

OVERVIEW

Recession is over, but major challenges persist

The EU economy is emerging from recession with GDP growth turning positive again in the second half of this year. This better-than-expected rebound in the near term is expected to be followed by a certain easing in growth. The outlook is thus for a gradual recovery further out, as several factors are set to restrain domestic and external demand in the medium term. Future developments in the labour market and public finances, discussed in greater detail in the two accompanying analytical chapters, will be crucial in this regard.

All countries hit, but to different degrees

The current recession has proved to be the deepest, longest and most broad-based recession in the EU's history. GDP is set to fall by about 4% in 2009 for both the EU and the euro area. The cumulative output loss amounts to some 5% since the recession started in the second quarter of 2008. This is about three times more than the average loss in the previous three recessions. All economies are affected by the crisis where, among the large Member States, the 2009 contraction ranges from about 2% in France to 4½-5% in Germany, Italy and the United Kingdom. In Poland, GDP growth is expected to slow sharply, although it escapes a fall in GDP. This divergence in economic performance reflects, inter alia, varying exposures to major financial sector disturbances, differing degrees of trade openness and the existence or not of a housing boom prior to the crisis.

Upturn in the EU economy...

Signs of improvement in the economic situation have become increasingly apparent in both confidence indicators and hard data since the summer. The exceptional monetary and fiscal measures put in place have not only prevented a systemic meltdown, but also allowed for a marked improvement in financial-market conditions, even with several indicators back at pre-crisis levels. The outlook for the world economy has also strengthened and especially so in emerging-market economies, mainly in Asia where China is leading the way. Together with the impact of improved confidence across sectors and countries, growth is expected to turn positive again as of the third quarter of 2009 in both the EU and euro area.

...potentially weakening further ahead as the economy moves towards a new equilibrium

This initial upturn in economic activity in the EU and abroad is, however, largely driven by temporary factors. In particular, the favourable impact of inventory adjustment (with the destocking process coming to an end) and stimulus measures are expected to fade away in the course of next year⁽¹⁾. The recovery thereafter is projected to be different from earlier cyclical upturns as the economy is finding its way to a new equilibrium. Several factors are expected to dampen domestic demand including a need for financial deleveraging across sectors, an expected further deterioration of the labour market and supply constraints stemming from the adverse impact of the financial crisis on potential output.

Exports not providing the usual kick-start to the EU economy...

The traditional pattern of EU recoveries typically begins with a pick-up in exports. The EU initially benefits from an improved outlook for global growth and a rebound in trade, notably in the more export-oriented EU economies. However, global activity is also set to go through a soft patch in the course of 2010 when temporary factors peter out, while private demand may not recover fast enough to support growth. The EU's external

⁽¹⁾ The outlook is prepared using the usual no-policy-change assumption, thus taking into account measures known in sufficient detail by the cut-off date of 22 October 2009.

environment is also affected by the ongoing rebalancing of world demand. As a result, EU export growth is set to firm only gradually over the forecast period.

...while domestic demand is held back by the ongoing adjustment

Notwithstanding the support from an improved external environment, a sustained pick-up in the underlying recovery would require an improved outlook for private domestic demand. Traditionally, an upturn in exports spurs demand for investment which subsequently supports employment and private consumption growth. At present, however, this export - domestic demand nexus is anticipated to be weaker. A historically low capacity utilisation rate, relatively weak demand prospects, subdued profitability gains and still moderating credit growth underpin the projected (unusually moderate) recovery of gross fixed capital formation, which is projected to turn positive only in 2011. This, together with the need to deleverage households' balance sheets further and the expected bleak labour-market situation, is likely to make private consumption sluggish (recovering to about 1% growth only by 2011).

Growth gradually picking up

Overall, after the temporary boost expected during the second half of this year, real GDP growth is expected to ease somewhat and to regain ground only by the second half of next year. As both external and domestic demand gradually strengthen, growth could recover to about 0.5% quarter-on-quarter (q-o-q) during 2011 in both the EU and the euro area. Taking into account the weak carry-over from this year, annual growth rates will be limited to about ¾% in 2010 in both regions. The following year, GDP could grow by some 1½%, thereby starting to gradually close the output gap that will have opened up by then as a result of the crisis.

But unemployment still on the rise...

The recession has caused a deterioration in the labour market, although a less dramatic one than initially expected. This is largely explained by the use of short-term policy measures, along with the impact of past labour-market reforms and labour hoarding in some Member States. Firms are, however, expected to increase labour shedding in the coming quarters and the unemployment rate is set to increase further, reaching 10¼% in the EU in 2011 (10¾% in the euro area). Looking ahead to the medium term and as discussed in the labour-market chapter, the financial crisis implies a number of risks for labour-market developments – including the possibility of a 'jobless' recovery, persistently high unemployment and a shrinking workforce - with prospects further out depending on the flexibility of the market and the policies in place.

...putting a lid on wage and price increases

Growing slack in the economy, particularly high unemployment, should dampen wage and inflationary pressures in the period ahead, although consumer price inflation is expected to rebound somewhat from its current, very low level. HICP inflation is estimated to average 1-1¼% in 2010 and around 1½% in 2011 in both the EU and the euro area. Differences across countries are less pronounced than they were prior to the crisis and, area-wide, both actual inflation and inflation expectations appear well behaved.

Deficit and debt to soar as a result of the crisis

Public finances have been hit hard by the crisis with the government deficit set to increase rapidly to 7½% of GDP by 2010 in the EU and to around 7% in the euro area (up from 2¼% in the EU and 2% in the euro area in 2008). This surge follows from the working of automatic stabilisers as the economic situation has deteriorated; the discretionary measures taken to support the economy; and the stronger-than-usual responsiveness of public revenues to the exceptional decline in economic activity and, as a result, tax bases, which

partly reflects the changed composition of growth (towards less tax-rich components). Similarly, public debt is bearing the brunt of the crisis and is expected to increase to 79¼% of GDP by 2010 in the EU (84% in the euro area). A certain improvement is foreseen in the deficit ratio in 2011 as economic activity picks up and temporary measures come to an end. However, the debt ratio remains on an increasing path in view of the still high primary deficit and rising interest payments, which have been only partly offset by the recovery in nominal GDP growth. Although a one-off increase in government debt does not in itself put public-finance sustainability at risk, the chapter on public-debt evolution argues that in combination with sustained large deficits, lower potential output and an unfavourable demographic development, the debt evolution is a source of concern for long-term sustainability.

Uncertainty stays high,
but risks are balanced

The economic situation remains highly uncertain. Overall, risks to the growth outlook are broadly balanced. On the one hand, the recovery could prove more pronounced in the near term, with activity temporarily supported by the impact of discretionary measures and the turning of the inventory cycle. Further ahead, policy measures might boost the soundness of the financial sector, and confidence, by more than expected, thereby supporting domestic demand. Global demand (and hence exports) could also pick up more strongly. On the other hand, if the banking sector does not repair its balance sheet, the credit channel is likely to remain impaired posing a major downside risk to the sustainability of the recovery. The impact of deteriorating labour-market conditions on wage formation and savings behaviour could also prove worse than expected. Moreover, the low capacity utilisation and higher cost of capital could weigh more on investment.

Risks to the inflation outlook also appear largely balanced. Higher commodity prices imply upward price pressures, but these are expected to be broadly offset by downward pressure stemming from the remaining slack in the economy.