

European Regional  
Economic Outlook

## **EUR Regional Economic Outlook**

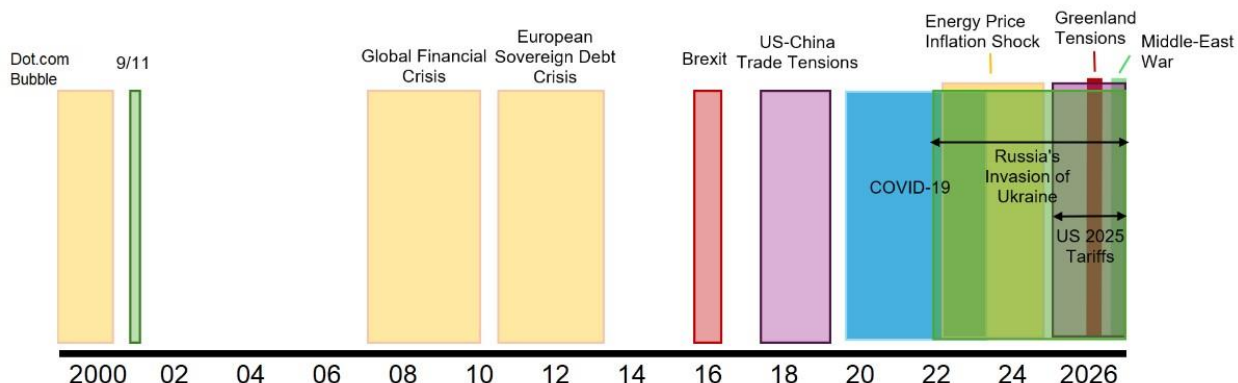
### **Reforming Europe Under Pressure**

MAY 5, 2026

Helge Berger, Deputy Director, European Department

## A global economy with more frequent and overlapping shocks

Geoeconomic and Geopolitical shocks with implications: 2000-2026



The **global economy** has become a much **more volatile place**.

The war in Iran affects European economies as an **adverse supply shock** that lowers growth and raises inflation. This alone would be complicated enough. But this shock is just the newest in a **series** that include—to focus just on the latest—**Russia's invasion of Ukraine** and the rise in **trade tensions**.

Shocks are now **more frequent, unpredictable**, and they are **overlapping**.

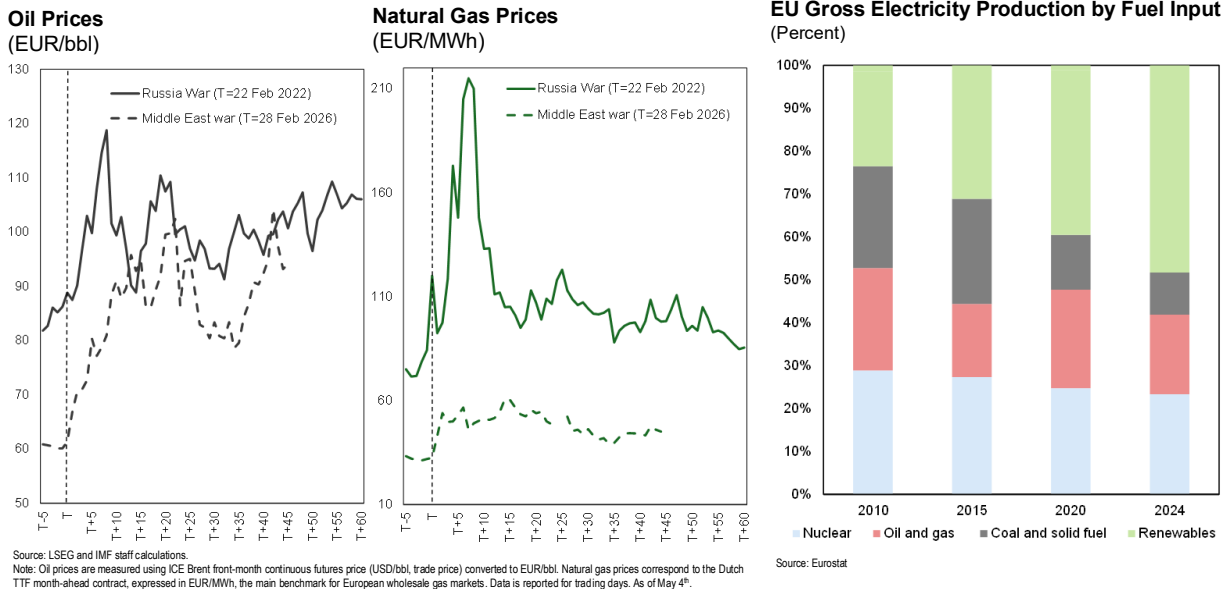
This **matters for economic policy** in a fundamental way.

Policymakers need to look for **policy action that is robust to rapidly changing circumstances** and adds to **resilience by hardening European economies** against external shocks.

In short, **Europe needs to reform while it is under pressure**.

But let's first **take a look at what we are facing at the moment ...**

## Energy shock is large, but Europe less exposed than in 2022



The energy price shock is large—if not quite as large as the one in 2022.

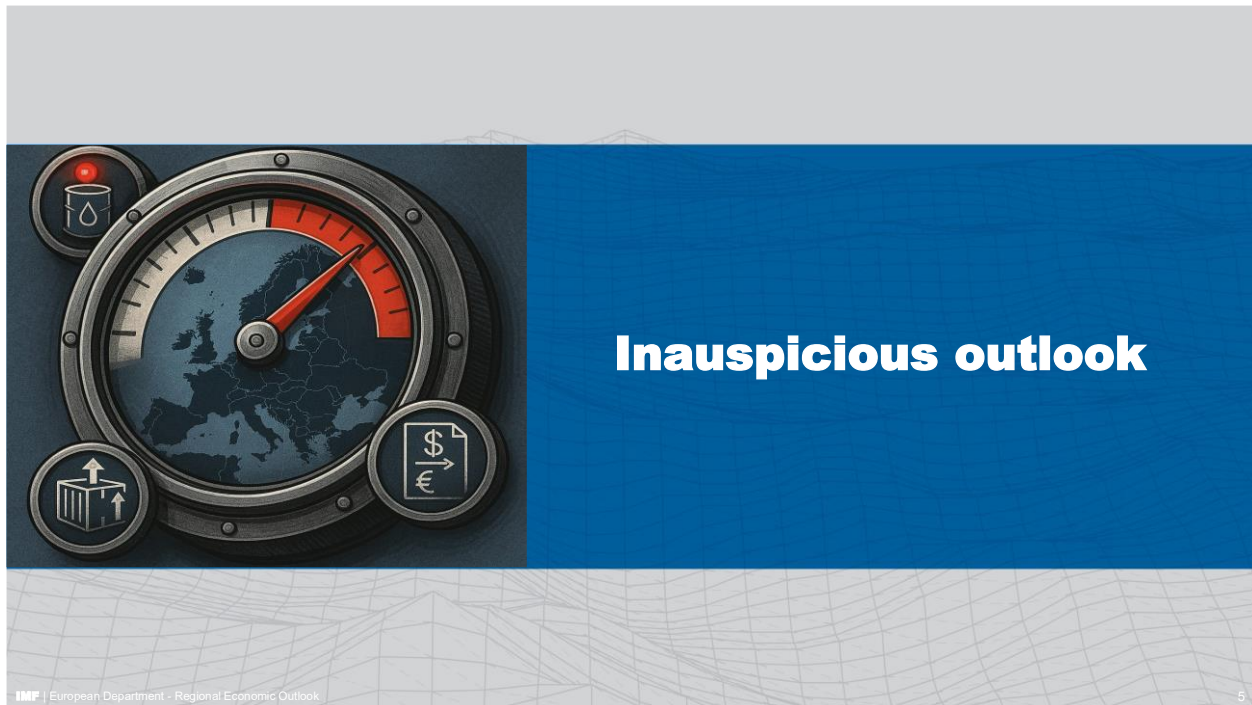
Crude oil prices have increased significantly, and are now up by about **50 percent**.

Natural gas prices in Europe are **40 percent** higher than before the war. This is a notable increase, but it still leaves prices well short of the exorbitant levels seen in 2022.

The good news is that the **rapid advance of renewables is increasingly** mitigating the effects of fossil fuel price shocks. As of 2024, **close to half of EU electricity generation comes from renewables (wind, solar, hydropower, bioenergy and waste)**—much more than in China and the U.S. where renewables account for around one third and one quarter of generation respectively. Moreover, the **EU's GDP energy intensity declined by 32 percent** from 2015 to 2025. **Energy consumption is 10 percent** lower than in 2021, and gas import volumes have fallen by **20 percent**.

Here you have a glimpse of what **Europe can do to harden its economy** to a more adverse global environment. And much of the underlying policies—from Europe's climate policies to integrating the electricity market are **in its own hands**.

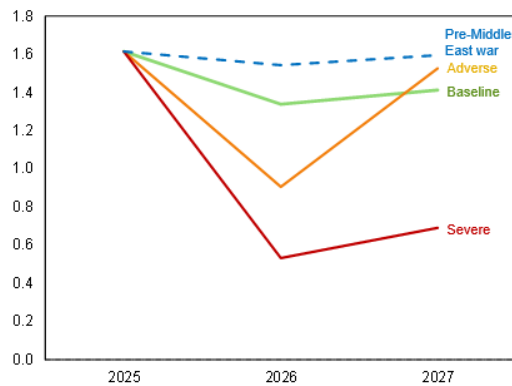
Nevertheless, the **overall energy price increase is sizable** and poses a serious headwind to growth. And **that is just under the baseline**.



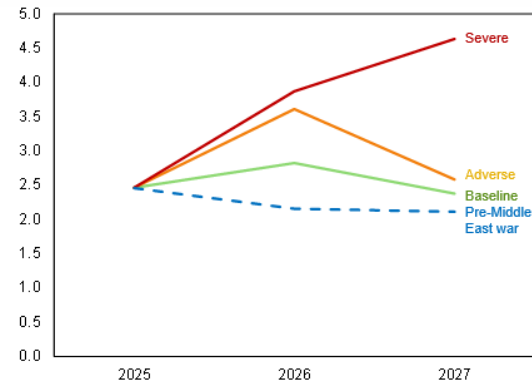
So, let's take a closer look at the **forecast**.

## The outlook is highly uncertain as downside risks dominate

European Union: Real GDP Growth (Percent)



European Union: Inflation Rate (Headline CPI, percent)



Sources: IMF, World Economic Outlook database, and staff calculations.

Note: Adverse scenario: (1) oil prices up 50 percent starting Q2 2025 relative to Jan. 2025 WEO Update baseline, falling back to 20 percent above baseline in 2027 and dissipating in 2028; gas prices up 160 percent in Europe and Asia before unwinding in 2027; food commodity prices up 2.5 percent; (2) one-year-ahead inflation expectations up by as much as 50 basis points by 2027 in advanced economies and as much as 90 basis points in emerging markets (excl. China); (3) risk-off episode increases corporate premiums in advanced economies and China by 50 basis points, while emerging markets (excl. China) experience a 100 basis points increase and a 50 basis points increase in sovereign spreads. Tightening in financial conditions fades in 2027. Severe scenario: (1) oil prices up 100 percent starting in Q2 2026, relative to Jan. 2026 WEO Update baseline, returning to baseline in 2028; gas prices for Europe and Asia up 200 percent over the same period; food commodity prices up 5 percent in 2026 and 10 percent in 2027; (2) one-year-ahead inflation expectations up by as much as 100 basis points in advanced economies by 2027 and by as much as 130 basis points in emerging markets (excl. China), also by 2027; (3) significant risk-off episode pushes corporate premiums in advanced economies and China by 100 basis points in 2026, staying at that level in 2027, while emerging markets (excl. China) see tightening in sovereign spreads of 100 basis points over same period and an increase in corporate spreads of 200 basis points.

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Before the war, **Europe was headed for a period of moderate growth and stable or declining inflation.**

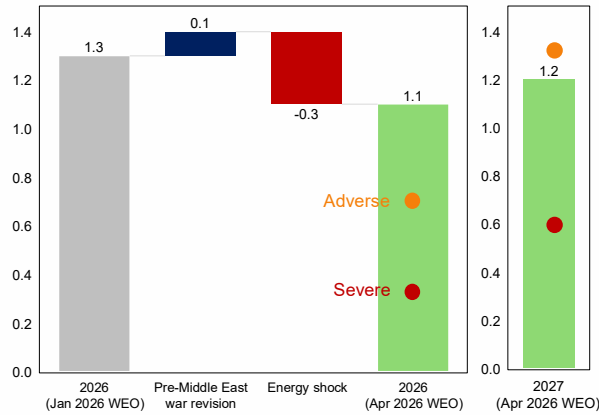
Now, **the outlook very much depends on the course of the conflict.**

- The baseline or “**reference**” forecast for the **European Union** is a **modest downgrade** from the January WEO, with **higher inflation**.
- This is based on the **strong assumption** is that the war remains short-lived.
- But, as the charts illustrate, in the **adverse** and **severe downside scenarios** in the WEO—with an increasingly longer and severe supply shock and rising sovereign and corporate yields—growth and inflation would move more substantially.

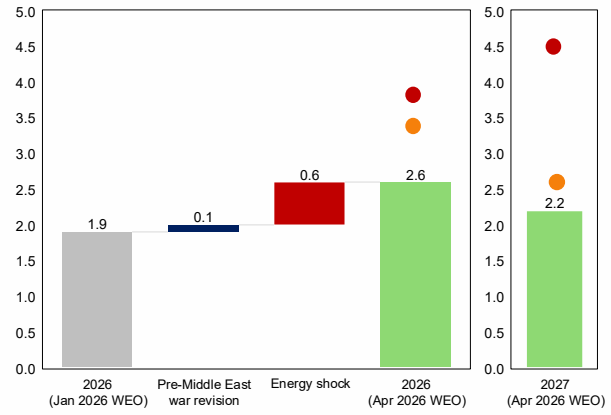
Let’s **break this down by region**, starting with the euro area ...

## The war is dampening growth and raising inflation in the euro area

**Euro area: Real GDP Growth Forecasts**  
(Pre-war vs live vintages, percent)



**Euro area: Inflation Forecasts**  
(Pre-war vs live vintages, percent)



Source: IMF, World Economic Outlook database and staff calculations.

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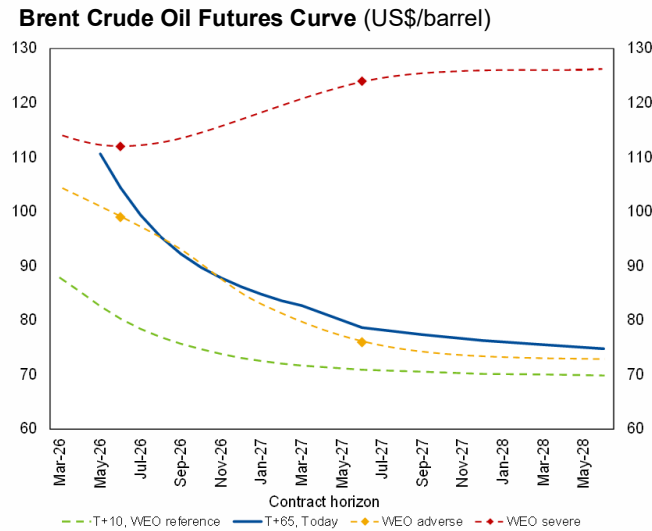
Under the **baseline**, **growth** in the **euro area** is expected to **slow** to 1.1 in 2026 and 1.2 percent in 2027, with **inflation rising** 0.7 percentage points to 2.6 percent in 2026 and declining to 2.2 in 2027.

This downgrade would have been higher if not for **better-than-expected Q4** data and some **tailwinds from higher public spending on defense and infrastructure**.

For the **Central, Eastern, and South-Eastern European economies** (CESEE; not shown), average **growth will drop** to 2.4 percent in 2026 and 2027. Depending on the country, this is between 0.2 and 0.7 percentage points lower in 2026 than forecasted before the war. Headline **inflation is projected to increase** by almost 1 percentage point to 4.2 percent in 2026, before falling to 3.3 percent in 2027.

But, as said, this **assumes that the war ends soon**. In the **“severe” downside scenario** of the April WEO, the **euro area could come close to a recession**.

## Assumptions underlying IMF forecasts remain in flux



Sources: Bloomberg Financial L.P.; and Intercontinental Exchange. Note: Time "T" refers to the start of the Middle East war As of May 4<sup>th</sup>. Futures curves in the WEO scenarios are interpolated from annual averages.

### So, how close are we to the downside?

**GDP data released last week** shows **euro area growth** in the first quarter of 2026 was broadly in line with the WEO “reference forecast” (once excluding the volatile Ireland data), while **inflation** in April was slightly higher than expected.

But **markets are getting more pessimistic on energy prices**. While natural gas prices are still anticipated to move roughly in line with the “reference” forecast, **future oil prices** evolve in a way that is **closer to the “adverse” scenario in the April WEO**.

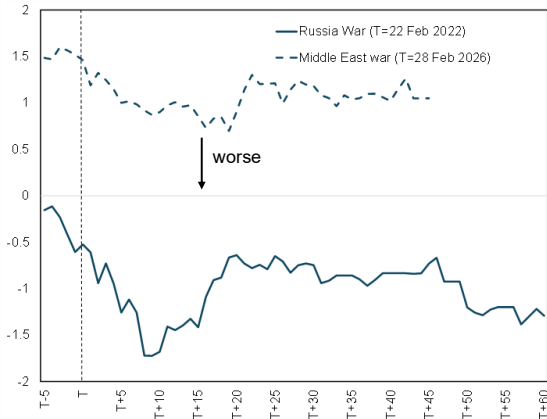
And, in April, **consumer confidence** dropped to its lowest point since late 2022.

In short, the **downside risks to our “reference” forecast** are increasing. But keep in mind that **uncertainty is extremely high** and all outcomes remain possible, depending on how the conflict evolves.

## Growing headwinds from tighter financing

### Financial Conditions

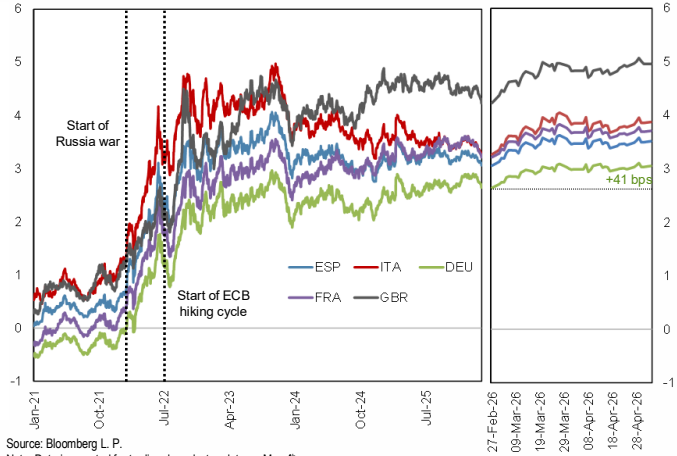
(z-score deviations from pre-crisis levels (1990s-2008))



Source: Bloomberg L.P. and staff calculations.  
Note: Data is reported for trading days; last update on May 4<sup>th</sup>. Positive values represent accommodative conditions; negative values correspond to tighter conditions.

### 10-Year Government Bond Yields

(Percent)



Source: Bloomberg L.P.  
Note: Data is reported for trading days; last update on May 4<sup>th</sup>.

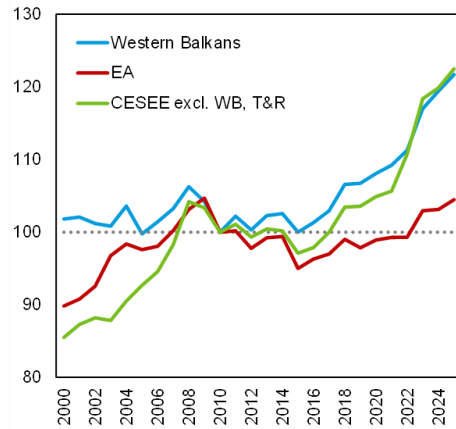
While energy prices are a key driver of the downgrades to the growth forecasts, another is **financial conditions**. Sovereign **yields and spreads have risen**.

But things could get **get worse**, which is embedded in the adverse and severe scenarios. In addition, **equity valuations** in some sectors are high and higher sovereign spreads could spill over to the private sector and **hurt credit quality**.

These **financial stability risks need close monitoring**.

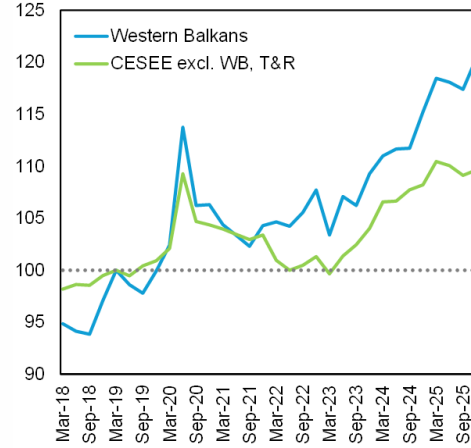
## CESEE's growth model is at risk of losing competitiveness

**Real Effective Exchange Rate**  
(Index, 2010=100)



Sources: Haver Analytics and IMF Staff calculations.

**Real Wage-Productivity ratio**  
(Q/Q seasonally adjusted index, Mar-2019=100)



Sources: Haver Analytics and IMF Staff calculations.  
1/ Real wage deflated using the GDP deflator.

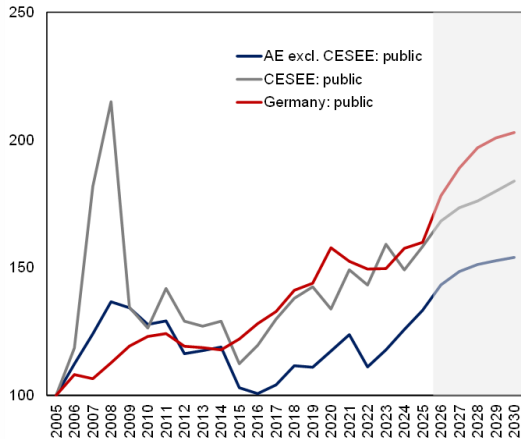
Another headwind worth attention affects particularly the **CESEE region**.

The region has traditionally relied on exports, foreign investment, and integration with EU and global supply chains. This means they are now highly **exposed to the volatile external environment**.

Higher energy prices are particularly dangerous because retaining **cost competitiveness has already become a challenge**. Before the war, inflation was already too high in several countries. **Real wage growth** outpaced productivity gains and real exchange rates appreciated.

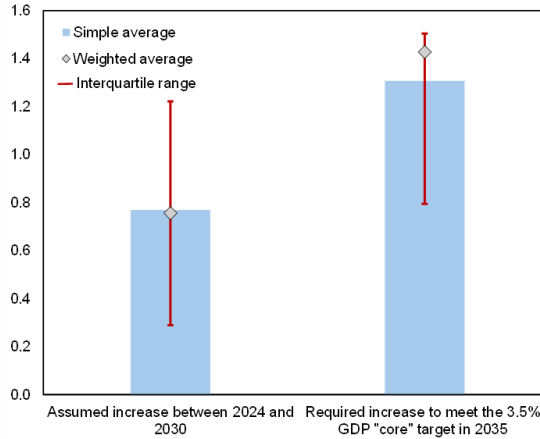
# Tailwinds from public spending will offer some support

**Evolution of Fixed Capital Investment**  
(Index, 2005 = 100)



Sources: IMF, World Economic Outlook database and staff calculations.

**Core Defense Spending Increase in European Union**  
(Percentage points of GDP compared to 2024 levels)



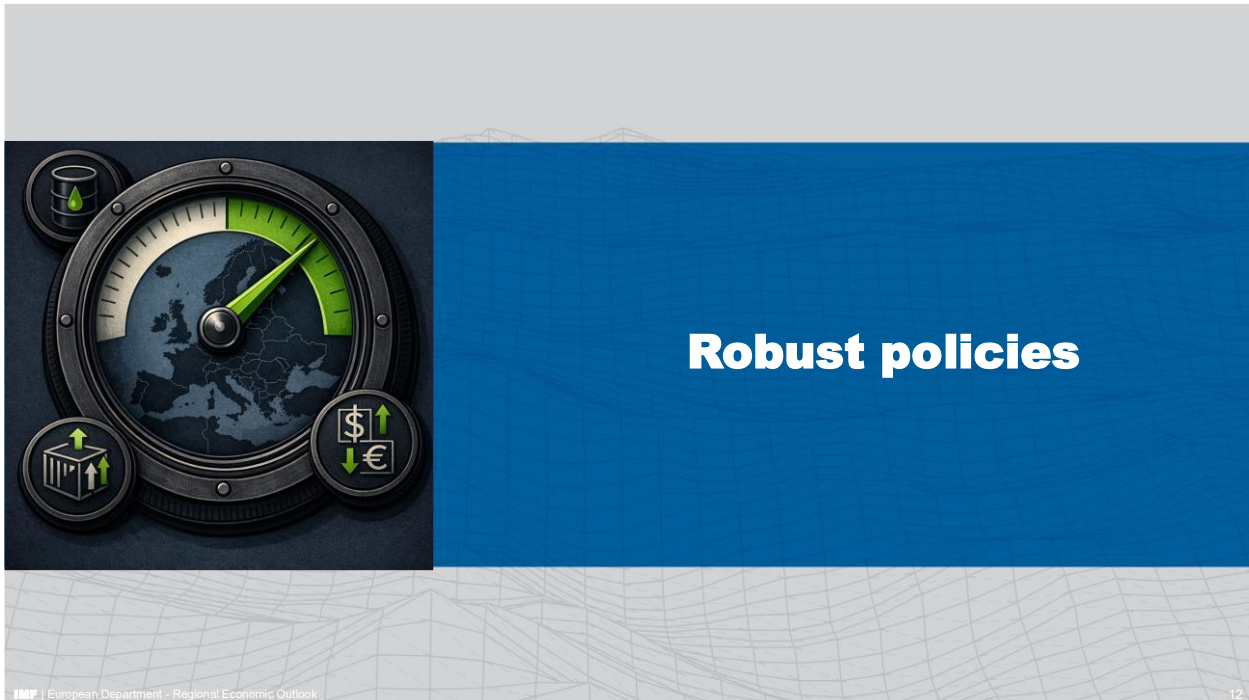
Sources: Eble and others 2025; IMF EUR fiscal desk survey April 2025; IMF, World Economic Outlook; NATO; and staff calculations.

Note: According to NATO accounting, core defense spending refers to government expenditures essential for the maintenance and operation of national armed forces, mainly those recorded in the Ministry of Defense budget. It covers personnel, operations, equipment procurement and maintenance, military pensions, research and development, peacekeeping, and contributions to NATO common infrastructure. Spending outside core military functions, such as civil defense or war damage payments, is excluded. The whiskers span 50 percent of the data, from the bottom 25 percent to the upper 75 percent.

There are **still some tailwinds**.

Support for growth continues to come from public **infrastructure investments** and **defense spending**. For example, in the case of Germany, the added fiscal spending from public investment and defense lifts growth by about 0.3 percentage points in 2026 and 0.6 percentage points in 2027.

This is helpful, but, overall, **not enough to uphold growth** at the levels expected before the war broke out.



Clearly, **policymakers** have their work cut out for them.

Europe is **no stranger to crises**, but what makes **this episode particularly difficult** to navigate is that there are **multiple possible scenarios** and—at this point—it remains unclear which one will transpire.

The answer is, it is necessary to **craft policies that are robust to different outcomes** and allow for **learning** about which scenario is materializing along the way.

- First, **macroeconomic policies must adapt to uncertainty**—there is value in waiting before we act, but we also cannot act too late.
- Second, **any market interventions** in reaction to higher energy prices or to bolster economic security need to **carefully weigh their efficiency costs**.
- Third, Europe's standing **single market agenda** has just become much more **urgent** because it would not only **raise growth** sustainably but also greatly **improve the resilience** of Europe's economies.

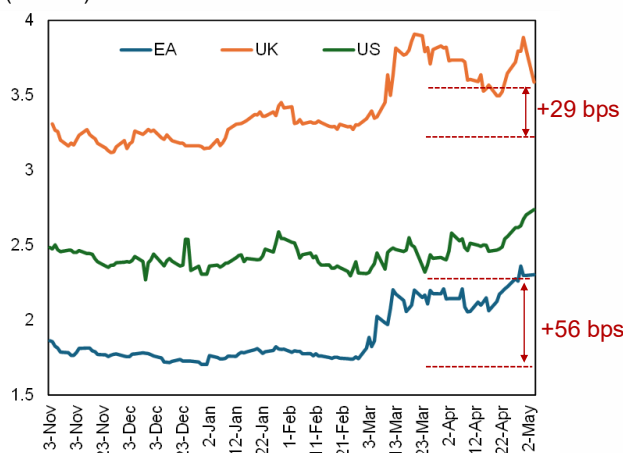


## Macroeconomic management

Let's look at **macroeconomic policies** first.

## Macroeconomic policies need to deal responsibly with shock

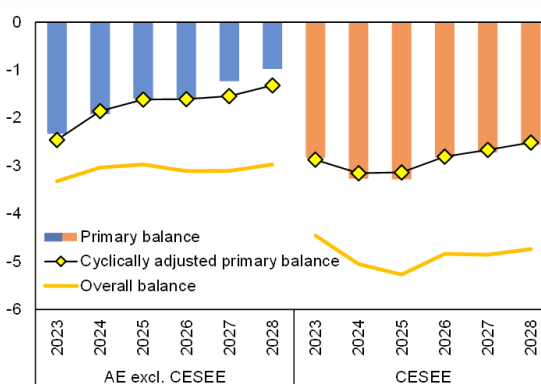
**1y1y Forward Inflation Linked Swap (Percent)**



Source: LSEG.  
Note: Data is reported for trading days. As of May 4<sup>th</sup>. The changes in bps are taken by subtracting the most recent value with the rates of February 27<sup>th</sup>.

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**Fiscal Consolidation (Percent of GDP)**



Sources: IMF, World Economic Outlook database; and staff calculations.  
Note: AE excl. CESEE includes Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Luxembourg, Malta, Netherlands, Norway, Portugal, San Marino, Spain, Sweden, Switzerland, and the United Kingdom. CESEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, North Macedonia, Moldova, Montenegro, Poland, Romania, Serbia, Slovak Republic and Slovenia.

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On the monetary policy front, the inflation shock is **complicating the life of Europe's central banks**.

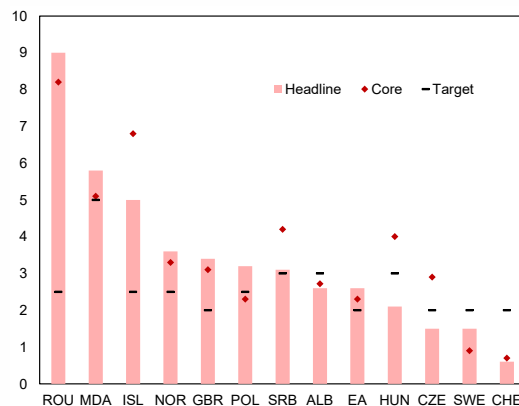
Short-term inflation expectations have risen. This would be consistent with a short-term supply shock—but we will **not know** just how **persistent** this shock really is **for a while**.

**Fiscal policymakers face a similar challenge.**

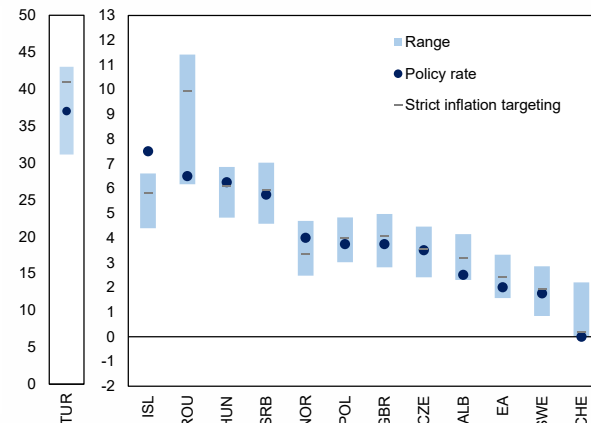
If they have fiscal space, support should be **geared to the severity and duration** of the shock which is difficult to assess.

## Monetary policy should reflect initial conditions and evolving data

**March 2026 Inflation**  
(Percent, year over year)



**Current policy rate and pre-war Taylor Rule**  
(Percent)



Sources: Consensus Economics; Haver Analytics; IMF, World Economic Outlook database; National Central Banks, and IMF staff calculations.

Note: Panel 2 compares the current nominal policy rate to an estimated range of rates consistent with a Taylor-type rule, allowing for uncertainty about the neutral rate of interest, and different central bank reaction functions (April 2023 Regional Economic Outlook: Europe). For illustrative purposes, the "Strict inflation targeting" lines indicate a Taylor rule rate for the hypothetical case where the central bank responds to inflation deviations from target, but not to changes in the output gap. This rule does not necessarily reflect the optimal simple policy rule or central bank mandates. Euro area (EA) policy rate refers to the deposit facility rate. Policy rates are taken as of April 21<sup>st</sup>. For ALB annual results for 2026 are shown due to data limitations. The Central Bank of the Republic of Türkiye uses various quantitative and macroprudential rules as part of its monetary policy regime that are not taken into account here.

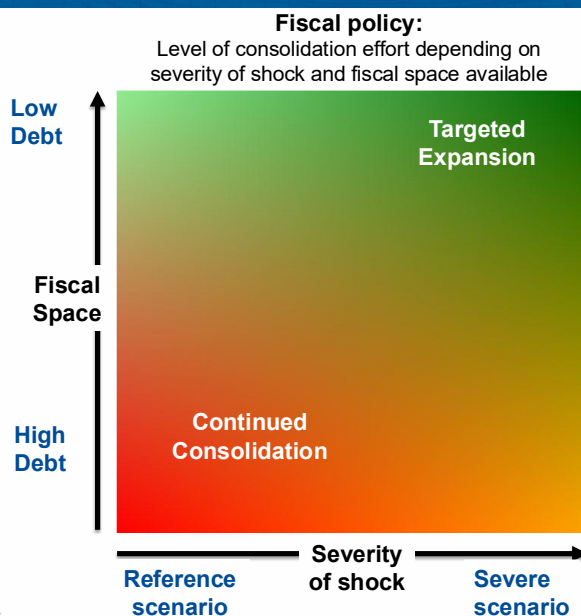
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The IMF's advice is that **monetary policy** needs to be **tailored to the starting conditions** on the ground and **adjust to the evolving data**.

- In the **euro area** and other countries where inflation is at or close to the inflation target, medium-term inflation expectations are well behaved, and the policy stance is broadly neutral, **central banks have at least some time** to see how the energy price shock plays out. That is broadly what the **ECB** has signaled, and the IMF anticipates a 50-basis point cumulative increase in the policy rate (to 2.5 percent) by the end of 2026. This would keep the real interest rate broadly unchanged. But **if there are signs** that core inflation will rise meaningfully and expectations begin moving away from target, policy action will be needed.
- For the **BoE**, holding the policy rate constant for the remainder of the year would keep monetary policy sufficiently restrictive. But given heightened uncertainty, monetary policy decisions should continue to be taken on a meeting-by-meeting basis, guided by incoming data.
- In some **CESEE** countries where inflation is still above target, wage growth is still high, and inflation expectations are more backward looking, the case for a **more restrictive** policy stance is already building.

## Fiscal policy should reflect debt levels and severity of the shock



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**Fiscal policy** must be **equally nimble** and **very aware of the available fiscal space**. This includes fully accounting for rising **long-term spending pressures** from surging defense spending, pensions and health care, and the energy transition.

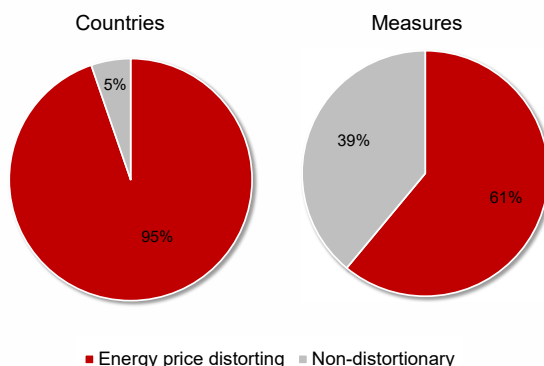
- In countries where **debt is already high** and there is **no fiscal space**, existing consolidation plans should continue under the baseline. If conditions worsen, they need to be **careful not to stretch the patience of financial markets** at a time of elevated stress.
- **Countries with high debt but some space** can allow for now automatic stabilizers to work in full by allowing the deficit to increase. If conditions worsen, they can provide some additional macroeconomic support, and pay for targeted and temporary energy support measures.
- **Low debt countries** are less constrained and have more room to absorb the shock and support their economies while avoiding adding to inflation pressures.

**The EU can play an important role** in this context.

A **larger EU budget** that focuses on jointly delivering European public goods—defense, R&D, and energy sector investments—could lessen **countries' fiscal** burdens while **improving coordination and cost efficiency**. This might be particularly important if Europe was faced with a severe downside scenario.

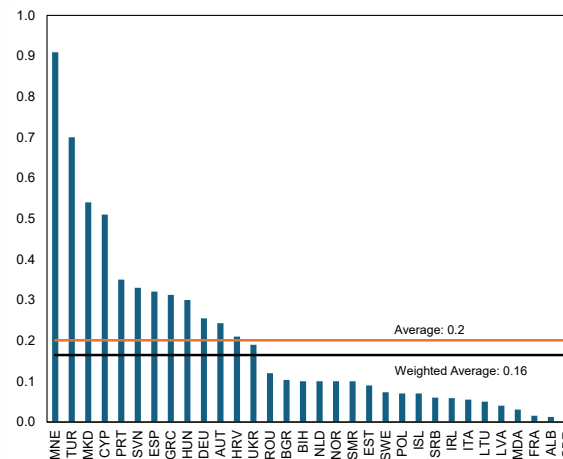
## Energy Support Measures in Europe

**Energy Support Measures**  
(Percent of total)



Source: IMF staff calculations (as of April 28, 2026).  
Note: The left pie shows the percent of countries that have adopted at least one distortory measure.

**Fiscal Cost of Energy Support Measures**  
(Percent of GDP)



Source: IMF staff calculations (as of April 28, 2026).

Moving from the overall fiscal stance to specific energy support policies, **European governments are understandably acting to provide prompt relief** for suffering households and firms.

The announced measures are mostly tax-based, with around **three-quarters of European countries implementing fuel excise adjustments**. The measures tend to be temporary and cost much less than those implemented after the Russian invasion of Ukraine, but too many are **distorting market prices** for energy.

Policies that **suppress the energy price signal are highly problematic**, since they reduce the incentive to lower energy consumption, improve efficiency and invest in alternatives. This slows the necessary adjustment to constrained supply.

**Europe can do better.** The IMF's advice is that interventions should be **targeted, temporary, and preserve price signals**. There is well-established **precedent** for this, such as Germany's support program in 2022, which based transfers on past-year energy use, thus preserving incentives to reduce energy consumption.

**Coordinating support across European countries**, both for households and firms, also avoids unnecessary distortions. **Ignoring** these principles will add to Europe's **energy dependence** at the worst possible juncture.



## Addressing pressure points & building resilience

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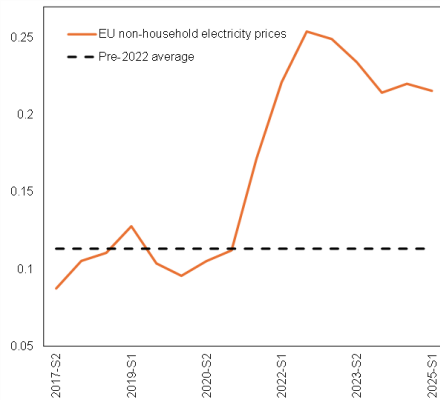
While sound macroeconomic policy is critical, wider reforms are needed.

Europe is a **resourceful continent**, and this is **not the first crisis** that its policymakers face.

Now is the time to take action **to make the region more robust to shocks**.

## Fend off energy shocks with calibrated policies & integrated market

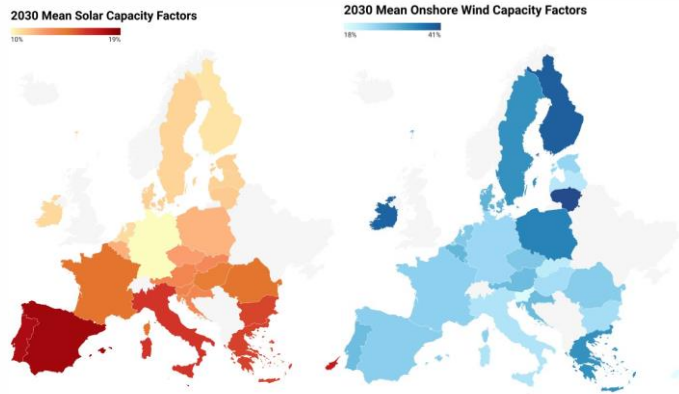
**Pre-War EU Electricity Prices for Non-Household Consumers (EUR/kWh)**



Sources: Eurostat and staff calculations.  
Note: Prices are for all consumption bands according to Eurostat and include all taxes and levies. Time frequency: semesterly.

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**Europe's Renewable Energy Capacity by 2030**



Source: Zachmann et al. (Bruegel, 2024).  
Note: Capacity factor refers to electricity produced at realistic wind or solar conditions, relative to the amount produced if the plants would in each hour have operated at their peak capacity. The figures are based on the assumptions for installed renewable capacities in 2030 reports to ENTSO-E

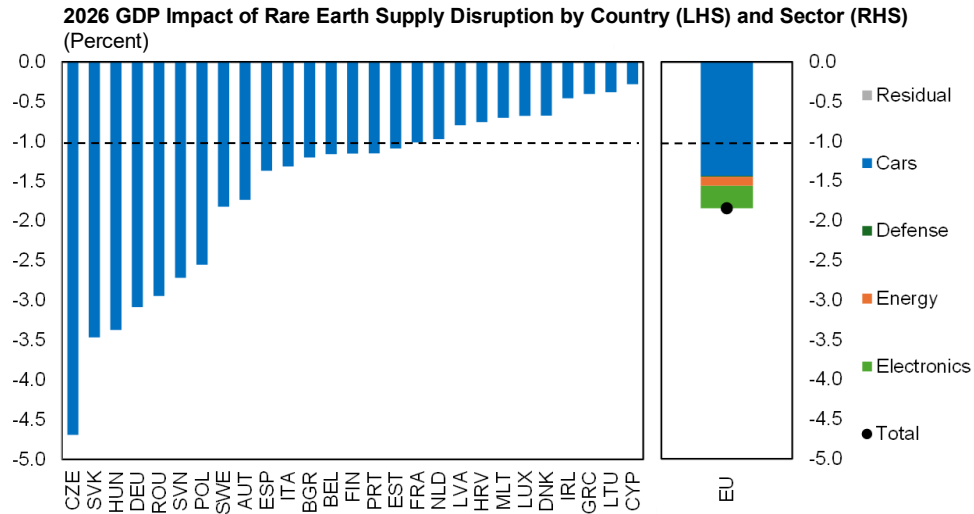
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European energy prices have never returned to the levels prevailing prior to Russia's invasions of Ukraine, and prices paid by industry were **two to three times above** levels in the U.S. and China, even before the war in the Middle East. So, the recent price volatility in energy markets is just the latest reminder that **Europe's energy dependence remains a key vulnerability**.

This makes it critical that Europe stays the course and delivers policies to increase energy security. To be concrete:

- **Giving up on the ETS would threaten progress** Europe has made towards the use of renewables (see chart on slide 4).
- Europe also needs to **complete its single market for energy**. Here the 2025 EC's Grids Package is an important step. But Europe needs more. It needs a blueprint that manages and plans its energy supplies efficiently across Europe. Wind and solar are created at different times and regions. Using them effectively requires coordination across countries.

## Economic security interventions for strategic inputs and sectors



Source: Dizioli, A., and R. Varghese. (forthcoming). *IMF Working Paper*.

**Building resilience** also involves evaluating and managing disruptions to strategic inputs and sectors. To consider one illustrative example, a complete interruption to the global supply of **rare earths** could reduce GDP by over 1 percentage point in most EU countries, mainly affecting the interconnected automobile and electronics sectors.

The Commission’s **Industrial Accelerator Act (IAA)** proposal, designed to improve economic security, includes a number of important remedies for these kinds of disruptions, such as diversification in sourcing.

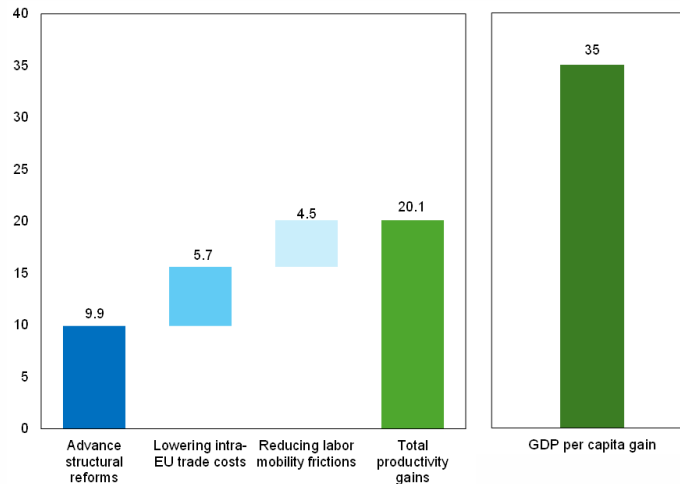
But the **IAA also brings risks**. “Made in EU” procurement requirements or conditioning inward FDI on local value creation **could distort markets** away from comparative advantage.

**Safeguarding strategic sectors** is important, but it **needs a disciplined cost-benefit approach**. Instruments differ widely in cost, design matters, and intervention should be limited to cases where markets or firms cannot easily adjust.

## Large growth potential and better shock-absorption through reforms

### Long-term Gains from EU and National Reforms

(Productivity and GDP per capita, cumulative gains over 10 years, in percentage points)



Source: IMF EUR REO Note 2 Fall 2025.

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IMF analysis shows that that a combination of **domestic reforms** and **integrating EU labor and product markets** toward US levels could **raise productivity by 20 percent**.

Higher productivity would, in turn, **crowd in** additional investment. **GDP per capita** could increase **by 35 percentage points**, eliminating the gap with the US.

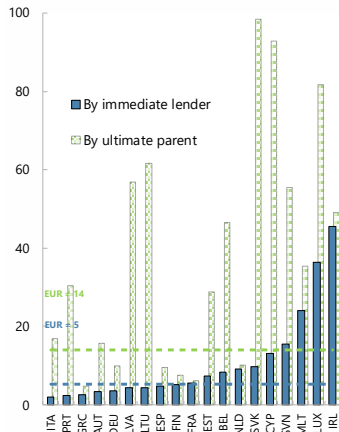
And the **benefits** include **greater resilience** and **ability to weather shocks**.

- Higher **growth means larger buffers** once an adverse external shock like the current one hits.
- **More fiscal risk sharing**, in the form of a larger EU budget, would also help.

## Integrating capital markets supports investment and builds resilience

### Incomplete banking union

(share of cross-border NFC loans, percent)

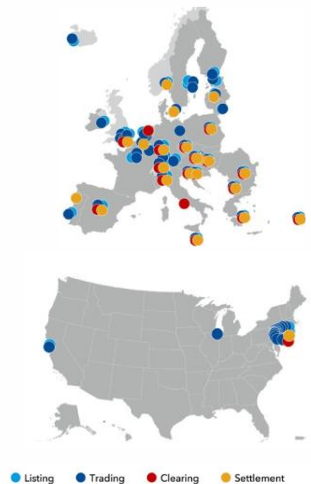


Sources : ECB, IMF staff calculations  
 Note: The chart shows the percentage of firm level borrowing that comes from cross border banks across European countries. Data covers 2023Q3.

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### Fragmented Financial Market Infrastructure

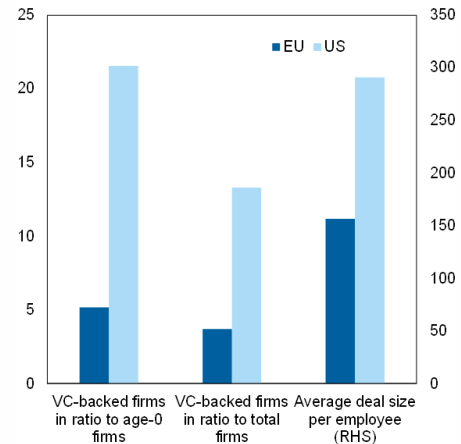
(US versus EU)



Source: New Financial.

### Venture Capital in the EU versus the US

(Left scale: per 10,000 firms; Right scale: \$1,000)



Sources: Huang and others (forthcoming).

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It is possible to build on these already large gains from reform through **better integrated banking and capital markets**.

The **EU's financial markets** remain **fragmented**. This is true for banking, public equity markets and venture capital:

- **Cross-border banking** in the EU is still very limited, even accounting for lending through subsidiaries and branches;
- **Public equity markets** are fragmented through a proliferation of listing, trading, clearing and settlement venues; and
- **Venture capital** reaches far fewer young, innovative firms than in the US.

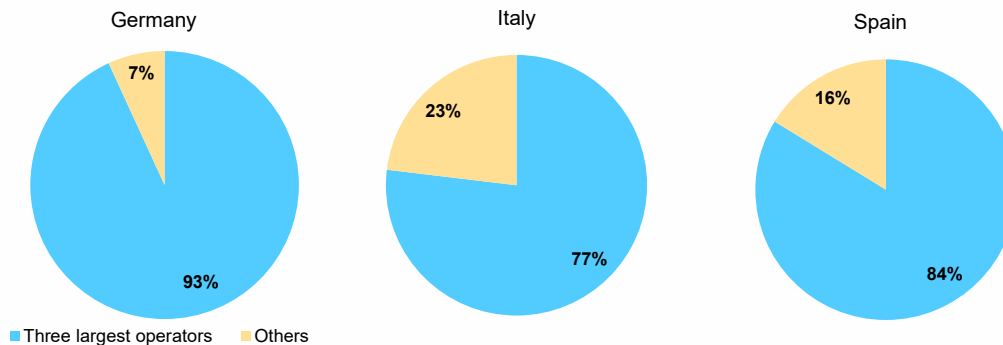
The **map** of Europe's dispersed financial infrastructure tells it all.

Closer integration will not only help provide Europe's most productive firms the capital they need to scale up, but will also build resilience. **More diversified portfolios and more cross-country financial flows will reduce exposure** when external shocks hurt member countries to different degrees.

## Relaxing merger rules could backfire in segmented markets

### Mobile Broadband

(Domestic market share 2024-25, percent)



Sources: Bundesnetzagentur; Autorità per le Garanzie nelle Comunicazioni (AGCOM) and Comisión Nacional de los Mercados y la Competencia (CNMC).  
Notes: **Germany** (based on number of registered subscribers in 2025 Q4; three largest operators are Deutsche Telekom, Vodafone and Telefónica); **Italy** (based on total SIMs in December 2024; three largest operators are TIM, Vodafone and Wind Tre); **Spain** (based on number on lines in December 2025; three largest operators are Movistar (Telefónica), MASORANGE and Vodafone).

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Alongside these policy recommendations, it is also **worthwhile emphasizing what *not* to do**. The following policies have been proposed and would be counterproductive.

- **Simply relaxing merger rules can backfire** if trade and competition barriers across Europe remain in place, and can simply increase market power of dominant firms in still-segmented national markets. A better integrated single market, however, would allow building scale without sacrificing market contestability.
- **Uncoordinated national industrial policies will not deliver** the intended results because of the large negative spillovers these have elsewhere.
- **And ‘buy Europe’ and backsliding on the energy transition have large drawbacks.**

Although many of these policies are reactions to challenges that need to be met, the **way forward is through carefully weighing the costs and benefits** of interventions and doing the hard reform work that needs doing.

## Key Takeaways

- ❑ The **outlook is highly uncertain** and dependent on assumptions
- ❑ Policies should be **robust to different scenarios** and build resilience
  - *Monetary and fiscal policy that **reflects initial conditions***
  - *Targeted, temporary **energy support** that does not distort price signals*
  - *Interventions in **strategic sectors** subject to cost benefit analysis*
  - *Advance **domestic structural reforms, integrate capital and energy markets***
- ❑ **Stay the course** on ETS, don't relax merger rules and avoid uncoordinated industrial policy

In conclusion, **shocks have become more frequent and less predictable, while also becoming increasingly costly.** Europe will need to adapt.

Policymakers need to look for **policies that are robust to these changes and reforms that make Europe's economies more resilient.** Advancing these reforms will reduce the cost of future shocks.

The longer Europe **waits**, the greater the **pressure** will become.

If **Europe delivers on this agenda now**, it will be far better placed to navigate this shock-prone world.

# Annex

## REO Tables – GDP Growth

	Europe	Advanced European Economies ex. CESEE	Euro area	CESEE ex. BLR, RUS, TUR, UKR	Emerging European Economies
<b>2026</b>	1.5	1.1	1.1	2.4	2.0
Revision from Oct. 2025	-0.1	-0.2	0.0	-0.1	-0.2
<b>2027</b>	1.6	1.3	1.2	2.4	2.1
Revision from Oct. 2025	-0.2	-0.1	-0.2	-0.3	-0.3
<b>2028</b>	1.8	1.5	1.4	2.6	2.3
Revision from Oct. 2025	0.0	0.1	0.1	-0.1	-0.1

Source: IMF, *World Economic Outlook* database; April 2026; WEO live 4/6/2026.

## REO Tables – Inflation

	Europe	Advanced European Economies ex. CESEE	Euro area	CESEE ex. BLR, RUS, TUR, UKR	Emerging European Economies
<b>2026</b>	5.4	2.6	2.6	4.2	10.9
Revision from Oct. 2025	0.9	0.7	0.7	0.7	1.2
<b>2027</b>	4.3	2.2	2.2	3.3	8.4
Revision from Oct. 2025	0.4	0.2	0.1	0.4	0.7
<b>2028</b>	3.8	2.1	2.1	3.4	7.3
Revision from Oct. 2025	0.2	0.1	0.1	0.8	0.5

Source: IMF, *World Economic Outlook* database; April 2026; WEO live 4/6/2026.