2025 outlook – the consequences of interest rate easing

Since the middle of this year, Western central banks have been lowering their key interest rates. The major interest rate turnaround is likely to boost the economy in 2025, although the easing of monetary policy will have less of an effect in economically weakened countries like Germany. We provide an outlook for the next year.

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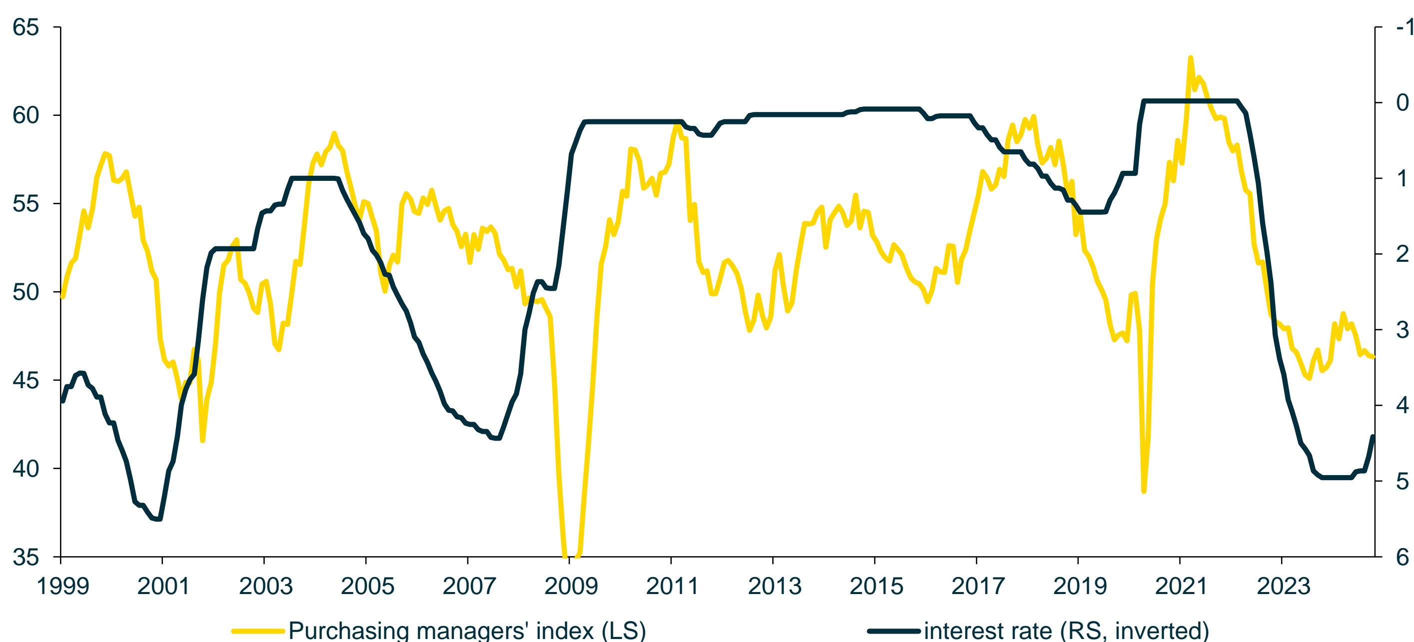
Rates are no longer rising, but falling

The high inflation of 2022 forced the western central banks to raise their key interest rates massively. The Federal Reserve, for example, raised its key interest rate from 0.25 to 5.5%, while the ECB increased it from -0.5% to 4.0%. This tightening of monetary policy caused economic indicators such as the purchasing managers' index to slump, especially in 2022 (Chart 1).

Since mid-2024, key interest rates have been falling again. The ECB and the Fed have each lowered them by a total of 75 basis points, and the futures markets are pricing in further rate cuts. This turnaround in interest rates is significantly improving economic conditions. From spring onwards, survey based sentiment indicators should recover. However, the various economies are likely to react differently to the monetary easing, depending on structural problems, fiscal policy and other factors.

Chart 1 - Turnaround in interest rates improves backdrop for growth

Purchasing managers' index (USA: ISM; euro area: PMI) and key interest rate in %, GDP-weighted average of USA and euro area



Source: Markit, Bloomberg, S & P Global, Commerzbank Research

Germany: Erosion of competitiveness dampens effect of monetary easing

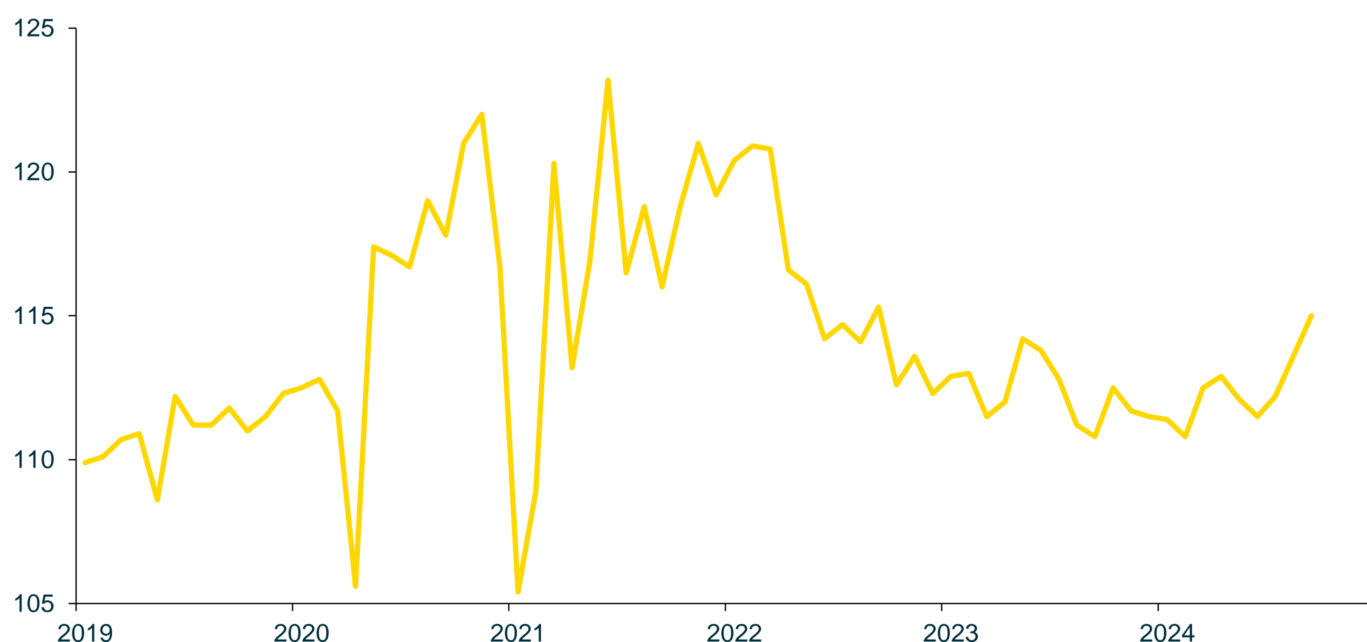
The leading indicators for Germany, which have been falling since spring 2024, point to a difficult winter half-year, during which German GDP will at best stagnate. But the easing pain from past monetary policy tightening suggests a certain economic upturn from spring onwards also in Germany – especially since around two-thirds of the energy price shock of 2022 will have been reversed and private consumption has finally started to recover somewhat after the decline in inflation (Chart 2).

But because of the erosion of Germany as a business location since the Merkel years, many companies are disillusioned and reluctant to invest in Germany, especially since the next federal government could consist of parties that, like the parties forming the traffic-light coalition (i.e. SPD, FDP and Greens), have no common ideas about the necessary economic policy reforms. In addition, there

is the waning demand from China, which had for a long time given Germany tailwinds. The economic recovery driven by monetary policy is therefore likely to be significantly dampened. We expect growth of just 0.2% in 2025 and 1.0% in 2026 (or just 0.7% in 2026 when adjusting for the unusually high number of working days in that year).

Chart 2 - Have German retail sales turned?

Retail sales, volumes, seasonal adjusted monthly figures, 2015=100



Source: S&P Global, Destatis, Commerzbank Research

Euro area: Decline of EU money flows to Southern Europe partly neutralizes effects of rate cuts

The other countries of the euro area should also benefit from the ECB's rate cuts. However, this will be partially offset by special factors in individual countries:

- **Italy:** Large government subsidies for energy-efficient home renovations have contributed significantly to the strong growth in construction investment in Italy. Without this boom, Italy's GDP could have been 4% smaller (Chart 3). The phasing out of the subsidies is likely to trigger a normalization of construction investment, which should dampen economic growth noticeably. We do not expect economic growth in Italy to pick up despite the interest rate cuts (0.6% in both 2025 and 2026, compared to an estimated 0.7% in 2024).

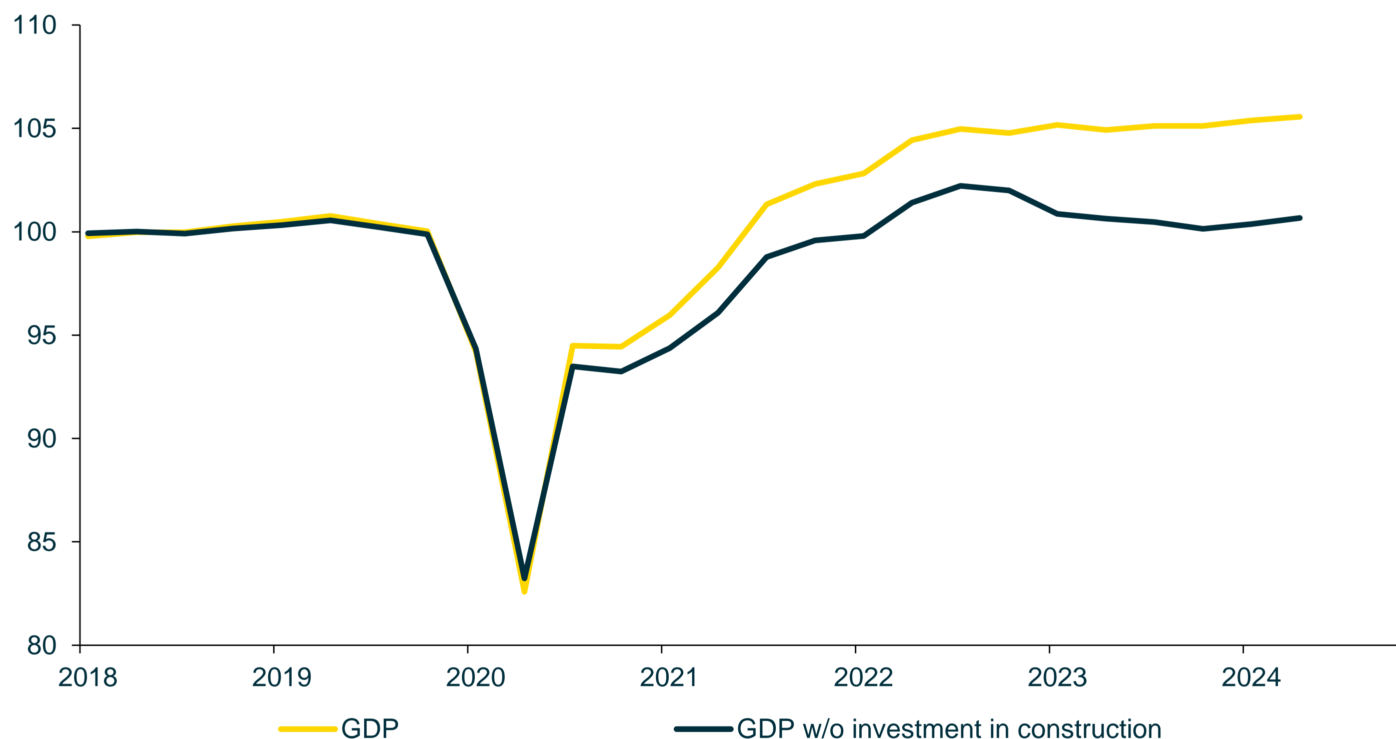
- **Spain:** The recovery of tourism after the end of the pandemic and the boost provided by the Corona recovery fund (the grants alone correspond to more than 5% of GDP) have already allowed the Spanish economy to grow by a strong 2.7% in 2023, with the same rate also emerging for this year. As the special effects subside, economic growth in Spain should normalize (2025: 1.6%; 2026: 1.2%).

- **France** is likely to post a budget deficit of 6% of GDP this year. Without countermeasures, it would rise to 7% in 2025. To avoid dangerous debt dynamics, the government wants to reduce the deficit in 2025 by €60 billion through tax increases and spending cuts. This corresponds to 2% of GDP. Even if it is not certain whether the government will be able to implement its plans one-to-one, fiscal policy is likely to slow the French economy in 2025.

All in all, we expect a moderate economic recovery for the euro area as a whole from spring onwards, and forecast growth of 0.9% in 2025 and 1.0% in 2026.

Chart 3 - Italy: GDP growth strongly driven by investment in construction

Italy, real GDP, 2018=100



Source: Eurostat, Commerzbank Research

ECB monetary policy lays the groundwork for too high inflation in the medium term

As an after-effect of the weak economy in the winter half-year of 2024/5, consumer prices excluding energy and food are likely to continue to rise at annualized rates by the end of 2025 that roughly correspond to the ECB's 2% target. Accordingly, the ECB is likely to cut its deposit rate from the current 3.25% to 2.0% by mid-2025. But that means the key interest rate is well below the so-called neutral rate, which neither boosts nor slows the economy and which we see at 3% in view of the long-term real growth outlook of around 1% and the ECB's 2% inflation target. Monetary policy will therefore be too loose in 2025. This suggests that, with a slowly recovering economy and high wage settlements, inflation will settle above the ECB target at 2.4% in 2026. Structural inflation drivers such as demographics, de-carbonization and de-globalization, which is likely to accelerate due to the election of Donald Trump, are also working in this direction.

US in for good growth in 2025

The massive interest rate hikes from 2022 to 2023 did not push the US economy into the feared recession in 2024. The unemployment rate rose only slightly, and capacity utilization barely fell at all. In this respect, unlike after a recession, there is little room to further stimulate US growth through monetary easing. Instead, GDP growth should normalize to 2.3% in 2025, after growth in 2024 (2.7%) is estimated to have once again significantly exceeded trend growth (we put trend growth at $1^3/_4$%).

Despite fairly strong economic growth, US inflation has fallen significantly. However, it is likely to rise by around 1 percentage point from mid-2025 to mid-2026 if the incoming President Trump implements at least half of his planned tariffs.

The Federal Reserve is likely to cut its key rates further from the current 4.75% to 4.0% by spring 2025. Due to the tariff related increase in inflation risks and a still tight labor market, it is likely to end the interest rate cut process, although it will not explicitly announce this, but will merely switch off the autopilot in its communication. The Fed is unlikely to go so far as to raise interest rates in response to a renewed rise in inflation. After all, Donald Trump will publicly pressure the Fed to support his policies by keeping interest rates low. The US central bank will not be completely unimpressed by this. All of this suggests that inflation will not return to the 2.0% target in the long term.

China: Monetary policy is barely effective due to unresolved structural problems

The Chinese central bank has also loosened its monetary policy. It has lowered its key interest rates, pushing down the interest rates for new and existing mortgages. This helps the many private homebuyers who are already suffering from falling real estate prices. In addition, the central bank is giving state-owned enterprises loans to take unsold apartments off the market and convert them into rental apartments.

The monetary easing, together with fiscal policy measures such as the debt restructuring of regional governments, is easing the economic situation to some extent, but does not much to change the fundamental problems of the Chinese economy. The construction and real estate sectors, which are bloated relative to GDP, must shrink, which will dampen construction investment for years to come. In addition, the government is pursuing an autarky policy in response to the conflict with the US, which is lowering productivity. Furthermore, the environment for private companies has deteriorated, and they are now investing less than state-owned enterprises. All in all, we remain cautious about China. We expect growth of just 4.3% in 2025 and 4.0% in 2026.

What all this means for the financial markets

Falling key interest rates are creating a favorable environment in the western financial markets. This applies particularly to the stock markets in the USA. In the past, the major US stock indices regularly benefited from rate cuts, provided that the US economy avoided a recession and corporate earnings did not collapse. In this respect, 2025 should be another good year for equities, although temporary setbacks related to the high valuation of technology stocks can not be ruled out..

In contrast to equity prices, US bond prices only performed positively in the run-up to key interest rate cuts. After the start of interest rate cuts, the picture has not been uniform so far. Looking ahead to 2025, we expect slightly rising bond yields only in the second half of the year, when US inflation should rise due to tariffs and Trump increasingly interferes in monetary policy. This should have a knock-on effect on longer-dated German government bonds (see **Ahead of the Curve**).

The dollar should continue to benefit a little from the planned US tax cuts and deregulation until spring, which should increase the profitability of real capital investments. However, if it later becomes apparent that the Federal Reserve is not unimpressed by Trump's pressure, the dollar should weaken again and EUR-USD should recover accordingly.

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