



EUROPE'S POWER PREDICAMENT

THE EU IS BEING SQUEEZED IN A GEOPOLITICAL VICE BETWEEN AN INCREASINGLY PROTECTIONIST US AND AN AGGRESSIVELY MERCANTILIST CHINA. Germany is particularly exposed: its industry has lost access to cheap Russian gas and is now losing out to China in green industries and electric vehicles. Amid increasing political fragmentation, the question arises: which way will Europe turn to avoid secular decline?



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THE EUROPEAN PROJECT'S FRAGILITY: A STORY OF ENERGY DEPENDENCY

Europe is adrift in the G-2 world that has emerged from the last decade and a half of Sino-American competition. As the material and political requirements for raising current living standards slip away, the 'more Europe' of Mario Draghi's report on the future of European competitiveness, published in September 2024, may seem the answer simply because Europe faces a largely common predicament of decline. Yet the European project itself is part of the explanation why rebooting it to advance Draghi's plea for additional investment of €800 billion a year may be a hopeless fantasy.

Europe's accelerating decline is first and foremost an energy story. This is a manifestation of the historical failure of the European Union (EU) in geopolitical terms. Energy predicaments constituted the origins of the post-1945 European project. The predecessors of the EU created by West Germany, France, Italy, the Netherlands, Belgium and Luxembourg between 1950 and 1957 represented a succession of efforts to deal with energy problems: France's coal weakness in the case of the European Coal and Steel Community; a shared energy alternative to foreign oil imports in the European Atomic Energy Community; and a large protected market for Algerian oil in the European Economic Community when Algeria was still part of France. Dominating collective European ambitions in the 1990s, the single currency was an indirect response to the breakdown of the Bretton Woods monetary regime as the system's energy underpinnings – America's relative domestic self-sufficiency in oil – unravelled.

Now, the EU's energy weaknesses and the architecture of the EU's monetary union have come together. The euro's operation on the terms established by the Maastricht Treaty in 1991 created all kinds of problems that since 2008 have required repair jobs at moments of crisis without the 27-member state EU ever becoming a complete monetary union. At issue now is whether the eurozone can be structurally adapted to create the fiscal and investment capacity for the whole EU that would allow it to navigate through its present energy reckoning.

FUELLING DECLINE: SHAFTED BY THE US SHALE BOOM AND CHINA'S GREEN MANUFACTURING DOMINANCE

Europe possesses neither the fossil fuel advantages the shale boom gives the US nor those China enjoys on low-carbon energy, having established control of supply chains from battery manufacturing to metal processing. On fossil fuels, Europe is directly exposed to the Houthis' bid to disrupt passage through the Red Sea. Meanwhile, the EU has chosen to pursue the energy transition by imposing significant carbon costs on energy-intensive industries, unlike the US and China.

The scale of the energy gulf is evident in electricity. The 2024 International Energy Agency (IEA) report on electricity noted costs are much higher for energy-intensive industries in the EU than in the US or China. Europe cannot use cheap natural gas in the sector as the US does. Nor, unlike China, can it generate 60% of its electricity from

“ CHINA SHIFTED ENERGY GEARS

**TO ADD 40-50 GW OF COAL-FIRED
POWER STATIONS ANNUALLY
FROM 2024 TO 2026.**

**BY CONTRAST, THE HIGH GAS PRICES
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EXPENSIVE ELECTRICITY.”**

coal when even the German government, having chosen coal over nuclear power for the medium term, says publicly that this high-emissions fossil fuel must be repudiated.

The comparison with China is becoming stark. During the energy crisis that began with sharply rising prices of liquified natural gas (LNG) in the second half of 2021, Europe appeared in a superior position. In September 2021, the Chinese state rationed electricity to industry while European companies won the competition for scarce LNG after Russia's invasion of Ukraine, since China and other Asian countries were deterred by the high prices required to procure spot market purchases. But China shifted energy gears to add 40-50 GW of coal-fired power stations annually from 2024 to 2026. By contrast, the high gas prices Europeans paid translated into more expensive electricity. Already, by late 2022, electricity consumption per capita in China was higher than in the EU, even though household use was lower. Beijing's 'whatever it takes' approach to energy in 2022 provides a material foundation for the Chinese economy, a foundation which is near entirely lacking in European attempts to reactivate an industrial policy.

China is also far ahead in installing new solar and wind capacity. Unlike European states, it need not choose between the cost of decarbonisation and its industrial prospects. The IEA's 2023 report on renewables projected China would deploy nearly four times more solar and wind capacity than the EU over the period until 2028. Meteorologically, northern European states are further disadvantaged. They must rely on the wind more than the sun, when it is the wind sector that has struggled more with the macroeconomic fallout of inflation and higher debt costs from the 2021-2022 energy crisis.

(L)OSTPOLITIK: GERMANY AS GROUND ZERO OF THE GORDIAN KNOT

Germany is ground zero for the European Gordian Knot: how to compete directly with China while pursuing the energy transition. German industrial production has been in non-cyclical decline since May 2018. The German Economy Minister, Robert Habeck, publicly admitted in early 2024 that the economy was performing "dramatically" badly. Volkswagen, Germany's largest company in the country's most significant industry, revealed in September 2024 that it has "one, maybe two, years" to turn around its principal car brand and avoid closing factories in Germany for the first time in its history. Its CEO's explanation of the crisis was simple: "There are no more cheques coming from China."

A singular economic relationship with China was fundamental to Germany's stability through the political turbulence experienced elsewhere in Western countries after the global financial crisis. German industry delivered manufactured products, especially cars, into the Chinese market, with Volkswagen having operated a factory in Shanghai since 1984. In 2023, Volkswagen earned more than half of its global profits from the Middle Kingdom. Unlike many other Western economies, Germany pulled off Eurasian economic interdependency without deindustrialising at home.

This achievement has unravelled over three serial crises, moving ever closer to Germany's core industrial strength. The first began in the early 2010s with low-carbon energy manufacturing. Domestically, the country's *Energiewende* (energy transition) was sold as an industrial opportunity for German companies.

At the time of the global financial crisis, the German company SolarWorld was a central player in the global photovoltaics panel industry. But, when China poured state money into the sector after 2008, SolarWorld slumped. In 2011, the firm petitioned the European Commission (EC) to investigate Chinese trade practices. A year later, it needed a large-scale debt restructuring to stave off bankruptcy. Yet, when the EC imposed tariffs on Chinese imports in June 2013, Angela Merkel's government opposed the move, wishing to prevent retaliation against German companies producing in China. The tariffs had so little effect that SolarWorld filed for insolvency proceedings in May 2017. Having destroyed German competition, China now supplies over 95% of the solar panels used in the EU.

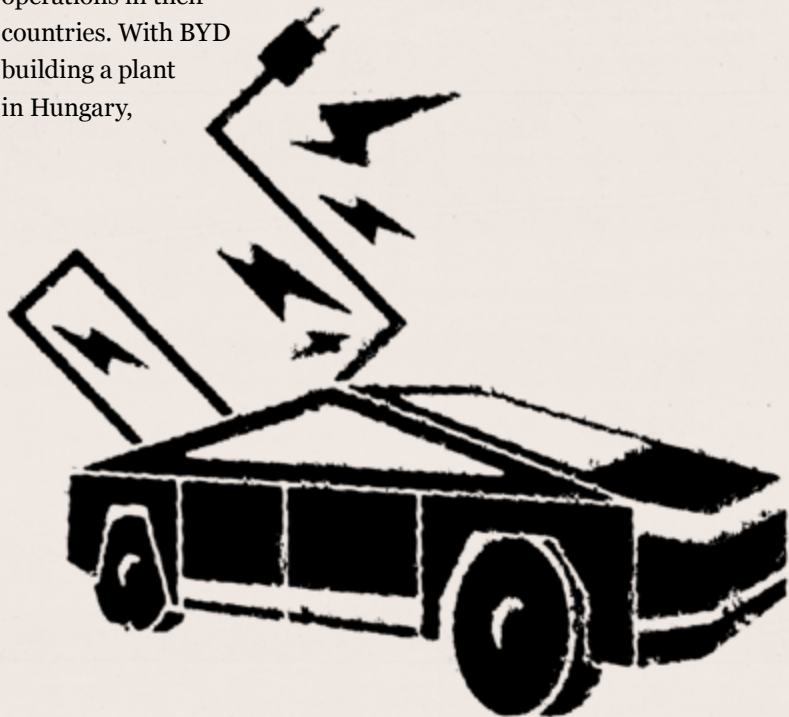
The second crisis for German industry emerged from Made in China 2025, Beijing's 2015 bid to establish technological dominance within a decade. Unprepared for the shift in Chinese investment patterns, the German government was soon constrained in formulating a strategic response by Washington's geopolitical reaction to China's manufacturing ambitions. In 2016, a Chinese company bought the German robotics manufacturer KUKA. Just months later, the Obama administration intervened to block another Chinese firm buying the German chip equipment manufacturer Aixtron, saying the sale would impact work on the upgrade of Patriot missiles and thus threaten American security.

China's extraordinarily rapid emergence as an auto power since 2021 is now striking the third blow. German dominance of the Chinese car market is over: in 2023, BYD, China's biggest car company, overtook Volkswagen as the best-selling auto brand in China.

Through exporting electric vehicles (EV) that are much cheaper than their European counterparts, Chinese companies are also suddenly prospering in the EU market, with their largest sales in Germany.

What to do about the EU's EV market while German car manufacturers rapidly lose market share in China is an existential issue for Europe that has proved exceptionally difficult for the German government. On the surface, the whole EU has to choose between cheaper electrification of transportation and the interests of European auto firms. In imposing significant provisional tariffs on Chinese EVs in July 2024, the EC moved to protect European manufacturers. Thereafter, to avoid any counter measures against German car companies in China, the German government tried and failed to stop the tariffs becoming permanent, casting a futile vote against the EC on 4 October 2024.

The EU's economic structure also makes defending its market near impossible. Some European states want Chinese manufacturing operations in their countries. With BYD building a plant in Hungary,



Budapest has no intention of subordinating itself to a collective 'confront China' stance. In a remarkably frank speech last July, Hungary's Prime Minister, Viktor Orbán, said Asia has such technological, capital and demographic advantages that it is already too late for Europe to compete. Hungary, he continued, had simply done what was necessary in the circumstances and accepted "the maximum offer possible" from China. The same month, the Turkish government announced BYD will build a \$1 billion car factory in the country. Since Turkey enjoys a customs union with the EU, these vehicles will be exported tariff-free into the Single Market. To entice this agreement, the Turkish President, Recep Tayyip Erdoğan, announced 40% tariffs on EV imports in early 2024. But conceding domestic auto production to Chinese firms as a strategy for dealing with the G-2 world would be an entirely different proposition for Berlin than for Ankara.

REVENGE OF HISTORY: EUROPE'S TRIAL STEMS FROM ITS PAST

The EU and Germany must work out what to do about China's manufacturing prowess in the worst geopolitical environment for western Europe since the Second World War. This European nightmare is tied to G-2 competition through the strategic dilemmas Russia's invasion posed for Washington about the importance of Russian territorial gains weighed against the security threats from China in the Pacific.

But the European trial fundamentally arises out of European history. The dissolution of the Soviet Union and the end of the Cold War could never permanently eradicate the old conflict between the Russian empire and the peoples of eastern

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Europe who wanted their own nation states, especially when the western Soviet successor states contained millions of ethnic Russians. Even when the present war ends, any lasting peace settlement in Ukraine remains unlikely. Yet the EU is committed to a process for a post-war Ukraine's accession to the Union and would only weaken Ukraine's security by changing course.

Again, Germany is the epicentre of the European plight. After 1991, German governments bet on peace and disarmed. Economically, Germany's energy-intensive industries – especially the world's largest chemical company, BASF – aligned with Russia to protect a cheap, pipelined gas supply and built the Nord Stream infrastructure under the Baltic Sea to avoid the geopolitical risks of transit through Ukraine. Yet the German government lacked the power to defend the country's energy interests, being unable to influence Vladimir Putin's decision-making towards Ukraine after the 2004-2005 Orange Revolution, or ultimately resist Washington's pressure from 2019 to terminate the second Nord Stream pipeline. Under wartime conditions, even Ukraine, whose concerns the Germans had assumed were too low in the European hierarchy to

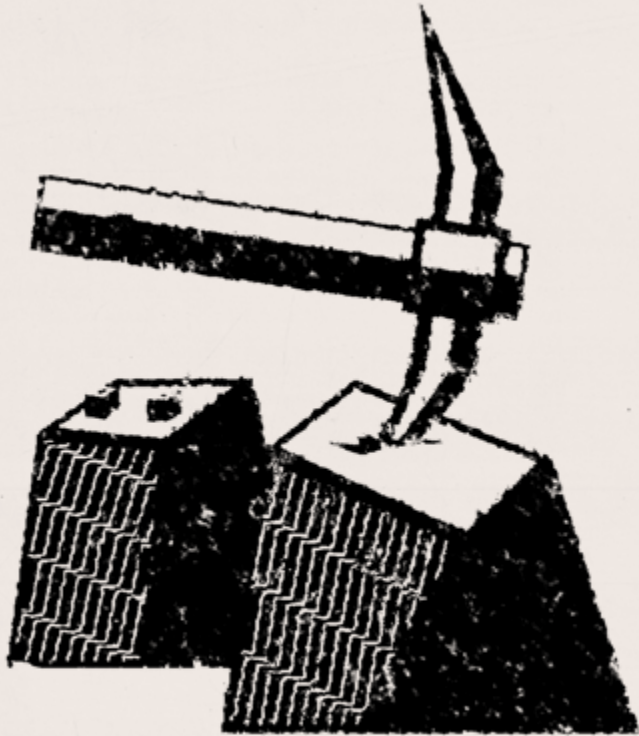
matter, had the ability to impose energy costs, culminating in what seems to have been Ukraine's destruction of the two Nord Stream pipelines. For BASF, the ensuing industrial shock has been near overwhelming, leading to job losses at its principal plant at Ludwigshafen and the loss of a third of its share value since the Russian invasion.

The Draghi report's bid for new EU load-bearing capacity includes greater defence collaboration to improve the EU's easternmost members' security against Russia. But the EU has no more effective collective agency to deal with the threat of further Russian territorial expansionism than with Sino-American competition or the energy transition.

This weakness is in part a matter of the EU's missing Europeans. Whatever the undoubted difficulties Brexit causes for the UK in navigating the G-2 world, the EU is stuck trying to find a way to move beyond its earlier preoccupation with the integrity of EU rules in its relations with the UK. Without UK participation, no European security guarantee for Ukraine could withstand Washington's focus being diverted by a war in the Pacific. Given the UK's relative size, it will also be tough for the EU alone to deepen the emerging bloc of electricity interconnectors for cross-border trade across the North Sea to minimise the problems caused by north-west European states using intermittent sources of electricity generation.

For a common foreign economic policy to deliver the investment in countries rich in energy-transition metals that the Draghi report envisages, there would need to be shared energy purposes.

Given its paramount importance for batteries as well as transportation, consensus on securing better access to lithium has proved easy, yielding an EU strategic



partnership with Serbia in July 2024 to develop what would be Europe's largest lithium mine.

But, since Germany has repudiated nuclear power while France, with the world's largest nuclear industry, plans to increase it, Berlin and Paris are on radically different decarbonisation paths for electricity. Just four months after the coup against the French-backed regime in Niger in July 2023 – from where around a quarter of French uranium supply has come for the last few decades – Macron travelled to uranium-rich Kazakhstan to complete bilateral agreements on critical raw materials. Unilateral French engagement can only complicate the EU's long-term approach to Russia as Kazakhstan is home to the largest ethnic Russian population of any former Soviet state and has become central to Russian-Chinese competition in Central Asia.

DOMESTIC POLITICAL FRAGMENTATION => GER/FRA DIFFERENCES ON DRAGHI REPORT

Reforming the EU's decision-making to make it less responsive to economic and geopolitical differences is politically hard when some member states face underpriced risks to political stability, including from the demands for more Europe. Electoral politics in the western European states that first founded the EU is fragmenting, and constructing party alliances that collectively can govern is arduous. The last Dutch election took place in November 2023, but only in July 2024 did a new government take office, and it is led not by a politician but by a former director of the intelligence services. The 2021 German election yielded the first tripartite federal coalition in Germany's post-war history. The agreement struck in November 2021 between the Social Democrats, the Greens and the Free Democrats was premised on a €60 billion climate fund. Yet, two years later, the German Constitutional Court ruled the fund unconstitutional, leaving a void at the centre of German decision-making that lasted until Chancellor Olaf Scholz finally dissolved the government in November 2024.

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Without a German government that could support Draghi over more EU fiscal capacity, its toleration for the European Central Bank's (ECB's) ability to support the bonds of states with high debt is the condition of keeping the eurozone in its present stasis. Securing such acquiescence from Angela Merkel was Draghi's signature achievement as president of the ECB. In the crisis caused by the German Constitutional Court ruling in May 2020 that the ECB's quantitative easing policy was incompatible with EU and German law, Merkel treated the judicial decision as a threat to the existence of the euro and conceded there could be some limited common EU debt.

Since then the ECB appears to have had a relatively free hand. During the 2021-2022 energy crisis, it devised a Transmission Protection Instrument to buy virtually all Italy's net bond issuance in June and July 2022, seeing Italy through Draghi's resignation as prime minister and a general election. Although the support seems to have been unconditional, there was no evidence of German push-back. But the large fiscal problem the Constitutional Court inflicted by its climate fund ruling pushed the German government to demand firmer fiscal discipline within the eurozone. On 30 April 2024, a new set of EU rules replaced those suspended in 2020 to allow governments to spend freely to combat the pandemic. These included reinstating an excessive deficit procedure. When, two months later, the EC for the first time began a process against France, the question of tolerance for ECB support moved from Berlin to Paris.

This change had an immediate impact on French politics, helping to push President Macron to call new elections for the National Assembly. After the 2022 presidential

election, Macron's prime ministers have presided over minority governments lacking the political means to pass an expenditure-cutting budget of the kind required to appease the EC without triggering a confidence vote. Macron's decision to call an election prompted the then German Finance Minister, the Free Democrats' Christian Lindner, to warn the ECB that using the Transmission Protection Instrument to help France through any ensuing bond market turbulence could be illegal. With the second round of the election in early July not producing a majority for any party, the structural forces destabilising France became palpable: the Fifth Republic constitution is not premised on the likelihood of minority governments, let alone of such governments having to explain what they spend to Brussels or to appease an unstable coalition government in Berlin.

EU CAN'T ALWAYS GET WHAT EU WANT

The European project has never rested on Franco-German unity. So far as it has delivered, it has required the two states to find the means to navigate through their differences, starting in 1950 with the simple fact that Germany was a coal-rich state and France coal-poor in comparison. Then the US had a Cold War interest in forcing both states to make concessions. After the 1956 Suez Crisis, when an American president forced Britain and France to withdraw from the war they launched against Egypt to defend western European energy interests, American intervention in European affairs constituted its own problem.

France's long-term ambition for European strategic autonomy, now articulated again by Macron, ultimately requires energy sovereignty from the US. For Germany, this

condition crumbled in early February 2022 when Scholz had to stand next to President Joe Biden in Washington and hear that in the event of a Russian invasion of Ukraine "we will bring an end to Nord Stream 2." Although France has not been humiliated in this way, the majority of French LNG imports in 2023 came from the US. These imports began not in a search for alternatives to pipelined supply from Russia but through the pressure the Trump administration placed on the EU in 2018 to purchase American LNG.

The gap between the capacity of the French and German states to carry more debt has serious consequences for the EU's ability to rebuild sovereignty through a transition to decarbonised electricity and electrification. If the French wish for more EU debt to exploit Germany's much stronger fiscal position in advancing the Draghi report agenda, there is simply no space in the present fragmentation of German politics to deliver that outcome. Germany can only escape the constitutional bind it has imposed upon itself in its debt brake by a cross-party consensus that would deliver a two-thirds vote for change. The deterioration in France's fiscal position through 2024 renders France instead vulnerable to a German-backed move to cut what the French state can invest. Perhaps France is too big to fail and the EC will have to return to ignoring the French deficit, as its then president Jean-Claude Juncker did during François Hollande's presidency, with the ECB mopping up any ensuing market pressure. But, if France does acquire a pass, those in Berlin most adamantly opposed to Draghi's plea for more EU fiscal firepower will see the indulgence as another reason why they should protect themselves from financing other states' spending commitments.

For Macron, Donald Trump's return to the White House might seem the shock needed to jolt the German political class into a reappraisal by subordinating fiscal fears to the likelihood of a US-EU trade war that would force further distance from China and an American disengagement from NATO as Ukraine is effectively partitioned. But it is no coincidence that the German government collapsed the day after Trump's election. So long as any German government that can command a parliamentary majority must contain a party of the right opposed to creating more legal fiscal headspace, the German government has to choose between domestic and external spending priorities. Trump clarifies that choice, because the effect of his election is that the external must prevail across Europe even as the parties in Germany committed to that imperative – the Free Democrats and the Christian Democrats – appear to dissent from Trump's desire to end the war in Ukraine.



“ THE QUESTION FOR 2025 IS WHETHER THE POLITICAL FRACTURING OF GERMANY IN CIRCUMSTANCES OF ECONOMIC CRISIS WILL BREAK THE EXISTING POLITICAL ORDER AND FORCE A POLICY REALIGNMENT.”

What Macron needs, and what is not there at the moment, is a German political party committed to a repeal of the debt brake, to pooled EU investment in the energy sector and to much higher defence expenditure that could sustain a security guarantee to Ukraine. The question for 2025 is whether the political fracturing of Germany in circumstances of economic crisis will break the existing political order and force a policy realignment.

There is no solution to the fundamental problem caused by Europe's lack of a resource base commensurate to the economic and ecological expectations of its citizens. What has changed over the past decade is that the period when Germany had domestic remedies to address the problem and could use its relative economic strength to lead the EU is over. The rhetoric of the European project is that strategic autonomy must continue: in this sense, the French vision has prevailed. But it has done so at just the point when it could not be clearer that the conditions for realising change do not exist without the scale of the crisis precipitating a transformative moment across multiple fault lines in German politics that touch on Germany's engagement across the world, not just Europe. ●

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