

Strength and weakness of Germany's economy

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Abstract

Germany's economic strength, reflected in its huge trade surpluses, has hinged on restrictive fiscal and wage policies, which have suppressed domestic demand. However, these policies have increasingly been backfiring, as its trading partners in the EU, induced to emulate the German policy model, have regained the ability to run trade surpluses. The present political change in Germany brings some hope, and a large fiscal stimulus package is on the agenda. But the idea of 'kick-starting' the economy by implementing a new version of Agenda 2010 lives on; if implemented, its consequences would be bad for Europe – and for Germany itself.

Symptoms of economic weakness in the German economy are multiplying. In 2024, Germany's GDP shrank by 0.5%, following a 0.9% contraction in 2023. But the anaemic growth of the German economy is not merely a feature of the last few years: it has been going on for quite some time – it has just become more pronounced in recent years. Over a longer period (1996-2024), Germany's average annual GDP growth was a mere 1.2%, compared to 1.6% for the rest of the euro area (hardly an impressive result there either). Evidently, in terms of its growth performance, Germany has long been the 'sick man of the euro area' (or rather, one of its sicker members).

The current weakness of the German economy is often attributed to structural factors, such as bureaucratic over-regulation of the economy (motivated among other things by environmental considerations), over-specialisation (automotive industry), misguided energy generation policies (abandonment of nuclear power plants), etc. More recently, the loss of supplies of cheap gas from Russia has often been mentioned. Some commentators also cite the impact of unfavourable demographic and employment trends. Finally, there is the issue of the increased expansion of highly competitive exports from China.

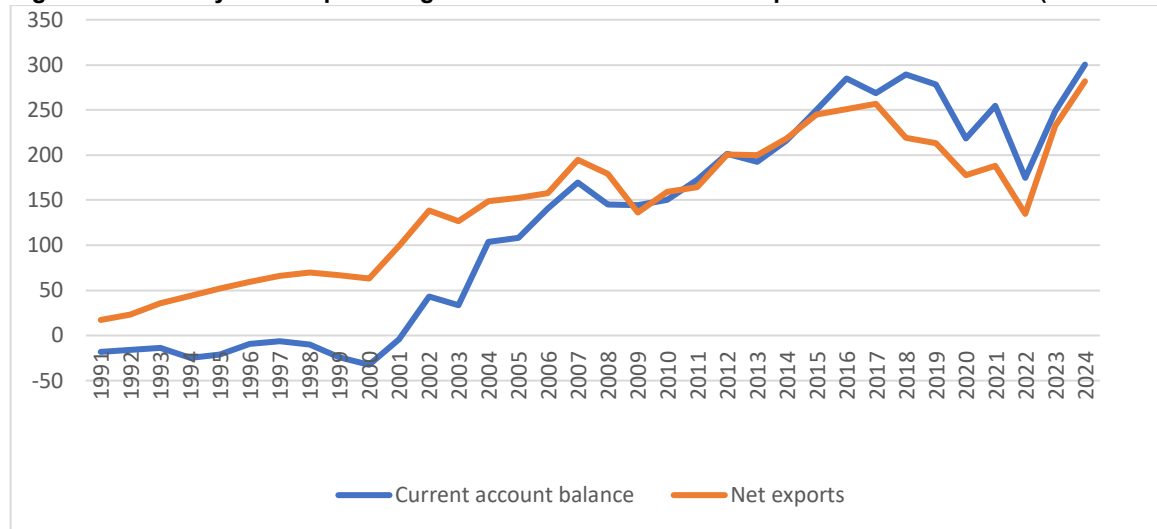
All of the above factors, goes the argument, are likely to have an adverse impact on the German economy; and taken together, they are supposed to justify the claim of a progressive loss of the country's competitiveness. However, this claim appears rather unjustified. Germany's economy remains remarkably competitive on the international market. And this is particularly true of its industrial sector.

Germany's strength: huge current account surpluses

¹ Thanks are due to Vasily Astrov for helpful comments on the earlier draft of this note.

None of the above-mentioned structural factors – more expensive energy, increased Asian competition, etc. – has diminished Germany’s ability to generate huge surpluses in goods trade and, consequently, in the current account (Figure 1). This demonstrates the remarkable competitiveness of Germany’s economy vis-à-vis the rest of the world.

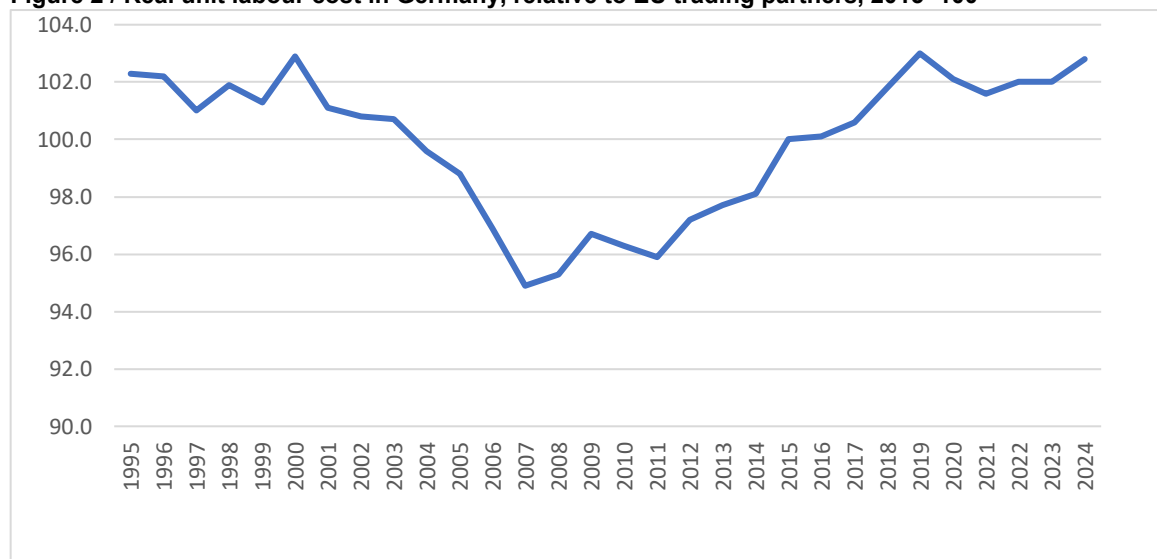
Figure 1 / Germany’s net exports of goods and current account surplus from 1991 to 2024 (billion euros)



Source: AMECO.

It is noteworthy that Germany recorded small current account deficits between 1991 and 2001. This probably reflected the extraordinary circumstances surrounding the integration (and reconstruction) of the Bundesländer inherited from the GDR. The transition from small deficits to rapidly growing surpluses occurred around 2003, when a whole package of reforms (the so-called Agenda 2010) started to be implemented. The reforms focused on making the labour market more flexible, the termination of many social privileges and the systemic reduction of the deficit in public finances. An important outcome (and goal) of Agenda 2010 was to reduce labour costs and improve price competitiveness vis-à-vis Germany’s main trading partners. This goal was achieved (see Figure 2).

Figure 2 / Real unit labour cost in Germany, relative to EU trading partners, 2015=100



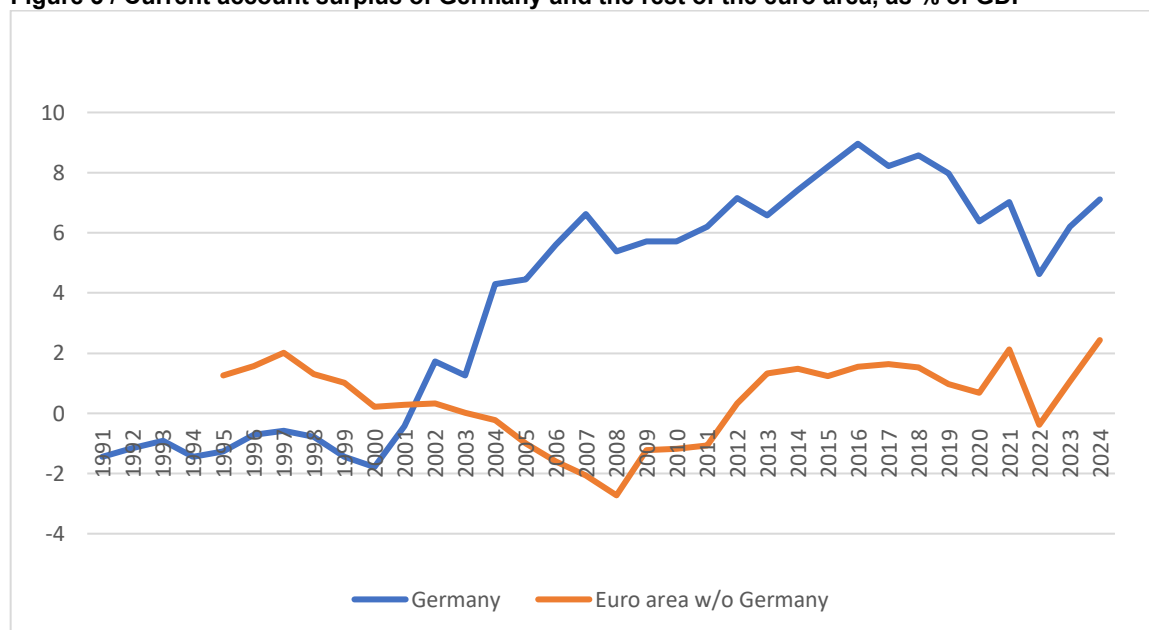
Source: AMECO.

The progressive reduction since 2003 in real unit labour costs, relative to the country's trading partners, has been achieved – among other things – on account of a decline in real wages in Germany itself. Between 2002 and 2007, the average real wage in Germany fell steadily, by an average of 0.3% a year. It is worth noting that it was only after 2019 that Germany's real unit labour cost, relative to its trading partners, returned to the level of the late 1990s. The improvement in Germany's wage competitiveness was clearly related to the rapidly growing expansion of exports (with still limited growth in imports) and the build-up of surpluses in the current account of the balance of payments.

An additional pro-export stimulus came with the launch of the common European currency. Before the introduction of the euro, the 'weaker' currencies of the area's member countries devalued quite freely and systematically against the German mark. This was especially true of the Italian lira, which fell steadily.² As a result, during the pre-euro era, the products of Germany's European trading partners successfully competed with German products, including in third-country markets. After the introduction of the euro, the devaluation of a currency to restore a country's competitiveness became impossible. This provided additional stimulus to Germany's exports – at the expense of other euro area economies, especially Italy.

This is reflected in the deterioration of the current account balance of the remainder of the euro area (Figure 3). Note that initially it generated surpluses – which, however, declined in parallel with the expansion of Germany's surpluses. It is worth remembering that the euro area also includes countries that are closely integrated economically with Germany (including in terms of wage-setting): Austria and the Netherlands. They, too, were running surpluses. By 2008, therefore, the aggregate current account deficits of the euro area without Germany, Austria and the Netherlands – especially its southern flank – were growing more than Figure 3 suggests.

Figure 3 / Current account surplus of Germany and the rest of the euro area, as % of GDP



Source: AMECO.

After the global financial and economic crisis of 2008-2009, the growth in Germany's current account surplus slowed. This can be attributed to recessionary crisis (and post-crisis) trends in the global and European economies. Another 'collapse' of exports and a significant reduction in the current account

² In 1974, the German mark was worth about 200 lira. By the late 1990s, it was around 1,000 lira.

surplus occurred during the COVID-19 pandemic (2022). However, even these 'slumps' were still accompanied by huge surpluses (e.g. nearly EUR 180 bn in 2022). Even in the midst of an acute global crisis, Germany's economy thus remained remarkably competitive against the rest of the world (and also its euro area trading partners).

Since 2011, the euro area countries have followed the path of Germany

Since 2003, the 'scissors' between Germany's current account surplus and the (combined) current account deficits of the rest of the euro area countries have been opening rapidly (Figure 3). Among the consequence of this trend were the growing foreign claims of German entities (including banks) and the growing foreign debts of economic entities (including banks) of the other euro area members. Until the outbreak of the global financial and economic crisis of 2008-2009, this situation presented no cause for concern – not least because of low interest rates and the widespread abundance of available capital (much of it speculative).

However, the outbreak of the global crisis (2008) and the subsequent debt crisis in the euro area (2009-2010) put an end to the option of easy borrowing by the economic entities of Germany's trading partners. This had consequences for both Germany and its partners. The latter found themselves faced with the need to work out trade (and current account) surpluses. Among other things, this meant adopting Germany's practices with regard to wage formation. In a recessionary environment, a process of so-called 'internal devaluation' has been taking place in Germany's partner countries since 2011. This has boiled down to a reduction in wage growth (or even an outright wage reduction). The process has led to a gradual decline in Germany's competitive advantage (see Figure 2) and the return of competition from its European trading partners (as well as a reduction in the scale of German current account surpluses, as can be seen in Figure 3).

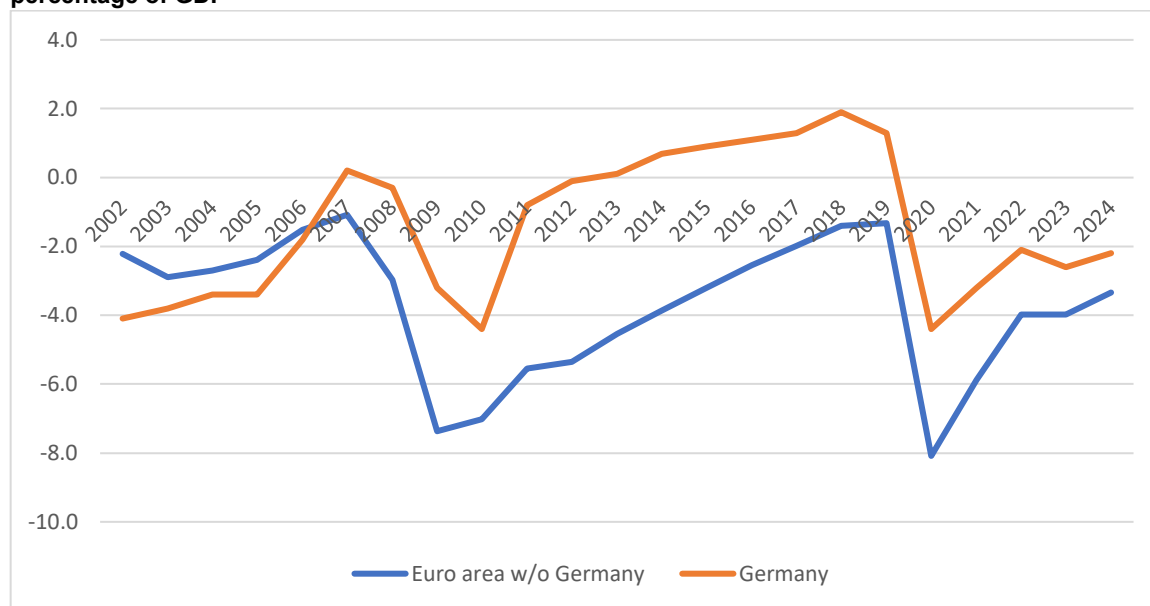
It is worth recalling that in 2009-2011 some of the excessive debts burdening the private sector were transformed into the public debt of individual countries. The partial nationalisation of bad private debts quite imperceptibly gave rise to the practice of blaming fiscal policy – i.e. the public sector – for the euro area's debt crisis. The fiscal policies of the most indebted countries (the so-called PIGS: Portugal, Italy, Greece and Spain, as well as Ireland) were placed under the scrutiny of the European Central Bank, the International Monetary Fund and the European Commission. Another Fiscal Pact (2011) followed, whose essence was to strengthen 'fiscal discipline' across Europe.

The imposition of policies minimising fiscal deficits was presumably intended to facilitate the workout of current account surpluses that would help the settlement of partner countries' foreign debts, primarily to Germany. Nor is it at all coincidental that the 'spirit' of this pact (and earlier treaties on the public finances of EU member states) corresponds to the views and practices of economic policy long dominant in Germany. Among these is the doctrine of 'black zero'. This is understood as a requirement that public finances should be balanced (or even show a slight surplus).

Germany's tendency to run a fiscal surplus is documented in Figure 4. As can be seen, there were sizable fiscal surpluses between 2012 and 2019. Only during the crisis periods (2008-2011 and after 2020) did Germany's public finances have to run a deficit – despite the best intentions of the German government, seeking to maintain fiscal discipline even in the face of deep economic slumps. The public finances of the other euro area countries (taken together) reacted much more sharply to the crises. Moreover, even in periods of relative prosperity, they were characterised by significant deficits. This sometimes gives rise to claims that those countries were at fault for not taking advantage of the good times to put their public finances in order. This ignores the fact that their prosperity may have been due

precisely to those fiscal deficits. Successful implementation of the programme to fix public finances may even have wiped out economic growth.

Figure 4 / Balance of public finances ('net lending/borrowing') of Germany and the rest of the euro area, percentage of GDP



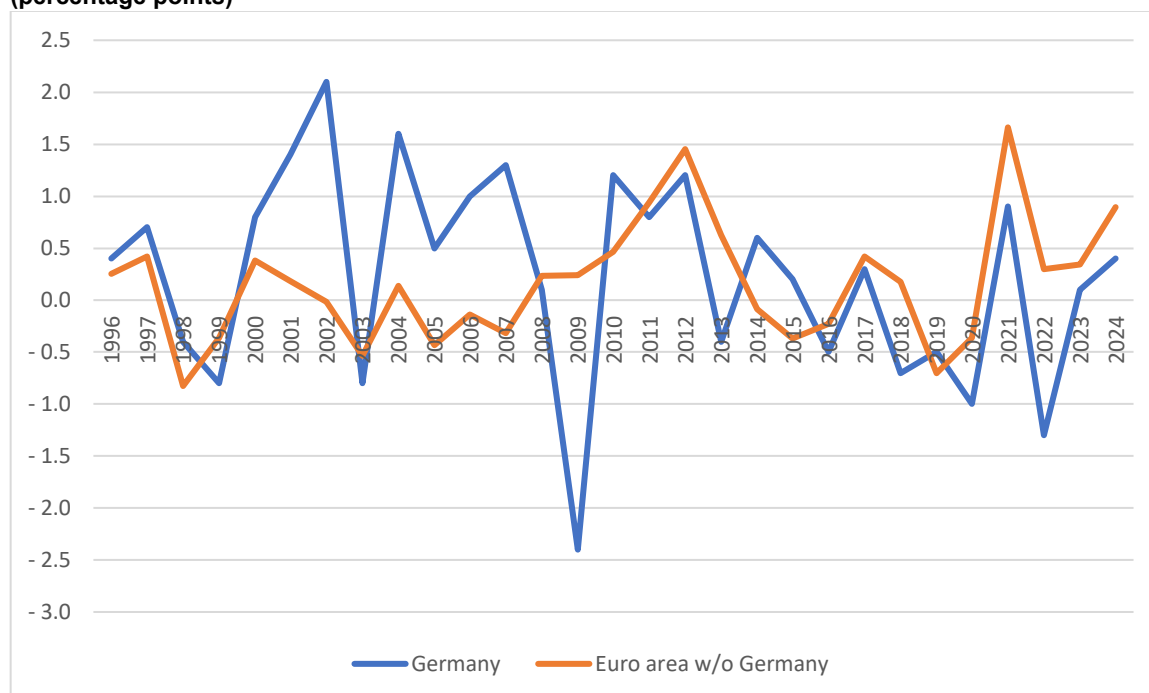
Source: AMECO.

The weakness of Germany's economy is a reflection of its strength

The 'virtues' of Germany's pursuit of a balanced budget (and generally the greater fiscal discipline there than elsewhere) and its supposedly 'economy-friendly', prudent wage policies have not been rewarded. Economic growth has been weaker in Germany than in the euro area generally. On average, Germany's GDP grew by 1.2% annually between 1996 and 2024, compared with about 1.6% for the rest of the euro area. It turns out that economic growth in Germany has been disproportionately the result of foreign trade (in goods and services). On average, foreign trade generated 0.2 percentage points of GDP growth throughout the period. Growth in domestic demand (i.e. primarily private consumption) generated 1 percentage point.

The contribution of domestic demand to GDP growth in the rest of the euro area was noticeably higher: 1.7 percentage points on average (while the contribution of foreign trade was negative, at -0.1 percentage points). Thus, foreign trade generated economic growth in the euro area to a much lesser extent than in Germany.

The differences in GDP growth rates and foreign trade contributions in the periods before and after the 2009 crisis are significant (see Figure 5). In the run-up to the 2009 crisis (1996-2008), foreign trade generated on average as much as 0.7 percentage points (pp) of Germany's 1.1% GDP growth, with only 0.4 pp coming from domestic demand (i.e. mainly consumption). During the same period, euro area GDP (excluding Germany) grew by an average of 2%, and the contribution of trade was negative (-0.6 pp). Domestic demand growth generated 2.6 pp of GDP growth.

Figure 5 / Contribution of changes in foreign trade (goods and services) to GDP growth rates (percentage points)

Source: AMECO.

Over the entire post-crisis period (2010-2024), Germany's annual GDP growth averaged 1.6%, compared to 2.6% in the rest of the euro area. The contribution of trade to growth in Germany was 0.1 pp versus 0.2 pp in the remainder of the euro area.

Evidently, the overall period 1996-2024 can be divided into two sub-periods that fundamentally differ as regards the role of trade in generating GDP growth. In the first sub-period (before 2009), foreign trade strongly supported growth in Germany and inhibited growth in the rest of the euro area. In the second sub-period (after 2009), foreign trade supported (albeit moderately) GDP growth in both Germany and the remainder of the euro area.

The above differences in the sources of GDP growth largely reflect differences in wage formation. This is particularly evident between 1999 and 2008. During that period, the effects of labour market reform, which resulted in wage restraint, were manifest in Germany. As a result, while the contribution to GDP of changes in domestic demand was clearly positive in Germany's trading partners during this period, it was low in Germany. After 2009, the contribution of foreign trade to Germany's GDP growth declined dramatically. Most likely, internal devaluations in other euro area countries led to a strengthening of their competitiveness, making it difficult for Germany to work out even higher trade surpluses (Figure 3). Of course, differences in GDP growth rates must also have been influenced by differences in the fiscal policies pursued (Figure 4).

Conclusions

Germany's economic strength, reflected in its huge trade surpluses, has been built on a restrictive fiscal policy, combined with a restrictive wage policy. The latter seems to have been accepted not only by the country's political elite, but also by the labour unions. This policy mix naturally leads to a

structural retardation of the economy (manifested, for example, in the underdevelopment of the service sector) and stagnation of consumption (and, as it turns out, of investment as well). As a result, Germany's economic growth has become dependent on expanding trade surpluses. The latter, however, depend on maintaining 'wage and fiscal discipline' – i.e. on stagnant domestic demand. And on foreign economic prosperity.

Working out trade surpluses is becoming increasingly difficult and risky. The global economy cannot indefinitely (and smoothly) absorb Germany's (and also China's) growing trade surpluses. Finally, forces are emerging to oppose the excessive imbalances in global trade. This is demonstrated, for example, by the electoral success of President Trump, a politician openly hostile to the mercantilist policies of the US's trading partners. Worse, the 'German disease' of subordinating the entire economy to the needs of the export front is proving contagious. The fiscal doctrine imposed on euro area countries and the need for so-called internal devaluation are a recipe for weak growth. Moreover, the German-EU doctrine of 'sound' public finances and the same doctrine of ensuring competitiveness at the expense of wages (and consumption) is backfiring on Germany: its EU partners already seem to be enjoying restored competitiveness – at Germany's expense.

The economic (and therefore political) future of the European Union will depend on the fate of its biggest economy, Germany. The present political change in that country brings some hope, as the new government is determined to substantially relax fiscal policy – by 2 pp of GDP over the next ten years, via increased spending on infrastructure and defence. However, the idea of 'kick-starting' the economy by implementing a new version of Agenda 2010 lives on.³ The consequences of a resolute continuation of past policies ('more of the same') would, in my opinion, be bad for Europe – and for Germany itself.

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³ Calls for 'more of the same' have already come from the influential Institut der Deutschen Wirtschaft. See e.g. 'Eine Agenda für die neue Legislaturperiode: Wettbewerbsfähigkeit und Transformation', Policy Paper 1/2025 and 'Steigende Sozialversicherungsbeiträge belasten die Wettbewerbsfähigkeit', Policy Paper 3/2025.