The economy is growing again

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Authors: Dr Klaus Borger, +49 (0)69 7431-2455, klaus.borger@kfw.de
Dr Jenny Körner, +49 (0)69 7431-57189, jenny.koerner@kfw.de
Dr Philipp Scheuermeyer, +49 (0)69 7431-4017, philipp.scheuermeyer@kfw.de
Stephanie Schoenwald, +49 (0)69 7431-6446, stephanie.schoenwald@kfw.de
Press contact: Christine Volk, +49 (0)69 7431-3867, christine.volk@kfw.de

– Germany's GDP returned to moderate growth in the first quarter of 2024, after shrinking at the end of 2023 and virtually stagnating across the whole year. The leading indicators thus far available point to moderate growth for the second quarter of 2024 as well.

– The sharp drop in the inflation rate and strong increases in nominal wages mean that the conditions for a consumption-driven rebound are given. In addition, rate cuts by the ECB can be expected from the summer, providing a moderate boost to investment particularly in the coming year.

– Developments up to spring of 2024 have mostly reaffirmed the assumptions from the winter forecast. KfW Research therefore continues to expect growth to clock in at 0.3% in Germany in 2024, followed by 1.2% in 2025.

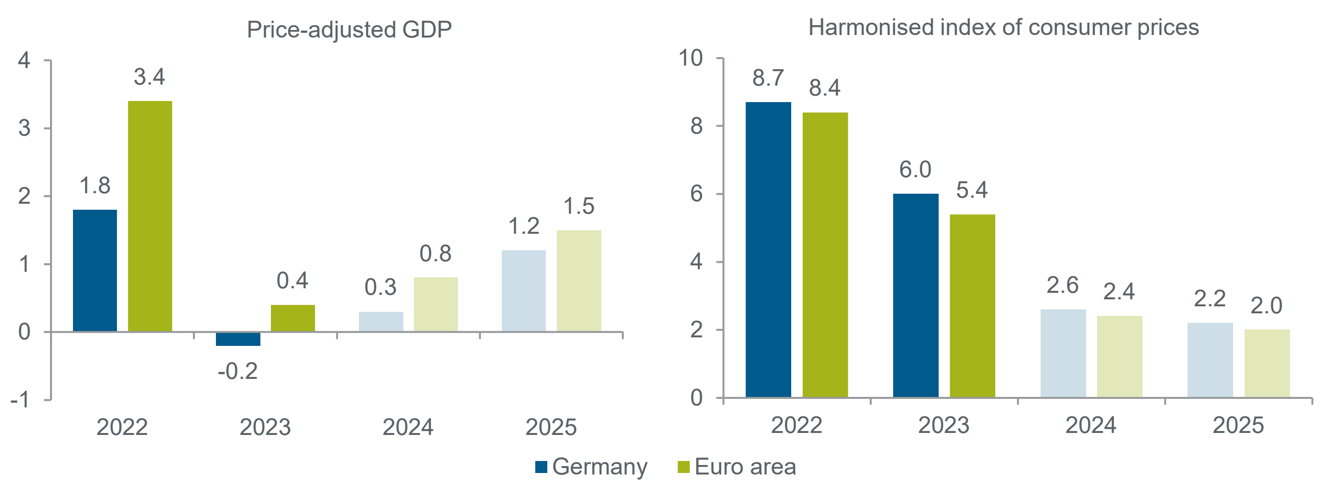
– Ecological price tag for GDP: Assuming the economy will perform as predicted, Germany's greenhouse gas emissions are set to decrease further. They will presumably remain below the caps established in the amended Federal Climate Change Act for the years 2024 and 2025.

– The above-average level of services inflation is proving to be persistent. KfW Research has slightly raised its forecast for German inflation (HICP). Consumer prices are likely to rise by 2.6% this year (+0.1 PP) and 2.2% next year (+0.2 PP).

– The euro area reported surprisingly solid growth at the start of the year. The economy expanded in all four major eurozone countries. KfW Research has therefore raised its forecast for euro area GDP growth to 0.8% for this year (+0.2 PP). The forecast for 2025 remains unchanged at 1.5%. Inflation will drop to 2.0% in 2025 (+0.1 PP) after reaching 2.4% this year (+0.1 PP).

Figure 1: Economic growth and inflation

Per cent year-over-year change



Source: KfW Research, Destatis, Eurostat

German GDP grew again at the start of 2024

Gross domestic product (GDP) adjusted for price, seasonal and calendar variations grew by 0.2% in the first quarter of 2024 after shrinking by a significant 0.5% in the final quarter of 2023. Growth was mainly driven by an increase in construction investment and exports. As both expenditure components showed a pronounced weakness in the preceding quarter, a positive rebound effect probably played a role here. Besides, the unusually mild weather in late winter benefited construction activity. Private spending, on the other hand, fell in the first quarter, which was mainly reflected in sharp declines in retail turnover. Furthermore, after incorporating new data material the Federal Statistical Office reported only a price-adjusted contraction of 0.2% for all of 2023 instead of 0.3%, which adjusted for price and calendar variations amounts to stagnation.

Economic indicators in Q2 point to continued growth

The ‘soft’ economic indicators based on business and consumer surveys have clearly brightened in recent months. The Ifo Business Climate Index, in particular, has risen over three consecutive months since February, and the Composite Output PMI exceeded the growth threshold of 50 balance points in April and May for the first time since June 2023. Even if these indicators in recent times were loosely related to GDP growth at best, they nonetheless suggest a certain economic upswing. The truck toll index, which closely correlates with output in the producing sector, also rose by a seasonally adjusted 0.9% in April. Household consumer confidence finally improved significantly after a temporary low in January, giving hope that the drop in consumer spending last quarter was an outlier. The leading indicators for manufacturing, on the other hand, remain mixed in the spring of 2024. Business and production expectations have improved clearly from a low level in recent months, to be sure, but there is still no turnaround in the volume of orders received. Domestic demand, in particular, has so far been on a steep downward trajectory, while international demand has stabilised since mid-2023.

Upswing is set to broaden

With inflation now on a moderate level amid significantly higher nominal wage increases and employment likely to remain steady in light of the skilled labour shortage, the conditions for a recovery driven by household consumption remain fulfilled. Public sector consumption expenditure is also likely to pick up again this year and next, after falling in 2023 for the first time since 2004 with the end of state-funded pandemic measures, slowing down growth considerably. Furthermore, German exports can benefit from the rebound in global trade, since the stockpiles of intermediate goods have now been largely cleared and, after a post-pandemic catch-up movement in the services sector, global consumption will likely shift more to goods again, all of which will probably have a positive effect on trade. However, since the recovery of consumption in Germany is likely to lead to sharp growth in imports as well, external trade will probably provide only a minor boost to GDP growth up until the end of the forecast horizon.

Gross fixed capital formation, on the other hand, is expected to see a sluggish recovery. To be sure, the ECB is now almost certain to begin lowering interest rates this summer, but the further loosening of monetary policy is likely to proceed only at a slow pace and the monetary tightening from previous years will have a lingering effect. Despite the positive development at the start of the year, a renewed sharp drop can be expected to occur this year particularly in private residential construction investment, which is particularly sensitive to the high level of interest rates. By contrast, corporate investment is likely to remain roughly steady, in part because of the high investment needs of the energy transition, and public investment expenditure will likely increase especially thanks to increased defence spending under the Special Fund for the Bundeswehr (Germany’s Armed Forces). The dampening effect of global monetary policy will then ease noticeably in 2025, however, benefiting the construction and manufacturing sectors in particular. Private residential construction investment will then also expand significantly again, bolstered by continuing high demand for housing.

Growth forecasts reaffirmed: +0.3% followed by +1.2%

We expect the German economy to grow at a similar rate in the current quarter as in the previous one, and to gain further momentum in the second half of the current year due to the increasing breadth of the economic upturn. As growth began from a low starting level due to the contraction at the end of the previous year (= negative statistical carryover), growth in 2024 as a whole is expected to be only 0.3%. We then expect a growth rate of 1.2% in the next year, with similar economic momentum during the year. We maintain our previous forecast from February since developments have thus far mostly reaffirmed our assumptions. [i] According to our forecasts, the annual rates – growth from Q4 to Q4 – will be +1.2% in both 2024 and 2025.

Annual GHG caps are being met

Even if the German economy is likely to return to growth this year, structural challenges remain. 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 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 were newly introduced for the current decade under the amendment to the Federal Climate Change Act will presumably be met in 2024 and 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.

Inflation: for now, sideways movement with fluctuations

The progress already made in the fight against inflation is considerable. The inflation rate in Germany is now well below the peak rates of autumn 2022. Inflation fell from then 11.6% to 2.4% in April, as measured by the annual variation of the Harmonised Index of Consumer Prices (HICP). The gap to the ECB’s 2% target now appears moderate. For now, however, a choppy sideways movement is to be expected for the coming months. The main reason for this is the stubborn persistence of

[i] The slightly better-than-expected first quarter of 2024 offset a final quarter of 2023 that was downgraded from -0.3% to -0.5%.

services inflation, which recently stood at an uncomfortably high 3.6%. Services are particularly relevant for the overall price trend because they make up around 45% of the basket of goods. The higher proportion of labour costs[1] in this group of goods makes strong wage increases more noticeable here. Besides, the inflation-reducing effect of the 49 Euro Ticket that was introduced a year ago will end in May. Viewed in isolation, this is likely to result in an increase in services inflation by 0.8 PP. The persistently high price increases in the services sector have so far been offset by falling levels of food and industrial goods inflation. But this is unlikely to continue at the same rate since the disinflation process is already well advanced. Furthermore, the tailwind from falling energy prices is easing. In the coming months, the annual energy inflation rate is likely to turn slightly positive again. This illustrates that further reductions in inflation crucially depend on easing price increases for services. Even if it might take slightly longer than we anticipated at the start of the year, the prospects for this generally look good. To be sure, collectively agreed wages in Germany rose again by a strong 5.6%[2] in the first quarter, taking into account special payments, but the steadily falling increases in salaries offered in job advertisements suggest that wage pressure is easing. We therefore lift our inflation forecast for Germany just slightly to 2.6% for 2024 (+0.1 PP). Next year, the increase in consumer prices is likely to converge further on the target, at 2.2% (+0.2 PP). Owing to the geopolitical tensions, the development of energy prices and supply chains in particular remains a forecast risk. Inflation may also turn out higher if the recovery of household spending is concentrated primarily on services consumption. In that case, businesses could seize on this to expand their profit margins.

Eurozone has likely overcome economic weakness as well

After the euro area contracted by a scant 0.1% in the fourth quarter, (price and seasonally adjusted) growth of 0.3% on the previous quarter was a positive surprise in Q1 2024. All four large euro area economies posted positive growth at the start of the year, although the southern European countries expanded at a stronger rate than France and Germany yet again. Spain took the lead, boasting a stronger contribution of gross fixed capital formation to GDP. Italy, on the other hand, benefited from an increase in net exports, while domestic demand remained rather weak. In France, private and public consumption clearly rebounded, and gross fixed capital formation grew on the previous quarter as well. The economic weakness of the second half of 2023 thus appears to have been overcome. For all of 2024, we now expect real growth of 0.8% in the euro area (previous forecast: +0.6%) and an inflation rate of 2.4%. For 2025, we continue to expect GDP growth of 1.5% and an inflation rate of 2.0% in the euro area. Thanks to noticeable increases in real incomes and continued growth in employment, household spending is likely to become the main driver of growth in the euro area as well. Against the background of falling market interest rates, savings incentives are also falling for households, which could boost spending growth additionally. As is the case in Germany, investment is not likely to grow significantly until the year 2025 as a whole. Among the four large countries, we see the strongest growth in Spain, which is benefiting from substantial investment impetus from the NextGenerationEU (NGEU) recovery programme and also still has broader scope for increasing the employment rate. In Italy, a boost from NGEU funds is also still to be expected in the forecast period, while budget consolidation is likely to slow down growth only moderately. The ‘Superbonus’ support programme for energy and anti-seismic building renovations, however, which had led to an enormous construction boom in previous years, will be scaled back from this year. For France, we expect similar economic momentum in the next quarters as in Germany, although the positive statistical carryover from the previous year will lead to a substantially higher annual growth rate, and another slight acceleration in growth is likely to occur in the year ahead (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	4.0	5.8	3.4
2023	-0.2	0.7	0.9	2.5	0.4
2024	0.3	0.9	0.9	2.2	0.8
2025	1.2	1.4	1.0	2.0	1.5

Source: Destatis, Eurostat, KfW Research

Economic risks

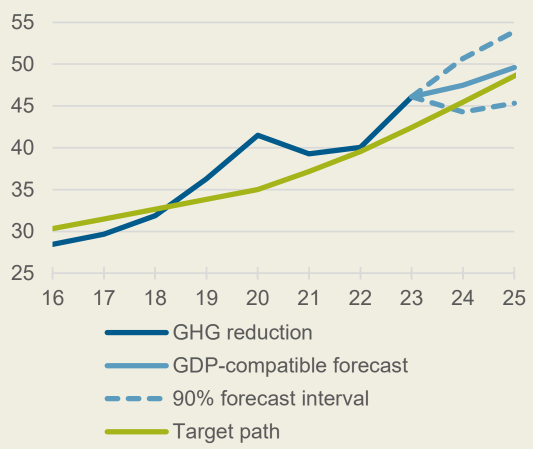
Among the forecast uncertainties are the continuing geopolitical and geoeconomic risks, particularly in connection with Russia’s invasion of Ukraine and the Middle East conflict. It is true that the attacks of the Huthi militia in the Red Sea so far have not left any obvious traces in European production data, and that both sides to the conflict between Israel and Iran appear to be refraining from further escalation. Should there be an escalation, however, a blockade of the Strait of Hormus could lead to a new oil price shock with considerable increases in inflation and growth losses. In addition, inflation would turn out more persistent if wage growth subsides more slowly or has a stronger impact on prices than expected when consumption picks up again. This would likely lead to rising interest rates which can then lead to weaker investment and sudden asset valuation corrections. The process of geoeconomic fragmentation poses a structural challenge for the economies of Germany and the euro area, but it could have an unexpectedly negative impact already during the forecast period, for example if the trade conflict between the US and China escalates further or the dispute over subsidies between the EU and China comes to a head. A re-election of Donald Trump as US president would present a direct risk to German industry through the trade channel. It could also cause the US economy to overheat, which in turn would probably worsen global financing conditions. Should Trump be re-elected, the issue of military security in Germany and Europe would also have to be reassessed, with potentially significant consequences for public spending. Finally, the scope and details of the consolidation requirements in the German national budget are another element of uncertainty, particularly for growth in 2025.

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 (see Figure A1). In the recent amendment to the Federal Climate Change Act[3] 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 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 are thus likely to amount to 657 million t CO_2 equivalents in the current year 2024. That would be 25 million t CO_2 equivalents or just under 4% less than the 682 million t CO_2 equivalents set by the act as upper limit for 2024 (see Table A1). In the year 2025, GHG emissions should then be 13 million t CO2 equivalents or just under 2% lower than prescribed by the reduction trajectory.

Table A1: GHG emissions and policy trajectory

Million tonnes of CO_2 equivalents

	2022	2023	2024	2025
Actual/forecast	750	674	657	630
Target path	756	720	682	643
Actual/forecast deviation from target path				
Absolute	-6	-46	-25	-13
Percent	-0.8	-6.4	-3.7	-2.0

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.

[1] Fagandini et al., Decomposing HICPX inflation into energy-sensitive and wage-sensitive items, ECB Economic Bulletin Issue 3, 2024.

[2] The rate of increase of 5.6% is the average value of annual rates of increase of monthly collectively agreed wages with special payments from January to March 2024.

[3] Federal Government adopts amended Climate Change Act | Federal Government.