GERMANY

REFORMS OR DECLINE

After outperforming between 2005 and 2018, German growth has since underperformed. Germany is the only major European economy to have seen its GDP stagnate for the third year in a row, due to the weakness of its industry (reflected this year in site closures and a moderate upturn in unemployment). The relative persistence of inflation and a fiscal policy limited by the debt brake rule are also weighing on the recovery potential. Finally, at a time when Germany is already being penalised by a lack of investment and high energy costs, it is vulnerable to a possible increase in US tariffs.

NO RETURN TO GROWTH IN THE SHORT TERM

According to our estimates, German GDP growth should be slightly negative in 2024 (-0.1% on annual average), as was the case in 2023, a pattern that the country already experienced in 2002 and 2003 (-0.2% and -0.5%), before a very moderate upturn in 2004-05. In our view, this is again what we can expect for 2025-26. Business surveys do not indicate any significant rebound in the short term. In November, the IFO business climate index fell back close to the level seen in September, which was already at its lowest since May 2020. Industry is the weak link. Indeed, the business climate in this sector (-21.9 in November) has only been getting worse during the recessions of 1993, 2008 and the COVID-19 crisis. Capacity utilisation even fell by almost 6 points in one year, to 76.3%, in Q4 2024, to such an extent that capacity destruction is expected in the automotive, chemicals and metalssectors, which is likely to have a negative impact on growth.

FAREWELL TO FULL EMPLOYMENT?

Germany is likely to see a return of unemployment in the coming months, after reaching a low of 2.9% in May 2019 and again in 2022. In industry, a third of companies saw their production limited by labour shortages at the end of 2022; they are three times less at the end of 2024. Fears of unemployment are at the heart of the sharp drop in household confidence in November 2024 (-5 points to -23.3), even as announcements of redundancy plans have multiplied. This dynamic should justify maintaining a high savings rate in 2025, and therefore moderate growth in household consumption.

However, the return of unemployment does not mean mass unemployment, and while industry plays an important role in Germany, the dynamics of the other sectors differ: in services, the proportion of companies where production is limited by labour shortages (27% in Q4) is not so different from two years ago (29%). Moreover, population trends suggest that major labour shortages will persist over the long term.

INFLATION: A GERMAN PECULIARITY

While household confidence has deteriorated, it is also due to the higher inflation the country is experiencing compared with its eurozone partners. Using our forecasts and comparing the general price level in 2025 with its pre-COVID level, the increase is almost 22% in Germany, compared with almost 4 to 5 points less in Spain, Italy and France. This difference can be explained, in particular, by a more marked rise in energy prices in Germany.

The sluggishness with which past inflation is passed on to negotiated wages (biennial bargaining), which rose by 8.8% y/y in Q3 2024, also explains the greater persistence of inflation. Even today, core inflation remains high (3.4% y/y in October) and is likely to remain above 2% throughout 2025.

GROWTH AND INFLATION

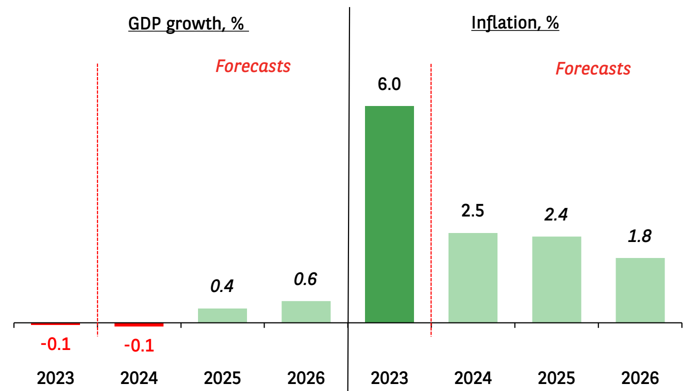

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PUBLIC FINANCES: RELEASING THE BRAKE PEDAL

Apart from exceptional periods (COVID crisis), when the room for manoeuvre was used, the debt brake rule limits the structural deficit to 0.35% of GDP. This rule has stabilised public debt at a level close to 60% of GDP (63% in 2024). It should be noted that a public investment effort, budgetary support for the green transition or an increase in the defence budget are not among the exceptions justifying an additional deficit.

The application of this principle prompted the withdrawal of subsidies for the purchase of electric vehicles in December 2023 (which resulted in a sharp fall in car sales and production). Moreover, it was a disagreement on this principle within the government that precipitated the break-up of the governing coalition in November. Reforming the debt brake will be one of the issues at stake in the early election on 23 February 2025. However, the time needed to build a new coalition means that a little patience is required to see German fiscal policy evolve.

FOREIGN TRADE: BROKEN-DOWN

In a country where exports account for almost 42% of GDP, their sluggishness is affecting GDP growth. In Q3 2024, exports of goods and services were 2.2% below their Q1 2023 peak. The damage is profound, since exports to the eurozone and China have stagnated compared with the pre-COVID period. This sluggishness is set to continue, in the absence of a sharp upturn in demand from these two regions, but also because of growing competition from China. Only exports to the United States have recently continued to grow, but the outlook is now uncertain (*see box*).

STRUCTURAL CHALLENGES: TWO AREAS OF TRANSFORMATION

The period of low growth mentioned above (negative in 2002-03 and weak in 2004-05) ended with fundamental reforms, including the Hartz Act, which made the labour market more flexible. However, Germany has reached the end of the model based on increasing the employment rate by achieving full employment at the end of 2018. This only makes accumulated delays more visible. Let's hope, however, that Germany will ultimately be able to make the necessary decisions, as it did in the early 2000s.

The first delay concerns investment, particularly public investment. In this area, no decision can be made until the political situation is clearer, and not before the second half of 2025. The second delay concerns the transition of the economy towards services. The reason why German growth is so low, apart from the fall in industrial production, is also because GDP from services is not taking over. Once again, this is a sign that investment is falling short of what it could be. On average, Germany has spent only 3.8% of its GDP on investments in intellectual property products over the past five years (compared with 5.1% in France). If more budgetary incentives are needed to get the ball rolling, there is room for manoeuvre in the budget, but their implementation depends on a relaxation of the debt brake rule.

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GERMANY'S (DE) CONTRIBUTION TO EUROPEAN UNION (EU) TRADE SURPLUS WITH THE US (EUR BN)

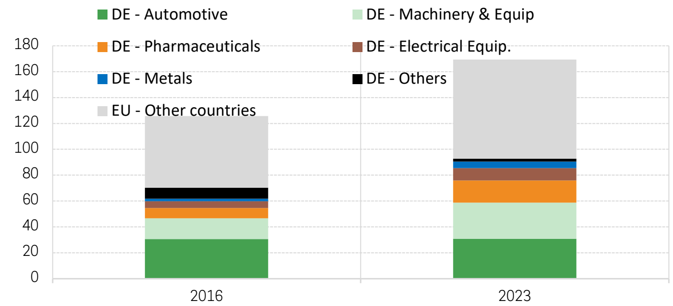

CHART 2 SOURCE: IMF, DESTATIS, BNP PARIBAS

GERMANY: CAPACITY UTILIZATION RATES (%)

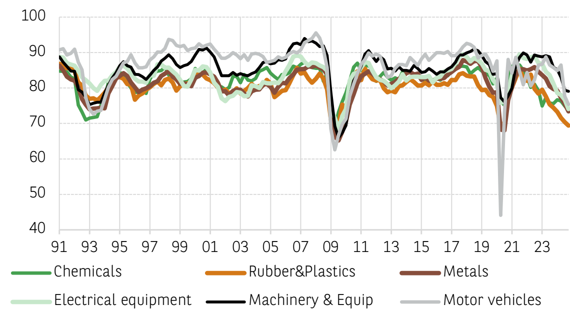

CHART 3 SOURCE: DG ECFIN, BNP PARIBAS

GERMANY VULNERABLE TO TRUMP 2.0

While energy production prices in Germany were 52% higher in September 2024 than in the summer of 2021, they were only 7% higher in the United States. For a country specialising in energy-intensive sectors, this is a more than significant problem of competitiveness, compounded by the lag in investments, including in the manufacturing sector. For example, while the market shares of the United States and Germany in world exports were comparable before the energy crisis, the United States' market share has not been challenged since, while Germany lost 1 percentage point of market share to 7.1% in 2023.

The paradox lies in the fact that the United States has been the only major growth market in recent years for German exporters, who have benefited from the resilience of US growth. However, German bilateral surpluses by product have only increased, leaving the country particularly exposed to an increase in US tariffs. Moreover, this exposure also extends to third markets from which German companies have been increasingly exporting to the United States, including Mexico. German exports to Mexico increased by 33% between 2019 and 2023 (thus contributing, along with other countries including China, to Mexico's surplus with the United States, which doubled between 2016 and 2023, reaching almost USD 220 bn).

The anticipated effects of a future increase in tariffs (which we are taking into account in our forecasts) are likely to have an immediate negative impact on German growth, which would then be affected by its implementation (with a particularly pronounced impact on growth in 2026).

The main sectors of German industry are in the front line, either because they could be directly targeted (the automotive industry), or because they are inputs into these sectors (metals, chemicals, plastics and rubber). These are sectors that would have little capacity to absorb such a shock, as they are already affected by a significant under-utilisation of production capacity.