The European economy continued to weather external headwinds in the second half of 2019 thanks to the strength of domestic drivers. Growth in the euro area turned out better than expected in the third quarter but disappointed at the end of the year. Leading indicators suggest that manufacturing output may stabilise in the months to come, although an upturn is not yet on the cards. However, with hints of a bottoming out in global trade flows, and as the dampening impact of domestic inventory adjustment fades, a trough may have been reached. With continued real income gains, a supportive policy mix and a construction sector buoyed by low borrowing costs, the European economy is well placed to navigate the challenging external environment, high trade policy uncertainty and dampening structural factors. This is, however, a fragile equilibrium, which could be easily derailed by unforeseen events.

Overall, the European economy remains on a path of steady and moderate growth. Over the next two years, annual GDP growth in the euro area is expected to settle at 1.2%, the same as in 2019. The outlook for 2020 and 2021 is unchanged since the autumn, as more positive developments are counterbalanced by negative events elsewhere. Economic fundamentals should provide the necessary resilience to external headwinds but remain insufficient to propel growth on to a higher trajectory. Much will depend on the performance of domestic growth engines and of the labour market. The pick up in core inflation since the autumn provides tentative evidence of a stronger pass-through of higher wages. Still, domestic price pressures are expected to build up only slowly as firms are likely to continue tolerating lower profit margins. On the back of supportive monetary policy, slightly higher oil price assumptions and some upward momentum in underlying price pressures, euro area headline inflation has been revised slightly upwards, to 1.3% in 2020 and 1.4% in 2021.

Since the autumn, some developments appear to have reduced downside tail risks while new ones have emerged and others continue to linger, leaving the balance of risks tilted to the downside. The ‘Phase One’ trade deal between the US and China has reduced tensions to some extent. Still, uncertainty around US trade policies remains high, creating obstacles for a widespread rebound in business sentiment. Political and social unrest in Latin America risks derailing the economic recovery in the region, while heightened geopolitical tensions in the Middle East have increased the risk of an escalating conflict. While there is now clarity about trading relations between the EU and the UK until 31 December 2020, there is still considerable uncertainty about the long-term relationship and the possibility of an abrupt change in trading relations at the end of the year. All these events interplay with still prominent medium-term downside risks, which include debt-related financial vulnerabilities and stretched asset valuations.

The outbreak and spread of the ‘2019-nCoV’ coronavirus and its impact on public health, human lives and economic activity has been a source of mounting concern. It has spurred uncertainty about the short-term prospects of the Chinese economy and about the degree of disruption across borders at a moment in which global manufacturing activity remains at a cyclical low. The baseline assumption is that the outbreak peaks in the first quarter, with relatively limited global spillovers. The duration of the outbreak, and of the containment measures enacted, are a key downside risk. The longer it lasts, the higher the likelihood of knock-on effects on economic sentiment and global financing conditions.