Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 06/01/2025

Germany is tottering. What will be the consequence for Europe?

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Abstract

For a long time, Germany was the economic powerhouse of Europe. Since 2008, it has been the lifeline in the financial and debt crisis. But now the economic giant is tottering. What will become of Europe?

Zusammenfassung

Deutschland war lange Zeit das wirtschaftliche Zugpferd Europas. Seit 2008 war es der Rettungsanker in der Finanz- und Schuldkrise. Doch nun wankt der wirtschaftliche Riese. Was wird aus Europa?

2025 could be a year of great upheaval. The Western world is in a deep crisis. Growth is low and inequality has risen sharply. Geopolitical tensions with Russia and China are worrying.

A devastating war in Eastern Europe has exposed Europe's neglect of its defence preparedness. Now US President-elect Donald Trump is questioning the US military protection for Europe.

The British magazine The Economist has once again confirmed Germany's penchant for sabotaging itself as the the sick man of Europe. Angela Merkel who is recently back in the limelight in Germany had after 16 years of "muddling through" made Germany dependent on US defence, the Chinese economy and Russian gas. Does Europe want to continue to be dependent on such a country?

For a long time, Germany has been the growth engine of Europe. After the Second World War, market reforms under the supervision of the US occupying power did more than just produce an economic miracle. While an economically and politically unstable Germany had dragged the whole of Europe into the abyss after the First World War, West Germany went on to become a haven of prosperity and political stability.

With the Treaty of Rome (1957), Germany's principles of economic freedom were embedded in the European integration process in the form of the single market – the free movement of goods, services, capital and labour. The stable German mark became the backbone of German economic growth and prosperity in Europe.

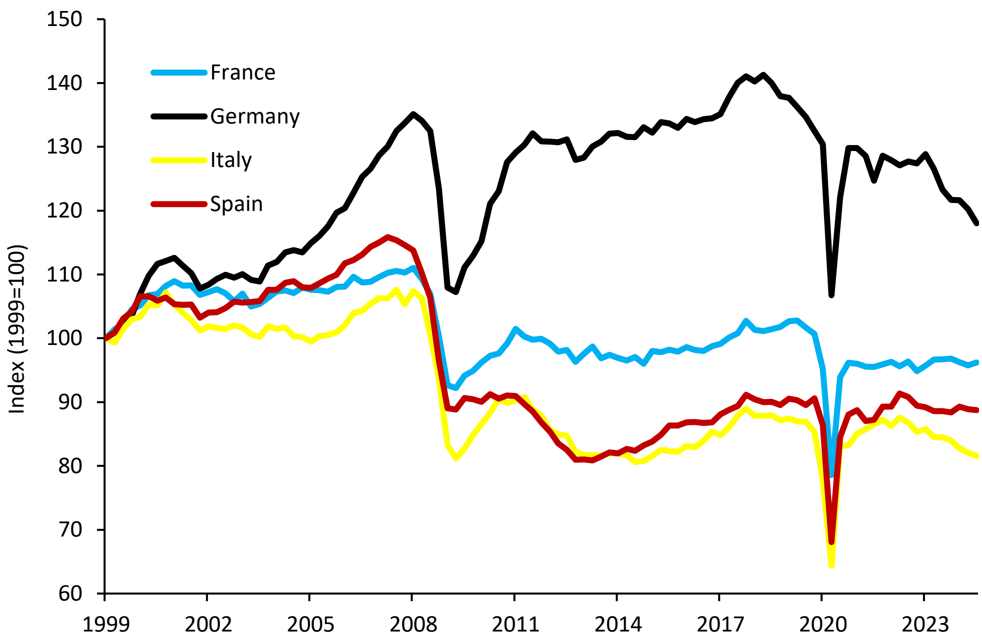
France pressed for the redistribution of financial resources from north to south through common European institutions – in particular European agricultural and regional policies. It pushed Germany towards a common European currency, thereby laying the foundation for the financing of government spending in a united Europe by the European Central Bank.

The flawed design of the euro – the ECB's common monetary policy came along with uncoordinated national fiscal policies – created the breeding ground for the European financial crisis (from 2008), which manoeuvred Germany into costly financial bailouts. A special fund for the stabilisation of financial markets (EUR 480 billion) supported German banks that had granted extensive loans to the south of the monetary union.

This was followed by "rescue packages" for the southern euro countries with considerable German involvement, including the European Financial Stability Facility (EUR 440 billion) and the European Stability Mechanism with a capital subscription of over EUR 700 billion. During the European debt crisis, the German Bundesbank accumulated claims totalling more than EUR 1,000 billion on the balance sheet of the European Central Bank, which must be considered as loans to economically unstable euro countries, such as Italy and Spain.

The NextGenerationEU recovery fund has not only prioritised the redistribution of over EUR 800 billion to the southern eurozone countries since 2021, Germany is also providing indirect support by tolerating the financing via EU bonds, which is actually prohibited by the European treaties. And on top of that, Germany grants them creditworthiness thanks to its good credit rating!

Figure: Industrial Produktion in Europe



Source: OECD, Flossbach von Storch Research Institute, as at January 2024.

But now the German giant which has carried like the mythological Atlas Europe financially on its shoulders, is beginning to buckle. Indeed, Germany is at the bottom of the [European Union´s]economic growth ranking for 2024. German industrial production and its business climate have been in steady decline since 2018 (see Figure).

Tax and social security contributions have reached a record level among industrialised countries. The costly rescue of the euro has come at the expense of neglected infrastructure investments. Generous social benefits, which no longer only benefit Germans, have come into competition with the EU's ambitious climate policy. Deteriorating economic and financial strength have recently been a significant factor in the collapse of the government.

Angela Merkel probably also agreed to the ECB's "whatever it takes" rescue of the euro (from 2012) because it would have been difficult to get further multi-billion-euro rescue packages through the Bundestag for the crisis-hit euro countries. However, permanently low interest rates and the ECB's extensive government bond purchases have made Germany's once dynamic companies sluggish. Instead of getting fit for the future, they are calling loudly for subsidies. Many voters have turned to the anti-EU Alternative for Germany (AfD) party because of the negative impact of the ECB's persistently loose monetary policy on growth and distribution.

This raises the question of Germany's future role in the EU. Expectations that Germany will continue to fulfil its role as the largest net contributor to the EU remain unchanged for the whole of Europe. With its Transmission Protection Instrument, the ECB has already signalled that it will buy government bonds from over-indebted euro countries if necessary.

With France in financial difficulty, the euro's credibility is now only backed by Germany's good credit rating. However, the Social Democratic Party of Germany (SPD) and the Greens are already openly in favour of easing the debt brake. A "reform" does not seem out of the question for the Christian Democratic Union/Christian Social Union of Germany (CDU/CSU) either. After all, from a German perspective, it makes little sense to forego a debt-financed restoration of the ailing infrastructure and neglected defence readiness if, in the end, all national debt in the EU is socialised.

However, lifting the debt brake could have severe consequences for Europe. Germany's debt-financed reunification once plunged the rest of Europe into crisis because Germany withdrew its savings from its neighbouring countries. This could happen again with a debt-financed German investment drive. And if financial flows from Germany are no longer to be expected, some countries could lose interest in the EU.

If the single market were to be lost as a result, the damage to Europe would be even greater. It is therefore time for Germany to regain its former economic strength through market reforms. This includes stabilising the single European currency.

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Publisher: Flossbach von Storch SE, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com, *Executive Board:* Dr Bert Flossbach, Dr Tobias Schafföner, Dr Till Schmidt, Marcus Stollenwerk, *Chairman of the Board of Directors* Kurt von Storch; *Registration*: No. 120 796 in the Commercial and Companies Register held at Cologne District Court; *VAT-No*. DE200075205; *Supervisory authority*: German Federal Financial Services Supervisory Author Prof. Dr Gunther Schnabl *Editorial deadline* 06 January 2025