

ADVANCED ECONOMIES

“ BEFORE THE OUTBREAK OF WAR IN THE MIDDLE EAST IN LATE FEBRUARY, OUR 2026 FORECASTS FOR THE MAJOR ADVANCED ECONOMIES CALLED FOR HIGHER GROWTH AND LOWER INFLATION. THIS NEW CONFLICT IN THE PERSIAN GULF IS A GAME-CHANGER. THE RESULTING ENERGY SHOCK IS OF A STAGFLATIONARY NATURE: GROWTH FORECASTS ARE BEING REVISED DOWNWARD AND INFLATION FORECASTS UPWARD, WITH THE MAGNITUDE VARYING BY COUNTRY. ”

ECONOMIC RESEARCH



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ECONOMIC OUTLOOK 2026-2027: ADVANCED ECONOMIES FACE THE RISK OF STAGFLATION

Before the outbreak of war in the Middle East in late February, our 2026 forecasts for the major advanced economies pointed to higher growth and lower inflation. However, this new conflict in the Persian Gulf is a game-changer. The resulting energy shock is of a stagflationary nature: growth forecasts are being revised downward and inflation forecasts upward, with variations observed across different countries. Most of the supportive factors that were present in 2025 are expected to remain in place in 2026, providing some buffer against the shock. Under the central scenario of the conflict losing intensity by the end of the second quarter, growth forecasts for 2026 are lowered by 0.4 percentage points (an average of the revisions for the countries considered here) while inflation forecasts are revised up by 1.1 percentage points. Fiscal support is expected to remain limited and targeted, with little room for manoeuvre. Monetary support, however, is not currently on the agenda. For the time being, central banks are more concerned about inflationary risks than the negative impact on growth. They appear ready to raise their policy rates, although a definitive decision has yet to be reached. This is our scenario for the ECB and the Bank of England (BoE). For the Bank of Japan (BoJ), such a hike would align with the ongoing process of monetary tightening. The Fed, for its part, would stick to the *status quo*.

At the start of the year, we expected 2026 to be as turbulent as 2025 (judging by geopolitical upheaval and tensions in the early days) as well as characterised by stronger growth, this latter being driven by the reinforcement of the supportive factors at work in 2025 (lower uncertainty, favourable financial conditions, low oil prices, resilient global trade, the AI boom, European revival, good labour market performance, lower inflation, less restrictive monetary policy, and broadly neutral fiscal policy). The challenge was to capitalise on the momentum and, as in 2025, overcome obstacles despite the risks: upward pressure on long-term interest rates, the full impact of the U.S. tariff shock, escalating trade tensions, AI-driven stock market correction, threats to the Fed's independence, and geopolitical tensions¹.

FROM ONE SHOCK TO ANOTHER

A few months later, geopolitical risk resurfaced. The Israeli-American offensive in Iran on 28 February, along with the spread of the conflict throughout the region, propelled the geopolitical risk indicator to an historic high, comparable to that reached when the Russian offensive in Ukraine began (see Chart 1). The resilience of the global economy is being severely tested by the new energy shock triggered by this latest war. This shock affects all countries, albeit to varying degrees, depending on their level of exposure and their capacity to absorb the impact. This is a negative shock for the global economy, in which there are only losers, even if net hydrocarbon-exporting countries will be less impacted than net importers. Of the seven advanced economies reviewed in this issue of EcoPerspectives, the United States is the least vulnerable, while Italy, Germany, the United Kingdom and Japan are more exposed; France and Spain fall somewhere in between.

Deprived of a number of its supporting factors (oil prices, uncertainty, inflation and monetary conditions, all previously favourable), to what extent will growth withstand the shock thanks to the cushioning effect of the remaining factors still in play? To what extent should we also be concerned about the apparent disconnect between, on the one hand, the stock markets' rather benign outlook and the geopolitical de-escalation they seem to be factoring in, and, on the other hand, a more difficult, complex and uncertain reality on the ground, characterised by substantial concerns (disruptions in fuel and derivative supplies, a prolonged and delayed return to normalcy)? Is there excessive optimism on one side and excessive pessimism on the other? At this stage, it is not easy to decide.

The war in the Middle East is driving geopolitical risk to a peak close to that seen at the outbreak of the war in Ukraine

Geopolitical Risk (GPR) Index, 30-Day Moving Average

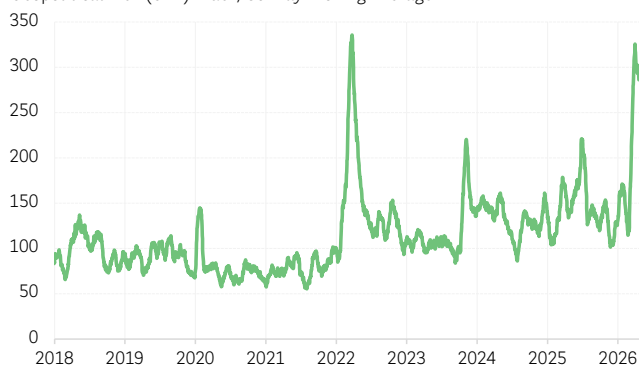


CHART 1

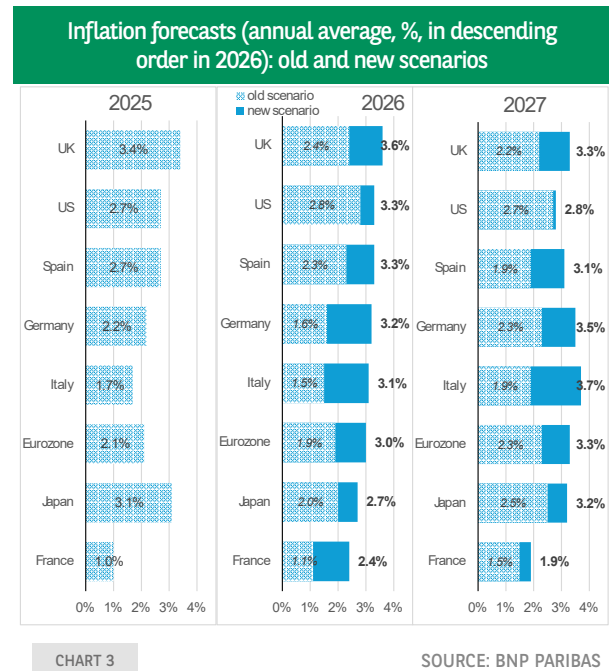
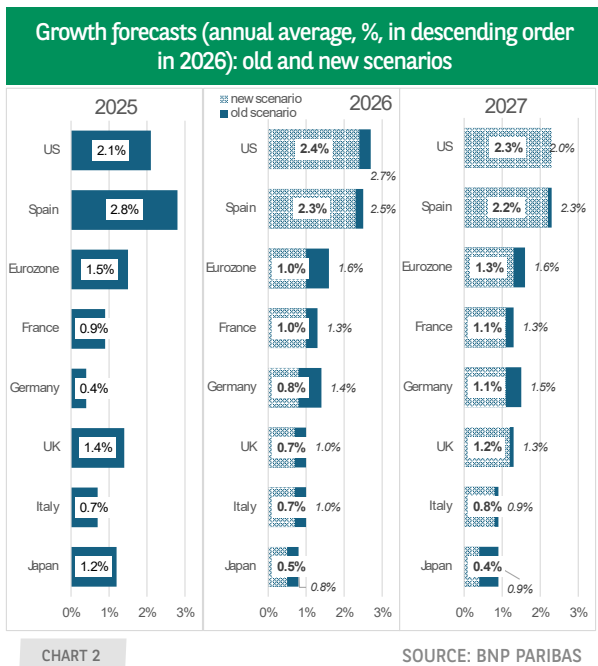
SOURCE: [MATTEO IACOVIELLO](#), BNP PARIBAS

In summary, our new baseline scenario strikes a balance: it acknowledges a definite shock mitigated by several structural supportive forces at play. However, a scenario involving a severe economic crisis cannot be ruled out: the longer the shock lasts, the greater the risk of cascading and non-linear negative effects will become, especially as the likelihood of reaching the limits of fiscal and monetary policies also increases.

Our baseline scenario posits that the conflict and associated supply disruptions will subside by the end of the second quarter. According to our forecasts, the energy shock is expected to reduce growth by 0.4 percentage points in 2026 (averaging our forecast revisions for the economies covered in this publication) and add 1.1 percentage points to inflation. The countries with the most significant revisions are Germany for the growth forecast (revised downward) and Italy and Germany for inflation (revised upward); the countries with the least significant revisions are Spain for growth and the United States for inflation (see Charts 2 and 3). Due to ongoing tailwinds, the shock is anticipated to remain generally manageable, particularly as the economic environment appears, at first glance, less inflationary than in 2022 (see our latest [Ecolnsight](#)). The spillover of rising energy prices to other components of the consumer price index will, nevertheless, be closely monitored.

¹ See Ecoweek editorial, [2026 Economic Outlook in Advanced Countries: Building on the Success of 2025, 12 January 2026](#).





SUPPORTING FACTORS SHOULD NOT BE OVERLOOKED

Household consumption appears to be the most vulnerable GDP component to this new energy shock, while investment (both private and public) could hold up better. On the one hand, the deterioration in the purchasing power of real wages (with expected inflation once again surpassing the growth in nominal wages, which is slowing) negatively affects household budgets but positively influences corporate margins. On the other hand, investment from both the corporate and public sector is likely to continue benefiting from favourable tailwinds, some of which are common to all countries (AI, defence, decarbonisation, electrification), while others are specific yet have global spillover effects (infrastructure in Germany, aerospace for France, European funds for Italy and Spain). Taken together, these factors would help offset the negative impact of uncertainty, escalating production costs and rising interest rates. The factors bolstering investment would also benefit foreign trade, which is further boosted by the ongoing reconfiguration of global trade and the resurgence of intra-European trade.

Survey data for March showed an initial, immediate but limited impact of the Gulf conflict, more pronounced in household confidence than in business confidence (illustrating households' heightened sensitivity). In terms of the business climate, the impact was more pronounced in the services sector than in manufacturing (illustrating the tailwinds in this sector)². As a well-known adage suggests, the situation is likely to get worse before it gets better. This, in any case, is what is outlined in our baseline scenario.

The resilience of the labour market will also be tested. However, this factor will play a central role in cushioning the impact of the energy shock on household confidence and consumption. Before the outbreak of war in Iran, indicators were mixed, revealing both signs of weakness and resilience. A prime example is the unique, uncomfortable yet sustainable equilibrium that defines the U.S. labour market, characterised by a low hiring and low firing regime. Looking ahead to the coming months, we expect the unemployment rate in the major advanced economies to rise overall, but only to a limited extent.

Fiscal policy should also provide some support, albeit limited, by targeting aid as effectively as possible given the lack of room for manoeuvre. Most governments are constrained by very high public debt ratios and already face challenging trade-offs between resource allocation and spending savings needed to make room for "old new" expenditures (defence, decarbonisation, ageing populations). These constraints are exacerbated by the upward trend in long-term interest rates (see our latest [EcoInsight](#), for more details on the measures taken so far). However, Europe can rely on alternative strategies aimed at jointly and structurally strengthening its growth and internal market (see table).

CENTRAL BANKS: CAUTIOUS, OBSERVANT, BUT ON HIGH ALERT

While the challenges faced by governments are not easy to tackle, those faced by central banks are even more complex. They are caught in a dilemma: should they raise their policy rates to counter inflationary risks (but further weaken growth), or should they lower them to address downside risks to economic activity (but fuel inflation)? For now, caution and patience remain the order of the day while they monitor the actual developments of the situation. Their response will depend on their own reaction function, on the timing and intensity of the risks that materialise, and potentially on the measures taken by governments (the less impactful these measures are, the less central banks will have to counter their demand-supporting effects to contain inflation).

Central banks are also on high alert and appear ready to act, currently leaning more towards tightening rather than easing. According to our forecasts, the ECB, the BoE and the Bol (for whom this would be part of its ongoing tightening cycle) are expected to raise their policy rates, while the Fed would favour the *status quo*.

Article completed on 23 April 2025

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² See our dashboard comparing the current energy shock with that of 2022 [Eco Charts 17 April 2026 - Economic Research - BNP Paribas](#).



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'One Europe, One Market' Plan — European Council of 18–19 March 2026

Priority areas	Key measures	Target deadlines	Objective
1. Single Market	28th regime ('EU Inc.')	Agreement by end of 2026	Create a unified European legal status for innovative companies to remove barriers to cross-border growth and foster the emergence of European champions.
	Unified electronic declaration — posted workers	Agreement in June 2026	Simplify administrative procedures for employers operating in multiple Member States and facilitate labour mobility within the internal market.
	Mutual recognition of professional qualifications	EC proposal — autumn	Enable skilled workers to practice more quickly in another Member State, boosting productivity and helping meet recruitment needs across Europe.
	European Business Wallet (digital identity, 'once only')	Agreement by end of 2026	Digitalise interactions between companies and public administrations under the 'once only' principle to reduce administrative burden and speed up cross-border operations.
	Merger Regulation review	EC proposal — 2026	Relax EU merger control to remove regulatory barriers to the formation of large, globally competitive European companies
	Priority given to regulations over directives	—	Ensure uniform application of EU law across all Member States to reduce internal market fragmentation and provide a more predictable framework for businesses.
2. Regulatory simplification	Finalisation of the 'Omnibus' packages	Agreement by end of 2026	Ease the regulatory burden on companies, particularly SMEs, to free up their capacity to invest and innovate.
	Omnibus IA	EC proposal — July 2026	Adapt and simplify the regulatory framework for artificial intelligence to accelerate AI deployment and strengthen the competitiveness of European players.
3. Energy	Short-term measures — electricity prices and volatility	End of 2026	Lower energy costs for European companies and limit price volatility — essential conditions for industrial competitiveness and household purchasing power.
	Revision of the ETS (emission allowances)	EC proposal — July 2026	Revise the emissions trading system to better reconcile the decarbonisation pathway with the competitiveness of European industries exposed to international competition.
	<i>Grid package</i>	Agreement in 2026	Modernise and interconnect electricity grids to secure supply, integrate renewables, and support industrial electrification.
4. Industry and innovation	Mapping of critical strategic dependencies	End of 2026	Identify European vulnerabilities in critical raw materials, components and technologies to guide economic sovereignty and industrial resilience policies.
	European Preference / Industrial Accelerator Act	End of 2026	Favour European products and suppliers in public procurement and strategic sectors to support reindustrialisation and accelerate the deployment of key technologies.
	Diversification of trade and investment links	—	Reduce excessive dependencies by diversifying trade and investment partners, strengthening the resilience of European value chains.
5. Investment	Savings and Investment Union (proposals on securitisation, financial markets integration and supervision package)	Agreement by end of 2026	Channel European savings towards companies and innovation projects by deepening capital markets integration and facilitating equity financing.
	Digital euro	Agreement by end of 2026	Provide Europe with a public digital currency to strengthen strategic autonomy in payments and support innovation in financial services.

TABLE

SOURCE: EUROPEAN COMMISSION



UNITED STATES

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GROWTH AND FULL EMPLOYMENT TESTED BY UNCERTAINTY

US growth remains robust, exhibiting strong momentum, but is still reliant on a narrow base – AI on the activity side and healthcare for jobs. The energy shock presents a new challenge, and its impact will depend on both the duration and severity of the Iran war. In any case, this situation is likely to drive inflation further above the target. Our baseline scenario projects 2.4% annual GDP growth in 2026 (down 0.3pp vs. the pre-conflict outlook) and 2.5% in 2027 (+0.3pp). Inflation is expected to reach 3.2% y/y in 2026. Against this backdrop, we expect the Fed to adopt a two-sided stance, with balanced risks around the Fed Funds rate and a hold as the baseline scenario. Tariffs continue to pose significant uncertainty, as does the trajectory of the federal deficit, which is set to widen, notably due to conflict-related outlays.

GROWTH: WILL AI-LED OUTPERFORMANCE WITHSTAND HIGHER ENERGY PRICES?

In 2026, growth should continue to be driven by the same factors as in 2025 – AI-related CapEx, wealth effects stemming from high equity valuations (until February), and healthcare outlays (up 0.4% to 6.0% of GDP in 2025, with stability expected in 2026). AI diffusion, coupled with near-stagnant employment, underpins productivity gains that significantly exceed pre-pandemic trends (2.3% y/y on average since 2023, vs. 1.4% from 2014 to 2019; see Chart 1). The Congressional Budget Office (CBO) expects productivity gains to continue in 2026 (at 2.2%). Nevertheless, growth remains narrowly based, with limited spillover effects and a “K-shaped” investment pattern ([see Chart of the Week on this topic](#)).

The Iran conflict introduces downside risks. Moreover, the US status as a net energy exporter does not fully shield its economy from the effect of higher inflation and rising costs on household purchasing power and corporate profit margins (which are already under strain due to tariffs). Consequently, GDP growth may be reduced by a few tenths in 2026, depending on the duration and severity of the conflict. In summary, the primary risk is not a shortfall relative to potential growth (1.8%), but rather a more uneven economic landscape, characterised by increasing fragility outside of AI-driven sectors.

A PUSH FOR BANK LENDING?

On 19 March, US banking regulators proposed a comprehensive review of the regulatory framework. The primary objective is to encourage banks to increase lending to households and businesses by reducing the capital requirements associated with lending activities, and to curb competition from the largely unregulated non-banking sector. While the expected benefits are unlikely to materialise in the short term (pending the finalisation and implementation of the regulations), their impact in the medium to long term may be constrained by other factors (paperwork and leverage requirements will remain unchanged, and some of the released capital could be allocated to other activities). More immediately, the uncertainties and inflationary pressures triggered by the Middle East conflict are likely to dampen credit demand. While 30-year mortgage rates had been trending downward since May 2025 (-90bp), they have rebounded by 25bp since late February, standing at 6.23% in late April. Therefore, the strong momentum observed in H2 2025 for both outstanding household loans and corporate financing flows could run out of steam.

¹ Summary of Economic Projections, Federal Reserve, March 2026.

Growth and inflation

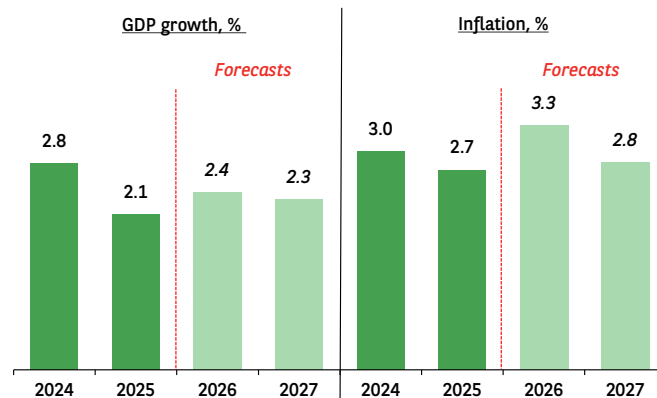


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

LOW PAYROLL GROWTH, YET FULL EMPLOYMENT PERSISTS

The labour market should remain close to full employment, with the unemployment rate hovering at 4.3%-4.4%, compared with an estimated long-term level of around 4.2%. Job creation has significantly decelerated in recent quarters, deviating from the post-pandemic dynamism. In Q4 2025, non-farm payroll growth stood at 0.2% y/y, marking the slowest rate (excluding recessions) since 2003. In addition, job growth is increasingly concentrated in education and health services (682k y/y in 2025, vs. 116k aggregate; see Chart 2). Those jobs are largely non-cyclical, which is positive, yet they are also low-value-added (17% of employment, 9% of GDP). The low rate of layoffs and discharges (1.1% in 2025, unchanged from 2024) reinforces the full employment scenario. The US economy is effectively in a ‘low hiring, low firing’ regime, as firms are reluctant to both recruit and reduce staff amid heightened uncertainty. Consequently, a slowdown linked to the Iran conflict would likely only marginally increase the unemployment rate – by 0.1pp to 0.3pp – compared with a flat baseline scenario.

INFLATION RETURNS TO CENTRE STAGE

CPI and core CPI are set to keep overshooting the 2% y/y target, at least until 2028. The pass-through from higher oil prices, coupled with partial, but likely, second-round effects from rising production costs, is driving inflation forecasts upward. Firms have already absorbed tariff


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costs into their margins over the past year, leaving little scope for further absorption. The uncertainty around this outlook remains high, hinging on the trajectory, duration and severity of the Middle East conflict. Any extension or escalation would further intensify price pressures. That said, the inflationary spike is likely to be far less pronounced than in 2022, when CPI peaked at 9.1% (June). Current conditions are, in fact, less conducive to second-round effects, on both the supply and demand sides (see [Chart of the Week on this topic](#)).

FOMC: TWO-SIDED OUTLOOK, STEADY POLICY RATE

Risks appear to be evenly distributed, given expectations of a slight uptick in inflation alongside ongoing labour market concerns. In this context, we project that the Fed Funds target range will hold steady at 3.5% - 3.75% until 2027. Nonetheless, we expect the FOMC to adopt a two-sided outlook, signaling equal readiness to implement rate hikes or cuts if necessary – marking a departure from the previous downward bias. This stance would allow for a wait-and-see approach on core inflation and economic activity, while keeping market inflation expectations anchored and allowing for the possibility of a rapid policy shift.

As a result, policy will lean more on communication than on adjustments in rates. This reflects the macroeconomic conditions that prevailed prior to the shock. Compared to 2022, the policy rate is significantly higher (3.75% upper bound in February 2026, vs. 0.25% in 2022), while CPI inflation is considerably lower (2.9% y/y in Q4 2025, vs. 6.8% in Q4 2021). Furthermore, the Fed tends to react more forcefully when inflation is demand-driven rather than supply-driven ([NBER Working Paper, 2026](#)), as monetary policy tools are more effective on the latter ([Powell, 2022](#)).

Finally, the upcoming replacement of Jerome Powell (Chair since 2018) does not alter our outlook. The incoming chair, Kevin Warsh, has recently called for rate cuts, which is at odds with the “hawk” reputation he earned during his governorship (2007–2011). However, the FOMC will continue to be governed by majority rule, and we do not foresee a dovish shift unless macroeconomic data dictate otherwise (see our [Eco Insight on this topic](#)).

THE FISCAL RISK OF WAR

The US federal deficit is susceptible to a potential decline in the near to mid-term, after narrowing to -5.9% of GDP (+0.4pp) in FY 2025, bolstered by student loan reform and additional tariff revenues. The latter were expected to stabilise at around USD 300 bn annually, allowing the budget deficit to hold at -5.8% of GDP in 2026 and 2027. However, the Supreme Court’s ruling that struck down “reciprocal” tariffs could trigger refunds on duties collected in 2025. At the same time, the Iran conflict is likely to exert pressure on public finances, primarily through higher defence spending, while no tangible measures to support demand have been implemented so far. The upward pressure on bond yields is set to extend, particularly on the long-end of the curve (10- and 30-year yields at 4.55% and 5.15% respectively by end-2026), notably reflecting the fiscal risk of the conflict.

Strong productivity growth is driving economic growth

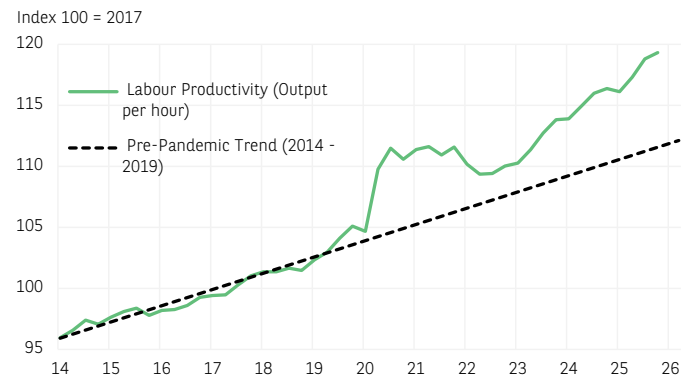


CHART 2

SOURCE: BEA, BNP PARIBAS

In summary, according to our forecasts, the federal deficit could widen to -6.5% of GDP as early as this year. Should plans to ramp up military spending materialise (President Donald Trump has called for a permanent USD 500 bn annual increase, or 1.6% of GDP), against the backdrop of ongoing war (and its associated costs), we anticipate that the deficit could exceed -8.0% of GDP by 2027. Additionally, debt-service costs, estimated at 3.3% of GDP in 2026–2027, could also rise accordingly. In any case, federal debt remains on an upward trajectory and is expected to exceed 100% of GDP as early as 2026.

FOREIGN TRADE: UNCERTAINTY PERSISTS

Following the Supreme Court’s ruling that terminated both “reciprocal” and fentanyl-related tariffs, a universal 10% tariff (excluding exemptions and bilateral agreements) has been implemented under Section 122 of the Trade Act of 1974², in force until 24 July 2026. By then, President Trump is expected to roll out a new tariff framework: i) sector-specific measures under Section 232 of the Trade Expansion Act of 1962 (pertaining to “national-security”); and ii) country-specific measures, under Section 301 of the Trade Act of 1974 (addressing “unfair trade practices”). According to our estimates, the average effective tariff rate is expected to reach at 8.4% to 10.6% in 2026, down from 10.1% in H2 2025, yet significantly higher than the 2.3% recorded at the end of 2024. While uncertainty is set to persist (particularly regarding the future of the USMCA), the US administration appears inclined to uphold the trade agreements concluded in 2025, notably with the EU and Japan.

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² “Section 122 authorises the President to impose temporary import duties or surcharges «[w]henver fundamental international payments problems require special import measures to restrict imports (1) to deal with large and serious United States balance-of-payments deficits” (Congress).



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

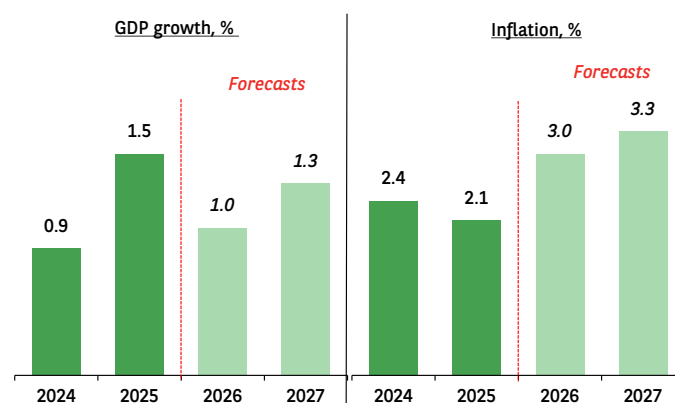


CHART 1

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.

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

Intra-UE trade should continue to gain traction

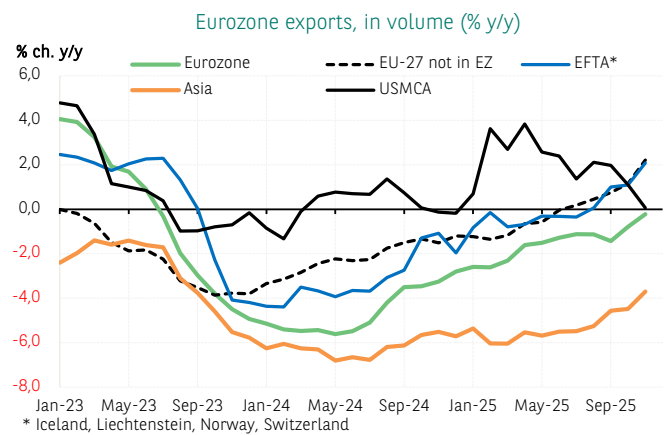


CHART 2

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' plan¹, 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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GERMANY

10

A WEAKER RECOVERY, BUT ONE THAT IS STILL EXPECTED TO TAKE HOLD

After two years of recession, German growth began to recover in 2025. We expect it to strengthen in 2026, driven by the ramp-up of investment plans. We are, however, revising our forecasts downwards, as the German economy remains vulnerable to the current shock to energy prices (+0.8% in 2026 [-0.6pp] and +1.1% in 2027 [-0.4pp]). This will weigh on private consumption due to the impact of rising inflation (3.2% in 2026 [+1.6pp] et +3.5% in 2027 [+1.2pp]) on the purchasing power of wages. The fiscal trajectory, meanwhile, is expected to remain broadly unchanged. Public debt is set to continue rising towards 70% of GDP by 2030, which, in the current context, would maintain upward pressure on long-term interest rates.

GROWTH SET TO HOLD UP BETTER THAN IN 2022

After two years of contraction (-0.7% in 2023 and -0.5% in 2024), German growth returned to positive territory in 2025 (+0.4%), despite the US tariff shock. It was mainly driven by private consumption and public spending. Foreign trade weighed on economic activity, but for relatively favourable reasons: nearly two-thirds of the rise in imports came from capital goods, foreshadowing the ramp-up in public investment expected in 2026.

At the same time, investment made no contribution to growth in 2025, as the decline in the private sector was offset by the increase in the public sector. However, it has been rebounding since Q3 and is expected to accelerate further in 2026. It will be supported by public investment plans and tax incentives. The increase in new industrial orders observed at the end of 2025 serves as an additional indicator of an impending acceleration in investment ([see our analysis](#)). In our view, the conflict in the Middle East will not undermine this favourable momentum. The prolonged nature of public investment plans and their rapid implementation at the start of the year suggest ongoing support for growth: between January and February, investment spending (excluding SVIK¹) more than doubled compared with the same period last year (see Chart 2), defence spending rose by 38%, and SVIK disbursements have already reached 1/4 of the 2026 target.

Conversely, the situation for Germany's industrial sector, which is particularly energy-intensive, is more challenging, as this shock compounds the issues faced in 2022, the rise in US tariffs and growing Chinese competition. At this stage, business surveys suggest these risks should be put into perspective: although companies are reporting sharp rises in input costs, the deterioration observed remains less severe than in 2022.

Household consumption, on the other hand, will be significantly affected by the ongoing rise in energy prices. The expected resurgence in inflation will weigh on their spending intentions, even as wages have caught up with inflation in 2022-2023 to a lesser extent than elsewhere in Europe (see Chart 3). The risk is that this will lead, as it did previously, in a sharper rise in the savings rate than in France, Italy or Spain.

THE PROSPECT OF WAGE PRESSURES IS RECEDING

The German labour market remains historically strong. The unemployment rate increased from a low of 3% to 4% and stabilised at that level between December 2025 and March 2026, while remaining low compared with the eurozone average (6.2% in February across the eurozone). This rise in unemployment is due to job losses in the manufacturing sector, despite ongoing job creation in the services sector. Job losses are expected to continue in sectors that are already in difficulty, which are also the most exposed to the energy shock.

¹ Investment spending takes into account only spending from the main budget (excluding SVIK, the EUR 500 billion infrastructure fund).

Growth and inflation

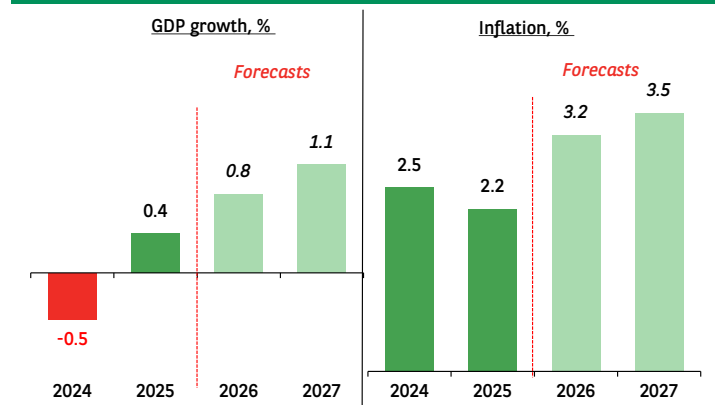


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

Investment spending (without SVIK) have more than doubled compared to the same period last year

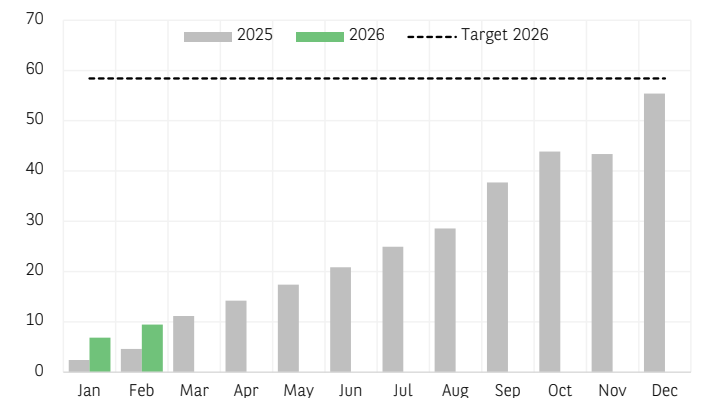


CHART 2

SOURCE: BUNDESFINANZMINISTERIUM, BNP PARIBAS

At the same time, the demand for labour has stabilised at a low level, and the tightness in the labour market continues to ease in both industry and services. Only construction remains an exception, although recruitment difficulties are easing there.

Against this backdrop, the gradual rise in employment linked to investment plans in defence and infrastructure is not expected to generate significant wage pressures. The redeployment of production capacity



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freed up by sectors in difficulty, and in particular their workforce, will in fact help to meet some of the needs of businesses. Furthermore, the prospect of wage growth once again falling short of inflation should mitigate the impact on profit margins of a likely rise in input costs.

INFLATION CONSISTENTLY ABOVE 2% COMPARED WITH THE REST OF THE EUROZONE

Inflation picked up again in March (+0.8 pp to 2.8% y/y), while the core component remained stable (2.5%). This rise is attributable to energy prices (+7.2% y/y). In the coming months, German inflation is expected to remain higher than that of the eurozone (2.5% y/y in March).

The high sensitivity of German electricity prices to fluctuations in gas prices suggests a sharper rise in inflation, which is likely to feed through to core inflation. Having accumulated nearly 5 percentage points of additional inflation compared with France and Italy since the onset of the inflationary crisis in 2022, this gap could widen further. This would pose a challenge to German competitiveness, which has already been in decline for nearly 10 years ([see our analysis](#)). Consequently, inflation is expected to remain above 2% at least until the end of 2027, a level below which it has not fallen since 2021.

In Germany, more than in other countries, this inflationary trend has significantly impacted real wages, which remain around 11 percentage points below their levels prior to the post-Covid inflationary crisis. The minimum wage increases planned for 2026 and 2027 (+8% and then +5%, to EUR14.60/hour) will have a direct impact on low-wage earners. However, their influence across the entire wage spectrum is likely to be limited. This situation is adversely affecting household confidence and consumption.

A FISCAL TRAJECTORY LARGELY UNCHANGED AT THIS STAGE

The current context does not call into question our assessment of a controlled increase in public spending. This is based on the budgetary reform initiated by the government in 2025, which includes a multi-year plan that derogates from the debt brake to finance investments in infrastructure and defence, while maintaining a constrained federal budget outside these sectors. Consequently, an initial rise in the public debt ratio was observed in 2025, to 63.5% of GDP (up from 62.2% in 2024).

At this stage, the budgetary cost of the measures adopted by the government in response to rising energy prices remains moderate (EUR 1.6 billion). These measures are centred on capping fuel prices and reducing the tax on petrol by EUR 0,17 / litre for a period of two months. In addition, a one-off, tax-free support payment of EUR 1,000 may be paid to employees. Further measures could be introduced if the conflict drags on and energy prices remain high. However, the scale of these measures is expected to be smaller than that seen in 2022, as there is less fiscal room for manoeuvre. Any additional measures or any deterioration in the deficit linked to a slowdown in growth will need to be offset in order to comply with the debt brake rule. Consequently, our public debt scenario remains broadly unchanged from our autumn forecast ([see our analysis](#)).

At the same time, financing requirements linked to extra-budgetary funds are likely to continue to exert upward pressure on sovereign yields. The yield on the 10-year Bund crossed the 3% threshold at the end of March, amid inflationary pressures and expectations of increased fiscal support. However, the effective interest rate on debt remains low (due to the prolonged period of negative long-term rates) and the debt burden (1.1% of GDP in 2025) is expected to increase only gradually, reaching 1.7% in 2030.

German wages have recovered less than in other countries to their pre-Covid inflationary crisis levels

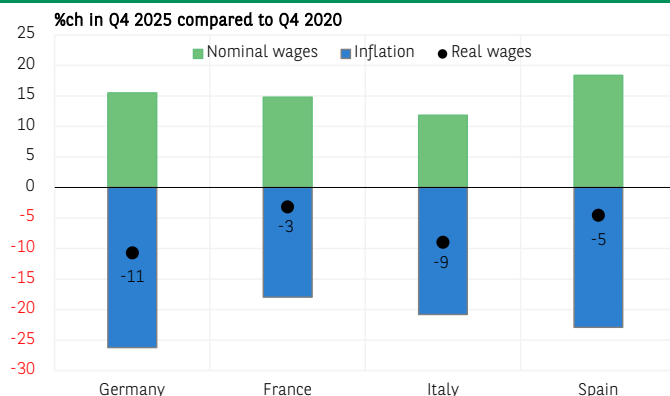


CHART 3

SOURCE: EUROSTAT, NATIONAL STATISTICS, BNP PARIBAS

Furthermore, structural reforms are ongoing, particularly those aimed at bolstering business investment, reforming tax and social protection systems, and expanding the labour supply. Fiscal measures are already in place (accelerated depreciation of business investment until 2027, to be followed by a reduction in corporation tax from 2028), supplemented by administrative simplifications for businesses, which will lead to an overhaul of the tax system effective from 1 January 2027. Finally, proposals for social security reform (pensions) have been put forward and will be finalised by the end of 2026.

A REBALANCING OF FOREIGN TRADE IS UNDERWAY

Exports continue to account for a significant share of the German economy (41% of GDP in 2025), significantly higher than the levels seen in the rest of the eurozone (nearly 30% in France, Italy and Spain). Although exports have not contributed to growth since 2023, they stabilised in 2025. This stabilisation is due to a geographical shift in trade patterns, with exports to the eurozone increasing (+4.1% y/y in 2025), compensating for the decline in markets outside Europe (notably China and the United States).

Beyond this geographical reallocation, a rebalancing of intra-European trade is underway. This shift is prompted by a reversal in competitiveness trends, characterised by a faster rise in labour costs in Germany than in other European countries over the past decade, in contrast to the previous period. As a result, Germany's trade surpluses with other European countries are gradually diminishing, as these countries increasingly benefit from German demand. This trend is reinforced by German investment plans and the intention to establish a European supply base as part of rearmament policies. It is evident in the rise of German imports and a reduction in bilateral surpluses, particularly with France. Therefore, German demand is fostering growth in other European countries, a recent development that is set to continue.

Article completed on 21 April 2026

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FRANCE

12

GROWTH, PUBLIC FINANCES: STAYING ON TRACK

Since rebounding in Q2 2025, French growth has been relatively robust. Things are not expected to have changed in Q1 2026, with growth supported in particular by precautionary spending. In Q2, higher inflation (and thus lower purchasing power) should weigh on household consumption, whilst support from public finances is expected to be more moderate than in 2022. However, French growth is expected to remain resilient, driven in particular by public investment (both French and European) in defence and private investment in AI. Overall, we are revising our growth forecasts to 1% in 2026 (-0.3 pp) and 1.1% in 2027 (-0.2 pp); and our inflation forecasts to 2.4% in 2026 (+1.3 pp) and 1.9% in 2027 (+0.4 pp). However, we are maintaining our forecasts for the public deficit at 5% of GDP in 2026 and 4.5% in 2027.

GROWTH: COPING WITH HIGHER INFLATION, BUT BENEFITTING FROM THE RESILIENCE OF INVESTMENT AND EXPORTS

The stars had aligned for 2026 to be a good year for growth. Rebounding aeronautics production and the implementation of European rearmament plans were set to support exports. The clearer pass-through of the ECB's monetary easing to lending rates for the non-financial private sector had boosted investment. After several months of wage growth outpacing inflation, growth in household consumption was accelerating. Finally, the budget adopted in February pointed to robust public consumption and investment.

With the war in Iran, private domestic demand is facing the most pronounced downside risks. Rising oil prices are weighing on household purchasing power, which is likely to affect their spending intentions. As a result, household consumption will likely decline in the second quarter.

Rising uncertainty and inflation have already weighed on interest rates (a 15-basis-point rise in lending rates to non-financial corporations between August 2025 and February 2026). It is still uncertain as to whether the ECB will raise its key interest rate. This would weigh on private-sector investment prospects, but would not call them into question. Business investment is expected to rise in both the services and construction (AI and data centres) sectors. Household investment is expected to mainly benefit maintenance/renovation (strong performance in second-hand transactions) and, to a lesser extent, new-builds (a slight rebound in housing starts). Public investment (+2.1% in 2025) is expected to continue to grow, supported by decarbonisation, rearmament and service investment efforts.

Overall, the business climate remained stable for the time being. It is underpinned by the situation in industry, which is benefitting in particular from public spending (rearmament plan) and robust exports, which are expected to continue.

FOREIGN TRADE: BULLETPROOF?

Since mid-2025, France has benefitted from a rebound in its exports of goods, particularly in aeronautics, defence, pharmaceuticals and industrial inputs (electronics). This momentum continued in January and February 2026, helping to restore the current account balance (following a deficit of EUR 12.5 billion in 2025, or -0.3% of GDP). Export gains are mainly intra-EU, primarily to Germany, and are expected to provide significant support for GDP growth. This momentum is expected to continue despite the war in Iran, as it is driven by industrial sectors with little exposure to the region. Furthermore, it depends on growing public demand driven by European rearmament plans (which are far from limited to the German plan; [see our analysis](#)) or investments that are not sensitive to the economic cycle (AI).

Growth and inflation

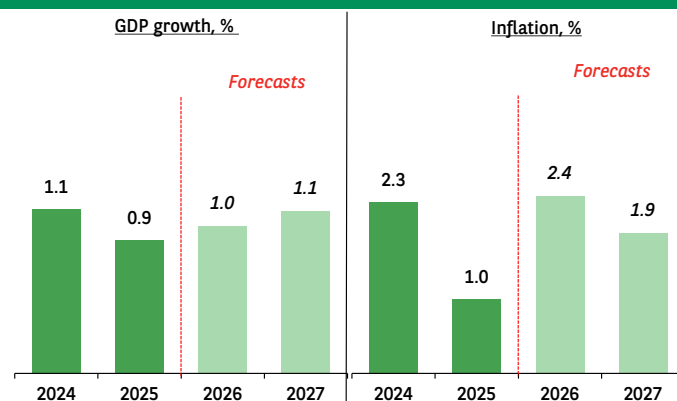


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

LOANS: GOOD MOMENTUM WITH SLIGHT DETERIORATION RISKS

The rate on new housing loans to households rose by 10 bp in Q1 2026. This modest rise contrasts with the stable rate, at around 3% in 2025. Despite a highly competitive environment, our rate scenario (money market and swap rates) suggests a slight increase in average mortgage rates in Q2, and probably a sharper rise thereafter. At the same time, monthly new lending has stabilised since Q2 2025, hovering around the moderate level of EUR 12.5 billion, before falling slightly in Q1 2026 (EUR 12 billion). A rise in rates would automatically weigh on the figures. Therefore, growth in outstanding loans is modest (+0.2% y/y in February) due to high repayment flows linked to the abundant new lending during the period of low interest rates. As a result of households' decreased ability to purchase property, transaction volumes are expected to decline and prices are expected to stabilise over the coming quarters.

Corporate investment loans remained buoyant in Q1 2026, driven mainly by the acceleration in the lending for construction purposes (up 4.6% y/y and 5.5% y/y in January and February, respectively). Market financing is keeping pace, rising by 6.1% y/y, against a backdrop of a slight fall in the cost of debt issued (-9 bp m/m). The forthcoming rise in market rates is likely to make bank financing more attractive. However, the profitability of investment projects could be eroded, but not enough to jeopardise them.



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INFLATION IS PAINFUL FOR THE CONSUMER

Harmonised inflation hit a low in January 2026 (0.4% year-on-year), which pointed to improved household purchasing power and suggested a rebound in household spending. At the time, it was not known that the period of wages rising faster than inflation (by a cumulative 2 percentage points over 2024–25) was about to end. Harmonised inflation accelerated in March to 1.9% y/y, driven by rising fuel prices. As a result, from Q2 onwards, it is expected to outpace wage growth. Although, according to our forecasts, inflation is expected to rise less sharply than in 2022–2023 (peaking at nearly 3% in early 2027, compared with 7.3% in February 2023) and spread less widely to goods and services, household purchasing power is also likely to be less protected than in 2022–2023. According to our calculations, public support measures adopted at the time prevented (at their peak) nearly 2.5 percentage points of inflation, whereas the support is likely to be more limited this time – with the government favouring targeted measures to prevent the public deficit from widening. According to our forecasts, the purchasing power of gross disposable income is set to contract by 0.3% in 2026 (compared with a gain of +0.4% in 2022, despite an inflation of nearly 6% according to the harmonised measure). Consequently (and despite a fall in the savings rate from 18.1% in 2025 to 17.5% in 2026), private consumption is expected to grow by just 0.5% in 2026 (as in 2025), compared with a 1% rebound anticipated before the war in Iran. This would reduce GDP growth by nearly a quarter of a percentage point.

LABOUR MARKET: MODERATE DETERIORATION

The slight decline in salaried employment in 2025 (-0.2% y/y in Q4, compared with +0.2% y/y in Q4 2024) followed the low point recorded in terms of growth (0.7% y/y in Q1 2025) and led to a slight rise in the unemployment rate (7.9% in Q4, compared with 7.3% a year earlier). In 2026, the unemployment rate is expected to rise to 8.2%, driven by a rise in youth unemployment. This moderate deterioration should limit the decline in household confidence. This situation is also consistent with the continued moderation of wage pressures, meaning that, like in 2022, corporate margins would be supported by a decline in real wages (albeit to a lesser extent), partly offsetting the impact of rising oil prices. This trend is expected to persist until mid-2027. Indeed, although an increase in the minimum wage is expected from May (with the price index having risen by 2% compared with the end of 2025), the imperfect indexation of wages above the minimum wage suggests that real wages are likely to decrease.

PUBLIC FINANCES: CONSOLIDATION REMAINS THE TARGET

The public deficit reached 5.1% of GDP in 2025, a more pronounced improvement on its 2024 level (5.8%) than the government's target (5.4%), linked to a 0.8-pp rebound in compulsory levies (43.6% in 2025, [see our analysis](#)). In 2026, the public deficit is expected to be in line with the government's 5% target. The consequences of the energy shock are likely to wipe out the fiscal leeway that had emerged following the strong performance of 2025, particularly due to an additional 0.1 percentage point in debt servicing costs (mainly due to the impact of inflation on index-linked bonds). A rise in bond yields would have only a very marginal upward effect on the latter, due to the debt's high average maturity (8.5 years).

French exports have rebounded sharply since mid-2025

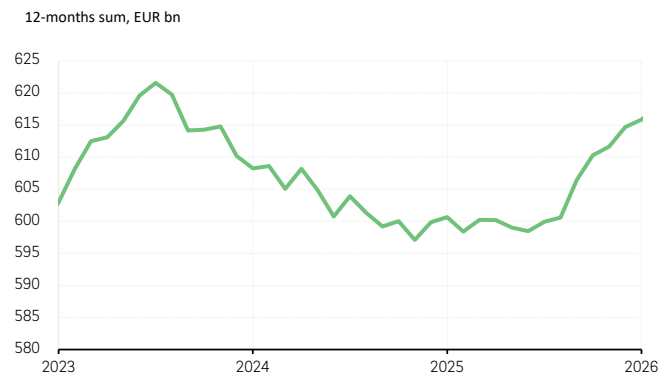


CHART 2

SOURCE: CUSTOMS, BNP PARIBAS

Support measures in response to the inflationary shock, currently amounting to EUR 400 million (less than 0.1% of GDP), have been announced. With no room for manoeuvre, the government has announced that any additional measures will be offset by equivalent savings. The increase in the defence budget and the debt service (together accounting for +0.6 percentage points of GDP) is expected to prevent a decline in the public expenditure ratio (which is projected to stabilise at around 57% of GDP in 2026 and 2027). As a result, the reduction in the public deficit would, once again, rely on a rebound in compulsory levies, which would return to their pre-COVID level (44.4% of GDP) by the end of 2027. Reducing the public deficit at an average rate of 0.5 percentage points of GDP per year would help to slow the rise in public debt (115.6% of GDP in 2025, +3 pp y/y) before stabilising it at around 120% of GDP in 2030, when the budget deficit is expected to return to the 3% of GDP target.

Article completed on 21 April 2026

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NAVIGATING ENERGY VULNERABILITY, RESILIENT TRADE AND LIMITED FISCAL CAPACITY

Italy entered 2026 with moderate momentum, posting a real GDP growth of +0.3% q/q in Q4 2025. However, the economy faces increasing risks due to its reliance on LNG and its exposure to the Strait of Hormuz. Consequently, growth is projected to be around +0.7% in 2026 (-0.3 pp), accompanied by weaker investment, consumption and exports. Inflationary pressures are also mounting, as are energy costs for businesses. Despite these challenges, foreign trade remains adaptable. Fiscal consolidation is progressing, although fiscal capacity remains limited.

🔄 FACING A DETERIORATING GEOPOLITICAL ENVIRONMENT

The deterioration of the geopolitical situation and the resulting energy shock have come at a time when the Italian economy was showing the first signs of a modest recovery. Real GDP grew by +0.3% q/q in Q4 2025, mainly due to a rebound in investment, giving the country a growth carry-over of 0.3% into 2026. In January and February, the composite PMI and the Ita-coin indicator still pointed to an expansionary trend, albeit at levels below the Q4 2025 average, and the demand for services was buoyed by the Milan-Cortina 2026 Winter Olympic Games. Although total and foreign orders in the first two months of 2026 hinted at a slight strengthening of the industrial sector, this momentum could stall or reverse if the war in the Middle East continues. In February, industrial production saw a modest increase of 0.1% m/m. Such lacklustre industrial performance is expected to continue throughout Q1 2026.

Assuming the conflict ends by Q2 2026, GDP is projected to slow down or stagnate. The impact of high global energy prices on economic activity is expected to become particularly evident in Q2 2026, when GDP is projected to slow down slightly relative to Q1. If tensions subside within around four months, the overall growth rate for 2026 would be around 0.7% (a downward revision of 0.3 pp). Investment would be most affected, while the NRRP remains the main stabilising force.

Despite an increase in total income in 2025, consumption remained structurally weak due to stagnation in per-capita wages. While employment growth contributed to a rise in aggregate labour income, it did not enhance its per-capita value; moreover, most of the income increase came from non-labour sources, which predominantly benefit the top income quintile, whose households have a very high propensity to save (45%).

🛢️ FRESH INFLATIONARY PRESSURES AMID ENERGY VOLATILITY

Italy's oil intensity – measured as barrels of oil per euro of GDP – has more than halved over the past 45 years, falling from 1.6 in 1980 to 0.66 in 2024. Between 2023 and 2026, Italy significantly transformed its energy supply mix, replacing Russian gas with LNG and with Mediterranean/Caucasus pipelines. This reduced dependence on a single supplier but created a new energy vulnerability: exposure to global maritime routes and chokepoints such as the Strait of Hormuz. A notable statistic illustrates this well: in 2024, over 46% of LNG came from Qatar. Energy accounts for 10.9% of Italy's consumer-price basket (4.7% attributable to fuel and transport, and 6.2% to household energy), a higher proportion than the Euro area average of around 9%.

Following a period of negative energy inflation in early 2026 (-6.2% y/y in January and -6.6% y/y in February), energy HICP prices are expected to rebound in Q2, ranging between +0% and +4%.

In a scenario where oil and gas prices peak at USD 130 and the war lasts for ten months, Confindustria¹ estimates that headline inflation would rise by 13 pp. By comparison, Italy's inflation rose by 12 pp

¹ Confindustria, Rapporto di previsione: Guerre, dazi, incertezza, a rischio la crescita, March 2026

Growth and inflation

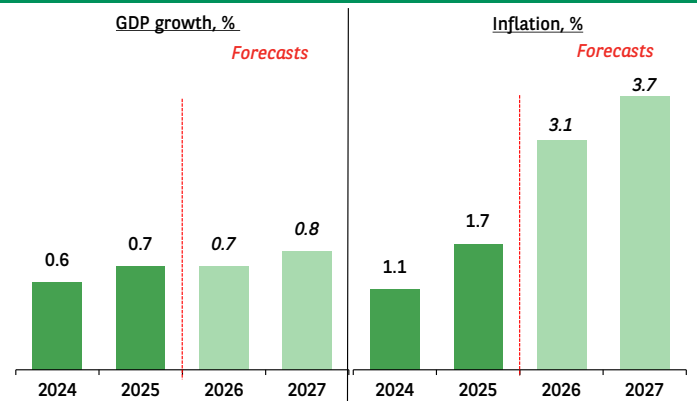


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

from trough to peak during the 2021-2022 period. Historical patterns suggest that second-round effects are likely to materialise around six months after the initial shock, although weaker demand and potential price mitigation measures (similar to those in 2022) could mitigate the impact.

Preliminary estimates indicate that the HICP increased by +1.6% m/m and +1.7% y/y in March 2026 (the highest level since March 2025). Higher energy prices and partial pass-through to core inflation could push headline inflation close to 3% in 2026.

A prolonged energy shock would increase costs for businesses, increasing the share of energy in total costs to around 5.9% in 2026 (4.9% in 2025). Given that Italian businesses already face higher energy costs than their main European competitors, any further increase in overall production costs would affect manufacturing output, which had already declined in 2025 (-0.5% y/y; -0.2% for industry as a whole), thereby impeding the ongoing recovery effort.

👤 THE EXCEPTIONAL EMPLOYMENT GROWTH THAT BEGAN IN 2023 IS BEGINNING TO RUN OUT OF STEAM

In the 15-64 age group, employment rose by just 0.8% in 2025, roughly half the rate seen in 2024, resulting in an employment rate of 62.5%. Job creation was driven mainly by the over 50s. The unemployment rate fell to 6.1%, the lowest annual rate ever recorded, while the inactivity rate returned to the 2023 low of 33.3%.

On the productivity side, between 2024 and 2025, value added grew by 2.2% cumulatively, whereas labour input fell by 0.4%. This combination brought labour productivity per employee back to pre-pandemic levels



by the end of 2025, although productivity per hour worked remains lower. Hourly wages rose by 3.1% y/y in 2025.

Early indicators for 2026 point to a labour market that remains generally robust but is clearly beginning to slow.

PUBLIC FINANCES: REAL PROGRESS, THIN MARGINS

Italy's fiscal deficit decreased to 3.1% of GDP in 2025, down from 3.4% the year before, while public debt rose to 137.1% of GDP (+2.2 pp compared with 2024). These figures demonstrate that consolidation is underway, but they are insufficient to secure an early exit from the EU's Excessive Deficit Procedure; the shortfall misses the target by 0.1 pp, largely due to the Superbonus scheme. Eurostat is set to confirm these figures on 22 April.

The shortfall is unlikely to derail the broader trajectory. Current spending remains on track, and tax revenues have exceeded expectations, raising the primary surplus from +0.5% to +0.7% of GDP, marking one of the highest primary surpluses in the Eurozone, alongside Portugal, Greece, Cyprus, Ireland and Luxembourg. Rating agencies have acknowledged these developments: S&P revised its outlook to "positive" in January 2026, Fitch maintained a "stable" outlook in March, and Moody's (27 March) described Italy's consolidation trajectory as credible and achievable, highlighting political stability as a key factor. According to Confindustria, this stability helped narrow the BTP-Bund spread and cut yields by 115 basis points between the end of 2023 and the end of 2025, reducing corporate borrowing costs by 12-14% in 2024-2025 and potentially saving up to EUR 30 billion in interest if debt were refinanced at current rates over the average 8-year maturity.

Nevertheless, the energy shock complicates the outlook and threatens to erode already tight budgetary margins. The government's response on 19 March consisted of temporary fuel-duty cuts (worth EUR 417 million), which were later extended to 1 May (with an additional EUR 500 million), together with anti-speculation measures. Finance Minister Giorgetti ruled out any immediate corrective actions but left the door open for EU coordination under the general safeguard clause.

Markets have already reacted: the BTP-Bund spread reached 100 basis points on 27 March, with the 10-year yield hovering above 4%. Interest expenditures now amount to 3.8% of GDP—almost double that of France and Spain, and four times that of Germany—and total debt exceeds EUR 3,095 billion. Even modest declines in growth caused by higher energy prices could reduce revenues and further reduce the limited fiscal margin available to absorb shocks without resorting to corrective measures.

ITALIAN FOREIGN TRADE REMAINS RESILIENT DESPITE REPEATED AND UNPREDICTABLE SHOCKS

Over the past few years, exports have demonstrated strong adaptability, thanks in large part to rapid geographical reallocation: approximately 8% of Italian products change their destination annually (6% for Germany)². Imports have also been highly dynamic, with a 12% annual recomposition rate in 2022-2023 (indicating the share of goods sourced from different suppliers) and have stabilised at around 9% in the last two years, significantly higher than the corresponding figure for Germany.

Share of energy in consumer basket

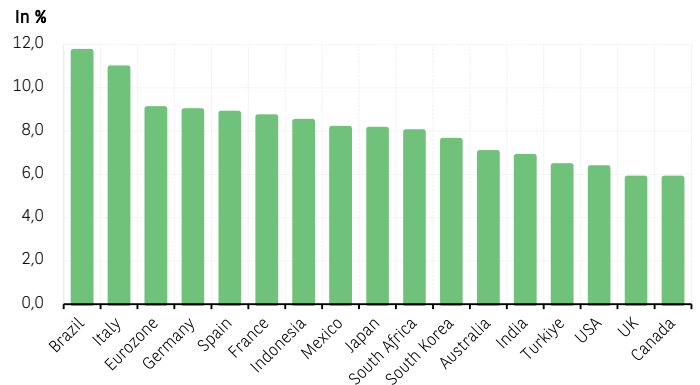


CHART 2

SOURCE: BNL ECONOMIC RESEARCH, OCSE

Multinational companies continue to play a key role, accounting for around three-quarters of manufacturing exports. Their significance is particularly evident in distant markets, where they account for 85.9% of exports to China and 83.1% of exports to the United States.

Nevertheless, the import side remains vulnerable to potential disruptions in the supply of strategic goods. Although Italy's dependence on strategic goods imports is broadly comparable to that of other major EU economies, it is more exposed to foreign energy inputs than Germany and France³. Moreover, 40.4% of Italy's strategic imports originate from countries classified as having "low" or "limited" political risk (51% for the four leading EU countries).

In January 2026, Italian imports fell by 1.3% m/m (-7.4% y/y), while exports were essentially flat (-0.1% m/m; -4.6% y/y). Exports to the United States, which had risen by +7.2% in 2025, declined by -6.7% y/y, with all product categories, except for pharmaceuticals, posting lower figures. Preliminary data for February suggest a modest rebound, but the comparison with early 2025 is distorted by the exceptional increase due to frontloading.

In the first half of 2026, foreign trade will be affected by the fallout from the conflict in Iran: a slowdown in global demand, reduced confidence, higher energy prices, rising transport costs, and increased prices for raw materials and imports, are all likely to negatively impact Italy's trade balance⁴.

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² Istat, March, 2026, Rapporto sulla competitività dei settori produttivi.

³ Istat 2026.

⁴ Bank of Italy, April 2026, Indagine sulle aspettative di inflazione e crescita.



BNP PARIBAS

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DOMESTIC DEMAND IS EXPECTED TO CONTINUE TO DRIVE GROWTH

The Spanish economy is in a favourable long-term cycle, characterised by strong growth, underpinned by domestic demand. In 2026, outperformance relative to the eurozone is expected to continue, but growth is projected to decelerate due to the weakening of its structural foundations (available labour), a lack of momentum (low productivity) and the inflationary shock. It is projected to reach 2.3% in 2026 (revised downwards by 0.2pp). Inflation is expected to rise to 3.3% (revised upwards by 1pp), which will impact household purchasing power. However, public finances are expected to have the capacity to mitigate this impact without jeopardising the trajectory of public debt ratio reduction.

GROWTH: MOMENTUM EXPECTED TO REMAIN STRONG

In 2025, Spanish GDP growth outpaced that of the Eurozone for the fifth consecutive year (+2.8% versus +1.5%, with an average gap of +1.8 pp over the five-year period). However, it is expected to slowdown in 2026. This slowdown is partly attributed to structural factors: growth relies heavily on job creation, which is expected to decline as full employment is approached, while productivity fails to pick up the slack (see below).

Spain is vulnerable to the consequences of the conflict in the Middle East, albeit to a lesser extent than other countries. In particular, its energy mix is more favourable: gas accounts for only around 21% of it (compared with 39.8% in Italy, 27.5% in Germany and 12.1% in France), while the share of renewable energy exceeds 58% of electricity generation¹. Industry also accounts for a significantly smaller share of economic activity (15% of Spanish value added, compared with 23% in Germany, 19% in Italy and 14% in France), which effectively limits this exposure. On the other hand, rising oil prices will, as elsewhere, weigh on household purchasing power, while inflation is already above the European average. The economic climate remains relatively favourable, however, with the composite and services PMIs in expansionary territory for nearly two and a half years. The manufacturing PMI, meanwhile, has been at or below 50 since December (48.7 in March).

Spain is therefore expected to continue posting growth above the Eurozone average. Pressures on purchasing power are unlikely to prevent domestic demand from remaining a driver of economic activity, buoyed by the strength of the labour market, although this strength is expected to gradually diminish. Investment is also expected to continue supporting growth, with 2026 being the final year for the disbursement of NGEU funds (with EUR 23 billion in grants and EUR 7 billion in loans still to be mobilised), before a likely slowdown in 2027. Conversely, foreign trade could be adversely affected by a decline in tourist flows.

LABOUR MARKET: A DRIVER NEARING ITS LIMITS

Household consumption remains strong due to a tight labour market. Job creation remains robust (22 million people in work in March, up 523,000 y/y), while the unemployment rate continues to fall (down 1.1 pp y/y to 9.8% in January, below the 10% mark for the first time since March 2008), underpinning wage growth. The services sector accounts for the bulk of this growth (79% of job creation). Furthermore, immigration continues to play a key role: the share of the foreign labour force stabilised at 17.7% in Q4 2025, helping to mitigate the effects of demographic ageing. At the same time, the government has launched a large-scale migrant regularisation process, which will affect around 500,000 people. This is expected to bolster the labour supply in the short term.

However, structural weaknesses remain. The unemployment rate remains above the Eurozone average (6.2%), particularly affecting young

¹ Compared with 58% in Germany, 51% in Italy and 22% in France.

² A temporary mechanism adopted in 2022 by Spain and Portugal, which allows for a cap on the price of gas used to generate electricity, in derogation from the European market regulations. This has helped to limit inflation during the energy crisis.

Growth and inflation

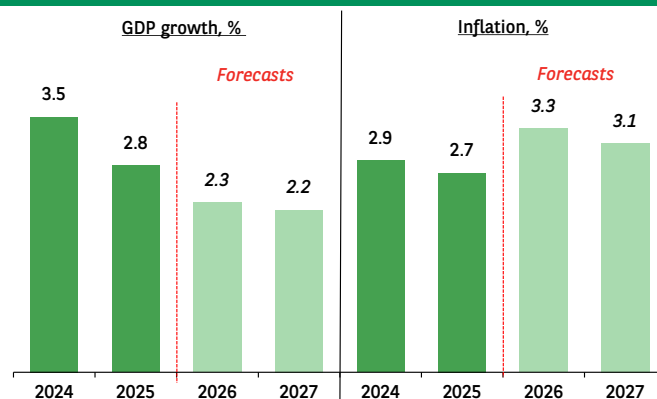


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

people (23.8% compared with 14.9%). Furthermore, business surveys indicate that labour shortages continue to hold back output, in both construction and services, at levels significantly above the historical average.

Against this backdrop, the Spanish labour market is gradually nearing its structural limits. Although unemployment is decreasing, it is projected to remain higher than in other major European economies (9.6% in 2027 according to the European Commission, compared with 6.2% in the Eurozone). As these gaps close, the contribution of employment to economic growth is expected to diminish, while wage pressures are likely to intensify. This trend suggests a gradual decline in the labour market's capacity to support economic activity, alongside an increase in wage and inflationary pressures in the medium term.

INFLATION WILL WEIGH ON PURCHASING POWER

Spain is facing an energy crisis with inflation exceeding the European average (3.3% y/y in March, compared with 2.5% in the Eurozone), indicating an economy under pressure. The rise in energy prices (+7.6% y/y in March) has not yet been reflected in core inflation. Nevertheless, the latter remains relatively high (2.9% in March).

Supply pressures in Spain, as in other countries, are less severe than in 2022. Demand, which was robust following Covid, is also more moderate now. However, unlike during that period, Spain no longer benefits from the Iberian exception². Nevertheless, its energy mix still provides some insulation against the pass-through of gas prices to electricity prices, due to the significant proportion of renewables in its energy mix.



Wage growth is slowing (+2.9% y/y in nominal terms in January–February, down from an average of +3.4% in 2025). Inflation is therefore already outpacing nominal wage growth, leading to an erosion of real wages. As a result, real wages are unlikely to recover the losses incurred since the inflationary crisis, remaining around 7 pp below the Q1 2020 level. However, growth in real gross disposable income is expected to be more resilient, as it is based on a consumption deflator that is less sensitive to imported energy prices, and is bolstered by public finances (see below). This resilience will help sustain household consumption, albeit at a more moderate pace.

A SOMEWHAT IMPACTED BUT STILL FAVOURABLE FISCAL TRAJECTORY

The government has swiftly introduced support measures to address the energy crisis, amounting to nearly EUR 5 billion (0.3% of GDP). These measures include energy tax relief (VAT reductions), targeted aid for the most vulnerable sectors, and support measures for households. These exceptional measures are temporary in nature and supplementary to the budget; they will weigh on public finances in the short term, while having a limited impact on the medium-term trajectory.

Spain is therefore making use of the fiscal leeway at its disposal, which is greater than that of other European countries. Its fiscal trajectory is indeed favourable, characterised by gradual consolidation facilitated by nominal GDP growth and the rollover of the state budget since 2023. Consequently, the public deficit fell to -2.2% of GDP in 2025 (-1.1 pp over three years), while debt stood at 100.7% (close to a return to its pre-Covid level).

Against this backdrop, the support measures are expected to result in a slight deterioration in the budget balance, due to a fall in revenue and a rise in expenditure. Nevertheless, the expected nominal growth (5.7% in 2026 and 4.9% in 2027) should enable the debt-to-GDP ratio to continue its downward trend. Consolidation is expected to continue, albeit at a slightly slower pace than anticipated. The deficit is projected to rise to -2.5% of GDP in 2026 before falling to -2.3% in 2027, while the primary balance is expected to return to surplus (+0.1% then +0.3%). Against a backdrop where the effective interest rate on debt (2.6%) is expected to remain below nominal growth, debt dynamics would remain favourable. The public debt ratio is projected to fall below the 100% threshold in 2026 (98.1%), with a continued decline anticipated in 2027 (96.5%). This favourable trend should help maintain a moderate spread against the German 10-year rate (around 50 bp since the outbreak of the conflict in Iran, compared with an average of 59 bp in 2025).

A NARROWING EXTERNAL SURPLUS

Spain's external accounts remain strong. Despite a decline, the current account surplus remained high at +2.3% of GDP in Q4 2025. It is expected to erode in the coming months, driven by an anticipated decline in the services surplus, particularly in tourism. Indeed, growth in tourist arrivals has slowed (+2.3% y/y in February 2026 compared with +6.1% a year earlier).

At the same time, the goods trade deficit is expected to widen due to the pressures of rising oil prices. Exports are expected to further decelerate, hampered by the impact of US tariffs. Indeed, although Spain's

Growth driven by employment and held back by productivity

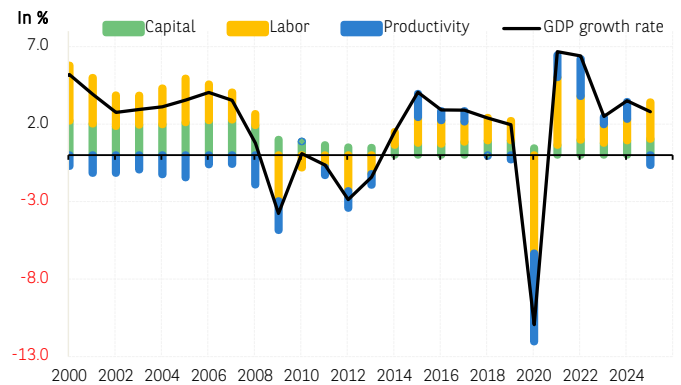


CHART 2

SOURCE: BNP PARIBAS, TOTAL ECONOMIC DATABASE

direct exposure to the United States remains limited (less than 5% of total goods exports and 1.3% of GDP), the indirect effects through its main European trading partners are considerable. However, in the medium term, an improvement in the growth outlook for the Eurozone could bolster exports.

Moreover, Spain continues to attract significant inflows of foreign direct investment (FDI), ranking as the second-largest recipient in Europe, after France. These investments help to strengthen the country's export capacity and, to some extent, mitigate the deterioration of the trade balance.

LOW PRODUCTIVITY HAMPERS GROWTH POTENTIAL

Spain's GDP per capita (EUR 26,740) is considerably lower than that of its Eurozone counterparts (EUR 32,850 on average), largely due to a structural productivity deficit. Data from the Conference Board indicates that one hour of work in Germany generates, on average, 30% more value added than in Spain (compared with an average of 28% over the period 2010–2019).

This disparity arises from the composition of Spain's economy, which is still dominated by low-value-added sectors, particularly tourism, despite the advancements in the renewable energy sector. Furthermore, the prevalence of small and medium-sized enterprises in the country restricts economies of scale and hampers innovation capacity. Finally, R&D expenditure in Spain stood at 1.5% of GDP in 2024, compared with 2.2% in France and 3.1% in Germany.

Against this backdrop, Spanish growth continues to rely heavily on an expanding labour force. In the long term, low productivity could become a major constraint on growth. This risk is exacerbated by an ageing population and a potential slowdown in migration flows – two factors likely to further reduce the available labour supply.

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UNITED KINGDOM

18

THE UNITED KINGDOM FACES THE RISK OF STAGFLATION

Following a strong performance in 2025, the UK economy will suffer in 2026 as a result of its dependence on imported commodities, with little fiscal headroom to address the situation. GDP growth is expected to fall to 0.7%. Inflation is expected to remain persistently above the Bank of England's (BoE) 2% target, standing at 3.6% in 2026 and 3.3% in 2027 (though this forecast will depend on the scale and duration of the conflict). However, demand is significantly less robust than in 2022, which should limit second-round effects. Nevertheless, the BoE is expected to respond. According to our forecasts, it will raise its key interest rate by 25 basis points in Q2 and then in Q3; it is expected to lower it again in 2027. Grappling with a structural trade deficit and reappraising its 'special' trade relationship with the United States, the United Kingdom is expected to continue its strategic rapprochement with the European Union.

GROWTH: VULNERABILITY TO RISING COMMODITY PRICES

In 2025, GDP growth accelerated to 1.4% (up from 1.1% in 2024), driven by private consumption (contributing 1 percentage point) and public and private investment (in digital and new technologies) (0.8 percentage points), whilst the trade balance deteriorated. However, after a very strong start to the year, performances faltered, with growth reaching 0.1% q/q in Q4 and private investment declining, against a backdrop of high uncertainty (a factor limiting output for two thirds of firms, according to the CBI survey).

Whilst the positive results from business surveys in Q1 2026 and the first monthly growth figures may have suggested a recovery (with manufacturing and services PMIs in expansion territory), the energy shock caused by the war in Iran is expected to weigh on the economy. Input costs and supply lead times have tightened significantly. In 2026, growth is expected to be mainly supported by the increase in public spending planned in the Budget. However, the United Kingdom appears to be one of the European countries most exposed to a rise in commodity prices (notably low gas stocks). Yet, the size of the public deficit and upward pressure on long-term interest rates limit the ability of public finances to support household purchasing power. Therefore, GDP growth is expected to be affected (-0.3 pp compared to our initial scenario).

DETERIORATION OF THE LABOUR MARKET

The unemployment rate rose to 5.2% in November 2025 (+1.6 pp compared with the low point in June 2022), a level around which it is tending to stabilise. There is a significant deterioration among young people, who are seeing an unemployment rate of 16% in December 2025 (+6.3 pp since June 2022). The number of job vacancies fell to 721,000 in February 2026, a drop of around 45% since early 2022, whilst the number of unemployed people per vacancy rose to 2.6.

Recent geopolitical developments have added further uncertainty. KPMG/REC surveys report a decline in recruitment (both permanent and temporary), whilst recent PMIs indicate a slight contraction in private-sector employment.

Rising unemployment and a decline in UK competitiveness (with wages rising faster than in other European countries) have started to weigh on wages. Wage growth has slowed significantly, with weekly wages excluding bonuses rising by 3.5% year-on-year in February 2026 (3.7% including bonuses), compared with 5.7% (5.9%) a year earlier, the lowest level since the post-COVID period. This trend is expected to continue, with wage growth likely to fall back below inflation (see Chart 2).

Growth and inflation

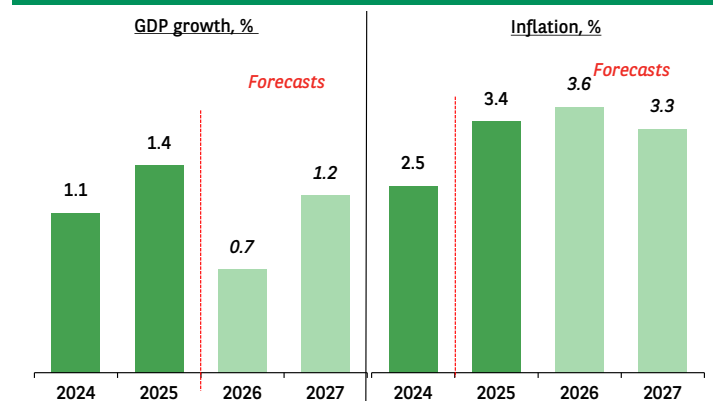


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

INFLATION: A TEMPORARY PHENOMENON?

We estimate inflation to stand at 3.3% year-on-year in March (+0.3 percentage points compared with February). According to our scenario, it will rise further, coming close to the 5% year-on-year threshold in January 2027. What's more, whilst the year-on-year change for seven out of twelve components still exceeded 3% in February 2026, core inflation is also expected to be pulled upwards and will once again exceed 4% by the end of the year, according to our forecasts. Rising energy prices have caused this rebounding inflation. Whilst fossil fuels (almost exclusively oil and gas) dominate its energy mix (nearly 76% in 2024), the country imports nearly 70% of its gas; as for oil, whilst production covers around 55% of demand, almost all (95%) of the fuels used have passed through an import stage. In addition, the country is being hampered by its low stock levels. They cover less than two days of average national consumption for gas (at the time of writing, due to its limited storage capacity), and are limited at the International Energy Agency's minimum reserve requirements for oil.

However, we expect that the peak in inflation will be more moderate than in 2022. The current environment is less conducive to second-round effects, as the post-COVID catch-up phase is behind us, the labour market has eased, financial conditions are tighter and direct fiscal support remains limited and targeted.



MONETARY POLICY: TIGHTENING WILL BE HARD TO AVOID

There has been a complete U-turn in the monetary policy outlook, shifting from ongoing easing prior to the war in Iran to the prospect of tightening. After a brief return to the BoE's target in 2024, inflation has subsequently picked up again and is not expected to return to target in the short-to-medium term. Inflation expectations (BoE business survey) have rebounded to 3.5% over 12 months (+0.5 percentage points m/m). As a result, the BoE has adopted a more hawkish tone following its March monetary policy meeting.

Whilst the BoE is continuing its quantitative tightening, it has slowed the pace and adjusted the distribution of sales in September 2025 in order to limit pressure on the gilt market and ease pressure on the long end of the yield curve. The stock of gilts held in the Asset Purchase Facility (APF) is expected to reach GBP 488 billion by the end of September 2026 (vs GBP 895 billion in February 2022, a fall of 45%). Unlike other central banks, the BoE does not limit itself to maturing securities but actively sells its holdings on the secondary market. The annual decision on the pace of QT for the following year (October 2026–September 2027) is expected to be taken in September 2026.

NO ROOM FOR MANOEUVRE IN PUBLIC FINANCES

In its 2025 Spending Review, the government aimed to reduce the public deficit gradually, through increased tax revenue (a freeze on tax thresholds and an increase in employers' contributions: GBP 28 billion by 2029–2030) combined with controlled growth in spending. However, this trajectory could be affected by the ongoing energy crisis. For the time being, the UK government has limited itself to measures targeting the most vulnerable households and most energy-intensive businesses, at a very modest budgetary cost (less than 0.01% of GDP in 2026 and 2027). This reflects its limited room for manoeuvre, particularly as the markets are showing increased sensitivity to developments in the United Kingdom's public finances. Since the start of the war in Iran, the gilt market has been particularly turbulent, with the sharpest rise in bond yields among advanced economies to date. While the average maturity of the debt is relatively long (13.8 years), nearly 11% of the total outstanding debt is due for refinancing this year and will be directly exposed to rising interest rates. Furthermore, around 24% of the debt is inflation-linked, which automatically increases the sensitivity of the interest burden to inflation. According to our forecasts, the interest burden will increase by around 0.4 percentage points of GDP in 2026 if bond yields stabilise at their current levels (4.8% for 10-year yields, up 50 basis points in six weeks).

Taking into account the latest growth and inflation forecasts, the debt-to-GDP ratio is set to continue rising in the coming years (increasing by 2.5 percentage points to 104.8% in 2026, following 102.3% in 2025 and 99.8% in 2024). Slower fiscal consolidation and/or a sharper rise in debt servicing costs would delay its stabilisation, which we anticipate by the end of the decade ([see our analysis](#)). In its forecasts published in March, the Office for Budget Responsibility anticipated that the government would meet the targets that it had set for itself: a balanced current budget and a reduction in net public debt as a percentage of GDP by the end of the term of office (in August 2029). The greater-than-expected fiscal headroom available to the government at the start of the year (thanks to stronger tax revenues) could help it to meet the deficit target for 2026, despite the impact of slower GDP growth on public finances, but is unlikely to allow for the implementation of substantial economic support.

Nominal wage growth is slowing and approaching inflation

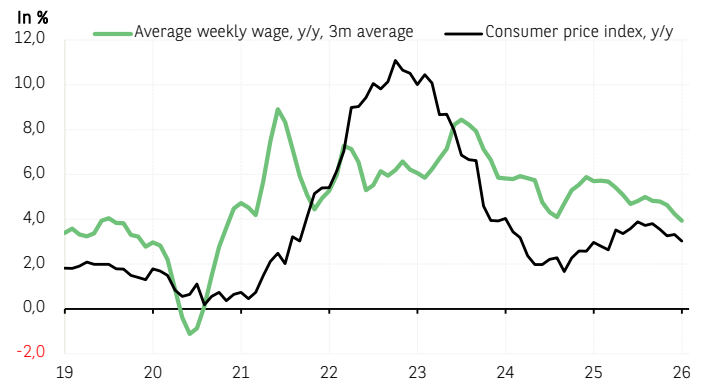


CHART 2

SOURCE: ONS, MACROBOND, BNP PARIBAS

FOREIGN TRADE: MOVING TOWARDS AN ACCELERATED RAPPROCHEMENT WITH THE EU

The United Kingdom's trade balance is still structurally in deficit (averaging GBP 37 billion since 2017, or -1.4% of GDP). The deficit in goods (primarily energy, food, vehicles and machinery), which is partially offset by the surplus in services, is expected to widen due to rising energy prices. Furthermore, the United Kingdom could lose the benefits negotiated under the bilateral trade agreement with the United States on 8 May 2025 (Economic Prosperity Deal (EPD)), whilst the United States is its largest export market (15.6% of goods), a position that has strengthened since Brexit. After the Supreme Court invalidated the measures based on the IEEPA, a blanket 10% tariff on US imports has been introduced for a period of 150 days, until 24 July. The sector-specific provisions of the EPD are being temporarily maintained pending the outcome of the ongoing renegotiations between the two countries. Closer ties with the European Union, however, open up favourable prospects for British industry, which could benefit from the EU's rearmament and reindustrialisation. The EU is still its main trading partner (41% of exports and 49% of imports), with a recurring deficit (of GBP 89 billion in 2025). Participation in the SAFE programme remains under discussion. British companies should automatically benefit from the Industrial Accelerator Act due to their status as trusted partners, provided, however, that legislative negotiations do not restrict the conditions for access. Finally, the UK government is preparing a bill to enable automatic regulatory alignment with future changes to EU rules in the areas covered by the negotiated agreements (currently limited to sanitary and phytosanitary standards, the carbon market and electricity trade). The bill, which aims to ease trade and reduce post-Brexit barriers, is expected to be presented to the UK Parliament this year.

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STRONG MOMENTUM ALREADY UNDER THREAT?

The improved health of the Japanese economy is evident. Consumer confidence and the Tankan business-conditions index hit post-COVID highs before the energy shock began. The shock, however, is expected to weigh on growth, which is projected at 0.5% in 2026 (revised -0.3pp). Inflation, at 2.7% in 2026 (revised up 0.7pp), is set to remain the BoJ. The two pillars of the policy mix could remain at odds in light of the new energy shock, with the government favouring an expansionary fiscal stance while the central bank is expected to keep raising its policy rate, projected to reach 2% by end-2027.

GROWTH: WILL THE ENERGY SHOCK DERAIL THE RECOVERY?

After a difficult 2025 marked by uncertainty over US tariffs, the de-escalation and the new government's early actions pointed to a marked improvement in 2026. The year got off to a good start, with consumer confidence hitting a post-COVID high in February and the Tankan business conditions index rising to a level not seen since 2018 in Q1 2026 (12, +1pt q/q, Chart 1). The upside has been continuous for large manufacturers since Q1 2025. However, the fallout from the Iran war is likely to impede this momentum. Consumer confidence fell sharply in March (-6.4 pts m/m). Still, the Composite PMI remained, on average for Q1 2026, at its highest level since 2013 (53.3), despite a decline in March (-0.9pp to 53.0). While a stronger impact of rising energy prices on business sentiment remains plausible – given Japan's external dependence on hydrocarbons, (especially after the phase-out of nuclear power) – any effect remains barely discernible at this stage.

INFLATION: A SHORT-LIVED DIP BEFORE A REBOUND

Inflation in Japan has fallen in recent months after fiscal support for electricity was reinstated at the end of 2025, pulling the energy component down to -9.1% y/y in February 2026. Core inflation (excluding fresh food) has therefore fallen back to 1.6% y/y (down from 3.0% y/y three months earlier). This decline also reflected strong base effects in rice prices (17.1% y/y, 80.9% a year ago). However, inflationary pressures remain sizable. New-Core inflation – which excludes energy and fresh food – stood at +2.5% a/a, remaining above the Bank of Japan's (BoJ) 2% inflation target virtually since October 2022.

Looking ahead, core CPI is expected to rise throughout 2026, driven by the transmission of higher energy prices, as indicated by the Tankan survey, which reports an increase in firms' one-year selling price expectations to 3.1% (+0.3pp). Market expectations, however, are currently in line with the BoJ's inflation target: the 10-year break-even inflation rate stood at a record-high of 1.8% in Q1 2026.

REAL WAGES ARE EXPECTED TO CONTRACT AGAIN

Japan's labour market is characterised by a structural shortage. The reason for this is demographic: the workforce was at 70.1 million in 2025 versus 67.4 million in 2000, with growth coming almost entirely from a doubling of the 'senior' cohort (age 65 and over) – from 4.9 million to 9.5 million). Consequently, the labour market is under constant pressure, with a generally stable unemployment rate (2.6% in H2 2025). Combined with the renewed persistence of inflation, the environment is fertile for wage growth, which is expected to extend into 2026 following the outcome of the annual trade-union negotiations (Rengo). However, real wages contracted in 2025 (-1.4% y/y on an annual average) and their rebound in early 2026 (0.7% in January and 1.9% y/y in February) looks temporary, due to the foreseeable rise in inflation.

Growth and inflation

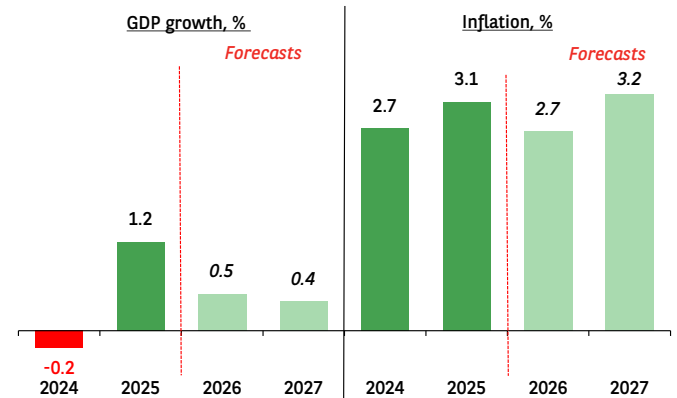


CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

A sustained improvement in the business climate, undeterred by the tariff shock

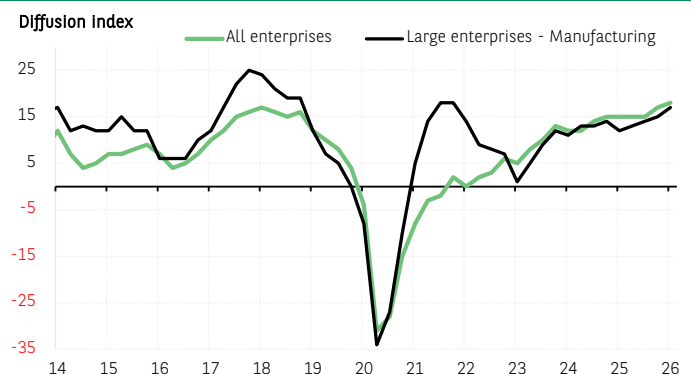


CHART 2

SOURCE: BOJ, BNP PARIBAS



MONETARY POLICY: HAWKISH BIAS MAINTAINED

Since 2024, the BoJ has been engaged in a process of ‘adjusting the degree of monetary accommodation’, reflected in cautious and gradual hikes to the policy rate. The rate currently stands at 0.75% (versus -0.1% prior to the first increase in March 2024). Several factors keep the committee on the normalisation path: core inflation remaining above its target virtually since 2022, solid wage growth, a strongly negative real interest rate, downward pressure on the yen, and GDP running at its potential. However, the tightening of financial conditions and the negative impact on growth call for caution in the rate-hike cycle. According to our forecasts, it will remain moderate and spaced-out: two hikes of +25bp each in 2026, followed by three in 2027, resulting in a 2% terminal rate. At the same time, the BoJ is continuing to scale back JGB (Japanese Government Bonds) purchases, with the monthly pace set to be JPY 2.7 trn in Q2 2026 (versus JPY 5.7 trn at the start of 2024).

In our view, the Iran war do not call into question the central bank’s outlook. The hawkish bias in monetary policy is reinforced by the risk of a resurgence in inflation, particularly given the interplay between a weaker JPY (the policy rate is positively correlated with the currency but is not the sole driver) and imported energy inflation. BoJ Governor Kazuo Ueda has openly raised the possibility of rate hikes even if activity faces downward pressure – provided that such pressure is not merely temporary and does not weigh on core inflation. Consequently, expected rate hikes could be spaced further apart, and/or an additional hike be warranted – depending on the differential impact on activity and inflation.

FISCAL SUPPORT AMID ENERGY INFLATION

The snap general election in February 2026 – which saw the Liberal Democratic Party secure an absolute majority (198 out of 316 seats) in the House of Representatives – gave Sanae Takaichi’s government leeway to run an expansionary fiscal policy. Nevertheless, the flagship campaign pledge – the consumption-tax cut on food (0.8% of GDP) – appears to have been postponed. It has been replaced by support for households struggling with energy inflation. The government capped the gasoline price at JPY 170 per litre as of March 2026. Extending this measure could cost JPY 500 trn per month (0.07% of GDP) and be accompanied by an extension of subsidies for gas and electricity bills (JPY 500 trn per quarter). Under those assumptions, the budget deficit may exceed our initial forecasts (-2.3% of GDP, -2.0% primary deficit), and the anticipated reduction in public debt (to 203.5% of GDP, -3.3pp) may be less significant. At the same time, upward pressure on long-term yields is intensifying, with the 10-year yield expected to reach 2.70% by end-2027. Japan’s yield curve has steepened since the outset of the Iran war.

FOREIGN TRADE HAS WEATHERED THE TARIFF SHOCK

Japan’s exports have held up well against the US tariff shock of 2025 – 15% levy on Japanese goods shipped to the US – in line with global-trade trends ([see our EcoWeek Editorial on this topic](#)). Indeed, the previous year was marked by a resurgence in goods exports in volume (2.7% annual average) after two years of decline. By contrast, services exports, long buoyed by the post-COVID tourism bounce, faced a downturn with the cessation of this growth momentum (-3.1% y/y in Q4 2025).

Real wages are struggling to move into positive territory

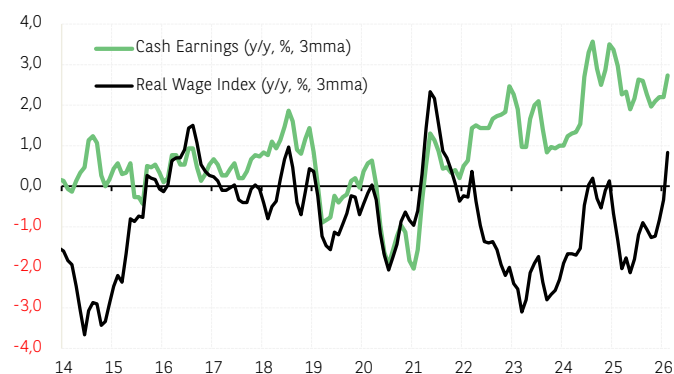


CHART 3

SOURCE: JAPANESE MINISTRY OF HEALTH, LABOUR AND WELFARE, BNP PARIBAS

The conflict in Iran adds to yen pressure. Our forecasts project a USDJPY at 160 in year-end 2026, following a weakening to 157 by end-2025, amid a near-continuous decrease from Q2 onwards. The war adds to downside risks, particularly with the likely widening of Japan’s trade deficit due to higher hydrocarbon prices, an expanded budget deficit resulting from household-support measures, and a potentially larger spacing of BoJ rate hikes. Indeed, since 27 February, the JPY has already depreciated by 1,6% against the USD, erasing all gains linked to rumours of coordinated intervention with the US (January) and the LDP’s election victory (February). Furthermore, a direct FX intervention remains likely this year, and has already been mentioned by Finance Minister Satsuki Katayama.

Article completed on 23 April 2026

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MAIN INDICATORS

Growth

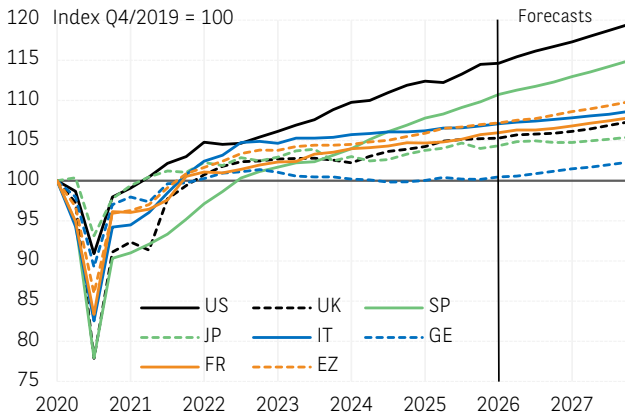


CHART 1

SOURCE: EUROSTAT, BEA, ONS, CAO, PREVISIONS BNP PARIBAS

Inflation rate

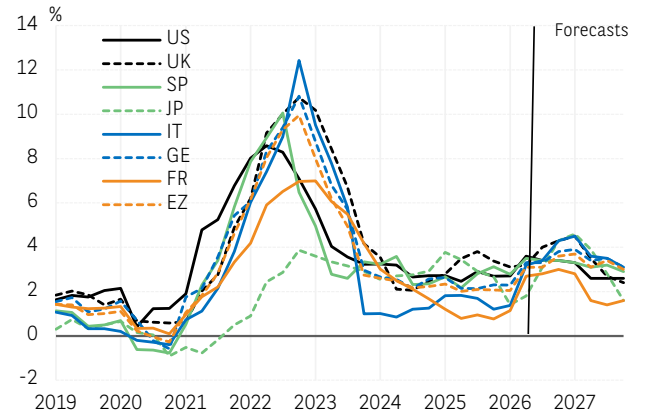


CHART 2

SOURCE: EUROSTAT, ONS, BLS, BNP PARIBAS FORECASTS

Unemployment rate

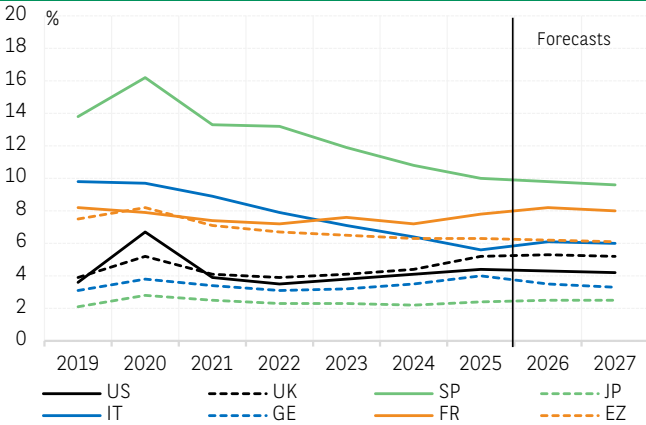


CHART 3

SOURCE: EUROSTAT, BLS, SBJ, DG ECFIN AMECO, OBR, BNP PARIBAS

Current account

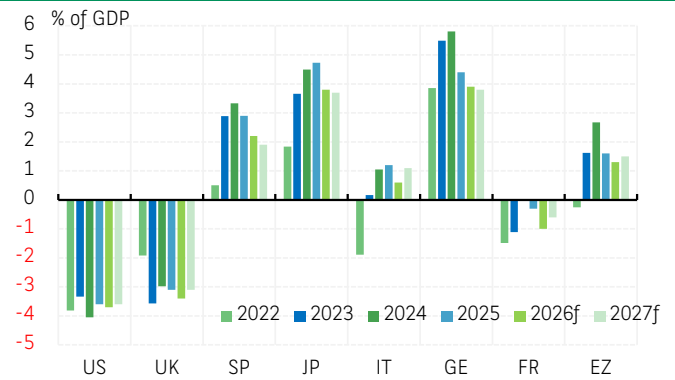


CHART 4

SOURCE: IMF, BNP PARIBAS FORECASTS

General Government balance

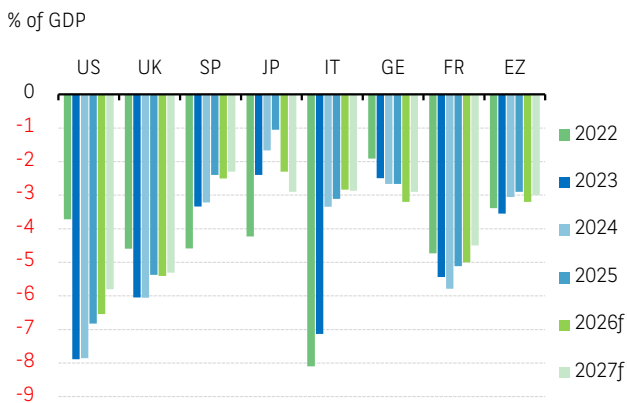


CHART 5

SOURCE: IMF, BNP PARIBAS FORECASTS

General Government debt

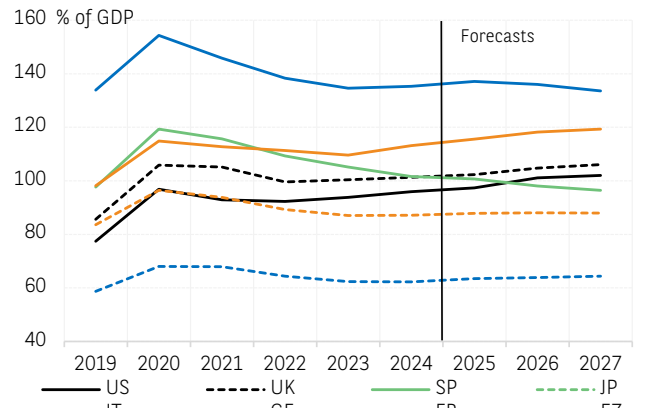


CHART 6

SOURCE: IMF, BNP PARIBAS FORECASTS



GROWTH: CONTRIBUTIONS

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		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
United States	GDP	0.2	0.9	0.8	0.5	-0.2	1.0	1.1	0.1
	Private consumption	0.3	0.7	0.7	0.7	0.1	0.4	0.6	0.3
	GFCF	0.1	0.1	0.1	-0.1	0.3	0.2	0.0	0.1
	Public consumption	0.1	0.1	0.2	0.1	-0.0	0.0	0.1	-0.3
	Inventories	-0.2	0.3	-0.0	-0.2	0.7	-0.9	-0.0	0.0
	Net exports	-0.1	-0.3	-0.1	-0.0	-1.2	1.2	0.4	-0.1

Source: BEA

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Eurozone	GDP	0.3	0.2	0.4	0.4	0.6	0.1	0.3	0.2
	Private consumption	0.3	0.1	0.3	0.3	0.2	0.2	0.1	0.2
	GFCF	-0.5	-0.6	0.3	0.2	0.6	-0.3	0.3	0.1
	Public consumption	0.0	0.2	0.1	0.1	-0.0	0.1	0.1	0.1
	Inventories	-0.0	0.2	0.5	-0.2	-0.3	0.4	0.2	-0.2
	Net exports	0.5	0.2	-0.9	0.0	0.2	-0.2	-0.4	-0.1

Source: Eurostat

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Germany	GDP	-0.1	-0.3	0.0	0.2	0.4	-0.2	0.0	0.3
	Private consumption	0.2	0.1	0.1	0.2	0.4	0.2	0.0	0.3
	GFCF	-0.1	-0.3	-0.1	0.1	0.1	-0.2	0.1	0.2
	Public consumption	-0.0	0.4	0.2	0.1	-0.2	0.1	0.1	0.3
	Inventories	0.1	-0.1	0.8	0.6	-0.5	0.2	0.5	-0.3
	Net exports	-0.3	-0.3	-1.0	-0.9	0.4	-0.4	-0.8	-0.1

Source: Eurostat

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
France	GDP	0.1	0.2	0.4	0.0	0.1	0.3	0.5	0.2
	Private consumption	0.1	0.0	0.5	0.1	-0.1	0.0	0.1	0.2
	GFCF	-0.2	0.1	-0.2	0.1	0.1	0.1	0.2	0.1
	Public consumption	0.1	0.0	0.1	0.1	0.1	0.1	0.2	0.1
	Inventories	-0.2	-0.4	0.7	-0.3	0.6	0.5	-0.4	-0.8
	Net exports	0.3	0.5	-0.6	0.0	-0.5	-0.4	0.5	0.7

Source: Eurostat

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Italy	GDP	0.1	0.2	0.0	0.1	0.3	0.0	0.2	0.3
	Private consumption	0.8	0.2	0.2	0.3	0.1	0.2	0.2	0.0
	GFCF	-0.6	-0.3	-0.4	0.5	0.3	0.4	0.2	0.2
	Public consumption	-0.0	0.1	0.0	0.1	-0.0	0.1	0.0	0.0
	Inventories	0.1	0.9	0.7	-0.7	-0.3	0.2	-0.3	0.7
	Net exports	-0.2	-0.7	-0.5	0.0	0.4	-0.7	0.1	-0.7

Source: Eurostat

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Spain	GDP	1.1	0.9	0.8	0.8	0.5	0.7	0.6	0.8
	Private consumption	0.3	0.7	0.7	0.5	0.3	0.4	0.5	0.5
	GFCF	0.3	0.1	-0.1	0.7	0.2	0.2	0.4	0.5
	Public consumption	0.1	0.0	0.3	0.0	0.1	0.0	0.3	0.0
	Inventories	0.1	0.1	0.2	-0.0	-0.2	0.2	0.1	-0.1
	Net exports	0.3	0.0	-0.3	-0.4	0.1	-0.1	-0.7	-0.1

Source: Eurostat

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
United Kingdom	GDP	0.8	0.6	0.2	0.3	0.7	0.2	0.1	0.1
	Private consumption	0.1	0.0	0.4	0.2	0.2	0.1	0.1	0.0
	GFCF	0.3	-0.1	0.3	0.0	0.6	-0.1	0.2	0.0
	Public consumption	0.1	0.2	0.1	0.2	-0.1	0.2	0.1	0.0
	Inventories	-0.8	1.8	-1.7	1.2	-0.2	0.4	-0.7	0.4
	Net exports	1.2	-1.3	1.1	-1.2	0.1	-0.4	0.5	-0.5

Source: ONS

		Q1 2024	Q2 2024	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025	Q4 2025
Japan	GDP	-0.5	0.2	0.7	0.5	0.3	0.6	-0.7	0.3
	Private consumption	-0.2	0.0	0.2	0.0	0.4	0.1	0.3	0.2
	GFCF	-0.5	0.2	0.3	-0.1	0.1	0.2	-0.4	0.4
	Public consumption	0.1	0.4	0.0	0.0	-0.1	0.2	0.0	0.1
	Inventories	-0.1	-0.1	0.3	-0.3	0.5	0.0	-0.2	-0.3
	Net exports	0.1	-0.5	-0.2	0.8	-0.6	0.1	-0.3	0.0

Source: Japan Cabinet Office



FORECASTS

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ECONOMIC FORECASTS

%	GDP Growth				Inflation			
	2024	2025	2026 e	2027 e	2024	2025	2026 e	2027 e
United States	2.8	2.1	2.4	2.3	2.9	2.7	3.3	2.8
Japan	0.1	1.2	0.5	0.4	2.7	3.1	2.7	3.2
United Kingdom	1.1	1.4	0.7	1.2	2.5	3.4	3.6	3.3
Euro Area	0.9	1.5	1.0	1.3	2.4	2.1	3.0	3.3
Germany	-0.5	0.4	0.8	1.1	2.5	2.2	3.2	3.5
France	1.1	0.9	1.0	1.1	2.3	1.0	2.4	1.9
Italy	0.5	0.7	0.7	0.8	1.1	1.7	3.1	3.7
Spain	3.5	2.8	2.3	2.2	2.8	2.7	3.3	3.1
China	5.0	5.0	4.6	4.5	0.2	0.0	1.3	1.4
India*	7.1	7.6	6.6	6.8	4.6	2.1	4.5	4.2
Brazil	3.4	2.3	2.0	1.6	4.4	5.0	4.7	4.5

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

SOURCE: BNP PARIBAS (E: ESTIMATES; F: FORECASTS)

FINANCIAL FORECASTS

Interest rates. %

End of period	Spot 22/04	Q2 2026	Q3 2026	Q4 2026	Q4 2027
US "Fed Funds (upper limit)"	3.75	3.75	3.75	3.75	3.75
T-Note 10y	4.27	4.40	4.50	4.55	4.55
Eurozone deposit rate	2.00	2.25	2.50	2.50	2.50
Bund 10y	3.00	3.15	3.20	3.35	3.10
OAT 10y	3.64	3.77	4.00	4.17	3.60
BTP 10y	3.75	3.85	3.95	4.10	3.60
BONO 10y	3.44	3.57	3.64	3.79	3.42
UK Base rate	3.75	4.00	4.25	4.25	3.50
Gilts 10y	4.87	4.70	4.60	4.50	4.30
Japan BoJ Rate	0.75	1.00	1.00	1.25	2.00
JGB 10y	2.40	2.40	2.55	2.60	2.70

Exchange rates

End of period	Spot 22/04	T2 2026	T3 2026	T4 2026	T4 2027
USD EUR / USD	118	119	120	121	125
USD / JPY	159	159	159	160	160
GBP / USD	135	135	135	135	136
EUR EUR / GBP	087	088	089	090	092
EUR / JPY	187	189	191	194	200

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


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