Danske Bank

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Research Germany

Worst is over in German manufacturing sector

- **In 2023, Germany's economy fared the worst among major economies, with GDP declining by 0.3% year-on-year and industrial production dropping by 2.5% compared to 2021. This can be attributed to its heavy reliance on manufacturing, past reliance on Russian gas, weak construction sector, and reduced global trade.**
- **The cyclical factors explaining the weak manufacturing sector are expected to ease further so the German manufacturing sector will be able to muddle through near-term and seize growth opportunities.**
- **The German manufacturing sector faces significant structural challenges from a declining work force, higher energy prices, and uncertainty about climate and fiscal policies, which means structural growth will be weak in coming years.**

German economy lags peers due to reliance on manufacturing

The German economy's underperformance compared to peers is largely due to its heavy reliance on manufacturing. Industrial production in Germany has declined over the past two years, notably dropping by 2.5% in 2023 compared to 2021. This decline mirrors a broader trend seen across the euro area, attributed to the significant increase in borrowing costs following ECB policy tightening. The impact on the German economy is amplified by the substantial contribution of manufacturing and construction sectors, accounting for 31% of the economy, exceeding the euro area average of 23%.

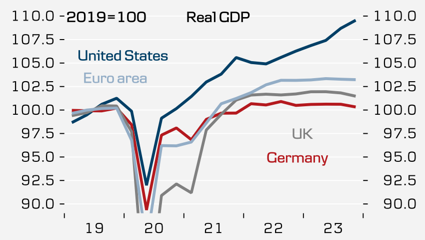
Germany falters due to Russian gas supply shutdown

The German manufacturing sector has faced pronounced challenges compared to its euro area counterparts, largely due to its historical dependence on Russian gas. In 2021, 60% of German natural gas consumption came from Russia, with 33% and 24% of oil and coal, respectively, also originating from there. The cessation of Russian gas imports in 2022 exacerbated the increase in energy prices for German manufacturing. As a result, energy-intensive sectors experienced a notable 16% decline in production since 2021, while overall industrial production decreased by 2.5%. These energy-intensive industries accounted for 26% and 22% of total industrial production in 2022 and 2023, respectively. In 2023, these sectors, making up 16% of manufacturing employment, saw a 0.2% decrease in employment, while others' rose by 1.3%, and thus, marginally cooled the labour market.

Germany weak due to openness of the economy

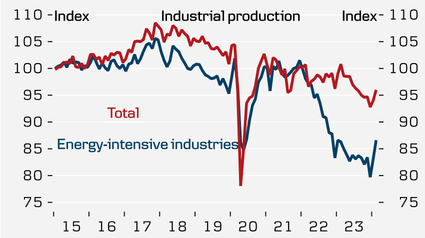
The highly open nature of the German economy has rendered it particularly vulnerable to the downturn in global trade witnessed last year. With trade to GDP ratio standing at 90% in Germany, in stark contrast to 67% in France and 18% in the US, the German economy's heavy reliance on exports is evident. Notably, vehicles, machinery, and electric equipment collectively constitute 45% of German goods exports. The reduction in the volume of world trade coupled with subdued demand for manufactured goods in trading partner nations, as indicated by our German export barometer (see chart on next page), have coincided with the decline observed in German exports.

German GDP unchanged since pre-pandemic following decline in 2023



Source: Eurostat, Statistisches Bundesamt, BEA, ONS, Macrobond Financial

Rising energy prices have hurt the German industry



Source: Statistisches Bundesamt, Macrobond Financial

Decline in global trade hurts Germany

Source: Destatis, CPB, Macrobond Financial

Analyst, euro area macro research
Rune Thyge Johansen
+45 40 26 04 36
rujo@danskebank.dk

Spillovers from construction sector weakens manufacturing

The German construction sector faces significant challenges, with production declining by 4.5% in 2023 compared to 2021 levels. Particularly in residential construction, the business situation assessment is at its lowest level in almost two decades, according to the Ifo survey. Additionally, low demand has resulted in a 7.2% year-on-year decrease in house prices in 2023. This weakened state of the construction sector has also impacted energy-intensive manufacturing sectors, with reduced demand for building materials such as steel, concrete, and glass. Combined with the supply shock of elevated energy prices, this has led to a significant production slump in these sectors.

German manufacturing to muddling through near term…

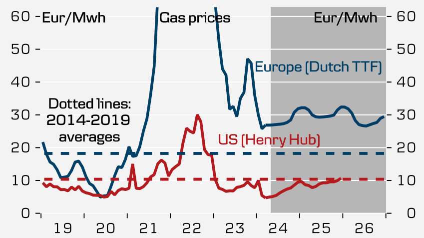
We expect the German manufacturing sector to muddle through and possibly seize short-term growth opportunities as cyclical headwinds fade further. Leading indicators from Asia signal a rebound in the global manufacturing cycle, see *Research Global: Manufacturing recovery to continue into the summer*, 15 April. This, coupled with a recovering global economy and increased spending on goods, will bolster German exports. Additionally, the recent decline in energy prices is expected to facilitate the recovery of energy-intensive industries in Germany, with latest data indicating a 4.2% increase in industrial production in these sectors in both January and February, surpassing the total industry growth rates.

Improved financial conditions since October will bolster the manufacturing sector and stabilize construction activity. However, despite these positive developments, PMI and Ifo surveys indicate ongoing subdued performance in the German manufacturing sector. We anticipate a scenario of muddling through rather than a robust rebound in activity. Upside risks to the outlook are a faster recovery in the factors mentioned above and stronger domestic demand following lower inflation and easing of monetary policy. Geopolitical tensions and higher inflation pose downside risks to the outlook.

… but structural problems spell low growth ahead

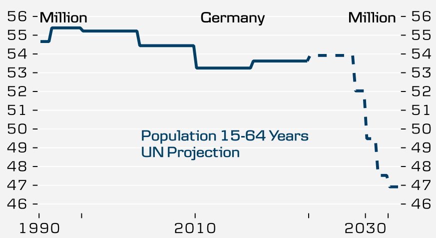
Despite near-term tailwinds, the German manufacturing sector confronts significant structural hurdles, signalling weak growth prospects in the medium term. Gas futures remain 70% higher than pre-COVID levels in Europe, contrasting with average levels in the US. This, coupled with rising EU carbon allowance prices, places Germany at a competitive disadvantage, as noted in the Ifo survey, with industrial companies reporting their poorest competitive position on record. Additionally, the workforce is projected to decline by 10% from 2023 to 2030, according to the UN, leading to expected structural GDP growth of merely 0.4% year-on-year in the coming years. Furthermore, uncertainty surrounding fiscal and climate policies are dampening investment sentiment.

Gas futures in Europe 70% higher than pre-covid average



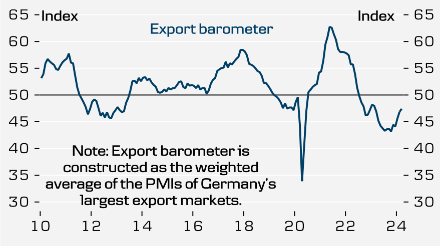
Source: EIA, ICE, Macrobond Financial

Prime working age population to decline significantly



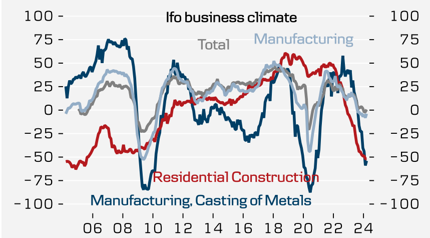
Source: UNDESA, Macrobond Financial

Manufacturing sectors improving in export barometer



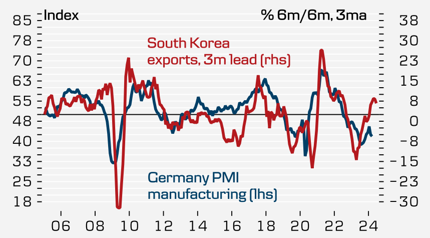
Source: S&P Global, Statistisches Bundesamt, Macrobond Financial

Construction and related manufacturing sector very weak



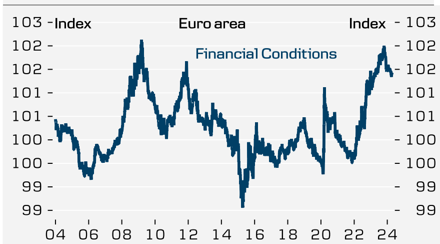
Source: Ifo, Macrobond Financial

Leading indicator points to higher manufacturing PMI in Germany



Source: S&P Global, Korea Customs Service, Macrobond Financial

Financial conditions have eased



Source: Goldman Sachs, Bloomberg

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