German economy is ready to take off

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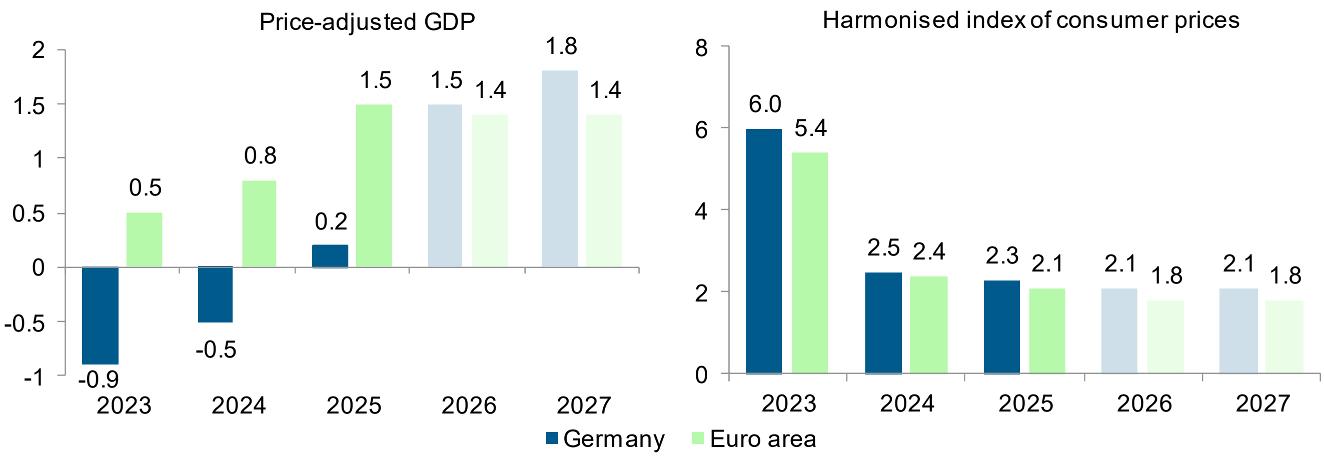
- In the final quarter of 2025, Germany's GDP grew by 0.3% on the previous quarter after stagnating in the third quarter. The drivers of growth at the end of last year were household and government consumption.
- For now, that is a solid foundation for the current year. In fact, given the recently very high order intake in the manufacturing sector, economic momentum is likely to even accelerate in the coming quarters and remain strong into the next year. We maintain our forecast of 1.5% GDP growth in Germany for 2026 and 1.8% for 2027.
- Euro area GDP also grew at a robust pace at the end of 2025 despite trade policy headwinds. On the back of last year's momentum, we have lifted our forecast for 2026 by 0.1 percentage points to 1.4%. Germany's fiscal impetus will carry growth into the euro area in 2027 as well. We expect growth of 1.4% here too.
- Inflation in Germany and the euro area has further converged on the ECB's 2% target. Our expectation is that the increase in consumer prices will remain with this range. Services inflation is likely to continue easing only slowly, to be sure. But combined with very limited increases in prices of industrial goods, this will be enough to push inflation in the euro area down to 1.8% in 2026 and 2027. We expect 2.1% inflation in Germany in both years.

Economic growth and inflation

Per cent year-over-year change



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

German economy is ready for takeoff

In the final quarter of 2025 Germany's gross domestic product, adjusted for price, seasonal and calendar variations, grew by 0.3% on the previous quarter, after stagnating in the third quarter. Following two years of recession, on balance this amounted to a moderate 0.2% increase in price-adjusted GDP for all of 2025 compared with 2024. At the end of last year it was mostly household and state consumption expenditure that contributed to GDP growth – as was the case throughout the year. And even so, a recovery trend was also evident in gross fixed capital formation.

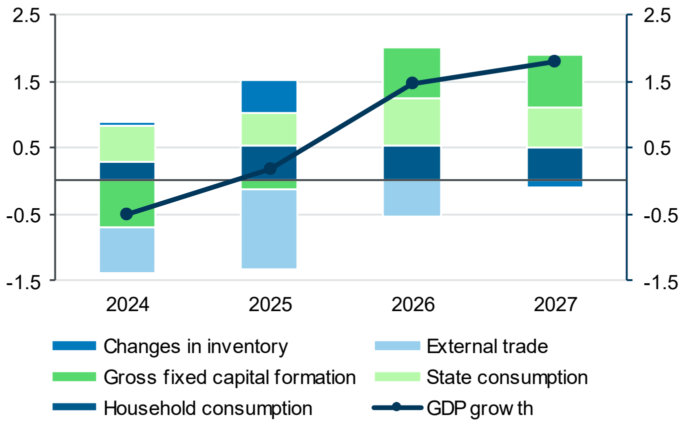
That is a solid foundation for GDP growth this year, which we continue to forecast at 1.5%. In the previous Business Cycle Compass we argued in detail that we believe the main driver to be the much-debated fiscal impetus, which is likely already manifesting itself in higher defence spending and, increasingly, greater infrastructure expenditure. On that basis, government consumption and investment will make tangible contributions to GDP growth (see figure). We expect the spark of increased public-sector economic activity to jump over to private business investment in the further course of 2026 as well as in 2027 – when capacity utilisation increases and prospects brighten further. At the same time, we expect foreign trade to weigh less on GDP growth this year and cease being a burden at all next year. This is predicated on the assumption that no additional material trade barriers will be erected and economic actors continue to adapt to the changes that occurred in the business environment in 2025. We believe the most recent change in US tariffs will have no significant impact on the existing situation. Finally, it is our view that, as was already the case in 2025, household consumption will make GDP growth contributions of around 0.5 percentage points in the following two years – amid a more or less stable labour market and continuing robust real wage growth. Combined, this should produce a GDP growth rate of 1.8% for Germany in 2027, which is even higher than for this year. The overall rate, however, masks weakening momentum throughout the year. We expect the fiscal impetus to have the strongest effects on GDP growth at the end of 2026.

So much for the forecast. But is it also consistent with reality? The first to point out is the volume of orders received by the manufacturing sector. Driven by domestic orders, it has literally skyrocketed since September 2025 and reflects the long-awaited fiscal impetus. In the fourth quarter it was 9.5% higher than the previous one. This development was characterised by major orders, which are likely attributable in large part to government defence expenditure. In other words, the broader economy has not yet benefited (see box on page 5 f.). However, first, the level of orders has improved in other sectors as well (see again box on page 5 f.), among other things as a result of the beginning normalisation in international trade after the tariff blows dealt until last summer, and second, the impetus will spread across the rest of the economy over time: first in the form of follow-on orders, then in the form of higher incomes which will at least in part be spent in other ways. Third, further orders from the public sector are to be expected and this year they will not consist mainly in expenditure from the defence budget but will increasingly also come from the Special Fund for Infrastructure and Climate Neutrality.

Apart from the broad economic effectiveness of current industrial orders, another question concerns their production efficiency. Manufacturing output already rose by 1.0% in the final quarter, in which price-adjusted GDP grew by 0.3% on the previous quarter. With this, and with the strong volume of orders built up towards the end of the year, the trend reversal has probably been completed (for more on production efficiency see box on page 5 f.). Originally, there were already green shoots of a trend reversal here since mid-2024, when the annual variations in production began to improve (see figure). But the trend stalled as a result of US protectionism in 2025. The fiscal impetus therefore came just in time to prevent the upward trend (shown in the figure) from reversing again. And this should be regarded as all the more important since manufacturing is traditionally – and likely continues to be – deemed to be the driver of the German economy, despite the turning point marked by the COVID-19 virus and Russia's war of aggression against Ukraine.

Germany – growth contributions to price-adjusted GDP (expenditure side)

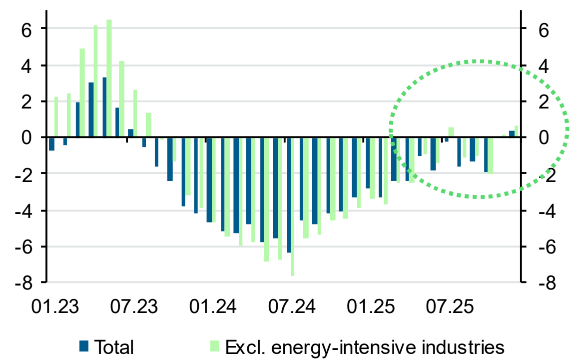
Growth in per cent, contributions of the components in percentage points



Sources: Destatis, KfW Research forecast as from 2026

Germany – manufacturing production

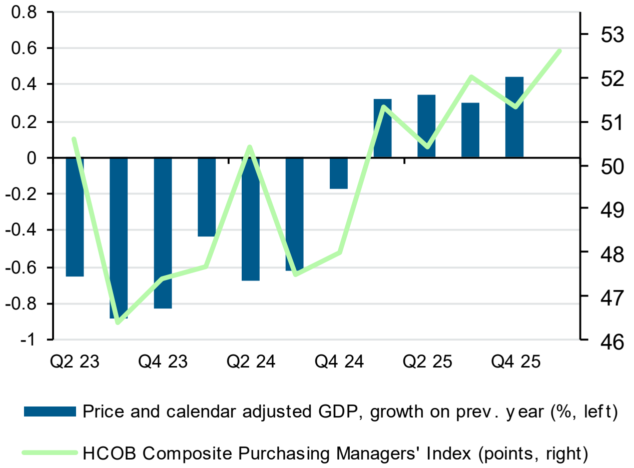
Three-month averages year on year, variations in per cent



Sources: Destatis, Macrobond

Now, let's take a look at the current quarter. The foregoing suggests that manufacturing production will likely continue to expand noticeably – despite the uncertainty around the production efficiency of the large-volume orders. The sentiment indicators such as the ifo Business Climate Index and the HCOB Composite Purchasing Managers' Index are also rising again after experiencing phases of weakness in 2025. The figure below shows the quarterly Purchasing Managers' Index for Germany with the annual variation rate of price- and calendar-adjusted GDP. The index has been trending upward since mid-2023 and indicates GDP growth of roughly 0.6% for the first quarter of 2026 compared with the previous year, which in this case roughly matches the rate of change on the previous quarter as well. As the link between sentiment indicators and GDP has weakened since the COVID-19 crisis, we tend to be slightly more cautious in this regard. But we do believe a renewed 0.3% rise on the previous quarter to be realistic.

Germany – quarterly GDP growth on the previous year and HCOB Composite Purchasing Managers' Index



Note: The Purchasing Managers' Index is an index based on business surveys in which values above 50 signal positive growth of private sector economic activity. For the ongoing quarter it exhibits the mean of the index levels for January and February.

Sources: Destatis, S&P Global, Macrobond

It remains to be noted that in the previous Business Cycle Compass we had compared the German economy with an aircraft in takeoff position waiting to be cleared for departure. Now, it is on the runway and has begun to roll. And it will probably lift off soon.

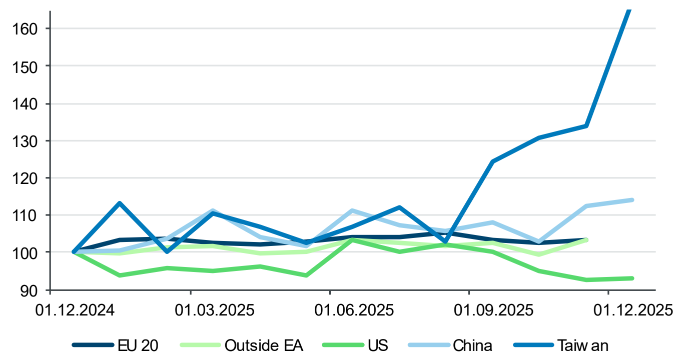
Euro area: solid growth momentum continues

As in Germany, the euro area (EA) exhibited GDP growth of 0.3% in the final quarter. This result confirmed the positive trend of the third quarter. Across the year as a whole, the euro area economy expanded by 1.5% on the previous year, surpassing the 0.9% growth rate of 2024. The quarterly growth rates in the four largest economies were much more similar this time: Spain impressed again with a 0.8% growth rate and the export heavyweight Italy also showed its resilience to US tariffs with 0.3% growth. France grew by a solid 0.2%. The contraction of Ireland's GDP in the final quarter (-0.6%) after strong growth in early 2025 was a minor dampener, otherwise the euro area economy would even have grown by 0.4%.

We have lifted our forecast for 2026 slightly by 0.1 percentage points to 1.4% because the statistical overhang was moderately higher than initially expected. We believe the euro area economy this year will be driven mostly by growth in investment and household consumption. Gross fixed capital formation already recovered in 2025 by 2.5% on the previous year, extra-polated on the basis of the first three quarters, after contracting by 2.0% in 2024. This upward trend is likely to continue, in part driven by the expected expenditure on infrastructure and defence in Germany. Residential construction investment has also failed to rebound in the euro area thus far but the recovery is now likely to set in. Household consumption still has room to grow, after expanding by around 1.2% in 2025. Although the increases in disposable incomes are not likely to remain quite as abundant, the saving rate continues to provide scope for higher expenditure. In 2025 it was still around two percentage points above the long-term average from before the COVID-19 crisis, at 15%. Besides, rising defence spending will further boost government consumption and, hence, GDP.

Euro area – imports by country

Volume index, December 2024=100, seasonally and calendar-adjusted

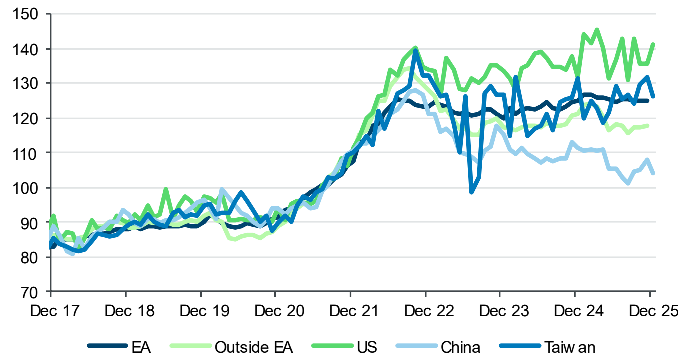


Source: Eurostat

Given the geopolitical situation, a special spotlight is still being cast on foreign trade. In the fourth quarter of 2025, US tariff policy led to a decline of approx. 15% in real goods exports to the US. The dampening effect on the overall development of goods exports will presumably last throughout the first half of the year but exports are likely to grow moderately for the year as a whole. At the same time, we expect the trend of rising imports to the euro area to continue. Recently, Taiwanese imports of computers and microchips in particular increased, which is likely connected to the AI boom (see figure). The prices of Chinese imports have also decreased significantly. A further rise in volumes can therefore be expected. Owing to the strong import momentum, the contribution of external trade to GDP growth will presumably be negative again. It should return to neutral in 2027.

Euro area – import price index by country

Import unit value index, seasonally and calendar-adjusted



Source: Eurostat

Finally, we expect the euro area to grow at a rate of 1.4% in 2027 as well. This growth will then be predominantly supported by the German economy, which will likely continue to benefit from the fiscal stimulus and its follow-on effects (see above). This will cushion the dampening effect from the expiry of the NextGenerationEU (NGEU) funds. Spain and Italy will benefit from these EU funds for the last time this year. Spain will continue on a strong path of growth in 2027 on the back of the good employment situation. For Italy, in turn, an economic downturn is looming. In France the pressure from fiscal consolidation measures appears to be on hold for the time being, which is giving the economy breathing space.

Euro area GDP growth

Variation on previous year in per cent, adjusted for prices, as at 19 February 2026

	DE	FR	IT	ES	EA
2024	-0.5	1.1	0.5	3.5	0.9
2025	0.3	0.9	0.7	2.8	1.5
2026	1.2	1.0	0.8	2.6	1.4
2027	1.7	0.8	0.6	2.2	1.4

Sources: Destatis, Eurostat; from 2026 KfW Research forecast

Risks

For **Germany** – and therefore for the euro area too – the question remains whether the investment expenditure planned in the budget can flow as quickly as we assume. The intensity and temporal dimension of the fiscal impetus remain difficult to estimate and probably present mostly downside risks to our economic forecast.

Besides, it is important to keep a close eye on external trade. Looking ahead, a significantly higher external value of the euro would lead to a deterioration of the current-account balances of the euro economies. Moreover, there are question marks over the economic development of the heavyweights US and China. Weakening momentum there would lead to weaker exports and, presumably, a further surge of low-priced imports, which has the potential to weigh on GDP growth in Germany and the **euro area** as a whole. The European Commission recently identified harmful import increases from China in six economic areas, and no other country exhibits similar imbalances.[1] For the euro area, the approaching end of the inflow of NGEU recovery funds – especially for Spain and Italy – poses a downside risk to our GDP forecasts. Here, it will be decisive how strong the offsetting effect of other fiscal measures – such as rising defence expenditure – can be.

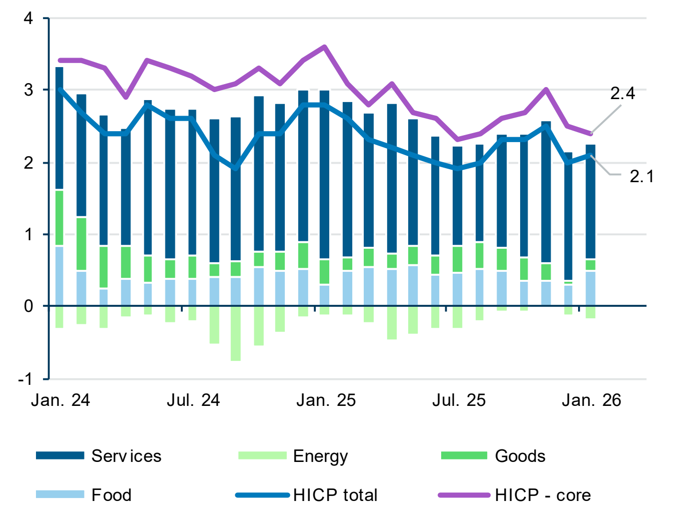
Finally, **global** trade and geopolitical risks remain, exemplified by the debate around a possible annexation of Greenland by the US or the war with Iran. There is also the risk that the high valuations in the US share market will lead to a correction. In particular, the high expectations being placed on investments in artificial intelligence suffer a noticeable setback, and both would have corresponding adverse effects on the global economy.

Inflation is weaker but remains within the ECB's target range

The past year brought the expected further decline in consumer price increases. Measured by the Harmonised Index of Consumer Prices (HICP), the average annual inflation rate in the euro area stood at 2.1% in 2025. Inflation in Germany was only a moderately higher 2.3%. The price of services, which increased by 3.9% in Germany, made the strongest contribution to the increase by far but food also cost 2.7% more. At the same time, the downward trend in energy prices (-2.3%) and weak price increases for other industrial goods (+1.0%) eased pressure on consumers. The inflation trend in the euro area materially followed the same pattern.

Contributions to inflation (HICP) in Germany

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



Sources: KfW Research, Eurostat

As of today, there is much to suggest that inflation will remain largely steady in the next two years, with only minor deviations from the ECB's inflation target. As a result, there is no pressure on European monetary policymakers to act and we anticipate that the deposit rate will remain on the current neutral level of 2% for the time being. We expect inflation to slow moderately to 2.1% in Germany and 1.8% in the euro area in 2026 and 2027.

Pressure on domestic prices will likely ease only slowly. For one thing, sales price expectations of retailers and services businesses are trending sideways above their historical mean levels. For another, the supply of skilled labour is still being perceived as tight despite the weak economic development of recent years. This strengthens workers' bargaining position. Accordingly, the strong wage dynamic will likely ease only gradually despite the return to lower inflation rates and remain above-average for the time being. Moreover, in Germany significant minimum wage increases will also contribute this year and next. Given the higher share of labour costs, this will primarily affect services inflation, which has a particularly heavy weight in the basket of goods and will therefore be extremely hard to reduce. We expect services inflation to continue rising significantly by 3% to 3.5% this year and to hardly ease in 2027.

For external trade, deflationary drivers resulting from the stronger euro and trade conflicts continue to prevail. Last year the euro had appreciated as a reaction to diminishing trust in the reliability of US policy[2]. The nominal effective euro exchange rate rose by around 6% against 41 trading partners in the period between March and September 2025. The euro exchange rate has stabilised since then and is trending sideways with lower fluctuations, to be sure. However, model-based estimates by the ECB demonstrate that the effects on the inflation rate will mainly appear this year.[3] The prices of industrial goods (without energy) are therefore likely to remain under pressure from low-priced imports and rise moderately at best in 2026 and 2027.

The development of food and energy prices is subject to particularly high uncertainty because of its dependence on weather events and geopolitical developments. For example, the oil price had lately increased again as a result of the Iran conflict. But based on forward prices, a consistently favourable price development of energy raw materials can be expected for the next two years. The dampening effect of energy prices on the inflation rate, however, will be much weaker from the second quarter of 2026 than it was last year. The sharp increases in food prices in recent years were a particular burden for households on lower incomes. These price increases are now set to ease in 2026 and 2027 because agricultural commodities had become significantly cheaper in the euro area of late. As this follows the extreme price rises of last year and commodities are only one cost component of processed foods, this will have only a moderate impact on consumer prices.

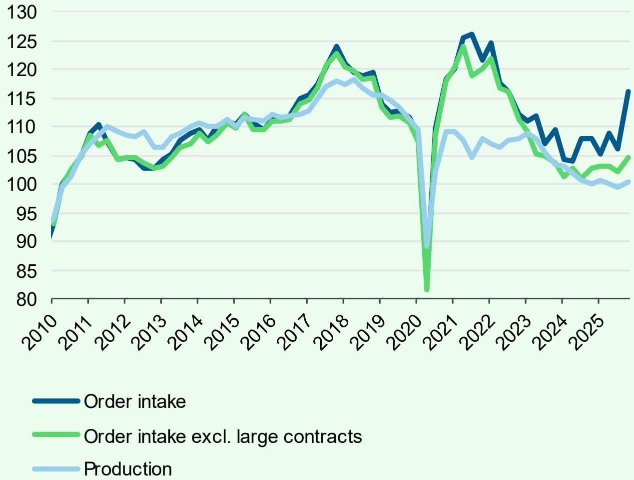
The generally favourable inflation outlook is subject to risks on both sides. A faster-than-expected drop in services inflation or a further strengthening of the euro could push consumer price inflation further below 2%. On the other hand, any escalation of geopolitical disputes could cause inflation to accelerate again. Besides a possible significant increase in raw material prices, this will also be the case if the EU imposes import tariffs of its own in the event of an escalation of trade-policy conflicts. In this uncertain environment it is understandable that the ECB continues to abstain from making any predeterminations of its future key interest rate trajectory.

Will the surge in orders bring the turnaround for industrial production?

While industrial production merely stabilised in the course of last year, the order intake saw a positive trend reversal that culminated in a significant surge at the end of the year. The volume of orders received across the entire German manufacturing sector grew by 7.5% on the same quarter of the previous year, opening up an unusually wide gap to the production index. Given the typically close correlation between order intake and production in the past, one could assume that there is considerable catching-up potential for industrial production in 2026. Moreover, in contrast with the large backlog of orders in the years 2021 and 2022, global supply bottlenecks hardly play a role today. Furthermore, capacity utilisation in German industry is currently 5.7 percentage points below its long-term average, whereas it was disproportionately high during the supply bottlenecks of 2021 and 2022.

Manufacturing: order intake and production

Adjusted for price, seasonal and calendar variations; index: 2010=100



Sources: KfW Research, Destatis

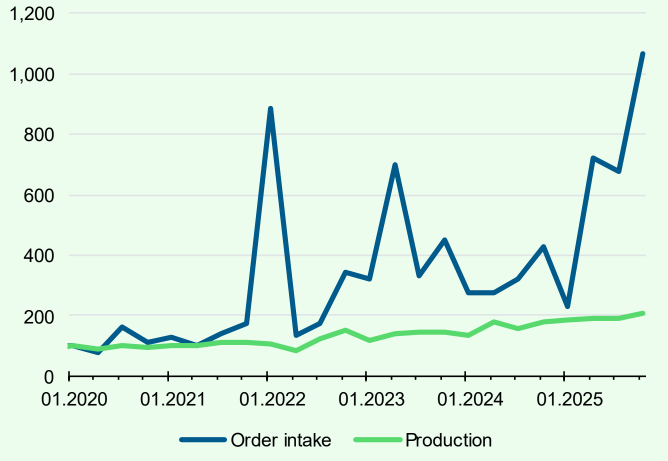
However, the fact that the order volume is currently heavily concentrated in large contracts for the defence industry suggests that industrial production will not follow quickly. In December 2025 alone the Bundestag (lower house of parliament) approved defence projects worth more than EUR 50 billion, some of which are now materialising as contracts with firms in Germany. The defence industry includes in particular the subsector ‘manufacturing of arms and ammunition’, where the volume of orders was recently 149% above the previous quarter’s level and experience shows that order intake tends to be very volatile. Above all, however, capacity utilisation here is already very high, which is why production followed the receipt of orders only slowly and incompletely in recent years (see figure). The same likely applies to businesses in other areas of the defence industry for which the Federal Statistical Office, however, does not publish relevant data. At a rough estimate, the categories ‘arms and ammunition’ and ‘other transport equipment’, where capacity utilisation is high, account for at least 2 percentage points of the 7.5% growth in orders at the end of 2025. They are only very slow to be productive.[4] Alternatively, the focus can be placed on the less volatile order intake without large-scale contracts, which was only 2% above the previous year’s level in the final quarter of 2025.

On balance, the precise extent of production growth can hardly be predicted today on the basis of order intake, which is primarily due to the important role played by defence contract. But there are also signs of a broader recovery of industrial activity. For example, the mechanical engineering, electrical equipment or pharmaceutical sectors received clearly higher order volumes at the end of 2025.[5] Furthermore, orders received from outside

Germany in the final quarter of 2025 also increased by a noteworthy 3% on the previous year. The positive development has not yet reached the energy-intensive chemical industry or automakers. Structural challenges such as high energy prices and tough competition from Chinese rivals weigh most heavily here.

Production of arms and ammunition: order intake and production

Adjusted for price, seasonal and calendar variations; index: 2010=100



Sources: KfW Research, Destatis

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[1] European Commission (2026), Dashboard – Task force on import surveillance, January 2026.

[2] Cf. Bales, S. (2025), Präsident Trumps Spiel mit dem Status der USA: Kurz- und langfristige Effekte der Wirtschaftspolitik (President Trump's gamble with the status of the US: short- and long-term effects of economic policy – in German), Focus on Economics No. 497, KfW Research.

[3] Lane, P. (2025), Inflation deviation and monetary policy, speech of 3 December 2025, Ljubljana.

[4] In order to calculate the contribution to growth, we had to draw on the turnover share of both sectors in 2024 because Destatis does not report any absolute values for order intake. The contribution to order intake is therefore likely to be slightly underestimated. Other transport equipment includes, among other things, the subcategory of military combat vehicles for which, however, Destatis does not publish relevant data.

[5] Cf. Scheuermeyer, P. (2026), Konjunkturerholung in der deutschen Industrie (Economic recovery in German industry – in German only), Auf einen Blick, KfW Research.