

OVERVIEW: LESS DYNAMIC GROWTH AMID HIGH UNCERTAINTY

Interrelated external and domestic risks are clouding the outlook

The European economy has moved into lower gear...

The EU economy is entering its sixth year of uninterrupted growth and all Member States are expected to grow over the forecast horizon. But the moderation of momentum since the start of the year and leading indicators both suggest that economic growth has peaked in 2017. The extraordinary impulse from the rebound in global growth and trade enjoyed by the European economy last year is already wearing off, as the outlook for global growth is weakening and trade tensions have risen.

...amid still robust domestic fundamentals.

The strength of Europe's domestic growth drivers should however be sufficient to allow activity to continue growing and unemployment falling. The improving labour market, slightly stronger wage growth and expansionary fiscal measures in some Member States, should help to sustain consumption next year. In addition, investment should enjoy the continued support of still favourable financing conditions, even assuming the gradual normalisation of monetary policy. The outlook, however, is clouded by the presence of a number of interrelated downside risks.

GDP growth is set to continue at a slower pace.

From 2.4% in 2017, euro area GDP growth is forecast to moderate to 2.1% this year and 1.9% in 2019, slightly below the growth rate projected back in the summer. It is then expected to ease smoothly to 1.7% in 2020. Exogenous factors, such as fading world trade growth, rising uncertainty and higher oil prices should have a dampening effect on growth in general, while economic

Table 1:

Overview - the autumn 2018 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
Belgium	1.5	1.5	1.4	2.3	2.1	1.6	6.4	6.1	5.9	1.2	1.1	1.1	-1.0	-1.1	-1.3
Germany	1.7	1.8	1.7	1.8	1.9	1.6	3.5	3.2	3.0	7.8	7.3	6.9	1.6	1.2	1.1
Estonia	3.5	2.8	2.4	3.5	3.3	2.5	5.7	6.0	6.0	3.5	3.2	3.2	0.5	0.5	0.2
Ireland	7.8	4.5	3.8	0.7	1.2	1.4	5.6	5.1	4.9	11.7	11.6	11.4	-0.1	-0.1	0.2
Greece	2.0	2.0	2.0	0.8	1.2	1.0	19.6	18.2	16.9	-0.2	-0.2	0.3	0.6	0.6	0.6
Spain	2.6	2.2	2.0	1.8	1.7	1.5	15.6	14.4	13.3	1.2	1.0	1.1	-2.7	-2.1	-1.9
France	1.7	1.6	1.6	2.1	1.7	1.6	9.0	8.8	8.4	-0.6	-0.7	-0.5	-2.6	-2.8	-1.7
Italy	1.1	1.2	1.3	1.3	1.5	1.4	10.7	10.4	10.0	2.6	2.5	2.5	-1.9	-2.9	-3.1
Cyprus	3.9	3.5	2.9	0.8	1.3	1.4	8.2	6.3	4.8	-8.2	-9.3	-9.5	2.8	3.0	2.9
Latvia	4.1	3.2	2.9	2.7	2.7	2.4	7.3	6.7	6.5	0.0	-0.4	-0.4	-0.8	-1.0	-0.7
Lithuania	3.4	2.8	2.5	2.6	2.2	2.1	6.5	6.3	6.3	-0.8	-0.8	-0.6	0.6	0.4	0.1
Luxembourg	3.1	3.0	2.7	2.0	2.0	1.8	5.3	5.2	5.2	4.2	3.8	3.3	1.3	1.2	0.9
Malta	5.4	4.9	4.4	1.8	1.9	2.0	3.9	4.0	4.0	12.3	11.2	10.6	1.3	1.2	0.7
Netherlands	2.8	2.4	1.8	1.6	2.5	1.7	3.9	3.6	3.6	10.1	9.5	9.1	1.1	1.1	1.0
Austria	2.7	2.0	1.8	2.1	2.1	2.0	4.8	4.6	4.4	2.0	2.2	2.4	-0.3	0.0	0.1
Portugal	2.2	1.8	1.7	1.5	1.6	1.6	7.1	6.3	5.9	0.0	-0.1	-0.1	-0.7	-0.6	-0.2
Slovenia	4.3	3.3	3.0	2.0	2.3	2.2	5.6	5.3	5.1	7.5	7.1	6.7	0.5	0.4	0.2
Slovakia	4.0	4.1	3.5	2.6	2.6	2.4	6.9	6.3	6.0	0.0	1.2	2.1	-0.6	-0.3	-0.1
Finland	2.9	2.2	1.9	1.2	1.6	1.8	7.8	7.2	6.9	0.7	1.1	1.6	-0.8	-0.2	-0.1
Euro area	2.1	1.9	1.7	1.8	1.8	1.6	8.4	7.9	7.5	3.8	3.6	3.6	-0.6	-0.8	-0.7
Bulgaria	3.5	3.7	3.6	2.6	2.0	1.8	6.0	5.8	5.7	5.9	4.6	5.1	0.8	0.6	0.6
Czech Republic	3.0	2.9	2.6	2.1	2.2	1.8	2.4	2.5	2.6	-0.5	-0.5	-0.1	1.4	0.8	0.7
Denmark	1.2	1.8	1.6	0.8	1.5	1.7	5.2	4.9	4.7	6.1	6.2	6.1	0.2	-0.1	0.6
Croatia	2.8	2.8	2.6	1.6	1.5	1.4	9.1	7.6	6.6	2.5	2.0	1.8	0.2	0.4	0.1
Hungary	4.3	3.4	2.6	3.0	3.3	3.0	3.6	3.3	3.2	1.2	0.0	0.3	-2.4	-1.9	-1.8
Poland	4.8	3.7	3.3	1.2	2.6	2.7	3.3	2.9	2.8	-0.6	-0.9	-1.3	-0.9	-0.9	-1.0
Romania	3.6	3.8	3.6	4.3	3.5	3.3	4.3	4.2	4.1	-3.7	-4.2	-4.5	-3.3	-3.4	-4.7
Sweden	2.4	1.8	1.8	2.1	1.9	1.6	6.3	6.2	6.2	3.2	3.0	2.9	1.1	0.9	0.8
EU27	2.2	2.0	1.9	1.8	1.9	1.7	7.4	7.0	6.6	3.5	3.3	3.2	-0.6	-0.8	-0.6
United Kingdom	1.3	1.2	1.2	2.6	2.0	1.9	4.3	4.5	4.7	-3.3	-3.2	-3.0	-1.3	-1.0	-1.0
EU28	2.1	1.9	1.8	2.0	2.0	1.8	6.9	6.6	6.3	2.5	2.3	2.3	-0.7	-0.8	-0.7
USA	2.9	2.6	1.9	2.5	2.4	2.2	3.9	3.5	3.5	-2.4	-2.6	-2.8	-5.8	-6.0	-6.0
Japan	1.1	1.0	0.5	0.8	1.0	1.3	2.7	2.6	2.5	4.7	4.7	4.7	-3.3	-3.1	-2.8
China	6.6	6.2	5.9	1.8	2.0	1.8	1.8	1.8	1.8	0.2	-0.2	-0.4	0.2	0.2	0.2
World	3.7	3.5	3.5												

activity should also weaken as labour market improvements slow, slack diminishes, and supply side constraints become more binding in certain Member States.

Global growth increasingly diverges as some risks partly materialised...

After rising in synchronised fashion, GDP growth across the world is set to become more divergent, especially within emerging markets, as previously identified risks related to trade protectionism and financial vulnerabilities in emerging markets have begun to materialise. Global growth, however, is forecast to remain robust in the near-term as economic activity in advanced economies will benefit from buoyant momentum in the US boosted by a pro-cyclical fiscal stimulus, strong labour markets and sentiment. Over the next two years, GDP growth in advanced economies (excluding the EU) is expected to moderate, as the economic cycle matures and less support comes from monetary and fiscal policies. In the US, the positive effect of the fiscal stimulus in 2019 is set to be partly offset by the negative effect of higher tariffs, and GDP growth is now expected to be moderately weaker than forecast in the spring.

...and the outlook is for a deceleration next year...

Global growth (excluding the EU) is now forecast to peak at 4.0% this year before settling down to rest at 3.8% in both 2019 and 2020. This downward revision since the spring, particularly for next year, is largely due to a deterioration in the growth outlook for a number of emerging market economies, which have been hit by tightening financial conditions, geopolitical tensions and domestic policy uncertainty. Rising oil prices cast an additional shadow on the outlook for oil importers but imply an improvement for several oil-exporting countries. Recent US tariff measures are expected to dent China's GDP growth, although their impact should be partly offset by domestic macroeconomic policy measures.

...surrounded by acute downside risks...

Under the central scenario, economic growth in the US is expected to fall gently below the economy's estimated potential growth rate in 2020. It also assumes the absence of a further escalation of trade disputes beyond the measures already adopted and firmly announced. Finally, it assumes that financial markets will continue to differentiate between emerging markets, thus containing broader contagion. These benign assumptions, however, imply that the global growth outlook is subject to significant downside risks.

...while global trade is set to ease more markedly amid rising trade tensions.

Global trade growth is expected to decrease markedly over the forecast horizon in light of weakening global activity and trade tensions. Having peaked at 5.5% last year, non-EU world import growth began losing momentum in the first half of the year and is expected to slow to 4.8% this year and 4.0% in 2019 (about ¼ and ½ percentage points below what was expected back in the spring). It is forecast to ease further to 3.7% in 2020, amid lower trade in investment goods as the boost to investment from the US stimulus package diminishes and the Chinese economy moves further away from investment-led to consumption-driven growth.

Financial market sentiment has softened...

In recent months, increased trade tensions and rising global interest rates, driven mainly by the rapid pace of monetary tightening in the US and somewhat lower than expected corporate earnings, have weighed on financial market sentiment. Stock markets have recently fallen in Europe, the US and Asia, while global benchmark bond yields are more mixed, still on the rise in the US and little changed elsewhere.

...while there is so far no contagion from higher Italian yields.	European equity indices have trended downward mainly due to concerns related to US trade policy and the turmoil in some emerging economies. The European banking sector has underperformed as a result of shocks, including the crisis in Turkey, money laundering scandals and the increase in Italian yields. The outlook for public finances in Italy has pushed Italian sovereign yield spreads significantly higher in recent months. So far, no contagion to other Member States has been observed.
The euro strengthened against emerging market currencies...	The euro has appreciated slightly in nominal effective terms in recent months due to a strengthening against a range of emerging market currencies. At the same time, it has weakened rather substantially against the US dollar, reflecting the different pace of monetary policy normalisation as well as uncertainty related to trade tensions. The euro's nominal effective exchange rate is assumed to appreciate by about 5% on average this year and by another 0.6% next year.
...and market-based funding costs slightly increased.	Net lending to households and non-financial corporations (NFCs) in the euro area is expected to continue increasing over the forecast horizon under the combined effect of relatively supportive bank credit conditions and strong demand. However, in most Member States, financing costs for NFCs have risen slightly from very low levels in recent months, reflecting higher corporate bond yields and lower equity prices. Financing costs have risen the most in Italy due to substantial increases in market-based funding costs.
Domestic demand should be the main driver of growth...	Lower momentum in the first half of this year compared to 2017 is largely attributable to the lack of contribution of net trade to growth. With external demand set to weaken further, GDP growth in Europe will depend mainly on domestic fundamentals.
...with private consumption increasingly fuelled by wages rather than by job creation...	Private consumption growth also moderated in the first half of the year, in line with decreasing consumer confidence. It is however forecast to remain a main growth driver supported by solid fundamentals. Labour markets should continue to improve, with wage increases contributing more towards household nominal disposable income growth than rising employment. Low interest rates should also help to sustain asset prices and household wealth. However, the increase in inflation is set to have a dampening effect on household purchasing power this year and next. Overall, private consumption in the euro area is forecast to increase this year by 1.6%, the same pace as last year, and to pick up to 1.8% in 2019 partly due to fiscal measures in some Member States. In 2020, as lower inflation should offset the impact of a further moderation in the pace of job creation, private consumption is set to fall back to 1.6%.
...and investment set to be dampened by fading external demand...	Last year's exceptionally benign global environment helped support investment in the euro area, which continued to grow significantly faster than GDP in the first half of 2018. Still favourable financing conditions, high rates of capacity utilisation in manufacturing and a positive earnings outlook are set to continue to support equipment investment. However, in a context of strong linkages between exports and the business investment, rising trade tensions and trade policy uncertainty have started to dent business sentiment, which combined with growing supply constraints should entail a moderation in the next two years. Residential investment should be supported by the continued dynamism in real house prices and positive income prospects. Yet with the expected steepening of the yield curve, new mortgages should progressively become somewhat more costly and make alternative

investments relatively more attractive. Overall, investment in the euro area is projected to lose some momentum over the forecast horizon.

...which should lead to a neutral contribution of net trade to growth...

In the first half of 2018, the growth of euro area exports was less than half the average pace of the previous year. In line with the weaker outlook for global trade, and the lagged impact of the euro's past appreciation, expectations for euro area exports have been lowered significantly since the spring, although in some Member States this also reflects the reality of more binding supply constraints. As a result, net trade, which made a sizeable contribution to growth in 2017, is projected to contribute less this year before turning neutral in 2019 and 2020.

...and a decline of the euro area current account surplus.

The euro area's current account surplus (as a percentage of GDP) peaked in 2017 and is set to recede somewhat this year before settling down to around 3.6% in 2019 and 2020. The main contributors to the surplus remain Germany and the Netherlands but their combined share is expected to decline, as smaller euro area Member States are forecast to add increasingly to the aggregate surplus.

Labour market slack has meaningfully receded...

Labour market conditions in the euro area continued to improve in the first half of 2018 with employment improving steadily despite the slower pace of growth. The unemployment rate continued to fall while the decline in broader measures of underemployment (e.g. involuntary part-time work) suggests that slack has also been reduced further and that the pool of further potential workers is shrinking. The situation in individual Member States, however, continues to differ significantly. Over the next two years, employment creation should continue to benefit from the economic growth as well as structural reforms and specific policy measures in some countries. Yet job creation is projected to be dampened by increasing labour shortages and the more moderate pace of economic growth. Net job creation in the euro area is projected to slow from 1.4% in 2018 to 1.1% in 2019 and 0.9% in 2020. This slowdown, combined with almost steady growth in the labour force, means that the unemployment rate is likely to fall less than in previous years.

...but the pass-through of higher wages to inflation is set to be only gradual.

Euro area headline inflation rose slightly above 2% in the third quarter of 2018, driven mainly by the rise in energy prices. As oil prices are assumed to peak in the last quarter of this year before falling marginally, strong positive base effects are expected for up to the first quarter of 2019. Despite some pick up in wage growth, core inflation, which excludes energy and unprocessed food prices, has been rather muted so far this year. The pass-through of higher wage growth into underlying price pressures is expected to be gradual and to take longer than previously expected. Over the course of the next two years, however, core inflation is expected to become the main driver of headline inflation, as labour markets progressively tighten further, wages rise more strongly and the output gap remains positive. Due to the upward revision of assumed oil prices, the forecast for euro area headline inflation in 2018 and 2019 has been revised up to 1.8%. It is then expected to recede to 1.6% in 2020, reflecting also the expected further slowdown in activity.

The reduction in the euro area headline deficit should come to a halt next year...

The euro area's general government deficit as a share of GDP is projected to decline further in 2018 thanks to a reduction in interest expenditure but its decline is set to come to a halt next year for the first time since 2009 due to looser discretionary fiscal policies. The euro area's general government deficit is expected to increase from 0.6% of GDP in 2018 to 0.8% in 2019 and to decline to 0.7% in 2020, based on a no-policy-change assumption.

Debt-to-GDP ratios are projected to fall in almost all Member States. In the euro area, the deleveraging is supported by a debt-decreasing primary surplus as well as nominal GDP growth outpacing the interest rate paid on outstanding debt. Based on a no-policy-change assumption, the euro area debt-to-GDP ratio is set to fall to 82.8% in 2020.

...as the euro area aggregate fiscal stance is set to turn slightly expansionary.

The fiscal policy stance for the euro area, as measured by the change in the structural balance, is expected to turn slightly expansionary in 2019. The assumed gradual monetary policy normalisation by the ECB, continued growth and strengthening core inflation should combine to add some upward pressure on nominal rates over the forecast horizon. Nonetheless, real short and long-term rates should remain clearly negative.

Downside risks to the outlook are rising and interconnected

The EU economy is facing a very high level of uncertainty, mainly with respect to economic and trade policies in the US. At the same time, the downside risks surrounding the central scenario are highly interconnected. The materialisation of any of these risks could amplify the others and magnify their impact on the EU economy.

Overheating in the US fuelled by the sizeable pro-cyclical fiscal stimulus could result in a faster-than-assumed monetary tightening that could alter the risk attitude of investors with detrimental effects to the US economy, given the high level of corporate leverage. This would also affect emerging market economies where financial turmoil and reverse capital flows could spill over more widely than they have so far. This would impact negatively on growth and financial stability in advanced economies as well. As a relatively open economy with strong trade links and banks exposed to emerging markets, the EU would suffer. Additionally, the expected deterioration of the US current account could lead to a further escalation of trade disputes. This could particularly hit China with its relatively high and rising corporate debt that is increasing financial fragilities. More globally, a further escalation of trade tensions would sharply and more permanently increase uncertainty, weigh on confidence, investment, global trade and global growth. Given its high integration in global value chains, Europe would be particularly vulnerable to such external shocks.

The materialisation of any of these risks is more likely to occur in 2020. An abrupt end to fiscal stimulus in the US in 2020 could lead to a sharper slowdown in the US with spillovers to its major trade partners (including the EU), while Chinese authorities' attempt to shore up growth could increase debt and heighten the risk of a disorderly adjustment.

In some high-debt euro area countries, most notably Italy, disruptive sovereign-bank loops could also re-emerge in case of doubts about the quality and sustainability of public finances, which in an environment of overall risk repricing and increasing financing costs, could raise financial stability concerns and weigh on economic activity. Finally, risks related to the outcome of the Brexit negotiations also remain. In case of a no deal scenario, the impact is expected to be much larger on the UK than on the EU27 overall.