ECONOMIC OUTLOOK SPRING 2018

EU GROWTH AT RISK OF PEAKING

ECONOMIC SITUATION

- **EU quarterly GDP growth** fell to 0.4% in the first quarter of this year, a clear slowdown from the very strong 0.6 to 0.7% quarterly growth during 2017. Whilst temporary effects may be at work, businesses are increasingly concerned that **EU growth is at risk of peaking**.

- For **2018**, we expect **GDP growth** of 2.4% in the EU and 2.3% in the Euro area, an upward revision of 0.3 percentage points compared to our autumn forecast. For **2019**, we expect growth to slow down to 2.1% in both the EU and the Euro area.

- Business federations are increasing concerned about a **shortage of relevant skills in the EU**, which is increasingly acting as a constraint on production capacity.

- We have seen a further improvement in **labour markets**, with EU unemployment amounting to 7.1% in April 2018, the lowest rate since September 2008. While unemployment is expected to further come down to 6.6% in 2019, rates remain uneven across EU member states and well above those forecasted for the US (3.5% acc. to IMF for 2019).

- Risks to the outlook remain in particular in form of a high level of policy uncertainty, with the **danger of increasing protectionism**. As outlined in our in-depth analysis box 1, external IMF analysis suggests that a broader application of tariffs across countries could lower global output by about 1¾% after 5 years and by close to 2% in the long-term, with the OECD warning that “the threat of trade restrictions has begun to adversely affect confidence, and, if such measures were implemented, they would negatively influence investment and jobs.”

POLICY CONSIDERATIONS

- The **Multiannual Financial Framework (MFF) post-2020** must include a strong focus on future-oriented investment, including innovation spending. Moreover, a swift agreement is needed as a last-minute deal after the European elections would imply significant delays in the start of programmes in 2021, and a lost year in investment by the EU budget.

- In order to boost long-term growth and competitiveness, policymakers must **implement labour and, product market as well as institutional reforms** that make EU economies and the EU as a whole more productive and resilient. Policymakers should ensure that regulation is well designed and properly enforced, with a minimum of administrative burdens.

- To address **labour market mismatches**, work-orientated learning for all age groups must be improved, including promoting digital skills, and reforms which help encourage people to stay longer in the workforce and ensure to properly integrate legal migrants into the workforce.

- It is essential that concrete steps are taken forward on **deepening EMU** in the June Council. Priority issues include completing the banking union, and the establishment of a stabilisation function. We support, in particular, the Commission’s proposal for an Investment Protection scheme, and hope the EU will agree to build up the capacity of this in future years.

- We are at a turning point in the **global trading system** and the EU must remain committed to open, fair and rules-based trade. At the same time the EU should stay united and committed in adequately protecting the interests of its companies and its citizens.

WHAT IS THE ECONOMIC OUTLOOK?

The Economic Outlook twice a year provides a business insight into recent and projected economic developments in Europe, based on a survey of BusinessEurope member federations.

Answers to this spring's questionnaire were received in May 2018.

FOR FURTHER INFORMATION:

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1. OVERVIEW

Having enjoyed strong growth of 2.4% in the EU in 2017, the highest in more than a decade, businesses are increasingly concerned that growth is at risk of peaking. EU quarterly GDP growth fell to 0.4% in the first three month of this year, a clear slowdown from the very strong 0.6 to 0.7% quarterly growth during 2017. Whilst such a fall might be due to temporary effects such as the very cold winter, we have also seen a broader fall in business confidence in both industry and services suggesting more permanent factors may be at work.

Nevertheless, since the recent drop in confidence comes from very high levels and is for the moment still relatively small, and since strong underlying factors such as improving labour market conditions, a supportive global growth environment, still relatively accommodative monetary policy and good financing conditions remain in place, we expect the European economy to continue growing at rates above 2% in the near future: For 2018, we expect GDP growth of 2.4% in the EU and 2.3% in the Euro area, an upward revision of 0.3 percentage points compared to our autumn forecast. For 2019, we expect growth to slightly slow down to 2.1% in both the EU and the Euro area.

Still, business federations are increasingly concerned about a shortage of relevant skills in the EU, with the share of industrial companies indicating that a lack of labour limits their production already now at twice the pre-crisis level and the highest on record since 1985. More generally, production capacity is increasingly tight, with capacity utilisation at the highest level in a decade.

In the longer-term, it is clear that the EU's underlying growth potential is too low, with the Commission estimating that trend growth is 1.7% and thus well below current cyclical growth. Moreover, our survey emphasises a high level of policy uncertainty, with the risk of increasing protectionism (more detail on potential impact of protectionism such as US tariffs on the EU economy in Box 1) and the US withdrawal from the Iran nuclear deal in particular bringing political and economic insecurity.

Policymakers should now seize the moment to implement labour and product market reforms as well as institutional reforms that make EU economies more productive and resilient, and increase the EU's potential for long-term growth and job creation. Given the emerging supply constraints, it is particularly important to address structural constraints to growth such as remaining barriers to investment and labour market mismatches. It is key to improve work-orientated learning for all age groups, including the promotion of digital skills, as well as reforms which help encourage people to stay longer in the workforce and ensure to properly integrate legal migrants.

Table 1 Economic growth appears to have hit its peak
BusinessEurope main forecast

Main Variables	EU28		Euro area	
	2018	2019	2018	2019
Real GDP (annual % growth)	2.4 (+0.3)	2.1	2.3 (+0.3)	2.1
Inflation (%)	1.7	1.9	1.5	1.7
Unemployment (%)	7.0	6.6	8.3	7.8
Government net lending (% of GDP)	-0.8	-0.8	-0.7	-0.6
Gross public debt (% of GDP)	81.2	79.7	87.3	85.2

GDP components	EU28		Euro area	
	2018	2019	2018	2019
Private consumption (%)	2.1	1.9	1.9	1.8
Public consumption (%)	1.4	1.3	1.2	1.3
Gross fixed capital formation (%)	4.6	4.0	5.1	4.2
Exports (%)	4.5	4.2	4.8	4.1
Imports (%)	4.7	4.3	4.9	4.4

Source: BusinessEurope's forecast based on survey of member federations

ECONOMIC OUTLOOK SPRING 2018

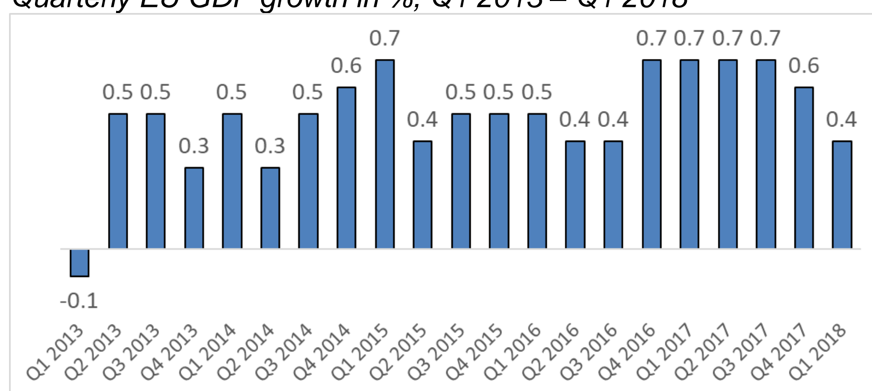
2. OUTLOOK FOR GDP GROWTH

Slight moderation of growth at the start of 2018

Recent official data points to a slight moderation of growth in the first quarter of 2018, with Eurostat reporting that EU quarterly GDP growth fell to 0.4% in the first three month of this year, which is a clear slowdown from the very strong 0.6 to 0.7% quarterly growth during 2017 (figure 1). Growth thus returned to a pace last seen in Q3 2016, with the overall expansion now lasting for 20 consecutive quarters.

Even though Eurostat did not yet provide a breakdown of Q1 2018 growth figures at our cut-off date, we will look in more detail at the growth drivers in section 3.

Figure 1 Slight moderation of growth in Q1 2018 after a strong 2017
Quarterly EU GDP growth in %, Q1 2013 – Q1 2018

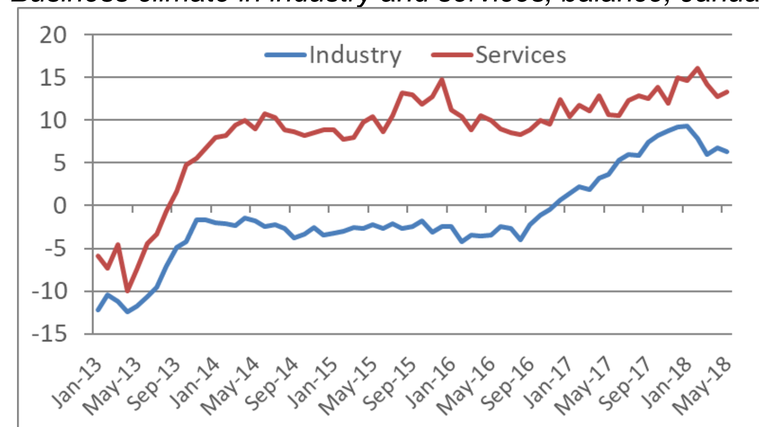


Source: Eurostat

Small drop in confidence across industry and services from high levels

More moderate growth came along with a slight drop in business confidence in both industry and services at the beginning of 2018 (figure 2). Confidence among firms in the industrial sector, which increased very strongly since July 2016, fell back to levels of August 2017. Confidence in the service sector, which had increased at a more gradual pace over the last two years, dropped to a level last seen in November 2017. Despite the recent decrease, confidence remains at relatively high levels in both sectors, well above long-term averages (of -5.4 for industry and 9.3 points for services).

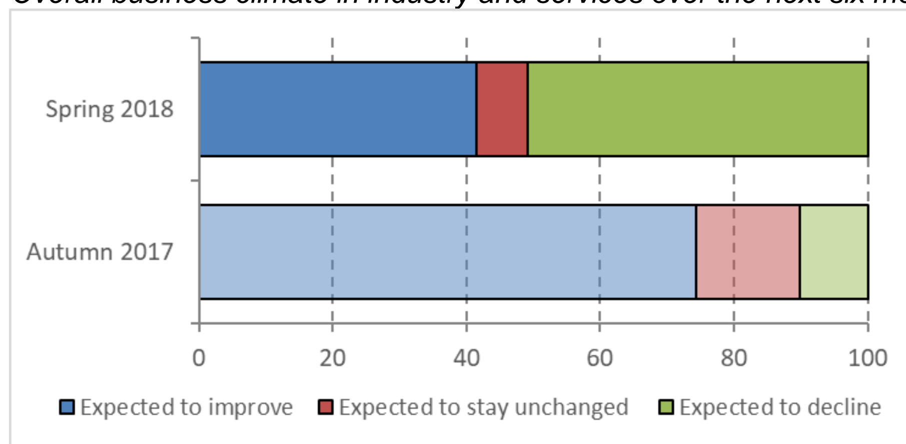
Figure 2 Business confidence dropped at the start of 2018, though remains at high levels
Business climate in industry and services, balance, January 2013 – May 2018



Source: European Commission

Respondents to our survey are split about whether to expect an increase or a further decrease in the business climate over the coming 6 months, with about half of the respondents (weighted average of 51%) expecting a further decrease, whereas 41% expect an increase, and 8% expect the business climate to remain at its current level (figure 3). This is an important change compared to our autumn Outlook where the clear majority of respondents (74%) expected an improvement of the business climate, and underlines that while growth was previously considered to remain on an upward path, there are now signs that it may have peaked.

Figure 3 Respondents split whether to expect an increase or decrease in business climate
Overall business climate in industry and services over the next six months



Source: BusinessEurope's forecast based on survey of member federations

Nevertheless, given that the drop in confidence is still relatively small and comes from very high levels, and given strong underlying factors such as improving labour market conditions, a supportive global growth environment, still relatively accommodative monetary policy and good financing conditions, we expect the European economy to continue growing at rates above 2% in 2018 and 2019: For 2018, we expect GDP growth of 2.4% in the EU and 2.3% in the Euro area, an upward revision of 0.3 percentage points compared to our autumn forecast. For 2019, we expect growth to slightly slow down to 2.1% in both the EU and the Euro area.[1]

Box 1: The potential impact of protectionism on the European economy

In recent months we have seen continuing political tensions that raise the possibility of measures being taken in a number of regions in the global economy which risk reducing the ease of international trade and investment. This box first brings out the different channels through which trade tensions could be felt, to then illustrate how different potential scenarios of a trade conflict could impact EU exports and growth.

Growing trade tensions

The most recent increase in tensions can be linked to the imposition of tariffs on US imports of steel and aluminium on 23 March under the assertion of national security concerns. While the cited goal was to address China's overcapacity, the measures will mainly hit other economies, prompting the EU considering exercising its rights before the WTO by imposing rebalancing measures. On 31 May, the US administration announced it would not prolong temporary exemptions for the EU, Canada and Mexico which had initially been granted.

[1] Please note that the cut-off date of our survey was before the US announcement on 31 May to not prolong the EU's tariff exemption of 25% on imported steel, and 10% on aluminium.

This was coupled by a sequence of additional measures concentrated on the US and China, but having a likely impact on EU companies, based on the August 2017 US investigation into Chinese intellectual property theft. On 01 April, China imposed tariffs on US imports worth around $3B in response to the US trade measures. On 03 April, the US Trade Representative proposed a 25% tax on close to 1,300 Chinese goods from the aerospace, machinery and medical industries. On 04 April, the Chinese government announced a further set of retaliatory tariffs, closely mirroring the US proposal of the previous day – 25% on 106 US products, worth approximately $50B. Since then both parties have publicly considered further measures and have filed separate complaints to the WTO. In parallel the two sides are also discussing ways to solve the trade conflict through a bilateral deal. This could imply a reduction of the US trade deficit if China accept to buy more US products.

While the dispute has concentrated so far on a limited number of products and sectors, a wider escalation of the conflict is likely to have salient implications on the global economy. The US Administration has announced on 24 May its intention to open a new investigation on imports of cars and car parts on the grounds of national security potentially leading to additional duties.

What are the transmission channels through which trade tensions could be felt?

There are a number of direct and indirect transmission channels through which trade tensions could be felt.

Direct channels

- As the ECB[2] notes, tariffs will lead to higher import prices for the imposing country, which would increase firms' production costs and reduce households' purchasing power. This is in particular the case if domestic and imported goods cannot be easily substituted. The result would be lower consumption, investment and employment.
- Economic activity also declines in the country which faces the tariffs as exports are hit, which, as the ECB notes may only be partially offset by lower imports.[3]

Indirect channels

- An escalation of a trade conflict is likely to have negative consequences on economic confidence, which would further contribute to consumers delaying expenditure, and businesses postponing investment as for example the ECB indicates.
- Protectionist measures may also reduce the risk appetite for institutional investors, causing them to avoid certain asset classes, entire countries, or higher risks in general, with negative second round effects that ultimately reduce economic growth.
- There may also be indirect effects on capital markets. The Commission explicitly warns in its recent Spring 2018 Economic Outlook that "protectionist policies could also trigger market corrections at a time of rising leverage among both sovereigns and corporates in many emerging market economies." The ECB notes that "by fuelling uncertainty among market participants, fears of a 'trade war' have added to the volatility already witnessed earlier this year in equity markets."

[2] ECB Economic Bulletin Issue 3, 2018. "Implications of rising trade tensions for the global economy".

[3] Panel contribution "The consequences of protectionism" by Benoît Cœuré, Member of the Executive Board, ECB. Cernobbio, 6.04.2018 & ECB Economic Bulletin Issue 3, 2018.

- Finally, even if trade protection measures were to focus mainly on relations between the US and China, they are still likely to have negatives repercussion to third countries such as the EU in form of trade diversion (e.g. outside EU exporters redirecting their US exports into the EU and/or into non-EU markets EU exporters are active in), delivery problems, and disruptions in value chains.

- In the longer term, the ECB notes that protectionism likely hinders productivity growth, and could also negatively affect potential output growth. This is because the benefits of larger markets, including competition from trade, help encourage a more efficient allocation of labour and capital across sectors and firms which, in turn, supports innovation and hence productivity.

While one may argue about the relative contributions of each of these channels, 3 potential scenarios and their impact on the EU economy are considered below:

Scenario 1: A de-escalation of trade tensions

The most favoured scenario would clearly be a de-escalation of recent trade tensions, and the development of further trade agreements. This would increase business confidence as well as generate direct gains from increased trade and investment openness. As a rule of thumb, a one percentage point increase in trade openness tends to raise real income per capita by 3 to 5% in the long run, with a slightly smaller effect (~2%) detected in the years after the financial crisis.[4]

Scenario 2: Increased tariffs on EU/US trade are limited to only a few sectors

An alternative scenario is that tensions between the EU and the US remain limited to tariffs on a few sectors.

The impact of a sectoral tariff on an economy will clearly be dependent upon both the tariff rate and the size of the sectoral exports. In this regard, Bruegel's assessment is illustrative, highlighting the top 10 product categories the EU exports to the US. In table 2[5] it can be seen that medical and pharmaceutical products and road vehicles make up the highest proportion of EU exports to the US, with a combined total €95.9B, or over a quarter of EU total goods exports. In total, the top 10 products make up almost 70% of bilateral EU exports.

Table 2: Top 10 EU products exported to the US (2-digit SITC) in 2016

Products	Billion EUR	% All exports
Medicinal & pharmaceutical products	48.3	13.3
Road vehicles	47.6	13.1
Other transport equipment	22.8	6.3
Power-generating machinery & equipment	22.4	6.2
Electrical machinery, apparatus and appliances, & electrical parts	21.6	5.9
General industrial machinery and equipment, and machine parts	20.7	5.7
Organic chemicals	19.2	5.3
Miscellaneous manufactured articles	17.0	4.7
Professional, scientific and controlling instruments and apparatus	15.9	4.4
Machinery specialised for particular industries	15.4	4.2
Total	**250.7**	**69.0**

Source: Bruegel based on Eurostat data (Comext)

[4] Diego A. Cerdeiro; Andras Komaromi. 2017. "Trade and Income in the Long Run: Are There Really Gains, and Are They Widely Shared?", IMF Working Paper 17/231. Analysis covers the period 1990-2015.
[5] Francesco Chiacchio. 15.03.2018. "Which sectors would be most vulnerable to EU-US trade war?". Bruegel.

There are two product categories which have been in a particular focus in the recent dispute, namely steel and aluminium. Passenger cars have been indicated on 24 May as the possible subject of a future national security investigation to be carried out by the US Commerce Department.

- The announced **US tariff of 25% on steel and 10% on aluminium imports** is estimated to affect respectively €5.1B and €1.1B of EU exports. In a more detailed estimate for steel, Bruegel expects the tariff to reduce US imports by 37%, which would amount to a reduction of EU steel exports equivalent to slightly over 1% of 2017 EU production.

- **The automotive sector** accounted for €125B in extra-EU exports in 2016. With European car exports to the US amounting to €38B, the US represents the largest outlet for EU car exports, followed by China accounting for about half the US amount. Bruegel estimates that a 35% tariff on cars imported by the US, as suggested in January 2017 by President Trump, could lead to a maximum reduction in EU export revenue by €17B per year (almost 14% of extra-EU car exports).[6]

Scenario 3: A broader application of tariffs between the EU and US

Given that the US is the top destination for EU exports and vice versa, an increase in trade tensions between the two economies has the potential to be significant (EU exports of goods and services to the US making up 22.7% of total EU exports in 2016 and US exports to the EU accounting for 23.6% of total US' exports.[7] The total value of EU to the US is estimated at 2.3% of EU GDP.[8])

Both the IMF and the ECB have considered the economic impact of a broader application of tariffs beyond just individual sectors.

The ECB[9] considers what it views as a hypothetical scenario whereby the US imposes a 10-percentage point increase in tariffs on all imports of goods, which its trading partners respond to with a similar 10 percentage point tariff increases.

The ECB notes that the country imposing the tariffs first is likely to be hit hardest, with in particular, higher import prices increasing firm productions costs and reducing household purchasing power, in turn affecting consumption, investment and employment. As aforementioned, the impact on economic confidence would further contribute to consumers delaying expenditure, and businesses postponing investment.

- Whilst the results of such hypothetical modelling need to be treated with caution, they are nevertheless startling. The ECB estimates that such tariff action could lower real economic activity in the US by up to 2½% in the first year alone, reduce world trade in goods by up to 3%, and lower global GDP by up to 1%.[10] While the ECB does not provide a figure for the European economy, it notes that "Euro area GDP would also decline, but by less than in the US."

- When it comes to the effects on individual economies, the ECB argues that this will depend on their size, trade openness and amount traded with the US, with the most negative impact on those economies that have the closest trade relations. Yet the ECB also acknowledges that even for

[6] Assuming the tariff is fully passed on to a 35% price increase of European car exports, and a price elasticity of -1.3.
[7] European Commission, DG Trade Statistics, BusinessEurope staff calculations of global export shares.
[8] Bruegel notes that EU exports to the US amounted to about $500B in 2016, of which domestic EU value added might have accounted for 76% (OECD estimate) or $380B, which comes down to about 2.3% of EU GDP. This assumes that the domestic value added share of exports to the US is the same as that of total EU exports.
[9] Panel contribution "The consequences of protectionism" by Benoît Cœuré, Member of the Executive Board, ECB. Cernobbio, 6.04.2018 & ECB Economic Bulletin Issue 3, 2018. "Implications of rising trade tensions for the global economy".
[10] Compared to the baseline scenario.

economies with less direct exposure, the effects could be significant due to their integration in global value chains. For example, the ECB notes the significant potential impact on economies such as those in South-East Asia that are particularly integrated into global value chains, even if they are not directly hit by tariffs.

The IMF[11] takes a more global approach than the ECB by estimating a 10% increase in import prices (on goods) *across countries*[12]. It calculates that such action would lower global output by about 1¾% after 5 years and by close to 2% in the long-term. In this scenario, exports and imports are expected to fall by 15% after 5 years and 16% in the long-term.

The European Commission in its Spring Economic Outlook does not focus on a specific scenario, but notes that the effects of trade protectionism "may be highly non-linear and hard to predict." The Commission also draws attention to the important consideration that even if US/EU relations are not significantly impacted, broader global trade tensions could still impact EU growth. They write specifically that, "if trade restrictions reach a point where the viability of complex global value chains is undermined, the drop in world trade could be sharp. The materialisation of these risks could throw the expansion off track in a European economy that has recently been more reliant on investment and exports." They note for example, the potential negative risk from "a sustained loss of confidence in the global multilateral trading system".

Finally, the OECD warned in its recent Economic Outlook[13] that the threat of trade restrictions has already begun to adversely affect confidence. "If such measures were implemented, they would negatively influence investment and jobs." It further notes that "closer trade and financial integration since the mid-1990s has made economies more dependent on developments abroad. Trade intensity has increased, helped by the expansion of global value chains, and cross-border asset and liabilities have risen considerably relative to GDP".

Conclusions

- **EU-US trade is of high mutual importance**, with each economy constituting the main outlet for the other's exports.

- The announced US tariff on **steel and aluminium** imports affects a total €6.1B of EU exports, with the think-tank Bruegel estimating that steel tariffs could reduce EU exports by about 1% of 2017 EU steel production. A 35% tariff on **automotives** imported by the US is similarly estimated to reduce EU export revenue by €17B per year (almost 14% of extra-EU car exports) in the worst-case scenario.

- A broader increase in tariffs would be particularly damaging for growth. The **ECB** estimates that a hypothetical 10-percentage point increase in tariffs *by the US* on all imports of goods, and an equivalent increase of tariffs *on US exports* by its trading partners, **could reduce US GDP by up to 2½% with Euro area GDP also declining**, but by less than in the US.

- Furthermore, a **broader application of tariffs** such as a 10% increase in import prices (on goods) *across countries*, **could, according to the IMF, lower global output by about 1¾% after 5 years** and by close to 2% in the long-term, with the **OECD** warning that "the threat of trade restrictions has

[11] IMF, WEO October 2016, Box 1.
[12] By a gradual increase of tariff and non-tariff barriers over the first three years, where it is assumed that half of the increase in import prices is from tariffs, with revenue returned to households via transfers, and the other half from an increase in non-tariff barriers.
[13] OECD Economic Outlook. 30.05.2018. "Stronger growth, but risks loom large".

> begun to adversely affect confidence, and, if such measures were implemented, they would negatively influence investment and jobs."
>
> Finally, as the **Commission** warns, there is a risk **that trade restrictions undermine complex global value chains**, which may lead to a sharp drop in world trade, and which the ECB emphasises may lead to significant impacts on economies not directly impacted by tariff increases.

3. KEY DRIVERS OF GROWTH

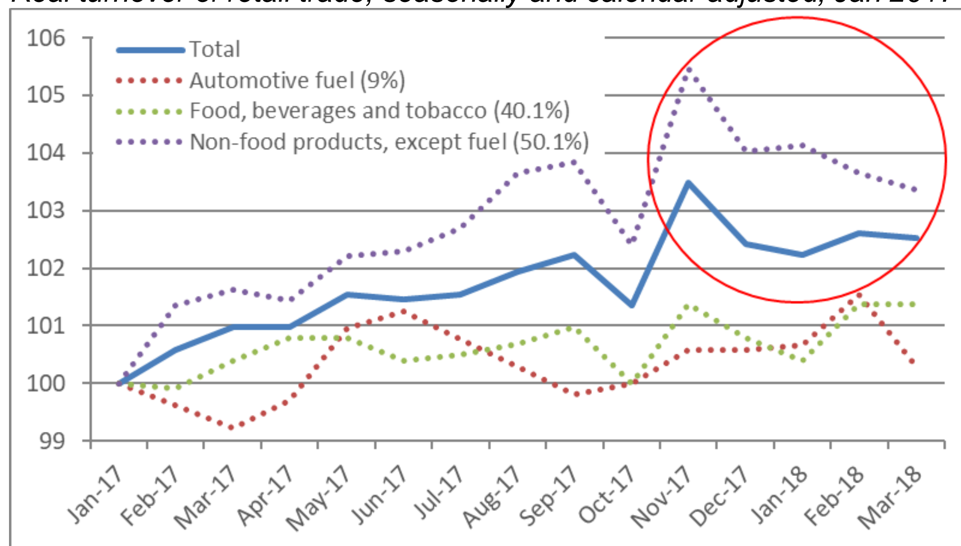
A slight slowdown in consumer spending is likely one reason for more moderate GDP growth in the first quarter…

Looking at the drivers of growth, consumer spending, the largest component of demand, has, according to Eurostat data, contributed slightly less to growth over the last half of 2017 than it previously did (0.2 percentage points, compared to an average of 0.3 pp since the start of 2015).

The slight slowdown in consumer spending may also be one reason for the moderation of growth at the beginning of 2018, with retail sales having dropped by about 1% from November 2017 until March 2018 (figure 4). In particular, weaker sales of non-food products have caused this overall drop in retail sales, while sales of food and beverages and automotive fuel remained at about the same level as in November.

Figure 4 Retail sales dropped by about 1% since November 2017, driven by weaker sales of non-food products

Real turnover of retail trade, seasonally and calendar adjusted, Jan 2017 = 100



Source: Eurostat, BusinessEurope staff calculations

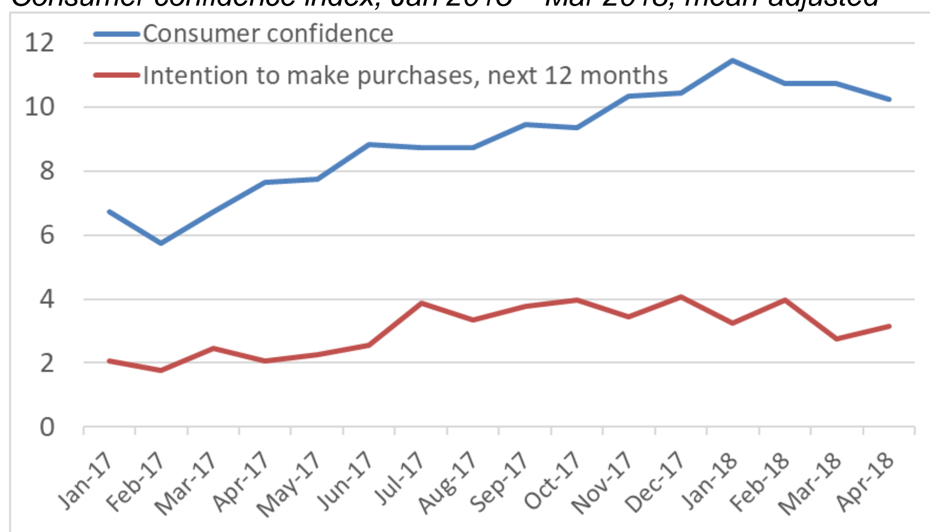
…while consumer spending is still expected to grow at a robust 2% in the year as a whole

Despite the recent weakening in retails sales, we expect private consumption to grow at around 2% in the EU and the Euro area in 2017 and 2018, supported by ongoing improvements in the labour market and further improving bank lending conditions to households.

While consumer confidence has slightly fallen since February 2018, it remains at an overall high level, thus also pointing to resilient consumer spending over the coming months (figure 5). At the

same time, consumers' intention to make major purchases remained unchanged, which may suggest that temporary factors such as the very cold winter played a role in the overall slowdown.

Figure 5 Consumer confidence remains at a high level despite slight recent decrease
Consumer confidence index, Jan 2015 – Mar 2018, mean-adjusted



Source: European Commission, BusinessEurope staff calculations

EU investment growth saw a strong pick-up in 2017

Since the financial crisis, weak investment had been the Achilles' heel of the European economy. EU investment experienced a pick-up only at the beginning of 2014, driven by low interest rates, increasingly tight capacities and reflecting an improvement in business confidence. While investment grew at an average of 2.7% between 2014 and 2016, it saw another strong increase in 2017, with growth of 3.8% in the first semester and 5.0% in the second.[14]

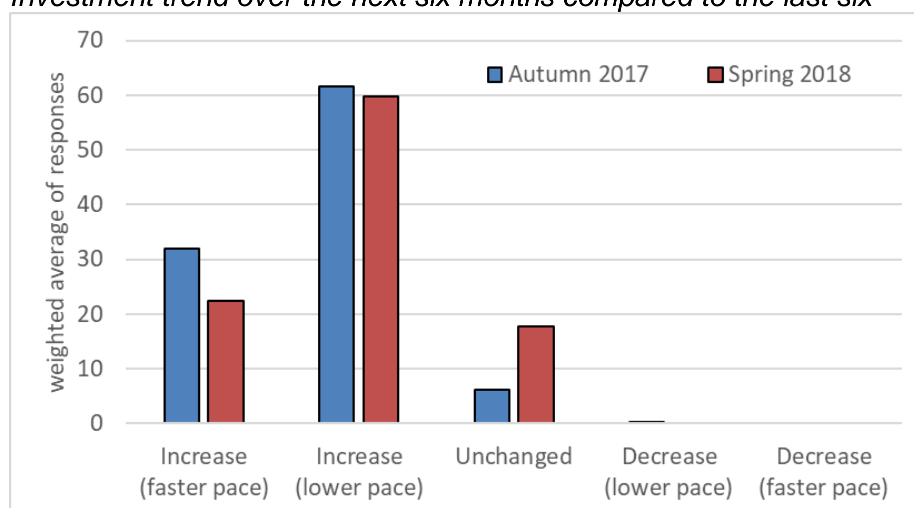
While investment growth is expected to see some further improvement in the coming months…

Our survey points out that the majority of respondents expect EU investment to see a further moderate increase over the coming six months compared to the last six (figure 6). Compared to our survey from last autumn, there are now however slightly fewer respondents that expect investment growth to see a significant boost (weighted average of 22% compared to 32% in autumn).

In line with increasingly tight capacity utilisation, which is at the highest since the financial crisis, we forecast investment to grow at 4.6% in the EU and 5.1% in the Euro area in 2018 and by 4.0% (EU) and 4.2% (Euro area) in 2019.

[14] Figures exclude Ireland due to considerable fluctuations in intellectual property investment.

Figure 6 Investment expected to increase at a moderate pace over the coming six months
Investment trend over the next six months compared to the last six



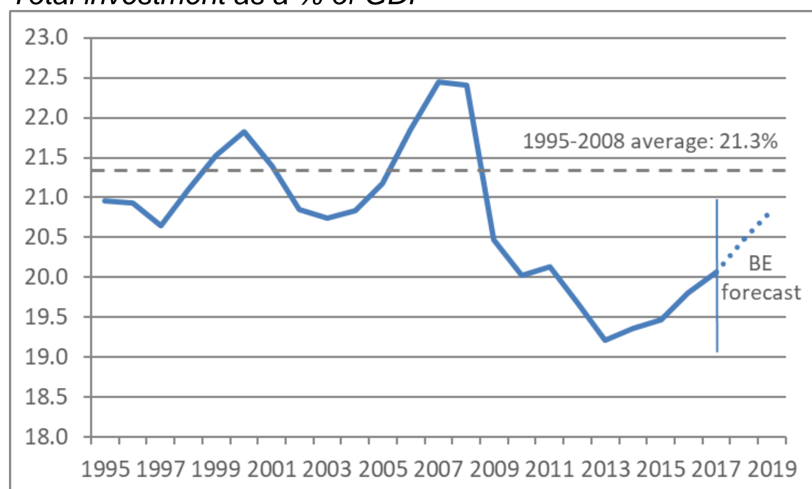
Source: BusinessEurope's forecast based on survey of member federations

…it remains insufficient to swiftly close the pre-crisis investment gap

While the strengthening of the investment outlook still remains insufficient to swiftly close the pre-crisis investment gap over our forecast horizon until 2019 (figure 7), it would at the current rate of investment growth now only take up until 2021 to close the gap, two years earlier than what we had expected in autumn.

However, as underlined in a recent analysis by the IMF, key investment barriers, which threaten to hold back investment in the medium-term, remain, with the most pressing ones relating to the availability of skilled staff (see Box 1), future uncertainty and stringent business and labour market regulations.[15] Of particular concern remains weak net investment, which takes into account capital depreciation. Net investment in the EU is estimated at only 3.4% of GDP in 2017, well below the 1995-2008 average of 6.1%.

Figure 7 Pre-crisis investment gap remains over forecast horizon
Total investment as a % of GDP



Source: European Commission, BusinessEurope staff calculations

[15] IMF Country Focus. 15.05.2018. "Europe on an Upswing—in Six Charts".

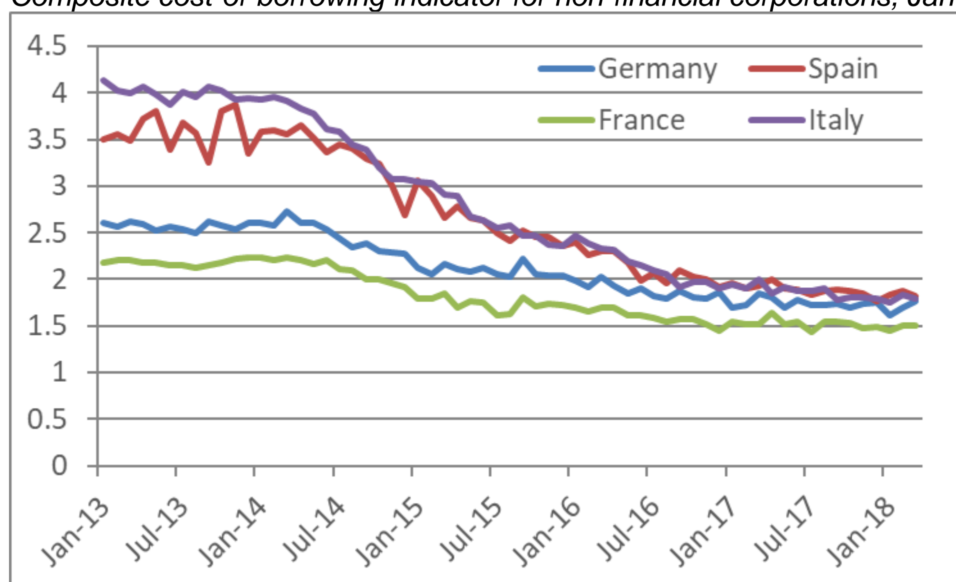
Companies' investment plans are supported by improved cost and access to finance

Companies' investment plans are also subject to the availability and cost of finance which have both improved over the recent years and are expected to remain supportive in the near future.

First, regarding access to finance, the latest April 2018 bank lending survey from the ECB indicates that credit standards for loans to enterprises eased considerably in the first quarter of 2018 (-8% in net terms), after remaining unchanged in the previous quarter. For the second quarter of 2018, banks expect a further slight easing for loans to enterprises (-2%). Similarly, the ECB survey on the access to finance of enterprises (SAFE) points to an improving availability of finance to SMEs since 2014, with some exceptions.

Second, regarding costs, the ECB's composite cost-of-borrowing indicator (figure 8), which is based on bank interest rate statistics and measures borrowing costs for non-financial corporations while enhancing cross-country comparability, shows that interest rates across countries remain considerably below the rates during the European debt crisis, with a significant convergance of rates between countries, a development supported by ECB monetary policy support.

Figure 8 Headline borrowing rates for European companies remain relatively low
Composite cost-of-borrowing indicator for non-financial corporations, Jan 2013 – Jan 2018, %



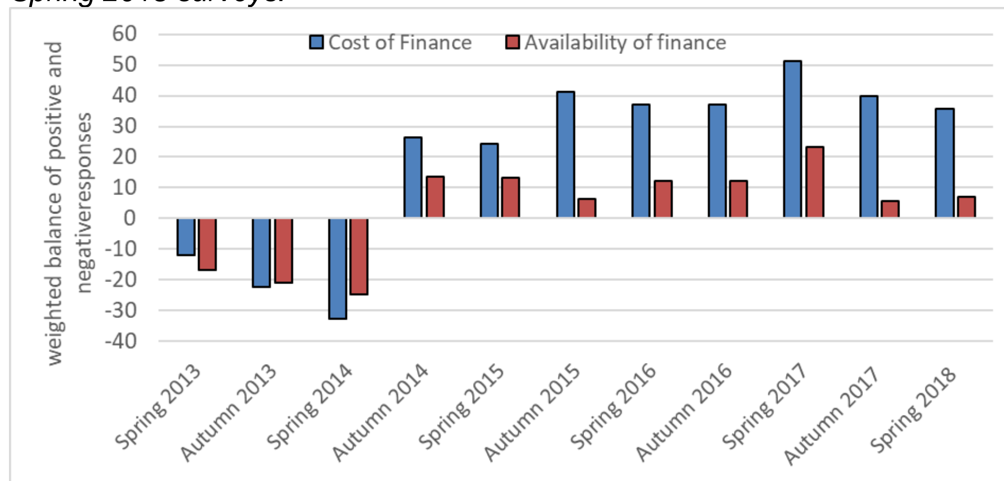
Source: European Central Bank

In line with these indicators from the ECB, our survey shows that both cost and access to finance are in overall terms expected to continue excerting a positive influence on companies' investment decisions (figure 9).

Whilst financing conditions are expected to remain supportive in a number of member states, it also remains the case that in other member states, efforts are needed to ensure that companies with viable business models are able to obtain the finance they require to invest and support employment growth. Rapid completion of both the capital markets union and the banking union, including the European Deposit Insurance Scheme, should be a priority for the EU. In many member states, national reforms to implement the bank recovery and resolution directive and the creation of harmonised deposit insurance systems, are necessary steps on the way towards establishing a common system.

Figure 9 Cost and availability of finance continues to exert a positive influence on companies' investment decisions

Influence of the cost and availability of finance on companies' investment decisions, Spring 2013 to Spring 2018 surveys.



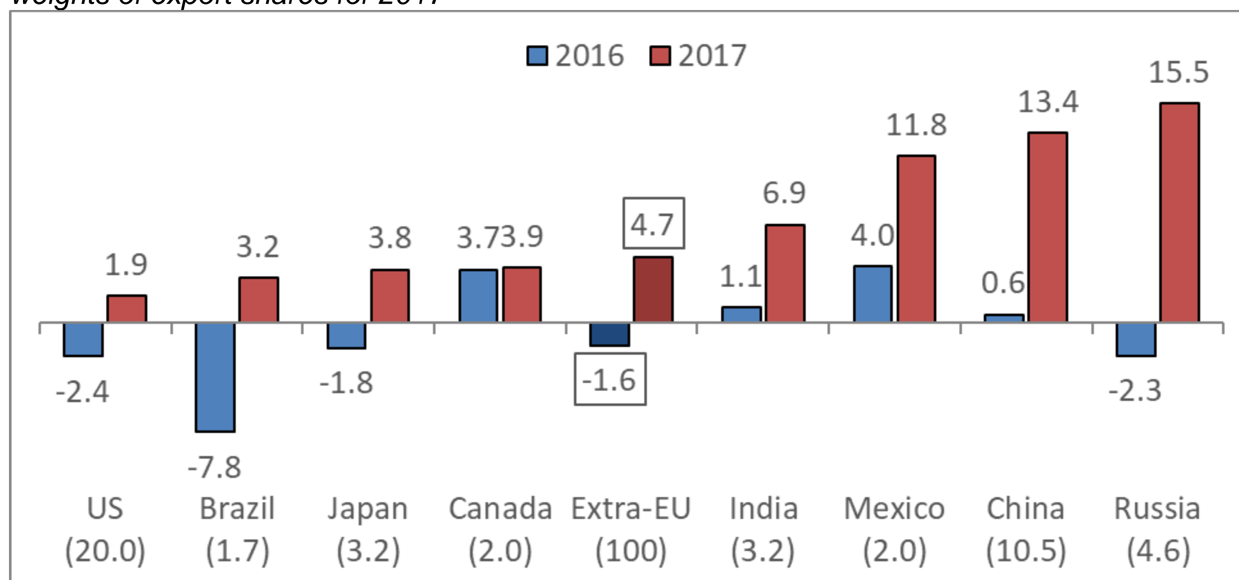
Source: European Central Bank

Strong export growth to countries outside the EU in 2017, after a drop in extra-EU exports in 2016

Extra-EU goods exports increased by a strong 4.7% in 2017, a significant improvement after a drop by -1.6% in the previous year. In particular exports to emerging market economies (Russia, China, Mexico, India and Brazil) saw a strong pick-up as shown in figure 10. But also EU exports to advanced economies such as the US (1.9% after -2.4%) and Japan (3.8% after -1.8%) experienced a rebound.

Figure 10 Extra-EU exports saw a strong rebound in 2017

Extra-EU goods exports in volumes to partner countries, % change compared to previous year and weights of export shares for 2017



Source: Eurostat

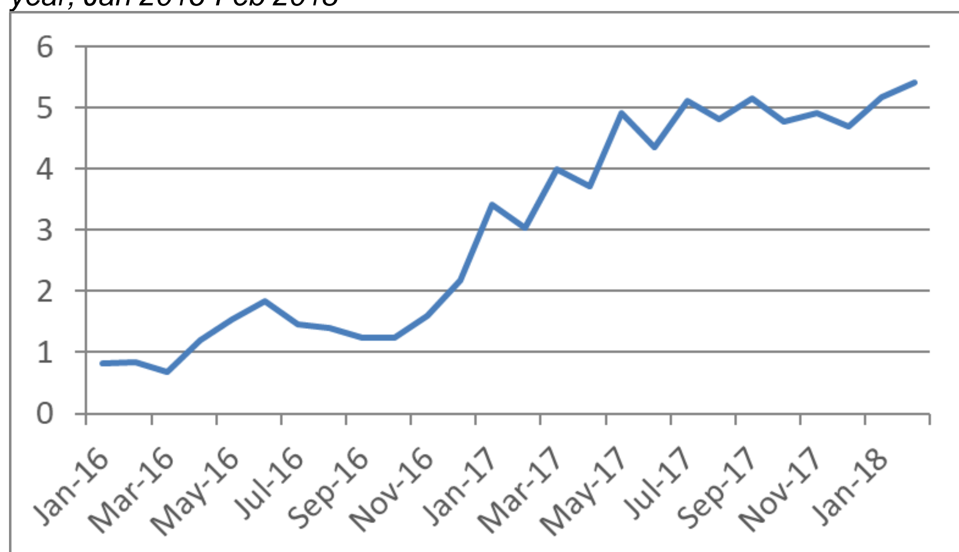
Higher EU exports come along with a strong increase in global trade growth

The improved performance of extra-EU exports came along with a brighening of the global trading environment. After a period of historically-speaking relatively low global trade growth (avg. of 1.5% in 2016), global trade picked up strongly to rates at and above 5% over the course of 2017 (figure 11).

The WTO notes in its latest World Trade Outlook Indicator (WTOI) from 17 May that the strong rate of trade expansion is likely to continue, while it may slow slightly in the second quarter of 2018. A recent dip of its indicator (from 102.3 to 101.8), reflects, according to the WTO, "declines in component indices for export orders in particular but also for air freight, which may be linked to rising economic uncertainty due to increased trade tensions."

Figure 11 Global trade increases

Global trade, average % change over last 3 months compared to the same period of the previous year, Jan 2016-Feb 2018



Source: CPB, BusinessEurope staff calculations

Against the background of strong global demand, which in the short-term may further benefit from pro-cyclical US policies, we expect export growth of 4.5% and 4.8% in the EU and the Euro area in 2018. For 2019, we expect export growth to slightly ease to 4.1-4.2% in the EU and the Euro area due the lagged impact of the Euro's recent appreciation (see figure 12) and a slight expected easing in world trade growth.[16] Given that imports are expected to grow at equally strong rates as exports, net trade is not expected to contribute to growth in 2018 and 2019.

[16] The IMF expects world trade growth to slow from 4.7% in 2017 to 4.6% in 2018 and 4.4% in 2019.

Figure 12 Euro effective exchange rate up by over 4% since May 2017

Nominal effective exchange rate for Euro area, Jan 2017 – May 2017

Source: European Central Bank

4. KEY GROWTH DRIVERS – MEMBER SURVEY:

Our specific survey of what member federations see as growth drivers for the upcoming 12 months (figure 13) shows that the overall picture of growth is driven by an improving external trading environment, in particular supported by a further expected strengthening of emerging market growth, a continuation of supportive finance conditions for business investment, and robust consumer spending on the back of improving labour market conditions.

But our survey also emphasises that members are highly concerned about policy uncertainty, which significantly increased compared to the previous year, geopolitical tensions and access to non-EU markets. In particular, the risk of increasing protectionism and the US withdrawal from the Iran nuclear deal bring political and economic insecurity. Next, uncertainty remains regarding the future relationship between the EU and UK. It is key to maintain an economic relationship that is as close as possible while preserving the integrity of the single market. Finally, members note that the higher Euro exchange rate may start increasingly weighing on exports.

Given the fact that growth cannot run above potential forever[17] and recent signals that growth is at risk of peaking, with medium-term economic prospects being less bright, policymakers should seize the moment to push forward with labour, product and institutional reforms that make EU economies more productive and resilient for the years to come, and raise the EU's long-term growth potential as well as its ability to retain and create jobs. Against the background of emerging supply constraints, it is particularly important to loosen structural constraints such as remaining barriers to investment, address labour market mismatches by for example improving work-orientated learning for all age groups, including the promotion of digital skills, as well as reforms which help encourage people to stay longer in the workforce and ensure to properly integrate legal migrants into the workforce.

Moreover, the Multiannual Financial Framework (MFF) post-2020 must play important role in boosting long-term growth and competitiveness. Businesses believe that the European budget post-2020 should reflect the future priorities of the EU and concentrate efforts on enhancing our competitiveness, particularly in areas where the EU can deliver concrete benefits and help industry

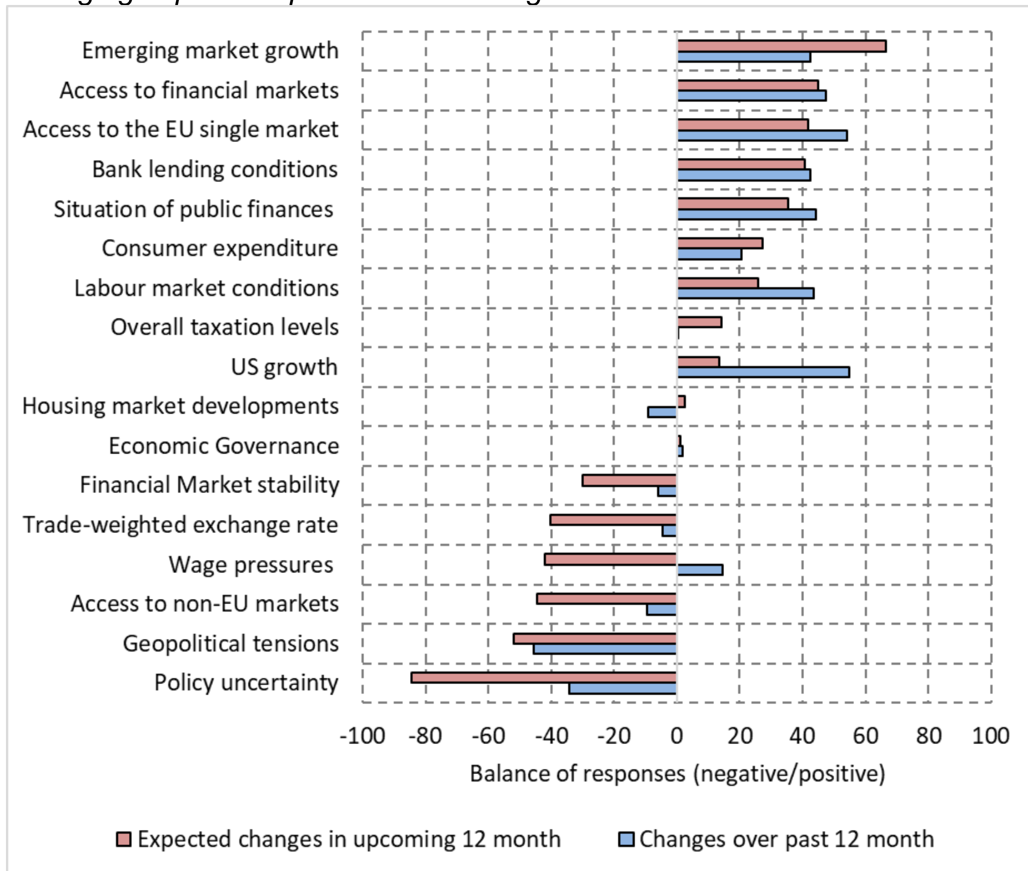
[17] Potential growth for 2017 is estimated to be 1.7% by the European Commission.

prepare for megatrends such as digitalisation and energy transition. We also hope that the Reform Delivery Tool will give much needed impetus for implementation of structural reforms.

Finally, completing EMU and strengthening trust in the Euro remains both a priority and matter of urgency for business. Business investment requires a safe and predictable environment based on a well-functioning economic and monetary union. It is essential that concrete steps are taken forward on deepening EMU in the June Council.

Figure 13 Uncertainty increasingly comes from politics

Changing impact of specific factors on growth forecast



Source: BusinessEurope's forecast based on survey of member federations

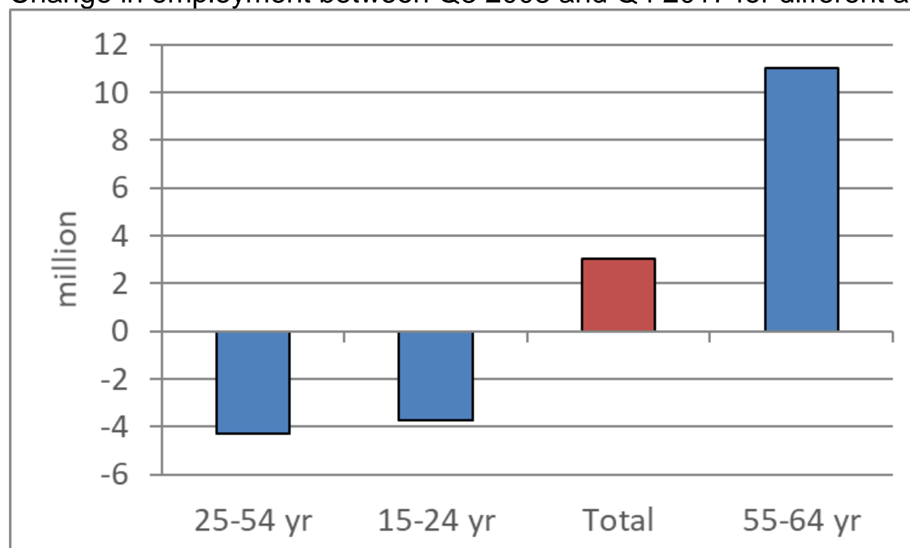
5. UNEMPLOYMENT, INFLATION AND PUBLIC FINANCES

While the recovery still remains incomplete, we already see the emergence of structural mismatches in labour markets

The strengthening of economic growth has led to a further improvement in labour markets. EU unemployment amounted to 7.1% in April 2018, the lowest rate since September 2008, marginally above the pre-crisis low of 6.8% in spring 2008. Unemployment in the Euro area needs still to come down a lot more to reach its pre-crisis level (8.5% in April 2018; 1.2 pp above rates ten years ago). While there are improvements, unemployment rates still remain uneven across EU countries, with three member states still facing rates (well) above 10%.

The overall improvement in EU unemployment rates has been driven by strong job creation, with total employment now three million above pre-crisis level. As shown in figure 14, this development is the result of strong job creation among the age group of 55-64 years-old, whereas employment for people in their early and mid-term career is still below its pre-crisis level. Despite the strong recent job creation, it is important to keep in mind that against international standards EU employment rates are still well below those in the US and Japan as illustrated in our 2018 Reform Barometer.

Figure 14 Overall job creation led by employment gains among older age-cohort
Change in employment between Q3 2008 and Q4 2017 for different age groups and total



Source: Eurostat, BusinessEurope staff calculations

More worrying is that while the recovery still remains incomplete, there are already signs of the emergence of a structural mismatch, where business across the EU increasingly report difficulties in hiring workers (Box 2).

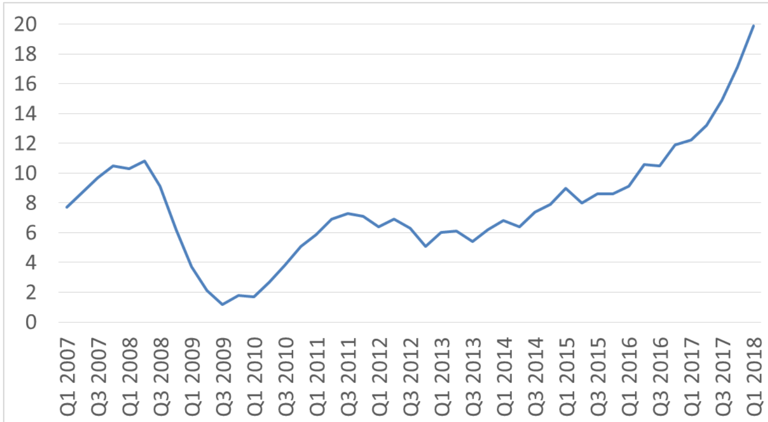
Box 2: Urgent policy action needed to address increasing labour market mismatches

Business federations are increasing concerned about a shortage of relevant skills in the EU, which is increasingly acting as a constraint on production capacity.

Whilst increasing skills shortages might be expected when the economy picks up, the share of industrial enterprises which indicate that insufficient labour limits their production is, despite the relatively recent recovery, already at twice the pre-crisis share and the highest on record since 1985 (figure 15). The latest

ECB Survey on the Access to Finance of Enterprises (SAFE) notes that “availability of skilled labour has become the main issue for euro area SMEs” (24%, compared to 23% in the previous survey and the highest on record since the beginning of the survey in 2009).

Figure 15: Companies are increasingly concerned that a lack of labour hampers production
Share of industrial enterprises which indicate that insufficient labour limits production

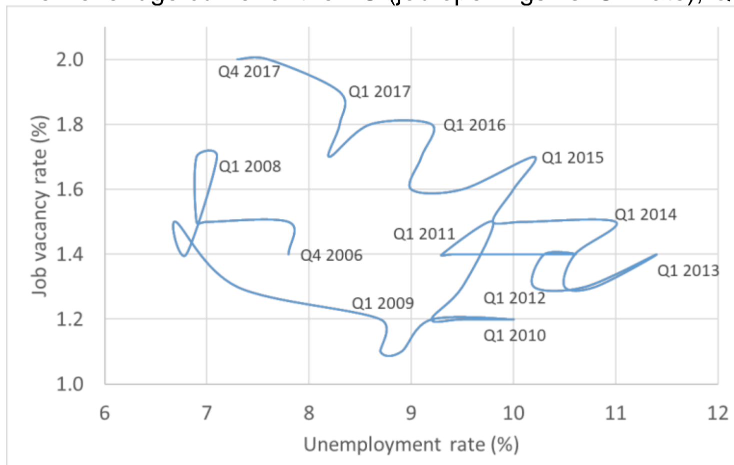


Source: European Commission

The picture of a structural shift in skills shortages is supported when we look at the relationship between job openings and unemployment rates. This relationship, the so-called Beveridge curve, is usually expected to show a decrease in job vacancies when unemployment increases.

However, when we look at the data, between the end of 2009 and the beginning of 2013 unemployment continued to increase, but, job vacancies also increased (figure 16). Thus, when unemployment rates started to gradually decrease, vacancy rates, already at an unusually high level, started to further go up. In other words, we may have seen a permanent shift, where a given level of unemployment now comes along with a higher vacancy rate. This shift may have to do with workers’ skills not having caught up fast enough with a changing structure of the economy and a rapid growth of digitalisation in the aftermath of the crisis.

Figure 16: Outward shift of Beveridge curve suggests structural mismatch in EU labour markets, where a given level of unemployment comes along with higher job vacancies
The Beveridge curve for the EU (job openings vs. UE rate), Q4 2006 – Q4 2017



Source: Eurostat

Against this background, we need to see urgent policy action to avoid that labour market mismatches increasingly act as a break on economic growth over the coming years. Next to a strong impetus to improve work-orientated learning for all age groups, including the promotion of digital skills, financial literacy and

STEM subjects, broader efforts are needed to ensure that regulation, collective-bargaining structures and the tax system all support employment creation. This includes reforms which encourage people to stay longer in the workforce, make pension systems sustainable in the long term, and ensure we properly integrate legal migrants into the workforce.

For 2018 and 2019, we expect a further reduction in the EU unemployment rate to 7.0% and 6.6%, respectively. For the Euro Area we expect an unemployment rate of 8.3% for 2018 and 7.8% in 2019. Rates thus remain well above those forecasted for the US (3.5% acc. to IMF for 2019).

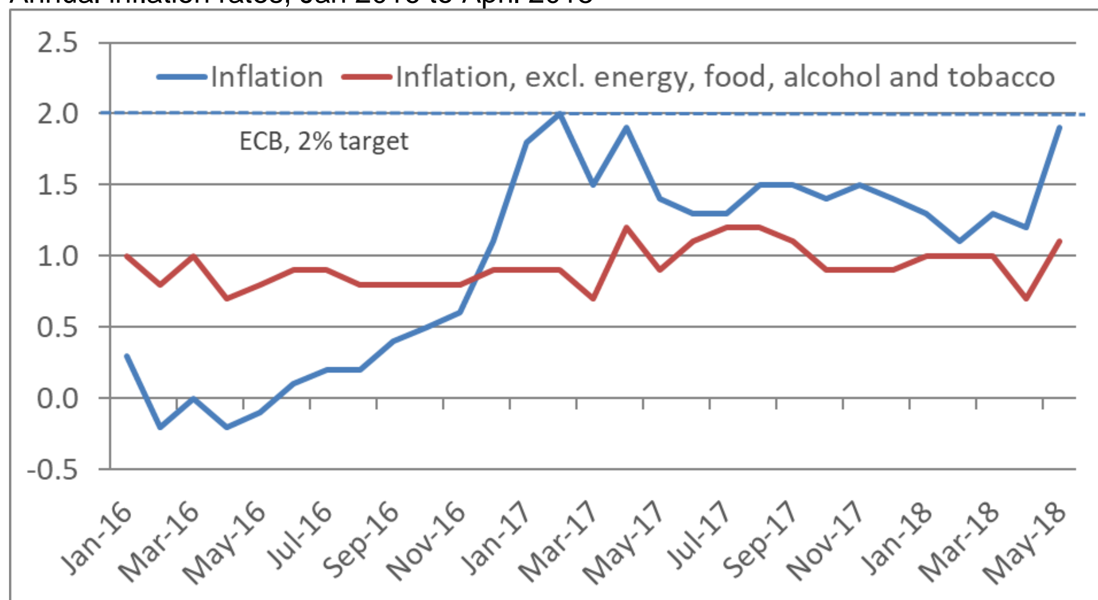
No strong pick-up in inflation prospects over the forecast horizon

Euro area inflation continues to be lacklustre, though volatile. After a strong pick-up from negative territory during 2015 and 2016 to rates of almost 2% at the beginning of 2017, mainly driven by fluctuations of energy prices, inflation fell sligthly during the course of 2017 to rates of around 1.5%. More recently, inflation saw some further slight falls, dropping to 1.2% in April 2018, followed by a strong pick-up to 1.9% in May (figure 17).

Core inflation (i.e. inflation excluding volatile items such as energy and food), which remained relatively stable at around 1% over the recent years, dropped to 0.7% in April. While it remains to be seen in the coming months whether permanent factors were at work, initial analysis from Nordea suggests that the drop may be attributed to one-time effects such as the timing of Easter holidays[18]. This is supported by a slight pick-up of core inflation to 1.1% in the folowing month of May.

In our forecast, we expect Euro area inflation to amount to 1.5% for 2018 as a whole, well below the ECB's target, and then to gradually pick up to 1.7% in 2019.

Figure 17 Euro area inflation continues to remain lacklustre
Annual inflation rates, Jan 2016 to April 2018



Source: Eurostat

[18] Nordea estimates that about -0.16 pp of the fall can be attributed to package holidays.
Tuuli Koivu and Anders Svendsen. 16.05.2018. "Euro-area inflation: Not as bad as at first sight".

While we have seen a gradual reduction in public deficits, debt levels remain high

There has been strong progress in reducing deficits in recent years, with the EU's deficit falling from -6.6% of GDP in 2009 to -1.0% in 2017 (Euro area: -6.3% and -0.9%, respectively). However, public debt, which peaked at 88.3% in 2014 in the EU (Euro area: 94.2%), fell only very slowly to 83.1% in 2017 (Euro area: 88.8%) and thereby remains well above the 60% Maastricht criteria.

For 2018 and 2019, we expect the reduction of debt to proceed at only a slow pace (EU debt: 81.2% in 2018 and 79.7% in 2019; Euro area debt: 87.3% in 2018 and 85.2% in 2019), while deficits are expected to see some further slight reductions.

It is now important to use the current upswing to place a greater focus on brining down government deficit and debt levels.

6. COUNTRY DIFFERENCES

All countries expected to grow, but important differences remain

2017 did not only show the highest growth in more than a decade (2.4% in 2017; 3% in 2007), it was also the first time since the 2008 crisis that all EU economies have posted positive growth.

While the recovery became more broad-based, important differences remain in countries' growth prospects. There are with Malta, Ireland, Slovenia, Romania and Luxembourg five countries which are expected to grow at rates above 4%, while there are two countries (Italy and the UK), which are expected to see growth at rates of 1.5% or less. In 2019, growth is expected to slow or stagnate at 2018 rates in all economies but Greece (+0.3 pp from 2018) and the Slovak Republic (+0.2).

Similiarly, when it comes to unemployment strong country differences remain. While in Greece, Spain and Italy unemployment rates are expected to remain above 10% at the end of our forecast horizon in 2019, rates are forecast to be below 4% in Hungary, the Netherlands, Germany and the Czech Republic. Finally, inflation is expected to exeed 2% in 12 countries in 2019, with the remaining 16 EU member states expected to see price increases in the range of 1.0% and 1.9%.

Table 3: Growth rates expected to slightly slow or stagnate in all but two economies in 2019
Main forecasts for all the economies surveyed.[19]

	Real GDP growth		Inflation		Unemployment	
% Change	2018	2019	2018	2019	2018	2019
Austria	2.8	1.9	2.1	2.2	5.2	5.2
Belgium	1.8	1.7	2.2	1.8	6.7	6.6
Cyprus	3.5	3.2	0.5	1.0	9.5	8.5
Estonia	4.0	3.2	2.9	2.3	5.8	6.2
Finland	2.8	2.4	1.2	1.5	8.1	7.7
France	1.9	1.5	1.6	1.8	8.3	8.0
Germany	2.3	2.0	1.7	1.9	3.2	3.0
Greece	2.0	2.3	0.5	1.2	20.1	18.5
Ireland	5.6	4.8	0.6	1.1	6.1	5.3
Italy	1.5	1.5	1.0	1.3	10.9	10.5
Latvia	4.0	3.4	2.8	2.4	8.0	7.7
Lithuania	3.2	2.7	2.9	2.6	6.5	6.2
Luxembourg	4.2	4.0	1.5	1.7	5.5	5.4
Malta	5.8	5.1	1.6	1.8	4.0	4.0
Netherlands	3.2	2.7	1.5	2.3	3.9	3.5
Portugal	2.3	1.9	1.2	1.4	7.3	6.3
Slovak Republic	4.0	4.2	2.4	2.1	7.1	6.3
Slovenia	5.1	3.8	1.5	1.9	5.3	4.6
Spain	2.8	2.6	1.1	1.3	15.1	13.1
Bulgaria	3.8	3.7	1.8	1.8	5.5	5.3
Croatia	2.8	2.7	1.4	1.4	10.0	9.1
Czech Republic	3.4	3.1	2.1	2.2	2.8	2.7
Denmark	2.1	2.1	1.0	1.4	4.6	4.3
Hungary	4.0	3.2	2.3	3.0	3.7	3.6
Poland	3.8	3.8	2.3	2.3	4.2	3.9
Romania	4.5	3.9	4.2	3.4	4.5	4.4
Sweden	2.6	2.0	1.8	2.1	6.3	6.1
United Kingdom	1.4	1.3	2.5	2.2	4.2	4.3
Norway	2.2	2.2	///	///	4.0	3.7

Source: BusinessEurope's survey of member federations

[19] Note that for blank surveys we used figures from the spring 2018 forecast of the European Commission. This is the case for Slovakia, Bulgaria, Hungary, and Romania.

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Cyprus

Czech Republic

Denmark

Denmark

Estonia

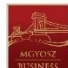
Finland

France

Germany

Germany

Greece


Hungary

Iceland

Iceland

Ireland

Italy

Latvia

Lithuania

Luxembourg

Malta

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Norway

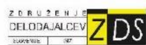
Poland

Portugal

Rep. of San Marino

Serbia

Slovak Republic



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Turkey

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