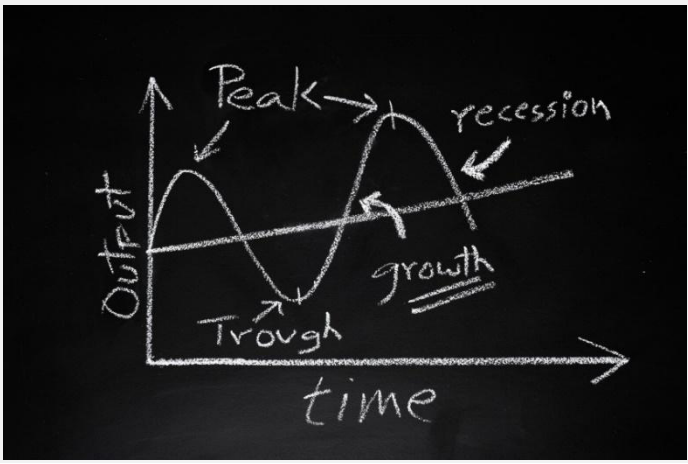
Creditreform Rating

Between Stagnation and Surge – Europe's Balancing Act in a Fragmented Economy



Creditreform Economic Briefs
07 November 2025

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Key Take-Aways

1.

The euro area economy confronts a challenging environment characterized by trade policy uncertainty, political instability, and structural competitiveness issues. While the EU-US trade deal prevents an immediate escalation, it imposes costs that will weigh on growth. Efforts to diversify trade through agreements with Mercosur and India offer long-term benefits but require time to materialize. Meanwhile, the region's growth trajectory remains modest, as manufacturers face competitive pressures and services growth moderates. Political risks, as seen in France, threaten to undermine the fiscal consolidation efforts required under the new EU rules.

2.

We have revised our euro area GDP growth forecast for 2025 to 1.2%, reflecting a slow but steady recovery. Recent easing by the European Central Bank (ECB) and fiscal support have stabilized conditions, although Germany's industrial weakness continues to weigh on the region. The EU-US trade deal favors US exports and adds pressure on European competitiveness. For 2026, we expect consumption-led growth to moderate to 1.0%, due to weaker exports and policy uncertainty as well as the weak growth momentum at the turn of this year.

3.

Headline inflation in the euro area is broadly in line with the ECB's target. However, core inflation remains stubborn, largely driven by elevated prices in the service sector. The ECB cut its deposit rate to 2.0% in June and we now expect it to remain at this level until the end of 2025. Meanwhile, the recent EU-US trade deal has reduced uncertainty, though it may influence price pressures through supply-chain cost effects. Under recent developments, the EU's fiscal landscape has grown still more challenging despite the 2025 governance reforms designed to balance discipline with flexibility. Borrowing costs for several member states have risen, pressuring debt servicing. Defense spending is expanding significantly, especially in Germany's 2025 budget, which includes special defense exemptions under the new rules.

4.

Following a weak performance in the second quarter of 2025, Germany's economy stagnated in Q3, weighed down by falling exports and weak industrial output. Recent months have shown only marginal signs of stabilization. The Merz government has launched a substantial fiscal package, comprising a €500 billion infrastructure fund and exemptions to the debt brake for defense spending. However, the promised structural reforms are being delayed or watered down. Meanwhile, the newly signed EU-US trade deal has eased the threat of steeper tariffs. However, German exporters still face elevated barriers and uncertainty, hindering the recovery of export-led growth. In light of these challenges, we project real GDP growth of 0.2% in 2025, followed by a modest recovery in 2026. Nevertheless, projected real GDP growth of 0.9% hinges on domestic demand, effective reforms, and improved external trade conditions.

5.

The UK's real GDP forecast for 2025 is still pegged at 1.3%, underpinned by a strong first quarter and relatively resilient household and business spending. However, recent months have revealed growing

signs of stagflation, characterized by sticky inflation, high wage growth, and weak industrial output, alongside a flatter growth trajectory. The Bank of England (BoE) reduced rates by 25bps to 4.0% in August, yet is showing caution, likely holding rates steady through year-end due to persistent inflation pressures. The UK-US "Economic Prosperity Deal", reducing tariffs on key British exports has eased trade frictions, but its benefits are uneven and cannot fully offset the drag from global trade uncertainty and supply-chain disruption.

6.

The US economy is now expected to slow to 2.0% growth in 2025, but the economic outlook is marked by mounting challenges. Growth is fragile, consumption is slowing, and investment is subdued. Inflation remains above target, largely due to tariffs. The labor market is cooling, and consumer confidence is sliding. The Federal Reserve began its easing cycle with a 25-bps rate cut in mid-September, followed by a further 25-bps cut to 3.75-4.00% at its late-October meeting. We should see one more 25-bps cut this year, with further easing depending on incoming inflation and labor market data. Meanwhile, fiscal policy has become both a stimulus and a source of risk, with deficits and debt surging to levels that unsettle markets. The result is an economy caught between short-term protectionist and fiscal gains and long-term risks to prosperity, institutional credibility, and global leadership. This policy mix will likely result in higher borrowing costs, elevated inflation, weaker confidence, and diminished fiscal sustainability well beyond 2025.

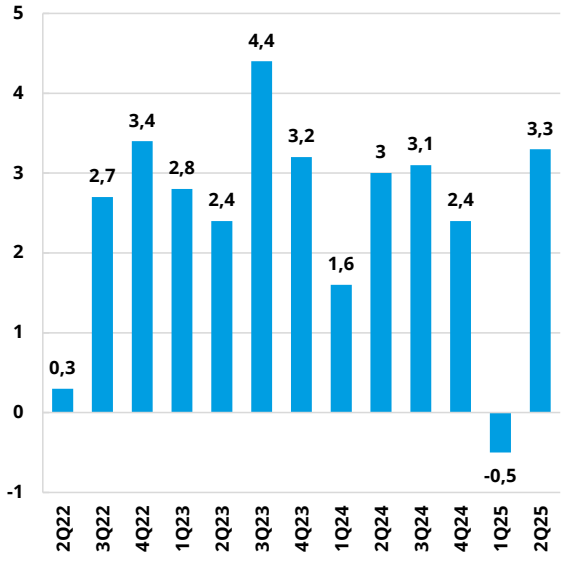
1. World

US Growth Falters as Trade and Fiscal Risks Collide

The US economy in 2025 is characterized by short bursts of growth overshadowed by deepening fragility. Following a contraction of 0.5% in the first quarter, GDP rebounded by 3.3% in the second quarter (annualized growth, see figure 1), driven by investment and consumer spending. However, this momentum should prove to be short-lived. Mounting trade tensions and political uncertainty have left their mark on the dynamics of real GDP.

Figure 1: US GDP growth rebounded in the second quarter

Real GDP, seasonally adjusted at annual rates in %



Sources: US Bureau of Economic Analysis (BEA), Creditreform Rating

Since "Liberation Day" on April 2, 2025, tariffs have been extended under emergency powers. This established a universal baseline tariff of 10% to 15% for most imports, while significantly steeper tariffs have been imposed on strategic sectors, such as semiconductors, metals, and cars. Country-specific surcharges have further strained relations with Brazil, India, and particularly China, which are facing punitive hikes. These measures were designed to protect domestic producers and increase fiscal revenue, but they have instead caused a sharp rise in import prices, fractured supply chains, and increased costs for firms and households.

Some exemptions have been made, notably for Canada and Mexico under the United States–Mexico–Canada Agreement (USMCA), whereas the treatment of China and other Asian partners remains under negotiation. At the same time, the US administration has pursued new trade agreements with the UK, the EU, and Japan. That said, many details remain unsettled, and the overall direction of policy is uncertain. Retaliatory tariffs from affected trading partners are being prepared or implemented, threatening US exporters and risking the very economic pressures the tariffs were intended to alleviate.

Both Consumption and Investment Lose Momentum, while Inflation Pressures Mount

The IMF forecasts now project growth of only 2% in 2025 and 2.1% in 2026, down from 2.8% in 2024, as per its latest October World Economic Outlook report. Real GDP is thus projected to slow, reflecting higher household costs, waning confidence, and weaker real incomes, as wage gains are being eroded by inflation. Indeed, the immediate effects of tariffs are becoming evident in consumer and corporate behavior. Real personal consumption, once the backbone of US growth, is cooling.

Fixed investment initially rose as firms placed orders ahead of time to avoid tariffs, but that brief surge has given way to hesitation. Uncertainty over trade rules, profitability, and long-term supply chain reconfigurations has curbed new spending. Many multinationals are being cautious, either relocating production abroad or de-

laying new projects. This undermines the domestic investment base that tariffs were intended to bolster.

Meanwhile, inflation remains stubbornly above the Federal Reserve's 2% target, and tariffs are exacerbating underlying price pressures. The headline consumer price inflation (CPI) rose from 2.4% in May to 3% in August, while the core CPI climbed from 2.8% to 3% in the same time frame. These price increases have spread beyond targeted sectors such as automobiles, metals, and electronics, affecting broader categories of consumer goods and increasing costs.

The Fed's preferred measure, the PCE index, tells a similar story: headline PCE inflation stood at 2.7% in August (up from 2.2% in April), while core PCE reached 2.9%. The IMF's forward-looking expectations suggest further inflationary persistence, with the annual headline CPI inflation rate reaching 2.8% in 2025 as new tariffs take effect and retaliation by trading partners drives fresh price distortions.

Business and Consumer Sentiment Under Strain

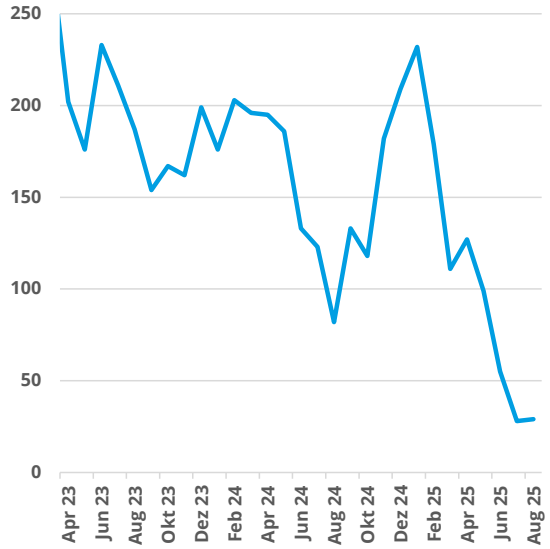
Business surveys also confirm the weakening outlook. The ISM manufacturing purchasing managers' index (PMI) remained stuck in contraction territory at 49.1 in September, reflecting declining orders and squeezed margins. Some firms have described conditions as "worse than the Great Recession," highlighting the severity of tariff-induced disruptions. Services activity, with the services PMI at 50, is barely expanding, weighed down by higher input costs and softening demand. By the same token, households are also displaying mounting anxiety. The University of Michigan Consumer Sentiment Index fell to 53.6 in October, the lowest it has been since May. Retail sales data show a 0.6% increase in August, reversing the May contraction, which was driven by discounts in the auto and online retail sectors. However, discretionary spending remains flat beyond these sectors as households face rising prices and declining confidence.

Labor Market Softens

The labor market, once a key strength of the US economy, appears to cool as well. Job growth averaged just 81,000 per month over the past six months, while the unemployment rate climbed to 4.3%, the highest rate in four years. Revised data show that nearly 900,000 fewer jobs were created between March 2024 and March 2025 than was initially reported, revealing hidden fragility. Lower-skilled and manufacturing workers, who are disproportionately affected by tariffs and supply chain disruptions, are bearing the brunt of this decline. Meanwhile, wage growth is being offset by inflation, putting pressure on real incomes.

Figure 2: Job growth has slowed since the Trump administration took office

3-month employment average growth in absolute terms



Sources: US Bureau of Labor Statistics (BLS), Creditreform Rating

Adding to these concerns, the three-month average of employment growth has steadily declined since January 2025 (see figure 2), the first year of the Trump administration. This trend has begun

to divide opinion within the Federal Reserve, where some policymakers argue that weakening labor momentum warrants further rate cuts. Others caution that persistent inflation leaves little room for monetary easing without risking credibility.

The "Big Beautiful Bill" and its Reckoning

Overlaying these strains is President Trump's "Big, Beautiful Bill," a comprehensive fiscal package that has further complicated the economic landscape. The plan extends tax cuts from the 2017 Tax Cuts and Jobs Act (TCJA), while increasing spending on defense and border security. At the same time, it cuts funding for Medicaid, student loans, and food aid.

Although the package is designed to stimulate growth and reinforce political priorities, it carries heavy fiscal costs. As per the Congressional Budget Office (CBO), it is estimated to add $3.4 trillion to the national debt over the next decade, exacerbating already worrisome trends. The federal budget deficit for 2025 is projected to be $1.9 trillion, equivalent to 6–7% of the estimated 2025 GDP. In the first half of the fiscal year alone, the budget deficit reached $1.3 trillion, the second highest on record. The debt-to-GDP ratio is expected to surpass 100% and continue rising steadily.

These imbalances have worsened since the government shut down in October 2025, when Congress failed to agree on funding for the 2026 fiscal year. Partisan divisions over healthcare and welfare spending resulted in approximately 900,000 federal employees being furloughed and hundreds of thousands more having to work without pay.

Bond yields reflect this unease. The 30-year Treasury yield rose above 5.09% in May, the highest it has been since October 2023, and it remains around 4.8% as of October. Investors are demanding greater compensation for long-term fiscal and political risks, causing the term premium to expand.

Short, Medium, and Long-Term Repercussions

The combination of aggressive tariffs and substantial fiscal expansion creates a potentially inflationary and destabilizing policy mix. While customs duty revenues have modestly reduced monthly deficits in the short term, this benefit is overshadowed by higher borrowing costs and a weakening growth base.

In the medium term, rising debt-servicing costs should further strain the US' fiscal position. Interest payments are already consuming a growing share of federal revenue, and with yields climbing, the burden should only intensify. The combination of a ballooning deficit, slowing growth, and elevated inflation may undermine domestic stability and the US's international financial standing.

In a dismal scenario, the long-term credibility of American fiscal and monetary institutions is at stake. Speculation about political interference in the Federal Reserve, alongside legal challenges to tariff measures, has already unsettled markets. Although the US dollar's role as the world's reserve currency is not threatened at this stage, one must be wary of shifts in investor sentiment, which could signal a gradual erosion of trust.

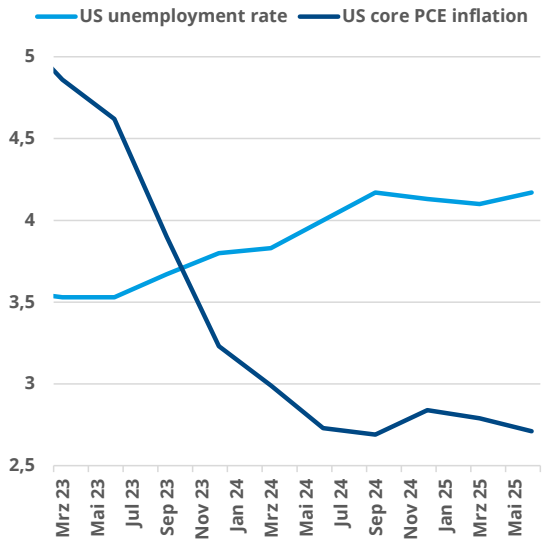
The Fed's Balancing Act

Amid these crosscurrents, the Fed is faced with a formidable task. With unemployment rising, the Fed is under pressure to further cut rates, as markets anticipate one additional 25-basis-point cut this year, following the October rate cut. However, tariffs are keeping inflation elevated, leaving policymakers torn between supporting jobs and protecting the economy from further

inflationary pressure (see figure 3). The perception of political interference compounds the dilemma. Disputes over Fed appointments and threats to dismiss governors could undermine the institution's independence. Any loss of credibility could cause bond yields to rise, further complicating fiscal management and potentially weakening the US dollar's reserve status.

Figure 3: Unemployment and inflation stabilizing in the US since rate cut in September 2024

Annual changes in %, quarterly data



Sources: US Bureau of Labor Statistics (BLS), Creditreform Rating

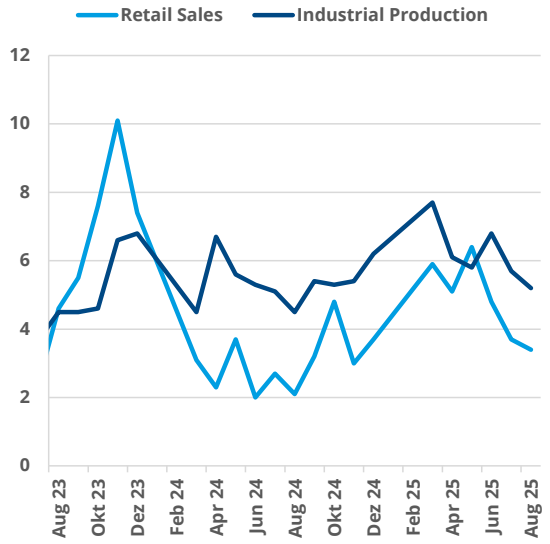
Thus, the US's economic outlook for 2025 is marked by mounting challenges. Growth is fragile, consumption is slowing, and investment is subdued. Inflation remains above target, largely due to tariffs. The labor market is cooling, and consumer confidence is sliding. Meanwhile, fiscal policy has become both a stimulus and a source of risk, with deficits and debt surging to levels that unsettle markets. The result is an economy caught between short-term protectionist and fiscal gains and long-term risks to prosperity, institutional credibility, and global leadership. This policy mix will likely result in higher borrowing costs, elevated inflation, weaker confidence, and diminished fiscal sustainability well beyond 2025. This will leave the US economy walking an ever-narrower tightrope between resilience and instability.

China's Fragile Recovery under the Shadow of Tariffs and Weak Demand

China's economy showed resilience in early 2025, though signs of fragility became more evident as global headwinds intensify. While growth was tracking towards the government's "around 5%" target, momentum clearly weakened as the year progressed. This slowdown was cemented by recently published Q3 data, which showed GDP growth cooled to 4.8% y-o-y, slipping from 5.2% in the second quarter and marking the weakest pace in a year.

Figure 4: Growth in China's industrial production and consumer spending has weakened

Change in retail sales y-o-y in %, factory output growth y-o-y in %



Sources: National Bureau of Statistics of China (NBS), Creditreform Rating

This reflected earlier warning signs, such as August's industrial output growth slowing to 5.2% and retail sales expanding at a mere 3.4% (see

figure 4). A prolonged property slump, trade tensions, and softer labor market conditions all weighed heavily on demand. Underscoring this stress, unemployment crept up to 5.3% in August, its highest rate in six months, leaving policymakers under pressure to shore up momentum.

Price pressures remain muted. The headline CPI fell by 0.4% y-o-y in August, marking the sharpest decline in six months, followed by a 0.3% decline in the next month. At the same time, producer prices dropped 2.9% over August, followed by a 2.3% fall in September, which still signals deflationary pressures. However, core inflation rose to 0.9%, the highest level in two and a half years. Nevertheless, the subdued inflation backdrop emphasizes weak underlying demand and the challenge of stimulating confidence in both households and firms.

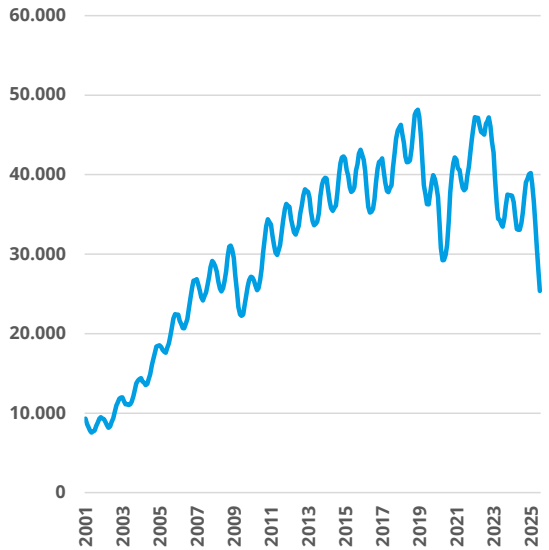
PMI surveys reflect a fragile industrial environment. The official manufacturing PMI remained below 50 for the fifth consecutive month in September, coming in at 49.8. While this is marginally better than the 49.4 figure in August, it still points to ongoing contraction. Factories are holding back on new orders due to weak demand and uncertainty over trade relations. Consumer sentiment has also been hesitant, shaped by employment insecurity, falling home prices, and a cautious approach to spending, despite government pledges to boost consumption.

Tariffs remain a critical headwind. On April 9, President Trump imposed sweeping tariffs of up to 145% on all Chinese imports, prompting Beijing to retaliate with tariffs of up to 125% on US goods, including agricultural products and technology. The shock continues to disrupt trade flows, with Chinese exports to the US falling 33% y-o-y in August and imports from the US dropping 16% y-o-y to $26 billion, the lowest since 2009 (see figure 5).

The US administration later suspended the heightened tariffs in August, reducing them temporarily to 10% to facilitate negotiations. However, this fragile calm shattered in October 2025, as the trade war escalated again dramatically. President Trump announced a staggering new 100% tariff on all Chinese imports, effective November 1st, and imposed new restrictions on critical software exports. Beijing's response was swift and targeted. It immediately expanded its export controls on vital rare earth minerals, matched the US with new port fees and retaliatory tariffs, and launched an investigation into major US chip firm, Qualcomm. This rapid tit-for-tat sequence marked one of the most intense phases of the economic rivalry, reviving severe market disruptions.

Figure 5: US Imports from China at their lowest level since 2009

US imports from China in millions of $, moving 6-month-average



Sources: US International Trade Commission (USITC), Creditreform Rating

Looking ahead, we expect the People's Bank of China to maintain a cautious stance. Having already cut rates to historic lows, the central bank is likely to reduce the policy rate further in late 2025. However, any easing will remain modest

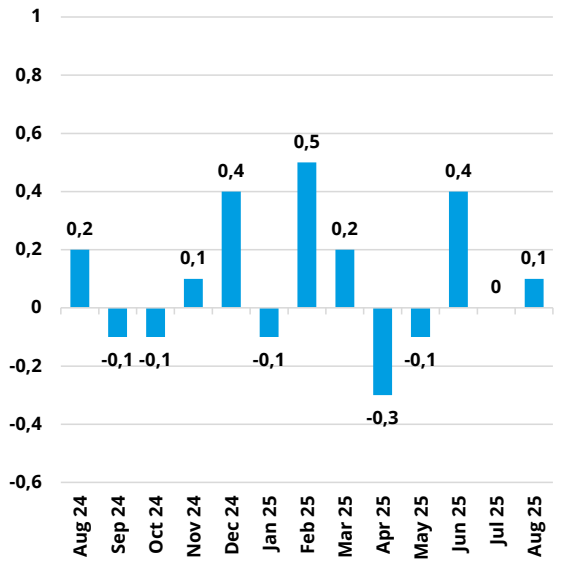
due to concerns about financial stability and local government debt. The IMF now forecasts that China's economy will grow by 4.8%, matching its July estimate. This likely reflects the persisting uncertainty in global trade. For now, China's outlook depends on whether diplomacy can ease tariff pressures and domestic policy can restore confidence at home.

UK: Tariff Relief Offsets Fragility as Stagflation Risks Grow

In 2025, the UK economy entered a more precarious phase, with modest growth masking underlying fragility. Following a robust start to the year, GDP growth slowed sharply in the summer. Output recorded only a meager 0.1% growth in August, following stagnating growth in July, due to a contraction in manufacturing and weakening consumer demand. On a quarterly basis, GDP expanded by only 0.3%, down from 0.7% in the first quarter (see figure 6).

Figure 6: UK GDP growth prospects appear to have moderated

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



Sources: Office for National Statistics, Creditreform Rating

Meanwhile, the Services PMI reached 54.2 in August, the highest reading in more than a year. This was helped by the easing of US tariff concerns. However, it eventually fell to 50.8 in September, marking the weakest pace of expansion since April. The construction sector remained in deep contraction at 46.2 in September. The composite index increased to 53.5 from 51.5 in July but then fell to 50.1, indicating the weakest reading in five months and suggesting stagnant private-sector activity. Consumer confidence has been declining since March 2016, reaching a low of -19 in September. Households are being squeezed by rising prices and a deteriorating labor market. Unemployment rose to 4.7% in July, a four-year high. Concurrently, vacancies continued to decline, and starting pay growth slowed to its weakest level since 2021.

The UK's trade deal with the US has provided some relief. Tariffs on steel and aluminum have been removed, while car exports now face a 10% duty, down from 27.5%, for up to 100,000 vehicles annually. These changes have helped protect around 59,000 jobs in sectors concentrated in Wales, Yorkshire, and the Humber. The agreement also covers only a quarter of the UK's goods exports and excludes services, so aerospace and pharmaceuticals stand to benefit from preferential treatment.

The fiscal backdrop remains challenging. As of July, public debt stood at 96% of GDP. Although new fiscal rules introduced in the last Autumn Budget of 2024 aim to stabilize the outlook, spending pressures and higher bond yields constrain room for maneuver. Against this backdrop, the BoE faces a delicate balancing act. Interest rates have been cut five times since 2024, most recently to 4%, despite inflation remaining high at around 4%. With growth slowing and the labor market cooling, we expect another 25bps rate cut in the upcoming December policy meeting which will allow the BoE to assess impact of the policy announcements in the budget as well. However, this could fuel inflation at a time when stagflation fears are already mounting.

Looking ahead, the IMF now expects the UK economy to grow by 1.3%, up from an earlier forecast of 1%, supported by the limited trade deal with the US. That said, the UK economy appears trapped between stubborn price pressures and weakening demand. Tariff relief from the US deal offers short-term support, but lasting recovery depends on whether fiscal discipline and monetary caution can restore confidence without tipping the economy into a deeper slowdown.

2. Euro area

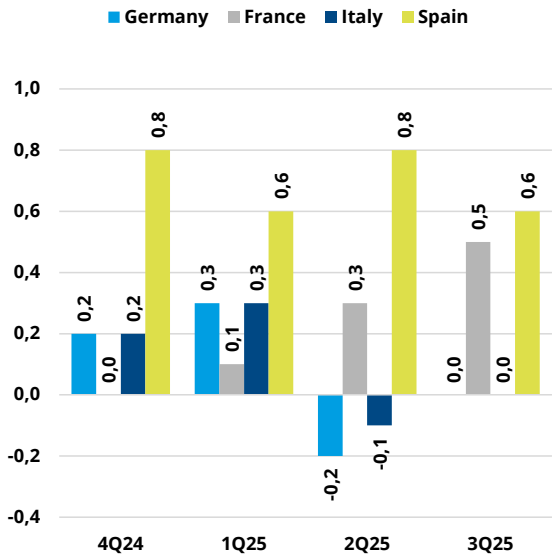
GDP Growth Loses Steam Amidst Persistent Trade Challenges

In the second quarter of 2025, the euro area's economic momentum decelerated sharply, with GDP growth slowing sharply to 0.1% q-o-q. This was the weakest performance since late 2023 and a significant slowdown from the 0.6% expansion recorded in the first quarter of 2025. Growth inched up to 0.2% q-o-q in the third quarter. This slowdown reflects growing caution among businesses and households as they weigh the benefits of lower inflation against mounting trade uncertainties, particularly regarding US tariff policies. Year-over-year growth slowed from 1.6% in the first quarter to 1.5% in Q2, reaching 1.3% y-o-y in the third quarter.

Among the major economies, Germany's and Italy's growth was flat (0.0%), while France's real GDP growth increased from 0.3% to 0.5%. Meanwhile, Spain continued to stand out in terms of its growth momentum, with GDP growth posting at 0.6%, following 0.6% and 0.8% in Q1 and Q2 respectively (see figure 7).

Figure 7: Spain continues to stand out among major economies within the euro area

Real GDP q-o-q growth in %



Sources: Eurostat, Creditreform Rating

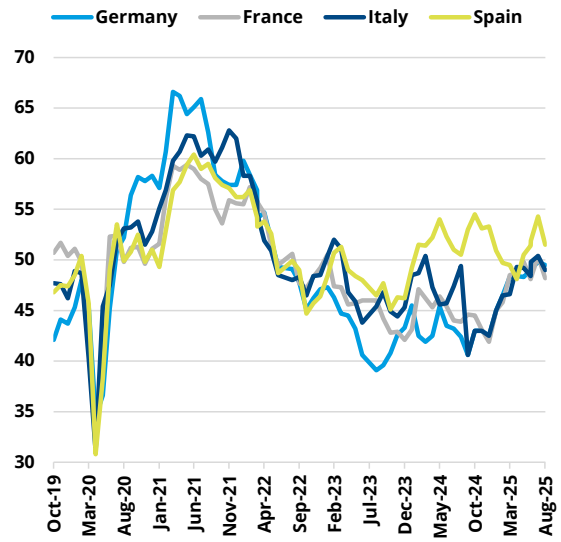
Manufacturing Shows Tentative, not yet Self-Sustaining Signs of Life

In a rare piece of positive news, the manufacturing sector saw the PMI rise from 49.8 in July to 50.7 in August. This marked the first expansion in factory activity since June 2022 and ended more than three years of contraction. This improvement was driven by the most significant surge in factory output since March 2022 and the first monthly increase in new orders in almost three and a half years. However, the PMI fell back into contractionary territory in September, reaching 49.8.

Growth was particularly robust in Greece and Spain, while France and Italy returned to slight expansion after experiencing weakness. Even Germany, the bloc's largest economy, posted its highest reading in 38 months, at 49.8, in August, before dropping to 49.5 in September. The euro area composite PMI strengthened slightly to 51.2 in September from 51.0, marking the sharpest expansion in private-sector activity in over a year (see figure 8).

Figure 8: European manufacturing recovering

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



Sources: S&P Global, Creditreform Rating

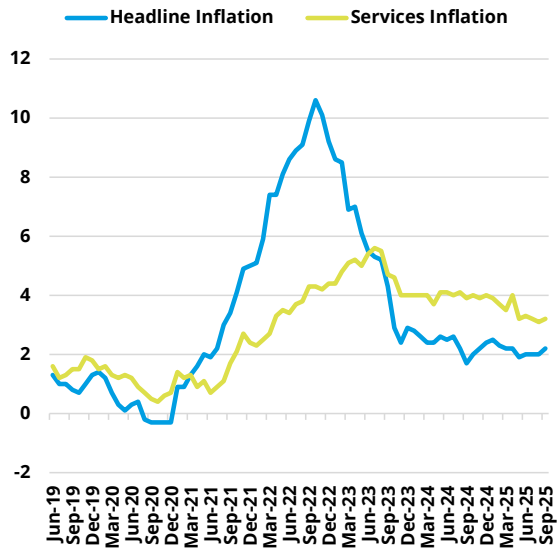
Inflation Edges Higher but Remains Controlled

In September 2025, euro area headline inflation rose to 2.2%, slightly above August's reading of 2.0% and exceeding market expectations, but is now more closely aligned with the ECB's objective. This increase was primarily driven by a smaller decline in energy costs. Conversely, core inflation, excluding volatile food and energy components, remained at 2.3% for the fourth consecutive month, marking its lowest level since January 2022. Nevertheless, service prices remain significantly above the ECB's 2% target, at 3.2%, having edged up from 3.1% in August (see figure 9).

We expect inflation to average around 2.1% for the remainder of 2025 before moderating to approximately 1.7% in 2026 as price pressures ease. Still, services inflation may persist due to ongoing labor cost pressures. Risks remain tilted to the upside, particularly from potential energy price shocks and ongoing international trade pressures. Therefore, policymakers are expected to remain vigilant in striking a balance between supporting growth and keeping inflation expectations firmly anchored around the target.

Figure 9: Euro area headline inflation softens but services inflation remains sticky

Monthly data, annual rate of change in %



Sources: Eurostat, Creditreform Rating

Labor Markets Remain Resilient

Unemployment continued to decline gradually, falling to 6.3% in August from 6.4% in May. This was a slight increase from the record low of 6.2% in July. The number of unemployed persons decreased by 170,000 m-o-m in August, bringing the total to 10.8 million across the euro area. Youth unemployment improved significantly as well, dropping to 13.9% from 14.3% the previous month. Among major economies, Germany and the Netherlands posted the lowest unemployment rates, at 3.7% and 3.8%, respectively. Meanwhile, Spain continued to struggle with a rate of 10.4%.

Consumer Sentiment Deteriorates and Retail Sales Disappoint

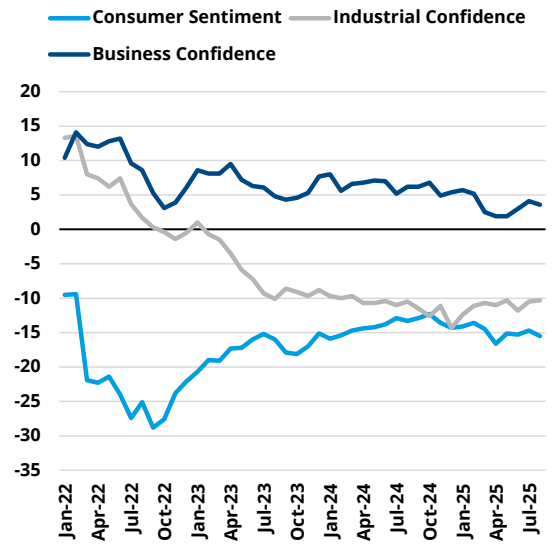
In contrast, consumer confidence in the euro area decreased further, dropping from -14.7 in

July to -15.5 in August. This was the lowest level in four months before stabilizing at -14.9 in September. The decline reflected growing pessimism about households' future finances, even as perceptions of the wider economy remained relatively unchanged. Retail sales also disappointed, increasing just 0.1% from July to August due to weaker food, beverage, and fuel purchases. Annual growth slowed from 3.5% in June to 1% in August, raising doubts about the resilience of domestic consumption.

The euro area's weakness is tied to a broader European trend: EU consumer sentiment remains stagnant, with more than half of households feeling pessimistic about their national economies. High living costs and political and environmental anxieties are causing consumers to be cautious with their spending, leading them to cut back on non-essentials. Business sentiment, by contrast, is more stable, with an indicator of 3.6 in September. However, uncertainty about demand, geopolitics, and regulation continues to cloud the outlook (see figure 10).

Figure 10: Consumer sentiment deteriorates while industrial confidence remains downbeat

Euro area sentiment indices in absolute values, balances



Sources: Eurostat, Creditreform Rating

The EU–US Trade Deal: A Pyrrhic Victory

On July 27, 2025, European Commission President von der Leyen and US President Trump announced a trade agreement that seemed to avert disaster. The deal set a 15% tariff on most EU exports to the US, including automobiles, pharmaceuticals, and semiconductors. The EU eliminated its 10% tariff on US cars and agreed to purchase up to $750 billion worth of US gas by 2028, as well as make an additional $600 billion in investments across strategic sectors in the US.

The immediate consequences vary across Europe. Germany, Italy, and Ireland, which rely heavily on exporting cars, machinery, and industrial goods to the US, face the sharpest blow. For these countries, the tariff means absorbing higher costs or passing them on to American consumers, which could erode their competitiveness against domestic producers. The pharmaceutical and semiconductor industries, both of which are deeply integrated into transatlantic supply chains, also face new barriers that could disrupt years of collaboration in research and development.

In contrast, the US appears to have secured long-term energy deals and attracted major investments that may bolster its economic strength. Some European industries, such as aerospace, chemicals, and certain agricultural products, were largely protected due to special exemptions. For European policymakers, the outcome was sobering, as the once-reliable Atlantic corridor now appeared fragile and driven more by short-term politics than long-term strategy.

The deal has also widened fractures within the EU. Fearing an escalating tariff war that could devastate their export-dependent economies, France and Germany lobbied strongly for a quick resolution with Washington. However, Eastern

European nations voiced different priorities. For Poland, the Baltic states, and others on the bloc's eastern edge, the war in Ukraine has fundamentally altered trade politics. For these countries, aligning with the US is not only about commerce, but also about security. Therefore, they favored closer trade ties with Washington to strengthen the American presence in Europe and serve as a counterweight to Russia.

The transatlantic deal looks less like a triumph and more like a stopgap. While it avoided the worst-case scenario of 30% tariffs, it established a new baseline of costs and distortions that threaten Europe's competitiveness. The winners appear to be US energy suppliers, US investors, and a handful of protected European sectors. The losers are equally visible: European carmakers, pharmaceutical firms, semiconductor producers, and, most seriously, the credibility of European unity.

Looking Beyond Traditional Partners

Recognizing the dangers of overreliance on the US, Brussels has accelerated efforts to diversify trade relationships. The EU-Mercosur agreement, finalized in December 2024, represents the bloc's most significant tariff reduction to date, eliminating €4 billion in annual duties. Over the next 15 years, tariffs on 91% of European exports to Brazil, Argentina, Paraguay, Uruguay, and Bolivia will be phased out, offering new opportunities for sectors ranging from cars to machinery.

Meanwhile, parallel negotiations with India are expected to conclude by the end of 2025. These negotiations aim to deepen an already substantial trade partnership, which was worth $137 billion in 2023–24. Particular gains are anticipated in the pharmaceuticals, chemicals, and mechanical engineering sectors. The EU–Mexico agreement, signed alongside the Mercosur agreement and set to take effect in 2026, further signals a deliberate pivot toward Latin American and Asian markets. As von der Leyen noted, diversification is no longer a choice, but a necessity in an era of geopolitical turbulence.

France Faces Political Crisis as Bayrou Ousted in Confidence Vote and Lecornu Resigns

France's political turbulence poses another threat to euro area stability. On September 8, 2025, Prime Minister François Bayrou lost a confidence vote in the National Assembly by a landslide, ending his minority government's nine-month tenure.

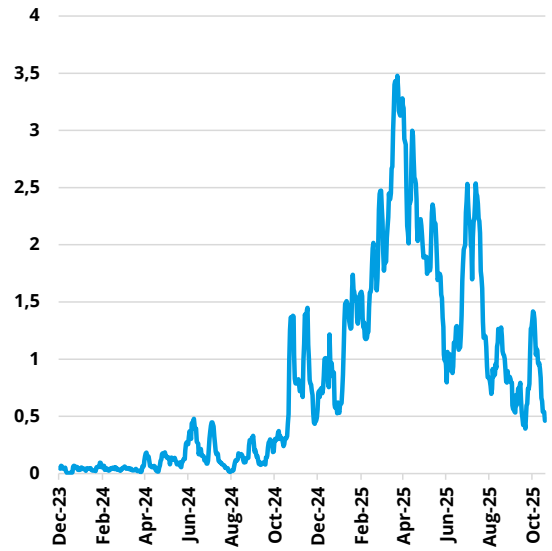
Following Francois Bayrou's resignation, President Emmanuel Macron faced the daunting task of appointing a new prime minister capable of navigating a fractured parliament. His initial choice, Sebastien Lecornu, took office amid urgent calls for unity and fiscal restraint. Yet, just 27 days later, Lecornu stepped down on 6 October, citing the futility of leading a center-right minority government paralyzed by partisan gridlock. The resignation deepened concerns over France's political stability and fiscal direction. However, in a dramatic twist, Macron reappointed Lecornu only days later, defying critics and sparking outrage among opposition leaders. With France mired in its worst political crisis in decades, Macron is betting on Lecornu's loyalty and resilience to steer a divided legislature.

Meanwhile, France's debt crisis has reached alarming proportions. Public debt stands at €3.346 trillion, equivalent to 114% of GDP, as of the end of the first quarter of 2025. The consequences for France and the euro area are profound. Rising yields and fiscal uncertainty threaten economic stability across the bloc. French 10-year yields climbed from 3.29% in June to 3.61% in September, reflecting growing investor anxiety about fiscal sustainability and political coherence.

This episode occurs against a backdrop of unusually high economic policy uncertainty in the euro area (see figure 11). Ongoing wars in Ukraine and the Middle East have unsettled confidence in defense, energy security, and trade flows. Domestic politics in France and Germany, coupled with contentious fiscal debates, have added to the uncertainty. Meanwhile, US tariff disputes and shifting supply chains have made it difficult for exporters to plan, and the phasing out of energy subsidies has created doubts about future fiscal stances. Although the uncertainty index eased by October, it remained elevated. Investors remain cautious as structural challenges, including climate policy, technological transitions, and regulatory shifts, continue to cast a shadow.

Figure 11: Economic policy uncertainty lingering in the euro area

Economic Policy Uncertainty Index



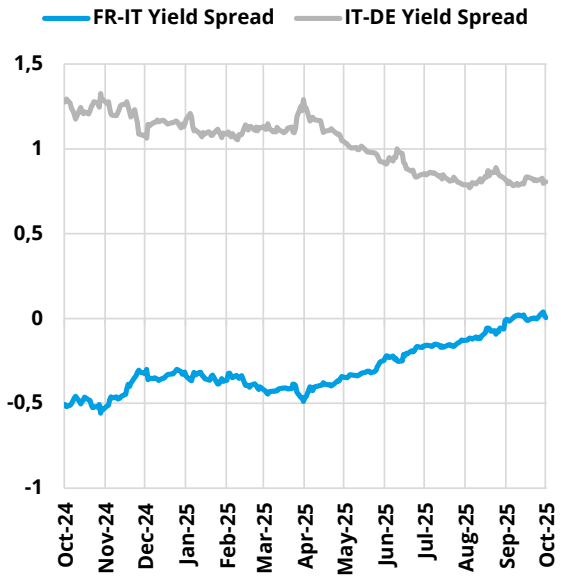
Sources: FRED Economic Data, Creditreform Rating

Fixed Income Market Dynamics Reflect Shifting Risk Perceptions

European bond markets reflect the changing risk landscape across the bloc. The Italian-German 10-year yield spread narrowed dramatically below 0.8% in September 2025, reaching its tightest level since 2010. This reflects improved investor sentiment toward Italian debt and is supported by Prime Minister Meloni's market-friendly fiscal approach and political stability. Conversely, France-Italy yield convergence reached historic highs of 0.04% in September 2025 (see figure 12), suggesting that markets now view French and Italian credit risks as nearly equivalent. This is a notable shift that highlights concerns about French fiscal sustainability.

Figure 12: Italy-Germany yield spreads narrowed while France and Italy yields converge

France, Italy, Germany 10 year government bond yields in %



Sources: Reuters, Creditreform Rating

Monetary Policy: The ECB's Delicate Balancing Act

At its October policy meeting, the ECB maintained its deposit policy rate at 2%, as economic conditions support a pause in the easing cycle. The assertion by ECB board member Schnabel that the current rate may be "mildly" stimulating an economy showing early signs of stabilization indicates the central bank's satisfaction with its current position.

Looking ahead, the euro area economy confronts a challenging environment characterized by trade policy uncertainty, political instability, and structural competitiveness issues. While the EU-US trade deal prevents an immediate escalation, it imposes costs that will weigh on growth. Efforts to diversify trade through agreements with Mercosur and India offer long-term benefits but require time to materialize. Meanwhile, the region's growth trajectory remains modest, with forecasts suggesting continued sluggish expansion as manufacturers face competitive pressures and services growth moderates. Political risks, as seen in France's crisis, threaten to undermine the fiscal consolidation efforts required under the new EU rules.

Nevertheless, the ECB's policy framework provides stability, and the gradual improvement in the manufacturing PMI indicates tentative signs of recovery. The success of ongoing diversification efforts and the resolution of immediate political challenges will be crucial in determining whether the euro area can navigate these headwinds while maintaining its position in an increasingly fragmented global economy.

The combination of modest growth momentum, controlled inflation near the ECB's 2% target, and a resilient labor market suggests that the central bank will maintain its current policy stance. The deposit rate is likely to remain at 2.0% until the end of 2025, followed by a narrowly expected 25bps rate cut in 2026. Nevertheless, the fragile nature of the recovery, coupled with external trade risks and uneven performance across member states, means policymakers must remain vigilant in navigating the balance between supporting growth and maintaining price stability.

3. Germany

Germany's Grand Ambitions, but only Modest Progress

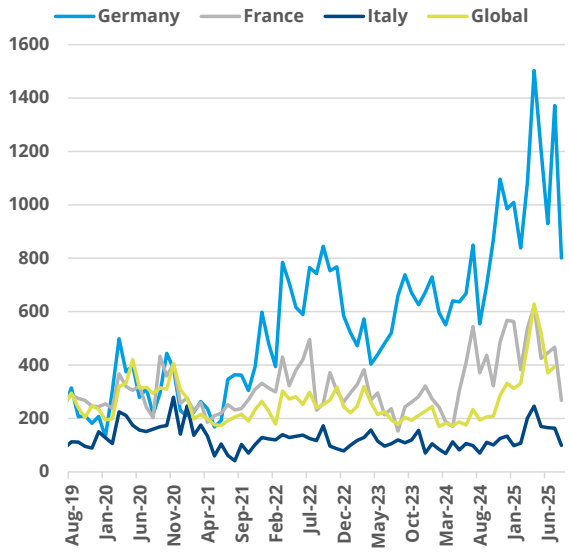
The autumn of 2025 in Germany tells the story of an economy stuck between structural decline and tentative renewal. While Chancellor Friedrich Merz's ambitious €500 billion infrastructure program has delivered more hope than tangible results thus far, German firms are grappling with the harsh realities of tariff wars and deindustrialization.

The constitutional reform adopted in March 2025 marked Germany's most significant fiscal shift in decades. The infrastructure fund, equivalent to 11.6% of 2024 GDP, operates outside the traditional debt brake constraints, targeting areas such as transportation, healthcare, energy, education, digitalization, and defense. €100 billion is earmarked specifically for local public investment, while defense spending above 1% of GDP is completely exempt from fiscal restrictions.

Yet, implementation remains painfully slow. Detailed investment plans are not expected until 2026. The draft budget for 2026 has provided some clarity, with a total spending proposal of €520.5 billion and additional spending from special funds, bringing the total to €630 billion. Although domestic policy uncertainty has declined since the election (see figure 13), implementation delays continue to cloud the outlook. Business dynamism initiatives, such as reducing administrative burdens, digitizing public administration, and simplifying licensing regulations, remain largely aspirational rather than operational.

Figure 13: German economic policy uncertainty highest among major European economies

Policy uncertainty indices in absolute terms



Sources: FRED Economic Data, Creditreform Rating

The Merz Government's Troubled Autumn

The promised "autumn of reform" has devolved into bitter coalition warfare. By August, two-thirds of Germans expressed dissatisfaction with Merz's performance, and his approval ratings plummeted to 32%. The coalition is facing a staggering €172 billion budget shortfall for the years 2027 to 2029, which has forced painful debates over increasing the pension age, cutting welfare, and raising taxes.

Internal tensions between Merz's pro-business agenda and his SPD partners' priorities to protect workers have led to weak agreements instead of clear decisions so far. Power-grid fee reductions have been smaller than promised and electricity tax cuts apply only to specific sectors. Finance Minister Klingbeil effectively wields veto power over CDU proposals, making it difficult for Merz to please his conservative supporters without upsetting coalition partners.

EU-US Trade Deal: Fragile Relief for German Automotive

The provisional EU-US trade agreement offers modest relief to Germany's struggling automotive sector by reducing tariffs from 30% to 15%, which could save millions of dollars in duties per month. However, the situation remains delicate. Trump's threats of new tariffs cast doubt on the agreement's durability. Moreover, German carmakers face deeper challenges than just tariffs. They are struggling to transition to electric vehicles without controlling battery technology and are heavily reliant on Asian suppliers. Meanwhile, European EV demand appears to be rather volatile, and Chinese competitors are becoming more aggressive. The sector's crisis extends beyond trade policy and reflects Germany's broader decline in industrial competitiveness.

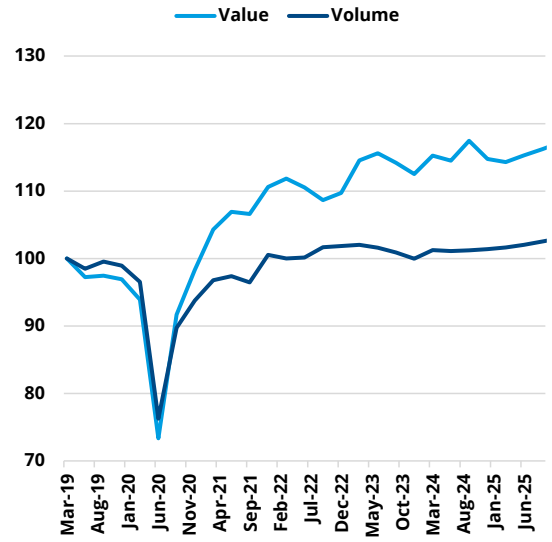
Manufacturing Output Weakens, but Value Added Remains Resilient

In early 2025, German firms had front-loaded exports to preempt tariff hikes, generating a somewhat biased first-quarter expansion of 0.4%. However, by April, exports to the US had fallen sharply by 10.5% m-o-m, dragging industrial production to pandemic-era lows. In June 2025, production contracted by 1.9% m-o-m, returning to levels last seen in May 2020.

Although manufacturing production volumes have declined significantly, the sector's gross value added has shown greater resilience. In fact, the first quarter saw a rise in gross value added despite output challenges, suggesting that German manufacturers have cushioned their profitability by shifting toward higher-value activities even as overall volumes weakened (see figure 14).

Figure 14: Value-added performance in manufacturing remained strong

Gross value added and gross volume added, 2019=100



Sources: Federal Statistical Office, Creditreform Rating

Investments Revival on the Horizon

At the beginning of 2026, we think Germany should see the first signs of an investment revival after three years of decline. Although overall activity will likely remain stagnant in 2025, improved fiscal incentives and targeted public spending are expected to generate momentum beginning in 2026. The federal government's new "investment booster" provides enhanced tax depreciation options, giving firms greater liquidity to reinvest.

We project equipment investment growth to rise significantly to levels beyond 5% in 2026 and 2027 respectively. This increase is driven by stronger defense spending, rising order backlogs in mechanical engineering, and renewed global demand. Together with the €500 billion infrastructure and climate fund, these measures mark a turning point, laying the groundwork for a broader economic recovery led by a resurgence in the private sector.

Fragile Recovery Ahead

We see policy uncertainty as the main obstacle to Germany's recovery in 2025. Ambiguity over fiscal measures and international trade, particularly the impact of US tariffs, has stalled momentum, leaving growth prospects nearly nonexistent. Business sentiment reflects this uncertainty, with weak exports, restrained investment, and subdued consumer demand highlighting the fragile environment.

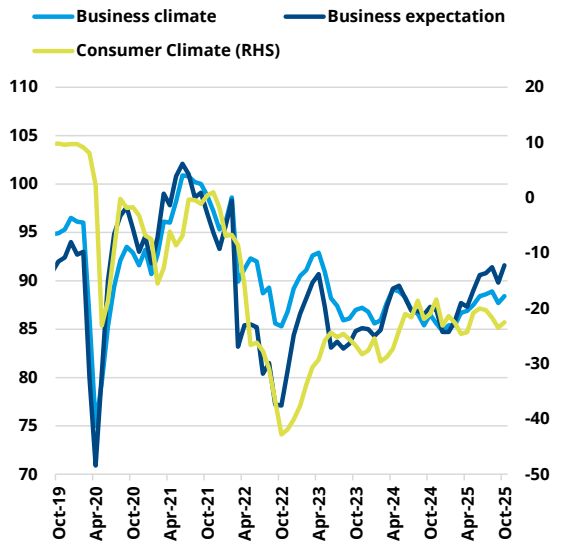
We project that GDP will only grow by 0.2% this year. Tariff pressures continue to have a significant negative impact on the economy, and their cumulative effect could persist until 2027. Although recent increases in industrial output in July and August, driven by the machinery, automotive and pharmaceutical sectors, have provided temporary relief, production trends remain volatile and dependent on external conditions. Critical supply lines appear to be at risk, as evidenced by Nexperia's recent decision to temporarily stop shipping essential semiconductors, which are vital for Germany's automotive industry. Without these chips, production lines at major car manufacturers could grind to a halt, threatening to wipe out the already modest growth forecast.

The outlook beyond 2025 hinges on fiscal policy. If implemented effectively, expansionary measures could lift growth to 0.9% in 2026 and 1.5% in 2027. However, delays in infrastructure spending cast doubt on whether these gains will materialize as planned. Adding to these downside risks are Germany's persistent fiscal doubts; budgetary uncertainty could dampen external demand, weighing heavily on our forecast. Additionally, without deeper structural reforms, the risk is that fiscal support becomes a temporary buffer rather than a catalyst for lasting competitiveness.

As the final quarter of 2025 begins, Germany is at a crossroads. Although domestic demand needs to play a greater role, consumer confidence remains low. In October, it was at -22.5 points (see figure 15). Business expectations have shown tentative improvement since March, indicating optimism surrounding fiscal stimulus. Nevertheless, Europe's largest economy requires more than deficit spending; it needs structural agility and political clarity to translate stimulus into sustainable growth.

Figure 15: Elevated policy uncertainty dampened consumer confidence

Ifo Business Indices and Gfk Consumer Index



Sources: Ifo business surveys, Gfk, Creditreform Rating

Figure 16: We have revised our growth forecasts

In percent, IMF forecasts for the World, UK, US, and China, Creditreform forecast for euro area

	2010-19	2021	2022	2023	2024	2025e	2026e
World	3.7	6.5	3.5	3.3	3.3	3.2	3.1
Euro area	1.4	6.1	3.5	0.4	0.9	1.2	1.0
Germany	2.0	3.2	1.8	-0.2	-0.2	0.2	0.9
France	1.4	6.9	2.6	0.9	1.1	0.7	0.9
Italy	0.3	8.3	4.0	0.9	0.7	0.5	0.8
Spain	1.1	6.4	5.8	2.5	3.2	2.9	2.0
UK	2.0	8.7	4.3	0.1	1.1	1.3	1.3
US	2.4	5.8	1.9	2.5	2.8	2.0	2.1
China	7.7	8.6	3.1	5.4	5.0	4.8	4.2

Sources: Creditreform Rating, IMF, Eurostat

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