MAKING GERMANY GROW AGAIN

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Long-term, future-focused investment can rescue Europe's largest economy from stagnation

More than a quarter century after *The Economist* first dubbed Germany the "sick man of Europe," the label applies again.

And this time, the illness is a chronic condition, requiring a long-term treatment plan. The incoming government's fiscal plan to fund infrastructure investment and increased defense spending is a start. But Germany must also open its economy to future-oriented technologies, push for greater market integration in Europe, and build stronger capital markets at home.

For the past five years, Germany's economy has been stagnant, growing by just 0.1 percent since 2019. Over the same period, the US economy has grown by 12 percent and the euro area as a whole by 4 percent. The forecast does not look any brighter. The German Council of Economic Experts, an independent panel that advises the federal government, expects growth to remain sluggish for the next two years, with potential output increasing by only 0.4 percent per year.

When *The Economist* first called Germany a sick man in 1999, the country was plagued by high unemployment and low economic growth. Then Germany made a recovery. Major labor market reforms in 2003–05 helped reduce unemployment significantly. Wage restraint in the 2000s lowered relative unit labor costs and increased price competitiveness.

The Alps are seen as the sun sets over Munich, Germany.

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But Germany's challenges are different now. The economy does not lack jobs; it lacks workers. In the next 10 years the situation will worsen as 20 million workers are expected to retire while only 12.5 million enter the labor market. Older workers are less likely to work, and those who do, will work fewer hours. The aging population will worsen the labor crunch the country is experiencing today, further driving up labor costs.

Labor costs are in fact the main driver of the decline in German price competitiveness, even more so than rising energy costs. Sluggish productivity growth, combined with rising wages, has led to a deterioration in unit labor costs, also compared with other major European economies such as France and Spain.

Also holding Germany back is a high degree of employment stability, reinforced by measures such as "short-time work," which keeps people on payrolls at reduced hours. While this may sound like a positive for the working population, it has in fact slowed structural change and reallocation to more productive sectors, as there is less pressure on companies and employees to adapt to a changing economy.

Manufacturing decline

We see these adverse factors at work in particular in the manufacturing sector, once the motor of German economic growth but now in continuous decline since 2018. Even when foreign demand, especially from China, picked up again after COVID, manufacturing and other core industries did not benefit, and exports failed to rise accordingly. The loss of competitiveness, combined with rising trade fragmentation, the threat of US tariffs, and increasing competition from China in global markets, will make it more difficult for Germany to regain its footing.

High energy costs matter, too. Although Germany weathered the spike in natural gas and electricity prices following the Russian invasion of Ukraine, output in energy-intensive industries has been declining almost continuously since the start of 2022. Energy prices remain elevated, not only historically and relative to the US, but also relative to many neighboring European countries. This has made Germany less attractive for new energy-intensive industries, such as artificial intelligence, which relies on data centers that consume vast quantities of power. Estimates by the International Energy Agency point to a potential doubling of global electricity demand from data centers between 2022 and 2026, which Germany is not ready to provide at low cost.

In addition to labor shortages and energy costs, Germany's low growth can be linked to two additional factors.

DATA

0.1%

Germany's economy has grown by just 0.1 percent since 2019, compared with 4 percent for the euro area as a whole.

Legacy technologies

First, the country's legacy of leadership in the automotive, mechanical engineering, and chemical sectors has left it focused on, and reliant on, existing technologies. Existing infrastructure, specialized skills, and established markets in these traditional sectors have made it difficult for Germany's economy to diversify into high-tech sectors like IT and biotechnology. While private R&D spending remains relatively strong by international standards, it is concentrated in these "mid-tech" sectors, which can no longer deliver the desired growth.

Second, under the traditional German financial system, too much capital is allocated by the banking sector and too little flows to innovative and higher-risk businesses.

Deep and liquid capital markets foster long-term growth by channeling financial capital to the most productive and innovative companies. This is especially true for young and innovative firms such as start-ups. But German companies have traditionally relied on bank financing rather than the broader capital markets. Although the volume of venture capital grew from an average of 0.02 percent of GDP in 2011–13 to almost 0.09 percent in 2021–23, the volume is still insufficient, particularly for late-stage financing of growing companies. There are fewer and smaller venture capital funds in Europe than in the US or Asia, which makes it hard for start-ups to obtain funding through multiple large financing rounds.

One important reason is a lack of large institutional investors willing to invest in European venture capital. They either prefer to invest in less risky assets or they favor larger and established US funds. This poses a challenge, particularly for larger European scale-ups that frequently move to the US, where deeper capital markets and better exit options, especially as initial public offerings (IPOs), await.

What are the solutions to German stagnation? We think the country must address its economic development from two perspectives: It must look outside and drive European market integration, and it needs to look inside and foster long-term, future-oriented investment.

European integration

To ignite growth, Germany and the other European countries need large integrated markets, which allow businesses to scale up. No European country alone can be competitive with the large US market—nor the Chinese, for that matter. Hence, Germany must actively push for greater European integration in goods, services, capital, and energy markets. Rather than reacting to changes in US economic policy, Germany and the European Union should focus on their existing strengths and actively pursue coordinated plans aimed at becoming economically stronger as an integrated single market.

While there are no formal barriers to trade in the single market, many nontrade barriers persist. These include complex or burdensome procedures for obtaining required permits and licenses to sell goods and services or the lack of tax harmonization. These barriers prevent German and other European companies from scaling up and making use of the potential opportunities that a single market with almost 500 million consumers offers. The EU Commission should make it a key priority to remove any barriers to trade in goods and services and coordinate the harmonization of national regulation.

The same holds for energy. A coordinated buildout of national electricity systems would reduce system costs and increase the efficiency of energy trading. Here, too, it is important to assume a European perspective rather than focusing exclusively on domestic needs. A European energy solution can be significantly more efficient and cost-effective, if all countries cooperate and coordinate.

To finance the substantial investments required for digitalization, defense, and the green transition, Germany must focus on building stronger and more integrated capital markets. A key step is for Germany to lead efforts to improve and harmonize national insolvency regimes, making it easier to value assets across EU borders.

In addition, the European Union should strengthen and reform the European Securities and Markets Authority. Increasing venture capital funding at the European level can be achieved by channeling resources to the European Investment Fund or the European Tech Champions Initiative. Moreover, German households need to learn about the advantages of investing directly in capital markets. A significant change in saving vehicles, away from savings accounts and toward broadly diversified stock market investment, would not only enhance returns but also encourage long-term investment.

Addressing labor shortages

Looking inside the country, it is evident that Germany needs to increase its domestic labor force significantly, both by improving workforce participation and by attracting foreign-born workers. Supplying high-quality and reliable childcare is crucial to increase the hours worked by mothers, as about one in two women now work part-time. Improving incentives for older people to continue working include restricting early retirement and linking the standard retirement age to longer life expectancy. Speeding up administrative immigration processes and extending the Western Balkans Regulation—which eases labor market access for those with a job offer—to additional countries could help attract more skilled foreign workers.

Germany has neglected future-oriented public investment for years, in particular in infrastructure, defense, and education. The incoming government recognizes those needs, and Parliament has passed a financial package creating a special fund for infrastructure and exempting defense spending above 1 percent of GDP from the "debt brake," Germany's constitutional limit on public borrowing. This change in fiscal rules is bold and brings much-needed funds to upgrade creaking infrastructure.

However, it does not address two major issues. First, the proposal does not address design flaws of the current debt brake. One is the lack of transition phases. After a crisis year, the debt brake is reinstated immediately the following year, which risks stifling a potential economic recovery. A more effective approach would allow for a gradual and orderly reduction of the structural deficit. Another flaw is that the existing rules do not account for the overall debt-to-GDP ratio; they apply the same constraints regardless of broader fiscal sustainability.

The second major issue is that the reform fails to tackle the existing political bias favoring short-term benefits for the current electorate over long-term gains for future generations. While the special fund is designated to cover only "additional" infrastructure investment, it is unclear how this will play out in practice. Moreover, redefining what constitutes defense spending may create short-term fiscal space by excluding it from the debt brake; this risks encouraging consumptive expenditure rather than structural reform. If Germany is committed to reaching the 2 percent North Atlantic Treaty Organization (NATO) defense spending target in the long term, defense spending should come from the core budget.

More broadly, any available fiscal space must be used strategically, prioritizing future-oriented investments that strengthen long-term competitiveness rather than masking deeper structural weaknesses. Otherwise, chronic stagnation is all but certain. F&D

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