PART I

EA and EU outlook
LESS DYNAMIC GROWTH AMID HIGH UNCERTAINTY

Interrelated external and domestic risks are clouding the outlook

The EU economy is entering a period of less dynamic expansion after five years of continuing growth. A high degree of uncertainty and interrelated external and domestic risks are clouding the economic outlook. After shifting down a gear from 2017’s record levels in the first quarter in 2018, economic growth held steady in the second quarter. This reflects the lower, but by historical standards, still high readings of survey indicators and the favourable labour market situation, which has allowed the euro area unemployment rate to fall to levels last seen about a decade ago. While wages have picked up somewhat in the first half of the year, headline inflation in the euro area remains mainly driven by developments in energy prices.

With global growth set to slow and become less synchronous, economic activity in Europe will come to depend almost entirely on the fundamentals behind private consumption and investment: continued employment growth; favourable financing conditions; rising profitability; and the steady outlook for domestic demand. In the near term, economic growth is expected to continue at about the same pace as in the first half of the year, resulting in euro area growth of 2.1% in 2018. The waning momentum of foreign trade due to weakening global economic activity and growing trade tensions, slower employment growth and increased uncertainty impacting on investment, are factors behind less dynamic growth forecast in the coming two years. Increasingly binding supply constraints and diminishing tailwinds from favourable financing conditions are further factors that suggest less dynamic growth in 2019 and in 2020, when euro area GDP is forecast to expand by 1.9% and 1.7%, respectively. With oil prices falling slightly towards the end of the forecast horizon, domestic price pressures should gradually take over as main determinants of headline inflation. Economic growth is set to remain sufficient to gradually diminish remaining pockets of slack in the labour market and slowly push up core inflation via a pick-up in wage growth. Overall, HICP inflation in the euro area is projected to rise from 1.5% in 2017 to 1.8% in 2018 and in 2019 before moderating to 1.6% in 2020.

The balance of risks to the growth outlook is tilted to the downside. Interrelated external and domestic risks are clouding a rather benign economic outlook. Such risks are more likely to materialise in full force in 2020. An overheating in the US fuelled by a pro-cyclical fiscal stance could result in a faster-than-assumed monetary tightening by the Fed, which could alter the risk attitude of investors with detrimental effects to the US economy given the high level of corporate leverage, and to emerging market economies, resulting in negative spillovers to advanced economies. The deterioration of the current account in an overheating US economy could also lead to a further escalation of trade disputes. This could particularly hit China with its relative high and rising corporate debt that is increasing financial fragilities. Attempts to shore up growth via domestic policies could raise debt and further heighten the risk of a disorderly adjustment. Such shocks would negatively impact global trade and activity, and disrupt cross-border supply chains. As a relatively open economy with strong trade links and banks exposed to emerging markets, the EU would suffer. Disruptive sovereign-bank loops could also re-emerge in some high-debt euro area countries, which in an environment of risk re-pricing and increasing financing costs, could raise financial stability concerns.

Graph I.1: Real GDP, euro area

Figures next to horizontal bars are annual growth rates.

Graph I.2: HICP, euro area

Figures next to horizontal bars are annual inflation rates.
1. PUTTING THE FORECAST INTO PERSPECTIVE: TRADE

The euro area’s substantial openness to trade allowed net exports to act as a cyclical buffer during the crisis. Similarly, the euro area economy has benefitted from the recent acceleration in global activity and trade. With global growth now expected to slow and trade tensions on the rise, however, euro area growth is likely to feel a chill.

This introductory section examines the euro area’s trade linkages with the rest of the world and their bearing on the business cycle. It argues that the integration in global value chains has increased the exposure to partners outside the EU beyond what gross export and import trade figures suggest. Model simulations highlight the transmission of global developments to domestic demand. Finally, the impact of the trade restricting measures so far adopted between the US and China is analysed and compared to the impact of a generalised increase in protectionism.

The golden era of global trade...

Over the past few decades trade has become increasingly important for the global economy. This has been facilitated by a conducive trade and investment policy environment, the integration of China into the world economy and several waves of EU enlargement. Broad-based liberalisation coupled with technological advances that pushed down transport and communication costs, fuelled relocation of manufacturing and led to the proliferation of regional and global value chains. Consequently, global trade grew steadily and increased its share of global GDP threefold from around 10% in the early 1960s to over 30% in the run-up to the economic and financial crisis of 2008 (see Graph I.3).

…supported by a marked rise in EU openness.

EU Member States played an active part in this process, benefitting from the creation and subsequent enlargements of the EU single market, the introduction of the euro, and opportunities created by the expansion of the manufacturing base in China and other emerging markets. This has driven the share of exports in euro area GDP up from below 20% in early 1960s and 25% in the early 1990s to over 45% in 2017, with roughly two-thirds representing intra-EU trade. This is more than double the analogous figure for China and roughly four times higher than the corresponding share for the US (Graph I.3). While caution is needed when making such direct comparisons due to the weight of intra-EU trade in the euro area aggregate, an outsize share of exports in its GDP is a testimony to the importance of trade for euro area economies.

Importance of trade for the euro area economy

Given its high openness to trade, it is unsurprising that trade developments have a substantial bearing on the euro-area business cycle as well as its trend GDP growth. The direct contribution from net exports for instance was instrumental to euro area growth during the early 2000s, as global demand provided a much-needed cushion to the collapse in domestic demand, and subsequently during the euro area sovereign debt crisis in 2011-2013. More recently, net exports staged a strong cyclical revival in 2017 when an investment-driven rebound in world trade benefitted EU exporters and contributed three-quarters of a percentage point to euro area GDP growth (see Graph I.4).
However, the importance of trade for the euro area, (and for any other economy) goes far beyond the direct contribution of net exports. Export demand boosts investment, which in turn stimulates imports. (1) thus setting in motion a positive and self-reinforcing virtuous circle of investment, consumption and trade. This benefit comes on top of medium-to-long term gains linked to a well-established role of trade in spreading innovation, boosting productivity and, ultimately, upgrading economies’ long-term growth potential. (2) In fact, a recent IMF cross-country analysis shows that a one percentage point increase in trade openness tends to raise real per capita income on average by 3% to 5% in the long run (even if this effect may have been weakened by the financial crisis). (3) At the same time, the distributional impact of trade openness very much depends on accompanying measures, including tax policy, education and welfare systems.

Model analysis confirms that external demand constitutes an important cyclical source of growth and was a key factor behind the good performance of the euro area economy in 2016 and 2017. With world growth set to slow, this positive contribution is now expected to turn negative. Simulations (4) show that a one-percentage-point drop in world demand dampens euro area GDP growth by roughly half a percentage point. The effect on investment growth is even stronger, with the analogous shock to world demand slowing investment growth by around ¾ of a percentage point. (5)

High integration in global value chains fostered productivity but also increased Europe’s vulnerability to external shocks

Gross data on imports and exports, however, do not provide the full picture of trade integration and the geographical distribution of added value. The expansion of global value chains (GVC) in the two decades preceding the economic and financial crisis meant that increasingly, intermediate goods crossed multiple borders before being consumed or exported as a final good, boosting gross trade flows amid a steady increase in the share of intermediate goods in total trade.

European countries have been very active in the process of international fragmentation of production since the 1990s and Europe is now among the regions most integrated in manufacturing value chains, with much of this coming from close intra-EU links. Based on some standard metrics, such as import content of exports or the share of re-exported intermediate goods in imports, the importance of value chains for the euro area economy has grown steadily in the last two decades and is now well above Japan’s or the United States’ and roughly comparable with that of China (Graphs I.5 and I.6).

While a very high degree of participation in global value chains has enabled euro area companies to exploit comparative advantages down the production chain, boosting productivity and profits, it has also increased the exposure of producers and exporters to developments in other countries and regions. It made them more vulnerable to e.g. third-country supply

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(2) See e.g. OECD (2018). ‘Productivity and Jobs in a Globalised World’.


(5) Results are nevertheless sensitive to the nature of the shock hitting the economy as well as its position in the cycle.
disruptions (6), but also to changes in prices, exchange rates, tariffs and non-tariff barriers. Consequently, the current escalation of trade tensions, so far largely contained to the US and China, may impact the euro area economy considerably more than a simple analysis of euro area trade links with these two countries would suggest. Moreover, investigating the structure of euro area exports based on value-added rather than on gross flows reveals a higher relative importance of non-EU economies, such as China and the US. This is so because tight supply chain integration within the EU single market ‘nets out’ many EU/euro area gross trade flows, leaving countries outside the single market with a higher share of EU/euro area value added exports. Notably, the EU accounted for nearly two-thirds of all the euro area’s gross exports in 2014, but only roughly one-half of exported value added. This aspect of a high participation in GVCs further increases the exposure of the EU economy to developments in third countries, including those currently affected by rising trade tensions.

**The trend of trade liberalisation has come to a halt**

Intense trade liberalisation in the early 1990s, culminating in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), the creation of the World Trade Organisation (WTO) in 1995, and China’s accession to the organisation in 2001, created a supportive environment in which trade thrived amid ever-decreasing tariff and non-tariff barriers. Import tariffs applied by advanced economies were falling continuously since the early 1990s until the early 2010s, with the average tariff lowered from around 5% in the early 1990s to around 2.5% in 2013. Reductions in emerging markets were considerably sharper with the average applied tariff reduced from nearly 40% to around 8% over the same period. (7)

Average tariffs remained largely stable after the economic and financial crisis but have started to edge up in advanced economies in recent years. Given the deadlock at the WTO following the collapse of the Doha Development Round, trade liberalisation efforts moved towards bilateral or regional trade deals in the 2010s. Over the past couple of years, however, the apparent shift in sentiment against trade liberalisation and the rise in anti-globalisation rhetoric have slowed trade reforms and led to a sustained rise in non-tariff barriers which increased six-fold between 2010 and 2016. (8) Recent WTO reports on G20 trade measures (9), as well as Global Trade Alert (10) confirm this trend, revealing a rising trend in implementing trade-restricting measures by G20 countries and discriminatory state interventions, respectively.

**Recent shifts in US trade policy have started to affect the outlook**...

In this context, the recent shifts in US trade policy add greatly to concerns over the future of trade liberalisation. One of the first decisions of the current US Administration was to withdraw from the Trans-Pacific Partnership and trade talks with the EU (Transatlantic Trade and Investment Partnership), as well as force a renegotiation of the North American Free Trade Agreement under the threat of withdrawal from the agreement. Trade tensions escalated to new level in late 2017 and early 2018. As of late October, the US imposed tariffs on goods worth USD 306 bn or 13% of its imports, and put an additional USD 268 bn under review (see table I.1).

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(6) As exposed by supply problems following a series of natural disasters in 2011: tsunami in Japan and floods in Thailand.


(9) [https://www.oecd.org/g20/topics/trade-and-investment/g20.htm](https://www.oecd.org/g20/topics/trade-and-investment/g20.htm)

(10) [https://www.globaltradealert.org/](https://www.globaltradealert.org/)
Table I.1: Timeline of the recent escalation in trade tensions

<table>
<thead>
<tr>
<th>Date in effect</th>
<th>Average tariff rates (%)</th>
<th>Value (USD bn) in 2017</th>
<th>Goods targeted</th>
<th>Country affected</th>
<th>% of US imports**</th>
<th>% of world trade***</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 3, 2017</td>
<td>5.0</td>
<td>10.8</td>
<td>Solar panels, lumber</td>
<td>Canada</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>February 7, 2018</td>
<td>1.8</td>
<td>0.4</td>
<td>Washing machines</td>
<td>Multiple</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>February 7</td>
<td>8.5</td>
<td>0.4</td>
<td>Solar panels</td>
<td>Multiple</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>March 23/ June 1</td>
<td>23.4</td>
<td>1.0</td>
<td>Steel</td>
<td>Multiple</td>
<td>1.0</td>
<td>0.1</td>
</tr>
<tr>
<td>March 23/ June 1</td>
<td>16.4</td>
<td>0.7</td>
<td>Aluminium</td>
<td>Multiple</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>July 6/ August 23</td>
<td>15</td>
<td>2.1</td>
<td>Variety (focus: tech, auto, manufact.)</td>
<td>China</td>
<td>2.1</td>
<td>0.3</td>
</tr>
<tr>
<td>September 24</td>
<td>10/25</td>
<td>8.5</td>
<td>Variety</td>
<td>China</td>
<td>8.5</td>
<td>1.2</td>
</tr>
<tr>
<td>Enacted by 22 October (cut-off date)</td>
<td>10/25</td>
<td>13.0</td>
<td>Variety</td>
<td>Multiple</td>
<td>13.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Under review</td>
<td>25</td>
<td>11.4</td>
<td>Autos and parts</td>
<td>Multiple</td>
<td>11.4</td>
<td>1.6</td>
</tr>
<tr>
<td>Enacted, announced and under review</td>
<td>575</td>
<td>24.4</td>
<td>-</td>
<td>-</td>
<td>24.4</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Notes:
1. As of January 1, 2019. The tariff rate increases to 25%.
2. Based on annual 2017 values from the Census Bureau (US) and CPB (world).

Confidence and productivity shocks were considered to supplement the simulation with more realistic and complex channels of indirect impact. They were chosen to mirror the increase in uncertainty and risk associated with the tariff hikes and current trade tensions that weigh on investment and consumption decisions, and eventually also on total factor productivity, leaving permanent scars on potential growth.

Simulations show that the already implemented tariffs have the potential to weigh on EU GDP in the short term, with a negative impact of around 0.2 pps. in the first year (12), when confidence and productivity shocks are taken into account. The effect turns largely neutral in the long run, as Europe benefits from trade diversion away from the US and China; while lower prices, thanks to a stronger euro, generate a positive supply shock. On the other hand, the US and China, mired in a trade conflict, unsurprisingly lose market shares and experience a much more severe hit to their exports.

(12) Largely due to the appreciation of the EUR (as US and CN currencies weaken reflecting falling demand for their exports).

...through their impact on output and confidence.

The macroeconomic impact of these measures remains difficult to establish at this point. While the goods affected so far represent around 2.5% of world merchandise trade, the magnitude of the impact and the list of countries affected may be considerably larger once complex manufacturing value chains are taken into account. Furthermore, risks associated with a further escalation of trade tensions are high, and relate closely to broader concerns about the future of the multilateral and rules-based trading system. If these were to materialise, they would have the potential to sharply and more permanently increase uncertainty, weigh on confidence, investment, trade and growth.

The European Commission’s QUEST model has been used to assess the economic impact of two scenarios. Scenario 1 takes into account all imposed (and announced) tariffs enacted by 22 October, the cut-off date (see Table I.1). Scenario 2 represents a hypothetical escalation in trade tensions exemplified by a global multilateral 2pps. increase in tariffs by all countries (13). For each scenario, simulations are made assuming (i) a direct effect via the traditional channel of impact (negative supply shock), (ii) impact via a confidence channel (30 bp. increase in risk premia), and (iii) impact via a confidence and productivity channel, with the latter shock proportional to the reduction in trade volumes.
The corresponding impact on GDP is roughly -0.3 pps. and -0.6 pps., respectively, after three years, but increases to -0.5 pps. and -0.8 pps. in the long run (see Graph I.7).

Scenario 2 of a generalised multilateral 2 pps. increase in tariffs shows more symmetric effects across countries, and therefore, a much higher impact on Europe. EU GDP falls by -0.1 pps. to -0.2 pps. on impact, with the loss increasing to roughly -0.5 pps. in the long run when all impact channels are considered. The impact on the US and rest of the world (RoW) economy is comparable, while that on China is roughly double in size compared to other regions, reaching 0.6 pps. in the long run. Confidence and productivity effects are quite significant in all cases (see Graph I.7).

All in all, as the escalation of trade tensions so far remains largely contained to China and the US, it is these countries that are expected to experience the most negative impact on their economies (scenario 1). However, should the tensions rise further and spill over to other countries and regions, affecting global trade flows more broadly, the effect would be much more severe, entailing a marked hit to global growth (scenario 2). These findings are broadly in line with estimates by other international institutions. For the October’s World Economic Outlook, the IMF ran an equivalent scenario to QUEST scenario 1 described above and came to the conclusion that “the impact of the tariffs that have been imposed to date is small, but material, with the United States and China bearing the brunt of the costs.”

The risk of reverting to protectionism has also been emphasised by the World Bank. In its 2017 report, the authors show that “a worldwide increase in tariffs up to legally allowed bound rates coupled with an increase in the cost of traded services would translate into annual global real income losses of 0.8 pps. relative to the baseline after three years”. A full-blown trade conflict would likely lead to raising tariffs beyond the legally allowed bound rates, resulting in an even larger welfare loss.

While model simulations such as described above capture the various channels through which tariff hikes may affect the real economy (including confidence and productivity), the resulting estimates should be treated as the lower bound of the possible impact. This is so because the channels considered may in fact turn out much stronger, while other, unknown and unpredictable negative feedback loops may emerge. This is very likely given the sharp increase in the importance of trade for the world economy in recent decades.

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(13) Even if the USD depreciation reflecting falling demand for US exports, provides a temporary boost to the US economy in the short term.

(14) The IMF warns, however that, if tariffs are imposed on additional products and the tit-for-tat continues, leading firms to curtail investment and provoking global financial tightening, the output losses could be much deeper and more universally spread.

(15) The risk of reverting to protectionism has also been emphasised by the World Bank. In its 2017 report, the authors show that “a worldwide increase in tariffs up to legally allowed bound rates coupled with an increase in the cost of traded services would translate into annual global real income losses of 0.8 pps. relative to the baseline after three years”.

(17) A full-blown trade conflict would likely lead to raising tariffs beyond the legally allowed bound rates, resulting in an even larger welfare loss.
coupled with an unprecedented rise in interconnectedness and integration of manufacturing value chains that may amplify some of the effects to an extent that is not yet clear at present.

A hit to trade and growth is also likely to provoke various policy responses to counter the slowdown, including in China where additional stimulus could aggravate imbalances and financial instability concerns. This would in turn further exacerbate the balance of risks to the short to medium-term outlook (see section I.10).

2. EXTERNAL ENVIRONMENT

The outlook for global economic growth remains robust in the near term but more uneven and much less synchronised. Short-term economic activity in advanced economies is benefitting from strong growth in the US, which is expected to exceed potential this year and next. The growth outlook for emerging markets is weaker than in the spring with significant divergence across countries and regions. The outlook for emerging Asia is still solid even though growth prospects in China have slightly deteriorated due to recent US tariff measures. Rising oil prices, as well as tighter financing conditions, cast a shadow on the outlook for oil importers. Growth prospects have deteriorated sharply in several other emerging markets, most notably in Argentina and Turkey, as financing conditions have tightened and geopolitical tensions have risen.

Amid high uncertainty, risks to the global growth outlook are skewed to the downside and are closely interconnected. In the US, the highly procyclical fiscal loosening risks overheating the economy, which could trigger a faster-than-expected tightening of financing conditions in the US and globally, with negative repercussions for the world economy. Rising leverage in the US corporate sector and many emerging markets has increased their vulnerability to higher interest rates. Moreover, trade tensions have continued to increase and further escalation would have a material impact on growth and trade flows, not only in the US and China, but also globally. Rising trade protectionism also aggravates the long-standing risks of a disorderly adjustment in China.

Divergence in global growth becomes more accentuated

Global growth remained robust overall in the first half of 2018 but the performance of different regions and countries has become increasingly divergent. Moreover, some previously identified risks related to trade protectionism and financial vulnerabilities in emerging markets have started to materialise. Global growth picked up slightly to 1.0% (q-o-q) in the second quarter of 2018 on the back of stronger activity in the US, Japan and emerging Asia. At the same time, growth in several emerging markets outside Asia (e.g. Argentina, Mexico and South Africa) fell short of expectations.

Recent high frequency indicators signal a gradual softening of global output growth as well as further divergence across countries and regions. The Global Composite PMI eased again in the third quarter to a two-year low of 52.8 in September, on the back of a moderate deceleration in both advanced and emerging economies (see Graph I.3). While global manufacturing PMIs have been losing momentum since the beginning of this year, reflecting broad-based softening in global output and new export orders, service sector PMIs have shown greater resilience and only began to decelerate in the third quarter. Composite PMIs in both advanced and emerging economies are now around the levels seen in late 2016 but continue to signal expansion.

Global growth (excluding the EU) is forecast to pick up slightly from 3.9% in 2017 to 4.0% in 2018 before settling down to 3.8% in both 2019 and 2020. This implies a downward revision since the spring forecast of 0.2 pps. in 2018 and 0.4 pps. in 2019, which is mainly explained by the sharp downward revision to the growth forecast in some
Emerging economies. Economic activity in advanced economies will benefit from strong growth momentum in the US in the near term and then moderate over the forecast horizon. Growth in emerging markets as a whole is expected to remain broadly stable over the forecast horizon but to show greater divergence across countries and regions. The recent tightening of financial conditions, currency turmoil, as well as geopolitical developments, have led to significant downward revisions in the growth outlook for a number of emerging markets (e.g. Argentina, Turkey, Iran and Venezuela). Growth prospects have also weakened in Brazil, South Africa and several other countries that struggle with sizeable macroeconomic imbalances coupled with domestic policy uncertainty. By contrast, the outlook has improved slightly in several oil-exporting countries where higher oil prices should boost exports and improve current account balances and fiscal positions. Recent tariff measures implemented and announced by the US are likely to have a noticeable negative impact on GDP growth in China, which will, however, partially be offset by a weaker Renminbi and domestic policy measures.

The central scenario is based on several important assumptions, including a ‘soft landing’ for the US economy. The pro-cyclical fiscal loosening in 2018-2019 is not expected to ignite the kind of price pressures that could lead to a faster pace of monetary policy tightening than assumed in the central scenario. As a result, monetary policy is expected to normalise gradually and slow growth to only slightly below potential. In 2020, a Congressional agreement to extend current expenditure levels in the US is assumed, implying a growth-neutral fiscal stance. Second, on the trade side no further escalation of trade protectionism beyond what has already been adopted (and announced) is factored in (see Section I.1). It is also assumed that any negative confidence and productivity effects from the current trade tensions will remain relatively limited. Finally, the central scenario assumes that the recent financial market turbulence in some emerging markets will not lead to broader contagion or a significant slowdown in emerging market growth overall. These benign assumptions imply that the global growth outlook is subject to significant downside risks (see the risk section below).

### Advanced economies: growth to continue beyond peak amid mounting risks

Economic activity in advanced economies has remained solid, with recent GDP data from the second quarter confirming robust growth in the US and Japan after a soft patch in the first quarter. Overall, economic growth in advanced economies excluding the EU is expected to remain stable at
2.6% in 2018, supported by strong labour markets, high consumer and business sentiment and an expansionary fiscal stance in the US, before decelerating in 2019 and further in 2020. The gradual growth moderation after 2018 reflects an outlook for a progressively maturing cycle across most advanced economies combined with withdrawal of monetary (US, Canada, and Australia) and fiscal (Canada, Australia, and Japan) policy support and continued uncertainties surrounding global trade relations.

GDP growth in the US is forecast to remain strong at 2.9% and 2.6% in 2018 and 2019, respectively, supported by strong consumer and business sentiment, a tightening labour market and fiscal stimulus. Corporate tax cuts are already providing a considerable tailwind to private investment and personal income tax cuts are boosting household consumption. (18)

The recent decision to raise tariffs on USD 200 bn worth of Chinese goods imports (adding to earlier trade policy measures) and retaliatory measures by China, are expected to have only a limited direct impact on consumer prices and real activity. Nonetheless, these additional tariffs will marginally weigh on the economy’s buoyant momentum (19) and slightly offset the benefits provided by tax cuts. This contributes to marginally weaker GDP growth (-0.1 pps.) in 2019 than predicted in the spring forecast. For 2020, growth is expected to moderate more noticeably to below 2%, slightly below potential growth estimates, as supply-side constraints limit the pace of economic growth and macroeconomic policy support fades.

Monetary policy in the US is assumed to continue tightening gradually, in line with the Federal Reserve’s forward guidance. This implies that the federal funds rate should reach a broadly neutral level over the course of 2019 before turning slightly contractionary thereafter. At the same time, a gradual increase in longer-term borrowing costs among corporates is assumed in a context of already high corporate leverage, which reached 74% of GDP in the first quarter of 2018 (from 66% in 2012). (20) On the fiscal side, the growth impulse provided by the stimulus package is expected to be largely exhausted by the end of 2019, with the fiscal stance assumed to turn broadly neutral thereafter.

In Japan, GDP growth should drop to a level of around 1% in 2018 and 2019 (down from 1.7% in 2017), driven by tighter labour market conditions and lower net exports, although monetary policy conditions are expected to remain accommodative. The growth profile, however, could turn more volatile in the second half of 2019, reflecting front-loaded expenditure ahead of a planned consumption tax hike. In 2020, the pace of growth is expected to slow to 0.5% on the back of retrenchment in private consumption following the planned future fiscal consolidation.

A differentiated growth outlook in emerging markets amid localised pressures

The acceleration of economic activity in emerging markets that has been going on since 2015 (see Graph I.9), continued over the first half of 2018 amid still benign financing conditions and rising oil prices. Since then however, it has become more differentiated across countries, as the impact of higher interest rates, a stronger US dollar and increasing trade tensions have started to hit some countries more than others. On aggregate, growth in emerging economies is forecast to inch up to 4.7% in 2018 and to remain stable over the rest of the forecast horizon. This implies a downward revision of 0.3 pps. in both 2018 and 2019 compared to the spring forecast. Economic activity is expected to be driven by growth in advanced economies, which remains robust, and firming commodity prices, which should benefit commodity exporters. Recent financial market turmoil in Argentina and Turkey, as well as renewed US sanctions against Iran will, however, weigh heavily on the regional outlook of these economies. On the policy front, fiscal space to support demand is limited amid existing vulnerabilities, while several emerging markets

(18) In the US, the 2017 tax act permanently lowered the top corporate income tax rate (to 21%), changed the way that companies’ foreign income is taxed, lowered individual income tax rates, and broadened the base of income subject to tax through 2025. The Bipartisan Budget Act of 2018 increased the caps on discretionary funding for 2018 and 2019 and provided substantial funding for emergency assistance. The Consolidated Appropriations Act, 2018 provided appropriations for all discretionary accounts for 2018.

(19) In the US, already in mid-July 2018 a survey conducted by the Federal Reserve Bank of Atlanta found that announced tariffs or retaliation has caused one-fifth of firms to reassess their capital expenditure plans. See D. Altig, N. Bloom, S.J. Davis, B. Meyer, and N. Parker (2018). ‘Are tariff worries cutting into business investment’. Macroblogin (Federal Reserve Bank of Atlanta), August 7.

(20) Bank for International Settlements data on credit to non-financial corporations from all sectors.
have begun to raise interest rates to support their currencies and put a lid on inflationary pressures.

Financial conditions in emerging markets tightened materially between February and October 2018. This tightening, which was triggered by a reappraisal of US growth and inflation prospects, has been driven by higher global long-term interest rates and a decline in emerging market equity prices. Long-term yields have also risen and sovereign spreads have widened, reflecting lower capital flows to emerging market economies (see Graph I.10), though markets appear so far to differentiate between countries, as spreads have widened more for those with greater external financing needs. Nevertheless, tighter global financial conditions, reflecting factors such as the ongoing normalisation of monetary policy in the US, are likely to limit growth prospects in emerging markets as a whole going forward.

Regional divergences in the growth outlook are increasing. In Latin America, the Middle East, Turkey and South Africa, growth is expected to be weaker than forecast in the spring, as financing conditions have tightened and geopolitical tensions have risen. Argentina and Turkey experienced severe currency turmoil over the summer and are expected to slip into recession, recovering slowly in 2020. Growth in other Latin American countries is forecast to pick up over the forecast horizon from the protracted slowdown in recent years, even though political uncertainty and more restricted access to foreign financing will dampen the recovery.

In India, growth has shaken off temporary disruptions from demonetisation and the sales tax reform and should remain buoyant, though the economy remains vulnerable to higher oil prices and tighter global financial conditions. Economic activity in Russia is set to moderate over the forecast horizon as the effects of higher oil prices cannot fully counterbalance the impact of long-term growth bottlenecks and increased uncertainty related to the recent wave of US sanctions.

Accordingly, emerging market currencies came under pressure across the board, and particularly in Turkey and Argentina (see Graph I.11). As a result, higher bank funding costs and more restrictive bank lending standards are likely to weigh on the outlook of emerging markets, though to varying degrees.
Global trade still robust overall in 2018 but poised to slow down amid trade tensions

Following a strong rebound in 2017, world trade growth started to lose momentum in the first half of 2018. Trade still received support from the steady growth of global demand and in particular from solid manufacturing production and investment at the beginning of 2018 but began to decelerate thereafter. The abrupt turnaround was felt across most regions of the world with, the US, China and Japan, in particular all recording a considerable slow-down in import growth in the first half of the year (see Graph I.12).

In line with leading indicators, world imports (excluding the EU) are expected to expand at 4.8% in 2018, 0.7 pps. below the 2017 growth rate and 0.3 pps. below the value predicted in spring. Trade this year is set to benefit from the relative strength of global demand, with across-the-board positive contributions from advanced and emerging economies (Graph I.8). Import growth in particular is expected to be sustained in the US, where the positive effect of fiscal stimulus will likely more than offset the negative effect of higher US tariffs. On the other hand, several countries with large current account deficits, in particular Turkey and Argentina, which were affected by turbulence in international financial markets, are expected to reduce their import demand sharply this year.

Beyond 2018, non-EU global import growth is expected to slow to 4.0% in 2019 and 3.7% in 2020, reflecting primarily the weakening of economic activity but also, to a more limited degree, the impact of growing trade tensions.

The elasticity of global imports of countries outside the EU (non-EU imports) with respect to non-EU GDP growth increased sharply to 1.4 in 2017 (see Graph I.14), the highest level since 2011. This is largely reflecting a strong rebound in investment, the most trade-intensive component of GDP, following several years of weak global capital spending. The trade elasticity is expected to moderate gradually over the forecast years, reflecting the waning effects of the US stimulus on investment both in the US and in other regions. The ongoing rebalancing from investment-intensive growth to consumption in China and current trade tensions (see Section I.1) are expected to weigh on global trade elasticity and bring it towards 1.
Oil prices increase amid rising uncertainties

Upward pressure on oil prices eased in early summer 2018 as OPEC raised production levels but intensified again in September with Brent crude rising to 86 USD/bbl as renewed worries about US sanctions on Iran and optimism over global economic growth propelled the market higher. Furthermore, the current increase in oil prices has been driven by supply disruptions in Venezuela and Libya and fears that increased output from Saudi Arabia and Russia might not be enough to fully compensate for these supply shortfalls. Over the forecast horizon, upward price pressures are expected to be held down by growing oil production in Canada and the US, although additional supply from the US is likely to reach international markets only in the second half of 2019 due to pipeline capacity constraints. A moderation in global oil demand growth in line with slowing global economic growth, as projected by the International Energy Agency, is also expected to weigh on prices. Substantial uncertainties around this scenario relate to the scale of the reduction in Iranian crude exports, the willingness and ability of Saudi Arabia to bridge this gap, the volatility of Libyan and Venezuelan production as well as the evolution of demand should trade tensions intensify.

The assumptions for Brent oil prices (see Graph I.15) are revised upwards to an average of 75.1 USD/bbl in 2018, 80.6 USD/bbl in 2019 and 76.7 USD/bbl in 2020, or up by 11% in 2018 and 26.1% in 2019 compared to the spring forecast (see also Box I.5). Given the annual average of 54.8 USD/bbl in 2017, this implies a rebound of 38% in 2018, following an increase of about 21% in 2017. The upward revisions since the spring forecast are even higher in euro terms, amounting to about 16% and 35% in 2018 and 2019, respectively.

The prices of other commodities are gradually stabilising. After a robust recovery in 2017, metal prices have declined this year by about 12% from their peak in February, pulled down by weaker demand from China following changes to environmental regulations and tighter credit conditions. They are expected to increase modestly in 2018 before declining again in 2019 due to trade tensions and lower growth in China. Food prices are expected to increase moderately in both 2018 and 2019, as adverse weather conditions have boosted prices for some (e.g. wheat) while trade tensions cloud the price outlook for others (e.g. soybeans).

A complex web of downside risks building up

Risks to the outlook for the external environment are skewed to the downside and are closely interconnected (see also Section I.10). In the US, the highly pro-cyclical fiscal loosening risks adding further impetus to price and wage growth, which could accelerate the process of monetary policy normalisation and trigger a stronger-than-assumed increase in long-term interest rates that would weigh on domestic demand. This could also cause a rise in risk aversion and portfolio adjustments, which in a context of high corporate leverage, could have a negative impact on firms’ ability to borrow and invest, dampening business activity. The current fiscal stimulus is projected to erode policy buffers available for offsetting adverse shocks in the future, which adds to concerns over US fiscal sustainability and elevated debt levels (both public and private). Over the medium term, a lack of firepower to deal with future shocks could result in a deeper or more
prolonged downturn when the cycle eventually turns. In the absence of Congressional agreement on spending levels, an abrupt tightening of fiscal policy in 2020 is also a downside risk for the US. Moreover, an escalation of trade tensions could imply a negative supply-side shock and add to inflationary pressures more strongly than expected, which could trigger faster-than-expected monetary tightening. Faster-than-expected monetary policy normalisation and a more pronounced slowdown in the US would have a negative impact on the outlook for the rest of the world and on the situation in emerging markets in particular.

In emerging markets, direct contagion from the recent currency sell-off in Turkey and Argentina has so far been broadly contained. At the same time, rising leverage (including in foreign currencies) in many emerging markets has increased their vulnerability to external shocks. An escalation of financial market turmoil – triggered for instance by higher interest rates in the US - would entail sharper-than-expected tightening of financial conditions across emerging markets, accelerate deleveraging and result in restrictive macroeconomic policies that would dampen growth in emerging markets and constrain global economic prospects. An additional downside risk for emerging markets in 2020 stems from the fact that most major global economies are currently projected to slow down that year in a rather synchronised way, which would make it very challenging for emerging markets to sustain their expansion paths.

Some of the previously identified trade-related risks have partly materialised, as trade tensions have continued to increase since the spring. In September, the announcement of additional tariffs on selected imports from China worth USD 200bn and the announced increase in tariff rates as of January 2019 has heightened the risk of a further escalation of the trade dispute between China and the US beyond retaliatory measures already announced. A sharper-than-projected slowdown in global growth resulting from additional protectionist measures represents a downside risk to the forecast, particularly if confidence effects, disruption of global value chains and the impact on inflation in the US prove to be larger than expected.

Rising trade protectionism also aggravates the long-standing risks of a disorderly adjustment in China. China’s domestic growth targets remain important for political reasons and China has already started to loosen policy to counteract the impact of US tariffs. But a return to more domestic stimulus may come at the cost of impeding domestic deleveraging, aggravating macro-financial risks in the future.

All these downside risks are closely tied. For example, the fiscal stimulus in the US is expected to boost domestic demand and imports, widening the US current account deficit in the near term. This could reinforce the calls for more protectionist US trade policies. Additional tariffs imposed by the US could also result in higher inflationary pressures which would further aggravate the risk of tighter financing conditions for emerging markets. Also, China’s policy response to the trade measures adds to the concerns about financial stability and may imply a weaker Renminbi, which in turn would aggravate trade tensions with the US.

3. FINANCIAL MARKETS

Since spring, rising global interest rates and increased global trade tensions have weighed on financial market sentiment. However, continued economic growth and low inflation combined with very gradual normalisation of monetary policies across the globe have helped to maintain financial market volatility at rather low levels. Shocks that came along with the tightening cycle were mostly visible in bond markets and less so in stock markets with exceptions in February and October. Overall, financial market conditions have remained supportive of growth in the EU economy.

Further rate hikes are assumed in the US, but global monetary policy is set to remain rather accommodative. Even so, the aggregate liquidity provided by the major central banks may have peaked in the middle of this year. Crises in some emerging market economies (e.g. in Turkey and in Argentina) have impacted markets domestically with repercussions on exchange rates. The outlook for public finances in Italy has pushed Italian sovereign yield spreads significantly higher in recent months. So far, no contagion to other Member States has been observed.
Monetary policy normalisation is proceeding at different paces in major regions

In the US, the Federal Reserve tightened further its monetary policy in a widely-expected move in September, raising its main policy rate in for the eighth time since the tightening cycle started in December 2015. The 25 basis point increase in September lifted the target range for the Federal funds rate to between 2.00% and 2.25%. In addition, the removal of language characterising monetary policy as ‘accommodative’ in its statement signalled that the funds rate was considered as having moved into neutral territory. Moreover, the Fed indicated that further interest rate hikes may be required over the forecast horizon (2018-2020).

In the euro area, monetary policy normalisation has so far mainly affected the size of net asset purchases and the details of the ECB’s forward guidance. Starting in October this year, the ECB reduced the amount of its monthly purchases under the Asset Purchase Programme (APP) to EUR 15bn. At its September meeting, the ECB Governing Council reiterated its intention to end its net asset purchases at the end of the year, subject to incoming data confirming its medium-term inflation outlook. Despite this, the ECB’s monetary policy remains very accommodative and will continue to provide significant monetary stimulus even after the end of net asset purchases. This stimulus will be provided by the sizeable stock of acquired assets and the associated reinvestments, as well as by the ECB’s enhanced forward guidance introduced in June 2018. According to the latter, the ECB expects key policy rates to remain at their current levels ‘at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term’. As for the reinvestments, the ECB forward guidance states that the Eurosystem intends to reinvest the ‘principal payments from maturing securities purchased under the APP for an extended period of time after the end of … net asset purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation’.

Outside the euro area, some central banks in the EU have also maintained an accommodative monetary policy stance but opened the door to some degree of monetary policy normalisation by the end of this year or over the course of next year (e.g. Sweden and Hungary). At the same time, a number of other non-euro area central banks in the EU have continued to further normalise their monetary policies (e.g. in the UK and in the Czech Republic).

Meanwhile, monetary policy has also been kept accommodative or has been eased further by other major central banks around the world. Having been obliged to repeatedly cut its inflation forecast, the Bank of Japan has maintained an accommodative stance and introduced new forward guidance at the end of July 2018. The Bank of Japan also revised the formulation of its long-term interest rate target to accommodate for a possible degree of fluctuation depending on the changes in economic and inflation conditions. China’s central bank has eased its monetary policy stance since mid-April this year to cushion a domestic growth slowdown and any materialisations of the possible negative impact of US tariffs. China’s central bank has mainly cut the rate on the reserves that commercial banks are required to keep in order to maintain ‘reasonable and sufficient liquidity’ to help supply credit to smaller businesses and ‘optimise the liquidity structure’ of commercial banks.

Strengthening of euro mainly against emerging market currencies

The euro has appreciated slightly in nominal effective terms in recent months. This has been largely due to a strengthening of the euro against a range of emerging market currencies, while at the same time, it has weakened rather substantially against some major currencies such as the US dollar, the Japanese yen and more recently the pound sterling. These developments largely reflected the different pace of monetary policy normalisation in the euro area on the one hand and in the US and the UK on the other hand. However, they were also associated with policy uncertainties relating to local and global factors (e.g. fiscal policy-related worries in some euro area Member States and trade tensions at the global level). As regards the pound sterling, more optimistic investor perception surrounding the outcome of Brexit negotiations might have also contributed to the recent rebound of the pound sterling against the euro.

(21) According to this new forward guidance, the Bank of Japan expects that short- and long-term interest rates will stay at their current low levels for an extended period of time.
Sovereign yields have resumed their upward trend...

Benchmark sovereign bond yields have been on the rise since late August after a period of stabilisation or slight decline. 10-year US sovereign bond yields have recently broken the 3% threshold and are currently around 3.2% amid strong growth data and the tightening labour market. Following the US, the yield on German 10-year Bunds also increased somewhat, reaching around 0.55%, also supported by a positive, though softening, growth outlook and the confidence expressed by the ECB that inflation is likely to converge towards its target in the medium term. UK 10-year yields have been most of the year below 1.5%, but recently broke that ceiling again, and are currently close to 1.7% (see Graph I.16).

...with the largest spread widening in Europe related to domestic policy issues.

Euro area sovereign bond spreads have moved in different directions against the German Bund in recent months. After widening in May in the wake of general elections, Italian sovereign bond spreads began widening further in late September reaching 300 basis points on investor concerns about the governments budget plans (see Graph I.17). While on previous occasions, such as during the euro area sovereign debt crisis in 2011-2012, there were strong spillovers from developments in one country on other countries’ bond markets, the contagion from the current sell-off of Italian bonds has been limited (see Box I.2). Despite some minor contagion to other Member States during the first stress episode in May, spillovers to others recently have been almost inexistent. Spain’s sovereign spreads have remained at around 100 basis points for most of the year, while Greece’s sovereign spreads have even narrowed this year.

Global stock markets have diverged

Despite price corrections in early October, the S&P 500 Index, tracking the US stock market, has risen this year, supported by strong corporate earnings and equity buybacks. In Japan, the Nikkei 225 was also on the rise. Conversely, equities in the EU and especially China have underperformed significantly. European equity indexes have trended downwards since spring (see Graph I.18), mainly on concerns related to the impact of US trade policy on export perspectives, but also in relation with the turmoil in some emerging economies (in particular Turkey). The European banking sector has underperformed the wider index in response to various shocks, including the increase in Italian yields (see Box I.2), the crisis in Turkey, and several money-laundering scandals. A number of other factors, however, may also be weighing on European banking stocks including low profitability and still high levels of non-performing loans in some Member States.

Due to a deteriorated economic outlook, emerging market stock indexes fared worse, with the Hang Seng index showing significant losses since its peak in January, mainly due to growing trade tensions.

(22) This is in line with empirical studies of sovereign bond market stress that emphasise that the nature and the intensity of spillovers varies markedly across time: see e.g. C. García-de-Andoain and M. Kremer (2018). ‘Beyond spreads: measuring sovereign market stress in the euro area’. ECB Working Paper 2185, October.
Bank lending remains strong in the euro area...

The accommodative monetary policy in the euro area has been transmitted through the banking sector to interest rates on loans to households and non-financial corporations (NFCs). The resulting low interest rates have pushed the growth of net lending flows to the private sector, which stood in August at an annual rate of 3.4%. At 4.2%, the pace of net lending growth to NFCs exceeds the pace of lending to households which stood at 3.1%. Despite the increase, the annual growth rate of loans to households for house purchases remains low from an historical perspective. This masks, however, stronger origination of new loans and a high level of repayments resulting from the boom period in mortgage markets before the financial crisis.

Loan growth continues to be supported by low or declining bank lending rates across the euro area and increases in the supply and demand for bank loans. Interest rates for new loans in Italy and Spain marginally increased in August. However, at the time of the cut-off date of the autumn forecast, it is too early to conclude at a trend attributable to the increase in Italian sovereign yields since May.

...with net easing of credit standards for all loan categories,...

The results of the ECB Bank Lending Survey, published in July, were consistent with a steady recovery of bank lending volumes in the euro area. Banks reported a further easing of credit standards for all loan categories as well as rising demand for loans. Banks expected that the net easing of credit standards for all loan categories would extend into the third quarter of 2018, while net demand was expected to increase further. The main drivers behind the easing of credit standards were increasing competitive pressure and lower risk perception. Terms and conditions on new loans continued to ease across all loan categories, driven mainly by narrower margins. The net percentage share of rejected loan applications increased slightly for loans to NFCs, and remained unchanged for housing loans, while it decreased further for consumer credit and other loans to households.

Overall, lending growth to households and NFCs is expected to continue increasing over the forecast horizon under the combined effect of relatively supportive credit terms and conditions by banks and strong demand (see Table I.3).

...while market funding is also expanding.

Market funding has continued to expand in the euro area in 2018. Bond issuance by NFCs has shown steady net growth despite slightly wider corporate bond spreads compared to earlier this year. The rise in spreads concerns all investment grade ratings and even more so the sub-investment category. Patterns in individual euro area countries, however, have varied over the last few months, with Italian firms in particular seeing a rise in yields (see Box I.2). There have also been signs of fragile market liquidity. Bid-ask spreads even for relatively highly-rated European corporate bonds rose late in spring and over the

### Table I.3: Financing side - euro area and EU

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<th>Euro area</th>
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<th>EU</th>
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<td>Spring 2018 forecast</td>
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<td>Credit to the domestic private sector (% of GDP)</td>
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<td>3.0</td>
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<td>Credit to households (% of GDP)</td>
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<td>4.9</td>
<td>4.6</td>
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<tr>
<td>Credit to other domestic private sectors (% of GDP)</td>
<td>1.2</td>
<td>1.4</td>
<td>1.5</td>
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</tbody>
</table>
summer, and have remained at elevated levels since.

Higher market-based funding costs (resulting from higher corporate bond yields and lower equity prices) has also translated into somewhat higher composite financing costs for NFCs (CFCIs) even though bank lending rates have declined in most euro area Member States compared since the end of last year. While composite financing costs for NFCs have moved higher from historically-low levels in most euro area Member States this year, financing costs rose the most in Italy as a result of substantial increases in market-based funding costs in recent months.

All in all, despite some significant headwinds, financial markets have continued pricing credit and interest rate risks at relatively low levels, and spillover effects from country-specific risks have remained contained. Market participants expect a further gradual increase in risk-free interest rates, which would support further price adjustments in some of the more risky and highly-priced market segments globally.

**Banking sector profitability continued increasing in the euro area...**

The economic expansion in the euro area has strengthened the debt-servicing and loss-absorption capacities of households, non-financial corporations and the financial sector. Lower credit losses and credit risks have contributed to a further improvement in the profitability of the banking sector. This is evident from the increase in the aggregate return on equity of the biggest euro area institutions, which had increased in 2017 to around 6% from 3.5% in the year before, and stood at 6.6% in the first quarter of 2018 (latest available data).

**...but going forward profitability is facing important challenges.**

In 2018, the slower formation of non-performing loans bodes well for a further improvement in the profitability in the euro area banking sector. However, the stock of non-performing loans remains high in some Member States, suggesting that these stocks remain a significant challenge to the profitability and viability of certain EU banks. Other key determinants of future profitability include the pass-through of higher interest rates, the pace of changes in the yield curve, and the composition of assets and liabilities in bank balance sheets. The possible re-emergence of the sovereign-bank nexus points to the remaining importance of country-specific characteristics, such as the share of holdings of bonds issues by the domestic sovereign (see also Section I.10).

### 4. GDP AND ITS COMPONENTS

The EU economy is entering a period of less dynamic growth after five years of uninterrupted increases in economic activity. The EU economy is still doing quite well overall, continuing to expand for the sixth year in a row. But growth is expected to be at rates that are lower than last year and the speed looks unlikely to increase again soon.

**Growth achievements in the past decade have been muted...**

In the 10 years since the economic and financial crisis burst into the open with the collapse of Lehman Brothers in September 2008, the EU economy has made substantial progress in removing the scars of the crisis (see Graph I.19). (24)

![Graph I.19: GDP and components - 10 years after the Lehman collapse (2008-Q3 - 2018-Q2), euro area](image)

![cumulative change since 2008-Q3 (%)](image)

Graph I.19: GDP and components - 10 years after the Lehman collapse (2008-Q3 - 2018-Q2), euro area

<table>
<thead>
<tr>
<th>Cumulative change since 2008-Q3 (%)</th>
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<tr>
<td>GDP</td>
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<tr>
<td>Public consumption</td>
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<tr>
<td>Investment</td>
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In April 2018, the current economic expansion, which began as a subdued recovery in the second quarter of 2013, entered its sixth year. At the time of publication, economic growth has lifted GDP and its domestic components above the levels seen 10 years ago. But the post-crisis growth record signals that the results were overall rather limited in terms of the accumulated growth of GDP, private consumption and investment. With this aggregate picture hiding a lot of heterogeneity across Member States, it is clear that in some economies improvements in living standards over the past decade were very small or even non-existent. Between the first quarter of 2008 and mid-2018, real per capita GDP in the euro area (see Graph I.20) has only increased by 4.0%. The continuation of the economic expansion is therefore a necessary condition for raising living standards in all Member States markedly above the 2008 level.

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The initial relative weakness of the recovery raises questions about how long the current period of growth can continue. The euro area’s position in the cycle as well as domestic growth drivers point to a ‘soft landing’ rather than a cyclical downturn. However, this benign outlook is challenged by recent disruptive developments outside and within the euro area and subject to major downside risks (see Section I.10).

Output gaps in the EU and the euro area are estimated to have closed in 2017 and 2018...
respectively, which suggests that output could be expected to gradually converge towards potential levels, which would imply actual growth rates falling below the growth rate of potential output. However, several of the mechanisms that could potentially lead to this outcome look rather unlikely. Signs of overheating might constitute a risk in the US given its advanced position in the cycle (see Sections I.2 and I.10) but can hardly be seen in recent growth patterns in Europe. The mechanism of a build-up of high private debt and stretched asset price valuations that could raise default concerns and thereby widening corporate spreads and slowing economic growth, appears also to be a distant possibility in the euro area. The over-accumulation of capital after strong investment growth that causes a cyclical weakness is also hard to expect given the observed weakness of investment in the euro area after the economic and financial crisis.

Another approach is to look closer at cyclical patterns. Comparisons with previous recoveries are of limited use since structural differences distort the comparability of cyclical phases over time. (25) The relatively long-lasting and very subdued recovery has indeed provided evidence of the limited comparability of cyclical patterns after a severe economic and financial crisis. (26) Acknowledging these limitations puts the focus on two questions: first, are there signs that the economy has already passed a turning point in terms of economic growth rates? Second, what could bring the expansion to an end or even cause a recession? While the former question requires looking at developments in short-term indicators (see below), the second one calls for an evaluation of risks (see Section I.10).

### Has economic growth in the euro area already peaked?

The moderation in economic growth that was observed in the first quarter when GDP growth fell in the euro area to 0.4% (q-o-q) from at least 0.7% in each of the five quarters before and the continuation of the expansion at an unchanged pace in the second quarter could suggest that growth has peaked.

### Legend

- **ln Euro**: Logarithmic Euro
- **Cur. prices**: Current prices
- **% GDP**: Percentage of GDP
- **Real percentage change**: Real percentage change
- **Autumn 2018 forecast**: Autumn 2018 forecast
- **GDP**: Gross Domestic Product
- **GNI**: Gross National Income
- **Final demand**: Final demand
- **Imports (minus)**: Imports minus
- **Exports**: Exports
- **Inventories**: Inventories
- **Investment**: Investment
- **Public consumption**: Public consumption
- **Private consumption**: Private consumption
- **Private consumption**: Private consumption
- **Public consumption**: Public consumption
- **Investment**: Investment
- **Inventories**: Inventories
- **Exports**: Exports
- **Final demand**: Final demand
- **Imports (minus)**: Imports minus
- **Net exports**: Net exports

### Table I.5: Composition of growth - EU

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### Contribution to change in GDP

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### Notes


(26) Features characterising the economic development since the end of the ‘Great Recession’ in 2008-2009 have been discussed in various forecast documents. These discussions related to the initial contribution by Reinhart and Rogoff (see Reinhart, C. M. and K. S. Rogoff (2009). ‘This time is different: eight centuries of financial folly’. Princeton University Press 2009) but also to subsequent empirical work (see e.g. Fernald, J. G., Stock, J. H., Hall, R. E. and M. W. Watson (2017). ‘The disappointing recovery of output after 2009’. Brookings Papers on Economic Activity, Spring, pp. 1-81).
The extraordinary impact of the rebound in the global environment last year may have provided an additional stimulus that cannot be expected to occur again. In fact, the growth contribution of net exports in 2017 (0.8 pps. in the euro area, 0.6 pps. in the EU) was the highest since the start of the recovery in 2013. Thus, the pull-back from the levels of growth seen in 2017 can be associated with the smaller growth contribution of net exports in the first half of the year. In addition, a number of domestic factors have weighed on growth in some Member States such as strikes, extraordinary weather conditions not captured by seasonal adjustment, higher tax burdens for consumers, and unusually high levels of sick leave.

In the near term, leading indicators seem to suggest that growth rates have entered a downward trend. Survey indicators continue to signal expansion but have retreated from the levels seen at the beginning of the year. As regards companies in the euro area, this applies to the Commission’s Economic Sentiment Indicator but also to the Purchasing Managers’ Indexes (see Graph I.21). As regards households, consumer confidence has also been falling since the start of 2018 (Graph I.22).

A closer look at the manufacturing sector reinforces the suggestion that growth is unlikely to pick up again soon. Abstracting from rather volatile short-term movements (month-on-month), industrial production has gained very little overall this year, which is in line with the more moderate level of economic growth observed in the first half of the year (see Graph I.23).

…and will eventually depend on the interplay of demand and supply constraints.

A number of factors are expected to come to the fore over the coming months, some of which will be supportive of growth, while others will have a dampening effect. In terms of the latter, a significant factor is that past tailwinds have been fading. This includes the boost to the economy from the decline in oil prices (from mid-2014 to 2016), the highly synchronised uptick in global growth (2016-2017), the improvement in funding conditions (especially after the introduction of
quantitative easing in 2015), and the depreciation of the euro (in parallel to the introduction of quantitative easing). Having been in a position of high unemployment, the euro area has also substantially benefited from a high rate of job creation (job-rich recovery) that eventually will decline. Another tailwind unlikely to come back soon given the context of rising trade tensions, is a revival of strong global economic growth. The expected moderation of growth in the external environment in 2019 and 2020 points to the growing importance of domestic factors.

On the demand side, household real disposable income growth will be constrained by the rise in consumer price inflation. What may even be more important for demand is the expected slowdown of employment growth in an environment where cyclical unemployment has diminished (see Section I.6). Linked to that, on the supply side, a relatively high number of companies are reporting labour shortages as a limiting factor of production and thus as a possibly growth-limiting factor.

Growth momentum has diminished since the start of the year...

Looking at recent GDP developments in greater detail, the first half of 2018 saw GDP growth shifting down a gear compared to the exceptional levels of 2017. Real GDP growth in the EU and euro area came in at 0.4% (q-o-q) in the first and the second quarter, following five quarters with rates of at least 0.6%. Half year-on-half year, it expanded by 0.9%, in line with the average observed between the second half of 2013 and 2016. Despite the growth moderation, GDP increased in all Member States for which data are available.

As some of the factors that pushed growth higher in 2017 have since faded, GDP growth has slowed somewhat in the first half of 2018. Weaker foreign demand has coincided with a shift in growth sources from higher net exports towards higher domestic demand contributions. In terms of growth, for both euro area exports and imports, the first half of 2018 was the weakest half year since the start of the recovery in 2013. In the case of exports, a lower impulse from global trade has been compounded by the lagged impact of the euro’s appreciation. At the same time, private consumption grew at its slowest pace since the first half of 2014, whereas investment expanded at its highest rate since the second half of 2016.

…with survey indicators signalling more easing in late 2018...

Incoming data on activity and sentiment provide evidence that euro area activity in the third quarter did not pick up from the first quarters of the year.

The Commission’s Economic Sentiment Indicator (ESI) for the euro area reinforced this message by declining for the ninth consecutive month this year. It fell in September from 111.6 to 110.9 (112.5 in the second and 114.0 in the first quarter of 2018), despite remaining at a high level by historical standards and consistent with almost steady economic growth (see Graph I.24). Economic sentiment in the euro area has been weighed down by lower confidence among consumers and industry, while services, retail and construction have remained buoyant. Furthermore, the final Eurozone PMI Composite Output Index showed the pace of growth slowing to one of its lowest in two years. While remaining at a relatively high level, it came in at 54.1 in September, a deterioration on August’s 54.5 and lower than the average reading of 54.7 in the second quarter of 2018 (57.0 in the first quarter).

![Graph I.24: Economic Sentiment Indicator and Markit Composite PMI, euro area](Image)

Source: European Commission, Markit.

The Ifo Economic Climate for the euro area also showed sentiment weakening in the third quarter.
Although experts’ assessments of the current situation only deteriorated slightly, their expectations dropped to their lowest level since the end of 2012.

...consistent with available ‘hard’ data for the third quarter.

Recent data releases of monthly indicators paint a similar picture of moderating economic growth.

• In August, industrial production in the euro area rebounded (1.0% m-o-m) following declines of 0.7% in each of the two months before. In July, at 0.3% the annual rate of change had been the lowest since January 2017. Given industry’s direct and indirect exposure to tariffs, and the expected weakening of global trade, developments in industrial production are the focal point of attention, but one has to keep in mind that recent European readings were blurred by some exceptional factors, mainly in the car industry, which reported a strong decline in the production of motor vehicles in July and August (Graph I.25). The sharp decline in the durable-goods component of industrial production (-2.3% y-o-y in July and -1.1% in August) is related to the weakness in motor vehicle production (-3.0% and -19.2% y-o-y) due to problems with the certification of cars under the new Worldwide Harmonised Light Vehicle Test Procedure (WLTP), (28) which has particularly hit German car producers (-4.8% and -22.3% y-o-y in July and August).

(28) Since 1 September 2018 all newly built cars must be certified according to the WLTP test procedure. While its predecessor determined test values based on a theoretical driving profile, WLTP was developed using real-driving data. And while previously car producers could just have tested one model of a line, under the new regulation all variants of a line, and all combinations of its body and gearing, have to be tested. There is evidence that some carmakers which were not able to meet the deadline on WLTP certification, had to suspend the sale of some car types and thereby slowed car production, for example by introducing part-time work and/or four-day weeks in some factories. The delays in switching production to WLTP compliant cars is also reported to have caused car deliveries to fall behind.

• New industrial orders in the euro area fell in all but one month this year. In July, they contracted by 0.9% m-o-m, with the 3m-o-3m growth rate at -0.2%.

• In August, the euro area retail trade volume fell 0.2% m-o-m, driven by a 0.6% decline in fuel sales which can be partly related to price increases in preceding months, as well as by a 0.3% decline in sales of food, drinks and tobacco. The less volatile 3m-on-3m rate stood at 0.1% (0.8% in June).

• In August, the production in construction in the euro area decreased further (-0.5% m-o-m), which suggests that growth in the third quarter will be lower than in the second (1.5% q-o-q). The average production level in July and August stood 0.3% higher than on average in the second quarter.

Notwithstanding some sector-specific developments (e.g. in the car industry) that are expected to affect the profile of economic growth in the near term, recent developments suggest that growth should on average continue at a moderate rate in the second half of the year. All in all, with the moderation of growth in the first half of the year expected to persist, but a relatively high carry-over from 2017, the forecast for GDP growth in the euro area in 2018 remains at 2.1%, unchanged from the summer interim forecast.

More moderate economic growth in 2019 and in 2020...

The fundamentals for the continuation of the growth of economic activity remain in place. Domestic demand is expected to benefit from a slightly expansionary fiscal stance in 2019; the
continued transmission of growth-supportive monetary conditions, with low financing costs for corporates and governments alike, despite the gradual withdrawal of monetary stimulus; favourable labour market conditions that allow for slightly higher wage increases; and improving corporate and household balance sheets which create lower deleveraging pressures.

Moreover, the current expansion is still shorter in length and smaller in size when compared to other historical episodes. (29) Although structural changes may limit the comparability of different business cycle phases across different economic expansions, economic growth is still rather moderate when compared to what has been observed in previous recoveries. (30) While assessing how advanced the economic upswing is, a comparison with the economic recovery in the US suggests that there is still some way to go, with room for an exceptionally long expansion and lower concerns regarding a maturing business cycle.

With the scope for further labour market improvements more limited amid binding supply constraints in several Member States and diminishing slack elsewhere, employment gains are expected to be more moderate. As such, absent further drops in business sentiment, rising labour utilisation should lead firms to focus on additional capital spending in order to increase supply. Even though tighter labour markets in a number of Member States may limit the pace of employment growth, they are also likely to spur investment in technology and training, thus supporting productivity growth.

The expected normalisation of monetary policy in the euro area is set to gradually raise financing costs for both companies and households and thereby affect their spending decisions. At the same time, waning foreign trade momentum, and the lagged impact of the strengthening of the euro are set to weigh. How firms reassess their investment plans in light of rising and intensifying trade tensions is also a source of uncertainty. Besides raising input costs and reducing the attractiveness of some investments, an uncertain outlook can also lead companies to postpone investment decisions, following a wait-and-see behaviour, particularly in capital-intensive sectors such as manufacturing. (31)

Overall, real GDP growth is now forecast at 1.9% in the euro area and at 2.0% in the EU27 in 2019, slightly less than expected in the summer interim forecast. Economic growth is projected to continue moderating further in 2020. Real GDP is forecast to grow by 1.7% in the euro area and by 1.9% in the EU27, with the difference between the fastest and slowing growing economies diminishing (Graph I.26). In several Member States, growth is expected to fall below its potential rate, resulting in a gradual closure of the positive output gap.


Potential output in the euro area is estimated to have expanded at increasing rates, starting from ¼% in 2012 to almost 1½% in 2017, supported by increasing contributions from labour and total factor productivity (Graph I.27). The larger contribution from labour reflected a declining Non-Accelerating Wage Rate of Unemployment (NAWRU), which fell from its latest peak of 9.4% in 2012 to 8.4% in 2017, and the continued increase in trend labour participation rates. The rebound in investment supported the gains in TFP that have been estimated for the past years to have exceeded ½ pps. in terms of contribution to GDP.

growth, but which remain relatively low.\(^{(32)}\) According to the Commission’s estimates, the growth rate of potential GDP in the euro area is expected to rise slightly above 1½% in 2018 and to remain almost constant in 2019 and in 2020.

Strong economic growth over the past four years has helped to narrow the negative output gap in both the euro area and the EU. With economic growth in both areas expected to remain at an annual rate of around 2% in 2018, the output gap is projected to turn slightly positive (¼% of potential output in the euro area, ½% in the EU). This implies that the cyclical upturn should have been strong enough to lead the economy towards full capacity utilisation.

In 2019 and 2020, GDP growth is set to be less dynamic in the euro area and in the EU, with the pace of growth gradually settling back towards its potential rate. At more moderate growth rates in 2019 and in 2020, the positive output gap is projected to widen less than in the past. In all three forecast years, strong employment growth in the euro area is expected to allow the unemployment rate to remain below the estimated Non-Accelerating Wage Rate of Unemployment (NAWRU). The NAWRU is projected to continue to decline to about 8% in 2019 and 2020. However, as estimates of potential output and output gaps are inherently uncertain, these results should be interpreted with caution.\(^{(33)}\)

\(\text{The slowing of economic growth is expected to include all Member States...}\)

All Member States are expected to see growing economic activity in the forecast years, but in most of them the pace of economic growth in 2019 and in 2020 is set to fall behind the pace registered on average in 2017 and 2018 (see Graph I.28). In most cases, the strongest performers in recent years are set to continue to outperform and the weaker performers will continue to perform below average. Among the larger EU economies, Poland, Spain, and the Netherlands are expected to be economic outperformers, with real GDP growth rates above the EU average, whereas Germany is expected to grow slightly below the average in 2019 and in line in 2020. Italy, the UK and France are set to lag in both years. In 2020, all EU27 Member States except Italy (1.3%) and Belgium (1.4%) are projected to grow by more than 1.5%, but for a large majority of Member States, economic growth will likely be lower than in 2019.

GDP per capita growth rates are also expected to continue to differ between Member States. In 2020, among the largest euro area countries, France (1.2%), Italy (1.3%), the Netherlands and Germany (1.4%) are projected to grow below the euro area average (1.5%).

...with growth depending almost entirely on domestic demand.

With the momentum of foreign trade waning, real GDP growth will come to rest almost entirely on domestic demand growth. In 2019, the contribution to growth from domestic demand is expected to

\(^{(32)}\) See e.g., van Ark, B., de Vries, K. and K. Jäger (2018). ‘Is Europe’s productivity glass half full or half empty?’. *Intereconomics* 53:2, pp. 53-8.

increase (from 1.8 pps. to 1.9 pps.), driven by a pick-up in private and public consumption, while the contribution from net exports is set to turn neutral (from +0.3 pps. in 2018). A lowering of the positive contribution to growth from domestic demand (to 1.7 pps.) explains the annual growth moderation expected in 2020 (see Graph I.29).

Given the ongoing negotiation over the terms of the UK’s withdrawal from the EU, projections for 2019 and 2020 are based on a purely technical assumption of status quo in terms of trading relations between the EU27 and the UK. This is for forecasting purposes only and has no bearing on the talks underway in the context of the Article 50 process.

The growth of private consumption slowed in the first half of the year...

Private consumption growth has been the main driver of the current economic expansion. In the last two years, consumer spending has been resilient due to strong employment growth. But in the second quarter of 2018, private consumption growth moderated, with a weakening to 0.2% q-o-q (euro area) and 0.3% (EU) (from 0.5% in the first quarter of 2018 in the euro area and 0.6% in the EU). Half year-on-half year, it stood at 0.8% in the euro area (0.9% in the EU), unchanged compared to the second but lower than in the first half of 2017. Weaker private consumption growth is one of the reasons for the moderation of growth this year. Private consumption growth has moderated in line with the decrease in consumer confidence but despite steady employment growth and a reduction in the euro area household saving rate (which stood at 12.0% in the first quarter of 2018, the same as in the fourth quarter of 2017 and at its lowest since 1999).

A look at the breakdown of private consumption shows that the slowdown in the first half of the year is explained by lower momentum in the consumption of durable goods. Growth in durable goods consumption fell from a half-year-on-half year rate of 2.1% in the second half of 2017 to 1.4% in the first half of 2018; while non-durable consumer goods and services consumption picked up marginally from 0.5% to 0.6%. With spending on durable goods usually being more sensitive to the business cycle than spending for other types, the observed change in the pace could be associated with economic growth shifting to a lower gear. Moreover, the pent-up demand for durables might have been exhausted after several years of economic expansion. (35)

The slowdown in the second quarter was broad-based across the largest euro area economies, with France posting a contraction for the first time since the third quarter of 2016, driven by a fall in the consumption of non-durable goods and services. This was partly related to temporary factors (e.g. strikes) but also to the unwinding of factors that supported private consumption in the first quarter (e.g. strong energy consumption related to unfavourable weather conditions). Significant differences between countries were apparent in the first half of the year. Private consumption picked-up in Germany (from 0.6% to 0.8%), Italy (from 0.4% to 0.5%) and the Netherlands (from 1.4% to 1.7%) and remained strong in Spain (at 1.2% from 1.5% in the second half of 2017). Only in France did it decelerate.

...is expected to remain moderate in the second half of the year...

The short-term indicators of private consumption are consistent with consumer spending growth returning to the levels seen before the exceptionally weak second quarter.

- The Commission’s Consumer Confidence Indicator declined in September to its lowest level since May 2017 (Graph I.30), but remained well above its long-term average. The


decline was mainly driven by consumers’ less favourable outlook over the next 12 months for their financial and for the general economic situation and the more pessimistic assessment of risks of becoming unemployed. By contrast, households’ intentions for major purchases over the next 12 months have been quite stable until September 2018, which sends a positive signal for a possible rebound in private consumption growth after the slowing in the second quarter.

- Consumers’ views on the current and the future economic situation have deteriorated in recent months and the gap between both assessments has closed (Graph I.31). Since expectations that situations will improve in the future are seen as an incentive to advance spending in an attempt to smooth consumption, the closing of the gap does not bode well for an acceleration of private consumption growth. However, as for several other survey indicators, it has to be noted that the level of the expectations is still relatively high by historical standards.

- The Commission’s Retail Trade Confidence Indicator has been hovering around historically high levels since early 2017, with no discernible cyclical path (see Graph I.32).

- New passenger car registrations in the euro area fell markedly in September 2018 (-37% m-o-m), however, this data may be somewhat misleading because the introduction of a new emissions test for new cars (WLTP) at the beginning of the month caused an exceptional surge in August (20% m-o-m) when car producers registered vehicles manufactured under the old testing rules in order to be able to sell them without having to apply the new rules. In the first nine months in 2018, 4.6% more new cars were registered than in the first nine months in 2017.

- Loans to euro area households for consumption purposes continued to expand more quickly than loans for any other purpose and recorded an annual increase of 7.1% in
June, close to its highest growth rate since late 2006.

All in all, while the recent data releases could question the near-term outlook for private consumption, it is important to recognise that a broad set of household fundamentals has remained favourable when assessing the prospects for 2019 and 2020.

...but to continue delivering the largest growth contribution in the next two years.

Over the forecast horizon, the expansion of private consumption should get support from the acceleration of nominal disposable income, which is also supporting consumer confidence. The growth of labour incomes is expected to benefit relatively more from wage and salary increases than in the past and less from increases in headcount employment, as employment growth in the euro area is expected to slow. Private consumption will thus lose one of its most important push factors.

With slowing employment creation, the momentum in consumer spending will depend on both the extent to which wages move higher and on changes in non-labour incomes (Graph I.33). Gross wages and salaries in the euro area are expected to increase by 4.0% in 2018 (from 3.6% in 2017), moderating to 3.7% in 2019 and 3.5% in 2020. At the same time, non-labour incomes should grow more moderately. All in all, household nominal gross disposable income is forecast to expand by 3.2% in 2018 (up from 2.9% in 2017), peaking at 3.6% in 2019.

In some Member States, the development of nominal incomes is strongly affected by fiscal policy measures. This includes Germany, where households are set to benefit in 2019 from new measures (see Section II.5). Moreover, some technicalities affect the growth of employee compensation. In France, for example the CICE (Tax Credit for Competitiveness and Employment) (see Section II.10), which is recorded as a subsidy to firms until the end of 2018, is due to be replaced by a permanent reduction in social security contributions in 2019. This is set to reduce the contribution of employers in total compensation but not the wages and salaries component; thus it should not have an impact on the take-home pay of households per se.

Taking into account the expected acceleration in annual consumer price inflation in both 2018 and 2019, household real disposable income in the euro area is forecast to pick-up to 1.5% in 2018 (1.3% in 2017) and 1.9% in 2019. In 2020, real disposable income is projected to grow more moderately (1.6%), driven by lower nominal disposable income growth and a slowdown in consumer price inflation.

There are several factors that matter for the link between the projected increases in real disposable incomes and the outlook for private consumption. First, the composition of income growth is expected to be less favourable for consumer spending because growth will be increasingly driven by wages rather than employment, which usually implies a lower impact. Second, beyond the negative impact on the purchasing power of households, the increase in energy prices could contribute to higher uncertainty about future prices and lead consumers to postpone purchases of durables and increase precautionary savings. (36)

Households intending to finance spending via consumer credit should continue to benefit from favourable lending conditions, as reported in the ECB Bank Lending Survey. However, in an environment of rising financing costs, the normalisation of monetary policy will also affect the debtors among households. But the impact of higher interest rates on households is not clear cut.

Although it remains low by historical standards, in a perfectly symmetric set-up, higher interest expenditure would be mostly offset by higher

Graph I.33: Gross disposable income and its components, euro area

Note: Forecast figures are annual data.

(36) Moreover, empirical studies suggest that the impact of an increase in oil prices is stronger in an environment with elevated uncertainty; see A. Evgenidis (2018). ‘Do all oil price shocks have the same impact? Evidence from the euro area’. Finance Research Letters 26, pp. 150-55.
household incomes from savings. As net savers are less inclined to spend out of a rise in income than net borrowers, rising interest rates tend to depress spending overall. Moreover, higher interest rates could also increase the attractiveness of saving versus spending, all else being equal. The quantitative relevance of these arguments depends on the strength of household balance sheets in the euro area, which differ across countries.

The aggregate household balance sheet remains in solid shape, amid a rise in households’ net worth, due in part to rising house prices and past stock market gains. Households’ net worth (including both financial wealth and non-financial assets) is close to its highest level as a percentage of GDP since the end of 2010 and remains close to its all-time peak as a percentage of gross disposable income. The household debt service burden is low, reflecting both the extended period of low interest rates in Europe and declining household indebtedness. Household’s debt-to-income ratio reached 93.7% in the second quarter of 2018, down from a peak of 99% in the fourth quarter of 2010.

The dampening effects of rising interest rates are likely to be strongest in countries with higher household debt and a predominance of floating-rate loans. By contrast, in countries where fixed-rate household loans are more common, households could see their returns from financial assets grow faster than their liabilities. That being said, the increase in long-term interest rates is assumed to be rather modest over the forecast horizon. At the same time, still low interest rates should also continue to support asset prices and household wealth, including in housing, with moderate positive effects on private consumption.

With growing real incomes, the number of households with precautionary savings is likely to increase. Indeed, given a still-high level of household indebtedness in some Member States and continued increases in life expectancy, precautionary saving motives have an important role in making households more sensitive to income changes due to e.g. concerns related to unemployment risks and having adequate income during retirement. This is consistent with consumption-smoothing behaviour and – amid a gradual monetary policy normalisation - should be reinforced by the diminished impact of persistently low interest rates on the propensity to save, particularly among financially constrained households.

On aggregate, the household saving rate in the euro area is expected to remain stable between 2018 and 2020, although the situation in individual countries differs considerably. An almost equal number of economies are expected to see saving rates decrease compared to those expected to see saving rates increase or remain unchanged. Furthermore, any increase in uncertainty, even if unrelated to existing economic fundamentals, could have a lasting affect consumer sentiment and subsequently the economic outlook.

All in all, private consumption growth in the euro area is forecast to remain stable in 2018 at 1.6%. It is then expected to pick up to 1.8% in 2019, partly due to fiscal measures in some Member States, before moderating, as employment growth, to 1.6% in 2020 as employment growth slows. Among the largest euro area countries, private consumption growth is expected to peak in 2019 in

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(38) Nocera and Roma (2017) found only a modest housing wealth effect in the euro area, with the exception of Ireland and Spain, where a housing demand shock, in terms of a 1% increase in real house prices, is associated with a significant increase of real private consumption of 0.15%, but even this is substantially below the 0.47% estimate recently presented by Aladangady (2017) for the US economy. See A. Nocera and M. Roma (2017). ‘House prices and monetary policy in the euro area: evidence from structural VARs’. ECB Working Paper Series 2073; A. Aladangady (2017). ‘Housing wealth and consumption: evidence from geographically linked microdata’. American Economic Review 107:11, pp. 3415–46.

(39) Precautionary saving theory shows that savings also serve as insurance against contingencies, mostly those affecting income, e.g. unemployment and liquidity constraints. Households thus save not only to buffer lower future income but also to insure against different types of risks. On the measurement of the risk to income see Antonin, C. (2018). ‘Measuring precautionary savings related to the risk of unemployment’. Sciences Po OFCE Le Blog. June.

(40) In particular highly indebted households are more sensitive to income changes because of borrowing and liquidity constraints, highlighting the importance of looking into the heterogeneity of debt burdens. See Nakajima, J. (2018). ‘The role of household debt heterogeneity on consumption: Evidence from Japanese household data’. BIS Working Papers 736. July.

(41) Commonly referred to as “animal spirits”, these sentiment shocks can prove self-fulfilling and be particularly long-lasting for private consumption. See Benhabib, J., Shapiro, B., and M. M. Spiegel (2018). ‘How persistent are the effects of sentiment shocks’. Federal Reserve Bank of San Francisco Economic Letter 22. October.
Germany, also driven by supportive fiscal measures, while a gradual softening is forecast in the Netherlands and Spain. In both France and Italy, private consumption growth is forecast to strengthen in 2019 and to remain stable thereafter.

**Public consumption growth has moderated in the first half of the year…**

In the first half of the year, government consumption expanded by 0.4% in both the euro area and the EU (0.7% in the second half of 2017), its slowest pace since the second half of 2013. According to the sectoral breakdown available up to the first quarter of 2018, the slowdown in that quarter appears to be driven by relatively weaker growth in the acquisition of goods and services, which were not compensated by a small uptick in public spending on compensation of employees (see Graph I.34).

In the second quarter, government consumption rebounded (to 0.4% q-o-q, from 0.1%), posting a positive contribution to growth following two consecutive quarters of neutral contributions. This pick-up was broad-based across the larger euro area economies, with a particularly strong rise in Germany (from -0.3% to +0.6%), with the exception of the Netherlands, where there was a slowdown.

...but is projected to pick up in 2019 before moderating again.

Taking into account the outturn of the first half of the year, aggregate government consumption is expected to grow slightly more than in 2017, increasing by 1.3% (1.2% in 2017) in the euro area, on the back of stronger compensation of employees and intermediate consumption expenditure. In 2019, public consumption growth is projected to pick-up, before moderating in 2020 (1.6 and 1.3%, respectively). The modest slowing projected in 2020 is associated with a no-policy-change assumption, in which measures are only factored into the forecast if they have been adopted and presented to national parliaments or are known in sufficient detail to be taken into consideration.

These projections mask some divergence among Member States (see Section I.8) with differing consolidation needs and economic situations. In 2019, government consumption growth is forecast to accelerate in the Netherlands, Germany, and Italy, while remaining steady in France and slowing in Spain, whereas the projected softening in 2020 is broad-based, except in Italy where it is forecast to pick-up marginally.

**Investment dynamics remain buoyant…**

Following its steep fall during the economic and financial crisis, it took investment (gross fixed capital formation) many years to return to pre-crisis levels. After several years of weak dynamics, as the economic recovery that started in 2013 gained traction, investment began to grow at rates of at least 3%. This exceeds the growth rate of GDP but remains moderate for a highly cyclical component during an upswing.

In the first half of 2018, investment was 1.6% higher than in the second half of 2017, but the marginal increase in the pace of growth (from 1.5% in the second half of 2017) can be attributed to the rebound of investment in Ireland after a sharp contraction in the second half of 2017 (investment growth in the euro area excluding Ireland fell from 2.3% in the second half of 2017 to 1.5% in the first half of 2018). While investment rose markedly in Germany and Spain, it slowed substantially in France and Italy and less markedly in the Netherlands.

Looking at quarterly developments in the euro area, the pick-up in the second quarter was much stronger than the one in the first (1.4% q-o-q after 0.1% q-o-q). These developments lifted the investment-to-GDP ratio to 21%, which is still about one full percentage point lower than the average in the period 2000-2005. However, the aggregate ratio hides substantial differences in the ratios for equipment and for construction investment, with only the former fully recovering.
Differences also persist between investment in the public and in the private sector. While public investment remained in 2017 at the all-time low of 2.6% of GDP that it had arrived the year before, private investment has increased steadily since 2013 to 18.2% of GDP, which is the highest rate since 2008.

In both 2018 and 2019, public investment in the euro area is expected to grow at rates of 3.3% and 3.0% respectively, which translates into a share of 2.7% of GDP. The projected growth of public investment by 3.0% in 2020 is set to lift this share to 2.8%.

In the private sector, increases in the business investment rate are set to be supported by an above-average marginal value of capital, as measured by the equity-to-net worth ratio. As regards the financing of investment spending, bank lending to firms and other funding for companies should continue to be supported by relatively low though increasing interest rates and favourable credit standards (see also Section I.3). In the second quarter of 2018, the leverage ratio of non-financial companies, i.e. the ratio of debt and total financial assets, decreased to its lowest level since 2000, while other leverage measures show less sizeable adjustments.

Investment has also continued to benefit from the support provided by the Investment Plan for Europe (“Juncker Plan”). As of October 2018, operations approved under the Investment Plan for Europe (EUR 67.3 bn.) were expected to trigger EUR 344bn. in investments, with around 793,000 small and medium-sized businesses benefitting from improved access to finance.

Against the background of the weak first quarter and a less favourable demand outlook, investment growth has been revised down from the spring forecast. In 2018, investment growth in the euro area is now forecast to pick-up from 2.6% last year to 3.3% (0.9 pps. less than in the spring), with investment returning to its pre-crisis peak level reached in 2007.

Further ahead, investment should continue to grow but at declining pace. In both 2019 and 2020 investment is expected to grow by 3.0% in the euro area, in line with less buoyant external demand. The year 2019 is also expected to be the first since 2007 in which investment increases in all EU Member States. The continued strength of investment implies strong growth contributions and increases in capital deepening which further support cyclical improvements in labour productivity.

...with equipment investment between capacity constraints and slower demand growth...

Equipment investment has continued to grow on the back of very favourable financing conditions, rising corporate profitability and solid demand. In the first half of 2018, the acceleration in investment rested on developments in equipment investment, which increased by 2.0% compared to the second half of 2017. On a quarterly basis, equipment investment had even contracted in the first quarter of 2018 (-0.6% q-o-q), but rebounded in the second quarter (2.6%).

While the first half of the year was less dynamic than the second half of 2017, several short-term indicators continued to signal solid equipment investment growth in the near term. Capacity utilisation in manufacturing in the euro area fell in the third quarter (survey conducted in July) by 0.2 points to 84.1% but remains above the average since 1990 (81.0%), and capacity utilisation in services increased by 0.4 points to 90.6%, which is above the average since the start of the series 2011 (88.7%). Confidence in all sectors surveyed by the European Commission (manufacturing, services, construction, and retail sectors) has been moderating in 2018 but in September was still well above long-term averages. As regards profitability, earnings expectations remain favourable; according to the euro area sectoral accounts for the second quarter of 2018, business margins (measured as the ratio of net operating surplus to value added) remain close to their highest level since early 2009. Furthermore, August saw the strongest annual growth of loans to non-financial corporations (adjusted for sales and securitisation) since May 2009, boding well for business investment spending. The demand outlook though still favourable has been clouded by interrelated downside risks.

Less favourable signals come from the production of capital goods. Monthly data on capital goods production in the euro area stood on average in July and August 0.2% below the average level in the second quarter of 2018, when they increased by 0.1% q-o-q (2.3% y-o-y). And increased uncertainty, trade tensions, and increasing input...
prices are not conducive to equipment investment growth.

Towards 2019, the outlook for equipment investment (see Graph I.35) is expected to continue benefitting from still favourable financing conditions, rates of capacity utilisation that remain above the long-term average, falling but still decent business confidence and a favourable earnings outlook. The impact of these supportive factors, however, is likely to be partly offset in the short term by rising supply hindrances (particularly on the labour market), which in some Member States are constraining the recruitment required to expand capacities. Another impediment to investment growth is related to uncertainty regarding the external environment, through both its direct impact on current demand, as well as on future demand prospects.\(^{(42)}\) Elevated economic uncertainty has been shown to significantly impact corporate decision making, particularly with respect to investment decisions and cash holdings, even in an environment of historically low interest rates.\(^{(43)}\) Finally, similarly to previous forecast rounds, pending challenges related to the still high stock of non-performing loans in some countries are expected to continue to weigh on investment but to a lesser extent, as volumes of non-performing loans are gradually receding.

All in all, euro area equipment investment is forecast to grow by 5.5% in 2018, and to moderate thereafter to 3.5% in 2019 and 3.1% in 2020. A lower growth path is expected in all but five EU Member States.

\[^{(42)}\] Uncertainty arises when economic agents cannot reasonably assess the likelihood of all possible future states of nature or characterise the probability distribution of their possible impacts. The real options channel suggests that the option value increases with uncertainty in the case of irreversible investment or consumption decisions. See ECB (2016). ‘The impact of uncertainty on activity in the euro area’. Economic Bulletin 8, pp. 55–74.


… and construction investment benefitting from the recovery in housing markets.

The construction sector is set to register its fourth consecutive year of recovery in 2018. Over the first half of the year, it continued to expand, though more slowly than equipment investment. The expansion was particularly strong in Spain, the Netherlands and Germany (2% or above) while losing some pace in France and Italy. Overall, in the second quarter of 2018, construction investment registered its twelfth consecutive quarter of positive growth.

House prices have been particularly dynamic. Eurostat’s House Price Index rose at an annual rate of 4.3% (y-o-y) in the euro area in the second quarter of 2018, after reaching its highest rate in 11 years the quarter before. Similarly to previous quarters, the slower increase in household real disposable income suggests a decline in the average affordability of housing.\(^{(44)}\) At the euro area aggregate level, there is growing evidence that the gap between the level of residential investment and the level implied by real disposable incomes is closing.

Taken together, most signals seem positive for future construction investment. On the one hand, the current positive momentum is reflected in increasing confidence in construction sector surveys, such as in the Commission’s Construction Confidence Indicator, which reached its highest historical level in the third quarter of 2018. The number of building permits in the second quarter

\[^{(44)}\] For a more granular analysis of house price affordability (e.g. house prices-to-income, loan-to-value ratios) and valuation gaps (based on supply, demand and institutional factors) see Geng, N. (2018). ‘Fundamental drivers of house prices in the Netherlands? A cross-country analysis’. IMF Country Report 18/131, pp. 15–31, May.
increased by 1.1% (q-o-q), after growing by 0.4% for two consecutive quarters, and reached its highest level since early 2011. Furthermore, the annual growth rate of loans for house purchases stood at 3.2% in August, close to its highest since September 2011.

While net loan flows (newly originated loans adjusted for the repayment of previously granted loans) suggest that mortgage lending remains relatively subdued compared to the pre-boom period, the current level of loan origination is estimated to be close to its average since 2001. (45) These developments are in line with both the previously mentioned buoyant house price growth and messages from the Bank Lending Survey on both credit standards and loan demand.

Construction investment should continue to enjoy the support of low interest rates but, new mortgages should progressively become more costly, making alternative investments relatively more attractive. Interest rate increases have been shown to have an asymmetric impact on residential investment, having a more sizeable effect than interest rate decreases, particularly when the share of residential investment in GDP is rising strongly, which is not the case at the moment. (46) The continued dynamism in real house prices and favourable income prospects should further support residential investment, despite the challenges posed by demographic factors.

In 2018, growth in construction investment is expected to reach 3.3% in the euro area, after peaking at 3.8% in 2017, with its share of GDP (about 10%) still below its peak, which was reached in 2007. It is projected to lose some momentum towards 2020 as capacity constraints in the construction sector become more binding in some Member States (2.8% in 2019 and 3.0% in 2020) with all Member States participating in the expansion. The relatively steady growth path at the aggregate level masks different trends in some Member States. For example, growth is expected to slow in the Netherlands and Spain but to remain broadly unchanged in both Germany and France and to pick-up in Italy (see Graph I.36).

Global factors are weighing on exports and imports...

Strong export growth (goods and services) has been a key factor behind the ongoing economic expansion in the euro area. In 2017, strong growth in export markets (4.7%) pushed euro area exports up 5.2%, which, in combination with slightly less dynamic import growth (3.9%), led net exports to make a strong growth contribution to growth (0.8 pps.). In the first half of 2018, the growth of euro area exports (goods and services) was less than half as strong as it was in the previous year and weaker than at any time since the first half of 2013. On a quarterly basis, the first quarter of 2018 was the first since 2013 in which euro area exports contracted.

The slowdown in export growth over the first half of the year was widespread among the largest euro area economies with Italy registering a sizeable contraction. While most saw a contraction in the first quarter of 2018, exports either completely or partly rebounded in the second quarter, with the exception of Spain where exports expanded strongly in the first quarter but contracted in the second. For the euro area, international trade data shows that the rebound in exports resulted from an uptick in intra-euro area exports (to rates in line with those observed over the second half of 2017), whereas extra-euro area exports remained unchanged. The slowdown in extra euro area export growth was mostly driven by manufactured products, particularly machinery and transport goods, as well as energy products.


As regards the near-term outlook, most indicators suggest that euro area export growth is likely to remain subdued:

- **Export expectations in manufacturing** as measured by the Commission’s quarterly survey, have been steadily moderating since late 2017 and fell to their lowest level since the second quarter of 2017 in the third quarter of this year.

- The monthly assessment of export order books in the Commission’s manufacturing survey has fallen from the post crisis high reached in January 2018. In the third quarter of this year, the indicator averaged its lowest since the third quarter of last year.

- In September, the index of new export orders in the Manufacturing PMI fell below the no-expansion threshold of 50 for the first time since June 2013, after having fallen in the two preceding months. The decline in new export orders was widespread across the largest Member States and substantial over time and with respect to the peaks observed since the start of the recovery in the second quarter of 2013 (see Graph I.37).

- **Monthly trade data** from the Centraal Planbureau (CPB) shows that the volume of trade in goods in the euro area declined in July (-0.5%) after having rebounded in the second quarter of 2018 (+0.7% after -0.5% in the first quarter).

These more negative signals for the euro area outlook come on top of other negative signals from the external environment (see also Section I.2). The Global Composite PMI declined in the third quarter of 2018 with the component for new export orders falling in September below the no-growth threshold of 50 for the first time since June 2016.

Overall, these signals suggest that euro area export growth remains slower than in the past, which is also mirrored in the projected annual forecast of 3.3% in 2018, down from 5.2% in 2017.

…and are dampening the export outlook…

In 2019 growth in euro area export markets is forecast to remain broadly stable at 3.9% (3.8% in 2018) and to slow to 3.6% in 2020, rates that are somewhat lower than they have been for most of the years of the current expansion. Another important dampening factor concerns the composition of euro area exports, which are usually closely linked to global investment growth. Increased economic policy and trade policy uncertainty is projected to slow the momentum of global investment growth (see also Section I.2) with a negative impact on euro area exporters.

At the current juncture, the direct impact of protectionist measures elsewhere is expected to remain low and the outlook for trade in goods and services is based on the assumption that trade disputes will not escalate any further. What is expected to weigh on trade flows is the impact of the uncertainty generated by implemented, announced and threatened trade measures. This also relates to investment, which is an important determinant of export volumes and where delayed or modified global spending decisions are set to weigh slightly on euro area export volumes. An escalation of trade tensions is a substantial downside risk (see Section I.10) as it would hurt both trade and investment through confidence channels, if it were to materialise.

All in all, several factors are expected to dampen export growth. In addition to the projected moderation in world trade and increased uncertainty with respect to trade policies, the lagged impact of the euro’s appreciation, mainly against a range of emerging market currencies, is deteriorating the price competitiveness of euro area companies and constraining their ability to gain market share. Moreover, in some countries and sectors, increasingly binding supply constraints limit the room for further increases in export volumes, particularly where companies tend to prioritise domestic customers. Accordingly, euro area export growth is forecast to remain at around
3½% in 2019 and 2020 (see Graph I.38). Compared to the spring, downward revisions are sizeable, amounting to -1.9 pps. for 2018 and -1.1 pps. for 2019.

As in previous forecasts, the export and import growth projections for 2019 and 2020 are based on a purely technical assumption of status quo in terms of trading relations between the EU27 and the UK.

Graph I.38: Global demand, euro area exports and new export orders

...but also clouding the import outlook...

Euro area imports of goods and services also grew more moderately in the first half of the year, in line with the more subdued growth of final demand. Import growth declined by a quarterly rate of 0.5% in the first quarter and rose by 1.2% q-o-q in the second quarter. According to international trade data, extra euro area import growth slowed across product categories, with the exception of energy products which increased on a half-year-on-half year basis.

The impact of import tariffs implemented by the EU in response to US tariffs on steel and aluminium is expected to be very small due to the small share of import goods affected. Going forward, the assumption of no further escalation of trade disputes applies.

Imports of goods and services are thus expected to grow by 3.0% this year compared to 3.9% in 2017, in line with the moderation in exports. A pick-up is expected in 2019 due to a positive carry-over effect from the rise between the first and second half of 2018. Further out, robust domestic demand this year and continued export growth are set to remain important determinants behind the expansion in imports. Euro area imports are projected to grow by 3.6% in 2020.

...altogether turning the growth contribution of net exports neutral.

Reflecting the weakening of export momentum in the first half of 2018, the contribution of net exports to GDP growth turned broadly neutral and thus lower than in the second half of 2017 when it made up 0.6 pps. of GDP growth as compared to the first half of the year.

Although export growth is projected to slow more than import growth in 2018 (-1.9 pps vs. 0.9 pps.), exports are still expected to grow faster than imports. As a result, net exports should continue to contribute to GDP growth (0.3 pps., down from 0.8 pps. in 2017). As domestic demand is expected to remain relatively strong in the euro area, import growth is expected to overtake export growth in 2019 and 2020, leading to a broadly neutral growth contribution from net exports.

5. THE CURRENT ACCOUNT

In 2017, the current account surplus of the euro area continued to rise and reached a historically high level of 4.0% of GDP on the back of a surge in the surplus from the trade in services and an increase in the net primary income surplus. Also, the adjusted current account (47) surplus remained unchanged at its historical highs of 3.2% of GDP in both 2016 and 2017. Looking ahead, the current account surplus as a percentage of GDP is expected to recede somewhat and remain at a high level, largely on account of a decreasing surplus in the merchandise trade balance and a melting primary income surplus.

The current account surplus reached a new high in 2017...

Last year’s peak was preceded by a long period of gradually rising current account surpluses, which started after the global financial crisis with the support of several factors. The sharp decline in commodity prices in 2014-2015, gains in price competitiveness due to the lower external value of

(47) The adjusted current account and merchandise trade balance of the euro area and the EU take into account discrepancies between the sum of the trade balances of the Member States and the aggregate, which theoretically should not exists, but are usually observed due to reporting errors.
the euro and the sluggish momentum of investment spending coupled with high private sector savings, all contributed to the steady increase of the surplus. Most of these supportive factors, however, weakened in recent years due to a rebound of oil prices and an appreciation of the nominal effective exchange rate of the euro. In parallel, domestic demand has strengthened albeit to a lesser extent. Despite these developments, the strength of global growth and the rise in net primary income continued to power the euro area current account surplus to a new record in 2017.

The adjusted merchandise trade balance peaked in 2016, in parallel with the fall in the oil-trade deficit to an all-time low that was driven by plunging oil prices (Graph I.39). As oil prices picked up relatively quickly in 2017, the euro area’s terms of trade deteriorated for the first time after four years of steady improvement on the back of falling import prices. Rising oil prices and a higher external value of the euro began weighing on the merchandise trade surplus in 2017 and resulted in a drop of the adjusted merchandise trade balance from 3.4% of GDP in 2016 to 3.0% in 2017. This, however, was counterbalanced by a surge in the services balance in 2017, which picked up substantially (about +0.5 pps. of GDP) and lifted the current account surplus.

…and is expected to remain at a high level until 2020…

The euro area current account surplus is set to recede somewhat but to remain at elevated levels in 2019 and 2020, as the trade balance surplus (as a percentage of GDP) is expected to decline somewhat next year and hold steady in 2020. The dampening effects on the trade balance are expected to stem mainly from a faster rise in imports than exports in both 2019 and 2020 as the positive output gap is projected to be widening, leading to a slight decrease of the merchandise trade surplus relative to GDP.

Over the forecast horizon, global economic activity is expected to slow down, while global import elasticity is expected to moderate gradually from high levels in tandem with abating investment growth globally. Euro area export markets are projected to grow at 3.9% in 2019 and 3.6% in 2020, surpassing economic growth outside the euro area in 2019, but lagging slightly behind it in 2020. As increases in export prices in 2019 and 2020 broadly match the increases in import prices, the euro area’s terms of trade should remain broadly neutral over the next two years, with a slight deterioration in 2019 and a marginal improvement in 2020. Deteriorated price competitiveness, as measured by the real effective exchange rate based on unit labour costs, is set to weigh on the euro area’s export performance.

The broad stabilisation of the current account surplus over the forecast horizon is expected to be the result of different developments in the saving/investment relationships in the private sector and in the public sector that broadly offset each other. Private sector net lending is expected to continue slowly receding in 2019 and 2020, as investment levels remain robust and gross saving increases only marginally. Net borrowing by the public sector has been falling thanks to the increasing public sector saving rate and is set to be broadly balanced by the end of the forecast period.

…with Germany and the Netherlands being the main contributors.

In the past few years, a growing number of Member States have contributed to the euro area’s current account surplus. In 2017, 15 euro area Member States posted positive balances. However, the main contributors to the surplus remain the Netherlands and Germany, which together accounted for about 80% of the euro area’s overall current account surplus (see Graph I.40). Over the forecast horizon, their combined share is expected to decline as smaller euro area Member States are forecast to contribute more to the current account surplus in both relative and absolute terms.
Even though the euro area current account surplus is expected to broadly remain at an elevated level over the forecast horizon, the aggregate figure masks significant differences in the current accounts of Member States (Graph I.41). Some of them successfully turned large current account deficits in the years before 2008 into surpluses that are expected to continue in the next two years (e.g. Spain, Estonia, Slovakia). On the other hand, the current accounts of some other countries are expected to slip back into deficit after a short period of rebalancing (e.g. Latvia, Lithuania, Portugal), while Malta, the Netherlands, Germany and Slovenia are forecast to maintain large current account surpluses of at least 5% of GDP. Following relatively low current account deficits up to 2016, the current accounts of Belgium and Finland are expected to improve and remain in surplus over the forecast horizon. Finally, the current accounts of France and Cyprus are projected to remain in negative territory, with the Cypriot balance expected to deteriorate further in 2019 and 2020.

6. THE LABOUR MARKET

Labour market conditions in the euro area continue to improve. The noticeable increases in employment and the continued decline in unemployment confirm the particularly job-rich nature of the current expansion compared to others in the past (see Graph I.42).

Labour market conditions improved further in 2018...

Labour market conditions have continued to improve in the first half of 2018. Employment has been rising further, both in terms of the number of persons and the number of hours worked. The unemployment rate has been declining further and broader indicators show that underemployment (e.g. involuntary part-time work) also has been receding.

In the four quarters up to mid-2018, employment in the euro area increased by 1.6% from the four preceding quarters and thus at the same pace as in 2017. Despite slower GDP growth in the first half of 2018, headcount employment continued to expand robustly at an unchanged rate of 0.4% quarter-on-quarter in both the first and the second quarter of 2018. Reflecting the ongoing rapid improvement in labour market conditions, the number of people employed in the euro area in the second quarter of 2018 stood 2.4% above the pre-crisis peak recorded in the first quarter of 2008. Employment reached a new record level with more than 158 million people in work. The recent

strength in employment growth has been broad-based across countries and sectors.

Employment has been rising uninterrupted since 2013, benefitting from the ongoing economic expansion, modest wage growth, structural reforms and specific policy measures in some countries. In terms of the number of hours worked, however, the current economic expansion has been less impressive (Graph I.43). Hours worked per person employed increased by 0.3% in the second quarter of this year and even declined in the first. The average hours worked during the expansion have remained broadly stable so far while total hours worked remain below pre-crisis levels. This can be explained by the large share of part-time workers in total employment as well as changes in the sectoral composition of employment.

Graph I.43: Employment and hours worked per employed person, euro area

More recently, the strength of employment growth has brought the multiyear rise in the share of part-time employment to a halt (see Graph I.44).

At the same time, labour supply has expanded rapidly over the past few years. This is mainly thanks to increasing participation rates, but migration within the EU towards Member States with low unemployment and net migration into the EU, have also contributed. (49) The labour force in the euro area and the EU grew strongly in 2017 (+0.5% and +0.6% respectively) compared to the rise in the total population, which lifted the activity rate further. The rise in labour market participation now evident for over a decade, mainly reflects increased activity among older people (55-64) and a parallel decline in the share of younger cohorts (15-24). In 2017 the participation rate hit 77.3% (76.6% in the EU).

…and the unemployment rate fell to a 10-year low in the summer 2018.

Driven by the rise in employment, unemployment in the euro area and the EU fell further over the summer to 8.1% and 6.8% respectively, their lowest levels since 2008.

(49) For example, the Institute for Employment Research (IAB), the Research Institute of the Federal Employment Agency in Germany, reports a total net migration into Germany between 2014 and 2017 of 3.1 million of which net migration from non-EU countries was 1.8 million.
Between January and August 2018, unemployment rates fell for men and women of all age groups. In August 2018, the youth unemployment rate fell to 16.6% in the euro area and 14.8% in the EU, their lowest since end-2008. In parallel, long and very long-term unemployment (those unemployed for a year or more; or for at least two years) have continued decreasing, benefiting from the favourable labour market developments and the ongoing economic expansion. The share of long-term unemployed in total unemployment is still high (43% in the first quarter of 2018 in the EU, 47.3% in the euro area respectively) but is slowly decreasing.

Meanwhile in the euro area, economic slack in the labour market, as measured by broader measures of unemployment (i.e. involuntary part-time, people who do not search actively, or who are not available to take a job within two weeks), has diminished further (see Graph I.45). After five years of economic expansion, fewer and fewer workers are available on the side-lines. Yet, the euro area aggregate masks some large disparities among Member States.

In some countries (e.g. in Germany, Belgium and the Netherlands) and sectors (e.g. construction in Germany), the availability of labour has already become a concern for companies and labour shortages have risen up the list of factors that constrain further economic growth.

The short-term outlook remains favourable...

Short-term indicators pointed to continuing strength in the labour market at the end of the third quarter of 2018, even if a slight but noticeable decline has been registered since the beginning of 2018. The hiring intentions of firms remained well above their long-term average in September, in all sectors of the EU and the euro area, even if they have moderated somewhat from very high levels in sectors such as industry (see Graph I.46). Consumers’ unemployment expectations remain close to historical lows, following a slight pick-up after May 2018.

...while an adjustment of job creation to the pace of economic growth appears to be underway...

Labour market conditions are projected to improve further over the next two years, but at a more moderate pace than in the previous two. Employment creation should continue to benefit from growing economic activity and wage growth levels that, though higher than recent years, remain moderate. In some countries, structural reforms and labour market policies will also play an important role. The pace of job creation over the next two years, however, is projected to moderate as labour shortages increase and GDP growth slows.

The Commission’s quarterly surveys indicate that firms are facing challenges from a tightening labour market. The share of euro area and EU firms mentioning the availability of labour as a factor limiting production in the industry, the services and construction sector stood at (construction) or close (manufacturing and services) has almost steadily increased in recent years (see Graph I.47).

Additional evidence of binding labour shortages comes from the unmet demand for labour, as expressed by the job vacancy rate. It has broadly risen since late 2014 in the euro area and reached its highest value since 2006 at 2.1% in the first
quarter of 2018. The simultaneous increase of the job vacancies rate and the decrease in unemployment could also be linked to increased mismatches, i.e. an outward shift of the Beveridge curve (see Box I.4).

All in all, these arguments suggest that the room for further employment growth in 2019 and 2020 has become more limited. Headcount employment is expected to expand by 1.4% in 2018, 1.0% in 2019 and 0.9% in 2020 in the euro area (respectively 1.3%, 0.9% and 0.7% in the EU27).

...the unemployment rate should continue to recede but more slowly...

The labour force is expected to continue expanding over the next two years, though its growth should moderate slightly from 0.6% in 2018 to 0.4% in 2020 in the euro area, and from 0.5% in 2018 to 0.4% in the EU. The increase in the labour force is set to be supported by the net immigration of workers in regions with strong job opportunities, the expected integration of refugees, and ongoing increases in labour market participation rates.

Reflecting the slowdown in the pace of job creation and the continued growth of the labour force at strong rates, unemployment should continue to decline but more slowly than in recent years. With job creation increasing twice as quickly as the labour force, unemployment rates in both the euro area and the EU should fall towards their pre-crisis troughs and below the NAWRU level. In the euro area, the unemployment rate is forecast to fall to 7.5% in 2020 after 7.9% in 2019 and 8.4% in 2018.

Following its cyclical pattern, labour productivity is projected to rebound only slightly in the euro area and the EU as the economic expansion remains job-rich. Labour productivity should grow by 0.9% in the euro area and 1.1% the EU in 2020, compared to 0.6% and 0.8% respectively in 2018.

...with the disparities among Member States very gradually diminishing.

The labour market situation has improved in all countries under the current economic expansion, with unemployment rates falling in all Member States and employment growing everywhere. Despite moving in the same direction, large differences between unemployment levels are still apparent (see Graph I.48).

Partly explained by structural features, the gap between the highest and lowest unemployment rates remains wide. In August 2018, for example, unemployment ranged from 2.5% in the Czech Republic to 19.1% in Greece (see also Box I.4). Going forward, the range in unemployment rates is expected to narrow further as unemployment rates are forecast to fall most in those countries that were most affected by the crisis.
7. INFLATION

Inflation in the euro area, as measured by the Harmonised Index of Consumer prices (HICP), averaged 2.1% in the third quarter of 2018, its highest level since the fourth quarter of 2012 and slightly more than forecast in the summer (Graph I.49). Headline inflation has been driven mainly by the continued rise in energy prices, which topped 9% during the summer months when oil prices rose. Elevated food price inflation which averaged 2.5% (food, alcohol and tobacco category) in the third quarter, also played a role. Although the effect of energy prices was to some extent expected, given base effects compared to last year’s energy price levels, the continued rise in oil prices and the drop in the euro exchange rate against the US dollar since mid-April, have added further upward pressure on inflation. These developments largely explain the upward revision in headline inflation for 2018 and the first half of 2019. Core inflation, which excludes energy and unprocessed food prices, by contrast, has remained subdued and the pass-through of higher wage growth to underlying price pressures is expected to be gradual and to take longer than previously expected.

Following past episodes of substantial oil price increases between 2007 and 2008 and between 2009 and 2011, the increase in energy inflation was followed by a notable acceleration in processed food prices and, to a smaller extent, service prices (which contains sub-components like transport services which are sensitive to oil price movements). The impact of progressively higher oil prices on non-energy industrial goods inflation appears less uniform, even if oil prices are an important component in many input costs of energy inflation are expected to remain until the first quarter of 2019 before slowly tapering off.

Brent oil prices seem to have stabilised and moved in a narrow range over the summer. Recently, however, they rose again slightly above 80 USD/bbl (at the cut-off date of 22 October), the highest levels recorded this year. As a result, oil price assumptions have been revised higher since the summer and so too their expected impact on headline inflation. According to the revised technical assumptions, the price of Brent oil is expected to peak in the last quarter of 2018 but should remain relatively stable in 2019 before falling marginally in 2020 (see Section I.2). The revisions are larger in euro terms due to the depreciation of the euro against the US dollar, which is the main currency used for trading oil (see Graph I.50). Given the high share of USD-denominated oil imports in the euro area, the depreciation of the euro against the dollar is likely to drive import prices in the euro area further upwards, even though the picture varies quite a lot from country to country. These two factors largely explain the upward revision for headline inflation in 2018 and the first half of 2019, while in 2020 the technical assumptions lead to a phasing out of base effects in energy inflation.
industrial goods. Demand conditions may be a more relevant factor for this category. In the case of unprocessed food inflation, the determining factor may be supply factors, especially weather and harvesting conditions, given that this category is usually a staple of household demand and perishable goods (see Box I.1).

...yet core inflation remains subdued...

Despite the notable increase in the headline rate, core inflation (excluding energy and unprocessed food prices) has been rather muted and moved only little so far this year. It has also been weaker than expected in the summer interim forecast despite the uptick in wages and the projected closure of the output gap in most euro area economies. Core inflation averaged 1.2% in the third quarter, broadly the same as in the first and second quarters.

Services inflation - the main component of domestic price pressures with a weighting of around 55% in the core consumption basket and usually correlated with wage growth – has been relatively contained, rising by only about 1.3% since the beginning of the year. In September, it fell again to slightly below 1.3%, from 1.4% in July and 1.3% in August. Thus the average for the third quarter stood at similar levels to the second, and slightly below the first quarter. Somewhat puzzlingly, service prices related to housing (with a weight of around 10% in the consumption basket), have been stable since 2016 (see Graph I.51). This is despite the fact that actual house prices have been on an upward trend for at least the past five years and have increased by around 4% in the euro area in 2017 alone, and even more in some regions with risks of overheating. An increase in house prices tends to shift demand towards renting due to declining affordability, consequently putting upward pressure on rents. So far, the reported growth in house prices is not having the expected impact on this component of inflation, because rising incomes may have mitigated the impact of house prices on affordability.

...and pipeline pressures remain modest.

Likewise, non-energy industrial goods inflation has not registered any discernible trend. In 2018 it has hovered around last year’s average rate of 0.4%, suggesting competitive pricing pressures along domestic supply chains despite a context of rising oil prices and generally high capacity utilisation across the euro area, as reported by corporate survey respondents. Industrial producer prices excluding energy have also remained modest overall, with some differences within the categories. Non-durable consumer goods inflation slowed during the year to zero in August, while durable consumer goods and intermediate goods inflation firmed to 1.3% and 3.2%, respectively. Total industrial producer prices increased to 4.2% in the same month, driven disproportionally higher by energy producer prices (12%) (see Graph I.52). Industrial import prices have firmed throughout the year, standing at 5.5% in August - reflecting mainly the steep increase in the energy category and the decline of the euro against the US dollar – but have so far had only a limited pass-through on domestic pipeline price pressures.
On the other hand, processed food inflation including alcohol and tobacco (considered as part of core inflation in the European Commission’s analysis) peaked at 3% in April, before moderating to 2.3% in September. While the processed food category is less volatile than unprocessed food inflation because of the latter’s perishability and higher sensitivity to weather and harvesting conditions, it demonstrates rather strong and lagged correlation with energy inflation (see Graph I.53).

Inflation to remain close to 2% in the short term...

The near-term outlook for inflation remains under the influence of base effects in energy in line with commodity price assumptions and to a smaller extent in food prices until the first half of 2019 where headline inflation is projected to stay at levels close to 2%. The impact of higher oil prices on headline inflation is expected to gradually taper off next year as base effects fade away. However, the strong upward trend in oil prices in 2018 is expected to have some lagged impact on the other components of inflation sensitive to oil prices, as producers respond to higher input costs and capacity constraints. Moreover, in 2019, changes in taxes and administered prices in some countries are also expected to influence the quarterly inflation pattern. On average, headline inflation in the euro area is forecast at 1.8% both in 2018 and in 2019.

... but the pass-through of higher wage growth into higher core inflation looks delayed.

Further out, underlying inflation in the euro area is expected to become the main driver of headline inflation. Over the course of 2019 and 2020, it is set to gradually gather pace as labour markets progressively tighten further, wages rise more strongly and the output gap remains in positive territory. While the increase in wage growth in the first half of 2018 (Graph I.54) was broadly expected with tighter labour markets clearly evident in some economies and industries (see Section I.6), the pass-through to domestic prices has so far been rather weak.

This can be seen, for example, in the growing gap between the growth of compensation per employee – which increased noticeably in the first half of 2018, standing at 2.3% in the second quarter - and recent service inflation. Historically, the two are closely correlated, since the part of wages in overall service costs is large (see Graph I.55).

Growth in compensation per employee in the euro area is projected at 2.0% in 2019, a decline compared to a robust 2.3% increase in 2018. The forecast for 2019, however, is strongly affected by the replacement of the CICE (Tax Credit for Competitiveness and Employment) in France (see
Section II.10) - which is recorded as a subsidy to firms until the end of 2018- by a permanent reduction in social security contributions in 2019. Accordingly, the change reduces the contribution of employers in total compensation but not the wages and salaries component; thus it should not have an impact on the take-home pay of households per se. In the rest of the euro area (i.e. the euro area excluding France), compensation per employee is expected to increase by around 2½% next year. In 2020, compensation per employee is projected at 2.4% in the euro area as a whole. The growth of real compensation of employees, after deducting for inflation, should remain positive throughout the forecast horizon.

As a result of the increase in compensation per employee growth this year, unit labour cost growth in the euro area is expected to increase substantially to 1.6% in 2018. In 2019, a decrease to 1.2% is projected that can be associated with the CICE measure in France. In 2020, unit labour costs are projected to increase by 1.5%. These rates essentially bring unit labour cost growth to levels similar to those observed before the crisis, 10 years ago. Labour productivity growth in the euro area is expected to remain relatively stable at around ¾% over the forecast horizon.

The outlook for inflation will therefore hinge in part on the extent to which further wage growth translates into higher domestic underlying inflation, especially after the projected impact of oil price base effects has run its course in the first quarter of 2019. This translation is expected to happen gradually with the impact of higher wages on inflation becoming more pronounced only towards late 2019. Thus, headline inflation in the euro area is expected to average 1.6% in 2020, slower than in 2019, but reflecting also the expected further slowdown in activity in 2020.

**Inflation expectations indicators stabilised despite higher inflation**

After increasing in line with developments in oil prices earlier this year, market-based measures of inflation expectations have been moving sideways despite inflation data coming in above expectations over the summer. This suggests that markets expect the current rate of energy inflation to be temporary. At the cut-off date of this forecast, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at 1.4% (see Graph I.56). Swap rates at the three-year forward three-years-ahead horizon imply an average inflation of 1.5%. On a longer horizon, the widely watched five-year forward five-years-ahead indicator suggests inflation of 1.7%, slightly below the ECB’s definition of price stability in the medium term.

Survey-based measures of inflation expectations have continued to trend slowly upwards. According to the Commission’s surveys, selling price expectations in manufacturing edged up higher in the third quarter of 2018 while that for services stabilised, with both indicators standing above their long-term average. Consumers also reported higher price trends over the past twelve months. Price expectations in the construction sector remain high. Euro area PMI indexes for October show price pressures building up along the supply chain, consistent with a gradual increase in inflation. The assessment of average selling prices in both the manufacturing and services sectors suggest inflation at a more solid clip.

The monthly mean of market forecasters calculated by Consensus Economics stood in October at 1.7% for both 2018 and 2019. The results of the ECB
Survey of Professional Forecasters for the third quarter of 2018 showed average inflation expectations at 1.7% in 2018, 2019, and 2020. Longer-term inflation expectations (for 2023) remained at 1.9%.

**Inflation differentials to narrow**

Aggregate HICP inflation rates continue to mask substantial differences across euro area Member States (Graph I.57). While temporary inflation differentials are usually not seen as a matter of concern, persistent inflation differentials have been among the factors behind the build-up of past imbalances (e.g. price and cost imbalances) in the euro area. By contrast, the narrowing of inflation differentials helps to make financial conditions, as measured by real interest rates, more similar across euro area countries.

By the fourth quarter of 2020, HICP inflation rates at or above the euro area annual average of 1.6% are projected in all euro area economies, except Italy, Ireland, Greece and Cyprus. In 2020, seven euro area Member States are expected to experience inflation at or above 2%; mostly those small euro area countries which are growing strongly and still converging towards average price levels. With most countries projected to record inflation rates within a narrower range, the dispersion of inflation rates, as measured in terms of the unweighted standard deviation, is expected to decline further. The spread between the highest and lowest inflation rate across the euro area is also set to fall to a post-crisis low.

Outside the euro area, inflation differentials are more pronounced; by the fourth quarter of 2020, headline inflation rates are projected to range from 1.5% in Croatia to 3.3% in Romania.

8. **PUBLIC FINANCES**

In 2017, the aggregate public deficit of the euro area continued to fall, supported by robust economic growth and low interest rates. The decline in the aggregate deficit is projected to continue in 2018 before coming to a halt in 2019, for the first time since 2009. Following a slight improvement in 2017, the structural balance\(^{(50)}\) of the euro area is expected to stabilise in 2018 and to worsen slightly in 2019 (see Graph I.58). Debt-to-GDP ratios are projected to fall in almost all Member States over the forecast period, driven by primary surpluses and nominal GDP growth outpacing interest payments on outstanding debt.

By 2020, HICP inflation rates are projected to be at or above the euro area annual average of 1.6% in almost all euro area countries, except Italy, Ireland, Greece and Cyprus. In 2020, seven euro area Member States are expected to experience inflation at or above 2%; mostly those small euro area countries which are growing strongly and still converging towards average price levels. With most countries projected to record inflation rates within a narrower range, the dispersion of inflation rates, as measured in terms of the unweighted standard deviation, is expected to decline further. The spread between the highest and lowest inflation rate across the euro area is also set to fall to a post-crisis low.

Outside the euro area, inflation differentials are more pronounced; by the fourth quarter of 2020, headline inflation rates are projected to range from 1.5% in Croatia to 3.3% in Romania.

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(50) The structural balance corrects the headline balance for both cyclical, one-off and temporary budgetary factors, and hence isolates the impact of discretionary government policy action and interest expenditure.
The forecast for 2019, which for euro area Member States takes into account the measures announced in the Draft Budgetary Plans in October 2018, points to a slight decline in the aggregate budget balance (to -0.8% of GDP in the EU and -0.8% in the euro area), which implies the first deterioration in the headline budget balance since 2009. Nevertheless, budget balances are now considerably lower than 10 years ago, as in 2009 they had reached a trough of -6.6% of GDP in the EU and -6.2% in the euro area.

In 2020, the aggregate budget deficit is set to decline again slightly, based on a no-policy-change assumption. Looking at the drivers of the change in the aggregate budget balance of the euro area (see Graph I.59), the change in the cyclical component of the budget is set to remain positive over the entire 2018-2020 forecast period, since actual economic growth is forecast to outpace potential growth. A positive contribution is also expected from falling interest expenditure in 2018. Conversely, the change in the structural primary balance is projected to contribute negatively in 2019, due to looser discretionary fiscal policies. Finally, one-off measures are set to have a negative impact on the aggregate budget balance in 2019 but to have a positive impact in 2020.

Budgetary outcomes are forecast to be mixed among individual Member States. While around half of EU Member States are expected to keep their budget balance in surplus over the forecast period, some Member States are projected to maintain rather large public deficits. Among them, Romania is set to post a deficit of over 3% of GDP in 2018 and 2019 and over 4% in 2020; Italy is expected to run a deficit close to 3% of GDP in 2019 and over 3% in 2020, under a no-policy change assumption. A deficit greater than 2% of GDP is expected in Spain and France in 2018 and 2019.

Over the forecast period, both revenue and expenditure ratios are set to decline at aggregate level in the EU and the euro area (see Table I.8). In particular, the aggregate expenditure-to-GDP ratio of the euro area is projected to fall by 0.9 pps. (from 47.0% in 2017 to 46.1% in 2020). The decline is partly explained by lower interest expenditure, which is set to fall from 2.0% of GDP in 2017 to 1.8% in 2020. In addition, labour market developments are expected to reduce spending on unemployment benefits (see also Section I.6). The remainder of the fall in the

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**Table I.8:**

<table>
<thead>
<tr>
<th>General government budgetary position - euro area and EU (as % of GDP)</th>
</tr>
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<tbody>
<tr>
<td><strong>Autumn 2018 forecast</strong></td>
</tr>
<tr>
<td>Total receipts (1)</td>
</tr>
<tr>
<td>Total expenditure (2)</td>
</tr>
<tr>
<td>Actual balance (3) = (1)-(2)</td>
</tr>
<tr>
<td>Interest expenditure (4)</td>
</tr>
<tr>
<td>Primary balance (5) = (3)+(4)</td>
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<tr>
<td>Cyclically-adjusted primary balance (a)</td>
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<tr>
<td>Structural budget balance (b)</td>
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<tr>
<td>Change in structural budget balance (a)</td>
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</tbody>
</table>

**Graph I.59:** Breakdown of the change in the aggregate general government balance, euro area

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(a) as a % of potential output. The structural budget balance is the cyclically-adjusted budget balance net of one-off and other temporary measures estimated by the European Commission.

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Notes:

51. More specifically, the change in the cyclical component is set to give a positive contribution of around 0.3 pps. of GDP in 2018, 0.1 pp. in 2019 and 0.1 pp. in 2020.

52. The aggregate structural primary balance is projected to deteriorate by 0.3 pps. in 2019 and stabilise in 2020.

53. In 2019, sizeable negative one-offs are expected to affect the budget balance in France (see Section II.10 for more details). Examples of typical one-offs include revenues from tax amnesty and from sales of non-financial assets, and expenditure related to short-term emergency costs or to the financial crisis (for more information on one-off measures see European Commission (DG ECFIN). (2015). ‘Report on Public Finances in EMU 2015’. Institutional Paper 14).
expenditure ratio reflects the denominator impact from actual GDP growth above potential growth. (54)

In terms of the quality of public spending, the aggregate public investment-to-GDP ratio in the euro area is projected to increase marginally, from 2.6% in 2017 to 2.7% in 2018-2019 and 2.8% in 2020, which is still below its pre-crisis average (3.2% of GDP over 2000-2007). (55) Public investment is expected to benefit from the implementation of the 2014-2020 programming period of EU funding, as well as from the Investment Plan for Europe. Positive cyclical developments are set to reduce the weight of social transfers as a share of total general government expenditure in the euro area aggregate by 2020, despite additional discretionary spending in some Member States. The weight of the wage bill on public expenditure is set to stabilise by 2020 (see Graph I.61).

The revenue-to-GDP ratio of the euro area aggregate is projected to decline by 0.6 pps. over the forecast period (from 46.1% in 2017 to 45.5% in 2020), mainly reflecting the projected fall in social contributions. This decline is largely due to the impact of discretionary measures taken by governments, while underlying revenue developments appear to be in line with the projected increase in nominal GDP. (56)

(54) By comparison, the primary expenditure ratio of the euro area is set to remain broadly stable over 2017-2020 when computed in terms of potential GDP.

(55) By 2020, the fall in public investment relative to the pre-crisis period would remain sizeable in Spain and Portugal (about -2 pps. of GDP), Ireland and Malta (about -1.5 pps.), Greece and Italy (about -1 pp.).

(56) For further details on expenditure and revenues elasticities see Mourre, G., C. Astarita and S. Princen (2014).

...with the debt ratio remaining on a declining path.

The aggregate general government debt-to-GDP ratio of the euro area has been on a declining path since 2014 (see Table I.9), when it reached a peak of 94.2% (88.1% in the EU). In 2017, the debt ratio fell to 88.9% (83.2% in the EU) and is projected to fall further over the forecast period to reach 82.8% in 2020 (77.6% in the EU), under a no-policy-change assumption. In the euro area, the deleveraging of the government sector is supported by low interest rates paid on debt and robust nominal GDP growth, implying a debt-decreasing snowball effect. (57) Over the forecast period, positive cyclical conditions should also help to keep a debt-decreasing primary surplus of around 1.0% of GDP for the euro area aggregate on average (see Graph I.62). Over 2018-2020, the debt-to-GDP ratio is projected to increase only in Romania, due to a large primary deficit. The debt ratio is now forecast to remain relatively stable in Italy, where the snowball effect is projected to provide a debt-increasing contribution.

The debt-to-GDP ratio in 2020 is expected to remain above 100% in three Member States (Greece, Italy, and Portugal), and above 90% in four others (Belgium, Spain, France and Cyprus).
Monetary conditions in the euro area remain very accommodative, overall. Based on the standard technical assumptions, short-term money market rates will remain unchanged for the remainder of 2018 before increasing gradually in 2019 but they should remain very low overall in both nominal and real terms. In addition, a further gradual increase in long-term inflation expectations should keep real long-term financing costs negative. As regards the fiscal policy stance, as measured by the change in the structural budget balance, it turned broadly neutral in 2015 and is expected to remain so in 2018. In 2019, the aggregate fiscal policy stance of the euro area is set to become slightly expansionary.

9. MACROECONOMIC POLICIES IN THE EURO AREA

Monetary conditions are expected to remain accommodative

The assumed gradual pace of monetary policy normalisation by the ECB, in conjunction with continued economic growth in the euro area and gradually strengthening core inflation should put some upward pressure on nominal rates over the forecast horizon. Nonetheless, given that rates are low at present and that the rate of normalisation is expected to be only very gradual, financing conditions in the euro area should remain very loose by historical standards. Accordingly, nominal long-term rates, which have decreased somewhat since the spring, started to pick up again in August and September and are expected to continue to trend up modestly. The high stock of assets purchased under the Expanded Asset Purchase Programme (EAPP) in the Eurosystem’s balance sheet, in combination with the continued reinvestment of maturing securities, should ensure that nominal long-term rates stay low, overall. Empirical evidence suggests that the portfolio rebalancing effect of asset purchases on bond market yields works predominantly via the size of the stock of purchased assets rather than the size of the monthly flows.
May (see Graph I.63). Real long-term interest rates, which have been negative since mid-2014, decreased somewhat in the second quarter before edging higher again in August and September. This behaviour mirrors the developments in nominal rates that were amplified somewhat by opposite movements in longer-term inflation expectations.

Looking ahead, overnight rates are assumed to remain close to current levels until the second quarter of 2019 and to increase rather gradually thereafter, as suggested by EONIA forward rates. At the time of writing, markets had fully priced in a 10 bp. rate hike only for autumn 2019. This is broadly in line with the ECB Governing Council’s forward guidance, according to which interest rates are expected to remain at present levels at least through the summer of 2019. As inflation is expected to remain at its current level for the remainder of the year and decrease somewhat over the course of 2019 and 2020, this should lead to a roughly flat profile for real short-term interest rates for the remainder of 2018, and a gradual increase in the following years. Nonetheless, real short-term rates should remain clearly negative. At the same time, forward rates suggest a continued gradual rise in nominal long-term rates over the forecast horizon, which should also translate into higher, but still negative, real long-term rates, as long-term inflation expectations increase at a much slower pace.

The transmission of these developments to nominal financing conditions in the non-financial private sector is captured by the composite credit cost indicators (CCCI) for non-financial corporations and households (see Graph I.64), for which developments at the long end of the term structure typically dominate. In line with the gradual changes in nominal money market rates, developments in credit costs have been rather muted since the spring. While credit costs have decreased marginally in net terms for households on account of slightly lower rates on housing loans, the CCCI for non-financial corporations has edged up marginally from very low levels, reflecting both an increase in corporate sector bond yields and somewhat higher bank lending rates for medium-term loans.

Fiscal policy broadly neutral in 2018 and slightly expansionary in 2019

Following the strong consolidation achieved between 2011 and 2014, the fiscal policy stance in the euro area has been neutral overall since 2015 and is expected to remain broadly so in 2018. In 2019, the euro area fiscal policy stance is projected to become slightly expansionary (see Graph I.65).

Real rates are derived from the respective short- or long-term rate minus annual HICP inflation and expected average inflation according to 10-year inflation swaps, respectively. Forecasts are derived from futures and forward rates, deflated by the Commission’s inflation forecast and market-based measures of inflation expectations.

The CCCI are calculated as weighted averages of interest rates on different types of bank loans and corporate bonds (in case of non-financial corporations).

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(60) Real rates are derived from the respective short- or long-term rate minus annual HICP inflation and expected average inflation according to 10-year inflation swaps, respectively. Forecasts are derived from futures and forward rates, deflated by the Commission’s inflation forecast and market-based measures of inflation expectations.
The discretionary fiscal effort, an alternative indicator to assess the fiscal policy stance shows a slightly expansionary fiscal stance between 2018 and 2020. The negative fiscal effort mainly reflects discretionary revenue cuts, also visible in the reduction in the structural revenue ratio (see Graph I.66). Moreover, primary expenditure is set to increase more than medium-term potential growth.

Five euro area Member States with high debt-to-GDP ratios (Belgium, Spain, France, Italy and Portugal) are forecast to have a sizeable structural deficit in 2019 and thus, pending adjustment needs (see Graph I.68).

The policy mix in the euro area in 2018 reflects the interplay between financing conditions and fiscal policy (see Graph I.69). On the monetary side, the additional measures taken by the ECB since the end of 2014 have exerted a significant downward pressure on nominal long-term rates in recent years and real long-term interest rates are anticipated to remain in negative territory over the forecast horizon. However, monetary easing has only been partially transmitted to real rates, as long-term inflation expectations also declined over the same period and only started to pick up towards the end of 2016. Meanwhile, the continued appreciation of the euro in recent years has had a slight tightening effect on broader monetary conditions in the euro area.

Regarding the distribution of the fiscal stance, eleven euro area Member States are projected to have a neutral or broadly neutral fiscal stance combined with a positive output gap in 2019 (see Graph I.67). Looking at the five largest euro area Member States, France and Spain are set to keep a broadly neutral fiscal stance, while Germany and the Netherlands are expected to use part of their fiscal space to support growth. A loose fiscal stance is projected in Italy.

### Footnotes

For 2018, average real long-term rates (derived from the 10-year swap rate deflated by inflation expectations) are expected to be only slightly higher than in the previous year. They are expected to increase further in 2019 in the context of monetary policy normalisation, albeit at a gradual pace. Thus, overall financing conditions should remain very supportive. At the same time, the overall fiscal policy stance is expected to remain slightly supportive for growth.

10. RISKS

The EU economy is facing a very high level of uncertainty, including with respect to economic policies and future trading relationships. At the same time, the downside risks surrounding the central scenario are characterised by a high degree of interconnectedness, which could magnify their impact on the EU economy. These risks are more likely to materialise in 2020 than before. Overall, risks to the growth outlook are skewed to the downside.

Increasing uncertainties could weigh more heavily on economic growth

Uncertainties have increased since the start of the year, mainly with respect to trade policies and the future of multilateralism. The latter is evident in the US where trade policy uncertainty has substantially increased as trade rhetoric escalated and trade tensions intensified in 2018 (see Graph I.70). Furthermore, the upcoming electoral cycles in the US create some uncertainty with regard to the US fiscal policy stance in 2020.

These uncertainties are already weighing on economic growth in the euro area, but it cannot be excluded that the effects could turn out to be stronger than currently expected.

Uncertainty affects various segments of the economy, including investment where it could lead companies to delay or reduce investment spending, and private consumption, where consumers could increase precautionary savings. The negative impact of uncertainty on investment could lower the efficient allocation of resources as the most productive firms abstain from expanding; market entry of new firms is delayed; or production chains, particularly cross-border chains, are reconsidered in anticipation of distortionary trade policy decisions, for example.

While the central scenario takes into account all effects that are sufficiently assessable, uncertainty about the magnitude and timing of further protectionist measures and counter measures means that not all potential effects are incorporated. Thereby the elevated uncertainty adds to the margin of errors that is unavoidably involved in all macroeconomic forecasts.

Downside risks are highly interconnected...

Since the forecast in spring, some risks have fully or partly materialised and entered the central scenario, such as the introduction of additional protectionist measures. Nevertheless, in autumn, the risks to the GDP growth forecast are wider than before and they remain tilted to the downside. The main downside risks to the economic growth forecast are closely interconnected, and could amplify each other.
Risks to the growth projections originate from several major sources: (a) In the US, an overheating in the near-term and a faster monetary tightening as well as an abrupt reversal of fiscal policy in 2020, could lead to a sharper deceleration of the economy; (b) In emerging markets financial turmoil could spill over more widely if a sharp tightening of global financial conditions were to raise debt servicing costs and increase refinancing risks, particularly in countries with large dollar-denominated debt, which could lead to capital outflows that would damage growth and financial stability with possible contagion effects to Europe; (c) Across countries, a further escalation of trade conflicts could weigh on trade flows and distort cross-border production links; (d) In China, several triggers could derail the economic rebalancing towards a more services and consumption-based growth model, including the effects of trade tensions and political instability linked to a further increase in debt in a context of already high public and corporate debt; (e) In the euro area, there are risks from financial tensions linked to the resumption of sovereign-bank loops; and (f) In Europe, the outcome of the Brexit negotiations could lead to a more disruptive impact on the EU-UK trade relationship than currently envisaged under the purely technical assumption on trade relations after the UK’s exit from the EU.

These areas are closely related and the risks, should they materialise, could not only trigger the materialisation of other risks, but could also amplify each other (see Graph I.71). With vulnerabilities in a number of EU Member States linked to high levels of public and private debt, and in some cases, impaired bank balance sheets, the impact on economic growth could be large. For example, overheating in the US could lead the Fed to tighten monetary policy faster than assumed. This could alter the risk attitude of investors with detrimental effects on the US economy given the high level of corporate leverage. It would also hit emerging market economies and result in negative spillovers to advanced economies. The ensuing deterioration of the US current account could also lead to a further escalation of trade disputes. This could particularly hit China, where high and rising corporate debt represents a financial fragility, which could be further aggravated if Chinese authorities respond by carrying out domestic stimulus or depreciate the currency in response to foreign trade protectionism. The attempt to shore up growth via domestic policies would heighten the risk of a disorderly adjustment. Such shocks could add up and negatively impact on global trade and activity, disrupting cross-border supply chains.

As a relatively open economy with strong trade links and banks exposed to emerging markets, the EU would suffer. A key transmission channel from the US to Europe could operate via term premia, which are usually highly correlated across sovereigns. While the US monetary tightening cycle has so far seen a compression of term premia to the lowest levels in a decade, a sudden rise in US term premia could also impact on long-term interest rates in Europe and thereby negatively affect interest-rate sensitive spending decisions in Europe.

As regards rising protectionism and the retreat from multilateralism, the central scenario of the forecast assumes that a further escalation of trade disputes will be avoided. But tariffs in place so far may only be the tip of the iceberg relative to those under review or threatened. Non-tariff trade barriers (e.g. rules on the production of goods) and the size of tariff rates come to mind, and even threatened tariffs can have a negative impact. They would challenge the international production fragmentation that has been one of the most important features of globalisation in recent decades. (63) Additionally imposed tariffs or higher tariff rates would not only have a direct impact on global growth, they could also exert negative effects via secondary transmission channels that amplify the negative impacts of an escalation in a

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tit for tat trade war. Such secondary transmission channels via global supply chains have the potential to substantially amplify negative drags from tariffs, even if the nominal amounts are low.

In the euro area, overly expansionary fiscal policies insufficiently addressing potential growth objectives could create doubts about fiscal sustainability in high-debt countries. Concerns about sovereign debt paths risk fuelling a decompression of risk premia and could lead to a more general repricing of risks that could hit sovereigns and spread through the banking system. Such a risk reappraisal could cause sovereign-bank loops between vulnerable banks, indebted sovereigns and weak economies to take hold in some high-debt euro area countries, most notably Italy, as financing costs for the banking sector would increase and the repair of bank balance sheets would be hampered. Although unconventional monetary policy in the euro area has altered the link between fundamentals and spreads, sovereign-bank loops could hurt the real economy via higher interest rates and reduced credit supply due to increased leveraging needs for banks. Moreover, such events could hurt economic sentiment, which would further weigh on economic activity and could imply that measures taken with the aim of stimulating economic activity could actually have an adverse impact.

Given the ongoing negotiations on the terms of the UK’s withdrawal from the EU in March 2019, and a proposed transition period until the end of 2020, the forecast for 2019 and 2020 is based on the purely technical assumption of status quo in terms of trading relations between the EU27 and the UK. The uncertainty around the future status of the UK outside the EU is expected to weigh on UK growth. There are large downside risks to the forecast, particularly in the case of a no deal scenario. The results of relevant studies generally show that Brexit is a lose-lose situation economically. As there is no frictionless trade outside the EU customs union and single market, trade between EU27 Member States and the UK will be affected by Brexit. Under any scenario, the impact is expected to be much larger on the UK than on the EU27 overall. The EU27 is preparing for any scenario.

 widens the range of possible outcomes...

In addition to the aforementioned strong downside risks that surround the global outlook, including the euro area outlook, a number of risks identified in previous forecast rounds remains in place. They include heightened geopolitical tensions (e.g. Syria, Iran, Ukraine), which could be enhanced by the strict imposition of secondary sanctions on EU-based companies in the cases of Russia and Iran.

Moreover, some of the technical assumptions underlying the forecast also constitute risks. Oil prices, for instance, could rise stronger than assumed due to export declines in some oil producing countries, for example Iran, in response to US sanctions and secondary sanctions against Europe.

There are fewer elements that could cause an upside surprise. Labour market reforms and migration might have expanded labour supply more than currently estimated, which would widen the scope for employment growth and make labour shortages a less binding supply-constraint than currently expected in the central scenario. The past increase in capacity utilisation rates could also have a stronger impact on investment than currently expected. Moreover, a reduction of trade-
related uncertainties could release stronger growth momentum than currently envisaged. The recent agreement on a successor to NAFTA, the US-Mexico-Canada trade agreement (USMCA) provided evidence that a reduction of trade tensions is a possibility that cannot be excluded.

...and implies that risks to growth are tilted to the downside.

To assess the importance of risks the possible impact of their materialisation is crucial. In that regard, the more than five years of uninterrupted economic growth and the improvements made to the architecture of the EU and the euro area have raised the resilience of the economy against shocks. Gauging against this background the aforementioned upside and downside risks, two results emerge: the dominance of downside risks and the relatively wide band of possible outcomes surrounding the central scenario. This is visualised in the fan chart (Graph I.72), which shows the uncertainty around the central scenario for euro area GDP growth with different confidence intervals.

The very high degree of uncertainty of the central projection is reflected by the large width of the fan chart, most notable in 2020, and the depicted skew of the distributions of the forecasts illustrates the balance of risks of the forecasts, which is seen on the downside.

...whereas risks to the inflation outlook appear broadly balanced.

Risks to the inflation outlook have changed since spring, but their balance is considered to be roughly even. Some of the formerly identified upside risks have already partly materialised (e.g. a sharper increase of oil prices) and thus entered the central scenario, whereas other risks have become more pronounced, such as the price pressures from tariffs.

On the upside, a faster-than-expected recovery, or substantially higher oil prices, which could come from geopolitical tensions in the Middle East or new sanctions against oil-exporting countries, could push HICP inflation in the EU beyond the forecast levels. A faster pick-up of inflation could also originate from bottlenecks in the labour market that push wages much higher.

Downside risks relate to the impact of less dynamic economic growth, which could negatively affect the expected pick-up of wages and slow the build-up of domestic price pressures more than incorporated in the central scenario. The complex web of downside risks surrounding the economic outlook could, if they materialise, dampen the upward movement of energy and commodity prices, which would reduce import prices and keep a lid on external price pressures.