EEAG (2017), *The EEAG Report on the European Economy,* "Macroeconomic Conditions and Outlook," CESifo, Munich 2017, pp. 12–49.

Macroeconomic Conditions and Outlook

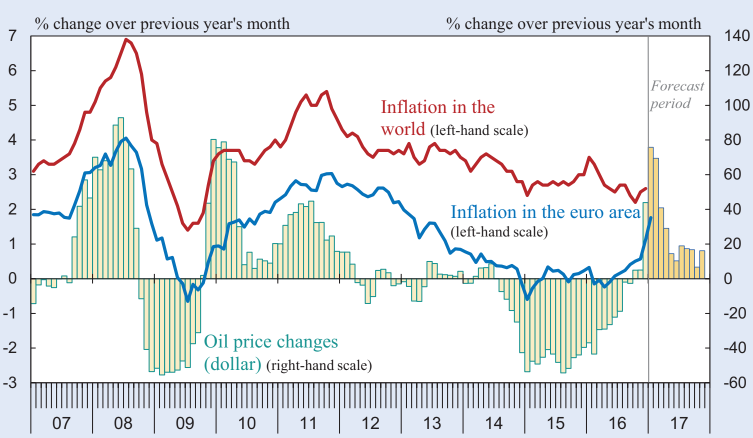
1.1 Introduction

The world economy remained in recovery mode last year, despite a slight global slowdown. The initial decline was mainly caused by disappointing growth in advanced economies during the winter of 2015/2016.[1] During the second half of 2016, an increase in exports accounted for a significant uptick in the pace of expansion in the United States. In Japan repeated postponement of fiscal consolidation and the implementation of a new stimulus package supported economic activity. Furthermore, the moderate recovery in the euro area has continued. In major emerging countries like China, India and Indonesia, expansionary economic policies stimulated growth in the summer of 2016. Finally, recessionary trends in commodity-exporting emerging economies like Russia and Brazil have weakened, especially since the prices of many industrial and agricultural commodities have been creeping upwards again for several months and the price of crude oil has been largely stable over the summer and autumn at around 45 US dollars per barrel, after reaching a trough of below 30 US dollars in January last year. These relatively stable oil prices were principally driven by two key effects: rising demand for oil from mainly China and India; and negotiations amongst OPEC members that led markets to expect a limitation of future oil production. In November 2016, and for the first time since 2001, a global supply agreement was reached that was also signed by Russia. Subsequently, the oil price rose to over 50 US dollars per barrel. Both the low oil price at the start of 2016 and its increase by the end of the year imply strong impulses for inflation rates around the world, especially during the first months of 2017 (see Figure 1.1).

The political changes that have occurred over the past eight months may have far-reaching consequences for the global economy in the years ahead and have certainly already increased uncertainty. In a referendum in June 2016, the United Kingdom decided to leave the European Union (see Chapter 3 of this report). Negotiations over the conditions of this so-called Brexit between the new British government and the European Union are due to start soon. In November 2016 Donald Trump won the presidential elections in the United States. Also Trump's victory came as a surprise to many and raises questions about the future orientation of economic policy in the United States, and particularly of fiscal and trade policies. On several occasions during his campaign the newly elected president argued in favour of more expansionary fiscal and protectionist trade policies, together with a significant reduction in his country's security commitments on the international stage. Finally, in December 2016 Italy held a referendum on constitutional changes that was clearly rejected at the polls. These constitutional changes would have made this economically-troubled country more capable of political and economic reform. Instead its Prime Minister Matteo Renzi stepped down and a caretaker government took over. The Italian president will most likely initiate new elections this year, ahead of the next regular elections scheduled for early 2018. The populist 5 Star Movement, which has been popular at the polls for over a year now, has

Figure 1.1

Inflation in the world and oil price movements



Source: IMF International Financial Statistics, last accessed on 31 January 2017. Forecast based on a constant oil price assumption from January 2017 onwards.

[1] This development is illustrated in Figure 1.26, presented below.

announced a referendum on Italy's exit from the euro area should it win. Depending on how the current caretaker government reforms election law, a relative majority of votes may suffice to win an absolute majority in parliament. Given Italy's economic weight and its high public debt levels, the announcement of a referendum, or even the increased awareness of such an outcome, is likely to cause major turbulence in financial markets.

Overall, none of these political developments have triggered the adverse cyclical effects expected. After a brief period of turbulence, financial markets have by and large staged speedy recoveries. Of the three events cited above, the Brexit referendum triggered the most visible market reactions. Nevertheless, in late summer most stock market indices were already above their positions of May 2016. Similarly, consumer and producer sentiment in the United Kingdom and the European Union only weakened temporarily during the summer, but have improved steadily since then. Finally, the British real economy proved to be robust and recorded a similarly high growth rate for the third quarter of 2016 as seen in the previous three quarters. The US presidential election did neither negatively affect the financial markets, nor consumer or producer confidence. Sentiment even improved after Trump's election probably thanks to expectations that the newly elected president will implement expansive fiscal policy measures.

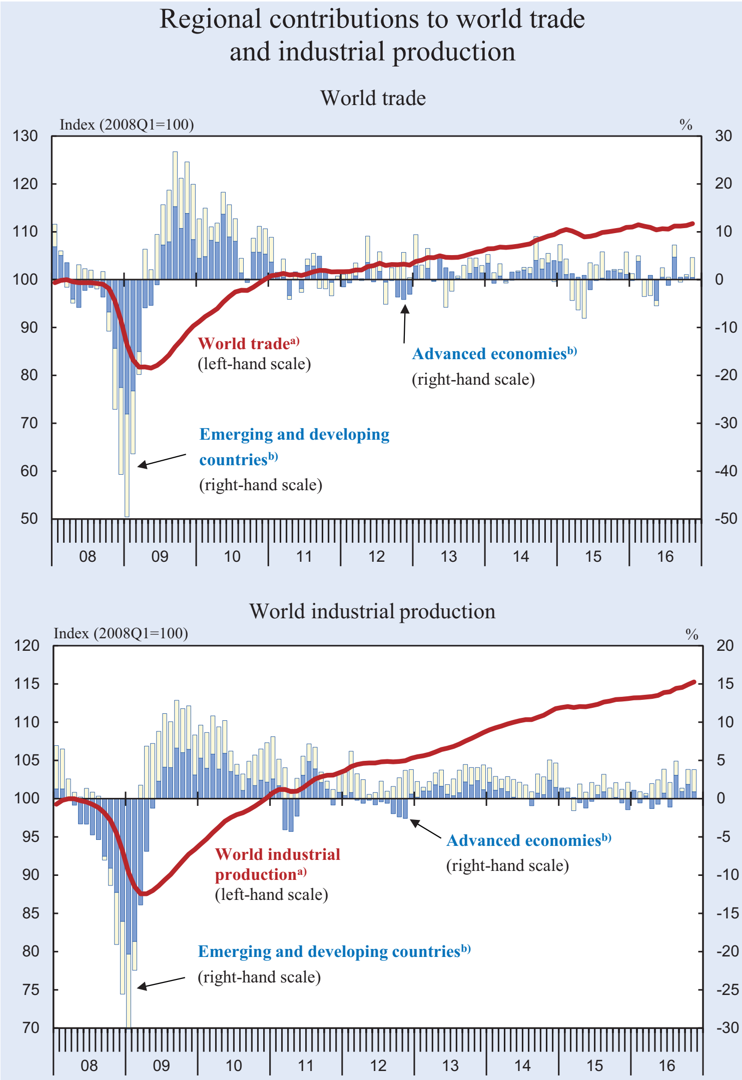
Nevertheless, the election of Donald Trump as US president and the rejection of constitutional reform in Italy may have major negative consequences in the short term too. Indicators of political uncertainty in the United Kingdom, several other European countries and the United States increased sharply in June and have risen significantly again in November after a previous temporary decline. At the end of last year, uncertainty indicators were still at a significantly higher level than at the beginning of 2016. This may in itself reduce willingness to invest and acquire more durable consumer goods, and thereby affect the economic performance over the forecasting period.

1.2 The current situation

1.2.1 The global economy

As in 2015, world trade declined during the first half of 2016 only to subsequently recover again (see Figure 1.2). Industrial production also picked up during the second half of 2016. However, whereas trade impulses were largely generated by advanced econo-

Figure 1.2



[a)] Three month moving average level. [b)] Contribution to annualised monthly growth rate thereof.

Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor: November 2016.

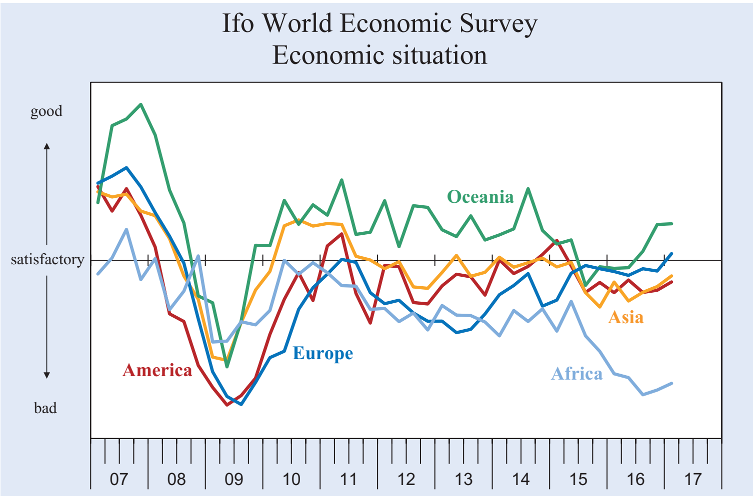
mies, industrial production growth in the emerging and developing countries outweighed that of their advanced counterparts. From an overall perspective, after a subdued first half of the year, the global economy subsequently regained momentum. Advanced and emerging economies alike have contributed almost equally to revive the global economy.

By and large economic sentiment in most parts of the world remained stable. In Asia, America and Europe sentiment remained at historically low levels, while in Oceania the situation took a turn for the better at the end of last year. Africa, on the other hand, was on a downward path throughout last year (see Figure 1.3). World trade and world GDP are expected to have increased by 0.8 and 2.4 percent respectively last year (see Table 1.A.1).

Nevertheless, the global economy is still growing less than it did in the years preceding the financial crisis. World trade in particular seems to have moved down into a different gear since 2011. Whether this is a structural or a more temporary phenomenon is heavily debated and will depend on which of the various theories turns out to bear more weight. We broadly distinguish between three lines of thought.

Firstly, growth in global investment has been rather subdued since the financial crisis. Since investment is the most trade-intensive component of GDP, this development has depressed growth in cross-border trade in goods. It remains unclear, however, to what extent the weakness in investment growth is a temporary phenomenon that may perhaps be related to higher levels of uncertainty, or is of a more structural nature.

Figure 1.3



Source: Ifo World Economic Survey I/2017.

What speaks for the structural story is the gradual rebalancing of the Chinese economy towards greater consumption and the re-evaluation of the assets and structural changes undertaken in several advanced economies towards less capital intensive sectors. These might have translated into slower, but more sustainable investment growth.

Secondly, growth in global value chains might have matured. This is supported by empirical studies showing that this effect is especially strong in China and is also present to a smaller extent in the United States. As China moves up in the global value chain, in particular, the foreign content of its exports diminishes.

Finally, the slowdown in trade liberalisation, or even the adoption of protectionist measures in the aftermath of the financial crisis, may also have depressed trade growth. It is difficult to predict whether the change in political attitudes is temporary or of a more lasting nature.

1.2.2 United States

Momentum in the US economy was weak during the first half of 2016 and remained below the potential 1.5 percent as estimated by the Congressional Budget Office. During the second half of the year, however, growth picked up, with real GDP increasing by 1.6 percent in 2016.

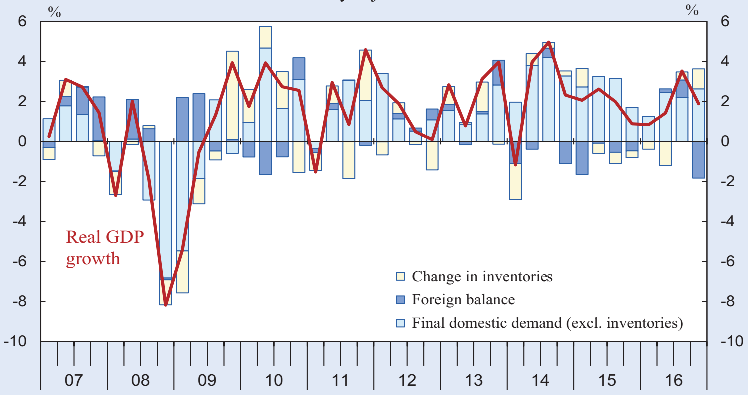
Although consumer spending provided far less of a boost to the US economy in 2016 than in the preceding two years, spending on healthcare and leisure goods, motor vehicles and housing continued to generate high growth contributions (see Figure 1.4). The overall slight increase in government spending was driven by expenditure at the state and local level, while the federal government has hardly provided any economic impulses largely due to lower expenditure on public defence.

Gross capital investments contributed negatively to overall growth. While commercial con-

Figure 1.4

Contributions to GDP growth[a)] in the United States

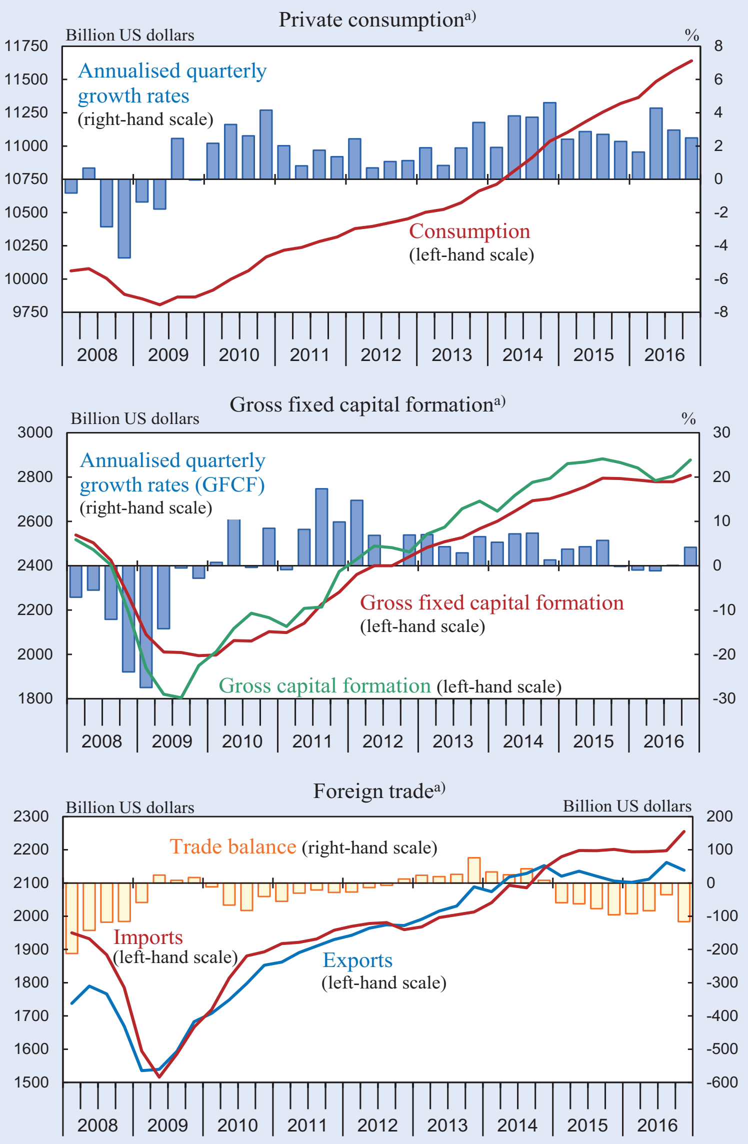
Seasonally adjusted data



[a)] Annualised quarterly growth.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2017; EEAG calculations.

Figure 1.5

Business cycle developments in the United States



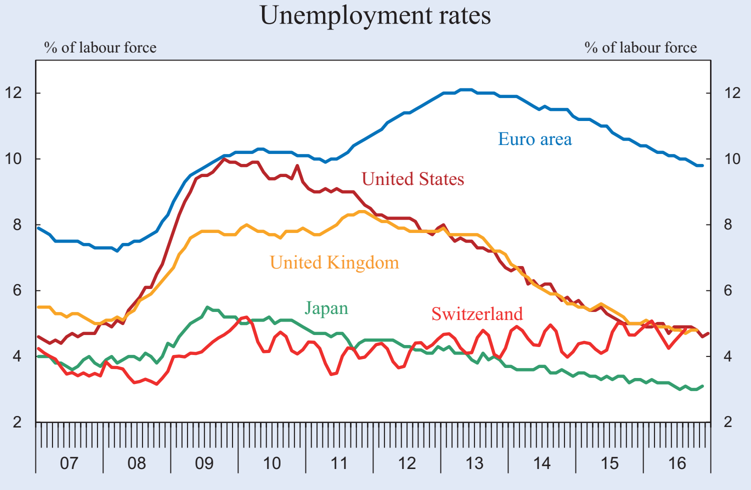
[a)] In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2017.

struction remained weak, residential construction activity fell. After strong growth in the number of building permits in 2015, the rate has now stabilised at half of its 2007 level. Lower investment by manufacturers and the public sector has negatively impacted non-residential construction. The latter is characterised by lower spending on infrastructure projects like water and energy supplies. Low capacity utilisation rates in manufacturing, mainly due to subdued developments in raw material extraction caused by low oil prices, had a dampening effect on equipment investment.

For the first time in two years, foreign trade contributed positively to GDP growth last summer and autumn. Exports expanded sharply in autumn (see Figure 1.5). This was, however, mainly a result of increased demand for US soybeans caused by poor harvests in Brazil and Argentina. After a long flat phase, imports increased.

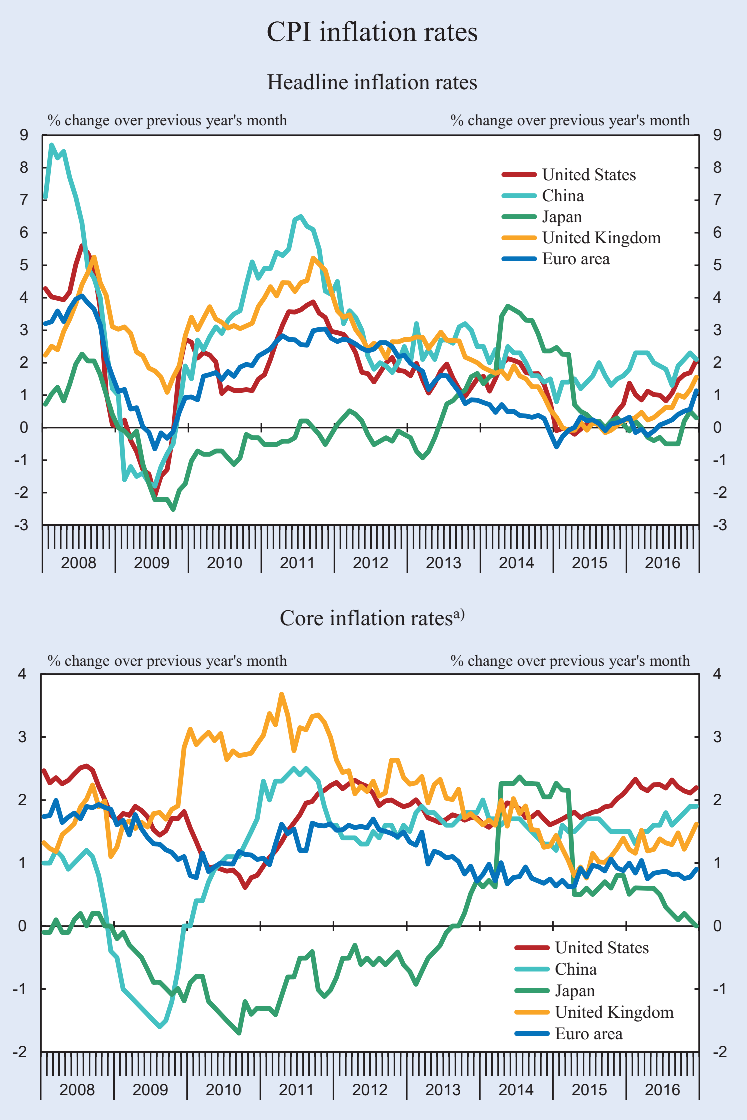
The labour market continued to develop positively in 2016, although to a lesser degree than in previous years. An average of 180,000 new jobs were created per month, with recruitment proving particularly strong in the healthcare and education sectors, as well as in the business-related services. The unemployment rate has thereby settled down to levels in line with full employment, resulting in an average unemployment rate of 4.9 percent for 2016 (see Figure 1.6). Also, broader key measures, which include e.g. the number of discouraged workers and the share of full-time workers, have recovered accordingly. The number of vacancies is well above the pre-crisis level, and many voluntary resignations indi-

Figure 1.6



Source: OECD, Main Economic Indicators, SFSO, last accessed on 31 January 2017.

Figure 1.7



a) Consumer Price Index (CPI) excluding food- and energy-related items.
Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2017.

cate good employment prospects. The labour force participation rate also stabilised at slightly below 63 percent, which – despite being substantially lower than before the start of the financial crisis – is seen as a positive sign by the US Federal Reserve when taking into account demographic developments.

The low level of unemployment is gradually driving up nominal wage growth, which is likely to increase price pressure. The personal consumption expenditure (PCE) deflator excluding energy and food, a preferred inflation measure of the Federal Reserve, has tended sideways since the beginning of 2016 and stood at 1.5 percent at the end of last year. The change in the consumer price index excluding energy and food was consistently above 2 percent throughout 2016. However, taking food- and energy-related items into the basket paints a different picture: the annual change in the index of consumer prices averaged only 1.2 percent in 2015 (see Figure 1.7). As the underlying base effects of previous decreases in raw material prices have started to disappear, headline inflation is ensured to recover this winter.

1.2.3 Asia

Growth in *China's* economy remained at a historically low, but steady pace throughout 2016: real GDP expanded by 6.7 percent. Monetary and fiscal impulses mainly compensated for the structural downward trend in the manufacturing sector and have stimulated the construction sector and real estate services since the beginning of last year.

The state-orchestrated stimuli for industries with high overcapacity have stopped the fall in producer prices in the manufacturing sector, which had manifested itself since 2012. Core inflation has also risen slightly since the beginning of 2016. After largely stagnating since 2014, house price developments have followed an upward trend since the beginning of last year. As a result, in addition to monetary authorities, many local governments reactivated macro-prudential measures during the second half of 2016. These measures included tighter regulations on private individuals owning several houses or apartments.

The *Japanese* economy started off with a high pace of growth slowing to more or less the potential rate at the end of 2016. Due to a low base year effect stemming from 2015, the annual growth rate only turned out to be 1.0 percent last year. The key drivers of growth were public investment and private construction investment. Exports suffered from the strong appreciation of the yen during the first half of 2016. The revaluation was due to financial markets downwardly adjusting their expectations about the future extent of monetary policy divergence between Japan and the United States combined with higher risk aversion due to an uncertain global outlook. As a result of the strengthening of the yen, consumer price inflation slid back into negative territory. Energy price developments made this a temporary phenomenon: in October inflation turned positive again. The yen's appreciation was largely reversed during November and December 2016, which should support inflation in the near term.

The growth rate of *India's* economy was above average last year. Whereas investment and exports were weak, positive impulses to consumption, coming from a near normal monsoon and an increase in public wages, drove the pick-up in GDP growth. In addition, government spending on subsidies and infrastructure surged. The trade deficit has declined markedly since 2014. However, this development is no longer due to very dynamic exports, but rather to far weaker imports. Inflation rose to around 6 percent during the first half of 2016 only to fall back to 3.6 percent in November last year. The year 2016 has probably seen a 7.4 percent increase in GDP for India.

After a weak winter half in 2015/2016, the Asian Tiger countries (*South Korea, Taiwan* and *Hong Kong* and *Singapore*) regained momentum. Both private consumption and investment were able to recover from their temporary weakness. Foreign trade also picked up. With the structural weakening seen in the Chinese economy since 2012, however, massive export growth has become a thing of the past. As a reaction to unfavourable economic conditions and weak price pressure, the central bank of South Korea reduced its base rate to a historical low of 1.25 percent in June last year.

The emerging Asian economies (*Indonesia, Thailand, Malaysia* and the *Philippines*) also picked up again after having a rather cautious start to the year 2016. Public consumption delivered an above-average contribution to growth, while foreign trade was weak. In addition, the central bank of Indonesia cut its base rate by a total of 100 basis points in January, February, March and June.

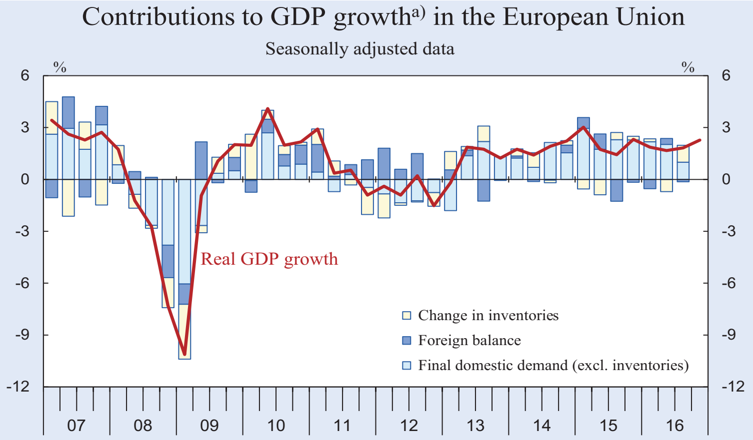
1.2.4 Latin America and Russia

Not least because of political uncertainties, the economic momentum in Latin America (Brazil, Mexico, Argentina, Venezuela, Columbia and Chile) remained weak last year. In the economic heavyweight Brazil, overall output continued to shrink. Financial investors looking for returns and confronted with delayed monetary policy tightening in the United States nevertheless started to bet on a political and economic stabilisation in Brazil. This led to a strong real appreciation of the Brazilian real against the currencies of its most important trading partners, and thereby actually dampened the strong momentum in foreign trade. Negative growth contributions also came from private consumption, while for the first time in three years there was an increase in gross fixed capital formation. Albeit slowly falling and despite the decline in import prices, inflation is still well above the 4.5 percent inflation target. The central bank of Brazil nevertheless cut interest rates twice in October and November last year.

Apart from a temporary decline in growth in the second quarter of last year, the *Mexican* economy has remained on an otherwise stable expansion path for the last three years. While domestic demand continued to develop strongly, foreign trade has not to date benefitted from the sharp depreciation of the Mexican peso that began in early 2015. This did, however, push up inflation, forcing the Mexican central bank to increase its base rate five times last year.

In *Argentina*, extensive reforms implemented by the liberal government have not yet produced the desired results. In the hope of attracting more foreign direct investment, the government has lowered trade barriers and government subsidies, but this has so far failed to pull the country out of the recession that it entered at the end of 2015. The reforms did, on the other hand, lead to a strong depreciation of the Argentine peso, which in turn boosted inflation. The rate of change in overall output in the Latin-American region is expected to have been –1.6 percent last year.

Figure 1.8



a) Annualised quarterly growth.
Source: Eurostat, last accessed on 31 January 2017; EEAG calculations.

Although the rate of decline started to abate during 2016, the *Russian* economy remained in the recession that started mid-2014 and was caused by a plunge in oil prices, as well as international sanctions following the annexation of Crimea and the outbreak of war in Ukraine. Inflation has been falling rapidly since August 2015, when it peaked at around 16 percent. At the end of last year it stood at 5.4 percent. Fluctuations in the Russian ruble are largely driven by the prices of oil and natural gas, which are Russia's main commodity exports. The currency took a dramatic fall to a historical low in January 2016, as oil prices reached their lowest levels in over a decade. As oil prices subsequently started to recover, the ruble also gradually stabilised. The decline in inflation and the stabilisation of the ruble allowed the central bank to further reduce its base rate by a total of 100 basis points in June and September last year. Overall GDP probably declined by 0.5 percent last year.

1.2.5 The European economy

The cyclical situation

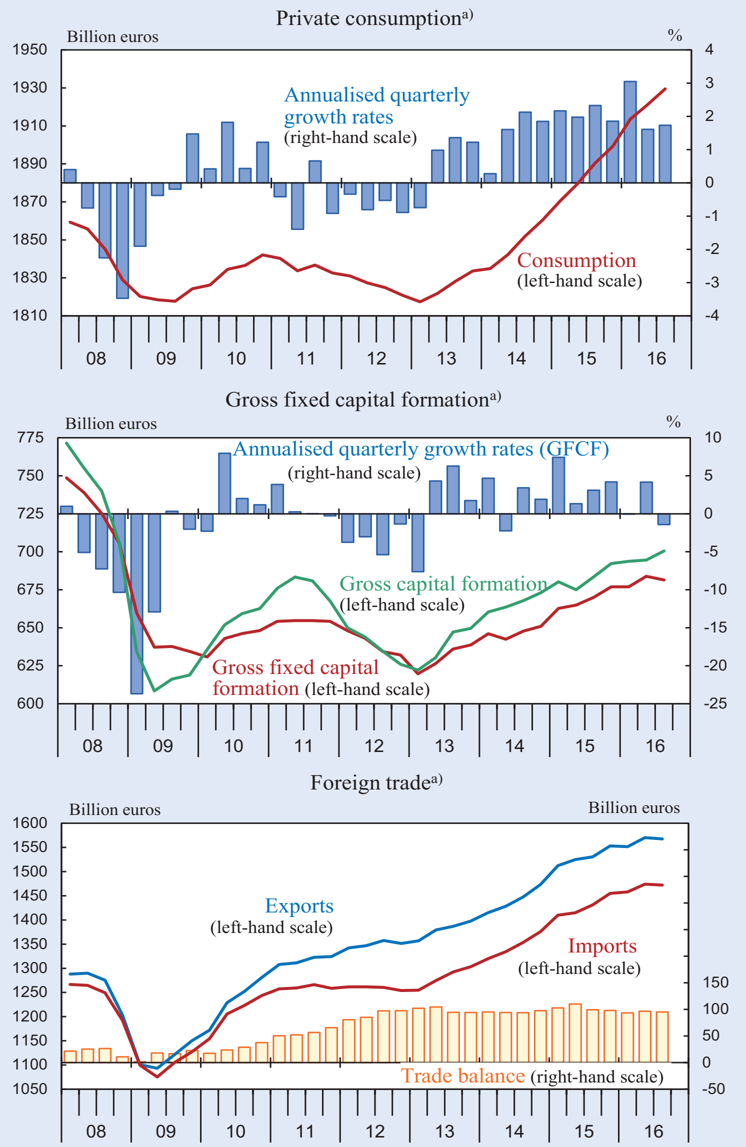
Although a moderate slowdown in growth was observed, the overall economic recovery continued throughout 2016 (see Figure 1.8). Since the end of the recession in the second quarter of 2013, the average annualised GDP growth rate in the European Union has amounted to 1.9 percent. The recovery was fuelled by private and public consumption. Private consumption reached its highest quarterly growth level since 2007 to date in the first quarter of 2016 (see Figure 1.9). The small, and partly even negative inflation rates, which were at least partially caused by the substantial reduction in energy prices, did relieve household budgets and gave an unexpected boost to growth in private consumption. Investment was more volatile throughout last year, but also contributed positively overall. Despite the low real value of both the euro and the British pound, foreign trade only provided small impulses.

The pace of recovery still remains well below those of previous post-crisis upturns. According to estimates by the IMF, the European Commission and the OECD, Europe still has a significant output gap, although this is closing slowly, partly because of lower potential growth. Possible reasons are a lack of willingness to carry out necessary labour and product market reforms, as well as initiating a credible consolidation of fiscal budgets in crisis-afflicted countries. Other constraints include the outcome of the Brexit referendum (see Chapter 3), a continuation of the migrant crisis (see Chapter 4) and the strengthening of populist movements (see Chapter 2). Each of these factors have a negative impact on business confidence in Europe and thereby prevent investment from taking off.

The recovery in Europe has helped to reduce the EU unemployment rate, which fell from its peak of 11 percent in April 2013 to 8.3 percent in October 2016. In the euro area, it fell below the 10 percent mark for more than a month for the first time since 2009. In the European Union, employment levels thereby surpassed pre-crisis levels for the first time. When focusing on the euro area, these figures point in the same direction, albeit in a still somewhat less pronounced manner. Employment remains below the levels seen before the wake of the financial crisis.

Figure 1.9

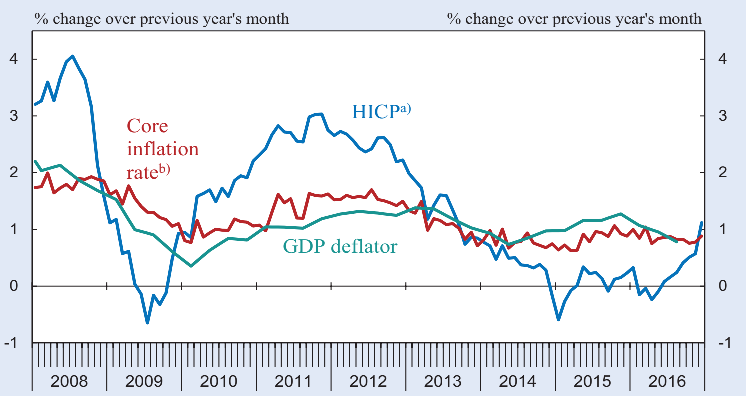
Business cycle developments in the European Union



a) In constant prices, chain-linked volumes, reference year 2010, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 31 January 2017.

Figure 1.10

Price developments in the euro area



a) Harmonised Index of Consumer Prices. b) HICP excluding energy, food, alcohol and tobacco.
Source: Eurostat, last accessed on 12 January 2017.

In the wake of the still significant output gap, core inflation remained broadly unchanged during last year. Although headline inflation rose to 1.2 percent in December after declining to a low of –0.2 percent in April, this increase was entirely due to the fading effect of past decreases and a more recent acceleration of energy prices. When looking at core inflation, i.e. excluding food and energy prices, the inflation rate remained at 0.8–0.9 percent throughout the same period. It thereby stayed well below the medium-term target of the European Central Bank (ECB) to keep overall inflation below or close to 2 percent. Since the financial crisis, core inflation has consistently remained below target (see Figure 1.10). The fall in core inflation, as also shown by reduced increases in the GDP deflator, mainly reflects the continued under-utilisation of production capacities and the still limited scope for firms to increase prices as a result. Furthermore, the efforts required in crisis countries to improve competitiveness through wage and price reductions keep exerting deflationary pressures on the euro area as a whole. Finally, the price effects of past tax increases (e.g. increases in value added tax rates) as part of austerity packages have now faded.

Differences across Europe

In the individual countries of the European Union, the economic recovery looks quite diverse. Among the larger economies, growth rates in France and Italy were once again below average. The (former) crisis countries Greece and Portugal also still have not caught up to the rest of

Europe. Cyprus, Spain and Ireland, on the other hand, posted above-average growth rates last year.

Despite a weak performance during the second half of last year, largely driven by disappointing contributions from external trade, the *German* economy continued its upswing that began in 2013. As GDP has, on average, been expanding at rates higher than potential output, the output gap that materialised during the euro crisis has now more than closed. The upswing has nevertheless been modest compared to previous ones. It not only differs from past recoveries in that way, the underlying forces for Germany are also unusual. Such previous phases were often driven by a substantial increase in exports that then transferred to the domestic economy through an expansion in machinery and equipment investment and income growth. This time is different. In none of the previous booms since the 1970s was such a small increase in exports recorded as during the last couple of years. Weak demand from its European trading partners and the significant slowdown of the Chinese economy and other emerging countries were probably key factors in this development and are likely to be the main reasons why the current upswing in Germany can only be described as moderate. The dynamics of machinery and equipment investment have also been rather weak historically. In light of the exceptionally low lending rates, this may seem surprising at first, but can be explained by the slowly developing sales prospects in many foreign markets and the unusually high level of uncertainty over the future course of economic policy in many important partner countries.

Key pillars of the current recovery have been private and public consumption together with construction investment. As far as private consumption is concerned, however, it should be noted that Germany has witnessed a substantial increase in population. Strong immigration, largely triggered by external developments, has offset the demographically-induced decline in Germany's domestic population. More heads mean higher consumption of goods and services. Such exogenous population growth stimulates the economy per se. In per capita terms, consumer spending developed similarly as in any other past boom. However, refugee consumption levels tend to be well below the German average. In that sense, refugee migration alone depressed average per capita private consumption in Germany. Hence, the increase in population through a strong inflow of refugees cannot fully explain historically strong private consumption growth.

The fact that the refugees primarily received social benefits in kind during the asylum procedure meant that their arrival did trigger public consumption. Compared to previous upswings, the government sector did contribute significantly to overall economic expansion in Germany. Fuelled by loose financial conditions, the increase in construction investment is also above average. Overall, economic growth reached 1.8 percent in Germany last year.

During 2016, growth in *France* moved like a rollercoaster. Whereas it started off the year on a high note and then turned negative, growth recovered subsequently. For the year as a whole, a modest growth rate of 1.1 percent resulted, which was not sufficient to turn around labour market conditions for the better and allow for a significant decline in unemployment figures. Unemployment still stood at 9.5 percent in November last year. Last summer a labour market reform was adopted in which firm-specific working condition agreements are to take precedence over industry-wide arrangements. Over time, this reform might lend some moderate support to employment development. However, in the short run, it triggered strikes and protests that led to production disruptions and thereby contributed to the stagnation in investment spending, which had expanded substantially in the three preceding quarters. Exports have so far neither benefited from Europe's slow recovery, nor the weaker euro.

After a good first quarter supported by the weather and ticket sales for the European Football Championship, private consumption subsequently stagnated. Only public consumption thereby turned out to be a robust spending pillar in France. The recovery of the oil price ended the short phase of negative inflation rates at the beginning of the year. Inflation continued to rise to 0.8 percent in December. However, high unemployment and the still clearly negative output gap are dampening underlying price pressure. Core inflation has stayed below the euro area average and hovered around 0.6 percent for most of the year.

Even before the Brexit referendum on 23 June last year, the first rifts were seen in the stable upswing experienced by the United Kingdom in recent years. Although the UK economy expanded significantly during the first half of the year due to robust private consumption and a surge in construction activity, the subliminal effects of uncertainty about the outcome of the referendum were already visible. Machinery and equipment investment already grew more slowly than previously, and the expansion in construction investment was exclusively attributable to public construction activity. During the second half of last year, i.e. after the Brexit vote, public and private consumption also remained the main stabilisers of the economy; and investment activity was mainly driven by public construction. Investments in equipment and machinery, on the other hand, were very weak and confirmed the assessment that companies have already begun to restrain their investments due to uncertainty over the future relationship with the European Union. The uncertainty is also reflected in the exchange rate: since the referendum in June, the British pound has depreciated by 10 percent against the euro with consequences for foreign trade. Imports declined during the second half of the year, while exports increased somewhat. Real GDP grew by 2.1 percent in 2016.

Italy has not been able to participate in the European recovery that started in 2013 to date. Real GDP has only increased by a mere 2 percent and is still nearly 8 percent below pre-financial crisis levels. Accordingly, the unemployment rate in Italy remained broadly unchanged and averaged 11.6 percent in 2016. In contrast to the year before, private consumption barely contributed to overall growth. This was particularly due to depressed consumer sentiment created by uncertainty surrounding the referendum on constitutional reform in November and the stability of Italian financial institutions. Besides these uncertainties, the investment climate remained poor also because of Italy's rigid labour laws, high labour costs, inefficient public services and its judicial system (see Table 1.1). Consolidation efforts by the public sector also led to small growth contributions from public spending.

Table 1.1

Labour costs[a)]

	Compensation per employee[b)]		Real compensation costs[c)]		Labour productivity		Unit labour costs		Relative unit labour costs[d)]		Export performance[e)]		
	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	2016
Germany	1.4	2.5	0.4	0.7	0.6	0.5	0.8	2.0	– 1.3	0.8	0.6	0.6	0.0
France	2.6	1.1	1.1	0.4	0.7	0.5	1.8	0.4	0.0	– 1.0	– 1.6	0.4	– 1.2
Italy	2.0	0.3	– 0.1	– 0.6	– 0.3	– 0.1	2.5	0.7	0.5	– 0.4	– 3.0	0.1	– 0.5
Spain	2.6	0.6	0.2	0.4	0.6	0.5	2.3	0.3	0.5	– 0.8	– 0.7	1.6	3.5
Netherlands	2.7	1.2	0.8	0.9	0.8	1.2	2.0	0.0	0.1	– 1.1	– 0.2	0.6	0.7
Belgium	2.7	0.4	0.9	– 0.6	0.8	0.6	2.0	– 0.4	0.3	– 1.7	– 0.9	0.7	1.6
Austria	2.2	1.6	0.5	– 0.1	0.8	0.1	1.5	1.8	– 0.3	0.4	– 0.5	– 0.7	– 1.0
Finland	3.0	1.2	1.3	– 0.3	0.9	0.3	2.1	0.8	– 0.3	0.8	– 1.4	– 1.9	– 0.4
Greece	2.8	– 1.3	0.6	– 0.4	0.8	– 1.2	2.8	0.3	0.6	– 0.1	– 1.0	– 3.9	– 9.5
Ireland	3.6	2.4	1.5	1.2	1.8	10.1	2.0	– 6.8	0.6	– 8.8	2.1	12.7	0.5
Portugal	2.7	– 0.2	0.4	– 1.7	1.1	– 0.2	1.9	0.7	0.0	– 0.4	– 0.2	0.8	0.4
Slovakia	6.5	2.4	3.3	2.7	3.5	1.5	2.4	1.6	2.0	0.7	4.6	1.0	1.4
Slovenia	5.7	1.3	2.1	0.4	1.9	1.4	3.6	0.0	– 0.1	– 1.0	1.0	2.7	3.4
Estonia					3.8	0.1	4.9	4.7	2.2	5.2	1.2	0.9	1.6
United Kingdom	3.6	1.2	1.6	0.1	1.1	0.6	2.4	0.4	– 1.1	0.2	– 1.6	– 1.5	0.3
Sweden	3.6	2.6	2.0	0.9	1.4	1.8	2.3	1.2	0.4	– 2.8	– 0.8	1.8	0.7
Denmark	3.1	2.0	1.0	1.4	1.0	0.1	2.2	1.9	0.2	1.0	– 0.5	– 1.3	– 1.6
Poland	5.2	2.3	2.0	1.8	3.4	1.8	2.2	0.9	– 0.5	– 0.9	2.4	4.4	6.2
Czech Republic	4.8	2.9	3.0	1.4	2.4	2.0	2.1	1.3	2.5	– 1.0	3.6	3.5	2.1
Hungary	6.6	2.5	1.4	0.7	2.0	– 0.4	5.1	3.0	1.7	0.3	3.8	5.2	5.2
Switzerland	1.5	– 0.7	0.8	0.0	0.7	– 0.2	1.0	0.1	1.1	2.6	– 0.1	– 3.1	1.7
Norway	4.8	2.8	– 0.1	4.0	0.5	0.9	4.4	1.8	3.1	– 5.1	– 3.6	– 1.9	– 4.2
Iceland	6.5	6.7	1.5	2.2	1.6	0.5	5.3	6.1	– 1.5	12.2	0.7	2.9	3.6
United States	3.3	2.4	1.2	1.0	1.6	0.3	1.7	2.2	– 1.6	7.2	– 1.6	– 0.4	– 0.3
China									4.1	3.8	10.1	0.1	0.2
Japan	– 0.9	0.7	0.3	– 0.6	1.0	– 0.2	– 1.5	1.3	– 2.9	0.9	– 3.0	0.6	– 2.5

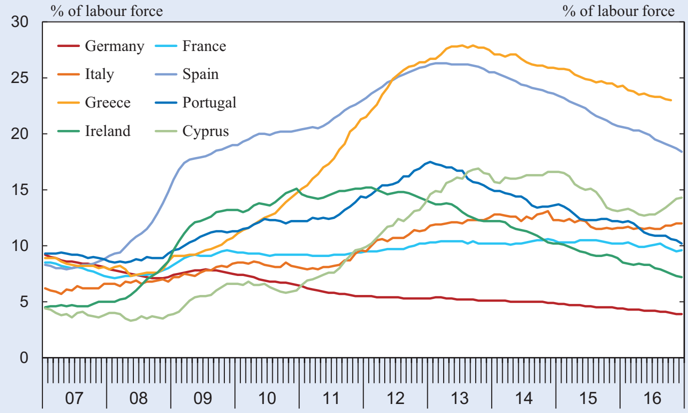
[a)] Growth rates for the total economy. – [b)] Compensation per employee in the private sector. – [c)] Compensation per employee in the private sector deflated by the GDP deflator. – [d)] Competitiveness: weighted relative unit labour costs. – [e)] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares. – [f)] Covers the period 2010–2013.

Source: OECD Economic Outlook No. 100, November 2016.

Doubts about the stability of Italian credit institutions cooled down the business climate last year. Although these banks generally weathered the global financial crisis fairly well, as they did not invest excessively in speculative investments abroad and were not – through too little diversification in their lending portfolios – exposed to negative developments in the real estate sector. However, the weak economic development in the aftermath of the financial crisis and the postponing of structural reforms led to an accumulation of bad loans: around 18 percent of the loans granted in Italy have now been classified as "non-performing loans". A recapitalisation of the distressed financial institutions by the government is not in line with the new EU directives, which prescribe that the shareholders and creditors of subordinated bonds first need to be taken on board. The securitisation of distressed loans, as initiated by the Italian government, and the increase in the capital of private banks by private funds has defused the situation for the time being.

Figure 1.11

Unemployment rates in selected euro area countries



Source: Eurostat, last accessed on 31 January 2017.

Despite political uncertainty created by not being able to set up a government for ten months until October last year, the *Spanish* economy managed to stay on its high growth trajectory that started in 2014. With a rate of 3.3 percent in 2016, it achieved the by far highest GDP growth rate amongst the larger EU countries. With the exception of public consumption, all spending components significantly contributed to this upswing. Indeed, GDP almost returned to its pre-crisis level of early 2008. Although the unemployment rate is still high, this development led to a drop from 20.5 percent at the start of 2016 to 19.3 percent in November.

Of the smaller (former) crisis-afflicted economies, *Cyprus* and *Ireland* fared well. Cyprus has been back on a steady growth path since early 2015, with average annualised growth rates of almost 3 percent. Ireland is even surpassing this performance with an average annualised growth rate of over 5.5 percent. Last year these two economies grew by 2.9 and 4.3 percent respectively. In *Portugal* real GDP has also been on an upward trend since spring 2013, albeit at a rate (1.3 percent) that is not comparable to that of Cyprus or Ireland. Although Greece has technically moved out of recession with a growth rate of 0.3 percent for 2016, its economy has basically been stagnant since 2013. Despite these low growth rates, these two countries have also seen a noticeable turnaround in their labour markets. Unemployment has been steadily falling in all four economies since at least 2015 (see Figure 1.11).

Albeit going strong, the recovery in the *Central and Eastern European* member states of the European Union lost some of its momentum during last year. This was mainly due to weaker demand from the euro area. Domestic demand was robust almost everywhere. Cheap oil and low commodity prices continued to act as an economic stimulus. In addition, real household income increased, not least because the price level rose only slightly and even declined in some places. Equipment investment also made an overall positive contribution to the increase in GDP in the region. Its expansion was facilitated by interest rates, which remained low throughout the year. All of this led to a further noticeable improvement in the labour market situation everywhere, which was accompanied by a significant drop in unemployment rates in all countries.

Nevertheless, differences between these Central and Eastern European countries continued to prevail. Whereas Romania, Slovakia and Bulgaria each reported growth rates of well above 3 percent, Latvia, Estonia and Hungary were the laggards of the region last year, with expansion rates of below or equal to 1.5 percent. As a result, the central bank of Hungary lowered its key policy rate in three equal steps by a total of 45 basis points to 0.9 percent. The Baltic states still suffered from the recession in Russia.

1.3 Fiscal and monetary policy

1.3.1 Fiscal policy

Fiscal policy is unlikely to continue the consolidation course of recent years seen in most large advanced economies in 2017 (see Figure 1.12). In the United States, the further increase in the structural fiscal deficit generated significant impulses for economic activity last year. As no concrete fiscal plans for the new US government are available yet, the present forecast assumes that fiscal orientation will remain roughly neutral this year, in the sense that the structural deficit will hardly change. However, it is possible that a further increase in the fiscal deficit of the United States will emerge.

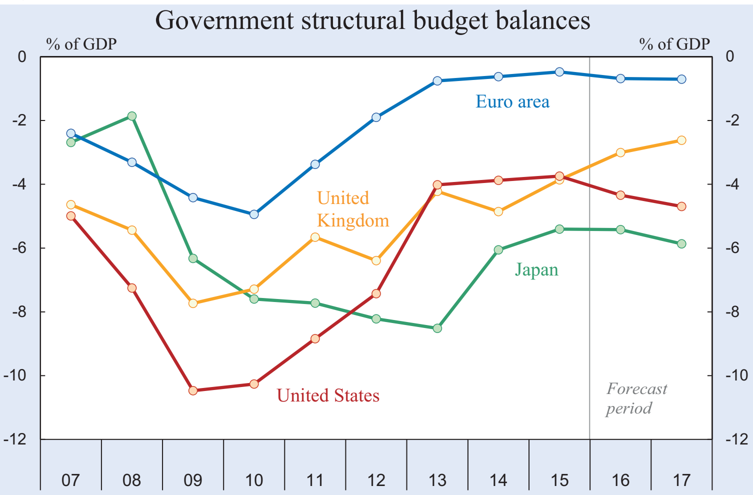
In Japan, in view of the low rate of expansion, a new economic stimulus plan was launched at the beginning of last year. Furthermore, the planned value added tax increase for April 2017 was postponed to 2019. Other originally foreseen fiscal consolidation measures were further shifted out into the future. As a result, the intensity of fiscal consolidation has decreased noticeably for 2017.

In the major emerging economies, the expansionary orientation of fiscal policy seen last year is expected to continue. In China, for example, large-scale public investment programmes were announced in early 2016, and lending by state banks markedly expanded in the summer of 2016. Further support measures are foreseen for this year. In India, wages in the public sector have recently been massively increased and indirect tax reforms have been implemented. The governments of Indonesia and Russia are also planning to expand their investment and consumption spending. Albeit to a lesser degree than in the recent past, fiscal policy in Brazil is likely to be contractionary.

The fiscal consolidation course of the years 2011 to 2013 has since been relaxed in Europe. The fiscal deficit of the euro area and the European Union has nevertheless continuously improved since 2010 and reached approximately –1.9 and –2.0 percent last year (see Table 1.2). However, during the last few years the improvements have only been achieved due to increased revenues and lower spending that are related to the economic recovery on the one hand, and the ECB's expansionary monetary policy on the other hand. The latter resulted in a reduction of governments' interest payments. Correcting for these effects, and hence looking at the so-called structural primary balance, actually shows a slight worsening of the fiscal balance in the euro area in recent years. According to the most recent estimates by the European Commission, the thus measured discretionary fiscal impulse was – like the previous year –0.2 percentage points in relation to potential GDP last year. The greatest impulses were observed in Spain (1.1 percentage points), Austria (0.8 percentage points) and Italy (0.4 percentage points). In Germany, the structural primary surplus decreased by 0.4 percentage points, while fiscal policies in Greece, Ireland, the Netherlands and Portugal are likely to have been restrictive last year.

Many euro area countries are not consolidating their government budget, despite their still high public debt levels (see Figure 1.13). Although a large number of countries far from fully complying with the rules of the European fiscal compact, particularly with regard to the debt-to-GDP ratio (allowing for a maximum of 60 percent relative to GDP) and the structural fiscal deficit (allowing for a maximum of 0.5 percent relative to GDP), a loose fiscal policy course is likely to continue in the euro area this year. The experience of the past few years has shown that these fiscal rules hardly have any disciplinary effect. Last year, the fiscal impulse

Figure 1.12



Source: OECD, OECD Economic Outlook, Vol. 2016 issue 2, November.

Table 1.2

Public finances

	Gross debt[a)]				Fiscal balance[a)]			
	1999–2007	2008/2009	2010–2015	2016	1999–2007	2008/2009	2010–2015	2016
Germany	62.2	68.7	77.1	68.1	– 2.3	– 1.7	– 0.7	0.6
France	62.6	73.5	90.0	96.4	– 2.5	– 5.2	– 4.7	– 3.3
Italy	102.9	107.5	124.7	133.0	– 2.9	– 4.0	– 3.2	– 2.4
Spain	48.2	46.1	85.1	99.5	0.2	– 7.7	– 7.9	– 4.6
Netherlands	49.0	55.5	64.6	63.0	– 0.5	– 2.6	– 3.3	– 0.8
Belgium	100.6	96.0	104.0	107.0	– 0.5	– 3.2	– 3.5	– 3.0
Austria	66.2	74.1	83.0	83.5	– 2.2	– 3.5	– 2.4	– 1.5
Finland	40.6	37.2	55.0	65.4	3.8	0.8	– 2.4	– 2.4
Greece	103.8	118.1	168.7	181.6	– 6.3	– 12.7	– 9.1	– 2.5
Portugal	59.6	77.6	120.4	130.3	– 4.3	– 6.8	– 6.8	– 2.7
Ireland	30.9	52.0	103.1	75.4	1.6	– 10.4	– 10.7	– 0.9
Slovakia	40.5	32.0	49.5	53.3	– 5.2	– 5.1	– 4.0	– 2.2
Slovenia	25.7	28.2	62.3	80.2	– 2.2	– 3.6	– 6.5	– 2.4
Luxembourg	7.2	15.6	21.5	23.2	2.5	1.3	0.7	1.3
Lithuania	20.1	21.8	39.2	40.8	– 1.7	– 6.1	– 3.7	– 0.5
Latvia	12.2	27.6	41.3	40.0	– 1.7	– 6.6	– 2.7	– 0.8
Cyprus	58.7	49.0	86.2	107.1	– 2.4	– 2.3	– 5.2	– 0.3
Estonia	5.0	5.8	8.9	9.4	0.9	– 2.4	0.3	0.5
Malta	65.5	65.3	67.4	62.1	– 5.0	– 3.7	– 2.6	– 0.7
Euro area	**69.0**	**75.0**	**90.6**	**93.4**	**– 1.9**	**– 4.2**	**– 3.6**	**– 1.9**
United Kingdom	38.1	57.2	84.2	89.2	– 1.7	– 7.6	– 6.9	– 3.5
Sweden	48.9	38.6	40.3	41.6	1.1	0.6	– 0.7	0.0
Denmark	43.6	36.9	44.0	38.9	2.3	0.2	– 1.6	– 0.9
Poland	42.6	47.9	53.1	53.4	– 3.9	– 5.4	– 4.3	– 2.4
Czech Republic	24.6	31.4	41.6	39.7	– 3.7	– 3.8	– 2.5	– 0.2
Romania	19.5	18.2	36.1	38.9	– 2.5	– 7.5	– 3.3	– 2.8
Hungary	58.7	74.7	77.7	73.4	– 6.3	– 4.1	– 3.1	– 1.5
Croatia[b)]	38.1	44.3	74.9	85.0	– 3.6	– 4.4	– 5.6	– 2.1
Bulgaria	45.3	13.4	19.5	29.4	0.5	– 1.2	– 2.2	– 0.8
European Union	**61.8**	**67.4**	**84.6**	**86.0**	**– 1.7**	**– 4.5**	**– 4.0**	**– 2.0**
United States[b)]	60.7	79.4	101.8	108.2	– 3.1	– 9.9	– 6.7	– 4.1
Japan	167.0	201.0	237.8	250.4	– 5.9	– 7.3	– 8.0	– 5.2
Switzerland	56.0	48.4	46.3	44.7	0.2	1.2	0.3	– 0.3

[a)] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF. – [b)] Data on Croatia and the United States are only available from 2001 onwards.

Source: European Commission, Autumn 2016; IMF World Economic Outlook, October 2016.

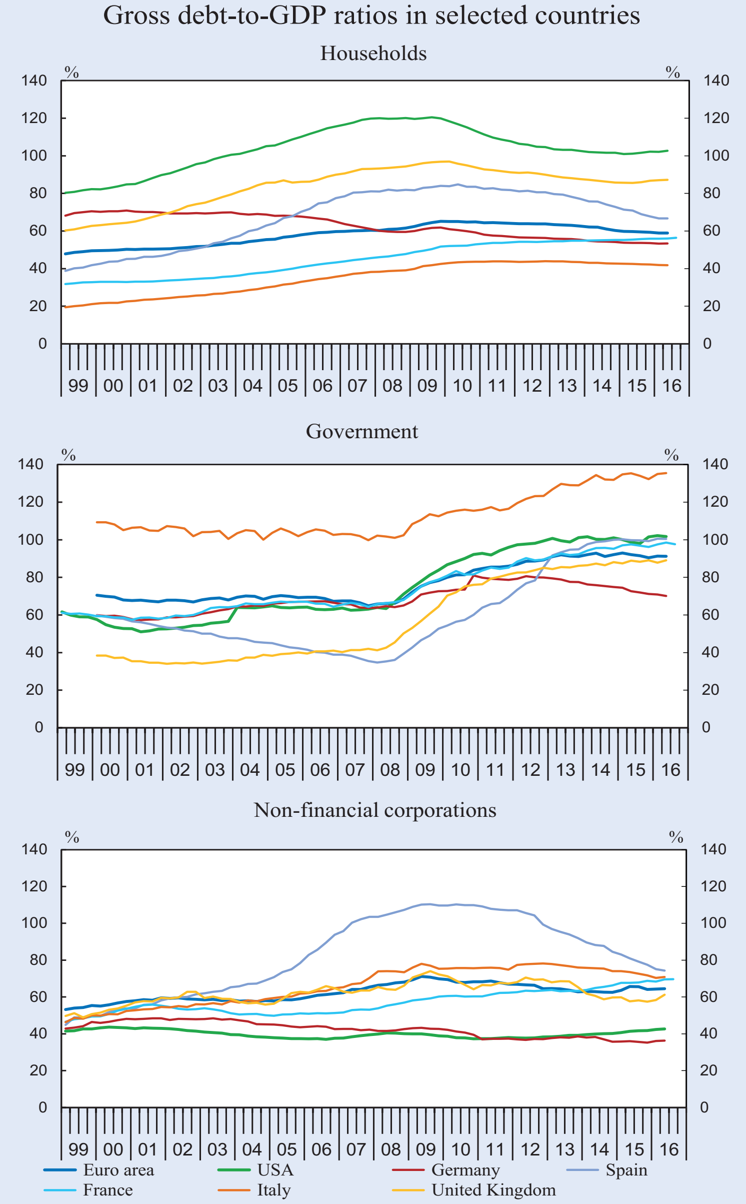
was the largest in those countries that should have had the least fiscal leeway given their high debt-to-GDP ratio. Fiscal policy is also likely to have a slightly positive impact on the economy this year. It is true that in some cases, such as in Germany and Austria, this can be traced back to the additional costs associated with the refugee crisis. However, the bulk of this fiscal easing mainly results from the marked fall in interest rates on governments bonds and the benevolent attitude of the European Commission towards member states that violate the fiscal rules. According to current estimates, the planned discretionary measures for 2017 are far more expansionary than they were a year ago in almost all countries, and particularly in Spain and Italy. For the euro area as a whole, the fiscal impulse is likely to be 0.2 percentage points in relation to GDP this year.

1.3.2 Monetary conditions and financial markets

Monetary conditions

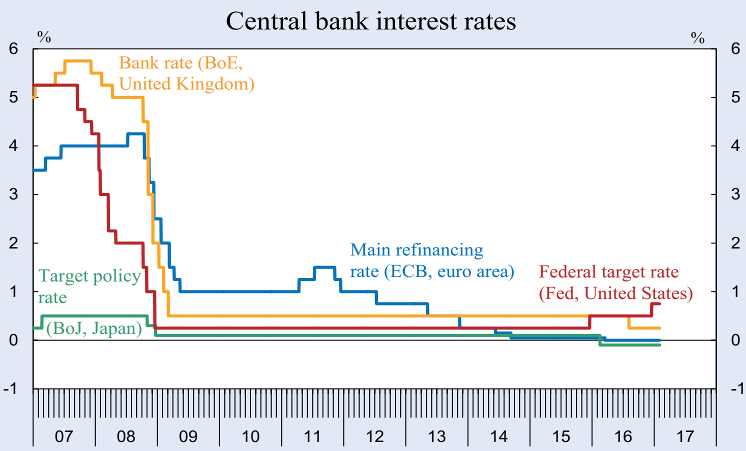
In the major advanced economies, monetary policies remain extremely expansionary. However, their degree of expansion and their focus were adjusted to varying degrees last year. Whereas the Federal Reserve of the United States increased the Federal funds rate in December 2016 for the second time since the financial crisis (see Figure 1.14), the governing council of the ECB decided to extend its asset purchase programme from April 2017 onwards, but reduce the volume. Although the Bank of Japan kept the volume of its asset purchases and the levels of its key interest rates unchanged, in an attempt to increase inflation expecta-

Figure 1.13



Source: Banque de France, last accessed on 31 January 2017.

Figure 1.14



Source: European Central Bank, Federal Reserve Bank of St. Louis, Bank of England, Bank of Japan, last accessed on 31 January 2017.

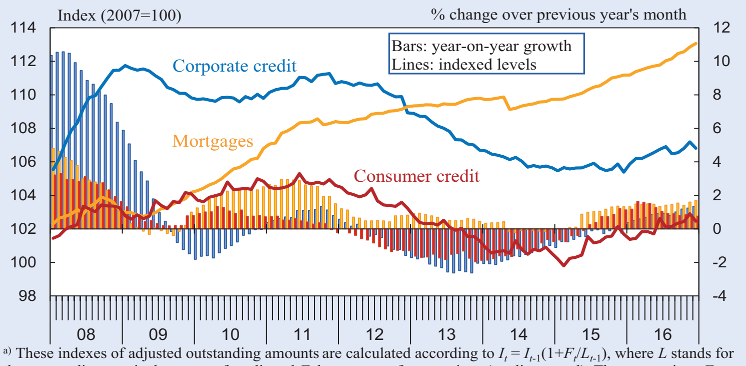
tions, it adopted a number of adjustments to its objectives and to the communication of its actions. In the United Kingdom, monetary policy was relaxed again after the Brexit referendum.

It took the Federal Reserve a full year to follow up on its first interest rate hike made in December 2015. The reasons for the cautious attitude of the Fed throughout last year were the relatively weak growth of the US economy during the first half of 2016 as well as concerns that the economic slowdown in China and in other emerging markets during the winter of 2015/2016 could aggravate and have a negative impact on the US economy. However, faced with a basically closed output gap, a strong expansion of aggregate economic output during the second half of 2016 and an increasing inflation rate – which is now only slightly below the Fed's target value of two percent – the Federal Reserve increased the target of the federal funds rate by 25 basis points to a range of between 0.5 and 0.75 percent in December. This year the tightening of monetary policy in the United States is likely to continue. However, this will happen at a slow pace, implying that monetary policy will remain accommodative throughout the year.

Monetary policy in the emerging economies was very mixed last year. Despite significantly undershooting its inflation target, the Chinese central bank has not taken any further steps towards monetary easing. Instead, Chinese policy makers turned to fiscal policy in order to stimulate the economy. One reason for this shift was to avoid even stronger overheating in the property market and a further acceleration of lending to the already heavily indebted corporate sector. Another reason was to prevent a further devaluation of the renminbi. The Chinese currency lost value, particularly during the first half of last year, not least because of ongoing capital withdrawal. This development even accelerated in the third quarter of 2016 compared to the first half of 2016. In order to curb the withdrawal of capital, the Chinese central bank introduced macro-prudential measures like a tightening of capital controls and restrictions on the use of credit cards for individuals. Furthermore, it returned to a tight control of the currency market in contrast to earlier announcements of a gradual liberalisation. Despite low inflation, China's monetary policy will, given the risks of overheating in the construction sector and the devaluation pressure on the renminbi, remain largely unchanged this year.

Figure 1.15

Credit developments in the euro area[a)]



a) These indexes of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1+F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details). A specific securitisation operation in France has led to a downward level shift in mortgages in May 2014.
Source: European Central Bank, last accessed on 31 January 2017.

In the face of declining inflation rates, stable currencies and solid inflows of foreign capital, the central banks in India and Indonesia lowered their interest rates last year. The central banks of Brazil and Russia took the declining inflationary pressures and the current stability of their currencies as an opportunity to also relax monetary policy somewhat again. This year, the major emerging economies are not expected to significantly loosen their mostly already accommodative monetary policy stance any further. The danger of facing undesirable currency devaluations as a result of the turn-around in monetary policy in the United States is too high.

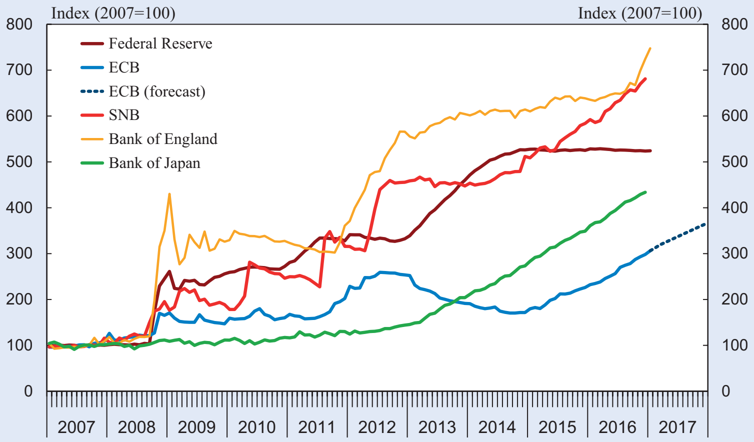
Against a background of low inflation in the euro area, the ECB kept its degree of expansion unchanged until December last year. As of March 2016, the main refinancing rate stands at 0 percent and the deposit rate is –0.4 percent. During this period monthly bond purchases have averaged 80 billion euros. In the context of this asset purchase programme, the ECB provided commercial banks with an amount of 1.532 trillion euros of central bank money by the end of December 2016. At the same time, current ECB holdings of securities for monetary policy purposes amount to a total of 1.654 trillion euros. Expansion of the ECB's balance sheet will continue. In its last meeting of 2016, the Governing Council of the ECB decided to continue its net asset purchases after March 2017 until the end of 2017, or beyond, if necessary. It will, however, reduce its monthly volume of purchases from 80 to 60 billion euros. By keeping interest rates unchanged, the ECB has therefore initiated a gradual phase-out of ultra-loose monetary policy.

Despite the substantial increase in liquidity, credit growth is only slowly picking up in the euro area. Mortgage loans have been steadily increasing for years now and consumer credit growth also returned to positive dynamics in 2015. As of 2016, loans to the corporate sector have also started growing again (see Figure 1.15). The pace at which this is happening is still modest, especially in the light of historically low interest rates and the huge amount of liquidity that the ECB is injecting into the system. In the case of Spain, the substantial reduction in the debt levels of non-financial corporations is noteworthy (see Figure 1.13). This development will support credit growth in Spain in the years to come.

In order to put the different quantitative easing programmes of the major central banks into perspective, a closer look at the development of the size of the respective central banks' balance sheets may be helpful. Although all major central banks have introduced non-standard monetary policy measures in an attempt to keep monetary policy effective despite hitting the zero lower bound, these programmes differ substantially across banks and over time. What they do have in common is that, by buying up assets, they blow up the size of the central bank's balance sheet. Whereas the Federal Reserve's balance sheet has more than quintupled through the implementation of three

Figure 1.16

Balance sheet sizes of major central banks

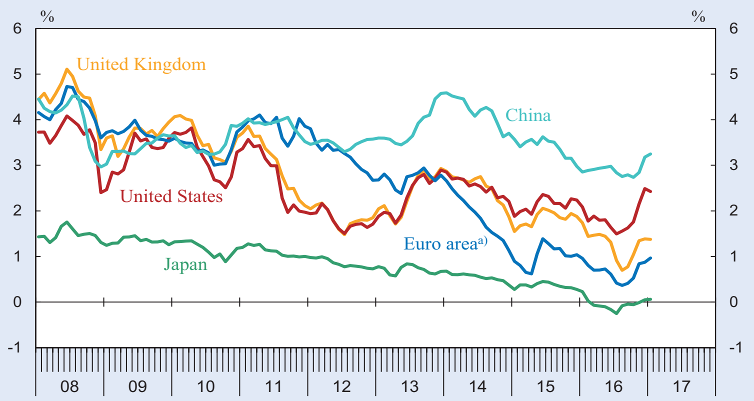


Source: Federal Reserve, Bank of Japan, European Central Bank, Bank of England, Swiss National Bank, last accessed on 31 January 2017; EEAG calculations.

quantitative easing programmes, the balance sheet of the ECB has "only" tripled so far (see Figure 1.16). Although not the first quantitative easing programme in Japan's recent history, the "quantitative and qualitative monetary easing" programme that was introduced in 2013 is the one that really took off the size of the Bank of Japan's balance sheet. Furthermore, although not introduced as quantitative easing programmes, attempts by the Swiss National Bank to circumvent an even stronger appreciation of the Swiss franc have also led to a substantial increase in its balance sheet. The recent jump in the size of the Bank of England's balance sheet reflects its decision to resume the purchase of additional government and corporate bonds and expand its liquidity to commercial banks. The aim of these measures was to mitigate possible financial turmoil and the negative short-term economic effects resulting from the Brexit referendum. In this context, it also decreased interest rates by 25 basis points last summer.

Figure 1.17

10-year government bond yields



a) The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream, last accessed on 31 January 2017.

Bonds, stocks and foreign exchange markets

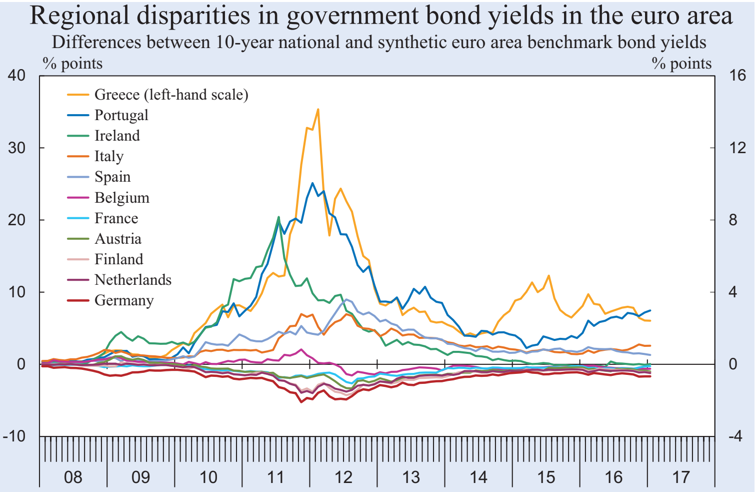
In all major economies, long-term government bond yields were lower on average in 2016 versus 2015. However, the improvement in economic activity in the United States since last summer, the stabilisation of commodity prices, associated expectations of an upturn in inflation, an anticipated increase in government spending following the election of Donald Trump as the new US president, and a reduction in taxes since August have increased US government bond yields. International interest rate linkages have transferred this turnaround to the rest of the world, where government bond interest yields have also started to increase (see Figure 1.17).

With the clear exception of Greece, government bond yields of euro area member states reached historical troughs in August last year. In Germany 10-year government bond yields even turned negative for a couple of months. However, the decline during the first eight months of 2016 in the interest rates on 10-year government bonds with the highest credit rating (AAA) was more or less nullified by the subsequent increase during the remaining four months of the year, whereby the biggest upward jump was realised in November – after the US election. Only Greece experienced a further decline; its economic outlook started to improve and perceived default risks therefore started to abate.

Within the euro area, the normalisation after the peak of the euro area crisis led government bonds with a triple-A status to witness a relative increase in their yields. This trend stopped and even reversed in 2016. At least to some extent, the increased uncertainty initiated a movement of financial capital towards quality. In Ireland, Italy and Portugal in particular country risk premiums increased again (see Figure 1.18).

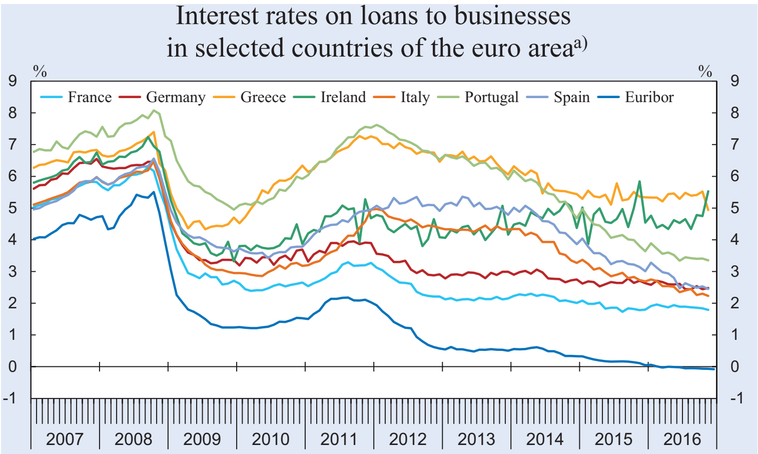
The overall funding costs of the banking sector continued to fall

Figure 1.18



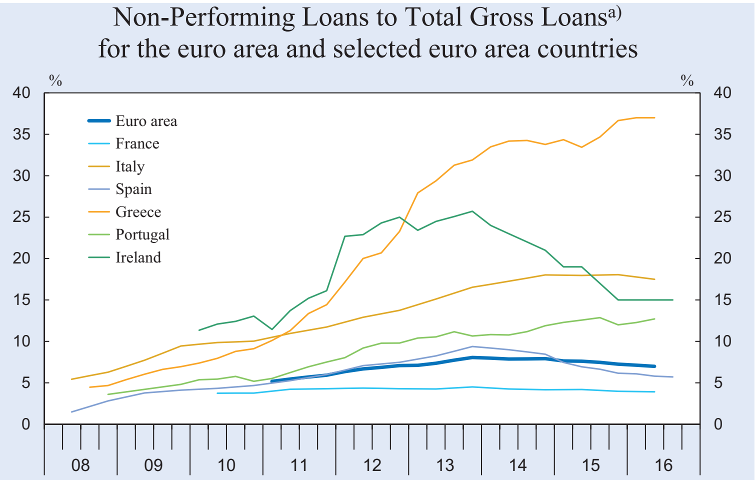
Source: Datastream, last accessed on 31 January 2017.

Figure 1.19



[a)] New loans to non-financial corporates up to one million euros using floating rates or up to one year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 31 January 2017.

Figure 1.20



[a)] Due to lack of data, the euro area average is calculated without Germany and Finland.
Source: IMF, last accessed on 31 January 2017, EEAG calculations.

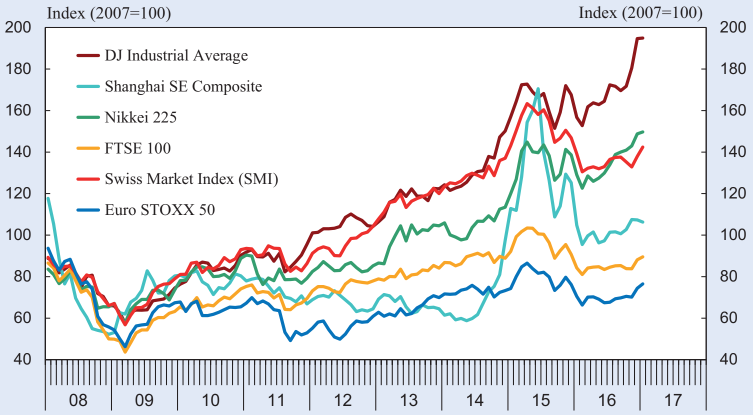
last year, as indicated, for instance, by a slide in the interest rate on secured interbank loans with a maturity of one year into negative territory. Almost everywhere in the euro area lower funding costs led to lower lending rates for non-financial corporations (see Figure 1.19). In countries like Italy, Portugal and Spain, the decline was too strong to solely be attributed to the reduction in interbank rates, suggesting that the creditworthiness of many companies in those countries improved; and that the supply-side constraints caused by high inventories of impaired loans may have started to abate.

Indeed for the euro area as a whole, but also for Italy and Spain, the share of non-performing loans clearly started to decline in 2016 (see Figure 1.20). The sheer share of non-performing loans in Greece and Italy is nevertheless alarming. Not without reason, concerns over Italy's banking sector have received quite some headwind in recent months. The banking sector faces mounting recapitalisation, which appears a daunting task given new EU rules effective this year that restrain the role of state intervention to support the sector, combined with a record-high public debt-to-GDP ratio in Europe.

In contrast to 2015, stock markets generally showed a relatively steady upward tendency last year. After the trough reached in February 2016, all major indexes increased until the end of year with mostly two-digit rates. The US stock market in particular saw a strong increase of 21.1 percent when measured in US dollars. The appreciation of the dollar turns this increase into 27.4 percent

Figure 1.21

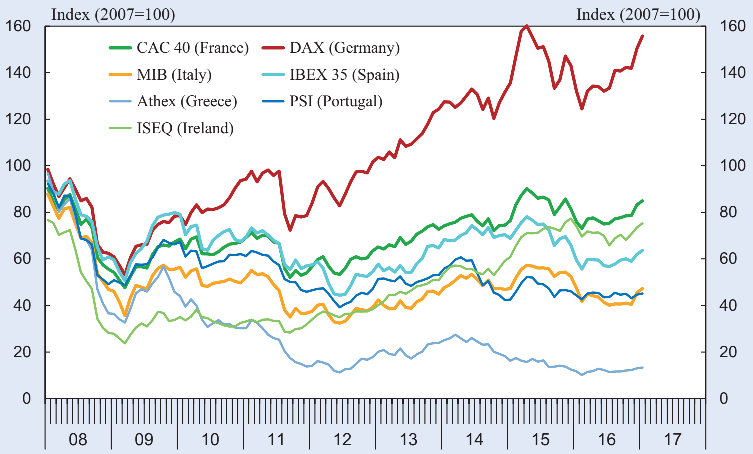
Developments in international stock markets



[a)] Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2017.

Figure 1.22

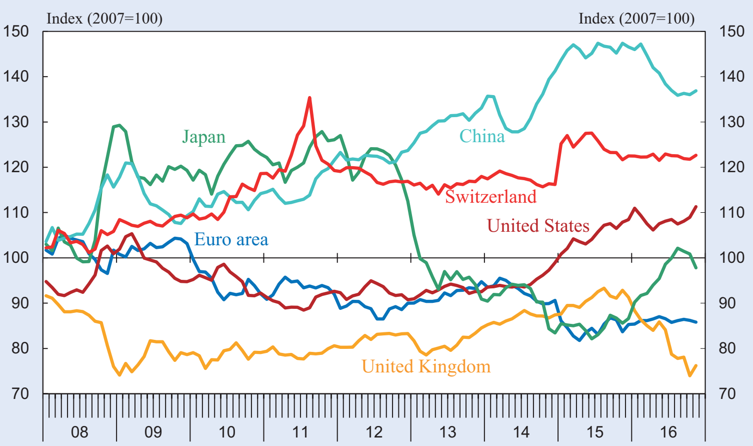
Developments of selected stock markets within the euro area



Source: Datastream, last accessed on 31 January 2017.

Figure 1.23

Real effective exchange rates around the world



Source: Bank for International Settlements, last accessed on 12 January 2017.

when measured in euros. These increases were also double digit for the Nikkei 225, the Shanghai Stock Exchange Composite and the Euro STOXX 50, and reached, respectively 21.4, 12.4 and 12.1 percent over the same period when measured in euros (see Figure 1.21). By contrast, for the FTSE 100, the increase was a mere 8.8. This lower performance was largely due to the depreciation of the British pound.

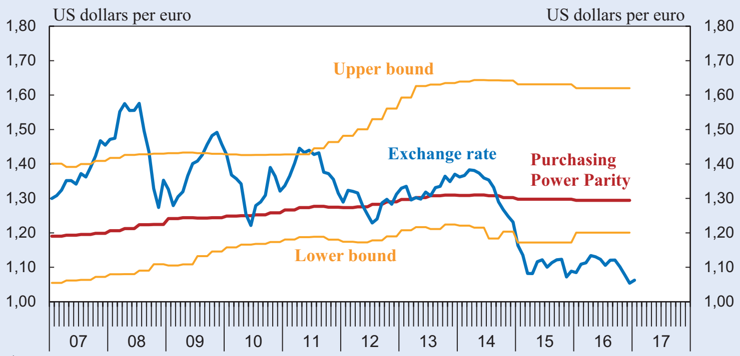
The major stock market indices within the euro area have also improved since February 2016 (see Figure 1.22). Most indices are nevertheless still well below the levels reached before the start of the financial crisis. The Greek Athex reached a new low in February, standing at only 10 percent of its pre-crisis level. Since then, it managed to increase by almost 30 percent. The German DAX performed well, approaching its peak of spring 2015 again in 2016.

Although the ECB has slowly started tapering its asset-buying programme and long-term interest rates are likely to rise further, financing conditions for the private sector will remain favourable throughout the year. The situation in the banking sector and the demand for corporate credit are likely to continue to improve.

In relative terms the real effective values of the US dollar and the euro remained quite stable throughout 2016. The US dollar only strengthened somewhat after the US election and the second interest rate increase by the Federal Reserve since the financial crisis. The Japanese yen and the Chinese renminbi, by contrast, moved substantially during 2016. The yen first reversed

Figure 1.24

Exchange rate of the euro against the US dollar and PPP[a)]



a)(PPP) is given at a quarterly frequency. The US dollar (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used.
Source: OECD, OECD Economic Outlook, Vol. 2016 issue 2, November, European Central Bank, last accessed on 31 January 2017.

course and gained value as compared to 2015, but lost ground again in November and December 2016. The renminbi experienced a particularly strong downward trend during the first half of 2016 (see Figure 1.23). The British pound also depreciated substantially throughout 2016.

As of November 2016, the euro again depreciated compared to the US dollar (see Figure 1.24). The prospect of even more diverging monetary policy regimes and expected fiscal stimulus in the United States has made the US dollar more attractive and the euro less so. From a purchasing power parity perspective, however, the euro has now been undervalued for two years in a row.

1.4 The macroeconomic outlook

1.4.1 Assumptions, risks and uncertainties

This forecast assumes that the Brexit negotiations between the United Kingdom and the European Union will be without noticeable distortions and that a "soft Brexit" will emerge at an early stage that will not significantly affect the current economic links between the European Union and the United Kingdom.

It is also assumed that the US government will not significantly alter, or even terminate, those free trade agreements already in force; and will not restrict its cross-border exchange of goods, services and capital with the rest of the world. In the absence of concrete plans or even decisions, it is assumed that the fiscal policy orientation of the United States will not change drastically this year. We do, however, take into account that these potential changes in US policy have already induced economic policy uncertainty and thereby affect investment and durable consumption decisions. Finally, a persistently protracted reform process is expected in Italy; and this forecast assumes that the precarious situation of the Italian banking sector does not lead to any major financial turmoil.

A major downside risk to global economic development this year is the departure of the United Kingdom from the European Union. In the run-up to the actual Brexit, the parameters of the bilateral economic relations between the United Kingdom and the European Union, as well as trade agreements with over 50 other countries that are based on EU law, have to be renegotiated. However, it is still neither clear when the formal negotiations will begin and when the Brexit will actually take place, nor are there any indications as to how the new agreements might look.[2] If, for example, these new agreements were to create new barriers to trade in goods and capital movements, there would be a noticeably negative impact on medium-term economic growth in Europe and other regions of the world. A persistently high level of uncertainty among private agents could even weigh on investment activity in the United Kingdom and the European Union this year. This could be the case if, for example, a scenario that is unfavourable for future trade emerges; or the negotiations are characterised by major impasses.

The future economic, foreign and security policy orientation of the United States has also become difficult to predict since the presidential elections; and is therefore a source of numerous both positive and negative risks to global political and economic development.

The newly-elected president has campaigned for a strong expansion of infrastructure investments in conjunction with corporate tax cuts, a markedly more protectionist trade policy, and a significant reduction

[2] At the time of writing, the High Court's decision over whether the government is allowed to issue the exit notification without an explicit act of parliament to authorise is pending. This might further delay the start of these negotiations.

in the international security policy commitment of the United States. To what extent and when such policies can be implemented is still completely uncertain. A strong increase in the degree of fiscal expansion would, for example, give the US economy a positive boost that could spill-over to the rest of the world (see Box 1.1).[3] Negative risks to the global economy are the result of a possible transition of the United States to greater protectionism in its trade policy. This would hamper world trade and reduce the potential for technological spillovers throughout much of the world. Finally, a strong reduction in US security involvement within NATO or in international crises and conflicts could increase political uncertainty and significantly dampen investment activity in many countries.

Figure 1.25

Global Economic Policy Uncertainty (EPU) is calculated as the GDP-weighted average of monthly EPU index values for the United States, Canada, Brazil, Chile, the United Kingdom, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland and Australia using GDP data in current prices from the IMF World Economic Outlook Database.
Source: Baker et al. (2016), www.policyuncertainty.com, last accessed on 31 January 2017.

Another major downside risk for global economic development this year is the electoral success of populist parties in main European countries. Such parties tend to favour more protectionism in their country's external relations, or call for a thorough revision of EU treaties; and, in some cases, even for their country's withdrawal from the EU or the euro area. It cannot be ruled out that such radical political groups emerge as winners in the parliamentary elections that will take place in France, the Netherlands and probably in Italy this year. This could seriously undermine confidence in the political stability and cohesion of the European Union and would have negative economic consequences for the entire world. The economic burdens will be even more pronounced if new trade barriers were to be built within Europe, or if other countries start following the example of the United Kingdom and opting for a withdrawal from the European Union. For instance, a victory on the part of the 5 Star Movement could trigger a referendum on Italy's exit from the euro area that is likely to cause major turbulences in financial markets.

Global economic policy uncertainty has increased over the last two years, and particularly since last summer. This is confirmed by indicators based on newspaper articles in several countries as analysed by Baker et al. (2016) and published on www.policyuncertainty.com (see Figure 1.25).[4] The Brexit decision in June 2016 in the United Kingdom created a very pronounced surge in uncertainty. After a temporary decline to still historically alleviated levels in early autumn, economic policy uncertainty peaked again in November 2016. This increase was probably due to the surprising outcome of the US presidential elections. The overall higher level of uncertainty since 2016 is probably also related to the rise of populist parties in those European countries in which parliamentary elections are to be held this year.

Although numerous sentiment indicators have improved last autumn, it is still quite likely that such a higher level of economic policy uncertainty is clouding the investment moods of consumers and firms in much of the world and thereby dampening economic momentum. In a VAR analysis including real GDP, consumer prices, long-term government yield and economic policy uncertainty, Wollmershäuser et al. (2016) show for the United States, the euro area, Germany and the United Kingdom that the jump in uncertainty as sizeable as that witnessed in the United States between the third and the fourth quarter last year, i.e. an increase in economic policy uncertainty of 67 percent, is followed by a reduction in GDP between 0.3 and 0.5 percentage points during the first year after the shock. Overall, their results suggest that the recent further increase in economic uncertainty will cer-

[3] Such a short-run boost may be achieved at the cost of larger problems in the long run through a stronger accumulation of debt.

[4] The Global Economic Policy Uncertainty Index is a GDP-weighted average of national Economic Policy Uncertainty indices for 16 countries: Australia, Brazil, Canada, China, France, Germany, India, Ireland, Italy, Japan, Russia, South Korea, Spain, the United Kingdom, and the United States. Each national index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy, policy and uncertainty.

Box 1.1

Short-term impact of Donald Trump's election as the new US president

Economic policy was a major focus of the new US president's election campaign. During the campaign it became clear that Trump is willing to set economic policy impulses that directly influence the economic development of the United States. The large number of announced measures for tax relief for companies, deregulation of the financial sector, more protectionist trade policy, increased infrastructure investments – to name but a few cornerstones – makes it difficult to predict the economic effects. Besides setting positive impulses, these measures may also have the opposite effect: while import-substituting sectors benefit from more restrictions on trade, companies that are specialised in exports, or rely on a large proportion of imported intermediate goods for their production process, will suffer because other countries can be expected to take countermeasures. It is therefore all the more interesting to see how economic indicators have developed since the election of Donald Trump.

While share prices have declined slightly since summer, the Dow Jones rose by 8.2 percent between the election on November 8 and the end of 2016. Over the same period, 10-year government bond yields increased by 0.6 percentage points, continuing their trend reversal since July 2016. Part of the increase in November was possibly linked to the expectation (which materialised) that the Federal Reserve would make its next interest rate move in December 2016. After depreciating in the immediate run-up to the election, the US dollar clearly regained in value afterwards; in nominal terms it appreciated by 4.6 percent against the euro. Business confidence indicators continued to trend upwards. The purchasing managers' indices increased in October and continued to rise after the November election. In November and December consumer confidence rose sharply both in terms of assessments of the current situation and expectations. Economic policy uncertainty rose sharply in connection with the Brexit vote in June, but declined just as quickly in the United Kingdom. The Trump election led to a comparable surge in uncertainty. Although it also faded subsequently, uncertainty has remained at a higher level since the election. Industrial production also fell again towards the end of the year and retail sales lost momentum somewhat in November.

Overall, since the presidential election the indicators do show an improvement in sentiment among both producers and consumers, which is probably due to the expected implementation of certain future economic policy measures. At the same time, however, economic uncertainty has clearly increased, which in itself is likely to weigh on the economic prospects for the United States. Overall, the available indicators have slightly increased GDP – and so have forecasts for the United States. This is illustrated by the distribution of model projections for the fourth quarter of 2016 and the first quarter of 2017. These model projections are based on the IFOCAST approach (see Carstensen et al., 2009), in which a large variety of models are estimated. A comparison of these model projections from November (almost exclusively with indicators published before the Trump election) and December shows that their distribution has shifted slightly to the right. The median of the projected real growth rates of GDP over the previous quarter rose from 0.51 percent to 0.54 percent for the fourth quarter of 2016 and from 0.52 percent to 0.55 percent for the first quarter of 2017.

The positive effects of the anticipated expansive fiscal policy measures in the United States on the euro area can also be quantified. To this end, the Ifo-DSGE model is used (Hristov, 2016). Due to uncertainty over whether the new US government will intervene on the demand side – by increasing government expenditure – or on the supply side – through improved infrastructure or a cut in production costs through tax cuts – two alternative scenarios are simulated. The first scenario assumes that the US fiscal impulse is purely demand-driven and thus boosts overall demand in the United States. In the second scenario, the policy measures are modelled as a positive supply shock that leads to a higher supply in the United States for any given level of demand. It is assumed that the measures will be implemented in the first quarter of 2018. The fourth quarter of 2016, however, will be set as the announcement date regarding these measures. As argued above, Trump's election campaign and his subsequent election have already triggered positive expectations. The level of the shock in each respective scenario is determined in such a way that the resulting nominal effective depreciation of the euro is 0.9 percent. This corresponds to the actual change in the euro's external value against the rest of the world (i.e., a currency basket from the 36 most important trading partners) from the average of the third quarter of 2016 to the end of the fourth quarter.

Table 1.3 shows how much GDP and its growth rate differ from the baseline forecast in the United States and in the euro area in each of the two scenarios. Although the actual fiscal policy measures are taken in 2018, economic agents already react to the announcements of the newly elected US president. These announcements change the expected profitability of various investment opportunities, the expected competitiveness of different industries and the expected income of private households. At the time of announcement, all this leads to a revision of the original plans and thus to shifts in consumption, investment and production behaviour. Through the expectation channel, economic policy decisions can influence the state of an economy before their actual implementation.

Both scenarios are accompanied by higher levels of GDP and corresponding higher growth rates both in the United States and in the euro area this year already. The effect is stronger in the United States where the shocks originate. The export sector of the euro area benefits from increased demand from the United States, which is generated in each of the two scenarios. The resulting interest rate differential already allows the euro to depreciate at the announcement of the change in policy and leads to a transfer of funds from the euro area to the United States. In 2018, however, the economic development of the two scenarios differs. When the policies can be better described as demand-pull shocks, GDP is still higher in the euro area than in the baseline scenario. The opposite is true if the US economy is stimulated through a positive cost shock, as in the supply-side scenario. This is because the relative international competitiveness of the United States improves in the second scenario. This effect reaches its peak approximately three years after the announcement. Although this effect already sets in at the moment of the announcement, the negative effect on euro area GDP in 2017 is more than compensated for by the increase in US demand.

Table 1.3

Effects of alternative scenarios regarding US fiscal policy on US and euro area GDP

	Scenario 1 Demand-pull shock		Scenario 2 Cost-push shock	
	United States	Euro area	United States	Euro area
GDP effect as percentage of baseline forecast				
2017	0.5	0.1	0.5	0.1
2018	0.4	0.1	0.0	– 0.1
GDP growth deviation from baseline in %-points				
2017	0.5	0.1	0.5	0.1
2018	– 0.1	0.0	– 0.5	– 0.2

Source: Wollmershäuser et al. (2016).

tainly have a dampening effect on overall economic expansion this year.

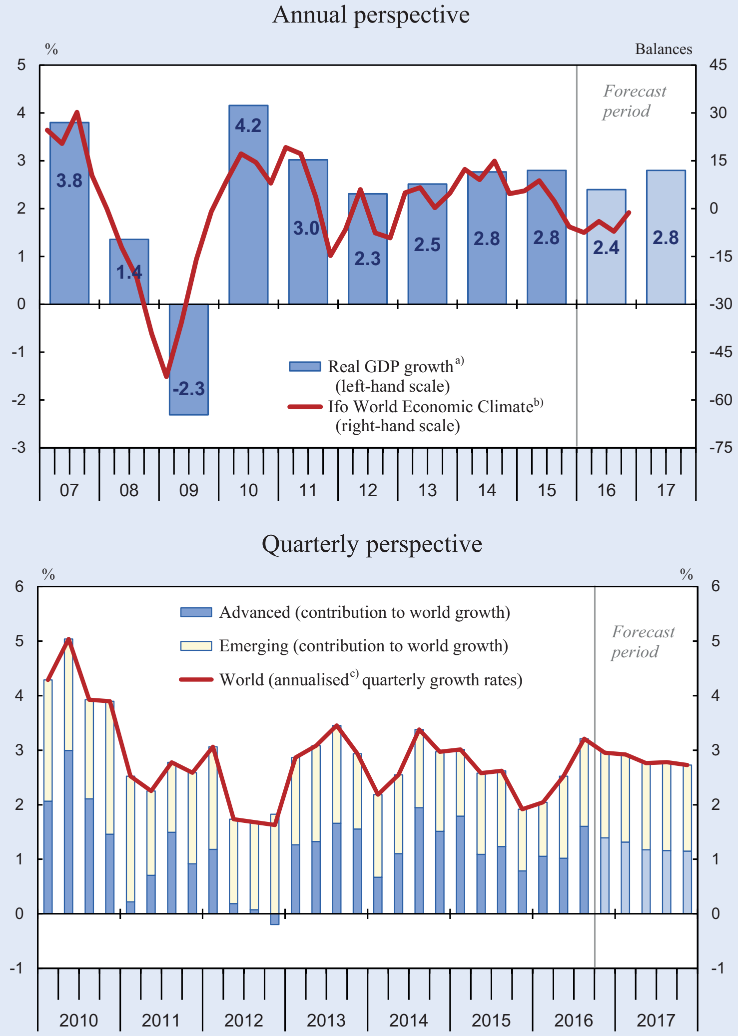
1.4.2 The global economy

The pace of global economic expansion is expected to have slightly decreased this winter compared to the third quarter of 2016 (see Figure 1.26). Although the results of the Ifo World Economic Survey show an upward tendency in basically all regions of the world (see Figure 1.27), political events with uncertain consequences, such as the Brexit decision, the election of Donald Trump as US president and the growing popularity of right- and left-nationalist parties in major European countries have led to a massive increase in political uncertainty in many places. This higher uncertainty, together with the continuing slowdown in economic growth in China, is likely to dampen the expansion in global production.

Overall, the world economy is expected to expand more than it did during the first half of 2016 during the forecast period. The growth rates are, however, expected to be only about half as high as in the years before the global financial crisis. This year, the total economic output of the world is forecast to increase by 2.8 percent (see Figure 1.28). World trade is expected to expand by 1.8 percent after 0.8 percent last year. The current accounts of most commodity-exporting emerging markets will thereby improve somewhat, while those of China and the United States are likely to deteriorate slightly in the face of relatively strong domestic economic dynamics.

Figure 1.26

World economic growth and the Ifo World Economic Climate

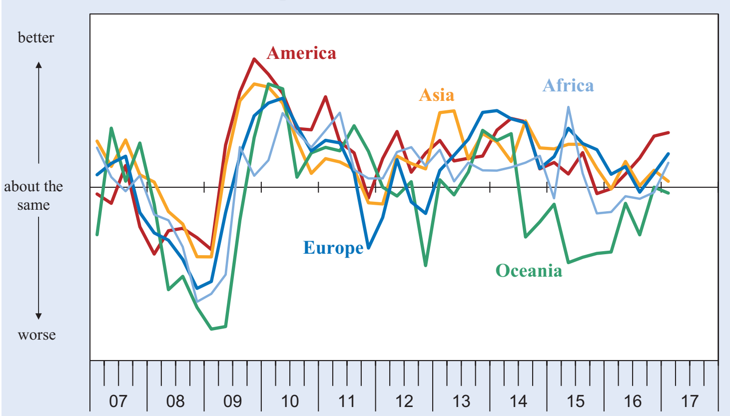


[a] Countries are weighted according to previous year's nominal GDP in US dollars. [b] Arithmetic mean of judgements of the present and expected economic situation. [c] Growth contributions of advanced and emerging economies thereof. Countries are weighted according to previous year's nominal GDP in US dollars.
Source: IMF World Economic Outlook, October 2016; GDP 2016 and 2017: EEAG forecast; Ifo World Economic Survey I/2017.

Figure 1.27

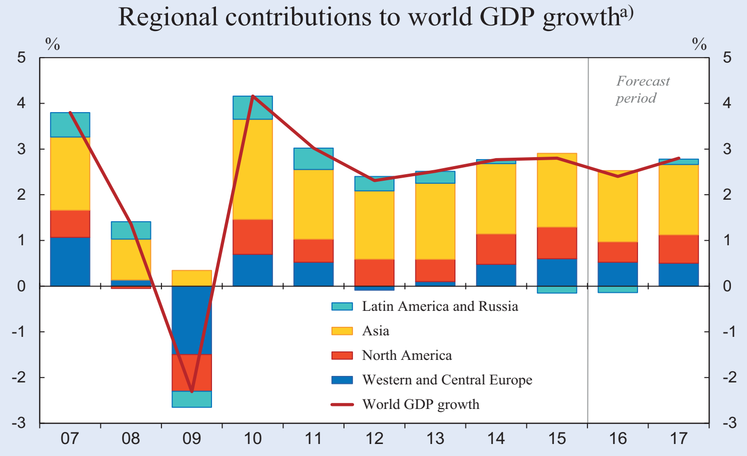
Ifo World Economic Survey

Economic expectations for the next six months



Source: Ifo World Economic Survey I/2017.

Figure 1.28



[a] Based on market weights.
Source: IMF World Economic Outlook, October 2016; EEAG calculations. 2016 and 2017: EEAG forecast.

The major economies will continue to develop heterogeneously. The US economy will continue to grow more strongly than that of the euro area and Japan respectively. In the United States, the output gap has largely closed and real GDP will grow at trend levels, or slightly above them, in the quarters ahead. The euro area economy is still characterised by the massive structural weaknesses of some member countries, as indicated by, for example, the large volume of non-performing loans on bank balance sheets in Greece, as well as in Italy and Portugal; and the lack of competitiveness of the French and Italian economies. Accordingly, the recovery will continue, albeit at a moderate pace despite the ECB's extremely accommodating monetary policy. Although monetary policy is highly expansionary and fiscal policy will be supportive until at least the second half of 2017, Japan is also only expected to expand moderately. The stimulus from monetary and fiscal policy is offset by the burden of structural factors such as a shrinking labour force, a rising old-age dependency ratio and tight immigration controls.

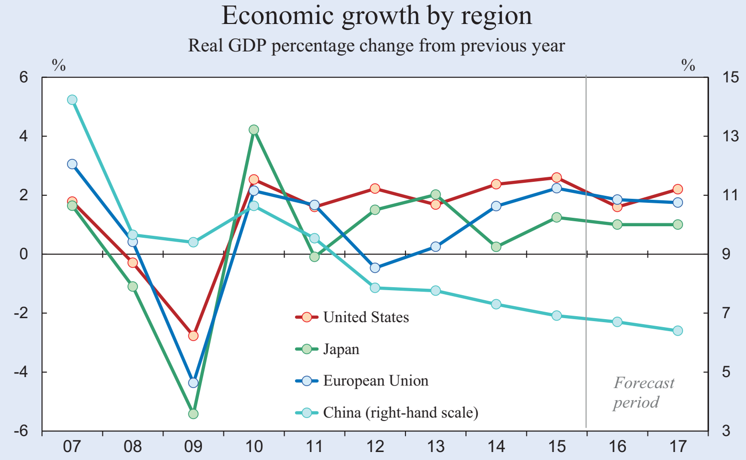
The pace of expansion in emerging markets will gradually slow down over the forecast period, although monetary policy was relaxed somewhat recently in many places. In view of the higher oil prices and the slight recovery of prices of other raw materials, Brazil and Russia will probably pull out of recession in the course of this year. India is also likely to expand rapidly. However, these positive impulses are offset by forces that are preventing a significant economic upturn. The decline in economic growth in China will probably continue. The driving forces here are the declining pool of potential employees, as well as the slowdown of capital accumulation and the gradual reduction of the macroeconomic productivity growth associated with increasing stages of development. In order to achieve its growth target of 6.5 to 7 percent per year, the Chinese economy will need to perform a balancing act between expansionary and contractionary measures. It is probable that those sectors in which a cooling emerges will be supported, while those sectors that risk overheating will be exposed to contractionary economic policy interventions. Finally, rising interest rates in the United States are likely to negatively impact financing conditions in emerging economies. Growth in these emerging markets is nevertheless twice as high as that in advanced economies.

1.4.3 United States

The US economy is likely to pick up again this year. Supported by high real wage growth and good labour market prospects, private consumption expenditure will be particularly strong. Exports are expected to generate some positive impulses. Currently, sentiment indicators point towards an increase in new export orders. On the other hand, hardly any impetus is expected from gross fixed capital formation. A slowing rise in house prices and stagnating building permits since the beginning of last year indicate weak construction activity, while the shrinking order books for investment goods indicate a continuing moderate development in equipment investment. The uncertainty about the economic policy impact of the unexpected outcome of the presidential elections last November should also have a negative impact on investment activity. For the current year, GDP is forecast to grow by 2.2 percent (see Figure 1.29).

Last year's change in consumer prices amounted to 1.2 percent and core inflation without energy and unprocessed food was 2.2 percent. The expiring base effects of earlier energy price reductions are expected to accelerate headline inflation to 1.8 percent in 2017. Rising inflation, good employment prospects and the absence of distortions in the financial markets after the presidential election should allow the US Federal Reserve to increase the federal funds rate to 1.25 percent by the end of the year.

Figure 1.29



Source: US Bureau of Economic Analysis; Eurostat; ESRI; National Bureau of Statistics of China. 2016 and 2017: EEAG forecast.

1.4.4 Asia

The economic growth target of *China* is expected to remain at the current range of between 6.5 and 7.0 percent, while monetary and fiscal policies will likely remain accommodative. Uncertainty rests on the political and thereby economic relationship between the two economically largest countries in the world, the United States and China. The newly elected US president has made several statements, like questioning the "One-China" policy that might lead to a severe cooling down of economic ties. Although China is moving away from its traditional export-led growth strategy, it remains the world's biggest trading nation along with the United States with an export share of 18 percent. The economy will moderate next year on the back of a cooling housing market and a slow, but steady domestic economic rebalancing, though the impact of these factors will be cushioned by the policy support cited above and somewhat stronger global growth.

The recent weakening of the *Japanese* yen following Donald Trump's victory in the US presidential election, together with a modest pick-up in global growth, are supporting Japanese exports and have enabled its economy to make a fairly strong start to the year. On the downside, low wage growth continues to constrain private consumption. As a result, the government is encouraging salary increases and intends to rein in social security costs to boost the country's workforce. Moreover, it has approved a supplementary budget to finance earthquake reconstruction and additional military spending. As a result of a fiscal stimulus program adopted in August last year, public investment is expected to grow temporarily. For this year a growth rate of 1.0 percent is forecast.

In *India*, after the government's announcement of plans to replace the two largest banknotes as legal tender with new notes in November last year, a cash shortage has emerged in the country, and economic momentum faltered, especially in the cash-oriented services sector. The demonetisation is likely to have caused consumers to postpone non-essential purchases. However, supported by a central bank that will continue its stability-oriented course, these effects are expected to be transient and the economy is likely to get back on track. Real GDP growth of 7.3 percent is forecast for 2017.

For the East Asian region as a whole (*South Korea, Indonesia, Taiwan, Thailand, Hong Kong, Malaysia, Singapore* and the *Philippines*) some increase in economic growth is expected. Differences across the individual countries are, however, substantial. Whereas Indonesia, Thailand and the Philippines will witness some acceleration in growth, the economies of Korea, Taiwan, Hong Kong, Malaysia and Singapore face another slight decline, initially at least. The expected pick-up in global trade, together with robust developments in China and India, will in principle support growth in all countries of this region. However, this effect is partly muted by increased global uncertainty, largely originating from a possible increase in trade protectionism triggered by the upcoming US administration and the US interest rate normalisation. The latter could trigger a downturn in the housing market of Hong Kong, for instance. Political uncertainty in South Korea, combined with highly indebted households and problems in some of Korea's flagship industries, will also prevent strong growth in the largest country within this group. On the other hand, households have benefited from low inflation and loosening monetary policy conditions in most of these countries, which will allow domestic demand to gain some steam this year. The firming up of commodity prices (in the cases of Indonesia and Malaysia) and further fiscal stimulus measures (in Indonesia, Thailand and the Philippines) will also support growth. All in all, real GDP is expected to grow by 4.2 percent in these East Asian countries this year.

1.4.5 Latin America and Russia

In 2017, the Latin American region, i.e. *Brazil, Mexico, Argentina, Venezuela, Colombia* and *Chile*, is expected to grow by 1.2 percent. Although in Brazil consumer confidence and business climate have improved significantly in recent months, the ongoing consolidation of public finances and the outflow of capital are expected to continue to dampen economic activity in the coming quarters. The largest economy of this region should nevertheless pull out of recession this year. Argentina is also expected to return to positive growth this year. Whereas Brazil and Argentina are slowly recovering, the Mexican economy has experienced a clear weakening of its growth prospects. Mexico is probably the country to be most heavily affected by any potential changes in US migration and trade policies. The fiscal impulses that the new US administration may set through tax cuts and additional infrastructure spending are not likely to fully compensate for these adverse effects. Although the recovery in oil prices is, in principle, supporting the economy of Venezuela, the country is nevertheless in a tailspin of economic, social and political chaos. Its economy has been contracting since 2014 and is not expected to grow anytime soon. In Colombia, on the other hand, the oil price recovery and the recently reached peace agreement could reignite growth by supporting tourism, oil exploration and foreign direct investment. Chile's economy is also expected to accelerate marginally in 2017.

Russia will exit its recession this year. Business survey and industrial production data signal a strengthening of economic activity this winter. The increase in commodity prices is supporting the economy. On the other hand, fiscal consolidation, which intends to drastically reduce the fiscal deficit through higher taxes on the extraction of minerals and oil, dividend distributions from state-owned enterprises and higher consumption taxes, is constraining Russia's path towards recovery. Real GDP is expected to increase by 0.8 percent in 2017.

1.4.6 The European economy

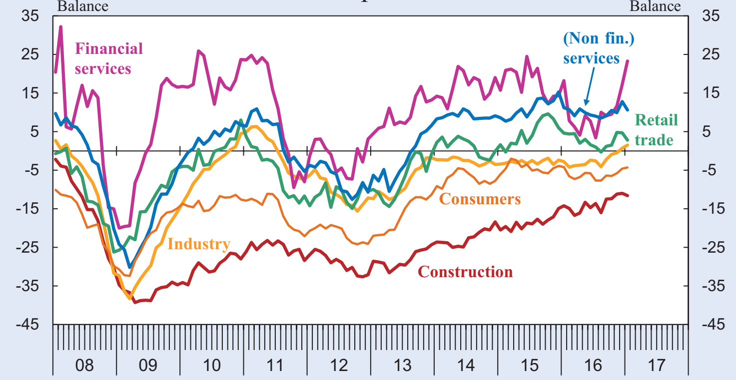
The cyclical situation

The noticeable increase in a variety of leading indicators for the euro area in recent months – after some decline in the previous months – points to some acceleration in economic momentum during the winter months (see Figure 1.30). Real GDP in the fourth quarter of 2016 and the first quarter of 2017 is expected to slightly outpace the previous two quarters. Growth rates are then expected to weaken gradually (see Figure 1.31). The positive effects of the fall in oil prices and the euro depreciation in late 2014 and early 2015 are slowly phasing out. Overall, this will result in a slight decline in the annual growth rates for both the European Union and the euro area to 1.8 and 1.6 percent respectively.

The fact that structural reforms are only being implemented slowly in some member countries speaks against a faster recovery of the European economy. Labour markets that are still characterised by high structural unemployment rates in many places, but also by the sluggish improvement in price competitiveness in some of the crisis-hit countries, are hindering stronger growth. The high level of economic policy uncertainty is also having a clearly dampening effect, as measured by an index based on newspaper articles (www.policyuncertainty.com). Last year the index stood even at a higher level than during the peak of the euro crisis in 2011. This recent rise in uncertainty is largely due to the forthcoming Brexit negotiations, the implications of the new presidency in the United

Figure 1.30

Confidence indicators[a)] for different sectors in the European Union



[a)] Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.
Source: European Commission, last accessed on 31 January 2017.

Figure 1.31

Source: Eurostat; EEAG calculations and forecast.

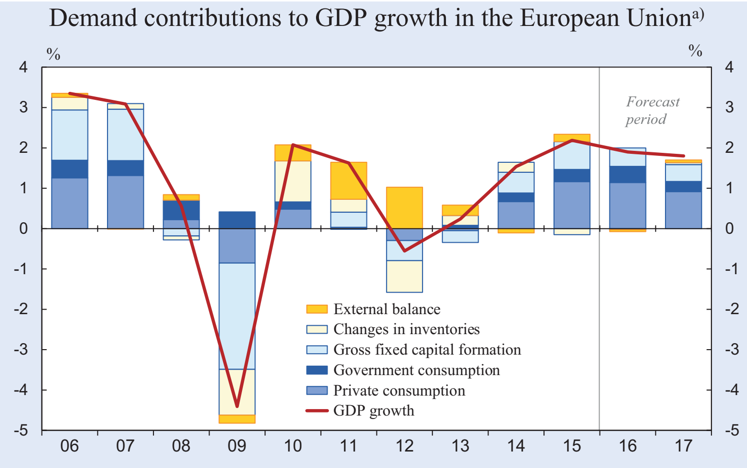
States, as well as the outcomes of a series of parliamentary elections in member states in 2017. The three largest euro area member countries, Germany, France and (perhaps) Italy, will hold elections. In the fourth largest economy, Spain, the weak minority government that has recently been installed is unlikely to complete its term, while elections are also scheduled in the Netherlands. In each case, populist and thereby Eurosceptic parties are likely to gain growing power, with unknown consequences. The lack of policy guidance from the United Kingdom and the United States complement the uncertain political prospects.

The nevertheless ongoing economic recovery is still mainly driven by developments in private consumption. The improving income situation of households and rising employment are contributing to this phenomenon. Consumption growth rates this year will nevertheless be somewhat lower than last year, because the gains in purchasing power attributed to lower energy prices will disappear. In principle, government consumption will continue to expand. However, reduced refugee flows will facilitate a decline in related government spending in some countries. This will reduce overall growth rates in government spending as compared to previous years. Gross fixed investment – as compared to previous upswings – is expected to contribute far less than normal to overall economic development. The lower than usual interest rate environment does not seem to fully compensate for the low medium-term growth prospects in a number of countries, and the high level of political and economic uncertainty that is still around. The latter are likely to deter companies from expanding investments. The forecasted global recovery and the weaker euro are allowing exports to grow slightly faster than last year. Exports to the United States in particular are likely to pick up gradually. The increase in the value of the US dollar relative to the euro in recent months makes it attractive for US firms and consumers to import goods and services from the euro area. However, since imports into the euro area are also expected to grow somewhat more strongly, the growth contribution of net exports will remain modest and significantly short of the figures in previous recoveries (see Figure 1.32).

In this upward spiral, the recovery will allow for the further creation of additional jobs (see Figure 1.33). Although employment growth will not reach the rates seen a year ago, they are still sufficient to further slowly reduce the overall unemployment rate in both the European Union and the euro area to an average of 8.3 and 9.7 percent respectively (see Figure 1.34 and Table 1.A.2).

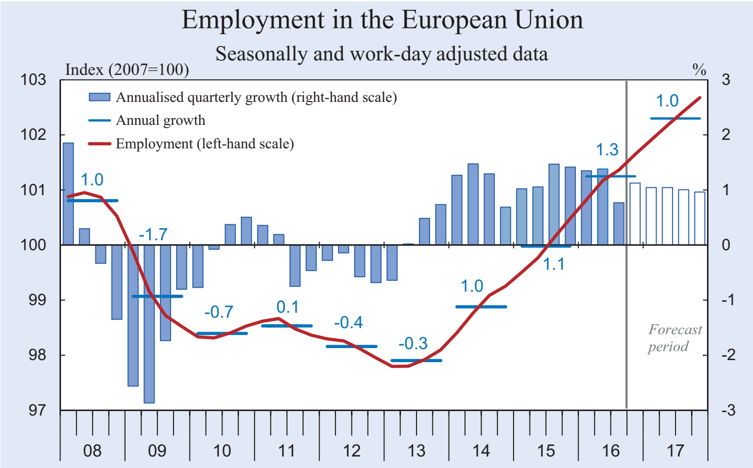
With oil prices having risen last year instead of falling as in 2015, consumer prices are expected to rise particularly during the first months of 2017. In line with the ongoing recovery that will lead to a further reduction of the output

Figure 1.32



a) Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; EEAG calculations and forecast.

Figure 1.33



Source: Eurostat; EEAG calculations and forecast.

gap during the year, core inflation will also pick up. The inflation rate should therefore gradually approach the ECB's inflation target and on average amount to 1.4 percent this year in the euro area and 1.5 percent in the European Union.

Differences across Europe

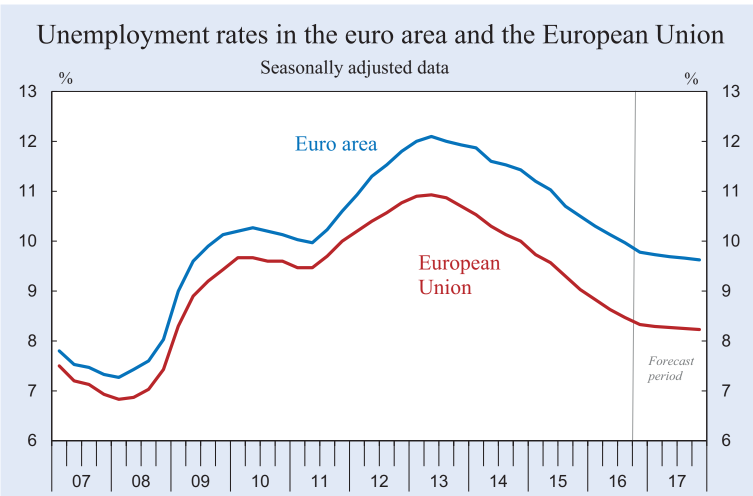
The moderate upswing in *Germany* is expected to continue this year at a similar pace as last year. It will mainly be driven by domestic demand. Private consumption growth remains strong and is supported by higher wages, increasing transfer income and increasing employment. The hitherto primarily migration-driven public consumption, however, is losing momentum as the influx of people seeking help is expected to fall and will increasingly be granted financial support instead of benefits in kind. Machinery and equipment investment will continue to expand below average as compared to previous recoveries. The main reasons for this weak performance are slow growth in developing sales prospects in many foreign markets and unusually high uncertainty over the future course of economic policy of important trading partners. Residential investment, by contrast, is still benefiting from the favourable interest rate environment and the large number of people searching for a home. Foreign trade is not expected to contribute significantly on aggregate, as exports and imports will continue to expand at similar rates. All in all, total economic output will grow by 1.8 percent in 2017 (see Figure 1.35).

Employment remains directed upward. The level of unemployment, however, will be influenced by refugees entering the labour market. The annual average 2017 unemployment rate is expected to remain at about the level of last year, i.e. 4.2 percent.

This year, domestic inflation pressure will increase. The dampening impulse from oil prices that dominated inflation dynamics last year will also disappear. Taken together, the annual average 2017 consumer price level is expected to increase by 1.6 percent after 0.3 percent last year. Average core inflation is expected to rise from 1.2 to 1.4 percent this year.

For *France*, the available indicators will point to a slight acceleration in economic momentum in the quarters ahead, not least due to improved consumer sentiment regarding the future economic situation. Consumption is therefore likely to remain the main source of growth in France. Machinery and equipment investment will overcome its temporary weakness, but there are no signs that the high growth rates of the second half of 2015 will be reached again. No impetus is to be expected from foreign trade, as the pick-up in global demand is only mar-

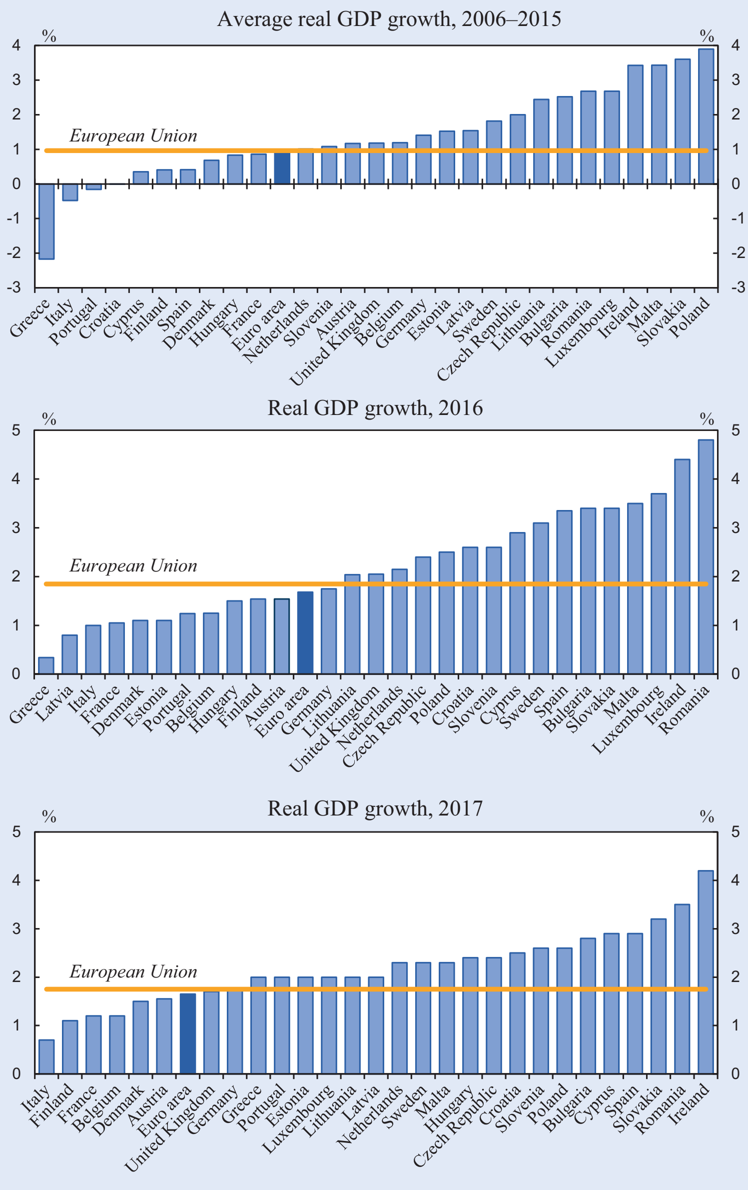
Figure 1.34



Source: Eurostat; EEAG calculations and forecast.

Figure 1.35

Economic growth in EU member countries



Source: Eurostat, last accessed on 31 January 2017. 2016 and 2017: EEAG forecast.

ginal and the French economy has last year lost part of its (previously obtained) price competitiveness again. Overall, GDP growth is projected at 1.3 percent for this year. As the output gap will only close slowly, underlying price dynamics will remain low. Due to energy prices, this year's inflation rate is expected to rise to an average of 1.3 percent.

Although the negative effects of the Brexit decision in the *United Kingdom* are far less pronounced than initially feared, companies are nevertheless likely to postpone long-term projects due to the uncertainty about the future shape of the relationship with the EU and the associated future attractiveness of the United Kingdom as a production location. Some slowdown in the manufacturing sector is already visible. In particular, the order intake for machines has declined noticeably lately and capacity utilisation has decreased. Low unemployment, however, is expected to initially keep private consumption robust. Rising inflation due to the sharp depreciation of the British pound and the rise in energy prices will, on the other hand, supress real disposable incomes. This effect will become more important over the course of the year. Devaluation does support foreign trade. Finally, the economy will continue to be supported by expansive fiscal and monetary policy this year. All in all, the effects of the referendum will be noticeable and GDP will increase by 1.7 percent, as compared to the previous year's slightly reduced rate of 2.1 percent. Inflation is expected to increase to 2.0 percent due to higher import prices.

The *Italian* economy is the main reason why the recovery in the euro area is not taking off quicker. The growth rate of real GDP in Italy is likely to be less than half as high as in the euro area as a whole. The Italian banking sector has been burdened by a high proportion of non-performing loans for several years. Some Italian banks are therefore facing enormous solvency problems and a sustainable solution is not yet in sight. The sharp increase in the Target liabilities of Italy in recent months suggests that there has recently been a massive withdrawal of capital from the Italian banking system similar to the capital flight seen in 2011 and 2012 (see EEAG, 2012, Ch. 2; and EEAG, 2013, Ch.2).

The downward trend in sentiment indicators in Italy that began last year seems to have ground to a halt. At present, most indicators are still standing just above their long-term average, suggesting a weak, but positive expansion in production. However, the political uncertainty behind the failed Constitutional referendum and Italy's lower attractiveness for investment as a result of the anticipated stagnation in reforms are having a negative impact. Real GDP is expected to grow by only 0.7 percent. The value added tax increase of two percentage points that has been postponed to January 2018 may lead to higher consumption growth towards the end of 2017 if it is not postponed again in the next budget. In the quarters ahead, economic stimulus will, however, mainly come from the recovery of the euro area.

The *Spanish* economy will continue to recover with growth rates well above the European average. However, its rate of expansion will moderate somewhat as the beneficial effects of a weak euro and low oil prices dissipate. The economy is expected to grow by 2.9 percent in 2017 and exceed the production level last seen before the financial crisis hit Spain. This strong performance will allow unemployment to continue its downward trend and reach an average rate of 18.8 percent this year.

After Ireland, Portugal and Cyprus, *Greece* will also finally pull out of its GDP trough and start growing again. After basically stagnating since 2013, the Greek economy is forecast to grow by 2.0 percent and thereby keeping pace with *Portugal*. The recovery of the economies of *Cyprus* and *Ireland* remains on an even faster track with growth rates of 2.9 and 4.2 percent respectively.

The economies in the *Central and Eastern European* region will continue to grow at about the same pace as last year. Some stimuli in foreign trade are to be expected from the ongoing recovery in the euro area and the end of the recession in Russia. Positive impulses are expected from domestic demand in all countries of the region. The decline in unemployment and still low (but rising) inflation will support consumers' purchasing power. Historically low interest rates will also continue to support investment dynamics in the region.

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Appendix 1.A
Forecasting Tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in %	GDP growth			CPI inflation			Unemploy-ment rate[d)]		
		in %						in %		
		2015	2016	2017	2015	2016	2017	2015	2016	2017
Industrialised countries:										
EU-28	27.4	2.2	1.9	1.8	0.0	0.3	1.5	9.4	8.6	8.3
Euro area	20.1	2.0	1.7	1.6	0.0	0.2	1.4	10.9	10.1	9.7
Switzerland	1.0	0.8	1.3	1.6	– 1.1	– 0.4	0.3	3.2	3.3	3.1
Norway	0.7	1.6	0.6	1.2	2.2	3.5	2.3	4.4	4.8	4.8
Western and Central Europe	29.1	2.1	1.8	1.7	0.0	0.3	1.5	9.2	8.4	8.1
US	25.7	2.6	1.6	2.2	0.1	1.2	1.8	5.3	4.9	4.8
Japan	6.8	1.2	1.0	1.0	0.5	– 0.4	0.3	3.4	3.1	2.8
Canada	2.6	0.9	1.3	2.1	1.6	1.7	2.0	6.9	7.0	6.7
Industrialised countries (total)	**64.3**	**2.2**	**1.6**	**1.9**	**0.2**	**0.7**	**1.5**	**7.0**	**6.4**	**6.2**
Newly industrialised countries:										
Russia	3.0	– 3.7	– 0.5	0.8	12.9	6.0	5.0	.	.	.
China	15.3	6.9	6.7	6.4	1.5	2.0	2.2	.	.	.
India	3.0	7.3	7.4	7.3	4.9	5.1	5.0	.	.	.
East Asia[a)]	6.6	3.9	3.7	4.2	2.5	2.0	2.6	.	.	.
Latin America[b)]	7.8	– 0.5	– 1.6	1.2	16.2	34.8	30.2	.	.	.
Newly industrialised countries (total)	**35.7**	**3.9**	**3.8**	**4.5**	**6.1**	**9.8**	**8.9**	.	.	
Total[c)]	**100.0**	**2.8**	**2.4**	**2.8**	.	.	.	.	.	.
World trade, volume		2.0	0.8	1.8	.	.	.	.	.	.

[a)] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2014 levels of GDP in US dollars. – [b)] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, Chile. Weighted with the 2013 level of GDP in US dollars. – [c)] Weighted average of the listed groups of countries. – [d)] Standardized unemployment rate.

Source: EU, OECD, IMF, ILO, National Statistical Offices, CPB, 2016 and 2017: forecasts by the EEAG.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth[a)] in %			Inflation[b)] in %			Unemployment rate[c)] in %		
		2015	2016	2017	2015	2016	2017	2015	2016	2017
Germany	20.8	1.7	1.8	1.8	0.1	0.3	1.6	4.6	4.2	4.2
France	15.6	1.3	1.1	1.2	0.1	0.3	1.3	10.4	10.0	9.6
Italy	12.0	0.7	1.0	0.7	0.1	– 0.1	1.0	11.9	11.6	11.1
Spain	7.8	3.2	3.3	2.9	– 0.6	– 0.4	1.3	22.1	19.8	18.8
Netherlands	4.8	2.0	2.1	2.3	0.2	0.1	1.4	6.9	6.0	5.4
Belgium	2.9	1.5	1.2	1.2	0.6	1.7	2.1	8.5	8.0	7.7
Austria	2.4	1.0	1.5	1.6	0.8	1.0	1.9	5.7	6.0	5.8
Finland	1.5	0.2	1.5	1.1	– 0.2	0.4	1.1	9.4	8.9	8.5
Greece	1.3	– 0.2	0.3	2.0	– 1.1	0.0	0.5	24.9	23.5	22.9
Ireland	1.3	26.3	4.3	4.2	0.0	– 0.2	0.9	9.4	7.9	7.3
Portugal	1.3	1.6	1.3	2.0	0.5	0.6	1.1	12.6	11.2	10.6
Slovakia	0.5	3.8	3.4	3.2	– 0.3	– 0.5	0.9	11.5	9.7	9.1
Slovenia	0.3	2.3	2.6	2.6	– 0.8	– 0.1	1.3	9.0	7.9	7.6
Luxembourg	0.3	3.5	3.8	2.0	0.1	0.0	1.0	6.5	6.3	5.6
Lithuania	0.3	1.8	2.3	2.2	– 0.7	0.6	1.6	9.1	8.0	7.6
Latvia	0.2	2.7	0.8	2.0	0.2	0.0	1.6	9.9	9.7	9.5
Cyprus	0.1	1.7	2.8	2.9	– 1.5	– 1.2	0.2	15.0	13.3	12.9
Estonia	0.1	1.4	1.0	2.0	0.1	0.7	2.0	6.2	6.9	7.2
Malta	0.1	7.4	3.5	2.3	1.2	0.9	1.2	5.4	4.9	4.7
Euro area[d)]	73.5	**2.0**	**1.7**	**1.6**	**0.0**	**0.2**	**1.4**	**10.9**	**10.1**	**9.7**
United Kingdom	14.9	2.2	2.1	1.7	0.0	0.6	2.0	5.3	4.9	4.9
Sweden	3.2	4.1	3.1	2.3	0.7	1.1	2.0	7.4	6.9	6.4
Denmark	1.9	1.6	1.1	1.5	0.2	0.0	0.9	6.2	6.2	6.3
EU-22[d)]	93.5	**2.1**	**1.8**	**1.7**	**0.0**	**0.3**	**1.5**	**9.8**	**9.1**	**8.8**
Poland	2.9	3.9	2.5	2.6	– 0.7	– 0.2	1.2	7.5	6.3	5.8
Czech Rpublic	1.2	4.5	2.4	2.4	0.3	0.6	1.4	5.1	4.0	3.9
Romania	1.1	3.9	4.8	3.5	– 0.4	– 1.1	0.9	6.8	6.0	5.6
Hungary	0.7	3.1	1.5	2.4	0.1	0.4	1.7	6.8	5.1	4.7
Croatia	0.3	1.6	2.6	2.5	– 0.3	– 0.8	1.1	16.3	12.7	12.0
Bulgaria	0.3	3.6	3.4	2.8	– 1.1	– 1.3	0.7	9.2	7.6	7.1
New Members[e)]	7.9	**3.6**	**2.7**	**2.7**	**– 0.4**	**– 0.2**	**1.2**	**7.8**	**6.6**	**6.2**
EU-28[d)]	100.0	**2.2**	**1.9**	**1.8**	**0.0**	**0.3**	**1.5**	**9.4**	**8.6**	**8.3**

[a)] GDP growth rates are based on the calender adjusted series except for Ireland, Slovakia and Romania for which EUROSTAT does not provide working-day adjusted GDP series. – [b)] Harmonised consumer price index (HICP). – [c)] Standardised unemployment rate. – [d)] Weighted average of the listed countries. – [e)] Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria.

Source: EUROSTAT, 2016 and 2017: forecasts by the EEAG.

Table 1.A.3

Key forecast figures for the European Union

	2015	2016	2017
	Percentage change over previous year		
Real gross domestic product	2.2	1.9	1.8
Private consumption	2.1	2.1	1.6
Government consumption	1.4	1.9	1.2
Gross fixed capital formation	3.5	2.3	2.1
Exports of goods and services	6.2	2.7	3.7
Imports of goods and services	6.2	3.4	4.0
Net exports[a)]	0.2	0.0	0.1
Consumer prices[b)]	0.0	0.3	1.5
	Percentage of nominal gross domestic product		
Government fiscal balance[c)]	– 2.4	– 2.0	– 1.7
	Percentage of labour force		
Unemployment rate[d)]	9.4	8.6	8.3

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2016 and 2017: forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat; 2016 and 2017: forecasts by the EEAG.

Table 1.A.4

Key forecast figures for the euro area

	2015	2016	2017
	Percentage change over previous year		
Real gross domestic product	2.0	1.7	1.6
Private consumption	1.8	1.7	1.4
Government consumption	1.4	1.9	1.2
Gross fixed capital formation	3.2	2.9	2.8
Exports of goods and services	6.5	2.4	3.5
Imports of goods and services	6.4	3.1	4.1
Net exports[a)]	0.3	– 0.1	0.0
Consumer prices[b)]	0.0	0.2	1.4
	Percentage of nominal gross domestic product		
Government fiscal balance[c)]	– 2.1	– 1.8	– 1.5
	Percentage of labour force		
Unemployment rate[d)]	10.9	10.1	9.7

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2016 and 2017: forecasts of the European Commission. – [d)] Standardised unemployment rate.

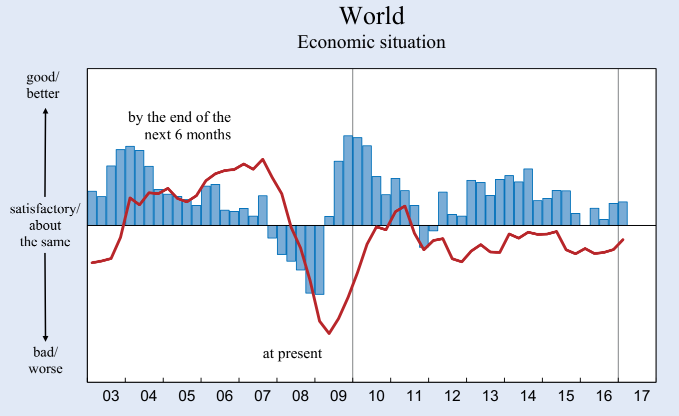
Source: Eurostat; 2016 and 2017 forecasts by the EEAG.

Appendix 1.B
Ifo World Economic Survey (WES)

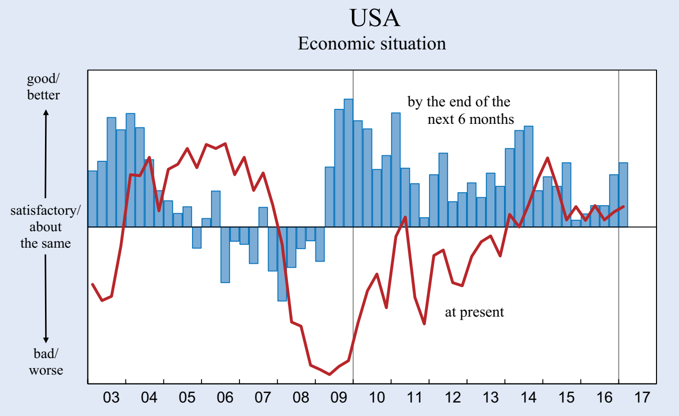
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organisations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2017, 1,147 economic experts in 118 countries were polled.

The survey questionnaire focuses on qualitative information: on assessment of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The "grading" procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

Ifo World Economic Survey (WES)



Source: Ifo World Economic Survey (WES) I/2017.



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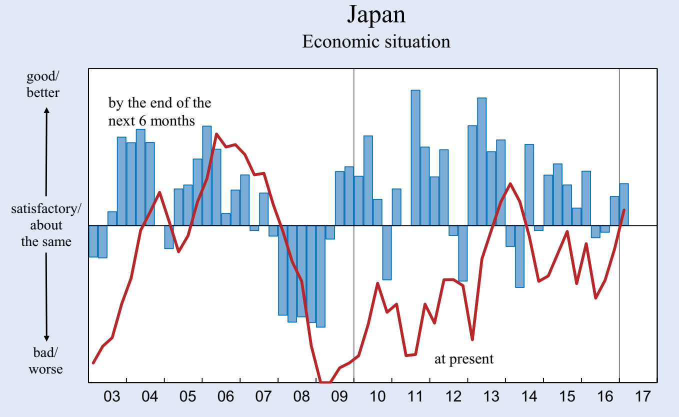

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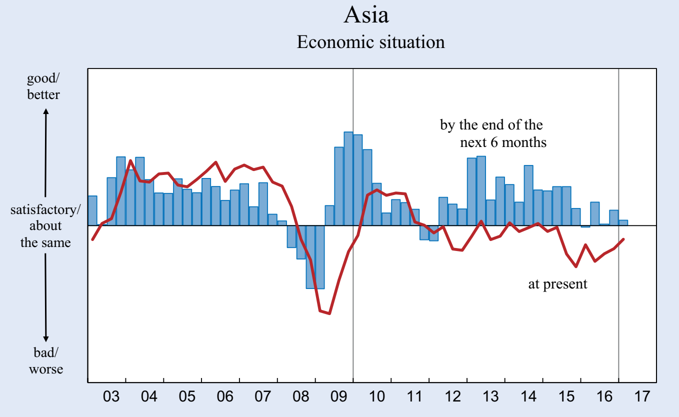

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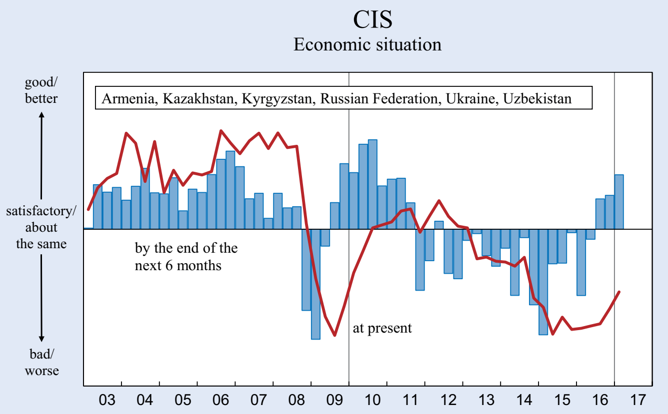

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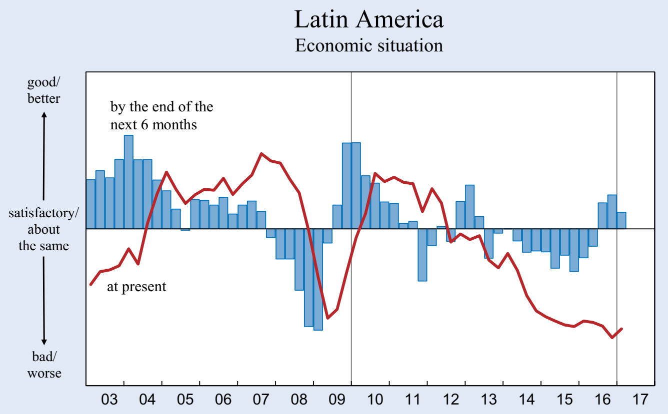

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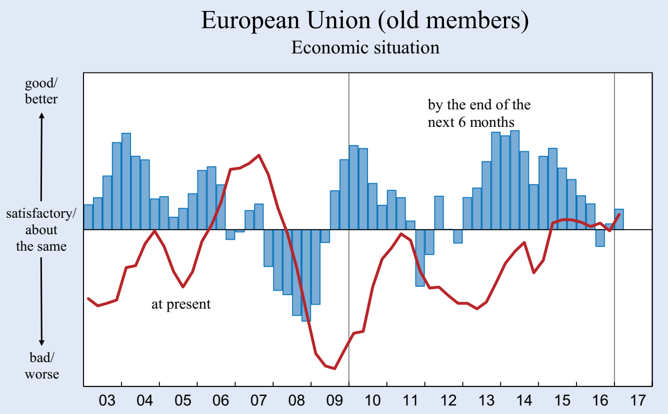

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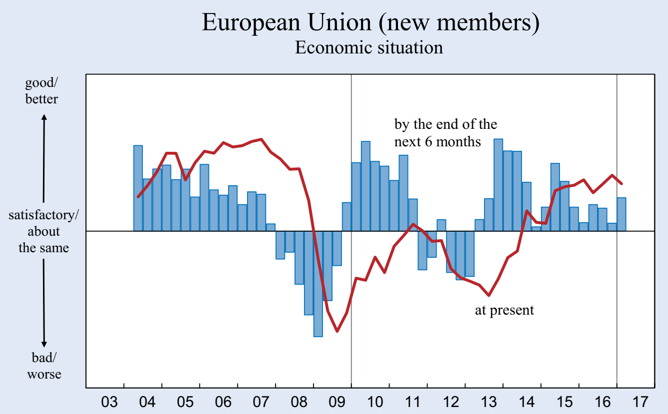
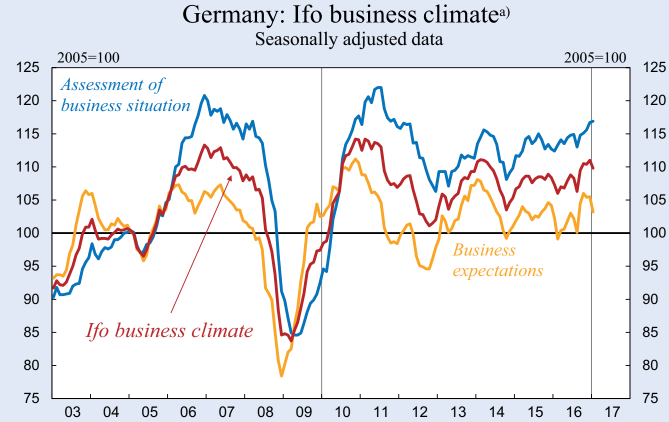
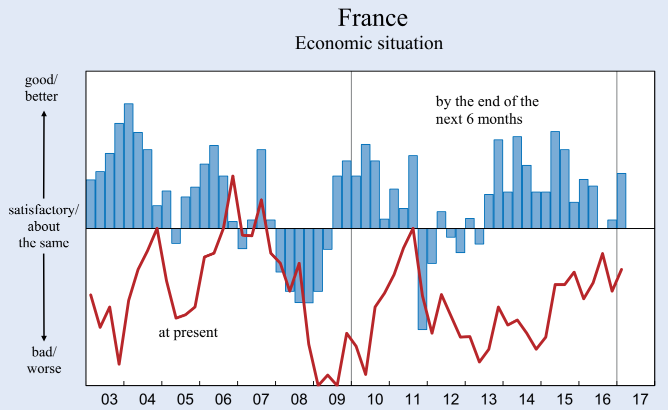


Source: Ifo World Economic Survey (WES) I/2017.



[a)] Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2017.



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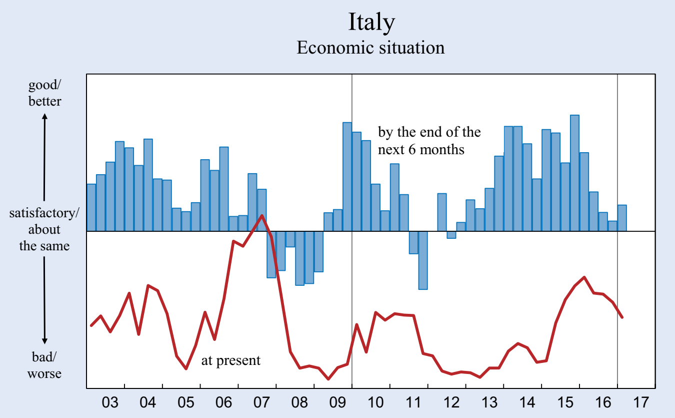

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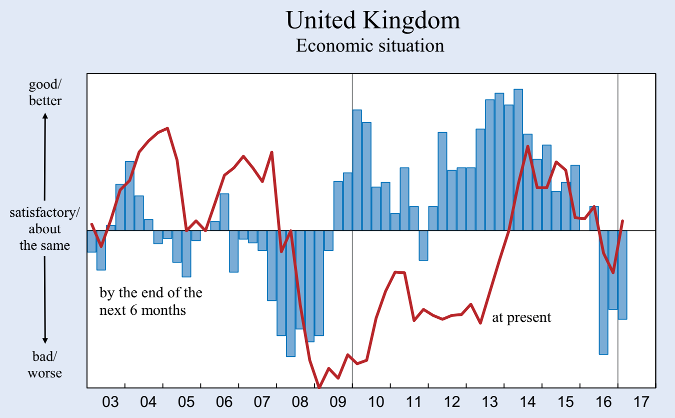

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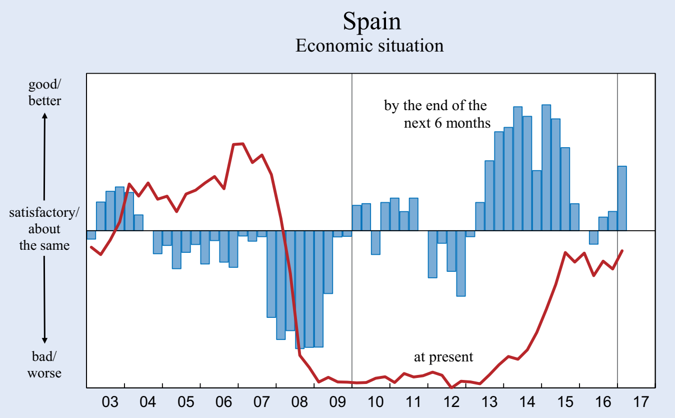

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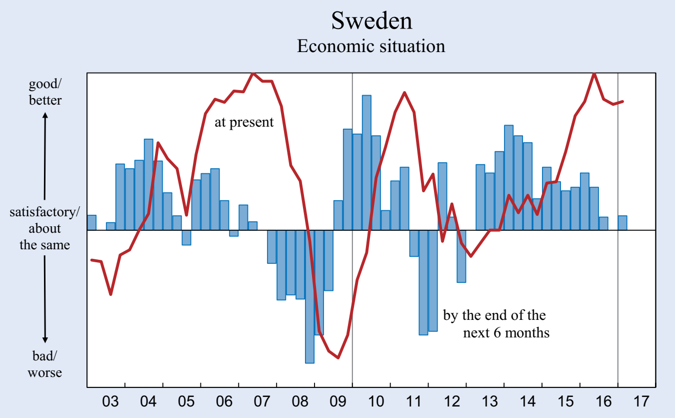

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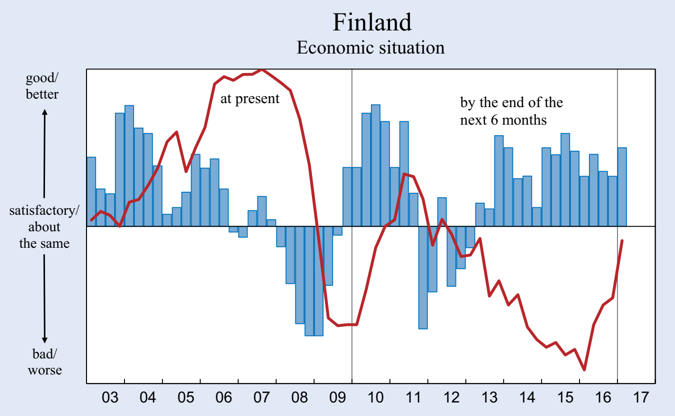

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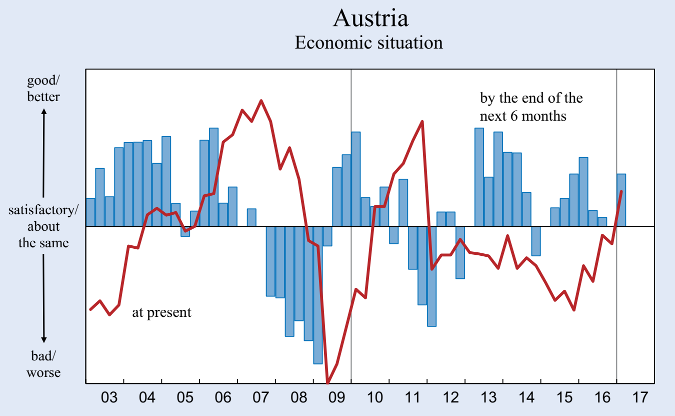
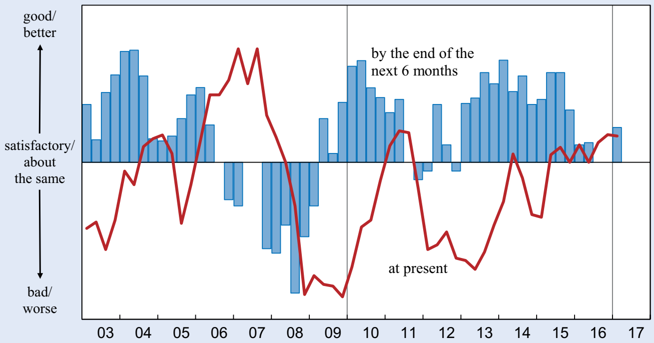


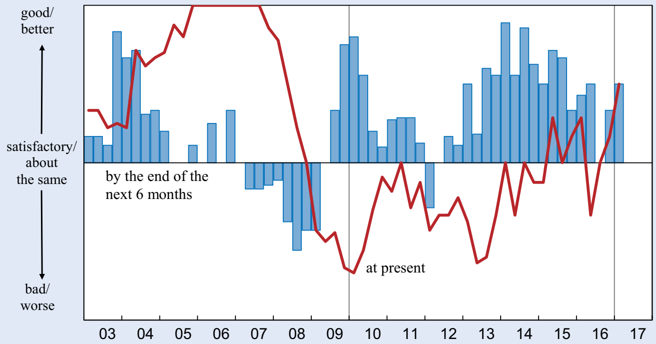
Source: Ifo World Economic Survey (WES) I/2017.

Belgium
Economic situation



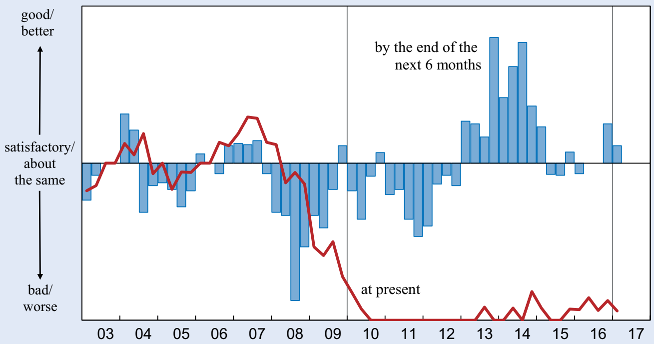
Source: Ifo World Economic Survey (WES) I/2017.

Denmark
Economic situation



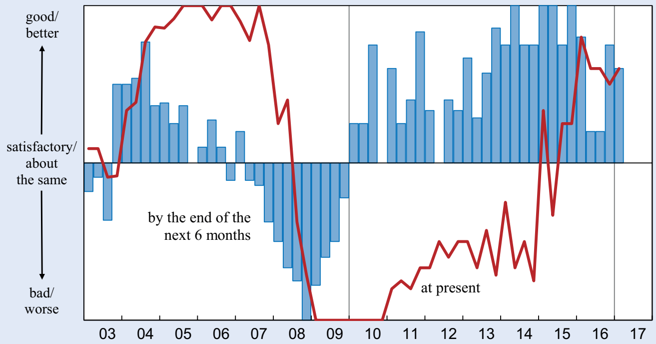
Source: Ifo World Economic Survey (WES) I/2017.

Greece
Economic situation



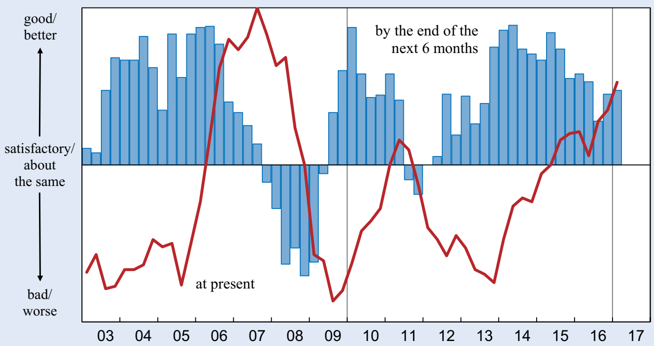
Source: Ifo World Economic Survey (WES) I/2017.

Ireland
Economic situation



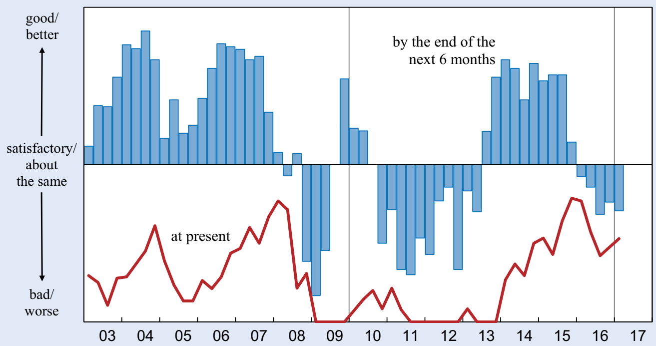
Source: Ifo World Economic Survey (WES) I/2017.

Netherlands
Economic situation



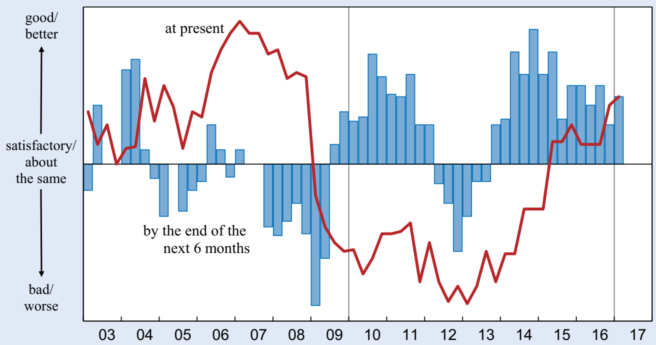
Source: Ifo World Economic Survey (WES) I/2017.

Portugal
Economic situation



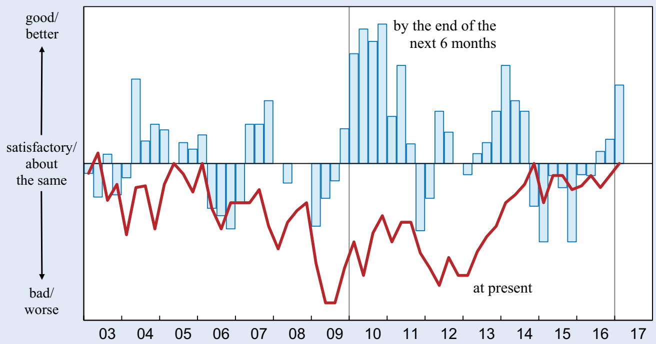
Source: Ifo World Economic Survey (WES) I/2017.

Slovenia
Economic situation



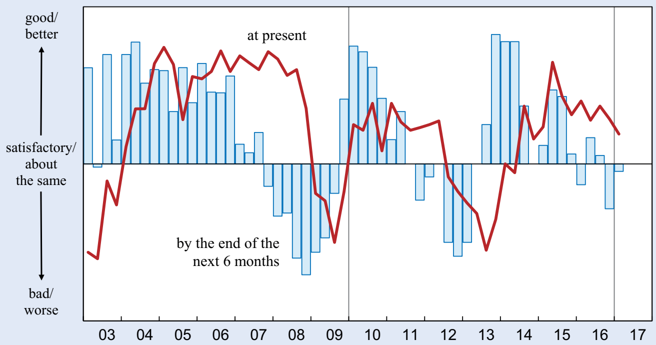
Source: Ifo World Economic Survey (WES) I/2017.

Hungary
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.

Poland
Economic situation



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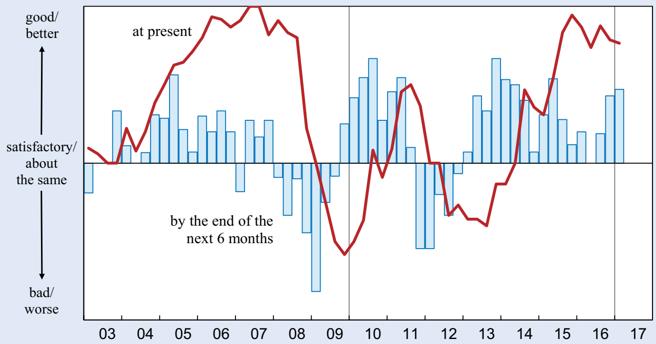
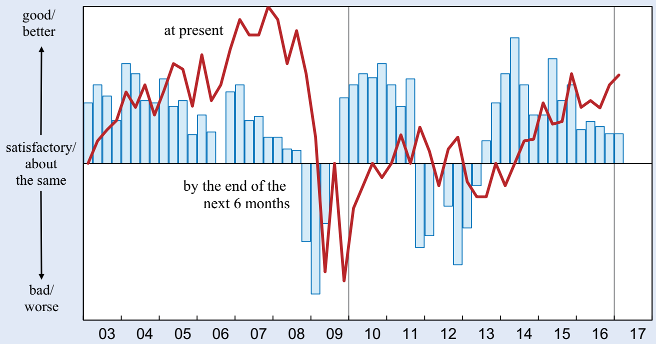
Czech Republic
Economic situation



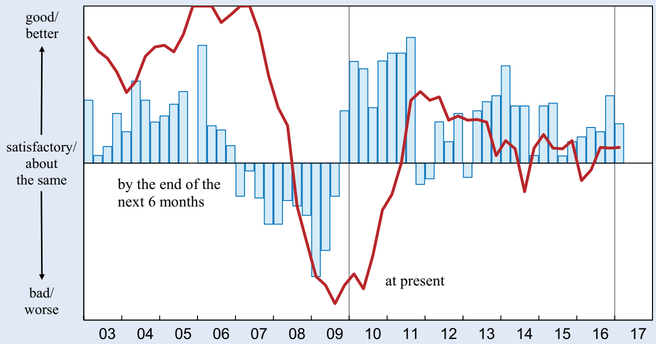
Source: Ifo World Economic Survey (WES) I/2017.

Slovakia
Economic situation



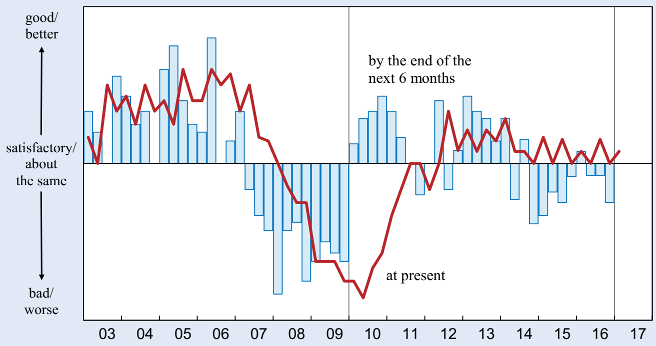
Source: Ifo World Economic Survey (WES) I/2017.

Estonia
Economic situation



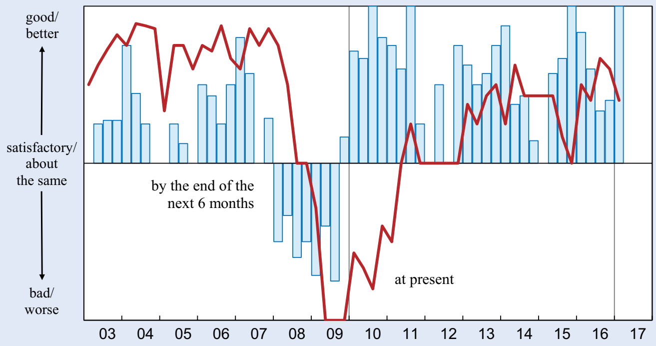
Source: Ifo World Economic Survey (WES) I/2017.

Latvia
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.

Lithuania
Economic situation



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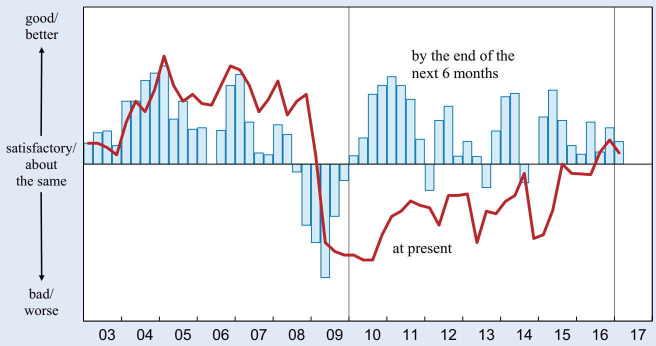
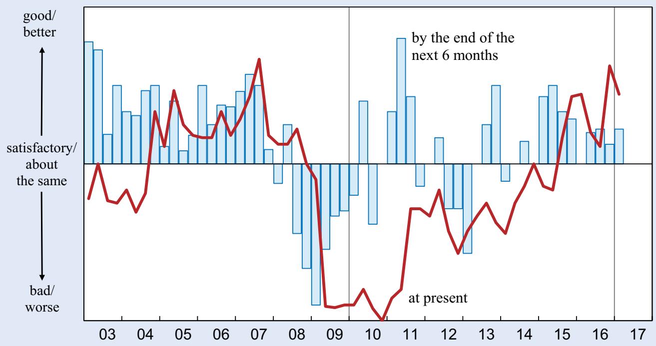
Bulgaria
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.

Romania
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.