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

GROWTH AND INFLATION

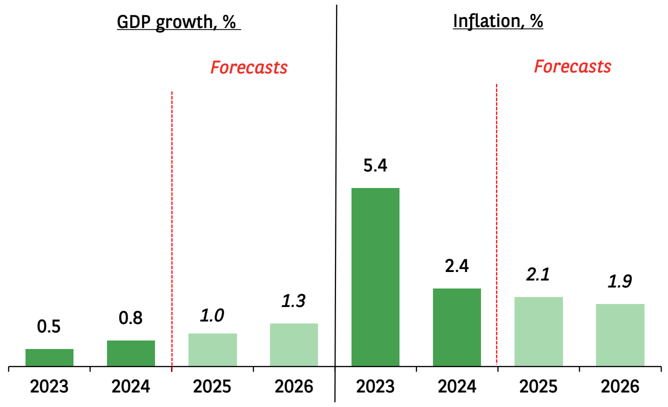

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

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]

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

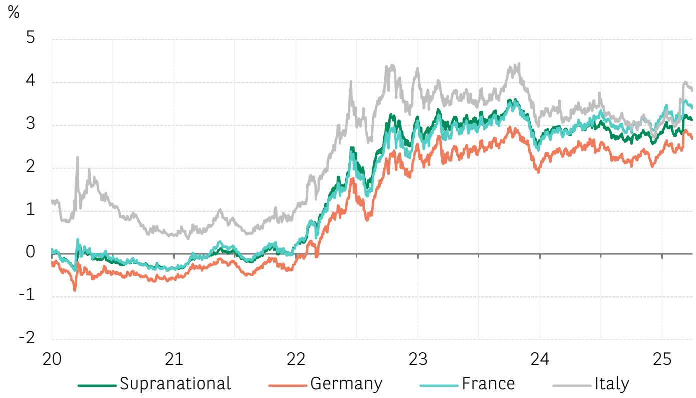

CHART 2

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.

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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.