

Boysen-Hogrefe, Jens; Fiedler, Salomon; Groll, Dominik; Kooths, Stefan;
Stolzenburg, Ulrich

Article

Euro Area: Improved Outlook in Spite of Uncertainties

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Euro Area: Improved Outlook in Spite of Uncertainties

Jens Boysen-Hogrefe, Salomon Fiedler, Dominik Groll, Stefan Kooths and Ulrich Stolzenburg

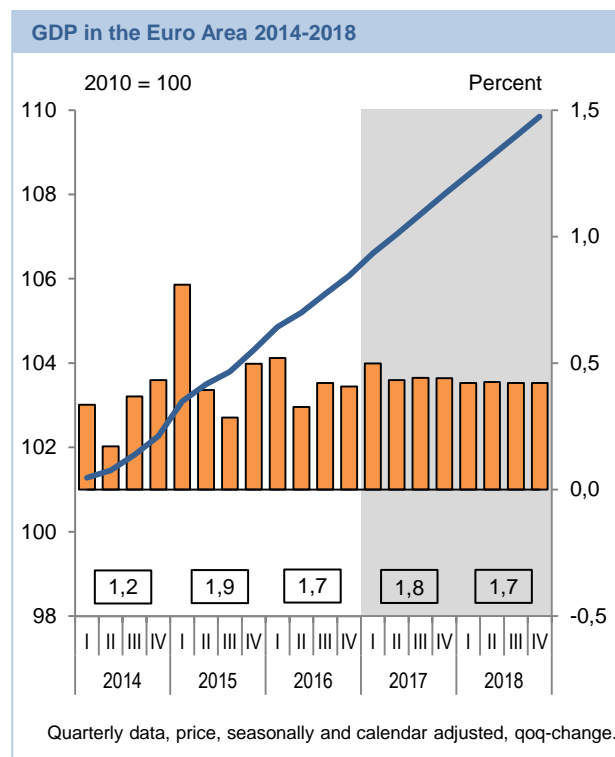
The economic recovery in the euro area remains moderate. While several sentiment indicators have improved considerably over the past few months, and therefore suggest that the recovery might gain some momentum, this has not yet been reflected in hard data, in particular not in the quarterly GDP growth rate in the fourth quarter of 2016. So far, there is a lack of striking evidence for a sustained acceleration of the recently recorded moderate pace of economic recovery. Meanwhile, political uncertainty will remain elevated over the forecast horizon due to upcoming elections in four out of five of the biggest member states, negotiations with the United Kingdom on terms and conditions for leaving the EU, and possible changes in trade policies triggered by the new US government. Nevertheless, the euro area economy is set to continue its recovery – unemployment continues to decline, numerous early activity indicators point upwards, fiscal policy is expected to be mildly expansionary over the forecast horizon, and the recovery is continuously supported by low interest rates and the low external value of the euro.

➤ **We expect the euro area economy to broadly maintain the current speed of expansion in the following years.** GDP is expected to rise by 1.8 percent (2017) and 1.7 percent (2018). For the euro area excluding Germany we forecast a GDP growth rate of 1.7 percent (2017) and 1.6 percent (2018).

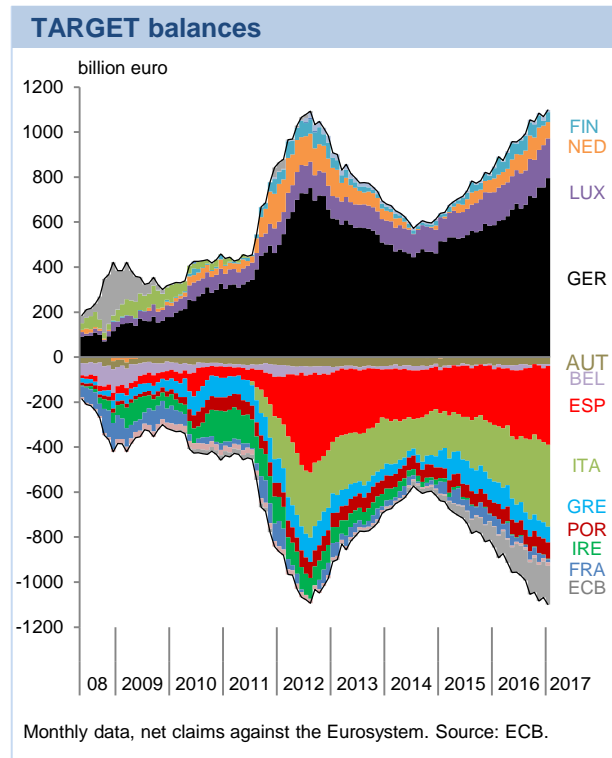
➤ **Headline inflation has recently jumped to a level of 2 per cent, but is expected to revert to about 1.5 per cent over the course of this year.** Prices for energy and unprocessed food are currently much higher than one year ago, which drives the recent increase of headline inflation. The core rate, however, which excludes effects from these more volatile price components, remained at 0.9 per cent. Provided that energy prices remain fairly stable over the forecast horizon, their recent effect will vanish soon, while the core rate gradually increases due to the continued recovery and possible second-round effects. For 2017 and 2018, we expect annual inflation rates of 1.5 percent and 1.4 percent.

➤ **Labor market conditions are expected to improve further.** Supported by the economic recovery and moderate growth in labor costs, the unemployment rate continues to decline, from currently 9.6 percent to an annual average of 8.7 percent in 2018.

➤ **Fiscal policy is expected to be mildly expansionary over the forecast horizon.** The expected decline of the structural primary balance is particularly pronounced in Italy. The Spanish and French governments are expected to maintain a broadly neutral fiscal policy stance. However, future fiscal policy depends to some extent on the results of upcoming elections. Over the forecast horizon, the total budget deficit for the euro area average is expected to improve from 1.6 per cent in 2016 to 1.4 per cent in 2017 and 2018. The expected improvement in budget deficits is mainly driven by declining interest rate payments and the economic recovery rather than consolidation efforts.



➤ **The asset purchasing program of the European Central Bank has been accompanied by an increase of the Target imbalances to a new all-time high.** There are different reasons for this development: First, those who sell bonds to the Eurosystem are not evenly distributed among member states, but are connected to the Eurosystem overproportionately via the Deutsche Bundesbank. Once liquidity is transferred to these bond holders, the German Target surplus increases. Second, there may still be a different risk perception for national financial systems. To the extent that those who sell assets consider their money safer in core countries, they transfer deposits to these countries. Third, the excessive provision of central bank liquidity does not promote interbank market transactions by which liquidity is transferred from banking systems with excess liquidity to others with a lack of liquidity. Such interbank credit relations would contribute to a reduction of target imbalances. (see Box: „Neues Allzeithoch bei Target-Salden“).



➤ **Quantitative Easing is accompanied by growing risks.** There are different channels along which the asset purchasing program of the ECB can take effect: The signalling channel, the portfolio-balance-channel and the exchange-rate channel. Empirically, QE appears to affect financial market variables such as bond prices and yields. Effects on variables like GDP and inflation are less obvious. Meanwhile, QE is accompanied by a number of side effects and increasing risks. Necessary adjustments in the financial sector and political reforms are probably delayed, as the period of low interest rates defers default and temporarily relieves pressure from public finances. Furthermore, artificially low interest rates for a prolonged period of time give increasingly rise to distortions in the production structure of the economy. Finally, additional risks may accumulate as banks are inclined to engage in excessive maturity transformation (see box: “Quantitative Lockerung”).

Key Economic Data for the Euro Area, 2015–2018

	2015	2016	2017	2018
Real GDP ^a	1.9	1.7	1.8	1.7
without Germany ^a	2.1	1.7	1.7	1.6
Consumer prices (HICP) ^b	0.0	0.2	1.5	1.4
Unemployment rate ^c	10.9	10.0	9.3	8.7
Budget balance ^d	-2.1	-1.6	-1.4	-1.4

^aChange of price- and calendar adjusted GDP in percent. — ^bChange over previous year in percent. — ^cIn percent of labor force. — ^dPercent of nominal GDP. — Shaded: IfW forecast.

Prof. Dr. Stefan Kooths

Phone: +49 (0) 30-2067-9664 (Office Berlin)

Phone: +49 (0) 431-8814-579 (Office Kiel)

stefan.kooths@ifw-kiel.de

Dr. Ulrich Stolzenburg

Phone.: +49 (0) 431-8814-605

ulrich.stolzenburg@ifw-kiel.de