OVERVIEW: NAVIGATING THROUGH CHOPPY WATERS

Euro area recovery continues, surrounded by heightened uncertainty

The economic recovery is set to continue at a moderate pace but the forecast is surrounded by uncertainty...

There is a high degree of uncertainty surrounding the global economic outlook at present. This comes after an already difficult 2016, in which the European economy had to cope with numerous international and domestic challenges including the lowest pace of global and trade growth since 2009, geopolitical tensions, terrorist attacks in several Member States, stressed banking sectors, UK's vote to leave the EU, and a mounting backlash against globalisation. So far though, the European economy has proved to be resilient and has stayed the course of economic growth and job creation. EU GDP growth rose towards the end of last year and looks to have maintained its momentum into this year. This resilience has been supported by a number of well-known favourable factors, including the relatively low oil price, the past depreciation of the euro, accommodative monetary policies and a broadly neutral fiscal policy stance. The implementation of structural reforms in some Member States has also helped to underpin the recovery, particularly in the labour market. Private consumption has remained the main growth driver while investment has continued to disappoint. This persistent weakness in investment casts a shadow of doubt over the sustainability of the recovery and the economy's potential growth.

Table 1:

Overview - the winter 2017 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2016	2017	2018	2016	2017	2018	2016	2017	2018	2016	2017	2018	2016	2017	2018
Belgium	1.2	1.4	1.6	1.8	2.0	1.8	8.0	7.8	7.6	1.0	1.2	1.3	-2.9	-2.2	-2.3
Germany	1.9	1.6	1.8	0.4	1.9	1.5	4.1	4.1	4.1	8.7	8.3	8.0	0.6	0.4	0.4
Estonia	1.1	2.2	2.6	0.8	2.8	2.8	6.9	7.9	8.7	0.6	0.3	0.0	0.1	-0.5	-0.2
Ireland	4.3	3.4	3.3	-0.2	0.9	1.0	8.0	7.0	6.7	9.6	9.5	9.3	-0.9	-0.6	-0.6
Greece	0.3	2.7	3.1	0.0	1.3	1.0	23.4	22.0	20.3	-0.7	-0.7	-0.6	-1.1	-1.1	0.7
Spain	3.2	2.3	2.1	-0.3	1.9	1.7	19.6	17.7	16.0	1.8	1.7	1.6	-4.7	-3.5	-2.9
France	1.2	1.4	1.7	0.3	1.5	1.3	10.0	9.9	9.6	-2.3	-2.6	-2.7	-3.3	-2.9	-3.1
Italy	0.9	0.9	1.1	-0.1	1.4	1.3	11.7	11.6	11.4	2.7	2.1	1.8	-2.3	-2.4	-2.6
Cyprus	2.8	2.5	2.3	-1.2	1.2	1.1	13.3	12.0	11.0	-1.6	-2.1	-2.3	0.0	-0.2	0.4
Latvia	1.6	2.8	3.0	0.1	1.9	2.0	9.7	9.5	9.0	-0.1	-2.5	-3.3	0.0	-1.0	-1.0
Lithuania	2.2	2.9	2.8	0.7	2.1	1.9	8.0	7.5	7.1	-1.6	-2.9	-2.6	-0.5	-0.7	-0.7
Luxembourg	3.8	4.0	3.9	0.0	2.0	2.1	6.3	6.2	6.2	5.3	4.9	5.8	1.6	0.2	0.3
Malta	4.0	3.7	3.7	0.9	1.6	1.8	4.8	4.9	4.9	5.0	5.3	6.0	-0.7	-0.6	-0.6
Netherlands	2.1	2.0	1.8	0.1	1.4	1.4	6.0	5.2	4.7	8.0	7.4	7.1	-0.1	0.2	0.3
Austria	1.5	1.6	1.6	1.0	1.8	1.6	6.0	6.1	6.2	2.4	2.2	2.4	-1.4	-1.2	-0.9
Portugal	1.3	1.6	1.5	0.6	1.3	1.4	11.2	10.1	9.4	0.3	0.4	0.6	-2.3	-2.0	-2.2
Slovenia	2.5	3.0	3.0	-0.2	1.1	2.3	7.9	7.0	6.2	6.3	5.5	5.0	-2.0	-1.7	-1.4
Slovakia	3.3	2.9	3.6	-0.5	0.9	1.4	9.7	9.0	7.9	1.2	1.2	1.5	-2.2	-1.4	-0.6
Finland	1.5	1.2	1.5	0.4	1.5	1.2	8.8	8.6	8.3	-0.5	-0.6	-0.5	-2.2	-2.3	-1.8
Euro area	**1.7**	**1.6**	**1.8**	**0.2**	**1.7**	**1.4**	**10.0**	**9.6**	**9.1**	**3.6**	**3.2**	**3.1**	**-1.7**	**-1.4**	**-1.4**
Bulgaria	3.3	2.9	2.8	-1.3	0.8	1.2	7.7	7.1	6.8	2.6	1.4	0.8	-0.4	-0.5	-0.3
Czech Republic	2.4	2.6	2.7	0.6	2.0	1.8	4.0	3.9	3.8	-0.2	-0.5	-0.4	0.3	0.1	0.2
Denmark	1.0	1.5	1.8	0.0	1.4	1.6	6.2	5.9	5.7	7.3	7.0	7.0	-1.6	-1.6	-0.9
Croatia	2.8	3.1	2.5	-0.6	1.7	1.6	12.8	10.8	9.3	2.8	1.8	1.3	-1.8	-2.1	-1.8
Hungary	1.9	3.5	3.2	0.4	2.2	3.1	5.2	4.8	4.5	5.4	3.7	3.2	-1.8	-2.4	-2.5
Poland	2.8	3.2	3.1	-0.2	2.0	2.1	6.3	5.6	4.7	0.2	-0.4	-0.8	-2.3	-2.9	-3.0
Romania	4.9	4.4	3.7	-1.1	1.6	2.9	6.0	5.7	5.6	-2.2	-2.9	-3.1	-2.8	-3.6	-3.9
Sweden	3.3	2.4	2.1	1.1	1.7	1.8	6.9	6.5	6.4	4.8	4.8	4.9	0.5	-0.2	0.2
United Kingdom	2.0	1.5	1.2	0.7	2.5	2.6	4.9	5.2	5.6	-5.0	-4.8	-3.9	-3.4	-2.8	-2.5
EU	**1.9**	**1.8**	**1.8**	**0.3**	**1.8**	**1.7**	**8.5**	**8.1**	**7.8**	**2.1**	**1.9**	**1.9**	**-1.9**	**-1.7**	**-1.6**
USA	1.6	2.3	2.2	1.3	2.4	2.5	4.9	4.6	4.5	-2.5	-3.0	-3.5	-4.8	-5.1	-5.7
Japan	0.9	1.0	0.5	-0.1	0.4	0.6	3.1	3.1	3.0	3.9	4.1	4.2	-3.7	-4.0	-3.8
China	6.7	6.4	6.2	:	:	:	:	:	:	:	:	:	:	:	:
World	**3.0**	**3.4**	**3.6**	:	:	:	:	:	:	:	:	:	:	:	:

...which has reached a new high.

There is increasing evidence that the exceptional strength of the supportive factors has started to fade even as Europe faces numerous challenges. Uncertainty is rising to an extraordinarily high level, driven by the uncertain outcome of the UK's 'Brexit' negotiations and by upcoming elections in a number of large Member States. The outcome of the US presidential election adds some upside risks related to fiscal stimulus, but has also raised the possibility of isolationist and protectionist policies that would hurt the global and European economy, should they be enacted.

Overall, after 1.7% in 2016, euro area GDP growth is set to ease somewhat this year to 1.6% and then pick up slightly to 1.8% in 2018. This steady but moderate expansion should remain driven by domestic demand. Global GDP growth is expected to have reached a low point in 2016 and is projected to strengthen this year and next. Growth outside the EU is projected to pick up gradually from 3.2% in 2016 to 3.7% in 2017 and 3.9% in 2018.

Fiscal stimulus in the US is likely to raise interest rates and the US dollar

Growth prospects for advanced economies outside the EU have recently improved somewhat and a modest rebound is forecast this year, largely given assumptions of fiscal stimulus in the US. The implementation of a fiscal stimulus package would likely boost US GDP in the near term, but even though its timing, size and breakdown are still unknown, its multiplier is likely to be very low as the combination of loose fiscal policy and tighter monetary policy could spur further appreciation of the dollar and lead to an increase in long-term interest rates.

Growth in emerging markets remains fragile. After five years on a persistent downward trend, the protracted downturn appears to have bottomed out in 2015-2016 and a gradual recovery is expected to begin this year. This recovery should be supported by a gradual increase in commodity prices, as well as recovering demand from advanced economies, including some positive spillover effects from the planned US fiscal stimulus. However, tighter financial conditions and heightened uncertainty regarding future US policies are likely to impact business confidence and investment.

Financial markets have so far reacted positively to the US elections...

Global financial markets have rediscovered some optimism since the autumn, driven by improving macro-economic data, a pick-up in inflation, and expectations of a pro-growth policy in the US. In Europe, market perceptions of an improving economic outlook, sustained ECB asset purchases and expectations about US policy have led equity markets higher. Government bond yields have picked up, raising slightly credit financing costs but also providing some relief for bank profitability. Euro area sovereign bond spreads widened moderately on account of perceptions of heightened political risks in some Member States.

...while monetary policy is set to remain accommodative...

In the short term, the trajectory of monetary policy in the US and the euro area is expected to diverge and the dollar has already seen a broad-based strengthening on the back of expectations that monetary policy accommodation in the US will roll back more quickly. In the euro area, the extension of the ECB's asset purchase programme should ensure the prolongation of the stimulus.

...allowing favourable funding conditions...

Credit costs for non-financial corporations remained broadly unchanged on balance over the path months, as rising corporate bonds yields were compensated by further declines in bank lending rates. In some Member States, banks still face balance sheet constraints and low profitability but overall, euro area banks have continued to improve their capacity to support lending by strengthening their capital positions and reducing the risk on their balance sheets. As a result, both bank and market funding should remain supportive over the forecast horizon.

...which is a necessary but not sufficient condition for investment.

Investment remained weak last year despite substantial policy support and the related improvement in financing conditions. This year, investment is expected to be dampened by the demand outlook, which remains moderate, and by the heightened uncertainty related to the path of the UK's exit from the EU and the uncertainty surrounding future US policies. Also, in some Member States, corporate deleveraging still more than offsets the positive impact of improving financing conditions. The pace of growth in construction investment is, however, expected to have increased in the euro area in 2016 thanks to low mortgage rates and improved access to loans for house purchases. The recent rise in construction output and house prices also supports the expectation that the adjustment in the housing sector is ending. Investment is expected to accelerate somewhat next year thanks to low financing costs, the improving global demand outlook, high capacity utilisation, and recovering profit margins. A growing number of projects approved under the umbrella of the Investment Plan for Europe are also expected to move to the implementation phase, boosting both public and private investment. Investment growth is nevertheless set to remain subdued as the abovementioned hindrances to investment are likely to persist.

Private consumption is likely to moderate but remains the main growth driver...

Private consumption was the principal contributor to growth in 2016 and is expected to remain the main growth driver over the forecast horizon, underpinned by a continued acceleration of nominal labour and non-labour incomes. Households should indeed continue benefitting from employment growth and a rise in compensation, whilst increases in house prices are set to generate positive wealth effects. However, the expected increase in inflation will dampen the growth of real disposable incomes. Household saving rates are expected to remain broadly stable as the pass through to savings of past oil price-related income gains should come to an end, while uncertainty could lead to precautionary savings.

...whilst public consumption is a steady growth contributor...

Government consumption is expected to continue its rather steady contribution to GDP growth. After moderating slightly this year following the boost from refugee and security-related expenditures in some Member States last year, public consumption growth should remain stable next year under a no-policy change assumption.

...but little support is expected from export demand.

World trade is expected to firm this year, driven by the projected cyclical strengthening in advanced economies and the rebound in commodity prices, which should help with investment and the terms of trade in commodity exporters. Excluding the EU, imports of goods and services likely grew by a meagre 0.8% in 2016, but are expected to recover gradually to 3.0% in 2017 and to accelerate to 3.7% in 2018, which is more robust than expected back in the autumn due to the effects of the assumed US fiscal stimulus and a firmer trade outlook for China.

This rebound is set to raise foreign demand for European exports, but it should be partly offset by slowing growth in the UK and the pound's depreciation. Despite some further price competitiveness gains in terms of relative unit labour costs, European exporters are also likely to lose marginal market shares this year and next in line with past trends. Imports are set to continue following a similar pattern to those of exports, while growing stronger. Overall, the contribution of net exports to GDP growth is set to be fairly neutral.

Heterogeneity among Member States might widen again...

The recent appreciation of the US dollar and the increase in benchmark yields could affect euro area Member States in different ways, causing growth differences, which have been diminishing, to widen again. Different degrees of openness and uneven progress in achieving price and cost competitiveness imply that changes in the external value of the euro impact differently on the economic performance and the external position of countries. Moreover, the vulnerability of Member States to a normalisation of long-term interest rates will also differ depending on the strength of the banking sector and its exposure to bond markets, persistent impacts from the crisis and fiscal consolidation needs. The extent to which deleveraging has taken place, the labour market situation and the extent to which reforms have been implemented will also make a difference.

...while labour market slack persists despite broad improvements...

Improvements in the labour market are expected to continue, supported by the domestic-demand driven expansion, still relatively moderate wage growth, as well as structural reforms and policy measures implemented in some Member States. The pace of net job creation in 2017 and 2018 should, however, be slower than last year which may reflect a normalisation of some temporary factors that boosted employment in some Member States. Employment growth is projected to moderate from 1.3% to 1% in the euro area and to a lower 0.8% in the EU in 2017 and 2018 respectively. As job creation should outpace labour force growth, unemployment is likely to continue declining, yet unlikely to recover to pre-crisis levels over the forecast horizon. Also the slow recovery in the number of working hours per employee and the increase in the share of involuntary part-time work suggest that there is still non-negligible slack in the labour market.

...and the rise of energy prices is temporarily driving inflation up.

Inflation in the euro area has been picking up since the second half of 2016, mostly reflecting the recovery in oil prices from very low levels and base effects. Core inflation was fairly stable in 2016, as slack in the labour market as well as structural reforms implemented in some Member States prevented underlying prices from rising further. The depreciation of the euro against the dollar and rising global input price pressures are set to drive import prices further up in 2017, contributing to a rise in headline inflation this year. The impact of positive base effects in energy inflation, however, is set to fade over the forecast horizon. The slight increase in wages expected this year and next, as well as the narrowing and closure of the output gap, should begin supporting a moderate and gradual pick up in underlying price pressures. As a result, euro area headline inflation is forecast to rise from 0.2% in 2016 to 1.7% in 2017 and to recede to 1.4% 2018, as the gradual increase in core inflation is not expected to fully offset the fading inflationary impact of higher oil prices.

Public debt ratios are set to decline further...

The general government deficit in the euro area is expected to decrease from 1.7% of GDP last year to 1.4% in 2017 and, under a no-policy-change assumption, to remain at 1.4% in 2018. This decline reflects the reduced expenditure (as a percentage of GDP) on social transfers, which is a consequence of the economic recovery and falling unemployment, wage bill moderation in the public sector and the reduction in interest expenditure. The debt-to-GDP ratio in the euro area is projected to continue declining gradually from 91½% last year to 89¼% in 2018. This reduction derives from both higher primary surpluses and a more favourable snowball effect driven by reduced interest expenditure, modest real GDP growth and the expected uptick in inflation.

...whereas the policy mix in the euro area should remain growth-supportive.

The fiscal policy stance, measured by changes to the fiscal structural balance, stopped being restrictive in 2015 and is expected to turn broadly neutral over the forecast horizon. Real financing costs should decrease somewhat in the short run thanks to the full implementation of the set of monetary policy measures and rising inflation.

The range of possible outcomes has considerably increased

This forecast is surrounded by exceptionally high uncertainty. The balance of risks remains tilted to the downside although upside risks have also emerged, especially in the short run.

In the near term, the eventual package of US fiscal stimulus and pro-business reforms could provide a stronger boost to global GDP than currently expected. But in the medium term, potential disruptions associated with shifting US positions on trade policy could damage international trade at a time when global growth is bottoming out and its recovery is still fragile. A faster reversal of the US' monetary policy stance and a stronger-than-expected dollar appreciation could negatively impact emerging market economies, particularly those with unhedged USD-denominated debt. As financial markets may be challenged by all these factors, a sudden and abrupt drop in global risk appetite and a re-assessment of currently compressed risk premia could cause significant turmoil in global financial markets. Long-standing risks surrounding a disorderly adjustment in China have increased amid rapid domestic credit growth and continued reliance on stimulus measures.

On the domestic side, the UK 'leave' vote continues to pose a significant downside risk to the UK and to a lesser extent the overall European economy, as does the political uncertainty surrounding upcoming elections in large Member States. Fragile banking sectors in some countries are also a concern, even though the recent steepening of the yield curve provides some relief.