OVERVIEW

Growth in the EU has stalled and it will take time to pick up again.

The outlook for the European economy has taken a turn for the worse. Sharply deteriorating confidence and intensified financial turmoil is affecting investment and consumption, while urgent fiscal consolidation is weighing on domestic demand and weakening global economic conditions are holding back exports. Real GDP growth in the EU is now expected to come to a standstill around the end of this year, turning negative in some Member States. Only after some quarters of zero or close-to-zero GDP growth, a gradual and feeble return of growth is projected in the second half of 2012. The uncertainty related to the sovereign-debt crisis is expected to gradually fade over the forecast horizon, provided the necessary policy measures are implemented. Nevertheless, growth is likely to be held back by more difficult financing conditions, ongoing deleveraging and sectoral adjustment. Growth will be insufficient to deliver an overall reduction of unemployment within the forecast period.

Uncertainty has increased since the summer and is now extremely high. Accordingly, the downside risks have become very strong. If left unchecked, negative interactions between debt concerns, weak banks and slowing growth are likely to lead to a relapse of the EU economy into recession.

EU growth slowed down after a strong first quarter...

At the time of the spring 2011 forecast, there were signs of a pick-up of domestic demand offering the prospect of a self-sustained recovery, even though a soft patch was expected for the second half of 2011. However, already in the second quarter, domestic demand shrivelled and net exports took again over as the remaining driver of growth. Over the summer, the outlook worsened abruptly. Concerns about the sovereign-debt crisis in euro-area Member States intensified and broadened, debt sustainability in advanced economies outside the EU also moved into investors' focus, and the global economy lost steam.

… as financial market conditions have deteriorated sharply…

The aggravation of the sovereign-debt crisis and the deteriorating outlook for the global economy triggered global financial-market turmoil amid a generalised re-assessment of risk. Equities tumbled worldwide, but most strongly in Europe. While bond yields of the euro-area Member States with vulnerable fiscal positions increased, the yields of bonds considered as safe havens fell to record lows. Uncertainty about the exposure of banks to euro-area sovereigns resulted in a freeze-up of inter-bank lending and a sharp deterioration of the banking sector's funding conditions. While the predicaments of banks differ, banks are now expected to accelerate the strengthening of their capital buffers. Although banks can refinance at the Eurosystem with lengthened maturities and full allotment, the latest bank lending survey suggests tightening credit supply conditions going forward. By now, the weakening real economy, fragile public finances and the vulnerable financial sector appear to be mutually affecting each other in a vicious circle.

… and the global economy has moved to a lower growth trajectory.

While global financial markets are affected by spillovers from the sovereign-debt crisis, the global economy is also subject to events located outside Europe. Over the summer, the recovery in the US lost steam. Going forward, high unemployment, ongoing deleveraging and fiscal policy tightening are set to weigh on US growth. Emerging market economies have moved to a more moderate growth path, but are expected to hold up quite well. Growth in Japan is projected to experience a rebound in 2012. Meanwhile, world trade has slowed down strongly and is projected to go through a soft patch in 2012 before picking up again in 2013.

The EU economy is set to stagnate for some quarters before anaemic growth gradually returns.

As a result of the domestic and external weaknesses, GDP in the EU is projected to stagnate towards the end of 2011. This deterioration of the outlook is supported by the accelerated decrease of leading indicators in recent months. GDP is expected to recover very gradually from the spring of 2012 onward, returning to modest growth later in the forecast period. This outlook for a gradual recovery is in line with an assumption of declining uncertainty and financial market stress, which is, however, conditional on appropriate policy action. To the extent it materialises, it will allow a return of domestic demand, while net exports benefit from fading impediments to the global recovery. However, the need for ongoing balance-sheet adjustment, both in the private and the public sector, the legacy of high unemployment and the negative impact of the crisis on potential growth will continue to weigh on the speed of growth going forward.

As uncertainty will weigh on domestic demand in the coming quarters …

While at the time of the spring forecast a broadening of the recovery on the back of more robust domestic demand appeared to be in the cards, domestic demand turned out to be disappointing in the second quarter of 2011. Private consumption, which has made a moderate contribution to GDP growth since the 2008-09 recession, is set to be held back by the increase in uncertainty and the worsening outlook for employment. The projected further decrease of inflation and moderate wage growth will underpin disposable income, which should support a modest pick-up of private consumption along with the expected dissipation of uncertainty from the second half of 2012 on. However, deleveraging of household debt takes time and is expected to restrain consumption over the forecast horizon. The contribution of government consumption to growth has been vanishing in 2011, and further consolidation needs point to a moderately negative impact in 2012.

The outlook for investment has darkened rapidly following the strong rebound until the first quarter of 2011. Increased uncertainty accompanied by the perspective of a slowdown is expected to lead to stalling investment. As firms adopt a wait-and-see attitude, their generally strong financial position and still good conditions for external financing will not prevent a strong slowdown in investment. Only in the later half of the forecast horizon, investment is expected to pick up again, in line with the assumption of improved confidence and strengthening export demand.

… the growth forecast for 2012 has been revised down substantially.

Expected GDP growth is revised down for the second half of this year as well as for 2012; for 2013, a return of modest growth is projected. Mostly due to the strong GDP growth in the first quarter of this year, annual GDP growth for 2011 remains close to the values projected in the spring forecast, at 1.6% in the EU and 1.5% in the euro area. Growth for 2012 is revised down substantially, by 1¼ percentage points to ½% in both the EU the euro area. For 2013, annual growth is projected at 1.5% in the EU and 1.4% in the euro area. In terms of quarterly profile, growth is expected to be nil in the fourth quarter of 2011. On account of a gradual return of confidence and abating external drag, quarterly GDP growth is then expected to slowly increase to around 0.4% in both the EU and the euro area by the fourth quarter of 2012. This modest level of quarterly growth is forecast to be maintained throughout 2013.

The debt crisis hits growth in all EU Member States…

No group of Member States will escape the expected slowdown, but growth differences will persist. Growth in the Member States that displayed the strongest growth performance in 2010-11 is forecast to decelerate faster than the EU average. Some of the drivers of recent growth differentials are fading, as countries that had been hit by banking and/or housing market crises are gradually advancing in their adjustment. However, the aggravation of the sovereign-debt crisis has led to more differentiated financing costs across Member States for governments as well as the private sector. Member States' fiscal consolidation needs continue to differ. As a result, growth differentials across Member States are likely to persist in 2012-13.

but heterogeneity won't disappear, yet.

While the confidence shock related to the sovereign-debt crisis affects Member States in a broadly similar way, differences in their growth performance are mainly related to the legacy of the credit and housing boom as well as different openness to, and orientation of, international trade. In *Germany*, investment, consumption and exports are all set to weaken strongly in the fourth quarter of 2011. However, only a temporary interruption of growth dynamics is expected until uncertainty dissipates and a robust growth momentum is resumed. In *France*, weakening corporate investment and to lesser extent softening private consumption are set to cause a marked slowdown to slightly negative GDP growth at the end of 2011. A moderate return of growth is projected in the second half of 2012. *Italy* is set to experience two quarters of slightly negative GDP growth around the turn of the year and frail growth thereafter, as domestic demand remains very subdued. The *Spanish* economy is projected to go through some quarters of stagnation in late 2011 and early 2012 before growth very gradually returns. This projection is largely driven by the technical assumption of no change in fiscal policy reflecting the absence of a 2012 budget. However, further fiscal consolidation measures are very likely after the general elections. GDP in *the Netherlands* is forecast to stagnate in the current and coming quarters as domestic demand and exports simultaneously weaken. Modest growth in the second half of 2012 and into 2013 is set to mainly rely on net exports.

Among the largest Member States outside the euro area, the *UK* economy is set to stagnate in late 2011 and the first half of 2012, mainly on account of continued weakness of household consumption, before returning to growth around potential in the later part of the forecast horizon. *Poland* is expected to experience a comparably benign slowdown around the end of 2011, mainly on account of weaker foreign demand. Domestic demand is set to remain fairly resilient, though growth is projected to be more moderate than projected in spring.

Current-account adjustment continues.

Concerning Member States' current accounts, remarkable progress has been made in reducing imbalances in many Member States, in particular in the euro area. Many of those countries with a current-account deficit in 2010 are projected to reduce their external deficit over the forecast period. In some of the surplus countries, more balanced positions are also expected

With meagre employment growth, high unemployment is set to persist, …

The recovery in the past two years has entailed only slow employment growth. While this partly reflects labour hoarding during the recession, employment growth has not been strong enough to reduce persistently high unemployment markedly. With the expected slowdown ahead, firms are set to put hiring on hold, as is already reflected in their deteriorating employment expectations. Employment growth is expected to grind to a halt in 2012, and the low level of activity is even likely to lead to a temporary decrease in hours worked. The expected pick-up of GDP growth starting in the second half of next year is too moderate to produce any strong labour market performance within the forecast horizon. Employment growth in 2013 is therefore expected to remain meagre. As a result, unemployment is not expected to fall over the forecast horizon. However, cross-country differences in labour market performance are expected to remain large.

… and the risk of labour market sclerosis has increased.

Chapter 2 of this forecast examines the labour market developments since the end of the recession in 2009 and the forces likely to shape employment and joblessness going forward. Employment started to increase in late 2010, but the overall performance of the matching process in the labour market appears to have deteriorated. As job-finding rates have remained rather low, the unemployment rate remains persistently high, average unemployment spells have lengthened and youth unemployment has surged in many countries. Related to the adjustment of the pre-crisis imbalances, the skills of those laid off do not match the skills sought for new employment creation well, so firms find it harder to fill their vacancies than the headline unemployment figure would suggest. The increase of structural unemployment has negative repercussions on growth potential. On the positive side, labour market participation has remained high despite the increase in unemployment. If this resilience of participation continues it will contribute to potential growth going forward.

Inflation is expected to stabilise below 2%.

Headline HICP inflation accelerated in the first half of 2011, mainly driven by the pass-though of high energy and food commodity prices. As commodity prices have peaked in the first half of 2011, and oil futures prices point to a gradual further decrease going forward, headline inflation is expected to gradually abate, falling back below 2% in the course of 2012. Deferred pass-through can, however, still produce some volatility in the headline figure, as evidenced by the acceleration of inflation in September 2011. Increases in indirect taxes in Member States with fiscal consolidation needs can also temporarily affect headline inflation. As for the underlying price pressures, persistent output gaps, which are expected to widen slightly in most Member States in 2012, will continue to hold back inflation, while wages are expected to grow only moderately in view of high unemployment.

2011 marks the switch from fiscal stabilisation to consolidation; yet, debt-to-GDP ratios take time to stabilise.

Fiscal deficit outcomes for 2011 are now projected at 4.7% of GDP in the EU and 4.1% in the euro area. The slight improvement compared to the spring forecast for the euro area is mainly due to additional fiscal measures in some Member States. Deficits are forecast to decrease further, albeit at a slowing pace, due to both reduced expenditure and higher revenues. For 2012, deficits are projected at 3.9% in the EU and 3.4% in the euro area. The EU's gross debt ratio is forecast to reach a peak of about 85% of GDP in 2012 and to stabilise in 2013. In the euro area, gross public debt is projected to rise over the whole forecast horizon, albeit at decreasing pace compared to the 2008-10 period, breaching 90% already in 2012.

The projected turnaround strongly depends on the appropriate policy.

The present forecast heavily relies on the assumption that policy measures to combat the sovereign-debt crisis will eventually prove effective. It is assumed that the uncertainty related to the sovereign-debt and financial-market crisis will dissipate gradually towards mid-2012, and that this will lead to a reduction of financial-market volatility and gradually release deferred investment and consumption. Indeed, many important decisions have already been taken, not least in late October 2011. They cover a large spectrum of measures to ensure or restore debt sustainability, repair the financial sector and strengthen the policy rules within EMU.

The risks to the main scenario are strongly tilted to the downside.

Against the backdrop of the high level of uncertainty, the overall balance of risks to the growth outlook is strongly tilted to the downside. Some of the risks that were identified earlier on have materialised. Since the spring forecast, the global financial market situation has deteriorated against the backdrop of a deeper and longer sovereign-debt crisis with contagion, while global demand has weakened, in turn also contributing to the weakness of financial markets. This is now reflected in the present forecast's baseline scenario. Nonetheless, serious downside risks remain. In view of the frail GDP growth expected under the main scenario, the risk of a recession is not negligible.

The main downside risks of the GDP forecast stem from fiscal sustainability, the financial industry and world trade. Ensuring fiscal sustainability remains a challenge across Europe, but also in major advanced economies outside the EU. Lack of credible progress with in addressing the sustainability challenges could lead to even stronger financial stress. The banking sector, rather than increasing capital to improve balance sheets, might resort to divestment and lending restrictions, potentially producing a credit crunch as of early 2012, which would obviously depress domestic demand. The contraction of world trade in the second quarter of 2011 – though apparently influenced by supply chain disruptions in the wake of the earthquake in Japan – is also a reminder that trade is very sensitive to global growth dynamics. A further softening of global demand could affect net exports quite substantially. Moreover, there are worrying signs of mounting protectionist pressure. Finally, there is a potential for negative dynamic interactions (feedback loops), which could alter the growth dynamics more substantially. Slower growth already affects the sovereign debtors, whose weakness weighs on the health of the financial industry. If the latter were to restrict lending more strongly than currently projected, this would depress GDP growth and fiscal revenues further.

On the upside, confidence might return faster than currently assumed, releasing the potential for an earlier-than-expected recovery of investment and private consumption. Global growth could prove more resilient than projected in the baseline scenario, due e.g. to inherent growth dynamics in emerging market economies, and provide support to EU net exports. Finally, a larger decline in commodity prices could enhance real disposable incomes and consumption.

Risks to the inflation outlook appear broadly balanced. On the one hand, a stronger-than-expected slowdown of GDP growth or a more rapid fall of commodity prices could dampen price developments further. On the other hand, a stronger rebound in the global economy or renewed unrest in oil exporting countries could exert upward pressure on prices. Finally, the exceptionally large liquidity creation by central banks in advanced economies over the past years could yet be transmitted into inflation pressures.