



REPORT ON THE ECONOMIC SITUATION

3/2024

Optimism for the German economy?

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The economic policy discussions that took place in recent months often took on quite a harsh tone: Removal of agri-diesel subsidy – Increased strength of right-wing movements in rural areas, increase of the reduced VAT rate for the hospitality sector back to 19 percent – massive die-off of restaurants, missing subsidies for construction interest – those who build go bankrupt, high energy prices – extensive de-industrialisation and out-migration of basic industry. That is more or less what the headlines looked like. But how is the German economy really doing?

Considering the way in which the situation was exaggerated in the summer of 2022, when there was talk that high energy prices caused by the war in Ukraine could lead to double-digit losses in economic activity, the weak recession in 2023 and the current stagnating environment seems pretty mild by comparison. The energy crisis certainly had an impact in that it slowed economic growth. In 2022, prior to the war in Ukraine, the Expert Panel still expected the gross domestic product (GDP) to grow by 4.6 percent. Instead, this number was reduced to 1.8 percent because of the energy crisis. At the same time, the GDP did not suffer double-digit losses. Rather, quarterly developments in GDP growth have been around zero since Q2 2022, i.e. a stagnating German economy.

The same could probably be said for the other headlines noted above, even if the concerns expressed in those days do contain a kernel of truth. Privately, farmers accept that the removal of the subsidy will not be a major negative factor, but they are rightly concerned about the extensive regulations. The hospitality sector rolls over the higher VAT to the customer, but its problems in rural areas have little to do with taxes. And so on. After all, exaggeration is the name of the game for interest groups and the media.

Added to these are special factors that contribute to the lack of growth. Higher energy prices are particularly problematic because industry accounts for such a large portion of value creation in Germany; the weakness of the Chinese economy puts even more pressure on Germany's export-oriented economy; and higher interest rates mean that the construction industry cannot be counted on to support economic activity.

But this assessment still falls short. On top of the economic developments there are also structural problems. The German economy is facing a cost problem. Considering the demographic trends, it is unlikely that high labour costs will be reduced to any significant degree

(beyond the current excessive wage demands). High energy costs are here to stay, not least because of the required increase in carbon pricing as part of the climate policy. Added to the above are the high tax burden and the high cost of regulation. Moreover, politicians create uncertainty with regard to economic policy, or they further weaken the German economy with a misguided policy of prohibitions. Take the European ban of combustion engines as an example.

A look at the main competitors in the fight for the best business location can help with setting the correct course for the future. Essentially, the three large economic areas in the Northern hemisphere are fighting it out with regard to business location. But because of the existing geo-strategic rivalry, China has lost some of its attractiveness. While German direct investments have increased again recently, this is probably due to various large projects that had already been planned for some time. Overall, the Chinese economy reported an 8 percent decline in direct investments in the year 2023. The de-risking strategy of Western companies plays a major role in this context.

On the other hand, the US is still Germany's main competitor. Since the financial crisis - and definitely since the COVID-19 crisis - the American economy has performed much better than the German economy. Investments and innovation are also facilitated by the deep American capital market. Other factors are the Tax Cut and Jobs Act of the Trump administration, which greatly reduced the corporate tax burden, plus the already low regulatory intensity. A subsidy policy, which has been used by Germany and Europe for some time already, only recently emerged in the US. With or without the Inflation Reduction Act, it pays to invest in the US rather than in Germany. No wonder that German companies are very relaxed when it comes to the upcoming American presidential elections. It is not evident why the federal government is so confident that its proposed industry policies will change this situation.

Sincerely yours

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