

Germany's economy goes from bad to worse

It was with Teutonic understatement that [Robert Habeck](#) noted economic conditions were “not satisfactory”. Germany's economy minister was speaking on October 9th, just after official forecasts for the year had been revised from growth of 0.3% to a contraction of 0.2%. This would follow a 0.3% decline in output last year, meaning that [Germany](#) faces its first two-year recession in more than two decades.



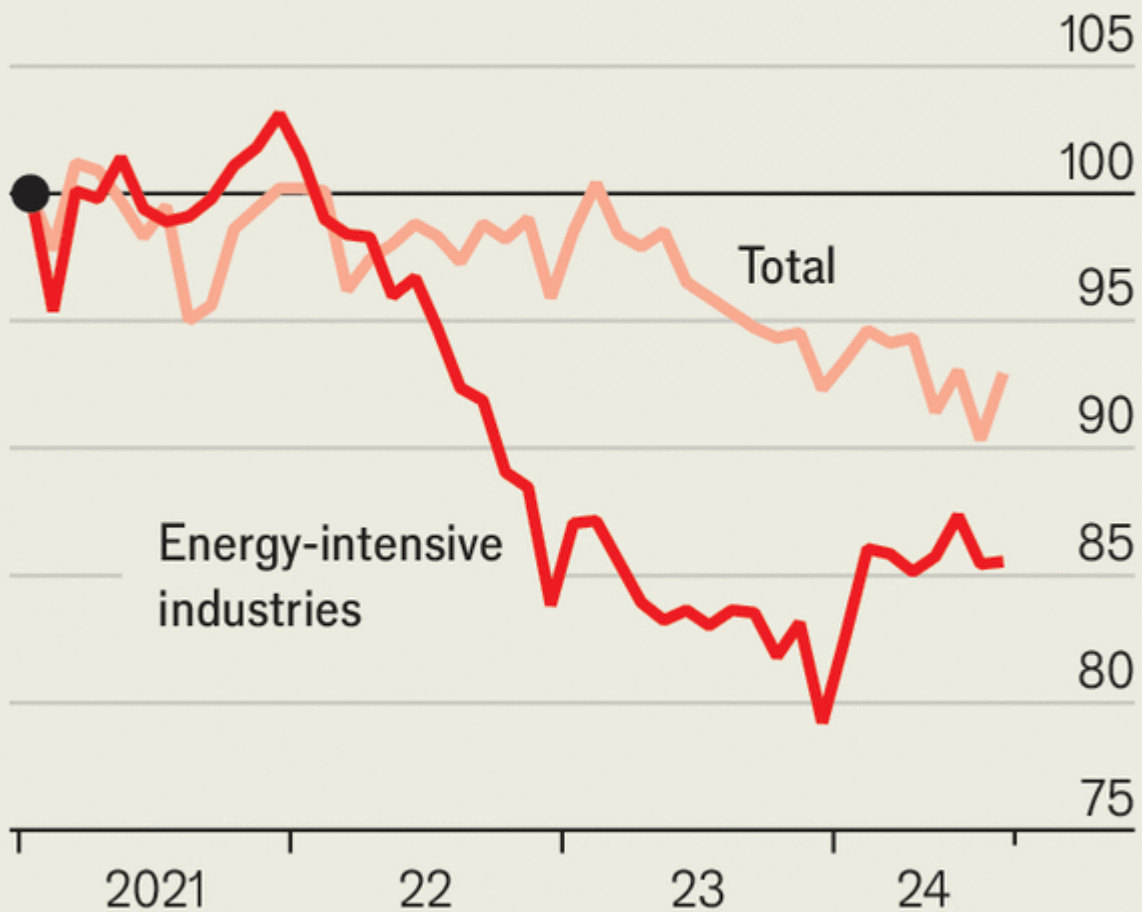
Europe's largest economy has barely advanced since covid-19 struck, lagging behind the rest of the rich world (see chart 1). Isabel Schnabel of the European Central Bank has noted that euro-zone growth excluding Germany has been "remarkably resilient" since 2021 and faster than that of many other big economies. But talking about the euro-zone economy without Germany is like talking about the American economy without California and Texas. The country, once a motor of European growth, has become a drag.

It is difficult to imagine a worse confluence of circumstances for the export-dependent and manufacturing-heavy German economy than those it has faced since 2021. Soaring energy prices followed Russia's invasion of Ukraine; now China's industrial overcapacity is causing havoc abroad. Comforting as it might be to blame economic weakness on external factors, however, Germany's problems run deeper, with many of them homegrown. On top of this, a fractious three-way coalition is hampering the political response.

In the wars

2

Germany, industrial production, Jan 2021=100



Source: Destatis

Industrial production has struggled in recent years. Energy-intensive industries, such as chemicals, metal-work and paper manufacturing, have been hit particularly hard (see chart 2). These sectors account for just 16% of German industrial output, but consume almost 80% of industrial energy. Many firms responded to higher energy costs by pausing production.

Shifting patterns in global demand are a bigger problem for most firms. As Pictet Wealth Management has noted, Germany's economic relationship with China has shifted. In the 2010s the two countries' growth was complementary: Germany sold cars, chemicals and machinery to China, and in turn bought consumer goods and intermediate inputs, such as batteries and electronic components. Now China is able

to produce for itself much of what it once imported and, in some cases, has become a serious rival for export markets, not least in the old German staple of cars.

Yet the gloom about German industry can be overdone. Although manufacturing production has fallen since 2020, its gross value added has been remarkably stable. Manufacturing firms, in many cases, have been able to shift into producing higher-value items even as they have lost market share. And last year, as the overall economy contracted, trade continued to make a contribution to growth, something that looks set to repeat this year.

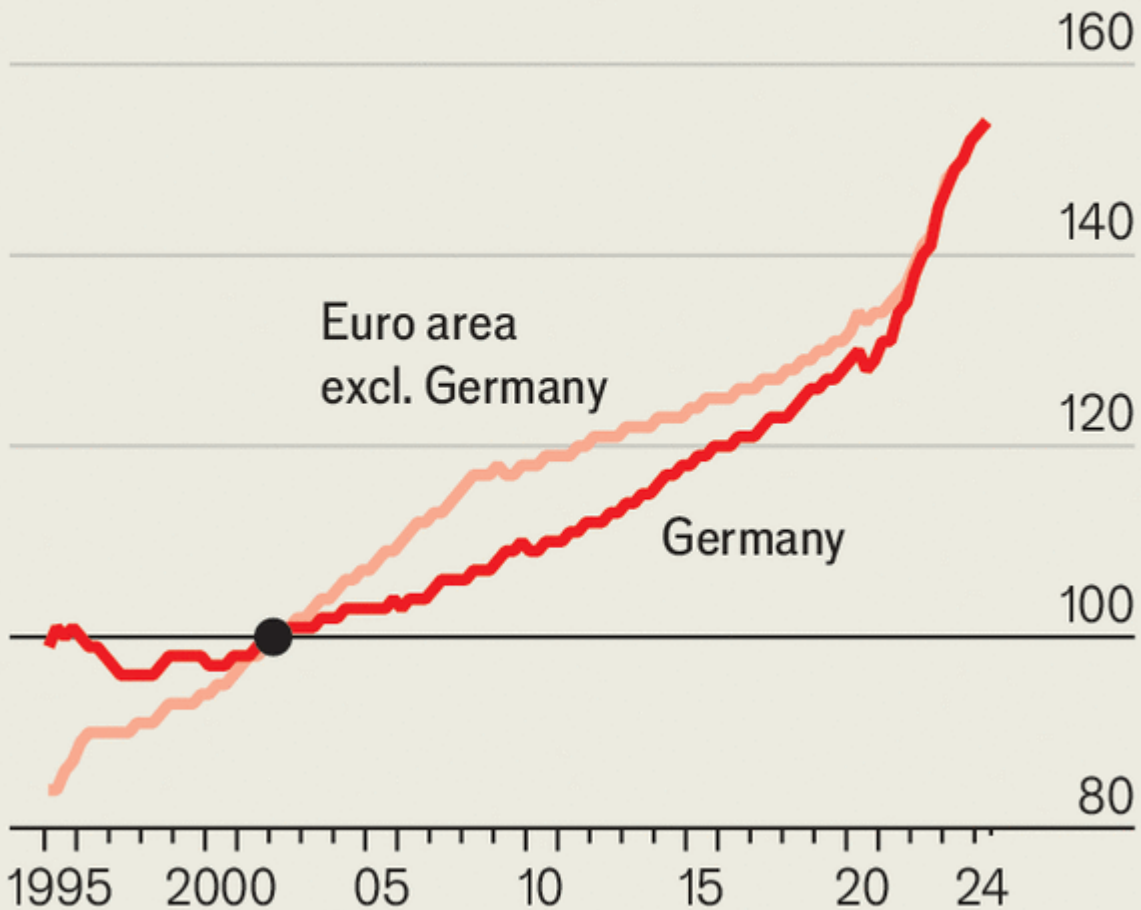
Higher real household incomes, as inflation comes down, have been slow to lead to greater demand, but they should eventually show up in consumer spending. The worst of industry's energy squeeze is in the past, too. Most observers expect a pickup in growth next year. The government has pencilled in growth of 1.1% in 2025 and 1.6% in 2026, based on the assumption that private consumption will begin to rebound. To some scepticism, ministers assume this will happen in part owing to their own growth-inducing policies.

But an overdue upswing would not mean an escape from longer-running structural problems. In reality, Germany's economic weakness predates recent geopolitical and economic shocks. As Ms Schnabel noted this month, German GDP at the end of 2021 was only 1% higher than its level of four years earlier, compared with 5% growth in the rest of the euro zone and more than 10% in America.

Competitive disadvantage

3

GDP price deflator, Q2 2002=100



Sources: Pictet; Eurostat

German success in the 2010s reflected the country's competitive advantage against the rest of Europe. At the start of the century, Germany was struggling with reunification. Its price level was higher than others in the common-currency area (see chart 3). Then, in the early 2000s the Hartz reforms, which included labour-market liberalisation, put a lid on costs by weakening labour's bargaining power. At the same time, debt-fuelled growth in southern Europe drove the price level higher in the euro area as a whole.

Over time, though, this competitive edge eroded. After the debt crisis of the early 2010s, peripheral European economies embarked on their own structural reforms. From 2015, after a decade of moderation, German wage costs began to grow faster.

By 2019 the price-level gap between Germany and the rest of the euro area had narrowed. The impact of the energy squeeze, with Germany especially reliant on Russian gas, pushed the country's price level higher. For the first time in more than two decades, Germany does not have a cost advantage over its euro-zone peers.

As Germany deals with this loss of competitiveness, it must also contend with demographic shifts. In recent years the country's ageing population has been balanced by high immigration. But fewer migrants are now arriving, leaving firms short of workers. All told, the IMF expects the German working-age population to shrink by 0.5% a year for the coming five years, the steepest decline of any big economy.

IMF officials say that, unless productivity improves, German economic growth will settle at 0.7% a year, half its pre-pandemic level. More government spending could provide a boost, but ministers are constrained by self-imposed fiscal rules. Annual net public investment has fallen from 1% of GDP in the early 1990s to zero. Although criticism of the "debt brake", which limits the federal structural deficit to 0.35% of GDP a year, has become more common, few observers expect any change before next year's federal election.

Germany's recession is painful both for Germans themselves and for the broader euro zone. An economic recovery next year, produced by lower inflation and lower energy costs, will not alleviate structural problems. Germany's economy was showing signs of strain long before the pandemic struck, Russia invaded Ukraine and China began to throw money at struggling industries. It will continue to show signs of strain for some time to come.