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Amplified Divergence or Course Correction?

... Make Europe Great Again!

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June 2025

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Any authors named on this report are research analysts unless otherwise indicated.

Lagarde's hawkish pivot ...

... to a rate cut holiday

Entering wait-and-see mode

Skipping July

*“with today’s cut, at the current level of interest rates, we believe that **we are in a good position to navigate the uncertain conditions that will be coming up**”*

Did markets over-interpret the “end of the cycle” comment?

*“with today’s cut and the current level of interest rates, number one, **I think we are getting to the end of a monetary policy cycle** ...*

... that was responding to compounded shocks, including COVID, the illegitimate war in Ukraine and the energy crisis ...

*... **But of course we are now into a different time with different players, with different partners, with different policies**. And we will continue to analyse and assess and measure and make sure that we deliver on our 2% medium-term target.”*

Source: ECB, Nomura

There are two possible reaction functions for the ECB

Risk management vs. wait, see and respond accordingly

“reactions in the market suggest that in the short term, tariff threats have been perceived as a negative and inflation-lowering, or deflationary, demand shock”

“serious disruptions to supply chains and disruptions in financial markets have been excluded from the analysis”

“we should take into account that the overall impact of tariffs on inflation in the euro area is highly uncertain in the medium term. It depends not only on the magnitude of the tariffs implemented, but also on the target countries and sectors of the tariffs, and on the reorientation of international trade.”

Source: Suomen Pankki, Nomura

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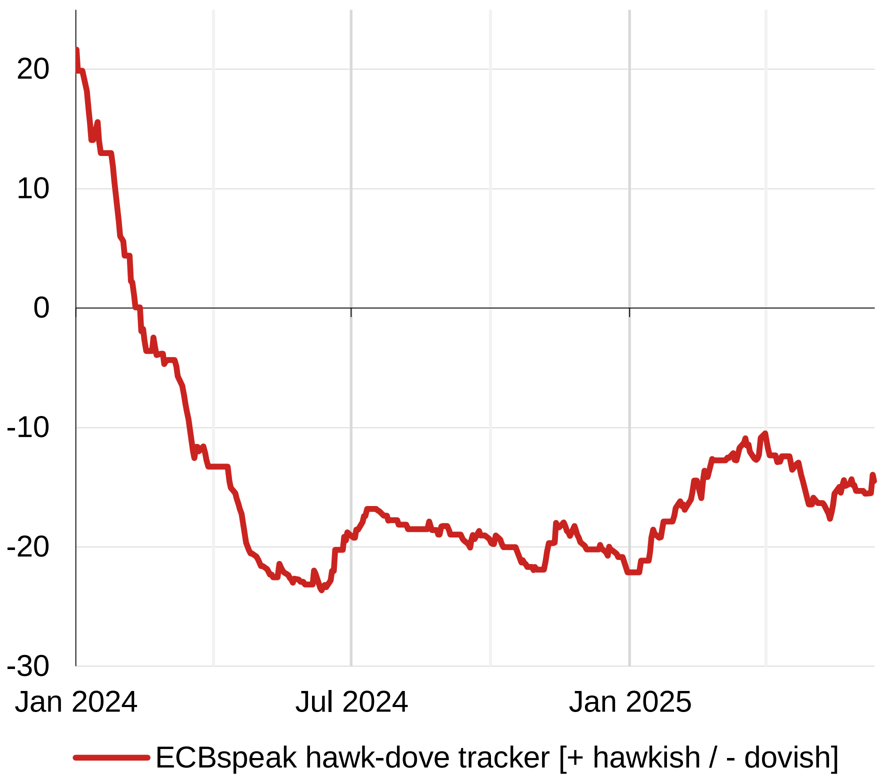
Not the end

ECBspeak edged dovish after 2 April



We believe the ECB will have to cut further

Tool	Key assumptions
ECB Deposit Rate (Current: 2.00%)	
2025	25bp cuts in Sep, Dec
2026	No change
Peak	4.00% (Sep 2023)
Trough	1.50% (Dec 2025)
Balance sheet - passive roll-off	
APP: Full roll-off since 1 July 2023	
PEPP: Full roll-off since 1 January 2025	

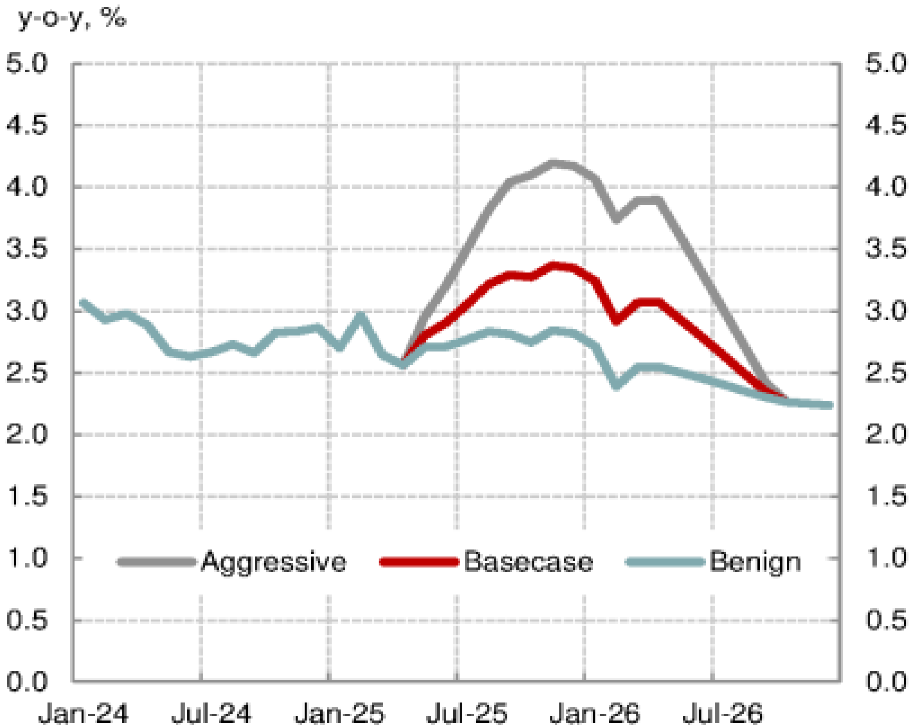
Source: Macrobond, Haver Analytics, Nomura

Asymmetries from US tariffs

How Europe will be hit differently

Recapping our US view

US tariffs will be inflationary in the US



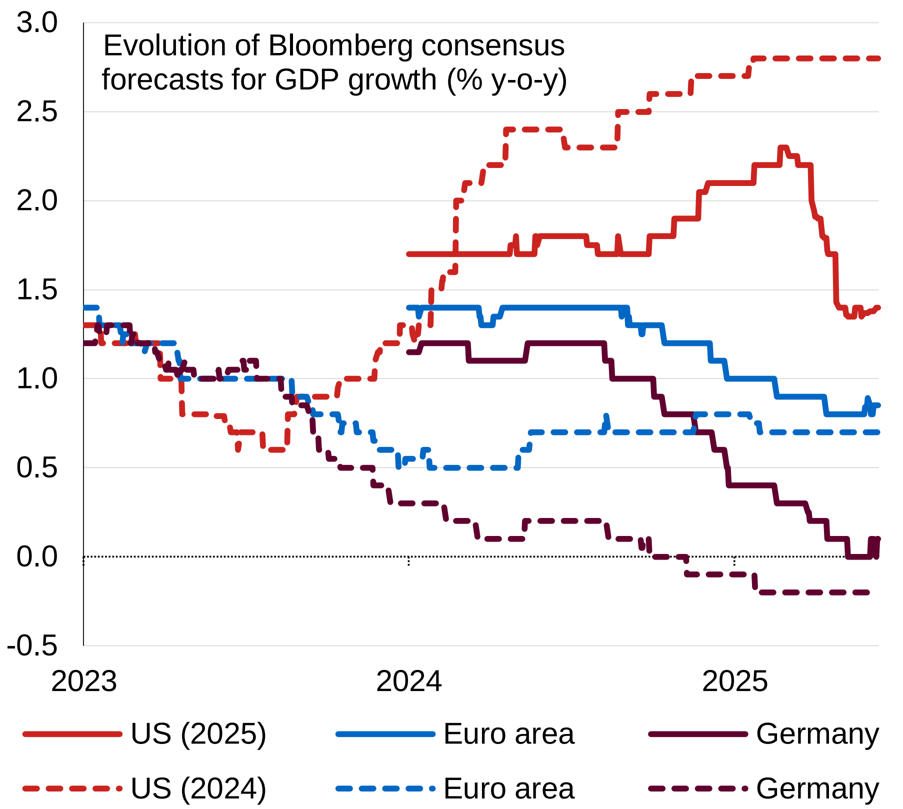
The Fed will remain on hold until December

Tool	Key assumptions
Fed Funds Rate	
2025	25bp rate cut in Dec, EOP 4.125%
2026	Two 25bp cuts in Jan and Mar, EOP 3.625%
Peak	5.25 - 5.50% (Jul 2023)
Trough	3.50 - 3.75% (Mar 2026)
Balance sheet - passive roll off	
Cap	$40bn/month ($5bn UST, $35bn MBS) through March 2026
End	After March 2026
Sales	No

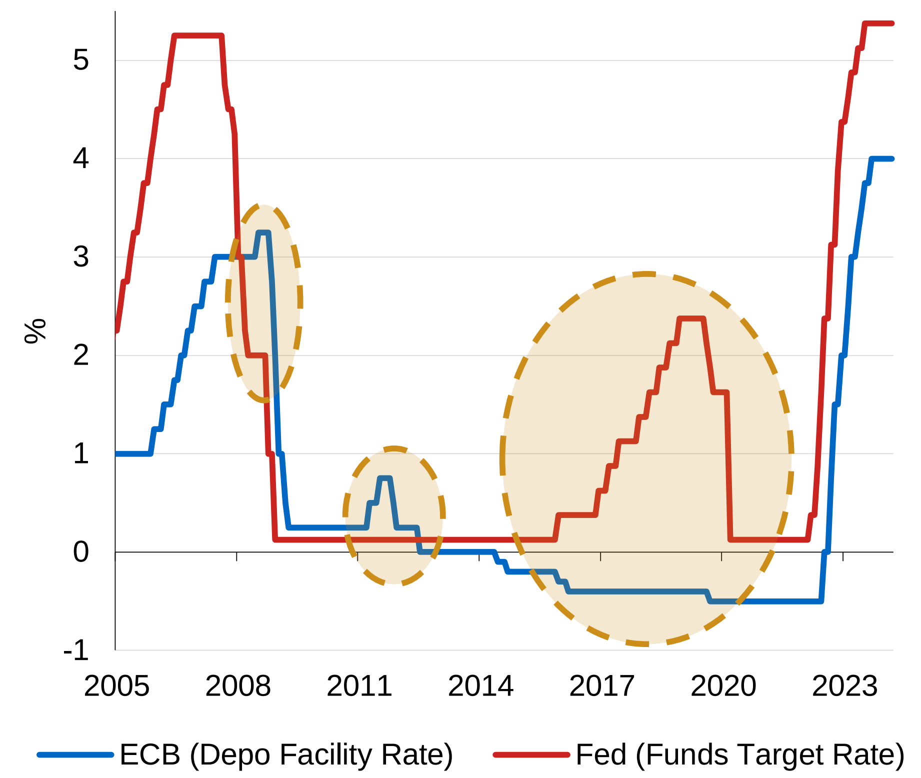
Source: Macrobond, Haver Analytics, Nomura

Can the ECB go it alone?

Decoupling macro cycles can lead to ...



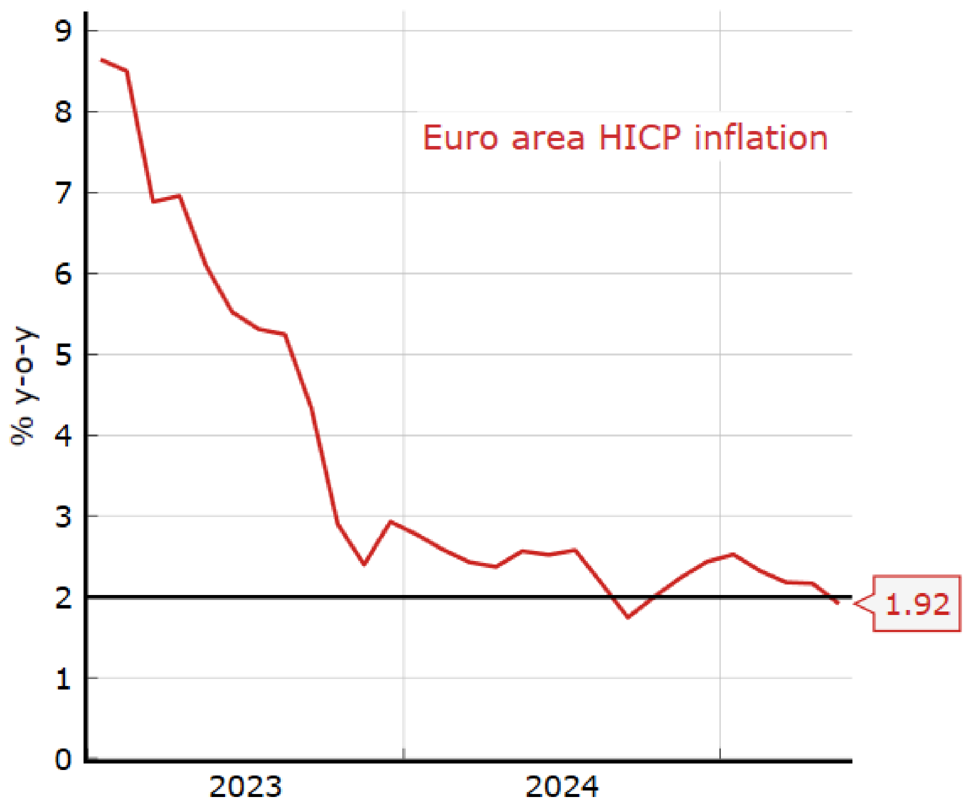
... asynchronous central bank moves



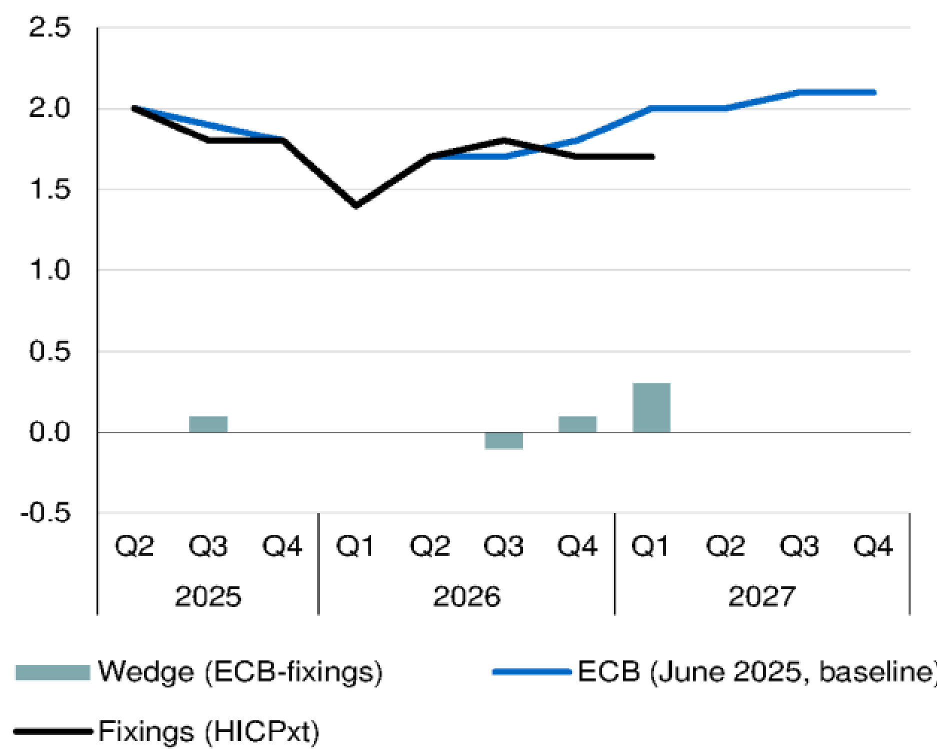
Source: Macrobond, Haver Analytics, Nomura

Inflation is now less of a concern

Inflation fell below the ECB's target in September and April



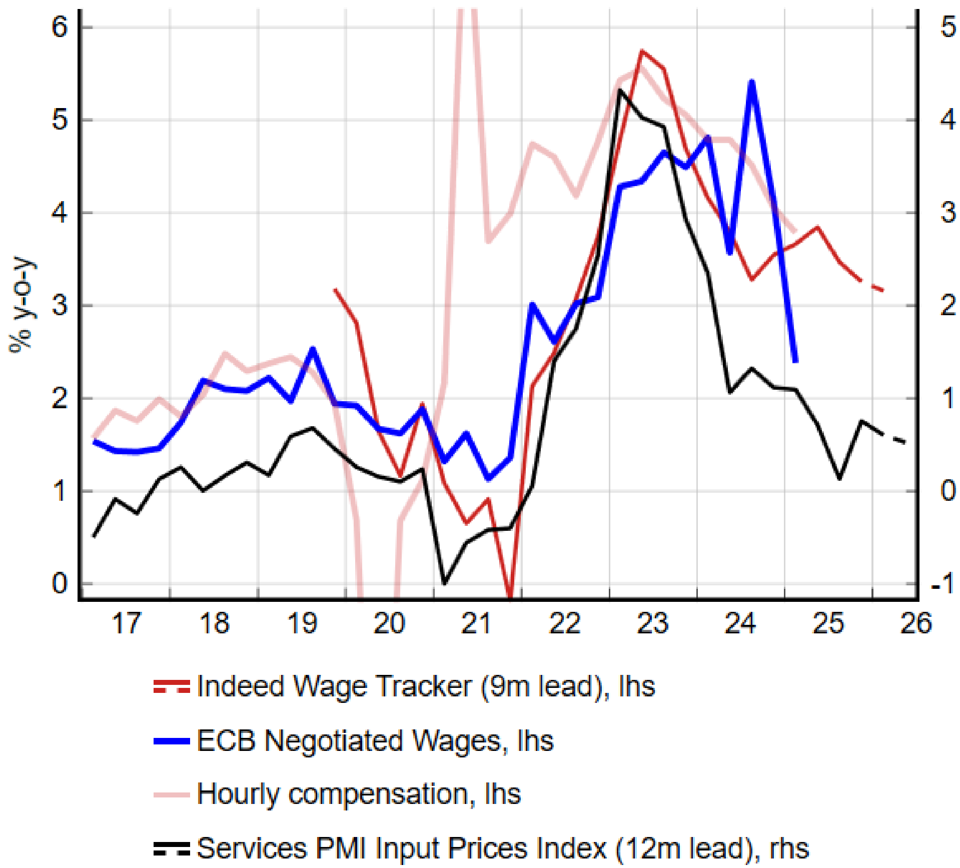
Markets believe inflation will undershoot following tariffs



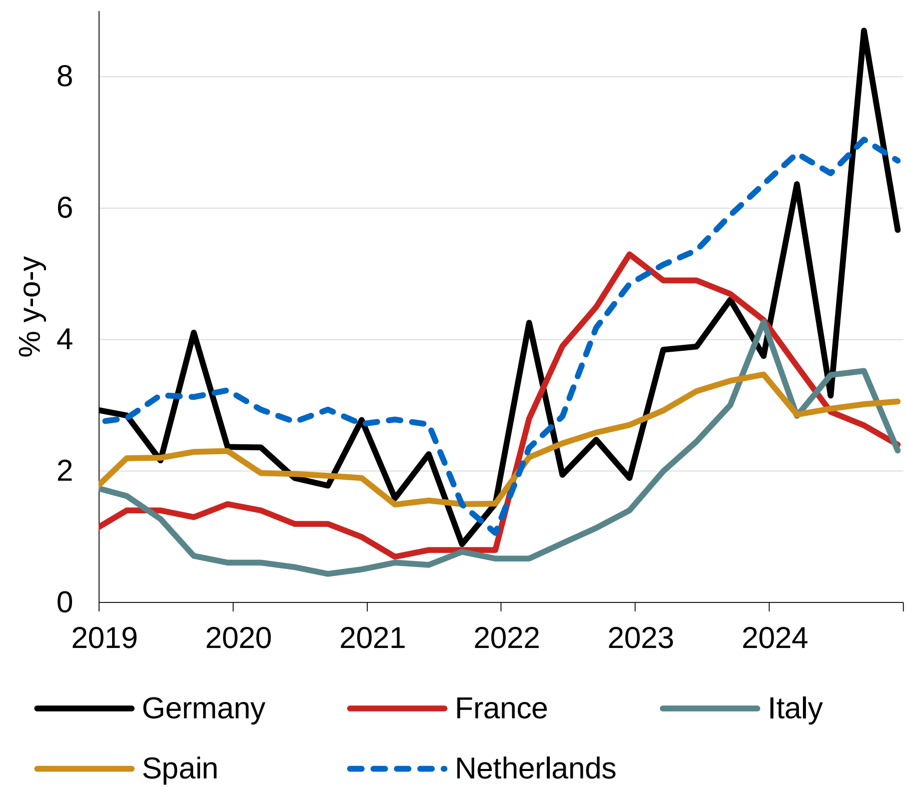
Source: Macrobond, Haver Analytics, Nomura

Slowing wage growth means weaker domestic inflation

Wage growth measures are broadly subsiding



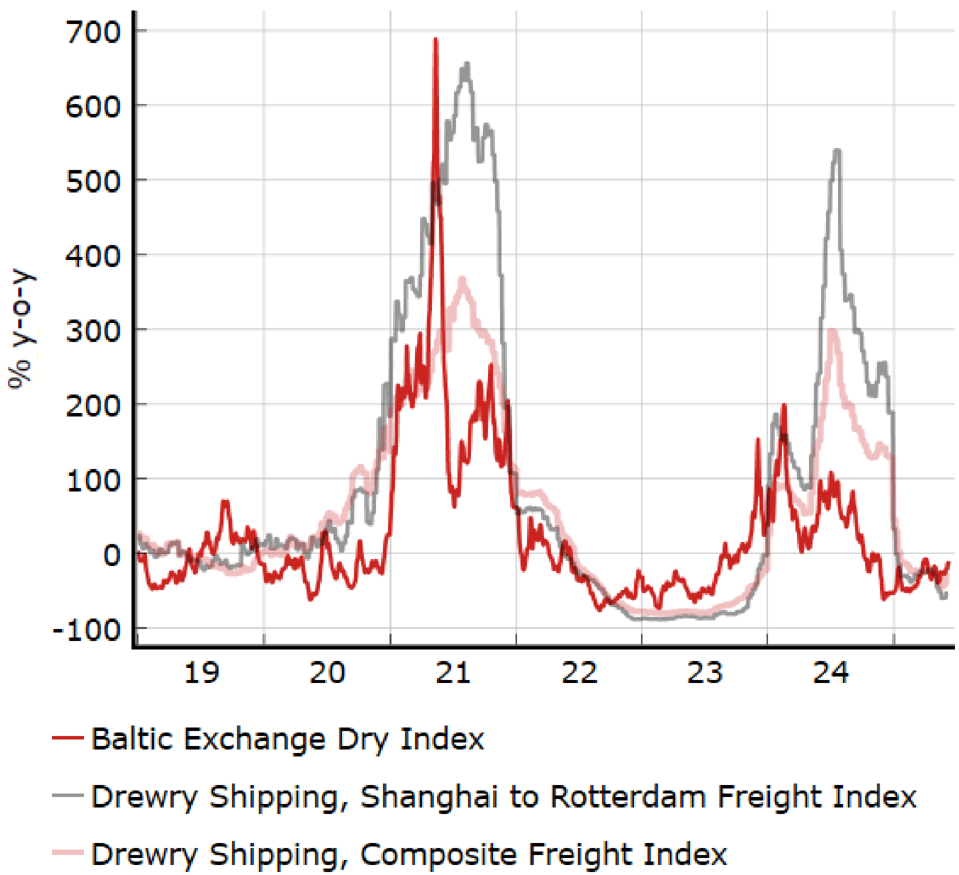
Germany is behind recent euro area wage strength



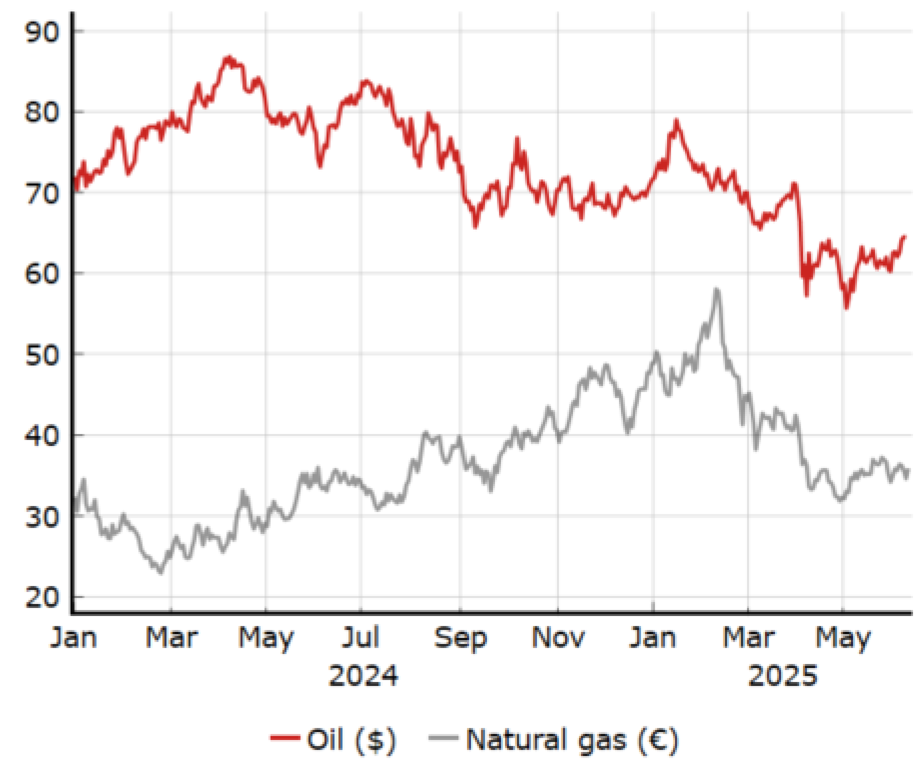
Source: Macrobond, Haver Analytics, Nomura

Lower input costs are adding to disinflationary pressures

Freight rates rose sharply, but have since collapsed



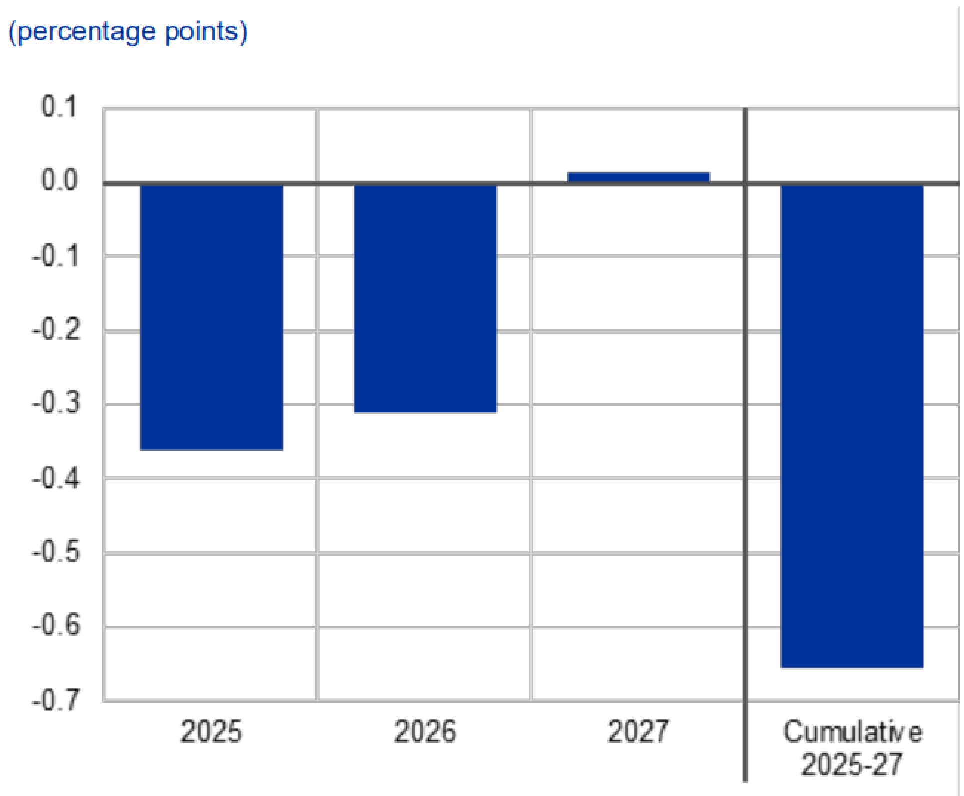
Commodity prices have steadily declined since Jan 2025



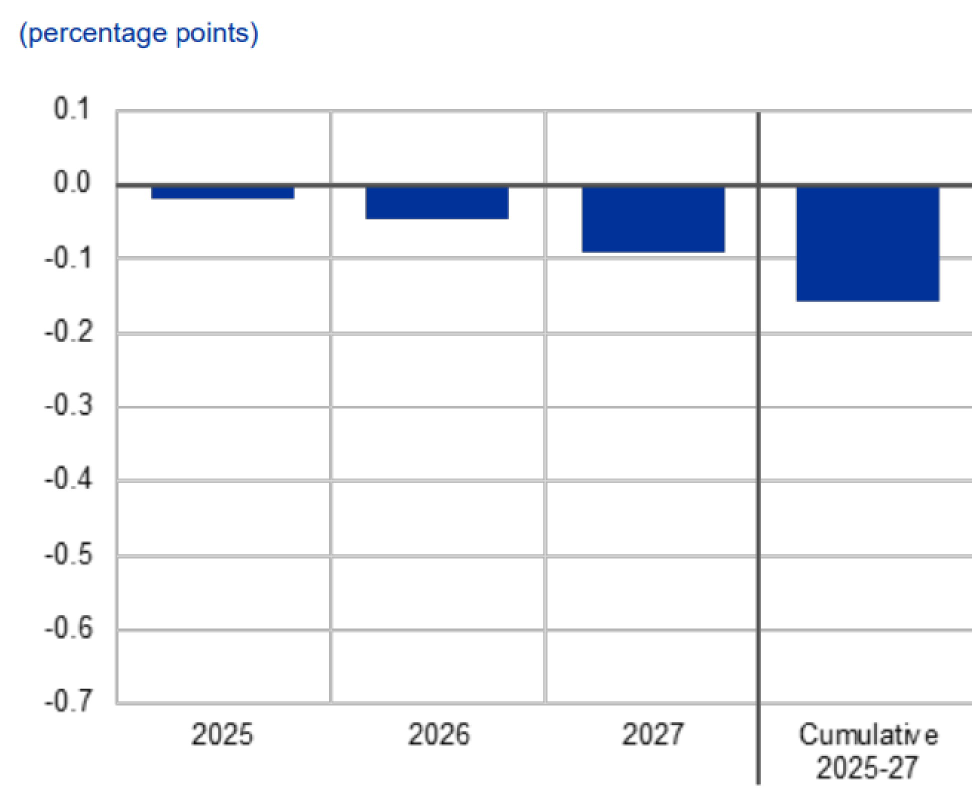
Source: Macrobond, Haver Analytics, Nomura

ECB's view: a hit to growth, limited impact on inflation

A material hit to euro area GDP growth



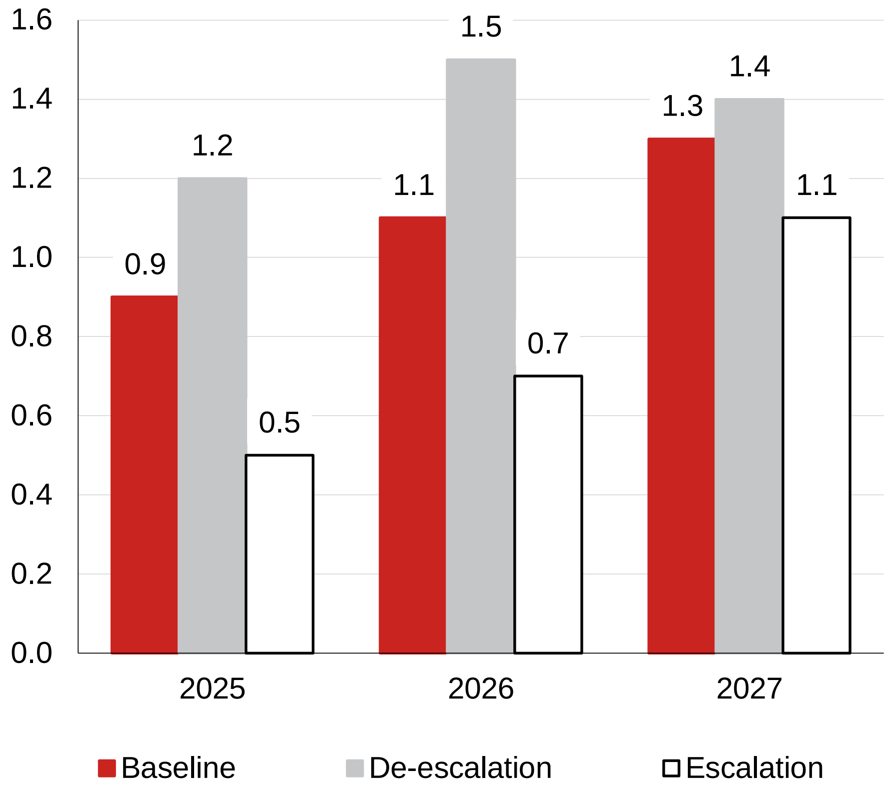
But a less pronounced effect on HICP inflation



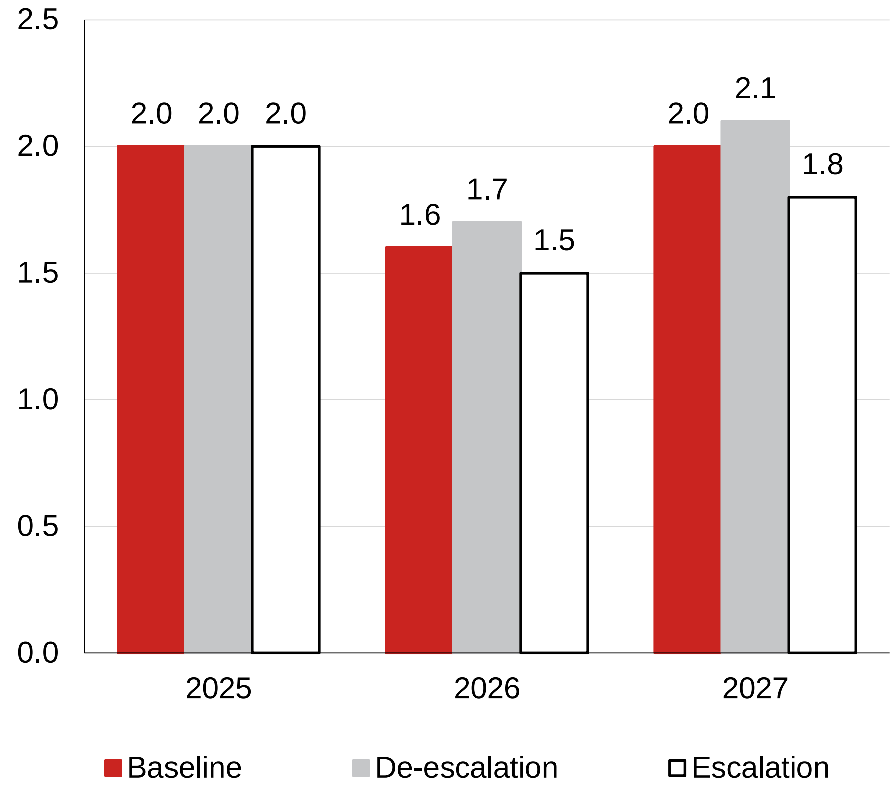
Source: Macrobond, Haver Analytics, Nomura

ECB's view: do tariffs have any impact on inflation?

ECB scenarios - GDP growth



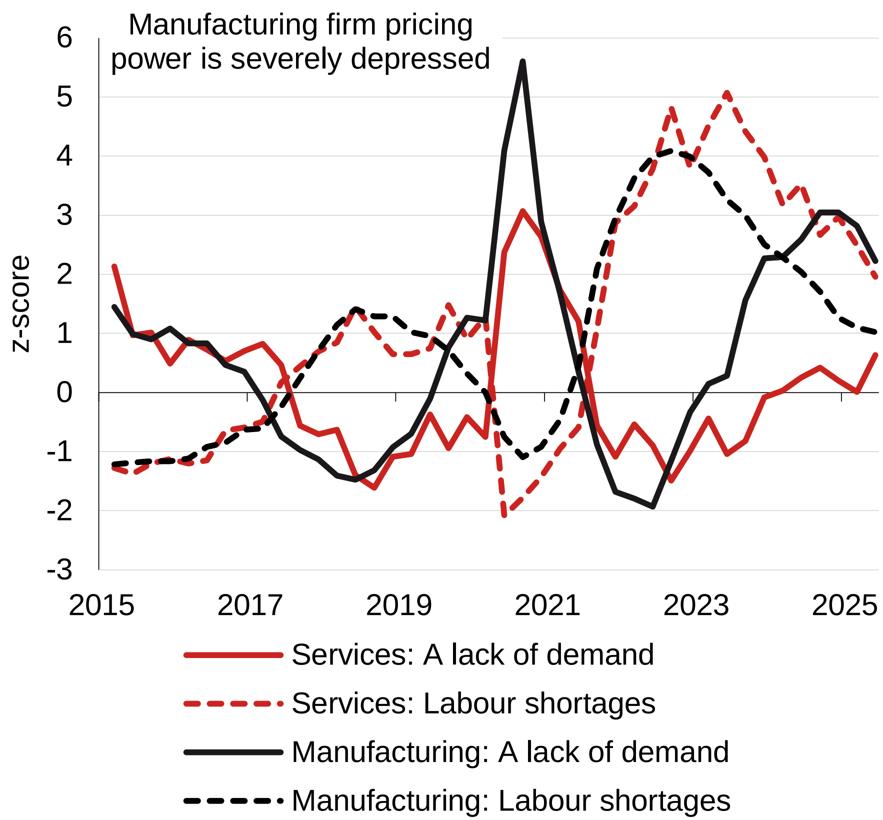
ECB scenarios - HICP inflation



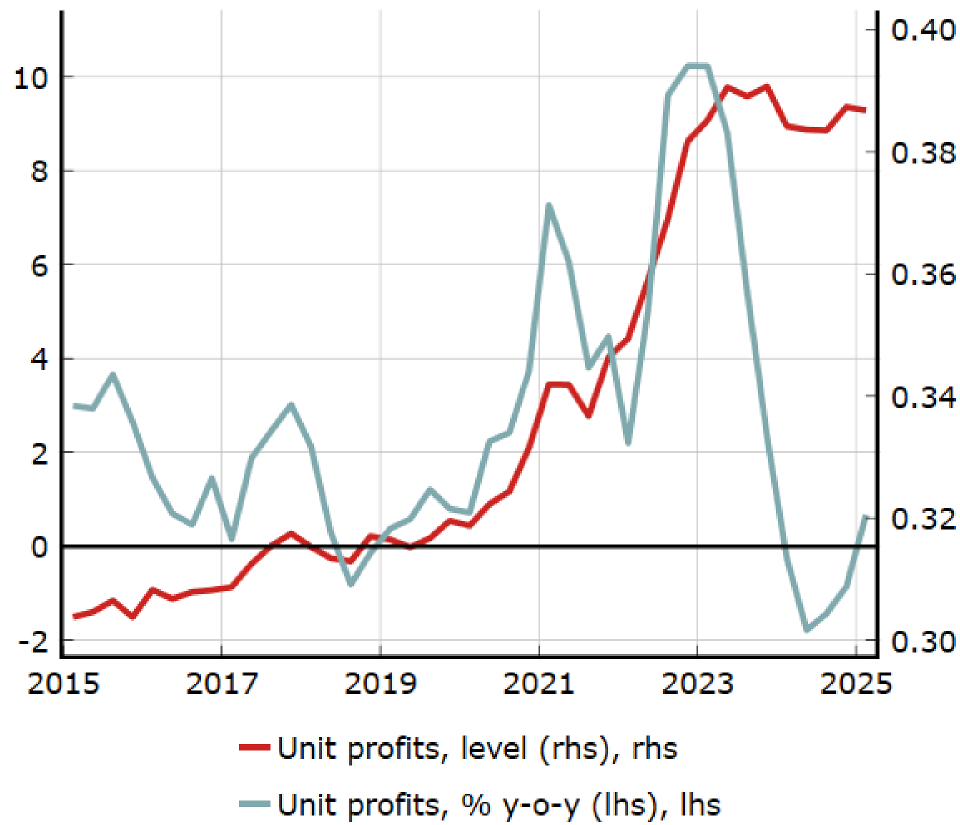
Source: Macrobond, Haver Analytics, Nomura

No passing on retaliatory tariffs – if there even are any

Manufacturing firms' pricing power is severely depressed



Unit profits remain elevated relative to pre-pandemic

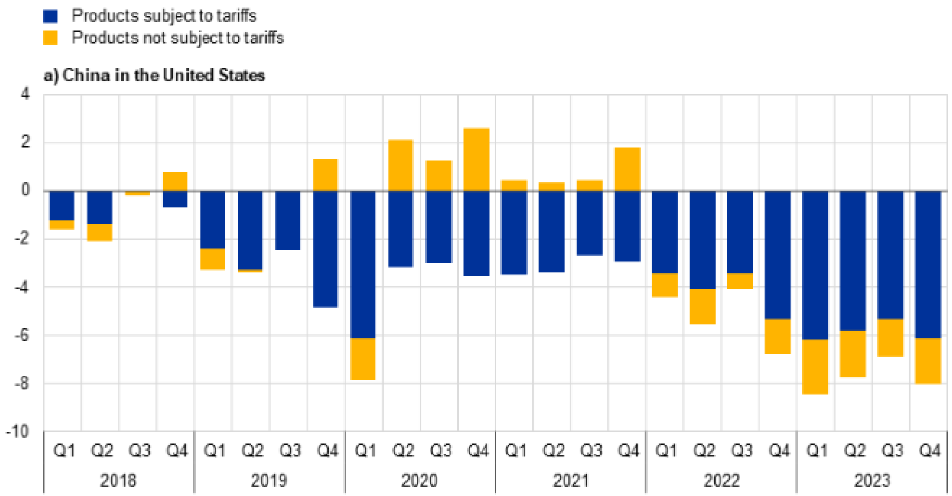


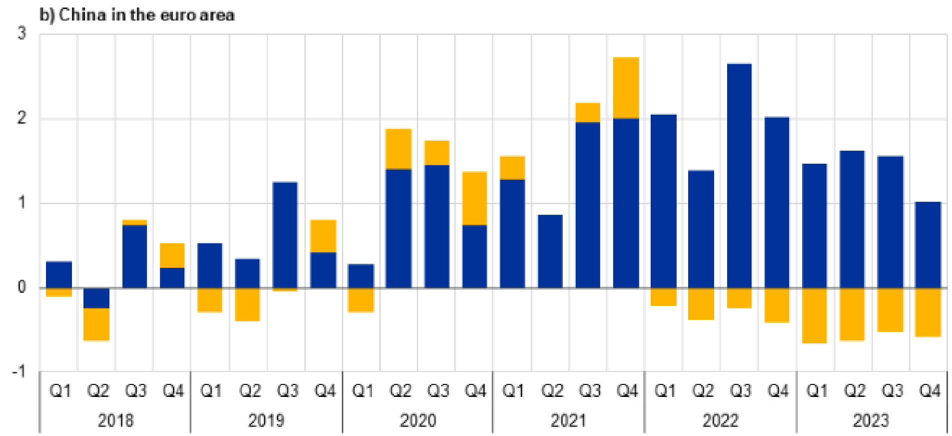
Source: Eurostat, Macrobond, Haver Analytics, Nomura

The ECB assumed no goods dumping in its forecasts

Changes in import market shares

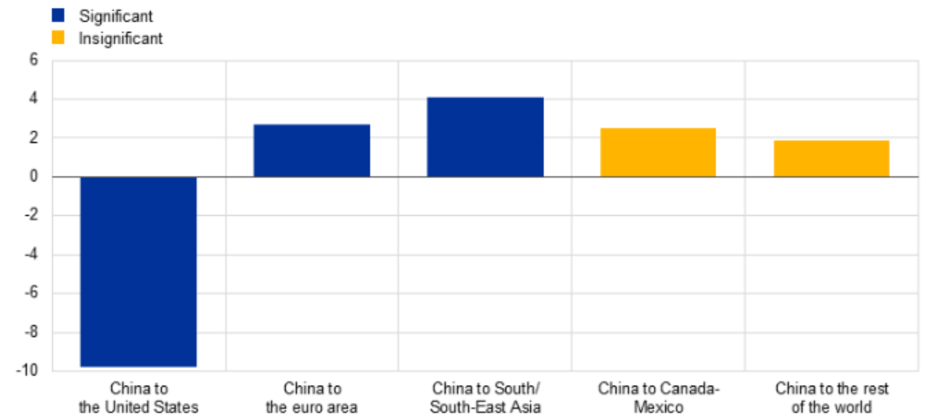
(percentage point change since 2017)





Empirical evidence of the effect of US import restrictions on Chinese exports

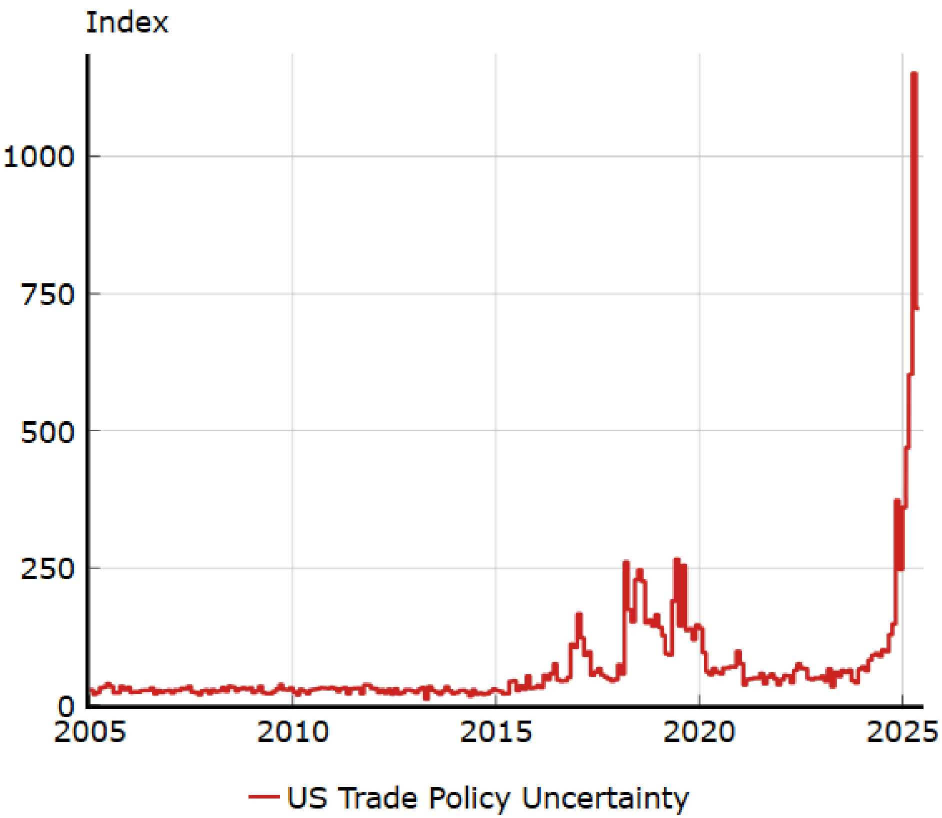
(effects, percentages)



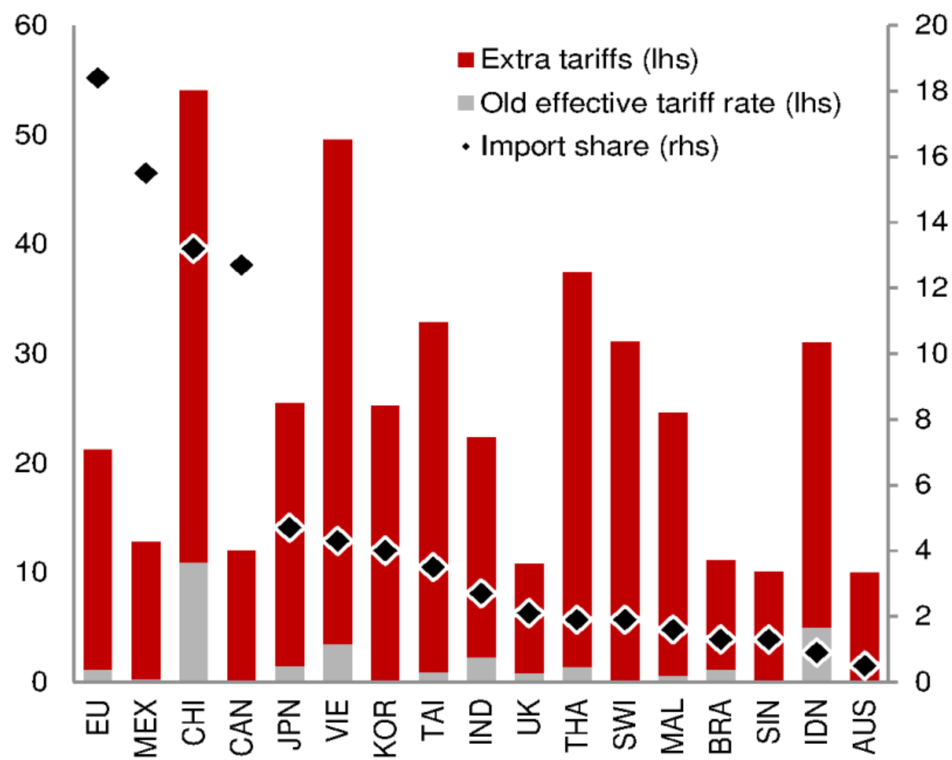
Source: ECB, The implications of US-China trade tensions for the euro area – lessons from the tariffs imposed by the first Trump Administration

But what is the end-point?

US trade policy uncertainty has skyrocketed



"Reciprocal tariffs" were worse than markets had feared



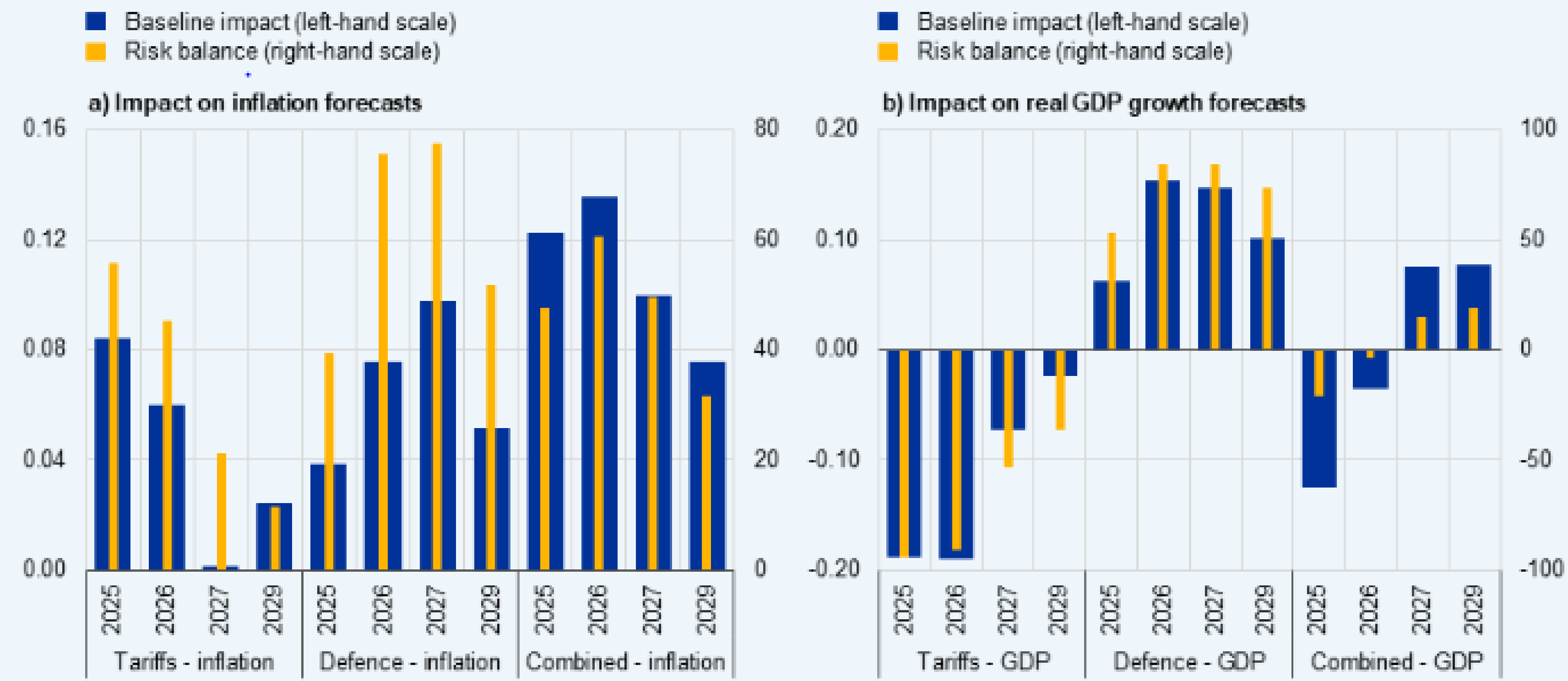
Source: ECB, Navigating a fragmenting global trading system: insights for central banks

Course correction?

... Make Europe Great Again!

Fiscal policy – course correction

(left-hand scale: percentage points; right-hand scale: percentages)

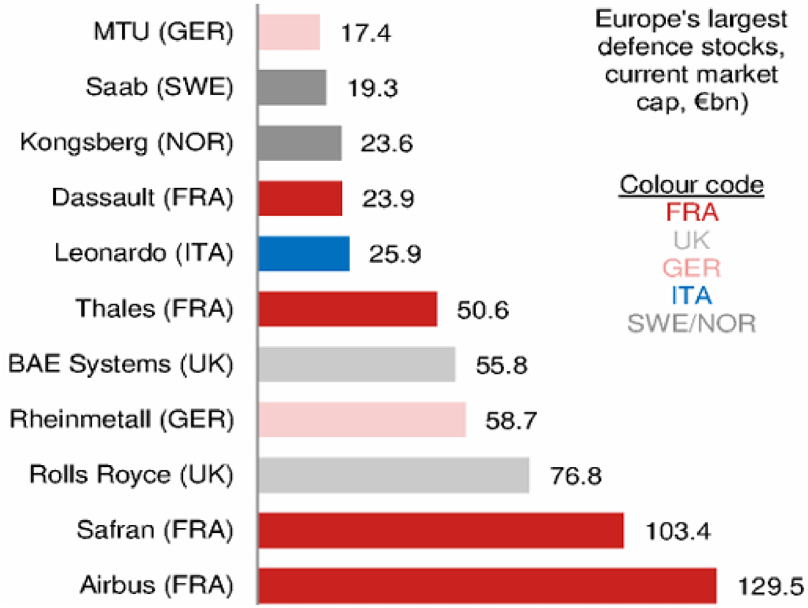


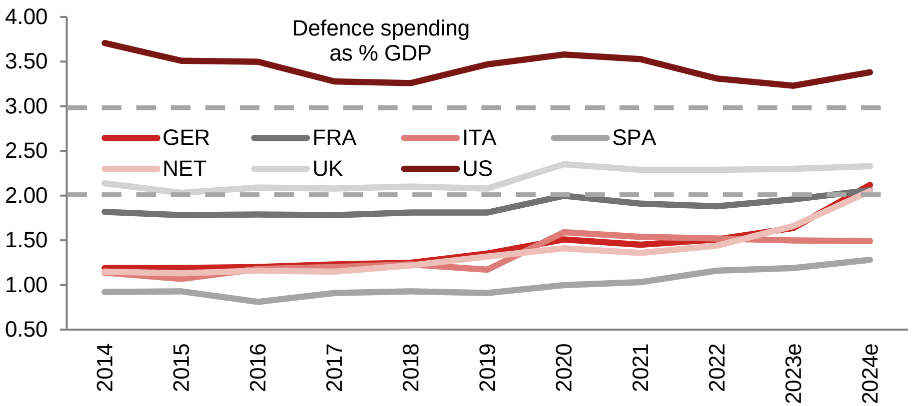
Notes: Risk balance is calculated as the net percentage of respondents indicating upward and downward risks. For the combined impact, the baseline is the sum of the two factors (tariffs and defence spending), while the risk balance is the average of the two factors.

Source: ECB, Nomura

Fiscal policy – defence spending

"ReArm Europe": EU to allocate €150bn in defence loans, and a €650bn defence exemption of the SGP. Germany's debt brake to exempt defence above 1% of GDP – freeing 1% of GDP for any fiscal spend plus unlimited defence spendi





Multipliers

- Various studies suggest fiscal multipliers typically range from 0.5 to 0.8 (average 0.65)
- An IMF study from 2014 suggested the range for defence multipliers specifically was similar

Defence procurement

- February 2022-June 2023: **78%** of EU procurement came from outside of the EU (**63%** of which from the US)
- **65%** of the €150bn loan scheme must come from suppliers inside the EU, Norway, Ukraine (possibly UK too after May 19 EU-UK summit)
- EU is aiming for **50%** of defence investments coming from within the EU by 2030, **60%** by 2035 (EDIS)

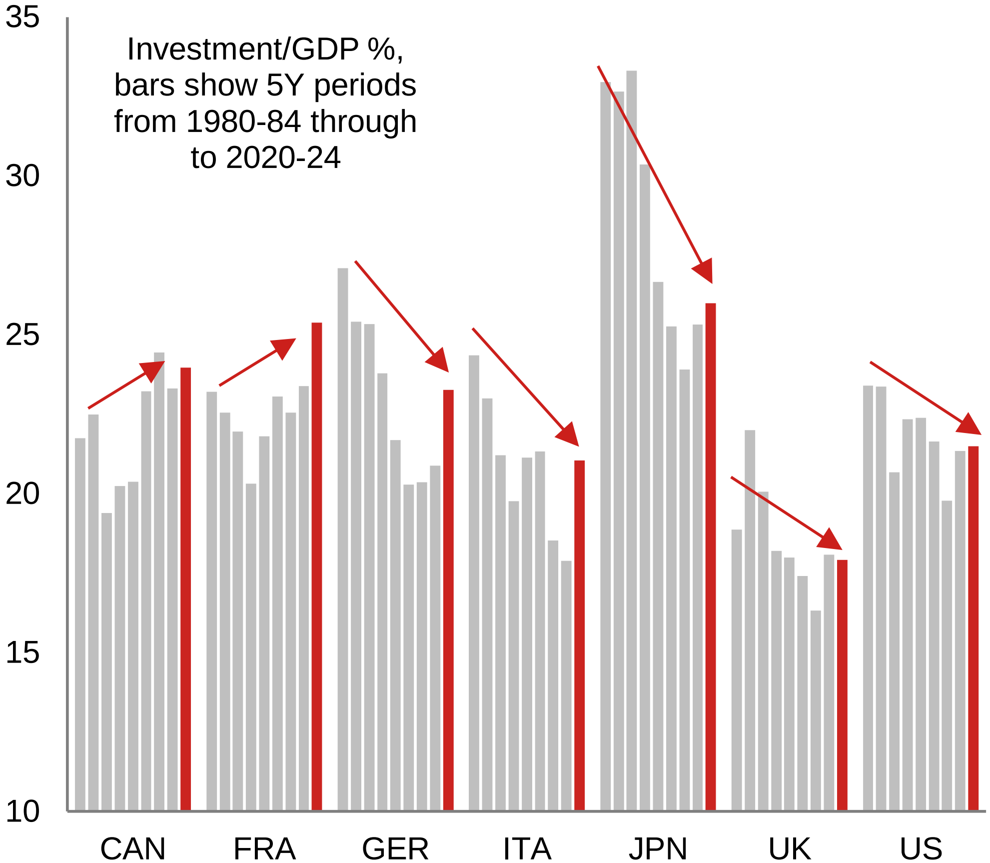
Broader innovations prompted by military spending

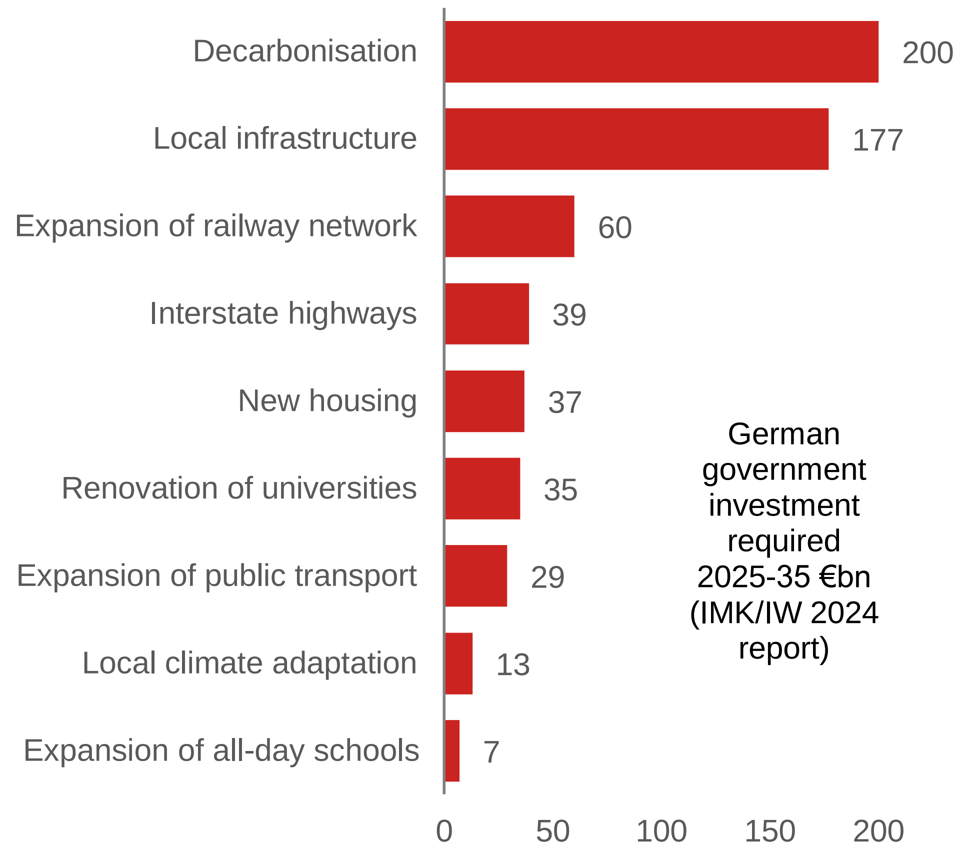
- The internet, GPS and microwave ovens have all been born out of conflict
- Despite certain scientific areas benefitting, the advancement of knowledge more generally may suffer from conflict

Source: Mercatus Centre, NATO, European Commission, European Defence Industrial Strategy, Nomura

Fiscal policy – German infrastructure

Germany's €500bn infrastructure plan (€42bn or 1% GDP pa) is outside of the debt brake and will allocate €100bn to local governments and €400bn to the federal government over 12 years. €100bn will earmarked for climate change.

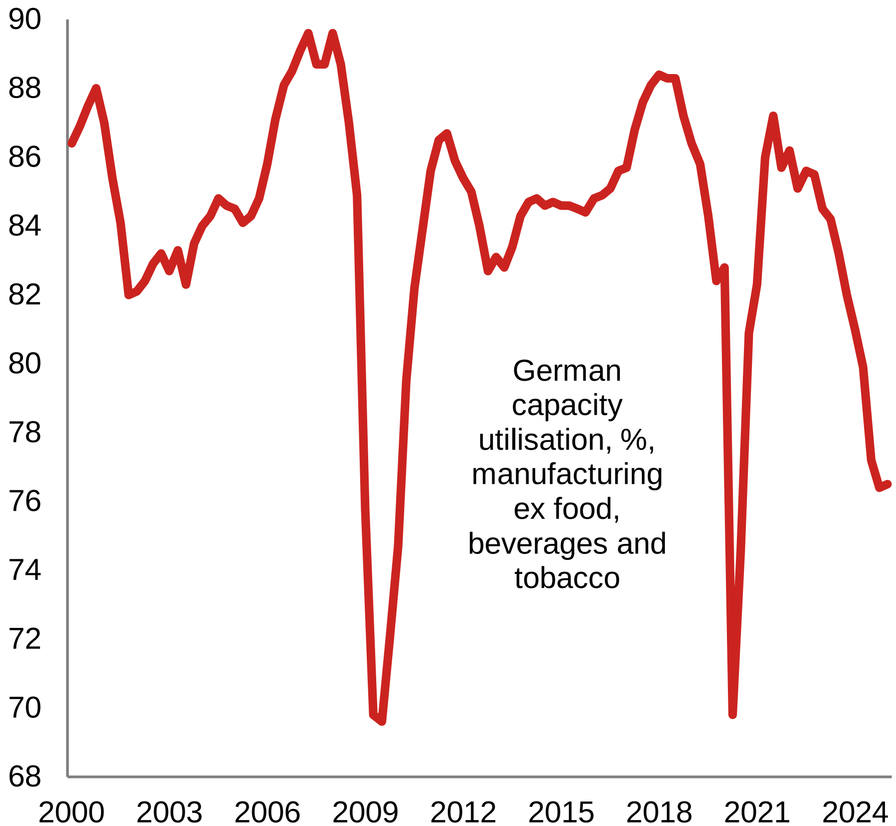




Source: Haver Analytics, FT, IMK/IW, Nomura

Upside risks from Germany's fiscal bazooka

Factories have plenty of spare capacity

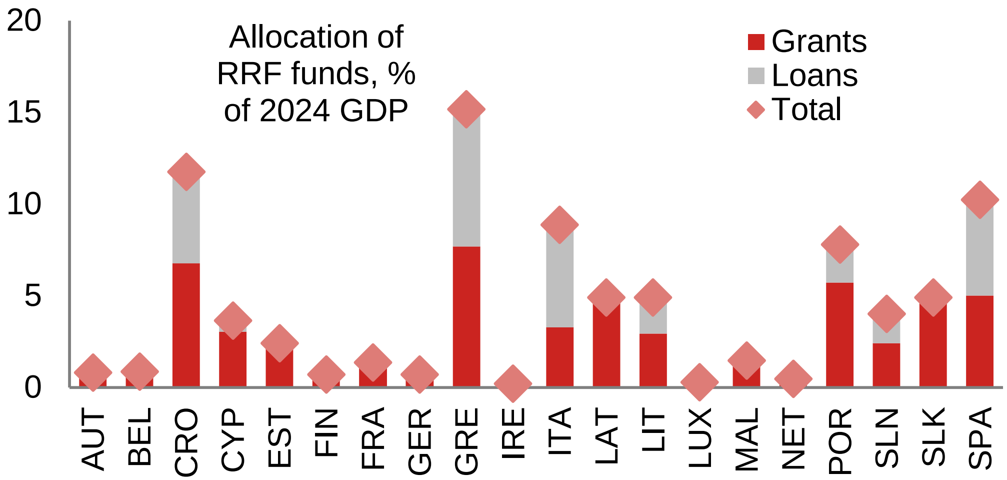


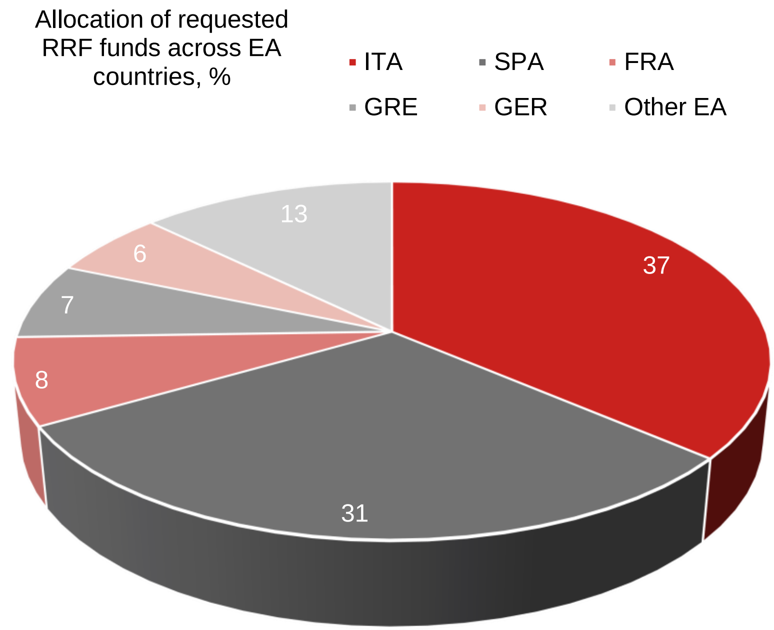
The number of short-time workers has risen markedly

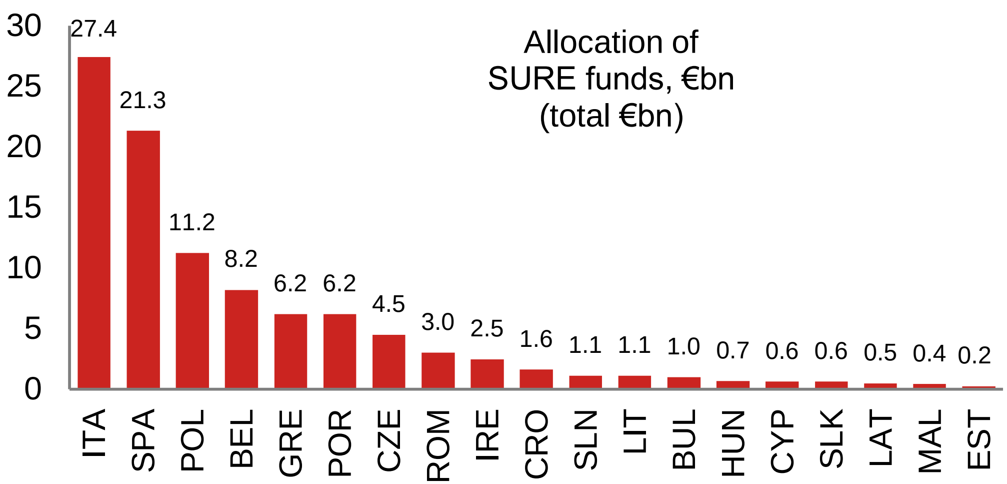
Source: Macrobond, Haver Analytics, Nomura

Joint funding could underpin Europe's growth

Italy and Spain are the biggest recipients of RRF funds. The ECB thinks the RRF could add around 1% to the level of GDP by 2031.







Estimated total impact of the RRF on euro area GDP

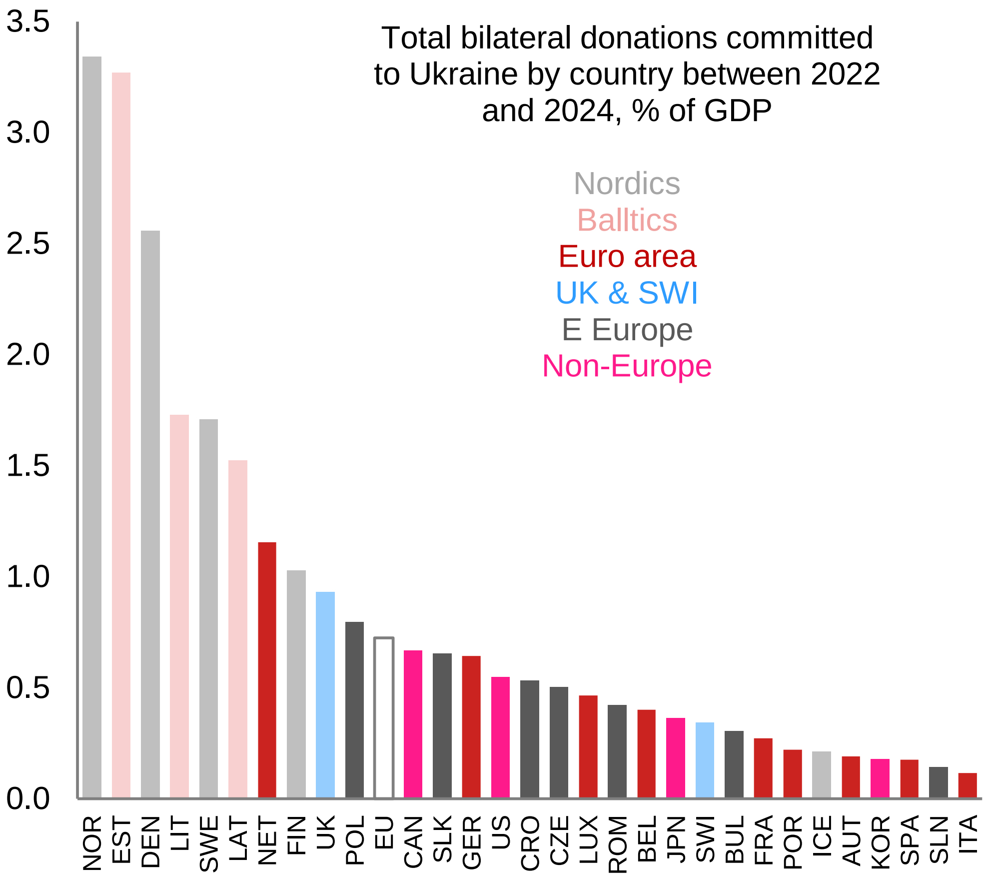
	Impact on GDP (percentage deviation from the non-NGEU baseline)	
	Up to 2026	Up to 2031
Fiscal measures	0.3 to 0.8	0.2 to 0.6
Structural reforms	0.1	0.6
Combined results	**0.4 to 0.9**	**0.8 to 1.2**

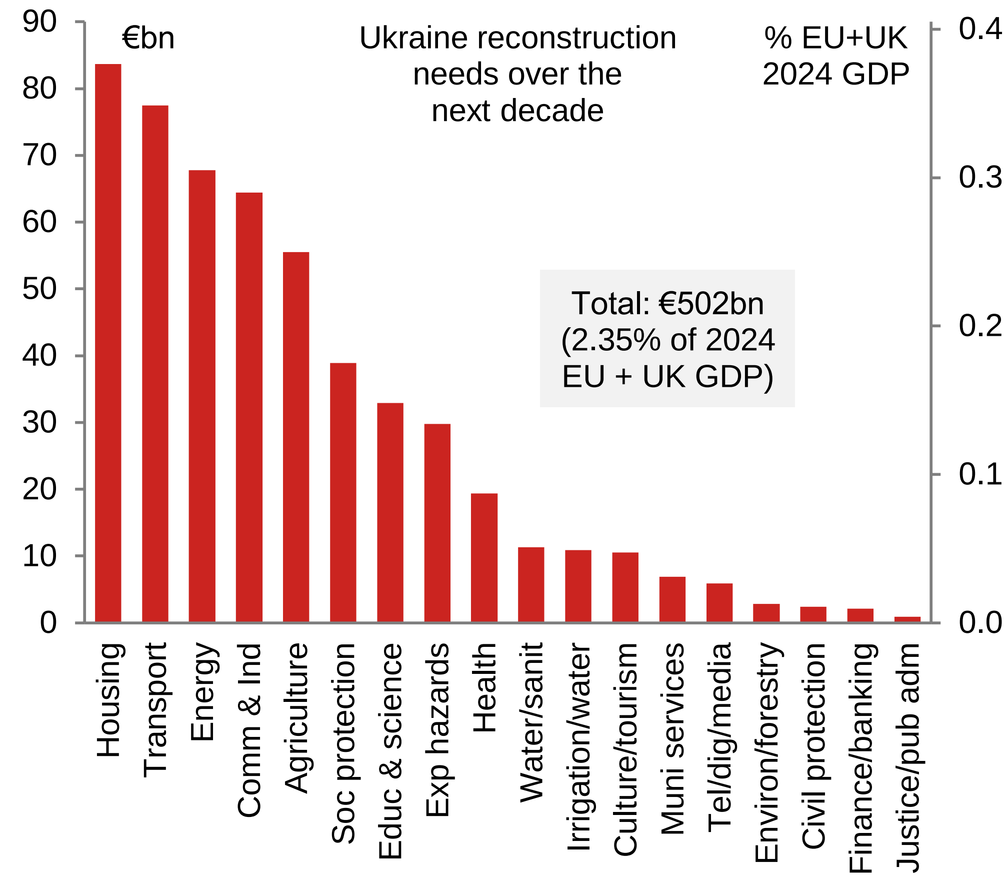
Source: ECB staff and Eurosystem (December 2024)

Source: ECB, European Commission, Nomura

End of the Russia/Ukraine war – reconstruction

The World Bank expects Ukraine reconstruction costs to be over €500bn over the coming decade. Financing is likely to come largely from European countries, but firms in these countries could also reap the rewards of increased demand.

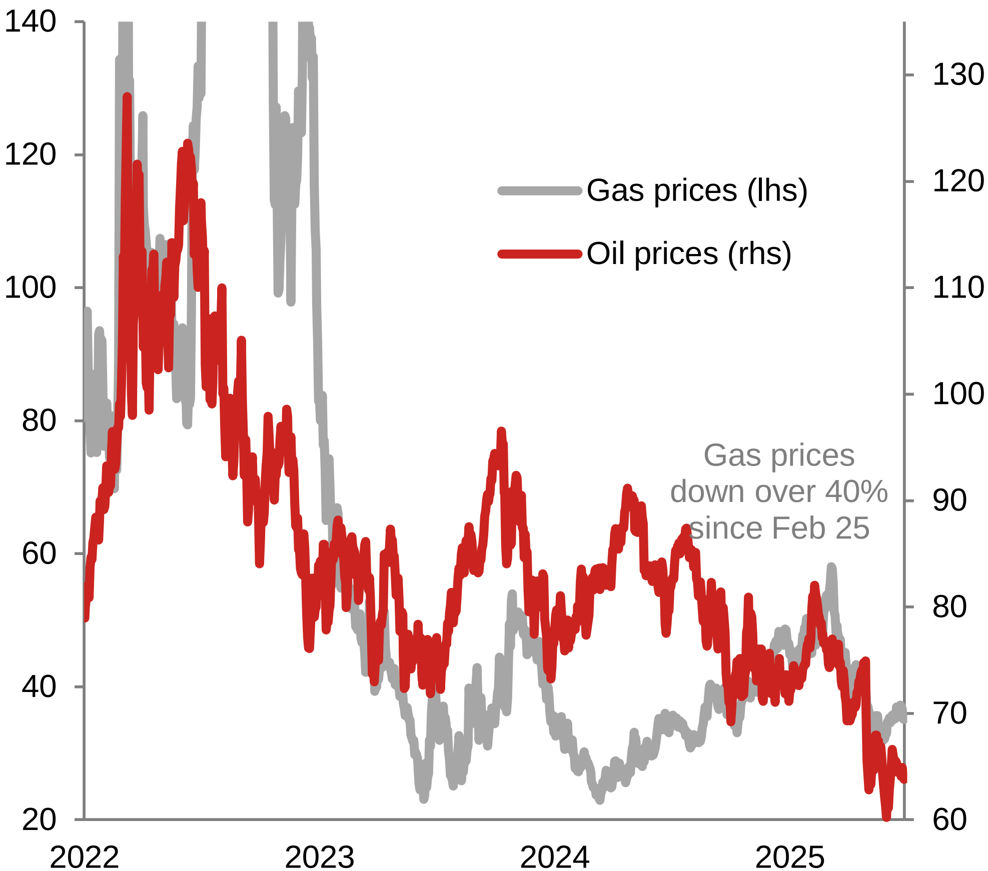




Source: World Bank, Ifw-Kiel Institute, Haver Analytics, Nomura

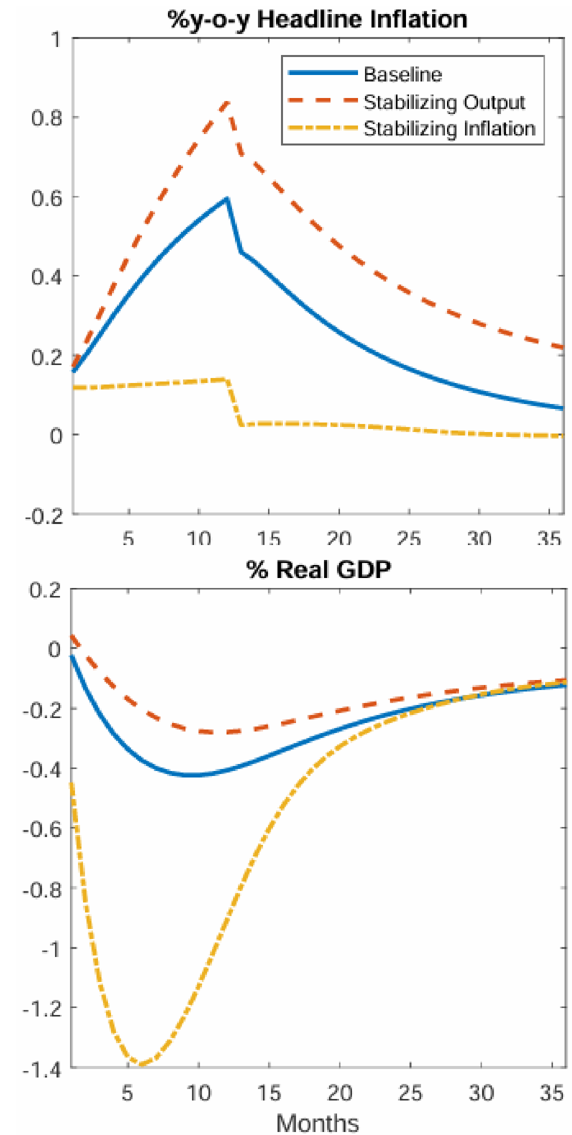
End of the Russia/Ukraine war – lower energy prices

A fall in gas prices (down ~45% since early February, partly thanks to expectations of an end to the war) should lower inflation and interest rates and (other things being equal) raise GDP growth.



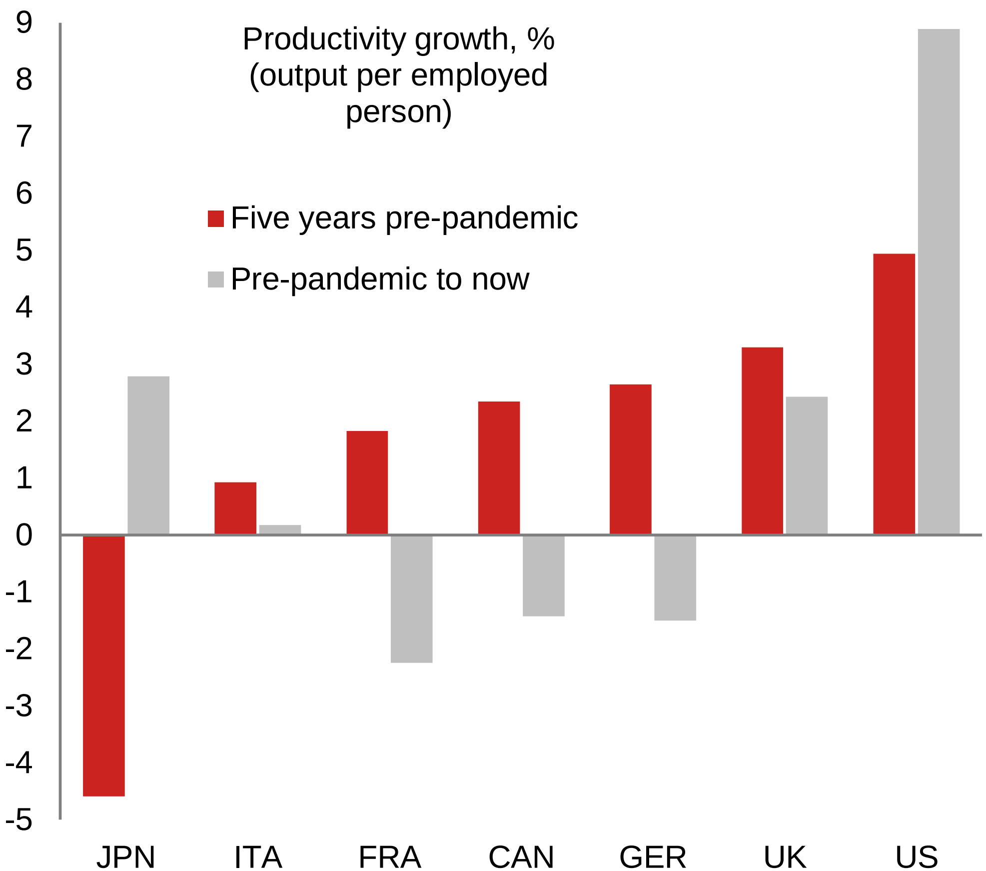
Source: ECB, Bloomberg, Nomura

ECB working paper (*The pass-through to inflation of gas price shocks*, 2024) shows the following responses of GDP and inflation to a 10% rise in real gas prices:



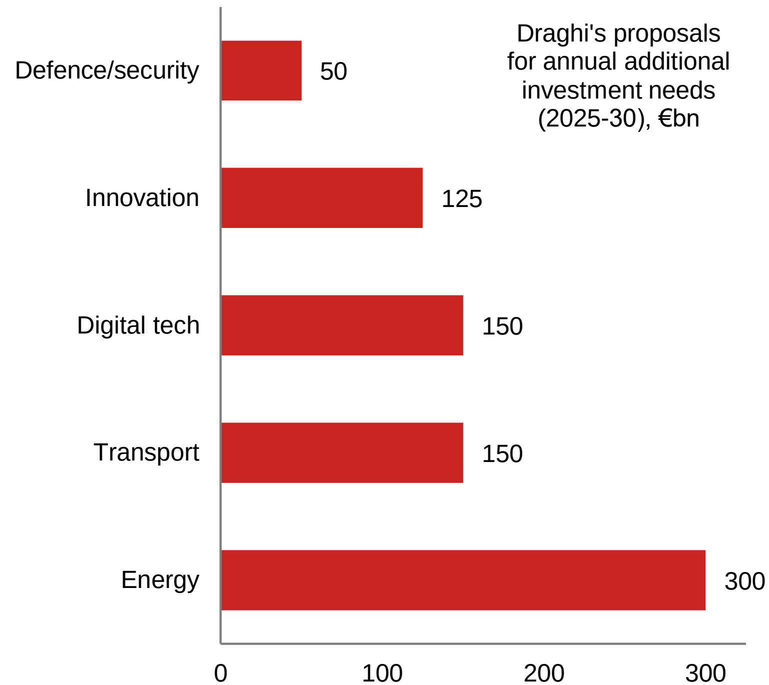
Draghi Report recommendations

In September 2024, Mario Draghi published his recommendations to improve European competitiveness. He suggested common issuance and procurement, market consolidation and up to €800bn of extra annual investment spending.



Source: European Commission, Haver Analytics, Nomura

- €750-800bn of additional annual investment required, or 4.4-4.7% of EU GDP
- Would like to see common issuance for European public goods (notably energy and defence) – a difficult sell in some northern European countries, though increasingly palatable with Trump in the White House
- At the least, coordination of national procurement, defence projects and market consolidation



Appendix A-1

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