1 Global economy

1.1 Global economy robust so far despite trade disputes

The second quarter of 2025 once again saw the global economy in robust shape.US gross domestic product (GDP) rose significantly in the second quarter after having fallen slightly at the start of the year. The Chinese economy recorded similar growth to the first quarter despite the higher tariffs imposed by the United States. GDP in the euro area increased again slightly in the second quarter following the strong start to the year. The global economy appears so far to have been able to withstand the tougher and in part erratic US trade policy. This resilience was supported by the short-term front-loading and diversion of trade flows.

Looking ahead, however, the United States' erratic, protectionist trade policy is likely to place more of a strain on the global economy. In the year to date, the average tariff rate imposed by the United States on all its trading partners has climbed by more than 14 percentage points, reaching its highest level since the 1930s. A deal with the United States' most important trading partner, China, is still pending, however. Given the in part erratic US tariff policy, the risk of an escalation of the trade disputes persists. This and the tariff hikes that have already been adopted are likely to place a mounting strain on global trade. Overall, the trade policy concessions made by some partner countries of the United States are too insignificant to offset the adverse effects of additional US tariffs on global trade. Global trade activity was already sharply lower in April and May, after US imports in particular had previously risen sharply in anticipation of tariff hikes. In addition to the unwinding of these front-loading effects, the initial dampening impact of the increased tariffs on demand from the United States became apparent. The medium-term outlook for global trade will depend on whether further countries give in to the temptations of protectionism and likewise seal themselves off more.

1.2 Global disinflation process proceeded further, just not in the United States

Energy markets were shaped by geopolitical influences during the reporting period. As the military conflict between Israel and Iran came to a head, crude oil prices spiked sharply higher for a time, primarily on account of concerns over supply shortfalls. With the subsequent easing, prices went down again. Prices were buoyed, however, by surprisingly brisk demand as well as fresh sanctions, and threats of the same, by the EU and the United States on the Russian oil industry, and dampened by production hikes by some OPEC countries and their partners.

The global disinflation process is intact in many countries, but not so in the United States. Headline inflation in advanced economies came to 2.6 % on the year in July, up somewhat on the April rate, while core inflation (excluding energy and food) has also picked up somewhat of late. This was largely a reflection of developments in the United States, where strong services inflation did not decline any further, and goods inflation increased. To date, though, the tariff hikes have played only a small part in this. The tariff-induced price hikes that are already clearly visible at upstream stages of production will probably only be gradually passed on to US consumers in the coming months. In most other advanced economies, meanwhile, the disinflation process appears to be intact, including in the euro area, where underlying consumer price inflation has diminished markedly since April.

2 Financial market environment

2.1 Financial markets bounce back after turmoil caused by US tariff policy

In financial markets, the sharply higher uncertainty surrounding US tariff policy at the beginning of April eased, and risk appetite rose. After the US administration announced large-scale tariffs at the beginning of April, investors lowered their growth expectations in many places. In addition, uncertainty about the scale of the expected economic downturn initially put financial markets under considerable pressure. However, when it emerged from the deals that have since become public knowledge that the tariffs actually imposed by the United States would fall short of the tariffs that had previously been threatened, financial market nervousness eased, risk premia fell, and risk appetite increased. The US-EU trade deal announced at the end of July followed the same pattern and failed to have any lasting influence on capital markets.

2.2 Euro appreciates against US dollar

While yields on US government bonds rose, Bund yields barely changed on balance; nonetheless, the euro appreciated markedly against the US dollar. In the United States, government bond yields rose noticeably until the end of May amid growing concerns about the US administration’s trade and fiscal stance, the resulting fiscal risks and the upside impact these had on risk premia. However, this was counteracted by the economic picture in the United States, which continued to deteriorate over the course of the quarter. From the perspective of market participants, this increased the likelihood that the Federal Reserve would ease monetary policy more strongly over the next few months, yet yields on ten-year US Treasuries rose on balance. By contrast, yields on German federal securities were dampened, especially in April, by high demand for safe assets, before picking up again thanks to the somewhat brighter economic outlook in the euro area. At the same time, the US dollar depreciated significantly both against the euro and in nominal effective terms. Taken together, the

United States’ widening interest rate advantage over the euro area and the persistent marked depreciation of the US dollar could indicate a loss in confidence amongst international investors in US economic and fiscal policy. This impression was particularly strong as the second quarter got underway; as that quarter progressed, upward pressure on the euro came increasingly from monetary policy on both sides of the Atlantic. This is because expectations of further monetary policy accommodation dwindled in euro area money markets after the ECB indicated in June that its rate-cutting cycle may be nearing its end. This change in expectations persisted after the Eurosystem left key interest rates unaltered at the ECB Governing Council meeting in July.

2.3 Equity markets up after slump in April

Markets for riskier assets saw prices rise as risk appetite grew. In the international equity markets, uncertainty about the outcome of the tariff dispute has increasingly taken a back seat since the end of April. Greater optimism among market participants regarding the outcome of the trade dispute and growing risk appetite boosted European and, above all, Japanese and US equity prices. In addition, despite the subdued US economic outlook, US firms’ higher earnings expectations helped to drive the sharp rise in the price of US securities. In European corporate bond markets, an increased appetite for risk sent risk premia into decline, with high-yield corporate bond spreads narrowing particularly sharply.

3 Monetary policy and banking business

3.1 ECB Governing Council leaves key interest rates unchanged in July

At its monetary policy meeting in June 2025, the Governing Council of the ECB decided to cut the key ECB interest rate further to the current level of 2 %. In the baseline of the Eurosystem projections from June, euro area headline inflation is set to average 2.0 % in 2025, 1.6 % in 2026 and 2.0 % in 2027. Underlying inflation should also settle at around the Governing Council's 2 % medium-term target on a sustained basis.

In July, the ECB Governing Council then left the key ECB interest rates unchanged for the first time following seven consecutive interest rate cuts. The incoming data broadly confirmed the Governing Council's June assessment of the inflation outlook. Domestic price pressures have continued to ease, and wages are growing more slowly.

3.2 Lending to the domestic private sector increases only moderately

Monetary growth diminished slightly overall in the second quarter of 2025. The broad monetary aggregate M3 expanded to a lesser extent than in the previous quarter, with its annual growth rate falling to 3.3 % by the end of June. Persistently high inflows to overnight deposits were offset by a stronger reduction in other short-term deposits. This development is in line with the continued narrowing of the interest rate spread between these forms of deposits.

Lending to the domestic private sector also continued to increase, albeit only moderately. The persistently high geopolitical uncertainty is also likely to have dampened demand for loans to enterprises for investment purposes. There were no new impulses from the loan supply side: The banks surveyed by the Bank Lending Survey (BLS) left their credit standards for loans to enterprises virtually unchanged in the second quarter. They are expecting a moderate increase in demand for loans in the third quarter.

4 German economy

4.1 German economy suffers setback in second quarter

The recovery in economic output in Germany suffered a setback in the second quarter of 2025. According to the Federal Statistical Office's flash estimate, real GDP decreased by 0.1 % on the quarter after seasonal adjustment. Revised data indicate that it was still rising markedly in the previous two quarters.

In its flash estimate of GDP for the second quarter of 2025, the Federal Statistical Office published revisions with a significant impact on the GDP path between 2021 and 2024. Firstly, the recovery after the coronavirus pandemic in 2021 and 2022 appears to have been stronger. Second, the bout of weakness following the start of Russia's war of aggression against Ukraine is now more pronounced. This means that the German economy was now clearly in recession in the years 2023 and 2024, in the sense of a significant, prolonged and broad-based decline in economic output with underutilisation of aggregate capacity. This decline faded out in the middle of last year and evolved into a slight recovery. In the first quarter of 2025, economic output was additionally supported by front-loading effects in anticipation of higher US tariffs.

After tariffs were raised at the beginning of April, however, industrial output and exports recorded rebound effects in the second quarter. Economic policy uncertainty remained high, mainly owing to the trade dispute with the United States. This weighed on planning certainty and thus on firms' investment, as is also reflected in the muted demand for bank loans among German firms. Also consistent with this was the BLS finding that banks tightened their credit standards again – albeit marginally – in the second quarter of 2025 on the grounds of a perceived increase in credit risk. Orders in the construction sector were still too weak to provide impetus for higher production. Lending to households for house purchase, meanwhile, continued the recovery that has been observed since the third quarter of 2024. Private consumption benefited from strong wage growth. The labour market remained weak, though, counteracting a significant increase in consumption.

4.2 Labour market remains weak, but negotiated wages rise more sharply than before

The labour market continued to move sideways in the second quarter of the year. The level of employment has been virtually unchanged for two years now. However, there are significant sectoral upheavals underlying this development. Unemployment saw a moderate uptick again. Leading indicators do not suggest any fundamental change in this development over the next few months.

This sideways movement and falling consumer price pressures are dampening earnings growth. Basic pay adjusted for special factors rose by 6.7 % on the year in the second quarter, just as sharply as in the first quarter. Actual earnings, too, may have increased at a similar rate to the previous quarter, in which growth stood at around 4 % on the year. However, the most recent wage agreements show predominantly lower wage increases than before. The remaining new wage agreements to be concluded by the end of 2025 are also likely to be lower than last year's as inflation rates are declining and the economic environment is weak. Trade unions' wage demands continue to decline, and the percentage of their demands achieved are markedly lower than when inflation was at its peak. The rise in negotiated wages in the second half of the year is being dampened in part by inflation compensation bonuses, which were paid in the previous year and have now been discontinued.

The general statutory minimum wage is to be raised substantially from January 2026 onwards following a recommendation of the independent Minimum Wage Commission. The Minimum Wage Commission has proposed a gradual increase of 13.9 % to €14.60 per hour by 1 January 2027, thus falling short of demands made in various quarters in the run-up to the decision calling for an increase to €15. The planned minimum wage increases will also contribute to a higher aggregate wage increase via spillover effects. Compared with the June forecast for Germany, however, no major revisions are required with regard to aggregate average wages and employment.

4.3 The inflation rate fell distinctly in the second quarter

Inflation declined significantly in the second quarter. The annual inflation rate fell sharply in the second quarter of 2025 to 2.1 %. Energy prices, which fell in part owing to the significant decline in oil prices and the appreciation of the euro, were one factor driving disinflation. Another was that services prices no longer rose quite as sharply as in the previous quarters. The core inflation rate (HICP excluding energy and food) therefore also fell considerably to 2.8 %. However, excluding the volatile components clothing and travel services, the core rate remained unchanged, as it has for several quarters, at around 3 %. In July, prices rose somewhat more sharply than before compared with the previous month. However, the annual inflation rate fell markedly from 2.0 % in June to 1.8 %, and the core rate eased slightly to 2.4 %.

The inflation rate is likely to be temporarily somewhat higher in the next few months. A base effect means that the previously negative energy inflation will turn positive. By contrast, looking at services, the disinflation process is set to continue, in principle, although a base effect is expected to drive rates higher temporarily towards the end of the year. The future lower wage increases will have an impact here. Overall, the inflation rate is likely to rise to slightly above 2 % and thus be temporarily somewhat higher than expected in the June projection. Core inflation could likewise turn out to be slightly higher and fluctuate around the level reached in July. However, geopolitical factors mean that the outlook remains highly uncertain.

4.4 Economic activity could languish in the third quarter

In the third quarter, economic activity could more or less stagnate. The deal reached in the trade dispute between the United States and the EU has likely reduced uncertainty about future tariff levels. However, this uncertainty remains high and the tariff burden on German exports to the United States will increase. The negative impact of US tariffs is being offset by somewhat more robust demand from other economic areas. Overall, foreign demand for German industrial products has recently trended up. Strong frontloading in the first quarter means, though, that there could yet be marked rebound effects in industrial production and exports in the current quarter. The gloomy outlook for global trade, the still weak orders situation and low utilisation of existing capacity are expected to continue to weigh on business investment. Construction is unlikely to provide any strong stimuli yet, although new orders continue to exhibit signs of recovery. The subdued labour market outlook and the weakening wage dynamics are holding back private consumption.

5 Public finances

5.1 Expansionary fiscal policy adopted

German fiscal policy to enter an expansionary phase following a significant relaxing of the debt brake by legislators. The deficit ratio could decline moderately again this year, as the fiscal projects will have little impact to begin with. However, it is expected to increase significantly from 2026 onwards, and it could reach around 4 % in structural terms in 2027 (2024: 2.7 %). This reflects additional spending on defence, non-military investment and subsidies. However, expenditure on health, long-term care and pensions will also see dynamic growth. On the revenue side, the contribution rates of the social security funds are rising to finance this. At the same time, tax relief measures are in place. The structural expenditure ratio (comprising social contributions and taxes) could therefore remain more or less stable at around 42 % until 2027. The expenditure ratio could rise to as high as 52 % by then. The debt ratio will increase step by step and pull further away from the 60 % limit (2024: 62.5 %).

A higher deficit will be well manageable for a few years. Persistently high deficits and rising debt ratios would be problematic, however. This would further restrict future fiscal leeway and would not be compatible with EU rules.

So far, there are no signs that the deficit ratio and the debt ratio will fall again in future. And the expenditure ratio is likely to increase further. For example, central government is planning a considerable rise in spending on defence and higher grants to the pension insurance scheme. Interest expenditure is also growing strongly. Specifically, central government (core budget and off-budget entities together) is planning a structural deficit ratio of almost 4 % in 2029 and cumulative new borrowing of around €850 billion for 2025 to 2029. From 2027 onwards, as yet unspecified consolidation measures are planned in order to ensure that new borrowing does not exceed the planned level. These required measures are rising steadily and amount to 1½ % of GDP (€74 billion) in 2029 alone.

The Federal Government will therefore have to adjust its budgetary stance significantly as time progresses. In this context it seems highly unlikely that a structural acceleration in the potential rate of GDP growth will even come close to covering these planned measures. Given that deficits are already high, cautious fiscal planning not based on optimistic growth assumptions is advisable in any case.

5.2 Additional leeway for deficits is not focused on infrastructure and defence

At present, it makes sense to bolster defence capabilities and infrastructure through borrowing – and this is why the scope for borrowing has been expanded. However, this scope is in fact set to be used to a considerable extent for other purposes as well. This can be seen, for example, in the draft central government budget for 2025: If borrowing under the new defence exemption amounts to €32 billion, expenditure under the NATO definition will only be around €11 billion higher than last year. Borrowing of €37 billion is planned for the new special fund for infrastructure and climate neutrality. This is set against additional infrastructure investment expenditure by central government amounting to €2½ billion. The remaining borrowing is not clearly tied to additional government infrastructure investment or new measures to reduce greenhouse gas emissions.

In order for the debt to actually be used to strengthen defence and infrastructure, much stronger safeguards are needed than currently planned. To this end, the envisaged implementation rules would have to be adjusted. These could stipulate that central, state and local governments may only use the new scope for borrowing for defence, infrastructure and climate neutrality to the extent that they increase appropriately defined expenditure in this respect compared with 2024 (in relation to GDP). This would also mean that scope for other expenditure and tax relief would have to be covered by budgets – or these measures would have to be renounced. This is politically more ambitious. However, it would be in line with the objectives formulated when the scope for borrowing was expanded.

5.3 Securing sound public finances again in the long term through effective fiscal rules

National and European fiscal rules are currently opening up considerable scope for borrowing. As a result of the reform, the national budget limits are very loose. In addition, the Federal Government has requested very lenient EU fiscal targets for the coming years. To this end, its medium-term fiscal-structural plan (MTP) deviates from the Commission’s reference trajectory for Germany. This is understandable in terms of the additional scope provided by the defence exemption and the extended adjustment period of seven years. In other areas, however, Germany is expanding the scope once again very significantly, and the European rules are being implemented in a disquieting manner. For example, growth in potential GDP and the GDP deflator is estimated to be implausibly high over the term of the MTP (2025 to 2029). Another critical issue is that the MTP initially (irrespective of defence spending) adopts an expansionary stance and postpones the necessary consolidation to the years at the back end of the term – i.e. to the next legislative period. The EU rules actually envisage uniform consolidation steps so that the adjustments are not postponed. If Germany makes use of the broad scope for spending under the MTP, the deficit ratio could reach around 6 % for a time in line with the rules. The debt ratio could then rise to 80 % by 2029.

After a transitional phase, the deficit and debt ratios will have to fall again over time to ensure sound finances – and this is also stipulated by the EU rules. Germany’s debt brake exemption for defence spending within the framework of the EU rules ends in 2028. Germany plays a key role in the acceptance of European fiscal rules. Moreover, it appears neither sustainable nor well justified in economic terms if defence spending is largely exempt from the borrowing limit and, in this context, growing interest expenditure increasingly restricts the remaining fiscal scope. At the same time, demographic challenges are having more and more of an impact on government finances.

The announced debt brake reform can be used to derive clear prospects for sound public finances. The reform elements put forward by the Bundesbank lay out a path that leads back to a rules-based national fiscal policy and preserves the scope for investment. The proposals provide a good basis for effectively safeguarding sound public finances following the transitional period. They include binding credit limits, prioritise government investment in budgets and are likely to keep conflicts with the EU rules to a minimum.