Global Macro Research

20 February 2025

8:03 minute read

#Europe / #Fiscal Policy / #Politics

Can Germany's next government restore its competitiveness?

Sunday's elections will very likely result in a change of government, with CDU leader Friedrich Merz the probable incoming chancellor. He will inherit a faltering economic model facing multiple structural headwinds. We expect modest debt brake reform to increase investment and defence spending. But, despite some improvement, Germany's long-term growth prospects will remain among the worst in the Eurozone.

Key Takeaways

- Germany's economic model is under pressure from multiple structural headwinds.
- The government formed following Sunday's elections needs to deliver an economic strategy capable of confronting these headwinds.
- Many of Germany's structural challenges can be traced back to relatively slow capital deepening. Restoring competitiveness, then, will mean expanding capital expenditure in both the private and public sector.
- However, the government's ability to invest is currently limited by the debt brake, a constitutional amendment restricting government deficit spending to 0.35% of GDP.
- We think the next government will look to expand public sector investment, as well as increase defence spending, through limited debt brake reform.
- In addition, the new government might look to boost the supply-side by restarting recently closed nuclear reactors.
- In all, structural headwinds are likely to continue to weigh on growth prospects. But potential growth expectations could be revised higher depending on the next government's agenda.

Germany's next government will inherit serious structural headwinds

Polling data suggest that Germany is set for a change of government after elections this Sunday.

Christian Democratic Union (CDU) Leader Friedrich Merz is likely to become chancellor, though the precise coalition his party will share power with remains uncertain.

Merz will inherit an economic model based on manufacturing-intensive, export-led growth that is under pressure on multiple fronts. Structural economic headwinds have pushed down on potential growth. This is particularly difficult to deal with because the usual levers of fiscal and monetary stimulus are ineffective.

Moreover, the necessary structural reforms are often challenging because they may clash with broader social preferences, entrenched interests, and existing political settlements.

Nonetheless, there are some feasible reforms the next German government could pursue to push up on potential growth.

Underinvestment has left key industries uncompetitive

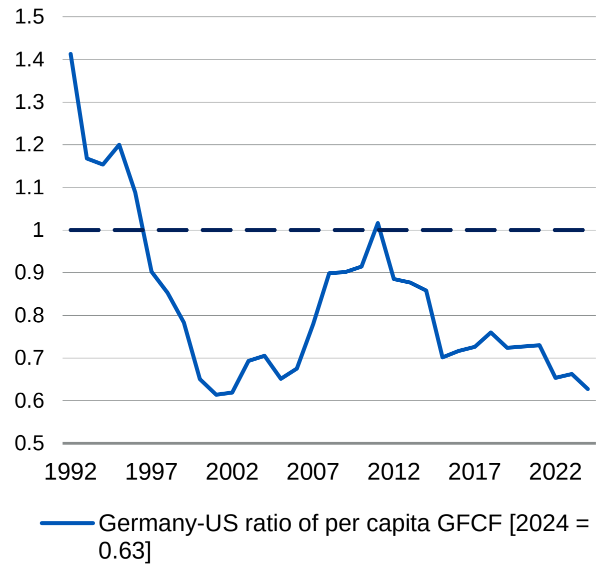
GDP growth can be decomposed into contributions from labour, capital, and total factor productivity (TFP).

Historically, Germany's comparatively high capital stock gave it a competitive edge in the production of capital-intensive goods such as cars and chemicals.

But the economy's recent sluggish pace of capital accumulation has contributed to its growth slowdown.

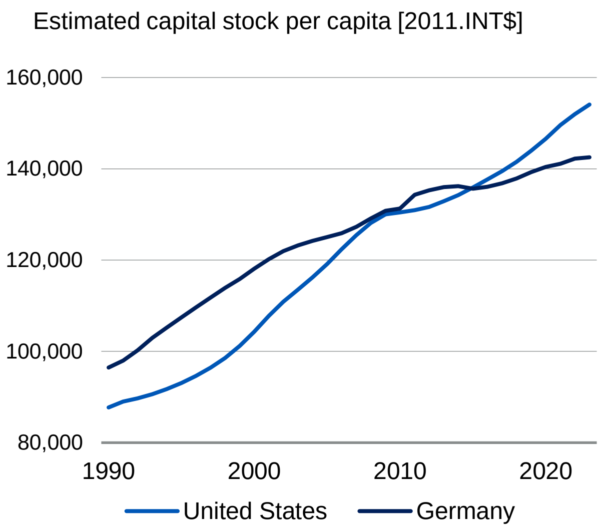
Indeed, international peers have been closing the gap through higher investment (see Figure 1) and Germany has lost its position as the world's most capital-intensive major economy to the US (see Figure 2).

Figure 1: US per capita investment has consistently outstripped Germany's in recent years



Source: abrdn, Haver, February 2025

Figure 2: German workers now have less capital to work with than their American counterparts



Source: abrdn, Haver, February 2025

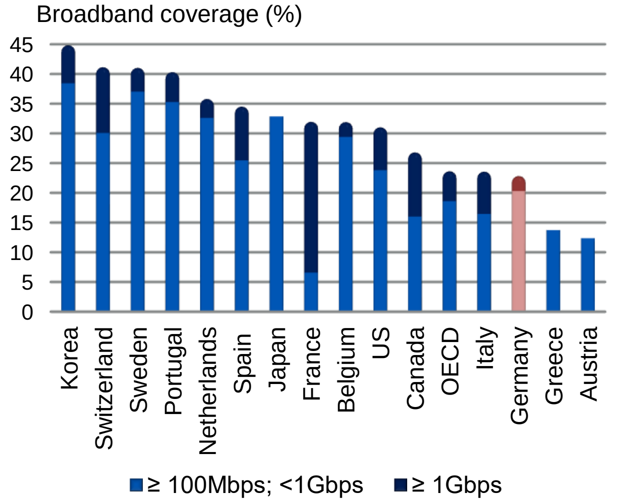
Without this advantage, producers of capital-intensive goods have lost competitiveness in international markets and Germany's share of the global market for these goods has shrunk.

And it's not just capital-intensive industry that has suffered from a lack of investment.

Germany lags most of the Western world on investment in information and communications technology (ICT) and digital infrastructure, with implications for productivity across the economy.

Flagship infrastructure projects such as former Chancellor Angela Merkel's plan to achieve 75% high-speed broadband coverage have fallen by the wayside. At present, Germany's high-speed broadband coverage remains well behind that of most of its peers' (see Figure 3).

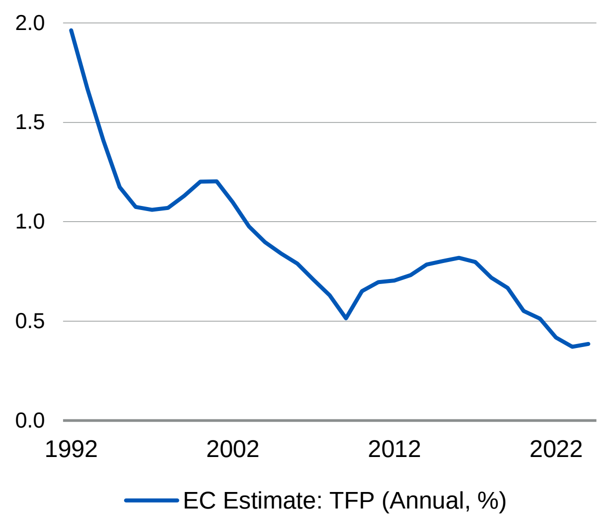
Figure 3: Lagging digitalisation poses another headwind



Source: abrdn, OECD, February 2025

Network infrastructure such as this is especially important for productivity growth as it has spillover effects that can also boost total factor productivity (TFP). So, the failure to invest in these technologies also helps explain Germany's sharp TFP slowdown (see Figure 4).

Figure 4: German TFP growth has been very weak



Source: abrdn, Haver, February 2025

Auto manufacturing is in reverse

The twin pressures on the German economic model from slow capital deepening and lagging digitalisation are exemplified in the auto industry.

Manufacturers have lost competitiveness not just because of the emergence of international rivals in capital-intensive production, but also because of technological innovations such as the shift in the auto industry away from internal combustion engines (ICEs) to electric vehicles (EVs).

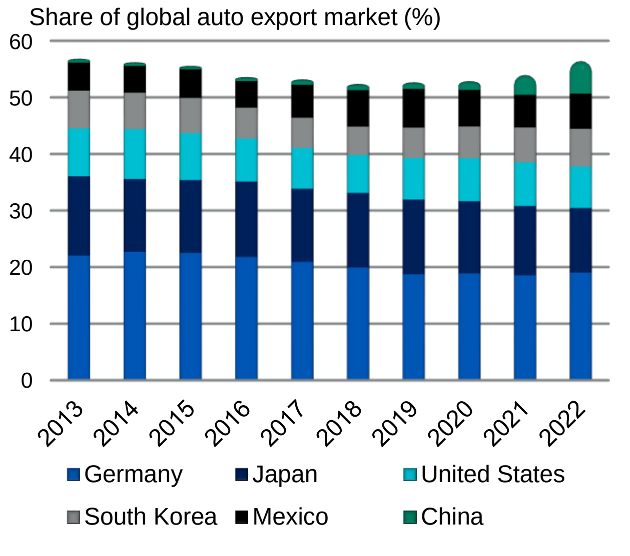
In the past, the depth of its capital resources, accumulated institutional knowledge, vocational education programmes geared toward the industry, and a network of mid-sized domestic firms producing auto-specific intermediate goods came together to give Germany a comparative advantage in ICE auto production.

However, the physical capital, expertise, materials and intermediate goods needed to produce EVs differ materially to those needed for ICE vehicles.

Meanwhile, the US and China have both secured a leading position in EV production through aggressive industrial policy.

As a result, Germany's competitive edge in auto production has been undermined (see Figure 5).

Figure 5: Germany's share of the global auto export market is shrinking



Source: abrdn, Haver, February 2025

Transforming energy supply chains won't be cheap

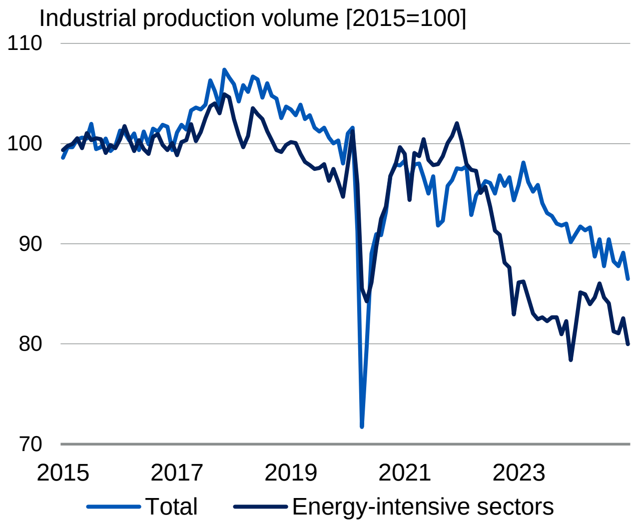
Geopolitical disruption is also posing structural problems to German industrial production.

Russian gas supply was a lynchpin of Germany's industrial strategy, aimed at maximising manufacturers' competitiveness by securing relatively cheap inputs for producers.

But following Russia's invasion of Ukraine, Chancellor Olaf Scholz pursued a strategy of *Zeitenwende*: a "turning of an era" in foreign and security policy to decouple Germany from Russian energy supply.

This had significant consequences for Germany's energy-intensive industrial production, with activity in sectors such as metals, chemicals, and cement declining sharply (see Figure 6).

Figure 6: Energy-intensive industries have been particularly weak



Source: abrdn, Haver, February 2025

The challenge for the next government is to lower energy prices without reintroducing dependency on Russian gas.

One option is to increase supply by turning nuclear plants closed under Scholz's government back on. As the planned decommissioning of these plants has not begun, this is technologically feasible. However, the policy would require a €2bn capital outlay.

Moreover, a political consensus in favour of restarts might be difficult to find. The CDU has confirmed it will consider this policy, but the Social Democratic Party (SPD) and Greens have reiterated their opposition to nuclear power and would likely only support restarts in return for major concessions on other issues.

Germany might also look to the US for additional gas supply. US President Donald Trump has previously indicated that he is keen on the idea, given his focus on "energy dominance" and the US trade deficit.

Increasing investment won't be easy

Given the depth of challenges Germany faces, both the private and public sectors will need to play a significant role in boosting investment.

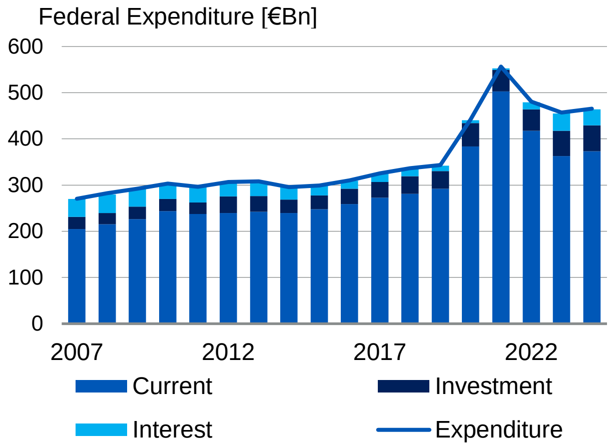
Merz proposes to encourage private investment by cutting income and corporate taxes and deregulating the economy.

These reforms could indeed push up on private investment, though there is a risk that households choose to use the proceeds of lower income taxes to increase consumption instead.

On the public side, Germany's debt brake, which limits the federal government's deficit-to-GDP ratio to 0.35% per year, makes expanding investment difficult.

Given the pressures on the federal budget from welfare and defence, there is little left for investment (see Figure 7).

Figure 7: Only 12% of federal spending was on investment in 2024



Source: abrdn, Haver, February 2025

When faced with deficit reduction obligations, successive German governments have cut capital spending rather than current expenditure such as on salaries or welfare. And with Germany's interest payments rising, there is a danger of capital expenditure being squeezed out even more to stick to the debt brake.

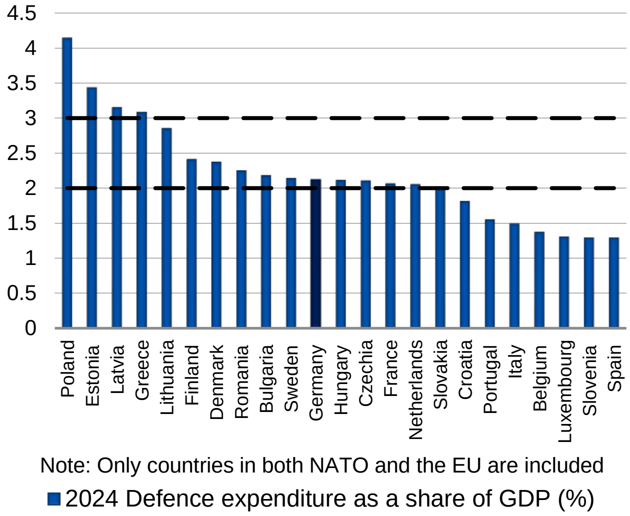
Europe on the defensive

Complicating matters further is international pressure on Germany to increase its defence spending.

NATO Secretary General Mark Rutte supports increasing members' defence spending obligation from 2% to at least 3% of GDP. Trump has been an outspoken proponent of increasing this target even more.

Germany spent 2.1% of its GDP on defence in 2024, much less than the US, but more than Italy and Spain (see Figure 8).

Figure 8: Germany meets current the NATO defence spending target, but this could be increased



Source: abrdn, Haver, February 2025

A €100bn off-budget fund set up in 2022 helped drive defence spending up from its 2021 level of 1.45%.

However, this fund will be fully depleted by 2028. Over the medium-term, then, an increase to NATO defence spending requirements would present the government with a: either raise taxes, reduce spending in another area, or relax the debt brake.

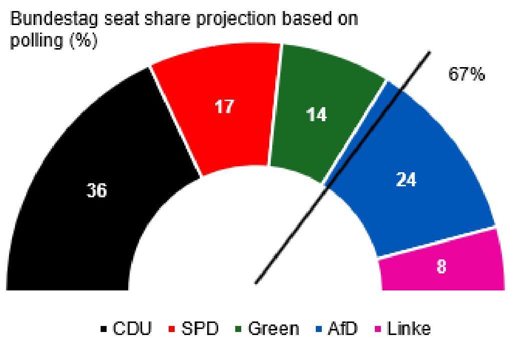
Breaking the debt brake?

Merz has said he is open to debt break reform, while the SPD and Greens both supported reform while in government. But, as the debt brake was brought in via a constitutional amendment, reform would require a two-thirds supermajority in the Bundestag.

Polls suggest it will be a close-run thing whether the CDU/CSU, SPD, and Greens together command this majority (see Figure 9).

Much depends on how many smaller parties clear the 5% threshold for seat allocation. If several do, they might form a blocking minority in conjunction with the Alternative for Germany AfD.

Figure 9: A supermajority is on a knife-edge



Source: abrdn, Dawum, February 2024

The precise form any debt brake reform takes is also crucial.

Given the CDU's fiscal conservatism, outright abolition is unlikely. A compromise retaining the annual deficit limit, but opening some additional fiscal space is more probable.

Significantly, investment expenditure could be exempted from debt brake calculations. Such a reform might be paired with other measures that tighten the rules along other dimensions. For instance, newly implemented exemptions might only apply if Germany's debt to GDP ratio, currently 63% drops below 60%, the limit defined by EU fiscal rules.

Whether or not the debt brake is reformed, the EU fiscal rules will continue to apply. Given its relatively secure fiscal position, these rules are not currently binding for Germany. But they do place a hard upper bound on the fiscal space debt brake reform can open.

The EU fiscal rules could also be reformed

However, the EU fiscal rules themselves could be reformed soon, potentially creating more fiscal space in Germany.

Currently, the rules require most member states to lower debt-to-GDP or deficit-to-GDP ratios. However, the EU has estimated additional defence spending requirements over the next 10 years at EUR500bn. In this context, the current fiscal framework looks unsustainable.

And more transformative solutions are also on the table, with a renewed push in Europe to consider the issuance of joint-EU debt to fund greater defence spending following the apparent shift in the US' defence posture.

Breaking with the traditional German conservative stance, Merz has expressed openness to the idea. However, this is conditional on the exact form any proposal ends up taking. In addition, key players such as the Netherlands oppose the idea.

Nonetheless, that Merz would even consider such a proposal is a sign of European leaders' shifting attitudes towards novel ways of financing public spending.

A new economic model?

On balance, we continue to think that Germany's long-term growth prospects are among the worst in the Eurozone. But there is low-hanging fruit to be picked via the right structural reforms, and even partial implementation of these measures could lead us to revise our expectations higher.

Authors

Felix Feather & Lizzy Galbraith

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 14 June 2024)

United Kingdom (UK)
abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa
[1]In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: abrdn Investments Middle East Limited, Cloud Suite 205, 15th floor, Al Sarab Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa**: abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 1 George Street, Edinburgh EH2 2LL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notic e 3 of 2022) and can render financial services to the classes of clients specified therein.

AA-210225-189667-28