Slow growth after a difficult winter

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– After a long period of stagnation, German GDP shrank noticeably in the final quarter of 2023. Important monthly indicators such as production remained weak in December and sentiment clouded over yet again in January. We expect stagnation in the first quarter of 2024.

– The falling inflation rate and rising nominal wages, however, mean that conditions for a consumption-driven recovery remain intact. In addition, key interest rate reductions are to be expected in the further course of the year, which will encourage investment and exports, giving manufacturers new impetus.

– All in all, despite the difficult winter KfW Research maintains its expectation that the German economy will grow again in 2024 (+0.3%; previous forecast +0.6%). GDP growth is likely to accelerate to 1.2% in 2025 (initial forecast).

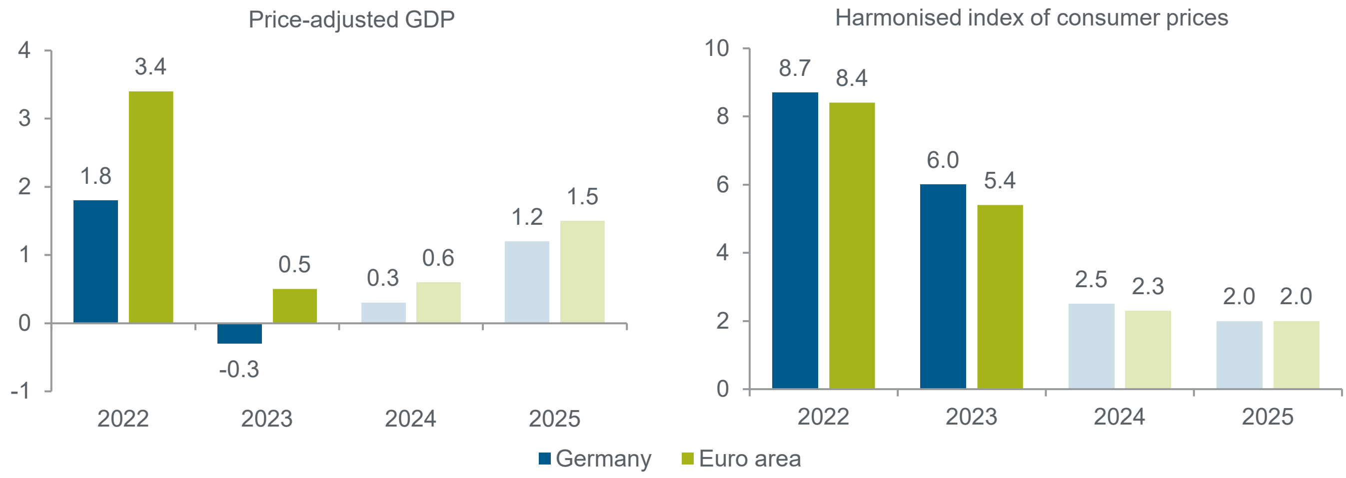
– Ecological price tag for GDP: Greenhouse gas emissions are expected to drop further with the predicted cyclical development. Germany will presumably remain below the caps established in the planned amendment to the Federal Climate Change Act for the period from 2023 to 2025.

– Since the weak economic environment gives businesses limited scope for enforcing price increases, the rise in consumer prices is likely to slow down further. KfW Research continues to forecast an inflation rate of 2.5% for Germany in 2024 (HICP) and 2.0% next year (initial forecast).

– The euro area showed a mixed development. While Spain and Italy grew, France only stagnated. Overall, euro area GDP should grow by 0.6% this year and 1.5% next year. Inflation will drop from 2.3% in 2024 to 2.0% in 2025.

Figure 1: Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

German economy contracted at the end of 2023

Gross domestic product (GDP) adjusted for price, seasonal and calendar effects shrank by 0.3% in the final quarter of 2023 after more or less stagnating since the spring of 2022. The falling economic output at the end of last year was due in part to the noticeable drop in investment in machinery and equipment (-3.5%), which had still grown significantly in the first three quarters of the year. This is probably a reflection of the end of the environmental bonus for the purchase of commercially used electric vehicles at the end of August, which is likely to have prompted many businesses to pull forward vehicle fleet investments. Thus, 2023 also saw a GDP contraction rate of 0.3% for the year as a whole, with consumption and residential construction in particular putting the brakes on annual real growth.

Stagnation in the first quarter of 2024

Important monthly indicators such as output in the producing sector (-1.6% on the previous month)[1] and retail turnovers (-1.6% on the previous month)[2] remained weak in December and the mood among businesses clouded over again in January, as shown by the KfW-ifo SME Barometer.[3] High illness rates as well as strikes in the railway and aviation sector were also a burden. At the same time, the truck-toll mileage index rose again in January after the overdrawn weather-related December slump, sending a rare positive signal (+2.4% on the previous month).[4] Given this data situation, growth in the first quarter of 2024 can be expected to stagnate at best, bringing the risk of a second consecutive minor GDP contraction and, hence, a technical recession in the winter half-year within the realm of possibility.

German GDP set to grow by 0.3% in 2024

However, given the falling rate of inflation, increasing nominal wages, almost steady employment as a result of growing skilled labour shortages and a rebound in global trade, the conditions for a household consumption- and export-driven recovery remain intact. These are the silver lining on the horizon and they are likely to kickstart the economy little by little from the spring. Public sector consumption expenditure is also likely to pick up again in 2024, after falling in 2023 for the first time since 2004 as a result of the end of state-funded pandemic measures. Furthermore, the European Central Bank and other globally important central banks can be expected to lower key interest rates in the later part of the year. The tightening of interest rates of the past years is likely to lead to another drop in highly interest rate-sensitive residential construction investment in 2024 due to the delayed effects of monetary policy. The high need for energy transition projects, however, is likely to stabilise business investment, while higher defence spending will drive public sector investment. Even if, unlike in the previous year, exports will likely pick up again, foreign trade will likely reduce growth slightly in arithmetic terms in 2024. After all, with the expected consumption-driven rebound in domestic demand, the growth of imports will likely exceed that of exports. Despite the difficult winter, we maintain our expectation that the German economy will at least grow moderately again in all of 2024. Nevertheless, we must revise our forecast downward to 0.3% because of the unfavourable start to the year (previous forecast +0.6%).

Growth will accelerate to 1.2% in 2025

The momentum that built up in the course of 2024 is set to intensify in 2025 and further stimulate economic growth as consumption continues to increase. The impetus of the monetary policy relaxation that is expected to begin already in 2024 is then likely to become visible in the form of growing investment, including in dwellings, which could pick up again for the first time in five years. Exports are also likely to grow significantly so that manufacturing will benefit most strongly alongside construction next year. As price pressure eases around the world, purchasing power will increasingly return among Germany’s trading partners as well, while global consumption increasingly shifts to goods after the end of the post-pandemic services boom. With its large export industry, which specialises in high-quality capital goods and consumer goods, Germany is particularly predestined to meet this rebound in global demand for goods. External trade will therefore likely support growth again next year, even if the persistent expansion of domestic demand will also push imports up further. On balance, we expect real GDP growth to accelerate to 1.2% in our initial forecast for 2025.[5]

New annual GHG caps will be met

Given the numerous crises and great challenges, the return to growth this year and next is grounds for hope. In the medium to long term, transitioning the economy and society to carbon neutrality will likely be the greatest of these challenges. According to the Ecological Price Tag for GDP, the new indicator which we introduced in the autumn of 2022, our current economic forecast implies that greenhouse gas (GHG) emissions will continue to decline. The annual caps on GHG emissions that are to be newly introduced for the current decade under the planned amendment to the Federal Climate Change Act will presumably be met in the forecast period of 2023 to 2025 (see annex). Nonetheless, the urgency to act on climate change remains high in order to also meet the GHG reduction target of 65% by 2030 and the long-term goal of climate neutrality by 2045, particularly in buildings and transport.

Downward inflation trend remains intact

Inflation decreased significantly in Germany and the euro area over the past year. In recent months, however, base effects produced ups and downs in the rise of consumer prices. This was particularly due to the one-off suspension of payments on account for natural gas and heating in December 2022 in Germany, which resulted in significant variations in the basis for comparison. Irrespective of this, price pressure across the economy is easing further in line with expectations. Thus, the German inflation rate, measured by the year-on-year variation of the Harmonised Index of Consumer Prices (HICP), dropped again by a significant 0.7 percentage points to 3.1% in January – despite the lifting of the carbon price and the end of the discounted value added tax rate on hospitality and energy price caps. This illustrates that weak economic performance currently limits businesses’ scope for price increases. We therefore anticipate that rising wage costs, too, can be only partly passed on to consumers. The gas and electricity markets are also providing additional tailwind. Wholesale energy prices are falling continuously. One-year electricity contracts are currently on levels last seen in the summer of 2021. We therefore maintain our prediction of 2.5% inflation on average for Germany in 2024. Annual inflation next year will likely converge with the monetary policy target again (+2.0%). The main risks that the inflation rate may be higher than our forecast may originate from possible new disruptions to supply chains in a fragile geopolitical environment and a stronger than expected persistence of services inflation. In this important economic sector, companies' sales price expectations recently increased again.

Euro area will grow by 0.6% in 2024, a similar rate as in the previous year

In the fourth quarter, the southern European countries overtook France and Germany with positive growth rates. Spain boasted an above-average growth rate, as it did for the year as a whole. The key to this improvement was household consumption, which was driven by a rapidly decreased and relatively low inflation rate and offset the weak investment activity. The increase in the Purchase Manager's Index points to a further improvement in Spain, as well as in Italy, where the producing sector was still weak in the summer but provided a positive surprise at the end of the year. In France, on the other hand, gross fixed capital formation decreased and the rebound in consumer spending has yet to arrive, putting the brakes on economic output, while the Purchase Manager's Index points to a modest outlook for now. Combined with the contraction in Germany, the euro economy stagnated in the final quarter after shrinking by 0.1% in the third quarter. We predict slow growth in the first quarter of 2024 which is then likely to pick up in the course of the year. For all of 2024, we expect real growth of 0.6% in the euro area (previous forecast: +0.8%) and an inflation rate of 2.3% (unchanged from the November forecast).

Euro area will pick up steam with 1.5% growth in 2025

Decreasing investment activity in some euro area countries shows the impact of restrictive monetary policy on the real economy. Despite initial signs that interest rates have plateaued, high financing costs will continue to weigh on growth in the euro area for the time being, as will the fiscal policy tightening after the crisis years. As inflation falls, household consumption will increase in both Germany and France after already expanding in Spain and Italy, acting as a tailwind for moderate growth in the euro area economy. A change in the European Central Bank's monetary policy trajectory this year is likely to additionally bolster euro area growth. We expect higher GDP growth of 1.5% and an inflation rate of 2.0% for 2025. Of the four large euro area countries, we see the strongest growth in Spain, as its economy is well positioned with continuing high employment potential and, like Italy, continues to benefit from the NextGenerationEU recovery package. We expect growth in France to remain weak this year, as we do for Germany, but pick up noticeably next year (see Table 2).

Table 2: Price-adjusted GDP growth in the euro area

Per cent year-over-year change

	DE	FR	IT	ES	EA
2022	1.8	2.5	3.7	5.8	3.4
2023	-0.3	0.9	0.7	2.5	0.5
2024	0.3	0.5	0.5	1.7	0.6
2025	1.2	1.4	1.0	2.0	1.5

Source: Destatis, Eurostat, KfW Research

Economic risks are concentrated on the downside

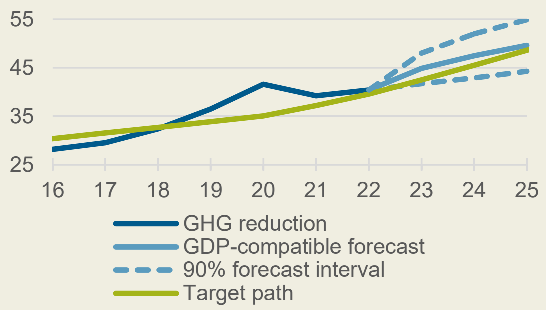
The geopolitical and geoeconomic risks in connection with Russia's invasion of Ukraine and the Middle East conflict are currently among the greatest imponderables of the economic forecast. For example, disruptions or blockades of major shipping routes such as the Red Sea or the Strait of Hormus could lead to disruptions in global supply chains, but also to shortages and abrupt price increases in energy markets or for important intermediate goods. Furthermore, inflation could prove to be more persistent than expected, for example because the high wage growth could have a stronger impact on demand and, hence, prices than we assume or, unlike before, households could resort to spending the significant excess savings they accumulated during the pandemic. This would lead to higher economic growth but likely also to delays in key interest rate reductions, which for its part could result in corrections to the values of assets. However, irrespective of interest rate movements, tangible downward corrections are also possible, particularly for commercial real estate prices, for example because demand for office space increasingly falls behind supply as working from home becomes more and more prevalent. According to the ECB's Financial Stability Report, European banks at least would be capitalised well enough to absorb rising loan defaults. In addition, growing tensions between the US and China could lead to a more abrupt fragmentation of the global economy, which would likely intensify in the event of a re-election of Trump to the US presidency. Germany's close integration into complex international value chains and high openness to international trade make the country particularly vulnerable as soon as these risks materialise. Should Trump be re-elected as US president in autumn, the issue of military security in Germany and Europe would also have to be reassessed, with possible significant consequences for public spending given the already limited fiscal scope due to Germany's debt brake. With the tight constitutional limits on debt financing, this would force the German Federal Government to make difficult prioritisation decisions, with the financing of growth-enhancing transformation projects potentially losing importance in favour of new defence requirements. Finally, environmental and natural disasters including extreme weather events such as floods and droughts, which are becoming increasingly more likely as a consequence of climate change, can have an unforeseen impact on the predicted economic development.

Annex: Ecological price tag for GDP

Economic growth has a wide range of social and ecological consequences that are typically disregarded in the usual economic forecasts. It is a necessary but not sufficient condition for sustained prosperity, as the growing risks from climate change demonstrate in dramatic fashion. Global heating poses a threat to the natural bases of human life and, thus, to economic activity. It is therefore high time to focus more comprehensively and rigorously than before on the impact of economic activity on the environment and climate in particular.

Figure A1: GHG emissions in Germany

Reduction against 1990 baseline in per cent



Source: Destatis, Eurostat, KfW Research

To this end we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany. The starting point is an identity equation according to which total GHG emissions are the product of GDP and the emission of GHG per unit of GDP, in other words, GHG intensity. We take the GDP from our economic forecast and estimate the expected development of GHG intensity using a linear trend extrapolation. Our approach is explained in detail here. It enables the greenhouse gas emissions being expected under current conditions to be compared with the reduction targets set by policymakers, which require Germany to reduce its emissions by 65% against the 1990 baseline by 2030 (see Figure A1). In the planned amendment to the Federal Climate Change Act, which was published by the German Federal Government in draft form on 11 September 2023,[6] the reduction target for 2030 remains unchanged but will now be supplemented by concrete GHG emission caps for each year from 2020 to 2030. We have incorporated these new annual targets into our approach beginning with this edition of the KfW Business Cycle Compass and adjusted the reduction trajectory accordingly in Figure A1. The systematic comparison of expected economic growth and GHG emissions will sharpen our awareness of the trade-off that exists between more goods and income on the one hand and the consumption of key natural resources on the other hand. It means we attach an ecological price tag to GDP, as it were, that will tell us how much the expected growth will presumably cost us as a society in the form of GHG emissions that harm the climate. On the basis of our new economic forecast, the ecological price tag predicts that emissions will drop in the forecast period and in all years will remain slightly below the annual ceilings prescribed by the amended Federal Climate Change Act. Under our approach, GHG emissions in Germany thus likely amounted to 690 million t CO_2 equivalents in 2023.[7] That would be 30 million t CO_2 equivalents or a good 4% less than the 720 million t CO_2 equivalents set by the amendment as upper limit for 2023 (see Table A1). GHG emissions should then be 24 million t CO_2 equivalents or just under 4% lower in the current year 2024, and still 12 million t CO_2 equivalents or just under 2% lower in 2025 than prescribed by the new reduction trajectory.

Table A1: GHG emissions and policy trajectory

Million tonnes of CO_2 equivalents

	2022	2023	2024	2025
Actual/forecast	746	690	658	631
Target path	756	720	682	643
Actual/forecast deviation from target path				
Absolute	-10	-30	-24	-12
Percent	-1.4	-4.2	-3.6	-1.9

Source: Destatis, Eurostat, KfW Research

Like all forecasts, the ecological price tag for GDP also involves forecast risks. With reference to the 90% forecast interval presented in Figure A1, which is derived from the historic forecast errors of our approach, the statement that the annual minimum GHG reduction targets will be reached in the forecast period appears to be validated.

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[1] Production in December 2023: -1.6% on the previous month - Federal Statistical Office (destatis.de).

[2] Einzelhandelsumsatz im Jahr 2023 real um 3,3 % niedriger als 2022 (*Retail turnover in 2023 3.3% lower than in 2022 in real terms* – our title translation, in German) (Federal Statistical Office).

[3] Borger, K. (2024), KfW-ifo SME Barometer January 2024, KfW Research.

[4] Truck toll mileage index in January 2024: +2.4% on the previous month – Federal Statistical Office (destatis.de).

[5] As 2025 has approximately one less working day than 2024, this amounts to a GDP growth rate of 1.3% when adjusted for price and calendar effects. In the current year 2024, however, the calendar effect is negligible so that the original and calendar-adjusted rate of GDP growth for the current year are identical.

[6] Drucksache 20/8290 Gesetzentwurf der Bundesregierung Entwurf eines Zweiten Gesetzes zur Änderung des Bundes-Klimaschutzgesetzes (bundestag.de).

[7] The actual amount of GHG emissions for the previous year ended is statistically reported by the German Federal Environment Agency only at a later date; in 2023 this occurred in mid-March for the 2022 reporting year. The first estimate for 2023, however, was already provided by Agora Energiewende, which estimated GHG emissions last year to be 673 million t CO_2 equivalents and, thus, slightly lower than our model approach, with an explicit reference to the sharp drop in production in energy-intensive manufacturing and its influence on energy consumption as the cause.