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Recession for Everyone, Germany Included

The current consensus will eventually collapse in the face of statistics released in the last twenty-four hours. The IFO's July Business Climate Survey abundantly confirms a scenario that has looked inevitable since early spring—Europe has unquestionably entered a recession and no country will escape it. This should be a sobering warning to consensus economists, who were still predicting an improved outlook for 2013 in July, with 0.5 percent growth in the Eurozone as a whole, 0.7 percent in France, and 1.3 percent in Germany! But while this grim news ought to prompt a wrenching re-evaluation, the forecasting community shows such inertia that we are unlikely to see any real change in the consensus until November or December. By then, it will be impossible to deny the undeniable: in 2013, the recession will spread from Southern Europe to the entire rest of the region, and the sovereign debt crisis will become increasingly hard to untangle.

The German Locomotive Is Running on Empty

This, by the way, could hardly be otherwise. After all, in volume terms, Germany ships almost half of its exports to its Eurozone partners, the vast majority of which are in recession, or on the verge of it.

Those economies in Southern Europe that had managed, after a fashion, to weather the serial crises of the past two years went into a tailspin as soon as their exports could no longer offset the domestic downturn. Even before the Rajoy administration announced a new austerity plan in mid-July, virtually all the indicators in Spain pointed to an economy on the brink of depression. An additional surge in unemployment left over half the country's young people jobless. In the first quarter, purchasing power fell at an annual rate of 4 percent. The real estate crisis deepened, credit became increasingly scarce, business and consumer confidence hit an all-time low. And to top it all off, the summer began with a banking crisis and the announcement of an austerity plan that will require households to cut their spending by 10 percent between now and the end of 2014. Italy is not faring much better, either. After three quarters in recession, GDP was already contracting at a 1.5 percent annual rate in the first quarter, while domestic demand slid by more than 6 percent year-on-year. Nor has there been any improvement in the interim. The mild upturn in exports posted in early spring is unlikely to last, and on the domestic front, things are getting increasingly critical now that upward pressure on sovereign yields is once again on the increase.

Spain and Italy, which together account for close to 30 percent of Eurozone GDP, have entered a Greek-style downward spiral that seems unstoppable in the short run and that will have a growing impact on the rest of the region. This raises the question of what other options are open to German exporters. French consumers are spending less and less, and French industry is likewise facing recession conditions. Although still Germany's biggest trading partner, France offers fewer and fewer outlets for German exports, and in turn finds fewer and fewer for French goods and services in Germany. **We have clearly come full circle. The ripple effect of the crisis is working its way across the entire region, and as invariably happens during major shifts in the business cycle, we can expect any number of surprises.** In these circumstances, how can the export-driven German economy fail to be affected by a shock of this magnitude? Because its investment and employment cycles are dependent on the country's foreign trade figures, they should reverse particularly fast now that German exports to the rest of the world are also winding down. It would be nice to think that Germany's consumers could take advantage of the considerable gains they've made over the past few quarters to pick up the slack. Unfortunately, they have hardly been what you would call big spenders. After a decade of stagnation, consumer spending has risen by an annual average of just 0.7 percent in the last three years, and the current environment is not in the least conducive to a change of behavior.

What Next?

The German locomotive is grinding to a halt, as the upcoming data will soon confirm. The country's gross domestic product could well recede by more than 0.5 percent in the third and fourth quarters, driving the average for the year down from 0.9 percent—the consensus forecast—to 0.5 percent. **With such an economic profile, however, the outlook will become even more disturbing in 2013, when the export shock will have its most serious impact on investment and employment.** Suppose that the European leaders take unprecedented steps to rescue Spain and Italy from the vortex currently pulling them down. Suppose as well that the recession reaches its trough in the fourth quarter. Even then, Germany's GDP will shrink by an average of at least 0.5 percent next year—a hypothesis that no consensus economist entertains at this point.

Does anyone have the ability to predict the cascading effects such a scenario will produce in the midst of a steadily worsening sovereign debt crisis?

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