Can Germany rid itself of the ‘Sick man of Europe’ label?

The current international debate on whether or not Germany is once again the 'Sick man of Europe' could finally bring about the long-awaited sense of urgency for a new reform programme by the government

Source: Shutterstock

It has been the big summer theme in Europe: weak growth, worsening sentiment and pessimistic forecasts have brought back headlines and public discussion about whether Germany is once again the ‘Sick man of Europe’. *The Economist* reintroduced the debate this summer more than two decades after its groundbreaking front page. The infamous headline seems currently justified when looking at the state of the German economy.

The 'Sick man of Europe' debate

The optimism at the start of the year seems to have given way to more of a sense of reality. In fact, the last few weeks have seen an increasingly heated debate about Germany’s structural weaknesses under the placative label “sick man of Europe”. Disappointing industrial data, ongoing problems in the energy-intensive industry and a long list of structural problems have fuelled the current debate. And indeed, no other eurozone economy is currently facing such a high number of challenges as the German economy.

Cyclical headwinds like the still-unfolding impact of the European Central Bank's monetary policy tightening, high inflation, plus the stuttering Chinese economy, are being met by structural challenges like the energy transition and shifts in the global economy, alongside a lack of investment in digitalisation, infrastructure and education. To be clear, Germany's international competitiveness had already deteriorated before the Covid-19 pandemic and the war in Ukraine.

To a large extent, Germany's issues are homemade. Supply chain frictions in the wake of the pandemic, the war in Ukraine and the energy crisis have only exposed these structural weaknesses. These deficiencies are the flipside of fiscal austerity and wrong policy preferences over the last decade.

Fiscal stimulus during the pandemic years and last year to tackle the energy crisis have prevented the German economy from falling deeper into recession. However, with our current forecast of a contraction of the entire economy by roughly 0.5% over the entire year and yet another contraction next year, the economy would basically be back to its 2019 level in late 2024. There are many varieties of illness and the German economy has clearly caught a few bugs due to its own lifestyle choices.

Has anything changed over the past two decades?

The current economic situation and the public debate in Germany feel eerily familiar to that of 20 years ago. Back then, the country was going through the five stages of grief, or, in an economic context, the five stages of change: denial, anger, bargaining, depression and acceptance. From being called 'The sick man of the euro' by *The Economist* in 1999 and early 2000s (which created an outcry of denial and anger) to endless discussions and TV debates (which revelled in melancholy and self-pity) to an eventual plan for structural reform in 2003 known as the 'Agenda 2010', introduced by then-Chancellor Gerhard Schröder. It took several years before international media outlets were actually applauding the new German Wirtschaftswunder in the 2010s.

In the early 2000s, the trigger for Germany to move into the final stage of change management – 'acceptance' (and solutions) – was record-high unemployment. The structural reforms implemented back then were, therefore, mainly aimed at the labour market. At the current juncture, it is hard to see this single trigger point. Generally speaking, the current situation is worse and better than the one in the early 2000s.

It is better because 20 years ago Germany breached European fiscal rules, while it currently has one of the most solid public finances of all eurozone countries, leaving sufficient fiscal space to react. What is worse is that there is currently a long list of other problems.

Finally, low unemployment is a bit of a blessing in disguise. While positive for the economy and very different from 20 years ago, low unemployment also seems to have reduced the sense of urgency for policymakers. Given the multifaceted challenges, it will be harder than it was in the early Noughties to find and then politically agree on a policy answer.

Another important difference between the current situation and two decades ago is the external environment. Back then, Germany had some good luck, or put differently, the economic reforms coincided with a favourable macro environment. Think of EU enlargement, which enabled many

German corporates to outsource production to much cheaper-wage countries in Eastern Europe. The rise of China on the global stage also brought an almost symbiotic trade partner. China had a strong appetite for German investment goods and at the same time flooded world markets with deflationary policies.

Finally, Germany actually benefitted from the euro crisis and the ECB's "whatever it takes" approach as interest rates were artificially low and the euro artificially weak. None of these factors will sugarcoat any reform efforts at the current juncture. If anything, China has become a rival and competitor and the ECB needs to fight inflation. This lack of any sugarcoating makes the need for reform even more pressing, but will probably also make these reforms initially more painful.

Waiting for 'Agenda 2030'

Structural reforms implemented in the early 2000s were mainly aimed at the labour market. This was known as 'Agenda 2010'. Today, the German economy needs an 'Agenda 2030'. Short-term fiscal stimulus can ease the pain but will do very little to regain international competitiveness and restructure the entire economy.

What Germany needs is a full menu card with policy measures. These measures could be categorised into those boosting confidence and giving companies security and clarity, as well as supply-side improving measures. In the first category, think of an energy price cap for industry. Not for one winter but for several years. Such a measure should be accompanied by a clear schedule for the energy transition. This would prevent more companies from exiting Germany and producing elsewhere. Combined with fast depreciation rules of investments in digitalisation and renewable energies, this could safeguard the economy's industrial backbone. With subsidies for sectors like artificial intelligence, batteries or hydropower, the government could support innovation.

Finally, less bureaucracy, more investment into e-government and consequently faster public tenders and implementation of federal investments at the regional level would strengthen the supply side of the economy. It is a long list that can easily be extended and broadened. One thing, however, is clear: any overhaul of the economy will be almost impossible as long as fiscal austerity remains the dominant tune.

The German economy is in for a longer period of stagnation. The new debate about the 'sick of man Europe' could finally increase the sense of urgency among decision-makers; more than a protracted period of de facto stagnation could.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de