LETTER FROM

BERLIN

Dragging Down Europe

Germany in the hot seat.

BY KLAUS C. ENGELEN

The key message from the International Monetary Fund annual meeting in October 2022 was that Germany would fall into recession in 2023 with the worst economic growth among the major countries. This did not come as a surprise. It showed how difficult it would be for the world's leading export country to preserve its international competitiveness without access to cheap Russian gas and oil. The *Handelsblatt* headline of June 28, 2023, laid out the problem: "Investors on the Run: Germany falling internationally behind. Firms complain about high costs and prefer to invest abroad."

As the German traffic-light coalition of Social Democrats, Greens, and liberal Free Democrats were congratulating themselves for their crisis management after Russia invaded Ukraine, the $132 billion more in foreign direct investment outflows from Germany compared to inflows in 2022 was the highest outflow among forty-four countries. It showed how much international investors had lost confidence in the German economy.

On June 21, 2023, the Ifo Institute came out with its summer 2023 economic forecast. The German economy was predicted to shrink by 0.4 percent in 2023. In the spring, Ifo had expected a decline of only 0.1 percent. The researchers predict an increase of 1.5 percent for next year, adjusted downward from their previous estimate of 1.7 percent. Inflation is expected to slowly decline from 6.9 percent in 2022 to 5.8 percent this year, and then to 2.1 percent in 2024. "The German economy is only very slowly working its way out of the recession," said Timo Wollmershäuser, head of forecasts at Ifo, when presenting the projections.

IS GERMANY'S ECONOMIC MODEL TRULY KAPUTT?

In August 2023, *The Economist* cover story asked, "Is Germany Once Again the Sick Man of Europe?" Even before that, there was a torrent of worst-case predictions and warnings from the top echelons of German industry, the economics profession, and the major opposition parties. Other world-class economic papers and magazines also reported alarming news about the dismal state of the German economy.

"Germany Is Dragging Down Europe's Economy" reported the *Wall Street Journal* on June 23, 2023, arguing that the country's economy heavily depends on manufacturing, which has been hurt as foreign governments rush to protect domestic industries.

On August 11, 2023, the *Wall Street Journal*'s "Heard on the Street" column even asked, "Is Germany's Economic Model Truly Kaputt? An overreliance on foreign markets puts Germany in a difficult place, but its well-preserved industrial base is an advantage at a time of widespread reshoring." On August 29, 2023, the *Wall*

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Street Journal came to the conclusion, "Germany is losing its mojo. Finding it again won't be easy. Europe's biggest economy is sliding into stagnation, and a weakening political system is struggling to find an answer."

EUROPE'S SICK MAN ONCE MORE?

In asking "Is Germany once again the sick man of Europe?" *The Economist* in August tried to soften the blow. It recalled that nearly twenty-five years ago it had called Germany "the sick man of the euro" when the combination of reunification, a sclerotic job market, and slowing export demand all plagued Germany's economy, forcing unemployment into double digits.

In its lead, the magazine made an important point: "For Germany to thrive in a more fragmented, greener and ageing world, its economic model will need to adapt. Yet whereas high unemployment forced Gerhard Schröder's coalition into action in the 1990s, the alarm bells are easier to ignore this time. Few in today's government, made up of the Social Democrats, the liberal Free Democrats, and the Greens, admit to the scale of the task. Even if they did, the coalition is so fractious that the parties would struggle to agree on a remedy. Moreover, Alternative für Deutschland, a far-right populist party, is polling at 20 percent nationally and may win some state elections next year."

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For years, argues the magazine, "Germany's outperformance in old industries papered over its lack of investment in new ones. Complacency and an obsession with fiscal prudence led to too little public investment…. Bureaucratic conservatism also gets in the way. Obtaining a licence to operate a business takes 120 days—twice as long as the OECD average."

And not least, *The Economist* points out, "Of all large Western economies, Germany is the most exposed to China. Last year, trade between the two amounted to $314 billion." As more Western policies are reoriented to "de-risk," the more the dominant German economic stake in China is threatened, especially in chemical and automobile markets.

Another major challenge for German manufacturing industries comes from the energy transition. According to *The Economist,* "Germany's industrial sector uses nearly twice as much energy as the next-biggest in Europe, and its consumers have a much bigger carbon footprint than those in France or Italy. … A lack of investment in grids and a sluggardly permit system are hobbling the transition to cheap renewable energy."

SABOTAGED BY BUREAUCRATS

What makes *The Economist's* reporting on the German crisis this time so valuable is its accompanying analysis on Germany's bureaucracy with the heading "Scoring own goals." Linking to the article, *The Economist* tweeted, "Creaking bureaucracy is sabotaging German business and government. Politics makes it worse."

A glaring example for such "own goals": The government's decision, in the midst of the energy crisis, to retire its last three nuclear power plants. According to the magazine, "this has benefited neither the country's energy consumers nor its citizens' health, as dirty coal plants had to be fired up temporarily to meet demand." And the nuclear plant closures are also behind the 155 percent hike in industry electricity costs from 2020 to 2022.

The Economist also points out that local governments "have often held up permits for solar and wind installations, or the building of transmission lines to distribute power between the country's windier north and sunnier south."

DER SPIEGEL'S ASSESSMENT

After *The Economist* and other major international media came up with new shocking insights into the worsening crisis of Europe's largest economy, Germany's *Der Spiegel* magazine was challenged and in September offered a twelve-page assessment of Germany's economic and political malaise. The cover story in English: "Wirtschaftblunder: Why Germany's Economy Is Flailing—And What Could Help."

The heading adds, "It seems like only yesterday that Germany was the economic engine of Europe. Now, it's bringing up the rear among Western industrialized nations. The country's prosperity is threatened and the government seems to be at a loss."

"Of all large Western economies, Germany is the most exposed to China."

Going over the story, a few aspects and persons can be mentioned in this curtain-raiser effort.

There is Paul Niederstein of the company Coatinc in Siegen, an international surface finisher employing 1,500 workers, complaining: "[I]nstead of helping the companies … Germany's current coalition government is creating competitive disadvantages with its misguided energy policies."

Der Spiegel continues, "The economy is stagnating for the third quarter in a row, and more bad news seems to come in on an almost daily basis."

"Deindustrialization has started," was the key message from Matthias Zachert, head of the chemical giant Lanxess when interviewed by the magazine's reporters. Zachert is in the process of closing two plants in the city of Krefeld near Düsseldorf.

"The Germans are 'afraid of change,'" Moritz Schularick of the Kiel Institute for the World Economy tells *Der Spiegel.* "The economist expects that the pressure on policymakers will likely have to increase before any action is taken."

Schularick's predecessor Gabriel Felbermayr—now head of the Austrian Institute for Economic Research and a *TIE* contributor—"draws a painful comparison: 'The truth is that the situation in Germany now is similar to that in Italy, Spain, or Greece fifteen years ago, but no one wants to hear that.'"

NAGEL MORE OPTIMISTIC

When Frank Wiebe and Leonidas Exuzidis of *Handelsblatt* published their September interview with Bundesbank President Joachim Nagel, they started with the question: "In the words of the UK magazine *The Economist,* Germany is once again—as it was just over twenty years ago—the 'sick man of Europe'. Indeed, growth here has recently been below that of other major euro area countries. What do you think now needs to be done in order for us to catch up?"

Nagel replied, "The current situation cannot be compared with the situation back then. It is true that we slid into a technical recession in the winter half-year and that economic developments since then have not been satisfactory. The covid pandemic, high inflation, and then Russia's war of aggression against Ukraine have left their mark. But: we expect the picture to brighten up again next year. For instance, the labor market remains very robust and is in a much better place than at the end of the 1990s. Germany is not the sick man of Europe. I think this is a misdiagnosis, and one that can resonate all too easily with many."

Nagel continued with an answer rebutting Schularick's "afraid of change" diagnosis for Germany. "Compared with other countries, Germany is doing well on the whole, not only with regard to employment and debt sustainability. The country has demonstrated its ability to adapt time and again. Who would have thought one year ago that our gas supply would get us through the winter so well?" But Nagel added, "Our economic model undoubtedly faces great challenges. Just think of demographics, digitalization, decarbonization and the need to make international trade relations more resilient."

German authorities ought to consider modifying the debt brake.

MITTELSTAND TO THE RESCUE?

This is also the way that Tony Barber, the European comment editor of the *Financial Times,* a veteran foreign correspondent who had assignments in Austria, Belgium, Germany, Italy, and Poland, looks at the "sick man of Europe" label. As he put it in his "Reviving the German Economy" piece on September 2, 2023, the label "seems overdone to apply it today."

It is noteworthy that Stefan Schneider, Deutsche Bank's chief German economist, rejects the label vigorously in contrast to Joerg Kraemer, chief economist of Commerzbank, who still uses the "sick man Europe" label in his debates. According to Schneider, "Germany can count on its impressive *Mittelstand,* the midsized, often family-run companies that are famously known as the backbone of the economy. These are rarely household names, especially outside Germany, but they have an unmatched ability to win and keep large shares of world markets for the specialized products they make."

Barber's piece prominently featured Holger Schmieding, Berenberg Bank's veteran international economist and also a *TIE* contributor, who contends that "the doomsayers who say Germany is in deep trouble, because it relies too much on "old-fashioned" industries such as diesel cars and chemicals, are missing the point. … the real drivers are the large numbers of often owner-led small- and medium-sized companies. Taken together, they comprise one of the best search engines for innovation ever invented."

Barber points out, "Schmieding also makes a trenchant point about the aftermath of the 1998–2005 reform era. … [I]n terms of domestic economic policy, Merkel failed to build on the Schröder era reforms and let things drift. In some respects, she stored up problems for the future by insisting on rigid fiscal discipline—symbolized by the 'debt brake' inserted in 2009 into Germany's constitution. This had the effect of stifling much-needed public investment in infrastructure, digitalization, and other areas."

As the *Financial Times* notes, the IMF politely suggested that German authorities ought to consider modifying the debt brake. "The irony is that, as the IMF points out, Germany has in practice skirted round the debt brake by creating 'multiple extrabudgetary funds totalling about 9 percent of GDP' to pay for new climate action and defence initiatives.'"

If Germany had followed the IMF's advice, "everyone would have a clearer picture of what's going on in the public finances."

Barber concludes with an assuring, if not optimistic, note: "First, who would have predicted, eighteen months ago, that Germany would wrench itself off its heavy reliance on Russian gas so quickly and decisively? It has caused much disruption to industry, but it has happened. Second, the challenges of managing reunification and reforming the economy around the turn of the century were at least as formidable as anything Germany faces today. Germany dealt with those challenges. There's no reason, in principle, why it can't do the same again." ◆