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What to watch: A light at the end of the tunnel after three years of war in Ukraine?

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In summary

Ukraine: A fragile ceasefire ahead? The most likely scenario (40% probability) would see Russia halting offensives but retaining control of occupied areas, and Ukraine seeking strong security guarantees from the US and Europe. Some Western sanctions are likely to be reduced, but gas sanctions would persist. Europe is likely to increase defense spending by at least 0.5pp, getting close to 3% of GDP on average from 2.2% currently. The multiplier on boosting Eurozone growth can reach 0.5 if EU procurement rules are reinstated. In this scenario, inflation is projected to decrease by -0.5pp from the current 1.9%, with oil prices likely to decrease by 5-10% and gas prices likely to drop by 25%, targeting 37 EUR/MWh. Hence, Eurozone GDP growth could be +0.5pp higher than our current forecast of +1% in 2025. However, if Ukraine and Europe reject the US-brokered deal with Russia, hostilities could resume, the US would likely withdraw military assistance to Ukraine and leave NATO and Europe would face a deteriorated growth outlook amid higher gas prices. Markets are holding onto hope, already positioned for the best-case scenario, with possible gains of 0 to +5pps and a total return of +10%. German year-end 2025 rates are anticipated at 2%. The EUR/USD exchange rate is expected to stabilize at 1.10 and corporate credit spreads could narrow by 0 to -5bps, reaching around 85bps.

How can Europe close its defense spending gap? While defense spending in the EU is expected to rise by EUR140bn annually (from 2.2% to 3% of GDP), doubling current military capacities in two years would require spending 4% of GDP, translating to EUR320bn annually, with half of it spent on equipment, from the current 25%. With Germany's debt brake likely remaining in place after the election and a EU-wide resistance to raising taxes amid a weak economic outlook, EU debt funding is the most likely short-term source of funding, especially with EUR300bn in unused NGEU funds available until 2026. However, EU debt has already surged through previous programs such as the ESM, SURE and NGEU, reaching EUR840bn by the end of 2024. The EU as an issuer has already surpassed all states except France in net debt issuance, which has contributed to rising interest rates. This will translate into debt-servicing costs rising to 20% of the EU commission's budget by 2026 from virtually zero pre-Covid, raising concerns about long-term fiscal sustainability and potentially further rising yields if military spending is not eventually funded via tax hikes or spending cuts.

An ECB rate cut is certain, but Europe's defense scenarios will shape the terminal rate. At its next meeting on 6 March, we expect the ECB to cut the deposit rate to 2.5% as widely expected by markets. However, what happens next remains less clear. Our baseline scenario, which now also covers an end to the war in Ukraine, still sees the terminal rate at 2.0% to be reached in June and quantitative tightening (QT) to continue. However, in the scenario of significantly higher fiscal deficits due to defense spending, we see a terminal rate of 1.5% and an earlier stop of QT, with a risk of returning to Quantitative Easing (QE) mode.

Ukraine: A fragile ceasefire ahead?

Three years into the war in Ukraine, is there finally some light at the end of the tunnel? While some sort of ceasefire now looks possible, with the US and Ukraine nearing a preliminary deal for rare earth minerals in return for US support in negotiations with Russia, the path to peace remains complex and fraught with challenges. We outline below four scenarios and their potential outcomes, each with differing implications for regional stability, economic growth and geopolitical dynamics.

The most likely scenario is a partial ceasefire, with a fragile truce (40% probability). In this scenario, Russia would halt its military offensive but retain control over occupied areas under a mixed civilian-military administration. Ukraine, seeking to prevent further territorial losses, would accept a ceasefire while demanding security guarantees from the US and Europe, though it would not recognize the Russian occupation. The domestic political landscape would remain fragile, with elections scheduled by 2026. Europe would increase defense spending from 2.2% of GDP to get closer to 3% of GDP. The fiscal easing in Europe would equal +0.5% of GDP. Territories outside Crimea, Donetsk and Luhansk would become demilitarized buffer zones under a UN peacekeeping mission. Some Western sanctions would also be reduced, but gas sanctions would persist. In this scenario, Eurozone GDP growth is expected to increase by +0.5pp, driven by a boost in exports (EUR45bn), investment (EUR55bn) and consumption (EUR50bn). Inflation is projected to decrease by -0.5pp. Oil prices are likely to decrease by -5-10%, while gas prices could drop by -25%, targeting 37 EUR/MWh. The ECB would maintain a terminal rate of 2%, with quantitative tightening continuing. German year-end 2025 rates are anticipated at 2%, with stable breakeven inflation and positive real rates. Equity markets may see gains of up to +5pps, with a total return of +10%. The EUR/USD exchange rate is expected to stabilize at 1.10 and corporate credit spreads could narrow by 0 to -5bps to reach around 85bps.

A comprehensive peace deal is slightly less likely (30%), though it would have much better implications for growth as sanctions will be fully lifted by 2027, allowing business to return to normal. A comprehensive peace agreement would see Russia maintaining control over occupied areas while demobilizing its troops. Ukraine would formally commit to neutrality, ending its NATO aspirations in exchange for robust security guarantees and economic integration with the EU and the US. This would lead to the lifting of martial law and elections in the second half of 2025, alongside the launch of a USD500bn reconstruction fund. Europe would support Ukraine's position and boosts defense spending, with fiscal easing between 0.5pp and 1pp. Territories under Russian control would gain international recognition and open to Western businesses, with sanctions gradually lifted by 2027. In this scenario, Eurozone GDP growth would be boosted by +1pp based on a significant rise in exports (EUR90bn), investment (EUR103bn) and consumption (EUR97bn). Inflation is anticipated to decrease by -1pp on the back of a -10-20% fall in oil prices and a -50% decrease in gas prices, targeting 25 EUR/MWh. The ECB would maintain a 2% terminal rate, continuing quantitative tightening. German rates would be expected to remain at 2%, with improved breakeven inflation and significantly positive real rates. Equity markets may rise by +5-10pps, with a total return of +15%. The EUR/USD rate could reach 1.20 and corporate credit spreads might tighten by -5 to -10bps, reaching around 80bps.

We see only a 25% chance of a stalemate & prolonged conflict. With no agreement between Russia and the US, this scenario would see the conflict drag on, with Ukraine maintaining control over its current territory but facing the risk of renewed fighting. Europe would remain aligned with Ukraine, increasing defense budgets to beyond 3% of GDP. Territorial divisions would persist, and Western sanctions remain unchanged, with gas flows continuing as before. In this scenario, the economic recovery would remain limited, with slightly higher growth and inflation due to additional fiscal spending. Global oil and European gas prices would also remain volatile. The ECB's terminal rate would be set at 1.75%, with quantitative tightening ending in 2025. German rates would be projected at 2.5%, with slight increases in breakeven inflation and neutral real rates. Equity markets may fluctuate between 0 to -5pp, with a total return of +8%. The EUR/USD exchange rate is anticipated at 1.05. Corporate credit spreads could widen by 0 to +5bp, around 90bps. Fiscal deficits are projected to rise by more than 1% of GDP.

If Ukraine and Europe reject the Russia-US deal, hostilities could resume, deteriorating the economic outlook for Europe. We assign only 5% probability to the worst-case scenario in which Russia's attempt at a territorial deal with the US would be rejected by both Ukraine and Europe, leading to resumed hostilities. If they do reject the deal, the US would withdraw military assistance to Ukraine and leave NATO, forcing Europe to significantly increase military spending to at least 4% of GDP. Territorial disputes would remain unresolved and the US would partially lift sanctions. The economic outlook would be weak, with a negative confidence shock reducing consumption and investment. Increased fiscal spending on defense would be insufficient to offset these declines. Global oil and

European gas prices would rise in this scenario, and the ECB may lower its terminal rate to 1.5%, restarting quantitative easing. German rates might drop to 1.5%, driven by increased safe-haven demand. Equity markets could decline by –5-10pps, with no total return. The EUR/USD rate could fall to 0.90 and corporate credit spreads may widen by +10-20bps, reaching around 110bps. Fiscal deficits would likely rise by at least 2% of GDP.

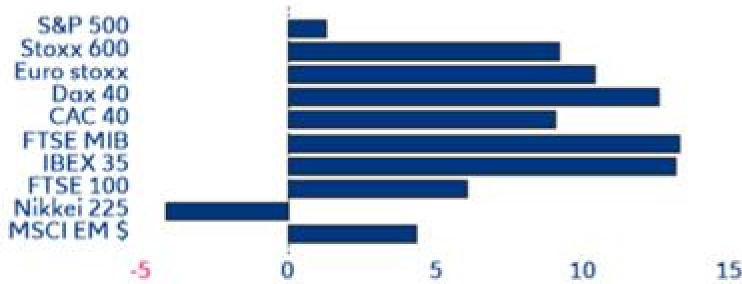
Table 1: Economic implications on the Eurozone from the Ukraine scenarios

	1) Partial ceasefire, fragile truce (40%)	2) Comprehensive peace deal with sanctions lifted (30%)	3) Stalemate & prolonged conflict (25%)	4) Ukraine & Europe reject Russia-US deal, fighting resumes (5%)
GDP and inflation	Annual GDP growth will increase by 0.5pp, with exports increasing by EUR45bn, investment by EUR55bn and consumption by EUR50bn Inflation will decrease by 0.5pp	Annual GDP growth will increase by 1pp, with exports increasing by EUR90bn, investment by EUR103bn and consumption by EUR97bn Inflation will decrease by 1pp	Limited economic recovery, slightly higher growth and inflation due to additional fiscal spending	Weak economic outlook, due to negative confidence shock dragging down consumption and investment with additional fiscal spending on defense not enough to compensate.
Oil and gas prices	Oil prices will decrease by -5 to -10% Gas prices will decrease by 25% (target level 37 EUR/Mwh)	Oil prices will decrease by -10% to -20% Gas prices will decrease by 50% (target level 25 EUR/Mwh)	Global oil prices and European natural gas prices remain volatile	Global oil prices and European natural gas prices increase
ECB	Terminal rate 2% QT continues	Terminal rate 2% QT continues	Terminal rate 1.75%, QT ends in 2025	Terminal rate 1.5%, QE restarted
Rates (DE eoy 2025)	2.0% breakeven inflation -, real rates +	2.0% breakeven inflation --, real rates ++	2.5% breakeven inflation +, real rates 0	1.5% Save haven demand ++
Equity (eoy)	0 to +5pps (+10%TR)	+5 to 10pps (+15%TR)	0 to -5pps (+8%TR)	-10 to -5pps (0%TR)
EUR/USD	1.10	1.20	1.05	0.9
Corporate Credit	0 to -5bps (~85bps)	-5 to -10bps (~80bps)	0 to +5bps (~90bps)	+10 to +20bps (~110bps)
Fiscal policy	EU average at 2.7% of GDP, fiscal deficits rising by 0.5pp	EU average at 2.7% of GDP, fiscal deficits rising by 0.5pp	EU average beyond 3% of GDP, fiscal deficits rising by 1 pp	EU average beyond 4% of GDP, fiscal deficits rising by 2 pp

Sources: Allianz Research

European markets are holding onto hope, already positioned for the best-case scenario. Since the beginning of the year, European markets have been outperforming global peers for several reasons. First, European equities have been underweight in portfolios for a prolonged period, making their valuations more attractive now. At the same time, investors are increasingly expecting both an earnings and revenue recovery, if not an outright acceleration. This confluence of more favorable valuation metrics, combined with the anticipated stabilization from improved geopolitical conditions, has prompted a significant shift in investor sentiment, making European equities a compelling destination (Figure 1).

Figure 1: Global equities year-to-date performance (%)



Sources: LSEG Datastream, Allianz Research

The prospect of an end to uncertainty in turn sets the stage for an easing of energy prices, which European markets are particularly sensitive to. Historically, lower Economic Policy Uncertainty levels have correlated with improved equity valuations, suggesting that Europe may begin to close the gap with US markets (Figure 2). Moreover, a simple correlation analysis reveals that German and French equities – particularly mid-cap and small-cap stocks – tend to move inversely with natural gas prices. This negative correlation suggests that a decline in gas prices should, in turn, drive higher valuations in European equity markets (Figure 3). However, while markets are optimistic on all these fronts, and the outlook for European equities appears bright in 2025, we remain cautious about the sustainability of the current European market rally. An earnings consolidation will be needed to support this trend.

Figure 2: European vs US Economic Policy Uncertainty and PE ratios (%)

Sources: LSEG Datastream, Allianz Research

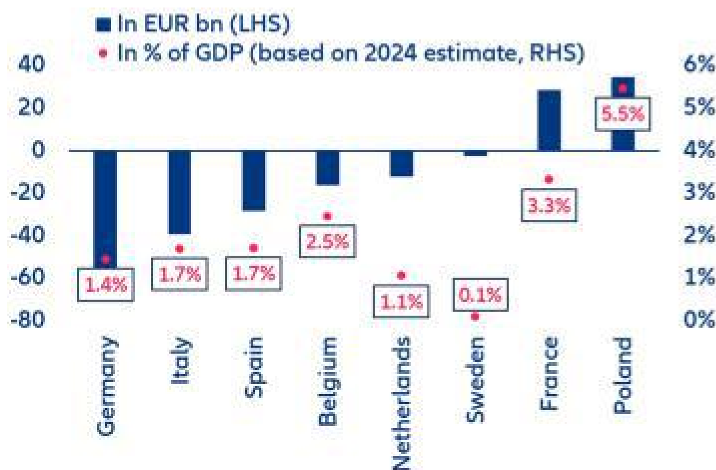
Figure 3: 3y correlation of weekly returns between TTF gas prices and equity markets

Sources: LSEG Datastream, Allianz Research

How can Europe close its defense spending gap?

While our baseline sees defense spending in the EU rising by EUR140bn annually (to 3% of GDP), to effectively increase defense autonomy, European countries must undertake a more comprehensive overhaul of their defense strategies, requiring substantial financial investments and structural changes. Doubling current military capacities in two years would require increasing defense spending to 4% of GDP, translating to EUR320bn annually, with half of it spent on equipment, from the current 25%. Germany, Italy, Spain, Belgium and the Netherlands alone have a EUR135bn investment deficit in military equipment (Figure 4). Closing the military gap with the US will require tackling decades of underinvestment, not only with increased spending but also by channeling new funds into productive and innovative investments. The EU currently allocates about 25% of its defense budget to new equipment and R&D compared to around 40% in the US.

Figure 4: Defense investment net balance based on 2% budget/20% procurement rule (2014-2024 period)



Sources: NATO, Allianz Research

This scenario demands significant industry dedication, including American support, and even then achieving such rapid expansion might be challenging. Military products usually have long production times (for small arms and ammunition it might be three months and for tanks a minimum of six months; for missiles, aircrafts, helicopters,

air defense systems and naval vessels it takes between two to three years on average and is highly labor intensive (see Table 2)). Moreover, hiring and training new troops (estimates go from 150K to 300K additional) is also time consuming. While it is economically feasible for Europe to increase its military capabilities independently, several obstacles remain, including potential US export restrictions and reliance on US intelligence and satellite services. Additionally, Europe's nuclear capabilities are significantly dwarfed by Russia's, emphasizing the strategic importance of US backing.

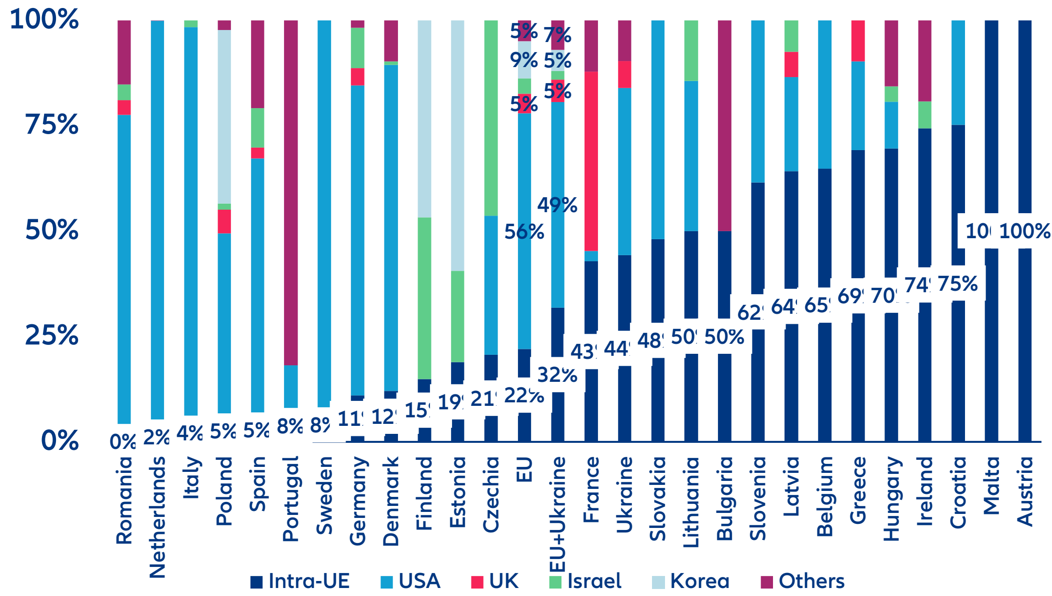
Table 2: A deep dive into the production of military products

Type of military product	Minimum production cycle	Labor intensity	Notes
Small Arms & Light Weapons	1 month	Medium	Can be mass-produced in established factories.
Ammunition & Artillery Shells	1 month	Medium	High-speed production lines can churn out thousands per day.
Armored Fighting Vehicles	6 months	High	Existing production lines can shorten time, but assembly is labor-intensive.
Tanks	1 year	High	Mass-production is difficult to reach due to a mix of complex mechanical and electronic systems.
Missiles & Guided Munitions	1-2 years	High	Limited by electronic and warhead production constraints.
Naval Vessels (Frigates, Destroyers)	2-3 years	High	Wartime efforts can cut construction time, but shipbuilding remains slow.
Submarines	4-5 years	High	Wartime efforts can cut construction time, but shipbuilding remains slow.
Combat Aircraft (Fighters, Bombers, Drones)	1 year	High	Assembly speed depends on existing parts and trained workforce.
Transport aircraft	2 year	High	Assembly speed depends on existing parts and trained workforce.
Helicopters	1-2 years	High	Can be accelerated if using pre-existing designs and supply chains.
Air Defense Systems (SAMs, Radars)	2 years	High	Some radar and missile systems can be assembled faster with stocked components.
Military satellites	2 years	High	Long testing process due to high precision technology involved is weighting on the delivery time
Nuclear Weapons & Strategic Systems	5 years	Very High	Requires uranium/plutonium processing, which takes years even in wartime.
Cyber & Electronic Warfare Systems	6 months	Medium	Software-based systems can be developed faster, but integration takes time.

Sources: company details, Allianz Research

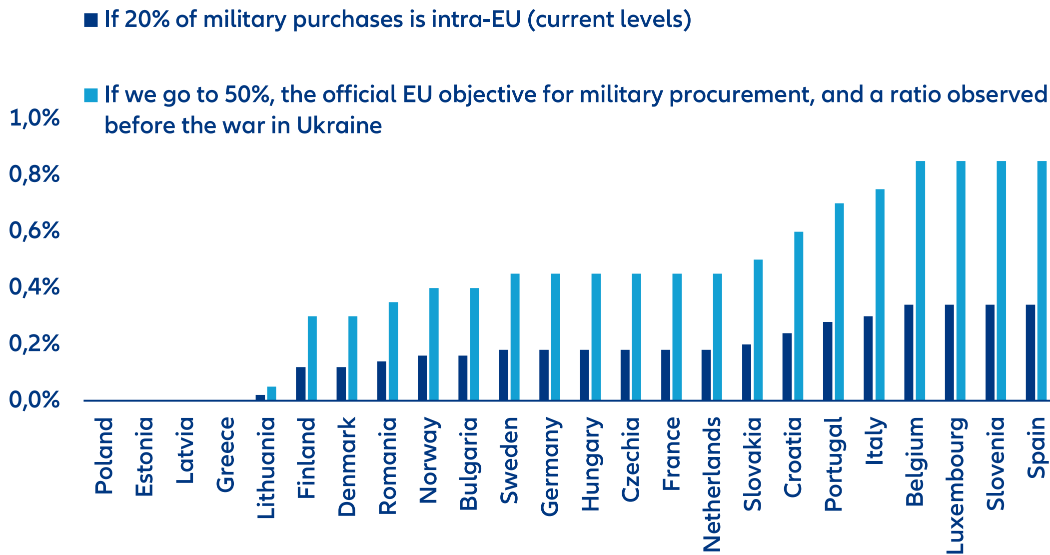
Higher defense spending could boost EU growth by around +0.2-0.5pp. This is based on the share of EU procurement that decreased to 22% since 2022 (Figure 5) as the US became the EU’s main supplier of military goods since the war in Ukraine started (56% of military imports come from the US while Europe used to supply 52% of them before the war in Ukraine). However, the EU’s target is 50% procurement. In this scenario, Spain’s GDP growth could be boosted by +0.8pp should defense spending increase to 3% of GDP (Figure 6).

Figure 5: EU military products imports over the 2022-2023, per region/country supplier



Sources: SIPRI, Allianz Research

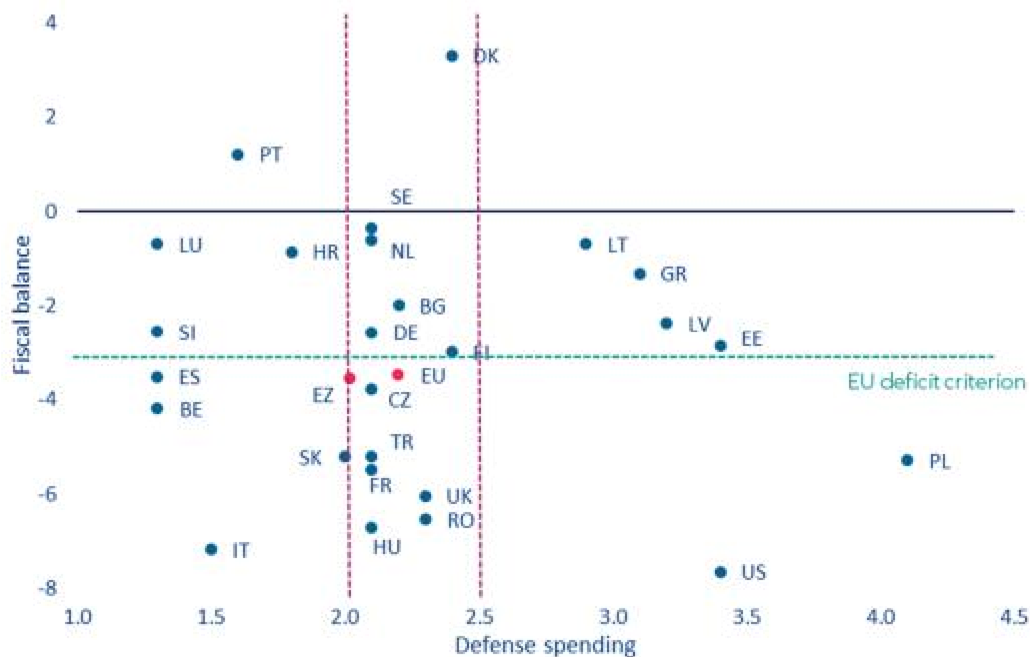
Figure 6: Direct impact on GDP growth for an increase to 3% of GDP for each EU member state part of NATO



Sources: SIPRI, Eurostat, Allianz Research

But many European nations will struggle to reach higher defense spending without breaching EU deficit rules (Figure 7). Increasing military spending from 2.2% of GDP for the EU on average in 2024 to 3.0% of GDP requires spending of +0.8% of GDP for Germany and up to +1.25% of GDP for Spain annually. This would lead to higher fiscal deficits unless offset by other measures. Based on 2024 numbers, the structural increase in government spending could range around EUR107.6bn across the EU annually. Funding through national debt would create tensions with fiscal-consolidation requirements, particularly for France, Italy and Spain. Establishing a permanent exception for defense spending would require a lengthy reform process, with new proposals needing approval from the EU Council and Parliament. EU President von der Leyen recently proposed triggering the escape clause to allow member states to increase defense spending in a controlled way. However, the escape clause is a temporary solution as it cannot be used permanently, leaving long-term funding issues unresolved. And this would not help Germany, given its debt brake.

Figure 7: Defense spending and fiscal balance, in % of GDP 2024



Sources: ECB, NATO, LSEG Datastream, Allianz Research

In Germany, fiscal loosening remains on the cards, especially given the current geopolitical situation, but it might be even more complicated after the elections. The centrist parties lack a two-thirds majority, holding 414 of 630 seats (65.6%). As a result, it will be more challenging to dismantle the debt brake or create a special fund to address the significant public investment needs, estimated at 9-18% of GDP over the next five to 10 years, particularly in areas like decarbonization, transport, education and defense. Several options for easing fiscal policy are available:

1. Changing the debt brake to allow higher deficits for defense spending is less likely. The centrist parties would need to negotiate constitutional reform with Die Linke, which opposes increased defense spending. Even with some openness from Die Linke, this would come with demands for expanding social infrastructure, making it less feasible.
2. Emergency suspension of the debt brake due to security concerns could provide more fiscal flexibility, but it would require an absolute majority (50%+) and could face challenges in the Constitutional Court. Additionally, it must be renewed annually, offering only temporary relief.
3. Creating a special fund dedicated to defense spending in the Constitution requires a two-thirds majority. The new government would make itself dependent on votes of the AfD, which supports defense spending but opposes altering the debt brake.
4. Technical loopholes and workarounds could offer some fiscal flexibility without constitutional change, though their effectiveness is uncertain and they could also be challenged in court.

5. The fallback option may be financing defense spending through EU joint borrowing, freeing up space in Germany's budget for other expenditures. This now looks more likely than ever.

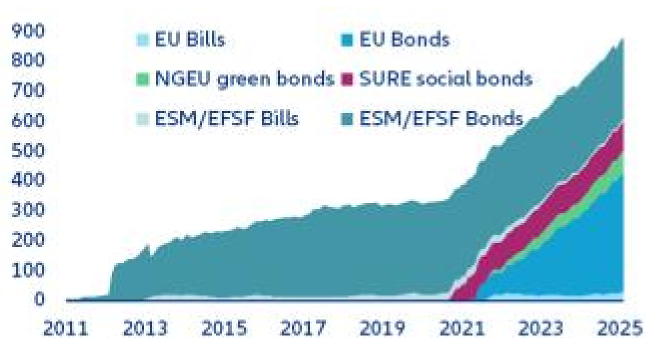
A combination of these approaches is likely, but the process may be slower and more complicated than under the previous Bundestag. Coalition talks could take up to two months, with a new government possibly in place by Easter. Ultimately, Germany is more likely to avoid fiscal tightening than implement the stimulus urgently needed.

To finance higher EU defense spending, several options are under consideration. Besides triggering the escape clause for a temporary flexibility in fiscal rules, repurposing the remaining 62% of the Next Generation EU (NGEU) funds, about EUR90bn (0.6% of EU GDP) for military spending is another option. This would require EU Council approval and could provide loans to member states with higher borrowing costs until 2026, reducing reliance on national debt issuance. Although temporary, this option is the least disruptive and could serve as a stepping stone towards more permanent solutions. Other ideas include relaxing the European Investment Bank's (EIB) lending criteria for military R&D to support defense companies and fostering joint procurement initiatives to integrate markets and reduce national biases. The proposed Buy European Defense Act aims to strengthen the European defense industry by encouraging procurement from European firms, enhancing innovation, autonomy and cost-effectiveness. Leveraging the European Stability Mechanism (ESM) could activate a specific lending facility directed to the support of military spending but can only temporarily substitute the issuance of domestic debt.

In the medium term, proposals include creating a defense financing vehicle backed by national guarantees and additional EU budget contributions. This could involve non-EU countries and allow for the issuance of EU debt to benefit from market liquidity, though this would take time as it would need the approval of all national parliaments in addition to the EU parliament. But it provides two advantages: First, it would allow the EU to utilize the unified funding approach, allowing issuance of EU debt that would enter the general pool and benefit from market liquidity. Second, it could also fund the disbursement of grants for pivotal projects to the EU defense force: every 0.1% of GNI committed to the facility could allow about EUR50bn of grants.

Another option would be issuing common EU bonds for military spending. The EU's joint borrowing began during the Eurozone debt crisis with the European Financial Stability Facility (EFSF) in 2010, issuing bonds to support countries like Greece and Ireland. In 2012, the European Stability Mechanism (ESM) replaced it as a permanent crisis fund, backed by Eurozone members' capital. During the Covid-19 pandemic, the EU launched SURE (EUR100bn) to fund job-protection schemes and the landmark NextGenerationEU (NGEU) (EUR800bn, not yet fully funded) to drive the recovery and green investments, financed through EU bonds, including green bonds. The EU also uses the Macro-Financial Assistance (MFA) for non-EU countries and the Balance of Payments (BoP) facility for non-Eurozone EU states, but these programs are small and negligible in comparison. In total, this has boosted the amount of debt that the EU (or the Eurozone in case of EFSF/ESM) has issued on its own (Figure 8) and has to be taken into account on top of the sovereign government debt issued by member countries.

Figure 8: EU/Eurozone debt outstanding has risen sharply since Covid, bn EUR



Sources: EU, ESM, Allianz Research
Notes: ESM/EFSF debt is legally tied to Eurozone members, as opposed to the rest which is EU member debt. EU bonds and bills are largely used for NGEU financing.

The EU now holds more debt than the Netherlands and is on track to become the largest net issuer in the bloc. Outstanding EU bonds reached EUR840bn at the end of 2024 (including EUR275bn ESM debt which is tied to Eurozone countries), surpassing Dutch sovereign debt. This adds approximately 4pps to the EU's aggregate debt-to-GDP ratio. But the rate of increase in debt is even more eye-catching. Net issuance by the EU has overtaken Italy's and is expected to surpass France in 2025 as significant portions of the NGEU program still require funding. With rising debt levels, investor caution has increased, leading to higher interest rate demands. Comparing yields to 10-year OIS swap rates (ESTR) – the risk-free benchmark reflecting ECB policy rate expectations – reveals a substantial spread widening from around 0bp during Covid to 70bps now (Figure 9).

Figure 9: EU debt outstanding (LHS) overtook NL and net issuance (RHS) higher than IT, bn EUR

Sources: LSEG Datastream, EU, ESM, Allianz Research

EU outstanding debt will rise further on additional NGEU issuance and potentially defense spending, posing a threat to future EU budgets. Remaining NGEU funding will require additional bond issuance of roughly EUR300bn until 2026. If this money is not redirected towards defense, an additional EUR140bn could come on top. While feasible, this also means that the EU will have to make room in its budget for increased debt-servicing budget going forward. A back of the envelope calculation of a total of EUR1trn of debt outstanding at an assumed interest rate of 3% would lead to EUR30bn in debt servicing per year. This is equivalent to a staggering 20% of the EU's 2025 revenues – a sharp rise from virtually zero in 2020, when debt was lower and interest rates close to zero.[1]

Figure 10: EU debt becoming more expensive, spreads versus 10y OIS bps

Sources: Bloomberg, Allianz Research

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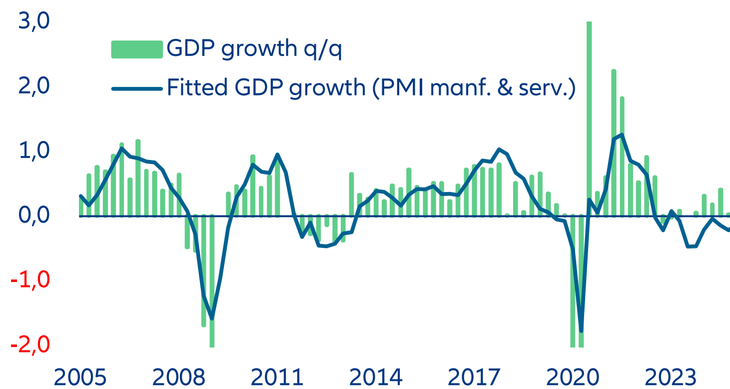
[1] *EUR1trn would be the amount of debt issued by the EU only (i.e. excluding ESM/EFSF) if the remaining NGEU would be funded plus an additional EUR140bn for defense on top.*

While debt financing either using EU or national resources seems plausible in the short run, at some point, a structural solution has to be found either by raising taxes or cutting spending elsewhere. One option would be to raise the VAT in the EU collectively. A back of an envelope calculation would require the average VAT to be raised by around 2.3pps to 24% to finance EUR140bn of annual spending. However, implementing such a substantial VAT rate hike could have significant economic and social implications, potentially affecting consumer spending, business operations and overall economic growth negatively.

An ECB rate cut is certain, but Europe's defense scenarios will shape the terminal rate

The ECB is set to deliver its sixth rate cut in the current cutting cycle amid a bleak growth outlook. At its next meeting on 6 March, the ECB is expected to lower the deposit rate again by 25bps to 2.5%. Economic growth has surprised on the downside, with a low +0.1% q/q in the last quarter of 2024[2] and survey data from purchasing managers (PMI) show still subdued growth in the near term (Figure 11). Geopolitical risks, from looming US tariffs to potential shifts in the Ukraine conflict, continue to cloud the outlook, complicating the ECB's policy path further down the road.

Figure 11: Eurozone GDP growth nowcast remains subdued given PMI data, q/q %

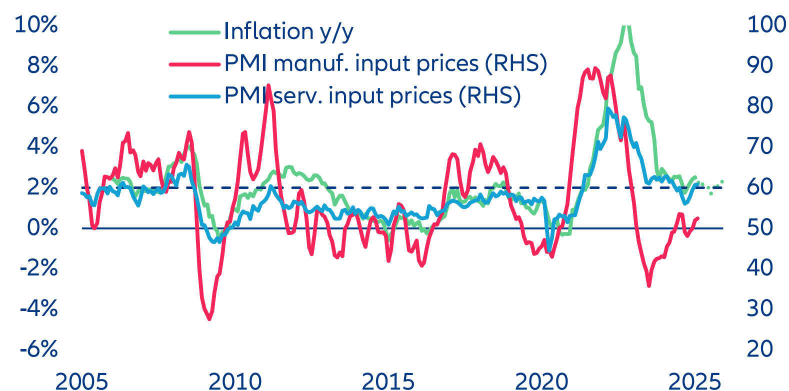


Sources: LSEG Datastream, S&P global, Allianz Research
Note: Fitted GDP growth is a simple regression model based on PMI Manufacturing and PMI Services.

Headline inflation rose to 2.5% y/y in January due to higher energy costs amplified by a weaker euro, but the underlying inflation picture still looks more stable reinforcing our view that inflation will decelerate back toward target in the coming months. Eurozone headline inflation rose to 2.5% y/y in January, up from 1.7% in September last year. Meanwhile core inflation stayed put throughout the same period at 2.7% y/y. The rise in headline inflation was partially driven by unfavorable base effects but also due to the rise in oil and gas prices as well as a weaker euro, which has dropped around 8% since September. This effect alone raises inflation by around 0.2-0.4pp structurally[3]. However, looking at consumer prices sequentially, the picture looks more favorable. The three-month-average change in core prices stands at an annualized 1.9%, below the ECB's target. Leading indicators such as PMI input prices recently inched up but are still hovering around long-term averages consistent with the 2% inflation target. Moreover, wage growth has fallen significantly lately, with the most recent Indeed Wage Tracker reporting a 2.6% rise in January, the lowest number since 2021. As a result, we expect headline inflation to move closer towards the target again in the next months with already the February print dropping likely to 2.2%.

[2] See our report: *Allianz | What to watch I January 31, 2025.*
[3] See our report: *Allianz |What to watch | April 11, 2024.*

Figure 12: Inflation to hover around target going forward, y/y %, index

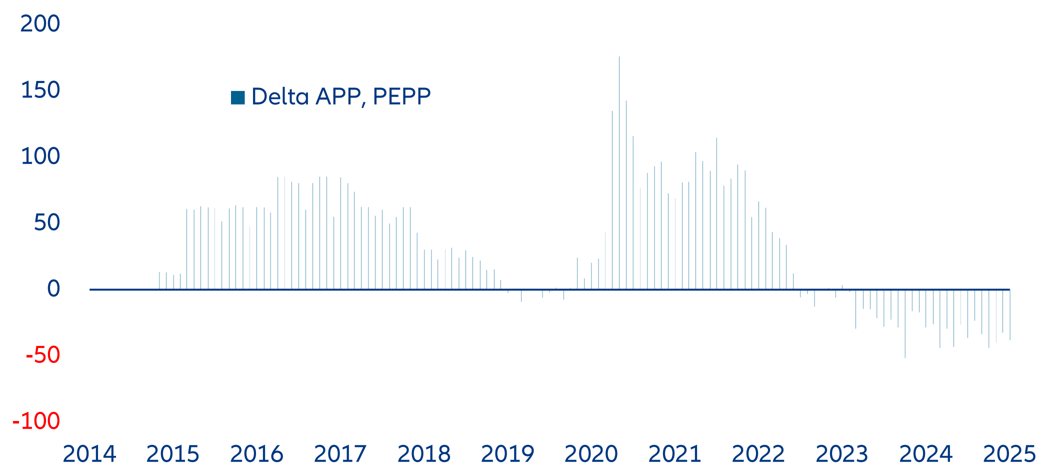


Sources: LSEG Datastream, S&P global, Allianz Research

The monetary policy outlook largely depends on geopolitics, with risks tilted to the downside. Our baseline scenario of an end to the Ukraine war, with higher defense spending and lower energy prices, would translate to higher growth and lower inflation in the near term. This scenario would not change our previous outlook of a terminal rate of 2% to be reached in June (meeting-by-meeting approach) and ongoing quantitative tightening. The scale of higher growth and lower inflation would ultimately depend on the extent to which sanctions on Russia are lifted, and thereby how much oil, gas and electricity prices would drop in Europe (see Table 1). In the downside scenarios of a prolonged war in Ukraine, unchanged energy prices and significantly higher defense spending, we see a more supportive monetary policy stance for two reasons: First, a weaker growth outlook despite the fiscal boost from defense spending as the confidence shock among consumers would outweigh the fiscal boost. A transatlantic divide, the threat of an attack by Russia on Europe and in the worst case a conflict with the US over Greenland would lead to higher precautionary savings and thereby lower consumption and private investment. Secondly, higher fiscal deficits in the scale of 1-2pps would threaten debt sustainability and trigger widening government bond spreads. This might call for the ECB to intervene also quantitatively using its Transmission Protection Instrument (TPI) program, thereby effectively restarting quantitative easing (QE). However, the reluctance to use QE is high, given large losses among central banks in the Eurozone, effectively the result of this monetary experiment[4].

[4] *The Bundesbank has reported a loss of EUR19.2bn in 2024 this week, see Monetary policy measures shape the Bundesbank's balance sheet | Deutsche Bundesbank and an analysis 2024_02_29_what_to_watch.pdf (allianz.com)*

Figure 13: Quantitative tightening expected to continue at around EUR40bn per month, bn EUR



Sources: LSEG Datastream, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS
The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

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