OVERVIEW: STAYING THE COURSE AMID HIGH RISKS

The euro area economy continues to grow modestly

An ongoing but fragile economic expansion...

For more than a year, the European economy has been benefitting from an exceptional combination of favourable factors. Low oil prices, a low euro exchange rate, supportive monetary policy measures and increased public expenditure associated with the inflow of asylum seekers in some Member States, have provided generous support to the economy. In recent months, however, the boost from these factors has been partly offset by external headwinds stemming from the downturn in emerging economies and, more recently, from a slowdown in major advanced economies. As a result, economic growth has remained moderate.

...amid fading tailwinds and growing headwinds...

The strength of some of the positive factors supporting the euro area is likely to fade over the forecast horizon. On the one hand, although the renewed drop in oil prices early this year should still sustain the purchasing power of households, the expected rebound in inflation will eventually slow the expansion of real disposable incomes. Additionally, the benefits of the euro's earlier depreciation, which take time to feed through, will start to wane, while its appreciation since the start of this year is likely to compound the slowing impact of the external environment on the euro area. On the other hand, additional measures taken by the ECB in March have improved access to credit and reduced funding costs, further improving the conditions for an acceleration of investment. Fiscal policy is expected to be slightly supportive to growth this year. Meanwhile, high levels of public and private debt will continue to weigh on growth, along with other legacies from the crisis, such

Table 1:

Overview - the spring 2016 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Belgium	1.4	1.2	1.6	0.6	1.7	1.6	8.5	8.2	7.7	1.3	1.8	1.9	-2.6	-2.8	-2.3
Germany	1.7	1.6	1.6	0.1	0.3	1.5	4.6	4.6	4.7	8.8	8.5	8.3	0.7	0.2	0.1
Estonia	1.1	1.9	2.4	0.1	0.8	2.9	6.2	6.5	7.7	2.0	0.9	1.6	0.4	-0.1	-0.2
Ireland	7.8	4.9	3.7	0.0	0.3	1.3	9.4	8.2	7.5	4.4	4.6	4.6	-2.3	-1.1	-0.6
Greece	-0.2	-0.3	2.7	-1.1	-0.3	0.6	24.9	24.7	23.6	-0.2	0.6	1.3	-7.2	-3.1	-1.8
Spain	3.2	2.6	2.5	-0.6	-0.1	1.4	22.1	20.0	18.1	1.4	1.5	1.3	-5.1	-3.9	-3.1
France	1.2	1.3	1.7	0.1	0.1	1.0	10.4	10.2	10.1	-1.5	-1.1	-1.0	-3.5	-3.4	-3.2
Italy	0.8	1.1	1.3	0.1	0.2	1.4	11.9	11.4	11.2	2.2	2.4	2.3	-2.6	-2.4	-1.9
Cyprus	1.6	1.7	2.0	-1.5	-0.7	1.0	15.1	13.4	12.4	-3.5	-4.2	-4.6	-1.0	-0.4	0.0
Latvia	2.7	2.8	3.1	0.2	0.2	2.0	9.9	9.6	9.3	-1.2	-2.6	-2.4	-1.3	-1.0	-1.0
Lithuania	1.6	2.8	3.1	-0.7	0.6	1.8	9.1	7.8	6.4	-1.5	0.0	0.1	-0.2	-1.1	-0.4
Luxembourg	4.8	3.3	3.9	0.1	-0.1	1.8	6.4	6.2	6.2	5.5	5.3	4.8	1.2	1.0	0.1
Malta	6.3	4.1	3.5	1.2	1.4	2.2	5.4	5.1	5.1	9.9	5.6	4.4	-1.5	-0.9	-0.8
Netherlands	2.0	1.7	2.0	0.2	0.4	1.3	6.9	6.4	6.1	9.2	8.9	8.2	-1.8	-1.7	-1.2
Austria	0.9	1.5	1.6	0.8	0.9	1.7	5.7	5.9	6.1	3.1	3.1	3.3	-1.2	-1.5	-1.4
Portugal	1.5	1.5	1.7	0.5	0.7	1.2	12.6	11.6	10.7	-0.1	0.3	0.5	-4.4	-2.7	-2.3
Slovenia	2.9	1.7	2.3	-0.8	-0.2	1.6	9.0	8.6	8.1	7.0	7.0	6.9	-2.9	-2.4	-2.1
Slovakia	3.6	3.2	3.3	-0.3	-0.1	1.5	11.5	10.5	9.5	0.8	-0.6	-1.1	-3.0	-2.4	-1.6
Finland	0.5	0.7	0.7	-0.2	0.0	1.3	9.4	9.4	9.3	0.1	0.3	0.4	-2.7	-2.5	-2.3
Euro area	**1.7**	**1.6**	**1.8**	**0.0**	**0.2**	**1.4**	**10.9**	**10.3**	**9.9**	**3.6**	**3.7**	**3.6**	**-2.1**	**-1.9**	**-1.6**
Bulgaria	3.0	2.0	2.4	-1.1	-0.7	0.9	9.2	8.6	8.0	1.9	2.3	2.7	-2.1	-2.0	-1.6
Czech Republic	4.2	2.1	2.6	0.3	0.5	1.4	5.1	4.5	4.4	-2.0	-1.5	-1.3	-0.4	-0.7	-0.6
Denmark	1.2	1.2	1.9	0.2	0.3	1.5	6.2	6.0	5.7	7.0	6.3	6.2	-2.1	-2.5	-1.9
Croatia	1.6	1.8	2.1	-0.3	-0.6	0.7	16.3	15.5	14.7	5.1	4.4	4.0	-3.2	-2.7	-2.3
Hungary	2.9	2.5	2.8	0.1	0.4	2.3	6.8	6.4	6.1	4.9	5.0	4.5	-2.0	-2.0	-2.0
Poland	3.6	3.7	3.6	-0.7	0.0	1.6	7.5	6.8	6.3	0.1	-0.3	-0.9	-2.6	-2.6	-3.1
Romania	3.8	4.2	3.7	-0.4	-0.6	2.5	6.8	6.8	6.7	-0.9	-2.1	-2.8	-0.7	-2.8	-3.4
Sweden	4.1	3.4	2.9	0.7	0.9	1.2	7.4	6.8	6.3	4.9	5.8	5.7	0.0	-0.4	-0.7
United Kingdom	2.3	1.8	1.9	0.0	0.8	1.6	5.3	5.0	4.9	-5.2	-4.9	-4.4	-4.4	-3.4	-2.4
EU	**2.0**	**1.8**	**1.9**	**0.0**	**0.3**	**1.5**	**9.4**	**8.9**	**8.5**	**2.0**	**2.2**	**2.1**	**-2.4**	**-2.1**	**-1.8**
USA	2.4	2.3	2.2	0.1	1.2	2.2	5.3	4.8	4.5	-3.3	-2.8	-3.1	-4.0	-4.4	-4.4
Japan	0.5	0.8	0.4	0.8	0.0	1.5	3.4	3.4	3.3	3.3	3.9	4.1	-5.2	-4.5	-4.2
China	6.9	6.5	6.2	:	:	:	:	:	:	:	:	:	:	:	:
World	**3.0**	**3.1**	**3.4**	:	:	:	:	:	:	:	:	:	:	:	:

as high structural unemployment and high levels of policy uncertainty. Overall, euro area GDP is forecast to grow at modest rates, rather than gather momentum, over the 2015-2017 period, as it is projected at 1.6% in 2016 and 1.8% in 2017 after 1.7% in 2015.

…as global growth has been slowing…

The outlook for global GDP growth has weakened further in recent months. Growth outside the EU is expected to have fallen to 3.2% in 2015, its slowest pace since 2009, and is now forecast to pick up only modestly to 3.3% in 2016 and 3.7% in 2017. Reflecting increased external headwinds from the slowdown in emerging markets, growth in advanced economies lost momentum at the end of last year and is expected to remain at 2% this year and next. In the US, weak external demand is likely to continue to weigh on activity while domestic demand should continue to support it. But the maturing cycle limits the scope for growth to pick up further. In Japan, sluggish wage growth is likely to remain a drag on private consumption while the investment outlook suffers from weak potential growth. Domestic demand is also expected to be increasingly volatile ahead of planned fiscal consolidation measures.

Growth in emerging markets slowed down last year to its weakest annual pace since 2009. It is expected to pick up only marginally in 2016 before stabilising commodity prices, a gradual easing of the deeper-than-expected recessions in Brazil and Russia, and some progress in adjustments in other emerging markets support a mild rebound next year. But this outlook is fragile and subject to a high degree of uncertainty. In particular, the challenges surrounding an orderly rebalancing and gradual slowing of the Chinese economy remain pressing and entail considerable risks, even though pressures on the exchange rate and capital outflows have recently abated.

…and trade flows remain weak…

World imports of goods and services excluding the EU are estimated to have grown by a meagre 0.5% in 2015, dragged down by sharp contractions in Russia and Brazil and the marked deceleration of import growth in China. Non-EU trade is expected to firm over the forecast horizon as a result of a progressive normalisation in Chinese imports, the assumed stabilisation of commodity prices at low levels and the expected pick-up in emerging market growth. Slowing demand for imports in the US, which is largely triggered by the weakness of its own exports, should, however, also limit non-EU trade growth to 2.1% this year, while an increase to 3.4% is expected next year. Growth in European export markets should continue to outpace GDP growth outside the euro area in general, but should be less robust than expected at the beginning of the year.

…while financial markets somewhat stabilise…

In early 2016, financial markets recorded losses as investors shunned risk amid intensified concerns about a further global slowdown and worries that macroeconomic policies would be lacking space to react to it. These concerns have recently abated with inter alia the slight rebound in oil prices, but volatility remains elevated. The EU's financial sector continues to underperform the broad market reflecting concerns about banks' profitability prospects amid the low interest rate environment and the persistence of high levels of non-performing loans in some countries. Expectations of divergence between the monetary policies of major central banks receded somewhat since the beginning of the year. On the one side, the ECB and the central banks of Sweden, Hungary and Japan have, for instance, further eased their monetary policies, while on the other side, expectations of monetary policy tightening by the US Fed and the Bank of England have been pushed back. The euro has appreciated as a result.

...and funding conditions remain favourable.

The accommodative policy stance of the ECB has led to very favourable monetary and credit conditions in the euro area. Net bank lending flows to households and non-financial corporations have remained positive over the recent months, supported by lower interest rates, which improve the attractiveness of bank lending relative to market funding. Bank lending rates have also come down significantly in vulnerable Member States, suggesting that the transmission of monetary policy to the real economy has improved and that financial fragmentation across Member States has receded.

Domestic demand should drive growth...

With net exports turning negative, GDP growth was entirely driven by domestic demand in 2015. This pattern is expected to continue this year and next although the composition of domestic demand is expected to show some rebalancing, as private consumption moderates and investment gathers speed.

...although private consumption should lose momentum...

Private consumption should continue to benefit in 2016 and 2017 from improving labour market conditions, moderate rises in wages and higher non-labour incomes. The very low inflation foreseen this year should also support stronger increases in real gross disposable incomes. Private consumption should then pick up slightly, as households are expected to spend much of this oil-price windfall rather than increase their savings significantly. The pace of private consumption growth, however, should slow down next year as the expected rebound in inflation shaves off a larger portion of the growth in nominal incomes.

...as should public consumption...

Government consumption is also set to lose some momentum next year after having gathered further pace this year mainly as refugee-related spending in some Member States is set to continue increasing.

...while conditions are favourable for a pick-up of investment...

Investment strongly accelerated at the end of last year, but most available data suggest that this rebound was mainly driven by temporary factors. Investment is expected to moderate in the near term as it is held back by expectations of weak global demand and still considerable uncertainty of economic and non-economic nature. Nevertheless, the conditions for investment to pick up further down the line have recently improved, as borrowing conditions have eased, capacity utilisation is above its long-term average, corporate deleveraging pressure is fading, and global demand is expected to gradually strengthen. Construction investment, meanwhile, should benefit from sustained growth in households' real disposable incomes, very low mortgage rates and progress in the adjustment in the housing sector. In some countries, the demand for housing should also rise due to the need to host refugees. The Investment Plan for Europe is also expected to yield increasing tangible results on public and private investment as a growing number of projects should move to the implementation phase.

...and net trade should be a drag on growth this year.

The deterioration in external demand turned net trade into a drag on growth last year despite the resilience of intra euro area exports and the positive impact of the euro’s past depreciation on euro area exporters' price competitiveness. Export growth is expected to slow down markedly this year reflecting both the slow growth of euro area external export markets and the euro’s recent appreciation. But with real unit labour costs still declining, euro area exporters are well-positioned to benefit from the expected rebound in global economic activity next year. Imports, with the support of resilient domestic demand, are expected to follow the same pattern. As a result, net exports are projected to have a negative impact on GDP growth in 2016 that should turn neutral in 2017.

Inflation remains driven by energy prices...

Oil prices fell again at the start of 2016, dragging inflation below zero. It is expected to remain negative in the near term as a result of base effects. External price pressure is also weak due to the slight appreciation of the euro and overcapacities in several emerging market economies that are holding back global producer prices. At the same time, core inflation has so far failed to show an upward trend, as moderate economic growth and subdued wage developments have kept a lid on domestic price dynamics. Inflation in the euro area is therefore set to remain very low for longer than previously forecast and the projection for inflation in 2016 has been revised downward to 0.2%. With the assumption of gradually increasing energy prices, inflation is expected to step up in the second half of this year when positive base effects start to kick in. The further narrowing of the output gap and higher domestic demand should eventually add upward pressure on domestic prices. In 2017 inflation is expected to reach 1.4%.

...labour markets continue to improve...

Labour market conditions are set to continue their moderate pace of improvement, driven by the lagged response to improved cyclical conditions and contained wage growth. In some Member States, labour market reforms implemented in recent years and fiscal policy measures are also supporting a rise in net job creation. Overall, employment is set to continue to grow at about 1% this year and next. The labour force is also expected to increase, mainly on the back of higher participation rates and, in some Member States, net migration flows. The unemployment rate in the euro area is projected to fall from 10.9% in 2015 to 9.9% next year. Although labour market disparities are set to remain for some time, unemployment is expected to fall in almost all euro area countries over the forecast horizon, particularly in those that have implemented labour market reforms (e.g. Spain, Cyprus, Ireland and Portugal).

...and the fiscal stance should be slightly expansionary this year.

The general government deficit is expected to continue declining this year and next underpinned by the ongoing economic expansion, the improvement in labour markets and, to a lesser extent, the drop in interest expenditures. Discretionary tax cuts to lower the tax burden on labour in some Member States and additional government expenditures related to the inflow of asylum seekers in some countries explain the slightly slower decline in the headline deficit this year. The general government deficit in the euro area is expected to decrease from 2.1% of GDP to 1.9% in 2016, and to decrease further to 1.6% next year under a no-policy-change assumption. The fiscal stance is expected to be slightly expansionary in the euro area this year but to turn neutral in 2017. The debt-to-GDP ratio is forecast to continue declining gradually over the forecast horizon, although less than earlier expected due to the slower pace of nominal GDP. It should reach 91.1% in the euro area in 2017.

Downside risks are considerable

The uncertainty surrounding these projections is substantial and the European economic outlook is exposed to considerable downside risks. On the external side, the risk that slowing growth in emerging market economies, particularly China, could trigger stronger spillovers or turn out worse than currently forecast remains particularly significant for growth in Europe and the world. Uncertainty linked to geopolitical tensions remains high and could affect European economies more negatively than currently expected. Abrupt moves in oil prices or financial turmoil could also dampen European growth.

On the domestic side, risks associated with European policies remain considerable, as for instance the pace of implementation of structural reforms and the uncertainty ahead of the UK's EU referendum. [1] A failure to find common solutions at the EU level to common challenges of economic and non-economic nature could also affect private consumption and further delay the expected rebound of investment. On the upside, the positive impact from structural reforms could turn out greater than estimated and the transmission of very accommodative monetary policies to the real economy could prove to be stronger than expected.

(1) See also IMF (2016) World Economic Outlook, April and Kierzenkowski et al (2016) The Economic Consequences of Brexit: A Taxing Decision, OECD Economic Policy Paper 16.