European Economic Outlook

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December 2025

- Household consumption to continue as the primary engine of Eurozone GDP growth in 2026, despite subdued consumer confidence and high savings intentions.
- The outlook for the manufacturing sector remains weak, with PMI surveys signalling no meaningful recovery on the horizon. Competitive challenges add structural headwinds.
- Major European central banks have ended their rate-cutting cycles. Interest rates are expected to stay stable through 2026 as inflation returns to target levels.
- The fiscal stance across the Eurozone is expected to be broadly neutral in 2026, with consolidation plans in many countries offsetting expansion elsewhere. Thereafter we expect more expansionary fiscal policies as some countries leave the excessive deficit procedure while spendings on defence increase to meet NATO targets.
- Europe's reliance on China for critical raw materials, including rare earths, poses strategic risks. Demand for rare earths is projected to rise fivefold by 2030, requiring diversification and investment in refining and recycling.
- High electricity prices following the pivot from Russian gas continue to erode competitiveness in energy-intensive sectors, driving structural adjustments and increasing reliance on imports.

Table 1: KPMG projections for the Eurozone economy

	2024	2025	2026	2027
Real GDP	0.8	1.4	1.0	1.4
Consumer spending	1.2	1.3	1.3	1.3
Investment	-2.1	2.4	1.3	2.3
Unemployment rate	6.4	6.3	6.2	6.2
Inflation	2.4	2.1	1.6	2.2
Base interest rate	3.0	2.0	2.0	2.0

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

GDP, consumer spending and investment are all measured in real terms. Average % change on previous calendar year except for unemployment rate, which is average annual rate, while interest rate represents level at the end of calendar year. Investment represents Gross Fixed Capital Formation. Inflation is measured as HICP.

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Outlook for European economic growth

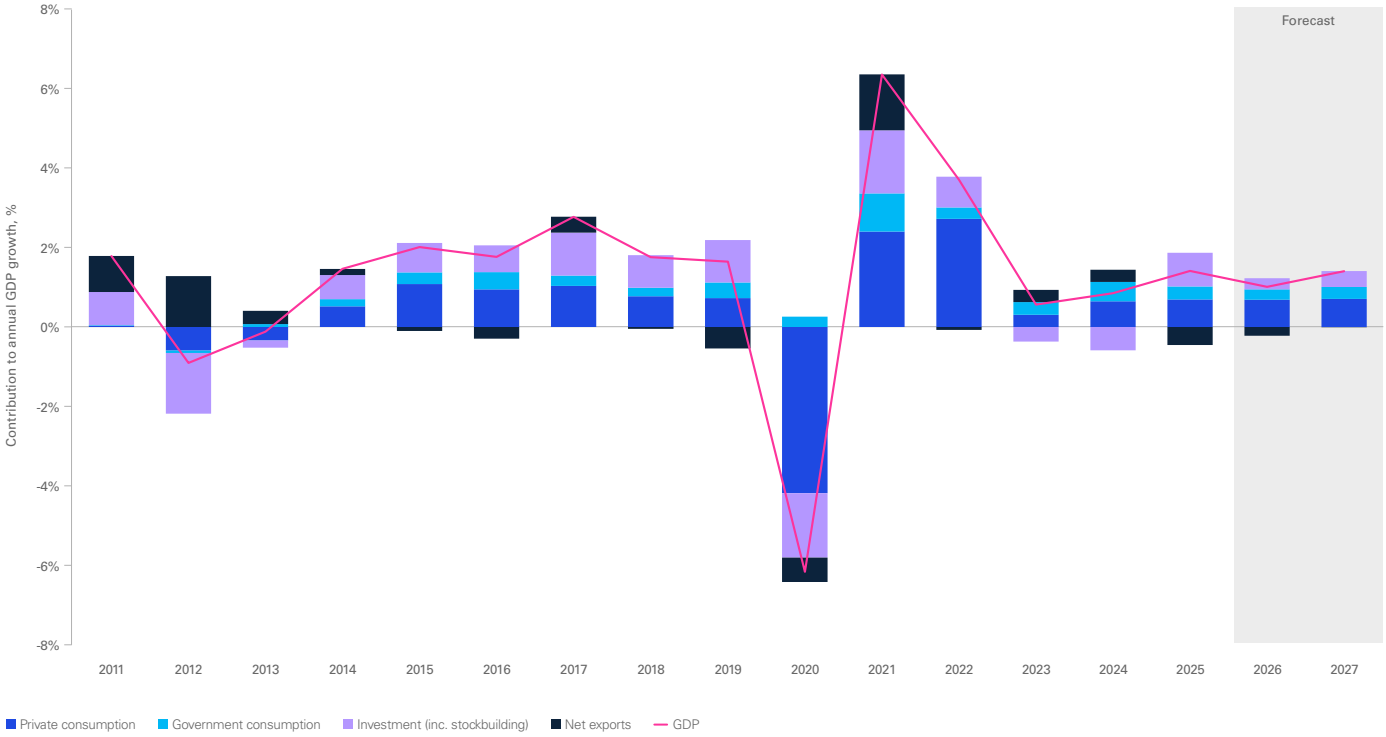
Economic growth across Europe has shown a notable resilience throughout 2025, successfully weathering global economic headwinds and sustaining a steady, albeit modest, pace of expansion. We anticipate this modest growth to persist into 2026 and 2027, with Eurozone GDP growth of approximately 1.1% and 1.4% in 2026 and 2027 respectively (Table 1).

The largest contribution to economic growth is expected to come from higher consumer spending (Chart 1). The labour market remains strong, with robust job creation across parts of southern Europe offsetting softer conditions in northern and eastern economies such as Germany and Poland, where weakness across industrial sectors is holding back employment growth (Chart 2). Overall, we expect to see relatively strong real wage growth, supporting sustained increases in households spending power over the next two years.

Chart 2: Robust job creation in southern economies is offsetting weakness in central and eastern European economies

Source: Eurostat. Quarterly series, long run average is from 2010Q1-2025Q2.

Chart 1: Households spending to drive growth in 2026

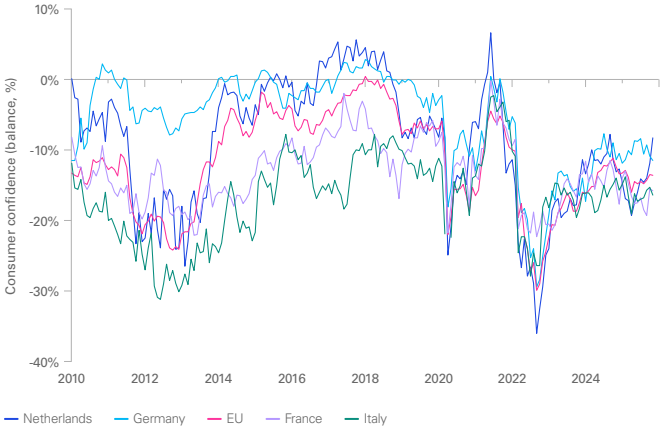


Source: KPMG forecasts using the Oxford Economics Global Economic Model.

However, elevated uncertainty, particularly in countries such as France due to protracted negotiations around the budget, is supressing consumer confidence across the region (**Chart 3**). Savings intentions remain high, with a consistent majority of consumers indicating an intention to increase savings (**Chart 4**), dampening the prospects for an acceleration in consumer spending growth in 2026.

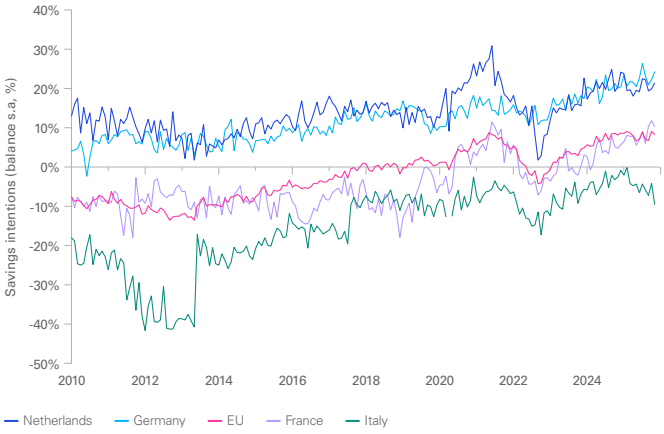
Southern EU member states are expected to continue to out-perform in 2026, albeit to a lesser extent than 2025. With the Recovery and Resilience Fund (RRF) funding period ending in August 2026, accelerated absorption of EU funds is likely to continue to support productive investment, as well as providing some reprieve from fiscal consolidation. We expect this uplift to persist well into 2027, owing to how funding is accessed as well as delays in project completion. Any shortfall in funding following the ending of the RRF scheme is likely to be compensated by a more intensive application of other available EU funds, which have been relatively underutilised so far.

Chart 3: Consumer confidence remains subdued across Europe



Source: European Commission/Haver Analytics.

Chart 4: Consumer surveys point to persistent savings intentions



Source: European Commission.

Industrial production to face growing competition and limited uplift from higher defence spending

Uncertainty surrounding US tariff measures has eased following the EU-US and Swiss-US trade deals. However, trade uncertainty remains elevated (Chart 5) as secondary impacts and the wider realignment of global trade patterns, continue to unfold.

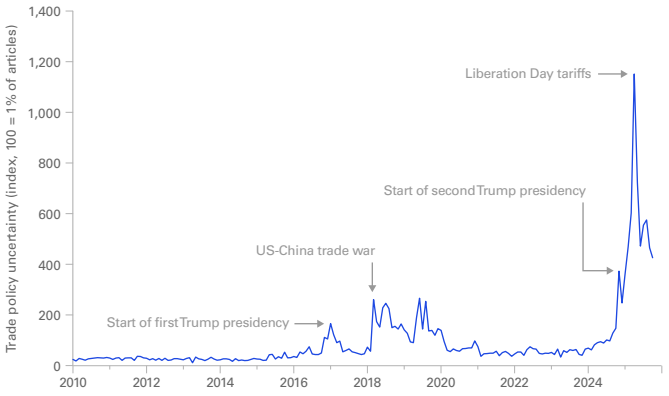
Lower US tariffs relative to other key US trading partners may provide an opportunity for EU industry. The EU-US trade deal has resulted in the effective tariff for European economies being relatively lower than other major US trading partners such as China and India (Chart 6), increasing their competitiveness in the US market.

However, increased competition in domestic markets may present headwinds for EU industry, particularly countries such as Germany and Italy due to similarity with Chinese exports. The volume of imports from China has risen throughout 2025, alongside declining prices (Chart 7). This signals a potential redirection of Chinese trade flows into European markets, increasing competition with domestically produced goods.

Furthermore, structural shifts may exacerbate the degree of competition that European producers face in global markets. China's technological advancement has increasingly shifted it closer to the technological frontier, putting it in direct competition with European producers (see Chart 8).

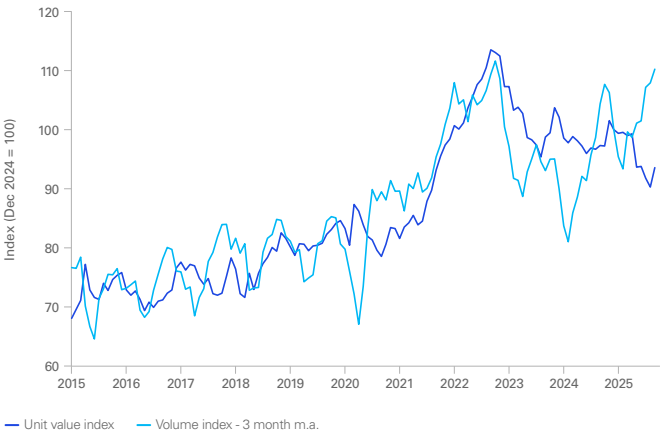
The rise of domestic substitutes has led China to scale back imports from Europe, whilst also cutting back the market share of European producers in third markets. Recent appreciation of the Euro may further damage the competitiveness of EU-produced goods when priced in local currencies.

Chart 5: Trade policy uncertainty has passed its peak, but remains elevated



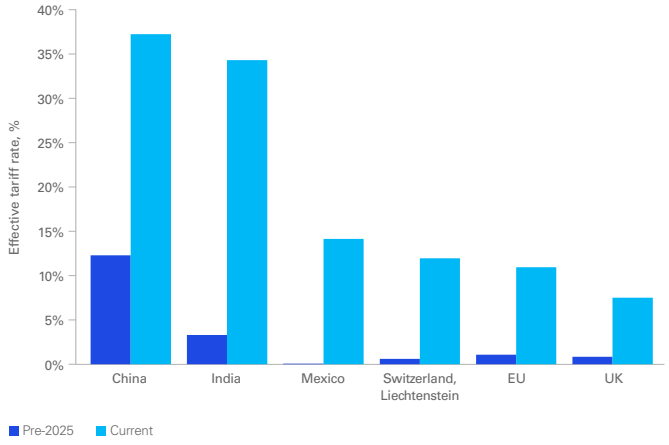
Source: Caldara et al (2020).

Chart 7: Chinese exports to Europe have increased, accompanied by falling prices



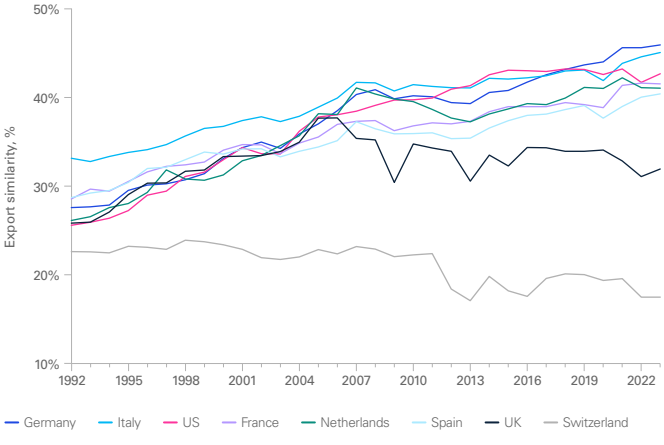
Source: Eurostat.

Chart 6: European effective tariff rates are lower than other major US trading partners



Source: UNCTAD.

Chart 8: Chinese export similarity with selected manufacturing hubs has increased



Source: de Soyres et al. (2025).

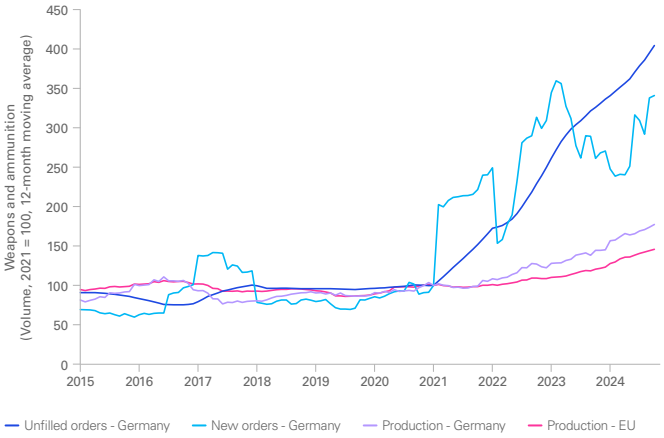
The anticipated boost in European defence spending offers a modest upside to parts of the manufacturing sector. However, we anticipate this uplift could be limited in 2026, as capacity constraints restrict production. Chart 9 shows that despite German production increasing 78% since 2021 (compared to a rise of 44% in the EU as a whole), unfilled German orders have increased fourfold since over the same period.

The high import dependence of military procurement may also limit the impact of defence spending on overall economic growth. Data shows that 78% of military procurement for the EU was sourced from outside the bloc between February 2022 and June 2023[1].

Despite a greater focus on defence, European industrial production is expected to remain weak, with EU manufacturing PMI pointing at neutral levels following some recovery in 2025 (Chart 10). European Commission surveys of firms' perceptions show order books stabilising but remaining broadly negative (Chart 11), supporting the conclusion that EU manufacturing has reached a trough in output, but that recovery is not yet forthcoming.

Despite weakness in industrial production, overall business activity has maintained solid growth, with composite EU PMI having increased in recent months, driven by a resilient services sector (Chart 10). A strong tourism sector, particularly in southern economies such as Spain, has supported service sector activity. Whilst initiatives to modernise IT infrastructure and integrate artificial intelligence into business operations is providing a boost to professional services sectors. Services output is anticipated to continue to perform strongly in 2026 with many EU funded projects focusing on modernising digital infrastructure.

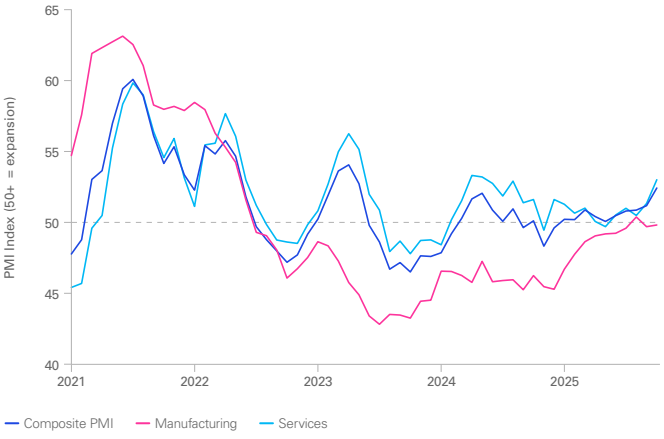
Chart 9: The Defence sector is capacity constrained, restricting the increase in defence output



Source: Statistisches Bundesamt/Haver Analytics.

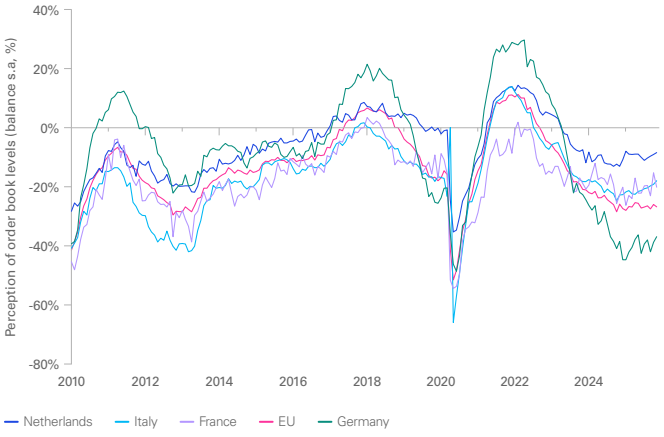
Note: Weapons & Ammunition includes small arms, explosives and military weapons such as tanks, but does not include warships.

Chart 10: EU PMI surveys suggest no meaningful recovery in manufacturing



Source: S&P/Haver Analytics.

Chart 11: Perceptions of manufacturing order books remain negative



Source: European Commission.

1 *A new European Defence Industrial Strategy: Achieving EU readiness through a responsive and resilient European Defence Industry*, European Commission.

Fiscal stance could remain broadly neutral in 2026

Owing largely to capacity constraints limiting the absorption of public funds, the fiscal stance is anticipated to be broadly neutral across the Eurozone in 2026. Fiscal consolidation in countries such as Italy and France is expected to offset expansionary policy elsewhere, especially in Germany (Chart 12).

We anticipate a more expansionary fiscal stance in 2027 as German defence and infrastructure spending gains momentum. Italy is also expected to exit its excessive deficit procedure, allowing for less restrictive fiscal policy, with recent comments by Italy's defence minister pointing at a potential uplift in defence spending to meet NATO targets.

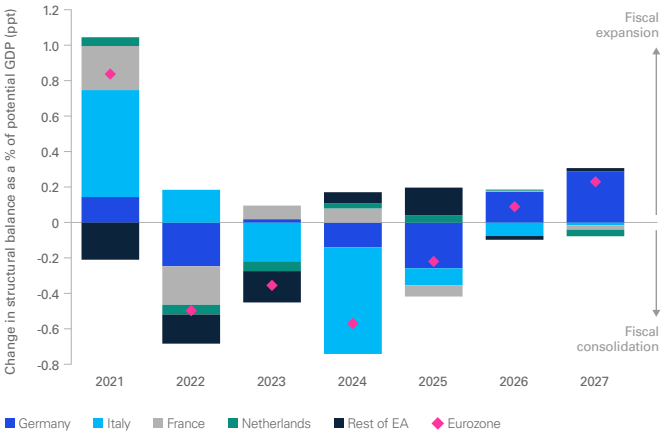
Muted inflation signals the end to rate cutting cycle for the major European central banks

Inflation across Europe is returning to target, reducing concerns for policymakers and supporting the view that rate-cutting cycles have ended (see Chart 13). In the Eurozone, inflation is expected to fall to 1.6% in 2026, below the 2% target, due to energy base effects. The ECB is unlikely to respond, viewing this fall in inflation as temporary and maintaining a high threshold for further cuts.

In Switzerland, inflation is expected to remain near zero, driven by the Franc appreciation which is causing goods deflation while services inflation persists. The Swiss National Bank has intervened in the FX market and expanded its balance sheet to curb further Franc appreciation, reducing the need for negative rates unless global conditions deteriorate.

In Sweden, inflation remains elevated, with November data exceeding Riksbank's forecasts. A planned VAT cut on food and continued energy price declines should ease headline inflation in 2026. After lowering its policy rate to 1.75% in September, the Riksbank is expected to hold rates steady through 2026.

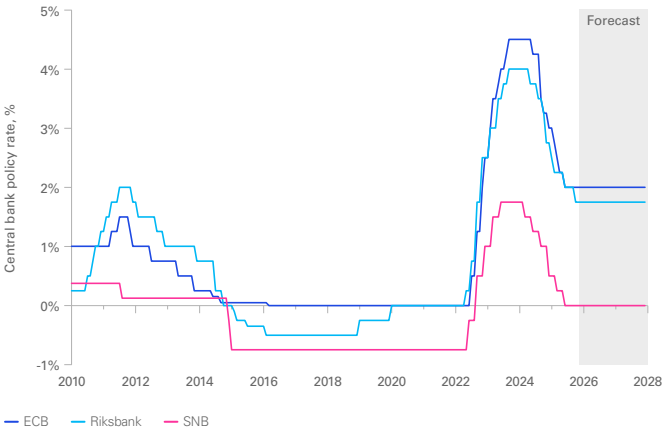
Chart 12: Fiscal expansion to gain momentum in 2027



Source: KPMG forecasts using the Oxford Economics Global Economic Model.

Note: Structural balance refers to the government's budget balance if the economy were operating at full employment.

Chart 13: The major European central banks have concluded their rate cutting cycles



Source: Bank of International Settlements.
KPMG forecasts using the Oxford Economics Global Economic Model.

Supply chains and rare earths in an era of strategic competition

As global trade relations shift towards increased competition and rivalry, evidenced by a fivefold increase in export restrictions since 2009, EU supply chains are faced with increasing risk. With 38% of raw material inputs sourced from outside the EU bloc in 2022, access to critical raw materials is becoming more uncertain and is increasingly shaped by foreign policy decisions.

Over recent decades, EU trade has shifted away from geopolitically aligned countries, with a larger share of trade flowing to and from low alignment countries[2], rising from 12% in 2002, to 25% in 2020 (see **Chart 14**).

Despite some recent evidence of friendshoring[3], EU trade with non-aligned countries remains persistent. Notably, trade shares with 'Low alignment' countries, defined as those with the largest geopolitical distance, have remained broadly stable since 2020, suggesting potential dependencies on our most dissimilar trading partners.

These trends have in large part been driven by the rapid development and growth of China, which has increasingly integrated itself in global supply chains. This is illustrated by the steady increase of Chinese components in industrial products in European economies since 2010 (**Chart 15**).

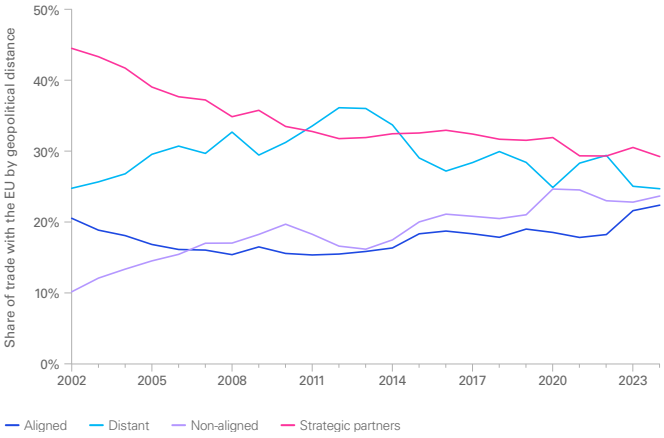
Two factors are relevant here: on one side, China's gradual movement toward higher value-added activities, such as design and advanced manufacturing, driven by China's growing technological capabilities, puts Chinese producers in direct competition with European suppliers. While on the other side, China's rising dominance in upstream industries such as rare earths means that European industries have become increasingly reliant on Chinese suppliers. This could therefore represent a growing risk to EU's growth and development, particularly in sensitive sectors such as defence and energy.

On rare earths, almost half of the EU's 2024 imports were sourced from China. While current demand remains low, it is anticipated to increase sharply, rising over five folds by 2030. This surge will be driven by the expansion of green technologies, such as wind turbines supporting the EU's net-zero transition, and defence technologies, including aircraft and precision weaponry to meet NATO expenditure objectives. To support growth in production and safeguard Europe's strategic autonomy, particularly in sectors like defence, it may be necessary to reduce reliance on external suppliers.

In rough terms, a robust European supply chain for rare earths requires two components: access to raw materials and refining capacity; both areas are currently dominated by Chinese producers.

Some headway has been made in refining capacity as Europe hosts two operational facilities – in France and Estonia – which are expected to meet approximately 60% of EU demand by 2030, and other EU initiatives focusing on the recycling of rare earth materials could further boost supply. However, given the relatively small scale of European operations, more investment may be needed. High European production costs due to the energy intensive nature of processing raw materials means private industry investment alone may not be sufficient to fill the need, and China can supply the global market at lower prices making private sector investment less attractive.

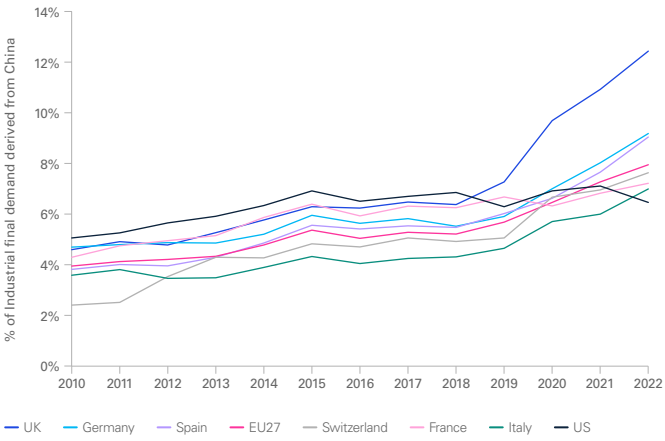
Chart 14: Despite moves towards more friendshoring, EU trade is more geopolitically fragmented than in 2002



Source: Eurostat/Comext and Bailey (2015) data, KPMG analysis.

Strategic partners represent the closest nations to the EU, followed by aligned, whilst non-aligned represents countries with differing geopolitical views to the EU.

Chart 15: European supply chains are increasingly reliant on China



Source: OECD TIVA.

2 Geopolitical alignment is measured using UN voting patterns. Countries' geopolitical classification is held fixed at 2024 values.

3 See Grover, A and P-L Vézina (2025), "*Geopolitical Fragmentation and Friendshoring: Evidence from Project-Level Foreign Investment Data*", World Bank Policy Research Working Paper.

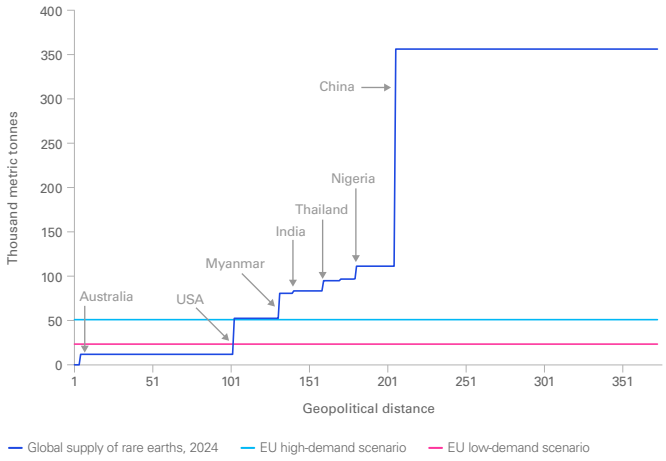
The issue of raw materials is more complex as although rare earth deposits exist in the EU, the lengthy process to start extraction makes domestic mining a long-term prospect rather than an immediate fix (see **Chart 16**). These delays can in large part be attributed to the regulatory burden of the EU's permitting process, as evident by a rare earth deposit identified in Sweden where permitting process and environmental considerations are needed before extraction can commence.

A more promising medium-term alternative to expanding EU's own mining capacity is to forge partnerships with likeminded third countries. To illustrate the scale of the task, Chart 17 highlights EU demand under two alternative scenarios: a high-demand scenario, reflecting full achievement of green transition goals, digitalisation and defence initiatives, and a low-demand scenario, representing delayed progress.

Chart 17 also shows the total supply of rare earths mined (based on 2024 data) by geopolitical distance of the supplier to the EU. Whilst EU demand is relatively small, expected growth in the high demand scenario accounts for almost the entire supply of the US and Australia in 2024. Considering that the US remains and is expected to be a net importer of rare earths, securing EU supplies may depend on other sources. While strategic alignment is currently evolving, the EU may need to secure links with producers such as India, Thailand and Nigeria in order to diversify supply of rare earth ore.

Subsequently, Europe's ability to withstand geopolitical tensions and maintain access to critical raw materials hinges on striking the right balance between diversifying supply through global partnerships and strengthening domestic production capabilities.

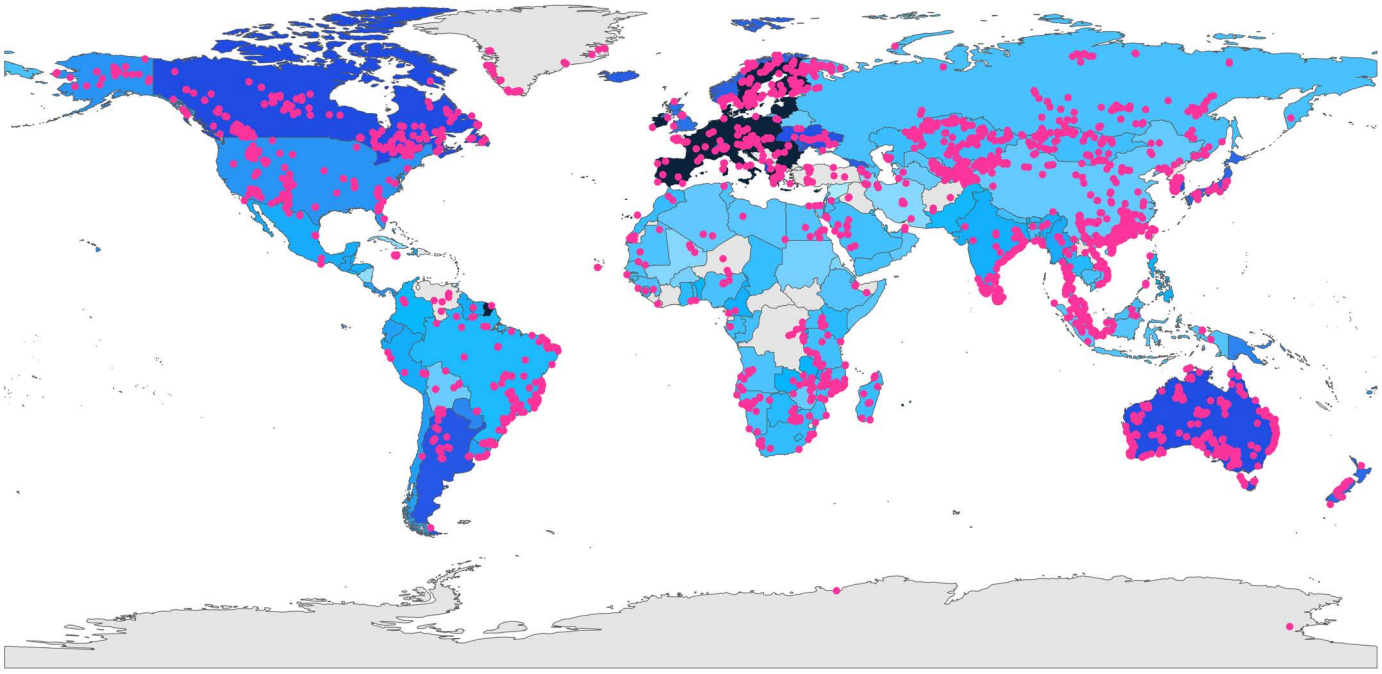
Chart 17: European expected demand for rare earths



Source: USGS, European Joint Research Centre.

Growth rates from the paper "*Supply chain analysis and material demand forecast in strategic technologies and sectors in the EU – A foresight study*" have been applied to all EU imports of rare earths to get demand. Rare earths are defined as HS codes 284610, 284690, 280530.

Chart 16: Deposits of rare earth metals and geopolitical distance from Europe



Source: Bailey (2015) and USGS data. KPMG analysis.

Lower geopolitical distance signals a closer aligned country to Europe. Dots represent deposits of rare earths. EU27 countries in dark blue. Grey represents countries without data.

European energy prices: Continent's costly adaptation

High energy costs that arose in the aftermath of Russia's invasion of Ukraine continue to be significant challenge for European industry's competitiveness and growth. As Chart 18 shows, industrial electricity prices increased by an average 58% between 2021 and the first half of 2025 as Europe has cut its reliance on pipeline gas imports from Russia and shifted to more costly LNG imports.

The importance of natural gas for electricity generation hinges on its role as the marginal supplier to the grid. While investment in green energy has helped reduce reliance on natural gas from around 20% in 2019 to 16% in 2024, it remains the key supplier during periods of high demand. This means that the relatively high import costs of natural gas continue to drive electricity prices on the continent.

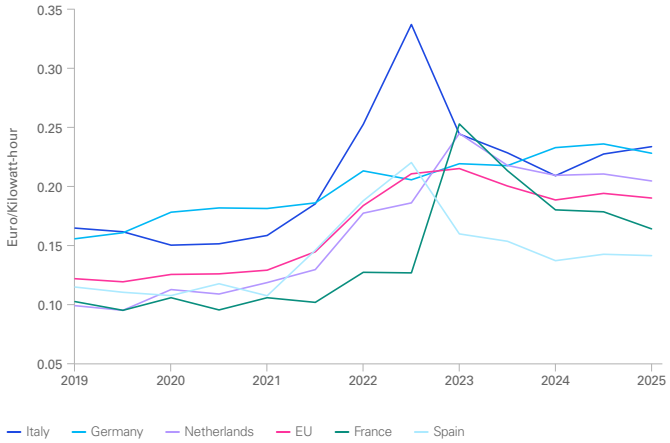
The consequences of high energy prices are most apparent for Europe's energy intensive industries[4], which since 2022 have seen a deeper and earlier decline in output than Europe's wider manufacturing sector (see Chart 19).

Overall EU manufacturing output in the first three quarters of 2025 was 2.3% higher than in 2019, whereas all energy intensive subsectors have seen a fall in production ranging from -6.1% for paper manufacturing to -15.7% for the chemicals industry.

Europe has managed to successfully pivot away from Russian pipeline gas over the past few years, but this has involved paying more for imported LNG from the US and elsewhere.

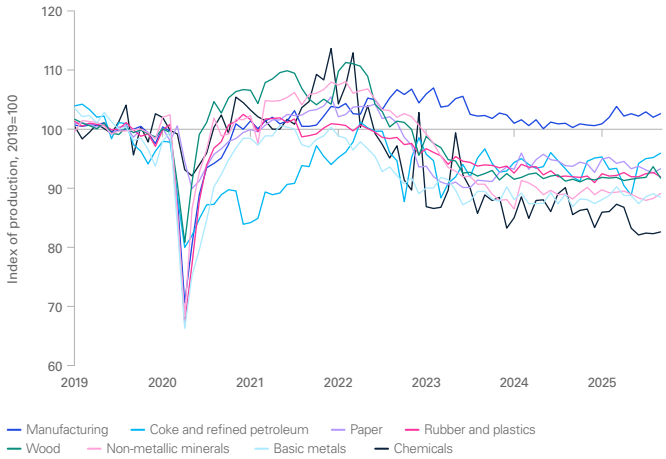
Simon Virley
Vice Chair and Head of Energy and Natural Resources, KPMG in the UK

Chart 18: European energy prices remain elevated



Source: Eurostat.

Chart 19: Output in EU energy intensive industries



Source: Eurostat.

4 These include the production of coke & petroleum, non-metallic minerals, chemicals, basic metals, paper, rubber & plastic, and wood.

As production in energy intensive industries declined, the shortfall in output has been met through increases in imports, with the average value of monthly imports of chemicals into the EU up by 44% compared to 2019 (see Chart 20). A large majority of the demand for energy intensive sectors is used as an input by other downstream sectors, pointing to an ongoing substitution away from EU-based production. This represents a potential adaptation route for European industry, with energy intensive inputs becoming embedded in imported intermediate goods.

To mitigate elevated energy costs, which are linked to ongoing dependence on costly natural gas imports, a sustainable long-term strategy could involve greater investment in renewable energy sources like wind and solar. Between 2019 and 2024, renewable energy's contribution to electricity generation increased from 34% to 47%, while fossil fuels' share decreased from 39% to 29%.

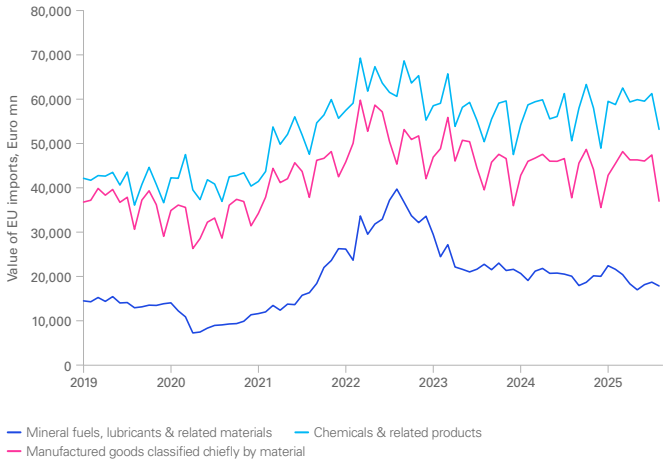
However, the transition to renewable sources of energy requires significant increases in capacity in complementary energy storage, greater interconnection and demand side responses to help mitigate the intermittency problem inherent to solar and wind energy sources.

Unsurprisingly, battery capacity has risen sharply, with an additional 4.9GW capacity added in 2024, up to an estimated total of 13GW. However, much more investment is needed to keep up with the energy transition, with projected requirements rising to 200GW by 2030 and 600GW by 2050, as Europe moves closer towards its net zero targets.

Furthermore, a full transition away from fossil fuels is likely to take time, as under the EU's latest proposal a full phase-out of fossil fuels is not envisaged to take place before 2040[5]. In the meantime, we expect to see ongoing competitive pressures to constrain growth across the EU's manufacturing sectors and in particular the energy intensive sectors highlighted above.

European economies therefore face two potential choices, continue with costly investments in alternative energy to reduce reliance on gas-powered plants, while using industrial policies to support domestic producers of critical energy-intensive goods. Or alternatively, reorganise production chains to shift energy intensive production to countries outside of Europe, where energy is more abundant and commands a lower price. A combination of investing in alternative energy and reorganising production chains is likely. However, even with strong investments in energy infrastructure, the downturn affecting energy-intensive industries is expected to persist unless there is significant state intervention.

Chart 20: European energy-intensive products imports have increased



Source: Eurostat.

Note: Manufactured goods classified chiefly by material includes leather, rubber, cork, wood, paper, textile, metal and non-metallic mineral manufactures as well as items composed of iron and steel as well as other non-ferrous metals.

5 EU 2040 climate target, scenario 3.

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