OVERVIEW: MODEST GROWTH IN CHALLENGING TIMES

Differences still large across the euro area

The expansion of euro area GDP progresses at moderate speed…

The European economy has maintained its course of moderate growth in the three first quarters of this year, with a set of supportive factors broadly offset by a number of hindrances to growth. These include elevated geopolitical and political uncertainty, slowing growth outside the EU and weak global trade. In several Member States, legacies from the crisis, such as non-performing loans, high private and public debt and deleveraging processes, as well as an ongoing process of balance sheet repair in the banking sector, also continued to weigh. The risk of hysteresis- that the economy's weak performance in recent years could have a detrimental impact on its future prospects- has not yet been overcome. Although headline unemployment figures have been declining gradually, the slack in the labour market remains substantial. Furthermore, low investment in recent years is weighing on potential growth, while expectations of low growth ahead are having a dampening effect on investment activity. The persistence of slack raises questions about the strength of the recovery and suggests that there is scope for GDP to grow faster without raising inflation.

…as the support from low commodity prices and the euro's past depreciation are already fading…

In the coming years, the European economy will no longer be able to rely on the exceptional level of support from external factors from which it has been benefiting, as the strength of these is already diminishing. The windfall gain from low energy prices since 2014 has been largely consumed, energy prices have started edging up again and inflation is set to pick up further in the

Table 1:

Overview - the autumn 2016 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2016	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**
Belgium	1.2	1.3	1.5	1.7	1.7	1.8	8.0	7.8	7.6	0.6	0.6	0.6	-3.0	-2.3	-2.4
Germany	1.9	1.5	1.7	0.4	1.5	1.5	4.4	4.3	4.2	9.0	8.7	8.5	0.6	0.4	0.3
Estonia	1.1	2.3	2.6	0.8	2.6	2.7	6.5	7.4	8.3	1.8	1.6	1.5	0.5	-0.4	-0.2
Ireland	4.1	3.6	3.5	-0.2	1.2	1.4	8.3	7.8	7.6	7.9	7.7	7.4	-0.9	-0.5	-0.4
Greece	-0.3	2.7	3.1	0.1	1.1	1.0	23.5	22.2	20.3	0.0	0.2	0.3	-2.5	-1.0	0.9
Spain	3.2	2.3	2.1	-0.4	1.6	1.5	19.7	18.0	16.5	1.7	1.5	1.5	-4.6	-3.8	-3.2
France	1.3	1.4	1.7	0.3	1.3	1.4	10.0	9.9	9.6	-2.1	-2.3	-2.6	-3.3	-2.9	-3.1
Italy	0.7	0.9	1.0	0.0	1.2	1.4	11.5	11.4	11.3	2.8	2.5	2.1	-2.4	-2.4	-2.5
Cyprus	2.8	2.5	2.3	-1.1	0.7	1.3	12.5	11.1	10.0	-2.8	-3.3	-3.4	-0.3	-0.4	0.0
Latvia	1.9	2.8	3.0	-0.1	1.8	2.0	9.6	9.2	8.8	0.0	-1.2	-1.9	-0.8	-1.1	-1.2
Lithuania	2.0	2.7	2.8	0.7	1.7	2.1	7.6	7.4	7.0	0.1	-1.2	-0.7	-0.6	-0.8	-0.7
Luxembourg	3.6	3.8	3.6	0.0	1.6	1.9	6.2	6.1	6.2	5.6	5.6	5.8	1.3	0.0	0.1
Malta	4.1	3.7	3.7	1.0	1.6	1.8	5.0	5.2	5.2	2.0	1.7	3.7	-0.7	-0.6	-0.6
Netherlands	1.7	1.7	1.8	0.1	1.0	1.1	6.1	5.8	5.4	8.5	8.0	7.7	-0.8	-0.3	-0.1
Austria	1.5	1.6	1.6	1.0	1.8	1.6	5.9	6.1	6.1	2.8	2.9	3.3	-1.5	-1.3	-1.1
Portugal	0.9	1.2	1.4	0.7	1.2	1.4	11.1	10.0	9.5	0.5	0.8	1.2	-2.7	-2.2	-2.4
Slovenia	2.2	2.6	2.2	0.1	1.5	1.9	8.4	7.7	7.2	7.4	7.0	6.4	-2.4	-2.0	-1.5
Slovakia	3.4	3.2	3.8	-0.5	0.8	1.4	9.7	8.7	7.5	0.6	0.1	0.6	-2.2	-1.5	-0.5
Finland	0.8	0.8	1.1	0.3	1.1	1.2	9.0	8.8	8.7	-0.8	-0.9	-0.7	-2.4	-2.5	-2.0
Euro area	**1.7**	**1.5**	**1.7**	**0.3**	**1.4**	**1.4**	**10.1**	**9.7**	**9.2**	**3.7**	**3.5**	**3.3**	**-1.8**	**-1.5**	**-1.5**
Bulgaria	3.1	2.9	2.8	-0.9	1.0	1.2	8.1	7.1	6.3	2.0	1.0	0.6	-0.9	-0.8	-0.7
Czech Republic	2.2	2.6	2.7	0.5	1.2	1.6	4.2	4.1	4.0	-0.8	-0.7	-0.7	-0.2	-0.6	-0.7
Denmark	1.0	1.7	1.8	0.0	1.2	1.6	6.1	5.9	5.6	6.5	6.4	6.3	-0.9	-2.0	-1.4
Croatia	2.6	2.5	2.3	-0.9	0.8	1.5	13.4	11.7	10.3	3.0	2.4	1.8	-2.1	-1.8	-1.4
Hungary	2.1	2.6	2.8	0.4	2.3	2.7	5.1	4.7	4.1	4.1	3.1	4.1	-1.5	-2.3	-2.3
Poland	3.1	3.4	3.2	-0.2	1.3	1.8	6.2	5.6	4.7	0.8	0.2	-0.1	-2.4	-3.0	-3.1
Romania	5.2	3.9	3.6	-1.0	1.8	2.9	6.5	6.4	6.3	-2.2	-2.6	-2.8	-2.8	-3.2	-3.2
Sweden	3.4	2.4	2.1	1.1	1.6	2.0	6.8	6.4	6.4	5.0	4.9	4.9	0.0	-0.1	0.1
United Kingdom	1.9	1.0	1.2	0.7	2.5	2.6	4.9	5.2	5.6	-5.6	-4.9	-3.3	-3.5	-2.8	-2.3
EU	**1.8**	**1.6**	**1.8**	**0.3**	**1.6**	**1.7**	**8.6**	**8.3**	**7.9**	**2.1**	**2.1**	**2.2**	**-2.0**	**-1.7**	**-1.6**
USA	1.6	2.1	1.9	1.2	2.0	2.1	4.9	4.7	4.7	-2.5	-2.6	-2.7	-4.6	-4.2	-4.0
Japan	0.7	0.8	0.4	-0.3	0.0	0.1	3.2	3.2	3.2	3.7	3.7	3.7	-5.0	-5.1	-5.0
China	6.6	6.2	6.0	:	:	:	:	:	:	:	:	:	:	:	:
World	**3.0**	**3.4**	**3.5**	:	:	:	:	:	:	:	:	:	:	:	:

coming quarters. This normalisation is welcome but it also implies an end to the boost that household purchasing power has been receiving. Similarly, the depreciation of the euro since 2014 helped European exporters to gain market share last year, but no further gains are expected as the euro's trade-weighted exchange rate has recently appreciated.

Monetary policy, however, is supportive of growth and is expected to remain so over the coming years. Fiscal policy has significantly eased in recent years and is not forecast to become restrictive again.

...and the UK vote to leave the EU has raised uncertainty.

In the first months since the UK's referendum on EU membership, the euro area economy seems to have shrugged off the result, but the sharp increase in policy uncertainty associated with it is expected to persist and to weigh on economic activity over the entire forecast horizon. Well beyond the UK, political uncertainty has increased in the context of a rising discontent with globalisation and its impact on the distribution of incomes in advanced economies.

Overall, after having reached 2% in 2015, euro area GDP growth should decelerate somewhat and remain broadly stable between 1.5% and 1.7% over the 2016-2018 period. This expansion is set to be led by domestic demand, underpinned by steady employment growth.

Global growth is set to pick up modestly...

Global GDP growth has slowed further in recent months and is projected to grow this year at its slowest pace since 2009. Growth outside the EU is expected to bottom out at 3.2% in 2016, marginally lower than in 2015, and to pick up modestly to 3.7% next year and 3.8% in 2018.

In the first half of 2016, growth across many advanced economies outside the EU slowed down, leading to a downward revision of forecasts for this year, but not to a major reassessment of their underlying growth momentum. In the US, activity is expected to rebound in the second half of 2016 and to continue at a relatively robust pace next year, as the drag from destocking, past dollar appreciation and low energy prices gradually fades. But in 2018, expansion is set to moderate as the economic cycle matures. In Japan, supportive macroeconomic policies are expected to temporarily boost growth next year before some of these effects unwind and growth slows again in 2018.

After several years on a downward trend, GDP growth in emerging markets as a whole appears to have bottomed out in 2015 and is set to gradually strengthen as of this year. In China, growth is expected to ease to 6.0% by 2018, assuming that macroeconomic policies remain supportive and that current financial fragilities remain under control. However, this outlook remains subject to significant and increasingly negative risks.

...but little support is to be expected from export demand.

World trade is set to strengthen gradually over the forecast horizon, following an exceptionally feeble performance in 2016, pulled down by the remaining weakness of emerging markets but also by the sharp and unexpected deceleration of import demand from advanced economies. World imports of goods and services excluding the EU are expected to grow by 1.0% in 2016, marginally up from 2015, and to recover to 3.0% and 3.3% in 2017 and 2018, respectively. This rebound reflects the assumption that the elasticity of global imports should gradually recover from its current historically low level, underpinned by the cyclical rebound in advanced economies, a modest recovery in import demand from China, and the abatement of temporary dampening factors, such as the contraction in commodity-related investment across the world and the severe terms-of-trade shock which hit many emerging markets after the abrupt falls in commodity prices.

Accordingly, growth in European export markets now looks likely to be significantly less robust this year than expected back in the spring and should even underperform global GDP growth outside the euro area. As of 2017, export markets are expected to grow again in line with global GDP and slightly faster in 2018. The current account surplus of the euro area is projected at 3.5% of GDP this year. Nevertheless, net exports are not expected to contribute to GDP growth over the forecast horizon.

Financial markets have shown resilience to the UK 'leave' vote…

Financial markets have shown resilience in recent months; after the initial hit following the UK referendum, asset prices and investor risk appetite recovered. The monetary easing by the Bank of England in August 2016 appears to have calmed markets and contributed to improving economic sentiment although sterling remains under pressure. Meanwhile, expectations of monetary policy tightening by the US Federal Reserve have been pushed back to December as the Fed kept rates on hold in September.

However, despite the improvements in the stability and capital positions of the banking sector in recent years, European banks are subject to concerns about profitability, fragmentation and high overhead and operational costs as well as high levels of non-performing loans in some Member States. Since mid-September, euro area sovereign bond yields have faced some upward pressure as investors revised slightly upwards their expectations on the future path of monetary policy.

…and funding conditions are supportive…

Funding conditions are supportive for both bank and market funding in the euro area thanks to the exceptionally accommodative monetary policy stance and its improved transmission through the euro area banking system. Corporate bond spreads have tightened significantly, facilitating net issuance of corporate bonds and contributing to the reduction of financing costs for the non-financial corporate sector. Moreover, net bank lending flows to euro area households and non-financial corporations have remained positive over the last few months, supported by further declines in lending rates across euro area Member States. However, banks' poor profitability could adversely impact credit supply and the capacity of the banking sector to accompany the expansion going forward, once credit demand increases.

…while steady employment growth is supporting private consumption.

Private consumption is set to remain the main growth driver over the whole forecast horizon. In 2016, private consumption should benefit from a rise in household real gross disposable income, stemming from robust employment growth and low inflation. Most of these purchasing power gains are expected to be consumed as the household saving rate is expected to change very little. Over the next two years, private consumption is set to continue benefitting from steady but decelerating employment growth as well as a slight pick-up in wage growth that should help offset the dampening impact of rebounding inflation on real disposable incomes. In sum, private consumption growth in the euro area is expected to moderate slightly next year.

Public consumption is keeping pace with GDP growth…

Government consumption is expected to continue contributing to economic growth in 2016. In some Member States, increased public consumption reflects refugee-related expenditures, whereas in others, security-related expenditures have recently increased. The fall in the number of asylum seekers entering the EU will, however, entail some slowdown in government consumption dynamics.

...investment should pick up but in 2018 only.

Investment growth has recovered somewhat in recent quarters, but it continues to reflect hindrances from low demand growth and expectations of weak potential growth, ongoing corporate deleveraging in some Member States, as well as heightened economic and policy uncertainty, including the extra layer of uncertainty added by the UK's 'leave' vote. For now, these factors more than offset the positive impact of improving financing conditions and the expected strengthening of external demand. Investment is forecast to grow this year broadly at the same pace as in 2015 and to slightly decelerate in 2017. The balance of factors driving investment, however, should become increasingly favourable over the forecast horizon supporting the expectation of a pick-up in 2018. Projects financed under the Investment Plan for Europe, as well as, in some Member States, projects co-financed with EU funds from the 2014-2020 programming period, are also expected to yield increasingly tangible results on private and public investment as they enter the implementation phase. Moreover, the recent growth of house prices and of loans for house purchases suggest that construction investment is set to finally end a long period of decline.

Euro-area Member States at different stages of recovery

Over the forecast period, economic activity is set to expand further in all Member States of the euro area. So far, however, the cumulated growth of GDP since the end of the recession differs substantially across Member States. In some, GDP now stands more than 10% above its trough, having passed the pre-crisis level some time ago. In others, the expansion from the trough is still modest, and GDP remains so far lower than at the onset of the crisis.

Net trade should be impacted by the UK 'leave' vote

The current weakness of global trade outside the EU is weighing on euro area exports despite the resilience of intra-euro area trade. Additionally, heightened uncertainty concerning the future trade relationship between the UK and the EU, but also increased protectionist sentiment, are expected to weigh on trade volumes during the forecast years. European export growth is set to decrease strongly this year, and no additional market share is likely to be gained. Over the next two years, euro area exports are expected to accelerate in line with the projected gradual strengthening of world trade. The weaker expected outlook for the UK has actually contributed to a strong downward revision of euro area foreign demand compared to the spring. Furthermore, the sizeable depreciation of sterling vis-à-vis the euro is expected to have an adverse direct impact on euro area exports to the UK. Euro area export market shares are therefore expected to marginally decrease in 2017 and to stagnate in 2018. As import growth is forecast to be stronger than export growth, the contribution of net exports to GDP growth in the euro area is set to remain slightly negative until 2018.

Inflation is picking up...

Inflation in the euro area was very low in the first half of 2016, dragged down by falling energy prices, but it started to pick up in the third quarter, as the impact of negative base effects in energy inflation began to unwind. The inflation profile until the second half of 2017 will be strongly shaped by positive base effects in energy inflation. Thereafter, while these positive base effects fade, headline inflation is expected to remain above 1% and to gradually increase given the current market expectations of a moderate increase in oil prices. Some stabilisation of import and producer prices, as well as higher nominal wage increases, a further narrowing of the output gap and a further slight rise in profit margins, are also expected to be very gradually reflected in a rise in core inflation. Euro area headline inflation is then expected to rise from 0.3% in 2016 to 1.4% in both 2017 and 2018.

…and the current recovery is relatively job-rich.

Employment in the EU and the euro area is expected to grow by 1.4% this year, faster than at any time since 2008. As a corollary to rather job-rich growth, labour productivity growth is set to remain subdued. Robust headcount employment growth, however, has not been enough yet to make up for the large losses seen in the level of hours worked during the recession years. Employment creation is set to continue benefitting from the sustained domestic demand-driven expansion, moderate wage growth, as well as fiscal policy measures and structural reforms implemented in some Member States. Employment growth in the euro area is projected to remain relatively solid, though slightly moderating to 1.0% in 2017 and 2018. In the EU as a whole, employment growth is set to subside a touch more markedly due to the slowdown of the UK economy. Despite the expectation of faster labour force growth this year, due to increased participation rates and the gradual integration of refugees in the labour market, the unemployment rate in the euro area is set to decline relatively fast, from 10.1% this year to 9.2% in 2018.

Public deficit and debt ratios are set to decline further albeit at a slower pace…

The general government deficit in the euro area is expected to decrease from 1.8% of GDP this year to 1.5% in 2017 and, under a no-policy-change assumption, remain at 1.5% in 2018. This decline reflects factors including lower social transfers as a consequence of falling unemployment, wage bill moderation in the public sector, and the lower interest expenditure. The debt-to-GDP ratio in the euro area is projected to continue declining gradually from 91½% this year to 89½% in 2018. This reduction derives from both higher primary surpluses and a more favourable snowball effect driven by reduced interest expenditure, modest real GDP growth and the expected uptick in inflation.

…while fiscal policy should not become restrictive again and monetary conditions should remain ample.

The fiscal policy stance, measured by changes to the fiscal structural balance, turned broadly neutral in 2015 after years of consolidation and is expected to remain so over the forecast horizon. Meanwhile, the full implementation of the set of monetary policy measures introduced in recent years is expected to maintain downward pressure on both bank lending rates and bond yields and thus to ensure that monetary conditions remain accommodative over the forecast horizon.

Risks have intensified and are tilted to the downside

Overall, risks to the outlook are tilted to the downside. Risks have intensified in recent months, mainly in the wake of the UK 'leave' vote. Anticipation effects could be triggered by developments over the course of the upcoming negotiations as news emerges about the shape of the future agreement between the UK and the EU. An extended period of uncertainty could also magnify its negative impact. The leave vote could also be seen as an indicator of the increased political risks deriving from opposition to globalisation and free trade arrangements and thereby to the outlook for global trade.

Risks have increased on the external side, in particular of a disorderly adjustment in China and aggravating geopolitical conflicts. The cycle of advanced economies outside the EU (e.g. the US) could also be more mature than thought, entailing a weaker rebound than expected. Risks have also increased on the domestic side, in particular those related to the capacity of the banking sector to accompany the expected expansion of investment in view of its low profitability.