Geopolitics take centre stage for the eurozone

Geopolitics have shifted into the spotlight, with European politicians struggling to get involved in a Ukraine peace deal while at the same time trying to prevent higher US import tariffs on European goods. Calls for higher defence spending are gaining traction. With the economy bottoming out, the ECB thinks the trough in interest rates is approaching

US President Donald Trump meets with French President Emmanuel Macron in Washington DC

Europe less than prepared for geopolitical shifts

The early weeks of US President Donald Trump's second term in office have already caused significant upheaval in the European Union. It now appears likely that, starting from the second quarter, the US will use reciprocity as a justification to increase import tariffs on European goods in sectors where European tariffs are higher than those in the US. The Trump administration also views VAT as an additional import tariff in Europe, which could increase the scope for US tariff increases.

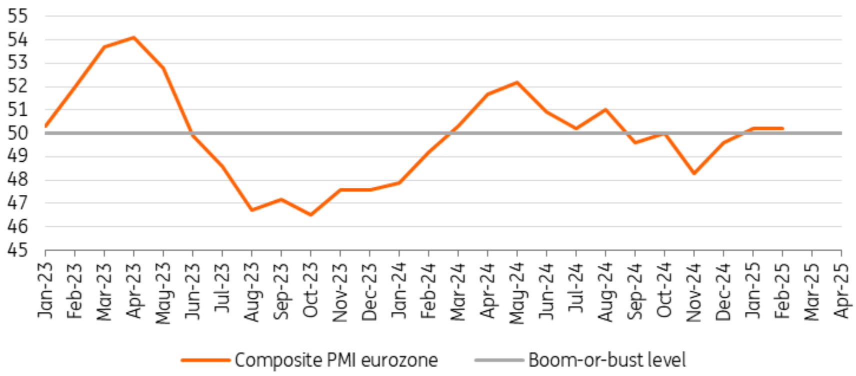
Simultaneously, Trump has been advocating for a ceasefire in Ukraine, largely sidelining Europe and Ukraine as potential partners in the negotiations. While peace in Ukraine would be beneficial for business and consumer sentiment and could potentially lower energy prices, a deal is not yet guaranteed – especially if Russia is treated too favourably. Meanwhile, the US has made it clear that Europe must enhance its own defence efforts, as the US is less willing to continue guaranteeing Europe's security. This has led to confusion and indignation in European capitals, but no clear common response has emerged so far.

More defence spending

On a positive note, the German elections have resulted in only one viable coalition: a "grand coalition" between the CDU/CSU and the SPD. Unfortunately, scrambling together the two-thirds majority needed to amend the debt brake seems challenging. However, we remain confident that the new chancellor, Friedrich Merz, will find a way – such as declaring a state of fiscal emergency – to increase government spending, particularly for defence. Germany still has some budgetary room for fiscal expansion.

Other countries that also need to increase defence spending (Europe should probably move from about 2% to 3.5% of GDP over the next five years), but have less fiscal space, will need to find savings elsewhere. On top of that, when taking the long lags and high import content of military spending into consideration, GDP stimulus for this year and next year seems limited. Nonetheless, we have already added 0.1 percentage points to our 2026 growth forecast, and the boost for 2027 could be slightly higher. The likelihood of the extra military spending being financed by a European defence fund with borrowing capacity remains small for now.

Eurozone economy bottoming out, but growth outlook remains subdued



Source: LSEG Datastream

Economic situation not as bad as markets feared

Since December, European economic indicators have surprised positively, mainly because they weren't quite as bad as the market expected. The best description for the state of the eurozone economy seems to be "bottoming out." The composite PMI stabilised at 50.2 in February, just above the boom-or-bust level. However, the new orders component remained weak and employment fell, especially in manufacturing. Consumption has been disappointing due to a less positive assessment of the labour market, leading to a higher savings rate. While there is potential for stronger consumption growth, geopolitical uncertainty is not helping boost consumer confidence. We've therefore maintained our growth forecast of 0.7% for this year, while raising it to 1.3% for 2026, driven by additional military spending.

The ECB is approaching the neutral rate

Inflation is likely to remain above the European Central Bank's projections in the first quarter, and higher input prices in both manufacturing and services have increased selling price expectations. At the same time, the ECB's wage tracker continues to indicate a deceleration in wage growth in the second half. In February, the ECB published estimates of the neutral interest rate, which ranges between 1.75% and 2.25% based on recent model updates, and between 1.75% and 3.0% based on all available models.

It's therefore no surprise that ECB director Isabel Schnabel stated that the central bank is approaching the point where it might need to pause or halt rate cuts. We still believe that 2% will be reached by the summer, and 1.75% is feasible if the upturn remains very subdued. However, the consensus within the central bank seems to be that any recovery might quickly encounter supply constraints, making it risky to adopt an overly expansionary monetary policy.

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