

From trade shock to fiscal boost

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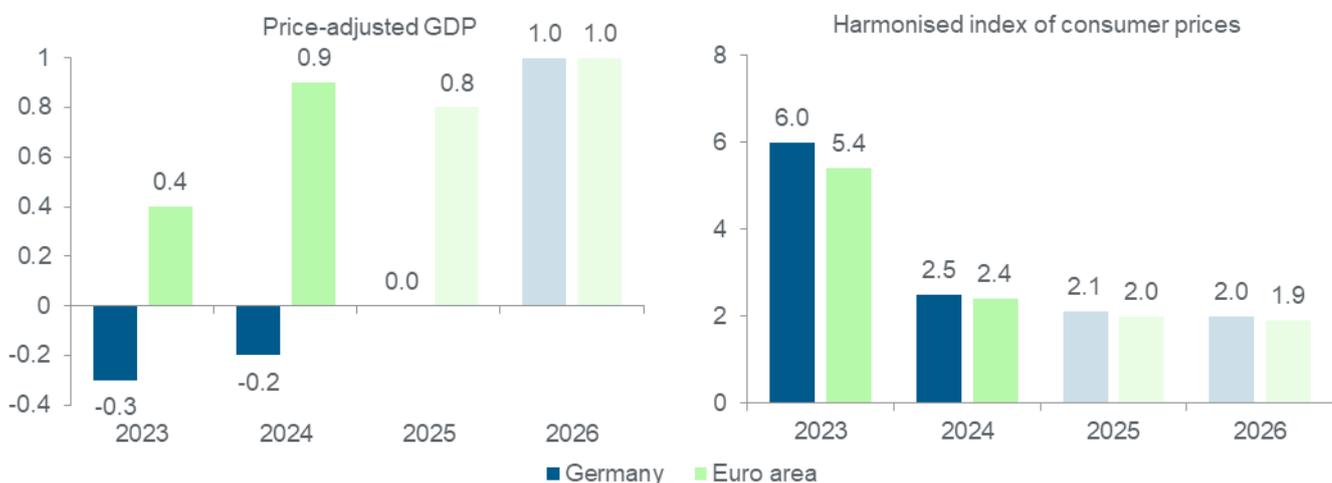
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- After contracting slightly at the end of 2024, Germany’s gross domestic product grew by a strong 0.4% in the past quarter. Quarterly rates have alternated between positive and negative in a sawtooth-shaped pattern for the 13th consecutive quarter. On balance, the growth trend has been slightly negative since mid-2022.
- In the short term, the outlook for a genuine trend reversal is dim. US tariffs and trade uncertainty are set to put the brakes on exports and corporate investment. Although we have revised our forecast for 2025 upward by 0.2 percentage points on the positive start to the year, we expect merely stagnation for the year as a whole, assuming the current tariff level is maintained.
- After a long barren spell, however, the increased fiscal space and investment plans of the Federal Government provide the prospect of a growth spurt next year. We have lifted our forecast for 2026 by 0.7 percentage points to now 1.0%.
- For the euro area, the shocks from trade and fiscal policy are also significant but less than for Germany. We expect price-adjusted growth in the euro area to weaken slightly to 0.8% in 2025 and then to pick up to 1.0% in the year 2026.
- Persistent services inflation contrasts with falling energy prices and disinflationary impetus coming from US tariff policy. We have lowered our inflation forecasts (HICP) for 2025 to 2.0% in the euro area and 2.1% in Germany (previous forecasts: +2.2 and +2.4%).

Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

Price-adjusted GDP growth in the euro area

Per cent year-over-year change

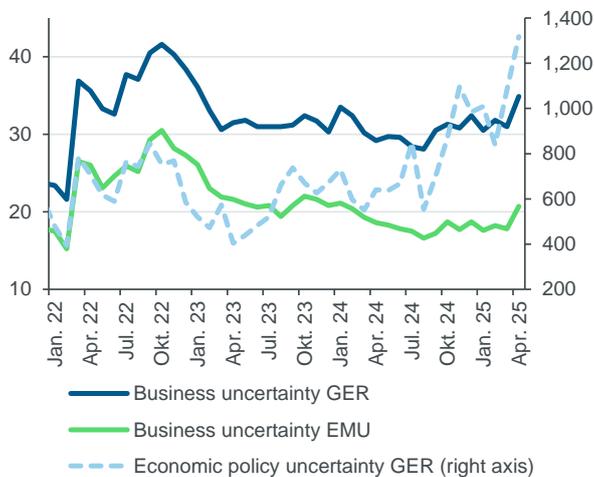
	DE	FR	IT	ES	EA
2023	-0.3	0.9	0.7	2.7	0.4
2024	-0.2	1.2	0.7	3.2	0.9
2025	0.0	0.5	0.4	2.4	0.8
2026	1.0	0.7	0.6	2.0	1.0

Sources: Destatis, Eurostat, KfW Research

Germany: real trend reversal probably only in 2026

The sawtooth pattern of the business cycle remains predictable. After a mild contraction at the end of 2024, gross domestic product adjusted for price, seasonal and calendar variations grew again by 0.4% in the first quarter of 2025. Amid a generally slightly negative trend that has now led to significantly under-utilised production capacities, quarterly rates have alternated between positive and negative for the 13th consecutive quarter. An economic setback is now likely to follow in the current quarter or in the summer at the latest, also due to the significant increase in US tariffs since April (see Box 1 on our assumptions regarding tariffs). Given these trade policy headwinds, exports in particular are likely to contract again this year after experiencing a temporary boost at the start of the year, not least due to the pulling forward of exports to the US. Furthermore, the reduction in potential sales and profits caused by US protectionism and the renewed increase in uncertainty will also put the brakes on investment activity by businesses in Germany.

Indicators of uncertainty



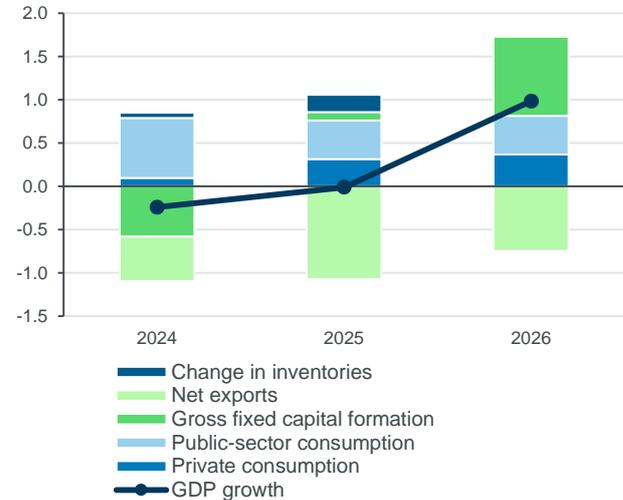
Sources: EU Commission, policyuncertainty.com.

However, the initiated easing of ECB monetary policy and the noticeable increases in real wages last year are currently providing some impetus. Nonetheless, households are likely to increase their spending only moderately as real wages growth is slowing again significantly and the household saving rate, which grew substantially in 2024, is likely to drop only slightly in light of rising unemployment risks. Most of the indicators of dwelling construction, on the other hand, have trended upward so that we expect to see the beginning of a slow recovery in residential construction investment this year. The growth of public-sector consumption is likely to ease slightly compared with 2024 but still contribute significantly to GDP growth in the cur-

rent year. All in all, the economic picture from our winter forecast, including the US tariff increase, remains intact. Although we are revising our forecast for 2025 upwards by 0.2 percentage points in view of the good start to the year, we expect no more than stagnation for the year as a whole

Real GDP growth in Germany – by expenditure components

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



Sources: Destatis, KfW Research forecast as from 2025

For 2026, on the other hand, the growth outlook has clearly improved as a result of the adjustment that was made to the German debt brake in March (see Box 2). A deficit-financed expansion in public infrastructure investment and defence spending is likely to make a direct and significant contribution to growth. Furthermore, the general fiscal scope has widened somewhat, enabling moderate economic impetus through measures such as the introduction of the diminishing balance method of depreciation. Business investment, too, is likely to grow noticeably again next year as a result. Besides, household spending is also likely to continue increasing moderately. However, Germany is still undergoing a challenging structural transformation and US protectionism will probably continue to weigh on the global economy in 2026 as well. Therefore, exports in particular can be expected to grow only slowly in 2026 amid strong import growth and, as a result, a continuing negative external trade balance. On balance, we have lifted our growth forecast for 2026 by 0.7 percentage points to now 1.0%. Upside and downside risks exist primarily from uncertainty around US trade policy and the fiscal boost in Germany (see Boxes 1 and 2).

Euro area: growth will slow temporarily in 2025

The shocks from trade and fiscal policy are also significant for the euro area economy but less than for Germany. For one thing, demand from the US plays less of a role for most other member states, which implies lower losses from the tariff increase. After posting solid growth at the start of the year, the euro area economy can be expected to roughly stagnate in the second and third quarter. An increase in defence spending, on the other hand, is likely to kick-start growth in the euro area as well by next year, although the fiscal boost there will be smaller than in Germany because of the significantly more difficult fiscal situation prevailing in the other large euro countries. The EU

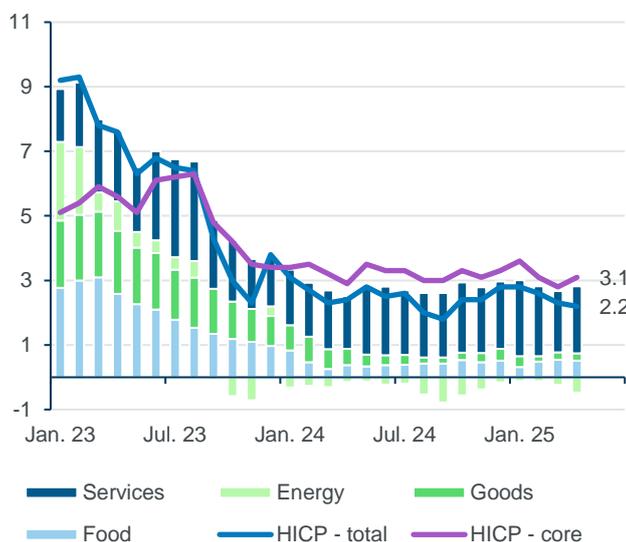
loans extended under the SAFE (Security Action for Europe) Programme, which offer only some states an interest rate advantage on the defence spending thus financed, will also do little to change this. With the exception of defence spending and the expenditure financed under the Next Generation EU Fund, most euro countries are on a path of moderate consolidation. We expect price-adjusted growth in the euro area overall to weaken slightly to 0.8% this year, followed by 1% in the year 2026. Growth is likely to be relatively low particularly in France and Italy, while Spain's strong economic performance will likely soften only slowly.

US tariffs with disinflationary (side) effects

After the temporary high around the turn of the year, the increase in consumer prices has clearly slowed again. Measured by the Harmonised Index of Consumer Prices (HICP), the inflation rate in April was reported as 2.2% for both Germany and the euro area.

Contributions to inflation (HICP) in Germany

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



Sources: KfW Research, ECB.

The lower inflation rates are an indirect consequence of the erratic US tariff policy. Together with the expansion of oil production output by the OPEC states, the resulting deterioration in the global economic outlook has reduced the prices in energy markets. Consumers experience this mainly with falling fuel prices. Overall, HICP energy prices in April decreased significantly year over year (euro area: -3.6%; Germany: -5.3%). This masks the fact that lasting progress in reducing services inflation is not yet in view. To be sure, the late Easter dates this year led to a temporary decline in March. But the price markups charged by service providers returned to the level prevailing in the second half of 2024, reaching 4.0% in the euro area and 4.5% in Germany. That confirms our assessment from the beginning of the year that domestic price pressure is easing only slowly. What is crucial for the further inflation trend, however, is the impact of the tariff conflict. Up until 'Liberation Day', higher US trade barriers would have been expected to lead to a moderate rise in inflation in the euro area – with a weaker euro as the key driver. But this expectation did not hold.

Instead, the visible unpredictability and willingness of President Trump to escalate the conflict eroded trust in the US dollar and led to an appreciation of the euro.¹ Thus, the disinflationary impetus of the negative demand shock is likely to have the upper hand if the current tariff regime remains in place. We have therefore lowered our inflation forecast moderately and predict an inflation rate of 2.0% for the euro area (previous forecast: +2.2%) and 2.1% for Germany (previous forecast +2.4%) for this year. On average for the coming year, inflation is likely to even drop a bit further to 1.9% in the euro area (previous forecast: +2.0%) and 2.0% in Germany (previous forecast: +2.2%). The uncertainty around the progression and ramifications of the trade conflict remains enormous. Retaliatory measures and unexpectedly severe disruptions of supply chains pose relevant upside risks to the inflation outlook.

Box 1: Development and economic effects of US tariffs

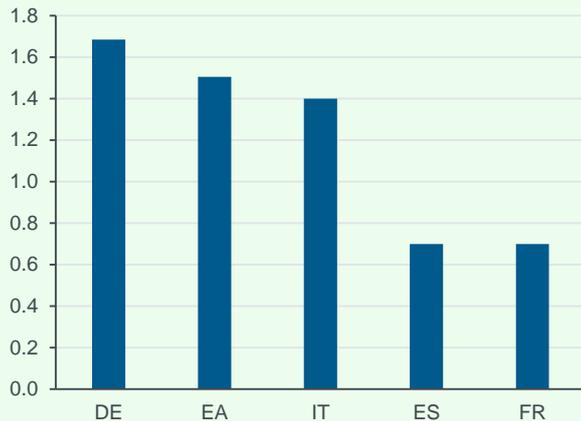
On 2 April the US administration announced a massive increase in tariffs against numerous trading partners. Based on the deficit of the US in bilateral trade with each country, so-called 'reciprocal tariffs' were introduced. Imports from the EU were to be subject to a tariff of 20%. As a result of severe market turbulence, however, the 'reciprocal tariffs' were suspended again for most countries after only one week. During a 90-day negotiating pause, the US is imposing a basic tariff of only 10% for most countries instead of the 'reciprocal tariffs' in addition to previously decided sector-specific tariffs. The tariff conflict with China, on the other hand, had escalated to a US tariff level of 145% before a significant reduction in tariffs to 30% was announced on 12 May for the duration of further negotiations. For the EU, almost all goods are currently subject to a basic tariff of 10%, while automobiles as well as steel and aluminium specifically are subject to a 25% tariff. Thus, the average US tariff against the EU has been increased by a good 10 percentage points since March. In the ongoing negotiations the EU is urging the US administration to withdraw all tariff increases and has not yet taken any retaliatory measures. For our forecast, we assume that the US will maintain its basic tariff of 10%, of which the preliminary results of the negotiations with other countries are indicative: Even the United Kingdom has been unable to negotiate the lifting of a 10% tariff despite a more favourable starting position. A renewed increase of US tariffs against the EU to the originally announced level of 20% is also a significant risk scenario. However, we believe it is less likely that the most recently threatened tariffs of 50% against the EU will be implemented and, in particular, maintained in the long term as these appear to be mainly a negotiating tactic.

As a single country the US was by far the most important foreign sales market for German goods last year, accounting for 10% of exports. To take into account inputs and indirect trade links, we must consider the value added in Germany that is generated by final demand from the US. This shows that around 7% of industrial value added in Germany is dependent on the US market, which corresponds to an estimated 1.7 % of total gross value added in Germany. In the euro area it is around 1½%. The immediate growth losses from exports should therefore be rather moderate. The global trade model of the Institute for the World Economy, for example, estimates that with the current tariff level, German gross domestic product would fall by

around 0.2% in the short term.² The loss for the euro area is likely to turn out even smaller. Taking into account uncertainty and second-round effects, however, the losses caused by US protectionism are likely to increase.³ Besides a tariff-induced decrease in external trade, our economic forecast primarily accounts for a reduction in business investment. If the negotiations with the US fail and US tariffs against the EU are raised to 20% permanently from July, we expect growth to be 0.2 to 0.3 percentage points lower for both 2025 and 2026. If the US tariffs are largely withdrawn, we expect price-adjusted GDP growth of +0.2% in 2025, followed by +1.3% in 2026.

Value added through US demand

Percentage of value added generated from US-demand for goods, in per cent of total value added; 2023



Sources: OECD TIVA, Capital Economics.

Box 2: Impacts of the fiscal U-turn

The amendments to Germany's basic law ("Grundgesetz") 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. A special fund of EUR 500 billion for investment in infrastructure and climate neutrality was also adopted for 12 years, enabling annual expenditure of just under 1% of GDP if spread evenly.

According to the coalition agreement, the Federal Government alone wants to use this fund to finance measures of some EUR 150 billion in the years 2025 to 2029. The federal states were also granted limited structural scope for debt in a similar way as the federation, so that the joint structural deficit of the federal and state governments may now amount to as much as 0.7% of GDP in addition to the exemptions mentioned above. However, Germany is still subject to the fiscal rules of the EU, which now limit Germany's government debt more strongly than the amended "Grundgesetz". Although the EU fiscal rules also exempt defence spending under an emergency clause, they do so only according to a narrower definition, only up to a maximum of 1.5% of GDP, and for the time being only through to 2028. In principle, there is no additional scope for deficit spending as Germany is already approaching the limits of the EU fiscal rules even without higher infrastructure investment.⁴ However, as the EU and its member states also have an interest in higher investment expenditure in Germany and the sustainability of Germany's government debt is unquestionable, a significant increase in new borrowing for defence and infrastructure investment should ultimately be made possible. We anticipate a primarily investment-driven fiscal impulse of just under 1% in 2026.⁵ Yet, uncertainty about this remains high. At any rate, no major investment surge is likely to occur this year given the planning times and provisional budgeting currently in place.

The volume of additional government expenditure is just as uncertain as its effect on gross domestic product (= 'fiscal multiplier'). It depends primarily on the extent to which there are spare production capacities for the additional government expenditure.⁶ What is also relevant is the import intensity in the supported areas, as is the possibility of crowding-in of private investment as well as demand effects along the production network. On balance, given the currently mixed conditions in Germany, a short-term fiscal multiplier of approx. 1 is plausible, although there are significant upside and downside risks given the large span of multiplier estimates in the economic literature.⁷

¹ Cf. Bales, S. and Schumacher, D. (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.

² Cf. [US-chinesische Zollpause: Etwas Entspannung für die USA und China, geringe Effekte für die EU](#) (US-Chinese tariff pause: tensions are easing slightly for the US and China, minor effects for the EU – our title translation, in German), | Kiel Institute for the World Economy

³ Cf. Scheuermeyer, P. 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. [Germany's fiscal rules dilemma](#)

⁵ Expanding the structural primary deficit is referred to as a fiscal impulse.

⁶ A recent study has estimated that in the short term, capacities for increasing infrastructure spending of roughly 0.5% of GDP and increasing defence spending of likewise around 0.5% of GDP are possible. In segments that are under particular pressure, such 'other automotive construction', which covers civil engineering and the defence industry, capacity utilisation is already quite high at the moment, so that further capacity increases would require transferring workers from nearby, underutilised sectors such as the automotive industry. Cf. [Haben wir die Kapas? \(Do we have the capacities? – our title translation, in German\) - Dezernat Zukunft](#)

⁷ A recent study based specifically on data from Germany has already 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, GDP could be bolstered twice as strongly as we assume. However, some other studies have only shown a multiplier of well below 1 for the short-term effect of higher government expenditure. For a relatively current overview of the literature, cf. <https://www.iwkoeln.de/studien/martin-beznoska-boern-kauder-thomas-obst-investitionen-humankapital-und-wachstumswirkungen-oeffentlicher-ausgaben.html> p. 15 ff. and: <https://academic.oup.com/oeq/article/67/3/553/2362401#83093432>