ECOWEEK

Issue 25.08
24 February 2025

“ WHILE DEEP UNCERTAINTIES REMAIN, A CEASEFIRE BROADLY ALONG THE LINES OF OUR CENTRAL SCENARIO, COUPLED WITH SENSIBLE ECONOMIC POLICY DECISIONS, CAN BE SEEN AS ANOTHER UPSIDE RISK TO THE EUROPEAN OUTLOOK.

ECONOMIC RESEARCH

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UKRAINE CEASEFIRE: WHAT ARE THE ECONOMIC IMPLICATIONS FOR EUROPE?

Peace talks have started. We do not know how soon or exactly where they will land. But things are moving fast. While much of the focus is, rightly, on the unexpectedly daunting geostrategic challenges, it's not too soon to start mapping out the key economic implications for Europe.

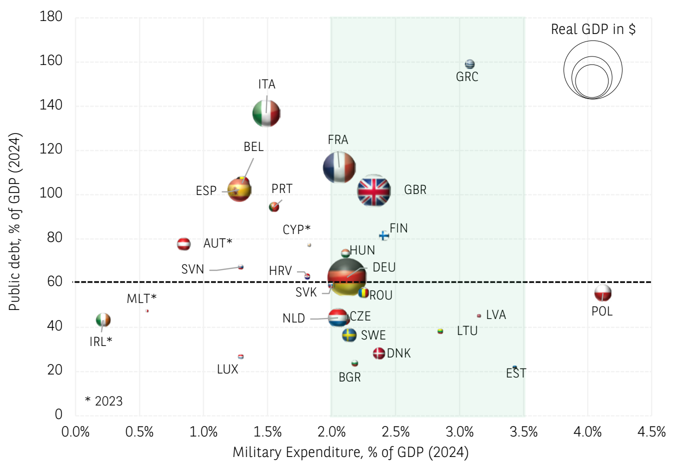
Overall, the implications should be positive both in the near and the longer term; how much will depend to a large extent on decisions Europe itself makes. In a nutshell, the ceasefire should boost GDP growth in the near term primarily through the demand channel, with scope for a long-term boost to potential output. The impact on inflation is more uncertain, as there are multiple drivers going in opposite directions, but overall more limited, and European currencies might benefit as well (dampening inflation). These impacts would be most pronounced on Central and Eastern European countries, and least pronounced on the UK, with Western Europe in between.

The central scenario assumed here is one where the ceasefire agreement freezes the conflict broadly along the current frontline (with 19% of Ukraine territory occupied). Actual peace, with internationally-recognized borders and full re-integration of Russia in the global economy still seems elusive for the foreseeable future. A majority of the 5-8 million Ukrainian refugees living in Europe gradually return home. Reconstruction begins immediately. Both EU and UK take immediate steps to boost defense spending very meaningfully to make up for the US curtailing its own involvement.

By far the biggest economic driver will be increased defense spending. Until a few days ago, estimates of the economic dividends of peace emphasized the confidence boost for Europe that it would entail. But this will now be offset by the previously unimagined prospect of a fundamental geostrategic pivot from the US away from Europe. Estimates of what's needed to make up for this pullout range around USD 250-300bn per year, bringing total defense spending to 3.5% of GDP (from 2% currently).[1] Estimates suggest an elasticity of 0.5 to 1 for defense spending in the EU, i.e. an increase in spending of 1.5% of GDP should boost GDP by around 0.9 to 1.5% (even accounting for substantial "leakage" through imports of equipment, which should diminish over time based on EU leaders statements of intent). Above and beyond this cyclical boost, there is a potential positive impact on productivity, to the extent that a meaningful part of the defense spending is allocated to R&D that subsequently benefits the entire economy.

Most of this increase in defense spending should not, initially, need to be offset by cuts in other spending. As seen in the chart, many EU members in need to boost defense spending have the fiscal space to do so. Others, like France or Italy, are much more constrained, but the EU is considering activating the escape clause to suspend its fiscal rules to provide additional flexibility, and discussions are reportedly progressing fast on EU-level financing, whether by repurposing existing funds or even new common borrowing.

PUBLIC DEBT AND DEFENSE SPENDING AS A SHARE OF GDP



SOURCE: NATO, IMF, BNP PARIBAS

CHART 1

The UK, by contrast, appears much more constrained and may therefore not benefit from direct extra fiscal stimulus. It should, however, receive positive spillovers from the additional growth and defense spending of its European neighbours. Over the longer term, however, sustaining much higher defense spending could only be accommodated through higher revenue collection, or cuts in other types of expenditures. Any permanent boost to growth would then be down to productivity effects.

An additional boost to growth might be expected via higher exports to Ukraine as rebuilding gets underway. Reconstruction needs were estimated in early 2024 by International Organizations at nearly $500bn over the coming decade.[2] They are likely larger now. Raising financing of that scale will be an issue, particularly if international consensus on the use of frozen Russian assets to this end remains lacking. But the EU has already pledged a 50bn euros facility which will enable to kick-start rebuilding of essential infrastructure such as housing, transportation and productive capacity. In the longer term, both the EU and Ukraine have much to gain from greater economic integration, with Ukraine being rich in natural resources that Europe has identified as critical to its economic sovereignty, as well as a potential AI and tech powerhouse.[3]

1 See for example Defending Europe without the US: first estimates of what is needed.
2 Updated Ukraine Recovery and Reconstruction Needs Assessment Released, World bank, February 2024.
3 Cf. Ukraine isn't a financial burden but an opportunity for the EU's digital transition - CEPS.

Conversely, the return of refugees to Ukraine will negatively impact European growth, but this impact should be small and gradual overall. The largest contingents of refugees settled in Germany, Poland, and to a lesser extent the Czech Republic, with relatively large numbers (approx. 200,000) in Spain and UK as well. It is hard to estimate what percentage of these refugees will eventually return home. In the UK, where a large proportion are employed, surveys suggest a large majority would prefer to stay. Poland and the Czech Republic appear more vulnerable for having both large numbers of refugees and a high share of them employed. Their return home would reduce both labor supply and demand. In Germany, where a much lower share of the Ukrainian refugees are employed, the impact would be felt primarily via lower demand, though on the scale of the German economy this impact would be negligible.

Decisions regarding usage of Russian gas via the Ukraine pipeline will have a significant impact on both growth and inflation. From a technical standpoint, this is the only operational one. Reopening it would require Ukraine's agreement (for which transit fees will be an incentive) as well as interest from neighboring EU members to purchase this gas.[4] This prospect has already contributed to pull down the reference spot price (TTF) by 10%, and further downward movement would be highly likely, perhaps by as much as 20-25% overall, everything else equal. This would benefit all European importers of gas in the form of higher growth and lower inflation.

By contrast, the ceasefire should have a negligible impact on other commodities. Ukraine's production of cereals and other food products is running roughly at its pre-invasion level apart from the portion that used to come from the currently occupied territories. Russian oil exports have remained constrained more by OPEC+ quotas than by sanctions, and its exports of other commodities have not been sanctioned.

Transportation costs might decrease, however, in the event of return to pre-war traffic of the Black Sea transit route (recent tonnage has been running at about 50% of the pre-war level).

In sum, while deep uncertainties remain, a ceasefire broadly along the lines of our central scenario, coupled with sensible economic policy decisions, can be seen as another upside risk to the European outlook, consisting of:: positive growth effects at least in the near term; and an impact on inflation that varies depending on the balance of inflationary and disinflationary effects in each country, but that should be manageable overall without requiring meaningful deviations from currently expected monetary policy paths.

Isabelle Mateos y Lago

Data visualisation and cartography: Tarik Rharrab

4 While the decision may be politically sensitive, it ultimately belongs to individual member states. Slovakia and Hungary have continued to receive piped Russian gas via Turkey. Europe never ceased to rely on Russian LNG, oil and coal throughout the war, and reliance on the Ukraine-pipeline gas might end up being seen as an acceptable temporary solution to ease this and next winter's crunch, at time of low gas storage levels, tight global LNG market, and high pain from elevated energy prices. Thanks to additional LNG capacity coming on stream in 2026, notably from the US, which President Trump is keen for the EU to buy, this would not be incompatible with the EU's commitment to wean itself fully of Russian gas by 2027.

ECONEWS

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ADVANCED ECONOMIES

United States

The Fed: the virtues of patience. The members of the FOMC agree on the central message of maintaining a restrictive policy in the absence of significant new progress on inflation and in the presence of a "strong economy and a solid labour market." The Minutes of the latest meeting report balanced risks around the growth scenario (reduction of the output gap) and employment (unemployment rate around its neutral level, but with upward risks on prices (recent disappointments in core inflation and fears of upward pressures related to possible changes in trade and immigration policies). They also point to the possibility of pausing quantitative tightening until uncertainty about the effects of the federal debt ceiling on money markets is lifted. 5-10-year household inflation expectations reached a 30-year high in February at +3.5% according to the University of Michigan, which also revised its consumer sentiment index downwards.

Eurozone

February flash PMIs are stable, despite a sharp drop in the services index in France. The composite PMI remains at 50.2, with an increase in the index in Germany offsetting the decline in France. The manufacturing index for the euro zone rose by 0.7 points (47.3), but services fell by 0.6 points (50.7). Household confidence has reached its highest level in five months, according to the European Commission's preliminary estimate. The urgent need to free up additional funds for defence is likely to lead the EU to suspend its fiscal stability rules once again, and work is underway to reallocate some of the undisbursed funds from the pandemic response plan, among other avenues being explored.

Germany **An improvement in leading economic indicators, but weaknesses persist.** The HCOB Composite PMI Flash rose to 51.0 in February (50.5 in January), due to a moderation in the contraction of the manufacturing PMI (46.1, the best level in two years) and a stable services PMI at a good level (52.2 in February). The employment component is deteriorating due to losses in industry. The centre-right CDU-CSU alliance won the elections on 23 February. Their leader Friedrich Merz has announced his desire to form a coalition government, presumably with the centre-left SPD, within two months. Read our analysis in our latest EcoFlash: German election: A government by Easter?

Spain The strong growth recorded during 2024 led to a **3.3pp drop in the public debt-to-GDP ratio** (to 101.8%). **In terms of the real estate market,** 2024 is the **second best year for the sector since 2008.**

France **The INSEE business climate rebounded** to 96 in February from 95 in January and a low of 94 in December but remains below its long-term average (100). The industry and services components explain this rebound. However, the employment climate deteriorated sharply from 98 in January to 94 in February (the lowest level excluding Covid since January 2015), due to market services, and the flash PMI for services fell from 48.2 to 44.5.

United Kingdom **The employment outlook is worsening, despite upward revisions in recent months.** The composite employment PMI fell in February to its lowest level since November 2020. Wage increases remain steady (+5.9% y/y in the private sector). The unemployment rate rose by 0.1 points to 4.4% in Q4 compared with the previous quarter, according to the LFS. **Inflation is picking up again, but short-term price increases are losing momentum.** Headline inflation rose from 2.5% to 3.0% in January, but with a lower than expected increase in services. Core inflation is also picking up, but this masks a recent slowdown in monthly prices, which should fuel disinflation over the coming months. Retail sales rebounded by 1.6% m/m in January, after four consecutive months of decline.

Japan **Japanese GDP growth accelerated in Q4**, to +0.7% q/q compared with +0.4% in Q3, mainly due to a rebound in non-residential investment (+0.5% q/q). The growth rate stands at +0.9pp for 2025. Inflation rose in January to +4.0% y/y (+0.4pp). The index excluding energy and fresh food increased by +2.5% y/y (+0.1pp). The PMI for February 2025 improved marginally, to 48.9 (+0.2pp) for the manufacturing sector and 53.1 (+0.1pp) for services.

EMERGING ECONOMIES - CAPITAL FLOWS

Strong resistance of portfolio investments to emerging countries. According to IIF estimates, portfolio investment flows in the bond and equity markets of the main emerging countries reached USD 35.9 billion, including USD 45 billion in debt securities. With the exception of China, the situation is the same, although the flows are less significant. With regard to investments in debt securities, these estimates should be treated with caution because, during H2 2024, they were much higher than the balance of payments data.

China **Return to favour of private companies in the technology sector.** On 17 February, President Xi Jinping brought together the directors of China's major tech companies (including Alibaba, Tencent, Huawei, Xiaomi, DeepSeek, etc.). The President gave a speech in support of private entrepreneurship, marking a radical change of tone compared to the last five years – the tech sector had faced a severe tightening of regulations in 2020-2022. This return to political favour can be explained by the need to strengthen innovation, investment and job creation.

COMMODITIES

According to the EIA (US Energy Information Administration), US LNG exports have reached a new record in the last two weeks, reaching 16.1 bcf/day, an increase of 25% over a year. As for Europe, the increase in LNG imports is contributing to the fall in the price of gas in the short term (the TTF has fallen by 19% over the last ten days after reaching a high since October 2023).

MARKETS OVERVIEW

Bond Markets

	in %	in bps			
	21/02/2025	1-Week	1-Month	Year to date	1-Year
Bund 2Y	2.12	-1.2	-11.4	+5.6	-84.1
Bund 5Y	2.21	+1.6	-4.9	+9.7	-23.9
Bund 10Y	2.44	+3.9	-4.0	+7.4	+2.1
OAT 10Y	3.09	+5.8	-10.2	-3.4	+25.5
BTP 10Y	3.44	+3.8	-3.8	+2.2	-50.9
BONO 10Y	3.06	+4.0	-4.2	+3.6	-21.3
Treasuries 2Y	4.21	-7.1	-7.2	-4.1	-45.9
Treasuries 5Y	4.27	-6.9	-11.3	-11.0	-3.4
Treasuries 10Y	4.43	-5.2	-13.2	-14.5	+8.9
Gilt 2Y	4.24	+2.5	+11.8	+9.3	-38.6
Treasuries 5Y	4.32	+4.7	-2.7	-3.1	+31.2
Gilt 10Y	4.58	+7.2	-1.7	+0.3	+39.5

Currencies & Commodities

	Level	Change, %			
	21/02/2025	1-Week	1-Month	Year to date	1-Year
EUR/USD	1.05	-0.5	+0.5	+1.0	-3.2
GBP/USD	1.26	+0.2	+2.8	+0.9	+0.2
USD/JPY	149.56	-1.7	-3.7	-4.8	-0.5
DXY	111.99	+7.9	+11.5	+10.5	+6.1
EUR/GBP	0.83	-0.7	-2.2	+0.0	-3.4
EUR/CHF	0.94	-0.3	-0.4	+0.2	-1.2
EUR/JPY	156.36	-2.2	-3.2	-3.9	-3.7
Oil, Brent ($/bbl)	74.45	-0.7	-6.4	-0.4	-10.2
Gold ($/ounce)	2931	+1.1	+7.0	+11.7	+44.8

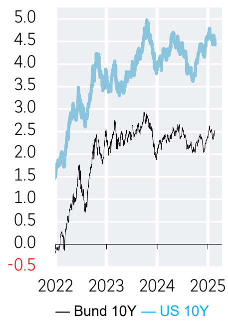
Equity Indicies

	Level	Change, %			
	21/02/2025	1-Week	1-Month	Year to date	1-Year
World					
MSCI World ($)	3843	-1.4	+0.7	+3.6	+17.4
North America					
S&P500	6013	-1.7	-0.6	+2.2	+20.7
Dow Jones	43428	-2.5	-1.4	+2.1	+12.5
Nasdaq composite	19524	-2.5	-1.2	+1.1	+25.3
Europe					
CAC 40	8155	-0.3	+4.9	+10.5	+4.4
DAX 30	22288	-1.0	+5.9	+11.9	+30.2
EuroStoxx50	5475	-0.3	+6.0	+11.8	+14.6
FTSE100	8659	-0.8	+1.3	+6.0	+13.0
Asia					
MSCI, loc.	1425	-1.2	+0.7	-0.5	+5.9
Nikkei	38777	-1.0	-0.6	-2.8	+1.3
Emerging					
MSCI Emerging ($)	1147	+2.0	+6.1	+6.6	+12.4
China	76	+3.9	+18.6	+17.6	+41.6
India	951	+0.2	-2.4	-7.5	-1.6
Brazil	1326	-3.0	+6.8	+12.7	-23.4

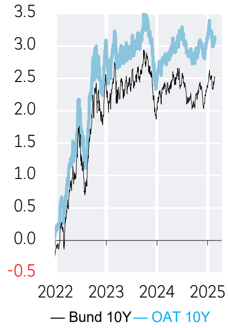
Performance by sector

Eurostoxx600		S&P500	
Year 2025 to 21-2, €		*Year 2025 to 21-2, $*	
+18.6%	Banks	+13.9%	Telecoms
+10.9%	Consumption Goods	+8.0%	Food, Beverage & Tobacco
+10.7%	Industry	+7.0%	Retail
+10.3%	Technology	+6.9%	Bank
+9.9%	Financial services	+6.2%	Healthcare
+9.4%	Telecoms	+6.2%	Pharmaceuticals
+9.1%	**Eurostoxx600**	+5.6%	Utilities
+8.3%	Health	+5.3%	Commercial & Pro. Services
+8.1%	Chemical	+5.2%	Energy
+7.9%	Oil & Gas	+5.1%	Real Estate
+7.6%	Commodities	+4.6%	Materials
+7.5%	Construction	+3.8%	Media
+7.1%	Insurance	+3.7%	Consumer Services
+6.4%	Media	+3.4%	Insurance
+5.3%	Food industry	**+2.2%**	**S&P500**
+2.9%	Retail	+0.8%	Semiconductors
+2.8%	Real Estate	+0.7%	Capital Goods
+0.7%	Utilities	-0.8%	Consumer Discretionary
-0.9%	Travel & leisure	-0.9%	Tech. Hardware & Equip.
		-15.5%	Automobiles

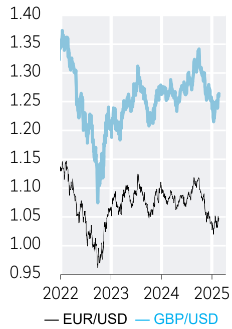
Bund 10Y vs US Treas. 10Y



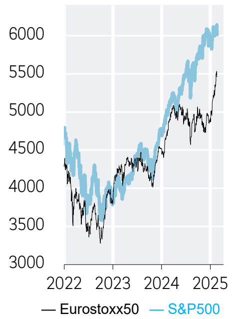
Bund 10Y vs OAT 10Y



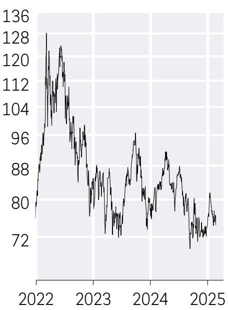
EUR/USD vs GBP/USD



EUROSTOXX 50 vs S&P500

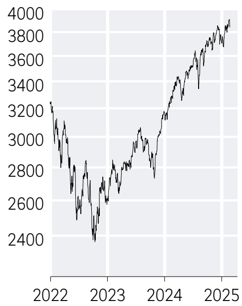


Oil, Brent ($/bbl)

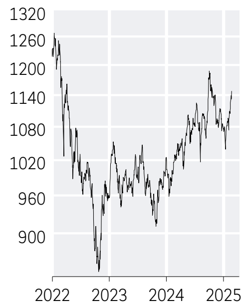


Gold ($/ounce)

MSCI World ($)



MSCI Emerging ($)



SOURCE: LSEG, BLOOMBERG, BNP PARIBAS
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