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European Economic Outlook

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October 2025

- Eurozone's growth outlook remains below potential, with GDP growth expected to reach 1.2% in 2025 and 1% in 2026.
- Relatively strong labour market and lower interest rates may not be sufficient to entice households to increase spending, with low consumer confidence potentially pointing at savings ratios remaining relatively high.
- Stronger emphasis on growth and defence could see public spending taking a bigger role in supporting economic growth in the short-term, although high government debt levels will require further fiscal consolidation in the medium-term.
- Inflation remains near target across Europe, with Eurozone inflation expected to fall below the European Central Bank (ECB)'s 2% by the end of 2025.
- European central banks are nearing the end of their rate cutting cycle, with a potential one more interest rate cut from the ECB, Swiss National Bank (SNB) and the Riksbank.
- While uncertainty around trade is potentially diminishing, US tariffs could see EU growth on average 1% lower by the end of 2026.
- More than a year from the publication of Draghi's report, Europe's competitive position continues to deteriorate.

Table 1: KPMG projections for the Eurozone economy

	2024	2025	2026
GDP growth	0.8	1.2	1.0
Consumption growth	1.2	1.2	1.3
Investment growth	-2.1	2.2	1.4
Unemployment	6.4	6.3	6.2
Inflation	2.4	2.1	1.7
Base interest rate	3.0	1.75	1.75

Source: KPMG projections using Oxford Economics' Global Economic Model.

Annual average growth rates, except for unemployment and inflation which is average annual rate. Inflation is measured as HICP. Base Interest Rate is the deposit facility rate for the ECB at the end of the calendar year.

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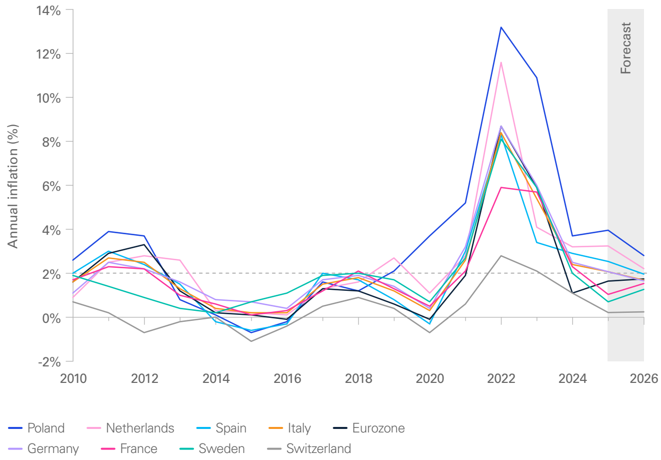
Outlook for Europe's economy

Europe's growth outlook remains below potential, with household spending and increased public investment expected to underpin medium-term growth. While the effects of the rise in public spending are likely to be unevenly distributed across the region, as national priorities, sectoral exposure, and capacity vary significantly across European countries, trade tensions and policy uncertainty continue to weigh on the short-term outlook.

Inflation remains near target across Europe as central banks appear close to concluding the current interest rate-cutting cycle. In the Eurozone, headline inflation rose to 2.2% in September – driven by a volatile energy component – while core inflation remained unchanged. Underlying price pressures, particularly in services remain elevated, but are expected to moderate in the near term as consumer caution and weak growth weigh on domestic demand (see Chart 1).

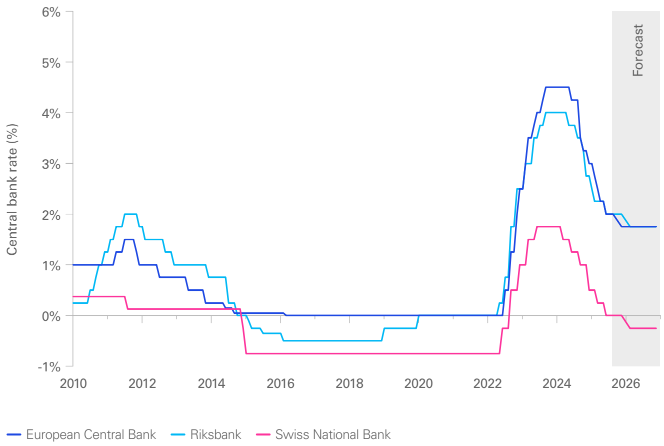
We expect **Eurozone** inflation to fall further, potentially dipping below 2% by year-end. This would likely prompt one final rate cut from the ECB in December, bringing the deposit rate to 1.75%. In **Switzerland**, services remain the main source of price pressure, however, the recent appreciation of the franc has weakened export demand and contributed to deflation in imported goods prices. With inflation remaining low at 0.2% in September, the SNB may consider a further rate cut, potentially pushing base rates below zero (see Chart 2).

Chart 1: Inflation nears target, but varies across the region



Source: Eurostat, KPMG projections.

Chart 2: Europe's central banks are nearing the end of the rate-cutting cycle



Source: Bank of International Settlements, KPMG projections.

European labour markets remain resilient despite recent weak growth and heightened uncertainty, with unemployment rates below pre-Covid levels across many economies (see Chart 3). However, labour market strength may be put to the test as weak external demand and trade tensions weigh on business earnings.

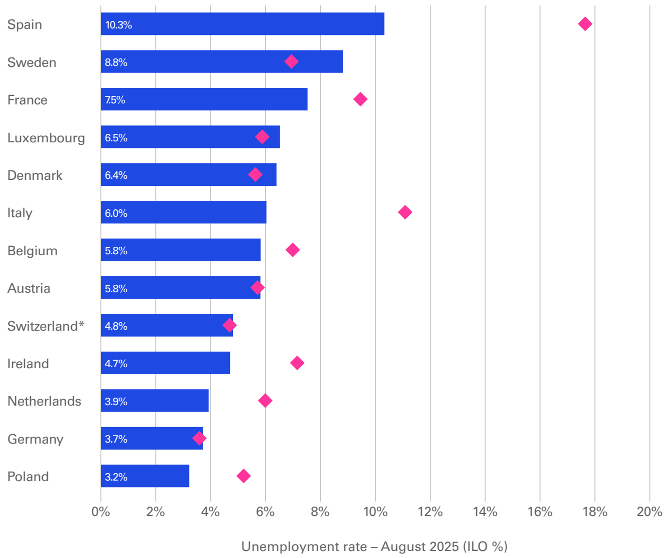
While consumer demand has been the primary driver of growth, the outlook is mixed. Households' savings rates have risen significantly since Covid (see Chart 4). As lower interest rates make their fuller impact on households' finances, and lingering policy uncertainty diminishes further, households' savings ratio may also decline. While we expect savings ratios to remain above the pre-Covid average, reflecting relatively higher interest rates across the region, the fall in savings intentions could still provide some support to consumer spending. Nevertheless, weak consumer confidence suggests that the higher savings preference may endure.

Rising caution on the part of consumers could hold back consumption growth in countries such as **France** where savings rates are significantly higher than their pre-Covid average. **Spain** continues to perform well, partly shielded from the impact of higher US tariffs due to its sectoral composition, although Spanish unemployment remains structurally elevated. While in **Italy**, strong job creation and increased working hours are supporting consumption despite weak growth in real wages.

As consumer spending takes more of a back seat in driving European growth, public spending is expected to take a more prominent role in the short-term, although public funds may prove more constrained in the longer-run given the fiscal position of many economies.

The majority of public spending will be determined by the fiscal room in each country. The **German** government announced a significant increase in spending in its latest Budget, focusing on infrastructure and defence, with potential spillover benefits for closely linked economies such as **Poland** and **Hungary**, although implementation delays are likely to limit the scale of the impact in 2025/26. See further discussion of the outlook for fiscal spending below.

Chart 3: Labour markets remain resilient despite recent weak growth

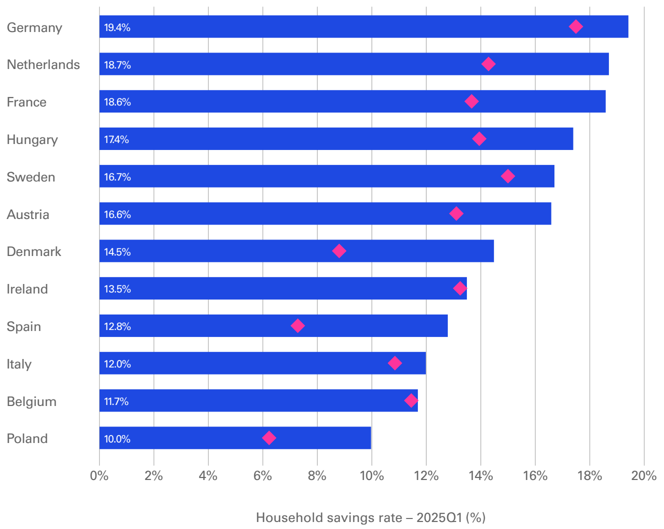


◆ 2015-2019 average

Source: Eurostat, KPMG analysis.

* Switzerland unemployment is from June 2025.

Chart 4: Household saving rates are elevated



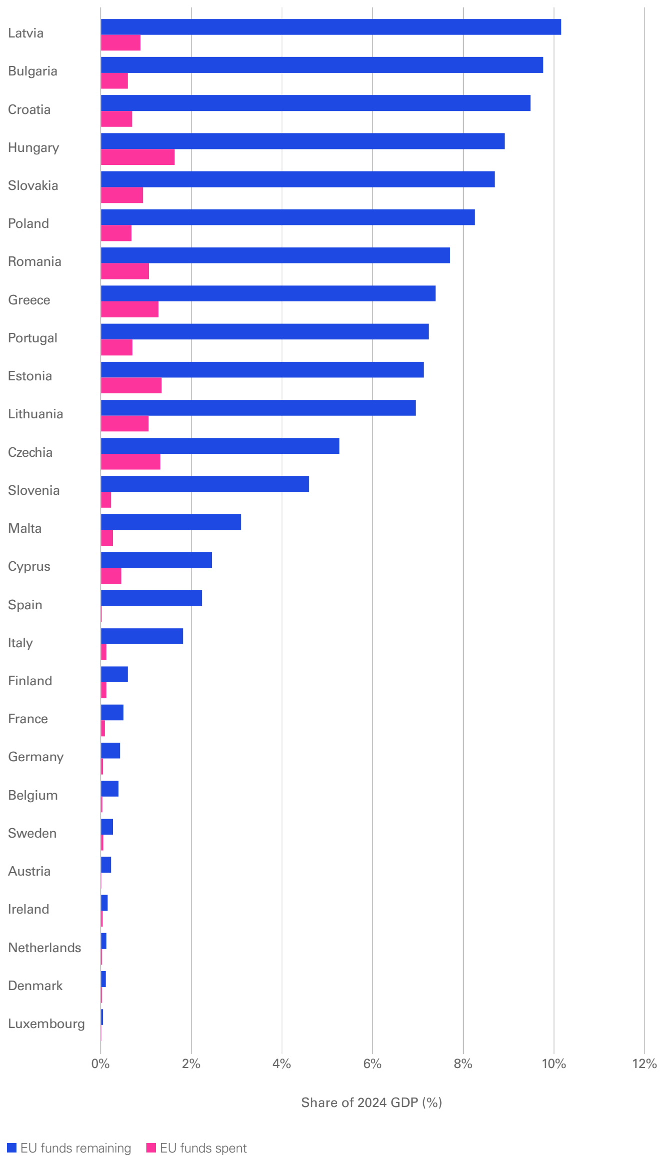
◆ 2015-2019 average

Source: Eurostat, KPMG analysis.

With the current EU multiannual financial framework ending next year, we expect an acceleration in the rate of EU fund spending, particularly in **Spain**, **Italy**, and **Poland** – countries with large allocations but slow disbursement to date. Proportionally, however, it is the smaller largely central and eastern European economies that may see the biggest relative boost to growth (Chart 5).

Meanwhile, uncertainty around trade policy – especially affecting pharmaceutical-heavy economies like **Switzerland** – is dampening business outlook. With the outcome of Section 232 investigation unclear, investment in affected sectors is likely to remain subdued. We discuss some of the broader implications of changing trade relations below.

Chart 5: Disbursement of EU funds expected to pick up in 2026 ahead of the end of the 2021-2027 MFF



Source: Cohesion open data portal, Eurostat, KPMG analysis.

Trade headwinds to persist

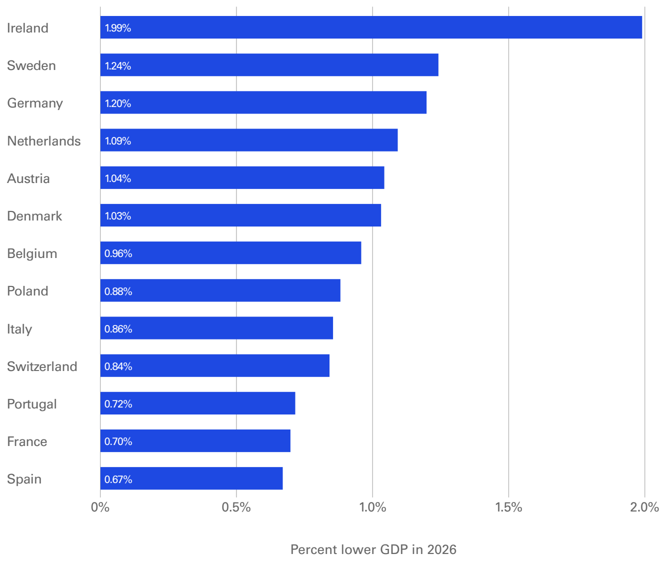
Growing frictions in international trade show a departure from a century long pattern of declining tariffs and trade liberalisation, with the effective tariff in the US rising from 2.4% to 17.4% so far this year[1], although the actual rate may be somewhat lower due to special dispensations agreed.

Trade deals already announced resolve some of the ongoing uncertainty but imply higher tariff rates than those that prevailed at the start of the year. The EU-US trade deal saw tariffs increase to 15% on most EU exports to the US, whilst steel, aluminium and copper remain at 50%. For some sectors, such as automotive, this represents a tariff reduction, from the 25% tariff rate which had been in place since February.

Overall, KPMG estimates suggest tariffs announced so far could reduce EU GDP by up to 1% by the end of 2026, with countries such as **Ireland** being disproportionately impacted given their large exposure to the US economy (see Chart 6). **Switzerland** faces a steep 39% tariff on exports of most goods to the US, although announcements exempting gold bars and all pharmaceuticals at this stage dampen the overall severity.

The timing of tariff announcements has led to a frontloading of exports to the US in the early part of the year. Global goods trade has since slowed and is estimated to have risen by only 0.3% in the year to July[2], whilst EU-US goods trade fell by 4.4%[3] over the same period.

Chart 6: Our estimates suggest EU GDP will be approximately 1% lower due to tariffs by 2026



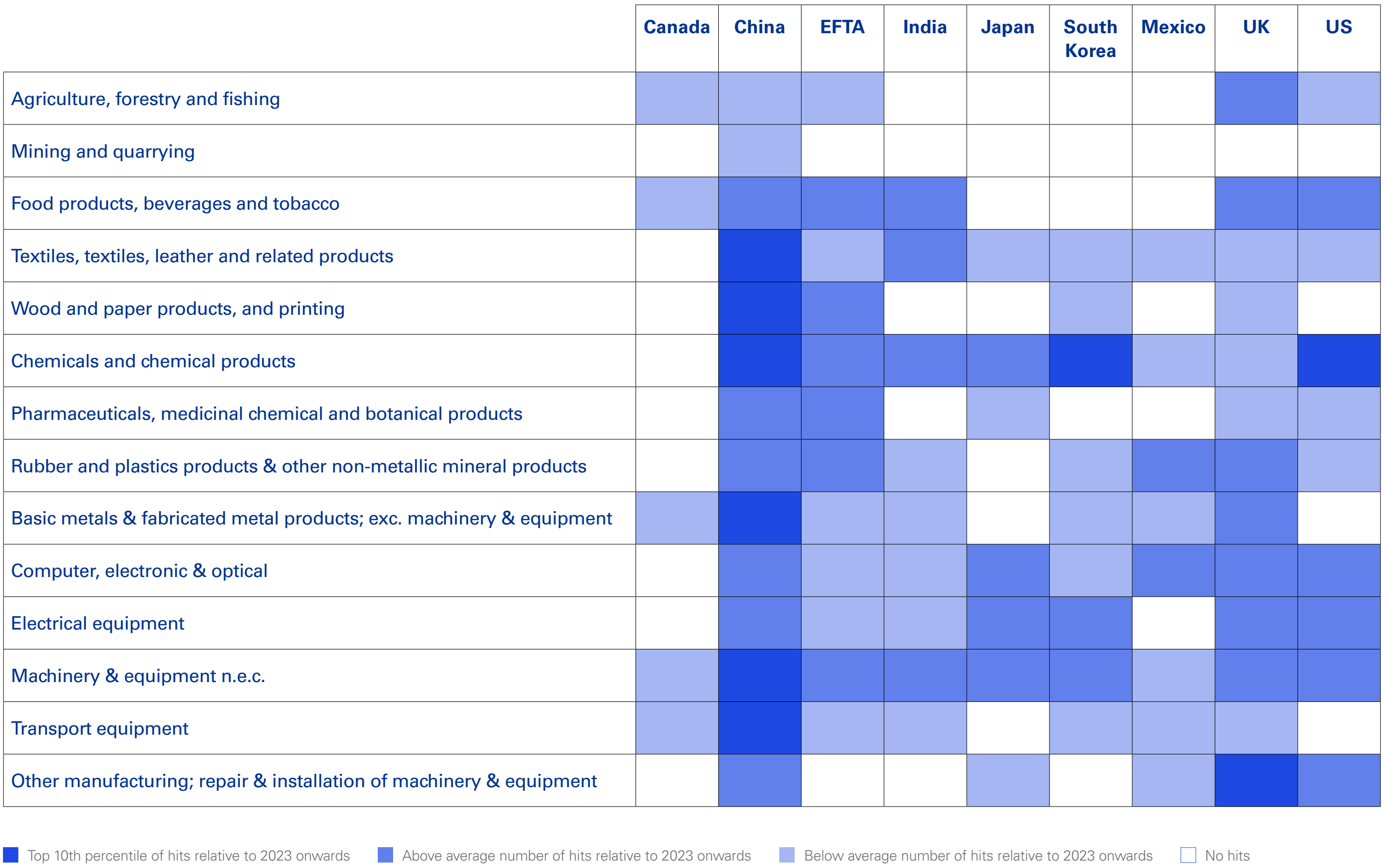
Source: KPMG estimates using the Oxford Economics Global Economic Model. We assume the 15% tariffs as agreed in EU-US trade deal and latest exemptions; non-generic pharmaceutical products are subject to a 15% tariff from Q3 2025.

1 State of U.S. Tariffs: September 4, 2025 | The Budget Lab at Yale.
2 Trade Monitor | PortWatch.
3 Database – International trade in goods – Eurostat.

High tariffs on some of US trading partners could impact trade flows to other destinations, causing further realignment of global trade, and potentially increase import flows to Europe. China is one of the countries that could be at the centre of changing global trade flows, given its role as a major exporter and the large increase in tariff it faces from the US. Indeed, Chinese exports to the EU rose by 12% in the seven months to July 2025 compared to the previous year, with notable increases observed in the imports of pharmaceuticals (121%), iron and steel (19%) and aluminium (22%)[4]. The European Commission import surveillance task force monitors early signs of potential trade diversion, with results suggesting increases in imports from China across a broad range of goods categories (Chart 7).

Chart 7: Initial signs that trade diversion is taking place

Preliminary indicators pointing to increases in imports from China.
Sectors and partners with significant increases in imports and reductions in price:



Source: European Commission import surveillance task force.

Note: A hit is generated for each HS8 product code when a good that is produced within the EU, and has a minimum value of imports experiences at least a 5% increase in quantity imported and 5% decrease in price in the given month.

4 Iron and steel sector is defined as HS2 codes: iron and steel and articles of iron or steel. Aluminium is defined as HS2 code Aluminium and articles thereof.

Fiscal outlook

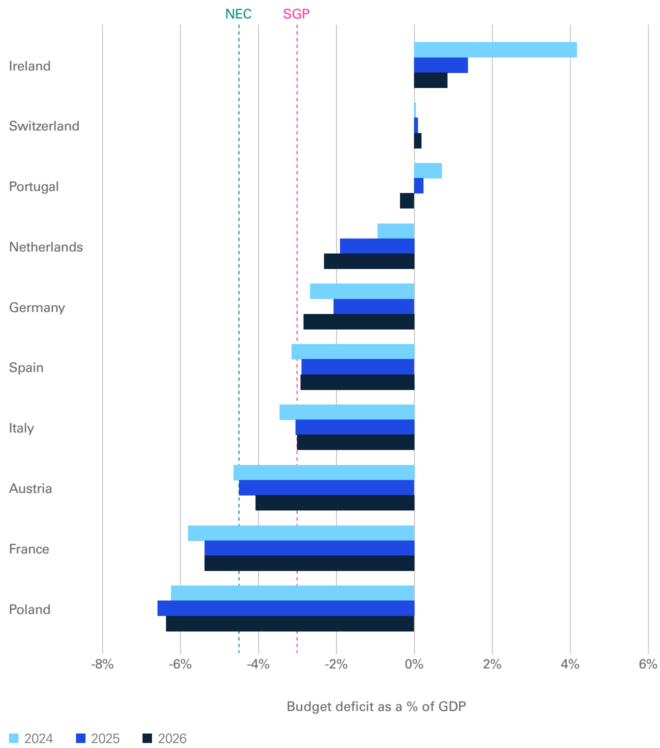
The fiscal outlook across major EU economies is increasingly shaped by the tension between short-term stimulus – particularly to meet NATO defence spending targets – and long-term fiscal sustainability (Chart 8). While several member states are ramping up investment to support growth and strategic objectives, others are tightening budgets to reduce deficits and comply with EU fiscal rules.

Public finances across Europe are under strain from rising spending demands and higher debt servicing costs, increasing pressure for medium-term debt sustainability and fiscal consolidation. In June, NATO members pledged to raise defence spending to 5% of GDP by 2035, with 3.5% earmarked for core defence and up to 1.5% for broader security-related expenditures. While dual-use infrastructure may count toward the latter, meeting the 3.5% core target will likely require additional investment in the coming years. At the same time, ageing populations are driving up demand for health and social care, further burdening already stretched public healthcare systems, as well as raising the costs of state pension provision.

Germany's 2026 Budget represents the largest shift to higher public investment, supported by a EUR 500 billion infrastructure fund, to be spent over the next 12 years, and exemptions from the debt brake for defence spending. Investment is said to reach EUR 126.7 billion in 2026, supporting short-term growth and helping Germany meet its NATO target of 3.5% of GDP in defence spending by 2029. However, delays in procurement and delivery of these ambitious plans may limit the impact on growth this year, while significant cuts to non-military spending may be required in the medium term to meet longer term fiscal goals.

In **France**, the incoming leadership faces the challenge of securing parliamentary support for a revised fiscal package, scheduled for presentation in early October. The lack of political consensus is likely to constrain efforts to implement significant fiscal consolidation.

Chart 8: Limited fiscal space constrains policy in some European counties



Source: European Commission, KPMG projections.

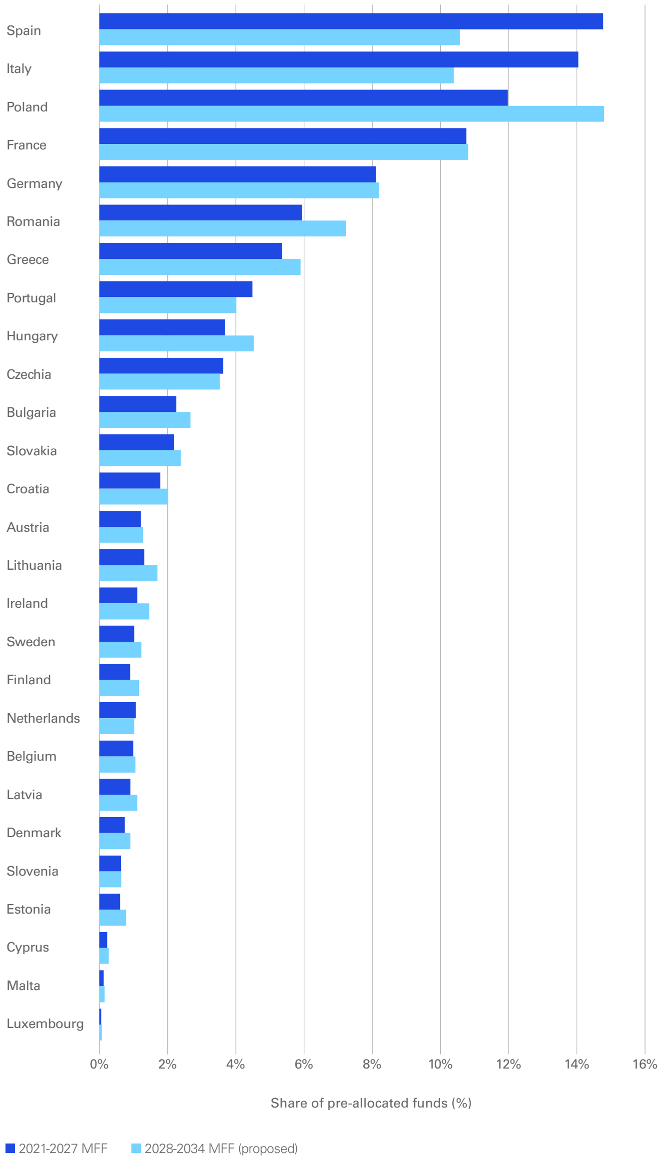
Note: Switzerland is not subject to EU fiscal rules. Stability and Growth Pact (SGP) mandates the budget deficit cannot exceed 3% of GDP. The National Escape Clause (NEC) exempts countries from the SGP rules, allowing a maximum of 1.5% above the 3% limit during exceptional circumstances. Defence is classified as an exceptional spending category by the European Commission. As of May 2025, 16 Member States including Germany and Poland have applied for the NEC exemption.

While countries such as **Italy** may have little room for fiscal expansion despite the potential activation of NEC providing short-term relaxation of EC fiscal rules, they may also find the next EU budget less supportive. The European Commission's proposal for the 2028–2034 Multiannual Financial Framework (MFF) marks a strategic shift in EU spending, prioritising security, R&D, and digital technologies, while reducing agricultural subsidies and cutting back on regional development funding. Defence and digital investments are set to rise sharply, with Eastern European countries and larger economies like **Germany** and **France** expected to benefit most. In contrast, Common Agricultural Policy (CAP) funding is projected to fall by 38% in real terms.

Pre-allocated funding under the new budget is down by 27% relative to the 2021-2027 MFF in the initial allocations published, with **Spain** and **Italy** seeing the largest proportional decline in allocated funds and **Poland** the largest increase (see Chart 9). However, in cash terms, all member states are due to receive less pre-allocated funding than in the previous budget, casting uncertainty over the availability of funding for member states, which can potentially further slow absorption rates during the next budget cycle.

In addition, while headline figure for the overall envelope of the next MMF suggests a significant increase, the proposal represents an estimated 18% real-terms decline compared to the current 2021-2027 framework when covid related overspent is included. Nevertheless, MMF could still support medium-term economic performance across the bloc, especially for the smaller economies and poorer regions where funds represent a significant share of overall investment.

Chart 9: Proposed pre-allocations under the 2028-34 MFF



Source: European Commission, KPMG analysis.
Current prices, 2021-2027 MFF includes NGEU funds.

European competitiveness: Running to stand still

More than a year on from the publication of Mario Draghi's report looking at the issues holding back competitiveness in the European Union, progress appears to be slow. According to EPIC, a Brussels-based think tank, only 11.2% of the 382 recommendations of the Draghi report have so far been implemented. The report had identified weak pace of investment and innovation as some of the key drivers of weaker economic growth on the continent.

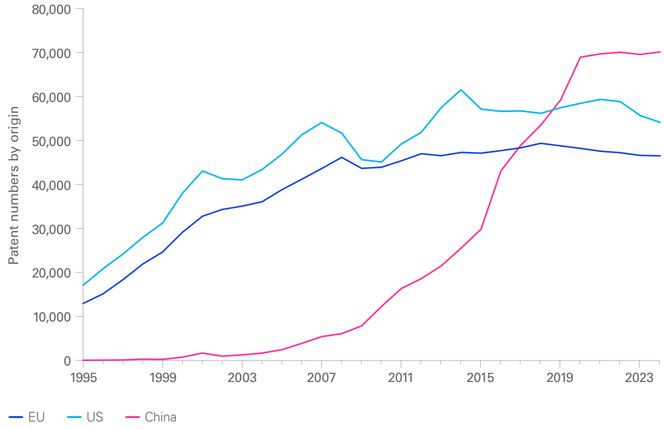
Meanwhile, while policymakers look to agree a solution, Europe's competitive position continues to deteriorate. European productivity data shows output per hour in the EU increased by 0.3% in 2024 to reach a level just 2% above that in 2019; while in the US productivity grew by 2.7% in 2024 alone and was 10.8% higher than in 2019. Innovation statistics paint a similar picture, **Chart 10** shows that countries in the EU continued to lag behind both China and the US in 2024, seeing a modest fall in overall patent numbers that year. Furthermore, contrary to the recommendations of the Draghi report, which identified the need to increase investment by 4-5% of GDP, business investment in the EU declined to 12.6% of GDP in 2024, compared to 13.1% in the year before.

The European policy response has come in the form of the European Commission's Competitiveness Compass, which follows along the same lines as the recommendations of the Draghi report. Some progress has already been achieved, mainly on the simplification agenda, as the Commission has worked on omnibus bills, which simplify regulation as well as exempting smaller and medium businesses from the burden of compliance with environmental reporting requirements. In parallel, the EU is also undertaking a competition review, with new guidelines potentially in place by 2027; allowing for more cross border merger activity and responding to Draghi's call to create firms of a sufficiently large scale as to be able to compete on world markets as well as have the resources to devote to innovative activity.

However, progress on the key initiatives such as the EU's Saving and Investment Union, completion of the Single Market and investment in energy infrastructure as well as an Energy Union appear to be stalling. Progress here is particularly challenging as it can pit the interests of member states against common objectives.

The shift in focus towards defence could help spur increases in investment, especially in Europe's manufacturing sector, which has had to deal with higher energy prices, as well as increased competition from China and higher US tariffs. However, European defence manufacturing remains heavily fragmented across member states, which can hold back individual producers from attaining the necessary scale to drive lower unit costs and greater innovation. Bridging this gap and ensuring that EU economies reap the benefits of higher spending requires deeper level of cooperation.

Chart 10: EU patent numbers lag other competitors



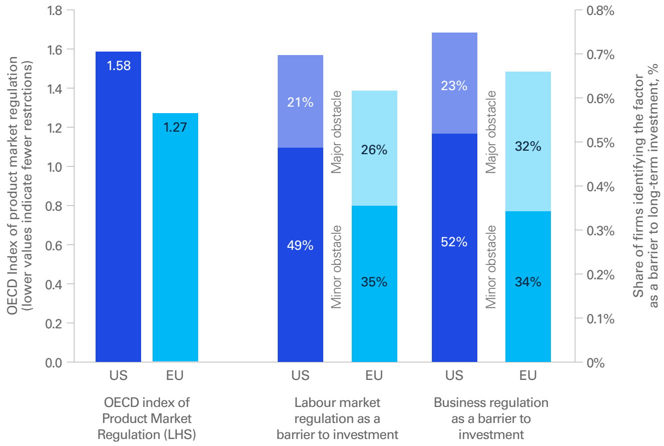
Source: WIPO, KPMG analysis.

Calls to increase European competitiveness are not new, with Europe undergoing a series of initiatives throughout the past decades aimed at increasing competitiveness, including the Lisbon Strategy of 2000. While some data point at the EU having a less restrictive level of product market regulation than the US, with lower reported rates of business and labour market regulations acting as barriers to investment according to the latest EIB investment survey (see Chart 11), fewer US firms report labour market or business regulation being a major obstacle to investment than in the EU.

Meanwhile the Draghi report points to an expanding array of regulations, with frequent changes, and further barriers due to differences in the national transposition of EU legislation, which creates additional barriers between member states.

Nevertheless, this is an important moment for Europe to act. The pressure from US tariffs, the disruption from emerging Artificial Intelligence (AI) technologies, and growing geopolitical tensions, provide an opportunity for Europe to seize a leadership position in key industries. While it seems unlikely that regulatory changes on their own can deliver the kind of return that would be necessary to spur growth in the region, a more radical set of changes that allow the creation of a large domestic market which can be fully exploited by new and growing firms, could inject more of the dynamism needed to generate the growth of the future.

Chart 11: Steady progress on regulatory frameworks has not delivered growth outcomes in Europe



Source: OECD index of product market regulation (2023), EIB Investment Survey (2024).

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