

Germany’s growth model is broken

By Mark Sobel and Taylor Pearce / 2 September 2024

Absent major fiscal reform, stagnation will persist no matter who is in power

The German economy, Europe’s largest, has stagnated since the end of the pandemic. Recent data hardly give rise to optimism about its near-term prospects and the stagnation has reinforced malaise among German society – especially in the economically weaker former German Democratic Republic states, as evidenced by [1 September elections](#) in Thuringia and Saxony. Debates are now swirling, even if improbable, about whether the current governing coalition can remain intact through its term.

But the economy’s roadblocks are far more than cyclical. They are deep-seated and structural and were manifesting themselves even prior to Covid-19. Is Germany becoming once again the ‘sick man of Europe’?

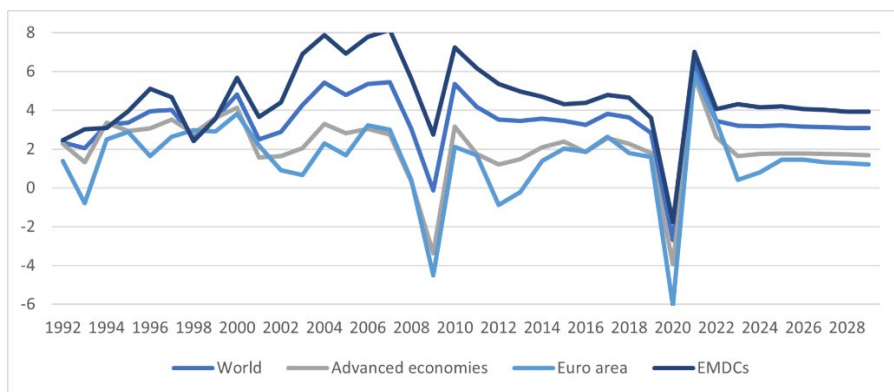
Anaemic global demand

Germany’s economy has long thrived, reflecting the country’s stability-oriented policies, successful Mittelstand (small and medium-sized businesses), the capacity to produce high-quality manufacturing goods, especially cars, and its reliance on export-led growth. This longtime successful growth model is now largely broken.

It is difficult to export goods when global demand is anaemic. In past decades, global growth of around 5% was considered normal. The International Monetary Fund is predicting global growth to remain around 3% (Figure 1), pulled down by slowing growth in advanced economies as well as in emerging markets and developing economies on the back of slower Chinese growth.

Figure 1. Growth predicted to slow down in advanced and developing economies

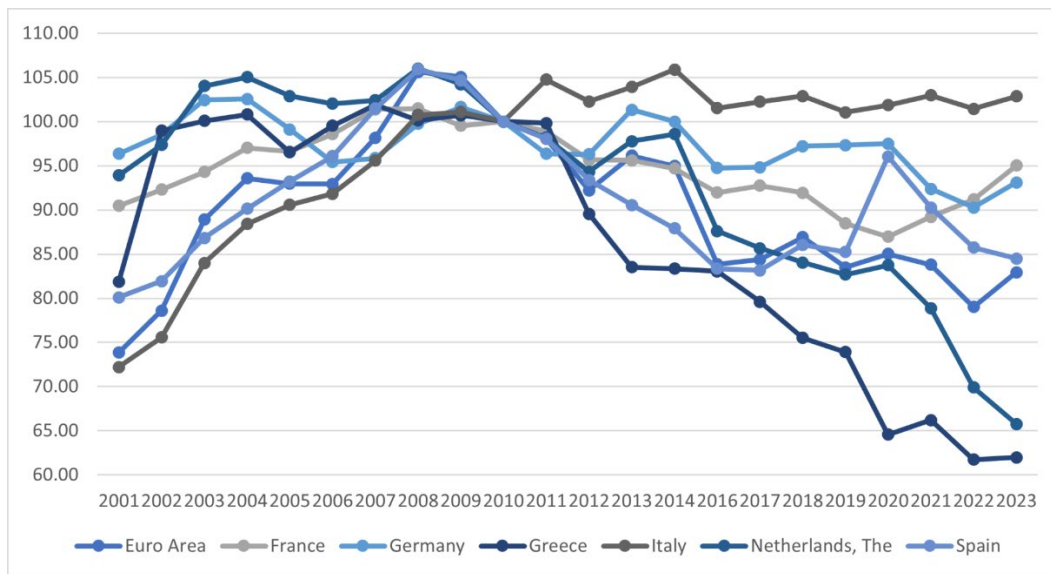
Global growth, %



Source: IMF World Economic Outlook Database.

Figure 2. German real effective exchange rate highly competitive in previous years

Select Euro country real exchange rates



Source: IMF, International Financial Statistics; exchange rates adjusted for unit labour costs.

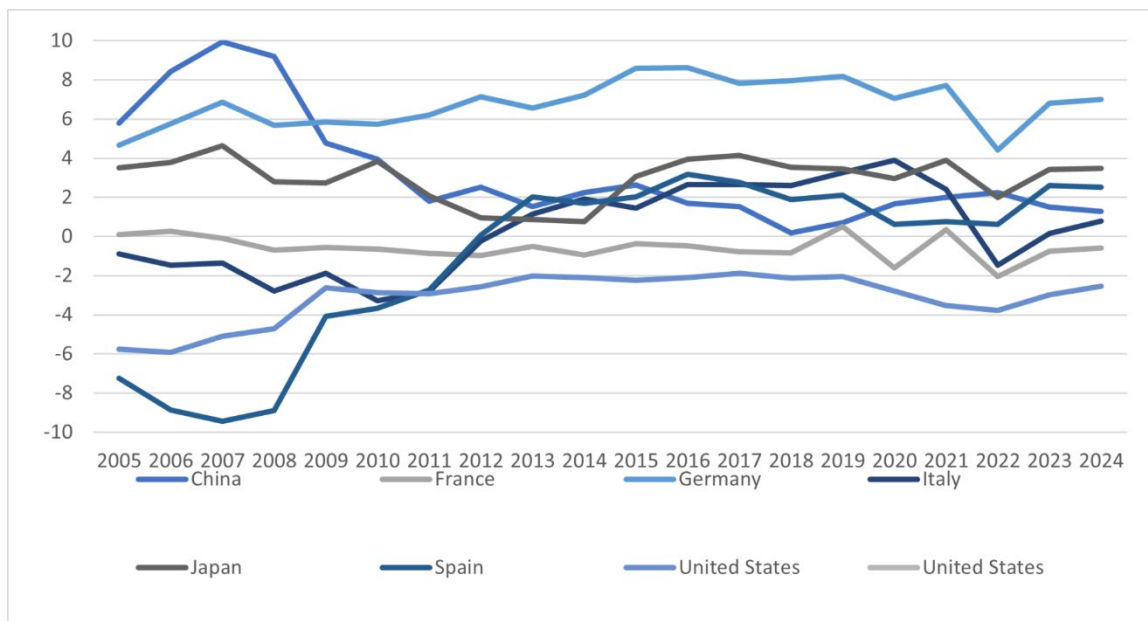
However, given slowing global growth, Germany is only now able to retain its large surplus, notwithstanding sharply lower exports, through import compression reflecting weak domestic demand.

The German automotive industry accounts for some [5% of GDP and over 800,000 jobs](#), yet it is by all reports under increasing pressure from China, which is seen as having a major lead on electric vehicles. China has been a major export market for German industry, but slowing Chinese growth and geopolitics may [further diminish the pace of exports](#). Trade with Russia has also fallen considerably since Russia’s barbaric invasion of Ukraine and here too prospects appear bleak.

In this regard, Germany’s manufacturing sector accounts for nearly 1/5th of GDP. China’s manufacturing sector is closer to 30% of GDP and receives significant subsidies. The US share is closer to 10%, as is the case for other European countries such as the UK, France and Spain. Germany’s heavy manufacturing dependence [may prove a liability in coming years](#).

Figure 3. Germany's trade dependence exhibited by historically large current account surpluses

Current account as a share of gross domestic product (%)



Source: IMF World Economic Outlook Database.

After Russia's invasion of Ukraine and spiking energy prices, German dependence on previously cheap Russian energy was believed to make German manufacturing costs uncompetitive. At the outset of the war, that rang true. However, Germany met its energy needs through remarkable efforts to shift the locus of imports and energy prices have now receded.

Germany faces other large looming challenges

Demographic trends and aging are atop the list of challenges for Germany, whose population has been bolstered in recent years by net migration. But the number of retirees is now rising rapidly and this cohort will live longer, placing a burden on public finances. Meanwhile, the share of young workers in the population will fall and absent net migration, Germany's population [may well level off](#). Chronically underfunded public infrastructure, overly burdensome bureaucracy and red tape are all dragging down productivity and investment. In addition, Germany remains behind peer countries on digitalisation.

The good news is that there is policy space to address these structural issues.

First, immigration of skilled workers could substantially boost Germany's growth prospects. Given popular concerns about immigration and the current political climate, the country is changing its tune on immigration policy. Shifting from a largely humanitarian-based model to more 'economically' driven immigration policy, the current coalition has passed a comprehensive reform to the immigration framework in November 2023. The new '[Skilled Immigration Act for Qualified Professionals](#)' framework seeks to attract skilled and semiskilled workers from third countries to plug gaps in the labour force for the manufacturing industry, as explained by a high-level German

official at an OMFIF roundtable. It remains to be seen whether this will suffice to address labour shortages in key sectors.

The state election results on 1 September will certainly deal a blow to the current coalition, particularly as immigration appears to be a catalysing factor in the far-right AfD's strong result. But this shouldn't be blown out of proportion – the AfD will not govern, as the other parties have banned building a coalition with the far-right party. Moreover, these states represent just 7% of the population, so this result is unlikely to be replicated at the federal level in next Autumn's elections. Germany may change the substance of its immigration policy, but it cannot afford to completely stymie immigration flows.

Second, a more expansionary fiscal policy could go a long way to address underinvestment in infrastructure and defence, and to adhere to net-zero ambitions. While fiscal space has been squeezed for governments around the world following the pandemic and war-related energy shocks, Germany has tremendous fiscal space, but instead shackles itself to *Schuldenbremse* (Germany's constitutional debt brake). Political will on this may too be changing, as evidenced by some prominent state-level [Christian Democratic Union politicians calling for reform](#), though the CDU leader – Friedrich Merz – has backed adherence to the *Schuldenbremse*.

The German economy faces continued structural stagnation. Given the Free Democratic Party's presence in the current governing coalition, Constitutional Court rulings and CDU views on debt and deficits, there appear to be few prospects for Germany to change its spots on the *Schuldenbremse* straitjacket. Immigration policy, while undergoing major changes, will take time to plug the gaps in labour shortages and anti-immigration rhetoric won't make this easier. Meanwhile, the external environment is increasingly challenging and stacked against Germany's manufacturing sector. Stagnation appears well entrenched no matter which party governs.

Given domestic constraints and the changed international environment, it will be a long and hard road to implement the necessary political and economic measures to address Germany's structural challenges. That said, after reunification, people called Germany the 'sick man of Europe'. It adjusted. One shouldn't underestimate Germany's capacity to adjust and rebound if facing dire circumstances.

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