ECOPERSPECTIVES

2nd Quarter 2025
April 2025

ADVANCED ECONOMIES

2025

"As a result of the tariff shock imposed by Donald Trump, the US economy is expected to slow down significantly. It should avoid recession, under the optimistic assumption that the trade war will de-escalate. Buoyed by European rearmament efforts and the German investment plan, growth in the eurozone is expected to remain higher in 2026 than in 2025 and to outpace US growth."

ECONOMIC RESEARCH

BNP PARIBAS

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TABLE OF CONTENT

US TARIFFS: THE BIG SHAKE-UP

One direct and immediate consequence of Donald Trump's announcements on 2 April on tariffs, which are reciprocal and reduced in name only, was to accentuate the downside risks to the US economy and to seriously shake up the financial markets. According to our forecasts, the US economy will slow sharply but avoid recession, on the optimistic assumption of a de-escalation in the trade war and an easing of uncertainty. Our US scenario looks like stagflation, as we expect inflation to rise sharply at the same time. Between two evils, the Fed should opt for the monetary *status quo*, extending it until the end of this year. The outlook for growth in Europe, which had received a boost from planned rearmament efforts and the German investment plan, is also down by a few tenths of a percentage point. However, in the Eurozone, growth in 2026 (1.3% as an annual average) should remain higher than in 2025 (1%) and higher than US growth (1.1% in 2026 after 1.3% in 2025). While growth rates are expected to converge on both sides of the Atlantic, inflation and monetary policy trajectories are forecast to diverge: inflation in the Eurozone is likely to remain contained at around 2%, leaving the way clear for the ECB to make two other rate cuts in June and July after the one in April.

BEFORE AND AFTER

There could clearly be a before and an after to 2 April and the shock caused by Donald Trump's announcements, featuring a massive and widespread increase (albeit differentiated by country) in US tariffs, far greater than anyone could have imagined. Since then, there have been numerous retractions and reversals, except in relation to China, with which the escalation has continued (see our Tariff tracker for a summary). This US neo-protectionist shock is a major turning point, although it remains difficult at this stage to imagine all the consequences, both in the short and long term. There is no doubt that they will be negative, primarily for the United States[1]; the uncertainty concerns the extent of the repercussions and the reconfiguration of world trade and the international financial system. And even if time is given for negotiations and they lead to agreements and the lifting or lowering of tariffs, the context remains extremely uncertain, with major and lasting negative effects on economic activity.

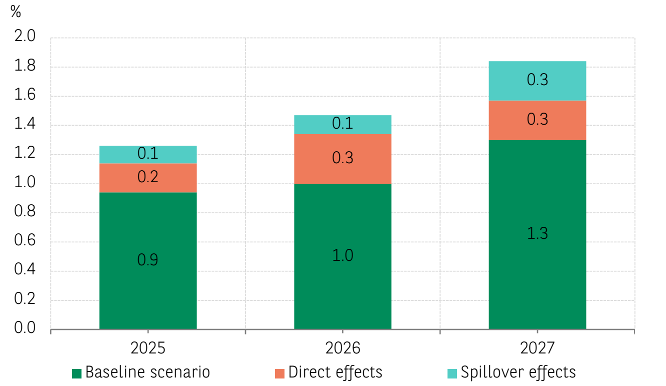
BEFORE 2 APRIL, AN INITIAL CHANGE OF PERSPECTIVE, FAVOURABLE TO EUROPE

Let's rewind a bit. Prior to the announcements on 2 April, we revised our growth forecasts in March. For the United States, we lowered them for 2025 by 0.5 percentage points (from 2.3% to 1.8% as an annual average) and left the 2026 forecast unchanged (1.3%). For the Eurozone, we raised our growth forecast by 0.4 pp for 2025 (from 0.9% to 1.3%) and by 0.5 pp for 2026 (from 1% to 1.5%). Indeed, the economic horizon had somewhat brightened, in both senses of the word:

• On the one hand, despite everything, there was a little more clarity about the nature, scale and timing of the new US administration's tariff measures, but the economic outlook for the United States was clouded at the same time.

• On the other hand, the economic horizon was looking a little brighter for Europe, thanks to a series of announcements from Germany and the European Commission marking a major change in terms of (a larger) support for the economy and fuelling hopes of a tangible revival of the EU (see chart 1 and, for more details, the articles on Germany and the Eurozone in this issue, as well as the various sections on the budgetary challenge of rearmament in each country's fact sheet).

EUROZONE GROWTH FORECASTS: IMPACT OF DEFENCE SPENDING INCREASES AND GERMANY'S INFRASTRUCTURE PLAN



SOURCE: BNP PARIBAS CALCULATIONS

CHART 1

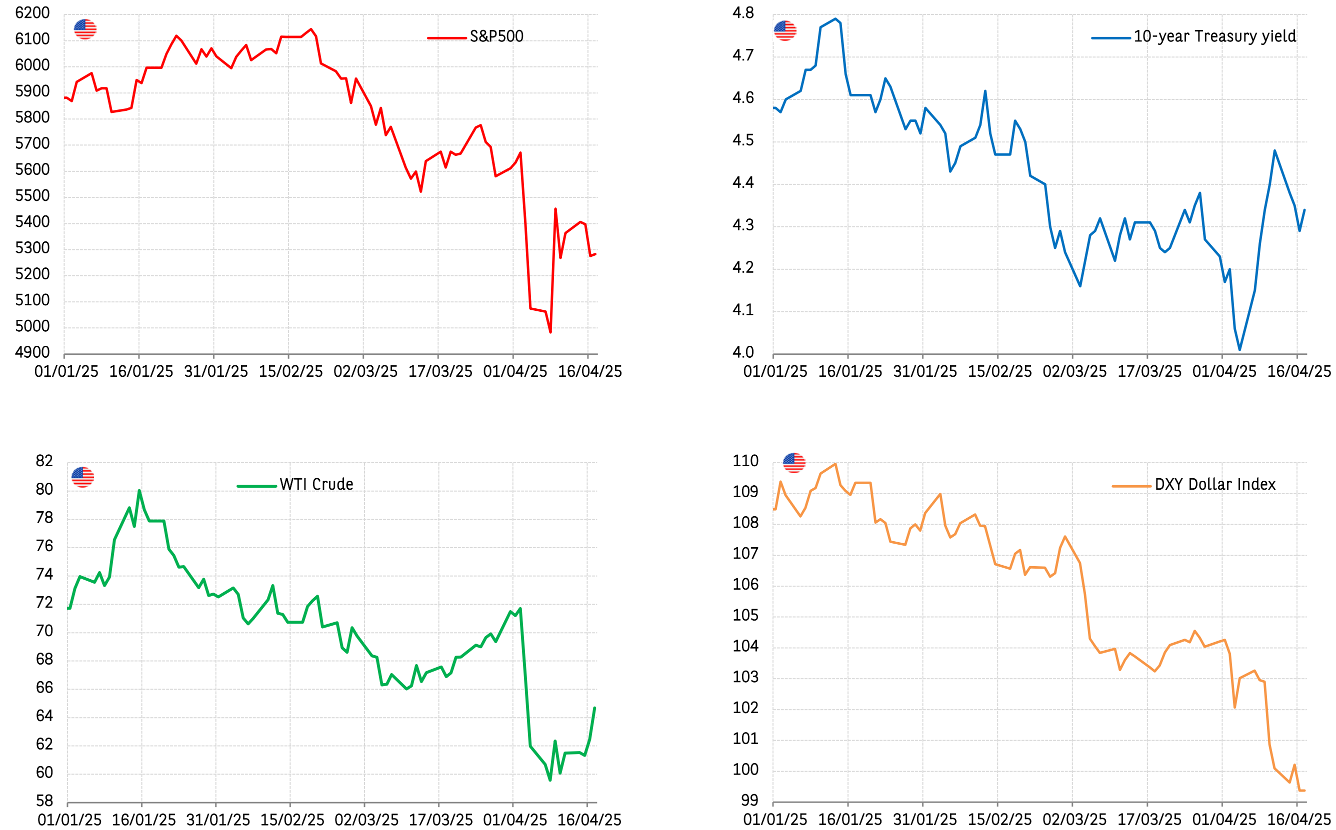
The emergence of more negative economic signals in the United States and more positive ones in the Eurozone supported this change in outlook, which was also reflected in a remarkable turnaround in the financial markets.[2]

EUROPEAN RESPONSIVENESS IS A POSITIVE THING, BUT ALSO A SOURCE OF COMPLICATIONS

The German budgetary turnaround and the European rearmament effort, while welcome, also raise new questions and complications[3]. Managing to reconcile the various imperatives of the moment (discretionary increases in public spending on defence and energy transition, and mechanical increases in spending on an ageing population), in an environment of higher interest rates, with very high public debt-to-GDP ratios in many countries and limited growth potential in most of the same countries and in many others, is like squaring a circle.

1 See EcoWeek editorial by Isabelle Mateos y Lago, «Reciprocal» tariffs are bad for world growth and worse for the US, 7 April 2025.
2 See EcoWeek editorial by Isabelle Mateos y Lago, How the 2025 Davos consensus was upended in two months, and what comes next, 17 March 2025.
3 See EcoWeek editorial by Jean-Luc Proutat, Europe's major investment projects: an increasingly complex financial equation, 31 March 2025.

THE BESSENT DASHBOARD



UPDATED ON 18 APRIL 2025

The bond markets are keeping a close eye on things, and their pressure, which for the time being is limited, is a clear incentive not to relax budgetary consolidation efforts in those countries with the biggest imbalances and the least room for manoeuvre (for example, the United Kingdom, where 10-year bond yields rebounded sharply between 4 and 9 April, almost as much as US yields, while German, French and Italian yields showed little change over the same, short, period).

However difficult it may be, not reducing primary deficits (where they are currently the largest) is not a feasible option, as this would require a very negative r-g differential to stabilise public debt ratios (all the more so as the current primary deficit is far from the stabilising level), far from what can be achieved in the current state of affairs. As for the option of allowing debt ratios to drift further, this can only be envisaged in a contained manner and over a short period of time, given the current nervousness of the markets and the increased risk of tensions on interest rates[4]. As the United States showed in the week of 7 April, it too is not immune to an episode of stress on interest rates, caught up in the scale of its fiscal imbalances at a time when the US protectionist shift, and the chaotic and ineffective conduct of policy are leading to fears of a loss of confidence among foreign investors.

AFTER 2 APRIL, A NEW TIPPING POINT AND A LEAP INTO THE UNKNOWN

One direct and immediate consequence of the 2 April announcements was to accentuate the downside risks to the US economy and seriously shake up the financial markets. US Treasury Secretary Scott Bessent, who wants to see lower US long-term interest rates, a lower dollar and lower oil prices, has certainly been granted his wish, but with two notable drawbacks: (much) lower stock market indices too and a sharp rise in US long-term interest rates that followed a few days after "Liberation Day" (see charts 2a-2d). The reversals on 9 April and the days thereafter partially halted the damage. But there is still a great deal of uncertainty about the future course of the trade war, and consequent fears about US and world growth remain high[5]. The risk of a recession in the United States has suddenly reappeared. We give it a probability of 25%.

At this stage, our central scenario is that of a marked slowdown in US growth (to 0.5% y/y in Q4 2025 and 1.3% as an annual average, then to 1.1% in 2026, i.e. respectively 0.5 and 0.2 pp lower than our previous forecast of 19 March; see the article on the United States in this issue for a more detailed presentation of our analysis of the situation and outlook).

4 In the European Commission's latest report on debt sustainability (Debt Sustainability Monitor 2024, 17 March 2025), only two countries are identified as facing a high short-term budgetary risk (Romania and Slovakia). Medium-term risk(with unchanged fiscal policy) are considered high for 11 countries (Belgium, Greece, Spain, France, Italy, Hungary, Austria, Poland, Romania, Slovakia and Finland). In terms of long-term risks (again assuming no change in fiscal policy), four countries are exposed to a high risk (Belgium, Luxembourg, Malta and Slovakia).
5 The WTO's mid-April forecast of a fall (even a slight one of -0.2%) in world trade in 2025 is a clear illustration of these fears (WTO | 2025 News items - Temporary tariff pause mitigates trade contraction, but strong downside risks persist, 16 April 2025).

The US economy would avoid recession under the optimistic assumption of a tariff[6] de-escalation and reduced uncertainty. Otherwise, recession would become the most likely scenario. If, on the other hand, the de-escalation were to go faster and further than anticipated, this would obviously be a plus for growth.

Nor does the accentuation of the post-Liberation Day tariff shock leave Europe's growth prospects unscathed (see the articles on the euro zone, Germany, France, Italy, Spain and Belgium in this issue for a more detailed presentation of our analysis of the situation and outlook). It has taken about half of the extra growth in the Eurozone generated by rearmament and investment efforts and the knock-on effects between countries. We are now forecasting annual average growth of 1.1% in 2025 and 1.3% in 2026 (-0.2/-0.3 pp below our previous forecast of 26 March). However, despite the US slowdown, a growth pick-up is still expected in the Eurozone between 2025 and 2026, thanks to the ramp-up of the German infrastructure plan and defence spending across Europe. Our scenario, which was already characterised by a noteworthy convergence in growth rates between the United States and the Eurozone, now also has the distinctive feature of forecasting growth in the Eurozone higher than in the United States in 2026. This is not insignificant and is more the exception than the rule.

In the United Kingdom, average annual growth is expected to change little (-0.1 pp, to 1% in 2025 and 0.8% in 2026), with the country being less penalised than its European neighbours (see the article on the United Kingdom in this issue for a more detailed presentation of our analysis of the situation and outlook). In Japan, the expected rebound in growth in 2025, which is already modest and comes between two years of barely positive growth (0.1% in 2024, 0.2% in 2026), has also been revised downwards (to 0.7% from 1% previously) in view of the country's high exposure to the United States (see the article on Japan in this issue for a more detailed presentation of our analysis of the situation and outlook).

INFLATION AND MONETARY POLICY: DIVERGING TRAJECTORIES CONFIRMED

The current outlook for inflation and monetary policy on both sides of the Atlantic reinforces the anticipated divergence in trajectories outlined in our previous issue of Eco Perspectives[7]. Admittedly, the latest data available, for March, shows that disinflation is continuing in the Eurozone, the United Kingdom and the United States. But the risk of higher inflation on the other side of the Atlantic, caused by the substantial increase in US tariffs, remains very real.

According to our forecasts, US inflation will visibly start to pick up from Q3 2025 onwards, rising slightly above 3% y/y and peaking at 4% in Q2 2026. Average annual inflation is expected to be 3.1% in 2025 and 3.7% in 2026. This increase is not the result of a self-sustaining inflationary loop, as in 2021-2023. From this point of view, it is of a transitory nature (assuming the Fed does not prematurely cut rates, see below). An even sharper slowdown in the US economy, or even a recession, could moderate this inflation bump. Could it even disappear? It's hard to say, and no more acceptable as the price to be paid for the trade war (inflation or recession? bearing in mind that stagflation, a combination of the two, remains a possible scenario). On the other hand, there is one favourable development at the moment, which will drive down US inflation, but not only: the fall in oil prices.

Given the risk of inflation expectations in the United States becoming unanchored, we are maintaining our central scenario of a prolonged monetary status quo by the Fed in 2025. We continue to believe that, given this de-anchoring risk and based on our inflation and growth forecasts, the Fed cannot ignore the rise in the former and cut rates in response to the slowdown in the latter. We see the upside risks to inflation and the downside risks to growth as cancelling each other out (and not the latter as more important than the former, as suggested by the rate cuts priced by the markets). In 2026, on the other hand, the Fed should be in a position to resume rate cuts (-100bp), as the inflation/growth trade-off shifts in favour of the latter.

In the Eurozone, we see the balance continuing to tip towards further disinflation and a safe return to the target. In terms of domestic components, the momentum is disinflationary, while in terms of non-domestic components, inflation imported from the United States and the additional costs arising from friction and the reorganisation of production chains should be offset by the strengthening of the EUR/USD, the absence of any major retaliatory measures and disinflation, or even deflation, imported from China. In 2026, inflation is even expected to (slightly) fall below the 2% target. Core inflation, however, would remain above this mark, with a slight upward trend in the second half of the year, fuelled by the German fiscal stimulus and European rearmament efforts.

For the ECB, the conditions remain ripe for further rate cuts in the short term. We continue to expect another 25 bp cut in June, following the one in April, and followed by another one in July given the downside risks to growth. In 2026, on the other hand, in the second half of the year, the slightly more favourable growth picture combined with the inflationary nature of the rearmament effort is likely to lead the ECB to raise its rates (+50 bp according to our forecasts), further accentuating the decoupling with the Fed. The BoE has less leeway than the ECB on the inflation front (higher and more persistent in the United Kingdom than in the Eurozone) while facing a difficult economic situation. According to our forecasts, this would lead the BoE to continue its easing at the slow pace of one cut per quarter, spreading it out until Q1 2026. The BoJ, which has stood out by cautiously raising its key rates, is set to move closer to its peers by putting this adjustment on hold for the rest of the year. A status quo like the Fed, but for different reasons: in Japan, concerns about growth are predominant. Once these concerns have passed, the BoJ is likely to resume its cautious rate hikes in 2026 (+25 bp in Q1 and +25 bp in Q3).

Article completed on 17 April 2025

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6 Average effective tariff on US imports lowered to 16% from 27.3% based on announcements on 10 April.
7 Eco Perspectives - Advanced Economies | 1st Quarter 2025 - Economic Studies - BNP Paribas, 17 December 2024

POLICY CHANGES HARMFUL FOR THE ECONOMY

After the outperformance of 2023-2024, US growth is expected to slow sharply under the impact of the uncertainty and tariff shocks triggered by the new administration. Recession concerns are returning into the spotlight. Meanwhile, inflation is projected to rebound sharply under the impact of additional tariffs. In this context, the Fed should refrain from easing monetary policy in 2025.

GROWTH: A GLOOMY AFTERMATH?

The United States experienced another year of dynamic growth in 2024 (+2.8% annual average, after +2.9% in 2023) – well above its long-term pace (+1.8% according to the Fed). Growth was largely underpinned by household consumption, strong productivity gains and the supply-side rebalancing of the labour market enabled by immigration.

Growth is expected to slow significantly in 2025. The tariff shock (*see below*) will weigh on activity: its inflationary effect is negative for household demand, which is also exposed to the downturn in the financial markets (wealth effect). The general climate of uncertainty and financial volatility is fuelling the risk of a significant recession, which we estimate at 25%, especially by weighing on investment and hiring decisions. In addition, a possible tightening of financial conditions as a result of a sustained bond sell-off could represent a serious drag on activity. Finally, while the scale of the downturn is uncertain, as it mainly hinges on the landing point for extra tariffs, our central scenario projects a marked slowdown in growth to +0.5% y/y in Q4 2025 (compared with +2.5% in Q4 2024).

For the time being, the negative signs are mainly apparent in survey data. Household sentiment has been deteriorating sharply since November 2024. Small businesses have been reporting substantial uncertainty according to the NFIB survey, while CEO confidence, as measured by the CE Group, fell to its lowest level since 2012 in March 2025.

TRUMP VS. THE TRADE DEFICIT

The US trade deficit reached USD -1,202 bn in 2024 (4.1% of GDP), an all-time record in absolute terms. This situation underlies D. Trump's tariff offensive, which culminated in the announcement, on 2 April, of 'reciprocal tariff reductions' (ranging from 10% to 50% depending on the bilateral trade balance). On 9 April, these were suspended (for 90 days) and replaced by a harmonised 10% tariff following the ensuing market backlash in the wake of the 2 April announcements (plunges in the US dollar, Treasuries and US equities). The tariff movement is part of a bid to reduce the trade deficit, re-industrialise the economy and increase federal revenue. At the same time, it is intended as a negotiating weapon aimed at reshaping global economic relations to the greater advantage of the United States.

As of 10 April 2025, the tariff offensive has been focused on China (extra-tariffs starting from 10% in February and amounting to 145% in April following further steps and Chinese retaliation), Mexico (25%) and Canada (ditto, excluding energy: 10%), excluding goods covered by the USMCA free trade agreement, which are exempt. At sectoral level, 25% tariffs were introduced on steel and aluminium (March 12), followed by motor vehicles (April 3, prior to car parts on May 3). On the other hand, semiconductors and pharmaceuticals are exempt from additional tariffs. Eventually, we expect to see a moderate de-escalation in tariffs, which would not prevent the new levels from settling significantly above pre-Trump 2.0 levels.

We also expect the USD to weaken further against the EUR as the growth differential between the US and the eurozone narrows (and European long-term interest rates rise). In 2026, the resumption of monetary easing by the Fed, combined with a rise in key ECB interest rates in H2, would further strengthen the EUR/USD.

GROWTH AND INFLATION

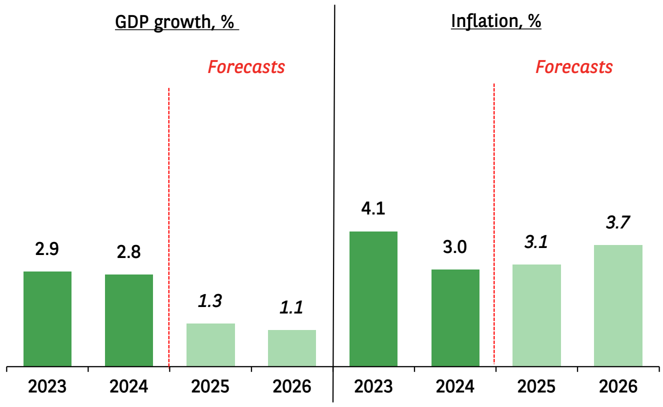

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LABOUR MARKET: SO FAR, SO GOOD?

Nonfarm payrolls growth was maintained at a monthly pace of +150k - +170k since H2 2024. This is substantially above the equilibrium level, which the Fed's officials estimate at below 100k. At the same time, layoffs were not soaring, and the unemployment rate (4.2% in March 2025) remained below neutral (4.3% according to the Congressional Budget Office, CBO). While households have been gloomy about the unemployment outlook (51% expect more unemployment one year ahead, according to the University of Michigan, the highest level since April 2020), we expect the unemployment rate to rise to 4.6% by the end of 2025. However, the increased recession risk mechanically implies greater downside risks to employment. In addition, the action undertaken by the DOGE (Department of Government Efficiency) is likely to affect federal employment (1.9% of nonfarm payrolls in 2023) and adjacent employment (5.4% in the same year).

INFLATION: IMMINENT TAKE-OFF

Disinflation has been stalling lately. In Q1 2025, CPI headline and core inflation stood at +2.7% and +3.1% y/y, compared with +2.7% and +3.3% in Q3 2024, i.e. at the start of the rate cuts. We anticipate a sharp pick-up in inflation as a consequence of the Trump administration's trade and immigration policies. The main driver should be the rise in the price of goods, which will be directly affected by tariffs. Core inflation is expected to increase to +4.4% y/y in Q2 2026. The first signs of the upturn were visible in the ISM Manufacturing prices paid sub-component, a leading 1-year indicator of underlying inflation, which reached its highest level since 2022 in March.

Household inflation expectations have been soaring since Trump's election. According to the University of Michigan survey, they jumped from +2.7% to +5.0% over 1 year and from +3.0% to +4.1% over 5-10 years (the highest since 1991) between October 2024 and March 2025. At the same time, market expectations for the medium to long term remain well anchored (5Y5Y inflation swap below 2.2% in March), cf. *Chart 2*.

DEBT CEILING LOOMING

The next fiscal challenges relate to the extension and expansion of tax cuts under the Tax Cuts and Jobs Act (TCJA, the signature fiscal law of Trump 1), whose non-permanent provisions expire at the end of the year. In early April, the Senate voted to pass a budget resolution along these lines, which would increase the deficit by USD 5.8 trn over the 2026-2034 period (according to the Committee for a Responsible Budget), if adopted. The issue of debt sustainability (*see box*) would then become even more acute. The debt ceiling question will also quickly come to the fore. The CBO estimates that the 'X-date', i.e. the day after which the Treasury will no longer be able to honour its obligations to its creditors, will occur in August or September 2025 if the debt ceiling (USD 36.1 trillion) is not raised.

EXTENDED PAUSE FOR THE FED

The FOMC halted the easing cycle in 2025, holding the Fed Funds Target Range steady at +4.25% - +4.5% on two occasions, as employment concerns eased, and disinflation stalled. The Committee's position is now to await the 'net effect' (J. Powell's terminology) of the Trump administration's policy decisions – which we believe to be negative for growth overall and upbeat for inflation (due to tariffs and immigration restrictions) – before making any further adjustments. In this context, we expect the policy rate to remain stable throughout 2025. Moreover, despite recession worries, we believe that the prospect of a 'pre-emptive' cut is unrealistic – and risky – given that inflation is persistent and expected to rise. The easing would resume in 2026 (-125bp) in the face of rising unemployment and the start of a drop in inflation. Finally, beyond rate decisions alone, the Fed faces a major challenge in preserving its independence.

HOUSEHOLD' INFLATION EXPECTATIONS SOARING SINCE TRUMP'S WIN

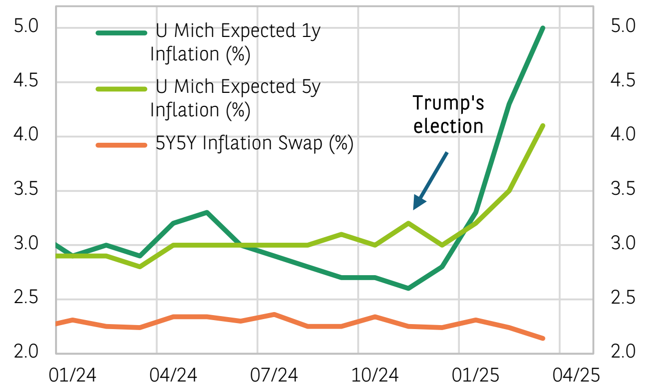

CHART 2

SOURCE: FRED (FEDERAL RESERVE ECONOMIC DATA), UNIVERSITY OF MICHIGAN, BNP PARIBAS

Article completed on 11 April March 2025

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Fiscal Metrics: Thanks to the 'Exorbitant Privilege'

The CBO projects that the US federal deficit, which has been negative since 2001, will reach 6.2% of GDP in 2025, before averaging 5.8% between 2026 and 2035. These levels, unprecedented in the absence of war or recession, would contribute to raising the debt/GDP ratio to an all-time high in 2029. Furthermore, these projections are based on the current state of legislation. For example, they forecast a 1.0pp reduction in the deficit by 2027, due to the end of the TCJA's permanent provisions. However, the Trump/Bessent tandem's objective of extending these provisions poses an upward risk to the deficit (see 'Debt Ceiling Looming'). As for the possibility that tariff revenues or spending cuts (via DOGE actions or a vote in Congress) will help to reduce the deficit, this seems unrealistic given the likely negative effect of these measures on demand. In addition, the US is already facing a significant increase in interest charges, which will exceed discretionary spending (excluding defence) and military spending from this year onwards.

Such fiscal metrics would give rise to legitimate concerns about debt sustainability for any other sovereign. The United States escapes these considerations as the issuer of the USD, the world's reserve currency, and Treasuries, which play a predominant role in financial markets. Nonetheless, the possible implementation of heterodox policies, which cannot be entirely ruled out, aimed at challenging the independence of the Fed and/or depreciating the USD by forcing currency holders to exchange it for perpetual bonds (as mentioned by Stephen Miran, Chairman of the Council of Economic Advisors), would undermine the privileged status of the greenback.

EUROZONE

A REBOUND IN ACTIVITY THREATENED BY TARIFFS

The economic scenario for the Eurozone remains dependent on the evolution of the trade conflict and implementation of possible US reciprocal tariffs of 20%. The increase in defence spending will nevertheless support GDP. Against this backdrop, and although slightly positive signals are emerging in the industrial sector, structural difficulties in export-oriented sectors such as chemicals, steel and automotive could continue. Faced with American protectionism, some levers do exist - deepening of the domestic market, increase in investments and strengthening of external trade partnerships. As disinflation continues, and given the downside risks to growth, two ECB rate cuts of 25 bps are still expected by July.

GROWING IMPACT OF INVESTMENT PROGRAMMES

The floor rate of 10% US tariffs, in force for 90 days from 9 April 2025, will be likely to reduce activity in the Eurozone by 0.1 percentage points (pp) of GDP, or even double in the event of a reciprocal rate of 20%[1]. The trade war between the US and China, and the resulting slowdown in demand for these economies, will also weigh on European growth in the short term, in addition to the effect of extremely high uncertainty. The increase in defence spending and the German infrastructure plan, on the other hand, are expected to increasingly support growth in the Eurozone (+0.3 percentage points (pp) from 2025 and +0.5 pp in 2027[2], see *chart 1* of the Editorial).

This rise in activity will be distributed as follows. Countries with sustained GDP growth (Spain, Portugal) are less economically linked to Germany. They will therefore benefit less from the spillover effects of German plans, and do not plan to increase their military spending very significantly. Moreover, fiscal impulses will be negligible in France and Italy, due to constrained budgetary situations. The fiscal impulse will be strongest in Germany, leading to a rebound in its growth and that of those countries most connected to Germany (Central Europe, neighbouring open small economies).

LABOUR MARKET: IN GOOD SHAPE

The increase in investments in the Eurozone will help the labour market better absorb the shock from the increase in US tariffs. Despite weak economic growth, the unemployment rate in the Eurozone remained at a historic low (6.1% in February), while the latest survey data remained quite positive[3]. This dynamic is supported in particular by an increase in the proportion of jobs in the public sector (defence, public administration, education) and health. These public-sector jobs now account for more than a quarter of employment in the Eurozone, a record outside the Covid period. In the short term, this will limit the extent of job losses if there had to be losses as a result of the US tariff shock. However, this is putting a strain on public expenditures in some Member States.

INFLATION: NO REBOUND EXPECTED IN 2025

The 2% inflation target is expected to be reached at the beginning of the second half of 2025, fuelled by downward pressure on energy prices. Further disinflation is likely in services, with the ECB wage tracker supporting the scenario of a wage slowdown in 2025. The scale of the European Union's trade response to the increase in US tariffs will impact imported inflation. However, our central scenario does not include any significant effects at this stage. Several factors are likely to offset the initial inflationary shock, including a rerouting of a proportion of Asian exports to Europe (Chinese companies' sale prices are lower than those of their competitors). The moderate strengthening of the EUR-USD, which we anticipate in 2025, should only have a marginal effect on inflation, with the pass-through to consumer prices excluding energy being low on average.[4]

GROWTH AND INFLATION

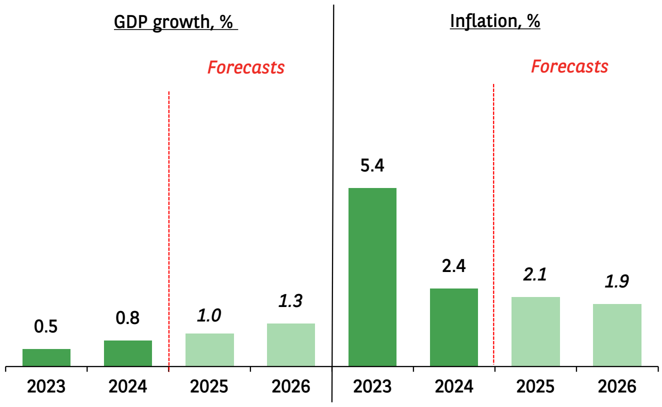

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

MONETARY POLICY: FROM ONE INSTRUMENT TO ANOTHER?

The path seems clear for the ECB to make two further rate cuts in June and July, bringing the deposit rate to 1.75%, i.e. the low end of our neutral rate estimate range (1.5-2.5%). Eventually, the ECB wants to introduce a "structural" portfolio of securities to preserve sufficient liquidity for the banking system. Since the start of quantitative tightening in March 2023, the proportion of sovereign securities held by the Eurosystem has fallen from 41% to 33% (March 2025), a figure higher than before Covid and implementation of the PEPP (Pandemic Emergency Purchase Programme). Since January 2025, the ECB has not reinvested PEPP assets at maturity.

1 The share of exports of goods from the Eurozone to the US amounted to 3.2% of GDP in 2024. Assuming an import price elasticity of 0.3, a 10% increase in tariffs would lead to a drop in exports of 0.1 points of GDP.
2 We estimate the impact of an increase in defence spending in all Eurozone countries, as well as the impact of infrastructure spending in Germany on growth, through a direct effect (consequences in terms of consumption and public investment) and an indirect effect mainly linked to an increase in intra-zone trade.
3 The composite employment PMI was again above the expansion zone (50.1) in March.
4 See for example E. Ortega, C. Osbat, Exchange rate pass-through in the euro area and EU countries, April 2020.

FISCAL POLICY: CONSOLIDATION DIFFICULT TO PURSUE IN 2025

On average, the budget deficit of Eurozone countries is expected to have approached the threshold of 3% of GDP in 2024, which, against a backdrop of rising interest rates, is remarkable. However, performance differs between countries at the epicentre of the sovereign debt crisis (Italy, Spain), which are continuing to consolidate their public accounts, and other countries, such as France, which have less favourable trajectories. Conversely, countries with low debt (Germany, the Netherlands) should move towards a slightly larger budget deficit, without this jeopardising the sustainability of their public finances. Rising defence spending and the likely need to support industries hit by the US protectionist offensive, add to the structural challenges of the Eurozone (i.e. ecological transition and ageing population). This will imply increased financing needs (see our focus[5]). However, the fiscal consolidation post-European sovereign crisis of 2010-2012 offers some room for manoeuvre, at least to the monetary block as a whole.

DEEPENING THE COMMON MARKET, A NECESSARY AND DESIRED OBJECTIVE

The European Union remains the most integrated common market in the world. The deepening of the internal market will be one of the main levers for growth in the face of rising protectionism and fragmentation of the global economy. The FMI estimates that restrictions on intra-EU trade in goods and services are equivalent to tariffs of 45% and 110%, respectively[6]. Through its multiple initiatives, which are mainly based on the recommendations of the Draghi report, the European Commission intends to strengthen the common market in the economic sector (easing of competition policies, European preference), the financial sector (strengthening securitisation and the capital markets union), and the energy sector.

SUBDUED APPRECIATION OF THE EURO AGAINST THE US DOLLAR

The anticipated tightening of growth rates between the Eurozone and the US should, in our view, lead to an appreciation of the EUR/USD in 2025, even though this could be limited by a more restrictive US Federal Reserve monetary policy.

EUROZONE: 10-YEAR GOVERNMENT BOND YIELDS

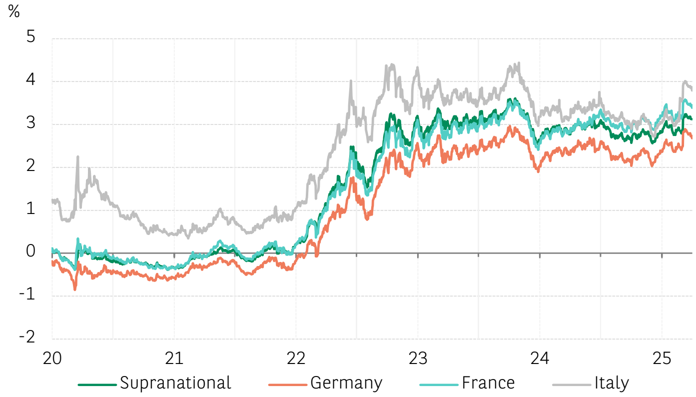

CHART 2

SOURCE: BLOOMBERG

The Eurozone current account surplus also remains significant, supported by the sharp rise in services exports (+8.2% in value in 2024). Exports of information/communication technology and "other professional services"[7] each grew by more than 10% in 2024[8]. These two sectors now account for nearly half of European services exports, and are expected to continue to grow with the increasing digitalisation of activities.

Article completed on 18 April 2025

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5 Also read J-L Proutat Europe's major investment projects: an increasingly complex financial equation, BNP Paribas Ecoweek 31 March 2025.
6 See FMI Regional Economic Outlook: Europe, October 2024, page 19.
7 This category mainly includes research-development, management consulting and engineering architecture services.
8 Source: Eurostat.

What are the solutions to respond to increasing financing needs?

The increased financing needs of European states, against a backdrop of high bond yields, should lead to an increase in their interest costs. According to our calculations, an additional and permanent increase of 100 basis points in sovereign rates in the Eurozone (compared to our central scenario) would increase debt services of Eurozone countries by 0.2 pp of GDP in 2025 and 0.4 pp in 2026 on average (with greater effects in France, Italy, Spain and Finland). The process of extending maturities, employed during the pre-Covid period (and which increased the average maturity of exchangeable securities on the markets to 8 years and 3 months in February 2025, compared to 6 years and 5 months ten years before), makes it possible to contain, in the short term, the effects of the rise in long-term bond yieldson the debt burden.

The ReArm Europe Plan, which includes EUR 150 billion in European loans financed by securities issues on the markets, could limit the rise in the apparent interest rate. These supranational debt issues, whose yields are close to those of the German Bund (see chart), offer almost all Member States more favourable financing conditions than those that they would obtain individually. The idea of a new common European loan is also making its way into some countries, including France.

GERMANY

GERMANY'S ECONOMY HANGS ON THE FORTHCOMING INVESTMENT PLAN

Against a backdrop of heightened international competition and trade tensions linked to the United States' new tariff policy, the German economy is seeing its traditional growth drivers challenged. In the short term, the increase in customs duties imposed by the Trump administration will weigh on exports and heighten economic uncertainty. The future German government is preparing a series of far-reaching reforms to deal with this. These include an ambitious investment plan, as well as focusing on infrastructure and defence, which could trigger a structural transformation of the economy. However, its effects will only really be felt in the medium term. Furthermore, the European rearmament effort offers Germany the opportunity to overhaul its industry by leveraging its strategic sectors.

FACED WITH EXTERNAL SHOCKS, GERMANY IS REFORMING ITS ECONOMY

The stagnation of German GDP between the end of 2021 and the end of 2024 is mainly due to the decline in exports, which have long been a driving force behind the country's growth. They fell by 4.2% in volume terms between Q4 2022 and Q4 2024, reflecting a loss of export market share owing to the rise of Asian competitors in several sectors (automotive, chemicals, electrical equipment), and a loss of industrial competitiveness (high energy costs).

The new US tariff policy is likely to exacerbate existing pressures. The United States is a core market for Germany, accounting for 10.4% of German exports in 2024. An increase in customs duties (+25% on imported vehicles, +20% on goods from the EU1) could lead to a fall in demand and/or a squeeze on margins, depending on whether or not the additional cost is passed on to end consumers. The German economy is also exposed to the indirect effects of US tariff hikes on Germany's trading partners. The Governor of the Bundesbank, Joachim Nagel, has estimated that the US tariff policy could reduce German GDP by 1.5 percentage points by 2027.

The investment plan launched by the coalition formed after the February elections could mitigate the effects of this shock, provided it is implemented quickly and in a targeted manner. This plan is based on two pillars: i/ EUR 500 bn of public investment in infrastructure over twelve years (including 100 bn allocated to the Länder and 100 bn for the low-carbon transition), ii/ the exclusion from Germany's debt brake rule of all military spending exceeding 1% of GDP (including aid to Ukraine). We expect growth of +0.4% in 2025, then +1% in 2026. The effects of this plan should be felt mostly in the medium term, by strengthening growth potential.

THE LABOUR MARKET UNDERGOING TRANSFORMATION

The employment outlook in Germany is mixed, at a time when the labour market is already showing signs of strain. Between the beginning of 2023 and February 2025, the unemployment rate rose from 2.9% to 3.5%. In 2024, 26,000 jobs were lost, mainly in industry and construction, while underemployment has been rising since 2022 (+17% between May 2022 and September 2024 according to the latest available data).

Against this backdrop, the new US customs barriers could exacerbate the difficulties faced by certain export sectors, such as the automotive and chemicals industries, which are highly dependent on the North American market.

GROWTH AND INFLATION

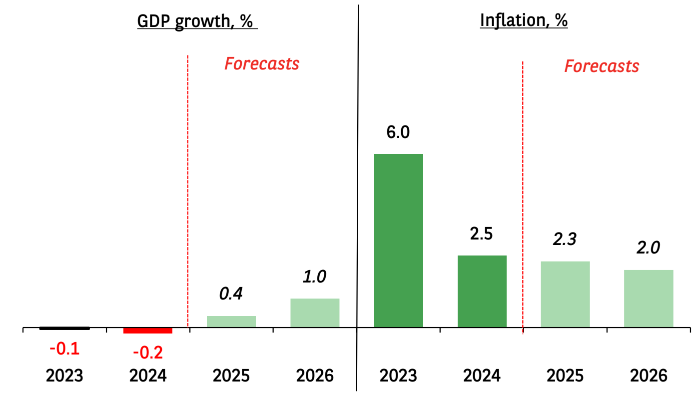

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The new public investment plan should, however, bolster the job market. As part of the rearmament programme, demand for labour is expected to focus on construction, industry, defence and related services. Certain sectors, such as metallurgy and electrical equipment, could also benefit by redirecting their production towards defence and domestic market needs. In the medium term, investment in public infrastructure and the low-carbon transition could help move the economy upmarket and boost skilled employment. This would be the case for renewable energies, digital infrastructures and R&D. However, this dynamic could in turn rekindle recruitment difficulties in certain sectors, and accentuate wage pressures.

Negotiated wages have continued their recent rise, albeit at a slower pace (+5.8% y/y vs. +8.9% y/y in Q3). The new coalition has also announced an increase in the minimum hourly wage (from the current EUR 12.82 to EUR 15).

INFLATIONARY PRESSURES PERSIST

Harmonised inflation stands at 2.3% y/y in March 2025 and underlying inflation at 2.6%, down from February (2.6% and 2.7% respectively), thanks to the continued fall in energy prices and the slowdown in inflation in services, which nevertheless remains sustained (+3.5% in March). The pace of wage growth is also tending to moderate.

We expect inflation to stabilise over the next few months, averaging 2.3% annually in 2025 and rising to 2.1% in 2026. Such a pace could be considered high, and could therefore weigh on household confidence and hamper the recovery in consumption.

1 Customs duties on imported vehicles have been in force since 2 April. The application of reciprocal customs duties on goods imported from the EU has been postponed until 8 July, with an interim rate of 10% applying in the meantime.

In addition, the implementation of the investment plan in Germany, combined with the increase in defence spending at European level, could add to the pressure on supply. Bottlenecks in supply chains could exert further inflationary pressure. Furthermore, there are inflationary risks linked to the increase in US customs duties, especially if the European Union decides to retaliate.

TOWARDS AN END TO EXTREME BUDGETARY RIGOUR AND MORE STRUCTURAL REFORMS

The increase in public spending is likely to be financed mainly through borrowing. Budgetary savings are envisaged (reduction of bureaucracy, reform of social benefits), but their economic impact will not be immediate.

This budgetary stance will lead to an increase in the deficit and debt. The risks remain under control: with public debt at 62.9% of GDP in 2024, Germany still has considerable room for manoeuvre. On the other hand, this exposes fiscal sustainability to a higher interest rate environment. The public deficit is expected to fall to -2.9% of GDP in 2025, then to -3.5% in 2026, with debt reaching 64.6% of GDP by 2026 and 70% by 2030. Ten-year yields, which jumped by 40 bp the day after the spending plan was announced, are likely to remain higher for the long term.

On the reform front, in addition to the investment plan, Germany's new coalition plans to review business and household taxation, reduce electricity prices, make the labour market more flexible, overhaul welfare benefits and tighten immigration policy. The government is due to take office in early May, marking the operational launch of this programme.

EUROPEAN REARMAMENT TO THE RESCUE OF FOREIGN TRADE?

Germany's current account remains in surplus (+EUR 230 bn in 2024), despite the erosion of the trade surplus driven by the fall in goods exports. The services balance, meanwhile, has remained in deficit since 2021 (-EUR 20 bn in 2024) due to tourism.

Outside the EU, the outlook for exports is deteriorating further in the face of tougher US trade policy, in addition to the challenges posed by the rise of China.

GERMANY: LEVEL OF CAPACITY UTILIZATION (%)

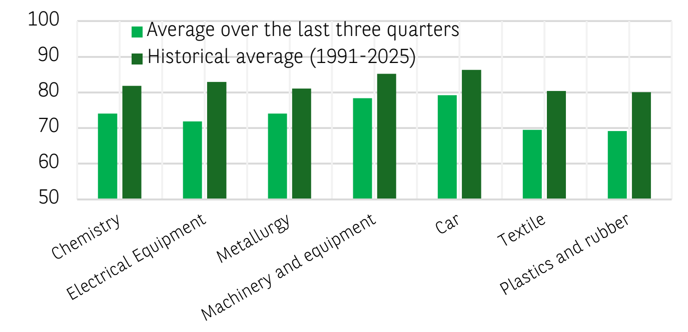

CHART 2 SOURCE: DG ECFIN, BNP PARIBAS

Conversely, intra-European trade could intensify from 2026 onwards as part of European rearmament. Germany is well positioned to respond to the rise in defence investment thanks to its industry specialising in machinery and equipment, metallurgy, electrical equipment and chemicals, all of which can be used for defence (*see our box below*). The public investment plan, which has yet to be finalised, could also encourage intra-European circuits by favouring European companies in calls for tender. However, these developments should further reduce the surplus on goods, as Germany is preparing to invest more than the other main European countries.

Article completed on 17 April 2025

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European rearmament and industrial recovery: an opportunity for Germany

Faced with persistent geopolitical tensions and weakening US military support, European countries are planning to significantly increase their military spending. This strategic shift represents an economic opportunity for German industry.

Indeed, Germany has a robust industrial base. Groups such as Rheinmetall, ThyssenKrupp, Hensoldt and Diehl play a central role in the defence industry, supported by a network of companies specialising in mechanics, electronics and advanced materials. Between 2020 and 2024, the country accounted for 2.6% of global arms exports (SIPRI) and was an active participant in European defence programmes.

The context is favourable, with many industrial capabilities currently under-utilised. According to the European Commission, the capacity utilisation rate in key sectors was 74% over the last three quarters (unweighted average of textiles, chemicals, plastics and rubber, metallurgy, machinery and equipment), 8.3 points below the 2010-2025 average (see *Chart 2*). Some companies are already starting to reorient their activities towards the defence sector. This would make it possible to mobilise available resources without fuelling inflation.

Even if obstacles to the adaptation of the productive fabric remain, the acceleration of procedures and the simplification of administrative rules planned by the future government would make it possible to respond effectively to the new needs.

MULTIPLE CONSTRAINTS ON GROWTH

French growth is set to bottom out in 2025, due to political and trade uncertainties. It should pick up again in 2026, buoyed by a rise in public consumption driven in particular by defence spending and the expected acceleration in German growth. This more promising European environment would therefore outweigh the shock of the rise in US tariffs by 2026. Inflation is expected to remain moderate and the deterioration in the labour market contained. The level of the public deficit will remain a brake in a higher interest rate environment.

GROWTH MAY NOT IMPROVE UNTIL 2026

The late implementation of the 2025 budget (only voted for in February) complicated the start of the year. Business sentiment hit a low point in December 2024, at 94 (97 in March 2025), as did consumer confidence, at 88 (92 in March 2025). Consumers are pessimistic about the future economic situation and the outlook for living standards. Uncertainty indicators remain at high levels, with trade uncertainty now prevailing. This should primarily affect sectors where the United States is a direct market (aerospace, wine and spirits) or an indirect market through Germany (such as French subcontractors to German industry).

French growth is expected to recover in the long run. The implementation of the budget is accompanied by an increase in collective public spending (defence, police, justice), while individual public consumption (education, health) is not affected by the budgetary consolidation effort. From the second half of the year, and even more so in 2026, the implementation of Germany's «whatever it takes» policy is set to benefit French growth, which is expected to hit 1.1% in 2026 (0.6% in 2025).

GROWTH AND INFLATION

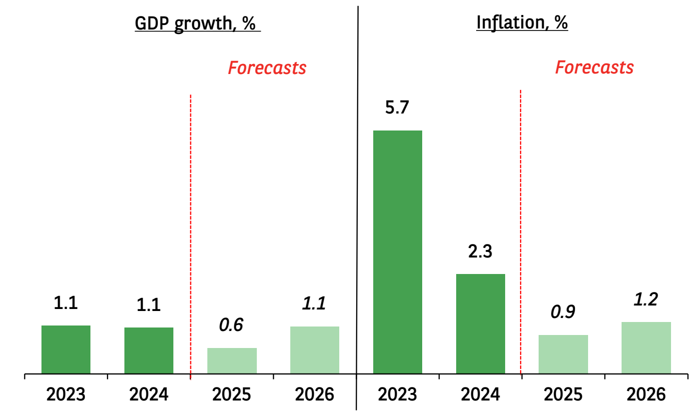

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

RISING UNEMPLOYMENT: EXCESSIVE FEARS?

The labour market has deteriorated, with 90,000 net job losses in the fourth quarter of 2024. 2025 began on a negative note, with a decline in the employment climate to 93 in February (96 in March), according to INSEE. The balance of opinion on the fear of unemployment rose sharply (+46 in March compared with +30 on average in Q3 2024) in the household survey.

However, the unemployment rate fell in the fourth quarter to 7.3% from 7.4% in Q3, due to a drop in the youth participation rate. At the same time, the proportion of 15-29 year-olds not in employment or training hit its highest level, outside the COVID period, since Q3 2019, at 12.8%.

Weak demand and the deterioration in the capacity utilisation rate are leading to a rise in unemployment. However, this is expected to be modest and limited in time. The unemployment rate is set to reach 8% by the end of 2025, before falling again in 2026 as a result of the foreseeable improvement in activity.

INFLATION SET TO REMAIN MODERATE

Disinflation is significant. Inflation has returned to pre-Covid levels in most items of the consumer price index. However, INSEE's business climate survey shows limited prospects for price rises, including in services (where inflation remains slightly higher).

A European retaliatory response to the Trump administration's increase in tariffs could lead to rising inflation. However, the euro's appreciation against the dollar since the start of the year (and its continuation towards 1.12 at the end of 2025 and 1.2 at the end of 2026, according to our forecasts), and the recent fall in energy prices should limit imported inflation. In addition, the wage moderation seen over the last few quarters is also consistent with contained inflation and gains in real wages.

As a result, household purchasing power is expected to increase by 0.7% in 2025 and by 0.4% in 2026. However, these increases will be lower than in 2024 (+2.5%), when they were underpinned by exceptional growth in social benefits (+6.1% in 2024, offsetting inflation in 2023).

PUBLIC DEBT RATIO UP DESPITE CONSOLIDATION

The budget deficit deteriorated in 2024 (5.8% of GDP after 5.4% in 2023) and the public debt to GDP ratio returned to 113% of GDP, its 2021 level (wiping out the gains made in 2022-23 during the inflationary period). The adoption of the budget for 2025 paves the way for the implementation of budgetary priorities (defence, security, justice) and should therefore support the increase in public consumption. The budget target finally set for 2025 brings the deficit back to its 2023 level (5.4% of GDP). It may not seem very ambitious. However, the budgetary effort, excluding the rise in the interest burden (+0.4 points of GDP in 2025) and new expenditure (+0.2 points of GDP), is close to 1 point of GDP. However, with this level of deficit and nominal growth expected to fall to 2.5%, public debt is set to hit 115.5% of GDP in 2025, exceeding its previous record in 2020. Counteracting this increase will be difficult in the years ahead (*see our box*).

FRANCE REMAINS ATTRACTIVE

Budgetary uncertainty and the measures considered during the to-and-fro between the houses of parliament (capital gains tax, in particular) sparked fears that France's attractiveness for foreign investment (the leading European country, according to the EY barometer) would deteriorate. Ultimately, this has not been the case. While the increase in corporate taxation can be penalising, the exceptional nature of the corporation tax surcharge is a lesser evil. The increase in social security contributions is ultimately more limited (EUR 1.6 billion) than in the initial plan, and is therefore impacting labour costs less than expected. Another positive sign is the continuing momentum in business creations, which since November have been approaching the level maintained until August 2024.

EXPORTS: ON THE BRINK OF A MAJOR UPHEAVAL

Growth in exports of goods and services slowed markedly in 2024 (+1.1% in volume terms). In terms of goods, France suffered a drop in exports to Europe (EUR -15 billion in value, of which almost -5 billion each to Germany and Italy), while aeronautics exports stagnated. In addition, exports to the United States rose the most (EUR +3.5 billion).

The next few quarters should be marked by a profoundly negative change - because France is exposed to the customs tariffs that the US administration could decide on (pharmaceuticals, luxury goods, wines and spirits), followed by a more positive one - a rebound in growth in Germany and the eurozone that could be generated by the European defence investment plan. What's more, aeronautics production is set to increase as the sector manages to overcome its supply constraints. As a result, exports should regain momentum, underpinning French growth in 2026.

Article completed on 17 April 2025

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FRANCE: DECOMPOSITION OF FISCAL DEFICIT (% OF GDP)

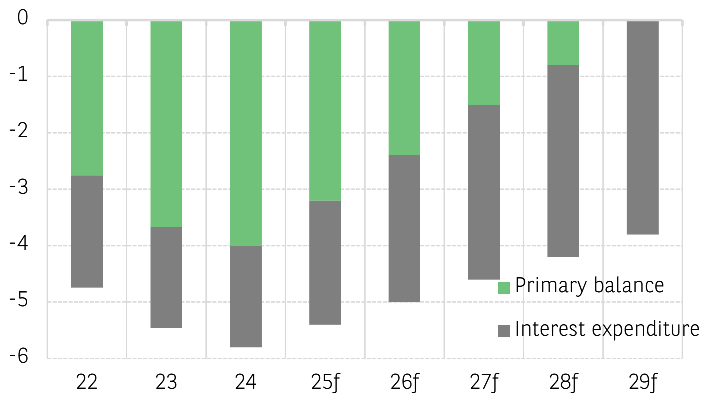

CHART 2 SOURCE: INSEE, BNP PARIBAS FORECASTS (F)

Rearmament constrained by budget constraints

France, the world's second largest arms exporter (9.6% in 2024, according to SIPRI), should benefit from the massive investment plan announced by Germany and from the European rearmement effort, which will eventually bring military spending in European Union countries to 3.5% of GDP.

However, France is not expected to make the biggest effort because of its tight budget. For the time being, the government has declined the budgetary leeway of 1 point of GDP that the European Commission will grant in terms of public deficit to countries that increase their military spending.

Interest rates are the primary constraint . While the effect of their rise on the interest burden is delayed due to the relatively high average maturity of French debt (8.5 years), the weight of the interest burden is set to double between 2024 and 2029 (increasing by almost 2 points of GDP to hit 3.8% of GDP).

The second constraint, which is also long-term, is the increase in military spending. Even if the low range were to be adopted (a target of 3% of GDP in 2030), the additional effort would be almost 1 point of GDP compared with 2024. However, this effort will be smoother than elsewhere in Europe, as, in France, we anticipate an increase in military spending of 0.2 points of GDP per year from 2026 onwards, while Germany's is set to rise from 2% of GDP in 2024 to 3.5% in 2027.

Third constraint: with Parliament divided, it will be difficult to consolidate the budget by de-indexing social spending (which was mooted for a while) or by making more direct savings on local authority spending. In 2025, the budget savings mainly concern central government spending. This will result in budgetary consolidation spread over a long period. In order to reduce the deficit, tax increases seem inevitable.

Our assumptions include an increase of 0.5 points of GDP in military spending compared with the French military programming law (LPM), which would result in a deficit of more than 3% of GDP in 2029 (still possible in the future, even if France rules it out for the time being, see Chart 2). Assuming that 10-year interest rates structurally above 3%, the apparent interest rate should go above nominal growth (about 2.5% of GDP), public debt would continue to rise inexorably between now and the end of the decade.

ITALY

INVESTMENT REBOUND SUPPORTS GDP GROWTH

The mild rebound recorded in Q4 2024 enabled Italy's real GDP to grow by 0.5% over the year. In 2025, real GDP is expected to grow by 0.8%, while in 2026, it should reach 1.3%. GDP growth is expected to remain subdued in the first part of 2025. It should gain momentum later in the year, mainly driven by consumption, which is projected to benefit from increased disposable income. In 2024, labour market conditions showed a favourable trend: in Q4, the number of people employed was 756,000 higher than in Q4 2019. The uncertainty surrounding international trade is likely to prevent the foreign sector from contributing significantly to economic growth.

ECONOMIC ACTIVITY: A RECOVERY IN INVESTMENT AT THE END OF 2024 UNDERPINS MILD GDP GROWTH

In 2024, the Italian economy grew by 0.5% on an annual average basis. Net exports and domestic demand contributed most to real GDP growth (+0.3 p.p. and +0.4 p.p. respectively), while inventories held back growth (-0.2 p.p.).

After stagnating in Q3, the Italian economy experienced a slight rebound in Q4, with real GDP rising by 0.1% q/q. Thanks to the good performance in Q4, real GDP at the end of 2024 was 5.9% higher than in Q4 2019. Notably, in the last quarter of 2024, fixed investment rebounded by +1.6% q/q after three consecutive declines. The recovery benefited all sectors, but mainly affected investments in machinery and the construction sector, which also benefited from the strengthening of the financial structure of Italian firms.

Added value grew by 2.0% y/y in agriculture, 0.7% in construction and 0.9% in services, while it decreased in industry (-1.5%). The weak performance of the manufacturing sector over the last two years was mainly due to the struggling energy-intensive wood and paper, metals and chemicals industries. This was compounded by the on-going difficulties in the textiles, clothing and leather industries: in 2024, production in these sectors was 30% lower than in Q4 2019.

Spillovers from Germany's economic rebound expected in 2025-2026, and the ReArm EU plan should stimulate Italian growth over the next two years. However, the uncertainty surrounding international trade might prevent exports from supporting economic growth. Moreover, the phasing out of incentives for residential construction investment should be only partly offset by measures implemented through Next Generation EU funds. For this reason, investment should contribute only marginally to growth. Therefore, Italy's real GDP is expected to grow by 0.8% in 2025. In 2026, it should reach 1.3%, notably driven by higher growth in Germany.

International trade faces downside risks from escalating frictions and geopolitical tensions. These could create new obstacles within global supply chains. Preliminary estimates project a 0.2 p.p. fall in Italian GDP were the threatened tariffs to be fully applied. The agro-food, pharmaceuticals, and chemicals sectors are expected to experience the most pronounced impacts, with potential reductions in exports, while fashion and furniture may undergo a more modest contraction due to the high level of product differentiation in these areas making these products less easy to replace in the short run.

LABOUR MARKET: EMPLOYMENT CONTINUED ITS FAVOURABLE TREND

In 2024, the labour market maintained its positive momentum. In Q4, the number of people employed was 168,000 higher than a year earlier. This brought the employment rate to 62.4% – a historically high level, although still below the EU average (70.9% for the 15-64 age group).

GROWTH AND INFLATION

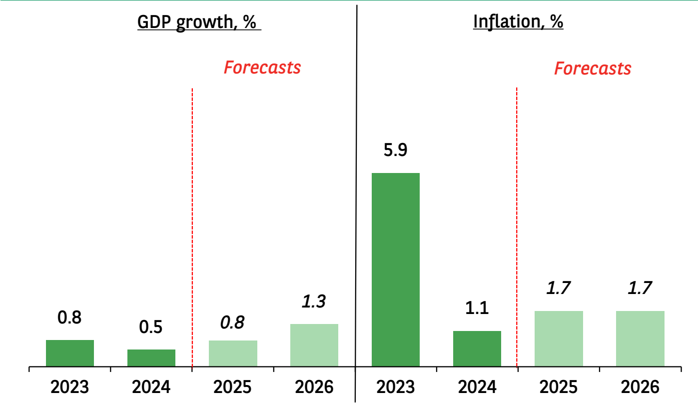

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Despite this positive trend, the Italian labour market is suffering from the demographic decline, which is shrinking younger cohorts and making it more difficult to replace older workers. In Q4 2024 the number of employed people was 756,000 higher than in Q4 2019. However, this increase was largely driven by the 55-64 age group, whereas the rise among those aged 25-34 was more limited. In contrast, employment in the 35-54 age group declined.

Structurally, employment in Italy has been supported by controlled labour costs. In recent years, labour costs have risen more slowly than inflation, making labour a cheaper input compared to other production factors. Most companies have sought to preserve their human capital, even at the cost of retaining underutilized workers (labour hoarding). According to Istat, between Q4 2019 and Q3 2024, gross wages per unit of labour increased by less than 10%, while consumer prices rose at twice that rate.

The situation is expected to shift as firms increasingly adopt Artificial Intelligence (AI). According to the Bank of Italy, approximately 15 million workers are either moderately or highly exposed to AI. An "exposed" occupation is one linked to certain AI applications. This does not necessarily imply a risk of replacement but may indicate potential complementarities. The complementary workers are more numerous than the replaceable ones (9 million versus 6 million, respectively).

INFLATION: THE RECOVERY IN HOUSEHOLD PURCHASING POWER SUPPORTS PRIVATE CONSUMPTION

In Q4, private consumption in Italy increased (+0.1% q/q, after +0.4% in Q3) mainly due to an improvement in both the economic situation and households' financial conditions.

Recently, household consumption also benefited from increased purchasing power. In 2024, hourly contractual wages rose by about 3% y/y, outpacing inflation (which fell from 6% y/y in 2023 to 1.1% in 2024). At the beginning of 2025, the annual inflation rate rose to 1.7%, primarily due to rising food and energy prices. Although higher than in 2024, inflation should still remain below the 2% level for the next two years (+1.7% in 2025 and 2026).

FISCAL POLICY: IMPROVING PUBLIC FINANCES

Despite the economic slowdown, Italy's public finances improved significantly in 2024. The public deficit-to-GDP ratio fell from 7.2% to 3.4%, reflecting both higher revenue and lower expenditure. The primary balance also improved, shifting from -3.6% to +0.4%. For its part, the tax burden (measured as the ratio of total revenues to nominal GDP) remains high: it increased from 41.4% in 2023 to 42.6% in 2024. Overall, the increase in defence spending could weigh on Italy's public finances (*see our box below*).

FOREIGN TRADE: AMONG THE EU COUNTRIES MOST EXPOSED TO NON-EU MARKETS

After increasing by about 20% in 2021 and 2022, Italy's exports in value grew by 1.9% in 2023 and marginally declined (-0.4%) in 2024[1]. On the positive side, food exports grew by 8% and pharmaceutical exports by 9.5%. On the downside, sales of metal products declined by 3.3% and those of transport equipment fell by more than 12%.

In 2024 Italian exports were affected by weakness in Germany, the main destination for Italy's goods (accounting for 11.4% of total exports). Sales to Germany dropped 5%, mainly due to the decline in transport equipment exports (-20.2%) and metal products (-10.9%). However, Italian food exports to Germany rose by 5.5%, while pharmaceutical exports increased by almost 16%.

Italy is one of the EU countries most exposed to non-European markets. In 2024, over 48% of Italy's total exports went to countries outside the EU, compared to 45% for Germany and France and just 37% for Spain. The United States is the second largest importer of Italian goods, accounting for 10.4% of total exports – almost twice as much as in 2010. In 2024, exports to the US declined by 3.6%. Sales of transport equipment fell by more than 30%, while food exports rose by 17% and pharmaceutical exports by 26%.

ITALY'S EXPORTS TO GERMANY IN 2024
(% OF TOTAL EXPORTS TO GERMANY)

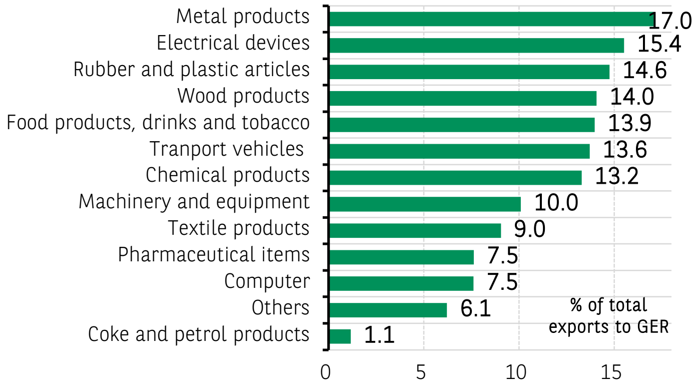

CHART 2 SOURCE: BNL ECONOMIC RESEARCH, ISTAT

CHALLENGES: GERMAN INVESTMENT POLICIES AND SPILLOVER EFFECTS ON ITALY

On 18 March, Germany's parliament approved a comprehensive spending package, which includes a EUR 500 billion infrastructure fund over 12 years and relaxations in debt regulations for defence spending. Given Germany's role as Italy's primary trading partner, the plan is expected to stimulate Italian exports, particularly in machinery and intermediate goods. The interdependence between the German and Italian economies has been evident in past economic cycles. A very recent Istat research report estimates that weak German growth reduced Italian GDP by 0.2% in both 2023 and 2024.

Positive spillover effects on Italy's economy could also come from enhanced trade and collaborative opportunities. Increased demand for construction materials, machinery, and technology could drive export-driven growth, while joint infrastructure and defence projects may stimulate deeper industrial cooperation between Italian and German firms. However, uncertainties remain regarding the timeline for implementation of Germany's investment plan and its broader economic impact.

Article completed on 17 April 2025

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[1] The data in this paragraph are not seasonally adjusted.

Focus: Impact of the readiness 2030 plan on Italy

Under the ReArm EU plan, Member States will be allowed to increase defence spending beyond the limits set in the national medium-term fiscal-structural plans, up to an additional 1.5 pp of GDP. Defence investments across the EU could reach EUR 800 billion over four years, including a EUR 150 billion fund (Security Action for Europe) allocated to back loans for defence investments.

A recent analysis by OPCI (an Italian think tank) presents a scenario where Italy's defence spending gradually rises from 1.6% of GDP in 2024 to 3.1% by 2028. Under this scenario, the additional EUR 128 billion in expenditure is estimated to increase the deficit by approximately EUR 15 billion on average each year (0.6 percentage points of GDP), as it should be partially financed through fiscal savings. Italy's debt-to-GDP ratio should reach 135.5% by 2031, exceeding both the 2024 level (+0.02 p.p.) and the baseline forecast in the Structural Budget Plan (+3.5 p.p.).

SPAIN

DYNAMIC GROWTH, BUT FOR HOW LONG?

Over the next two years, Spanish growth should be stronger than anticipated in our last issue of EcoPerspectives. Continued disinflation and the good performance of the labour market should continue to drive domestic demand, at the expense of foreign trade. Despite expectations of higher defence spending, strong nominal growth should continue to facilitate the rebalancing of public finances. However, Spain's structural vulnerabilities threaten its continued outperformance in the longer term.

ECONOMIC ACTIVITY: FORECASTS REMAIN POSITIVE

After rebounding in 2024 (+3.2%), Spanish growth will decline very slightly over the next two years. Nevertheless, it will remain well above the Eurozone average (+2.6% and +2.1% in 2025 and 2026, compared to 1.0% and 1.3%).

Private consumption should continue to underpin economic activity. The robustness of the labour market, wage growth and the slowdown of inflation will boost household purchasing power. The disbursement of funds from the European Union's recovery plan (NGEU) and the easing of monetary policy by the ECB will benefit investment, which should rebound. However, foreign trade is no longer expected to contribute positively to growth, as rising domestic demand will support imports more than has been the case in recent years.

Lastly, the increase in US tariffs announced by Donald Trump raises major uncertainties about growth forecasts in the Eurozone, starting as early as 2025. Although the consequences for Spain are likely to be limited—due to its heavy reliance on the services sector and its low exposure to the US (the share of total Spanish goods exports to the US amounting to just 1.2% of GDP in 2023)— the country is likely to suffer from the slower growth of its main European trading partners (Germany, France and Italy), which are more affected. According to our forecasts, it is only from 2026 onwards that the positive effect on growth of European fiscal policy reorientation will dominate, via an expected defence spending increase, and should ultimately have a positive effect on Spanish growth.

LABOUR MARKET: BOOSTED BY IMMIGRATION

The labour market remains buoyant: the number of unemployed fell again in February (-0.4% m/m[1]), while the number of people in work continued to rise (+0.3% m/m). The proportion of foreign workers in the workforce continues to rise (15.2% in Q4 2024; +0.6 pp over one year). Employment growth is set to continue, driven mainly by these migratory flows. This positive outlook, combined with continued strong wage growth (negotiated wages up 3% y/y in February, and minimum wage raised to EUR 1184 gross in 14 instalments [+4.4%]) and disinflation, will continue to support private consumption. However, real income gains will moderate over time, as growth in negotiated wages has already begun to slow.

INFLATION: DRIVEN BY RISING ELECTRICITY PRICES

After remaining at a high level in February (+2.9% y/y), due to the abolition of the reduced VAT rate on basic foodstuffs and the rise in electricity prices (itself linked to the abolition of tax cuts at the start of the year), harmonised inflation slowed sharply in March (+2.2% according to the INE's estimate). Inflation is likely to remain close to this level over the coming months due to the anticipated slowdown in energy prices. Core inflation, meanwhile, is slowing (2.0% y/y) and is close to the ECB's target.

1 Seasonally adjusted data

GROWTH AND INFLATION

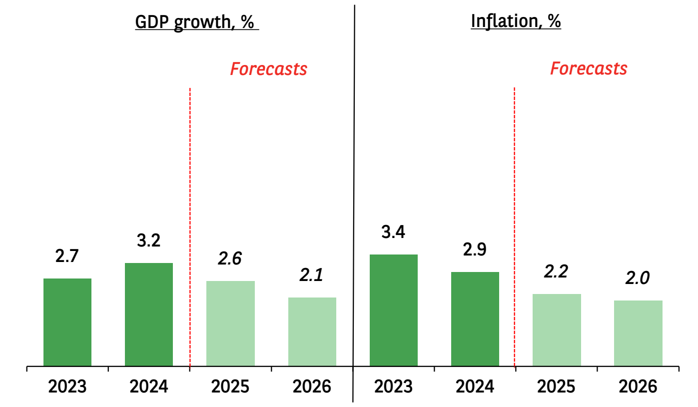

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

PUBLIC FINANCES: NOMINAL GROWTH TO SUPPORT BUDGET RATIOS

Despite political fragmentation and the expected rise in defence spending, the dynamics of public finances should remain positive as long as nominal growth remains high. This will enable the public debt/GDP ratio to continue to fall (see *Chart 2*). In 2024, it had already fallen by more than initially expected (101.8% compared with 102.5% estimated by the Bank of Spain). It is therefore possible that it will approach the 100% mark or even pass it by 2026 (100.6% in 2025 and 99.6% in 2026 according to our forecasts), notwithstanding the increase in defence spending (*see our box*).

FOREIGN TRADE: SERVICES SURPLUS HITS AN ALL-TIME HIGH

Spain's external accounts remain solid. In Q4 2024, the current account reached its best level since 2018 (cumulative surplus of EUR 92.7 bn over twelve months). This remains underpinned by the services surplus, which reached an all-time high (EUR 266 bn), boosted by the record tourism figures for 2024 (93.8 million visitor arrivals, +10.1% y/y).

STRUCTURAL CHALLENGES: BETWEEN LOW PRODUCTIVITY AND THE HOUSING CRISIS

The low level of productivity observed in Spain threatens its continued outperformance in the medium term. Over the last decade, productivity trends (measured by the ratio of GDP to hours worked) show that the country still lags behind the Eurozone average. Between 1995 and 2022, productivity increased by 18.7% in Spain, compared to an average of +29.1% in the Eurozone. This weakness is explained by a larger proportion of the economy being reliant on sectors with lower productivity, such as tourism services. However, once the positive cyclical trends have dissipated, this lack of productivity could act as a brake on the country's growth.

Housing activity rebounded in 2024. Over the year, demand for housing has picked up, with transactions recording their best figures since 2008 (with a total of 642,208 homes sold [+10% y/y]). However, the housing supply is still not keeping pace, pushing up prices (+7.7% y/y in February). The regions most affected by these shortages are those with the highest levels of economic activity and tourism, such as Catalonia, the Madrid region and Andalusia. Furthermore, according to the Bank of Spain[2], the housing deficit could rise to 600,000 units this year.

Article completed on 17 April 2025

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BUDGET BALANCE AND PUBLIC DEBT OF SPAIN

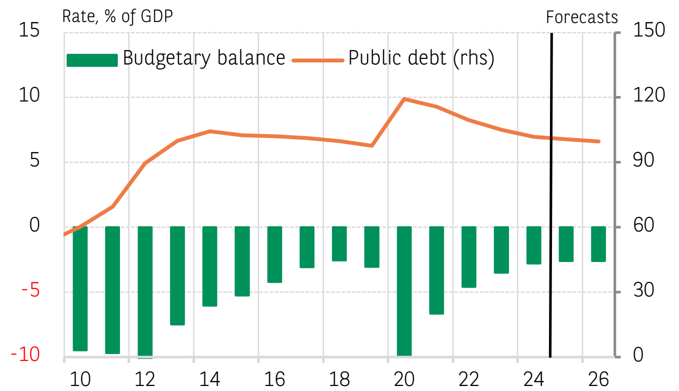

CHART 2 SOURCE: EUROSTAT, DG ECFIN AMECO, MACROBOND, BNP PARIBAS

2 April 2024 note: The Spanish Housing Market, Bank of Spain

Focus: The increase in defence investment should not threaten Spain's public finances

Spain's public finances are on a fairly favourable path. Strong nominal growth has enabled the ratios of public debt and budget deficit to GDP to fall. The latter has actually fallen by more than expected in 2024 (-2.8%), as has the debt ratio (see above).

The country is benefiting from nominal growth (6.2% in 2024) that is higher than the average cost of debt (2.5% of GDP), allowing it to be reduced. This gives the government significant room for manoeuvre to increase spending without worsening the public debt ratio.

In 2024, Spain's defence spending will represent just 1.28% of GDP, one of the lowest levels among NATO countries. The prime minister recently pledged to increase public investment in defence to 2% by 2029. However, political fragmentation may make his task more difficult. Without a budget bill, the government plans to deploy this spending without a parliamentary vote, by playing on budget lines through extraordinary credits.

Over the next two years, despite the end of support to the private sector in response to rising energy prices, public spending is set to rise as a result of increased defence spending. However, rising revenues could offset this trend. Revenues are set to rise as a result of an increase in social security contributions, due to the rise in the number of workers, and the abolition of the VAT reduction on basic foodstuffs. As a result, the budget deficit/GDP ratio should fall to -2.6% in 2025, and then remain at this level in 2026.

BELGIUM

BUT WE ONLY JUST GOT STARTED...

A new government has emerged, with the coalition agreement under immediate pressure from protesting unions and criticism on its underlying assumptions. Growth remains positive, albeit below trend as capex spending could take a hit while net exports still weigh on GDP. The housing market slump seems to be gradually dissipating, with prices having marched on regardless. Looking ahead, during the next quarters growth should be affected by higher trade tariffs. From 2026, growth should be supported by trade linkages with Germany, where growth should accelerate.

GDP GROWTH: PROS AND CONS

Having posted positive quarterly growth at the end of last year, the Belgian economy looked set for a slowdown. The outlook for international trade is poor and further deteriorating because of recent events. Pharmaceutical firms in particular look vulnerable to rising tariffs on US exports but so do just-recovering manufacturers. In addition, the effect of tariffs through a slowdown of important neighbouring trade partners like Germany could be sizeable. However, recent events point to a more positive outlook on that front, at least as fiscal spending is set to boost the Germany economy.

That could lessen some of the burden on domestic demand as a growth engine, with private consumption delivering the goods. While the gradually softening labour market did cause a temporary spike in terms of unemployment fears, for the most part, consumer sentiment held up quite well: it is currently slightly higher than its historical average. Momentum on the housing market has yet to return and firm capex spending looks set to decline this year. An uptick in government spending on defence could push growth higher (see below). For the full year, we expect to see growth of 1.2% this year and the next.

GROWTH AND INFLATION

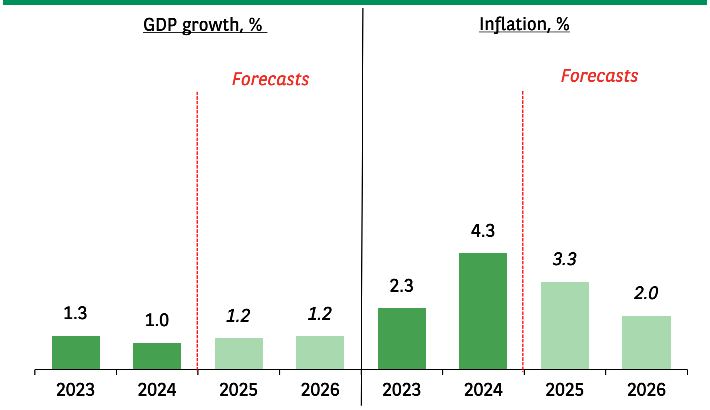

CHART 1 SOURCE: BNP PARIBAS FORTIS

INFLATION COOLING OFF SLOWLY

Inflation, measured by the ECB's HICP metric, came in at 4.3% for the full year 2024. Behind this full-year average, a more complicated picture emerges. Government support measures to lower the energy bill for households drove down energy costs throughout 2023. The fading out of these measures mechanically increased last year's energy component of inflation. The resulting base effect is the main reason why Belgium has been the EU country with the highest inflation, behind only Romania. We expect the HICP to gradually reach 2.0% by the end of the year, as core and food inflation continue their normalisation.

Meanwhile, the health index, used to track the cost of living, broke through its latest 2% barrier last month. As a result, automatic wage indexation kicked in. The Belgian Plan Bureau expects another wage indexation later this summer and then no more subsequent ones throughout its 2-year forecasting horizon as price growth slows down.

LABOUR MARKET OF BELGIUM: SOFT LANDING

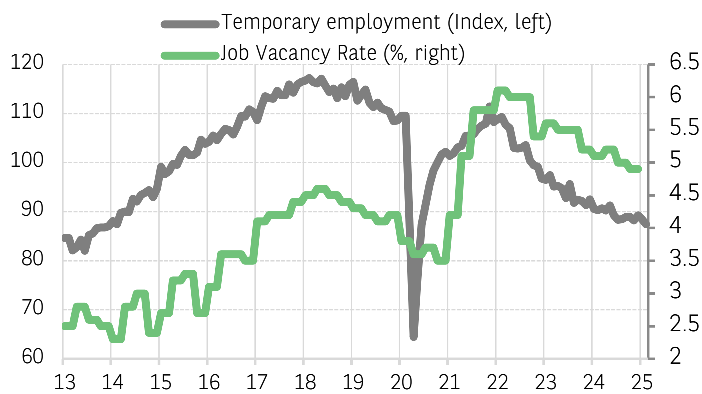

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS FORTIS

LABOUR MARKET: SOFT LANDING (IF THAT)

Firm bankruptcy rates are up. They now stand at 4% above pre-covid levels. A historical analysis suggests that the excess could reach double-digit figures in the next couple of quarters. Bankruptcies among constructors, manufacturers and transport firms led to significant job losses last year.

Job creation is clearly slowing down. The Federgon index for temporary employment, a leading indicator, has been steadily trending down since 2021. A soft landing still looks like the most likely scenario, however, as unemployment remains essentially stable at around 5.8%. We are looking at an increase to 6.5% by the end of next year.

PUBLIC FINANCE FAIRY-TALES

The European Commission is breathing heavily down Belgium's neck about the spiralling budget deficit and public debt ratio forecasted to rise to 140% over the next ten years under current (2024) policy settings. The five-party coalition emerged with a reasonable-looking plan to bring the deficit back from its current 4.5% to 3% over the next couple of years.

Some kinks remain to be ironed out however, as Bart De Wever hopes to exclude the obligatory pick-up in military spending (currently 1.3%) from consideration in the structural deficit measure on which the EC likes to focus its analysis.

The assumption of 500,000 extra jobs out of a current total of slightly more than 5 million people at work seems highly unlikely over the next four years. Especially as the Michel I government, with its "Jobs! Jobs! Jobs!" tagline, only managed to crank out some 250,000 new positions.

In 2023, a new government bond, targeted at Belgian retail investors, raked in north of EUR 20 billion. Spiced up by tax breaks, this bond helped the debt agency complete its financing goals for the year in advance. Subsequent issues targeted at a wider audience lacked tax advantage and were much less popular.

The average maturity of government debt remains above 10 years, but the average yield on outstanding loans rose from the 2021 low point of 1.43% to 1.98% at the end of last year. Compared to 2024, long-term funding is issued this year at a comparable cost, but at a lower average maturity (it might turn out to be 12 years – compared to almost 15 years in 2024).

Article completed on 9 April 2025

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Military expenditures

Defence spending picking up

With just 1.3% of GDP spent on defence last year, Belgium comes in last in NATO's ranking, together with Spain and Luxembourg. 0.15% of the total amount spent constitutes support to the ongoing war in Ukraine, with this outlay entirely financed by exceptional corporate tax receipts from returns on frozen Russian assets held in Belgium according to the National Bank. The government now aims to increase military spending to 2% of GDP already by summer, while new defence minister Theo Francken is floating the target of 3.5% further down the line.

Spending categories

Labour costs account for close to half of what the country spends on defence. Military personnel has declined by more than 25% over the last 10 years, whereas the neighbouring countries kept their dedicated labour force stable, or even on an increasing path in the case of Germany.

That could all be about to change, however. Since the start of the year, the defence department has reported a record uptick in new applicants, with résumés arriving at HQ at about double the pace of last year. This is one area where the increased appetite for defence spending is at odds with much-needed structural reforms, as the IMF recommends in its article IV review to gradually raise the retirement age for specific civil servant groups, including certain military personnel. This could hinder the effort to increase the Defence payroll, losing out to better-paying private firms.

At barely 15%, the share of total defence outlay on Equipment puts Belgium once again dead last of all NATO countries. Neighbours France, Germany and The Netherlands spend about double that. Expect this number to shoot up however, as talks of using a now abandoned car production site in Vorst for increased military production are ongoing.

Financing

The question of how to pay for this uptick remains a thorny issue, given the weak ties that bind this coalition. It emerged that there is limited appetite to increase the already heavy reform package to offset the fiscal impulse. The uptick in defence spending as of Q3 will therefore most likely be debt-financed, at least for this year.

In terms of what comes next, various scenarios have been debated, with none proving particularly convincing so far. In the wake of 2023's successful retail bond issue, dedicated military bonds look like a tempting option, however practical constraints remain. Theo Francken is also interested in setting up a military investment fund to support the sector on a more structural basis. Lastly, talk of selling some of the government's holdings in telecom and/or financing seem preliminary but will almost surely return to the fore as the pressure to balance the budget piles up in the coming months.

As a result, additional military spending this year would likely constitute EUR 2 bn or about 0.3% of GDP, as a purely debt-financed fiscal impulse, unless the EC agrees to De Wever's request. Typically, more than half of all EU military equipment is procured in the US, but recent events will undoubtedly encourage a search for EU-based alternatives. As the labour market cools off gradually, the risk of crowding out seems rather low. We thus expect to see increased defence spending at home and abroad (especially by key trade partner Germany) to boost short-term GDP growth by 0.2% this year and 0.4% next year.

A new world, with new needs, is emerging fast, while this government struggles with the inheritance of the old one.

UNITED KINGDOM

THE OBSTACLES TO ACTIVITY ARE PILING UP

Although the United Kingdom has been penalised less severely than its European neighbours, it has not escaped the 10% tariff floor on US customs duties. The negative impact on activity will add to the pre-existing domestic brakes. The household savings rate is rising against a backdrop of high inflation. Increased defence investment in the United Kingdom and elsewhere in Europe will have a positive effect on GDP, but this will be offset by the effects of the trade war in the short term. The rise in long-term bond yields, which became more pronounced after 2 April, further complicates the budgetary equation. The Bank of England's key interest rate cut will remain gradual, given the moderate slowdown in inflation that we continue to expect in 2025.

ECONOMIC ACTIVITY: THE OBSTACLES ARE PRIMARILY DOMESTIC

The direct effect of the rising US customs duties on the United Kingdom would be contained at around 0.1 points of GDP[1]. The United Kingdom's exposure is mainly indirect, and activity will suffer from the growth shock in the European Union and the United States, the extent of which remains highly uncertain at this stage. Defence spending, which is set to rise from 2.3% of GDP in 2024 to 2.5% in 2027, will bring about increased activity, in addition to the effects of rearmament within the EU and particularly in Germany (where this effort should be pronounced). This growth surplus for the EU (+0.5 pp of GDP by 2027 - see Eurozone page) will support activity in the United Kingdom and will just offset the decline in exports to the United States[2]. The UK economy will therefore have limited room for acceleration in 2025 and 2026. The industrial recession continues, with PMI surveys even showing a plunge in new export orders in March[3]. Furthermore, the recovery in household purchasing power (+4.2% in 2024) is not fuelling consumption, but rather the savings rate, which hit a post-COVID record in Q4 2024, at 12% of gross disposable income. The high cost of constrained expenses (energy, housing) is weighing on the financial situation of some households, fuelling a rise in payment arrears.[4]

LABOUR MARKET: SIGNS OF STABILISATION TO BE CONFIRMED, BUT GROWING DISPARITIES

The labour market, on the other hand, is proving resilient. Payroll employment rose slightly in January-February (+0.1%), with job openings remaining at pre-COVID levels. Will April, which saw the introduction of several budgetary measures (including the increase in the national insurance contribution rate for employers, and the 6.7% rise in the National Living Wage) mark a turning point? Surveys are pointing in the wrong direction (PMI, KPMG/REC), and job losses in sectors that are already weakened and more exposed to the risk of customs tariffs (industry, retail trade) could increase. While GDP growth expected in 2025 should limit the deterioration in employment, sectoral divergences are likely.

In five years, the number of employees in UK industry has fallen by almost 4%, making it the sector that has seen the most job losses, along with trade. Less than 8% of employees now work in industry. The most affected regions, Wales, the Midlands and the North, have lost more than 5% of their industrial jobs compared to pre-Covid. Total job creation has remained more dynamic in London (+6% in five years), so the gap between the capital and the rest of the country has widened.

GROWTH AND INFLATION

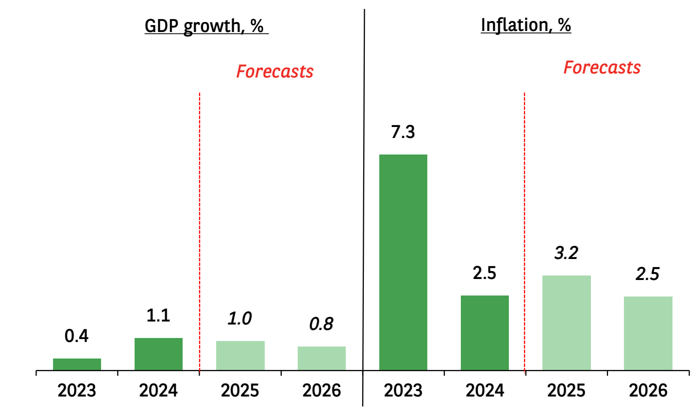

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The UK authorities' efforts to reduce geographical imbalances (the "Levelling-up" programme launched in July 2021 is the flagship) are therefore slow to bear fruit. These imbalances are a structural brake on activity, exacerbating tensions in the capital's property market. Northern Ireland, however, is an exception. Industrial employment rose significantly during this period (+4.5%), with the region benefiting from its special post-Brexit status (Northern Ireland Treaty), giving it privileged access to the European market.

INFLATION: THE 2% TARGET OUT OF REACH IN 2025-2026

The expected rise in food, capital goods and energy inflation will keep headline inflation above 3% in 2025. Disinflation in the services sector has been slow to materialise, due to the dynamism of wages, which the slowdown in the labour market is failing to curb for the time being. The Bank of England[5] survey forecasts wage moderation in 2025 of between 3% and 4% y/y, which is insufficient to anticipate a return of inflation back towards the 2% target in 2025. According to our forecasts, this target will still be out of reach in 2026. Inflation remains structurally high due to major constraints on supply (weak productivity gains and high energy costs, imbalance in the real estate market). The de-anchoring of households' long-term inflation expectations, which has been seen in some surveys (*see chart 2*), will further limit the disinflation dynamic.

1 This result is based on the ratio of exports of goods to the United States to GDP (2.1% in 2024) and the assumption of a 3% fall in imports as a result of the 10% increase in US tariffs (import price elasticity of 0.3).
2 With UK exports to the EU amounting to 6.1% of GDP in 2024, an increase in EU GDP of 0.5 pp would support UK growth, which would be approximately 0.2-0.3 points of GDP as a high estimate.
3 The index fell by 5.7 points to 39.1 in March, its lowest level since August 2023.
4 The proportion of housing loans in arrears rose to 1.32% of total outstandings in Q4 2024 (source: Financial Conduct Authority). Average arrears on gas and electricity bills hit GBP 1,376 and GBP 1,616 respectively in Q4 2024 (source: Ofgem).
5 Bank of England, Decision Maker Panel, March 2025.

PUBLIC FINANCES: WALKING A TIGHTROPE

The rise in long-term bond yields, in a context of weak growth, will force the government to carry out more fiscal consolidation in order to restore public finances, with the risk of weighing on activity. The fiscal headroom estimated by the OBR (GBP 9.9 billion) is very small and the public body's growth forecast for 2026 (+1.9%) is significantly higher than our current estimate (0.8%). The public deficit, which stood at 5.6% of GDP in the 2023 fiscal year, should remain close to 5.5% in 2024. As the primary balance remains significantly worse than the threshold required to stabilise the debt-to-GDP ratio, the latter will remain on an upward trajectory in 2025 and 2026, approaching 105% of GDP[6].

MONETARY POLICY: FURTHER EASING

Our central scenario remains one of moderate easing in the BoE's key rates – at a rate of one cut per quarter – extending to 2026. Despite persistently high inflation, an acceleration in rate cuts in 2025 is a conceivable alternative scenario, given the risks of a slowdown in activity and the fact that monetary policy is still very restrictive. The BoE's other path of easing would be through less drastic quantitative tightening. Unlike the US Federal Reserve and the ECB, which are taking a passive approach to reducing their balance sheets, the BoE is actively selling some of the Gilts in its Asset Purchase Facility (APF) portfolio. Faced with potential shocks on the bond market, the BoE could decide to limit or halt its sales of securities as a precautionary measure, with the aim of stabilising long-term rates.

EXTERNAL POSITION: DIAMETRICALLY OPPOSED TRENDS BETWEEN GOODS AND SERVICES

The United Kingdom has a strong presence in trade in services. Despite Brexit, the country has remained really dynamic in the technology sectors, which led to a sharp rise in service exports of 7.7% in value terms in 2024 (see chart) and an increase in the trade surplus in this segment to 6.8% of GDP. Conversely, goods exports fell by 7.5% in 2024 and the trade deficit widened to 7.9% of GDP. As a result, exports of goods as a percentage of GDP plunged to 13.2% in Q4 2024, while exports of services hit a record high of 18.6%. The trade ramifications are significant: if trade tensions with the United States were to extend to services, the United Kingdom would be one of the most exposed countries.

6 Central and local government debt (as defined by Maastricht).

UNITED KINGDOM: HOUSEHOLDS MEDIAN LONG-TERM INFLATION EXPECTATIONS (5-10 YEARS)

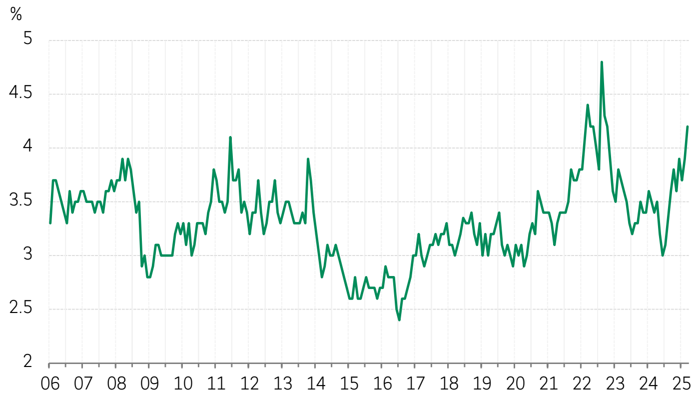

CHART 2 SOURCE: YOUGOV/CITI

Article completed on 17 April 2025

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Fairly limited refinancing risks in the short term

According to our forecasts, the UK Treasury's financing needs will amount to 8.4% of GDP per year on average over the 2025-2027 period; however, this is a relatively limited level, which is due to the high average maturity of the debt (over 13 years). This means that the effects on the interest burden of refinancing at higher rates can be smoothed out considerably over time. In addition, as almost a quarter of sovereign bond outstandings are indexed to inflation, the fall in inflation was a major factor in the decline in the government's interest burden in 2024. This should remain fairly stable at around 3% of GDP in 2025-2026. The significant rise in long-term interest rates creates a significant upside risk to these forecasts. Nevertheless, by sticking with its fiscal rules, the government is able to retain the credibility it needs to contain the upward pressure on bond yields and limit the collateral effects on the property market.

JAPAN

EXTERNAL FEARS AND PAUSE IN THE MONETARY ADJUSTMENT

Japan is heading for a year without quarterly growth. Domestic demand is still constrained, with nominal wages rising at a slower pace than inflation. In addition, the trade policy of the United States, Japan's largest export market, poses a downside risk. The monetary adjustment carried out by the Bank of Japan is jeopardized by the fragility of growth and developments in the US.

2025: TOWARDS A GROWTH-LESS YEAR

The near stagnation in 2024 (annual average growth of +0.1%) masked an improvement throughout the year, with real GDP up 0.4% q/q in Q3 and up 0.6% q/q in Q4, but the negative carry-over effect from 2023 (-0.3 pp) and the contraction in Q1 (-0.5% q/q) adversely affected the average annual result. Our growth forecasts for 2025 indicate a moderate or even negative quarterly pace. The Japanese economy's high exposure to the turmoil triggered by the US administration underpins these expectations.

In fact, the United States is the leading destination for Japanese exports of goods (cf. *Chart 2*). They accounted for JPY 21.3 trillion in 2024, or 3.5% of Japan's nominal GDP. Therefore, the US decision to apply a 24% "reciprocal tariff" to Japanese imports from 9 April has been implying a significant downside risk to Japanese growth. This remains the case insofar as, while the reciprocal tariff has been suspended and replaced by a lower level of 10% for 90 days, a sectoral tariff of 25% on automobiles, which account for a third of Japanese exports to the United States, has applied since 3 April.

A Japan/United States agreement is conceivable in the short term. But this is likely to be to the detriment of the country's economy, thereby not fully erasing the negative impact on growth. In addition, the indirect effects of the disruption to international trade, the climate of uncertainty and the slowdown of other partners — principally China — are likely to persist. Thus, the upcoming challenges for exporters and the negative fallout of uncertainty on corporate investment will be the main forces driving growth down in the short-term.

SUBDUED REAL WAGE GROWTH

In January 2025, growth in scheduled contractual wages hit +3.1% y/y, its highest level since 1992, boosted by an unemployment rate of 2.5%. On the other hand, real wages were struggling to make any lasting progress (-1.8% y/y over the same period), which is an obstacle to reviving domestic demand via household consumption.

Nominal wages are expected to continue to grow dynamically this year. The Rengo trade union confederation announced an agreement for a 5.46% wage increase at the end of the annual negotiations for 2025. This is the highest increase since 1991, and an improvement on the already sizeable figure for 2024 (+5.1%). In addition, the Bank of Japan's Summary of Opinions (January 2025) points to a medium-term "shift away from the zero norm", i.e. persistently sluggish nominal wage growth, which should eventually feed the wage-price spiral.

INFLATION STILL ABOVE THE TARGET

Headline inflation has recently accelerated (from +2.3% y/y in October 2024 to +3.7% in February 2025), due to rising energy prices (+6.9% y/y in February) and rice prices (+80.9%). Core inflation (excluding unprocessed food, up from +2.3% to +3.0%) and new-core inflation (excluding energy, up from +2.3% to +2.6%) have risen more moderately. On the other hand, the price of services, a relevant index of households' pro-

GROWTH AND INFLATION

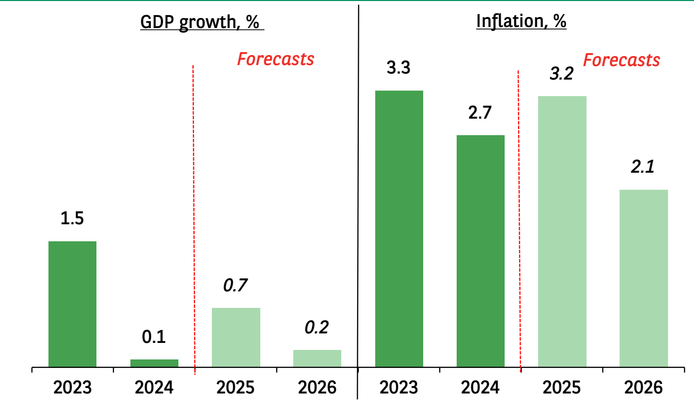

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

pensity to consume and feed a wage-price spiral, has struggled to gain momentum (+1.3% in February).

In addition, core inflation is expected to decelerate over the course of 2025, falling from +3.2% y/y in Q1 to +2.7% in Q4, before remaining slightly above the 2% target in 2026. However, the dynamics of food inflation pose an upside risk. The good news is that optimism about Japan's ability to escape deflation over the long term is reflected in the 10-year breakeven inflation rate (1.6% in February, an all-time record, before 1.5% in March).

A LARGER BUDGET BUT FEWER BOND ISSUES IN 2025

The budget for fiscal year 2025 (April 2025 - March 2026) was passed by the House of Representatives on 4 March 2025. Having failed to win an absolute majority in last autumn's elections, the Liberal Democratic Party has been forced to make a JPY 300 billion reduction in the draft budget initially adopted by Shigeru Ishiba's cabinet, an event which has not occurred since 1996. The final version of the budget amounts to JPY 115.2 trillion (+2.6% y/y), an all-time record, and includes a +9.7% increase in defence spending, making it an expansionary budget. However, the increase in tax revenues, linked to corporate sector profits, will lead to a significant reduction in bond issues (-24.2% y/y). On the other hand, there is a high likelihood that a supplementary budget will be adopted in view of the current downside risk on growth.

MONETARY TIGHTENING: NO MORE HIKES IN 2025

The Bank of Japan (BoJ) has kept gradually adjusting its monetary stance, with the uncollateralized overnight call rate rising to +0.5% (+25 bps) in January, before remaining unchanged in March. The process, which began in January 2024, was meant to continue provided that the BoJ's forecasts materialise: these include a core inflation forecast of +2.4% for the 2025 fiscal year (starting on 1 April), with risks trending upwards, compared with +2.8% according to our forecasts.

However, we anticipate the rate hikes to interrupt for the remaining quarters of 2025. The BoJ's cautiousness, rooted in the fragile demand and the risk of market destabilization, will be even more important in the ongoing environment of uncertainty and the anticipated slowdown in growth. Monetary tightening would resume cautiously in 2026, with a policy rate amounting to +1.0% by year-end.

The maintenance of a restrictive monetary policy in the United States should prevent the JPY from strengthening, which is rather good news for the Japanese economy. According to our forecasts, the USD/JPY will remain above 150 in 2025.

CONTRARY DEMOGRAPHICS

Japan is facing a structural labour shortage. Admittedly, female participation (15-64 year olds) has risen sharply, from around 60% at the start of the century to 76% in 2024, helping the total activity rate to hit 81.6%. But this progress is hampered by demographics. The population of 15-64 year olds has been declining since 1998, while the proportion of people aged 65 and over has reached 29% of the total population — a world record. This constrained labour supply is contributing to weak potential growth, which the Cabinet Office estimates at +0.6% per year. In addition, the number of hours worked has fallen over the years: the annual average was 1,643 in 2024 compared with 2,064 in 1990, adversely affecting potential growth by -0.3 pp.

Article completed on 17 April 2025

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MAIN EXPORT MARKETS FOR JAPANESE GOODS (JPY TRN, 2024)

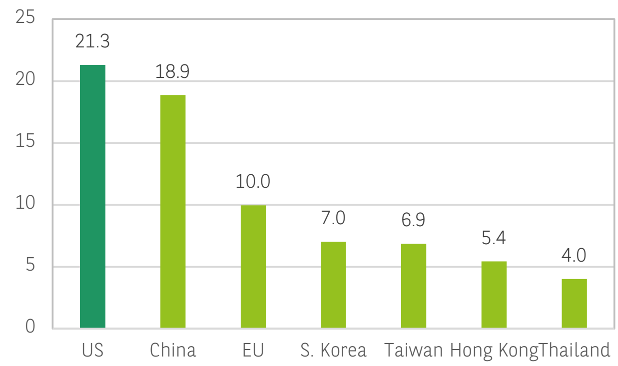

CHART 2

SOURCE: MACROBOND, BNP PARIBAS

Budget Challenges

Japan has the highest level of public debt as a percentage of GDP in the world, at 251% in 2025, according to the IMF. This is expected to fall slightly to 245% in 2029, as inflation supports nominal GDP and tax revenue increases. Alongside strong domestic holdings, the appeal of Japanese debt has increased with the rise in 10-year yields from 0% at the end of 2021 to 1.5% in March 2025. In addition, the current political situation - minority government, weak confidence - is an obstacle to possible consolidation. More generally, Japanese governments face an ambivalent situation. On the one hand, the extraordinarily high level of the public debt ratio suggests the importance of consolidation. On the other hand, the weakness of potential growth, the endemic weakness of domestic demand and the ageing of the population are all factors that will generate new expenditure to remedy them, and which in any case complicate any consolidation that would further worsen the economic situation.

In addition, the change in monetary paradigm represents a new difficulty for the Japanese government in terms of interest charges. From 2013 onwards, the Bank of Japan's quantitative and qualitative easing (QQE) policy has helped to absorb debt issues, boost the central bank's credibility with other investors, and keep interest rates at particularly low (or even negative) levels. However, the monetary adjustment began in 2024 includes the end of yield curve control and a plan to halve the monthly pace of JGB purchases by the BoJ by 2026 (to JPY 3 trillion from JPY 4.4 trillion today). Thus, in March 2025, 10-year bond yields on JGBs exceeded +1.5%, their highest level since 2008. Consequently, the -0.7pp reduction in the primary deficit that we anticipate between 2024 and 2026 would be absorbed by the increase in the interest burden and the total deficit would change little (-0.1 pp to 2.7% of GDP).

FORECASTS

ECONOMIC FORECASTS

%	GDP Growth 2023	GDP Growth 2024	GDP Growth 2025 e	GDP Growth 2026 e	Inflation 2023	Inflation 2024	Inflation 2025 e	Inflation 2026 e
United States	2.9	2.8	1.3	1.1	4.1	2.9	3.1	3.7
Japan	1.5	0.1	0.7	0.2	3.3	2.7	3.2	2.1
United Kingdom	0.4	1.1	1.0	0.8	7.3	2.5	3.2	2.5
Euro Area	0.5	0.8	1.0	1.3	5.4	2.4	2.1	1.9
Germany	-0.1	-0.2	0.4	1.0	6.0	2.5	2.3	2.0
France	1.1	1.1	0.6	1.1	5.7	2.3	0.9	1.2
Italy	0.8	0.5	0.8	1.3	5.9	1.1	1.7	1.7
Spain	2.7	3.2	2.6	2.1	3.4	2.9	2.2	2.0
China	5.2	5.0	4.5	4.3	0.2	0.2	0.8	1.0
India*	7.0	8.2	6.2	6.7	6.7	5.4	4.8	4.2
Brazil	2.9	3.2	2.1	1.0	4.6	4.4	5.3	4.8

* Fiscal year from 1st April of year n-1 to March 31st of year n

SOURCE: BNP PARIBAS (E: ESTIMATES)

FINANCIAL FORECASTS

Interest rates. %

End of period		Q2 2025	Q3 2025	Q4 2025
US	*"Fed Funds (upper limit)"*	4.50	4.50	4.50
	T-Note 10y	4.65	4.40	4.20
Eurozone	deposit rate	2.00	1.75	1.75
	Bund 10y	2.00	2.10	2.25
	OAT 10y	2.80	2.95	3.13
	BTP 10y	3.10	3.25	3.40
	BONO 10y	2.65	2.75	2.90
UK	Base rate	4.25	4.00	3.75
	Gilts 10y	3.90	4.00	4.00
Japan	BoJ Rate	0.50	0.50	0.50
	JGB 10y	1.50	1.60	1.70

Exchange rates

End of period		Q2 2025	Q3 2025	Q4 2025
USD	EUR / USD	1.10	1.11	1.12
	USD / JPY	150	152	152
	GBP / USD	1.29	1.31	1.30
EUR	EUR / GBP	0.85	0.85	0.86
	EUR / JPY	165	169	170

SOURCE: BNP PARIBAS (MARKET ECONOMICS, INTEREST RATE STRATEGY, FX STRATEGY, COMMODITIES DESK STRATEGY)

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