European Economic Outlook

Resilient growth amid persistent shocks

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Underlying euro area GDP growth remained resilient in Q2 2026 despite the Middle East conflict

Euro area GDP growth remained resilient in the first half of 2026. Excluding Ireland, euro area GDP expanded by 0.3% q/q in both Q1 and Q2 2026, with year-on-year growth of 1.1-1.2%, broadly matching the pace recorded in H2 2025. While consumption and investment slowed somewhat, weighed down by higher energy prices and conflict-related uncertainty, growth was supported by robust exports, as the European economy appears finally to be benefiting from the expansion in global trade. At the sectoral level, manufacturing output recovered slightly in Q2 2026 but remained stagnant year on year. Services activity appears to have accelerated, led by transport, tourism and consulting.

All major European economies recorded positive quarter-on-quarter GDP growth in Q2. Most notably, Germany's GDP expanded for the third consecutive quarter, marking an exit from the stagnation of previous years. We estimate that this expansion was largely attributable to fiscal stimulus, although exports were also supportive in the first half of 2026. Growth in France, Germany, Italy and the UK remained relatively sluggish at 0.5-1.2% y/y. Spain continued to outperform at 2.7% y/y, as growth continued to be driven by booming tourism and housing activity, strong immigration flows, and NextGenEU disbursements.

Growth remained divergent across other European economies, although it generally exceeded the euro area average:

- Growth remained resilient in the Netherlands at 0.4% q/q and 1.5% y/y and accelerated sharply in Switzerland to 1.9% q/q and 2.3% y/y on the back of stronger external demand. By contrast, Belgium and Austria stagnated, remaining among Europe's weakest-performing economies.
- Poland and several other CEE economies (Slovenia, Lithuania, Bulgaria, Serbia) continued to grow strongly at around 3-4% y/y, supported by real income gains, expansionary fiscal policy and NextGenEU spending. Regional performance remained uneven, however, with solid growth of 1.5-2.0% y/y in Czechia, Croatia and Hungary, near-stagnation in Slovakia and a contraction in Romania amid fiscal tightening and high inflation.
- The Nordic economies recorded a strong quarter. Growth in Sweden accelerated to above 3% y/y. Denmark remained among Europe's fastest-growing economies, although headline growth continued to be disproportionately influenced by the pharmaceutical sector. Growth in Finland and Norway also accelerated to 1.6-2.0% y/y, although momentum in Norway's mainland economy remained sluggish as elevated interest rates constrained investment.
- Irish GDP partially recovered in Q2 following declines in previous quarters. However, headline GDP remains heavily distorted by pharmaceutical production and is therefore a poor indicator of underlying economic activity. We estimate that growth in modified final domestic demand slowed significantly in Q2 but remained positive at around 1.5% y/y.
- In Turkey, we estimate that GDP growth partially recovered in Q2 following an abrupt decline in exports in Q1, but remained relatively subdued by historical standards at around 3% y/y. Similarly, growth in Kazakhstan picked up to 4.1% y/y as oil production came back online, but remained significantly below last year's pace.

The labor market remains broadly balanced. Euro area employment growth has slowed to 0.5% y/y in H1 2026, with Spain acting as the main driver in an otherwise subdued labor market. As the slowdown in employment growth has broadly matched weaker labor force growth amid increasingly unfavorable demographic trends, the unemployment rate remained broadly unchanged, hovering near historical lows. However, unemployment continued to fall in Southern Europe while edging up in Germany and the UK. Nominal wage growth in the euro area slowed to 3.3% y/y as real wages have caught up with productivity. CEE economies continue to record much faster wage growth than Western and Southern Europe. At the other end of the spectrum, France and Switzerland stand out with slower wage growth, which is constraining consumer spending.

Oil prices have declined despite the Hormuz closure, but inflation remains elevated; the ECB hiked rates while most central banks stayed on hold, and bond yields continued to rise

Except for a brief partial reopening in June, the Strait of Hormuz has remained closed. Despite the continued closure, oil prices are below their May peaks. Gasoline and diesel prices have fallen much less, however, keeping fuel price inflation elevated. The relatively muted oil price response to the closure of the Strait, given the scale of the shock, can be explained by the rerouting of supplies through Fujairah and the Red Sea, the pre-conflict oil market surplus, weaker oil demand (especially from China) and substantial inventory drawdowns.

Supported by some moderation in oil prices and a decline in food inflation, headline inflation in the euro area fell to 2.9% in July from 3.2% in May. Core inflation remained broadly unchanged at 2.5%, around 0.2 pp above its pre-conflict levels due to some acceleration in core goods inflation. Supply chain disruptions, higher energy and metal prices from the Middle East conflict and AI-related investment are likely to push core goods inflation higher in the coming months.

Cross-country inflation differentials have narrowed in recent months, with most economies recording HICP inflation of around 3% in July. Nevertheless, several exceptions are worth noting:

- Among the major euro area economies, Spain records the highest inflation (3.9% in July) reflecting stronger and accelerating core price pressures. These pressures may be explained by robust domestic demand, which is facilitating a stronger pass-through of the energy shock to consumer prices.
- Romania continues to record the highest inflation in the EU (at 8.2% in July) due to broad-based price pressures exacerbated by increases in VAT and fuel prices. Inflation exceeds 4% in Lithuania and Bulgaria, reflecting strong wage growth, high services inflation and (in Lithuania) deregulated electricity prices.
- In contrast, inflation remains low in Switzerland and Sweden (below 1%), followed by Denmark, Czechia, Hungary and Serbia (below 2%) due to a mix of factors: tax and regulated electricity price cuts (Sweden, Denmark, Czechia, Serbia), limited wage growth (Switzerland, Sweden), currency appreciation (Sweden, Hungary), strong food price deflation (Czechia, Hungary, Serbia), and a fuel price freeze (Hungary).
- Disinflation stalled in Turkey following the energy shock, with price growth remaining above 30% y/y. By contrast, disinflation continued in Kazakhstan, where inflation declined to 10.2% in July.

In response to the energy shock, the ECB raised the deposit facility rate by 25 bp to 2.25% in June. The Fed and the Bank of England have kept their policy rates unchanged, as rates in both economies are already above neutral, at 3.75%. In the UK, the decision to remain on hold has also been supported by disinflation in non-energy components. Most other central banks in Europe have likewise kept policy rates unchanged, as falling food prices and regulatory measures have at least partly offset the impact of the Middle East conflict on headline inflation. The central bank of Hungary is an exception, having cut rates by 100 bp to 5.5% amid FX appreciation and low inflation. The central bank of Kazakhstan has also reduced its policy rate by 125 bp to 16.75%, as inflation eased.

Despite cautious monetary policy and the partial reversal of the oil price shock, bond yields have generally continued to trend up, pointing to broader concerns about inflation risks and fiscal sustainability. Nevertheless, credit demand has remained resilient, while exchange rates have been broadly stable in recent weeks. Equity prices have continued to rise in many European economies, particularly in CEE and Southern Europe. By contrast, global equity indices have remained broadly unchanged over the past three months as the AI-related rally has lost some momentum.

Underlying euro area growth is projected to accelerate in 2026 despite headwinds and strengthen further in 2027-2028

Under the baseline scenario of gradually moderating commodity prices, we expect underlying euro area growth (excluding Ireland) to rise to 1.2% in 2026 from 1.0% in 2025, as resilience in global trade, AI-related investment and German fiscal stimulus outweigh the effects of the Middle East conflict and US tariffs. Growth should strengthen further to 1.3% in 2027 and 1.4% in 2028 as these headwinds ease. Due to volatility in Ireland, headline euro area growth is expected to slow from 1.3% in 2025 to 0.9% in 2026, before accelerating to 1.5% in 2027-28.

Country highlights:

- **Germany:** After export- and government spending-led growth over the past three quarters, momentum is likely to soften in H2 2026 as exports slow and the Middle East conflict weighs on demand. Growth should reaccelerate in 2027-28 as external headwinds diminish. Structural competitiveness challenges and demographic headwinds will continue to constrain growth, with GDP projected to rise 0.9% in 2026, 1.0% in 2027 and 1.3% in 2028.
- **UK:** GDP is expected to stagnate through the remainder of 2026 as the Middle East conflict restrains consumption and investment, with growth averaging 1.0%, down from 1.3% in 2025. A gradual recovery is expected thereafter, with growth accelerating to 1.3% in 2027 and 1.5% in 2028.
- **France:** Following stagnation in H1 2026, momentum should gradually improve, initially driven by exports and later by stronger consumption and investment as sentiment improves and real incomes rise. Growth is projected at 0.7% in 2026, increasing to 1.1% in 2027 and 1.4% in 2028.
- **Italy:** After relatively strong growth over the past four quarters, momentum is expected to stall in H2 2026 as the Middle East conflict weighs on consumption, investment and exports. From 2027, quarterly growth should return to its estimated potential pace of around 0.2%. GDP is forecast to expand by 0.6-0.7% in 2026-28, broadly matching the previous two years.
- **Spain:** Growth should remain strong at 2.7% in 2026 before slowing to 2.0% in 2027 and 1.6% in 2028 as support from immigration, tourism and housing gradually fades.
- **Rest of Western Europe:** Dutch growth is expected to remain close to potential at 1.3-1.5% in 2026-28. In Switzerland, following an export-driven but broad-based acceleration in Q2, we expect growth to average 1.9% this year before moderating to 1.6% in 2027 and 1.3% in 2028. In Ireland, pharma-driven weakness is expected to push GDP down 5.9% in 2026, before rebounding by 7.1% in 2027 and 3-4% thereafter. Modified final domestic demand in Ireland is expected to slow to 2.2% in 2026 before strengthening to 3-4% from 2027.
- **Nordics:** Following strong growth in 2026 (Denmark 3.6%, Sweden 2.5%, Finland 2.2%), GDP growth is expected to ease toward 1.5-2.0% as cyclical recovery and pharmaceutical sector expansion moderate. In Norway, growth may improve slightly from 1.3% in 2026 to 1.5% in 2027-28 as mainland activity strengthens while hydrocarbons slow.
- **Poland:** Poland is expected to remain the fastest-growing large European economy, with GDP rising by 3.9% in 2026, supported by real income gains, NextGenEU funding and defense investment, before slowing toward 2.5-2.7% in 2027-28 as public investment plateaus and demographic constraints increasingly weigh on potential growth.
- **Other CEE economies:** Growth will remain uneven and modest on average in 2026, reflecting contraction in Romania, slower growth in Czechia, Bulgaria and Croatia partly because of the effects of the Middle East conflict, and recovery in Hungary and Serbia. From 2027, growth should strengthen and remain in the 2-3% range, supported by rising real incomes and an industrial recovery.
- **Turkey:** Growth is projected to slow from 3.6% in 2025 to 2.8% in 2026 as the Middle East conflict weighs heavily on activity, before accelerating to 4.2% in 2027 as investment and exports recover. Thereafter, annual growth should stabilize at around 3.5%.

Despite emerging second-round effects, euro area inflation is expected to return to around 2% from Q2 2027

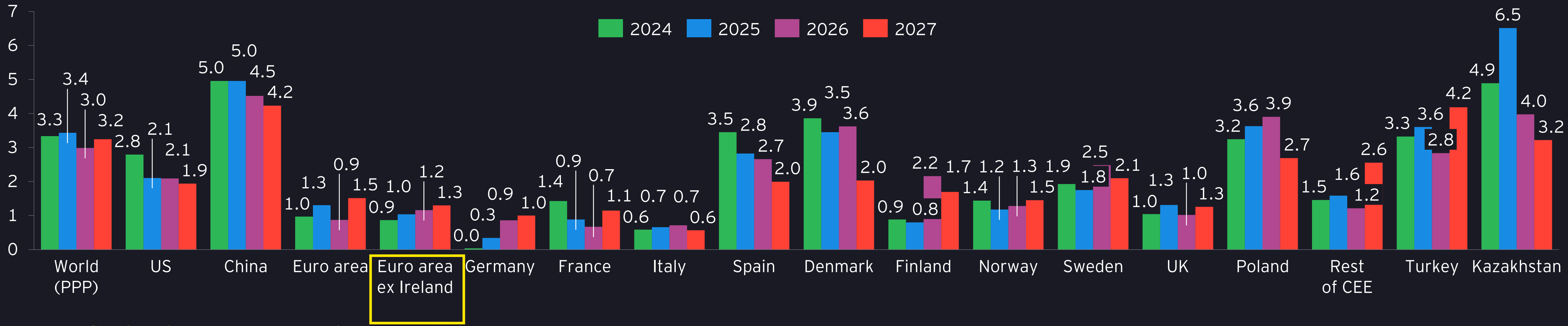
We expect euro area inflation to average 2.8% in 2026, 2.3% in 2027, and 2.0% in 2028. The direct impact of the Middle East conflict on fuel prices will be the main driver of elevated inflation between Q2 2026 and Q1 2027. We expect supply chain bottlenecks and elevated energy and metal prices to pass through to core goods and consumer electricity prices in the near term. Food inflation should remain subdues through end-2026 before gradually picking up. These inflationary pressures are expected to be largely offset by a further moderation in services inflation, reflecting a slowdown in wage growth in recent quarters. As a result, core inflation is projected to remain around 2.5% through end-2027 before converging to 2% as the effects of the Middle East shock fades. Headline inflation should return to around 2% from Q2 2027, when the increase in fuel prices drops out of the year-on-year calculation.

Country highlights:

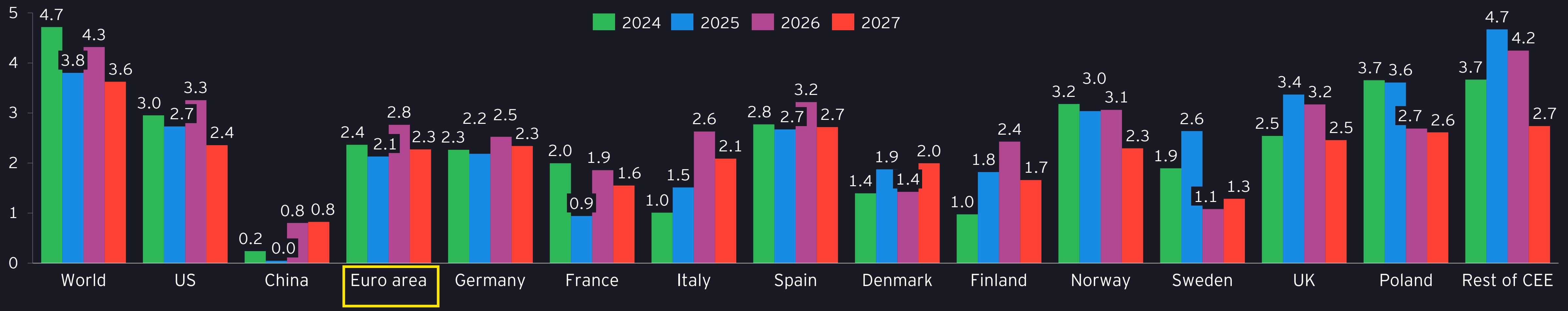
- Among the major economies, inflation is expected to remain elevated in Spain (3.2% in 2026, 2.6-2.7% in 2027-28) as core price pressures subside only gradually. In contrast, after the fuel price increase falls out of the year-on-year calculation, CPI inflation is expected to undershoot the target in France (1.6-1.7% in 2027-29) because of relatively weak wage growth. In Germany, inflation is projected to be very close to the euro area average. In the UK, inflation may rise in the second half of 2026 due to increasing electricity prices but should return to 2% from mid-2027. In Poland, inflation is expected to remain close to 2.5% as low food inflation offsets higher fuel and core prices in the near term.
- In Romania, after averaging 8.2% this year, inflation is expected to subside relatively quickly as the VAT hike drops out of the year-on-year calculation and underlying price pressures ease due to weak demand and more restrained public-sector wage growth, with headline inflation converging to the 2.5% target by 2028.
- After averaging 4-5% this year, inflation in Greece, Croatia and Bulgaria should decline to around 2% from 2027 onward as the fuel price increase drops out of the year-on-year calculation. Inflation may prove more persistent in Slovakia and Ireland at close to 3% in 2027 and 2028 due to lingering core price pressures.
- At the other end of the spectrum, we expect inflation in Switzerland to remain persistently low at close to 0.5% due to muted wage growth and low inflation expectations.
- In Sweden, CPIF inflation is expected to remain low until Q2 2027 when the food VAT cut drops out of the year-on-year calculation and may increase sharply in 2028 if the standard VAT rate is reinstated. Underlying price pressures should nevertheless pick up, with non-food non-energy CPIF inflation increasing from 1.2% in 2026 to 1.9% in 2027 as core goods prices increase. In Denmark, inflation should increase from 1.4% in 2026 to 2% in 2027 as electricity and food price declines fade. In Hungary, inflation is expected to gradually increase but remain subdued, returning to the 3% target only in 2029. In Serbia, inflation is set to rise toward 5% by end-2026 as core inflation accelerates further because of strong domestic demand and higher energy prices, while the drop in food prices falls out of the year-on-year calculation.
- In Turkey, we expect inflation to remain above 30% by year-end. Disinflation is expected to restart in 2027, with headline price growth declining to 17.5% at end-2027 and 11% at end-2028. In Kazakhstan, we expect disinflation to continue, with headline inflation dropping to 6.5% at end-2027 and stabilizing thereafter.

Underlying euro area growth is projected to accelerate this year despite headwinds. Inflation is expected to return to the 2% target from Q2 2027

GDP growth in 2024-2027 (in percentage)



Inflation in 2024-2027 (in percentage)



Source: Oxford Economics, EY EAT forecast, EY UK, EY Italy, EY-Parthenon US Macroeconomics Team.
The Nordics include Denmark, Finland, Norway and Sweden. Rest of CEE includes Bulgaria, Croatia, Czechia, Hungary, Romania, and Slovakia.

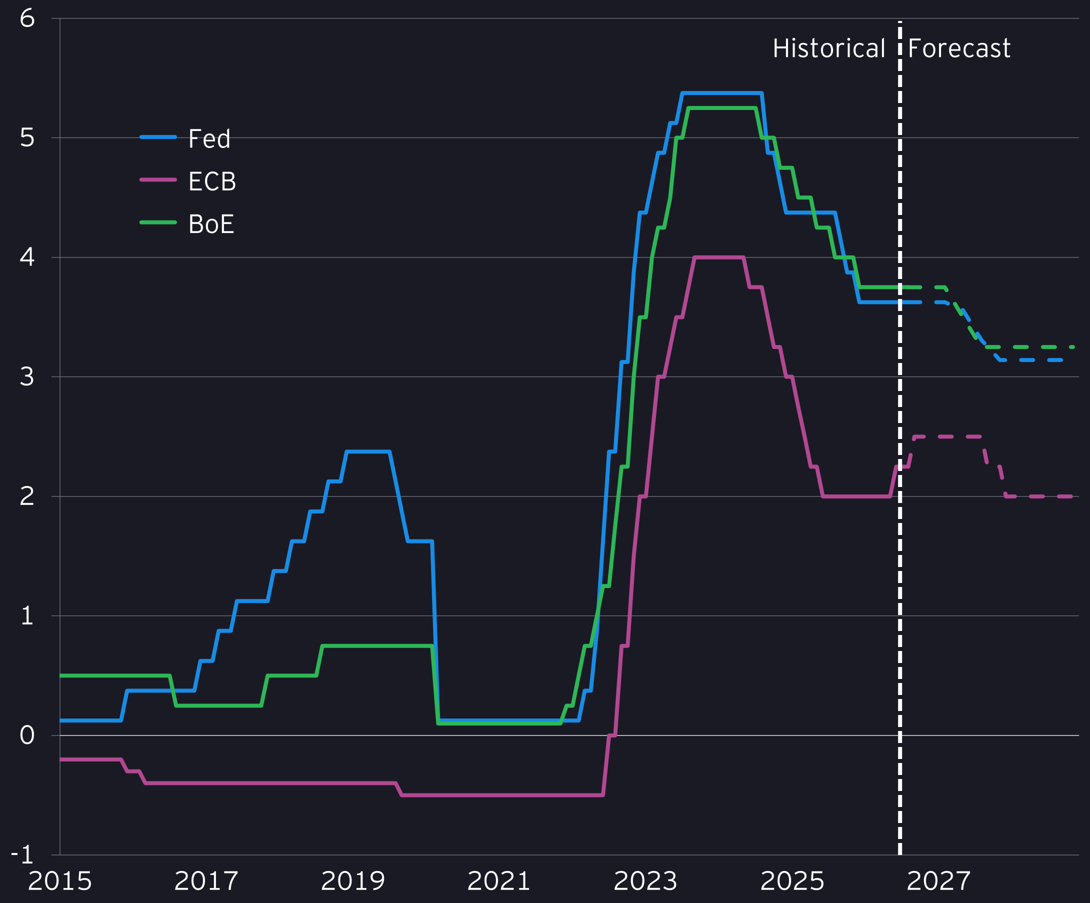
We expect one further ECB hike in September, followed by a reversal of this year's tightening in H2 2027. Most other central banks should remain on hold through year-end and resume easing in 2027

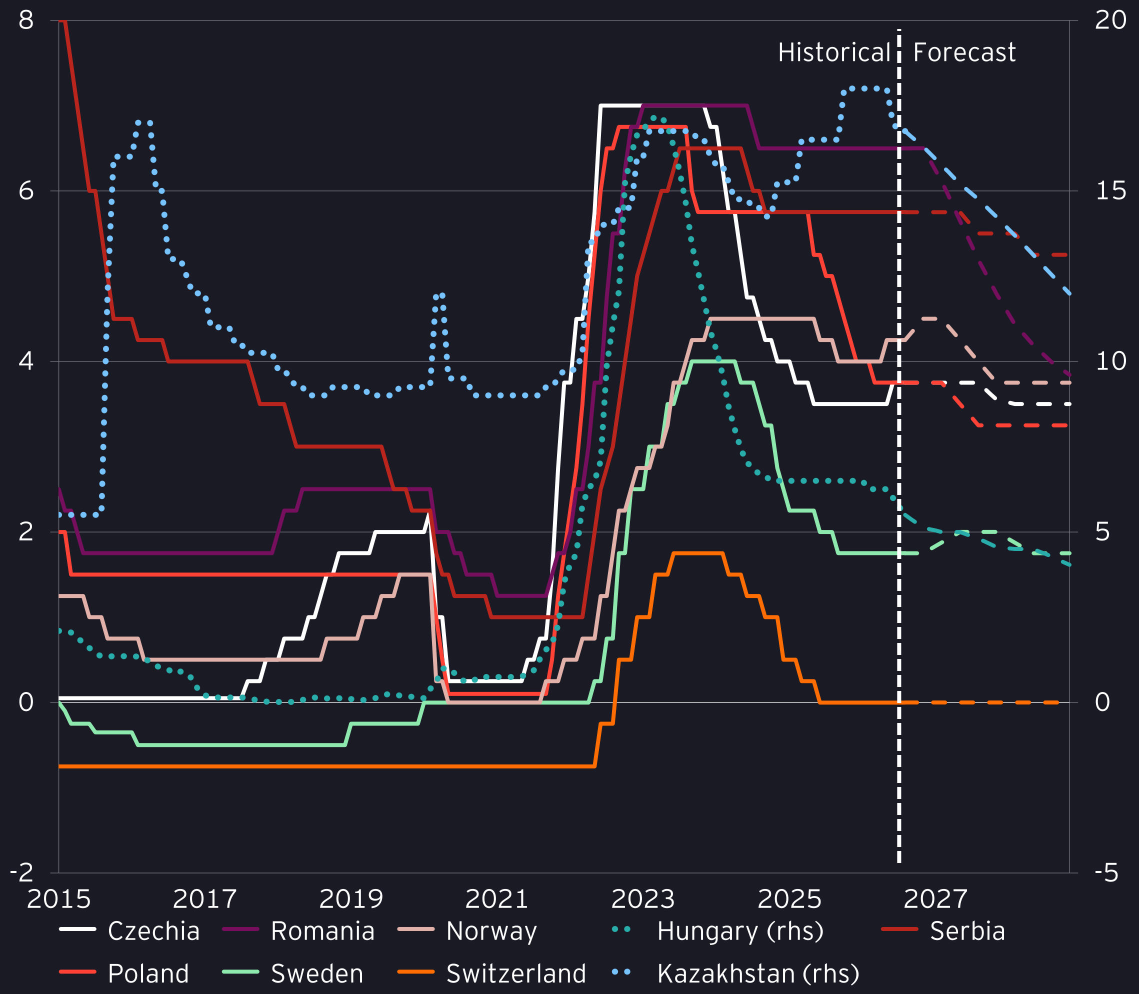
Monetary policy:

- **ECB:** We expect one 25 bp rate hike in September. Given our expectations of inflation returning to 2% as early as Q2 2027 and core inflation beginning to subside in the second half of 2027, we expect the ECB to cut the deposit rate back to 2% in H2 2027.
- **Fed:** While we continue to expect the Fed to remain on hold in 2026 before delivering 50 bp of cuts in 2027 as inflation normalizes, recent hawkish communication increases the likelihood of a rate hike this year.
- **BoE:** Given easing underlying price pressures, we expect the BoE to keep rates unchanged in 2026, before delivering 50 bp of easing in 2027 when headline inflation normalizes.
- **SNB:** With inflation remaining low, we expect the policy rate to stay at 0% through end-2029.
- **Sweden:** Rising core inflation and higher ECB rates should prompt a 25 bp hike in early 2027. As CPIF inflation falls below 2% in 2028, the policy rate may subsequently decline toward 1.75%.
- **Norway:** We expect one final 25 bp hike to 4.5% in September, followed by gradual easing to 3.75% by end-2027 as inflation falls.
- **CEE:** Apart from Hungary, we expect central banks to stay on hold this year before resuming easing in 2027.
  - **Poland:** We anticipate the National Bank of Poland (NBP) to keep the reference rate unchanged at 3.75% this year, given that core inflation is projected to rise toward 3.5%, preventing easing. Rate cuts are possible in 2027 after core inflation begins to decline, with an estimated terminal rate of 3.25%.
  - **Czechia:** Despite the CNB's hawkish stance, low inflation should make further hikes unlikely. Rates may be cut to 3.5% by late 2027 as core inflation eases.
  - **Hungary:** Low inflation and a stronger forint should allow rates to fall to 5.0% by year-end, followed by a pause in H1 2027. We see the terminal rate of 3.75%.
  - **Romania:** Persistently high inflation is likely to keep rates unchanged through year-end. Easing should resume in early 2027, with rates falling to 4.75% by end-2027 and 3.75% by end-2028.
  - **Serbia**: With core inflation projected to rise above 5%, household demand receiving additional fiscal support, and credit growth remaining strong, the NBS is likely to keep the policy rate at 5.75% until the second half of 2027 and ease only gradually thereafter, once domestic price pressures begin to recede.
- **Turkey:** We expect the TCMB to align its 40% funding rate with the official 37% policy rate by year-end by reinstating one-week repo auctions. Rate cuts should start in 2027, reaching 24% by end-2027 and 15.5% by end-2028.

Interest rate forecasts

Central bank policy rates (%)





Source: Oxford Economics, ECB, Fed, BoE, CNB, NBR, Norges Bank, MNB, NBS, Riksbank, SNB, NBP, EY UK, EY Parthenon US Macroeconomics Team, EY EAT forecast.
Dashed lines denote forecast.

The economic outlook remains highly uncertain, with the Middle East conflict the main near-term risk and AI an increasingly important driver

The balance of risks remains skewed toward higher inflation and interest rates and lower GDP growth.

The Middle East conflict remains the main near-term risk. The Strait of Hormuz remains closed and progress in US-Iran talks has been limited. The impact on oil and gas prices has so far been contained by inventory drawdowns, weak demand (especially in China) and the pre-conflict oil surplus. However, if the closure persists, these factors may fade, triggering a stronger rise in commodity prices. Conversely, a full reopening could lead to a faster-than-assumed decline in oil prices, although the potential upside to growth appears smaller than the downside risk associated with a renewed commodity price spike.

To illustrate these risks, we constructed three scenarios:

- **Optimistic scenario**: oil prices quickly fall to USD 68-70/bbl.
- **Adverse scenario:** oil prices return toward USD 100/bbl and then decline gradually.
- **Severe scenario:** oil prices rise above USD 140/bbl in the short term and remain close to USD 100/bbl over the medium term.

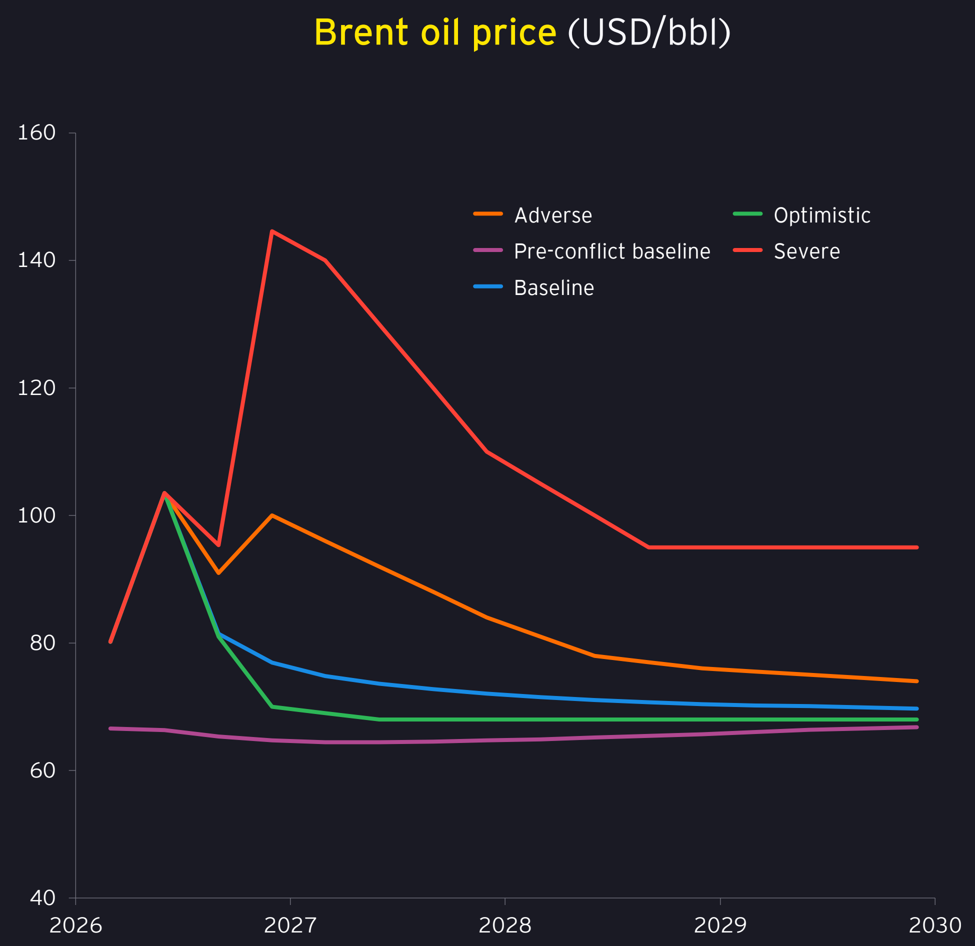
Under the optimistic scenario, euro area inflation would be 0.6 pp lower and GDP growth 0.2 pp higher in 2027 than in the baseline scenario. Under the adverse scenario, euro area HICP inflation would be 1.3 pp higher and GDP growth 0.4 pp lower. Turkey would be most affected, followed by Czechia, Romania and the UK, while the Nordics, Poland and the Netherlands would be least impacted. Under the severe scenario, euro area inflation would peak at close to 6%, and GDP growth would be 0.8-0.9 pp lower in both 2027 and 2028 compared to the baseline scenario.

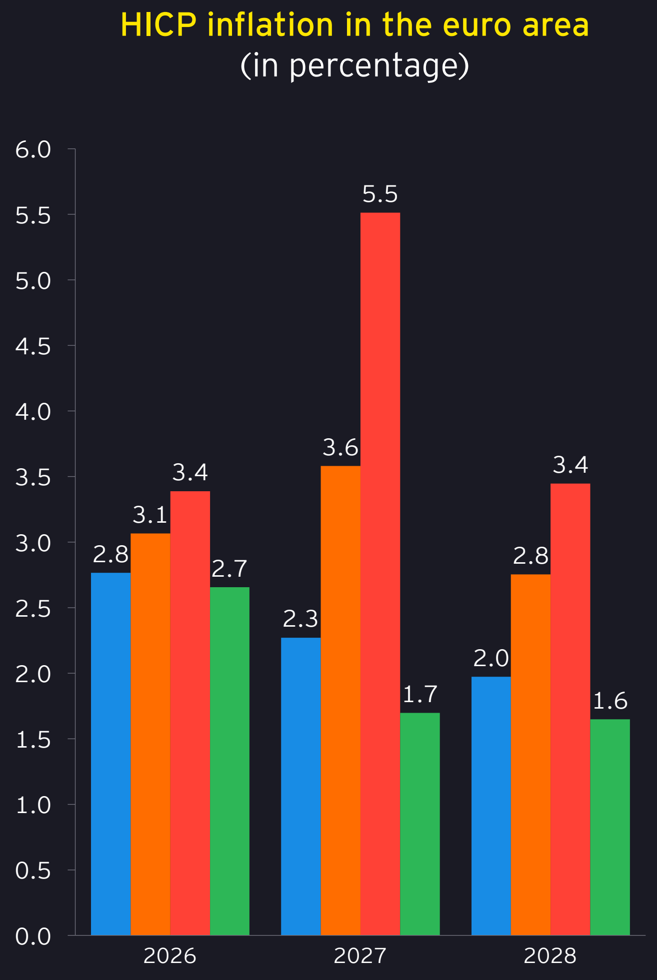
AI is another key driver of the outlook. AI is already influencing activity through investment, trade and equity prices and may have contributed to the productivity revival in the US. Although the effects of AI are most evident in the US and several Asian economies, Europe is benefiting indirectly from stronger global trade. Over time, AI-driven productivity gains will be crucial in offsetting adverse demographics. We estimate that AI may already have raised Europe's productivity by around 0.2% and assume 0.4% of additional gains by 2029. Risks are tilted to the upside. Conversely, if AI leads to labor displacement, the impact on GDP may be reduced.

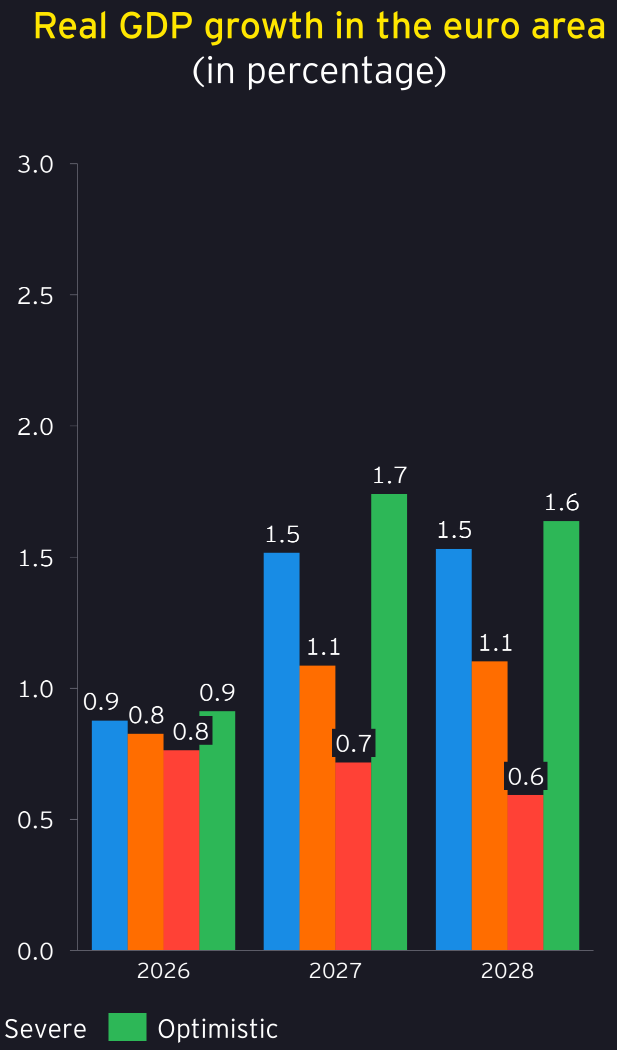
Other important sources of uncertainty include:

1. **Fiscal policy:** Germany's fiscal package is being implemented, but the pace, scale and economic impact remain uncertain. The timing and design of measures to cushion higher energy prices affect near-term inflation. Further risks arise from high fiscal deficits, political instability and elections in countries including France, Poland and Romania.
2. **Tariffs and trade policy:** Global trade has remained resilient despite US tariffs, supported by AI-related trade, and the tariff framework has stabilized. Nevertheless, tariffs remain a source of uncertainty due to potential legal challenges, their use in political negotiations, and uncertainty over their durability beyond the next US presidential election.
3. **Exports and competitiveness:** European exports underperformed global trade in 2024-25, particularly in Germany and France. While we expect export growth to accelerate, the shift toward AI-related goods and a structural loss of industrial competitiveness may prolong Europe's underperformance and weigh on GDP growth.
4. **Equity prices:** US equity valuations are elevated by historical standards and, by some measures, are approaching levels observed during the dotcom bubble. If expectations of AI-related earnings growth are not realized, the risk of a significant market correction would increase. Although European valuations remain considerably lower and stock markets play a less important economic role, a major US market downturn would affect Europe through weaker external demand and sentiment, as well as tighter financial conditions. We estimate that a dotcom-style equity market downturn could reduce euro area GDP by 0.6%.
5. **Demographics and migration policy:** Europe's unfavorable demographics, tighter migration policies and political resistance to immigration weigh on growth prospects. However, immigration and labor force participation have continued to surprise on the upside. The EU's working-age population is currently 1.6% higher and its labor supply 2.3% higher than we projected four years ago, suggesting upside risks to our baseline assumption of broadly stagnant labor supply through 2029.

The outlook remains highly uncertain, with risks clearly skewed toward higher commodity prices and inflation and lower GDP growth







Source: EY EAT analysis.

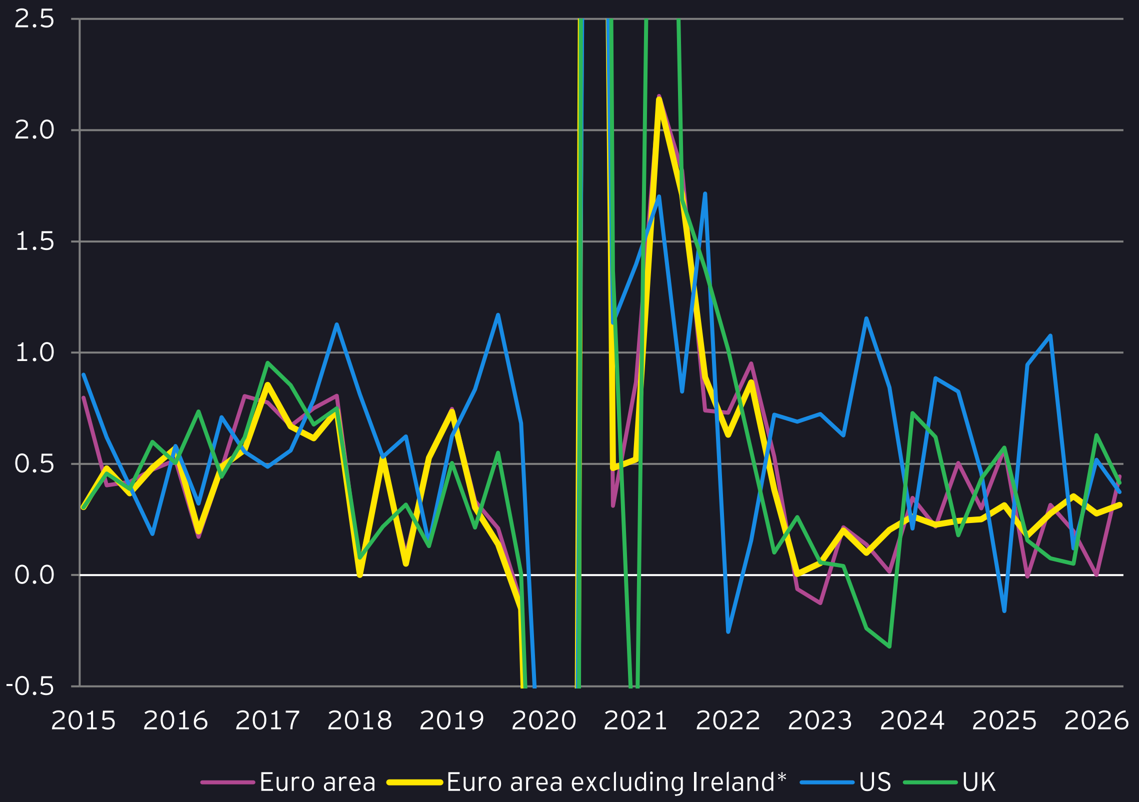
Chapter 1

Economic activity in recent quarters

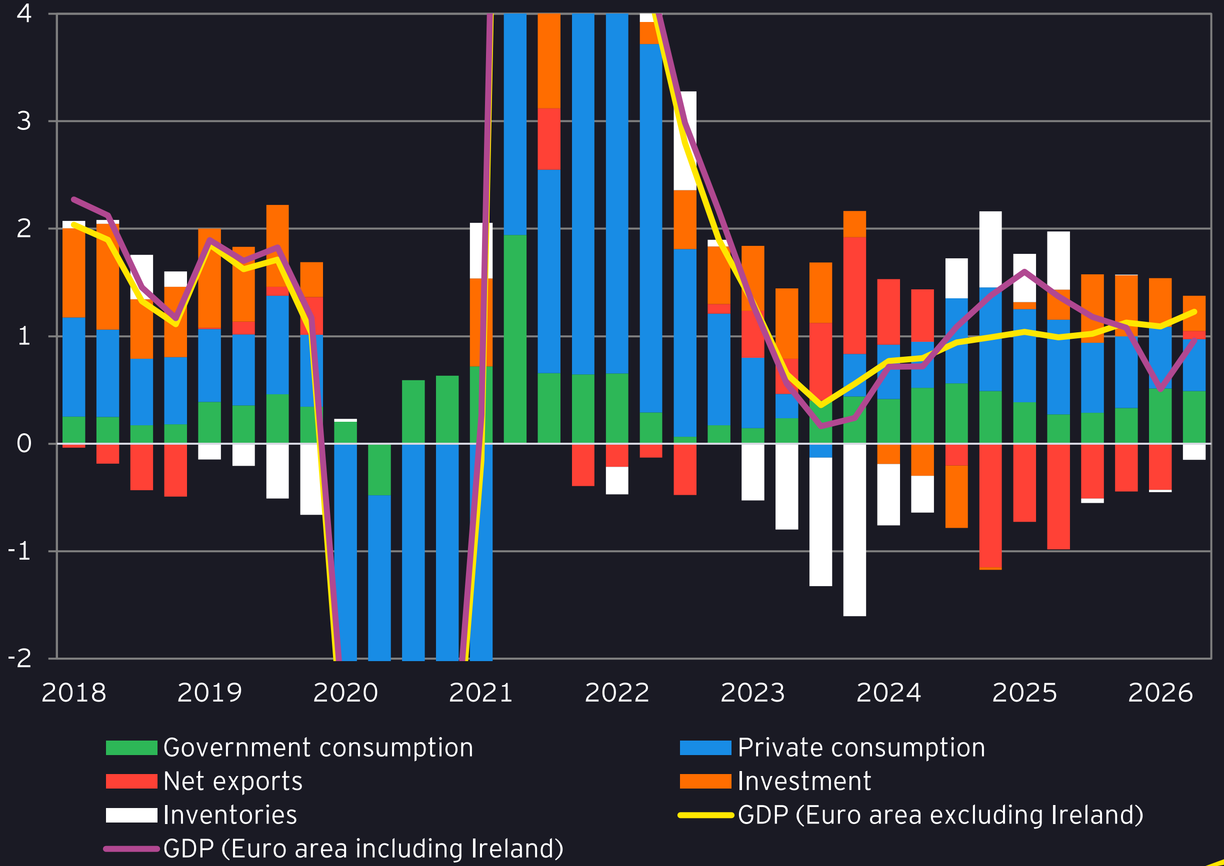
Underlying euro area GDP growth remained resilient in Q2 2026 despite the Middle East conflict

- Underlying euro area real GDP growth (excluding Ireland) remained at 0.3% q/q in Q2 2026, similar to previous quarters
- Headline GDP growth continued to be more volatile due to large fluctuations in Ireland
- Growth was driven primarily by a recovery in exports and robust government spending, while private consumption and investment decelerated slightly

Q/q real GDP growth
(in percentage, seasonally adjusted)



Contributions to y/y GDP growth in the euro area excluding Ireland* (in percentage points)

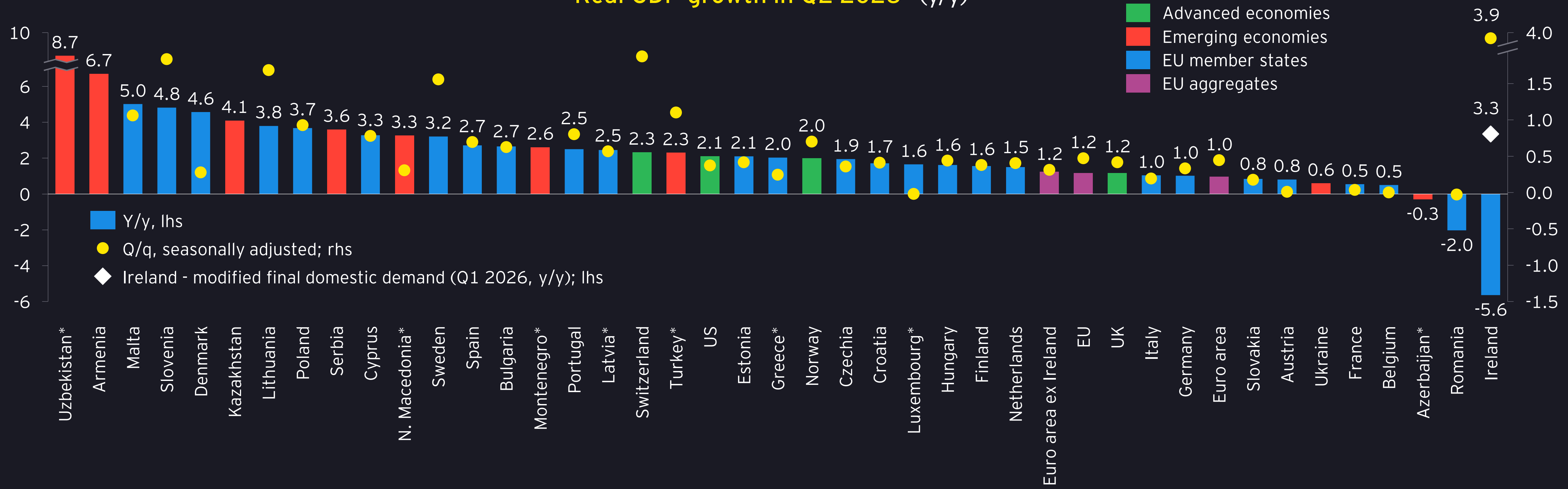


Source: Eurostat, Fred, ONS.
* Ireland is excluded as its GDP tends to be very volatile, reflecting the outsized role multinational corporations play in the economy.

Growth remains strong in most of Southern Europe and CEE and has picked up in the Nordics, while France, Italy and Germany continue to lag

- All major European economies recorded positive quarter-on-quarter growth in Q2. Germany saw a third consecutive quarter of growth, marking an exit from the stagnation. However, growth in France, Germany, Italy and the UK remained subdued. Spain continued to outperform, supported by strong tourism, housing activity, immigration and NextGenEU funds.
- Growth remained resilient in the Netherlands and accelerated sharply in Switzerland on stronger external demand. By contrast, Belgium and Austria stagnated, remaining among Europe's weakest performers.
- Poland and several other CEE economies (Slovenia, Lithuania, Bulgaria, Serbia) continued to grow strongly, supported by real income gains, expansionary fiscal policy and NextGenEU spending. Regional performance remained uneven, however, with solid growth in Czechia, Croatia and Hungary, near-stagnation in Slovakia, and contraction in Romania amid fiscal tightening and high inflation.
- The Nordics had a strong quarter. Growth surged in Sweden, while Denmark remained among Europe's fastest-growing economies, although headline growth was still boosted by pharmaceutical sector. Growth in Norway and Finland also accelerated, although momentum in the Norway’s mainland economy remained sluggish.
- Irish GDP partially recovered in Q2 after previous declines. However, it remains heavily distorted by pharmaceutical production and is therefore a poor indicator of underlying economic activity.

Real GDP growth in Q2 2026* (y/y)

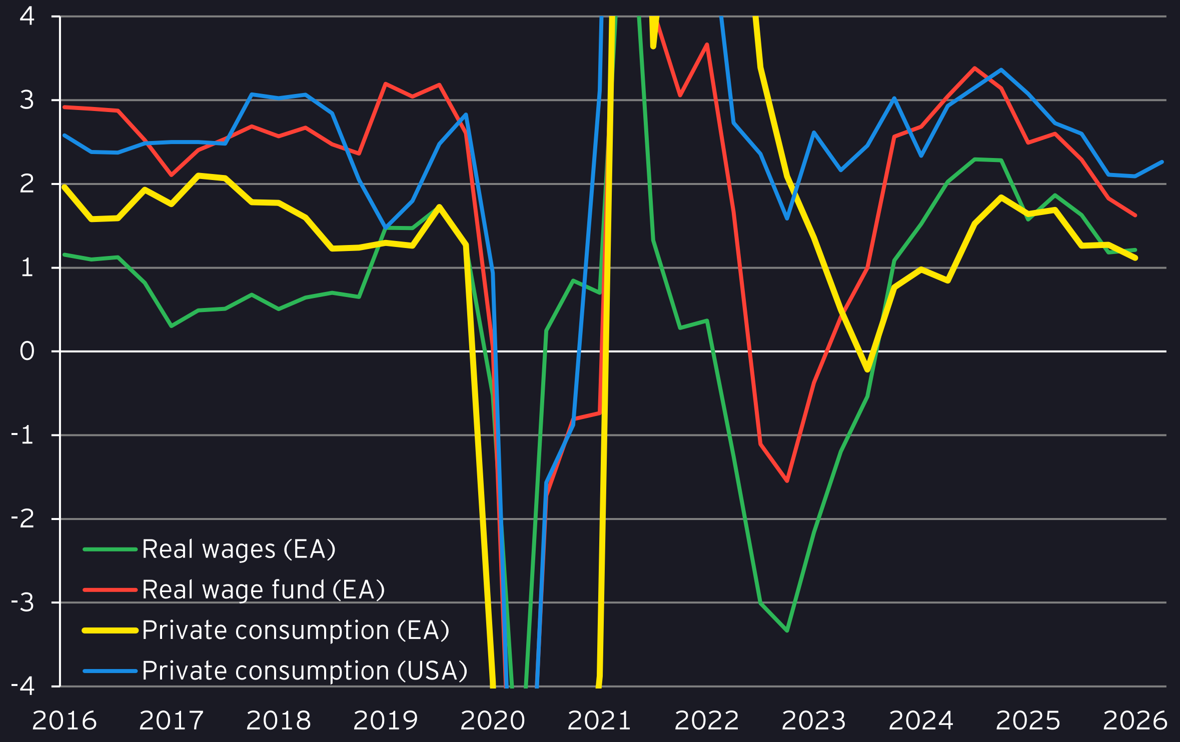


Source: Eurostat, Oxford Economics, Trading Economics, national statistical offices.
* Q1 2026 data are shown where Q2 data were not yet available.

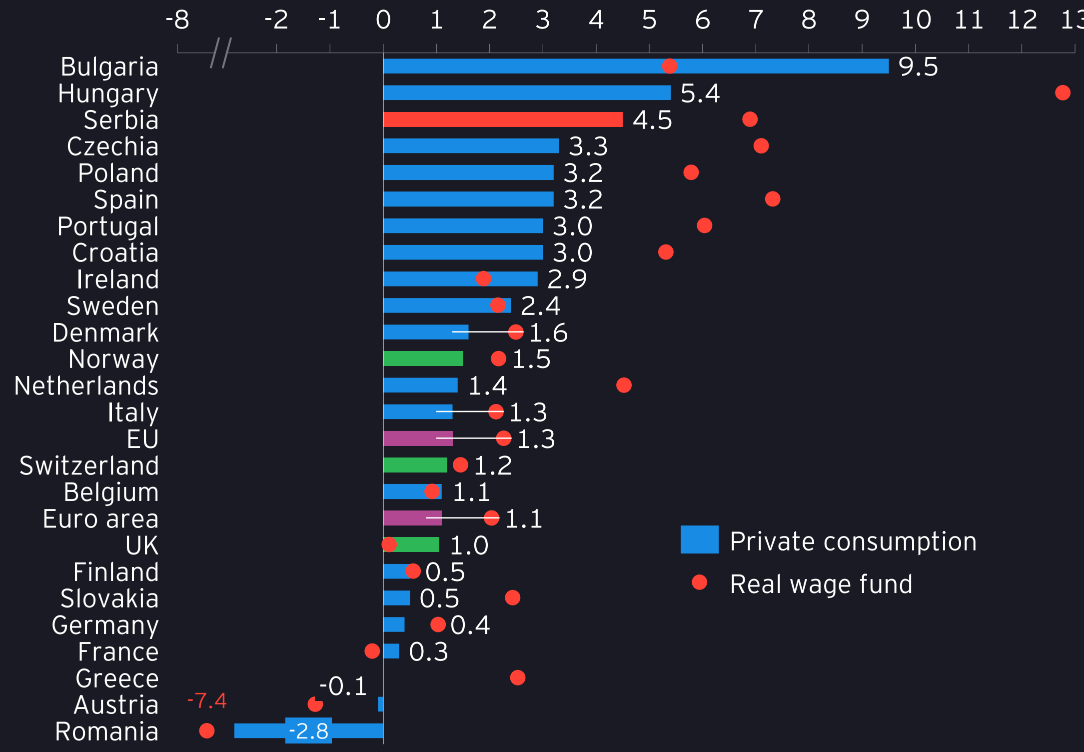
Consumer spending continued to grow, but at a slower pace than in 2024, as real income growth decelerated while savings rates stayed elevated

- We estimate that private consumption growth in the euro area slowed further to 0.9% y/y in Q2 2026 as the Middle East shock weighed on real incomes.
- Private consumption growth remains highly heterogenous across Europe.
- Consumer spending continued to surge in Bulgaria and remained robust in Hungary, Poland and Czechia, supported by strong nominal wage growth and moderate inflation. In Spain and Portugal, spending continues to be supported by immigration, employment growth and strong tourism. In the Nordics, consumption is recovering following earlier contractions.
- In contrast, consumption is falling in Romania amid high inflation and fiscal tightening which is constraining public sector wage growth.
- Consumer spending is largely stagnant in France and Austria due to low wage growth and in Greece following the inflation spike.

Real wages, real wage fund, and real private consumption in the euro area and the US (% y/y)



Private consumption and real wage fund in Q1 2026* (% y/y)

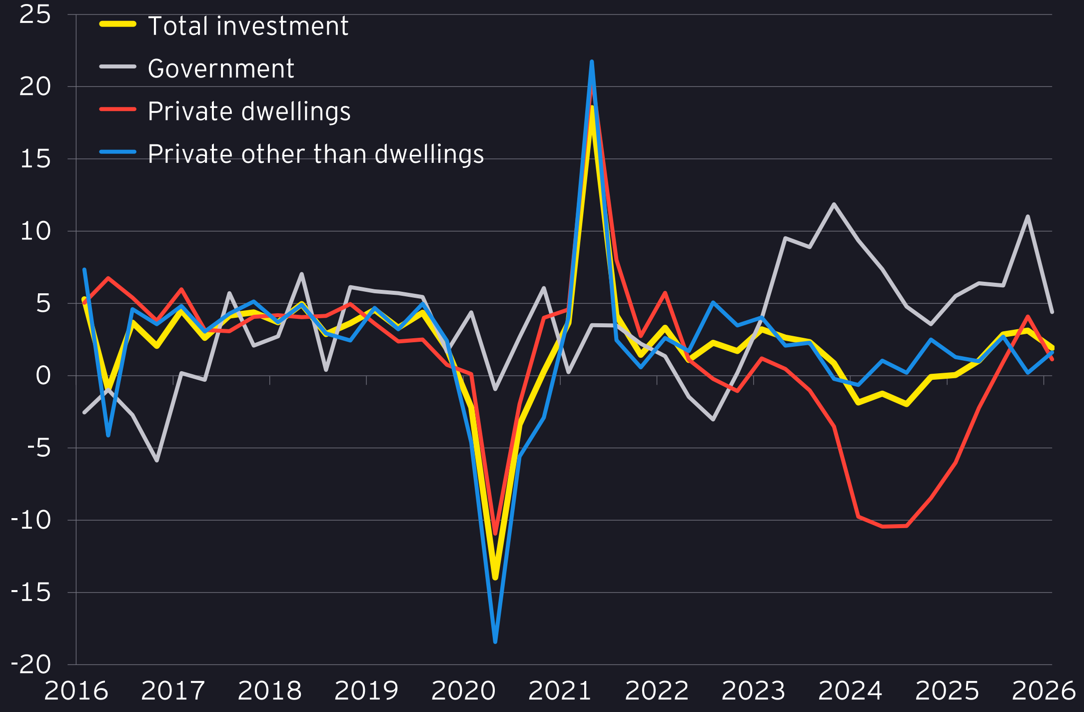


Source: Eurostat, Oxford Economics, FRED.
* More recent Q2 data are available for only a limited number of countries

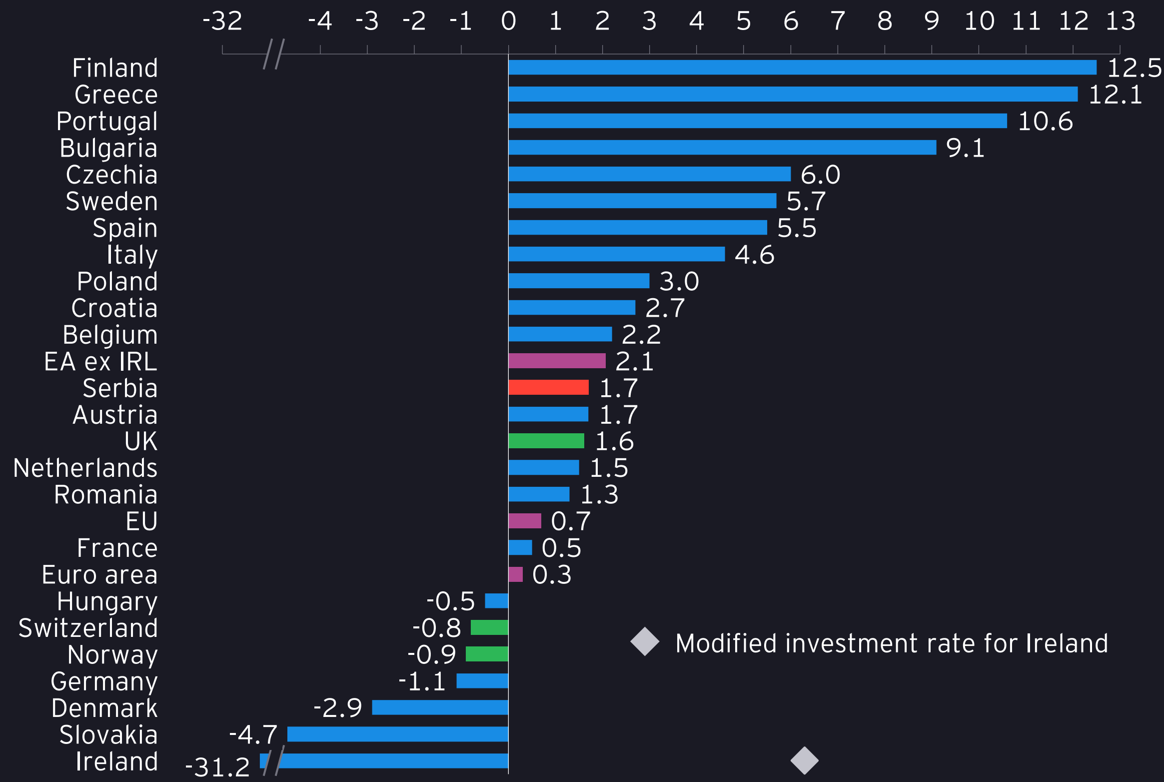
Investment growth slipped in the first half of 2026 as government investment slowed and growth in residential and business spending remained muted

- We estimate euro area investment growth excluding Ireland slowed to 1.6% y/y in Q2 2026 from 2.8% y/y in Q4 2025.
- Government investment continued to expand, supported by NextGenEU disbursements and higher military spending, though at a slower pace.
- After recovering through 2025, housing investment appears to have slowed in H1 2026 as the Middle East conflict weighed on long-term interest rates and household sentiment.
- Non-residential private investment growth remained subdued amid weak profit growth and deteriorating sentiment despite support from AI-related investment.
- Greece, Portugal and Bulgaria recorded the strongest investment growth, driven by NextGenEU and housing investment. Investment also remained strong across much of CEE and Southern Europe, with military spending providing an additional boost in Sweden and several CEE economies.
- By contrast, investment stayed weak in Germany, France, Switzerland and Norway due to limited profit growth, weak sentiment and a depressed housing sector. In Hungary, investment is beginning to recover after several years of contraction.

Real fixed capital investment by type in the euro area excluding Ireland* (% y/y)



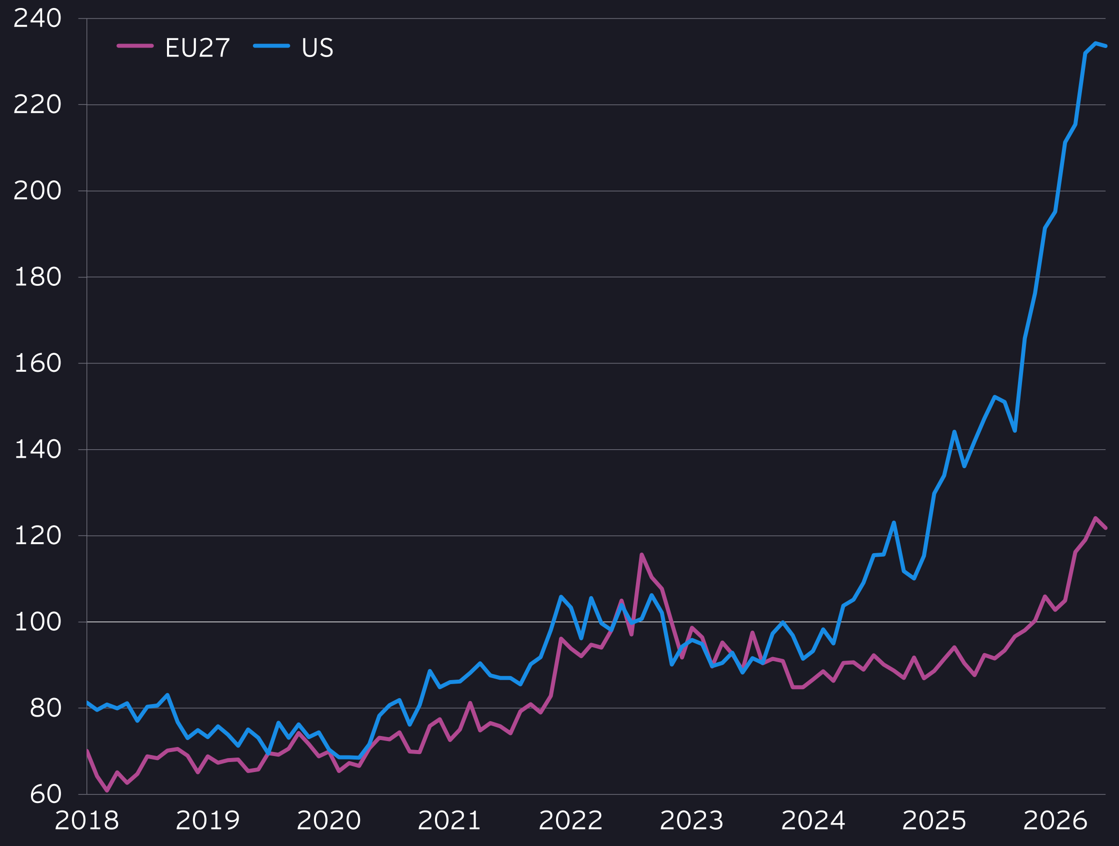
Y/y real fixed capital investment in Q1 2026** (%)



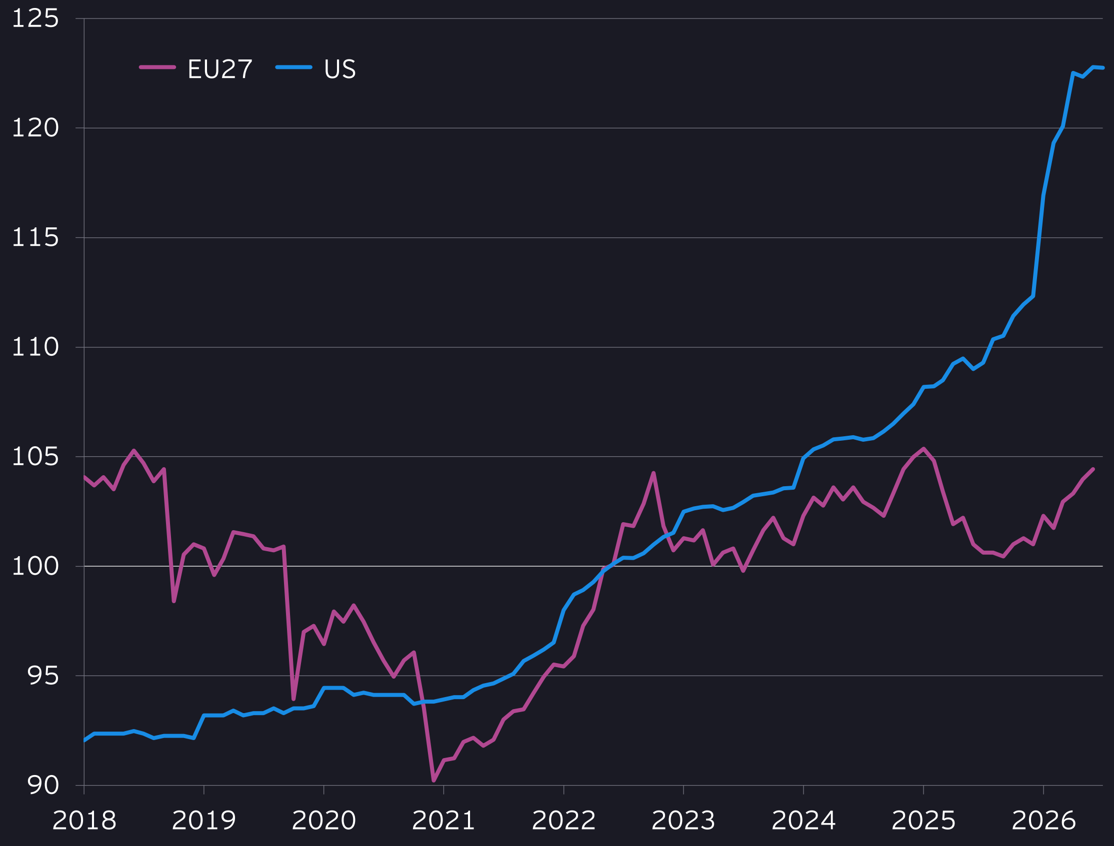
Source: Eurostat.
* Investment data for Ireland are excluded because they are highly volatile, influenced by the global activities of multinational corporations, and do not appropriately reflect the underlying investment in the domestic economy.
** More recent Q2 data are available for only a limited number of countries

Available indicators point to a pickup in AI-related investment in Europe in 2026, although the increase remains fall smaller than in the US. Weaker European demand is also keeping electronics producer prices from rising as rapidly as in the US

Imports of high-tech, AI-related goods*
(2022=100, seasonally adjusted, national currency)



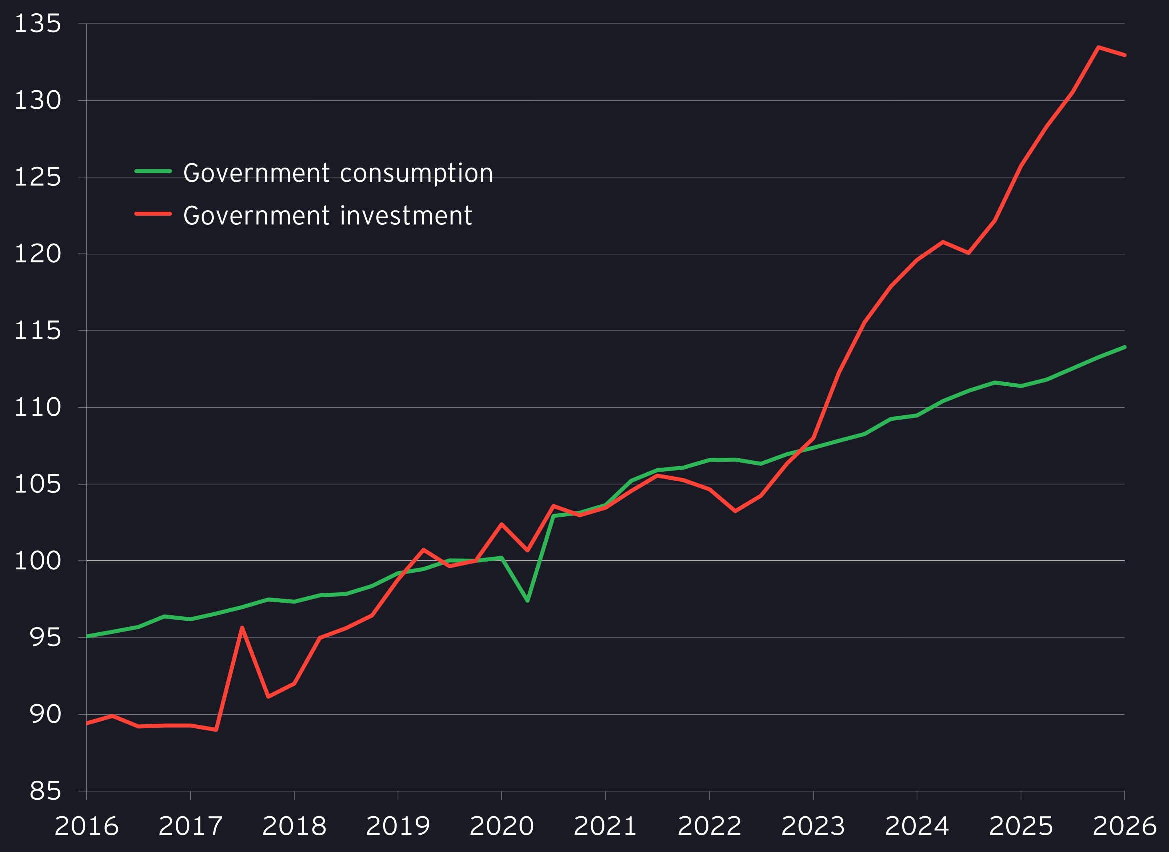
Producer Price Index in Computer and Electronic Product Manufacturing** (2022=100)



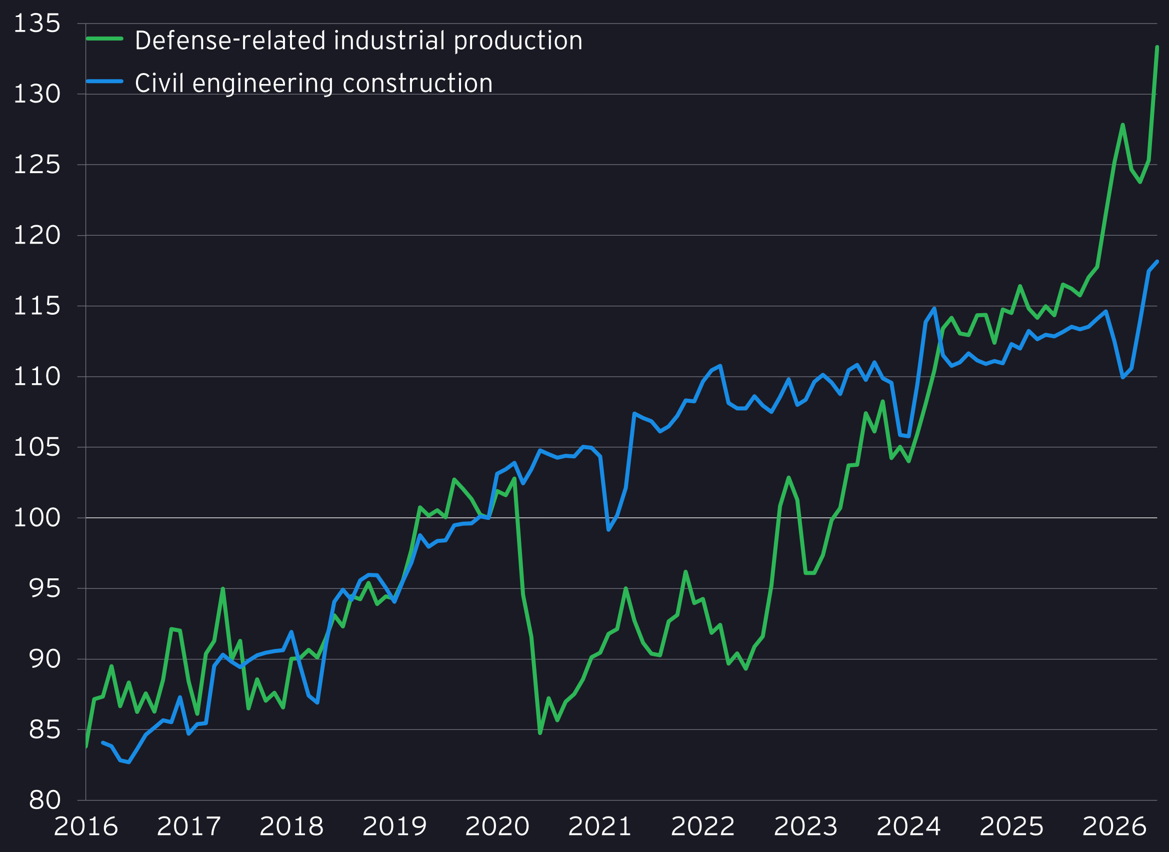
Source: Eurostat, US International Trade Commission.
* Includes the following SITC sections: computers and their parts (752, 75997), semiconductor devices (7763), electronic integrated circuits (7764), printed circuits (7722), Electrical boards and consoles < 1000V (77261), telecommunications equipment (764 excluding 76493 and 76499), optical fibre cables (77318).
** For EU27: PPI in Manufacture of computer, electronic and optical products

Government spending continues to support growth. German fiscal stimulus is starting to filter through, particularly in the defense sector

Government consumption and investment in the euro area
(Q4 2019 = 100)

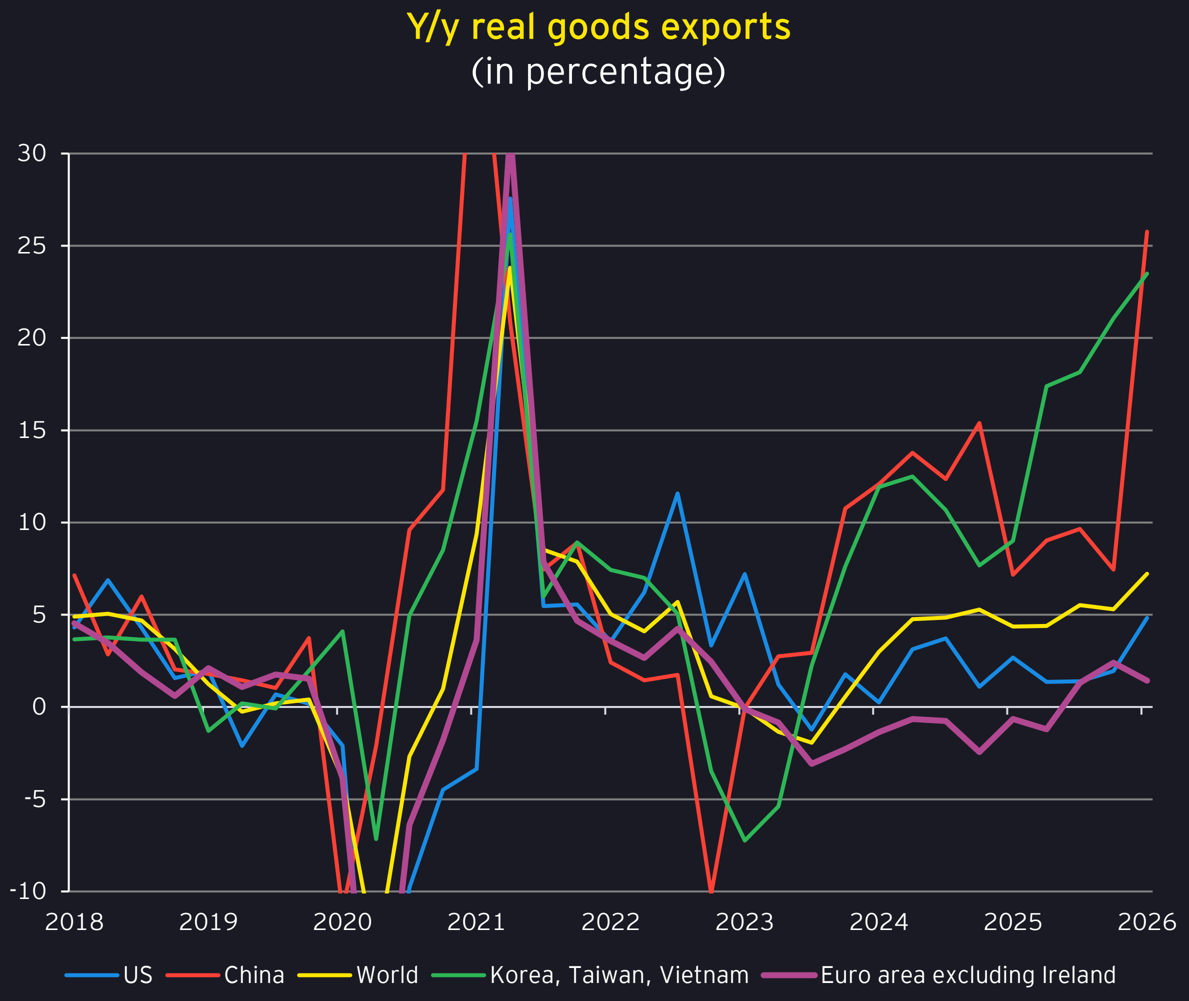


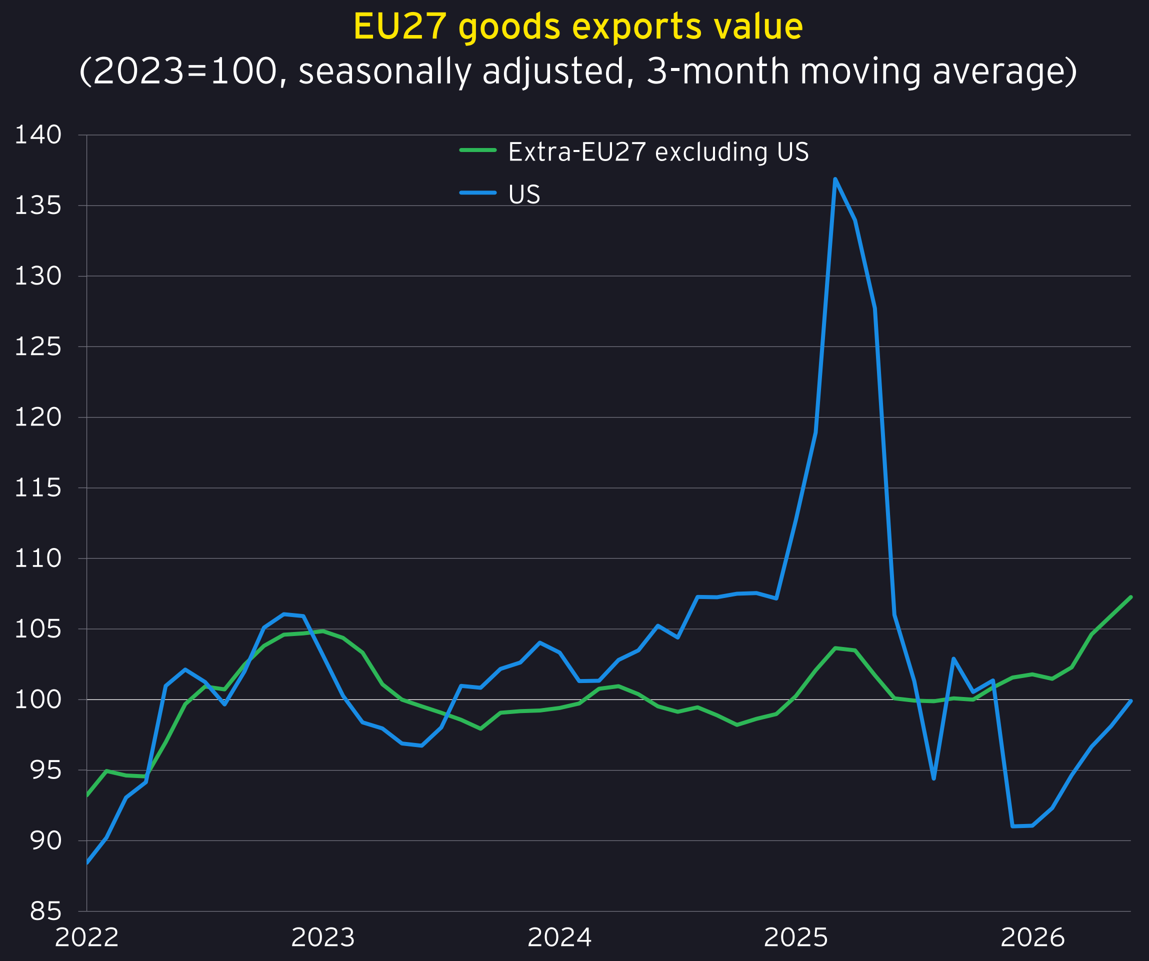
Defense-related industrial production and civil engineering construction in Germany
(Q4 2019 = 100, 3-mth moving average)



Source: Eurostat, Oxford Economics.
Notes: Defense-related industrial production is a weighted average for the following sections: manufacture of weapons and ammunition, building of ships and boats, manufacture of air and spacecraft and related machinery.

Euro area exports have picked up despite weaker trade with the US but still lag global trade

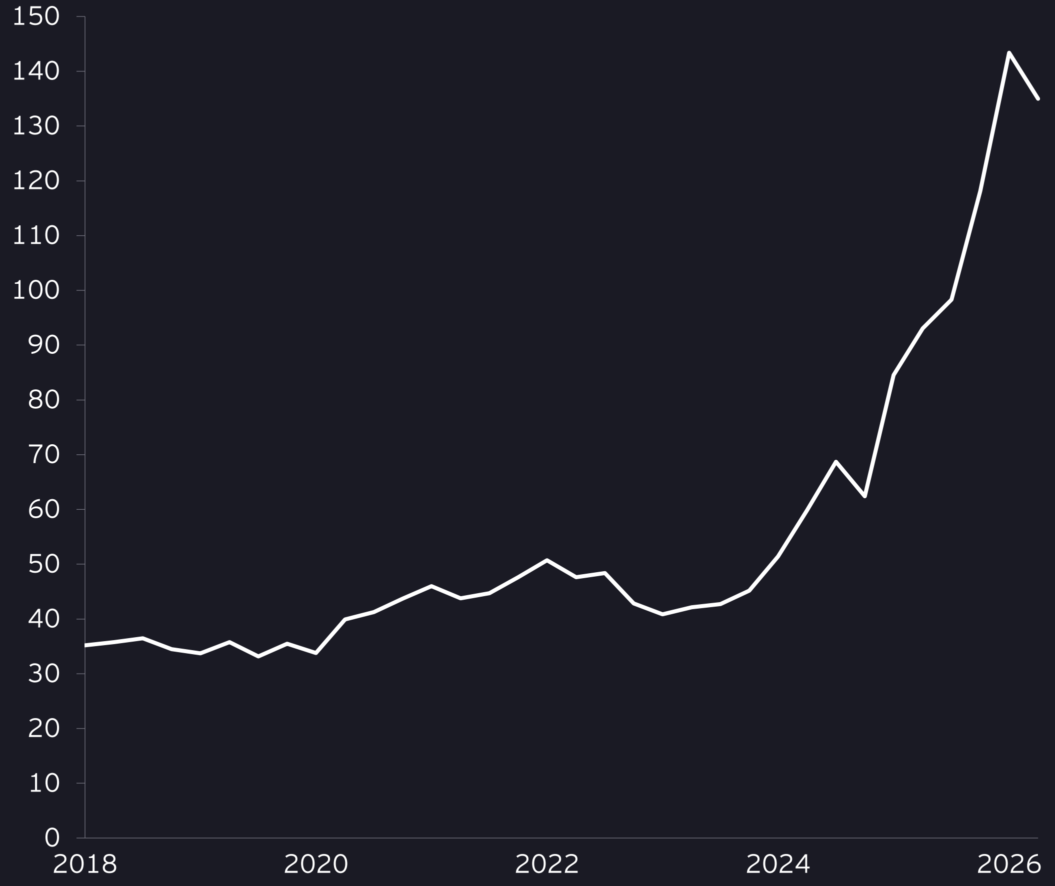




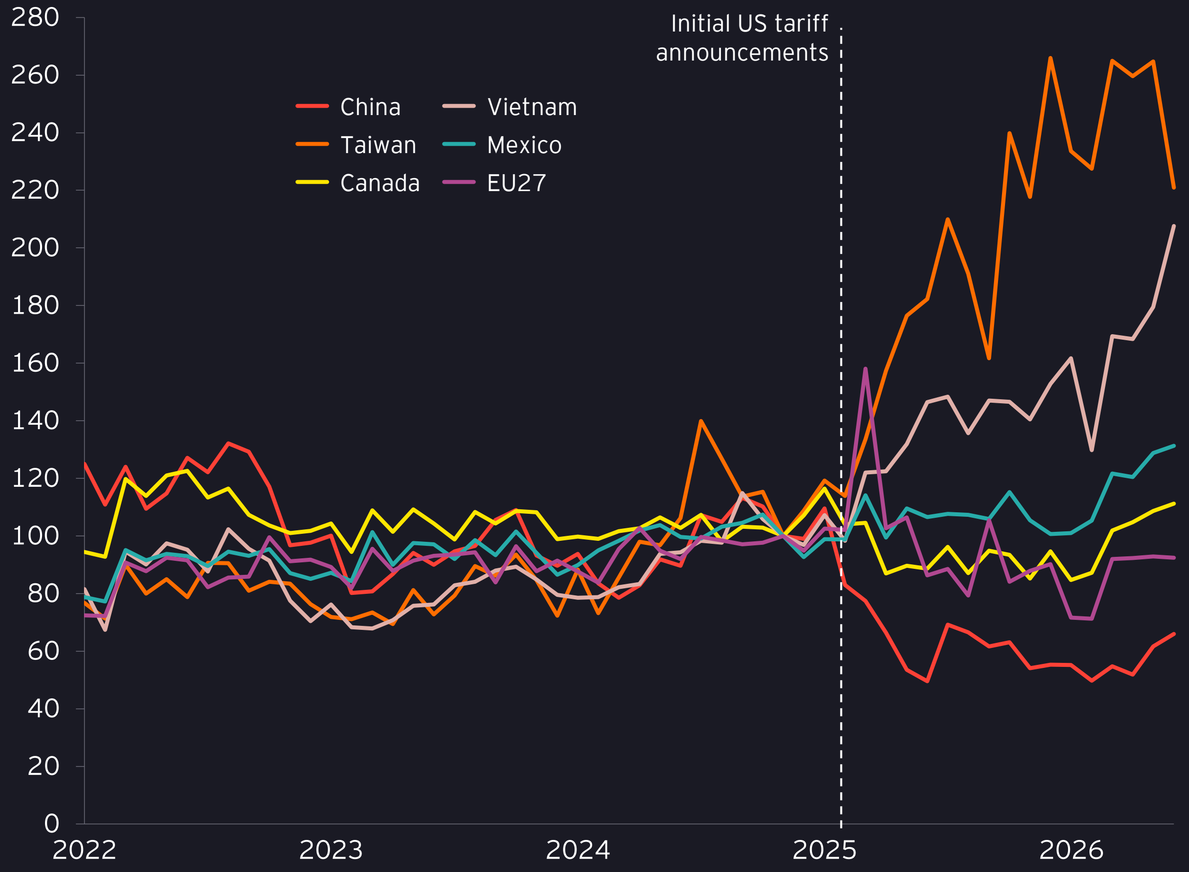
Source: Oxford Economics, Eurostat.

Exports of AI-related goods from Asia (excl. China) to the US are booming. US imports have shifted away from China toward Taiwan, Vietnam and other Asian suppliers since the initial tariff announcements

Real imports of computers, peripherals, and parts in the US
(USD bn, 2017 prices)



US imports by country (November 2024=100)



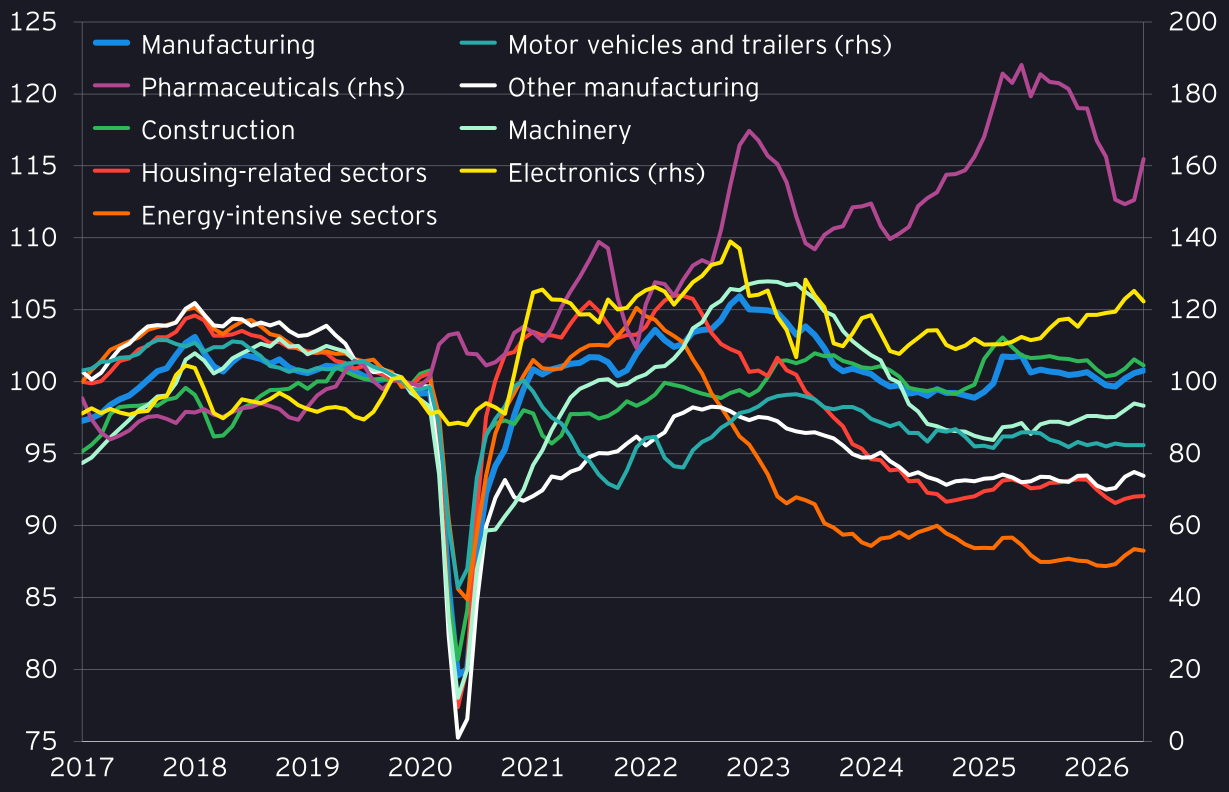
Source: FRED, US International Trade Commission.

Manufacturing output recovered slightly in Q2 2026 but remained flat year on year. Growth in services appears to have picked up, driven by transport, tourism and consulting

- While the Q2 recovery in manufacturing was driven primarily by the Irish pharmaceutical sector, output has also been rising in electronics and machinery, pointing to increased business investment, including AI-related spending.
- Energy-intensive sectors also picked up, despite higher energy prices, but remain depressed. Automotive and housing-related industries remain stagnant and significantly below pre-pandemic peaks. Construction also remains broadly stagnant, even though government spending supports infrastructure projects, as residential and business construction continues to contract.

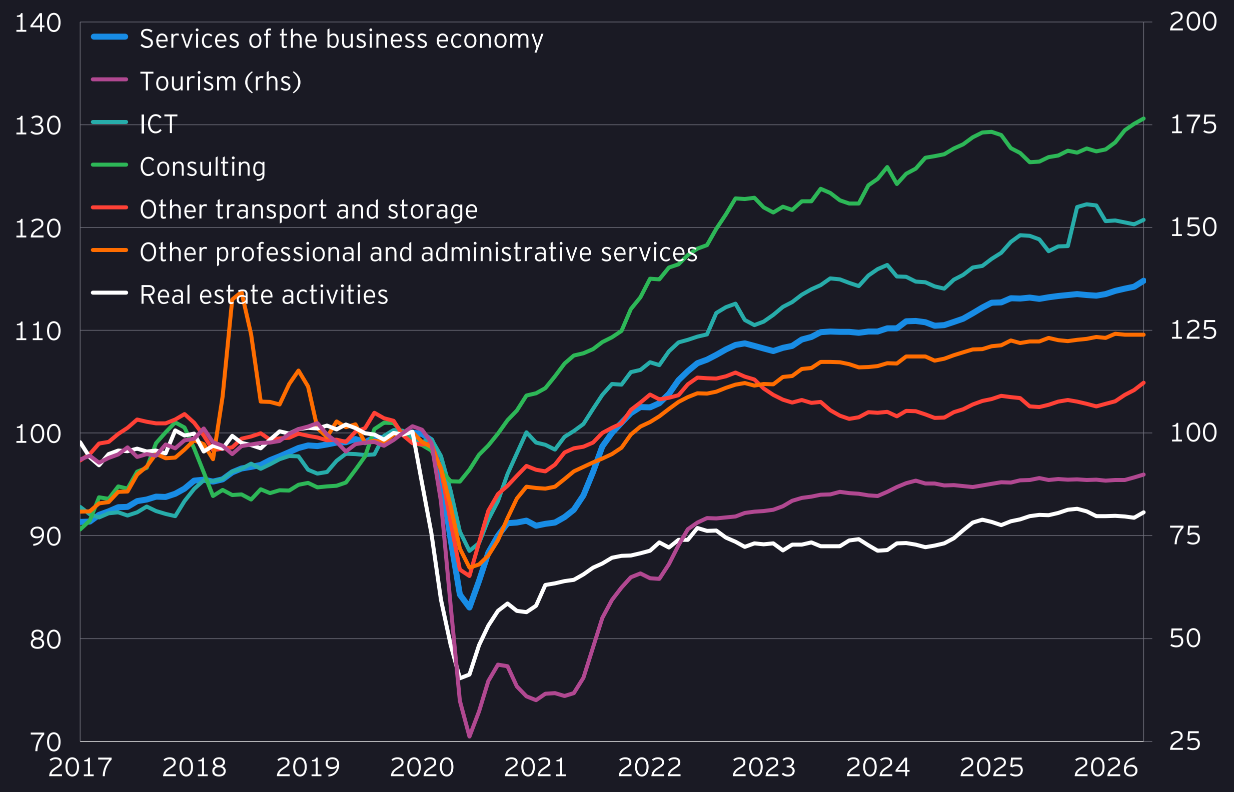
Manufacturing production in the euro area

(3-mth moving average, index, Q4 2019 =100, seasonally adjusted)



Services activity in the euro area

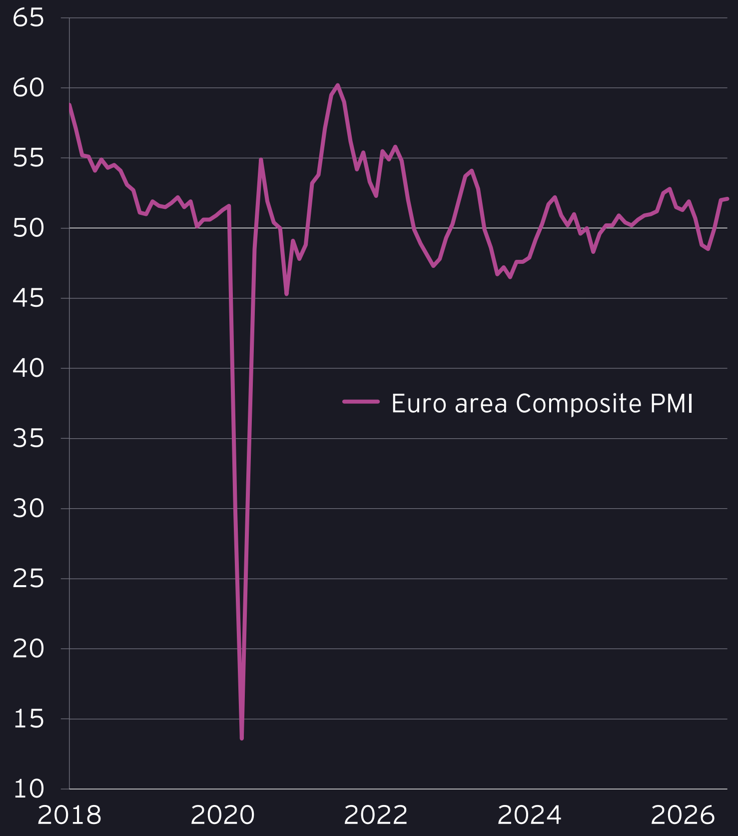
(3-mth moving average, index, Q4 2019 =100, seasonally adjusted)



Source: Eurostat.
Notes: Energy-intensive sectors: paper, chemicals, basic metals and non-metallic mineral products. Housing-related sectors: wood, furniture and electric equipment. Other manufacturing is an arithmetic average of the remaining manufacturing NACE divisions. Services of the business economy except for trade and financial activities. Tourism includes accommodation and food service activities, air transport, travel agencies and related activities.

Business confidence has recovered, pointing to continued growth in Q3, although soft indicators failed to capture Q2 resilience

Euro area business sentiment indicators



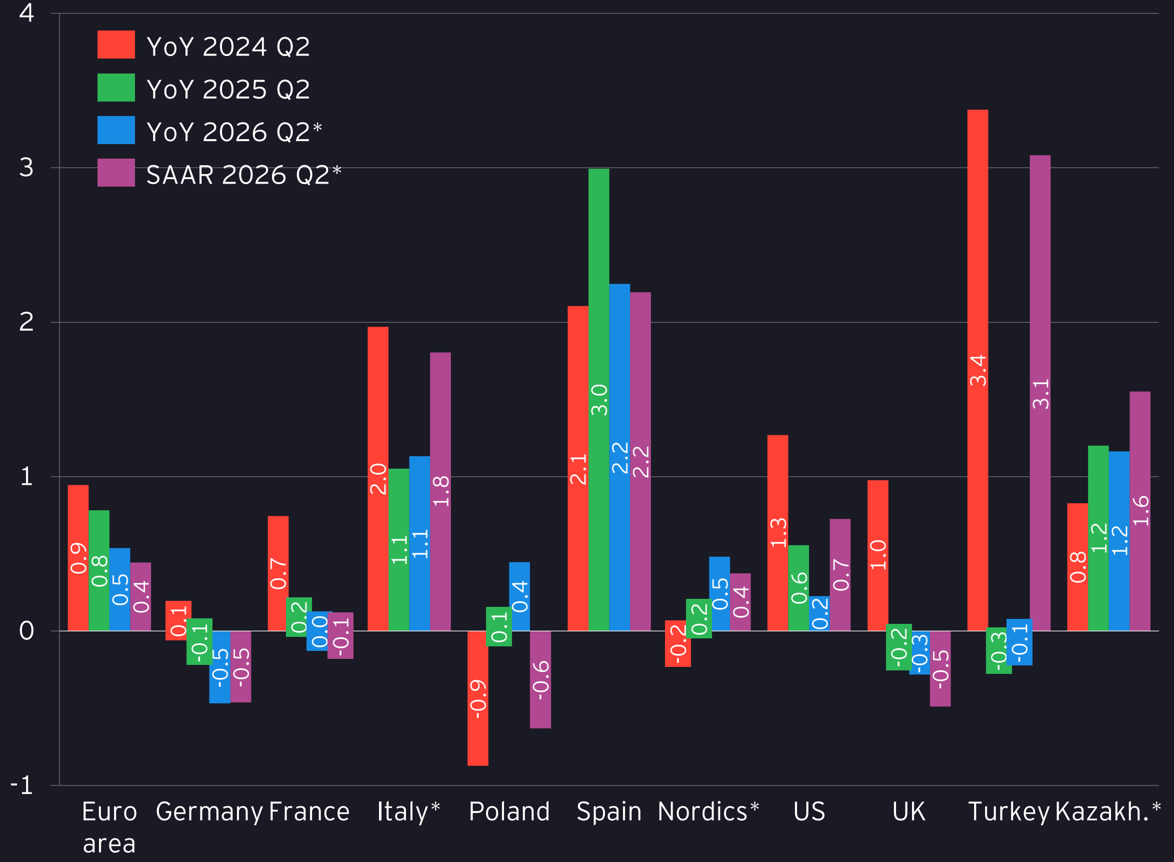
Ifo Institute Germany sentiment survey (2015=100)

Source: European Commission, ifo Institute, S&P Global.

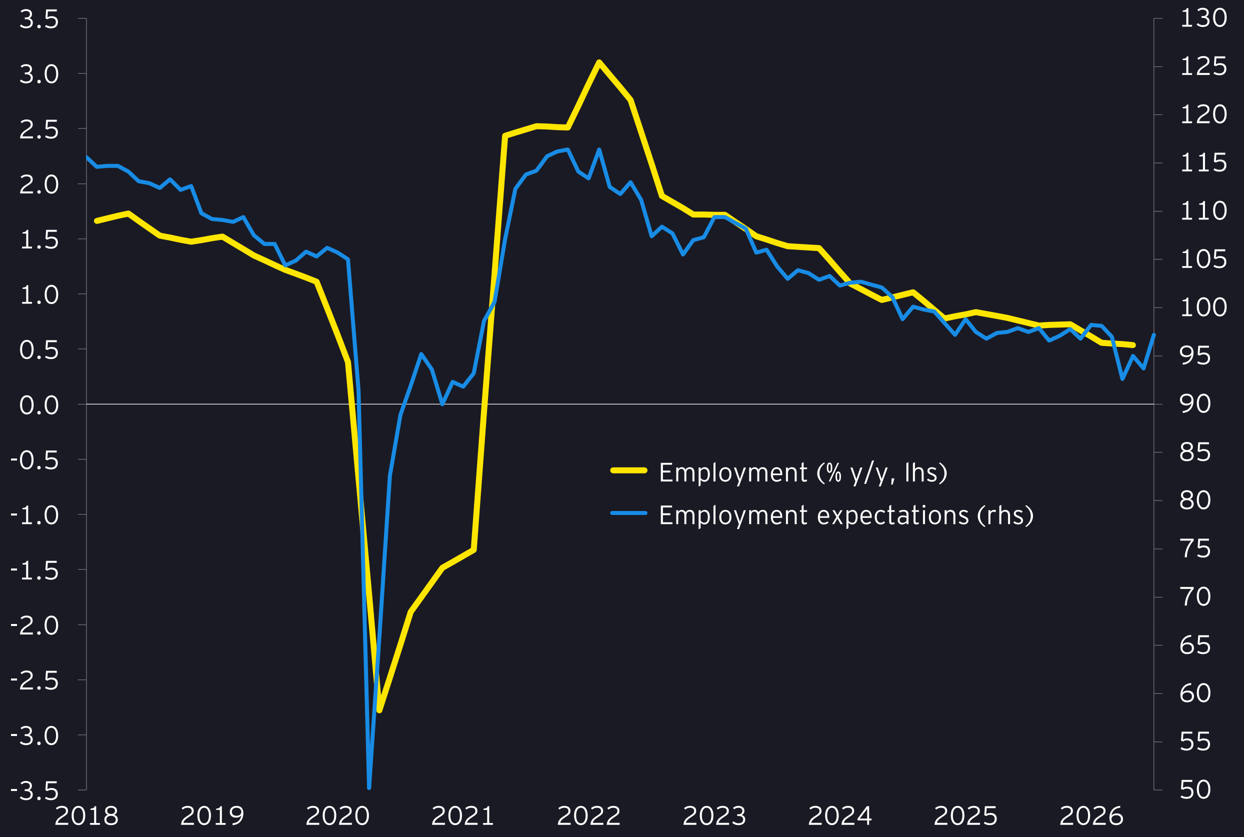
Euro area employment growth has continued to slow, with Spain the primary driver in an otherwise subdued labor market

- Many major European economies are seeing stagnant or declining employment, while Spain stands out as the main driver of job creation, supported by strong immigration inflows (notably from Latin America and North Africa).

Employment growth (in percentage)



Euro area employment (% y/y) and employment expectations (index)

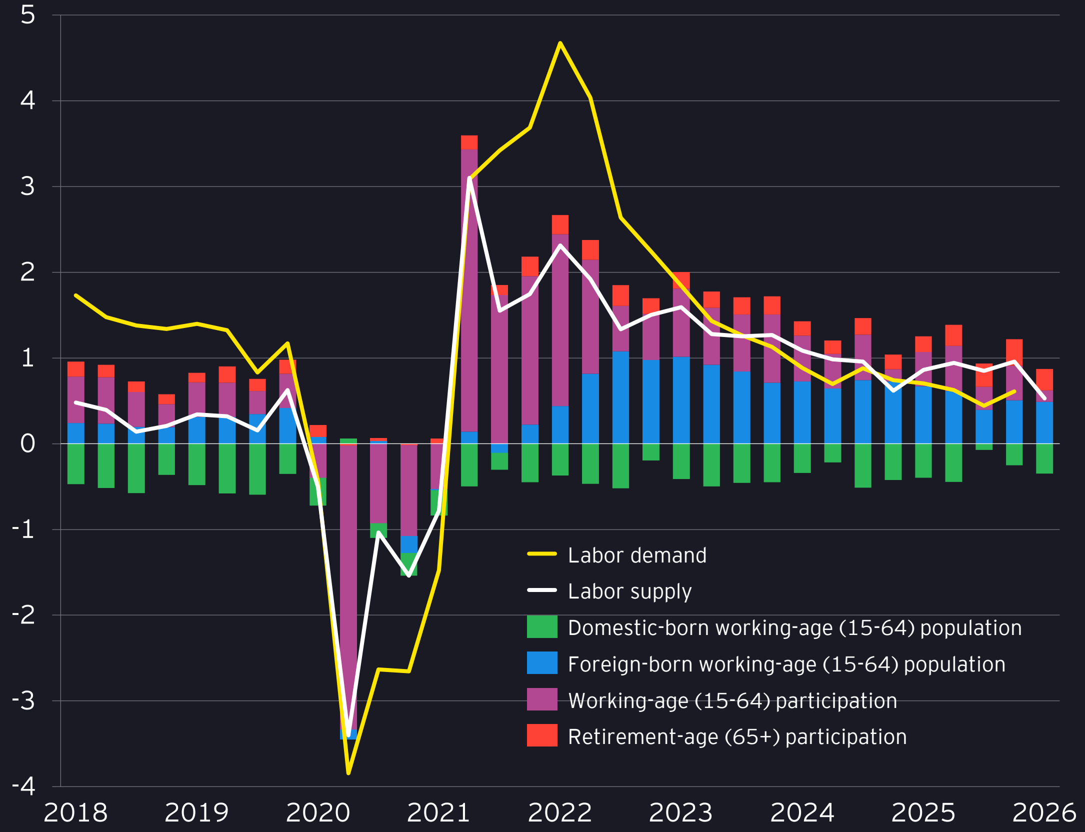


Source: Eurostat, FRED, ONS, TURKSTAT, Kazakhstan Bureau of National Statistics.
Notes: SAAR = Seasonally Adjusted Annual Rate of growth. Nordics = Denmark, Finland, Sweden and Norway.
* Q1 2026 data are shown where Q2 data were not yet available.

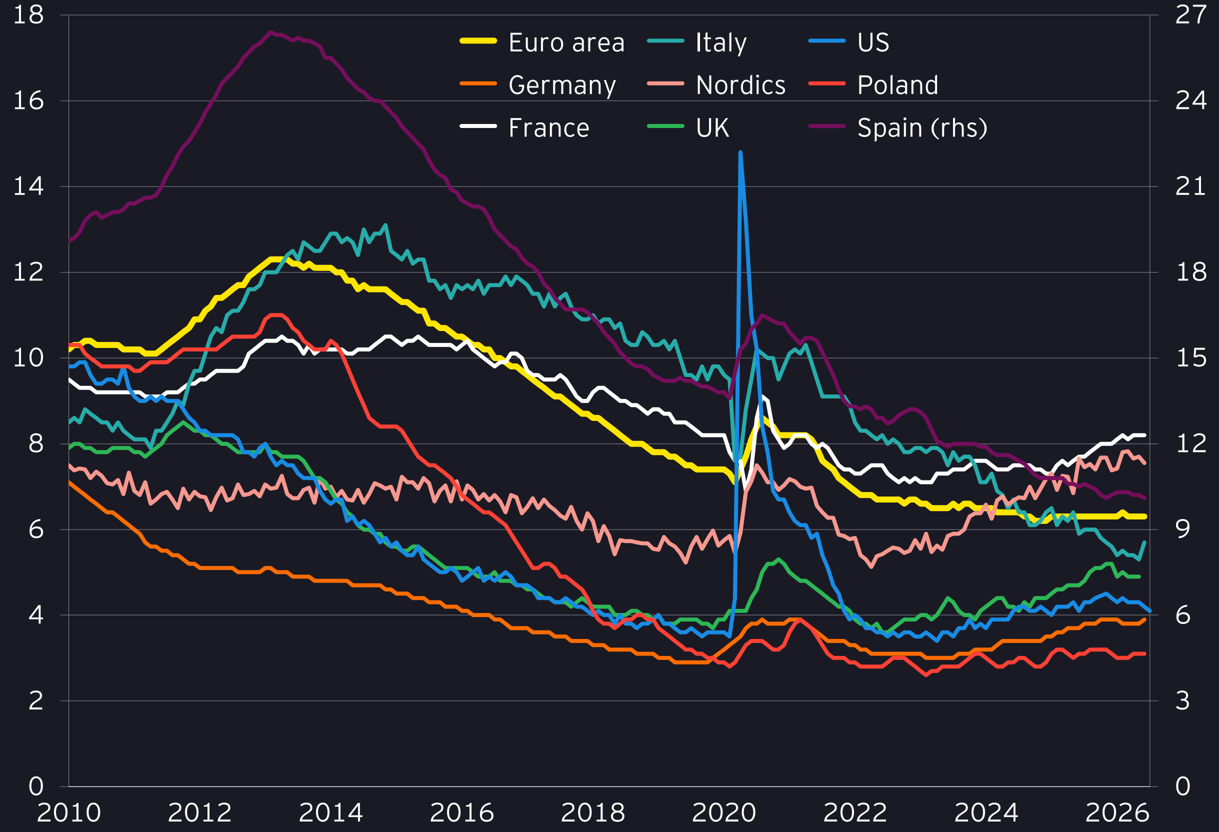
Labor supply growth slowed in early 2026 following 2025 strength. With concurrent slowdown in employment, the unemployment rate has remained stable

- Unemployment has been rising in France and the Nordics, although there are tentative signs of stabilization. It appears to have stabilized In the UK and Germany. Meanwhile, unemployment continues to decline in Spain, albeit more slowly, while it has rebounded somewhat in Italy after an earlier rapid decline.

Labor supply and demand change in the euro area
(% y/y, in percentage)

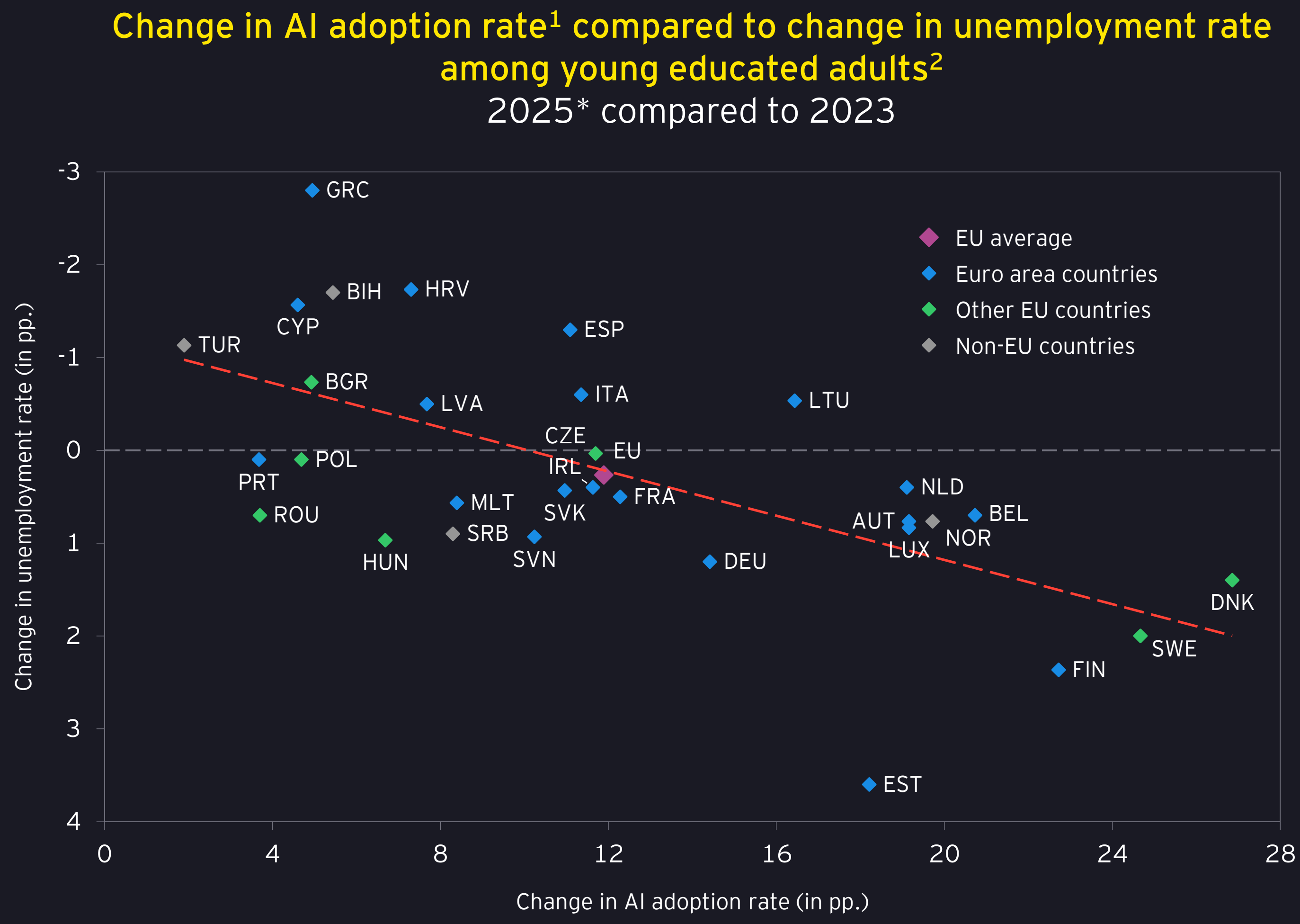


Unemployment rate (in percentage)



Source: Eurostat, BLS, FRED, ONS.
Notes: Labor demand is the sum of employment and vacancies. The Nordics include Denmark, Finland, Norway and Sweden.

Rapid AI adoption coincides with weaker labour-market outcomes for young educated workers in several Nordic economies

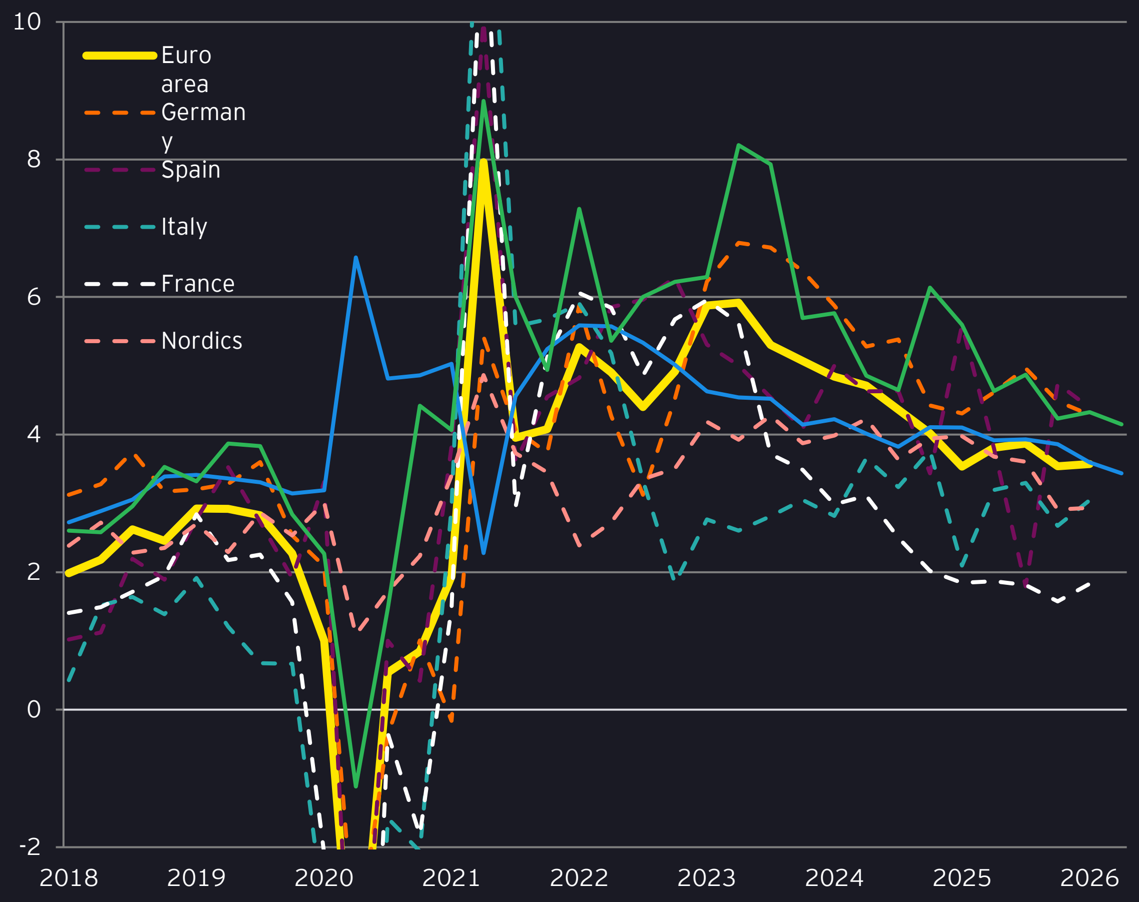


* For unemployment rate, Q1-Q3 2025 average.
1. Enterprises with 10 or more employed persons using at least one AI technology.
2. Persons with tertiary education aged 15-39.
Note: The relationship is correlational and does not establish causality

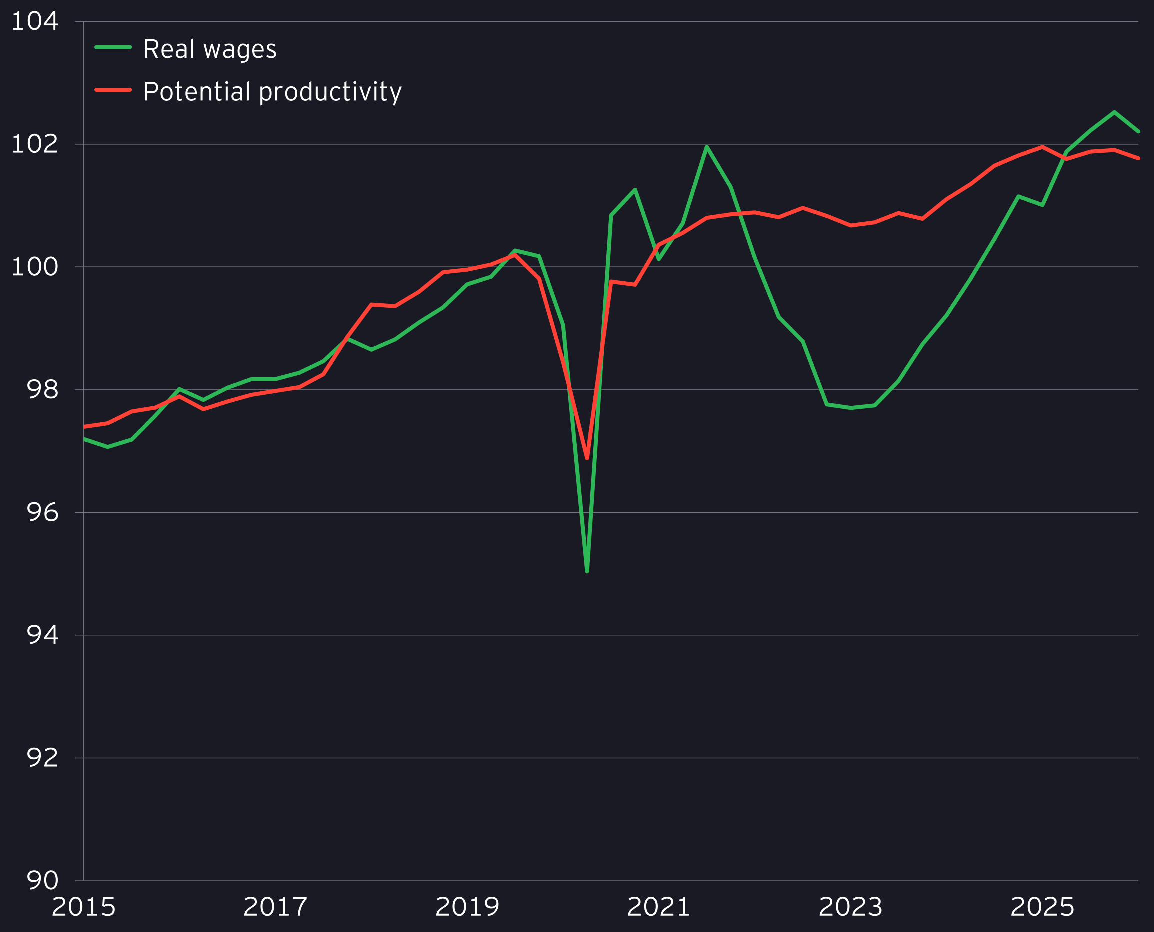
Source: Eurostat.

Nominal wage growth has slowed as the real wages have caught up with productivity

Nominal wage growth (y/y, in percentage)



Real wages vs. potential productivity in the euro area (index, 2019 = 100)

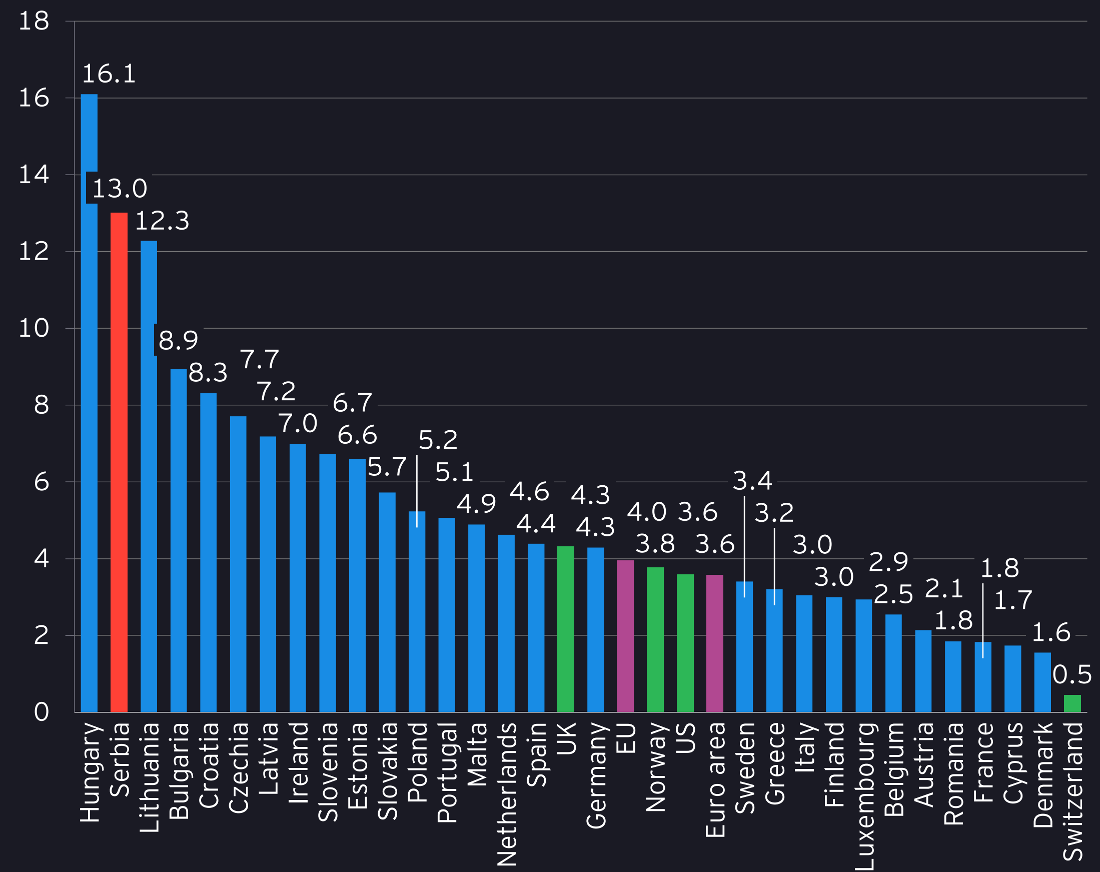


Source: Eurostat, ONS, FRED, Oxford Economics
For the euro area countries, wages and salaries per employed person; for the UK, average weekly earnings in the whole economy, total pay; for the US average hourly earnings of All Employees, Total Private. The Nordic aggregate is the unweighted average of Denmark, Finland, Norway, and Sweden.
Potential productivity is defined as potential GDP over employment at NAIRU (non-inflation accelerating rate of unemployment).

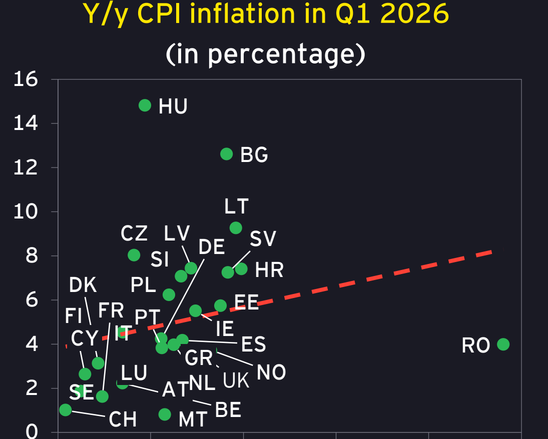
Significant cross-country disparities in wage growth persist, reflecting differences in inflation dynamics, public sector pay policies, minimum wage growth, and labor market slack

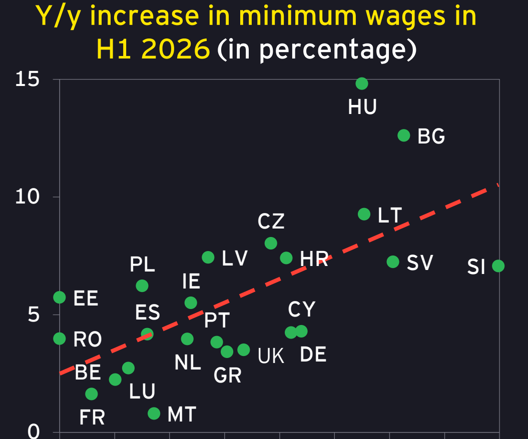
- CEE economies continue to record significantly stronger wage growth than Western and Southern Europe. In most Western European economies, wage growth is moderate (around 2.5-4.5%). France and Switzerland stand out on the downside, with weaker wage growth constraining consumer spending.

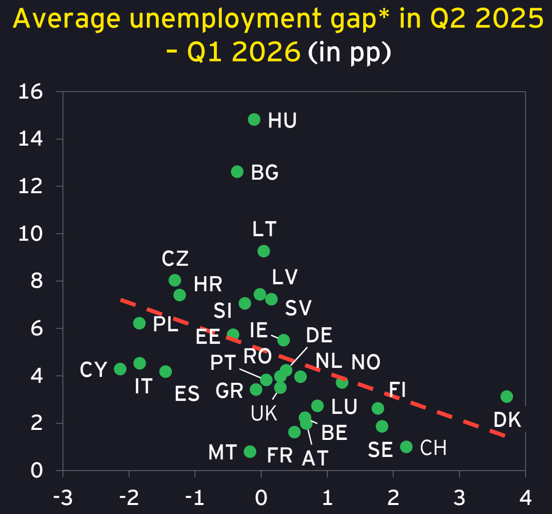
Nominal wage growth in Q1 2026 (y/y, in percentage)

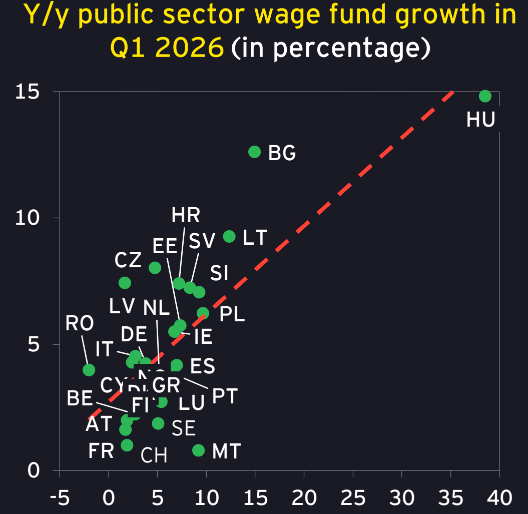


Y/y nominal wage growth in Q1 2026 (y axis, in percentage) vs.:





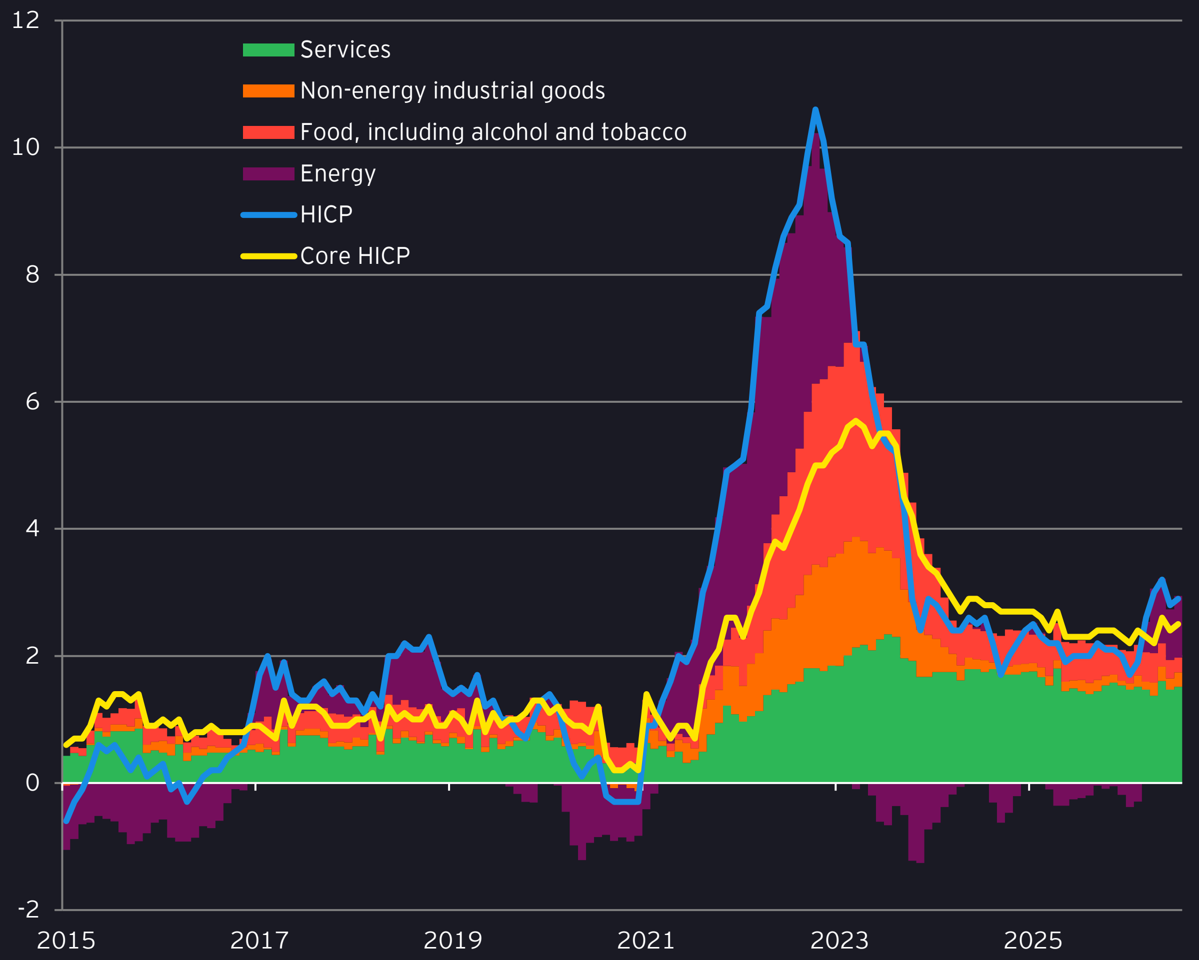




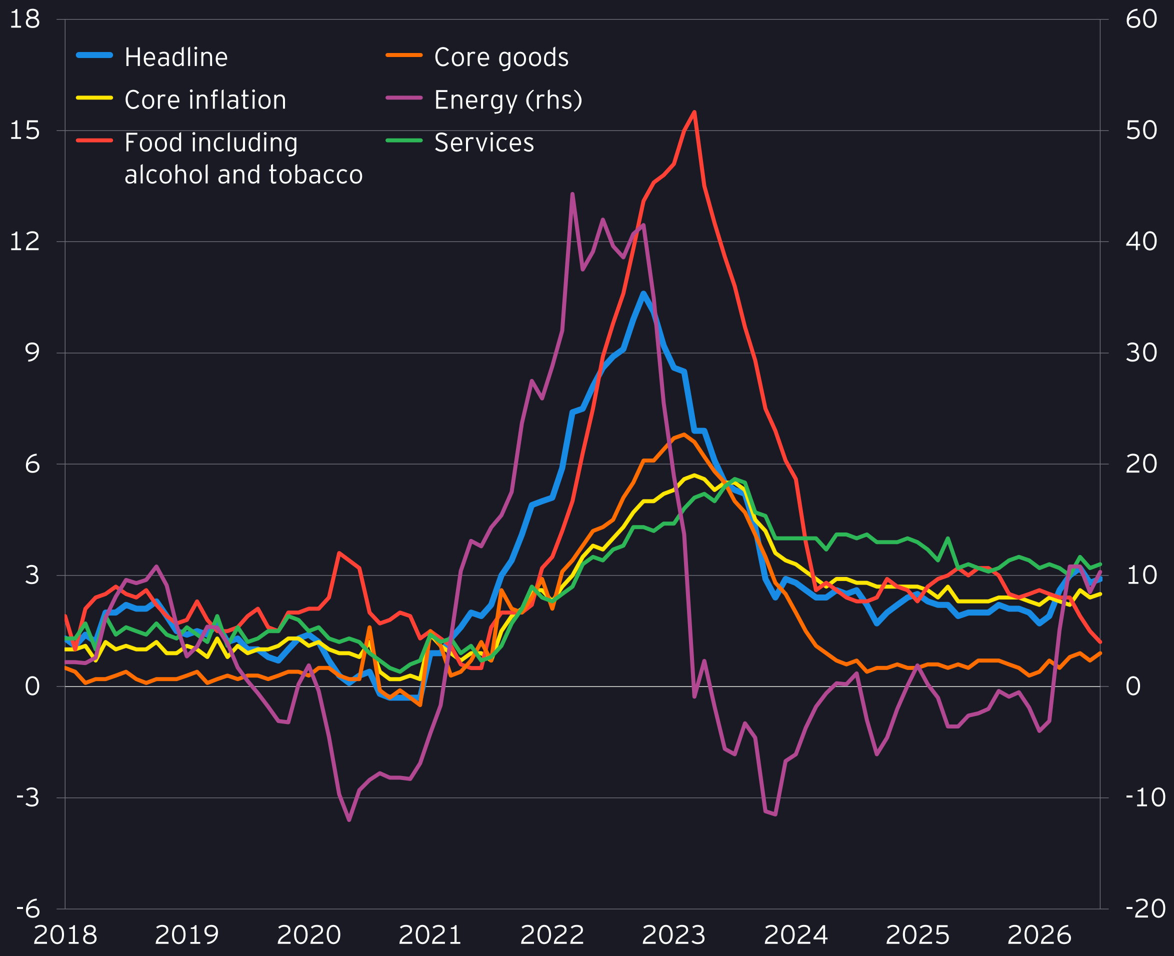
Source: Eurostat, ONS, FRED, Oxford Economics
For the euro area countries, wages and salaries per employed person; for the UK, average weekly earnings in the whole economy, total pay; for the US average hourly earnings of All Employees, Total Private. The Nordic aggregate is the unweighted average of Denmark, Finland, Norway, and Sweden.
* Unemployment gap is the difference between the Unemployment rate and NAIRU (non-inflation accelerating rate of unemployment).

Euro area inflation fell from 3.2% in May to 2.9% in July as food inflation eased, while energy prices remained elevated. Non-energy components have remained broadly stable, indicating limited second-round effects from the energy shock so far

Statistical decomposition of y/y HICP inflation in the euro area (in percentage points)



HICP inflation in the euro area (y/y, in percentage)



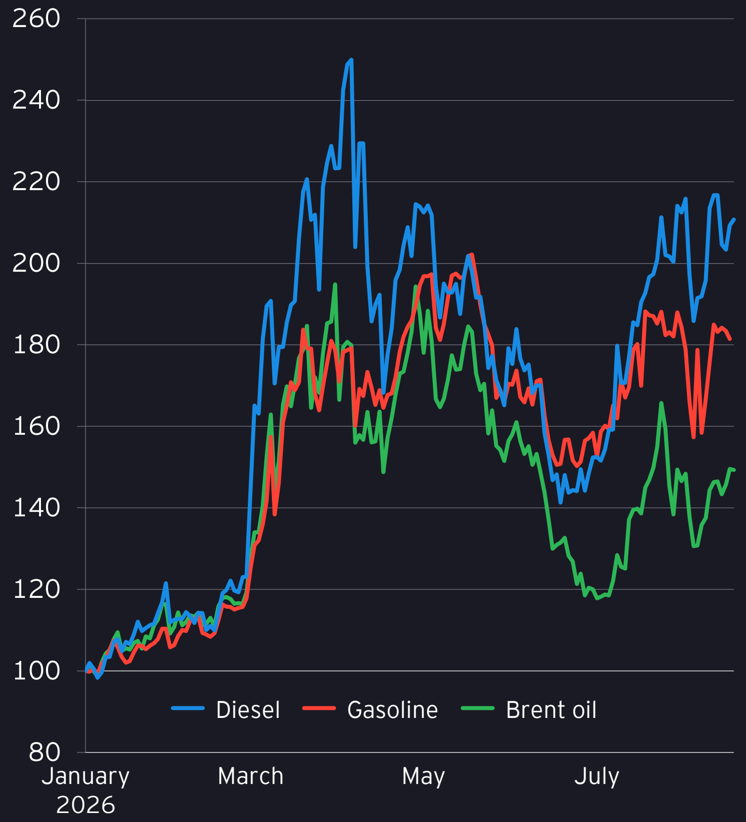
Source: Eurostat.

Oil prices have fallen substantially from their May peaks, but gasoline and diesel prices remain much more elevated

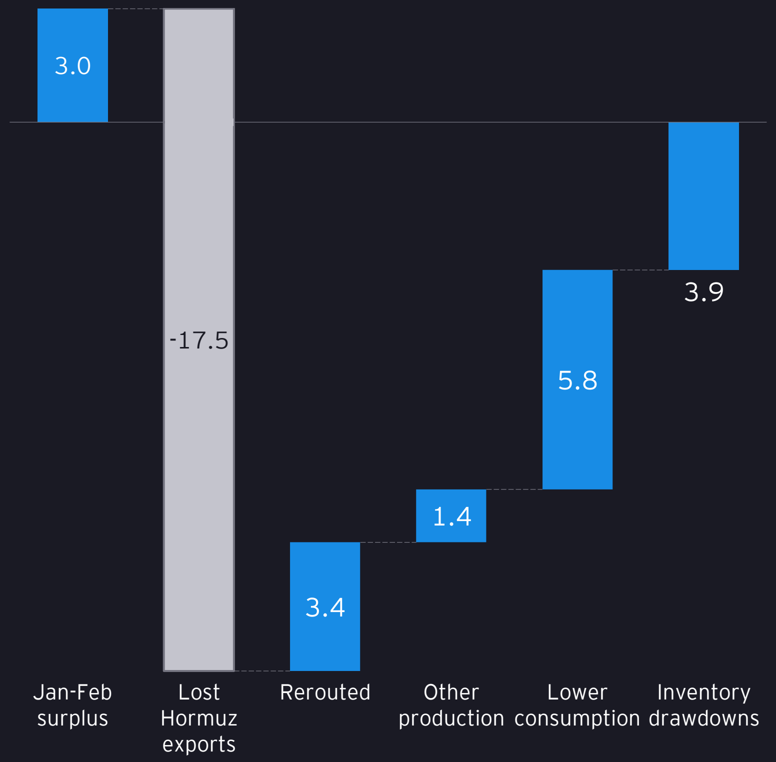
- Except for a brief and partial reopening in June, the Strait of Hormuz has remained closed. Despite this, oil is trading below May peaks, although gasoline and diesel have fallen much less, keeping fuel price inflation elevated.
- The relatively muted oil price response, given the scale of the shock, to the Hormuz closure can be explained by the rerouting of supplies through Fujairah and the Red Sea, pre-conflict oil market surplus, reduced oil demand (especially from China) and large inventory drawdowns. However, if the closure persists, these factors may fade, triggering a stronger rise in commodity prices.

Number of tankers crossing the Strait of Hormuz (7-day rolling total) January 1, 2022 – August 9, 2026

Energy commodities futures prices
(USD, January 2nd 2026 = 100)



Global oil balance
(Millions of barrels per day, Q2 vs. January-February)

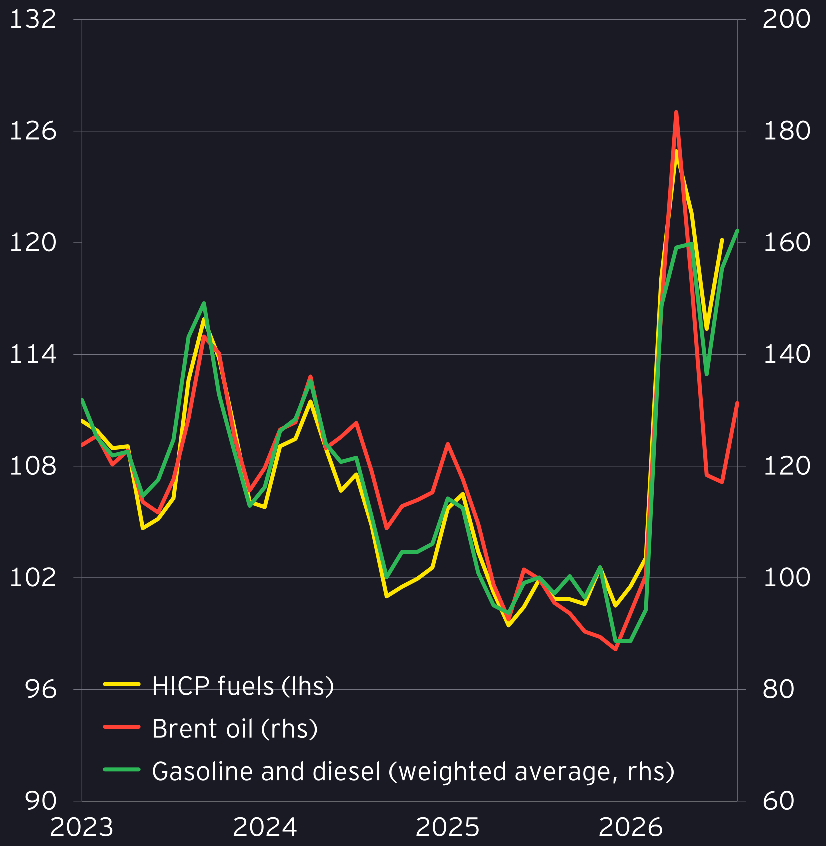


Source: IMF, LSEG, IEA, Oxford Economics.

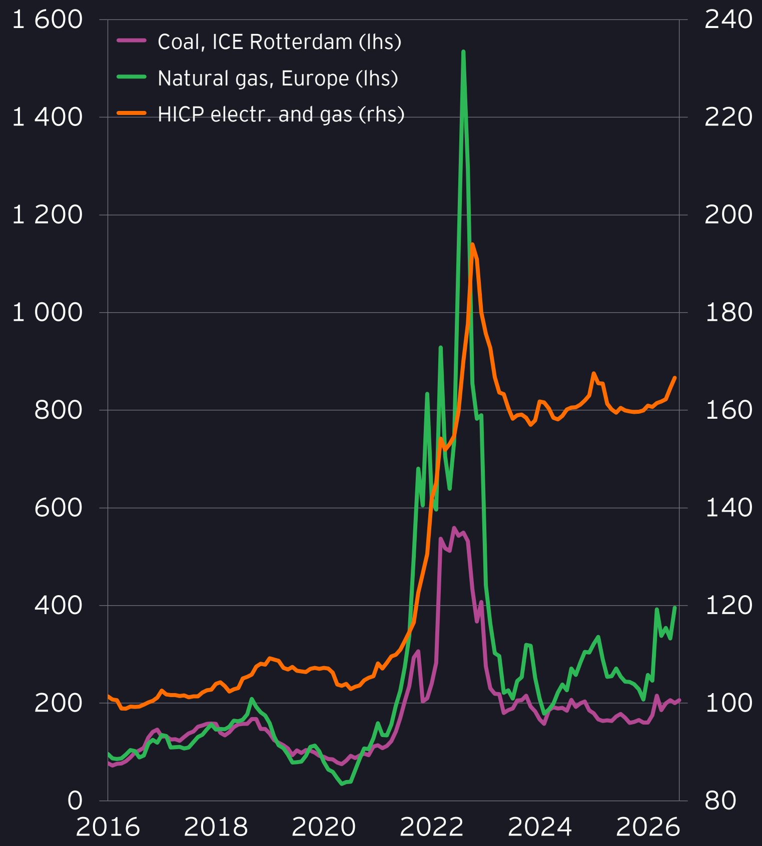
Energy prices remained near April–May levels in July despite lower crude oil prices, as refining margins rose, electricity and heating prices increased, and some support measures were withdrawn

- Government measures, combined with structural differences in local fuel and energy markets, have led to a highly heterogeneous pass-through of the Middle East price shock to consumer energy prices

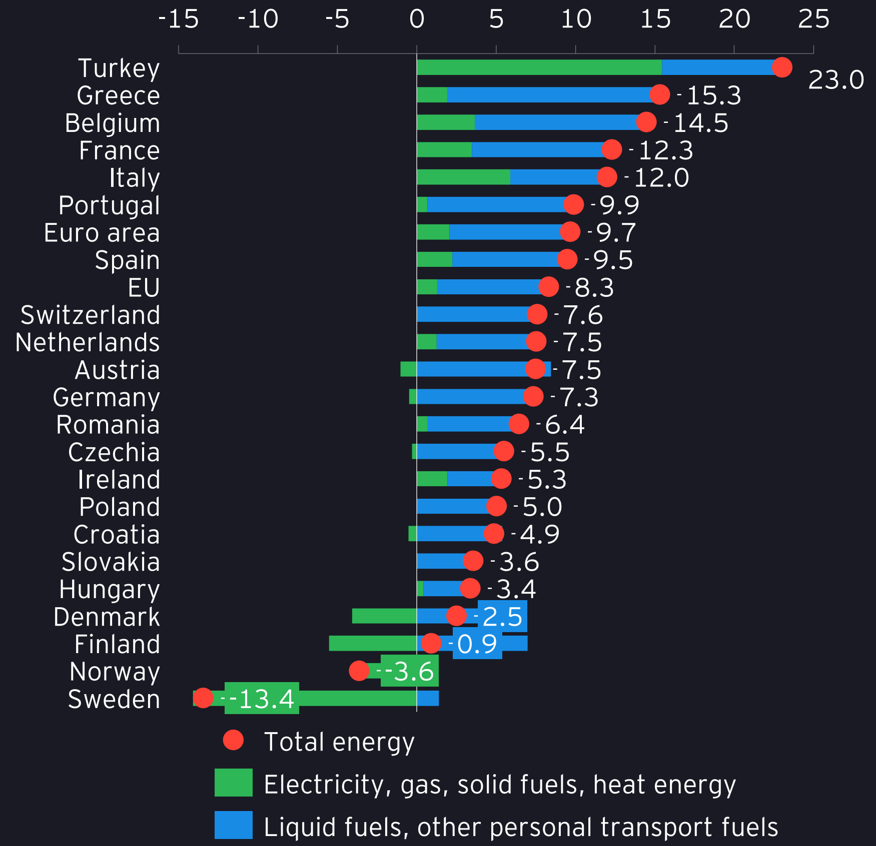
HICP fuels in the euro area vs. oil and fuel prices (index, 2025 = 100)



Natural gas and coal prices vs. HICP electricity and gas (index, 2016 = 100)



Energy price change* decomposition (in percentage points; July 2026 compared to February 2026)

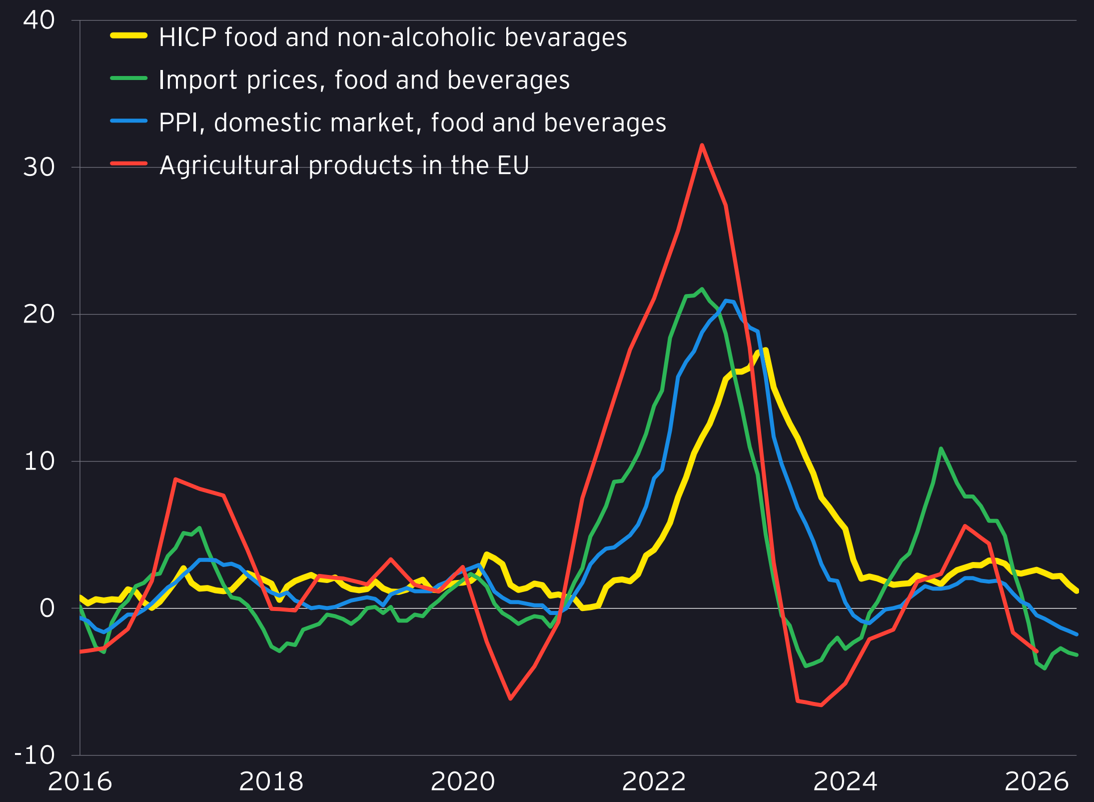


* Percentage change in HICP energy index between February 2026 and July 2026.
Source: International Energy Agency, LSEG, Eurostat, European Commission, ONS, government press releases.

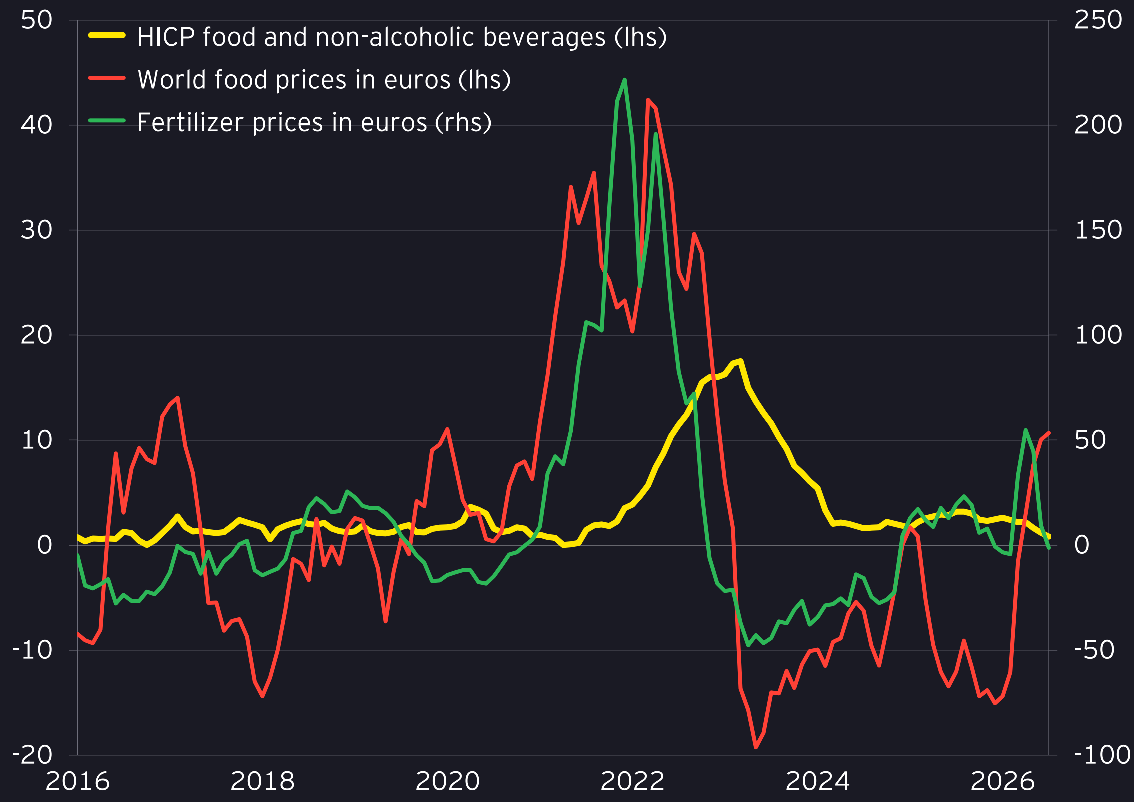
Food inflation fell on improved supply conditions before the outbreak of the Middle East conflict. While fertilizer prices have eased from their post-conflict peaks, food inflation is still likely to pick up next year, given unfavorable weather conditions across much of Europe this year

- Food and non-alcoholic beverages inflation eased to 1.2% in the euro area, reflecting improved supply conditions across key categories (meat, dairy, fruit, cocoa, coffee).
- However, higher global food commodity prices (driven by the Middle East conflict) and less favorable weather conditions in the first half of 2026 are expected to push food inflation higher with a lag, with effects likely to materialize next year.

Food inflation in the euro area vs. its short-term drivers (y/y)



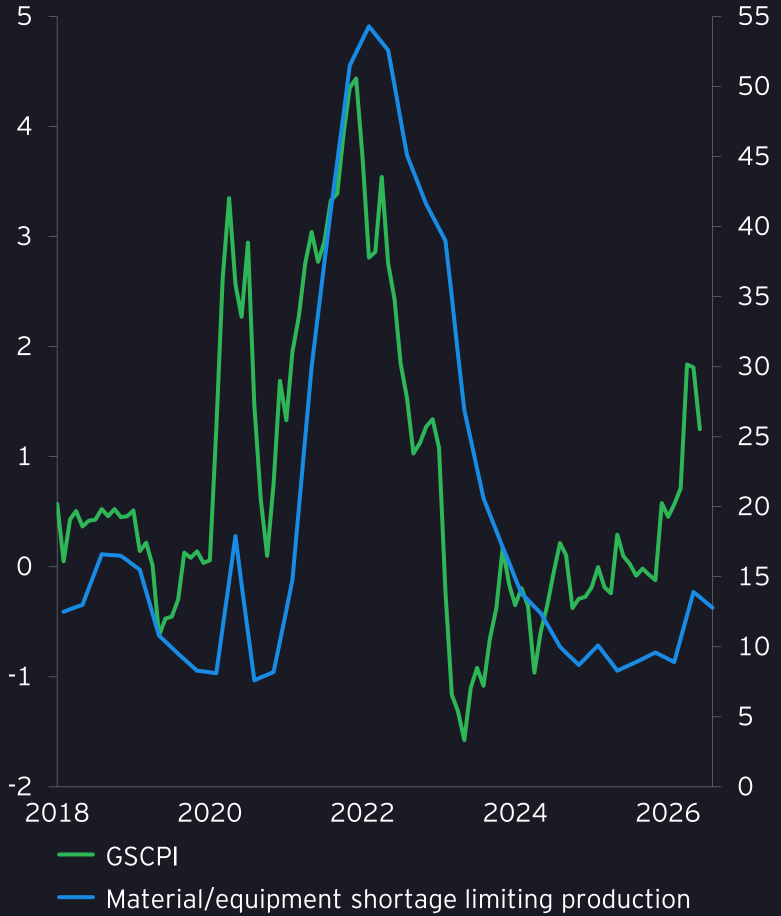
HICP food inflation in the euro area vs. world food and fertilizer prices (y/y)



Source: World Bank Commodity Prices; BIS; Eurostat; stooq.pl.
* ICE Rotterdam coal price.

Supply chain pressures from the Middle East conflict and AI-related demand are likely to raise core goods inflation in the near term

Global Supply Chain Pressure Index (index) vs. euro area supply chain production hindrance[1] (percentage)



Global base metals[2] price index (% change y/y)

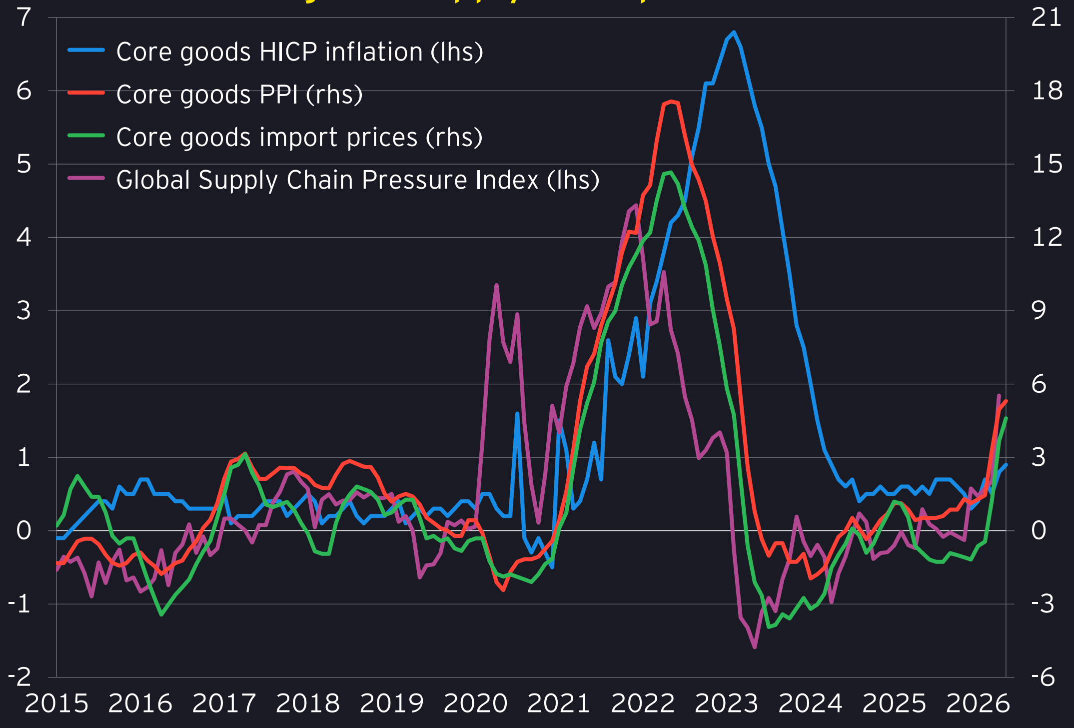
Containerized Freight Index (index)

Source: Federal Reserve Bank of New York, European Commission, International Monetary Fund, Trading Economics.
[1] Percentage of surveyed enterprises declaring material or equipment shortage as a factor limiting production.
[2] The index reflects a weighted average for Aluminum, Cobalt, Copper, Iron Ore, Lead, Molybdenum, Nickel, Tin, Uranium and Zinc price indices.

While core inflation has remained stable in recent months, supply chain disturbances and higher energy prices point to higher core goods inflation ahead

- Core inflation has held around 2.5% in recent months, marginally (~0.2 pp) higher than before the Middle East conflict as core goods inflation ticked up slightly while services inflation remained broadly unchanged.
- However, supply chain disruptions and higher energy and metal prices are already feeding into producer prices (including non-energy non-food categories) and are likely to lift core goods inflation with a lag. The pass-through to services inflation should be more muted, as balanced labor markets are likely to contain wage-driven second-round effects.

Y/y core goods inflation in the euro area vs. y/y core goods PPI and import prices in the euro area (in percentage) and global supply chain pressures



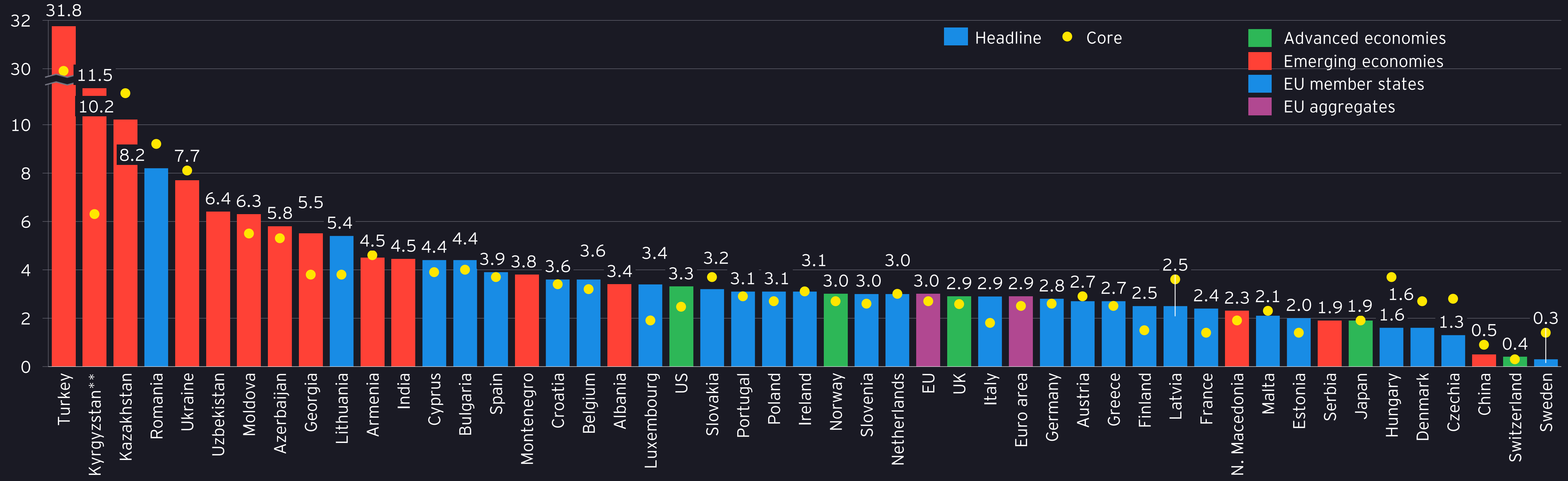
Y/y services inflation vs. y/y nominal wage growth in the euro area (in percentage)

Source: Eurostat, Oxford Economics, Federal Reserve Bank of New York.

Inflation dispersion has narrowed over the past two to three months as food inflation fell and energy prices normalized in several high-inflation economies

- Among major euro area economies, Spain records the highest inflation due to more pronounced (and accelerating) core price pressures, which may be explained by relatively strong demand inducing a stronger pass-through of the energy shock to consumer prices.
- Romania continues to record the highest inflation in the EU due to broad-based price pressures exacerbated by the VAT and fuel price hikes. Inflation exceeds 4% in Lithuania and Bulgaria due to strong wage growth, high services inflation and (in Lithuania) deregulated electricity prices.
- In contrast, inflation remains low in Switzerland and Sweden, followed by Denmark, Czechia, Hungary and Serbia due to a mix of factors: tax and regulated electricity price cuts (Sweden, Denmark, Czechia, Serbia), limited wage growth (Switzerland, Sweden), FX appreciation (Sweden, Hungary), strong food price deflation (Czechia, Hungary, Serbia), and a fuel price freeze (Hungary).
- Disinflation has been halted in Turkey due to the energy shock, with price growth remaining above 30% y/y, but continued in Kazakhstan.

HICP inflation in July 2026 (y/y, in percentage)

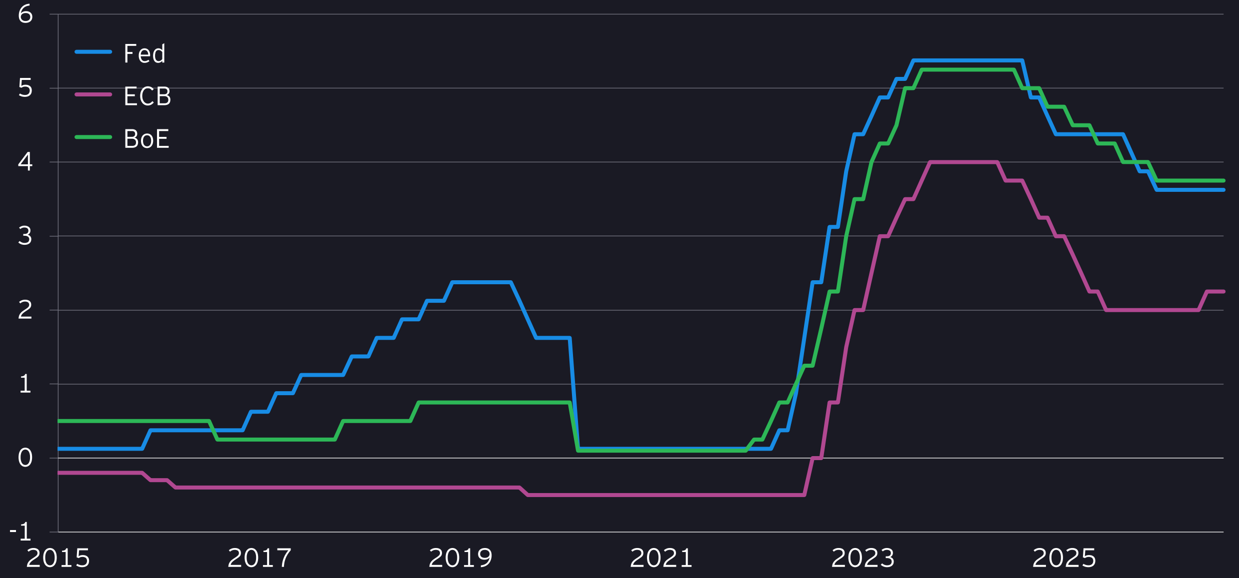


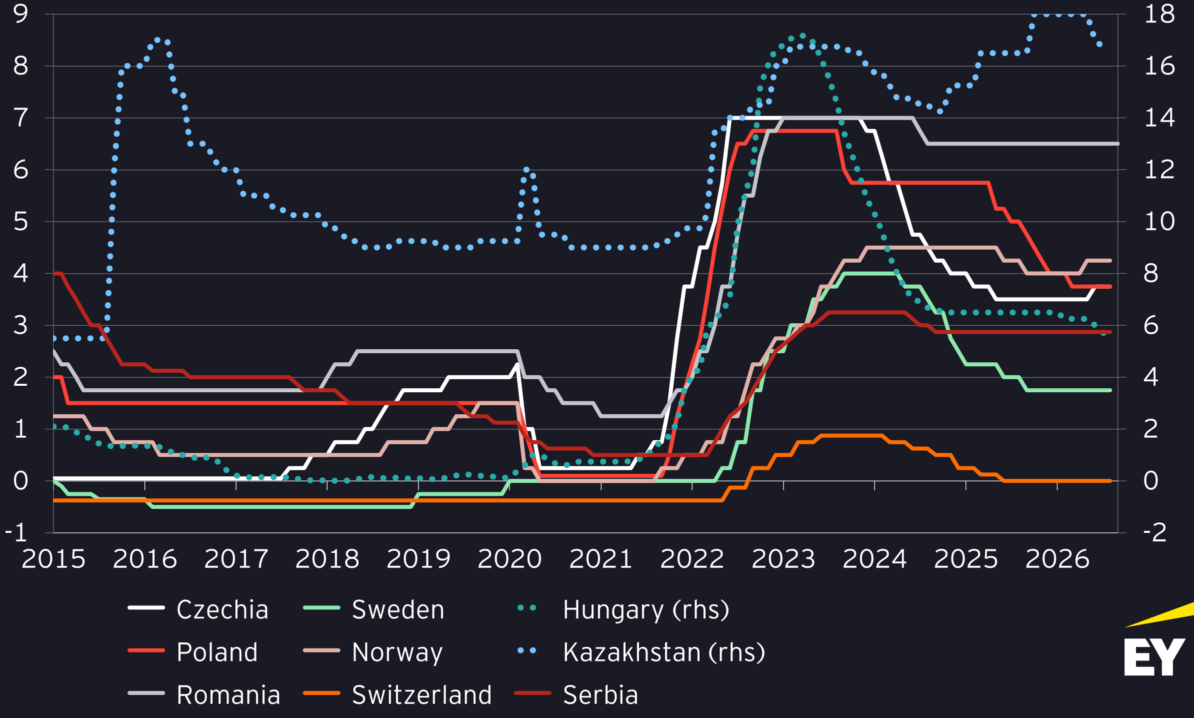
Source: Eurostat, FRED, ONS, Trading Economics, national statistical bureaus.
Note: For non-EU countries, CPI inflation.
**June 2026 - Core inflation only

The ECB hiked rates in June and remained on hold in July. Most other central banks kept rates unchanged

- The ECB increased the deposit rate to 2.25% in June in response to the energy shock but kept interest rates unchanged in July as the Middle East conflict appeared to be dissipating.
- The Federal Reserve has held rates at 3.5–3.75% since December 2025, though with inflation persistently above target, stable labor market and solid GDP growth, policymakers are increasingly tilting toward a rate hike, with 3 FOMC members voting in favor of a hike in July.
- The Bank of England has kept the Bank rate unchanged at 3.75% as inflation fell below 3% despite the Middle East conflict.
- Central banks of Switzerland and Sweden have also stayed put in light of weak price pressures, though Riksbank signaled growing risk of tightening given the impact of the Middle East conflict. Norges Bank kept rates unchanged at 4.25% in June following a hike in May but signaled that further tightening may be needed as inflation remains too high.
- The central bank of Hungary initiated an easing cycle in June, cutting rates by 75 bp to 5.5% by July, amid FX appreciation, reduced risk premia, and muted inflation following the parliamentary elections. In contrast, Czechia increased the policy rate to 3.75% amid elevated core inflation, wage and lending growth, despite low headline inflation. Policy rates have remained unchanged in Poland (at 3.75%), Romania (6.5%) and Serbia (5.75%).
- The central bank of Turkey delivered a *de facto* tightening from 37% to 40% by suspending weekly repo auctions to guard against derailment of disinflation amid the Middle East shock. The National Bank of Kazakhstan cut the policy rate to 16.75% in July amid easing inflation.

Central bank interest rates (in percentage)

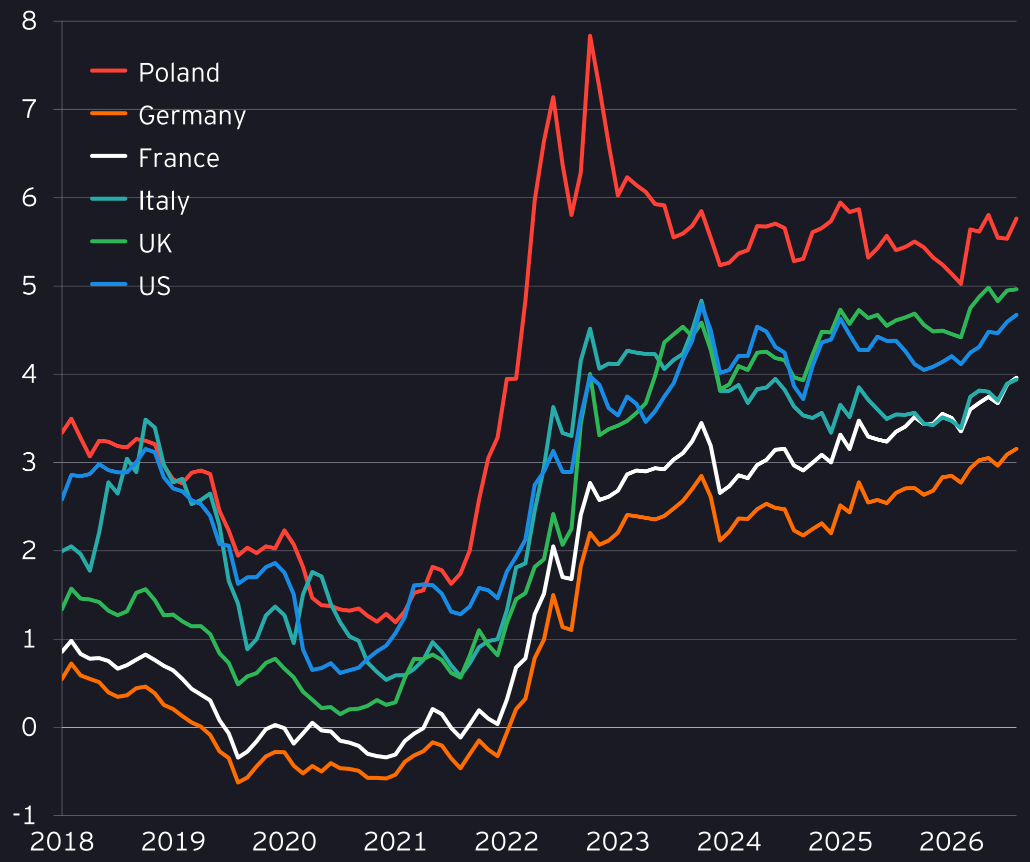




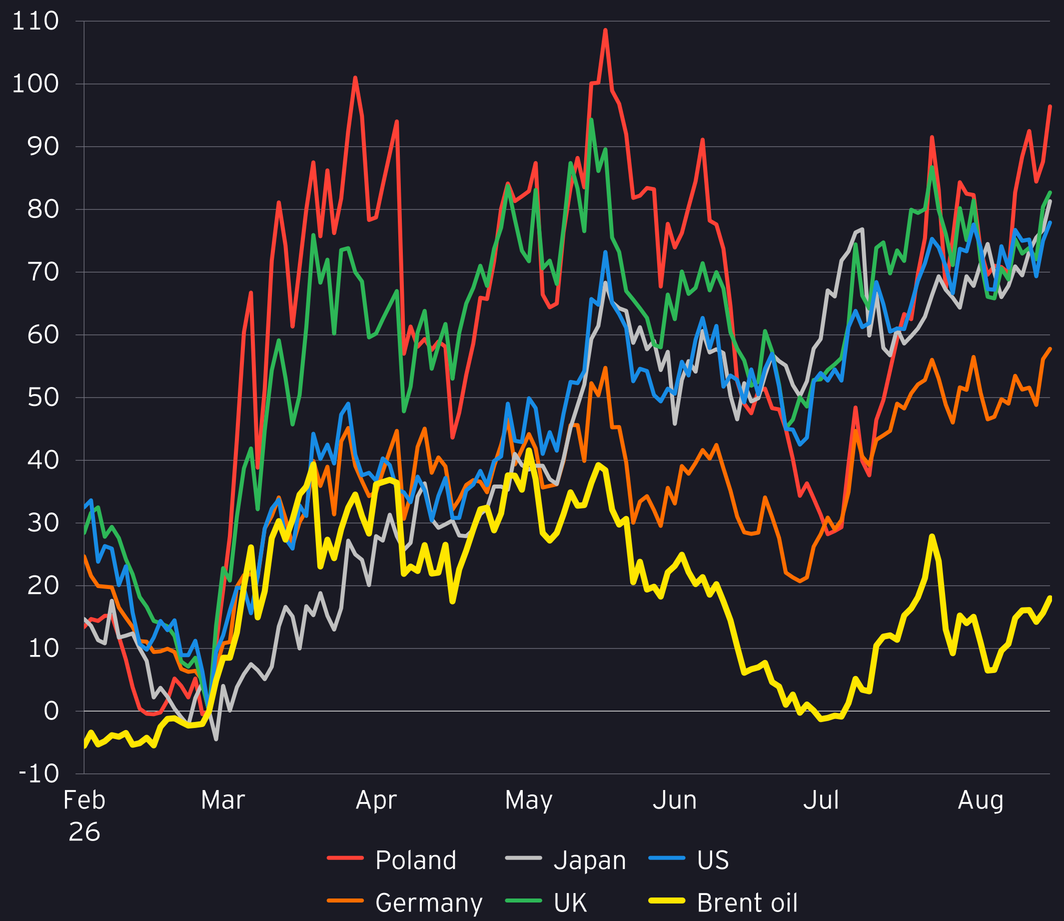
Source: ECB; Fed; BoE; BIS, Trading Economics.

Bond yields have continued to rise despite lower oil prices, suggesting that broader factors – including fiscal sustainability concerns – are at work

10-year government bond yield
(in percentage)



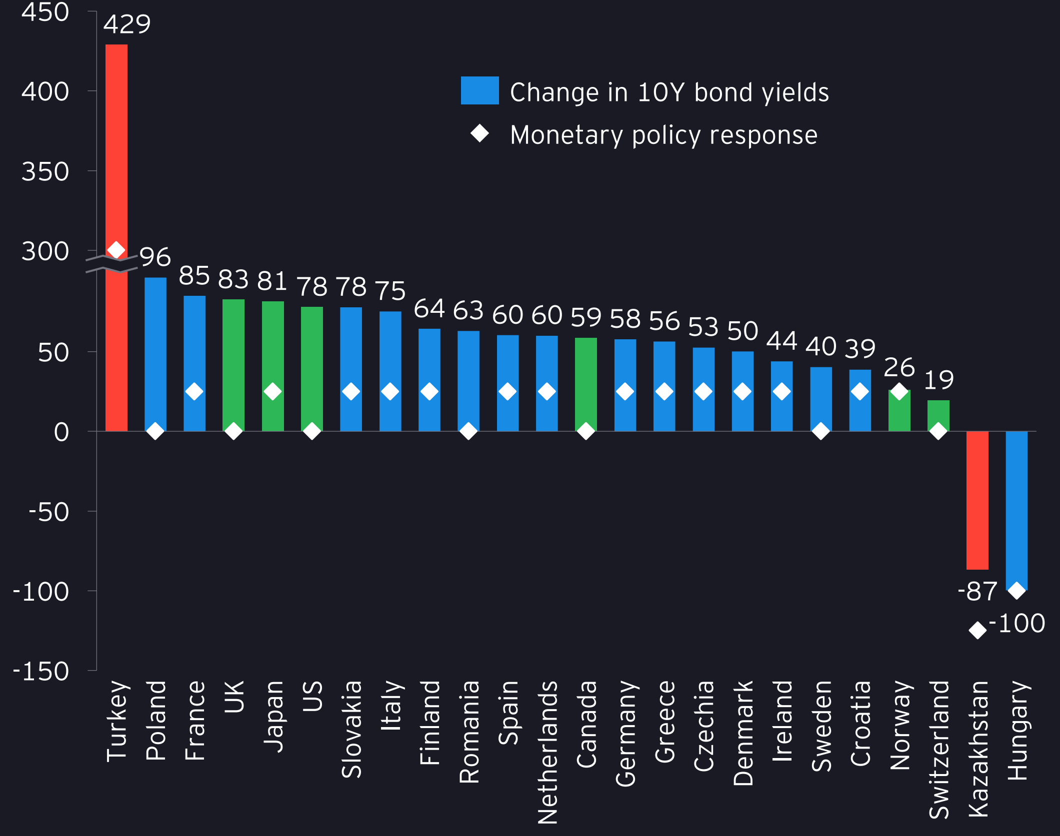
Change in 10-year government bond yields (bp)
vs. change in Brent oil price (USD/bbl)
since the outbreak of the Middle East conflict



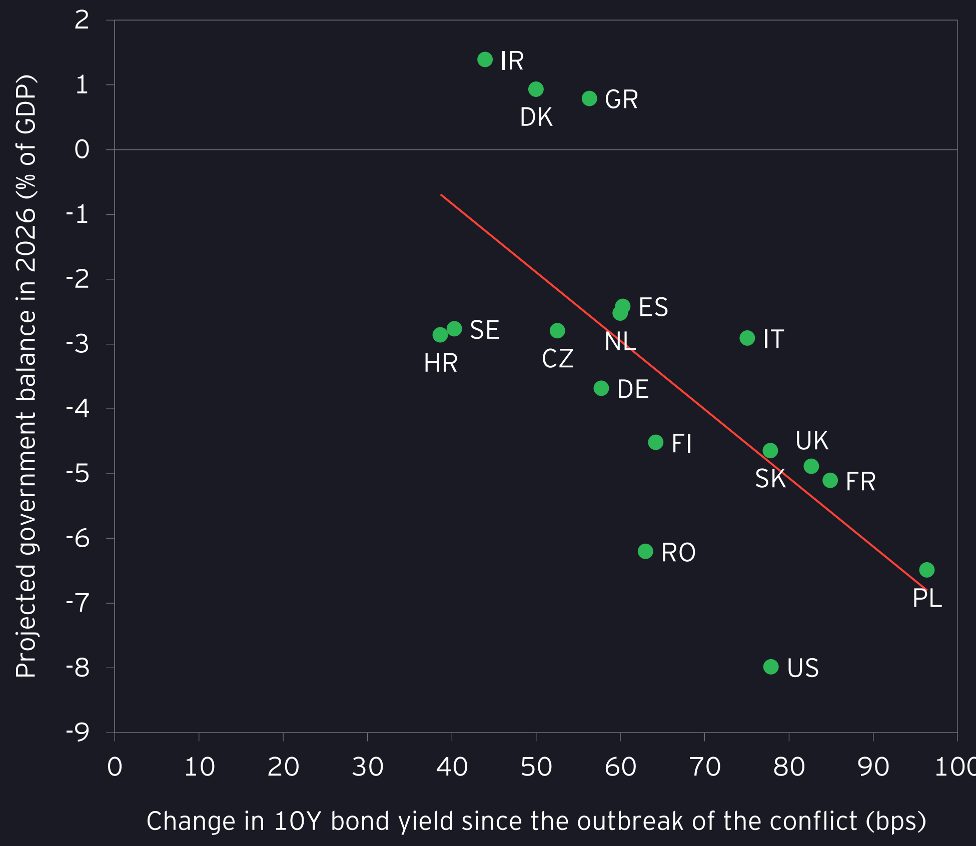
Source: Stooq.pl, LSEG, Trading Economics.

The response of bond yields to the energy shock has varied across countries depending on the monetary policy response and the fiscal stance

Change in 10-year government bond yields since the outbreak of the conflict and monetary policy response (bp)



Change in 10-year government bond yields since the outbreak of the conflict (bp) vs. projected government balance in 2026 (% of GDP)

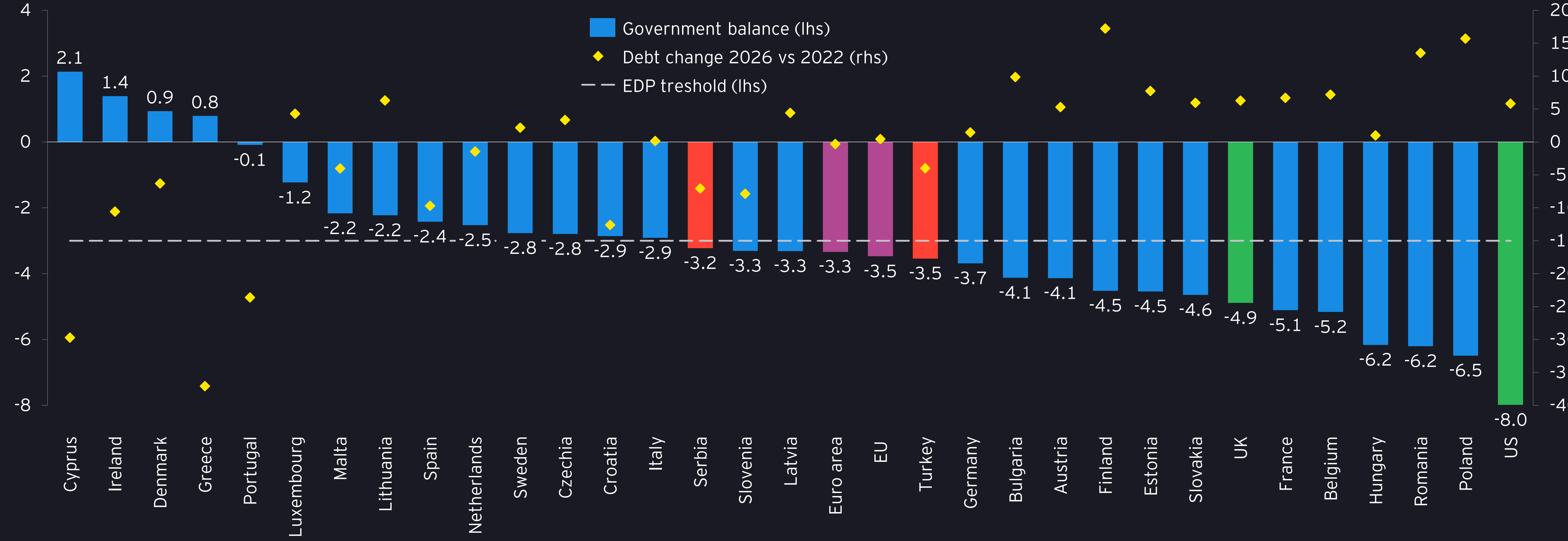


Source: Stooq.pl, LSEG, Trading Economics, AMECO.
Countries with large monetary policy responses (Hungary, Kazakhstan, Turkey) are excluded from the right chart.

Government deficit is expected to increase in the EU in 2026 amid the fiscal response to the Middle East Conflict

- Fiscal outlooks vary widely across EU economies, with 14 countries projected to exceed the 3% threshold under the EU's Excessive Deficit Procedure (EDP). Fiscal policy positions have also shown considerable persistence: government debt has generally increased since 2022 in countries pursuing expansionary policies, while it has remained stable or declined in most other economies.
- Regional divergence remains pronounced, with an expansionary fiscal stance across much of CEE, fiscal consolidation in Southern Europe, and a broadly neutral stance in Western Europe. Greece, Cyprus, Portugal and Croatia are recording the largest debt reductions, while Poland, Romania and Hungary continue to run the largest deficits in the EU. Romania has already begun substantial fiscal consolidation, while political constraints are complicating efforts to reduce deficits in Poland, Belgium and France. Meanwhile, the US continues to pursue a highly expansionary fiscal policy, although the resulting increase in the debt-to-GDP ratio has been partly contained by robust nominal GDP growth.

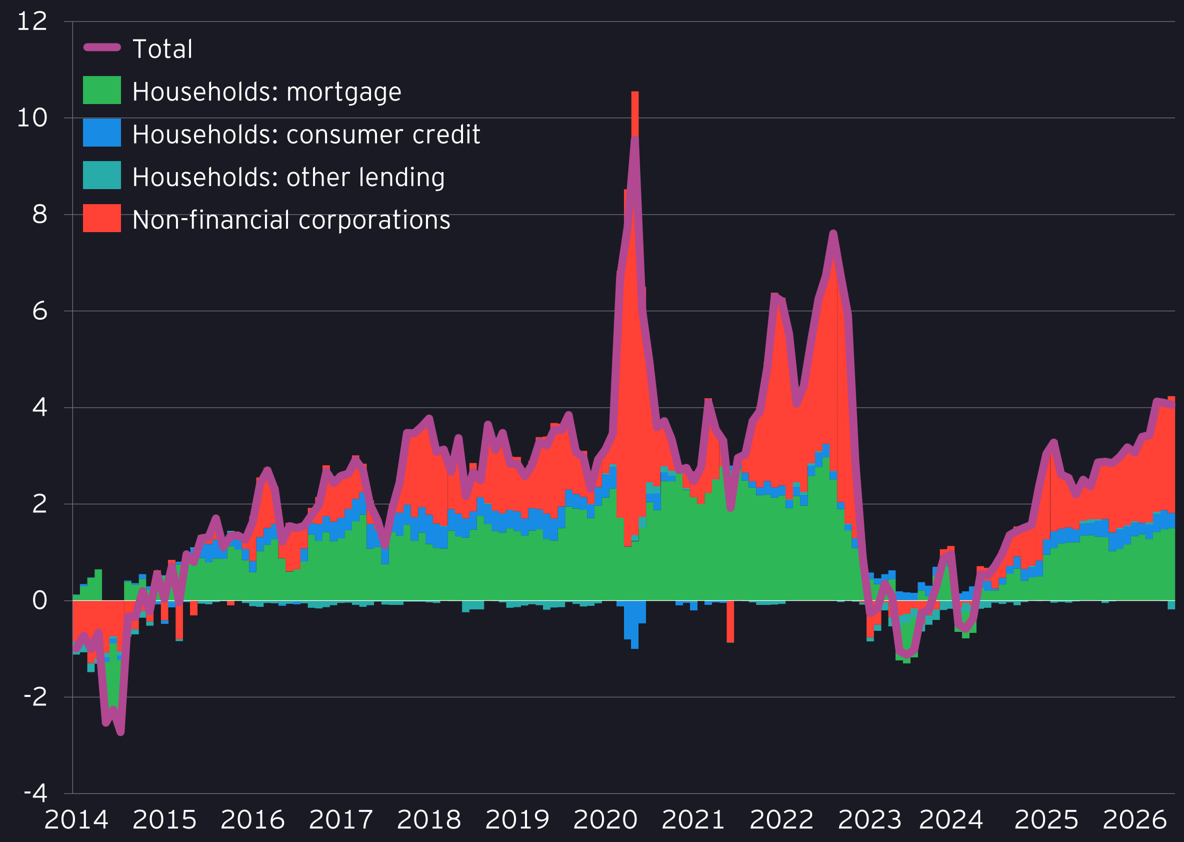
Government balance and debt projection for 2026 (% of GDP)



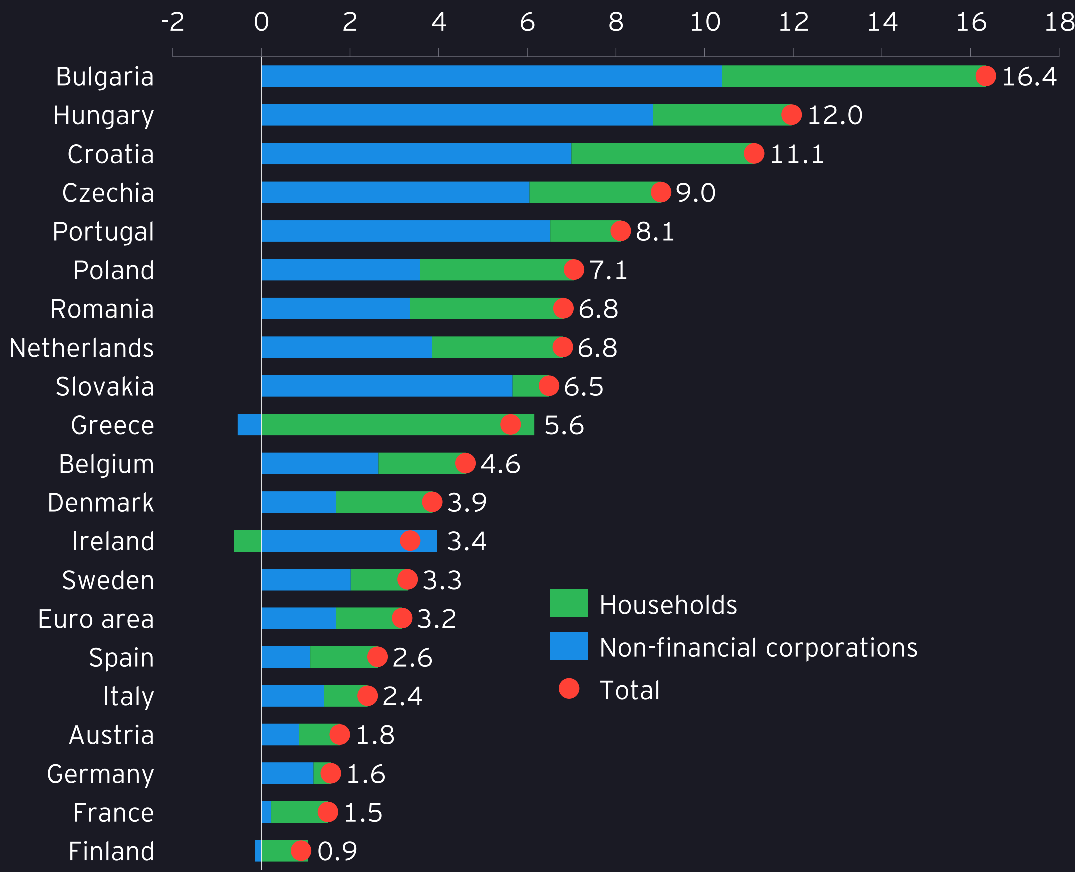
Source: AMECO.

Despite higher long-term interest rates, credit growth has continued to accelerate in recent months, particularly in the corporate segment. Credit is expanding strongly in CEE but remains relatively weak in Germany, France, Italy and Spain

Monthly growth in loans to households and non-financial corporations in the euro area (in percentage, annualized and seasonally adjusted, 3-mth moving average)



Stock of loans to households and non-financial corporations (Q2 2026; % y/y)



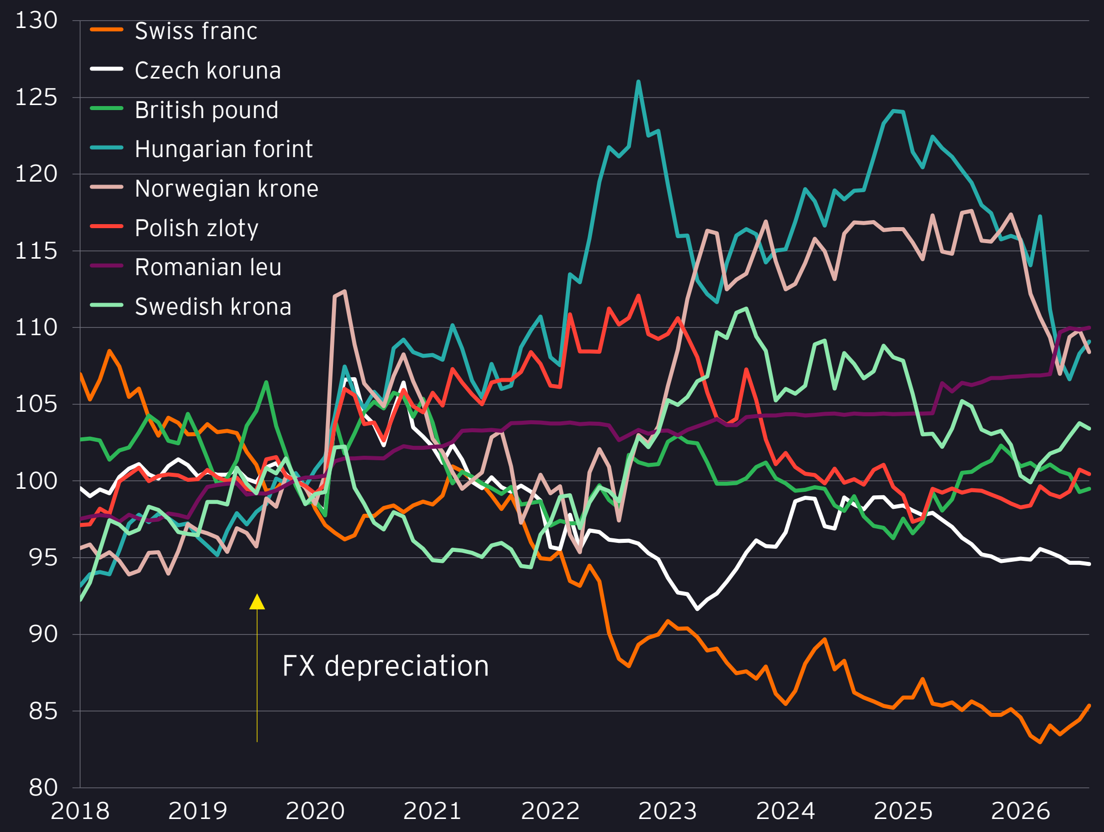
Source: ECB, EY calculations.
Note: Series for households include NPISH.

The euro has depreciated slightly against USD over the past three months amid expectations of tighter Fed policy. Most European currencies, except GBP, have weakened slightly against the euro

- Following strong appreciation in the first half of the year, the Norwegian krone and Hungarian forint have weakened slightly in recent weeks.
- The Polish zloty, Swiss franc and Swedish krona have also depreciated modestly against the euro, partly reflecting relatively dovish central bank signals.
- The British pound has been the main exception, appreciating somewhat against the euro as markets reacted positively to the reshuffle at Downing Street.

EUR/USD exchange rate

Exchange rates vs. EUR (Q4 2019= 100)

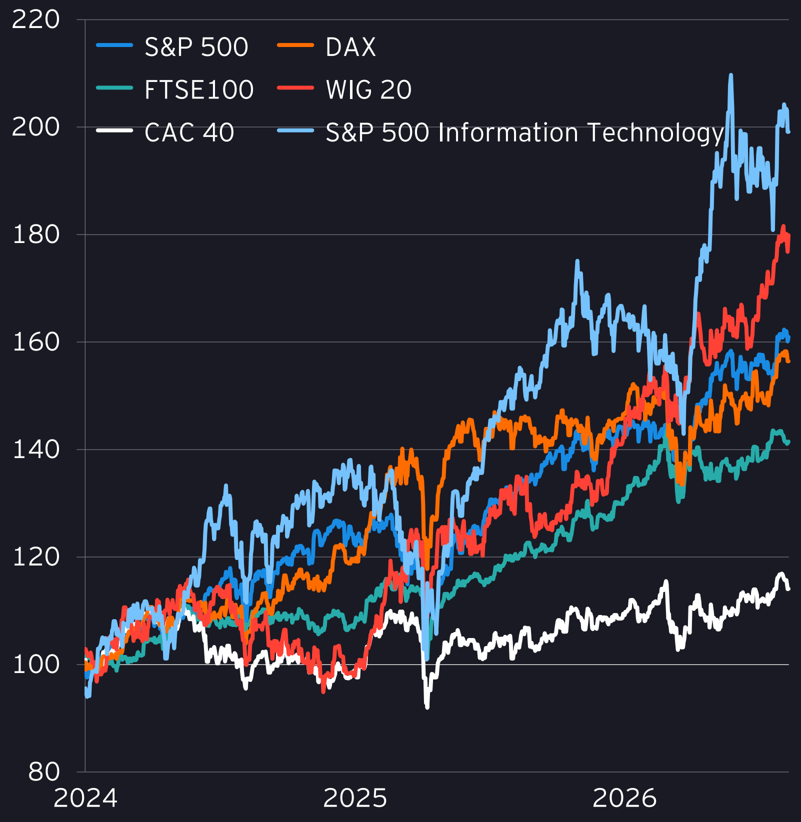


Source: Bank for International Settlements (BIS), LSEG.
* British pound as EURGBP

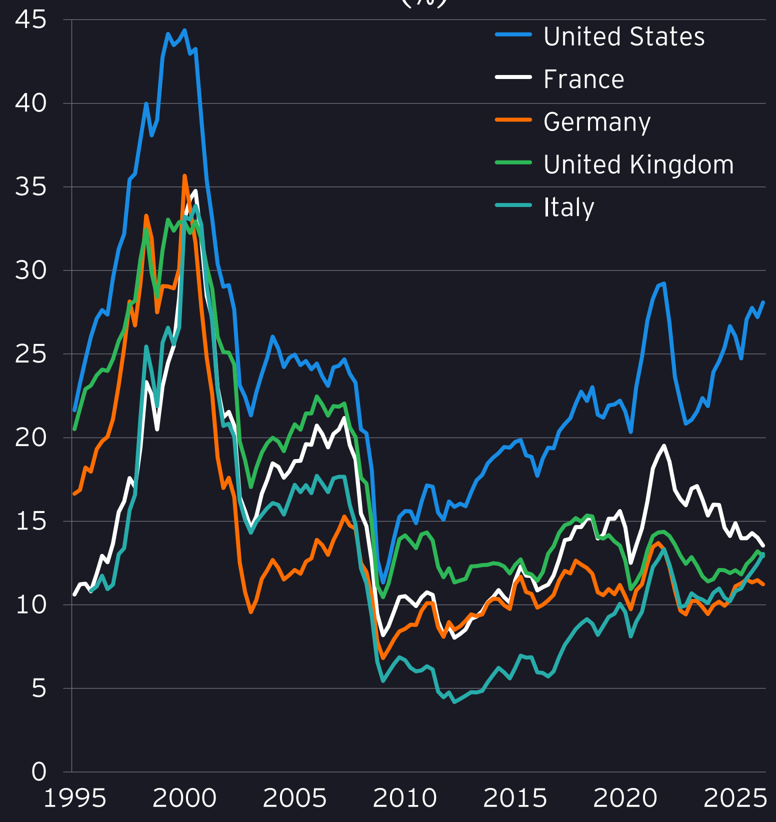
European stock indices have continued to rise, while the AI-driven rally in the US has lost momentum

- US equity valuations are elevated by historical standards. If expectations of AI-related earnings growth are not realized, the risk of a significant market correction would increase. European equity valuations remain considerably lower, but a major US market downturn would still affect Europe.
- Many stock markets in Southern Europe and CEE have recorded very strong returns in recent years, significantly outperforming the broad US market and, in some cases, approaching the gains recorded by US technology stocks.

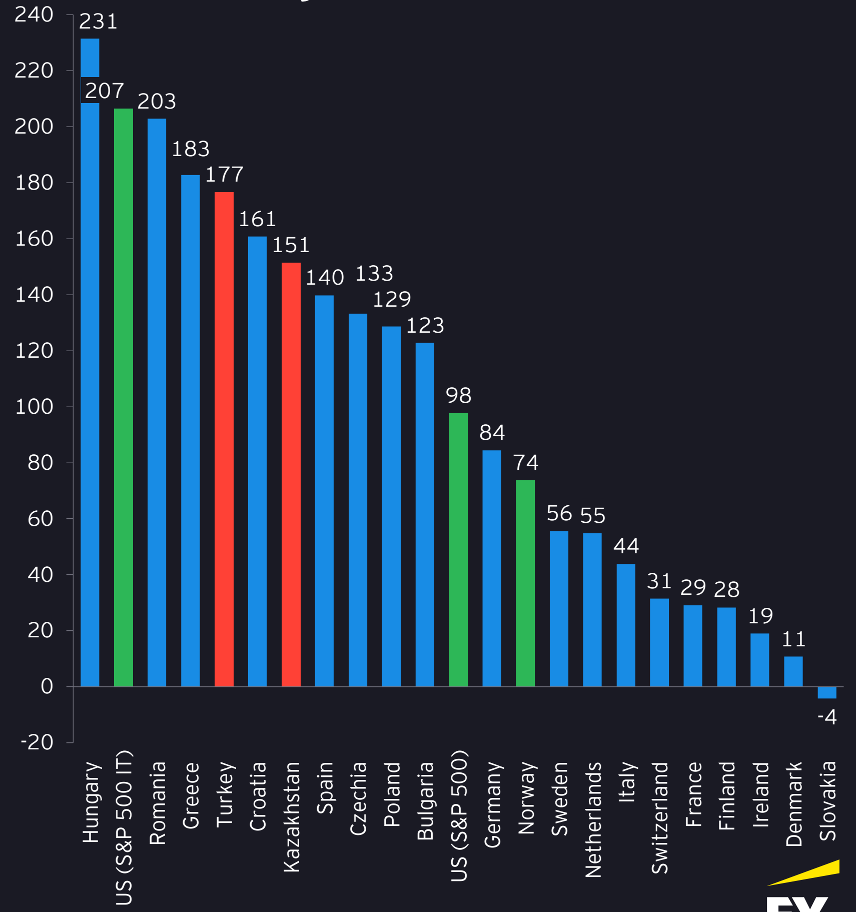
Major stock price indices
(index, 2024-01=100)



Stock market cyclically-adjusted Price-Earnings ratio
(%)



Stock price indices
(% growth from 2022-12)



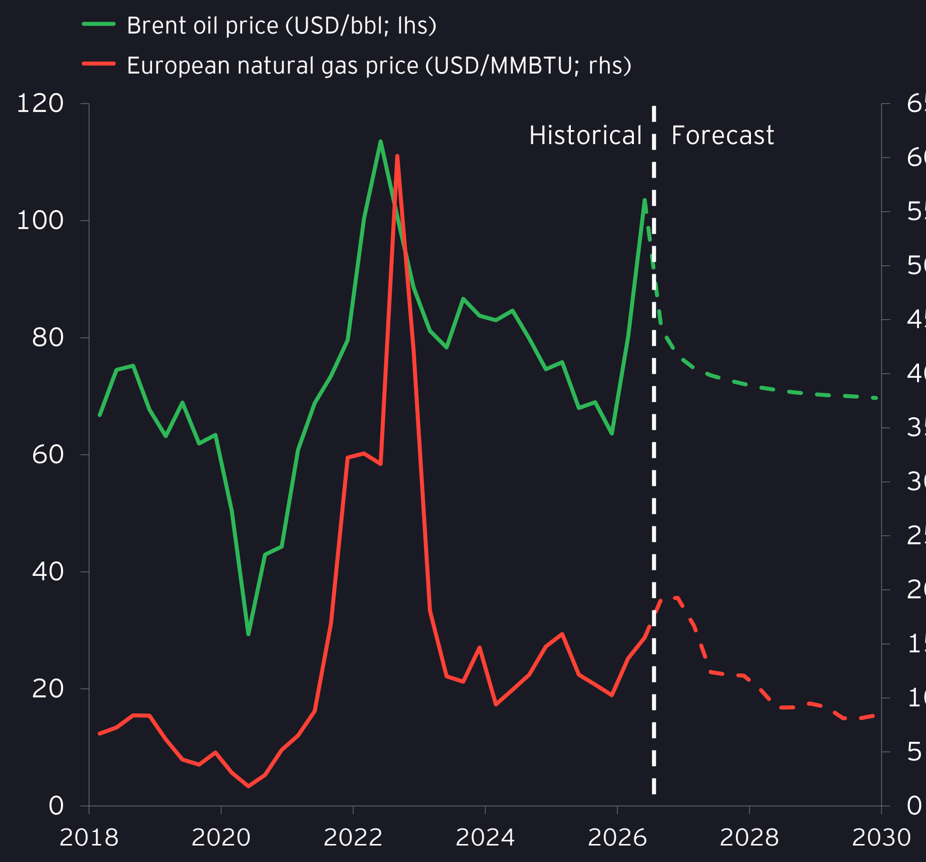
Source: Investing.com, stooq.pl, Trading Economics, LSEG, Oxford Economics.

Chapter 2

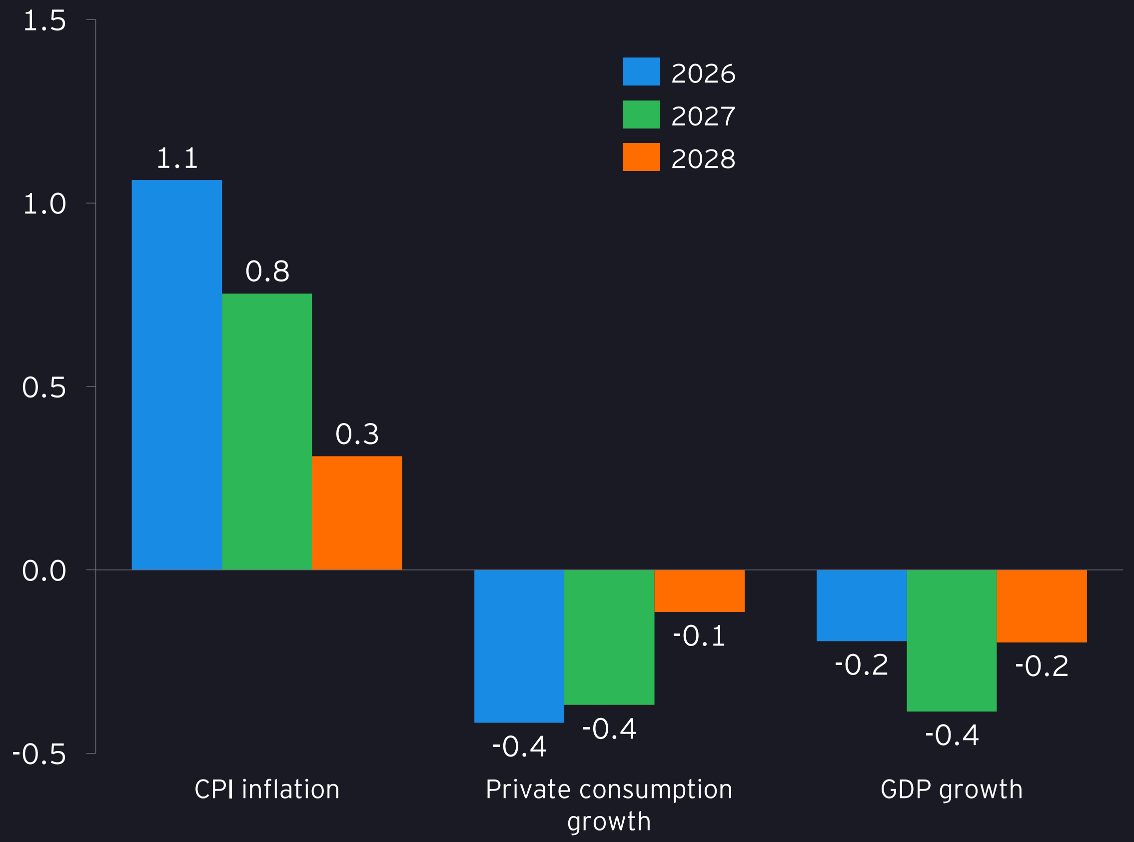
Key forecast drivers

The Middle East conflict remains the key driver of the outlook. Under our baseline scenario of a gradual normalization in energy commodity prices, we expect the conflict to have a persistent impact on inflation, moderately weighing on growth

Key commodity price assumptions



The impact of the Middle East conflict on the euro area economy under the baseline scenario (in percentage points)

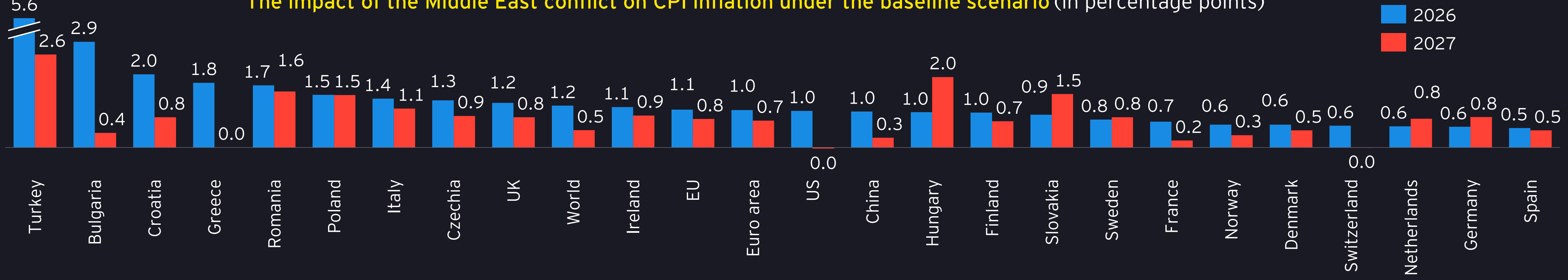


Source: EY EAT analysis.

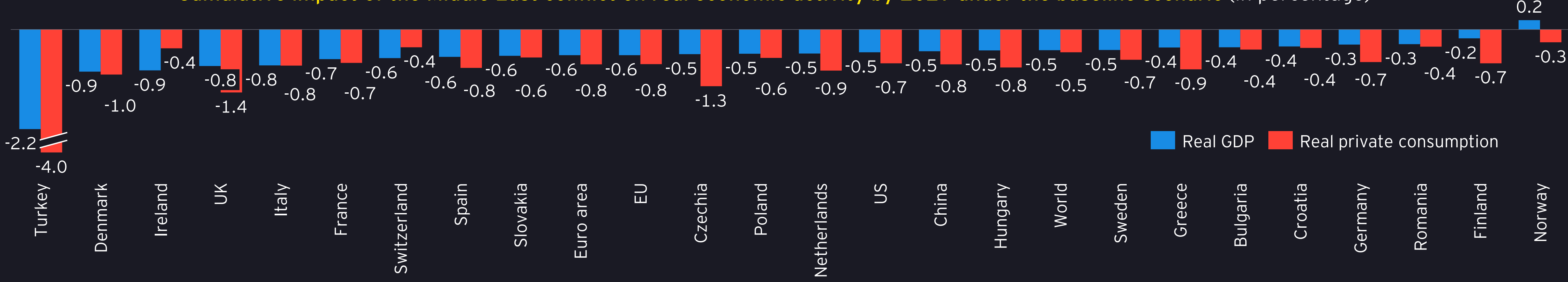
Turkey is the economy most affected by the energy shock, with consumption hit harder than GDP through lower real disposable income

- In Turkey, inflation expectations are de-anchored and prices respond strongly to shocks, weighing on real incomes and consumer spending. Together with Turkey's relatively close economic ties to MENA countries, these factors result in a particularly large impact on GDP.
- The cumulative inflationary impact the conflict depends primarily on the energy mix and the share of energy in the consumer basket, with CEE economies generally the most affected and Switzerland the least affected. The US is less impacted than Europe because it does not face a comparable increase in natural gas prices. The speed of pass-through depends on the extent of energy price regulation and government intervention. Pass-through is relatively rapid in Bulgaria, Croatia and Greece, while the price response is delayed in Hungary and Slovakia.

The impact of the Middle East conflict on CPI inflation under the baseline scenario (in percentage points)



Cumulative impact of the Middle East conflict on real economic activity by 2027 under the baseline scenario (in percentage)

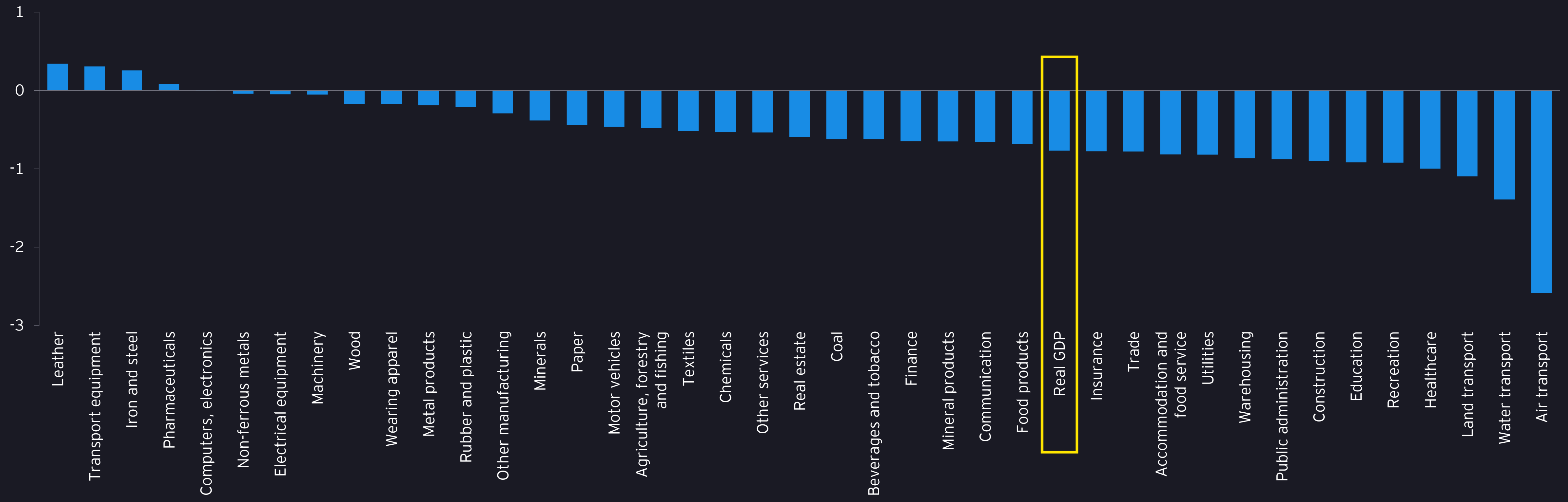


Source: EY EAT analysis.

Transport is most exposed to higher energy prices. Most manufacturing sectors are considerably more resilient

- Higher energy costs erode household disposable incomes, reducing demand for discretionary services and weighing on activity despite the sector's low direct energy intensity.
- Higher energy prices also increase costs for non-EU producers. Given higher energy intensity of Chinese manufacturing, the negative impact on EU firms is partly offset by an improvement in their relative cost competitiveness.

Impact of the Middle East conflict on value added by sector in the EU in 2028
(percentage deviation relative to a no-conflict scenario)



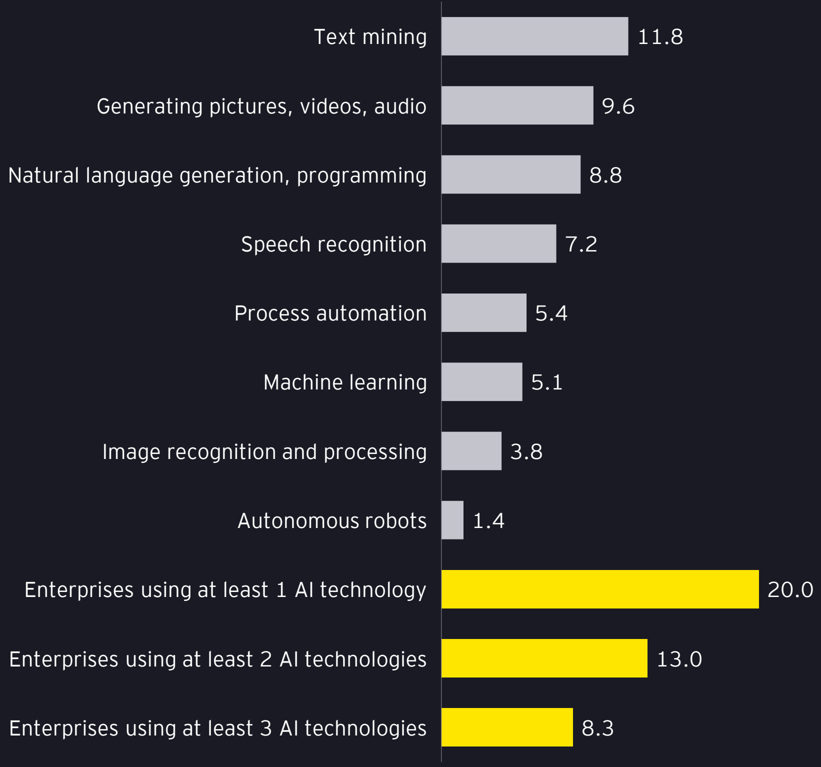
Source: EY simulations using the EY UPGRADE CGE model.

AI is another key driver of the outlook, but adoption remains in early stage: while 20% of EU firms use at least one AI technology, only 4% use AI in production processes

- EU firms use AI primarily to process and generate text, code and pictures/videos, mainly in marketing, sales and business administration. However, even the most widely adopted technologies and use cases are used by only 5-10% of firms.

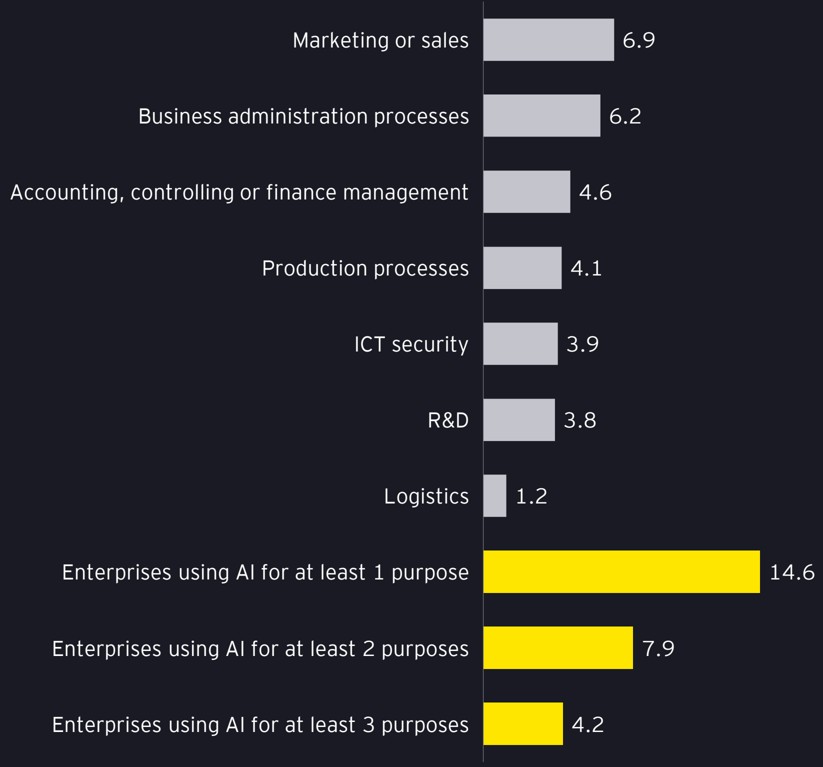
What AI technologies are used?

Percentage of enterprises in the EU in 2025



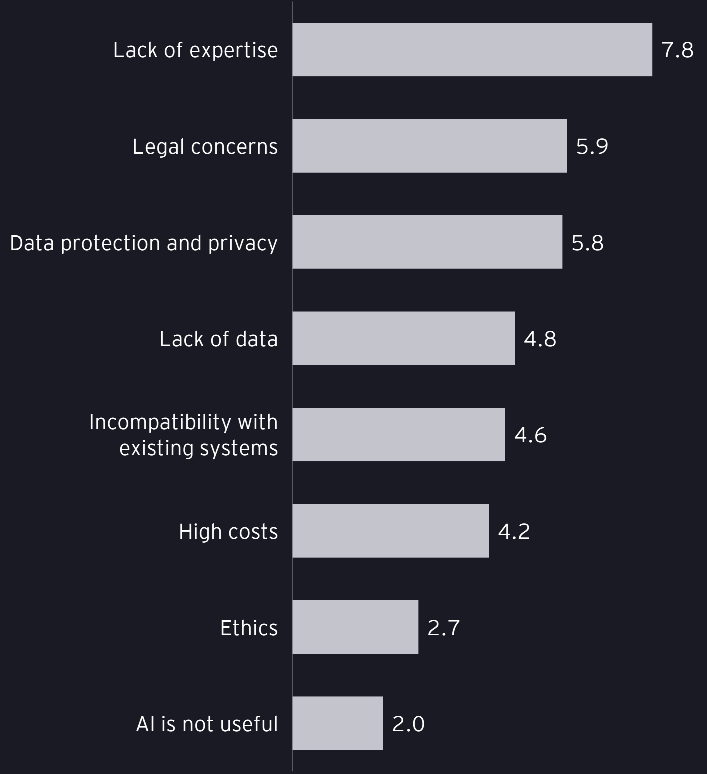
What are AI technologies used for?

Percentage of enterprises in the EU in 2025



Why is AI not used?

Percentage of enterprises in the EU in 2025

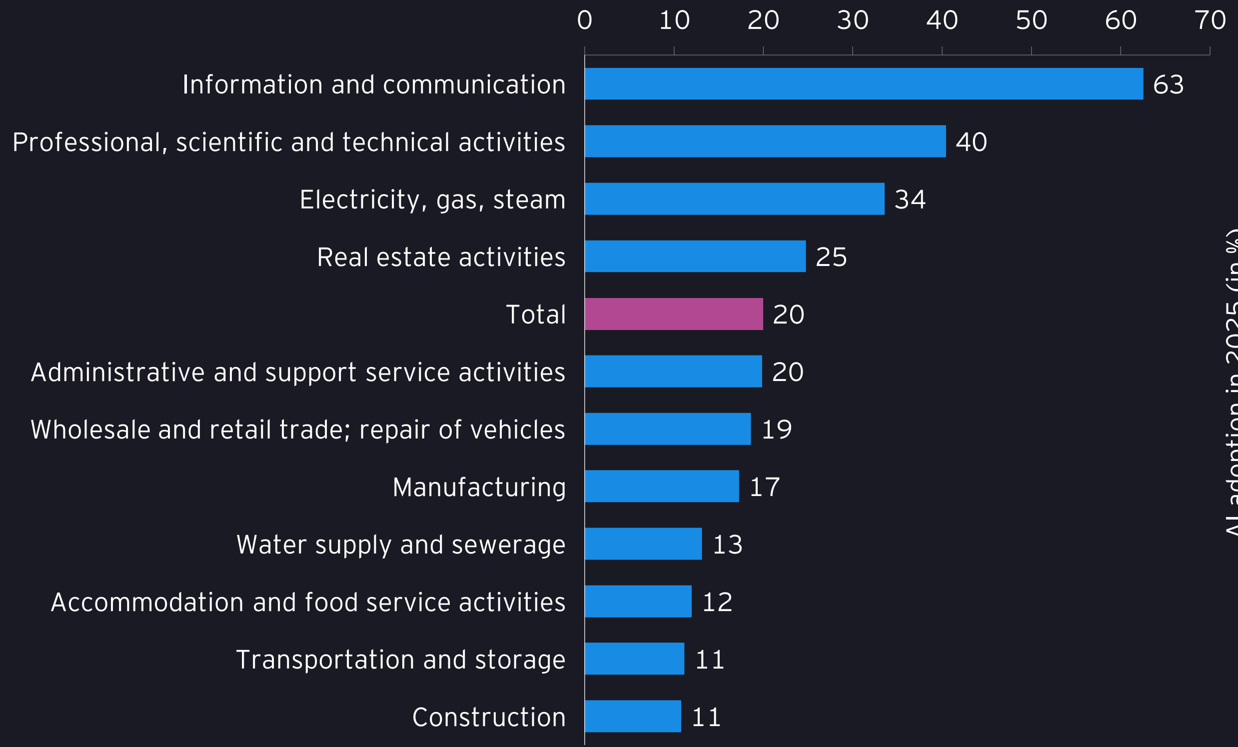


Source: Eurostat.
Enterprises with 10 or more employed persons.

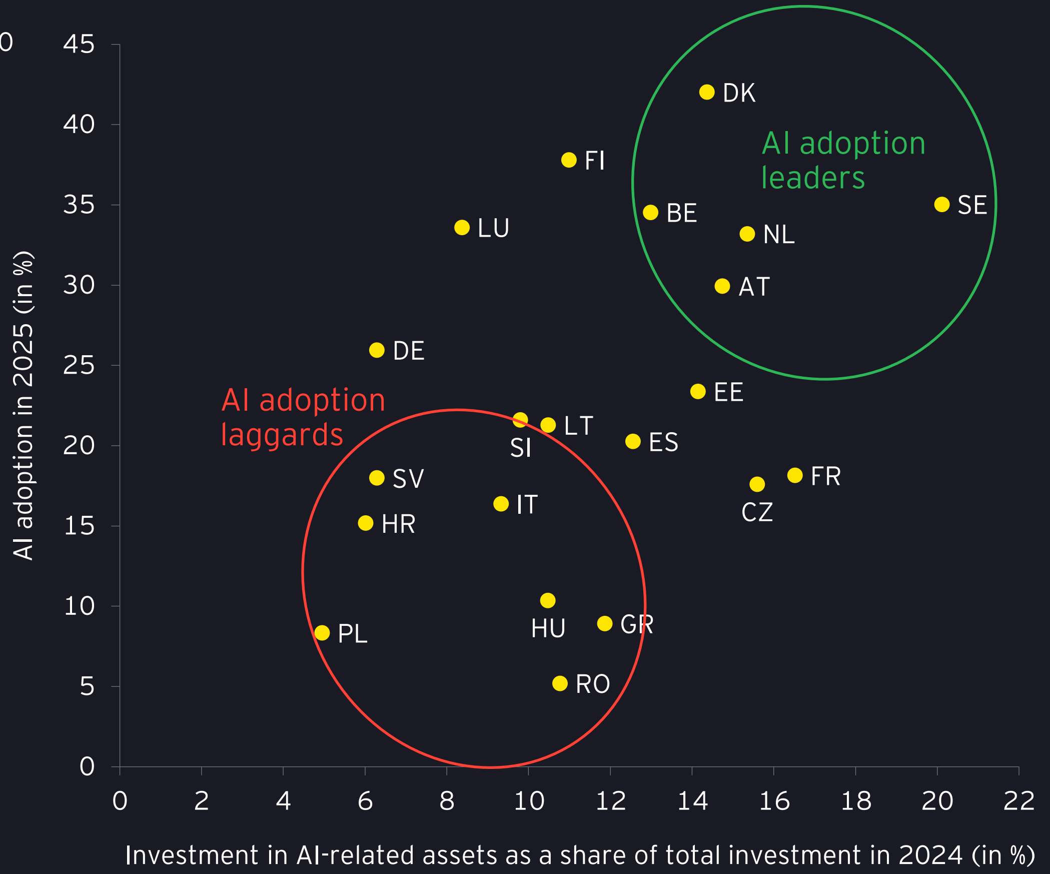
AI adoption varies widely across countries and sectors: the Nordics and Benelux lead, while Poland, much of CEE and Italy lag

- AI adoption also varies significantly across sectors, with ICT and professional services leading. By contrast, adoption remains more limited in construction, transportation, and tourism, where applications are still relatively constrained.

AI adoption rate[1] in the EU by economic activity in 2025
(% of enterprises)



Investment in AI-related assets as a share of total gross fixed investment in 2024 compared to AI adoption rate[1] in 2025

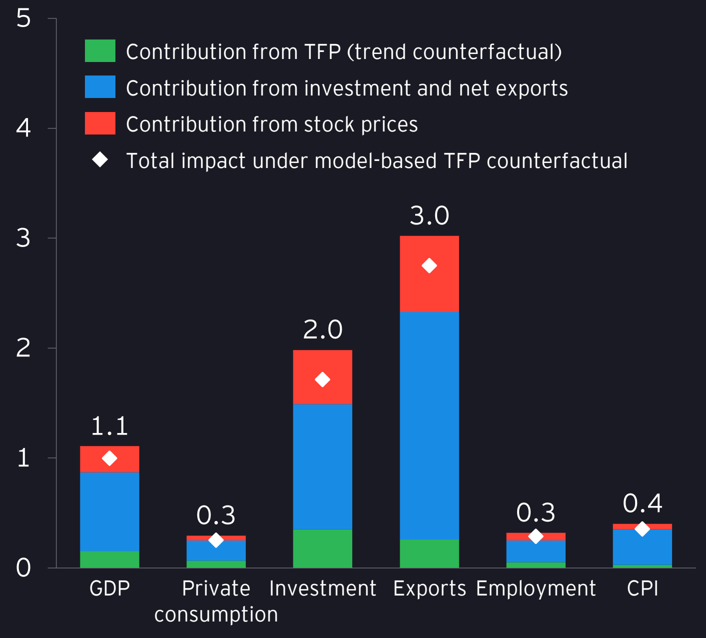


Source: Eurostat.
1. Enterprises with 10 or more employed persons using at least one AI technology.

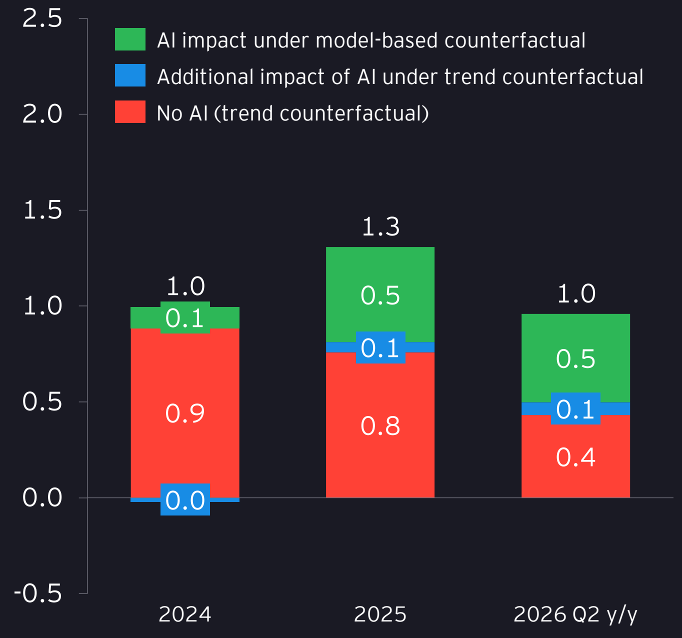
Although AI adoption remains at an early stage, we estimate that stronger AI-driven US import demand may have indirectly raised euro area GDP by up to 1%

- We estimate AI's impact to date using our global macroeconometric model and two counterfactual scenarios. In the first scenario, US potential total factor productivity (TFP) follows its pre-2024 trend; in the second, counterfactual TFP is estimated using the approach described on the next page. In both scenarios, US real investment in information-processing equipment and software, as well as real exports and imports of computers, peripherals and parts, follow their pre-2024 trends. We also assume that the cyclically-adjusted price-to-earnings ratio (CAPE) of the US stock market remains broadly in line with its 2023 level. Finally, we apply TFP shocks to other economies using the approach described on the next page.
- Although the direct impact of AI on the euro area economy has so far been limited, stronger US import demand has supported euro area exports and investment, raising GDP by an estimated 1.0-1.1%. This should be regarded as an upper-bound estimate because the model allocates the increase in US imports across trading partners in proportion to their existing shares of US imports. In practice, Asian semiconductor and electronics producers appear to have benefited considerably more than European producers.
- In Europe, countries most exposed to trade with the US are estimated to have benefitted the most from the AI boom.

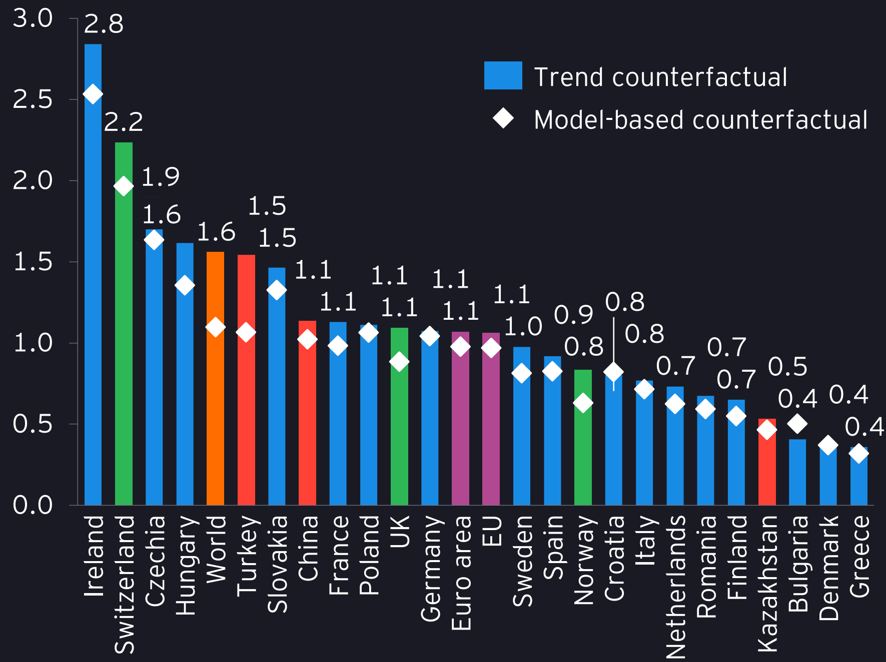
Estimated cumulative impact of AI on levels of key macroeconomic indicators in the euro area by Q2 2026 (in percentage)



Estimated impact of AI on real GDP growth (in percentage points)



Estimated cumulative impact of AI on real GDP level by Q2 2026 (in percentage)

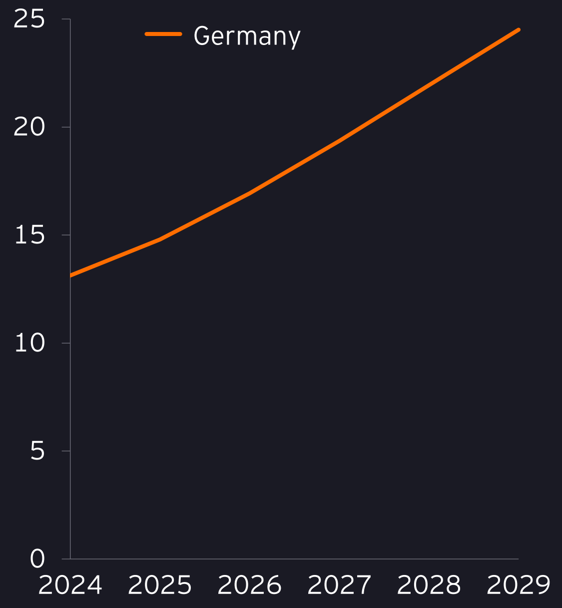


Source: EY EAT analysis.

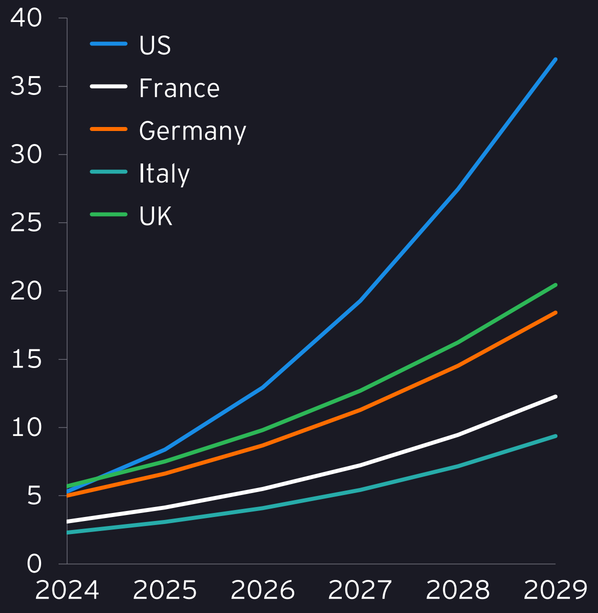
Under conservative baseline assumptions, AI-driven productivity gains may increase euro area potential output by an additional 0.4% by 2029

- AI's impact on productivity depends on three factors: 1) exposure to AI, 2) AI adoption, and 3) the rate at which the worker-level productivity gains identified in microeconomic studies translate into aggregate TFP gains
  - Exposure to AI is measured using task-level automation exposure, which increases over time, combined with each country's occupational employment structure
  - Adoption is defined narrowly as the use of AI in producing goods and services. It follows an S-shaped curve calibrated to the available data
  - We assume that 15% of the worker-level productivity gains identified in microeconomic studies translate into aggregate TFP gains.
- No AI-related job displacement is assumed
- The analysis does not incorporate additional effects from AI-related investment or higher equity prices.
- For our analysis of AI's estimated contribution to GDP through Q2 2026 see the previous page.

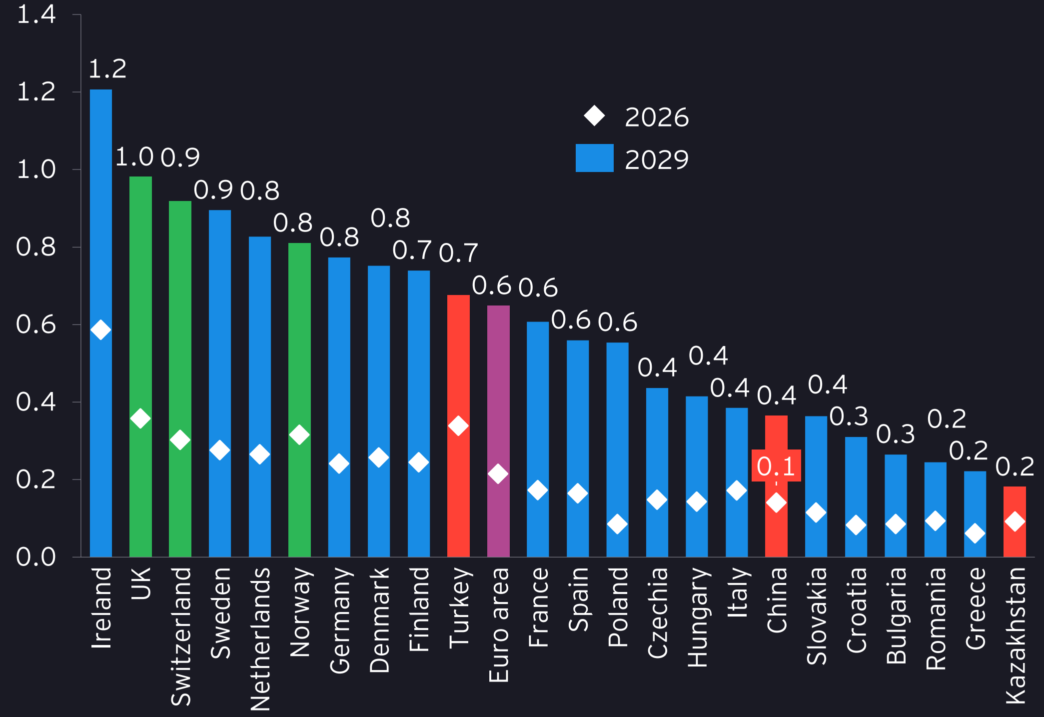
AI occupational exposure in Germany* (In percentage of employment)



AI adoption (percentage of enterprises using AI in production processes)



Impact of AI on potential GDP level (In percentage)

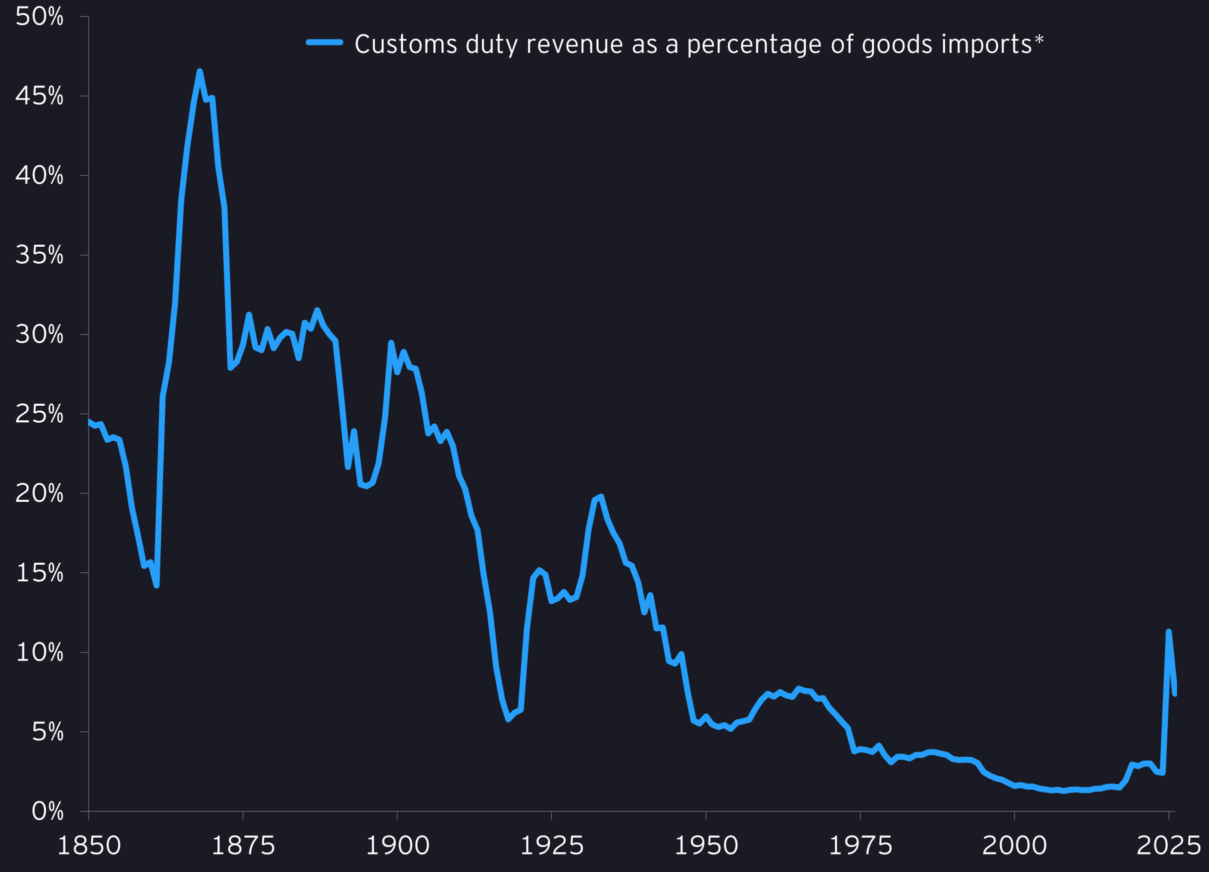


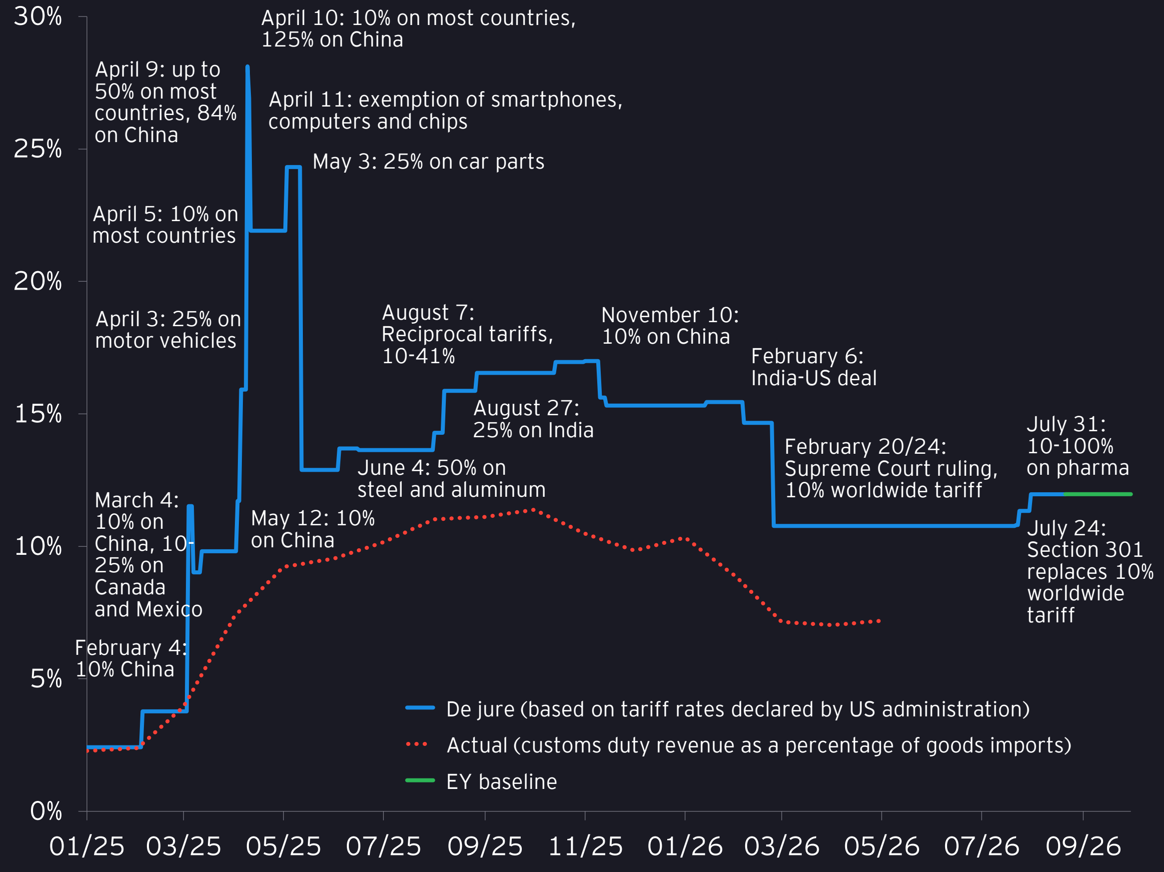
Source: EY EAT analysis based on Oxford Global Economic Model.
* Differences in exposure levels and trends across countries are relatively minor – Germany is displayed as an example.

Tariffs remain a material headwind. The replacement of Section 122 with Section 301, together with new pharmaceutical tariffs, has raised the average effective US import tariff to 12%

- The *de facto* tariff rate (measured as customs revenues relative to imports) remains significantly below the statutory (*de iure*) rate implied by the tariffs in force and import composition. This gap reflects factors including trade rerouting and product reclassification and is unlikely to close fully.

Average effective tariff rate in the US
(in percentage)





Source: The Budget Lab at Yale, Penn Wharton Budget Model, WITS, the White House, EY EAT calculations.
* An estimate for 2026.

Uncertainty surrounding US tariff policy remains high, as Section 301 investigations could broaden tariff coverage across multiple countries and the US continues to signal possible additional measures against trading partners

US tariff actions and statements *(as of August 24, 2026)*

Trade partner	Tariff		Status
Canada	50% on various products including dairy, alcohol, cement, textiles, sporting goods	Effective	Effective August 22, 2026
Brazil	Section 301 (unreasonable policies): 25% on most goods[1]	Effective	Effective July 22, 2026
Vietnam	Section 301 (intellectual property)	Threatened	Under investigation
All nations	50% on steel and aluminum (25% on the UK)	Effective	Effective March 12, adjusted on June 4, 2025
	25% on cars and auto parts (15% on the EU, Japan, and Korea; 10% on the UK)	Effective	Effective May 3, adjusted on August 7, 2025
	50% on semi-finished copper products and intensive copper derivative products	Effective	Effective August 1, 2025
	10% on lumber and 25% on wooden furniture (10% on the UK, 15% on the EU)	Effective	Effective October 14, 2025
	25% on trucks and truck parts, 10% on buses	Effective	Effective from November 1, 2025
	100% on patented pharmaceuticals (15% on the EU, Japan, and Korea; 10% on the UK), exemption for companies with onshoring deals	Effective	Effective July 31, 2026
	40% on shipments rerouted to avoid tariffs	Effective	Effective August 7, 2025
	25% on re-exported semiconductors	Effective	Effective January 14, 2025
	10% on most goods[1]	Removed/withdrawn	Expired
	Section 301 (forced labour): 10/12.5% tariff on most goods[1]	Effective	Effective July 24, 2026
Many European and Asian countries	Section 301 (excess capacity)	Threatened	Under investigation

Trade partner actions and statements — to US *(as of August 24, 2026)*

Trade partner	Tariff		Status
China	10% on goods (with some exceptions)	Effective	Effective May 13, 2025
	34% on goods (with some exceptions)	Paused	Paused until November 2026
	Non-tariff countermeasures	Paused	Paused until November 2026
	Rare-earth export controls	Paused	Paused until November 2026
Canada	25% on United States-Mexico-Canada Agreement (USMCA) noncompliant goods	Removed/withdrawn	Removed on September 1, 2025
	25% on steel and aluminum, and USMCA noncompliant vehicles	Effective	Effective March 12, 2025
	50% on goods	Threatened	Threatened, not effective
EU	Threats on retaliatory tariffs on various goods	Removed/withdrawn	Withdrawn
Mexico	Threats on retaliatory tariffs (without details)	Threatened	Threatened, not effective
Brazil	50% on goods	Threatened	Threatened, not effective

Note: **The 10% worldwide tariff has been replaced by Section 301 tariffs, with 10% rate applied to the EU, UK,** Canada, Mexico and India, while China, Japan, Brazil and Switzerland subject to a 12.5% levy. Under Section 301 an additional 25% tariff has been imposed on Brazil and further investigations target many other countries (mostly European and Asian).

Effective | Paused | Threatened | Removed/withdrawn

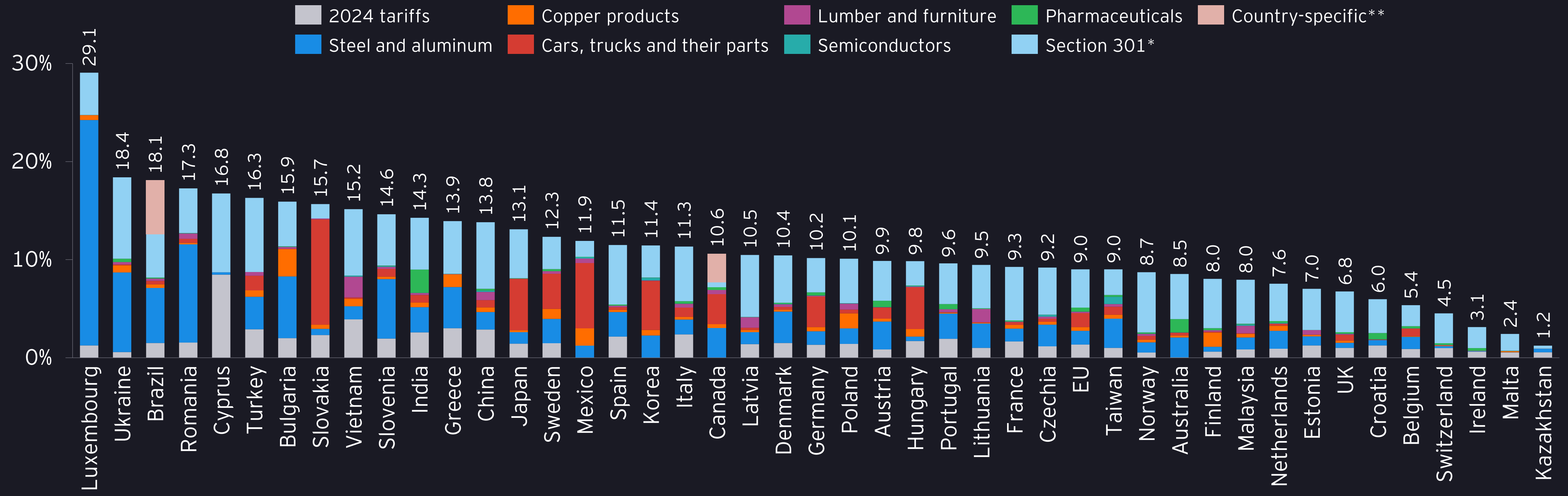
1. They do not apply to pharmaceuticals, semiconductors, lumber, copper, electronics, and certain food products and goods covered by sectoral tariffs.

Source: Government websites; EY analysis.

The overall direct impact of pharmaceutical and Section 301 tariffs on Europe has so far been limited

- The replacement of 10% global tariff with Section 301 tariffs had no direct impact on most European economies, as the applicable tariff rates remained unchanged. By contrast, China, Japan, South Korea, Australia, and Brazil became subject to higher tariffs of 12.5%. In addition, Brazil and Canada have been targeted by further tariffs of 25% and 50%, respectively.
- Meanwhile, the baseline tariff on patented pharmaceutical products increased up to 100% from 31 July. However, the effective tariff rate is significantly lower for many countries, reflecting existing trade agreements and onshoring arrangements between the US administration and major pharmaceutical companies. These arrangements provide tariff exemptions in exchange for investment commitments in the US.
- Since early 2025, the largest increases in statutory tariff rates have occurred in economies where steel and aluminum account for a relatively high share of exports to the US, including Luxembourg, Romania, Bulgaria, and Slovenia.

De iure effective tariff rate in exports to the US (in percentage)

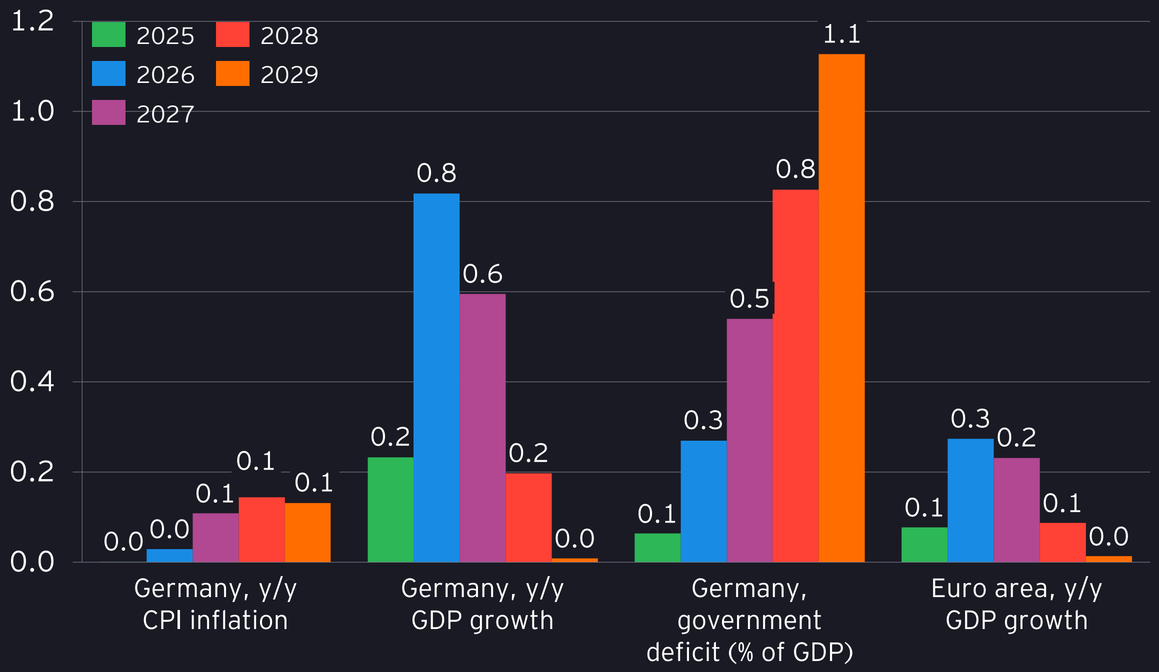


Source: EY EAT calculations, WITS database, The Budget Lab at Yale.
Notes: Effective tariff rates calculated by multiplying new sectoral and regional tariffs by country's structure of exports to the US.
* Tariffs grounded on claim that US trade partners have failed to prevent trade in goods produced using forced labor.
** 25% tariff on selected goods from Brazil and 50% tariff on selected goods from Canada.

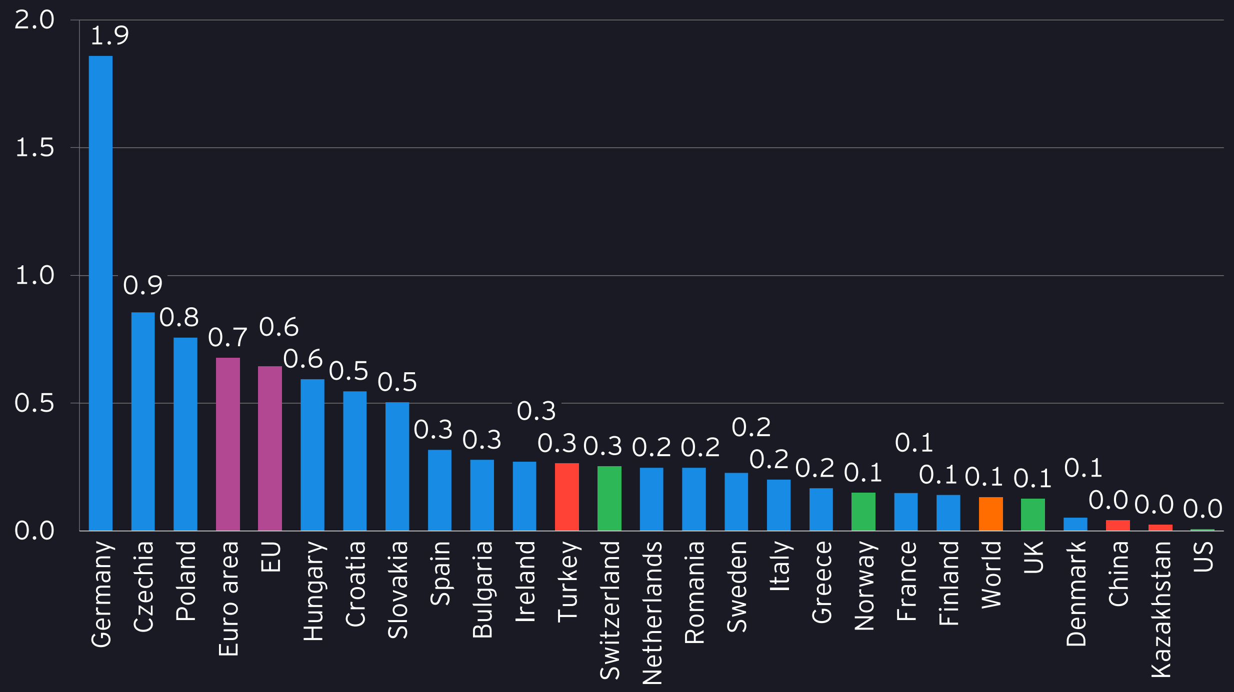
The drag from US tariffs and the Middle East conflict is being partly offset by fiscal expansion in Germany

- In March 2025, the German Parliament adopted a fiscal package marking a clear shift away from its previously conservative stance
  - A EUR500 billion infrastructure fund (~11.5% of 2024 GDP) will be deployed over 12 years, including €100 billion for the Climate Transition Fund and the remainder for infrastructure investments—€300 billion at the federal level and €100 billion for state governments. The fund sits outside the 'debt brake' constraints.
  - Defense spending above 1% of GDP will not count toward the 'debt brake'.
  - Germany's 16 federal states are now allowed to run a structural deficit of up to 0.35% of their economic output, ending the previous prohibition on state deficits.
- We estimate that the package has already significantly contributed to growth over the past three quarters, helping the German economy emerge from stagnation. While the vast majority of the package is yet to be implemented, going forward, it is more likely to sustain growth than to provide an additional acceleration.
- Given its composition, which is focused on infrastructure and defense spending, we do not expect the package to have a meaningful impact on consumer-price inflation.
- CEE economies are expected to benefit most from Germany's fiscal expansion because of their close integration with German industrial supply chains. Spillovers to the rest of Europe are likely to be more limited.

Impact of German fiscal expansion on y/y GDP growth, CPI inflation, and government deficit in Germany and the euro area (in percentage points)



Impact of German fiscal expansion on 2029 GDP level (in percentage)

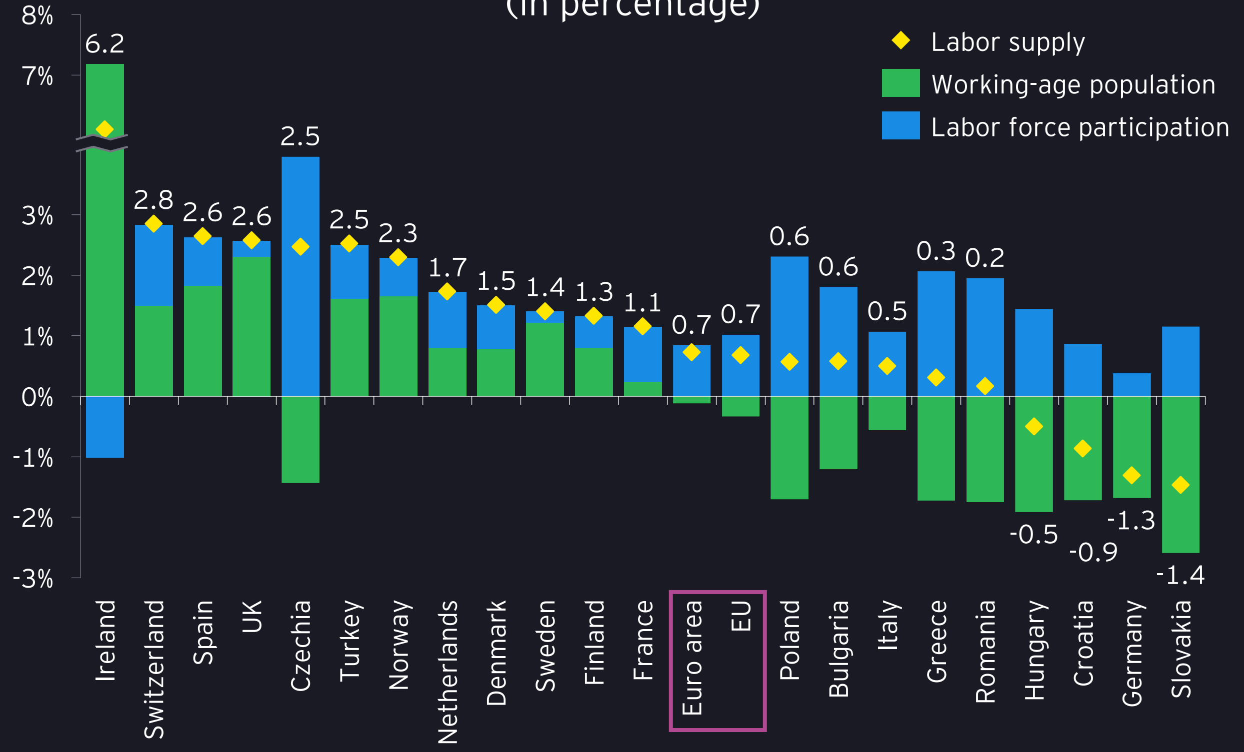


Source: EY EAT calculations.

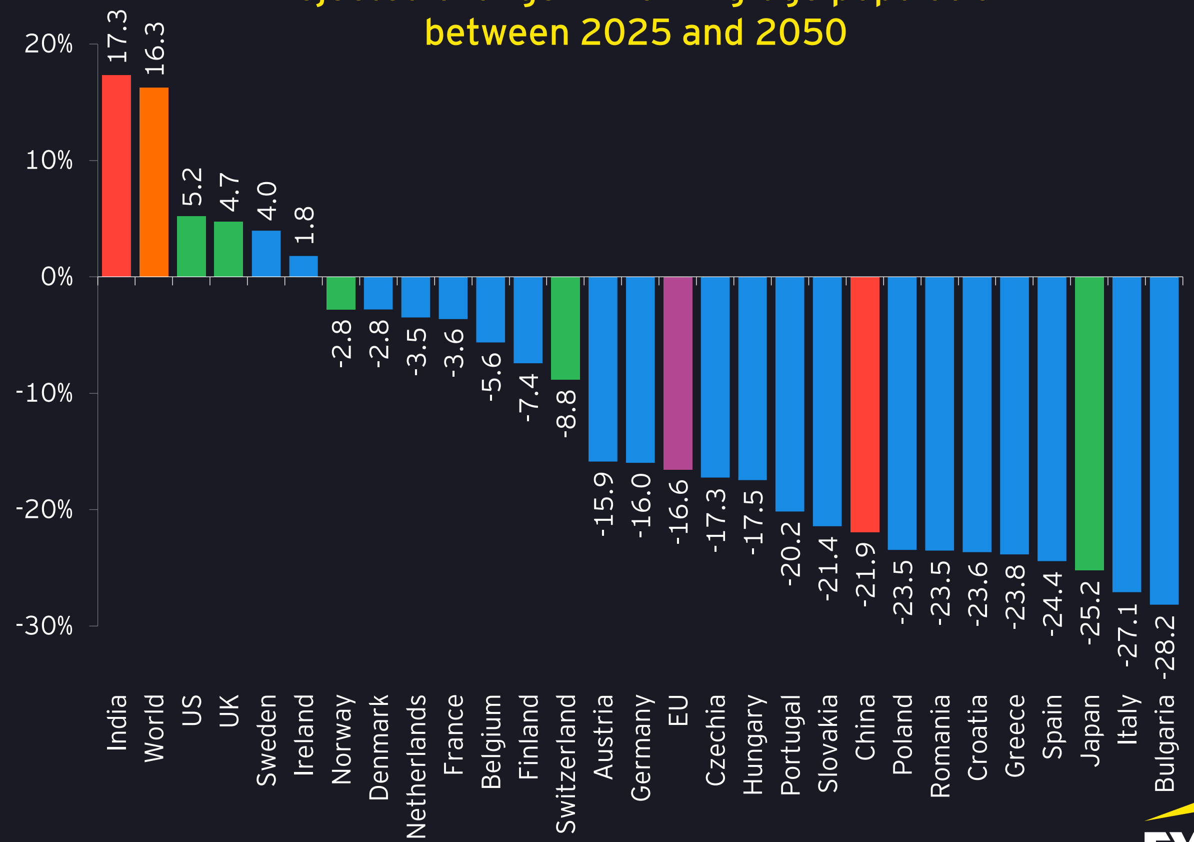
The EU's labor supply is expected to remain broadly stagnant over the medium term, with significant cross-country divergence, before declining over the longer term

- The EU's labor supply is expected to increase only slightly by 2029, as the working-age population remains broadly unchanged and labor force participation rises only modestly. Developments will vary significantly across countries: labor supply is projected to grow strongly in Ireland, Switzerland, Spain and the UK, driven mainly by immigration and further gains in labor force participation. Turkey, Nordics and the Netherlands are also expected to observe meaningful gains in labor supply. In contrast, Germany, Slovakia, Croatia and Hungary are projected to see declines in labor supply, as shrinking working-age populations outweigh improvements in participation.
- Over the longer term, most European countries are expected to face a decline in the working-age population. As the scope for further increases in labor force participation diminishes, this demographic decline will increasingly translate into a contraction in labor supply. Demographic pressures will be most acute in CEE and Southern Europe.

Projected change in labor supply between 2025 and 2029 (in percentage)



Projected change in working-age population between 2025 and 2050



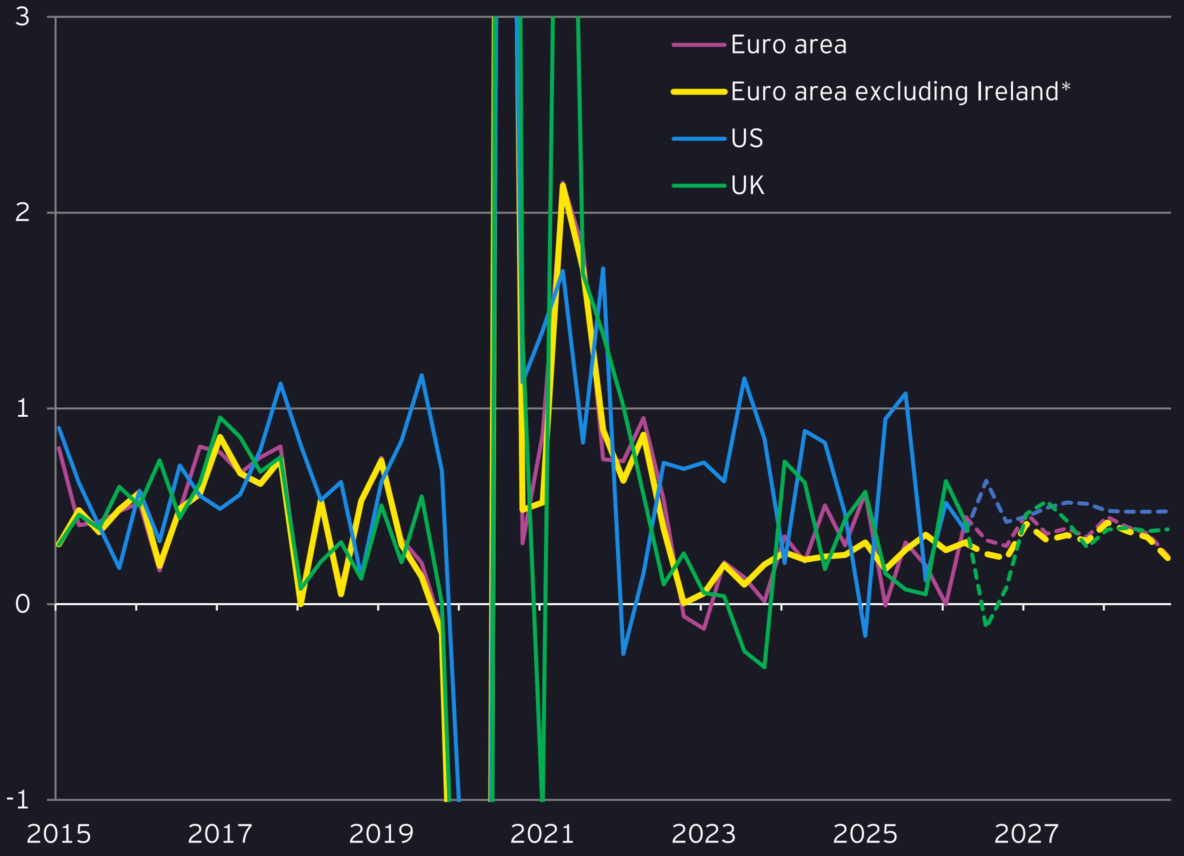
Source: EY EAT forecast, UN World Population Prospects 2024.

Chapter 3

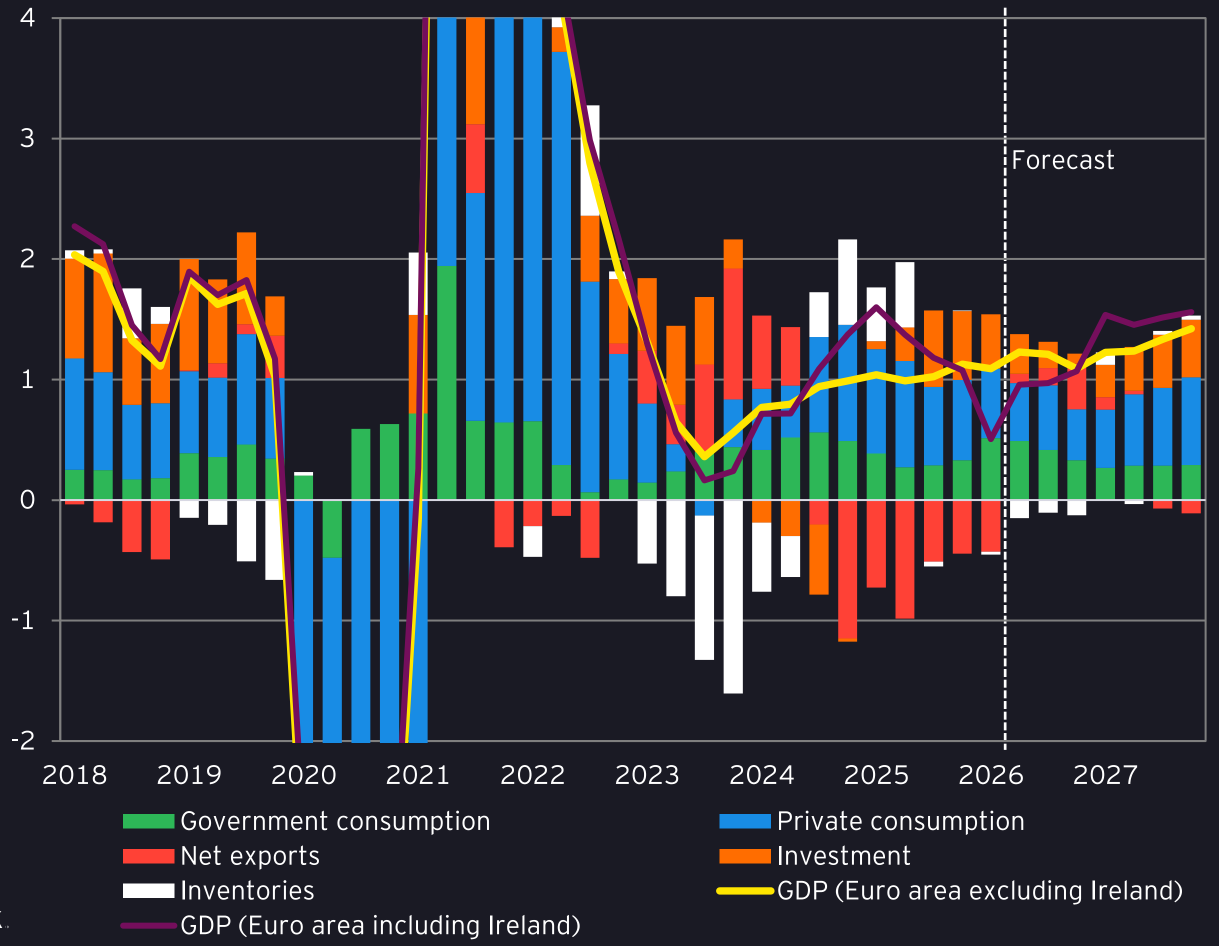
Economic outlook

Euro area growth is expected to remain resilient this year despite headwinds from the Middle East conflict, before accelerating from 2027 onwards

Q/q real GDP growth (in percentage, seasonally adjusted)



Decomposition of y/y GDP growth in the euro area excluding Ireland* (in percentage)

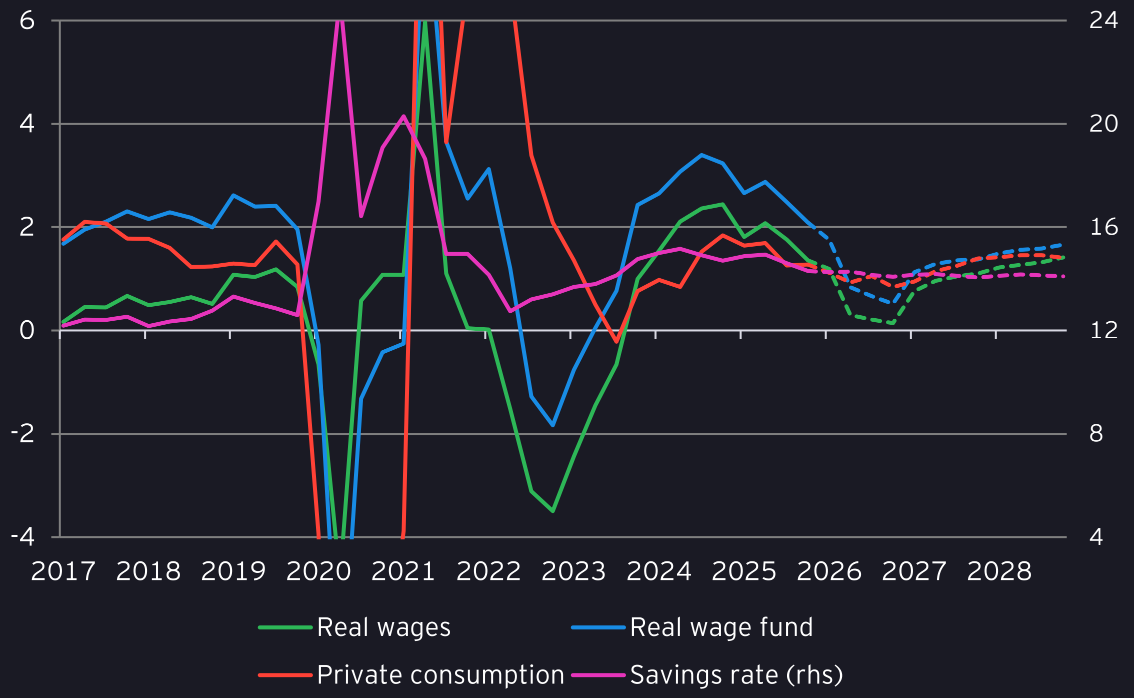


Source: Eurostat, FRED, ONS, EY EAT forecast, EY Parthenon US Macroeconomics Team, EY UK.
Dashed lines denote forecast
* Ireland is excluded as its GDP tends to be very volatile, reflecting the outsized role multinational corporations play in the economy. While Irish GDP is expected to severely contract in 2026 (-5.9%), modified final domestic demand (a proxy for underlying activity) is projected to increase by 2.2%.

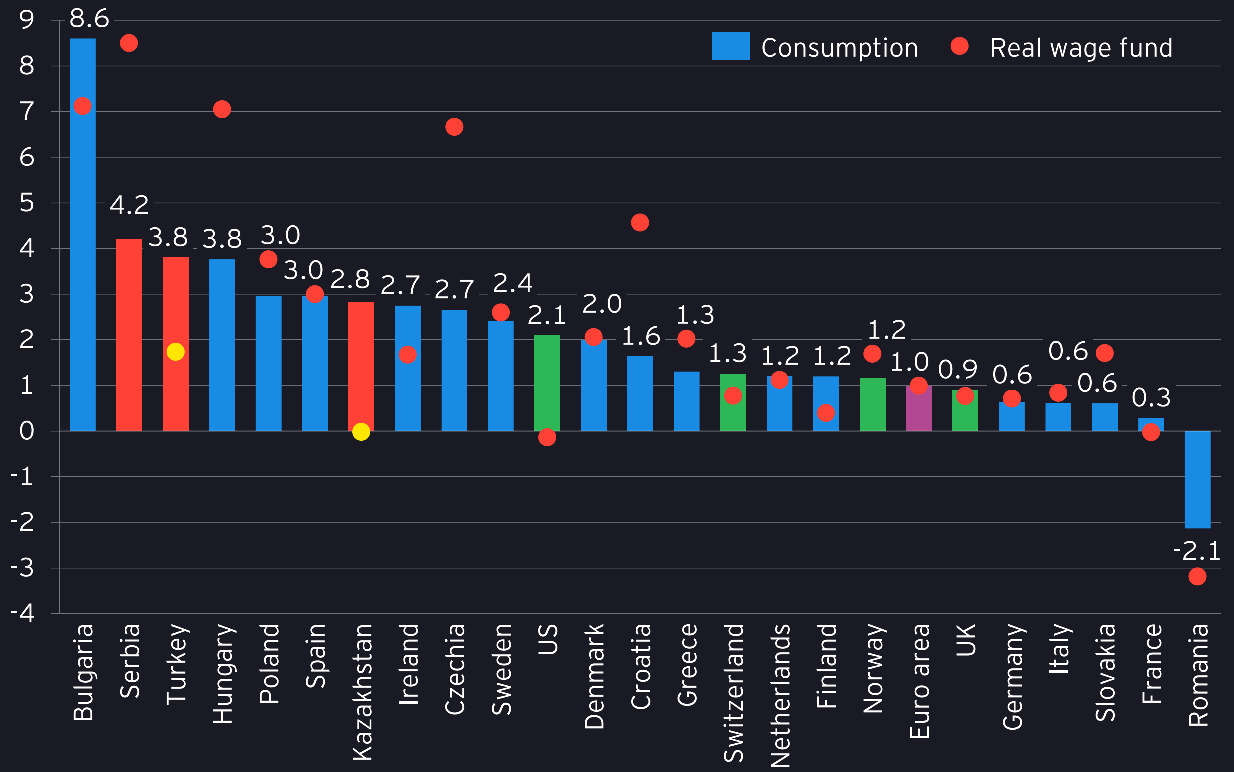
Consumer spending is expected to slow this year as the Middle East conflict weighs on real incomes and sentiment before reaccelerating in 2027 and 2028

- Private consumption growth will remain highly heterogenous across Europe. In 2026, consumption is expected to grow strongly across most of CEE, as nominal wage growth remains robust and inflation increases only moderately, partly reflecting government measures limiting the pass-through of higher energy prices. Consumer spending is also expected to remain strong in Spain, supported by immigration, and to continue recovering across the Nordics.
- In contrast, consumption is projected to decline in Romania amid high inflation and fiscal tightening, which has led to slower public sector wage growth. Consumer spending is expected to be broadly stagnant in France due to particularly weak nominal wage growth.

Y/y growth in real wages, real wage fund, real private consumption and savings rate in the euro area (In percentage)



Real private consumption and real wage fund growth in 2026 (In percentage)

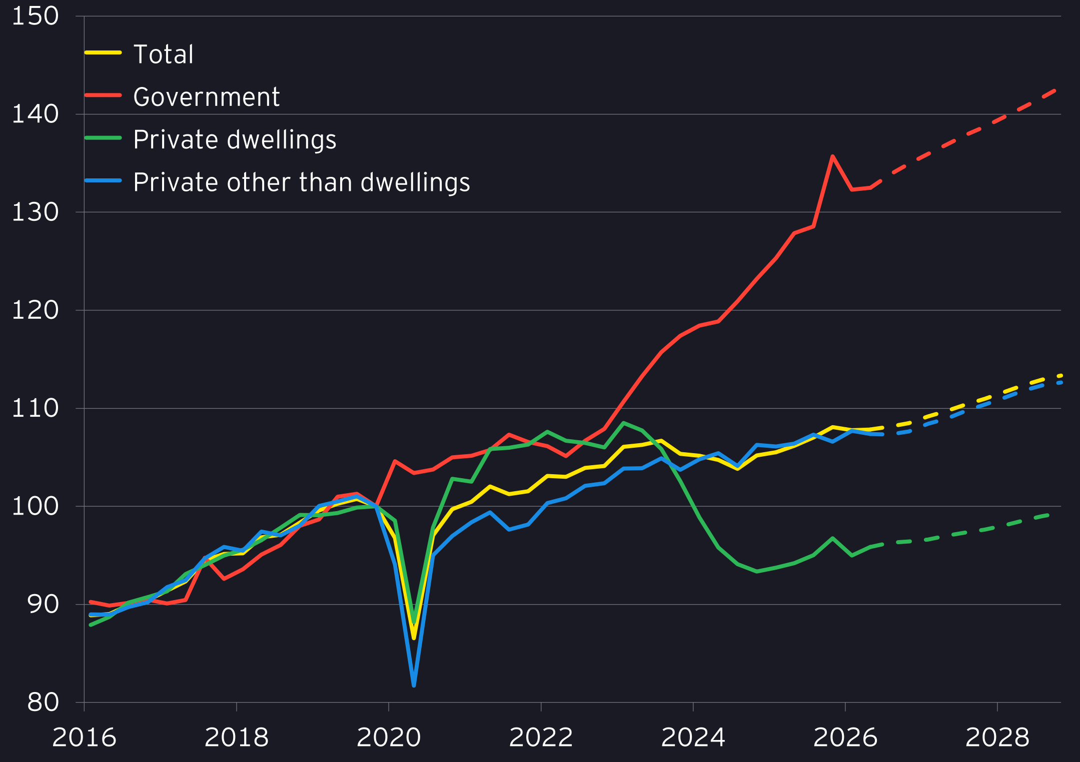


Source: Eurostat, EY EAT forecast.
Dashed lines denote forecast.

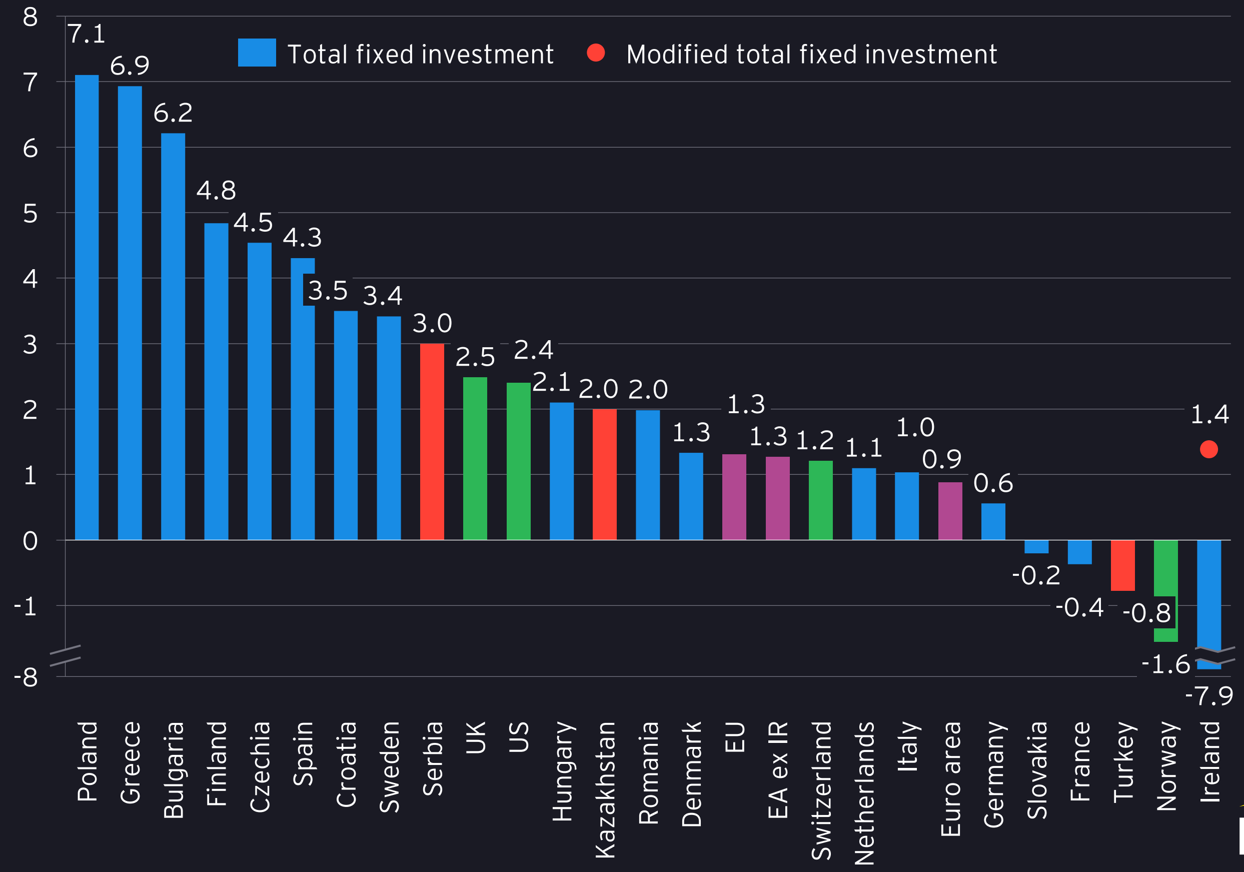
Public investment is expected to remain the main driver of investment growth, supported by Germany's fiscal package, while private investment is projected to stagnate in 2026 before recovering from 2027

- Poland is expected to record the strongest investment growth, driven by the delayed disbursement of EU Recovery and Resilience Facility funds. Several Balkan and Southern European countries should also see robust investment growth, supported by EU-funded projects. In contrast, investment is projected to decline in Norway, Turkey, France, and Slovakia, reflecting weak sentiment and heightened uncertainty related to the Middle East conflict.

Real fixed capital investment by type in the euro area excluding Ireland (Q4 2019 = 100)



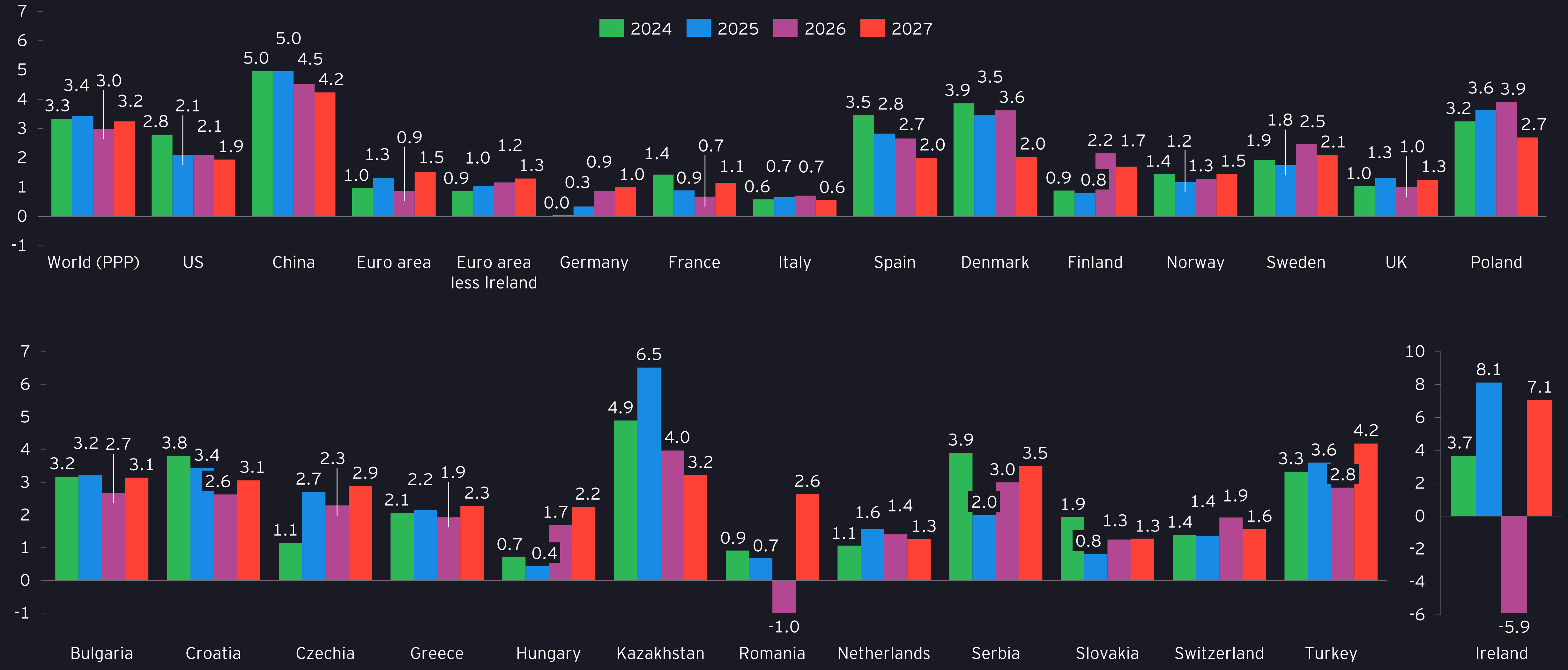
Real fixed capital investment growth in 2026 (In percentage)



Source: Oxford Economics, EY EAT forecast.
Dashed lines denote forecast.

Poland and Denmark* are projected to be the fastest-growing EU economies in 2026, while Romania is expected to contract

GDP growth in 2024-2027 (in percentage)

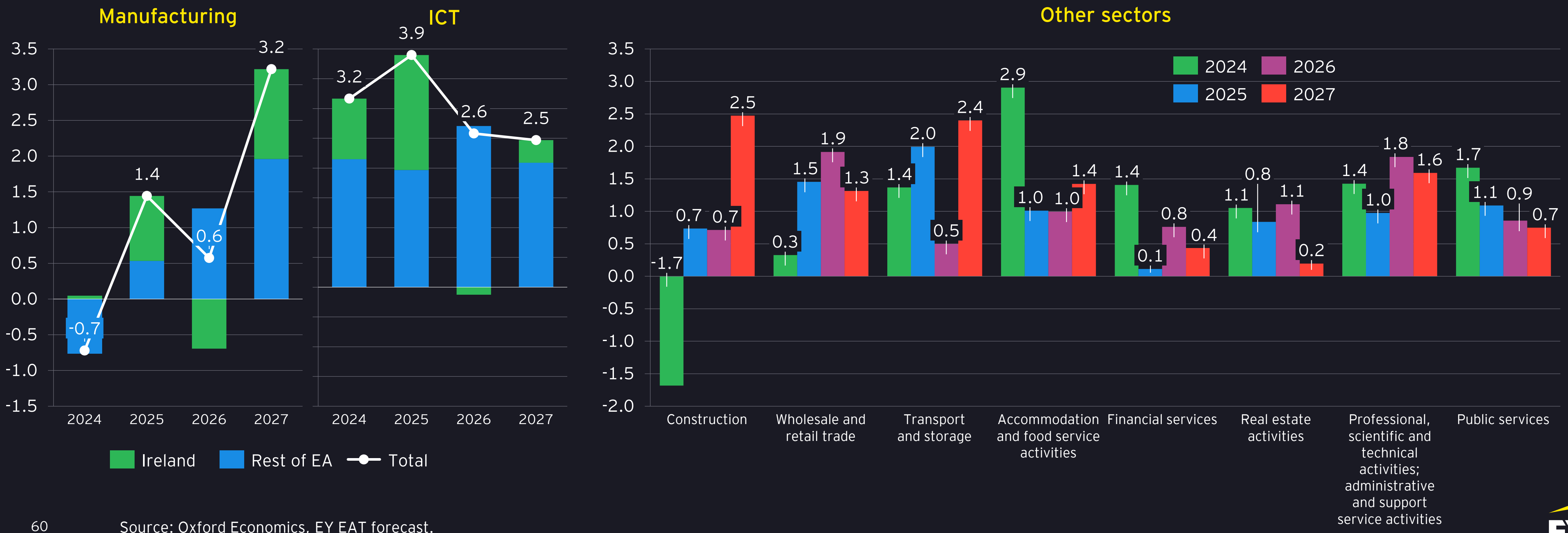


Source: Oxford Economics, EY EAT forecast, EY UK, EY Italy, EY Parthenon US Macroeconomics Team, EY Serbia.
* GDP in Denmark is volatile and heavily influenced by pharmaceutical sector. Underlying growth in the economy is significantly weaker (2.0% in 2025 and 1.2% in 2026).

Manufacturing and trade remain resilient to the Middle East conflict, while transport is more affected by higher fuel prices

- Headline manufacturing growth is expected to slow in 2026, primarily because of lower pharmaceutical production in Ireland. However, underlying growth is expected to improve, supported by stronger external and domestic demand associated with AI-related investment and government spending. Growth should accelerate further in 2027 as the current headwinds fade.
- Growth in the ICT sector is likely to moderate this year due to volatile activity among multinational companies operating in Ireland.
- The recovery in construction is being delayed despite higher government investment and improving private credit growth. Nevertheless, we still expect growth to accelerate in 2027.
- Growth in transport slows this year, held back by higher fuel prices, but the sector should recover in 2027 as energy prices normalize and manufacturing activity strengthens.
- Professional services are anticipated to remain among the strongest-performing sectors.

GVA growth by sector in the euro area (y/y, in percentage)

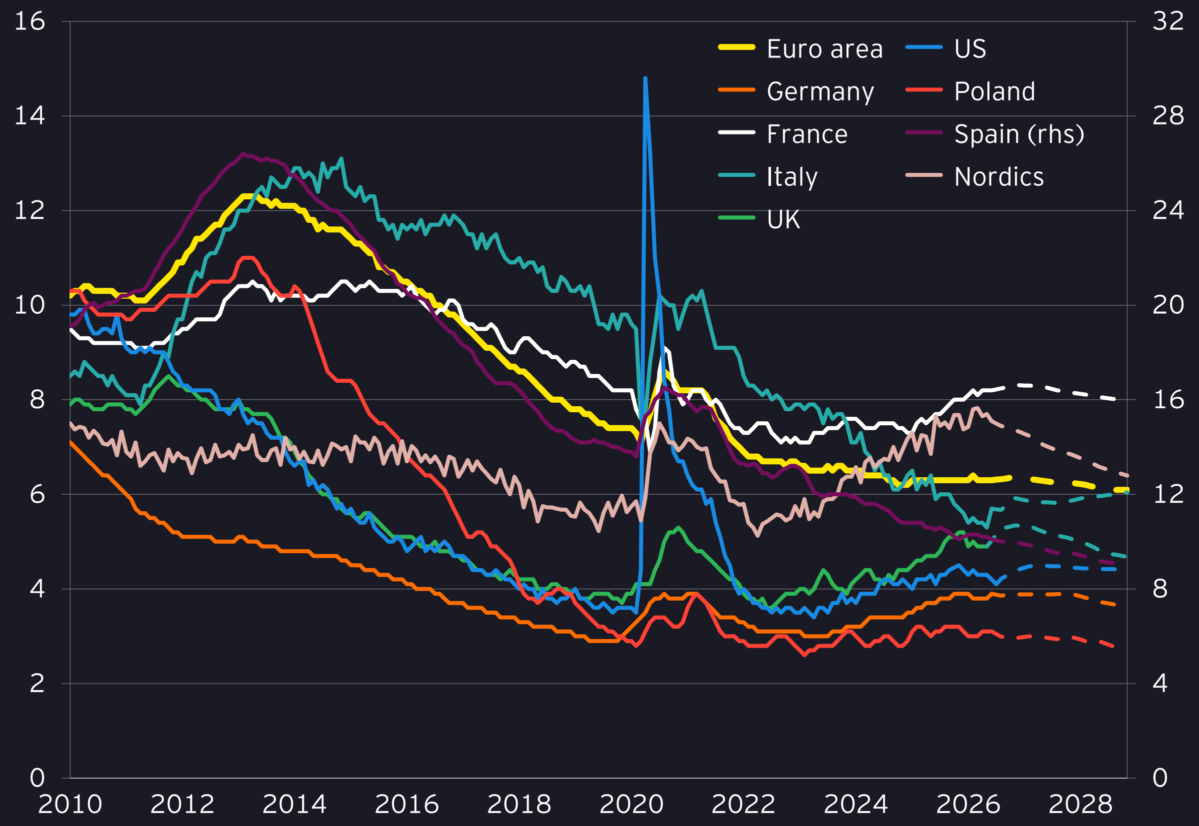


Source: Oxford Economics, EY EAT forecast.

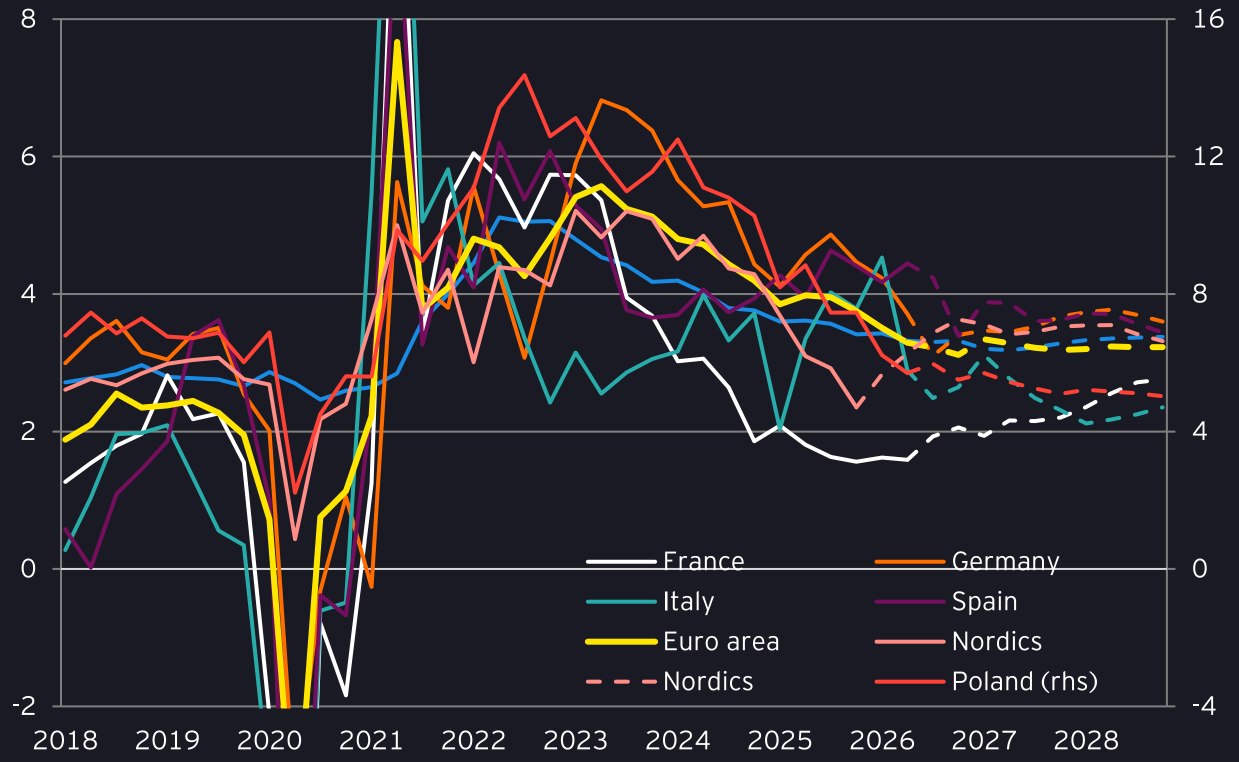
Euro area labor market conditions are expected to stabilize further, with wage growth settling slightly above 3% amid structurally tighter labor markets

- Euro area employment growth is expected to slow from 0.7% in 2025 to 0.5% in 2026 and 0.3% in 2027, reflecting increasing demographic constraints. Despite this slowdown, the unemployment rate is projected to remain broadly stable in both 2026 and 2027.
- In Spain, employment growth is projected to slow but remain relatively robust, while the unemployment rate should continue to decline. Employment is expected to remain broadly stagnant in other major European economies. Unemployment should gradually decline across the Nordics and remain broadly stable in most other countries.
- Wage growth is expected to moderate across CEE but remain relatively strong at 4.5-6%. Across most of the rest of Europe, wage growth should converge toward a range of 3-3.5%, although it is likely to remain lower in France in the short term. In Switzerland, wage growth is expected to remain below 2% amid low inflation.

LFS unemployment rate (in percentage)



Wage growth (y/y, in percentage)

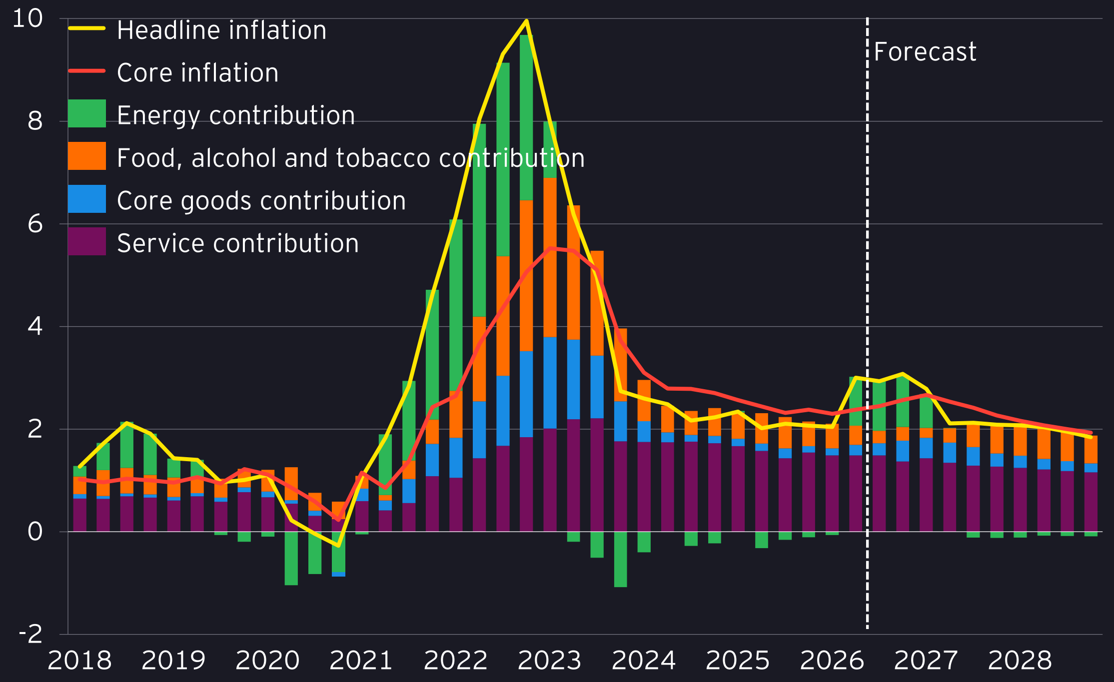


Source: Eurostat, Oxford Economics, EY EAT forecast, EY-Parthenon (US forecast), EY UK, EY Italy.
Dashed lines denote EY EAT forecast.

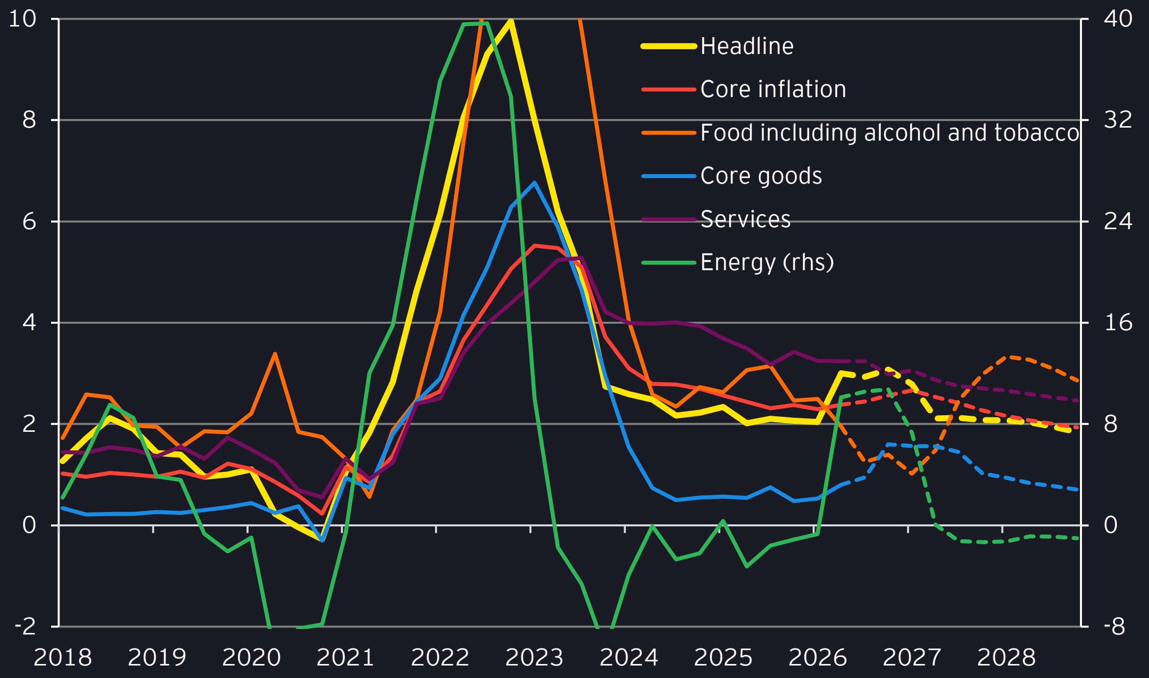
Despite emerging second-round effects, euro area inflation is expected to return to the 2% target from Q2 2027

- We expect euro area inflation to average 2.8% in 2026, 2.3% in 2027, and 2.0% in 2028.
- The direct impact of the Middle East conflict on fuel prices will be the main driver of elevated inflation between Q2 2026 and Q1 2027.
- In the near term, supply chain bottlenecks and elevated energy and metal prices are expected to pass through to core goods prices and consumer electricity prices.
- Food inflation should remain subdued through the end of 2026 before gradually picking up, with this year's unfavorable weather conditions adding to the price pressures caused by the Middle East conflict.
- These inflationary pressures should be largely offset by a further moderation in services inflation, reflecting the recent slowdown in wage growth.
- As a result, core inflation is expected to remain around 2.5% through end-2027 before converging to 2% as the impact of the Middle East shock fades. Headline inflation should return to 2% from Q2 2027, when the increase in fuel prices drops out of the year-on-year calculation.

HICP inflation in the euro area
(y/y, in percentage)



HICP inflation in the euro area
(y/y, in percentage)

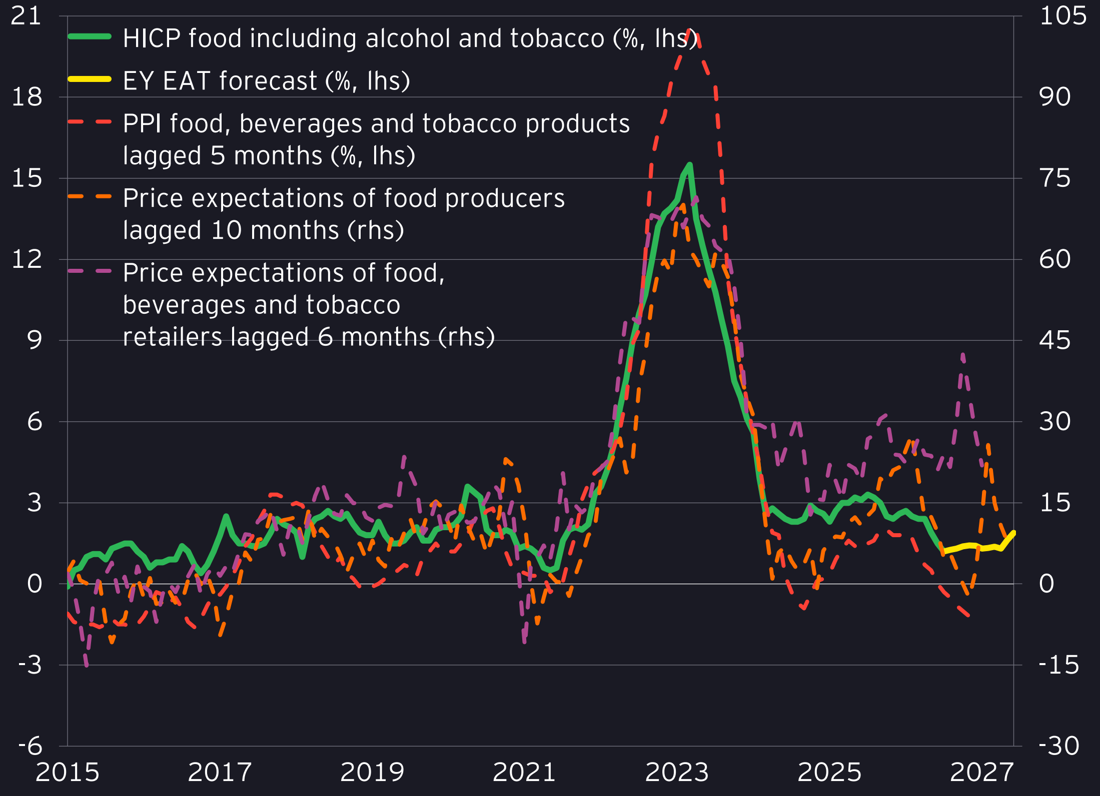


Source: Eurostat, Oxford Economics, EY EAT forecast.
Dashed lines denote EY EAT forecast.

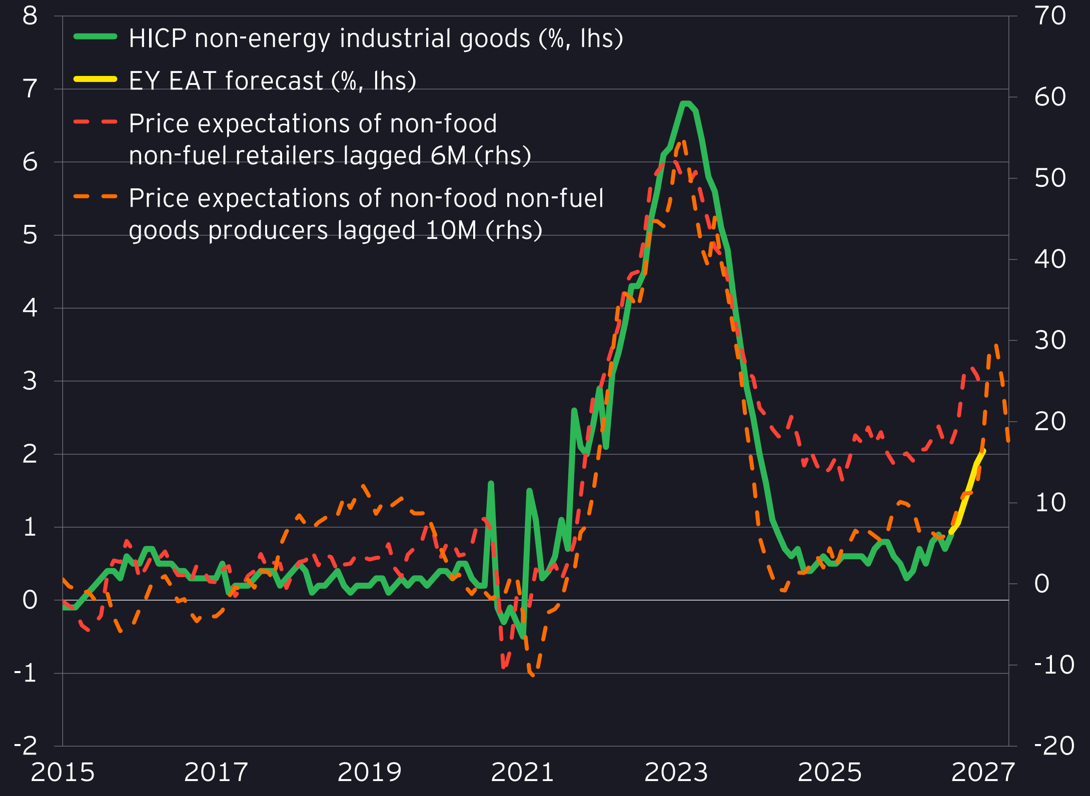
Euro area core goods inflation is set to rise, while improved pre-conflict supply conditions should keep food inflation subdued through end-2026

- Improved supply conditions have recently slowed food producer-price inflation and should continue to offset the impact of the Middle East conflict in the near term. As a result, euro area consumer food inflation is expected to remain subdued and broadly stable in H2 2026.
- In contrast, core goods producer prices have already begun to rise, while producer price expectations indicate that this trend will continue. We expect euro area core goods consumer inflation to increase from 0.9% in August to 2.0% in January. With services inflation easing slightly toward 3%, this should result in a modest increase in overall core inflation to around 2.7%.

Food HICP y/y inflation and its leading indicators in the euro area



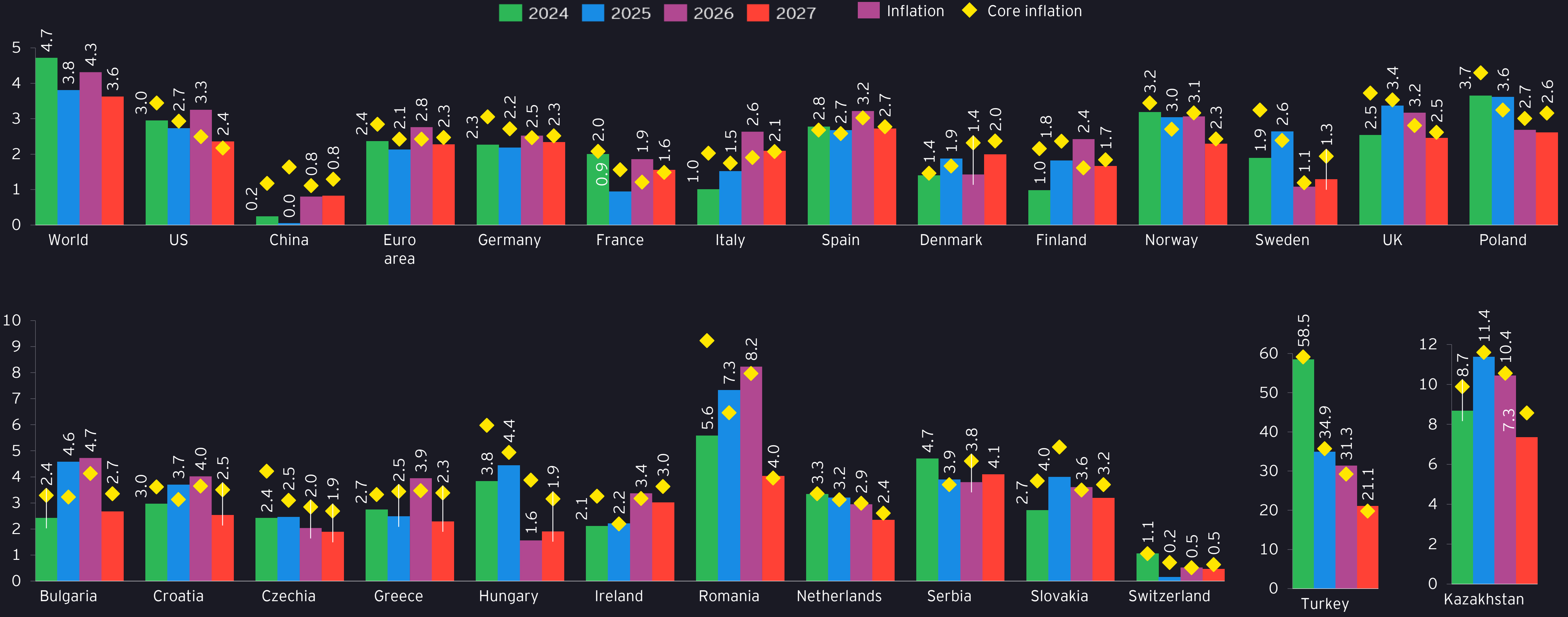
Core goods HICP y/y inflation and its leading indicators in the euro area



Source: Eurostat, European Commission, Oxford Economics, EY EAT forecast.

Inflation is expected to remain elevated this year in Turkey, Kazakhstan, and Romania, rise to ~4% in Southeast Europe, and undershoot targets in Switzerland, Sweden, and Hungary

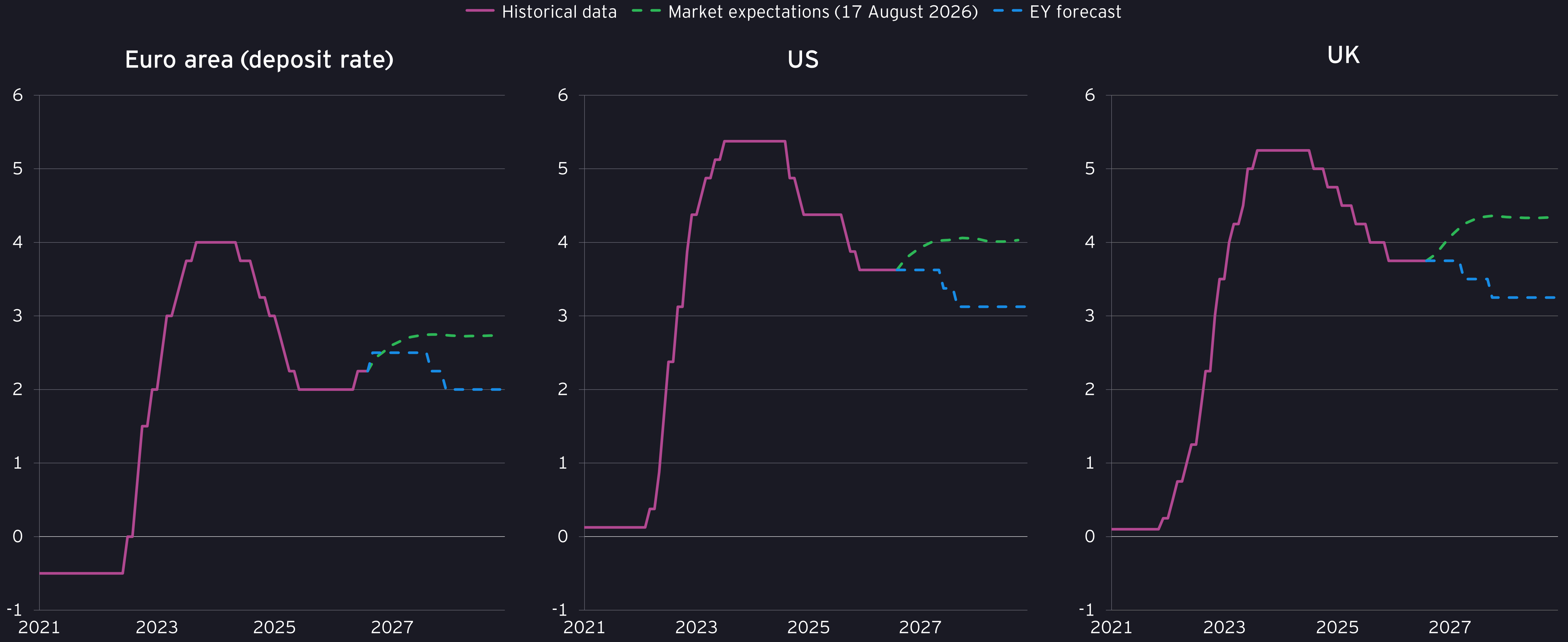
Inflation in 2024-2027 (in percentage)



Source: Oxford Economics, EY EAT forecast, EY UK, EY Italy, EY Parthenon US Macroeconomics Team, EY Serbia.
Nordics include Denmark, Finland, Norway and Sweden; rest of CEE includes Czechia, Slovakia, Hungary, Romania, Bulgaria, and Croatia.
* For Sweden, CPIF; for Finland and the euro area, HICP; for others, CPI.

We expect one further ECB hike in September before the tightening is unwound in H2 2027. With interest rates already higher in the US and UK, the Fed and BoE are expected to hold rates in 2026 and resume easing in 2027

Historical and expected* central bank interest rates (In percentage)

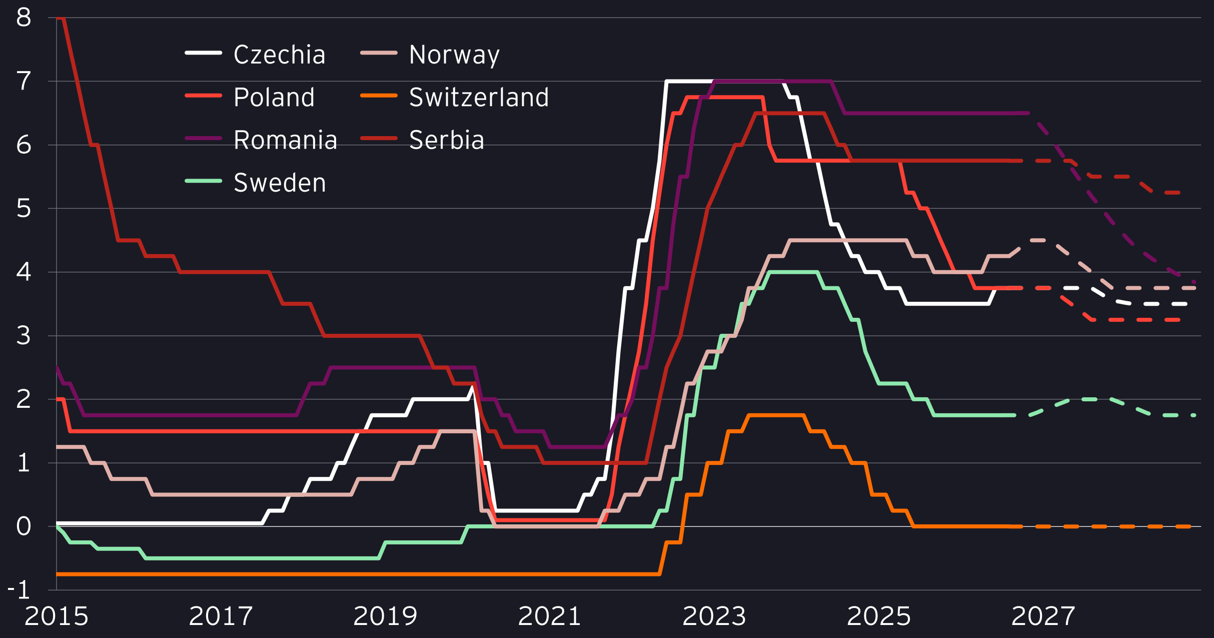


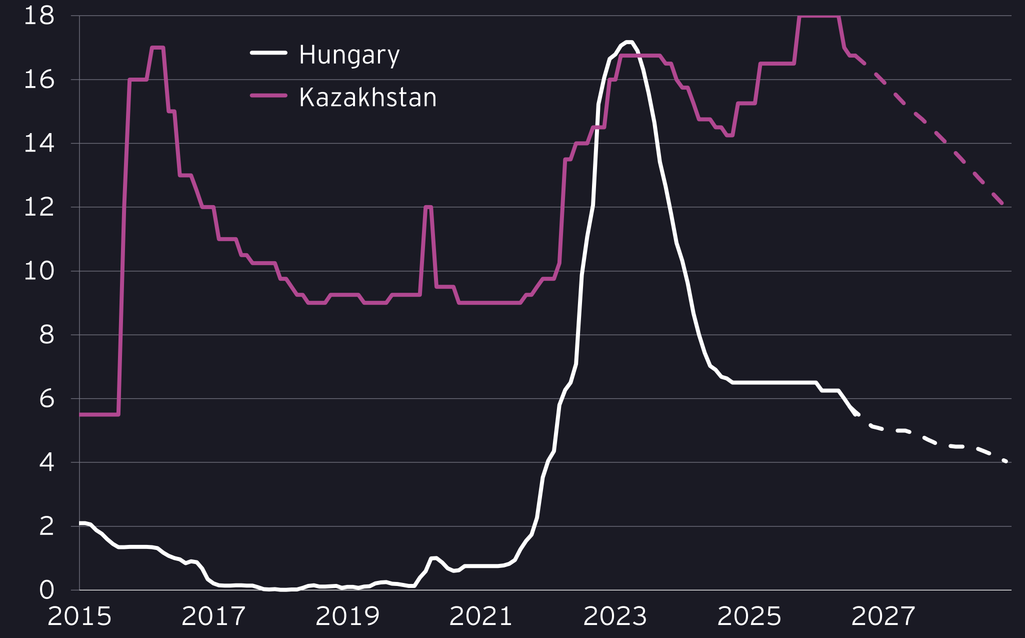
Source: ECB, Fed, BoE, CME group, ICE, EY UK, EY Parthenon US Macroeconomics Team, EY EAT forecast.

Most other central banks are expected to remain on hold through year-end, with easing becoming more widespread in 2027

- **SNB:** With inflation remaining low, we expect the policy rate to stay at 0% through end-2029.
- **Norway:** One final 25 bp hike to 4.5% in September, followed by gradual easing in 2027 to 3.75% by year-end as inflation falls.
- **Sweden:** Rising core inflation and higher ECB rates should prompt a 25 bp hike in early 2027. As CPIF inflation falls below 2% in 2028, rates may decline toward 1.75%.
- **Poland:** We anticipate the National Bank of Poland (NBP) to keep the reference rate unchanged at 3.75% this year, given that core inflation will rise toward 3.5%, preventing easing. Rate cuts are possible in 2027 after core inflation begins to decline, with estimated terminal rate of 3.25%.
- **Czechia:** Despite the CNB's hawkish stance, low inflation should preclude further hikes this year. Rates may be cut to 3.5% by late 2027 as core inflation eases.
- **Hungary:** Low inflation and a stronger forint should allow rates to fall to 5.0% by year-end, followed by a pause in H1 2027. We see the terminal rate of 3.75%.
- **Romania:** Persistently high inflation is likely to keep rates unchanged through year-end. Easing should resume in early 2027, with rates falling to 4.75% by end-2027 and 3.75% by end-2028.
- **Serbia**: With core inflation projected to rise above 5%, household demand receiving additional fiscal support, and credit growth remaining strong, the NBS is likely to keep the policy rate at 5.75% until the second half of 2027 and ease only gradually thereafter, once domestic price pressures begin to recede.
- **Turkey:** We expect the TCMB to align its 40% *de facto* rate with the 37% *de iure* rate by year-end via renewed one-week repo auctions. Rate cuts should start in 2027, reaching 24% by end-2027 and 15.5% by end-2028.

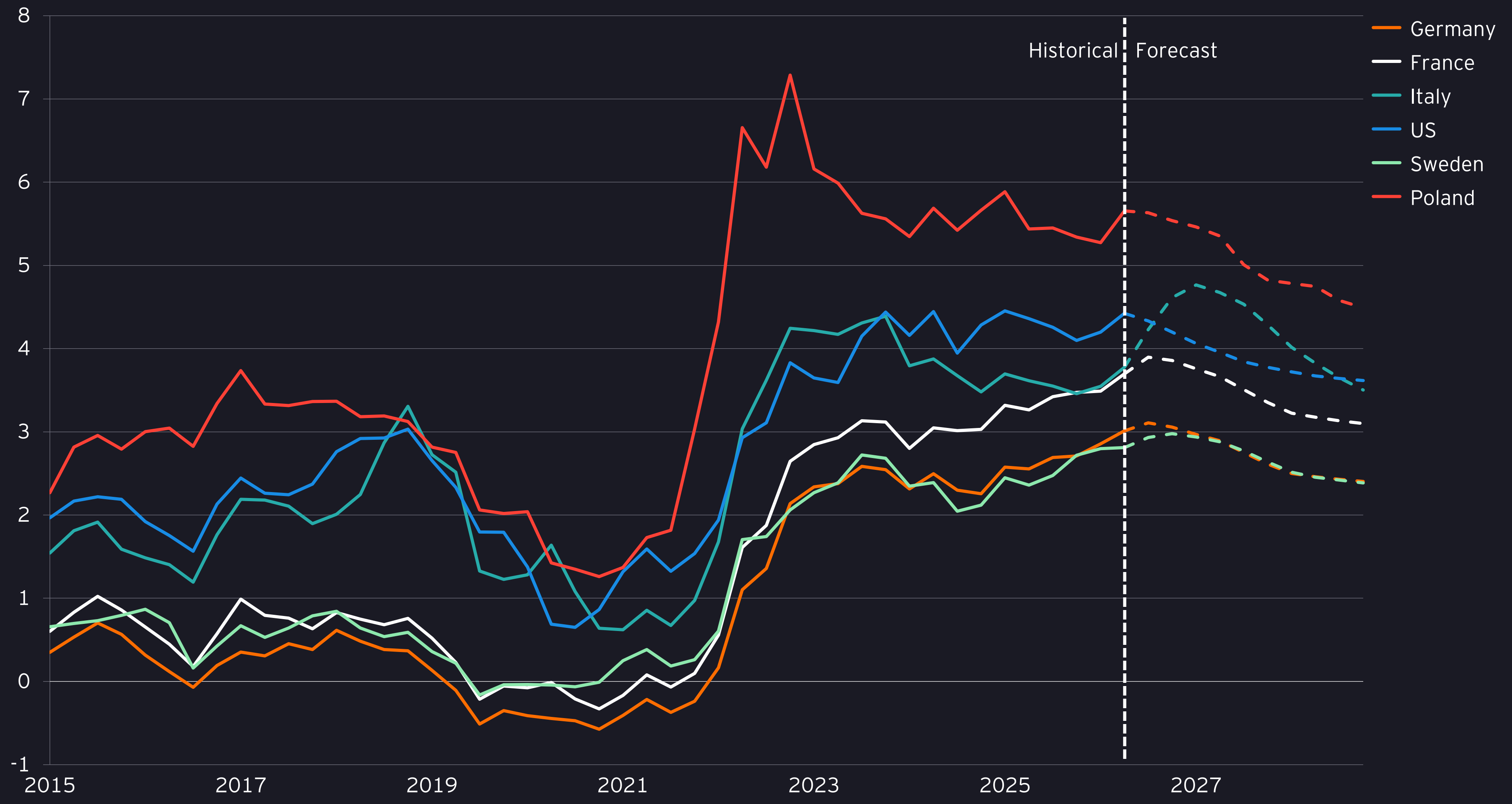
Historical and forecast central bank interest rates* (In percentage)





Source: Trading Economics, Stooq.pl, EY Serbia, EY EAT forecast.
Dashed lines denote forecasts.
* For Hungary, 1-month interbank rate.

As Middle East-related risk premia fade and inflation stabilizes, bond yields are projected to moderate



Source: stooq.pl, EY Parthenon US Macroeconomics Team, EY EAT forecast.
Dashed lines denote forecast.

Chapter 4

Risks

The economic outlook remains highly uncertain, with the Middle East conflict the main near-term risk and AI an increasingly important driver

The balance of risks remains skewed toward higher inflation and interest rates and lower GDP growth.

The Middle East conflict remains the main near-term risk. The Strait of Hormuz remains closed, and progress in US-Iran talks has been limited. The impact on oil and gas prices has so far been contained by inventory drawdowns, weak demand (especially in China) and the pre-conflict oil market surplus. However, if the closure persists, these factors may fade, triggering a stronger rise in commodity prices. Conversely, a full reopening could lead to a faster-than-assumed decline in oil prices, although the potential upside to growth appears smaller than the downside risk associated with another price spike.

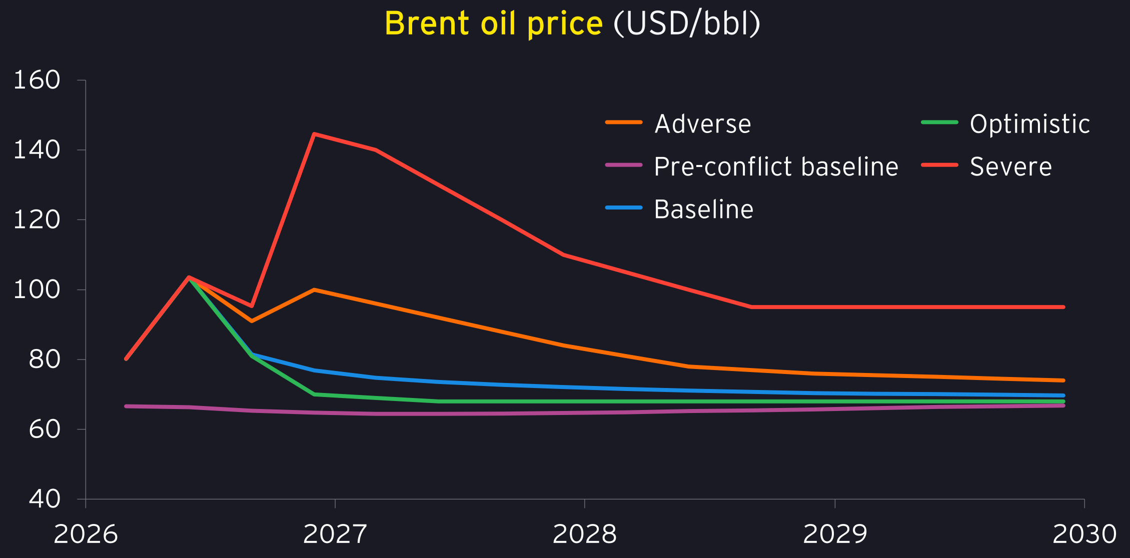
To illustrate the risks associated with the Middle East conflict, we have constructed three alternative scenarios:

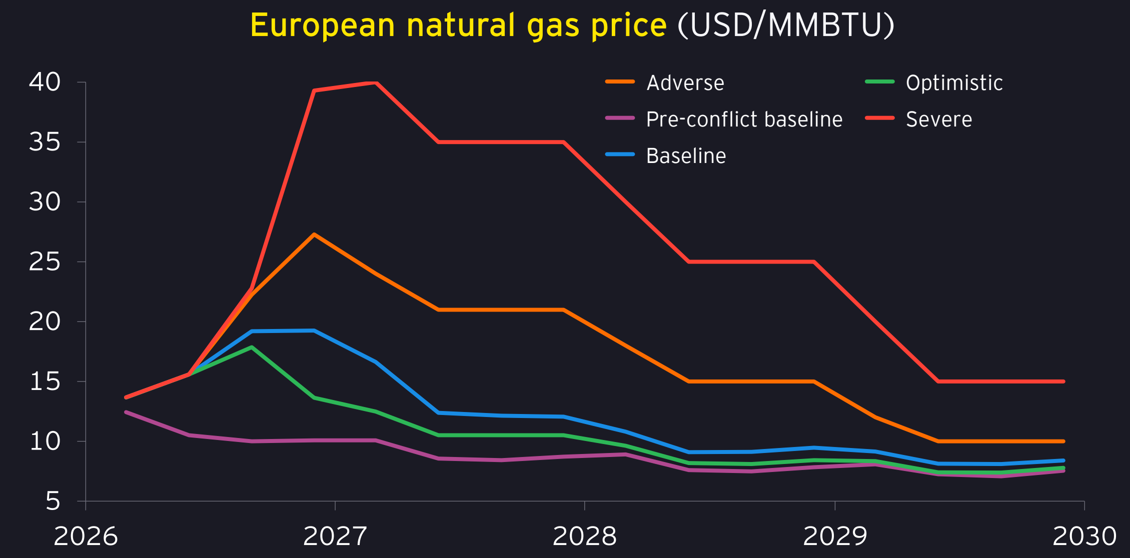
- Optimistic scenario: oil prices quickly fall to USD 68-70/bbl
- Adverse scenario: oil prices return toward USD 100/bbl and then decline gradually
- Severe scenario: oil prices rise above USD 140/bbl in the short term and remain close to USD 100/bbl over the medium term.

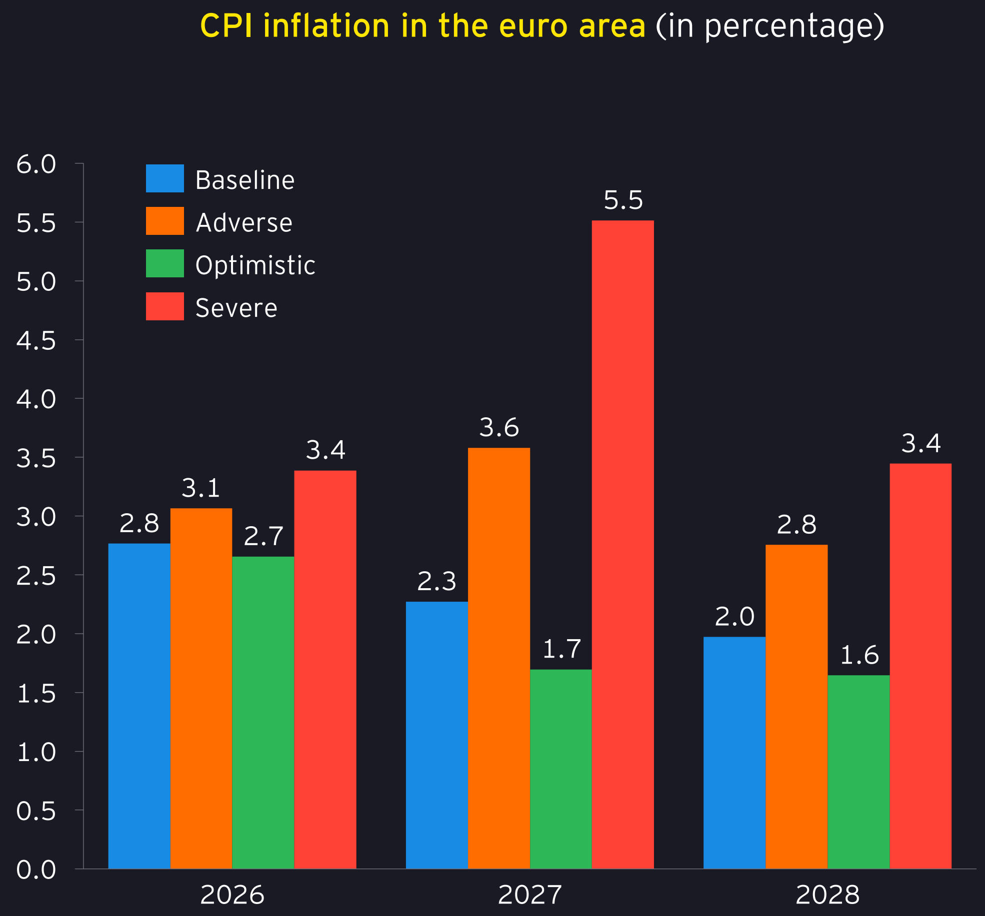
Under the optimistic scenario, euro area inflation would be 0.6 pp lower and GDP growth 0.2 pp higher in 2027 than in the baseline scenario. Under the adverse scenario, euro area HICP inflation would be 1.3 pp higher and GDP growth 0.4 pp lower. Turkey would be most affected, followed by Czechia, Romania and the UK, while the Nordics, Poland and the Netherlands would be least impacted. Under the severe scenario, inflation would peak at close to 6%, and GDP growth would be 0.8-0.9 pp lower than under the baseline in both 2027 and 2028.

AI is another key source of uncertainty. AI is already influencing global economic activity through higher investment, trade and equity prices and may have contributed to the recent productivity revival in the US. Although the effects of AI are most evident in the US and several Asian economies, Europe is benefiting indirectly from stronger global trade, while domestic AI-related investment also appears to be increasing. AI therefore represents a potential source of upside risks even in the short term. Over the longer term, AI-driven productivity gains will be increasingly important in sustaining economic growth in Europe and globally as demographic conditions become less favorable. We estimate that AI-related developments may already have raised Europe's productivity by around 0.2%, and our baseline assumes an additional gain of 0.4% by 2029. Risks around this assumption are tilted to the upside: a stronger translation of worker-level productivity improvements into aggregate total factor productivity could raise potential GDP by a further 0.4% by 2029. Conversely, if AI leads to significant labor displacement, the positive impact on GDP could be halved.

Middle East scenarios point to asymmetric risks, with significantly more upside to commodity prices and inflation than downside

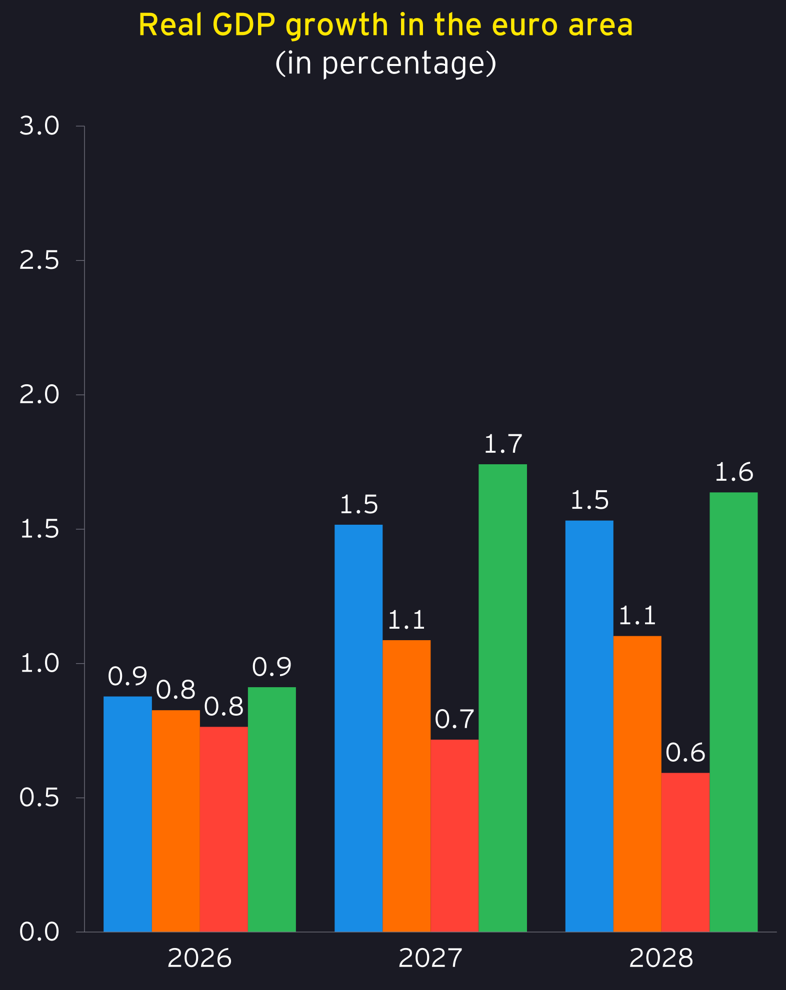


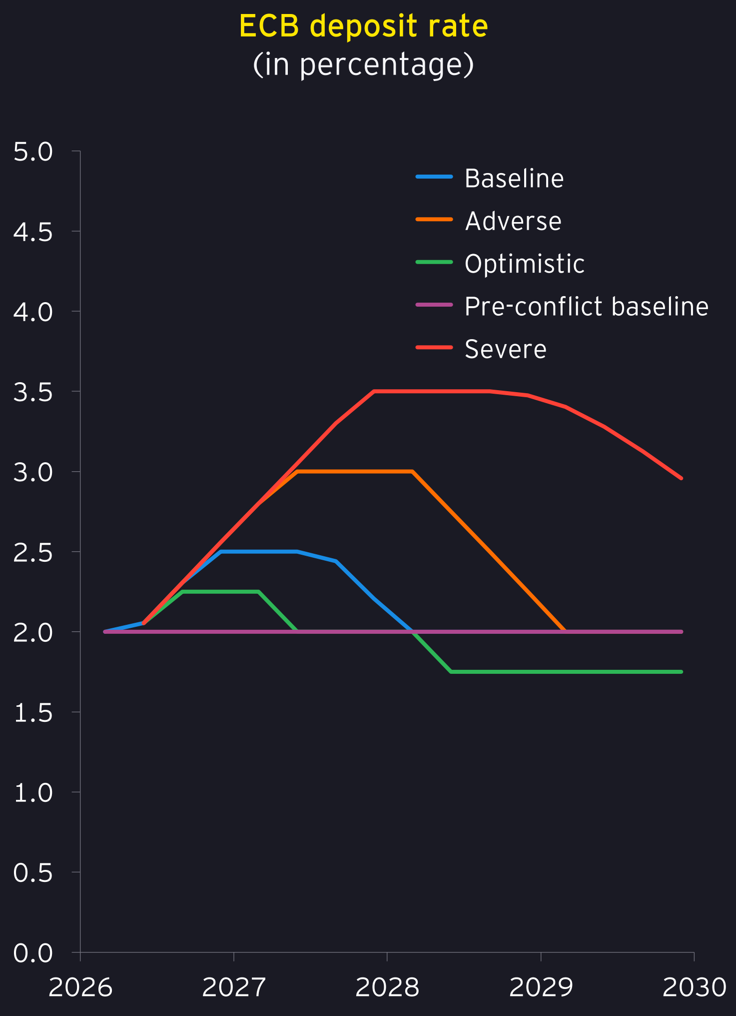




Source: EY EAT and EY-Parthenon analysis.

Higher inflation under more adverse Middle East scenarios would keep ECB rates higher and materially weaken GDP and consumption growth

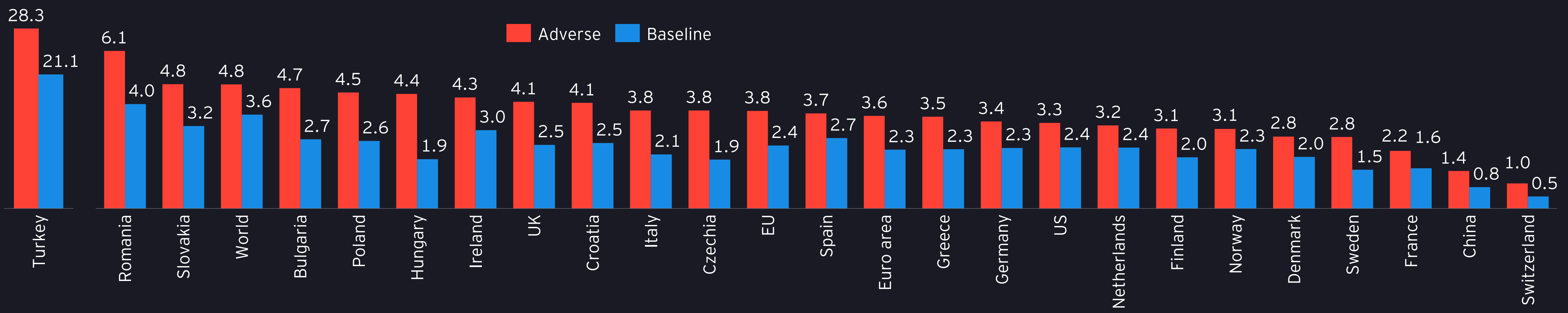




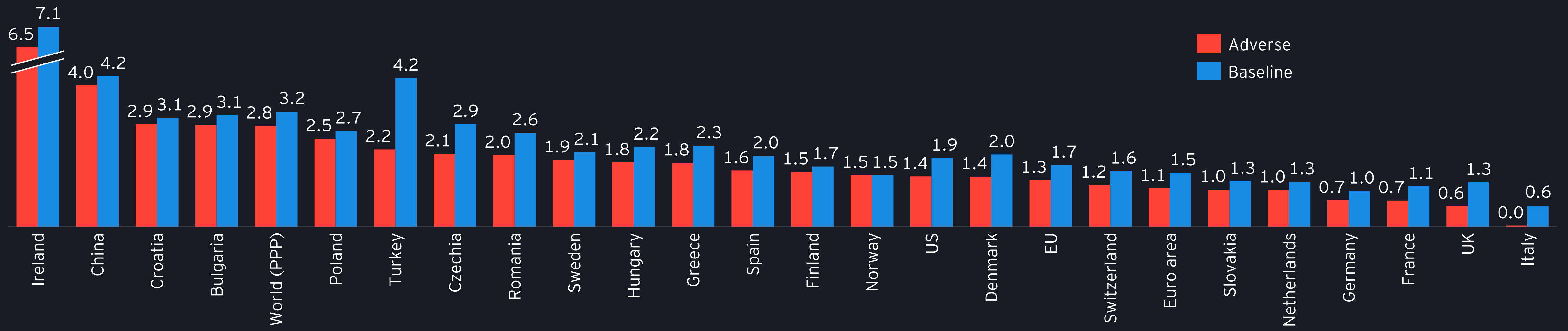
Source: EY EAT and EY-Parthenon analysis.

Under the adverse scenario, inflation would be higher and GDP growth lower than in the baseline in 2027 as higher energy prices and supply chain bottlenecks pass through to core goods and food prices

CPI inflation in 2027 (in percentage)



GDP growth in 2027 (in percentage)

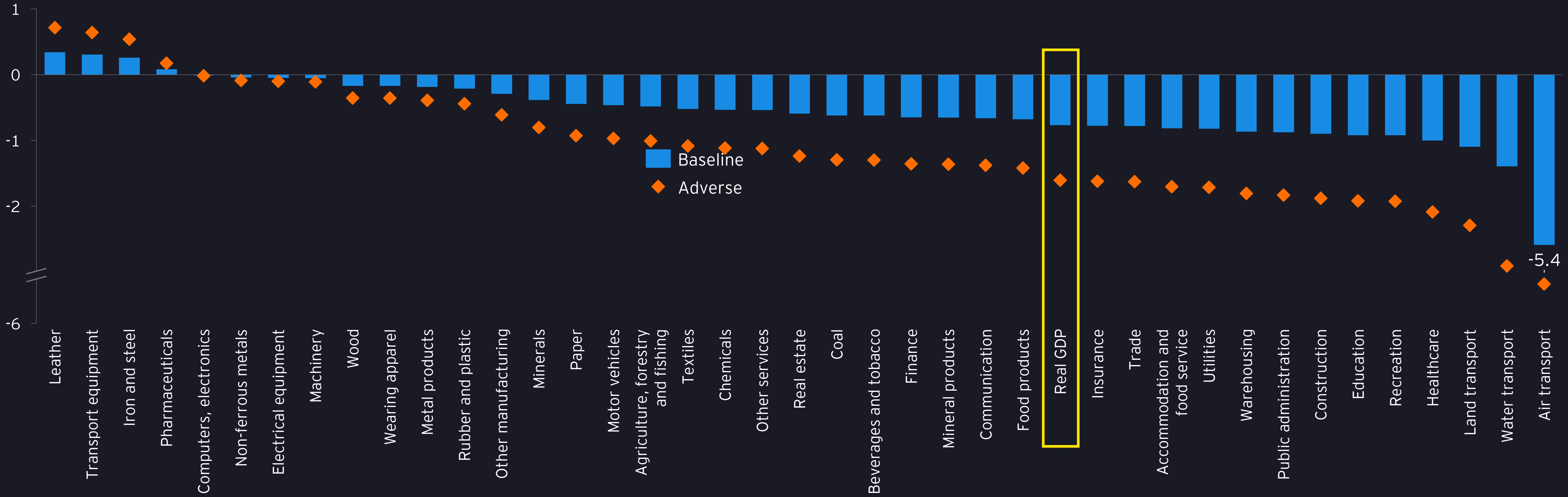


Source: EY EAT analysis.

The sectors most exposed to the conflict are unchanged in the adverse scenario, but the magnitude of the impact approximately doubles

- Higher energy costs erode household disposable income, reducing demand for discretionary services and weighing on activity despite low direct energy intensity.
- Higher energy prices also increase costs for non-EU producers. Given the greater energy intensity of Chinese manufacturing, the adverse impact on EU firms is partly offset by an improvement in their relative cost competitiveness.

Impact of the Middle East conflict on value added by sector in the EU in 2028
(percentage deviation relative to a no-conflict scenario)



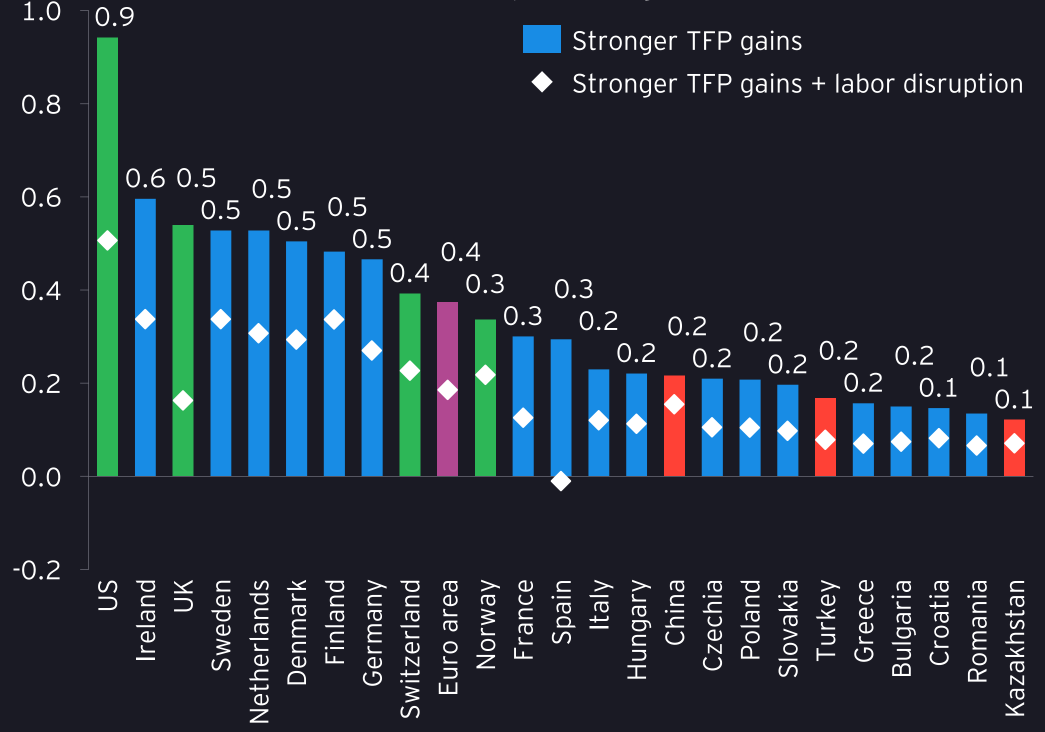
Source: EY simulations using the EY UPGRADE CGE model.

The economic impact of AI remains highly uncertain: stronger productivity gains could raise potential output, but labor displacement may offset part of the benefit

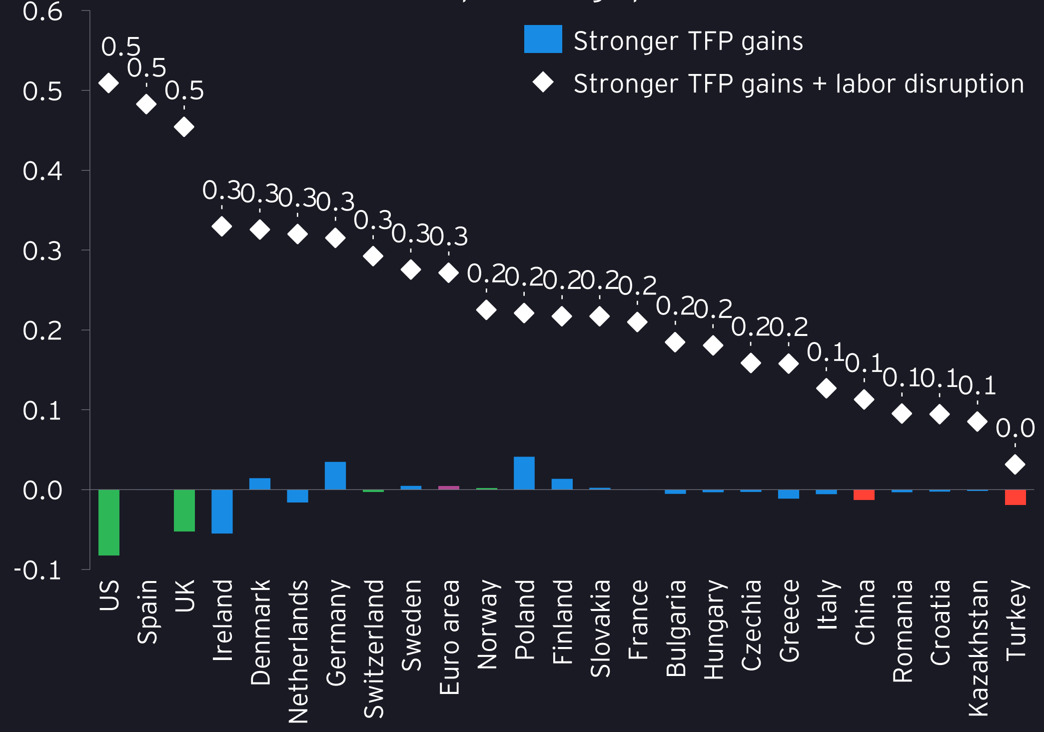
- We have developed two alternative scenarios for the economic impact of AI by 2029:
  - Stronger productivity gains: The conversion rate from worker-level productivity gains to aggregate productivity gains gradually increases from 15% to 30%
  - Stronger productivity gains with labor displacement: In addition to the higher conversion rate, productivity gains reduce labor demand in line with the model-implied relationship between employment and GDP
- Under the stronger productivity scenario, the potential GDP level in 2029 is 0.9% higher in the US and 0.4% higher in the euro area than under the baseline. Across European economies, the estimated gains range from 0.1% in Southeast Europe to 0.5-0.6% in Ireland, the Nordics and the Netherlands. The impact on unemployment is very limited
- When labor displacement is also assumed, the increase in potential GDP is approximately half as large because of the decline in labor input. In Spain, the positive productivity effect is fully offset by lower labor input. At the same time, the unemployment rate rises by up to 0.5 pp relative to the baseline.
- The scenarios do not capture additional effects from AI-related investment or higher equity prices, which could be material.

Impact of AI in 2029 relative to the baseline scenario

Potential GDP level
(In percentage)



Unemployment rate
(In percentage points)



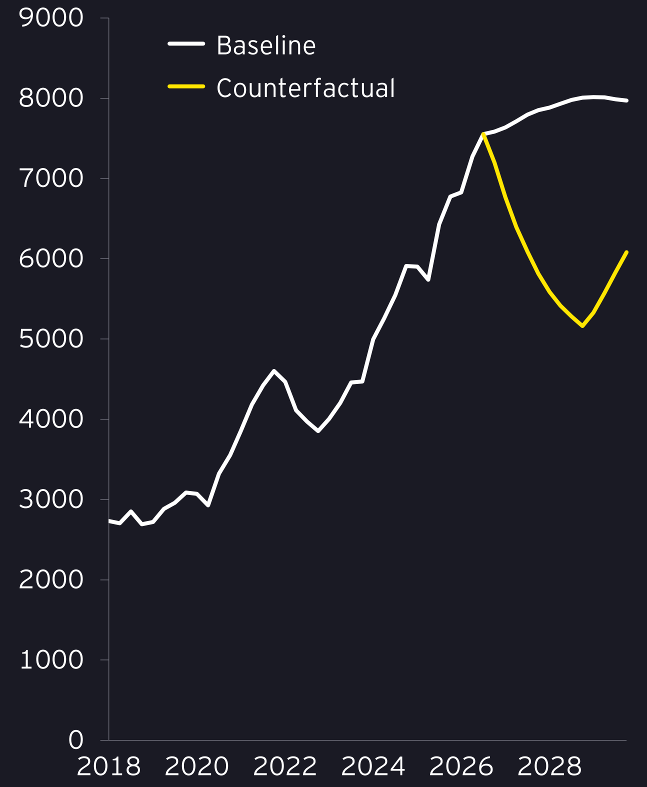
Source: EY EAT analysis using Oxford Global Economic Model.

Other important drivers of the economic outlook and sources of uncertainty

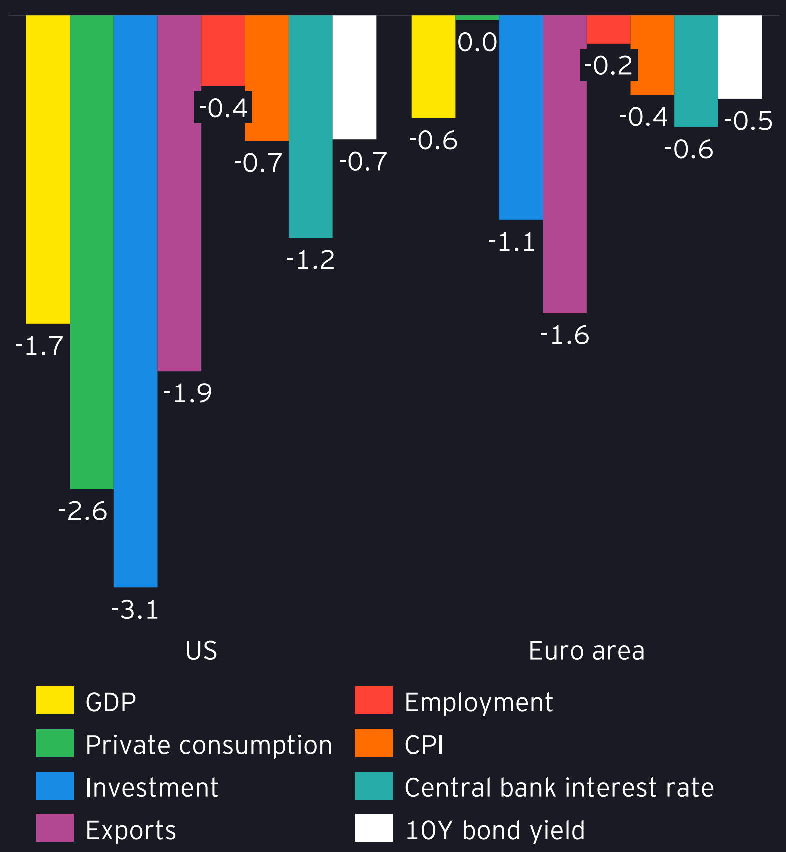
1. **Fiscal policy:** Germany's fiscal package is being implemented, but its pace, scale and economic impact remain uncertain. Faster or more extensive implementation than assumed in our baseline could raise Germany's GDP by 0.5% by 2029. In recent months, governments across Europe have introduced measures to cushion the impact of the energy shock on consumers and businesses. Some of these measures have already been withdrawn or scaled back as oil prices fell. However, the renewed increase in energy prices in recent weeks has prompted some governments to reintroduce support or develop new measures. Uncertainty over the timing and design of these interventions creates additional uncertainty around the near-term inflation outlook. Further risks arise from high fiscal deficits, political instability and elections in countries including France, Poland and Romania.
2. **Tariffs and Trade Policy:** Global trade has remained resilient despite US tariffs, supported by AI-related trade, while the tariff framework has become more stable. Nevertheless, tariffs remain an important source of uncertainty. The recently introduced Section 301 tariffs may face legal challenges similar to those brought against the IEEPA tariffs. Tariffs also continue to be used as leverage in broader political and trade disputes. Over the longer term, it remains unclear to what extent the current tariffs would remain in place after the next US presidential election.
3. **Exports and Competitiveness:** European exports underperformed global trade in 2024-25, particularly in Germany and France. We expect export growth to accelerate, an expectation supported by the recent pick-up in exports. However, the reorientation of the global trade toward AI-related goods and Asian producers, combined with the structural deterioration in the competitiveness of European industry and a relatively strong euro, could result in continued export underperformance and weaker GDP growth.
4. **Equity prices:** US equity valuations are elevated by historical standards and, by some measures, are approaching levels observed during the dotcom bubble. If expectations of AI-related earnings growth are not realized, the risk of a significant market correction would increase. European equity valuations remain considerably lower despite sizeable returns over the past three years, and equity markets play a less important role in financing investment and supporting consumption in Europe than in the US. Nevertheless, a major US market downturn would affect Europe through weaker external demand and confidence, as well as tighter financial conditions. We estimate that a dotcom-style equity market downturn could reduce euro area GDP by around 0.6%. Conversely, continued positive sentiment in European equity markets would support the recovery in business investment.
5. **Demographics and migration policy:** Europe's unfavorable demographics, tighter migration policies and political resistance to immigration could further constrain labor supply growth. However, immigration and labor force participation have continued to surprise on the upside in recent years. The EU's working-age population is currently 1.6% higher and its labor supply 2.3% higher today than we projected four years ago. Consequently, the risks around our baseline projection of broadly stagnant labor supply through 2029 are tilted to the upside.

A dotcom-style equity market downturn could reduce euro area GDP by around 0.6% through weaker exports and investment, with Ireland, Switzerland and highly trade-exposed CEE economies likely to be most affected

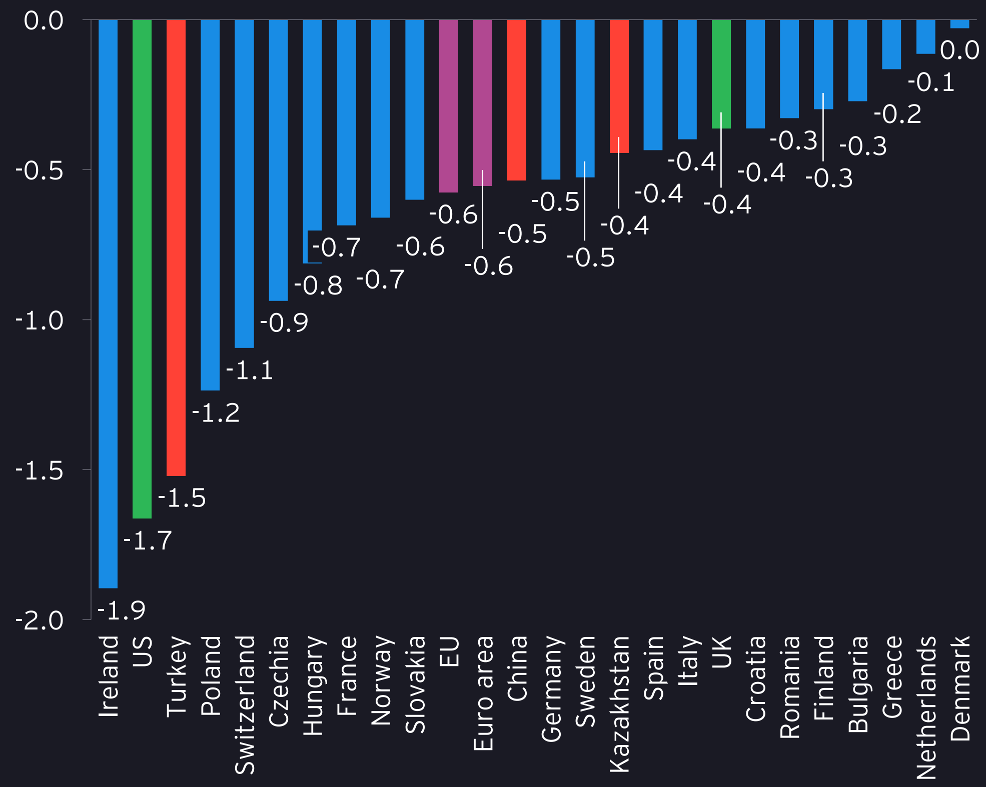
S&P 500



Peak impact on key macroeconomic variables (In percentage)



Peak impact on annual real GDP (In percentage)



Source: EY EAT analysis.

Summary: GDP and inflation forecasts

GDP (% y/y)

Location	2023	2024	2025	2026 F	2027 F	2028 F	2029 F
Bulgaria	1.7	3.2	3.2	2.7	3.1	3.1	3.4
Croatia	3.7	3.8	3.4	2.6	3.1	3.3	2.9
Czechia	0.2	1.1	2.7	2.3	2.9	2.7	2.7
Denmark	1.1	3.9	3.5	3.6	2.0	1.8	1.8
European Union	0.6	1.1	1.6	1.3	1.7	1.6	1.5
Euro area	0.6	1.0	1.3	0.9	1.5	1.5	1.4
Euro area excl. Ireland	0.7	0.9	1.0	1.2	1.3	1.4	1.3
Finland	-1.3	0.9	0.8	2.2	1.7	2.0	1.6
France	1.8	1.4	0.9	0.7	1.1	1.4	1.2
Germany	-0.8	0.0	0.3	0.9	1.0	1.3	0.9
Greece	2.1	2.1	2.2	1.9	2.3	1.8	1.5
Hungary	-0.7	0.7	0.4	1.7	2.2	2.8	2.2
Ireland	-3.5	3.7	8.1	-5.9	7.1	4.0	3.3
Italy	1.0	0.6	0.7	0.7	0.6	0.7	0.9
Kazakhstan	5.1	4.9	6.5	4.0	3.2	4.0	3.2
Netherlands	-0.6	1.1	1.6	1.4	1.3	1.5	1.8
Norway	0.6	1.4	1.2	1.3	1.5	1.5	1.4
Poland	0.2	3.2	3.6	3.9	2.7	2.5	2.5
Romania	2.3	0.9	0.7	-1.0	2.6	3.0	2.8
Serbia	3.8	3.9	2.0	3.0	3.5	3.0	3.0
Slovakia	2.1	1.9	0.8	1.3	1.3	2.1	2.3
Spain	2.5	3.5	2.8	2.7	2.0	1.6	1.6
Sweden	0.1	1.9	1.8	2.5	2.1	1.6	1.6
Switzerland	0.9	1.4	1.4	1.9	1.6	1.3	1.4
Turkey	5.0	3.3	3.6	2.8	4.2	3.7	3.6
United Kingdom	0.3	1.0	1.3	1.0	1.3	1.5	1.4

Inflation* (yearly average, % y/y)

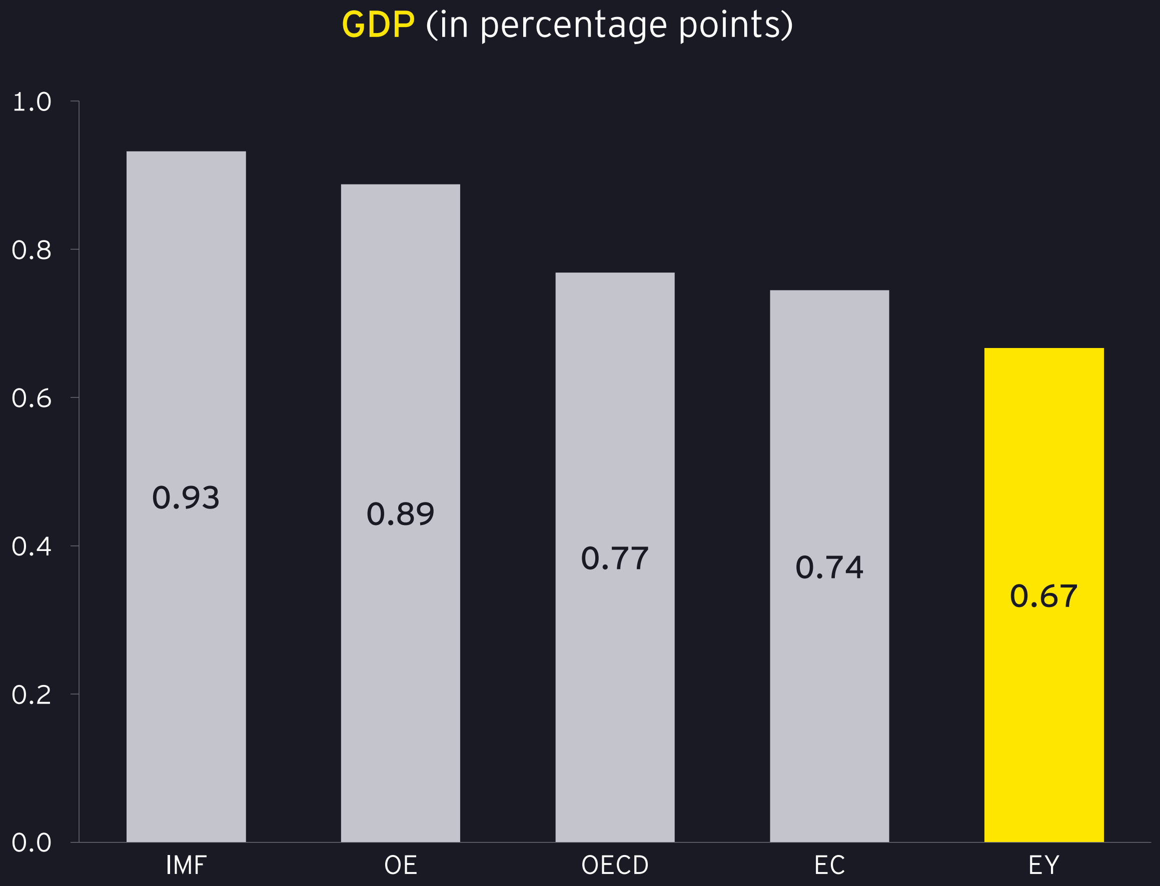
Location	2023	2024	2025	2026 F	2027 F	2028 F	2029 F
Bulgaria	9.5	2.4	4.6	4.7	2.7	1.8	2.3
Croatia	8.0	3.0	3.7	4.0	2.5	2.6	2.3
Czechia	10.7	2.4	2.5	2.0	1.9	2.1	2.8
Denmark	3.3	1.4	1.9	1.4	2.0	2.4	1.5
European Union	6.4	2.6	2.5	2.9	2.4	2.2	1.9
Euro area	5.4	2.4	2.1	2.8	2.3	2.0	1.7
Finland	4.3	1.0	1.8	2.4	1.7	1.5	1.1
France	4.9	2.0	0.9	1.9	1.6	1.7	1.6
Germany	5.9	2.3	2.2	2.5	2.3	1.9	1.6
Greece	3.5	2.7	2.5	3.9	2.3	1.9	2.0
Hungary	17.1	3.8	4.4	1.6	1.9	2.4	2.9
Ireland	6.3	2.1	2.2	3.4	3.0	2.8	2.2
Italy	5.6	1.0	1.5	2.6	2.1	1.4	1.3
Kazakhstan	14.5	8.7	11.4	10.4	7.3	6.6	6.4
Netherlands	3.8	3.3	3.2	2.9	2.4	1.7	1.6
Norway	5.5	3.2	3.0	3.1	2.3	2.3	2.1
Poland	11.4	3.7	3.6	2.7	2.6	2.5	2.2
Romania	10.4	5.6	7.3	8.2	4.0	2.7	2.7
Serbia	12.4	4.7	3.9	3.8	4.1	3.0	3.0
Slovakia	10.5	2.7	4.0	3.6	3.2	3.0	2.5
Spain	3.5	2.8	2.7	3.2	2.7	2.6	1.9
Sweden	6.0	1.9	2.6	1.1	1.3	2.6	1.7
Switzerland	2.1	1.1	0.2	0.5	0.5	0.6	0.6
Turkey	53.9	58.5	34.9	31.3	21.1	13.0	9.4
United Kingdom	7.3	2.5	3.4	3.2	2.5	2.2	2.3

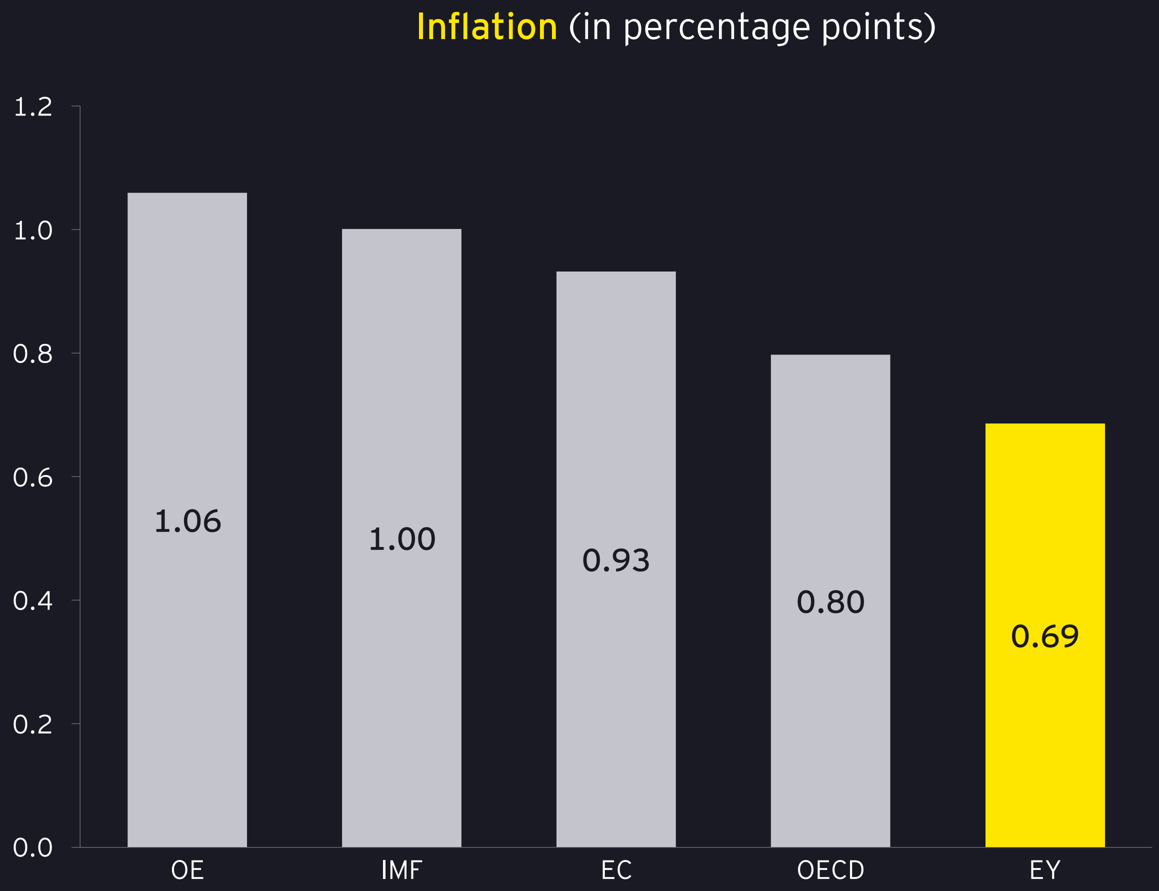
A full set of forecasts can be found on our SharePoint site.

Source: EY Forecasts
CPIF for Sweden, HICP for Finland, the euro area and the EU; CPI for others.

On a common country sample, our 2025 forecasts had lower average absolute errors than those of major international institutions

Average absolute error for the 2025 forecast formulated around January 2025*





*Compared forecast: EY EAT: European Economic Outlook: 2025 January; Oxford Economics: Country Economic Forecast January 2025; for central banks, EC: Autumn 2024 Economic Forecast, IMF: WEO October 2024 except GDP estimation for France, Germany, Netherlands, Poland, Spain and the euro area (January 2025 update); OECD: Economic Outlook December 2024.

The assessment covers all EU economies (excluding Italy) as well as Norway and Switzerland.

Sources: EY EAT analysis, Oxford Economics, OECD, IMF, EC

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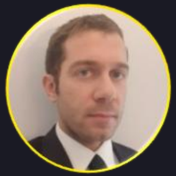

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Forecast and country-specific outlook sources

- Forecasts for most economies are prepared by EY Economic Analysis Team (EY EAT) using an amended version of the Oxford Global Economic Model (GEM)
  - EY EAT adjusts model equations, assumptions and data inputs where appropriate
- Forecasts for the US have been prepared by EY-Parthenon Macroeconomics Team
  - Contact: https://www.ey.com/en_us/strategy/macroeconomics
- Forecasts for the UK have been prepared by EY UK
  - Contact: parnold@uk.ey.com
- Forecasts for Italy in 2026-27 have been prepared by EY Italy
  - Contact: alberto.caruso@it.ey.com
- Forecasts for Serbia have been prepared by EY Serbia
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