GERMANY

GERMANY'S ECONOMY HANGS ON THE FORTHCOMING INVESTMENT PLAN

Against a backdrop of heightened international competition and trade tensions linked to the United States' new tariff policy, the German economy is seeing its traditional growth drivers challenged. In the short term, the increase in customs duties imposed by the Trump administration will weigh on exports and heighten economic uncertainty. The future German government is preparing a series of far-reaching reforms to deal with this. These include an ambitious investment plan, as well as focusing on infrastructure and defence, which could trigger a structural transformation of the economy. However, its effects will only really be felt in the medium term. Furthermore, the European rearmament effort offers Germany the opportunity to overhaul its industry by leveraging its strategic sectors.

FACED WITH EXTERNAL SHOCKS, GERMANY IS REFORMING ITS ECONOMY

The stagnation of German GDP between the end of 2021 and the end of 2024 is mainly due to the decline in exports, which have long been a driving force behind the country's growth. They fell by 4.2% in volume terms between Q4 2022 and Q4 2024, reflecting a loss of export market share owing to the rise of Asian competitors in several sectors (automotive, chemicals, electrical equipment), and a loss of industrial competitiveness (high energy costs).

The new US tariff policy is likely to exacerbate existing pressures. The United States is a core market for Germany, accounting for 10.4% of German exports in 2024. An increase in customs duties (+25% on imported vehicles, +20% on goods from the EU1) could lead to a fall in demand and/or a squeeze on margins, depending on whether or not the additional cost is passed on to end consumers. The German economy is also exposed to the indirect effects of US tariff hikes on Germany's trading partners. The Governor of the Bundesbank, Joachim Nagel, has estimated that the US tariff policy could reduce German GDP by 1.5 percentage points by 2027.

The investment plan launched by the coalition formed after the February elections could mitigate the effects of this shock, provided it is implemented quickly and in a targeted manner. This plan is based on two pillars: i/ EUR 500 bn of public investment in infrastructure over twelve years (including 100 bn allocated to the Länder and 100 bn for the low-carbon transition), ii/ the exclusion from Germany's debt brake rule of all military spending exceeding 1% of GDP (including aid to Ukraine). We expect growth of +0.4% in 2025, then +1% in 2026. The effects of this plan should be felt mostly in the medium term, by strengthening growth potential.

THE LABOUR MARKET UNDERGOING TRANSFORMATION

The employment outlook in Germany is mixed, at a time when the labour market is already showing signs of strain. Between the beginning of 2023 and February 2025, the unemployment rate rose from 2.9% to 3.5%. In 2024, 26,000 jobs were lost, mainly in industry and construction, while underemployment has been rising since 2022 (+17% between May 2022 and September 2024 according to the latest available data).

Against this backdrop, the new US customs barriers could exacerbate the difficulties faced by certain export sectors, such as the automotive and chemicals industries, which are highly dependent on the North American market.

GROWTH AND INFLATION

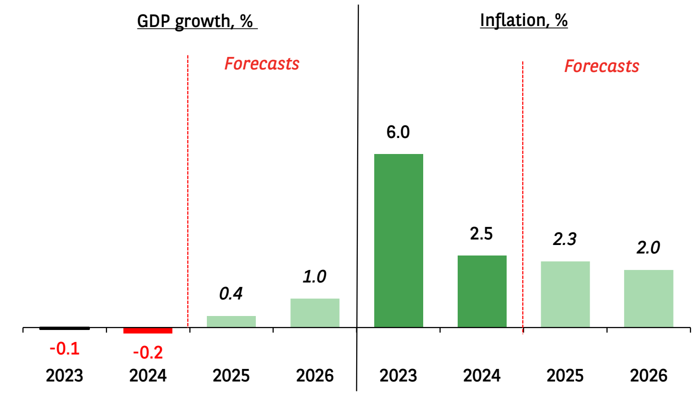

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The new public investment plan should, however, bolster the job market. As part of the rearmament programme, demand for labour is expected to focus on construction, industry, defence and related services. Certain sectors, such as metallurgy and electrical equipment, could also benefit by redirecting their production towards defence and domestic market needs. In the medium term, investment in public infrastructure and the low-carbon transition could help move the economy upmarket and boost skilled employment. This would be the case for renewable energies, digital infrastructures and R&D. However, this dynamic could in turn rekindle recruitment difficulties in certain sectors, and accentuate wage pressures.

Negotiated wages have continued their recent rise, albeit at a slower pace (+5.8% y/y vs. +8.9% y/y in Q3). The new coalition has also announced an increase in the minimum hourly wage (from the current EUR 12.82 to EUR 15).

INFLATIONARY PRESSURES PERSIST

Harmonised inflation stands at 2.3% y/y in March 2025 and underlying inflation at 2.6%, down from February (2.6% and 2.7% respectively), thanks to the continued fall in energy prices and the slowdown in inflation in services, which nevertheless remains sustained (+3.5% in March). The pace of wage growth is also tending to moderate.

We expect inflation to stabilise over the next few months, averaging 2.3% annually in 2025 and rising to 2.1% in 2026. Such a pace could be considered high, and could therefore weigh on household confidence and hamper the recovery in consumption.

1 Customs duties on imported vehicles have been in force since 2 April. The application of reciprocal customs duties on goods imported from the EU has been postponed until 8 July, with an interim rate of 10% applying in the meantime.

In addition, the implementation of the investment plan in Germany, combined with the increase in defence spending at European level, could add to the pressure on supply. Bottlenecks in supply chains could exert further inflationary pressure. Furthermore, there are inflationary risks linked to the increase in US customs duties, especially if the European Union decides to retaliate.

TOWARDS AN END TO EXTREME BUDGETARY RIGOUR AND MORE STRUCTURAL REFORMS

The increase in public spending is likely to be financed mainly through borrowing. Budgetary savings are envisaged (reduction of bureaucracy, reform of social benefits), but their economic impact will not be immediate.

This budgetary stance will lead to an increase in the deficit and debt. The risks remain under control: with public debt at 62.9% of GDP in 2024, Germany still has considerable room for manoeuvre. On the other hand, this exposes fiscal sustainability to a higher interest rate environment. The public deficit is expected to fall to -2.9% of GDP in 2025, then to -3.5% in 2026, with debt reaching 64.6% of GDP by 2026 and 70% by 2030. Ten-year yields, which jumped by 40 bp the day after the spending plan was announced, are likely to remain higher for the long term.

On the reform front, in addition to the investment plan, Germany's new coalition plans to review business and household taxation, reduce electricity prices, make the labour market more flexible, overhaul welfare benefits and tighten immigration policy. The government is due to take office in early May, marking the operational launch of this programme.

EUROPEAN REARMAMENT TO THE RESCUE OF FOREIGN TRADE?

Germany's current account remains in surplus (+EUR 230 bn in 2024), despite the erosion of the trade surplus driven by the fall in goods exports. The services balance, meanwhile, has remained in deficit since 2021 (-EUR 20 bn in 2024) due to tourism.

Outside the EU, the outlook for exports is deteriorating further in the face of tougher US trade policy, in addition to the challenges posed by the rise of China.

GERMANY: LEVEL OF CAPACITY UTILIZATION (%)

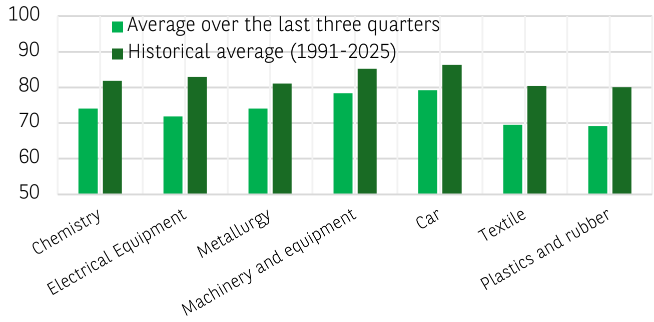

CHART 2

SOURCE: DG ECFIN, BNP PARIBAS

Conversely, intra-European trade could intensify from 2026 onwards as part of European rearmament. Germany is well positioned to respond to the rise in defence investment thanks to its industry specialising in machinery and equipment, metallurgy, electrical equipment and chemicals, all of which can be used for defence (*see our box below*). The public investment plan, which has yet to be finalised, could also encourage intra-European circuits by favouring European companies in calls for tender. However, these developments should further reduce the surplus on goods, as Germany is preparing to invest more than the other main European countries.

Article completed on 17 April 2025

Marianne Mueller
marianne.mueller@bnpparibas.com

European rearmament and industrial recovery: an opportunity for Germany

Faced with persistent geopolitical tensions and weakening US military support, European countries are planning to significantly increase their military spending. This strategic shift represents an economic opportunity for German industry.

Indeed, Germany has a robust industrial base. Groups such as Rheinmetall, ThyssenKrupp, Hensoldt and Diehl play a central role in the defence industry, supported by a network of companies specialising in mechanics, electronics and advanced materials. Between 2020 and 2024, the country accounted for 2.6% of global arms exports (SIPRI) and was an active participant in European defence programmes.

The context is favourable, with many industrial capabilities currently under-utilised. According to the European Commission, the capacity utilisation rate in key sectors was 74% over the last three quarters (unweighted average of textiles, chemicals, plastics and rubber, metallurgy, machinery and equipment), 8.3 points below the 2010-2025 average (see *Chart 2*). Some companies are already starting to reorient their activities towards the defence sector. This would make it possible to mobilise available resources without fuelling inflation.

Even if obstacles to the adaptation of the productive fabric remain, the acceleration of procedures and the simplification of administrative rules planned by the future government would make it possible to respond effectively to the new needs.