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SNAP ANALYSIS

A Domino (Economic) Interdependence: **Russian Gas, German Industry, Romanian Subcontracting**

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The steep increase in energy prices that became evident after the invasion of Ukraine by Russia created a plethora of direct and indirect effects, some intended, some unintended. While the entire global economy is under stress, the most turbulent consequences in the 'developed' part of the world are prone to take place within the Euro area and - especially - affect the EU's industrial champion: Germany.

More precisely, with a disproportionate part of its GDP generated by exports to third countries, Germany is particularly sensitive to energy prices (with an emphasis upon gas), as its industry is energy intensive in the manufacturing sector. In addition, Berlin lacks the nuclear component to offset a drop in inputs of cheaper (Russian) gas to produce electricity even for household consumption.

At the time being, flows through Nord Stream 1 have dropped consistently under pre-war levels, while a gas shutoff is not inconceivable. Preparing for such scenarios is not an easy task, as Germany's gas storage capacity only reaches about 25 bcm (2 months's winter consumption) and does not possess - on the short-term - sufficient LNG-import capacity. Thus, IMF experts estimate that such a decoupling from Russian supplies could have an impact of more than 5 percent of the GDP and generate inflation up to 2.5 points the following year (accounting only to the direct effects).[1]

From a sectorial perspective, Germany's automotive industry - responsible for a consistent part of its exports - had been already suffering a relative decline during the pandemics, due to blockages in global supply chains, while also adjusting to the 'transition' to a green economy. Now, the combined effects of the war - with higher prices, a lack of alternative supply and an overall export-oriented business model appearing to crumble - are more acute.

[1]Ting Lan, Galen Sher, Jing Zhou, 'The Economic Impacts on Germany of a Potential Russian Gas Shutoff', IMF Working Paper No. 2022/144, 19 July 2022.

Raw economic data show that Germany's manufacturing PMI is dropping fast, along with the Business Climate Index that reflects companies' confidence in recovery/growth[2], reaching some of the lowest levels since the 2008 global crisis. That reflects both an incapacity to maintain customer demand steady (as everyone around the globe is financially affected and not necessarily keen to buy higher-priced German goods) and a no-confidence perspective of global markets in Berlin's possibilities to navigate through this economic storm.

At the same time, such a drop in demand for German products will generate indirect effects upon subcontractors and suppliers for the industry. And Romania is definitely one of these. Germany represents Romania's largest export market (accounting for 22% of its overall exports), mainly components for the automotive sector.[3]

From another perspective, Germany is second only to the Netherlands (very often serving as proxy for other countries in FDI-related issues) in terms of invested sums in Romania, with FDI stocks rising to more than 11 billion EUR at the end of 2020.[4] Moreover, the total number of employees in direct relation to German business ventures is as high as 200000, transforming Berlin into an unique (and largely irreplaceable) business partner for the national economy.

As regards the manufacturing sector, the most active - and significant - German companies operating in Romania are Continental, Bosch, Dräxlmaier, Daimler, Leoni (with more than 50000 local employees) along with a multitude of subcomponent manufacturers. Such businesses are fully integrated with the functioning of the overall German industry and directly rely on the producer of the final goods for their upcoming orders (and solvability).

[2] See, in this regard, the recent survey published by ifo Institute, 'ifo Business Climate Germany: Results of the ifo Business Survey for July 2022', 25 July 2022.

[3] According to UN Comtrade Data for 2021.

[4] See the report published by the National Bank of Romania, 'Foreign Direct Investment in Romania in 2020'.

In addition, there are numerous German companies present in the retail sector such as Kaufland, Lidl, Rewe or Selgros - leaders in the Romanian market - which are highly dependent upon their group's capacity to negotiate and deal globally in ensuring stable supply chains. For such complex operations, trouble at home means trouble elsewhere, as pressure from the metropolis tends to spread across the entire network of commerce.

Therefore, a decline of the German economy is prone to produce effects EU-wide, including Romania. A drop in Berlin's exports and - consequently - GDP will not be limited to the Euro area, but will affect all those integrated in the German business networks. While Romania's relative energy independence makes it more insulated from the perils of a Russian cutoff, it is - nonetheless - under the constraint of its German customer for auto components and the mother-companies' capacity to arrange global supply chains. Such a tendency might not only translate in lesser profits and taxes paid locally in Romania - and, thus, a short-term contraction for the national budget - but also in higher unemployment.

Nonetheless, for many local subcontractors this could, as well, prove to be a (forced) opportunity to diversify their customer base and benefit from Romania's embedded energy advantages on the global market, while also transforming German subsidiaries here into more lucrative points of economic interest. In the end, much depends upon Bucharest's own capacity to harness its circumstantial superior position in regard to energy and low employment costs. Troubles may be European, but solutions can be national.