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COVER NOTE

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2026 European Macroeconomic Report

Accompanying the document

Recommendation for a
COUNCIL RECOMMENDATION

on the economic policy of the euro area

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EXECUTIVE SUMMARY

The euro area and the European Union are navigating an increasingly complex international landscape. Shifting geopolitical dynamics, rapid technological advancement, rising climate risks, an ageing society, and low productivity are affecting economic prospects. These developments present significant challenges but also transformative opportunities for the euro area and the EU, underscoring the critical importance of robust macroeconomic policy frameworks.

This new European Macroeconomic Report (EMR) analyses these challenges, and it provides a comprehensive overview on these aspects. By providing solid analysis it aims to inform strategic policy choices to strengthen the euro area and EU's resilience in the face of a rapidly evolving global order. This year's report is divided into four chapters. The first two chapters provide an overview of the macro-structural landscape and review the risks of macroeconomic imbalances with special attention given to the economy of the euro area. The thematic chapters three and four are respectively examining the allocation of savings and the macroeconomic impacts of defence spending.

At the backdrop of strong headwinds in recent years, the euro area and the EU have continued to grow, albeit at a modest pace. Member States have recovered their pre-pandemic income levels and unemployment rates have reached historically low levels. The EU budget, particularly the Recovery and Resilience Facility (RRF), has played a crucial role in supporting public investment and driving growth. However, as outlined in Chapter 1, growth remains constrained by sluggish productivity, which threatens the European economy's long-term prosperity and global influence. The rise of emerging market economies, at times engaging in unfair competition practices, and persistently high energy costs further weigh on the competitiveness of EU producers. The first chapter finds that to unlock new opportunities and drive growth, the euro area and the EU need to focus on three key areas: supporting innovation by increasing R&D spending and leveraging human capital; further deepening the Single Market and expanding trade partnerships; and unlocking private investment to finance the Union priorities through initiatives such as the Savings and Investment Union. Long-run growth also depends on EU's ability to bolster its economic security and tackle dependencies in numerous strategic value chains. By addressing these challenges and capitalising on its strengths, the EU and the euro area can reinforce their global standing and ensure long-term growth and prosperity. The euro area also stands to benefit from growth drivers linked to the single currency. These include the creation of a digital euro and an enhanced international role of the euro, which would also serve to boost Europe's economic sovereignty. Overall, the euro area and the EU's ability to adapt to the changing geopolitical landscape and to seize opportunities linked to the transition to a digital and decarbonised economy, and the need to strengthen our security will be crucial in determining its success.

In order to ensure macroeconomic stability and balanced growth, a number of vulnerabilities must be addressed. These are examined in Chapter 2. First, the euro area and the EU have consistently run an external surplus, making them more vulnerable to

external developments and hindering domestic growth prospects. This trend reflects an excess of savings over investment, with households as the main contributors. While abundant savings provide the means to fund European priorities and strengthen the economy, they are often invested abroad, highlighting the need for deeper and more integrated capital markets in Europe. Second, government debt dynamics are becoming more challenging as the favourable differentials between interest rates and nominal GDP growth of recent years are diminishing. Moreover, Member States face increasing defence spending needs and significant investments in the digital and decarbonisation transitions. Ageing populations are putting further pressure on pension, health, and long-term care spending. To address these challenges, medium-term fiscal strategies are needed to strengthen debt sustainability. This will require prioritising spending and rationalising spending programmes, mobilising revenue, and implementing structural reforms to boost growth. Third, the chapter also discusses how inflation differentials are a particular concern within the euro area and, if persistent, they can undermine the effectiveness of monetary policy. At the same time, housing affordability has become a macroeconomic issue in many countries. House prices are rebounding, as low investment keeps housing supply muted.

The euro area and the EU are characterised by high private savings. Chapter 3 discusses how savings are largely channelled to the US, with no clear signs of a shift away from this trend. An analysis of EU capital flows shows that a significant portion of European savings originates from households, whose savings rates are consistently higher than those of their international peers. European households tend to favour traditional investment channels, such as bank deposits, and rarely invest directly in capital markets. Instead, most of their financial wealth is intermediated through the financial sector, which ultimately channels about half of these savings into assets abroad. This limited investment by households in European firms reflects the fragmented and underdeveloped nature of Europe's capital markets. Advancing towards a genuine Capital Markets Union is therefore essential. A multifaceted strategy is needed to strengthen the EU economy and enhance the attractiveness of the euro as an international currency. This can be achieved by improving the efficiency and resilience of the financial sector and promoting more effective intermediation of household savings to support EU companies and investments. By doing so, the EU can unlock the potential of its savings and drive economic growth and stability.

The increase in government spending on defence capabilities is a critical dimension in the current macroeconomic landscape in the EU. This issue is examined in Chapter 4. Russia’s aggression on Ukraine and adverse geopolitical developments have led to a significant deterioration of European and global security. The chapter finds that a significant expansion of industrial capacity in the EU is required to meet the new security needs. Efficient and effective spending requires a coordinated approach among EU Member States. Pooling procurement efforts could help achieve economies of scale, which would give Member States more buying power and encourage the expansion of the European defence industry’s production capacity. An increase in defence spending can be compatible with fiscal sustainability if financed in the medium term by reprioritising government expenditure and increasing revenue. New model simulations suggest that meeting NATO's updated spending target could moderately increase GDP in the euro area and the EU. However, the impact of this increase varies significantly depending on several factors, such as import content, the degree of frontloading, the share of infrastructure spending, and the level of debt financing. In fact, the increase in defence spending has positive effects especially if the

additional defence spending focuses on domestic investment and R&D, rather than just imports or current spending. The impact of higher defence spending on total employment is expected to be modest, while it could have implications on skills shortages in specific occupations.

1. ECONOMIC LANDSCAPE

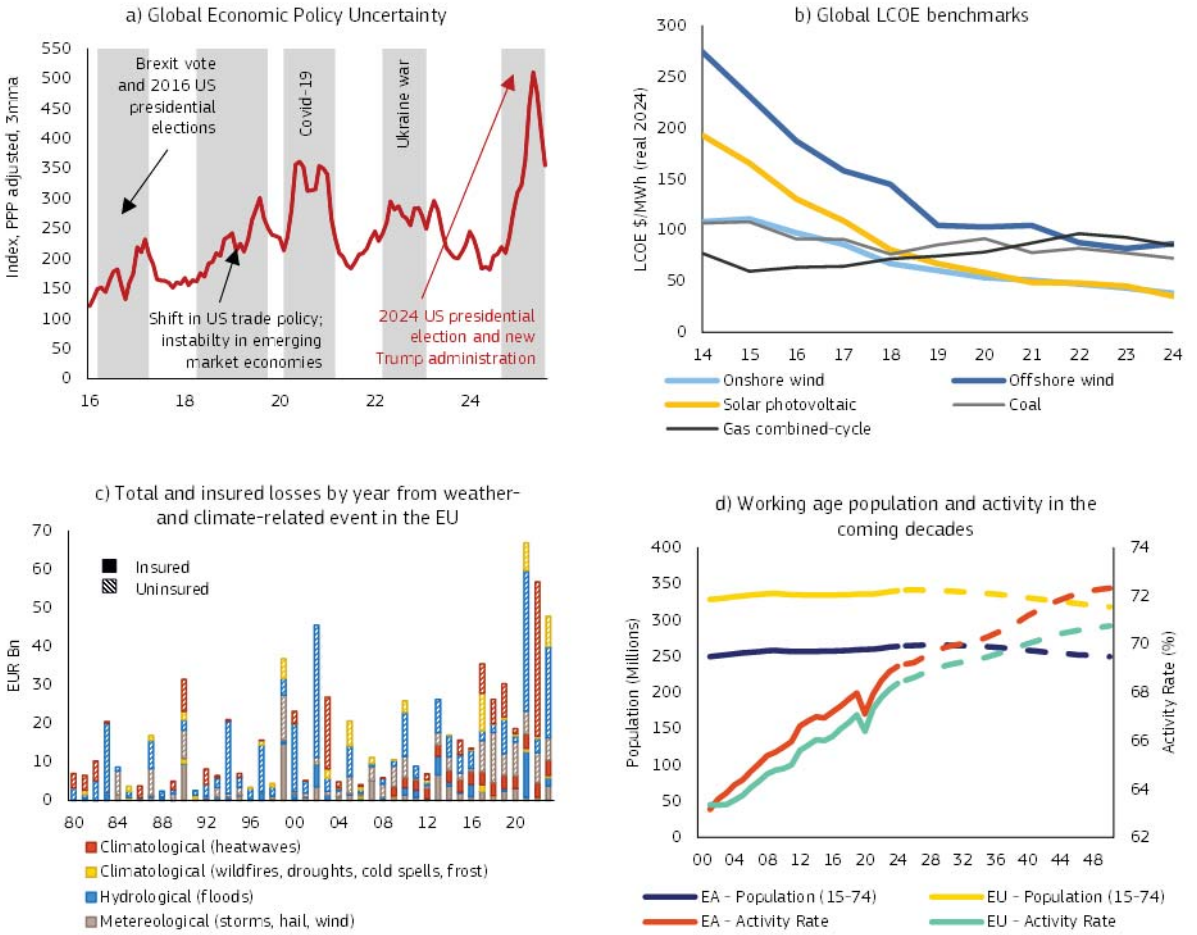
The European economy is navigating a complex international landscape, marked by shifting geopolitical dynamics, rapid technological advancements, and increasing climate risks. The euro area and the EU economies have proven resilient, absorbing large shocks while continuing to grow at a modest pace. However, the current environment presents both significant risks and transformative opportunities for the Union, underscoring the need for robust macroeconomic surveillance and adaptable policy frameworks.

The changing economic landscape presents significant challenges to the euro area and the EU

The euro area and the EU are navigating an international landscape marked by elevated uncertainty and evolving security challenges ([1]). The geopolitical order is shifting. In recent years, trade barriers have been increasingly used as a geopolitical and industrial policy tool, undermining the rules-based trade system. This trend has been accelerated due to the US's unilateral decision to significantly raise import tariffs **(Graph 1.1.a** and **Box 1.1 on recent trade developments)**. At the same time, the continued ascent of emerging economies, particularly China, has altered the economic landscape. Russia's war of aggression against Ukraine also demonstrates the reality of security risks in Europe. The euro area and the EU have proven remarkably resilient in recent years, absorbing large shocks while continuing to grow, albeit at a modest pace, which demonstrates the strength and adaptability of its economy.

The challenges and transformations facing the euro area and the EU are compounded by pre-existing trends. First, digitalisation and rapid technological advances, including the progress in the field of artificial intelligence (AI) and decarbonisation **(Graph 1.1.b)**, are redefining industries and business models. Second, climate-related risk is also becoming an increasingly pressing issue in Europe, with more frequent and severe natural disasters **(Graph 1.1.c)**. At the same time, the acceleration in global warming calls for progress with the decarbonisation of economic activity. Lastly, major demographic shifts are taking place, marked by a shrinking working-age population and increasing dependency ratios, with important implications for the EU economy, labour market and social security systems **(Graph 1.1.d)**.

Graph 1.1:**Global long-term trends affecting the euro area and the EU**



Notes: Graph b): LCOE stands for levelized cost of electricity. These are reported without subsidies or tax credits; Graph c): The 30-year moving average for total and insured economic losses is calculated by pooling all weather- and climate-related events.

Source: Graph a): Economic policy uncertainty; Graph b): Bloomberg NEF; Graph c): European Environmental Agency; Graph d): European Commission services based on Eurostat and OECD data and EUROPOP population projections.

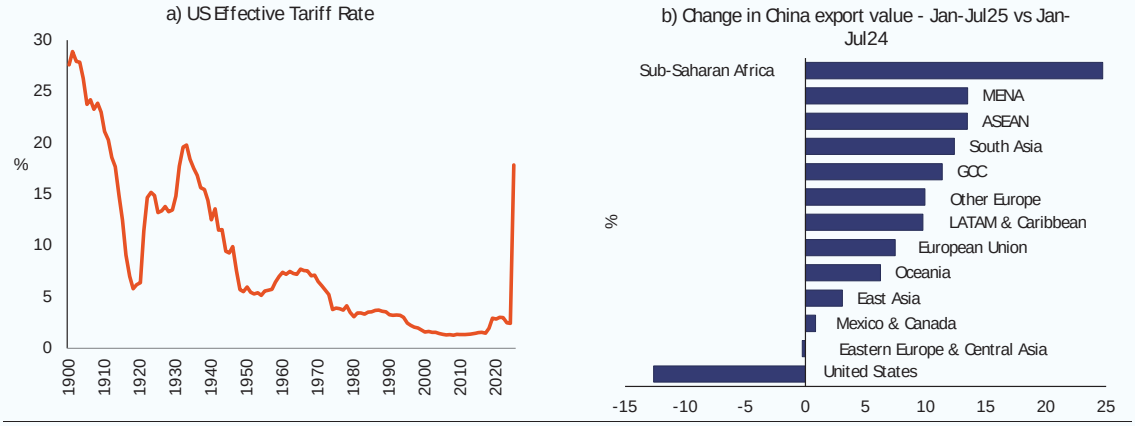
Box 1.1: **The reshaping of global trade**

This box examines how recent changes in US trade policy are reshaping global trade dynamics and examines how Chinese trade is diversifying with impacts on the EU as well.

In 2025, the US triggered one of the sharpest shifts in trade policy in decades. The US announced a broad package of import tariffs, pushing the effective import tariff rates from 2.4% in 2024 to around 17.9% by October 2025 **(Graph 1.a).** The anticipation of US tariffs has triggered a surge in global trade in 2025-Q1 and a strong albeit temporary impulse to global merchandise trade activity. Many US firms frontloaded their purchases and US goods imports rose nearly 18.4% q-o-q in 2025-Q1. Consequently, global merchandise trade expanded by 4.5% y-o-y in the first quarter, well above the 2.3% annual growth recorded in 2024. However, by April the effect reversed: US imports declined by 20% m-o-m and continued to decline in 2025-Q2, dragging down global trade momentum.

The tariffs have been felt most prominently in US–China trade. Chinese exporters frontloaded shipments in early 2025. Exports to the US then fell sharply as the escalating trade conflict in April resulted in tariffs peaking at 145% and despite the temporary tariff reduction during a truce extended until November ([1]). In spite of this China's total exports overall have shown remarkable resilience growing by 8.6% y-o-y in 2025-H1. Transhipment activity is playing a significant role in sustaining export levels, with "connecting countries", particularly in Southeast Asia, serving as key hubs for re-exporting Chinese goods. Moreover, China is diversifying its exports, with most regional export markets posting rapid growth during the first half of the year **(Graph 1.b)**. Overall, these trends more than compensate for the decline in Chinese exports to the US.

Graph 1: **US import tariffs and China export diversification**



Notes: Graph b): Regional aggregates are Sub-Saharan Africa (SSA), Middle East and North Africa (MENA), ASEAN members (ASEAN), South Asia (SA), Gulf Cooperation Countries (GCC), non-EU Europe (EnonEU), Latin America and Caribbean (LAC), European Union (EU), Oceania (OCE), East Asia (EA), USMCA members ex-US (USMCA), Eastern Europe and Central Asia (EECA).
Source: Graph a): The Yale budget Lab; Graph b) China's Customs Administration.

Shares of China in EU imports have increased marginally in 2025 for total goods, but more significantly for manufactured goods. To investigate the diversion of Chinese goods, imports from China must be analysed against a broader trend in imports, that are likely to follow EU domestic demand. China accounted for 22.1% of total EU imports ([2]) in the first 8 months of 2025 **(Graph 2.a)**, marginally up from 20.8% in 2024, 20.9% in 2023 and 21.1% in 2022. The increase in China shares was

([1]) In 2024, before the increase in US tariffs, Chinese goods exports to the US amounted to approx. 14.7 percent of China goods exports and approx. 13.3 percent of US goods imports.
([2]) EU imports and exports mean in this box extra-EU imports and exports.

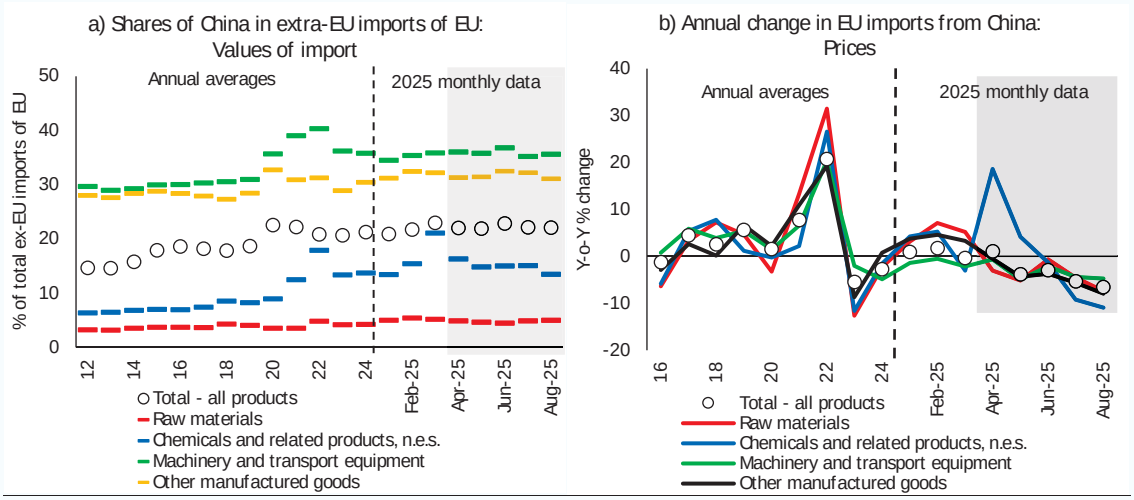
(Continued on the next page)

Box (continued)

particularly noticeable in other manufactured goods whose share reached post-COVID highs in the second quarter ([3]).

EU imports from China expand at elevated rates in 2025 amid initial signs of rising competitive price pressures. The EU is one of the most likely directions of diversion of Chinese goods – given the size of the market. Early signals point to elevated imports dynamics in 2025 (compared to historical averages), though no immediate evidence of the impact of the tariff surge from April. Volume of total imports from China were up by 12.1% y-o-y in the 8 months of 2025, visibly above growth in recent years, thought for some categories (chemicals) the increase was markedly higher. Elevated import volumes were accompanied by the deepening price (unit value) deflation **(Graph 2.b)**. Annual rate of change of Chinese imports prices fell from 0.8% y-o-y in the first quarter of 2025 to -1.9% in the second and -3.7% on average in July-August.

Graph 2: **EU imports from China**



Notes: Graph a): Seasonally and calendar adjusted values of imports. Shaded area represents a higher tariff environment. 2012-2024 annual averages; monthly values in 2025; Graph b): Unit values (prices). Shaded area represents a higher tariff environment. 2016-2024 annual averages; monthly values in 2025.
Source: Eurostat.

([3]) The EU Commission Trade Diversion Monitor increasingly identifies growth in Chinese goods imports as "potentially harmful" in 2025. China has been identified as a source of potentially harmful increases to a much higher extent than other regions, with affected sectors including textiles, wood productions, chemicals, basic metals, machinery and equipment and transport equipment.

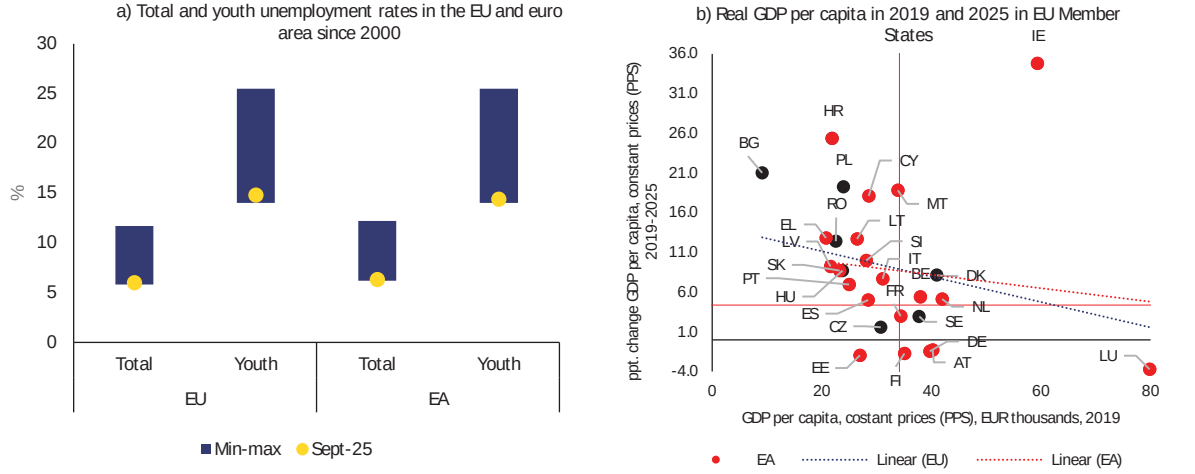
The euro area and the EU have remained resilient

Despite strong headwinds, the euro area and the EU have continued to grow over the past years. By the end of 2022, most Member States had recovered their 2019 income levels, recouping the income losses experienced during the pandemic. Since then, the euro area and the EU economy have grown at an average pace of 0.7% in 2023-24 and they are expected to grow by 1.3% and 1.4% respectively in 2025. The performance of the euro area and EU was driven by domestic demand, sustained by easing financing conditions, the rollout of the Recovery and Resilience Fund (RRF), a sound financial sector **(see Chapter 2)**,

and robust labour market outcomes. Importantly, the unemployment rates in the euro area and the EU are currently at historically low levels **(Graph 1.2.a)**.

Income convergence within the EU has continued in recent years, although not in all countries. Between 2019 and 2025, GDP per capita grew faster than the EU average in several lower income Southern and Central and Eastern Member States (Licchetta and Mattozzi, 2023) **(Graph 1.2.b)**. EU funds have played a significant role in supporting growth and investment, strengthening social and territorial cohesion in these regions. In some lower income countries, however, convergence appears to have stalled. This is the case in Estonia and Czechia, where income levels, measured in PPS, relative to the EU have remained largely unchanged in 2024 compared with 2019 **(see Chapter 2)**. Several Northern Member States have recorded below-average improvements, with income levels declining in some cases.

Graph 1.2:**Unemployment and GDP**



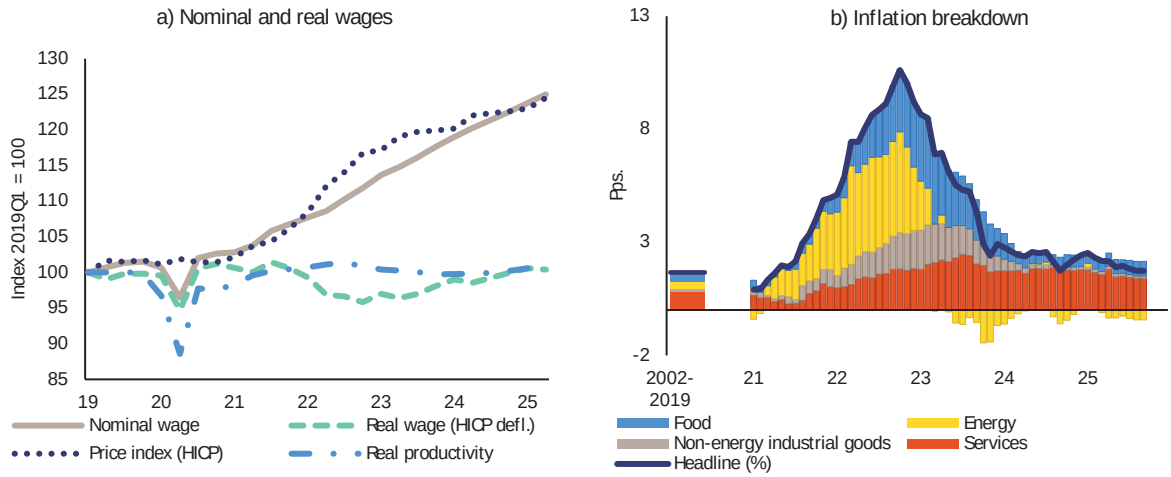
Notes: Graph a): The min-max range is calculated for the period January 2000 – September 2025 (latest reading); Graph b): Red lines represent EU GDP per capita, constant prices (PPS) in 2019 (vertical) and the percentage growth of the EU GDP per capital, constant prices (PPS) between 2019 and 2025 (horizontal).
Source: European Commission.

Employment has been an important driver of growth. The EU employment rate reached a record 76.1% in 2025–Q1, including thanks to high participation rates from young people and women. Real wages have grown in nearly all Member States, gradually returning to levels observed prior to the inflation surge ([2]). By 2024-Q2, in the euro area, wage growth had closed the gap that had been formed following the pandemic between real wages and productivity **(Graph 1.3.a)**. Additionally, the 2024 EU-SILC survey found a decline of 1.2 and 0.1 million people at risk of poverty or social exclusion was recorded in the EU and euro area, respectively. The resilience in the labour market is particularly notable in some Member States and illustrates that firms and workers adapted to changed circumstances (European Commission, 2025l). It also suggests that the various structural reforms adopted by Member States over the last decade are showing positive results and have made their economies more flexible and resilient ([3]), including measures aimed at enhancing labour market participation ([4]). However, recent data shows that employment growth has slowed down, and the labour market is loosening **(see Chapter 2)**.

In the euro area, inflation continues to moderate (Graph 1.3.b). Since Spring 2025, inflation in the euro area has fluctuated around levels broadly consistent with the ECB

inflation target. Euro area headline HICP inflation reached 2.1% in October 2025, after declining earlier in the year, while core inflation remains at its lowest levels in over three years. The recent appreciation of the euro **(see Chapter 2)** and stabilising wage growth are expected to support further easing of underlying price pressures. While inflation expectations remain well-anchored overall, household inflation perceptions have remained persistently high. Survey-based measures indicate that consumers perceive inflation to be roughly twice its actual level. This apparent disconnect can likely be attributed to the large rise in price levels during the period 2021–2023 and the structural increase in inflation attention it has produced (Buelens and Lindén, 2025). While this perceptions gap does not automatically affect inflation expectations, it may however facilitate their de-anchoring in reaction to inflation shocks. Furthermore, it may weigh on consumer sentiment and lead to more precautionary behaviour.

Graph 1.3:**Wages and inflation in the euro area**



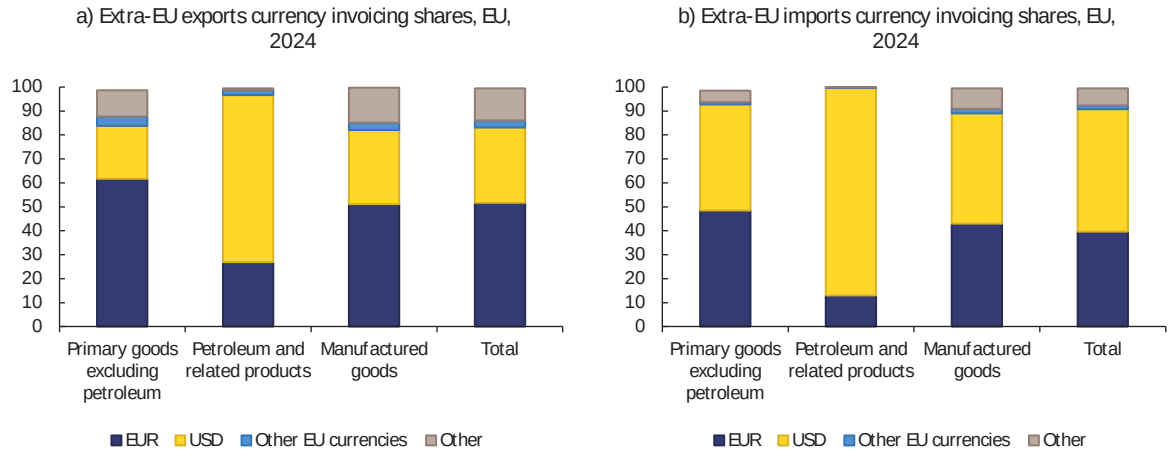
Notes: Graph a): Real wages are adjusted using the HICP deflator.
Source: Graph a): European Commission calculations based on Eurostat; Graph b): Eurostat.

The euro appreciated significantly in 2025, driven by a combination of factors. From its trough in February 2025 to October 2025, the euro nominal effective exchange rate (NEER) appreciated by 7.3%, largely on account of a considerable strengthening against the US dollar and the Chinese renminbi (which tends to follow the US dollar). The weakness of the dollar in 2025 was due to a combination of macroeconomic factors, including changing yield differentials, revised US growth expectations, and a perceived increase in the riskiness of US financial assets linked to heightened economic policy uncertainty in the US **(See Box 3.1 in Chapter 3)**. Similarly, the euro real effective exchange rate (REER) appreciated by 6.8% over the February-August period, with various REER measures indicating that, in real terms, the euro remains close to its long-run average although slightly above it.

In the short term, the immediate effect of an appreciation of the euro is a favourable terms of trade effect before further adjustments take place. More than half of EU imports are invoiced in US dollars, implying a cheaper price in euros, provided that prices are fixed in the short term in the currency of invoice. This is particularly the case for petroleum and related products, and to a lesser extent for manufactured goods **(Graph 1.4.a)**. On the exports side, more than half of extra-EU exports are invoiced in euro, with only about 30% in dollar **(Graph 1.4.b);** this insulates most export revenues from exchange rate risk, but makes

EU exports priced in euros more expensive for foreign buyers, eventually leading to price adjustments and possible reallocation of resources. While the fixed prices assumption could hold in the short run, over the medium term prices will adjust depending on demand elasticities and pricing practices. The final change in relative prices will determine the extent of sectoral reallocation that may take place. Should the euro position remain strong, it could impact the overall cost-competitiveness. This could particularly affect Member States with low and medium-tech exports, which are more exposed to substitution.

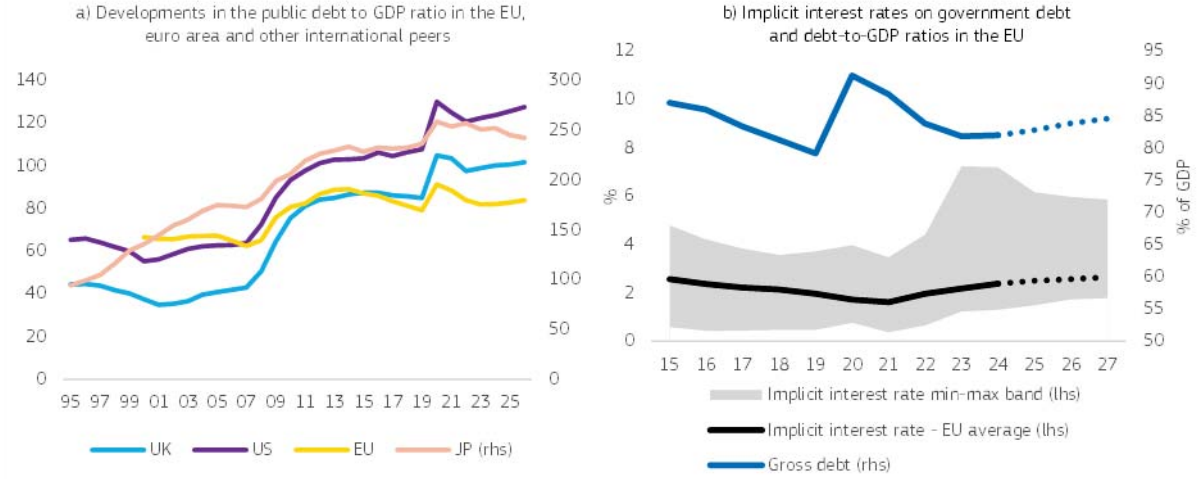
Graph 1.4: **EU's extra-EU trade invoicing shares by currencies**



Source: Eurostat.

Fiscal positions of EU Member States have improved since the pandemic, but challenges remain. In 2024, the EU government debt-to-GDP ratio declined to about 81.9%, standing 9 percentage points below its 2020 peak, while the euro area recorded a similar improvement. Looking ahead, the EU debt-to-GDP ratio is projected to increase to 84.9% in 2027 (91.3% for the euro area), however remaining well-below the levels shown by its international peers **(Chart 1.5.a).** This projected increase in the debt ratio is due to ongoing primary deficits, including the increase in defence spending. Moreover, the increase in refinancing rates is leading to higher interest expenditure **(Graph 1.5.b)** and hence a less favourable interest-growth (r-g) differential. Looking ahead, long-term spending pressures from areas such defence, pensions, health, and the green and digital transitions as well as from climate change related events are also going to increase, putting additional fiscal pressure on the sustainability of public finances of many EU Member States (IMF, 2025b).

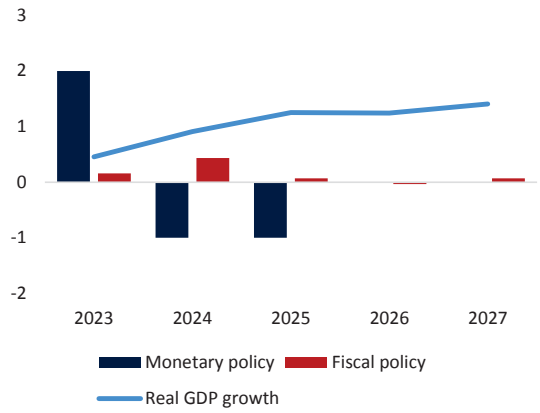
Graph 1.5:**Fiscal developments in the euro area, the EU and other international peers**



Notes: Graph b): The implicit interest rate is calculated as the ratio of interest expenditure to the outstanding debt.
Source: European Commission.

Overall, the policy mix in the euro area since 2020 has been consistent with prevailing macroeconomic conditions. ([5]) After an expansionary stance following the pandemic, the fiscal stance turned broadly neutral in 2023 and slightly contractionary in 2024 in the euro area, supporting the fight against high inflation by the ECB. The monetary policy rate in the euro area has come down closer to its long-term value and the euro area fiscal stance ([6]) is expected to be broadly neutral in 2025 and 2026 **(Graph 1.6)**. Since 2025, the euro area fiscal stance has been influenced by the adjustment requirements of the new EU fiscal framework aimed at improving fiscal sustainability and the activation of the national escape clause that provides flexibility in 2025-28 for higher defence expenditure. Beyond 2028, higher defence spending commitments will require additional fiscal adjustments, in addition to the pressure exerted by the financing of other priorities **(see also Chapter 4)**.

Graph 1.6:**Euro area policy mix**

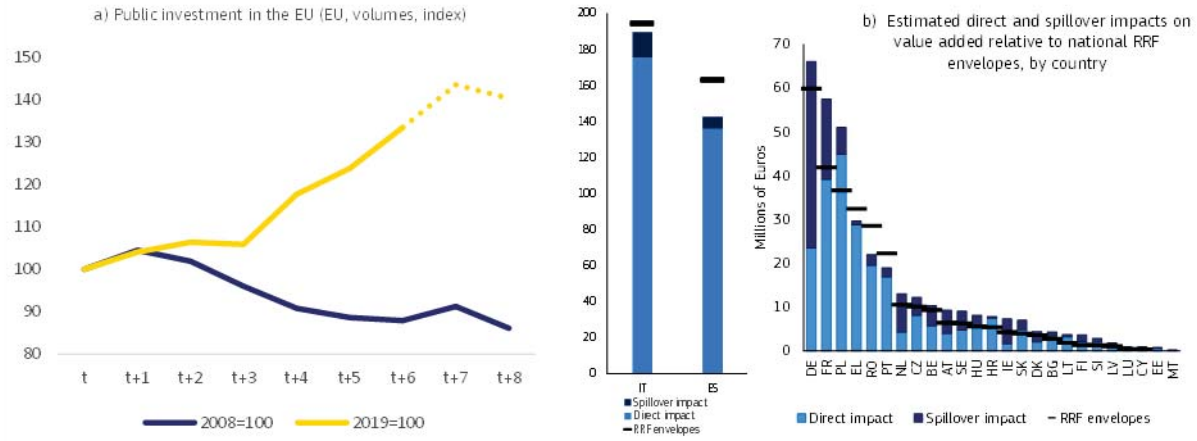


Notes: Monetary policy is measured as the overall change of the ECB deposit facility rate in the year, until June for 2025. The fiscal stance profile in 2020-2023 does not include the temporary impact of COVID-19 emergency measures.
Source: European Commission and ECB.

The EU budget has significantly supported public investment. Public investment has increased noticeably in recent years, especially as compared to the post-global financial crisis developments **(Graph 1.7.a)**. The available estimates indicate that half of the increase in public investment between 2019 and 2025 has been related to investment financed by the EU, mainly via the RRF (European Commission, 2024c) ([7]), The full economic impact of the RRF is yet to be realised and will depend on Member States catching up on implementation delays. These benefits are expected to continue beyond 2026, with important spill-over effects across Member States ([8]) **(Graph 1.7.b)** and financial instruments encouraging more private investment. Assuming the full implementation of all the Recovery and Resilience

Plans (RRPs) (as of mid-January 2025), in 2020-30 the RRF-funded investments are estimated to increase the EU GDP by over EUR 685 billion (around 4.9 % of GDP ([9]), with direct and intra-EU spillovers impact combined (European Commission, 2025m). According to the most recent ECB study, when the long-term impact of structural reforms is considered, the potential output gains could reach up to 1.3% of GDP over the period of 2020-33 as compared to a counterfactual scenario without the RRF.

Graph 1.7:**Public investment and direct and spillover impact of RRF funds**



Notes: Graph b): Direct impacts of the national RRF envelopes are immediate boost in production and employment
in national recipient industries and the increased demand for inputs from domestic supplier industries. Spillover impacts are additional boosts and increased demand in national recipient economies deriving from external RRF envelopes.
Source: Graph a): European Commission; Graph b): Michels et al. (2025) using the JRC FIDELIO model.

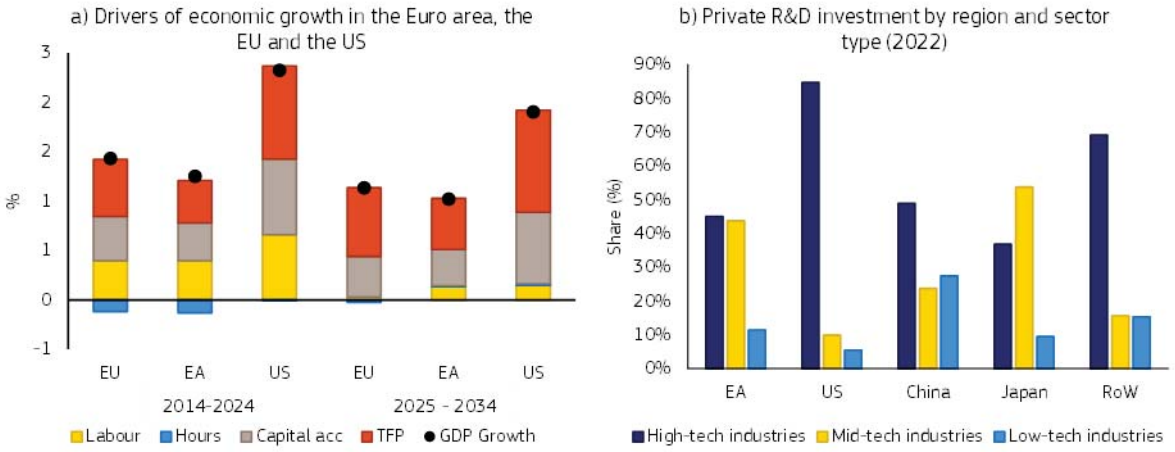
The euro area and the EU face structural challenges

While the euro area and the EU have shown resilience in the past years, their modest productivity growth affects their growth prospects. Relative to the US, both the euro area and the EU have recorded less total factor productivity (TFP) growth and less capital deepening over the past decade, implying weaker labour productivity growth **(Graph 1.8.a)** ([10]). Structural factors behind these weaknesses have been discussed in the Draghi report, including the role of weak private investment in the EU compared to its sizable investment needs and skills gaps and mismatches among the working-age population ([11]).

The productivity growth gap with the US has widened after the COVID-19 pandemic, although an important part of this increase has likely been cyclical in nature ([12]). The growing gap coincided with the energy crisis in Europe. The relative productivity growth slowdown has manifested itself through both a more muted contribution of capital deepening and TFP. Concerning capital per worker, investment ratios remained relatively resilient in the euro area and the EU, but they recorded a strong post-pandemic increase in the US. Weak TFP growth in the euro area and the EU, by contrast, has been mainly associated with varying capacity utilisation and labour hoarding. Employment remained resilient in the EU also given lower wage growth and declining real wage costs.

The increased productivity growth gap since 2023 may also be associated with structural factors. While most of the structural conditions explaining the longstanding productivity gap have not changed post-COVID—e.g., in terms of innovation output and inputs, regulatory and policy frameworks—the sectors that typically record high TFP growth rates and those that account for the bulk of the EU-US TFP growth gap in the past 20 years (mainly information and communication technology (ICT) manufacturing and services and professional services) have been expanding faster in the US than in the euro area and the EU, thus further widening the existing gap in terms of these sectors' share in total GDP. Innovation in Europe has predominantly focused on established technologies and 'mid-tech' industries (manufacturing) rather than transformative innovations in digital technologies (European Commission, 2024d) **(Graph 1.8.b)**. Moreover, the private investment gap in ICT industries, including AI, has further increased in favour of the US economy.

Graph 1.8:**Growth and innovation**



Notes: Graph a): Based on the European Union's Commonly Agreed Methodology for the elaboration of potential GDP projections. EUCAM T+10 provides a medium-term extension for the short-term T+2 forecasts and illustrates future growth paths if the trends of recent years were to persist into the future. The method is based on a production function approach, and the projections of its components - labour, capital and productivity - are determined by statistical time series processes and structural anchors or stabilisation rules. Both the nature of the assumed time series processes and the anchoring or stabilization ensure that the projections are not a simple extrapolation of current trends.
Source: Graph a): "Output Gap Estimation Using the European Union's Commonly Agreed Methodology: Vade Mecum and Manual for the EUCAM Software", Discussion Paper 148, European Commission.; Graph b): DG Research and Innovation, Common R&I Strategy and Foresight Service, Chief Economist Unit, based on data from the 2023 EU Industrial R&D Investment Scoreboard. Adaptation of Figure 2.1-9 in SRIP (2024).

Slow labour productivity growth together with unfavourable demographics translate into weaker GDP growth. GDP growth in the US has not only benefitted from stronger labour productivity growth, but also from stronger employment growth in recent years. The US has recorded stronger population and labour force growth than the EU – with the US population having increased by roughly 20% since 2000. In contrast, the EU population has increased by just 5%, while it has increased by 8% in the euro area. The US labour force increased by 18%, while it increased by 12% and 15% in the EU and euro area respectively ([13]). Total GDP growth is important beyond average living standards (also proxied by labour productivity) as it affects fiscal sustainability, and notably the ability to repay debt and finance spending that is not proportionate to population size. Sluggish total GDP growth also means that the EU and euro area lost weight in the global economy. Productivity growth

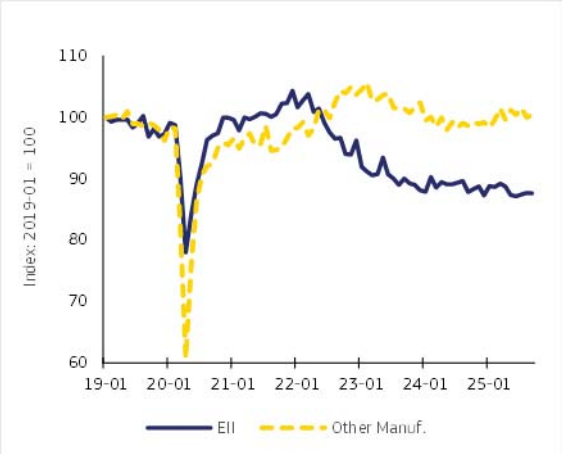
at the pace experienced since 2015 would only suffice to keep the level of real GDP of the EU economy constant by 2050, given demographic projections.

The European economy's sluggish productivity growth and unfavourable demographics pose a pressing threat to its long-term prosperity and global influence. With the US continuing to pull ahead, the EU's competitiveness gap is not only widening, but also jeopardizing its ability to finance its social model, ensure fiscal sustainability, and maintain its position on the world stage. If the EU fails to take ambitious action to address its productivity and competitiveness challenges - including catalysing private investments and supporting the activation of the underrepresented groups in the labour market complemented by attracting talent from abroad - it risks being left behind in the global economy. This could have far-reaching consequences for its citizens' standard of living, its economic security, and its ability to shape the global agenda. The persistent productivity gap can also drive the current account surplus and hence may also contribute to macro-financial risks ([14]).

The rise of emerging market economies is also challenging the competitiveness of EU producers. EU goods in global markets face increasing competition as emerging market economies—particularly China—have grown more competitive in sectors formerly dominated by advanced economies, increasingly producing substitutes rather than complements to advanced economy output (Al-Haschimi and Spital, 2024). China occupies a unique place given its market size and its manufacturing and export capacity; it is often at the forefront of the most technologically advanced segments such as drone, robotics and AI, sometimes outpacing the EU.

In parallel, EU firms have faced persistently higher energy costs in recent years. Since mid-2021, energy prices—especially for gas and electricity—have been elevated despite easing since the 2022-23 peaks, remaining above levels before Russia's invasion of Ukraine and generally above those of main trading partners **(**see also **Graph 1.11.a** below for electricity). Higher energy prices have increased production costs particularly in energy-intensive industries, with negative repercussions for production levels **(Graph 1.9)** ([15]). The transition towards a decarbonised economy is expected to deliver sustained reductions in energy production costs although additional investment in clean energy and infrastructure is needed in the short and medium run, including to strengthen the EU electricity grid and to increase the flexibility of the system ([16]). According to Commission estimates, reaching the Fit-for-55 objectives would entail additional private and public investment of about EUR 320 billion per year between 2021 and 2030 (excluding transport), compared to the historical 2011-2020 trend.

Graph 1.9:**EU production volume of energy intensive industries and other manufacturing sectors**



Notes: Energy intensive industries (EII) is defined as the highest concentration of energy use across the industry, including chemicals, iron and steel, food and beverages, cement and concrete, and forest products.
Source: Eurostat.

Investments into the EU net zero manufacturing capacity will also be needed which would require around EUR11 billion annually between 2023-30 ([17]). While substantial, these investments will help to deliver over time structurally more predictable and less volatile energy costs, reduced fossil fuel consumption and import dependence and thereby strengthen competitiveness and security.

Avenues to boost EU long term growth

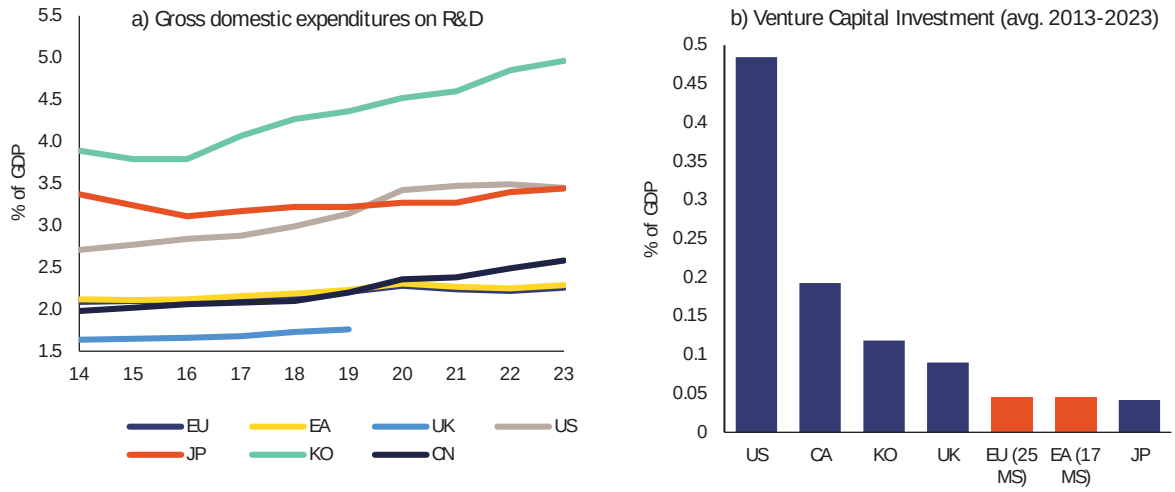
The EU should focus on innovation and knowledge, markets, and funding to unlock new opportunities, drive growth, and stay ahead on the global stage, while ensuring its economic security.

Innovation and knowledge

Increasing R&D spending, especially in cutting-edge technologies like AI, semiconductors, and biotechnologies, could boost productivity in the EU, while contributing to its strategic autonomy. While the EU and the euro area have recently increased their R&D spending, they both still lag behind global leaders in R&D intensity, with a rate of 2.1% of GDP in 2023, compared to 2.6% in China, 3.6% in the US, 3.4% in Japan, and 5% in South Korea **(Graph 1.10.a)**. Given its small size and dependence on public funding, the venture capital (VC) sector in Europe cannot replace comprehensive R&D support **(Graph 1.10.b)**. The VC ecosystem in many EU Member States is fragmented, undercapitalised, and overly reliant on public subsidies, which limits its capacity to back long-term, high-risk research and development at scale (Mack, 2024) **(see also Chapter 4)**.

The green, digital and security transitions present opportunities for European businesses. The shift towards green investment in the infrastructure and energy sectors, including increased electrification and EU integration of national energy networks, is expected to boost EU energy independence over time, reduce reliance on fossil fuels and lower energy costs**.** Technological advancements are reshaping production processes, with electrification based on clean energy from renewables being a key pathway for their decarbonisation (Roser, 2020). This global shift to renewables is making clean energy both environmentally and economically beneficial, with solar and wind now often the cheapest new electricity sources in many regions. In 2024, around half of electricity production in the EU came from renewable sources (IRENA, 2025), compared to around a quarter in the US **(Graph 1.11.b)**.Integrating substantial amounts of weather dependent renewable energy will require significant investments in electricity grids and non-fossil flexibility which are an integral part of the cost paid by end-users (see also above) ([18]).The digital transition, including developments in AI, is also set to improve productivity and reduce operational costs ([19]). However, the increased use of AI presents a new challenge as it is expected to drive up energy demand worldwide ([20]). The transitioning to higher levels of defence spending could also deliver important economic benefits, provided funds prioritize EU production and are addressed to the most productive segments that also happened to have been underinvested for a long time **(see Chapter 4)**.

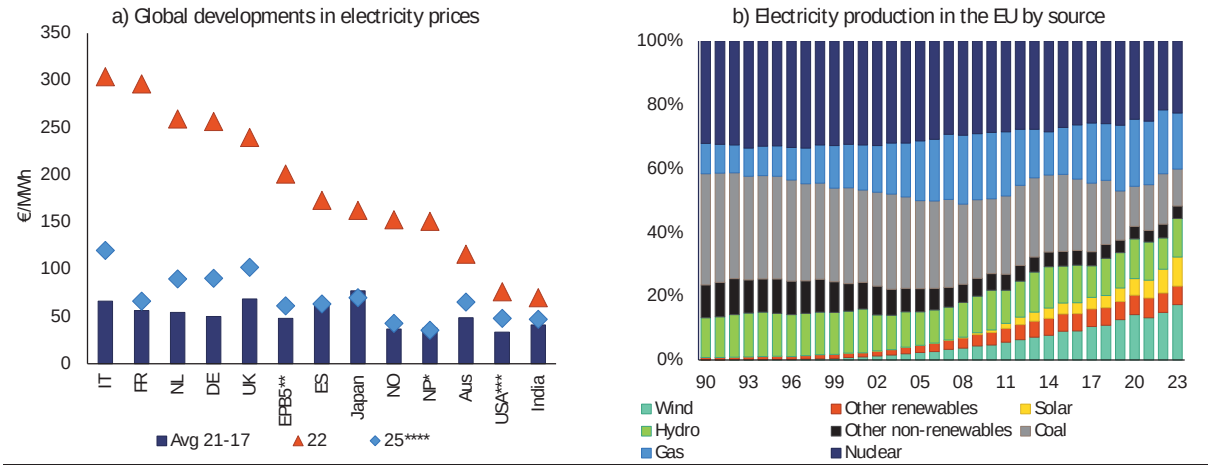
Graph 1.10: **Innovation and venture capital investment**



Notes: Graph a): Gross domestic expenditure on R&D (GERD) includes total (private and public) expenditures; Graph b): Venture capital is made up of the sum of early stage (including pre-seed, seed, start-up and other early stage) and later stage venture capital. The EU series has been computed based on data available for 25 Member States.
Source: Graph a): Eurostat; Graph b): OECD.

Leverage on human capital, notably through upskilling, reskilling, and enhancing the quality of the education and training systems could boost competitiveness. Lifelong learning, flexible training programmes, and public-private partnerships are key to providing workers with skills in clean energy, digital literacy, and AI. EU Initiatives like the Union of Skills, the Digital Europe Programme, the Digital Education Action Plan and the Net Zero Academies are helping to drive this effort, with the latter providing specialized training in clean energy, sustainability practices, and clean technologies. In this respect, it is important to consider how increased defence spending, and the expansion of the defence industry might affect the labour market, potentially aggravating shortages in high-skilled technological fields **(see Chapter 4)**. Enhancing the quality of education and training systems and aligning education systems and labour market policies with future needs—including via policies to support labour force participation, enhancing workforce mobility and targeted legal migration—is crucial for employability, competitiveness, and a just and inclusive transition (European Commission, 2025j). Properly designed social protection and social inclusion schemes can act as automatic stabilisers, thus supporting household incomes and having a stabilising effect on the overall demand for goods and services. Combined with effective labour activation measures, they can be an important tool to meet the Union's 2030 employment skills and poverty targets and support integration into the labour market of untapped labour potential.

Graph 1.11: **The electricity market**



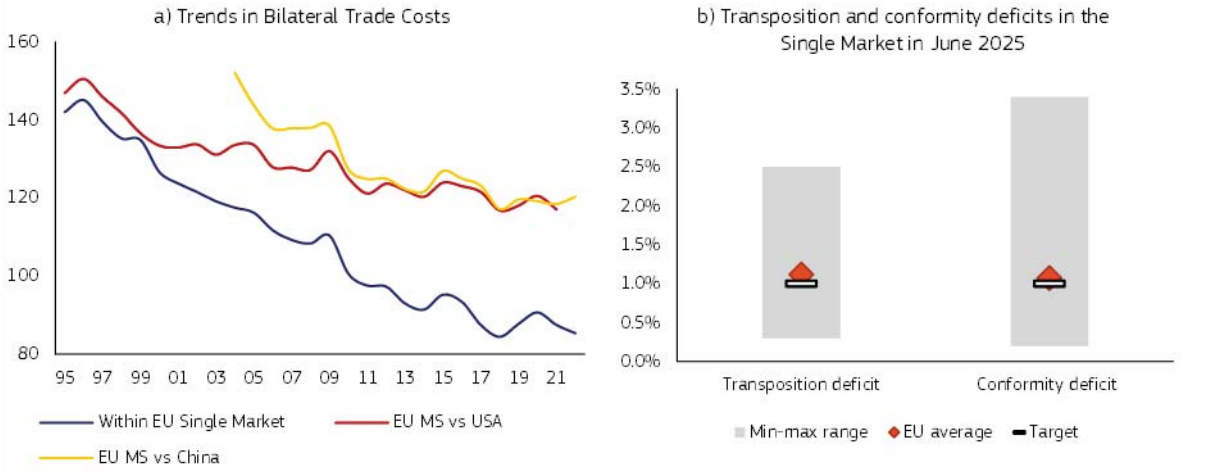
Notes: Graph a): *NP stands for Nord pool market (NO, DK, FI, SE, EE, LT, LV). **EPB5 stands for European Power Benchmark. ***USA is based on most representative US power Hubs. **** Average first half of 2025.
Source: Graph a): European Commission based on S&P Global Platts, Japan Electric Power Exchange (JEPX), Indian Energy Exchange Limited (IEX) India, Australian Energy Market Operator (AEMO); Graph b): European Commission.

Beyond productivity gains, strengthening Europe's economic security is an essential precondition for sustained long-run growth. Ensuring reliable access to critical raw materials, diversifying supply chains, and building strategic industrial capacities—particularly in energy, digital infrastructure and defence—helps reduce vulnerabilities to external shocks. While these investments may not always yield the highest short-term returns, they are vital to preserve the stability and resilience on which future growth depends.

Markets

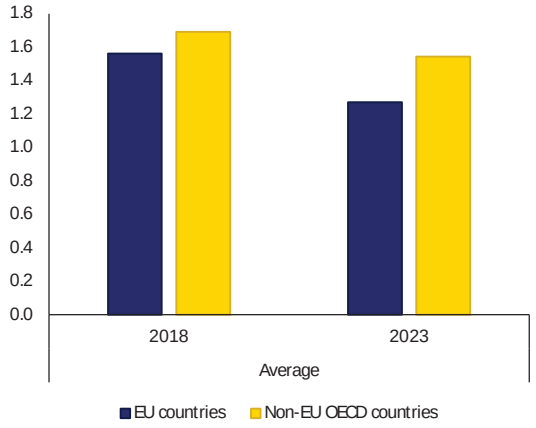
As global trade becomes increasingly fragmented, the EU is looking more closely at ways to further deepen the Single Market. The Single Market has been the most important source of welfare and productivity in Europe, benefitting all Member States and the EU citizens (European Commission, 2025k). Between 1995 and 2022, trade costs within the Single Market decreased by almost 40%, making internal EU trade significantly cheaper compared to trade with third countries such as the US ([21]) **(Graph 1.12.a)**. However, the Single Market remains incomplete, with high transposition and conformity deficits ([22]) not meeting EU targets despite progress over the last four years **(Graph 1.12.b)**. To unlock the Single Market's full potential ([23]), further liberalisation and progression in areas like services, digital and energy markets, and public procurement ([24]) are needed. The Single Market Strategy aims to remove existing barriers and prevent new ones, with a focus on the ten most harmful barriers. The upcoming Single Market Roadmap to 2028 will contribute to this goal, setting key milestones for progress in areas like capital, services, energy, telecoms, the 28th regime, and the fifth freedom for knowledge and innovation. Deepening the Single Market could also compensate for the impact of global market fragmentation, by scaling up EU businesses and maintaining a level playing field.

Graph 1.12: **The Single Market**



Notes: Graph a): Bilateral trade calculated using the Inverse Gravity Framework (Novy 2009), based on the World Bank Trade Costs Dataset. Graph b): The transposition deficit is measured as the percentage gap between the number of Single Market directives adopted by the EU and the number of those transposed by each Member State; the conformity deficit is measured as the percentage of directives incorrectly transposed. The EU targets for the transposition and conformity deficits are, respectively, 1% and 0.5%.
Source: Graph a): Pasimeni and Dura (2025); Graph b): European Commission.

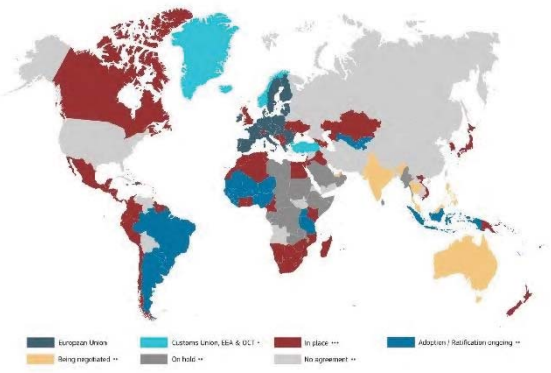
Graph 1.13: **Economy-wide PMR indicator**



Notes: Low values denote good performance; range 0-6.
Source: OECD Product Market Regulation database.

Simplifying the regulatory environment can bring significant economic benefits. Although regulations are crucial for addressing market failures and promoting equity and fairness, they can impose costs on citizens and companies ([25]). Restrictive regulation may also hold back private-sector innovation and investment ([26]). Although product market regulation in the EU Member States is not more restrictive on average than in non-EU OECD countries **(Graph 1.13)** ([27]), disparities exist across the Member States, raising costs of doing business in the Single Market. Surveys show that fast-changing legislation and policies are among the top concerns for companies operating in EU countries, alongside taxes and complex administrative procedures (European Commission, 2025d). Similarly, according to the 2024 EIB investment survey, approximately two-thirds of the surveyed firms in the EU consider regulatory environments, including business regulations, to be an obstacle to investment, with around half regarding it as a major obstacle. This proportion is higher than in the US, while the opposite holds for labour market regulation (European Investment Bank, 2024). In response to these concerns the Commission has put forward proposals to simplify EU regulations and procedures ([28]).

Graph 1.14: **EU trade agreements 2025**



Notes:
* European Economic Area (EEA) / Overseas Countries and Territories (OCT).
** Free Trade Agreement (FTA), Deep and Comprehensive Free Trade Agreement (DCFTA), Enhanced Partnership and Cooperation Agreement (EPCA), Partnership and Co-operation Agreement with preferential element (PCA).
+ The updated agreements with Tunisia, and Eastern and Southern Africa are currently being updated; the updated agreement with Chile is under ratification. The DCFTA with Georgia does not apply in South Ossetia and Abkhazia.
The designations employed do not imply the expression of any opinion whatsoever on the part of the EU concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitations of its frontiers or boundaries.
Source: European Commission.

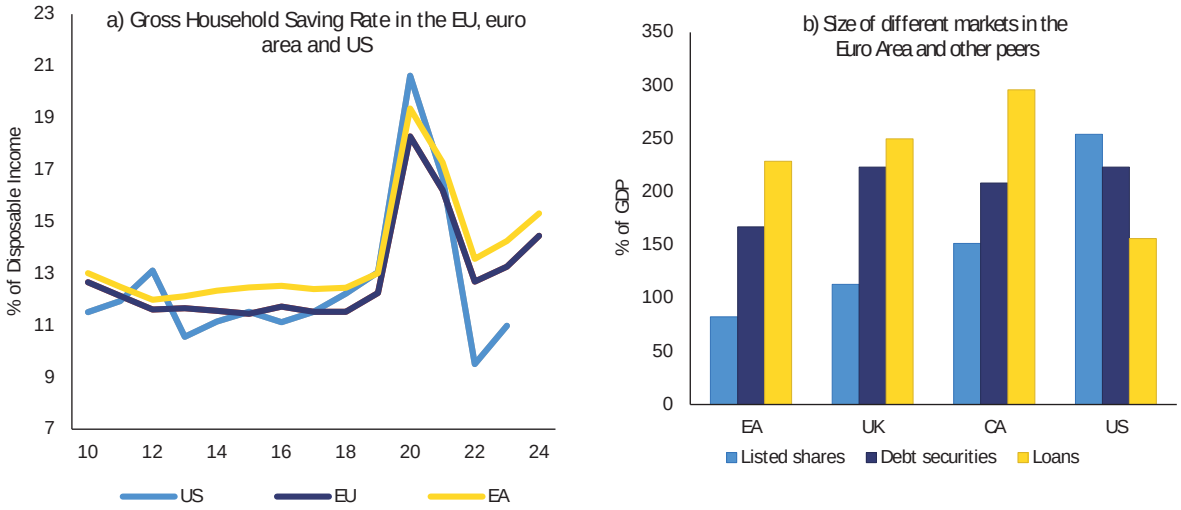
The geopolitical landscape provides additional incentives for the EU to expand and diversify its trade partnerships. The EU's prosperity relies on open trade, cross-border investment, and resilient supply chains. Over the years, the EU has built the largest network of trade agreements in the world, boasting agreements with 76 countries and enjoying 46% of its trade under preferential terms ([29]). In response to the shifting geopolitical environment, the EU is pursuing a multifaceted approach, stabilising its relationship with the US through a new Framework Agreement, while expanding its global trade network through agreements with Mercosur, Mexico, and Indonesia **(Graph 1.14).**

Funding

Europe's abundant savings offer a robust foundation to finance its own priorities. The household savings rate—which in 2014 stood at 14% of disposable income in the EU and 15% in the euro area—shows that Europe is not short of resources to finance investments **(Graph1.15.a)**. However, due to the fragmented financial markets, European savings are often invested abroad **(see Chapter 3)**, rather than in European businesses. By deepening its capital markets, Europe can turn its savings into a strong driver of competitiveness, allowing firms to grow, innovate, and compete globally. Currently, equity accounts for only about 82% of euro area GDP, compared to more than 255% in the US, showing the scope for catching up **(Graph 1.15.b)**. This "listing gap" limits European firms' ability to expand and innovate, while households remain under-represented in capital markets and companies rely on bank-based funding. The Savings and Investment Union (SIU) initiative, launched in 2025, aims to deepen EU capital markets and to channel Europe's savings into productive investments. Key measures include mobilising savings by supporting retail participation in the capital market and incentivising European private and institutional investors to channel funding to productive and innovative firms within Europe.

Innovative financing could bridge the investment gap and accelerate the deployment of strategic technologies. Sector-specific investment funds, supported by EU guarantees from the InvestEU programme and co-financed by Member States, could provide the capital needed for breakthrough technologies with longer development cycles. Additionally, creating incentives for pension funds and insurance companies to invest in European infrastructure and innovation projects would help redirect savings in institutional assets back into the European economy. Finally, the Strategic Technologies for Europe Platform (STEP) was established to bolster critical technologies in three sectors relevant to the green and digital transition: digital technologies and deep technology innovation; clean and resource efficient technologies, and biotechnologies. STEP uses resources across 11 EU funding programme and individual projects can benefit from cumulative funding under several instruments on the EU budget.

Graph 1.15: **Saving rates and market sizes**



Notes: Graph a): 2024 data point for the US is missing; Graph b): 2021 latest data available.
Source: Graph a): European Commission; Graph b): OECD.

The 2028-2034 EU budget offers a strategic opportunity to align capital with Europe's priorities. Compared to the 2021-27 EU budget, the Commission proposal for the 2028-34 Multiannual Financial Framework (MFF) assigns more funding to initiatives aimed at boosting EU competitiveness, research, and innovation, with an envelope of EUR 451 billion. Initiatives such as the European Competitiveness Fund and Horizon Europe, supported by a broader Savings and Investment Union agenda, would ensure that public resources stimulate private investment and help overcome fragmentation in EU financial markets.

Additional avenues to boost long-term growth in the euro area

As the euro area keeps expanding, its economic profile increasingly mirrors that of the EU as a whole. Since its creation, the euro area almost doubled in membership from 11 EU Member States in 1999 to 20 in 2023. It will rise to 21 members from the beginning of 2026 when Bulgaria will adopt the euro. Bulgaria's entry marks a major step toward deeper integration of its economy and society into the Union. The euro has contributed to

strengthen the EU Single Market and boosted the competitiveness of the participating members by removing exchange rate risks and lowering cross-border transaction costs, and by triggering progress in policy and institutional convergence. Today, the euro area accounts for 84.6% of the EU economy and for 11.9% of the world economy**.**

The digital euro can provide a true pan-euro area payments infrastructure. The EU payments landscape is generally vibrant and well developed, however, some of its key segments, such as payments at point of sale and e-commerce, are dominated by a few international card schemes. Given the systemic importance of digital payments in a rapidly digitalising economy, the large dependence of the euro area payments infrastructure on international providers presents a risk for the European strategic autonomy. In recognition of this and following the implementation of the Instant Payments Regulation in the euro area, successful European private payment solutions, both domestic and regional, have recently increased their efforts and investments to ensure their interoperability in order to create a viable alternative to international cards at point of sale. By providing an EU-governed, pan-euro area infrastructure, the digital euro will further reduce this dependence and enable scaling up domestic and regional payment solutions across the euro area. By providing a common, secure and interoperable digital payments infrastructure, it would create the foundation for the development of new business models and innovative financial services, such as conditional payments and integration with digital identity frameworks. This, in turn, would foster a more competitive and innovative European payments ecosystem, facilitate the scaling-up of domestic and regional payment solutions across the Single Market.

Strengthening the international role of the euro offers an important avenue to bolster growth and resilience in the euro area. Since its launch, the euro has been a key international currency widely used for global trade invoicing, financial transactions, and official reserve holdings, second to the U.S. dollar across most metrics ([30]). In recent years, the euro's international role has remained broadly stable (ECB, 2025a), with a share of about 20% in global foreign exchange reserves and 25% in foreign currency-denominated debt (bonds and loans). Its use in invoicing the euro area exports has remained robust—around 59%—though less so for imports (51.8%).

The euro's international standing reflects both underlying strengths and persistent limitations. The euro area meets many conditions associated with an internationally successful currency: it is one of the largest global economic and trading blocs, maintains a track record of price stability, and benefits from the credibility of a strong and independent central bank. However, its potential to expand its global role is held back by institutional fragmentation—particularly the absence of a unified issuance of sovereign debt and limited progress on capital markets integration. The lack of common defence capabilities also plays a role.

A stronger international euro would contribute to Europe's influence in a changing world. Greater global demand for euro-denominated assets would raise seigniorage revenues and foster deeper, more liquid European financial markets, reducing dependence on non-EU institutions. This would lower borrowing costs for euro area governments and firms, expanding fiscal space and supporting investment. An expanded use of the euro in trade, including commodities, would cut exchange-rate risk for European exporters and importers. Strategically, reducing reliance on third-country financial infrastructures would

strengthen monetary sovereignty and, in turn, foster a wider international use (see also above on the digital euro). It would enhance the EU's capacity to project influence globally, from enforcing sanctions regimes to structuring international financial assistance. In an era of geopolitical fragmentation and weaponised finance, reinforcing the euro's global standing is therefore central to Europe's strategic autonomy and soft-power influence**.**

Recent shifts in the global monetary system create new opportunities for the euro. The gradual move towards a more multipolar system - driven by heightened geopolitical fragmentation, concerns over U.S. policies, and declining demand for U.S. Treasuries - could open space for the euro to play a more prominent role **(see Chapter 3).** While the international role of a currency is market-driven and cannot be shaped by a single measure, targeted policies may play an important role in fostering the conditions that make a currency more attractive. In absence of a single euro area sovereign issuer, other policy levers remain available to enhance euro's attractiveness. Building a strong Investment and Savings Union, through a deeper Capital Markets Union and a completed Banking Union can improve the integration, scale, and efficiency of European financial markets, facilitating cross-border investment and strengthening the euro's financial ecosystem. Enhancing the role of the euro in strategic sectors such as energy and other commodities, and emerging-market finance—through trade agreements or investment partnerships—can also increase its international use. Finally, continuing with the enlargement of the euro area would further strengthen the currency's international standing by deepening its economic and financial base, expanding the pool of euro-denominated assets.

While further internationalisation of the euro brings advantages, it also entails specific costs and responsibilities. More specifically, a greater global role for the euro increases the expectation that the Eurosystem will have a responsibility and obligation in contributing to international financial stability, particularly in times of crisis. This includes providing euro liquidity to non-euro area countries through instruments such as swap lines and repurchase agreements. Moreover, rising global demand for euro-denominated assets may lead to currency appreciation, which could weigh on the European competitiveness. Another risk is the so-called external constraint: increased exposure to volatile capital flows and speculative pressures, which could limit the ECB's monetary policy autonomy. While the size and credibility of the euro area mitigate these risks to some extent, they nonetheless require careful institutional and policy coordination (Kenen, 2011; Tokarski, 2024).

2. MACRO FINANCIAL RISKS

This chapter looks at how the EU's economic vulnerabilities have been developing over the last year and presents their outlook for the near future. It is a complement to the analysis undertaken under the EU's Macroeconomic Imbalance Procedure (MIP) and looks at overall economic developments that frame the country-focused analysis under the MIP. It considers both long-standing vulnerabilities and how they have developed, and new developments that could have consequences for economic growth or macro-financial stability in the future. It should not be read as a central scenario for the EU or the euro area; instead, its focus is on risks and developments that may merit a policy response, or closer surveillance.

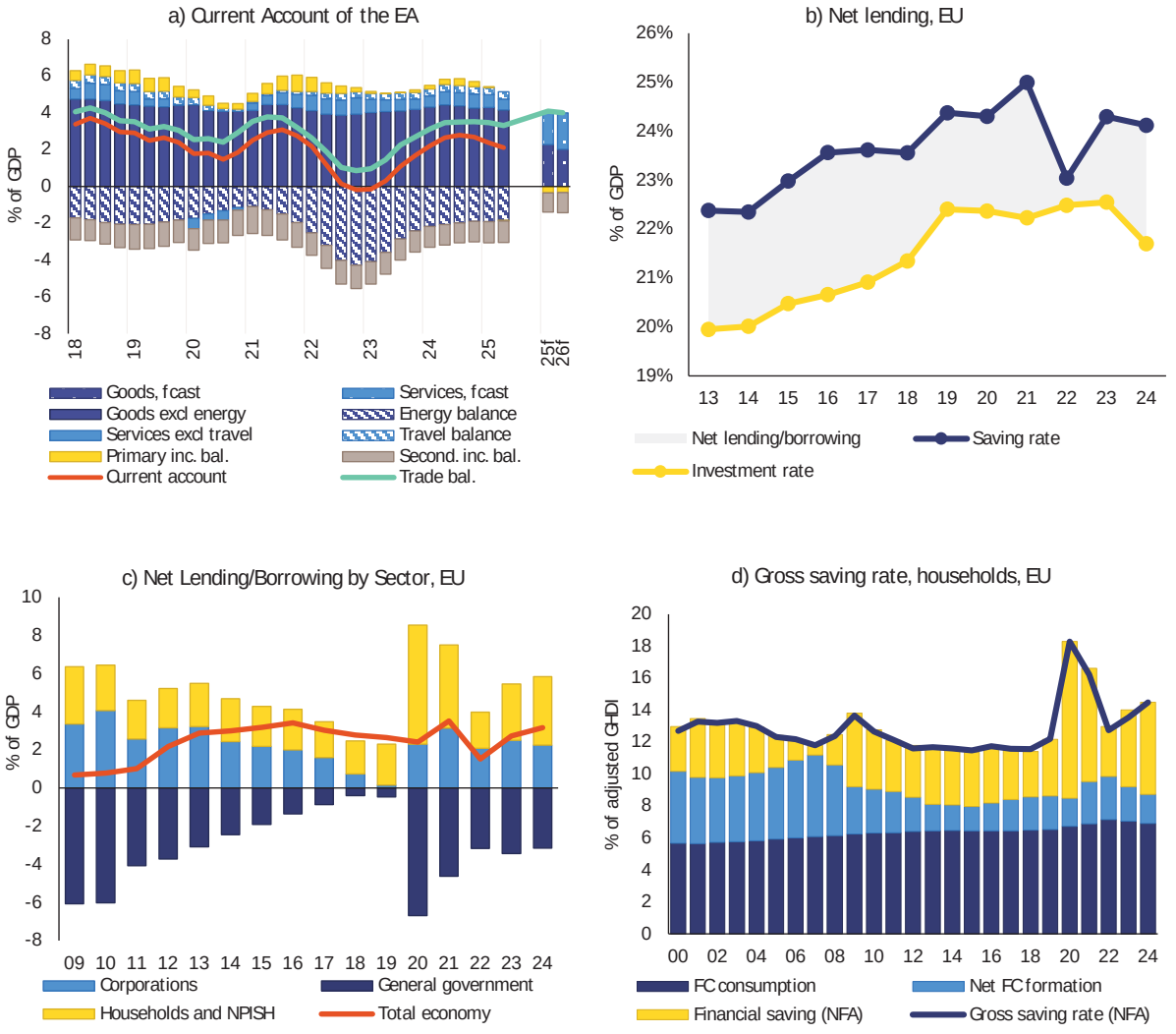
The EU's savings-investment imbalance limits the Union's growth potential

The euro area and the EU have long run an external surplus, reflecting an excess of savings over investment. The EA/EU's current account surplus—which corresponds to the differences between domestic savings and investment—rose to close to 2¾% of GDP in 2024 **(Graph 2.1.a)**. This increase in 2024 is the result of falling investment alongside stable saving rates, as shown in **Graph 2.1.b**. The current account surplus has however declined relative to its pre-pandemic level and is expected to reduce somewhat further in 2025. While the Union's relatively high income, ageing population and specialisation in manufacturing are consistent with running a current account surplus, its level remains higher than the long-term balance implied by economic fundamentals. The latter point to a current account of 0.7% of GDP in 2024, thereby implying an excess of current account of around 2 pps. of GDP ([1]).

The household sector is the main contributor to economy-wide savings in the EA/EU, and its contribution has been rising. As shown in **Graph 2.1.c** the private sector is the main contributor to the overall surplus of the EU economy. Household savings have increased since about 2018 and were again the factor behind the increase of the EU current account surplus in 2024. During the pandemic, excess household savings—both forced and for precautionary reasons—resulted in a sharp rise in the household saving rate **(Graph 2.1.d)**. The accumulated savings did not flow into substantially higher spending after the pandemic. While the saving rate fell over 2021 and 2022, it remained above its pre-pandemic level and has been rising again since 2023, as consumption growth lagged income growth. The persistently high household saving rate seems to be the result of both temporary factors, such as inflation and the related price uncertainty, interest rates, and weak economic sentiment, and structural factors, such as rising real incomes, house prices, an ageing population, and shrinking shadow economies. Chapter 3 elaborates on the accumulation and allocation of EU savings.

The recent fall in investment is driven by a reduction in corporate investment, accompanied by weak corporate borrowing. The reduction in overall investment in 2024 is in part due to the continued normalisation of inventories, but it also reflects muted sentiment in industry and a fall in private sector investment. Since 2019, corporate investment has fallen as a share of gross value added, and real investment shrunk in 2024. Manufacturing and construction have been particularly weak. Firms' borrowing and investment decisions have been affected by the uncertainty that started at the time of the pandemic and by the subsequent increase in financing costs **(see also Box 2.1)** ([2]). This low investment has been accompanied by weak credit growth, which declined below pre-pandemic trends in 2023 and 2024 following the increase in lending rates. Recent data show the first signs of recovery at the beginning of 2025; bank loan flows to corporates have started to increase again but remain below their pre-pandemic levels.

Graph 2.1:**Current account in the euro area and net lending in the EU**



Source: Eurostat and European Commission forecasts and calculations.

The low investment that underlies the current account surplus limits economic growth over time. Current account surpluses mean that savings are invested elsewhere instead of being used to finance domestic investment. Chapter 3 sheds light on the destination of financial flows from the EU, showing how household savings are routed to investments

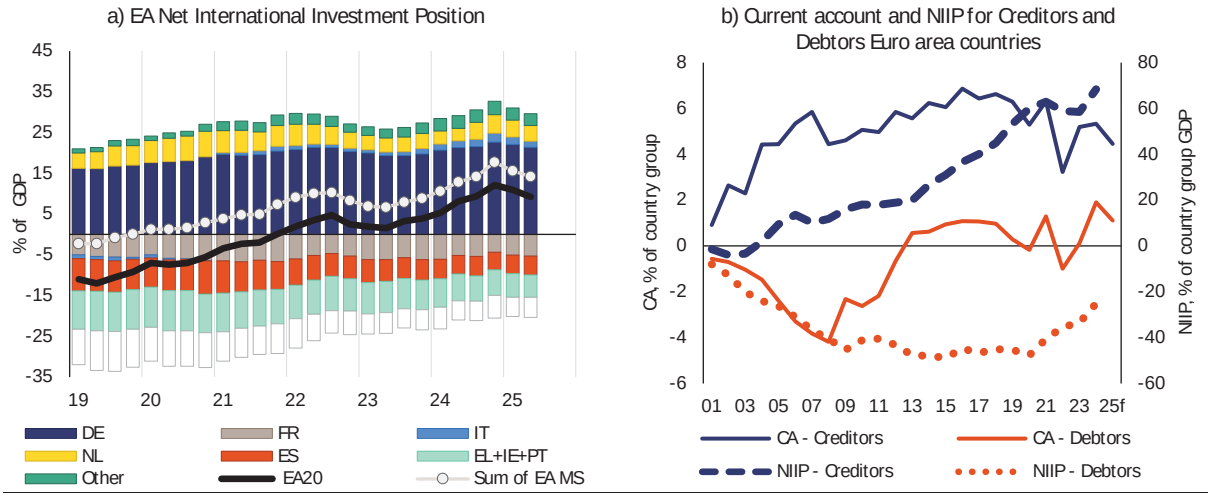
abroad. Low investment at home linked to various bottlenecks, limits the EA's/EU's growth potential. As a result, the financing for the massive investments needed to enable European firms to adjust to new trading relations following changes to the world's geoeconomic setup is reduced ([3]). The Draghi report on The Future of European Competitiveness assessed that improving Europe's competitiveness and achieving the digital, social and sustainable transitions would require investments amounting to around EUR 750-800 bn per year by 2030 (around 4.5% of EU GDP). Additional investments are needed to improve the EU's defence capabilities.

The stock of assets held abroad is a source of vulnerability to external developments. Due its current account surpluses, the EA/EU has been accumulating assets abroad, which are reflected in a positive and growing net international position (NIIP). These assets are subject to risks, including from trade disruptions and trade policy uncertainty, which may interplay with and compound the possible reaction by financial markets. Initiatives to relocate some production capacities to the US may result in outflows of direct investment and affect economic activity in the most exposed countries, such as Ireland. A further, general escalation of trade tensions could result in a rerouting of existing trade linkages and have strong effects on assets and investments held abroad. A diversion of capital flows resulting from weaning off the dollar as a safe-haven asset is a possibility. This could lead to augmented capital inflows into the EA/EU. In that case, it is also important that such capital goes into productive investment.

Within the EU, external developments differ across countries and some rebalancing between debtor and creditor countries has occurred. There are large differences in the net positions and current accounts of EU countries **(Graph 2.2)**. In 2024, the gap between creditor and debtor countries in terms of current accounts and NIIPs ([4]) has narrowed somewhat, delivering some rebalancing **(Graph 2.2.b)**. In the case of the NIIP-to-GDP ratios, nominal GDP growth has been the main driver behind the narrowing gap between creditor and debtor countries, as EU countries with large negative NIIPs have grown more quickly than those with positive NIIPs, with favourable terms of trade also playing a role ([5]). However, the persistent gap in current account balances is set to drive the stock positions further apart, as nominal GDP growth is expected to slow from 2025 on.

Large differences in external positions across the euro area call for coordination as well as differentiation of economic policies due to the different needs and vulnerabilities of creditor and debtor countries. Some countries are running current account deficits of up to some 8% of GDP like Cyprus or 6% of GDP like Greece or Slovakia, while others are running large current account surplus of up to 9% of GDP in the case of the Netherlands and 5% of GDP in Germany. Countries with significant deficits can face risks if there is a change in market sentiment and hence need to reduce their borrowing needs. At the same time, reducing those deficits is undermined by the presence of surpluses, particularly within the euro area. Taming demand is often needed to correct large current account deficits, while policies stimulating domestic demand, particularly investment, are needed to rebalance the large saving-investment discrepancies in creditor countries.

Graph 2.2: **Current account and NIIP across EU countries**

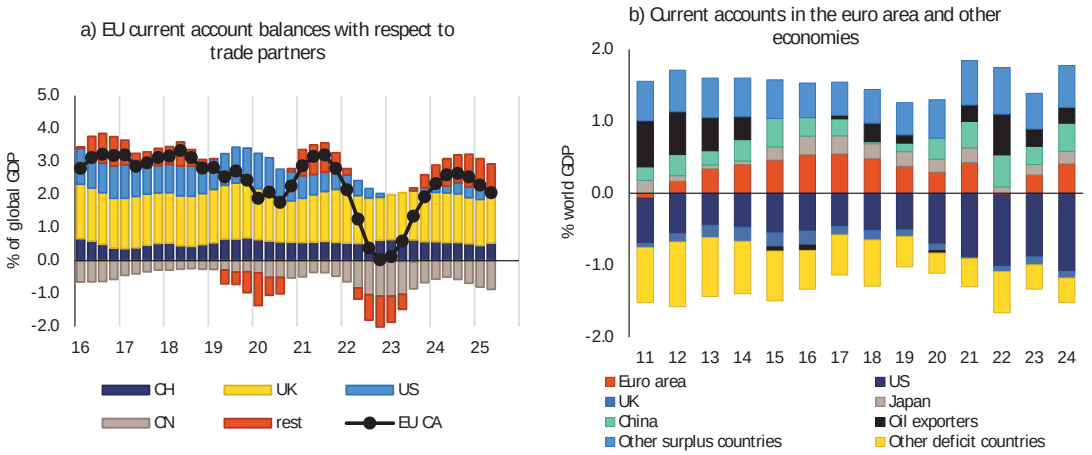


Source: Eurostat and European Commission forecasts and calculations.

The bilateral trade and income exposures of the EU have slightly changed over the past decade. The EU has maintained stable surpluses with Switzerland and the United Kingdom **(Graph 2.3.a)**. Trade intensity between the EU and United Kingdom has fallen since the United Kingdom's withdrawal from the EU, with the trade in goods between the two being some 20% lower in 2024 compared to 2019, but the trade balance does not seem to have visibly changed. The EU's previously large surpluses with respect to the United States have fallen considerably since 2022 given the increasing EU deficit in services trade, while the deficit with China has increased noticeably since mid-2024 **(Graph 2.3.a)**. In particular, in 2025, EU imports from China have expanded at elevated rates amid falling import prices **(see Box 1.1)**. The EU's current account balance with the rest of its trading partners is also strongly affected by energy prices.

The developments in the EU's external position take place against the broader context of increased global external imbalances and shifts in trade policy. Global external imbalances—as defined by the IMF and measured as the sum of the absolute value of individual countries' or trading blocks' current account surpluses and deficits—rose over the last year and have become a key topic in the global economic policy agenda. The surpluses of the EU, China and Japan all increased in 2024 **(Graph 2.3.b)**. This partly reflects weak domestic demand, particularly in China, whose surplus has recently increased faster than the EU's. In fact, the EU's contribution to global surpluses has declined relative to a decade ago, and the EU surplus is even forecast to recede somewhat in 2025, whereas China's surplus accounts for most of the widening in the global current account balances ([6]). The main contributor to the global current account deficit is the US, accounting for around three quarters of the global current account deficit in 2024. The US current account deficit has doubled over the past five years, mainly due to strong domestic demand fuelled by large fiscal deficits, and widened further in 2024.

Graph 2.3:**EU current account and current account in the euro area and other large world economies**



Source: Eurostat and European Commission calculations.

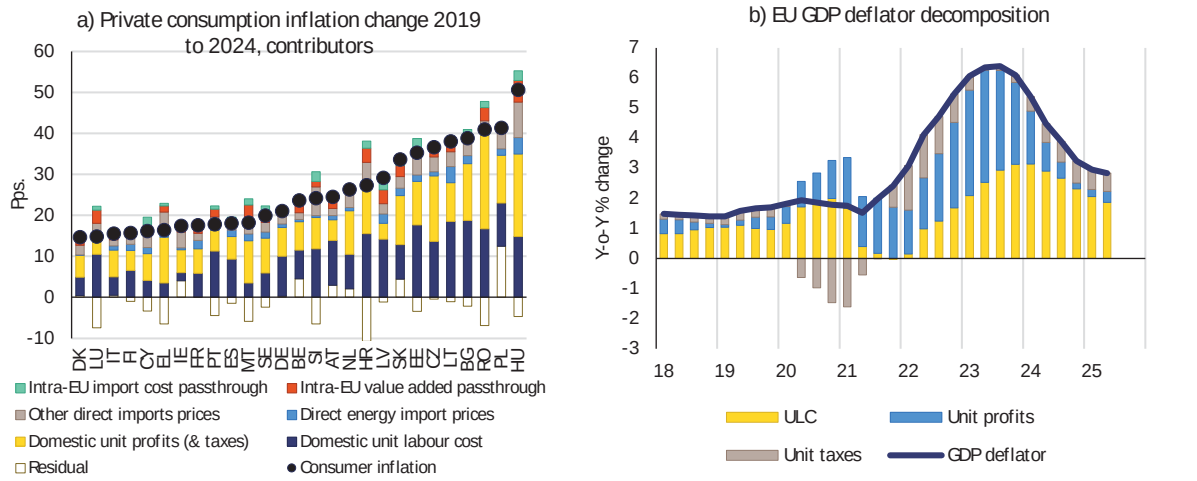
The inflationary period of recent years leaves behind cost competitiveness challenges for many EU countries

The recent inflationary period was sparked by the rise of energy prices, but domestic factors became the main drivers since 2023. Inflation rose with the re-opening of the economies following the pandemic. Although the commodities price shock following the start of Russia's war of aggression against Ukraine triggered its acceleration in 2022, the main overall contributor to inflation over the last five years have been domestic wages and profits. An input-output decomposition traces the effect that unit labour cost (ULC) and unit profit increases had on different prices, by following how increased input costs feed their way through the EU's economies ([7]). It shows that ULC and unit profit increases contributed almost three quarters of the total increase in prices for the EU countries over the period 2020 to 2024 **(Graph 2.4.a)**. Despite the marked surges in prices in 2022, the overall impact of energy and other import prices was smaller, not least because there was stabilisation or reduction in those prices in 2023 and 2024. The analysis shows also that these increases in value added (wages and profits) were passed through to inflation in other Member States; most notably, increases originating in other Member States accounted for increases in prices of more than 3 pps. in some central and eastern European countries since 2020 **(Graph 2.4.b)**.

Wage growth has contributed to recovering purchasing power, but, in the absence of offsetting productivity gains, leads to marked increases in unit labour costs. Over the years 2020 to 2024, the largest contribution to GDP deflator growth came from ULCs, but it was closely followed by unit profits **(Graph 2.4.b)**. Wages have increased strongly in nominal terms since 2022, supporting the recovery of purchasing power ([8]). In 2024, wages almost closed the gap in real terms with their 2019 levels. More recently, as signs of slack have started to appear in the labour market, wage growth has eased somewhat but continued to represent the main contributor to GDP deflator growth. Wage increases remain very high especially in Hungary, Poland, Bulgaria and Croatia, further compounding price pressures. The rise in wages has resulted in large increases in ULCs, as they have not been offset

sufficiently by productivity gains. Instead, in some countries, productivity growth was negative, compounding the impact of wage growth on labour costs. Over the forecast period however, the productivity gains are expected to slightly improve. Overall ULCs have increased by close to 20% in the EA and the EU, and over 50% in some central and eastern European countries over the last five years **(Graph 2.5.a)**. While unit profits also contributed substantially to the deflator over 2022 and 2023, over the course of 2024 they clearly slowed their growth, easing their impact on inflation. However, if continued for long, this may leave firms with less ability to absorb higher costs and hinder companies' abilities to finance investments from own resources.

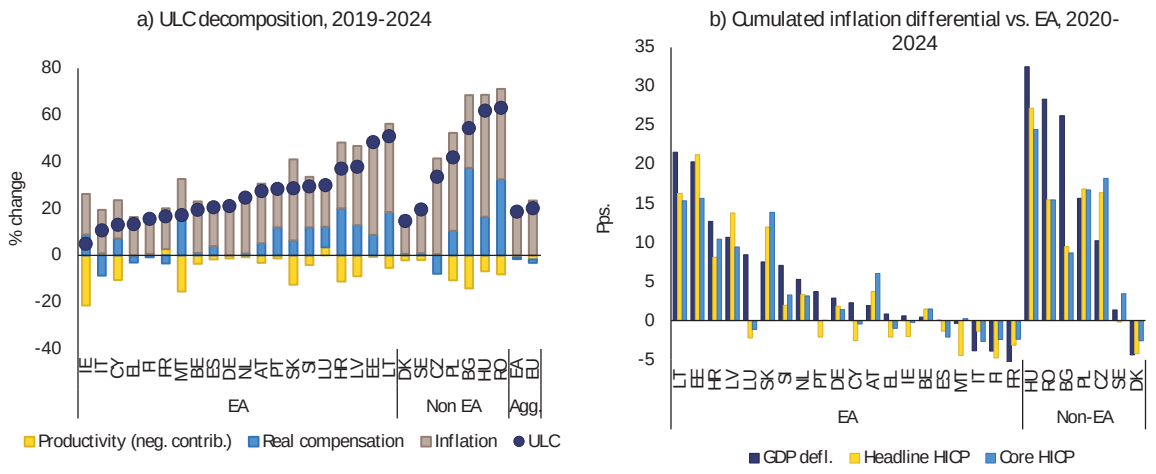
Graph 2.4:**Decomposition of HICP inflation in the euro area and of GDP deflator in the EU**



Source: Eurostat and European Commission calculations.

While inflation has fallen, differentials in cost and price developments between EU countries persist, adding to cumulated differences. Since the start of the inflationary period, differential inflation rates have resulted in the accumulation of large differences in prices and costs **(Graph 2.5.b)**. While disinflation has progressed and the euro area inflation has recently been approaching the inflation target, for some of the countries with the largest increases over these years, inflation remains high and is forecast to remain above the EU average, compounding further the total price rises and the differentials vis-à-vis the other euro area and EU countries. This is especially the case for Romania, where headline inflation is expected to average 6.7% in 2025, and Estonia, Slovakia, and Hungary with inflation higher than 4%. Continued significant inflation differentials are a particular concern within the euro area, as they can undermine the effectiveness of the area-wide common monetary policy.

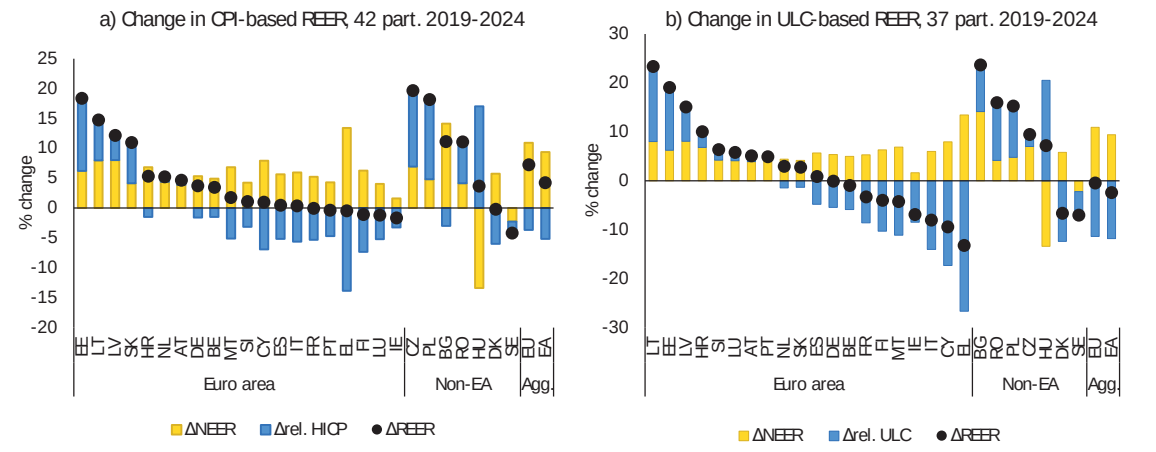
Graph 2.5:**Decompositions of ULC growth and cumulated inflation differentials in EU countries**



Source: Eurostat and European Commission calculations.

Rapid inflation in some countries was compounded by nominal exchange rate appreciation, leading to sharper real appreciations. The appreciation of the euro is the other side of the coin to the depreciation of the USD since early 2025 and especially since April. Overall, nominal exchange rate appreciation has led to an increase in the euro area's HICP-based real effective exchange rate (REER) of more than 7% since 2019, despite relatively lower inflation than in main trading partners. The impact of the euro appreciation is different across euro area members on account of different trade exposures and economic structures. With the exception of the Swedish krona and the Hungarian forint, all other EU currencies appreciated too, in some cases quite strongly. For cases such as the Baltic countries, Slovakia, Czechia, Poland, Romania, and Hungary, inflation differentials contributed to the strong REER appreciations; in most other countries, inflation lower than in trading partners at least partly tempered the REER appreciation **(Graph 2.6.a)**. More substantial intra-EU differences are evident when looking at REERs benchmarked by ULCs **(Graph 2.6.b)**. In particular, in the Baltic countries, Romania, Bulgaria, and Poland, the REERs appreciated by over 15%, despite staying constant in the EU as a whole.

Graph 2.6:**Real effective changes rates in the EU**

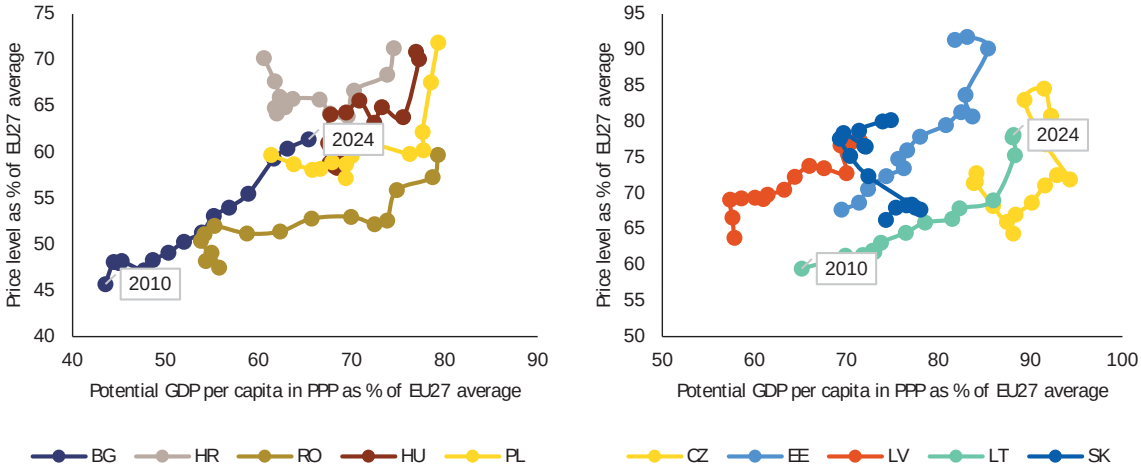


Source: Eurostat and European Commission calculations.

Recent cost-competitiveness dynamics can have implications for macroeconomic performance and stability. Over time, high price and cost levels and widening differentials can put pressure on the external sector, requiring adjustments through exchange rates outside of the euro area and/or through the more painful channel of internal devaluation. So far there has been some deterioration in export performance for a number of EU countries—particularly for Belgium, Germany, and Luxembourg, and Finland—but these are not the ones that have exhibited the highest cost-competitiveness deteriorations. Over the past five years, the economic backdrop has been very volatile, making it difficult to trace the impact of deteriorating cost-competitiveness positions on the external sector and at the macro level, as the overall picture is distorted by denominator effects, terms of trade, and other non-cost competitiveness factors ([9]). Moreover, global trade has clearly grown more slowly in recent years, also on the back of geopolitical fragmentation, after earlier decades of strong expansion, and that weakness is particularly sharper in manufacturing goods, while services exports have held up better. Nevertheless, the impact may be seen on a longer-term horizon and if risks do materialise, difficult adjustments will be required. The imposition of US tariffs can lead to further pressures, further harming the price competitiveness of particular industries and countries.

Several Member States with very high inflation have experienced some stalling of their economic convergence. The EU countries with the highest price and cost increases over the last five years are those in central and eastern Europe **(Graph 2.5.b)** ([10]). These countries displayed higher-than-average price growth already before the current inflationary period, which can be explained by their economies' convergence to higher levels of income. As **Graph 2.7** shows, all these countries are better off in terms of GDP/capita in PPP in 2024 than in 2005, with the strongest progress occurring in those with the lowest starting points. However, since 2020, economic convergence has stalled in Czechia and Estonia, and only marginally advanced in Latvia, while price and cost increases have accelerated. In these countries, economic convergence does not appear to be a plausible factor behind the recent strong cost and price wage dynamics. Conversely, the rising cost and price dynamics could be a factor in stalling the convergence and hampering competitiveness and may make it more difficult for these countries to return to a converging path.

Graph 2.7: **Price level versus potential GDP per capita, in central and eastern European Member States**

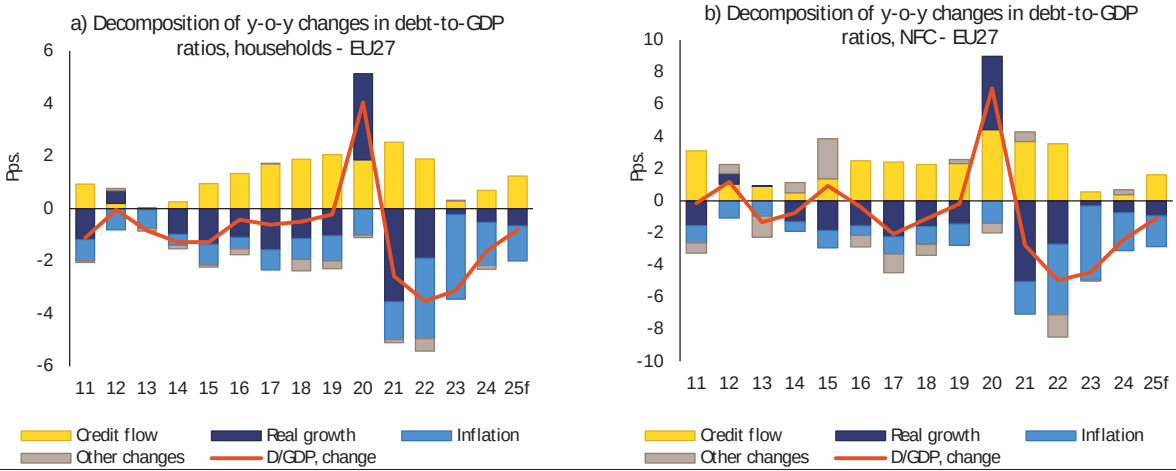


Source: Eurostat and European Commission forecasts and calculations.

The overall indebtedness of EU countries has been falling, reducing risks, but increased average borrowing costs are a challenge for governments

Despite some reduction in recent years, private debt ratios remain elevated in the EA and EU. Both household and corporate debt ratios have fallen every year since 2021, driven by both high nominal GDP growth acting on the denominator and by muted credit flows in the context of rising financing costs **(Graph 2.8)**. The EU average household debt-to-GDP ratio has decreased from 58% in 2021 to 50% in 2024, while the NFC debt-to-GDP ratio has dropped from 83% in 2021 to 72% in 2024. Going forward, the recovery in credit flows and lower nominal GDP growth will provide less support to the deleveraging of the private sector.

Graph 2.8: **Decomposition of changes in private debt**

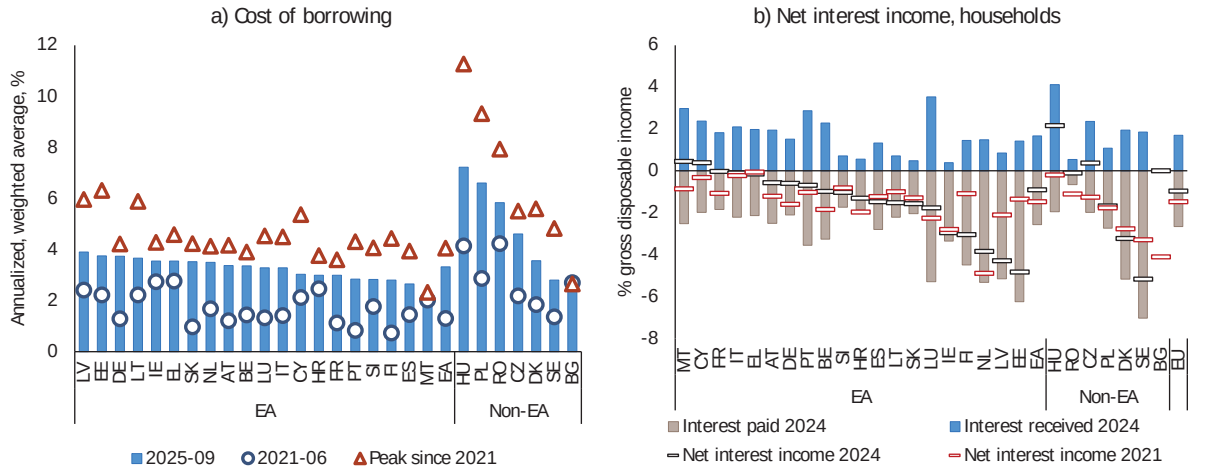


Source: Eurostat and European Commission calculations.

Households have recorded rising incomes and an increase in financial assets, on top of receding debts, supporting their ability to service higher interest rates. The fall in household debt has been compounded by an increased ability of households on average to service their debt, despite higher interest rates. In 2024, the real value of households' financial assets exceeded its pre-pandemic level, while financial liabilities have dropped by around 7% in real terms since 2019. In addition to an improving net financial asset position, households also benefited lately from robust growth in real disposable income. At the same time, in several countries interest rates on new loans remain close to their peak values **(Graph 2.9.a)**, following the overall rise in interest rates, and in some countries with predominantly fixed rate mortgages, interest rates on outstanding loans continue to increase. However, EU household balance sheets remain overall robust. The household sector on aggregate has a positive net position on interest-bearing instruments, such that similar changes in interest rates on deposits and loans have an overall small but positive contribution to disposable income **(Graph 2.9.b)**.

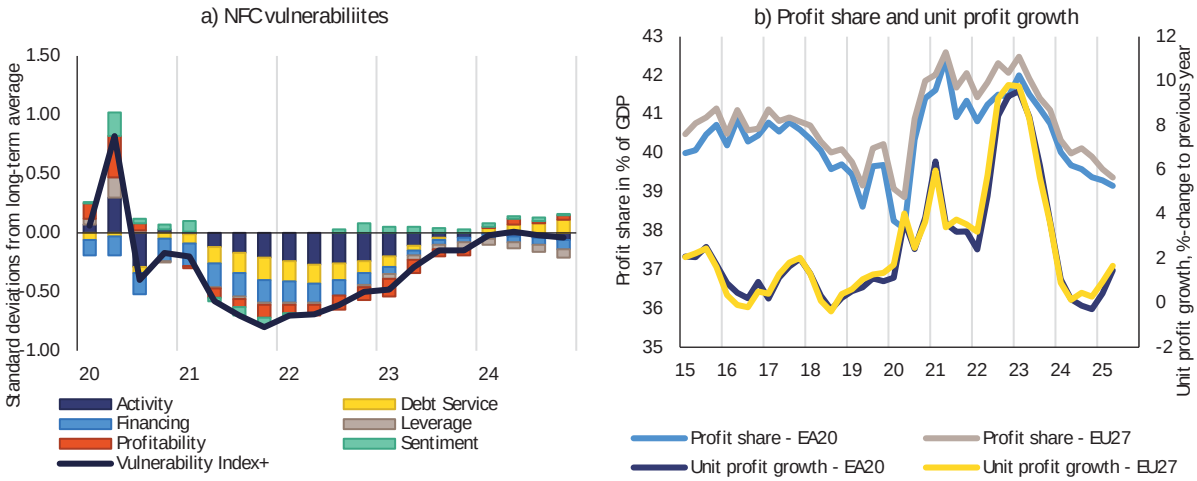
Corporate profitability and debt service capacity have fallen, but very recently there are signs of an impending recovery. Although corporate indebtedness fell in 2024, corporate vulnerabilities increased as firms' abilities to service their debt declined **(Graph 2.10.a)**. Over 2024, corporate savings fell and firms' interest coverage ratios ([11]) continued to decline, in part due to the fall in profits which took place over 2023 and 2024 after some years of above-average profits **(Graph 2.10.b)**. In addition, firms have been using up their cash reserves which they had accumulated during the pandemic and the high-profit period immediately after the pandemic, and their buffers have fallen. However, very recently there are indications that a turning point may have been reached. Data from early 2025 show a small rise in unit profits as well as an increase in economic activity and firm sentiment. Borrowing costs started to decrease from their post-pandemic peak in late 2023 and early 2024, indicating an improvement in debt service capacity in the near future. Although these point to a potential recovery of the corporate sector, it should not be taken as a given yet.

Graph 2.9: **Household finances: cost of borrowing and net interest income**



Source: ECB, Eurostat and European Commission calculations.

Graph 2.10: **Non-financial corporations finances: evolution of profits and vulnerabilities**

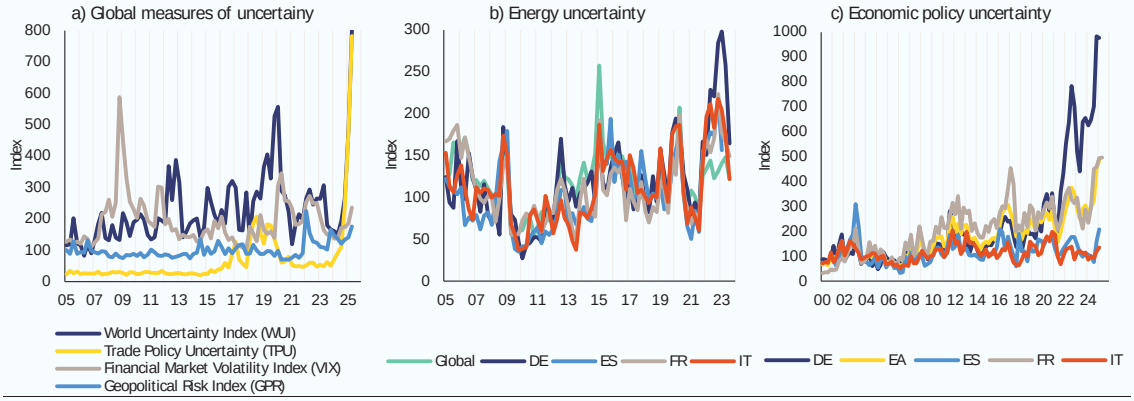


Source: Eurostat, ECB, and European Commission calculations.

Box 2.1: **Economic uncertainty and the corporate sector**

At present, European firms are navigating a landscape marred by heightened uncertainty. The current geo-economic situation creates a complex environment for firms. Uncertainty can stem from various global and local sources. Graphs 1.a, b and c present a number of different measures, covering economic uncertainty, investor and financial market uncertainty, energy uncertainty and economic policy uncertainty ([1]). While they all show a recent rise in uncertainty, economic policy uncertainty stands out as being particularly high by historical comparison. Empirical studies show that firms respond to increased uncertainty by reducing borrowing and investment, in line with what has been observed across the EU ([2]). The high readings across these measures of uncertainty suggest that even though there are now the first signs of recovery in corporate borrowing, the risks are tilted to the downside and the recovery may be short-lived.

Graph 1: **Measures of uncertainty**



(1) Last observation: Panels (a) and (c) 25Q2, panel (b) 23Q3.
Source: Economic Policy Uncertainty Index

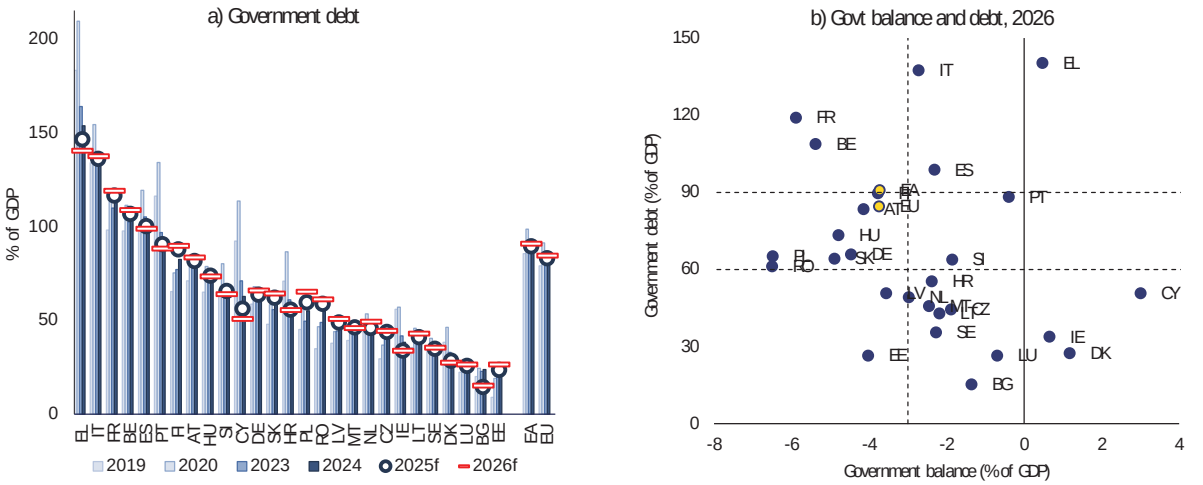
([1]) The World Uncertainty Index (WUI) gauges global economic uncertainty based on news data and is constructed by analysing the frequency of the word "uncertainty" (and its variants) in reports from the Economist Intelligence Unit. See Bloom and Furceri (2022). The financial market volatility index (VIX) reflects investor sentiment and financial market volatility and is constructed based on the 30-day expected volatility of the US stock market (Chicago Board Options). The Geopolitical Risk Index is based on Caldara and Iacoviello (2022a). Energy uncertainty indices are computed as the mean of economic uncertainty akin to the approach for the WUI and energy-related indices using energy-related keywords. See Dang et al. (2023). The Economic Policy Uncertainty index captures uncertainty arising from changes in economic policies. See Baker et al (2016).

([2]) See for example: (i) Londono et al. (2025); (ii) Gulen and Ion (2016); (iii) Julio and Yook (2012); (iv) ECB (2025b); (v) Caldara et al. (2020); (vi) Jurado et al. (2015); (vii) Caldara and Iacoviello (2022b); (viii) Correa et al. (2023); (ix) Kim, Lee and Lim (2023).

Government debt dynamics are becoming more challenging, as the favourable differentials between interest rates and nominal GDP growth of recent years are vanishing. Government debt—which remains high and above its 2019 levels in the EA and the EU—has been declining visibly in recent years, supported by high nominal GDP growth, despite persistent government deficits **(Graph 2.11.a)**. This is now ending, and debt ratios are forecast to rise again in most Member States, and for the EA and the EU as a whole. This is mainly because the difference between interest rates and nominal GDP growth rates is narrowing, or even turning positive in some countries, resulting in an unfavourable snowball effect. In the coming years, governments' budgetary positions will be the main driver of changes in debt-to-GDP ratios. For several countries, including some where debt currently exceeds 60% or even 90% of GDP, budget deficits are expected to remain large in 2026

based on currently legislated measures, which would lead to a further increase in debt **(Graph 2.11.b)**.

Graph 2.11: **Government finances**



Source: Eurostat and European Commission forecasts and calculations.

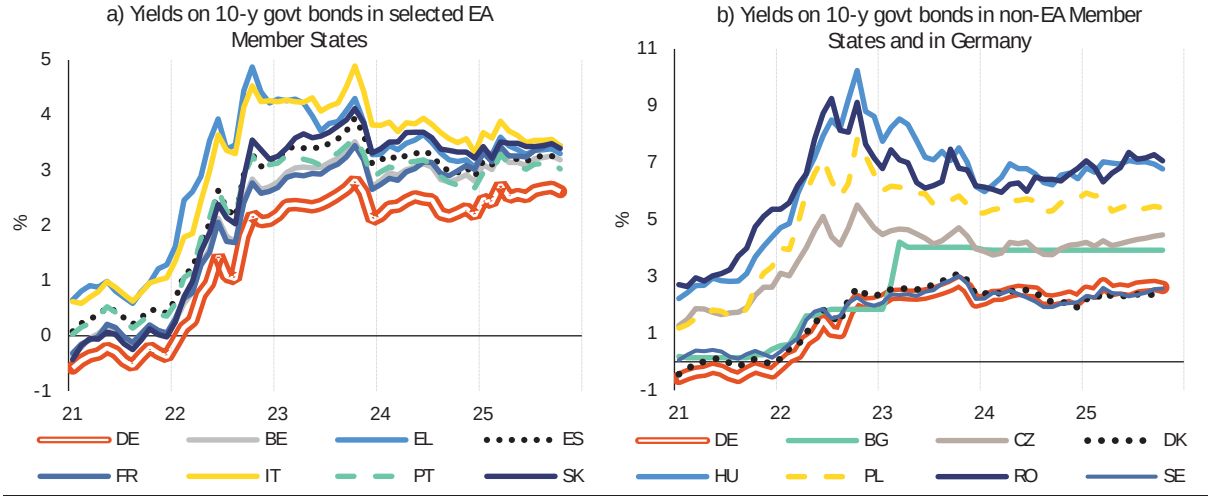
There is mounting pressure on the spending side of government budgets from different sources. As a follow-up to the ReArm Europe Plan/Readiness 2030 initiative, Member States will have to achieve and sustain higher defence spending amid a deteriorating geo-political context. Currently, 16 Member States benefit from flexibility under the national escape clause to help this move towards increased spending on defence up to 2028, while safeguarding fiscal sustainability. In addition, the transition towards a digital and decarbonised economy requires significant additional investment, including from the government sector. Finally, there are adverse underlying trends for public expenditure in the areas of old-age pensions, health care and long-term care due to population ageing. In that respect, the latest Ageing Report projects that, while the average increase in total age-related expenditure may be limited to 0.2 pps. of GDP from 2022 to 2030 for the EU as a whole, for some Member States the cost of ageing would increase by 1 to 3 pps. of GDP. Over the following decade (2030-2040), age-related spending for the EU as a whole is projected to rise by another 0.6 pps. of GDP (European Commission, 2024a).

Medium-term fiscal strategies will be needed to address these spending pressures while delivering on the required adjustment to secure debt sustainability. Under the new European economic governance framework, Member States have been set country-specific maximum growth rates for net expenditure for the coming years, geared towards the achievement of debt sustainability and taking into account the projected cost of ageing ([12]). However, in many Member States, accommodating the additional spending pressures mentioned above may require a higher consolidation effort than implied by these paths. Significant and competing spending needs demand a strong prioritisation and a reappraisal of the quality of public finances. The way forward would have to reflect each country's situation and preferences and could include action to rationalise spending programmes and mobilise revenue. Depending on its composition, the fiscal adjustment may impact economic activity and price developments, leading to a reduction in demand. This highlights the importance of reforms to boost productivity and growth.

Long-term yields for euro area governments have been volatile in 2025, with some increases for the best rated debt issuers. EU countries facing high debt, high deficits and/or short debt maturities typically have high gross financing needs and are more exposed to risks stemming from financial conditions. In early 2025, long-term interest rates increased somewhat for Germany, the best rated sovereign debt issuer in the euro area, and to a lesser extent for the other euro area governments, resulting in a narrowing of sovereign spreads within the euro area **(Graph 2.12.a)**. The narrowing has been marginal or even non-existent for countries with high debt ratios and high deficits, in particular France, Belgium, and Finland. However, these overall benign developments should not be taken for granted, and negative developments in yields in large countries, including outside the EU, could spill over across developed economies and to private sector borrowers too (IMF, 2024b).

For the EU countries outside the euro area, sovereign yields, which were already high, have typically increased somewhat since mid and late last year. For the Member States with lower ratings on their sovereign debt, especially Hungary and Romania, yields on long-term government bonds and spreads vis-à-vis the best rated debt of the euro area have increased somewhat further in 2024 and 2025 **(Graph 2.12.b)**. On the contrary, Poland has recorded slightly lower spreads on long-term government bonds. These three countries face additional risks as relatively large shares of their government debt are denominated in foreign currencies, meaning that borrowing costs may be impacted by variations in exchange rates, which are more likely the larger the external adjustment needs, which is especially the case of Romania.

Graph 2.12: **Yields in 10-year government bonds**



Source: Eurostat.

The banking sector is resilient, but the non-bank financial sector has been expanding in recent years and could be a source of vulnerability

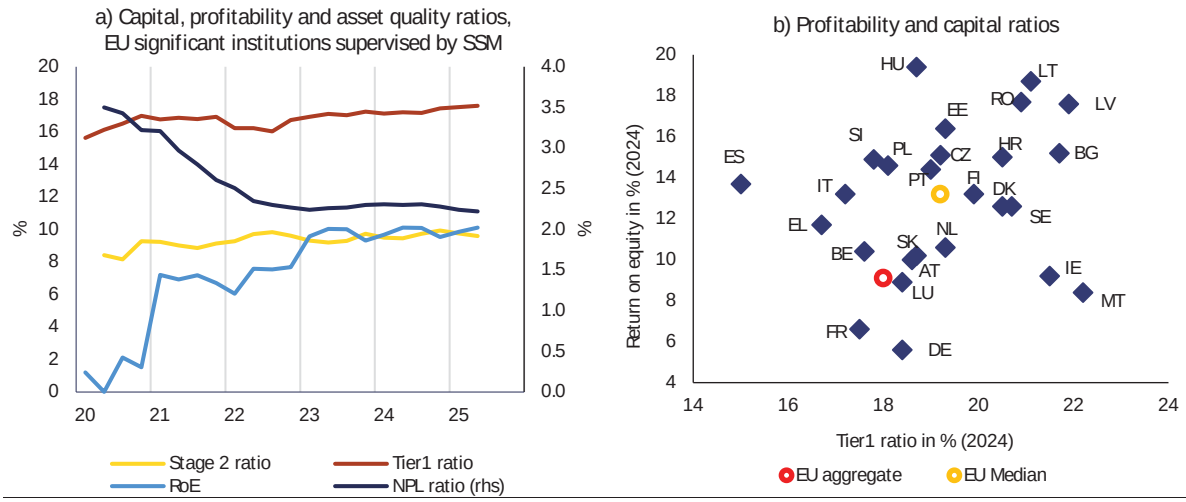
The EA and EU banking sector has remained resilient, maintaining high profitability and strong capital ratios, although a small deterioration of asset quality may be underway. The aggregate return on equity of EA and EU credit institutions remained high in

2024 and 2025, as higher fees and commissions compensated for lower interest margins, and the common equity Tier-1 ratio of EA/EU credit institutions stabilised at high levels **(Graph 2.13)**. The asset quality of EA/EU banks has been stable, although some small deterioration may be underway. The aggregate non-performing loan (NPL) ratio of EA/EU credit institutions increased only marginally over 2024 and remains low (1.9%). NPL increases were concentrated in countries with low levels of NPLs, while NPL ratios decreased in countries with higher legacy NPLs. The share of stage 2 loans slightly increased in the past four years, but banks reported a slight decrease in the first half of 2025.

Exposures to real estate and sovereigns remain a source of vulnerability. Banking systems in some EU countries are significantly exposed to real estate with mortgages representing almost 50% of banks' assets. The high exposure of the banking sector to domestic sovereign debt remains another standing issue, as it increases risks of feedback loops in countries that are highly indebted or rely on foreign currency funding. Non-bank financial institutions, namely insurers and pension funds, also have major exposures to CRE and sovereign debt, which may create additional contagion risks in stress periods.

The commercial real estate (CRE) sector remains under pressure, with only a modest recovery in 2024 after a two-year slump. CRE firms face profitability constraints driven by high funding costs, rising capital expenditures, and muted rental income. Non-performing exposures linked to CRE have begun to rise, although the increases remain moderate. While EU banks' aggregate exposure to CRE is smaller than their housing portfolios, it is significant in certain Member States, and in some cases large relative to banks' capital. Intra-EU exposures dominate, and banks have limited direct exposure to the US CRE market, which has experienced more severe stress. Most EU CRE loans maintain conservative loan-to-value (LTV) ratios, often below 60%, but the illiquid nature of CRE assets means valuation losses could be magnified in period of stress.

Graph 2.13: **Banking sector: profitability, capital ratios and asset quality**



Source: ECB, Eurostat.

The non-bank financial intermediaries' sector (NBFI) ([13]), which has expanded rapidly over the past years, is exposed to specific risks and its interconnectedness with the banking sector is a source of vulnerability. NBFIs have gained importance over the past years, with assets increasing from 140% to 400% of euro area GDP over the period 1999-

2024 (Pelizzon et al., 2025). The overall profitability, capitalisation and liquidity metrics for the various segments of the non-bank financial sector are healthy ([14]). However, parts of the NBFI sector are exposed to specific risks related to leverage and liquidity mismatch and NBFIs have significant exposures to the US, increasing their vulnerability to adverse market developments (ESRB, 2025). Furthermore, the interconnectedness among NBFIs and between them and the banking sector is a possible source of propagation of adverse developments into the real economy. While there are EU regulations aimed at tackling specific risks in some types of NBFIs such as investment funds, insurers and CCPs, there is no consistent approach to macroprudential supervision for NBFIs. Improving the adequacy of macroprudential policies for NBFI is one of the priorities of the European Commission in the current mandate ([15]).

The EU financial sector is subject to new risks that are difficult to quantify. Cyber risks have emerged as a new challenge in the context of the increasing digitalisation of the financial sector ([16]). Looking ahead, the growing importance of crypto assets and their interconnectedness with the financial sector could create financial stability risks. Climate change risks and climate transition risks are also a concern for financial stability. Climate change, such as extreme weather events, may damage infrastructure, disrupt supply chains, and can lead to significant economic and financial losses (Bellia et al., 2025). Recognising the gravity of these challenges, supervisory authorities have started to incorporate climate risks into their stress testing framework ([17]).

House price growth has resumed, driven by low supply, an issue that needs to be urgently addressed

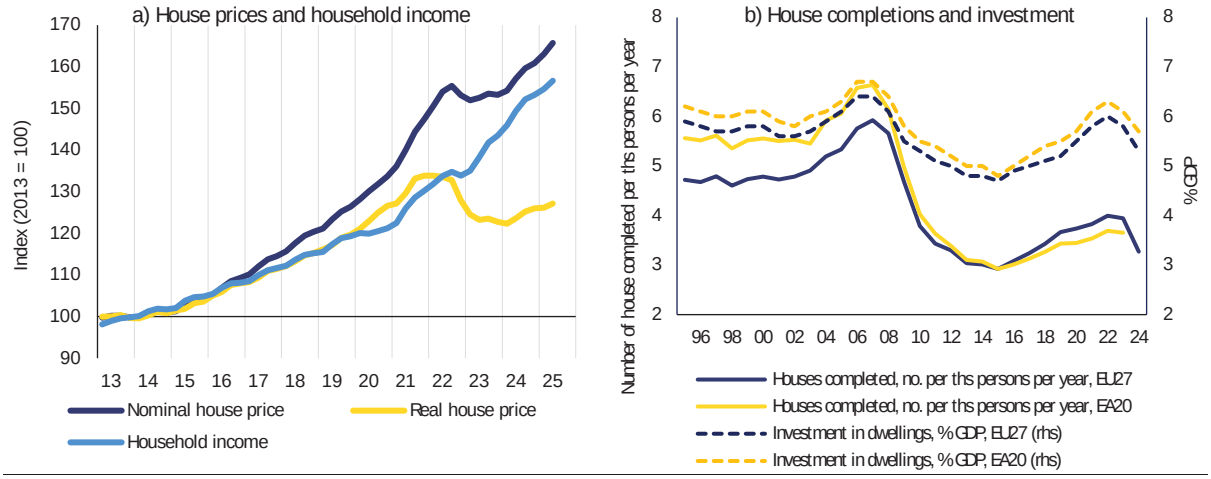
House prices are rebounding. Over late 2023 and 2024, house price growth accelerated in most EU countries, with house prices growing by 3.4% in 2024 and 5.4% y-o-y in 2025-Q2 in the EU, after a retrenchment in late 2022 **(Graph 2.14.a)**. This price recovery has been accompanied by a recovery in transactions, after a decline from 2022 to early 2024, as the market adjusted to the significant tightening of monetary conditions.

Low investment, which keeps housing supply muted, is a major reason behind the rise in house prices. Over the last decade, the supply of new homes has failed to keep up with demand, and the construction of new homes has been at historically low levels. While investment in housing plunged after the global financial crisis, its return to previous levels has not led to substantially higher construction of new homes as investment has focused on renovations **(Graph 2.14.b)**. In addition, widespread labour shortages and skills mismatches in the construction sector, regulations, increasing construction costs, as well as a sharp fall in building permits granted by local or regional authorities have acted as constraints on the housing supply. Against this backdrop, the supply response to housing demand has remained muted and is expected to remain the case in the foreseeable future, continuing to put pressure on prices.

Recent house price growth is stronger than what can be explained by household borrowing. Since most home purchases are financed through mortgage credit, households' borrowing capacity—which is largely determined by incomes and mortgage rates—has

historically been a key long-term driver of housing demand. After falling over 2022 and 2023, households' borrowing capacity rose in 2024, against the backdrop of falling interest rates and continued income growth, supporting demand for housing. In some countries, interest rates are even negative in real terms on account of relatively high inflation, underpinning buoyant housing demand.

Graph 2.14: **House prices and housing supply**



Source: Eurostat, ECB, and European Commission calculations.

Housing affordability remains a macroeconomic and social issue in many countries. Since 2023, household income growth has exceeded house price growth in the EA/EU, leading to a fall in price-to-income ratios. Price-to-income ratios are now less than 10% above their 2013 levels. However, this figure hides very strong national and regional variation. The surge in borrowing costs after 2022 has sharply reduced how much households can afford to buy using mortgage credit. . Moreover, in many EU countries, rental markets remain underdeveloped and do not provide a viable alternative to homeownership. Worsening housing affordability can have negative implications for labour mobility and labour market participation, access to higher education, and economic growth, and can disproportionately impact the most vulnerable groups. High house price growth in urban areas can act as a disincentive for workers to move to these more dynamic economic regions, undermining economic activity, in addition to social consequences (Cousin et al., 2025).

3. EU SAVINGS IN THE CONTEXT OF GEOECONOMIC RISKS

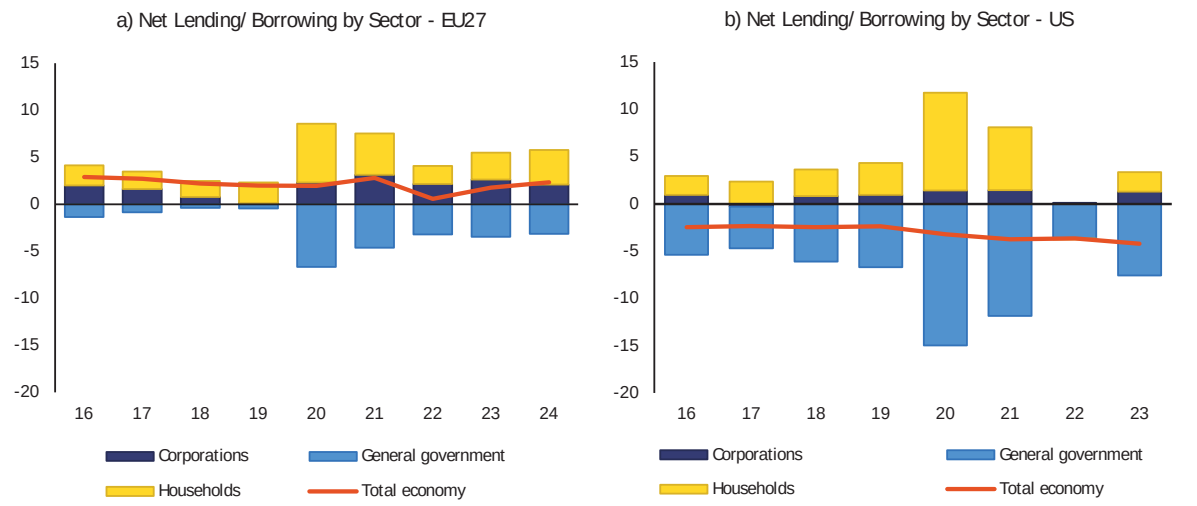
Abundant EU savings offer an opportunity to fund European priorities. Its large current account surpluses make the EU a key global supplier of capital. Every year, around EUR 300 billion of savings flow out of the EU in net terms, funding investment abroad, mainly in the United States. The bulk of these European savings originates from households ([1]), which typically rely on financial intermediaries rather than investing directly in capital markets. This section examines that EU household savings flow abroad via financial sector intermediation, and that the fragmented capital markets continue to impede a more efficient allocation within the Union. It also explores how higher perceived risks by investors may affect capital flows in the near future. The Savings and Investment Union seeks to mobilise European savings for domestic investment, by overcoming market fragmentation within the Union, thereby supporting Europe's long-term growth, security and resilience.

European savings are largely invested abroad

Persistently high private savings in the EU result in a large external surplus. As chapter 2 elaborates, EU savings largely exceed domestic investments, leading to a current account surplus of 2.5% of GDP in 2024. The private sector savings have strongly increased, lifting the EU's net lending position in 2024 well above its pre-pandemic average, despite the increased (but correcting) government borrowing **(Graph 3.1.a)**. In contrast, the United States' external deficit is driven mainly by the government's persistent borrowing, while private savings remain comparatively weak **(Graph 3.1.b)**.

A large part of EU surplus savings have been allocated to the US. Aggregate EU savings excluding amortisations account for ca. EUR 1.200 billion annually. Since 2015, an average net of more than EUR 300 billion (ca. 25%) of these EU savings flow into foreign assets each year, reaching EUR 437 billion in 2024 ([2]). These savings are mainly channelled into foreign direct investment, equity, and bonds. Since 2020, the US has been the main destination for these funds, in net terms **(Graph 3.2.a)** ([3]). European savings thus play a significant role in meeting global demand for capital. A substantial portion is allocated to the US, with the EU financing around 40% of the US external deficit between 2016 and 2024 **(Graph 3.2.b)** (Milesi-Ferretti, 2025). US financial markets remain especially attractive for European institutional investors due to their liquidity, and strategic investment options (ECB, 2025c). In addition, they offer a range of high-quality, dollar-denominated liquid assets, supported by a long track of solid performance and high returns (Davies et al., 2020). In contrast, Europe's more fragmented and bank-based financial system provides fewer financial investment opportunities ([4]).

Graph 3.1:**The EU external surplus reflects high private savings, while the US deficit mirrors its fiscal stance**

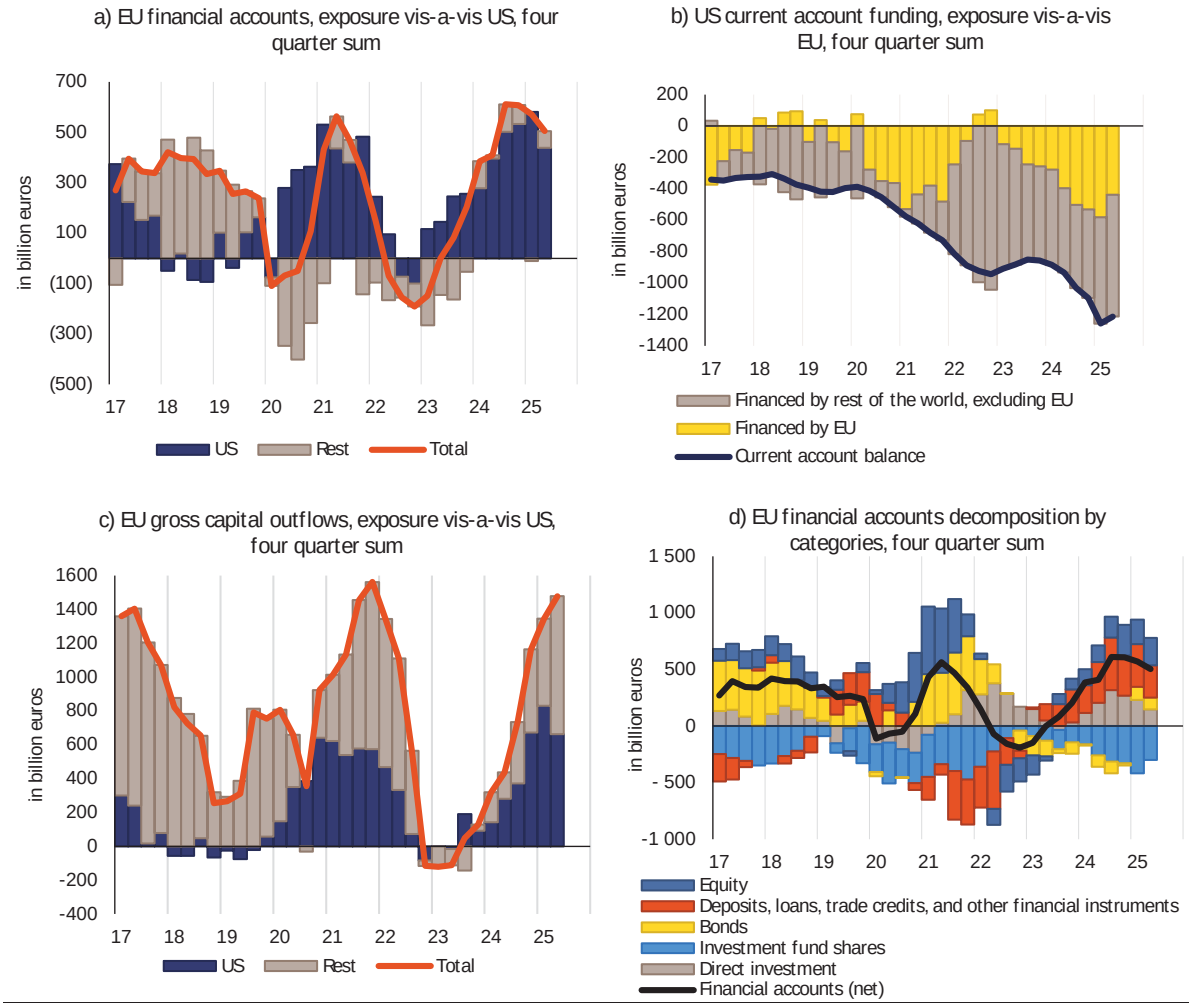


Notes: Net lending/ net borrowing indicates whether an economy is a net provider or user of financial resources vis-à-vis the rest of the world. The US net lending/ borrowing position shows the latest available data, up to 2023.
Source: Eurostat, OECD.

The allocation of gross EU capital outflows shows currently no clear shift away from the US. While the net outflows by mid-2025 increased slightly compared to mid-2024 **(Graph 3.2.a)**, gross financial outflows from the EU increased in the second quarter of 2025, to levels last seen in 2022 **(Graph 3.2.c)**. Looking at the US exposure, data also indicate no strong retrenchment in the recent quarters **(Graph 3.2.a)**, despite the dollar depreciation and higher perceived risks by investors in holding unhedged US assets **(see Box 3.1)**.

However, the composition of EU capital flows is changing. Up to the second quarter of 2025, net cross-border flows focused on deposits and equity, with a smaller emphasis on foreign-issued bonds (**Graph 3.2.d)**, the first being possibly related to high foreign exchange trading volumes (BIS, 2025). This contrasts with the development from 2017 to 2022, where flows were mainly allocated towards foreign equity and bonds.

Graph 3.2: **The EU allocates savings abroad, while the US needs foreign savings for funding**



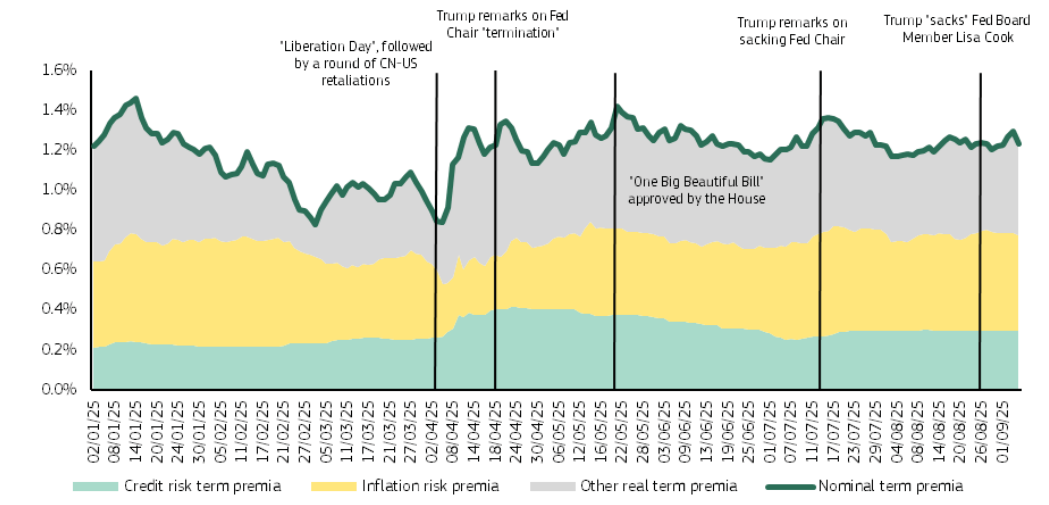
Notes: The EU financial accounts exposure vis-à-vis the US is adjusted for the portfolio investment liabilities, based on the International Transactions data by the Bureau of Economic Analysis (BEA). The split of EU financial accounts by equity (F51) and investment fund shares (F52) is based on euro area estimations.
Source: Own calculations based on Eurostat, BEA.

Box 3.1: **Higher perceived US dollar risk**

The US dollar's depreciation since February reflects macroeconomic factors and also heightened risk perceptions towards US assets. While the dollar exchange rate often tracks traditional macroeconomic factors such as expectations about monetary policy and economic momentum, the scale of the depreciation points to the role of other factors, in particular a perceived increase in the riskiness of US assets amid heightened economic policy uncertainty. At the same time, most estimates of the equilibrium real effective exchange rate suggest that the US dollar remains overvalued, implying further room for adjustment at least from the point of view of economic fundamentals (IMF, 2024a; IMF, 2025a). There are currently no signs of a persistent reversal of foreign capital inflows, but foreign investors have started hedging their dollar exposures more than in the past and there was a visible – albeit possibly temporary – weakening of the safe-haven status of the dollar over the spring, particularly following the so-called "Liberation Day". Finally, structural-fundamental forces may also have played a role as market commentaries started to pay more attention to the overvaluation of the dollar and the funding of the US external balance.

The behavior of US Treasury yields since the first quarter of the year is consistent with higher perceived risk among investors. Policy announcements since early 2025 triggered bouts of volatility, with tariffs and fiscal initiatives prompting selloffs in both Treasuries and the dollar. The initial effect of the trade policy announcements of the current US Administration in the direction of hiking tariffs to historically high levels was to dampen growth prospects, which in turn contributed to lower US bond yields in the first quarter of 2025. A rapid increase in US term premia took place between 4 and 11 April (Graph 1), signaling an increase in other real term premia and credit risk perceptions ([1]). Public disputes between the US President and the Federal Reserve and concerns over fiscal sustainability following the so called "One Big Beautiful Bill" (which contains tax and spending policies set to increase US government debt) further fed these pressures and also promoted an increase in inflation risk premia. The risk premium embedded in 10-year Treasuries drifted higher during the summer, underscoring that investors increasingly demand compensation for policy, inflation and credit uncertainty.

Graph 1: **Decomposition of 10-year US term premia**



Source: PRISM model estimates.

Temporary reversals in the relationship between US dollar asset prices and uncertainty indices revealed fragility in the dollar's safe-haven role. The established correlations between the dollar, US asset prices, and measures of uncertainty broke down temporarily in the second quarter of 2025, indicating a shift in sentiment (Graph 2). In the past the dollar tended to strengthen alongside increases in volatility indices such as the VIX (a measure of stock market risk), reflecting its safe haven status. Following the April tariff announcements,

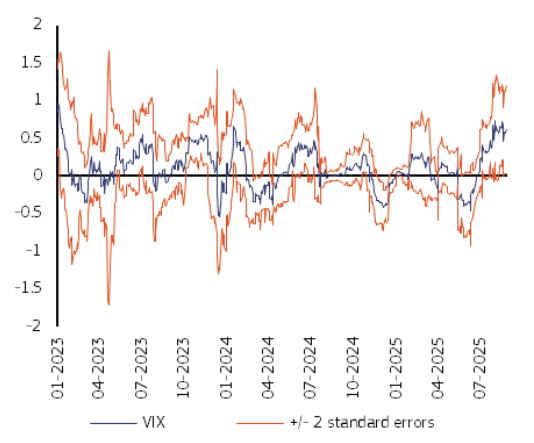
([1]) Term premia estimates and decompositions are based on the PRISM model (Monteiro, 2025). In Graph 1, "other real term premia" is a residual component capturing pricing factors unrelated to credit and inflation risks. These can include the relative balance of bond supply and demand at a given maturity, the predominant direction of risks to real rates (upwards vs downwards) and market liquidity aspects.

(Continued on the next page)

however, this relationship briefly turned negative: rising uncertainty coincided with dollar weakness. Similarly, correlations between the dollar and US policy uncertainty indices became negative, indicating that higher uncertainty was increasingly priced as a dollar-specific risk rather than a driver of safe-haven demand. Rolling regressions suggest that these tensions were temporary, with correlations reverting over the summer, but they highlight investors' uneasiness about the safe-haven role of the US dollar.

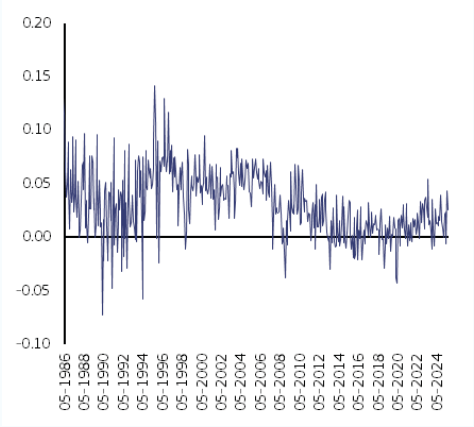
Capital flows into the US recovered after April's outflows, but increased hedging points to heightened risk perceptions. In April, the US recorded a net outflow of portfolio capital, but the inflows resumed in the following months confirming that there was no permanent flight from US assets. The April 2025 outflow of portfolio investment was significant but not unprecedented and was quickly offset by renewed inflows in May and June (as shown by the ratio of net foreign purchases over total sales of US equities, Graph 3). However, the resumption of inflows did not restore dollar strength, pointing to a change in how capital markets perceive and price US assets. A notable trend has been the increase in hedging the US dollar exposures: investors appear more concerned about exchange rate risks even when they maintain or increase their holdings of US securities ([2]). This hedging activity underlines that the depreciation of the dollar is not only about flows, but also about the perception of higher risk in holding unhedged US assets.

Graph 2: Time-varying coefficient of the VIX uncertainty index from rolling regressions of the NEER USD



Source: Commission calculations, data from Bloomberg, policyuncertainty.com
Notes: rolling regressions on daily percentage changes, time window 30 days, heteroskedasticity and autocorrelation-consistent standard errors

Graph 3: Historical evolution of the ratio of net foreign purchases of US securities to total gross sales of US securities (1986-2025)



Source: Commission calculations, data from US Treasury

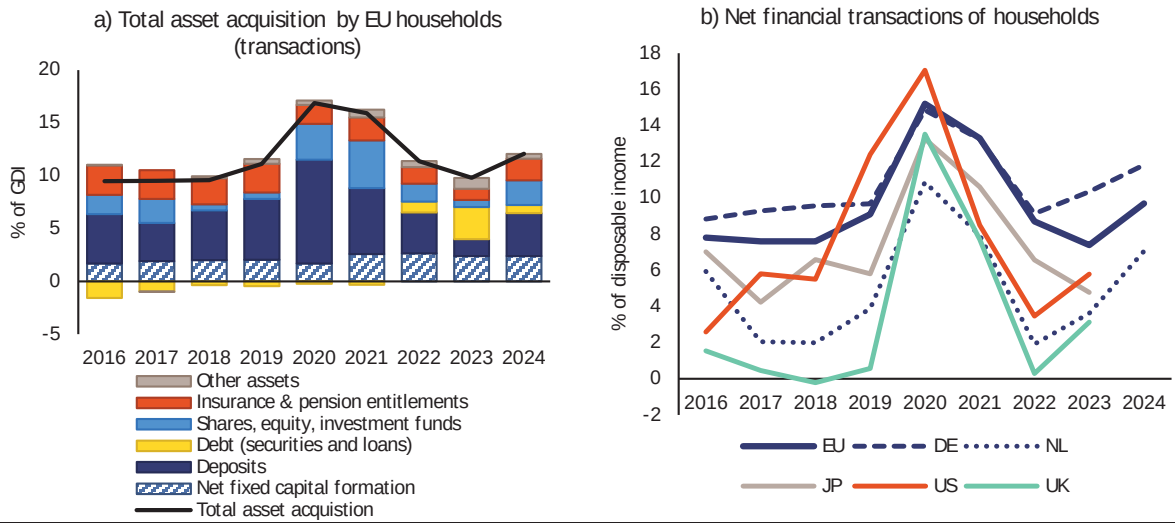
([2]) Data on hedging activity is not available, but indirect evidence is presented in Shin et al. (2025).

European household savings consist mainly of bank deposits, earning low returns

The EU is a net exporter of capital, and the bulk of gross European savings originates from households. The external surplus reflects the fact that a part of the EU savings is not invested in the EU but abroad. As elaborated in the previous section, the household sector accounts for the majority of the savings within the EU **(Graph 3.1.a)**. Understanding why the household savings ultimately flow abroad is therefore central to understanding the EU's investment gap and financial intermediation efficiency (Draghi, 2024).

European households have higher savings than their international peers. In 2024, EU household net financial savings (acquisition of financial assets) amounted to close to 10% of gross disposable income, around two percentage points above pre-pandemic levels. Since 2016, EU households have maintained higher net financial flows in relation to income compared to those in the US, UK, or Japan, except in 2019 and 2020, when the US experienced a temporary surge in household savings **(Graph 3.3.b)** (European Commission, 2025i). In the beginning of the pandemic, EU households have built up substantial savings and continue to do so. After the pandemic, a motive for continued elevated saving rates may have been the efforts to rebuild financial buffers, as inflation has eroded the real wealth, and higher living costs absorbed much of the increase in nominal savings (European Commission, 2024b).

Graph 3.3: **EU households have recorded higher financial savings flows than their international peers, and allocate them mostly in deposits**

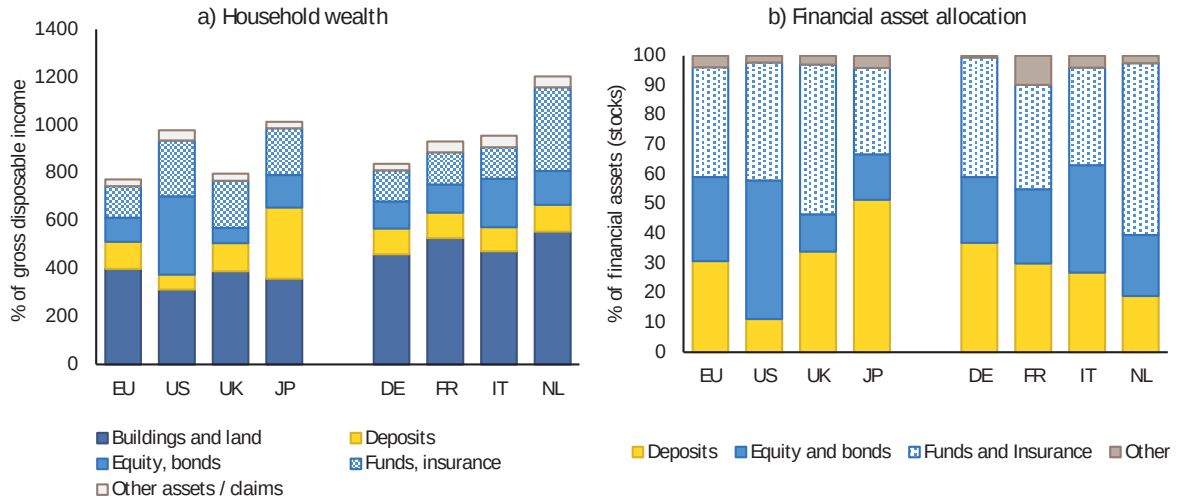


Notes: Information on net financial transactions of households for Japan, US and UK is only available up to 2023, shown as percentage of net disposable income, while EU is shown as financial asset transactions in percentage of gross disposable income.
Source: Eurostat, OECD.

Households favour bank deposits as their primary form of financial investment. Before 2020, households in the EU channelled on average around 60% of their financial flows into bank deposits **(Graph 3.3.a)**. During the pandemic, precautionary and involuntary excess savings were also channelled primarily into bank deposits, with some additional flows into

shares, equity, and investment funds. Deposit accumulation slowed markedly, and purchases of debt securities picked up over 2022/23. In 2024, a partial rebalancing occurred, with deposits regaining importance. This pattern suggests that households avoid direct risk-taking and might reflect a combination of structural factors in portfolio choices, such as income and wealth levels, age, and employment stability (European Commission, 2025i).

Graph 3.4: **Despite higher financial savings, EU households' wealth levels remain relatively low**



Notes: Graph 3.4.a) OECD non-financial asset holdings and non-consolidated financial asset holdings 2023 for the household and non-profit institutions serving households sector (NPISH), 2022 for missing values. Buildings and land includes the value of non-residential buildings held by households (N111 and N211). Deposits refers to F2 excluding cash. 'Equity, bonds' denotes equity (F51) and debt securities (F3). Funds/insurance groups mutual funds (F52) and insurance claims (F6). Other financial assets mainly comprise unlisted and other equity, typically entrepreneur stakes in companies. Other assets/claims groups other financial assets (like claims from loans. F4) and non-building produced non-financial assets. Buildings and land figures are based on 2023 data, and where missing, 2022 data was used by updating with the headline house price index; Graph 3.4.b) OECD share of financial instruments in financial assets of households and NPISH in 2024.
Source: OECD, Ameco.

While EU households save more than their international peers, their total wealth levels remain comparatively low. This feature partly reflects the relatively low yields that accrue to EU households compared to other advanced economies. Indeed, EU households' portfolios are mainly concentrated in low-yield, bank-based instruments, which bring lower returns and partly affects the wealth levels **(Graph 3.4.a)** ([5]). Real estate and deposits together account for more than half of the total EU assets, while the exposure to higher-return financial assets remains modest ([6]). By contrast, households in the US and the UK have a more diversified portfolio with a larger share in financial assets, including listed shares, bonds, investment funds, and insurance products **(Graph 3.4.b)**. This reflects a greater reliance on capital markets in these economies. As a result, households in the US and UK generate more wealth through returns on riskier portfolios. However, households in UK have also increased their deposit holdings ratio over time, from around 23% in 2016 to 34% in 2024. In Japan, deposit holdings account for more than 50% of the total financial assets of households. Some reasons might be low financial literacy and risk aversion of Japanese households, a legacy of bank-based financial policy anchoring deposit savings, and the illiquidity of the real estate market in Japan (Altman, 2019).

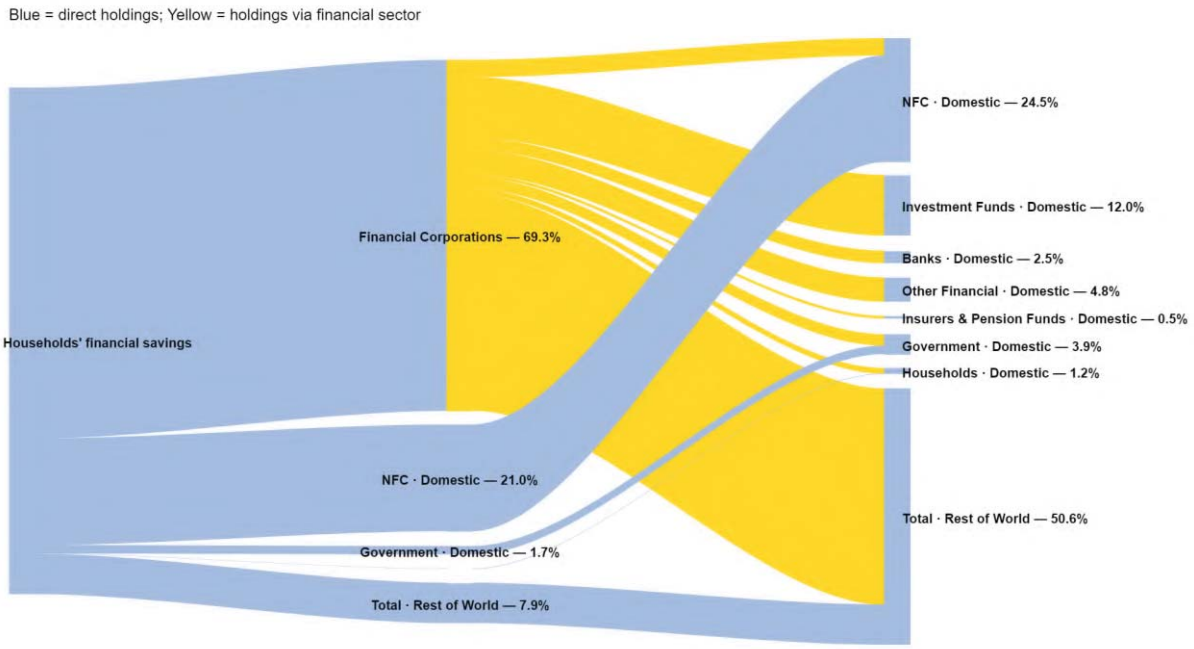
There are also differences in portfolio choices among households within the EU. Countries such as Germany, France, and Italy rely heavily on deposits, as well as mutual funds and life insurance. Yet, the share of the latter two instruments in relation to total financial assets remains well below that in Anglo-Saxon economies **(Graph 3.4.b)**. The Netherlands is one of the largest exceptions to the EU pattern, with its mandatory second-pillar pension system and larger allocation to funds and insurance, which might also imply a stronger exposure to US equity markets than their euro area peers.

The financial sector channelled the EU household savings essentially abroad in 2024

Households rarely invest directly in capital markets or foreign assets; instead, they place most of their financial wealth in the financial sector. These financial intermediaries then shape the destination of these financial savings, allocating most of them abroad (outside the EU) in recent years, and only a low share towards EU non-financial corporations (NFCs). This section tracks the channelling of household savings through the EU financial system from 2023 to 2024 ([7]).

European households allocated most of their financial savings to the financial sector in 2024, making it the main conduit to channel them abroad. In 2024, almost 70% of households' financial savings were directly channelled to financial corporations within the EU, namely banks, funds, insurers, and other financial institutions **(Graph 3.5)**. Only about a fifth went directly to NFCs, mostly through unlisted equity holdings, which represent an important funding source for European NFCs. Less than 10% of financial savings were directly invested abroad. In contrast, US households allocated around 50% of their financial savings to the financial sector in 2024, while the NFC sector received 44% of these flows ([8]). This highlights the strong difference in direct allocation between the EU and the US.

Graph 3.5:**EU households' financial asset allocation vis-à-vis counterpart-sectors, adjusted flows from 2023 to 2024**



Notes: Results based on preliminary data from a refactoring of the ECFIN-JRC 'Finflows' dataset. "Adjusted (financial) flows" refer to calculated financial flows derived from financial assets. They aim to approximate the underlying transactions in financial instruments, providing a clearer picture of financial activity from 2023 to 2024. The calculations for the 'financial sector intermediation' are based on the asset allocation for the total financial corporation sector. This may also reflect the impact of multinational enterprises operating via holding companies, households' indirect investment choices via ETFs, and other effects.
Household assets are defined as the total financial assets excluding currency (F21), financial derivatives (F7) and other accounts receivable (F8). The allocation of adjusted flows is shown in two steps: First, the direct allocation vis-à-vis counterpart sectors (blue). Second, the allocation of adjusted flows after the transformation by the financial corporations (yellow), which are based on the asset allocation share of the total financial corporation sector.
Source: European commission calculations based on ECB, Eurostat, IMF.

Financial corporations intermediate most household savings and preliminary findings suggest that they channel about half of them into assets abroad ([9]). In 2024, European households allocated 21% of their financial savings directly to EU NFCs. After accounting for the intermediation of European household savings by financial corporations, this share increases only slightly to a total of around 25%. This illustrates that only a small portion of household savings is used by the EU financial sector to finance EU companies. NFCs in Europe also rely on intra-sectoral and cross-border funding. At the same time, the share of household financial savings invested in foreign assets increases from 8% directly invested to over 50% **(Graph 3.5)**.

The limited share of household financial savings invested in EU companies reflects Europe's fragmented capital markets. The allocation of the majority of EU savings abroad reflects to some extent geographic risk diversification strategies by institutional investors, but it also results from the comparatively low depth and liquidity of the EU capital market. The low domestic absorption of EU savings limits the ability of EU firms to finance

themselves on the market and therefore has direct implications for the EU's competitiveness (Draghi, 2024).

Advancing towards a Savings and Investment Union would be key to efficiently mobilising capital for Europe

Europe's abundant savings are a unique opportunity to strengthen its economy and the international role of the euro. If effectively mobilised, these resources can underpin investment in the Union's long-term priorities, such as the green and digital transitions, defence, and innovation, while reinforcing its resilience. The analysis above shows that households continue to prefer safe and liquid instruments within the EU, while financial intermediaries channel a substantial share of these resources abroad. This highlights untapped potential: redirecting domestic savings into domestic investment, consistent with the objectives of a deep and well-functioning Single market, could become a powerful engine for domestic growth. This, however, requires advancing towards a genuine Savings and Investment Union (European Commission, 2025n). Such reforms would not only strengthen Europe's capacity to absorb capital flows but also underpin the international role of the euro, by enhancing the depth, safety, and attractiveness of euro-denominated assets**.**

To advance toward a genuine Savings and Investment Union and strengthen EU capital markets, the EU and its Member States need to continue pursuing a multifaceted and ambitious strategy. First, actions in relation to citizens and savings should focus on enhancing individual wealth opportunities through accessible savings and investment products and a strengthened financial literacy strategy ([10]). Empowering citizens to better prepare for retirement, including through auto-enrolment schemes, will not only improve financial well-being but also channel additional resources into capital markets. This will contribute to greater market depth, liquidity and resilience by broadening the investor base. Second, in the area of investments and financing, efforts should aim at facilitating equity investments by institutional investors—such as banks, insurers and pension funds—and at fostering the development of venture capital and growth funds. These measures, together with steps to revitalise the securitisation market, will help mobilise private capital towards Europe's strategic priorities, supporting innovation and long-term growth. Finally, deeper market integration and stronger supervisory coordination are critical to improving efficiency and achieving economies of scale. Removing remaining cross-border barriers will enhance the attractiveness of EU capital markets as a stable and competitive source of financing, while gradually strengthening listings and exit opportunities for investors in venture capital, growth capital and private equity funds.

Advancing the Banking Union project would also strengthen the EU's financial sector, enhancing its efficiency, resilience, and ability to support the Capital Markets Union. Banks are central to capital markets, particularly in the EU's bank-based economy, providing key services to investors and issuers. Yet, the sector remains segmented, with a strong home bias towards national assets (or the liquid US market) rather than investing in other EU Member States. This fragmentation does not exploit the potential for cross-border allocation of capital within the single market and impedes the pooling of savings for investment in strategic priorities. It also leaves the euro area vulnerable in times of stress. Further

developing the Banking Union—by advancing crisis management and deposit insurance reforms, enabling cross-border pooling of capital and liquidity, and creating conditions for deeper integration of banking markets—would support the development of truly European capital markets.

4. MACROECONOMIC IMPACTS OF DEFENCE SPENDING

Several adverse developments in the European neighbourhood have led to a significant deterioration of European and global security. To boost defence capacity, NATO allies have committed to a significant increase in defence- and security-related spending by 2035. This chapter focuses on macroeconomic impact of the increased defence spending. Efficient and effective spending requires a coordinated approach among Member States. The benefits of such a coordinated approach go beyond economic gains and also create positive spillovers in terms of a strengthened security situation for the EU as a whole.

Composition of defence spending in the EU

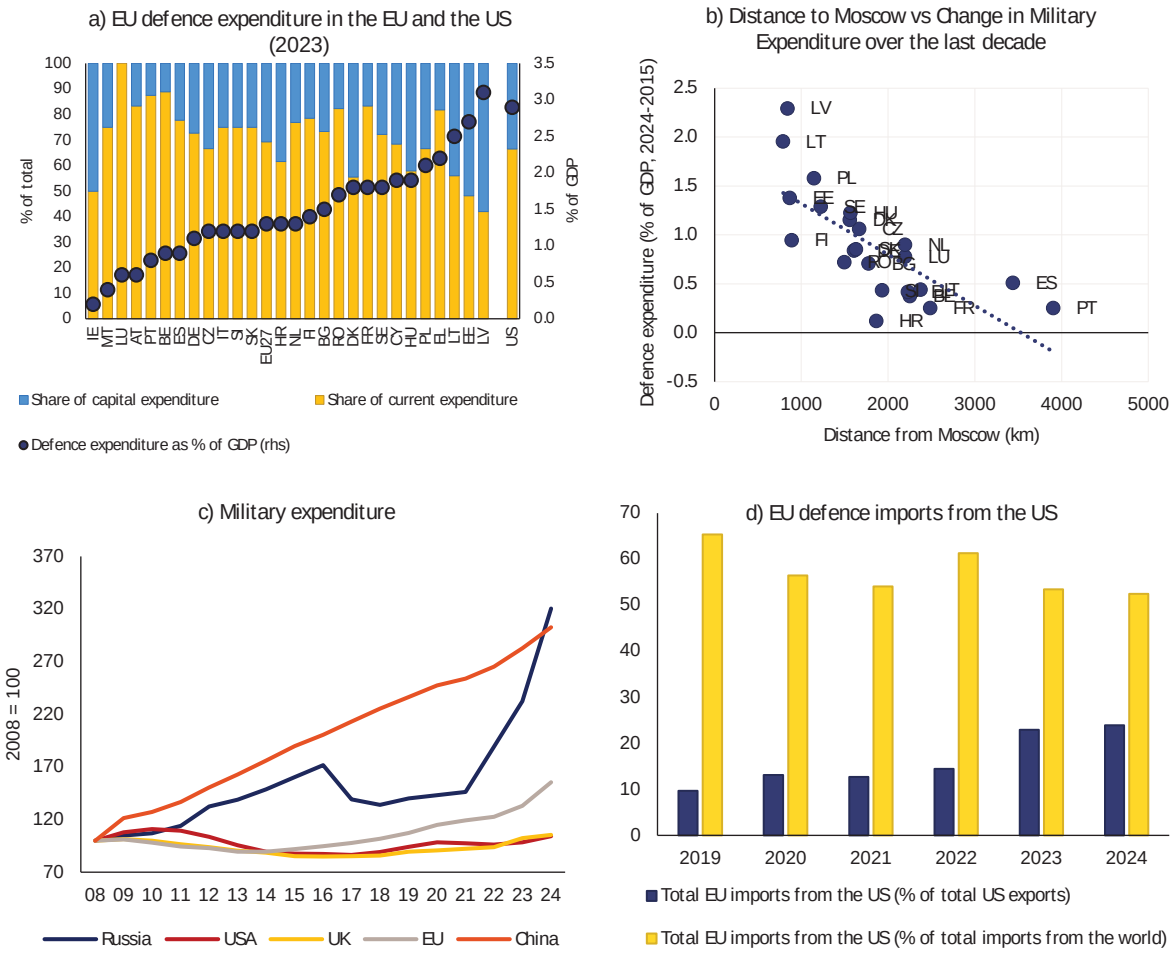
EU Member States are facing an important multi-year period of increased defence spending after many years of underinvestment. The primary goal of increased defence spending is safeguarding Europe's security and protecting its borders, it also represents a valuable opportunity to ramping up investment and increase the potential for innovation (Ilzetzki, 2025). Defence spending increased over the last decade following Russia's illegal annexation of Crimea, although there are differences among EU countries. Defence spending across EU Member States averaged 1.3% of GDP in 2023 **(Graph 4.1.a)** ([1]). The biggest increases in total defence spending in recent years have been registered by the Baltics and Poland, demonstrating that the Member States geographically closer to Russia have generally moved faster in this regard **(Graph 4.1.b)**.

Defence spending of EU Member States increased less than in other international players. The US spent 2.9% of GDP on defence by in 2023. Almost 1% of US GDP was related to capital expenditure in defence, compared to 0.4% of GDP spent by EU Member States in 2023. Moreover, the US has strengthened its position as the top arms exporter between 2015-19 and 2020-24, reaching 43% of global arms exports (from 35%) European arms imports have surged by 155% over the same period **(Graph 4.1.d)** ([2]), indicating that EU Member States have favoured imported non-EU manufactured arms over EU sourcing, especially in artillery systems, air defence systems and multirole fighter aircrafts. Overall, less than 50% of defence procurement is sourced in Europe **(Table 4.1)** (BusinessEurope, 2025). Looking at other international players, Russia and China have increased their defence budgets at significantly higher rates than the EU or the US over the last two decades **(Graph 4.1.c)**.

The European defence industry is fragmented. There are 121 different weapons systems across the 27 Member States, compared to 21 in the US (Centrone and Fernandes, 2024). This has led to inefficiencies and limited economies of scale for the European producers of defence equipment and hampers military interoperability. As US systems are integrated, NATO rely on their system rather than the fragmented and non-integrated systems

produced in the EU. Overall, less than 50% of defence procurement is sourced in Europe **(Table 4.1)**.

Graph 4.1: **Defence expenditure in the EU and other international players**



Source: Graph a): Eurostat, Bureau of Economic Analysis; Graph b): Nato, Google Maps; c) SIPRI Military Expenditure Database; d) Commission services calculations based on the SIPRI Arms Industry Database.; b) Nato, Google Maps.

Table 4.1: **Procurement by EU Member States from EU and non-EU sources**

	EU sourcing	Non-EU sourcing
Armoured fighting vehicles	10.4	8.8
Artillery systems	3	10.5
Air-defence systems	36.8	94.5
Multirole fighter aircraft	18.2	53.3
Combat ISR UAVs	6.9	1.5
Principal surface combatants	36.4	
Submarine programmes	33.5	
ASW and maritime patrol aircraft	5.3	3.8
Sum	150.5	172.4

Notes: Procurement data since February 2022. EUR billion.
Source: Business Europe based on International Institute for Strategic Studies.

Fragmentation across Member States leads to cost inefficiencies in defence spending. The lack of coordinated procurement and dependence on non-EU suppliers carries costs ranging from EUR 18 billion to EUR 57 billion (6.5% to 20.5% of all the European military spending) annually (Centrone and Fernandes, 2024). Market fragmentation gives national suppliers significant market power, and the small orders usually placed by single European countries result in higher unit costs. However, as production volumes increase, economies of scale can be achieved, leading to lower unit costs. Wolff et al. (2025) found that unit costs can fall by 10-15% with each doubling of production, and that cost reductions of 20-30% can be achieved as production experience grows.

Certain modern military technologies are currently unavailable in the European defence industrial base (Wolff et al. 2025). It could take long for Europe to catch up with the US in domains such as air defence and satellite communication (Table 4.2). Moreover, while European companies are exploring new defence technologies, they still fall behind the US in terms of investment and innovation (Wolff et al., 2025). Between mid-2021 and 2024, total venture capital funding for defence start-ups in the U.S. was 2.4 times higher than in Europe (McKinsey, 2025).

Table 4.2: **Time horizons for the development and production of weapons systems**

	Time horizon
Next generation of main battle tanks	2040
Sixth -generation aircraft	>2045
Air defence	2030-2035
Rocket artillery systems (like HIMARS)	~2045
Transport helicopters (like Chinook)	2030
Satellites (like IRIS for communication)	2030
Europe has 10 satellites, compared to 100s for the US	2030-2035

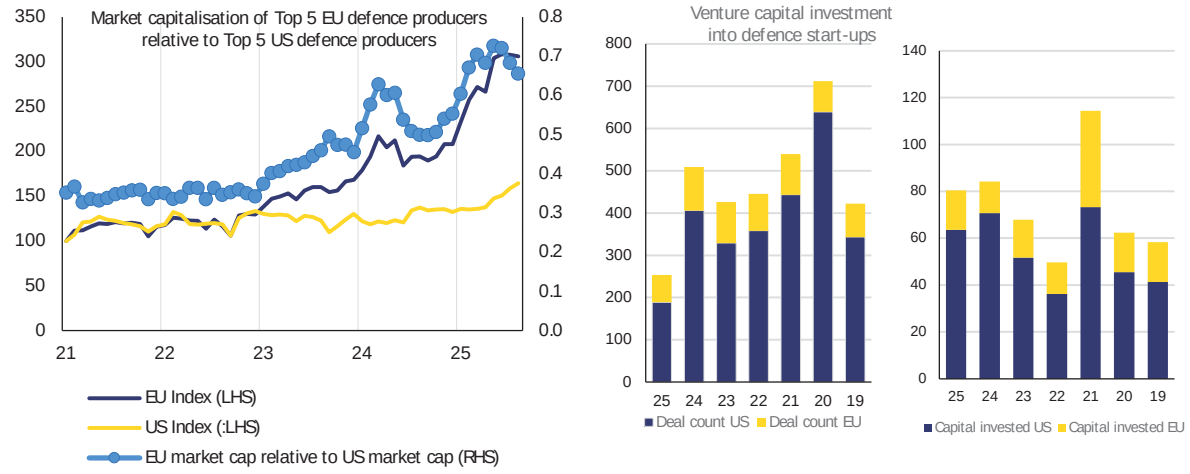
Notes: For the next generation of battle tanks and the sixth-generation aircraft time horizon refers to first product deliveries. For other products, it refers to European autonomy.
Source: Bruegel based on Kiel Institute, MGCS, and other sources.

Intra-European consolidation in the production of defence goods—which would result from a coordinated EU-wide procurement—could lead to a significant increase in demand for certain items, potentially reducing unit costs and prices by 50-90%. Evidence from the Second World War suggest that the supply response could bring significant cost reductions, helping to alleviate pressures on the budget from rising demand (Harrison, 1990; Streb & Streb, 1998; Herman, 2012; Lafond et al., 2022).

Historical evidence for the US has shown that learning by doing can drive large scale increases in capacity, but current labour market conditions in the EU may serve as a constraining factor. Over the course of World War II, US shipbuilders and aircraft manufacturers saw enormous decline in costs which appeared to be correlated with growing experience (Ilzetzki, 2024). Similar increases in capacity for EU Member States may be constrained especially by different labour market conditions. In fact, the pre-war labour market was characterised by low participation rates, particularly from women, which facilitated the increase in capacity during World War II. The current EU labour market, in turn, faces constraints from employment levels at record levels, demographic change, limited immigration, and issues relating to labour market integration of certain groups of society.

The market capitalisation of EU defence producers has partially caught up with US defence producers. In 2022, market capitalisation of the Top 5 EU defence producers was about 35% of that of the top 5 US defence producers. Latest data indicate that this value increased to about 65% **(Graph 4.2a)**. This indicates that European defence companies are expanding rapidly and gaining market share, and this trend is expected to continue. The sector's growing relevance in investor's asset allocation might also reflect the market belief that European defence producers can respond to increasing demand for defence products by EU Member States.

Graph 4.2: **Market capitalisation and venture capital investment**

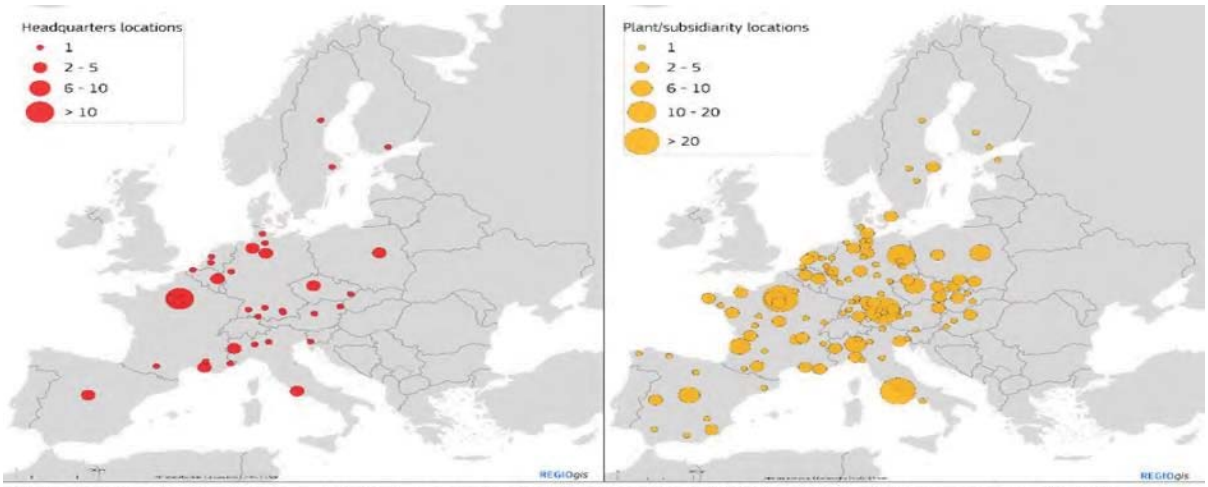


Source: Graph a): Bloomberg; Graph b): Pitchbook

Increasing venture capital investment into European defence companies also bodes well for increasing production capacity and innovation. Companies in the sector have raised EUR 60 billion since the start of 2022, including EUR 16 billion in the first seven months of 2025 (Graph 4.2b). The US provided more than 65% of venture capital defence tech investment in Europe so far in 2025, up from 18% in 2023. The increase marks a sharp

reversal from the previous year, when more than half of VC funding for defence tech in Europe came from domestic investors (Financial Times, 2025).

Graph 4.3: **Defence-related companies: location of headquarters and industrial production**



Main locations of defence-related companies: Headquarters (left) and plants/subsidiaries (right)

Source: DG REGIO elaboration based on ReCoRD experimental data at the NUTS3 level, 07/04/2025

Defence capabilities are spread across much of the EU, including the CEE region. Experimental, analysis ([3]) on the basis of a comprehensive list of defence companies with production sites in the Union shows the historical connection of these companies with a few industrial regions in the EU **(Graph 4.3)** ([4]). Most of the headquarters are in Western Europe while the distribution is less dense across Southern Europe and parts of Scandinavia **(Graph 4.3.a)**. When focusing on plants and subsidiaries, the geography of defence production appears to be more widespread, with important clusters appearing in other European regions **(Graph 4.3.b)**.

The regional concentration of defence-related companies can foster technology spillovers but aggravate regional imbalances. It might facilitate the expansion of defence industries by exploiting geographical spillovers or facilitating civilian industries that aim at shifting their production to military products. On the other hand, the concentration of defence production among a limited number of leading firms whose headquarters are located in specific regions of the EU might contribute to attract workers to these regions

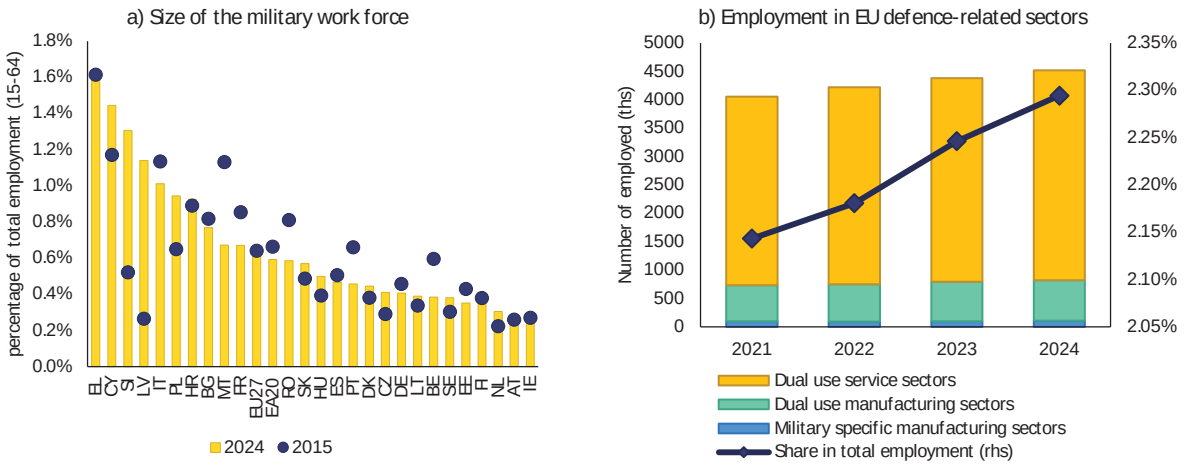
Employment in the defence sector

Over the past decade the size of the military armed forces in the EU has remained broadly constant (Graph 4.4.a). According to the EU Labour Force Survey (EU LFS), about 1.2 million people were employed in military roles in 2024, which represents about 0.6% of total employment in the Union. This however varies greatly across EU Member States.

Employment in the defence-related manufacturing sectors represented a small proportion of EU employment in 2024 ([5]). Military-specific sectors focused on producing weapons, ammunition and military vehicles employed 111 000 people, or 0.06% of EU

employment. However, considering also other sectors that are broadly relevant to defence, the number amounted to around 4.5 million workers or 2.3% of the EU employment **(Graph 4.4.b)**.

Graph 4.4:**Size of the military work force and employment in EU defence-related sectors**



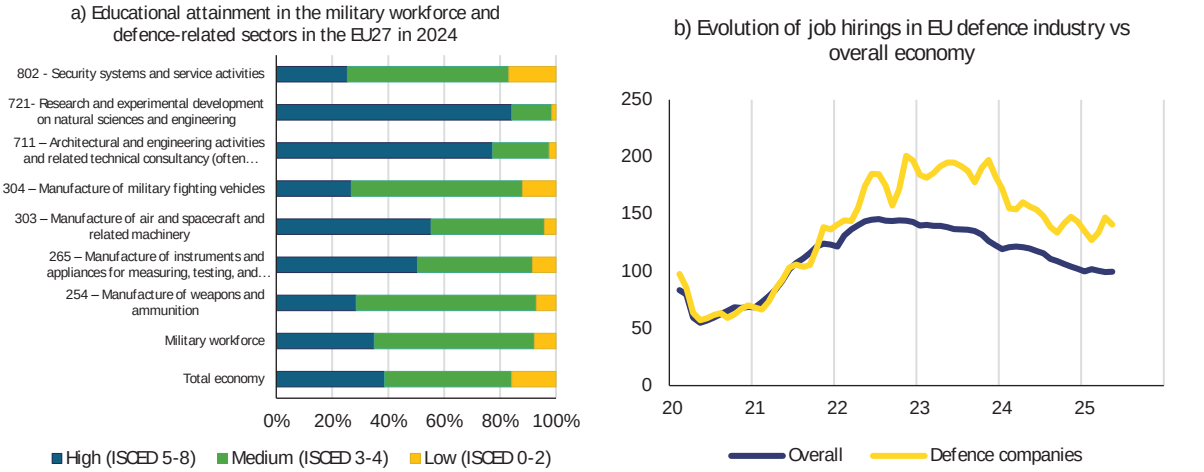
Source: Graph a): EU Labour Force Survey (lfsa_egai2d); Graph b): EU LFS special extraction.

Tertiary and medium educated workers are overrepresented in the military workforce and other defence-related sectors. When compared to the overall workforce, the military workforce is predominantly male and has a younger average age. Additionally, military personnel has on average higher levels of educational attainment, which may be linked to the younger age profile of this workforce. Simiarly, higher levels of education are observed in several defence-related sectors **(Graph 4.5a)**.

In recent years, there has been an increase in job postings for specialised roles in the defence industry, but major defence companies signalled recruitment difficulties across the EU lately ([6]). In May 2025, job postings were 41% higher than in 2021, while the EU average was slightly lower than in 2021 **(Graph 4.5.b)**. In particular, there has been an increase in demand for certain occupations such as specialised engineers, IT and software experts, and technicians involved in production, installation and maintenance, as well as metalworkers ([7]).

The long-term impact of increased labour demand in defence and related sectors is likely to be limited, although it could exacerbate labour shortages for specific profiles in the defence as well as in the civilian sectors that are competing for the same talent. While the impact on overall labour demand is expected to be limited, there is a growing need for highly skilled workers in areas such as advanced manufacturing, aerospace, engineering, cybersecurity, and R&D in emerging technologies. There are already significant shortages of candidates with technical profiles. As defence competes with civilian sectors for the same talent, higher defence spending can exacerbate these shortages, push up wages, and create regional skill gaps.

Graph 4.5: **Defence-related educational attainment and evolution of job hirings**



Notes: The data covers all EU Member States plus Switzerland and European NATO members for which an indeed site exists. Note that 100 equals the average monthly postings in 2021.
Source: Graph a): EU Labour Force Survey (lfsa_egais) and EU LFS special attraction; Graph b): Indeed database.

Fiscal impact of national and EU funding of boosting defence capacity

The urgent need to increase defence spending in the short-term requires debt financing in a context of heterogeneous fiscal space across the EU. The activation of the national escape clause of the Stability and Growth Pact provides Member States with the flexibility to ramp up core defence expenditure in line with the EU's new fiscal rules (European Commission, 2025a). The national escape clause allows Member States to exceed the maximum net expenditure growth rates set out by the Council, provided that this excess is due to an increase in defence spending and safeguarding fiscal sustainability. The flexibility is framed in time (up to 2028), scope (defence spending only) and size (capping it to 1.5% of GDP, based on the increase in defence spending compared with the 2021 level, or 2024 if lower) to avoid endangering fiscal sustainability. As explained in chapter 1, this implies that net expenditures other than defence expenditure are expected to follow the recommended net expenditure paths **(Graph 4.6.a)** ([8]).

Further Union instruments are available to help Member States increase defence expenditure. The new instrument SAFE (Security Action for Europe) is designed to provide up to EUR 150 billion in competitively priced, attractively structured long-maturity loans to Member States. This new instrument has received strong demand by Member States exceeding the available budget of EUR 150 billion. [15] By end November, the national defence investment plans, describing the use of the possible financial assistance, will be presented by Member States and assessed individually by the Commission to ensure compliance with the rules governing the SAFE instrument ([16]). The loans have clear eligibility conditions for contractors and subcontractors to ensure that investments serve the Union's security and defence interests and bolster the European Defence Technological and Industrial Base and promote common procurement. It can also be put to the direct benefit of Ukraine, the frontline of European defence.

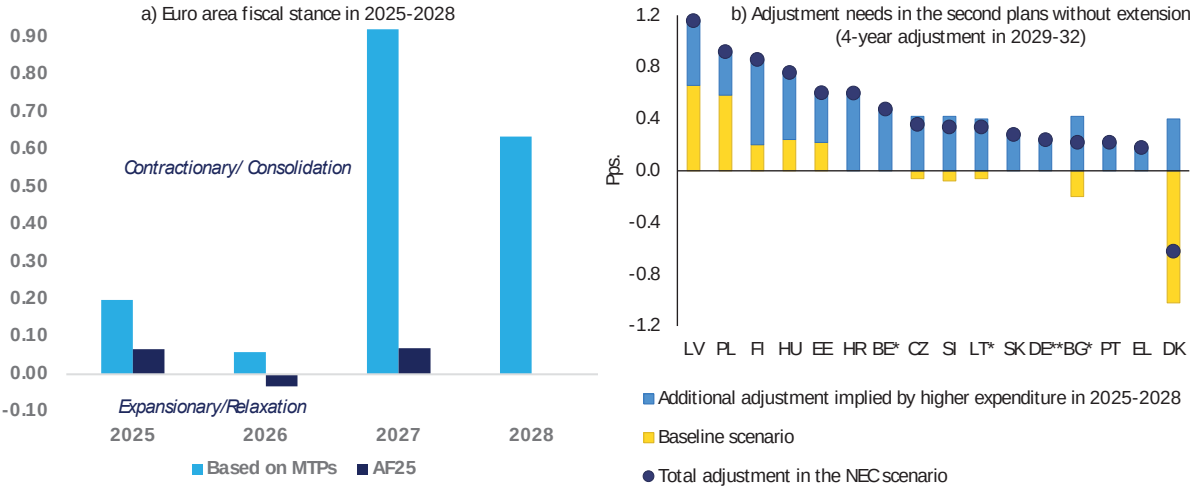
Defence projects would be further facilitated by the possibility to reallocate grants from EU cohesion policy and the eligibility of defence projects for EIB lending. The legislative package on the mid-term review of Cohesion policy for the period 2021-27 enables the use of cohesion funds to foster military mobility and develop resilient defence infrastructure in EU Member States and regions, including the eastern border regions affected by the Russian war of aggression against Ukraine. These regions will receive an exceptional one-off prefinancing if they dedicate 10% of their funds to these new strategic priorities. Furthermore, the EIB widened the scope of its lending to defence and security projects notably by proposing an adjustment of the Group's eligibility criteria to ensure that excluded activities are more precisely defined and as limited as possible in scope to align with the new policy priorities of the EU.

Funds available through the Recovery and Resilience Facility could also be used to support defence expenditure. With the final stages of the Recovery and Resilience Facility approaching, the Commission has invited Member States to review their national Recovery and Resilience Plans to include only measures achievable by 31 August 2026 and explore alternative measures to use their remaining financial allocations. Revisions to the plans could support Member States' investments in the defence sector, for example through voluntary national contributions to the forthcoming European Defence Industry Programme.

Increased defence spending supports Ukraine, which is now part of the EU security architecture. The necessity of providing enduring support to Ukraine has been recognised by NATO in the Hague Summit Declaration and is explicitly included in the updated NATO commitments. The collective support to Ukraine could incidentally help Member States to meet their NATO commitment.

The ramp up of defence spending by the Member States will require a higher fiscal adjustment after deactivation of the national escape clause. According to stylised scenarios, the higher government spending that results from higher defence expenditure during the period of activation of the national escape clause (2025-28) will require an additional required fiscal effort of 0.4 percentage points on average for the period starting in 2029 under the Union's fiscal rules (European Commission, 2025c). This additional annual effort could however be more modest (0.25 percentage points on average) if in the years after 2028 the Member States adopted plans ([9]) with an extended adjustment period of seven years. This illustrates the need to reshuffle revenue and spending priorities in conjunction with fiscal-structural reforms in the interest of fiscal sustainability **(Graph 4.6.b)**.

Graph 4.6: **Euro area fiscal stance and fiscal adjustment needs**



Notes: Graph a) The fiscal stance in the forecast also reflects the use of the flexibility for higher defence spending within the NEC. In 2027, it is based on unchanged policies. In 2027, according to the MTPs, a mechanical assumption implies that the fiscal stance will be affected by the phase-out of the RRF; Graph b): Based on simulations and do not consider the deficit resilience and debt sustainability safeguards for the second round of plans. They do not prejudge the actual adjustment requirements for future plans, which will be computed in due time, based on latest outturn data and forecast.
Source: Graph a): European Commission services' calculations on the recommended net expenditure paths and European Commission Autumn 2025 Forecast. Graph b): European Commission, Assessment of the Fiscal Sustainability Condition for Member States Requesting the Activation of the National Escape Clause, Institutional Paper 321, June 2025.

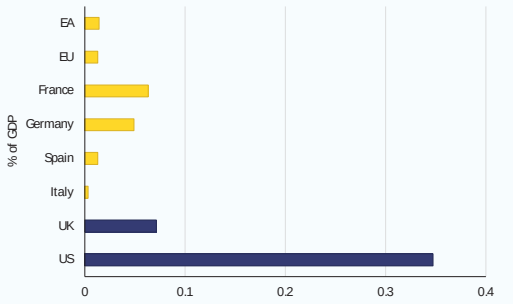
Macroeconomic impact of boosting defence capabilities

There is mixed evidence on the relationship between defence spending and economic growth . Empirical estimates (vary depending on factors such as country context, time horizon, spending levels and methodological approaches Cepparulo and Pasimeni, 2024; Sheremirov and Spirovska, 2022). Higher government spending, as suggested by Keynesian economics, can boost demand and production. However, over time this could lead to higher interest rates, discouraging private investment and eventually offsetting the positive effects of this government spending. Research on the multiplier effect of defence spending shows varied results. Advanced economies tend to see more benefits than less developed countries. In the US, defence spending tends to have a significantly positive impact, whereas the effects in European countries are often negligible or even negative. This difference is largely attributed to different levels of imported goods for defence procurement in the US and in most European countries.

Box 4.1: **R&D spillovers**

Increasing defence capabilities requires greater investment in defence, particularly spending in research and development (R&D). In many OECD countries, government spending on defense-related R&D represents an important form of public support for innovation (Graph A1). The United States has the highest share of defense-related R&D in total government R&D spending among OECD countries. EU countries fall substantially short of that. (European Defence Agency, 2025).

Graph 1: **Defence R&D spending**



Source: OECD, IMF.

The literature has highlighted several channels for the transfer of defence-related innovations to civilian industries and products. Firms not involved in the production of defence equipment may benefit from research funded for military purposes through related research publications, patents, or workforce mobility (Cohen and Levinthal, 1990). Technology transfer programmes, such as the U.S. Defence Advanced Research Projects Agency, actively promote the commercialisation of military innovations (Fuchs, 2009); Terzi et al., 2022) and have led to the development of new technologies, including artificial intelligence. industrial linkages between firms involved in the production of defence equipment and other commercial firms. This may, therefore, contribute to the diffusion of advanced manufacturing techniques and materials.

Empirical analysis confirms that higher government spending in defence-related spills over to private R&D spending. Impulse response functions([5]) suggest crowding-in of private R&D investment, with a cumulative increase of private R&D investment of close to 1.5% of GDP nine years after the public defence spending shock([6]) (Graph A2) (Kraemer et al. 2025). ([7]) ([8]) Overall, these findings are robust when restricting the sample to the EU Member States, and in line with related studies (Antolin and Surico, 2025, for the US; Moretti, 2025, for OECD countries). The crowding-in effect remains visible when using patents as a proxy for private R&D spending to account for endogeneity concerns.

Splitting the sample according to more innovative and less innovative countries shows significant country heterogeneity.([11]) The magnitude of the crowding-in response is stronger for countries with a higher pre-shock level of public innovation spending (Graph A3).

([5]) Estimated with local projections based on Jorda (2005).

([6]) The considered shock corresponds to an increase in public spending on defense R&D equal to 1% of GDP. As shown in Graph A1, this value is well above current levels. However, it reflects the prospect of a substantial rise in overall defense expenditure (up to the projected 5% of GDP) and a significant expansion of its research component. The framework considers a one-off shock—a discrete 1% of GDP rise in defense R&D spending at time t. This approach, consistent with the econometric specification of the local projection model, allows to identify the dynamic response of private investment to an exogenous fiscal impulse. While actual policy will likely involve a gradual build-up of defense budgets, the estimated responses to a one-off shock provide a useful benchmark for understanding the short- to medium-term effects of a sustained increase.

([7]) The dataset is an unbalanced panel, with the maximum time span running from 1981 to 2022. The sample consists of data for Australia, Belgium, Canada, Denmark, Estonia, Finland, France, Germany, Greece, Italy, Japan, Korea, Netherlands, Norway, Portugal, Romania and Spain. Country selection for the sample is based solely on data availability, specifically the existence of time series spanning at least 30 years, which is necessary to meet the requirements of the empirical analysis.

([8]) This result also holds when restricting the sample to EU countries.

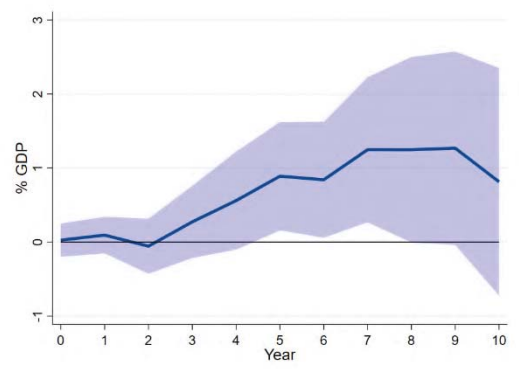
([11]) The classification is based on the 2024 edition of the Global Innovation Index (Dutta et al., 2024), which ranks countries according to their innovation performance.

(Continued on the next page)

Box (continued)

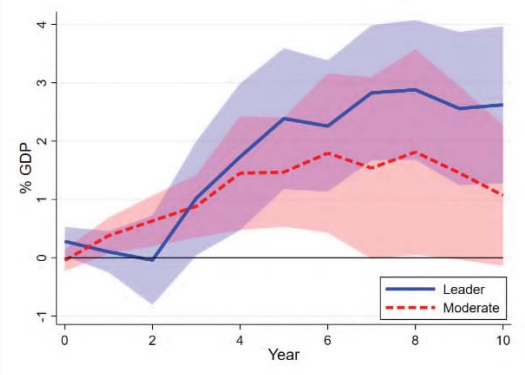
This divergence suggests that the positive spillover of defence-related R&D spending on other industries increases when the level of defence-related R&D is durably high.

Graph A2: Impulse response to a contemporaneous government defence R&D expenditure shock (% of GDP)



Source: Kraemer et al. 2025. Dependent variable: cumulative change in R&D financed by the private sector (as % of GDP). Shaded areas represent 90% confidence intervals.

Graph A3: Impulse response to a contemporaneous government defence R&D expenditure shock (% of GDP)



Source: Kraemer et al. 2025. Dependent variable: cumulative change in R&D financed by the private sector (as % of GDP). Shaded areas represent 90% confidence intervals.

Defence spending can have significant spillover effects on civilian industries, first through equipment demand and later through R&D-driven innovation and investment. Sustained investment in areas like infrastructure and R&D can have a lasting impact, gradually building up the country's capital and fostering the spread of innovation. Research suggests that higher government spending on R&D leads to higher private spending on R&D and increased productivity in the long term (Antolin and Surico, 2025; Moretti et al., 2025; Kraemer et al., 2025) **(see Box 4.1)** ([10]).

Model simulations shed light on the range of macroeconomic effects of higher defence spending under different assumptions. For this purpose, the Commission's QUEST model in its two-region version (EU and rest of the world) provides a coherent framework to assess the effects across scenarios. The model is well suited for this type of analysis, as it captures the interactions between fiscal policy, monetary policy, trade, and private sector behaviour (Motyovszki et al., 2024) ([11]).

The two components to NATO's targets are simulated separately. The so-called "core 3.5%" of GDP, which raises spending from the current level of around 2% of GDP to 3.5% of GDP by 2028 for essential military needs, and an extra 1.5% of GDP on broader defence-related initiatives. Analysis done in the Commission's Spring Forecast (SF25) assessed the macroeconomic impact of achieving the "core 3.5%" of GDP ([12])**.** Notably, the simulations

presented in SF25 highlight the potential economic implications of a higher import share of "core" defence spending (e.g. associated with military equipment purchased outside the EU). **Box 4.2** reports modelling results on the "extra 1.5%" of GDP on broader defence and security-related spending.

Meeting NATO's 5% defence spending goal could moderately increase EU GDP, though outcomes vary widely across scenarios (Graphs 4.7**.**a, 4.7.b). The primary goal of increased defence spending is, as discussed above, security not economic growth. Nevertheless, considering both components (i.e. the "core 3.5%" and the "extra 1.5%") EU GDP is projected to increase by about 0.8% by 2035. This increased spending would also lead to a higher debt-to-GDP ratio. Importantly, the impact on economic activity is uncertain and could differ significantly depending on how the spending is designed and implemented. The relatively modest total GDP effects reflect that the additional spending is partly financed through offsetting measures, the impact of aggregate demand partly "leaks" abroad via imports and is dampened by higher interest rates that crowd out private demand. The debt-to-GDP ratio would also be somewhat higher due to the initial financing via additional borrowing.

The economic contribution of the two components varies over time, with the initial increase driven by front-loaded "core" *defence spending*. However, over time, its impact fades as higher taxes are, in the model, introduced to bring down the accumulated debt. By contrast, the "extra 1.5%" *spending* for broader defence and security contributes more modestly at first, given the assumption on a more gradual spending profile. Over time, it can yield longer-term benefits if directed toward productive investment and implemented as additional spending.

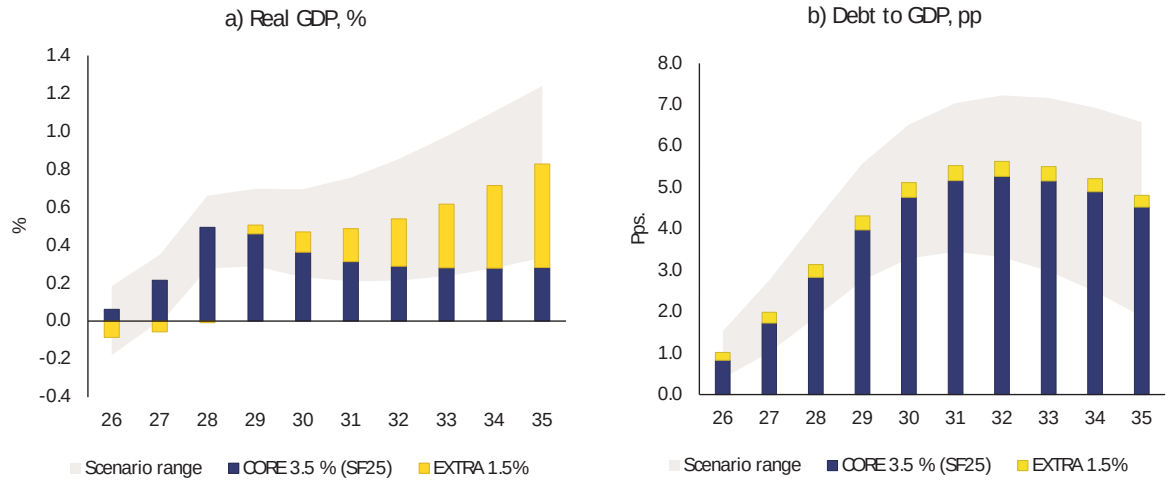
Table 4.3: **Modelling assumptions for the two components**

Timing	Reach 3.5% of GDP within 4 years (increase from around 2% of GDP defence spending per year to 3.5% by **2028)**	Distributed over a longer period, reaching 1.5% of GDP in 10 years (by 2035)
Financing	Initial debt financing (based on the application of national escape clauses)	Ex-ante budget-neutral thanks to offsetting measures
Composition	10% of spending directed towards highly productive projects	20% of spending directed towards highly productive projects
Alternative scenarios	Higher import share, higher R&D and infrastructure share	Different financing assumptions, higher R&D and infrastructure share

Source: European Commission.

The range of simulated outcomes underlines that policy design, including import shares, spending composition, and financing, plays a key role. Graph 4.7 further illustrate how sensitive the outcomes are to different assumptions **(see also Table 4.3)**, with the shaded areas indicating the range of simulation results across scenarios**.** The benefits would be larger if spending relies more on domestic production and is financed in ways that weigh less on economic activity, while a focus on less productive uses could reduce the overall impact.

Graph 4.7:**QUEST Simulation results, reaching the NATO 5% of GDP target by 2035, EU27**



Notes: Graph a): This figure reports the level of EU real GDP in percent deviation from a no-policy change baseline. The variables are reported in levels. Scenario range: combined impact across alternative spending, financing, and composition assumptions**;** Graph b): This figure reports EU government's debt-to-GDP ratio in percentage point deviation from a no-policy change baseline.
Source: European Commission calculations.

Box 4.2: **Simulation results of the extra 1.5% of GDP component**

This box summarises the simulation results for the "extra 1.5%" component, covering broader defence- and security-related spending.([1]) Table 3 compares the modelling assumptions used in the analyses on the two components.

The "extra 1.5%" of GDP spending is projected to raise EU real GDP only moderately, by about 0.5% above the no-policy-change baseline by 2035. At the same time, the debt to GDP ratio remains broadly unchanged, reflecting upfront budget-neutral financing and limited primary balance effects ex-post.

The relatively moderate increase in GDP associated with the "extra 1.5%" reflects assumptions on financing and spending profile.([2]) It is assumed that the spending will gradually increase over time, reaching 1.5% of GDP after 10 years. Moreover, cutting other public investment and transfers to finance spending upfront can reduce the impact on growth compared to debt financing. The model shows that when social transfers are reduced, households with tight budgets have less income, which decreases demand.

Backloading spending and higher interest rates reduce private demand because households and firms anticipate future tax and interest rates increases, reducing their consumption and investment. Inflation remains also contained because fiscal spending is only gradually implemented and financed upfront, which, combined with the central bank's response, restrains demand and price increases. If Member States boost their defence spending more rapidly, the effect on GDP could be greater, according to the model. This sensitivity also arises because, in the model, households' and firms' expectations about the future can already influence today's outcomes.([3])

The economic impact of the "extra 1.5" for broader defence and security may also be smaller, as part of spending may already be planned. The possibly limited increase in effective spending can also be seen as implicit in the financing assumptions outlined above, where additional spending is partly offset by reallocating funds from similar budget areas. In general, lower "additionality" would proportionally reduce the overall impact in the model.

On the upside, channelling additional defence and security-related spending towards more productive investments can yield long-term benefits. Such supply-side gains have a greater impact on economic output beyond 2035, ultimately bringing GDP to a 1.1% above baseline in the long run.

Additional scenarios illustrate how the GDP and fiscal impacts depend on the composition of spending and how it is financed. Two alternative scenarios for the "extra 1.5%" defence- and security-related spending illustrate the main channels involved (**Graphs A1, A2**). In a ***"Lower productivity"*** scenario the impact on GDP is minimal. When a smaller share of spending is allocated to productive investment, there is a much smaller impact on

([1]) The SF25 analysis examined the other, core defence component, including sensitivity scenarios. See European Commission, (2025h)

([2]) In the QUEST model, fiscal multipliers are not fixed parameters but vary according to the fiscal instruments employed and factors such as the economic environment and timing of the measures. For the EU aggregate, short-term government consumption in QUEST, typically, yields multipliers of 0.7-0.8, which aligns with the literature. For example, see Coenen et al. (2012). Productive government investment can have larger (cumulative) multipliers by enhancing productivity of private sector. By contrast, a longer spending program, as considered here, raises the need for future financing, which dampens the growth effects, in addition to import leakages.

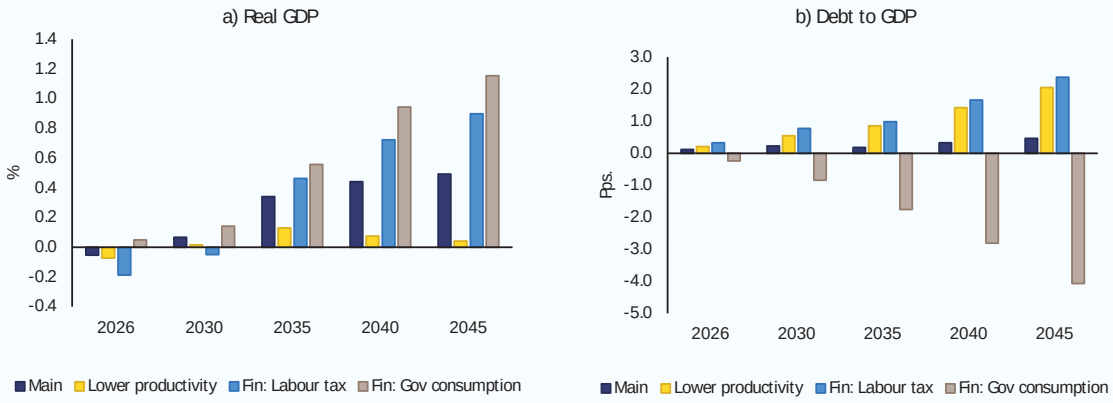
([3]) For additional comparisons across modelling tools, see Bokan et al. (2025).

(Continued on the next page)

Box (continued)

productivity. By contrast, **more growth-friendly financing *("Fin: Gov consumption")*** leads to better outcomes. Cutting "unproductive" government consumption instead of reducing productive public investment fosters productivity gains and lifts real GDP by around 0.7% by 2035, and improves the primary balance compared to the main scenario.

Graph 1: **Extra 1.5%, QUEST Simulation results, EU27, different scenarios**



Note: a) This figure reports the level of EU real GDP in percent deviation from a no-policy change baseline; b) This figure reports EU government's debt-to-GDP deviation from a no-policy change baseline.
Source: European Commission

ANNEXES

	Population (millions)			Share of World (%) GDP (PPP)			Real GDP per capita (PPP)			Real GDP (y-o-y growth rate %)			Inflation (y-o-y %)		
	2010	2020	2024	2010	2020	2024	2010	2020	2024	2010	2020	2024	2010	2020	2024
Euro area	338.6	345.6	350.7	14.8	12.3	11.5	50097	51811	57581	2.1	-6.0	0.9	1.6	0.3	2.4
European Union	439.9	446.5	449.8	17.6	15.2	14.2	46003	49391	54997	2.1	-5.6	1.1	1.8	0.7	2.6
China	1340.9	1412.1	1408.3	12.7	18.5	19.3	10443	19192	23835	10.6	2.3	5.0	3.3	2.5	0.2
United States	309.7	331.3	340.1	17.0	15.2	14.8	59728	67462	75676	2.7	-2.1	2.8	1.6	1.3	3.0
India	1243.5	1402.6	1450.9	5.4	7.0	8.2	5059	7400	9818	8.5	-5.8	6.5	9.4	6.2	4.6
Japan	127.6	125.8	123.9	5.0	3.8	3.3	41251	43361	46285	4.1	-4.2	0.1	-0.7	0.0	2.7
Russia	142.8	147.7	146.1	3.5	3.3	3.5	33161	36376	41667	4.5	-2.7	4.3	6.8	3.4	8.4
Brazil	194.7	209.2	212.6	2.9	2.4	2.4	17965	17286	19594	7.5	-3.3	3.4	5.0	3.2	4.4
Indonesia	237.6	270.2	281.6	2.0	2.3	2.4	9171	12600	14567	6.4	-2.1	5.0	5.1	2.0	2.3
United Kingdom	62.8	67.1	69.2	2.7	2.3	2.2	48771	48656	54475	2.2	-10.3	1.1	3.3	0.9	2.5
Türkiye	73.1	83.4	85.5	1.5	1.7	1.8	20087	29253	36500	8.5	1.8	3.3	8.6	12.3	58.5
Mexico	114.8	128.2	132.3	2.2	1.8	1.7	20099	19745	22065	5.0	-8.4	1.4	4.2	3.4	4.7
Korea	49.6	51.8	51.8	1.8	1.8	1.6	39698	49529	55244	7.0	-0.7	2.0	2.9	0.5	2.3
Canada	34.0	38.0	41.1	1.5	1.3	1.3	51892	53378	56108	3.1	-5.0	1.6	1.8	0.7	2.4
Saudi Arabia	24.0	31.6	35.3	1.2	1.1	1.3	54912	57421	62793	5.0	-3.8	2.0	3.7	3.4	1.7
Australia	22.2	25.6	27.4	1.0	1.0	1.0	53796	57541	60924	2.4	-2.0	1.0	2.9	0.9	3.2
Argentina	40.8	45.4	47.1	1.0	0.7	0.7	28400	23780	25962	10.1	-9.9	-1.3	10.5	42.0	219.9
South Africa	51.4	60.0	63.0	0.7	0.5	0.5	14424	13374	13812	3.0	-6.2	0.5	4.2	3.3	4.4

	Unemployment rate (%)			Total investment (% of GDP)			Current account balance (% of GDP)			Government balance (deficit (-) / surplus (+)) (% of GDP)			Governmnet gross debt (% of GDP)		
	2010	2020	2024	2010	2020	2024	2010	2020	2024	2010	2020	2024	2010	2020	2024
Euro area	10.3	8.0	6.4	20.8	22.0	21.3	-0.3	1.8	2.6	-6.3	-7.0	-3.1	85.7	98.5	88.5
European Union	10.1	7.2	5.9	20.9	22.1	21.5	0.6	2.4	3.2	-6.0	-6.7	-3.1	80.6	91.3	82.0
China	:	5.6	5.1	46.5	42.3	40.6	3.9	1.6	2.3	-0.4	-9.6	-7.3	33.3	69.0	88.3
United States	9.6	8.1	4.0	18.7	21.4	21.5	-2.9	-2.8	-4.0	-11.0	-14.1	-8.0	95.6	132.5	122.3
India	:	8.7	4.9	39.8	28.9	32.9	-2.9	0.9	-0.6	-8.8	-12.9	-7.9	67.7	88.4	81.6
Japan	5.1	2.8	2.6	22.6	25.2	26.1	3.8	3.0	4.8	-9.1	-9.1	-1.5	205.9	258.4	236.1
Russia	7.4	5.8	2.5	20.7	23.5	26.3	4.1	2.4	2.9	-3.2	-4.0	-1.6	10.1	19.2	20.3
Brazil	8.0	13.8	6.9	21.8	16.1	16.9	-3.9	-1.7	-2.7	-3.6	-11.6	-6.2	62.4	96.0	87.3
Indonesia	7.1	7.1	4.9	32.9	32.3	31.4	0.7	-0.4	-0.6	-1.2	-6.1	-2.3	26.4	39.7	40.2
United Kingdom	7.9	4.6	4.3	16.1	17.6	17.7	-2.8	-2.9	-2.7	-9.2	-13.2	-5.7	75.9	105.8	101.2
Türkiye	11.0	13.1	8.7	28.5	34.2	30.7	-5.7	-4.2	-0.8	-3.0	-4.6	-4.6	39.2	38.7	24.0
Mexico	5.3	4.4	2.7	23.3	20.2	24.1	-0.3	2.4	-0.9	-3.8	-4.3	-5.7	40.2	58.5	58.3
Korea	3.7	4.0	2.8	32.8	31.5	30.0	2.3	4.4	5.3	1.6	-2.1	-0.8	28.3	45.9	49.8
Canada	8.2	9.7	6.4	23.5	22.7	23.2	-3.6	-2.0	-0.5	-4.7	-10.9	-2.0	84.0	118.1	111.3
Saudi Arabia	5.5	7.7	3.5	30.9	23.3	30.2	14.1	-3.3	-0.5	4.4	-10.2	-2.5	8.4	29.7	26.2
Australia	5.2	6.5	4.0	26.3	22.5	24.7	-3.7	1.7	-1.9	-5.1	-8.7	-2.3	20.4	57.1	50.7
Argentina	7.8	11.6	7.2	17.7	14.4	15.8	-0.4	0.7	0.9	-1.4	-8.7	0.5	43.5	103.8	84.7
South Africa	24.9	29.2	32.6	17.6	12.3	14.1	-1.3	2.0	-0.7	-4.5	-9.6	-5.8	31.2	68.9	76.0

Source: IMF World Economic Outlook Database, October 2025, except for Euro area and European Union data for real GDP, inflation, unemployment rate, government balance and government gross debts, which are sourced from AMECO (updated on 17 November 2025) and own calculations.

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(1) The scope of this report encompasses both the EU and the euro area. Unless otherwise specified, the policies and discussions referenced in this report are generally applicable to both the EU and the euro area.

(2) Czechia, Germany, Italy, Finland and France are the countries in which real wages still remain below their 2019 levels.

(3) For example, see Bettarelli et al. (2025). It suggests that reforms reducing the generosity of unemployment benefits have dampened the response of unemployment to output changes, though reforms reducing the stringency of employment protection legislation may have amplified it.

(4) European Commission: Employment and Social Developments 2025, Employment and Social Developments in Europe 2025 - Employment, Social Affairs and Inclusion

([5]) The policy mix refers to the combination of fiscal, monetary, and structural policies that are used to achieve the economic objectives of a country or a currency area.

([6]) The fiscal stance measures the fiscal impulse of budgetary policy to the economy, from the national budget and from EU funding. It is measured by the change in net expenditure by national budgets and spending financed by RRF grants and other UE funds relative to a 10-year potential GDP growth. It is broadly neutral at a value within -0.25%/+0.25% of GDP range.

([7]) Over 2020 to 2024, EU countries reported RRF-related use equivalent to 46% of the total RRF grant allocation, amounting to 167 billion. Gross fixed capital formation accounted for 21% of the reported use of RRF funds, while more than a half corresponded to capital transfers. Current expenditure represented 28% of the use, and other costs the remaining 1%. In parallel, Member States have implemented a broad scope of structural reforms which are expected to reinforce resilience and boost productivity, with 40% of nearly 7 thousand milestones and targets already fulfilled and an additional 19% reported as completed by Member States as of the end of October 2025.

([8]) Assuming full implementation of the 27 plans, the German economy stands to benefit from a medium-term stimulus of about EUR 66 billion (1.6% of Germany's GDP), more than twice the size of Germany's Recovery and Resilience Plan. See Michels et al. (2025).

([9]) 2023 GDP, 2015 prices terms.

([10]) Labour productivity growth consists of capital deepening and growth in total factor productivity.

([11]) For example, see (i) Draghi, M. (2024); (ii) Nikolov et al. (2024). On investment patterns (tangible vs intangible assets and sectoral distribution), see also (i) Gros et al. (2024); (ii) Hanzl-Weiss and Stehrer (2024).

([12]) For example, see Dias da Silva et al. (2024).

([13]) Source: Would Bank Development Indicators.

([14]) See e.g. A. Ifrim, R. Kollmann, P. Pfeiffer, M. Ratto W. Roeger, Europe's trade surplus, international relative prices, and the productivity growth gap, https://cepr.org/voxeu/columns/europes-trade-surplus-international-relative-prices-and-productivity-growth-gap.

([15]) To address the problem of high energy prices, the Commission has adopted the Affordable Energy Action Plan. See European Commission (2025b)

([16]) For example, see (i) Bijnens et al. (2024); (ii) Archanskaia et al. (2024).

([17]) Delivering on the environmental targets would require an additional average investment of about €120 billion per year over the 2021-2027 period. See European Commission. (2023). Figures expressed in 2022 euros. See also European Commission Communication on the 2025 Environmental Implementation Review. Figures are expressed in 2022 prices.

([18]) The extent of this impact on end-user costs will in part depend on effective planning and strategic investment in grid and renewable infrastructure. By minimising the need for additional investments and maximising their utilisation rate, robust planning can help mitigate costs for end-users.

([19]) For a discussion of the economic policy implication of AI, see Korinek (2024), which highlights that transformative advances in AI could fundamentally reshape economic structures by diminishing the role of human labour, accelerating productivity, and challenging existing frameworks for income distribution, education, macroeconomic management, and global governance. See also Acemoglu (2024), which stressed the risk that the impact of AI on total factor productivity may be overstated, as current evidence mainly reflects efficiency gains from automating simple, easy-to-learn tasks. On AI diffusion across EU countries and its main economic implications, see also Simons et al. (2024).

([20]) Computing infrastructure required to train and operate increasingly powerful models consumes substantial amounts of electricity and risks driving up emissions if not met by clean energy sources (Korinek, 2024).

([21]) Pasimeni and Dura (2025) have found that trade costs within the Single Market have decreased twice as fast as trade costs between the EU and the US.

([22]) For references and definitions regarding the transposition and conformity deficits see: https://ec.europa.eu/implementing-eu-law/transposition-directives/en

([23]) For example, some studies indicate that even modest efforts to increase services trade and achieve high convergence in implementing Single Market rules could lead to gains amounting to one-third of the benefits realised since 1990. See Dura and Pasimeni (2025). More ambitions deepening of the Single Market with full integration of goods and services markets would even double the already achieved gains. See Fontagné and Yotov (2025).

([24]) Public procurement accounts for about 16% of the EU's GDP (around EUR 2.5 trillion per year), with with over 250 000 public authorities as principal buyers in key sectors, such as: energy, transport, waste management, social protection and the provision of health or education services. Unlocking access to public procurement not only could yield significant gains (1% efficiency gain allow up to EUR 20 billion savings per year, but could be a powerful tool to create markets, especially in digital and defence sectors. See Draghi (2024), and Single Market and Competitiveness Scoreboard

([25]) The costs of regulation fall into different categories such as administrative burden from reporting requirements, compliance costs from product and services standards, and financial costs from taxes and administrative charges.

([26]) See for example: (i) Aghion et al. (2023); (ii) Coffey et al. (2020). For instance, each year German companies spend EUR 65 billion for administrative compliance costs, along the total alternative cost of EUR 146 billion from untapped output potential hindered by regulatory environment. See also Falck et al. (2024).

([27]) Available OECD indicators measuring the quality of law-making process reveal that the EU institutions are among the best performers, while the average performance of EU and euro area countries is slightly below that of non-EU OECD countries. See OECD (2025).

([28]) The European Commission has made reducing administrative burdens and streamlining legislation a key priority, aiming to cut overall administrative costs by at least 25% and by 35% for SMEs. As outlined in the Annual Overview Report on Simplification, Implementation, and Enforcement, the Commission adopted six "omnibus" packages in first half of 2025, supported by 28 implementation dialogues led by the College of Commissioners and aimed at cutting administrative costs. These measures are projected to save 8.6 billion EUR, placing the Commission one-fifth of the way toward its five-year target. These six Omnibus

packages have covered a broad range of files, including sustainable finance reporting, investment rules, the Common Agricultural Policy, digitalisation, defence, and the chemical industry.

([29]) For more information on EU trade negotiations and agreements see https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/negotiations-and-agreements_en

([30]) For an historical perspective of the international role of the euro, see Terzi (2024).

([1]) Current accounts in line with fundamentals (current account norms) are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See Coutinho et al. (2018). The positive impact of swiftly growing NIIP of the EU explains part of the excess of the current account readings vis-à-vis the current account norm. In addition, the recent slowdown in credit to the private sector pushed the current account balance slightly higher.

([2]) The EIB investment survey indicates that while EU firms in summer 2024 expected to grow investment, particularly in high and mid-tech industries, the share of firms expecting to increase investment halved compared to 2023 (European Investment Bank, 2024)

([3]) Structural factors have been extensively discussed in Draghi (2024). .

([4]) The gap in the current accounts is the difference between the (lower) average current account of debtor countries and the (higher) average current accounts of creditor countries. The larger the gap, the more it contributes to the difference in the net overall positions.

([5]) This has contributed a rebalancing of the previously very negative net external positions for Greece, Spain, Croatia, Cyprus, and Portugal, which between 2020 and 2024 managed to boost their NIIPs by 20-40 pps. of GDP, boosted by nominal GDP growth.

([6]) As set out in the IMF's external sector report "*Our assessment for 2024 shows that about two-thirds of the widening in global current account balances is in fact excessive. The increase in excess balances is the largest in a decade, driven primarily by China (+0.24 percent of global GDP), the US (-0.20 percent) and more modestly by the euro area (+0.07 percent).*" (IMF, 2025a)

([7]) European Commission, Economic Spillovers and Linkages in the EU. Paper Accompanying the 2025 in Depth Reviews, Institutional Paper 317 (LU: Publications Office of the European Union, 2025), https://data.europa.eu/doi/10.2765/808918.

([8]) Nominal compensation per employee deflated by the HICP. For the EU it was still 0.9 pps below the 2019 levels, while for the euro area, the gap was 0.4 pps below.

([9]) European Commission (forthcoming), "After the inflation shock – taking stock of price competitiveness in the EU".

([10]) Bulgaria, Czechia, Croatia, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, and Slovakia.

([11]) The interest coverage ratio is calculated as gross operating surplus over total interest before Financial Intermediation Services Indirectly Measured (FISIM) allocation; it measures how easily companies can pay the interest on their outstanding debt.

([12]) Government debt will decline over the medium term in all Member States where it currently exceeds 60% of GDP if the net expenditure paths, and assumptions of their medium-term fiscal-structural plans, materialise. Overall, the plans imply lower debt paths than a scenario at unchanged policies for most countries (European Commission, 2025e).

([13]) Non-bank financial intermediaries (NBFIs) comprise different types of financial institutions, including insurance corporations and pension funds, central counterparties (CCPs), investment funds, money-market funds, and financial vehicles. They are heterogeneous in terms of business models, risk profiles, regulation and supervision.

([14]) The European insurance sector has remained healthy in 2024, with improved profitability and stable and robust aggregate capital and liquidity positions but with some heterogeneity across Member States. The European occupational pension sector has also remained resilient. European investment funds experienced robust growth and strong investor demand in 2024. Equity exchange-traded funds (ETFs) attracted record net inflows, reflecting renewed investor appetite for equity exposure, while bond funds also saw a surge in inflows as interest rates declined. Money market funds (MMFs) remained an important liquidity vehicle.

([15]) In particular, the Commission conducted a targeted consultation assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI).

([16]) In Europe, the finance sector is the third sector most targeted by cyberattacks (after public administrations and transports), with specific cyberattacks peaks linked to geopolitical developments, notably to Russia's war of aggression against Ukraine (European Union Agency for Cybersecurity, 2024).

([17]) The ECB carried out a climate stress test in 2022 and, upon a Commission request, the ECB and the European Supervisory Authorities (EBA, EIOPA and ESMA) conducted in 2024 a one-off EU-wide climate stress test against scenarios developed by the ESRB which incorporated the implementation of the Fit-for-55 package.

([1]) In this chapter, the term 'households' includes households and non-profit institutions serving households.

([2]) This figure reflects the EU's net lending position, computed as the sum of the current account and capital account balance, which averages around EUR 300 billion since 2019 and reached EUR 437 billion in 2024. Note that its counterpart, the financial account balance, which measures the net acquisition of foreign assets, reached EUR 609 billion in 2024. The discrepancy reflects a high amount of statistical net errors and omissions.

([3]) The euro area's position as a US net creditor does not translate into higher income inflows from the US. This phenomenon is linked to profit-shifting by US multinational enterprises via financial centres such as Ireland and the Netherlands. See Emter et al. (2025).

([4]) Gita Gopinath (2025) highlights the vulnerabilities in current economic structures and stresses the importance of preparedness and resilience to mitigate the impact of future economic shocks.

([5]) For example, see: (i) European Commission (2024b); (ii) Draghi (2024).

([6]) The distribution of household wealth differs across the euro area, with the poorest 50% holding a share of around 5% of the total net wealth according to the ECB's distributional wealth accounts: https://data.ecb.europa.eu/data/datasets/DWA/data-information

([7]) Direct savings allocation refers to the immediate counterpart sector, which receives the financial investments. The presented results are based on preliminary data from a refactoring of the ECFIN-JRC 'Finflows' dataset. "Adjusted (financial) flows" refer to calculated financial flows derived from financial assets. They aim to approximate the underlying transactions in financial instruments, providing a clearer picture of financial activity from 2023 to 2024.

([8]) The estimates for the US households are based on Issuer-to-Holder (from-Whom-To-Whom) data, published by the Federal Reserve. Please note that the sectoral classification in the US financial accounts differs from the European System of Accounts. Access to the underlying data: https://www.federalreserve.gov/releases/efa/enhanced-financial-accounts.htm

([9]) These results are preliminary and based on the allocation of assets for the total financial corporation sector. They may also reflect the influence of multinational enterprises operating via holding companies, which are part of the financial sector, as well as households' indirect investment choices through ETFs.

([10]) In September 2025, the Commission has adopted the recommendation on increasing the availability of Savings and Investment Accounts, as well as the Communication on Financial Literacy. These two initiatives aim to foster greater retail participation in capital markets**.**

([1]) There are differences between the way NATO defines and calculates defence spending, and the way Eurostat does it. The Eurostat figures on defence are based on the international classification of the functions of government (COFOG), and are consistent with the several concepts used in the context of the Stability and Growth Pact (like government deficit or net expenditure). For specific purposes – like the monitoring of NATO targets, or the implementation of the national escape clause (NEC) of the Stability and Growth Pact, it is important that the right concepts are used, though in most cases the differences between the two definitions are not very large. This note does not discuss or otherwise elaborate on the differences between those concepts; for many macroeconomic analyses, one concept is a relatively good proxy of the other.

([2]) Germany (6.8%) and France (5.3%) were the next largest arms suppliers to Europe. For more information refer to SIPRI Arms Transfers Database | SIPRI.

([3]) The geographical location of the production activities of the main defence actors active in the EU is examined, using firm-level data obtained through an innovative AI-assisted approach, relying on a large language model that has been specifically enabled to process sensitive yet non-classified Commission data.

([4]) This approach identifies 103 major defence-related parent companies, of which 60 are headquartered in the EU. These companies have a total of 560 locations, of which 459 are within the EU and distributed across 36 NUTS3 regions in 11 Member States. The EU plants and subsidiaries are spread across 118 NUTS3 regions in 15 Member States.

([5]) To identify the military-specific sectors, a selection based on key words relevant for defence (e.g. military, weapons) is used, while the identification of dual-use industries is based on AI (prompting Co-Pilot with the question "sectors at Rev. 2.1 three-digit level highly relevant for defence"). Military-specific sectors include manufacture of weapons and ammunition (254) and manufacture of military fighting vehicles (304). In addition, AI classifies also manufacture of instruments and appliances for measuring, testing, and navigation (256), manufacture of air and spacecraft and related machinery (303), architectural and engineering activities and related technical consultancy (711), research and experimental development on natural sciences and engineering (721), and security systems and service activities (802) as highly relevant for defence. Note, however, that while defence may depend on the technologies developed in these dual-use industries, it is difficult to understand to what extent these technologies would not be developed without the demand from the defence sectors. Moreover, it is likely that these defence-related activities represent only a very small proportion of the overall activities in the sector.

([6]) For example, see Reuter (2025).

([7]) Indeed reports that some corporate/project functions, such as project managers, supply chain and logistics managers and technical sales, have also been in high demand.

([8]) To avoid penalising Member States' applying for the national escape clause that have already increased defence spending since 2021, a general flexibility is granted for the increase in defence spending occurred between 2021 and 2024.

([9]) The fiscal adjustment covers a period of four years, or—if extended—up to an additional three years, supported by a commitment to implement relevant reforms and investments.

([10]) On the impact on productivity of governmnet demand from defence industry, see also Ilzetzki, E. (2024), 'Learning by Necessity: Government Demand, Capacity Constraints, and Productivity Growth,' American Economic Review, 114-8, p. 2436.

([11]) For public expenditure response in the QUEST model, see Motyovszki G., Pfeiffer, P., & in 't Veld, J. (2024), "The Implications of Public Investment for Debt Sustainability", *European Economy Discussion Paper 204*.

([12]) The 2025 Spring Forecast assessed the impact of raising *core defence* spending by up to 1.5% of GDP over 2025–28 to advance the 3.5% core target. The results of the main scenario showed that real GDP would rise by 0.5% above the baseline by 2028, while the EU government debt-to-GDP ratio would be 2 pps. above the baseline by 2028.