Germany’s three most pressing structural problems

With slightly more than one month to go before the crucial elections, we take a look at Germany's most pressing structural problems

For decades, German politics and elections epitomised stability, often described as boring. Few parties in parliament, clear majorities, and two-party coalitions provided political and economic stability, making Germany a crucial anchor for Europe. While many European countries experienced political fragmentation, Germany followed suit only hesitantly and gradually. However, with the end of the Merkel era, Germany lost this unique selling point of political stability. The first three-party government coalition ever collapsed after three years, and on 23 February, the country is heading to the ballot for snap elections.

A crucial topic in the election campaign is the dire state of the German economy. Just last week, news broke that the German economy contracted in 2024 for the second year in a row. However, economic problems have been around for longer. In fact, the economy is currently the same size as it was in early 2020, marking five years of de facto stagnation. The reasons for this stagnation have been discussed endlessly here on Think. In short, a combination of cyclical and structural headwinds has paralysed the economy. While cyclical headwinds like high inflation, high interest rates, high inventory levels, or even high policy uncertainty can fade away rather quickly, the structural headwinds remain. Germany has started to realise that the old macro business model of cheap energy and easily accessible large export markets is no longer working. Ten years of underinvestment, deteriorating competitiveness, and China's shift from export destination to fierce industrial competitor have taken – and will continue to take – their toll on the German economy.

Germany's three most pressing structural problems

With roughly one more month to go before the elections, let's take a closer look at Germany's structural problems. The list is long, but to keep it simple, we will focus on the basics of the German macro-economic business model: energy, China, and competitiveness.

Energy

Prior to the Russian invasion of Ukraine, energy prices and supply had never been a concern for German industry. Cheap energy was a given. In a country that doesn't have commodities, except for coal, energy imports can become crucial, particularly as part of the green transition.

Contrary to common belief, Germany decided in 2002 to phase out nuclear energy over a period of some 30 years. The first nuclear power plants were closed in 2003 and 2005. In 2010, this transition period was extended, but with the Fukushima catastrophe, the German government expedited the decision to phase out nuclear energy, closing many power plants almost immediately, with the rest phased out by 2023. As a result, the share of nuclear power in Germany's energy mix declined rapidly, from around 20% to zero, while the share of renewables increased from 20% to more than 60%. At the same time, however, gas imports from Russia remained an important source to smooth the transition.

Until the Russian invasion of Ukraine, energy prices and supply hadn't been an issue for industry at all. Low prices and stable supply were simply a given. In 2019, Germany still had one of the lowest electricity prices in the EU, much lower than, for example, in France, and at similar levels as in the US. In 2023, electricity prices in Germany were three times as high as in 2019, twice as high as in France and China, and three times as high as in the US.

On a more positive note, Germany has front-loaded the green transition and is ahead of many other industrial countries. On a more negative note, however, the high costs, the still unstable flow of renewable energy, and the high costs of importing gas to bridge any disruption in renewable energy supply have significantly undermined Germany's industrial foundation. This problem is likely to be aggravated by surging energy demand due to the use and application of AI and other web services.

China

In the early 2000s, China was the saviour of the German economy; now it's the worst threat. China's fast growth, accelerated by joining the World Trade Organization, brought huge appetite for industrial goods 'Made in Germany'. While many Germans still thank former Chancellor Gerhard Schröder for his structural reforms in the early 2000s, the role of China was at least as important, if not more so, for Germany's return as an economic powerhouse. While German exports to the rest of the world doubled over the last twenty years, exports to China increased eight-fold.

However, with the start of the pandemic, China's role as an important growth driver for Germany has changed. First, Chinese demand dropped due to weak domestic demand, then it dropped as China increasingly became able to produce goods it normally imported from Germany, particularly cars. In fact, in 2018, China announced its 2025 strategy 'Made in China', which aimed to secure China's position as a global powerhouse in high-tech industries – a better Germany. The strategy was almost a copy of what Germany knew as its own 'Industry 4.0' strategy. The biggest difference is that China put its money where its mouth was; Germany didn't. China has become a competitor for many German industries.

Competitiveness

The 'China factor' has highlighted a more general problem of the German economy: the gradual loss of international competitiveness. In the most prominent international competitiveness rankings, Germany was in the Top 5 in the early 2010s. Currently, it ranks between 20 and 25. The reasons for this loss in competitiveness include a rapid decline in infrastructure, education, and digital infrastructure. Regarding infrastructure and education, Germany has been too complacent and simply forgot (or didn't deem it necessary) to reinvigorate itself, while regarding digital infrastructure, the country collectively forgot to invest and innovate. Somehow, former Chancellor Angela Merkel's words from 2013 that the internet was a complete novelty labeled an entire nation's failure to embrace digitalisation.

But it's not only the conventional and digital infrastructure that is weighing on Germany's growth performance. For a country that used to be famous for its skilled employees, the poor performances in the OECD's PISA tests are equally worrisome.

The drop in international competitiveness is closely linked to chronic underinvestment. Over the last twenty years, German public investment as a percent of GDP has been significantly below the EU average, and private sector investment has also been lower than in many other countries. While the holding back of public investment can be explained by increased public consumption and the constitutional debt brake, private investment has been held back by higher taxes, regulation, and outsourcing, but also generational changes. Particularly in the famous German Mittelstand, investments were held back as business owners couldn't find adequate succession planning. Several studies have tried to estimate the current investment gap in Germany, with results ranging between 400 billion and 600 billion euros (10% to 15% of GDP).

How to get out of the stagnation?

After five years of de facto stagnation, last year finally brought broad awareness in German politics and society that the economic problems are not just cyclical. The country is still one of the richest economies in the world, but it needs an overhaul to stop the gradual deterioration. Just addressing main issues energy, China and competitiveness will be a challenge. Add to this unfavourable demographics and the impact on healthcare and pension systems and it's clear that there is no easy way out of the current situation.

Looking at the economic ideas of the political parties, it is becoming increasingly clear that even in a best-case scenario with reforms and investments, any new government will not try to overhaul the old economic business model, but rather try to rejuvenate the old one. Less red tape, some tax cuts to stimulate spending and investments, possibly attempts to lower energy costs and infrastructure investment – all of which feature in any European economist's wish list, and a growth booster for the economy; at least temporarily.

Whether these measures will really be sufficient in competing against China and the US is a completely different question. What Germany would get after the elections is a refurbished model of its economy – clearly better than the old one with cracks, battery failures and very few gadgets, but also not a shiny, sprinkling new model that makes the competition speechless. But we will have a closer look at the different proposals in the second part of our German election coverage.

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