2024: Two recovery anomalies 2025: Three policy pivots

EMEA Chief Economist Sylvain Broyer's Year-End Reflections

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This report does not constitute a rating action

For the final 2024 edition of our Essential Economics Newsletter, we asked each S&P Global Ratings chief economist to share their insights on following questions:

- *What was the biggest surprise for you in 2024, and what are the takeaways?*
- *What will you be watching most closely in 2025, and why?*

2024: Two recovery anomalies

The recovery arrived in 2024, as expected, but it remains subject to two surprising anomalies. The first is the lack of renewed confidence. Whether we look at households, businesses, or investors, most indices relating to confidence remain below long-term averages. In fact, confidence has deteriorated since the spring of 2024, despite improvements in the European economy, including inflation close to the ECB target, employment at an all-time high, and the return of improving purchasing power.

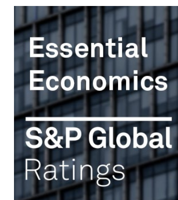
Most economists, including us, agree that GDP will grow faster in 2025 than it did in 2024. So why is confidence still low? The reasons include still restrictive monetary and fiscal policies and wage growth that is outstripping productivity and thus putting pressure on corporate profits. Furthermore, while inflation has eased, households have yet to feel the benefits.

But surveys also point to nervousness stoked by reasons beyond economic forces. Small and midsize enterprises complain more about red tape than Chinese competition. Households cite fears around social cohesion. And both share a belief that politicians can't solve current problems. The roots of this angst run deep.

The second notable anomaly in 2024's recovery is the coexistence of a negative output gap and a positive unemployment gap. The European Commission and the International Monetary Fund estimate that GDP will remain 0.4 percentage points below potential GDP next year. At the same time, the unemployment rate (6.3% in October) is at its lowest level in decades and likely beneath the equilibrium rate (i.e., the non-wage accelerating level of unemployment, or NAWRU), which is estimated to be about 7%. There may be issues in estimating potential GDP and the NAWRU, but upward pressure on wages is evident. Normally, unemployment and output gaps move in the same direction, so how can we explain this anomaly? There is a common belief that firms have

Contacts

Sylvain Broyer
Frankfurt
+49 69 3399 9156
Sylvain.broyer@spglobal.com



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been hoarding labor since the pandemic to offset an aging workforce and as cover for employees making greater use of sick leave. That may be true, but it is a strategy that comes at a cost for companies.

Takeways: We consider that these anomalies are unlikely to persist over the longer term. It is uncertain if the recovery will be strong enough to restore confidence, and possible that weak confidence could hamper the recovery, for example, if households continue to save despite falling interest rates. If productivity doesn't accelerate, it is also possible that unemployment could increase by more than is generally expected in 2025.

2025: Three policy pivots

Looking to 2025, there seems to be consensus that GDP growth should strengthen due to continued real income growth and will be less restrained by interest rates. The result could be an increase of 1.2% in Eurozone GDP in 2025, up from a 0.8% increase in 2024.

Yet, that forecast is clouded by three events that could result in policy pivots:

1) The change in the U.S. administration, which comes with a potential overhaul of trade, migration, and tax measures. The extent to which the policies promised (or at least discussed) by president-elect Donald Trump during his election campaign will be delivered remains uncertain, as does their timing and the reaction of the U.S.'s trading partners.

2) Recent changes in the European Union leadership, including a new European Commission, a new rotating EU presidency, and a new European Council President. They add uncertainty to the extent to which the EU will be willing to implement measures advocated in the Noyer report on savings, the Letta report on the single market, the Draghi report on EU competitiveness, and implement potential new defense policies.

3) Forthcoming German elections, which raise questions over the potential to ease the country's constitutional debt-brake and the make-up of the governing coalition--even if polls leave little doubt that the CDU/CSU, led by Friedrich Merz, will emerge as the winner. The CDU/CSU's manifesto, published in 2024, is pro-European, favors deregulation, increased military spending, and the use of nuclear power. The party also traditionally has close ties with the U.S. (Merz chaired the "Atlantik-Brücke" (Atlantic Bridge) association, which promotes German-U.S. ties, for ten years).

What to watch: Between the possible correction of the economic anomalies that emerged in 2024 and the potential for policy pivots in 2025, we expect European economies and markets will be subject to high volatility over the coming 12 months.

Chart 1

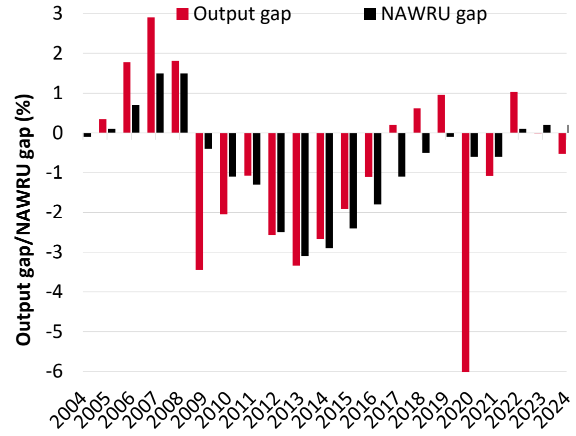
Anomaly No.1: Confidence has not kept pace with growth

Confidence indicators	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24
EC - ESI	-0.4	-0.4	-0.4	-0.3	-0.3	-0.4
EC - Industry confidence	-0.7	-0.7	-0.8	-0.7	-0.8	-1.1
EC - Services confidence	0.1	0.0	-0.1	0.0	0.1	0.1
EC - Consumer confidence	-0.5	-0.5	-0.3	-0.3	-0.2	-0.2
EC - Retail sector	-0.1	-0.3	-0.5	-0.3	-0.3	-0.2
PMI Composite	-0.1	-0.4	-0.6	-0.4	-0.7	-0.6
PMI Manufacturing	-0.9	-1.2	-1.2	-1.2	-1.3	-1.1
PMI Services	0.1	0.0	-0.2	0.1	-0.3	-0.3
PMI Composite - new orders	0.0	-0.5	-0.6	-0.6	-0.9	-0.8
PMI Composite - employment	0.4	0.1	-0.2	-0.2	-0.3	-0.5
PMI Composite - backlogs	-0.3	-0.7	-0.7	-0.9	-1.0	-0.9
Sentix - investor sentiment	-0.4	-0.2	-0.6	-1.0	-1.1	-1.0
Sentix - current situation	-0.7	-0.5	-0.8	-0.9	-1.0	-1.0
Sentix - future expectations	0.3	0.4	-0.1	-0.8	-0.7	-0.4
ZEW - economic sentiment	0.9	1.0	0.8	0.0	-0.3	0.1
ZEW - economic situation	-0.4	-0.4	-0.4	-0.3	-0.5	-0.5

Note: Heat zones are calculated as a Z-score for each indicator with the mean and standard deviation taken over the pre-pandemic period 2003-2019. A red zone indicates poor conditions. Source: S&P Global Market Intelligence, S&P Global Ratings.

Chart 2

Anomaly No. 2: Below-potential GDP coexists with record-high employment levels



Note: The output gap represents the difference between actual and potential GDP, expressed as a % of potential GDP. The NAWRU gap is the difference between the unemployment rate for which wages are not accelerating (NAWRU) and the actual unemployment rate. Source: AMECO, S&P Global Ratings.

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