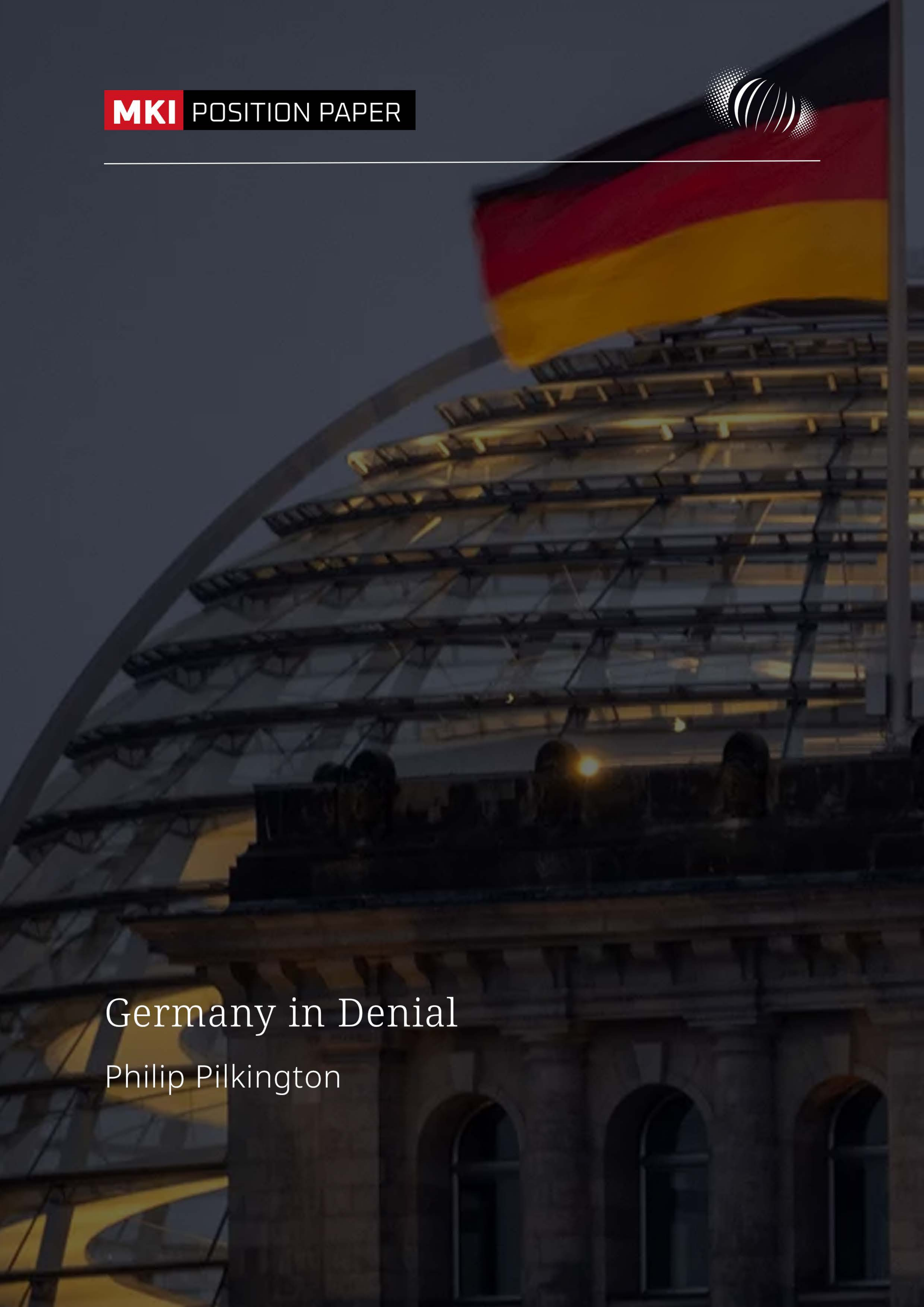
MKI POSITION PAPER



Germany in Denial

Philip Pilkington

Written by Philip Pilkington, Senior Research Fellow, HIIA
September 25, 2024

Germany in Denial

The German economy is experiencing a major crisis – but most Germany commentators and policymakers prefer to look the other way. Earlier this month German automotive giant Volkswagen announced that it was considering closing one of its plants in the country for the first time in the company's 87-year history. More recently the company has announced that it will stop production at one of its plants in China. Clearly the company is experiencing major problems.

None of this is surprising to those who have been following the macroeconomic picture in Germany since the beginning of the Ukraine war in February 2022. In response to the war, the German government made strong commitments to sanctions Russia. The problem for Germany is that Russia is a major provider of raw materials for Germany, especially energy in the form of oil and natural gas. This relationship between the two countries is centuries old and severing the relationship was always going to have profound consequences for the German economy.

It became clear how the sanctions would do tremendous damage to the German economies after only weeks of being imposed. European natural gas futures, which predict the cost of natural gas, went from around €70 per megawatt-hour before the war to as high as €335 per megawatt-hour in the summer of 2022. Futures prices have since come down – the volatility in these markets always causes them to overshoot – but the signal that they were sending is clear: after the war and the sanctions, energy prices in Europe were set to be very high in the future.

The futures markets made the right prediction. Since 2021, the cost of electricity for European businesses after taxes and subsidies has risen 125% – even more than household prices which have risen around 50%. While futures prices have fallen, electricity prices have remained elevated and show no sign of coming down. It is electricity prices themselves that matter, not the futures price, because these are the actual prices that businesses pay.

This is not the only hit that the sanctions-induced energy crisis has done to the European economy. Higher household bills have fed into inflation which has led to workers demanding higher pay to make ends meet. This higher pay is feeding into higher labour costs across the continent. Before the war, labour costs in Europe typically rose around 2% annually – roughly in line with the European Central Bank's inflation target. But since the war it is not unusual to see annual increases of 5% or 6%.

These rising labour costs come at a time when the labour costs of competitor countries are falling. Commentators that are sceptical of the Chinese economy often highlight the fact that the country has very low inflation or even outright deflation and say that this is evidence of economic weakness. In fact, it is due to a flood of extremely cheap high-tech products – like Chinese-made electronic vehicles (EVs) – hitting the Chinese domestic market. These low rates of inflation mean that Chinese workers do not demand higher wages and so, as labour costs rise in Europe, they fall in China.

This competitiveness differential is further exacerbated by the European Union's misguided protectionist policies. The European Commission recently announced that it will impose tariffs of anywhere from 9% to 36% on Chinese-made EVs. This is on top of the 10% tariff applied to all EV imports into Europe. Without access to these cheap goods, European workers require higher wages to consume the same amount of goods – further damaging Europe's competitiveness.

Take the example of a small business that produces simple components for the international market. A small business of this type is faced with an average bill for an EV of around €50,000 in Europe. But their Chinese competitor business has access to an EV for the average price of around €30,000. If the European Commission gets in the habit of imposing massive tariffs on European imports, this problem will spread to other goods.

Now consider that the protectionist policies can only be understood considering the competitiveness crisis unleashed by the war and the high energy prices. Prior to the war, there were certain problems in the European economy with regards to competitiveness. But they were largely long-term problems, such as the lack of a developed social media sector on the continent. When the war hit and the energy prices rose, however, policymakers saw a very real, very immediate crisis in front of them. Their reaction has been to panic and impose self-defeating tariffs on China.

The data shows clearly that at the heart of the competitiveness crisis in Europe is energy. Consider the German industrial production statistics in this regard. The industrial production index measures the amount of output produced by a country's industry. Since 2021, overall German industrial production has fallen around 5%. But if we look at energy-intensive industrial production we see that it has fallen by 15%.

Everywhere we look we see crises and lying behind each crisis, from rising labour costs to falling industrial production to the panicked embrace of protectionism, we see the high energy prices caused by the war. We might expect that since the root cause of all these problems is so simple that politicians and policymakers would be focused on it. But this is not the case. Because of the ideological fervour surrounding the war a taboo has been imposed on discussing high energy prices.

This is most clear if we look at the recent competitiveness report released by former head of the European Central Bank and former Prime Minister of Italy Mario Draghi. The report goes into substantial detail about a whole host of supposed problems in Europe – from the lack of a competitive technology sector to the question of domestic supply chains – but when it comes to the core issue, energy, the report is unable to grasp the nettle. The report devotes only three sentences to discussing the fact that sanctions have given rise to higher energy prices in Europe.

The report's solution to this problem is even more bizarre: it prescribes decarbonisation to bring down energy prices. Economists typically think of decarbonisation as a necessary cost that we impose on our societies in pursuit of ending the use of fossil fuels. So, we accept that our energy might come from more expensive sources in the immediate future because we want to reduce CO_2 emissions. But the Draghi report claims, with no evidence or argument whatsoever, that decarbonisation is actually a viable path to reduce energy prices.

The situation regarding energy prices is like the children's story of the emperor's new clothes. Politicians and policymakers stand in front of the emperor, in this case high energy prices, as he parades naked through the streets unable to point out the problem for fear of the response from their peers. The damage that this collective lie is doing to Europe is immeasurable – and it is Europe's industrial powerhouse, Germany, that is suffering the most.

Because German leaders are forced into a situation where they must lie about the root cause of their problems, they become even more irrational. Take the example of nuclear power in Germany. In August of this year, people around the world watched in horror as Germany's Grafenrheinfeld nuclear power plant was demolished. Anyone who had read a newspaper knew that Germany was experiencing a major energy crisis that was destroying its economy, and yet here was a video of the German government demolishing power sources that might help alleviate the problem.

The German public, like the child who finally calls out the emperor's nakedness, is coming to realise that there is a serious problem with their leadership – which seems intent on destroying themselves and their country. This explains the stunning electoral success of alternative political parties like the *Alternative für Deutschland* on the right and the *Bündnis Sahra Wagenknecht* on the left in Eastern Germany. These parties are associated with dissident opinions in Germany but increasing shares of the population are starting to realise that the present political class does not have the best interests of the country at heart. Much was East Germany quietly rebelled against the Soviet satellite state thirty years ago, they are now rebelling against similar levels of economic mismanagement coming from Berlin today.

To turn around its fortunes, Germany will need to regain access to cheap energy. This means that the war in Ukraine will have to end and the sanctions – or, at least, some of the sanctions – will have to be lifted. This is inevitable. There is no scenario in which Germany takes this punishment for a century or even a decade. But the question is how long it will take Germany to start behaving rationally. The longer the current absurd situation goes on for, the more damage is done to the German economy.