GROWTH CLOUDED BY EXTERNAL FACTORS

At mid-year, the European economy shows resilience in domestic demand, but export-oriented activity remains subdued. The recent escalation in trade tensions and the corresponding uncertainty is depressing already weak global activity, particularly in the manufacturing sector. Recent hard and soft data confirm that the 'soft patch' in manufacturing and trade that began in 2018 has extended well into 2019. In the quarters ahead, economic activity in the euro area will depend on the way three divergences play out: the resilience of the services sector and the labour market in the face of manufacturing weakness; robust growth in Central and Eastern Europe, which contrasts with the slowdown in Germany and Italy; and the missing pass-through from higher wages to core inflation.

Economic growth in the euro area exceeded expectations in the first quarter of the year, driven by domestic demand. However, the economy's strong performance was flattered by a number of temporary factors such as stockpiling in the UK ahead of the original Brexit date, the mild winter and the rebound in car sales. Their positive impulse is set to unwind in the second quarter and likely weigh on activity. Further ahead, the rebound anticipated later in the year now looks weaker, as the global manufacturing cycle has yet to bottom out and the outlook for trade and investment continues to be clouded by protectionism and uncertainty. The labour market remains the bright spot in the euro area outlook. But here too the outlook is increasingly challenged by the protracted weakness in manufacturing and external demand, which may eventually spill over to services and dampen job creation, wage growth and private consumption.

Overall, the euro area economy is set to continue expanding this year and next, with annual growth forecast to slow from 1.9% in 2018 to 1.2% in 2019 (1.4% in the EU) before firming up at 1.4% in 2020 (1.6% in the EU) helped by a higher number of working days. The relative stability in the annual growth outlook compared to the spring, however, masks a weakening in near-term growth prospects that fully offsets the positive growth surprise in the first quarter. While the annual GDP growth forecast for this year remains unchanged, the lower growth projected in the second half of the year could undermine the continued resilience of the services sector and the expectation of robust domestic demand as the key growth driver of the euro area economy. Despite vigorous wage growth, subdued demand and high uncertainty keep firms from raising prices. As oil prices are also assumed to remain subdued, euro area headline inflation has been revised slightly lower, to 1.3% in both forecast years.

The euro area growth outlook is thus subject to risks that are skewed to the downside and appear even more interconnected than before at this fragile juncture in the global economy. Any further escalation of trade tensions and an increase in policy uncertainty, could prolong the current downturn in global trade and manufacturing and trigger a sharp shift in global risk sentiment and rapid tightening of global financial conditions. This adds to concerns about the medium-term outlook in China and the recent intensification of geopolitical tensions in the Middle East. On the domestic side, given the purely technical assumption of status quo in terms of trading relations between the EU27 and the UK, a "no deal" Brexit remains a major source of risk.

Table 1:
Overview - the Summer 2019 interim forecast

	Real GDP growth						Inflation					
	Summer 2019 interim forecast			Spring 2019 forecast			Summer 2019 interim forecast			Spring 2019 forecast		
	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
Euro area	1.9	1.2	1.4	1.9	1.2	1.5	1.8	1.3	1.3	1.8	1.4	1.4
EU27	2.1	1.4	1.6	2.1	1.4	1.7	1.8	1.5	1.5	1.8	1.5	1.6
EU28	2.0	1.4	1.6	2.0	1.4	1.6	1.9	1.5	1.6	1.9	1.6	1.7