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ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

# The EU's growth prospects in a globalised economy

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## Short-term growth prospects and challenges for the EU

**The European Commission's most recent economic forecast shows an improving outlook for the EU economy.** After being hit by two recessions since 2008, there are genuine signs that a more lasting recovery is taking place in the EU and the euro area. In recent months, confidence has slightly improved and business indicators have remained above their long-term levels, supporting the Commission's central scenario of a recovery that is gradually gaining strength and spreading across the EU.

Growth turned positive in a large majority of Member States over the course of last year and the outlook has improved even in the more vulnerable ones. Real GDP growth is projected to proceed with moderate momentum in 2014. The EU is expected to grow by 1.6 % in 2014 and 2.0 % in 2015, while growth in the euro area is expected to reach 1.2 % and 1.7 %.

**The motor of EU growth is shifting towards domestic demand.** Whereas exports propelled the economy during the crisis, the recovery in most of the EU's Member States is now becoming more self-sustained, as domestic demand strengthens.

Private consumption is again expanding, though at a slow pace. Improved confidence and low inflation are providing some support to household spending, notably in the short run. Sustained household consumption growth will, however, depend crucially on improvements in the labour market. Even though joblessness is projected to decline only slowly, there are encouraging signs that employment growth is gradually setting in, helped by recent labour market reforms in vulnerable Member States, which are starting to bear fruit.

## Summary

Leading indicators point towards an economic recovery in the EU, including even the vulnerable euro area Member States.

The legacy of the crisis means that growth is expected to remain moderate, but a gradual easing of the drag from deleveraging, financial fragmentation, adjustment of external imbalances and uncertainty is already discernable.

External risks to the EU's growth could come from slower growth in certain emerging markets and new geopolitical risks have emerged in Ukraine and Russia.

In the short term the EU's challenge is to boost growth by tackling unemployment, debt levels and guarding against a prolonged spell of low inflation.

In the medium and long term, the EU needs to boost its capacity to exploit technology and address the problems associated with population ageing.

Secular stagnation is unlikely but policy makers cannot afford to ignore the threat. Determined actions to implement structural reforms that can lift the EU's long-term growth potential are vital.

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As is usually the case during cyclical recoveries, investment has picked up more robustly than consumption, and is set to strengthen further, albeit from a very low base. The constraints responsible for the large investment shortfall since 2008 are gradually fading: capacity utilisation is slowly increasing; corporates are deleveraging; financial conditions are gradually normalising; and uncertainty is abating.

Investment is recovering but in contrast to previous cycles, it is largely unsupported by credit growth. This can be explained by some specific features of the current credit cycle, such as the high level of corporate indebtedness and banks' need to repair their balance sheets. This is not necessarily a major constraint in the very short run, as firms typically use internal funds to finance investment in the early stages of a recovery. Further ahead, however, data from the European Central Bank's Bank Lending Survey suggest that credit supply conditions should continue to ease. A successful conclusion to the EU banking supervisors' health-check of the banking system should also have a positive impact.

Finally, after several years of frontloaded adjustment, domestic demand is also benefitting from the broadly neutral budgetary policy stance of the euro area and the EU as a whole.

**A number of short-run policy challenges still need to be tackled**. Although the economic outlook has improved, the strength of the recovery depends on the EU and national governments continuing to pursue credible policies. Recent structural reforms have increased the adaptability of labour and product markets in a number of Member States. Even so, important challenges remain, including unemployment, which is at record high levels. Public and private debt are still high and there are concerns about the fair distribution of adjustment costs. The strength and pace of the recovery is also still rather timid and slow compared to other advanced economies, particularly the US. All these factors could erode support for implementing further reforms.

Moreover, if the very low level of inflation across the EU were to persist for a prolonged time, this would make the necessary competitiveness adjustment and debt reduction strategies of vulnerable economies more difficult.

In 'core' countries, reforms to strengthen domestic demand are needed. Supervisors should encourage banks to take advantage of benign market conditions to strengthen their capital bases ahead of the ECB's comprehensive assessment of bank balance sheets and the European Banking Authority's stress tests this autumn. At EU level, reforms to deepen capital markets so as to provide a complement to bank credit and strengthen SMEs' financing will be important to sustain the recovery beyond the short term.

## Medium-term growth prospects and policy challenges for the EU

**EU growth rates are likely to be substantially weaker over the coming 10 years, compared with the pre-crisis decade, if current policies remain unchanged.** While the recent forecasts point to a strengthening economic recovery in the short term, the Commission's most recent projections for the EU's medium to long-term growth prospects are not very encouraging. There has been a structural decline in the EU's growth rate over the last 15-20 years, and this trend can be expected to continue over the coming decade unless EU governments react with appropriate policies. The current forecast is for the EU to grow at an annual average rate of about 1.5 % for the next 10 years (2014-2023), a full percentage point lower than in the decade leading up to the crisis (1998-2007). Low future growth rates will essentially reflect the influence of weak pre-crisis trends, most notably for Total Factor Productivity (TFP), a concept which measures an economy's ability to exploit technology. They will also reflect the economic realities of ageing populations and the continuing fallout from the financial crisis.

**Addressing these policy challenges could greatly improve the EU's growth prospects.** The disappointing projections for EU growth prospects in the long-term are not 'set in stone,' as they assume that government policies remain unchanged.

The EU has enormous potential for catch-up growth, with its living standards only expected to be at roughly 60 % of US levels by the end of the coming decade. The introduction of a range of growth-enhancing structural reforms focused on the many unexploited growth opportunities linked to labour and TFP, could significantly boost EU income prospects. This would create much more favourable conditions for the budgetary challenges that need to be faced over the coming years.

The most pressing immediate challenges are those linked to the fallout from the financial crisis, with policy makers needing to focus on the problems created by the crisis for EU labour markets, for investment and for TFP.

The key issues for labour markets relate to the need to help the newly-unemployed take advantage of employment opportunities in expanding industries and ensuring that they do not remain unemployed for long, as this can have severe negative effects for individuals and the economy.

Investment levels fell dramatically during the crisis as risk premia on loans to firms and households shot up, banks became more cautious, and there was a correction from a boom period in which many investments were unproductive and over-leveraged.

With respect to TFP, a key concern is the striking differences between EU countries. Some countries have robust trend TFP growth rates, whereas others (especially a number of the southern EU countries) have had TFP growth rates close to zero for a long time.

**Growth must be the goal**. The key challenge for EU governments is to place growth at the heart of their agendas. Like other regions around the world, the EU is going through a period of transformation, with the pressure to reform not just linked to the financial crisis but also driven by the additional demands imposed by ageing populations and from the competitiveness pressures of globalisation. Against this background, it is essential that all Member States play their role in promoting the growth-enhancing structural reforms which are needed to make Europe's economy fit to face the challenges ahead. Domestic structural reforms should also be trade-friendly, helping to increase trade flows, secure a better trade performance, and rebalancing growth.

Since the current growth forecast of 1.5 % annually over the next 10 years assumes unchanged policies, this relatively gloomy growth picture could be improved significantly with the implementation of an ambitious programme of structural reforms focused on addressing the current, well documented, weaknesses in the EU's labour and product markets.

Research by the Commission services suggests that if Member States could close half of the gap with the three best-performing EU Member States, EU GDP growth rates could be boosted by 0.5 percentage points each year, over a 10-year period.

Equivalent simulations for convergence with US levels of technology exploitation would produce significantly higher growth rate gains for the EU. Since TFP levels in the EU are expected to be at less than 75 % of US levels in 10 years' time, and since structural unemployment rates will be substantially higher than those of the US, there is considerable potential for the EU's economy to outperform over the coming years.

**The risk of a prolonged period of low growth is low but not inconceivable.** The EU is seeing some signs of a recovery but both employment and investment are currently stuck at low levels. Even in the US, which is in a more advanced state of recovery, there are ongoing concerns about a jobless recovery.

Weak growth patterns have two fundamental sources; either low productivity growth, or sluggish demand. There is evidence that both factors are playing a role in the EU. The extremely low level of TFP growth rates in the EU (the annual average rate has been close to zero since 2008) could be seen as evidence supporting the view that the growth slowdown is directly associated with the financial crisis (i.e. driven by increased risk aversion and higher financing costs for innovative activities). However, if one controls for low levels of capacity utilisation, TFP trends have in fact not been dramatically affected by the crisis. In addition, low and falling inflation rates are inconsistent with the productivity story.

Whilst it is true that the EU's RULCs did increase at the start of the financial crisis, they have been gradually declining in the EU since 2010. However, the relatively slow decline has been insufficient to prevent a rise in EU unemployment, given that the process of structural change and reform is still ongoing and given the size of the adverse demand shocks experienced.

The EU, with its rising old age dependency ratio and low population growth rates, particularly for those of working age, is potentially a candidate 'secular stagnation.' The EU does show symptoms similar to those exhibited earlier by Japan: adverse demographic trends, close to zero interest rates and low GDP growth. There are other similarities too, such as the levelling off in educational attainment levels, rising inequality and globalisation pressures which all tend to provoke lower private consumption growth rates. These potentially growth-inhibiting factors also resonate strongly in current US policy discussions, which is perhaps not that surprising given that median income growth rates in the US have been stagnant for many years now.

**The Commission has a crucial role to play in supporting growth across the EU.** Although secular stagnation is unlikely, it would be dangerous for EU policy makers to ignore. The Compact for Growth and Jobs agreed in June 2012 is one of the EU's major tools aimed for re-launching growth, investment and employment as well as making Europe more competitive. Its implementation is essential. While substantial progress has been achieved in a number of areas, efforts should continue to ensure that the potential of the Compact is used to its fullest extent.

Given the risk to growth from policy inaction, the Commission has a crucial role to play in convincing the Member States of the importance of implementing an ambitious growth agenda. The issue was forcefully highlighted at the launch of the Lisbon Strategy back in 2000, when EU growth rates were at a much healthier annual rate of 2.5%. Well over a decade later, it is clearly necessary to highlight this growth issue once again, as the case for reform now is even more pressing.

As demonstrated by the wide variation in the past and current growth performances of individual EU countries, policies matter greatly in determining medium to long-run growth and income. Over the last few years, Europe has reinforced its economic governance. In order to bring the growth potential of all EU countries up to that of the best performers, structural reforms must be continued and further advanced in line with the priorities identified by the Commission in the European Semester and in the 'Europe 2020' programme.