Consumption is recovering only slowly as new headwinds are emerging

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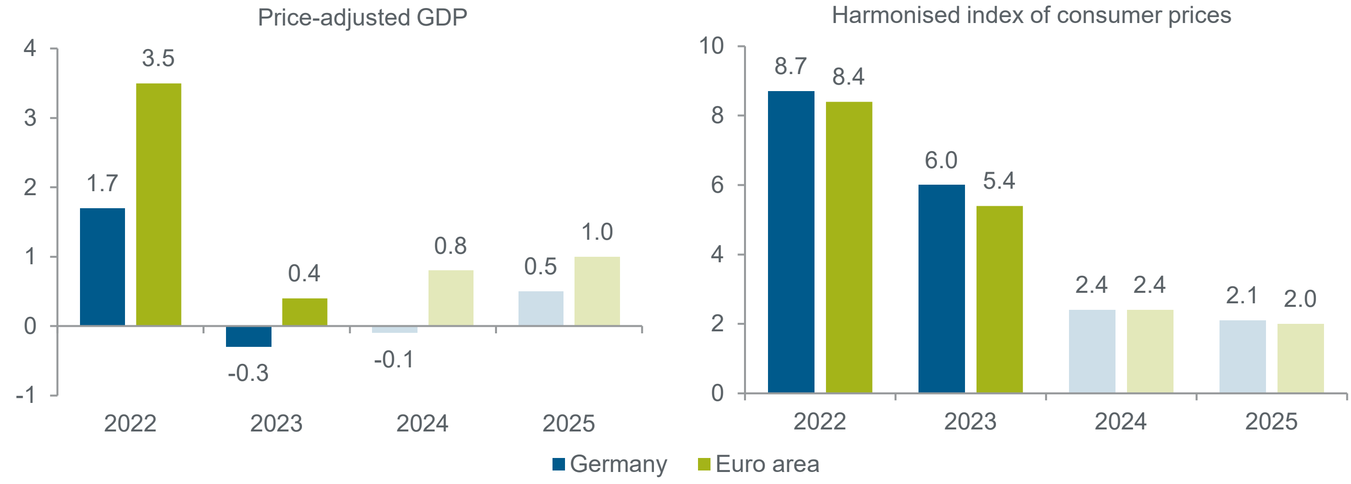
- The German economy grew by 0.1% in the third quarter and is likely to expand moderately in the current quarter as well. The main driver is consumption, which is benefiting from real wage growth.
- With wage growth easing, household purchasing power is likely to grow at a slower pace in 2025 than in 2024. Employment growth will no longer be a pillar of the economy either. That leaves household consumption as the most important economic driver but with less traction than previously assumed. In addition, protectionism in the USA is a headwind.
- KfW Research has revised the growth rate expected for 2024 slightly downward to now -0.1% (previous forecast: +0.1%). On a price-adjusted basis, economic growth in Germany 2025 will presumably be +0.5%, which is weaker than anticipated in the summer (previous forecast: +1.0%). Protectionist measures by the US will likely weigh on growth next year and beyond.
- Ecological price tag for GDP: Assuming the economy will perform as predicted, Germany's greenhouse gas emissions are set to decrease further. Germany will presumably remain below the caps established in the Federal Climate Change Act for the period from 2024 to 2025.
- As energy prices evolved favourably in the summer, inflation in Germany has fallen more rapidly than predicted. KfW Research now expects Germany's inflation rate as measured by the HICP to sit at 2.4% in 2024 (previous forecast: 2.6%) and drop to 2.1% in the coming year as a result of weak economic performance (previous forecast: +2.2%).
- KfW Research has left its GDP forecast for the euro area for 2024 unchanged at 0.8%. We have lowered the forecast for 2025 slightly to 1.0% (previous forecast +1.3%). After 2.4% this year, euro area inflation should moderate to 2.0% in 2025 (previous forecasts: 2.4 and 2.2%).

Figure 1: Economic growth and inflation

Per cent year-over-year change



Sources: KfW Research, Destatis, Eurostat

German GDP grew slightly in the summer of 2024

Germany's gross domestic product (GDP) expanded by 0.1% in the fourth quarter of 2024, when adjusted for price, seasonal and calendar variations. This was mainly due to a rise in consumption expenditure driven by high real wage growth in the previous quarters and government consumption. It was also reflected in retail turnover, which increased by 1.2% overall in the third quarter. At the same time, significant declines in exports and a renewed drop in investment expenditure acted as brakes on growth. Industrial output fell accordingly (by 1.9%), as did construction output (by 1.4%). As before, the trend was split within the German economy. While the turnover of service businesses increased on the whole, manufacturing and construction are in recession.

Moderate growth likely in autumn as well

Economic indicators based on business surveys pointed to a recession in the third quarter, thus significantly understating the growth rate. However, the indicators brightened on quite a broad front in October, at the beginning of the fourth quarter. According to the Ifo Business Survey, business expectations and situation assessments both improved on a low level. The Purchasing Managers' Index rose quite significantly. What also improved in October was consumer sentiment, which had suffered a setback in the summer. The outlook for industrial production, which has been contracting almost without interruption since the beginning of 2023, also brightened slightly. In particular, the volume of new orders received by manufacturers in the third quarter rose by 4.2%, although a minor contraction was recorded across the quarter if we leave out the volatile large-volume orders. Given the outcome of the US election and the additional political uncertainty that emerged after the dissolution of the German government, it is possible that the sentiment indicators will cloud over again in November. However, we expect that an increase in household consumption expenditure in particular will likely drive at least moderate economic growth in the fourth quarter as well.

Expectations for consumption in 2025 have fallen

Consumption expenditure is the mainstay of Germany's economy in the current year. But household consumption expenditure has developed more slowly than expected, especially in the first half of the year, since a strong increase in real income was offset by an increase in the saving rate. This can be explained in part by the higher interest being paid on savings deposits after the rapid monetary tightening in the years 2022 and 2023.[1] With the cycle of interest rate cuts now initiated by the ECB, this effect is likely to reverse in the coming year, stimulating consumption. Nonetheless, nominal wage growth will slow in the year ahead and real income growth will presumably turn out to be around 1%, lower than in 2024. This will be compounded by moderate headwinds from the labour market since the number of people in employment has been declining gradually since mid-2024, after growing significantly in the previous years, and is not likely to grow in 2025 either. Reports about layoffs in the industrial sector and the crisis in the automotive sector are also likely to weigh on consumer sentiment. We have therefore reduced our expectations but still expect a moderate push from household consumption next year.

Many question marks hang over investment activity

Sharp declines in corporate and residential construction investment constitute the largest brake on growth in 2024. Many construction projects were cancelled particularly as a result of the interest rate rises of 2022 and 2023. But the cycle of interest rate cuts initiated by the ECB in the summer means that the monetary-policy induced headwinds for construction will ease. Besides, property prices are likely to have fallen slightly and, in combination with sharp rises in rentals, this is changing the way housing enterprises and households calculate their investments.[2] We therefore expect residential construction investment to recover slowly in the course of the coming year. The easing of monetary policy is the most important beacon of hope with a view to corporate investments as well. Declines in key interest rates will likely have a positive effect both directly through financing costs and indirectly by increasing demand for industrial goods. But the interest rate effect is smaller here than in residential construction. Furthermore, low capacity utilisation, particularly in manufacturing and small and medium-sized construction firms, as well as pessimistic business expectations make a strong recovery of corporate investment unlikely. What also plays a role is the deterioration of the business location deplored by many enterprises, as well as what will likely remain a prolonged period of heightened political uncertainty as a result of the political situation in Germany and, in particular, US policies under the newly elected President Trump (see below). Public-sector investment increased substantially this year, unlike household investment. Among other things as a result of the Federal Government's provisional budget, there is great uncertainty around public-sector expenditure for 2025. But we assume that public-sector investment will increase again particularly owing to further increases in defence spending.

US politics has stirred up new headwinds

The election of Donald Trump as US president means that the German economy will be facing new headwinds. In particular, the introduction of new tariffs on all US imports, which was regularly announced during the election campaign, would directly harm the German economy and especially its industry (see box). But the specific formulation of US trade policy is as yet unclear. We assume that the new US administration will advance its protectionist agenda at the very start of its tenure but will at first implement only part of the threatened tariff increases while using threats of further steps as bargaining chips for negotiations. Besides, most of the losses from US protectionism will not affect the growth rate until 2026 since experience shows that tariffs unfold their negative effects gradually and it is also likely that exports to the US will be brought forward. On balance, we now expect German exports to grow only marginally in 2025, whereas prior to the election of Donald Trump we had predicted that German exports would grow significantly as a result of the revival of global goods trade. Imports will also perform more poorly than was expected in the summer, as Germany's imports of intermediate goods are also likely to turn out weaker and we have lowered our expectations for consumption. In our scenario of moderate US protectionism, the balance of foreign trade will thus be only slightly negative. Finally, corporate investment is likely to be impaired by the elevated level of trade uncertainty.

Box: How vulnerable are Germany and the euro area to new US tariffs?

Trump's campaign promises have been erratic but the firm ones, which will have immediate impacts on trading partners, include the introduction of new tariffs. He promised to impose a blanket tariff of 10 to 20% on all imports and 60% or more on imports from China.

Traditionally, the US has been a very important trading partner for the German economy. In the year 2023, the US was by far the most important foreign sales market for German goods with a value of around EUR 158 billion and a share of 10% of total exports. Germany's exports to the US make up 3.8% of German GDP, euro area exports to the US amount to 3.2% of euro area GDP. The main exports from Germany to the US are automobiles, machinery and pharmaceuticals. In order to also take indirect trade links with the USA into account, value-added exports must be analysed. In other words, trade flows including indirect links via intermediate inputs. Here we find that around 7% of industrial value added in Germany depends directly or indirectly on the US market. In 2023, approx. 1.7% of aggregate economic value added in Germany was attributable to the demand for goods from the US.[3]

Predictions about the impact of tariffs vary in line with the assumptions made and effects modelled. According to one calculation based on the ifo Trade Model, German exports would be nearly 2% lower overall in the long run if the US were to impose tariffs of 20% on all imports and 60% on goods from China.[4] Natixis economists have calculated that German GDP would fall by around 0.5% in the medium term through the trade channel if US tariffs were to be raised by a blanket 10 percentage points.[5] However, the Cologne Institute for Economic Research has determined in a macro-economic model calculation that a US tariff of 10% would cause German gross national product to fall by up to 1.4% compared with a base scenario without tariffs. Yet, it would take around three years for this loss to accumulate and the simulated rapid tariff introduction would cause a decline of only 0.3% of GDP in 2025.[6] So for the most part, tariffs implemented in 2025 would not impact on the annual growth rate until 2026. Economists from Goldman Sachs have quantified that a blanket US tariff increase to 10% would result in a 1% reduction of GDP in the euro area in the medium term.[7]

Downward revisions for growth in 2024 and 2025

We have moderately downgraded our forecast for price-adjusted growth during the current year 2024 to now -0.1% (previously +0.1%). The growth rate in the third quarter is roughly in line with our expectations from the summer forecast. However, the Federal Statistical Office has corrected the contraction in the second quarter downward from -0.1 to -0.3%. For the year 2025, KfW Research now expects growth of just +0.5% (previously 1.0%). After a moderate recovery in the winter half-year 2024/2025, protectionist US policy and a weakening tailwind from private consumption threaten to lead again to an economy in which positive and negative quarterly growth rates alternate. Aggregate economic production capacity is therefore likely to remain underutilised in the forecast period.[8]

Annual GHG caps are being met

Even if it is foreseeable that the German economy will grow moderately again in the coming year, significant structural challenges remain. In the medium to long term, transitioning the economy and society to carbon neutrality will likely be the greatest of these challenges. According to the Ecological Price Tag for GDP, the indicator which we published for the first time in the autumn of 2022, our current economic forecast implies that greenhouse gas (GHG) emissions will continue to fall. The annual caps on GHG emissions specified for the current decade under the amendment to the Federal Climate Change Act will presumably be met in 2024 and 2025 (see annex). Nonetheless, it remains a matter of urgency to act on climate change to meet the GHG reduction target of 65% by 2030 as well and the long-term goal of climate neutrality by 2045, particularly in buildings and transport.

Uncertainty over tariffs dampens outlook for euro area as well

The forecast for real growth in 2024 as a whole remains unchanged at +0.8%. The recovery that began in the euro area in the first quarter continued in the third quarter. Adjusted for price, seasonal and calendar effects, GDP grew by 0.4% on the previous quarter. At 0.8%, Spain once again achieved the strongest quarterly growth rate of the four large economies. Alongside the minor expansion of German GDP, France's GDP also grew by a moderate 0.4%. Italy, on the other hand, surprised on the negative side with economic stagnation. In their assessments, Germany, Spain and France reported that household consumption made a positive contribution to their GDP growth rates. This increased consumption propensity is thus likely to apply to the euro area as well and is reflected in the significant increases in retail turnover in the third quarter. The European Commission's consumer confidence index continued its upward trend in October, while a higher household saving propensity is evident at the same time. Household saving behaviour driven by precautionary motives is likely to be reinforced by uncertainty around the development of the economy in spite of foreseeably falling deposit interest rates. KfW Research expects consumption to be the engine of economic growth going forward as well, in a similar way as in Germany, but with less momentum than previously expected.

A major cornerstone of growth in the euro area in 2025 is likely to be the recovery of investment activity on the back of more favourable financing conditions, as the ECB's interest rate reversal is increasingly reflected in bank loans. The labour market, too, will remain robust with solid employment. The announcement by US president-elect Donald Trump to introduce protectionist measures, on the other hand, is cause for us to revise our euro area forecast for 2025 downward as well owing to the slightly less favourable export outlook. Furthermore, increased uncertainty over monetary policy is likely to act as an additional dampener on the ailing industrial sector. KfW Research has therefore lowered its forecast for the year 2025 to +1.0% growth (previous forecast +1.3%).

Table 1: Price-adjusted GDP growth in the euro area

Per cent year-over-year change

	DE	FR	IT	ES	EA
2022	1.7	2.6	4.7	6.2	3.5
2023	-0.3	0.9	0.7	2.7	0.4
2024	-0.1	1.2	0.5	3.1	0.8
2025	0.5	0.9	0.7	2.0	1.0

Source: Destatis, Eurostat, KfW Research

Our current country forecasts reflect the impact of the assumed US tariffs in line with the country-specific export dependency on the US. Germany will be disproportionately affected and Italy almost as much, while France will be less affected and Spain only marginally. Thus, Spain will continue to convince with robust growth driven by the only slowly moderating tourism boom next year as well. Besides, the country is benefiting from strong workforce growth as a result of high immigration. According to France's draft budget for 2025, substantial fiscal tightening will lead to lower growth. Consolidation measures are also weighing on Italy, which explains the downward revision for these two countries. Italy is also affected by the crisis in the automotive industry.

The structural challenges faced by European businesses such as high energy prices, the dwindling workforce and the lull in innovation are hampering strong, resilient economic growth in the euro area. The implementation of the proposals put forward by Mario Draghi would therefore be an important step to ensure that the euro area remains competitive amid changing globalisation.[9] A relevant proposal in Draghi's report is a coherent European plan for a shared, more flexible trade policy designed to reduce dependencies and deliberately protect specific economic sectors or to benefit from their openness, as is the case in innovative technologies. Another important aspect is to drive forward decarbonisation towards more sustainable, lower-cost sources of energy. In doing so, Europe's competitiveness should be taken into account in order to secure growth impetus during the transition as well. At the same time, a shared strategy for promoting innovation should be defined.

Lower energy prices are pushing down inflation

An unexpectedly welcome development of energy prices significantly slowed down the increase in consumer prices throughout the summer. Despite the war in the Middle East, the price of Brent crude oil fell by more than 10% in the months from August to September. The drop also benefited consumers in the form of lower fuel prices. This was the decisive factor that caused the inflation rate to temporarily fall even below the 2% target in Germany as well as in the euro area. But there is still no reason to assume that the ECB will significantly speed up its cycle of interest rate cuts. As expected, inflation picked up pace again in October. Whereas the inflation rate as measured by the annual variation of the Harmonised Index of Consumer Prices (HICP) rose to 2.0% in the euro area, the overall rate in Germany surged to 2.4%. In addition to unfavourable base effects from energy goods, this development was driven by price increases for food (Germany: +3.3%) and services (Germany: +4.8%). With a view to the continuing excessively high services inflation, it is also evident that the underlying domestic price pressure still needs to ease in order to achieve price stability on a sustained basis. The moderate increases in sales price expectations from service enterprises suggest that this will take some time yet. And even if the strong growth of 8.9% in collectively agreed wages in Germany in the third quarter is skewed to the upside by the temporary special payments, the increase in the cost of labour-intensive services remains high for now. The latest collectively agreed settlements and slowing salary rises offered in job advertisements, however, suggest that wage pressure will foreseeably ease. Given that the price level has fallen as a result of lower energy prices, we have largely downgraded our inflation forecasts. We now expect consumer prices to be 2.4% higher in Germany and the euro area this year. Next year, inflation is likely to fall to 2.0% in the euro area (previous forecast: +2.2%) and 2.1% in Germany (previous forecast: +2.2%). We base this forecast on the assumption that effects of US import tariffs that drive inflation and those that reduce it will be roughly balanced.

Numerous risks, especially on the downside

Economic forecasts are currently fraught with particularly high uncertainty. The most acute risks to German and European growth in 2025 and beyond include US policies, which could weigh even more not just on exports but also on investment in the euro area. The German economy in particular could suffer more harm from ever-new selective threats of tariffs from the US administration than from a blanket, moderate increase in general US tariffs. Any EU involvement in an escalating trade war between the US and China could potentially have serious repercussions. An unexpectedly sharp economic slump in the Middle Kingdom would also weigh on Germany. A rapid expansion in US sovereign debt would also create global risks, including possible overheating trends with sharp rises in US interest rates. Depending on US policies, growth in Germany may disappoint if the weakness in the labour market worsens or leads to significant consumer restraint. With the snap election, uncertainty about politics in Germany will also remain high until the conclusion of coalition negotiations, especially since it will be possible to manage the budget only on a provisional basis until then. Depending on the outcome of the election and the parties' ability to compromise this situation may continue even after the spring.

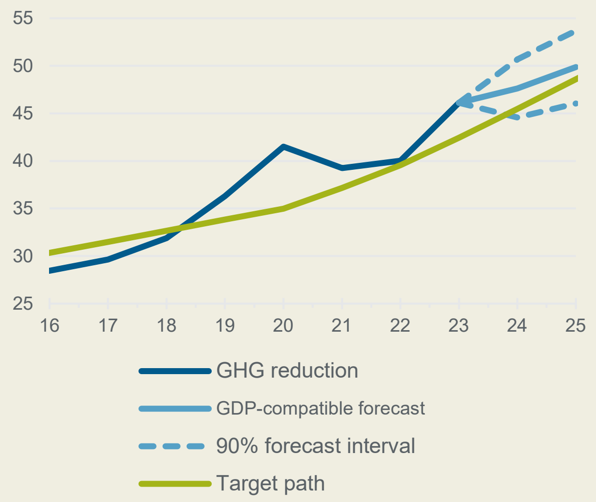
On the other hand, possibilities of higher growth than forecast could also arise. In particular, there is a chance that the unusually high household saving rate drops more steeply than predicted here. Potential for higher growth may also emerge in the rather unlikely event that the economic policy uncertainty eases unexpectedly, including any decision against higher US tariffs on goods from the EU, an end to Russia's war of aggression against Ukraine and emerging reconstruction-related export opportunities for Germany, or a surprising productivity surge on the back of artificial intelligence. Among the frequently mentioned upside risks for Germany is also a reform of the debt brake on the part of a new Federal Government, which could widen fiscal policy scope at least moderately. However, this would likely not be reflected in growth until 2026. As a consequence of a reduction in US security guarantees, a new government could also provide some economic impetus through a significant increase in military spending in Germany.

Annex: Ecological price tag for GDP

Economic growth has a wide range of social and ecological consequences that are typically disregarded in the usual economic forecasts. It is a necessary but not sufficient condition for sustained prosperity, as the growing risks from climate change demonstrate in dramatic fashion. Global heating poses a threat to the natural bases of human life and, thus, to economic activity. It is therefore necessary to focus more comprehensively and rigorously than before on the impact which economic activity has, especially on the environment and the climate.

Figure A1: GHG emissions in Germany

Reduction against 1990 baseline in per cent



Source: KfW Research, German Federal Environment Agency

To this end, we have developed a simple approach for systematically integrating the expected greenhouse gas (GHG) emissions into our economic forecast for Germany. The starting point is an identity equation according to which total GHG emissions are the product of GDP and the emission of GHG per unit of GDP, in other words, GHG intensity. We take the GDP from our economic forecast and estimate the expected development of GHG intensity using a linear trend extrapolation. Our approach is explained in detail here. It enables the greenhouse gas emissions being expected under current conditions to be compared with the reduction targets set by policymakers, which require Germany to reduce its emissions by 65% against the 1990 baseline by 2030 (see Figure A1).

In the amendment to the Federal Climate Change Act[10], which entered into force in July 2024, the reduction target for 2030 remains unchanged but will be supplemented by concrete GHG emission caps for each year from 2020 to 2030. The target trajectory in Figure A1 is based on these caps. The systematic comparison of expected economic growth and GHG emissions will sharpen our awareness of the trade-off that exists between more goods and income on the one hand and the consumption of key natural resources on the other hand. It means we attach an ecological price tag to GDP, as it were, that will tell us how much the expected growth will presumably cost us as a society in the form of GHG emissions that harm the climate.

On the basis of our new economic forecast, the ecological price tag predicts that emissions will drop in the forecast period and in both years will remain below the annual ceilings prescribed by the amended Federal Climate Change Act. Under our approach, GHG emissions in Germany are thus likely to amount to 653 million t CO_2 equivalents in the current year 2024. That would be some 29 million t CO_2 equivalents or a good 4% less than the 682 million t CO_2 equivalents set by the act as upper limit for 2024. In the year 2025, GHG emissions should then be 21 million t CO_2 equivalents or a good 3% lower than prescribed by the reduction trajectory (see Table A1).

Table A1: GHG emissions and policy trajectory

Million tonnes of CO_2 equivalents

	2022	2023	2024	2025
Actual/forecast	750	674	655	627
Target path	756	720	682	643
Actual/forecast deviation from target path				
Absolute	-6	-46	-27	-16
Percent	-0.8	-6.4	-3.9	-2.5

Source: KfW Research, German Federal Environment Agency

Like all forecasts, the ecological price tag for GDP also involves forecast risks. With reference to the 90% forecast interval presented in Figure A1, which is derived from the historic forecast errors of our approach, the statement that the annual minimum GHG reduction targets will be reached in the forecast period appears to be empirically validated.

[1] And would therefore be an intended channel through which monetary policy can act.

[2] We do not have recent data on land prices. Yet, we assume that the prices of building land have fallen at a similar rate as the house price index.

[3] Allen-Reynolds J. (2024): Impact of 10% US tariff on euro-zone would be small, Capital Economics, Europe Economics Update, 15 November 2024.

[4] Baur et al. (2024): Deutsch-amerikanische Handelsbeziehungen vor der US-Wahl: Auswirkungen eines Trump-Comebacks (*German-US trade relations before the US election: Effects of a Trump comeback* – our title translation, in German), ifo Schnelldienst 09/2024

[5] Schumacher, D. and Dezeure, N. (2024): Europe: How much damage could tariff hikes cause? SUERF Policy Note | No. 353 | 18 July 2024.

[6] Obst et al. (2024): Handelspolitische Konsequenzen einer Wiederwahl von Donald Trump (*Trade policy impact of a Donald Trump re-election* – our title translation, in German), ifo Schnelldienst 09/2024.

[7] Hatzius J. (2024): Implications of Higher Tariffs for Euro Area and US Monetary Policy, Slides presented at the ECB Forum on Central Banking, 02.07.2024.

[8] After several years of stagnation, production capacity is currently underutilised by around 1% to 2% according to a typical estimation method, with significant differences between service industries and the manufacturing sector. Cf. Joint Economic Forecast Autumn 2024: German Economy in Transition – Weak Momentum, Low Potential Growth, p. 34.

Our growth forecast for 2025 is roughly in line with the potential growth estimated under the Joint Economic Forecast. Capacity utilisation is therefore likely to remain on a similarly low level in 2025 as in 2024.

[9] Cf. Draghi M. (2024): The future of European competitiveness, Part A | A competitiveness strategy for Europe, September 2024.

[10] Federal Government adopts amended Climate Change Act | Federal Government; Document 20/8290 Federal Government's bill for a second act to amend the Federal Climate Change Act (bundestag.de).