

THE VIEW

Economic Research
14 February 2020



IS GERMANY A STRANDED ECONOMY?

- 03 Recession avoided in 2019, but no rebound on the cards for 2020
- 04 Subdued economic outlook provides a glimpse of a “stranded” future
- 05 Structural headwinds are already blowing in the car sector
- 06 Why is Germany struggling with the digital transformation, despite its potential?
- 07 A lost decade is not a done deal for Germany, yet!

EXECUTIVE SUMMARY



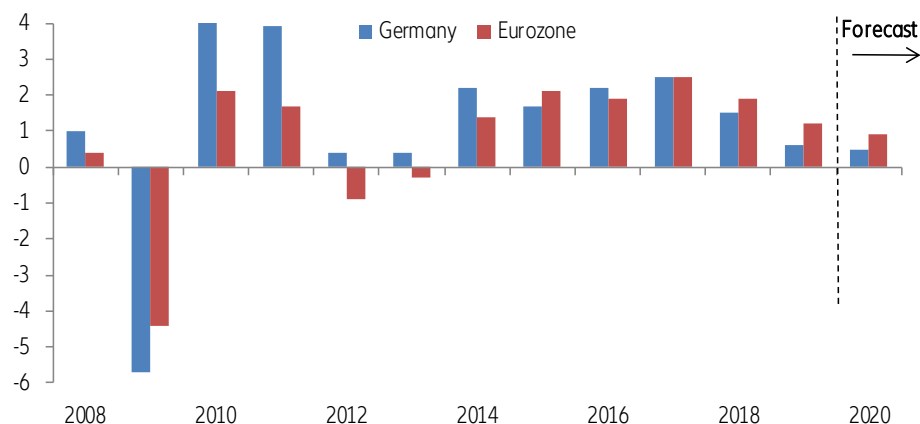
Ludovic Subran
 Chief Economist at Allianz and Euler Hermes
 +49 (0) 1 75 58 42 725
 ludovic.subran@allianz.com



Katharina Utermöhl
 Senior Economist Europe
 katharina.uterhoehl@allianz.com

- Recession avoided in 2019, but no rebound on the cards for 2020. At +0.6%, about half the rate for the Eurozone as a whole, German GDP grew at the slowest pace since the region’s sovereign debt crisis. We do not expect 2020 to bring much relief with GDP growth likely to slow marginally to a seasonally-adjusted +0.5%. Moreover the risk that Germany’s “golden” decade of uninterrupted economic growth – the longest period of expansion since reunification – will come to an end in 2020 remains on the table for now, given the cautious outlook for global trade and the automotive industry as well as lingering elevated political uncertainty over trade and Brexit.
- The subdued outlook for the German economy provides a glimpse of a “stranded” future. Europe’s economic powerhouse is struggling to keep up with structural change, putting it at risk of becoming a “stranded economy” with its long-standing competitive advantage in industry and in particular the car sector becoming obsolete. While the German economy remains highly innovative, it is increasingly struggling to leverage its potential, given the lack of even a basic digital infrastructure, a growing digital skills gap and inadequate start-up funding.
- But a “lost” decade for Germany is not a done deal, yet. What is needed is a significant long-term investment plan focused on upgrading infrastructure, updating the education system, boosting research & development capabilities and creating a venture fund to co-invest in promising start-ups. But solely throwing money at the problem is not the solution. Instead the German economy’s digital catch-up initiative needs to be accompanied by a “simplification shock” i.e. a notable reduction in red tape to allow for a better delivery of large-scale infrastructure projects, as well as to make life easier for corporates, particularly SMEs.

Figure 1: Real GDP (% y/y)



Source: Datastream, Allianz Research

RECESSION AVOIDED IN 2019, BUT NO REBOUND ON THE CARDS FOR 2020

After four consecutive years of strong economic growth above the potential rate, the high-flying German economy experienced a sharp deceleration in momentum in 2018. The combination of some key characteristics of Europe's largest economy – including its export-dependence, geographic export concentration (China, Italy and the UK account for almost 20% of exports) and large share of gross value added accounted for by industry – proved highly unfavorable in an environment of slowing global momentum and elevated political uncertainty. In addition, the dominance of the automotive sector turned from a core strength to major vulnerability, as production registered a marked setback, thanks to a homemade regulatory shock related to stricter emissions norms.

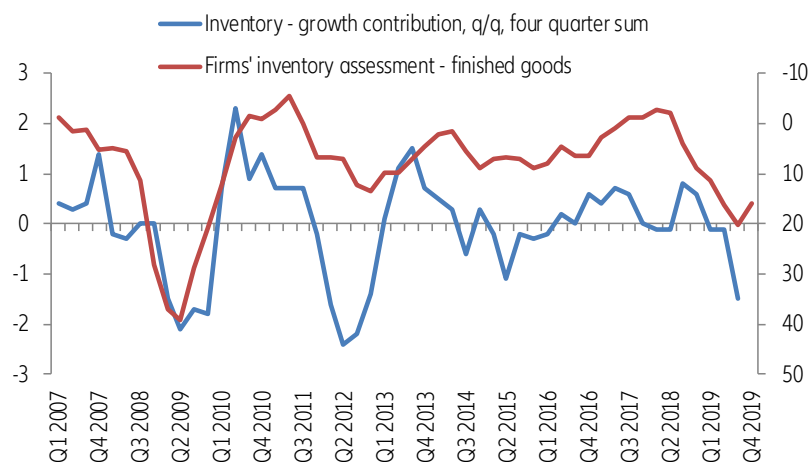
At 0.6%, about half the rate for the Eurozone as a whole, Germany recorded its weakest GDP growth rate since the region's sovereign debt crisis in 2019.

A recession was only narrowly avoided, thanks to a resilient German consumer and the ongoing boom in the construction sector. However, this is hardly a reason to celebrate, as a rebound in momentum is not in the cards for 2020. While the cyclical trough may be close – depending on the negative impact from the spread of the coronavirus which could even temporarily push the German economy into a technical recession in early 2020 – the German economy has yet to enter into a clear recovery mode.

Going forward the negative drag from inventories looks set to fade, but given

the cautious outlook for global trade and the automotive industry – which we recently downgraded further due to the expected negative impact from the coronavirus – as well as lingering elevated political uncertainty surrounding trade and Brexit, mini GDP growth rates can be expected at best in the coming quarters. Meanwhile the risk that Germany's "golden" decade of uninterrupted economic growth – the longest period of expansion since reunification – comes to an end in 2020 remains firmly on the table for now. Overall, we expect 2020 German GDP growth to register at a seasonally-adjusted +0.5% – less than half the economy's potential rate of growth.

Figure 2: Germany: Firms' inventory assessment (rhs) vs. inventories' quarterly growth contribution (ppt, four quarter sum, lhs, inverted axis)



Source: Refinitiv, Allianz Research

SUBDUED ECONOMIC OUTLOOK PROVIDES GLIMPSE OF A “STRANDED” ECONOMIC FUTURE

Germany's subdued economic performance in 2019-20 may well provide a pre-taste of what is in store for the world's fourth largest economy if its traditional growth engines of manufacturing and exports falter as the country fails to keep up with structural change. Missing the technology train would put the European economic powerhouse at risk of becoming a “stranded economy”, with its long-standing competitive advantage in industry and in particular the car sector becoming obsolete. In such a scenario, Germany's recent “golden” economic phase, could well be followed by a “lost” decade.

Warning signs hard to ignore

The flashing warning signs are hard to ignore, suggesting that Europe's largest economy is at risk of being left behind by the 21st century tech revolution:

- Apple's market capitalization recently surpassed the combined value of Germany's 30 largest listed

companies. It does not help that Germany lacks a recent tech success story in the DAX index. After all, the youngest listed IT company, SAP, was founded almost half a century ago.

- Comparative figures for unicorn start-ups – private companies that are valued in excess of \$1bn – provide additional food for thought: Out of 445 firms that qualify as unicorns across the globe, only 12 are based in Germany, compared with 217 for the U.S., 106 for China and 24 for the UK.
- Meanwhile, on key technologies such as artificial intelligence (AI), the economic importance of which is often compared to the invention of the steam engine or electricity, Europe and in turn Germany are lagging behind. In fact, more than 80% of global AI investments come from just two countries: the U.S. and China. According to the leading AI ex-

pert Kai-Fu Lee, Europe is not even competing for the bronze medal.

- Looking further at the micro level, Germany's business leaders appear to be asleep at the wheel: Recent surveys indicate that within the SME sector – which accounts for 70-80% of Germany's economic power – only every fifth company has a digitalization strategy and regards the topic as a priority.
- Lastly, Germany also punches below its weight when it comes to the number of start-ups founded per year. With 250,000 it clearly can't keep up with more than 6 million companies registered annually in China and the U.S., respectively. Globally, Germany now accounts for about 1.5% of all new businesses – this is only half of its share in global economic output, which stands at about 3%.

STRUCTURAL HEADWINDS ARE ALREADY BLOWING IN THE CAR SECTOR

For now, concerns that Germany's economy is falling behind largely center on the country's still much-envied car sector, which accounts for 5% of GDP and a third of total R&D spending. Germany has been a car country for more than a century. It is not a law of nature that this should remain so. After all, the production setback in 2018/19 – which in magnitude was comparable to the trend in 2008/09 – was to some extent already driven by structural headwinds, including stricter environmental regulation (in particular related to compliance with the WLTP deadline on September 1, 2018), the switch to e-mobility and emerging trends such as car-sharing, suggesting that a v-shaped recovery and a return to business-as-usual is not in the cards.

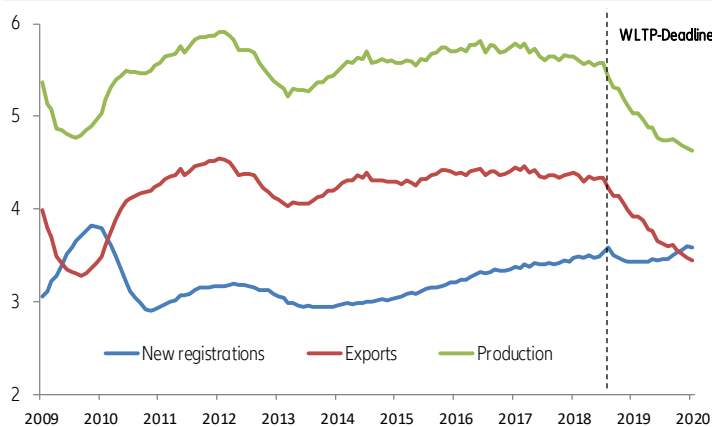
Out of the above mentioned factors, in

particular, the transition to electric vehicles will have far-reaching consequences for the sector as the focus in production shifts from highly complex mechanical systems to electronics. A key challenge is that the battery, for which production facilities are for the time being mainly located in Asia, makes up a significant part of the value added. Even if production in Europe were to increase rapidly, the net impact on employment would still be negative; studies estimate that over the next decade as many as 400,000 jobs could be at risk from the shift towards electric vehicles. So far, German automakers have played only a secondary role in the e-vehicle segment, as reflected in their relatively small share in global production. In fact, the world

market leaders in the first half of 2019 were Tesla, BAIC and Nissan, with no model produced by a German car maker making the top 10 most sold. The structural headwinds the sector is facing are likely to be felt already in the short to medium-term as consumers postpone car purchases in the face of regulatory and technological uncertainty. For instance we expect car sales in Germany – which so far have proved relatively resilient – to decline on average over the coming four years.

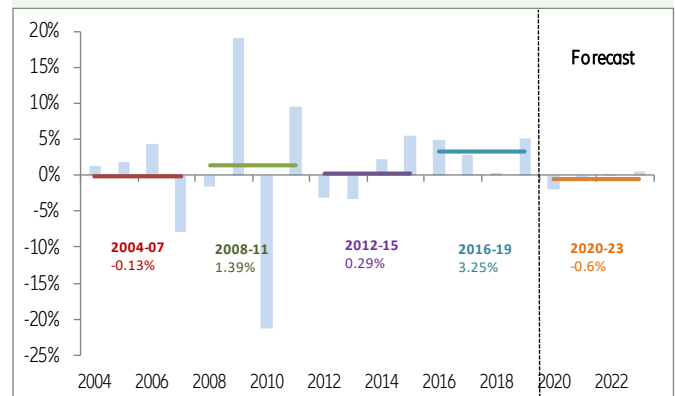
The car sector provides only one example where Germany's long-standing competitive edge could become obsolete. But with digitalization transforming most sectors of the economy, much more is at stake.

Figure 3: Car production, exports & new registrations (12-month moving average, in million)



Source: Datastream, Allianz Research

Figure 4: Domestic car sales (annual change vs. average growth over four-year horizon, in %)



Source: KBA, Allianz Research.

WHY IS GERMANY STRUGGLING WITH THE DIGITAL TRANSFORMATION, DESPITE ITS POTENTIAL?

To clarify, this situation is not for a lack of ideas. In fact, Germany regularly features among the top economies in international innovation rankings, thanks to high marks in the areas of R&D intensity, patent activity, productivity, high tech intensity and research concentration. Moreover, Germany has been making leading contributions in the fundamental research of key technologies. In fact, the foundations of modern AI were developed decades ago in Bavaria. Ernst-Dieter Dickmanns, a professor at the Bundeswehr University in Munich, began experimenting with robot cars as early as the mid-1980s. In 1995, he completed a trip of more than 1700 km travelling at a speed of up to 175 km/h. Today, German industry still holds half of all patents for autonomous driving.

So what is then holding back structural change in Germany, despite so much potential? We see three key areas that need to be tackled in order to boost Germany's ability to master the digital transformation:

1. **Basic digital infrastructure:** Even on the basic requirements for a successful digital transformation, Germany is missing the boat. The goal of nationwide coverage with gigabit-capable internet connections is still a long way off. Too much copper remains where fiber-optic should be. The results of the World Economic Forum's Global

Competitiveness Ranking help provide an international context: With an overall ranking of 72 for fibre-optic internet connections and 58 for mobile broadband connections, when it comes to information technology use, Germany has fallen behind Russia, China, all the Baltic and Nordic countries, and several Gulf countries as well. This is annoying not just for households that are unable to stream films at home. It also holds back small and medium-sized businesses in certain regions because companies with weak Internet connections work less effectively. Moreover, fibre is also key for the deployment of 5G, which in turn is essential for the implementation of major new use cases, such as the Internet of Things.

2. **Tech talent pipeline:** For one, there is arguably a lack of entrepreneurial spirit in Germany. In 2018, only a quarter of the German working population would have liked to be their own boss - a record low. As recently as 2000, the comparable figure was 45%. Moreover, the German economy's digital skill-set is in urgent need of an upgrade. Surveys show that the largest factor holding back digital competency in Germany is a serious lack of adequate equipment in schools. For instance, according

to the IEA's International Computer and Information Literacy Study only a quarter of German schools has wifi, compared to the international average of 65%. Meanwhile, in Germany only 3% of schools equip all teachers with their own laptops or tablets, compared to 24% for the international average and 91% in Denmark. Even more worryingly, in the Centre for European Policy Studies' EU index of readiness for digital lifelong learning Germany placed last.

3. **Venture capital funds:** Germany is lacking the necessary venture capital to turn great ideas into great business models and companies. While the country has a long tradition of innovation taking place in mid-sized companies, there is little awareness of the contribution that start-ups provide in adopting new technologies and developing marketable products. Insufficient financing for innovative companies – in particular in the later “scaling-up stage” – is frequently cited as a reason why they do not base themselves in Germany, or Europe for that matter. In fact, the absolute amount of risk capital in Europe is only about a sixth of that in the U.S..

A LOST DECADE FOR GERMANY IS NOT A DONE DEAL, YET!

Making sure that Germany's digital transformation is a success is not just fundamental to safe-guarding the country's economic prosperity but in the end it is also about retaining its digital autonomy and in turn protecting its free and democratic society. So what can be done to keep Germany from becoming a "stranded" economy?

Clearly part of the answer is the government launching a significant long-term investment plan aimed at future-proofing the German economy, with a particular focus on upgrading its infrastructure, updating its education system to enable digital life-long learning, boosting its research & development capabilities, with a focus on application-oriented research, and creating a venture fund to co-invest in promising start-ups.

However, solely throwing money at the problem is not the solution. According to a study by the Hertie School of Governance and the OECD, Germany does not do particularly well in the planning

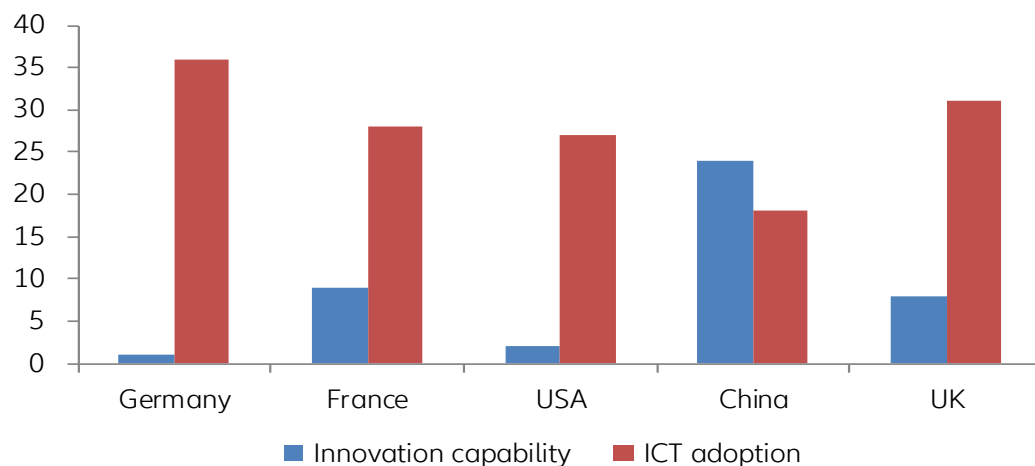
and implementation of major infrastructure projects (rank 18 out of 36). Excessive bureaucratic procedures and demanding legal regulations are named as the greatest weaknesses. This does not surprise, given that since 1990 the number of building regulations has quadrupled from 5,000 to 20,000. Therefore, given the urgency of the matter, critical infrastructure projects, such as an upgrade of the telecommunication infrastructure, should be given special regulatory treatment, including fast-track permits.

Why stop there when in fact a "simplification shock" i.e. a notable reduction in red tape would also help boost business activity? After all, excessive regulation and legal requirements are usually cited as the biggest obstacles to doing business in Germany. Germany's Ministry for Economic Affairs and Energy estimates the annual costs to firms from bureaucracy at EUR45 billion – about half the total amount invested in R&D in 2018. Ideas aimed at

cutting red tape include the relaxation of reporting requirements, as well as simplified approval procedures for SMEs – in particular in the area of starting a business, where Germany ranks 125th out of 190 countries, according to the World Bank's Ease of Doing Business Survey – and the set-up of an intelligent e-government.

Last but certainly not least, since market size matters, it is mission-critical for Germany to think and act European in its digital catch-up initiative wherever possible. This includes pushing for an expansion of the EU single market to cover also data and risk capital, as well as for the completion of the Capital Market Union to make it easier for start-ups to get funding and to scale up. Similarly, a coordinated broadband expansion and a harmonized 5G rollout across the EU are also essential. Finally, European competition rules should be bolstered to avoid unfair competition from big market-dominating digital companies.

Figure 5: World Economic Forum's Global Competitiveness Index 2019: Rankings in sub-categories



Source: WEF, Allianz Research

Director of Publications: Ludovic Subran, Chief Economist
Euler Hermes Allianz Economic Research
1, place des Saisons | 92048 Paris-La-Défense Cedex | France
Phone +33 1 84 11 35 64 |
A company of Allianz

<http://www.eulerhermes.com/economic-research>
research@eulerhermes.com



[euler-hermes](#)

[eulerhermes](#)

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.