Economic Commentary

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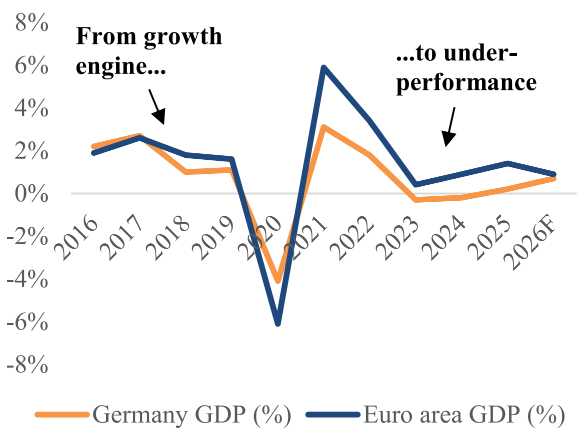
Once the growth engine, Germany is now an economic laggard in the EU

Once the powerhouse of the Euro area, Germany has become its laggard. Real output contracted in 2023, before stagnating in 2024 and growing only marginally at 0.2% in 2025, even as the Euro area as a whole expanded at a healthier pace. In 2026, Germany has returned to modest positive growth, with GDP rising 0.4% quarter-on-quarter in Q1 and a revised 0.3% in Q2, bringing the year-on-year gain to 1.0% in the second quarter. Germany's Economy Ministry nonetheless cut its full-year 2026 growth forecast to 0.5%, citing the energy price spike from the Iran war as a significant headwind. At the heart of Germany's prolonged underperformance lies its industrial core: the manufacturing sector and the export-oriented Mittelstand - the dense network of small and medium-sized, often family-owned firms that forms the backbone of German employment and exports - that have long defined its economic model.

Germany and Euro Area GDP Growth
(%, annual real GDP growth, 2016–2026)



Source: IMF, QNB Economics

Understanding Germany's difficulties matters for the whole of Europe, given the country's economic weight and its deep supply-chain links with its neighbours. Manufacturing value-added peaked as long ago as 2017, and overall industrial production now sits around 15% below its previous high. This is a decline spanning across most of a decade rather than a single difficult year. The IMF estimates that manufacturing and construction accounted for the bulk of Germany's growth gap relative to the Euro area, and much of the shortfall reflects sustained underperformance and growth rather than temporary, cyclical factors. Because industry still accounts for around a fifth of German output, a far larger share than in France or the United States, this weakness impacts the entire economy, from investment to employment. In this article, we discuss three dimensions of Germany's underperformance: the industrial recession at its core, the competitiveness squeeze impacting the Mittelstand, and the energy cost headwinds in the short term.

First, Germany's lagging performance has been, above all, an industrial one, with deeper structural headwinds constraining growth. Years of underinvestment have left ageing infrastructure and a persistent lag in digitalisation, while a shrinking working-age population, chronic skilled-labour shortages and heavy bureaucracy all weigh on potential growth. High relative unit labour costs have prompted some firms to shift new investment abroad. Against this backdrop, the government has enacted a major fiscal expansion, including large infrastructure funding and higher defence spending financed through a reform of the constitutional debt limit. This is expected to support and strengthen demand from 2026 onward, though its impact will depend on execution and on whether it is accompanied by the structural reforms needed to restore competitiveness.

Second, the long-celebrated Mittelstand is caught in a competitiveness squeeze. Over the last two decades, China has shifted from a vital export market into a formidable competitor, displacing German machinery and vehicles both in third markets and within China. With German goods exports more exposed to China than those of France or Italy, these pressures fall especially hard on the export-oriented Mittelstand. The scale of the shift is striking: German exports to China fell by more than 12% year-on-year in the first half of 2026, dropping China to only the ninth-largest market for German goods — a position that would have been unimaginable just five years ago, when China ranked second. Over three-quarters of German mechanical engineering companies now identify China as their greatest strategic threat. Through its "10,000 Little Giants" initiative, Beijing has deployed targeted subsidies to build specialised firms explicitly designed to displace Germany's market-leading hidden champions. The strategy is working as economists cite that "China has already eaten much of German industry's lunch and is preparing to start on dinner."

Third, there is the short- and medium-term impact of energy prices and its effect on the competitiveness of German industry. Industrial electricity prices in Germany are roughly double those in the United States, a lasting legacy of the loss of cheap pipeline gas. This is a particular burden for the energy-intensive industries that anchor many industrial supply chains. While wholesale gas and electricity prices in Germany have retreated from their crisis peaks, they remain well above pre-2022 levels and those faced by many international competitors. As a result, German manufacturers continue to face a difficult adjustment period as they invest in energy efficiency and adapt to a more expensive energy environment. The US-Iran conflict has aggravated this vulnerability further: energy prices in Germany jumped 7.2% year-on-year in March 2026, the first increase since December 2023, prompting the government to halve its 2026 growth forecast to 0.5%. The Energy Transition Barometer, a measure of the energy transition's impact on competitiveness published by the German chamber of commerce fell to -11.5 in 2026, its lowest reading since 2023, as a growing number of firms delayed investment plans or considered relocating production abroad.

All in all, Germany's underperformance is rooted in the mounting strains on the industrial, export-led model that served it so well for decades. The evidence supports the view that the manufacturing sector and the Mittelstand sit at the centre of the problem, pressured by high energy costs, intensifying competition from China and domestic structural rigidities. Whether Europe's largest economy can reinvent its model, as other countries such as Spain in the Euro area have begun to do, will help shape the continent's prospects for years to come. However, this will require Germany to modernise its infrastructure, undergo painful structural reform to ease administrative burdens and adapt its industrial base to a changed global economy.