OVERVIEW

The EU recovery is firming …

Europe's economic recovery, which began in the second quarter of 2013, is expected to continue spreading across countries and gaining strength while at the same time becoming more balanced across growth drivers. As it is typical following deep financial crises, however, the recovery remains fragile. Nevertheless, recent positive economic news means that the forecasts for GDP growth this year and next have been raised slightly since the autumn. EU GDP, which rose 0.1% in 2013, is now expected to rise 1.5% this year and 2.0% next year, while growth in the euro area, which was -0.4% for 2013 as a whole, is expected to be 1.2% in 2014 and 1.8% in 2015. After two years of contraction, domestic demand is gently firming, as the crisis' legacy of excessive debt, financial fragmentation, economic uncertainty and the need for adjustment and fiscal consolidation fades, and confidence is improving. The fiscal stances of the EU and euro area this year are expected to be broadly neutral. At the same time, rising import demand means that external trade's contribution to growth will become more muted. In line with these developments, unemployment should fall slightly from its peak, as the labour market turns the corner. The forecast for inflation in the EU and the euro area

Table 1:

Overview - the winter 2014 forecast

	Real GDP				Inflation				Unemployment rate			
		Winter 2014 forecast				Winter 2014 forecast				Winter 2014 forecast		
	2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015
Belgium	-0.1	0.2	1.4	1.7	2.6	1.2	0.9	1.4	7.6	8.4	8.5	8.2
Germany	0.7	0.4	1.8	2.0	2.1	1.6	1.4	1.4	5.5	5.3	5.2	5.1
Estonia	3.9	0.7	2.3	3.6	4.2	3.2	1.8	2.8	10.2	8.8	8.3	7.7
Ireland	0.2	0.3	1.8	2.9	1.9	0.5	0.8	1.1	14.7	13.1	11.9	11.2
Greece	-6.4	-3.7	0.6	2.9	1.0	-0.9	-0.6	0.2	24.3	27.3	26.0	24.0
Spain	-1.6	-1.2	1.0	1.7	2.4	1.5	0.3	0.9	25.0	26.4	25.7	24.6
France	0.0	0.3	1.0	1.7	2.2	1.0	1.2	1.2	10.2	10.8	11.0	11.0
Italy	-2.5	-1.9	0.6	1.2	3.3	1.3	0.9	1.3	10.7	12.2	12.6	12.4
Cyprus	-2.4	-6.0	-4.8	0.9	3.1	0.4	0.4	1.4	11.9	16.0	19.2	18.4
Latvia	5.2	4.0	4.2	4.3	2.3	0.0	1.9	2.1	15.0	11.9	10.5	9.2
Luxembourg	-0.2	2.1	2.2	2.5	2.9	1.7	1.5	1.7	5.1	5.9	6.0	5.9
Malta	0.9	2.0	2.1	2.1	3.2	1.0	1.2	1.9	6.4	6.5	6.4	6.4
Netherlands	-1.2	-0.8	1.0	1.3	2.8	2.6	1.1	1.3	5.3	6.7	7.4	7.2
Austria	0.9	0.3	1.5	1.8	2.6	2.1	1.8	1.8	4.3	4.9	4.8	4.7
Portugal	-3.2	-1.6	0.8	1.5	2.8	0.4	0.8	1.2	15.9	16.5	16.8	16.5
Slovenia	-2.5	-1.6	-0.1	1.3	2.8	1.9	0.8	1.3	8.9	10.2	10.8	10.7
Slovakia	1.8	0.8	2.3	3.2	3.7	1.5	0.7	1.6	14.0	14.2	13.9	13.4
Finland	-1.0	-1.5	0.2	1.3	3.2	2.2	1.7	1.6	7.7	8.2	8.3	8.1
Euro area	**-0.7**	**-0.4**	**1.2**	**1.8**	**2.5**	**1.4**	**1.0**	**1.3**	**11.4**	**12.1**	**12.0**	**11.7**
Bulgaria	0.8	0.6	1.7	2.0	2.4	0.4	0.5	1.8	12.3	12.9	12.7	12.1
Czech Republic	-1.0	-1.2	1.8	2.2	3.5	1.4	1.0	1.8	7.0	7.0	6.8	6.6
Denmark	-0.4	0.3	1.7	1.8	2.4	0.5	1.5	1.7	7.5	7.0	6.9	6.7
Croatia	-2.0	-0.7	0.5	1.2	3.4	2.3	1.3	1.5	15.9	17.6	17.6	17.2
Lithuania	3.7	3.2	3.5	3.9	3.2	1.2	1.1	1.9	13.4	11.8	10.4	9.6
Hungary	-1.7	1.1	2.1	2.1	5.7	1.7	1.2	2.8	10.9	10.2	9.6	9.3
Poland	1.9	1.6	2.9	3.1	3.7	0.8	1.4	2.0	10.1	10.4	10.3	10.1
Romania	0.7	3.5	2.3	2.5	3.4	3.2	2.4	3.4	7.0	7.2	7.2	7.1
Sweden	0.9	0.9	2.5	3.3	0.9	0.4	0.9	1.8	8.0	8.0	7.7	7.3
United Kingdom	0.3	1.9	2.5	2.4	2.8	2.6	2.0	2.0	7.9	7.6	6.8	6.5
EU	**-0.4**	**0.1**	**1.5**	**2.0**	**2.6**	**1.5**	**1.2**	**1.5**	**10.5**	**10.9**	**10.7**	**10.4**
USA	2.8	1.9	2.9	3.2	2.1	1.5	1.6	1.9	8.1	7.4	6.5	5.8
Japan	1.4	1.6	1.6	1.3	0.0	0.4	2.5	1.2	4.3	4.0	3.8	3.8
China	7.8	7.7	7.4	7.4	2.6	2.5	2.4	2.4	:	:	:	:
World	**3.1**	**2.9**	**3.6**	**3.9**	**:**	**:**	**:**	**:**	**:**	**:**	**:**	**:**

has been lowered significantly since the autumn. Inflation in the EU is now expected to dip to 1.2% in 2014 before rising again to 1.5% in 2015. In the euro area, inflation is seen at 1.0% in 2014 and 1.3% in 2015.

…while the global environment is differentiated

The world economy picked up in the second half of last year, driven by stronger growth in advanced economies, especially in the US, but also by a rebound in some emerging market economies. Growth is expected to accelerate for most advanced economies outside the EU. In the US where the headwinds from fiscal policy have been waning, private consumption is gaining speed benefitting from robust job creation and rising house prices, while the Federal Reserve has initiated a gradual shift towards less accommodative monetary policy. In Japan, growth is expected to remain relatively stable in 2014. Among emerging market economies, the picture is uneven. There are continued signs of weakness in Russia and Brazil, some stabilisation at more sustainable growth rates in China and an improved outlook for India. Recent financial tensions have so far mostly affected emerging markets with relatively weak macroeconomic fundamentals, such as Argentina, Turkey and South Africa, while the EU Member States have been largely spared so far.

After lacklustre 2013, economic activity outside the EU is expected to accelerate to about 4% this year and 4½% in 2015. Global trade is forecast to rise more than GDP, with world import growth doubling from 2½% in 2013 to about 5% in 2014 and rising to 6% in 2015, reflecting both the strengthening of the global recovery and the impetus from trade-intensive sectors. Over the forecast horizon, oil prices are forecast to continue declining along the same path as assumed in November, supported by adequate supply. The nominal exchange rate of the euro against main trading partners (based on the technical assumption of unchanged nominal exchange rates) is now projected about 2% higher than last autumn.

Adjustments within the EU begin to bear fruit

The recovery in Europe is expected to be broad-based across EU Member States as activity has also started to strengthen in the vulnerable countries of the euro-area periphery. Growth differentials persist but the gap is projected to narrow. In 2014, only *Cyprus* and *Slovenia* are still expected to register negative annual GDP growth rates. By 2015 all EU economies are expected to be growing again. Internal and external adjustment in vulnerable Member States is progressing, underpinned in many cases by significant structural reforms that are starting bearing fruit. *Ireland* has successfully completed its financial assistance programme in December 2013. Driven by strong exports, growth is significantly firming in *Spain* and *Portugal*, while a moderate rebound is expected in *Greece*. Among the bigger economies, a steady domestic demand-driven expansion is expected over the forecast horizon in *Germany*, while in *France* economic growth is only slowly recovering, supported by a timid pick up in private consumption. Mild economic recoveries in the *Netherlands* and in *Italy* are set to be driven by net exports and investment. Strong growth is foreseen in the *United Kingdom* and in *Poland* on the back of increasingly robust domestic demand.

Final demand is rebalancing …

The rebalancing of Europe's growth engines is confirmed as domestic demand overtakes exports as main thruster. The strengthening of domestic demand, though still expected to be modest in 2014, will be fuelled by all components, both private and public.

Investment growth, in particular investment in equipment, is projected to significantly strengthen, as the main impediments to firms' demand and profits (uncertainty, financing conditions, deleveraging needs) are slowly receding, and the improvement in the economic outlook is confirmed. Uncertainty has significantly receded over the past year and a half and should continue to do so under the assumption of smooth policy implementation at the EU and Member-State levels. Financing conditions are also expected to improve and to support further investment spending.

Private consumption showed only marginal growth at the onset of the recovery but is expected to gain momentum over 2014-2015, as the labour market slightly improves, real disposable incomes benefits from low consumer price inflation and the drag of fiscal consolidation diminishes. In line with improved confidence and lower precautionary savings, households are expected to spend most of the increase in real income. Public consumption is also expected to pick up as fiscal consolidation needs become less acute.

…and external imbalances are receding in vulnerable Member States

The current-account surpluses of both the EU and the euro area increased in 2013 and are expected to remain broadly stable (at respectively 1½% and 2¼% of GDP) this year and next. Most of the recent strengthening is the result of significant adjustment, involving improved exports but also a largely permanent contraction in domestic demand, in the euro-area Member States that previously recorded high deficits. This external rebalancing is supported by enhanced price competitiveness resulting from lower unit labour costs. High external indebtedness, however, requires the external adjustment in some Member States to go further still.

Financial market conditions are improving…

Financial market conditions in the EU improved in 2013, as a result of the better macroeconomic outlook and sustained low-interest rate environment. Financial fragmentation considerably receded in the sovereign- and corporate-debt markets, with most bond spreads of vulnerable Member States continuing to narrow, thanks to investor confidence in the success of the ongoing fiscal adjustment and economic reforms. However, despite some normalisation in bank funding conditions, financial fragmentation on the euro-area lending market continues to impair the transmission of monetary policy, hurting mainly small and medium-sized enterprises. The ECB's comprehensive assessment of banks' balance sheets and a smooth implementation of the Banking Union should further reinforce confidence in European banks and fan the recovery.

…and the fiscal stance is now close to neutral

Substantial improvements in public finances have been achieved in the EU since 2011. On the basis of policy measures already approved by national parliaments or known with sufficient detail, the fiscal stance is expected to be close to neutral over the forecast horizon. The fiscal effort this year, measured in terms of change of the structural balance, is indeed expected to be broadly neutral in the EU and in the euro area. At the same time, fiscal consolidation is expected to move gradually from revenue measures to expenditure control. Headline fiscal deficits are set to shrink further in 2014 (to around 2¾% of GDP in the EU and 2½% of GDP in the euro area) before stabilising in 2015 under the assumption of no policy change. The debt-to-GDP ratio is expected to peak in 2014 at 90% in the EU and at 96% in the euro area.

Labour markets improve only slowly …

Labour market conditions stabilised in mid-2013 but only a small improvement is expected in 2014 and 2015 because labour markets typically react with a certain lag to rebounds in economic activity and the recovery remains modest. In the early phase of the recovery, private employment growth is expected to be dampened by the usual adjustment in working hours. Decisive structural reforms implemented in some Member States may shorten this period and help prevent the very high level of unemployment from becoming structural. Employment in the EU and the euro area is expected to start rising modestly in 2014 by ½% and about ¼% respectively, slightly better than projected last autumn. This increase will not yet be sufficient to meaningfully curb unemployment in the EU, but it will trigger a stabilisation of the unemployment rate in the euro area. In 2015, employment growth is set to accelerate to ¾% in both areas, resulting in a slight reduction of unemployment to 10.4% in the EU and 11.7% in the euro area. Labour markets will continue to perform differently across Member States.

…and inflation remains subdued

Headline inflation decreased markedly over the course of 2013, particularly in the last quarter of the year, due to falling energy and commodity prices, weak demand, the fading impact of some temporary factors, and the continued appreciation of the euro. The expectation that the output gap will close only slowly suggests that weak demand will continue to contribute to low inflation. Subdued pressures are expected to keep consumer price inflation down to 1.2% in the EU and 1.0% in euro area in 2014. Only a slight increase is expected for 2015 when economic growth gains momentum. Low inflation is expected to support private consumption because it boosts real disposable incomes. However, since inflation expectations have been sagging, real interest rates have actually risen since the autumn. Moreover, low aggregate inflation makes it harder for vulnerable countries to gain price competitiveness and increases the real value of both public and private debts.

A risk of protracted low growth

Risks to the growth outlook have become slightly more balanced, but still weigh more heavily on the downside. The main risk to the forecast would be stalling or partial implementation of structural, fiscal and institutional reforms at Member States or European level, resulting in low actual and potential growth and protracted high unemployment. A weaker than projected labour market would have both short- and medium-term detrimental effects on private consumption and also on potential growth. Moreover, the debt overhang, the investment shortfall in recent years and slowing total factor productivity could hurt growth in the medium term if they are inadequately addressed by structural reforms, resulting in an extended period of low growth. The risk of low growth would be exacerbated in the short term by lower than expected inflation and a slower reduction in financial fragmentation.

Inflation could turn out lower than the current forecast if economic agents were to perceive the current very weak price pressures as becoming entrenched. Lower inflation would increase real interest rates with negative effects on growth and on the real debt burden. However, confidence is rising and growth is picking up so there is only a marginal probability of shocks large enough to initiate outright EU or euro-area wide deflation.

Credit growth could remain anaemic if the implementation of the Banking Union and the Asset Quality Review (AQR) and stress tests were to fail to clean up balance sheets and restore confidence, also given the still elevated deleveraging needs in the private sector. The resulting prolonged weakness of credit supply would impose a limit on the recovery of investment. Downside risks could also stem from heightened financial instability in emerging markets.

The recovery could also be stronger than envisaged if firmer domestic demand in the core countries helps further the rebalancing process, while the competitiveness boost in peripheral countries is larger than envisaged. In the medium-term, the implementation of additional and bold structural reforms could lift further the potential growth of Member States, with positive impact also in the short-term, notably through increased confidence. Positive confidence effects could lead to a stronger rebound of investment in particular if financial fragmentation is reduced to a greater extent following a successful AQR and the introduction of the Single Supervisory Mechanism.