Germany economic update: emerging impact of the war in Ukraine

Market Report

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Prepared by the New Zealand Embassy in Berlin

Summary

- Germany – Aotearoa New Zealand's number one trading partner in Europe – is particularly exposed to the economic effects of the war in Ukraine, western sanctions, threatened energy security and stressed supply chains. As a result, Germany's post-COVID-19 economic recovery will at best be delayed and at worst reversed, with trade in goods and services with Germany remaining challenging.

Report

- Germany is the largest economy and our number one trading partner in Europe. It is also Russia and Ukraine's second most important trading partner. Importantly, Russia is Germany's number one source of gas (>50%), coal (>50%), and oil (>30%). This report canvasses the broader impact of the war in Ukraine on the German economy and the potential effects on our bilateral trade.

German economy 2022: a recovery at risk

Prior to the war in Ukraine, the German economy seemed to be up for a good year, but now the outlook is more sobering. The most immediate impact of the war relates to Germany's trade with and investment in Russia and Ukraine. Last year Germany exported goods worth €27 billion to Russia and has invested a total of €25 billion. Western sanctions, the proactive withdrawal of German businesses and a recession in Russia will see exports collapse and a lot of investment written off. As a result of disrupted business and war-related destruction, economic relations with Ukraine will also suffer significantly. And the war in Ukraine will have even broader impacts on the German economy.

Energy insecurity

Germany's heavy dependence on what have until recently been relatively cheap and stable **energy imports** from Russia has suddenly become a major economic risk. German industry relies on the import of Russian gas – sent direct to Germany via pipeline – and does not currently possess national terminals for the import of liquefied natural gas. Russian gas continues to flow into Germany for now, but with a European (or Russian) energy embargo looming and the German Government seeking to reduce dependence as quickly as possible, gas prices on the spot market have increased tenfold year on year, despite businesses anticipating a decline this year. This is driving both electricity cost and the cost of using gas in industrial processing, making certain economic activities economically unviable.

Supply chains

German industry supply chains are taking another major hit. Not only are German-Russian and German-Ukrainian supply chains disrupted, the situation is also impacting other shipping schedules to and from German ports such as Hamburg. German shipping companies are also reporting a loss of Ukrainian and Russian seamen.

Air cargo between Europe and northern Asia has been complicated by sanctions on Russian providers, with aviation now having to avoid Russian and Ukrainian airspace, meaning detours which drive fuel costs and reduced freight capacity). The previously fast-growing cargo train connection between China and Germany – via Russia –is also liable to disruption. Complicating the picture too are reports that Ukrainian drivers operating in Germany have left their jobs to fight in the conflict. Petrol prices have reached record highs, putting serious strain on smaller carriers. All of these factors are limiting freight capacity, driving the cost of shipping, and resulting in delays or even the temporary halt of production.

In the wake of Russia-related disruption, economic growth is now expected to turn negative again this quarter, signalling a `technical recession´ with inflation (currently at 5%) increasing further. At least for now, economic recovery is still expected to continue slowly over the remainder of the year (1-3% growth), but a full recession and/or longer period of `stagflation´ is also possible, depending on further developments in the energy markets. The German Government has already announced various support measures such as cheap loans for affected businesses, investment in a national gas reserve and support for low-income households. More measures are still under discussion at the time of writing but what is already certain is that the Gerrman Government will accrue more public debt this year to keep the economy afloat.

Potential impact on New Zealand-Germany bilateral trade

In 2021 bilateral trade remained somewhat suppressed by COVID-19, which can be largely attributed to the fact that no German tourists travelled to New Zealand. New Zealand goods and services exports to Germany in 2021 were below NZD$1 billion last year for the first time in years, whereas German goods (in particular vehicles) and services exports into New Zealand reached NZD$3.6 billion.

In the **meat** sector, European producers are experiencing rising costs for feed (e.g. grain.), fertiliser and energy, and as a result meat prices are expected to increase, potentially improving the price competitiveness of New Zealand produce in the German market. On the other hand, growing inflation and declining consumer confidence could have a dampening effect on the market. This could potentially also extend to New Zealand's fruit, honey, and wine exports to Germany, although these sectors look less directly affected than arable and meat.

Prior to the war in Ukraine, surveys suggested a record appetite for holiday travel in Germany. While the German tourism industry admits that the war is an additional challenge, it appears to remain confident that Germans will still be keen to travel more .l. History suggests that regional wars, natural disasters and/or terrorist attacks may influence German holidaymakers change destinations, but not their general intention to travel. That being said, rising energy cost and sanctions requiring airlines to fly detours are expected to trigger ticket price increases, and travellers may make bookings later, given the grown uncertainty.

Looking at New Zealand's key **imports** from Germany, we note that the loss of important car parts previously produced in Ukraine (for Volkswagen and BMW in particular) and metals from Russia is posing yet another supply chain challenge to the German car industry, triggering temporary production stops. Combined with full order books, New Zealand customers may experience delivery delays and rising prices, not only for German cars but also lorries, tractors and agricultural machinery.

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