# Economic outlook for the euro area

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# ECONOMIC OUTLOOK FOR THE EURO AREA

While a Grexit was avoided in the summer 2015, the same was not true for a Brexit, as on 23 June 2016 British voters chose to leave the EU. This should, however, be a slow process since the United Kingdom and the European Union have a period of two years following notification by the British government of its decision to implement Article 50 of the Treaty on the European Union to come to an agreement specifying the conditions for withdrawal. This is triggering a new political crisis in Europe that will have long-term implications, as the agreement will redefine not only trade relations between the EU and UK but also the conditions governing the movement of people.

In the short term, this raises the question of how the Brexit decision will affect growth not only in the UK but also in the rest of the euro area, especially as this impact will hit even as the wounds from the crisis have yet to heal. Unemployment in the euro area remains well above its level recorded before the Great Recession. Despite the numerous measures taken by the ECB, inflation is low and has not returned to the 2% target. The recovery that began in 2014 and gathered momentum in 2015 could be undermined, especially if the factors that initiated it gradually diminish.

While an end to the recovery should be avoided, the growth in the euro area will nevertheless slow down from 1.9% in 2015 to 1.3% in 2018. In these conditions, the trend to reduce imbalances should weaken, with unemployment falling slowly and inflation remaining below the 2% target until 2018. Furthermore, the fact that the recovery is losing steam raises questions about the potential sources of growth in the euro area. Eight years after the crisis struck, the euro area is plagued by multiple sources of uncertainty that might well be at the origin of a lack of investment.

Table 3. **Growth performance of EU countries**

| | 2016 | 2017 | 2018 | 2016 Revisions | 2017 Revisions |
|---|---|---|---|---|---|
| **DEU** | 1.9 | 1.3 | 1.4 | -0.1 | -0.5 |
| **FRA** | 1.4 | 1.5 | 1.5 | -0.4 | -0.5 |
| **ITA** | 0.8 | 0.8 | 0.5 | -0.8 | -0.4 |
| **ESP** | 3.1 | 2.1 | 1.8 | -0.3 | -0.9 |
| **NLD** | 1.7 | 1.7 | 1.6 | 0.0 | -0.1 |
| **BEL** | 1.3 | 1.4 | 1.1 | -0.2 | 0.0 |
| **FIN** | 0.8 | 1.2 | 1.8 | -0.2 | -0.3 |
| **AUT** | 1.7 | 1.5 | 1.5 | 0.1 | -0.3 |
| **PRT** | 0.9 | 1.1 | 1.4 | -0.9 | -0.7 |
| **GRC** | -0.4 | 0.7 | 1.2 | -0.3 | -1.1 |
| **IRL** | 2.3 | 2.9 | 2.4 | -1.4 | -0.7 |
| **EA** | 1.6 | 1.4 | 1.3 | -0.4 | -0.5 |
| **GBR** | 2.0 | 1.0 | 1.4 | 0.0 | -0.8 |
| **SWE** | 3.5 | 2.6 | 2.2 | 0.6 | -0.1 |
| **DNK** | 0.9 | 1.3 | 2.0 | -1.1 | -0.7 |
| **EU 15** | 1.7 | 1.4 | 1.4 | -0.3 | -0.5 |
| **New member states** | 3.2 | 3.1 | 3.0 | 0.0 | -0.1 |
| **EU 28** | 1.9 | 1.6 | 1.6 | -0.2 | -0.4 |

*Sources:* IMF, OECD, national sources, iAGS forecasts, October 2016.

## 1.1. Factors less favourable to growth

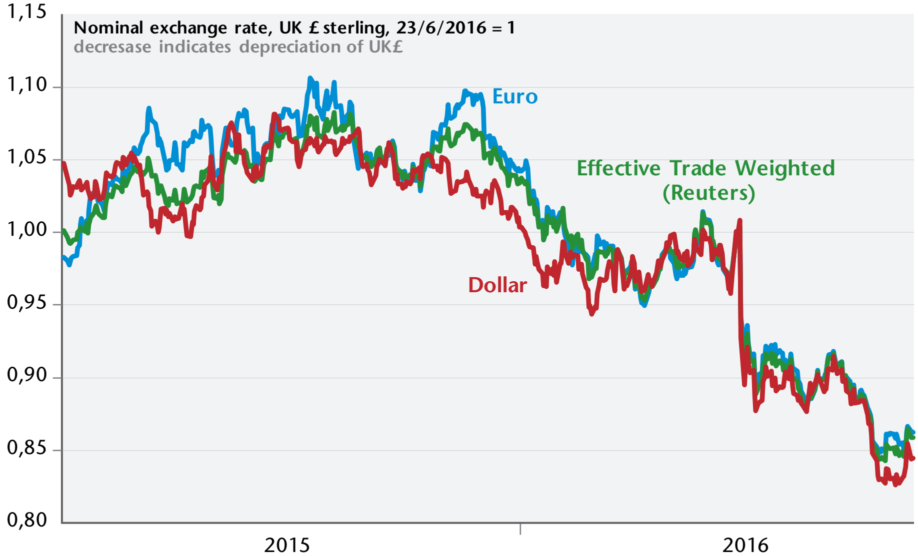
The year 2015 was marked by an acceleration of growth in the euro area, with GDP rising by 1.9% (Table 3). Several external factors have combined to initiate a process of recovery that finally pointed towards a significant reduction in unemployment and the start of a virtuous cycle of growth. Brexit is likely to hit UK growth. As for the rest of the euro area, the contagion effects will be negative, but limited. But what is happening most of all is that the various winds that have pushed ahead growth might be faltering.

### a) Brexit: contagion to the euro area would be limited …

The UK's withdrawal from the EU should be a lengthy process. The Brexit announcement will however affect short-term growth. Indeed, the pound depreciated as soon as the results of the vote came in. Between June and early

October 2016, the pound fell about 15% against the euro, and more than 17% against the dollar (Figure 8). This is the first vector through which Brexit will affect activity and inflation. This depreciation will on the one hand be favourable to the United Kingdom's foreign trade but will on the other lead to more imported inflation, thereby reducing the purchasing power of British households and thus their consumption. Moreover, the current situation is also marked by great uncertainty about the outcome of the negotiations.[1] This uncertainty could dampen investment in the UK, as firms adopt a wait-and-see position on decisions to invest or hire, which will put the brakes on production and employment.

Figure 8. **British pound exchange rate**



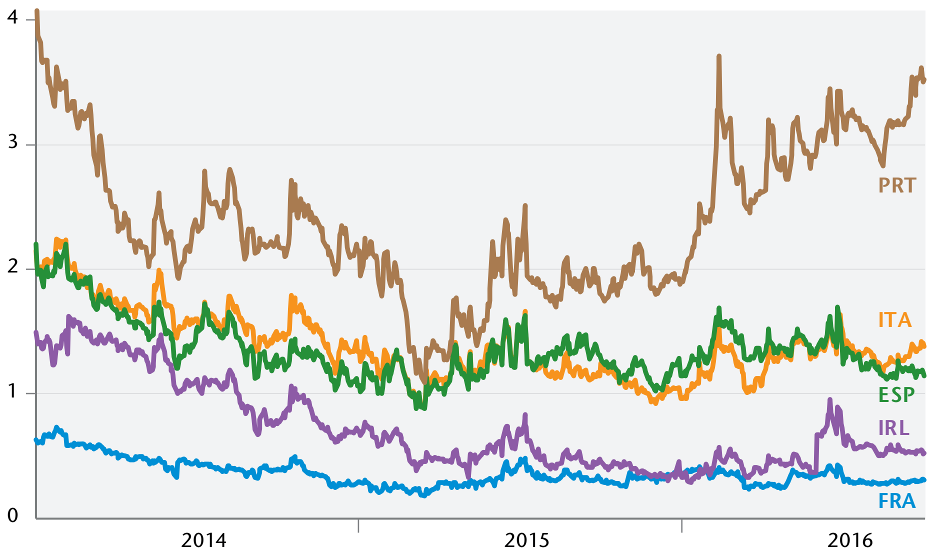

*Source:* Datastream.

Contrary to what had been feared, there has, up to now, not been a large-scale financial shock. The London Stock Exchange and the euro area stock market indices have remained buoyant. Nevertheless, the period of negotiations that is now underway will be accompanied by numerous declarations that heighten market volatility. As for interest rates, the expected increase in sovereign risk

1. Recall that even though recent studies suggest that uncertainty shocks have a significant impact on growth, measuring and quantifying this is still difficult. See Bloom (2009 and 2016).

has not materialized.[2] Government bond rates in the United Kingdom even fell after the vote. In the euro area, some long-term rates rose in the so-called peripheral countries, particularly Portugal (Figure 9). This is due, however, more to these countries' internal context. Only the rise seen in Ireland at the time of the vote might suggest that the markets expect greater contagion effects in this small and very open economy which is more exposed than other euro area countries to the UK's growth. In Spain and Italy, volatility seems to have increase after the results of the came in but no significant increase. The rise in sovereign yields for Italy during the summer would mainly be related to the risks in the Italian banking sector. Consequently, it seems for the moment that the risk of an exit from the euro area union has not become more likely.

Figure 9. **Interest rate spreads in the euro area**




*Source:* Datastream.

Finally, the UK economy will be hit the hardest, with growth halving between 2016 and 2017 (Table 3). In the rest of the euro area countries, growth will be amputated by at most 0.1 point, due to the relative appreciation of the euro and reduced British imports.

2. See Kierzenkowski *et al.* (2016).

## b) … but the winds propelling growth are faltering

While Brexit's impact should a priori be moderate, other factors that had especially promoted growth in 2015 will see their impact fade gradually from 2016. Oil prices will rise again, and while the depreciation of the euro relative to the dollar should continue, this will not be on the same scale as in 2014-2015, and it will be partly offset by a higher rate against the pound. Moreover, demand for euro area products will grow more slowly over the 2016-2018 period than between 2012 and 2015. Only fiscal policy will on average be propping up growth in the euro area, while it will continue to weigh down the British economy.

## c) The rebalancing of supply and demand for oil is pushing its price up again

The fall in oil prices that began in autumn 2014 continued until early 2016. The price of a barrel dropped from over USD 100 to below USD 50 in August 2015. A floor was reached in the first quarter of 2016 with a barrel at USD 34. The price is now rising, and supply and demand should reach equilibrium in 2017. We expect oil prices to stabilize between USD 50 and 60 in 2017 and 2018, as the record levels of stocks will limit the rise in prices. The fact remains that oil's boost for growth since mid-2005 will fade gradually from late 2016. In the four big European countries, the positive impact that oil had on GDP, about 0.5 point in 2015, will decline to 0.3 point in 2016, then 0 in 2017, and it will be slightly negative in 2018 (-0.1). The rise in oil prices will result in higher inflation and therefore a reduction in household purchasing power and business margins.

## d) Exchange rates: less depreciation for the euro but more for the pound

The anticipated divergence between the monetary policies pursued by the US Federal Reserve and by the ECB has led to the euro's depreciation against the dollar since mid-2014, with the level falling from slightly under 1.40 euros per dollar and fluctuating since early 2015 around 1.10. The Federal Reserve will continue its gradual normalization of monetary policy, while the ECB is not likely to raise rates before the end of 2018. In addition, it is continuing to provide strong support for the economy with the implementation of negative rates[3] and the continuation of securities purchases to the tune of 80 billion

3. See Blot and Hubert (2016).

euros. The euro-dollar exchange rate should drop a bit more, from 1.12 in early October 2016 to 1.05 in the second quarter of 2017, representing a 6.25% depreciation, while between March 2014 and October 2016 it depreciated by more than 19%. On the one hand, the impact of the divergence in monetary policy between the two areas has to a great extent already been taken on board by the markets in the exchange rate level. On the other hand, the euro area's current account surplus and the contrasting current account deficit of the United States are forces that tend instead to push the euro upwards. Ultimately, most of the expected depreciation of the euro has therefore already taken place, and further shifts will boost growth less in 2017-2018 than in 2015-2016. These effects will also be increasingly offset by the euro's relative appreciation against the pound. Conversely, while the pound's appreciation from mid-2013 to late 2015 cut the UK's growth by 0.1 point on average in 2014 and in 2015, the recent depreciation will help to cushion the impact of Brexit.

### e) Fiscal policy: a few pockets of resistance to ending austerity

After the phase of synchronized fiscal consolidation between 2011 and 2014 that held back growth in the euro area, fiscal policy was slightly expansionary in the zone in 2015 and remains it in 2016. Fiscal policy will become neutral 2017 and will once again cut average growth in the euro area in 2018. This assessment is consensual among ECFIN, the IMF and the OECD[4] (Table 4).

Table 4. **EA Aggregate Fiscal Stance (change in structural balance)**

**As % of potential GDP**

| | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|
| **iAGS** | -0.1 | -0.2 | 0.0 | 0.2 |
| **ECFIN, November 2016** | 0.1 | -0.2 | -0.1 | 0.0 |
| **IMF, October 2016** | 0.2 | -0.3 | 0.0 | — |
| **OECD, June 2016** | 0.1 | -0.2 | -0.1 | — |

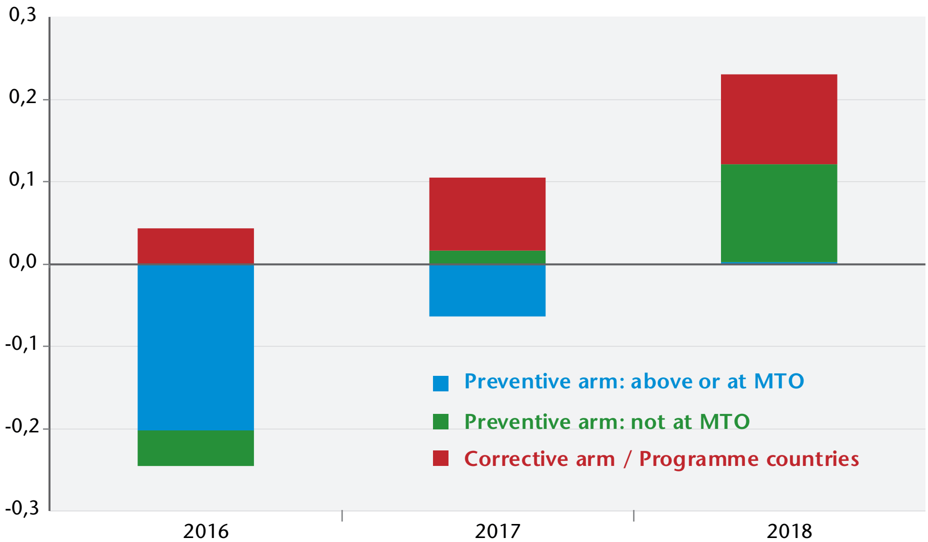
*Note:* ECFIN's scenario for 2018 is made under a 'no-policy change' scenario and is not directly comparable to the iAGS scenario
*Source:* ECFIN (Spring Forecast), IMF (World Economic Outlook), OECD (Economic Outlook)

4. The differences in the aggregate fiscal stance may arise either from different assessment about fiscal policy either from potential growth estimates. However, between 2015 and 2017 the analysis converge among all the institutions.

The aggregate fiscal stance of the euro area hides the heterogeneity of fiscal policy, which persists among EA countries. This heterogeneity is explained essentially by the position of different countries vis-à-vis the Stability and Growth Pact (SGP). Countries less constrained by the fiscal governance, that is to say countries in the preventive arm of the SGP that are at their MTO, will implement an expansionary policy in 2016 and 2017 and a neutral policy in 2018 (Figure 10). On the other hand, countries in the corrective arm will implement a restrictive policy in 2016, 2017 and 2018. Between them, countries in the preventive arm whose structural balance is below their MTO, will implement a fiscal policy close to the EA aggregate: slightly expansionary in 2016, neutral in 2017 and contractive in 2018.

Figure 10. **Aggregate Fiscal Stance and the stability and growth pact**

**Contribution to the change of the change in structural balance (in potential GDP point)**




*Sources:* National accounts, iAGS forecast, October 2016.

Our country-by-country fiscal policy assumptions are displayed on Table 5. In Germany, which has run a budget surplus since 2014, the government has room for manoeuvre, which will allow it to lower taxes and to avoid problems in handling the additional expenses related to the intake of migrants. Although Italy's budget deficit is under 3%, it is still constrained by its structural deficit well above its medium term objective (according to the European Commission, 1% of GDP in 2015 instead of 0%—and increasing 2016) and its high level of debt (133% of GDP in 2015), which it is supposed to bring down to 60% by annual increments of 1/20th. Nevertheless, the requested adjustment path towards the MTO can be suspended under certain conditions: in 2016, the Renzi government justified a reduction in the effort by invoking the clause on structural reforms, the investment clause and the refugee crisis. Fiscal policy's support for Italy's growth will come to 0.3 point in 2016. As for Spain, which has lacked a government for nearly a year, the country has been granted a stay despite running a deficit of more than 3%; the fiscal impulse was positive in 2015 and 2016 and will be close to neutral in 2017-2018. Finally, France has continued its adjustment in 2016 and 2017, even if on a smaller scale than in 2011-2014. The end of the President's five-year mandate has been marked by smaller adjustments in public spending, while at the same time the implementation of the CICE (Crédit impôt compétitivité emploi) tax credit and the Responsibility Pact has eased the tax burden. In 2016 and 2017, the impact of this policy on growth will be minus 0.2 point on average. Outside the euro area, the UK's fiscal policy will continue to be restrictive, but much less so than earlier, and particularly with respect to what was expected before Brexit, as the government scales back its ambitions to cut the deficit in order not to exacerbate Brexit's impact on growth.

Table 5. **Fiscal stance**

**% GDP**

| | 2011-2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| **EA** | -0.8 | 0.1 | 0.2 | 0.0 | -0.2 |
| **AUT** | -0.8 | 0.0 | 1.0 | 0.1 | -0.1 |
| **BEL** | -0.3 | -0.1 | 0.3 | -1.3 | -1.1 |
| **FIN** | -0.1 | -0.4 | -0.1 | -0.2 | -0.1 |
| **FRA** | -0.9 | -0.3 | -0.2 | -0.1 | -0.4 |
| **DEU** | -0.6 | 0.2 | 0.5 | 0.2 | 0.1 |
| **IRL** | -1.7 | 0.2 | -0.3 | -0.2 | 0.0 |
| **ITA** | -0.8 | 0.0 | 0.3 | 0.3 | -0.4 |
| **NLD** | -1.1 | 0.0 | 0.2 | -0.2 | -0.6 |
| **PRT** | -2.2 | -0.7 | -0.9 | -0.1 | -0.5 |
| **ESP** | -1.7 | 0.5 | 0.1 | -0.5 | -0.2 |

*Note:* the fiscal impulse is the opposite figure than the change in structural balance
*Sources:* National accounts, iAGS forecast, November 2016.

Considering the weakening of the recovery, it is still appropriate to support demand in the euro area through an expansionary fiscal policy. A positive fiscal stance has just been recommended by the European Commission.[5] For 2017, they suggest a fiscal expansion of up to 0.5% of GDP. This is surely a welcome change in approach as it stresses the need to adopt a global view on the policy mix in the euro area. However, this objective is not compatible with the current country level policy decisions. In particular, at the time of writing it does not seem likely that Germany will heed the Commission's call and make use of available fiscal space.

Moreover, the evolution of the structural balance is not sufficient to evaluate the aggregate fiscal stance. This measure neglects some recent advances in economic theory. Mostly, the impact of fiscal policy on growth is dependent on the position of the cycle and of the composition of the fiscal policy. Once we take into account those elements the assessment about fiscal policy in the Eurozone is modified. Fiscal policy will have a null impact on GDP in 2016 despite the aggregate fiscal impulse of 0.2 point of GDP. Most of the expansionary policy is concentrated in countries where the output gap is closed, like Germany, with low multiplier effect. If the Italian fiscal impulse could be more growth-supportive its composition prevents it. The Italian fiscal impulse relies on tax decreases, with low multiplier effect, partially compensated by a reduction of expenses with high multiplier. Hence, the impact on Italian GDP is low. In 2017, the impact of fiscal policy will also be slightly negative (-0.1 point of GDP) while the structural balance will remain stable. Again, this is explained by the split of the neutral fiscal impulse: fiscal policy will be expansionary in countries with low multipliers (Germany) and will remain contractive in countries with high multipliers (France and Spain among others). Finally, if the announcements of the Stability Programmes are implemented, fiscal policy will contribute to lowering GDP growth rate by 0.2 point in 2018.

## f) **Global trade is continuing to slow down**

The last few quarters have confirmed the slowdown in the Chinese economy observed since 2014. In the second quarter of 2016, GDP growth came to 6.7% y-o-y, the lowest level recorded since 1992, with the exception of the first quarter of 2009 when the Great Recession hit. This slowdown is the result of the country's transition to a model of growth that is more oriented towards the

5. See the 16.11.2016 Recommendation for Council recommendation on the economic policy of the euro area.

domestic market. Given the increasing role played by China in the world economy, this transition is a source of turbulence, as we saw in the summer of 2015 when fears of a hard landing provoked a sharp fall in stock market indices in both the emerging and industrialized countries. The slowdown in China's growth and industrial output has held back demand for commodities and global trade.

However, the trajectory of world trade since 2012[6] points to a general slowdown in global trade that is due not only to China but also to a structural change in the dynamics of international trade. Over the period 1991-2007, global imports increased at an average rate of 7%. Since 2012, the elasticity of trade to world GDP has fallen sharply and is now near or even below 1. For 2016, world imports will fall by -0.3%. Our scenario is based on an increase in world imports of "only" 2.3% in 2017 and 2018. In the short term, this global trade shock will have uncertain effects on growth, since there will simultaneously be a reduction in imports in each country or geographic-area and a drop in exports linked to a fall in demand. The effect on the growth of each country or geo-area will depend on the magnitude of these two related shocks: a reduction both in imports and in demand for exports. In the longer term, the slowdown of trade might have a negative impact on growth if it triggers a reduction in transfers of technology.

## g) The euro area is seeking new winds

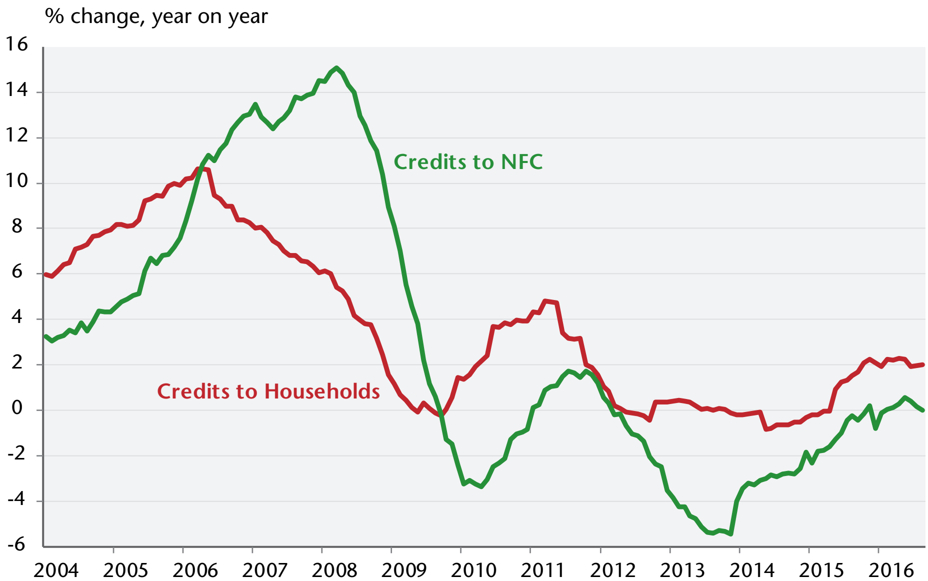
While for a long time the euro area lagged behind the global recovery that began in 2009, the recovery that started in the zone in 2014 (1.1%) and picked up pace in 2015 (1.9%) presaged more favourable prospects. While the recovery was still underway in the first half 2016, it is weakening. The slowdown will continue in 2017 and 2018, suggesting that a positive internal dynamic is having trouble taking over from the positive factors that helped initiate the recovery.

Both household consumption and business investment (and more recently household investment) fuelled the recovery in the euro area from 2014. Consumers benefited from the revival of job creation in 2014, which picked up pace in 2015 and 2016. In contrast, nominal wages grew only moderately in the euro area (1.2% in 2015), although they picked up with growth in Spain (0.6%), and progressed strongly in Germany (2.7%). Above all, low inflation

6. See IMF (2016).

has allowed real income to grow at a rate not achieved since 2006 (about 2% in early 2016). Falling oil prices can no longer be expected to have a positive impact, which will affect household purchasing power, even though nominal wages will accelerate in most countries. Job creation will also grow more slowly, in line with the slowdown in growth and with the increase in productivity, which will in turn affect household consumption, which will slow in most countries. Housing investment will on the other hand remain dynamic, due to the continuation of positive financing conditions. This should allow the rate of investment in housing to stabilize, thanks to continuing construction in Germany and the nascent recovery in Spain. Households in the euro area have benefited from low interest rates to renegotiate their bank mortgages; this has had the effect of cutting the level of interest paid by consumers. Nevertheless, the share of net interest in the disposable income has remained stable in the aggregate euro area in recent years, as interest received has fallen simultaneously by the same order of magnitude. As for outstanding loans, growth has been moderate and far lower than in the 2000s or even during the first phase of recovery in 2010 2011 (Figure 11).

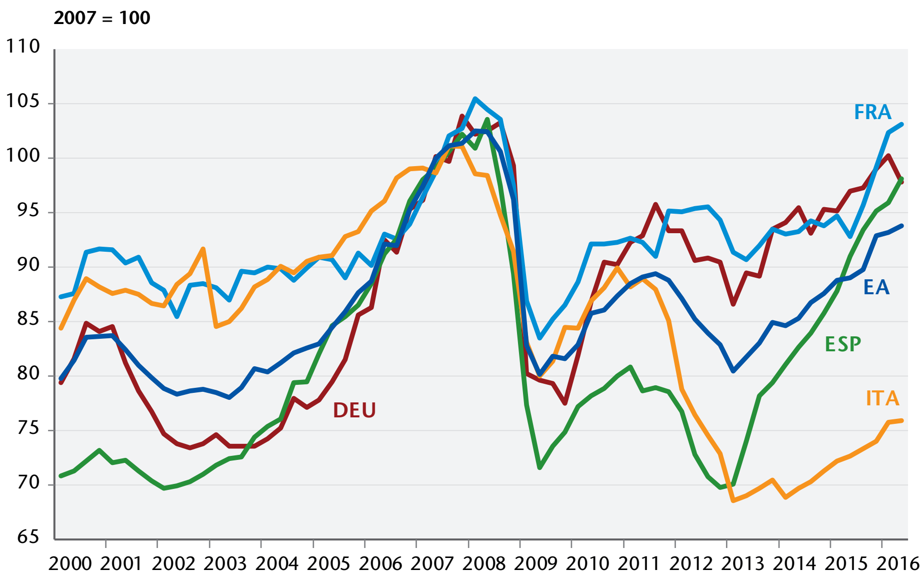
Figure 11. **Growth in outstanding loans in the euro area**




*Source:* ECB.

With respect to the volume of capital expenditure on machinery and equipment, no country has gotten back to its pre-crisis level (Figure 12). The situations are quite heterogeneous, however, and include a very critical state of affairs in Italy. The level of investment is still very low. The nascent recovery since 2014, has triggered a positive accelerator effect on investment. Moreover, recent tax measures allowing additional depreciation have improved the profitability of Italian investment and encouraged capital expenditures in the recent period. In Spain, the recovery has been spectacular spur by the conjunction of several positive factors. Domestic demand and exports have picked up substantially, in line with positive forces aforementioned (oil price, competitiveness and less fiscal consolidation), triggering an accelerator effect for investment. Spanish firms and households also benefited from decreasing interest rates and easing of credit supply conditions. In Germany and France, the decline was less pronounced, and the recovery relatively timid. However, the recovery has been more substantial in France in recent quarters, due to improved corporate margins (with support from the CICE tax credit and the Responsibility Pact) and additional depreciation measures, such as in Italy – measures that will continue to encourage investment in France and Italy.

Figure 12. **Productive investment for the private sector in the euro area**

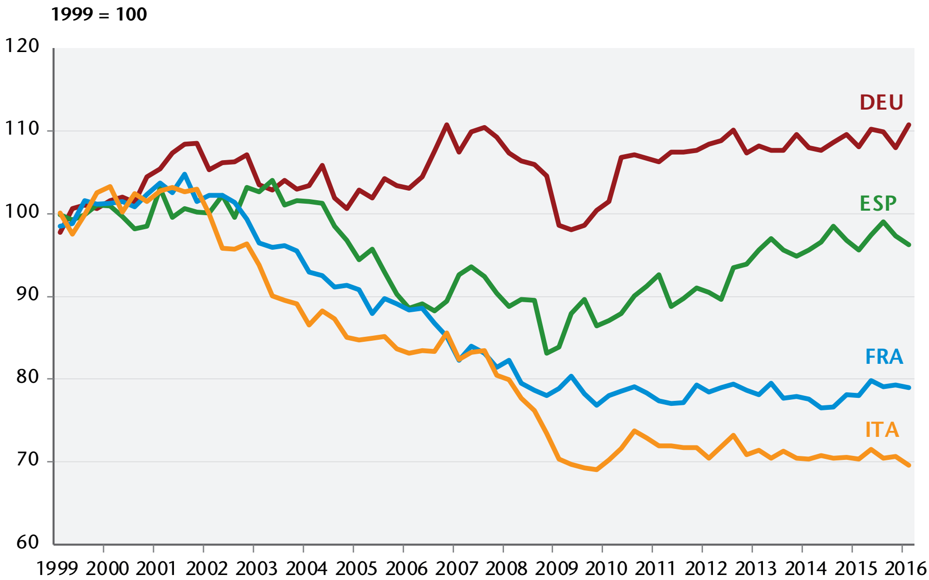



*Source:* Eurostat.

Overall in the period 2014-2018, the contribution of external trade to growth will reach about 0.1 GDP percentage point per year. Imports and exports will generally grow at a low rate in 2017 and 2018 (slightly above 2%), in line with more sluggish domestic demand and export demand that is growing much more slowly than in the mid-2000s.

There are nevertheless differences within Europe on export performance: Spanish companies have gained market share since 2007 (Figure 13[7]). This is to some extend due to a strategy of competitive disinflation, with unit labour costs falling by 6% in Spain since 2009, even as they continued to rise in France, Italy and Germany. In this context, Italy have lost market share whereas France stabilized its exports market share since 2007. The German case is atypical, since its companies have experienced slight gains, even though unit labour costs rose by 8% (against a fall of 1% over the period 1999-2007). Gains outside the euro area since 2014 can be explained by exchange rates, but Germany undeniably

Figure 13. **Export market shares**




*Source:* IMF, National accounts, OFCE calculations.

7. Export market shares are computed as the ratio of exports of goods in volume on an indicator of external demand, derived from imports of goods of trading partners. It takes into account the structure of external trade of the year 2013.

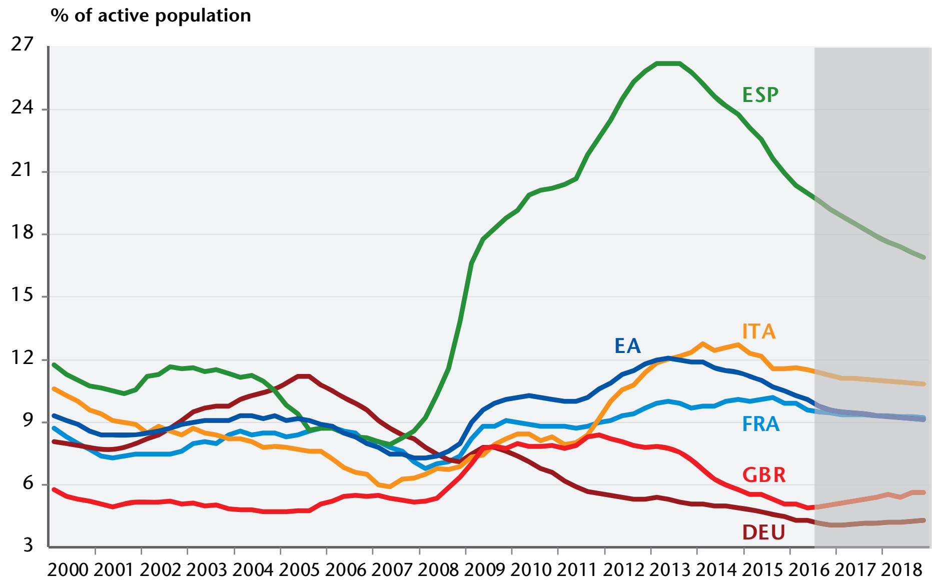
has a non-price advantage that allows it to retain its export positions. In 2017 and 2018, most euro area countries will stabilize their market share as the euro stabilizes. Spain should manage to maintain a high share, as it continues to enjoy a competitive advantage over the other European countries, which should also provide more solid support for its growth. In Germany, companies will lose market share because of an inflation differential with its partners.

## 1.2. Unemployment and the risk of deflation are persisting

### a) Unemployment rate remains high in the euro area

Europe's slower growth will affect the growth of employment and therefore the reduction of the unemployment rate. In countries where the rate has returned to or even dropped below the pre-crisis level, the unemployment rate will once again begin to rise (Germany and the UK) as growth slackens (Figure 14). In Germany, this will be coupled with stronger growth in the labour force due to the influx of refugees. Elsewhere, the unemployment rate should continue to fall (Spain, France and Italy), but at a slower pace.

Figure 14. **Unemployment rate**




*Source:* Eurostat, iAGS forecasts October 2016.

Employment would slow down in Spain from an annual growth rate of 2.9% in 2015 to 1.4 in 2018, and labour force would stabilize. Whereas the unemployment rate fell 2.4 percentage points in Spain in 2015, the decline in 2018 will be only 1.1 point. The unemployment rate would then come to just over 17% for the year, far from the 8% level in 2007, which was close to the French unemployment rate at that time. In Italy, the annual rate at which unemployment is being cut will fall from 0.7 point in 2015 to 0.2 in 2018, also in line with a decline in jobs creation (a 2.5% increase in 2016 but only 0.4% in 2018). As for France, over the period 2016-2018 the cumulative reduction in the unemployment rate will be only 0.6 point, thus returning to the level of early 2012. In this general context, underemployment will continue to be significant in the euro area, which will hold back inflation.

## b) **Headline inflation is accelerating, but fails to meet the target**

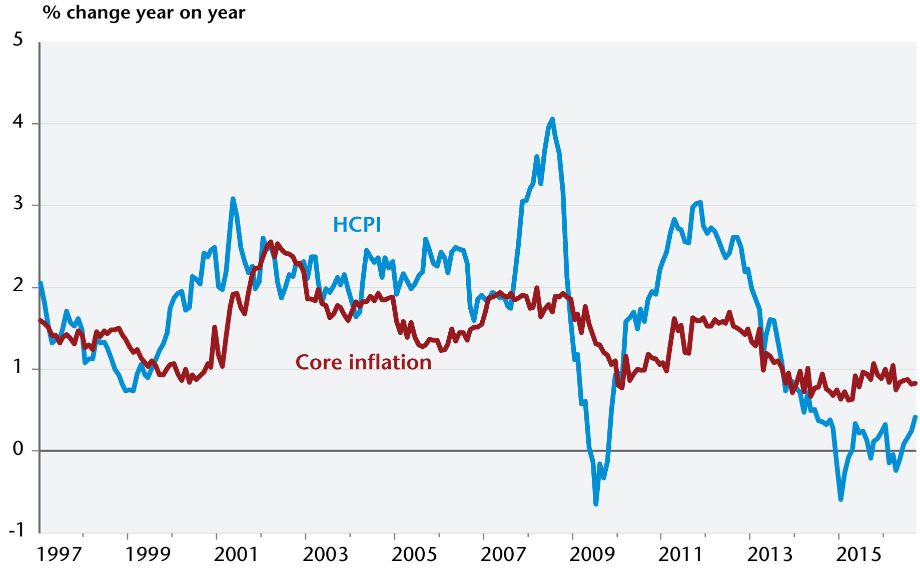
In September 2016, inflation in the euro area was still at a historically low level (Figure 15): 0.2% yoy. This continuing weakness can be explained in part by the sharp drop in oil prices that has occurred since the second half of 2014, with repercussions that are still being felt. This effect is nevertheless tending to fade, as falling prices are behind us, and we can now expect them to rise gradually. Inflation should then recover and reach 1.5% in 2017 and then 1.7% in 2018. The ECB's target will not, however, be met.

Above all, the level of underlying (and core) inflation[8] (0.8% in September 2016) shows that the euro area is still in a situation of sluggish price rises. Despite the ECB's quantitative easing, very low interest rates and a significant weakening of the euro, underlying inflation has still not risen above the 1% ceiling that it has been butting against for about three years. This situation is mainly due to two factors: the unemployment rate and the implementation of competitive disinflation policies in different countries. Moreover, expected inflation from professional forecasters indicate that it would remain sluggish (Figure 16) and fails to anchor on the 2% target set by the ECB in the short term (1 and 2 years). In the longer term, expected inflation is also below the 2% for professional forecasters. It is even lower according to market indicators suggesting that the risk of a sustained period of low inflation is still pervasive.

With an unemployment rate across the euro area that was even above 10.1% in the second quarter of 2016, and which is expected to diminish by only one

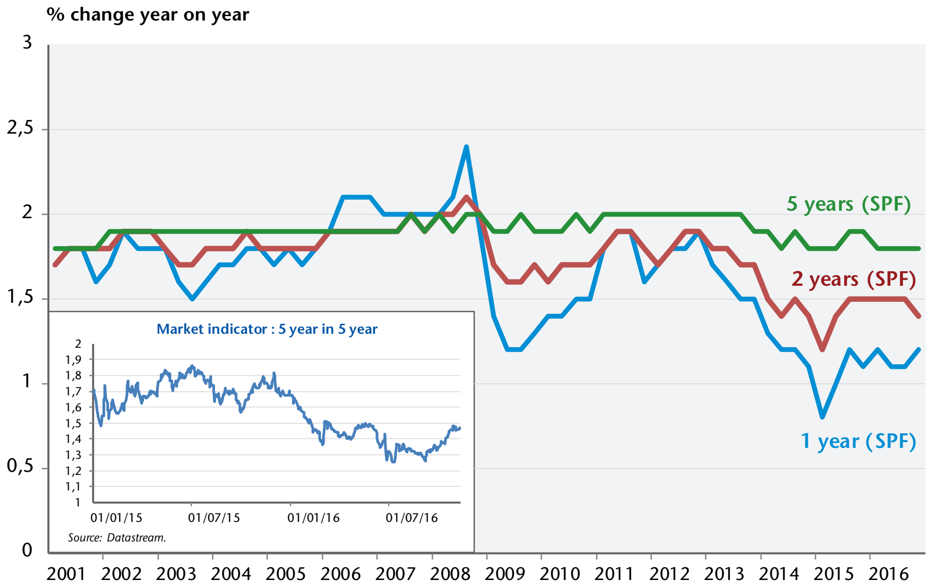
8. Note that the index of underlying inflation excludes food and energy prices.

Figure 15. **Inflation in the euro area**




*Source:* Eurostat.

Figure 16. **Expected Inflation in the euro area**

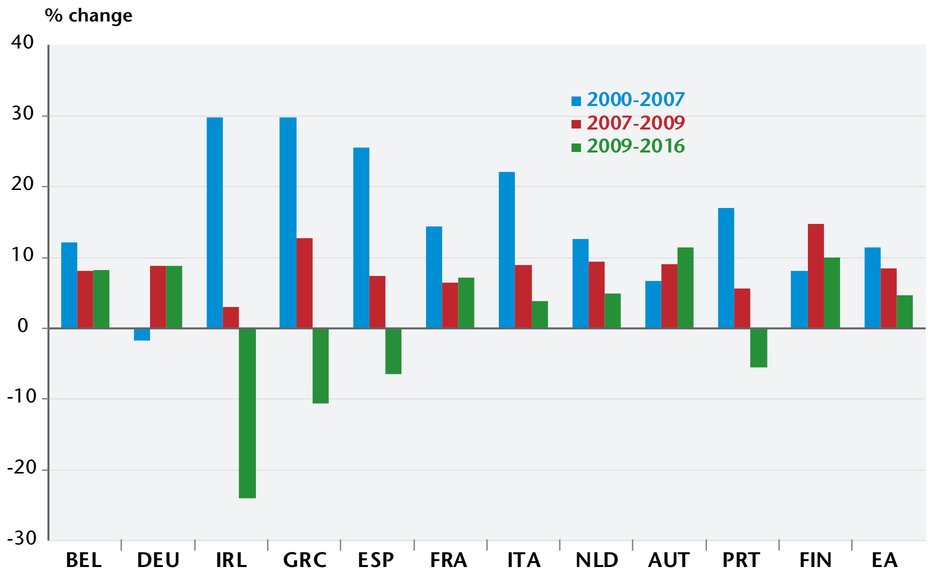



*Source:* ECB (Survey of professional forecasters).

point by the end of 2018, wage deflation pressure is still present. The risk is not equal in all countries. While in Germany the introduction of a minimum wage and full employment is stimulating wage increases, in Spain the slow reduction in unemployment, which would still exceed 17% in 2018, will keep inflation low: 0.4% in 2017 and 0.7% in 2018. France and Italy would lie in an intermediate zone, with inflation of around 1.5%.

In addition, since 2010, in a context marked by steep rises in unemployment and reform of European governance, the euro area countries, and in particular those hit by the sovereign debt crisis, have been encouraged to carry out structural reforms of their labour markets (France, Italy, Spain, Portugal, Greece and Ireland). These reforms have aimed to make labour markets more flexible by reducing job security provided by employment contracts and by enforcing greater decentralization in wage bargaining. They have in practice increased the pressure on employees, cutting their bargaining power and encouraging them to accept greater wage restraint, as happened in Germany in the 2000s. In some cases, (Ireland, Portugal and Greece), measures freezing or lowering the minimum wage have had an immediate impact on the cost of labour, as have measures lightening social and fiscal charges, such as France's CICE tax credit to enhance competitiveness. This process has resulted in a decline in unit labour costs since 2009 in Ireland, Greece, Spain and Portugal (Figure 17).

Figure 17. **Change in the unit labour costs of euro area countries**




*Source:* Eurostat.

While these adjustments can help reduce the current account imbalances that arose in the 2000s, they have also weighed on prices by putting downward pressure on labour costs, which undoubtedly explains part of the difficulty that the euro area is experiencing in getting back to a 2% inflation level. It can be added that at the euro area level, the increase in the unit labour cost is far behind the benchmark of the golden wage rule (see Chapter 4), which should increase by the inflation target set by the ECB. If we compare the increase in ULC in the seven years since 2009 (4.6 %) with the ones from 2000 to 2007 (12.7%), we see that in both periods the cumulative benchmark of 14.9% was missed. It notably illustrates that the adjustment has remained asymmetric with large decrease in unit labour costs in crises countries and subdued increase in surplus countries.

## 1.3. Does uncertainty contribute to a sluggish recovery?

The prospect of a Brexit has created a new source of uncertainty in Europe, one year after the tension over the situation in Greece, which could have led to a Grexit. This political and institutional uncertainty in particular is combining with other sources of macroeconomic and financial uncertainty.

### a) Multiple sources of uncertainty …

It is likely that a Greek exit from the euro area would have had a much greater impact in that it would have called into question the process of monetary unification itself. There is no monetary dimension in effect for a Brexit; the discussion will focus on trade relations and on the free movement of persons between the UK and the rest of the EU. The fact remains that this situation will result in a setback for the process of European integration. Beyond the British voters, there is a fairly widespread movement of distrust in the European project among EU citizens more generally.

While there has been a vast wave of reform of European governance, the European political project nevertheless seems to be out of momentum and lacking clarity, which could lead economic actors (households, companies) to turn inwards. In a very different political register, Spain's difficulties in forming a government, upcoming elections in France and Germany or Italian referendum are new sources of political uncertainty. What course will the new governments choose for construction of the European Union? What weight will have populists and sovereigntists in future policies?

The macroeconomic debates and uncertainties are just as numerous and concern both the nature of the recently observed changes in the dynamics of growth in international trade as well as the possibility of secular stagnation, a term used for a long-term period of weaker growth. Beyond the terminology, the questions being posed by the post-Great Recession world concern the potential for growth and trends in productivity.

Table 6. **Non-performing loans**

**% of non performing loans as of total loans**

| | 2010 Q2 | 2015 Q1 | 2016 Q1 |
|---|---|---|---|
| **AUT** | 2,6 | 6,5 | 5,1 |
| **BEL** | 4,0 | 3,6 | 3,4 |
| **CYP** | 5,6 | 37,6 | 38,7 |
| **DEU** | 2,5 | 2,3 | 2,8 |
| **EST** | 36,3 | 11,5 | 10,8 |
| **ESP** | 3,8 | 6,4 | 5,3 |
| **FIN** | 1,0 | 1,1 | 1,1 |
| **FRA** | 4,7 | 3,8 | 3,6 |
| **GRC** | 5,3 | 31,7 | 38,1 |
| **IRL** | — | 18,1 | 14,7 |
| **ITA** | 7,4 | 16,3 | 16,1 |
| **LTU** | 17,5 | 9,7 | 8,4 |
| **LUX** | — | 1,9 | 1,6 |
| **LET** | 17,7 | 7,2 | 4,8 |
| **MLT** | 5,3 | 6,4 | 5,0 |
| **NLD** | 2,3 | 2,7 | 2,3 |
| **PRT** | 3,2 | 14,7 | 15,4 |
| **SVN** | — | 18,7 | 13,9 |
| **SVK** | 3,8 | 7,4 | 5,6 |
| **EA** | 4,1 | 6,4 | 5,7 |

*Source:* BCE, Consolidated banking data, Gross non-performing debt instruments [% of total gross debt instruments], National accounts, OFCE october2016.

Furthermore, 2016 was marked by a resurgence of banking risk in connection with the situation of the Italian banks, which poses a serious threat to the country's public finances and its growth. The latest stress tests conducted in 2016 by the European Banking Authority (EBA) and the European Central Bank (ECB) on a sample of 51 European banks suggest that the Italian bank Banca Monte dei Paschi di Siena needs significant recapitalization. In addition to the case of this specific bank, the Italian banking system has a stock of bad debt amounting to over 16% of total outstanding loans, representing about 22% of GDP. This situation poses a major risk to the public finances, should the banking system need to be recapitalised, as well as to growth. The bad debt is a burden on the profitability of the banks, which may affect the banks' rates for the non-financial sector—as the banks seek to restore their profitability—or could force them to curb their supply of credit in order to deal with the risk to their balance sheets. While Italy concentrates a high level of risk to the banking system as a whole, Germany could in turn be plunged into new banking turmoil due to the critical situation of Deutsche Bank, which is facing the threat of a USD 5 billion financial penalty by the US courts for having misled investors by selling structured products backed by toxic mortgages in the United States. Because of financial fragmentation, national banks situation has a direct impact on economic situation of the country, not to mention the still present death kiss loop when national banks hold a large amount of public debt of their country.

Furthermore, the problem of bad loans is not only an Italian problem (Table 6), as the share of bad debt in outstanding loans exceeds 38% in Greece and Cyprus, and reached 14.7% in Ireland and 15.4% in Portugal. These figures are reminders that the euro area has never completely absorbed the shock of the financial crisis that erupted in 2007.

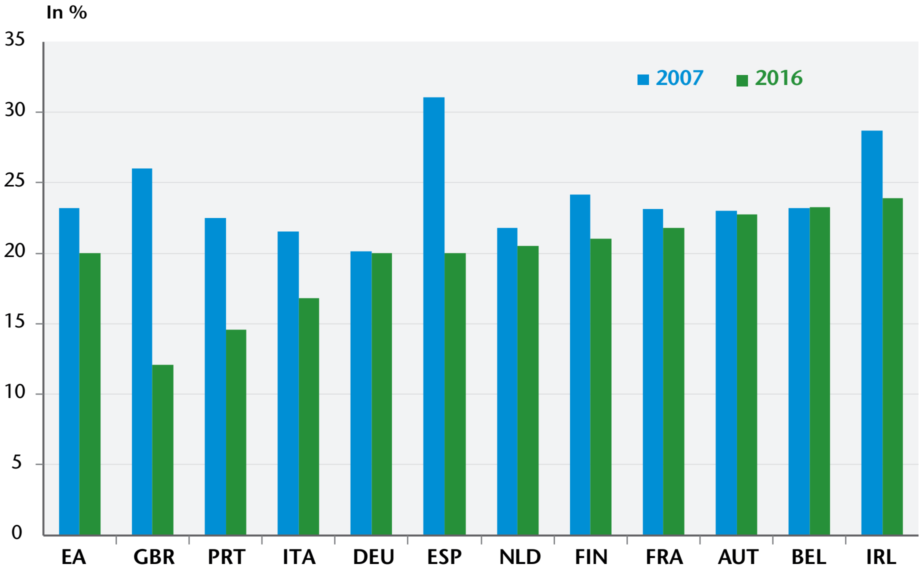
### b) … are holding back investment

This multiplicity of sources of risk and uncertainty could encourage a wait-and-see attitude, a turning inwards, and discourage risk-taking. The result would be a situation where households and businesses prefer savings to investment, which would slow growth and confirm the fears of an economy trapped in low growth and low inflation, validating ex-post analyses that point towards a decline in productivity and potential growth.

This may have contributed to the sluggish recovery in investment and why the overall investment rate in every euro area country is still below its pre-crisis peak

(Figure 18). The euro area's record current account surplus (above 3% in 2015) illustrates this situation of excess savings in the euro area.

Figure 18. **Investment to GDP ratio**




*Source:* ECFIN (Autumn Forecast) 2016.

## c) A new wave of fiscal consolidation?

Besides, the scenario described above does not account for a risk of a new episode of fiscal consolidation. The fiscal impulse is neutral for 2017 and slightly negative in 2018. But, some element may suggest that it could be made more restrictive. On the one hand, Spain can be expected to implement new measures of fiscal consolidation as it has not respected the nominal target for the public deficit in 2016. In the absence of government, the European Commission chose to postpone the implementation of sanctions, but with the new government now in place, the pressure for the introduction of new measures of budgetary measures would strengthen. On the other hand, euro area countries should also comply with other fiscal rules. First, the country-specific structural deficit targets, the so-called medium-term objectives (MTOs). Second, public debt is expected to converge to 60% of GDP. The reduction of debt should reach 1/20$^{th}$ of the spread between the current level of debt and the 60% target on average within three years. Third, an expenditure rule, which limits public expenditure growth (depending on potential growth). At present, Commission and Council focus in their evaluation of fiscal policies as well as their policy recommendations on the first rule, as it is the most restrictive one and it is in the centre of the TSCG, the so-called Fiscal Compact. However, the political attention can change quickly, notably when all EA countries will comply with the 3% rule for public deficit. All the rules have to be kept in mind.

As long as the debt-to-GDP is above 60% and has not converged to that threshold, discussions on the need of further fiscal effort will not stop. Therefore, we simulate the path of public debt-to-GDP ratios until 2035, which is the horizon of the 1/20th debt rule incorporated in the revised SGP and in the Fiscal Compact. The simulated path of public debt depends on the fiscal impulses which have been forecasted in the euro area in 2017 to 2018. We then assume zero fiscal impulses beyond 2018. Simulations are realized with a model representing the main countries of the euro area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. Details of the model are available in a technical appendix to this chapter. The impact of fiscal policy on the economic activity depends on the fiscal multiplier effect, which is supposed to be time-varying. It is high when the output gap is negative (-1.5 for an output gap below -3%), supposed to be equal to 0.5 when the output gap is zero and it becomes small (0.2) when the output gap exceeds 3%.[9]

In the baseline scenario,[10] we suppose that interest rates in all euro area countries converge to the same level and that inflation expectations are anchored to the same inflation target (2%). Under these assumptions (initial conditions for the simulations are presented in the technical appendix), we compute the debt dynamics, structural balance, inflation rate and GDP growth rate (or output gaps) from 2017 until 2035. Results are reported in Table 7. The simulations suggest that France, Italy, Spain, Belgium, Portugal, Greece, and Finland would not reach a 60% debt-to-GDP ratio by 2035. Consequently, these countries would have to implement additional fiscal efforts to be able to comply with the debt rule. With public debt reaching 178% of GDP in Greece, consolidation would have to be substantial. The gap would also be significant for Spain (106%), Italy (99%), France (91%) and Portugal (89%). It must yet be noted that while the debt ratio in Italy and in Portugal would be far from 60%, it would decrease significantly between 2020 and 2035 indicating that the convergence is ongoing. Conversely, the convergence would not have started

9. See Appendix for details of the model and Blot *et al.* (2014).
10. The initial value of debt does not account future stock-flow adjustments, that reduce or increase the debt ratio.

in Greece or in Spain and would be very slow in France. Finally, though Belgium and Finland would not reach the 60% target, additional effort would be limited.

Considering a "no change in fiscal policy" beyond 2018, debt level would decrease below 60% in other countries, providing some fiscal space. Germany and the Netherlands would be in this situation, with public debt reaching 34% and 39% respectively in 2035. Ireland would also be concerned whereas Austria would be very close to 60%. The situations of public finances may also be illustrated by structural balances. France would record a structural deficit amounting to -2.3% in 2020 and the situation would still deteriorate from 2020 to 2035 because of hysteresis effects present in the model. Germany would benefit from a surplus increasing the room for manoeuvre to implement more expansionary fiscal policy in the future.

Moreover, the average output between 2016 and 2035 would still be negative for the euro area with Portugal and Greece being in the worst situation.[11] Actually, all countries but Germany and Ireland would be in a situation of negative average output over the period. The inflation rate would remain below the 2% target until 2019.

The next step is to assess whether countries are able to meet the ceiling by 2035. As for previous reports, the aim is to reach 60% for all countries. Then countries, which have a debt below 60% in Table 7, implement positive fiscal impulses. Considering current fiscal rules, we apply fiscal impulses capped at +/-0.5. Successive positive (if country-debt is below 60% in Table 7) or negative (if country-debt is above 60% in Table 8) impulses are implemented from 2017 until the debt-to-GDP reaches 60%. We find that all countries but Greece would be able to comply with the fiscal rule on public debt despite a significant consolidation effort. Yet, it may involve a significant additional effort. The cumulated fiscal impulse would reach 9.4 points of GDP. The cumulated effort between 2016 and 2035 would amount to 3.7 points in Spain (Table 8). In France, additional effort would amount to 3 points, which is 2.3 points above the expected effort announced until 2018. Italy, Portugal, Belgium and Finland would have to implement further consolidation with effort ranging from 1.6 points to 2.7 points.

11. It would be negative until 2022 for the euro area.

Table 7. **Public finance and output performances under the baseline scenario**

**(no risk premium. no fiscal impulse beyond 2018. time-varying fiscal multiplier,hysteresis effects)**

| | Public debt (% of GDP) | | Structural balance (% of GDP) | | Cumulative fiscal impulse | GDP growth rate (%) | | Average output gap | Inflation rate (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (1) 2020 | (2) 2035 | (3) 2020 | (4) 2035 | (5) 2016-2035* | (6) 2016-2020 | (7) 2021-2035 | (8) 2016-2035 | (9) 2016-2020 | (10) 2021-2035 |
| **DEU** | 60 | 33 | 0.0 | 0.6 | 1.0 | 1.3 | 1.0 | 0.5 | 1.6 | 2.0 |
| **FRA** | 95 | 91 | -2.3 | -3.1 | -0.7 | 1.6 | 1.4 | -0.3 | 1.5 | 2.0 |
| **ITA** | 129 | 101 | -0.8 | -0.5 | 0.2 | 0.7 | 0.3 | -0.3 | 1.3 | 2.0 |
| **ESP** | 102 | 101 | -3.1 | -3.6 | 0.0 | 2.3 | 1.4 | -0.1 | 0.7 | 2.0 |
| **NLD** | 61 | 41 | -0.3 | -0.3 | -0.7 | 1.6 | 1.3 | -0.1 | 1.0 | 2.0 |
| **BEL** | 99 | 65 | -0.2 | -0.3 | -2.1 | 1.3 | 1.6 | -0.6 | 1.8 | 2.1 |
| **PRT** | 121 | 87 | -0.4 | -0.5 | -1.5 | 1.4 | 1.1 | -1.4 | 1.4 | 2.1 |
| **IRL** | 82 | 51 | -0.9 | -0.1 | -0.7 | 2.2 | 1.9 | 0.9 | 0.7 | 1.9 |
| **GRC** | 178 | 182 | -4.8 | -6.4 | 0.3 | 1.8 | 1.2 | -2.5 | 0.9 | 2.2 |
| **FIN** | 66 | 79 | -2.1 | -3.8 | -0.4 | 1.6 | 1.7 | -1.0 | 1.3 | 2.1 |
| **AUT** | 77 | 61 | -0.6 | -1.2 | 0.4 | 1.4 | 1.5 | -0.8 | 1.5 | 2.1 |
| **EA** | 89 | 71 | -1.1 | -1.3 | 0.0 | 1.4 | 1.1 | -0.1 | 1.3 | 2.0 |

* In the baseline scenario. fiscal impulses are equal to 0 from 2019 to 2035.
*Source:* iAGS model.

Germany would benefit from fiscal space according to the debt criterion and may implement a fiscal stimulus of 2.6 points, which is 1.7 points higher than what is currently expected and shown in Table 8. The Netherlands would also implement expansionary fiscal policy in this scenario while the cumulated fiscal impulse would still be negative for Ireland but the fiscal effort would be reduced by 2.8 points in comparison to the baseline scenario. This would result in higher GDP growth for these countries. From 2016 until 2020, the average GDP growth would be 0.2 point higher. Conversely, growth performance in countries implementing a new wave of fiscal consolidation would be deteriorated: by 0.8 point in Greece, 0.4 point in Portugal, 0.3 point in Spain and 0.2 point in France and Italy. Besides, structural balance would become in surplus in 2035 for Italy, Spain, Portugal and Greece. In Greece, the surplus would reach 4% of GDP. This clearly questions the social sustainability of this policy. As illustrated in previous reports, there is obviously a trade-off arises between the debt objective and the growth objective. Though all countries but Greece would meet the 60% debt-to-GDP ratios in 2035, it would imply a reduction in growth for countries implementing additional fiscal consolidation and for the euro area.

Table 8. **Is it possible to reach a 60% debt-to-GDP ratio?**

**(baseline scenario except +/- 0.5 fiscal impulses depending on public debt gap *vis-à-vis* 60% target)**

| | Public debt (% of GDP) | | Structural balance (% of GDP) | | Cumulative fiscal impulse | GDP growth rate (%) | | Average output gap | Inflation rate (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (1) 2020 | (2) 2035 | (3) 2020 | (4) 2035 | (5) 2016-2035* | (6) 2016-2020 | (7) 2021-2035 | (8) 2016-2035 | (9) 2016-2020 | (10) 2021-2035 |
| **DEU** | 62 | 60 | -1.5 | -1.8 | 2.8 | 1.4 | 1.0 | 0.7 | 1.6 | 1.9 |
| **FRA** | 93 | 60 | -0.8 | -0.1 | -3.0 | 1.4 | 1.5 | -0.5 | 1.4 | 2.0 |
| **ITA** | 128 | 60 | 1.0 | 3.2 | -2.6 | 0.5 | 0.3 | -0.6 | 1.2 | 2.0 |
| **ESP** | 101 | 60 | -1.4 | 0.5 | -3.1 | 2.0 | 1.5 | -0.4 | 0.6 | 2.0 |
| **NLD** | 62 | 60 | -1.6 | -2.1 | 0.8 | 1.9 | 1.3 | 0.2 | 1.1 | 2.0 |
| **BEL** | 98 | 60 | -0.3 | 0.4 | -2.4 | 1.5 | 1.5 | -0.5 | 1.9 | 2.0 |
| **PRT** | 123 | 60 | 0.8 | 2.2 | -3.8 | 1.0 | 1.2 | -1.8 | 1.3 | 2.1 |
| **IRL** | 84 | 60 | -1.5 | -1.0 | 0.0 | 2.2 | 1.9 | 0.9 | 0.7 | 1.9 |
| **GRC** | 185 | 114 | -2.7 | 3.7 | -9.4 | 0.9 | 1.1 | -4.1 | 0.6 | 2.2 |
| **FIN** | 63 | 60 | -0.9 | -2.1 | -1.7 | 1.5 | 1.7 | -1.1 | 1.2 | 2.1 |
| **AUT** | 75 | 60 | -0.6 | -1.2 | 0.5 | 1.5 | 1.5 | -0.7 | 1.6 | 2.1 |
| **EA** | 88 | 61 | -0.8 | -0.2 | -0.8 | 1.4 | 1.1 | -0.2 | 1.3 | 2.0 |

*Source:* iAGS model.

Growth would be reduced in the euro area as a whole and heterogeneity in growth performance would widen as growth would deteriorate in countries, which have already suffered from the double dip recession. The countries with fiscal space are already those in which the unemployment rate has recovered to or close to pre-crises levels.

These simulations suggest that there is still a risk of a new wave of fiscal consolidation in the future, unless fiscal rules will be changed (see Chapter 3) or at least not applied strictly. This may still entail output costs and add deflationary pressures for the euro area and notably in countries where the output gap is negative and the unemployment rate high Greece, Portugal, Spain, Italy and France).