Berlin Perspectives
Analysing German European Policy

From Decline to Dynamism
Germany's Role in Restoring EU Competitiveness

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In September 2024, Mario Draghi, former Italian Prime Minister and head of the ECB, published a much-noted report which alerted Europeans that they are losing ground in the global contest for economic leadership. Indeed, the EU's share of global economic output has nearly halved from 27.7% in 1980 to just 14.4% in 2024. Current growth projections confirm this downwards trajectory. While the EU's GDP is expected to grow by 1.1% in 2025, other major economies such as the US and China are forecast to expand by 2.7% and 4.6%, respectively. In the long run, analysts project that the EU's economic clout will shrink further.

The consequences of diminished competitiveness are apparent: Key sectors such as the automotive industry are struggling with increased competition from abroad and losing global market shares. This is particularly felt in Germany, Europe's largest economy, which in 2024 recorded the second year of recession in a row and is witnessing major car manufacturers laying off workers in the tens of thousands. Furthermore, an Ipsos poll reveals that over half of Europeans perceive to have lost purchasing power, and nearly a third say they are experiencing a precarious financial and material situation. Alongside job displacement and reduced consumption, a low-growth path eventually leaves European welfare states underfunded and risks that key objectives such as the green transition lack the necessary funds.

Over the last two decades, Europe's economies have been battered by a chain of crises. Still reeling from the global financial crisis of 2007/08 that plunged the EU into a prolonged dispute over sovereign debts, the COVID-19 pandemic and the Russian full-scale invasion of Ukraine have disrupted global supply chains, cut off energy supplies and sparked inflation. Overall, growing geopolitical tension as well as waning international commitment to free trade and the rules-based liberal order hurt Europe's export-oriented economies.

However, the EU's economic downturn cannot be blamed on external factors alone. European manufacturers champion technologies of the previous century but are ill-prepared for the future. According to the McKinsey Institute, Europe "missed the boat on the last technology revolution, lagging behind on value and growth in information and communications technology (ICT) and on other disruptive innovations". Although the EU is a top global actor in scientific output, lower R&D investment, a fragmented research ecosystem, a lack of private funds and brain drain threaten the bloc's scientific leadership.

The Draghi Report makes several recommendations how to revitalise the EU's economic competitiveness. Among others, it underscores the need for a Europeanised industrial policy, a more integrated and efficient single market, streamlined bureaucracy, common foreign industrial and trade policies, and institutional reforms to accelerate decision-making. For the EU's economy to become competitive again, the report ultimately calls for more investments in innovation, suggesting an additional €750–800 billion annually across the bloc.

Draghi's unabashed analysis has led to a public reckoning with economic policy across the EU. Despite pointing towards several past mistakes, his recommendations have mostly been met with appreciation by state leaders and found their way into EU policy proposals. Commission President von der Leyen named competitiveness her highest priority for her second term in office, and her so-called Competitiveness Compass outlines the framework for economic policy in the years to come. Similarly, the European Council adopted the Budapest Declaration on the New European Competitiveness in November 2024, which reflects several of Draghi's points including the need for more R&D spending.

However, the significant investments proposed in the report are highly contentious, especially with regards to financing. Fiscally conservative member states such as the Netherlands or Germany have time and again proven unwilling to shift their position on common European debts. Thus, the already tight national budgets and growing demand for defence spending present notable obstacles to the implementation of Draghi's recommendations. Moreover, decision-making in the EU has been hampered by government crises in both France and Germany. While President Macron lost the majority in parliament after snap elections in June 2024, Germany's disunited coalition government under Chancellor Scholz fell apart in November the same year. As a result, both states have been preoccupied with domestic affairs, thus stalling the infamous Franco-German engine of European integration.

Germany's economic struggles and the challenge of leadership

As the EU's largest member state by population and GDP, Germany's economic policy will be a determining factor for any common European approach to catch up with other major economies. However, already dubbed the 'Sick Man of Europe' again in 2023, economic recession and lack of leadership have raised concerns over Germany's ability to take the initiative in Europe's efforts to restore competitiveness.

Germany's economic woes are related to being disproportionately affected by external challenges as well as deep structural issues. The COVID-19 pandemic disrupted global supply chains, particularly affecting Germany's export-driven manufacturing sectors. Long dependent on Russian gas, the sudden import ban after the Russian invasion caused surging energy costs for businesses and consumers, high inflation and reduced purchasing power. The related commitments to raise defence spending have further impeded budgetary flexibility to invest in growth and innovation, especially due to the constitutionally enshrined debt-brake (Schuldenbremse), which prohibits taking up government debt above 0.35% GDP. Structural issues such as an ageing population, a shortage in skilled labour, slow and reluctant digitalisation, as well as crumbling infrastructure compound these issues.

In recent years, the German government has resorted to extensive state subsidies in response to crisis-induced economic disruptions. Following a bloc-wide trend of increasing investments, Germany´s state aid surged by 246% between 2012 and 2019. According to the European Commission´s 2023 State Aid overview, Germany allocated 1.8% of its GDP to state aid in 2022, the second-highest share in the EU after Hungary, and accounting for 32.3% of total state aid in the bloc. A significant portion of these investments were directed towards stabilising the energy sector and assisting industries most severely affected by Russia's invasion of Ukraine. But the German government also undertook longer-term investments in strategic sectors, among them the controversial and now frozen €10 billion subsidy for US chipmaker Intel to establish a new factory in Saxony-Anhalt.

In view of the stubbornly negative economic outlook, economic and fiscal policy have played their part in the fracturing of Germany's 'traffic light' coalition consisting of the social democratic SPD, the Greens and the liberal FDP. In a position paper, Robert Habeck, co-chairman and lead candidate of the Greens and Minister for Economy and Climate Protection, broadly endorses Draghi's suggestions. He calls for a decidedly European approach and, among other things, the creation of a public fund (Deutschlandfonds) financed by debt to support investments in infrastructure, education and digitalisation. His criticism that the debt-brake impedes growth is widely shared within the SPD, whose leader and Chancellor Olaf Scholz has called for a reform to allow for more investments.

In contrast, former Finance Minister Christian Lindner of the FDP dismissed Draghi´s proposal for the EU to adopt common debt mechanisms to finance European industrial investments. He, thus, reflects Germany's longstanding fiscally conservative stance within the European Union. In view of the upcoming federal elections in February 2025, this position is unlikely to change. The conservative CDU has consistently polled at around 31% and is set to lead the incoming government. In its 2024 manifesto, the party declares itself "categorically against a debt union" and reaffirms in its 2025 economic strategy paper 'Agenda 2030' a commitment to "an economically competitive Europe." Advocating a return to fiscal conservatism, the party seeks to drive growth by lowering taxes and reforming social spending.

Despite the recent attempt to pass a parliamentary motion on migration with the votes of the far-right AfD, currently polling in second place at around 20%, the CDU still categorically excludes working together with the far-right. Thus, forming a majority in parliament after the general election likely requires a coalition involving the SPD or the Green Party – or both. Compromising their opposite approaches to boost competitiveness will be tough, but Germany cannot afford political deadlock. The intensifying geopolitical contest and serious threats to liberal democracy both from inside and outside Europe are only some of the contemporary challenges faced by Germany and the EU that can only be met on the basis of economic strength. Thus, the next German government would do well to heed the warnings expressed in the Draghi report.

The EU needs unity and ambition

In recent months, numerous ways how to up Europe's economic competitiveness have been floated. Reducing the cost of energy, minimising bureaucracy, lowering taxes, increasing government subsidies, or expanding debt-funded public investments all have the potential to generate economic growth. While some ideas are widely shared across the political aisles, others are fraught with ideological tension. Instead of engaging in fundamental debates over which lever to pull, in the short term it will be important to muster general political willingness to address the problem at hand. As the EU's largest economy and with substantial financial means at its disposal, Germany is uniquely suited to assume leadership in the European Council and give the issue of economic competitiveness the momentum it deserves.

Given the significant divergence of positions across the bloc, a solution for pooling finances at the EU is unlikely in the short term. Instead, Germany should work towards a two-level approach: On the European level, the Commission and member states should coordinate common goals and set clear priorities to prevent unproductive fragmentation between competing national strategies. Investments should be forward-looking and target, for example, renewable energies, digital infrastructures and high-tech sectors. At the same time, the nature of investment financing, whether through debt or budget restructuring would remain the competence of national governments.

In the medium term, the EU should strategically position itself to not only close the gap with other leading economies but also to ensure sustained growth and avoid future setbacks. Key to this is the development and deployment of groundbreaking new technologies. With greater access to public and private funds for R&D and start-up companies, China and the US managed to pull ahead in digital technologies and other key sectors. An early draft of the Budapest Declaration foresaw an increase of the EU's current target of 3% GDP for R&D investments to 4%. While Germany meets the current 3% objective, the bloc only reaches a combined 2.2%. In the interest of German and European economic competitiveness, the new federal government should propose a binding, EU-wide 4% minimum threshold. Unlike NATO's regularly undercut military spending target, EU law already contains mechanisms to ensure compliance. Effectively doubling R&D investment would have a significant effect on innovation and industrial output.

Ultimately, it is essential to recognise that economic competitiveness is not an end in itself. A robust economy is crucial for sustaining European welfare systems, addressing the need for greater military capabilities, and funding the transition to a sustainable and environmentally friendly economy. These fundamental goals must remain central to the process, with measures to enhance competitiveness strategically aligned to support their achievement.

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