German economy ends 2025 on a high

With 0.3% quarter-on-quarter growth, the German economy finally pulled out of stagnation at the end of last year. A cyclical rebound is clearly in the making but more is needed to improve potential growth

With today's data, the protracted period of de facto stagnation in Germany seems to be coming to an end.

The German economy grew by 0.3% QoQ in the final quarter of the year (slightly better than the preliminary 0.2% QoQ reported two weeks ago), leaving the technical summer recession behind. Details will only be released in February but based on available monthly indicators and the statistical office’s press release, public and private consumption were the main growth drivers.

Still, to temper any excessive enthusiasm, this positive surprise needs to be put into perspective. At just 0.3%, the fourth quarter performance is admittedly modest yet still the best quarterly performance in the last three years. It's a reminder of the title of one of Paul Krugman’s books: “The age of diminished expectations”.

Cyclical recovery in the making, but more needed to increase potential growth

The reasons for Germany’s economic malaise should really be known by now. Caught between cyclical and structural headwinds, the German economy is currently the same size as it was in 2019, with a potential growth rate of no more than 0.5%. Under-investment and a lack of reform in the 2010s, as well as the rise of China from export destination to system rival, have pushed the economy into this de facto stagnation. The export-oriented business model has come under severe pressure. While a cyclical improvement is currently in the making, driven by fiscal stimulus, structural reforms and more investment are needed to improve potential growth.

Looking ahead, increasing new orders and falling inventories bode well for at least a soft turnaround in industry. At the same time, the announced infrastructure and defence investment plans will finally begin to reach the economy this year. Critics often overlook the sluggishness of Germany's federal decision-making process. It took until late last year for parliament to approve the 2026 budget and almost 30 military procurement contracts. With the rapid expansion of defence production capacity, there is a good chance that a large part of the defence spending will remain within the domestic economy and not leak to other countries. In fact, we see the defence sector as a potential positive surprise in 2026. And even though corporates never tire of complaining about elevated energy costs, the government's decision to bring those costs down to one-third of their current level should bring further relief, if implemented. Admittedly, the stronger euro, the delayed impact of US tariffs and possible additional tariffs could still spoil the cyclical rebound party.

As much as we remain convinced of the upcoming economic recovery, we continue to stress that the economy's problems are deeply rooted, often structural and largely self-made, except for the China problem. Solving these issues quickly is impossible. This is a completely different challenge from some 20 years ago, when Germany was the 'sick man of Europe'. The economy still needs an almost complete makeover, from familiar measures such as reducing red tape and introducing e government, to addressing the financial burden of demographic change or providing relief through tax cuts. It is up to German Chancellor Friedrich Merz and his government to implement these reforms this year and turn a long-awaited rebound into a sustainable recovery.

With today's data, the protracted period of de facto stagnation seems to be coming to an end. However, the list of potential downside risks is still long. And while there is very little Germany can do to prevent new external shocks, it has full and absolute control over not shifting from one extreme to the other: the biggest domestic risk remains any sudden shift from national depression to national complacency.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de