15 May 2023

German Industry Outlook

The industrial recession has ended – what happens next?

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Economics - Germany

- In Q1, the three-quarters-long industrial recession that followed the start of the Russia-Ukraine war came to an end
- Easing supply shortages could help support output further…
- …but the elephant in the room is the continued erosion of domestic and external demand

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Easing supply disruptions should underpin German industry…

After heavily stuttering through much of 2022, the German economic engine finally found its next gear in Q1 2023, when industrial output rose 2.4% q-o-q, following three quarters of contraction. The main reason for the comeback of Europe's largest industrial sector was the easing of supply chain disruptions that had for over a year taken their toll on manufacturing and construction activity and caused a large gap between output and demand. With corporate surveys signalling a continued improvement in the availability of materials across all manufacturing sub-sectors and given orders books are still full, the stage seems to be set for further recovery over the course of the year.

…but the erosion of demand is a concerning sign

However, the March industrial output and, in particular, industrial orders data put a big question mark over that narrative. The 10.7% m-o-m drop in German new orders exemplified the vulnerability of the German manufacturing sector to a global demand downswing as a result of the energy crisis and a substantial tightening in financing conditions. In fact, both domestic and foreign orders have already trended down successively since mid-2021 and are now – with the exception of the COVID-19-related plunge in 2020 – lower than during most of the past decade.

Medium term, industrial output is expected to only grow slowly

As the effects of restrictive monetary tightening continue to filter through with the usual lags and act as a drag on activity, we think hopes for a substantial demand improvement for German industrial goods will likely be disappointed. Hence, even if the accumulated order backlog helps to keep output levels at current levels for a while, there is little sign of a sustained rise in output activity over the medium term. We thus expect only a modest 1.5% full-year rise in German industrial production in 2023 despite the extremely strong start to the year. With pent-up effects from supply chain disruptions expected to fade in the course of 2023, next year could end up bringing even lower average industrial production growth of 0.7%.

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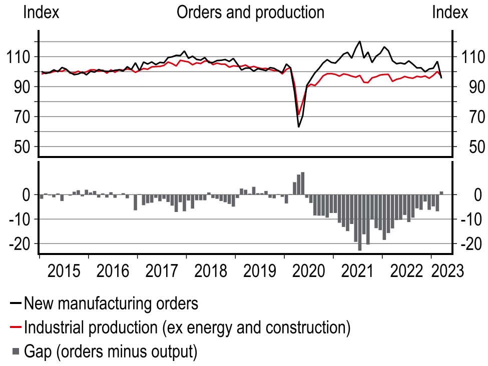
Supply chain disruptions acted as a major drag in 2022

German industrial orders and output decoupled in 2022…

Germany's industrial sector on the cusp of a recovery after two difficult years

The German industrial and manufacturing sector has seen something of a post-pandemic paradox: while demand for manufacturing goods soared to unprecedented heights in summer 2021 and remained at these levels for over a year, industrial output remained lacklustre as production declined in six out of eight quarters from Q1 2021 to Q4 2022 (charts 1 and 2).

1: Orders and production diverged during the pandemic



Source: Macrobond, HSBC

2: Industrial production increased strongly in Q1, officially ending the recession

Source: Macrobond, HSBC

…due to pandemic- and war-related supply chain disruptions

Initially, the main driver of this rather odd scenario was the global supply chain disruption originally caused by trade and production distortions in the aftermath of the COVID-19 lockdowns and further exacerbated by the Russia-Ukraine war. Given the strong dependence of the German manufacturing sector on intermediate goods (in particular microchips from Asia and other parts of the world), Europe's largest economy was hit particularly hard by this, reflected in business surveys such as the PMI and the ifo (charts 3 and 4).

3: The manufacturing PMI has been in contractionary territory since mid-2022

Source: S&P Global, Macrobond, HSBC

4: ifo manufacturing business expectations have recovered

Source: Macrobond, HSBC

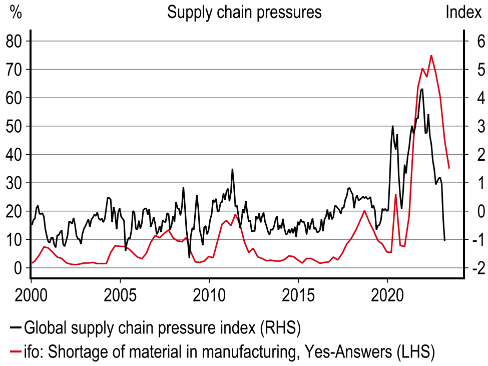
Moreover, additional pressure was put on the German industrial sector over the course of 2022 by the unprecedented rise in energy costs for gas, electricity and oil in light of the war in Ukraine, the resulting cost-of-living crisis, and the global rise in interest rates. As a consequence, German industrial orders have fallen sharply since Q2 2022 and even dropped temporarily below their historically low pre-pandemic levels. But surprisingly, German manufacturing as a whole started to recover in the second half of 2022, returning to positive quarterly growth rates by Q3 2022. It even posted a 1.8% q-o-q increase in Q1 2023, despite an unexpectedly large 3.2% monthly contraction in March.

The Global Supply Chain Pressure Index is now back to 2009 levels

Supply chain normalisation fostered a rebound in German manufacturing

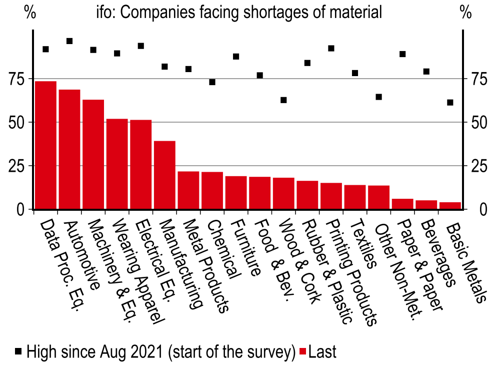
So what are the reasons for the German manufacturing comeback and how sustainable is it? Looking at the first question, the obvious answer is an easing of supply chain distortions. For instance, the Global Supply Chain Pressure Index, which measures supply-side distortions on a global scale, has recently fallen back to pre-pandemic levels and even recorded the lowest level since 2009.

5: Supply chain disruptions have eased, and so should material shortages



Source: Macrobond, HSBC

6: In many subsectors, lack of materials does not play a role anymore



Source: Macrobond, HSBC

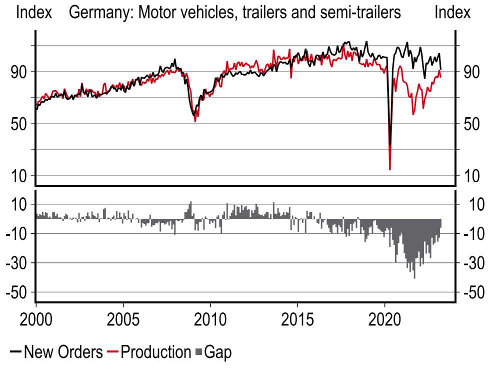
As a consequence, the share of companies complaining about a lack of materials hampering production more than halved from 75% in June 2022 to 35% in April, with historical correlations to the Global Supply Chain Pressure Index suggesting a further substantial fall over the coming month (chart 5). Importantly, the improvement has been broad-based with every manufacturing subsector mentioning an easing of shortages compared to the recorded peaks.

However, as chart 6 shows, not all is well yet. In particular, in three of the four largest German manufacturing sectors (autos, machinery and equipment and electronics), which account for more than 40% of Germany's total manufacturing output, more than half of the companies are still complaining about materials shortages. Even so, things are better than in August 2021, at the height of the supply chain crisis. Moreover, it underlines the potential for further improvement in production activity when shortages, such as for chips and semiconductors, are eventually overcome.

In this respect the automotive sector still has the greatest potential. According to the Association of German Car Manufacturers (VDA), the availability of materials has improved and car sales have risen strongly in Q1 2023. Although real production in Germany's largest manufacturing sector has already seen a sizeable rebound over the past few months, this came to an abrupt halt in March and is still a long way below the pre-pandemic output levels, let alone the peaks in 2018 (chart 7). But unfortunately, orders in this sector took a strong blow at the end of Q1, so that the sustained gap between orders and production which was pointing towards more output gains in the future narrowed considerably.

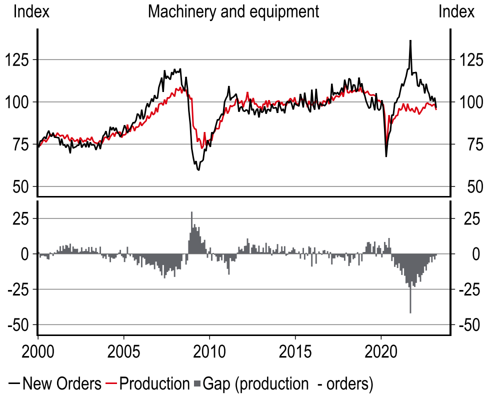
Although the other heavyweight sector in the German manufacturing business, mechanical engineering, had held up better during the supply chain crisis, it also lags behind its pre-pandemic output levels and, more importantly, in contrast to the automotive sector, has yet to show signs of a sustained rebound from easing supply chain issues. Actually, the gap between orders and production closed from the wrong side, with orders coming back down after a strong rise in 2021. Since hitting a peak in 2021, new orders for those goods have decelerated consistently and further weakened in March (chart 8), likely reflecting subdued global economic momentum in manufacturing as a result of the energy crisis and a substantial tightening in financing conditions.

7: The gap between car orders and production had been pretty sustained…



Source: Macrobond, HSBC

8: …but has been closed by weaker orders in machinery and equipment

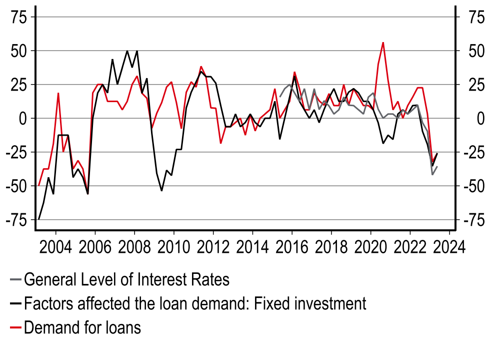


Source: Macrobond, HSBC

Stringent monetary tightening threatens to weigh on investment goods demand

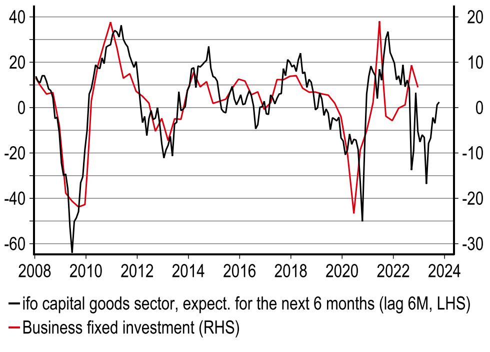
Although energy prices have fallen back to pre-Russia-Ukraine war levels, the stringent tightening of financing conditions as a consequence of quick and large ECB rate hikes is likely to continue to put a lid on demand for investment goods. The recent Bundesbank lending survey signalled weaker demand for corporate lending for investment financing purposes due to a rise in interest rates (chart 9). This chimes well with still muted ifo business expectations in the German capital goods sector (chart 10). Overall, this raises questions about the sustainability of the Q1 industrial rebound.

9: Surging interest rates have started to weigh on loan demand for investment



Source: Macrobond, HSBC

10: Sentiment in the capital goods sector has improved, but is far from strong



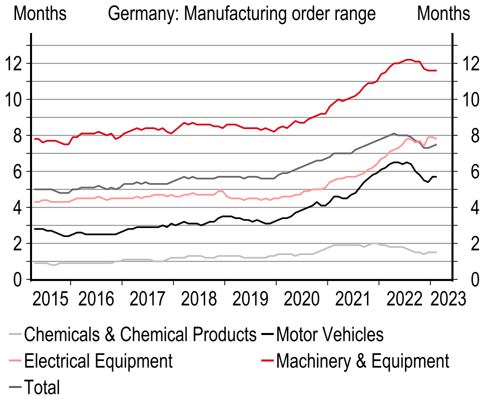
Source: Macrobond, HSBC

Full order books could provide support to production in the short term...

Full order books should support output in the short term…

That said, at least in the short run, German manufacturing can rely on exceptionally full order books, which across many subsectors have risen sharply since 2020, particularly in the machinery and equipment, electrical equipment and automotive sectors. This should underpin production for a while, as current total order books should last for about 7.5 months, close to the all-time high of just over eight months recorded in April 2022. It tells us how long firms can continue to produce at the current pace without receiving any new orders, provided there are no cancelations. However, industrial confidence data show that firms have become less optimistic on balance, probably reflecting the deterioration of both domestic and external demand over the past couple of months. Historical relationships suggest that the duration of production assured by order books should follow with a lag of roughly one quarter.

11: Hard data show that production is assured for several more months…



Source: Macrobond, HSBC

12: …but firms have become less positive on their order book assessment

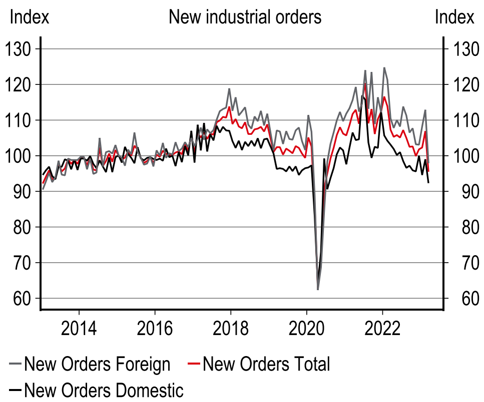
Source: Macrobond, HSBC

…but longer term a demand problem looms

…but the steady fall in new orders is a concerning sign

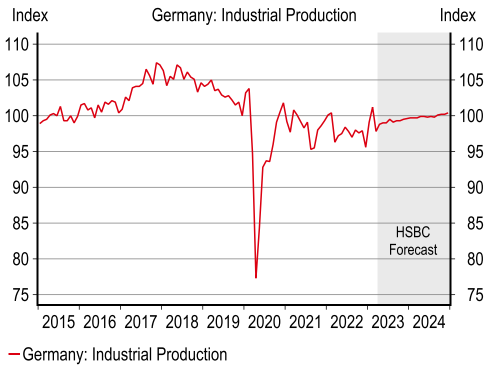
The elephant in the room, however, is the continued and steady erosion of demand. True, it is too early to say that the 10.7% m-o-m drop in March is the start of a trend as order numbers tend to be volatile and could be revised substantially, but both domestic and external order indices have already trended down successively after hitting peaks in mid-2021. The current levels are – with the exception of the COVID-19-related plunge in 2020 – lower than during most of the past decade (chart 13).

13: In- and external orders have fallen to the lowest level since mid-2020



Source: Macrobond, HSBC

14: Industrial output in Germany expected to remain stuck at 2015 levels



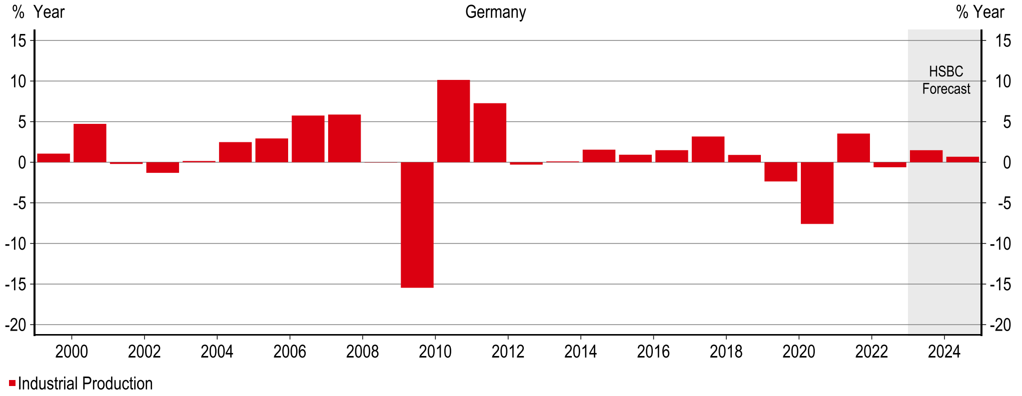
Source: Macrobond, HSBC

German industrial production set to stagnate until year-end '24

With monetary headwinds persisting, we see little improvement in demand

On balance, the considerable drop in manufacturing output in March might be only a one-time blip, and output should recover at least some of the decline in Q2, supported by the still comparably high order backlog. However, the drop in new orders limits the scope of any longer-term recovery over our forecast horizon until the end of 2024. Even if – in the context of slowing global economic cycle and a historically very high interest rate environment – demand for German manufacturing goods stabilises around current levels, this would chime at best with industrial output close to the pre-pandemic index levels of around 100pts (chart 14). This is equivalent to the base-year output level of 2015 (and considerably below the record highs recorded in 2017). Since year-end 2019, this threshold was overcome only during a few positive outlier months.

15: Growth rates expected to remain comparably low in 2023 and 2024



Source: Macrobond, HSBC

Industrial output forecast for 2023 lifted, but lowered for 2024

With little indication of an improvement in domestic and external demand in sight, German industrial output will probably remain close to these levels, at least until the end of 2024. Overall, we therefore expect only a modest 1.5% full-year rise in German industrial production in 2023, despite the extremely strong start to the year, followed up by an even lower 0.7% in 2024, which is, on balance, close to our previous 2024 year-end level for German IP, provided that no further negative output shocks occur (table 1).

Table 1: German industrial production forecasts

Industrial production (% change)	2022	2023f	2024f	Q1 2023	Q2 2023f	Q3 2023f	Q4 2023f	Q1 2024f	Q2 2024f
q-o-q	**-**	**-**	**-**	**2.4**	**-0.5**	**0.4**	**0.2**	**0.3**	**0.2**
old	-	-	-	1.1	0.3	0.5	0.4	0.4	0.5
y-o-y	**-0.6**	**1.5**	**0.7**	**0.5**	**1.2**	**1.7**	**2.5**	**0.4**	**1.0**
old	-0.6	0.8	1.5	-0.9	0.6	1.3	2.3	1.5	1.7

Source: HSBC forecasts

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