OVERVIEW: WEATHERING NEW CHALLENGES

A mild recovery in the euro area surrounded by risks

Moderate recovery continues amid heightened risks

The European economy remains supported by a number of positive factors such as oil prices, euro's exchange rate and financing costs which have stimulated exports and private consumption. Investment, however, remains hampered by economic and policy uncertainty and in some countries, excessive debt. Now, as it enters its fourth year of recovery, the European economy is facing headwinds and substantial risks from the slowdown in emerging economies. Economic growth strong enough to reduce unemployment substantially has so far failed to materialise and evidence of a reinvigoration of investment, which is crucial for the sustainability of the recovery, remains limited.

Tailwinds should support economic activity for longer…

The euro area's economic recovery remains moderate despite the substantial support from these positive factors that are now likely to be somewhat stronger and longer lasting than previously expected. In particular, driven mainly by abundant supply, the oil price has slipped again and is now assumed to remain markedly lower and to rebound later than in the autumn forecast. While this should support a further increase in the purchasing power of euro area households, it is also likely to delay the rebound of inflation from its current very low level and to put additional financial pressure on commodity-exporting countries. Fiscal policy in the euro area is becoming slightly more supportive to growth, largely due to government expenditures associated with the inflow of asylum seekers in some Member States. The

Table 1:

Overview - the winter 2016 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
Belgium	1.3	1.3	1.7	0.6	1.4	1.7	8.3	8.0	7.4	1.6	2.1	2.5	-2.9	-2.8	-2.4
Germany	1.7	1.8	1.8	0.1	0.5	1.5	4.8	4.9	5.2	8.8	8.6	8.3	0.5	0.1	0.0
Estonia	0.9	2.1	2.3	0.1	1.0	2.5	6.3	6.3	7.5	1.9	1.6	0.3	0.3	0.2	0.1
Ireland	6.9	4.5	3.5	0.0	0.6	1.4	9.4	8.5	7.8	3.6	3.7	3.1	-1.8	-1.3	-0.8
Greece	0.0	-0.7	2.7	-1.1	0.5	0.8	25.1	24.0	22.8	-1.8	-1.4	-0.9	-7.6	-3.4	-2.1
Spain	3.2	2.8	2.5	-0.6	0.1	1.5	22.3	20.4	18.9	1.5	1.4	1.3	-4.8	-3.6	-2.6
France	1.1	1.3	1.7	0.1	0.6	1.3	10.5	10.5	10.3	-1.4	-1.5	-2.0	-3.7	-3.4	-3.2
Italy	0.8	1.4	1.3	0.1	0.3	1.8	11.9	11.4	11.3	2.2	2.1	2.1	-2.6	-2.5	-1.5
Cyprus	1.4	1.5	2.0	-1.6	0.2	1.3	15.5	14.5	13.2	-4.8	-4.9	-5.3	-1.0	0.1	0.4
Latvia	2.7	3.1	3.2	0.2	0.4	2.0	9.9	9.2	8.6	-1.9	-2.0	-2.2	-1.3	-1.0	-1.0
Lithuania	1.6	2.9	3.4	-0.7	-0.1	2.1	9.0	8.0	7.2	-1.1	0.2	0.0	-0.9	-1.2	-0.4
Luxembourg	4.7	3.8	4.4	0.1	0.4	2.4	6.1	6.0	6.0	4.8	4.9	4.2	0.2	0.5	0.5
Malta	4.9	3.9	3.4	1.2	1.7	2.1	5.4	5.4	5.4	4.3	5.9	6.5	-1.6	-1.1	-1.0
Netherlands	2.0	2.1	2.3	0.2	0.9	1.5	6.9	6.6	6.4	10.4	9.9	9.4	-2.2	-1.8	-1.5
Austria	0.7	1.7	1.6	0.8	0.9	1.8	6.0	6.2	6.4	3.3	3.5	3.6	-1.6	-1.7	-1.7
Portugal	1.5	1.6	1.8	0.5	0.7	1.1	12.6	11.7	10.8	0.7	1.1	1.1	-4.2	-3.4	-3.5
Slovenia	2.5	1.8	2.3	-0.8	-0.3	1.1	9.1	8.8	8.4	6.9	7.2	6.9	-2.9	-2.4	-1.9
Slovakia	3.5	3.2	3.4	-0.3	0.3	1.7	11.5	10.3	9.3	0.3	-2.2	-2.2	-2.7	-2.1	-1.7
Finland	0.0	0.5	0.9	-0.2	0.1	1.5	9.5	9.4	9.3	0.0	0.4	0.7	-3.2	-2.8	-2.5
Euro area	**1.6**	**1.7**	**1.9**	**0.0**	**0.5**	**1.5**	**11.0**	**10.5**	**10.2**	**3.7**	**3.6**	**3.4**	**-2.2**	**-1.9**	**-1.6**
Bulgaria	2.2	1.5	2.0	-1.1	-0.1	0.9	10.1	9.4	8.8	1.9	2.2	2.8	-2.5	-2.3	-2.0
Czech Republic	4.5	2.3	2.7	0.3	0.4	1.4	5.1	4.8	4.7	-2.4	-2.0	-1.9	-1.6	-1.1	-1.0
Denmark	1.2	1.7	1.9	0.2	0.9	1.7	6.0	5.8	5.6	7.1	7.3	7.2	-2.0	-2.7	-1.9
Croatia	1.8	2.1	2.1	-0.3	0.3	1.6	16.2	15.1	13.8	4.2	3.1	3.2	-4.2	-3.9	-3.2
Hungary	2.7	2.1	2.5	0.1	1.7	2.5	6.7	6.0	5.2	5.0	5.6	6.3	-2.1	-2.0	-1.9
Poland	3.5	3.5	3.5	-0.7	0.6	1.7	7.5	7.0	6.5	-0.2	-0.7	-1.4	-3.0	-2.8	-3.4
Romania	3.6	4.2	3.7	-0.4	-0.2	2.5	6.7	6.6	6.5	-1.0	-2.1	-2.9	-1.1	-3.0	-3.8
Sweden	3.6	3.2	2.9	0.7	1.1	1.4	7.4	6.9	6.7	5.4	5.3	5.3	-1.0	-1.1	-1.2
United Kingdom	2.3	2.1	2.1	0.0	0.8	1.6	5.2	5.0	4.9	-5.0	-4.7	-4.3	-4.4	-3.1	-2.1
EU	**1.9**	**1.9**	**2.0**	**0.0**	**0.5**	**1.6**	**9.5**	**9.0**	**8.7**	**2.1**	**2.1**	**2.0**	**-2.5**	**-2.2**	**-1.8**
USA	2.5	2.7	2.6	0.1	1.2	2.2	5.3	4.8	4.7	-3.3	-3.1	-3.2	-4.2	-4.3	-4.4
Japan	0.7	1.1	0.5	0.8	0.8	1.8	3.4	3.3	3.3	2.7	3.4	3.7	-5.1	-4.2	-3.6
China	6.9	6.5	6.2	:	:	:	:	:	:	:	:	:	:	:	:
World	**3.0**	**3.3**	**3.5**	:	:	:	:	:	:	:	:	:	:	:	:

external value of the euro has somewhat fallen over the last months, especially against the US dollar, which should be helpful for euro area exporters. Additionaly, measures taken by the European Central Bank in December mean that financing costs in the euro area should remain low for a longer period of time than earlier expected. Meanwhile, the boost from these factors is increasingly being offset by a worsening global environment, and some legacy issues from the crisis (mainly high levels of policy uncertainty, debt and unemployment) continue to weigh on growth.

…but growth is expected to increase only gradually amid headwinds and legacies of the crisis.

GDP in the euro area is forecast to accelerate slightly from 1.6% in 2015 to 1.7% this year, which is a notch lower than forecast in the autumn. Once global economic activity starts to rebound, positive effects should be felt later in 2016 and 2017. Also, some of the structural reforms implemented in Member States should continue to have a positive impact on growth. As legacies of the crisis recede, consumption and investment should benefit. Although debt levels remain high in some parts of the economy, easy financing conditions should limit acute deleveraging pressures. Overall, euro area GDP growth should pick up further to 1.9% in 2017.

Global GDP growth in 2015 is set to have been at its weakest since 2009…

The outlook for global GDP growth has again deteriorated and risks have increased considerably, mainly due to the intensified downturn in emerging markets. Global economic growth outside the EU is expected to have slowed from 3.7% in 2014 to 3.2% in 2015. It is now forecast to recover gradually to 3.6% in 2016 and 3.8% in 2017; lower than expected in the autumn.

Developments in China have so far been broadly consistent with a ‘rebalancing’ scenario, since policy stimulus, combined with buoyant private consumption and services, have so far counterbalanced the recessionary developments in sectors where unsustainable expansion had led to the build-up of major imbalances. Turmoil in China’s still relatively under-developed financial markets should in principle trigger only limited spillovers to the real economy, but as an accommodative monetary policy stance is expected to remain in place, pressure on capital flows and the renminbi will persist. The relatively smooth structural adjustment assumed over the forecast horizon is consistent with a gradual recovery of trade and a slowing in Chinese GDP growth from 6.9% in 2015 to 6.2% in 2017, as forecast in the autumn, but this is subject to major and increasing risks.

…and prospects for emerging economies have worsened…

Growth prospects for most commodity-exporting regions have worsened as prices of a wide range of commodities remain depressed. In many regions, this negative terms-of-trade shock has interacted with net capital outflows and considerably tighter financial conditions. This is due partly to the US Federal Reserve’s decision to raise interest rates but also to a combination of looming fiscal and political problems, geopolitical instability, and supply-side constraints. Even though a gradual normalisation of US monetary policy without any serious upheavals is assumed, the financial environment in most emerging and developing economies looks likely to become more challenging. Growth prospects have deteriorated sharply for Russia and Brazil as well as for countries in the Middle East, Northern Africa and Sub-Saharan Africa. All in all, the downturn in emerging markets is still expected to have bottomed out in 2015, but the forthcoming recovery is set to be more subdued and drawn-out than forecast in the autumn and surrounded by heightened risks.

…while advanced economies are relatively resilient…

The outlook for advanced economies has only marginally weakened since the autumn. Throughout the forecast horizon, advanced economies appear relatively immune and are likely to benefit from the gradual recovery of trade in China, though many commodity exporters remain vulnerable to the renewed wave of commodity price declines. Economic momentum in the US has remained robust and GDP growth is expected to be around 2.5% over the forecast horizon amid a maturing cycle, with more support from fiscal policy, but continued headwinds from the strong dollar and the gradual normalisation of monetary policy. In Japan, as expected, growth should pick up again this year before slowing in 2017, mainly as a result of a planned consumption tax hike.

…and world trade is expected to gradually recover.

Available data for 2015 suggest that global trade volumes, and in particular non-EU trade, grew at their slowest pace since 2009, as the slowdown in Chinese trade and commodity-exporting regions (e.g. CIS, MENA) quickly spilled over to other emerging markets. Imports globally (excluding the EU) are expected to recover somewhat more slowly than in the autumn from 0.8% in 2015 to 2.9% and 3.7% in 2016 and 2017, as global activity picks up and China's demand for services imports remains strong amid its rebalancing towards consumption. Further support should also come from the continued recovery in advanced economies including the EU. These developments should in turn underpin an acceleration of euro area export markets.

Volatility has increased in financial markets ….

Increasing concerns about growth prospects in emerging economies have triggered bouts of volatility in global financial markets in recent months. In Europe, asset prices declined substantially at the start of the year given the uncertainty about how the growth outlook would be impacted by a further weakening of economic activity in China and other emerging markets.

…as well as monetary policy divergence…

Monetary policy divergence between central banks increased at the end of 2015. On one side, the ECB and the Bank of Japan decided to further ease their monetary policy given subdued inflationary pressures, while on the other side, the US Federal Reserve raised its target range for the federal funds rate for the first time since June 2006. This divergence of monetary policy stances has contributed to a weakening of the euro vis-à-vis the US dollar since the autumn. Signals from the Fed point to a faster tightening pace over 2016 and 2017 than financial markets had expected, while the ECB has signalled its intention to maintain an appropriate degree of monetary accommodation and its readiness to loosen policy further, if needed, over the course of the year.

…while financial conditions are set to remain favourable for longer.

The combination of quantitative easing and credit easing by the ECB has successfully kept financing costs and yields at low levels and thereby helped to reduce financial fragmentation and differences among Member States. The euro area lending cycle to both households and non-financial corporates (NFCs) is now in positive territory, suggesting that transmission of accommodative monetary policies to the real economy has improved. Surveys point to further improvements in the availability of bank lending and a loosening of funding constraints to euro area SMEs. As funding on capital markets has continued to increase, the cycle of external corporate funding is picking up, although it remains weak compared with previous cycles, mirroring low investment demand and the still-intensive use of internal funds by NFCs. This suggests that the corporate deleveraging process is still ongoing. Since bank lending and market funding cycles are expected to accelerate this year, both external and internal funds should be more easily accessible to finance a rise in investment.

The recovery is widespread across Member States…

2015 is expected to go down as the first year since the crisis in which no Member State reported a decrease in output. But substantial growth differences persist, reflecting both structural features and different cyclical positions. For example, differences in terms of openness to trade and the geographical orientation of trading relationships, as well as the pass-through of lower oil prices, could make a significant difference under current conditions. In 2016, Member States should continue moving along a recovery path, including Greece, where growth is set to pick up again in the course of the year. In 2017 economic activity should be on the rise in all Member States.

…mainly driven by steady consumption growth…

As expected, private consumption was supported last year by the rise in real gross disposable incomes attributable to the fall in headline inflation and improved labour market conditions. A further acceleration is foreseen this year, and private consumption should continue to be the main growth driver, supported by the expected acceleration in real disposable income driven by low oil prices. Rising wages and salaries, thanks to higher employment, somewhat stronger increases in profit and property-related incomes, as well as higher transfers to households, should further support this steady growth of consumption, although households are also expected to increase their saving rate slightly this year. In 2017, however, private consumption growth will likely slow down since household real disposable income growth is expected to lose some momentum due to the forecast rise in inflation.

…and some positive surprises from public consumption…

Government consumption in 2015 now looks likely to have been more supportive to growth than expected in the autumn, since security measures and refugee-related expenditures in some countries are set to have led to additional fiscal expenditures. Public consumption growth is projected to slow marginally in 2016 and 2017 but spending projections associated with the arrival of large numbers of migrants fleeing insecurity remain difficult to ascertain.

…although investment has so far failed to rebound…

Investment has so far failed to emerge as a strong driver of the ongoing recovery as it has been held back by the slowdown in growth momentum outside the EU and the high level of economic and policy uncertainty. Investment levels at the moment also appear to be not very sensitive to changes in financing conditions. But, investment is expected to gradually pick up in the near term as demand increases, capacity utilisation rates rise and profit margins improve thanks to lower energy prices and funding costs. Investment in equipment should rise on the back of higher demand and modernisation needs and should also gradually benefit from the expected rebound in global growth and the fading of deleveraging pressures. The Investment Plan for Europe should also start to have a positive impact on public and private investment. Construction investment, meanwhile, is expected to benefit from rising real disposable incomes and very low mortgage rates. High levels of household debt in some Member States, however, will continue to prevent a stronger increase in construction investment in 2016 but this should be a softer constraint in 2017.

…and net exports are not expected to support growth in the short term…

The deterioration in the external environment started to have a visible impact on euro area exports in the second half of 2015, offsetting the positive impact of the euro's depreciation. But thanks to improved price competitiveness, which is largely the result of the euro's past depreciation and the decline in relative unit labour costs, and because foreign demand is expected to strengthen; export growth should accelerate over the course of 2016 in line with growth in export markets. However, the annual rate of growth of euro

area exports of goods and services looks set to be less than it was last year, largely as a result of the low carry-over from the second half of 2015. Imports, meanwhile, are expected to mirror developments in exports due to the high import content of many export goods and because of the growth in domestic demand. As a result, net exports are expected to have a negative impact on GDP growth in 2016 that should turn neutral in 2017.

…while the external surplus of the euro area is set to remain elevated…

In 2015, the strong increase in the current account surplus of the euro area reflected a combination of falling import prices, a depreciation of the exchange rate and subdued domestic demand. While remaining at historically high levels, the euro area's current account surplus, measured as a percentage of GDP, is expected to slightly recede in 2016 and 2017, as domestic demand is forecast to continue expanding and external demand is expected to rebound more slowly. Additionally, the assumed increase in oil prices should lead to a small deterioration in the terms of trade in 2017. The rebalancing within the euro area that has been observable over the last few years is likely to slow, mainly due to a weakening export performance in some of the former deficit countries.

…and lower oil prices drive inflation down this year.

With energy prices falling sharply, inflation in the euro area struggled to rise much above zero towards the end of 2015. Core inflation also remained below expectations and is now forecast to take longer to pick-up in tandem with increased domestic demand. This persistent weakness reflects the fact that the euro area continues to operate at below potential and that wage developments remain subdued. Even though the output gap is projected to continue closing over the forecast horizon and wages are expected to grow stronger, the remaining output gap will continue to dampen the responsiveness of inflation to increases in domestic demand. The forecast for inflation in 2016 has therefore been revised lower to 0.5%. With the assumed path of commodity prices, inflation should remain very low in the first half of the year before stepping up in the second half when positive base effects come to dominate. In 2017, inflation is expected to reach 1.5% as a result of the impact of higher real wages and domestic demand, and a moderate assumed increase in oil prices.

The fiscal stance is expected to become more supportive to the recovery in the euro area...

The general government deficit is expected to continue declining over the forecast horizon, albeit at a somewhat slower pace than in recent years due to the fiscal expenditures associated with the arrival of asylum-seekers in a few countries and to fiscal policy measures adopted by some Member States to lower the tax wedge on labour. The operation of automatic stabilisers and, to a lesser extent, the lower interest expenditure, underpin the projected deficit reduction. In 2015, the general government deficit in the euro area is expected to have declined to 2.2% of GDP and is set to decrease further to 1.9% and 1.6% in 2016 and 2017 respectively. The estimated structural balance has remained broadly stable in 2015, while the euro area's fiscal stance is expected to be slightly expansionary in 2016. Next year, under a no-policy-change assumption, the structural balance is projected to remain broadly stable in both the euro area and the EU. The debt-to-GDP ratio of the euro area is forecast to decline from its peak of 94.5% in 2014 to 91.3% in 2017.

…and labour markets continue to recover…

The improvement in labour market conditions continues with the moderate economic recovery underpinning a modest rise in employment growth. Overall, employment is expected to have risen by 1.1% in the euro area in 2015 and is projected to continue at about the same speed this year and next on the back of strengthening economic activity, improved business

confidence and higher capital accumulation. Higher labour market flexibility and moderate wage increases are also expected to contribute to employment growth. The labour force is forecast to pick up more strongly than previously expected in the euro area, largely driven by higher participation rates as a result of improved economic and labour market conditions, the fading of discouragement effects, and net migration flows. Unemployment rates are then set to continue their gradual decline over the next two years but at a slower pace than last year. The unemployment rate in the euro area is projected to fall from 11% in 2015 to 10.5% in 2016 and 10.2% in 2017. Unemployment is expected to decrease in almost all euro area countries this year and next, especially in countries that have benefitted from recently-implemented labour market reforms (e.g. Spain, Portugal, Cyprus, Ireland).

…but the outlook is subject to increased external and domestic risks.

The economic outlook for the euro area remains highly uncertain and overall risks are clearly tilted to the downside. Risks to the growth outlook from the global economy and global financial markets have clearly increased, in particular due to the slowing growth in China and other emerging markets, which could trigger stronger spillovers than envisaged or which could become worse than forecast. Combined with the uncertainty regarding the adjustment in China, the continuation of monetary policy normalisation in the US could have a more negative impact on vulnerable emerging market economies, especially those with high levels of foreign currency-denominated debt, and could also affect the stability of financial markets. The materialisation of any of these downside risks would result in negative spillovers to the Member States via various transmission channels.

Uncertainty around the technical projection for the oil price remains high due to geopolitical tensions, the removal of sanctions against Iran and the response of oil producers with break-even costs above current spot prices. While a faster-than-assumed rebound in energy prices would hurt economic activity in Europe, a further sharp fall in commodity prices could also impact negatively on its growth outlook as it could affect the financial stability of oil-exporting countries. This would not only lower European exports but could also trigger turmoil in financial markets. Geopolitical tensions are also keeping uncertainty at high levels and could become a larger impediment to investment spending than currently expected.

In Europe, domestic risks have also increased lately. Any unexpected relapse into crisis in Greece could weigh more heavily on investment decisions and thus on economic growth. Moreover, if major political challenges were not successfully coped with at the EU level (e.g. handling of migration flows), that could trigger developments that become impediments to growth.

Still, the combination of tailwinds from low commodity prices, low financing costs, and the euro's depreciation could be stronger than expected or translate into stronger economic growth momentum than currently envisaged.