Flash Economics

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The different reactions of long-term interest rates in the United States and the euro zone

The 10-year interest rate on US government debt fell from 4.80% in mid-January 2025 to 4.37% on 27 March 2025. This fall in long-term interest rates is a reaction to the weaker growth forecast and the rise in risk perception, even though inflation remains high and could be increased by the introduction of tariffs, and the US public deficit is very high. It was therefore the reaction to the anticipated decline in growth that dominated the trend in US long-term interest rates.

In contrast, the 10-year interest rate on German public debt rose sharply from 2.36% at the end of February 2025 to 2.77% on 27 March 2025. Other interest rates in the euro zone countries have risen in parallel, while interest rate spreads with Germany have remained stable.

In the euro zone, the ECB is still forecasting inflation close to 2% at the end of 2025 and growth is weak. The rise in long-term interest rates is essentially linked to changes in the rules of fiscal policy: increased military spending not taken into account in the calculation of the public deficit as defined by Maastricht, massive investment in infrastructure in Germany. It is therefore the reaction to the rise in the future public deficit that dominates the trend in long-term interest rates in the euro zone.

The determination of long-term interest rates has therefore been very different in the United States and the euro zone in recent times.

Since the (downward) reaction of long-term interest rates in the United States takes no account of inflation or the public deficit, and since the (upward) reaction of long-term interest rates in the euro zone takes no account of weak growth, we can assume that these reactions are too strong and will be corrected.

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In the United States, expected growth and risk perception dominate long-term interest rate trends

The US long-term interest rate has fallen significantly since mid-January 2025, from 4.80% to 4.37% today (**Chart 1**).

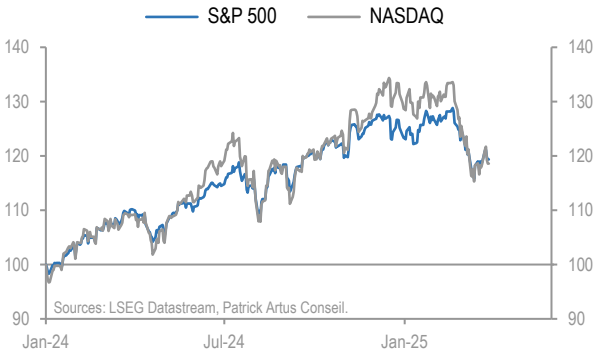
Chart 1
United States: Interest rate on 10-year government bonds (as %)



This fall in long-term interest rates in the United States is a reaction:

- **To the rise in risk perception**, which also explains the decline in the US equity market (**Chart 2**);

Chart 2
United States: Stock market indices (01.01.2024 = 100)



- **To the prospect of a decline in growth**, which can be seen in the fall in the manufacturing and services PMI (**Chart 3**) and the sharp fall in the Expectations index measured by the Conference Board (**Chart 4**);

Chart 3
Euro zone: Manufacturing and services PMI (indices)

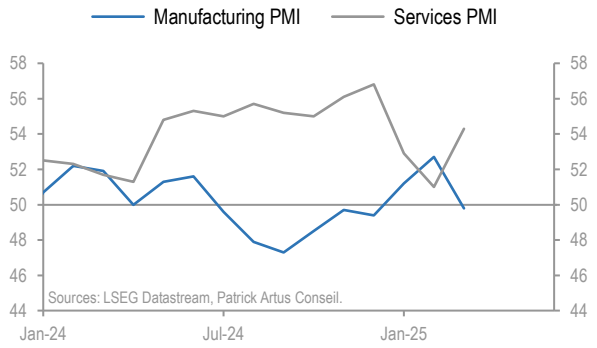
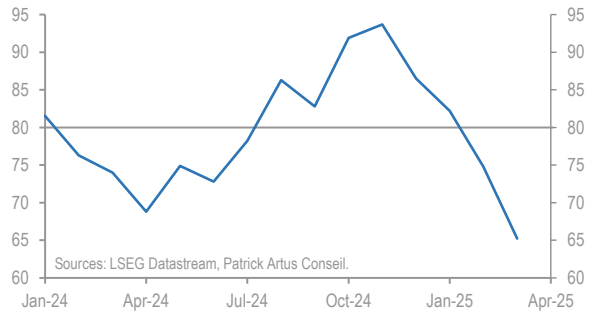


Chart 4
Unites States: Consumer confidence index - Expectations index (Conference Board, 1985 = 100)



However, **underlying inflation remains high** (**Chart 5**), and the public deficit is high (**Chart 6**); it is expected to reach at least 7% of GDP in fiscal year 2025, if we extrapolate the figures for Q4 2024 and Q1 2025.

Chart 5
United States: Core inflation
(CPI excluding food and energy, Y/Y as %)

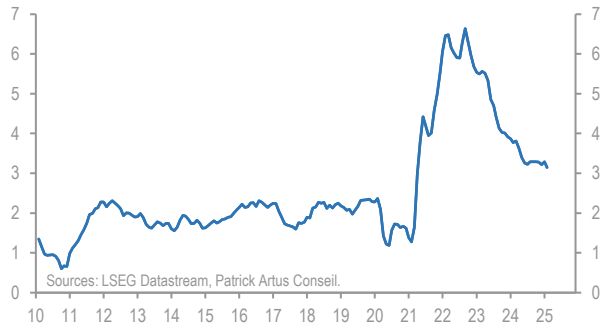
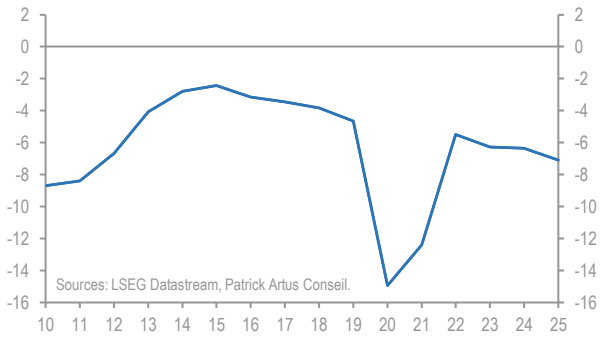


Chart 6
United States: Budget deficit (as % of nominal GDP)



But in recent times, it is the weakening of growth and the resulting rise in risk perception that have dominated the determination of long-term interest rate levels in the United States. We can also see that expected long-term inflation (measured by 10-year inflation swaps) has also fallen since the end of 2024 (**Chart 7**).

Chart 7
United States: 10-year inflation swaps (as %)



In the euro zone, the public deficit is dominating the trend in long-term interest rates

The 10-year interest rate on German public debt has risen sharply, from 2.3% at the end of February 2025 to 2.77% today (**Chart 8**). This sharp rise in the long-term interest rate is not due to any inflation surprises (**Chart 9**), nor to any good news about growth (**Chart 10**).

Chart 8
United States: Interest rate on 10-year government bonds
(as %)

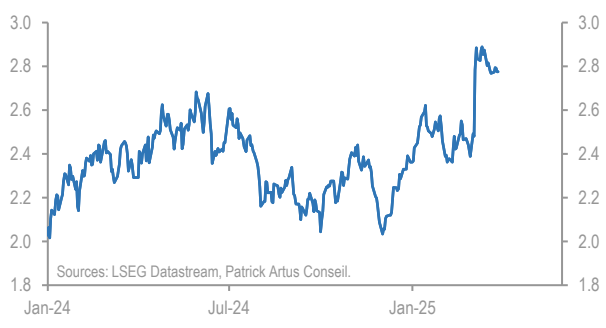


Chart 9
Euro zone: Core inflation
(HICP excl. energy and unprocessed food, Y/Y as %)

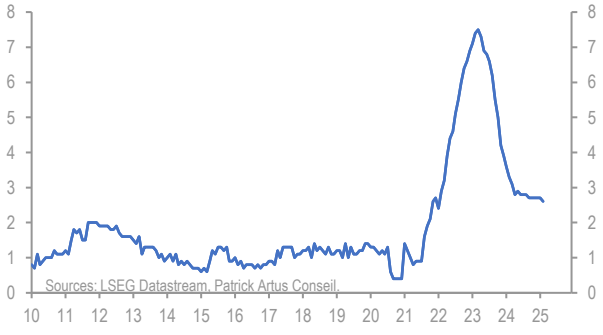
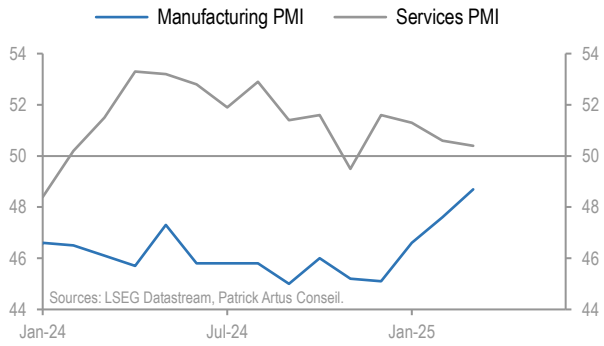


Chart 10
Euro zone: Manufacturing and services PMI (indices)

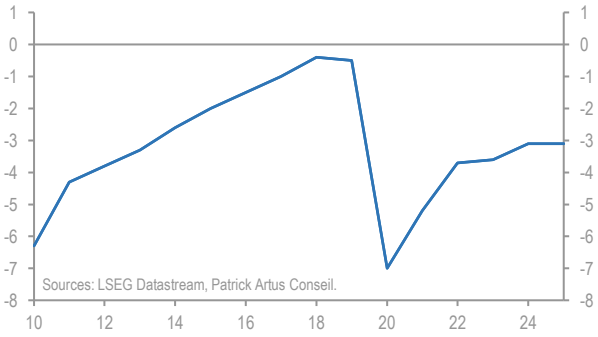


This is due to the revision of the euro zone's budgetary policy. Euro zone countries have collectively decided to increase their military spending (apart from the Baltic States, Greece and Finland, which is low: 2.1% of GDP in 2024 in Germany, France and the Netherlands, 1.6% of GDP in Italy, 1.3% of GDP in Spain), and the European Commission has authorised countries to allow this increase in military spending not to be taken into account when calculating their authorised public deficit (below 3% of GDP).

Germany has decided to implement a major infrastructure investment plan (transport, energy) worth €500 billion over 10 years.

The announcement of a rise in the average public deficit in the euro zone (Chart 11)**, and in particular the announcement that Germany is abandoning the debt brake (Schuldenbremse), are the main cause of the rise in long-term interest rates in the euro zone.**

Chart 11
Euro zone: Fiscal deficit (as % of nominal GDP)



Summary: a very big difference in the response of long-term interest rates in the United States and the euro zone

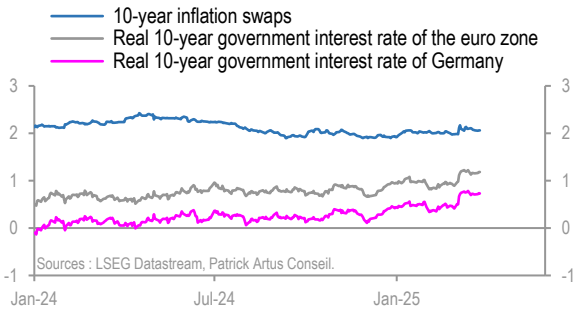
Since the end of 2024, long-term interest rates have reacted:

- Essentially to the expected slowdown in growth in the United States;
- Essentially to the increase in the public deficit expected in the future in the euro zone.

This asymmetry in the determinants of long-term interest rates is surprising, especially as the public deficit and inflation are high in the United States, and growth is weak in the euro zone. **This suggests that the reaction of long-term interest rates (downwards in the US, upwards in the euro zone) is too strong and will be corrected**.

Unlike the United States, expected long-term inflation (measured by 10-year inflation swaps) is stable in the euro zone, **and it is real long-term interest rates that are rising** (**Chart 12**).

Chart 12
Euro zone: 10-year inflation swaps and real interest rate on 10-year government bonds (as %) (deflated by the inflation swap, as %)



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