GERMANY

A RECOVERY IN THE MAKING

The resumption of German growth has been hampered by US tariffs. However, the outlook continues to brighten thanks to the government's strategy, which is structured around a vast programme of public investment and incentives for business investment. Beyond the anticipated economic rebound, the structural recovery of growth will depend on the country's ability to control its value chains and reposition itself in global trade amid increased competition. Inflation is expected to continue to decline. Despite unfavourable developments in industry, unemployment remains contained, and labour market tensions could quickly resurface. Public debt is expected to grow as a result of the widening budget deficit and rising interest rates (the effects of which will be felt by other Eurozone members).

DESPITE A DIFFICULT FIRST SEMESTER, ECONOMIC RECOVERY SEEMS TO BE UNDERWAY

After a dynamic start to the year (+0.3% q/q in Q1), driven by a surge in exports in anticipation of higher US tariffs, activity declined in Q2 (-0.3% q/q). While exports are experiencing an expected backlash, their decline is moderate. The decline in investment in machinery and equipment, as well as in construction, explains the negative figure for Q2. Yet this decline could be explained by the postponement of projects that will benefit from support (for businesses) and additional funding (for infrastructure and defence, see below) from the second half of the year onwards – an analysis that is corroborated by the nine-month uninterrupted recovery in the Ifo business climate index (+4.2 points between last December and August, when it reached 89 points). At the same time, household consumption remains constrained by deteriorating sentiment. In mid-2025, real GDP will thus remain close to its end-2019 level[1].

In a context where external pressures are likely to persist, the recovery will depend on the new government's economic policy. This policy aims to support a rebound in public and private investment (notably through the accelerated depreciation of investment scheme, which reduces corporate tax). The first effects are expected in the second half of the year, before accelerating in 2026 due to anticipated spillover effects. The diagnosis of a decline in investment in Q2 linked to a postponement of these expenditures reinforces the expectation of an imminent rebound. Our growth forecasts are +0.3% in 2025 and +1.4% in 2026 (after -0.5% in 2024), respectively 0.1 point below and 0.2 point above the Consensus Forecasts for September.

EMPLOYMENT LEVELS OFF, BUT UNEMPLOYMENT RATE REMAINS LOW

Although job creation momentum has slowed due to the industrial recession, the labour market remains historically strong. After hitting a low of 3% in 2023, the unemployment rate gradually rose to 3.7% in July 2025 – still a low level, particularly compared to the Eurozone average of 6.2%.

Job losses continue in the manufacturing sector (-85,000 in H1 2025, -220,000 since 2023), in contrast to the services sector, which continues to create jobs, particularly in health and social services (+120,000 in H1 2025).

In the short term, the economic recovery should boost labour demand and support new hiring. However, in the longer term, labour supply could become a constraint: without sufficient and appropriate immigration, demographic trends are likely to lead to labour shortages, particularly for skilled workers.

GROWTH AND INFLATION (YEARLY AVERAGE)

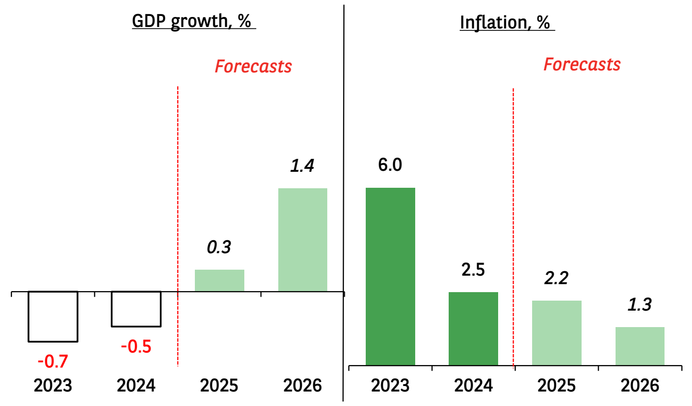

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

DISINFLATION IS EXPECTED TO CONTINUE BEYOND THE ECB'S TARGET

Inflation has slowed significantly, and this trend is expected to continue. After averaging +2.5% in 2024, harmonised inflation is expected to settle at +2.2% in 2025 and +1.3% in 2026. Energy is expected to continue to pull the index down (particularly if the planned reduction in electricity taxes is effectively implemented) while services inflation would continue to ease as wage growth slows (labour cost index up +3.4% y/y in Q2 25, after +2.5% in Q1 but an average of +5% between 2022 and 2024).

However, several factors could hinder the continuation of disinflation, such as the planned increase in the minimum wage (EUR 13.9 in 2026, then EUR 14.6 in 2027, vs. EUR 12.82 currently) and the German investment and European rearmament plans, which are likely to revive wage pressures in the long term.

AN AMBITIOUS FISCAL POLICY WITH CONSEQUENCES BEYOND THE COUNTRY'S BORDERS

Germany is undergoing a major shift in its economic and fiscal policy under the Merz government. A EUR 500 billion fund, spread over twelve years, is intended to modernise public infrastructure and accelerate the low-carbon transition. The defence budget is also expected to increase significantly. These measures have required a relaxation of the 'debt brake'.

1 For comparison, see the 'growth' chart on the charts page at the end of this publication.

At the same time, the government is undertaking a series of reforms aimed at supporting businesses. As these reforms are not covered by the relaxation of the debt brake, their cost will have to be offset by austerity measures. A reform of social security benefits is being considered to achieve this, although no consensus has yet been reached between the various stakeholders in the ruling coalition.

This new German fiscal policy implies increased borrowing and is likely to widen the budget deficit, which, according to our estimates, would rise from -2.8% of GDP in 2024 to -3.8% in 2025 and -4.4% in 2026. At the same time, public debt would reach 66% in 2026 (compared with 62.1% of GDP in 2024). The 10-year Bund would continue to rise to 3.2% at the end of 2026 (compared with 2.66% at the beginning of September 2025) – a significant development for the Eurozone as a whole, for which German rates are the benchmark.

GERMAN FOREIGN TRADE, A PILLAR OF ITS ECONOMY, IS WEAKENED

In 2025, exports still account for nearly 41% of German GDP and help to maintain recurring external surpluses (current account balance of +120 billion in H1 25, stable at around 5.5% of GDP). However, this traditional driver of prosperity has not been driving growth for several years.

This is due to the loss of outlets in two key markets. Exports to China, whose competitiveness has risen, have been falling for three years now (-28% in value seasonally adjusted since January 2022, latest data in July). And with the tightening of US trade policy, the last significant growth driver is now fading. German exports to the United States fell by 2.8% y/y in value seasonally adjusted in the first half of 2025, leading to a deterioration of EUR 3.9 billion (-11%) of the bilateral balance in one year.

The European Union, Germany's largest trading partner, has helped to offset some of these losses. However, given the size of the markets lost, the country has no choice but to seek further growth domestically. The reorientation of the German growth model towards investment, potentially financed by better mobilisation of domestic savings, could lead to an increase in imports and reduce the current account surplus, which would nevertheless remain comfortable.

WHAT ARE THE LEVERS FOR GROWTH?

In the short term, renewed growth could be achieved through better mobilisation of labour and capital, which are currently under-employed (capacity utilisation in manufacturing stood at 77.2% in Q3 25, nearly 6.5 pp below the historical average). However, these adjustments would only restore potential growth to a level that is already historically low. Estimated at 2.5% in the 1970s, it stood at 1.4% between 2000 and 2019, and has been below 1% since 2020. This decline can be explained by a weaker contribution from capital – a consequence of insufficient private and public investment – by slowing productivity gains and, more recently, by rising unemployment.

GERMANY: CHANGES IN GDP AND ITS COMPONENTS

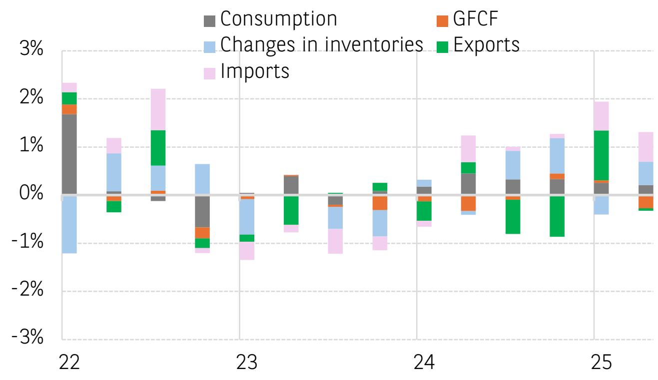

CHART 2 SOURCE: FEDERAL STATISTICAL OFFICE

GERMANY: NEW DEBT ISSUANCE AND PUBLIC DEBT RATIO

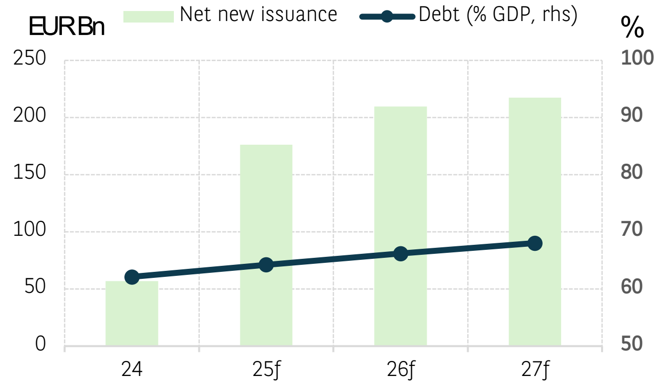

CHART 3 SOURCE: FEDERAL MINISTRY OF FINANCE, BNP PARIBAS FORECASTS

However, the coming years are set to be particularly challenging in view of demographic ageing and the fact that the energy transition – another major challenge – will have to be carried out in an economy dominated by energy-intensive industries. In the face of these challenges, the new government's economic policy is a source of optimism. By focusing on modernising and strengthening productive capital, as well as supporting innovation to boost productivity gains, it could partially offset the potential contraction in the labour factor. It remains to be seen whether these ambitions will actually and quickly translate into tangible results.

Article completed on 18 September 2025

Marianne Mueller
marianne.mueller@bnpparibas.com