FINANCE LATVIA ASSOCIATION

# Challenges Facing the European Economy: What Invesors Should Know

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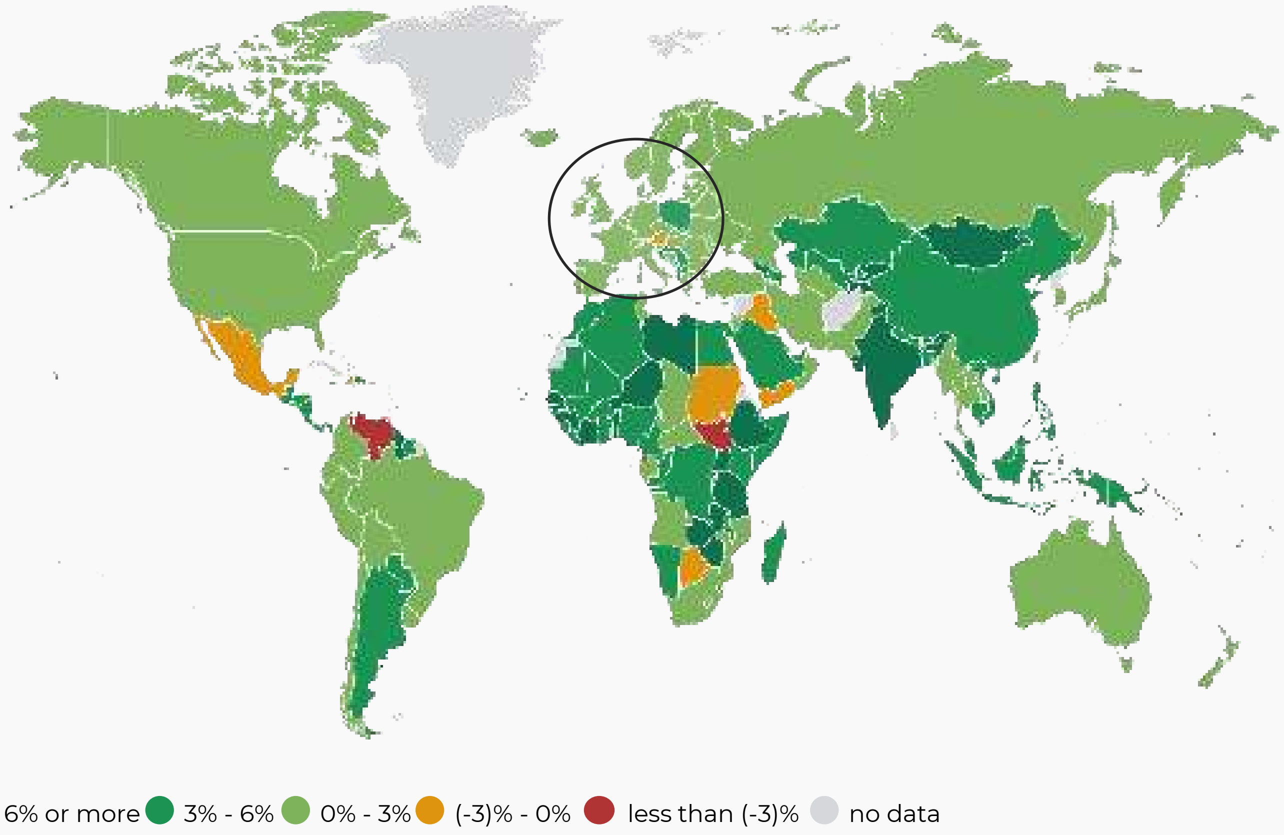
LatBAN Annual Meeting
May 2025

# The European Union is expected to have a slow economic growth in 2025, driven by significant policy shifts and economic uncertainty

***Real GDP growth in 2025***
*(annual percent change)*




Source: IMF World Economic Outlook, April 2025.

| | 2025 | 2026 | 2027 |
|---|---|---|---|
| **Advanced economies** | 1.4 | 1.5 | 1.7 |
| **ASEAN – 5** | 4.0 | 3.9 | 4.2 |
| **Emerging and Developing Asia** | 4.5 | 4.6 | 4.8 |
| **Emerging and Developing Europe** | 2.1 | 2.1 | 2.3 |
| **Emerging market and developing economies** | 3.7 | 3.9 | 4.2 |
| **Euro area** | 0.8 | 1.2 | 1.3 |
| **European Union** | 1.2 | 1.5 | 1.6 |
| **Latin America and the Caribbean** | 2.0 | 2.4 | 2.7 |
| **Major advanced economies (G7)** | 1.2 | 1.4 | 1.6 |
| **Middle East and Central Asia** | 3.0 | 3.5 | 4.0 |
| **Other advanced economies** | 1.8 | 2.0 | 2.2 |
| **Sub-Saharan Africa** | 3.8 | 4.2 | 4.3 |
| **World** | 2.8 | 3.0 | 3.2 |

# Intensifying downside risks dominate the outlook in both the short and the medium term

## *Downside risks*

**Trade tensions and fragmentation**

Intensified tariff regimes and regulatory barriers are disrupting global supply chains.

**Financial market volatility**

Heightened geopolitical tensions and monetary policy divergence are fueling capital flow instability and threatening macro financial resilience.

**Inflationary pressures**

Trade fragmentation, commodity supply constraints, and dollar strength risk renewed inflationary pressures, especially in import-dependent and low-income economies.

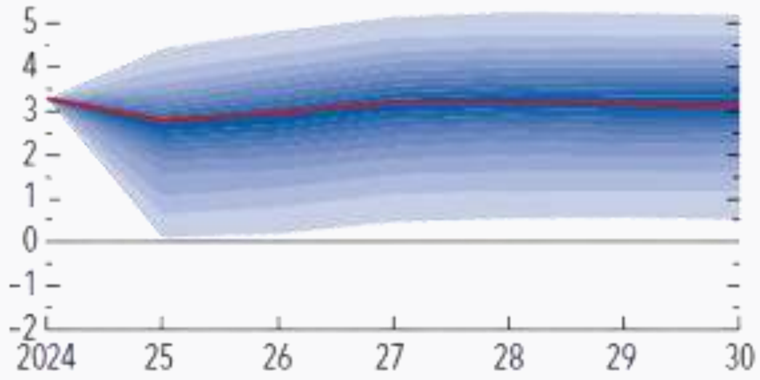
**Policy uncertainty and investment decline**

Persistent ambiguity in global trade and fiscal policy environments is curbing investor confidence and delaying capital expenditure decisions.

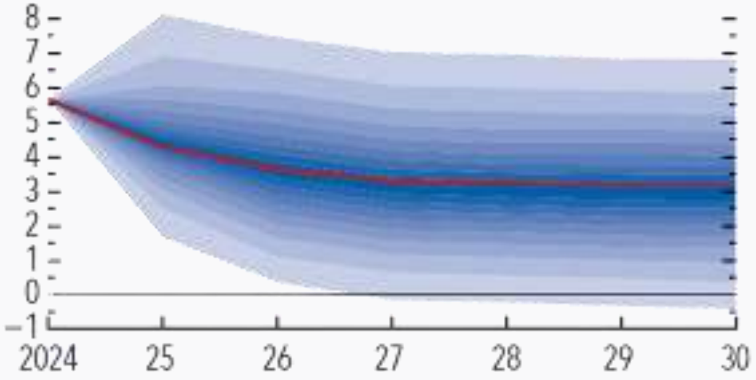
**Structural and social risks**

Rising sovereign debt burdens, constrained fiscal space, and declining potential growth are compounding risks of social unrest and institutional reform fatigue.

*The likelihood of **global GDP growth** falling below 2% in 2025 has risen to nearly 30%, up from 17 % in October.*




*Meanwhile, the probability of **global headline inflation** exceeding 5% stands at approximately 31%, a slight decline from the previous 34% estimate.*

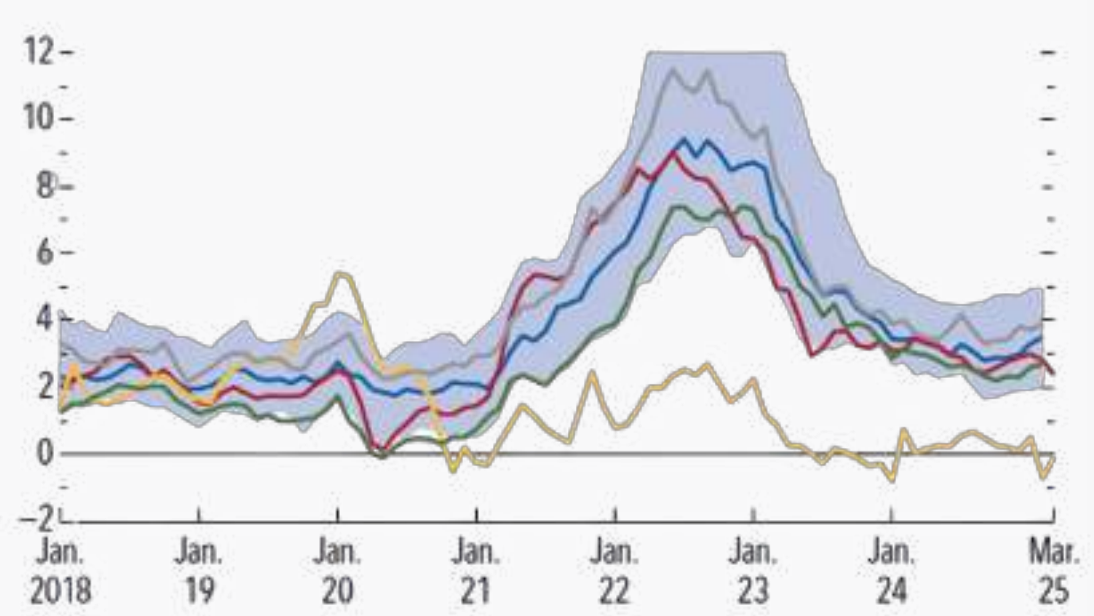



Source: IMF World Economic Outlook, April 2025.

# Inflation is almost under control, but lessons learned for central banks are yet to be formulated

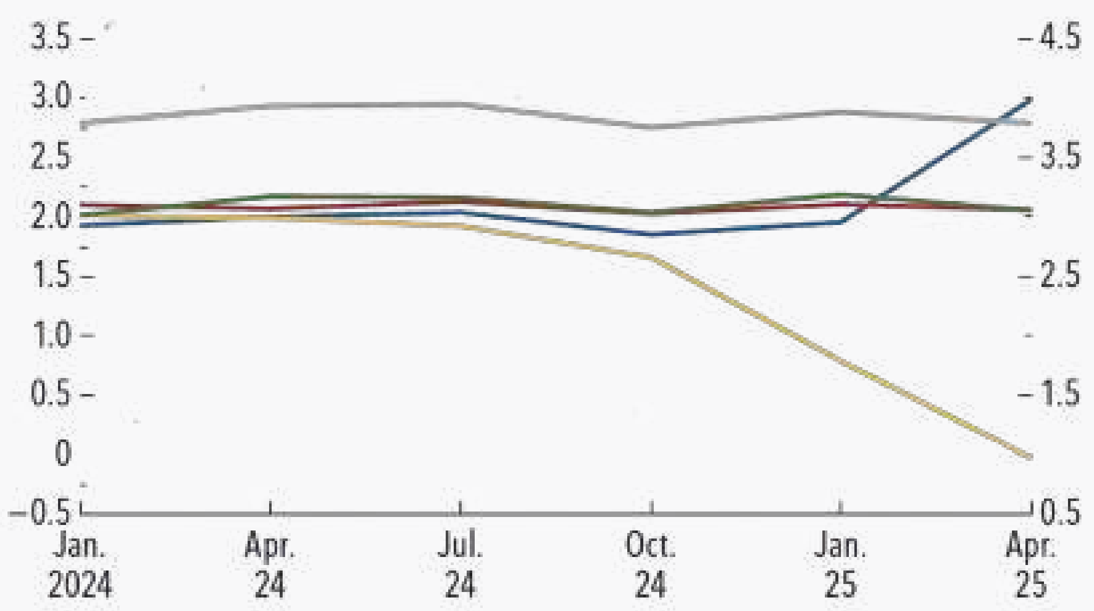
The global economy is stabilizing, and **inflation is gradually moving toward central bank targets**. Yet, it is still above pre-pandemic levels and exposed to new risks, especially to imposed tariffs by the US. The impact of recent tariffs will depend on their duration, firms' pricing responses, and currency invoicing.

***Headline inflation***
*(percent, year over year)*




World US China other AEs other EMDEs

***IMF inflation forecasts***
*(median, percent, year over year)*




US Euro area China AEs, excluding US and Euro area EMDEs, excluding China (right scale)

Source: IMF World Economic Outlook, April 2025.

# Worst-case scenario: trade shocks, tighter financial conditions, and rising global uncertainty stall growth

## *Key outcomes of the IMF's Worst Case Scenario*

### US fiscal policy

Slight near-term boost to US growth; inflation and interest rates rise ~30 bps; dollar appreciates modestly.

### Europe

Euro area GDP declines up to 0.5% by 2026; minimal inflation or rate change due to matching demand drop.

### Financial conditions

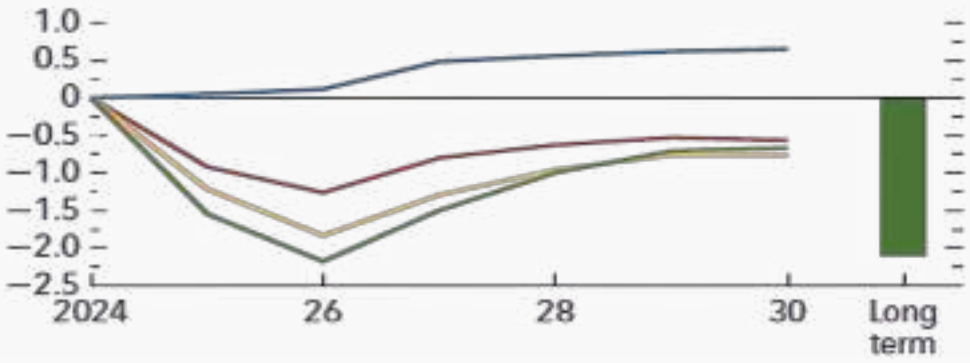
Global GDP falls 0.5% in 2025; credit conditions tighten broadly across regions.

### WORST CASE SCENARIO CAN GET EVEN WORSE

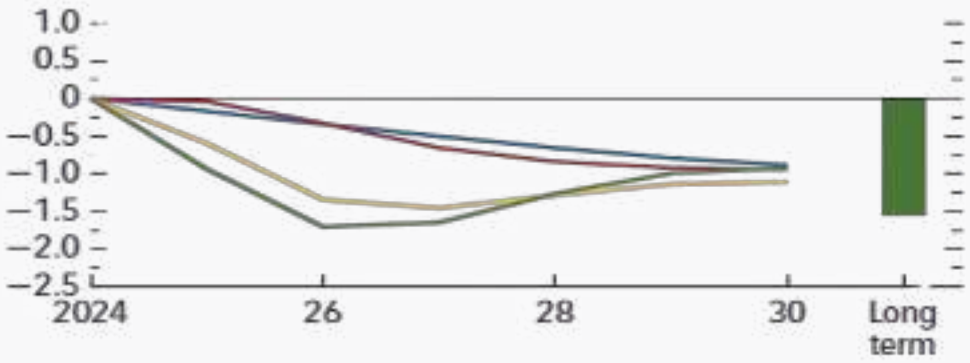
See the charts.

***Impact of IMF's Worst Case Scenario on GDP***
*(percent deviation from reference forecast)*

US:




Euro area:




global divergences · add trade war · add global uncertainty · add tighter financial conditions

Source: IMF World Economic Outlook, April 2025.

# Short - term tariff impact: immediate disruptions in trade and economic activity

## *Short - term key effects:*

### Growth Impact

Euro area GDP could decline modestly by 2027, though less sharply than in the U.S. and China. Estimated global GDP losses range between 0.4% – 1%, with Europe partially shielded due to trade diversion effects.

### Currency Volatility

The euro is expected to depreciate against the US dollar, especially under scenarios where tariffs are seen as permanent.

### Economic Activity

The Euro area could see short-term trade diversion benefits, though gains are likely to be limited and temporary.

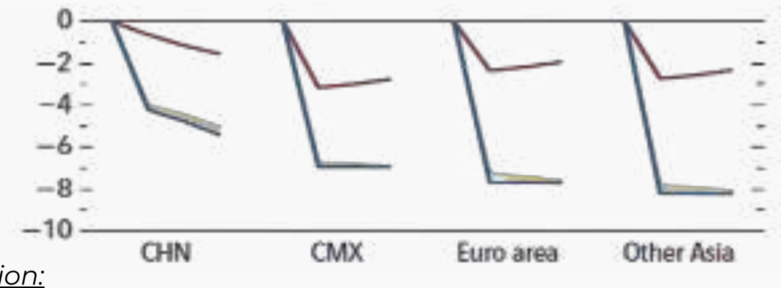
### Policy Sensitivity

Outcomes depend on how trade policy evolves, and on Europe's capacity to adjust through monetary flexibility and internal demand.

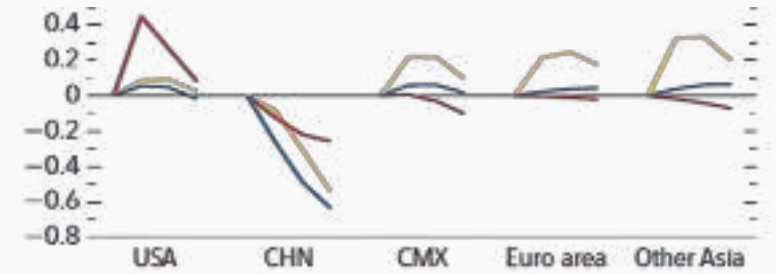
Source: IMF World Economic Outlook, April 2025.

**_Short - run effects of tariffs_**
*(percent deviation from a forecast with no tariffs)*

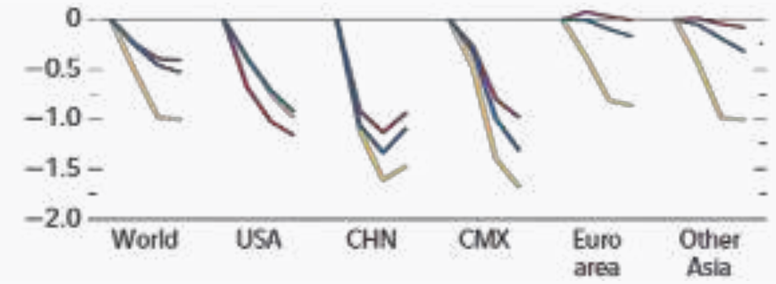
*Value of currency vs US Dollar:*




*Headline consumer price inflation:*




*Real Gross Domestic Product:*




all tariffs
temporary tariffs, higher pass-through
dollar invoicing for Global Value Chains

# Long - term tariff impact: structural losses in productivity and global trade

## *Long - term key effects:*

### Global Output

Permanent GDP losses across all regions, including the Euro area (up to 0.6%), due to lasting trade distortions.

### Export Losses

Exports in the Euro Area could fall by 1.1%, reflecting decreased demand from major trade partners and global trade reallocation.

### US and China-Led Disruptions

Tariff-driven slowdown in the US, China, and NAFTA indirectly impacts Europe via weaker demand and supply chain spillovers.

### Structural Headwinds

Europe’s potential output is weighed down by slower capital investment and productivity spillovers from global trade misallocation.

***Long-Run Effects of Tariffs***
*(percent deviation from a forecast with no tariffs)*

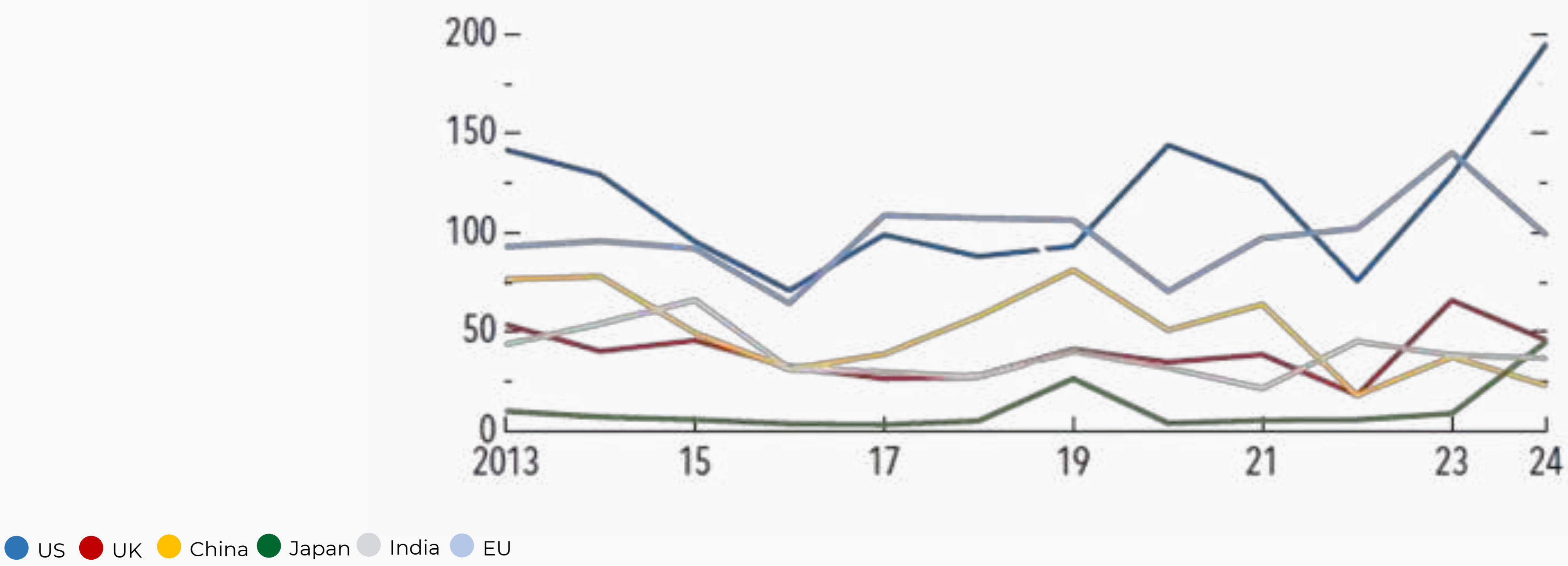
| | Real exports | | | Real GDP | | |
|---|---|---|---|---|---|---|
| | | Trade Models | | | Trade Models | |
| | GIMF | CP | CFRT | GIMF | CP | CFRT |
| **US** | -19.3 | -21.8 | -27.6 | -1.3 | -0.3 | -0.9 |
| **China** | -5.4 | -4.9 | -6.7 | -1.1 | -0.5 | -0.7 |
| **Canada and Mexico** | -5.7 | -1.8 | -6.0 | -1.9 | -0.5 | -0.7 |
| **Euro area** | -1.1 | 0.0 | -0.5 | -0.6 | 0.0 | -0.2 |
| **Other Asia** | -1.6 | -0.1 | -0.3 | -1.0 | 0.0 | 0.3 |
| **World** | -5.1 | -3.1 | -4.2 | -0.9 | -0.2 | -0.4 |

Source: IMF World Economic Outlook, April 2025.

# Europe’s Growth Outlook: FDI flows increase in the US; the EU comes in second

**In 2024, FDI flows have increasingly concentrated in the United States**, driven by its economic strength and perceived policy stability. Meanwhile, **Europe** has seen a decline in FDI in 2024, **remaining the second-largest destination**. This downturn can be attributed to several factors, including economic uncertainty tied to global inflationary pressures, energy costs, and slower post-pandemic recovery in some regions.

***Foreign Direct Investment Trends across Countries***
*(capital expenditure, billions of US dollars)*

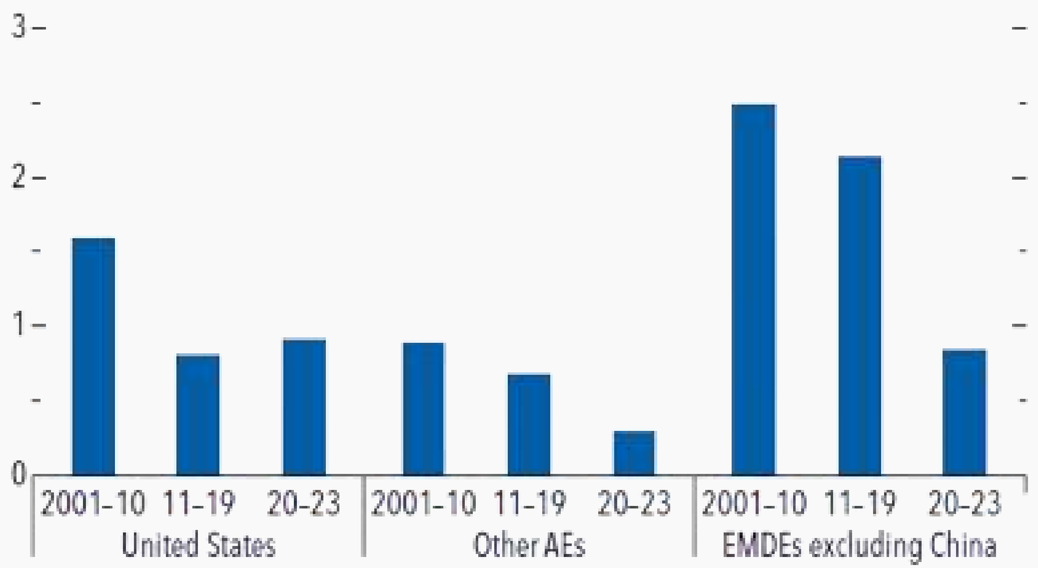



Source: IMF World Economic Outlook, April 2025.

# Europe's Growth Outlook: labor productivity in decline, resulting in lower investments

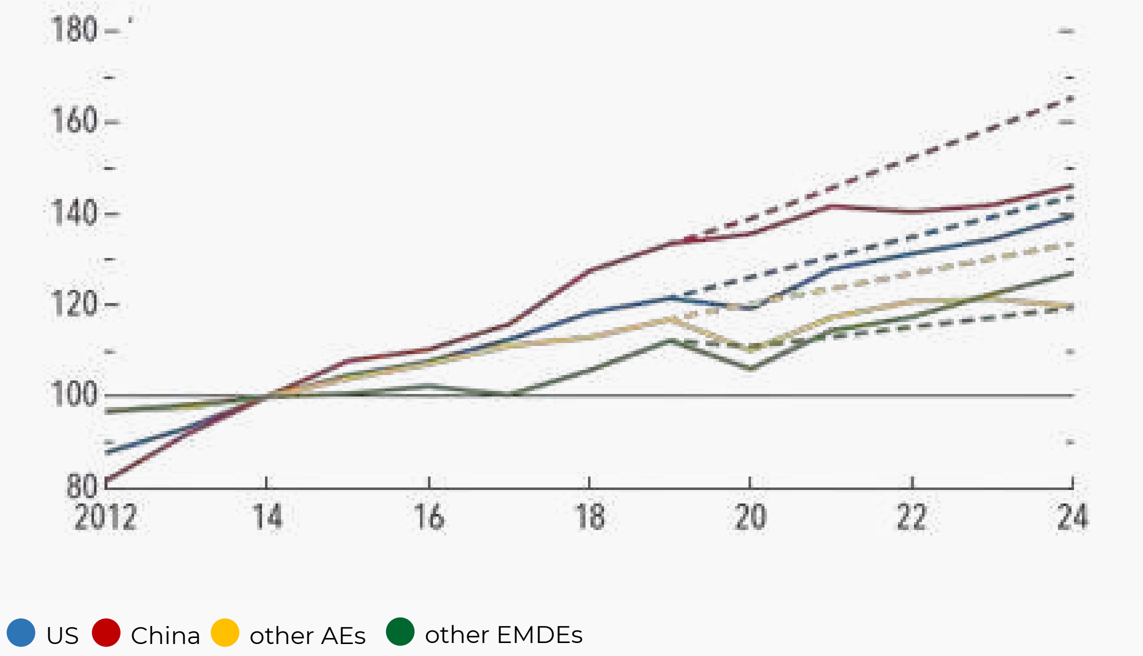
**Labor productivity growth has weakened globally, with the US standing out as an exception.**

***Labor productivity growth***
*(percent)*




**Underinvestment remains a key constraint on productivity growth, especially in advanced economies.** This divergence highlights the shift of manufacturing activity toward more investment-driven emerging markets.

***Private gross fixed capital formation***
*(index, 2014 = 100)*

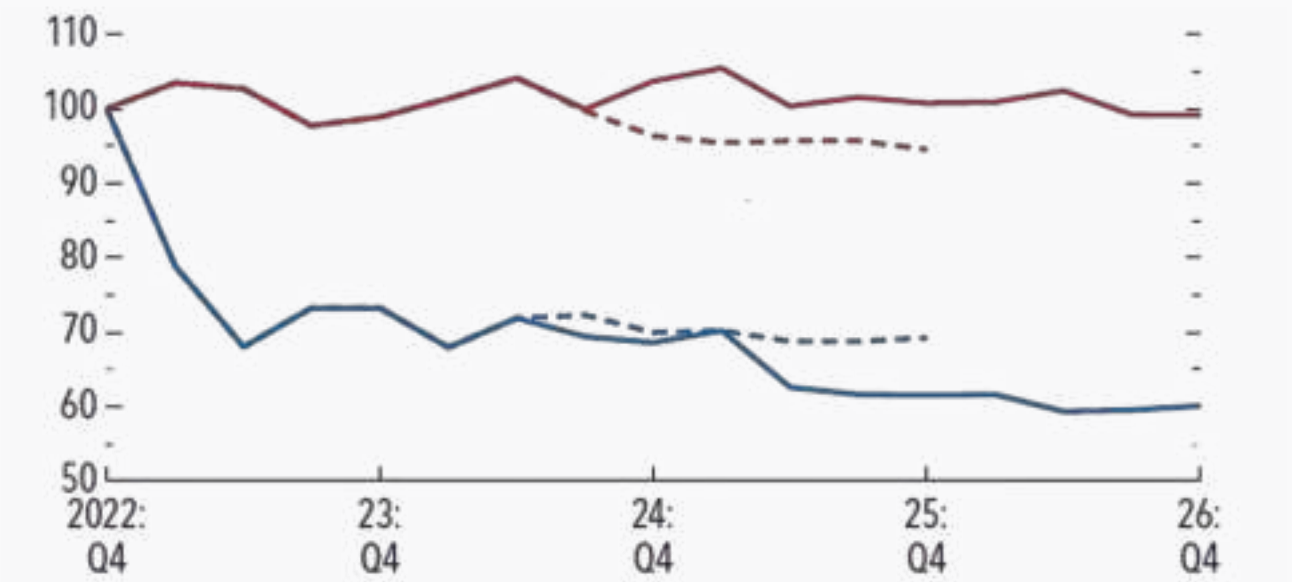



Source: IMF World Economic Outlook, April 2025.

# Europe’s Growth Outlook: relief from energy and food price pressures

**Energy and food prices are forecasted to decline through the end of 2025,** offering some relief to both industry and consumers. At the same time, stabilization in global food markets is easing inflationary pressures, supporting household consumption and aiding the recovery of real incomes. Despite these positive developments, structural vulnerabilities remain - Europe's continued reliance on energy imports poses medium-term risks, even as energy efficiency improves.

***Energy and Food prices***
*(index, Q4’ 22 = 100)*



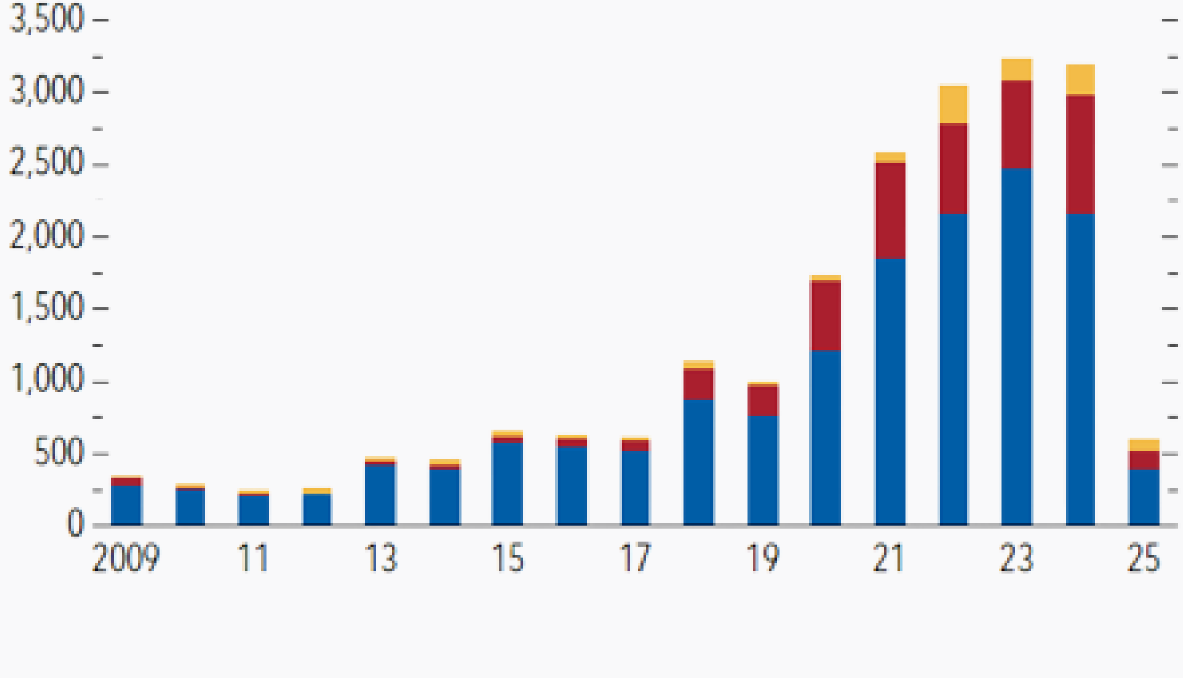

Energy  Food and beverage

Source: IMF World Economic Outlook, April 2025.

# Globalization no longer be taken for granted

**Persistent uncertainty around trade policy, particularly in advanced economies, is further discouraging investment and delaying key projects.** At the same time, macroeconomic risks such as technological decoupling, supply chain fragmentation, and growing geopolitical tensions are contributing to financial volatility and casting doubt on the stability of the global monetary system. The shift toward self-sufficiency, strategic autonomy, and risk aversion signals a critical turning point – continued globalization cannot be taken for granted.

***Trade restrictive measures***
*(number of measures)*

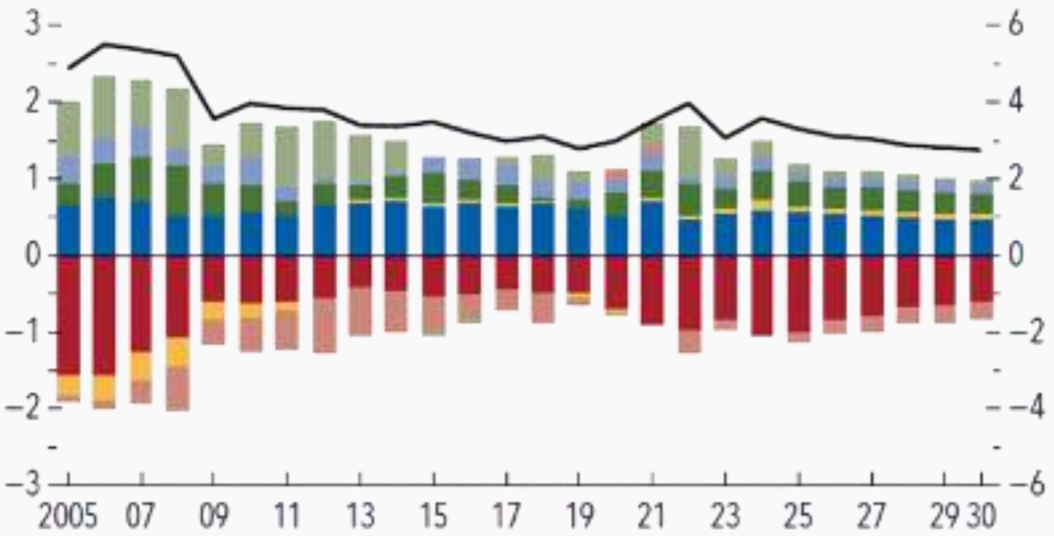



Source: IMF World Economic Outlook, April 2025.

# Europe's Growth Outlook: resilient trade surplus in a shifting global trade landscape

**Current account balances are projected to narrow over the medium term,** reflecting increased tariff restrictions.

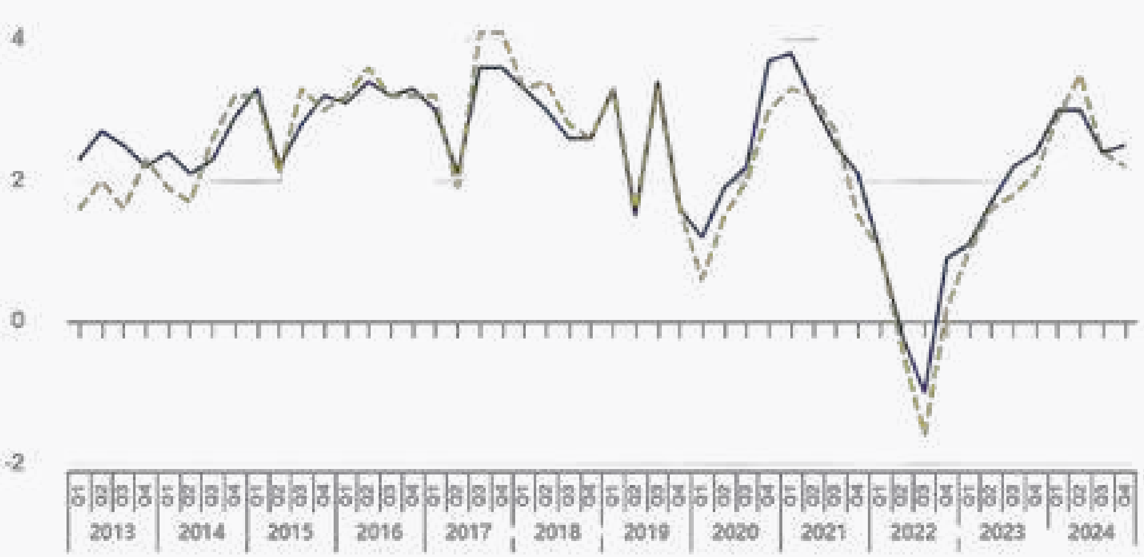
***Current account and international investment positions***
*(percent of global GDP)*




European creditors · US · European debtors · China · Others · Oil exporters · Overall balance (right scale)

**Since 2023, the EU's current account balance has remained consistently in surplus, reflecting a resilient external position.** Continued strength in goods and services exports, alongside moderating deficits in income and capital accounts, has supported this positive trend through late 2024.

***EU current account balance***
*(as a percent of GDP, adjusted calendar and seasonally)*




Euro area · EU

Source: IMF World Economic Outlook, April 2025. Eurostat.

# Rising bond yields and constrained fiscal space: a global trend

### Rising Debt-to-GDP Ratios

Fiscal measures during the pandemic and the war in Ukraine sharply increased public debt. While some reductions have occurred, budget deficits remain high, limiting fiscal flexibility.

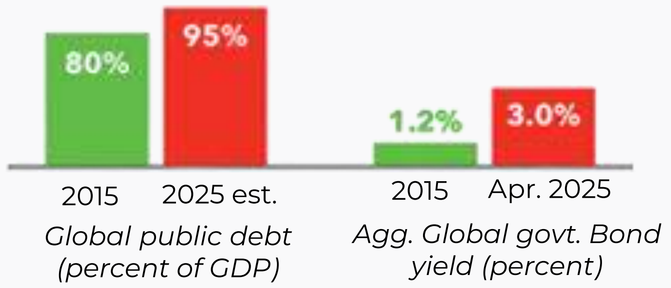
### Surge in Real Government Bond Yields

Real long-term government bond yields have surged after a decade of low interest rates.

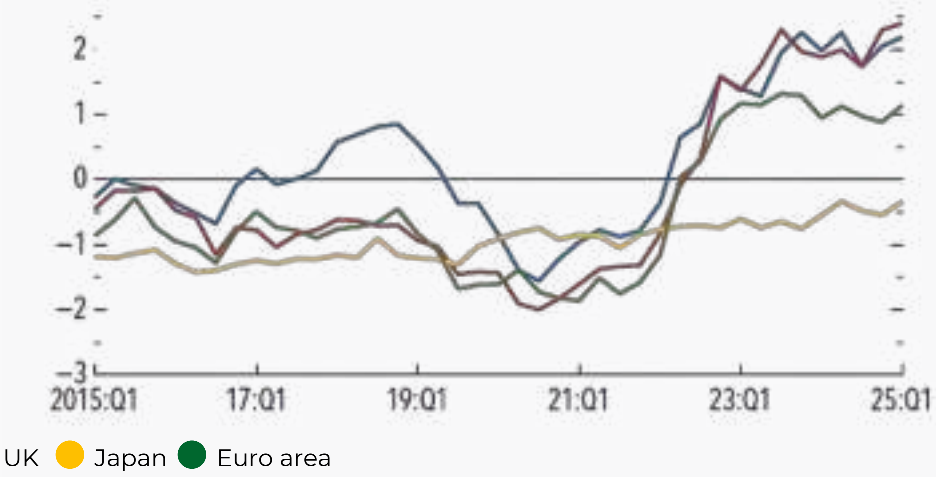
### Implication for Europe

Europe faces similar challenges with rising real government bond yields, as the region grapples with high public debt and constrained fiscal space.

***Global Debt Aggregate***




***Real 10 - Year government bond yields***
*(percent per year)*

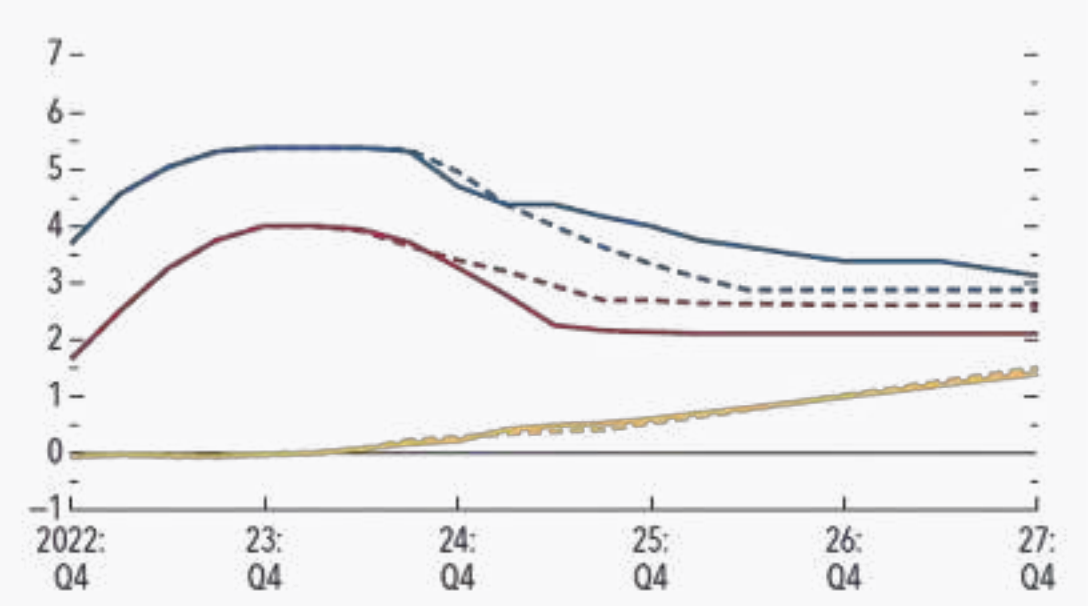



Source: IMF World Economic Outlook, April 2025. IMF Global Financial Stability Report, April 2025.

# Europe's growth outlook: monetary policy stance is still restrictive, but fiscal policy remains accommodative

**The European Central Bank plans to implement a more gradual reduction,** with 100 basis points of cuts expected in 2025, bringing the policy rate to 2% by mid-year.

***Monetary policy projections***
*(percent, quarterly average)*




US Euro area Japan

**In the Euro area, fiscal deficits are expected to widen,** particularly in Germany, driven by increased defense and public investment spending.

***Euro area balance***

| | | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| **GDP market prices (mp)** | (million euro) | 12 613 587 | 13 722 911 | 14 604 759 | 15 160 962 |
| **Government deficit (-) / surplus (+)** | (million euro) | -643 043 | -475 295 | -515 536 | -468 580 |
| | % of GDP | -5.1 | -3.5 | -3.5 | -3.1 |
| **Government expenditure** | % of GDP | 52.0 | 50.0 | 49.5 | 49.6 |
| **Government revenue** | % of GDP | 46.9 | 46.5 | 46.0 | 46.5 |
| **Government debt** | (million euro) | 11 840 208 | 12 288 469 | 12 753 756 | 13 258 118 |
| | % of GDP | 93.9 | 89.5 | 87.3 | 87.4 |

Source: IMF World Economic Outlook, April 2025. Eurostat.

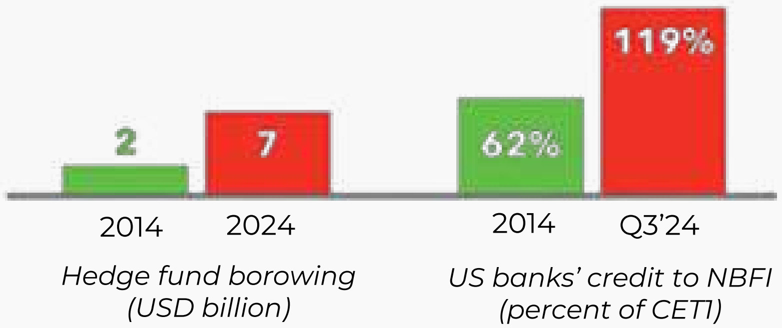
# Forward-looking vulnerabilities

**Economic policy and trade uncertainty remain** at an all-time high, combined with relatively high asset prices (even after the recent correction).

**High leverage** in the non-bank financial institutions and interconnectedness with the financial system.

**Turbulence could descend** upon sovereign bond markets, especially in jurisdictions where government debt levels are high.

***Highly leveraged non-bank financial institutions are interconnected with the banking system***

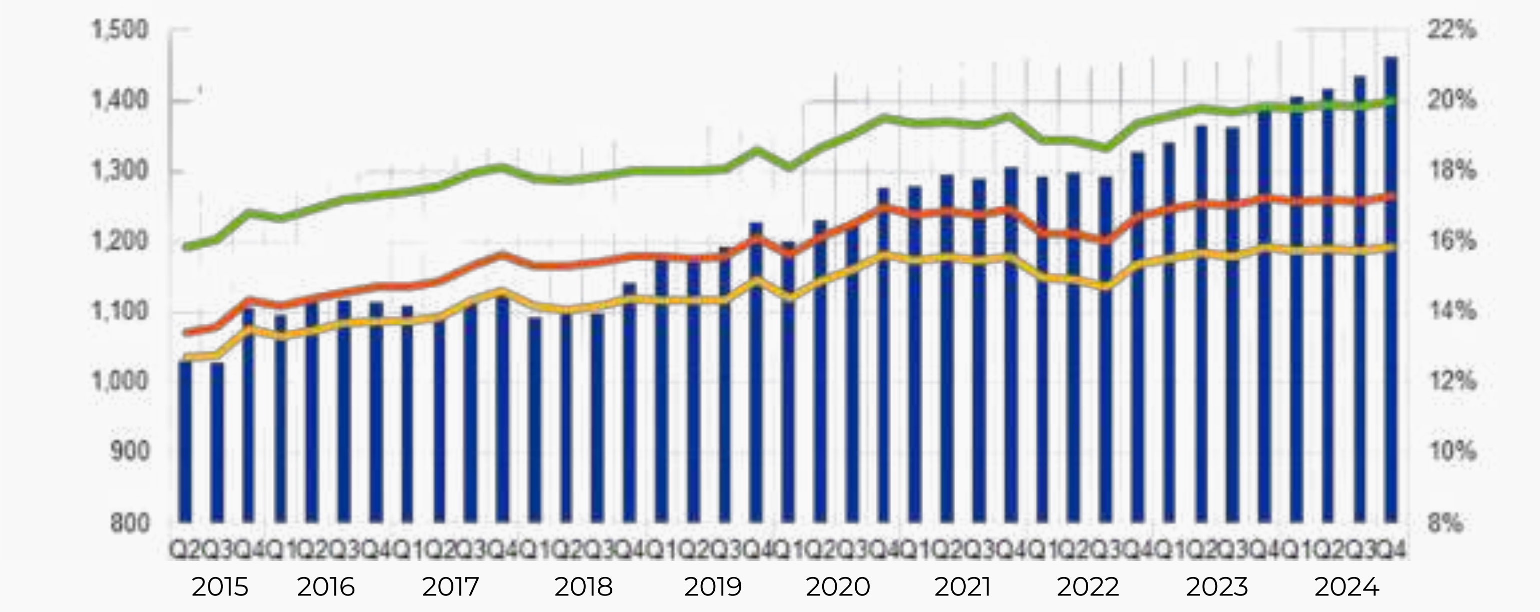



Source: IMF Global Financial Stability Report, April 2025.

# The EU banking sector is healthy

**The EU banking sector continues to demonstrate resilience.**
The aggregate CET1 ratio of 15.86% underscores a robust capital position, though the dispersion across jurisdictions - from 12.88% in Spain to 22.05% in Latvia, highlights the importance of continued national-level vigilance.

***Capital ratios and CET1 amount (bn Eur)***




CET1 amount (left-hand scale)
CET1 ratio (right-hand scale)
Tier 1 ratio (right-hand scale)
Total capital ratio (right-hand scale)

Source: ECB

# Key policy challenges faced by EU policy - makers

The key policy challenge **lies in striking an appropriate balance** between supporting weak economic growth and avoiding the risk of renewed inflationary pressures or a deterioration in fiscal sustainability.

**Ensuring adequate financing** for defense, the green transition, and digital transformation.

A key policy **debate for the upcoming EU funding cycle will center on reallocating resources**, as currently around one-third of the EU budget (over EUR 50 billion) is dedicated to the Common Agricultural Policy.

# What does the EU Savings and Investment Union initiative mean for the LatBAN members?

**Incentives for savers** to invest in higher risk products.

**Shifting savings away from deposits** to pensions products, investment funds, shares and UCITS.

**More efficient** secondary capital markets infrastructure.
More cross-border business within the EU.

Single **supervisory mechanism** for capital markets?

# Draghi report about the EU’s competitiveness

**Urgent Need for Action**

- The EU faces a critical challenge in maintaining its competitiveness against global powers like the U.S. and China.
- The report stresses the risk of "slow agony" if the EU fails to adapt.

**Focus on Key Transformations**

- *Innovation*: Closing the innovation gap, particularly in advanced technologies like AI and digital infrastructure.
- *Decarbonization*: Harmonizing ambitious climate goals with industrial competitiveness.
- *Economic Security*: Reducing dependencies on external actors and strengthening strategic autonomy.

**Strategic Recommendations**

- Increased investment in research and development (R&D).
- Deepening the Single Market and capital markets union.
- Enhancing coordinated industrial policy and joint financing.
- Strengthening the EU's defense capabilities.

**Call for a truly European approach instead of fragmented national policies.**

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