Economy in a standby position

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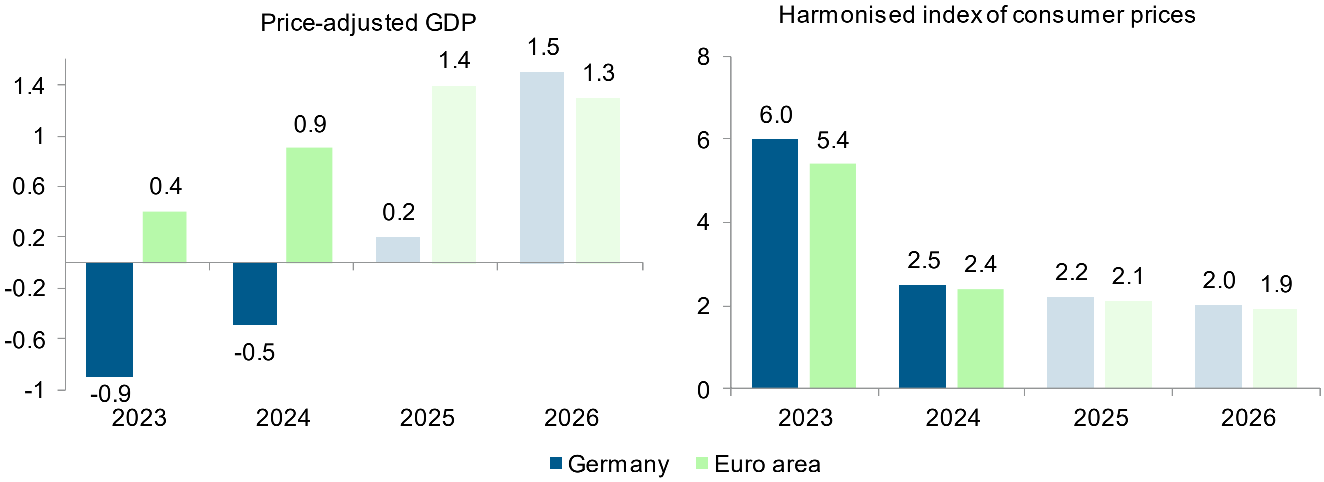
- Germany's gross domestic product stagnated in the third quarter. US tariffs weighed on exports and household consumption was also weaker. Capital expenditure, however, rose again.
- The upswing has not yet begun but the German economy is likely to now be first in line for take-off and output will likely pick up again slightly in the final quarter.
- After slipping into recession in the two previous years, German GDP will expand slightly this year. It is then likely to accelerate significantly in 2026, driven by rising government expenditure. KfW's growth forecasts for 2025 and 2026 remain unchanged at +0.2 and +1.5%.
- The economy in the euro area is growing at a robust pace despite the trade barriers that have emerged since the spring. We have therefore revised our forecast for 2025 upwards by 0.2 percentage points to 1.4%. Growth is unlikely to be negative towards the end of the year as well, so that the economy can start the next year with impetus. We expect slightly stronger growth of 1.3% in 2026 as well (+0.2 percentage points).
- Since the summer, consumer prices have increased somewhat faster again, partly as a result of accelerated services inflation, but remain near the ECB target of 2%. Lower energy prices will keep the lid on price rises in 2026, particularly at the start of the year. We have slightly lifted our inflation forecasts for 2025 to 2.1% for the euro area and 2.2% for Germany, keeping them unchanged for 2026.

Economic growth and inflation

Per cent year-over-year change

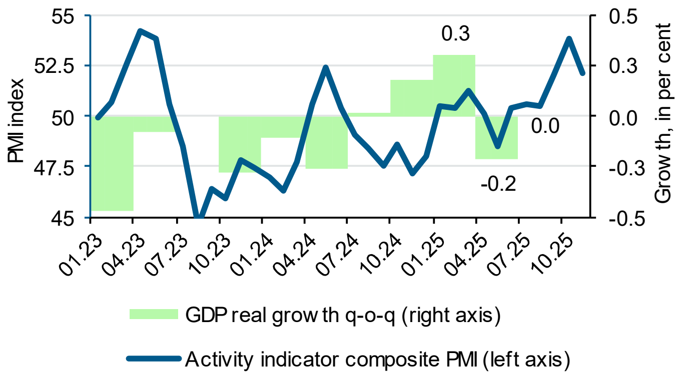


Sources: Destatis, Eurostat; from 2025 onwards KfW Research forecast (as at 26 November 2025).

Economy in a standby position

Adjusted for price, seasonal and calendar variations, Germany's gross domestic product (GDP) stagnated in the third quarter. It had contracted slightly in the second quarter (-0.2% on the previous quarter) and expanded in the first quarter (+0.3%). US tariffs weighed on exports in Q3. Furthermore, household consumption contracted moderately for the first time since the end of 2023. At the same time, gross fixed capital formation, particularly investment in plant and equipment, stabilised again after falling sharply, while public consumption picked up once more.

Growth momentum in Germany



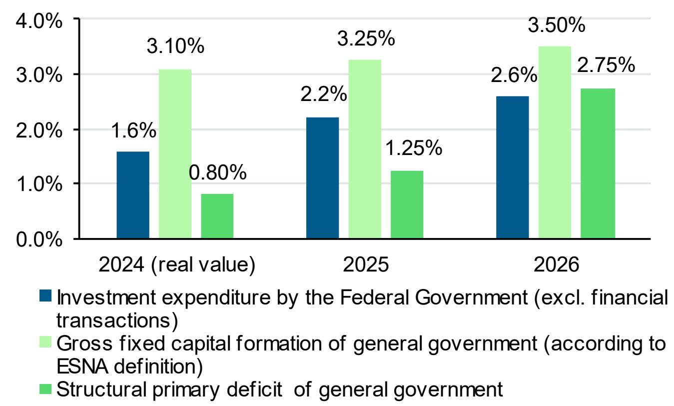
Note: The PMI is an index based on business surveys in which values above 50 indicate positive growth of private sector economic activity.

Sources: Destatis, S&P Global, Macrobond

Whereas US protectionism and the losses in competitiveness experienced in recent years are weighing on the growth outlook, the planned massive increase in public-sector expenditure offers good prospects for domestic demand – not just for infrastructure investment and defence. The national budgetary plan provides for a considerable 1.2 to 1.5% of GDP increase in the structural primary deficit from 2025 to 2026,[1] which will lead to a significant growth surge irrespective of the type of fiscal expansion, even if not all the funds are disbursed.[2] Furthermore, the ECB's monetary easing, which began in June 2024, is having a moderately positive impact on the business cycle. Although the upswing has not yet begun, the German economy is likely to now be in pole position. The composite PMI (see figure) suggests that economic output will pick up again in the final quarter – even if the leading indicators do not paint an unequivocally positive picture of the economy. Even so, after two years of recession, moderate growth of +0.2% can still be expected for 2025. For 2026 we then expect significant growth to the tune of 1.5%, which means we maintain both forecasts unchanged. Apart from economic drivers – such as the fiscal-policy impetus –, growth will be driven by an unusually large number of working days next year. The calendar effect alone accounts for 0.3 percentage points of the GDP growth we expect.

Fiscal projections by the Federal Ministry of Finance

In per cent of GDP



Note: Investment expenditure is not directly comparable with gross fixed capital formation according to the ESNA definition. The former term is more broadly defined and includes, for example, certain investment grants, while the latter is limited to the formation of physical capital.

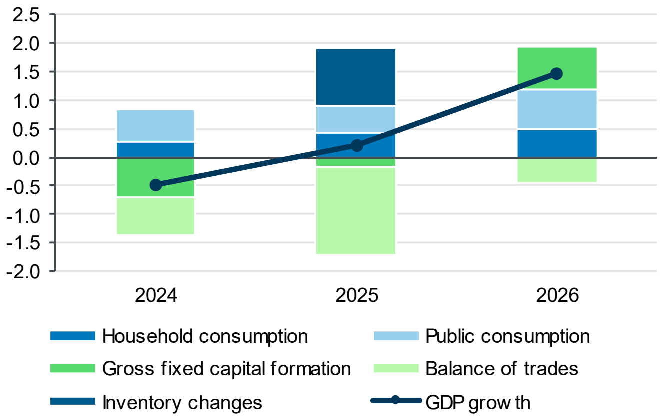
Figures for the state as a whole were taken directly from the national budgetary plan (cf. footnote 1). Investment expenditure by the Federal Government (core budget and special funds) was taken from the monthly reports of the Federal Ministry of Finance and likewise placed in relation to GDP from the Federal Government's spring projections.

Sources: Federal Ministry of Finance, KfW Research

Initially, quarterly GDP is likely to continue expanding at a moderate pace next year. In the second half of the year, however, the increase in public-sector investment and defence expenditure provided for in the national budget should then get underway and lead to significantly accelerated growth. On the expenditure side, this will be reflected in significantly rising public-sector investment but also in a noticeable increase in public-sector consumption. Growth in defence spending will be a particularly important factor here. Business investment, too, is likely to expand again significantly next year as capacity utilisation increases. The prospects of public-sector contracts will play a major role in the defence industry and construction sector. But the fiscal policy-induced economic recovery is likely to increase the investment appetite of businesses from other sectors as well (see box on Page 5). Private residential construction investment, on the other hand, will remain burdened by high construction interest rates and low affordability. Yet, regulatory changes such as the 'construction turbo', in turn, will have a supporting effect. Most of the leading indicators of dwelling construction have also trended upward already so that after the deep slump of the past years we expect to see a partial recovery in residential construction investment as well from 2026. Household consumption, too, is likely to expand moderately as real wages growth will probably remain positive and the labour market is likely to improve again with the surge in public sector demand.

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

The balance of trade (exports minus imports) will continue to put the brakes on economic growth in 2026 as a result of the increased trade barriers imposed by the US, a flood of exports from China and, most of all, the increase in German imports of military equipment. It is true that trade uncertainty has eased in the wake of the trade deal reached between the EU and the US in July 2025. At around 15%, however, the effective US tariff on goods from Germany remains significantly higher than the 2% rate that was in effect before the second Trump administration took office. As a result of the US tariff increases, German goods shipments to the US already slumped considerably in the course of the second and third quarter. Overall, however, German exports stood their ground better thanks to growing exports to other EU countries. Besides, export expectations of businesses have now recovered and new orders from abroad have at least stabilised. The International Monetary Fund expects global trade to grow again in 2026 despite higher tariff barriers. Even if conditions for export-oriented manufacturing remain difficult, on balance we anticipate moderate German export growth in the coming year. German imports, however, will expand even more strongly, particularly as a result of defence procurement and, more broadly, the demand surge triggered by the expansionary fiscal policy.

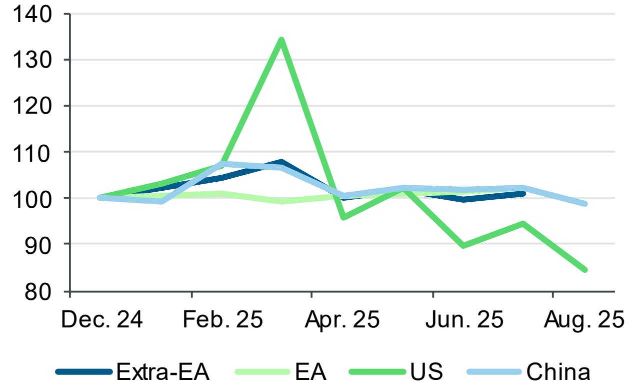
Euro area remains resilient so far despite tariff barriers

Euro area GDP remained reasonably resilient to increased US import tariffs in the third quarter, growing by +0.2% on the previous quarter, after +0.1% already in the second quarter. The main contributor to this was French GDP with surprisingly strong +0.5% growth, which benefited primarily from an increase in exports. Against this backdrop, we have revised our forecast for 2025 slightly upwards by +0.2 percentage points and now expect euro area GDP to grow by 1.4% on the previous year.

Exports from the euro area to the US fell by around 15% from January to August, while exports to non-EU countries overall remained steady. We expect European exports to grow again in 2026 despite the tariff barriers. However, as imports are likely to grow at an even stronger rate, the growth contribution of net exports will be negative.

Euro area exports by country

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



Source: Eurostat.

A positive effect, however, is emerging from the easing of the tariff-induced uncertainty and it should strengthen further with the gradual implementation of the trade agreement between the US and the EU. This and the relatively low interest rates in the wake of the ECB's monetary easing, which continues to have an impact, will lead to a more considerable rise in gross fixed capital formation than in 2025. Household consumption, however, will remain the main economic driver next year as well. It continues to benefit from growing real wages. In addition, we expect a normalisation of the currently elevated household saving rate in 2026. On the basis of the existing budgetary plans of the euro countries, the fiscal impetus will likely be only marginally positive in 2026 despite the very expansionary policy in Germany.

GDP growth in the euro area

Variation on previous year in per cent, adjusted for prices, as at 26 November 2025

	DE	FR	IT	ES	EA
2023	-0.9	1.4	1.0	2.5	0.4
2024	-0.5	1.2	0.7	3.4	0.9
2025	0.2	0.8	0.5	2.9	1.4
2026	1.5	0.8	0.6	2.5	1.3

Sources: Destatis, Eurostat; from 2025 KfW Research forecast

Overall, we forecast growth of 1.3% for the eurozone in 2026 compared with the previous year. This represents a slight upward revision of 0.2 percentage points due to the now higher carryover from 2025. In France, adverse economic consequences of the fragile political situation appear to be limited as soft economic indicators are pointing upwards and the government has now significantly watered down its consolidation plans – even if the inadequate consolidation efforts increase the risk of an adverse market reaction at a later date. Spain, the growth champion, continues to benefit from, among other trends, a positive development of labour supply from migration, while Italy is suffering from weak industrial production.

No forecast comes without risk

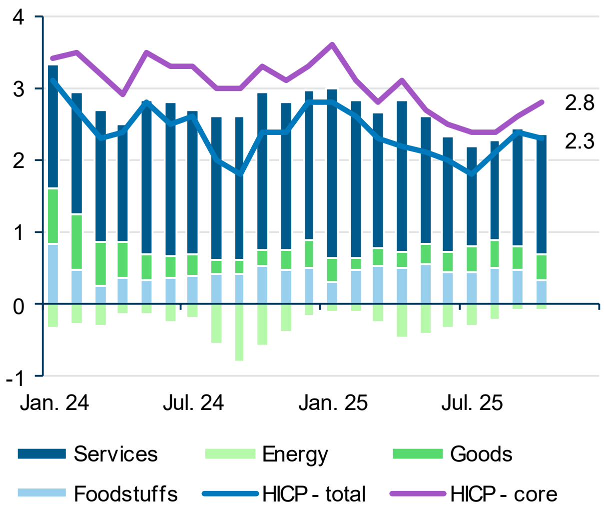
As always, the forecast is subject to numerous imponderables. For Germany, these include, in particular, the question how quickly the authorities are able to deliver the investments provided for in the budget and how quickly they will actually lead to higher expenditures, particularly at state level.[3] The immediate economic risks for the euro area include a potential loss of confidence in the government bond markets that could force countries with precarious public finances, especially France, to make an abrupt consolidation and would worsen financing conditions for households. At global level, trade and geopolitical risks remain, particularly in connection with US policy. Furthermore, in light of extremely high valuations, there is also a risk of a crash in the US stock market that would also have negative repercussions for the global economy. On the other hand, in the rather unlikely event that the hoped-for potential of artificial intelligence, which the stock market has already priced in, should manifest itself surprisingly fast, slightly higher growth could also be possible in 2026.

Inflation will dip temporarily at the start of 2026

The inflation rate in Germany and the euro area as measured by the Harmonised Index of Consumer Prices (HICP) has accelerated again slightly since the summer. But this is not a trend reversal that would require a monetary response. For one thing, the rise in consumer prices is still moving close to the ECB's two-percent target and, for another, significantly lower inflation rates must be expected in the first months of the year 2026.

Contributions to inflation (HICP) in Germany

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



Sources: KfW Research, Eurostat

Inflation was expected to pick up pace in the course of the third quarter of 2025. For one thing, the price declines for energy dampened the inflation rate much less despite further declines in oil and gas prices in commodity markets. In July, German consumers were still paying 3.4% less for energy (euro area: 2.4%) than in the same month of the previous year but by October the price decline shrank to a mere 0.9% (1% in the euro area). The causes for this, however, were foreseeable base effects. Energy products had become significantly cheaper in the summer of 2024. As a result, the basis for comparison decreased accordingly. For another, after the prices for services eased in the spring, service providers have now raised them more sharply again. Services inflation in Germany increased from 3.0% in July to 3.6% in October. In the euro area the increase from 3.2 to 3.4% was slightly more moderate. Given the declining sales price expectations of services businesses and easing wages growth, we consider this to be merely a pause in the downward trend. Nonetheless, the delay in the further reduction of services inflation has prompted us to slightly amend our inflation forecasts for the euro area and Germany for 2025 by +0.1 percentage points each to now 2.1 and 2.2%.

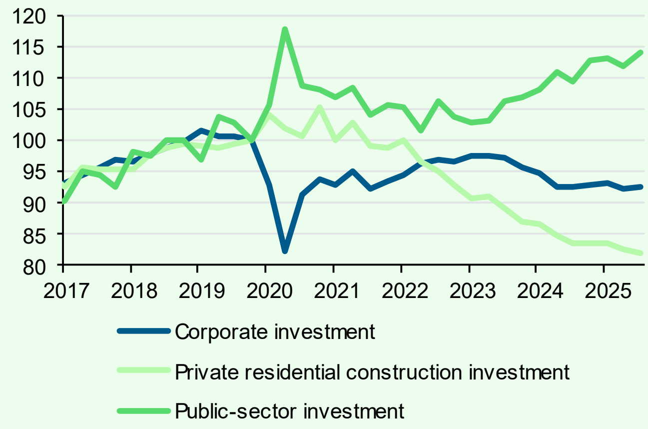
We maintain our forecast of consumer price inflation of 1.9% in the currency union and 2.0% in Germany for 2026. It is true that the persistently steep price increases in the services sector led to a higher starting level at the beginning of the year. But with the de-escalation of the Middle East conflict, the outlook for energy raw materials has improved yet again. The likelihood of outliers to the upside has thus reduced and the forward rates are signalling a sideways trend of oil and gas prices for 2026. The favourable energy price development is likely to have a strong impact particularly at the very start of the year. A price surge for energy products in January 2025 and government relief measures in Germany (reduction of network fees for electricity and abolition of the gas storage levy) will likely push the total annual inflation rate in the euro area and Germany well below two per cent in the first quarter before inflation picks up again in the further course of the year. The risk of persistently low inflation rates and, as a consequence, further key interest rate reductions by the ECB is relevant and could materialise if inflation expectations are de-anchored or if the increases in the prices of industrial goods (without energy) continue to moderate through the redirection of low-cost import products to Europe.

How does rising government spending impact on business investment?

Given that business investment in Germany has languished for a long time, the question arises whether the Federal Government's expansionary fiscal policy can redress this situation.

Development of investment in Germany

Adjusted for price, seasonal and calendar variations; index: Q4 2019=100



Sources: KfW Research, Destatis

As a general rule, a debt-financed expansion of government expenditure can influence private-sector investment activity in different ways. On the one hand, it potentially leads to higher interest rates, making borrowing more expensive for the private companies and thereby reducing their investment (financial crowding out). In an economy operating at full production capacity utilisation, the activity of the state would additionally compete with private economic activity by exacerbating the scarcity of resources, especially skilled labour (real crowding out). On the other hand, public-sector investment and subsidies can also improve the business environment for the private sector, thereby stimulating private investment (crowding in). Finally, debt-financed government expenditure – whether for investment or consumption – increases aggregate economic demand, which should lead to higher profits and greater capacity utilisation, potentially stimulating private investment as well.

At present, particularly the significant underutilisation of capacity in the German economy suggests that debt-financed state expenditure will have a positive effect on business investment in the short term –almost irrespective of the purpose.[4] Accordingly, business surveys on current investment impediments show that weak domestic demand or the overall economic development is often cited as the main factor.[5] Furthermore, regression models allow the development of business investment in the euro area to be largely linked to the development of GDP or aggregate economic demand.[6] If we apply the macroeconometric model of the Deutsche Bundesbank to the German economy, a permanent 1% of GDP expansion of government investment leads to an expansion of business investment by initially 1/3% in the first year and by almost 1% after four years. If state consumption is expanded to the same extent, the effect in the Bundesbank model is very similar.[7]

Nevertheless, there are also empirical studies in which a longer-term analysis has found evidence that an increase in state consumption expenditure can crowd out private investment.[8] The investment and growth effect of fiscal policy (that is, the fiscal multipliers) vary quite strongly depending on the overall environment and the empirical method of estimation. Overall, however, public investment appears to be the most effective fiscal impetus for private investment activity and GDP.[9] A current study on the basis of a panel of 34 OECD countries, for example, has concluded that every additional euro in public investment ultimately attracts roughly two euros in private investment.[10] According to a study by the IMF, increasing state investment by 1% of GDP can even increase private investment by 3.5% after just one year.[11]

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[1] Cf. German Federal Ministry of Finance (2025): German Budget Plan 2026: it quantifies the expansion of the structural primary deficit as 1.5% of GDP. But it also warns that this fiscal projection is still based on the Federal Government's spring forecasts, which likely predict too low nominal economic growth. With the higher growth of the autumn projection, the fiscal impetus is likely to be only around 1.2% of GDP.

[2] As in the summer forecast, we expect that fiscal policy alone can boost German GDP by 0.8% in 2026. This is based on our prediction for the expansion of the structural primary deficit by around 1% of GDP, which is also aligned with the most recent predictions of the EU Commission – which in turn are based on general national budgetary planning. Cf. Scheuermeyer et al. (2025): KfW Business Cycle Compass August 2025, box: How large is the effect of German fiscal policy?

[3] The predictions by the Council of Economic Experts, for example, sit at the bottom end of the forecast range. In its Economic forecast in the 2025/2026 Annual Report it expects the expenditure under the financial package to contribute only 0.3 percentage points to GDP growth.

[4] According to the ifo Business Survey, in the third quarter aggregate capacity utilisation was around 3 percentage points below the long-term average. In the manufacturing sector, underutilisation was significantly higher.

[5] Cf. Scheuermeyer, P. (2025): Investitionsentwicklung in Deutschland – Eine Bestandsaufnahme (Development of investment in Germany – taking stock – in German only), Focus on Economics No. 485, KfW Research

[6] Cf. Barkbu et al. (2015): Investment in the Euro Area: Why Has It Been Weak? IMF Working Paper 15/32 and Banbura et al. (2018): Business investment in EU countries, ECB Occasional Paper Series No 215.

[7] Cf. Hertel et al. (2022): The macroeconometric model of the Bundesbank revisited, Bundesbank Technical Paper 01/2022

[8] Cf. Carvelli G. (2023): The long-run effects of government expenditure on private investments: a panel CS-ARDL approach, Journal of Economics and Finance (2023) 47: 620–645

[9] Cf. Gerchert (2015): What fiscal policy is most effective? A meta-regression analysis, Oxford Economic Papers, Volume 67, Issue 3, July 2015: 553–580

[10] Cf. Matvejevs O. and Tkacevs, O. (2023): Invest one – get two extra: Public investment crowds in private investment, European Journal of Political Economy.

[11] Cf. IMF (2020): Chapter 2. Public Investment for the Recovery. IMF Fiscal Monitor, October 2020 (Figure 2.8)