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Euro Area Outlook 2025: Under Pressure

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- We expect 2025 to be another challenging year for the Euro area economy. First, US President-elect Trump's plan to impose tariffs is likely to weigh significantly on growth, with much of the drag stemming from higher trade policy uncertainty. Second, the negative trade effects are likely to be reinforced by continued structural headwinds in the manufacturing sector, including high energy prices and competitive pressures from China. Third, we expect ongoing fiscal consolidation across the Euro area.
- That said, we see several reasons for continued growth, rather than a Euro area recession. Growth momentum remains modestly positive; consumption is likely to recover given rising real incomes and elevated savings; and we expect the South to show continued resilience compared with the North.
- We therefore forecast Euro area growth of 0.2% in Q1 and Q2, 0.1% in Q3 and 0.2% in Q4. This results in area-wide growth of 0.8% for 2025, notably below the 1.2% consensus. We look for the weakest growth in Germany (0.3%), followed by Italy (0.6%) and France (0.7%), with Spain again outperforming notably (2%).
- Given our subdued growth outlook, we expect the unemployment rate to rise next year, reaching 6.7% by early 2026. We see wage growth slowing to 3.2% by 2025Q4, as pay catch-up completes and the labour market softens. Underlying inflation has resumed its downward trend since the summer, and we look for headline and core inflation to return to 2% sustainably by end-2025, driven by a further cooling in services inflation.
- Subdued growth and continued disinflation imply rising pressures for the ECB to lower rates and we expect the Governing Council to cut the deposit rate to 1.75% in July. We believe that 25bp cuts remain more likely than 50bp steps but see a low hurdle for a step-up in the pace in Q1 if the growth and inflation data disappoint notably. Our probability-weighted rate path therefore remains below market pricing.
- Next year will also bring a number of political and fiscal risks. A change in government in Germany raises the prospect of a fiscal expansion, but we would expect the Conservatives to support only limited additional fiscal measures with negligible growth effects before 2026. France will attempt to cut the deficit sharply, but significant fiscal slippage looks likely and renewed legislative

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elections are possible after July 2025. Italy's government is likely to stick to its ambitious fiscal targets, providing a constructive backdrop for BTPs. Although Spain will likely produce a larger deficit than planned because of the flooding in Valencia, its debt ratio remains on a downward path.

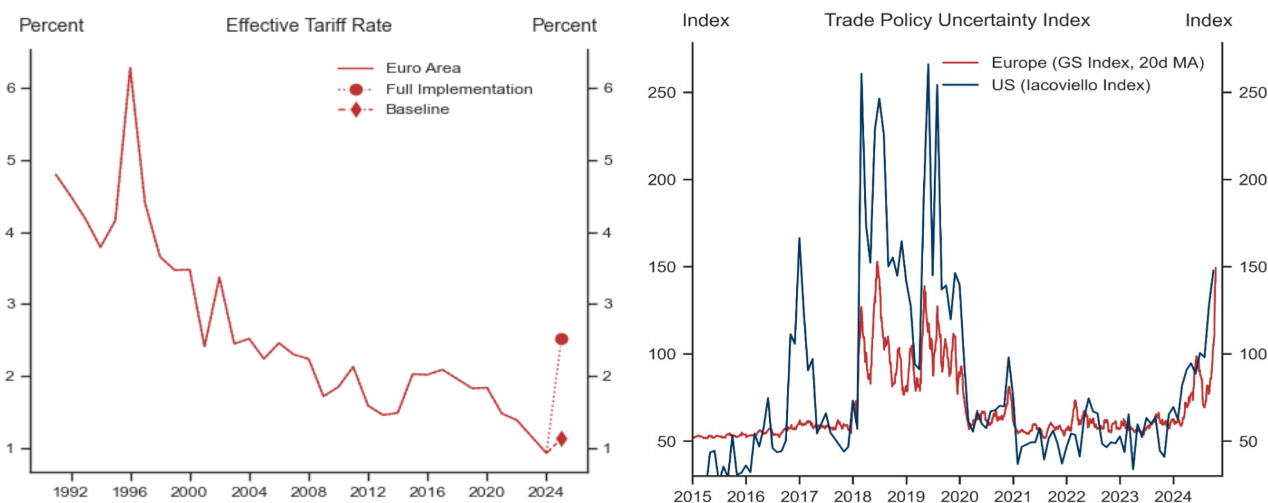
- The structural outlook for the Euro area economy remains challenging. We currently see Euro area potential growth at 1% but expect trend growth to slow to 0.8% by 2030. While Mario Draghi's report identified areas of policy action to raise growth in Europe, we see significant hurdles for implementation, especially around additional joint EU funding. However, we see scope for additional EU defence spending and some regulatory harmonisation from next year.

Euro Area Outlook 2025: Under Pressure

We expect 2025 to be another challenging year for the Euro area economy.

First, US President-elect Trump's plan to impose tariffs is likely to weigh significantly on Euro area growth. While the size of any US tariffs is highly uncertain, our analysis suggests that much of the growth drag will come from higher trade policy uncertainty, rather than the actual tariff increases themselves (Exhibit 1). Trade policy uncertainty measures have already been on the rise.

Exhibit 1: Higher Trade Policy Uncertainty to Weigh on Growth

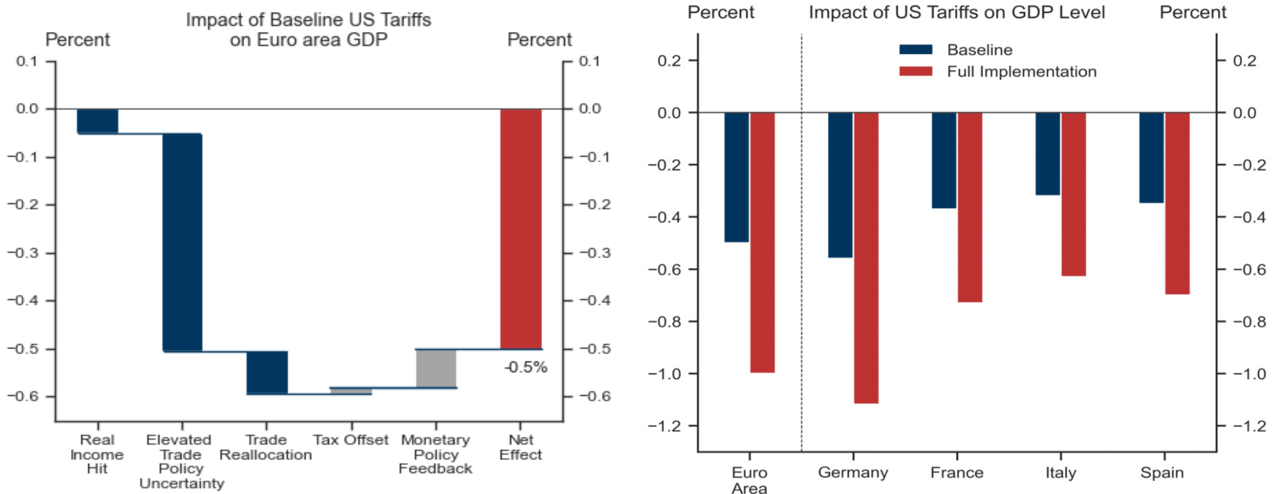


In the left chart, full implementation assumes a 10% tariff on all US imports (including from Europe) and baseline assumes a more limited set of tariffs on Europe, including on autos-related imports, and tariffs on China. In the right chart, we plot the European TPU Index as of the 13th of November 2024.

Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg

Our baseline is that Trump imposes targeted tariffs on Europe, focusing on autos-related exports. We estimate that elevated trade tensions will lower the level of area-wide real GDP by 0.5%, including effects on real incomes, trade reallocation and policy offset (Exhibit 2, left). We expect the growth hit to concentrate over one year, starting in 2025Q1 with a peak growth drag in Q3. The cumulative hit is likely to be largest in Germany (0.6%) and smallest in Spain and Italy (0.3%), given differences in trade openness and manufacturing intensity (Exhibit 2, right). Our analysis suggests that the GDP hits will be twice as large in a downside scenario where Trump imposes a 10% across-the-board tariff on the EU.

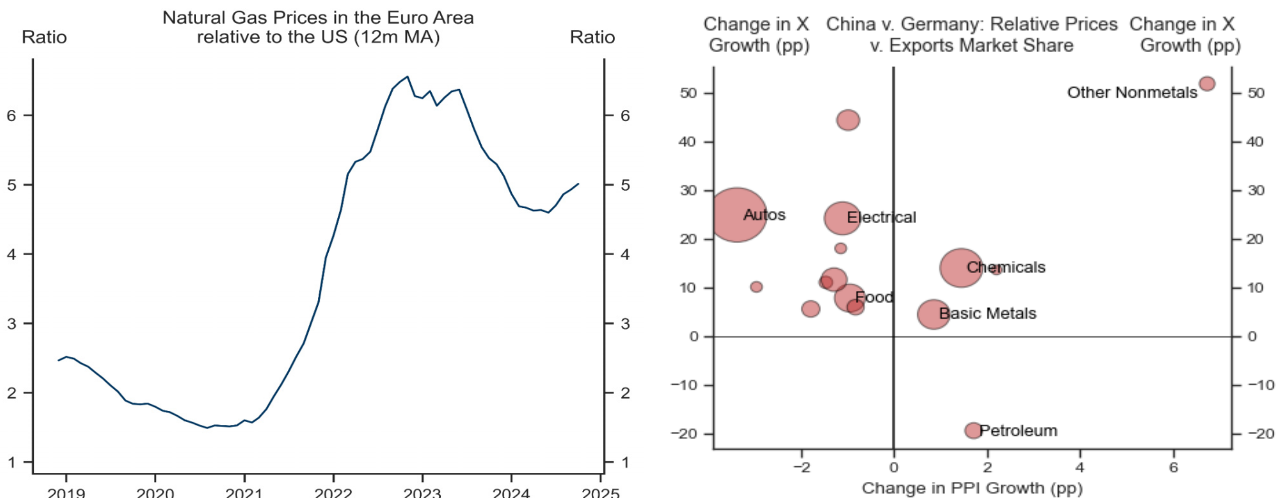
Exhibit 2: We Expect a 0.5% GDP Hit from Trade Tensions



Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, we expect the negative trade effects to be reinforced by continued structural headwinds in the manufacturing sector. Energy prices have fallen markedly from their peak, but European gas prices remain notably above pre-2022 levels and materially higher than in the US (Exhibit 3, left). Meanwhile, China has emerged as a key competitor to European goods production, materially gaining market share in industries that have seen cost increases (Exhibit 3, right). As a result, we see a continued structural headwind to the industrial recovery next year, particularly in Germany.

Exhibit 3: Structural Headwinds from Energy Prices and China Competition



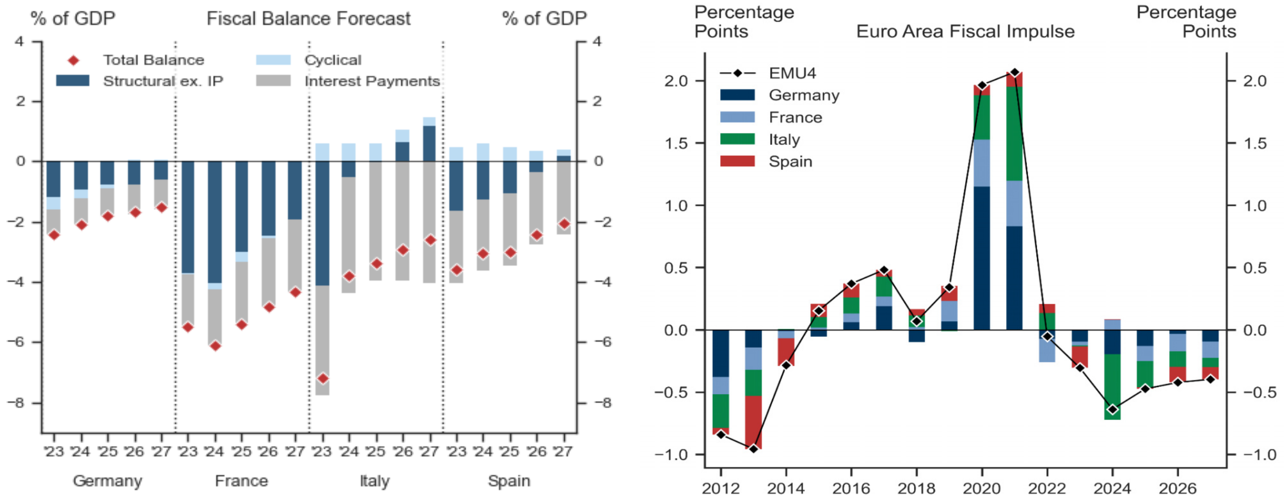
The size of the bubbles in the right chart represents the German export share out of total German exports for each sector. The growth differentials are calculated as the difference between Chinese and German sectoral exports and PPI yoy percentage growth as of July 2024.

Source: Goldman Sachs Global Investment Research, Haver Analytics

Third, we expect ongoing fiscal consolidation in 2025 with an area-wide growth drag of 0.5pp (Exhibit 4). In Germany, the constitutional debt brake will continue to constrain fiscal space; France plans to embark on a major fiscal adjustment; Italy has promised a faster fiscal consolidation than previously expected; and while Spain is likely to deliver a

larger-than-expected deficit due to the flooding in Valencia, it remains on track to deliver a steady adjustment based on the 2024 three-year plan. Fiscal support through the European Recovery Fund remains positive in 2025, but the boost is not enough to overturn the contractionary stance of national fiscal policies.

Exhibit 4: Ongoing Fiscal Consolidation

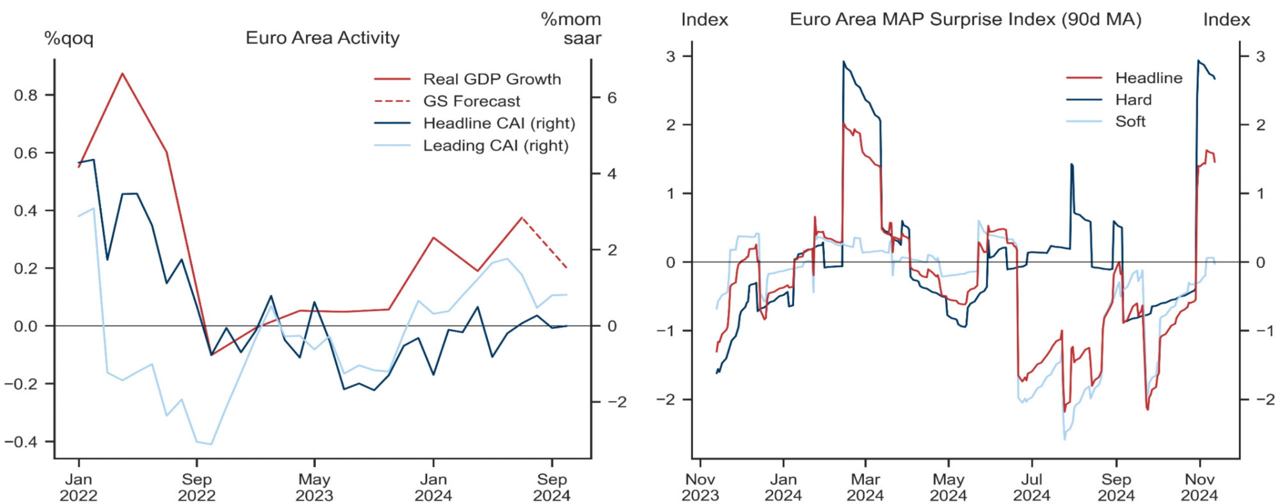


Source: Goldman Sachs Global Investment Research, Haver Analytics

That said, we see several reasons for continued growth, rather than a Euro area recession.

First, area-wide growth momentum is modest but positive (Exhibit 5). The survey data remain weak, with the PMIs at slightly contractionary levels, our CAI around zero and a loss of momentum in the forward-looking surveys. But the recent data have surprised to the upside and the hard data look more constructive, with a surprisingly firm 0.4% gain in Q3 real GDP. Considering the likely payback from the Olympics in France, we are tracking Q4 GDP at 0.2%, with the annualised underlying trend around 1%.

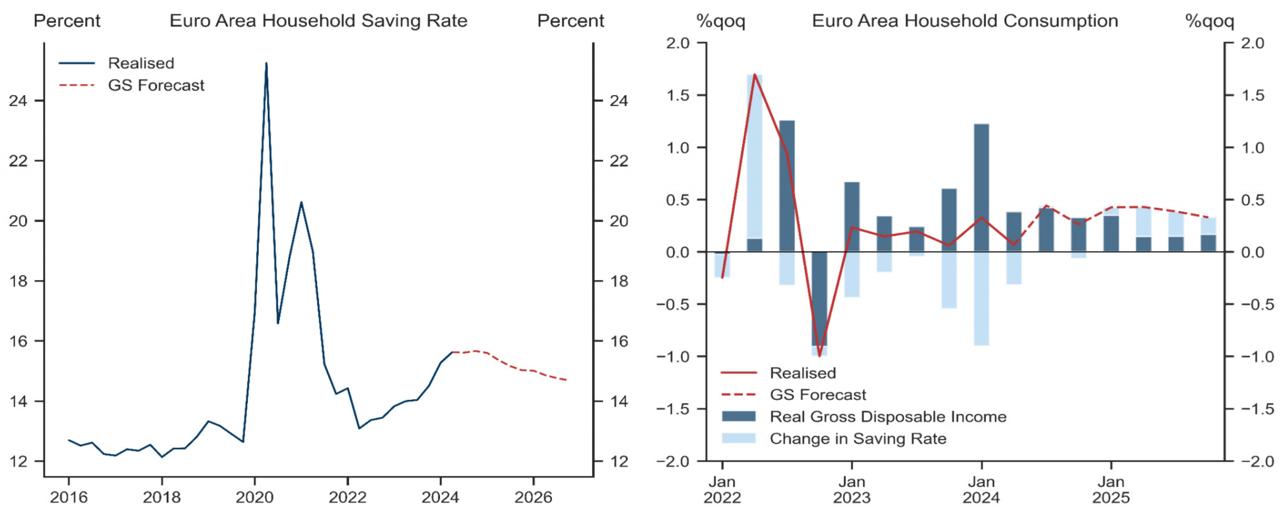
Exhibit 5: Modest But Positive Growth Momentum



Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, we expect consumption to recover given rising real incomes and elevated savings (Exhibit 6). Lower headline inflation and ongoing firm nominal wage growth suggest that real disposable income will grow by around 1% on a Q4/Q4 basis in 2025. While the increase in the household saving rate in H1 is difficult to explain, we still expect the saving rate to fall gradually next year as deposit rates fall and savings behaviour normalises. As a result, we look for significant gains in consumption, up 1.6% on a Q4/Q4 basis in 2025.

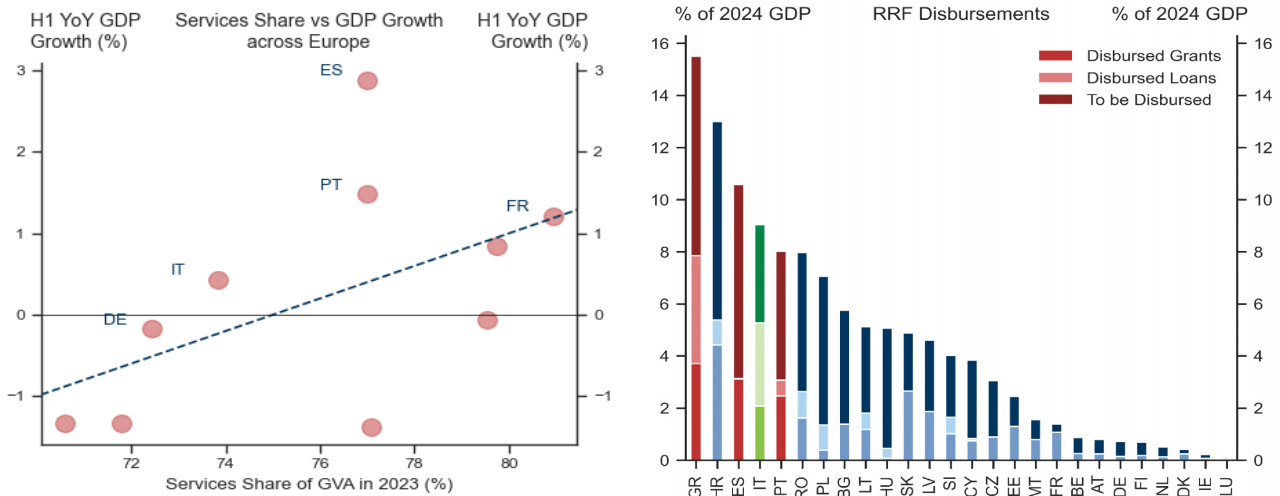
Exhibit 6: A Gradual Recovery in Consumption



Source: Goldman Sachs Global Investment Research, Haver Analytics

Third, we see continued growth resilience in the South (Exhibit 7). The economic outperformance of Spain, Portugal and Greece has been striking this year, driven by firm services growth (responsible for a greater share of overall activity than in the North), elevated immigration (underpinning strong employment growth) and investment support from the Recovery Fund. We look for growth moderation across the South next year, but we see greater resilience to trade tensions and competitive pressures from China than in the North.

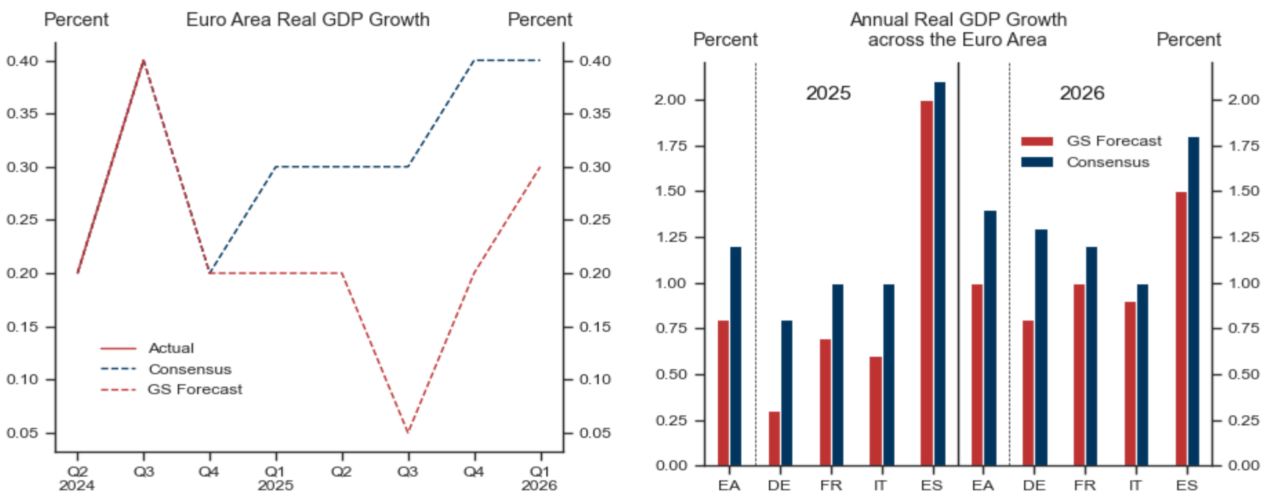
Exhibit 7: Southern Resilience



Source: Goldman Sachs Global Investment Research, Haver Analytics, European Commission

Taken together, we therefore look for weak but positive Euro area growth in 2025 (Exhibit 8). At the Euro area level, we forecast 0.2% in Q1 and Q2, 0.1% in Q3 and 0.2% in Q4. This results in annual average growth of 0.8% for 2025, notably below the 1.2% consensus. We look for some improvement in growth in 2026 as the effect of the trade tensions fade with 1% growth, but our forecast remains sharply below the 1.4% consensus. Looking across countries, our forecast is weakest for Germany (0.3% for 2025, notably below consensus) and strongest for Spain (2% next year, close to consensus).

Exhibit 8: Subdued Growth Ahead



Source: Goldman Sachs Global Investment Research, Haver Analytics, Bloomberg

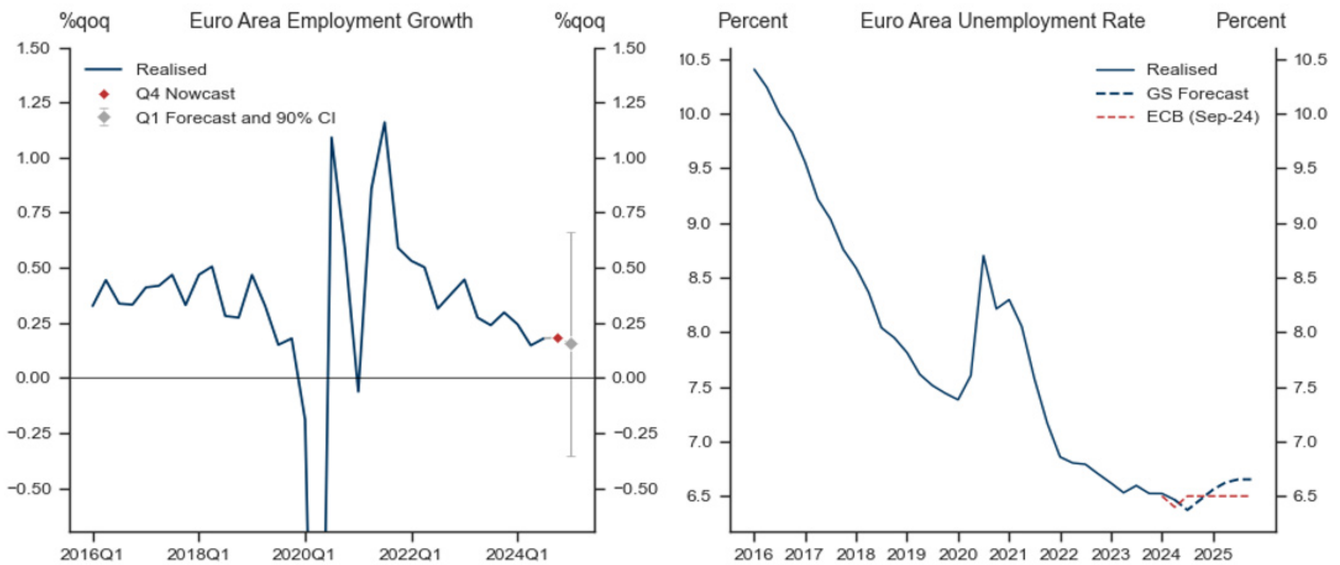
We see two main risks to our forecast. On the positive side, a faster normalisation in the household saving rate could drive stronger consumption growth than expected. On the negative side, President-elect Trump's policy agenda could weigh more sharply on the Euro area economy, via blanket tariffs on Europe and negative sentiment effects around the war in Ukraine. We see a 30% probability that the Euro area enters a

significant recession—with material labour market deterioration—over the next year.

Disinflation on Track

Although labour markets have remained resilient despite subdued GDP gains—with area-wide unemployment at an all-time low of 6.3%—measures of employment growth are slowing steadily (Exhibit 9). Following a gain of 0.2% in Q3, our nowcast model tracks area-wide employment growth at 0.2% in Q4 and 0.1% in Q1, driven by weaker employment surveys. Given our subdued growth outlook, we expect the unemployment rate to drift up through next year, reaching 6.7% by early 2026.

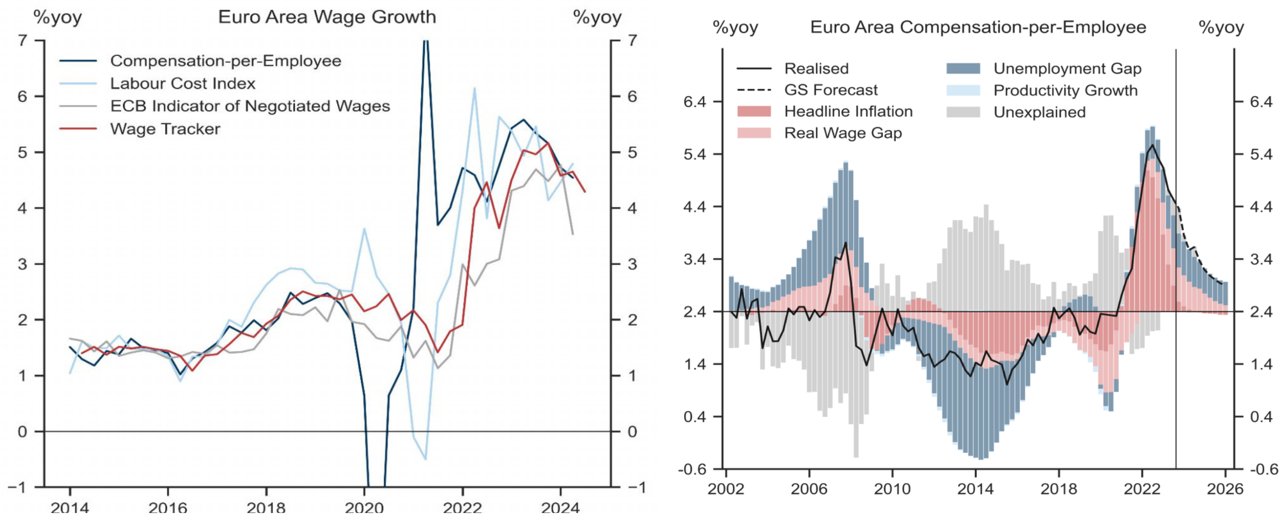
Exhibit 9: Steady Labour Market Softening



Source: Haver Analytics, Goldman Sachs Global Investment Research

A softening labour market supports our view of cooling wage growth (Exhibit 10). Following notable upside surprises early in the year, pay pressures have now cooled meaningfully, with our area-wide wage tracker running at 4.4% in Q3. Our analysis suggests that much of the remaining strength in wage growth reflects catch-up effects, which are likely to fade in coming months as the level of real wages realigns with productivity. Consistent with this, the forward-looking pay indicators point to slowing ahead, including wage surveys (such as the Indeed wage tracker) and national wage data in countries with short durations of pay agreements (such as France). We therefore expect wage growth to slow to 3.2% by 2025Q4, faster than foreseen in the ECB's staff projections.

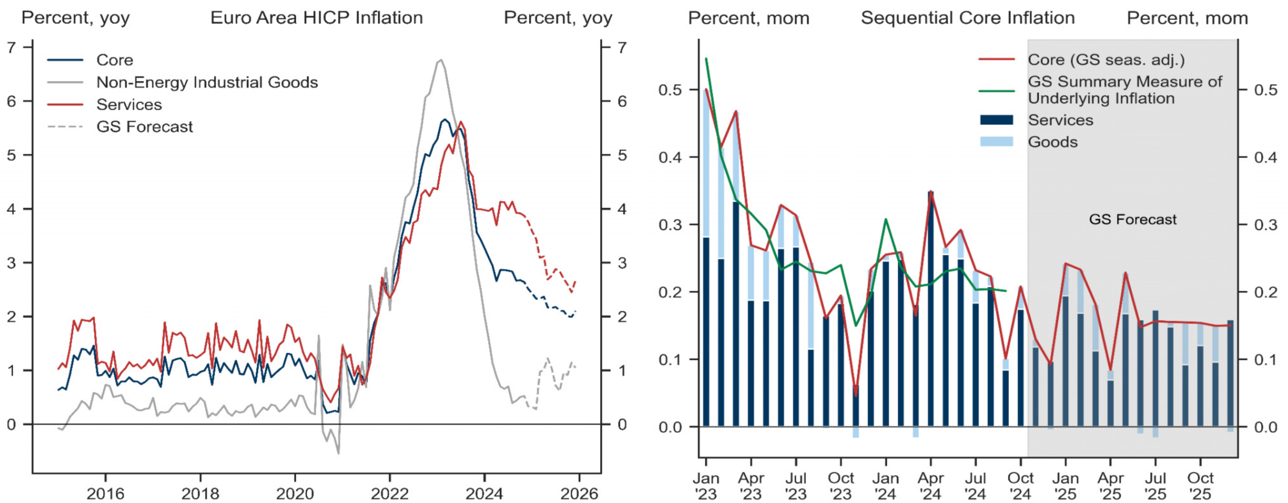
Exhibit 10: Wage Growth to Return to 3% in 2025



Source: Haver Analytics, Goldman Sachs Global Investment Research

Following sticky services inflation in H1, core inflation has resumed its downward trend since the summer (Exhibit 11). Our summary measure of underlying inflation—which combined alternative trend inflation indicators—now stands at 2.6%yoy, with the sequential monthly momentum down to 0.20% (from 0.24% in the middle of the year). Given residual seasonality, we expect further slowing during the rest of the year, with annual core inflation reaching 2.5% in December.

Exhibit 11: Disinflation is on Track

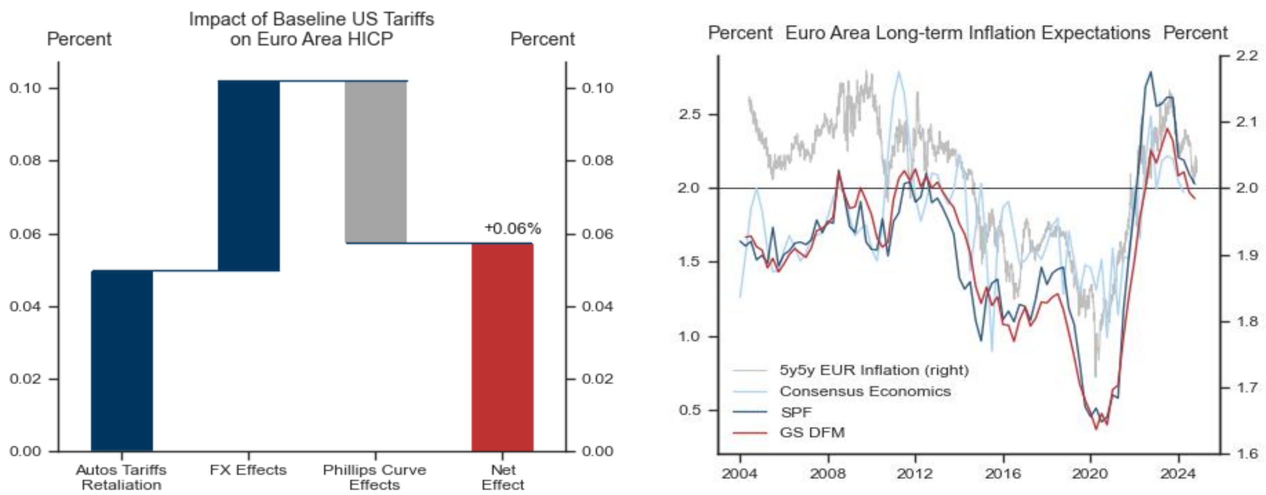


Source: Haver Analytics, Goldman Sachs Global Investment Research

We then see headline and core inflation returning to 2% sustainably next year, driven by subdued gains in goods prices and a further cooling in services inflation. In particular, we look for a further unwind in inflation of key backward-looking components, including indexation for rents and catch-up to costs for insurance. Moreover, we expect cyclical categories—including restaurants—to show further disinflation, as labour markets soften, wage growth slows and demand remains subdued. We expect modest upward inflation pressure from trade tensions with the US, with the EU retaliating against a

limited number of US tariffs (Exhibit 12, left). Taken together, we forecast year-over-year core inflation at 2.2% in Q2 and 2% in Q4 next year, consistent with inflation expectations around target (Exhibit 12, right).

Exhibit 12: We Do Not Expect a Sustained Inflation Undershoot



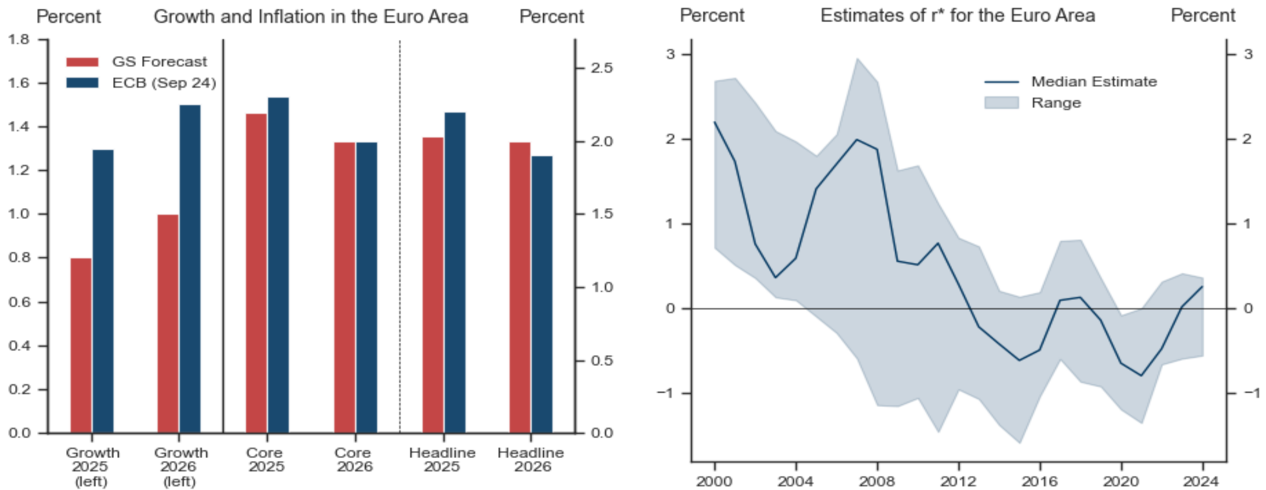
Source: Haver Analytics, Goldman Sachs Global Investment Research

The outlook for inflation, however, remains notably uncertain. On the upside, price resets in Q1 and further Euro depreciation could imply stickier-than-expected inflation pressures. On the downside, more pronounced labour market weakening could slow services inflation more than expected and US tariffs on China could incentivise China to sell excess goods at reduced prices into Europe.

More Pressure for ECB to Cut

Given subdued growth and continued disinflation, we see rising pressures for the ECB to lower policy rates next year (Exhibit 13). Our forecasts are now notably below the September staff projections on growth (0.8% vs 1.3% for 2025) and inflation (2% vs 2.2%), pointing to a significant downgrade at the December meeting and continued sequential rate cuts into next year. Existing studies point to a real equilibrium rate (or r*) in the 0-0.5% range, implying a 2-2.5% nominal neutral policy rate. Given our forecast for weaker growth and inflation, we expect the Governing Council to take rates slightly below neutral with 25bp cuts at every meeting to 1.75% in July.

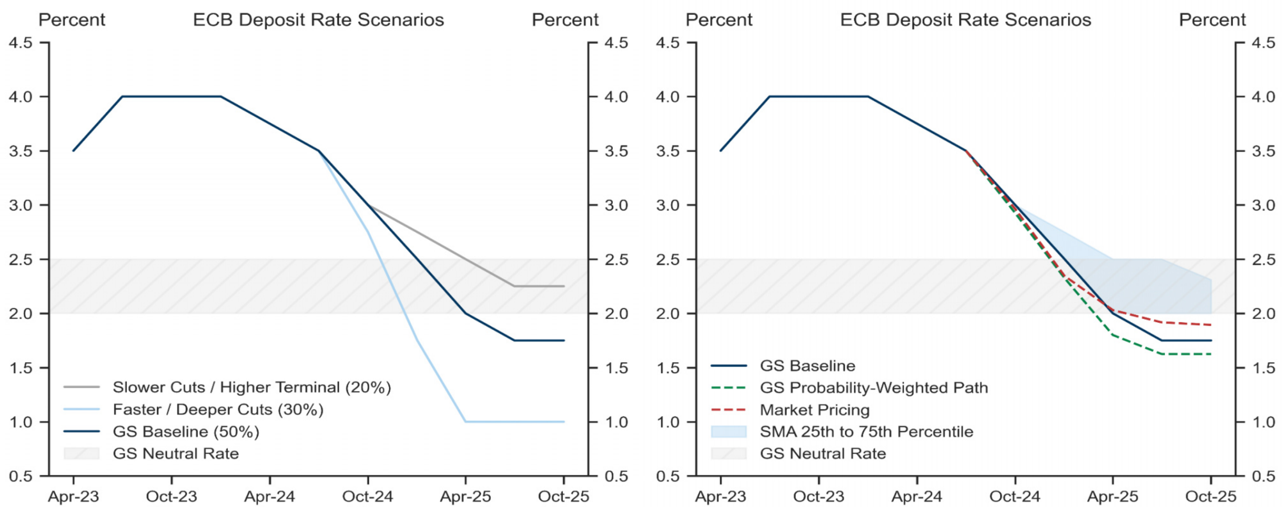
Exhibit 13: Pressures for Continued Sequential Cuts



Source: Haver Analytics, Goldman Sachs Global Investment Research

While a return to quarterly cuts is possible if the economy turns out to be more resilient than expected, we see risks skewed towards faster and deeper cuts (Exhibit 14). Given better-than-expected activity data in recent weeks and desire to see details behind President-elect Trump's policy agenda, we believe that a 25bp cut remains notably more likely than a 50bp step in December. That said, we see a low hurdle for a step-up in the pace in Q1 if the growth and inflation data disappoint markedly.

Exhibit 14: Risks Skewed Towards Faster and Deeper Cuts



Source: Haver Analytics, Goldman Sachs Global Investment Research, Bloomberg

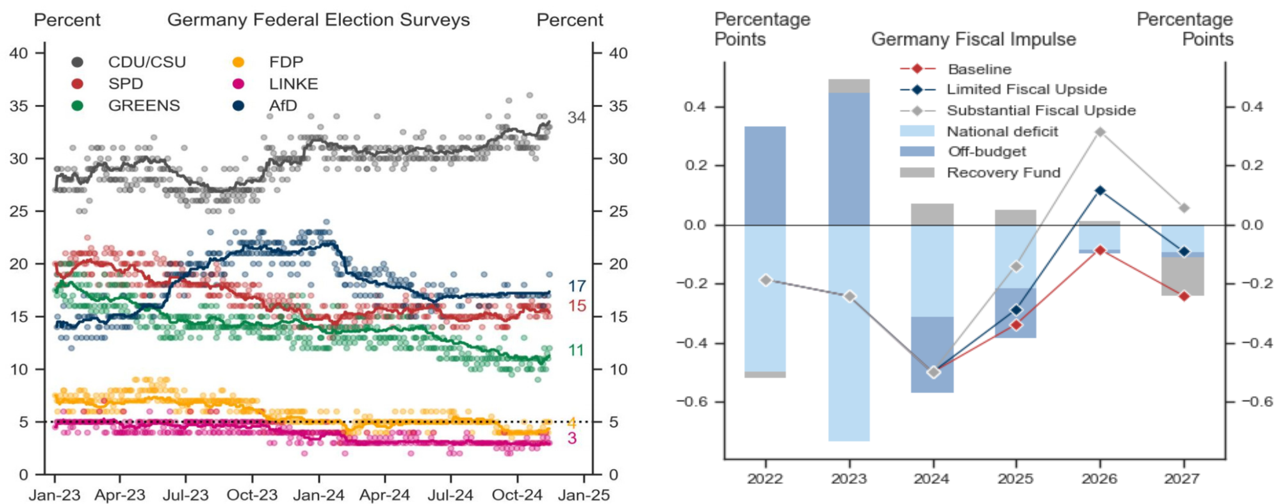
Turning to our stylised scenarios, we place a 50% probability on our baseline of sequential cuts to 1.75%, 20% on a return to quarterly cuts to a higher terminal rate and 30% on a deeper cutting cycle. We therefore continue to see downside risk to our modal terminal rate forecast, with our probability-weighted path below market pricing.

Political and Fiscal Risks

Next year will bring a number of political and policy risks.

First, Germany will face early elections next year, with the vote likely to be held on February 23rd. Current polls show the conservative CDU/CSU in the lead, suggesting that a "grand coalition" (with the social democrats, SPD) is most likely, followed by a "black-green" coalition (with the Greens). An agreement on the 2025 budget now seems unlikely, which could entail a slight fiscal contraction in 2025H1, but the new government could then pass a supplementary budget to provide an offsetting boost in H2. While a change in government raises the prospect of more expansionary fiscal policy given Germany's fiscal space, we would expect the Conservatives to support only limited additional fiscal measures. A plausible scenario could entail additional investment worth 0.5% of GDP per year via reform of the debt brake, which could support growth modestly from 2026 (Exhibit 15, right). A more substantial upside scenario—via activation of the debt brake escape clause and/or additional off-balance-sheet funds—might provide fiscal support worth 1% of GDP.

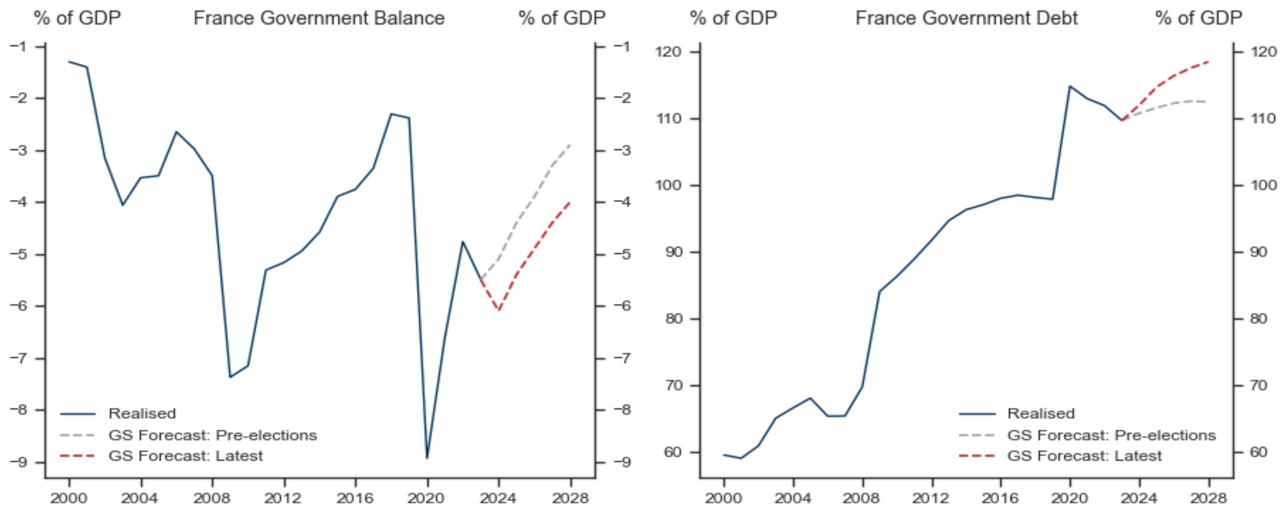
Exhibit 15: Limited Scope for More Fiscal Support in Germany



Source: Haver Analytics, Goldman Sachs Global Investment Research, Forsa

Second, France aims to cut the public deficit to 5% of GDP in 2025 (from 6.1% this year). The magnitude of the proposed consolidation and the reliance on tax increases gives us little confidence that the deficit target will be met, and we now look for a deficit of 5.4% next year. As a result, we expect the debt-to-GDP ratio to rise to 118% by 2027. While the fiscal and economic outlook is becoming more challenging, we see scope for some political stability in the near term, and our base case remains for PM Barnier's government to pass the budget bill before year-end. We continue to see significant uncertainty thereafter, however, with new legislative elections becoming possible after July 2025.

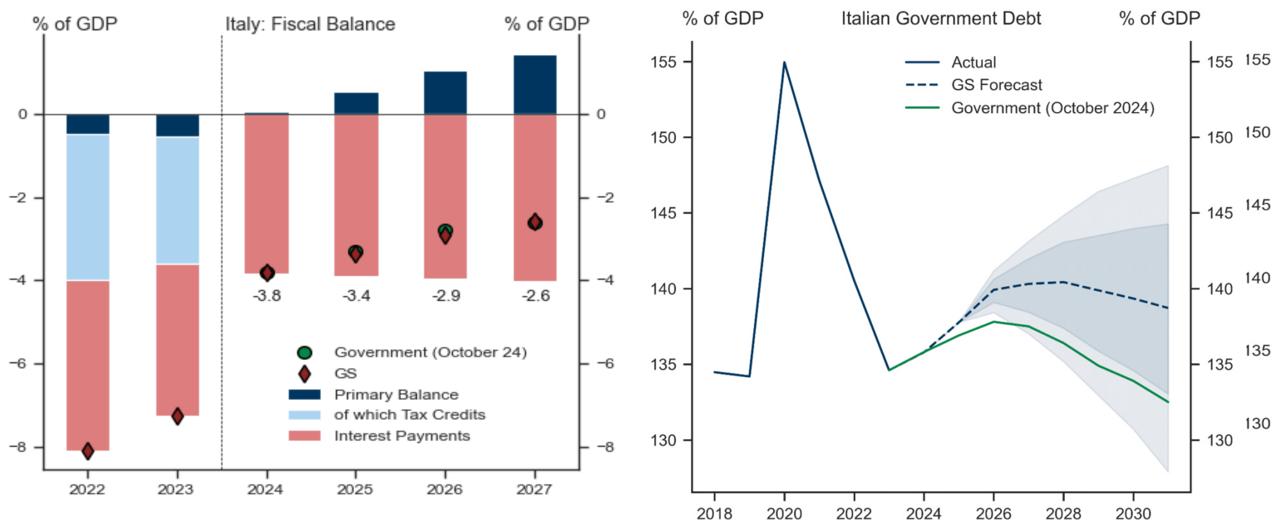
Exhibit 16: Fiscal Slippage in France



Source: Haver Analytics, Goldman Sachs Global Investment Research, Direction générale du Trésor

Third, the Italian government has lowered its deficit targets for the coming years, setting debt-to-GDP on a decreasing path from 2027. The government's plans would take Italy out of the Excessive Deficit Procedure (EDP) in 2026 and remain compliant with European fiscal rules afterwards. Rising real sovereign borrowing rates and slow growth, however, will make it challenging for Italy to remain compliant with fiscal rules in the medium term. Our forecast is that fiscal consolidation will be slightly slower than in the government plan from 2026 and debt-to-GDP will start to decrease, but a bit more slowly and only from 2027 given cooling nominal growth. Nonetheless, we expect the government to stick to its targets, providing a constructive environment for BTP valuation in the coming quarters.

Exhibit 17: Ambitious Fiscal Targets in Italy



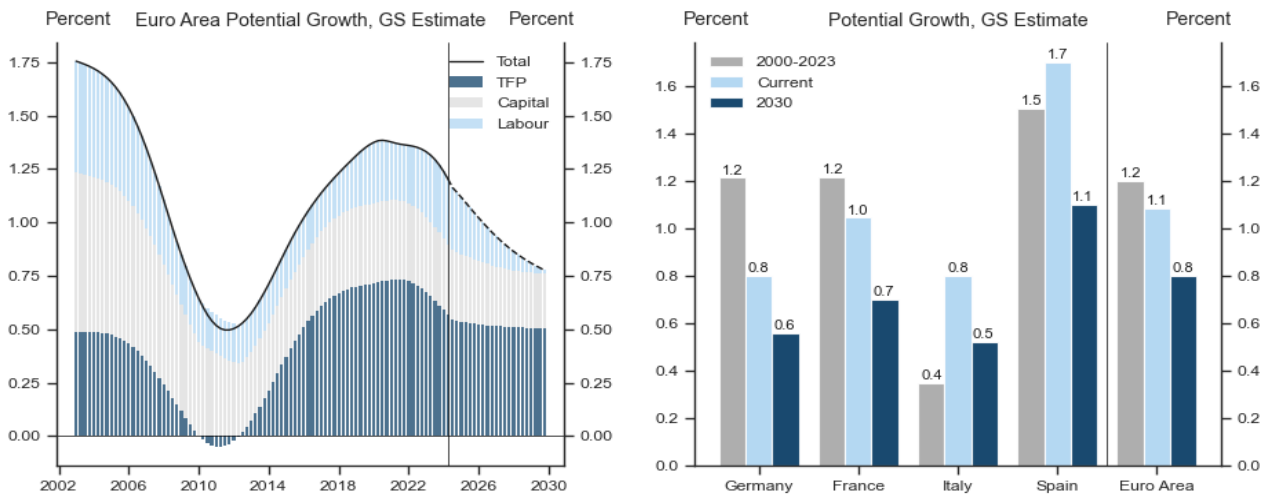
Source: Haver Analytics, Goldman Sachs Global Investment Research, Dipartimento del Tesoro

Little Progress on Structural EU-Wide Issues

The structural outlook for the Euro area economy remains challenging. In addition to

high energy costs, trade tensions and China competition discussed above, Europe has seen disappointing productivity growth and faces material headwinds from its ageing population. As a result, we currently estimate Euro area potential growth at 1%—down from 1.2% historically—and expect trend growth to slow to 0.8% by 2030 (Exhibit 18). Looking across countries, we estimate current potential growth to be 0.8% in Germany, 1% in France, 0.8% in Italy and 1.7% in Spain, but expect all countries to experience further structural slowing by 2030.

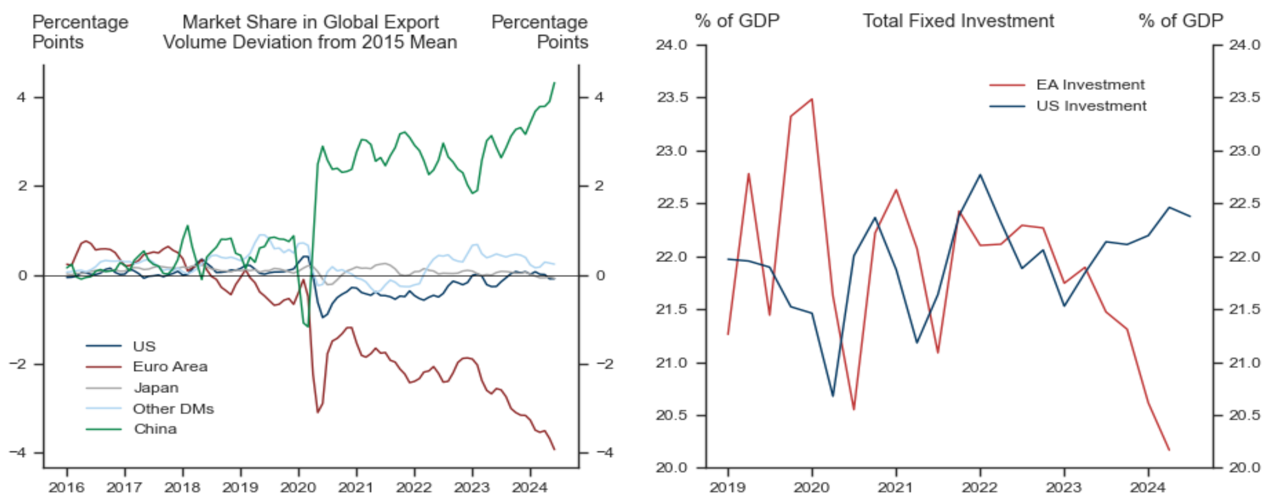
Exhibit 18: We See Potential Growth Slowing to 0.8% in 2030



Source: Haver Analytics, Goldman Sachs Global Investment Research

Mario Draghi's competitiveness report identified areas of policy action to raise growth in Europe. First, sluggish productivity has to be tackled in the sectors where it has been lagging behind and, therefore, it needs to be addressed with industrial policies at the sector level, in addition to general reforms. Green technology and defence offer primary examples. Second, raising productivity growth requires large-scale investment, which the report estimates at EUR 750-800bn annually, about 4.5% of EU GDP.

Exhibit 19: The European Competitiveness Gap



Source: Haver Analytics, Goldman Sachs Global Investment Research

While additional policy support for investment would be key to underpinning the European economic recovery, we see significant hurdles for implementing Draghi's recommendations. It is unlikely, in our view, that the EU will be able to scale up joint EU funding. However, we believe that additional EU defence spending is likely and some regulatory harmonisation could take place starting from next year.

European Economics Team

Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Filippo Taddei, Alexandre Stott, James Moberly and Katya Vashkinskaya, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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