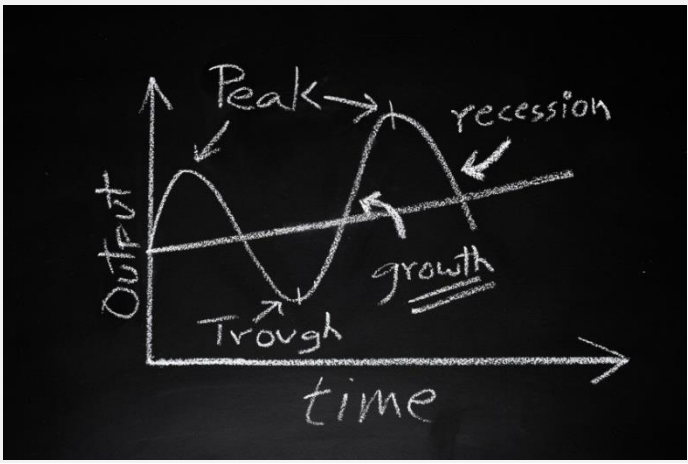
Creditreform Rating

Recovery on Fragile Ground – Trade Frictions and Fiscal Recalibration



Creditreform Economic Briefs

23 July 2025

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Key Take-Aways

1.

We have revised our forecast for euro area real GDP growth in 2025 to 1.0%, indicating a moderate and fragile recovery. While geopolitical instability, trade disruptions, and subdued global demand continue to weigh on sentiment, household spending remains a bright spot, supported by firm wage growth and labour market resilience. That said, Germany's ongoing weakness remains a key constraint on the region's overall performance. For 2026, we expect growth to accelerate to 1.2% as investment conditions improve and external demand gradually strengthens.

2.

Inflation in the euro area has continued to decline, with headline inflation reaching 2.0% by mid-2025—aligned with the European Central Bank's (ECB) target. Nonetheless, underlying inflationary pressures remain firm, reflecting ongoing wage increases and sticky services prices. Against this backdrop, the ECB lowered its deposit rate to 2.0% in June, and we expect a further reduction to 1.75% by the end of this year. The ECB remains cautious, seeking to strike a balance between supporting the recovery and maintaining a clear focus on containing persistent core inflation.

3.

The fiscal landscape in the European Union remains complex under the updated 2025 governance framework, which seeks to strike a balance between fiscal discipline and necessary flexibility. However, efforts towards fiscal consolidation are being challenged by rising borrowing costs, increased defence spending, and ongoing geopolitical tensions. While public investment holds promise for supporting growth, the outlook is clouded by uncertainties relating to global trade disputes and changes in monetary policy. Additionally, the economic impact of increased defence expenditure is expected to unfold gradually, with the effects on growth likely to be delayed.

4.

Following a prolonged period of stagnation, Germany's economy has shown marginal signs of recovery. As an export-oriented nation, however, it continues to face headwinds from declining exports, subdued domestic demand, and a contracting manufacturing sector. We currently project anaemic real GDP growth of 0.1% for 2025, with a gradual recovery driven largely by domestic demand expected in 2026 (1.2%). That said, the outlook is clouded by considerable uncertainty. Germany has implemented a substantial fiscal package, featuring strategic investments in defence and infrastructure. Alongside structural reforms, these measures should prove pivotal in reigniting economic momentum, potentially prompting an upward revision of our forecast, as more details become available. Meanwhile, the housing market is showing signs of resilience, with growing investor confidence and a recent increase in property transactions.

5.

We now forecast that the UK's real GDP will grow by 1.0% in 2025. While the UK economy performed strongly in Q1 compared to other G7 peers, recent monthly data signals growing volatility and a softening outlook. The Bank of England (BoE) is cautiously cutting rates amid persistent core inflation and robust

wage growth. Following a 25-bp cut in May, rates are expected to fall to 3.75% by year-end, in an attempt to support stability despite trade and fiscal uncertainties.

6.

The US economy is expected to experience a slowdown to 1.8% in 2025. Inflation is expected to remain above the Federal Reserve's target, with headline personal consumption expenditure (PCE) forecast to rise by 3%, partly due to higher import prices. Consequently, the Fed has maintained rates at 4.25%–4.50% but should cut them by 50 basis points by the end of 2025. Ongoing trade disputes and fiscal challenges continue to complicate the policy backdrop, requiring a delicate balancing act between growth and price stability.

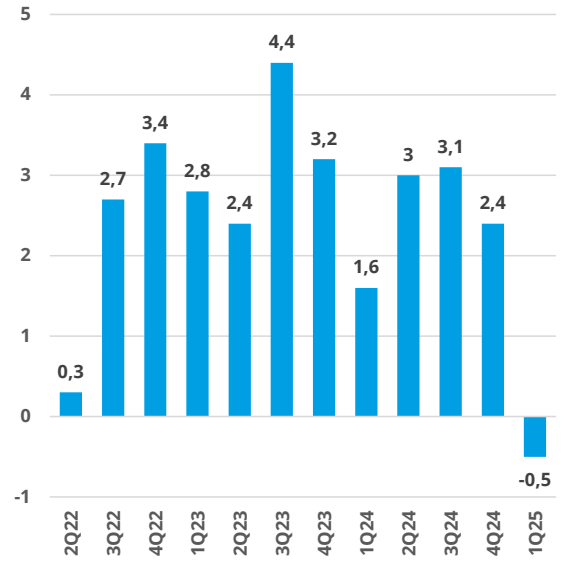
1. World

US economy contraction amid rising headwinds

The US economy contracted by 0.5% q-o-q in 1Q25 (Figure 1), marking its first decline in three years. This was due to a combination of domestic caution and global trade disruptions. A sharp 7.8% increase in fixed investment suggested firms were front-loading capital expenditures to mitigate expected cost pressures and supply chain risks following the Trump administration's tariff announcements. However, this investment momentum was outweighed by a staggering 37.9% surge in imports, as businesses and households rushed to stockpile goods ahead of the tariff rollout. The resulting trade imbalance had a significant negative impact on GDP, with exports rising by only 2.4%.

Figure 1: US GDP growth falling amid trade uncertainty

Real GDP, seasonally adjusted at annual rates in %



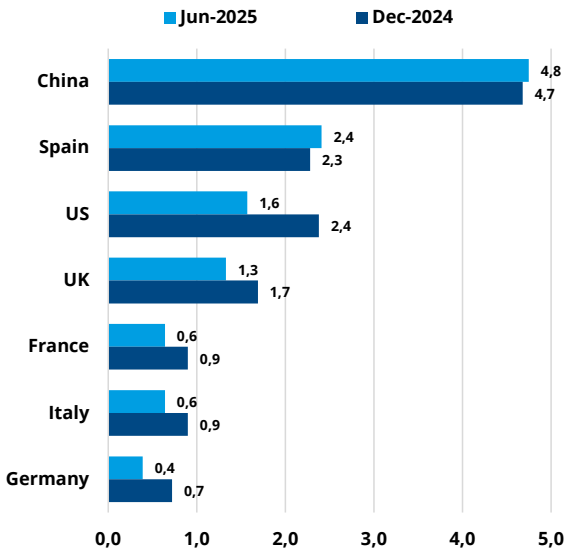
Sources: US Bureau of Economic Analysis, Creditreform Rating

Trade frictions, inflation, and weak consumer sentiment present near-term headwinds, with policy direction on tariffs and rates likely to shape the economic path ahead. Consumer spending – typically the key driver of US growth – slowed to 1.2% on a m-o-m basis in May, its weakest pace since mid-2023, as inflation and uncertainty over future prices prompted more cautious household behaviour. Additionally, retail sales have declined, and although consumer sentiment improved in June, it remains below historical norms. Moreover, manufacturing is now contracting, with the June Purchasing Managers Index (PMI) for manufacturing at 49. Meanwhile, the services PMI rose slightly above 50 to 50.8 from 49.9 in May.

Furthermore, PCE inflation remains stubbornly high and significantly above the Fed's target of 2.0%. Annual rates are projected to be 3.0% for 2025, as tariff-driven pressures are likely to push prices higher still by year-end, according to the latest FOMC projections from June. Unemployment remains steady at 4.1% in June, but job creation has slowed, and labour force participation is slipping.

Figure 2: OECD outlook for US growth has deteriorated significantly

OECD forecast for annual real GDP growth in selected economies in %



Sources: OECD, Creditreform Rating

Against this backdrop, the growth outlook for 2025 appears bleak, as the OECD revised its GDP growth estimates in its June 2025 Economic Outlook (Figure 2) to 1.6% from 2.4% earlier. In the same vein, the International Monetary Fund (IMF) projects US GDP growth of 1.8% in its April World Economic Outlook, representing a significant downward revision from the previous estimate of 2.7%.

Growing unease from Trump tariffs and rising fiscal pressures

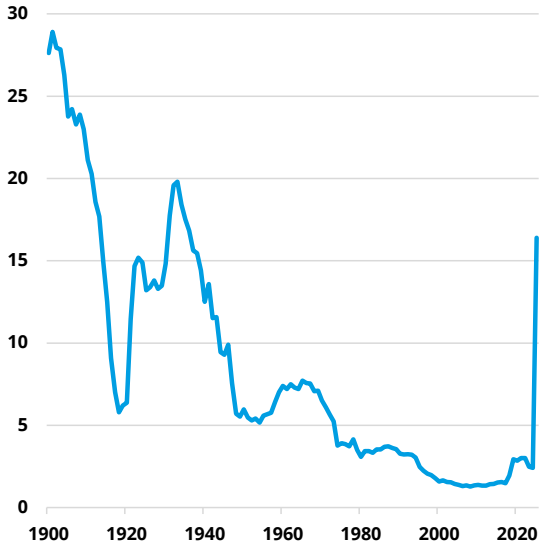
Since early 2025, the US has initiated a sweeping and aggressive tariff campaign under President Trump, significantly reshaping global trade dynamics and raising concerns over domestic inflation and geopolitical tensions. By late spring, the administration unveiled a "reciprocal tariff" framework, targeting over 180 countries. Initially scheduled to take effect on 9 July, the tariff rollout was postponed to 1 August for 21 countries, providing a brief window for negotiation.

In July, the first wave of formal tariff letters was dispatched to nations including South Korea and Japan. A second round followed shortly after, targeting Brazil with a 50% tariff, alongside the Philippines (20%), Moldova (25%), and several others. The UK and India have since secured limited agreements. The UK secured reduced tariffs (see below), and India agreed to a deal with an average tariff of 10%. However, further details remain to be awaited as negotiations continue.

Meanwhile, talks with the EU continue amid high stakes. The US plans to impose a 30% tariff on all EU imports starting 1 August, prompting Brussels to delay its own retaliatory tariffs on American wine, cheese, dairy, and pharmaceuticals until the deadline. However, EU officials have warned of swift countermeasures should no resolution be reached. China, for its part, has agreed to a trade truce until 12 August and a deal on the export of rare earth materials. Consequently, the average effective tariff rate on imports to the US has thus risen to its highest level since World War II (Figure 3).

Figure 3: Average effective tariff rate on US imports skyrocketing

Average import tariff rate in %, as of 12 May 2025



Sources: Yale Budget Lab, Creditreform Rating

Evidence of trade-driven price pressures began to appear in May's statistics. The Core PCE inflation rose by an 2.7% y-o-y in May, partly due to higher import costs for household appliances and electronics. This signalled that higher tariffs were starting to feed into broader price dynamics and complicating the Federal Reserve's outlook on interest rate policy.

Furthermore, budget volatility in the US has become increasingly evident. In May 2025, the deficit surged to $316 billion, the highest monthly shortfall of the year, only to swing to a $27 billion surplus in June, largely due to record customs duty revenues of $27.2 billion. This fiscal unpredictability reflects broader economic uncertainty. While higher tariffs are intended to shield strategic industries and reduce trade imbalances, they also risk stoking inflation and damp-

ening investment. For households and businesses, this creates a challenging environment of shifting costs and policy signals. Small firms, in particular, reported diminished confidence, with uncertainty over future duties causing them to defer investment and hiring plans. Meanwhile, fluctuating deficits and limited fiscal space raise concerns about the long-term viability of current pro-growth strategies, underscoring the need for a more stable and responsive fiscal framework.

OBBBA: A bold fiscal gamble?!

In a rapidly evolving economic landscape, the 2025 "One Big Beautiful Bill Act" (OBBBA) stands as President Trump's flagship fiscal intervention, signed into law on 4 July, to stimulate middle-class demand, domestic manufacturing, and family support structures. With over $2.4 trillion in tax cuts and subsidies, the bill features a 15% income tax cut for earners between $30K and $80K, full expensing of capital investments, and a generous expansion of child tax credits. New deductions for tipped and overtime workers, seniors, and loan interest on US-built vehicles, set to expire in 2028, further sweeten the bill for households. OBBBA also lifts the cap on state and local tax deductions until 2029, while making permanent many provisions of the 2017 Tax Cuts and Jobs Act (TCJA) that were set to expire.

However, these permanent extensions significantly inflate the bill's cost. The Congressional Budget Office now estimates a $3.4 trillion increase in deficits over the next decade, while the Committee for a Responsible Federal Budget warns this figure could rise to $5 trillion if temporary measures are extended. Offsetting these tax breaks are cuts to healthcare and nutrition assistance programs, as well as increased spending on defence and border security.

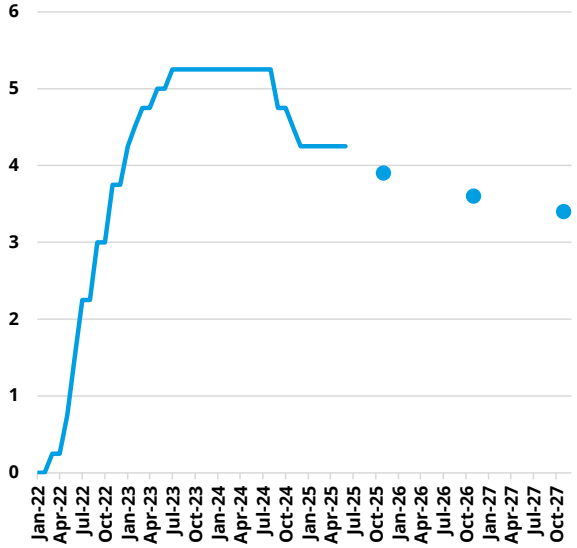
Concurrently, the OBBBA's demand-side thrust risks stoking inflationary pressures, which could prompt the Fed to adopt a more hawkish stance, thereby tightening financial conditions just as households and businesses begin to benefit. OBBBA may provide a growth jolt, but its durability ultimately rests on restoring fiscal credibility and addressing concerns about debt.

Fed holds rates, warns of tariff-led inflation as outlook darkens

The Fed maintained interest rates unchanged at its June policy meeting, maintaining its benchmark rate at 4.25%-4.5% while pencilling in two more cuts by the end of 2025 (Figure 4). That said, Fed Chair Jerome Powell urged caution amid heightened economic uncertainty and the looming inflationary shock from proposed Trump-era tariffs.

Figure 4: US policy rates have been on hold since December 2024

Federal funds rate (lower bound) in %, FOMC median projections for 2025-27 (as of 18-Jun-25)



Sources: Federal Reserve, Creditreform Rating

According to the latest FOMC forecast, the outlook has become more challenging, with officials revising growth forecasts downwards and unemployment forecasts upwards. Although the committee remains divided on the inflation outlook, some members have signalled support for

cutting rates, provided that inflation and labour market conditions continue to improve. Nonetheless, Powell stated that tariffs are at the heart of the Fed's caution. He noted that, without them, rate cuts might have come sooner, given the recent softening of inflation till April. However, with new duties pushing up import prices in May, leaving producers and retailers locked in a battle over who will bear the cost, some of the burden will likely be passed on to consumers.

China's stimulus-fuelled growth amidst global trade headwinds

China's economy maintained solid momentum in 2025, with real GDP expanding by 5.2% y-o-y in 2Q25, slightly down from the previous quarter's growth of 5.4%. Fiscal subsidies, a modest recovery in urban housing, and positive net exports supported growth. However, persistent pressures in the real estate sector and labour market continued to weigh on the outlook. After averaging 5.0% in 2024, GDP growth is projected to moderate to 4.5% in 2025 and 4.0% in 2026, according to the IMF. The slowdown reflects soft domestic demand, weaker export momentum amid trade frictions, and rising debt burdens.

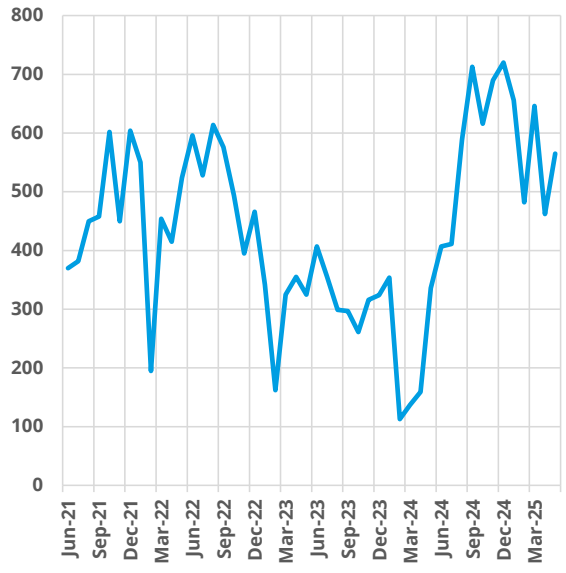
The manufacturing PMI fell to a 16-month low of 49.0 in April amid tariff escalations, before recovering slightly to 50.4 in June, as output rebounded, but purchasing activity remained subdued. Consumer sentiment stayed fragile despite a boost in January from an expansion in the consumer goods trade-in program. Headline inflation rose by 0.1% y-o-y in June, following an average annual inflation of 0.2% in 2024. Core inflation remained subdued at 0.4% y-o-y for the same period, slightly below the 2024 average of 0.5%, reflecting weak underlying demand.

Fiscal policy has thus become more expansionary, with a positive fiscal impulse of 1.6% of GDP in 2025, focusing on public investment, particularly in social protection, although direct household support remains limited. Elevated borrowing by local governments and public entities poses risks to fiscal sustainability. Meanwhile, monetary policy eased further in May, with a 10bp cut in benchmark rates to record lows. Reduced interest rates, combined with weak credit demand and high precautionary savings, are likely to result in lower net interest margins for banks.

Tensions between the US and China over trade intensified in April and May 2025. The US imposed protectionist tariffs of up to 145%, prompting China to retaliate with duties reaching 125% and restrictions on rare earth exports. The dispute eased on 10 June, with tariffs settling at 55% by the US and 10% by China. Nevertheless, Chinese exports rose by 6% y-o-y in the first five months of 2025, supported by early-year frontloading and strong demand for semiconductors and electronics. Gains in emerging markets and East Asia offset weaker shipments to the US (Figure 5).

Figure 5: Despite trade tensions, Chinese trade has remained broadly resilient so far

Balance of trade in $100mn



Sources: China State Administration of Foreign Exchange (SAFE), Creditreform Rating

Notably, the US and China finalised the London Trade Framework on 27 June 2025. China agreed to relax rare earth export controls, while the US committed to recalibrating technology restrictions, prospectively reducing supply chain risks for critical industries. A key implementation deadline is set for 12 August, by which both sides are expected to finalise enforcement protocols and compliance mechanisms. However, trade uncertainty and global headwinds continue to weigh on China's export prospects.

UK: Fragile recovery faces policy crossroads amid tariff uncertainty

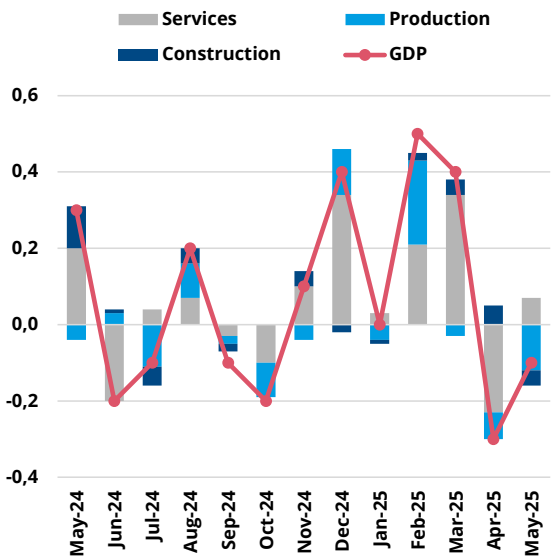
The UK economy expanded by a rather surprising 0.7% q-o-q in 1Q25, outperforming other major economies. This followed modest growth of 0.1% q-o-q in 4Q24 and an overall real GDP increase of 1.1% for 2024. Growth was driven by a strong performance in public services and retail, aided by an unseasonably warm weather in March, as well as resilient exports and a rebound in private borrowing following the Bank of England's (BoE) interest rate cuts.

However, on a monthly basis, UK GDP remained notably volatile throughout 2025. After rising by 0.5% month-on-month in February, it declined to -0.3% in April and -0.1% in May (Figure 6). This pattern of contraction raised concerns about a potential overall economic downturn in the second quarter. Meanwhile, inflation in June came in at 3.6% y-o-y (May: 3.4%), while core inflation unexpectedly accelerated to 3.7% from 3.5%. Forward-looking indicators suggest a softening outlook, as business activity appears to slow, and consumer confidence is weakening.

We thus continue to expect real GDP growth of 1.0% in 2025, while revising our 2026 forecast to 1.2%. Higher growth should come on the back of easing trade tensions and a rise in private sector activity.

Figure 6: UK GDP growth prospects appear to have moderated

Monthly real GDP growth y-o-y change in %



Sources: Office for National Statistics, Creditreform Rating

On April 2, 2025, the US imposed a 10% blanket tariff on UK goods, with higher rates of 25% on steel, aluminium, and automotive products. A trade deal on May 8 removed tariffs on steel and aluminium and lowered rates on auto exports, while retaining a 10% tariff on other goods. Accordingly, UK trade activity showed tentative signs of stabilisation in May after a sharp downturn in April. Goods exports grew by 2.5% m-o-m, partially recovering from the steep 8.8% fall the previous month, which had been driven by a £2.0 billion drop in exports to the US. Encouragingly, shipments to the US rebounded by £1.2 billion in May. Overall, the data indicate a modest recovery in trade flows, supported by improved supply chain conditions and recent progress in international relations, particularly with the US.

The fiscal deficit widened to £151.9 billion in FY25, up from £131.2 billion in FY24. The June 2025 Spending Review allocated £120 billion in funding through FY30, with a focus on infrastructure and energy. Fiscal consolidation encompasses cuts to overseas aid and adjustments to

tax rates. Public debt remains high, at 95.8% of GDP at the end of FY25, and is projected to reach 96.1% by the end of FY30. Hence, long-term sustainability will require difficult policy choices to rebuild fiscal buffers.

The BoE has eased monetary policy and reduced rates by 25 basis points in February and May 2025, respectively, with two more cuts expected this year amid slowing activity and a softening labour market. Inflation is likely to peak in 3Q25 at 3.5% and then trend downwards, gradually approaching the 2% target going forward, aided by easing wage growth and energy prices. We expect the BoE to proceed cautiously, striking a balance between mitigating inflation risks and stimulating growth.

2. Euro area

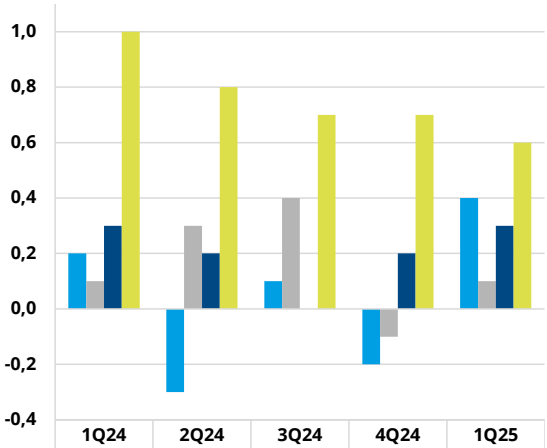
Modest euro area economic recovery amid divergence

The euro area economy began 2025 on a firmer footing, growing by 0.6% q-o-q in 1Q25, up from 0.3% in the final quarter of 2024. Whilst this acceleration suggests a tentative recovery, economic activity remains strikingly uneven across member states, due to persistent structural differences (Figure 7).

France posted a marginal 0.1% growth, narrowly escaping a second consecutive contraction. A recovery in consumer spending and inventory restocking largely drove the modest growth. Nevertheless, industrial output remains constrained by lingering supply chain disruptions, highlighting sectoral fragilities. Spain, in contrast, maintained its momentum with a 0.6% expansion. This was underpinned by resilient domestic demand and buoyant services exports, further strengthening its position as one of the bloc's strongest performers. Italy also displayed positive real GDP growth (0.3%), with gains in construction and agriculture being offset by ongoing weakness in manufacturing, reflecting broader industrial headwinds. Surprisingly, Germany grew by 0.4%, recovering from a contraction in 4Q24. However, its export-reliant model remains vulnerable to external shocks (see below).

Figure 7: Positive growth among major European economies in Q1

Real GDP q-o-q growth in %



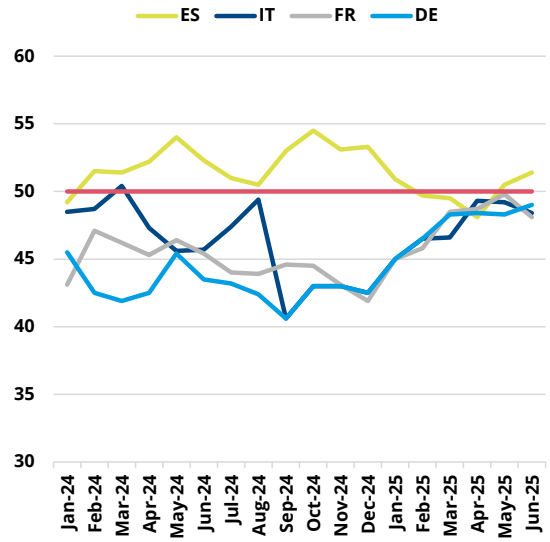
	1Q24	2Q24	3Q24	4Q24	1Q25
DE	0,2	-0,3	0,1	-0,2	0,4
FR	0,1	0,3	0,4	-0,1	0,1
IT	0,3	0,2	0	0,2	0,3
ES	1	0,8	0,7	0,7	0,6

Sources: Eurostat, Creditreform Rating

The euro area's composite PMI rose to 50.6 in June from 50.2 in May, indicating only modest overall growth. Notably, the services PMI rose to 50.5 from a previously recorded 49.7, while the manufacturing PMI improved from 49.4 in May to 49.5, signalling the 35th consecutive month of contraction (Figure 8). Meanwhile, consumer confidence remained subdued, reflecting ongoing concerns about job security and slow income growth. Overall, these indicators highlight a fragile euro area recovery with persistent headwinds across key sectors.

Figure 8: European manufacturing recovering, but remains in contraction

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



Sources: S&P Global, Creditreform Rating

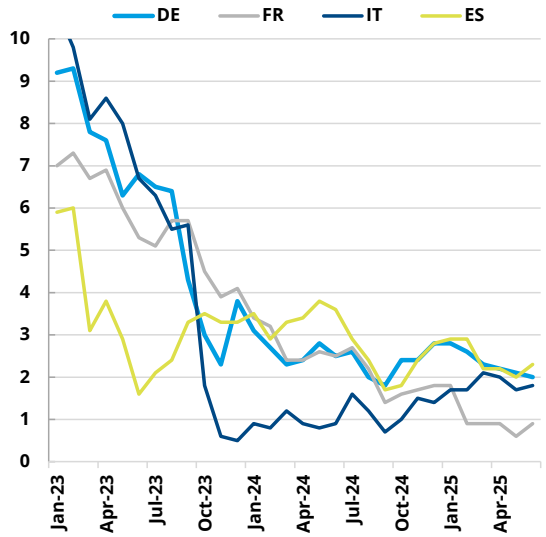
Inflation back to target, but risks linger

Headline inflation in the euro area fell to 2.0% in June 2025, slightly up from May's eight-month low of 1.9%, matching the ECB's 2% target. This indicates a significant easing of price pressures, driven by stabilising energy costs. Core inflation, which strips out volatile energy and food costs, declined to 2.3% in June from 2.7% in April, indicating a broader deceleration in underlying price pressures. However, inflation patterns vary significantly across the eurozone. France posted an exceptionally low 0.9% inflation rate, while Germany saw inflation moderate to 2.0%, the softest pace in eight months (Figure 9).

Despite these improvements, euro area services inflation, though down to 3.3% y-o-y in June from 4% in April, remains relatively sticky. This persistence is largely due to sustained labour cost pressures, which continue to drive up prices in the services sector. Consequently, while headline inflation is approaching the ECB's target, underlying inflationary forces have yet to dissipate fully.

Figure 9: Inflation rates falling in major economies

Monthly HICP Inflation, annual rate of change in %



Sources: Eurostat, Creditreform Rating

Looking ahead, we project inflation to average 2.1% in 2025 and to moderate further to 1.7% in 2026. Nonetheless, risks remain tilted to the upside, particularly from potential energy price shocks and ongoing international trade pressures. Therefore, policymakers are expected to remain vigilant, striking a balance between supporting growth and keeping inflation expectations anchored firmly around the target.

ECB's monetary policy pivots from easing to equilibrium

The ECB's two quarter-point rate cuts in April and June, which brought the policy rate (Deposit facility) to 2%, marked a turning point in its year-long easing cycle. After eight consecutive reductions since last summer, President Lagarde's assertion that rates are now in a "good position" signals a deliberate pause, rather than a rush to further accommodation.

At the heart of the ECB's current stance lies the debate over the neutral interest rate (r*), the level at which monetary policy is neither expansionary nor contractionary. Lagarde's comments imply that rates are now close to this elusive equilibrium. While the ECB is likely to keep policy rates unchanged in July, we expect a further quarter-point rate cut later this year. Growth remains modest, although increased government spending on defence and infrastructure offers some support. As monetary policy takes time to work its way through the economy, the ECB appears content to allow the previous stimulus to take effect while monitoring evolving global trade dynamics.

Labour market stability amid weakening consumer confidence

Unemployment in the euro area increased slightly to 6.3% in May, from a record low of 6.2% in April, matching the recorded figure over the previous three months. Notably, Spain and France experienced increases to 11.4% and 7.4%, respectively, in the first quarter of 2025, up from 10.6% and 7.3%, in 4Q24. These developments reflect ongoing structural challenges in certain member states, despite the broader resilience in the euro area labour market as a whole.

Moreover, wage growth in the euro area moderated to 3.4% y-o-y in 1Q25, down from 4.1% in 4Q24, representing the slowest annual increase since 3Q22. Among the bloc's major economies, Germany recorded a significant slowdown, with wages rising just 2.8% compared to 4.4% previously. Similar trends were observed in Italy (3.9% vs. 4.4%) and the Netherlands (5.6% vs. 6.2%). However, wage growth edged slightly higher in Spain, reaching 3.7% from 3.4%, and in France, where it ticked up to 1.9% from 1.8%.

Continued gains in wages, alongside easing inflation and a modest reduction in net interest payments, have contributed to a further increase in household gross disposable income. However, consumer confidence weakened in March and even more sharply in April and May. This decline suggests that households remain cautious, favouring precautionary savings over increased consumption. Additionally, efforts to rebuild wealth buffers, which were eroded by past inflation and falling real estate values, are likely to weigh on spending. Consequently, we expect the household saving rate to decline more gradually, reflecting the lingering caution among consumers despite improving economic fundamentals.

Risks mount as the US-EU trade tensions escalate

Throughout 2025, the trade relationship between the United States and the European Union, the world's largest trading partners, has reached a critical juncture. President Trump announced a 50% tariff on all EU goods, which was initially due to take effect on 1 June but was later delayed until 1 August following negotiations with the European Commission.

While the US government claims that these tariffs are necessary in order to protect US industries and address trade imbalances, the EU has refused to back down, insisting that any deal must be based on mutual respect, not threats. The EU has already prepared countermeasures targeting politically sensitive US exports, including soybeans, bourbon, and aircraft, and is ready to escalate the situation if necessary. These tensions arise at a time of already high global economic uncertainty and economic fragmentation.

The effects were immediate and widespread. Companies rushed to export and import goods before the tariffs took effect, causing EU exports to the US to jump by 8.6% q-o-q and imports by 4.1% q-o-q in 1Q25, and pushing the EU's trade surplus up by €30 billion in just one quarter. That

said, this was only a short-term boost, as the threat of higher tariffs and ongoing uncertainty made businesses anxious and slowed down investment decisions.

The impact was particularly acute for the euro area's major economies, which are deeply intertwined with US trade, particularly in sectors such as pharmaceuticals, machinery, agriculture, and the automotive industry. German carmakers face severe production cuts and layoffs, and the integrated European supply chain is expected to quickly spread the aftereffects to France, Spain, and Italy, affecting component suppliers and related industries. The EU's retaliatory tariffs on US agricultural goods pose risks for French wine and cheese, Spanish olives and olive oil, as well as Italy's renowned food and machinery exports.

Despite the heated rhetoric between the EU and the US, negotiators from both sides continue to engage in talks, trying to find common ground before the renewed 1 August deadline. The stakes are high: if no deal is reached and tariffs are imposed, there is a heightened probability of a euro area recession.

As of now, we forecast euro area real GDP growth of 1.0% GDP growth for 2025, only slightly above the growth rate of 2024, reflecting a cautious stance amid global uncertainties. Moreover, we project an acceleration to 1.2% in 2026, which hinges on a gradual improvement in trade and investment. Investor confidence has dropped, and there is a real risk that these trade tensions could tip the euro area into recession if they persist.

Impact of the Ukraine conflict and rising EU defence spending

As we move through the second quarter of 2025, the euro area economy remains heavily affected by the ongoing conflict between Russia and Ukraine. The EU's latest sanctions package, the 17th since the start of the conflict, is its most ambitious yet, targeting 342 vessels in Russia's shadow fleet and tightening restrictions on military technology. As a result of EU sanctions, Russian oil revenues have declined by €38 billion since these were imposed, and in March 2025, revenues dropped by 13.7% compared to the previous year.

Policymakers now face a delicate balancing act. Although defence spending is increasing, with the European Commission's €650 billion plan aimed at enhancing security, any economic improvements will be gradual rather than immediate. Meanwhile, the reconstruction of Ukraine remains a critical challenge. Damage to infrastructure totals an estimated $170 billion, and the country's GDP has fallen by 29% since 2022. The €9.3 billion EU reconstruction programme, combined with an annual €300 million from interest on frozen Russian assets, provides meaningful, though likely insufficient, resources relative to the need. Looking ahead, the euro area's resilience will be put to the test. However, the overall economic outlook will probably depend on whether ceasefire negotiations take place, which could boost investor and consumer confidence.

Navigating defence spending and debt challenges

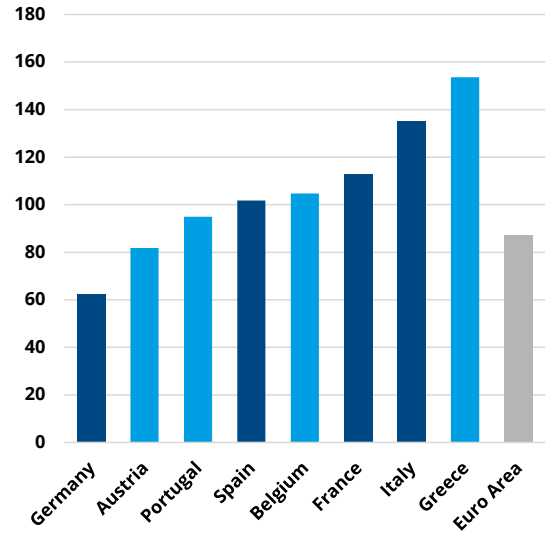
As a corollary, the euro area's fiscal landscape involves strategic rebalancing as policymakers navigate between security requirements and concerns about debt sustainability. The region has transitioned towards a broadly neutral position, marking a significant shift in European economic governance. The Russian invasion of Ukraine will likely continue to fundamentally transform Europe's spending priorities, with defence expenditure emerging as the dominant fiscal consideration. The European Commission's activation of the National Escape Clause under the Stability and Growth Pact in April 2025 pro-

vides member states with unprecedented flexibility to increase defence spending by up to 1.5% of GDP over the 2025-2028 period.

While this reflects a decisive shift in policy priorities, it also puts mounting pressure on public finances. Despite a slight improvement in the euro area's debt-to-GDP ratio, falling from 88.1% in Q3 to 87.4% in 4Q24, public debt in the euro area is likely to increase going forward, and debt servicing is becoming more challenging as interest-growth differentials have become less favourable.

Figure 10: Limited fiscal room for manoeuvre for Italy and France?

Debt-to-GDP for 4Q24, in %



Sources: Eurostat, Creditreform Rating

France and Italy, two of the euro area's largest spenders after Greece, face particularly acute challenges (Figure 10). While temporary exemptions for defence spending provide short-term relief, they mask deeper fiscal vulnerabilities. As the four-year flexibility period draws to a close, major euro area economies will need to undertake substantial fiscal consolidation to ensure long-term sustainability. The coming years will test the EU's ability to strike a balance between strategic investment and sustainable public finances.

3. Germany

Germany grappling with meagre growth and structural shifts

Germany's economy continues to face significant headwinds. Official data confirmed a 0.2% q-o-q contraction in 4Q24, followed by more vivid growth in 1Q25. Thus, Germany's economy surprisingly expanded by 0.4% in the first quarter, mainly due to export frontloading in the pharmaceutical and automotive sectors. In particular, German automakers have responded by "stockpiling exports" to the US ahead of tariff implementation.

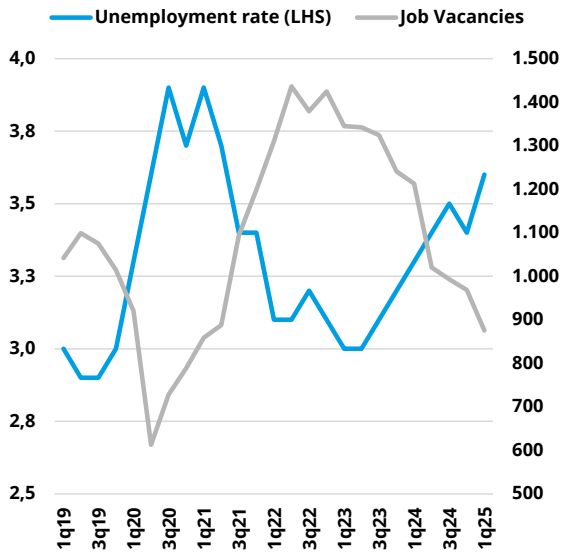
We believe, however, that this surge in exports represents a temporary phenomenon rather than a sustainable growth trend. We project anaemic economic growth of 0.1% in 2025 due to export weakness and investment stagnation, before recovering to 1.2% in 2026. This performance remains notably weaker than that of Germany's European counterparts, with the euro area as a whole having already grown by 5.8% over the past five years, compared to Germany's modest 0.3%.

Despite these economic challenges, unemployment has only increased moderately, standing at 3.7% in May 2025 for the second consecutive month. Meanwhile, reported vacancies have been falling, suggesting a cooling labour market (Figure 11). At the same time, headline inflation has moderated from 2.3% in February to 2% in June 2025. We anticipate that the HICP inflation rate will decrease to an annual average of 2.2% in 2025, before dropping to 1.5% in 2026, primarily due to lower energy prices. Core inflation is expected to remain more persistent at 2.6% in

2025, reflecting ongoing price pressures in the services sector, before easing to 1.9% in 2026.

Figure 11: German labour market conditions are softening

Unemployment rate in % (LFS-adjusted), job vacancies in thousands



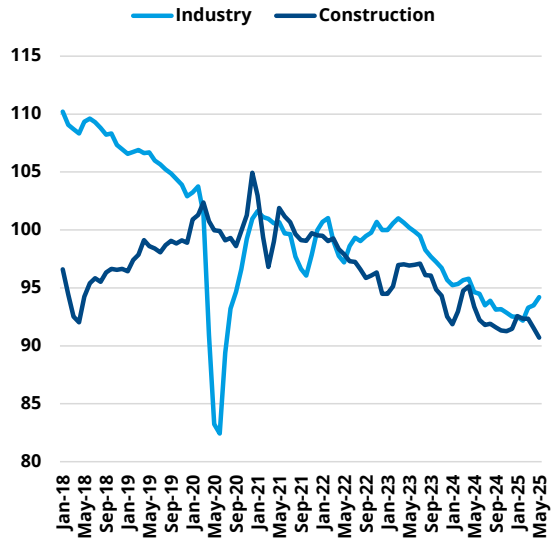
Sources: Eurostat, Creditreform Rating

Deteriorating German competitiveness, but sentiment has shown improvement

The manufacturing sector, historically vital to German economic growth, has been in decline since 2018, failing to capitalise even on the post-COVID recovery in foreign demand, particularly from China (Figure 12). While the manufacturing PMI improved to 49.0 in June from 48.3 in May, it continues to signal contraction, reflecting the sector's ongoing struggles. Energy-intensive industries have experienced almost continuous output declines since early 2022. This malaise in manufacturing has been exacerbated by Germany's deteriorating competitive position, largely driven by rising unit labour costs that have outpaced productivity gains. This has made German exports increasingly uncompetitive compared to those of neighbouring European economies. Furthermore, US tariffs and trade policy uncertainty are significantly dampening growth prospects.

Figure 12: Production has continued to fall in recent years, with industry in the limelight

Production in industry and construction, index, 2021=100, seasonally adjusted, 3-month-average



Sources: Destatis, Creditreform Rating

However, the ifo Business Expectations Indicator has also climbed steadily since March, signalling growing business confidence, even as trade policy uncertainty continues to loom. Additionally, retail sales demonstrated unexpected resilience, with volumes in May standing 1.6% above the previous year's level despite a 1.6% m-o-m decrease. At the same time, consumer sentiment has shown only modest improvement. The GfK and NIM Confidence Index deteriorated to -20.3 points for July 2025 (June: -20.0).

Urgent need for action and Germany's strategic fiscal stimulus

Germany is undergoing a historic fiscal shift, as the CDU-SPD coalition launches a €500 billion infrastructure fund, freed from the debt brake, following a 2025 constitutional reform aimed at

driving long-term investment and economic renewal. The 2025 federal budget outlines record expenditure of €503 billion, including investments of €115.7 billion. Around €143 billion of this will be debt-financed, which will push the general government deficit and debt upwards in future years.

Although critics argue that the budget lacks strategic focus, the Merz government views it as a necessary catalyst for growth, targeting not only GDP recovery but also the restoration of public trust in a capable state. Defence spending is also being significantly ramped up, with plans to more than double it by 2029 to meet NATO targets. Simultaneously, the government has launched a tax investment programme including accelerated depreciation for business equipment and e-vehicles, a phased corporate tax cut from 2028, and expanded R&D incentives, all aimed at boosting Germany's long-term competitiveness. However, limitations persist as interest payments are expected to surge, consuming 10% of the federal budget by 2029, potentially limiting future fiscal space.

Merz government pursuing a structural policy agenda

The Merz government's policy agenda is firmly grounded in structural reform. Priorities include bolstering defence, addressing infrastructure backlogs, modernising public administration, and tackling labour shortages while adopting a stricter migration policy. Measures such as enhanced depreciation allowances, reduced energy levies, and targeted subsidies aim to stimulate industrial renewal. Moreover, labour market reforms are intended to incentivise full-time employment and reward extra hours, while pledges to cut taxes and bureaucracy underscore a pro-growth stance. However, the success of this expansionary strategy hinges on its effective implementation.

Indeed, persistent administrative bottlenecks, housing constraints, and external risks, such as US tariffs, pose formidable challenges. To mitigate inflationary pressures, fiscal reforms should be complemented by structural reforms that reduce administrative burdens, eliminate regulatory barriers to entry, and foster greater competition. Additionally, the Merz administration's "de-risking" strategy towards China, which involves reducing strategic dependencies while preserving economic ties, introduces further complexity to Germany's export-driven economic model. Whilst Germany's fiscal transformation is bold, we think its effectiveness will be a test of leadership, institutional agility, and economic resilience.

Trump tariffs and the German economy

Furthermore, the German economy is facing significant crosscurrents due to President Trump's tariff policies. The tariffs and associated uncertainty could reduce GDP growth by approximately three-quarters of a percentage point over the forecast horizon until 2027, according to estimates from the Bundesbank. The German automotive industry, which accounted for 16.9% of total exports in 2024, is particularly vulnerable to the 25% tariff imposed by Trump on European car imports. These tariffs could affect up to €67 billion of EU automotive exports, with Germany accounting for almost two-third of the bloc's auto shipments. Last year, German manufacturers sold 3.4 million vehicles in the US market, highlighting their significant exposure. Furthermore, the appreciation of the euro against the US dollar has reduced Germany's competitiveness in terms of prices in international trade, putting further pressure on the manufacturing sector, which is already facing significant challenges.

If the above-mentioned tariff hikes were fully implemented alongside retaliatory measures, the German economy could face considerable

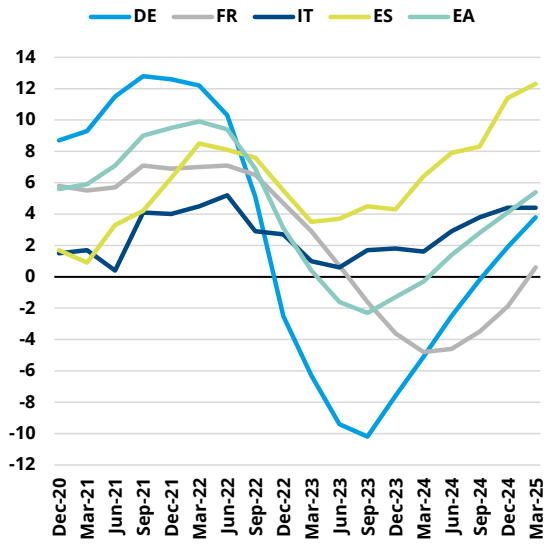
strain. Exports would suffer a sharp setback caused by losses in global growth and lower import demand from trading partners. Firms would likely defer investment decisions due to a lack of planning certainty, resulting in sizable losses in real GDP growth by 2027. In such a scenario, the broader economic recovery would likely be delayed further, prolonging the period of economic stagnation that has been in place since 2019.

Housing market is showing signs of recovery

After two challenging years, Germany's housing market has shown promising signs of recovery since the turn of the year. House prices began to stabilise towards the end of 2024, with house prices returning to positive growth of 1.9% y-o-y in 4Q24, the first positive annual change in nine consecutive quarters (Figure 13). In the first quarter of this year, house price dynamics gained further momentum, leaping to 3.8% growth.

Figure 13: German house prices up again for the first time in two years

House price index, y-o-y changes in %



Sources: Eurostat, Creditreform Rating

The average purchase price for existing apartments nationwide reached €3,403 per square metre, reflecting a 1.6% y-o-y increase. At the same time, new properties commanded an average price of €5,478 per square metre, marking a 2.9% annual increase. Munich remains Germany's most expensive market, with existing properties averaging €8,476 per square metre. Market experts anticipate continued price growth, projecting increases of 3.5% in 2025, followed by 3.0% in 2026 and 2027, respectively.

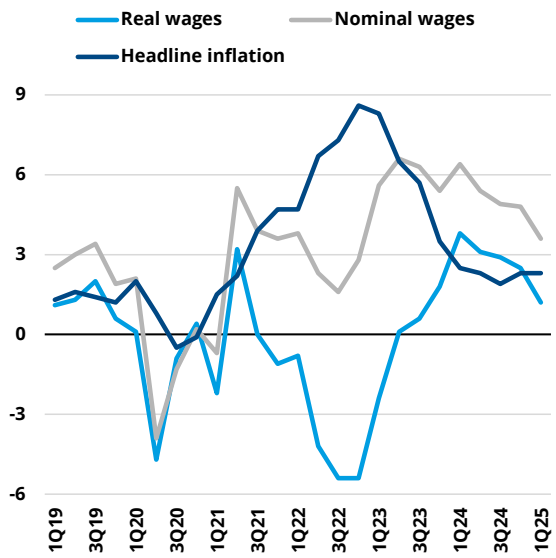
However, we still identify potential downside risks arising from economic weakness and trade uncertainties. The housing shortage continues to worsen, with only 251,937 residential units completed in 2024, a 14.42% decline from the previous year. Building permits have fallen to their lowest level since 2010. Meanwhile, demand remains strong, particularly in major urban centres. Over 52% of German households now reside in the rental market, which continues to experience only moderate growth. Rents in major cities increased by 3.5% in 2024 compared to 5% the previous year. To be sure, the Merz government has pledged to address the housing crisis by streamlining approval procedures and expanding land availability.

Hope in Germany's domestic-led recovery amidst trade turmoil

In conclusion, Germany's economic recovery now depends more on robust domestic demand than on its traditional strength in exports. As inflation approaches 2% and real wages increase, people will have more disposable income to spend, especially since recent wage increases have restored much of their lost purchasing power (Figure 14). The government's decision to ease the debt brake marks another significant change that will allow for increased public investment and should provide the economy with a much-needed boost.

Figure 14: Real wages increase with higher nominal wages and reduced inflation

Germany, y-o-y changes in %



Sources: Destatis, Creditreform Rating

However, higher US tariffs and global trade tensions pose a threat to Germany's export-driven manufacturing sector, which could hinder growth. The outlook remains unusually uncertain, and the success of this revival depends on how quickly public investments are implemented and whether reforms can manage inflation effectively as spending increases.

Figure 15: We have lowered our forecasts for 2025

In %, IMF forecasts for the World, US, and China

	2010-19	2021	2022	2023	2024	2025e	2026e
World	3.7	6.5	3.5	3.3	3.3	2.8	3.0
Euro area	1.4	6.1	3.5	0.4	0.9	1.0	1.2
Germany	2.0	3.2	1.8	-0.2	-0.2	0.1	1.2
France	1.4	6.9	2.6	0.9	1.1	0.5	0.9
Italy	0.3	8.3	4.0	0.9	0.7	0.6	0.8
Spain	1.1	6.4	5.8	2.5	3.2	2.4	1.8
UK	2.0	8.7	4.3	0.1	1.1	1.0	1.2
US	2.4	5.8	1.9	2.5	2.8	1.8	1.7
China	7.7	8.6	3.1	5.4	5.0	4.0	4.0

Sources: Creditreform Rating, IMF, Eurostat

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