Institute of European Right

ANALYSIS

Briefing: Recent Discussions on the State of the German Economy

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Germany's ongoing economic recession has sparked a significant volume of in-depth analysis, the conclusions of which are deeply worrying. A prevailing consensus among experts suggests that the German economy faces profound structural challenges that cannot be addressed by a new government or superficial reforms alone. Drawing on insights from leading analysts and commentators such as ***Guy Chazan, Michael Hüther, John Lough, Wolfgang Münchau, Patricia Nilsson, Olaf Storbeck, Adam Tooze, Holger Zschäpitz*** *and others, this briefing examines the current state of Germany's economy, identifies the major challenges confronting Europe's largest economy, and explores the potential consequences of its recent slowdown.*

Emerging from the devastation of World War II, the Federal Republic of Germany quickly positioned itself as an economic powerhouse, earning the moniker of the "German Economic Miracle".

At the core of this success was Germany's unique industrial model. The mid-20th century saw the rise of corporatism, where industrial growth was symbiotically tied to the state's supportive policies and a labour force deeply invested in collective success. Companies such as Siemens, ThyssenKrupp, and Volkswagen became both the industry leaders and the symbols of Germany's economic resurgence.

Equally significant was the entrepreneurial spirit that permeated post-war Germany. Small and medium-sized enterprises (*Mittelstand*) were pivotal in creating niche markets, specialising in high-quality mechanical engineering and precision manufacturing. These firms, often family-owned, embodied a culture of innovation and reliability, enabling Germany to be one of the dominant players in the global supply chains. From automotive components to advanced machinery, these businesses became indispensable to the global economy.

Globalisation amplified Germany's advantages. The expansion of international trade in the late 20th century coincided with the country's ability to leverage cheap energy imports, particularly from Russia, and access burgeoning markets in Asia. Germany's role as an export juggernaut was cemented, with its balance of trade consistently showing significant surpluses. The symbiotic relationship with China, initially characterised by German capital goods flowing into Chinese factories, reinforced its economic surge.

Energy policy played a critical role. The pipelines connecting German industries to Russian natural gas provided a competitive edge, reducing operational costs and ensuring consistent energy supplies. This dependency, while beneficial for decades, created vulnerabilities that would later manifest as Russia's imperial ambitions became a reality.

Finally, Germany's socio-economic model contributed to its legacy. The dual education system, which integrated vocational training with formal education, produced a highly skilled workforce adept at sustaining its industrial prowess. Combined with prudent fiscal policies, Germany became synonymous with financial stability, low unemployment, and robust social welfare systems.

However, the very factors that once propelled Germany to the forefront of the global economy have begun to show cracks under the pressures of technological change, geopolitical shifts, and an evolving global economic order. The legacy of the German economic miracle, while profound, is now shadowed by the challenges of adapting to an already changed world.

Decline

Germany's economic decline is not a story of sudden collapse but of gradual erosion. Cracks began to emerge in this seemingly unshakable foundation during the late 20th century, and these fissures widened in the 21st century.

The seeds of Germany's decline were sown during the 1980s and 1990s, as critical missteps in adapting to emerging technologies set the stage for long-term problems. While its industrial giants excelled in optimising engineering marvels like advanced diesel engines, they failed to anticipate the transformative impact of the digital revolution. The government, prioritizing short-term political gains over strategic foresight, overlooked the urgent need for investments in optical fibre networks and digital infrastructure, instead funnelling resources into outdated projects like analogue-based high-definition television, which quickly became obsolete. This neglect left Germany trailing global leaders in digitalisation and communication, while its industries became synonymous with incremental improvements rather than disruptive innovation. Dominant companies such as Volkswagen, BMW, and BASF narrowly dictated the course of progress within their domains, creating a "Smith Corona problem" that left entire sectors ill-prepared for global shifts, with the auto industry increasingly resembling the typewriter manufacturers of a bygone era.

These structural issues have been compounded by Germany's inability to foster an ecosystem for startups, as bureaucratic red tape and insufficient funding mechanisms deter entrepreneurial activity. Many of the country's most ambitious innovators have relocated to destinations like the United States, drawn by more supportive policies and abundant venture capital. This persistent brain drain further undermines Germany's ability to cultivate industries essential for driving future economic growth, deepening the challenges faced by an economy tethered to legacy models.

Reunification in 1990 marked a significant point. While it was a historic triumph, the integration of East Germany came at a steep economic cost. Billions of Deutsche Marks and later Euros were funnelled into rebuilding the former East, but the endeavour created long-term structural inefficiencies. As West Germany bore the financial burden of reunification, its economic dynamism began to falter, with stagnation creeping into key sectors. The challenges of reunification were compounded by the political leadership's adherence to traditional fiscal conservatism, which limited public investment in infrastructure and innovation at a time when transformative growth was most needed.

Germany's failure to innovate extended beyond technology. Its industrial champions became synonymous with incremental improvements rather than disruptive change. The automotive sector, for instance, excelled in refining internal combustion engines but dismissed the growing importance of electric vehicles and software integration.

Angela Merkel's 2013 remark about the internet being *Neuland* "unknown territory" exemplified the national reluctance to embrace transformative technologies. Meanwhile, the *Mittelstand*—Germany's vaunted small- and medium-sized enterprises—continued to excel in niche manufacturing but struggled to diversify into future-facing industries.

The 2000s ushered in globalisation's golden age, a period during which Germany thrived as a dominant exporter. Benefiting from cheap Russian gas, robust demand from China, and the efficiencies of global supply chains, the German industry enjoyed an era of profitability. Yet, this reliance on external markets masked vulnerabilities. Industries like automotive and chemicals grew complacent, doubling down on traditional strengths without sufficiently diversifying. The assumption that globalisation would continue unchecked left Germany exposed when geopolitical shocks —like the U.S.-China trade war and Russia's invasion of Ukraine—disrupted established trade flows and energy dependencies.

The global financial crisis of 2008 laid bare weaknesses in Germany's banking system and economic structures. Unlike the United States, which undertook significant financial reforms, Germany's regional banks— *Landesbanken*—remained politically entangled and inefficient. These institutions struggled to adapt to global financial dynamics, constraining Germany's capacity to support start-ups and foster innovation. As a result, Germany failed to cultivate a new generation of tech companies, leaving it reliant on ageing industrial champions like Volkswagen and BASF.

Throughout the 2010s, another major shift happened. China, once a voracious consumer of German machinery and vehicles, transitioned into a competitor, producing high-quality electric vehicles and industrial products at lower costs. Simultaneously, Germany's reliance on Russian energy—seen for years as a cornerstone of economic stability—became a liability following Russia's aggression in the region. The subsequent energy crisis revealed the fragility of a system that had placed affordability over resilience.

Domestically, Germany's rigid adherence to fiscal austerity further hampered its ability to adapt. Policies like the constitutional "debt brake", introduced in 2009, restricted public investment even as the country's infrastructure aged and technological gaps widened. Political leaders, wary of breaking from the consensus-driven culture of German policymaking, prioritised short-term stability over long-term transformation. This traditionalism stifled bold initiatives, leaving Germany unprepared for the demands of a rapidly evolving global economy.

The automotive, chemical, and engineering sectors—once a spine of Germany's economic strength—are now faltering under the combined weight of structural inefficiencies, global competition, and mounting external crises. Iconic companies like Volkswagen and others are facing unprecedented pressures, with plant closures looming as the industry wrestles with the twin demands of decarbonisation and electrification, while ThyssenKrupp struggles to transition to green steel production amidst a broader decline in industrial output.

These vulnerabilities, exacerbated by the COVID-19 pandemic and Russia's war in Ukraine, have plunged the economy into stagnation, with industrial production contracting and key sectors failing to adapt to decarbonisation and digital innovation. Germany remains tethered to legacy industries and outdated practices, and its fragile political coalitions, marked by deep divisions, have hindered the decisive action needed to navigate these challenges. Without significant restructuring, analysts warn that up to 20% (!) of Germany's industrial capacity could vanish within the next decade.

The history of Germany's decline is not a story of a singular failure but of compounding decisions and missed opportunities. Germany has repeatedly chosen stability over agility and convention over reinvention. As the global landscape grows more uncertain, Germany must reckon with the legacy of its decisions and chart a path toward renewal.

Crossroads

What was heralded as the "German economic miracle" has become a cautionary tale of an economy struggling to reconcile its past strengths with the demands of a volatile present.

Germany's energy landscape illustrates the pitfalls of reactive policymaking and reliance on outdated strategies. The abrupt pivot to liquefied natural gas (LNG) imports following Moscow's invasion of Ukraine highlighted the geopolitical necessity of abandoning Russian energy but came at a steep economic cost. Soaring energy prices have hit energy-intensive sectors such as chemicals and heavy industries particularly hard, while the decision to phase out nuclear power amidst a global energy crunch has further disrupted planning and undermined investor confidence. Once a pragmatic approach to energy transition, Germany's strategy has devolved into reactive measures, threatening the competitiveness of its industrial base.

The digital transformation has also left Germany floundering in a rapidly evolving global economy. The nation that once set the standard for precision engineering now lags behind in digitalisation. Outdated infrastructure and a lack of cohesive strategy have hampered the transition to a digital economy. While some companies, such as Siemens and SAP, thrive in niches, the broader economy remains ill-equipped for the challenges of a digital age. Startups are sparse, and many of the country's brightest entrepreneurial minds have sought opportunities abroad, further eroding Germany's competitive edge.

Geopolitical shifts have further upended Germany's economic relationships, transforming what were once pillars of stability into sources of vulnerability. China, once a reliable export market, has evolved into a formidable competitor, particularly in automotive manufacturing. Chinese electric vehicle producers now rival German automakers with more advanced and affordable options, steadily eroding Germany's market share. Simultaneously, Germany's reliance on the United States as a key export partner faces new threats, with potential tariffs under a new U.S. administration. These pressures underscore the fragility of Germany's global economic position.

Political instability, widely believed to have originated with Chancellor Merkel's decision to open Germany's doors to migrants, has exacerbated the country's economic challenges. Currently, the collapse of the coalition of the SPD, Greens, and FDP plunges Germany into deeper uncertainty. The coalition's inability to reconcile competing visions—particularly over the "debt brake" rule — has resulted in a minority government, exposing fundamental divides in Germany's fiscal policy and the need to implement coherent economic reforms.

This failure to deliver clear and consistent policy direction has eroded confidence among businesses and voters alike, leaving the government mired in provisional budget management and unable to address long-term priorities such as defence spending and industrial revitalisation. Abrupt

policy shifts, such as the withdrawal of electric vehicle subsidies, have directly impacted jobs and exacerbated uncertainty across critical sectors.

These fractures have created a political vacuum that populist forces have readily exploited. The far-right AfD continues to gain momentum, fueled by public frustration over immigration, energy prices, and economic stagnation, while Sahra Wagenknecht's breakaway movement has tapped into discontent among rural and working-class voters, opposing Germany's climate policies and support for Ukraine while challenging the traditional political order.

Together, these dynamics reflect a fractured political landscape, with conflicting agendas over fiscal conservatism and welfare commitments further destabilising its economic and political future.

Germany's current moment is not merely an economic downturn but a reckoning. Its traditional economic model, reliant on cheap energy, robust exports, and a stable political system, is no longer tenable in a world defined by geopolitical fragmentation and technological disruption.

Reckoning

Germany stands at a pivotal moment. The economic challenges it faces are not isolated or fleeting—they are the cumulative result of decades of decisions, both bold and cautious, that once drove unparalleled prosperity but now tether the nation to an outdated model. The industrial might that defined its postwar success, the export-led growth that fueled its rise, and the fiscal conservatism that shielded it during crises now seem ill-suited to the demands of a changed global order.

The time for nostalgia is over. Germany must confront the hard truth: the economic miracle has run its course. The world has changed, and Germany must change with it. Energy resilience, digital transformation, and geopolitical recalibration are no longer aspirations—they are imperatives. The way forward lies not in clinging to old strengths but in creating new ones.

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