CIO PERSPECTIVES

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Europe: Forecasting in the Fog

Our recent field trip to sunny Frankfurt sharpened our outlook for Germany and the Euro Area, but optimism remains limited. The current German stimulus and impact on the Euro Area is overshadowed by escalating Middle East uncertainties. We argue that the energy shock differs from 2022 and so too will the European Central Bank's (ECB) response.

1. STAGFLATION ALARM BELLS

As expected, Euro Area confidence data for March pointed to a fragile and uneven growth backdrop. The composite PMI activity index for the region declined to 50.5 from 51.9 in February, driven by a slowdown in services activity (index at 50.1 versus 51.9 previously), while the manufacturing sector recovered to 51.4 after 50.8. The latter was influenced by extended supplier delays, but this was of course due to shipping disruptions rather than higher demand. Strong new orders in German manufacturing were a silver lining but could prove short-lived if the energy crisis continues to intensify (see Box, page 3). Additionally, the input price index for industrial producers surged by more than 10 points, fuelled by a sharp increase in energy prices (the highest since October 2022). However, encouragingly, producer prices remain contained. On the consumer side, the European Commission confidence index has dropped sharply — reaching levels only previously seen during the pandemic and the Ukraine crisis. While the first signs of cyclical deceleration are now quite clear according to monthly surveys, these surveys nevertheless suggest that GDP growth remains positive in the first quarter of 2026. Looking ahead, with only muted consumption expected in the coming quarters, tighter market financial conditions and tensions on trade, **we have revised our GDP growth scenario down to 0.9% (from 1.3%) in 2026 and 1% (from 1.6%) in 2027 with the assumption of a temporary conflict in Iran that has pushed back the recovery in confidence.** Risks remain skewed to the downside, with the impact on tourism from airline inflation and a harsher reversal in the recovery of the construction sector.

On inflation, the impact of the energy shock is significant, but expected to be short-lived. In March, the first inflation figures from Spain (3.3%) and Germany (2.7%) confirm a jump from energy prices but had no effect on other prices. In fact, the core inflation rate – excluding energy and food prices – stayed unchanged in both countries. Looking ahead, energy represents approximately 10% of the Euro Area consumer basket used to calculate inflation. However, the world is still coming to grips with the extent of the impact on other goods, such as fertiliser, petrochemicals and shipping costs. Thus far, we have factored in an oil shock that will spike in April 2026, with prices up 70% higher compared to the same month in 2025. For the natural gas shock, since the beginning of the Iran conflict we have underscored the delayed pass-through of this energy shock in the Euro Area. According to a recent Golman Sachs paper, among the Big Four, the speed of transmission is faster in Spain and slowest in Germany (with a large share of fixed price contracts), but stronger in Italy where the energy-mix is more tilted to fossil-fuels. The weakest transmission of the shock is for France, where nuclear energy is more prominent and therefore surprising to see the extent of the downgrade from the energy shock in consumer confidence in March. **Combining these two shocks and adding a more modest shock to food prices, we ultimately have an average inflation rate climbing to 3% this year and remaining still high in 2027 (2.6%).**

2. WHAT'S NEXT FOR ECB POLICY?

The next ECB policy meeting is on 30 April. That is almost as far off still as the war has lasted so far. Investors have reacted to the sharp rise in energy prices by factoring in almost 75 basis points (bps) increase in the ECB's deposit rate. These so-called 'insurance hikes', so the narrative goes, are needed to make sure medium- to longer-term inflation expectations do not get detached from the 2% inflation target. While this reasoning is straightforward, one could still think of another approach to deal with the inflation issue at hand.

Importantly, the general macro background conditions significantly differ from the situation in 2022. First, when the initial shock hit in 2022, inflation was already at 6%. This stands in contrast to the latest reading of 2.5% in March 2026. Second, while the current labour market is still solid, it is not overheated as was the case four years ago, weakening the case for stronger wage demands. Third, in 2022 a negative supply shock collided with a massive positive demand shock from pent-up consumption. There is no excess demand today. Finally, whereas the ECB entered 2022 with a deposit rate of -0.5%, it is now at 2%, a level much closer to the so-called neutral rate.

All this to say that the ECB's starting position is way more comfortable than four years ago. At this point, when there is still a reasonable chance that the Strait of Hormuz will open before the next ECB meeting, it is still possible for the ECB to 'look through' the upcoming jump in inflation. In that scenario, while oil and gas flows would still be disrupted, the prospects regarding future supply would look brighter. Of course, the ECB keeps on signalling that it remains vigilant and ready to act. But that does not necessarily mean it will also follow up on this. In any case, hiking interest rates on the back of a negative supply shock, at a time when Europe needs more investments, is not a decision to be taken lightly and could be interpreted as a policy mistake.

A 'Maradona-move', a term coined by former Bank of England (BoE) Governor Mervyn King, cannot be ruled out. Just as Maradona ran in a straight line, beating defenders who expected him to turn, the ECB could dribble economic agents by signalling monetary hiking intentions without acting upon them. The feinting is crucial to rein in so-called second-round inflation effects. If businesses expect higher rates, they are less likely to push through broader price increases. Similarly, if households anticipate rising rates, their focus shifts toward job security rather than pay raises.

The implications for medium-term inflation crucially depend on the magnitude of indirect and second-round effects. A stronger and more persistent energy shock, therefore, would trigger rate hikes. After all, the ECB is haunted by the memory of 2022, when many observers said it reacted too late to the spike in inflation. **That said, our view for now is that a straight dribble, i.e. faking but not hiking rates, can still score a 2% inflation goal. The clock is ticking but it is not 30 April yet.**

Under blue skies and surrounded by cranes, the "sick man of Europe" narrative surrounding Germany is less obvious. From the ground, or more exactly from the skyscrapers, we interviewed multiple economists and other contributors[1] that helped us better understand the challenges surrounding the Germany economy at present.

1. A request for "boring, but stable policy"

Following our discussion with the Frankfurt-based Leibniz Institute SAFE who undertakes a Manager Sentiment Index (a text-based analysis of earnings calls and corporate communication), the dominant message from large German corporations is clear: corporates are calling for "boring, but stable policy." Expectations from the coalition remain low, but predictability is valued after years of conflicting red tape. Mentions of the government in corporate communication increased significantly (to 26% vs. 8% previous after previous elections).

Furthermore, Germany's political centre is facing an "identity crisis", particularly within the centre-left SPD, as it seeks to redefine itself after losing parts of its working-class base to the far right-wing AfD. This has created a "power vacuum in the middle." The SPD is likely to prioritise household protection measures, while broader disappointment with political leadership — including Friedrich Merz — reflects ongoing uncertainty around policy direction.

2. "Masses of money to buy bread"

Germany's high savings rate — around 20% of disposable income, well above the Euro Area average — reflects a deeply ingrained fear of inflation. As one participant put it, "school children still have images of masses of money needed to buy bread," referring to textbook images of hyperinflation that still shape behaviour. The 2022 inflation shock reinforced this mindset. While inflation has since fallen back toward approximately 2%, it is the level of prices, not the rate of change, that matters for households. Prices remain significantly higher than pre-crisis, weighing on sentiment. As a result, even with recovering real incomes, households continue to favour precautionary savings. Consumption has held up better than confidence suggests, highlighting a persistent gap between weak sentiment and improving purchasing power (before the Iran conflict).

3. "What's good for China is bad for Germany"

Germany's competitiveness has not only suffered from the post-Ukraine energy shock, but has also been eroded by higher financing rates, rising labour costs, taxation and regulation, and intensifying Chinese competition in key export markets. While energy prices initially dominated concerns, the consensus has shifted to reliability — "better to have expensive energy than unstable supply." Subsidies have cushioned the shock, and energy-intensive industries have already downsized. The more structural issue is that China is gaining market share, reinforced by signals from the latest high-level policy meeting pointing to a renewed focus on export-led growth — a clearly negative development for German exporters.

4. The "hole" vs. "something is happening"

Germany's fiscal outlook is characterised by a tension between structural weakness and cyclical support. On one side, there is a "hole" in the budget — linked to rising spending on healthcare, public employment and pensions — with concerns that about a third of infrastructure spending is being diverted to cover it. Institutions such as IFO and IW remain sceptical, noting that while stimulus supports short-term growth, it does little for long-term potential, estimated between 0.1% and 0.6%. As one participant put it, "the only thing for sure is that debt will increase."

[1] Source: interviews were held end of March 2026 with IFO, KFW, JPM, CA-CIB, Commerzbank, Amundi, Leibniz Institute SAFE and Goldman Sachs.

On the other hand, "something is happening": backlogs are skyrocketing, government spending is rising, measures such as VAT cuts for restaurants will be supportive. Even if stimulus partly finances this "budget hole" and supports consumption rather than investment, it still underpins near-term growth and avoids raising taxes. KFW estimates that the structural primary balance will increase by 1.2 percentage points of GDP in 2026, increasing GDP by 0.6 to 0.8% (with total investment up from 75 billion euros in 2024 to over 120 in 2026). However, concerns remain around spending quality (excluding defence spending which was relatively consensual), limited progress on digitalisation, and cost inflation in defence procurement. It is important to underline, the stimulus plan was however designed more as an infrastructure plan to "catch-up for years of under investment under the Merkel years" and not necessarily designed to combat all of Germany's competitiveness issues, not the least energy autonomy. Finally, the lack of conditionality linked to the stimulus funds transferred to the Länders increases the difficulty of following up the impact of spending.

5. Future industry mix: "the million-dollar question"

The evolution of Germany's industrial base remains "the million-dollar question." The share of energy-intensive industries (approximately 15% of value added) is set to decline, while autos (approximately 18%) remain important but are unlikely to drive growth. Encouragingly, incumbents are adapting — for example, BMW's planned 40 new or updated models based on its new technology platform by 2027 reflects ongoing transformation, echoing past adjustments during periods of external competition.

Future growth is likely to come from: new companies (Germany now has approximately 40 unicorns), niche specialisation (e.g. high-end machinery), aging and healthcare sectors linked to the change in German demography. There is also optimism around "transferable skills", with labour shifting from weaker sectors (auto parts) to stronger ones (defence). While recent European Union (EU) trade deals are positive, their impact is likely to materialise only in the 2030s.

6. Germany: "Fiscal stimulus vs. energy crisis"

The German economy is caught today between energy vulnerability from the Iran conflict and fiscal support which only started to accelerate late 2025. When asked if the German government could do more, many respondents were doubtful given the controversy already around the current stimulus plan. Policy flexibility remains limited. A further suspension of the debt brake would likely require a major external shock, such as a prolonged disruption in energy supply. A key risk scenario highlights this clearly: an oil price increase to 100 dollars for one year would wipe out the entire impact of the German stimulus. However, this is not the first energy shock Germany has had to navigate, and the energy-intensive industry is already a lot smaller.

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