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“INFLATION IS NO LONGER THE NO. 1 ECONOMIC PROBLEM THAT IT HAS BEEN FOR THE PAST THREE YEARS, BUT IT REMAINS A MAJOR CHALLENGE.

ECONOMIC RESEARCH

BNP PARIBAS

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THE CHALLENGE OF INFLATION: 5 THINGS TO LOOK OUT FOR

Inflation is no longer the No. 1 economic problem that it has been for the past three years, but it remains a major challenge. While it has not reached its 2% target yet, and the last pockets are slowly deflating, new inflationary pressures are mounting. At this stage, those pressures are limited but not negligible and new inflationary risks, linked to the economic and geopolitical context, are taking shape. The Fed's task is becoming more complicated by the risk of a US stagflation, and the ECB's one happens to be slightly trickier when balancing between downside and upside risks on growth.

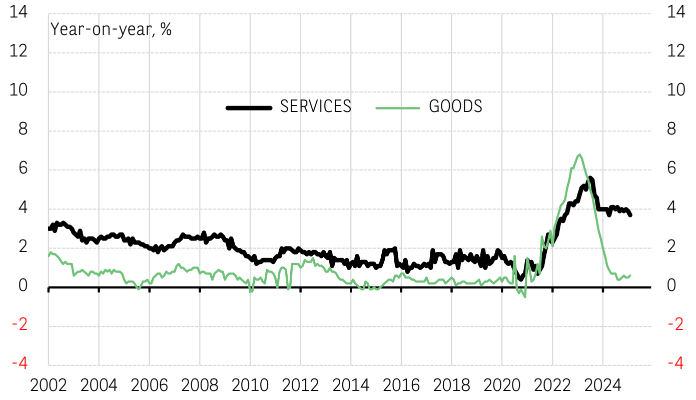
Still heading in the right direction overall. The latest data available for the United States (January) and the euro area (February, preliminary estimate) continue to point in the right direction overall. In the euro area, both headline and core inflation (for the first time since September 2024 for core inflation) fell slightly (-0.1 points to 2.4% and 2.6% y/y, respectively). The most encouraging point is the decline in services inflation, which can be expected to continue (after remaining stable at around 4% for just over a year). The process is likely to remain slow, as services inflation continues to be underpinned by the post-Covid shift in household consumption from goods to services, as well as by delayed adjustments to certain regulated prices[1]. However, the ongoing moderation in wage dynamics in the euro area is likely to fuel the disinflation process.

In the United States, January's inflation data were more mixed, but slightly positive on balance. CPI inflation rose by 0.1 points for both headline inflation (3% y/y) and core inflation (3.3%), but services inflation continued to decrease. What's more, inflation measured by the PCE deflator the Fed's preferred indicator fell slightly for headline inflation (-0.1 points to 2.5%) and more sharply for core inflation (-0.3 points to 2.6%). In addition, wage dynamics are also moderating in the United States but to a slightly lesser extent than in the euro area.

Inflationary pressures. It should also be noted that, on both sides of the Atlantic, the favourable trend in services inflation (downwards) is partly offset by the unfavourable one in goods inflation (upward in the United States, decline halted in the euro area), with much more pronounced trends in the United States (see charts 1 and 2). Although services have a bigger weight in the CPI, this less favourable trend on the goods inflation side is something to monitor. Besides, upstream inflationary pressures are once again developing, judging by the upturn in input and output price components of business confidence surveys. This upturn can also be seen in the services sector. While these pressures remain limited so far, they are likely to filter through price dynamics and have an upward impact on inflation figures over the next few months. In any case, a degree of volatility is to be expected given the forces at play. This volatility will be fuelled by the non-domestic components of inflation, while the domestic one should remain better oriented.

Inflation expectations: stable in the euro area, rising in the United States. As far as the euro area is concerned, the stability of inflation expectations at or close to the 2% target, both among households and professional forecasters, means that we should not be overly concerned about this rise in inflationary pressures. However, the story is different in the United States, where household inflation expectations, both 1 and 5 years ahead, have risen sharply in early 2025 (see chart 3).

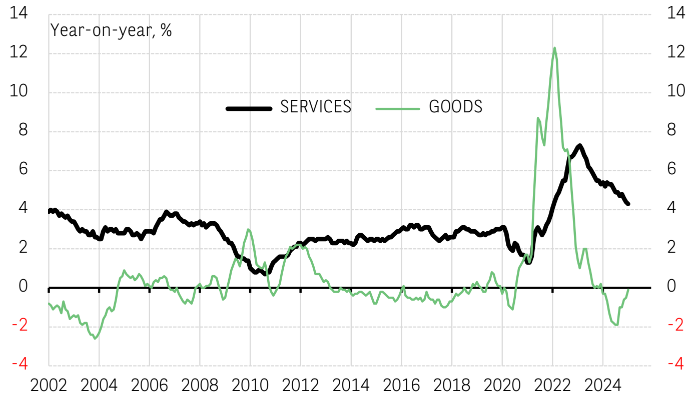
EURO AREA: CORE INFLATION DETAILS



SOURCE: EUROSTAT, MACROBOND, BNP PARIBAS

CHART 1

UNITED STATES: CORE INFLATION DETAILS



SOURCE: BLS, MACROBOND, BNP PARIBAS

CHART 2

1 For more details on the reasons for the stickiness of services inflation in the euro area, read, for example, the recent European Commission analysis, "The stickiness of services inflation in the euro area", Quarterly Report on the Euro Area Volume 23, No. 4 (2024), 20 February 2025.

On the corporate side, 1-year inflation expectations have also risen, but those for 3 and 5 years have not moved (yet) and remain anchored at 3% inflation[2].

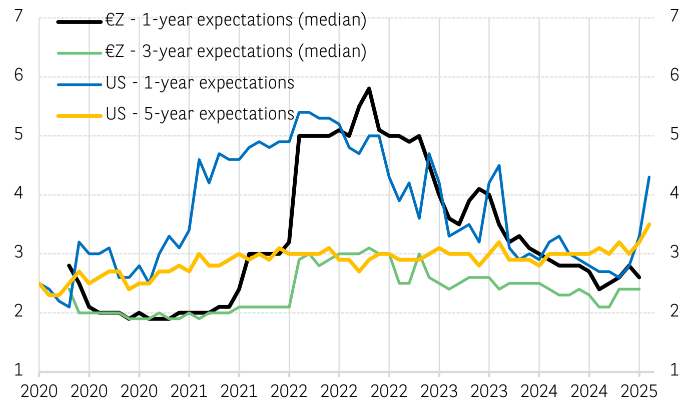
Inflationary risk 2.0. This rise in inflation expectations in the United States is fuelled by the announced hikes in US tariffs. As a result of this tougher tariff policy, a resurgence of inflation in the United States remains a risk (not a reality yet), but it has been clearly identified since the election of Donald Trump[3]. This risk has only grown in intensity since his inauguration and is likely to materialise more quickly than we had previously anticipated. To what extent can this extra-inflation in the US be exported elsewhere in the world? This depends partly on the scale of the retaliatory measures that will be taken. It also depends on the ability and willingness of companies to absorb the shock in their margins (a point that also applies to companies in the United States). There is considerable uncertainty surrounding these two transmission channels. An appreciation in the exchange rate can also help to offset the inflationary impact (and conversely, a depreciation may lead to a little more inflation). Finally, depending on the dynamics of domestic demand, the environment will be more or less inflationary. For both these transmission channels, the situation has recently changed somewhat on both sides of the Atlantic.

In the US, some concerns are beginning to emerge about the economic outlook. This is reflected in the latest Fed Beige Book[4]. While the term "recession" does not appear in it, the terms "customs duties", "inflation", "uncertainty" and "immigration" are mentioned a significant and increasing number of times. In some respects, the situation in the euro area mirrors the one in the US, with timid and sparse signs of improvement –going from an atonic starting point to a likely more solid growth. (despite the adverse effects coming from the United States). What makes us say that is the German turnaround on fiscal policy, the planned increase of military spending and the new plan to boost European competitiveness. The fall in the US stock markets over the last few days and the continuing upward trend in European indices illustrate well this change in outlook, as is the appreciation of the euro against the US dollar, which has quite clearly moved away from the parity towards which it seemed inexorably to be sliding.

These changes in the growth outlook (slightly less favourable in the US, slightly more favourable here) are broadly in line with our expectations. They have yet to be confirmed, of course. At this stage, they point to an inflationary risk that remains relatively high in the United States, but possibly falling slightly, and limited in the euro area, but possibly rising slightly.

The growth-inflation trade-off is becoming more complicated for the Fed and trickier for the ECB. While Scott Bessent, the US Secretary of the Treasury, highlights the temporary nature of the tariffs hikes impact on inflation and suggests that the Fed should not pay particular attention to that and continue to ease its monetary policy, we are of the view that it would be difficult for the Fed to look through the inflationary leap given the risk that inflation expectations become unanchored.

HOUSEHOLD INFLATION EXPECTATIONS



SOURCE: ECB, UNIVERSITY OF MICHIGAN, MACROBOND, BNP PARIBAS

CHART 3

For the time being, a prolonged monetary *status quo* looks to be the right approach to a stagflationary shock. But if the inflation-growth trade-off becomes more complicated, which is likely, with the risk of recession rising at the same time as inflation rises due to tariffs, this could lead the Fed to break away from its wait-and-see attitude and resume cutting rates.

The task is less complicated for the ECB, but the inflation-growth trade-off is becoming slightly trickier and reopens the range of possible decisions. More precisely, the likelihood of a further rate cut in April has diminished somewhat as the downside risks on short-term growth have decreased (thanks to the positive signal from the German and Commission budget announcements). However, a new cut (doubled by another in June) is still our central scenario at this stage, in view of the downside risks arising from Trump's tariff policy. Nor is there any counter-indication on the inflation front, given that the disinflation process is still well underway. And even if monetary policy is deemed to be "significantly less restrictive", according to Christine Lagarde, it has not yet reached its destination (neutrality), suggesting a bias towards further rate cuts. The current rise in long-term interest rates is also an argument in favour of limiting the tightening of financing conditions.

Hélène Baudchon

2 Firms' Inflation Expectations Have Picked Up - Liberty Street Economics, 5 March 2025.
3 We have incorporated this into our central scenario, published in December 2024. At the time, we were forecasting 2.9% annual average inflation in the United States in 2025 and 3.9% in 2026. After an update on 7 March 2025, these forecasts are currently 3.2% and 3.3%. They are likely to change again as part of the review of our overall scenario that is currently underway.
4 The Fed - Monetary Policy: Beige Book (Branch), 5 March 2025.

Find our scenario and forecasts

ADVANCED ECONOMIES

United States

Announcements, adjustments and temporary reprieves: In the United States, customs duties of 25% on imports from Canada (excluding energy: 10%) and Mexico came into force on Tuesday 4 March... before a reprieve was granted, until 2 April, for the automotive sector in both countries and for all products covered by the USMCA free trade agreement. Canada retaliated with 25% tariffs on CAD 30 billion of US products. At the same time, an additional 10 percentage points (pp) have been imposed on Chinese products (+20 pp since Trump's inauguration). In a speech to Congress, Trump announced that the "reciprocal tariffs" would come into force on 2 April and admitted that there would be some temporary "inconvenience".

Slowing down or contracting? Nonfarm payrolls growth picked up (+151,000 in February, +26,000 in January), but unemployment rose slightly (4.1%). The ISM manufacturing index slowed to 50.3 (-0.6 pp), with new orders and employment falling, while the prices paid index was at its highest level since 2022. The ISM non-manufacturing index recovered (53.5, +0.7 pp) thanks to the same two components. The monthly trade deficit (goods and services) increased and hit an all-time high: - USD 131 billion (surge in imports). The Atlanta Fed's GDPnow suggests that growth will fall sharply to -0.6% q/q non-annualised in Q1 2025 (compared with an estimate of +0.5% 2 weeks ago), against a backdrop of a negative contribution from foreign trade and stagnating private demand. On the economic policy front, President Trump has called on Congress to end the CHIPS and Science Act of 2022.

Eurozone / European Union

Historic strategic turning point in Europe. The European Commission has unveiled its "ReArm Europe" plan, which involves raising EUR 150 billion in joint loans for EU defence. In addition, a relaxation of budgetary rules is planned (exemption from European fiscal rules for defence spending). **The ECB cuts rates by a further 25 basis points, but offers less clarity for April.** It remains confident in the disinflation process and has indicated that its policy is "significantly less restrictive". The central bank forecasts 0.9% growth in 2025 and 1.2% in 2026 (-0.2 pp respectively). Eurozone growth for Q4 2024 has been revised upwards (from 0.1% q/q to 0.2% q/q). In January, the unemployment rate remained at an all-time low (6.2%) and retail sales fell by 0.3% m/m after two months of stagnation. The composite PMI held steady at 50.2 in February. The manufacturing PMI (47.6) returned to its highest level for two years.

Germany **The CDU/CSU and the SPD have announced an investment plan for infrastructure (EUR 500 billion over 10 years) and defence (spending in excess of 1 point of GDP would no longer be subject to the "debt brake"). This plan will have to be passed** by a two-thirds majority in the Bundestag on **18 March**, just before the formation of the new Parliament (25 March) in which the CDU/CSU, SPD and Greens will not have such a majority. This plan could significantly boost German growth. The anticipated increase in the country's debt resulted in a jump in the 10-year German bond rate (+35 bps between Tuesday 4 and Friday 7 March) from 2.48% to 2.83%. At the same time, **negotiations to form a coalition government between the CDU/CSU and the SPD are progressing and the first priorities have been announced.** After rising between August and December 2024, new industrial orders wiped out most of these gains in January.

France Manufacturing output contracted by 0.7% m/m in January (-2.4% y/y), but the decline did not affect the automotive sector. Housing starts rebounded with a cumulative 16% year-on-year increase over the last four months (October to January). President Macron has announced an increase in the defence budget, without specifying the amount, over and above what has been planned until now (2.5% of GDP in 2030). Financing will have to be reconciled with the budgetary consolidation effort begun in 2025 and the desire not to raise taxes. Several avenues are being explored (use of part of the Livret A savings account, creation of a dedicated savings account, and launch of a major loan to channel some of the [high] savings of the French).

United Kingdom The construction PMI deteriorated (-3.5 points to 44.6). The composite PMI was stable (-0.1 pt at 50.5), but the fall in the employment indices was pronounced, affecting the manufacturing sector (41.1) and services (43.9). House prices fell by 0.1% m/m in February (according to Halifax) and mortgages (excluding renegotiations) fell by 0.5% m/m in January, according to the Bank of England. The Prudential Regulation Authority has launched a consultation with a view to increasing the deposit limit above which a bank must comply with the "leverage ratio" rules.

China **Roadmap for 2025.** The authorities announced their macroeconomic targets at the opening of the annual session of the National People's Congress: i) the economic growth target of "around 5%", unchanged since 2024, is ambitious given the expected slowdown in exports and the weak domestic consumption; it reveals the authorities' intention to continue their monetary and fiscal support. ii) The CPI inflation target (a limit that must not be exceeded) has been revised to 2% for 2025, compared with 3% over the last 10 years (not surprising given the persistent deflationary pressures). iii) For the official budget deficit, the target is 4% of GDP, the highest level for 30 years. The Prime Minister reiterated that boosting private consumption would be a priority of the economic strategy in 2025.

Very slight improvement in the PMI indices in February. In the manufacturing sector, the PMIs returned to their Q4 2024 average level (50.2 for the NBS index and 50.8 for the Caixin index) after declining in January. The "new export orders" and "imports" sub-components (source NBS) have risen slightly, but remain below 50, with this lack of momentum confirmed by recent external trade figures. In services, the NBS and Caixin PMIs remain below their Q4 2024 levels (50 and 51.4, respectively).

COMMODITIES

OPEC+ countries have confirmed their intention to increase their crude oil production from April onwards, believing that market conditions have been met. Around 0.14 mb/d will be brought onto the market each month until the target of 2.2 mb/d is hit. With the European gas market under pressure, and in order to increase security of supply, the European Commission has proposed amending gas storage regulations (reaching 90% of reserves by 1st November each year), by extending its application from 2025 to 2027.

MARKETS OVERVIEW

Bond Markets

	in %	in bps			
	07/03/2025	1-Week	1-Month	Year to date	1-Year
Bund 2Y	2.24	+18.1	+16.2	+17.7	-69.4
Bund 5Y	2.47	+33.7	+33.1	+35.9	+10.8
Bund 10Y	2.81	+42.4	+45.8	+44.7	+53.5
OAT 10Y	3.39	+37.9	+37.5	+26.8	+64.3
BTP 10Y	3.79	+42.3	+43.6	+36.9	+17.8
BONO 10Y	3.40	+40.0	+44.7	+38.3	+29.4
Treasuries 2Y	4.03	+1.5	-28.1	-22.4	-52.8
Treasuries 5Y	4.10	+8.4	-25.1	-28.4	+0.2
Treasuries 10Y	4.32	+11.5	-17.4	-25.9	+22.3
Gilt 2Y	4.20	+1.1	+1.7	+5.5	-40.5
Treasuries 5Y	4.29	+12.8	+5.1	-6.1	+34.7
Gilt 10Y	4.64	+12.7	16.0	+7.1	+65.0

Currencies & Commodities

	Level	Change, %			
	07/03/2025	1-Week	1-Month	Year to date	1-Year
EUR/USD	1.09	+4.5	+5.1	+5.0	-0.5
GBP/USD	1.29	+2.6	+4.1	+3.2	+1.1
USD/JPY	147.49	-2.1	-2.6	-6.2	-0.4
DXY	111.99	+7.9	+11.5	+10.5	+6.1
EUR/GBP	0.84	+1.8	+1.0	+1.7	-1.6
EUR/CHF	0.96	+1.8	+1.5	+1.8	-0.6
EUR/JPY	160.32	+2.3	+2.4	-1.5	-1.0
Oil, Brent ($/bbl)	70.70	-3.9	-5.3	-5.4	-14.7
Gold ($/ounce)	2916	+2.3	+1.6	+11.1	+35.5

Equity Indices

	Level	Change, %			
	07/03/2025	1-Week	1-Month	Year to date	1-Year
World					
MSCI World ($)	3740	-1.7	-2.4	+0.9	+10.3
North America					
S&P500	5770	-3.1	-4.2	-1.9	+11.9
Dow Jones	42802	-2.4	-3.4	+0.6	+10.3
Nasdaq composite	18196	-3.5	-6.8	-5.8	+11.8
Europe					
CAC 40	8121	+0.1	+1.9	+10.0	+1.3
DAX 30	23009	+2.0	+5.6	+15.6	+29.0
EuroStoxx50	5468	+0.1	+2.7	+11.7	+9.9
FTSE100	8680	-1.5	-0.2	+6.2	+12.8
Asia					
MSCI, loc.	1402	+0.1	-1.8	-2.1	+1.5
Nikkei	36887	-0.7	-4.9	-7.5	-6.8
Emerging					
MSCI Emerging ($)	1129	+2.9	+1.8	+4.8	+9.5
China	77	+6.5	+13.7	+19.8	+46.2
India	936	+3.2	-4.6	-9.0	-5.3
Brazil	1287	+2.9	-3.0	+9.4	-23.9

Performance by sector

Eurostoxx600

Year 2025 to 7-3, €

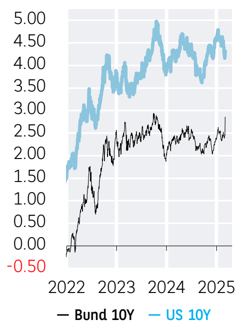
+24.9%	Banks
+14.2%	Construction
+12.5%	Industry
+12.2%	Insurance
+11.5%	Telecoms
+10.8%	Chemical
+9.0%	**Eurostoxx600**
+8.6%	Food industry
+7.5%	Health
+6.1%	Financial services
+5.2%	Commodities
+4.2%	Technology
+3.9%	Consumption Goods
+3.4%	Oil & Gas
+1.9%	Utilities
-0.8%	Retail
-2.8%	Real Estate
-2.9%	Media
-3.1%	Travel & leisure

S&P500

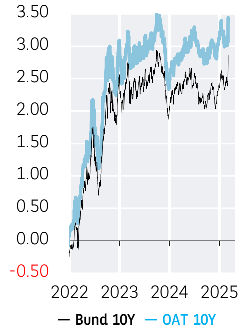
Year 2025 to 7-3, $

+17.9%	Telecoms
+9.4%	Food, Beverage & Tobacco
+9.1%	Pharmaceuticals
+7.9%	Insurance
+7.1%	Healthcare
+5.6%	Commercial & Pro. Services
+4.4%	Real Estate
+4.1%	Materials
+2.4%	Retail
+1.5%	Utilities
+1.4%	Energy
+1.0%	Consumer Services
+0.3%	Capital Goods
-1.6%	Bank
-1.7%	Media
-1.9%	**S&P 500**
-4.6%	Tech. Hardware & Equip.
-6.3%	Consumer Discretionary
-12.3%	Semiconductors
-32.1%	Automobiles

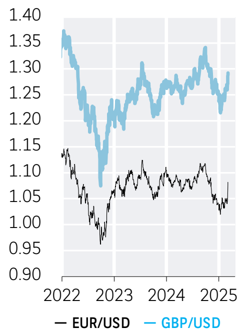
Bund 10Y vs US Treas. 10Y



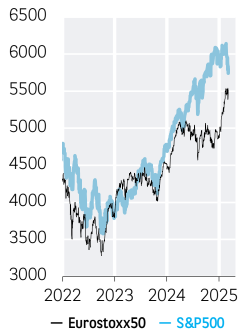
Bund 10Y vs OAT 10Y



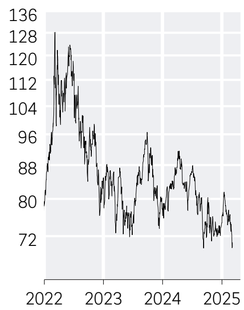
EUR/USD vs GBP/USD



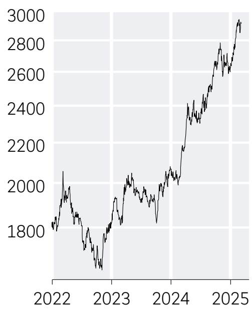
EUROSTOXX 50 vs S&P500



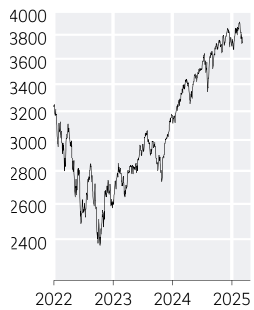
Oil, Brent ($/bbl)



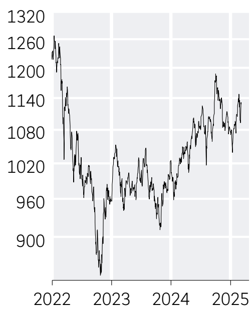
Gold ($/ounce)



MSCI World ($)



MSCI Emerging ($)



SOURCE: LSEG, BLOOMBERG, BNP PARIBAS
DATA VISUALISATION AND CARTOGRAPHY: TARIK RHARRAB

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