MACRO PICTURE

Germany’s Tentative Recovery and the Auto Industry Challenge

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15 September 2026

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Executive Summary

Germany's Recovery Gains Momentum, But Remains Fragile

- Germany's economy expanded 0.3% q-o-q in Q2, marking a third consecutive quarter of growth and leaving GDP 0.9% higher than a year earlier.
- Exports rose 2.0% q-o-q and have become the main driver of the recovery, accompanied by improving industrial activity and stronger business confidence.
- Stronger-than-expected data have lifted the outlook, with some economists raising their 2026 growth forecasts to around 1.1-1.2%, potentially Germany's strongest expansion since 2022.
- The recovery remains uneven, as household consumption increased just 0.1% and investment contracted 0.2%, while energy prices, geopolitical uncertainty and Rhine disruptions remain important risk.

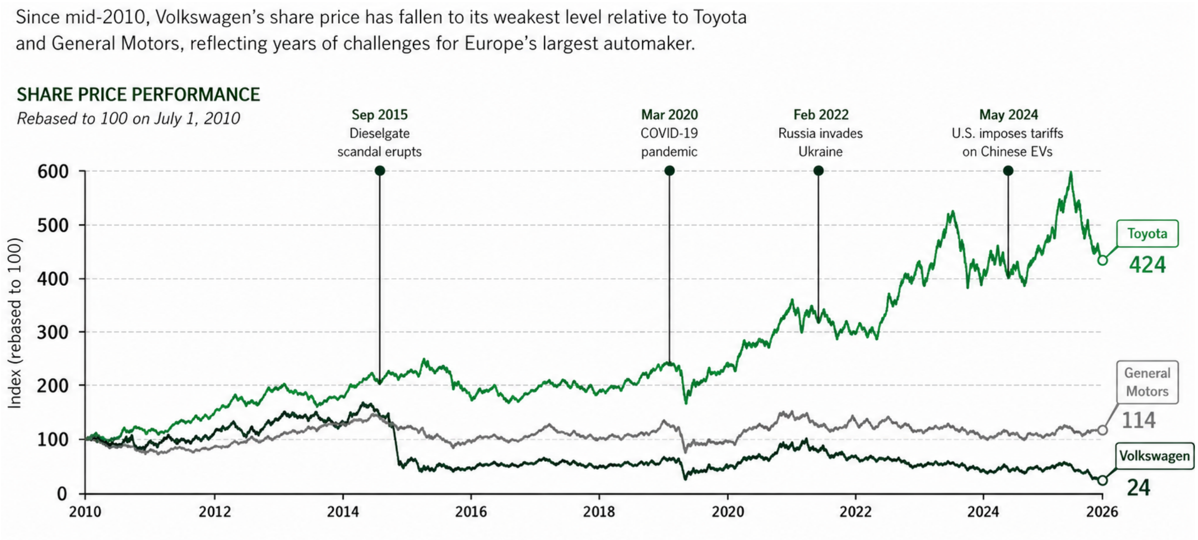
Structural Weakness Persists, With Autos at the Centre

- Corporate insolvencies reached their highest second-quarter level in 20 years, while more than 100,000 industrial jobs were lost in 2025 and another 100,000 could disappear in 2026.
- Germany's automotive sector is experiencing a particularly sharp adjustment, with employment falling 5.8% y-o-y to 691,500 in H1 2026, its lowest level since 2005.
- Volkswagen, BMW, Porsche, Mercedes and major suppliers are pursuing substantial job cuts, capacity reductions and cost-saving programmes as profitability and competitiveness come under pressure.
- Restructuring increasingly involves moving production and development abroad, raising the longer-term risk that Germany loses not only jobs but also technological capabilities and high-value industrial functions.

Chinese Competition Forces Germany to Rethink Its Industrial Model

- Intensifying Chinese competition is adding to Germany's industrial pressures, with Chinese manufacturers benefiting from lower costs, rapid technological adoption and increasingly competitive products.
- The challenge is becoming visible even in Germany's domestic auto market, where Chinese-brand vehicles have roughly doubled their market share over the past year.
- German companies are adapting their business models, with Jungheinrich combining Chinese manufacturing with German engineering and distribution, while Volkswagen increasingly develops vehicles locally through its "in China, for China" strategy.
- Germany therefore faces a broader industrial-policy challenge, balancing deeper integration with Chinese production and innovation against the need for stronger domestic competitiveness and an EU trade policy capable of preserving European industrial capacity.

Key Picture: Volkswagen Hits 16-Year Low Versus Global Peers



Source: [LSEG Workspace; The Daily Economy]

Germany's Economy Shows Tentative Signs Of Recovery

Germany's economy is showing tentative signs of recovery after several years of stagnation. GDP expanded by 0.3% q-o-q in Q2, above the initial estimate of 0.2%, following growth of 0.4% in Q1 2026 and 0.3% in Q4 2025. This marked a third consecutive quarter of expansion and left GDP 0.9% higher y-o-y in Q2. The improvement has also broadened across several indicators: exports rose 2.0% q-o-q, industrial value added has begun to recover, and the Ifo business climate index increased for three consecutive months, with sentiment improving particularly in manufacturing.

Importantly, the recovery has so far been driven primarily by foreign rather than domestic demand. Stronger exports have been the main source of growth since late 2025, while the contribution from government spending has remained relatively limited. By contrast, household consumption increased by just 0.1% in Q2, while investment contracted by 0.2%, highlighting continued weakness in domestic demand. The recovery therefore appears increasingly visible, but remains narrow and vulnerable.

Nevertheless, the stronger-than-expected data have prompted economists to become more optimistic about the outlook. Germany is now on track for its strongest annual growth since 2022, with some forecasts for 2026 raised to around 1.1-1.2%. Further support should emerge as spending from Germany's €500 billion infrastructure fund begins to feed into the economy, potentially supporting investment, capacity utilisation and domestic demand in the second half of the year.

However, significant downside risks remain. Higher energy prices, tighter monetary conditions, intensifying Chinese competition and potential disruptions to Rhine shipping could weaken the recovery. Geopolitical uncertainty adds another layer of risk: Finance Minister Lars Klingbeil has warned that the Iran conflict and ongoing US tariff disputes are weighing on global growth, while stressing the need to protect German industry and jobs.

Overall, the latest data suggest that Germany is gradually emerging from its prolonged period of stagnation, supported by stronger exports, improving industrial activity and recovering business sentiment. Yet weak consumption and investment, together with persistent external risks, mean that the recovery remains fragile.

The key question is whether the current export-led improvement can broaden into a more sustained recovery in investment, employment and household demand

Structural Pressures Persist Beneath The Recovery

Yet the improving headline indicators mask a deeper divergence between Germany's cyclical recovery and the structural pressures facing its corporate and industrial base. While output and sentiment have begun to recover, business failures and industrial job losses remain elevated, raising questions over how broadly the recovery is being felt across the economy.

Germany's recovery also remains vulnerable to logistical and climate-related disruptions. The Rhine carries around 80% of the country's inland waterway freight, including key industrial inputs such as oil and petrochemicals. Low water levels can restrict shipping capacity and force companies to use more expensive alternatives; a disruption comparable to the 2018 drought could potentially erase Germany's already modest growth this year.

Corporate insolvencies reached their highest second-quarter level in 20 years in 2026, with the insolvency rate among partnerships and corporations in June around 80% above the average for the same month in 2016-19. Crucially, the increase is no longer concentrated in manufacturing but has spread across industries, strengthening concerns that Germany is facing more than a temporary correction following the pandemic. The deterioration is also visible in employment. After more than 100,000 industrial jobs were lost in 2025, a further 100,000 positions could disappear in 2026, with cuts extending beyond automotive manufacturing to mechanical engineering and construction. Major German industrial companies have already announced significant workforce reductions, including Volkswagen, Bosch and auto supplier ZF.

Part of the increase in insolvencies may still represent a delayed post-pandemic adjustment, as government support is withdrawn and some previously protected businesses leave the market. There are also more encouraging signs: new business formation increased by more than 10% y-o-y in Q1, including growth-oriented startups in areas such as artificial intelligence. This suggests that Germany may be undergoing a broader structural transformation rather than simply experiencing industrial decline. However, the combination of elevated insolvencies and continuing job losses highlights the persistent weakness beneath the recent improvement in headline growth.

Germany's Automotive Sector Bears The Brunt Of Industrial Adjustment

The automotive sector has emerged as one of the clearest signs of the structural pressure facing German industry. Employment fell to its lowest level since 2005 in the first half of 2026, with the sector employing 691,500 people, down 42,300, or 5.8%, y-o-y. This was the sharpest employment decline among Germany's major industrial sectors, although autos remain the country's second-largest industrial employer after mechanical engineering.

The contraction has been particularly pronounced across the automotive supply chain. Employment among vehicle and engine manufacturers fell 6.1% to 429,200, while parts and accessories suppliers recorded an even steeper 7.6% decline to 219,500. The weakness forms part of a broader retrenchment in German manufacturing, where employment fell 2.7% y-o-y to 5.29 million, equivalent to around 144,100 jobs. However, the decline in automotive employment was more than twice the manufacturing average, highlighting the particularly acute adjustment underway in Germany's flagship industry.

Major manufacturers are responding with increasingly aggressive restructuring. Volkswagen has discussed workforce reductions of as many as 100,000 globally, while Porsche is cutting around 5,000 positions and BMW plans to eliminate 8,000 jobs by end-2027. Mercedes is seeking to reduce production costs by 10% and lower global production capacity from 2.5mn to no more than 2.2mn vehicles by 2027. The company has also faced deteriorating profitability amid weaker Chinese demand, with Q1 profit falling 17% y-o-y to €1.43bn, adding to pressure for further cost reductions and restructuring.

In particular, for example, Volkswagen's difficulties reflect a combination of costly EU regulation, weak EV demand and intensifying global competition. EU emissions requirements have pushed VW toward large investments in batteries, software and electrification, even as consumer demand for EVs has disappointed. VW estimates that its costs are around 20% higher than those of competitors, while lower-cost Chinese EV manufacturers such as BYD are gaining ground. At the same time, US tariffs have weakened VW and Audi sales in the American market. Therefore, VW's restructuring as the result of a broader competitiveness problem involving high costs, regulatory pressures, changing consumer demand and stronger Chinese competition.

Pressure is equally pronounced among suppliers. Bosch plans to eliminate around 13,000 additional German jobs by 2030, on top of 9,000 cuts announced in 2024, while Continental is cutting another 3,000 positions by end-2026. Schaeffler plans to eliminate 4,700 jobs by end-2027, including 2,800 in Germany. The scale of these reductions suggests that the adjustment extends well beyond individual manufacturers and is spreading across Germany's wider automotive ecosystem.

More concerning for Germany's longer-term industrial position is that restructuring increasingly involves the relocation of production and technological capabilities abroad. An IG Metall survey of 325 Bavarian companies found that almost half had shifted production activities overseas during the previous 12 months. Among the 43 automotive companies surveyed, nearly three-quarters had relocated production and almost two-thirds had shifted development activities. This raises the risk that Germany loses not only manufacturing jobs but also higher-value development and "lead plant" functions, where new products and production technologies are first introduced.

Intensifying Chinese competition adds to these pressures. Around 35,000 Chinese-brand vehicles were registered in Germany between January and August, equivalent to 1.9% of the 1.87mn vehicle market but roughly double their market share a year earlier. Including Geely-owned Volvo and Polestar raises the share to more than 4%. While still relatively small, the rapid increase illustrates how Chinese manufacturers are beginning to challenge German carmakers not only in China and third markets, but increasingly in their home market as well.

The contraction of traditional automotive production is also raising a broader question over how Germany should redeploy its excess industrial capacity and highly skilled workforce. One emerging option is defence manufacturing. Defence Minister Boris Pistorius has advocated closer cooperation between the automotive and defence industries, while Mercedes has explored cooperation with drone producer Tytan and defence group KNDS has been linked to its Ludwigsfelde van plant. However, the VDA cautions that defence jobs are unlikely to compensate for those threatened by the automotive transformation and that converting automotive capacity into defence production is technically complex.

The alternative is to redirect industrial capabilities towards other sectors. Some auto workers have advocated using spare capacity for public transport, rail equipment and medical technology, rather than defence. The debate therefore extends beyond the immediate decline in automotive employment: as traditional vehicle production contracts, Germany increasingly faces the question of how to preserve and redeploy its factories, engineering capabilities and skilled workforce towards new sources of industrial growth.

German Industry Adapts To The China Shock

Fierce competition in China's slowing domestic market has pushed firms to reduce costs and rapidly adopt new technologies. For German manufacturers, the challenge therefore extends beyond Chinese subsidies to a broader cost and competitiveness gap.

German companies are increasingly adapting their strategies rather than attempting to compete solely through domestic production. Forklift maker Jungheinrich, for example, has partnered with China's EP Equipment to combine lower-cost Chinese manufacturing with German engineering, branding and global distribution. The resulting AntOn range targets the cheaper "mid-tech" segment, with some models selling for around half the price of traditional Jungheinrich machinery. Volkswagen is pursuing a different version of the same strategy through its "in China, for China" model, developing vehicles locally for Chinese consumers. Both approaches illustrate how German companies are increasingly integrating Chinese production and innovation capabilities into their business models to remain competitive.

The policy response is also becoming increasingly important. Berlin is seeking to improve domestic competitiveness through infrastructure investment, tax measures and reduced bureaucracy, but these reforms do not directly address the impact of Chinese excess capacity on European manufacturers. Some economists therefore argue that a more substantial response will have to come from EU trade policy, with the European Commission already imposing targeted tariffs on selected Chinese products, including electric vehicles. The challenge for Germany and the EU is increasingly to balance the benefits of economic integration with China against the need to preserve domestic industrial capacity as Chinese competition intensifies.