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Euro area's economy weathers tariff turmoil

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The economy of the euro area has held on this year amid the considerable trade policy and geopolitical uncertainties. The tariff agreement reached by the EU with the United States has reduced the general uncertainty felt by businesses and consumers, but the tariff increases will weaken economic growth. Growth is nevertheless expected to pick up as time moves on. The drop in inflation and the lowering of interest rates have brought a positive boost to the euro area's economy. Consumption has been supported by earnings growth and also by the sufficiency of jobs in the euro area.

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- Inflation is at around the target.
- Geopolitical uncertainty is still slowing economic growth. Higher defence spending may boost growth.
- Purchasing power of euro area households has grown and savings are high.



The outlook for the euro area economy has this year been affected particularly by the uncertainty

over the policy of the United States on tariffs. The situation became clearer when a deal was reached with the United States in July on a broad 15% tariff for most EU goods exported to the US. This nevertheless means there will be tariffs many times higher than previous levels, which is not good news for businesses.

Of critical importance is how the tariff increases will affect the EU's position in relation to other economies that export goods to the United States. Key to this will be the level of tariffs set for goods imported to the US from China, in particular. If China has to pay higher tariffs than the EU, this will improve the EU's competitive position, but there would be risks to this as well.

The US tariff policies and the associated increase in uncertainty compared with last year are slowing economic growth in both the euro area and the global economy. Growth in the euro area economy is expected to be weak this year. In the coming years, this growth will pick up slightly.

Chart 1.



Households are still saving a large share of their income

If general uncertainty eases and households have greater confidence to spend, a faster recovery of the economy will be possible. The jobs market is good, and the drop in inflation and rise in wages mean that households should have the income and resources to consume more that at present. This will be further supported by the gradual reduction in households' loan servicing costs as a result of the lowering of interest rates. Households are nevertheless still saving a larger share of their income than normal. This is because consumers are being cautious due to their recent

experience of surging inflation and high interest rates, and the geopolitical tensions.

Inflation is at around the target

In the euro area there is welcome news that inflation is now at around the European Central Bank's (ECB) target of 2%. This has been attributable not only to the interest rate policy but also the fall in the price of oil and natural gas and the strengthening of the euro's value relative to the US dollar. The price outlook for industrial goods is moderate. By contrast, in labour-intensive service industries, prices have been pushed up by the substantial rise in wages as, in real terms, these have gradually returned to their pre-2022 path.

Although expectations of future inflation are currently stable, there are risks concerning the future path of prices. Inflation could, on the one hand, fall further than expected if the euro's strengthening against the US dollar were to continue for long and if economic growth were to slow by more than anticipated. On the other hand, inflation could increase more than expected if the rise in services prices does not stabilise. The impact of extreme weather phenomena, especially on food prices, could also drive up inflation.

Interest rates have fallen

With inflation having come down to around its target level, the ECB has been able to cut interest rates. The ECB's main interest rate used for monetary policy purposes has already been lowered by two percentage points since the middle of 2024, halving the rate. The interest rate reduction has been efficiently transmitted to market interest rates and especially for bank loans granted to businesses. The interest rates on such loans have fallen in just over a year from 4% to 3.3%. It has also been found that the key interest rates set by central banks have led to more investment by businesses with variable rate loans than by those favouring other loans.

The decrease in interest rates has already been evident as a gradual growth in both the stock of corporate loans and of housing loans. The effect on households' loan servicing costs has varied from one country to the next, depending on the share of residential mortgages tied to short-term market interest rates, in which the loan rate changes annually or more frequently to reflect the prevailing interest rates. In the euro area, the most common mortgages are those tied to long-term interest rates, where rate reductions are seen only after a lag. These are usually referred to as fixed rate mortgages, where the interest rate changes infrequently, perhaps only once every 10 years.

The lowering of interest rates also supports capital-intensive industrial production, and this has indeed started to increase this year, following weak performance over the past couple of years.

The improved situation for manufacturing has also contributed to a positive turnaround in labour productivity. Nevertheless, manufacturing remains vulnerable to the possible impact of tariffs on global trade and exports.

Economic impact of increased defence spending

In the coming years, higher defence spending will help not only the defence industry but also other industrial sectors that support it – and the larger the share of defence procurements going to EU-based companies, the greater this impact will be. The substantial increase in defence spending will occur in parallel with major investments in the green transition and in digitalisation. The risk is that public borrowing will grow and that investments which might produce a better return than in the defence industry will be sidelined.

The eventual impacts will depend on how the expenditure is divided between investment and consumption. Also of considerable significance will be the role of R&D expenditure in the spending increases and whether the necessary procurements can be made within the EU or whether they should be from elsewhere.