Funcas Intelligence

EUROPE IN THE CONTEXT OF GEOPOLITICAL CHANGE: THE FUTURE OF DEFENSE SPENDING, BANKS, CLIMATE STRESS TESTS AND FOREIGN INVESTMENT

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Funcas Intelligence (FI) is a publication directed towards a broad base of international and Spanish readers. Funcas Intelligence´s focus is to identify and assess the game changers and relevant events of the global economy and the financial sector with potential impact for Spain.

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Letter from the Editors

In the January issue of *Funcas Intelligence (FI),* we explore the defining economic and financial challenges of 2025, focusing on the interplay of geopolitical dynamics and policy responses. We begin by examining the diverging monetary paths of the Federal Reserve and the European Central Bank, with the former prioritizing inflation control while the latter seeks to revive Eurozone growth in the face of structural vulnerabilities. Next, we assess Europe's defense spending and trade outlook as the continent grapples with rising dependence and heightened fiscal pressures, compounded by complex geopolitical demands and transatlantic trade tensions. We then analyze the findings of recent EU climate stress tests on the financial sector, which indicate minimal financial stability risks from transition challenges but underscore the need for more nuanced methodologies to account for sectoral and geographic differences. Moving to the banking sector, we consider the outlook for European banks in 2025, where technological investments and fee-based revenue growth present opportunities, while macroeconomic, political/policy and structural risks loom. Finally, we delve into the intensifying focus on foreign investment screenings in both Europe and the United States, highlighting the delicate balance policymakers must strike between protecting national security and fostering economic growth in an increasingly polarized global landscape.

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Foreign investment and national security

European and U.S. policymakers seek to balance their desire to attract foreign investment while enhancing regulatory scrutiny of acquisitions by geopolitically sensitive SWFs, state-owned enterprises, and associated entities. The increased focus on investment screenings –both inbound and outbound– to safeguard national security and economic sovereignty could also contribute to geopolitical polarization, economic decoupling, and shifts in the global economic order.

The monetary policy wrestling match

The Fed and ECB's divergent 2025

→ The Fed and ECB are on diverging monetary paths in 2025, with the U.S. prioritizing inflation control while Europe races to lower rates to revive growth within the context of structural weaknesses.

→ Trump's tariff threats and the Big Tech-driven stock market rally add layers of complexity to an already volatile financial landscape where any misstep could trigger a global market correction.

2025 is shaping up to be a defining year in global monetary policy. The U.S. Federal Reserve and the European Central Bank (ECB) are charting distinctly different paths, reflecting very different economic realities. On one side, the Fed is signaling restraint, scaling back expectations for rate cuts as inflation proves stubborn. On the other, the ECB is aggressively easing interest rates, trying to reignite growth in a stagnating Eurozone. These opposing strategies underscore not just the economic divide across the Atlantic but also the delicate balancing act central banks face within the context of high uncertainty.

The Fed's now more cautious approach to rate cuts reflects upward revisions to inflation forecasts, now pegged at 2.5% for 2025, alongside steady growth projections

The Fed: A hawk in dove's clothing

The Federal Reserve's January meeting confirmed a significant shift in expectations for rate cuts. While markets once anticipated a steady easing cycle, the Fed has pared back its 2025 projections. Instead of four rate cuts, it now foresees just two 25-basis-point reductions. This caution reflects upward revisions to inflation forecasts, now pegged at 2.5% for 2025, alongside steady growth projections.

This decision underscores the persistent challenge of inflation, which remains above the 2% target. The Fed's current trajectory highlights its commitment to maintaining credibility in managing inflation, even at the risk of dampening growth momentum. Unemployment, forecasted to remain stable at 4.3%, adds to the Fed's confidence that the U.S. economy can withstand a more measured approach to easing.

The ECB: Cutting rates to keep the economy afloat

Meanwhile, the ECB is leaning heavily on rate cuts to counter weak growth and disinflationary pressures. Having already reduced its deposit facility rate to 2.75% in the first meeting of January 2025, the ECB is poised to cut further, potentially reaching the "neutral" 2% level by mid-2025. Economic forecasts paint a challenging picture: growth is projected at just 1.1% for 2025, and inflation is expected to align with the 2% target only by 2026.

This aggressive easing cycle reflects the ECB's acknowledgment that the Eurozone's structural weaknesses demand immediate relief. While monetary policy can provide short-term support, ECB President Christine Lagarde has repeatedly stressed the need for complementary fiscal reforms. Without structural change, even a deposit rate below neutral may struggle to deliver sustained economic recovery.

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Trump's tariff threats and the global economy

Adding complexity to this monetary divide is the uncertainty surrounding U.S. trade policy. The return of protectionist trade measures, including proposed tariffs on Chinese imports and global goods, has raised concerns about inflationary pressures and disruptions to global trade. For Europe, where export-driven industries form a crucial economic backbone, such policies could exacerbate existing challenges.

The ECB may find itself compelled to act more aggressively in response to these external shocks, particularly if trade tensions disrupt already fragile supply chains within the region or weaken industrial output further. Similarly, the Fed will have to weigh the domestic inflationary impact of such policies against the broader implications for global economic stability.

Both the ECB and the Fed will have to weigh the impact of trade tensions on their respective economies

Divergent consequences: Currency wars and economic realities

The different approaches of the Fed and ECB will inevitably shape global markets. A more cautious Fed will likely bolster the dollar, increasing borrowing costs for Eurozone nations and straining European firms. For the ECB, deeper cuts may weaken the euro, providing temporary relief for exporters but amplifying imported inflationary pressures. 2025 will also be another year to follow closely stock markets globally. The last two years have witnessed a rally, particularly in Nasdaq shares. Big Tech have had a strong rally, with some analysts suggesting some overshooting in their shares. With these very high stock values, investors become more cautious and any bad (macroeconomic or tech) news could lead to a market correction in stocks globally.

These dynamics underscore the interconnected nature of monetary policy. As the ECB focuses on easing, the Fed's restraint could limit the global economic recovery, especially in trade-dependent regions like Europe.

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2025: A year of monetary crossroads

As the Fed and ECB navigate their divergent paths, their decisions will ripple far beyond their own borders. The Fed's emphasis on controlling inflation highlights the challenges of balancing price stability with growth. Meanwhile, the ECB's aggressive easing underscores the urgency of addressing structural deficiencies in the Eurozone.

2025 will be a year of hard choices and high uncertainty. Both central banks face the same ultimate test: ensuring long-term stability while managing short-term pressures. Their success –or failure– will define the economic landscape for years to come.

EU defense spending and trade outlook

Navigation Trump's second term

→ President Donald Trump's second term will be even more disruptive to transatlantic relations than his first, as Trump has already threatened to impose tariffs on the EU, which could be more severe if the bloc does not significantly boost defense investments and U.S. imports.

→ EU leaders must manage the difficult task of maintaining unity within the weakened 27-member bloc as they explore negotiating strategies, evaluate proposals for increasing defense spending, and responsibly reduce the trade deficit while ensuring strategic autonomy, competitiveness, and fiscal stability; however, reaching the latest proposed targets for boosting EU defense spending does not appear feasible.

Trump's EU criticisms

Donald Trump's second term is expected to be even more disruptive to transatlantic relations than his first, as he will feel empowered and face fewer constraints

Relative to Donald Trump's first term, the president will feel empowered and emboldened to overhaul U.S. and global policy, challenge conventional norms, and face fewer constraints.

Defense and trade issues are some of Trump's biggest complaints about the EU. Trump has criticized Europe for relying too heavily on the United States for security guarantees. He repeatedly criticized NATO members for not meeting their defense spending target of 2 percent of GDP. After winning the November 2024 election, he told NATO leaders he would now demand they increase spending to 5 percent of GDP, although it remains to be seen if such a harsh demand is real or in part a negotiating strategy.[1] Trump also put Europe on notice by complaining it was not purchasing enough U.S. goods and threatened to impose a 10 to 20 percent tariff on imports. As of November 2024, the U.S. monthly trade deficit increased to $78.2 billion, up from $73.6 billion in October, with about $20 billion of this deficit corresponding to the EU.

EU's defense spending options

European countries spent over 3 percent of their GDP on defense during the Cold War.[2] After the war, Europe experienced relative peace and security, which led countries to decrease defense investments, increase social program spending, and rely on the U.S. security umbrella.

European defense budgets grew in 2014 after Russia annexed Ukraine's Crimea region in 2014 and accelerated after Russia's 2022 invasion of Ukraine. However, only 23 of NATO's 34 Member States were expected to meet the 2 percent target in 2024.[3]

By comparison, the U.S. government allocated USD $916 billion for defense in fiscal year 2023, representing around 3 percent of GDP.[4] The U.S. defense budget represents 40 percent of global military spending and is higher than nine of some of the major powers' spending (China, Russia, India, Saudi Arabia, UK, Germany, Ukraine, France and Japan) combined.[5] For instance, considering other NATO members' spending, the UK spent $74.9 billion, Germany $66.8 billion, and France $61.3 billion in calendar year 2023, approximately 2.2%, 1.5%, and 2% of GDP, respectively. While specific data is not available on the portion of this spending that is earmarked for U.S. military equipment, recent trends have shown that although there is some U.S. procurement, these countries do rely substantially on their domestic industries.

European Commission President Ursula von der Leyen believes the EU needs to invest at least €500 billion over the next ten years to meet the bloc's security needs.[6] However, there is no official target or consensus among EU nations, nor has NATO set such a goal. In 2024, the Commission created the post of Defense and Space Commissioner, and its first commissioner proposed increasing the defense budget from €10 to €100 billion in the EU's next seven-year budget.[7]

EU leaders agree the 2 percent defense spending target should be the floor, not the ceiling, but the 5 percent threshold Trump now demands will be extremely difficult to meet. The idea that most European countries would, willingly, spend 5% of GDP on defense anytime soon is difficult to imagine. It is hard enough for many of them to get to 2%, and as pointed out previously, not even the U.S. spends 5% of its GDP on defense right now.[8] Moreover, such a jump will be tough for many countries, given low growth, limited fiscal space due to high debt, different perceptions of risk, and domestic pressure for increased spending on other priorities areas, such as social welfare, as well as for investment in key areas such as decarbonization.

In relation to the 5% target, it is hard enough for many EU countries to get to 2% –not even the U.S. spends 5% of its GDP on defense right now

The most straightforward approach would be to offset increases in defense spending with decreases in non-defense or fund them through tax hikes. However, finding €500 billion would be challenging. Germany's government, which met the 2 percent target, recently collapsed amidst disputes about how to pay for its budget. France's government also fell apart as it sought to approve its 2025 budget. In the case of Spain, apart from the fiscal difficulties to meet even the 2% target, (Spain's defense spending reached 1.29% of GDP in 2023 or 18 billion euros), it would be even more difficult to envision at present given parliamentary gridlock to approve the General State Budget.[9] Moreover, seven countries, including Italy, are in an excessive deficit procedure, limiting their ability to increase defense spending.[10]

Some have argued the EU should exempt defense spending from the national budget to skirt EU fiscal spending rules that limit Member States from having a fiscal deficit of more than 3 percent of GDP and a public debt ceiling of more than 60 percent. Doing so would normally be difficult. However, the expected winner of the February 2025 German election indicated openness to increased defense spending, which could weaken opposition from fiscally conservative states. Nevertheless, this would also be controversial, as it would imply decreased transparency. As well, such a move would weaken the recently approved fiscal framework, and in any case, the extra spending would still require financing.

One new proposal that was initially well received was that of a voluntary joint fund, open to non-EU countries, of at least €500 billion for common defense projects and arms procurement. It would issue bonds backed by national guarantees from participating countries.[11] Its voluntary nature would avoid opposition from countries that previously blocked joint borrowing for defense Eurobonds. This approach could provide the necessary resources to strengthen Europe's defense infrastructure and close capability gaps, but political, policy, and legal challenges must still be addressed. Indeed, some countries have already come out against it. Complicating such an initiative even further, given that the EU does not have a regional army, it would be difficult to envision how the military goods acquired would be allocated across the bloc and how cooperation would be reached in this area. Europeans spend around half as much as America does on defense, but fragmentation means that European military capabilities are considerably less than half of America's. Emblematic of this is the fact that there are currently two programmes to develop next generation fighters in Europe: one is Franco-German-led and the other involves Italy, Japan and the UK.[12] Relatedly, some countries, including Spain, have proposed that the European Investment Bank (EIB) fund defense investments.

EU's trade options

Trade tensions between the U.S., Canada, and Mexico have escalated, but a temporary truce has been reached. President Trump has agreed to delay hefty tariffs on imports from Canada and Mexico for 30 days in exchange for increased border security commitments from both countries. However, broader trade frictions remain, as tariffs on Chinese imports are still set to proceed. This pause signals ongoing negotiations but does not resolve underlying trade and security disputes. Along these lines, Trump's frustrations with Europe lie in the fact that the trade deficit stems from barriers that make it harder for U.S. exports to compete in Europe. The average U.S. tariff rate was 3.3 percent in 2023 compared to the EU's 5.0 percent rate.[13] Trump has long criticized the 10 percent EU tariff on passenger cars. By comparison, the U.S. tariff rate is 2.5 percent. U.S. farmers have also complained about tariffs and other barriers, like substantial EU subsidies and strict food standards. The U.S. agricultural tariff is 4.8 percent, while the EU rate is 11.3 percent.

The EU is reportedly evaluating tariff options that would respond to U.S. tariffs.

This approach makes sense as a possible negotiating tactic but could trigger a larger trade war. In the case of higher tariffs on EU exports to the U.S., Ireland would be the most affected, followed by Germany and Italy. In terms of goods, chemicals, machinery and equipment industries would be the most vulnerable, and to a lesser extent, services too would be affected.[14]

An EU commitment to buy more U.S. goods, such as weapons, LNG (the potential buyers of LNG or agricultural products will be individual Member States or private companies, not the EU), or agricultural products, or address perceived barriers, like tariffs, subsidies, and product standards, would give Trump an important public relations win and show him the bloc is taking his concerns seriously. However, delivering on some of these commitments would be difficult.

European companies could explain how the proposed tariffs would affect their U.S. operations, though most do not have a U.S. presence. Firms could also shift production to the United States, (in fact they have been doing so to benefit from IRA) but to expand these initiatives would take time and be challenging for those trying to balance against any changes in Chinese trade.

Conclusion

Brussels may benefit from a two-pronged approach to negotiating with Trump: develop a bold plan to increase defense spending and prepare a comprehensive response to his trade concerns. It should also consider other measures that appeal to Trump, such as aligning China policy responses.

Brussels should also do everything possible to ensure the 27-member bloc negotiates as one to increase its leverage.[15] During Trump's first term, he preferred to negotiate bilaterally. EU leaders who think they could receive a better deal in a bilateral negotiation, like Hungary's Viktor Orbán and Italy's Giorgia Meloni, may see little interest in working as a bloc. On the other hand, an EU-U.S. negotiation would be preferred by vulnerable countries like Germany and Ireland, which rely significantly on the U.S. market for their exports. It would also likely benefit Belgium and Spain, which have some of the lowest defense spending levels in NATO.[16] As well, the EU needs to ensure that its actions serve to preserve a functioning rules-based multilateral trading system. Finally, the block should expand its networks of bilateral and regional preferential trade agreements, including Mercosur, among others.[17]

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Climate stress tests for banks

Addressing existing deficiencies

→ Climate stress testing for the financial sector has arrived, with the most recent EU climate stress tests revealing that the impact of transition risks on banks was low – not surprising given banks' moderate direct exposure to climate risk.

→ More generally, the methodology of EU climate stress testing is constrained by scope, timelines, and data, suggesting revisions are necessary to improve their usefulness.

Stress tests are essential for assessing whether a financial institution is at risk of becoming insolvent, which could have significant adverse consequences for the health of the broader financial market. In the past few years, these exercises have expanded to include climate related events and their impact on banks' financial resilience. Most recently, the European Central Bank (ECB) and the European System of National and Regional Accounts (ESA) analysed the impact of scenarios relating to the EU's Fit-for-55 climate transition plan, which included both macroeconomic factors and transition risks. With some observers questioning their methodology, it is worth considering some of the limitations of not only the Fit-for-55 stress tests, but EU climate stress testing more generally, as well as approaches taken in other jurisdictions.

Deconstructing the EU's Fit-for-55 testing

The Fit-for-55 stress test's baseline scenario envisioned a 55% reduction in carbon emissions across the EU by 2030.[1] The first adverse scenario included a bumpy transition whereby investors shed assets of carbon-intensive firms, impeding progress towards the green transition. The second adverse scenario amplified this shock with standard macro-financial stress factors. These stress tests were applied to 110 banks, 2,331 insurers, 629 institutions for occupational retirement provision (IORPs) and around 22,000 EU-domiciled funds.[2]

The ECB and ESA did not find any evidence that transition risks would upend financial market operations

The results of the Fit-for-55 stress tests suggest the risks to financial stability are minimal.[3] The ECB and ESA concluded that EU financial institutions are well-placed to weather any economic storms emanating from the EU's green transition and did not find any evidence that transition risks would upend financial market operations. The main result is that the direct impact of climate risks is small. This makes intuitive sense in a services economy in which banks lend relatively little to industry, agriculture, *etc*. It is the business cycle/macroeconomic events that have more impact on financial stability. Empirical results support this hypothesis: the results showed that total first-round losses (individual sectoral vulnerabilities) in the first adverse scenario would amount to between 5.2% and 6.7% of financial institutions' exposures. In the second adverse scenario, where macroeconomic shocks are included, financial institutions appear more vulnerable. Specifically, first-round losses for banks, insurers, occupational pension funds, and investment funds varied between 10.9% and 21.5%. These more painful losses are unsurprising given that some market disruptions would be expected if transition risks are combined with macroeconomic events.

Deficiencies in methodology of the Fit-for-55 tests may even be overstating negative results further. The use of a static balance sheet assumption underestimates the resilience of the financial system.[4] Although a standard approach for climate-related stress testing, it fails to capture the possibility that financial institutions may react to contain losses. If this is taken into account, the impact of the second adverse scenario could be even less disruptive to EU financial markets.

Without previous experience of global warming, it is difficult to predict with a high degree of confidence how quickly the planet will warm and when and at what level temperatures will peak

Additionally, climate modelling is constrained by the lack of relevant past data.[5] Without previous experience of global warming, it is difficult to predict with a high degree of confidence how quickly the planet will warm and when and at what level temperatures will peak. Data regarding a fast-tracked energy transition and what that might look like are similarly unavailable. Lastly, many companies do not publish emissions data, forcing banks to rely on proxy data from third party vendors.[6] Banks have complained that they require greater regulatory guidance in terms of the use of these data.

Banks have argued that the EU stress tests should also encompass a wider diversity of variables and timelines to improve their accuracy and usefulness.[7] An AFME survey of banks found a preference for incorporating a 30-year time horizon with a high-level dynamic balance sheet modelling approach to determine the full transition impacts and net-zero achievements. As well, shorter time horizons of three to five years could provide a greater variety of scenarios that test a banks' ability to quickly draw up and implement plans and minimise risks. More granular factors that take into account country-level differences would improve the tests' robustness.

Relatedly, a realistic decarbonization approach must account for sectoral disparities, technological trajectories, and geopolitical constraints. Recent advances in clean energy and policy commitments underscore that transition risks are not uniform. Stress tests should reflect these nuances by adopting granular, sector-specific, and country-level analyses. This would allow institutions to better anticipate localized risks and opportunities, ensuring financial stability while supporting climate goals. The financial industry is also concerned that the climate stress tests overlook market risks and additional risks relating to commodities, sovereigns, and counterparties.

Finally, ECB stress tests could take a more strategic approach to the inclusion of specific industries. Banks' exposures were assessed using the NACE list of

22 sectors.[8] Many of these sectors are not exposed to climate risks and their inclusion, banks argued, potentially distracts from real industry related risks. Instead, financial institutions have proposed focusing on those industries that are high-emitters or most exposed to transition risks. In any event, rather than debating whether outcomes are optimistic or conservative, stress testing frameworks should pivot towards asking forward-looking questions.

Stress testing: Geographic diversity across methodology

Australia, Canada, the UK, Singapore and the U.S. have all conducted some form of climate stress testing.[9] While the UK was a first-mover, the EU is generally viewed as having gone the furthest with climate stress testing. The methodologies differ in several ways including time horizons, the extent to which credit and market risks are assessed, whether it is a top-down or bottom-up exercise, and the choice of balance sheet approach.

Stress test methodologies differ in several ways including time horizons, the extent to which credit and market risks are assessed, whether it is a top-down or bottom-up exercise, and the choice of balance sheet approach

As the EU's primary competitor, the U.S. warrants further consideration. Although the U.S. Federal Reserve has conceded that climate change does pose a systemic risk, its actions have been far narrower than the ECB's.[10] It has tightly limited the scope of any risk assessment to its role as a macroprudential supervisor of financial stability. In line with this, the Fed has recently announced that it has withdrawn from the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). The Fed states that while the Board has appreciated the engagement with the NGFS and its members, the work of the NGFS has increasingly broadened in scope, covering a wider range of issues that are outside of the Fed's statutory mandate. The Fed in general is more inclined to leave climate risk management to Congress. It did launch a climate scenario analysis exercise in 2022 but emphasised the exploratory nature of these tests, which were separate from standard stress testing.

Looking ahead, it is extremely unlikely the Fed will further develop its climate stress testing exercises under a Trump administration. This creates a potential competitive disadvantage for European banks. While ECB stress tests do not influence capital requirements, they do entail administrative costs (indeed this is the predominant view in America) and could reduce EU banks' equity values relative to their American peers.

Conclusions

Climate stress testing is still in the early stages, with supervisors viewing them as learning exercises rather than a practical indicator for regulatory oversight. However, the risks associated with climate change and the green transition are real and do need to be provisioned against, as evidenced by disasters such as the catastrophic floods in Valencia in October 2024. As such, it is imperative that these tests be subject to thorough revision to address some of their vulnerabilities and weaknesses.

EXHIBIT – FIT-FOR-55 STRESS TEST RESULTS

	First-round losses			First and second round losses		
Sub-Sector	Baseline Scenario	First Adverse Scenario	Second Adverse Scenario	Baseline	First Adverse Scenario	Second Adverse Scenario
Banking	-5.8	-6.7	-10.9	-5.8	-6.8	-11
Insurance	-2.2	-5.2	-18.8	-2.9	-6.9	-23.3
Pensions	-3	-6.4	-21.5	-	-	-
Investment funds	-4	-6.1	-15.8	-6.6	-11.2	-25
Total financial system	-3.9	-6	-15.8	-5.3	-8.7	-20.7

Note: First round losses model individual sector vulnerabilities, while second round losses take stock of modelling of contagion and amplification effects across firms and sub-sectors of the financial system

Source: https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr241119~10b6083ce0.en.html

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European banks: Outlook in 2025… and beyond

Solid prospects in a year of change

→ The outlook for European banks remains solid in 2025, with improving economic growth and rising risk appetite supporting activity, despite falling interest rates; nevertheless, risks related to interest rates, growth, debt, geopolitics and various political or policy issues, including EU–U.S. trade tensions remain.

→ Banks appear poised to increase investment in technology and artificial intelligence (AI) to boost efficiency and control costs.

The Eurozone economy is expected to show some lackluster improvement in 2025, despite softer growth prospects for France and Germany and uncertainty related to EU-U.S. trade tensions

The macroeconomic outlook
According to the latest projections, albeit still demonstrating a lackluster performance, the Eurozone economy is expected to show some improvement in 2025 with growth of about 1.5 percent, up from about 0.7 percent in 2024. However, the outlook has been downgraded on weaker prospects for France, Spain and Germany. Despite uncertainty related to EU-U.S. trade tensions, improving real wages, a solid labor market, and easing financial conditions should underpin activity.[1] In the United States forecasters expect growth to moderate in 2025 following robust performance in 2024, while activity in China should continue to decelerate.[2]

With inflation declining, the European Central Bank (ECB) is expected to continue easing. In the U.S., a slower pace of easing is projected. The looser stance of the ECB will translate to increased net interest income (NII) pressures on Eurozone banks relative to their U.S. peers amid the Eurozone's already lackluster growth outlook and increasing risks.[3]

Political risk and uncertainty will cloud the Eurozone outlook in 2025. With Germany's economy slowing, agreement on fiscal policy will top the post-election agenda. Meanwhile, in France, fiscal policy and rising sovereign debt spreads will remain a key touchpoint. Risk and uncertainty over potential tariffs with the U.S., U.S. support for Ukraine, and geopolitics remain. Macroeconomic and political developments tend to impact the stability of the banking system through various channels, including borrowing costs and sentiment. The Spanish sector will also face the bank tax, an obstacle to maintaining its strong international competitiveness.[4]

Earnings prospects

Earnings will be driven by a combination of NII,[5] improving loan volume, and rising fee revenue, with funding costs remaining supportive. Nevertheless, loan loss provisions and ongoing cost pressures will weigh on profits. That said, streamlining branch networks and investing in digital service delivery could reduce costs while maintaining customer engagement in an increasingly online banking environment. Despite a slight increase in the European Banking Authority's overall capital requirements for the sector in 2025, some banks may also proceed with capital distributions.[6]

Earnings will be driven by declining, but still solid net interest income (NII), accelerating loan volume, and rising fee revenue

NII will remain a key source of income despite lower rates. Many Eurozone banks have reduced reliance on short-term deposits by improving deposit management strategies, protecting NII.[7] Still, NII is expected to decline, with estimates suggesting that a 100-bps reduction in the ECB's deposit facility rate would reduce interest incomes by about €30 billion across large banks in the Eurozone.[8] For some banks in Spain and Italy, and more broadly, smaller banks, where NII tends to be particularly sensitive to interest rate fluctuations, earnings may slow markedly in the coming years.[9] On the other hand, European banks have also expanded fee-based revenue streams such as wealth management or advisory services. Lower rates should also support market activity and transactions, lifting fees revenue and boosting asset inflows in 2025.

After near zero growth over 2024, total bank lending across the Eurozone is forecast to grow 3.1 percent in 2025 and 4.2 percent in 2026.[10] With economic prospects among the best in the Eurozone, Spain is expected to be a bright spot in 2025.[11]

Total bank lending across the Eurozone is forecast to grow 3.1 percent in 2025, after near zero growth over 2024

Funding costs and liquidity should remain stable in 2025, with the low deposit betas paid by European banks on customer deposits helping to contain costs.[12] Even so, loan loss provisions, especially in the commercial real estate sector in some economies, and rising operational costs, which are on track to outpace inflation at most European banks over 2025-26, will pressure profits.[13] Cost cutting and efficiency will also be key determinants of performance.

Risks

In 2025 key risks to European banks are tilted to the downside, stemming mostly from macroeconomic, political/policy, and structural issues. Key upside risks in 2025 include stronger growth and higher rates (better NII), faster loan growth (higher fees revenue), and stronger than expected markets activity (improved fees and asset inflows).

Risks to the outlook are tilted to the downside, stemming mostly from macroeconomic, political/policy, and structural issues

Downside risks include weaker growth (lower interest rates, fees and loan growth) and political/ policy risks. A weaker macroeconomic environment could also lead to a deterioration in asset quality, particularly in the commercial real estate sector, where ongoing hybrid work arrangements may reduce demand for office space and lead to increased defaults.[14] Geopolitical risks (Ukraine, Middle East, *etc.*) have the potential to disrupt supply chains and lead to commodity price spikes, while fiscal policy risks in France and Germany remain pertinent.

Trade disputes, especially potential U.S.-EU tariffs, could reduce trade finance activity and weaken credit demand in export-dependent sectors, necessitating adjustments in loan portfolio strategies. Financial market volatility and risk aversion could also increase in a scenario where stronger than expected growth leads to materially tighter financial conditions.[15]

Structural shifts including artificial intelligence (AI), cyber threats, and climate change necessitate a transformation in business models and risk management practices.[16] With the European AI Act phasing in, banks will need to increase investments in AI-driven security systems to meet compliance and mitigate the growing frequency of ransomware attacks.

Long-term trends

Long-term trends including consolidation and the growing role of artificial intelligence (AI) will continue to shape the future of the sector

Long-term trends including consolidation and the growing role of AI intelligence will be key themes across the European banking sector in 2025.

The transformation of the banking model will continue to advance in 2025, with AI here to stay. According to the European Banking Authority, more than 80 percent of European institutions use AI for different purposes and are leveraging it to change operational processes and service offerings.[17]

Banks are moving forward with plans to deploy AI-based tools, which, while costly upfront, should eventually improve productivity.[18] In October, Italian lender, BPER Banca, announced plans to reduce its workforce by 10 percent by leveraging AI-based tools.[19] Examples of AI's application in the sector include, client verification, fraud detection, portfolio optimization, default screening, and customer service automation, which, if done well, reduce operational costs and improve customer satisfaction.[20] Banks could introduce flexible digital solutions in consumer lending and payments to counter fintech disruptions, focusing on enhancing user experience and speed of service. AI can also be used to improve cyber defenses and risk management with cyber-attacks on the rise.[21]

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Foreign investment and national security

European and U.S. response to investment from countries of concern

→ European and U.S. policymakers seek to balance their desire to attract foreign investment while enhancing regulatory scrutiny of acquisitions by geopolitically sensitive SWFs, state-owned enterprises, and associated entities.

→ The increased focus on investment screenings –both inbound and outbound– to safeguard national security and economic sovereignty could also contribute to geopolitical polarization, economic decoupling, and shifts in the global economic order.

Recent cases of SWF interest in European companies highlight a broader trend of policymakers seeking to balance their desire to attract foreign investment while enhancing regulatory scrutiny of certain acquisitions by geopolitically sensitive entities

Introduction

In January, news was released that Poland's state development fund, or PFR, was more seriously considering a takeover bid of Spanish train maker Talgo, which would then merge the Spanish train maker with its Polish rival Pesa Bydgoszcz, which PFR controls. Since Hungarian consortium Ganz-Mavag withdrew a 619- million-euro ($637 million) tender offer for Talgo in August following the Spanish government's opposition to the deal on concerns that the Hungarian consortium had ties with Russia, this represents one of several potential buyers that have approached the company.

In addition, in January 2024, BlackRock agreed to acquire a 20.64% stake in Naturgy by purchasing the infrastructure fund Global Infrastructure Partners (GIP). Given Naturgy's strategic importance in Spain's energy sector, the Spanish government exercised its authority to review and condition such significant foreign investments. In September 2024, the government approved the acquisition but imposed specific commitments on BlackRock to protect national interests.

As well, in September 2023, Saudi Telecom Company (STC), majority-owned by Saudi Arabia's sovereign wealth fund (SWF), purchased a 9.9 percent stake in Telefónica, Spain's major telecommunications firm. The Spanish government had to review the deal before it could proceed. In December 2023, the government acquired a 10 percent stake in Telefónica to obtain more than STC. It then gave its approval in November 2024 despite concerns about the deal's potential impact on Telefónica's national security business with the Ministry of Defense.[1]

In May 2023, the German government confirmed it would continue with a controversial plan to sell 24.99 percent of shares in the Hamburg port to China's state-owned Cosco.[2] The government approved the deal in October 2022, but it was later put in doubt after authorities designated the port "an operator of critical infrastructure," which could have resulted in more restrictions.

The Talgo, Naturgy, Telefónica and Hamburg cases highlight a broader trend in Europe – echoing sentiment in the United States – of policymakers seeking to balance their desire to attract foreign investment with enhancing scrutiny of certain acquisitions by geopolitically sensitive entities, primarily in China and the Middle East, to safeguard national security and economic sovereignty.

U.S. and EU responses

SWFs have grown significantly over the past 25 years. In 2000, 58 funds held approximately USD 1.2 trillion in assets. By the end of 2024, 118 SWFs managed USD 13 trillion.[3] In parallel as geopolitical tensions rise, U.S. and EU policymakers are increasingly considering national security in their trade and investment decisions.

In 2018, the United States passed a law expanding the jurisdiction and review process of the Committee on Foreign Investment in the United States (CFIUS) to address concerns regarding nonpassive, noncontrolling investments and real estate transactions near military installations.[4]

CFIUS received 19 percent fewer notifications in 2023 than in 2022 (233 to 286) but pursued more mitigation practices.[5] This is likely due to new national security risks and geopolitical changes. CFIUS stopped less than 4 percent of transactions in 2023, consistent with prior years.[6] The committee subjected countries of concern to lengthier reviews. As a result, many cases notified by China and the United Arab Emirates (UAE), the top two filers in 2023, were refiled. China's filings dropped from 46 to 33 from 2021 to 2023.[7] There was a sharp rise in UAE filings from 0 to 22 during this period.[8] The next largest Middle East filer was Saudi Arabia, with a total of 7, including 0 in 2023.[9]

On 3 January, President Biden announced he would block Japan-based Nippon Steel from buying U.S. Steel because he determined it would threaten U.S. national security and supply chains.[10] Biden's decision to block an investment from Japan, an important ally, underscores how broadly the country uses national security to justify efforts to advance economic sovereignty.

On 2 January, the U.S. government began implementing new U.S. rules that prohibit and require notification of certain types of investments by U.S. persons in Chinese companies.

The EU's response to investment from countries of concern aligns with the United States, although it is more fragmented, slower and less aggressive

The EU's response to investment from countries of concern aligns with the United States, although it is more fragmented, slower and less aggressive.

Significant differences exist among Member States in national FDI screening mechanisms, including what constitutes a formal screening, the sectors covered, and notification requirements to national authorities. As such, the Commission published a legislative proposal in January 2024 to update the FDI Screening Regulation, which to date has not yet been approved. The proposed reforms would require Member States to screen foreign investments in EU companies in sensitive sectors and notify fellow states that they are reviewing a foreign investment.

EU Member States reviewed 1,808 cases in 2023, a 25 percent increase from 2022.[11] That said, similar to 2022 totals, 1 percent of cases were blocked, 4 percent were withdrawn prior to a final decision, and 85 percent were approved with no conditions. This likely means the increase in screenings has not translated into a more restrictive investment climate. The UAE and China accounted for two of the top four countries of origin – after the United States and the United Kingdom – with 7 percent and 6 percent of cases, respectively.[12] The Chinese share increased slightly from 2022 (5 percent), while the UAE share more than doubled (3 percent).[13]

The EU also launched a public consultation in January 2024 to inform future actions to address possible security risks associated with outbound EU investment transactions in certain sectors.

Investment and geopolitical implications

European and U.S. policymakers' increased focus on investment screenings –both inbound and outbound– aims to protect domestic interests but could also contribute to geopolitical polarization, economic decoupling, and global economic shifts

European and U.S. policymakers' increased focus on investment screenings –both inbound and outbound– aims to protect domestic interests but could also contribute to slower innovation, geopolitical polarization, economic decoupling, and global economic shifts.

Increased investment screenings shield certain companies or sectors from foreign investors' influence in the name of national security. They also promote economic sovereignty by reinvigorating domestic industry, promoting homegrown innovation, and reducing dependency on foreign actors for key resources and technologies.

On the other hand, greater scrutiny could deter foreign investors from pursuing acquisitions, even if there are just a few denials. Reduced foreign investment in key sectors could slow innovation and growth, leading to a capital shift to markets with looser regulations. It could also result in reciprocal trade barriers and a more fragmented global investment landscape.

The increased focus on scrutinizing investments from countries of concern, particularly China, makes sense given the government's prevalent use of economic, industrial, and cyber espionage and other problematic trade practices. The EU and U.S. through 2023 show that screenings have been employed as a limited and targeted tool. However, if the parameters are broadened or decisions are arbitrary with limited transparency or questionable justifications, like President Biden's controversial decision to block the U.S. Steel-Nippon Steel merger, it could undermine trust in the screening mechanisms and signal an unfair or unstable investment climate.

A few steps could be taken to improve transatlantic approaches and collaboration. The EU could promptly adopt the updated FDI Screening Regulation to ensure all Member States implement a mechanism and have a common approach. It could also reject efforts to narrow the critical technologies subject to review.[14] Across the Atlantic, the United States could expand CFIUS authorities to cover additional Chinese investments, such as those in emerging technologies and agricultural land near military installations. Lastly, the two allies should consider meeting periodically to discuss best practices, share investment trends, and align policy responses.

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Notes

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