OVERVIEW: A CHALLENGING ROAD AHEAD

Weaker trade set to test robustness of labour market

The EU economy is facing a combination of shocks…

The European economy has entered a protracted period of subdued growth and low inflation in the context of high uncertainty, a much less supportive external environment, and structural shifts mainly affecting the manufacturing sector. Global growth is set to fall this year to a pace usually associated with the brink of recession. International trade in goods has been stagnant at best, previously-identified risks of an increase in trade tensions and geopolitical conflicts materialised over the summer, and high uncertainties related to trade policies and Brexit have not receded. Leading indicators suggest that the weakness in global manufacturing will continue in the near term. Hence, the EU economy, which slowed down in the second quarter of 2019, is not likely to rebound in the near term.

…whose impact is cushioned by the strength of its labour market…

Labour markets in Europe, however, have remained strong and the unemployment rate has fallen to below its pre-crisis level, fuelling robust wage growth, which has allowed domestic demand to expand at a relatively steady pace, in a context of historically low borrowing costs. As on top, some Member States have introduced growth-enhancing fiscal measures and more domestically oriented sectors are expected to remain resilient, GDP should continue to grow in all Member States. All these factors are however unlikely to be strong enough to power growth to a higher trajectory than this year.

Table 1:

Overview - the autumn 2019 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Belgium	1.1	1.0	1.0	1.3	1.4	1.4	5.5	5.4	5.3	-0.8	-0.9	-1.0	-1.7	-2.3	-2.6
Germany	0.4	1.0	1.0	1.3	1.2	1.4	3.2	3.4	3.5	7.0	6.8	6.4	1.2	0.6	0.2
Estonia	3.2	2.1	2.4	2.4	2.1	2.2	5.1	5.4	5.8	1.4	1.6	1.6	-0.2	-0.2	-0.2
Ireland	5.6	3.5	3.2	0.8	1.1	1.4	5.2	5.0	5.0	0.8	1.3	1.7	0.2	0.3	0.6
Greece	1.8	2.3	2.0	0.5	0.6	0.9	17.3	15.4	14.0	-0.8	-1.1	-0.9	1.3	1.0	1.1
Spain	1.9	1.5	1.4	0.9	1.1	1.4	13.9	13.3	12.8	2.4	2.5	2.6	-2.3	-2.2	-2.1
France	1.3	1.3	1.2	1.3	1.3	1.3	8.5	8.2	8.0	-0.4	-0.6	-0.6	-3.1	-2.2	-2.2
Italy	0.1	0.4	0.7	0.6	0.8	1.1	10.0	10.0	10.0	2.9	2.9	2.9	-2.2	-2.3	-2.7
Cyprus	2.9	2.6	2.3	0.6	0.7	1.3	7.2	6.3	5.7	-8.1	-10.6	-11.1	3.7	2.6	2.4
Latvia	2.5	2.6	2.7	3.1	2.5	2.3	6.6	6.4	6.4	-0.8	-1.4	-1.8	-0.6	-0.6	-0.6
Lithuania	3.8	2.4	2.4	2.4	2.2	2.1	6.2	6.2	6.2	1.2	1.5	1.8	0.0	0.0	0.0
Luxembourg	2.6	2.6	2.6	1.7	1.6	1.9	5.3	5.3	5.3	4.4	4.4	4.4	2.3	1.4	1.4
Malta	5.0	4.2	3.8	1.6	1.7	1.7	3.6	3.5	3.6	9.0	8.5	8.2	1.2	1.0	1.0
Netherlands	1.7	1.3	1.3	2.6	1.4	1.5	3.5	3.7	4.1	9.8	9.0	8.6	1.5	0.5	0.4
Austria	1.5	1.4	1.4	1.5	1.6	1.6	4.6	4.6	4.6	2.2	2.1	2.2	0.4	0.2	0.4
Portugal	2.0	1.7	1.7	0.3	1.1	1.4	6.3	5.9	5.6	-0.4	-0.7	-1.0	-0.1	0.0	0.6
Slovenia	2.6	2.7	2.7	1.8	1.9	2.0	4.4	4.2	4.2	5.8	5.5	5.1	0.5	0.5	0.6
Slovakia	2.7	2.6	2.7	2.7	2.5	2.2	5.8	5.7	5.6	-2.4	-2.6	-2.3	-0.9	-1.2	-1.3
Finland	1.4	1.1	1.0	1.2	1.4	1.5	6.7	6.5	6.4	-1.3	-1.5	-1.7	-1.1	-1.4	-1.6
Euro area	**1.1**	**1.2**	**1.2**	**1.2**	**1.2**	**1.3**	**7.6**	**7.4**	**7.3**	**3.3**	**3.2**	**3.1**	**-0.8**	**-0.9**	**-1.0**
Bulgaria	3.6	3.0	2.9	2.4	1.6	2.1	4.4	4.1	4.0	5.5	5.5	5.4	1.1	0.9	0.9
Czechia	2.5	2.2	2.1	2.6	2.3	2.0	2.1	2.2	2.3	0.0	0.5	0.7	0.2	-0.1	-0.3
Denmark	2.0	1.5	1.6	0.8	1.3	1.4	4.9	4.8	4.7	7.1	6.7	6.7	2.2	0.5	0.0
Croatia	2.9	2.6	2.4	0.9	1.4	1.5	6.9	5.8	4.9	1.6	0.7	0.3	0.1	0.0	0.0
Hungary	4.6	2.8	2.8	3.4	3.1	3.0	3.4	3.4	3.4	-1.2	-0.8	-0.7	-1.8	-1.0	-0.8
Poland	4.1	3.3	3.3	2.2	2.6	2.5	3.5	3.6	3.5	-0.4	-0.4	-0.1	-1.0	-0.2	-0.9
Romania	4.1	3.6	3.3	3.9	3.5	3.4	3.9	4.2	4.3	-5.1	-5.3	-5.4	-3.6	-4.4	-6.1
Sweden	1.1	1.0	1.4	1.7	1.5	1.6	6.8	7.1	7.2	3.6	4.1	4.5	0.3	0.1	0.1
EU27	**1.4**	**1.4**	**1.4**	**1.4**	**1.4**	**1.6**	**6.8**	**6.7**	**6.5**	**3.0**	**2.9**	**2.8**	**-0.7**	**-0.8**	**-1.0**
United Kingdom	1.3	1.4	1.4	1.8	2.0	2.2	3.8	4.0	4.1	-4.3	-4.2	-4.2	-2.2	-2.4	-2.2
EU	**1.4**	**1.4**	**1.4**	**1.5**	**1.5**	**1.7**	**6.3**	**6.2**	**6.2**	**1.9**	**1.8**	**1.8**	**-0.9**	**-1.1**	**-1.2**
China	6.1	5.8	5.6	:	:	:	:	:	:	0.8	0.7	0.6	:	:	:
Japan	0.9	0.4	0.6	0.5	1.1	0.7	2.3	2.2	2.2	3.5	3.5	3.3	-2.8	-2.6	-2.2
United States	2.3	1.8	1.6	1.8	2.1	2.0	3.7	3.7	3.7	-2.5	-2.5	-2.5	-6.7	-6.7	-6.7
World	**2.9**	**3.0**	**3.1**	:	:	:	:	:	:	:	:	:	:	:	:

…but uncertainty and structural shifts should keep GDP growth subdued.

Lingering trade policy uncertainty, including on future relations between the UK and the rest of the EU, compounded by structural shifts, such as changing consumer preferences in the car industry and the damage already caused to trade integration, are likely to dampen growth and inflation in the euro area for a protracted period. Euro area GDP growth is thus forecast to slow from 1.9% last year to 1.1% this year and to stabilise at 1.2% in the next two years. While the growth rate in 2020 will be flattered by a higher number of working days, its expected stabilisation in 2021 should be helped by the fading negative impact of some shocks. Given the expected weakness in the second half of this year, which implies a lower starting point into next year, the projections for 2019 and 2020 are lower than in the Commission's spring forecast and slightly below the summer interim forecast.

As global growth is hurt by escalating economic conflict and lingering uncertainty...

Over the summer, the re-intensification of economic tensions between the US and China and elevated policy uncertainty took their toll on global investment, manufacturing and trade. Consequently, the modest rebound in global GDP growth in the first half of 2019 should be short-lived, and the near-term outlook has turned notably more subdued than expected in the spring. However, policy stimuli in a number of major economies, including the US and China, as well as resilient labour markets and easy financing conditions in advanced economies, should limit the depth of the global slowdown. Global GDP growth (excluding the EU) is forecast to decrease from 3.8% in 2018 to 3.2% in 2019, markedly lower than in previous forecasts.

…it is expected to remain subdued...

Over the next two years, elevated uncertainty around US trade policy, worries regarding the ability of the WTO to uphold the multilateral trading system and geopolitical tensions in the Middle East are all set to linger and weigh on global growth. As these will be compounded by structural factors such as population ageing and low productivity trends, the slowdown in China, protectionist tendencies and the impact of climate change, the global economy (excluding the EU) is set to continue expanding below trend at 3.3% in 2020 and 3.4% in 2021. The slight increase compared to this year mostly reflects the expectation of modestly improving cyclical conditions in some distressed emerging market economies. But the previously expected stronger rebound of emerging markets as a whole has been scaled back amid trade tensions, tighter financing conditions and low commodity prices, while the largely cyclical slowdown in advanced economies (excluding the EU) should proceed broadly as anticipated.

…and less trade-intensive.

Coinciding with record-high trade policy uncertainty, global trade growth weakened considerably in the first half of 2019 with no signs of a rebound yet. Non-EU world import growth is expected to slow down sharply from 4.1% in 2018 to 0.4% this year before picking up to 2.1% in 2020 and 2.5% in 2021. This slight increase is mainly expected to occur as a result of base effects linked to the fading impact of the trade uncertainty shock and due to the assumption that import elasticities will increase somewhat from their extremely low current levels. The weakness of trade has coincided with a pronounced, worldwide slowdown in industrial production and investment. The increasingly structural nature of the weakness in the manufacturing sector and the assumption that trade tensions and uncertainties will remain elevated over the forecast horizon, mean that the revival in trade dynamics would likely be limited.

Concerns about the global outlook have driven bond yields lower…

In response to concerns about slowing growth and the escalation in trade tensions, central banks across the world have recently shifted to more accommodative policies. Government bonds have rallied remarkably in recent months, leading to lower yields around the world. Stock markets have been volatile reflecting the ups and downs in the US-China economic confrontation but, overall, equity indices in advanced economies have recently hovered near record highs.

…and a large part of European sovereign bonds are traded at negative yields…

In Europe, financial markets have shown significant volatility, driven by similar factors. Equity markets recovered their substantial summer losses on expectations that the ECB would come up with a significant policy package, and recovered further after the subsequent announcement of the resumption of net asset purchases and the strengthening of the ECB's forward guidance. Indices for banks and export-oriented economies, however, have underperformed. In the bond market, the perception of a deteriorating outlook, expectations of a prolonged period of monetary policy accommodation and a further decline in the term premium put pressure on sovereign yields over the summer. As demand outpaced the supply of safe assets, a large share of sovereign bonds is trading at negative yields.

…while the euro exchange rate has been broadly stable …

The euro's weakness against the US dollar and the Japanese yen over the summer has been broadly offset by its appreciation vis-à-vis the currencies of most other EU countries and some emerging economies. On average, the euro's nominal effective exchange rate is assumed to depreciate by 1% this year and to broadly stabilise next year.

…and net lending has expanded further.

Net lending to the private sector in the euro area has continued to expand at a robust pace in recent months owing to an overall easing of credit standards, as well as rising demand for housing loans, which reflects the continued buoyancy of housing markets. Overall, funding costs for the private and public sectors are expected to remain supportive over the forecast horizon. At the same time, the real increase in credit volumes to the private sector is set to remain modest despite the very low interest rates.

Member States set to converge towards weaker outcomes…

Some of the shocks that have dampened activity in the euro area are expected to fade over the forecast horizon, as e.g. world trade is expected to bottom out and its drag on the manufacturing sector to lessen. However, the slowdown of activity is now expected also to affect Central and Eastern European economies. For some time, they seemed to be immune, but spillovers via cross-border production chains are bound to take place eventually.

…but private consumption should hold up well…

In the euro area, private consumption growth has held up relatively well so far this year. Households' purchasing power has increased on the back of further job creation and real wage growth, as well as supportive discretionary fiscal measures in some Member States. However, only part of the rise in real disposable income has actually been spent. Household decisions to save more have probably been driven by higher unemployment expectations and uncertainty regarding the scope and duration of technological and regulatory changes in the car industry, the latter reflected in still subdued car sales. Overall, private consumption growth in the euro area is expected to edge down this year to 1.1% (from 1.4% in 2018), dampened by a higher increase in the saving rate than previously expected. It is forecast to continue growing at about the same pace towards 2021, amid a softening of real income growth driven by slower employment creation.

…while investment is more hard hit…

The weakness of global trade is set to hit business investment in the euro area hard, as a large share of it is linked to trade. Investment growth in the euro area (excluding Ireland) is forecast to moderate this year, diminish further next year and to remain steady in 2021 as the drag from the external environment is fading. This ongoing moderation is not fully reflected in the data available for the first half of this year given the large swings related to the activities of multinationals in Ireland and the support that came from the increase in public investment in machinery and equipment in Germany. Still, looking beyond this, forward-looking indicators confirm that non-construction investment is set to slow down in the near term. Over the next two years, favourable factors such as historically low financing conditions and the support from various schemes such as the European Fund for Strategic Investments are likely to be offset by the declining rate of capacity utilisation, lower profit margins, as well as weaker corporate earnings in a context of subdued aggregate demand and elevated uncertainty. In the construction sector, the pace of further expansion should be limited by still elevated skilled labour shortages.

…and the contribution of net exports to growth should only return to neutral next year.

Due to its high openness and intense participation in global value chains, but also because of the high share of manufacturing in its exports, the euro area has been hit particularly hard by the weakness in foreign trade and heightened uncertainty about trade policies. In the first half of 2019, euro area exports of goods failed to grow with both intra- and extra-euro area exports underperforming. Leading indicators such as export order books signal that they are likely to remain sluggish in the near term. Euro area export growth is forecast to decrease by about one percentage point this year and to edge down further next year, before increasing modestly in 2021. The contribution of net exports to euro area GDP growth is forecast to be negative this year and quasi neutral in 2020 and 2021. The current account surplus of the euro area is set to decline from 3.8% of GDP in 2018 to 3.1% in 2021, largely mirroring the fall in the merchandise trade surplus.

Employment gains are set to slow down…

The labour market in the euro area has proved to be surprisingly resilient so far to the slowdown in economic growth, showing improvements both in terms of the number of persons employed and the number of hours worked and allowing a substantial reduction in the unemployment rate. However, as changes in the labour market situation usually lag developments in economic activity, the potential for further increases in employment has become more limited, particularly in the underperforming manufacturing industry where labour hoarding has taken place in some countries. Nevertheless, the labour market situation is expected to remain relatively favourable, with employment set to increase further, though survey indicators point to a significantly more moderate pace. Shifts in the sectoral composition of employment towards sectors like services with lower productivity increases are however likely to make low growth compatible with higher employment gains than before. In combination with more limited increases in the labour force than in previous years, the aggregate euro area unemployment rate is expected to fall slightly further from 7.6% this year to 7.3% in 2021.

…while inflation is expected to remain low for longer.

Inflation in the euro area has been on a downward trend so far in 2019, failing to pick up during the third quarter of this year, largely because of the fall in energy prices and the lack of pass-through from robust wage growth to core inflation. In a context of weak demand firms have been absorbing these increases by accepting lower profit margins rather than by raising prices. In line with subdued economic growth and under the assumption of moderately declining oil prices as well as subsiding external and industrial price pressures, inflationary pressures should remain muted over the whole forecast horizon. HICP inflation in the euro area is projected at 1.2% this year and next (0.2 pps. lower than last spring and slightly below the summer interim forecast) and to pick up only marginally to 1.3% in 2021.

The euro area's headline deficit is set to increase slightly but public debt ratios should continue to improve…

The euro area's general government deficit is expected to increase gradually, rising from the historical low of 0.5% of GDP recorded in 2018 to 1.0% in 2021, based on a no-policy-change assumption. The projected fall in the revenue ratio is the dominant factor behind this expected increase, as below potential economic growth and somewhat loose discretionary fiscal policies in some Member States affect structural revenues while structural expenditures should remain broadly stable as a share of potential GDP. The euro area aggregate debt-to-GDP ratio is projected to continue declining steadily over the forecast period. Based on a no-policy-change assumption, it is set to fall to about 84% in 2021. This deleveraging should find support from nominal GDP growth remaining higher than the very low implicit interest rates paid on outstanding debt.

…amid a broadly neutral aggregate fiscal stance.

The fiscal stance for the euro area is expected to remain broadly neutral over the forecast horizon under a no-policy-change assumption. Given the outlook for subdued economic growth and inflation as well as recent ECB decisions, including renewed monthly net asset purchases, upward pressure on nominal interest rates should be very limited over the forecast horizon and real short and long-term rates should remain negative.

Risks to economic growth are tilted to the downside

The EU economy is facing a period of very high uncertainty related to trade and other economic policies which is expected to last over the forecast years. A further increase in uncertainty could lead to a worse outcome than envisaged in this forecast. At the same time, substantial downside risks still surround the outlook. Outside Europe, any deviation from the assumption that the current trade and geopolitical tensions will not escalate further, or lower than assumed effectiveness of policy measures to boost global growth in general, and in China in particular, could deepen the slowdown of the global economy and make it more protracted than currently forecast. Within Europe, any deviation from the relatively benign technical assumption of status quo in terms of trading relations between the UK and the EU that underlies these forecasts would dampen economic growth, particularly in the UK. Another downside risk is that the recession in the manufacturing sector could have a bigger spillover effect on the services sector, affecting confidence, net job creation, domestic demand, growth expectations and ultimately resulting in worse growth outcomes.

On the upside, trade tensions could be resolved faster than assumed, the response to easing measures in China could positively surprise and geopolitical tensions could diminish. In in the euro area, the fiscal policy stance could turn out more expansionary than currently envisaged.