PICTET WEALTH MANAGEMENT

The great German stagnation

Structural as much as cyclical issues are at play

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FLASH NOTE

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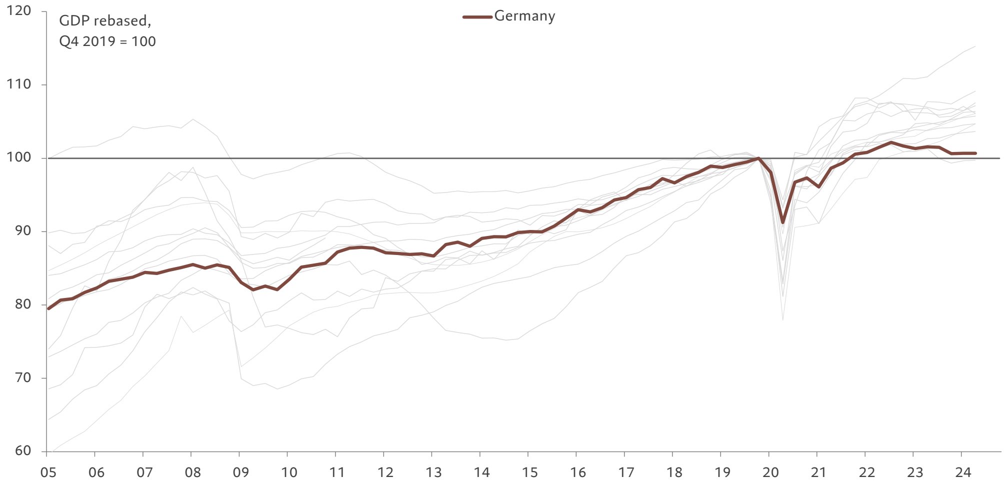
SUMMARY

- The German economy has broadly stagnated since 2020, lagging its euro area peers and raising many questions about its economic model.
- A succession of supply shocks over the last four years has worsened Germany's already declining competitiveness. Energy costs, dependency on the car industry, the shift in trade dynamics with China, rising protectionism, the lack of public investment and poor demographics are among the many challenges that the German economy is facing.
- Restoring German competitiveness as a business location will require stepping up public and private investments. For that, a change in mindset will be needed.
- Mario Draghi's call for more investment to boost European competitiveness has been greeted with scepticism by politicians in Germany, who have preferred to focus Draghi's call for more joint EU-issued debt rather than on the real challenges that Draghi says need to be tackled. The debt brake, written into the German constitution, is limiting government fiscal space. Divergent priorities among the three coalition parties continue to block the way to any compromise on this issue.

AN UNRECOGNISABLE ECONOMY

In the space of four years, the German economy has become a shadow of its former self. The growth engine of Europe's monetary union in the 2010s, expanding at an average annual rate of 2% between 2010 and 2019, has virtually stalled since 2020. In fact, the German economy in 2024 is the same size as it was in 2019. Over the same period, the other euro area economies grew by a median of 6%, and some by more than 15%. Only two of the 20 economies in the currency union will perform worse than Germany this year: Estonia and Finland.

Chart1: Real GDP in Germany and the other euro area economies



Source: Pictet Wealth Management, Eurostat, as of 24.09.2024

Since the pandemic and, especially, the energy crisis provoked by Russia's 2022 invasion of Ukraine, private demand in Germany seems to have simply evaporated. Household consumption has stagnated since 2022, with purchasing power still below its 2019 level. Investment has shrunk, first in construction and more recently in machinery and equipment. The same goes for external demand, with the continued sluggishness of Chinese domestic demand a significant drag on German exports. All in all, only public spending has prevented Germany from falling into recession.

On the supply side, the energy and construction sectors have paid a heavy price for the disruption to Russian gas supplies and the sharp rise in interest rates since 2022. Manufacturing, once the engine of German growth, has fallen back since the post-pandemic rebound through a combination of cyclical and structural reasons (*see below).* Only services have seen a consistent increase in business volumes.

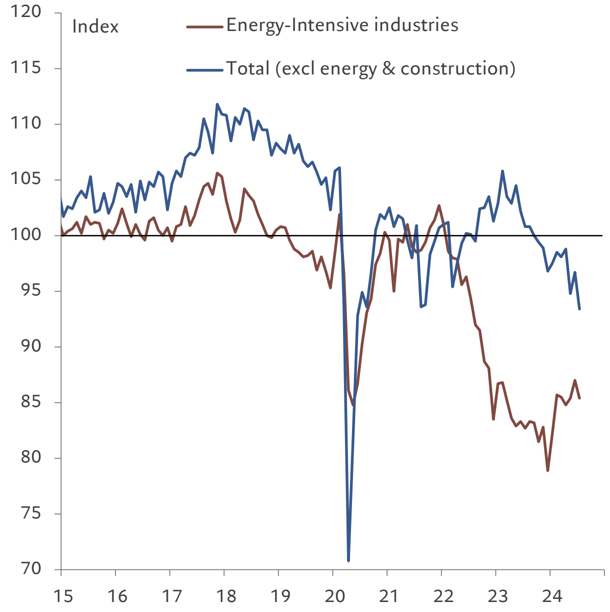
With economic stagnation, job creation has slowed down and is now concentrated in just three sectors (administration, information & communication, and real estate services). In manufacturing, employment has been falling since 2020, with a new wave of net job losses recently. In total, almost 4% of manufacturing jobs have disappeared in four years, with further declines to come. Against this background, Germany is one of the few EU countries where the unemployment rate is rising (albeit slowly).

The main question is whether this stagnation is temporary or structural. **Our conclusion is that the succession of supply shocks over the last four years has worsened an already deteriorating situation for Germany in terms of competitiveness, and that in the absence of a strong economic policy response, stagnation will continue.**

UNDERLYING CHALLENGES

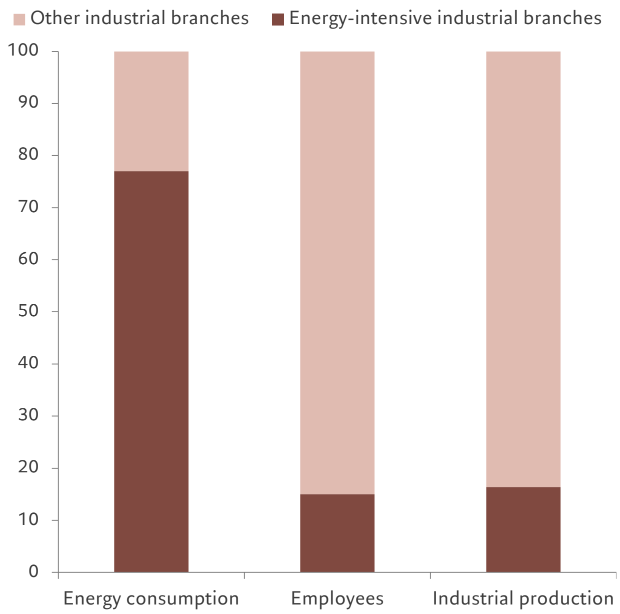
High energy costs. Germany's competitiveness has been increasingly threatened by rising energy costs, particularly in the wake of the energy crisis that was exacerbated by the war in Ukraine and the subsequent shift away from dependence on Russian gas. Rising energy costs have put German industrial companies at a disadvantage to competitors, especially those in countries with more stable or subsidised energy markets. The transition to renewable energy (the so-called Energiewende) and the phasing out of nuclear and coal power have further increased costs for businesses. Consequently, energy-intensive industries (chemicals and chemicals products, basic metals, coke and refined petroleum products and paper and paper products, which together account for 16% of industrial production) are struggling and many companies have already shifted parts of their value chain out of Germany.

Chart 2: Germany – industrial production



Source: Pictet Wealth Management, Destatis, as of 24.09.2024

Chart 3: Energy-intensive sectors as a % of total

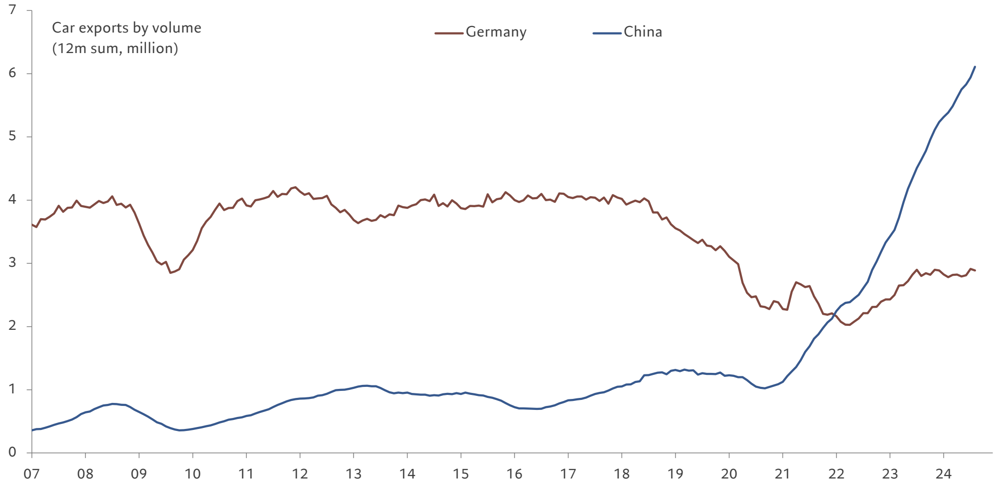


Source: Pictet Wealth Management, Destatis, as of 24.09.2024

Relations with China and overdependence on car sector. Over the past decade, Germany and China have developed a close economic relationship. Both economies were complementary. German industry delivered automobiles, machinery, chemicals, pharmaceuticals, electrical products and engineering know-how, while Germany imported mainly intermediate products (such as batteries and electronic components), capital goods (computer and telecommunications equipment) and consumer goods (e.g. consumer electronics and electrical household appliances). Surging demand from China, particularly for cars, helped Germany to become Europe's growth locomotive. But while this trade arrangement was a win-win situation for both countries, ties between them started to change a few years ago. China became increasingly able to produce goods it previously imported from Germany and in some areas, such as cars, it started to become a serious rival. Furthermore, many German firms started to produce locally in China rather than in Europe. Last but not least, the rise of Chinese electric vehicle (EV) makers has shifted trade dynamics.

Protectionism and the aftermath of the covid pandemic have also challenged Germany's export-led economic model. Europe, and in particular Germany, have become focused on de-risking rather than decoupling from China. Consequently, many firms in Germany have been rethinking their supply chains, with the aim to reduce imports from China in the future and to shift to other European and non-European countries in order to increase diversification, reduce freight costs and minimise disruption in transportation.

Chart 4: Germany and China – car exports



Source: Pictet Wealth Management, VDA, China Customs, as of 24.09.2024

Lack of public investment. Low public investment in Germany has been a persistent issue, particularly in areas such as digitalisation, infrastructure and education. Germany's public investment has been among the lowest of any European country over the past decade as a percentage of GDP. Indeed, public investment has steadily declined since the boom that followed unification in 1990.

Net public investment (gross public investment minus depreciation) has dropped from nearly 1% of GDP in the early 1990s to around 0% in recent years. This under-investment has resulted in ageing infrastructure and slowed the transition to renewable energy. Successive German governments have been reluctant to increase spending and more anxious to adhere to the constitutionally enshrined 'debt brake', which limits the annual structural federal budget deficit to 0.35% of GDP. The brake was lifted to deal with the covid crisis but was reinstated in 2024, reducing the scope for investment in the green transition, digital infrastructure and defence.

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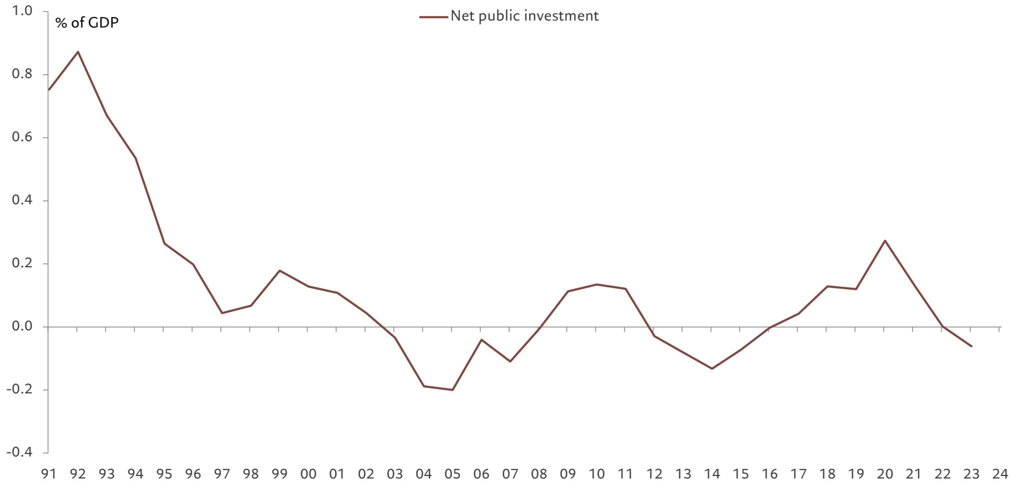
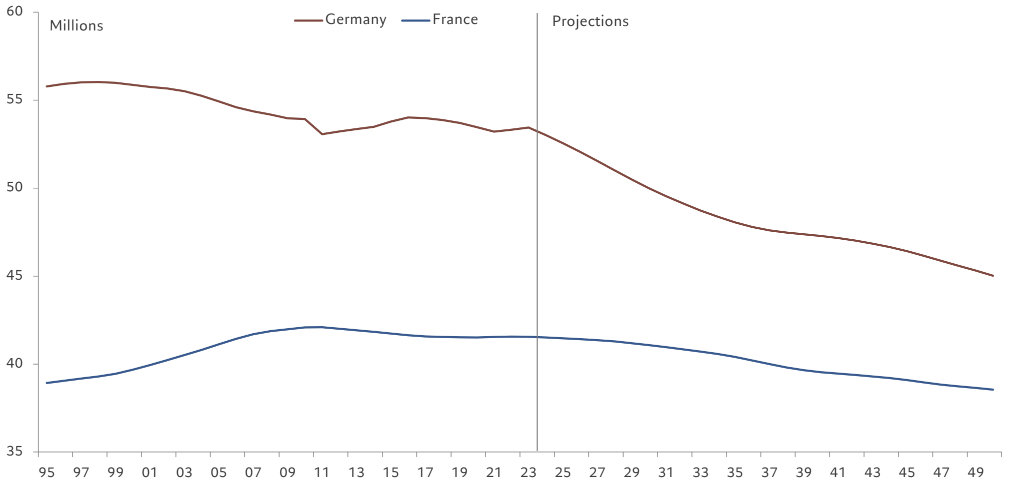
Chart 5: Germany – net public investment



Source: Pictet Wealth Management, Destatis, as of 24.09.2024

Demographics. A final challenge facing the German economy, and one that is likely to intensify in the coming years, is demographics. According to the World Bank, the working-age population (aged between 15 and 64) is expected to fall by almost 6% between 2024 and 2030. Together with Italy, this would be the biggest decline among the four major euro area economies. It represents a decline of around 3.5 million workers in the space of six years, compared with a fall of 'only' 2.5 million between 2000 and 2023.

Chart 6: Germany versus France: working age population, including projections.



Source: Pictet Wealth Management, Destatis, as of 24.09.2024

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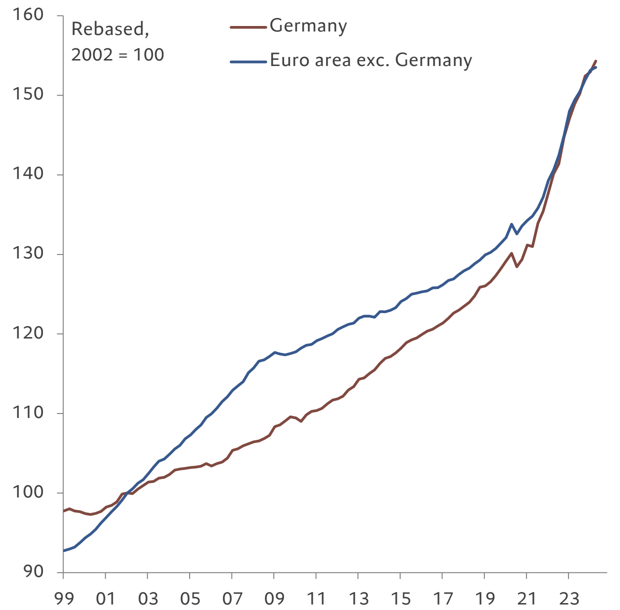
SOME COMPETITIVENESS ALREADY LOST BEFORE 2020

This sequence of challenges takes place against the background of a structural deterioration in German price competitiveness that was evident even before 2020. Indeed, starting in 2015, one sees a steady shift in relative price dynamics in favour of the rest of the euro area economy and to the detriment of Germany. From 2009-10, domestic price dynamics in the rest of the monetary union weakened following internal devaluations in economies hit by the sovereign debt crisis of those years and, in France, by the supply-side support policies instigated by the French government starting in 2013.

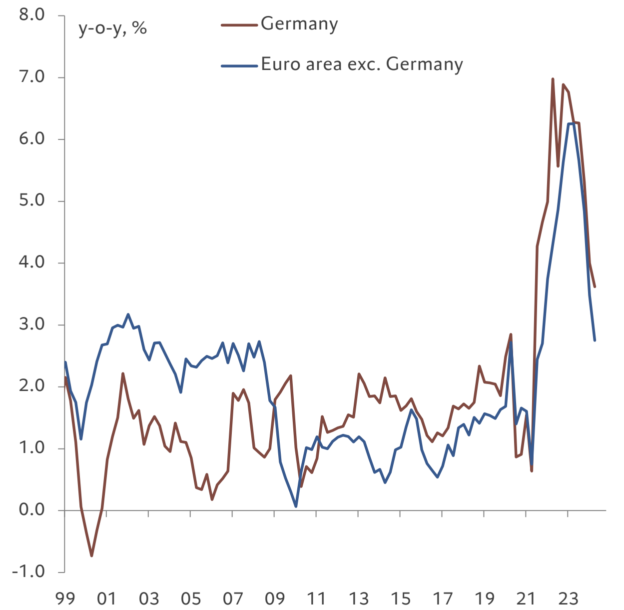
While domestic price dynamics moderated elsewhere in the euro area, they firmed in Germany. A return to wage growth since 2015 after a decade of moderation has pushed up unit labour costs and fed through to domestic prices. These two parallel movements meant that by 2019 the price gap between Germany and the rest of the EU was back to where it was at the beginning of the 2000s, undoing the impact of the Hartz reforms, which had helped to lessen Germany's disadvantage in terms of labour costs.

Chart 7: level in GDP deflator



Source: Pictet Wealth Management, Eurostat, as of 24.09.2024

Chart 7: change in GDP deflator



Source: Pictet Wealth Management, Eurostat, as of 24.09.2024

The loss of price competitiveness was not a major problem in 2019: Germany's prowess in heavy industry and the automotive sector meant that cost increases could be passed on to final buyers. But with the shocks of the 2020s, not only has price competitiveness deteriorated again, but product competitiveness in the key automotive industry is also under pressure, posing a significant threat to Germany's economic e model.

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CONCLUSION

Germany's economy is facing several structural challenges. While many of these emerged before the pandemic, they have seen become more acute. Since the country's previously successful export-led model has ceased to bear fruits, restoring German competitiveness will require stepping up public and private investments.

Mario Draghi's recommendations for boosting European competitiveness, contained in a report he delivered this month, included a call for more investments (of the order of EUR800 bn per year). The report has been received with scepticism by much of the political class in Germany, especially Draghi's call to step up joint EU debt issuance. A change in mindset will be needed if Germany is to meet the huge challenges it faces. Otherwise, the German economy is likely to continue to underperform its peers for some time.

The debt brake is currently limiting government fiscal space. Divergent priorities among the three parties that form the coalition government have prevented a compromise so far on this issue. While criticism of the debt brake has been rising, substantial reform will require a two-thirds majority in parliament, which seems unlikely before the next general election, scheduled for autumn 2025.

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