EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2016 and 2017

Summer 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

- Short run consequences of Brexit for the euro area economy mainly depend on the effects on confidence in the stability of the European Union and the currency area in particular. Anti-European (or indeed anti-globalization) movements are certainly encouraged by the British vote. More important, however, might be a reverse effect: from the perspective of the British turmoil, the euro area might in the near future appear as a zone of relative stability and calm.
- Against the background of a sluggish world economy, the euro area economy recently performed reasonably well: dynamics have been slowly increasing since 2013, and the rate of expansion in the first quarter of 2016 was one of the highest of the past couple of years.
- Looking forward, the drivers of the recovery should continue supporting growth in the second half of 2016 and for much of 2017. Our forecast is that euro area GDP will expand by 1.7% in 2016 and by 1.6% in 2017, with only a minor effect from Brexit. This year, like in 2015, average oil prices will probably be markedly lower than they were a year ago, supporting real incomes of private households and lowering production costs of firms, and monetary policy will still be supportive. Labour markets appear to continue improving slowly.
- Associated with the improved economic conditions, we expect a slight increase in euro area inflation during 2016, 0.3%, with a more marked increase in 2017, 1.3%.

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
					1.4		1.3		0.6
GDP	-0.3	0.9	1.7	1.6	1.9	1.7	2.2	1.6	2.5
					1.6		1.3		0.8
Potential Output	-0.1	0.7	1.2	1.7	1.8	1.5	1.7	1.2	1.7
					1.6		1.4		0.6
Private Consumption	-0.7	0.8	1.7	1.8	2.0	1.8	2.2	1.5	2.3
					1.2		0.9		0.2
Government Consumption	0.2	0.8	1.3	1.4	1.6	1.2	1.6	0.7	1.3
					1.8		1.0		0.9
Fixed Capital Formation	-2.6	1.3	2.9	2.9	3.9	2.9	4.7	3.7	6.5
					2.1		2.1		2.8
Exports	2.0	4.1	5.3	2.8	3.4	3.3	4.4	4.8	6.8
					3.6		3.0		3.1
Imports	1.2	4.5	6.1	4.3	5.1	4.2	5.5	5.1	7.2
					10.1		9.8		8.9
Unemployment Rate	12.0	11.6	10.9	10.2	10.3	10.0	10.2	9.5	10.1
					1.4		1.7		1.8
Labour Cost Index	1.2	1.3	1.5	1.6	1.8	2.0	2.3	2.4	3.1
					0.1		0.1		0.0
Labour Productivity	0.4	0.3	0.5	0.3	0.6	0.5	0.9	0.8	1.6
					-0.1		0.0		0.3
HICP	1.4	0.4	0.0	0.0	0.1	0.3	0.6	1.3	2.3
					1.3		-0.1		-1.1
IPI	-0.7	0.9	1.6	1.8	2.3	1.7	3.5	1.2	3.7

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

Brexit vote clouds long run prospects in Europe

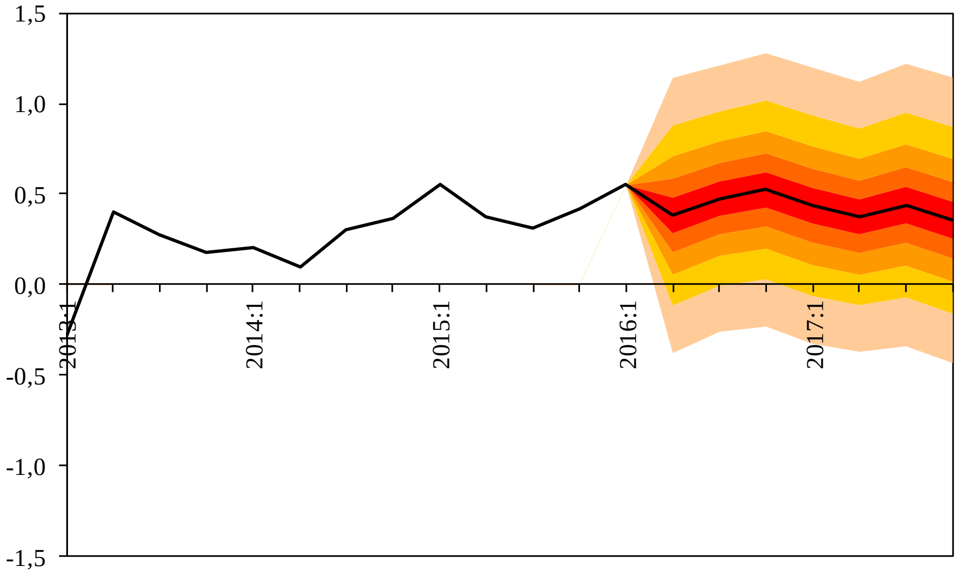
On June 23rd the British voted for an exit of the United Kingdom (UK) from the European Union (EU). In the night when the outcome of the votes became clear, Pound Sterling fell by about 10% of its value relative to the Dollar to a thirty year's low; the euro lost about 2%. Financial markets – as well as most economists – regard the exit decision as harmful for the British economy and, to a lesser degree, for the rest of the European Union. This is so although the long run consequences are unknown: economic conditions could broadly stay the same if Britain became, like Norway, a member of the European Economic Area, with a common market for goods and services and free movement of people, but with rules of this partnership mainly set by the EU; at the other end in the range of possible outcomes, Britain might leave the common market completely, with economic relations with the EU mainly defined by the rules of the World Trade Organisation (WTO). What matters for a forecast of the European economy in this year and in 2017 is that the uncertainty over the long run prospects is here to stay for some time and probably beyond these two years. This means that many investment projects will be put on hold in the UK, and private households will spend only cautiously. In addition, the fall in the Pound causes losses in purchasing power in Britain. If the years after the strong fall of the Pound in 2008 are any guidance, British exporters might little benefit from this time's depreciation. All in all, the British economy is likely to stagnate or shrink in the coming quarters.

The foreseeable downswing in Britain will, to some extent, weigh on the recovery in the euro area. Trade will be negatively affected: in 2015 Britain was, with a share of 13.5% and close behind the Unites States (US), the second most important destination of euro area exports in goods. Even more serious consequences might follow from a loss of confidence in the stability of the European Union and the currency area in particular. Clearly, anti-European (or indeed anti-globalization) movements have gained political ground all over Europe in the past decade and feel certainly encouraged by the British vote. More probable, however, appears the reverse: the awkward situation Britain finds itself in after the vote might very well deter many Europeans from demanding a similar move of their country. From the perspective of the British turmoil, the euro area might in the near future appear as a zone of relative stability and calm.

The euro area recovery: moderate, but still intact

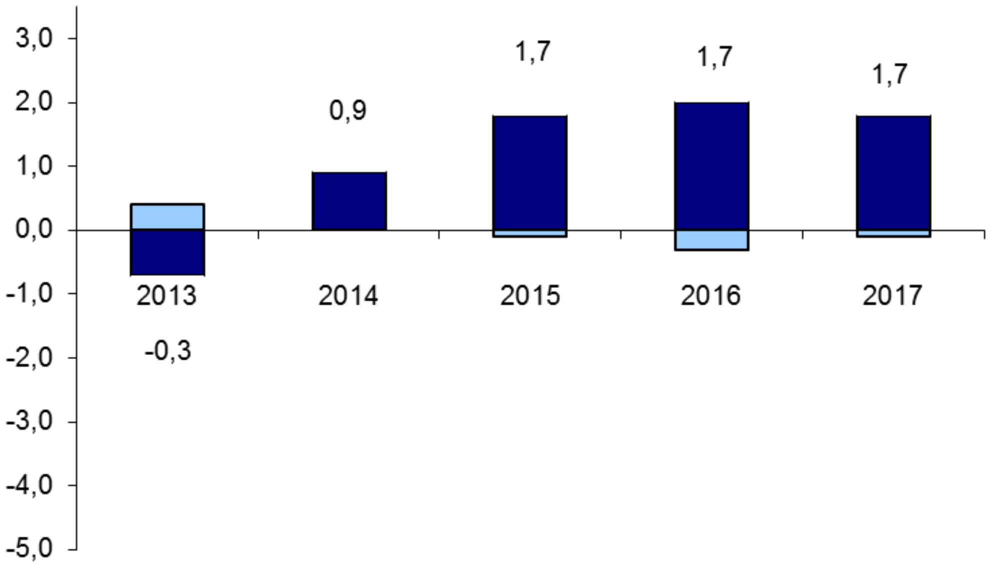
The world economy has been losing dynamics for more than a year now. At the beginning of the year production expanded only very moderately in the US, and markedly lost momentum in China. World trade in goods even contracted in the first quarter of 2016. Against this background the euro area economy, having been a drag on international economic growth for many years, performed quite well: dynamics have been slowly increasing since 2013, and the quarterly rate of expansion in the first quarter of 2016 was, with 0.55%, one of the highest of the past couple of years. Export expansion was slow and probably mainly due to intra-area trade, as exports of goods into countries outside the euro area decreased. The main driver of the present recovery is consumption of private households. It is expanding by about 1.7% per year since oil prices started falling in the second half of 2014, pushing up the purchasing power of euro area households. The second factor supporting incomes is employment growth. It began in early 2014 and has reached about 1.5% this year. As this rate is close to the output growth rate, productivity is nearly stagnant. Unemployment is, with 10.1% in May, still high, but it has been falling by 2 percentage points since summer 2013, mainly due to improving labour markets in Spain, Germany and the Netherlands. While there is some growth of employment in Italy and a bit less in France, a clear trend to lower unemployment rates is still not detectable for both countries, as participation rates are on the rise. The recovery in France is still dragged down by the continuing recession in the housing sector: house prices are, in spite of very low interest rates, not rising, and construction of dwellings has been shrinking for most of the past seven years, being now at no higher level than in 2002. The rest of French investment activity, however, has gained a bit of momentum, as has the aggregate of gross fixed capital formation in the euro area. Important causes are, besides expanding consumer demand, low costs of external financing, and ultimately the expansive monetary policy stance, with composite lending rates for nonfinancial corporations going down since 2012. Mildly expansive is the fiscal stance in the euro area. For example, in the first five months of 2016 the financial balance of the Spanish central government has, in spite of the better economy, not improved relative to last year, a result probably related to the inexistence of a strong government.

Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

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

Figure 3 Economic Sentiment Indicator and confidence bands

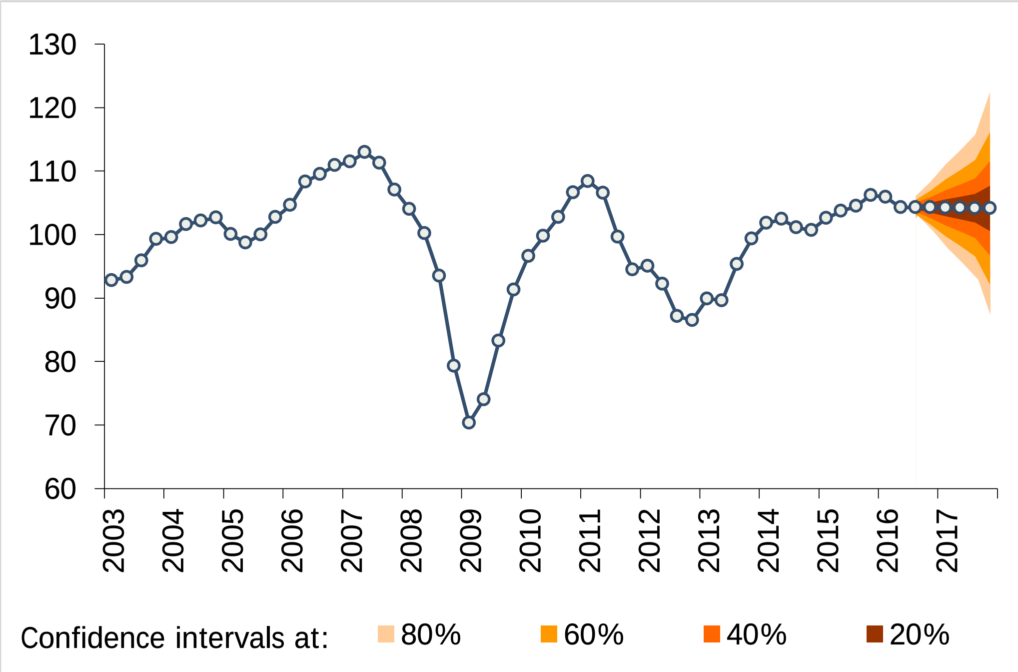
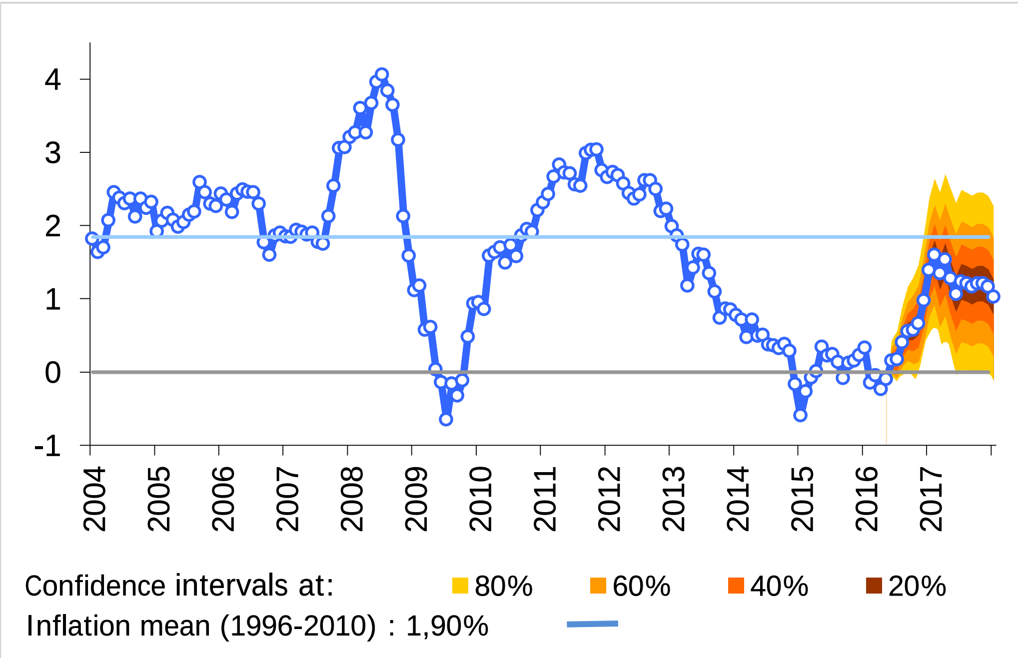


Figure 4 HICP and confidence bands



Looking forward, the drivers of the recovery should continue supporting growth in the second half of 2016 and for much of 2017. This year, like in 2015, average oil prices will probably be markedly lower than they were a year ago, supporting real incomes of private households and lowering production costs of firms. Monetary policy will continue to be supportive. Labour markets appear to continue improving slowly. Headwinds come, however, from abroad: world demand will be no more than moderate in 2016, with demand form the UK probably even receding for some time. But if confidence in the stability of the euro area keeps up, as well as that in its banking system, chances that the recovery of in the euro area will, in spite of strains coming from Brexit, continue, still look reasonably good. Gross domestic product will, according to us, increase by 1.7% in this year and by 1.6% in 2017, with most of the growth due to internal demand, see Figures 1 and 2. Industrial production is also expected to increase, by 1.7% in 2016 and 1.2% in 2017, with a particularly good performance for capital goods, see Table 2.

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

	2012	2013	2014	2015	2016	2017
Durable	-4.7	-3.2	-0.8	2.0	1.2	1.1
Non Durable	-2.2	0	3.1	1.8	0.6	0.8
Capital	-1.1	-0.5	1.7	2.3	3.3	2.6
Intermediate	-4.5	-1	1.1	0.7	1.6	1.0
Energy	-0.2	-0.7	-5.6	1.1	-0.8	-0.9
Total	-2.5	-0.7	0.9	1.6	1.7	1.2

Associated with the improved economic conditions and the still very expansionary monetary policy of the ECB, we expect a slight increase in euro area inflation during 2016, to 0.3%, with a more marked increase in 2017, to 1.3%, see Figure 4.

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 other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The forecasts are quite similar, but the EFN forecast is relatively optimistic concerning the effects of Brexit and the unemployment rate. About the latter, we think that chances for a further siginificant fall 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 number 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	1.7	1.6	1.6	1.8	1.5	1.6	1.6	1.7	1.6	1.7	1.6	1.6
Priv. Consumption	1.8	1.5	1.8	1.5	1.6	1.6	1.9	1.7	1.8	1.7	1.7	1.6
Gov. Consumption	1.2	0.7	1.4	1.2	1.1	0.7	1.5	0.8	1.7	1.1	1.5	1.1
Fixed Capital Form.	2.9	3.7	2.9	3.8	2.6	2.8	3.2	3.4	3.3	3.2	3.1	2.7
Unemployment rate	10.0	9.5	10.3	9.9	10.3	9.9	10.2	9.9	10.2	9.8	10.2	9.8
HICP			0.2	1.4	0.4	1.1	0.2	1.3	0.2	1.2	0.2	1.3
IP			na	na	na	na	na	na	na	na	1.6	1.8

EU: European Commission, Economic Forecast, May 2016; IMF: World Economic Outlook, April 2016; ECB: ECB Economic Bulletin, March 2016, OECD: Economic Outlook, June 2016; Consensus: Consensus Economics, Consensus Forecasts, June 2016. ECB: June 2016 staff macroeconomic projections.

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 remain at about 50$ in 2016 and only slightly increase in 2017. The assumption on world trade growth has once more been lowered relative to our April forecast. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from July 2016 onward.

Table 4 Variables of the world economy

	2015	2016	2017
US GDP Growth Rate	2.4	1.9	2.3
US Consumer Price Inflation	0.1	1.3	2.3
US Short Term Interest Rate (December)	0.2	0.7	1.5
US Long Term Interest Rate (December)	2.2	2.2	2.6
Japan GDP Growth Rate	0.6	0.5	0.9
Japan Consumer Price Inflation	0.8	-0.1	0.9
Japan Short Term Interest Rate (December)	0.1	0.0	0.0
Japan Long Term Interest Rate (December)	0.3	-0.1	-0.1
World Trade Growth Rate (CPB)	1.6	1.2	2.5
Oil Price (December)	38	50	53
USD/Euro Exchange Rate (December)	1.09	1.11	1.11
100Yen/Euro Exchange Rate (December)	1.32	1.16	1.16

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 rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.