Executive Summary

Economic activity in Europe has slowed on the back of weakness in trade and manufacturing. For most of the region, the slowdown remains externally driven. However, some signs of softer domestic demand have started to appear, especially in investment. Services and domestic consumption have been buoyant so far, but their resilience is tightly linked to labor market conditions, which, despite some easing, remain robust. Expansionary fiscal policy in many countries and looser financial conditions have also supported domestic demand.

On balance, Europe's growth is projected to decline from 2.3 percent in 2018 to 1.4 percent in 2019. A modest recovery is forecast for 2020, with growth reaching 1.8 percent, as global trade is expected to pick up and some economies recover from past stresses. This projection, broadly unchanged from the April 2019 *World Economic Outlook*, masks significant differences between advanced and emerging Europe. Growth in advanced Europe has been revised down by 0.1 percentage point to 1.3 percent in 2019, while growth in emerging Europe has been revised up by 0.5 percentage point to 1.8 percent.

Amid high uncertainty, risks remain to the downside, with a no-deal Brexit the key risk in the near term, which could have a sizeable negative impact on the economies in the region. An intensification of trade tensions and related uncertainty could also dampen investment. More broadly, the weakness in trade and manufacturing could spread to other sectors—notably services—faster and to a greater extent than currently envisaged. Other risks stem from abrupt declines in risk appetite, financial vulnerabilities, the re-emergence of deflationary pressures in advanced economies, and geopolitics.

Subdued inflationary pressures and slowing economic activity in many European countries call for monetary policy to remain accommodative. Wage growth has risen above productivity gains, especially in the European Union's newer member states, but, as discussed in Chapter 2, the pickup in wage growth is likely to have a more muted impact on inflation than in the past. Historically, wage growth has been an important determinant of price developments in Europe. However, the analysis suggests that the passthrough from wages to prices is weaker when inflation and inflation expectations are low, corporate profitability is high, and firms are exposed to greater competition—all characteristics of the current economic environment in most of Europe. At the same time, extending loose monetary policy for longer calls for heightened monitoring of financial sector vulnerabilities—such as rising house prices—and the active use of macroprudential measures as needed.

Given that unemployment rates are projected to remain close to or below levels reached during the pre-crisis boom, countries' fiscal stances should generally remain guided by medium-term objectives. At the same time, overall fiscal balances should be allowed to absorb cyclical fluctuations in activity. Countries with ample fiscal space should take measures to boost potential output, while countries with elevated debt and deficit levels should generally proceed with fiscal consolidation. This would also help address external imbalances. Given elevated downside risks, contingency plans should be at the ready for implementation in case these risks materialize, not least because the scope for effective monetary policy action has diminished. A synchronized fiscal response, albeit appropriately differentiated across countries, could become suitable. Reinvigorating structural reforms, including by raising labor force participation, enhancing human capital and infrastructure, and strengthening governance, remains vital to raise economic growth and address long-term challenges, such as adverse demographic trends.