



# The Ukraine war and the consequences for Germany's regions: Challenges and opportunities using the example of small and medium-sized businesses

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## Abstract

This article will take a close look at the state of Germany's small and medium-sized enterprises, focusing on the companies considered to be the winners and losers in the Ukraine crisis. Proceeding in this way will make it possible to draw some initial conclusions from the current crisis and to link them to the next major problem that the EU will have to face: its dependence on China. Looking at how Germany's small and medium-sized enterprises are currently faring will help us gauge how the EU's economic area might be hit should an even more severe crisis occur (e.g. in connection with China). In getting started, a comparison is made with the Covid-19 crisis to clarify the severity of the current crisis and to provide a basis for understanding what is yet to come.

## Keywords

Ukraine crisis, SMEs, Armaments industry, Energy crisis, Germany, China

## Introduction

After the Covid-19 pandemic and its severe economic consequences, the German economy and in particular the country's small and medium-sized enterprises (SMEs) set themselves up for a period of rapid recovery. However, Germany's dependence on Russian energy sources and supply chains, which continue to be severely impaired, is

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putting pressure on SMEs. Higher transport costs due to increased energy prices, coupled with lost revenue because of sales shortfalls seem to have become an insoluble problem for the German *Mittelstand* (on which, see below). Meanwhile, companies that are generally considered to be profiting from the war, such as medium-sized enterprises in Germany's industry, do not have enough influence on the Federal Republic's GDP to keep the economic developments in the sector positive.

This article argues that the EU should pay close attention to the current negative trends in the German SME sector as it is not only the jobs engine of the German regions and the backbone of the German economy but also accounts for a considerable share of total European economic output. Corresponding measures to reverse the current trends must therefore be taken, including at European level.

To support this argument, the article will analyse the importance of SMEs for the German and European economy. It will look at particularly significant trouble spots (e.g. the energy sector) but also at the supposed beneficiaries of Russia's war with Ukraine (e.g. the armaments industry). Finally, it will draw conclusions about what lessons can be learned by examining Germany's dependencies on Russia and what these reveal about the country's dependencies on China.

## **Excursus: the German *Mittelstand***

The *Mittelstand* is Germany's economic and employment engine. It is the driving force behind innovations and a strong partner for large companies worldwide. Regional roots; continuity; generational thinking; and responsible dealings with employees, customers and business partners are characteristics of the *Mittelstand*.

The term 'Mittelstand' is generally used when speaking of SMEs: these employ no more than 500 people and have annual sales of no more than €50 million. Medium-sized companies also include larger companies in terms of number of employees and sales if they are owner-managed or family-run. However, there is no universal definition of the term. From a qualitative point of view, it can be considered characteristic of the *Mittelstand* that ownership and entrepreneurial responsibility are in the same hands. Currently, the *Mittelstand* employs 40.65 million people, includes 6.1 million businesses and self-employed persons, and the annual sales of the sector amount to €5.6 trillion (Rudnicka 2022).

The *Mittelstand* is internationally unique. It is fast and reacts flexibly when the market demands it. Proximity to the customer and short decision-making paths contribute to its being able to respond to entrepreneurial challenges with impressive new and convincing products and services. The *Mittelstand* is a global market leader, and it is an essential link in the value chain for the EU as well. At the same time, it is responsible for the prosperity of the German regions and makes a significant contribution to the decentralised character of the Federal Republic. Because they are domiciled in the various regions

of Germany, SMEs play a major role both economically and in enhancing the attractiveness of the federal states.

## Review of Covid-19 and its economic consequences

The pandemic has set back the global economy sharply. Trends towards greater globalisation, previously thought to be unshakable, have slowed significantly. The pandemic has raised questions about alternatives, as global supply chains could suddenly no longer be maintained, causing production to grind to a halt worldwide, sales shortfalls to be recorded and purchasing power to drop sharply as a result of various lockdowns.

These developments have been strongly felt in Germany. Industry, the country's flagship, was hit particularly hard as it was either no longer able to manufacture its products or if it did, it could no longer export them. As the heart of the German economy, the *Mittelstand* has suffered in particular from the consequences of the pandemic. The business climate for German SMEs (measured as the difference between the percentage of the total number of reports that are positive and the percentage that are negative) was -22.1 points at the beginning of the pandemic (June 2020) and -13.8 points a month later (Rudnicka 2022). This surplus of negative reports continued until April 2021—in other words, for almost a year. There was a strong recovery period in summer 2021 due to falling Covid-19 numbers and the end of the lockdowns and other restrictions. This, in turn, was interrupted by a worsening situation in December, before recovery continued. Overall, however, the *Mittelstand* had significantly more negative than positive figures to report between March 2020 and February 2022.

This development was reflected in the GDP of the Federal Republic. At the start of the pandemic in spring 2020, this fell by 4.6%. Of course, other companies and trades also influenced this development, but these figures reflect the importance of the *Mittelstand* for the German economy as a whole. Supply chains to China in particular suffered during the pandemic. The German economy's links with the People's Republic therefore posed a major problem for the *Mittelstand* as China is its largest trading partner and will probably remain so in the future. The port in Bremen alone handled around €2.66 billion in trade with China in 2018 (Herr et al. 2020).

## The current situation: the Ukraine crisis

With the start of the Russian invasion of Ukraine, the next crisis was imminent for the global economy. On 24 February 2022 Russia stepped across its border with Ukraine and advanced all the way to Kyiv. This action, which is against international law, caused widespread indignation in the Western world, and the EU, the US and the G7 quickly agreed the first packages of economic sanctions against Russia. Indeed, on the day of the invasion, the EU adopted its first sanctions package, with the second following the day after. By May 2022 a total of six sanctions packages had been imposed against Russia, sanctions which primarily affected the energy, financial and economic sectors. The sanctions cut virtually every economic and financial link between Russia and large parts of

the rest of the world. In particular, the exclusion of Russian banks from the SWIFT system was intended to isolate the country almost completely. For the *Mittelstand*, however, this brought about the next set of profound challenges. Russia is an important sales market for many SMEs. But under the new conditions this market was lost, along with all the expected revenue. The *Mittelstand* had last reported negative figures in December 2021 due to the pandemic and had prepared for a long period of recovery. But in fact, the opposite happened, and another period of negative results was to start with the invasion and the sanctions packages that followed. German SMEs reported results of -9.4 points in March 2022, -5.8 points in June and -15.3 in July 2022—levels last seen in the first Covid winter of 2020 (Rudnicka 2022). It is therefore clear how severely the consequences of the war are being felt in Germany.

### **Gas, coal and oil: the energy crisis**

The Russian invasion is putting a particular strain on the production and supply of energy in Europe. Germany has been heavily dependent on Russia for oil and gas. In 2020, for example, Germany purchased 55% of its natural gas from Russia. Since the war began, this dependence has become more problematic than ever (BPB 2022). Energy self-sufficiency had hardly played any role in the years leading up to the war, and Germany became heavily dependent on Russia, not least because of the Nord Stream 1 pipeline. With the invasion, the energy supply increasingly came to be of geopolitical importance and swift political action was required to address it. The resultant high energy prices are being felt not only by individual citizens but also by the *Mittelstand*. On 28 July, German Minister of Economic Affairs Robert Habeck spoke of the ‘biggest energy crisis’ ever in Germany (RND 2022, authors’ translation).

The energy crisis in electricity and gas is hitting the *Mittelstand* harder than comparable sectors in other European countries. This is the conclusion of a new price and risk analysis published by the Stiftung Familienunternehmen (Family Businesses Foundation) and carried out by the Leibniz Centre for European Economic Research in Mannheim. In this study Prof. Rainer Kirchdoerfer, a board member of the foundation, comments, ‘Some researchers have tried to estimate the consequences of an embargo or a Russian supply freeze since the outbreak of war in Ukraine. Our study now shows how vulnerable Germany was even before the war began. Competitors overseas have no problem. And competitors in Europe can restructure more quickly in view of lower consumption volumes’ (Heinemann 2022, authors’ translation). Metal production and processing, chemicals, and paper and cardboard have been particularly affected.

In addition, according to the President of the German Farmers’ Association, Joachim Rukwied, *Mittelstand* companies producing milk, butter, yoghurt and other dairy products may face bottlenecks since the agricultural sector needs gas to produce fertilisers (Goebel 2022).

An end to the war is currently not in sight. Economists believe that there will be little easing of inflation in the winter. And even if the war were to end in the next few months,

the consequences of the sanctions against Russia would continue to impact Germany for a long time to come. A great recession is just around the corner. For decades the belief prevailed that globalisation would only result in a market of unlimited possibilities. Everything would be permanently available: avocados from Mexico and strawberries in the winter from Egypt. The Ukraine war, however, shows the limits of the globalised economy. For oil, gas and grain, these limits have been reached. To become crisis-resistant, Germany and Europe must become more independent in terms of supply. It is important to note, however, that not every sector of the economy is suffering equally from the consequences of the war. Although the German government has managed to diversify and find replacements for the German coal and oil supply, it is facing a markedly more difficult task when it comes to gas. The dependencies remain in place and are complicated to resolve.

### **Armaments industry: benefiting from the crisis?**

The German defence industry is one of the most innovative and advanced in the world. The special feature here is that, unlike its counterpart in the US, for example, it is not dominated by a few large corporations but involves many medium-sized companies that belong to the *Mittelstand*. And thanks to their effective working methods, these are particularly good at responding to customers' wishes. While the *Mittelstand* has generally been reporting consistently negative figures in the current economic and security crisis, the defence industry seems to be one of the beneficiaries of the current situation, despite restricted supply chains. Rheinmetall CEO Armin Papperger expects his company's annual sales to increase by 15% (*Süddeutsche Zeitung* 2022). Heckler & Koch is also expected to see significantly higher sales in 2022. However, these two companies are active globally and are listed on the stock exchange, so no fair comparisons can be made with the rest of the *Mittelstand* companies active in the defence industry. Diehl Defence, on the other hand, which manufactures guided missiles and air defence systems, is one of the medium-sized defence companies in Germany. Thanks to well-filled order books, the Diehl Group expects moderately increasing sales figures for 2022 (Diehl Holding 2022). KNDS, into which the medium-sized German company Krauss-Maffei-Wegmann has been integrated, expects sales to increase from €2.7 billion to €3.1 billion in fiscal 2022 (KNDS et al. 2022). Again, this expectation is justified by well-filled order books in the wake of the Ukraine war.

However, these figures should be treated with caution. At present, the forecasts are still based mainly on bulging order books. Disrupted supply chains and the associated high global demand for raw materials are likely to have an impact on whether defence companies can actually fill the orders. It therefore remains to be seen what role the defence industry will play in the recovery of the *Mittelstand* as a whole. Given the small impact of the defence industry on the GDP of the Federal Republic (1.34% of total GDP) (Statista 2022), it is not to be expected that the defence industry will keep the figures of the *Mittelstand* afloat in the foreseeable future. Rather, as order numbers rise, the industry is likely to suffer the same fate as the rest of the *Mittelstand*. The demand is such that it should be able to produce and sell much more than ever before, but the necessary raw

materials and vendor parts will not be sufficient to meet this demand. The *Mittelstand* companies, including those in the defence industry, will therefore continue to struggle, their futures depending on how the war in Ukraine develops. Thus, even those that might be expected to benefit from the war are likely to suffer from the current global situation.

This should also be taken into account at the European level. Given that each industry is affected by the consequences of the war in different ways and, above all, to different degrees, a one-size-fits-all approach will not be sufficient to remedy the problems. Instead, tailored solutions should be developed that offer the *Mittelstand*, but also the European economy as a whole, concrete solutions to specific problems. This is the only way to effectively overcome this crisis. The Russian war of aggression and its consequences for the German economy show how dangerous overdependence on individual countries or resources can be.

## **What is still to come? Conclusions about China**

Relations with China are currently under strain, and not only because of the supply-chain problems discussed above (resulting from Chinese lockdowns). Nancy Pelosi's trip to Taiwan is emblematic of Western relations with China. The rising tensions between the two could well turn out to be the third major crisis in a very short time. For years China has been laying claim to the Republic of China, that is, Taiwan. Both countries have existed for 72 years, one Communist in character, the other more nationalist. Moreover, since the end of the dictatorship in the 1980s, Taiwan has been one of the most politically stable democracies in Asia. Thus, the reunification desired by the People's Republic could lead to the next armed conflict, or at least to the next economic crisis triggered by sanctions packages, if the West was to react in the same way it has to Russia.

Germany and the EU are becoming increasingly dependent on China, while the latter is reducing its dependence on exports. In Germany around 1.1 million employees depend on consumption in China (Matthes 2022). In 2007, 4.4% of Chinese added value was linked to European consumption; in 2018, it was only 2.2%. For the EU the trend is reversed: in 2007 the figure was around 0.5%; by 2018 it had risen to 2% (Matthes 2022).

Trade volumes with China are reaching all-time highs in the Free State of Saxony, Saxony-Anhalt and Thuringia. China is Saxony's largest trading partner: last year Saxony's companies exported goods worth around €7.9 billion to China (Cygan and Menzel 2022).

Apart from the EU member states taken together, the US (€122.04 billion) and China (€103.69 billion) are the most important sales markets for the German economy (Statistisches Bundesamt 2022, 2). Eleven per cent of the *Mittelstand* companies surveyed stated that they were active in China (Rudnicka 2022). As early as 2012, 60% of the *Mittelstand* surveyed said that they exported to China (KfW 2012, 2). In addition to this obvious export dependency, parts of the *Mittelstand* have been acquired by Chinese

investors. In 2017—the peak year of Chinese foreign direct investment in Germany—an investment volume of \$177 billion was reached, from a starting point of \$10 billion in 2005 (IFW Kiel 2019). A famous example, which drew the attention of German politicians, was the takeover of the Bavarian robot manufacturer Kuka by Chinese investors. This takeover trend was expected to continue as it is anchored in a Chinese strategy that extends until 2025 and has as its objectives to dominate important key industries and to make ‘Made in China’ a global quality feature. However, sticking with Germany as an example, it should be noted that Chinese takeovers have been falling steadily since the peak (2017). The pandemic even caused new absolute lows in takeovers of German companies: in 2020 only 11 companies were taken over by Chinese investors (Hans Boeckler Stiftung 2021). That might indicate that the fears of a complete takeover of the German *Mittelstand* by Chinese investors is exaggerated, but the growing dependencies of the past have not yet been reversed.

In addition to the import and export dependency of the *Mittelstand* on China, there is therefore also an increasing direct interdependence in corporate structures, which in the worst case scenario could have a negative impact on the *Mittelstand* and thus on the overall German economic situation. The Ukraine war currently provides a good illustration of how sudden developments and their consequences (e.g. sanctions) can have a major negative impact—even at regional level.

In any case, the prevailing potential for conflicts with China is no less dangerous and in the coming years could move along lines similar to those currently being observed in connection with Russia. For the German *Mittelstand*, this would be the next and probably also the most tangible crisis, which it would have difficulties withstanding due to the interdependencies described above. It is therefore high time for the EU and the Federal Republic of Germany to provide greater protection for the *Mittelstand* (e.g. by making takeovers even more difficult) to help it get back on its feet and drastically reduce dependencies in the medium term. To use the German term, a *Zeitenwende* (turning point) in trade policy is needed more than ever before. Otherwise, the EU and its regions will have little means to counteract Chinese economic aggression, and nor will they be able to withstand the coming economic crises.

## Disclaimer

The opinions expressed within the content are solely the authors’ and do not reflect the opinions and beliefs of the website or the foundation.

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