Europe’s Economy Is Stalling Out

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CAMBRIDGE – As Europe prepares for a potential trade war after US President-elect Donald Trump takes office in January, its two largest economies are struggling. While Germany is heading into its second consecutive year of zero growth, France is expected to grow by less than 1% in 2025.
Is Europe’s economic stagnation the result of insufficient Keynesian stimulus, or are its bloated and sclerotic welfare states to blame? Either way, it is clear that those who believe simple measures like higher budget deficits or lower interest rates can solve Europe’s problems are detached from reality.

For example, France’s aggressive stimulus policies have already pushed its budget deficit to 6% of GDP, while its debt-to-GDP ratio has surged to 112%, up from 95% in 2015. In 2023, President Emmanuel Macron faced widespread protests over his decision to raise the retirement age from 62 to 64 – a move that, while meaningful, barely scratches the surface of the country’s fiscal challenges. As European Central Bank President Christine Lagarde recently warned, France’s fiscal trajectory is unsustainable without far-reaching reforms.

Many American and British progressives admire France’s model of big government and wish their own countries would adopt similar policies. But debt markets have recently woken up to the risks posed by France’s ballooning debt. Remarkably, the French government now pays a higher risk premium than Spain.

With real interest rates on advanced-economy government debt expected to remain elevated – barring a recession – France cannot simply grow its way out of its debt and pension problems. Instead, its heavy debt burden will almost certainly weigh on its long-term economic prospects. In 2010 and 2012, Carmen M. Reinhart and I published two papers arguing that excessive debt is detrimental to economic growth. The sluggish, indebted economies of Europe and Japan are prime examples of this dynamic, as subsequent academic research has shown.

Heavy debt burdens impede GDP growth by limiting governments’ ability to respond to slowdowns and recessions. With a debt-to-GDP ratio of just 63%, Germany has ample room to revitalize its crumbling infrastructure and improve its underperforming education system. If implemented effectively, such investments could generate enough long-term growth to offset their costs. But fiscal space is valuable only when used wisely: in reality, Germany’s “debt brake” – which caps annual deficits at 0.35% of GDP – has proven too inflexible, and the next government must find a way to work around it.
Moreover, increased public spending will not deliver sustained growth without significant reforms. Specifically, Germany must reinstate key elements of the Hartz reforms introduced by former Chancellor Gerhard Schröder in the early 2000s. These measures, which made the German labor market significantly more flexible than France’s, were instrumental in transforming Germany from the “sick man of Europe” into a dynamic economy. But a leftward shift in economic policy has effectively reversed much of this progress, severely undermining Germany’s vaunted efficiency. Its ability to produce much-needed infrastructure has visibly suffered; a glaring example is Berlin’s Brandenburg Airport, which finally opened in 2020 – ten years behind schedule and at three times the projected cost.

Germany will eventually overcome its current malaise, but the key question is how long that will take. Earlier this month, Chancellor Olaf Scholzfired Finance Minister Christian Lindner, leading to the collapse of his fragile coalition government. With elections scheduled for February 23, the uncharismatic Scholz must now step aside and let another Social Democrat lead or risk his party’s implosion.

Scholz has so far resisted calls to abandon his re-election bid, jeopardizing his party’s chances of remaining in power. His reluctance to step aside mirrors that of US President Joe Biden, who waited too long to pass the torch to a younger candidate, a misstep that undoubtedly contributed to her decisive electoral defeat.

Amid this political turmoil, Germany is grappling with mounting challenges that threaten its status as Europe's economic powerhouse. As the ongoing war in Ukraine continues to erode investor confidence, Germany's industrial base has yet to recover from the loss of cheap Russian energy imports. Meanwhile, the automotive sector has struggled to shift from gas-powered cars to electric vehicles, lagging behind global competitors, and exports to China – whose economy is also faltering – have declined sharply.

These problems are likely manageable if a more conservative, market-oriented government takes power next year. But getting Germany back on the right path will be far from easy, given that public support for structural reforms remains low. Without drastic changes, the German economy will struggle to regain the dynamism and flexibility needed to withstand the impact of Trump's impending tariff wars.

While most other European economies face similar challenges, Italy might perform slightly better under Prime Minister Giorgia Meloni – arguably the most effective leader on the continent. Spain and several smaller economies, especially Poland, may fill some of the void left by Germany and France. But they cannot fully offset the weakness of the EU's two economic heavyweights.

The economic outlook would have been much bleaker if not for Europe's enduring appeal as a tourist destination, particularly among American travelers, whose strong dollars are propping up the industry. Even so, the outlook for 2025 remains lackluster. Although European economies could still recover, Keynesian stimulus will not be enough to sustain robust growth.

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