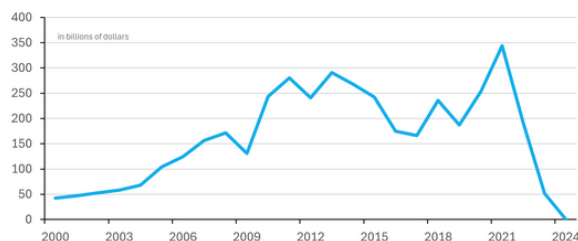


In this edition of the Economic Brief, we explore three key developments shaping the economic landscape: the erosion of European corporate confidence in China, the paradoxical movements in European long-term interest rates, and the implications of Germany's weakening economic status. Let's dive in.

European firms in China: confidence crisis

Global FDI to China



Sources: Macrobonds, Accuracy

Over the past decade, European companies operating in China have seen a marked deterioration in confidence. Once buoyed by low labour costs and vast market potential, firms now face a more hostile environment. According to the EUCCC's annual business confidence survey (European Union Chamber of Commerce in China), analysed by Natixis and Bruegel, foreign direct investment (FDI) flows into China have plummeted to reach a record low of just \$4 billion in 2024, a 29% drop from the previous year.

This crisis of confidence stems from multiple factors:

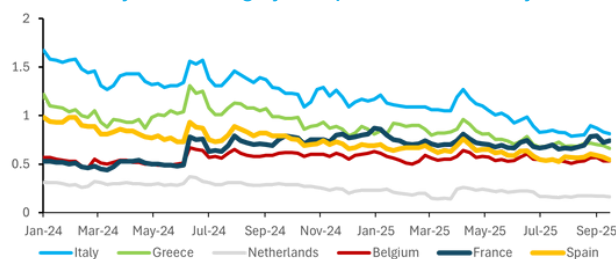
- Macroeconomic malaise: Domestic demand in China is subdued, deflationary pressures persist and competition is intensifying, all of which weigh heavily on profitability and growth prospects.
- Regulatory hurdles: European firms report discriminatory treatment in market access, intellectual property protection and public procurement.
- Geopolitical tensions: Rising diplomatic and trade frictions have amplified political pressure via state mechanisms.
- Operational siloing: Many firms, especially asset-heavy ones like those in the automotive sector, are isolating their Chinese operations from the rest of their global activities – a costly and complex manoeuvre.

Faced with this environment, companies are adopting varied strategies:

- Doubling down: Around one-third plan to expand in China, notably large firms that have already reduced foreign staff.
- Hedging: 15% aim to grow in China while simultaneously shifting operations to other emerging markets.
- Hibernating: Some firms are scaling back despite having the capacity to maintain operations.
- Ready to exit: A striking 30% express intentions to leave China (up from 22% in 2024).

European long-term rates: a misleading calm?

10-year sovereign yield spread with Germany



Sources: Macrobonds, Accuracy

At first glance, the narrowing spread between European sovereign yields and the German benchmark appears encouraging. Italy, for instance, has reached its lowest spread in 15 years, buoyed by a projected deficit below 3% of GDP and modest growth.

However, this optimism may be misplaced. The assumption that Germany remains a safe haven is increasingly under scrutiny. Indeed, rather than reflecting improved risk profiles elsewhere, the narrowing spreads may be reflecting a deterioration in Germany's own economic fundamentals – a sobering twist in the tale.

Germany's weakening anchor

Germany's economic slowdown is no longer just a domestic concern; it's reverberating across the Eurozone. As the traditional anchor of European fiscal and monetary stability, any cracks in its foundation risk undermining broader confidence in the region.

The paradox is clear: while peripheral countries like Italy show signs of fiscal discipline, the core is faltering. If Germany's economic woes persist, the Eurozone may need to rethink its assumptions about stability risk, and resilience.