Bank aus Verantwortung

Growth despite tariff barriers

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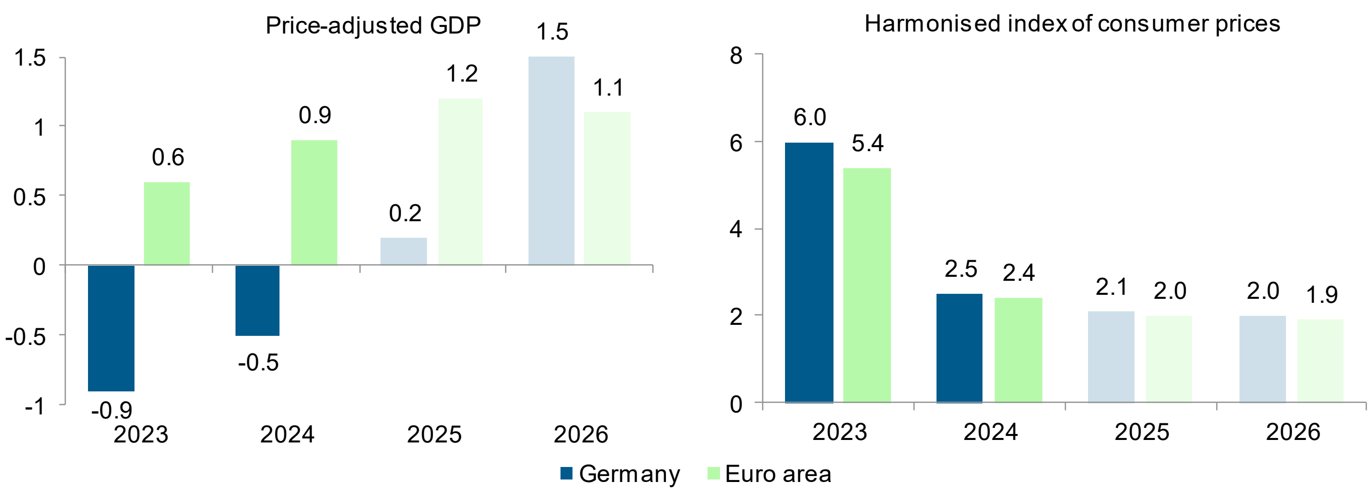
- Germany's GDP contracted by -0.3% in the second quarter after a growing by 0.3% in the first quarter. A setback was expected as a result of the increase in US tariffs in April and the end of front-running effects in exports. The downturn in investments also acted as a brake.
- While US protectionism is slowing growth, German fiscal policy is offering increasing tailwinds. The German economy will grow moderately at best this quarter but, after that, economic momentum should gradually intensify.
- We have slightly lifted our forecast for price-adjusted economic growth in 2025 to now 0.2% (previous forecast: 0.0%). For 2026, we have raised our growth forecast by a substantial 0.5 percentage points to now 1.5% because the Federal Government's fiscal stimulus will be even larger and come even faster than previously expected.
- Euro area growth this year is driven by surprisingly strong momentum at the start of the year (after revisions). We have upgraded our forecast for growth in 2025 by 0.4 percentage points to 1.2%. After tariff front-running has dissipated, it is moving along at a slower pace for the time being. We expect the economy to grow by 1.1% in 2026.
- Inflation remains steady on its target trajectory amid economic policy uncertainty. The expected drop in services inflation has materialised and the tariff agreement with the US is reducing the risks to consumer price inflation. We stand by our inflation forecasts (HICP) for 2025 and 2026 and expect price increases for the euro area in Germany to hold steady near the ECB's 2-per cent target.

Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat (as at 22 August 2025)

GDP growth in the euro area

Variation on previous year in per cent, adjusted for prices, as at 22 August 2025

	DE	FR	IT	ES	EA
2023	-0.9	1.4	0.7	2.7	0.6
2024	-0.5	1.2	0.7	3.1	0.9
2025	0.2	0.6	0.5	2.7	1.2
2026	1.5	0.5	0.6	2.1	1.1

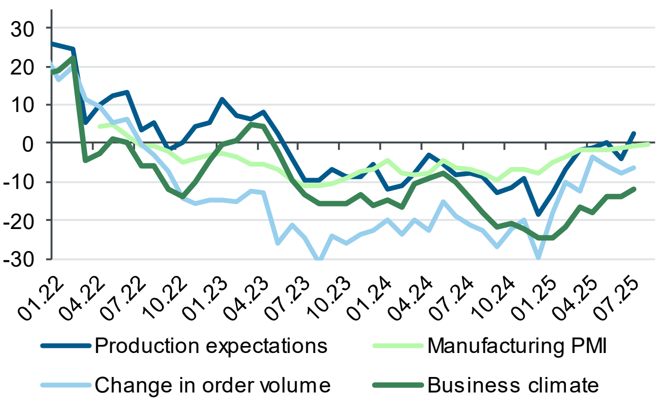
Sources: Destatis, Eurostat, KfW Research

Germany: fiscal policy tailwinds are picking up

Germany's GDP (adjusted for price, seasonal and calendar variations) contracted by -0.3% in the second quarter after growing by 0.3% in the first quarter. A setback was generally expected as a result of the increase in US tariffs in April and the end of pull-forward effects in exports. What also put the brakes on growth in the second quarter was the drop in investments, while household and public-sector consumption increased. The business sentiment measured by the ifo Business Climate Index continued to recover despite the negative GDP growth in the second quarter and also in July, with situation assessments improving slightly and business expectations for the coming months rising significantly. At present, the activity index of the composite PMI and the Nowcast of the ifo Institute point to moderately positive growth in the current third quarter.

Survey indicators from the manufacturing sector

Balances, seasonally adjusted



Note: We subtracted the value of 50 from the manufacturing PMI in order to ensure comparability with the ifo balances.

Sources: ifo Business Survey (latest value from July), S&P Global (latest value from August)

The tariff agreement reached between the EU and the US on 27 July sets the average US tariff on goods from Germany roughly on the level that was already in force since April.[1] Besides, the price competitiveness of German exports has worsened as a result of the appreciation of the euro.[2] Exports are therefore likely to remain weak in the second half of the year as well. But as most early indicators from the manufacturing sector are pointing upwards, businesses appear to have been coping quite well with the significant US tariff increases since the spring of 2025 (see figure).[3] And the Bank Lending Survey is showing increasing credit demand from businesses and households, which points to growing private investment activity.[4] Tailwinds generated by the ECB's key interest rate reductions since mid-2024 should be the primary driver of the German economy towards the end of the year. Above all, however, the very expansionary fiscal policy is likely to provide a significant boost already at the end of 2025 and particularly from 2026 onwards (see box). Finally, household consumption should continue to grow moderately since real wage growth remains noticeably positive while employment is moving roughly sideways.

On balance, we have raised our forecast for the price-adjusted growth rate of German GDP this year to +0.2% (spring forecast 0.0%). One reason is a slightly more positive outlook on the business cycle in the second half of the year. Most of all, however, the forecast was revised upwards for technical reasons because the statistical carry-over from the previous year increased after a data revision by the Federal Statistical Office. In addition, we have significantly raised our growth forecast for 2026 – mainly because the fiscal impetus from the Federal Government is likely to be even stronger and come even faster than expected in the spring. Instead of +1%, we now expect price-adjusted growth of around 1½% for 2026.[5] Sharply rising public sector investment and consumption expenditure can then be expected. Furthermore, business investment is also likely to expand substantially again as capacity utilisation increases, with the prospects of public-sector contracts playing a major role for the defence industry and construction sector. The external trade balance (exports-imports), on the other hand, is likely to continue to act as a brake on GDP growth next year as well given the increased trade barriers in the US, diversion of goods from China to Europe and, in particular, the rise in imports of military equipment.

Euro area: Strong start to the year has distorted the picture

After a very strong first quarter (+0.6%), euro area GDP growth cooled to only +0.1% in the second quarter. Exports to the US that were brought forward in Q1 played a significant role again. Ireland in particular had a disproportionately strong influence on the euro area in the first half of the year, as its growth rates were very volatile and heavily reliant on pharmaceutical exports[6]: Without Ireland, the euro area would have grown by a mere 0.3% in Q1, followed by 0.2% in Q2. Economic momentum is likely to remain subdued in the current quarter as well, before quarterly growth picks up again towards the end of the year. This assumption takes into account the EU-US tariff agreements, which will increase the effective average tariff on euro area exports only moderately at best compared with the tariff regime that was in place in the second quarter. Particularly because of the strong start to the year, we have now upgraded our forecast for euro area growth in 2025 by 0.4 percentage points to 1.2%. We expect real GDP growth of 1.1% in 2026. This year and presumably next year as well, the main economic driver in the euro area is household consumption, which is being driven by rising real wages and at least moderate employment growth. With the sharp increases in infrastructure and defence spending in Germany and the support from the expiring Next Generation EU (NGEU) Programme, the fiscal impetus in the euro area will also be significantly positive in 2026 and contribute to an investment rebound. In France, however, the second largest euro country, fiscal policy and the political uncertainty resulting from the consolidation course will significantly dampen growth in 2026.

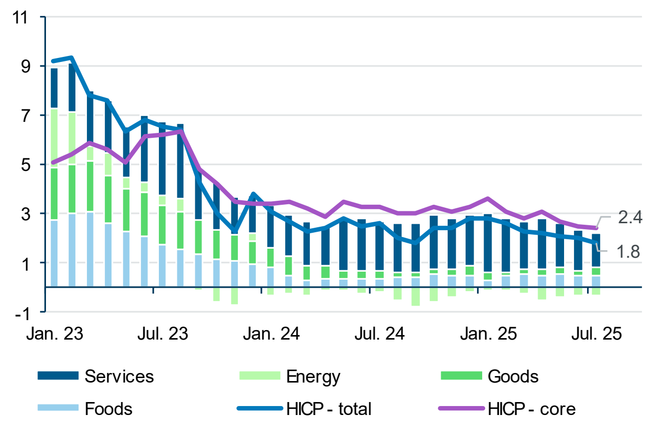
Upside and downside risks to the forecast for the development of the German and European economy arise particularly from uncertainties in connection with US trade policy and the extent and impact of the fiscal impetus in Germany.

Inflation has stabilised around the target level

In the midst of a difficult economic environment characterised by uncertainty, consumer price inflation stands out as a positive. In recent months, the inflation rate in Germany and the euro area as measured by the Harmonised Index of Consumer Prices (HICP) has been oscillating very near the two-per cent target of the European Central Bank. As we believe that price stability remains ensured for the medium term as well, it appears safe to conclude that after the past price shock, inflation in Germany is now back under control.

Contributions to inflation (HICP) in Germany

Inflation in per cent, contributions of the components in percentage points



Sources: KfW Research, ECB.

This assessment is essentially supported by the fact that excessive services inflation has moderated. The rate of increase in the price of services slowed between April and July from 4.0 to 3.2% in the euro area and in Germany even from 4.5 to 3.0%. Lower seasonal price increases than usual in the summer contributed to this outcome. Therefore, even if they may potentially accelerate again in the short term, the persistent moderation in wage and salary increases indicates that price pressure in the services industries is easing sustainably. On the other hand, energy prices acted as less of a dampener on inflation than three months ago. But in July, consumers in the euro area still paid 2.4% less for fuels and other energy products and those in Germany paid 3.4% less. The dampening effect on inflation should also continue into the year 2026 because the temporary escalation of the conflicts in the Middle East is not having a sustained impact on the market prices for oil and gas, which have been on the decline since the start of the year, and forward rates signal a continuation of the favourable trend. However, base effects can cause significant fluctuations in the annual rate.

The discussed development of the most recent inflationary trends is materially in line with our expectations. With respect to economic policy events and measures, the first thing to note is that the trade dispute with the US has (for the time being) not escalated. The decision of the EU not to retaliate has removed a major upside risk to consumer prices. The agreed tariff regime will thus continue to have the moderate disinflationary effects from the growing trade barriers which we have already taken into account. However, the euro was able to strengthen a bit more against the US dollar. The single currency has appreciated by a further 2.5% since May. The expected inflation-reducing effect of this strengthening, however, is limited.[7] In addition, the German coalition government is planning to reduce value added tax in hospitality, abolish the gas storage levy and lower network charges. These measures will have a direct dampening effect on consumer prices in 2026. As a result, the inflation rate in Germany could turn out around 0.2 percentage points lower. But this will be countered by the economic revival from the larger fiscal impetus in Germany which is now expected to be stronger.

On balance, we therefore see no need to revise our inflation forecast and maintain our prediction of 2.1% inflation in Germany this year and 2.0% next year. In the euro area we expect consumer prices to be marginally lower at 2.0 and 1.9% respectively.

How large is the effect of German fiscal policy?

The amendments to Germany's Basic Law that were passed in March 2025 significantly increased the flexibility of fiscal policy in Germany. In particular, defence spending above 1% of GDP is now exempted from the debt brake with no borrowing limit. A special fund of EUR 500 billion for investment in infrastructure and climate neutrality was also adopted for 12 years. The Federal Government now plans to run a very expansionary fiscal policy from this year already. According to the government's draft budget, net borrowing including the special funds is to jump from EUR 50 billion to EUR 143 billion this year, which represents an increase from 1.2% of GDP (2024) to 3.3% of GDP (2025). Next year it is then planned to rise to EUR 173 billion (3.8% of GDP).[8]

The primary driver of new debt is the credit-financed expansion of defence spending and public-sector investment. Already this year, the budgetary plan provides for investment expenditure from the federal government's core budget, the Climate and Transformation Fund (KTF) and the Special Fund for Infrastructure and Climate neutrality (SVIK) to rise by 55%, or EUR 41 billion, to a total of EUR 115.7 billion. This is to grow by another 10% to around EUR 127 billion in 2026.

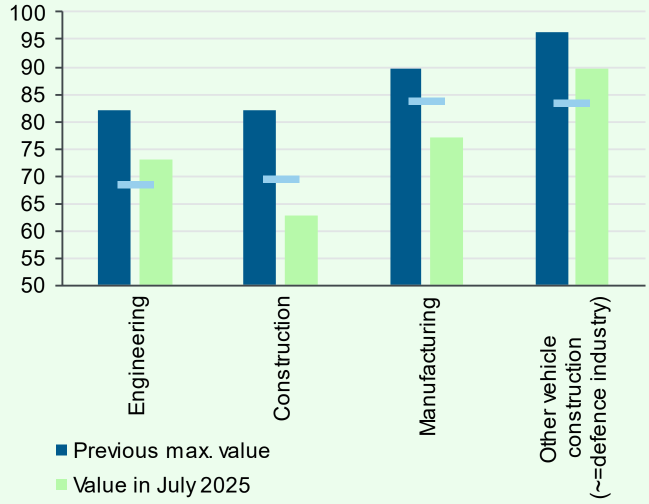
Without a doubt, the pace of this investment initiative is ambitious, especially since the 2025 budget is only provisional until it is voted on in the Bundestag in September, and considering that already last year only 80% of the initially planned investment expenditure was actually realised. For the economic forecast we therefore assume that the investment ramp-up will extend more strongly into the year 2026. It is estimated that investment expenditure will rise by around EUR 40 billion from 2024 to 2026, providing an overall fiscal impetus of 0.9% of GDP. The percentage increase in federal investment expenditure in 2026 would be roughly on the level that was already achieved with the stimulus package from the COVID-19 crisis. The Federal Government plans to increase defence spending from EUR 71 billion in 2024 to EUR 86 billion in 2025 and EUR 111 billion in 2026[9], which represents a total increase of 0.8% of GDP. Altogether, the fiscal impetus this year could already amount to approx. ½% of GDP, followed by a good 1% of GDP in 2026.

The degree to which fiscal impetus leads to an expansion of real gross domestic product is expressed by what is known as the fiscal multiplier. It can turn out large if state expenditure stimulates private-sector economic activity, for example when the prospect of government contracts prompts businesses to invest or infrastructure improvements generate investment incentives. The multiplier can turn out smaller if import intensity in the supported sector is high or public-sector economic activity ends up crowding out private-sector economic activity. Besides, high levels of capacity utilisation pose the risk that higher government spending drives prices up while the expansion of public-sector investment or public consumption expenditure turns out much smaller in real terms. Therefore, the effect of fiscal policy depends very heavily on the overall environment, where not just the type of government expenditure but, most of all, the rate of economic capacity utilisation is crucial. Some capacity in the main construction industry is now idle after multiple years with only weak construction demand (cf. figure). Besides, the trend in construction prices and, in particular, the prices of materials have eased again significantly from the peak levels of 2021 to 2023.[10] We therefore expect the new investment expenditure, particularly infrastructure investment, to have a relatively large impact on growth in the new forecast period.[11] For defence spending we would apply a fiscal multiplier well below one in the short term to account for the (initially) high share of imports and already high capacity utilisation in the defence industry. However, there is a chance that the reallocation of workers and possibly capital may lead to a relatively rapid increase in capacity in the defence industry.

On balance, we expect fiscal policy to boost growth by 0.8% of GDP next year. This year the effect could amount to 0.4% of GDP. In general, however, there is enormous uncertainty on both the volume of the fiscal measures that will be implemented (impetus) and their effect (multiplier), which is already evident in the considerable dispersion of the multipliers estimated in the various empirical studies.[12]

Capacity utilisation in relevant sectors

Capacity utilisation in per cent, seasonally adjusted



Note: Defence contractors are situated in various economic sectors and account for only a portion of other vehicle manufacturing. Here, capacity utilisation should be seen only as a rough indicator of capacity utilisation in the defence industry.

Sources: ifo Business Survey, Macrobond.

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1 The base tariff for exports from the EU to the US is rising from 10% to 15% but is now 'all-inclusive' and applies primarily to automobile exports, on which a significantly higher tariff of 25% was initially in place since April. The exact development of the effective average tariff on German exports to the US depends on the details in implementation. Cf. Schumacher, D. (2025), Einigung im Zollkonflikt EU und USA: Der Klügere gibt nach? (*Agreement in the EU-US tariff dispute: A wise man changes his mind...?* in German) Focus on Economics No. 510, KfW Research.

2 In June 2025, the euro appreciated by 6% against the average annual US dollar exchange rate of 2024. The nominal effective appreciation against a broad basket of currencies of 41 trading partners stands at 3.5%.

3 This is consistent with current calculations in trade policy models which describe an only minor drop in real production in Germany (-0.13%) and in the euro area (-0.11%) in the short term and purely through the export channel: Cf. Zölle und Handelskriege - Analysen, Simulationen und Kommentare (*Tariffs and trade wars – analyses, simulations and commentary* | Kiel Institute – our title translation, in German) By contrast, the losses in value creation would be significantly higher if uncertainty or a decline in sentiment among businesses were to also make them reluctant to invest, which so far does not appear to be the case. In the longer term, the price elasticity of German exports is likely to be higher and the loss is likely to roughly double. However, the tariff-induced losses in value creation would then still be very low. Cf. also Scheuermeyer et al. (2025): US-Zollpolitik: Wie verletzlich ist Deutschland? (US tariff policy: How vulnerable is Germany? – in German), Focus on Economics No. 493, KfW Research.

4 Cf. The euro area bank lending survey - Second quarter of 2025

5 On a price- and calendar-adjusted basis, we expect growth rates of 0.3% in 2025 and 1.2% in 2026. That means some of the high growth expected for the coming year is caused by an above-average number of working days (calendar effect).

6 Growth in Ireland was +7.4% in Q1 and -1.0% in Q2. However, the data from Ireland are highly susceptible to revision.

7 The Deutsche Bundesbank estimates that a lasting devaluation of the US dollar by 5% against the euro could reduce the inflation rate by around 0.1 percentage points. Cf. Bundesbank (2025), Forecast for Germany: US tariffs initially weigh on economic growth; fiscal policy provides impetus with a delay, Monthly Report to June 2025.

8 Cf. BMF-Monatsbericht Juli 2025 - Die richtigen Prioritäten für die Zukunft Deutschlands (*BMF Monthly Report July 2025 – the right priorities for Germany's future* – our title translation, in German)

9 Cf. Dezernat Zukunft, Budget Tracker: Growth and Budget Lab - Dezernat Zukunft

10 Construction prices for residential buildings in May 2025: +3.2% since May 2024 - Federal Statistical Office

11 We assume a fiscal multiplier equal to one for investment expenditure in the years 2025 and 2026. But in the longer term, capacity bottlenecks are likely to put the brakes on real expansion of investment – especially as a result of skilled labour shortages.

12 According to an overview of the literature of 2014, the mean fiscal multiplier for a variation in government expenditure sits at 0.9, within a range (in the form of a standard deviation) of 0.1 to 1.7: Cf. Are Fiscal Multipliers Regime-Dependent? - Macroeconomic Policy Institute (IMK) in the Hans Boeckler Foundation A recent study based specifically on data from Germany even arrived at a short-term fiscal multiplier of 1.9 for government investment expenditure: Cf. https://www.diw.de/documents/publikationen/73/diw_01.c.935984.de/dp2106.pdf In other words, it could drive GDP twice as strongly as we assume.