

The German dilemma: Berlin's response to the trade conflict with the USA

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In August, President Joe Biden signed the Inflation Reduction Act (IRA), one of the largest initiatives of this kind in recent years. Its name emphasises the importance of fighting inflation. The financing of investments in low-emission production is expected to reduce the costs and to slow down the growth in market prices.

The Biden administration's initiative has provoked a lot of controversy among US economic partners. On the one hand, the commitment to climate protection is appreciated. America's ambitions to accelerate the energy transformation by betting on an active role of the state and on industrial policy are also understandable. On the other hand, the IRA contains openly protectionist elements that could harm the functioning of the international economy, trigger a crisis in the World Trade Organization (WTO) and provoke serious political conflicts, including among close allies.

Germany will be particularly affected by Biden's programme, by both its positive and the negative consequences. Olaf Scholz's government is currently oscillating between two responses: on the one hand, a strong reaction (which France is insisting on, involving responding and a European support plan), and on the other, negotiations and toning down the dispute. From Berlin's perspective, the latter strategy appears more appealing.

The objectives of the IRA

The actual catalogue of the IRA's objectives is much broader than its name suggests. It offers not only an opportunity to deal with climate change more effectively, but also to strengthen American industry. The creators of the programme are counting on the construction of new factories in the 'Rust Belt', the Northeast and Midwest regions of the US that have been particularly hard hit in the global competition for jobs. The total amount allocated to this initiative will be at least US\$400 billion, of which as much as US\$50 billion will go to the electric car industry.

The IRA is distinguished by a slightly different approach to supporting certain developments in the economy. Previous initiatives have placed more emphasis on the 'punitive' taxation of harmful emissions. In this case, it is the incentives for business in the form of tax breaks and direct subsidies which are crucial. This means that in the event of a change of power, it will be more difficult to cancel the support without paying high political costs. In addition, the IRA clearly emphasises the preference for production in the US. The tax breaks and subsidies will be available to companies that manufacture on the US market or use components manufactured in the USA. Washington has offered some concessions to

Mexico and Canada in terms of setting the rules of origin of the goods. Asian countries (especially South Korea and Japan) and the European Union (which is negotiating with the United States within the framework of the Joint EU-US Trade and Technology Council, TCC) are also trying to temper the protectionist blade of the IRA.

More risks than opportunities for Germany

The US turn towards energy transformation is definitely beneficial to Germany. Considering Washington's long-standing reluctance to take radical action to defend the climate, the IRA's regulations are almost revolutionary. They increase the chances of the construction of a lasting international alliance (something Germany has been insisting on for years) to combat climate change, and make it more likely that developing countries, which have so far been sceptical, are convinced to accelerate their transformation towards a low-carbon economy.

The very fact that the IRA directs significant amounts of money to investments is also important for Berlin, as it increases hopes for a faster economic recovery in the US and an increase in purchases abroad. This is important because the US is Germany's key export market, much more significant than China, which dominates overall trade (see table). In 2022, the significance of the US market has increased further due to the deterioration of political and economic relations between Germany and China (in January-September, German exports to the US increased by 29.2% to €115.5 billion, and to China by 5.1% to €80.8 billion).

The problem is that hopes of increased trade may be dashed by the protectionist overtones in the IRA. The support for the American production of electric cars and batteries envisaged in the act is the biggest threat to Germany as this may undermine the competitiveness of German car manufacturers on the US market.

The government in Berlin may also be concerned about the impact of IRA financial tools on German industry's decisions regarding the location of production. The subsidies offered may encourage German companies to transfer their production to the US. This applies especially to energy-intensive industries, which may be prompted to relocate production overseas due to lower gas and electricity prices than in Europe. Therefore, the German concerns about a permanent loss of competitiveness of the entire economy and so-called deindustrialisation will intensify. Berlin is facing a political dilemma: whether to take action that will persuade the Biden administration to withdraw controversial regulations, or to consider a European response that would discourage its own industry from moving to the US.

The IRA also carries political risks at the global level (these cannot be disregarded) considering the high level of internationalisation of the German economy. First of all, its rules may constitute a violation of WTO rules and the principles of international economic cooperation. If the main player in the system opts for protectionism, it will be difficult to expect other participants to comply with the principles of non-discrimination and relatively equal competition. One warning sign would be Indonesia's decision to limit exports of rare earth elements and thus encourage car and battery manufacturers to produce on its market. This tendency would be a huge threat to the German economic model, which is based on exports in a relatively open, liberal global economy and on investments in building global supply chains.

The dispute over the limits of protectionism

The threat applies to the entire EU, and is manifested in the increasingly intense dispute between supporters of protectionism and interventionism and defenders of the liberal formula of economic cooperation that has been in play so far. The tone of the discussion is increasingly being set by France, for which the IRA is not only an opportunity to criticise the actions of the US, but also to push through the “buy European” principle in the European Union, the idea of EU ‘sovereignty’ being put into practice. France also believes that, in the face of growing cost pressure and due to the loss of industrial competitiveness (as a result of rising energy prices), the EU should consider a major investment programme modelled on the Recovery Fund.

Germany is very cautious about this mindset, and it is also internally divided. Robert Habeck, the Minister for the Economy, is interested in some French ideas and has even announced a multi-point support programme for EU companies as part of the so-called industrial policy offensive. Olaf Scholz, on the other hand, would prefer to focus on negotiations with the US and persuading Biden to ease controversial regulations. Scholz’s Office is pinning its hopes on the TCC talks. Moreover, Scholz believes that the best response to the IRA would be to return to negotiations on the creation of a transatlantic free trade area. Talks on this subject were held in the last decade, but were eventually abandoned by President Donald Trump in 2016. A ‘new TTIP’ would neutralise French demands and cut short discussions about another European fund which, from the German government’s point of view, would pose a challenge to fiscal stability in Europe. However, the chances of success in this field are slim. The Biden administration is far from supporting trade liberalisation. In this respect, the views of the incumbent US president do not differ much from the position represented by his predecessor.

A threat to transatlantic relations and the EU’s cohesion

German concerns about the growing dispute over the IRA are also about the stability of the transatlantic political alliance revived by the need to respond to Russia’s invasion of Ukraine. Since the outbreak of the war, the US and Europe have strengthened cooperation within NATO, and have begun to prepare a systemic response to the threat posed by aggressive authoritarian states. One of the pillars of the ‘new’ community will be economic cooperation based on, for example, friendshoring, i.e. ‘investing in friendly countries’, or developing trade in a bloc of countries which share similar values. This is how, for example, a clear increase in exports to the USA is often interpreted in Germany after the outbreak of the war in Ukraine.

In this context, the IRA represents a sharp dissonance that does not match the political declarations that have been made for months, nor does it meet expectations for enhancing the transatlantic alliance. Germany fears that the current situation may escalate into a serious conflict leading to a ‘war over subsidies’, terminating contracts, for example those concerning the purchase of arms, or imposing stricter restrictions on the activities of American technology companies in the EU. There would undoubtedly be a growing dispute between member states over these issues, which would undermine the cohesion of the European Union and its decision-making capacity. In these conditions, it would also be more difficult to maintain a consensus on military and financial support for Ukraine.

Table. Germany's trade in billions of euros in 2021 – key partners

	Exports		Imports		Total trade	
1	USA	122.0	China	143.0	China	246.6
2	China	103.6	Netherlands	105.1	Netherlands	206.2
3	France	102.7	USA	72.3	USA	194.3
4	Netherlands	101.1	Poland	69.0	France	164.6
5	Poland	78.8	Italy	65.4	Poland	147.8
6	Italy	75.5	France	61.9	Italy	140.9
7	Austria	72.4	Belgium	52.3	Austria	119.9
8	United Kingdom	65.0	Czech Republic	49.7	Switzerland	109.9
9	Switzerland	60.6	Switzerland	49.3	Belgium	103.7
10	Belgium	51.4	Austria	47.5	United Kingdom	97.3

Source: Destatis.