

Euro area outlook – Geopolitical noise, macro stability?

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- The euro area economy starts the year on a decent footing despite the range of obvious geopolitical risks. We expect quarterly growth to improve through 2026, supported by German fiscal stimulus, EU recovery fund disbursements and reasonable consumer dynamics. Brighter prospects for German industry, where we expect a moderate cyclical recovery, add to the case for gradually improving growth momentum at a euro area level.
- After stable inflation in 2025, the disinflation process is likely to resume this year – we see the headline rate averaging 1.7% in 2026. FX strength, trade diversion and lower energy prices could all push headline rates further below the ECB's target. But policymakers are clearly content with the current policy setting and the bar for policy adjustment will remain high, especially in the context of relatively firm economic activity.

The economy carries reasonable momentum into 2026

Recent data continues to suggest that the euro area economy starts the year with steady growth momentum, well-behaved inflation and a resilient labour market. In short, the macro fundamentals look fine, and the narrative of resilience which emerged last year remains valid. Survey data generally softened in December but on a quarterly basis both the composite PMI and the European Commission's sentiment indicator reached the highest mark since 2023 in Q4.

Growth is set to be supported in 2026 by a range of factors: the German government's spending spree, final disbursements from the EU recovery fund and reasonable consumer dynamics. We also see scope for a limited cyclical recovery in industry despite persistent headwinds to exports and private investment. Overall, we see growth slowing from 1.4% in 2025 to 1.2% this year. However, annual carryover distortions disguise a story of improvement with quarterly rates set to pick up moderately through the year and we judge that risks to our forecast lie slightly to the upside.

On the fiscal side, the German fiscal boost is proceeding more slowly than initially hoped but we expect the budget deficit to widen by around 1 pp of GDP to ~3.5% this year. That is less pronounced than the government's plans – we expect normal slippage and delays around infrastructure spending – but it would still provide a meaningful impulse. We expect German growth to rise to 1.1% this year (from 0.3% in 2025).

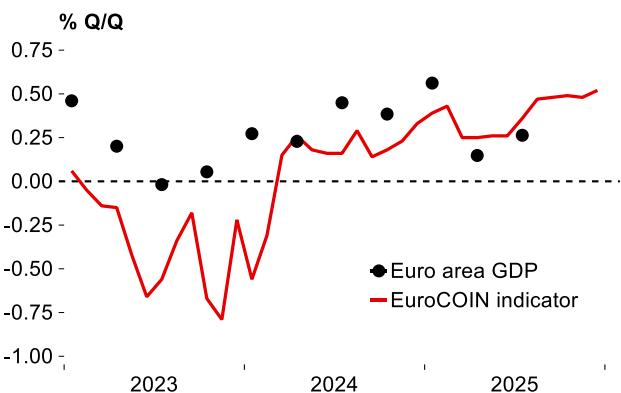
Fiscal policy is set to be more neutral elsewhere in the euro area, with mild consolidation in several member states. That said, public investment in peripheral countries will be supported by the Next Gen EU programme (the pandemic recovery fund) which is not included in national deficit numbers. The scheme has now entered its final year and it's a case of use it or lose it. Peripheral countries are set to benefit from significant funding – Italy, Spain, Portugal and Greece collectively have 55bn EUR of grants yet to be disbursed from the total envelope, equivalent to ~0.3% of euro area GDP.

Encouraging signs of life in German industry

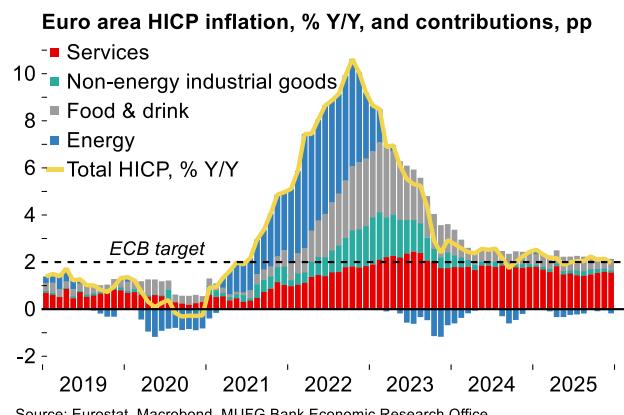
German industry is also showing some tentative signs of life, at last. Industrial production increased by 0.7% in the three months to November. Factory orders notably increased by 5.6% M/M, the third consecutive monthly improvement, with a likely boost from military contracts as the fiscal splurge starts to be felt. New orders have increased 2.1% on a three-month basis when large-scale orders are excluded. That points to stronger cyclical momentum at the turn of the year more broadly, and recent lower energy pricing could provide further support to industrial activity. The 3.2% M/M uptick in German truck mileage in December is another encouraging sign.

This is all relative, of course. German industrial production remains almost 15% below its 2017 peak, and the euro area manufacturing PMI new export orders slipped to an 11-month low in December. Externally, euro strength is likely to remain a headwind for exporters (see [here](#)) and increased competition from China, where producers have benefited from policy support to move up the value chain, is here to stay. Meanwhile, German exports to the US were down by 22.9% Y/Y in November, and the drag from tariffs could still be to come following last year's front-loading distortions. The range of geopolitical risks are also likely to constrain private investment. All told, we look for a limited cyclical industrial recovery this year which still leaves plenty of question marks around Europe's relative competitiveness.

The economy is carrying good momentum into 2026



Inflation was remarkably stable in 2025



Inflation risks still tilted to the downside

Euro area inflation was remarkably well-behaved through 2025 with the headline rate hovering within 0.3pp of target since February and ending the year at 2.0%. But our view is that the disinflation process has further to run in 2026 as wage pressures continue to fade. The gradual catch-up process after the 2021-22 inflation shock is essentially complete and wider AI implementation could also exert a dampening effect on wage growth. In our central scenario we see inflation averaging 1.7% this year. That is set to support real household income growth against the robust labour market backdrop.

The ECB has made it abundantly clear that it has no plans to adjust policy from the current setting. It has reasons to be content – inflation is bang on target and the deposit rate, at 2.00%, is within the ECB's estimate of neutral. We dropped our call for further easing this year (see [here](#)) after communication at the last policy meeting and stronger-than-expected growth momentum, but we maintain that a cut is more likely than a hike in 2026.

In the context of sticky services inflation, steady growth and a resilient labour market, the ECB will likely tolerate undershooting inflation this year to a degree. But the latest projections already show sub-2% headline inflation across much of the horizon and there are meaningful downside risks to inflation from FX strength, lower energy prices and trade diversion effects. A sustained period of inflation at around 1.5%, say, would certainly be a communication challenge and could test officials' resolve. In that case we think a policy calibration downward to 1.75% (still within the ECB's estimated range of 'neutral') is plausible, if there is progress on underlying inflation pressures and economic growth does not exceed potential rates.

Geopolitical noise, macro stability

Putting it all together, *our central scenario is rather straightforward: growth close to potential, neutral monetary policy, inflation marginally below target*. It's a disconcertingly simple story and there are plenty of obvious geopolitical risks which could shift the narrative. Tariff uncertainty could be revisited following the domestic legal challenge to the current framework, for example. More broadly, we wonder if US administration will have been emboldened by the initial success of recent foreign interventions and whether the approach of the mid-term elections might incentivise further policy tilts. Domestically, French political uncertainty could increasingly weigh on sentiment as next year's presidential election looms ever larger on the horizon.

Yet, for now at least, *geopolitical volatility contrasts with relative macroeconomic (and indeed market) stability*. Given the degree of momentum into the year and range of fundamental supportive factors, our base case continues to be for euro area growth to show moderate improvement through the year.

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