Allison Nathan: Germany slipped into a technical recession earlier this year as the export-heavy country struggles with a weaker manufacturing sector, high inflation, and a war on its doorsteps. At the same time, the country is contending with multiple immense transitions. It's aiming to rapidly decarbonize energy production, and its prized auto industry is rotating from combustion engines to electric. If that weren't enough, its relationship with China, a key source of growth in a critical export market, is under pressure.

So how are German companies and investors adapting to the macro and market pressures?

Wolfgang Fink: Given the amount of investment required to transition this economy and particular its
industrial base into a more sustainable renewable energy world, it's massive. It's massive investment, and it's massive investment not only at the micro side -- i.e., the company side -- but also on the macro side -- i.e., the whole infrastructure that is required.

**Allison Nathan:** I'm Allison Nathan, and this is Goldman Sachs Exchanges.

To help us understand the pressures facing Europe's largest economy and what German companies are doing to adapt, I'm speaking with Wolfgang Fink, CEO of Goldman Sachs for Germany and Austria. Wolfgang, welcome back to the program.

**Wolfgang Fink:** Thank you. Thank you for having me again.

**Allison Nathan:** So let's start with some macro context. Germany's underperformance has been one of the year's more notable surprises on the macro side. Why is the country finding itself in a weaker position?

**Wolfgang Fink:** Yeah, Allison, I think part is what we're
experiencing globally. The inflationary pressures that are weighing on the economy and on the consumer. Also, as we come out of COVID, there are very mixed signals that we are seeing also in the Germany economy, particularly if you think about the de-stocking that was going on post COVID, restocking. And that is giving us a lot of mixed signals as to how much the producing economy is really producing in the wake of the rapid de-stocking going on.

There is the big topic of energy transition, which is weighing on those companies. And clearly, another big topic, the dependency of the economy on exports, and particularly on exports to China, which has been experiencing a very bumpy reopening itself. So all of these factors are weighing on the economy in different forms. Hence, you see the overall picture, which is sluggish or even recessionary.

**Allison Nathan:** And as you said, China is Germany’s largest trading partner. It is also having a very disappointing performance this year, but Germany is taking steps to reduce that reliance on China. Talk to us about what you're seeing companies doing in that regard.
Yeah, I think it's well documented how dependent the German economy as such and in particular also the manufacturing economy is depending on China. And it has been, frankly, one of the success stories, I'd say, over the last, let's say, 30 years. And what you're seeing now is that, both on the export side where China is the second-largest destination after the US, and particularly also on the import side. The country's manufacturing economy is highly dependent on China.

Now, clearly COVID has seen some of the limits of that partnership already with the disruption in the supply chains and the questions about near shoring and a higher resilience in supply chains. The bumpy reopening now of China that I mentioned is another one where the German economy faces direct consequences of the issues that China faces itself. So that all has led companies to re-think their dependency on China, both on the sales and the distribution side but also on the manufacturing side.

On the other hand, it has led the government to come out and say, “Companies need to reduce dependency on China.” Now, that's all easier said than done. It's a long process, but signs of diversification in Asia itself where
companies, for example, go to Vietnam, go to other states, build up presences elsewhere to reduce dependency. But also you see it in Europe itself where there's an ample discussion about what needs to be shored back to Europe? What needs to be produced in Europe rather than in China?

Now, having said that, that all comes with a lot of costs and obviously skilled labor, regulation, and other issues. So it's a slow process, but clearly the problem has been, let's say, recognized. And there's not a single company that doesn't actively asks in their boardrooms today, “Okay, how dependent are we? And what can we do to reduce dependency in a sensible manner,” recognizing that a lot of their products still go there, recognizing that a lot of the margins are made in this market, and that there's a tendency as well in China to look at what these companies are doing.

So we're seeing a lot of strategies being developed, but I would say emerging you could see China for China as a strategy -- i.e., produce locally for the local demand but less reliance on China as a production hub for elsewhere. And then on the other hand, reduce exports from Europe
into China -- i.e., go local in order to basically better control the growth and the market activity you have there. Just two examples as toward the micro level and the macro level, as I just said. More government push towards diversification.

**Allison Nathan:** But as you said, this is a slow-moving process, so we're talking three-, five-, ten-year type of transition. Nothing that we will see second half of this year into 2024.

**Wolfgang Fink:** Absolutely. Yeah. And then the nature of the process is such that adaption and also the relations with the customers there will take time.

**Allison Nathan:** And you also talked about inflation. Obviously, it's been a huge problem across the developed world. How has that been affecting consumers and their spending patterns? What are you hearing from companies in that regard?

**Wolfgang Fink:** Yeah, in that regard, we have seen a softening of the consumer demand and mainly due to, as you say, the inflationary pressures that we are seeing. No
exception in Germany in that regard. I think interesting, though, there is still a lot of savings that the consumer has from the pandemic area, so that is cushioning a bit the fall in demand there or the reluctance to spend.

The other thing we are seeing is that wage growth is still there and is still happening. Hence, if you now look at more abating inflation pressure, if you look forward, and wage growth and the savings cushion that's there, we feel quite positive about consumer momentum going forward, despite the softening we see now.

Now, having said that, there are clearly a lot of demands as well to raise wages. There are wage rounds for many of the industrial employees coming in the second half, and the demands are very high. In many cases, double digit wage growth demands. And while that would obviously help to increase real economy in the household pockets, it will add to further inflationary pressure in the economy.

There's certainly a mixed picture there, but we are more constructive as to the coming months in terms of consumer holding up. We have seen some weakness, as you rightly say, in the recent months, and that we need to obviously
Allison Nathan: And in fact, labor still very much has the upper hand in the economy. As you said, wages are rising. Unemployment is near historically low levels. Why has the labor market been so resilient in the face of these macro headwinds?

Wolfgang Fink: Yeah, it's a very interesting phenomenon, which we also see elsewhere, but in the German economy, clearly there still has been a gap in terms of a labor shortage, given the ramp-up that we have experienced throughout the economy post COVID. Having said that, that gap is narrowing. So we see that there is less openings and clearly a softening.

Now, the interesting thing is the softening is happening in the manufacturing sector. We have seen more growth in the services sector, and that's interesting for an economy that traditionally is very much tilted towards where the weight of the manufacturing sector has been quite strong and prominent compared to other European economies. So there's a shift going on through the services part of the economy. Wage growth in the services part of the economy
has been stronger, also.

But having all said that, we're seeing a softening there, and so you have to watch this time lag that we're experiencing from the manufacturing sector coming down through the wages and the wage growth and, therefore, the opening's coming down. It's a transitory phenomenon.

And the other thing that concerns us a bit is the labor productivity. Where we have a lot of people in the job, the labor productivity is shrinking or is reducing. And in a way, that's a challenge for the economy as well. It would add to inflationary pressure if you need more labor to do the same output, but it clearly would also spur investment in automation in order to get more productive again.

**Allison Nathan:** We also hear a lot about how restrictive policy is in terms of the labor force. Is that a factor, having a role here on how quickly the labor market can adjust?

**Wolfgang Fink:** Absolutely. No, that's clearly a key point for the economy. It has been talked a lot about. The inflexibility of the labor market due to a lot of regulation and red tape is clearly a factor in this adjustment. It has
also basically stalled a low-wage sector from a very flexible element of the labor economy really fully developing. And it's still also a problem within the European Union, that the shift of labor within the union isn't as fluid as you would hope. And hence, all those phenomena make the economy less adaptive and again, I would say, ultimately, will force companies to look more for automation or for, again, going outside Germany or even the EU to source cheap labor. And that can't be in the interest of policy.

So something has to give there. And clearly, the more flexible labor sector is a key point on the reform agenda.

**Allison Nathan:** And you mentioned early in the conversation the focus on the energy transition, which has been such an important topic for Europe in the wake especially of the Ukraine conflict. Where are we in that green transition? And how is it affecting sectors of the economy at this point?

**Wolfgang Fink:** Yeah, I think what you have seen, especially when you look at the end of 2022/23 beginning, and the concerns of many observers as to how quickly the economy can adapt. In the wake of the war, the
consumption of hydrocarbons -- in particular, gas -- has been reduced drastically. The gas consumption of the German [UNINTEL] has gone down by approximately 30%.

Now, having said that, that you got by production cuts and easy-to-fix measures. Now, to go further in transitioning into green energy sources will require much more investment. So I'd say the easy part of that is done. The more complex part is coming, which is associated with a lot more CapEx and investment. And clearly there you need to have government stimulus, which is there but needs to actually flow through to basically foster that investment. And then bureaucracy -- i.e., permits and what have you -- to allow these companies to quickly readjust.

So you see the hard innings ahead of the economy and that are the businesses in the transition. But clearly, there's a lot of awareness that this needs now to happen and that government and the industry will have to work together to achieve the next step in order to reach the ambitious government targets -- the 2030 targets -- that clearly will be, from today's point of view, a major challenge, not necessarily technologically, but also in order to get it done and get the permits and get it executed.
**Allison Nathan:** And so are you already seeing signs of that CapEx and that investment on the company side? Or what other specific measures are companies taking at this point?

**Wolfgang Fink:** Yeah, I think you definitely see that. You definitely see companies thinking very hard, “How can I greenify my energy sources?” Simple examples, I buy a stake in an offshore wind park, so that gives me an amount of green energy I can work with in order to when I procure my own energy, swapping agreements.

But I think, again, to get to the targets of the economy that says economy-wide emissions have to be reduced 65% compared to 1990, 65% in 2030 or by 2030 and 88% by 2040, a lot more measures will to be taken. And I think what you see there is the build-out of the renewable energy sources is slow, and it's slow because A) the whole permit, bureaucracy, red tape that's required to get it done is still from a time that actually hasn't felt the urgency that we're now feeling today. So whole bureaucracy processes, permits, etc., have to be overhauled, have to be streamlined in order to get that investment executed.
And then secondly, clearly the capital. Companies are spending a lot of money in their CapEx plans to do it. The government is willing to spend a lot of money. Private investment will be needed. But you've got to build the funnels for that money to flow. And you've got to build the infrastructure of permits, permissions, etc., to get that money to be invested quickly. And I think we're in a race there in order to get to these very ambitious targets.

**Allison Nathan:** So Germany is widely recognized for its auto industry. How is that sector adapting to this challenge?

**Wolfgang Fink:** Yeah, I think the auto industry is obviously a case in point of what we just discussed. Very successful in their traditional technology with the combustion engines globally world recognized. They're now facing the transition to e-mobility. And I'd say that the auto industry has had a slow start in adapting, but now you see even on the street the battery electric vehicles of that industry or of the large auto companies, those models have been designed 2016/17. We are in the process of designing the real battery electric vehicles right now that
will come to the customer in four or five year. And hence, there was a slow start.

Having said that, given the technology strength and also the brands that have been established over many years to trust with the customers, this industry isn't a catch-up mode. So while you had first movers -- let's say, Tesla in the US and obviously increasingly the Chinese producers -- the trust and the marquee and the brand will help this industry to catch up. Let's put it this way.

An interesting point is still that most of the profits of that industry is generated by traditional technology. And a huge profit pools all over the world that this industry is tapping or is basically benefiting from. That pays for all the investment in battery electric technology.

Having said that, it's a complex transition. It doesn't only involve propulsion technology, it involves connectivity on the digital side. It involves new distribution, go-to-market models. And clearly, they are facing, at this particular point, heavy competition from not only Tesla and the US but massively from China's producers, especially in the volume segment, which is small cars, compact cars, that
are usually attracting much higher demand, much higher volumes globally. And I think, if you watch the battle, so to say, in the volume segment for market share and customer attention, the competition from China is extremely strong, extremely successful, and very price conscious. And hence, in the consumer environment that we just discussed, they're gaining share.

It's a multifaceted challenge. I would still say that, given the technology base that the traditional producers from Germany have, we think ultimately it could stand a very good chance to come out successful in this transition.

**Allison Nathan:** And more broadly, if you think about all of the challenges that the German economy is facing right now, what does foreign investment in Germany look like?

**Wolfgang Fink:** Yeah, I'd say that, given the amount of investment required to transition this economy, in particular its industrial base, into a more sustainable, renewable energy world, it's massive. It's massive investment, and it's massive investment not only at the micro side -- i.e., the company side -- but also on the macro side -- i.e., the whole infrastructure that is required.
Germany has a particular issue here where most of the energy that you can generate in a renewable way is generated in the north, and most of the production, the production base for -- we just discussed the auto industry -- is in the south. So we need to get the energy from north to south, so you've got to build the whole infrastructure there. So it's a massive undertaking with massive amounts of money necessary.

Now, companies are ready to spend. The government has put out big spending plans. And clearly, there's a huge demand from international investors for such transition. As I said before, though, the pipes to make that transition and this financing fluid and working fast haven't really fully built. And hence, we see a lot of interest, but we're just seeing more investment, international investment, coming to Germany. And I think it's a key topic for the government and its agencies in general to build an infrastructure, also from a regulatory point of view, from the returns that are allowed, for example, for large infrastructure projects, to get that done, to make the money flowing.
**Allison Nathan:** And clearly, technology investment is key. What is Germany doing when we think about artificial intelligence that's so in focus, software investment? What actions is the government taking? What actions do you see companies taking?

**Wolfgang Fink:** I think in particular on the company level, the whole question of digitalization and moving to a digital economy has been front and center for many years. Companies have seen a lot of change, in particular from very innovative parts of the global economy, be it in the US, be it in Asia. And the adaptation to that world in their production processes, in their manufacturing, in their go-to-market sales, has been a key topic on every CEO's agenda. So that's ongoing.

The government, on the other hand, has put out strategies, in particular for artificial intelligence, and had put out programs in order to foster that. I would say that the private sector is certainly ahead given the necessity to adapt quickly. And part of it is coming back to some of the topics we discussed -- energy, on the one hand, or the labor shortage, finding labor demand, being more efficient with production.
Near shoring was a digital infrastructure in order to create new production methods. All of these topics on a company level have been advanced, and I think many of the companies we’re talking about -- and you see also many of the results they’re generating from the change to a digital manufacturing, digital economy.

Now, again, the government is obviously a more complex undertaking, in particular when you think about the public side of services and procurement. Certainly other governments in Europe are farther ahead in terms of digitalization of the government work, but clearly we also have a good pool of innovative companies, startups. By now, for example, we have 30 unicorns in Germany alone that have pushed a lot digitalization, the use of AI in applications. And there also comes a positive pressure from that side to adjust and to adapt.

Allison Nathan: And how have all of these macro and structural transitions impacted the banking landscape in terms of financing, in terms of M&A?

Wolfgang Fink: Yeah, I would say we are not separate
from the global M&A and financing markets in that the inflationary environment have been dampening activity all over the place -- be it in M&A, but it in financing, or IPOs, for example. So Germany is no different there.

Having said that, as we go into a more balanced environment, peak rates, less inflation coming, we see a healthy backlog of financing activity that needs to be executed. And what that means is we will have a lot of flow that needs to be executed if we have a stronger normalization or better normalization of the environment.

Having said that, the economy and the businesses themselves have been dealing with these topics. And the current slowdown in some parts, the challenges we just discussed have led many companies to adjust, to invest more heavily in digitalization, to basically review the business portfolio, to work on carve-outs, spin-offs, to reduce the footprint of the portfolio in order to generate the sources to advance their businesses. And that is irrespective of where the market currently is. Those are internal projects. But clearly, they will also come to market to either sell, refinance, finance. So there is an undercurrent of restructuring that is going on in the
economy, and I think we'll see that coming through when the markets are more receptive, as we all expect in the next half of the year.

**Allison Nathan:** It's almost like Germany won't be recognizable in ten years with the amount of changes the country has to adapt to. Where do you see the country going in the medium to long term?

**Wolfgang Fink:** Yeah, it's obviously very interesting question that many of the larger economies, more mature economies are facing. And one aspect apart from the many aspects we just discussed is clearly the aging of the society. Germany has a relatively old society, and the aging of that society will pose a lot of problems to the countries and to Germany in particular.

Also, clearly, Germany was heavily reliant on foreign workers to basically address the labor demand in the economy. Now you see also a lot of movement there. For example, a lot of workers from Eastern Europe going back to their strong growing home economies. And hence, there will be a challenge, both from a skilled labor perspective, from the retiring of a large part of the productive
population, and that's a pretty strong aspect for a country that has heavily relied on manufacturing compared to a manufacturing industrial economy.

So clearly, there's a lot of transition happening there. I would say a lot of that is being addressed on a micro level, but clearly the move to a more digitized economy, the more to a stronger service economy, the fact that we all will work differently and live differently in a digital age, where particularly on this economy that is not only very manufacturing heavy but also characterized by a lot of mid-sized companies that are privately owned. So we'll see a lot of transition there, adaption there.

I'm very positive as to how companies deal with this. I think for politicians, the real challenge is to do all of this in a manner that keeps social cohesion and that keeps society together and offers perspective for all levels of society. And we obviously hope that this will work out. But clearly, given the stock of capital and experience and also technology in this country, I'm quite positive that Germany will master that transition.

Allison Nathan: Wolfgang, thanks for joining us and
sharing your insights.

**Wolfgang Fink:** Thank you very much for having me.

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