BUSINESSEUROPE

ECONOMIC OUTLOOK AUTUMN 2015

GLOBAL RISKS UNDERLINE NEED FOR REFORMS TO LOCK-IN EU RECOVERY

ECONOMIC SITUATION

- **The EU's economic recovery is expected to continue.** With oil prices remaining low, a still relatively low Euro exchange rate and ECB support, Europe's economic growth prospects are largely unchanged from last spring; we forecast GDP to grow by 2.0% in the EU in 2015, and by 1.7% in the Euro Area (compared to 1.9% and 1.6% in our Spring 2015 Outlook).

- **There is little evidence so far of specific factors such as emerging market slowdown impacting on EU output. However, this factor represents a potentially important downside risk to growth.**

- **For 2016 we expect growth to continue at roughly the same pace as this year**, with GDP growth of 2.0% in the EU and of 1.8% in the Euro Area (both -0.1 pp compared to our Spring Outlook).

- **Domestic demand remains the key driver of growth**, with EU private consumption expected to grow by 2.2% in 2015. **Investment is expected to gradually pick up** with 3.0% in 2015 and 4.0% in 2016 in the EU, in response to growing domestic demand, although remaining below pre-crisis levels.

- **We expect some improvements in labour markets with unemployment rates foreseen to gradually come down** in the EU (from 10.2% in 2014 to 9.0% in 2016) and Euro Area (from 11.6% in 2014 to 10.1% in 2016). Nevertheless, levels remain high and significant country differences persist.

- **Inflation is forecast to remain low in 2015 with 0.2% for the EU and Euro Area but to gradually increase in both areas to 1.2% in the EU and 1.1% in the Euro Area in 2016**, as the effect of higher import costs and stabilising energy prices work through.

POLICY CONSIDERATIONS

- **Both the EU and its member states urgently need to press ahead with growth-enhancing structural reforms that raise potential growth and 'lock-in' the present recovery**. The ongoing growth slowdown in emerging markets is likely to create a more challenging global trading environment which underlines the need for reforms to support competitiveness.

- There are signs that world trade growth is slowing. This reinforces the need for the EU to press ahead with a number of **free trade agreements,** including **TTIP**, especially considering the recent conclusion of the **Trans-Pacific Partnership agreement (TPP).**

- Given the potential for the **migration crisis** to impact on member states' public finances, it will be important to assess in how far the **Stability and Growth Pact** allows room to accommodate necessary expenditure.

- **Access to finance,** particularly bank lending, is improving in many Member States. However, we need to undertake structural measures to improve access to diversified financing routes. **The Capital Markets Union Action Plan** is an important step forward.

- We welcome the agreement on a 3rd support package for **Greece**. BUSINESSEUROPE hopes that the country **swiftly and comprehensively implements the structural reform and budgetary measures** agreed as part of the deal.

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 2015.

FOR FURTHER INFORMATION:

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1. OVERVIEW

The EU's economic recovery continues

Over the last 6 months EU businesses have experienced a continuing gradual economic recovery, broadly in line with the expectations of our Spring Economic Outlook.

Growth has been supported in particular by a gradual increase in consumer expenditure, in line with continuing low oil prices, and the ECB's expanded asset purchase programme. In addition, the EU economy has continued to benefit from the support to exporters provided by the relatively low euro exchange rate. But the potentially temporary nature of these factors supporting growth emphasises the continuing need to 'lock in' the recovery and increase the EU's trend growth rate through strong structural reform efforts.

Our overall forecast (table 1) is for GDP growth of 2.0% in the EU and 1.7% in the Euro Area in 2015, (both up by 0.1 percentage point compared to our spring projections). Growth is expected to continue at a similar pace in 2016 with 2.0% in the EU and 1.8% in the Euro Area (both down by 0.1 pp from spring). However, within Europe we see still a large divergence in growth prospects reaching from -1.5% in Greece in 2015 to 5.3% in Ireland.

In addition to a number of ongoing concerns raised by the IMF around financial instability and high indebtedness in Europe, a number of specific developments could potentially impact on the recovery. At present, the initial signs are that they are not likely to impact strongly on the recovery. Nevertheless, they represent clear downside risks to the EU economy. In particular:

- The **turbulence in Chinese financial markets** over the summer, which spilled over, particularly into emerging markets, may have to some extent been the result of the burst of a stock market bubble that had developed during the first half of the year. Nevertheless, it is also clear that China still needs to make a transition for a growth model based more on private domestic consumption and less on export and debt funded investment. Whilst our exporting businesses are not presently reporting a significant fall in business with emerging markets, the potential impact on EU exporters of a harder land for emerging markets, particularly China, than currently expected cannot be ignored.

- Secondly, while the **migration crisis** is first and foremost a humanitarian one, and one should bear in mind the positive contribution of legal migrants well integrated into the labour market, there are also potential economic consequences in the short-term via both the impact on government finances and on goods flows across borders.

- Finally, it too early to say how the **Volkswagen emissions** revelations are going to impact the EU economy. The extent to which overall EU output will be reduced will depend upon overall changes in sales both in the EU and overseas, how strong brand switching is, and in turn how the production location of those brands differs. Whilst we would not expect to see a fall in global car sales, there could be some switching between brands both in the EU and overseas, in particular we may see increased demand for petrol cars at the expense of diesel cars (stock markets have generally cut valuations of firms producing a high proportion of diesel cars by more than those for petrol specialised firms). Early data such as that from UK car sales in September suggests that the initial consumer response may be more focused on brand than on fuel source. But the potential impact on the EU is difficult to assess given the complexity of global supply chains, and the fact that large manufacturers have production facilities across the globe (e.g. Japanese car firms have large production facilities in the EU). Nevertheless, the impact could be stronger on small EU member states where manufacturing production is less diversified. A secondary question will be how any increased uncertainty, particularly regarding regulation, impacts on investment.

Table 1 More positive economic prospects for the EU and Euro area

BUSINESSEUROPE main forecast

	EU28		Euro area	
Main Variables	**2015**	**2016**	**2015**	**2016**
Real GDP (annual % growth)	**2.0** (+0.1)	**2.0** (-0.1)	**1.7** (+0.1)	**1.8** (-0.1)
Inflation (%)	**0.2** (-0.1)	**1.2** (-0.3)	**0.2** (-0.1)	**1.1** (-0.1)
Unemployment (%)	**9.3** (-0.2)	**9.0** (+/-0.0)	**10.4** (-0.2)	**10.1** (+/-0.0)
Government net lending (% of GDP)	**-2.4** (+/-0.0)	**-2.1** (-0.1)	**-2.0** (+/- 0.0)	**-1.8** (-0.1)
Gross public debt (% of GDP)	**87.4** (+0.1)	**86.5** (+0.1)	**93.2** (+/-0.0)	**91.8** (+/-0.0)

	EU28		Euro area	
GDP components	**2015**	**2016**	**2015**	**2016**
Private consumption (%)	**2.2**	**2.0**	**2.0**	**1.7**
Public consumption (%)	**0.9**	**0.7**	**0.9**	**0.8**
Gross fixed capital formation	**3.0**	**4.0**	**2.4**	**3.4**
Exports (%)	**4.6**	**5.1**	**4.7**	**4.8**
Imports (%)	**4.8**	**5.1**	**5.2**	**5.1**

Source: BUSINESSEUROPE's forecast based on survey of Member Federations

2. KEY GROWTH DRIVERS

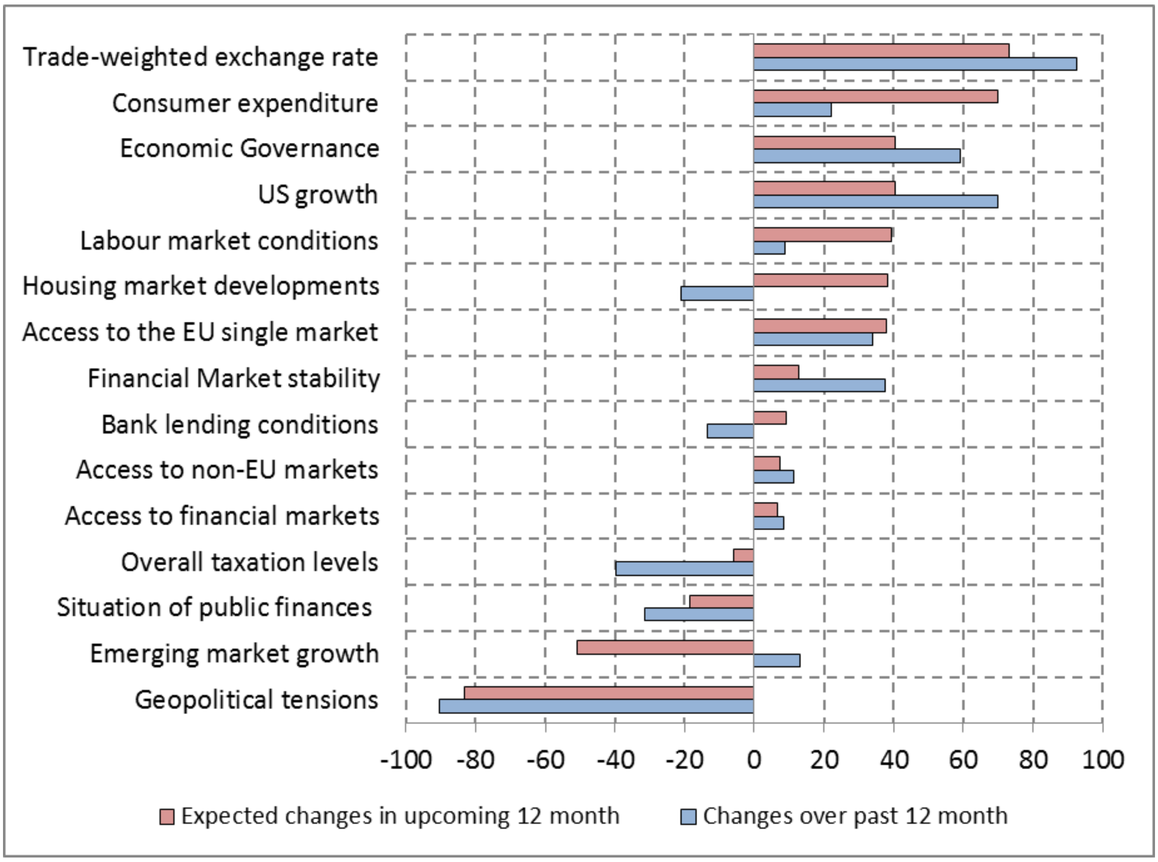
Lower emerging market growth becomes key concern next to geopolitical tensions

A more detailed look at the growth drivers as seen by our member federations (Fig 1), reinforces the key role of consumer expenditure in driving future growth. As aforementioned lower trade-weighted exchange rates are next to US growth still expected to play a prominent role for future growth but to a slightly lesser extent than in the past 12 month. Next to gradual improvements in countries' labour market, we have recently seen progress in housing market adjustments in some countries, as also reported in the ECB's Economic Bulletin 6/2015, which is likely to boost residential investment over time. Finally, a well-functioning EU single market and good economic governance remains pivotal for EU growth.

However, ongoing geopolitical tensions, the situation of public finances and high levels of taxation remain an ongoing concern and key obstacle to future growth in the EU. In addition, the slowdown in emerging markets became now an important concern for countries' growth prospects due to member states' export linkages.

Figure 1 Lower emerging market growth is now next to geopolitical tensions one of the key obstacles to future growth

Impact of past and expected future changes of different factors on growth forecast



Source: BUSINESSEUROPE's forecast based on survey of Member Federations

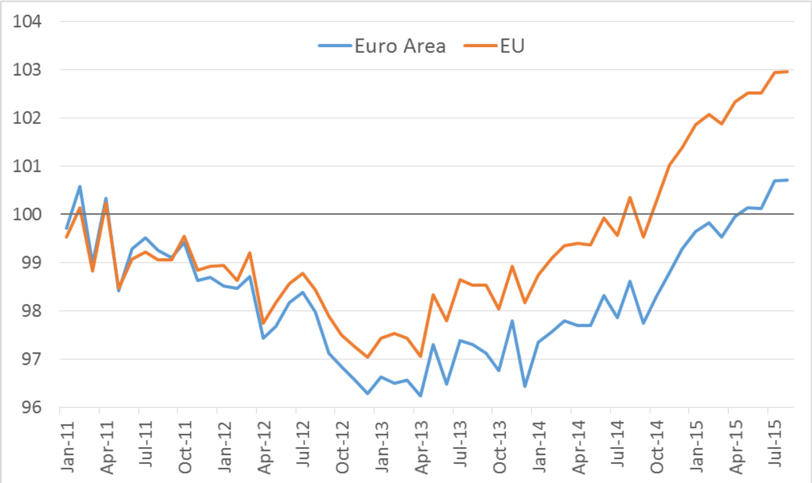
a) Growing consumer spending is increasingly driving growth

In line with a normal economic recovery path, consumer expenditure increasingly constitutes the key driving factor behind current economic growth, whereas in 2010-2013 the EU had been reliant on export growth. This is reflected in the strong upswing of retail sales over the past two years. In April 2015, Euro Area retail sales finally recovered to levels last seen in January 2011 (Fig 2).

Private consumption is set to further increase by 2.2% in the EU and 2.0% in the Euro Area in 2015 to then grow at a slightly slower rate of 2.0% in the EU and 1.7% in the Euro Area in the next year. This is largely compensated by an expected uptick in investment, in response to growing domestic demand, from 3.0% in 2015 to 4.0% in 2016 in the EU and from 2.4% to 3.4% in the Euro Area.

Figure 2 Strong increase in retail sales in line with growing consumer confidence

Real turnover for retail trade, Jan 2011 to Aug 2015, 2010=100

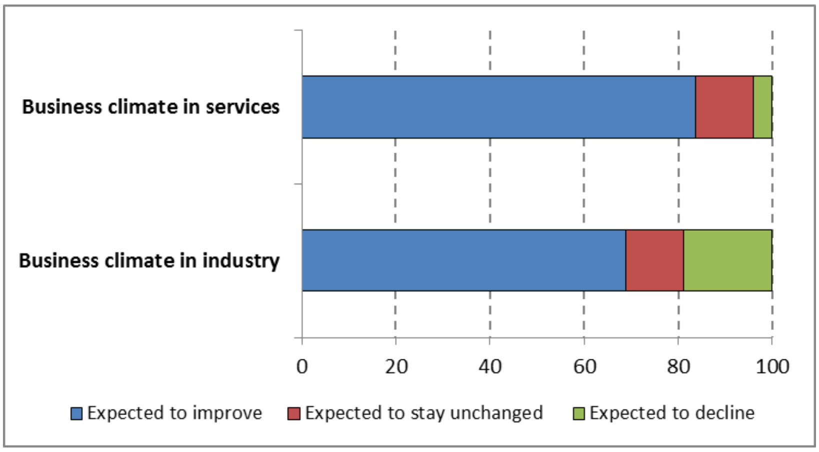


Source: Eurostat

Strong consumer spending and in particular the steady increase in retail trade feeds back into business confidence, especially in the service sector where further improvements are expected over the upcoming six months (Fig 3).

Figure 3 Strong expected improvement in business confidence in particular in services

Overall business climate in industry and services over the next 6 months



Source: BUSINESSEUROPE's forecast based on survey of Member Federations

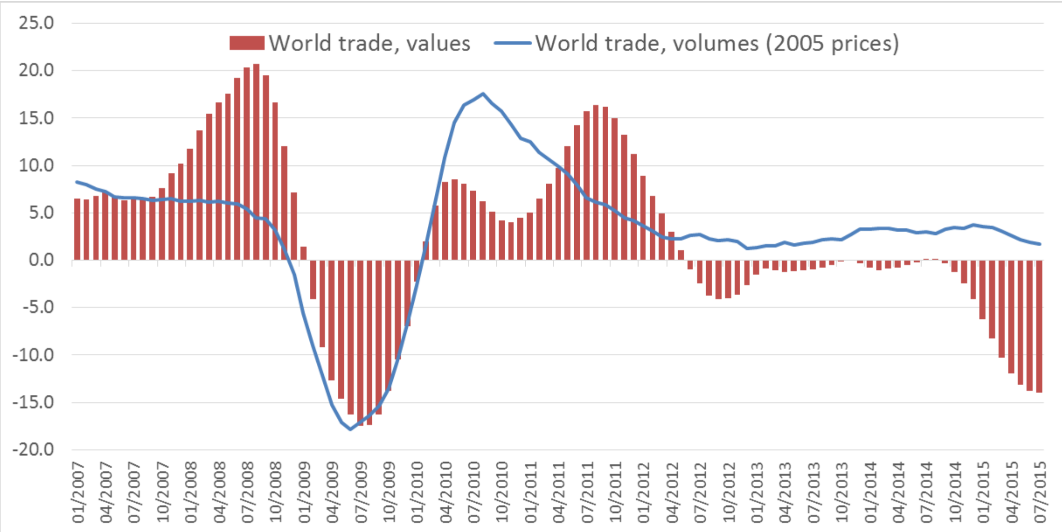
b) But the EU faces a more challenging international trading environment

The slightly weaker expected increase in the business climate in industry compared to services ties into the more challenging international trading environment that is likely to impact in particular the shipping of certain industrial goods (see Box 1).

When measuring trade in US Dollar (value-terms), world trade fell by about 14% in the six month leading to July, compared with the same period in the previous year (Fig 4). In particular lower commodity prices contributed to this falling trade figures. Adjusting for prices (volume-terms), trade is still growing but only at less than 2% and thus well below its long run average of over 5%.

Figure 4 Slowdown in world trade requires EU to improve its global competitiveness

Global trade, six-month average, % change on a year earlier

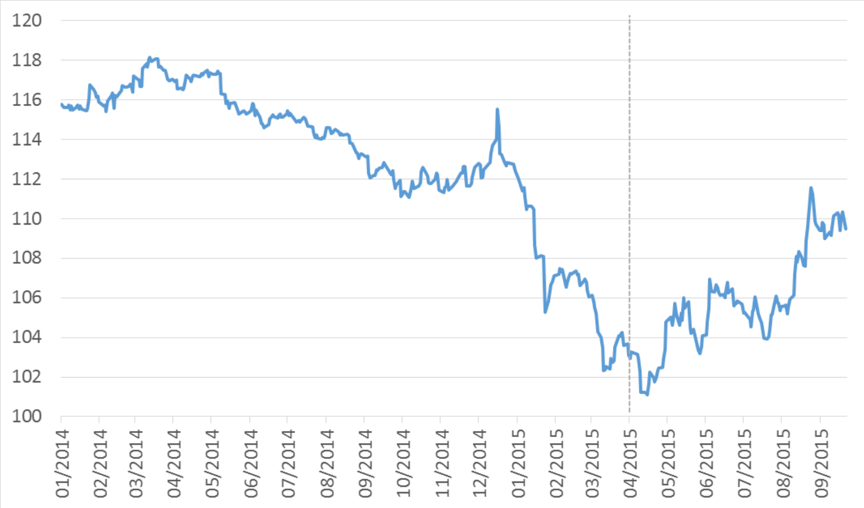


Source: CPB

While the euro's nominal effective exchange rate, here measured against 38 trading partners, is now by more than 6% higher than in April when we released our last forecast (Fig 5), it is still 2% lower compared to its long-term average over the previous 3 years. Nevertheless, if maintained we can expect the recent appreciation of the euro to gradually come through over the course of the coming months as previous contracts expire.

Figure 5 Six percent increase of euro effective exchange rate since our spring forecast

Nominal Effective Exchange Rate for the Euro Area, 01 Jan 2014 – 21 Sep 2015



Source: European Central Bank

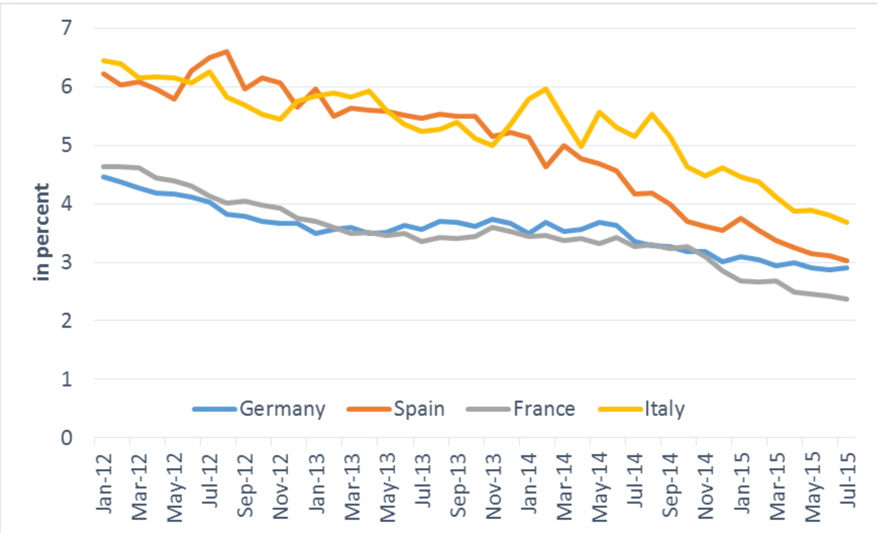
c) Both access to finance and business confidence continue to weigh on investment

A key litmus test for the recovery will be the return of investment. In order to see a pick-up in investment we both need to work on demand and supply factors, i.e. both businesses confidence to invest and their ability to access necessary finance.

On the supply-side, while we have recently seen a gradual convergence towards lower interest rates on business loans across the Euro Area (Fig 6), access to finance remains a key concern for business. But with the demand for finance picking up in line with a gradually improving economic outlook, insufficient finance remains a risks to firms' investment.

Figure 6 Decline and less divergence in interest rates for business loans in Euro Area

Interest rates on business loans, up to € 1 million, of maturity 1-5 years



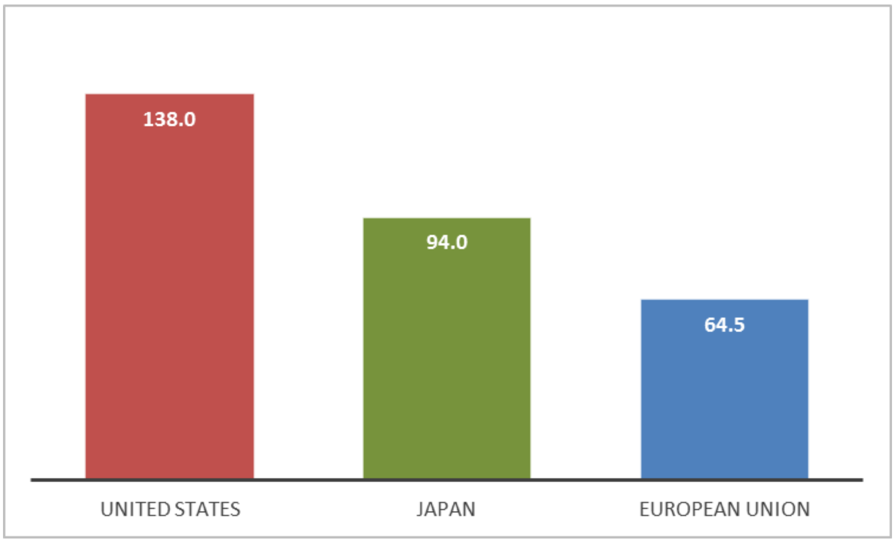
Source: European Central Bank

In order to give business more choices over funding, supporting them to invest and grow, Europe needs to work towards achieving stronger and deeper capital markets. This will also help to increase the resilience of the EU, particularly if we attain better cross border flows of savings and investment.

If we look at equity markets in Europe they are currently less than half the size than those in the United States (Fig 7). We therefore welcome the Commission's proposal on the Capital Markets Union which is an important initiative to try and improve the use of capital markets and broader equity markets in the EU. In particular, we support the initiatives aimed at making prospectuses for SME's more simple; slightly relaxing the regulatory requirements for investment in infrastructure; improving the securitization market; and finally assessing the overall cost of regulation on the financial sector as a whole supporting both stability and lending.

Figure 7 Capital market funding in the EU could play a stronger role

Stock market capitalisation as a % of GDP in 2014



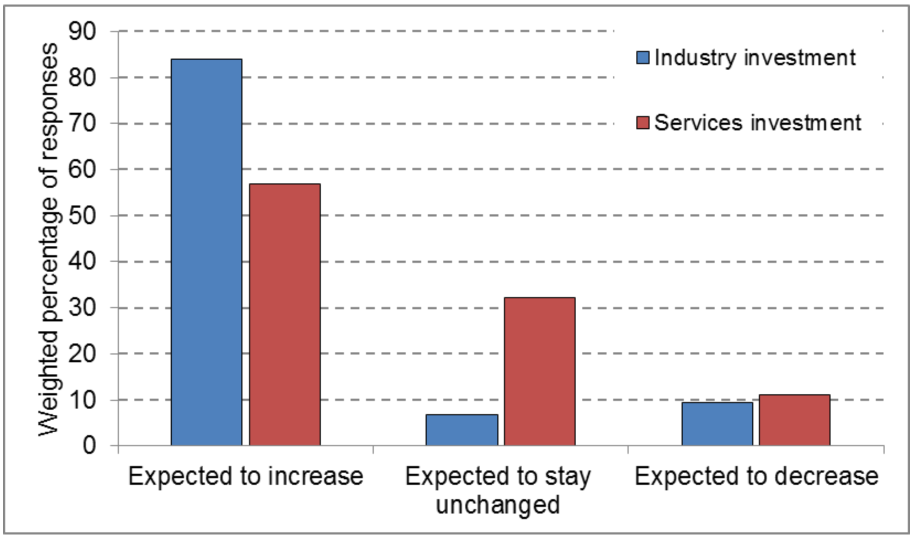
Source: European Commission

On the demand side, our survey indicates that we are seeing an increase in business' intentions to invest both in industry and in services (for the industrial sector a weighted average of 83.9% of respondents expect an increase in investment, while for services a weighted average of 56.8% expect an increase; Fig 8). Overall, we expect EU total investment to grow at 3% in 2015 and 4% in 2016.

The expected increase in investment is also consistent with recent data on capacity utilization, which increased by 0.6 pp in Q3 2015 from the same quarter of the previous year and is now at 81.4% – the highest level since Q3 2008 and thus the beginning of the financial crisis.

Figure 8 Both industrial and service companies are planning more future investment

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

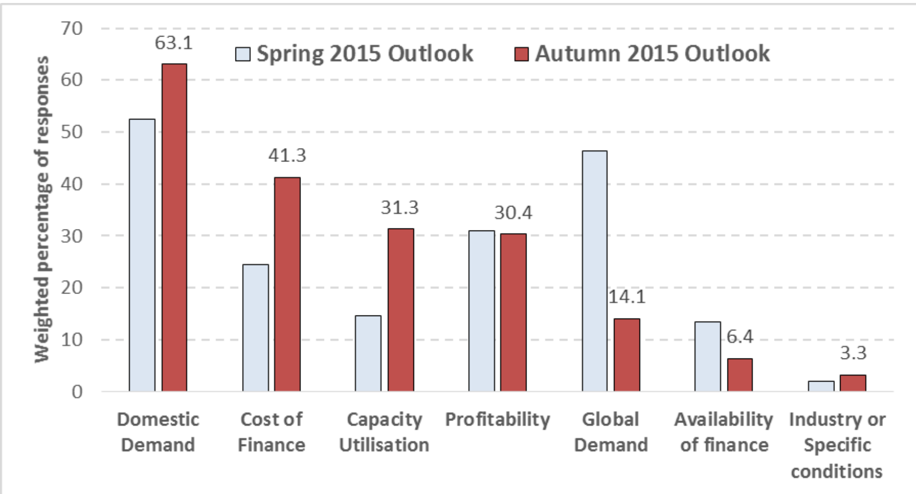


Source: BUSINESSEUROPE's forecast based on survey of Member Federations

Looking in more detail at the driving factors, we can see that the expected increase in investment is first and foremost driven by higher domestic demand but, compared to last spring, now much less by global demand (Fig 9). In addition, improvements in cost of finance, in line with the gradual decline in interest rates on business loans, and the aforementioned increase in capacity utilization are important drivers.

Figure 9 Domestic demand is driving investment decisions whereas global demand plays a much less prominent role compared to last spring

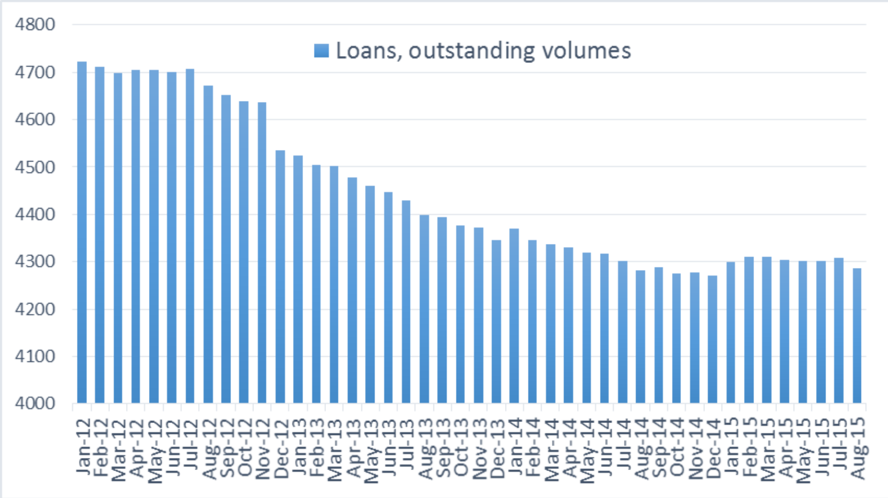
Factors influencing investment decisions of businesses



Source: BUSINESSEUROPE's forecast based on survey of Member Federations

Figure 10 Bank lending to business still at low levels despite slight increases as of January

Bank loans to Euro-area non-financial corporations, outstanding billion euros

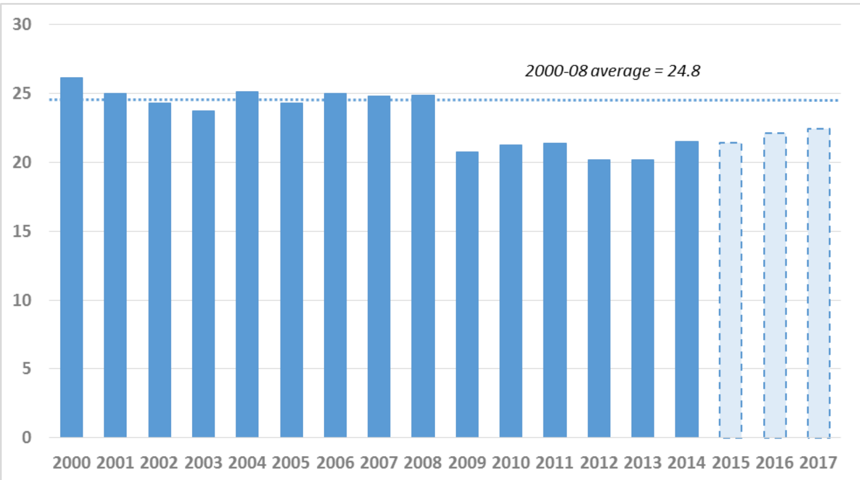


Source: European Central Bank

However, the expected uptick in investment is still not sufficient to bring investment back to its pre-crisis levels. As shown in Figure 10, bank lending to business, the outcome of both demand for investment finance and supply factors, has seen slight improvements since the beginning of the year, supported by an increasingly active European Central Bank, but remains well below historic levels (outstanding lending in August 2015 was more than 9% below 3 years earlier). In line with this, the IMF does not expect investment to return to its pre-crisis average of around 25% of GDP during their present forecast horizon (see Fig 11). This underlines the need for strong policy choices to support greater business confidence and the full implementation of the Commission's wide-ranging investment plan.

Figure 11 Investment not yet back to pre-crisis levels despite expected pick-up

Total investment as a % of GDP, 2000-2017

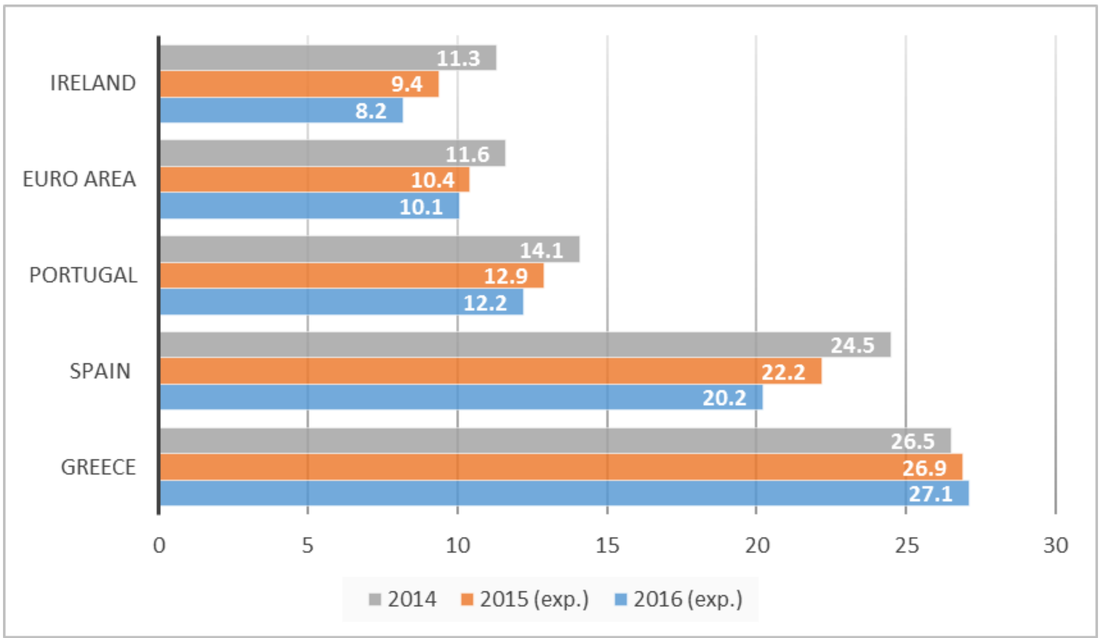


Source: IMF, Oct 2015

3. IMPROVEMENTS IN UNEMPLOYMENT RATES IN COUNTRIES WITH FINANCIAL ASSISTANCE

While remaining at high levels, unemployment rates are expected to gradually come down in the EU (from 10.2% in 2014 to an expected 9.0% in 2016) and Euro Area (from 11.6% in 2014 to an expected 10.1% in 2016) (Fig 12). In particular, we see a gradual improvement in the labour markets of the countries with financial assistance with the exception of Greece where unemployment is expected to increase from 26.5% in 2014 to 27.1% in 2016. Clearly product and labour market reforms are paying off in those countries where they are undertaken, but further progress has to be made across the EU.

Figure 12 Steady improvement in the job markets of countries with financial assistance
Unemployment rates in 2014, 2015 and 2016, in %



Source: Eurostat

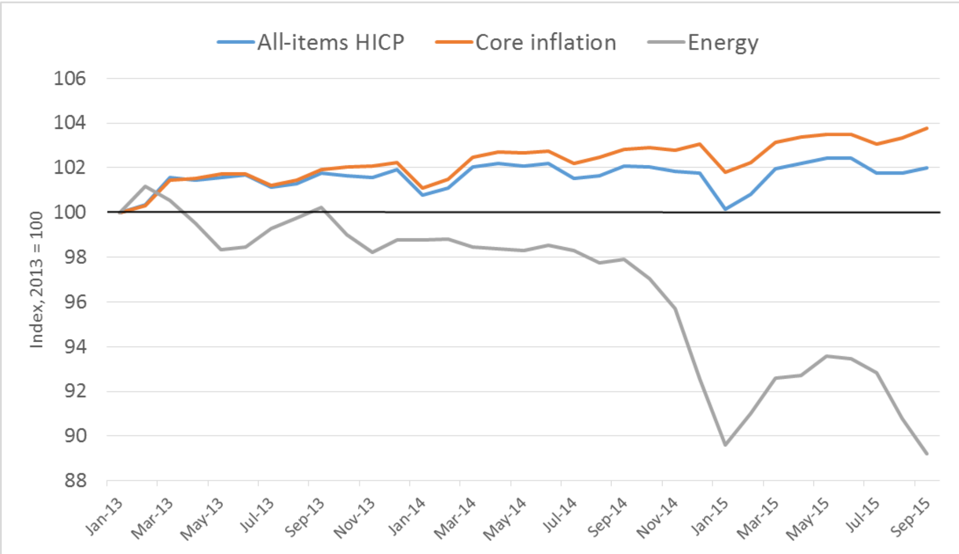
4. INFLATION RATES ARE LIKELY TO REMAIN BELOW ECB TARGET

As has been well documented, low inflation rates remain a particular concern in the Euro Area. Over the last 32 months (Fig 13), prices have increased by less than but close to 2%, otherwise the ECB's yearly target. For 2015, we expect inflation in the EU and Euro Area to increase by just 0.2%. In 2016, inflation is expected to increase by 1.2% in the EU and 1.1% in the Euro Area.

We therefore welcome the ECB's expanded asset purchase programme announced this January as well as President Draghi's recent announcement to stand ready to extend the "size, composition and duration" of the programme if necessary to fulfil the ECB's policy mandate.

Figure 13 Inflation up by less than 2% over the last 32 months

Overall inflation, food and energy prices in the Euro Area, Jan 2013 – Aug 2015



Source: Eurostat

5. COUNTRY DIFFERENCES

Competitiveness improvements are bearing fruits

With the exception of Greece that saw a -3.2 percentage point downward revision of 2015 growth compared to last spring, all members' states are expected to grow again this year (Table 2). However, a large divergence of growth prospects across EU member states remains. Ireland, the Baltic countries, Spain, and Poland stand out as very positive examples for the upcoming two years, clearly showing that reforms aimed at reducing competitive imbalances are paying off. Particularly weak growth for this year is expected in Greece (-1.5%), Cyprus (0.2%), Finland (0.3%), Croatia (0.3%) and Austria (0.5%).

While still high, we see a steady reduction in unemployment rates across most member states. Among the large member states France remains an exception where no significant improvement in unemployment rates is expected up to 2016. Inflation expectations are below 2% for all member states, with Austria, Hungary and Luxembourg being the notable exceptions for 2016.

Table 2: Wide growth divergence in surveyed countries in 2015 and 2016

Main forecasts for all the economies surveyed[1]

	Real GDP growth		Inflation		Unemployment	
% Change	**2015**	**2016**	**2015**	**2016**	**2015**	**2016**
Austria	0.5	1.3	1.2	2.0	5.8	5.8
Belgium	1.2	1.5	0.6	1.5	8.5	8.3
Cyprus	0.2	1.4	-0.8	0.9	16.1	15.1
Estonia	1.7	2.2	0.1	1.5	6.5	6.4
Finland	0.3	1.4	0.1	1.2	9.3	9.0
France	1.1	1.2	0.1	0.9	10.0	10.0
Germany	1.8	1.8	0.3	1.1	4.6	4.8
Greece	-1.5	-1.3	0.0	1.5	26.9	27.1
Ireland	5.3	4.4	0.1	0.9	9.4	8.2
Italy	1.0	1.5	0.2	0.7	12.2	11.8
Latvia	2.1	3.1	0.5	1.0	10.0	9.5
Lithuania	2.8	3.3	-0.4	1.7	9.9	9.1
Luxembourg	3.7	3.4	0.8	2.1	7.0	7.2
Malta	3.6	3.2	1.3	1.9	5.9	5.9
Netherlands	2.0	2.4	0.5	1.1	6.9	6.7
Portugal	1.7	1.9	0.5	1.2	12.9	12.2
Slovak Republic	3.0	3.4	-0.2	1.4	12.1	10.8
Slovenia	2.7	2.3	-0.4	0.8	9.4	8.9
Spain	3.3	2.9	-0.4	1.2	22.2	20.2
Bulgaria	1.0	1.3	-0.5	1.0	10.4	9.8
Croatia	0.3	1.2	0.1	1.3	17.0	16.6
Czech Republic	3.9	2.6	0.5	1.7	5.3	5.1
Denmark	1.5	2.0	0.3	1.0	6.2	5.9
Hungary	2.7	2.0	0.2	2.5	7.2	7.0
Poland	3.6	3.7	-0.2	1.3	7.7	7.5
Romania	2.8	3.3	0.2	0.9	6.6	6.4
Sweden	3.1	3.1	0.2	1.3	7.7	7.5
United Kingdom	2.6	2.4	0.4	1.6	5.4	5.3
Turkey	4.0	5.0	6.3	5.0	9.5	9.2
Switzerland	0.6	1.2	-0.8	-0.2	3.7	3.8

Source: BUSINESSEUROPE's survey of Member Federations

[1] Note that for blank surveys we used figures from the Spring forecast of the European Commission. This is the case for Bulgaria, Croatia, Lithuania, United Kingdom, Malta, Slovakia and Romania.

BOX 1: The slowdown in emerging markets and its impact on EU economies

Recently we have seen a lot of talk about the slowdown in growth of emerging markets (EM), and in particular of China, so that we decided to take a closer look at the potential impact on EU economies. The analysis shows the following:

- While the overall slowdown in emerging markets is unlikely to derail the European recovery, some direct impact on EU growth can be expected via lower foreign exports. The analysis shows that emerging markets are important trading partners for the EU with an export share of 33.7% going to EM compared to 18.3% of extra-EU exports going to the US. Exports to China make up 1.2% of EU GDP, so alone a reduction of Chinese imports could reduce EU growth by a few percentage points.
- However, the impact will differ between EU countries as well as sectors. While German exports to China make up 2.6% of its GDP, Cypriot, Greek and Croatian exports to China amount to only 0.1% to 0.2% of their respective GDP. The slowdown of China is also likely to have a more severe backdrop on machinery and electronics as well as transport equipment which make up the bulk of exports going to China.
- Next to this direct exposure via trade, there is the risk that the slowdown in EM may weigh on business confidence and thus ultimately indirectly impact on EU growth.
- The key impact on EU growth can clearly be expected to come from reduced exports. In contrast, the EU's banking sector has little direct exposure to China. Bank of International Settlements data show that Euro Area banks' claims on Chinese banks, companies, consumers and public sector are only 1.4% of their total foreign assets, though the share for UK banks is with 5.5% significantly higher.

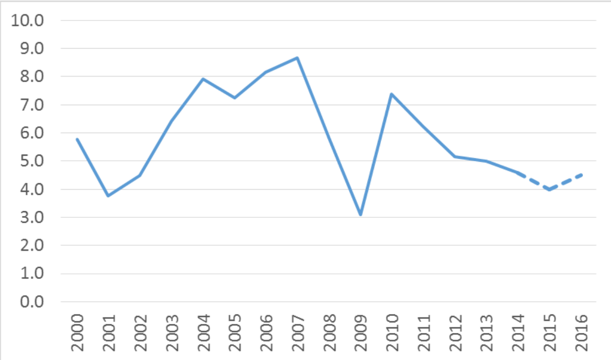
Slowdown in emerging markets

Emerging markets have experienced a slowdown in growth since the beginning of 2010. Aggregate EM GDP is expected to fall for the fifth consecutive year from levels over 7% in 2010 to 4% this year, its lowest level since 2001 (the 2008/9 crisis excluded) (see Fig 14). Lower growth has been broad-based, affecting the majority of EM countries.

One component behind the recent slowdown is structural, with potential growth coming down after the crisis. For example, China saw a moderation of capital accumulation after years of strong, debt-fuelled investment (gross capital investment in China averaged 45% of GDP over the last 9 years compared with 20% in the US, while total debt climbed to about 250% of GDP, up by 100 percentage points since 2008). Whilst the situation on the Chinese stock market may to a large extent reflect the bursting of an unsustainable bubble that had grown through the first months of the year (see Fig 15), it is clear that we can no longer expect China to grow at quite the levels it has experienced during the last 20 years. It needs to develop a new growth model based more on sustainable private domestic consumption and less on over-investment, debt and foreign demand.

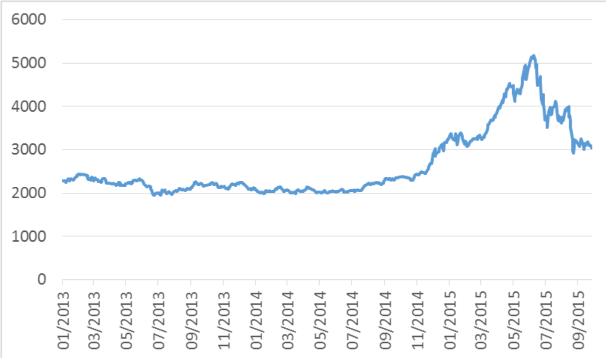
More recently, in other emerging markets we have seen a deterioration in their terms of trade due to lower raw material prices, in particular crude oil (down by about 50% over the last year) and industrial metals (down by around 30%). Finally, we have seen a reversal of capital flows outside of EM, exacerbated by prospects of US interest rate raises (the Institute of International Finance expects net capital outflows to amount to $540 bn this year, with the third quarter likely to have seen the fastest withdrawal of "hot money" since the collapse of Leman Brothers in 2008).

Fig 14: Gradual reduction in aggregate EM growth
Real GDP growth in emerging markets



Source: IMF, October Economic Outlook

Fig 15: Bursting of the Chinese stock market bubble
Shanghai Composite Index (China)



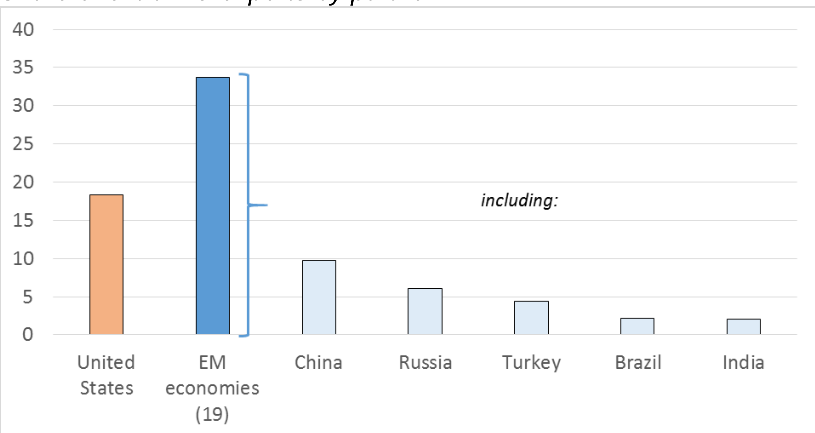
Source: Yahoo Finance

Potential impact on the EU economy

Given that emerging markets play an important role in driving the global economy and as EU trading partners, a stronger emerging market slowdown can be expected to adversely impact EU growth, especially via lowering extra-EU exports as recently acknowledged by ECB president Mario Draghi. The effect on extra-EU exports could come from a combination of reduced foreign demand and higher foreign prices (while still at low levels, the euro nominal effective exchange rate increased by more than 5% between mid-March and mid-September 2015).

Emerging markets constitute an important destination of extra-EU exports with a share of 33.7%, compared to a share of 18.3% of extra-EU exports going to the US (see Fig 16). The largest five EM outlets of EU exports are China (9.7%), Russia (6.1%), Turkey (4.4%), Brazil (2.2%) and India (2.1%).[2] Exports to China make up 1.2% of EU GDP, so a reduction of Chinese imports alone could reduce EU growth by a few percentage points which matters in a low growth environment.

Fig 16: Emerging markets are an important destination for extra-EU exports
Share of extra-EU exports by partner

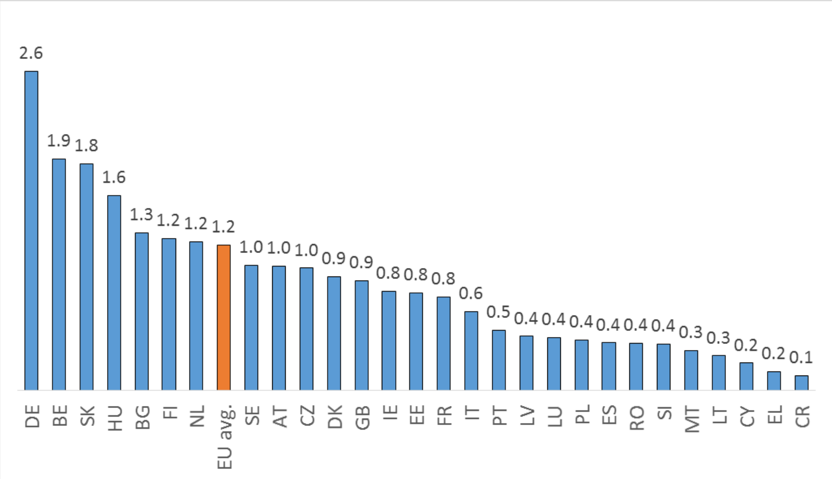


Source: Eurostat

There are however important country differences as shown in Figure 17. Germany, where exports to China make up 2.6% of GDP, is the EU country that is most exposed to lower Chinese import demand, followed by Belgium (1.9%) and Slovakia (1.8%). In contrast, Cypriot, Greek and Croatian exports to China make up only 0.1% to 0.2% of their respective GDP.

[2] EME as classified by the IMF, excluding EU countries.

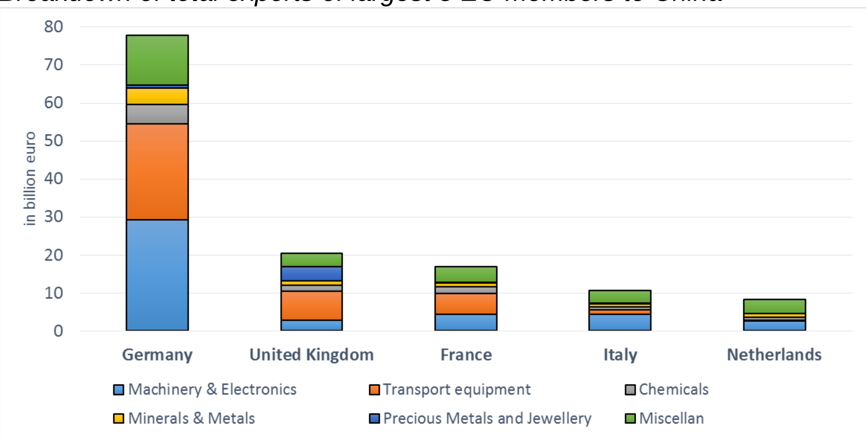
Fig 17: Large EU country differences regarding the importance of exports to China to their economy
Exports of goods to China as a % of GDP



Source: World integrated Trade Solutions (WITS)

Weaker Chinese growth will not only affect EU countries differently but also sectors. The slowdown of China is likely to have a more severe backdrop on machinery and electronics as well as transport equipment (i.e. mainly vehicles), in particular in Germany, making up the bulk of exports going to China (see Fig 18). In August German industrial orders were 1.8% lower than a month earlier; orders from outside the Euro Area were down by 3.7%, suggesting the knock-on effects of China's economic slowdown were starting to filter through.

Fig 18: Lower Chinese growth has most severe impact on machinery, electronics and transport equipment
Breakdown of total exports of largest 5 EU members to China



Source: World integrated Trade Solutions (WITS)

Still export statistics may underplay the true importance of EM to the European economy. The statistics show only direct exports to China and emerging markets more generally but not indirect exports via the value chains going to these countries.

Next to the EU's trade exposure, there is also the risk that the slowdown in EM may weigh on business confidence and thus indirectly impact on EU growth. In addition, there may be repercussions on investment. Some companies, especially car companies doing business in China, increasingly manufacture and sell locally – EU direct investment in China amounted to €8.2 bn in 2013, according to Eurostat. The devaluation of EM currencies implies that local sales are now worth less when converted into Euros, potentially leading EU companies to scale down their domestic investment. At the same time, the devaluation increases the costs for EM companies to invest in Europe.

Finally, when looking at bank exposures, the overall risk for the EU banking sector seems small. Just looking at China, Euro Area bank's foreign claims amount to only 1.4% of their total global exposure (according to BIS data). The UK's exposure is slightly higher but still only 5.5%. Yet similar to exports, the exposure increases should the slowdown in emerging markets have wider knock-on effects on the global economy.

With the likelihood of weaker growth across a number of emerging markets in the coming months, it is all the more important that Europe provides its companies with the supportive business environment that will be essential for them to compete effectively and raise employment in what is likely to be a more challenging global trading environment.

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