EU Forecasts Weak Growth, Warns About Debt

Bloc’s Economists Say Deflation Could Harm Recovery

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Deflation Threat

Inflation in the euro zone is expected to be so low this year and next that it is at risk of tipping into deflation.

Euro-zone inflation, measured by annual change in CPI

![Graph showing inflation trends in the euro zone from 2009 to 2015.](chart)

Source: European Commission

BRUSSELS—The European Union forecast tepid growth for most of the region through 2015 and warned that lingering debt burdens and the specter of deflation could sabotage the recovery.

Economists at the European Commission predicted a mild recovery over the next two years. The impact of budget austerity, a major drag on growth since the euro-zone debt crisis flared in 2009, is expected to fade this year. Meanwhile, policy overhauls in the euro zone’s weaker economies are starting to bear fruit, helping to boost their export sectors, the commission said.

Growth in the euro area is forecast at 1.2% this year and 1.8% next, after two consecutive years of contraction. That won’t be enough to make much of a dent in euro-zone unemployment, which is
seen hovering near record highs of 12% in 2014 and 11.7% in 2015. The commission report on Tuesday forecast growth in the broader EU—buoyed by strong momentum in the U.K.—at 1.5% this year and 2% next.

But the lackluster recovery faces some daunting obstacles. Debt owed by governments, households, businesses and banks remains too high in many of the bloc's countries, the commission report said. And low inflation in the euro zone, or even the possibility of outright deflation, threatens to make the debt problems even worse.

"Much depends on the stability of inflation expectations for the medium term," said Marco Buti, the director general of the commission's economics division. "Should they shift lower, the corresponding increase of real interest rates and the debt burden would make it harder for growth to accelerate."

The commission forecasts inflation in the euro zone at 1% this year and 1.3% next, well below the European Central Bank's target of just under 2%. Eurostat on Monday said inflation in the euro area is running at 0.8%. The ECB's meeting on March 6 is shaping up to be pivotal, with analysts divided on whether falling inflation readings will prompt the ECB to cut interest rates or adopt other stimulus.

ECB President Mario Draghi has said the bank is "ready to act," but still needs more economic data to decide what to do.

Low or negative inflation makes it more difficult for households, governments and businesses to cut their debt burdens. It can also making financing conditions tighter, by raising inflation-adjusted, or "real," interest rates. "Since inflation expectations have been sagging, real interest rates have actually risen since the autumn, which can affect debt dynamics," said Olli Rehn, the EU's economics chief.

The commission's thrice-annual forecasts serve as a guide for how much austerity governments are expected to undertake to meet the EU's budget rules, which generally require budget deficits under 3% of gross domestic product. While the bloc's overall budget is seen falling below that level this year, some of the biggest euro-zone countries still have work to do to meet their targets.

France has pledged to bring its deficit to under 3% of GDP in 2015, yet the commission forecasts the deficit next year at 3.9% of GDP. In Spain, the government has pledged to bring its deficit to under 3% in 2016. Hitting that target will require significant new cuts, as the budget deficit is forecast to hit 6.5% of GDP in 2015.

The commission, which monitors and enforces the EU's budget rules, has in recent years relied more on the "structural" balance—the actual budget balance adjusted for the strength of the economy—to evaluate national budget programs. That approach has allowed it to give national governments such as Spain and France more time to cut their deficits, since Europe's weak economy is depressing tax revenues and increasing social spending.
The commission raised its growth forecast for Spain in 2014 to 1% from 0.5%. New laws that have freed employers from having to follow collective-bargaining agreements are making Spanish firms more competitive, EU officials say. "Export growth is set to remain robust, backed by ongoing improvements in price and cost-competitiveness and healthy foreign markets growth."

Italy's growth prospects, however, remain dim, with the commission projecting growth of 0.6% this year. Exports will be the main growth driver, as "persistently tight credit conditions" continue to weigh on the domestic economy.

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