Growth against all odds

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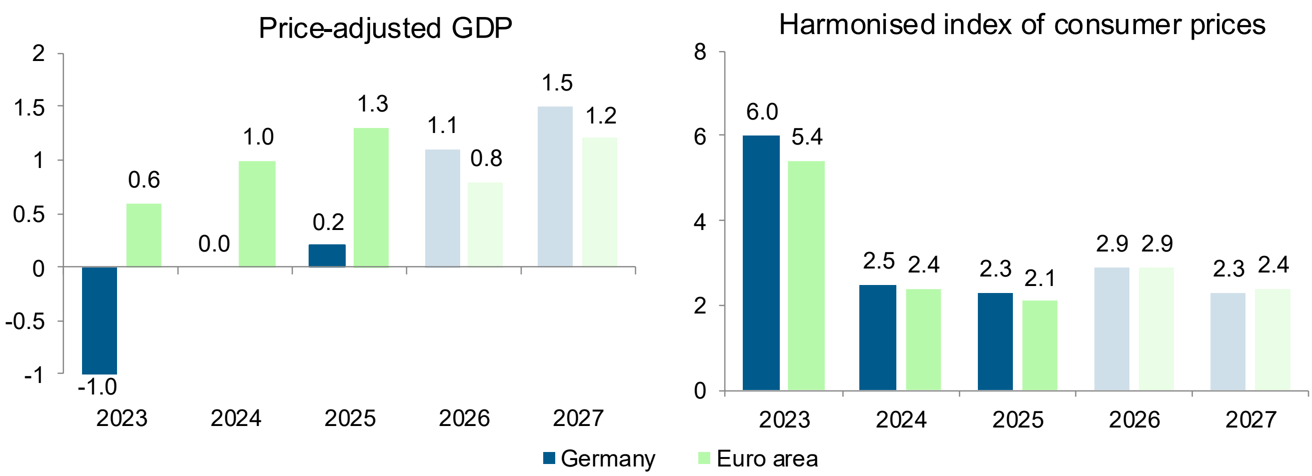
- Price-, seasonal- and calendar-adjusted German GDP rose by 0.3 % in the second quarter compared with the previous quarter, despite the burdens resulting from the war in Iran. At the start of the year it had even increased by 0.4 % quarter-on-quarter. In spring, exports were the main driver of growth.
- The German economy has therefore proved significantly more resilient than expected. And the next obstacle has already emerged: low water levels, especially on the Rhine, which are currently severely impairing inland waterway transport. However, this is unlikely to prevent German GDP from growing noticeably again in 2026 and 2027: for 2026 we now expect a (not calendar-adjusted) increase of 1.1 %, and for 2027 of 1.5 %. In doing so, we assume a crude oil price of just under USD 80/barrel until the end of 2026 and of around USD 75/barrel until the end of next year.
- The surprisingly robust GDP growth in the euro area in the second quarter provides a higher starting level for the remainder of the forecast horizon. Despite the still-assumed drag from the energy price shock and the setback caused by the heatwaves, we are, on balance, revising up our GDP forecast for 2026 by 0.2 percentage points to 0.8 %. For 2027, we expect growth of 1.2 % (+0.2 pp).
- Overall, we see hardly any need to adjust our inflation outlook. This year we expect consumer prices in Germany and the euro area to rise slightly less strongly, by 2.9 %. A more favourable development regarding the oil price is offset by higher gas prices and additional price pressures from the summer heat. In 2027 inflation will be lower again but at 2.3 % in Germany and 2.4 % in the euro area it will still exceed the ECB's 2 % target.

Economic growth and Inflation

Per cent year-over-year change



Sources: Destatis, Eurostat; from 2026 KfW Research forecast (as at 25 August 2026).

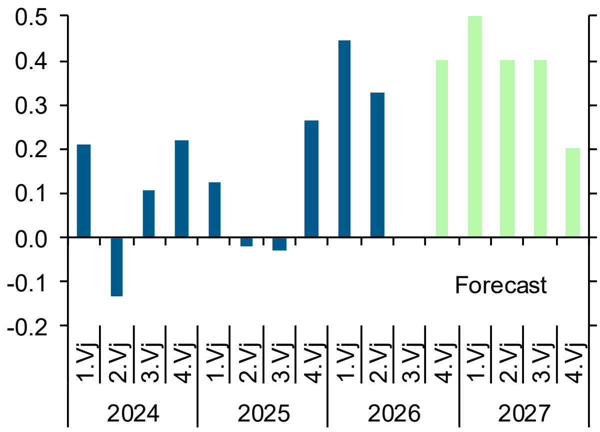
Germany: a repeatedly dampened upswing

In the second quarter, German (price-, seasonal- and calendar-adjusted) gross domestic product grew by 0.3 % compared with the previous quarter. In the preceding quarter it had even expanded by 0.4 % quarter-on-quarter. In spring, exports were the main driver of growth.

Thus, the German economy has proved much more resilient than generally assumed. Since the end of February, hardly any ships have been able to pass through the Strait of Hormuz because of the war in Iran, which has led to global delivery problems not only for crude oil and natural gas. Instead of an increase in GDP in the second quarter, we had therefore expected a slight contraction compared with the start of the year. Moreover, growth in the first quarter has now been revised up slightly from 0.3 to 0.4% quarter-on-quarter. Taken together, these two developments would – under otherwise unchanged assumptions – result in a noticeable upward revision of our GDP forecast for the current year. But the next dampening factor is already at work: extremely low water levels in German rivers. Shipping on the Rhine in particular is very important for German industry. If goods can no longer be transported by waterway, they must be shifted to road or rail, which is more expensive and in some cases not even feasible at short notice. This additional impediment is likely to prevent industrial output from growing by around 1 % in the current quarter and to dampen GDP growth by around 0.2 percentage points. Together with the ongoing burdens from the war in Iran, we therefore expect only stagnation compared with the spring quarter (see chart).

Germany – quarterly GDP growth

Price-, seasonal- and calendar-adjusted growth compared with the previous quarter, in per cent



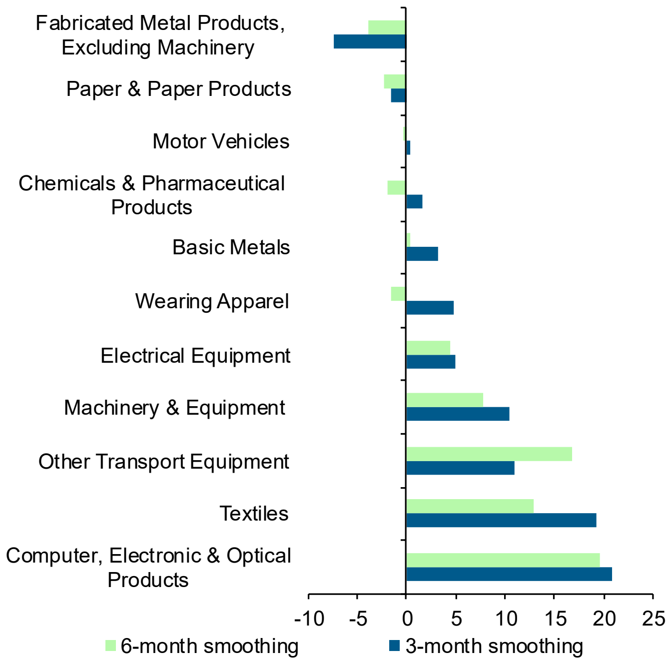
Source: Destatis; KfW Research.

The still solid performance of the German economy, however, has causes that do not vanish with the river water: it is essentially the rising new orders in the manufacturing sector. In the second quarter these increased by 1.4 % compared with the previous quarter (and by 4.5 % compared with the previous year). As a result, the order backlog as of June is, on a calendar-adjusted basis, 9.3 % higher than a year earlier. Large orders continue to play an important role here, and their impact on production is often associated with longer delays. Even if large orders are excluded, new orders in the manufacturing sector in the second quarter still show a slight increase of 0.1 % quarter-on-quarter. Above all, however, the data series currently stands, noticeably higher than it did last year (+3.4 % year-on-year). And the trend for both aggregates has been pointing upwards since the second half of 2025. In short: there is justified hope that industrial production will pick up significantly over time, once the impediments have finally been overcome. The expected momentum will then provide a corresponding impulse for the German economy. Against this backdrop, we expect positive, in some cases strong, quarterly growth rates again from the final quarter of this year onwards. For 2026 this results in GDP growth of 1.1 % (not calendar-adjusted). This corresponds to an upward revision of our end-May forecast by 0.4 percentage points. For 2027 we expect 1.5 %, which is 0.2 percentage points more than in our most recent forecast.

Which sectors of the economy are currently driving the positive trend in new orders? This is illustrated by the following chart: it shows the growth rates of smoothed new orders in the various sectors compared with the previous year, sorted in ascending order based on the three-month smoothing. The strongest increase, at around 21 %, is in the sector "Computer, Electronic and Optical Products". This includes, among other things, products that are benefiting from the current global AI boom, e.g. special lasers that the Dutch company ASML requires for the manufacture of its chip machines, as well as other products of the digitalisation industry. It is also likely that the currently strong demand for products related to the expansion of AI capacities is directly or indirectly benefiting Germany's important machinery sector. There, the three-month smoothing of new orders shows an increase of just over ten per cent. This figure is clearly above that of the six-month smoothing, which signals a recently increasing momentum.

Germany – orders received by sectors

3- and 6-month averages compared with the previous year, changes in per cent, as of June 2026



Sources: Destatis, KfW Research.

However, even beyond the AI boom – viewed overall – an upward trend in global industrial production has been evident since late 2024. German manufacturers are participating in this owing to their export orientation. And, of course, the frequently cited German fiscal impulse – although no longer exclusively – is generating new business. This is reflected, via higher defence spending, above all in the growth rates of "Other Transport Equipment" (water, rail, air and space vehicles as well as military combat vehicles and other means of transport), but also in the momentum in "Textiles" and "Apparel" (for uniforms and other equipment for the Bundeswehr) and in "Electrical Equipment" (which also includes electric motors, for which demand has risen as electromobility has expanded).

Euro area defies energy price shock

The economy in the euro area performed better than expected in the second quarter: real GDP increased by 0.4 % compared with the previous quarter. After GDP stagnation at the start of the year and the war-related sharp rise in energy prices in spring as a result of the conflict in the Middle East, this increase appears surprising at first glance. In fact, however, the jump primarily reflects the typical volatility of Irish economic data; excluding this factor, the euro area shows a remarkably stable growth rate of 0.3% in both quarters. Subsequent revisions could still alter this picture.

An economic downturn in the second quarter therefore failed to materialise despite the energy price spikes, for several reasons. Unlike during the 2022 energy price shock, the energy-intensive industries did not suffer a deep slump. This may be due, among other things, to the faster-than-expected decline in oil prices in June. Overall, the manufacturing sector performed slightly positively in the second quarter compared with the previous quarter, which is likely to have been driven mainly by production in defence-related and high-technology sectors and is probably linked to strategic stockpiling to hedge against supply chain risks. In addition, the rise in inflation hardly weighed on real retail sales on a quarterly average. This may be attributable to the government relief measures, most of which have already expired, which cushioned energy prices, and to the stable consumption behaviour of households. Moreover, the euro area countries have reduced their dependence on fossil fuels. Together with a more elastic global market response, this helped to mitigate the most recent price shock.[1] The region is likely to benefit from this increased resilience even in the event of renewed escalation with suddenly surging energy prices, although this adaptability also has its limits (see box below).

In view of this unexpectedly robust underlying trend and the optimistic sentiment indicators for July, we have revised our GDP forecasts for the euro area upwards: for 2026, compared with the May forecast, by 0.2 percentage points to 0.8 %, and for 2027 by 0.2 percentage points to 1.2 %. As in the previous forecast, we assume that direct and indirect price effects related to energy prices will lead to a slowdown in consumption growth in the second half of the year. In addition, the uncertainty associated with the war in Iran and higher interest rates are likely to dampen corporate investment activity. The forecast also considers the economic drag caused by the heatwaves in July and August. Crop failures in agriculture, constraints on energy generation, transport disruptions and heat-related reductions in labour productivity are likely to weigh on economic activity into next year. The economic losses are likely to be of a similar magnitude to those in Germany.

Euro area: annual GDP growth including forecasts

Per cent year-on-year, price-adjusted, as of 25 August 2026

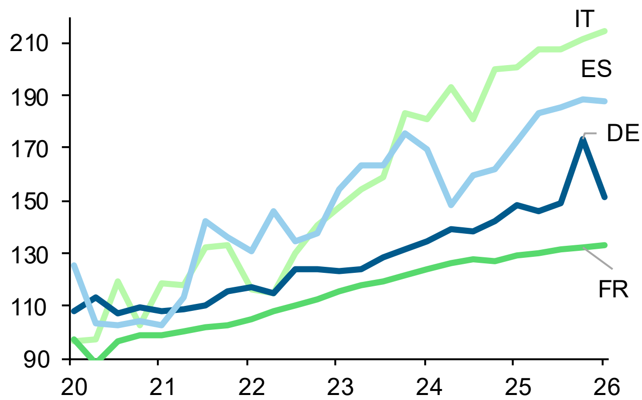
	DE	FR	IT	ES	EA
2024	0.0	1.4	0.6	3.5	1.0
2025	0.2	0.9	0.7	2.8	1.3
2026	1.1	0.6	0.9	2.6	0.8
2027	1.5	0.9	0.7	2.0	1.2

Sources: Destatis, Eurostat, from 2026 KfW Research forecast

By contrast, an expansionary fiscal policy is providing an impulse to growth, mainly driven by rising government defence expenditure. The defence boom is likely to benefit primarily Germany, France and Italy, where the highest-turnover European defence companies are based.[2] In the southern European countries, the drawdown of the remaining Next-Generation-EU funds via government investment spending (see chart below) is expected to give the economy a further boost.

Euro area – government investment expenditure

2019=100, SA, at current prices



Source: KfW Research, Eurostat.

By contrast, foreign trade is unlikely to make any significant positive contribution to GDP growth. Most recently, exports – in particular shipments to the United States, the most important export partner, which had previously fallen sharply – have stabilised at a low level. Since the end of July, a US import tariff of 15% has been applied to patented pharmaceutical products from large enterprises, although this is markedly lower than the tariff for trading partners without a corresponding agreement and allows company-specific exemptions. The strong stockpiling of pharmaceuticals may therefore come to an end. The trade effect is, however, not clear-cut, as the comparatively lower tariff could confer a relative price advantage compared with other countries. Overall, exports to destinations outside the euro area will weaken in annual terms. At the same time, the strong growth in imports will moderate in the near term owing to rising import prices. Among the four largest economies, Spain will maintain its position at the top of the growth league. Italy, Germany and France, meanwhile, are placed in the middle of the field, although a move into the fast lane appears to be on the cards for Germany in 2027.

Inflation: Energy prices cause ups and downs

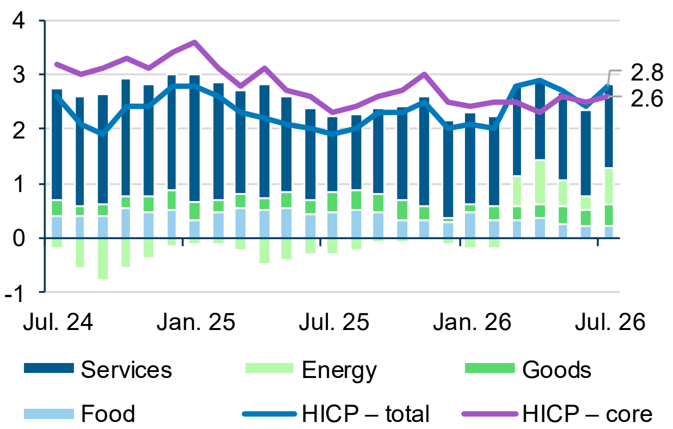
The volatility of the situation in the Middle East and the associated fluctuations in energy prices have been the main factors shaping the course of inflation over the past three months. The signing of the framework agreement between the US and Iran led to a weakening of consumer price increases in June, which in Germany was further amplified by the temporary reduction in taxes on petrol and diesel. However, this easing ended abruptly with the renewed flare-up of military hostilities. In July, the HICP headline rate in Germany was back at 2.8 % (EA: 2.9 %), thus almost matching the April readings.

By far the biggest driver of price increases remains liquid transport fuels, for which 22.9 % more was charged in Germany than a year earlier (EA: 17.4 %). By contrast, the European gas price (TTF, 1-month future), which has more than doubled since the outbreak of the war, is only gradually, or so far not at all, being passed through to consumers. While household gas prices in the euro area are slowly rising and are now 6.2 % above their level of a year ago, this energy source is even 2.4 % cheaper in Germany than twelve months ago. The pass-through of higher commodity costs is subject to a significant lag because of long-term price commitments and supply contracts.

Besides energy products, other industrial goods have seen somewhat stronger price increases, starting from very low levels. By contrast, services inflation has recently shown hardly any movement. At 3.3 %, it stands in Germany and in the euro area only marginally below the average of the past twelve months. Some relief has come from food, where price pressures have slowed markedly since April. This development is supported by the markedly lower agricultural producer prices compared with a year earlier. In Germany, the decline in June was 13.9 %, and in the euro area 9.1 %. It must be borne in mind that higher energy and fertiliser prices as well as climatic extremes only feed through with a substantial lag because of the long agricultural production cycles.

Contributions to inflation (HICP) in Germany

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



Sources: KfW Research, Eurostat.

KfW inflation forecast barely changed; risk of pronounced second-round effects has declined

On the basis of the current data, there is only limited need to adjust our inflation forecasts. For 2026 we now expect a somewhat weaker average increase in consumer prices of 2.9 % in Germany and the euro area (previous forecast DE: 3.1 %; EA: 3.0 %). In 2027, inflation is likely to be lower in both areas but will still slightly exceed the ECB's 2 % target. The status of the Strait of Hormuz remains by far the biggest source of uncertainty and, at the same time, the most important factor for price developments. At present, no clear path to a resolution of the conflict is emerging; the range of possible outcomes extends from unexpectedly rapid easing to renewed escalation (see box: Two alternative scenarios for growth and inflation). In our baseline scenario, we base the assumed trajectory of energy prices on the futures prices for oil (Brent) and European gas (TTF, 1-month future). Compared with the previous forecast in May, not only the current but also the expected future path of the oil price now appears significantly more favourable. Nevertheless, this has only a mildly dampening effect on the overall forecast. This is partly because European gas prices are rising more strongly than expected. The seasonally very low levels of European gas storage and competition with Asia for scarce LNG deliveries make the assumed prolonged period of high gas prices appear plausible. In addition, the dry and hot summer is giving rise to further price pressures. The extreme low water level of the Rhine is leading, in the short term, to higher transport costs and increased demand for fuels. Furthermore, fires and heat are likely, over the medium term, to push up the prices of food and services (insurance, tourism) further.

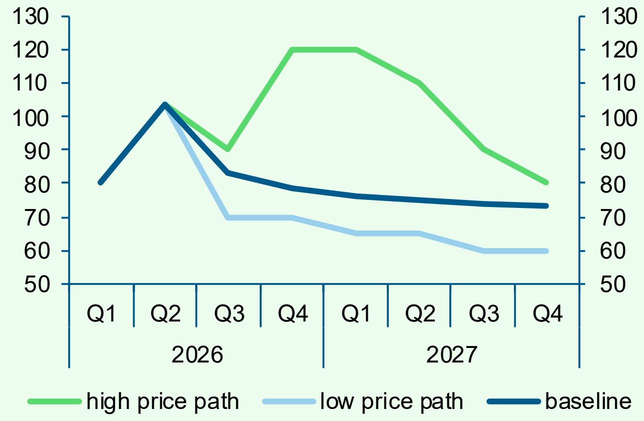
Clear signs of emerging second-round effects are still lacking. Firms' selling price expectations have already fallen back markedly, even though they remain somewhat elevated for industry and retail trade. The ECB Wage Tracker continues to point to collectively bargained wage increases of around 2.5 % at the beginning of 2027. Other wage indicators for Germany and the euro area are moving sideways or downwards. This suggests that the inflation wave is not spreading further and will quickly subside next year, despite the expected lagged effects on food prices. With regard to monetary policy, we therefore continue to assume that, after a final rate increase in September, the ECB will refrain from further tightening.

Two alternative scenarios for growth and inflation

Since there is still considerable uncertainty as to the extent to which ships will be able to pass through the Strait of Hormuz in future, crude oil and natural gas prices remain the biggest risks to our forecasts – primarily on the upside, although lower prices are also conceivable. Accordingly, in addition to the price path assumed in our baseline scenario, which corresponds to the futures prices for the two commodities as of early August, we have estimated two further price paths: a high one and a low one. The GDP and inflation forecasts resulting from these alternative price paths are presented here.With regard to the price paths: For the high price path we assume that the Strait of Hormuz initially remains closed. While in the third quarter released reserves on the crude oil market still have a compensating effect, this dampening influence disappears towards the end of the year. For both oil and gas, the first effects of adjustments in the remaining supply and on the demand side become apparent from spring 2027 onwards. In the course of 2027, ships are gradually able to pass through the Strait of Hormuz again, but freight traffic does not return to full normality. The opposite holds true for the low price path: the critical sea passage is reopened in the current quarter and prices for crude oil and natural gas therefore fall back relatively quickly to around their levels prior to the start of the war in Iran. In 2027, the crude oil price even comes under additional downward pressure, as a tendency towards oversupply becomes evident which had already weighed on the market before the conflict over the Strait of Hormuz (see charts below).

Price paths for crude oil

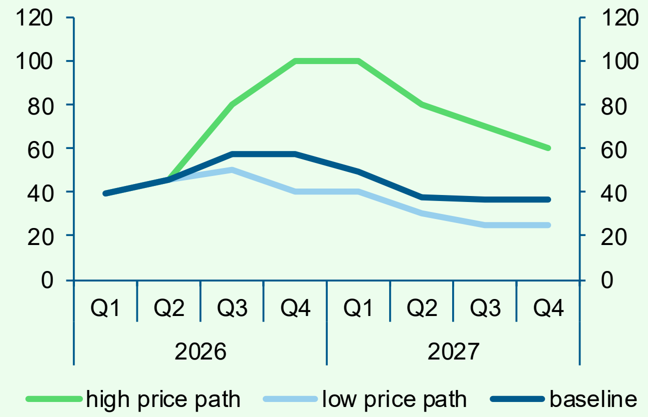
Brent, in USD per barrel



Sources: KfW Research, Bloomberg.

Price paths for natural gas

Prices for natural gas traded at the Dutch TTF exchange for delivery in one month, in EUR per MWh

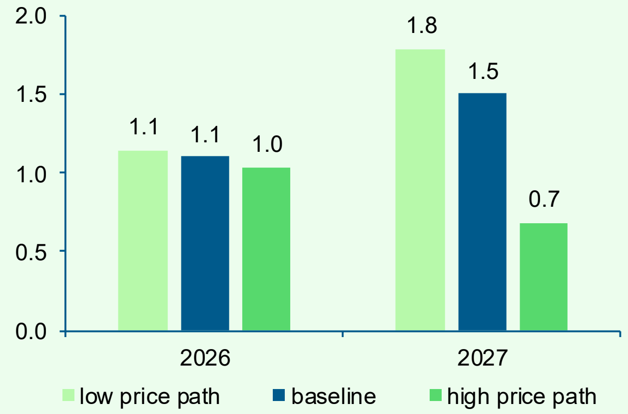


Sources: KfW Research, Bloomberg.

The effects on the GDP and inflation forecasts for Germany are shown in the next two charts. Overall, the impacts are more pronounced for 2027, chiefly because more than half of 2026 is already behind us and because some of the effects of the price paths – particularly on GDP – only materialise with a lag. Moreover, the inflation forecast reacts significantly more sensitively than the GDP forecast, as changes in energy prices feed directly into the inflation calculation, whereas GDP effects arise only indirectly. In the low-price scenario, Germany would achieve GDP growth of almost 2% in 2027, with an inflation rate remaining below this level. By contrast, the high-price scenario would be a severe blow to the German economy: GDP growth would be less than half as strong as in the baseline scenario, while inflation would reach almost 4% – and thus almost twice the ECB's target. For the euro area as a whole, the effects on GDP growth and inflation in the two alternative scenarios are virtually identical.

Germany: GDP growth in alternative scenarios

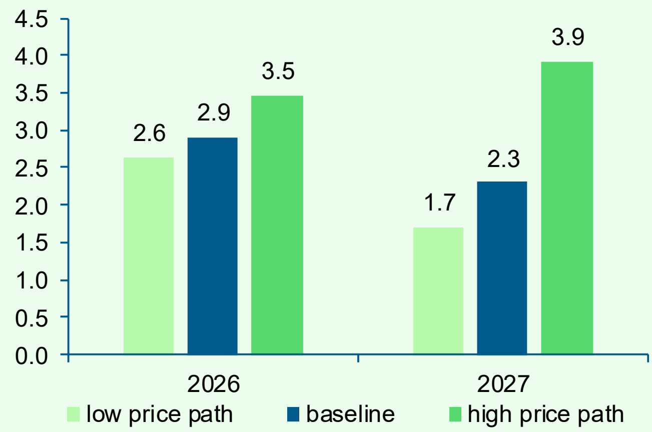
Year-on-year, in per cent



Source: KfW Research

Germany: inflation in alternative scenarios

Measured by HICP, year-on-year, in per cent



Source: KfW Research

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[1] Vgl. Demuth, L. et al. (2026) Energy shock: why oil and gas prices have risen less than expected, The ECB Blog, 27. Juli 2026.

[2] Vgl. Clapp, S. (2026) European defence industry, At a Glance, European Parliamentary Research Service, 2. Februar 2026.