

OVERVIEW

Recovery in progress...	Recovery is underway in the EU, albeit a gradual one. Real GDP started to grow again in the third quarter of 2009 (up by 0.3% quarter-on-quarter (q-o-q)), ending the longest and deepest recession in the EU's history. However, growth eased somewhat in the fourth quarter (to 0.1% q-o-q), as the impact of some temporary factors started to fade, including the exceptional crisis measures put in place across the globe to sustain demand. Inventory adjustments were particularly important in shaping short-run dynamics in the EU and globally.
...supported by global demand and improving financial conditions...	Looking ahead, the EU is likely to benefit from a stronger-than-expected turnaround in the global economy, most notably in emerging Asia. In 2010, global trade is set to grow more than twice as fast as projected last autumn. While financial-market conditions have improved markedly since early-2009, volatility increased at the start of 2010, balance-sheet adjustments remain incomplete in several sectors/countries and uncertainty is rife. Future developments as regards both <i>global imbalances</i> and <i>financial markets</i> , discussed in greater detail in the two analytical chapters, are therefore crucial for the outlook. Global imbalances affect the strength and, especially, the sustainability of the global recovery, while a key question regarding the financial system is whether banks' balance-sheet repair is sufficiently advanced to allow them to respond to a future rebound in credit demand.
...while the EU grapples with the aftermath of the crisis	At the same time, the EU faces headwinds on a number of other fronts that are set to restrain domestic demand for years to come. The downsizing of the construction sector is still ongoing in a number of Member States. The labour market is expected to remain weak: a higher degree of labour hoarding during this recession, which helped stemming the rise in unemployment, points to a potentially jobless recovery ahead. Supply constraints will also be present given the adverse impact of the financial crisis on potential output. In addition, research suggests that, following a period of financial stress, recoveries tend to be more muted, held back by weak private demand, as the economy transits to a new steady state.
Sluggish (post-crisis) recovery ahead...	Indeed, the current upturn is likely to be atypical. The first quarter of the upswing proved unusually marked, boosted by expansionary policy measures, as did the softening in the second. As for contributions of demand components, export growth has been and is expected to stay stronger than the average of previous recoveries. On the other hand, the weakness of domestic demand, especially investment, is projected to be more pronounced and protracted. This follows from the still very low level of capacity utilisation, the risk of an undershooting in several housing markets, the still ongoing deleveraging process and heightened risk aversion that could weigh on capital spending ahead. Moreover, private consumption growth is forecast to strengthen only gradually, as disposable income is held back by weak wage and employment growth.
...implying GDP growth of 1 and 1½% for this year and next	Overall, EU GDP growth is expected to remain rather subdued during the first three quarters of 2010, on average, and to regain ground only by the end of the year. This follows from, in particular, the fading impact of the temporary support that kick-started the recovery (both within the EU and outside). A temporary hike is expected in the second quarter, however, reflecting in large part a technical rebound in the construction sector that was

depressed by unusually adverse weather conditions during this winter. As both external and domestic demand gradually strengthen, GDP growth could recover to about ½% q-o-q during 2011 in both the EU and the euro area. Taking into account the easing in activity towards the end of 2009 (limiting the so-called carry-over to 0.2% in the EU), annual growth rates of about 1% are expected in both regions this year. For 2011, GDP growth could accelerate to, or just above, 1½%, thereby starting to slowly close the sizeable output gap that opened up during the recession.

Increasing differences across EU countries...

While all EU economies were hit by the crisis, there are important differences between them. Factors explaining the divergences include trade openness, exposure to the financial-sector disturbances and the existence of sizeable internal and/or external imbalances. Looking forward, the recovery is expected to advance at different speeds reflecting the challenges individual economies face and the policies they pursue. Mounting concerns about fiscal sustainability, especially in some euro-area Member States, which cause increased turbulence in government-bond markets, and differences in competitiveness positions are among the most important challenges in this regard.

...reflecting individual challenges

Among the largest economies, the upturn is set to be stronger than average for Germany and France this year (at 1¼%), albeit for different reasons, while Spain is projected to remain in recession. The recovery in the United Kingdom is expected to gather momentum during 2010, suggesting that its annual GDP growth could close to double from 1¼% this year to about 2% next. Poland, which was the only EU economy to escape a recession, is forecast to grow relatively fast (at 2¾% and 3¼%, respectively), also reflecting its initially lower GDP-per-capita level. Among the smaller economies, the rebound is particularly pronounced for Luxembourg, Slovakia and Sweden who are all posting GDP growth close to or above 2% this year, while GDP is projected to contract in Cyprus, Greece, Ireland, Latvia and Lithuania. By 2011, all EU countries, with the exception of Greece, are expected to have returned to positive economic growth.

Labour markets hit hard, albeit a bit less than earlier feared...

Labour markets were hit hard by the crisis, albeit somewhat less than initially expected. Job destruction was limited by the use of short-term measures and labour hoarding in some Member States, but also as a result of past reforms. Reflecting the usual lag between employment and output, employment still declined towards the end of 2009, although at a slower pace than before, and signs of stabilisation have begun to emerge: firms' employment expectations have improved and the unemployment rate was levelling off at 9½% in the EU (10% in the euro area) in February 2010, some 2½ percentage points (pps.) above the pre-recession rate. Differences across countries have widened with the rate of unemployment ranging from 4-5% in the Netherlands and Austria to around 20% in Spain and Latvia where a sharp decline in residential construction weighed heavily on the labour market.

...while the outlook is for a jobless recovery

Looking ahead and taking into account a negative carry-over from 2009, employment is expected to fall by around 1% this year, leading to a further rise in the unemployment rate in both the EU and the euro area. The relatively limited labour-market adjustment so far, together with a sectoral reallocation forced by the crisis, suggests a rather jobless recovery and (potentially persistent) high unemployment ahead.

Slack keeps inflation in check	Consumer-price inflation has rebounded somewhat from the very low levels recorded in mid-2009. Sizeable slack in the economy is nevertheless expected to keep both wage growth and inflation in check, partly offsetting expected increases in energy and commodity prices as well as, for the euro area, a weaker euro. HICP inflation is projected to average 1¾% in the EU both this year and next (and 1½% and 1¾%, respectively, in the euro area).
Public deficits tripled...	Public finances were also severely hit by the crisis. The general government deficit has tripled in recent years. The deficit reached 6.8% of GDP in the EU in 2009 (and 6.3% in the euro area), while the debt-to-GDP ratio rose by some 10 pps. to 73.6% in the EU (or 78.7% in the euro area). The surge in the deficit is attributable to the working of automatic stabilisers (such as unemployment benefits) and to the discretionary fiscal-stimulus measures that were taken under the European Economic Recovery Plan to combat the crisis. Moreover, public revenues dropped more than the extent of economic downturn would normally warrant in several countries, reflecting a change in the composition of growth towards less tax-rich components, such as exports.
...but set to improve somewhat, while debt continues to rise in 2011	The deficit ratio is expected to peak this year, with an improvement of about ½ pp. projected for 2011 in both regions, largely reflecting the end of the temporary expansionary measures. The debt ratio, in contrast, remains on an increasing path throughout the forecast horizon (reaching close to 84% of GDP in the EU and over 88½% in the euro area by 2011). Recalling the analysis presented in the autumn European Economic Forecast, a one-off increase in public debt does not necessarily put fiscal sustainability at risk. However, current trends in public debt may jeopardise long-term sustainability given the combination of sustained large deficits, low(er) potential growth than in the past and, in the not too distant future, unfavourable demographic developments.
Continued high uncertainty...	The tensions in the sovereign-debt markets in early 2010 illustrate well the high uncertainty that continues to surround economic projections. Overall, risks to both the growth and the inflation outlook remain broadly balanced.
...with broadly balanced risks for both the growth...	As regards economic activity, the external environment could continue to surprise positively, thereby boosting EU exports further. Moreover, policy measures could prove more effective than assumed (both in the EU and abroad), raising confidence among businesses and consumers further that, in turn, would strengthen domestic demand. Indeed, survey data have recovered firmly over the past year, especially in the manufacturing sector. If sustained, this would point to a stronger activity in the near term than other high-frequency indicators suggest at present. In contrast, the still fragile financial-market situation remains a source of concern. First, risk premium may increase in some Member States, leading to higher financing costs for firms and households, possibly also in other EU Member States. Second, while the banking sector has strengthened, the quality of the loan portfolio could deteriorate further. This could potentially hamper the ongoing process of balance-sheet repair, also endangering banks' capacity to cater for a future rebound in credit demand. In addition, monetary and fiscal policy exit could weigh more on consumption and investment than expected hitherto.
...and inflation outlook	Turning to inflation, the recent rebound in oil and other commodity prices and a lower-than-assumed euro-exchange rate constitute upside risks to the current projection. At the same time, large excess capacity, weak labour-market conditions and well-anchored inflation expectations are likely to contain inflationary pressures in the near term.