Marek Rozkrut
EY Chief Economist & Head of EY EMEIA Economists Unit

European Economic Outlook

EY Economic Analysis Team

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Topics

The European economy continues to grow at a modest pace, with Spain remaining a top performer and Germany lagging behind

- **The pace of real GDP growth in the euro area remained modest in the second half of 2024, at 0.2%–0.3% q/q.** While increases in real incomes have slowly begun to translate into an uptick in consumption, exports dropped as the industrial sector continued to struggle. Investment activity has remained relatively weak, weighed down by still tight monetary policy, subdued external demand, reduced profit margins, and weak business sentiment. Although government consumption and investment continued to support economic activity, fiscal policy more broadly constituted a drag on growth.
- **Economic performance continues to vary strongly across countries.**
  - Spain remains a top performer among larger economies, driven by increasing tourist inflows, government and NextGenerationEU spending, and rising employment. The manufacturing sector has also fared relatively better than in the rest of Europe, partly thanks to lower energy prices. Most other Southern and Southeastern European countries (Croatia, Bulgaria, Greece, Portugal) have exhibited relatively strong growth rates for similar reasons.
  - Headline GDP growth is also strong in Denmark and Norway, driven by a rapid expansion of a large pharmaceutical company and increasing natural gas extraction, respectively. However, underlying economic activity in these countries is subdued, similar to Sweden and Finland, with real incomes remaining below 2021 peaks and depressed housing sector activity weighing on consumer and investment spending.
  - Germany remains a key laggard, with GDP stagnating since 2021 Q4 and hovering near pre-pandemic levels. While consumer spending finally began to increase in 2024 H2, investment remains depressed amid gloomy business sentiment, exports are falling despite a modest increase in external demand, and fiscal policy does not provide much-needed respite. German struggles have a strong negative impact on its close trading partner, Austria, which remains in a recession.
  - Italy and the UK were also near the bottom of the country growth rankings, with both nations experiencing stagnant GDP in the latter half of 2024. Italy's performance diverged from other Southern European economies, impacted by fiscal consolidation and a prolonged recession in its manufacturing sector. The UK saw a normalization in activity in 2024 H2, following a very strong performance at the beginning of the year.
  - In France, GDP growth has largely mirrored the euro area average, though its pace seems to have picked up slightly in the second half of 2024. This uptick is partially attributed to the economic activity generated by the Paris Olympics, occurring amidst a backdrop of deteriorating sentiment due to political gridlock.
- **Labor market conditions seem to have stabilized, with employment growth at 0.2% q/q and unemployment rate at 6.3-6.4% in the euro area.** Vacancy rates continue to decline, pointing to gradually diminishing demand pressures and labor market mismatches. Labor supply growth is also moderating slightly amid slower gains in labor market participation. With the effects of the past inflation shock fading, euro area nominal wage growth has decelerated to 4.4% in 2024 Q3. Despite this slowdown, wage growth remains elevated and is not yet aligned with the ECB's inflation target.
- **However, labor market trends continue to diverge between countries.** In Spain, Italy, and Croatia, employment is increasing at a robust pace, and unemployment is falling from still elevated levels amid increasing labor force participation, vigorous economic activity, and significant immigration. Conversely, employment levels in Germany and many CEE countries are stagnant, with unemployment rates stabilizing at very low levels due to demographic constraints. In CEE, tight labor markets, alongside sizable public sector and minimum wage hikes, are keeping nominal wage growth above 10%. In the Nordics, where labor supply conditions are more favorable, weak economic activity has led to a cyclical labor market downturn, with falling employment and increasing unemployment.

GDP growth will accelerate modestly in the coming quarters, with Spain remaining a star performer and Germany a laggard, even as the growth gap between Southern and Central Europe gradually narrows

- **Despite a recent deterioration in business sentiment, we continue to expect that GDP growth will slowly gather pace over the course of 2025.** Monetary policy easing will support a continued uptick in consumption by prompting a reduction in savings rates, which are currently at historically high levels in the euro area, excluding the pandemic period. Lower interest rates, NextGenerationEU spending, and stronger consumer demand should bolster investment, particularly in the housing sector. Crucially, exports should finally pick up, supported by the recent depreciation of the euro and a modest acceleration in external demand. We anticipate the cyclical recovery to peak in 2026 before decelerating post-NextGenerationEU program. Following a 0.7% growth rate in 2024, we forecast the euro area's annual average GDP growth to accelerate to 1.3% in 2025 and 1.8% in 2026.

- **Performance disparities across countries are expected to persist,** even if momentum in Southern Europe's tourism and employment eases slightly, while Germany very slowly emerges from stagnation with recovering exports, growing consumption, and stabilizing investment . We project Spain's GDP to grow by 2.8% in 2025, while Germany's is anticipated to see a modest 0.5% increase. CEE countries, which experienced disappointing growth in 2024, are likely to witness a more robust recovery in 2025, with GDP growth ranging from 2.0 to3.5%. This resurgence should be fueled by an acceleration in investment and export growth, driven by increased absorption of EU funds (both NextGenerationEU and regular EU funds), a gradual recovery in Western Europe, and monetary policy easing. The Nordics are also expected to see a rebound in underlying economic activity, as rising real incomes and monetary policy easing finally translate into a pick-up in consumption and residential investment.

- **At the euro area level, labor market conditions are anticipated to remain stable,** with employment growth decelerating to 0.1% q/q amid weaker labor demand growth and mounting demographic pressures. The unemployment rate should stabilize at 2024 levels. Nominal wage growth is expected to continue its slowdown to 3%, as the effects of past inflation shocks on wages dissipate. In subsequent years, stronger economic growth should lead to further slight declines in unemployment, while wage growth is likely to stabilize just below 3% — a rate higher than pre-pandemic levels but consistent with the 2% inflation target and a structurally tighter labor market. The stability at the euro area level will mask cross-country divergences as employment growth is expected to remain robust in Spain and experience a cyclical recovery in the Nordics, while Germany and CEE will likely see stagnant employment levels. Wage growth is projected to remain elevated in CEE, although it should gradually decrease over time.

Inflation in the euro area is projected to stay slightly above 2% throughout 2025, while remaining above targets in CEE and falling below them in Switzerland and the Nordics

- **Euro area inflation has risen above 2% in recent months, but underlying price pressures have remained unchanged.** Headline inflation increased from 1.7% in September to 2.4% in December 2024, primarily due to an uptick in energy inflation resulting from base effects. Underlying price pressures have stayed largely unchanged, with services inflation sticky at 4.0% and core inflation at 2.7%. Additionally, significant tobacco excise tax hikes in several countries have contributed to the increase in headline inflation.

- **We anticipate euro area headline inflation to hover around 2.3% throughout 2025.** While core inflation is expected to moderate, reaching 2% by the end of 2025, food and energy components will keep headline inflation above 2%. Core inflation should decline as services inflation finally subsides on the back of slowing wage growth, even though core goods inflation is likely to pick up due to the fading of disinflationary forces in industrial goods markets and the EU's imposition of tariffs on selected US products in response to Trump tariffs. At the same time, food, alcohol, and tobacco inflation may stay elevated at close to 3%, driven by past supply shocks and tax hikes, and energy prices should modestly increase due to higher natural gas prices. **By 2026, headline and core inflation are projected to stabilize around 2%.**

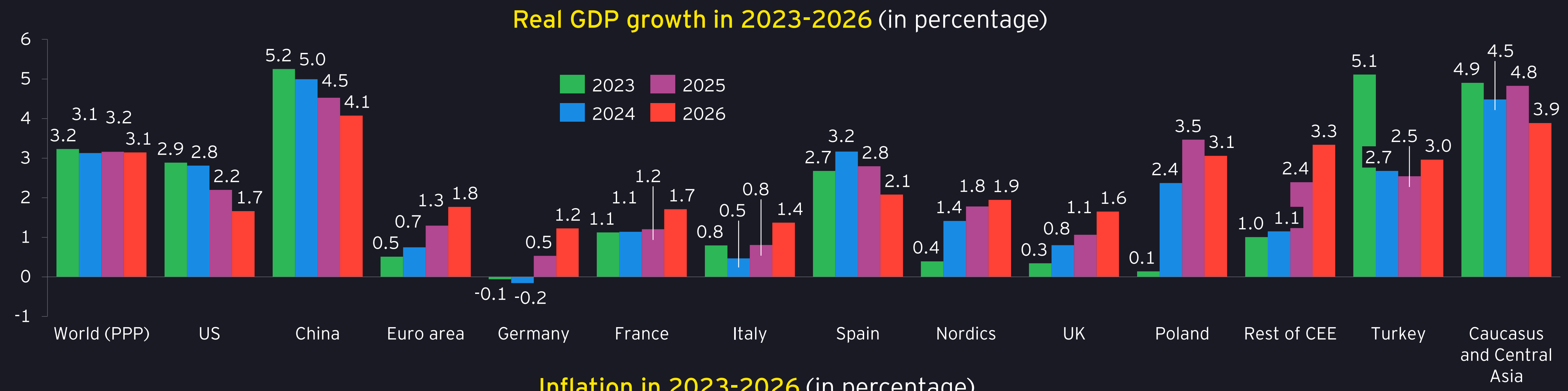
- **Inflation levels and underlying price pressures continue to vary across Europe due to differences in domestic demand, wage growth, energy price regulations, and tobacco excise tax hikes.** Romania, for instance, continues to experience the highest inflation rate, close to 5%, propelled by very strong domestic demand and wage growth. Inflation is also elevated in several other CEE countries, where services inflation and wage growth remain high. In Western Europe, Belgium and the Netherlands have the highest inflation rates, largely due to substantial tobacco excise tax hikes. Additionally, in Belgium, energy inflation has quickly responded to recent increases in natural gas prices , while in the Netherlands, services inflation remains elevated due to relatively strong wage growth. Conversely, Switzerland's inflation rate is below 1%, as a strong Swiss franc and subdued wage growth have led to goods deflation.

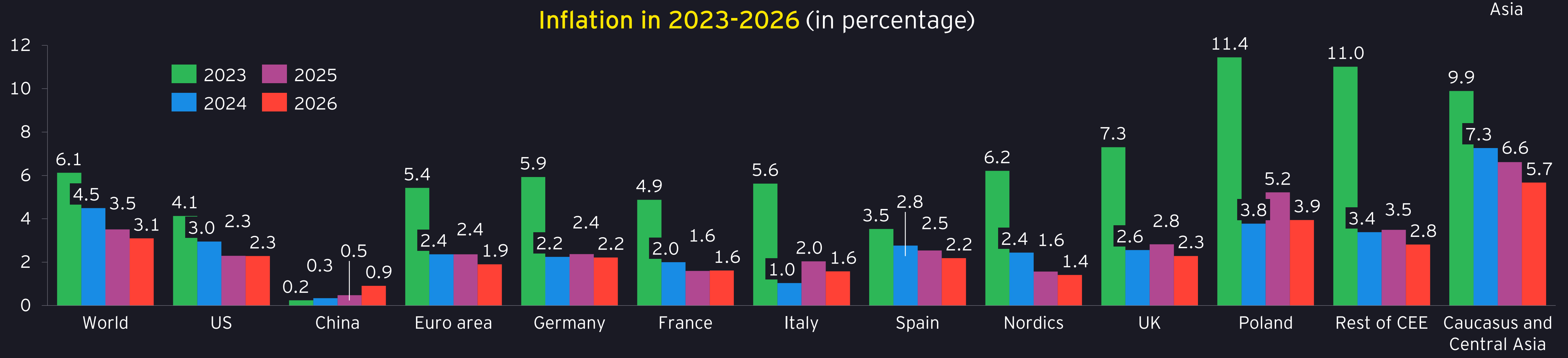
- **Looking ahead, CEE countries are expected to have the highest inflation rates, while the Nordics and Switzerland should experience the least price pressure.** In CEE, headline inflation in 2025 is anticipated to stay above 3.5% in several countries, driven by persistent services inflation and elevated food price inflation resulting from local supply shocks. Poland is expected to see the highest inflation rate, with a significant tobacco excise hike and an anticipated increase in regulated energy prices pushing inflation upwards. In contrast, a strong Swiss franc and low wage growth will continue to limit price pressures in Switzerland. In Finland and Sweden, methodological issues will bring down headline CPI inflation , though underlying price pressures will be relatively weak as well.

- **In most other European countries, we expect headline inflation in 2025 to stay within the 1.5%–3.0% range.** Belgium, the Netherlands, Norway, and Spain are likely to be closer to the upper boundary. In Belgium and Norway, energy prices should increase on the back of recent rises in natural gas prices. In the Netherlands, services inflation is anticipated to remain elevated, while in Spain, price pressures will be broad-based due to relatively strong economic activity. In contrast, food inflation in France should remain lower than elsewhere, keeping headline inflation below 2%.

* In Belgium, energy inflation is calculated based on prices of new contracts only. As a result, energy inflation tends to be more volatile and reacts quickly to swings in energy commodity prices.
** In Finland and Sweden, mortgage interest payments enter CPI. For this reason, interest rate cuts will have a strong negative impact on headline CPI inflation in 2025.

GDP growth and inflation forecasts



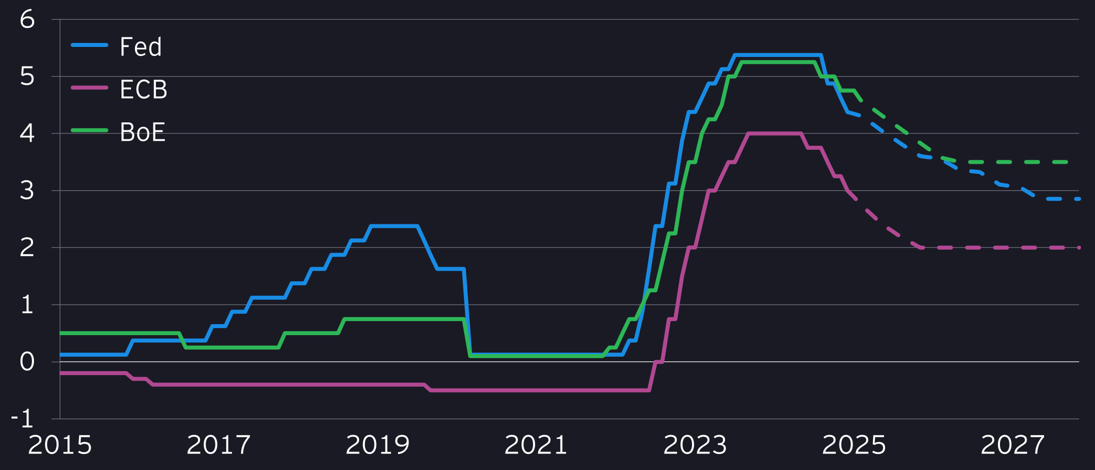


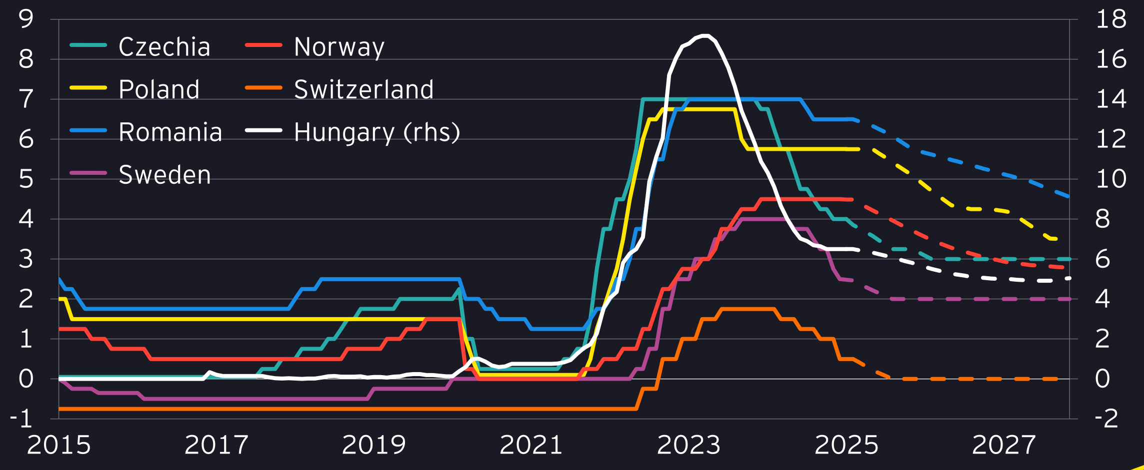
Source: Oxford Economics, Eurostat, EY EAT forecast, IMF (for Caucasus and Central Asia).
Nordics include Denmark, Finland, Norway and Sweden; rest of CEE includes Estonia, Latvia, Lithuania, Czechia, Slovakia, Hungary, Romania, Bulgaria, Croatia, Slovenia; Caucasus and Central Asia includes Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, Azerbaijan, Armenia and Georgia.

Monetary policy easing continues at varying pace across Europe, with interest rate disparities likely to persist

- Amid deteriorating business sentiment, the ECB accelerated the pace of easing in late 2024, implementing three consecutive 25bps rate cuts from September to December, bringing the deposit rate down to 3%. We expect this pace of easing to continue into 2025 Q1. However, as the deposit rate nears policymakers' estimates of the neutral rate and economic activity picks up, the pace of easing is likely to decelerate, especially as the Federal Reserve adopts a more cautious approach to rate reductions. **We project a total of 100bps of ECB easing in 2025, with the terminal rate of 2% to be reached by September 2025.** Risks are skewed towards a lower terminal rate should economic growth fall short of expectations.
- The Bank of England's Monetary Policy Committee (MPC) has established a "cut and hold" strategy, which we expect to be maintained throughout 2025. The Bank Rate is projected to decrease from 4.75% at the end of 2024 to 3.75% by the end of 2025, eventually settling at 3.5% in Q1 2026.
- The Swiss National Bank (SNB), facing a strong Swiss franc, low wage growth, and subdued inflation, reduced interest rates from 1.75% to 0.5% in 2024. We anticipate further cuts to 0% in the first half of 2025. Sveriges Riksbank has also outpaced the ECB in rate cuts, with rates reaching 2.5% by the end of 2024, prompted by stagnant economic activity and weak underlying price pressures. We expect two more rate cuts before the terminal level of 2% is reached. In contrast, somewhat higher inflation keeps Norges Bank more cautious, with gradual (25 bp per quarter) rate cuts expected to start only in March 2025.
- In CEE, elevated wage growth and services inflation, along with resurging food price pressures, have prompted central banks to slow or pause rate cuts in recent months. We expect that elevated inflation will prevent more aggressive easing in 2025, with central banks in Poland, Romania, and Hungary projected to reduce rates by 75 bp, leaving rates at a relatively high level of at least 5% by year-end. The return to longer-term nominal neutral rates of 3.5-4% is likely to take several years in Poland and Romania. Czechia stands as an exception, where weaker wage, demand, and price pressures have already led to a drop in interest rates to 4%. We expect the terminal rate of 3% to be reached by 2026 Q1.

Central bank interest rates (In percentage)





Source: Oxford Economics, ECB, Fed, BoE, BIS, stooq.pl, EY EAT forecast.
For Hungary, BUBOR 1M interbank rate.

The outcome of the US elections has further skewed the balance of risks for GDP growth to the downside and slightly heightened inflation risks

The economic outlook remains uncertain, with the balance of risks continuing to be tilted towards lower GDP growth in Europe, while inflation risks have shifted towards more contained price increases.

Key risk factors include:

- **Higher tariffs in global trade**. The potential resurgence of trade wars looms, with D. Trump signaling intentions to impose higher tariffs on imports to the US. This will likely lead to retaliatory actions from other nations. European GDP is expected to suffer in comparison to the status quo, not only due to direct reductions in exports (stemming from tariff-induced price increases and weakened global demand) but also due to the uncertainty tied to potential trade war escalations. Our baseline scenario assumes the imposition of limited tariffs targeting specific products (see slide 30), but risks are skewed towards broader tariffs. Blanket tariffs would pose a substantial drag on the European economy over the medium term, particularly impacting manufacturing-heavy countries such as Germany, Czechia, and Hungary (see slide 44 or our more detailed note).
- **Geopolitical risks**. The war in Ukraine persists and the Middle East continues to be a potential hotspot for conflicts despite some recent de-escalation. Additionally, recent signals from the new US administration hint at potential new areas of geopolitical tensions (Panama Canal, Greenland). Any escalations could amplify uncertainty, trigger commodity price spikes, further increase shipping costs, and create bottlenecks in global trade. These developments could reignite inflation and adversely affect global economic activity, with Europe being particularly vulnerable to global shocks due to its high degree of openness.
- **Prolonged downturn in manufacturing**. Risks for the manufacturing outlook are skewed to the downside as the structural loss of competitiveness by European producers, not least due to higher energy prices and intensifying competition from China, may be more pronounced than currently anticipated.
- **Delayed consumer recovery and subdued investment**. We expect consumers to gradually reduce their currently very high saving rates, and investment to rebound on the back of lower interest rates and NextGenEU spending. However, global uncertainty may negatively affect business and consumer sentiment, delaying the consumer and investment recovery.
- **Energy and food prices spikes**. Adverse weather conditions or local political unrest could also reduce the supply of or increase demand for energy and food commodities, leading to higher inflation and diminished economic activity.
- **Sovereign bond market stress**. With inflation no longer fueling revenue growth or aiding in the reduction of debt-to-GDP ratios, the risk of renewed stress remains elevated in the sovereign bond markets of emerging economies as well as in Southern Europe.

Despite these significant downside risks, several factors could positively influence growth

- **Lower than expected inflation**. Inflation may prove lower than expected if services inflation declines more rapidly, core goods inflation remains subdued at close to 0%, or positive supply shocks alleviate food inflation. Lower inflation would boost household disposable incomes and consumption. Concurrently, it would allow central banks to cut interest rates more aggressively to levels below current projections, providing an additional stimulus to investment and consumption.
- **Stronger rebound in consumption, supported by accumulated excess savings**. European consumers may reduce their saving rates more quickly than anticipated from the presently high levels, or even spend a portion of their substantial excess savings accumulated during the pandemic, resulting in stronger GDP growth. Over the medium term, it is unlikely that the saving rate will stay significantly above pre-pandemic levels, especially as incentives to save diminish with declining ECB interest rates.
- **Stronger productivity growth, due in part to AI**. Productivity growth, which has been notably weak over the past decade, represents another upside risk to the outlook. Tight labor markets should encourage firms to invest in productivity-enhancing and labor-saving technologies, including automation, robotization, and the potential of generative AI. In a recent series of EY articles, we highlighted AI's substantial potential to transform the labor market, boost investment, total factor productivity, and GDP growth, albeit with uneven effects across sectors. However, AI may also contribute to higher inflation and interest rates. The effects of faster implementation of AI solutions on GDP growth are summarized on slide 45.
- **Strong immigration flows alleviating demographic pressures and supporting potential growth**. Our baseline scenario predicts that labor supply in Europe will plateau after 2025 and decline post-2027, driven by demographic trends, with several countries, particularly in CEE, facing earlier and more severe reductions. However, tight labor markets in Europe and ongoing global population growth present an upside risk that immigration could at least partially offset these gaps. This scenario appears more plausible in CEE, which had not experienced significant immigration prior to the large-scale influx from Ukraine, rendering immigration projections typically conservative.

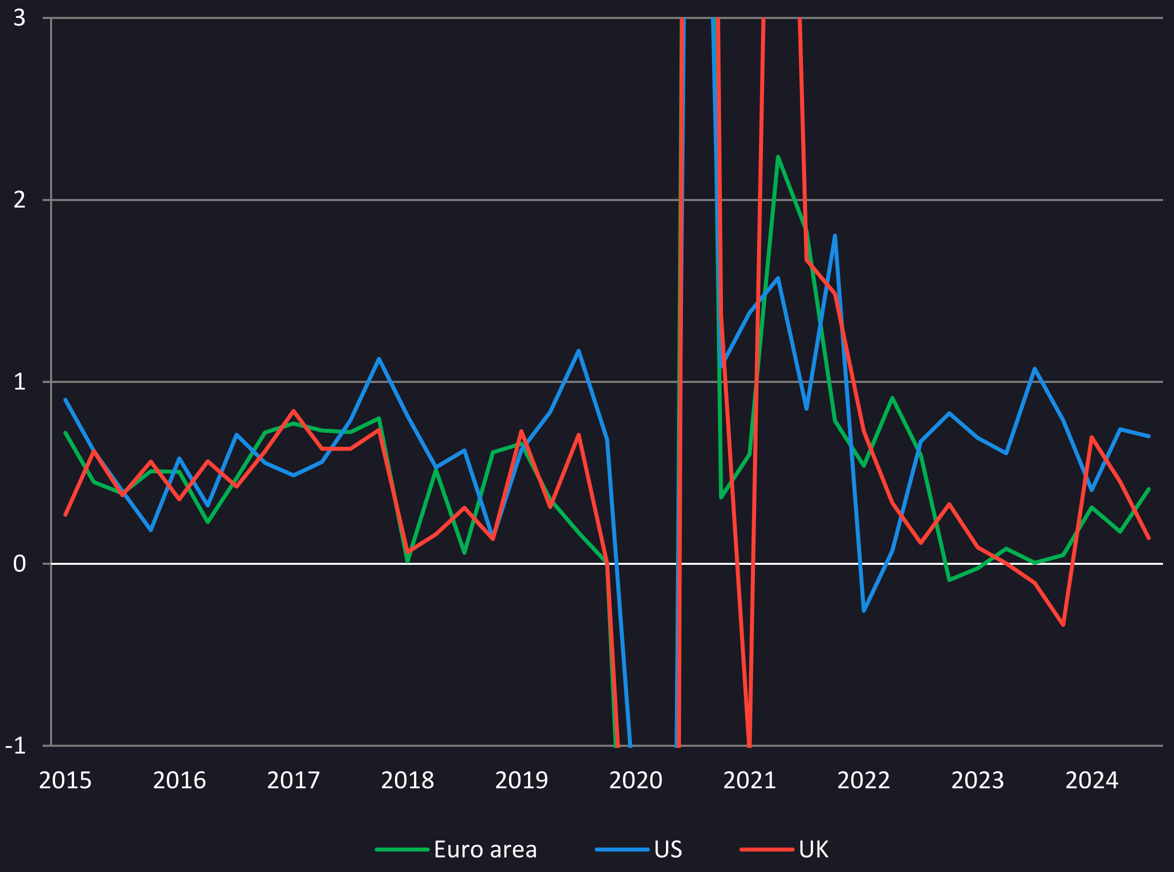
EY Global Economic Outlook

- For more information on economic developments around the globe, explore our bi-annual EY 'Global economic outlook', developed in partnership with various EY economics teams and experts.
- The report includes EY forecasts and views on the US, Canada, EU, UK, Japan, Australia, iia, China, ASEAN, Latin America, Middle East and Northern Africa (MENA), and Sub-Saharan Africa (SSA).
- EY article summarizing the key findings of the latest report can be accessed here.

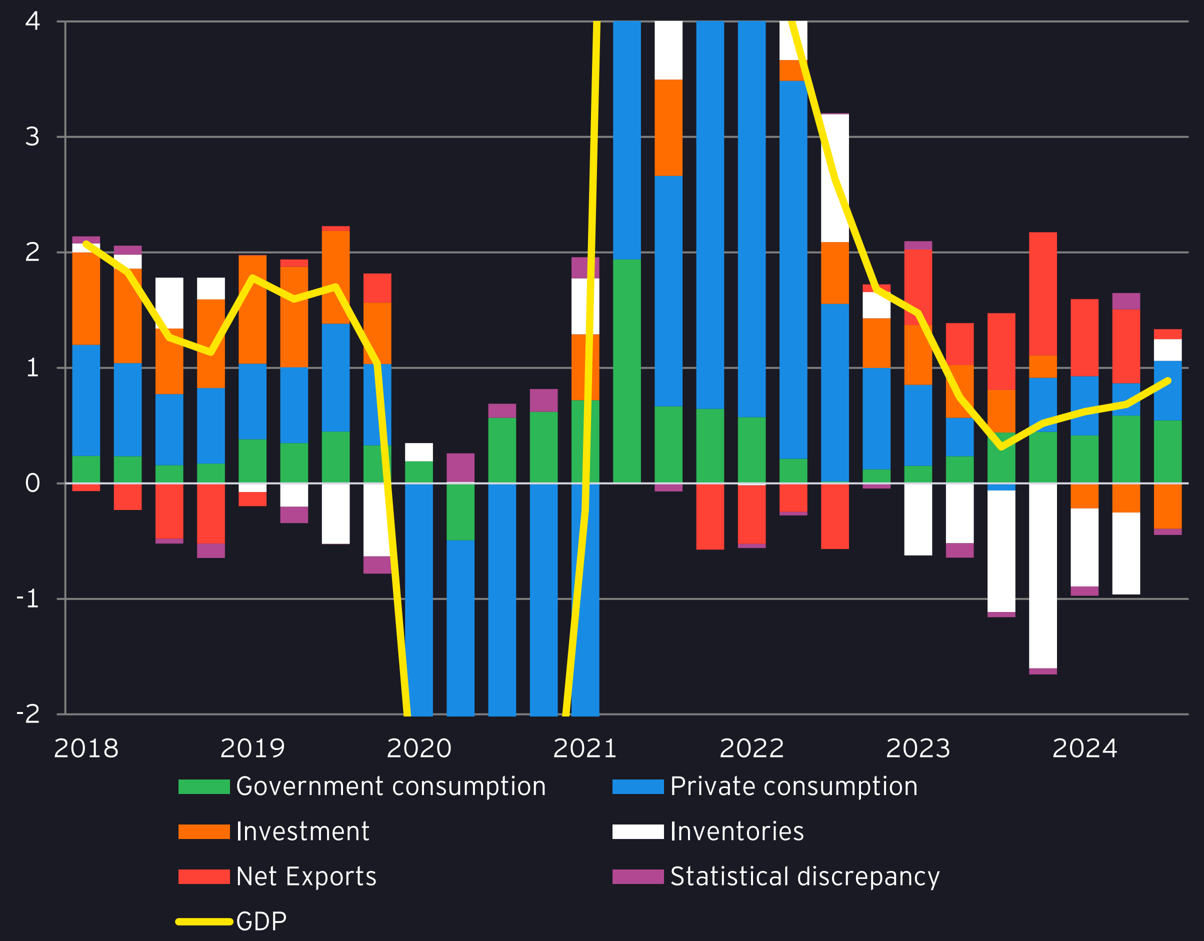
As we anticipated a year ago, the euro area's economy expanded at a modest 0.2-0.3% quarterly rate throughout 2024, notably below the US growth rates

- Sustained increases in government spending, a reversal in the inventory cycle, and a recovery in consumer spending have supported economic activity, despite stagnant exports and a downturn in investment

Q/q real GDP growth (in percentage, seasonally adjusted)



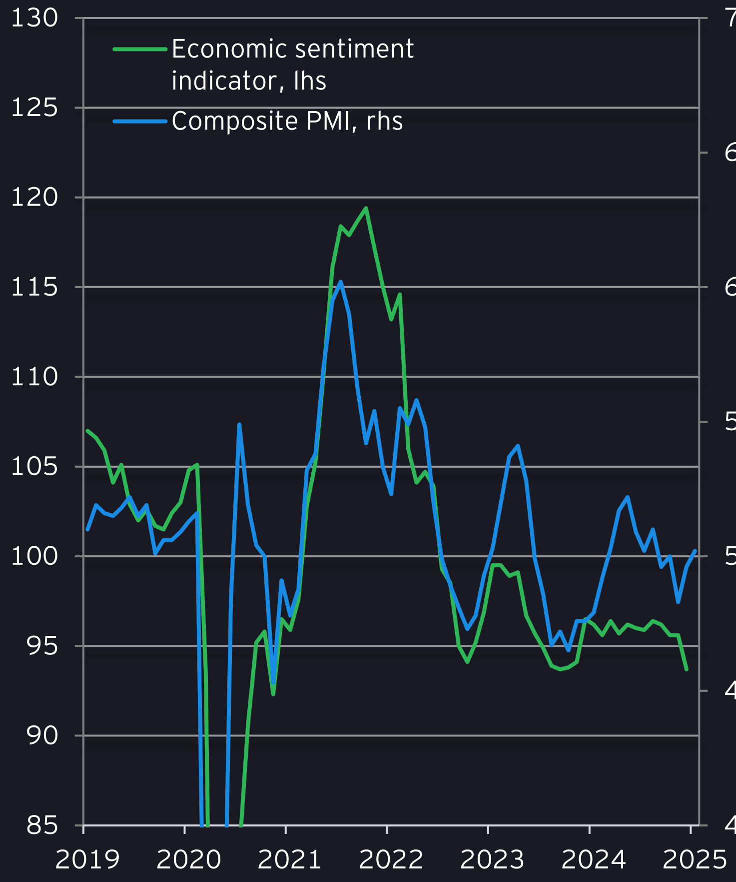
Decomposition of y/y GDP growth in the euro area less Ireland* (in percentage)



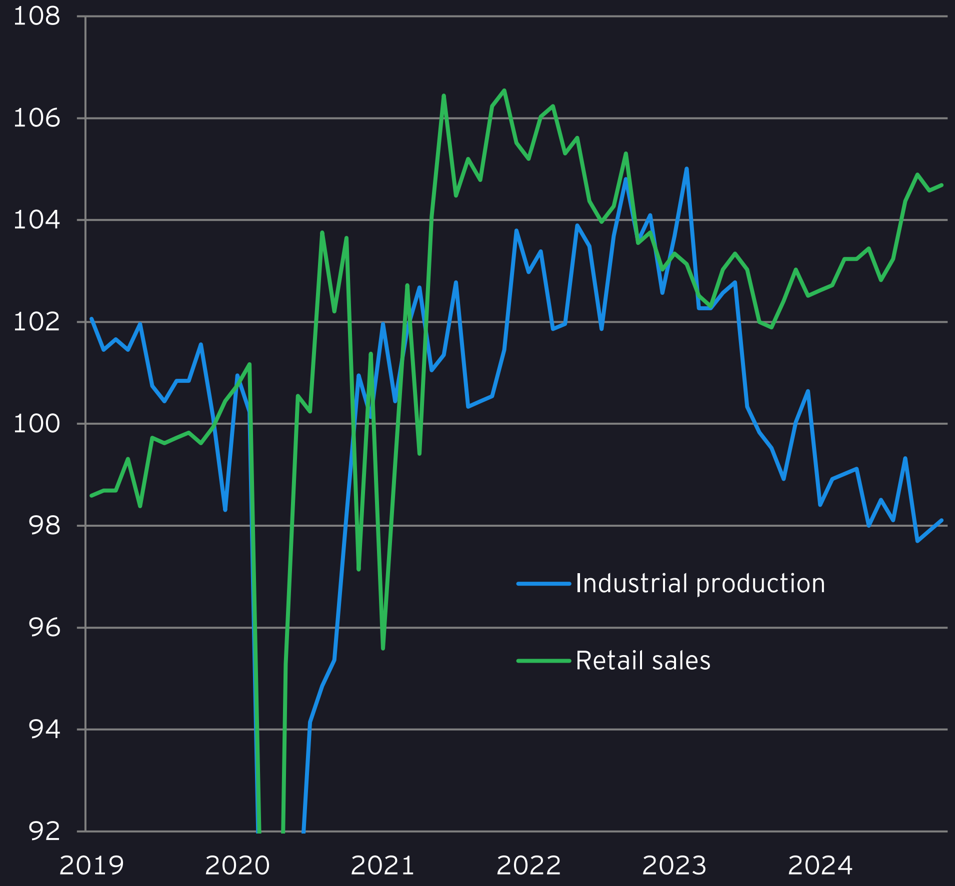
Source: Eurostat, Fred, ONS.
* Ireland is excluded as its GDP tends to be very volatile, reflecting the outsized role multinational corporations play in the economy.

Business sentiment remains downbeat, signaling no immediate pickup in growth. Hard data has continued to be somewhat more favorable, though

Business sentiment indicators for the euro area



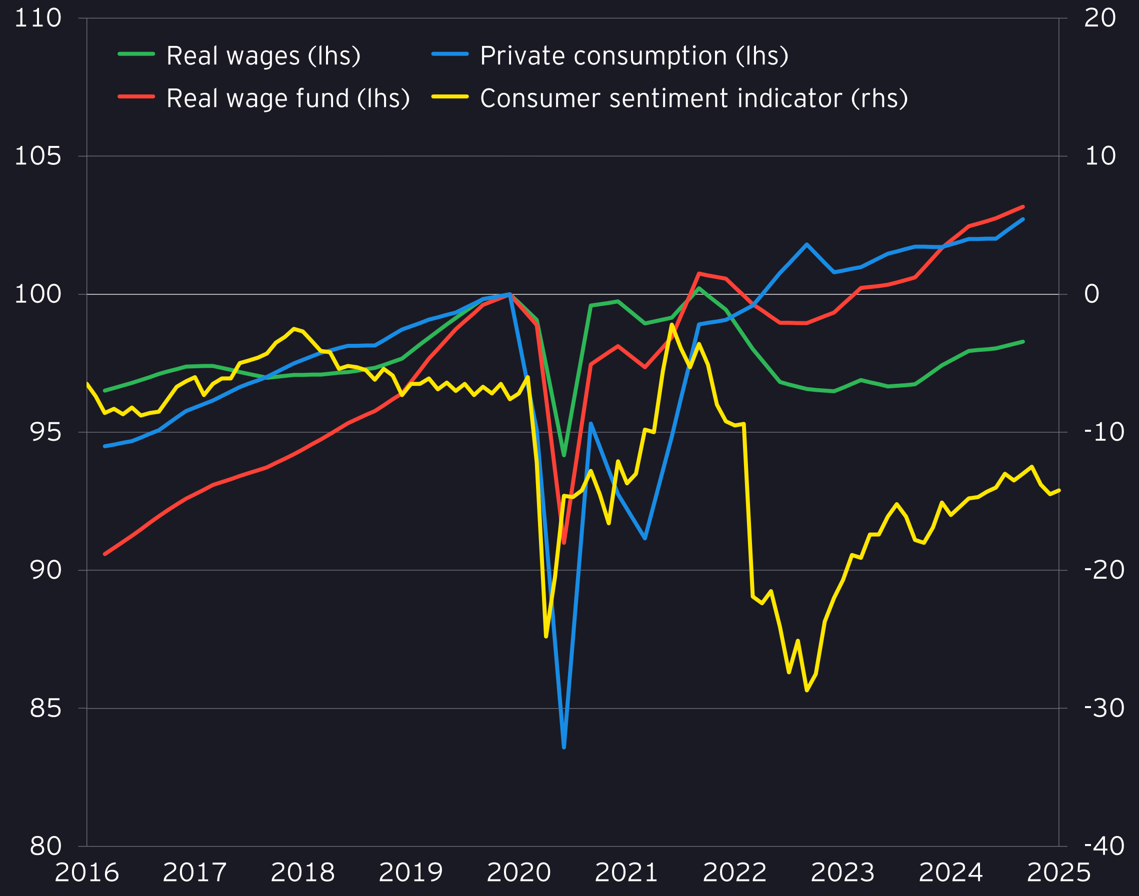
Retail sale and industrial production in the euro area (2019Q4=100)



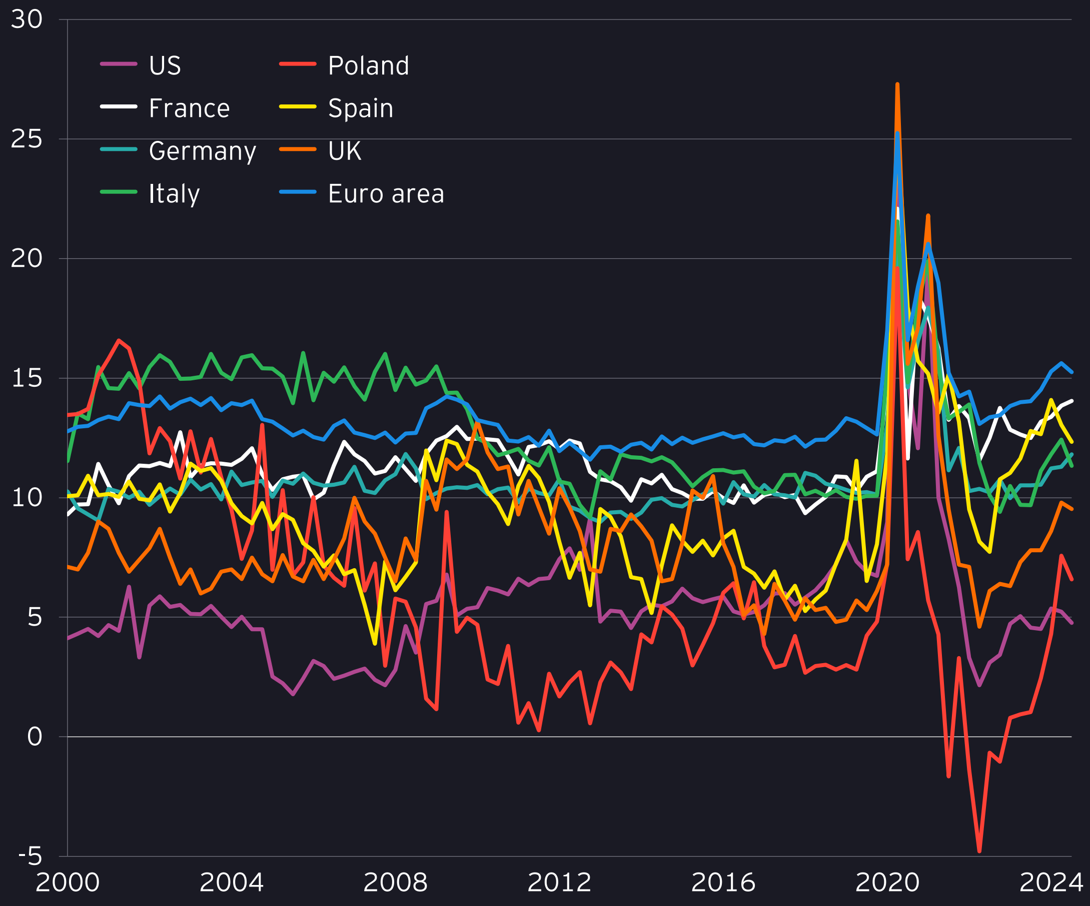
Source: Eurostat; Trading Economics, Refinitiv.

Growing real incomes are finally translating into increasing consumer spending, although saving rates remain elevated

Real wages, real wage fund, consumer sentiment and real private consumption in the euro area
(2019 Q4 = 100)



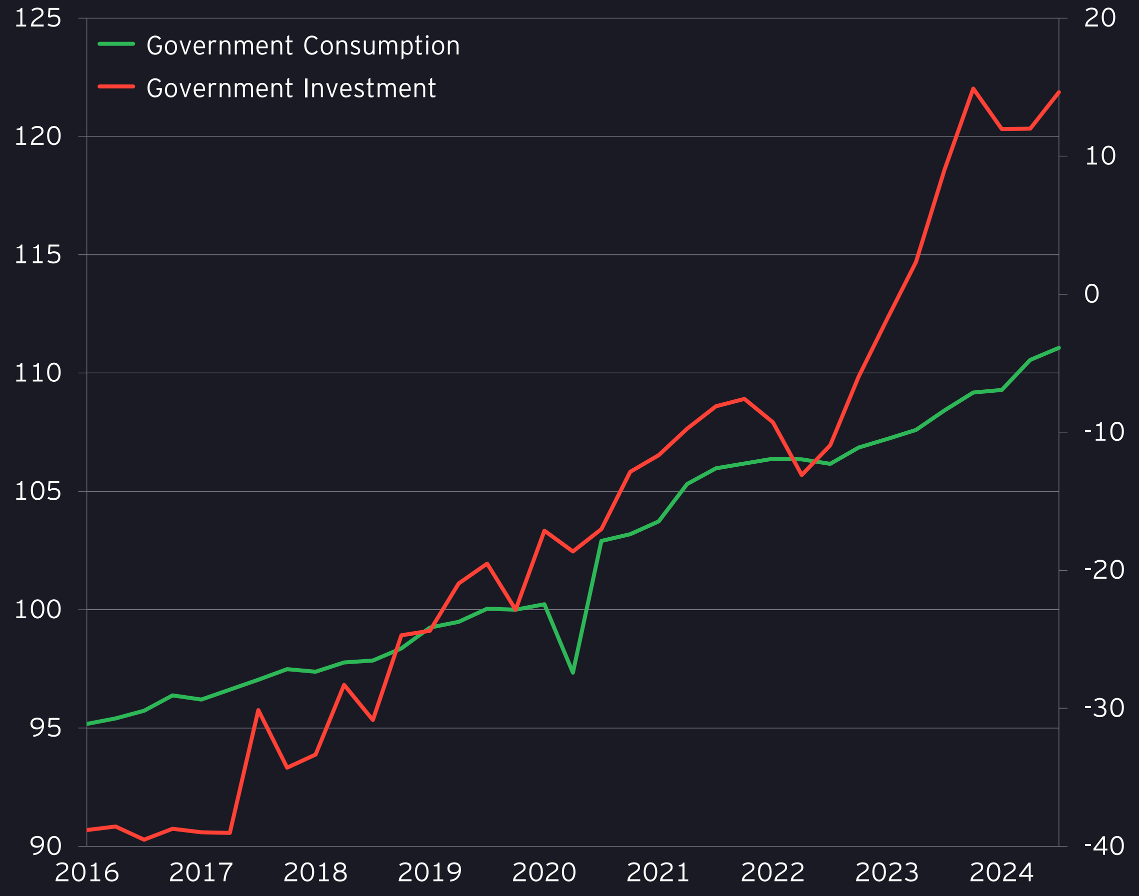
Household saving rate
(In percentage)



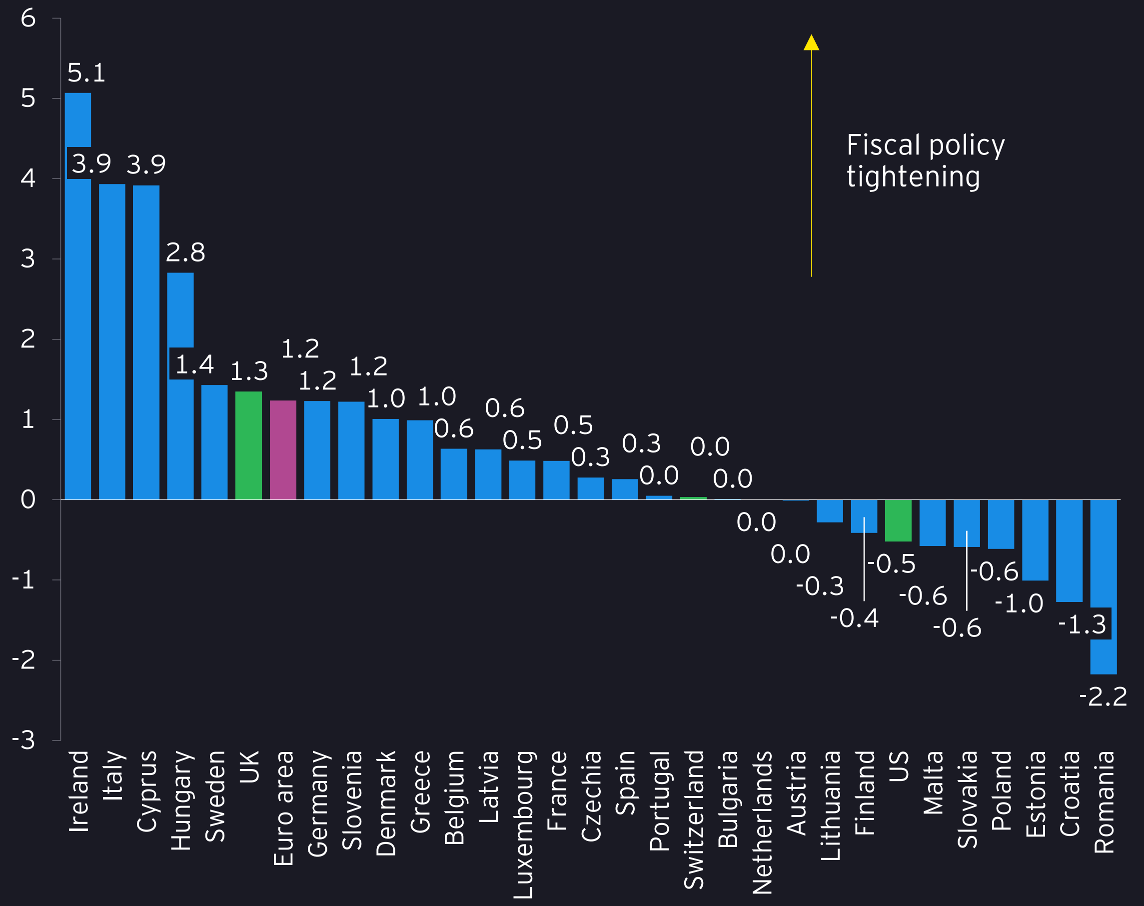
Source: Eurostat, Oxford Economics, FRED.

While government consumption and investment continue to support growth, broader fiscal policy is constraining activity

Government consumption and investment in the euro area
(2019 Q4 = 100)



Change in structural balance* to GDP: Q1 2024 – Q3 2024 vs. Q1 2023 – Q3 2023 (in percentage points)

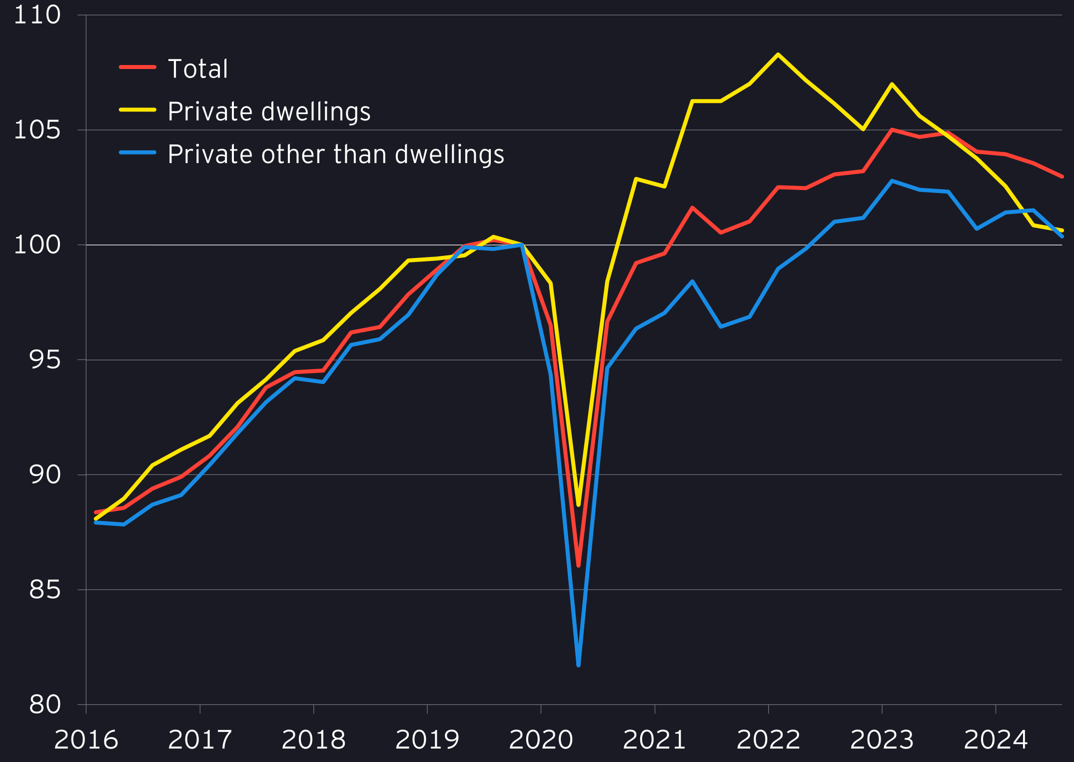


Source: Eurostat, Oxford Economics, FRED.
* Structural balance is general government balance corrected for cyclical and one-off factors.

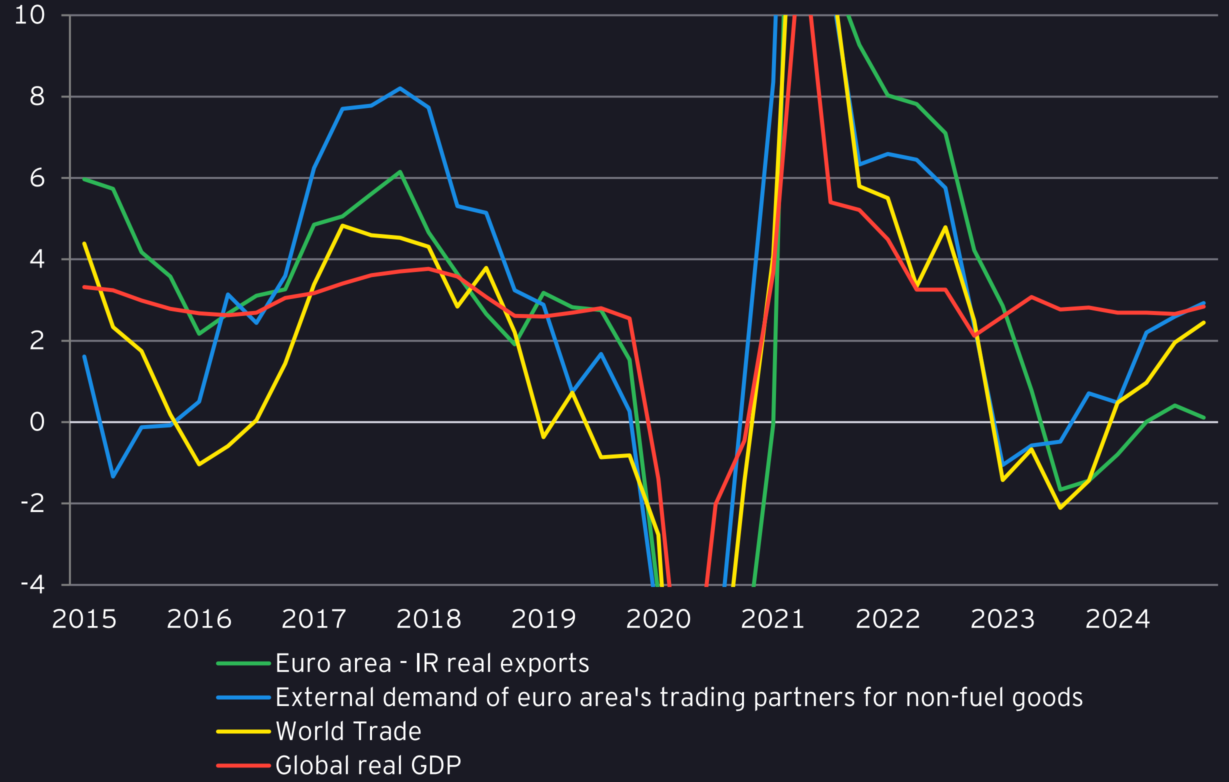
Despite support from government spending, investment exhibits a slight downturn. After a modest rebound in earlier quarters, exports regressed in 2024 Q3

- Elevated interest rates contribute to the ongoing decrease in housing investment
- Non-residential private investment is under additional strain from dwindling profits, reduced capacity utilization, negative business sentiment, and subdued external demand, compounding the effects of high interest rates
- Exports grow at slower pace than external demand or world trade – European producers are losing market shares

Real fixed capital investment by type in the euro area less Ireland* (2019 Q4 = 100)



Global real GDP, world trade, external demand of euro area's trading partners for non-fuel goods** and euro area less Ireland* real exports (y/y, in percentage)



Source: : Eurostat, Oxford Economics, CPB.

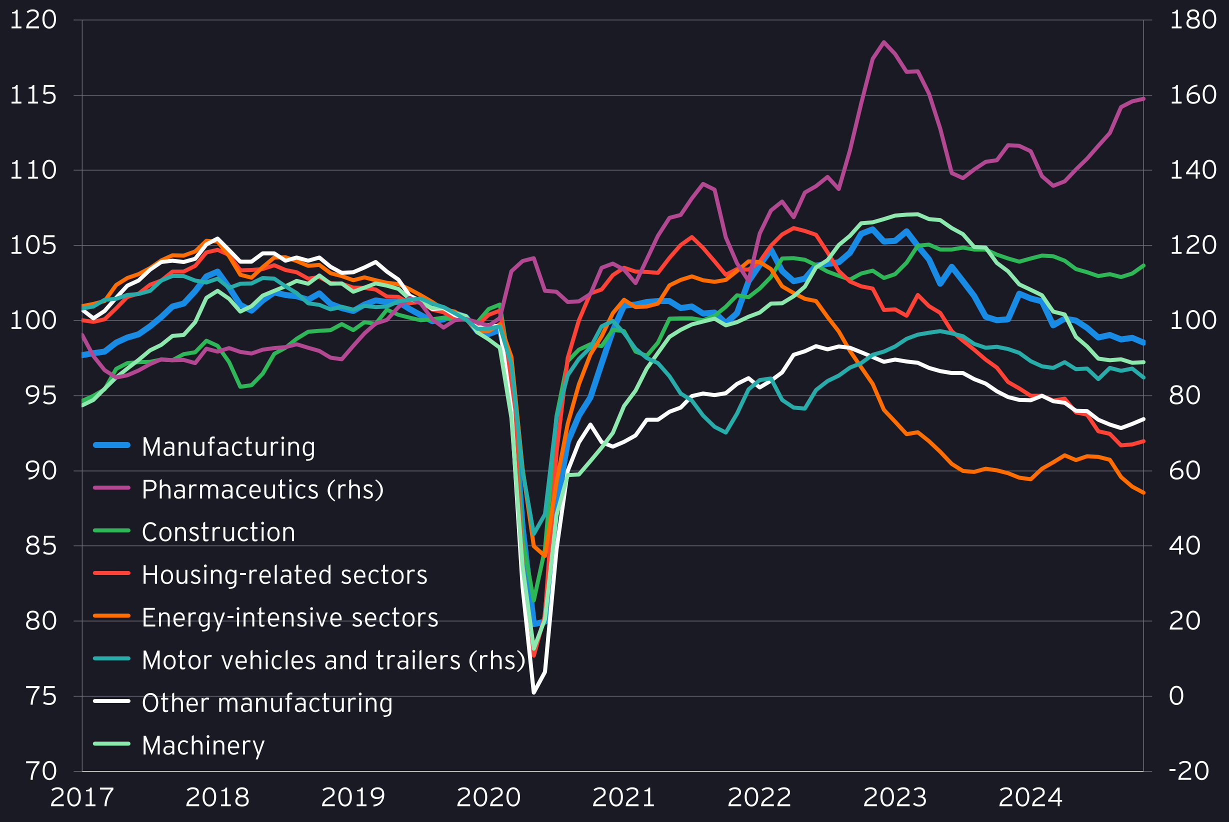
* Investment and exports in Ireland are excluded since they are very volatile, influenced by the global activities of multinational corporations, and do not appropriately reflect the underlying investment and exports in the domestic economy.

** External demand of euro area's trading partners for non-fuel goods is equal to real imports of trading partners, weighted by shares of those trading partners in the euro area exports.

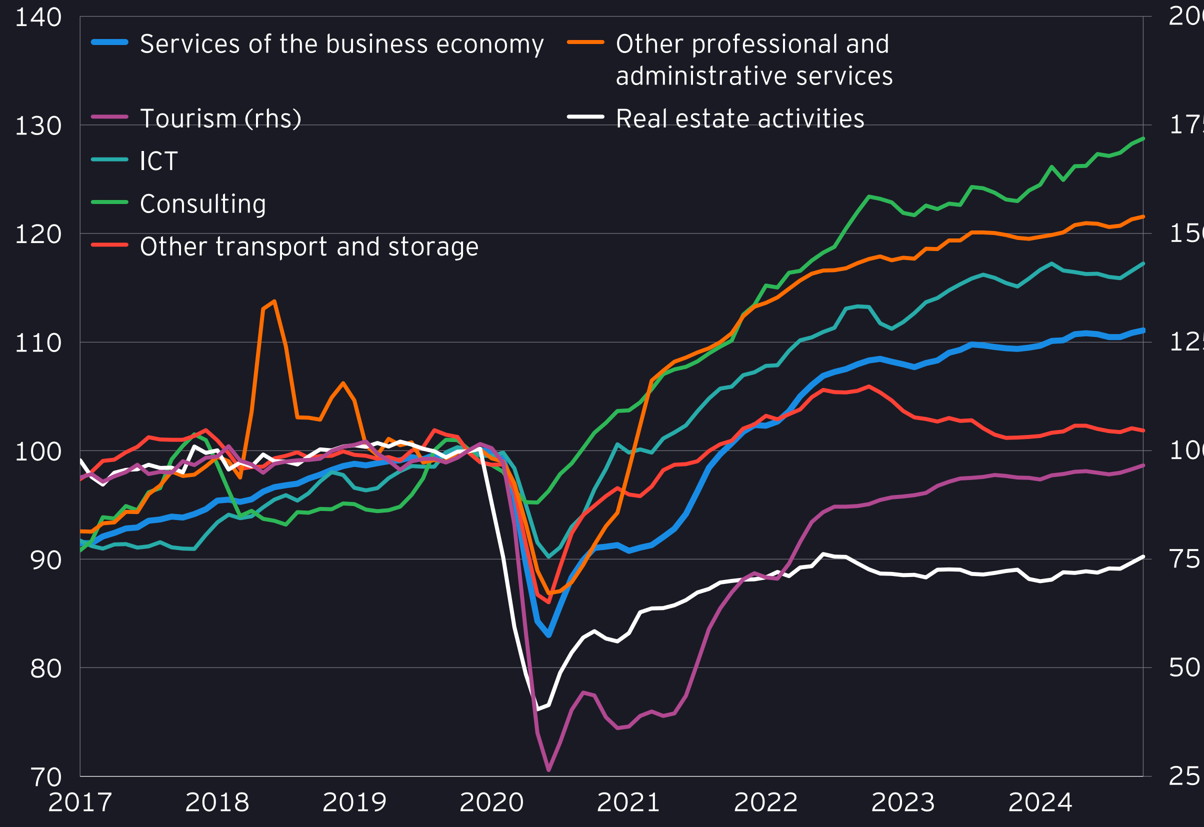
Manufacturing activity appears to be bottoming out, whereas the services sector maintains a modest to moderate expansion, with consulting and tourism leading the growth

- Manufacturing production seems to be bottoming out across most sectors, except for energy-intensive industries facing renewed downturns on the back of increasing natural gas prices
- The pharmaceutical sector remains a standout performer
- The construction, real estate, and housing-related manufacturing sectors are either bottoming out or starting to expand in response to monetary policy easing

Manufacturing production in the euro area
(3-mth moving average, index, 2019 Q4 =100, seasonally adjusted)



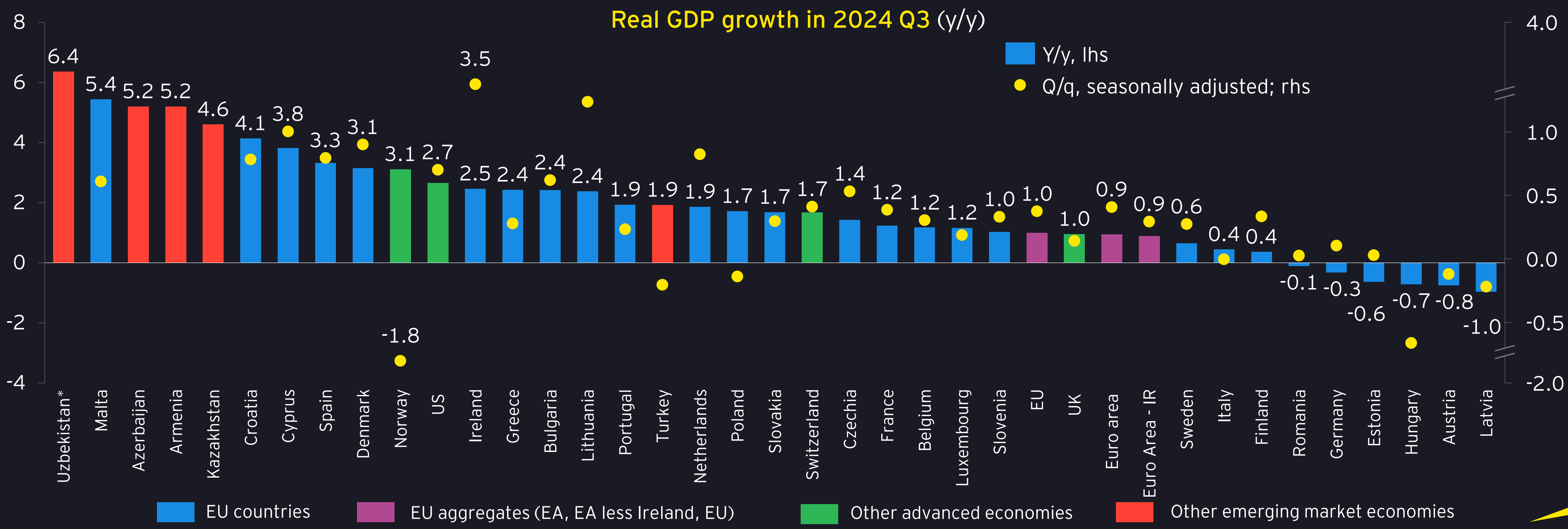
Services activity in the euro area
(3-mth moving average, index, 2019 Q4 =100, seasonally adjusted)



Source: Eurostat.
Notes: Energy-intensive sectors: paper, chemicals, basic metals and non-metallic mineral products. Housing-related sectors: wood, furniture and electric equipment. Other manufacturing is an arithmetic average of the remaining manufacturing NACE divisions. Services of the business economy except for trade and financial activities. Tourism includes accommodation and food service activities, air transport, travel agencies and related activities.

Growth disparities persist among countries, with Spain excelling and Germany falling behind

- Spain reaps the benefits of a booming tourism sector, NextGenEU spending, robust immigration, and relatively low energy costs.
- Germany's economic woes are multifaceted, stemming from an unfavorable mix of sectors, export partners, and energy sources, a constrained labor supply, restrictive fiscal policy, a continued loss in cost competitiveness, and sluggish development in emerging industries like ICT and pharma.
- Stagnation in Germany negatively affects its trading partners, particularly Austria.
- Denmark and Norway see strong growth, propelled by their pharma and oil & gas sectors, respectively. However, the underlying economic activity in the Nordics continues to be negatively affected by previous drops in real incomes and monetary policy tightening.
- The recovery in CEE countries stumbled in 2024 Q3, with several countries stagnating and Hungary slipping into recession.
- Turkey's economic momentum slows amidst stringent monetary and fiscal policies.
- The Caucasus and Central Asia region sustains its vigorous growth trajectory.

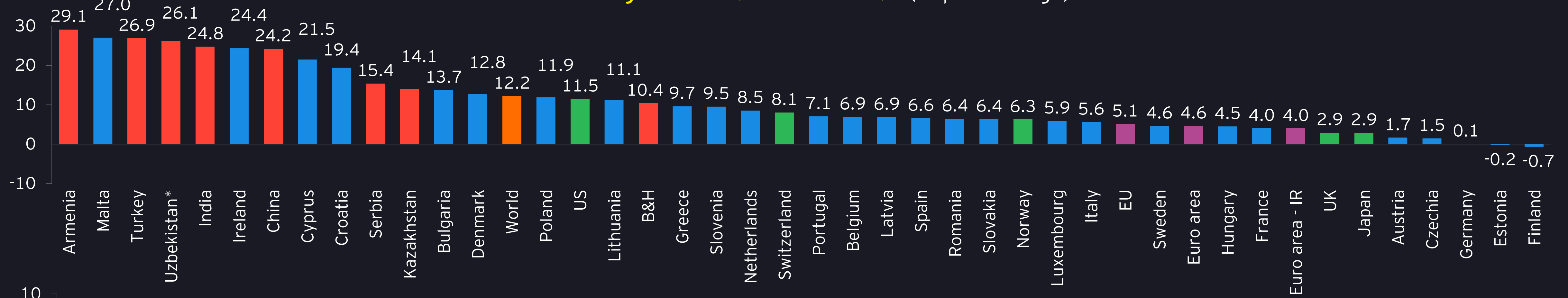


Source: Eurostat, Oxford Economics, Trading Economics.
*last data available for 2024 Q2

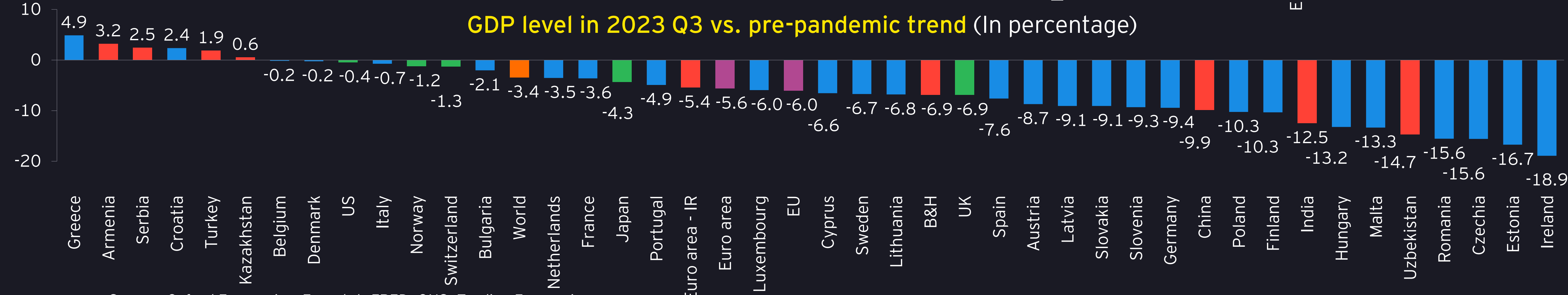
The euro area's economy stands 4% above its pre-pandemic level but remains 6% below the pre-pandemic trend, with notable variations among member states

- Germany, Austria, Czechia, Finland, and Estonia are among the nations where GDP hovers around pre-pandemic levels, impacted by a heavy dependence on manufacturing, a housing downturn, and consequences of the war in Ukraine.
- Conversely, several countries are approaching or surpassing the pre-pandemic trend: Italy, Greece, Turkey, and Croatia benefit from a tourism boom; Switzerland, Belgium, and Denmark are buoyed by their robust pharmaceutical industries; Norway is capitalizing on elevated energy prices; and the US's robust performance is driven by strong consumer demand and productivity growth.

GDP change: 2024 Q3 vs. 2019 Q4 (In percentage)



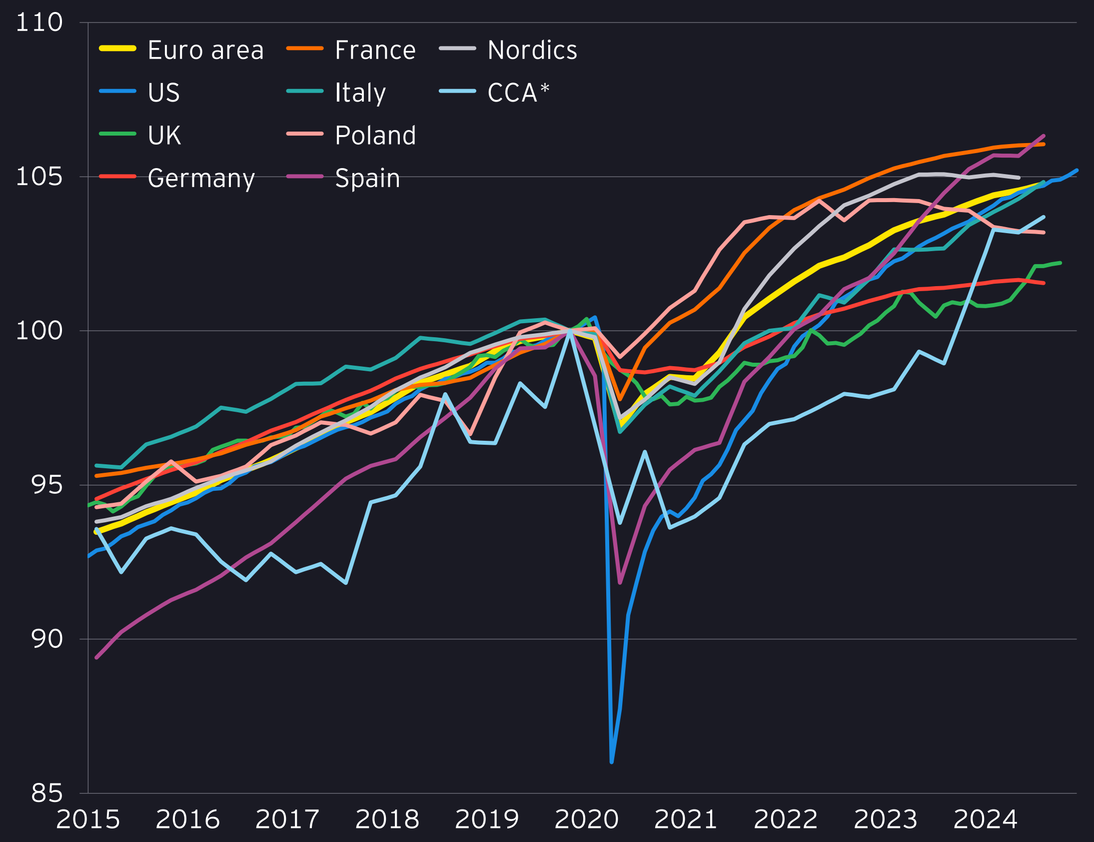
GDP level in 2023 Q3 vs. pre-pandemic trend (In percentage)



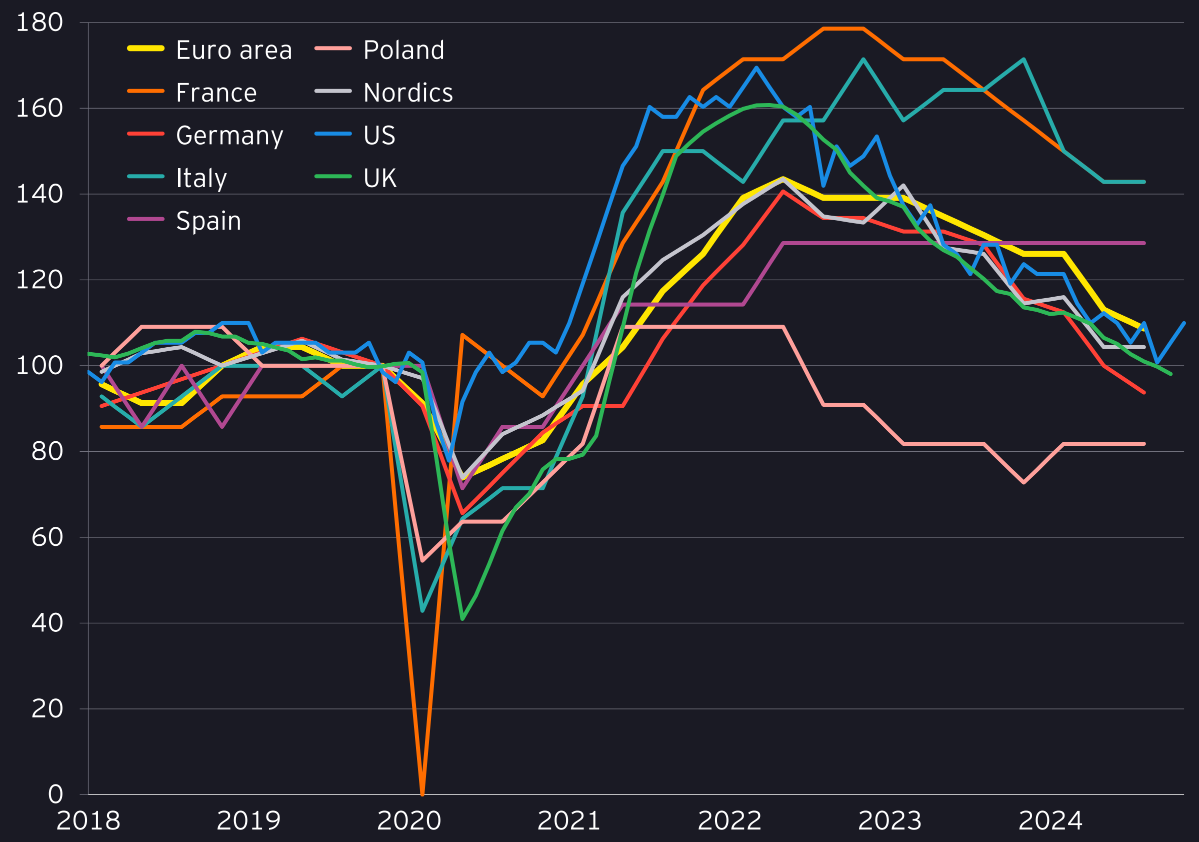
Source: Oxford Economics, Eurostat, FRED, ONS, Trading Economics.
Pre-pandemic trend is a logarithmic trend over 2014 Q1 – 2019 Q4. "Euro area – IR" stands for euro area less Ireland. Ireland is excluded as its GDP tends to be very volatile, reflecting the outsized role multinational corporations play in the economy.
*last data available for 2024 Q2

Employment growth in the euro area has stabilized close to 0.2% q/q. A concurrent decrease in vacancy rates suggests a cooling in labor market demand

Employment
(Index, Q4 2019 = 100, seasonally adjusted data)



Vacancy rate
(Index, 2019 Q4 =100)

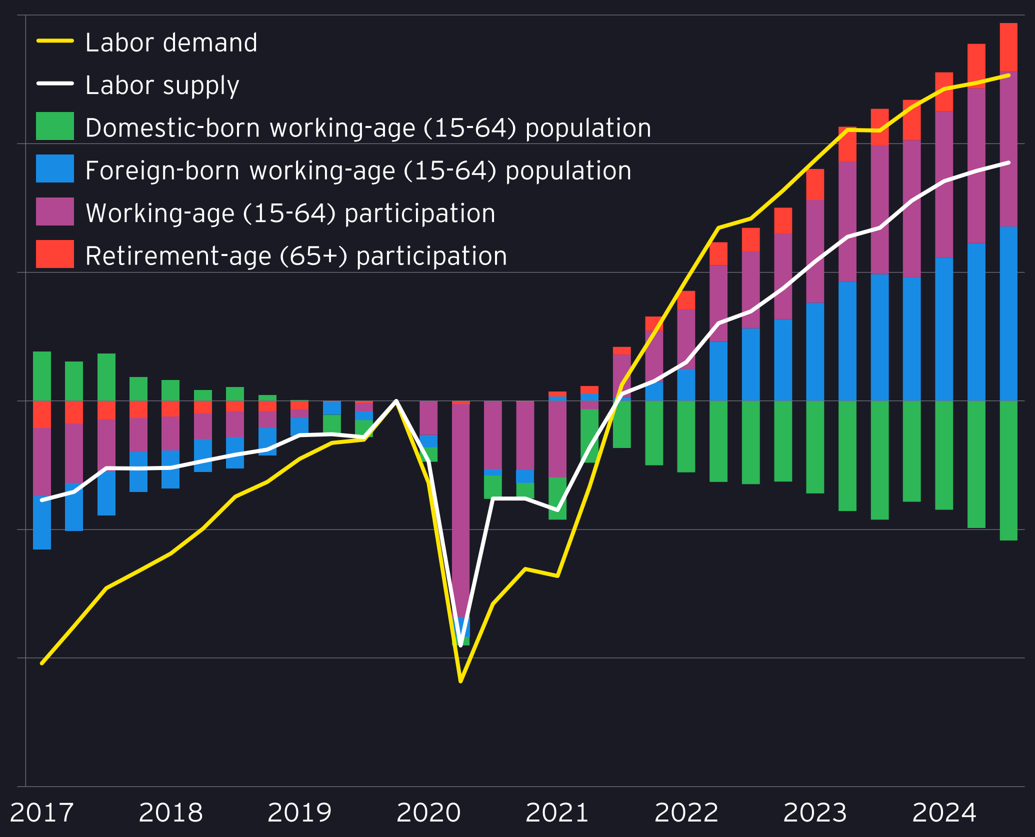


Source: Eurostat, FRED, ONS, Trading Economics.
*CCA includes Armenia, Georgia, Kazakhstan, and Kyrgyzstan.

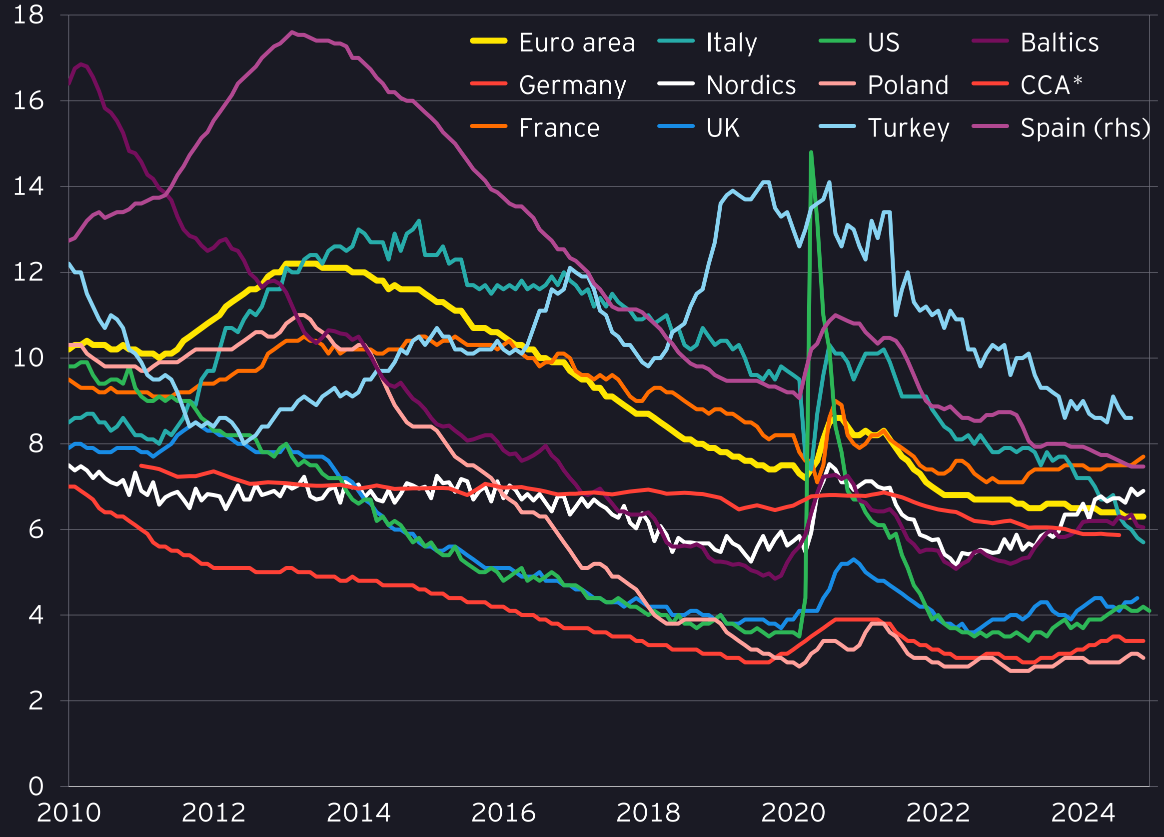
Simultaneously, the pace of labor supply growth has decelerated slightly due to more modest gains in labor force participation. As a result, unemployment rates have stabilized near historical lows

- However, this overall stability masks disparities between countries: unemployment rates are on a downward trajectory in Spain, Italy, and Croatia, whereas they have been edging upwards in the Nordic countries.

Labor supply and demand change in the euro area compared with 2019 Q4 (in percentage)



Unemployment rate (in percentage)

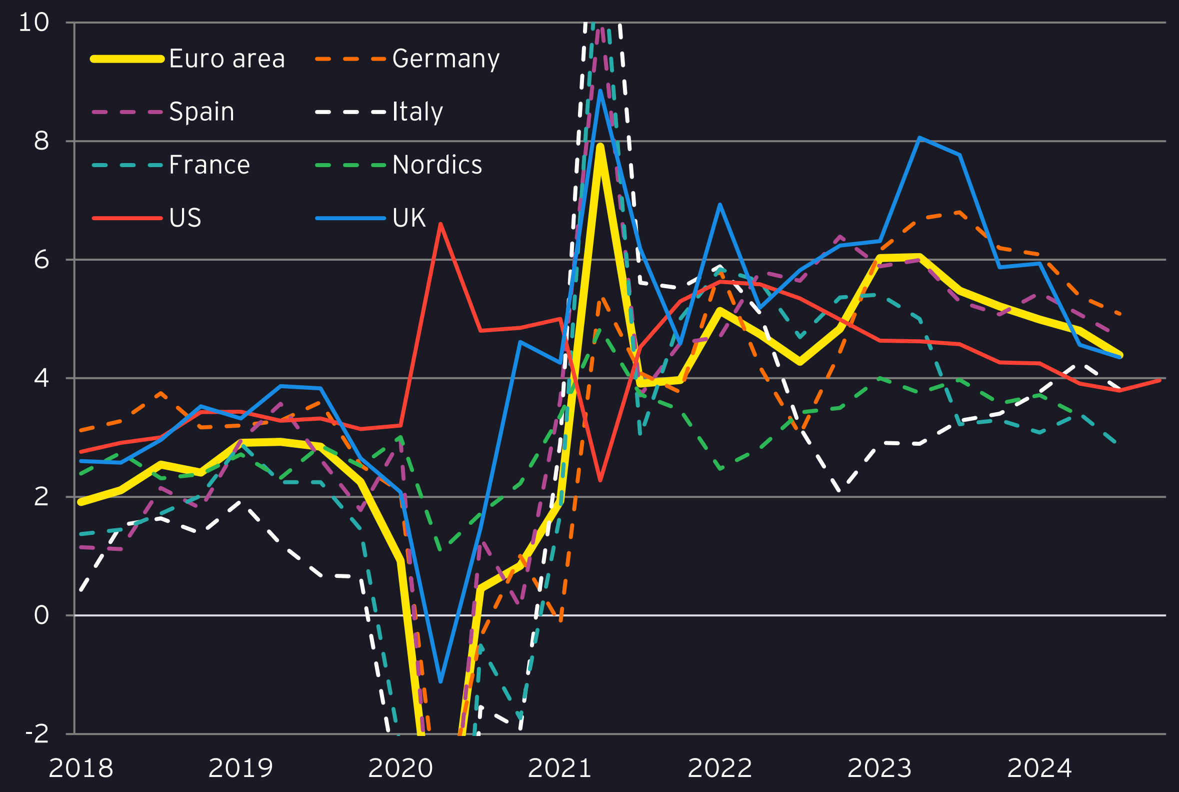


Source: Eurostat, BLS, FRED, ONS.
Notes: Labor demand is a sum of supply employment and vacancies.
* For the UK and the US there is no division between domestic-born and foreign-born, instead replaced by a working-age (16-64) population category.
** CCA is an average of unemployment rates for Armenia, Georgia, Kazakhstan, and Kyrgyzstan, weighted by GDP.

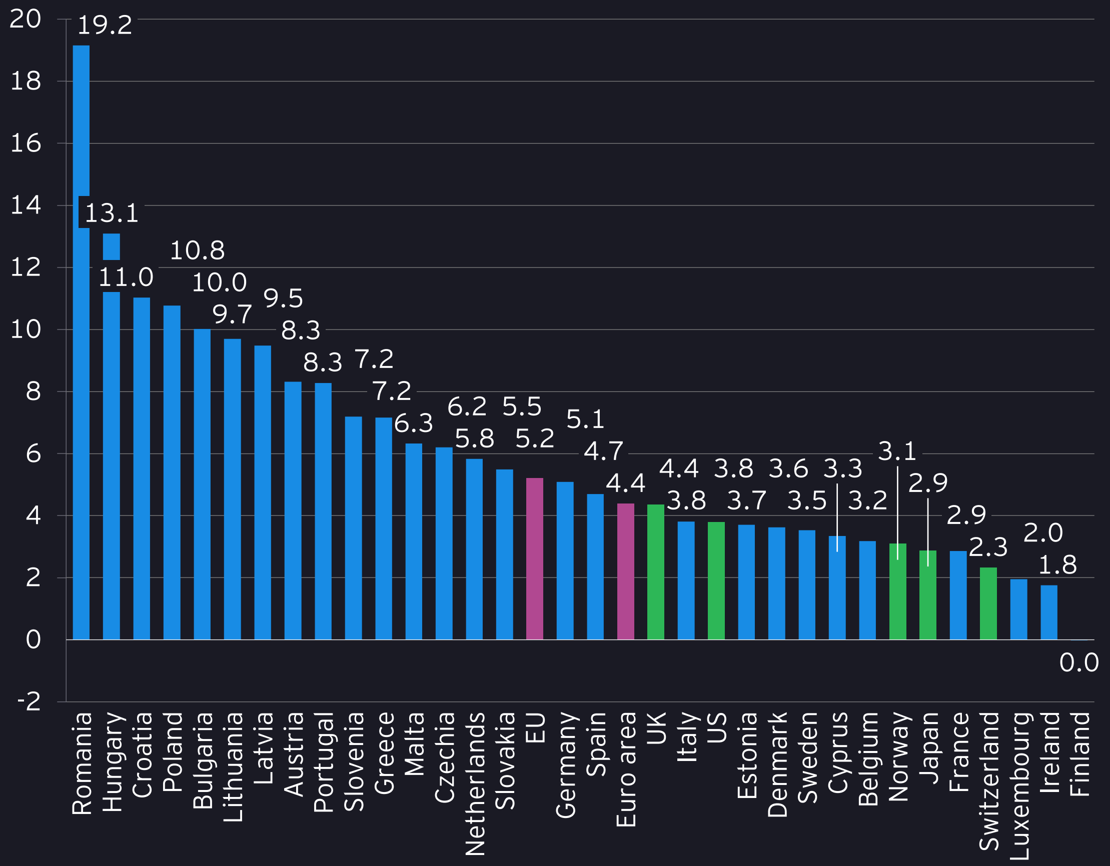
Nominal wage growth has gradually slowed, yet it still surpasses the rates consistent with the 2% inflation target

- The primary catalyst for the deceleration in wage growth is reduced inflation, while tight labor market conditions—albeit with some softening—and real wages catching up with productivity are keeping it elevated.
- Significant disparities in wage growth persist among countries. CEE economies exhibit significantly higher wage growth compared to Western and Southern Europe due to tighter labor markets, substantial hikes in minimum and public sector wages, higher inflation, and stronger underlying productivity growth.

Wage growth (y/y, in percentage)



Wage growth in 2024 Q3 (y/y, in percentage)

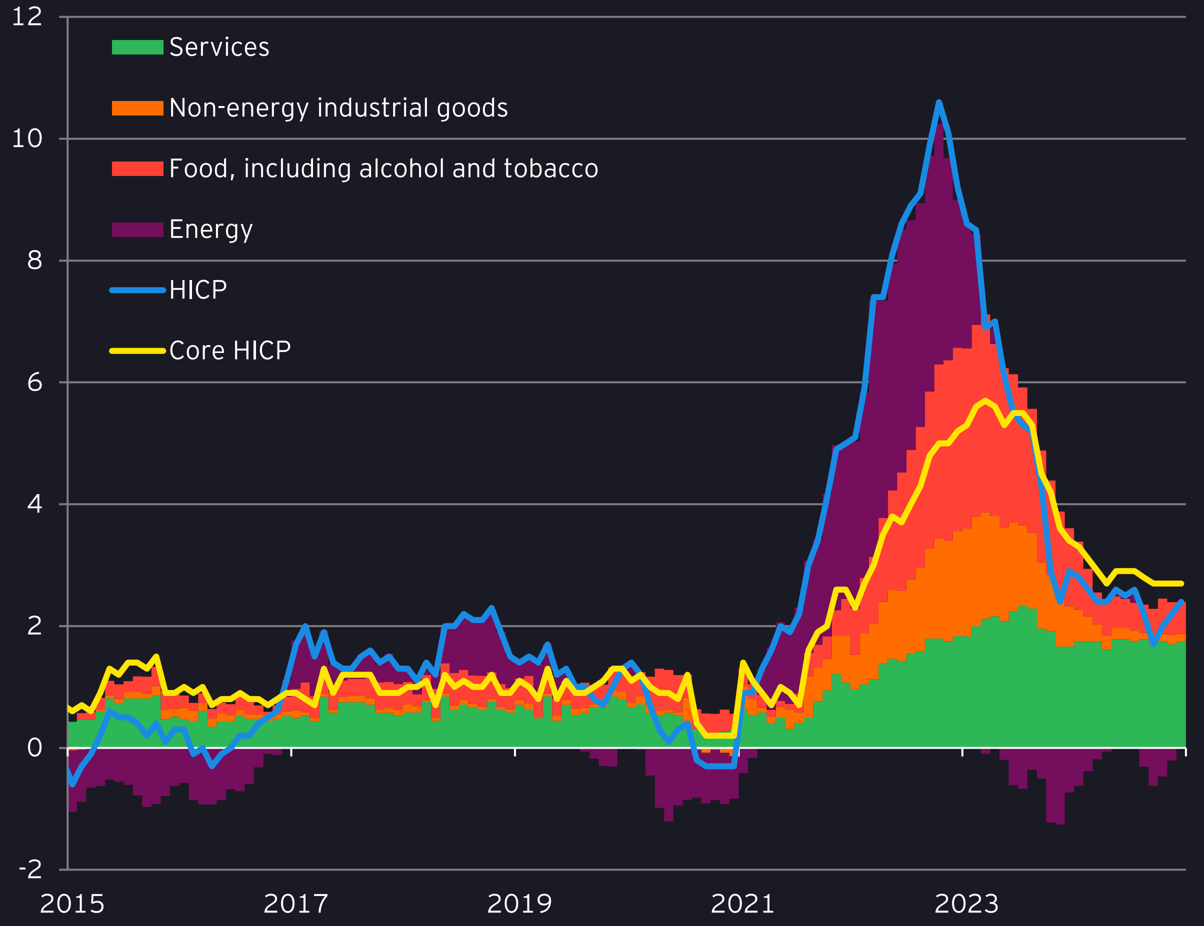


Source: Eurostat, ONS, FRED, Oxford Economics

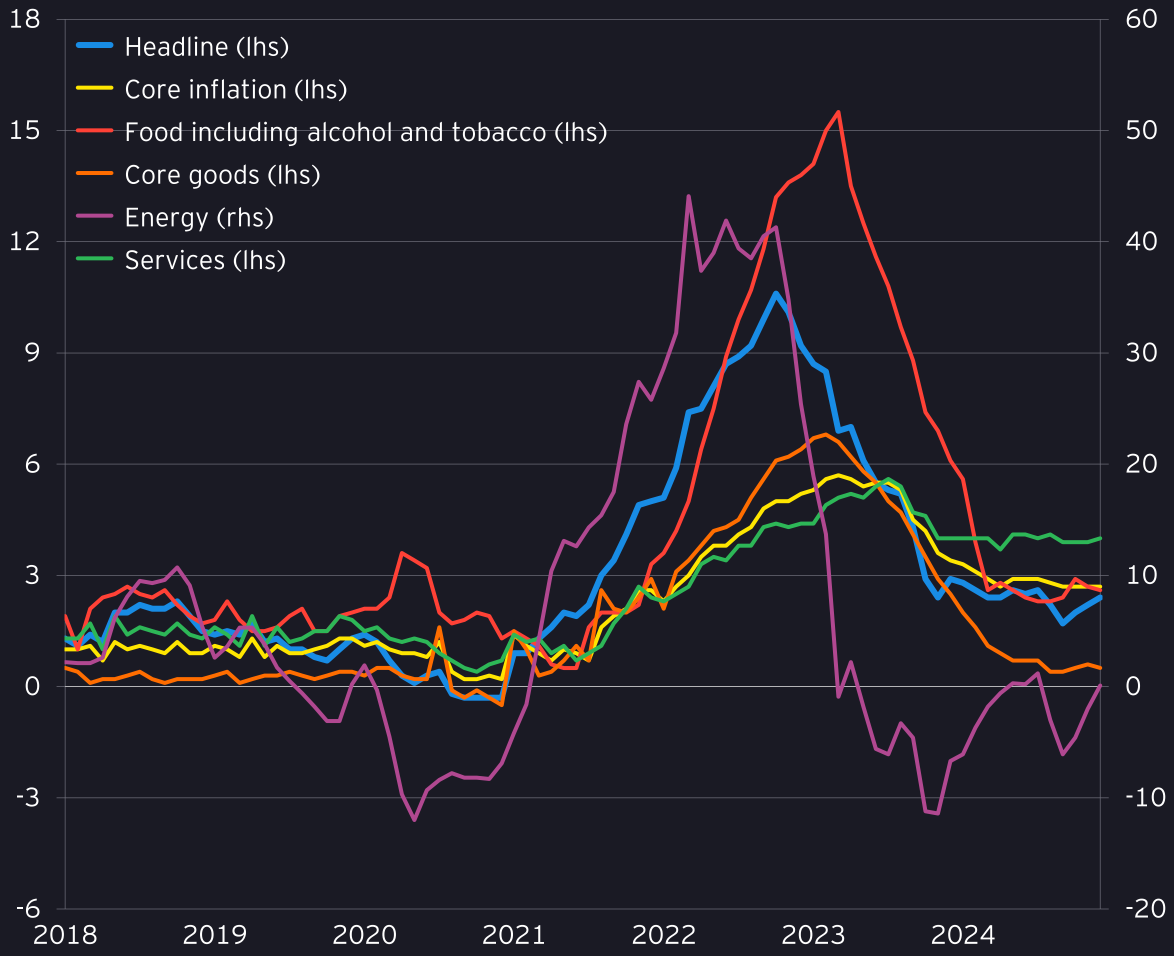
For the euro area countries, wages and salaries per employed person; for the UK, average weekly earnings in the whole economy, total pay; for the US average hourly earnings of All Employees, Total Private. Nordics as Norway, Sweden, Finland, and Denmark arithmetic average.

In the euro area, inflation has risen above 2% due to an increase in energy inflation stemming from base effects, whereas core inflation has held steady at 2.7% due to persistent price pressures in services

Statistical decomposition of y/y HICP inflation in the euro area (in percentage)



HICP inflation in the euro area (y/y, in percentage)

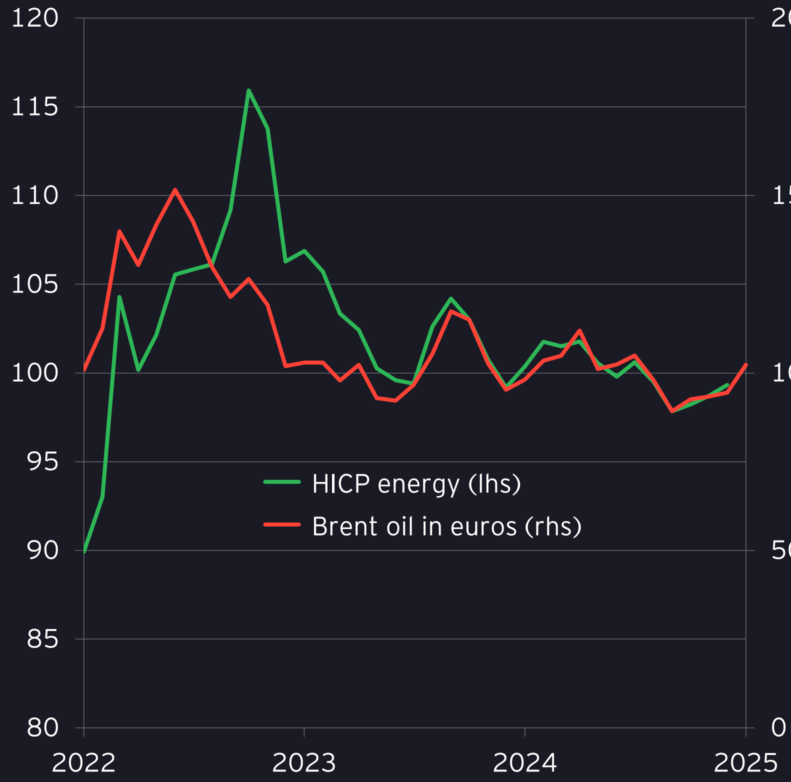


Source: Eurostat.

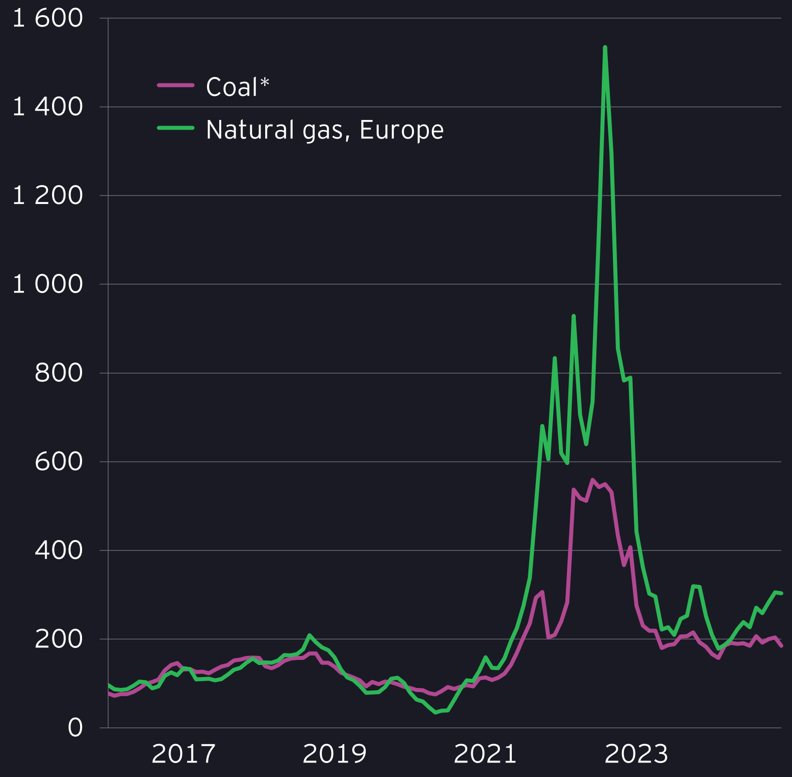
Non-core inflationary components have been increasing in recent months due to base effects in energy prices and excise tax hikes

- Oil prices stabilized at a relatively low level in 2024 Q4, and so has energy HICP. However, negative base effects—originating from a drop in oil prices in late 2023—have elevated the y/y energy HICP from negative values towards zero, contributing to a rise in headline inflation from 1.7% in September to 2.4% in December. The uptick in oil prices in January 2025 indicates that energy costs will likely continue to exert upward pressure on inflation also at the start of 2025.
- Natural gas prices were increasing over the course of 2024 but with little impact on consumer prices so far.
- Continued tobacco excise tax hikes have been pushing up inflation in the food, alcohol and tobacco category.

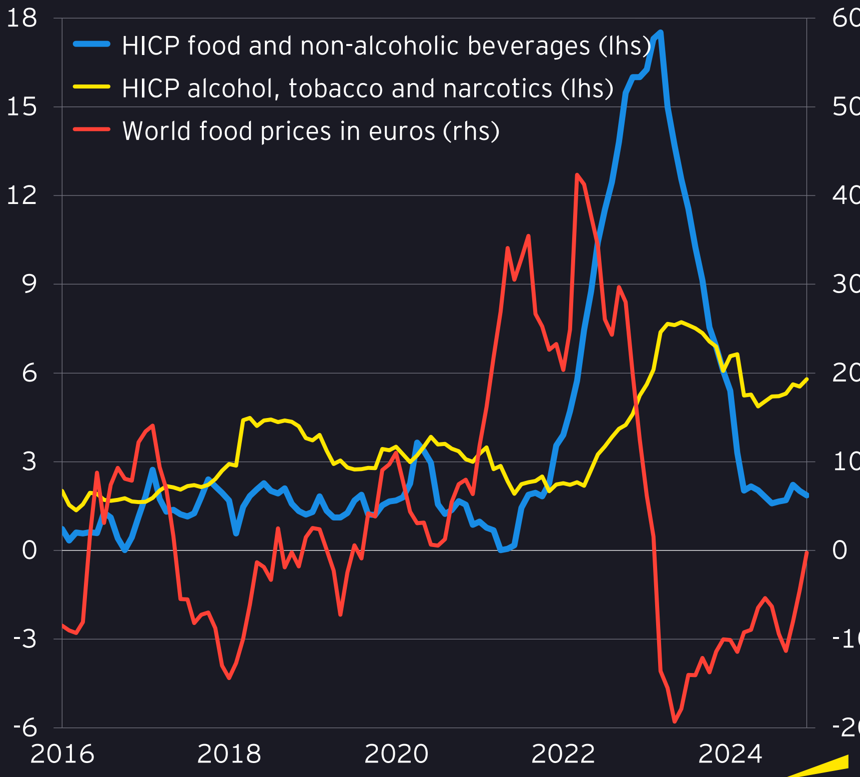
HICP energy in the euro area vs. oil prices (index, 2024 = 100)



Natural gas and coal prices (index, 2016 = 100)



HICP food measures in the euro area vs. world food prices (y/y)

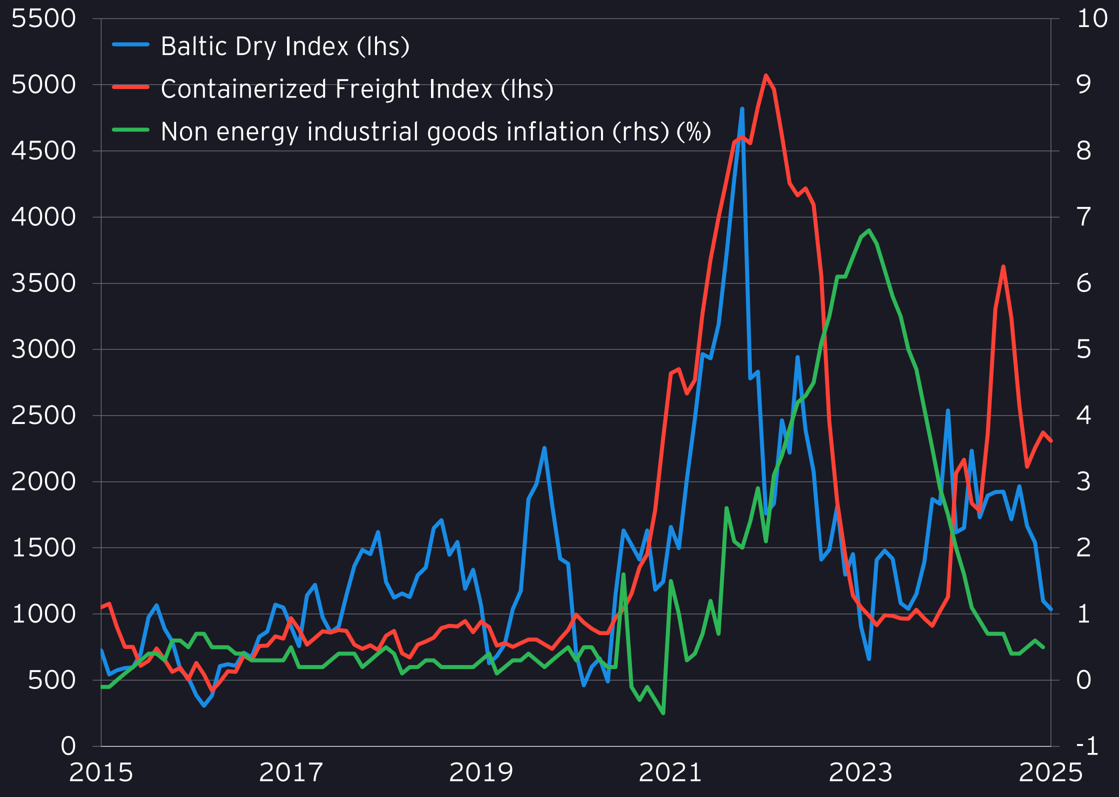


Source: World Bank Commodity Prices; BIS; Eurostat; stooq.pl.
* ICE Rotterdam coal price.

Core goods prices have largely stabilized despite elevated shipping costs, whereas services inflation remains persistent due to elevated wage growth and an ongoing catch-up with goods prices

- The proportion of labor costs in services is double that of manufacturing, creating a strong link between wage growth and services inflation.
- Additionally, services prices may be undergoing an adjustment to align with goods prices, driven by cost pressures from energy, food in restaurants, and equipment, alongside attempts by service providers to preserve their relative pricing.

Shipping costs of dry bulk and container transport vs. core goods inflation in the euro area (y/y, in percentage)



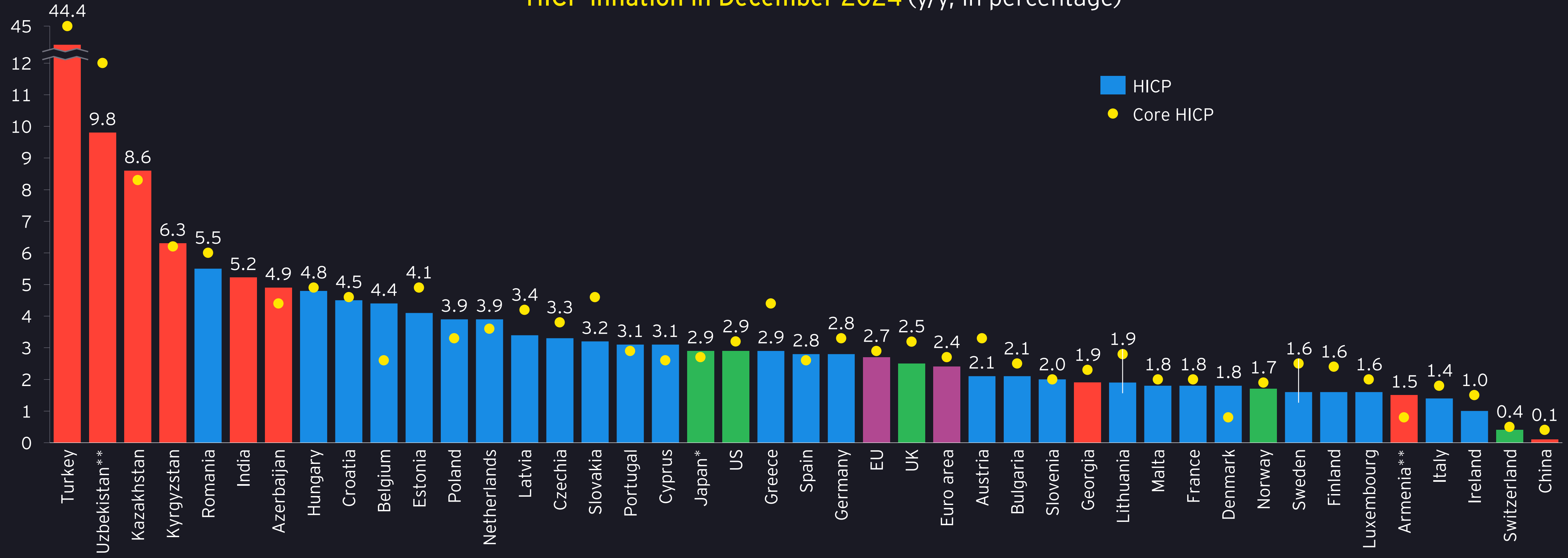
Y/y services inflation vs. y/y nominal wage growth in the euro area (in percentage)

Source: Eurostat, Oxford Economics, Trading Economics, investing.com, EY calculations.
Notes: Baltic Dry index is a shipping freight-cost index for dry bulk cargo. Containerized Freight Index tracked by Trading Economics considers the most current freight prices for container transport from the most important ports in China.

Inflation rates across Europe continue to diverge, influenced by disparities in wage growth, regulatory pricing, and excise tax hikes

- Romania continues to exhibit the highest rate of inflation, close to 5%, propelled by robust domestic demand and significant wage increases. Inflation remains elevated in several other CEE countries, characterized by persistent services inflation and strong wage growth. In Western Europe, Belgium and the Netherlands face the highest inflation rates, largely due to tobacco prices soaring by roughly 30% following substantial excise tax hikes. Additionally, in Belgium, energy inflation has swiftly responded to recent spikes in natural gas prices, while the Netherlands sees sustained services inflation, linked to relatively high wage growth. Conversely, Switzerland's inflation is below 1%, with a strong Swiss franc and subdued wage growth contributing to goods deflation.

HICP inflation in December 2024 (y/y, in percentage)

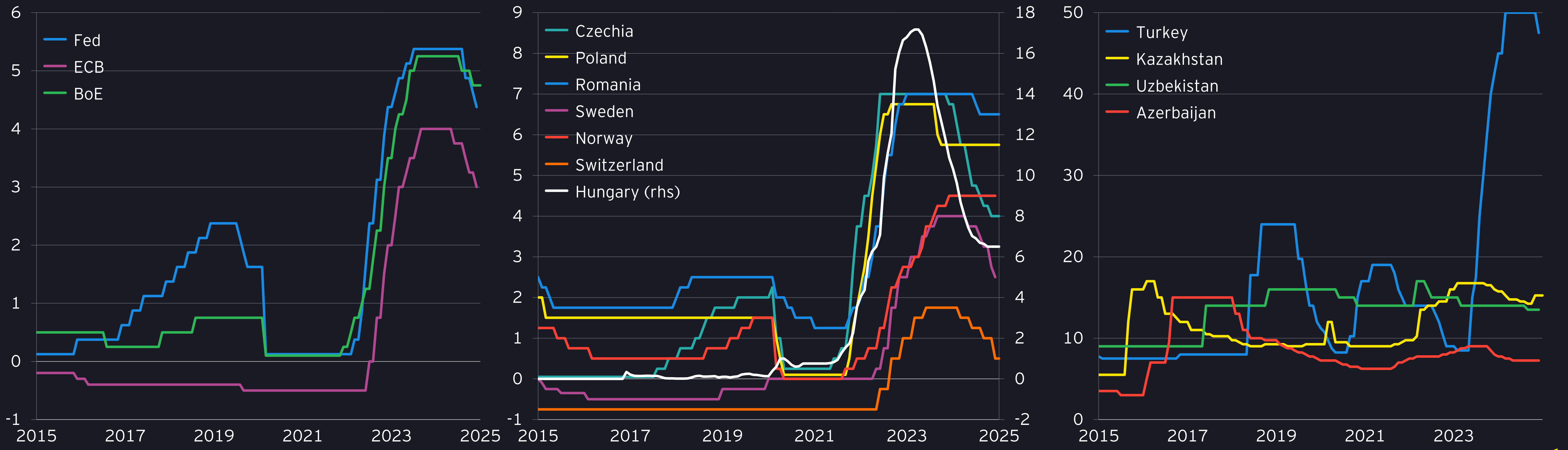


Source: Eurostat, FRED, ONS, Trading Economics, national statistical bureaus.
Note: For non-EEA countries, CPI inflation.
*November 2024
**November 2024 – Core CPI only

Central banks have been reducing interest rates, though the pace and timing of monetary policy easing vary significantly across jurisdictions

- Amid deteriorating business sentiment, the ECB accelerated the pace of easing in the latter part of 2024, implementing three consecutive 25bps rate cuts from September to December, which brought the deposit rate down to 3%.
- The Bank of England's Monetary Policy Committee has adopted a "cut and hold" approach, reducing rates by a total of 50 bps in 2024 and setting the bank rate at 4.75%.
- The Swiss National Bank (SNB), influenced by a strong Swiss franc, low wage growth, and subdued inflation, decreased interest rates from 1.75% to 0.5% in 2024. Sveriges Riksbank has also outpaced the ECB in rate cuts, with rates reaching 2.5% by the end of 2024, prompted by stagnant economic activity and weak underlying price pressures. In contrast, somewhat higher inflation keeps Norges Bank more cautious, maintaining rates unchanged at 4.5%.
- In CEE, strong wage increases, persistent services inflation, and rising food prices have caused central banks to decelerate or halt rate reductions recently. Interest rates in Poland, Romania, and Hungary remain high, ranging from 5.75% to 6.5%. Czechia stands as an outlier, with softer wage dynamics, demand, and inflation leading to a lower interest rate of 4%.
- The National Bank of the Republic of Kazakhstan (NBRK) increased the base rate by 100 basis points to 15.25% in December 2024 and maintained the rate in January 2025. Despite the absence of further rate hikes in January, the central bank's rhetoric continues to be hawkish.

Central bank interest rates (In percentage)

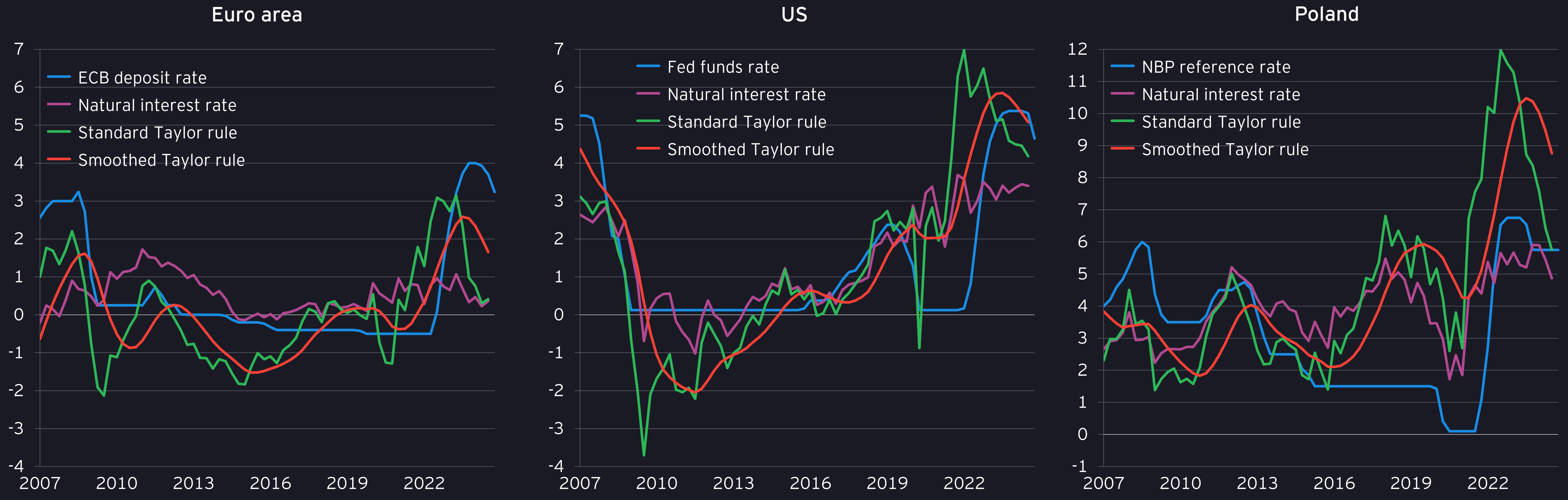


Source: ECB; Fed; BoE; BIS, Trading Economics.

Our analysis indicates that the neutral interest rate in the euro area is notably low, suggesting that the current stance of the ECB's monetary policy is excessively restrictive

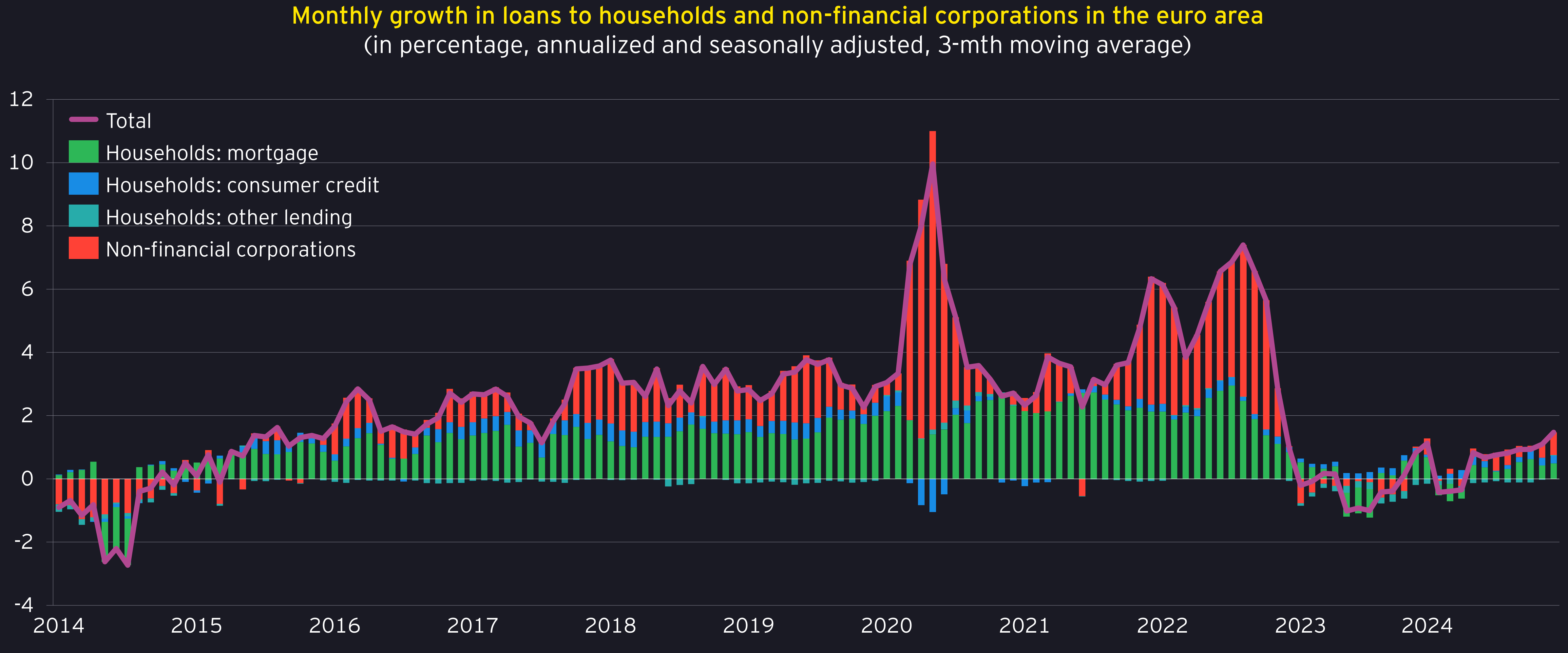
- We have estimated the nominal natural interest rates for the euro area, US, and Poland using a Kalman filter approach. This involves regressing our output gap estimates (as detailed in the previous edition of the Outlook) on its lags, the gap between the central bank policy rate and the unobservable natural interest rate, and a variety of other business cycle drivers*.
- The natural interest rate derived in this manner can be interpreted as the nominal interest rate that would, in the absence of any shocks, stabilize economic conditions in the medium term.
- We use these natural interest rate estimates to compute the central bank rates implied by standard and smoothed Taylor rules** that can serve as benchmarks for monetary policy
- We find that the natural interest rate in the euro area remains below 1%, with Taylor rules indicating that the ECB's deposit rate ought to be under 2%. In contrast, the natural rate in the US is much higher, at close to 3%, with the Fed funds rate aligning closely with Taylor rules. In Poland, the natural rate is estimated to be significantly higher, around 5%.

Central bank interest rates vs. natural interest rates and interest rates implied from Taylor rules (In percentage)



Source: EY EAT calculations based on Oxford Economics, Eurostat and FRED data.
* Other business cycle drivers include structural fiscal balance, external demand, pandemic restrictions, corporate credit spreads, real wage growth, and quantitative easing. We report one-sided Kalman filter estimates.
** The standard Taylor rule postulates that the central bank's policy rate should be equal to the nominal natural rate interest plus half of the deviation of core inflation from the inflation target and half of the deviation of output from its potential. The smoothed Taylor rule additionally includes two lags of the policy rate, assuming that the policy rate adjusts to the standard Taylor rule with a lag.

With monetary policy easing, credit growth is slowly picking up, especially in the domain of corporate lending

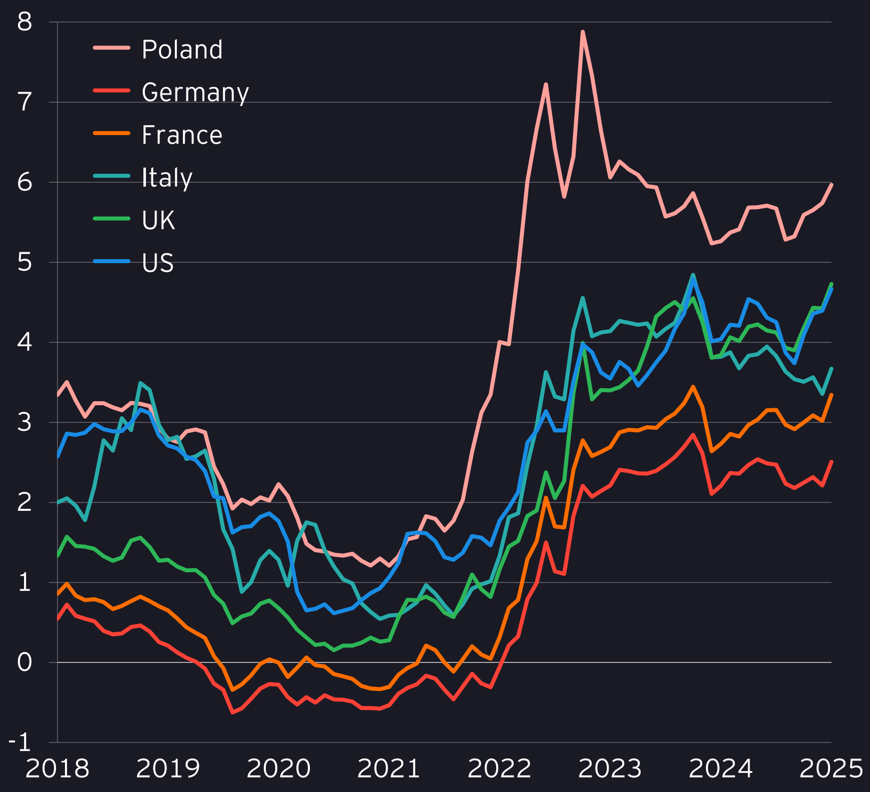


Source: ECB, EY calculations.
Note: Series for households include NPISH.

In the wake of the US elections, bond yields have risen, with the increase being more pronounced in the US and the UK compared to continental Europe. As a result, USD has strengthened against EUR

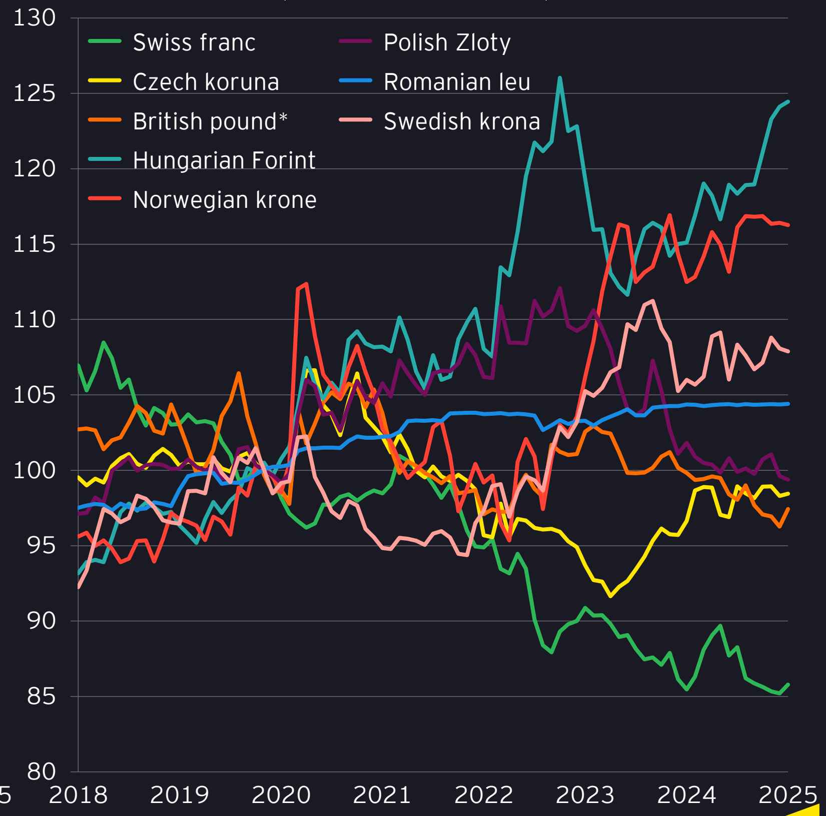
- Within the euro area, yield spreads over German bonds have been gradually decreasing in Italy, reflecting the country's successful fiscal consolidation. Conversely, in France, spreads have widened due to a political deadlock that has stalled any meaningful fiscal reforms.
- Other European currencies have remained relatively stable in relation to the euro in recent months, with the exception of the Hungarian forint, which has continued to depreciate, negatively affected by the outcome of the US elections and unfavorable macroeconomic data.
- Over a longer horizon, Nordic currencies are comparatively weak, a situation that is partly justified by their higher cumulative inflation relative to the euro area. Meanwhile, the Polish zloty and the Czech koruna are strong in real terms, maintaining exchange rates close to pre-pandemic levels despite experiencing much higher cumulative inflation.

10-year government bond yield (in percentage)



EUR/USD exchange rate

Exchange rates vs. EUR (2019-Q4= 100)

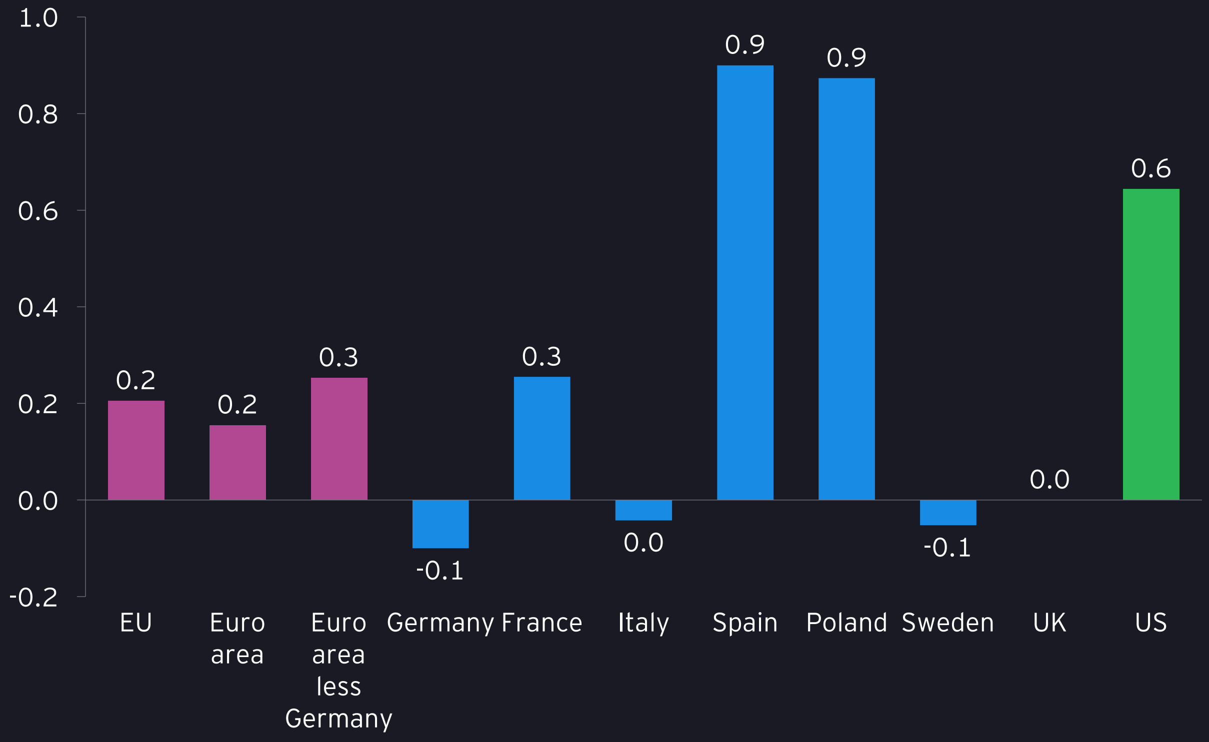


Source: investing.com, Bank for International Settlements (BIS), Stooq.pl.
* British pound as EURGBP

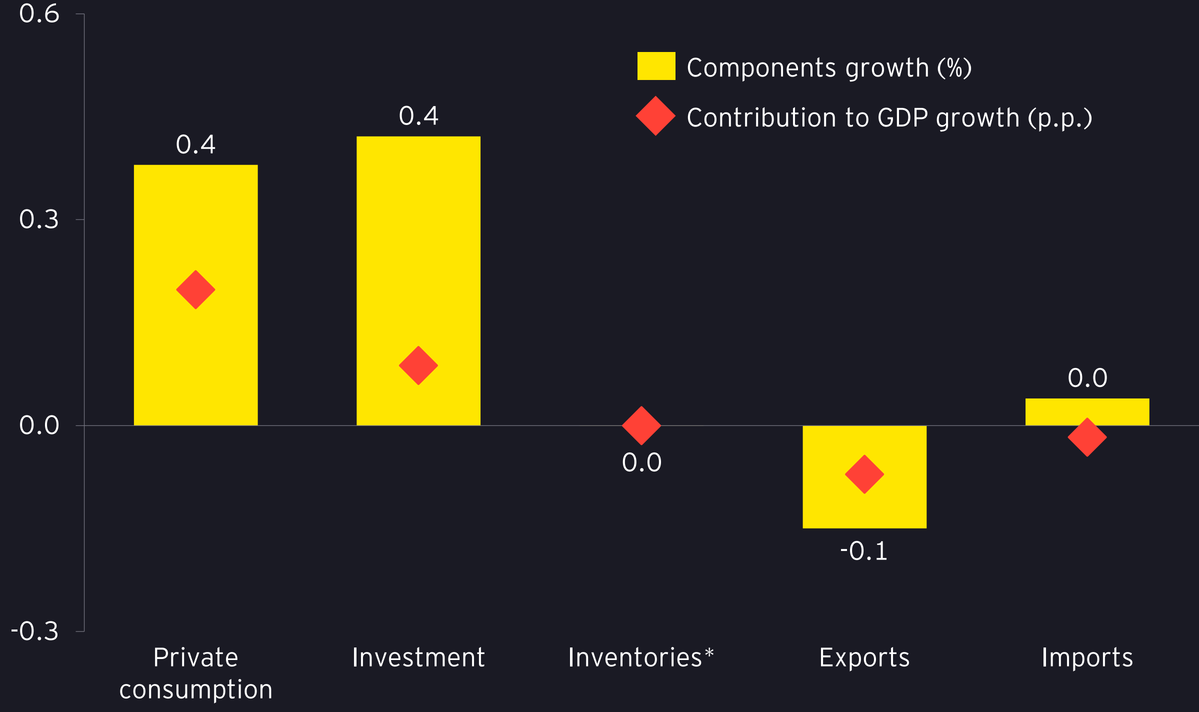
Our nowcasting models indicate that economic activity in the euro area maintained a modest growth rate in 2024 Q4, with ongoing disparities between the performances of Spain and Germany

- Consumption was the main driver of growth, in contrast to exports, which continued to contract.

Estimated seasonally adjusted q/q real GDP growth in 2024 Q4 (In percentage)



Estimated seasonally adjusted q/q growth in GDP components in the euro area in 2024 Q4 (In percentage)

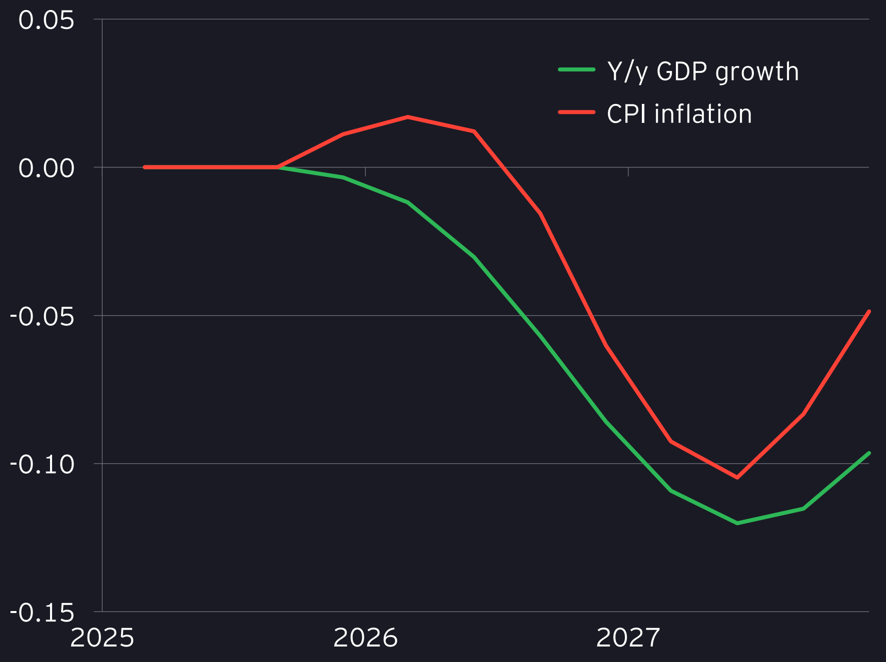


Source: EY calculations, AIReF.
For Germany, France, and Poland, nowcasts based on EY EAT nowcasting models. Models are estimated on quarterly data, missing monthly data at the end of the sample is imputed based on available data. For Spain, AIReF nowcast; for Sweden, nowcast based on monthly GDP data; for the UK, EY ITEM Club forecast; for the US, EY-Parthenon forecast. Nowcasts for the euro area and the EU are a combination of available nowcasts and model forecasts for the remaining member countries.
* For inventories, contribution to GDP growth.

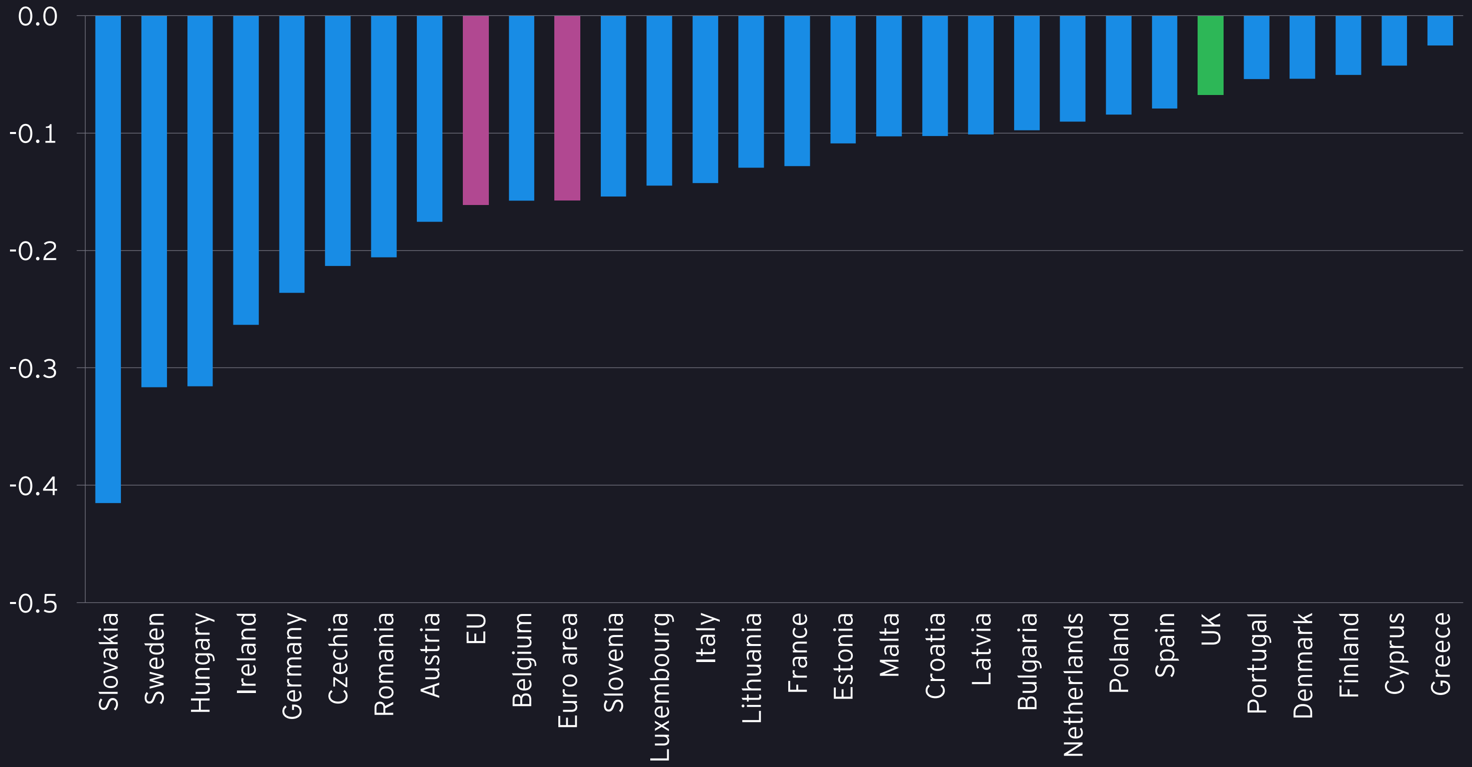
Our baseline scenario assumes that the new US administration will introduce only limited tariffs and modestly expand fiscal policy. Overall, this is expected to exert a modestly negative impact on the European economy

- Countries with significant exports of the targeted products (especially cars) to the US, such as Slovakia, Sweden, Hungary, and Germany, are anticipated to experience the most substantial, albeit still contained, GDP losses.
- The introduction of tariffs is likely to have a mildly inflationary impact in the immediate term; however, they are expected to have a deflationary effect over the medium term as lower global economic activity leads to lower prices of oil and other commodities.
- For more detailed analysis of economic impact of potential tariffs, including sectoral effects, see our note.

Impact of limited tariffs on y/y GDP growth and CPI inflation in the euro area
(in percentage points)



Impact of limited tariffs on 2027 GDP (in percentage)

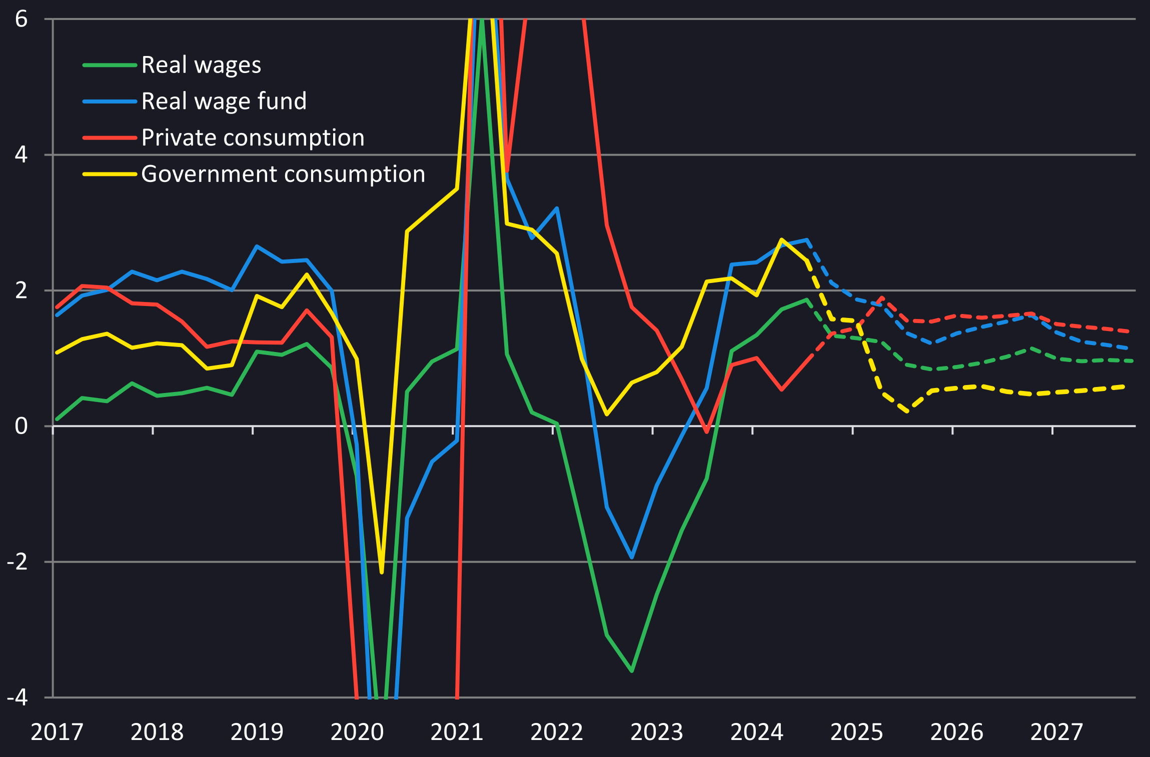


Source: EY EAT calculations.
The limited tariff scenario assumes the imposition of 25% tariffs on imports of steel, aluminum, and cars from the EU, and additional tariffs on Canada, Mexico, and China.

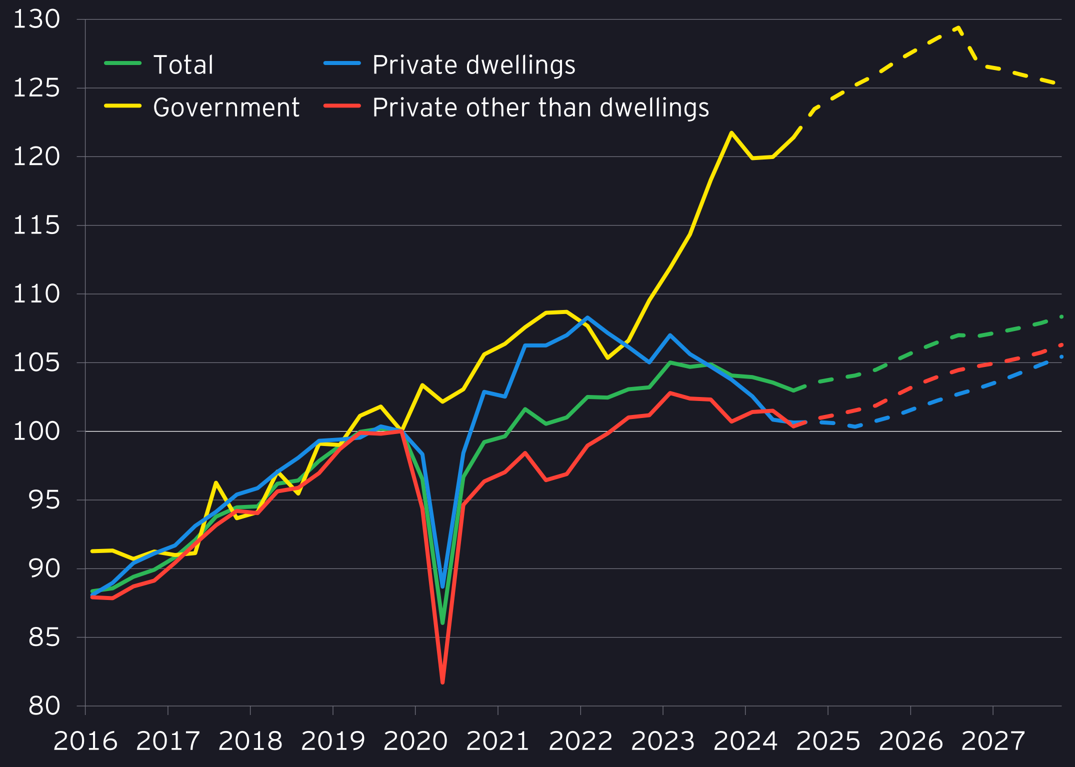
We maintain our forecast for a modest acceleration in growth over the next few quarters, propelled by the momentum in consumer spending and an investment boost from declining interest rates

- Consumption recovery will be supported by increasing real incomes—albeit at a slower rate—and falling interest rates.
- The recovery in investment is likely to be relatively slow, as the economy continues to operate slightly below its full capacity.
- With public sector wage and employment growth decelerating and a gradual fiscal consolidation, growth in government consumption is likely to slow, thereby tempering the overall speed of the recovery.

Y/y growth in real wages, real wage fund, real private consumption, and government consumption in the euro area (In percentage)



Real fixed capital investment by type in the euro area less Ireland (2019 Q4 = 100)

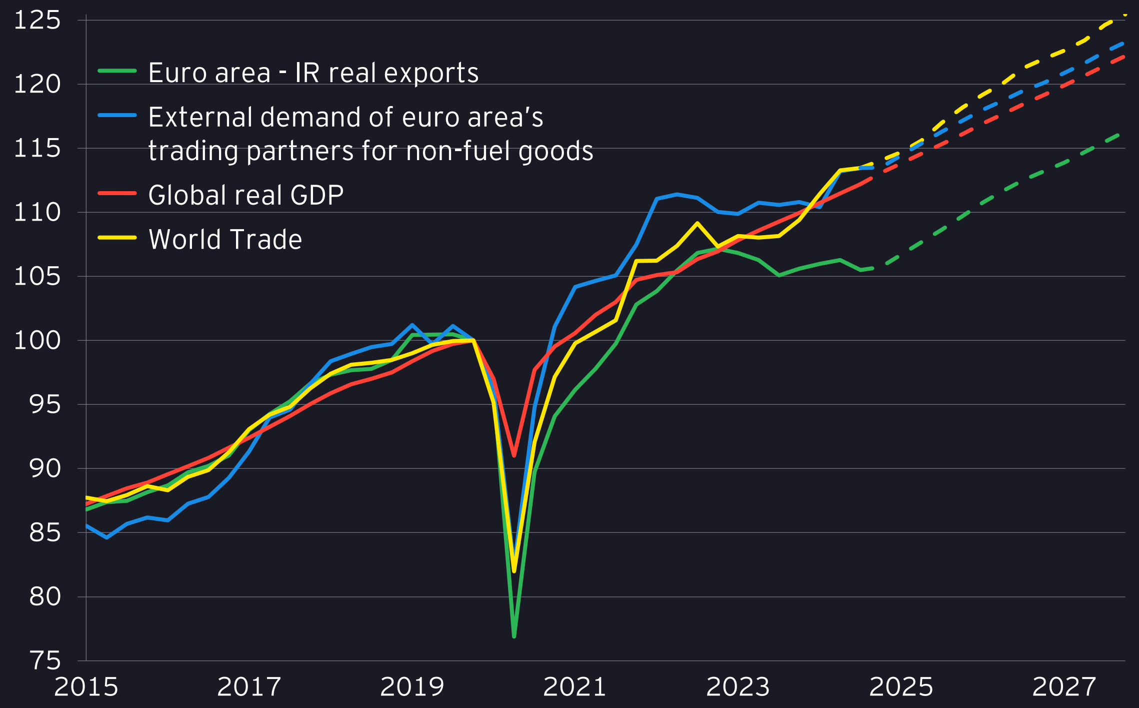


Source: Eurostat, Oxford Economics, EY EAT forecast.
Dashed lines denote forecast.

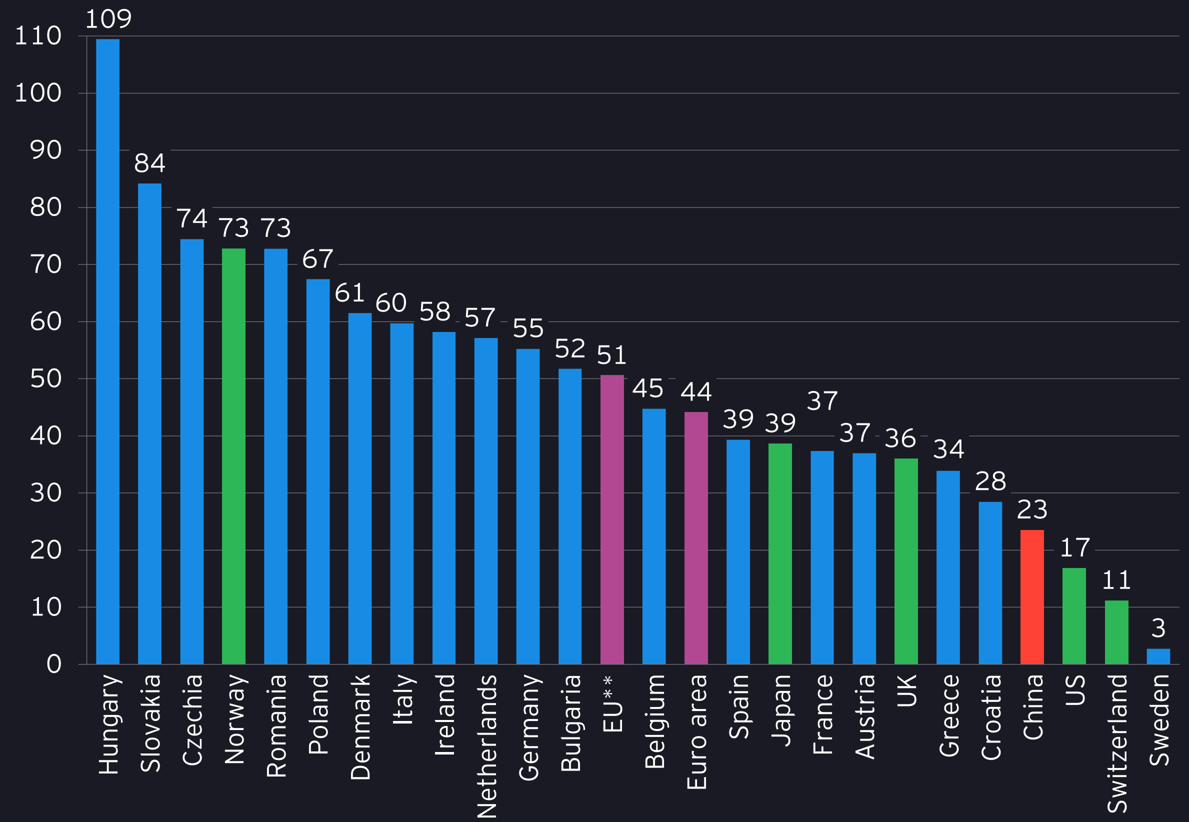
Exports growth should pick up slightly, supported by an upswing in external demand and the depreciation of the euro, despite tariffs and the diminished competitiveness of European producers

- The competitiveness of European producers has been eroded by several factors, notably the more pronounced rise in energy prices compared to other regions, with costs remaining significantly elevated above pre-pandemic levels.

Global real GDP and world exports, external demand for euro area non-fuel goods* and euro area less Ireland real exports (2019-Q4 = 100)



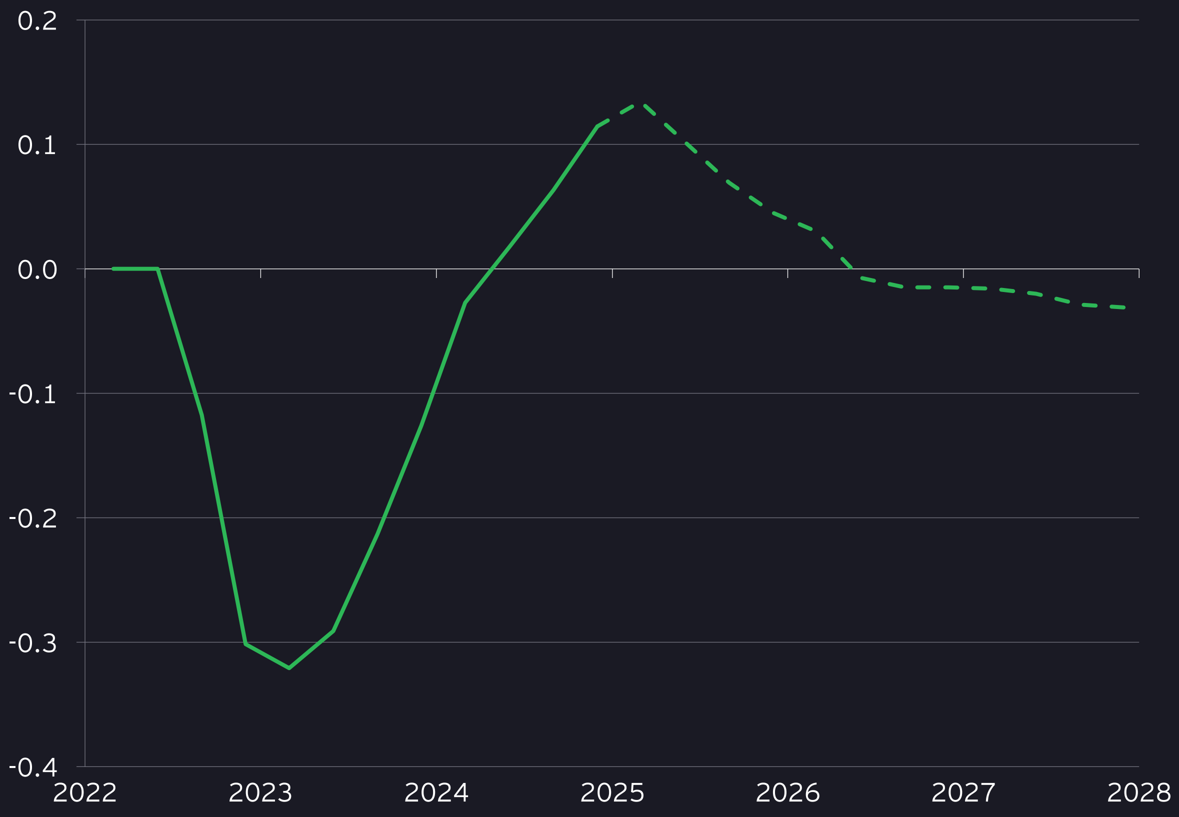
Change in energy prices***: 2024 Q3 vs. 2019 Q4 (in percentage)



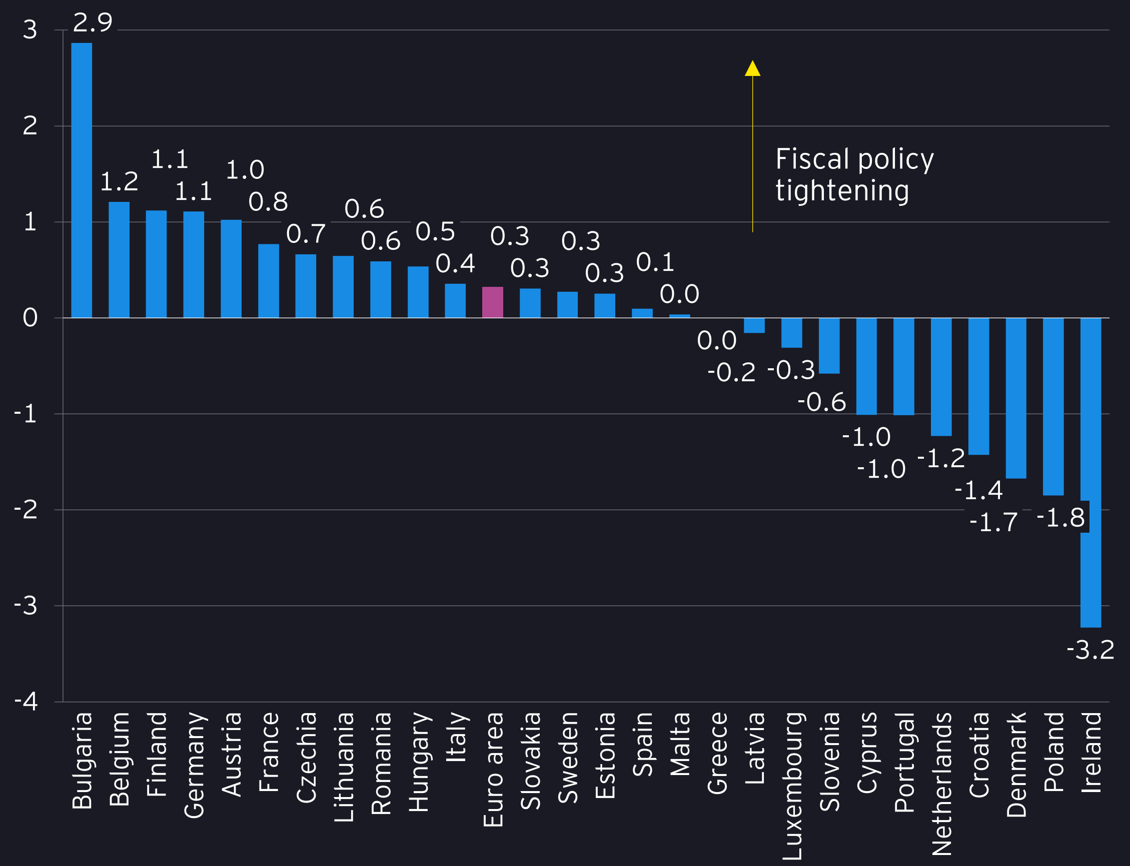
Source: Oxford Economics, EY EAT forecast.
*External demand for euro area non-fuel goods is equal to imports of trading partners, weighted by shares of those trading partners in the euro area exports.
**Country average for EU and euro area excluding Cyprus, Estonia, Latvia, Lithuania, Luxembourg, Malta and Slovenia.
*** Energy prices are the final price average of coal, natural gas, petroleum products, and PPI for electricity weighted by consumption.
Dashed lines denote forecasts.

Economic policy is expected to have a mixed impact on growth, with monetary policy supporting activity, while fiscal policy is being tightened in most EU countries

Impact of monetary policy on the euro area real GDP q/q growth (in percentage)



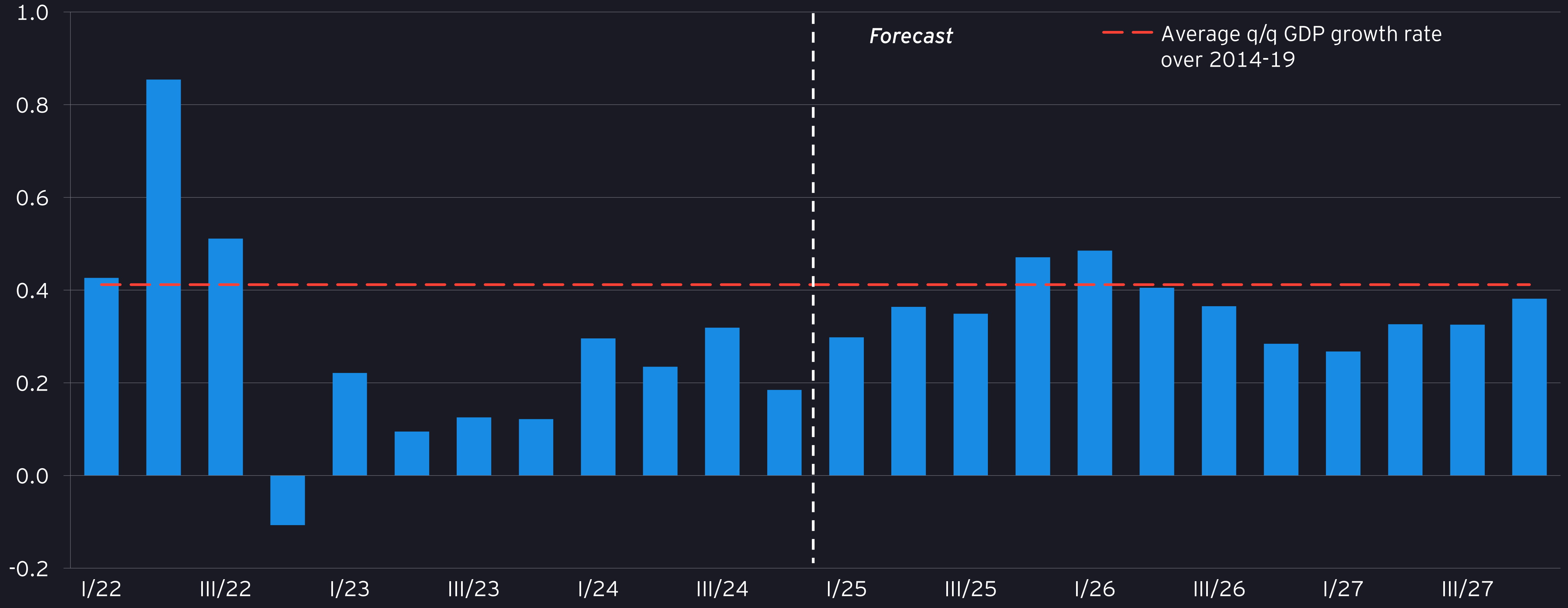
Expected change in structural fiscal balance* in 2025 (In percentage of potential GDP)



Source: Oxford Economics, EY calculations.
Dashed line denotes forecast.
* Structural balance is general government balance corrected for cyclical and one-off factors.

We forecast a modest rise in euro area GDP growth from 0.8% in 2024 to 1.3% in 2025. We expect the recovery to reach full pace in 2026, with GDP growth peaking at 1.8%, followed by a deceleration to 1.4% in 2027 as the NextGenEU program concludes

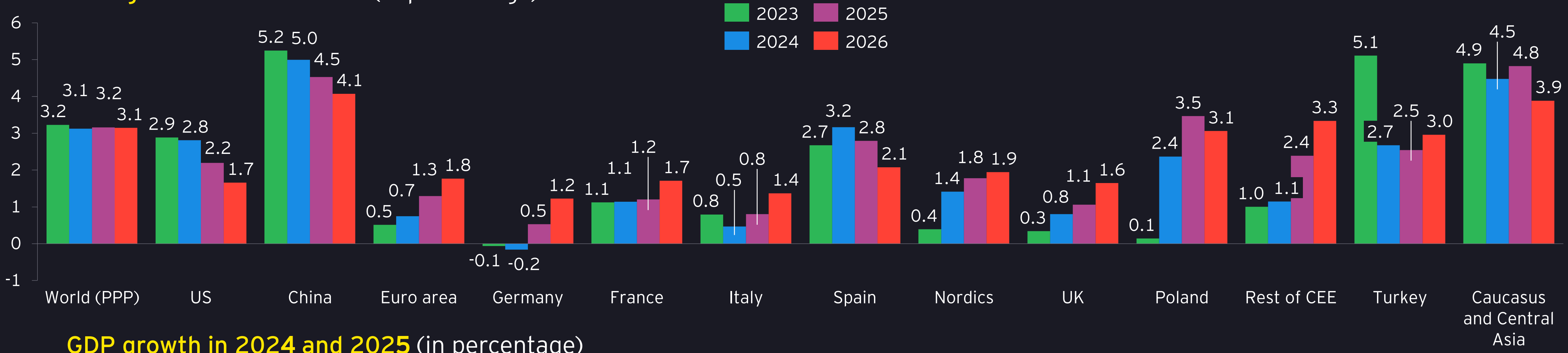
GDP growth in the euro area less Ireland
(q/q, in percentage)



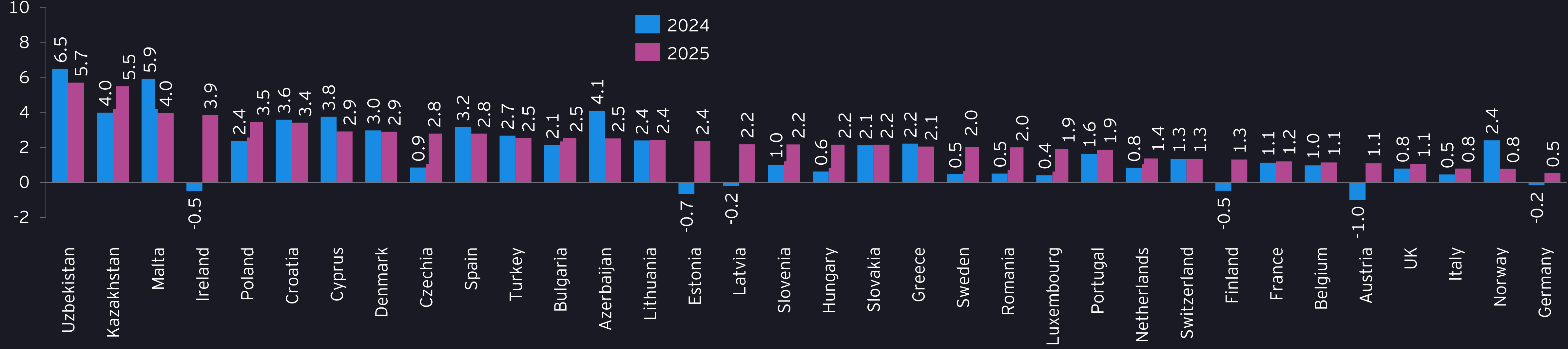
Source: Oxford Economics, EY EAT forecast.

Spain is poised to remain a star performer, while Germany is expected to lag behind, although the growth disparity between Southern and Central Europe is anticipated to narrow progressively

GDP growth in 2023-2026 (in percentage)



GDP growth in 2024 and 2025 (in percentage)

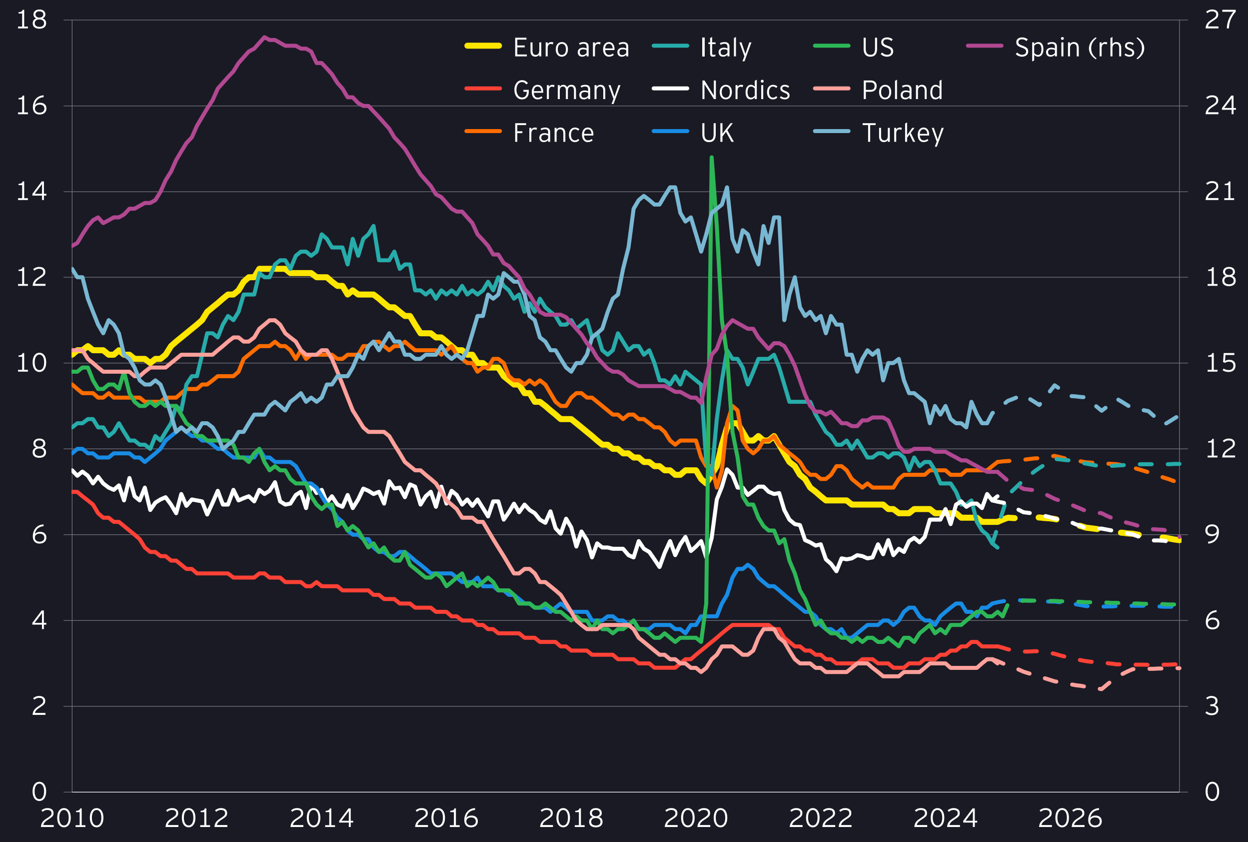


Source: Oxford Economics, EY EAT forecast; IMF (for Caucasus and Central Asia).
Nordics include Denmark, Finland, Norway and Sweden; rest of CEE includes Estonia, Latvia, Lithuania, Czechia, Slovakia, Hungary, Romania, Bulgaria, Croatia, Slovenia; Caucasus and Central Asia includes Kazakhstan, Uzbekistan, Kyrgyzstan, Turkmenistan, Tajikistan, Azerbaijan, Armenia, and Georgia.

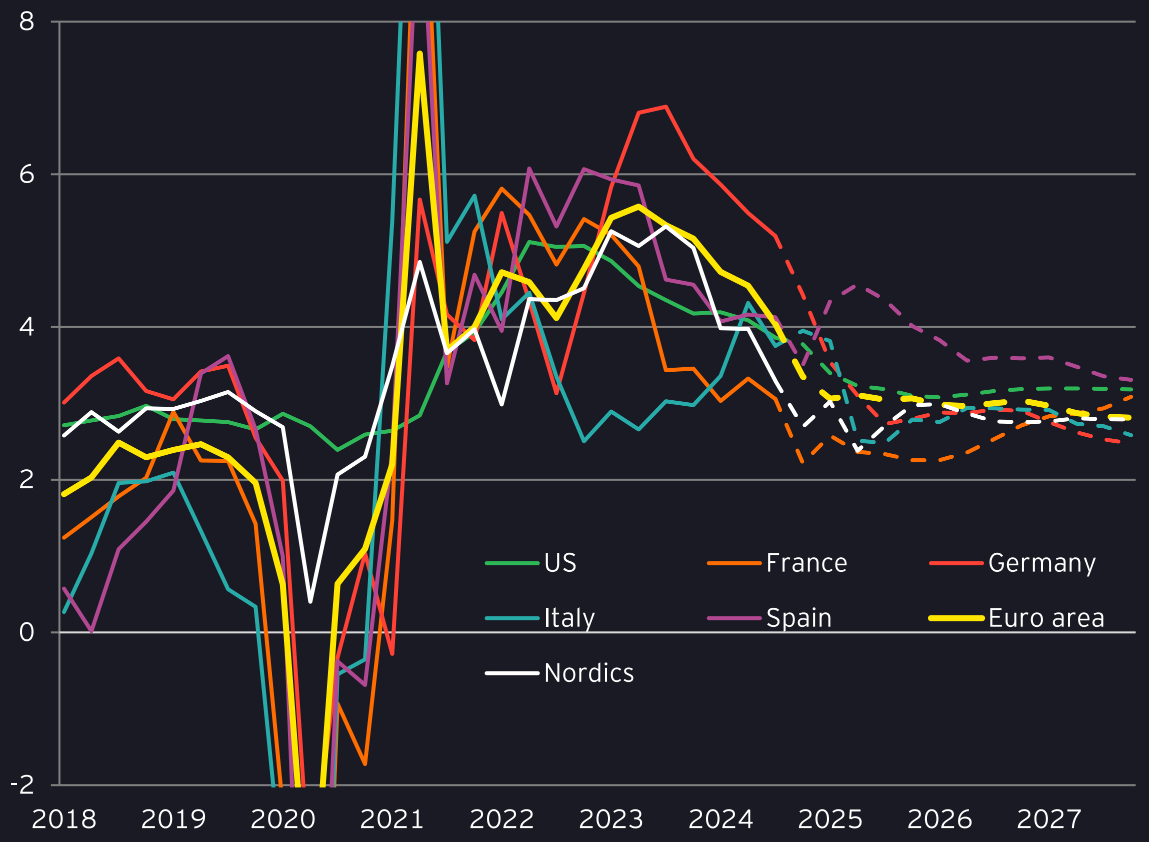
Labor market conditions in the euro area are expected to stabilize, with wage growth gradually declining towards 3%—still higher than pre-pandemic levels due to a structurally tighter labor market

- Amid slightly faster GDP growth and increasingly binding demographic constraints, employment growth is expected to stabilize at approximately 0.1% q/q. This rate is anticipated to be sufficient to maintain the euro area unemployment rate at 6.3-6.4% in 2025, with a slight decline expected thereafter.
- The stability at the euro area level will mask notable cross-country divergences, as employment growth is set to remain vigorous in Spain and experience a cyclical recovery in the Nordics, in contrast to the stagnation predicted for Germany and CEE. Wage growth in CEE is likely to outpace other regions, although it is expected to gradually decrease over time.

Unemployment rate (in percentage)



Wage growth (y/y, in percentage)

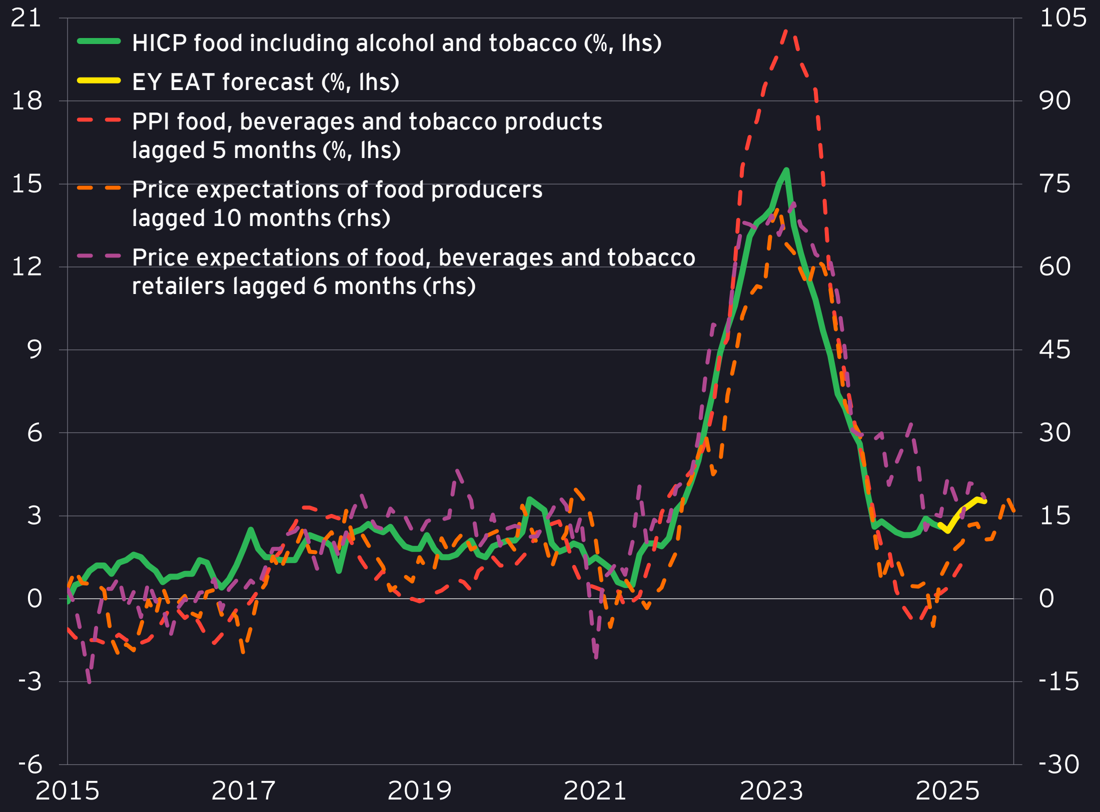


Source: Eurostat, Oxford Economics, EY EAT forecast.
Dashed lines denote EY EAT forecast.

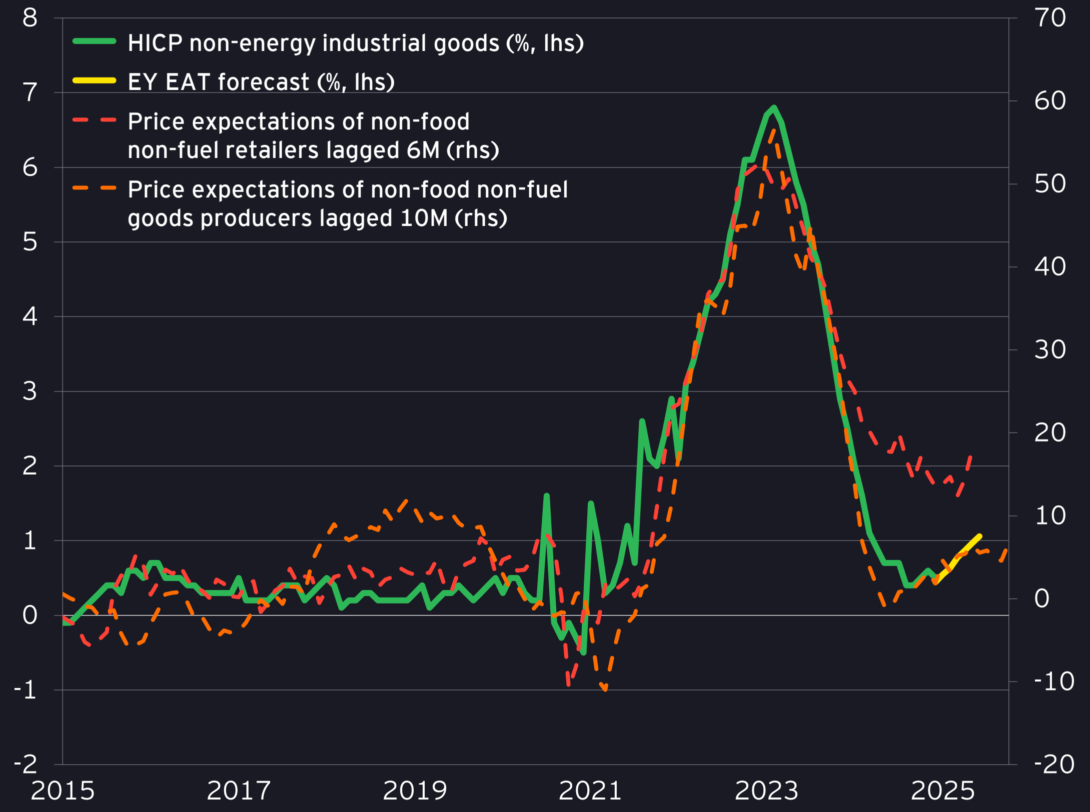
Rising producer price expectations indicate that food inflation could hover around 3% in the near term, while core goods inflation may pick up from its present subdued levels

- Inflation within the food, alcohol, and tobacco category is being driven by significant tobacco excise tax hikes in many countries, which is likely to keep this inflation component close to 3% in 2025.
- Concurrently, the factors that previously dampened core goods inflation—such as receding supply chain bottlenecks, soft demand, and falling energy prices—seem to be fading. Increased shipping and labor costs, alongside potential tariffs, are likely to elevate core goods inflation above 1% as 2025 progresses.

Food HICP y/y inflation and its leading indicators in the euro area



Core goods HICP y/y inflation and its leading indicators in the euro area

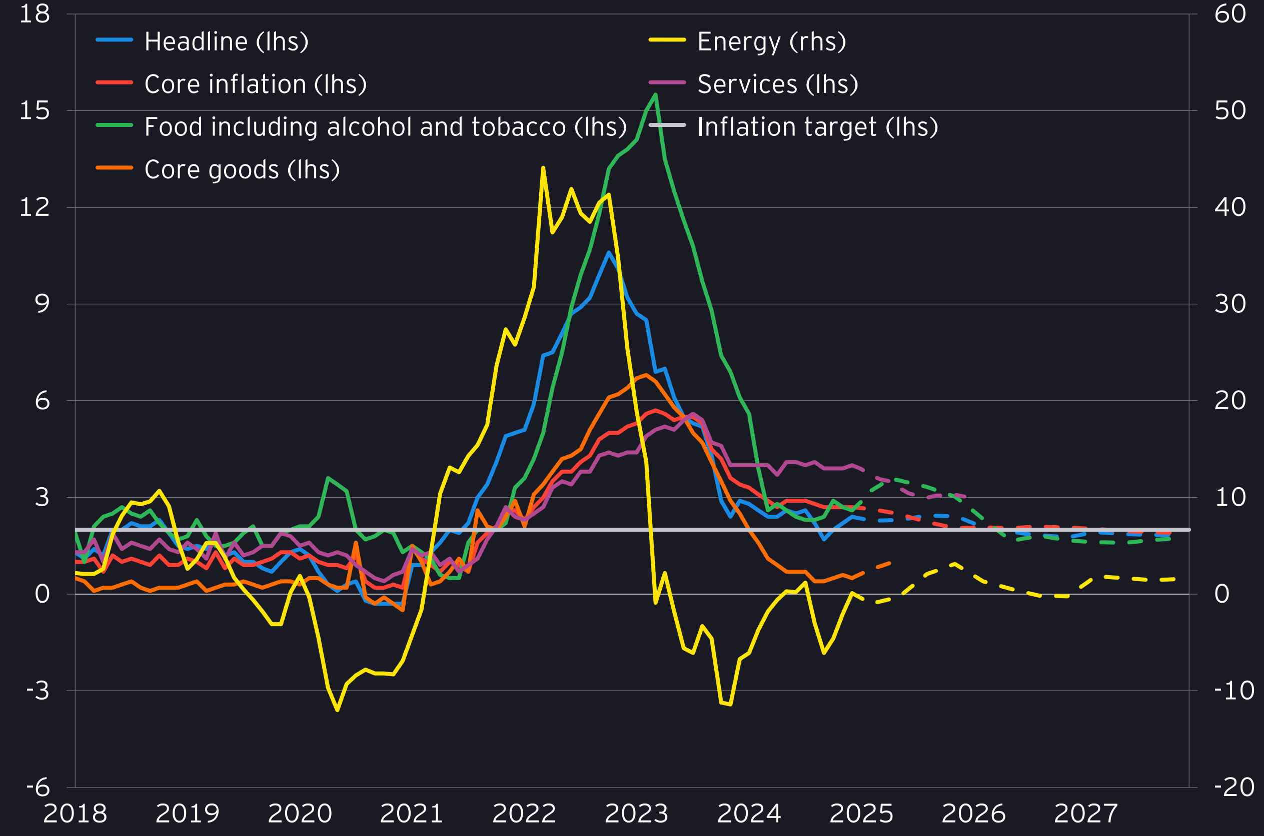


Source: Eurostat, European Commission, Oxford Economics, EY EAT forecast.

We anticipate headline inflation in the euro area to stay around 2.3% throughout 2025 before declining to 1.9% in the following years

- While core inflation is expected to moderate, reaching 2% by the end of 2025, food and energy components will keep headline inflation above 2%. Core inflation should decline as services inflation finally subsides on the back of slowing wage growth, even though core goods inflation is likely to pick up as disinflationary forces in industrial goods markets fade and EU imposes tariffs on selected US products in response to Trump tariffs. At the same time, food, alcohol and tobacco inflation may stay elevated at close to 3% on the back of past supply shocks and tax hikes, and energy prices should modestly increase due to higher natural gas and oil prices. In 2026, headline and core inflation should stabilize close to 2%.

HICP inflation in the euro area (y/y, in percentage)



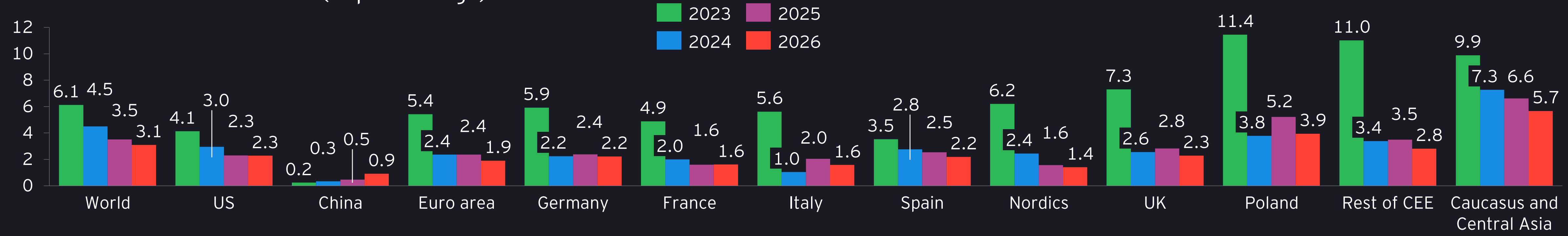
Y/y HICP services vs. nominal wage growth in the euro area (in percentage)

Source: Eurostat, Oxford Economics, EY EAT forecast.
Dashed lines denote EY EAT forecast.

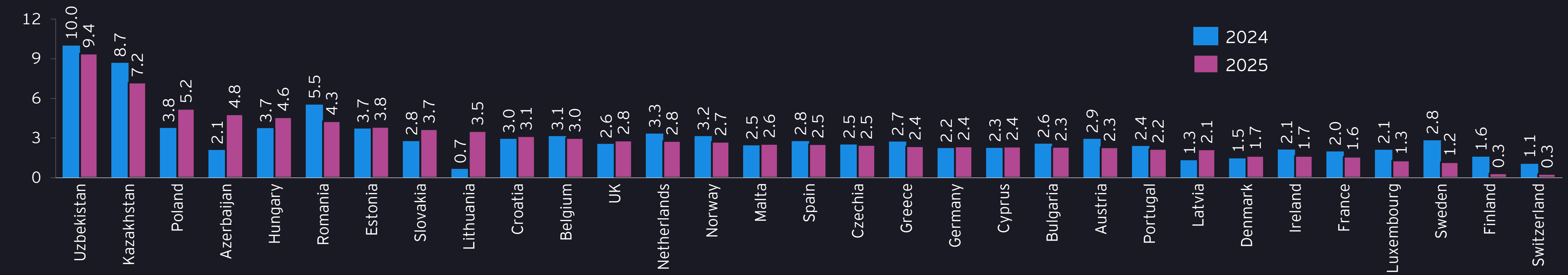
In 2025, CEE countries are expected to experience the highest inflation rates, whereas the Nordics and Switzerland are likely to face the least price pressure

- In CEE, headline inflation is expected to remain above 3.5% in several countries, driven by persistent inflation in services and elevated food price inflation. Poland is forecasted to have the highest inflation rate, influenced by a significant tobacco excise hike and an expected increase in regulated energy prices. Conversely, a strong Swiss franc and low wage growth will continue to limit price pressures in Switzerland. In Finland and Sweden, methodological issues are projected to reduce headline CPI inflation figures*, although the underlying price pressures are expected to remain relatively muted as well.
- For most other countries, we expect headline inflation to fall within the 1.5%–3.0% range. Belgium, the Netherlands, Norway, and Spain are likely to approach the higher end of this spectrum. In Belgium and Norway, recent surges in natural gas prices are expected to drive up energy costs. In the Netherlands, services inflation is anticipated to remain elevated, while Spain's broad-based price pressures are attributed to robust economic activity. In contrast, France is expected to maintain lower food inflation compared to other countries, which should keep its headline inflation below 2%.

Inflation in 2023-2026 (in percentage)



Inflation in 2024 and 2025 (in percentage)



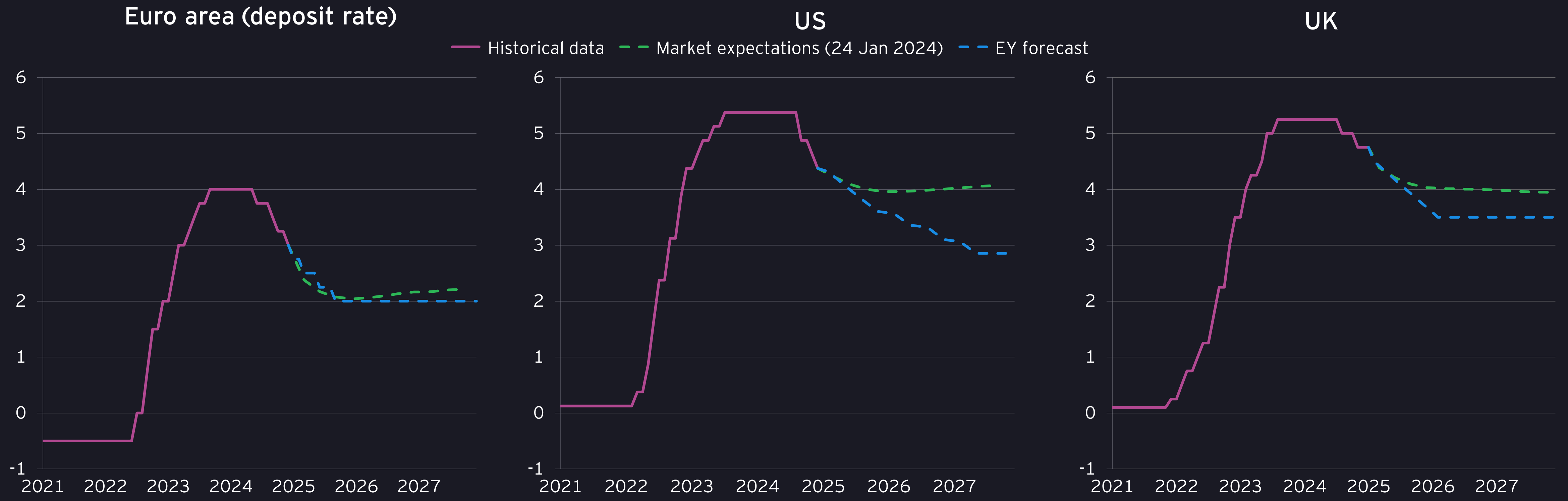
Source: Oxford Economics, EY EAT forecast.

* In Finland and Sweden, mortgage interest payments enter CPI. For this reason, interest rate cuts will have a strong negative impact on headline CPI inflation in 2025.

We expect the ECB to cut rates at each meeting until March, followed by a deceleration in the rate reductions pace. The Bank of England is set to proceed more cautiously due to higher wage growth, services inflation, and a more robust economic recovery

- We expect the ECB to maintain the pace of easing in the short term, cutting rates by 25 bp in January and March. However, as the deposit rate nears policymakers' estimates of the neutral rate and economic activity picks up, the pace of easing is likely to decelerate, especially as the Federal Reserve adopts a more cautious approach to rate reductions. We project a total of 100bps of ECB easing in 2025, with the terminal rate of 2% to be reached by September 2025. Risks are skewed towards a lower terminal rate should economic growth fall short of expectations.
- We expect the Bank of England's MPC to maintain its "cut and hold" strategy throughout 2025. The Bank Rate is projected to decrease from 4.75% at the end of 2024 to 3.75% by the end of 2025, eventually settling at 3.5% in Q1 2026.

Historical and expected* central bank interest rates (In percentage)

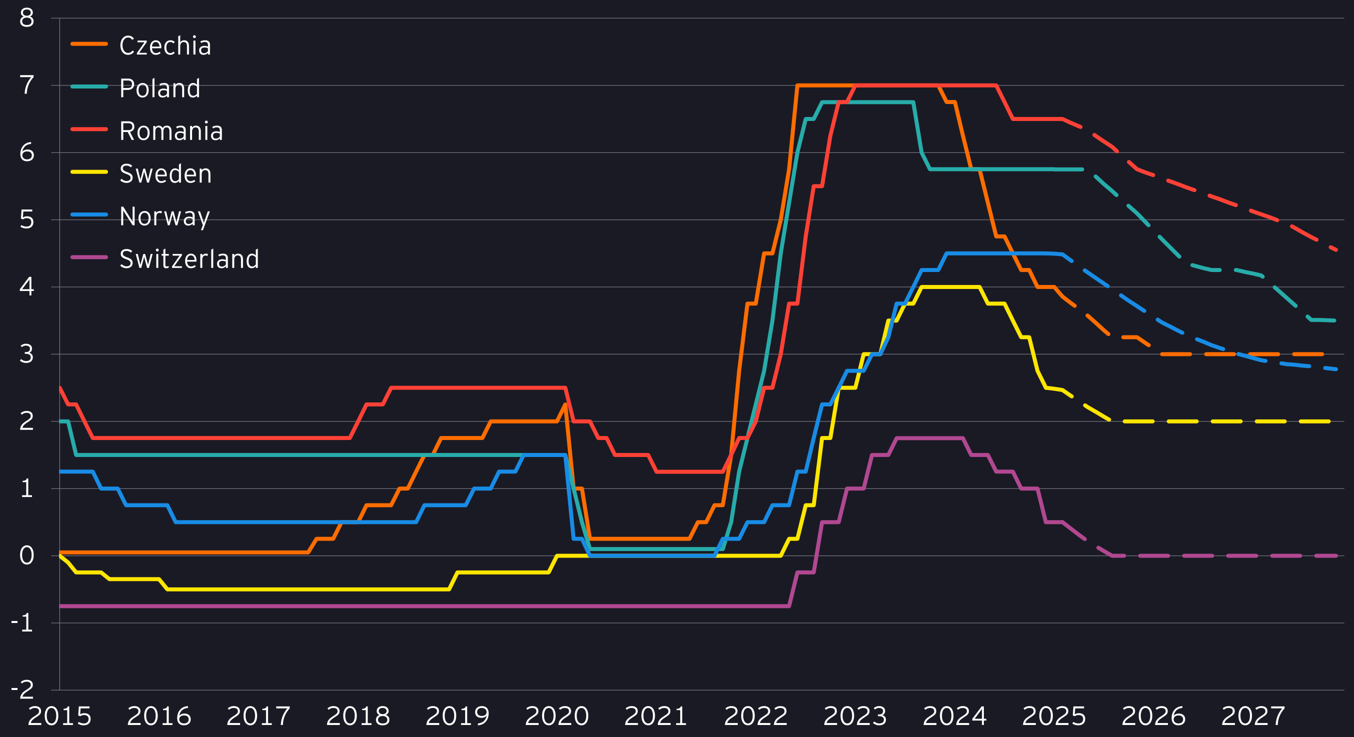


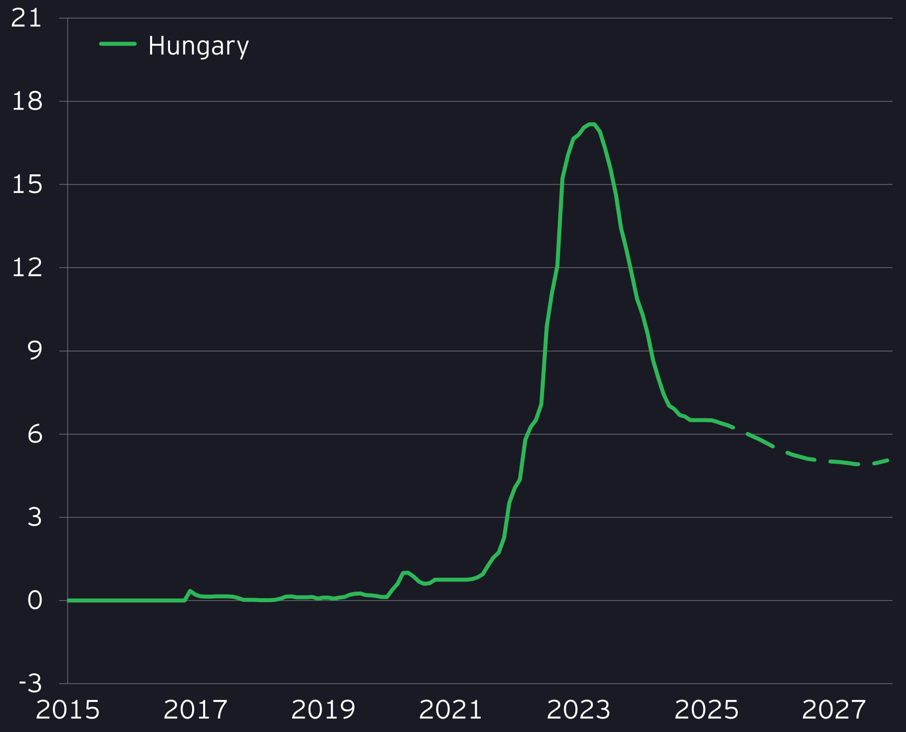
Source: ECB; Fed; BoE; CME group; EY EAT forecast.
* For the euro area and the UK, expected interest rates implied from SOFR (EA) and SONIA(UK) futures from CME group; for the US, expected interest rates from Atlanta Fed Market Probability Tracker.

CEE central banks are expected to lower interest rates gradually, Sweden is approaching the conclusion of its easing cycle, Switzerland's rates are likely to revert to 0%, and Norway is set to commence rate cuts in March

- The SNB is projected to reduce interest rates from 0.5% to 0% in the first half of 2025, influenced by the strong Swiss franc, limited wage growth, and subdued inflation.
- Sveriges Riksbank is anticipated to implement two additional 25 basis point rate cuts, aiming for a terminal rate of 2%.
- Norges Bank is expected to start a gradual easing cycle in March 2025, with rate cuts of 25 bp per quarter.
- In CEE, elevated inflation is expected to hinder more aggressive easing in 2025. Central banks in Poland, Romania, and Hungary are likely to reduce rates by 75 bp, resulting in relatively high year-end rates of at least 5%. The return to (nominal) neutral rates of 3.5-4% is likely to take several years in Poland and Romania.
- Czechia stands as an exception, where due to weaker wage, demand, and price pressures we expect the terminal rate of 3% to be reached by 2026 Q1.

Historical and forecast central bank interest rates* (In percentage)





Source: Trading Economics, Stooq, Oxford Economics; EY EAT forecast.
Dashed lines denote forecasts.
* For Hungary, 1-month interbank rate.

The outcome of the US elections has further skewed the balance of risks for GDP growth to the downside and slightly heightened inflation risks

The economic outlook remains uncertain, with the balance of risks continuing to be tilted towards lower GDP growth in Europe, while inflation risks have shifted towards more contained price increases.

Key risk factors include:

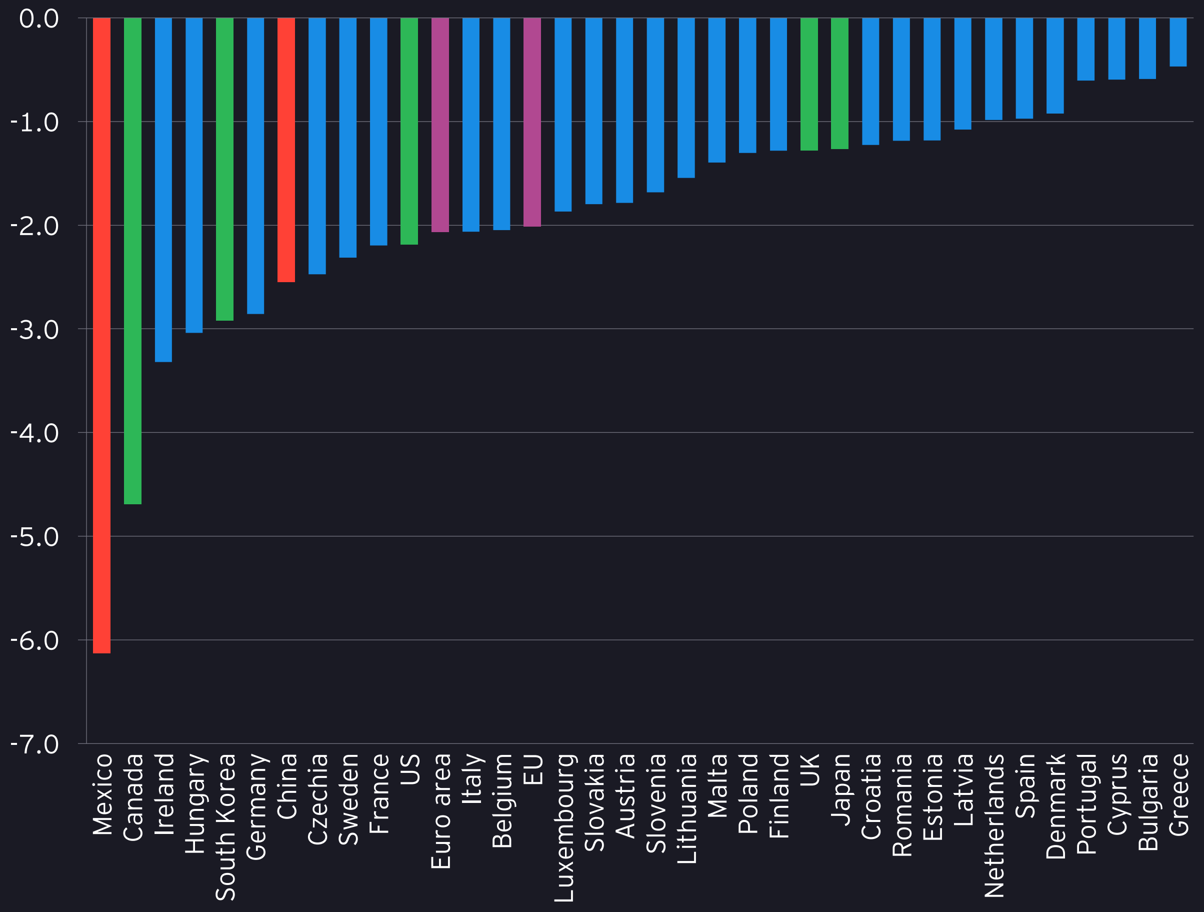
- **Higher tariffs in global trade**. The potential resurgence of trade wars looms, with D. Trump signaling intentions to impose higher tariffs on imports to the US. This will likely lead to retaliatory actions from other nations. European GDP is expected to suffer in comparison to the status quo, not only due to direct reductions in exports (stemming from tariff-induced price increases and weakened global demand) but also due to the uncertainty tied to potential trade war escalations. Our baseline scenario assumes the imposition of limited tariffs targeting specific products (see slide 30), but risks are skewed towards broader tariffs. Blanket tariffs would pose a substantial drag on the European economy over the medium term, particularly impacting manufacturing-heavy countries such as Germany, Czechia, and Hungary (see slide 44 or our more detailed note). The impact on GDP in the coming quarters, before tariffs come into effect, is ambiguous. On the one hand, the uncertainty negatively affects both consumption and corporate investment. On the other hand, we may see frontloading of imports as companies anticipate higher tariffs. The introduction of tariffs also presents inflationary risks, driving up the prices of goods—this effect is only partially mitigated by the dampening impact of slower economic growth on prices. Inflation could rise significantly, not only as a direct result of the tariffs but also indirectly through the exchange rate channel, should the US dollar appreciate.
- **Geopolitical risks**. The war in Ukraine persists and the Middle East continues to be a potential hotspot for conflicts despite some recent de-escalation. Additionally, recent signals from the new US administration hint at potential new areas of geopolitical tensions (Panama Canal, Greenland). Any escalations could amplify uncertainty, trigger commodity price spikes, further increase shipping costs, and create bottlenecks in global trade. These developments could reignite inflation and adversely affect global economic activity, with Europe being particularly vulnerable to global shocks due to its high degree of openness.
- **Prolonged downturn in manufacturing**. Risks for the manufacturing outlook are skewed to the downside as the structural loss of competitiveness by European producers, not least due to higher energy prices and intensifying competition from China, may be more pronounced than currently anticipated.
- **Delayed consumer recovery and subdued investment**. We expect consumers to gradually reduce their currently very high saving rates, and investment to rebound on the back of lower interest rates and NextGenEU spending. However, global uncertainty may negatively affect business and consumer sentiment, delaying the consumer and investment recovery.
- **Energy and food prices spikes**. Adverse weather conditions or local political unrest could also reduce the supply of or increase demand for energy and food commodities, leading to higher inflation and diminished economic activity.
- **Sovereign bond market stress**. With inflation no longer fueling revenue growth or aiding in the reduction of debt-to-GDP ratios, the risk of renewed stress remains elevated in the sovereign bond markets of emerging economies as well as in Southern Europe.

Despite these significant downside risks, several factors could positively influence growth

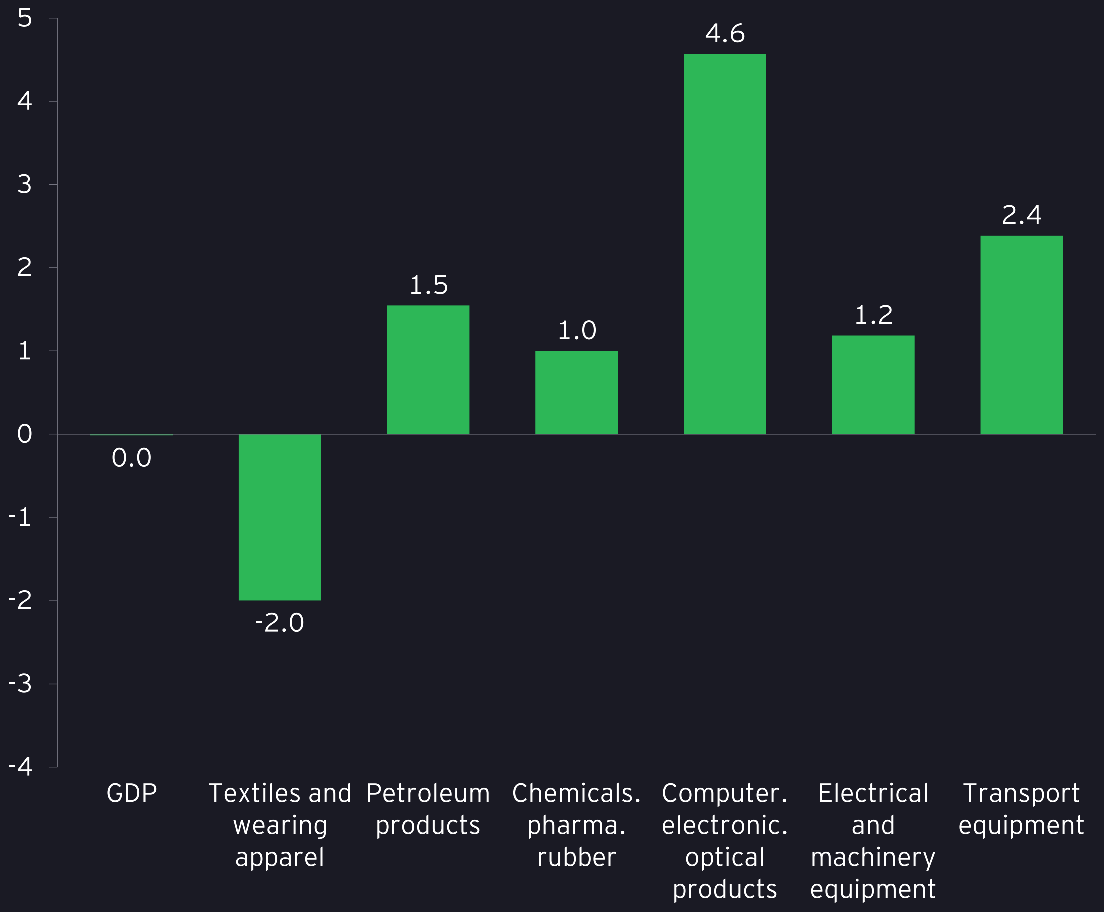
- **Lower than expected inflation**. Inflation may prove lower than expected if services inflation declines more rapidly, core goods inflation remains subdued at close to 0%, or positive supply shocks alleviate food inflation. Lower inflation would boost household disposable incomes and consumption. Concurrently, it would allow central banks to cut interest rates more aggressively to levels below current projections, providing an additional stimulus to investment and consumption.
- **Stronger rebound in consumption, supported by accumulated excess savings**. European consumers may reduce their saving rates more quickly than anticipated from the presently high levels, or even spend a portion of their substantial excess savings accumulated during the pandemic, resulting in stronger GDP growth. Over the medium term, it is unlikely that the saving rate will stay significantly above pre-pandemic levels, especially as incentives to save diminish with declining ECB interest rates.
- **Stronger productivity growth, due in part to AI**. Productivity growth, which has been notably weak over the past decade, represents another upside risk to the outlook. Tight labor markets should encourage firms to invest in productivity-enhancing and labor-saving technologies, including automation, robotization, and the potential of generative AI. In a recent series of EY articles, we highlighted AI's substantial potential to transform the labor market, boost investment, total factor productivity, and GDP growth, albeit with uneven effects across sectors. However, AI may also contribute to higher inflation and interest rates. The effects of faster implementation of AI solutions on GDP growth are summarized on slide 45.
- **Strong immigration flows alleviating demographic pressures and supporting potential growth**. Our baseline scenario predicts that labor supply in Europe will plateau after 2025 and decline post-2027, driven by demographic trends, with several countries, particularly in CEE, facing earlier and more severe reductions. However, tight labor markets in Europe and ongoing global population growth present an upside risk that immigration could at least partially offset these gaps. This scenario appears more plausible in CEE, which had not experienced significant immigration prior to the large-scale influx from Ukraine, rendering immigration projections typically conservative.

Blanket tariffs would pose a substantial drag on the European economy over the medium term, although their effects are expected to largely diminish in the long term

Impact of blanket tariffs on GDP in 2027 (in percentage)



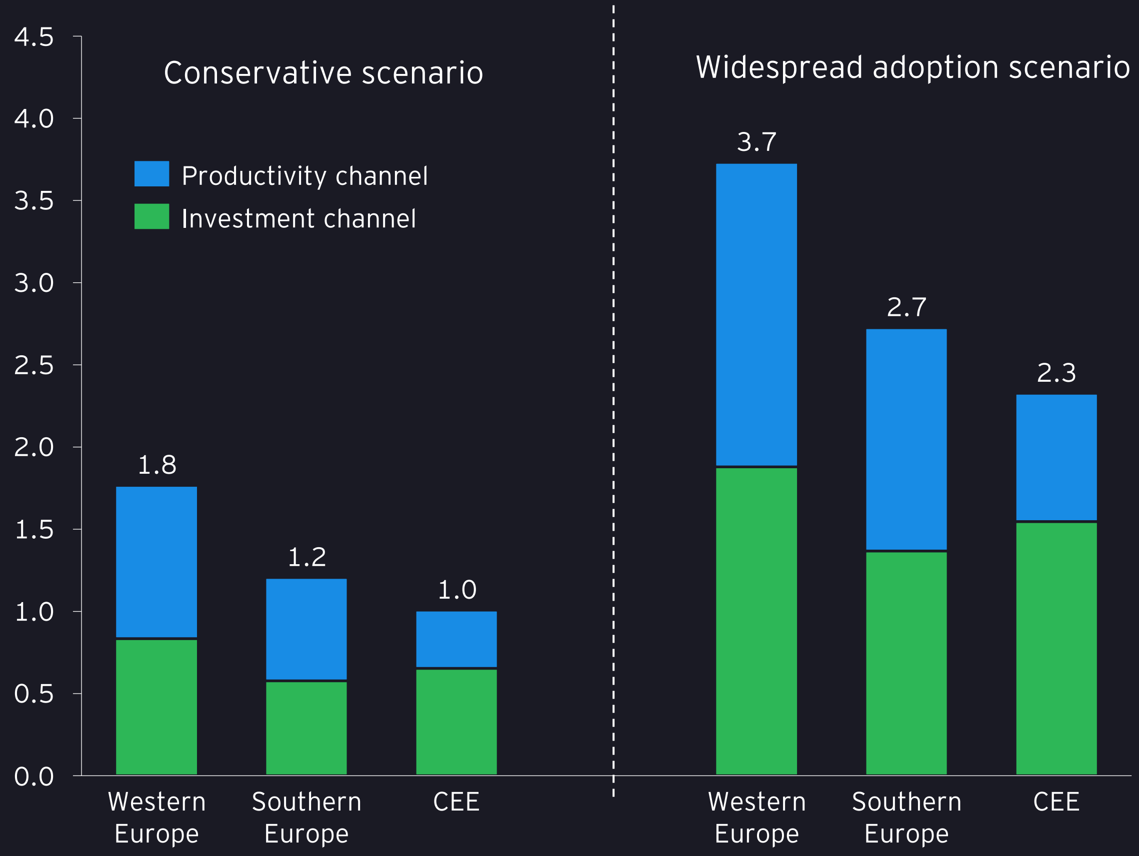
Long-term impact of blanket tariffs on the EU GDP and value added in selected sectors* (in percentage)



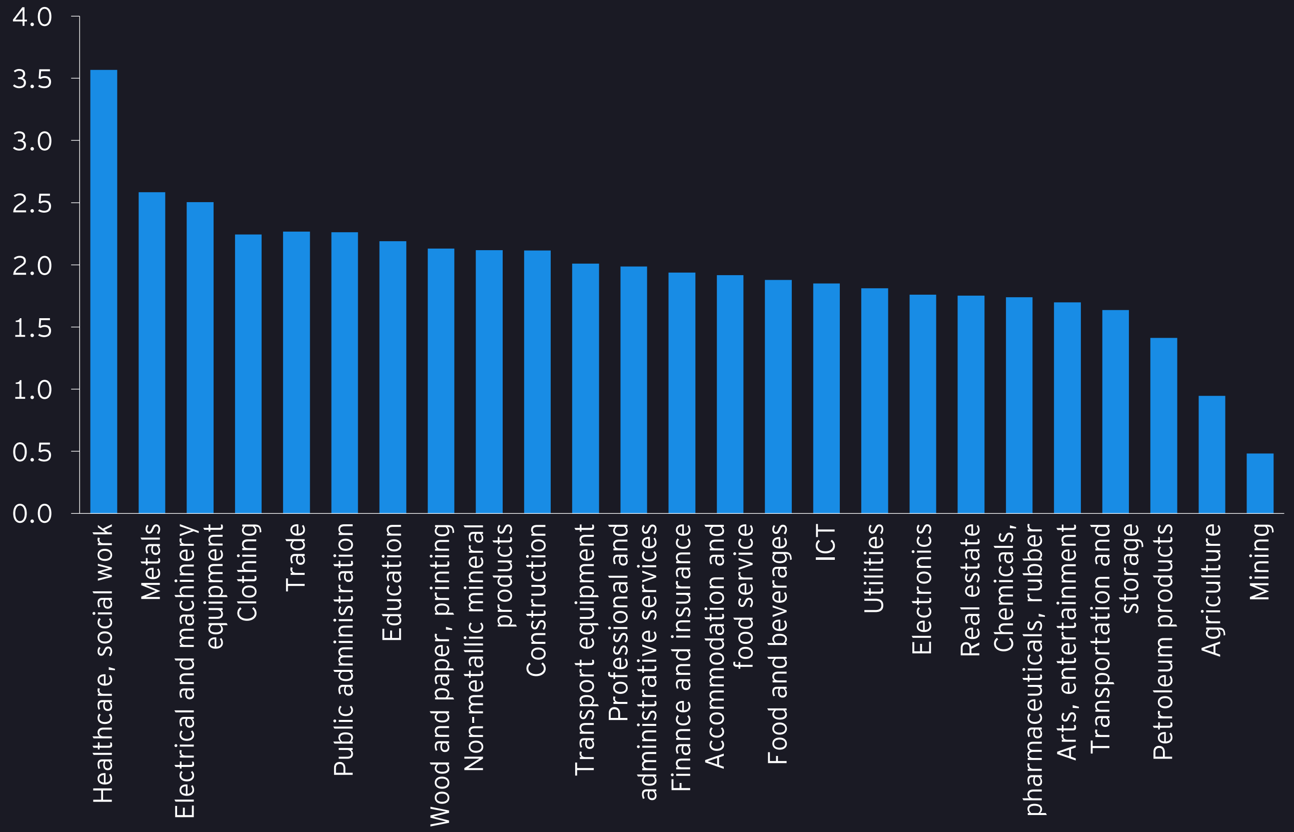
Source: EY EAT calculations.
The blanket tariff scenario assumes the imposition of 60% tariffs on imports of all goods from China, 25% tariffs on all imports from Mexico and Canada, and 10% tariffs on imports of all goods from the rest of the world.
* Sectors with at least 1% change in valued added in absolute terms are displayed.

Were AI to be adopted faster than we assume in the baseline scenario, Europe's GDP could be 1-2% larger by 2033

Impact of AI on GDP in 2033 (in percentage)



Impact of AI on sectoral real value added in Western Europe in 2033 under the widespread adoption scenario
(In percentage change from the baseline level)



Note: In our study, we examine four distinct scenarios characterized by varying levels of AI adoption (conservative or widespread) and degrees of international capital mobility (high or low). Presented figures correspond to a high international capital mobility scenario. The widespread AI adoption scenario assumes that AI is adopted at a similar pace as information and communications technology (ICT) during the 1990s and 2000s. The conservative scenario assumes 60% slower integration (based on existing relationship between AI and ICT adoption).
Source: EY EAT, EY UPGRADE CGE model

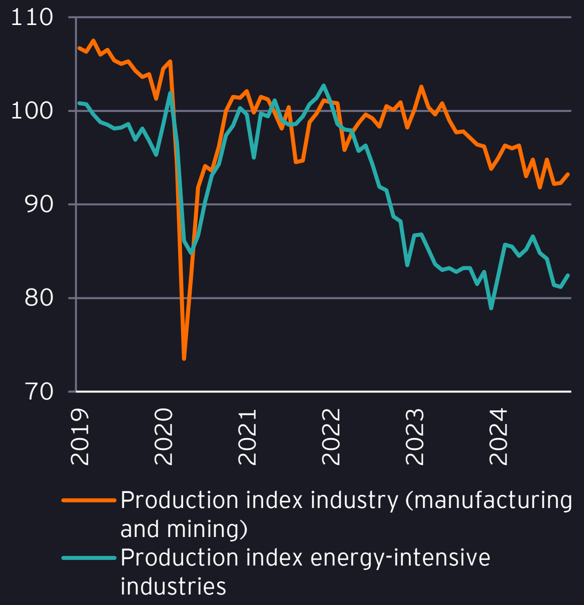
Germany: internal and external headwinds prolong stagnation and impede economic recovery

	GDP growth	Inflation	Current account balance	LFS unemployment rate
2024	-0.2%	+2.2%	+5.9%	3.4%
2025F	+0.5%	+2.4%	+6.1%	3.3%
	Real GDP growth (y/y)	Headline CPI Inflation (y/y)	In % of GDP	In % of civilian labor force
	Source: EY EAT.	Source: EY EAT.	Source: EY EAT.	Source: EY EAT.

Ifo business climate indicators (2015=100)

Source: Ifo

Energy-intensive industrial production (2021=100)

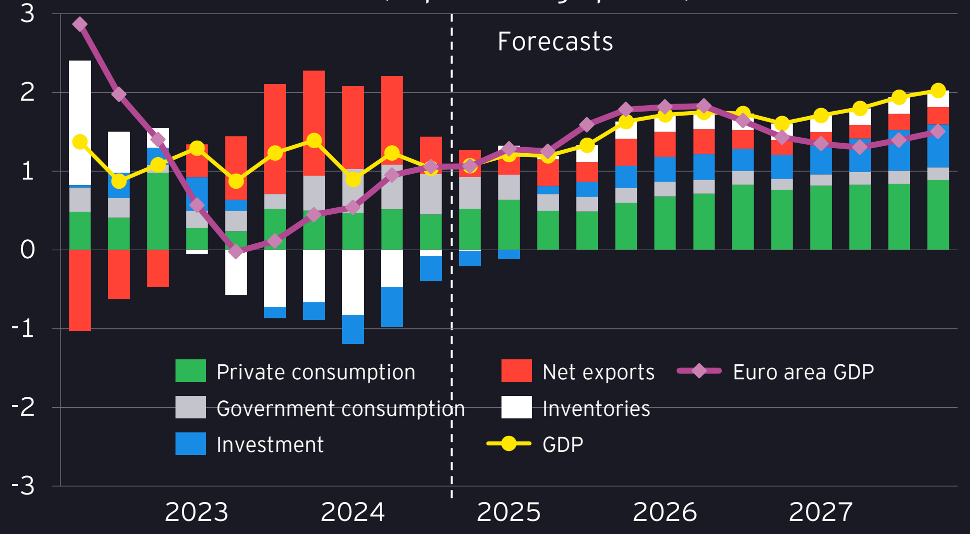


Source: Destatis

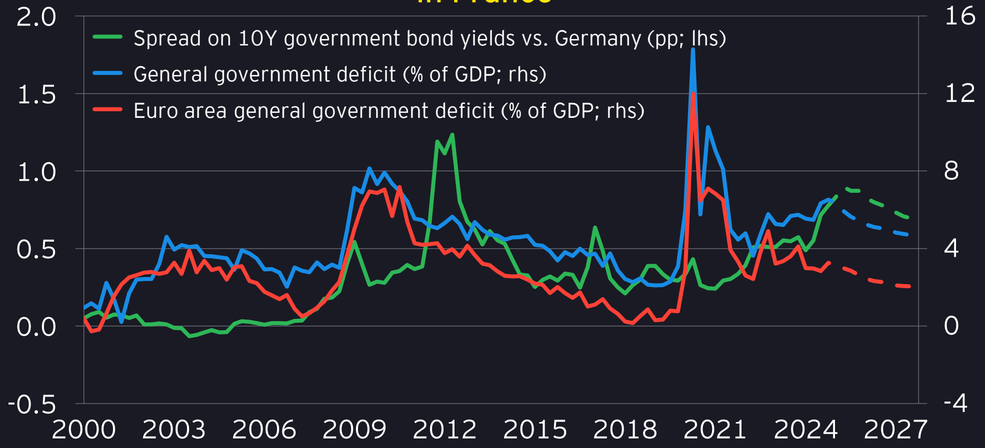
- The German economy remains in stagnation, with a 0.2% decline in real GDP in 2024. Growth is expected to recover slowly to 0.8% in 2025.
- The business climate index worsened in December 2024, reflecting more pessimistic expectations and a deteriorating order situation across sectors.
  - German companies perceive their competitive standing, both in Europe and globally, as significantly inferior compared to their counterparts in other European countries. Only 12.6% of German companies expect business improvements in 2025. The economic expansion of China further exacerbates the pressure on German firms, particularly in the automotive industry.
- Inflation in Germany averaged 2.2% in 2024, a marked decline from 6.0% in 2023, due to a tightening of monetary policy and lower energy prices. Inflation is expected to remain at around 2.4% throughout 2025.
- Germany's current account surplus decreased to EUR 19.7bn in November 2024, a 6.6% year-on-year drop. A slight improvement is expected in 2025 as exports finally pick up, aided by stronger external demand and a weaker euro.
- Due to subdued economic activity, unemployment is on the rise – the LFS unemployment rate averaged 3.4% in 2024, up from 3.0% in 2023. In 2025, we expect the trend to revert and unemployment to decline slightly, as the economy begins to recover gradually.
- Electricity prices dropped by 31% for industry and 11% for households at the end of 2024 compared to 2023, yet household prices remain high relative to pre-pandemic levels.
- The upcoming general elections in February 2025 add to the uncertainty, potentially altering the political landscape. Migration and economic development are key election issues. Additionally, energy policy remains a major point of contention:
  - The Union (CDU & CSU) and the FDP emphasize market-based mechanisms such as CO_2 pricing. The FDP, in particular, advocates for less stringent climate targets and supports a technology-open approach. The SPD and the Greens are campaigning for an accelerated energy transition, with the SPD focusing on infrastructure initiatives, including the development of a hydrogen network. The Left proposes combining ambitious climate goals with social measures and a stronger state control. Meanwhile, the BSW's stance on achieving climate neutrality remains ambiguous, mirroring the AfD's rejection of central climate policies and their proposition of radical, often unclear alternatives.
- Global tensions and conflicts, such as the war in Ukraine, the Gaza-Israel conflict, a new Syrian regime, and a newly elected US administration continue to pose uncertainty.
  - Trump 2.0 administration is likely to impose tariffs on imports, affecting global trade dynamics and particularly impacting the German automotive industry. The administration's adherence to the "America First doctrine" may necessitate a reorganization of global supply chains, potentially compelling German companies to expand their manufacturing operations within the US to circumvent tariffs.
  - The potential withdrawal of the US from international agreements and organizations presents a challenge for German companies, which may have to adapt to an increasingly fragmented international trade landscape.

France: despite deteriorating sentiment and political gridlock, growth seems to have picked up in the second half of 2024. With robust fundamentals, we expect steady growth in 2025 and an acceleration in 2026

Decomposition of y/y GDP growth in France
(in percentage points)



Sovereign bond yield spread and general government deficit in France

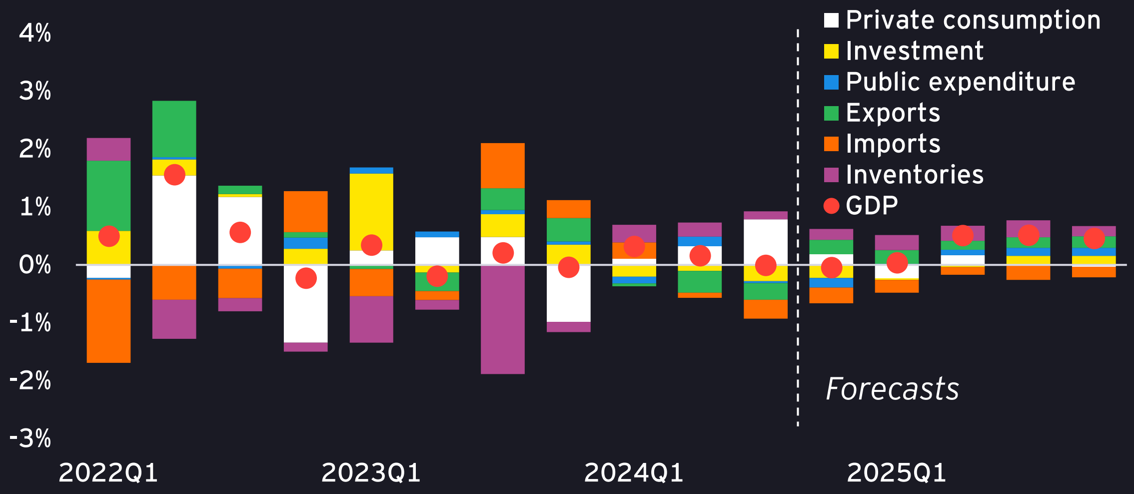


Source: Eurostat; Oxford Economics; EY EAT forecast.
Dashed lines denote forecast.

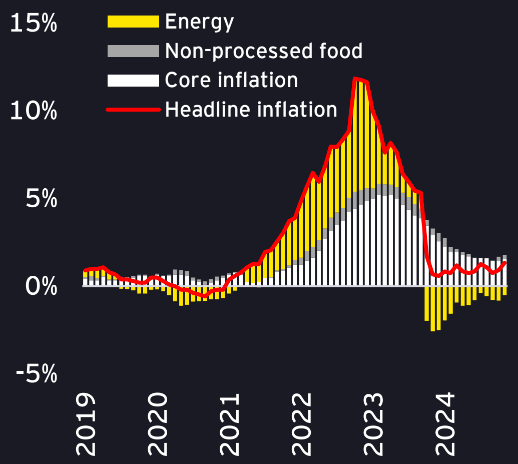
- GDP increased by 0.4% q/q in 2024 Q3, boosted by the Paris Olympics. Retail sales and activity in services remained high post-Olympics, indicating solid growth in Q4—we estimate a 0.3% q/q GDP increase. This occurred despite declining business and consumer sentiment, which may be negatively influenced by political gridlock, potentially underestimating the underlying pace of economic activity.
- **The estimated annual average growth reached 1.1% in 2024**, slightly surpassing the euro area average but falling short of our estimates for potential growth. This growth was propelled by government spending and robust exports, while declining private investment and inventories acted as constraints.
- **For 2025, we project growth to remain largely stable, with GDP expanding by 1.2%.** Investment is likely to cease its decline amid monetary policy easing, and the inventory cycle is expected to turn positive. However, these factors will be balanced by a deceleration in government spending. Declining sentiment presents downside risks to the short-term outlook.
- Looking at the medium-term prospects for the French economy, we are relatively optimistic, estimating potential growth to lie in the 1.5-2.0% range. We expect robust productivity growth in the coming years as the large influx of employees from 2021-22 is further integrated into firms' operations. Coupled with an anticipated increase in investment and exports, this should more than offset the effects of gradual fiscal tightening. Consequently, **we expect GDP growth to accelerate to 1.7-1.9% in 2026-28.** However, persistent political gridlock and a stronger-than-expected rise in trade barriers could reduce the growth outlook.
- **Price pressures remain relatively subdued, with inflation set to stabilize slightly below 2%.** CPI inflation marginally increased in recent months, reaching 1.3% y/y in December, on the back of energy base effects, while underlying price pressures remained broadly unchanged. Compared to the euro area average, France is characterized by very low food inflation (0% y/y in December, excluding alcohol and tobacco). Services inflation is also relatively low at 2.9%, resulting in a core HICP inflation of 2%. Moving forward, we expect non-core components to trend upward and services inflation to moderate slightly, with CPI inflation averaging 1.6% in 2025 and 2026.
- **Political gridlocks persist, with sovereign spreads trending up.** Michel Barnier's government collapsed after 3 months, and centrist François Bayrou was elected as the new prime minister. His administration is likely to be equally unstable, opting to forgo meaningful fiscal consolidation to improve its chances of surviving no-confidence motions. General government deficit is estimated to have exceeded 6% of GDP in 2024. Consequently, the 10-year sovereign yield spread with Germany has continued to widen, exceeding 80 bp in December 2024, and Moody's downgraded France's credit rating to Aa3. The short-term economic impact of the tightening financial conditions are minimal (~0.1% of GDP), but ongoing political uncertainty could dampen investment and potential growth over the longer term.

Italy: 2024 growth was driven by private consumption and net foreign demand, with the latter expected to diminish in 2025 due to an uptick in imports. Investment in 2025 is likely to be impacted by the end of fiscal support

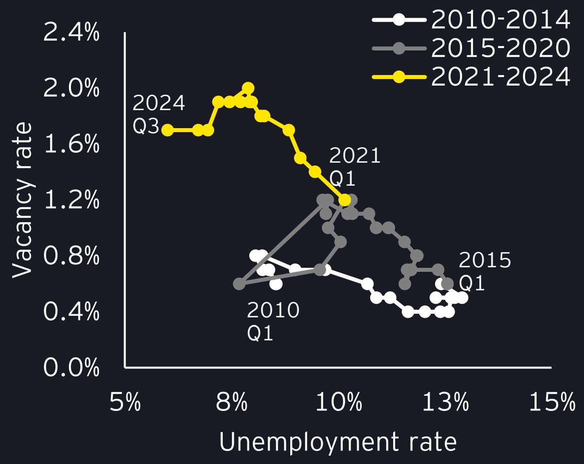
GDP growth decomposition in Italy
(q/q, in percentage points)



Headline inflation decomposition in Italy
(y/y, in percentage points)



Beveridge Curve, Italy

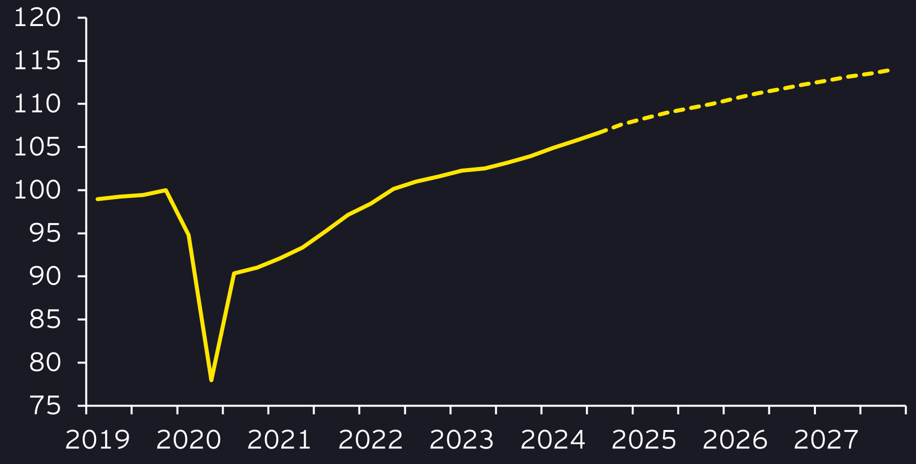


- We forecast Italy's GDP growth in Italy to accelerate modestly from 0.5% in 2024 to 0.8% in 2025. Concurrently, inflation is projected to rise from 1.0% in 2024 to 2.0% in 2025.
- The 2024 GDP growth can be attributed to a 0.7% increase in private consumption and a positive contribution from foreign demand, stemming from a 2.0% contraction in imports. 2025 growth is expected to be driven by domestic demand components, although overall investments are projected to contract by 1.2%, due to the termination of fiscal measures such as the "Superbonus 110%".
- Inflation has remained subdued (1.4% in November 2024), partly due to the dampening effect of energy prices.
- The labor market is robust. The Beveridge curve reveals that in recent years the vacancy rate reached unprecedented levels, while the unemployment rate dropped below its 2010 benchmark, indicating a period characterized by both declining unemployment and a high vacancy rate.
- The industrial sector continues to face significant headwinds, with October 2024 marking the twenty-first consecutive month of negative year-over-year growth. This trend is largely due to the sluggish performance of German industry and still-high energy prices.
- Key risks to the Italian economy include the potential acceleration of inflation, driven by a second-round effect from faster wage growth, higher commodity prices amid geopolitical tensions (Russia-Ukraine war, Middle-East conflicts), supply chain disruptions (Suez Canal), and trade uncertainties stemming from potential future trade-distorting measures.

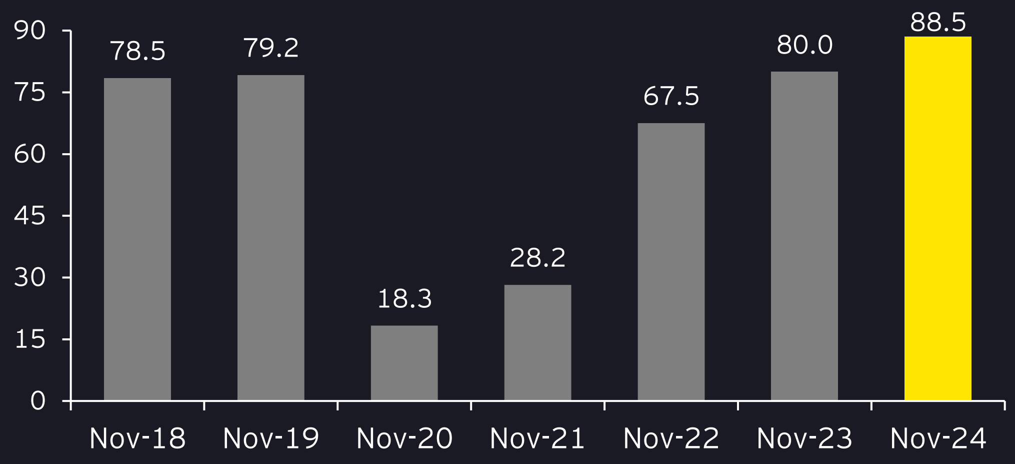
Source: EY Italian Macroeconomic Bulletin; ISTAT.

Spain: economic growth has picked up pace, bolstered by increasing incomes and a record-breaking tourism sector. However, GDP growth is expected to decelerate due to a weakening in employment, tourism and public consumption, coupled with rising inflation

Real GDP (2019 Q4 = 100)



Total tourists (millions, Jan-Nov)

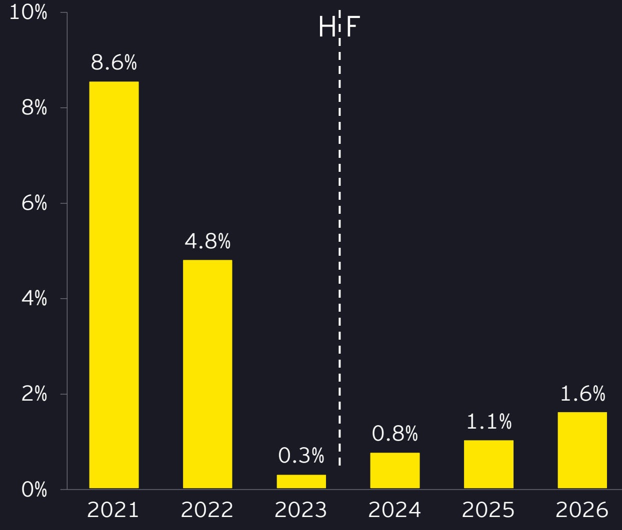


- **Recent PMI indicators** signal robust growth, with Spain leading European countries at 53.3 in manufacturing and 57.3 in services. Both indicators have consistently remained in the expansionary territory (above the 50.0 threshold) for over ten months.
- **In 2024 Q3, Spain's real GDP growth accelerated to 3.4% y/y, significantly outpacing the Eurozone's 0.9% growth rate**.
- **Tourism reached new highs**, with over 88 million tourists visiting from January to November 2024, and estimates suggest a total of 95 million for the entire year, well above pre-pandemic figures. Tourism continues to be a pivotal factor in Spain's economic recovery, with robust increases in both domestic and international visitors. However, the sector faces challenges from rising operational costs and evolving traveler preferences.
- **Inflation, which had decreased from 3.6% in May to 1.5% in September 2024, began to climb again in the following months, reaching 2.8% in December 2024**, primarily due to escalating energy costs. Core inflation has decreased slightly but remains relatively high at 2.6% y/y, with persistent services inflation.
- **We expect the Spanish economy to gradually lose momentum in the upcoming quarters.** We estimate that GDP continued to grow at a robust pace of 0.9% q/q in 2024 Q4. Looking ahead, we predict a slowdown in GDP growth as the impetus from employment, public consumption, and tourism starts to diminish. As a result, GDP is forecasted to grow by 3.2% in 2024, 2.8% in 2025, and 2.1% in 2026.
- **A pressing issue for Spain is the persistent housing crisis, with demand significantly outstripping supply, a situation that is unlikely to improve in the near term.** Stricter regulations, along with rising construction costs and declining public investment in housing, have limited housing availability.
- **The Spanish stock market has shown renewed vigor, outperforming several major European indices last year.** Bolstered by a favorable economic outlook and a decrease in interest rates, Spanish equities saw a 12.3% uptick in 2024, surpassing the EuroStoxx50's 7.5% gain.

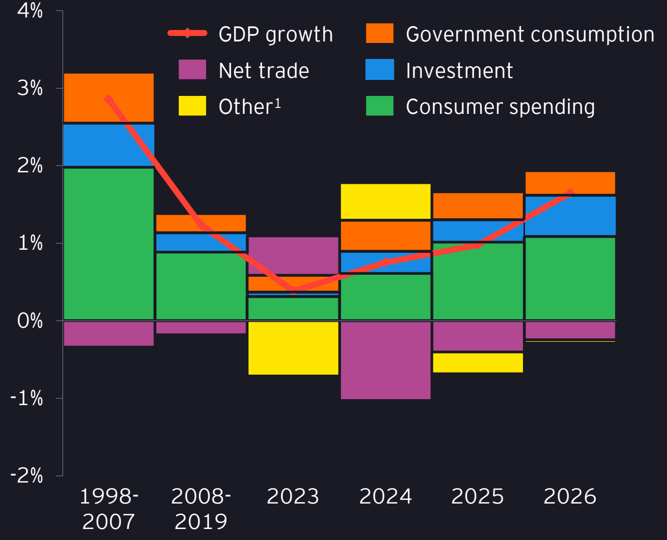
Source: Eurostat, EY EAT forecast, Instituto Nacional de Estadística (INE).

UK: economy faces a weak finish to 2024 but shows signs of gradual recovery in 2025 amid inflation challenges, monetary easing, and fiscal adjustments

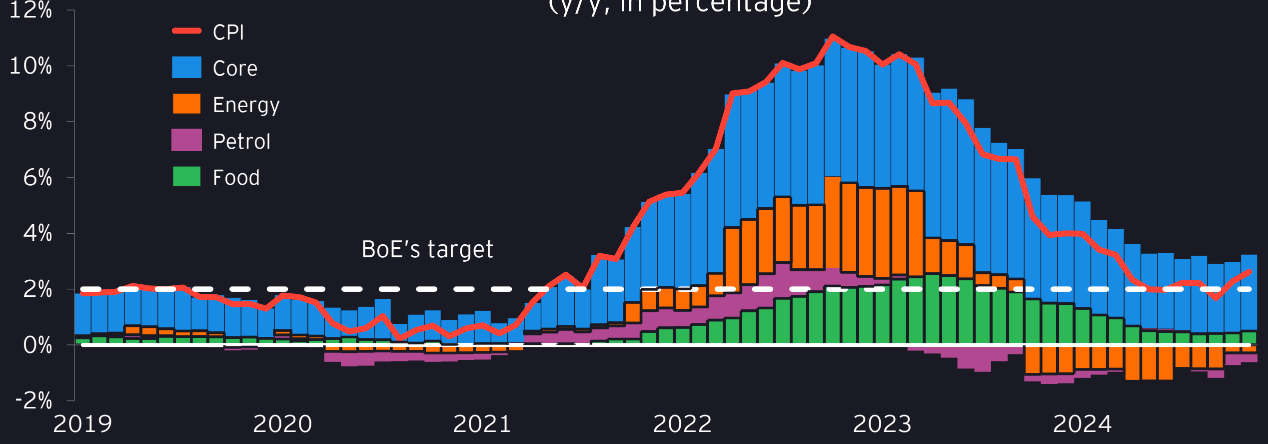
Real GDP growth (y/y, in percentage)



Decomposition of GDP growth
(y/y, in percentage points)



Decomposition of CPI inflation
(y/y, in percentage)



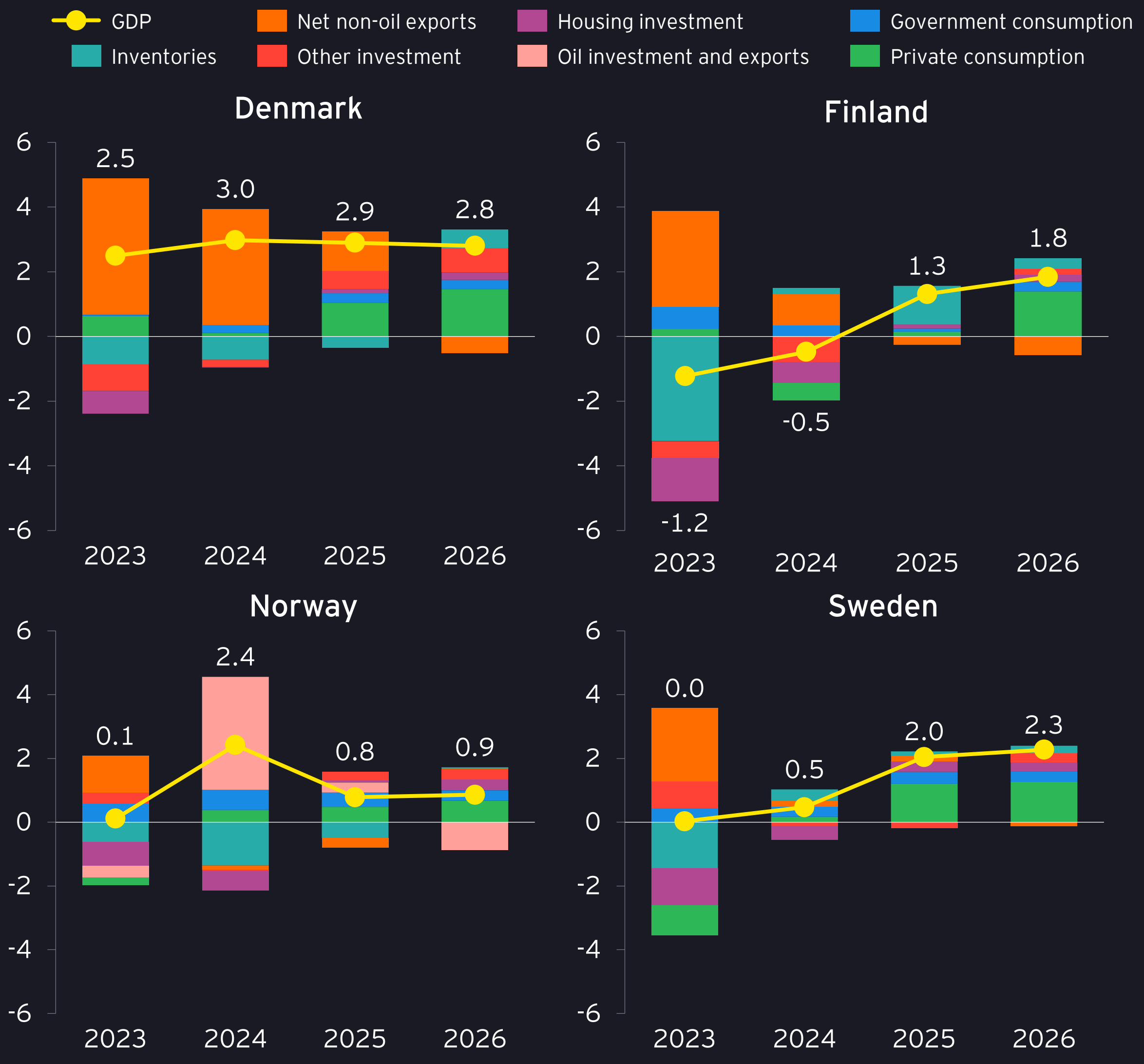
- **After a strong start to 2024, the UK economy lost momentum in the second half of last year.** Real GDP was flat in Q3 and likely Q4, given underwhelming monthly prints for October and November. However, the Q3 expenditure split was more positive with consumption and business investment still performing well. Additionally, residual seasonality may have depressed official activity estimates in Q3.
- **We view the soft end to 2024 as blip rather than a sustained slowdown.** Still, we have cut our real GDP growth forecast for 2025 to 1.1% from 1.5%, in part reflecting the passthrough of a weak final half of 2024.
- **In 2025, we expect real GDP growth to continue around trend rates with a gradual decline in interest rates, steady real income growth and less consumer caution providing a tailwind.** However, corporate uncertainty, ongoing fiscal consolidation, and private mortgage refinancing to higher interest rates will act as constraints on activity.
- **Consumer Price Index (CPI) inflation in the UK has climbed above the Bank of England's 2.0% target, as the period of rapid inflation improvement has concluded.** The earlier downward pressure on headline inflation from declining energy prices is fading, while core goods inflation is on the rise due to the diminishing benefits of improved supply chains. Services inflation has remained persistently high, reflecting its reliance on labor costs, in the context of a tight UK labor market. However, as the labor market shows signs of rebalancing, wage pressures are expected to ease to levels compatible with 2.0% inflation by early next year. Headline inflation is projected to stabilize at the 2% target by mid-2026.
- The Bank of England's Monetary Policy Committee **(MPC) has established a "cut and hold" tempo, which we expect it to stick to through 2025,** lowering the Bank Rate from 4.75% at the end of 2024 to 3.75% by the end of 2025, and with the Bank Rate settling at 3.5% in Q1 2026.
- The new Labour government loosened the purse strings in its first Autumn Budget. On its own, the changes announced in the Budget **slowed the tightening in fiscal policy** that the government inherited. However, we estimate that the recent tightening in financial conditions and uncertainty around the economic outlook broadly offset this boost to growth.

1. Including inventories.

Source: Haver Analytics; Refinitiv; EY analysis

Nordics: while growth in Denmark and Norway is supported by the pharma and oil industries, the underlying economic activity across the region remains subdued. However, a recovery is expected in 2025

Real GDP growth decomposition (y/y, in percentage points)

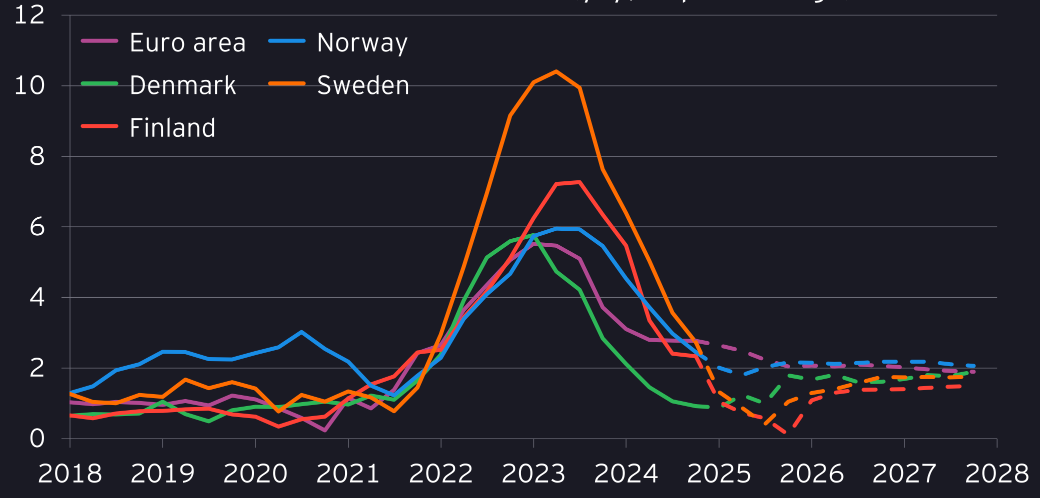


- **Economic growth in the Nordics continues to be uneven due to sector-specific factors.** Denmark's GDP growth of 3.9% y/y in 2024 Q3 was propelled by the expansion of a major pharmaceutical company, boosting industrial production and exports. Norway's GDP growth of 3.1% y/y in the same quarter was driven by increased fossil fuel production, investment, and exports due to the European energy crisis, despite volatility evidenced by a 2.0% q/q increase in 2024 Q2 followed by a 1.8% q/q decrease in Q3. Sweden and Finland, lacking such distinct sectoral drivers, experienced more modest growth rates of 0.6% and 0.4% y/y, respectively.
- **Beyond these sectoral distinctions, economic activity remains subdued across the region.** Nordic economies have been particularly vulnerable to high interest rates, which have led to some of Europe's most severe housing market downturns, with residential investment plummeting by 15-35% since early 2022. Weak demand has weighed on business investment, which has contracted in recent quarters. Consumption has stagnated as real incomes remain well below their 2021 levels, particularly in Sweden and Finland. This has resulted in reduced labor demand, with employment declining and unemployment rates rising by 0.8-2.0 pp from their 2022 lows.
- **However, there are first signs of a pick-up in economic activity.** Our nowcasts indicate that consumption across the region increased in 2024 Q4, driven by rising real incomes, although Finland remains an exception. With monetary policy easing, housing investment is showing signs of recovery, at least in Sweden and Denmark. Norway's non-oil economy is estimated to have grown by 1.0% in 2024, with unemployment rates beginning to decline in the latter half of the year.
- **These recent trends are expected to carry into 2025, with a rebound in underlying GDP growth.** Consumption and residential investment are set to continue their recovery, and with increased demand and lower interest rates, business investment is anticipated to gradually improve. This renewed domestic demand should bolster the labor market, with employment growth resuming and unemployment rates decreasing. Meanwhile, the contributions from the pharmaceutical and oil industries in Denmark and Norway are expected to diminish somewhat. Consequently, GDP growth in 2025 is forecasted to be positive across the region, with projections ranging from 0.8% in Norway to 2.9% in Denmark.

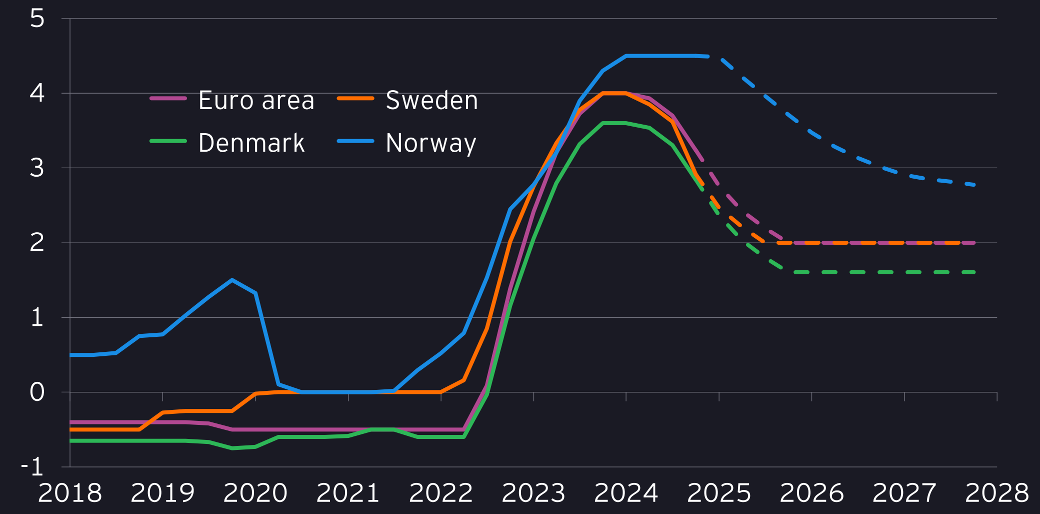
Source: Oxford Economics; EY EAT forecast.

Nordics: price pressures are generally subdued, while monetary policy stance continues to diverge between Sweden and Norway

Core inflation* (y/y, in percentage)



Central bank policy rate (in percentage)

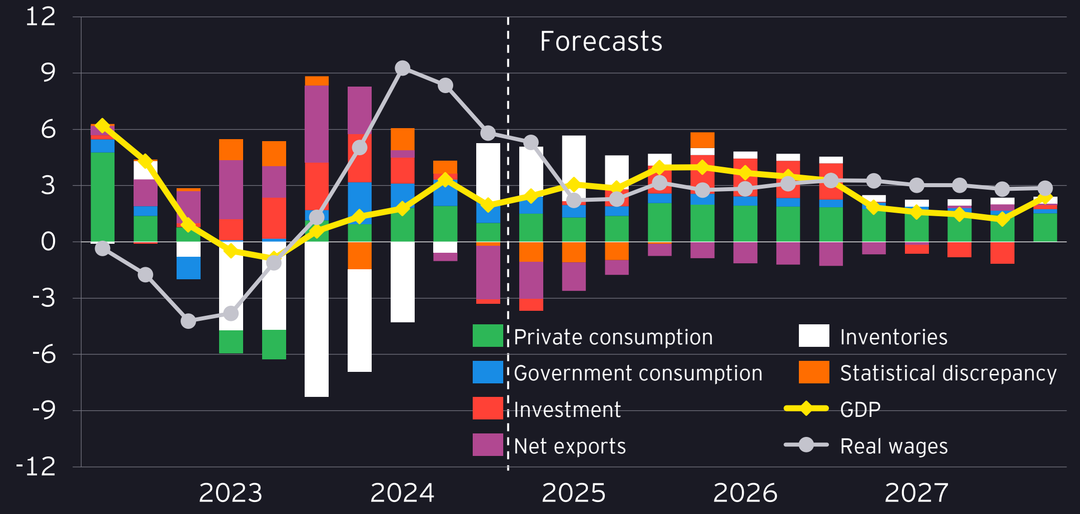


- **Price pressures in the Nordic countries are subdued, although inflation trends show variation.** CPI inflation concluded 2024 below 2% in all countries except Norway, where it was marginally higher at 2.2%. In Denmark, headline inflation has risen due to rebounding food prices, while core inflation has stayed low. In Sweden and Finland, CPI inflation has fallen below 1% owing to declining mortgage payments*, while underlying price pressures are somewhat more pronounced, with core HICP inflation above 2%. In Norway, inflation has been trending down towards 2% as the effects of past FX depreciation on goods prices gradually subside, yet food inflation remains elevated.
- **We expect inflation to hover around current levels for most of 2025.** Amid generally subdued demand pressures, even if economic recovery is expected to unfold, we expect price pressures in the Nordics to remain relatively low in 2025, though variations will persist across countries. In Denmark, core inflation is anticipated to remain subdued at about 1% and food inflation elevated at around 4%, keeping headline inflation just below 2%. In Norway, due to persistent food price pressures and increasing energy costs, headline inflation is likely to stay elevated in the 2.5-3.0% range, despite core inflation stabilizing at 2%. In Sweden, declining mortgage payments are projected to keep CPI inflation near 1%, in spite of resurging food and energy inflation. For Finland, less pronounced non-core pressures and decreasing mortgage payments are expected to bring CPI inflation down to approximately 0.3%, although core HICP inflation should remain near 2%.
- **Monetary policy stance continues to diverge between Sweden and Norway.** Amid economic stagnation and falling inflation, the Swedish Riksbank has continued its relatively aggressive easing cycle, cutting rates by 50 bp in November and 25 bp in December, bringing the policy rate to 2.5%. With approaching the neutral rate, the central bank's communication has recently become more cautious. Consequently, we expect the pace of easing to decelerate, with two additional 25 bp cuts anticipated in March and June before reaching the terminal rate of 2%.
- Despite inflation declining towards its target, Norges Bank has adhered to its forward guidance and kept interest rates unchanged. The bank seems to be prepared for an initial rate cut in March, while continuing to signal a cautious approach, with 25 bp reductions expected at every other meeting amid forecasts of inflation above 2% and the risk of currency depreciation. We maintain that such a hawkish stance may not be fully justified, given that price pressures and economic activity in Norway are only slightly stronger than, for example, in Sweden. Therefore, risks remain tilted towards a faster pace of easing.

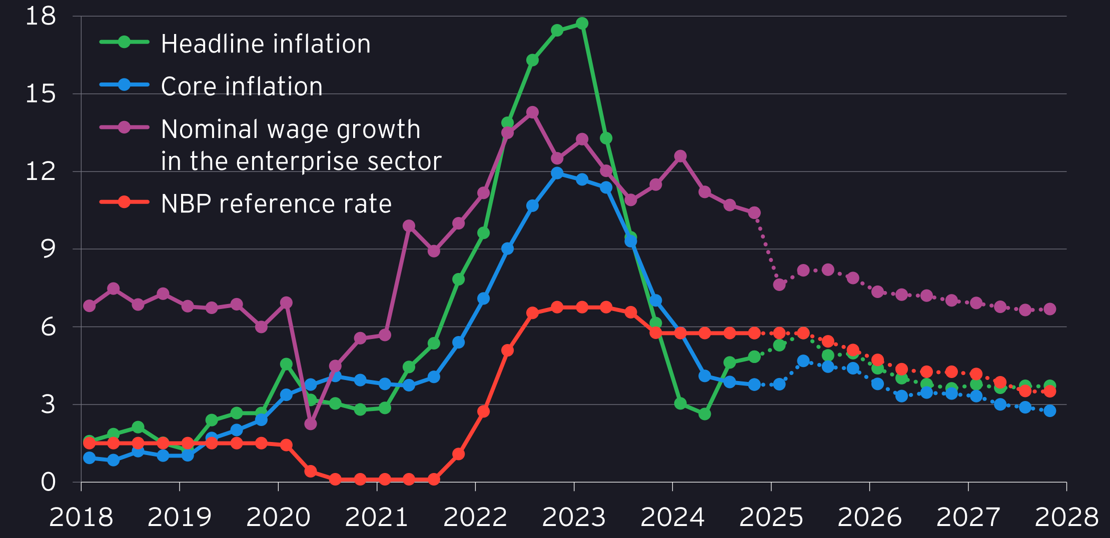
Source: Eurostat; Oxford Economics; EY EAT forecast.
* Core CPI inflation in Finland and Sweden cannot be directly compared to other countries as it includes mortgage interest payments and therefore exhibits a strong positive correlation with movements in central bank interest rates.

Poland: economic growth disappointed in 2024 Q3, yet the outlook remains positive. Inflation hovers around 5%, and the central bank is unlikely to reduce rates prior to the presidential election

Decomposition of y/y GDP growth (in percentage points)



Inflation, wages, and interest rates (in percentage)

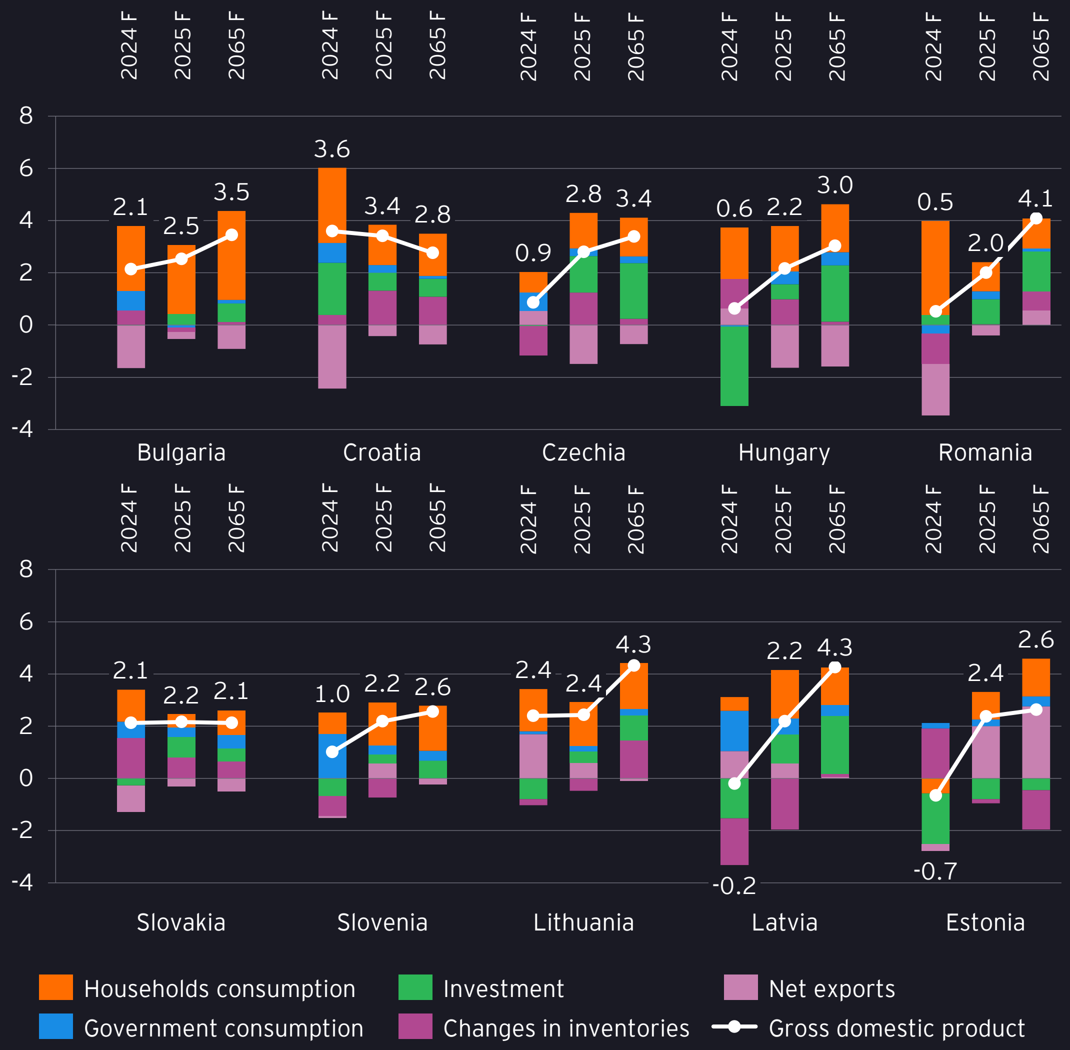


- **Uneven economic recovery continues despite a blip in 2024 Q3.** GDP stagnated in 2024 Q3, largely due to an unexpected slump in retail sales in September. Nonetheless, we estimate that the economy returned to solid growth in Q4 with a 0.9% q/q expansion. For 2024, GDP is estimated to have expanded by 2.4%−less than expected but still outpacing most of its peers. Government spending was a key driver of growth, with significant increases in family transfers, public sector wages, and military expenditure. Consumption rose by a robust 2.8%, although it lagged behind the surge in real incomes. Weak export growth of 1.0%, due to subdued external demand and a relatively strong currency, and a sharp 5.0% fall in private investment, on the back of a trough in the EU funding cycle, high interest rates, and reduced profit margins, have weighed on the economy.
- **In 2025, we project GDP growth to accelerate to 3.5%.** Both investment and exports are expected to pick up as EU Recovery Fund spending finally gathers pace and external demand rebounds. Consumption is anticipated to continue its growth at approximately 3% y/y, aligned with the slowing real income growth amid more moderate wage increases and higher inflation. The cyclical recovery is projected to peak in 2026 with GDP growth at 3.1%, coinciding with the conclusion of the EU Recovery Fund. A subsequent dip in investment in 2027 is likely to limit GDP growth to 1.7%.
- **Inflation is projected to hover around 5% throughout 2025, with a protracted return to the target thereafter.** Inflation stayed just under 5% in 2024 Q4, driven by elevated services inflation, increased regulated energy prices, and rising food prices. We expect inflation to average 5.2% in 2025, peaking at just below 6% in Q2, due to a significant tobacco excise hike, continued rise in food inflation, a resurgence in core goods inflation, and another increase in regulated energy prices. A likely deceleration in services inflation, as a result of slower wage growth, is expected to only partially offset these factors. In subsequent years, inflation should gradually decline as the impact of food and energy price shocks lessens and services inflation moderates. However, ongoing tobacco excise tax increases, the extension of the ETS in 2027, PLN depreciation, structurally high wage growth, and robust economic activity are likely to delay the return to the 2.5% inflation target until 2028.
- **The central bank (NBP) has adopted a more hawkish stance, making interest rate cuts unlikely before the presidential election.** Despite minimal changes to the inflation outlook and economic activity falling short of expectations, the NBP Governor has recently taken a more hawkish position, suggesting that interest rate easing may not resume until the second half of 2025. The upcoming presidential election, scheduled for May-June, appears to have influenced this pivot. Consequently, we now anticipate a gradual easing cycle to restart in July, with the risk of further delays. We expect 75 bp of cuts each year in 2025, 2026, and 2027, reducing the reference rate to 3.5%.

Source: Oxford Economics, EY EAT forecast.
Notes: In the botttom chart, solid lines represent historical data, and dashed lines are the EY forecasts.

Other CEE countries*: GDP growth in 2024 appears to have been softer than anticipated, but we still expect a rebound in 2025

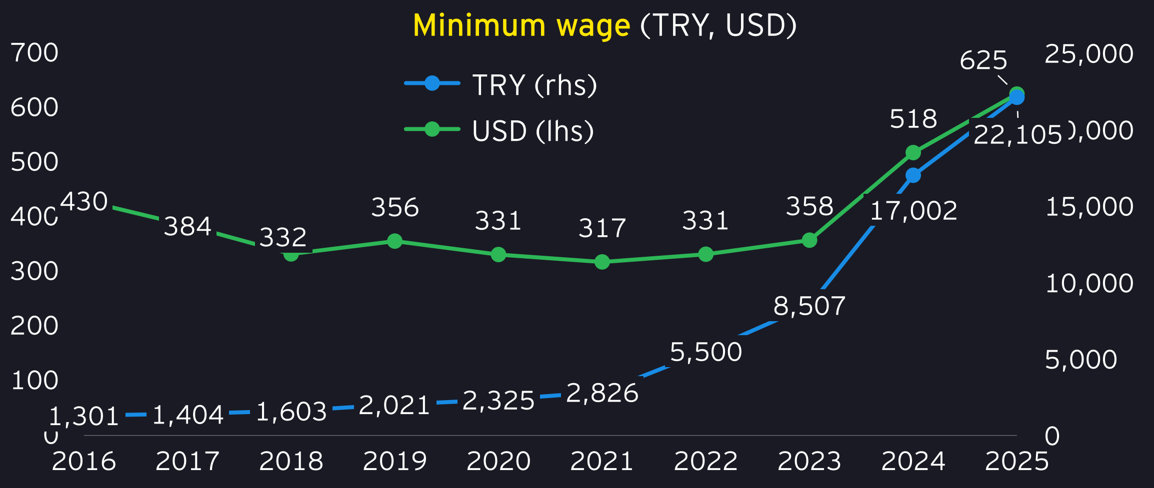
Decomposition of GDP growth (y/y, in percentage)

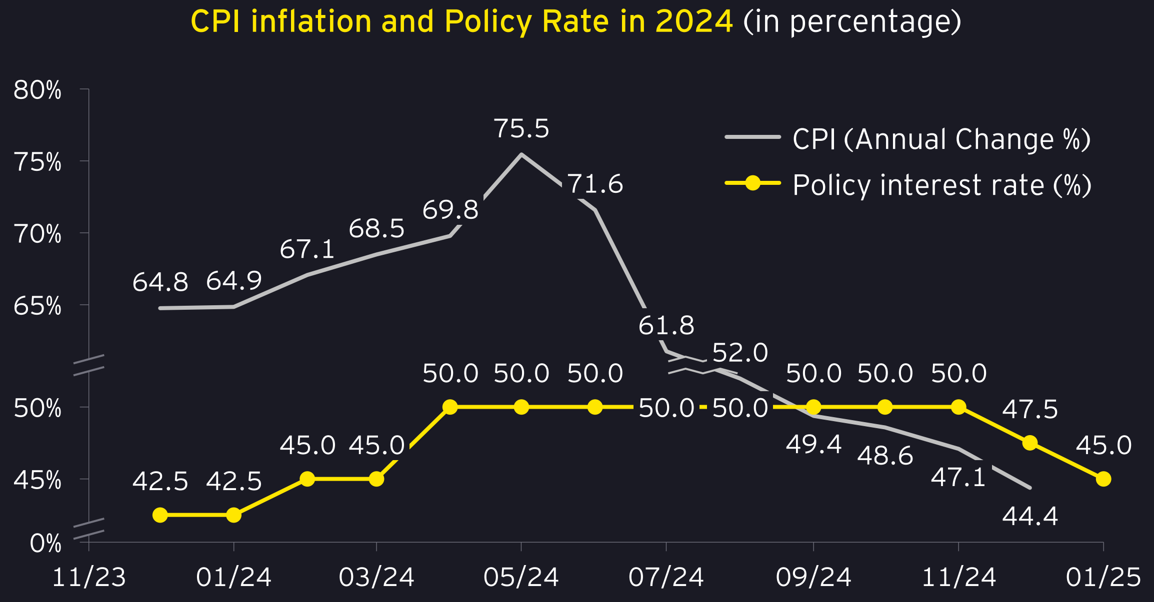


- **GDP growth disappointed in 2024 Q3.** In almost every CEE country, GDP fell short of expectations. Lithuania stood out as the sole exception, with its growth surpassing projections. Consequently, growth forecasts have been revised down for both 2024 and 2025, except for Lithuania. Notably, there is a divergence in growth among the Baltic states; Latvia and Estonia are facing stagnation, while Lithuania is demonstrating relative strength partly due to its more diversified export base and stronger trade ties with Poland, which is also experiencing high growth.
- Despite these setbacks, we still expect an **uptick in growth in 2025** for most of these economies. Croatia, however, is an outlier; after a strong growth in 2024, estimated at 3.6%, we expect a slight deceleration in its economy in 2025.
- The expected recovery in 2025 should be fueled mainly by **robust consumer spending**, underpinned by substantial disposable income growth. This is likely to stem from relatively high wage increases and generally stable inflation across most of the analyzed countries. Additionally, we still expect a **revival in investment** in 2025 as projects funded by the 2021-27 EU financial framework gain momentum.
- **Central bank policies** are also set to contribute to the recovery. Countries within the euro area will benefit from lower ECB rates. The central banks of Czechia, Hungary, and Romania are anticipated to continue reducing interest rates as well. However, these central banks face different circumstances. The Czech Republic's inflation appears to be under control, which should allow its central bank to cut rates to a level close to the neutral rate—we expect the policy rate to reach 3.25% by mid-year. Conversely, central banks in Hungary and Romania will likely proceed with more caution due to persistently high inflation, with both expected to implement a total of 75bp in cuts, bringing their base rates to 5.75% by year-end.
- **Hungary and Romania are projected to have the highest inflation rates in 2025**, at 4.6% y/y and 4.3% y/y, respectively. They are not alone in facing inflationary pressures; Slovakia, Estonia, Lithuania, and Croatia are also forecasted to see annual inflation rates above 3%. The remaining countries should experience relatively moderate headline inflation this year, within the 2-3% y/y range. Core inflation will likely remain elevated across the region, even in countries where headline inflation will be close to the target, with food and energy prices exerting a disinflationary influence in these jurisdictions.

Source: EY EAT forecast.
* Poland is not included to avoid overlap with the previous slide.

Türkiye: mild recession in 2024 Q2-Q3 but the economy seems to be turning a corner; inflation has continued to decline, although a 30% minimum wage hike may temper this progress in early 2025





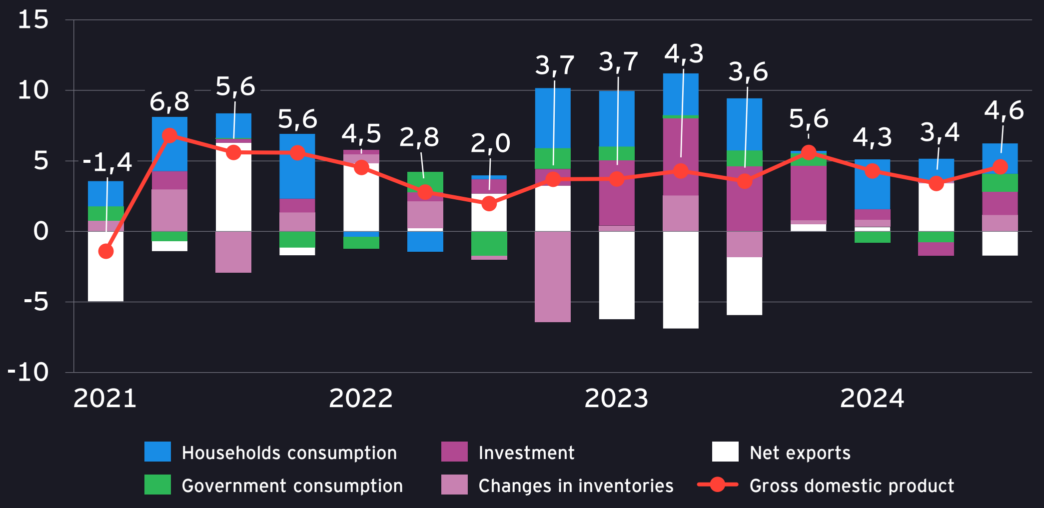
- GDP contracted by 0.2% q/q in both 2024 Q2 and Q3 on the back of significant tightening in fiscal and monetary policies over the past several quarters. However, recent data signals the worst is already behind the Turkish economy—manufacturing PMI rose from 44.3 in September to 49.1 in December, and industrial production saw a y/y increase in November for the first time in six months. Consequently, after an estimated 2.7% expansion in 2024, buoyed by strong growth in 2024 Q1 and throughout 2023, we project a healthy GDP growth of 2.5% in 2025.
- The Turkish government's medium-term plan sets an ambitious target for GDP per capita to increase from USD 13,000 in 2023 to USD 20,000 by 2027. This aligns with Türkiye's broader economic goals, focusing on growth in high-value sectors, exports, and innovation.
- CPI inflation decreased to 44.4% in December 2024, continuing a seven-month trend of gradual decline, driven by housing, electricity, gas, and fuel price stabilization. The monthly inflation rate of 1.03% in December underlines that price pressures have declined significantly.
- Despite this trend, inflation may increase in January due to the recent substantial minimum wage increase for 2025. The new minimum wage has been set at TRY 22,105 (approximately USD 625) per month, a 30% increase from the previous year.
- Nonetheless, we expect inflation to decline to around 25% by year-end, underpinned by Türkiye's tight monetary policy, measures to curb credit growth, and strategies to ensure financial stability. However, risks such as energy price fluctuations, geopolitical tensions, and domestic price rigidities remain potential obstacles.
- The central bank has begun an easing cycle, reducing interest rates by 2.5 pp at the meetings in December and January. The easing cycle is likely to continue throughout the year—we expect the policy rate to reach 28% by year-end, compared to the current 45%.

* MTP stands for Medium Term Program, Orta Vadeli Program (OVP) in Turkish, published by the government

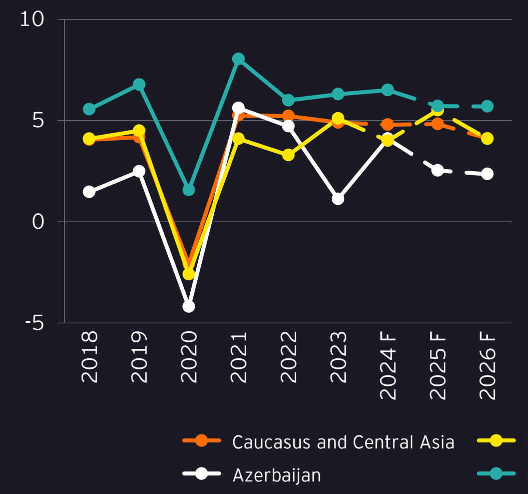
Source: Turkstat, Medium Term Plan, CBRT, Trade Ministry of Türkish Republic, EY EAT forecast.

Caucasus and Central Asia*: GDP performance has surpassed expectations, yet persistent high inflation remains a concern

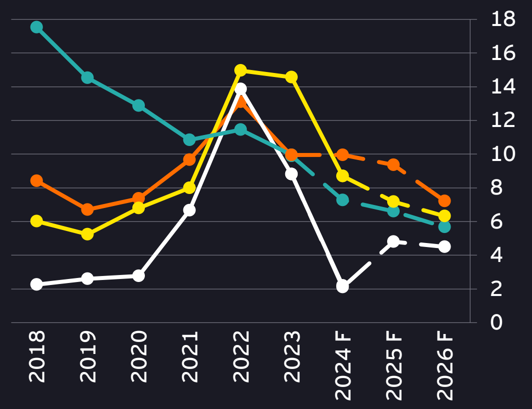
Kazakhstan - decomposition of y/y GDP growth (constant prices, pp)



Real GDP – IMF forecasts (% y/y)



CPI – IMF forecasts (% y/y)



- **GDP growth in Kazakhstan accelerated in 2024 Q3**, with the y/y growth rate reaching 4.6%. Private consumption was the largest contributor to GDP growth (adding 2.1 pp.), but nearly every other component also made positive contributions (1.3 pp. from general government, 1.7 pp. from investments, and 1.2 pp. from inventories). **Q4 appears to have been even stronger**—the Short-Term Economic Indicator (STEI), which closely tracks real GDP dynamics, suggests a y/y growth rate of 6.2%. The outlook is promising, with the IMF revising its GDP growth forecast for Kazakhstan upward to 5.5% y/y in 2025 and 4.1% y/y in 2026, an increase of 0.9 and 0.6 pp., respectively, in the January edition of the World Economic Outlook.
- The Central Bank of Kazakhstan (NBRK) opted to **raise interest rates** in December, maintaining a hawkish stance due to **persistently high inflation**, especially in the services sector. Year-end overall inflation stood at 8.6%, with a 2024 average of 8.7%, while services inflation reached 13.3%, averaging 13.5% for the year. The non-food goods sector also contributed to inflation, with price growth accelerating slightly since October to 8.3% y/y by year-end. Coupled with rising inflation expectations and signs of overheating in the real economy (as indicated by the NBRK), this situation suggests the potential for further rate hikes, particularly as the central bank's CPI forecasts remain above the 5% target for both 2025 (forecasted at 6.5-8.5%) and 2026 (forecasted at 5.5-7.5%).
- **GDP growth rates of other countries in the region also exceeded expectations.** Official 2024 GDP data for Azerbaijan and Uzbekistan have been released, with both countries reporting average annual growth rates nearly 1 pp. higher than the IMF's October projections—4.1% for Azerbaijan and 6.5% for Uzbekistan. While growth in Azerbaijan is expected to moderate in the coming years, the region's high GDP forecasts are primarily driven by the robust growth in Kazakhstan and Uzbekistan.
- **The inflation landscape across the region is mixed.** In Uzbekistan, inflation has remained around 10% y/y, double the 5% target, leading to the interest rate being held at 13.50% since July 2024. IMF forecasts suggest a gradual decline in inflation, but it is not expected to reach the target within the forecast horizon.
- In Azerbaijan, inflation has been low, averaging 2% y/y for 2024. However, there are signs of acceleration, with November alone showing a rate of 4.4%. Similar inflation rates (above 4% y/y) can be expected in the coming years, yet this is still within the central bank's target range of 4%±2pp.

* STEI index published by QAZSTAT is based on changes in production indices in key sectors: agriculture, industry, construction, trade, transport, and communication which constitute over 60% of GDP

Source: stat.gov.kz data, IMF. Data for CCA region include data from Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan, weighted by GDP share.

EY Economic Analysis Team (EAT) – Macroeconomic Insights Unit

Marek Rozkrut, PhD

EY Chief Economist and
Head of EY EMEIA Economists Unit

Contact:
marek.rozkrut@pl.ey.com
Economic Analysis Team

Economic Analysis Team

Maciej Stefański
Senior Economist
Economic Analysis Team

Maciej Zdrolik
Senior Economist
Economic Analysis Team

Bartosz Traczyk
Economist
Economic Analysis Team

For more information on specific countries or regions, reach out to economists from across the EY network

US

Gregory Daco
EY-Parthenon Chief Economist
Contact
gregory.daco@ey.com
Website

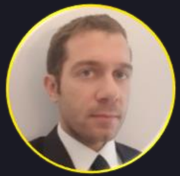
UK

Peter Arnold
UK Chief Economist
Contact
parnold@uk.ey.com
Website

Germany

Ferdinand Pavel
Director, Economic Advisory
Contact
ferdinand.pavel@de.ey.com

Italy



Alberto Caruso, PhD
Senior Manager,
Strategy and Transactions
Contact
Alberto.Caruso@it.ey.com

Spain

Jose Miguel Perez Gil
Socio / Associate Partner,
Strategy and Transactions
Contact
JoseMiguel.PerezGil@es.ey.com

Ireland

Loretta O'Sullivan
EY Ireland Chief Economist
Contact
Loretta.OSullivan@ie.ey.com

Turkey

Yusuf Bulut
Partner, EY-Parthenon,
Strategy and Transactions
Contact
yusuf.bulut@parthenon.ey.com

Africa

Angelika Goliger
Africa Chief Economist
Strategy and Transactions
Contact
angelika.s.goliger@za.ey.com

MENA

Armando Ferreira
MENA Leader
Economic Advisory
Contact
armando.ferreira@ae.ey.com

Canada

Mauricio Zelaya
National Economics Leader
Contact
mauricio.zelaya@ca.ey.com

Oceania

Cherelle Murphy
Oceania Chief Economist
Contact
cherelle.murphy@au.ey.com
Website

ASEAN

Bingxun Seng
Economic Advisory Leader
Singapore
Contact
bingxun.seng@sg.ey.com

Forecast and country-specific outlook sources

- Forecasts for most economies have been prepared by EY Economic Analysis Team (EY EAT) using an amended version of the Oxford Global Economic Model (GEM)
  - EY EAT have adjusted GEM equations, assumptions and data inputs
- Forecasts for the US have been prepared by EY-Parthenon Macroeconomics Team
  - Contact: https://www.ey.com/en_us/strategy/macroeconomics
- Forecasts for the UK have been prepared by EY ITEM Club
  - Contact: parnold@uk.ey.com
- Forecasts for Italy in 2024-25 have been prepared by EY Italy
  - Contact: alberto.caruso@it.ey.com

- Country-specific outlooks for Germany, Italy, Spain, the UK, and Turkey have been provided by economists listed on the previous page

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