# Germany

## 'Zeitenwende'

- Challenging times lie ahead for Germany's economy, as the three pillars of its old economic success model – industry, globalisation and cheap energy imports – have become its weakness.
- Until the energy crisis is resolved, Germany is unlikely to return as the euro area's economic powerhouse anytime soon. We expect a recession to take hold over the winter and extend further into next year.
- Inflation pressures will remain elevated in 2023, amid rising wage growth and delayed energy price pass-through.
- Stepped up investments on infrastructure, digitalisation and the green transition are an upside risk, and not least an interesting business opportunity for Nordic firms offering solutions in these areas.

Aila Mihr
Senior Analyst
+45 29 31 02 56
amih@danskebank.dk

## On the hunt for a new growth model

Challenging times lie ahead for Germany's economy, as the three pillars of its old economic success model – industry, globalisation and cheap energy imports – have become its weak spot. Strong order books, easing supply chain stress and pent-up consumer demand kept the economy afloat in 2022, but we think it is increasingly fighting gravity. Cracks in domestic demand have started to appear and especially industry is struggling to maintain its competitiveness amid rising cost pressures and more fragile global supply chains.

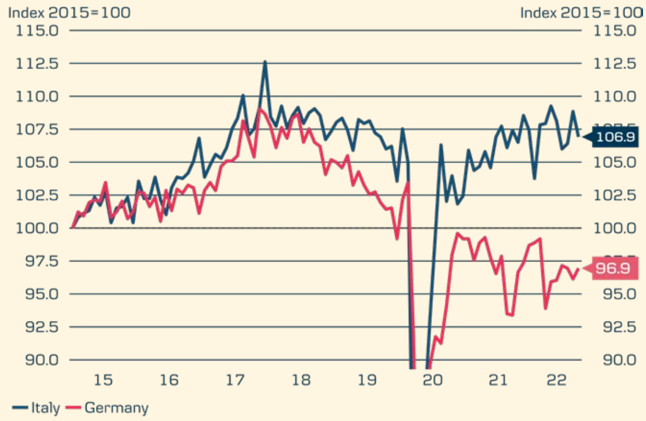
The energy crisis will continue to cast a shadow over the economy also next winter. Re-filling gas storage without Russian supplies will be difficult, leaving the risk of gas rationing (see theme box) still lurking in the background. That said, energy infrastructure investments and a large scale adoption of renewables have finally gotten political focus. On top of three planned LNG terminals, six Floating Storage Regasification Units are being set up along Germany's coasts, with three expected to start operating already in early 2023. To achieve the goal of an 80% renewable power share by 2030 (from 45% today), onshore wind capacity is targeted to rise five-fold and solar capacity four-fold from current levels. Faster planning processes and higher support for rooftop solar power complement the measures, although regional public resistance remains an issue.

Adverse demographics remains one of the biggest structural challenges for the German economy, as the workforce is projected to shrink by more than five million people by 2035. A declining workforce, combined with labour hording and furlough schemes will likely support the labour market, but we still expect to see an increase in unemployment from the current record low levels. Near-term, the tight labour market, combined with rising consumer inflation expectations should support a noticeable uptick in negotiated wage growth in 2023 to levels of 4-5%, followed by more moderate wage increases in 2024. Due to the delayed pass-through of gas and electricity prices, German consumers will likely continue to face further energy price increases in the coming months.

In sum, the outlook for the German economy is clouding and we expect a recession to take hold at the end of 2022. Domestic demand will increasingly feel the impact of falling real disposable incomes and higher borrowing costs, while weaker foreign demand will weigh on net exports. Fiscal support measures and a relatively resilient labour market will help to mitigate the downturn, but overall we revise the outlook for GDP growth down to -1.4% in 2023 and -0.5% in 2024, with a nascent recovery only taking shape from Q2 24 onwards as real incomes start to grow again.

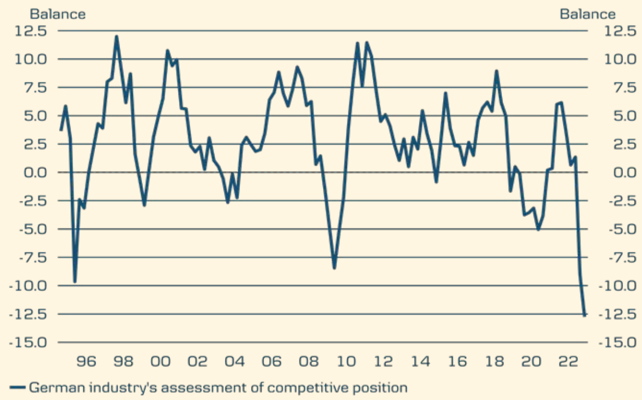
Until the energy crisis is resolved, Germany is unlikely to return as the euro area's economic powerhouse anytime soon. Germany has entered a phase of adjustment and reinvention that is pushing it to refocus and turn inward. This has created a power vacuum on the European political stage, as the souring Franco-German ties attest. Germany's lack of policy coordination over fiscal measures has antagonized many EU partners and efforts to restart the old mercantilist China policy (see theme box) are increasingly raising eyebrows in Brussels and Washington.

### Industrial production has not grown since 2015...



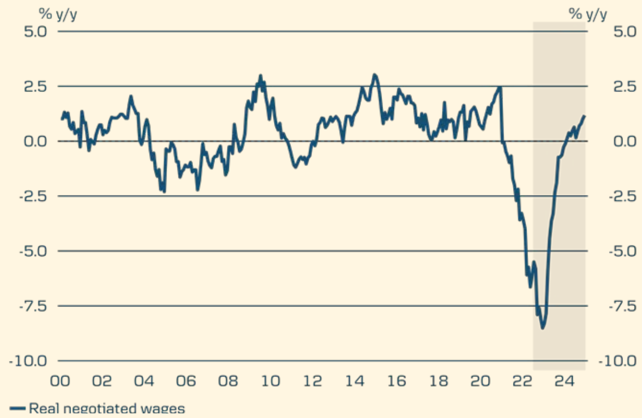

*Source: Destatis, Istat, Macrobond Financial, Danske Bank*

### ... and energy crisis is further weighing on competiveness




*Source: EU Commission, Macrobond Financial, Danske Bank*

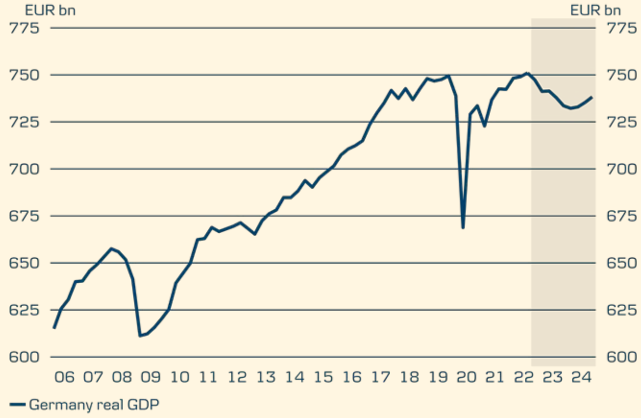
### High inflation is eroding consumers' purchasing power




*Source: Bundesbank, Eurostat, Macrobond Financial, Danske Bank*

The long-term growth prospects of the German economy remain mixed. Productivity growth has been declining for several decades, as innovation expenditures are increasingly concentrated on large companies. With technological change and the transition to a climate-neutral economy, many German industries will have to adapt their business models and production processes, not least the important car sector. To kickstart its growth prospects, Germany needs a 'Zeitenwende' (paradigm shift) beyond foreign and security policy. With globalisation slowing – or turning into 'friendshoring'– the economy has to adjust to a world, where services grow in importance relative to industrial exports. Stepped up investments on infrastructure, digitalisation and the green transition provide a silver lining, and not least an interesting business opportunity for Nordic firms offering solutions in these areas, but they will also require the clearing of bureaucratic hurdles and as well as public support e.g. for the adoption of digital solutions.

**A lacklustre growth outlook**




*Source: Eurostat, Macrobond Financial, Danske Bank*

## *The China connection*

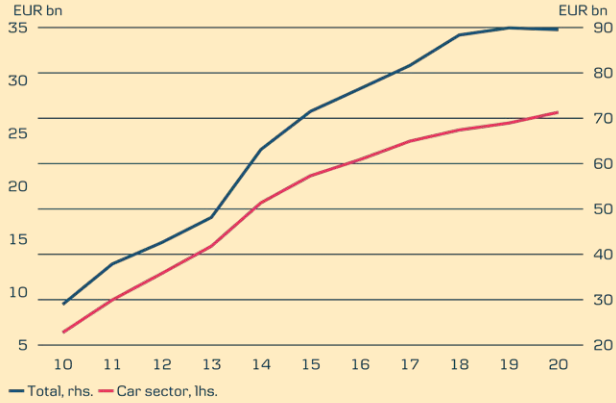
For years, German companies prospered from China's appetite for machinery, chemicals and cars. China remains Germany's largest trading partner and nearly half of German manufacturers rely on intermediate inputs from China (three-quarters for car industry). Sino-German trade supports more than one million jobs directly and of Germany's ten most valuable listed companies, nine derive at least 10% of revenues from China (compared to two in America).

Waking up to the reality of Russian energy blackmail, Germany's growing China dependencies have started to raise questions. The government's new "China Strategy" will likely include clear messages on the need to reduce dependencies and diversify supply chains and trading partners. Berlin has already signalled it will offer fewer guarantees to insure companies against political risks in China. That said, deep divisions persist between the Greens and parts of the SPD about the future of the relationship.

Many companies are taking a closer look at their dependencies amid growing concerns about China's sabre-rattling over Taiwan and continued economic disruptions caused by its zero-Covid policy. Nearly half of German manufacturers that receive significant inputs from China plan to reduce their Chinese imports according to the Ifo Institute. However, while many SMEs are looking to diversify their supply chains away from China, Germany's old industrial giants remain reluctant to leave the Chinese market.

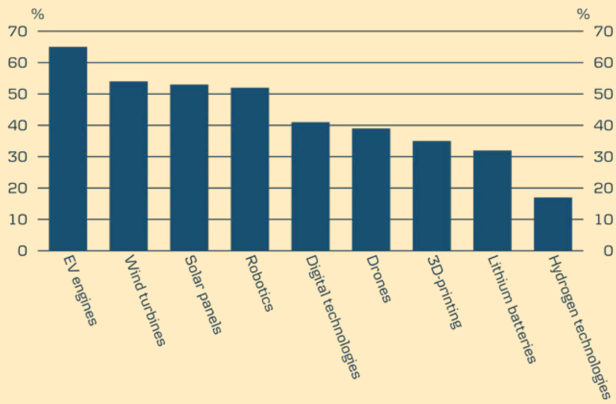
German companies leaving the Chinese market in droves remains unlikely. China remains a leading supplier of rare earths and many technologies that will be key for a successful green transition. That said, as the Chinese global growth engine is shifting into lower gear, the days of China being a one-way bet are gone. A successful diversification of German industry into alternative suppliers and export markets will be an important building block for future proofing the growth model, but it also leaves upside risk for more persistent inflation pressures from 'efficiency losses' during the transition phase.

**German FDI into China has stagnated, but continues to increase for car producers**




*Source: Bundesbank, Macrobond Financial, Danske Bank*

**China is a large supplier for EU imports of green transition raw materials and technologies**




*Source: EU Commission, Ifo*

### Macro forecasts - Germany

| % Change q/q | 2023 | | | | 2024 | | | | Calendar year average | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | 2022 | 2023 | 2024 |
| GDP | -0.8 | 0.0 | -0.5 | -0.6 | -0.2 | 0.1 | 0.3 | 0.4 | 1.7 | -1.4 | -0.5 |
| Private Consumption | | | | | | | | | 4.5 | -2.3 | 0.9 |
| Fixed Investments | | | | | | | | | 0.3 | -1.2 | 0.0 |
| Public Consumption | | | | | | | | | 3.4 | 1.7 | 2.3 |
| Exports | | | | | | | | | 1.7 | 1.4 | -0.1 |
| Imports | | | | | | | | | 5.5 | 2.1 | 3.0 |
| Unemployment rate (%) | 3.3 | 3.6 | 3.9 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 3.0 | 3.8 | 4.2 |
| HICP (y/y) | 11.8 | 8.8 | 7.2 | 5.7 | 4.5 | 3.7 | 3.1 | 2.3 | 9.0 | 8.4 | 3.4 |
| Public Budget[1] | | | | | | | | | -2.3 | -1.8 | -1.0 |
| Public Gross Debt[1] | | | | | | | | | 67.4 | 67.5 | 66.2 |

*1: Pct. of GDP*
*Source: Eurostat, Danske Bank*

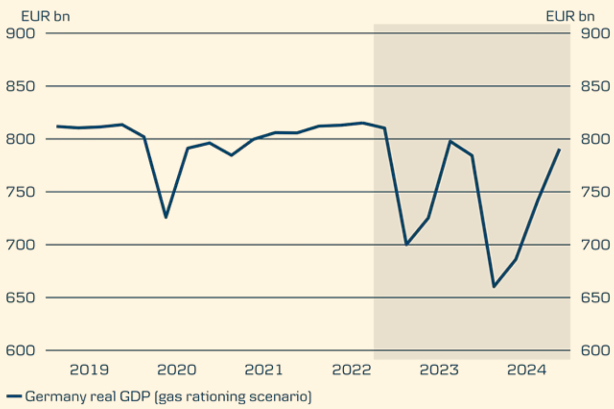
## *What does gas rationing mean for the economy?*

Ever since Russia curtailed gas supplies via the North Stream 1 pipeline, concerns about German energy shortages this winter have been mounting. A combination of factors, such as the weather, the availability of alternative energy supplies and the behavioural response of households and firms (who account for two-thirds of gas consumption) will determine whether gas rationing and blackouts can be avoided this winter.

Refilling of gas storage has occurred faster than expected, with most targets met roughly two months in advance. Diversification efforts as well as energy savings measures have been stepped up and gas consumption currently lies 20-30% below average, which is also partly due to warm weather. Still, it is too early to declare victory as continued high LNG deliveries to Europe are by no means assured and storage levels cover only roughly 2-3 months of demand during the peak heating season.

In case of a shortfall in gas supplies, the Federal Network Agency will determine supply for different sectors. Protected customer groups such as households, essential social services and district heating systems would be the last to experience rationing, while 'non-essential' energy-intensive manufacturing sectors such as chemicals, base metals, paper and glass will be most exposed. Gauging the economic consequences of such a drastic intervention is a difficult exercise, as no historical precedent exists. However, model simulations by German think tanks find devastating consequences for the German economy, which could trigger a decline in GDP by almost 8% in 2023 and more than 4% in 2024, an even deeper economic hit than during the Covid-19 pandemic.

### Sharp decline in GDP in case of gas rationing




*Source: Destatis, Gemeinschaftsprognose*

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# *Global Danske Research*


Global Head of Research
Heidi Schauman
+358 50 328 1229
heidi.schauman@danskebank.com

**Macro**

Chief Economist & Head of
Las Olsen
+45 45 12 85 36
laso@danskebank.com

Aila Mihr
+45 29 31 02 56
amih@danskebank.com

Allan von Mehren
+45 45 12 80 55
alvo@danskebank.com

Antti Ilvonen
+358 445 180 297
antti.ilvonen@danskebank.com

Bjørn Tangaa Sillemann
+ 45 45 12 82 29
bjsi@danskebank.com

Frank Jullum
+47 85 40 65 40
fju@danskebank.com

Louise Aggerstrøm Hansen
+ 45 45 12 85 31
louhan@danskebank.com

Minna Kuusisto
+358 44 260 9979
minna.kuusisto@danskebank.com

Pasi Kuoppamäki
+358 10 546 7715
paku@danskebank.com

**Sweden**

Head of
Filip Andersson
+46 8 568 805 64
fian@danskebank.com

Chief economist
Michael Grahn
+46 8 568 807 00
mika@danskebank.com

Jesper Fjärstedt
+46 8 568 805 85
jesppe@danskebank.com

Stefan Mellin
+46 8 568 805 92
mell@danskebank.com

Therese Persson
+46 8 568 805 58
thp@danskebank.se

**Fixed Income Research**

Chief Analyst & Head of
Jan Weber Østergaard
+45 45 13 07 89
jast@danskebank.com

Jens Peter Sørensen
+45 45 12 85 17
jenssr@danskebank.com

Piet P.H. Christiansen
+45 45 13 20 21
phai@danskebank.com

**FX and Corporate Research**

Chief Analyst & Head of
Kristoffer Kjær Lomholt
+45 45 12 85 29
klom@danskebank.com

Arne Lohmann Rasmussen
+45 45 12 85 32
arr@danskebank.com

Jens Nærvig Pedersen
+45 45 12 80 61
jenpe@danskebank.com

Kirstine Grønborg Kundby-Nielsen
+45 20 30 11 61
kigrn@danskebank.dk

**Credit Research**

Chief Analyst & Head of
Jakob Magnussen
+45 45 12 85 03
jakja@danskebank.com

Benedicte Tolaas
+47 85 40 69 13
beto@danskebank.com

Brian Børsting
+45 45 12 85 19
brbr@danskebank.com

Christian Svanfeldt
+46 076 721 6315
christian.svanfeldt@danskebank.se

Linnea Sehlberg
+46 8 568 80547
sehl@danskebank.com

Louis Landeman
+46 8 568 80524
llan@danskebank.com

Mads Rosendal
+45 45 12 85 08
madros@danskebank.com

Mark Thybo Naur
+45 45 12 85 19
mnau@danskebank.com

Marko Radman
+47 85 40 54 31
mradm@danskebank.com

Olli Eloranta
+358 407 715 769
olli.eloranta@danskebank.com

Rasmus Justesen
+45 45 12 80 47
rjus@danskebank.dk

Sverre Holbek
+45 45 14 88 82
holb@danskebank.com