EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2016 and 2017

Spring 2016

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Schuman Centre at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/Projects/EFN/Home.aspx.

Participating Institutions:

European University Institute, Robert Schuman Centre for Advanced Studies (*Coordinator*)
Team Leader: Massimiliano Marcellino (massimiliano.marcellino@eui.eu)

Centre d´Etudes Prospectives et d´Informations Internationales (CEPII)
Team Leader: Lionel Fontagné (fontagne@cepii.fr)

University of Birmingham, Department of Economics
Team Leader: Anindya Banerjee (a.banerjee@bham.ac.uk)

The Halle Institute for Economic Research (IWH)
Team Leader: Axel Lindner (Axel.Lindner@iwh-halle.de)

Universitat de Barcelona, Anàlisi Quantitativa Regional (AQR-IREA)
Team Leader: Jordi Suriñach (jsurinach@ub.edu)

Universidad Carlos III, Instituto Flores de Lemus (IFL)
Team Leader: Antoni Espasa (espasa@est-econ.uc3m.es)

University of Cambridge, Faculty of Economics
Team Leader: Sean Holly (sean.holly@econ.cam.ac.uk)

Coordinator of the Report: Massimiliano Marcellino

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Highlights

- Global growth will stay rather moderate this year. The peak of the upswing in the US appears to be over. For Japan, after three years of “Abenomics”, a prolonged upswing is still elusive. In China low profitability and high debt levels of many government-owned industrial firms continue to drag growth down.
- The low prices for commodities heighten uncertainty and volatility on financial markets since they increase the risks of financial crises in economies that are dependent on commodity exports.
- In the euro area, chances for the recovery to continue are good, as this year, like in 2015, oil prices will probably be markedly lower than they were a year ago, supporting real income of private households and lowering production costs of firms.
- In this context, our forecast is that euro area GDP will expand by 1.6% in 2016 and by 1.7% in 2017. These rates are higher than the rate of potential growth, but they are arguably low given the expansive monetary policy and the strong stimulus from decreased commodity prices.
- We do not expect an increase in euro area inflation during 2016, but prices will grow by around 1% in 2017, because the dampening effects of decreasing energy prices slowly fade off and the euro remains rather weak.
- However, risks for this cautiously optimistic forecast are substantial. New shadows on the financial sector, the uncertainty about whether or not the British will vote in favour of membership in the European Union and the lack of a viable political solution for the refugee crisis are some of the main uncertainties behind these forecasts.

Table 1 Economic outlook for the Euro area

	2013	2014	2015	2016: 1st half		2016: annual		2017: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	-0.3	0.9	1.6	1.5	1.0 2.0	1.6	0.9 2.4	1.7	0.8 2.7
Potential Output	-0.1	0.7	1.3	1.4	1.1 1.7	1.3	1.0 1.7	1.2	0.7 1.7
Private Consumption	-0.7	0.8	1.7	1.7	1.2 2.2	1.7	1.1 2.4	1.5	0.7 2.4
Government Consumption	0.2	0.8	1.3	1.2	0.8 1.6	1.0	0.5 1.5	0.7	0.1 1.3
Fixed Capital Formation	-2.6	1.3	2.7	2.5	0.5 4.5	2.7	0.5 5.0	2.8	0.4 5.3
Exports	2.0	4.1	5.0	3.2	1.9 4.6	3.9	2.2 5.7	5.1	3.0 7.2
Imports	1.2	4.5	5.7	6.5	1.9 8.9	4.6	3.0 6.1	5.2	3.2 7.2
Unemployment Rate	12.0	11.6	10.9	10.2	10.0 10.4	10.0	9.7 10.4	9.4	8.7 10.1
Labour Cost Index	1.2	1.3	1.5	1.1	0.7 1.5	1.5	1.1 1.9	2.2	1.5 2.9
Labour Productivity	0.4	0.3	0.5	0.3	-0.2 0.8	0.6	0.0 1.2	0.9	0.2 1.7
HICP	1.4	0.4	0.0	-0.2	-0.4 0.0	-0.1	-0.5 0.3	1.0	0.0 2.0
IPI	-0.7	0.9	1.6	2.2	4.1 0.3	2.2	4.2 0.1	1.5	4.1 -1.1

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2016 and 2017

The world economy: moderate expansion after slowdown in winter

A series of bad news at the beginning of this year revealed that the world economy had lost momentum in the final quarter of 2015. Growth dynamics in China slowed further down, and the recessions in Russia and Brazil continued. In addition, production expanded just a bit in the US and shrank in Japan, while the recovery in the euro area continued, but at a rather modest pace. All these news combined made financial markets worry about a global downswing soon to come. In January and February 2016, stock market evaluations tumbled and measures for risk awareness (such as VIX and VSTOXX) shot up everywhere. At the same time, crude oil prices fell markedly. It is striking that stock and oil prices have been highly correlated for about one year now: markets appear to see low oil prices less as a stimulus for advanced economies than as a sign of weak global demand and as a risk for the financial stability of oil exporting countries.

More recently, however, short-term indicators seem to show that a marked downswing is not imminent. Sentiment of firms in the manufacturing sector has improved for three months in a row in the US and more recently in China, and industrial production expanded in the US as well as in the euro area at the beginning of the year. Accordingly, stock markets have recovered during springtime. Still, prospects are not bright, in particular not for most emerging economies.

In advanced economies, as well as in China, monetary policy has reacted to the slowdown. The Federal Reserve Board and the Bank of England have signalled that they will raise key interest rates at a slower rate than expected in 2015; there will certainly be no move in the UK before the referendum about EU membership in June. In Japan and in the euro area, the scope for further actions such as experiments with negative key interest rates is rather limited. Short-term stimuli, however, can be expected from expansive monetary and fiscal measures in China.

Even taking into account these efforts, global growth will stay rather moderate this year. The peak of the upswing in the US appears to be over. For Japan, after three years of “Abenomics”, a prolonged upswing is still elusive. In China low profitability and high debt levels of many government-owned industrial firms continue to drag growth down. The low prices for commodities heighten uncertainty and volatility on financial markets since they increase the risks of financial crises in economies that are dependent on commodity exports. Apart from this, however, the net effect on global demand for goods should be positive, since low commodity prices increase real income in economies that typically have a high rate of internal absorption and decrease income in economies where up to recently parts of the aggregate income have been saved and invested on financial markets abroad.

The euro area economy: a slow recovery continues

In the second half of 2015, production expanded at an annualized rate of about 1.3%, which was a bit slower than in the first half of the year. In most single member states, growth dynamics have, as in the whole area, barely moved during the second half of 2015. An exception is Italy, where expansion has been slowing down in the past three quarters. In all larger economies, the recovery was driven by domestic demand, as the slowing world economy dampened the rate of export growth to below 1% in annualized terms. While consumption of private households lost momentum at the end of the year, investment both in equipment and in construction increased. Noticeable is the pick-up in non-housing construction that had, mainly due to public consolidation policies, been shrinking for some years.

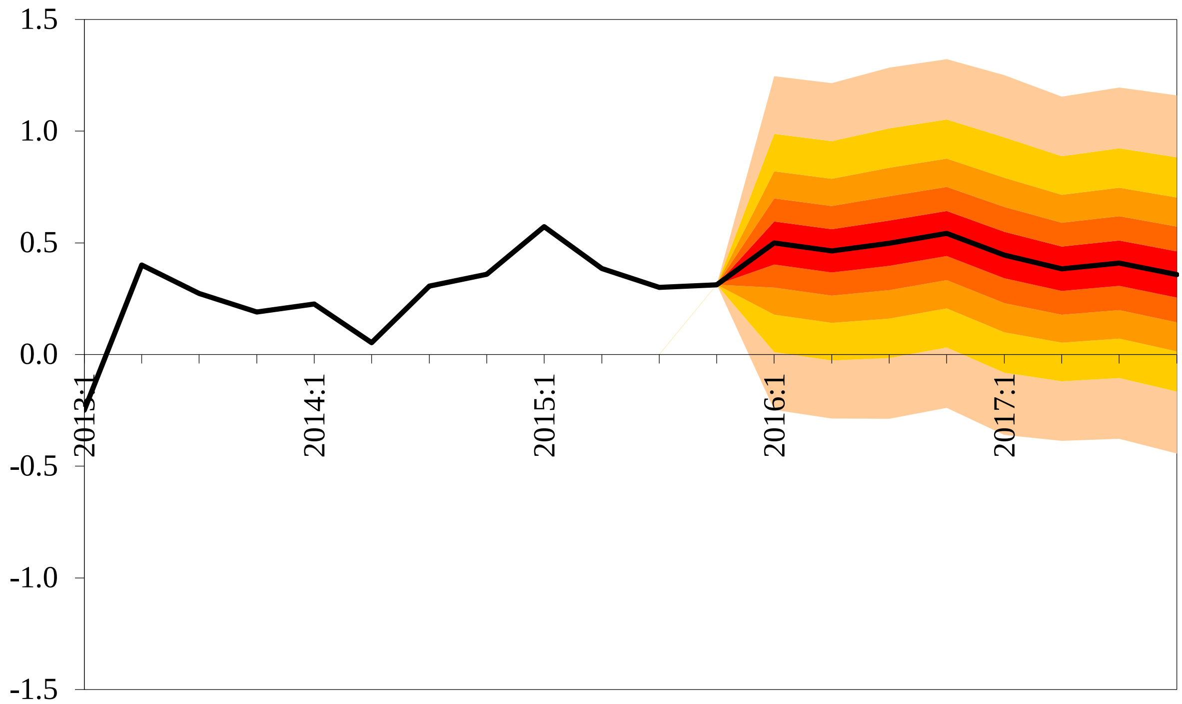
The expansion in euro area output has recently been accompanied by healthy employment growth, so that productivity is now nearly stagnant. The rate of unemployment has been falling steadily from 11.8% in March 2014 to 10.3% in February of this year. Employment rose markedly in Spain (albeit from an extremely low initial position), in the Netherlands, and in Germany, but turning points for labour market conditions are still not clearly detectable for Italy and for France. France is also the only large economy where fiscal consolidation slowly continues, while the fiscal stance in the most of the rest of the euro area is mildly expansive.

Monetary conditions should support growth in the whole area. The diverse unconventional measures of the ECB have certainly helped improving financial conditions a lot: governments and large corporations benefit from ultra-low bond yields, banks' composite costs of debt financing have been converging during the past two years in all large economies to very low levels, and borrowing costs for non-financial corporations have come down markedly. Low interest rates also support asset prices: house prices were, according to Eurostat, 2.9% higher at the end of 2015 than they had been one year before. The German property index is up by no less than 6%, and the Spanish and Dutch indices by more than 4%; the slowdown in French and Italian house prices might at least be bottoming out. What the recent monetary policy measures have not improved, is price competitiveness of euro area producers: the euro has, after depreciating for about a year by roughly 15% (measured by the real effective exchange rate), gone up since summer 2015 by about 5%. As world demand will be no more than moderate in 2016, a demand push from abroad is not to be expected.

Moreover, the euro area economy still suffers from high debt levels of households and the public sector as well as of firms in many member states. Efforts to bring these burdens down keep the saving rate of private households constant (at about 12.5%) and the growth of business investment low, although financial conditions are favourable. Banking conditions in some countries are also problematic due to the large share of non-performing loans, which might require additional capital injections and constrain credit expansion.

Still, chances for the recovery to continue are good. Unconventional monetary policy and mildly expansionary fiscal policy will slowly manifest their positive effects and this year, like in 2015, oil and commodity prices will probably be markedly lower than they were a year ago, increasing real income of private households and lowering production costs of firms.

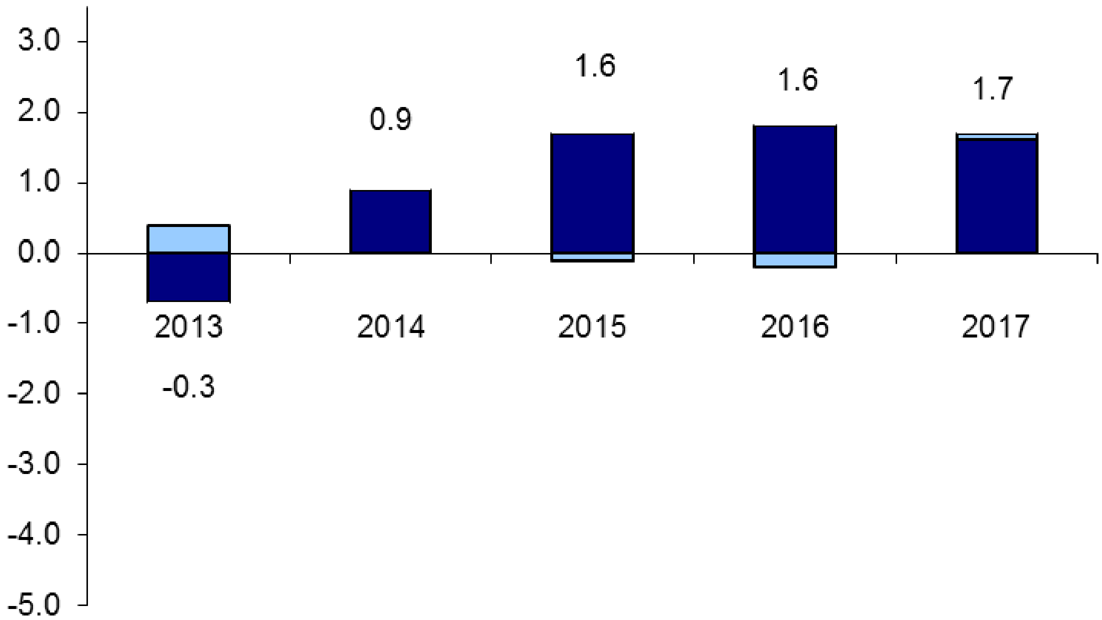
Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Overall, we forecast euro area GDP to expand by 1.6% in 2016 and by 1.7% in 2017. These rates are higher than the rate of potential growth, but they are still arguably low given the extent of expansive monetary policy and the strong stimulus from decreased commodity prices. We do not expect an increase in inflation during 2016, but prices will grow around 1% in 2017, because the dampening effects of decreasing energy prices are slowly fading off and the euro remains rather weak.

Figure 2 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

It is worth mentioning that risks for this cautiously optimistic forecasts are substantial. The price hike for insurances against defaults of European banks and the precipitate fall in bank equity valuations at the beginning of the year indicate potential risks in the financial sector. More generally, the fact that confidence of private households has been, according to the European Commission survey, slowly sinking for the past 12 months, indicates a wide spread sense of uncertainty that might, to a high degree, be related to the unpredictable future of European integration. It will be crucial for the short run perspectives of the euro area economy whether a viable political solution for the refugee crisis can soon be found and whether in June the British will vote in favour of membership in the European Union.

Figure 3 Economic Sentiment Indicator and confidence bands

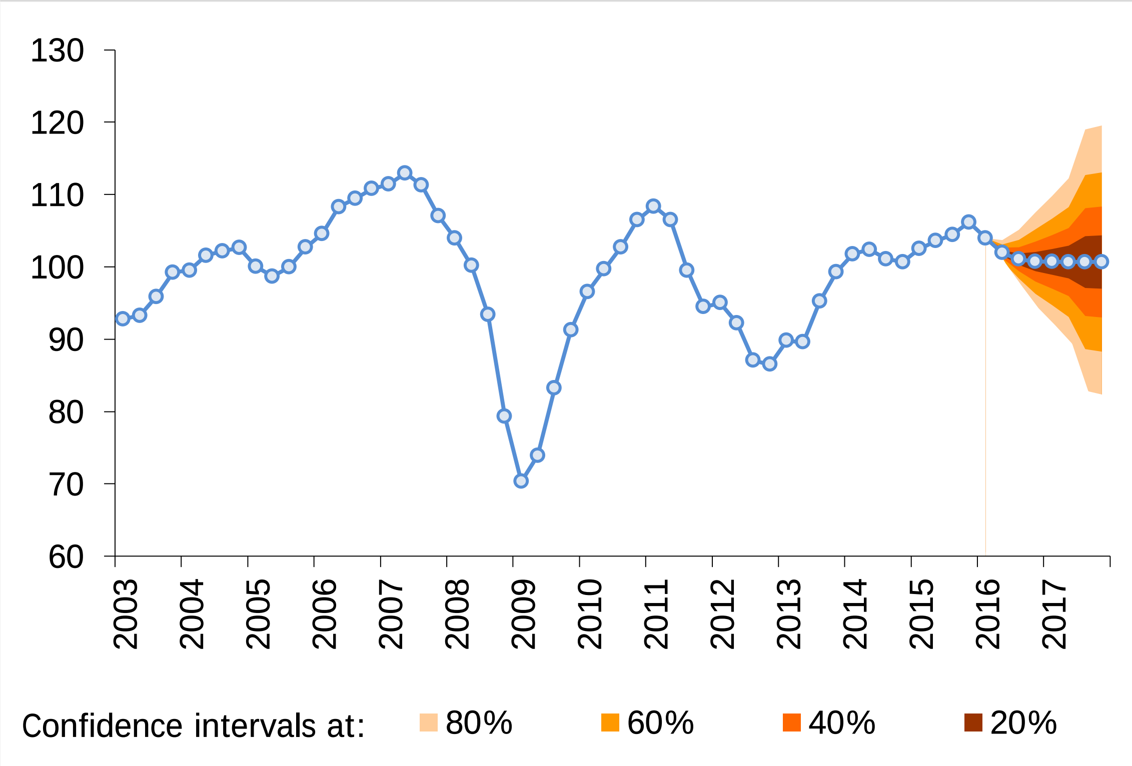


Figure 4 HICP and confidence bands

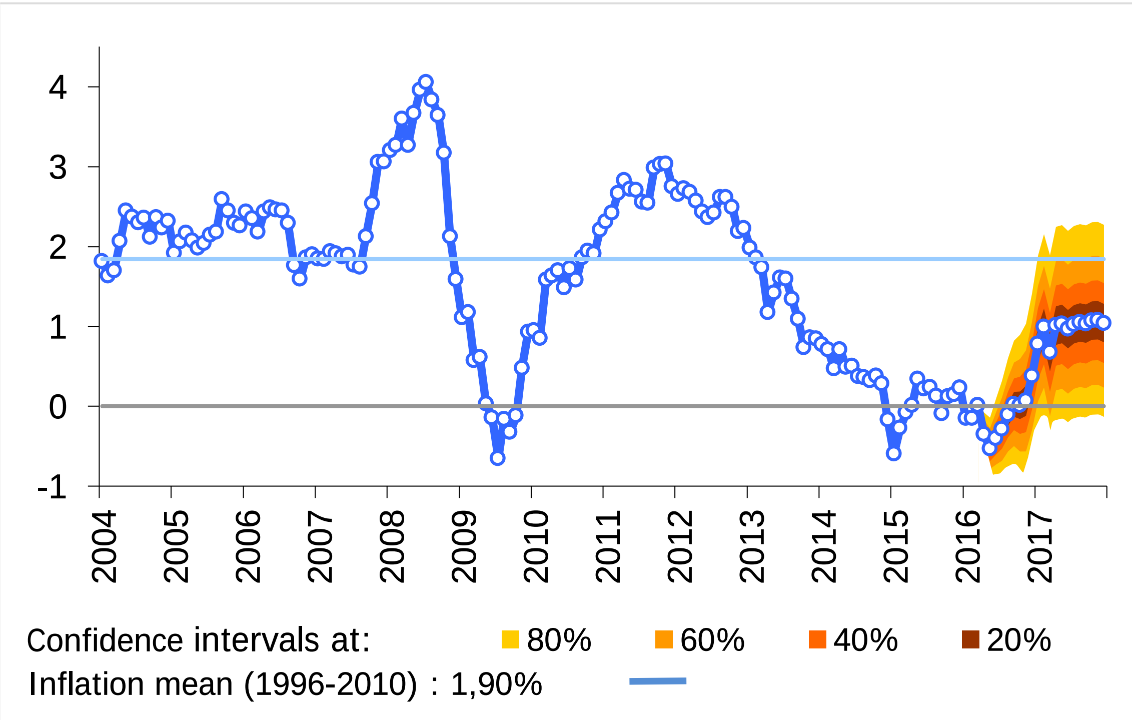


Table 2 Annual average rates for industrial production in the euro area

	2012	2013	2014	2015	2016	2017
Durable	-4.7	-3.2	-0.6	2.1	1.1	0.9
Non-Durable	-2.2	0	3.1	2.1	3.0	2.5
Capital	-1.1	-0.5	1.8	2.1	3.4	2.3
Intermediate	-4.5	-1	1.3	0.9	1.8	1.1
Energy	-0.2	-0.7	-5.4	0.5	-1.7	-1.0
Total	-2.5	-0.7	0.9	1.6	2.2	1.5

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The forecasts are quite similar, but the EFN forecast is, like that of the OECD, relatively optimistic concerning unemployment: we think that chances for a further significant fall in the rate are rather good. The high numbers of refugees might dampen the downward trend, but it will take some time until refugees enter the labour market, and most recent news indicate that the numbers of refugees coming to the euro area will be much lower in 2016 than it was last year.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF*		ECB		OECD**		Consensus	
	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017	2016	2017
GDP	1.6	1.7	1.7	1.9	1.6	na	1.4	1.7	1.8	1.9	1.5	1.6
Priv. Consumption	1.7	1.5	1.8	1.5	1.5	na	1.9	1.8	1.8	1.8	1.6	1.6
Gov. Consumption	1.0	0.7	1.3	1.2	0.6	na	1.5	1.1	1.1	1.0	1.5	1.1
Fixed Capital Form.	2.7	2.8	2.8	4.2	2.6	na	2.7	3.6	2.6	3.4	2.4	2.8
Unemployment rate	10.0	9.5	10.5	10.2	10.5	na	10.4	10.2	10.4	9.6	10.3	9.9
HICP	-0.1	1.0	0.5	1.5	1.0	na	0.1	1.3	1.0	1.6	0.3	1.4
IP	2.2	1.5	Na	na	na	na	na	na	na	na	1.2	1.8

EU: European Commission, Economic Forecast, February 2016; IMF: World Economic Outlook, October 2015; ECB: ECB Economic Bulletin, March 2016, OECD: Economic Outlook, November 2015; Consensus: Consensus Economics, Consensus Forecasts, March 2016. ECB figures correspond to their macroeconomic projections.
* Euro area GDP growth will, according to the IMF WEO update of January 2016, be 1.7% both in 2016 and in 2017.
** Euro area GDP growth will, according to the interim assessment of the OECD of February 2016, be 1.4% in 2016.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 4 below. We assume that the oil price will rise in 2016 and 2017, but only slowly. Growth rates for world trade of little more than 3% appear to be the new normal. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from April 2016 onward.

Table 4 Variables of the world economy

	2015	2016	2017
US GDP Growth Rate	2.4	2.1	2.4
US Consumer Price Inflation	0.1	1.3	2.2
US Short Term Interest Rate (December)	0.2	0.9	1.8
US Long Term Interest Rate (December)	2.2	2.5	2.9
Japan GDP Growth Rate	0.5	0.7	0.6
Japan Consumer Price Inflation	0.8	0.0	1.6
Japan Short Term Interest Rate (December)	0.1	0.0	0.0
Japan Long Term Interest Rate (December)	0.3	0.0	0.1
World Trade Growth Rate (CPB)	2.0	3.0	3.3
Oil Price (December)	38	43	45
USD/Euro Exchange Rate (December)	1.09	1.10	1.10
100Yen/Euro Exchange Rate (December)	1.32	1.26	1.26

Apart from the development of world trade, long-term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2016). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rate: 10-year treasury bills. Japan short-term interest rate: 3-month deposits (LIBOR). Japan long-term interest rate: 10-year treasury bills.