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Eurozone economy in the line of fire

While great uncertainty persists, it looks certain that the eurozone economy, as a major energy importer, is the most vulnerable to war-induced economic shocks, though we don't see current events derailing the recovery. Slightly lower growth and somewhat higher inflation will likely keep the ECB on hold for now



With inflation risks skewed upward, the ECB is expected to keep interest rates unchanged

War, China and tariffs

The eurozone economy is one of the most vulnerable to the Middle East war among the major economies. Although we anticipate that rising energy prices will be a temporary phenomenon, their negative impact is undeniable. At the same time, it's important to remember that other structural challenges, such as strong competition from China and ongoing US trade tariffs, persist. And while the European Parliament has suspended ratification of the US trade deal following the Supreme Court's move to strike down parts of Trump's tariff package, we see little reason to expect a meaningful easing of tariffs anytime soon.

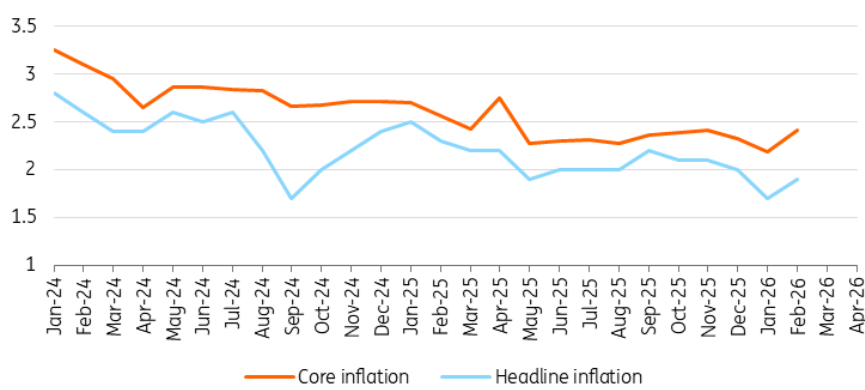
Slowing, but not halting the recovery

For Europe, higher energy prices essentially act as a foreign tax on households and businesses. Thanks to a high savings ratio, European consumers should generally be able to absorb these increased costs. However, the risk remains that diminished confidence could prompt

households to save even more, rather than less.

The manufacturing sector faces renewed difficulties, having already endured higher energy costs compared to the US and China. Despite these challenges, manufacturing entered the year with some momentum, supported by relatively low inventory levels. Additionally, Germany's fiscal stimulus is expected to gradually bolster the economy. As a result, we believe the current crisis will temporarily slow the recovery but not halt it altogether. We are forecasting weaker growth in the first half of the year, followed by a rebound in the second half, culminating in 1.1% GDP growth for 2026, after 1.5% in 2025.

Disinflation seems to be coming to an end



Source: LSEG Datastream

Higher inflation

Of course, elevated energy prices will also push headline inflation higher. Moreover, February's HICP reading was somewhat disappointing: headline inflation rose to 1.9%, still below the 2% target, but core inflation increased to 2.4%. With energy and food prices likely to add further upward pressure in the coming months, we expect second-quarter inflation to average 2.5%, raising our annual inflation forecast to 2.1%. This is still relatively low, but it is based on the assumption that there will be only a temporary surge in energy prices. Needless to say, the risk is skewed to the upside.

ECB still on hold

Since the high inflation episode in 2022, the ECB has exercised caution in labelling inflation increases as temporary. At this point, however, we do not believe a short-lived spike in energy prices will trigger significant second-round effects. Meanwhile, calls for further rate cuts, which were widespread during the dollar's weakening earlier this year, have likely been muted by recent events. In our view, the ECB will conclude that maintaining stable interest rates is the prudent course for the foreseeable future.

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