



# Economic Assessment of the Euro Area

Winter 2016/2017

February 2017

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This Euroframe Report presents an assessment of the euro area economic outlook for 2017 and beyond based on a synopsis of the forecasts of Euroframe institutes. It also contains brief country notes summarizing the individual institute's own country forecasts. In the focus section the impact of Brexit is discussed, based on work done in the Euroframe institutes.

In times of increased uncertainty and with tailwinds from lower oil prices fading, the euro area economy is expected to expand at a moderate pace with GDP rising by 1.6 per cent and 1.5 per cent in 2017 and 2018, respectively (Table 1). The economic impact of the decision of the United Kingdom to leave the EU is still hard to assess, given the high amount of uncertainty about the nature of the future relationship. So far the negative effects have been less pronounced than initially expected, but uncertainty could still substantially raise risk premia and weigh on investment, especially in the UK. Direct repercussions on growth in other European countries through trade linkages are so far mostly related to the devaluation of Sterling against the euro and likely to be rather limited, with Ireland and the Netherlands particularly affected. Indirect effects through uncertainties and changes in European policies triggered by the British decision could be significant but are much more difficult to assess.

Table 1: Euro Area Forecasts-Euroframe average

GDP			CPI Inflation*			Unemployment Rate**		
2016	2017	2018	2016	2017	2018	2016	2017	2018
1.7	1.6	1.5	0.2	1.4	1.4	10.0	9.6	9.2

\* HICP \*\* Eurostat definition.

## The Euro Area Outlook: Continued Moderate Expansion in Times of Uncertainty

The economic recovery in the Euro area continued in 2016. After having lost some momentum during the summer growth picked up towards the end of the year. Eurostat reports a GDP growth rate of 0.5 per cent for the fourth quarter and 1.7 per cent for the full year, respectively. Sentiment indicators have recently improved significantly and the [Euro Growth Indicator](#), which is calculated each month by EUROFRAME, suggests that growth will remain robust in the first months of 2017. A sustained acceleration of the pace of recovery is, however, still not in sight. EUROFRAME institutes expect economic growth to remain limited in 2017 and 2018, with annual GDP growth of 1.6 per cent and 1.5 per cent, respectively, on average.

The variance of the individual forecasts is fairly limited (Table 2), partly due to the fact that underlying assumptions are not substantially different. They include a modest increase in oil prices, a gradual

strengthening of external demand, with US growth generally expected to accelerate to close to 2 ½ per cent, and an exchange rate that more or less remains at its current competitive level vis-à-vis the US-dollar. US money market rates are expected to be gradually raised to a level of 1.5–2 per cent by the end of next year, whereas the ECB will keep the Main Refinancing Rate at zero for at least another 1 ½ years.

Supportive factors such as low interest rates and a low external value of the currency are accompanied over the forecast horizon by a neutral aggregate fiscal policy stance in the euro area. At the same time, however, the temporary stimulus to purchasing power from lower oil prices is going away, unresolved structural issues, such as weak banking sectors in a number of countries, continue to weigh on the recovery, and increased political uncertainty, including from the British decision to exit the EU, may negatively impact euro area on the economy in the coming months.

Overall, economic activity is expected to broadly maintain the recent pace of expansion over the coming two years. The labour market situation will continue to improve with the unemployment rate at the euro area level forecast to decline by close to ½ of a percentage point per year from the 10 per cent rate registered in 2016. Consumer price inflation has picked up recently in response to higher energy prices, but underlying inflation has remained low and EUROFRAME institutes do not expect that it will rise to the ECB’s target of close to 2 per cent any time soon.

Table 2: Euro Area Forecasts

Institute	GDP			CPI Inflation (HICP)			Unemployment Rate (Eurostat definition)			Forecast Date
	2016	2017	2018	2016	2017	2018	2016	2017	2018	
<b>Wifo</b>	1.6	1.5	1.5							16.12.2016
<b>ETLA</b>	1.7	1.6	1.5	0.2	1.3	1.7	10.0	9.5	9.1	31.01.2017
<b>OFCE</b>	1.7	1.5	1.3	0.2	1.5	1.5	10.0	9.5	9.2	30.10.2016
<b>DIW</b>	1.7	1.5	1.6	0.2	1.2	1.3	10.0	9.6	9.3	16.12.2016
<b>IfW</b>	1.7	1.7	1.7	0.2	1.2	1.4	10.0	9.5	8.8	15.12.2016
<b>Prometeia</b>	1.7	1.5	1.3	0.2	1.4	1.6	10.0	9.5	9.3	15.02.2017
<b>CPB</b>	1.6	1.7	1.7	0.2	1.5	1.3	-	-	-	17.02.2017
<b>NIESR</b>	1.7	1.5	1.5	0.2	1.4	1.3	10.0	9.8	9.6	01.02.2017
<b>Euroframe average</b>	1.7	1.6	1.5	0.2	1.4	1.4	10.0	9.6	9.2	

## Focus: Brexit effects<sup>1</sup>

There are short and long-run implications from the UK's decision to leave the EU. Analysis published prior to the 23<sup>rd</sup> June referendum suggested that, in the short run, a vote to leave the EU would cause an increase in uncertainty and risk premia on sterling and the costs of external financing to firms and households from the EU (Baker et al. 2016). Measures of uncertainty and risk premia have increased since the referendum, but not by as much as expected. The evolution of the exchange rate since the referendum has broadly been in-line with expectations. On a broad nominal trade weighted basis sterling currently is around 12 per cent below the pre-referendum level and close to 20 per cent below levels seen at the end of 2015.

In the short term, it is the domestic economy that is expected to be most dramatically affected. Further increases in risk premia and uncertainty would weigh on the investment decisions of firms and spending decisions of households. The latter, in particular, is expected to be exacerbated by the pass through to consumer prices from the depreciation of sterling.

The triggering of Article 50 of the Lisbon Treaty is a key milestone in the overall Brexit process. Judicial and legislative developments in the UK have not altered the government's target of triggering Article 50 by the end of March 2017, at the latest. At present considerable uncertainty is associated with the objectives of the UK government with regards their negotiated withdrawal from the EU, as well as the likely outcome of this negotiation. This is perhaps evidenced by the significant financial market moves around government announcements on the Brexit process (see Kirby et al. 2017). With these policy uncertainties present, the triggering of Article 50 itself is a significant event risk to the outlook.

While, these short run effects are expected to be transitory, the re-adjustment of the UK's trading relationships is expected to have a permanent effect on the UK economy. Ebell and Warren (2016) present three illustrative scenarios using the National Institute of Economic and Social Research's global econometric model (NiGEM). The analysis uses the effects from the presence of pre-existing trade deals to guide the likely effect of withdrawing from the EU to a new trading relationship. These scenarios modelled a narrow range of features relating to Brexit which include: a reduction in FDI, no longer contributing to the EU budget, the imposition of bi-lateral tariffs and the reduction in trade due to non-tariff based barriers to trade, something that is particularly important for a country with significant trade in services, such as the UK.

In light of recent speeches by the UK's Prime Minister, plausible options for a new trading relationship, from a UK perspective, appear to be a Free Trade Area (FTA) type agreement (the Prime Minister's 'bespoke' deal) or the transition to WTO status. The possible scenarios for the UK's future trading

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<sup>1</sup> Based on: Baker, J., Carreras, O., Ebell, M., Hurst, I., Kirby, S., Meaning, J., Piggott, R. and Warren, J. (2016), 'The short-term economic impact of leaving the EU', *National Institute Economic Review*, 236, pp. F108–20; Ebell, M. (2016), 'Assessing the impact of trade agreements on trade', *National Institute Economic Review*, pp. 238, R31–R41; Ebell, M. and Warren, J. (2016), 'The long-term economic impact of leaving the EU', *National Institute Economic Review*, 236, pp. F121–38; Kirby, S., Carreras, O. Piggott, R. and Warren, J. (2017) 'Prospects For The UK Economy', *National Institute Economic Review*, 239, pp. F50-79.

relationships with the EU and the rest of the world all contain a considerable risk that the level of total trade, in the long run, could be substantially less than in the counterfactual of remaining in the EU.<sup>2</sup> Ebell's (2016) estimates suggest that total trade in goods with the EU could decline, relative to the counterfactual by 35per cent (in the FTA case) and 58 per cent (in the WTO case) in the long term. Ebell's estimates suggest that total trade in services with the EU would be affected even more; 61per cent lower in the long run. Given the dominance of the EU in the UK's current trading relationships (Tables 3 and 4) it is unsurprising that such figures corresponding to substantial reductions in overall UK trade, relative to the counterfactual in the long-run. Ebell's estimates suggest that, relative to the counterfactual of remaining in single market, total UK goods trade could be around 20per cent lower and total UK service trade could be some 26per cent lower.

Existing FTAs are not as comprehensive as membership of either the EU or EEA. Assuming that the UK is able to negotiate new FTAs with the non-EU countries that are similar to those currently in existence, then Ebell's (2016) estimates suggest that the additional trade to non-EU countries generated would not be enough to fully offset the decline in trade associated with leaving the single market.

Mapping these into GDP effects, using NiGEM, suggests the level of GDP, in the long-run, could be around 2 per cent below the remain counterfactual in the case of an FTA type arrangement and approximately 3¾ per cent lower were the UK to move to WTO status.

Table 3: UK exports (per cent of total)

	Goods	Services
<b>France</b>	6.3	5.9
<b>Germany</b>	10.7	15.0
<b>Rest of EU</b>	29.9	33.3
<b>Russia</b>	1.0	1.1
<b>Other Europe</b>	5.9	7.3
<b>Brazil</b>	0.8	0.5
<b>USA</b>	16.6	8.4
<b>Other Americas</b>	3.0	2.8
<b>China</b>	4.5	9.2
<b>Hong Kong</b>	2.0	1.6
<b>India</b>	1.5	1.7
<b>Japan</b>	1.6	1.7
<b>Other Asia</b>	11.6	8.3
<b>Australasia</b>	1.6	0.7
<b>Africa</b>	3.0	2.4
<b>Total (£billion)</b>	284.9	225.5

Source: ONS Pink Book, 2016, Chapter 9.

Note: exports of services to international organisation are excluded.

Table 4: UK imports (per cent of total)

	Goods	Services
<b>France</b>	5.9	6.3
<b>Germany</b>	15.0	6.3
<b>Rest of EU</b>	33.3	26.8
<b>Russia</b>	1.1	1.3
<b>Other Europe</b>	7.3	12.2
<b>Brazil</b>	0.5	0.7
<b>USA</b>	8.4	23.5
<b>Other Americas</b>	2.8	3.5
<b>China</b>	9.2	1.6
<b>Hong Kong</b>	1.6	0.9
<b>India</b>	1.7	1.0
<b>Japan</b>	1.7	2.6
<b>Other Asia</b>	8.3	7.5
<b>Australasia</b>	0.7	2.7
<b>Africa</b>	2.4	3.1
<b>Total (£billion)</b>	411.1	137.7

Source: ONS Pink Book, 2016, Chapter 9.

Note: imports of services from international organisation are excluded.

<sup>2</sup> The reference year used for the long-run analysis is 2030.

## Assessment from other country's perspective

**Germany.** In the short term, Brexit will impact on the German economy primarily through the trade channel and increased uncertainty which could have a negative impact on investment. Given that the UK economy has so far been more robust than expected, the slowdown of economic activity in the country is now estimated to be less significant than had been the case immediately after the referendum, at least in the short term. Thus, the direct impact from lower demand in the UK on German exports should be relatively modest. However, as a result of the substantial Sterling devaluation vis-à-vis the euro German exports to the UK are nevertheless expected to be reduced by close to 10 per cent over the course of two years, which would dampen German GDP by around  $\frac{1}{4}$  percentage point. Various uncertainty measures have shown significant increases during the last year, indicating that increased uncertainty may have been a factor behind the recent weakness in corporate investment reported in the German Quarterly National Account Estimates. It is, however, difficult to tie this to the Brexit decision alone.

**Italy.** The quantitative evaluation of the economic impact of UK leaving the EU can only be tentative given that uncertainty about the character of new agreements and the timing of the process is still large. Prometeia's macro-econometric models allow us to explore the effects related to trade, both through changes in exchange rates and relative prices, and through the quantities traded between countries. Application of customs charges at the time the UK effectively exits the single market is another possible channel. More difficult is quantifying the impact on households' and firms' response to normative uncertainty and financial market volatility.

According to our models, a 10 per cent depreciation in the effective exchange rate of sterling and a 1pp reduction in the UK's GDP via a reduction in investment due to negative confidence effects affect euro area countries' GDP in a range between 0.1pp and 0.2pp, respectively, with effects on individual countries differing according to the relative importance of the UK market. Among euro area, Italy would be relatively less affected. Considering the structure of duties now in force between the EU and the US as an example of the application of customs charges, it emerges that rates are far from being homogeneous (close to 15 per cent on food products and almost zero on pharmaceuticals, for example), so their application will have very different sectoral effects. Taking into account the composition of Italy's exports to the UK, the average duty in this case would amount to some 5 per cent. Applying this to Italian trade vis-à-vis the UK, the effect would be to reduce exports by 0.3pp and imports by 0.1pp, which means an overall drop of less than 0.1pp in terms of GDP.

All in all, Brexit's effects on Italy's GDP growth would not be dramatic in terms of the value of commercial trade, but they would still not be negligible. Potentially much stronger, but difficult to assess, might be effects through confidence channels.

**The Netherlands.** A Brexit will have a relatively severe effect on the economy of the Netherlands, because the Dutch economy is relatively closely connected to the economy of the United Kingdom (UK) via trade. In a "hard Brexit", or a WTO scenario, these are calculated for 2030 at 1.2per cent of GDP. If the UK succeeds in establishing a Free Trade Agreement with the EU, the costs for the Netherlands are lower and drop to a GDP loss of 0.9per cent.

Short-term negative Brexit effects on the Dutch GDP are primarily caused by the weak British pound. A 10per cent decline leads to approximately a lower GDP growth of 0.1per cent. Because the Euro-pound exchange rate is not expected to deteriorate much more after the initial shock after the Leave Vote of June 2016, no GDP effect is expected for 2017.

**Austria.** The UK is of rather limited direct importance for the Austrian economy. Less than 5per cent of all goods exports are shipped to the UK and just 2.5per cent of tourists are of British provenience. Additionally, the World Input Output Tables show that the Austrian value added embedded in German exports to the UK is rather limited, too.

Short-term negative Brexit effects on the Austrian GDP are primarily caused by the weak British pound, which should lower GDP growth by 0.1per cent at most in 2017. Transmission time lags for currency effects on exports currently seem to be rather short; therefore, a stable exchange rate should generate no further negative growth effects in 2018.

The effects triggered by the prospective exit depend heavily on new arrangements which will regulate the future cooperation between the UK and the remaining union. As the uncertainty concerning such arrangements is very high, no quantitative estimates of effects are available.

It has to be mentioned that positive effects of a leave stemming from a relocation of British enterprises and institutions to Austria (e.g. the announcement of FIAT to return its truck production to Austria) can emerge as well. Furthermore, the new chance of a deeper integration of remaining countries could post positive effects, too.

**Finland.** Brexit affects the Finnish economy via the weakening British economy along with its global impacts. Despite the negative hit on exports in the short run, the effects on the Finnish economy seem to be somewhat restricted due to a favourable combination of relevant trade partners, comprising for instance Russia and China that are relatively immune to the negative effects of Brexit.

**Ireland.** With the UK as a destination accounting for a large proportion of Irish goods and services exports, its strong ties as a major trading partner are clear. Thus, we expect the impact from Brexit to be significant for the Irish economy.

In the short term, the main risk is due to currency fluctuations and in particular the weakening of the pound sterling. If the pound were to weaken further over the forecast period, we would expect to see a negative impact in the traded as well as the tourism sectors. As a result we have moderated back our export forecasts in 2017 and revised our GDP forecast down moderately.

Extensive research has been undertaken to determine the potential longer term impacts of Brexit on the Irish economy. A recent study measured the expected effects of Brexit under a variety of different trade arrangements such as EEA and WTO. The results of the simulations reveal that output would be lower under all scenarios ranging from 2.3 to 3.8 per cent lower over a 10 year horizon. In particular the shock would transmit through the traded sector by reducing demand for Irish goods and services. This would then feed through to employment and also into the general government balance.

## Country's details

### Germany

The German economy is expected to continue its robust expansion. The main drivers remain investment in construction and consumer spending, although private consumption is expected to slow somewhat due to higher inflation which will constrain the increase in purchasing power. This will be offset, however, by the boost to investment provided by the ongoing availability of low-cost finance, especially in the housing sector. The construction industry continues to operate at full capacity and the current order backlog in this industry is the highest in 16 years. German exports are expected to grow considerably thanks to significantly improved business prospects in the relevant foreign markets. Unemployment is expected to fall further as employment growth in the course of 2017 will likely remain on a strong upward trajectory driven by the sustained economic upturn, the continuing favourable relationship between real wage costs and productivity, and the expansion of the labour supply due to immigration. As a result of buoyant tax revenues and lower interest payments the general government budget is forecast to remain in surplus despite significantly higher public spending. Although the broad picture of the economic outlook is shared by both German Euroframe institutes, the GDP forecasts of DIW Berlin and [IfW Kiel](#) differ to some extent. While the Kiel Institute expects GDP to grow by 2 per cent in 2017 (adjusted for the smaller number working days), following 1.8 percent in 2016, DIW Berlin projects a lower rate of 1.5 per cent for 2017 mostly due to weaker export and investment dynamics (Table 5).

### France

French GDP grew by a mere 1.1 per cent in 2016. Domestic demand grew by 1.9 per cent, but net exports contributed to reduce GDP growth by 0.9 per cent. Subdued consumer price inflation and tax cuts allowed households' real disposable income to rise by 1.8, which translated into a similar rise in consumption. Housing investment rose again, after a 4-year fall. Companies benefited from tax cuts and profit ratios recovered, with a particularly clear improvement for companies in the industrial sectors. Corporate investment rose by 4.3 per cent in 2016, partly thanks to the over-depreciation scheme. Supported by several policy initiatives 220 000 jobs were created in 2016 despite mediocre output growth which, together with training schemes, led to a slight decrease in the unemployment rate to 9.9 at the end of 2016. Fiscal policy was slightly restrictive as public expenditure growth decelerated more rapidly than company tax cuts, and the government deficit decreased slightly from 3.5 per cent of GDP in 2015 to 3.3 per cent in 2016 supported by the possibility of the French government to borrow at very low interest rates.

If policy remained unchanged, French GDP could grow by ca. 1.5 per cent per annum in 2017-2018. The French government deficit would reach 3 per cent of GDP this year, under a fiscal effort of 0.3 per cent of GDP, despite further company tax cuts. Due to the rise in energy prices, inflation would rapidly stabilise at around 1.5 per cent. This would dampen households' purchasing power, which would grow by 1.1 per cent in 2017, restricting consumption growth to 1.3 per cent. Company margins would stabilise (the rise in energy prices offsetting the tax cuts). Company investment would rise by ca. 2 per cent. The improvement of the competitiveness of the French industry would at last allow net exports to have a nil contribution to GDP. Output growth and decreased employers' contributions would induce 180 000 job creation, but the decrease in unemployment would be modest (9.7 per cent at the end of 2017).



Beyond the risks from the international environment, including possible impacts of Brexit and policies of the Trump government, the forecast for the French economy is subject to a high political uncertainty this year. The elections which will take place in May (Presidential) – June (Parliamentary) will bring a new government into power. A centre-right government would be expected to implement further tax cuts on companies, on wealthiest households, social and public expenditure, labour market deregulation. In the short-term, this would increase the government deficit and raise risks of social conflicts. In the medium-term, the improvement of the attractiveness of French economy could offset the restrictive impact of lower public spending. The impact on unemployment is uncertain: will labour market deregulation offset job cuts in the public sector and retirement age postponing?

### Italy<sup>3</sup>

The latest data for the second half of 2016 suggest that the economic recovery in Italy is strengthening. A slightly better picture for the second part of 2016 coupled with the revision of past data has led to an upward revision of the 2016 GDP growth estimation to 1.0 per cent. Final domestic demand has been the main engine throughout the year, sustained by an improved credit and labour market climate and a negative inflation rate (-0.1 per cent. However, the increased political uncertainty following the resignation of Prime Minister Matteo Renzi in December and his replacement by former Foreign Minister Paolo Gentiloni would weigh on economic activity in 2017. The new government with a limited scope, the possibility of early elections and of a new referendum on labour market issues, coupled with the scheduled elections in important euro area countries, will increase uncertainty and offset the improvements over the second part of last year and the effects of slightly better international economic conditions. This will add to the already known banking sector difficulties.

The general government net borrowing in 2017 is expected to rise to 2.5 per cent from 2.3 per cent in 2016, the lowest level since the start of the financial crisis, reflecting a mildly expansive fiscal policy stance which importantly is including the planned reduction in the corporate tax (IRES) rate from 27.5 to 24 per cent. This compares with a government target of 2.3 per cent which is based on a higher GDP growth forecast and more optimistic assumptions regarding efficacy of spending measures. The increase in government bond yields, due to both a steeper yield curve (reflecting market expectations on the policy mix of the new US administration) and a larger spread between BTP and Bund than the one assumed at the time of the budget formulation will also have some weight. The government is likely to implement additional measures to address the risk of an excessive deficit of 0.2 per cent raised by the EC last January. Overall, we estimate that the increase in uncertainty and the less-than-expected expansionary fiscal policy could negatively affect growth in 2017 by as much as 0.3 per cent, and GDP growth is expected to slow to 0.7 per cent.

### The Netherlands<sup>4</sup>

The economic recovery is continuing. At the end of 2016, output per capita reached the level of 2008, following a double dip in 2009 and 2012 to 2013. By Dutch standards, the period that the economy returns

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<sup>3</sup> Based on Prometeia, Rapporto di Previsione, December 2016 and Prometeia Brief <http://www.prometeia.it/brief>

<sup>4</sup> With a few changes, the text is translated from Decemberraming 2016: economische vooruitzichten 2017. 14 pages | pdf document, 3.8 MB. ISBN 978-90-5833-752-8.

to pre-crisis levels (eight to nine years before) is exceptionally long, but this does occur more often after a financial crisis. Unemployment has fallen sharply, but is still above the long term average of over 5 per cent and well above the low level of 4 per cent in 2008. In addition to the recovery of employment, labour supply has also increased in the period 2008-2017.

Consumption contributes the most to economic growth in 2017, with growth of 2.1 per cent. Households are adjusting their spending gradually their income. The income growth of the past two years will be partly spent in the next year, leading to the savings rate to decline. The positive developments in the housing market provide a stimulus to consumption, through the expenses associated with relocation, as well as from the positive development of wealth due to rising house prices. The favourable development in the housing market is also evident in the investments in the housing market that grew for the third year in a row, even though it was less exuberant than in the past two years. In addition to consumption and housing investment, business investment, government spending and exports contributed positively to economic growth. Policy uncertainty in the European Union and the United States and continued weakness of economies in the euro zone are significant risks to economic growth.

The government budget next year will be in balance after a series of budget deficits from 2009. This is due to tax windfalls and favourable economic prospects for the coming year. The median static purchasing power increases by 0.7 per cent in 2017.

## Finland

The Finnish economy is estimated to have grown by 1.5 per cent last year. The growth was contributed by increases in household consumption and, in particular, private investments. The private investments were driven by a booming construction sector and to a smaller extent, corporate investments. The second half of the last year also saw the manufacturing sector finally picking up after many years of stagnation. Thus, the Finnish economy seems to be catching up the average growth rate of the Euro area. There is, however, still a long way to go for the Finnish economy while the current GDP is by more than 4 per cent lower than it was in 2008.

This year the focus of growth in Finland is expected to switch away from the domestic demand components towards the exports. This is helped by the competitiveness pact, a deal settled between the Finnish trade unions and employer organizations, which improves the competitiveness of the Finnish export sector. The deal was deemed necessary – although its implementation was anything but easy – with the background of the weakening market shares of the Finnish exports since the global financial crisis. Also the private consumption and investments are expected to contribute to GDP growth this year, albeit to a smaller extent if compared to their contribution last year. All in all, we expect the Finnish GDP to grow by 1.2 per cent in 2017. Nevertheless, there are positive risks not taken into account with this number, so there is a considerable probability that actual growth will outpace this estimate.

Next year, we expect the Finnish GDP to grow by 1.1 per cent. Considering the demand components, we expect that this year's development will continue, hence exports will contribute to GDP more than domestic demand will. The domestic demand is forecasted to make a smaller positive contribution to the Finnish GDP growth next year. From a broader perspective, GDP growth is restricted by the Finnish demography which will continue to cut down the growth numbers in the coming years. This also restricts

the use of fiscal policy to stimulate growth, and hence, we expect the Finnish fiscal policy to remain neutral or slightly contractionary next year.

## Ireland

The Irish economy is forecasted to grow at a rate of 3.5 per cent in 2017. The majority of growth is expected to originate from domestic sources such as consumption and investment. Although consumer confidence has been affected by international events such as Brexit and the US election leaving a clear air of uncertainty, the trends in consumer sentiment continue to remain reasonably positive. This coupled with strong tax receipts and relatively strong annual growth in retail sales should see consumption growing at an annual rate of 3.5 per cent in 2017. Notwithstanding, the various issues skewing the national accounts data in relation to intellectual property and aircraft leasing, the domestic investment climate excluding these factors appears to be picking up compared to previous years. In particular, building and construction has been steadily rising in 2016 and latest estimates suggests that we can expect somewhere in the region of 17500 housing completions in 2017.

Perhaps the greatest indicator of a positive outlook for 2017 is the steady fall in the unemployment rate that has occurred over the last few years. Since January 2016, for example, the rate fell from 8.5 per cent down to 7.1 per cent as of January 2017. It is our view that this decline in unemployment will continue over the forecast horizon and by the end of 2017 will reach 6.7 per cent. As a result of this improvement in the domestic sources of growth and particularly the gains to employment that our expected over the year, it is our view that the government deficit will also improve in 2017 and be broadly in balance.

In relation to our trade outlook, we have revised this down mainly as a result of currency appreciation following the Brexit referendum. Due to the approximately 14 per cent appreciation of the euro against the pound sterling since January 2016, we envisage falling demand for Irish exports from the UK, particularly in sectors such as the Agri-Food sector. We do, however, still believe export growth will be positive over the year largely due to positive expected growth in some of our other large trading partners such as the US and the EU.

## Austria<sup>5</sup>

In Austria growth accelerated in the second half of 2016. According to first estimates, GDP growth was 0.5 per cent (q-o-q, trend-cycle component) in Q4. Domestic demand was growing strongly, net exports contributed negatively. Private households translate their income gains from the tax cuts into higher consumption, and companies in many sectors see their situation improving. Exports of tourism services are performing relatively better than those of goods. Being less productivity-enhancing, they have a stronger employment effect, but at the same time exert upward pressure on inflation. Austria's inflation rate therefore remains above the euro-area average, though falling below 1 percent in 2016 for the second year in a row. Employment growth strengthened in 2016 from the previous year. At the same time the inflow of workers from the new EU member countries abated, so that the rise in unemployment virtually levelled off. However, in the next few years it will return to an upward trend when the immigrants granted

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<sup>5</sup> With a few changes, the text is taken from Schiman, St. „Prognose für 2017 und 2018: Kräftige Inlandsnachfrage hält noch etwas an“, Wifo, 16.12.2016.

asylum or subsidiary protection status join the labour market. By mid-2017, once the effect of the tax cuts wears off, consumer demand will lose momentum. Investment in machinery and equipment are expected to pick up only little, given the moderate outlook for foreign demand. Construction activity is set to rebound, although rising demand for housing space faces income constraints of many customers and high real estate prices. Against this background GDP is expected to grow with 1.5 per cent in 2017 and 1.4 per cent in 2018.

## UK<sup>6</sup>

Economic momentum was maintained in the second half of 2016 (since the referendum on membership of the EU)The resilience of the economy has largely been due to a robust expansion in real consumer spending, which in turn has been supported by rising real disposable incomes over the course of 2015 and 2016.

GDP growth is forecast to grow by 1.7 per cent this year before picking-up marginally, to 1.9 per cent in 2018<sup>7</sup>. However, the domestic economy faces substantial headwinds in 2017 and 2018. Sterling, on a broad trade-weighted basis, has depreciated by close to 20 per cent since this start of 2016, with over half of this depreciation occurring since the referendum. We expect the exchange rate depreciation to pass through to consumer prices. With labour market flexibility over the coming years assumed to continue to manifest in the form of an absence of downward real wage rigidities. The erosion of the purchasing power of households, coupled with an increase in precautionary saving due to a rising rate of unemployment are expected to weigh on the volume of consumer spending this year and next. Elevated uncertainty is expected to weigh on the spending decisions of private firms.

These modest rates of growth are below estimates of the UK's long-run potential rate, and as such constitute a widening rather than narrowing of the negative output gap. Furthermore, relative to the 'remain' counterfactual, these forecasts are broadly consistent with a short-term economic growth shortfall of around 1¾ percentage points over the period 2016-2019.

Consumer price inflation increased in each month of the final quarter, reaching 1.6 per cent in the twelve months to December, the highest rate since July 2014. Dipping underneath the headline rate we see a picture of building inflationary pressures. Producer input prices jumped markedly in the final quarter of last year, responding to sharp increases in the price of oil and imported metals. As you would expect, the sharp depreciation of sterling subsequent to the referendum has resulted in relatively quick pass-through from those commodities which trade at world prices. We expect to see further pass-through as prices continue to adjust to the depreciation of sterling. We expect the second stage of pass-through to push the rate of consumer price inflation to around 3.7 per cent per annum by the end of this year, before gradually moving back towards target in the subsequent two years

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<sup>6</sup> This forecast summary is based on Kirby, S., Carreras, O. Piggott, R. and Warren, J. (2017) 'Prospects For The UK Economy', National Institute Economic Review, 239, pp. F50-79. Published 01.02.2017.

<sup>7</sup> Since the publication of NIESR's forecast, the Office for National Statistics have revised (on 22.02.2017) their estimate for GDP growth in the first quarter of 2016, lowering the overall growth rate for 2016 by 0.2 percentage point to 1.8 per cent per annum.

As a result of the mild slowdown of the economy, we expect the unemployment rate to edge up to 5.1 and 5.4 per cent this year and next, respectively. The corollary of softening output growth and nearly constant unemployment rate is weak growth of labour productivity in both years, implying that real wages will be broadly flat.

The current account balance deficit is expected to shrink through 2017 and 2018, as the depreciation of sterling leads to a reduction in import volumes, a modest increase in export volumes and a positive contribution from the primary income balance. We forecast the current account deficit to be 2.7 per cent of GDP this year and ½ per cent next year.

Post referendum policy responses should support demand through this year and next. The Bank of England reduced Bank Rate by 25 basis points, announced an expansion of its balance sheet through the purchase of £60 billion of government bonds and £10 billion of sterling corporate bonds. To aid the monetary transmission mechanism a four year liquidity scheme for the banking sector was also introduced. We expect the Bank of England to look through the temporary period of above target inflation and to keep interest rates unchanged until the middle of 2019, increasing gradually at around 50 basis points per year thereafter.

In December, the government unveiled a new fiscal framework and a marginal loosening of fiscal policy, which is expected to provide a modest boost to demand in 2017. The new fiscal framework, scraps the previous target of reaching an absolute surplus by 2020–21, and replaces it with an overall objective for government to “return the balance back to surplus at the earliest date in the next parliament” and a target to reduce cyclically-adjusted public sector net borrowing to below 2 per cent of GDP by 2020–21; a target that is forecast to be met with relative ease.

## Poland

Poland’s economic outlook continues to be shaped by a mixture of favourable baseline economic conditions and risky policy choices. According to the Central Statistical Office, the Polish economy has grown by 2.8 per cent in 2016, in line with CASE’s forecasts. Household consumption was the main driver of growth, having increased by 3.6 per cent in 2016 (compared to 3.0 per cent in 2015). Exports benefited from the good economic performance of Germany, Poland’s largest export partner, although Poland’s export growth has been overtaken by import growth in the recent months. Unemployment continued to decrease in 2016 and reached a historical low (of 5.9 per cent according to Eurostat methodology) as a consequence of demographic trends, economic emigration, and the continued expansion of the economy. As these factors are not going to abate in the near future, unemployment in Poland is not projected to rise and may even decrease further. Late 2016 also brought an end of deflation, with a substantial increase of CPI in December, at 0.7 per cent m-o-m. Inflation is expected to be at 1.1 per cent in 2017 and 1.0 per cent in 2018.

In 2017 and beyond, Poland will face inflated public spending, which threatens public finances, and a climate of uncertainty, which depresses investment. The current populist Law and Justice government, incumbent since November 2015, has made heavy use of social spending. This caused the budget deficit to reach an estimated 2.8-2.9 per cent relative to GDP in 2016 and will pose an even greater challenge to the budget in 2017 and the following years, as the social programs introduced in 2016 move in full swing.

Measures to reduce the tax gap, especially with respect to VAT, are burdensome to businesses and at the same time have so far failed to yield a significant increase in tax collections. As more promising structural reforms, such as simplification of the tax system, are nowhere to be seen on the political horizon, a significant increase in tax revenue in the near future is unlikely. Even more dangerous in the long run are changes being done to the country's institutions. They include undermining the authority of the Constitutional Tribunal, subordinating the state media to the government, attempts to drastically reorganize the judiciary, frequent changes in the management boards of state enterprises, frequent and business-unfriendly changes in the tax system. The high level of uncertainty that they generate is the most plausible explanation of the considerable slowdown in investment, which dropped by 5.5% in 2016.

Given the current mixture of macroeconomic conditions and policy environment, GDP growth is currently forecast at 2.9 per cent in both 2017 and 2018.

Table 5: Individual Country Forecasts

Country	GDP growth (%) <sup>a</sup>			CPI Inflation (HICP, %)			Unemployment Rate (Eurostat definition, %)			Forecast Date
	2016	2017	2018	2016	2017	2018	2016	2017	2018	
<b>Austria (WIFO)</b>	1.5	1.5	1.4	0.9	1.7	1.7	6.1	6.2	6.2	16.12.2016
<b>Finland (ETLA)</b>	1.5	1.2	1.1	0.4	1	1.5	8.8	8.6	8.4	31.01.2017
<b>France (OFCE)</b>	1.1	1.4	1.5	0.3	1.6	1.7	10.0	9.8	9.7	30.10.2016
<b>Germany (DIW)</b>	1.9	1.2	1.6	0.5	1.4	1.5	4.1	4	3.8	14.12.2016
<b>Germany (IfW)</b>	1.8	2.0	2.0	0.3	1.4	1.6	4.2	4.0	3.4	15.12.2016
<b>Italy (Prometeia)</b>	1.0	0.7	0.8	-0.1	1.3	1.5	11.6	11.4	11.3	15.02.2017
<b>Ireland (ESRI)</b>	4.2	3.5	-	0	0.6	-	8.0	7.0	-	10.12.2017
<b>Netherlands (CPB)</b>	2.1	2.1	-	0.1	0.9	-	6.0	5.3	-	13.12.2017
<b>Poland (Case)</b>	2.8	2.9	2.9	-0.5	1.1	1.0	5.9	5.7	5.5	01.02.2017
<b>United Kingdom (NIESR)</b>	2.0	1.7	1.9	0.7	3.3	2.9	4.9	5.1	5.4	01.02.2017
<sup>a</sup> working day adjusted	1.99									