EUROZONE

CONSTRAINED ECONOMIC GROWTH

The upcoming protectionist shift in the United States, the structural difficulties in industry and the political instability in France and Germany will limit the eurozone's economic growth margins in 2025. However, the labour market is holding up well in many countries (the unemployment rate in the euro area is still at a record low level). In addition, some of the shock will be cushioned by inflation falling back down to its target level and by the continued cycle of interest rate cuts. Under these conditions, there is still anticipation of a slight increase in eurozone economic growth in 2025, to 1.0%, which will, again, be underpinned by significant differences in growth levels between Member States.

A MORE UNCERTAIN OUTLOOK AROUND STRONGER GROWTH

The scenario of tougher US protectionist measures remains a risk for the time being. However, while this policy will likely be implemented at least partially, it will not affect eurozone countries uniformly. Industry heavyweights, such as Germany, Italy and Ireland, which exported the equivalent of 3% or more of their GDP in goods to the United States in 2023 and which recorded major trade surpluses (principal focus of the Trump administration), are expected to be hit harder. However, trade agreements are possible in the long run, while the continued cycle of interest rate cuts and, to a lesser extent, the expected positive effects of the European Recovery Fund being ramped up on investment (*see box*) will support domestic demand. Differences in growth between Member States are expected to narrow in 2025, but the status quo from 2024 will not change. Spain should pull the eurozone average upwards again, with Italian and French growth standing at around the average level and Germany recording a more sluggish recovery.

LABOUR MARKET: PERIPHERAL COUNTRIES ARE HOLDING UP WELL

The labour market has been remarkably resilient in 2024, with nearly one million additional jobs created in the eurozone during the first three quarters of the year, and stable quarter-on-quarter growth of around 0.2%. There has been sustained employment growth in Spain and Italy, balancing out the declines seen in France and Germany. The eurozone labour market has been cooling but is still tight, with the vacancy rate moving slightly above its pre-COVID level during Q3 2024[1]. Under these conditions, the overall rise in the jobless rate in the eurozone should be fairly small in 2025, thanks, in particular, to economic activity in the peripheral countries holding up well. Nevertheless, if the downturns in Germany and France, which are already clear, were to intensify, this would affect the rest of the eurozone.

MONETARY POLICY: HALFWAY THERE

With four cuts in 2024 (the most recent occurring on 12 December), the process of normalising the eurozone monetary policy appears to be midway through, based on our forecasts. Interest rates are expected to settle at their neutral rate, which we estimate to be around 2%, in June 2025. However, should growth weaken further, the ECB could proceed with more rate cuts, which some members of the ECB's Executive Board have alluded to[2]. At the same time, the ECB will accelerate its quantitative tightening from January 2025, with the reinvestment of maturing securities within the PEPP portfolio being phased out completely.

GROWTH AND INFLATION

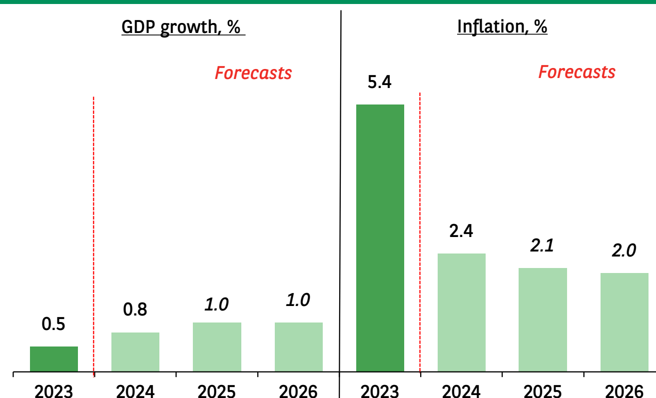

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

INFLATION: DOWN RATHER THAN UP

After a two-year period of uninterrupted disinflation (initially spearheaded by energy, and subsequently by industrial goods and food products), which helped inflation to fall below 2% y/y in September, inflation rose again due to adverse base effects on energy. Core inflation, driven by services, has remained broadly stable since spring 2024. However, some momentum in the services CPI has ebbed away, with an annualised 3m/3m rate dropping to 1.3% in November, its lowest level since August 2021[3]. Therefore, the scenario of core inflation gradually coming down to the 2% target is still intact. In addition, median household inflation expectations fell sharply (2.1% in October for three-year expectations), which is consistent with a continued slowdown in wage growth. Higher customs tariffs in the United States will have limited effects on inflation in the eurozone, as a decline in the euro caused by this policy, which will likely fuel inflation within the monetary union, will be offset by the negative effects on business activity.

FISCAL POLICY: ANOTHER GREAT DIVIDE

In 2025, fiscal policy is expected to be moderately restrictive in the eurozone, with greater control over current expenditure, particularly in Italy. The situation in France is still hanging on the adoption of a budget. Even with the deteriorating public finances of some countries, which have been subject to an excessive deficit procedure[4], we should not overlook the fact that fiscal consolidation has been continuing in the euro area overall. The public deficit is expected to come down close

1 According to Eurostat, the vacancy rate in the eurozone was 2.6% in Q3 2024, compared to 2.5% in Q4 2019.
2 See Financial Times article, *ECB must commit to faster rate cuts, says Bank of Italy Governor,* 19 November 2024.
3 Seasonally-adjusted data.
4 Belgium, France, Italy, Malta and Slovakia.

to 3% of GDP in 2024, compared to 3.6% in 2023. In Italy, the deficit will plummet in 2024, due to the Superbonus and energy subsidies being reduced. In Portugal and Greece, the country's fiscal consolidation and debt reduction are still a major policy focus, which should lead to a further increase in their primary surpluses in 2024.

STRUCTURAL CHALLENGES: A PRODUCTIVE BASE TO BE REBUILT

For the eurozone, generating growth underpinned more strongly by productive investment and productivity gains is still a key challenge. Between 2002 and 2023, hourly labour productivity gains in the eurozone increased by an average of 0.7% each year (compared to +1.6% in the United States[5]). This weaker performance is mainly due to the gap in intangible investments (software and R&D) that has been constantly widening for nearly twenty years. These investments currently account for more than 6% of GDP in the United States (Q2 2024), compared to 3 to 4% in the eurozone.

THE CURRENT ACCOUNT SURPLUS, SUPPORT FOR THE EURO

The eurozone's external accounts are still strong. Over a 12-month cumulative period, the current account recorded a surplus of EUR 425 billion in September, i.e. nearly 3% of eurozone GDP[6]. Although the trade surplus in machinery and equipment has shrunk from its record levels in 2014, due to Chinese competition in this segment in particular, the surplus in chemicals (made up largely of pharmaceutical products) has more than doubled over the decade. Meanwhile, the strength of tourism activity is driving the surplus on services to record levels. The current account surplus remains a support for the currency and the effective exchange rate, which, following a period of decline between 2008 and 2015, has generally been appreciating.

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EVOLUTION OF REAL GDP IN THE EUROZONE (INDEX 2002=100)

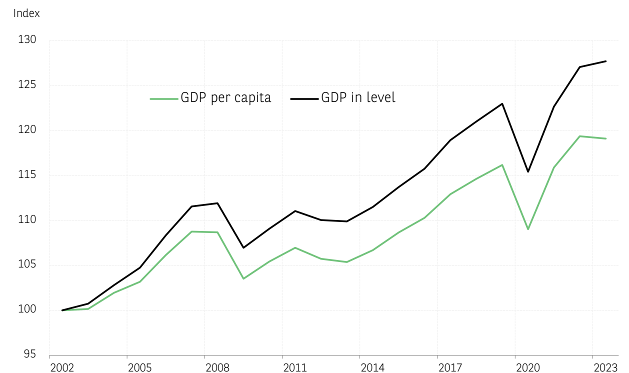

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS CALCULATIONS

DISBURSEMENT OF EU RECOVERY FUND (% GDP)

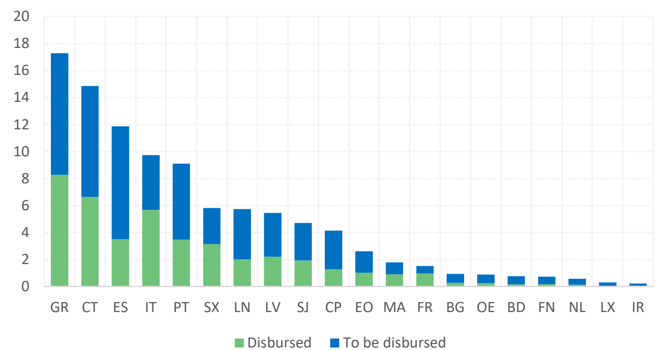

CHART 3 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS CALCULATIONS

5 OECD source. Constant purchasing-power-parity data (2015 basis).
6 Calculated against the 2023 nominal GDP.

EUROPEAN RECOVERY FUND: A RAMP-UP EXPECTED IN 2025

Almost four years after it was introduced (February 2021), the Recovery and Resilience Facility or RRF, commonly known as the "European Recovery Fund", has allocated less than half of its funds. At the beginning of December 2024, EUR 270 billion had been transferred to European Union Member States (EUR 95 billion in the form of loans and EUR 175 billion in the form of grants) out of a total budget of EUR 648 billion. With the official payment period spanning until the end of 2026, the next two years should see payments sped up, with more noticeable effects on investment as a result. This is the expectation of the European Commission, which, in its assessment of the medium-term fiscal-structural plans[1], stated that the absorption rate would increase to 0.4% of GDP in 2025. So far, the impacts on investment have been rather limited, and the mid-term report published by the European Commission in February 2024 highlighted a series of obstacles to distributing these funds on the ground, which are mainly administrative issues (such as higher procedural costs and a lack of human resources), but also the substitution effects between RRF funds and the EU Cohesion Policy programme.

1 See 2025 European Semester: Autumn package, European Commission, 26 November 2024.