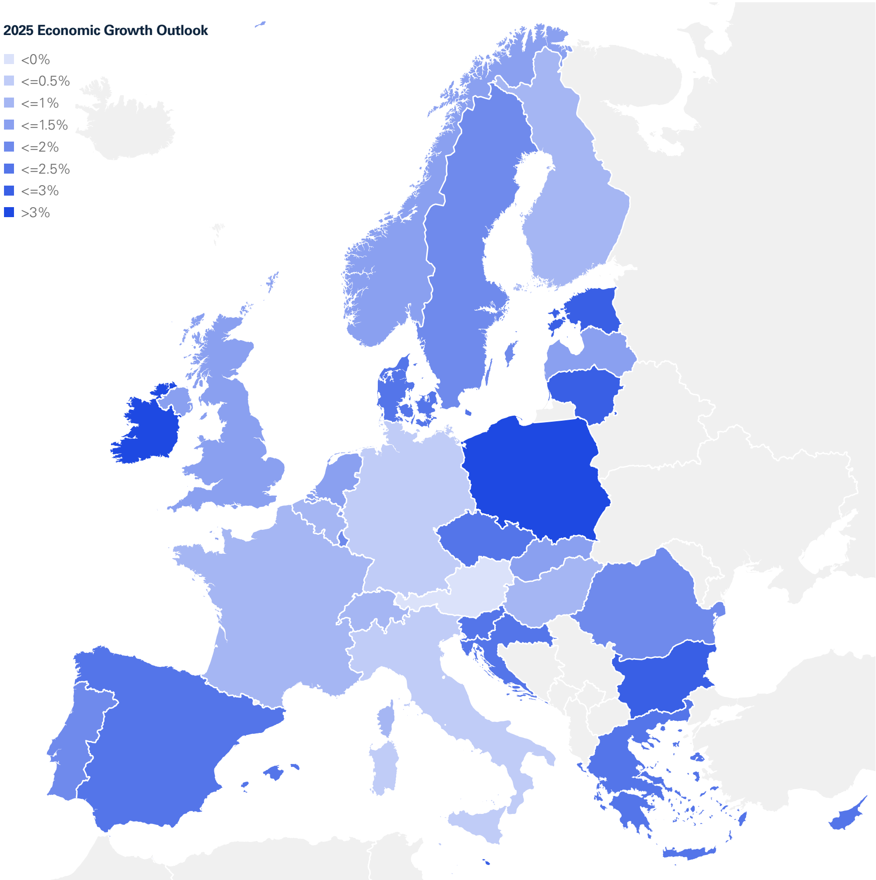
European Economic Outlook

Spring 2025

Europe faces a modest growth outlook in the short term, as uncertainty weighs on business investment and consumer confidence, with GDP in the Eurozone expected to increase by around 0.9% in 2025 and 1.1% in 2026.

The economic picture is mixed, however, with subdued overall growth masking divergent performance across the continent. European economies are shaped by differences in economic fundamentals such as sectoral mix and labour force characteristics, as well as fiscal constraints and exposure to current geopolitical headwinds (see Chart 1). Weak momentum is contributing to the continued fall in inflation with further interest rate cuts expected this year.

Chart 1: Europe faces diverging growth prospects



Source: KPMG projections.

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Growth outlook for Europe is mixed

There are a number of growth hotspots across the region. Spain has been a standout performer – where growth has been driven by resilient domestic demand, strong tourism inflows, and EU-funded investment in infrastructure and green energy. As a result, strong job creation and steady wage growth have helped support consumption despite tighter monetary conditions. However, as tourism spend returns to more normal levels and the stimulus from EU-funded investment tapers off, Spain's outlook is expected to moderate somewhat in the medium term.

Many of the Central and Eastern European (CEE) economies are also expected to continue growing at above-average rates, driven by strong domestic demand, wage convergence with the EU average, and nearshoring trends. EU funds have been supporting large-scale public investment, particularly in transport and energy. However, inflationary pressures remain elevated in some CEE countries, requiring careful monetary policy management.

Lower inflation provides space for most central banks to cut rates

The ECB is expected to cut rates in the second half of 2025 as inflation returns closer to its 2% target. Lower energy prices, weaker demand owing to global uncertainty, and increased competitiveness in domestic markets are set to exert downward pressure on headline inflation.

Eurozone inflation is expected to ease further and average around 2.1% this year, down from 2.4% in 2024. Services inflation is also falling, which will be reassuring for ECB policymakers who have previously expressed concerns about its persistence. Other major central banks are expected to continue loosening policy during this period, with the Bank of England expected to bring rates to 3.25% by the end of 2026 despite the recent spike in inflation.

Consumer demand takes lead role in driving growth

Declining interest rates should support a stronger pace of consumption growth across the continent. Stronger real wage growth continues to drive robust improvements in household incomes across most European countries, as the labour market remains supportive. However, a large part of the growth in income has been channelled into higher savings, leading to a weaker pace of consumption growth in parts of Europe alongside steady increases in saving ratios.

As interest rates decline and reduce household returns on saving, rising incomes may translate into a faster pace of consumption growth. This is likely to be the main driver of expansion in the Nordic countries as trade frictions create headwinds to external demand. Denmark for example, has shown solid growth helped by the activities of multinational companies and the reopening of the gas deposits at Tyra Field.

Likewise, solid domestic activity and strength in services exports should continue to support growth in Ireland. However, this may not be sufficient to offset the risk of external shocks tied to the multinational sector. Alongside Germany, Switzerland, Denmark and Belgium,the Irish economy remains particularly vulnerable to US trade policy uncertainty due to a heavy reliance on pharmaceutical exports.

On the other hand, tight fiscal rules and relatively weak productivity growth could constrain growth in France and Italy. While robust growth in household disposable incomes could help support consumer spending, further headwinds arising from ongoing uncertainty on US trade policy could see growth of less than one percent throughout 2025 and 2026.

Geopolitical pressures weigh on growth prospects

A number of manufacturing-oriented economies, especially the economies of central and eastern Europe, are facing headwinds from automotive tariffs imposed by the US. This alongside an ongoing downturn due to loss of competitiveness and elevated energy costs, has led to a continuing weak growth outlook in **Germany** and **Austria** in 2025. However, forecasts for 2026 have been revised upwards, partly due to the potential impact of higher defence and infrastructure spending in driving momentum in the manufacturing sectors in these countries.

Elevated global uncertainty is likewise having a damping effect on growth in **Switzerland**. With low inflation and base rates already nearing the lower bound, the space for rate cuts by the Swiss National Bank is limited. While the recent appreciation in the Swiss franc and rising global trade frictions could erode the competitiveness of export industries, a modest pace of growth is likely to be sustained on the back of growth in consumer spending.

While the direct impact of trade deals on the **United Kingdom** economy is likely to be small, the US deal has the potential to ease some trade related uncertainty. In addition, supportive fiscal and monetary policies should contribute to a modest acceleration in growth this year.

Table 1: KPMG forecasts for real GDP growth

	2024	2025	2026
Belgium	1.0	1.0	1.2
France	1.1	0.6	0.8
Germany	-0.2	0.1	1.1
Italy	0.5	0.5	0.6
Netherlands	1.0	1.1	1.1
Norway	0.6	1.1	2.6
Spain	3.2	2.5	1.8
Sweden	0.9	1.9	2.3
Switzerland	1.3	0.9	1.2
United Kingdom	1.1	1.2	1.1
Ireland	1.2	3.3	1.4
Poland	2.9	3.3	3.2
Austria	-1.3	-0.1	1.2
Denmark	3.7	2.3	1.8
Portugal	1.9	1.7	2.3

Source: National Statistical agencies and KPMG projections.

Figures for Norway refer to growth in mainland GDP. Forecasts do not include a potential increase of general US Steel and Aluminium tariffs from 25% to 50%.

Global headwinds put European resilience to the test

The European economy is facing a relatively modest growth outlook in the short term but the headline figures mask important variations. Southern and Eastern European economies such as **Spain** and **Poland** are performing strongly, thanks to robust domestic demand, targeted investment, and solid labour market performance.

In contrast, many core economies continue to face structural and fiscal constraints that could limit their growth. Global trade tensions, monetary policy adjustments, and defence spending priorities will shape the path ahead. For businesses, understanding these country-level dynamics is essential to identifying risks and opportunities in Europe's evolving economic landscape.

Trade outlook offers a limited upside

After nearly a century of tariff reductions and trade liberalisation, new tariffs imposed by the US this year have worsened recent trends of escalating trade frictions. Announced changes in trade policy have often been followed by short term reprieves, creating large swings in the applied rate of tariffs and amplifying the level of uncertainty for businesses.

The high degree of uncertainty on the course of US trade policy creates a multitude of potential scenarios for the evolution of trade frictions, with potential for both upsides and downsides on economies.

A negotiated US deal can pave the way to an upside scenario

An upside scenario hinges on the ability of the ongoing negotiations to reach a compromise that allows a reduction in US tariffs, although negotiations are unlikely to lead to a return to the tariff levels seen in 2024.

In the upside scenario we modelled, the US maintains a minimum import tariff of around 10%, with exceptions covering a limited range of goods exports, in return for some concessions. The deal that the US reached with the UK provides a potential framework for what the US may be seeking to accomplish in negotiations with other trading partners. The UK has secured tariff reductions across automotive, steel and aluminium sectors in return for concessions on ethanol and beef exports from the US. The UK deal also introduced a novel provision to maintain the security of supply chains for steel and aluminium products, potentially creating an additional hurdle for UK exporters seeking to sell into the US but crucially maintained a general 10% tariff level on UK exports to US.

Similar deals with other US trading partners, including those in Europe, are likely to take longer, potentially taking beyond the 90-day tariff pause. Furthermore, the scope of any concessions reached in these negotiations in return for an easing of the tariff regime remain unclear, potentially adding another source of uncertainty for businesses.

Initial reports have indicated that the EU have put forward a proposal to increase the volume of EU imports of energy and agricultural products, similar to past agreements with the Trump administration. Other potential concessions to the US could feature agreements on corporate tax levels, as well as levels of inbound EU tariffs. Depending on the shape of a deal between the US-EU, the impact on affected economies may vary from our scenario below.

Overall, we expect the impact of any upside scenario on economic growth in Europe to be limited. Both the relatively modest easing in tariff measures compared to the existing status quo and the high degree of uncertainty that exists in any scenario means the impact on GDP growth is likely to be small, with less than 0.1% uplift across Europe (see Chart 2 for details).

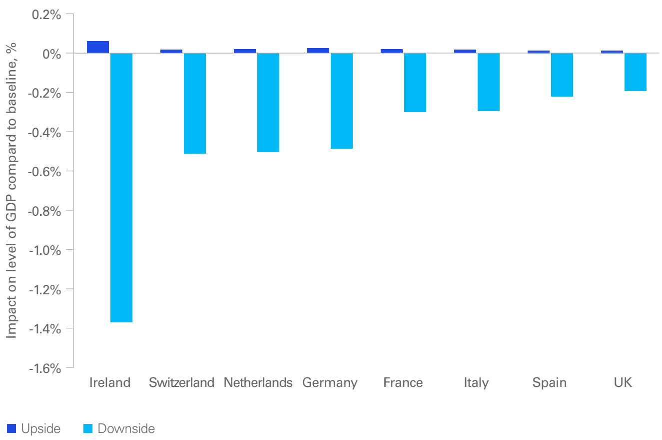
Renewed escalation of tariff measures could cause significant damage to growth

A failure of negotiations could give rise to a potential escalation of tariff measures, leading to the re-imposition of US reciprocal tariffs. The downside scenario we modelled includes the imposition of a 25% tariff rate on US imports of pharmaceuticals globally, which would be particularly damaging to the economies of **Switzerland** and **Ireland**. Such a scenario could see the level of GDP in 2026 down by 1.4% in **Ireland**, as well as 0.5% lower in **Switzerland, the Netherlands** and **Germany** compared to our main scenario where tariffs remain at the current 10% level (see Chart 2).

In a scenario where the EU faces a potential 50% tariff from the US, the impact is increased, such that the reduction to the level of GDP in 2026 could range from 1.8% in Ireland to 0.6% in Spain.

The UK already has a trade deal with the US and therefore we assume in our downside scenario that it avoids the direct impact of the escalation. However, it would still feel the impact of supply chain disruptions and a general economic downturn, which is likely to create an additional drag on economic growth.

Chart 2: Impact of alternative tariff scenarios on GDP



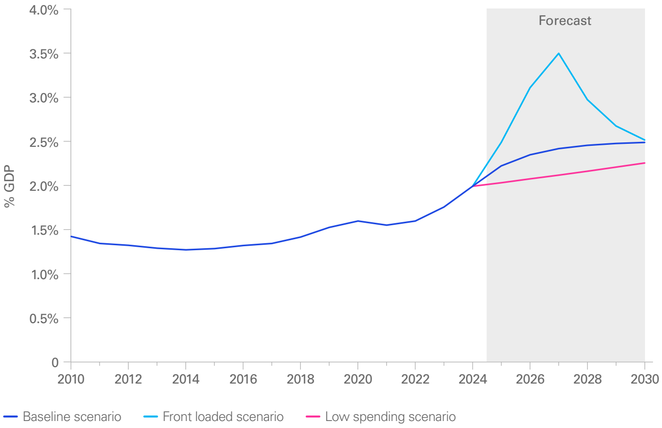
Source: KPMG modelling based on Oxford Economics Global Economic Model.

European defence outlook

A changing geopolitical environment is driving a shift in European defence spending, with governments across the continent announcing plans to devote higher level of funding.

There is ongoing uncertainty regarding the pace and size of future spending commitments, represented across three potential scenarios (see Chart 3). In all three scenarios, the bulk of the initial increase in spending is allocated towards purchasing equipment, which gradually transitions towards a larger share of day-to-day spending.

Chart 3: Scale of defence spending increase will depend on fiscal trade-offs governments make



Source: SIPRI, Oxford Economics, KPMG analysis.

Initial military build-up could be covered by higher borrowing

As the initial key goal of the increased defence spending plans will be to upgrade and replenish dated defence equipment, this aligns to higher borrowing to pay for this increase. Recent announcements have focused on debt instruments as a way of facilitating higher outlays on defence. The European Commission announced a EUR150 billion loans scheme which can only be spent on procuring defence equipment, while the German Parliament approved a EUR500 billion package for infrastructure and announced that defence spending above 1% of GDP would be exempt from the country's debt brake.

Given the space provided by additional borrowing, spending could potentially be ramped up more quickly than the gradual uplift assumed in our baseline scenario which sees defence spending rise at a gradual pace towards its long-term level. The alternative front-loaded scenario illustrates a rapid increase in defence spending where governments make full use of the available financing schemes. Defence spending rises to a peak of 3.5% in 2027, financed through higher borrowing amounting to an additional EUR1.5 trillion spent on defence, compared to EUR700bn in our baseline.

Fiscal pressures could mean that any long-term increase in defence spending is relatively modest

After the initial period of higher procurement spending, an increasing share of overall spend is likely to consist of day-to-day spending, with the share of equipment expenditures falling towards the NATO guideline level of 20%. Continuing to use debt as a way of funding the additional spending on defence would therefore lead to an unsustainably higher level of current deficits.

The nature of the fiscal arithmetic means that in the long run, defence spending has to compete with other public sector priorities. An already- high tax burden may limit the scope of any potential additional revenues. In addition, the backdrop of relatively weak growth coupled with rising age-related spending commitments and the energy transition, may limit the extent to which governments can sustainably raise defence spending. Defence expenditure could settle at around 2.5% of GDP in both the baseline and front-loaded scenarios. Our low spending scenario represents a more acute trade-off, which limits defence spending to just 2.25% of GDP by 2030.

Near term economic impact will be small but long-term gains could be unlocked if accompanied by higher R&D spending

Increased defence spending could have positive implications for economic activity, adding around 0.3 percentage points (p.p.) to Europe's GDP by 2030 in the baseline scenario and front-loaded scenarios and 0.1 p.p. in the low spending scenario. However, in the front-loaded scenario we anticipate a temporary surge of spending, which adds as much as 0.9 p.p. of GDP in 2027. The scale of the impact could increase further if a larger share of increased spending is channelled towards domestic producers, although this may require a period of investment to ramp up industrial capacity.

A potentially more lasting effect on economic growth could arise from higher spending on defence Research and Development (R&D). In 2024, the US allocated around 10% of its defence budget on R&D expenditure, compared to 4% in the EU. To match the US, the EU would need to increase its R&D budget by roughly EUR90 billion over the next 5 years. This could help unlock synergies and positive spillovers for dual-use technologies, as well as research-intensive defence subsectors such as aerospace, cybersecurity, advanced robotics, and autonomous drones.

Deal activity in the defence sector could rise over the coming years but longer-term challenges for the sector remain

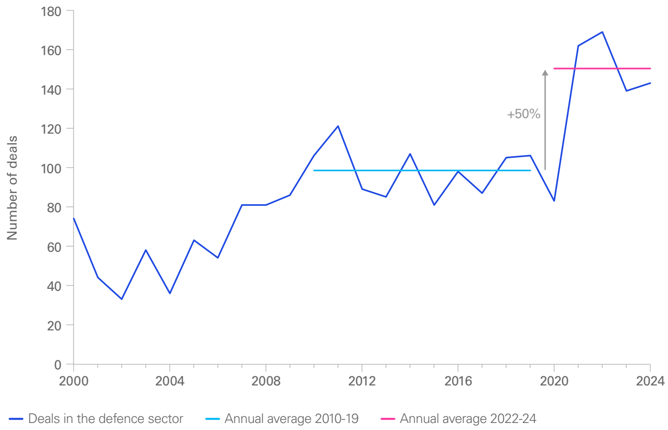
The increase in geopolitical tensions in Europe has been a key catalyst for the increase in deals activity across the European defence sector. Deals activity in the European defence sector has increased significantly since 2022. The average number of deals completed per year in Western Europe has risen by more than 50% since 2022 when compared to the period between 2010-19 (See Chart 4).

With defence budgets continuing to rise, coupled with increased clarity on funding plans over the near term, we expect deal momentum to accelerate further. Alongside the announced increases in defence equipment spending, European governments have also signalled their commitment to increasing spending in security related infrastructure including improving cyber resilience and the protection of green energy assets which are vulnerable to sabotage. Given this, we expect subsectors closely related to defence such as cybersecurity, logistics and infrastructure, to be key beneficiaries of increased activity.

Nonetheless, despite the expected increase in funding, the sector faces several key challenges. Unlike the more unified US defence sector, Europe's defence sector is fragmented, with procurement handled primarily at the national level rather than through a coordinated EU approach. This fragmentation limits firms' ability to achieve economies of scale in production and drives up costs across the industry. Without large, shared orders across countries, manufacturers cannot produce in bulk or standardise equipment, which makes each unit more expensive to design and build.

A lack of patient funding poses a further challenge for the European defence sector as it constrains the ability for long-term planning. US defence firms benefit from large, multi-decade contracts with a single procurer, providing a stable pipeline of work. In contrast, European firms face shorter-term, dispersed contracts from multiple procurers. Without a predictable flow of contract work, this constrains long term investments and innovation in cutting edge technologies. In order to bridge this gap, the increase in funding may need to be accompanied by policies which aim to simplify procurement processes in Europe and encourage greater cross border collaboration between defence firms.

Chart 4: Deals activity in Western Europe's defence sector has risen since 2022



Source: LSEG Datastream, KPMG analysis.

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