Global Macro Research - Insight

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Is Germany the 'New Sick Man of Europe'?

Having been outpaced by most developed countries in recent years, the German economy has earned a reputation as a laggard. If it is to shake this off, it must tackle structural challenges via industrial transformation and climate policy.

Key Takeaways

- Following a contraction in Q3, the German economy is just 0.3% larger than it was pre-pandemic. Most forward-looking indicators remain depressed, meaning the recession is likely to continue over the winter.
- But headwinds are as much structural as they are cyclical. Industrial weakness is likely to continue over the medium term as the effects of tougher industrial policy in key export markets weigh on demand.
- The global transition towards electric vehicles (EVs) has two important negative implications for the country's industry. First, Germany produces a far smaller share of the world's EVs than it does internal combustion engine vehicles. Second, the imposition of protective industrial policy in several key export markets undermines German competitiveness.
- Tasked with tackling these adverse structural drivers is an unpopular and increasingly fractious coalition government. Indeed, the coalition has suffered a major setback after its plan to free up €60 billion of funds beyond the limit set by the 'debt brake' was declared unconstitutional.

Energy shock scarring

The impact of the 2022 energy price shock triggered by Russia's invasion of Ukraine had a significant adverse impact on economies across Europe.

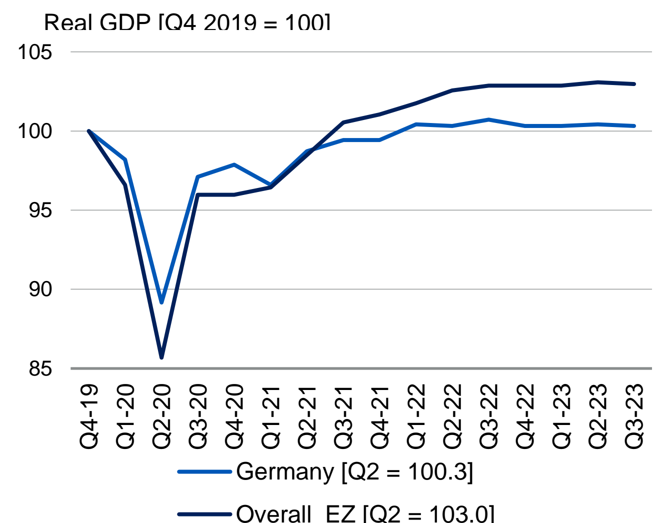
Already-stretched supply chains came under further strain, and the post-pandemic rebound in inflation was exacerbated, triggering significant monetary tightening from the European Central Bank (ECB).

These headwinds proved particularly unfavourable in Germany, whose pandemic recovery was already failing to keep pace with peers.

Its large, energy-intensive industrial sector was especially vulnerable to a rise in energy prices. And the withdrawal of natural gas supply coming from Russia – which constitutes a significant proportion of Germany's energy supply – combined to the phasing out of German nuclear capacity, triggered an outsized adverse impact on production costs.

The result is that German GDP growth has lagged behind the rest of the Eurozone since 2019. A (very plausible) contraction of just 0.3% this winter would leave the Eurozone's largest economy smaller than it was pre-pandemic (see Figure 1).

Figure 1: German GDP is only just above its pre-pandemic level



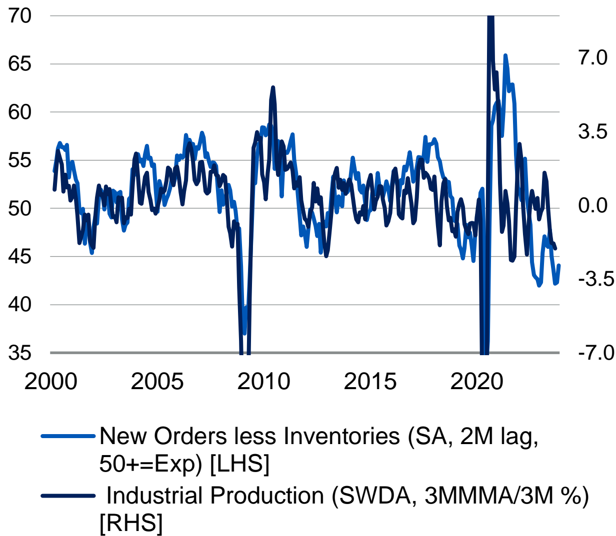
Source: Haver, abrdn, December 2023

Industry facing headwinds

Recent industrial data have been poor, as the effects of a historically sharp ECB hiking cycle take their toll on interest rate-sensitive sectors.

Admittedly, forward-looking indicators no longer suggest that the sequential contraction in production will deepen. But, even if the worst of the industrial contraction might be in the rear-view mirror, there is no indication of an imminent rebound (see Figure 2).

Figure 2: No sign of an industrial rebound in the data yet



Source: Haver, abrdn, December 2023

Risks to energy supply remain elevated, particularly in the context of conflict in the Middle East and its potential impact on commodity prices.

But with supply chain stresses continuing to ease for now, and the ECB no longer in hiking mode, cyclical drivers of industrial weakness should start to subside over coming months.

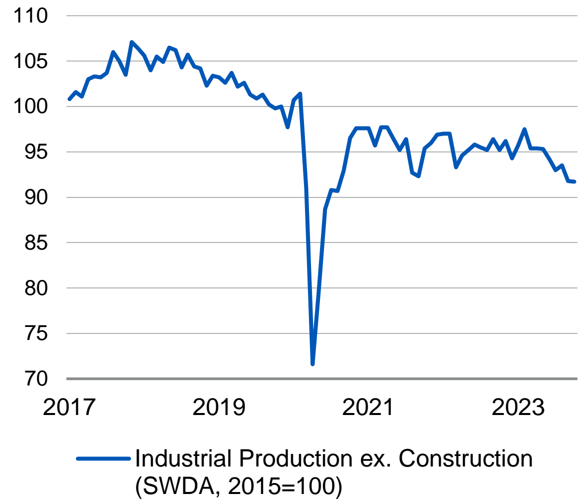
This isn't just cyclical

However, Germany's industrial woes go beyond the recent weak patch. While growth in the economy at large has been sluggish over the past five years, the industrial sector has been outright contractionary (see Figure 3).

Production volumes have been in decline since 2017, with the October reading 14.4% off its November 2017 peak. Cyclical drivers only cannot explain a contraction this deep and persistent.

The remarkable erosion of Germany's industrial power can be partially attributed to the loss of its leading position in key industries. A striking example is the car industry.

Figure 3: The medium-term trend in industrial production volumes is downward



Source: Haver, abrdn, December 2023

EV transition headwinds

Germany's long-standing position as a global leader in car manufacturing is threatened on two fronts: the global transition to electric vehicles (EVs), which has been so far led by the US and APAC, and less accessible export markets amid more protectionist industrial policy globally.

Both China and the US have introduced policies to not only re-orient car consumption towards EVs, but also to produce a larger proportion of these vehicles domestically. This has meant a concerted effort on the part of both countries to bring production of batteries and vehicles onshore.

For example, the $7,500 tax credit available to consumers purchasing electric vehicles under the US Inflation Reduction Act (IRA) applies only to vehicles assembled in North America. China has spent $29 billion on tax breaks and subsidies to producers in an effort to take a leading position in the industry.

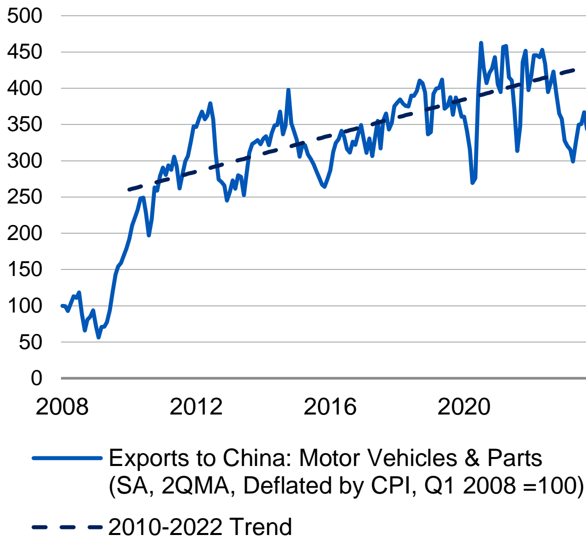
Meanwhile, the brand cache of German internal combustion engine vehicles has arguably failed to fully transfer across to EVs. US-produced cars in particular have captured much of this previously quintessentially German premium perception.

A more general deterioration in relations between Western countries and China does not bode well for Germany's access to China's domestic market either.

Since the financial crisis, China has become an increasingly important market for German produced vehicles – exports grew over a period when exports to the rest of the world have shrunk.

But a combination of cyclical and structural drivers, including China's own growth headwinds, have taken their toll over the last 12 months, and export volumes have fallen to around 2017 levels (see Figure 4).

Figure 4: After a strong period of export growth, Chinese demand for German cars is drying up



Source: Haver, abrdn, December 2023

More positively, the recent deal between the EU and the UK to delay the imposition of new tariff rules on EVs means the German auto industry has avoided an additional trade headwind for now.

The proposed changes would have introduced tariffs on EVs exported to the UK based on the country of origin of the vehicles' batteries. Estimates of the potential costs to EU manufacturers ranged as high as €1billion per annum, with German manufacturers taking an outsized hit.

Following an extended period of subsidy-induced growth in Chinese EV production, the risk of Chinese-subsidised EVs flooding the European market is now live. Against this backdrop, it is our assessment that the EU is becoming more likely to impose new tariffs against Chinese-produced EVs.

If imposed, the measures will be reinforced by the EU's efforts to ramp up domestic battery production.

The EU has of course responded to competitors' efforts with its own EV-related legislation. EU-led investment in battery production is well under way and accelerating. But while EU subsidies for green industries have doubled this year, they are still failing to keep up with the IRA. A key reason for this is the IRA's focus on subsidising operational expenditure. EU programmes mostly subsidise only capital expenditure, leaving EU producers at a comparative disadvantage.

Traffic light coalition at a crossroads

The German Constitutional Court has recently deemed the government's plan to circumvent the 'debt brake' – which limits budget spending deficits to 0.35% of GDP – by pooling debt authorisations related to pandemic support in with its Climate and Transition Fund, unconstitutional. This leaves Chancellor Olaf Scholz in a difficult position.

One consequence of the court's decision is that the €40 billion already spent in 2023 on energy price support can no longer be accounted for off budget. To avoid violating the debt brake, the government must pass legislation declaring an emergency retroactively, thereby securing a temporary exemption from debt-brake rules.

While this measure should clear legislative hurdles, further challenge in the courts is not impossible. Indeed, the German Federal Audit Court this week warned the bill was "problematic".

The ruling has exacerbated tensions between the parties of the governing 'traffic-light coalition' – Scholz's Social Democrats (SDP), the Greens, and the Free Democrats (FDP).

Climate spending is a key priority for the Greens and SDP, who are pushing for additional off-budget funding or a change to the debt-brake rules. FDP Finance Minister Chistian Lindner, meanwhile, has committed himself to upholding the debt brake where possible.

We expect compromises to be struck in a piecemeal manner that sees spending come through at a far slower pace than had been expected before the initial decision of the Constitutional Court.

More broadly, the decision comes after a difficult few months for the coalition, which have seen its constituent parties suffer in the polls.

Regional elections in Bavaria and Hessen saw the parties of government lose out to the centre-right Christian Democrat parties (CDU/CSU) and the right-wing Alternative for Germany (AfD).

Faced with growing unpopularity, the coalition parties are increasingly turning to their core principles in order to differentiate themselves from their partners and shore up their core vote. For the FDP this means re-asserting its fiscal conservatism. For the Greens and SDP funding for climate and welfare programmes have become red lines.

Should disfunction among Germany's coalition parties continue, the risk of a snap election will remain elevated. We will know more after next year's regional and European elections.

Significant fiscal drag compounding ongoing weakness

The government had expected to have €212 billion in off-budget climate funding available to it over 2024-27, but that figure now stands at €152 billion. Around €30-40 billion of this €60 billion discrepancy was scheduled to be spent in 2024, with the remainder being invested at a later stage.

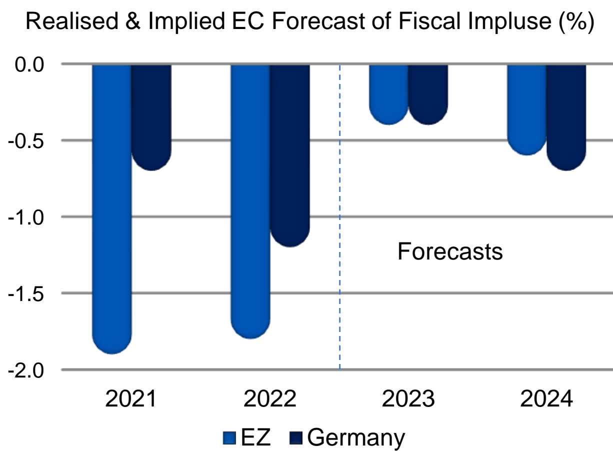
Lower fiscal spending will have both a cyclical and structural impact on Germany's growth prospects.

First, the removal of fiscal space afforded by the Climate and Transition Fund contributes to this, likely leading to less productivity-boosting investments designed to support Germany's industrial transition.

An important example is the industrial energy price support package agreed last month. The measure was able to win the support of the FDP through its focus on tax cuts. But, at a cost of €12 billion per year, the programme seems a likely candidate for cuts.

Second, the economy now faces a sizable negative fiscal impulse as pandemic- and energy price shock-related emergency spending unwinds (see Figure 5).

Figure 5: Fiscal policy is set to weigh on growth in 2024



Source Haver, European Commission, abrdn, December 2023

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Germany's temporary VAT exemption programme for energy bills will not be renewed when it expires at the beginning of next year.

In total, Germany is set to run its smallest deficit since 2019 in 2024, whether or not debt-brake rules are amended. Despite this, the country's current budget proposals are reportedly still €17 billion away from complying with debt-brake rules for 2024. This comes just at the moment it has fallen into recession.

With the ECB set to keep policy restrictive, structural headwinds persisting, fiscal policy unsupportive, and the global backdrop potentially challenging, 2024 looks set to be another year of tepid growth for the German economy. And, unless structural drivers of weakness are addressed, it could well continue over the medium term.

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