Flash Economics

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Germany's difficulties will persist

Since 2023, Germany has been facing a situation of negative growth, a decline in manufacturing output, and a drop in labor productivity. These challenges can be linked to the rise in energy prices since the beginning of the war in Ukraine, but also to the mid-range positioning of German industry (automotive, steel, chemicals, industrial equipment), demographic aging, and the economy's dependence on exports. In addition, there has been a sharp decline in the effectiveness of the education system. Of course, Chancellor Merz has implemented a massive investment plan in infrastructure (transport and digital), amounting to 2.8% of GDP per year through the end of the decade, along with accelerated depreciation for investments. However, this plan cannot fully offset all the structural weaknesses affecting the German economy (market positioning, energy costs, and aging population weakening domestic demand).

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Decline in GDP, manufacturing output, and labor productivity in Germany

Charts 1A/B/C show that Germany's real GDP has been falling since 2023, manufacturing output has been on a downward trend since 2018, and labor productivity has been declining since 2021. **The German economy is therefore facing a severe crisis.**

Chart 1A
Germany: Real GDP (Y/Y as %)



Chart 1B
Germany: Manufacturing production (100 : 2010.M1)

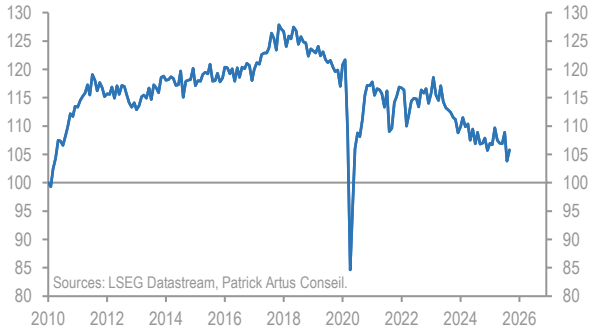
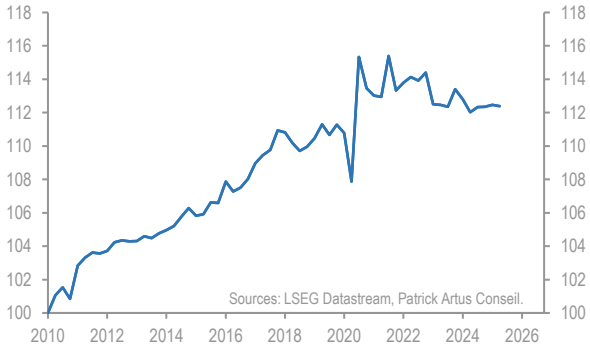


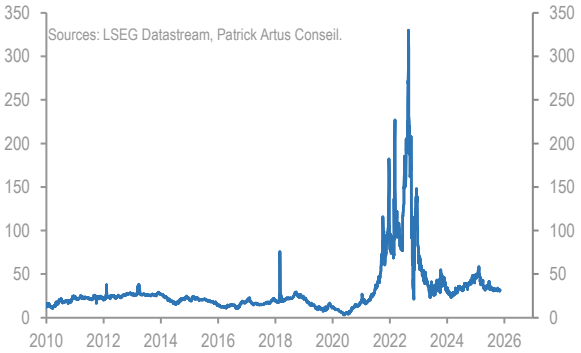
Chart 1C
Germany: Productivity per head (2010.Q1 = 100)



The main explanation for Germany's difficulties: the mid-range positioning of its industry

A first negative shock suffered by German industry was **the sharp increase in energy prices (especially natural gas prices)** starting in early 2022 (**Chart 2**), following the halt of natural gas imports from Russia.

Chart 2
Europe: Natural gas price (€/MWh)



However, the core issue of German industry lies in **its mid-range positioning. Four sectors dominate German industry**: automotive, mechanical engineering, chemicals, and electrical equipment. Among these, only aerospace production is growing (**Chart 3**), while the others are declining, leading to a fall in the share of manufacturing in GDP (**Chart 4**), even though services consumed by industry account for 75% of industrial value added.

Chart 3
Germany: Manufacturing production (100 : 2010.M1)

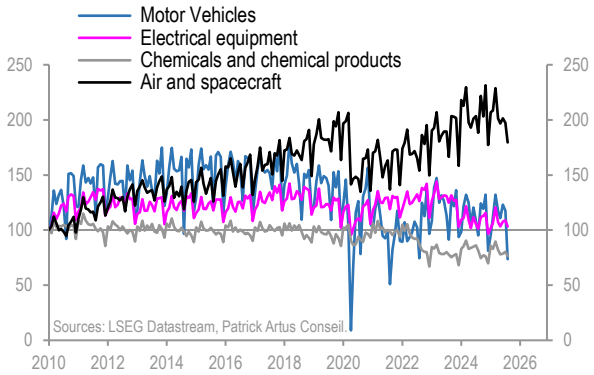


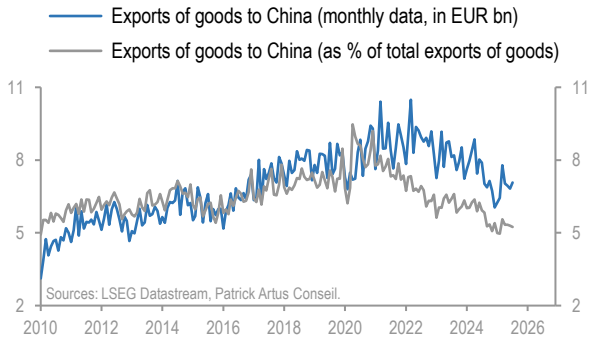
Chart 4
Germany: Real value added in manufacturing (as % of real GDP)



These dominant sectors of German industry are relatively traditional and face several threats:

- the shift to electric vehicles;
- growing competition from China, which represents 6% of Germany's goods exports (Chart 5);

Chart 5
European Union: Exports of goods to China (monthly data, in USD bn)



- rising energy costs;
- dependence on export markets (German industry exports nearly half of its production).

Other structural handicaps in Germany

Germany also suffers from:

- a sharp deterioration in the quality of its education system (Table 1);

Table 1 : Results of OECD PISA surveys (overall score, by decreasing score in the 2022 survey)

Country	2012	2015	2018	2022
Japan	540	529	520	533
Canada	522	523	517	506
Switzerland	518	506	498	498
Finland	529	523	516	495
United Kingdom	502	500	503	494
Denmark	498	504	501	491
United States	n.d	488	495	489
Sweden	482	496	503	487
Germany	515	508	500	482
Netherlands	519	508	502	480
France	500	496	494	478

Source: OECD.

- a rapid aging of its population (Charts 6A/B).

Chart 6A
Fertility rate (births per woman)

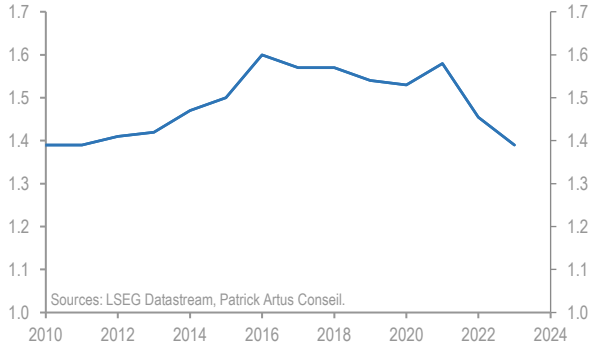
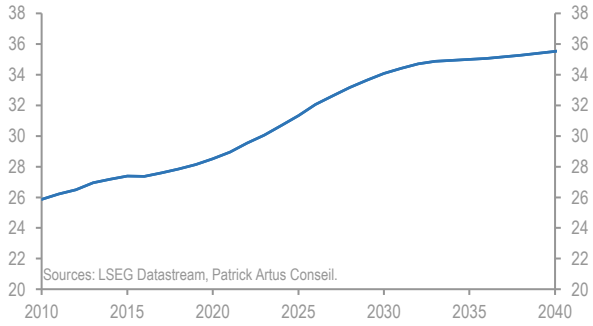


Chart 6B
Germany: Population aged 60 and over as a percentage of the total population



The "Merz Plan" will not be enough to significantly revive the German economy

German Chancellor Friedrich Merz had the Bundestag approve:

- a €500 billion public investment plan over 12 years, targeting infrastructure (transport, energy, etc..) and climate protection;
- accelerated depreciation (30% per year) for investments;
- a 5-point reduction in corporate tax from 2028;
- an increase in research incentives;
- a planned rise in military spending to 3.5% of GDP.

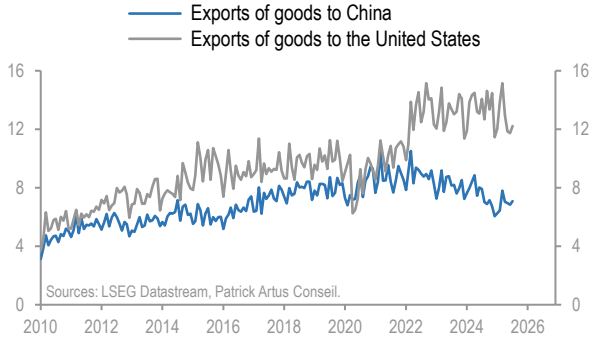
However, the overall fiscal stimulus remains limited: the public deficit is projected to rise from 2.8% of GDP in 2024 to 3.8% in 2027, an increase of only 0.33 percentage points of GDP per year. Even assuming a relatively optimistic **fiscal multiplier**, the **positive effect on growth would be limited to 0.5% of GDP between 2025 and 2027**. If growth without stimulus were negative (as in 2023 and 2024, at –0.7% and –0.5%, respectively), **Germany's growth would remain very weak even with the stimulus plan**.

Summary: Germany's structural handicaps may perpetuate a situation of weak growth

Had Germany maintained its previous fiscal rules (public deficit capped at 0.35% of GDP), it would have had to reduce its fiscal deficit by 2.45 percentage points of GDP compared with 2024 levels, leading to a deep and lasting recession. Yet even with today's greater fiscal flexibility, Germany will continue to struggle. **Improving infrastructure alone cannot**:

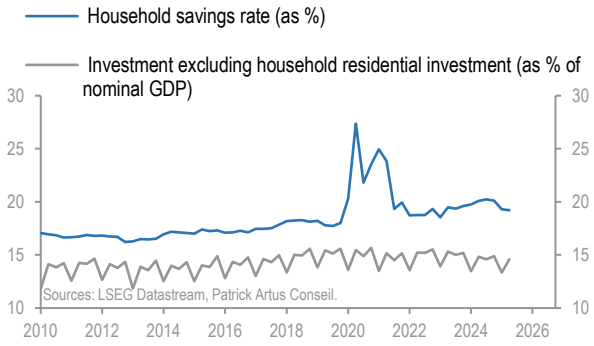
- make the country competitive in electric vehicle production;
- prevent the relocation of the chemical industry, largely due to Europe's high energy costs;
- offset the decline in exports to China (**Chart 7**);

Chart 7
European Union: Exports of goods to China and the United States (monthly data, in EUR bn)



- improve the quality of the education system;
- compensate for export market losses through strong domestic demand growth (Chart 8), which is constrained by a rising savings rate.

Chart 8
Germany: Household savings rate and investment excluding household residential investment



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