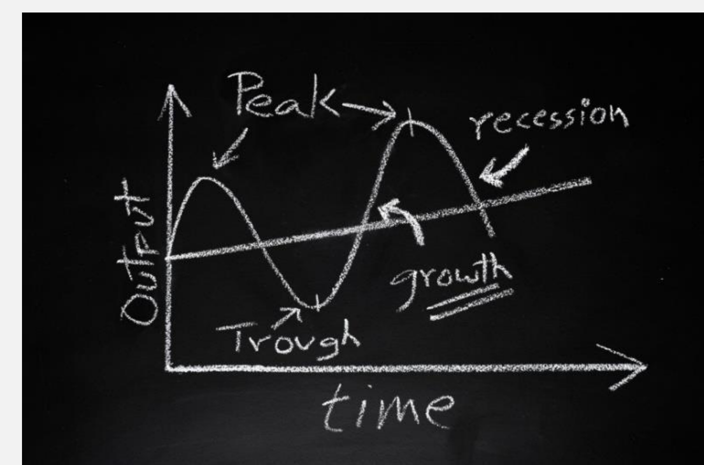
Creditreform Rating

Europe at a Crossroads – Navigating Growth amid Trump Tariffs and Domestic Weakness



Creditreform Economic Briefs

04 April 2025

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Key Take-Aways

1.

We have revised our forecast for the euro area's real GDP growth to 0.9% in 2025, reflecting a modest expansion. The recovery remains fragile, weighed down by geopolitical uncertainties, trade tensions, and weak external demand. Private consumption is expected to support growth, driven by real wage gains and a resilient labour market. Moreover, Germany's subdued performance acts as a drag on the broader euro area recovery. Growth momentum is expected to improve in 2026, with real GDP projected to rise by 1.2% as investment conditions stabilise and external demand picks up.

2.

Euro area inflation has moderated, with headline inflation at 2.2% in early 2025, nearing the European Central Bank's (ECB) target. However, core inflation remains sticky, driven by wage growth and high services inflation. The ECB cut rates, lowering the deposit rate to 2.5% in March 2025, with likely further cuts to 2% by the end of 2025. The ECB's cautious stance aims to support growth while controlling inflation risks.

3.

Fiscal dynamics in the European Union remain complex under the reformed 2025 governance framework, striking a balance between discipline and flexibility. Higher financing costs, rising defence spending, and geopolitical tensions challenge fiscal consolidation. While public investment may support growth, uncertainties persist due to trade disputes and shifts in global monetary policies. More generally, the growth impact of ramped-up defence spending is likely to materialise with some lags and should be balanced by rising imports.

4.

Germany's economy remains stagnant. Economic struggles persist due to falling exports, weak domestic demand, and a shrinking manufacturing sector. As of now, we anticipate real GDP growth of 0.2% in 2025, followed by a gradual recovery in 2026. That said, uncertainty is unusually high. Germany has agreed on a huge fiscal package including vast defence and infrastructure spending, which - in tandem with structural reforms - could be crucial to reignite growth. The housing market is showing resilience, with investor confidence improving and property transactions increasing lately. However, increasing bond yields should hamper the recovery of the housing market.

5.

We project the UK's real GDP to grow by 1.0% in 2025, as weak domestic demand, slowing retail sales, and industrial contraction weigh on the recovery. The Bank of England (BoE) is balancing rate cuts against persistent inflation. Core inflation is expected to stay above target throughout the year, while wage growth remains strong, complicating policy decisions. After two rate cuts, the BoE should lower rates to 3.75% by year-end, cautiously supporting economic stability amid trade tensions and fiscal uncertainty.

6.

The US economy is set to slow in 2025. Inflation is expected to remain above target. The Federal Reserve (Fed) has held rates at 4.25%-4.50% but should cut these by 50bps in 2025, likely starting in June. Trade uncertainty and fiscal pressures add risks, prompting the Fed to balance inflation control with economic support.

Note on recent changes in US trade policy:

On 2 April 2025, the so-called "Liberation Day", the Trump Administration announced a major expansion of its trade protectionist agenda, culminating in wide-ranging tariffs. These measures, including blanket and reciprocal tariffs on a wide range of imports, notably 35% on Chinese goods and 20% on EU goods, are likely to have far-reaching global repercussions.

These measures mark a significant shift in global trade policies and are likely to have a profound economic impact going forward. While the immediate effects include upward pressure on inflation and a likely drag on growth - both in the US and abroad - the full economic impact remains difficult to assess. This is mainly due to the considerable uncertainty surrounding the scope, duration and product coverage of the tariffs, as well as the nature and intensity of retaliation by key trading partners.

Importantly, the impact is not limited to direct trade flows. The tariffs are likely to have wider second-round effects, in particular through increased economic uncertainty and reduced business and household confidence. In the euro area, this could exacerbate existing vulnerabilities, with consumption and investment likely to remain subdued, keeping the region's growth trajectory sluggish.

Moreover, these developments will complicate the outlook for monetary policies of the major central banks, introducing additional risks on both the inflation and growth fronts. The path of interest rates is now more uncertain than before.

In terms of sector-specific vulnerabilities, the automotive industry in both Europe and the US will come under increased pressure as manufacturers face higher input costs and prepare for possible countermeasures. Sectors such as logistics, chemicals and retail could also be affected, given their close integration into global supply chains and sensitivity to shifts in consumer demand.

Please note that the forecasts do not yet reflect these developments due to the data cut-off and will be reassessed in forthcoming updates as further policy details and market reactions become available.

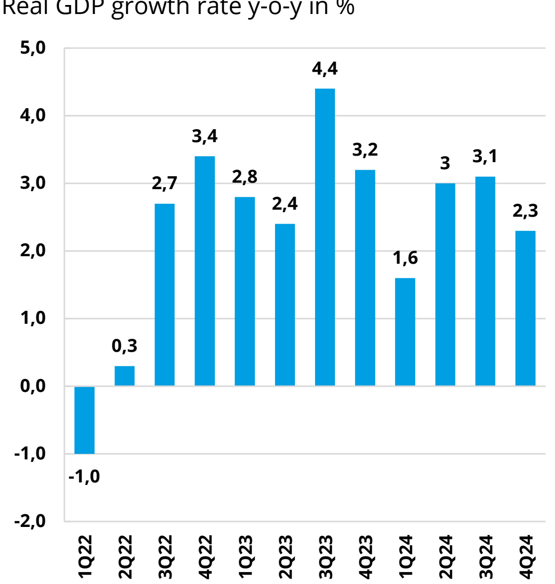
1. World

United States: Robust growth despite rising inflationary headwinds

The US economy remained resilient at the end of 2024, expanding by 2.3% y-o-y in the fourth quarter, driven mainly by strong consumer spending, resulting in a solid 2.8% expansion for the full year (Figure 1). Despite steady economic performance, households are feeling the pinch of rising prices. Consumer confidence has plunged to its lowest level in over two years, and long-term inflation expectations have climbed to 3.9%, the highest since 1993, suggesting lingering concerns about rising prices. Growth is expected to moderate in 2025, with the International Monetary Fund (IMF) forecasting a more modest expansion of 2.7% and 2.1% in 2026.

Figure 1: US economic growth remains resilient

Real GDP growth rate y-o-y in %



Source: US Bureau of Economic Analysis, Creditreform Rating

Inflation remains a key concern. Consumer prices rose by 0.2% m-o-m in February, the slowest pace in months, bringing annual inflation down to still high 2.8% from 3.0% in January. Core inflation, which excludes food and energy prices, posted at 3.1%. Inflation thus remains above the Federal Reserve's 2% target, complicating interest rate decisions. According to the latest FOMC meeting, the 2025 inflation forecast has been revised upwards, with headline PCE rising from 2.5% to 2.7% and core PCE increasing from 2.5% to 2.8%.

Once a pillar of economic strength, the US labour market is showing signs of softening. In February 2025, the economy added 151K jobs, falling short of expectations, while the unemployment rate inched up to 4.1%. More worryingly, household employment fell by 588K, and around 385K people left the workforce altogether, raising concerns about declining confidence in job prospects. Job openings dipped to 7.6 million in February from 7.7 million in January, adding to the labour market's mounting challenges. Businesses are grappling with growing uncertainty over trade policies under the Trump administration, making future hiring decisions even more cautious.

Growing concerns: Trade turmoil and rising budget deficits

Trade policy has become a growing source of economic uncertainty. In March 2025, markets have been rattled by President Trump's sweeping 25% tariff on imports from Canada and Mexico, alongside steep levies on steel and aluminium. Tensions have escalated further with 20% blanket tariffs on Chinese goods and a 25% duty on most Canadian imports, including an additional 10% on energy resources. The auto industry faces fresh headwinds, with a 25% tariff on imported cars and parts, while new duties on lumber and pharmaceuticals are under investigation.

Figure 2: Trump administration's tariff announcement and implementation

Trump tariff timeline 2025,)*TBD- to be decided

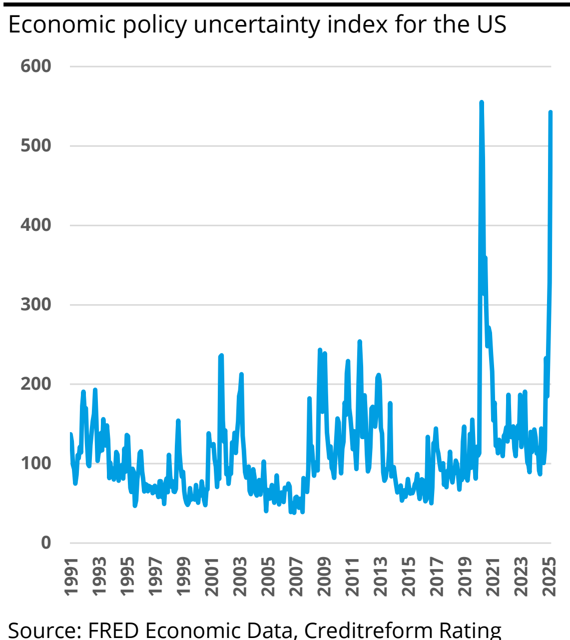
Target	Timeline	Import Scope	Tariff Rate
Canada	Ann. Feb 1; Eff. Mar 4; Exemptions from Mar 5 (indefinitely extended)	Up to $253bn (while exempted)	25% non-energy; 10% energy & potash; later 12% on non-USMCA imports (excl. energy & potash)
Mexico	Ann. Feb 1; Eff. Mar 4; Exemptions from Mar 5 (indefinitely extended)	Up to $236bn (while exempted)	25%; later 12% on non-USMCA imports
China	Ann. Feb 1; Eff. Feb 4; Raised Mar 4	$430bn	10%, later 20%
EU	Ann. Feb 26; Replaced by Apr 2 plan	$598bn	25%
Steel & Aluminum	Ann. Feb 10; Eff. Mar 12	$85bn (steel, aluminum, derivatives)	25%
Autos & Parts	Ann. Feb 12; Eff. Apr 2	$432bn (assuming USMCA excluded)	25%
Copper	Investigation Feb 25; Report due Nov 22	$17bn	TBD
Broad Reciprocal Tariffs	Ann. Feb 13; Signed Apr 2; First phase Apr 5; Country hikes Apr 9	$2.2tn (excl. autos, metals, energy, Canada, Mexico)	TBD
Semiconductors & Pharma	Ann. Jan 27; Rate set Feb 18	Not yet specified	25%+
Lumber & Derivatives	Ann. Mar 1; Report due Nov 26	$22.9bn	TBD
Agricultural Products	Ann. Mar 3; Eff. Apr 2	Not specified	TBD

Source: Taxfoundation.org, Creditreform Rating

What is worse, on 'Liberation Day' (2 April 2025), President Trump announced a far-reaching set of tariffs, including what he described as "reciprocal tariffs" on over 180 countries and a baseline tariff on others (Figure 2). Trump imposed a blanket tariff of 10% across various imports. This marks the most extensive US tariff package in decades. The move, framed as a step towards funding income tax cuts and reshoring manufacturing, sent immediate ripples through the world economy. Countries with which the US runs its largest trade deficits, China, the European Union, and others, have been hit with even steeper duties: 35% for China and 20% for the EU. As a result of the recalibration of America's role in global trade, supply chains are set to face new disruptions. That said, beyond immediate turbulence, the broader implications remain uncertain. While the full economic impact is yet to unfold, any measurable effects lie beyond the scope of this analysis due to the cut-off date.

Figure 3: US trade policy unleashes huge surge of uncertainty

Economic policy uncertainty index for the US



Source: FRED Economic Data, Creditreform Rating

While the effect of the tariffs will thus be more visible in the upcoming data releases, the rising trade tensions have led to a sharp increase in the US. Economic Policy Uncertainty Index, which surged past 540 in 2025, just shy of the 555-peak seen during the COVID-19 pandemic (Figure 3). A March Reuters poll found that 95% of economists now see heightened recession risks due to

erratic tariff policies. Small business confidence has also taken a hit, with optimism dipping in February. Uncertainty looms large as firms brace for potential retaliation from trading partners, holding back investment over fears of rising costs and supply chain disruptions. While the Trump administration insists these tariffs will shield American industries, they risk backfiring, driving up prices and slowing economic growth.

Meanwhile, fiscal pressures are mounting. In February 2025, the US budget deficit reached $307 billion, up 4% from the previous year. While tax revenues reached a record $296 billion for the month, government spending increased even faster, reaching $603 billion – a new record high. Efforts to curb spending have made little progress, raising questions about the sovereign's long-term fiscal sustainability.

The Federal Reserve's next move

Against this backdrop, the Federal Reserve has kept interest rates steady at 4.25%-4.50% in the latest FOMC meeting in March, following three cuts in late 2024. With economic uncertainty on the rise, the Fed is treading carefully. We believe the Fed could cut rates by 50 basis points by the end of 2025, with the first expected in June. However, policymakers remain cautious, closely monitoring inflation and economic conditions before making any moves.

In this vein, Fed Chair Jerome Powell recently acknowledged that tariffs add another layer of complexity. On the one hand, higher import costs could lead to higher inflation. On the other hand, economic uncertainty might curb spending and investment, dampening demand and exerting downward pressure on prices. Striking the right balance will be critical as the Fed aims to support economic stability without reigniting inflation.

China: Stimulus-fuelled growth amidst global trade headwinds

China's economy defied expectations in Q4 2024, expanding by 5.4% y-o-y, its fastest pace in 18 months, buoyed by a series of targeted stimulus measures. This sharp acceleration from the 4.6% growth recorded in the previous quarter underscored the resilience of the world's second-largest economy, even as global trade tensions intensified. A wave of policy interventions since September injected much-needed momentum, driving industrial output up by 5.9% y-o-y in the first two months of 2025, comfortably outpacing market forecasts of 5.3%. Retail sales also rebounded, climbing 4.0% in January-February, supported by the Lunar New Year celebrations.

For the full year, GDP growth settled at 5.0% in 2024, in line with Beijing's target but trailing the 5.2% expansion seen in 2023. Beneath the headline figures, however, structural challenges remain. Fixed-asset investment increased by 3.2% in 2024, a modest improvement from the previous year, while the troubled real estate sector continued to weigh on the broader economy, with real estate investment declining.

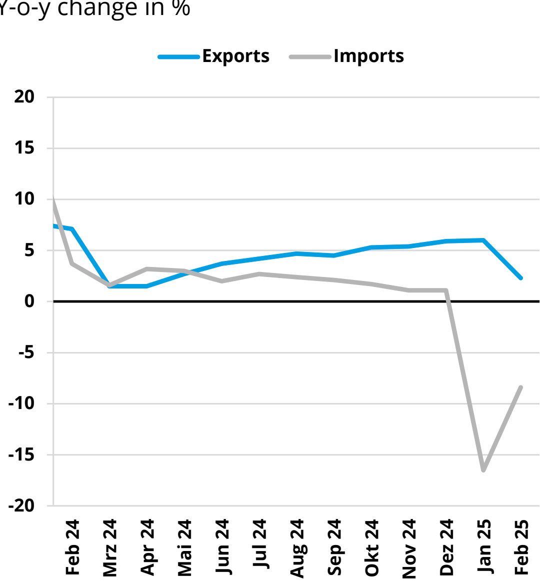
Exports extended their winning streak for the tenth consecutive month, but the backdrop was far from reassuring. Escalating tensions with the US culminated in fresh tariffs imposed by President Trump, which squeezed Chinese exports, resulting in a 2.3% growth rate —a sharp slowdown. Meanwhile, imports slumped by 8.4%, reflecting both weaker domestic demand and a shifting global trade dynamic (Figure 4).

Looking ahead, the Chinese economy is projected to grow by a relatively moderate 4.6% in 2025, according to the IMF, a slight upward revision from its earlier forecasts, reflecting the boost from fiscal measures. Labour market pres-

sures have intensified. The urban unemployment rate edged up to 5.4% in February, the highest level in two years, indicating fragile consumer confidence. At the same time, deflationary risks have emerged, with the consumer price index (CPI) sliding 0.7% y-o-y, while producer prices continued to decline, signalling persistent pricing pressures.

Figure 4: China's trade gets off to a weak start in 2025

Y-o-y change in %



Source: General Administration of Customs, Creditreform Rating

In response, policymakers have redoubled their efforts to stabilise growth and reinvigorate domestic demand. A newly unveiled "special action plan" aims to boost consumption through income-enhancing measures, childcare subsidies, and targeted incentives for electric vehicles and home appliances. Moreover, authorities have pledged stronger fiscal and monetary support, including potential cuts to the reserve requirement ratio (RRR) and interest rates to ensure liquidity remains ample. While uncertainties persist, Beijing's proactive approach reflects a clear commitment to sustaining economic momentum. We remain cautiously optimistic, noting that strategic policy recalibration and a renewed emphasis on innovation could help China navigate mounting external pressures and internal headwinds.

UK: Fragile recovery faces policy crossroads amid inflationary pressures

The UK economy had a challenging start to 2025, with growth prospects dampened by weaker-than-expected data and persistent structural issues. GDP unexpectedly contracted by 0.1% in January, weighed down by a sharp decline in industrial output, following a 0.4% expansion in December. However, over the three months to January, the economy expanded by 0.2%, slightly below the consensus forecast of 0.3%.

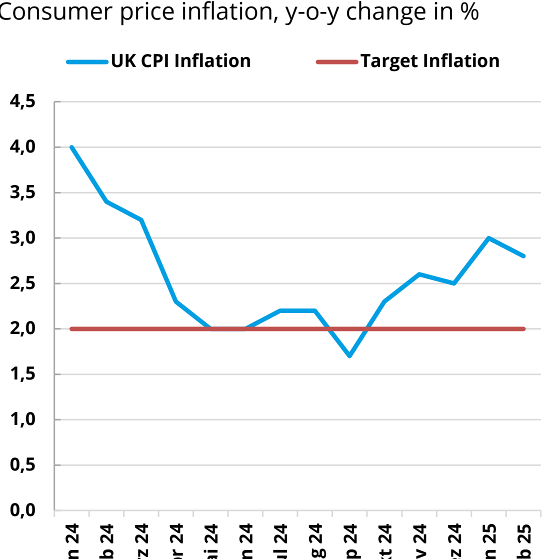
Against a backdrop of sluggish domestic demand and rising economic and political uncertainty, we have lowered our real GDP forecast down to 1.0% in 2025 from 1.5% previously and expect the economy to grow by 1.4% in 2026. The Labour government's planned £5 billion cut to the welfare budget by 2029/30 is aimed at stabilising public finances, but concerns remain over its potential impact on consumer spending. Retail sales growth has already slowed, rising by just 1.1% y-o-y in February, down from 2.6% in January. Meanwhile, industrial production remains under pressure, with British factories shedding jobs at the fastest pace in almost five years due to rising costs, which have been exacerbated by a payroll tax increase.

The Bank of England (BoE) has taken a cautious approach to monetary policy, striking a balance between inflationary pressures and weak economic growth. Following two 25bps cuts in November 2024 and February 2025, the BoE should hold interest rates at 4.5% at its upcoming meeting as policymakers assess the impact of previous easing measures. Inflation remained elevated at 2.8% in February, slightly lower than the

3.0% recorded in January (Figure 5), and core inflation is projected to remain above the 2% target throughout the year.

Figure 5: UK inflation diverging from the 2% BoE target

Consumer price inflation, y-o-y change in %



Source: Office for National Statistics, Creditreform Rating

Wage growth has further complicated the outlook, with private sector earnings increasing by 6.2% y-o-y in Q4 2024, challenging expectations of a slowdown. We expect at least three more rate reductions in 2025, likely in May, August, and November, which will bring the policy rate to 3.75% by year-end. However, ongoing trade tensions with the US and uncertainty surrounding fiscal policy could impact the BoE's approach. With inflation forecast to average at 3.5% in 2025, we expect the policymakers to proceed cautiously, ensuring that easing measures do not reignite price pressures while supporting economic stability.

2. Euro area

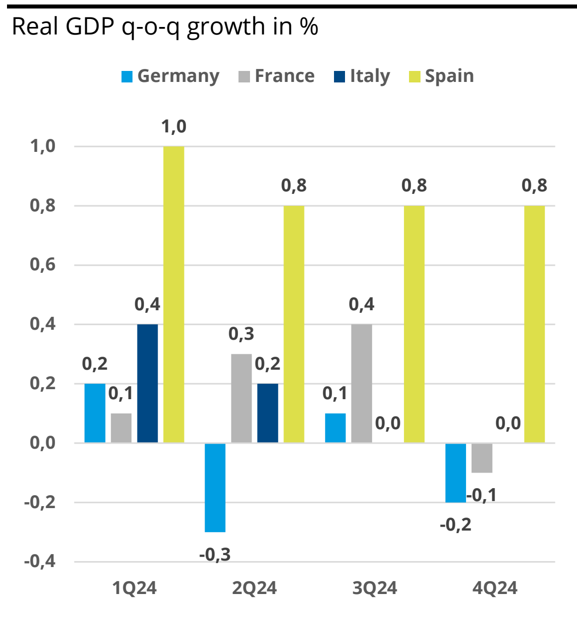
Euro area growth remains modest amid diverging national trends

After a prolonged and widespread stagnation in the second half of 2023, the euro area's economy returned to growth at the beginning of 2024. For the full year, GDP grew by only 0.9% in 2024, up from 0.4% in 2023. However, the recovery remained modest through the second and third quarters. Real economic activity in the euro area showed limited growth in the final quarter of 2024 (0.1% q-o-q).

Among the European economies, Spain continued to stand out positively, posting a strong quarterly growth rate of 0.8% q-o-q (Figure 6). In contrast, Germany remained a drag on the region's performance, with a contraction of 0.2% q-o-q, while France also recorded a slight decline of -0.1% q-o-q. Italy's economy stagnated in the final quarter, highlighting the uneven growth dynamics across the euro area.

Figure 6: Heterogeneous growth among European major economies persists

Real GDP q-o-q growth in %



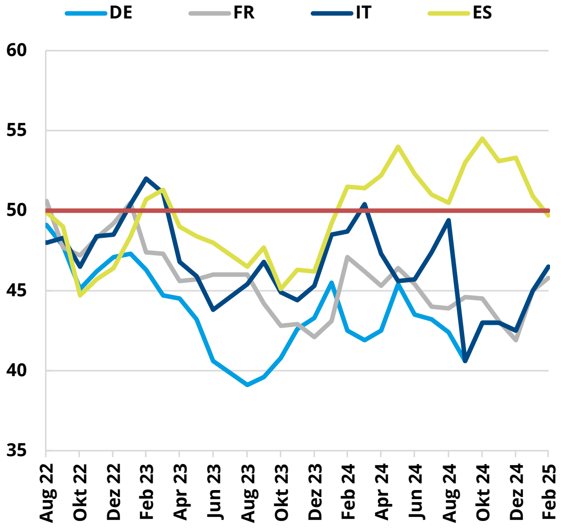
Source: Eurostat, Creditreform Rating

Indicating an anaemic expansion in European economic activity going forward, the HCOB Flash Composite PMI rose slightly to 50.4 in March from 50.2 in February. While the composite index remained above the 50-point threshold, the pace of expansion remained weak amid ongoing weakness in demand.

The services sector remained in expansionary territory, with the Services PMI coming in at 50.4, marginally down from 50.6 in February, constrained by weakening consumer demand and labour market anxieties. France's services sector contraction, with the PMI recorded at 46.6, highlights regional disparities, with southern economies disproportionately affected by the slowdown in tourism and reduced public investment.

Figure 7: European manufacturing remains under pressure

Manufacturing PMIs, <50: contraction, >50: expansion



Source: S&P Global, Creditreform Rating

Meanwhile, manufacturing output showed signs of improvement, with the Manufacturing PMI improving to 47.6 from 46.6 in January, but remaining in contractionary territory for the 20th consecutive month. The divergence in regional performance persisted, with Germany recording a second consecutive monthly rise in output, while Spain recorded the sharpest contraction in business activity in nearly 18 months (Figure 7). Despite muted demand and falling new orders, the euro area's overall economic momentum remained weak.

Inflation convergence and labour market paradox

The annual inflation rate has eased to 2.2% in March, down from 2.3% in February. Meanwhile, the latest available data suggests that wage growth has also slowed, with wages rising by 4.1% y-o-y in Q4 2024, the lowest so far that year. The labour market remains relatively stable, despite weak domestic demand, with the unemployment rate holding at a record low of 6.1% in February 2025. Employment growth has been modest, with a 0.1% increase in Q4 2024.

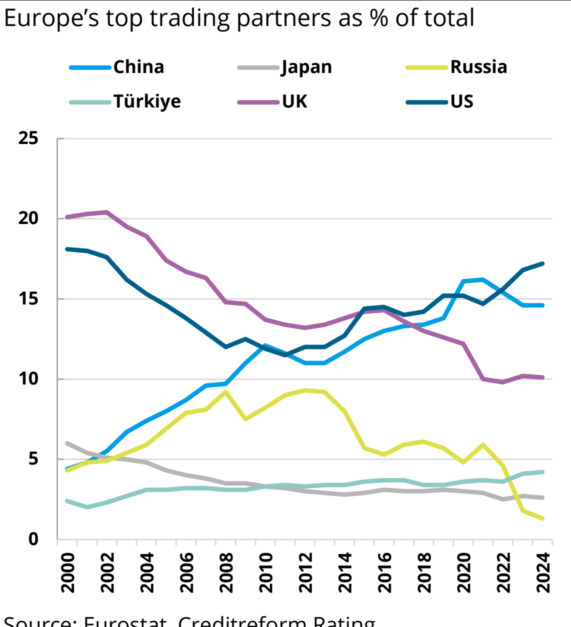
Overall, the euro area is navigating a period of cautious optimism, striking a balance between controlling inflation and maintaining steady employment and wage growth. The economic outlook remains highly uncertain, shaped by a mix of trade tensions, monetary policy adjustments, rising defence spending and geopolitical developments.

US tariffs: A looming trade war

The US remains the EU's largest trading partner, with bilateral trade in goods reaching €865 billion in 2024, accounting for 17% of the EU's total trade (Figure 8). This marks an increase from 13% in 2014. Over the same period, China's share grew from 12% to 15%. Other key EU trading partners in 2024 included the UK (10%) and Turkey (4%). Examining trade flows separately, China was the EU's top import source, accounting for 21%, followed by the US at 14%. Conversely, the US was the leading export destination (21%), ahead of the UK (13%) and China (8%).

Figure 8: Europe's trade with the US has increased since 2021

Europe's top trading partners as % of total



Source: Eurostat, Creditreform Rating

The Trump administration's decision to impose 25% tariffs on all EU auto imports has sent shockwaves through European automobile markets. These tariffs would directly affect exports worth €520 billion, with the German automotive industry alone set to lose €39 billion in additional costs. Beyond direct trade losses, the tariffs could also disrupt supply chains. Approximately 68% of the EU's imports of intermediate goods, including those used in the pharmaceutical and machinery sectors, originate from China. With potential US secondary sanctions on Chinese products, European manufacturers may face additional challenges. That said, the extent of the negative impact will depend not only on the scale of the tariffs but also on the uncertainty surrounding Trump's policies, both regionally and globally.

A serious trade conflict poses a significant risk and could have a severe adverse economic impact on the euro-area economies most exposed to the US. The effects could be even more negative if trading partners enter a vicious circle of measures and stronger countermeasures.

Geopolitical risks: Ukraine and defence spending

Beyond trade risks, geopolitical developments will play a pivotal role in shaping Europe's economic trajectory. A deterioration in the geopolitical situation in Ukraine, possibly triggered by a reduction or withdrawal of US support, could heighten uncertainty and slow growth in the euro area. Conversely, a ceasefire could boost consumer confidence and spending.

Higher defence and infrastructure investment may provide additional economic momentum. Indeed, European governments are planning a significant increase in defence spending, but we believe that expectations of an economic boom from military expenditures may be overstated. The European Commission's plan to 're-arm' Europe hinges on invoking the Stability and Growth Pact's escape clause, allowing countries to exceed the 3% GDP deficit threshold without triggering excessive deficit procedures. If fully enacted, this could unlock up to €650 billion, raising EU defence spending to 3.5% of GDP. Additionally, a €150 billion borrowing fund would provide more favourable financing conditions for countries with high debt levels.

Muted economic impact of defence investments

Despite these substantial defence commitments, the economic boost may be smaller than expected for several reasons. The funds are intended to help member states meet existing spending targets rather than increase spending further; their impact on overall economic activity may be limited. In addition, high debt levels in countries such as France and Italy may limit additional fiscal expansion, as governments may cut spending elsewhere to offset defence increases. More generally, a significant share of defence procurement relies on imports, meaning much of the expenditure should go abroad rather than stimulating the domestic economies. Europe's defence manufacturing capacity

is expanding, but the region remains dependent on external suppliers in the short to medium term, dampening the immediate GDP impact.

Overall, while fiscal stimulus in Germany and the EU could provide a tailwind to growth, risks remain skewed to the downside, particularly if trade disruptions intensify or financial markets react negatively to rising government deficits.

Heightened geopolitical and policy uncertainty is expected to weigh on economic growth in the euro area, slowing the expected recovery. This follows slightly weaker-than-expected growth at the end of 2024. Both domestic and trade policy uncertainties remain elevated. While our projection accounts for the initial impact of tariffs on US trade, concerns over potential shifts in global trade policies, particularly those affecting the European Union, are likely to dampen euro area exports and investment. Additionally, ongoing competitiveness challenges are expected to reduce the region's export market share further.

Despite these challenges, we anticipate that the euro area economy will regain some momentum going forward. Rising real wages and employment, supported by a resilient yet gradually cooling labour market, should drive a consumption-led recovery. Domestic demand is also expected to benefit from easing financing conditions, reflecting market expectations of lower interest rates. We expect the labour market to remain broadly stable.

As some of the cyclical factors that have weighed on productivity in recent years begin to fade, productivity growth is expected to improve, though structural challenges persist. We expect a moderate growth rate in the euro area economy, with a 0.1% increase in Q1 2025, followed by 0.2% and 0.3% in subsequent quarters of 2025. There is expected to be more muted growth in Germany, which is likely to weigh on euro area growth.

Overall, we forecast real GDP growth to be 0.9% in 2025. The weaker outlook is primarily driven by lower export and investment projections, reflecting a greater-than-expected impact of uncertainty related to geopolitical and policy uncertainty. Nonetheless, we expect euro area growth to accelerate to 1.2% in 2026. To be sure, the recently passed huge fiscal package by the German parliament (see below) adds some upside to our forecasts and will be factored into our upcoming projections as more details related to European and German fiscal plans become available.

Inflation outlook and the ECB's policy

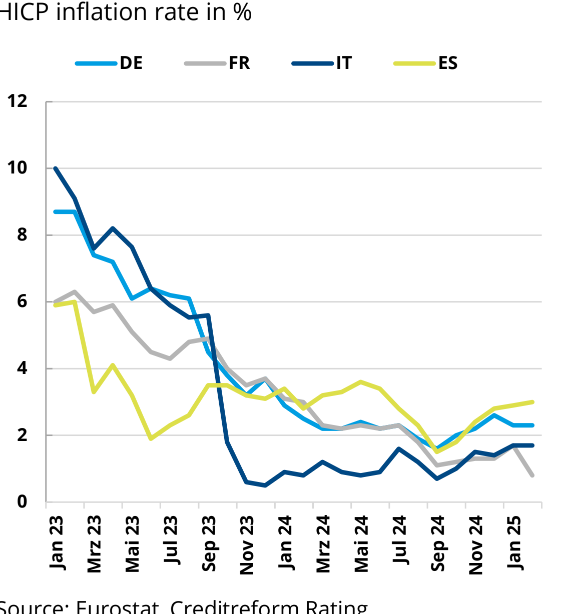
Annual inflation in the euro area has eased to 2.3%, moving closer to the ECB's 2% target. However, underlying price pressures remain evident, particularly in the labour market and energy sectors. The recent moderation in inflation has given the ECB room to ease monetary policy, but the trajectory has been anything but linear. After declining for much of 2024, inflation rebounded in late 2024, raising concerns about renewed price pressures. Despite this, the ECB opted to cut rates in early 2025, prioritising economic stabilisation amid weakening growth momentum.

Adding to the complexity is the European labour market. While unemployment hit a record low of 6.1% in February, reduced workloads in manufacturing and construction have led to precautionary savings, weakening consumption growth. This duality, low unemployment but subdued demand, highlights the ECB's policy challenge: the economy requires stimulus, yet inflationary risks remain. Adding to the uncertainty are escalating US-EU trade tensions, with the threat of tariffs and supply chain disruptions likely to weigh on economic growth. This could push the ECB towards further rate cuts to support activity.

Despite the overall decline in inflation, price pressures remain uneven across the euro area (Figure 9). France recorded a comparatively low inflation rate of 0.8%, while Germany's data suggests only a gradual cooling. Euro area services inflation remains elevated at 3.7% y-o-y in February, and wage growth pressures persist, with compensation per employee rising 4.6% in 2024. Furthermore, the ECB's Consumer Expectations Survey indicates that households anticipate inflation to reach 2.6% over the next 12 months, highlighting the risk of inflationary expectations becoming entrenched.

Figure 9: Inflation rates in major economies close to ECB target

HICP inflation rate in %



Source: Eurostat, Creditreform Rating

The ECB's revised inflation projections reflect a more persistent price environment than previously expected. Inflation is now expected to be 2.3% in 2025, 1.9% in 2026, and 2.0% in 2027, suggesting that achieving lasting price stability may take longer than initially anticipated. Stronger energy prices and service inflation trends drive the upward adjustment in headline inflation for 2025. Meanwhile, core inflation, which excludes energy and food, is projected to average 2.2% in 2025, gradually easing to 2.0% in 2026 and 1.9% in 2027, driven by moderating labour cost pressures.

ECB's evolving monetary policy stance

In response to slowing inflation, the ECB lowered the deposit rate to 2.5% in March 2025. ECB President Christine Lagarde has emphasised that future rate cuts or pauses will depend on economic conditions, reflecting growing internal debates over the neutral interest rate (r-star). Diverging policy views within the ECB further complicate the outlook. Some policymakers stress the persistent weakness in demand and advocate for continued accommodative measures, while others caution that further easing could reignite inflationary pressures, particularly amid rising trade tensions and increased defence spending.

The ECB now faces a delicate balancing act. Moving too aggressively with rate cuts could risk a resurgence in inflation, while maintaining a cautious stance may prolong economic stagnation. As inflation dynamics evolve, the ECB's challenge will be to navigate these crosscurrents while ensuring financial conditions remain supportive of long-term stability and growth. Against this backdrop, we expect the ECB to remain cautious, likely reducing rates only once for the remainder of 2025. Further deposit rate cuts towards 2% are anticipated by the end of 2025, as the central bank carefully balances the need to support growth while keeping inflation risks in check.

3. Germany

Navigating through economic challenges

In Germany, economic woes continued as official data confirmed a 0.2% contraction in the final quarter of 2024, marking the sixth consecutive quarter of y-o-y decline. Falling exports,

weak domestic demand, and a shrinking manufacturing sector drove the downturn. Unemployment remained low at 3.5% in January 2025, according to the Eurostat Labour Force Survey (LFS) data, while the manufacturing PMI, although improving to 46.5, continued to signal contraction. However, post-election consumer sentiment showed signs of life, with slight improvements in economic expectations, income outlook, and spending willingness. The GfK and NIM Confidence Index edged up marginally to -24.5 points for April 2025 from a revised -24.6 the previous month. Structural issues, high energy costs, and competitive pressures have led to two consecutive years of economic decline, prompting business leaders to call for bold reforms rather than minor policy adjustments.

Inflation remained stable at 2.3% in February 2025, as surging food prices offset falling energy costs and slower services inflation. Core inflation eased to a still-high 2.6%, albeit the lowest level since June 2021, offering some relief. Despite economic headwinds, retail sales showed resilience, surging 4.9% y-o-y in February, the strongest gain in three years. This followed an upwardly revised 3.3% rise, driven by robust online demand, offering a rare bright spot in an otherwise fragile economy.

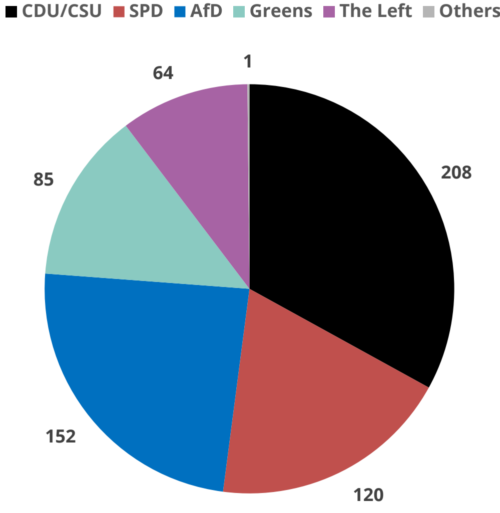
Fiscal dilemma and a test of leadership

At the heart of economic policy debates is Germany's constitutionally enshrined "debt brake," which limits government borrowing to 0.35% of GDP. This fiscal rule has become increasingly controversial as Germany faces mounting pressure to increase defence spending. The dispute over relaxing this rule contributed to the collapse of the previous traffic light coalition.

The 2025 German federal election, held on February 23, reshaped the political landscape of Europe's largest economy. The conservative Christian Democratic Union/Christian Social Union (CDU/CSU), led by Friedrich Merz, emerged victorious with 28.5% of the vote (Figure 10).

Figure 10: Official election result with the Merz government gaining majority seats

Total number of seats secured by each party



Source: Bundeswahlleiterin, Creditreform Rating

Germany's Bundestag finally approved a landmark fiscal package on March 18, paving the way for higher defence spending and a €500 billion infrastructure and climate fund. The bill, backed by 513 MPs and opposed by 207, also passed the Bundesrat on 21 March to be enshrined in the constitution.

The reform, spearheaded by the CDU/CSU and SPD, aims to bypass Germany's stringent debt brake and allow greater borrowing flexibility for defence and infrastructure projects. Additionally, Germany's states will have increased leeway in managing debt. The fiscal shift, a key part of the coalition negotiations between the CDU/CSU and SPD, reflects a strategic move to stimulate the economy amid ongoing economic challenges. A compromise was reached to secure support from the Green Party, allocating €100 billion of the fund for climate and economic transformation and broadening security-related exemptions from the debt brake.

While this marks Germany's most significant fiscal shift since reunification, its economic impact will depend on the effectiveness of structural reforms. Pervasive red tape in the public sector, persistent infrastructure deficits, housing sector woes, and US tariffs on European imports overshadow Germany's economic prospects. The incoming government will need to translate this fiscal expansion into sustainable growth to revive Germany's ailing economy. Although the current situation is quite fluid, we anticipate that the German economy will stagnate in Q1 2025. That said, we expect a modest recovery from the second quarter of 2025. Overall, we expect the German economy to post modest growth of 0.2% in 2025, with real GDP picking up to 1.0% in 2026.

The Trump factor: Threats to the automotive industry

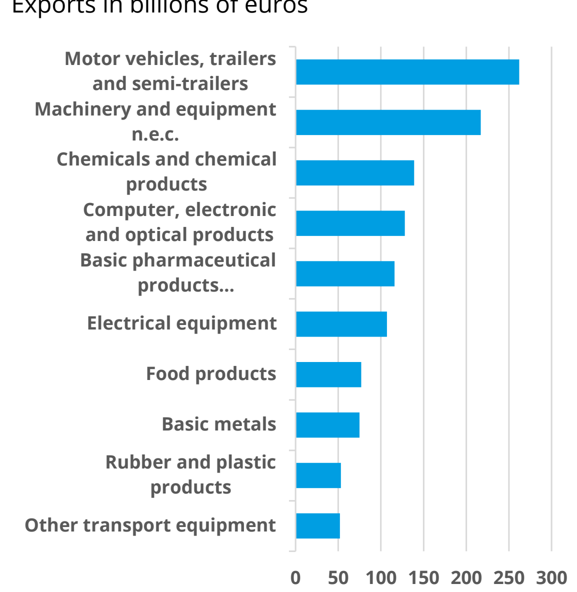
President Trump has proposed a 25% tariff on European car imports, effective 3 April 2025, posing a significant challenge to the German automotive industry. As a key driver of Germany's economy, the sector accounted for 16.9% of total exports in 2024, with the US serving as its largest non-European market. German manufacturers sold 3.1 million vehicles in the US that year, underscoring the deep economic ties between the two nations. The newly imposed Trump tariffs would not only hamper exports but also affect German manufacturers' US-based production, which supports 138,000 American jobs. The German Car Association (VDA) warns that such measures would raise consumer prices, harm both economies, and risk sparking a global trade conflict. For German carmakers, increased costs and supply chain disruptions would ultimately put further strain on an industry already grappling with structural challenges.

Industrial challenges and energy transitions in a changing global economy

Germany stands at a crossroads, facing economic and industrial challenges that threaten its status as Europe's powerhouse. The ongoing trade tensions, ignited by Trump's re-election and his imposition of a 20% tariff on EU exports, announced dramatically on his "Liberation Day", have dealt a fresh blow to Germany's export-driven economy. In 2024, motor vehicles, trailers, and machinery accounted for a significant share of Germany's approximately €500 billion in auto-related exports (Figure 11), underscoring the sector's importance.

Figure 11: Major German exported goods in 2024

Exports in billions of euros



Source: Destatis, Creditreform Rating

However, these new tariffs are expected to make it even more challenging for an already struggling manufacturing base. The signs are stark: factory orders stagnated in February 2025 after plummeting by 5.5% m-o-m in January, driven by falling demand for machinery, electronics, and transport equipment. The broader trend remains flat, with industrial production remaining stagnant over the past three months. Despite

the gloom, there's a glimmer of cautious optimism. The Ifo Business Climate Index rose to 86.7 in March, coming on the back of significantly stronger expectations, underpinned by prospects of increased public spending.

Structural weaknesses in German industry

The challenges confronting Germany's industrial base are deep-rooted, with high energy costs topping the list. Since the 2022 energy crisis, German industrial gas and electricity prices have remained well above the EU average, pushing energy-intensive industries to the brink. This persistent cost burden has fuelled fears of deindustrialisation as manufacturers struggle to remain competitive.

At the same time, demographic shifts linked to Germany's ageing population and declining birth rate exacerbate labour shortages across key sectors, while China's continued rise as a manufacturing superpower threatens German dominance in crucial industries. This is most evident in the automotive sector.

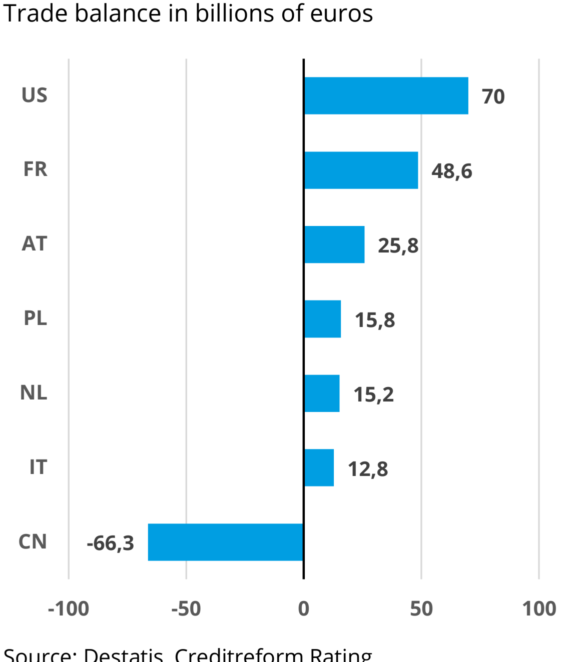
Missed opportunities in global trade

For decades, Germany stood as Europe's industrial powerhouse. Yet, in recent years, this once unquestioned dominance has begun to wane. Rising energy costs, an ageing workforce, and aggressive competition from China have left German industries struggling to maintain their competitive edge (Figure 12). Germany's economic model, built on meticulous engineering and export-led growth, is at a crossroads.

Across the globe, emerging economies are rapidly outpacing Germany in affordability and agility. Protectionist policies and shifting trade patterns have compounded the challenge, leaving Germany increasingly vulnerable. As European economies stagnate, Germany finds itself searching for new avenues of growth.

Figure 12: Germany's most important trade partners in 2024

Trade balance in billions of euros



Source: Destatis, Creditreform Rating

The Energy Price Dilemma

Germany's ambitious energy transition presents a paradox. While the country aims to reduce its reliance on energy imports from 70% to 27% by 2050, this shift introduces significant competitive risks. High electricity prices continue to be a significant obstacle, particularly for energy-intensive sectors such as steel, chemicals, cement, and paper.

Compounding the issue is what economists call the "renewables pull", the structural advantage enjoyed by regions with abundant renewable resources. Countries with more favourable solar and wind conditions can generate electricity far more cheaply, placing German manufacturers at a disadvantage. This raises challenging questions about whether industries should relocate to regions with lower energy costs or accept a greater dependence on imported energy-intensive materials.

The rise of Friedrich Merz has introduced new uncertainties into Germany's climate and energy policies. While he has criticised wind power as "transitional" and opposed the EU's 2035 ban on new combustion engine sales, his party remains committed to Germany's legal pledge of climate neutrality by 2045. This suggests that, despite shifting rhetoric, fundamental policy directions may remain intact. Balancing industrial competitiveness with long-term climate goals will be the incoming government's greatest challenge. Germany's future hinges on whether it can adapt to the new realities.

Germany's housing market outlook

Germany's housing market entered 2025 with renewed investor confidence, marking the beginning of a new cycle following two years of uncertainty. While Q1 activity remains modest, the sector shows resilience amid an election year. The positive momentum from late 2024, when property transactions surged by 12% y-o-y to €36.2 billion, has carried into early 2025, setting the stage for a gradual recovery.

Investor sentiment has improved, driven by stabilised inflation and more favourable interest rates. Major urban centres like Berlin, Munich, and Hamburg continue attracting strong demand, while cities like Leipzig and Nuremberg are emerging as investment hotspots. A growing focus on "manage-to-green" strategies reflects rising interest in energy-efficient properties, alongside continued demand for new developments.

Rental demand remains robust, although growth has moderated compared to the sharp increases seen in 2024. Residential property prices in key cities are expected to rise by 2% in 2025, with rental growth forecasted at 3.6%, the highest rental growth over the next five years, which is approximately 50 basis points higher than the European average rental growth forecast, according to CBRE. However, while construction activity is recovering, labour shortages and rising costs will keep supply constrained. At the same time, rising Bund yields have introduced further challenges, adding pressure to the outlook.

Overall, Germany's economy remains trapped in prolonged stagnation. Structural weaknesses and sluggish demand continue to weigh on recovery efforts, casting doubt over the country's economic resilience. Additionally, the Trump administration's tariffs have tested the region's economic strength, disrupting trade and heightening uncertainty. Yet, hope remains on the horizon as the government unveils a €500 billion infrastructure plan aimed at reigniting growth. While 2025 is expected to be challenging, we anticipate a gradual recovery in 2026, driven by rising investment, stronger exports, and a resurgence in consumer confidence.

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