

OVERVIEW

The recovery is struggling to gain momentum ...

As the vast majority of EU economies returned to growth over the course of last year, expectations were raised that Europe's economic recovery was becoming more broadly based and self-sustaining. In the first half of this year, however, GDP growth struggled to gather momentum, leaving the recovery not only subdued but also fragile. With confidence indicators declining since mid-year and now back to where they were at the end of 2013, and hard data pointing to very weak activity for the rest of the year, it is becoming harder to see the dent in the recovery as the result of temporary factors only.

GDP growth forecasts have therefore been revised down to reflect not only the materialisation of some of the risks identified in spring, but also a reassessment of the underlying dynamics of domestic demand, particularly investment, which has failed so far to emerge as a strong engine of growth. Annual GDP growth in the EU this year is now projected to be 1.3%, while growth in the euro area is expected to be 0.8%.

Economic activity, however, should gradually strengthen over the course of 2015 and accelerate further in 2016, as the legacies of the crisis fade away, structural reforms start to bear fruit, labour markets improve and more supportive policies and financing conditions are in place. Against this

Table 1:

Overview - the autumn 2014 forecast

	Real GDP				Inflation				Unemployment rate			
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
Belgium	0.3	0.9	0.9	1.1	1.2	0.6	0.9	1.3	8.4	8.5	8.4	8.2
Germany	0.1	1.3	1.1	1.8	1.6	0.9	1.2	1.6	5.3	5.1	5.1	4.8
Estonia	1.6	1.9	2.0	2.7	3.2	0.7	1.6	2.2	8.6	7.8	7.1	6.3
Ireland	0.2	4.6	3.6	3.7	0.5	0.4	0.9	1.4	13.1	11.1	9.6	8.5
Greece	-3.3	0.6	2.9	3.7	-0.9	-1.0	0.3	1.1	27.5	26.8	25.0	22.0
Spain	-1.2	1.2	1.7	2.2	1.5	-0.1	0.5	1.2	26.1	24.8	23.5	22.2
France	0.3	0.3	0.7	1.5	1.0	0.6	0.7	1.1	10.3	10.4	10.4	10.2
Italy	-1.9	-0.4	0.6	1.1	1.3	0.2	0.5	2.0	12.2	12.6	12.6	12.4
Cyprus	-5.4	-2.8	0.4	1.6	0.4	-0.2	0.7	1.2	15.9	16.2	15.8	14.8
Latvia	4.2	2.6	2.9	3.6	0.0	0.8	1.8	2.5	11.9	11.0	10.2	9.2
Lithuania	3.3	2.7	3.1	3.4	1.2	0.3	1.3	1.9	11.8	11.2	10.4	9.5
Luxembourg	2.0	3.0	2.4	2.9	1.7	1.0	2.1	1.9	5.9	6.1	6.2	6.1
Malta	2.5	3.0	2.9	2.7	1.0	0.7	1.5	2.0	6.4	6.1	6.1	6.2
Netherlands	-0.7	0.9	1.4	1.7	2.6	0.4	0.8	1.1	6.7	6.9	6.8	6.7
Austria	0.2	0.7	1.2	1.5	2.1	1.5	1.7	1.8	4.9	5.3	5.4	5.0
Portugal	-1.4	0.9	1.3	1.7	0.4	0.0	0.6	0.9	16.4	14.5	13.6	12.8
Slovenia	-1.0	2.4	1.7	2.5	1.9	0.4	1.0	1.5	10.1	9.8	9.2	8.4
Slovakia	1.4	2.4	2.5	3.3	1.5	-0.1	0.7	1.4	14.2	13.4	12.8	12.1
Finland	-1.2	-0.4	0.6	1.1	2.2	1.2	1.3	1.6	8.2	8.6	8.5	8.3
Euro area	-0.5	0.8	1.1	1.7	1.4	0.5	0.8	1.5	11.9	11.6	11.3	10.8
Bulgaria	1.1	1.2	0.6	1.0	0.4	-1.4	0.4	1.0	13.0	12.0	11.4	11.0
Czech Republic	-0.7	2.5	2.7	2.7	1.4	0.5	1.4	1.8	7.0	6.3	6.2	6.1
Denmark	-0.1	0.8	1.7	2.0	0.5	0.4	1.1	1.7	7.0	6.7	6.6	6.4
Croatia	-0.9	-0.7	0.2	1.1	2.3	0.2	0.6	1.1	17.3	17.7	17.7	17.3
Hungary	1.5	3.2	2.5	2.0	1.7	0.1	2.5	3.0	10.2	8.0	7.8	7.8
Poland	1.7	3.0	2.8	3.3	0.8	0.2	1.1	1.9	10.3	9.5	9.3	8.8
Romania	3.5	2.0	2.4	2.8	3.2	1.5	2.1	2.7	7.3	7.0	6.9	6.7
Sweden	1.5	2.0	2.4	2.7	0.4	0.2	1.2	1.5	8.0	7.9	7.8	7.6
United Kingdom	1.7	3.1	2.7	2.5	2.6	1.5	1.6	1.9	7.5	6.2	5.7	5.5
EU	0.0	1.3	1.5	2.0	1.5	0.6	1.0	1.6	10.8	10.3	10.0	9.5
USA	2.2	2.2	3.1	3.2	1.5	1.8	2.0	2.3	7.4	6.3	5.8	5.4
Japan	1.5	1.1	1.0	1.0	0.4	2.8	1.6	1.4	4.0	3.8	3.8	3.8
China	7.6	7.3	7.1	6.9	2.6	2.4	2.4					
World	3.1	3.3	3.8	4.1	:	:	:	:	:	:	:	:

background, growth in the EU is forecast to rise to 1.5% in 2015 and then increase modestly to 2.0% in 2016, while in the euro area, growth is forecast to reach 1.1% and then 1.7%. Domestic demand is expected to be the major driver of growth over the forecast horizon. To the extent that the strengthening of the economic recovery has been postponed, inflation has continued to decline, triggered also by falling energy and food prices. The forecast for inflation in the EU has been trimmed for this year and next.

... while world trade slowed.

Global GDP growth in the first half of the year turned out considerably lower than expected, mainly due to weakness in some advanced and emerging economies but also to rising geopolitical tensions in Ukraine and the Middle East.

A steady recovery is nonetheless expected in non-European advanced economies, as some of the factors that held back growth in the first half of 2014 will probably prove temporary. Notably, in the US, strong momentum in the economy will be supported by lower fiscal drag and the continuation of accommodative monetary policies. The growth outlook for emerging market economies is supported by relative resilience in emerging Asia, although a gradual deceleration of activity is likely in China. Global growth this year is now expected at 3.3 %, increasing to 3.8 % in 2015 and 4.1 % in 2016.

Mirroring the evolution of global growth, world trade weakened significantly earlier this year, revealing a steep contraction of trade flows in emerging markets. Despite a pick up since the summer, the forecast for trade growth has been revised down, reflecting also a reassessment of trade intensity to growth. World import growth is expected to reach 3.0 % in 2014, 4.6 % in 2015 and 5.5 % in 2016. Brent oil prices have sharply decreased since the spring, triggered by weak demand in the OECD and China, ample supply and market confidence in OPEC's capacity to balance any disruption stemming from geopolitical conflicts. The impact of lower commodity prices on inflation in the euro area, however, should be softened by the currency's depreciation.

The euro area is lagging behind ...

The EU's recovery appears particularly weak, not only in comparison to other advanced economies but to historical examples of post-financial crisis recoveries as well, even though these too were typically slow and fragile. Trend GDP growth, which was already relatively slow before the crisis as a result of low productivity gains, has fallen further due to low investment and high structural unemployment. In the euro area in particular, growth continues to be held back by deleveraging pressures, incomplete adjustment of macroeconomic imbalances as well as disappointment over the pace of structural and institutional reform. The legacy of the crisis is affecting Member States to different degrees but spillovers through trade and confidence are large.

Among the largest Member States, growth in *Germany* has halted, but is expected to gradually pick up again on the back of a robust labour market and strengthening external demand, while corporate investment is projected to resume only hesitantly. The *French* economy is expected to register only very slow growth in 2015 amid a subdued pace of private consumption and still contracting investment. In *Italy*, GDP growth is projected to turn positive early next year, as growing external demand is set to drive a still fragile recovery. In *Spain*, GDP growth is projected to increase, supported in particular by rising employment and easier financing conditions. Growth in *the Netherlands* is expected to firm as private consumption picks up again on

the back of increasing employment and the gradually recovering housing market. Outside the euro area, the *United Kingdom* is set to register robust growth, as both investment and consumption expand at a fast pace. Growth in *Poland* has moderated on the back of weaker external demand, but private consumption is set to support a still healthy expansion. Most of the euro-area Member States that had or have adjustment programmes are now catching up. Growth in *Ireland* and *Greece* is expected to be substantially above the EU average next year, and close to it in *Portugal*. In *Cyprus*, a modest recovery is expected to begin in 2015. While faster growth in these countries has to be seen against the backdrop of the large output losses during the crisis, it nonetheless points to significant progress in the adjustment. Finally, in most of the Member States that joined the EU a decade or less ago, output is growing faster as the process of real convergence continues.

... but positive factors should favour a self-sustaining recovery ...

Over the forecast horizon, domestic demand should increasingly benefit from the very accommodative stance of monetary policy, low financing costs, more favourable credit supply conditions, decreasing deleveraging needs, and the broadly neutral stance of fiscal policy in the EU. Private investment should gradually recover, benefitting also from progress with balance-sheet adjustments, improving demand prospects, and catching-up effects, though it will initially be held back by spare capacities, which remain ample. Equipment investment should accelerate mainly in 2016, spurred by accelerating output, while construction investment is set to recover steadily but more moderately. Rising real disposable incomes, low mortgage rates, and improved access to credit should support residential investment, although less so in countries where housing markets are still adjusting.

Private consumption is set to expand moderately in 2015 and 2016, supported by low commodity prices and rising incomes, as the labour market gradually improves. Moreover, despite lower inflation, consumers are not expected to postpone major purchases but to spend most of the projected increase in their real disposable income. In some countries where deleveraging needs remain significant, households may continue to increase their savings. As in the spring, public consumption is expected to contribute marginally to growth.

...since net exports will contribute little to growth.

The expected acceleration of global trade and the depreciation of the euro should both support EU exports. However, the increased import intensity of EU exports will limit the benefit of depreciation on trade, while imports are also set to rise as domestic demand slowly firms. Net exports are thus likely to contribute only marginally to GDP growth over the forecast horizon.

Financial conditions are increasingly supportive ...

Monetary policy in the euro area has become more accommodative since mid-2014 and some Member States outside the euro area have also cut interest rates. Following the ECB's decisions, short-term money-market rates have declined to close to (or below) zero and longer-term rates have shifted down even more than in the US. This is also a reflection of mixed economic data and of the slight decline in long-term inflation expectations. Bond spreads in vulnerable Member States have, overall, continued to tighten, and corporate bond yields have followed sovereign yields down. These benign developments are starting to translate into decreasing financial fragmentation and lower financing costs for firms. The bank credit cycle for non-financial corporates is expected to turn positive next year. This improvement should benefit SMEs along with ECB policies targeting improved monetary policy transmission. Meanwhile, corporations are expected to fund investments with internal resources to a greater extent than in past economic cycles, especially in countries where the level of non-performing loans and corporate

indebtedness are highest. Investor sentiment towards euro area banks has continued to strengthen amid further progress in bank balance sheet repair and an improved macro-financial environment. The recent correction in global and European financial markets reflects investors' growing concerns about the economic outlook. Benign financial market conditions and investment in risky assets can quickly reverse.

... and the fiscal stance remains neutral.

The deficit-to-GDP ratio in both the EU and the euro area are set to decrease further this year, albeit more slowly than in 2013, to respectively 3.0 % and 2.6 %. Government deficits are forecast to continue falling over the next two years, helped by strengthening economic activity. The fiscal policy stance is expected to be close to neutral in 2014 and 2015, as the fiscal effort, measured in terms of changes to the structural balance, should be broadly nil in both years. The debt-to-GDP ratios of the EU and the euro area are expected to peak next year at 88.3 % and 94.8 % respectively (under the ESA 2010 definition).

Labour markets are slowly improving ...

Recovery of the labour market in the EU is progressing but remains subdued, in line with the weakness of economic activity. Differences across Member States remain sizable but have started narrowing, thanks to improvements in stressed countries. The current pace of economic activity does not allow for rapid and massive absorption of excess capacities. Employment growth in 2014 is thus expected to be limited at 0.4 % in the euro area and 0.7 % in the EU; about the same as projected last spring. Supported by the economic recovery and the moderation shown in past wage increases, employment in 2015 is set to increase by 0.5 % in the euro area and 0.6 % in the EU before its growth gaining speed in 2016 to 0.9 % and 0.8 % respectively. As a result, the unemployment rate should fall slowly to 9.5 % in the EU and 10.8 % in the euro area in 2016, which is still above pre-crisis levels.

...and inflation is persistently low.

The disinflationary trend across EU Member States has continued this year, driven by lower commodity prices, especially for energy and food, the weaker-than-expected economic environment, and the euro's earlier appreciation. The slack in the labour market and economic agents' low expectations of future price developments have acted as a drag on wage developments, while producer prices have also been pulled down by spare capacities due to weak demand. Some Member States also experience very low, or negative, inflation rates as part of their inevitable adjustment process. In the near term, weak output and weak commodity prices should continue to dampen inflation over the rest of 2014. As economic activity gradually strengthens and wages rise, however, inflation should increase, also fuelled by the waning impact of low energy prices and slightly higher import prices due to the depreciation of the euro. HICP inflation in the euro area is now forecast to be 0.5 % this year, but to rise to 0.8 % in 2015 and 1.5 % in 2016. For the EU, inflation is seen at 0.6 % this year and then at 1.0 % in 2015 and 1.6 % in 2016.

External risks have increased

Even though the risk of higher geopolitical tensions has materialised since spring, risks to the growth outlook remain tilted to the downside. In particular, increased tensions with Russia, or intensified conflicts in the MENA region could hurt growth. Also, widespread and abrupt corrections in financial markets could occur as the US attempts to normalise its monetary policy, or because of increased global risk aversion. Further disappointment about the pace of implementation of reforms in the EU would also hurt the growth outlook.

Risks to the growth and the inflation outlook are closely linked. Downside risks to inflation stem mainly from weaker-than-expected domestic demand, a prolonged period of falling energy and commodity prices, and a deanchoring of inflation expectations. Lower-than-expected inflation could have potentially serious effects on economic activity by making relative price adjustments more challenging and deleveraging more difficult. The risk of outright deflation, in the sense of a broad-based and self-perpetuating fall in prices across the euro area, however, still appears low. By contrast, should the recovery be faster-than-expected or oil prices higher than assumed, HICP inflation in the EU could turn out higher than forecast.

Upside risks to the growth outlook are fewer and include the possibility of stronger than expected increase in foreign demand, a faster-than-expected recovery of investment and employment. Sentiment and growth could also rebound more strongly.