

# 1. EURO AREA AND EU OUTLOOK

## 1.1. THE GLOBAL RECOVERY REMAINS FRAGILE

### The global economy is holding up despite high policy uncertainty...

The pace of global GDP growth remained moderate in the third quarter of 2019 (3.1% q-o-q, annualised) but the risk of a sharper slowdown did not materialise (see Graph 1.1). In the US and Japan, the recovery remained robust, underpinned by solid private consumption (US) and some frontloading of demand ahead of a consumption tax hike in October (Japan). GDP growth in the UK temporarily picked up in the third quarter after a volatile first half in which growth was swayed first by corporate mitigation activity ahead of a possible withdrawal date from the EU and then by its unwinding. In most developed economies outside the EU, GDP growth decelerated.

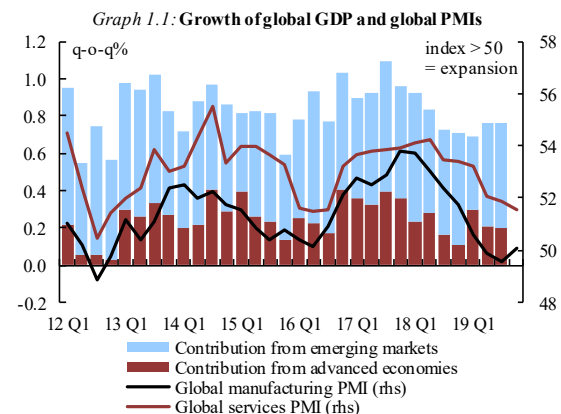
Growth in China continued to soften, reflecting domestic and external downward pressures on the economy. In other emerging markets, the situation remained highly differentiated, but on the whole, GDP outcomes improved somewhat during the third quarter as tailwinds from looser macroeconomic policies and easier financing conditions supported growth.

### ...and there are signs of stabilisation in business confidence...

Global business sentiment started to recover in the fourth quarter of 2019 underpinned by supportive macroeconomic policies and positive developments in the US-China trade relationship (see Box 1: Some technical elements behind the forecast). The ‘Phase One’ trade deal between the two countries changes the baseline outlook described in the autumn forecast, which had included an increase in US tariffs on Chinese

imported goods scheduled for mid-December. Emerging Asia led the bottoming out in global manufacturing sentiment as the region has also benefitted from an upturn in the tech cycle. In the services sector, there has been a more broad-based strengthening in activity fuelling the uptick in global business optimism.

At the same time, world merchandise trade volume rebounded modestly in the third quarter, after contracting for three quarters in a row. Forward-looking global trade indicators have also been showing signs of improvement, although they remain at subdued levels. Measures of new orders and export orders have picked up, and the reading of the WTO Trade in Goods Barometer for the fourth quarter increased for the first time since 2018-Q1.



Sources: OECD, IMF and national sources for GDP, JPMorgan/IHS Markit for PMI

### ...but clouds still loom over the horizon...

Despite some positive developments, elevated policy uncertainty as well as geopolitical and social tensions continue to weigh on global growth prospects. As expected in the autumn, incoming data has confirmed the resilience of labour markets and the tentative bottoming out in the

Table 1.1:

### International environment

(Annual percentage change)

	2016	2017	2018	Winter 2020 interim forecast			Autumn 2019 forecast		
				2019	2020	2021	2019	2020	2021
<b>Real GDP</b>									
World (excl. EU)	3.4	3.9	3.8	3.1	3.3	3.4	3.1	3.3	3.4
<b>Trade volumes</b>									
World (excl. EU) exports of goods and services	1.9	5.6	3.3	0.6	2.1	2.5	0.7	2.1	2.5
World (excl. EU) imports of goods and services	1.3	6.0	3.9	0.4	2.1	2.6	0.5	2.1	2.5

Note: Autumn data recalculated to include the UK.

manufacturing sector. Macroeconomic policies have also been supportive to global growth. The partial de-escalation of trade tensions between the US and China, by contrast, is a more positive development than expected in the autumn and slightly brightens the global growth outlook. The negative impact of the recent spate of social unrest and geopolitical tensions in Latin America, the Middle East and Asia, however, partly offsets this positive development.

Both the US and China are expected to benefit somewhat from the ‘Phase One’ trade agreement, but the pace of GDP growth in these countries is still projected to weaken over the forecast horizon. The US economy will likely slow down as the impact of previous fiscal stimulus measures is waning and an increasingly tight labour market puts limits on future growth. In China, the structural growth slowdown is set to continue as the economy is simultaneously facing unsustainably high domestic debt levels, the challenge of moving to a more consumption and innovation-based growth model, and the still challenging external environment.

In the very short term, US growth is expected to be dented by the substantial cuts in production at the aircraft maker Boeing. In China, the outbreak of coronavirus ‘2019-nCoV’ is affecting the services sector the most, particularly since it coincided with the New Year holiday. Any assessment of the economic impact of the outbreak is subject to large uncertainty. At the current juncture, it is assumed that China’s GDP will be hit mostly in the first quarter, with relatively limited global spillovers. As disruptions ease and both production and demand start catching up, a recovery is assumed to follow in the coming quarters. The macroeconomic impact is also assumed to be cushioned by additional policy stimulus.

In the UK, growth is expected to be broadly stable. Private consumption, supported by expansionary fiscal policy and real wage growth, should underpin growth in 2020, while continued uncertainty over the future relationship with the EU is set to weigh on investment and exports.

Across emerging markets (excluding China), prospects vary. Growth is expected to be solid in parts of Emerging Asia but the outlook in many countries in Latin America, Sub-Saharan Africa and the Middle East continues to be held back by

political tensions and a stalling momentum for structural reforms.

Overall, the outlook for global growth outside the EU is broadly unchanged since the autumn, with a pick-up in growth led by a moderate uptick in emerging market economies as a whole. Thus, the pace of global GDP growth (excluding the EU) is projected to gradually pick up from 3.1% in 2019 to 3.3% in 2020 and 3.4% 2021.

#### **...weighing on global trade growth...**

The persistent uncertainty surrounding US trade policies and the functioning of the WTO continues weighing on the outlook for global trade. While there is now clarity about trading relations between the EU and the UK until 31 December 2020, there is still considerable uncertainty about the long-term relationship and the possibility of an abrupt change in trading relations at the end of the year. These compound structural factors such as the slowdown and domestic rebalancing in China. Nevertheless, recent signs of bottoming out in global manufacturing alongside the positive effect of the US-China trade deal should support a gradual but subdued recovery in trade activity. As global growth picks up, and assuming no further escalation of trade tensions, world (excluding the EU) imports of goods and services are forecast to increase modestly by 2.1% and 2.6% in 2020 and 2021, respectively, after an estimated growth rate of just 0.4% last year.

#### **...and keeping oil price pressures contained.**

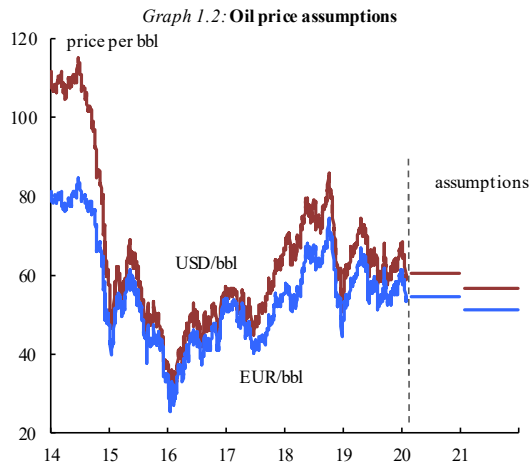
The escalation of geopolitical tensions between the US and Iran at the turn of the year caused volatility in oil markets and increased the risk premium in futures contracts. In addition, deeper OPEC+ <sup>(1)</sup> cuts for the first quarter of 2020 together with continuing supply disruptions in Venezuela and potentially looming disruptions in Libya and Iraq all contributed to concerns about tighter oil supply in the short term.

Still, the increase in Brent crude prices since the autumn has been very limited due to investors’ concerns about the negative impact of the coronavirus ‘2019-nCoV’ on the global economy.

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(1) OPEC+ is a group of 24 oil-producing countries, consisting of the 14 OPEC members and 10 other countries, including Russia and Mexico.

Over the forecast horizon, upward price pressures are expected to be largely contained by the subdued growth outlook and the prospect of a step-up in production in the event of a sustained rise in prices. Overall, an average Brent oil price of USD 60/bbl and USD 57/bbl is assumed for 2020 and 2021, respectively (see Graph 1.2). This is 5% higher than the assumption in the autumn forecast for 2020 and 1% more for 2021.



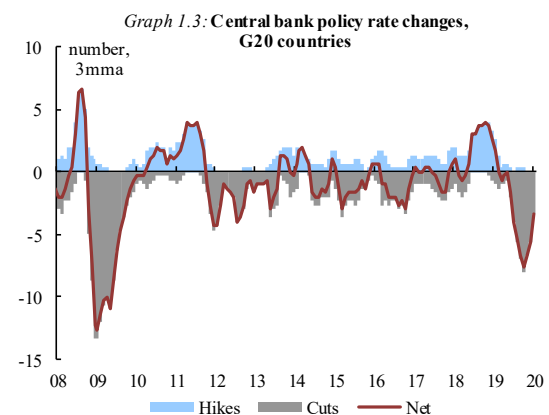
## 1.2. FINANCIAL MARKETS STAYED MAINLY FOCUSED ON THE BRIGHT SPOTS

### Global financing conditions remain favourable...

Global risk sentiment has improved somewhat since the autumn on the back of the US-China trade agreement and the adoption of the Withdrawal Agreement implying stable trading relations between the UK and the EU until the end of the year. At the same time, accommodative monetary policies have continued to support markets (see Graph 1.3). Nevertheless, the recent geopolitical tensions between the US and Iran, together with the fear amongst investors about the possible macro-economic consequences of the coronavirus have sent global markets into a renewed risk-off mode in the beginning of 2020.

As a result, the performance across global equity markets has been mixed. In the US, equity market sentiment has remained upbeat overall and corporate bond spreads have moved mostly sideways. But the ongoing public health crisis in China has unsettled stock markets in emerging Asia and the Pacific and sent corporate bond yields spiking in many commodity exporting emerging markets.

Safe haven assets rallied into the new year. In the US, the yield on 10-year Treasuries fell to 1.5%, while the upward trends for long-term yields in the euro area and Japan reversed. Demand for safe haven currencies has remained strong. Since the autumn, the US dollar and the Japanese yen have strengthened, particularly against currencies in emerging markets. Looking forward, however, global financing conditions are expected to be favourable over the forecast horizon, underpinned by the gradual recovery in global growth. This assumes that the coronavirus outbreak will peak in the first quarter of this year.



Note: Central banks from G20 economies. A positive number corresponds to a rate hike.

### ...with strengthening sentiment on European financial markets...

Over the past few months, investors have shown an increased appetite for financial assets in riskier market segments, while safe-haven assets were priced somewhat lower. This renewed risk appetite was supported by easing global trade tensions, improved economic data (e.g. the positive surprise on GDP growth in 2019-Q3 and tentative signs of bottoming out in manufacturing), and the continued, accommodative monetary policy stance of the ECB. In the past few weeks, however, the emerging risk posed by the coronavirus' spread has somewhat dented investor risk appetite in the EU.

The ECB has kept its monetary policy unchanged since September 2019. At its latest monetary policy meeting in January 2020, the ECB Governing Council considered that monetary policy would need to remain highly accommodative for a prolonged period of time to support underlying inflation pressures and headline

inflation developments over the medium term.<sup>(2)</sup> This is broadly reflected in market-derived interest rate assumptions, suggesting that the ECB's monetary policy is expected to remain highly accommodative over the forecast horizon.

#### ...and a weakened euro in an environment of improved global sentiment.

Improvements in market sentiment at the global level supported emerging currencies against the euro between autumn and mid-January. The pound sterling also appreciated against the euro once it was clear that the Withdrawal Agreement would be approved. Despite the recent deterioration in investor risk sentiment, the euro is now about 1% weaker overall in nominal effective terms than it was around the time of the autumn forecast.

#### Euro area sovereign bond yields have moved sideways since autumn...

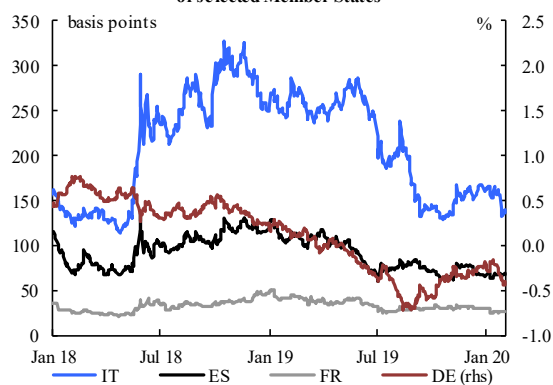
In line with more positive data outturns since autumn, investors' demand for safe assets declined, putting long-term sovereign bond yields in core euro area Member States on an upward trend until mid-January. Bond yields of other euro area Member States rose too, with 10-year spreads slightly widening in some cases. Over the last few weeks though, renewed risk aversion has given a new boost to safe assets, pushing yields lower across the euro area (see Graph 1.4). Overall, investor demand remains strong for euro area sovereign markets as reflected by oversubscribed auctions in January.

#### ...while corporate bond and equity markets have wavered along with investor sentiment...

European corporate credit spreads have narrowed overall with particularly strong spread compression in the high-yield segment. Stock market prices in the EU are marginally higher than in the autumn, having first risen on the back of strong corporate earnings and improved sentiment and then falling back in recent weeks as global risk sentiment deteriorated.

<sup>(2)</sup> see ECB (2020). 'Introductory statement'. *Press conference*, 23 January. For an overview of the ECB's monetary policy framework over the past 20 years and an assessment of the effectiveness of unconventional policy measures enacted over previous years, see M. Rostagno, C. Altavilla, G. Carboni, W. Lemke, R. Motto, A. Saint Guilhem and J. Yiangou (2019). 'A tale of two decades: the ECB's monetary policy at 20'. *Working Paper Series* 2346. December.

Graph 1.4: German bund yield and sovereign spreads of selected Member States



Source: Bloomberg

#### ...and private sector funding remains robust despite concerns about weakening demand.

Bank lending flows to the euro area private sector remained robust in the last few months. However, there was some mild softening in the corporate sector, which went in tandem with less dynamic corporate debt issuance. According to the ECB's bank lending survey for the last quarter of 2019, more banks reported a reduction in loan demand than an increase, the first time this has happened since 2013. This weakening demand concerns especially investment. At the same time, banks' credit standards remained broadly unchanged for both loans to enterprises and housing loans, suggesting that the softening in lending flows was demand driven. Overall, financing conditions for both the public and private sector continue to be very supportive across funding sources and are expected to remain so over the forecast horizon.

### 1.3. DOMESTIC GROWTH DRIVERS KEEP THE ECONOMY GOING

#### Growth surprised on the downside in the fourth quarter...

According to Eurostat's preliminary flash estimate, euro area GDP growth in the fourth quarter came in at 0.1% (q-o-q), its lowest since early 2013. This was only slightly below what nowcasts had suggested on the basis of high-frequency indicators. At the same time, the geographic distribution of growth brought with it some negative surprises, with economic activity contracting in both Italy (-0.3% q-o-q) and France (-0.1%). While the former was partially related to adverse weather conditions, the latter was partly affected by temporary factors such as the ongoing

strikes, especially in the transport sector, and a refinery maintenance which led to a sharp adjustment in inventories.

The negative surprise at the turn of the year comes in contrast to the higher-than-forecast outturn in the third quarter, when growth exceeded the Commission’s autumn forecast by 0.2 pps. This was mainly related to a stronger-than-expected growth rebound in Germany, which returned to positive rates and thereby avoided entering a (technical) recession. Economic activity in the euro area was mostly driven by consumer spending, partially reflecting the lagged impact of enacted government measures on household’s income.

The economic expansion in the euro area is now the longest on record since the introduction of the euro but its pace has become rather subdued. At an average growth rate of about 0.2% (q-o-q) in 2019, growth was about 0.5 pps. below the average recorded in 2017 and roughly at the same level as in 2018. In all, Eurostat estimates that GDP growth in 2019 fell to 1.2% in the euro area, down from 1.9% in 2018. This is in line with what was expected in the autumn.

Economic activity remains dampened by the still high level of uncertainty linked to trade policies, as well as by cyclical and structural factors. (3) Still, some cyclical headwinds are expected to diminish. Global growth is set to pick up gradually and the Asian tech cycle to turn for the better. By contrast, some of the structural drags are set to have a longer lasting effect. These include the economic transition in China, population ageing as well as the shifts in car demand and car production related to new environmental standards, technological advances and regulatory measures.

**...but domestic demand remained robust...**

The GDP breakdown for the first three quarters of 2019 confirms the key role of domestic demand, in particular of private consumption, as the driving force of growth. During this period, real GDP was 1.3% higher than in the first three quarters of 2018. As in previous years, however, euro area aggregates were significantly affected by the activity of multinational companies in Ireland, (4)

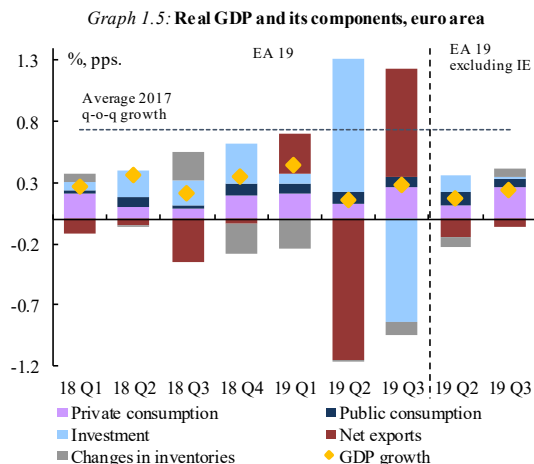
(3) See European Commission (DG ECFIN) (2019). ‘European Economic Forecast: Autumn 2019’. *Institutional Paper* 115, pp. 12-19.

(4) These activities of multinational firms include the relocation of intellectual property and contract

which mainly mattered for investment and imports of services and resulted in large shifts in the balance of domestic and external growth contributions. (5)

Disregarding developments in Ireland, economic growth in the first three quarters came in at 1.1% with domestic demand (excluding inventories) contributing 1.7 pps. and net exports subtracting 0.1 pps. Destocking weighed significantly on activity during this period, slashing it by about 0.4 pps. (see Graph 1.5). To look through the short-term volatility of euro area aggregates, data from Ireland is excluded in the analysis below.

Private consumption (excluding Ireland) remained the backbone of growth dynamics in the euro area, rebounding in the third quarter to 0.5% (q-o-q) from 0.2% in the second quarter and 0.4% in the first. Household income continues to benefit from ongoing improvements in the labour market, with continued though slower employment growth, as well as wage increases and fiscal measures in several countries. At the same time, public consumption growth fell only marginally (from 0.5% to 0.4%), but increased in Germany to its highest rate in three years.



Investment in the euro area (excluding Ireland) lost momentum in each of the first three quarters of last year. It failed to grow in the third quarter, after increasing by 1.2% (q-o-q) in the first and by 0.7% in the second quarter. However, looking at

manufacturing; see e.g. J. FitzGerald (2018). ‘National accounts for a global economy: the case of Ireland’. *ESRI Quarterly Economic Commentary 2* (Economic & Social Research Institute), Summer, pp. 85-122.

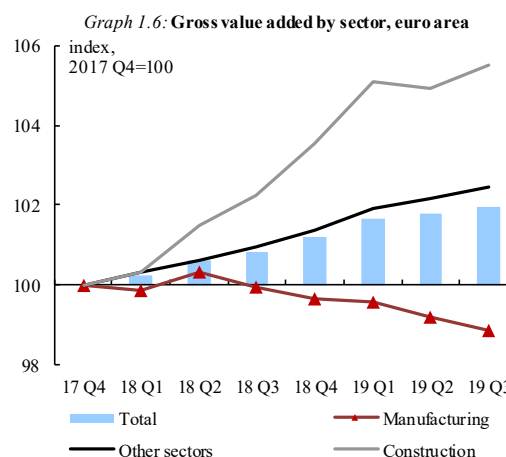
(5) In the first three quarters this is apparent from the growth rates of Irish investment (-23.4% q-o-q in the first, 165.0% in the second, and -55.3% in the third quarter) and services imports (0.2%, 52.5%, -28.1% respectively).

investment growth on a year-on-year basis, in the first three quarters, investment growth remained well above GDP growth at 3.2%. The picture is much more diverse across investment types. While construction investment held up in the third quarter (0.8% q-o-q), non-construction investment fell (-0.8%). The recently observed decline in equipment investment was in line with the fall in profit margins over recent quarters, the downturn in manufacturing activity, and uncertainty affecting trade.

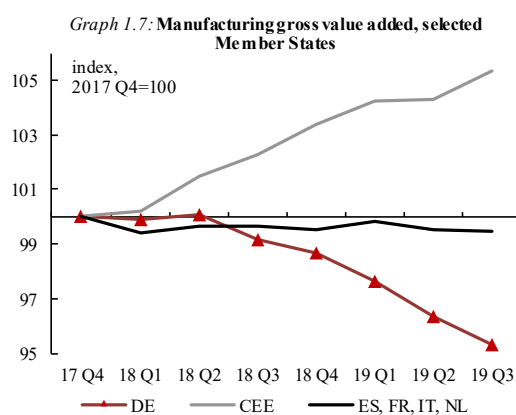
Exports of goods and services in the euro area (excluding Ireland) increased by 2.0% (y-o-y) in the first three quarters of 2019. The quarterly profile was strongly affected by trade with the UK, spurred by UK companies stockpiling in anticipation of the Brexit deadlines in March and October 2019. This pushed export growth to 0.9% (q-o-q) in the first quarter, followed by a payback in the second quarter (-0.3%) and a rebound in the third quarter (0.6%). By contrast, the growth path of imports for goods and services in the euro area (without Ireland) was steadier, with quarterly growth rates of between 0.4% and 0.6% (0.5% q-o-q in the third quarter). Accordingly, the growth contribution of net exports mainly reflected swings in export growth. The contribution of net exports fell from +0.2 pps. in the first quarter to -0.2 pps. in the second quarter before turning neutral in the third.

### ...while sectoral divergences were still in place.

The resilience of economic growth has been remarkable against the background of the global manufacturing downturn, triggered by factors including global trade tensions and the structural headwinds facing the automobile sector. The gross value added of the manufacturing sector in the euro area continued to decline in the third quarter, falling for a fifth consecutive quarter (-0.3% q-o-q, -1.1% y-o-y), whereas growth in other sectors held up (+0.3% q-o-q, +1.5% y-o-y) (see Graph 1.6).<sup>(6)</sup> One element behind the strength of the rest of the economy is the growth of gross value added in the construction industry (0.6% q-o-q, 3.2% y-o-y).



The further decline observed in manufacturing is mainly explained by developments in Germany, where the troubles in the car industry persist. Passenger car production in Germany fell further in the last quarter of 2019 and reached its lowest level since 1996 in the year as a whole. In the other large euro area countries, the manufacturing sector's gross value added was more stable and increased further in the group of Central and Eastern European Member States (see Graph 1.7).



Note: The group of Central and Eastern European economies includes BG, CZ, EE, LV, LT, HU, PL, RO and SI.

### Recent data show growth moving sideways at the end of the year...

In November 2019, the 0.2% increase in industrial production (m-o-m, excluding construction) was insufficient to offset the decline in October of -0.9% (revised from -0.5%). Industrial production has now been falling in year-on-year terms for 13 months. According to Commission surveys, confidence in the manufacturing industry ended 2019 below its long-term average but was fairly steady in the last two months of the year.

<sup>(6)</sup> For a more detailed analysis, see European Commission (DG ECFIN) (2019). 'Autumn 2019 forecast'. *Institutional Paper* 115, November; see also Forsells, M., Kennedy, N. and L. M. Timm (2019). 'Developments in the services 2 sector and its relationship with manufacturing'. *ECB Economic Bulletin* 7, pp. 25-28.

Other sectors of the economy have managed to remain largely insulated from the manufacturing sector's malaise.<sup>(7)</sup> The Commission's services confidence indicator rose strongly in December to its highest value since May. It is now back above its long-term average after a four-month reprieve. Retail trade volume moved up in November, more than offsetting the falls of the last two months and is on track to match its previous quarterly growth. The Commission's construction confidence indicator remained broadly stable in the fourth quarter after moderating in the previous one.

**...while leading indicators signal a small uptick in growth momentum.**

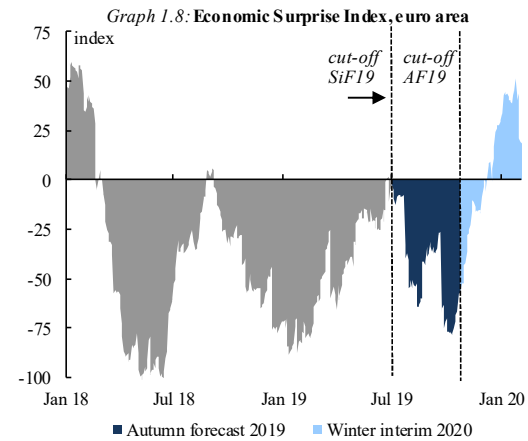
The near-term prospects for the euro area economy have not changed significantly since the autumn. The latest survey readings have been broadly consistent with growth remaining at low speed. Although some indications can be found that the downturn in manufacturing is bottoming out, an uplift has yet to emerge.

Forward-looking indicators confirm the expected slight pickup in growth following a stepdown in momentum in the last quarter. The Economic Sentiment Indicator (ESI) moved up to a five-month high of 102.8 in January, driven by a marked increase in confidence in industry and construction, while confidence in the service sector remained virtually unchanged. Also, Markit's Purchasing Managers Flash Composite Output Index (PMI) remained at 50.9 in January 2020 after reaching a four-month high in December 2019.

In the manufacturing sector, the January 2020 PMI jumped to a nine-month high but remained consistent with a contraction in activity. The new orders component of the PMI continues moving ahead of current output and signals a stabilisation of output in the coming months. Importantly, the capacity utilisation rate in the German manufacturing sector ticked up slightly in 2020-Q1 (Commission survey conducted in January) after declining continuously for almost two years. It moved in tandem with a strong recovery in production expectations in the manufacturing

<sup>(7)</sup> According to a recent study, there have been negative spillovers from both global factors and from manufacturing to services, but they have been overall limited and more significant for the former rather than the latter. See ECB (2019). 'Cross-country and cross-sector spillovers in the euro area'. *Eurosystem staff macroeconomic projections*, Box 3, December.

sector. In addition, Citigroup's Economic Surprise Index has increased significantly since early November, showing data outturns that are above the consensus forecasts of market economists. The index is currently at its highest level since early 2018 (see Graph 1.8).



Source: Citigroup

**Domestic demand is set to keep growth close to its moderate potential...**

These signals suggest that the euro area economy continues to hold up. Domestic growth drivers are set to remain the backbone of economic growth over the forecast horizon. Nonetheless, the euro area remains on a path of modest growth, as structural factors continue to weigh on potential.

On the demand side, the contribution of private consumption is expected to sustain the current growth momentum. The impact of destocking on growth, which was prominent throughout 2019, should fade as the inventory cycle adjustment is slowly exhausted. However, trade policy uncertainty is set to remain high and, together with the weakness of international trade, is expected to dampen equipment investment and exports.

The relatively bright outlook for *private consumption* gets support from the labour market, wage settlements and consumer sentiment. Despite more subdued growth and increased uncertainty, consumer confidence in the euro area has remained well above its long-term average. Additionally, while the employment outlook is less bright compared to previous years, the continued creation of additional jobs (in net terms) and further wage increases should benefit real disposable incomes, albeit to a lesser degree. Also, a more expansionary fiscal policy stance in some Member States should boost disposable incomes, for

example in Germany, where a part of income taxation (the ‘solidarity surcharge’) is planned to be abolished in 2021 for the majority of taxpayers.

*Investment* is expected to continue growing but at a very moderate pace. *Equipment investment* is set to remain weak, in line with subdued demand expectations both at home and abroad. It may also be dampened by the decline in capacity utilisation in manufacturing throughout 2019, which reduced the stringency of supply constraints to some degree. Whether low financing costs can still spur investment after having been in place for several years, is far from certain. Other factors such as uncertainty about trade tensions and regulatory frameworks and changes to cross-border supply chains may have gained importance.

*Housing construction investment* is expected to remain dynamic, as past increases in disposable incomes and favourable financing conditions have positively affected the affordability of house construction (and purchases). This outlook finds support in well-filled order books. However, in several countries, construction investment is likely to run into capacity constraints and to be impacted by the continued rally in house prices. These come on top of regulatory measures and demographic factors that could dampen demand.

*Public investment* is expected to increase significantly in a number of countries, involving transport and digital infrastructure investment. A number of investment support schemes (e.g. the European Fund for Strategic Investments, and InvestEU) exert a positive impact on investment decisions. By contrast, the impact of measures considered or announced in the context of the Green Deal is expected to be limited over the next two years, because planning phases, funding, and implementation will take time. <sup>(8)</sup>

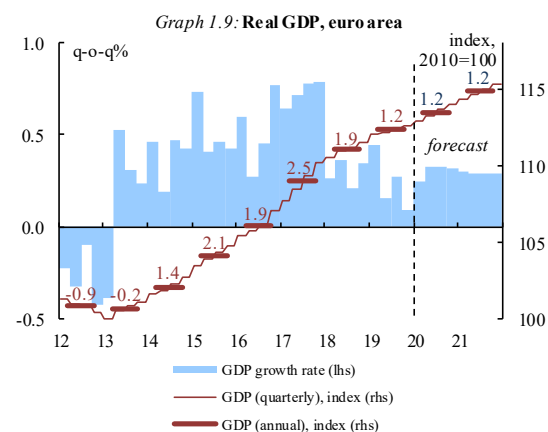
Relatively weak foreign demand combined with elevated economic policy uncertainty do not bode well for the trade outlook in the EU. Accordingly, *exports of goods and services* are not expected to bounce back and should remain subdued. This is also supported by the assessment of export order books in the Commission’s manufacturing survey, which has plateaued in recent months after a prolonged cooling down period. Moreover, export

expectations among manufacturers ticked up in the first quarter of this year after falling for seven consecutive quarters. Assuming no further escalation in trade tensions and that global demand will gradually become more supportive, euro area export growth is expected to pick up somewhat in 2020.

At the same time, more long term, structural factors are expected to continue weighing on growth, such as population ageing, shifts in regulations, supply chains and technologies in the automotive industry, as well as the trend decline in productivity.

### ...with the economy locked in a subdued growth path.

All in all, euro area GDP is forecast to grow by 1.2% in both 2020 and 2021 (see Graph 1.9). This stability, however, masks an important contribution from calendar effects in 2020, which is a leap year with a particularly large number of working days in several Member States. The GDP growth forecast for 2020 and 2021 is unchanged from the autumn 2019 forecast.



Note: Figures next to horizontal bars are annual growth rates.

Projections for 2021 are based on a purely technical assumption of status quo in terms of trading relations between the EU and the UK. This is for forecasting purposes only and reflects no anticipation or prediction of the outcome of the negotiations between the EU and the UK on their future relationship.

<sup>(8)</sup> For an analysis of the impact of measures against climate change on economic growth and inflation, see e.g. Deutsche Bundesbank (2019). ‘The impact of the Climate Package on economic growth and inflation’. *Monthly Report* 71:12, pp. 19-22.



#### 1.4. JOB CREATION TO CONTINUE BUT AT SLOWER PACE

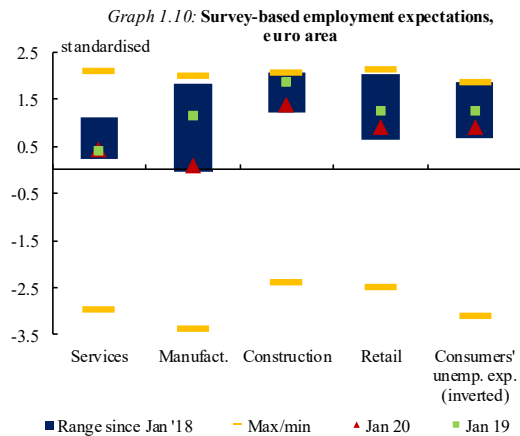
In 2019, the euro area labour market proved to be fairly resilient given the background of relatively moderate economic growth. The unemployment rate has stayed close to or at 7.4% in recent months, which is the lowest rate recorded since May 2008. In December 2019, the number of unemployed persons was 4.6% lower than one year before and 36.8% below the April 2013 peak.

Employment continued growing in 2019, albeit at a slower pace than in previous years. In the third quarter, total employment in the euro area was just 0.1% higher than in the second quarter, both in terms of hours worked and in terms of the number of persons. Also, the level of employment in the euro area in terms of persons was 1.0% higher than one year before and 3.9% above the pre-crisis peak recorded in the first quarter of 2008. <sup>(9)</sup>

The labour-market effects of the economic slowdown remain limited. The decline in manufacturing activity, however, is evident in the slower pace of employment growth in this sector compared to the rest of the economy. Moreover, there has been a decline in the share of manufacturing companies considering labour as a limiting factor in their production. Still, in the face of remaining labour shortages in several Member States, companies appear to have largely refrained from lowering headcounts in response to shrinking manufacturing output.

Forward-looking indicators suggest that the labour market should continue to show improvements. In January 2020, employment plans based on Commission surveys remained above their long-term averages in the euro area across all sectors covered. Furthermore, employment expectations in manufacturing improved and continued to hint at a stabilisation in both the services and the construction sectors. This was also reflected in a fall in consumers' unemployment expectations (see Graph 1.10).

<sup>(9)</sup> The detailed comparison of the labour market situation in 2008 and 2019 found that some labour market indicators are close to their pre-crisis levels, but that the underlying labour market structure has changed; see e.g. V. Botelho and A. Dias da Silva (2019). 'Indicators of labour market conditions in the euro area'. *ECB Economic Bulletin* 8, pp. 52-55.



Beyond the near term, employment growth is set to continue but at a lower pace. This is due to the aforementioned labour supply constraints and the expected moderation of labour demand, which is set to be more closely aligned with economic growth than in recent quarters. Accordingly, the unemployment rate is expected to barely budge over the forecast horizon.

#### 1.5. AN UPTICK IN INFLATION SUPPORTED BY HIGHER SERVICES PRICES

##### Headline inflation picked up...

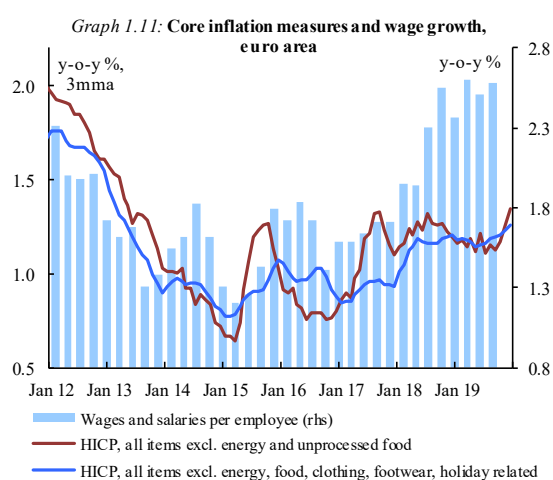
Headline inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), stood at 1.0% in the fourth quarter of 2019, in line with the autumn forecast and unchanged compared to the previous quarter. In December (at 1.3%) and January (1.4%), inflation ticked just above the 2019 yearly average, reflecting stronger developments in unprocessed food inflation as well as the phase-out of significant negative base effects in energy inflation.

Euro area core inflation (all items excluding energy and unprocessed food) crawled up to 1.3% in the fourth quarter, up from 1.1% in the third quarter, and to a level consistent with a slight firming over the past year. Core inflation was also at 1.3% in January 2020.

##### ...as services prices edged up.

The pick-up in core inflation since autumn, and of services inflation in particular, provide some signs that domestic inflationary pressures are building up slowly. Services inflation rose from 1.3% in the third quarter of 2019 to 1.7% in the fourth quarter, but this was in part due to the package holidays

and accommodation component, which recently underwent some methodological changes and now exhibits higher volatility. In fact, in January, services inflation moderated to 1.5% from 1.8% in December. Nevertheless, excluding some other volatile items from the core measure, such as clothing, footwear and holiday-related items, one can see a discernible increase in underlying price pressures over the past year (see Graph 1.11). In particular, the component of services inflation related to housing has moved up, which may signal that higher house prices are feeding through to consumer prices with a delay.



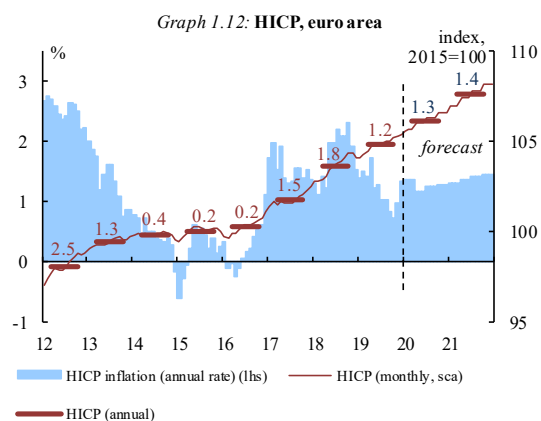
### Recent food and services prices support a small upward revision in inflation...

Inflation is being revised up marginally for both 2020 and 2021. This mainly reflects the impact of upside surprises in services and food inflation towards the end of 2019, but also slightly higher technical assumptions about oil prices. The quarterly profile in 2020 is expected to reflect some energy base effects, with a drop in the second quarter. In contrast, the quarterly profile is set to be broadly flat in 2021 as there is only tentative evidence of a stronger pass-through from higher wages to underlying price pressures. Overall, euro area headline inflation is forecast to average 1.3% in 2020, before increasing marginally to 1.4% in 2021 (see Graph 1.12).

### ...while inflation expectations are showing signs of stabilising.

Market-based measures of inflation expectations along the maturity spectrum have recovered from the low levels recorded around the time of the autumn forecast after which concerns about a spike in energy prices following US-Iran tensions and

higher inflation readings fuelled expectations. At the cut-off date of this forecast, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at 1.0%. Swap rates at the three-year forward three-years-ahead horizon imply an average inflation of 1.1%. On a longer horizon, the widely watched five-year forward five-years-ahead indicator suggests inflation of 1.3%, below the ECB's definition of medium-term price stability.



Note: Figures next to horizontal bars are annual inflation rates.

The latest ECB Survey of Professional Forecasters for the first quarter of 2020 shows HICP inflation expectations standing at 1.2%, 1.4% and 1.5% in 2020, 2021 and 2022, respectively. The figures for 2020 and 2021 remain unchanged from the previous survey round (2022 was not surveyed). Longer-term inflation expectations (for 2024) remained at 1.7%.

### 1.6. OUTLOOK STILL CLOUDED BY RISKS DESPITE SOME RAYS OF LIGHT

As in the autumn, the European economy is still faced with a high degree of uncertainty, particularly with respect to trade policies and the external environment. Though a variety of events has twisted the composition of risks to the growth outlook, the overall balance of risks remains tilted to the downside.

#### Some developments have reduced downside tail risks...

While there is now clarity about trading relations between the EU and the UK until 31 December 2020, there is still considerable uncertainty about the long-term relationship and the possibility of an abrupt change in trading relations at the end of the year. Trade tensions between the US and China

have also subsided following the signing of the ‘Phase One’ trade deal, which removed some of the uncertainty facing firms’ investment and production decisions. Continued steps in this direction could be a game changer for the global economy and could significantly reduce uncertainty.

**...but some new downside risks have emerged...**

The outbreak and spread of the ‘2019-nCoV’ coronavirus and its impact on public health, human lives and economic activity has been a source of mounting concern. Questions about the duration and severity of the outbreak raises uncertainty over short-term economic prospects in China and abroad. The baseline assumption is that the outbreak peaks in the first quarter, with relatively limited global spillovers and with a recovery in the following quarters. As such, the duration of the outbreak, and of the containment measures enacted, are a key downside risk. The economic impact on other countries could also be larger and more lasting if infections spread more globally, or if there were spillovers related to global value chain disruptions which are difficult to anticipate. The longer it lasts, the higher the likelihood that the outbreak sparks knock-on effects on economic sentiment and global financing conditions more generally, which add to direct supply-side (e.g. number of work days lost) and demand disruptions (e.g. travel bans, mobility restrictions, shop closures).

The uncertainty sparked by the surge in geopolitical tensions in the Middle East and the risk of an escalating conflict could be more relevant than the observed swings in oil prices. Any further intensification of tensions in this region risks raising oil prices, negatively affecting oil-importing countries and endangering the global recovery. Political and social turmoil in Latin America has also resurfaced, particularly in Chile, Bolivia, Argentina and Venezuela which risks postponing the expected recovery in this region.

Closer to home, Turkey’s gas explorations in the waters off Cyprus have fuelled tensions with the EU, which are yet to be resolved.

**...and substantial risks remain unchanged.**

Both economic and trade-policy uncertainty remain at high levels. Uncertainty around US trade

and economic policies remains high amid the risk that new trade barriers could be enacted on a wider range of items. Any renewed economic confrontation could lead to a reversal of risk sentiment and tighter financing conditions. Abrupt financial market adjustments, triggered by changes in expectations, or a sudden reassessment of risks, can impact investor risk aversion, financial conditions and capital flows. This could endanger financial stability, especially in emerging markets but also in countries such as the US, where corporate debt is at a record high.<sup>(10)</sup> Such a development would weigh on the fragile recovery in global business confidence and create further obstacles to growth.

Medium-term downside risks also remain elevated. The current policy stimulus measures in China could increase leverage further, exacerbating the risk of a sharper economic adjustment in the future. Additionally, its impact could turn out to be less effective than assumed, which would result in a sharper slowdown. In the US, a prolonged period of accommodative monetary policy when the economy is at full employment risks exacerbating financial imbalances and vulnerabilities, which together with reduced fiscal policy space, could lead to a deeper or more prolonged downturn once the cycle turns.

On the positive side, the European economy could benefit from more expansionary and growth-friendly fiscal policies both in emerging markets and domestically. Positive spillovers from more benign financing conditions in some euro area economies may also still be on the cards.

Climate change-related risks are expected to matter most beyond the forecast horizon, but this does not rule out the occurrence of events that negatively affect production, prices and economic growth in the near future. The devastating bushfires in Australia are a strong reminder of such risks.

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<sup>(10)</sup> See T. Adrian and F. Natalucci (2020). ‘A call for vigilance after a strong year for risky assets’. *IMF Blog*, January.