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European Economic Outlook

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February 2026

- The signing of two trade deals; the EU-India and the EU-Mercosur, may see small economic payoff in the near term, due to limited bilateral trade volumes and lengthy tariff phase in schedules.
- Europe's manufacturing sector may finally be turning a corner, with early signs of a fragile recovery emerging from a period of pronounced weakness. Fiscal support in major economies appears to be bolstering demand and helping stabilise industrial activity.
- Headline Eurozone inflation is expected to remain below target this year, allowing the ECB to keep rates unchanged. At the same time, quantitative tightening (QT) programmes by central banks may soon conclude, potentially lowering long-term rates.
- Lower long-term borrowing costs could increase support for long-term business investment and ease the fiscal pressure for governments. In the UK, we estimate that the end of QT programme could add around £5bn to the Chancellor's fiscal headroom.
- European AI adoption is keeping pace with the US, with more than one-third of firms already integrating AI into their operations. However, there are large variations in adoption rate among countries, with Finland, Denmark and the Netherlands leading in their share of firms already using the technology.
- The different make up of European economies impacts the extent to which AI could be used to substitute some tasks, with the Luxembourg and Belgian economies showing the highest potential to benefit from the initial phase of AI.
- While the risk of AI induced unemployment over the long term remains low, as new tasks and services are created through the adoption of the new technology, European governments are likely to need to take an active role in providing retraining opportunities to support the adaptability of the European labour market.

Table 1: KPMG projections for the Eurozone economy

	2025	2026	2027
GDP growth	1.5	1.1	1.5
Consumption growth	1.3	1.3	1.4
Investment growth	2.6	1.4	2.2
Unemployment	6.4	6.4	6.3
Inflation	2.1	1.7	2.0
Key deposit rate	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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Economic outlook for Europe

Economic growth across Europe is expected to remain modest, with Eurozone GDP anticipated to grow by 1.1% in 2026 and 1.5% in 2027, supported by domestic demand as Europe seeks to realign its global trade network.

More uncertain transatlantic relations have driven the EU to accelerate the pursuit of strategic trade agreements with third countries, in a move to reposition extra-EU trade.

The EU has recently agreed two trade deals; the EU-India trade deal and the EU-Mercosur deal. While they both represent a significant milestone after a period of protracted negotiations, the economic benefits to European economies may be limited in the short term, given the relatively small scale of bilateral trade involved and the long phasing in periods attached to many of the tariff reductions. As a result, any meaningful economic impact is likely to materialise only gradually over the longer term.

The EU-India free trade agreement will reduce tariffs on over 95% of product groups, yet India currently accounts for less than 2% of extra EU exports, meaning the deal is unlikely to generate substantial economy-wide gains for the EU at present. Some sector specific benefits may emerge, notably for autos: tariffs on EU car exports will fall from 110% to 40% for up to 100,000 vehicles worth over EUR 15,000, with the quota gradually expanding to 250,000 cars at a 25% tariff over ten years. Although beyond these quotas, exports will continue to face the full 110% tariff. Overall, the decline in the effective tariff on EU exports is expected to be modest initially, with quota limits significantly constraining the upside for EU industry.

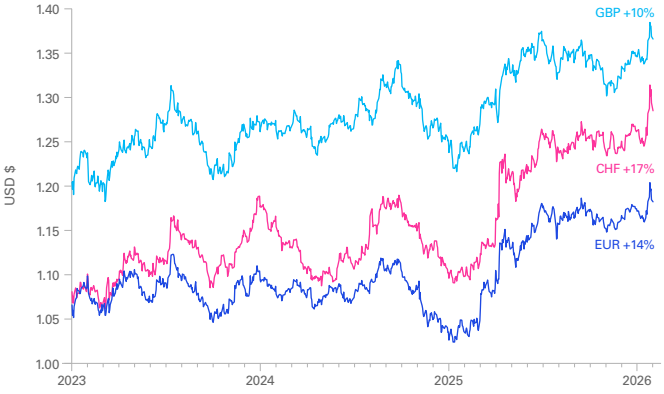
Ratification of the recently signed Mercosur trade deal now faces delays following the vote in the European Parliament to seek judicial review – although the deal could still be provisionally applied while waiting for the courts' judgement. The deal could in the long run add 0.1%[1] to EU GDP based on the Commission's estimates. Despite its relatively small economic impact, owing to the modest size of EU exports to the Mercosur area, the deal could hold significant strategic value by helping secure a more reliable supply of essential raw materials for example.

Agriculture proved to be the most contentious point in negotiations over the Mercosur deal. To secure agreement, the Commission granted member states early access to EUR 45 billion under the next Multiannual Financial Framework (MFF) for agricultural policy, equivalent to roughly two thirds of the funds previously earmarked for the mid-term review. This concession significantly reduces EU budgetary flexibility, intended to be one of the defining features of the next budget.

As negotiations on the next EU budget continue, another key point of contention is the reallocation of resources towards new priority areas such as innovation, competitiveness, and defence. Historically, innovation funding has disproportionately been awarded to larger member states, notably **Germany** and the **Netherlands**. As such, smaller countries fear that shifting EU priorities will limit their access to EU resources and deepen existing innovation and competitiveness gaps across the bloc.

Despite the new trade agreements, European exporters are likely to continue to face headwinds in global markets. The strength of the Euro, especially against the Dollar (see Chart 1), is likely to weigh on competitiveness. The US Dollar saw a consistent depreciation against European currencies through 2025 and into the start of this year as one potential consequence of US foreign policy. While the US Dollar remains the dominant global currency, there has been a decline in its role in international transactions, largely in favour of the Euro. The picture is even more pronounced in the holdings of global international reserves, which have seen a shift away from the US Dollar and towards the Euro (Chart 2).

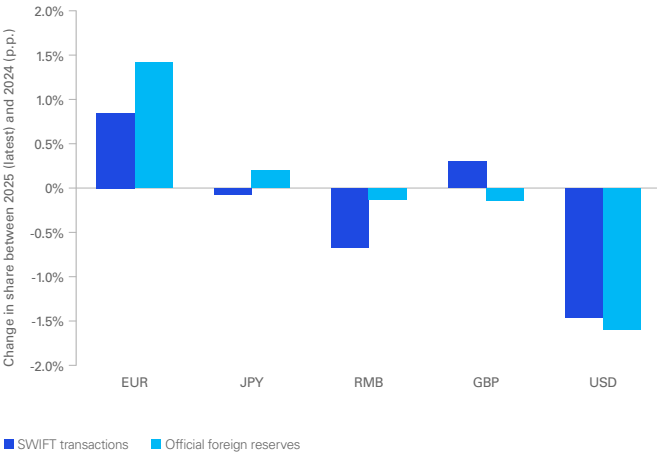
Chart 1: European Exchange rates have strengthened against the US Dollar



Source: LSEG.

Data until end of January 2026. Growth rates are year to 30 January 2026.

Chart 2: The use of the Euro has become more prevalent in 2025



Source: RMB tracker, IMF.

SWIFT transactions exclude intra-eurozone transactions. SWIFT data is December values. Official foreign reserve data is from 2025Q3. Official foreign reserves is the world total of official foreign exchange reserves by currency.

1 European Commission, *An update on the economic, sustainability and regulatory effects of the trade part of the EU-Mercosur Partnership Agreement*.

Reflecting these developments, EU industry perceptions of competitiveness weakened at the end of 2025 (Chart 3). This came despite initially resilient trade figures, supported by firms front-loading exports to the US ahead of tariff implementation, and by an expansion of intra-EU trade. Looking ahead, we expect competitiveness pressures to intensify. Increased external competitive pressures, combined with domestic industrial challenges, such as high energy prices and elevated unit labour costs, continue to weigh on Europe's role in global trade.

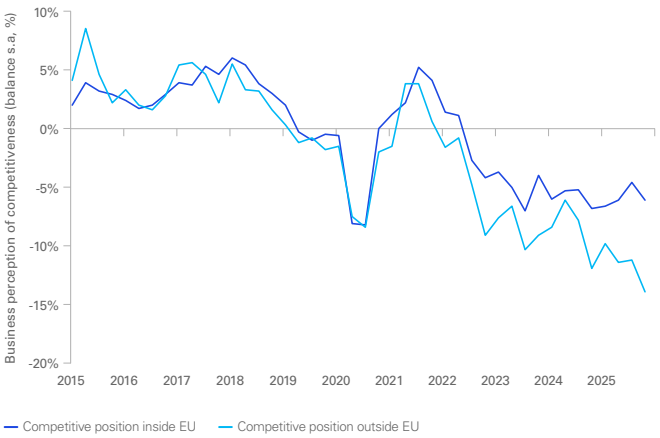
Moreover, the US's apparent shift towards industry level negotiations to cut prices and increase investment, continues to pose a challenge for European economies. More broadly, the European pharmaceutical sector has come under pressure to cut costs to US consumers and invest in US based manufacturing. These firm specific agreements could see a reallocation of investment toward the US, negatively impacting domestic investment activity particularly in countries such as **Switzerland** and **Denmark**.

Against this backdrop, with external dynamics increasingly acting as headwinds, the outlook for European growth prospects is set to depend more heavily on domestic demand.

The European manufacturing sector is showing early signs of recovery, potentially supported by expansionary fiscal policy. In **Germany**, higher defence and infrastructure spending is now being felt through a small increase order book volumes for capital and intermediate goods, contributing to a modest uptick in industrial confidence in January 2026. Similar gains in **France** and the **Netherlands** point to a broader industrial stabilisation across the Eurozone. While still tentative, these developments suggest that fiscal support may help accelerate a turnaround in Europe's industrial sector during 2026. Despite this positive data, the sector still faces substantial structural challenges from higher energy costs and elevated global uncertainty, that could weigh on recovery.

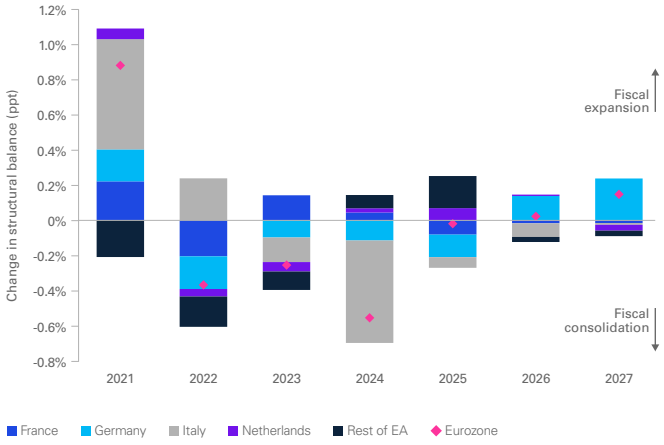
Looking ahead, we expect the Eurozone to maintain a broadly neutral fiscal stance in 2026. Expansionary domestic fiscal policy in countries such as **Germany** will likely be offset by consolidation efforts in countries such as **Italy** (Chart 4). From 2027 onwards, however, rising German defence and infrastructure spending is likely to make the overall European fiscal stance gradually more expansionary. In **Italy**, an expected exit from its excessive deficit procedure as early as spring 2026, could also create room for higher defence spending.

Chart 3: Perceptions of competitiveness have declined further in 2025



Source: European Commission.

Chart 4: German fiscal expansion is offset by consolidation in other Eurozone countries in 2026



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

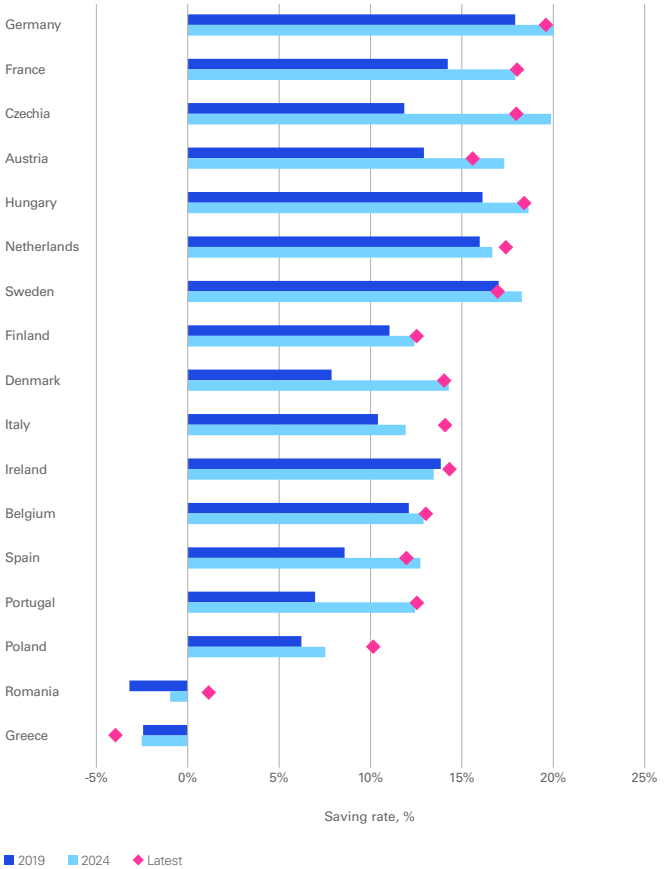
Structural balance refers to the government's budget balance if the economy were operating at full employment.

In **France**, having failed to reach an agreement on the 2026 budget, the Prime Minister invoked article 49.3 to enact a revised 2026 budget without a vote in the national assembly. In doing so he was required to scale back all spending-reduction ambitions, and this year's budget will do little to reduce the government deficit relative to GDP.

With fiscal spending plans not expected to gain momentum until 2027, European economic growth is reliant on the modest pace of consumption growth as the main driver this year.

Savings remain elevated across most EU economies (Chart 5), particularly in **France** and **Italy**, which is dampening household consumption growth. Despite this, a resilient labour market (Chart 6), especially in southern economies such as **Italy**, and strong nominal wage growth, while inflation is projected to moderate further, are together expected to lift real disposable incomes, sustaining consumption growth despite the drag from high savings even though interest rates have fallen from their peak at the start of 2024.

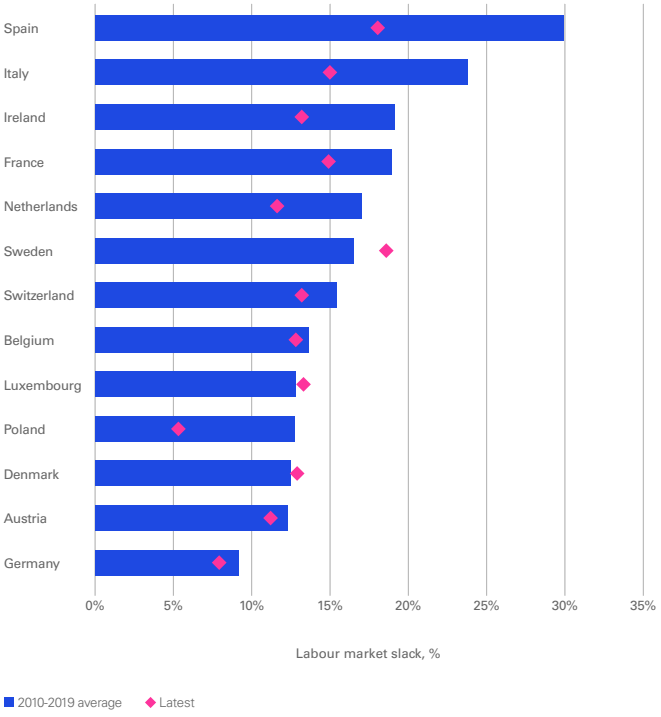
Chart 5: Savings rates across the Eurozone remain elevated



Source: Eurostat.

However, a sharp acceleration in consumption is unlikely. Despite evidence of improvement, consumer confidence remains weak, with sentiment surrounding the general economic conditions and major purchases over the coming year remaining negative across Europe. This points at consumer prudence persisting into 2026, with savings rates kept elevated.

Chart 6: European labour markets remain tight in southern economies



Source: Eurostat.

Labour market slack is defined as all unmet need for employment, incorporating unemployment, underemployment, people available to work but not seeking work, and people seeking work but not immediately available to work as a percentage of the extended labour force.

While aggregate inflation for the Eurozone is continuing to ease, dynamics among different Eurozone economies vary (Chart 7). In a majority of Eurozone economies inflation remains elevated, though in some countries such as **France**, **Italy** and **Finland** inflationary pressures continue to ease.

In the Eurozone, inflation is anticipated to fall below target in 2026, to around 1.7%, as past increases to energy prices drop out from the headline measure. The ECB is likely to have ended its rate lowering cycle, with interest rates unlikely to change in the near term unless the outlook for inflation changes.

In **Switzerland**, annual average CPI inflation came in at 0.2% for 2025. Services prices remain the primary driver of inflation, whilst goods prices fell due to the continued strength of the Swiss Franc.

Despite inflation undershooting the SNB's expectations at the end of 2025, the Bank kept rates at 0% at its December meeting, citing broadly unchanged medium-term inflationary pressures. With the policy rate already at zero, we expect the SNB to require a high bar before proceeding with further loosening, and instead to continue to prioritise foreign exchange market interventions.

In **Sweden**, consistent with the Riksbank view that price movements earlier in the year were driven by temporary factors, inflation is now close to or slightly under the 2% target. Inflation in 2026 is predicted to fall below target as base effects from energy price increases and a re-weighting of the consumer basket are expected to contribute to a decline in inflation. With underlying inflation near target, and notable spare capacity in the labour market (see Chart 6 above) domestic inflationary pressures appear muted and in line with target going forward, hence we anticipate no further rate cuts from the Riksbank throughout 2026 (Chart 8).

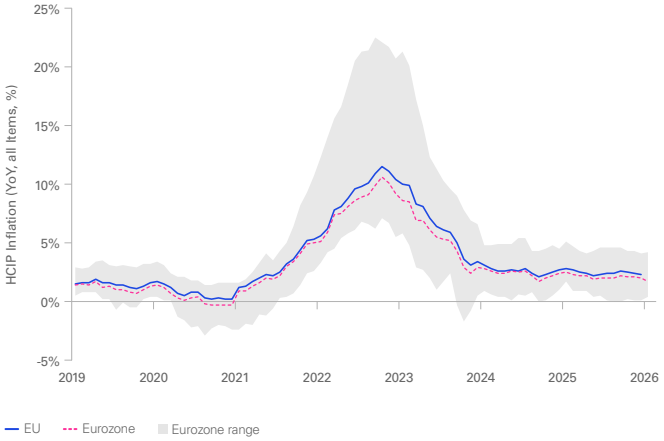
Table 2: KPMG projections for European economic growth

	2025	2026	2027
Austria	0.6	0.8	1.4
Belgium	1.0	1.4	1.6
Bulgaria	3.2	3.2	2.9
Croatia	3.0	3.0	2.6
Czech Republic	2.5	2.3	2.4
Denmark	2.3	2.0	2.3
Estonia	0.5	2.1	2.5
Finland	0.1	1.2	1.2
France	0.9	0.8	1.1
Germany	0.4	0.9	1.9
Greece	2.0	2.2	1.7
Hungary	0.3	1.9	2.6
Ireland	13.3	-0.3	2.3
Italy	0.7	0.6	0.8
Latvia	1.1	2.2	2.6
Lithuania	2.7	2.7	2.7
Luxembourg	0.7	1.7	1.9
Netherlands	1.9	1.2	1.6
Norway*	1.6	1.4	2.0
Poland	3.6	3.8	2.8
Portugal	2.0	2.3	1.7
Romania	0.6	0.7	2.1
Slovak Republic	0.7	1.4	2.3
Slovenia	0.9	2.4	2.0
Spain	2.8	2.2	1.7
Sweden	1.7	2.4	1.8
Switzerland	1.3	1.3	1.5

Source: KPMG projections using the Oxford Economics' Global Economics Model.
GDP is annual average % change on previous calendar year.

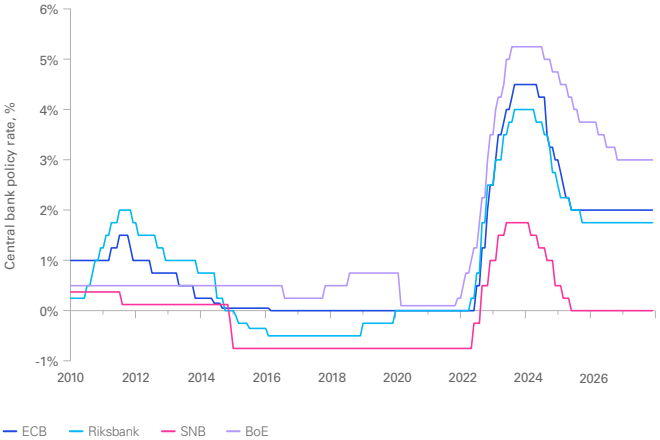
* Norway refers to mainland GDP.

Chart 7: Eurozone inflation returned to target, but paths diverge at a national level



Source: Eurostat.

Chart 8: Major European central banks have concluded their rate cutting cycles



Source: Bank of International Settlements, KPMG forecasts.

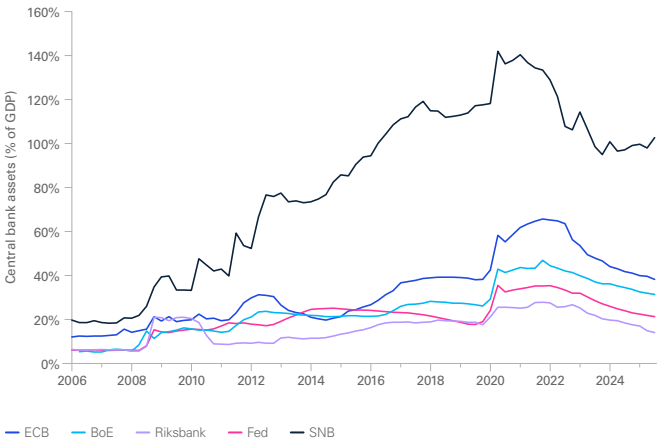
Quantitative tightening in Europe: end may be in sight

In 2022 and 2023, most central banks in Europe began the policy of quantitative tightening (QT), alongside raising interest rates, following the post-pandemic inflation spike. QT refers to the process by which central banks reduce the size of their balance sheets by allowing government and corporate bonds to mature without reinvestment (passive QT) and, in some cases, by actively selling assets (active QT).

Long-term interest rates have risen since QT has been in place, with evidence suggesting that reduced demand for bonds from central banks has played a role in increasing borrowing costs for governments. The aim of QT has been to reduce the size of central bank balance sheets, which increased significantly following the Great Financial Crisis (GFC) and again during the Covid pandemic, peaking in 2022.

Since then, central bank balance sheets have decreased significantly. This reversal has created additional headroom for central banks in the event of future economic shocks (see Chart 9), should a return to quantitative easing (QE) be needed.

Chart 9: Central bank balance sheets have fallen since 2022 across advanced economies



Source: LSEG Datastream, FRED, Bank of England, Riksbank, KPMG analysis.

In the US, the Federal Reserve's balance sheet fell from 35% in Q2 2022 to 21% in Q3 2025. In Europe, the European Central Bank's (ECB) balance sheet as a share of GDP has dropped from 66% to 39% during the same period. Whereas the Bank of England's (BoE) balance sheet declined from nearly 50% at the start of 2022 to 31% in Q3 2025.

The Swiss National Bank (SNB) has been an exception compared to other central banks in Europe. Despite having the largest balance sheet in Europe as a share of GDP, it has not explicitly pursued a QT policy. The SNB's relatively large balance sheet mainly reflects the accumulation of foreign exchange reserves from market interventions aimed at stemming the rise in the Swiss Franc, rather than domestic bond purchases aimed to injecting more liquidity to the domestic market. The SNB's balance sheet fell from a peak of 142% in Q2 2020 to 103% in Q3 2025, this was largely due to the scaling back of foreign exchange interventions and valuation effects.

Although central banks in Europe have signalled their intention to continue QT in the near term, these programmes could potentially be nearing their end.

In December 2025, the Federal Reserve took the lead in announcing the end of its QT programme, opting to maintain the current size of its asset holdings as a share of GDP. The Fed halted QT after early indications that markets were showing signs of strain as the amount of available liquidity declined. With some central banks' balance sheets now close to their pre-pandemic levels, Europe may also be running closer to the point where further meaningful balance-sheet reduction risks unsettling money markets.

QT among the factors behind the rise in long-term government borrowing costs

There is a wide variation of approaches to QT, with passive being the most common approach. Since 2022, some central banks have opted to run off their balance sheets by simply allowing bonds they hold to mature. This approach has been used by the Federal Reserve, which stopped reinvesting in maturing Treasury bonds and mortgage-backed securities in 2022, causing its balance sheet to shrink naturally over time. The ECB has followed a similar path, gradually reducing the size of its bond holdings.

The Bank of England and the Riksbank took a more proactive approach by actively selling parts of their bond portfolios. For the Bank of England, the structure of its balance sheet played a key role in the decision to select a more proactive form of QT. During QE, the Bank of England purchased a relatively large share of long-dated government bonds compared with central banks such as the ECB and the Federal Reserve. Because these bonds take longer to mature, relying solely on passive run off would have seen a slower pace of balance sheet reduction. Active sales were therefore used to accelerate the reduction of its holdings.

Evidence suggests that more aggressive forms of QT come with higher costs. Actively selling bonds, rather than letting them mature, can create more volatility in government bond markets and push up borrowing costs for governments. The Bank of England estimates that its QT programme has raised long-term borrowing costs by around 15 to 25 basis points. Higher bond yields raise the cost of issuance for governments and the debt interest payment bill. In the UK, we estimate that, had QT not been in place at the time of the Autumn Budget 2025, the Chancellor's fiscal headroom would be around £27 billion rather than the current £22 billion, representing a £5 billion cost associated with the QT programme.

In November 2025, the UK's Debt Management Office (DMO) adjusted the maturity profile of gilt issuance, increasing the share of shorter-dated gilts to limit debt interest costs at a time when long-term yields remain elevated. However, this shift increases the government's exposure to refinancing pressures in the years ahead, as a larger share of its debt will need to be rolled over more frequently and could face higher interest rates at renewal. Ending QT could reduce this risk, as it may lower the upward pressure on long-dated bond yields and lead the DMO to reduce its share of short-dated issuance.

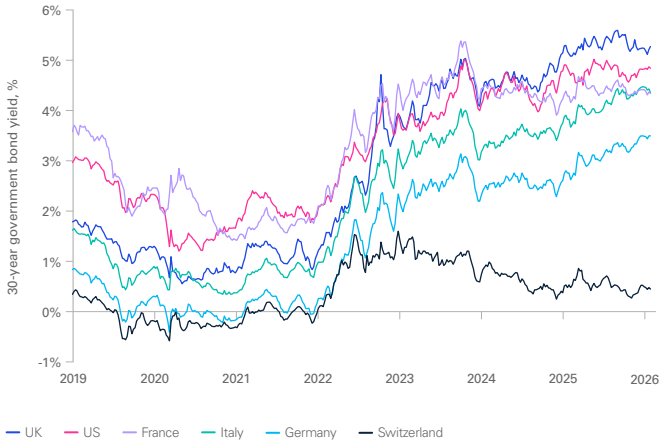
QT hasn't been the only source of upward pressure on government bond yields. Despite falling recently, short-term interest rates are expected to remain higher than their pre-2022 level across many European markets. This has contributed to the rise in long-term government bond yields.

Fiscal sustainability concerns have also pushed up borrowing costs, driven by increased need to spend on the energy transition, as well as supporting an aging population, while facing growth challenges from trade frictions.

The winding down of defined-benefit pension schemes in the UK has also reduced a major source of long-dated gilt demand, while regulatory changes in the Netherlands have led pension funds there to scale back their holdings of long-dated government bonds.

These factors have been a key driver of the increase in long-dated government bond yields seen over the past four years (see Chart 10).

Chart 10: Long-term government borrowing costs have risen since 2022



Source: Haver Analytics, LSEG Datastream.

Ending QT to benefit borrowers of long-dated maturities

Bringing QT to a close could offer important advantages for businesses, particularly those that depend on long-term financing, as pressure on long-dated bond yields would likely ease, lowering the cost of issuing longer-maturity debt.

Firms could be able to refinance existing debt at more favourable rates, helping them reduce interest costs and strengthen their cash positions. With less volatility around future funding conditions, companies would also be better placed to plan and commit to long-term projects, including investment in new equipment, upgrades to capacity and infrastructure.

This would be especially beneficial for sectors that rely heavily on stable long-term funding such as utilities, infrastructure, transport, telecommunications and commercial real estate, where companies commit to financing over extended time horizons.

Impact of AI on European labour markets

The development of AI technologies is an important potential driver of European productivity and economic growth in the next decade.

Currently, the development of foundational AI models is dominated by the US and to some extent Chinese companies. Europe has continued to lag behind, potentially reflecting a more restrictive regulatory environment albeit one that is under review, but which currently limits the pace of data centre infrastructure construction and electricity connection, as well as lower levels of capital availability.

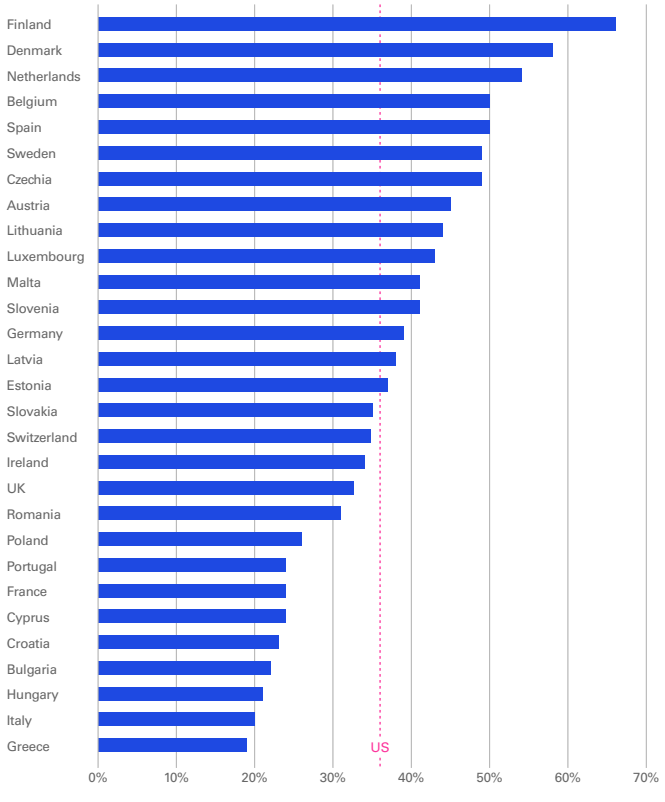
The current lack of infrastructure may have shut Europe out of the race for 'Artificial General Intelligence' (AGI), where an AI model could match or surpass humans across all domains of cognition. As untapped training data becomes increasingly scarce, achieving AGI within a realistic timeframe appears unlikely. In response, AI providers are focusing on refining existing foundational models rather than pursuing new architectures, intensifying competition in the market.

The opportunity for European AI may lie in developing specific applications of existing foundational AI models to specific domains and tasks. Current data shows that in terms of AI adoption, European companies are broadly in line with those in the US, with 37% of EU firms reporting some degree of AI use, compared to 36% for the US. But as **Chart 11** below highlights, variations remain in the degree of adoption across Europe, ranging from 66% in Finland to 20% in Italy and 19% in Greece.

Generative AI applications are rapidly transitioning from an experimental phase to scale up and organisational transformation. Specific use cases range from summarisation, drafting and image generation.

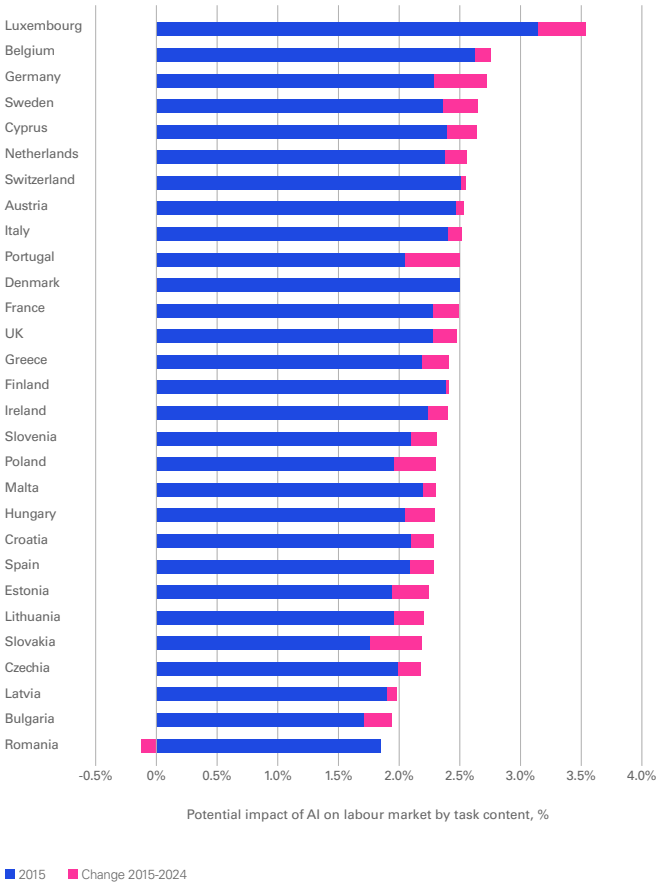
Europe's industrial and occupational mix makes it a relatively good fit for Generative AI technologies, with an average 2.5% of tasks currently performed by workers in the EU potentially suitable to some degree of automation (see **Chart 12**).

Chart 11: Generative AI adoption in Europe and the US



Source: EIB, ONS, Microsoft Institute, KPMG analysis.

Chart 12: Potential share of tasks that could be subject to AI automation



Source: Eurostat, ONS, Swiss Federal Statistical Office, O*Net, KPMG analysis.

Furthermore, since 2015, almost all EU labour markets apart from Romania, have seen an increase in the share of tasks suitable for Generative AI automation. This reflects the ongoing shift toward greater share of cognitive based tasks and services in economic activities, which corresponds to the type of tasks that are more amenable to be performed by AI systems.

How the labour market adjusts in response to a widespread adoption of AI technologies is uncertain. The potential changes to the labour market can be grouped into several effects:

01 **AI directly replaces human labour for some tasks.** This may roughly correspond to the 2.5% estimate of the overall number of affected tasks above. We would expect affected occupations to shift towards a more intensive focus on non-AI tasks – leading to higher productivity under current distribution of activities.

02 **Emergence of new tasks for both human workers and AI applications.** While emerging tasks are inherently unpredictable, we could envisage a new category of tasks of interfacing with AI tools, such as prompt engineering, verification and editing of AI outputs to become more prevalent. Other tasks may also emerge in response to shifts in demand and consumption patterns.

03 **Changes arising from the degree of substitution or complementarity between AI and non-AI tasks.** These changes are likely to lead to unpredictable changes to demand for both AI and non-AI tasks due to wide uncertainties whether AI tasks complement or substitute for human activities. For example, if the application of AI tools leads to a dramatic increase in online content, the resulting surge in demand for human moderation would represent a complementary relationship between AI and non-AI tasks. Conversely, AI's potential to simplify how users interact with coding languages could sharply diminish the demand for coding instruction, an example of AI substituting for human labour.

04 **A general increase in demand for both AI and non-AI tasks due to rising incomes enabled by higher productivity.** This impact is likely to be more pronounced for goods and categories seen as non-essential, due to their higher sensitivity to incomes. In line with this, an increase in demand for leisure time could therefore reinforce the ongoing trend towards a decline in average weekly working hours per person.

Despite AI's expected net positive contribution to overall incomes, the immediate transition could be marked by disruption. Workers in highly exposed occupations facing a sudden decline in demand for their skills would clearly benefit from retraining and support to transition to other occupations. This is one area where the public sector has a clear role to play, in enabling a rapid transition to a new mode of working, while minimising the negative impacts on affected workers.

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