

## THE RECOVERY IS FRAGILISED BUT NOT CALLED INTO QUESTION

According to our forecasts, the impact of the conflict in the Middle East is likely to restrict GDP growth to 1.0% in 2026 and 1.3% in 2027 (down from 1.6% for both years prior to the conflict). Private consumption will be hit by falling real wages (with inflation projected at 3.0% in 2026 and 3.3% in 2027, compared to initial estimates of 1.9% and 2.3%). However, the high savings rate will enable households to mitigate the impact over time. Economic activity could suffer from less favourable interest rate dynamics (we anticipate a 50bp increase in ECB rates in 2026). However, the ongoing investment in defence, AI and electrification is expected to continue and boost intra-EU trade. The expected deterioration in public finances in 2026 will be significantly less severe than in 2022.

### GROWTH HINDERED BUT STRUCTURAL STRENGTHS PRESERVED

The conflict in the Middle East is undermining the prospects for a recovery in household consumption in the first half of the year, as rising energy prices are weighing on real wages. Real wages are expected to fall (by around 0.5 percentage points) this year, with wage growth falling below inflation from Q2 2026 onwards. Nevertheless, the savings rate remains high (14.4% of disposable income in Q4 2025), enabling households to cushion the effects of the shock over time. Furthermore, the more structural factors supporting economic activity remain intact: investment in AI and digital infrastructure is ongoing, while the recovery in hourly productivity is becoming clearer (+0.9% in 2025 compared with 2024), albeit unevenly across different countries, and is expected to continue. Investment spending in Germany is already strengthening (see the Germany section) and, according to our calculations, spending in the European defence sector is set to rise by nearly EUR 80 billion in 2026 (see our analysis). However, due to the strengthening of domestic demand, it will be difficult to improve the external balance's contribution to GDP (it was negative in 2025, at 0.6 pp). Instead of the smooth growth trajectory expected in 2026 prior to the outbreak of war in Iran, the growth trajectory will be bumpy: Q1 is expected to be resilient (as suggested by our nowcast) before a slowdown in Q2, followed by a rebound in activity in the second half of the year.

### THE PERIOD OF STABLE INTEREST RATES IS COMING TO AN END

We anticipate monetary tightening by the ECB in 2026, which will likely be accompanied by a rise in long-term rates. Against this backdrop, a continued rise in rates for new household mortgage loans, which began in January 2026, appears inevitable (+10 bp to reach 3.4% in January). For the time being, only rates on new fixed-rate loans – accounting for around 35% of new mortgage lending in the Eurozone – have risen. For the remainder of 2026, their rise is expected to continue but will be more moderate than that of new variable-rate loans (mainly due to the rise in long-term market rates, which anticipates that of short-term rates). The slowdown in new mortgage lending since December 2025 is therefore expected to continue, exerting pressure on the construction sector and property-related activities in particular.

As regards consumer credit, the rise in market rates and risk premiums imposed by banks, together with their reduced risk tolerance, could push up the cost of borrowing, which is already at a historically high level (7.5% in January 2026 compared with an average of 5.5% between 2018 and 2022). The slowdown in new output is expected to intensify in 2026 and weigh on economic activity, particularly in the retail sector (+1.5% y/y in January 2026 compared with +1.7% y/y in December 2025 on a year-to-date basis).

Growth in new investment loans to businesses is already less vigorous (+11.9% y/y in January 2026 compared with +15.2% y/y in October 2025

### Growth and inflation

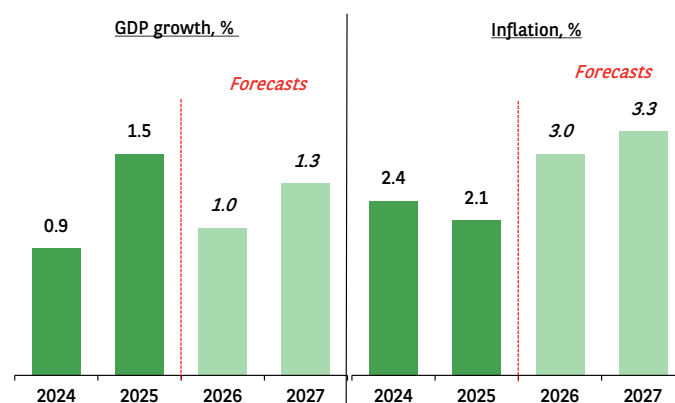


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

on a year-to-date basis). Interest rates have remained relatively stable since November 2024, hovering around 3.6% for fixed-rate loans, and are not, to date, among the main factors limiting investment decisions, despite concerns regarding sluggish demand and weak growth. Rising energy and raw material costs are likely to increase demand for working capital, which is already at an unprecedented level.

### INFLATION: A SIGNIFICANT RISE, BUT LIKELY LESS SEVERE THAN IN 2022

The precise magnitude of the price rise remains dependent on how the conflict in the Middle East unfolds and on the second-round effects of the energy shock. Rising production costs will impact corporate profit margins, which are already under pressure (39.2% of value added in Q3 2025, one percentage point below their historical average). However, the likely fall in real wages should mitigate this shock. Furthermore, firms are expected to limit increases in their selling prices to what is strictly necessary, in light of demand being depressed by the energy shock. Thus, the rise in core inflation is expected to begin only in Q3 and remain contained. Moreover, imported deflation from China remains a significant factor in moderating goods prices in Europe, although this could diminish with the energy shock. Import prices for machinery and equipment from China were still down 2.3% year-on-year in January 2026 (-3.2% for chemicals). Inflation is then expected to ease in 2027, bringing an end to the contraction in real wages in the second half of 2027.



## LABOUR MARKET: MORE PRONOUNCED SECTORAL DIFFERENCES

The labour market is expected to continue facing headwinds. AI could have a greater impact on job creation in the digital and tech sectors than in the past. Job creation in this sector has been robust post-Covid ([see our analysis](#)), but it slowed significantly in 2025 (41,800 compared with 198,000 in 2024 and an average of 285,000 for 2022–2024). This comes at a time when competitive pressure from China and declining opportunities in the US will continue to affect some industrial employment in 2026, with these difficulties compounded by the renewed rise in energy prices. Nevertheless, the strengthening investment cycle is expected to bolster employment in other sectors (defence, energy, construction), while demographic ageing will continue to underpin employment in healthcare. Against this backdrop, the unemployment rate is expected to remain at a level comparable to that of 2025 (6.2–6.5%), which is close to the structural unemployment rate that does not trigger an acceleration in inflation (6.5% according to the European Commission).

## MONETARY POLICY: RATE HIKES COULD OCCUR FROM 2026

The rise in inflation raises the risk of the ECB tightening monetary policy as early as 2026, whereas before the outbreak of the conflict in the Middle East, we had expected this to occur in the second half of 2027. In our previous scenario, these rate hikes were prompted by stronger growth, which in turn fuelled inflation. Now, such tightening would serve to limit second-round effects arising from a supply shock. The question of whether tightening will occur and the timing of any rate hikes remains unresolved, as they are subject to significant uncertainty. The March data does not, for the time being, suggest any significant acceleration in inflation outside of energy prices (three-month selling prices, excluding the oil sector, show a moderate rise; [see our analysis](#)). Furthermore, the ECB is likely to take time to observe this transmission mechanism before making any adjustments to its strategy. It aims for price stability in the medium term, which could allow for a temporary increase in inflation above the target, consistent with its operational framework set in June 2025).

Should tensions arise, the ECB might be tempted to take pre-emptive measures to limit second-round effects and reduce the scale of any necessary rate hikes. Real interest rates are now significantly higher than in 2022 and aggregate demand is weaker ([see our analysis](#)), which allows for a measured response. Furthermore, the likelihood that fiscal support will be lower than in 2022 should reduce the ECB's risk of needing to counterbalance the impact of this support on inflation dynamics with a more restrictive policy.

## PUBLIC FINANCES: MODERATE DETERIORATION EXPECTED, IN CONTRAST TO 2022

In our scenario, national measures designed to cushion the energy shock would remain much more targeted and limited than in 2022, resulting in a limited impact on public finances in 2026. Compared with a pre-conflict scenario, in which the overall public deficit in the Eurozone was expected to stabilise at around -3% of GDP in 2026, as in 2025, there is now a risk of a slight increase. Indeed, a rise in the deficit remains likely in Germany (linked to investment plans rather than the conflict in Iran), while the previously expected improvements in France, Italy and Spain are likely to yield only slight stabilisation.

<sup>1</sup> [Boosting EU competitiveness: the way forward - Consilium](#).

## Intra-UE trade should continue to gain traction

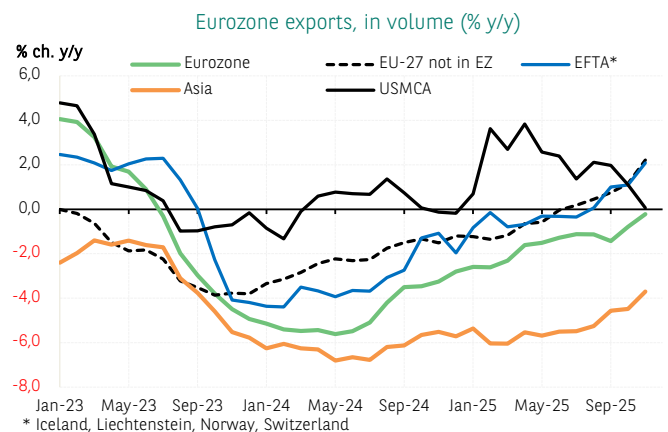


CHART 2

SOURCE: EUROSTAT, BNP PARIBAS

Interest payments are expected to continue rising, reaching 2.0% of GDP in 2026, with an upside risk in countries where inflation-indexed debt is more widely used. The recent rise in bond yields does not alter our longer-term forecasts ([see our analysis](#)). Indeed, they have now reached the levels we anticipated (which were below our scenario prior to the conflict in Iran). Furthermore, the average maturity of public debt (8.3 years in February 2026) will help to mitigate the impact of rising rates on interest expenditure over time.

## THE REORGANISATION OF EXPORT FLOWS WILL CONTINUE

Exports from the Eurozone to China fell further in 2025 (-9.9% by volume). However, total exports are holding up, thanks to a greater focus on regional markets, particularly neighbouring countries with a growing industrial base (Türkiye, Morocco, the Balkans; [see our analysis](#)). The growth of intra-European exports, which was modest in 2025 (+0.4% in volume in 2025, +2% with the rest of the EU and EFTA offsetting the intra-Eurozone decline of -0.2%), is expected to strengthen. This growth would benefit from the ramp-up of the rearmament plan, as well as from European preference policies and the consolidation of the single market, as outlined in the 'One Europe, One Market' plan<sup>1</sup>, the effects of which will be more visible in 2027 than in 2026. Furthermore, the extension of the framework agreement with the United States should help stabilise exports to the region in 2026, although there is uncertainty regarding potential new tariffs. The entry into force of the agreement with Mercosur (on 1 May 2026), and the conclusion of new agreements (with Australia, India and Indonesia) are expected to have a positive impact in the medium term.

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