BEA 東亞銀行

Economic Research

March 2025

Market Monitor – Europe

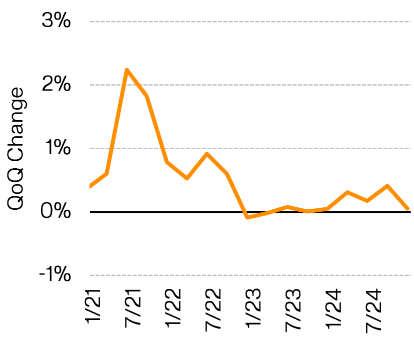
Stepping up efforts to raise defense spending and investment

- European countries proposed sharp increases in defence spending and investment, possibly reviving business sentiment in the region.
- Marginal expansion in economic activities in early 2025, with the threat of tariffs rising.
- Divergent inflation readings between the Eurozone and the UK. The European Central Bank delivered its sixth cut in the current cycle.

The upcoming increase in defence investment could benefit the growth outlook in the region

European countries proposed sharp increases in defence spending and investment, possibly reviving business sentiment in the region. After repeated threats from the new US administration to cut back military support to its European allies, together with the Oval Office argument, European leaders stepped up their efforts to raise defence spending and investment. First, the UK and France agreed to contribute troops to be a peacekeeping force, alongside further aid and loans, under a US-brokered ceasefire agreement between Russia and Ukraine. Second, European Union (EU) Commission President Ursula von der Leyen announced a defence package amounting to EUR 800 billion as the centrepiece of the new ReArm Europe Plan. This is made up of EUR 150 billion in loans given to member states for defence investment and EUR 650 billion of additional fiscal space at the country level through the national escape clauses within the EU fiscal rules.

Eurozone Economic Growth



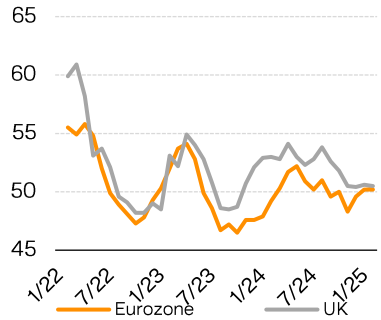
Source: CEIC

Third, the new German leader is proposing a massive U-turn on fiscal policy, including a EUR 500 billion infrastructure fund, exemption of required defence spending from the debt brake, and additional deficit allowance for state and local governments. In the case of Germany, the proposal must be rushed through the current Bundestag by 25th March, when the current Bundestag ends, as the opposition parties will hold a blocking minority in the new Bundestag. The above measures are remarkable, if not unprecedented, which showed the European leaders strong commitment to investing in defence. Increased public investment and the potential ceasefire between Russia and Ukraine could lift sentiment and pull in private investment, which could be a meaningful offset to the challenges created by US trade policy.

Marginal expansion in economic activities in early 2025

Composite PMI in both the eurozone and the UK showed marginal expansion in activities in early 2025. The eurozone composite PMI remained unchanged at 50.2 in February, driven by the moderation of services PMI from 51.3 in January to 50.7 and an improvement of manufacturing PMI from 46.6 to a still depressed level of 47.3. Germany, France and Italy recorded a recovery in their respective manufacturing sectors. Germany and France recorded some pullback in their services sectors, while the expansion in Spain and Italy propelled further. Similarly, the UK composite PMI barely changed from 50.6 in January to 50.5 in February, but its manufacturing sector declined to a 14-month low of 46.9, and the services sector rose from 50.8 to 51.0 in February.

Eurzone and UK composite PMI



Source: Bloomberg

More tariff threats could hit the European Union going forward. Despite not being a direct target in the first round, the 25% tariff on steel and aluminium, the threat of reciprocal and 25% tariffs, if implemented, could notably hit the European Union ahead. The impact would be more material if the US goes through with the reciprocal tariff at a product level or a broad-based tariff. As mentioned above, European leaders have increasingly prepared to take a stronger role in defence and peacekeeping efforts for Ukraine and the region, but whether such increases in defence spending will meet US expectations or if further compromises will have to be made by European leaders remains to be seen. Nevertheless, the prospect of rising public and private investment could partially offset the challenges created by US trade policy.

Diverging inflation in the Eurozone and the UK

Eurozone headline and core inflation both edged down by 0.1 percentage point (ppt) from 2.5% year-on-year (YoY) and 2.7% in January to 2.4% and 2.6% in February, respectively. The former was mainly driven by a 1.7 ppt decline to 0.2% YoY in energy price inflation, while the latter was dragged by a 0.2 ppt decline to 3.7% YoY in services inflation. With subdued growth momentum, price pressures are expected to stay modest in the near future. However, the US tariff threats and the potential sharp increase in public spending could bring some uncertainties further ahead.

The European Central Bank (ECB) delivered its sixth cut in the current cycle.

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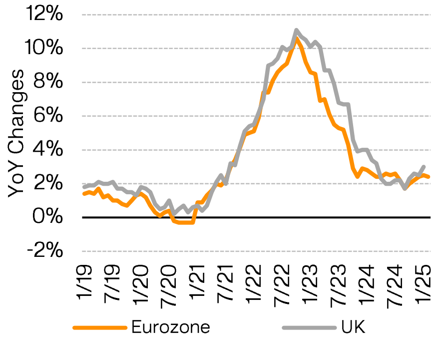
On March 5, 2025, the ECB held its monetary policy meeting and decided to lower interest rates by 25 basis points. This decision reflects the ECB's ongoing efforts to ease monetary policy as inflation continues to slow and economic growth weakens across the eurozone. The ECB has shifted to a more hawkish tone, moving from stating that "monetary policy remains restrictive" to "monetary policy is becoming meaningfully less restrictive," which indicates a potential slowdown or pause in future interest rate cuts. The decision was reached by consensus, with no opposition, though one member abstained, amid uncertainties including potential U.S. tariffs and plans for increased European military spending.

Inflation Rate



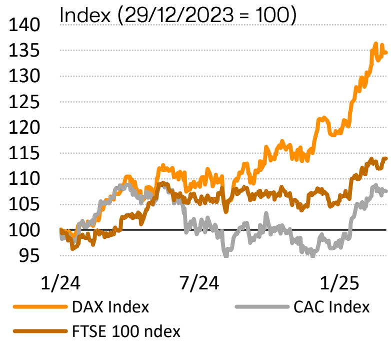
Source: CEIC

Food prices lifted UK headline inflation in January. The UK headline inflation accelerated from 2.5% YoY in December 2024 to 3.0% YoY in January 2025, while core inflation rose from 3.2% to 3.7%. The former was mainly driven by the increase in food and non-alcoholic beverage prices, rising from 2.0% to 3.3%, while normalisation of air fares and VAT-driven education price increases contributed to the latter. Even though UK inflation is expected to remain bumpy for a while, the still restrictive monetary environment and subdued growth momentum have opened the door for the Bank of England to calibrate its monetary policy stance cautiously. After a 25 basis points cut in February, it is expected to stay put in its upcoming March meeting.

Stock markets hit fresh highs in February

European stock markets recorded another solid performance in February. Key European equity indices hit fresh highs in February 2025, driven by the expectation of rate cuts, a potential ceasefire between Russia and Ukraine, and a possible shift in fiscal stance by European governments. The FTSE 100, German DAX and French CAC indices were up 1.6%, 3.8% and 2.0% month-on-month (MoM), respectively, in February. Meanwhile, the euro and British pound appreciated against the US dollar by 1.5% and 0.1% MoM, respectively.

Stock Market Indices



Source: Bloomberg

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