BUSINESSEUROPE

ECONOMIC OUTLOOK AUTUMN 2016

EU RECOVERY CONTINUING DESPITE BREXIT VOTE

ECONOMIC SITUATION

- **The modest economic recovery in the EU and the Euro Area is expected to continue** despite substantial global and political uncertainty, in particular the UK vote to leave the EU in the referendum on 23 June.

- We expect **growth** to reach 1.9% in the EU (-0.1 pp compared to our Spring Economic Outlook) and 1.7% in the Euro Area (unchanged) in 2016. For 2017, we expect growth to slightly slow to 1.6% in the EU (-0.3 pp) and 1.5% in the Euro Area (-0.2 pp).

- Member federations have generally not revised down their GDP growth expectations for 2016 as a result of the **Brexit vote**, although most expect a small fall (around -0.25 pp) in GDP in 2017, in line with weaker exports to the UK following euro/sterling appreciation and lower UK demand.

- **Consumer spending is expected to remain the key driver of growth**, with EU private consumption expected to grow by 2.2% in 2016 and 1.8% in 2017. In contrast, **net exports** will make a negative contribution with EU imports (3.7% in 2016) slightly outpacing exports (2.8% in 2016). While growth slightly slowed to rates of around 2% at the beginning of this year, **investment** is expected to pick up in the second half and reach 2.6% in 2016.

- **Unemployment rates are forecast to continue to gradually come down** (2016: 8.6% in EU and 9.7% in the Euro Area; 2017: 8.3% in the EU and 9.3% in the Euro Area), but substantial country differences still persist.

POLICY CONSIDERATIONS

- Mitigating adverse consequences of **Brexit** for companies and citizens across Europe is essential. We want to maintain as close as possible economic relations between the EU and the UK but this must not happen at the expense of the integrity of the Single Market. Therefore, cherry picking between the four Single Market freedoms and ill-designed compromises opening the way to “Europe à la carte” is not an option.

- The continuing slowdown in global trade growth increases the importance of reducing remaining barriers to global trade. **The EU must press ahead with a number of global free trade agreements, including TTIP.**

- Member states need to continue with **structural reforms**, focus government spending on **growth-enhancing investment,** and, where necessary, pursue further **fiscal consolidation** while drawing on the flexibility within the Stability and Growth Pact.

- Given continuing **investment** weakness, the EU must urgently address existing barriers in order to increase the attractiveness of Europe as an investment destination. We welcome the proposal to extend the European Fund for Strategic Investments (EFSI) but there must be greater focus on the additionality of investment and its geographic coverage.

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 autumn's questionnaire were received in September 2016.

FOR FURTHER INFORMATION:

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1. OVERVIEW

European business federations expect the recovery of the European economy to continue in the coming months with the UK's vote to leave the EU appearing to not have so far significantly damaged business confidence. Over 80% of our member federations from across Europe expect businesses to increase investment rates over the coming 6 months, compared to just over 50% when we surveyed them in spring.

Overall, we expect growth to reach 1.9% in the EU (-0.1 pp compared to our Spring Economic Outlook) and 1.7% in the Euro Area (unchanged) in 2016. For 2017, we expect growth to slightly slow down to 1.6% in the EU (-0.3 pp) and 1.5% in the Euro Area (-0.2 pp). These moderate downward revisions for 2017 are particularly linked to the likelihood of both a slowdown in the UK economy and lower exports to the UK as the appreciation of the euro against the sterling starts to impact.

Table 1 Economic growth prospects for the EU and Euro area remain positive

	EU28		Euro area	
Main Variables	**2016**	**2017**	**2016**	**2017**
Real GDP (annual % growth)	1.9 (-0.1)	1.6 (-0.3)	1.7 (+/- 0.0)	1.5 (-0.2)
Inflation (%)	0.3 (-0.1)	1.3 (-0.1)	0.3 (-0.1)	1.2 (-0.1)
Unemployment (%)	8.6 (+/-0.0)	8.3 (-0.1)	9.7 (+/-0.0)	9.3 (-0.1)
government net lending (% of GDP)	-2.2 (+/-0.0)	-1.9 (-0.1)	-1.9 (+/-0.0)	-1.7 (-0.1)
gross public debt (% of GDP)	85.8 (-0.9)	85.2 (-0.3)	91.0 (-1.0)	90.5 (-0.7)
	EU28		**Euro area**	
GDP components	**2016**	**2017**	**2016**	**2017**
Private consumption (%)	2.2	1.8	1.9	1.4
Public consumption (%)	1.7	1.4	1.6	1.2
Gross fixed capital formation	2.6	3.0	3.1	2.7
Exports (%)	2.8	4.0	2.3	3.9
Imports (%)	3.7	4.5	3.0	4.4

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

Our forecast builds on official data for the first half of the year. It shows that improvements in consumer spending, in line with low oil prices, continued to be the main impetus for growth. Growth also continues to be supported by the ECB's expanded asset purchase programme, while net exports, boosted by the lagged impact of the fall in the value of the euro in 2015 had a positive effect on growth in the second quarter of 2016.

Nevertheless, the outlook is subject to significant political risks. As we note in a special article, the UK's vote to leave the EU represents a long-term risk to both the EU and UK economies given the profound interconnectedness of these two economies. In addition, 2017 will see elections in countries including Germany, France, the Netherlands and the Czech Republic, with a positive outcome in the forthcoming constitutional referendum in Italy key to ensuring that growth in that country is sustained. Finally, with global trade growth slowing, the EU will face a more difficult trading environment in the coming months, particularly given the rise in the euro exchange rate since last spring.

2. RECENT DEVELOPMENTS IN MORE DETAILS

Moderate growth continued at the beginning of this year…

Official data shows the EU economy continued to show moderate growth in the first half of 2016. We saw strong growth of 0.5% in both the EU and the Euro Area in the first quarter (compared to Q4 2015), followed by increases of 0.4% in the EU and 0.3% in the Euro Area in the second quarter. The EU grew thereby at a slightly faster pace than the US economy which grew by 0.2% in Q1 and 0.3% in Q2 of 2016.

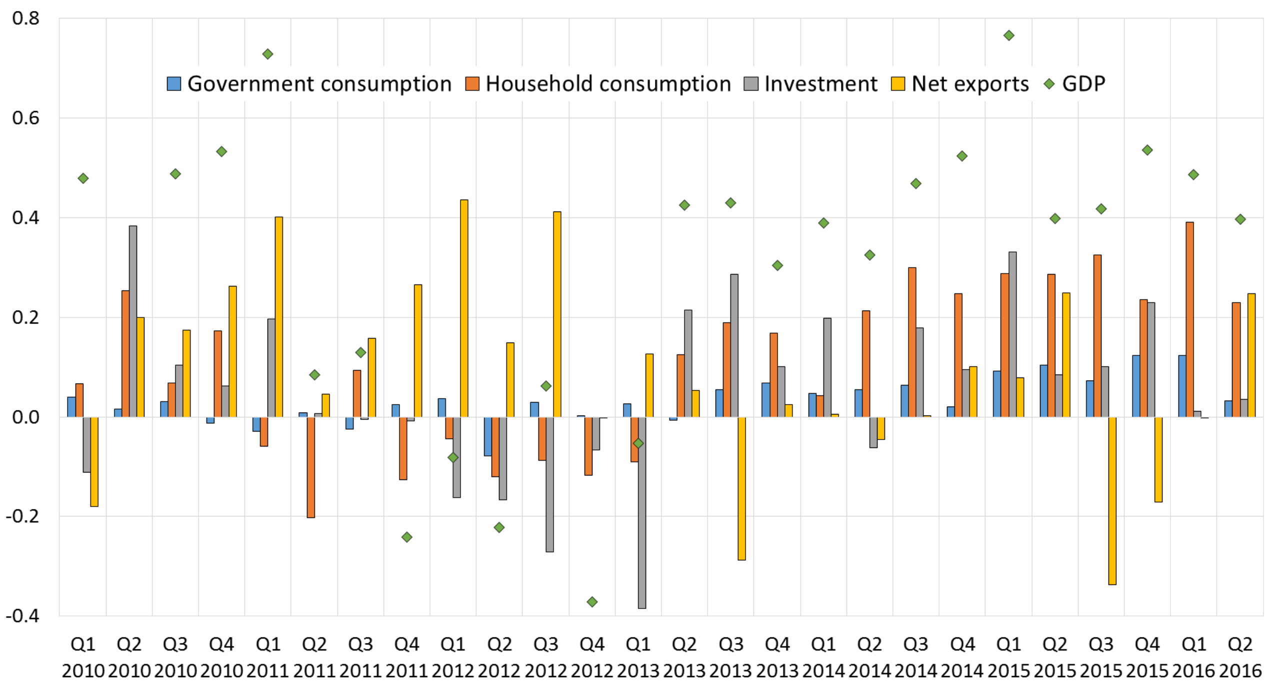
…with growth driven by consumer spending and improved net exports

Since the beginning of 2013, we have seen a gradual pickup in household consumption, which has increasingly replaced net exports as the most supportive factor for EU growth (fig 1).

This steady growth in consumer spending has continued in 2016, although in contrast to recent quarters, net exports made a strong contribution to growth in Q2 this year as the lagged effect of the fall in the value of the euro in the first half of 2015 helped export competitiveness.

Figure 1 Recent growth driven by consumer spending, while contribution of investment slows slightly at the beginning of 2016

Contributions to quarterly GDP growth and overall GDP growth in %, Q1 2010 – Q2 2016



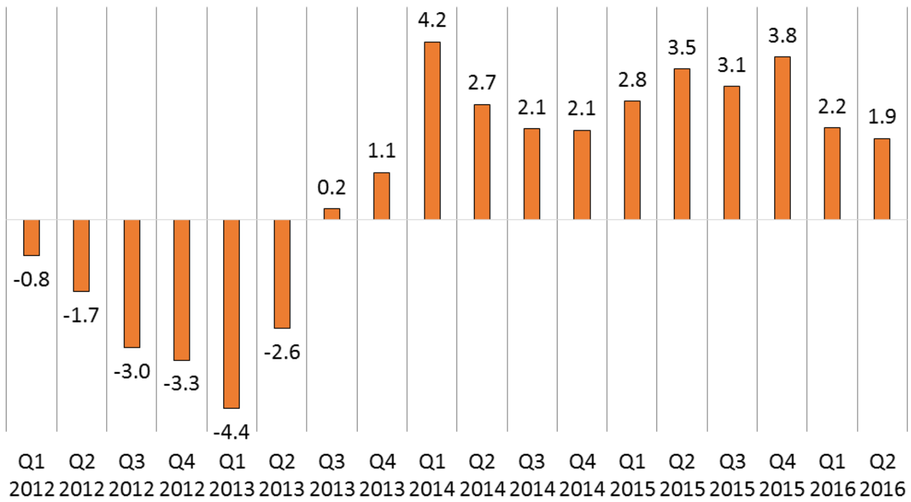
Source: Eurostat, BusinessEurope staff calculations

EU investment has yet to show a more sustained recovery, despite some improvements in access to finance

It is of some concern that investment, which as of 2013 started making a positive contribution to growth, made virtually no contribution in the first two quarters of 2016, although a more detailed examination of the data suggests that this may have been due to a (possibly temporary and weather-related) fall in construction rather than business investment.

Looking in more detail, while investment started slowly picking up at the beginning of the second half of 2013 (fig 2) and recorded an average growth of 3.3% last year, investment growth slowed slightly to 2.2% in Q1 2016 and to 1.9% in Q2 2016.

Figure 2 While investment growth returned as of mid-2013, it recently slowed slightly
Investment, % change compared to the previous year, seasonally and calendar adjusted, Q1 2012 – Q2 2016



Source: Eurostat

The fall in investment at the beginning of the year comes alongside a slight drop in capacity utilisation (from 81.2% in Q4 2015 to 81% Q1 & Q2 2016). However, capacity utilisation increased again to 81.8% in the EU and thus its highest level since the beginning of the financial crisis, pointing to a likely gradual increase in investment growth in the coming quarter.

Companies' investment plans are also subject to finding access to finance, with a number of measures suggesting that provision is further improving in most member states. Interest rates on short-term, small business loans fell in the Euro Area to 2.41% in July 2016 from 3.56% a year earlier. The ECB's latest bank lending survey from July indicates that credit standards for loans to enterprises eased further (net percentage of -7%, compared with -6% in Q1 2016), even though this improvement is not observed in some countries.

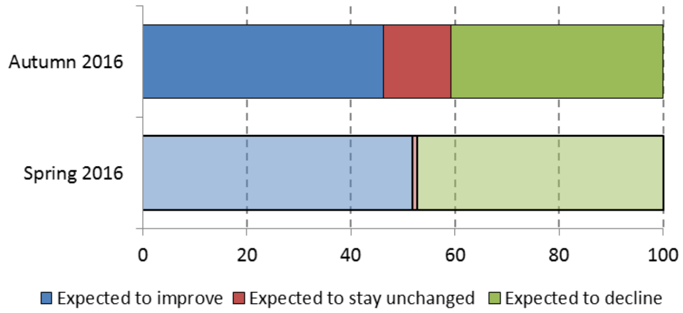
3. Future prospects

EU businesses expect continuing growth despite Brexit vote

Our survey of member federations suggests that, so far, the Brexit vote has had a very limited impact on business confidence in the EU overall, with respondents continuing for the moment to be largely balanced between those that expect to see an improvement in economic performance and those that expect a decline (fig 3). However, in the longer term, there could be more important implications for EU growth, depending on the future nature of the EU's economic relations with the UK.

Figure 3 Limited impact of Brexit vote on overall EU business confidence

Overall business climate in industry and services over next 6 months

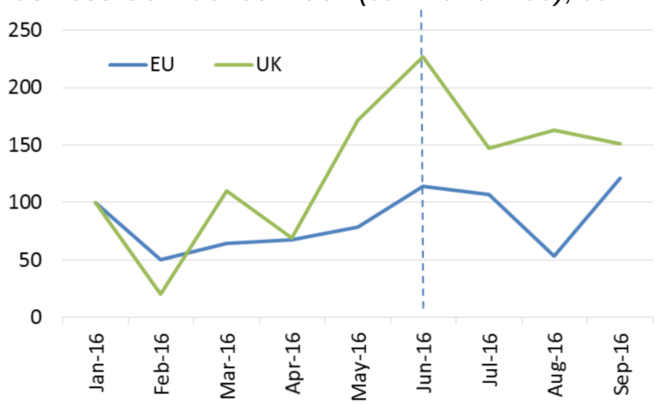


Source: BusinessEurope's forecast based on survey of member federations

This is also reflected in the Commission's business confidence indicator which suggests that overall EU business confidence largely held up after the referendum and even saw a strong increase in September (fig 4). In particular, Germany's IFO index of business confidence saw a sharp improvement in September, rising from 106.3 points in August to 109.5 points in September. For the UK, the Commission index shows an initial drop in July, after strong increases in the two prior months, but no significant changes in the August and September readings.

Figure 4 Businesses remain confident about prospects even after the referendum

Business Confidence Index (Jan 2016=100), Jan 2016 – Sep 2016



Source: European Commission, BusinessEurope staff calculations

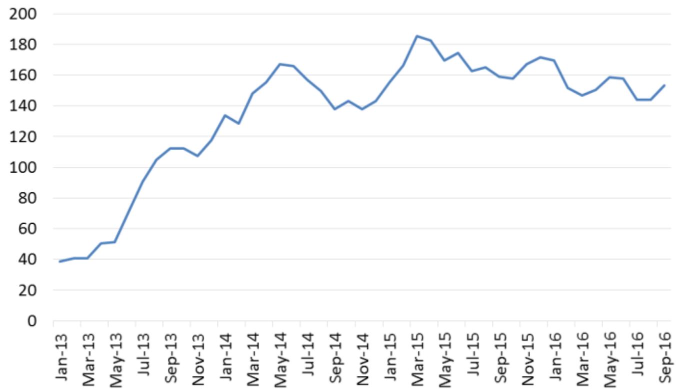
Consumer spending remains on course to gradually increase

Similarly, there are few signs that consumers in the EU have been deterred by the Brexit vote. We have seen a gradual increase in retail sales since the start of 2013. Initial data suggests this trend has continued into the summer in both the UK and EU as a whole (monthly retail sales growth, which can be volatile, was 1% for the EU and 1.3% for the UK in July, and -0.1% for the EU and -0.3% for the UK in August).

The Commission's consumer confidence indicator also suggests that EU consumer confidence is now at a similar level to where it was at before the UK referendum (fig 5).

Figure 5 Consumer confidence holds up after Brexit vote

Consumer confidence index (Jan 2010 = 100), Jan 2013 – Sep 2016



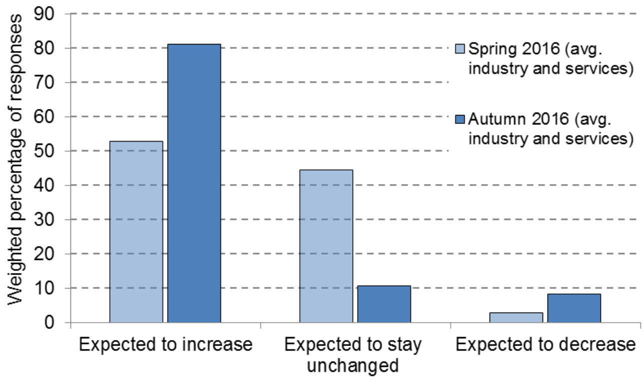
Source: European Commission

EU investment intentions have improved despite the Brexit vote with no significant impact on access to finance

In line with improvements in EU business confidence, our member survey indicates that over 80% of federations expect to expand investment over the next 6 months (fig 6), a more positive outlook than we saw in in our Spring 2016 Economic Outlook.

Figure 6 Investment is likely to recover from the lower rates seen in the first quarter

Investment trends over the next 6 months compared to the last 6 months



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

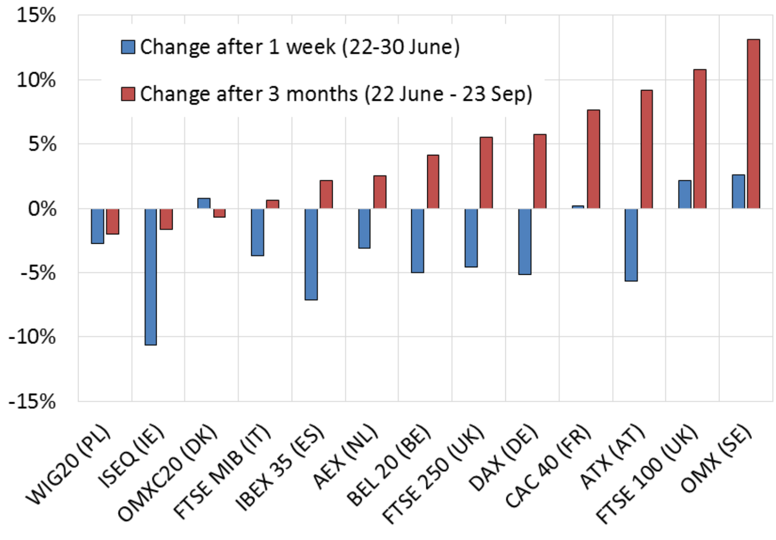
In terms of access to finance, the vote appears unlikely to have damaged prospects for EU firms to receive funding, which remains a constraint for many firms despite gradual improvements in some member states. The most recent ECB bank lending survey for July notes that "no clear picture has so far emerged on how banks assess the impact of the UK referendum on lending conditions". The survey was conducted partly before and after the UK referendum (14 to 29 June), but when splitting replies into replies given before and after the referendum, no negative shock could yet be identified for credit supply or demand. For the third quarter of 2016, the survey suggests that banks expect broadly unchanged credit standards on loans to enterprises.

EU financial markets have been relatively stable following the Brexit vote

More broadly, financial markets in the EU, after some initial instability, have not been significantly impacted by the Brexit vote. While major European stock indices fell strongly in the week after the referendum, most recorded gains in the subsequent 3 months (fig 7). For the UK, note that many companies in the FTSE 100 have large overseas holdings, with rises in the FTSE in part reflecting the increased value of profit flows from these overseas interests in sterling terms as a result of the fall in the UK exchange rate. Nevertheless, the FTSE 250, which arguably presents a broader picture of market perceptions of UK prospects given its constituent companies have a more UK focus, has also grown significantly in sterling terms.

In addition, concerns that there may be a rise in peripheral bond yields in line with investors moving away from assets perceived as being more risky did not come to fruition.

Figure 7 Fall in European stock prices after the referendum but subsequent gains
Changes in major European stock indices

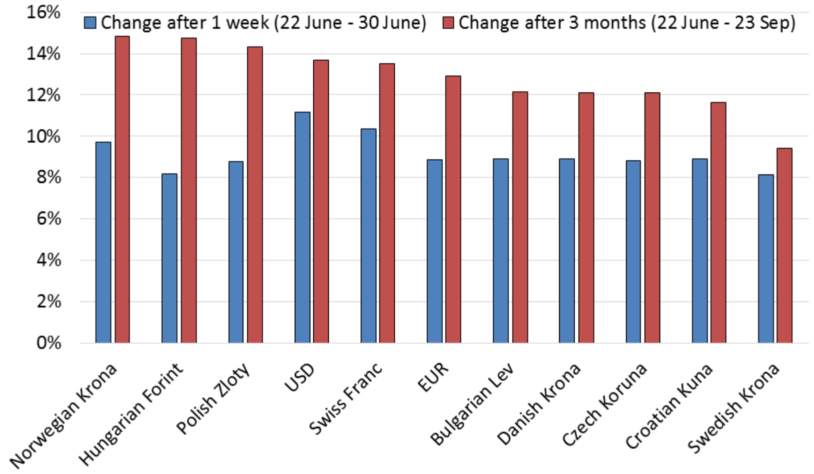


Source: investing.com, BusinessEurope staff calculations

In currency markets, we saw initially a slight depreciation of the Euro against the USD (of about 2%), although the euro has largely regained these losses. In contrast, the effective exchange rate of the British pound fell immediately by about 15% and has remained at its lower level. As the flipside of this, European currencies as well as the US Dollar appreciated by between about 10-15% against the Pound in the 3 months after the referendum (fig 8).

Figure 8 Large appreciation of currencies against the Pound after the Brexit vote

Changes in value of currencies against the British Pound



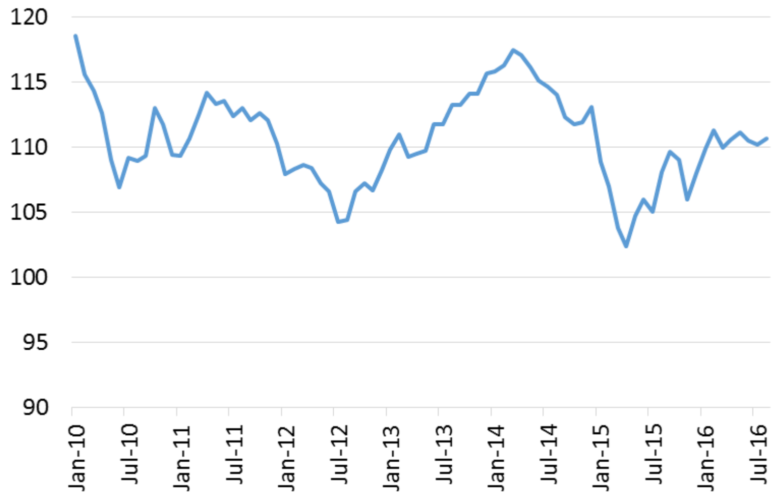
Source: investing.com, BusinessEurope staff calculations

Export prospects: Sterling devaluation adds to challenges for Euro Area exports in a slowing global trade environment

While net exports provided a boost to EU GDP in Q2 this year, two factors are expected to weigh on future exports. First, as figure 9 shows, the euro's effective exchange rate has been appreciating in recent months. While Euro Area exports were recently still benefiting from the lagged effect of the fall in the euro effective exchange rate between January 2014 and April 2016, the euro's appreciation since mid-2015 will increasingly act as a drag on exports in the coming months.

Figure 9 In the future exports will receive less support from a lower euro exchange rate

Nominal Effective exchange rate for Euro Area, Jan 2010 – Aug 2016

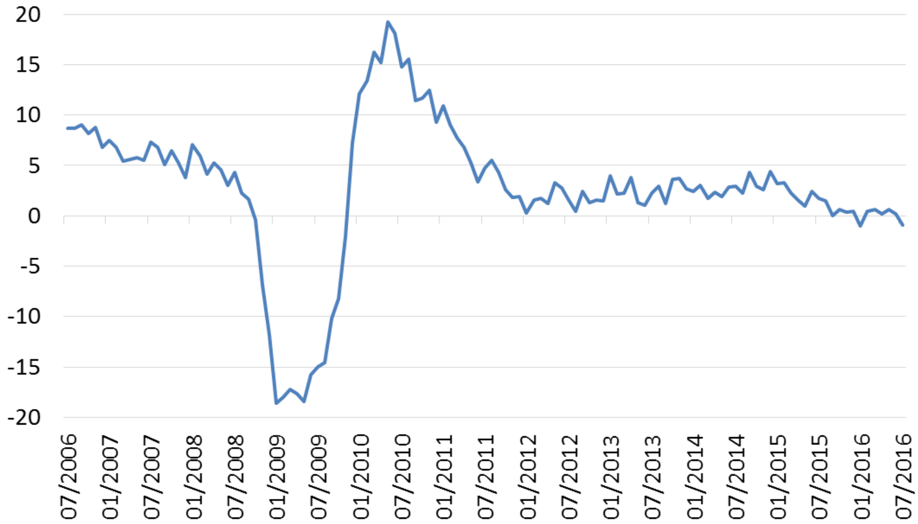


Source: ECB

Second, the slowdown in global trade growth to annual rates of below 1% (fig 10) points to an increasingly challenging trading environment for European companies. In its recent World Economic Outlook, the IMF points out that “the overall weakness in economic activity, in particular in investment, has been the primary restraint on trade growth, accounting for up to three-fourths of the slowdown.” However, the IMF also indicates that other factors are weighing on trade such as the “waning pace of trade liberalization and the recent uptick in protectionism” as well as the “decline in the growth of global value chains”. The IMF thus makes a strong case for further trade reforms that can lower export barriers.

Figure 10 Slowdown in world trade to annual rates of below 1%

Global trade, change in % compared to previous year, July 2006 – July 2016



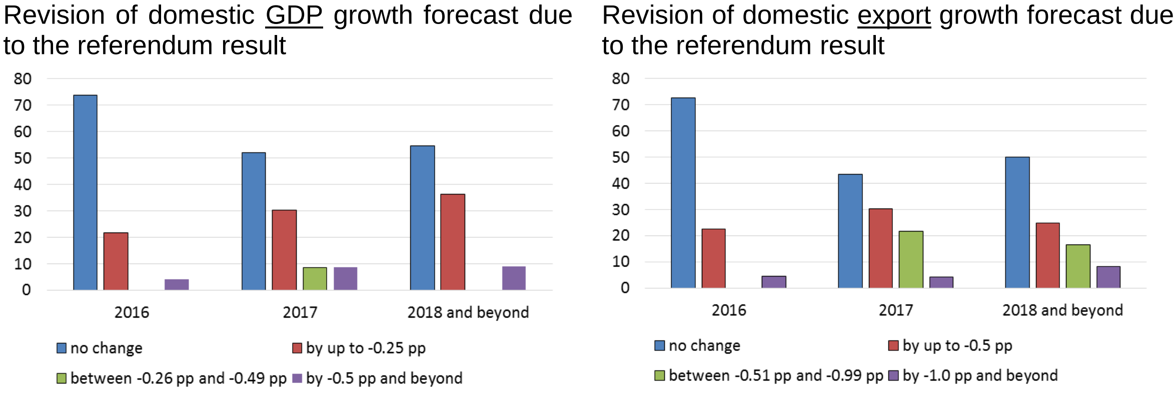
Source: CPB, BusinessEurope staff calculations

Summary: The UK referendum has led to a moderate revision of EU economic growth prospects for 2017

Overall, we find that the UK referendum is likely to have a limited impact on medium-term economic growth. The vast majority of our federations (70%) has not revised down their GDP and export growth expectations for 2016 as a result of the referendum outcome (fig 11). The picture becomes more mixed for 2017 where around 30% of federations revised down their growth forecast by up to -0.25 pp and their export forecast by up to -0.5 pp, with some federations indicating the impact could be larger (in some cases above -0.5 pp for GDP).[1] Similar for 2018 (if applicable), almost half of the federations made a downwards revision for both GDP growth and export growth. Such revisions are in line with lower EU exports to the UK as a result of both falling UK domestic demand and the appreciation of the euro in relation to the sterling.

[1] Looking at a weighted average the 2017, the revision in GDP growth is in line with the -0.3 pp downwards revision of our main forecast for the EU (Table 1).

Figure 11 No substantial downward revision of 2016 forecast due to referendum outcome

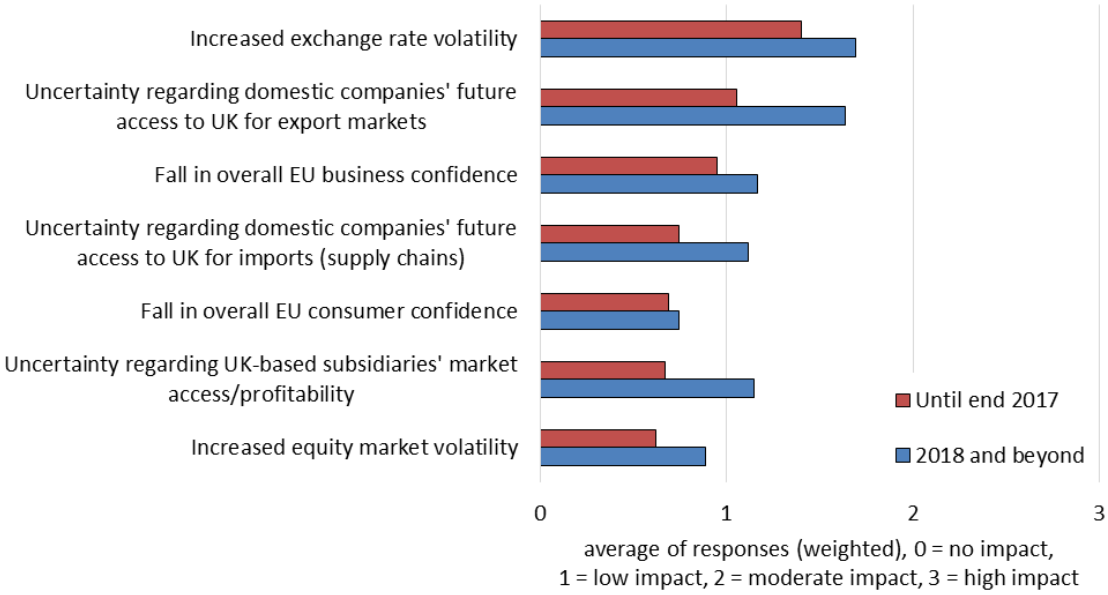


Source: BusinessEurope's forecast based on survey of member federations

The importance of the exchange rate to businesses is underlined when we look at what member federations expect to be the main channels through which the Brexit vote could impact EU growth, with increased exchange rate volatility presently the main concern (fig 12). As we move beyond 2017, some member federations are increasingly concerned about the potential impact on firms in the countries losing some access to the UK as an export market, as well as their access to the UK for supply chain imports, and the market access and profitability of their UK subsidiaries. Of course, how these concerns will develop will clearly be linked to progress in negotiations between the UK and the EU on their future relationship. The question of the long-term potential impact of Brexit on EU member states and sectors is looked at in more detail in Box 1.

Figure 12 Increased exchange rate volatility likely to be the main channel through which the Brexit vote could impact on EU growth

Potential consequences of the Brexit vote and likelihood of impact on growth



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

Box 1: Potential long-term implications for the EU economy of BREXIT

As we have noted, the outcome of the UK's referendum to leave the European Union has potentially significant implications for economic prospects both, in the UK, and the wider EU, for a number of years ahead.

To complement the analysis of the short- and medium-term implications elsewhere in the outlook, this box considers the long-term implications of BREXIT, and in particular, the extent of trade, investment and migratory linkages in different member states, which, dependent upon the future nature of the EU's economic relationship with the UK could potentially have important implications for EU growth.

Member states have very different levels of trade linkages to the UK

The UK decision to leave the European Union is most likely to impact on economic activity in the long-term in both the remaining EU 27 and the UK if businesses can no longer trade between the two economies without overcoming either tariff or non-tariff barriers.

A number of studies have pointed to the importance of the single market to EU growth, through traditional trade channels such as increased specialisation, economies of scale, competition and knowledge exchange. For example, Nauro F. Campos, Fabrizio Coricelli and Luigi Moretti (2014)[2] estimate that without deep economic and political integration coming from EU membership, per capita incomes would have been, on average, approximately 12% lower today. In addition, the single market provides additional welfare benefits to consumers through increased choice.

With about 41% of UK exports currently going to the EU and accounting for 11% of GDP, the Confederation of British Industry has made "retaining the ease of UK-EU trade that businesses get from the single market" one of its principles for the UK's new relationship with the EU. Whilst in comparison, only about 7% of the EU's exports to EU and non-EU countries presently go to the UK (less than 4% of EU GDP), the UK is nevertheless an important market.

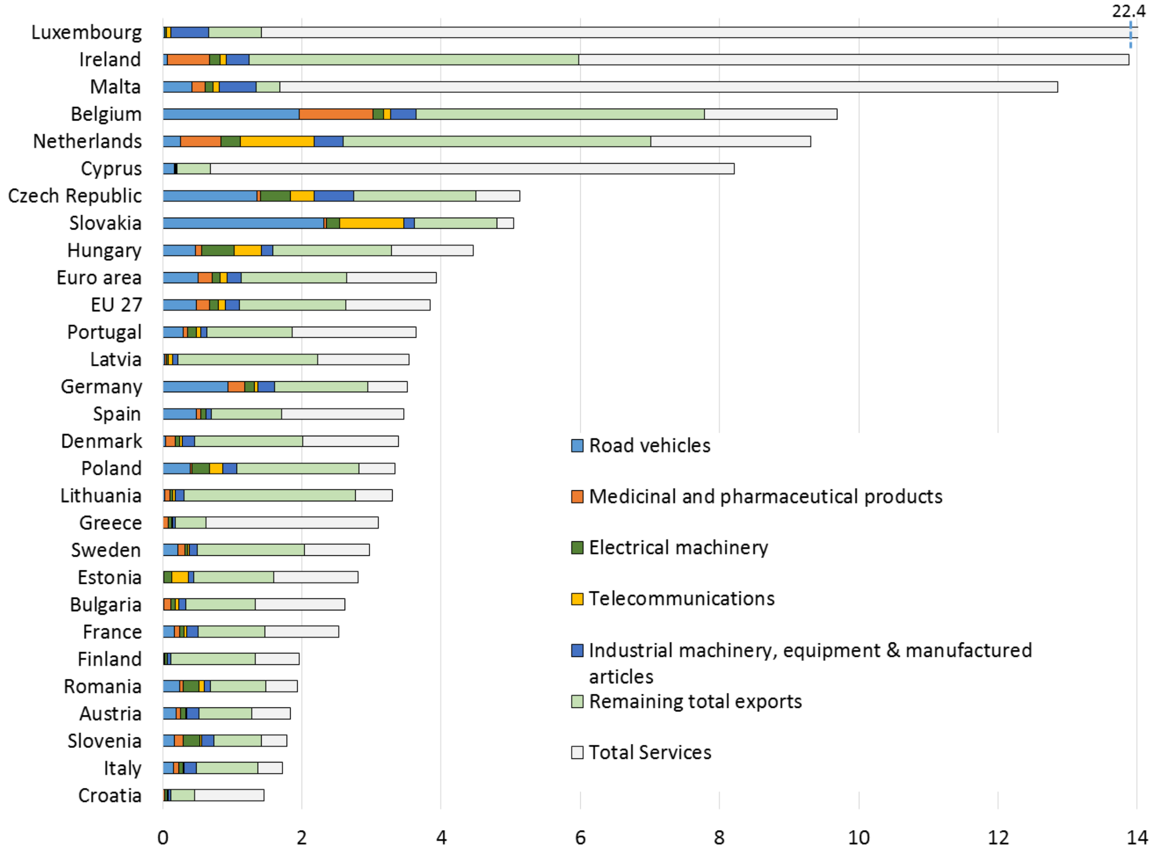
The question of export linkages between the EU and the UK can be considered in more detail through two key types of data, namely gross exports and value-added in exports.

Traditional export data showing total exports of goods from a country to the UK has the advantage of allowing some additional sectoral analysis. As figure 13 suggests Luxemburg, Ireland, Malta, Belgium the Netherlands and Cyprus, are countries which at present have a relatively large export footprint in the UK, with overall exports to the UK exceeding 8% of their respective economic output. In contrast, exports to the UK make up less than 2% of GDP for Finland, Romania, Austria, Slovenia, Italy and Croatia.

It is also important to look at the composition of exports from different member states, particularly given that any final trading arrangement between the UK and the EU may have different provisions for different types of goods and services. Figure 13 illustrates that for Belgium exports of road vehicles and medical and pharmaceutical products alone make up 3% of GDP, while exports of cars to the UK are also highly important for Slovakia, the Czech Republic and Germany. In contrast, for the Netherlands, Estonia and Slovakia telecommunication make up also a substantial part of their UK exports, whilst services make up over 50% of total exports to the UK for Luxembourg, Malta, Cyprus, Greece, Croatia, Ireland and Spain.

[2] "Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using the Synthetic Counterfactuals Method". Institute for the Study of Labor, Bonn, Germany.

Figure 13: Export exposure to the UK differs widely between EU 27 countries
Goods and services exports to the UK as % of countries' GDP, latest data available



Source: Eurostat, UN Comtrade, BE staff calculations

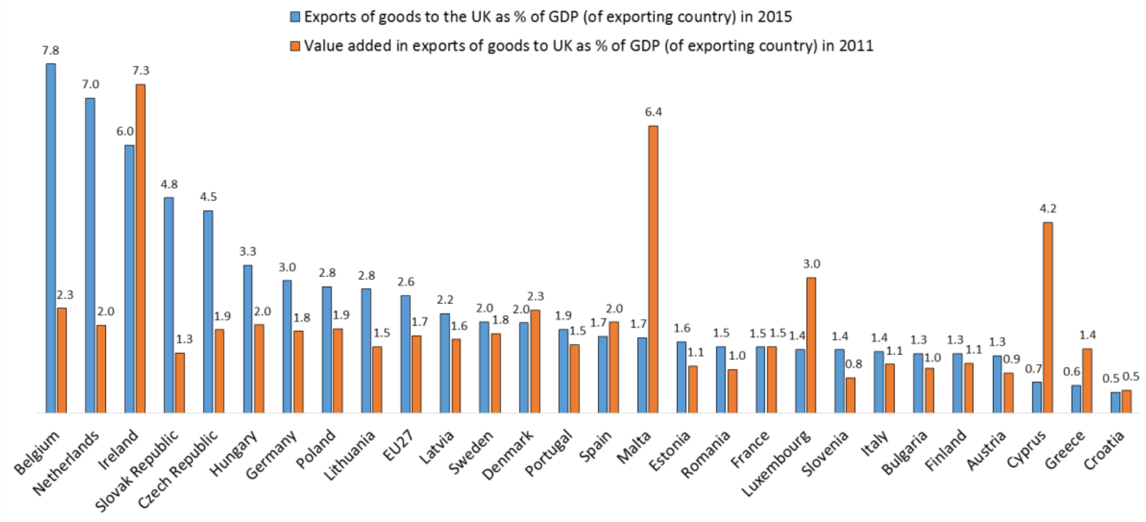
However, such traditional export data has the weakness that it may in part reflect some goods being imported to a country (e.g. as components) and then re-exported (e.g. as final goods), rather than being produced in the country in question.

More recently, statisticians have developed value-added data for exports of goods, which aim to measure the proportion of an export, which was actually made (value-added) in the respective country. Such data continues to be developed, and should be treated with caution. It has the added disadvantage of only being produced most recently up until the year 2011, and is available only for total goods but not services.

Figure 14 shows that differences in value-added in exports are much less divergent between EU member states than for the overall export data. The importance of geographical location in particular is much diminished, with linkages between the UK, Belgium and the Netherlands in particular looking much less strong. In contrast, historical country linkages become much more important, with Ireland, Malta and Cyprus all having relatively strong share of value-added exported to the UK when it comes to the exports of good only.

Figure 14: Differences in value-added in exports to the UK are much less divergent for EU countries than for overall exports

Gross exports of goods and value-added in exports of goods to the UK



Source: Eurostat, OECD, BE staff calculations

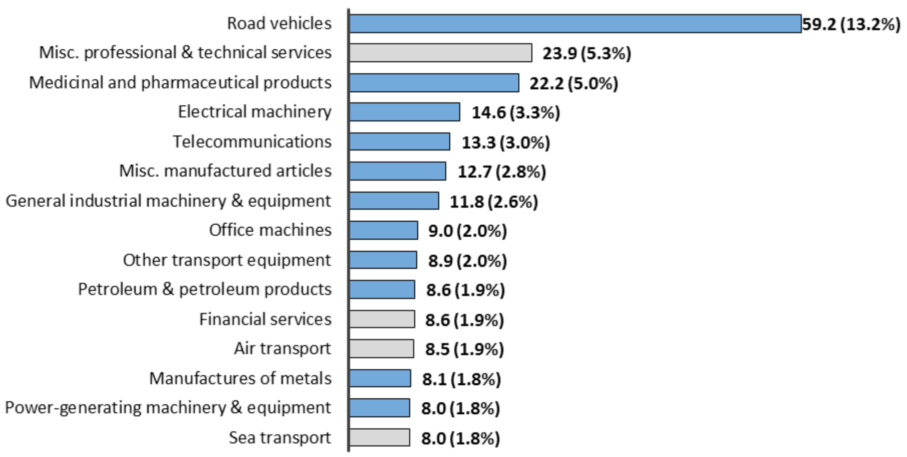
UK-EU trade intensity also varies considerably between sectors

Looking more widely at this sectoral story across the EU, figure 15 shows that automobiles makes up the largest chuck of export to the UK (€59.2 bn, or 13% of the total in 2015). This is followed by exports of professional & technical services (€23.9 bn), medical and pharmaceutical products (€22.2 bn), electrical machinery (€14.6 bn), telecommunications (€13.3 bn) and manufactured goods (€12.7 bn, or €24.6 when combined with general industrial machinery and equipment).[3]

For the UK, road vehicles make up the largest part of goods exports to the EU (€19.4 bn or around 6.7% of total goods and service exports), followed by petroleum products (€17 bn) and medical and pharmaceutical products (€12.6 bn). For services, business services (€22.7 bn), travel (€15 bn) and transportation (€14.7 bn) are the largest categories.

Figure 15: Cars, professional services & medicinal products make up the largest chunk of exports to the UK

EU's top 15 exports of goods and services to the UK in 2015, billion euros (% of total)



Source: Eurostat, BE staff calculations

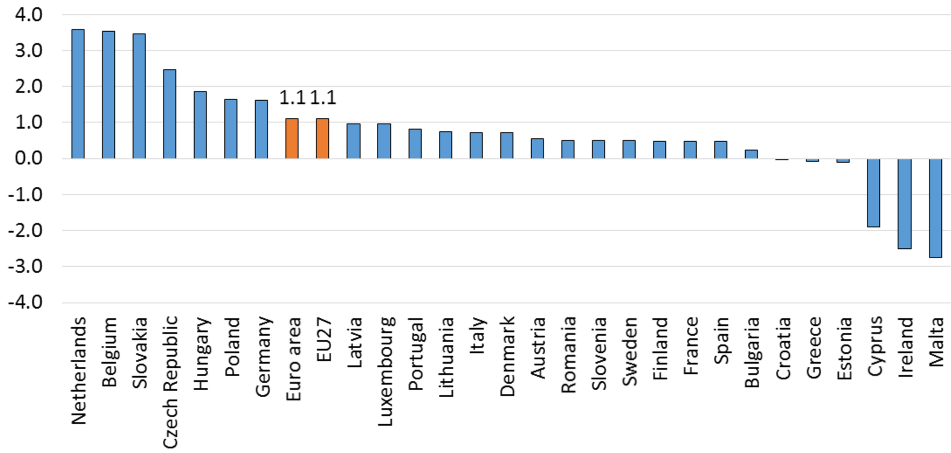
[3] Note that when looking at a higher aggregated level for goods exports to the UK, "food and life animals" comes out 5th place (€31.4 bn or 7% of the total for goods and serives), after various manufacturing items and chemicals.

A large trade imbalance with the UK could also be significant

Although the most important issue for many member states will be the extent to which their firms are drawing on the UK as an export market, governments will also be considering their overall trading positions with the UK. In particular, in the scenario where UK/EU trade is disrupted post-Brexit, those countries running trade deficits with the UK are much more likely to see some losses in output in UK export-oriented sectors being compensated by output and employment increases in areas of the economy that were previously importing consumer goods from the UK, compared to those countries running a trade surplus with the UK. Although a high level of UK imports may be less positive in such a scenario if those imports form part of a supply chain, rather than being for final consumption.

As figure 16 indicates, the EU as a whole runs a small trade surplus of goods with the UK.[4] Overall figures suggest that the surplus is largest with Netherlands, Belgium and Slovakia (over 3% of GDP in each country), although once again it is important to emphasise that this may in part reflect the nature of supply chains whereby final goods are assembled and exported in a given country, and not reflect the actual value-added taking place in the member state.

Figure 16: Only three member states run a sizable trade deficit with the UK
Trade Balance in goods as % of EU countries' GDP



Source: Eurostat, BE staff calculations

Investment

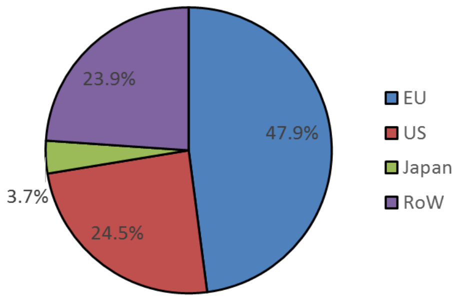
Many international European businesses are heavily invested in the UK. Almost half of the stock of FDI in the UK comes from the EU (fig 17), making up around €615 bn in 2014. This €615 bn in turn, represents 8% of EU 27 Foreign FDI.

The transmission mechanism through which such linkages translate into GDP in specific member states is however complicated. Businesses with FDI interests may suffer either falls in profitability or in the market value of their capital if growth or growth prospects in the UK fall, and could see additional falls if the value of both profits and capital is reduced in euro terms by a fall in the value of sterling. However, while a company owning FDI will be headquartered in a certain member state, shareholders are likely to be more widely dispersed, meaning the ultimate impact upon living standards is difficult to calculate.

Beyond, these purely financial consequences, FDI can act as an important proxy for overall supply chain linkages between firms in EU member states and in the UK. Having said this, some EU companies will have invested in the UK primarily as a base to service UK consumers, while others will have production facilities which form parts of larger supply chains.

[4] The surplus will amount to 1.4% for the EU and Euro Area when looking at both goods and services. Given that the UNCOMTRADE database has not for every EU country the latest period available, one should only regard the combination of goods and services data as an indication.

Figure 17: Almost half of the UK's inward investment comes from EU counties
Inward stock of FDI in UK in 2014, % of total

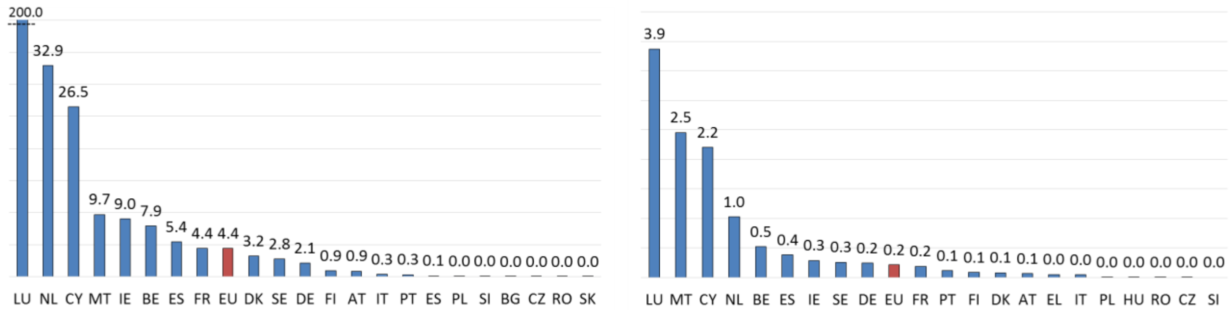


Source: ONS, BE staff calculations

In terms of country linkages, relative to their GDP, Luxembourg, the Netherlands and Cyprus are the countries with the strongest FDI linkages, followed by Malta, Ireland and Belgium (fig 18). However, one needs to be careful when assessing these figures since in some of these countries corporates might channel their FDI via a holding company so that it is difficult to determine where the ultimate investor is located.

Overall, earnings from FDI amount to just 0.2% of GDP for the EU, although this figure is almost 4% for Luxembourg, 2.5% for Malta, 2.2% for Cyprus and 1% for the Netherlands.

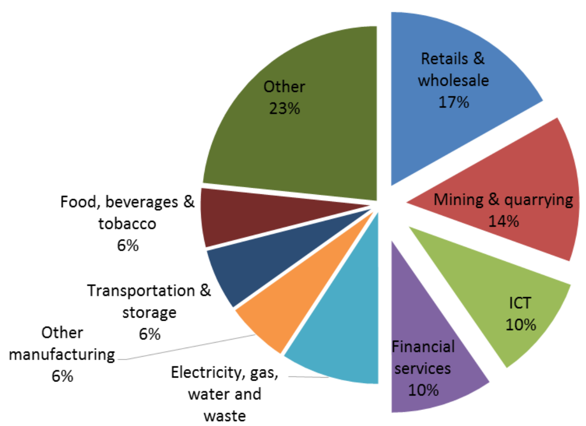
Figure 18: Large differences in EU countries FDI exposure to the UK
FDI stock in the UK by country, 2014, % of GDP *Earnings from FDI in the UK, 2014, % of GDP*



Source: ONS, Ameco, BE staff calculations *Source: ONS, Ameco, BE staff calculations*

At a sectoral level, the retail and wholesale, mining, ICT and financial services sectors are most heavily invested in the UK, making up almost half of the total €615 bn stock (fig 19).

Figure 19: Half of the total EU investment into the UK comes from only 4 sectors
EU's FDI stock in the UK by sector in 2014, as % of total



Source: ONS, BE staff calculations

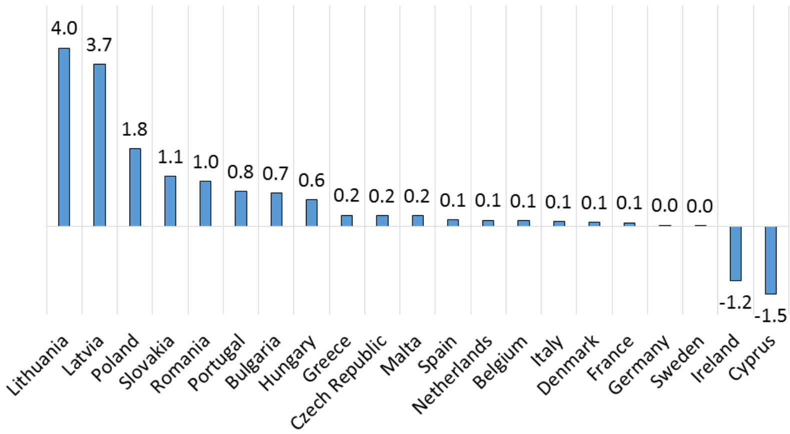
Labour market implications

As figure 20 indicates, in recent years, a large number of people from other member states moved to the UK, with for example the equivalent of 4% of the Lithuanian population arriving in the UK between 2005 and 2015, along with 3.7% of the Latvian population, 1.8% of the Polish population and around 1% of Slovakians and Romanians.

Whilst the initials indications were that the UK government is keen to secure the rights of citizen of EU member states already resident in the UK[5], the extent to which the UK will continue to accept migration from the EU under post-Brexit arrangements is unclear.

Should the UK no longer accept free movement for EU citizens, this may arguably lead to a change in the conditions of both EU and UK labour markets[6]. This might be particularly important for some of the smaller member states mentioned above, where recent immigration may have impacted upon local unemployment levels, wage pressures and skill levels. This increases the importance of all member states ensuring that they have wage setting mechanisms that respond to productivity changes and international competitiveness considerations, as well as labour market institutions which encourage both job creation and transitions between different sectors.

Figure 20: A large number of people from EU countries in recent years moved to the UK
Change in number of UK residents born in other EU member states between 2005 and 2015, as % of member state's 2015 population



Source: UK Office for National Statistics (ONS), BE staff calculations

Concluding remarks

The UK's vote to leave the EU represents a significant long-term risk to both the EU and UK economies given the profound interconnectedness of production in the two economies and, in particular, the importance of exports between the two economies.

The analysis above shows that linkages tend to be strongest between countries located nearest to the UK such as Belgium and the Netherlands or those with historic linkages such as Cyprus and Malta, or in the case of Ireland. At a sectoral level, trade linkages in car production are particularly strong alongside professional services and pharmaceuticals. In terms of investment interest, the EU has particularly strong UK interests in the retail sector.

The long-term economic impact of the Brexit vote will clearly depend upon the nature of the long-term relationship between the EU and UK. Mitigating adverse consequences of Brexit for companies and citizens across Europe is essential. We want to maintain as close as possible economic relations between the EU and the UK but this must not happen at the expense of the integrity of the Single Market. Therefore, cherry

[5] The Guardian (27. July 2016). "Theresa May: EU citizens' rights depend on fate of Britons abroad"
[6] The CBI are for example advocating that the new EU/UK relationship must 'ensure the UK's migration system allows companies to access the people and skills they need, while recognising public concerns'.

picking between the four Single Market freedoms and ill-designed compromises opening the way to "Europe à la carte" is not an option. Furthermore, in order to limit uncertainty, achievable solutions should be delivered in a reasonable period of time.

4. UNEMPLOYMENT, INFLATION AND PUBLIC FINANCES

Gradual reduction in unemployment rates but from high levels

Although we have seen a gradual reduction in unemployment rates, high structural unemployment, and the related dangers of a gradual skill erosion and social exclusion of the unemployed still remain a key concern for the European economy.

For 2016 as a whole, we expect unemployment to each 9.7% in the Euro Area and 8.6% in the EU. A further decline is forecast for 2017 with 9.3% for the Euro Area and 8.3% for the EU.

Inflation prospects picking up slightly with fall energy prices falling out of the index

According to Eurostat's flash estimate, Euro area annual inflation is expected to be 0.4% in September 2016, up from 0.2% in July and August 2016. This follows successive increases from 0.1% in June and -0.1% in May, driven first and foremost by less negative energy prices (-3.0% in September compared to -8.1% in May). Still core inflation, stripping out the effects of food and energy, stood only at 0.8% in September.

We do expect Euro Area inflation to reach 0.3% in 2016 and 1.2% in 2016, with the fall of energy prices dropping out of the index and supported by further improvements in the labour markets which is likely to bolster consumer spending. In contrast, the gradual fading of upward pressures as a result of the past declines of the euro exchange rate is likely to weigh on the pickup in inflation in the year ahead.

Consolidation of public finances supported by lower interest payments

Finally, the general government deficit in the EU and Euro Area is expected to decrease to levels below 2% of GDP over the forecast horizon, supported by lower interest payments. Similarly, we expect slight further reductions in the debt level.

5. COUNTRY DIFFERENCES

Strong country divergences remain with regards to growth, unemployment and inflation

With the exception of Greece where growth is expected to be flat, all EU member states are expected to grow again this year. However, we still observe a large divergence of growth prospects across the EU. With Romania, Malta, Ireland, Sweden, Luxembourg, the Slovak Republic, Poland and Spain, eight countries are expected to record growth rates of more than 3% in 2016. In contrast, growth is expected to remain 1% or less for Portugal, Denmark, Italy and Greece in 2016, although growth is expected to exceed 1% in 2017 for all countries except Italy (where medium-term economic prospects are in turn particularly dependent upon a positive outcome of the forthcoming constitutional referendum).

While still high, we see a steady reduction in unemployment rates across most member states. In several countries unemployment rates remain above 10% over the forecast horizon, while Germany, the Czech Republic and the UK have rates at 5% or below. Inflation expectations are below 2% for all EU countries, with the notable exception of Belgium in 2016 and Estonia, Latvia, Malta and Romania in 2017.

Table 2: Wide growth divergence in surveyed countries in 2016 and 2017

Main forecasts for all the economies surveyed[7].

* For the UK, we used figures from the IMF World Economic Outlook, October 2016

	Real GDP growth		Inflation		Unemployment	
% Change	**2016**	**2017**	**2016**	**2017**	**2016**	**2017**
Austria	1.5	1.3	1.0	1.7	6.1	6.2
Belgium	1.5	1.5	2.0	1.6	8.3	8.0
Cyprus	2.4	2.5	0.9	1.4	13.5	13.0
Estonia	2.2	2.8	1.2	2.5	5.8	6.8
Finland	1.1	1.2	0.4	1.1	9.1	8.9
France	1.3	1.1	0.3	1.3	9.6	9.4
Germany	1.9	1.6	0.3	1.4	4.1	4.1
Greece	0.0	2.4	-0.5	0.0	24.7	23.6
Ireland	3.9	3.2	0.3	0.6	8.2	7.5
Italy	0.7	0.5	0.0	0.6	11.5	11.2
Latvia	2.8	3.1	0.2	2.0	9.6	9.3
Lithuania	2.8	3.1	0.6	1.8	7.8	6.4
Luxembourg	3.3	3.9	-0.1	1.8	6.2	6.2
Malta	4.1	3.5	1.4	2.2	5.1	5.1
Netherlands	1.7	1.7	0.0	0.5	6.2	6.2
Portugal	1.0	1.3	0.8	1.0	11.4	10.7
Slovak Republic	3.2	3.3	-0.1	1.5	10.5	9.5
Slovenia	2.3	2.9	0.1	1.4	8.2	7.5
Spain	3.1	2.3	-0.2	1.3	19.6	17.8
Bulgaria	2.0	2.4	-0.7	0.9	8.6	8.0
Croatia	2.3	2.5	-0.9	1.2	15.0	14.6
Czech Republic	2.5	2.7	0.5	1.2	4.1	4.0
Denmark	0.9	1.3	0.5	1.0	6.1	6.2
Hungary	2.0	2.7	0.5	1.5	5.2	5.1
Poland	3.1	3.3	-0.6	0.5	6.0	6.0
Romania	4.2	3.7	-0.6	2.5	6.8	6.7
Sweden	3.4	2.5	1.0	1.3	6.7	6.5
United Kingdom*	1.8*	1.1*	0.7*	2.5*	5.0*	5.2*
Norway	1.5	1.6	///	///	4.7	4.5
Switzerland	1.5	1.7	-0.3	0.3	4.3	4.1
Turkey	4.5	5.0	7.5	6.0	10.2	9.9

Source: BUSINESSEUROPE's survey of member federations

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

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Denmark	Denmark	Estonia	Finland	France	Germany
Germany	Greece	Hungary	Iceland	Iceland	Ireland
Italy	Latvia	Lithuania	Luxembourg	Malta	Montenegro
Norway	Poland	Portugal	Portugal	Rep. of San Marino	Serbia
Slovak Republic	Slovenia	Spain	Sweden	Switzerland	Switzerland
The Netherlands	Turkey	Turkey	United Kingdom		

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