EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2016 and 2017

Winter 2015/16

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.

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Highlights

- At present, growth in manufacturing and investment activity are weak, particularly in China but, to a lesser extent, in advanced economies as well. World activity in many service sectors, however, proves resilient.
- Worldwide demand is primarily backed by low interest rates and low prices for energy and commodities. However, the latter also cause serious risks for the stability of economies that are dependent on commodity export revenues.
- Since the sovereign debt crisis began to recede during 2013, fiscal policies have become ever less restrictive in most member states of the currency union. In 2016, fiscal policy in the euro area will even become a bit expansive.
- However, we expect only a moderate acceleration of the recovery in the euro area, because foreign demand will not expand by much due to the weakness of emerging market economies, and internal demand will still be dragged down by high debt levels of firms and households in many member countries. In particular, according to our forecasts, the euro area GDP will grow by 1.8% in 2016 and 2017, and this will be accompanied by a decline in the unemployment rate below 10%.
- Our inflation forecast for 2016 is 1.1%. For 2017, we expect inflation to increase up to 1.5% as during next year the dampening effects of decreasing energy prices will slowly fade off.

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	1.5	1.9	0.9 3.0	1.8	1.0 2.7	1.8	0.8 2.8
Potential Output	0.4	0.3	0.9	0.8	0.4 1.3	0.9	0.5 1.3	0.8	0.3 1.2
Private Consumption	-0.7	0.8	1.6	1.6	0.6 2.6	1.6	0.8 2.4	1.4	0.5 2.3
Government Consumption	0.2	0.9	1.4	0.4	-0.2 1.1	0.8	0.2 1.3	0.5	0.0 1.0
Fixed Capital Formation	-2.6	1.3	2.4	3.5	0.9 6.2	3.2	0.8 5.5	3.1	0.2 6.0
Exports	2.1	4.1	5.0	5.7	3.4 8.0	5.2	3.2 7.1	5.5	3.3 7.6
Imports	1.2	4.5	5.4	5.9	3.4 8.4	5.8	3.8 7.8	5.5	3.2 7.8
Unemployment Rate	12.0	11.6	10.9	10.2	9.7 10.7	10.4	10.0 10.8	9.9	9.1 10.7
Labour Cost Index	1.2	1.3	1.6	1.9	1.3 2.5	1.7	1.1 2.3	2.1	1.1 3.1
Labour Productivity	-0.2	0.6	0.9	1.0	0.1 2.1	0.8	0.1 1.6	1.0	0.1 1.9
HICP	1.4	0.4	0.1	0.8	0.6 1.0	1.1	0.4 1.8	1.5	0.5 2.5
IPI	-0.7	0.9	1.8	1.2	-0.5 2.9	1.2	-0.8 3.2	1.1	-1.6 3.8

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: weak industrial production, but robust services

Volatility on markets for currencies, capital and commodities markedly increased at the start of the year 2016, driven by a fall of stock prices in China, a slowing Renminbi and a massive decrease in oil prices. Although volatility on these markets already increased in 2015, world production has been expanding quite smoothly and at a moderate pace for quite some time.

The economies of the United States and the United Kingdom are on the upswing, while the recovery in the euro area continues. Economic activity in China indeed seems to have stabilised following a pronounced period of weakness at the beginning of 2015. The time path of Chinese industrial production has shaped that of world trade: after shrinking in the first half of the year, trade has been recovering in the second half. Brazil and Russia, however, appear to be still in recession at the end of the year. Both commodity exporters suffer from the sharp drop in prices for their commodities that has been caused by the struggle for market shares on world oil markets, but also by the continuing weakness of investment and manufacturing in China and, to a lesser extent, in advanced economies. Worldwide economic activity in the service sector, however, proved resilient.

As a consequence of the decline in commodity prices, inflation rates are close to zero, as are the policy rates in many advanced economies. However, since the cyclical positions of the main advanced economies differ substantially, monetary policies head into different directions: due to the economic upturn in the United States, the Federal Reserve Board has started raising policy rates in December. As recoveries in the euro area and in Japan are hesitant, the ECB and the Bank of Japan aim at stimulating demand by further broadening their monetary bases. Fiscal policy will in general (with exception of Britain) be eased in advanced economies during 2016, turning even expansive in the case of the euro area.

Still, worldwide production is not expected to expand significantly faster in 2016 than in 2015. Although chances are good that the upswing in the US and in Britain will continue, capacity utilization is probably high in both economies, and room for faster expansion is limited. For Japan, policy has aleady become about as expansive as possible and reforms have probably not yet raised potential output by much. Growth dynamics in China will continue to slow, and while political interventions should be capable to prevent the outbreak of deep crises, they come at the price of a slower sectoral change that will be a further drag on Chinese growth.

Worldwide demand is primarily backed by low interest rates and low prices for energy and commodities. However, the latter also cause serious risks for the stability of economies that are dependent on commodity export revenues.

The euro area economy: further stimuli keep the recovery alive

Production in the euro area has been increasing by a bit less than 1½% at annual rates since summer 2014, and capacity underutilization is slowly coming down. The recovery is mainly due to growing consumption of private households. A strong increase in investment, which would be typical for an upswing, takes only place where property crises have come to an end: in Spain, in Ireland, and in the Netherlands. Exports that, supported by the weak euro, had expanded healthily before, have been close to stagnant in the third quarter 2015, mainly due to slowing demand from emerging markets.

A main driver for the recovery in the euro area is the fall in energy prices. By its own, it has propped up real incomes by a bit less than 1% since summer 2014. With inflation only slightly higher than 0%, real wages are increasing by about 1 ½% per year. In addition, employment goes up, whether calculated in people employed or in hours worked, by about 1%. As a result, the unemployment rate is slowly retreating, by one percentage point since November 2014 to 10.5% in November 2015. A bit more pronounced than the increase in wage income is that of profits. However the share of capital income in GDP, if measured by gross operating surplus of non-financial enterprises, is, with about 40%, still 3 percentage points lower than it was shortly before the Great Recession in 2008. This may be one factor that holds investment activity of firms back.

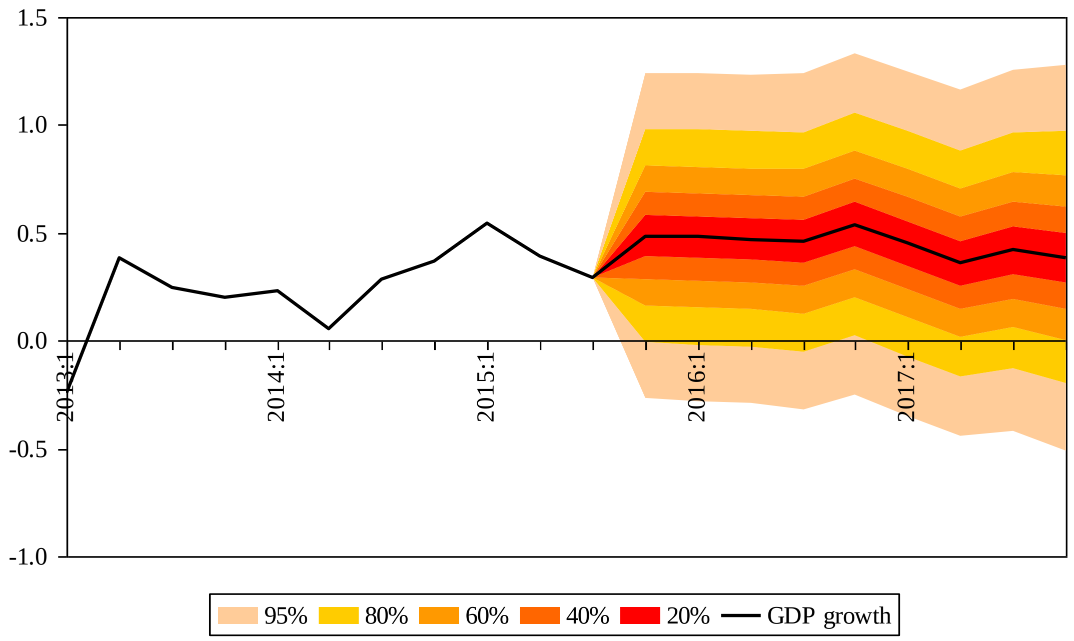
Since the sovereign debt crisis has started to recede during 2013 (mainly owing to the reassuring communication by the ECB), fiscal policies have become ever less restrictive in most member states of the currency union. The draft budgetary plans for 2016 of all larger member states imply larger cyclically adjusted deficits (or smaller surpluses) than those predicted by the European Commission in its spring report 2015, and only France might slighty reduce its structural deficit. All in all, fiscal policy in the whole area will become even a bit expansive. The public costs of accommodating the high number of refugees are difficult to predict, but an estimation of about 0.1% relative to GDP in the euro area seems reasonable.

There is a whole bunch of conditions that help the recovery to continue: a comparably low external value of the euro that helps exporters, mildly expansive fiscal policies and a very expansive monetary policy, low interest rates for firms and households, reduced risk premia for credit in former crisis countries, and energy prices that are, with less than 35 dollars per barrel, at the beginning of 2016 about a third lower than on average in 2015. Still, we expect only a moderate acceleration of the recovery, because foreign demand will not expand by much due to the weakness of emerging market economies, and internal demand will, as before, be dragged down by the high debt levels (of firms, private or public households) in many member countries.

Overall, GDP growth should reach 1.8% in 2016, after 1.5% in 2015. During the year 2017, the dynamics will, according to this forecast, slightly decrease, as the favourable stimuli from the energy prices, the weak euro, and economic policy slowly fade off. In both years, the bulk of growth will be due to internal demand rather than next exports.

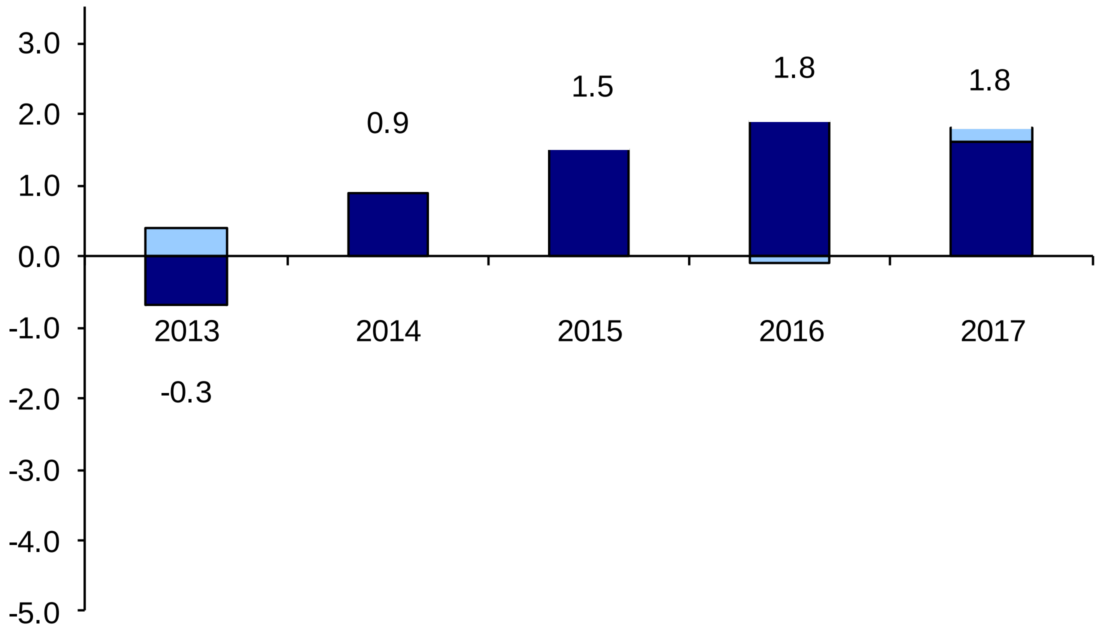
The persistent recovery will stabilize the economic sentiment indicator at values well above 100, and we also expect a limited increase in inflation, to 1.1% in 2016 and 1.5% in 2017, also due to the slowly fading off of the favourable effects of decreasing energy prices.

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

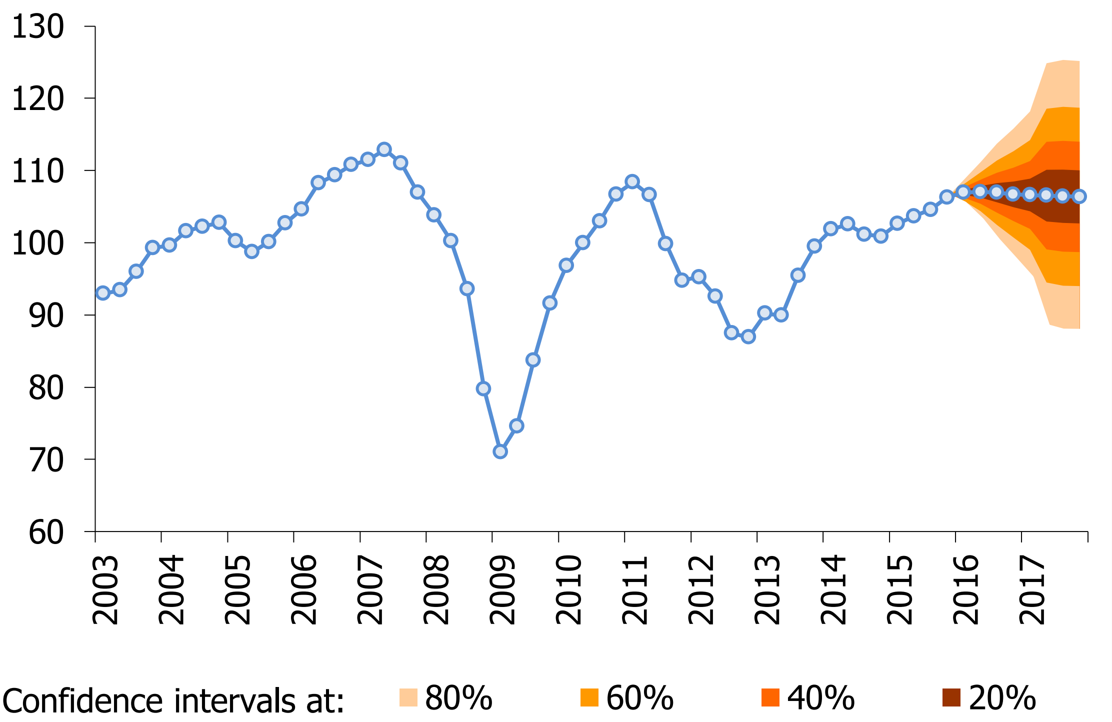


Figure 4 HICP and confidence bands

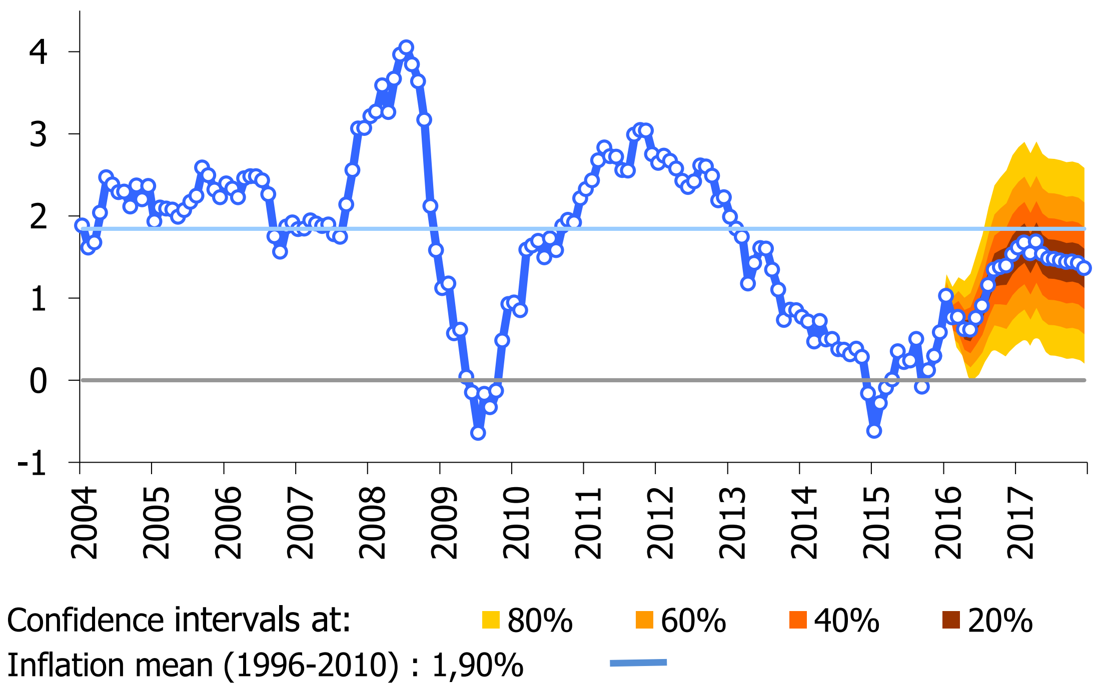


Table 2 Annual average rates for industrial production in the euro area

	2012	2013	2014	2015	2016	2017
Durable	-4.7	-3.2	-0.8	2.0	3.0	2.1
Non Durable	-2.2	0	3.1	1.8	1.8	1.7
Capital	-1.1	-0.5	1.7	2.3	2.5	2.1
Intermediate	-4.5	-1	1.1	0.7	0.6	0.5
Energy	-0.2	-0.7	-5.6	1.1	-1.1	-0.8
Total	-2.5	-0.7	0.7	1.8	1.2	1.1

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 different institutions predict GDP growth rates that are close to each other. According to the EFN forecasts, investment will not accelerate between 2016 and 2017, and consumption growth will slow down, because the positive effects of lower energy prices and expansive monetary and fiscal policies will wane in 2017.

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	1.8	1.8	1.8	1.9	1.6	na	1.7	1.9	1.8	1.9	1.7	na
Priv. Consumption	1.7	1.4	1.7	1.5	1.5	na	1.9	1.7	1.8	1.8	1.7	na
Gov. Consumption	0.8	0.5	0.8	1.1	0.6	na	1.2	1.0	1.1	1.0	1.1	na
Fixed Capital Form.	3.2	3.1	3.0	4.4	2.6	na	2.8	3.8	2.6	3.4	2.6	na
Unemployment rate	10.4	9.9	10.6	10.3	10.5	na	10.5	10.1	10.4	9.8	10.5	na
HICP	1.1	1.5	1.0	1.6	1.0	na	1.0	1.6	0.9	1.3	1.0	na
IP	1.2	1.1	na	na	na	na	na	na	na	na	1.7	na

EU: European Commission, Economic Forecast, November 2015; IMF: World Economic Outlook, October 2015; ECB: Eurosystem Staff Macroeconomic Projections for the Euro Area, December 2015, OECD: Economic Outlook, November 2015; Consensus: Consensus Economics Inc., Consensus Forecasts, December 2015.

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, after its repeated steep fall since summer 2014, rise in 2016 and 2017, but only modestly. In the past few years, growth in world trade has been much lower than it was on average in the past 25 years or so, and we assume that it will gain little momentum in 2016 and 2017. The exchange rates of the dollar and the yen relative to the euro are assumed to be stable.

Table 4 Variables of the world economy

	2015	2016	2017
US GDP Growth Rate	2.4	2.5	2.4
US Consumer Price Inflation	0.2	1.7	1.9
US Short Term Interest Rate (December)	0.3	1.1	1.9
US Long Term Interest Rate (December)	2.2	2.8	3.2
Japan GDP Growth Rate	0.6	1.2	0.9
Japan Consumer Price Inflation	0.8	0.7	2.1
Japan Short Term Interest Rate (December)	0.2	0.2	0.4
Japan Long Term Interest Rate (December)	0.3	0.6	0.8
World Trade Growth Rate	1.5	2.5	3.4
Oil Price (December)	38	42	45
USD/Euro Exchange Rate (December)	1.09	1.09	1.09
100Yen/Euro Exchange Rate (December)	1.33	1.33	1.33

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 (2015). 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.