Is the German economy on the mend?

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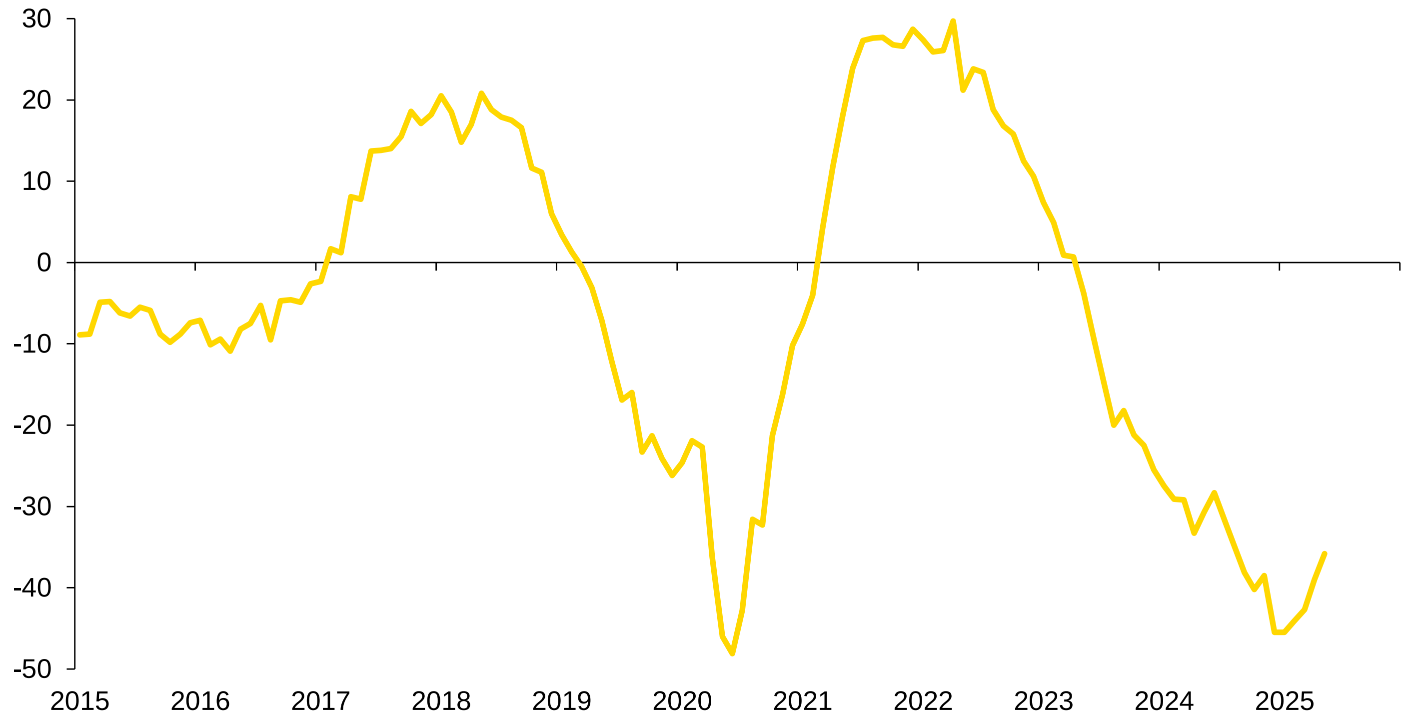
Key German economic indicators appear to have bottomed out. This is mainly due to the ECB's recent rate cuts. The German government's huge fiscal package is also likely to boost the economy soon. The period of negative growth surprises is probably over for now. However, we do not expect a strong, sustained upturn because the US is raising its tariffs and the necessary economic policy reboot in Germany is unlikely to materialize.

Economic indicators have bottomed out

The German economy has been stagnating for more than five years. But the manufacturing sector, which sets the tone for the economy, appears to have bottomed out:

- In the first quarter, order intake (adjusted for volatile large orders) and production were above the level of the fourth quarter of last year. This is a positive sign, even if the March data benefited somewhat from companies bringing forward exports in anticipation of higher US tariffs.
- The Ifo business climate has risen significantly since January despite Trump's tariff announcements.
- Since January, companies have been assessing their order books somewhat more positively again in the Ifo Institute's survey **(Chart 1).** As this indicator has developed fairly steadily in the past, this is unlikely to be due to random fluctuations and is therefore meaningful.

Chart 1 - Manufacturing companies have started to judge their order backlog less negative
Manufacturing companies' assessment of their order backlogs in the Ifo survey, seasonally adjusted monthly figures

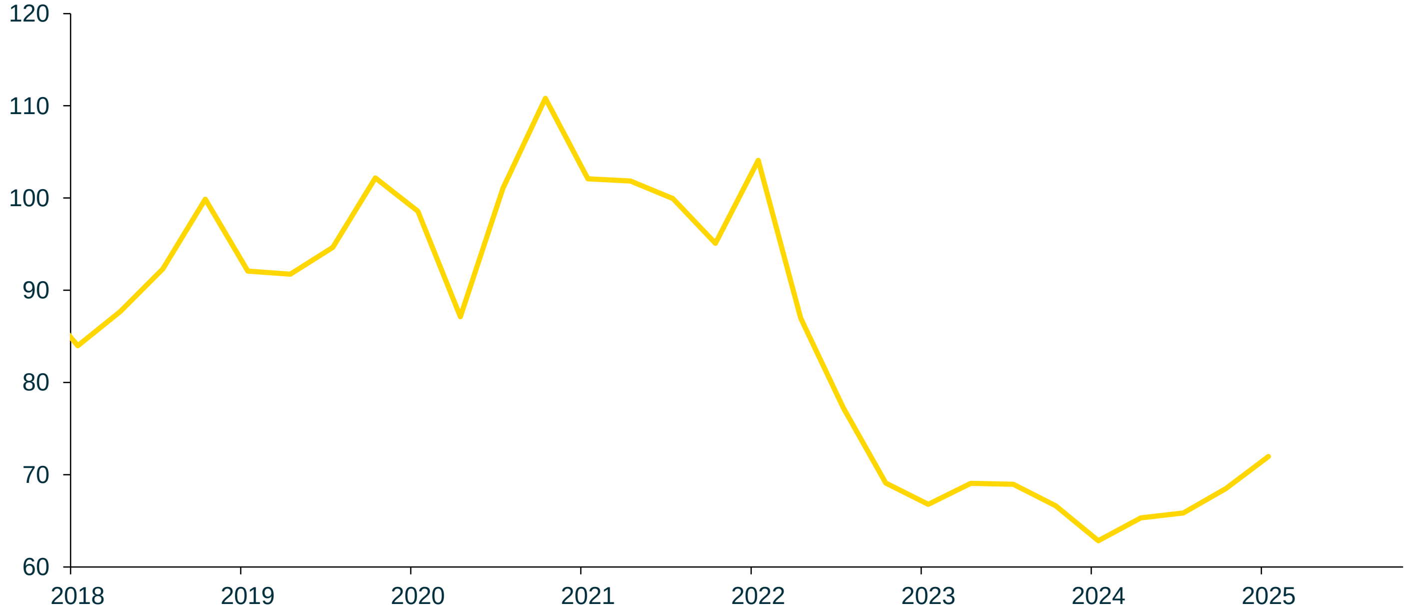


Source: S&P Global, Commerzbank Research

Signs of recovery are also visible outside the manufacturing sector. Retail sales (adjusted for inflation) have been rising since the middle of last year. The construction sector also appears to be turning the corner. New orders have been picking up again for about a year now. This also applies to residential construction, which seems to be gradually overcoming the crisis it has experienced in recent years (Chart 2).

Chart 2 - Signs of life from the residential construction sector

Order intake for residential construction, volumes, seasonally adjusted monthly figures



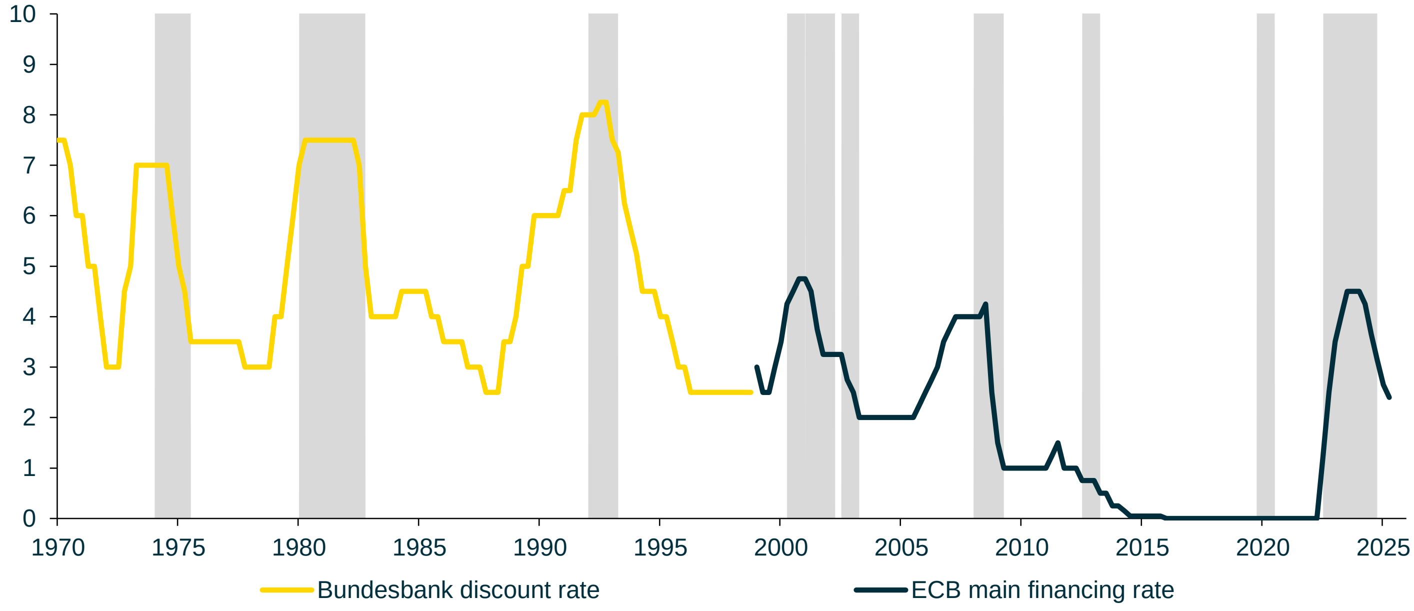
Source: Destatis, S&P Global, Commerzbank Research

First driver: Interest rate shock digested, ...

All in all, there are increasing signs that the German economy is slowly emerging from stagnation. It is no coincidence that the latest good news has come from the manufacturing and housing sectors. These two sectors are capital-intensive and were particularly hard hit by the ECB's massive rate hikes of 450 basis points in total between the summer of 2022 and the fall of 2023. This interest rate shock led to a noticeable deterioration in financing conditions, rendering many investment projects unprofitable. It is no coincidence that almost every recession in the last 50 years has been preceded by a noticeable tightening of monetary policy (Chart 3). [1]

Chart 3 - Significant rise in key interest rates regularly causing recessions

Key interest rates of the Bundesbank (discount rate, until 1998) and of the ECB (main financing rate, starting 1999), in percent; grey areas mark recessions in Germany



Source: Bundesbank, Destatis, S&P Global, Commerzbank Research

... interest rate cuts are gradually taking effect

By now, companies should have adjusted to the higher interest rates and discontinued all projects that were no longer profitable after the ECB raised rates. The effects of these high interest rates are therefore unlikely to slow down the economy any further. Instead, the central bank's interest rate cuts since last summer, totaling almost 200 basis points, are likely to gradually take effect and boost demand, particularly in manufacturing and the construction sector.

Second driver: increasingly loose fiscal policy

Next year, a significantly more expansionary fiscal policy will add another driver to the economy. While fiscal policy is slowing the economy this year due to the expiry of some relief measures adopted during the coronavirus pandemic and provisional budget management, it is likely to have an expansionary effect in 2026. In their semi-annual study on the state of the German economy, the German economic research institutes conclude that the measures planned for the coming year will, on their own, increase the government deficit ratio – i.e., the budget deficit of the entire government as a percentage of GDP – by about half a percentage point. This year, however, fiscal policy measures are likely to reduce the deficit ratio by about the same amount. The resulting swing of the fiscal stimulus of around one percentage point is considerable. Economic growth is therefore likely to be correspondingly higher in 2026 than in 2025.

The institutes assume that defense spending and infrastructure investment will be ramped up relatively slowly, even though extensive funds are available following the amendment to the German constitution. The increase in defense spending will be slowed by the limited capacity of defense industry, and additional infrastructure investment must first be planned and then approved, which will take some time despite the legislative changes planned by the new government.

In the end, the fiscal stimulus could still be somewhat larger. This is because the institutes have not yet included some of the measures laid down in the coalition agreement, as they had not yet been agreed in detail when the study was prepared. These include the extension of maternity benefits, a reduction in VAT in the hospitality sector, better depreciation conditions for companies, a subsidy for electricity prices for companies and private households, and a bonus for the purchase of electric cars. Since less defense spending will be counted toward the debt brake in the regular budget in the future and some investments are likely to be financed through the new special fund, some leeway will become available in the regular budget. As a result, the projects mentioned are likely to be implemented at least in part at the beginning of next year, so that the fiscal stimulus will probably strengthen by more than 1 percent of GDP.

But Trump's tariffs are slowing things down, ...

Lower key interest rates and looser fiscal policy will give the economy a significant boost on their own. But the German economy is facing strong headwinds from Trump's tariffs.

Ultimately, the US is likely to impose an average tariff of around 15% on goods from the EU. That would be less than the 25% we expect for China, the US's biggest political and military adversary. But a 15% tariff would cause German companies to lose an estimated one-third of their US export business. Even if they sell some of the goods in other countries, this would reduce German GDP by around 0.5% within two years. Added to this is the uncertainty surrounding the outcome of the tariff dispute, which could prompt some German companies to cancel planned investments for the time being in order to gain time.

... as is the lack of a fresh start for German economic policy

Loose monetary and fiscal policy would fall on fertile ground if, after many years of eroding business conditions, the federal government were to succeed in relaunching its economic policy. The coalition agreement does contain a few points that will help businesses somewhat, such as the abolition of the German supply chain law and relief on electricity costs. But all in all, this is not really a fresh start. Corporate taxes are not set to fall until 2028. When it comes to reducing bureaucracy, declarations of intent dominate, without all coalition parties fundamentally trusting businesses and markets, which is a prerequisite for less bureaucracy. Despite the large amount of money available, the renewal of the transport infrastructure will not progress quickly because the excessive participation and litigation rights of environmental organizations are unlikely to be significantly curtailed. In addition, non-wage labor costs are likely to continue to rise rapidly because the coalition wants to maintain the pension level of 48% and subsidies for early retirement.

Conclusion: Cyclical recovery, but poor growth prospects in the long term

Economic indicators have begun to respond positively to the ECB's monetary policy easing, with the usual time lag. From now on, the German economy should recover slowly, although Trump's tariffs will dampen the upward trend and could cause real GDP to stagnate again in the second quarter after a surprisingly strong first quarter (0.4% vs. Q4). We raised our growth forecast for 2025 as a whole from 0.0% to 0.2% a week ago. The period of negative growth surprises should be over for now; for 2026, we even expect temporary high growth of 1.4% due to the massive fiscal stimulus. Despite the improving outlook, however, we should remain realistic. On average over the next ten years, growth of just under 1/2% per annum is likely due to the lack of a new start in economic policy.

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[1] Exceptions are the declines in real GDP in the wake of the sovereign debt crisis and the coronavirus pandemic. In both cases, the reasons were clearly not to be found in tighter monetary policy. (back to text)

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