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Germany as an Industrial Location

The German economy is currently in a difficult situation. Germany is the only one of the G7 countries that expects a shrinking gross domestic product in 2023. The Economist magazine asks whether Germany is once again the “sick man of Europe,” similar to in the late 1990s. The end of Russian gas imports through Nord Stream as well as rising energy prices have prompted energy-intensive industries in Germany to scale back production. Several companies want to relocate sites to countries with lower energy prices. All this has led to a debate about whether Germany is under threat from deindustrialization. This debate raises several questions. First, it needs to be clarified whether the problems are temporary or permanent. If the difficulties of German industry were solely a result of current crises, one might hope that it is only a dip and not a threat of permanent deindustrialization. Second, highly developed economies have been undergoing a structural shift for some time now – away from industrial production toward services. This raises the question of whether deindustrialization would be detrimental at all. Third, it needs to be clarified what contribution economic and fiscal policy can and should make to prevent undesirable deindustrialization.

Problems of German Industry: Temporary or Permanent?

The current debate on deindustrialization was triggered by Russia’s attack on Ukraine. The focus here is on energy shortages. Until now, the decades of stable energy policy cooperation with Russia ensured that Germany was supplied with comparatively cheap natural gas through the European integration of the gas market, especially in northwestern Europe. There were even plans to expand gas imports. In terms of price, natural gas supplies for German industry were between the low level in the US and the higher level in Asia, where reliance on liquid gas supplies was already much higher than in Europe. The decline in gas imports from Russia since Russia’s invasion of Ukraine and the destruction of the Nord Stream pipelines has made gas much more expensive in Europe. Even if more new liquefied natural gas terminals were built quickly, Europe would lose competitiveness in the price of natural gas to the US and Asia. One must assume that this shift is of a permanent nature. Even if the Ukraine war were to end soon, gas imports from Russia are hardly likely to resume. Another reason this shortage of natural gas is serious for Germany as an industrial location is that, according to previous plans, gas was to play an important role in the decarbonization of the energy supply. Following the phaseout of nuclear energy and electricity production using coal, an expansion of gas-fired power plants in Germany was to help fill the resulting gap and supplement the electricity supply from wind and solar power, which fluctuates due to weather conditions. At the same time, decarbonization of industrial production means that electricity demand from industry will increase sharply. A similar effect is seen in the conversion of transport to electric vehicles and the increased heating of buildings with heat pumps instead of oil

or gas heating. Although the electrification of industrial processes and heating also saves gas, gas shortages will nevertheless remain a problem for energy supply in the coming years.

A second consequence of Russia’s attack on Ukraine is that geopolitical risks to existing economic relations are attracting increased attention. Tensions between the US and China are intensifying. The scenario of a conflict between China and Taiwan has increased awareness as a downside risk for the global economy. While such risks had existed prior to the Ukraine war, they had been largely suppressed. In the wake of Russia’s aggression and China’s support for Russia, the risk of geopolitical conflict with China can no longer be ignored. Since German industry has particularly strong ties with China, these tensions heighten concerns about Germany as an industrial location. This change is not expected to be temporary either.

In addition, the future of Germany as an industrial location depends on whether it succeeds in overcoming longer-term and fundamental challenges. These include the shortage of labor in the context of demographic change, digitization, and decarbonization as mentioned above. The ongoing decline in Germany’s industrial production, even when compared to the Eurozone, suggests that the challenges facing the country’s industry are more than just temporary, crisis-driven weaknesses.

Structural Shift toward Services and Deindustrialization

In highly developed economies, a structural change has been taking place for decades in which the share of industrial production is declining in favor of services. Germany is a rather atypical case, with an almost stable share of industry over the past two decades. In Germany, there is a particularly widespread view that a high level of prosperity requires a high share of industry. At first glance, this seems difficult to reconcile with the fact that among the leading economies there is no systematic correlation between the degree of industrialization and their growth performance. For example, countries such as Japan and Italy had a significantly higher degree of industrialization in 2000 than the US, Australia, or the UK. However, their economic performance has been significantly worse since then. Germany also had a high level of industry and showed better economic development, even though the country could not keep up with the US. All of this suggests that there is no clear link between industrialization levels and growth, but rather that the different growth models reflect differences in the comparative advantages of different countries. Economic growth in the US has been strongly driven by the development of digital companies, while in Australia it is more likely to be commodity producers. For Germany, however, it appears that the economy has, at least so far, demonstrated comparative advantages in the industrial sector and in the

organization of highly efficient international value chains. If this is true, accepting deindustrialization in Germany with a mere shrug of the shoulders would be reckless at best. It cannot be taken for granted that industrial contraction can be offset by growing value creation in other sectors. This leads to the important question of what economic and fiscal policy Germany should implement in view of the challenges it faces as an industrial location.

Need for Economic and Fiscal Policy Action

Currently, Germany is discussing the introduction of a subsidized industrial electricity price as a measure to combat deindustrialization. Various forms of this are conceivable. For example, it has been proposed that electricity be made available to industry for 6 cents per kilowatt hour (KWh) (and even for 5 cents per KWh for firms which pay union wages. To incentivize energy savings, this would be limited to 80 % of electricity consumption (or a nonconsumption-based quota) in a reference year. Assuming that the rise in energy prices in Germany is permanent, it is obvious that subsidizing energy consumption in this way would be self-defeating. Proponents of the concept, however, argue that the subsidy should be paid only temporarily because the expansion of renewable energies will bring Germany falling electricity prices in a few years anyway. The electricity price subsidy, they argue, is merely a bridge to that future.

This argument has three weaknesses. First, recent studies suggest that electricity costs in Germany will be permanently higher than in many other countries, despite the expansion of wind and solar power. This is not only because the sun shines longer and more wind blows in other countries. The fact is that Germany, with its nuclear phaseout and renunciation of its own shale gas production, is pursuing a very specific and narrow policy that is tightening its own energy supply.

Second, an electricity price subsidy would be hard to justify even if the prospect of low electricity prices in the future were realistic. In this case, subsidies should not color companies' decisions on how to bridge temporarily high electricity prices. A market failure justifying such interventions is not discernible.

Third, it should be noted that procuring electricity at the lowest possible cost is an important management task today. Depending on its design, a state-guaranteed electricity price could impair or even eliminate incentives to purchase electricity as cheaply as possible and to make appropriate adjustments in return. This would be counterproductive. The proposal of the German Federal Ministry for Economic Affairs and Climate Action envisages reimbursing companies for the difference between the exchange electricity price and 6 cents per KWh. This would preserve the incentives for

individual companies to procure electricity as cheaply as possible. Nevertheless, there is ultimately no way around the fact that German industry will have to adapt to the changed energy prices. In doing so, it will not be possible to prevent particularly energy-intensive parts of production from migrating or being outsourced. The decisive factor is that this loss of added value is offset by other activities. This can be done through the expansion of other companies. The German economy still has many companies that operate with great success on domestic and global markets. Particularly worthy of mention here are the so-called hidden champions – i.e., highly productive companies that have risen to become world market leaders in their field, in some cases through extreme specialization and innovation. Providing these companies with better conditions for their development can make an important contribution. Moreover, it is important to make better use of the potential for business start-ups.

Broad-Based Supply Side Policy Required

Successfully leading Germany into the future as an industrial location requires a broad-based policy focusing on the supply side of the economy. The Growth Opportunities Act of 2023 has taken the first steps in this direction by improving the tax framework for investment. But this is by no means enough. Of central importance would be a reform package to strengthen labor supply. It should include amended crediting rules for the basic allowance, a reform of family taxation, better childcare, and improved incentives for longer working lives. Reforms of schools and vocational education and training could increase labor productivity. In energy policy, the aim should be to use market signals, i.e., prices geared to current shortages, and to expand infrastructure to achieve more efficient use of the available energy supply. Germany also has a strong interest in deepening the integration of the European energy market. Bureaucracy reduction, faster expansion of infrastructure for transport and data transmission, and more openness combined with less restrictive regulations for digital business models are further building blocks of this agenda. The challenges for Germany as an industrial and business location are immense, and the danger of deindustrialization must be taken seriously. The good news is that there are opportunities for economic and financial policy to create conditions that allow these challenges to be overcome.

Clemens Fuest
Professor of Public Economics and Finance
President of the ifo Institute

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