

LUISS 

Institute for European
Analysis and Policy

Jean Monnet Centre of Excellence
on EU Inclusive Open Strategic Autonomy

Germany's economic weakness may help strengthen the European Union

Carlo Bastasin

Policy Brief 3/2024

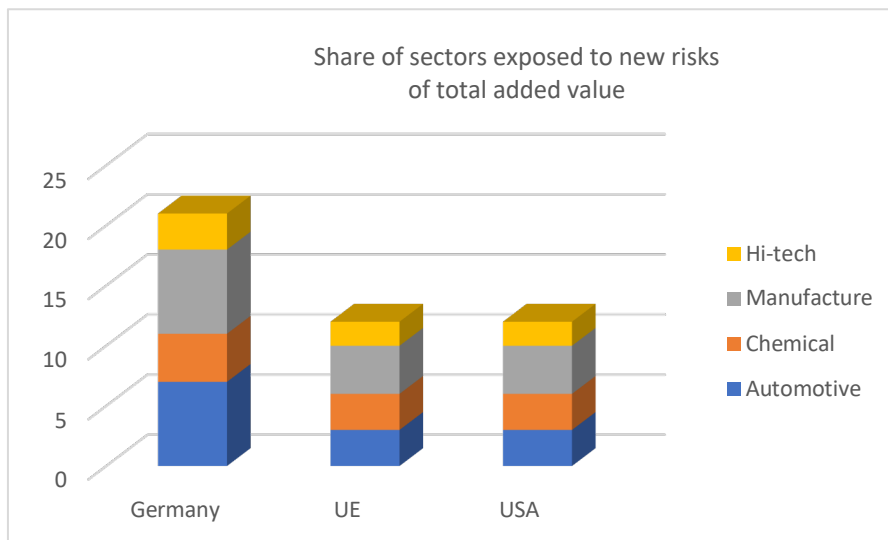
January 30, 2024

Germany's economic weakness may help strengthen the European Union

Carlo Bastasin

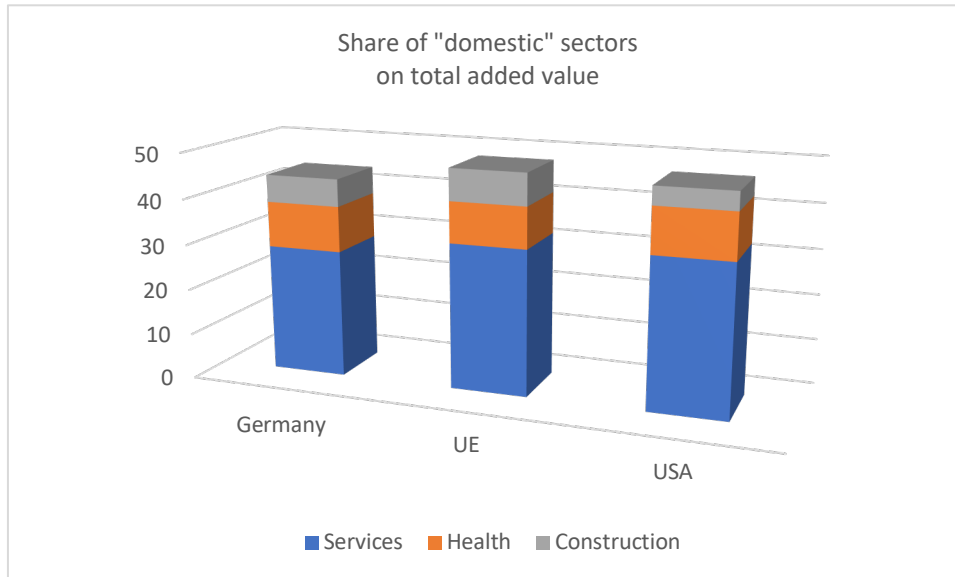
Germany's economic weakness, highlighted by the recession in 2023 and the uncertain outlook for the current year, has non-cyclical characteristics that have been amplified by the recent dramatic crises of both a strategic and macroeconomic nature. The challenge for German leadership involves a long-term vision that goes beyond the modernization of the national business model and needs to define the geo-economic role of the country. While in the past Germany's business interests were determined by relations with non-European countries, starting with energy supply from Russia and the import of growth from China and the United States, in the years to come economic interaction with European Union countries may be set to become vital again, with implications for Berlin's incentives to support greater European economic and political integration.

The four industrial sectors most exposed to current geopolitical and macroeconomic risks account for more than one-fifth of the gross value added of the German economy. The estimate expressed in the graph below (based on PwC and Statistisches Bundesamt data) shows a very high share compared to the weight – equal to less than an eighth – of the same sectors in the rest of the European Union and the United States.

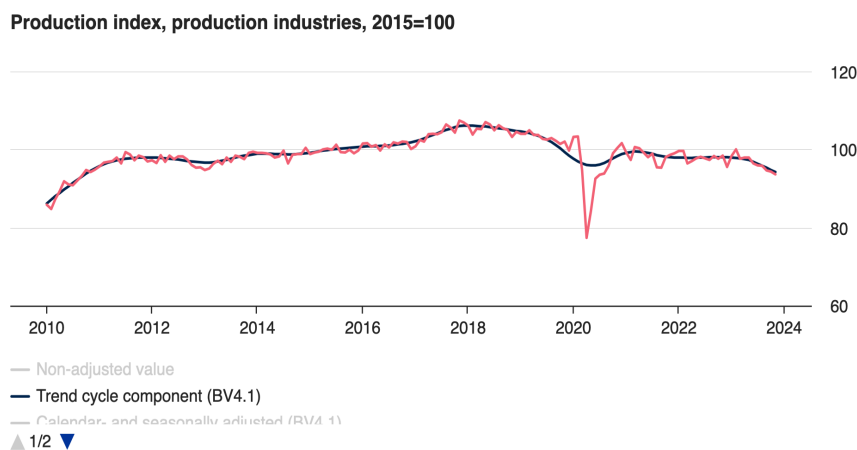


Automotive, chemicals, traditional and high-tech manufacturing are particularly affected by rising commodity and energy prices, supply chain bottlenecks, protectionism and global political instability. The "domestic" sectors -

services, healthcare and construction - have a lower weight in Germany than in the EU and the US and are therefore able to play a less significant role in stabilizing German production in disruptive circumstances such as those of recent years.



However, recent crises, including of course the pandemic crisis, the return of inflation and severe global geopolitical tensions, have come after a phase in which the need to rethink the German business model was already obvious. As is well known, well before the post-2020 crises, a program was in place to pursue the digital and environmental transitions. The graph below, based on Destatis data, shows that the inflection point of the industrial cycle had already occurred before 2018.



© Statistisches Bundesamt (Destatis), 2024

Considering that the current serious challenges are not likely to be temporary, Germany must rethink some features of its business model by focusing on less traditional sectors than basic chemicals and automotive, starting with those with higher technological content, including those applied to manufacturing, and specializing more in sectors such as pharmaceuticals and life sciences. To some extent, the transition to a new sectoral composition of German production supply is already underway. While in the chemical sector there has been a 20% decline in production since 2015, in the electrical engineering sector there has been an increase of 18% (source: DBResearch). The drop in car production has been dramatic (about 40% less in number of units), but contrary to what has been assumed so far, the German industry looks set to maintain a leading position in the production of premium electric cars as well, as shown by a recent study by Ifo and an analysis by PwC.

To overcome the ongoing industrial transition, however, Germany will have to develop a geo-economic strategy in the context of the European Union, first and foremost to reduce its energy supply gap. It will also have to diversify its main commercial partners in the short term and make its supply and destination chains more flexible than they were in the 2000s.

Without intervention, the estimated level of potential growth will remain weak, perhaps below 0.5% and therefore similar to that of Italy. The Council of Experts (the group of so-called *Wirtschaftsweise*) estimates a potential growth rate of 0.4% over the next decade, mainly as a result of the population decline. In fact, the supply of labor is falling both because of the lower labor force volume and because the number of hours per worker is being reduced. The weakness of the economy interacts with demographic problems, and in this prospect, it is unreasonable to imagine that Germany could renounce its role as a global exporting economy because such a role would allow it to "import" population growth through trade with countries that have more vigorous demographic profiles.

Against this backdrop, at least two factors favor Germany's economic weakness being translated into a greater political-economic commitment to the European Union. The first is that Spain and Greece are set to play an increasingly important role as producers of renewable energy and are already setting up the infrastructure to transport the energy they produce to Germany and central Europe. The second – decisive – factor is the development of trade and production transformation interactions with the countries of Eastern Europe. Already in recent years, trade volumes between Germany and Eastern Europe have increased significantly, more than compensating for the decline in German trade with China.

Eastern Europe consists of a large group of partner countries, of which those most integrated in the EU see Germany as a point of reference, not only economically. Recent political developments in Poland have restored the framework of alignment between Warsaw and Berlin, while the EU's increasing pressure on Hungary could defuse the major factor of dystonia with Germany. Other countries, particularly in the western Balkans, are interested in the new EU enlargement process. The population of this group of countries could increase substantially if Russia's aggression is halted and Ukraine is rapidly integrated into the European Economic area.

Economic survival, geopolitical factors and its strategic role are therefore closely intertwined in the scenario of Germany's exit from the structural crisis in which it finds itself, making it likely that Berlin will play a more resolute role in favor of the strategic strengthening of the European Union.