OVERVIEW

A gradual and timid recovery continues amid more challenging global conditions

The economic recovery of the euro area and the EU is now entering its third year and is forecast to continue. Although subdued compared to past experiences, the present recovery has so far proven resilient to temporary bouts of uncertainty. The slowdown in emerging market economies and the recent sharp fall in global trade growth, however, are set to take their toll, and downside risks related to the external environment have increased.

Euro area recovery supported by tailwinds

As expected, the recovery in the euro area has been supported this year by a conjunction of positive factors including low oil prices, a relatively weak external value of the euro, and policy support, in particular the ECB's very accommodative monetary policy and a broadly neutral fiscal stance. These tailwinds have visibly stimulated private consumption and exports but the pace of economic growth overall remains relatively muted considering the strength of these factors. Investment activity, in particular, is still lagging despite favourable financing conditions due to economic and policy uncertainty. In some Member States, deleveraging pressures still linger.

Emerging market slowdown puts the brakes on world trade

While economic growth should still benefit from these tailwinds, their strength is expected to fade and the euro area and EU economy now face headwinds from the slowdown in emerging market economies (EMEs), increased global uncertainty, and persistent geopolitical tensions. The euro's past depreciation has so far helped to sustain euro area exports but the sharp

Table 1:
Overview - the autumn 2015 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Belgium	1.3	1.3	1.7	0.6	1.7	1.5	8.6	8.4	7.9	1.8	2.0	1.9	-2.7	-2.6	-2.3
Germany	1.7	1.9	1.9	0.2	1.0	1.7	4.7	4.9	5.2	8.7	8.6	8.4	0.9	0.5	0.4
Estonia	1.9	2.6	2.6	0.1	1.8	2.9	6.5	6.5	7.6	1.6	1.2	-0.1	0.2	0.2	0.1
Ireland	6.0	4.5	3.5	0.3	1.4	1.6	9.5	8.7	7.9	5.9	5.7	4.7	-2.2	-1.5	-1.5
Greece	-1.4	-1.3	2.7	-1.0	1.0	0.9	25.7	25.8	24.4	-1.0	-0.3	0.1	-4.6	-3.6	-2.2
Spain	3.1	2.7	2.4	-0.5	0.7	1.2	22.3	20.5	19.0	1.4	1.3	1.4	-4.7	-3.6	-2.6
France	1.1	1.4	1.7	0.1	0.9	1.3	10.4	10.4	10.2	-1.3	-1.6	-2.2	-3.8	-3.4	-3.3
Italy	0.9	1.5	1.4	0.2	1.0	1.9	12.2	11.8	11.6	2.2	1.9	1.9	-2.6	-2.3	-1.6
Cyprus	1.2	1.4	2.0	-1.6	0.6	1.3	15.6	14.6	13.3	-3.5	-3.2	-3.0	-0.7	0.1	0.3
Latvia	2.4	3.0	3.3	0.2	1.4	2.1	10.1	9.5	8.8	-1.8	-1.9	-2.2	-1.5	-1.2	-1.1
Lithuania	1.7	2.9	3.4	-0.8	0.6	2.2	9.4	8.6	8.1	-0.8	0.2	-0.3	-1.1	-1.3	-0.4
Luxembourg	3.1	3.2	3.0	0.3	1.7	1.7	5.9	5.8	5.8	4.3	4.0	3.7	0.0	0.5	0.5
Malta	4.3	3.6	3.1	1.1	1.8	2.2	5.8	5.7	5.8	2.0	3.8	4.2	-1.7	-1.2	-1.1
Netherlands	2.0	2.1	2.3	0.2	1.2	1.5	6.9	6.6	6.3	10.5	10.4	9.6	-2.1	-1.5	-1.2
Austria	0.6	1.5	1.4	0.9	1.8	2.0	6.1	6.1	6.0	2.6	2.6	2.8	-1.9	-1.6	-1.3
Portugal	1.7	1.7	1.8	0.5	1.1	1.3	12.6	11.7	10.8	0.5	0.5	0.3	-3.0	-2.9	-2.5
Slovenia	2.6	1.9	2.5	-0.6	0.8	1.4	9.4	9.2	8.7	7.0	7.5	7.2	-2.9	-2.4	-2.0
Slovakia	3.2	2.9	3.3	-0.2	1.0	1.6	11.6	10.5	9.6	0.0	-1.2	-0.3	-2.7	-2.4	-2.0
Finland	0.3	0.7	1.1	-0.2	0.6	1.5	9.6	9.5	9.4	-1.1	-1.0	-0.9	-3.2	-2.7	-2.3
Euro area	**1.6**	**1.8**	**1.9**	**0.1**	**1.0**	**1.6**	**11.0**	**10.6**	**10.3**	**3.7**	**3.6**	**3.4**	**-2.0**	**-1.8**	**-1.5**
Bulgaria	1.7	1.5	2.0	-0.8	0.7	1.1	10.1	9.4	8.8	1.4	1.3	0.9	-2.8	-2.7	-2.7
Czech Republic	4.3	2.2	2.7	0.4	1.0	1.6	5.2	5.0	4.8	-2.5	-2.4	-2.1	-1.9	-1.3	-1.1
Denmark	1.6	2.0	1.8	0.4	1.5	1.9	6.1	5.8	5.5	7.0	6.9	6.5	-3.3	-2.5	-1.7
Croatia	1.1	1.4	1.7	-0.1	0.9	1.7	16.2	15.6	14.7	4.4	2.9	3.2	-4.9	-4.7	-4.1
Hungary	2.9	2.2	2.5	0.1	1.9	2.5	7.1	6.7	6.2	4.3	5.5	6.1	-2.3	-2.1	-2.0
Poland	3.5	3.5	3.5	-0.6	1.4	1.9	7.6	7.2	6.8	-0.5	-0.9	-1.5	-2.8	-2.8	-2.8
Romania	3.5	4.1	3.6	-0.4	-0.3	2.3	6.7	6.6	6.5	-0.8	-1.9	-2.6	-1.2	-2.8	-3.7
Sweden	3.0	2.8	2.7	0.8	1.5	1.7	7.7	7.7	7.4	5.9	5.9	5.8	-1.4	-1.3	-1.2
United Kingdom	2.5	2.4	2.2	0.1	1.5	1.7	5.4	5.4	5.5	-4.3	-3.9	-3.4	-4.4	-3.0	-1.9
EU	**1.9**	**2.0**	**2.1**	**0.0**	**1.1**	**1.6**	**9.5**	**9.2**	**8.9**	**2.2**	**2.2**	**2.0**	**-2.5**	**-2.0**	**-1.6**
USA	2.6	2.8	2.7	0.2	2.1	2.3	5.3	4.8	4.6	-2.3	-2.4	-2.7	-4.0	-3.5	-3.2
Japan	0.7	1.1	0.5	0.8	0.7	1.8	3.4	3.3	3.3	2.3	2.8	3.1	-6.6	-5.7	-5.1
China	6.8	6.5	6.2	:	:	:	:	:	:	:	:	:	:	:	:
World	**3.1**	**3.5**	**3.7**	:	:	:	:	:	:	:	:	:	:	:	:

fall in global trade growth is likely to weigh on foreign demand and investment in the coming quarters.

As tailwinds gradually fade, other factors should drive growth…

The growth outlook for the euro area is thus likely to remain modest over the forecast horizon. As the tailwinds fade, other factors will come to play a larger role in driving economic growth in 2016 and 2017. Monetary policy is set to remain highly accommodative and fiscal policy to remain broadly neutral. Credit constraints are clearly receding and market funding will continue to play an increasing role in supporting investment, which should progressively become a stronger driver of GDP growth. Deleveraging pressures and a high share of non-performing loans remain in some Member States and unemployment remains high in the euro area as a whole. However, progress in overcoming these legacies of the crisis should increasingly support growth. The strengthening of global economic activity from next year on is likely to be gradual and should support European exports, but less than expected in spring. In some Member States, the fruits of recent structural reforms will become increasingly tangible but in the euro area as a whole, and some core countries, structural reforms implemented so far have not been enough to significantly increase growth potential. Eventually, the increased inflow of asylum seekers into the EU should result in additional government spending in several Member States, adding to aggregate demand.

…while differences in cyclical positions and the legacy of the crisis partly explain why growth is lower in the euro area than the EU.

Real GDP in the euro area is projected to grow by 1.6% in 2015 and to pick up to 1.8% in 2016 and 1.9% in 2017. In the EU, GDP growth is forecast to rise from 1.9% in 2015 to 2.0% in 2016 and 2.1% in 2017. This implies somewhat stronger growth in the Member States not belonging to the euro area, which reflects renewed catching-up in some Central and Eastern-European Member States, but also the more advanced cyclical position of the UK and strong growth in Poland and Sweden. Non-euro area countries seem to be less affected by legacies of the crisis such as unemployment and deleveraging pressures and this is reflected in their somewhat higher investment rates.

Global GDP growth set to fall to its slowest pace since 2009…

The outlook for global GDP growth and world trade has deteriorated considerably since the spring, mainly due to a broad-based and deeper downturn in EMEs and a sharper and more disruptive adjustment in China.

Given the difficulties in steering a reorientation of growth drivers in China from investment and debt towards consumption, a macro-financial adjustment process that has become increasingly complex, real GDP growth in China is expected to slow down somewhat more than before. Economic growth in China is now projected to slow from 6.8% in 2015 to 6.2% in 2017. This relatively benign 'soft landing' scenario assumes that the current rebalancing of the economy will continue without a sharp correction, and rests on the capacity of the Chinese authorities to boost demand if growth moves too far away from the official target. However, the changing composition of growth in China means that trade has been marked down much more significantly than economic activity, a trend that is already having a visible impact on other EMEs.

Moreover, low oil and commodity prices are weighing on the growth performance of commodity exporters this year and next. Prospects that the gradual normalisation of US monetary policy could be accompanied by a reversal of capital flows, also underpin the current weakness in EMEs. Geopolitical tensions, domestic political instability, and increasing domestic imbalances are also expected to continue looming over their growth outlook across the forecast horizon.

The downturn in growth across EMEs is however expected to bottom out this year, with a gradual, moderate recovery setting in from 2016, assuming a stabilisation of commodity prices, a gradual cyclical recovery in some countries, and progress with structural adjustments and reforms in others.

…as the recovery in advanced economies cannot offset weakness in EMEs…

As the gradual recovery in advanced economies is not powerful enough to offset a sharp slowdown in EMEs and oil-exporting countries, global growth (excluding the EU) is expected to slow from 3.7% in 2014 to 3.3% this year, before strengthening gradually to 3.8% in 2016 and 4.0% in 2017. The economic recovery in the US is expected to continue at a robust pace, supported by low energy prices, a waning fiscal drag, and a monetary policy that is still supportive. However, due to a disappointing first quarter and the impact of the US dollar’s appreciation, growth momentum this year now looks somewhat weaker than it did in the spring and GDP growth is now expected to hover between 2.6% and 2.8% over the forecast horizon. In Japan, a further contraction in private consumption is set to dampen growth prospects this year. Growth is expected to pick up next year, as a result of favourable investment conditions and front-loaded demand in anticipation of fiscal consolidation measures, but is projected to fall back again in 2017 when these measures are implemented.

… while world trade is expected to gradually recover.

The slowdown in EMEs, and in particular, the contraction in import demand in China, Russia and Brazil, is expected to lead to a sharp fall in global trade growth, from 3.4% in 2014 to 2.6% this year, and to trigger a decline in the elasticity of global imports with respect to global GDP. As trade bottoms out in China and bounces back in other EMEs (particularly Russia, Latin America, the Middle East and North Africa), and as a result of modest increases in advanced economies, world trade growth is projected to recover to 3.7% in 2016 and 4.4% in 2017. This should in turn underpin an acceleration in EU export markets in both years.

Financial conditions remain favourable…

The deterioration of the global growth outlook and persistent uncertainty about the timing and pace at which the US Federal Reserve may start raising interest rates have triggered an upsurge in market volatility in recent months and a tightening of financial conditions in several parts of the world. Even though financial markets in the euro area and the EU have been caught up in this turmoil and have suffered from tensions related to Greece, overall financial conditions remain favourable. Sovereign bond spreads widened in the euro area amid discussions on Greece, but contagion in the periphery proved rather limited and short-lived, due also to support by the ECB's expanded Asset Purchase Programme (APP).

…on the back of an accommodative policy stance.

The combination of quantitative easing and credit easing by the ECB has successfully kept financing costs and yields at low levels and thereby helped to reduce financial fragmentation and cross-country differences. Annual loan growth in the euro area has now turned positive for non-financial corporations. In the euro area, the additional liquidity arising from the ECB's asset purchase programme has also improved banks’ willingness to lend and surveys suggest that euro area banks will continue to ease their credit standards. This positive trend is supported by lower refinancing costs for banks, which suggests an improvement in the transmission of the ECB’s accommodative monetary policy throughout the euro area banking system.

Elsewhere in the EU, central banks have also kept their monetary policy rates at historically low levels amid renewed declines in inflation.

The recovery is widespread across Member States…

Tailwinds are supporting economic growth in all Member States, albeit to different degrees. Domestic demand growth is strengthening in most euro area Member States this year, while it is weakening in most non-euro area countries. In 2016 and 2017, economic activity should be on the rise in all Member States with an acceleration expected in 2017 in most of them. Growth differences result from country-specific structural features such as differences in balance-sheet adjustment, deleveraging in the private sector and catching-up in some Member States. Other factors include different cyclical positions, differences in the pass-through of lower oil prices, different degrees of exposure to China's rebalancing and differences in the price elasticity of exports.

…and driven by the strengthening of domestic demand…

Private consumption has been fuelling the pick-up in domestic demand and is expected to maintain its growth momentum in the near term, supported by a continued rise in nominal incomes and the positive impact on purchasing power of lower energy prices, which may not yet have been fully passed through. Overall in 2015, improved labour market conditions and the increased scope for household spending, as a result of higher real wages, should generate steady consumption growth in the euro area and even more so in the EU as a whole. In 2016 and 2017, private consumption growth should continue to be supported by improving labour market conditions, further gains in non-labour income, and consumer price inflation which will still be relatively low (as oil prices are now assumed to rebound later and less than expected in spring). However, as the rate of inflation normalises, real disposable incomes should grow more slowly than this year. Private consumption is nevertheless expected to decelerate only slightly over the forecast horizon because household saving rates are expected to decline somewhat. This is partly due to the likely decrease in precautionary savings on the back of improving labour market conditions, but also because to the discouraging impact that an extended period of low interest rates is likely to have on savings.

…on the back of the tentative recovery in investment…

Investment is forecast to strengthen gradually over the forecast horizon, but less than in past recoveries. This is a result of subdued demand expectations, economic and policy uncertainty associated with developments in the external environment, geopolitical concerns and, in some Member States, the persistence of corporate deleveraging pressures and credit supply constraints. After having fallen rather steadily since the recession in 2008-2009, the adjustment of construction investment is expected to come to an end this year, which should allow construction investment to gather pace in 2016 and 2017. Support should mainly come from the relatively strong growth in household real disposable income, low mortgage rates, and a return to rising house prices. However, since these factors will continue to be partially offset in some Member States by high levels of household debt and remaining sluggishness in the non-residential construction sector, the rebound in construction investment should be moderate. Equipment investment is supported by improved profit margins, on the back of low energy prices, and low financing costs. It should increasingly benefit from a brighter demand outlook and a need to modernise the capital stock. Lower growth momentum outside the EU, however, will likely prevent equipment investment from becoming more dynamic in 2016 but stronger growth is expected in 2017 with the pick-up in global demand. Even though corporate deleveraging should have become a softer constraint for equipment investment than in the years immediately following the recent economic and financial crisis, it is expected to continue holding back investment in some Member States.

...while net exports should contribute little to growth.

So far, weak growth in emerging markets has not significantly hit euro area export growth. On the back of the euro's past depreciation and the decline in relative unit labour costs, this should lead euro area exports to gain market share, even more so than EU exports as whole. However, euro area exports cannot be expected to remain immune to global headwinds. Besides, the weakness of currencies in emerging markets, particularly commodity exporters, strengthens the nominal effective exchange rate of the euro, as well as other EU Member State currencies. Export growth is thus expected to ease next year and to pick up moderately in 2017, in line with the projected strengthening of global trade. On the back of recovering domestic demand, the profile of import growth is projected to be similar to that of exports, so the contribution of net exports to GDP growth is expected to be broadly neutral.

The current account surplus is expected to recede...

The current account surplus of the euro area is set to increase further this year as a result of the shrinking deficit in the oil trade balance, improvements in the terms of trade, and because domestic demand remains subdued. Improvements in deficit countries and further strengthening in most surplus countries will contribute to this rise. The current account surplus, however, is expected to peak, as a rebound in oil prices and a deterioration in the terms of trade should eventually result in a slight decline. Nonetheless, the current account surplus will remain at historically high levels close to 3% of GDP.

...and lower oil prices result in very low inflation.

After a brief rebound in the second quarter, inflation in the euro area dropped below zero in September due to the renewed plunge in energy and commodity prices and the recent strengthening of the euro, which made imports cheaper. The non-energy components of inflation, however, are starting to show rising inflationary pressures, slowly reflecting the strengthening of private consumption. Prices are also set to experience upward pressure once oil and other commodities recover and upward base effects from the energy component kick in. In addition, stronger wage growth and domestic demand, and the narrowing of the output gap, are set to add steam to the underlying pressures building. Annual HICP inflation is expected to rise from 0.1% in the euro area this year to 1.0 % next year and 1.6% in 2017.

The fiscal stance remains broadly neutral in the euro area...

The fiscal outlook continues to improve, supported mainly by the cyclical strengthening of economic activity and to a lesser extent, by the further reduction in interest expenditure resulting from the non-standard monetary policy measures of the ECB. This year, the deficit-to-GDP ratio in the euro area and the EU is projected to decline to 2.0% and 2.5% respectively. Government deficit ratios are then expected to continue declining in 2016 and 2017 to reach 1.5% in the euro area and 1.6% in the EU. Following the substantial fiscal adjustment achieved over the past few years, the aggregate fiscal policy stance is expected to be broadly neutral in 2015 in both the euro area and the EU. Next year, the fiscal stance is projected to remain broadly neutral for the euro area, while limited fiscal consolidation is still forecast in the EU. In 2017, the structural balance is expected to remain broadly unchanged in both areas. The debt-to-GDP ratio in the euro area and the EU is forecast to decline as of this year from the peak reached in 2014, to reach 91.3% and 85.8% respectively in 2017.

…while progress in reducing unemployment is limited…

Labour market conditions continue to make slow but steady improvements in line with rising economic activity. The unemployment rate however, is declining only gradually and disparities across Member States remains substantial. As the recovery strengthens, business confidence improves and wage growth remains restrained, more jobs will be created. Hard-hit countries which have implemented labour market reforms should see further gains in employment growth. In the euro area, employment is expected to grow by 0.9 % this year and next and to pick up to 1% in 2017. In the EU, employment is set to increase by 1.0% this year and 0.9% in 2016 and 2017. However, the pace of economic growth and job creation looks unlikely to reduce unemployment rates to below pre-crisis levels. The rather modest decline in unemployment also reflects a more rapid increase in the labour force. In 2017, unemployment is expected to reach 10.3% in the euro area and 8.9% in the EU.

…and the outlook is subject to downside risks, particularly external ones.

Overall, the uncertainty surrounding the economic outlook shows few signs of abating. Heightened global risks, including persistent geopolitical tensions and a shallower-than-forecast rebound in inflation have recently added a new layer of uncertainty.

The impact of the weakness in some EMEs could turn out to be larger than envisaged. In particular a 'hard landing' in China would be a substantial risk to the continuation of the global recovery and the dynamics of global trade. The expected normalisation of US monetary policy could prove more negative than expected for EMEs, while surprises in this normalisation process could be one of a number of possible triggers for volatility in financial markets and abrupt shifts in asset valuation. Should these downside risks materialise, they would become a larger impediment to investment spending and economic activity than currently expected.

On the domestic side, risks related to the integrity of the euro area have receded recently, thanks to the political agreement on Greece. Meanwhile, the legacy of the crisis may continue to weigh more heavily on investment activity than expected.

On the upside, a stronger-than-expected revival in global growth dynamics and world trade could push demand for European exports more than expected. A more favourable impact from already-implemented and future structural reforms, or the Investment Plan for Europe, could also provide additional impetus to economic growth. Should a larger-than-expected number of refugees enter the EU and in turn join the EU labour force faster than expected, this would boost demand and the labour supply.