

Iran war dampens growth prospects

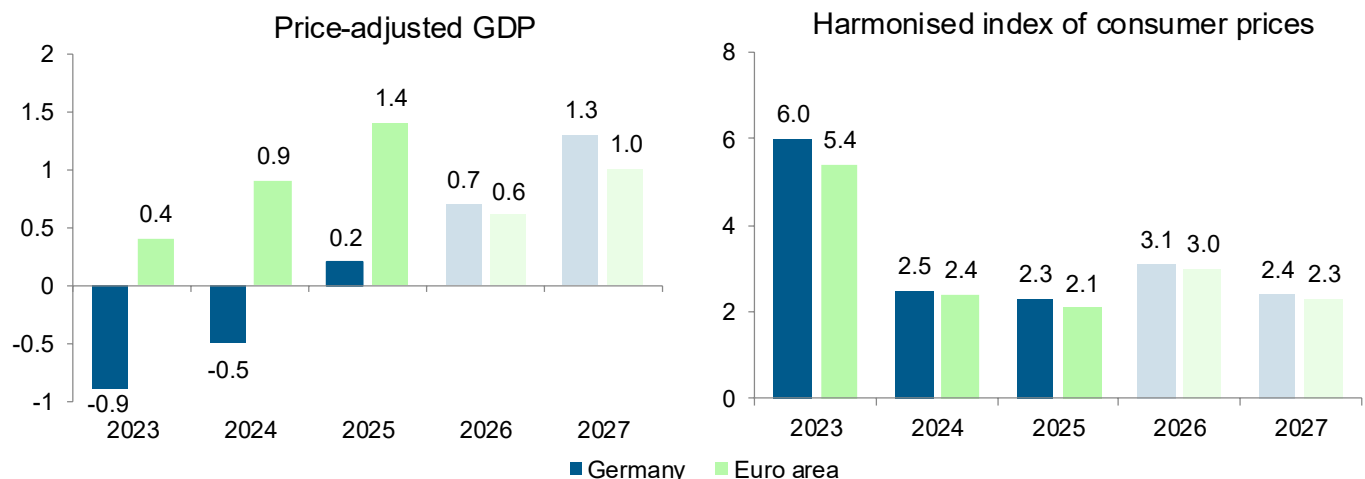
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- The German economy made a solid start to the year with quarter-on-quarter growth of 0.3%. Growth was driven by government consumption and exports. By contrast, private consumption stagnated and defence spending as well as the weather generated volatility in investment.
- The Iran war is now clouding the economic outlook: For real gross domestic product (GDP) in Germany in 2026, KfW Research now expects growth of only 0.7%, followed by 1.3% in 2027 (February forecast: 1.5 and 1.8%).
- GDP in the euro area increased only slightly at the start of the year and the current quarter is now being clearly weighed down. We therefore expect GDP growth of only 0.6% for the current year. As from the second half of 2026, momentum is likely to pick up again and then carry over into the following year, so we anticipate an increase of 1.0% for 2027.
- The war in the Middle East is pushing up energy prices and, as a result, consumer price inflation. The magnitude of the energy price shock nevertheless remains well below that of 2022. We are raising our inflation forecast for 2026 for Germany to 3.1% (EA: 3.0%). In 2027 as well, the rise in prices is likely to remain above the ECB's 2% target, at 2.4% (EA: 2.3%). We therefore expect a moderate monetary policy tightening in order to send a clear signal in favour of price stability.

Economic growth and inflation

Per cent year-over-year change



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

Germany: solid start to the year

In the first quarter, the war in Iran has so far left hardly any trace on the German economy: The German Federal Statistics Office reports price- and seasonally-adjusted growth of +0.3% on the previous quarter for the opening quarter, following +0.2% in the final quarter of 2025. The slight upturn that had already begun at the end of 2024 thus continued and was interrupted only briefly by the US tariff gyrations. As at the end of last year, government consumption drove growth at the start of the year (+1.1%). By contrast, private consumption, which had still been fairly strong until recently, stagnated. Exports, however, rose surprisingly sharply (+3.3%) while imports increased only slightly (+0.1%). Only gross fixed capital formation contracted significantly (-1.5%): here, the cold and snowy weather in January and February is reflected in construction investment. Above all, however, public investment in equipment declined markedly (-20.2%) after it had virtually exploded in the previous quarter (41.3%). As a result of the Federal Government's rearmament drive, which is reflected in equipment investment that also includes military weapons systems, there is a great deal of volatility but, overall, also a steep upward trend. It is also encouraging that corporate investment has offset the decline seen in the previous quarter (+1.0%) and is thus at least continuing last year's broad sideways movement.

But energy price shock clouds the outlook

In the meantime, however, the upswing is stuck in the Strait of Hormuz. Owing to its effective closure to shipping since the beginning of March, oil and gas prices have risen significantly, which has abruptly pushed inflation up from around 2% to around 3% in March and April (see inflation section). In view of the associated losses of purchasing power, consumer confidence has slumped and business sentiment, as measured by the Ifo Business Climate Index, has fallen. The Purchasing Managers' Index (Composite PMI), a relatively good leading indicator of growth, averaged 48.5 points in April and May, thus pointing to a slight contraction in real GDP in the second quarter. One bright spot, however, is industrial new orders, which have been on an upward trend for several months now and increased markedly again in March.¹

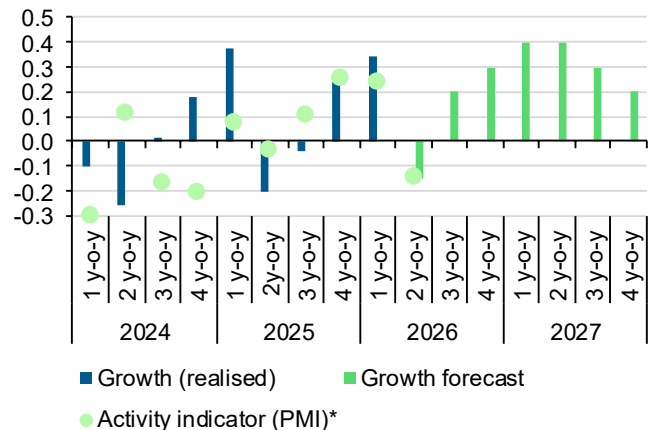
Growth forecast: +0.7% in 2026 and 1.3% in 2027

In particular, consumption growth is likely to be held back by the energy price shock and corporate investment is also being impaired by deteriorated global economic prospects and increased uncertainty. In addition, there are negative effects via a rise in interest rates, which has resulted from higher inflation expectations and the anticipation in financial markets of an interest rate response by the ECB. In an interim forecast published on 2 April, we had already made a downward revision of 0.6 percentage points to the February forecast of 1.5% for GDP growth in 2026 against this background.² Owing to a deterioration in the leading indicators that has been somewhat stronger than expected and a statistical carry-over from 2025 that has slightly shrunk after revisions, we are now again

slightly lowering our growth forecasts for 2026: For real GDP, we now expect growth of 0.7% this year, followed by +1.3% in 2027 (February forecast: +1.5 and +1.8%).³ After a slight decline in GDP in the current quarter, we expect positive growth rates again from the second half of the year onwards. As the normalisation of energy prices and trade flows will take time, however, this is likely to proceed at a somewhat subdued pace.

Germany: Growth dynamic

Price-, seasonally- and calendar-adjusted GDP, quarter-on-quarter change, in per cent



Note: *Activity indicator: (value of the Composite PMI – 50)/10

Sources: Destatis; S&P Global, KfW Research forecast from Q2 2026

The main reason for our still significantly positive growth expectation for the full year, and especially for 2027, is the fiscal stimulus from the Federal Government. Defence expenditure in particular has been rising rapidly since the end of 2025 and has translated into orders for armaments from German industry. By contrast, the disbursement of funds from the special fund has been somewhat slower in recent months, although we continue to expect an acceleration from the second half of the year.⁴ Looking at the expenditure components of GDP, we therefore expect primarily positive contributions to growth from public investment – which also includes military equipment – as well as from government consumption. Indirectly, however, the increase in government spending is also likely to have a positive impact on private consumption, which, despite the price shock, is expected to expand at least slightly in 2026 and 2027 and will initially still benefit from robust wage growth.⁵ If the uncertainty caused by the war in Iran diminishes in the second half of the year, rising capacity utilisation should also put corporate investment on a slight growth path. However, we do not expect positive growth on an annual basis in this area until 2027. Moreover, after a poor start to the year and in view of the renewed headwinds from higher interest rates and possibly also construction costs, private residential construction investment is likewise unlikely to expand again on an annual basis before 2027.

¹ Brought-forward orders to get ahead of price increases or supply bottlenecks are likely to partly explain their 5% increase in March. However, the rise in new orders is too broad-based to attribute the positive development to this factor alone.

² Cf. Schumacher, D. (2026): Ein hartnäckiger Energiepreisschock (A persistent energy price shock – in German). Economics in Brief No. 260, KfW Research.

³ On a price- and calendar-adjusted basis, our current forecast stands at +0.5% for 2026 and +1.2% for 2027. An above-average number of working days contributes to growth in both years.

⁴ The federal government plans to increase its capital expenditure (excluding financial transactions) from EUR 70.6 billion to EUR 118.3 billion. Disbursement of just over 80% of the budgeted funds appears realistic.

⁵ Nominal wages in Q1 were 4% higher than in the same quarter of the previous year.

Growth in 2026, and to a somewhat lesser extent still in 2027, will be dampened by net exports, since government spending also increases imports and therefore arithmetically reduces economic output somewhat. Exports are likely, in view of higher foreign orders and export expectations, to pick up somewhat again in 2026 and 2027 but probably at a significantly slower pace than imports. Intense competition from Chinese firms is also likely to continue weighing on the external balance.

Implications of the war in Iran remain highly uncertain

The economic trajectory still depends heavily on the path of energy prices. Here we base our projections on the oil and gas futures prices prevailing in mid-May, which, despite the closure of the Strait of Hormuz that has now been in place for more than two months, have evolved somewhat more moderately than feared in our interim forecast. However, a precondition for the gradual decline in energy prices embedded in the futures from the second half of the year onwards is presumably that the Strait of Hormuz is reopened in the current quarter. If this does not happen, a further substantial increase in energy prices would be likely, as would supply bottlenecks impairing production for numerous goods that are produced petrochemically or traded via this well-known maritime bottleneck. If, however, the hostilities are resolved swiftly and durably, there are also upside risks to our forecast: In particular for the current year we have gone well beyond the model-based growth markdowns, not least in order to take account of negative sentiment effects as well.⁶

Assumptions for the oil and gas price in the forecast

	Oil (USD/Barrel)	Gas (EUR/MWh)
2026 Q1	80	40
Q2	103	45
Q3	101	45
Q4	91	45
2027 Q1	85	44
Q2	81	36
Q3	79	34
Q4	78	34

Note: Based on Futures from 04.05. – 08.05.2026

Source: Bloomberg

Euro area: War in Iran is a major blow

The development of real GDP in the euro area as a whole was relatively weak at the start of the year: In the first quarter it increased by 0.1% compared with the previous quarter. The GDP growth rate for the final quarter of 2025 was also revised down slightly, namely to 0.2% quarter on quarter. The current quarter is now dominated not only in Germany but across the entire euro area by the burdens arising from the war in Iran, i.e. higher energy prices and actual or emerging supply bottlenecks. We therefore expect economic output in the euro area to

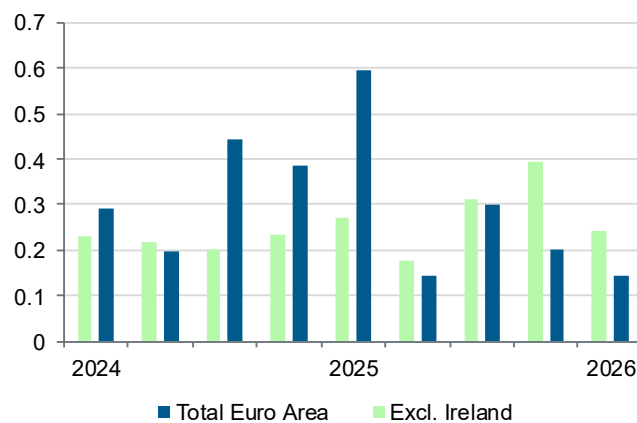
contract in real terms in the second quarter as well. With the reopening of the Strait of Hormuz, which we expect by around the end of June, growth rates are likely to turn positive again. Consequently, we have revised our GDP forecasts for the euro area noticeably downwards: for 2026 by 0.8 percentage points compared with the February forecast to now 0.6% and for 2027 by 0.4 percentage points to 1.0%.

Ireland distorts the overall picture

A closer look at the euro area figures shows, however, that up to the first quarter the underlying momentum was somewhat better than the aggregate data suggest: Excluding Ireland, GDP in the opening quarter grew by around one tenth of a percentage point more than in the previous quarter, that is by a rounded 0.2% quarter on quarter. Already in the final quarter of 2025, the small euro area member state in the north-west had noticeably dragged down GDP growth in the euro area as a whole. Excluding Ireland, euro area GDP had in fact expanded by 0.4% at that time (see chart below). Irish GDP data are increasingly dominated by multinational enterprises and their recording of intellectual property products. From an outside perspective, it appears somewhat doubtful that this value added actually takes place in Ireland. The Irish Statistical Office points to the phenomenon of GDP fluctuations caused by these products but has not yet proposed any alternative way of dealing with it.

Euro area: GDP growth with and without Ireland

Price-, seasonally- and calendar-adjusted GDP, quarter-on-quarter change, in per cent



Sources: Eurostat, Macrobond.

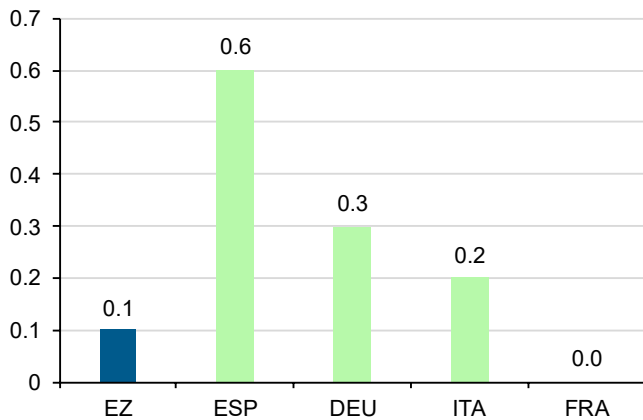
Spain remains the growth champion

A comparison of the GDP growth rates of the largest euro area countries (see chart below) is revealing. Germany has now moved into second place behind Spain. While the economy on the Iberian peninsula grew by 0.6% in the first quarter compared with the previous quarter, Germany's real GDP (see also above) increased by 0.3%. Germany is thus – above all thanks to the fiscal impulse – ahead of Italy, with 0.2%, and France, where growth stagnated.

⁶ Our simulation using the macroeconomic model of Oxford-Economics alone results in a reduction in growth of only 0.3 percentage points for 2026.

Euro area: GDP growth of the largest economies in the first quarter of 2026

Price-, seasonally- and calendar-adjusted GDP, quarter-on-quarter change, in per cent



Sources: Eurostat, Macrobond.

In France, according to the statistical office INSEE, growth was dampened not only by domestic demand but also, among other factors, by a pronounced weakness in exports of the aerospace industry. Whether this was merely a temporary blip will become clear over the coming months. In any case, this disappointing start to the year is weighing noticeably on the expected annual GDP growth rate of our neighbouring country (see table below).

Euro area: annual GDP growth including forecasts

Per cent year on year, price-adjusted, as at 22 May 2026

	DE	FR	IT	ES	EA
2024	-0.5	1.2	0.8	3.5	0.9
2025	0.2	0.8	0.5	2.8	1.4
2026	0.7	0.5	0.4	2.1	0.6
2027	1.3	0.8	0.5	1.8	1.0

Sources: Destatis, Eurostat, from 2026 KfW Research forecast

Inflation: energy prices push inflation higher

The consequences of the closure of the Strait of Hormuz are feeding through into prices more quickly than into growth. Measured by the Harmonised Index of Consumer Prices (HICP), inflation has accelerated markedly from levels of around 2% since the outbreak of the war. In April, the HICP headline rate in Germany stood at 2.9% (EZ: 3.0%). This is the highest figure since early 2024. The key driver of this – hardly surprisingly – is energy inflation, which in Germany, at 8.9%, approached double-digit territory and has already reached it in the euro area at 10.8%. The rise in inflation would have been even more pronounced had it not been for the development of service prices, which exerted a dampening effect. These increased by 3.1% in Germany (EZ: 3.0%), several tenths less than in previous months, which, given the high weight of services in the basket of almost 50%, also had an impact on the headline rate. The decline in services inflation was supported by this year's early Easter date. In particular, package holidays and airfares were therefore significantly cheaper in April than a year earlier, both in Germany and in the euro area.

So far, the effects of the rapid rise in energy prices on world markets on consumer prices have been largely confined to the directly affected product groups such as liquid fuels, in particular petrol, diesel and heating oil. Since February, prices

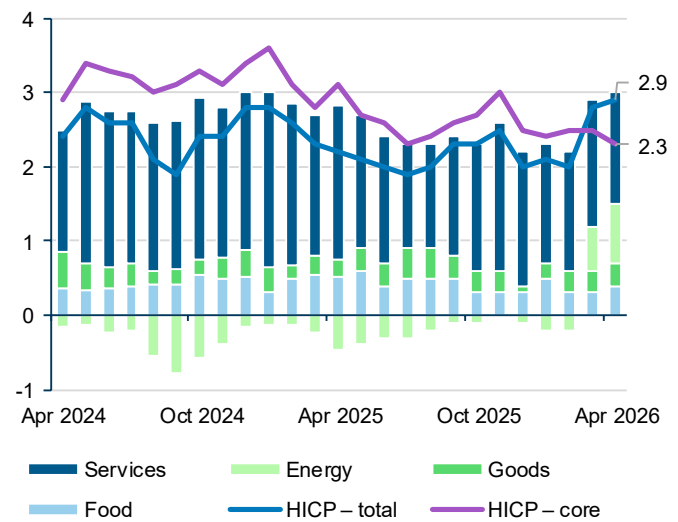
for these products have risen by 20.7% in Germany (EA: 21.6%). According to econometric analyses by the European Commission, this means that the expected pass-through of the increase in the oil price (Brent, USD/barrel) by around 50% since the end of February has already been completed. This is good news in that consumer price inflation for energy products is unlikely to rise much further.

At the same time, we expect the acceleration in inflation gradually to spill over to other components of household energy consumption such as gas and electricity. So far, significant price increases have not materialised in these areas. Long-term supply agreements and contracts with fixed prices counteract rapid tariff adjustments. As a result, developments on world markets are reflected only with a lag and typically to a much lesser extent in gas and electricity prices. Provided oil prices fall again noticeably in the fourth quarter, as indicated by futures, these effects are likely to offset one another.

In May and June, the fuel rebate of 17 cents per litre is also providing relief. Based on fuel prices at public filling stations, the inflation rate is likely to be 0.2 to 0.3 percentage points (PP) lower. Other countries in the monetary union, including Spain and Italy, have also adopted temporary reductions in energy taxes on motor fuels.

Contributions to inflation (HICP) in Germany

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



Sources: KfW Research, Eurostat.

Signs of a broadening of price pressures

Even if the conflict in Iran eases soon, it will take time for energy flows to normalise again. This is priced into the energy price futures for oil and gas that we use in the forecast. This means that the price shock is likely to spill over into additional consumer-facing sectors. The transmission process has begun, but needs time to fully unfold. Basic chemicals, fertilisers and aviation fuel are among the intermediate products whose prices have already risen sharply. At the same time, global supply chains are coming under increasing strain. This is also reflected in firms' selling price expectations, which are already rising significantly. This applies in particular to industry, the construction sector and retail trade, and less so to service providers, which are more dependent on wage developments.

It is foreseeable that food prices will rise noticeably. During the energy crisis of 2022/2023, the peak in food inflation was around one third of the peak in energy inflation. However, it took around a year to reach that point because of the long production cycle in agriculture. Applied to the current situation, this implies that food price inflation is likely to accelerate to 3 – 4% by mid-2027. Moreover, we expect a moderate acceleration in the currently still very low inflation for core goods, while at the same time services inflation will ease somewhat, albeit only slightly, as wage dynamics weaken. In our assessment, the difficult economic situation in Europe, and especially in Germany, will act as a counterweight to strong second-round effects. Trade conflicts, intense competitive pressure from China, a weaker labour market and a higher interest rate level are the main factors here.

Inflation forecast: 3% in Germany and in the euro area

Overall, we expect an average inflation rate this year of 3.1% in Germany and 3.0% in the euro area. The assumed gradual decline in energy price inflation and the spreading of the cost shock through the economy mean that consumer prices are also likely in 2027 to rise more strongly than the ECB would wish, at 2.4% in Germany and 2.3% in the euro area. Given the

geopolitical situation, these forecasts are naturally subject to considerable uncertainty. The longer the conflict between Iran and the US drags on, the more strongly the tightening of energy supplies could push up prices. On the other hand, services inflation could weaken more than assumed. Recently, leading indicators for this sector of the economy have cooled surprisingly sharply.

ECB will raise key interest rates

It is becoming apparent that the European Central Bank will respond to the renewed energy price shock with a moderate monetary policy tightening. Recent statements by Council members also point in this direction. The primary aim is to strengthen the ECB's credibility and anchor inflation expectations. The case for a rate increase is reinforced by rising selling price expectations. At the same time, inflation expectations among European consumers have also jumped and, for the three-year horizon, are already back at 3%, the same level as in March 2023. This suggests heightened sensitivity among consumers as a result of their experience during the last energy crisis. Financial markets have already priced in up to three rate hikes this year, and long-term interest rates have also risen noticeably.