Bundesverband der Deutschen Industrie e.V.

EUROPEAN GROWTH OUTLOOK

Europe defies global turbulence

However, growth is not yet self-sustaining

February 2016

- **The economy of the European Union is likely to grow by 1.9 percent in 2016; the economy of the Euro area by 1.7 percent.** The biggest driver of growth is still private consumption, which is being boosted by cheap oil and low interest rates. The weaker euro is supporting exports, but exports are still only likely to make a small contribution to growth. Investments are gradually increasing, yet remain far from pre-crisis levels.

- **The future development of the emerging market countries, migration flows towards Europe and geopolitical conflicts pose considerable forecast risks.** The influx of refugees will lead to higher public spending in the short term and provide a mild economic stimulus. In the medium to long term the economic impacts will depend on how the refugees are integrated into the labour market.

- **The unemployment rate is likely to fall slightly from 9.5 percent in 2015 to 9.0 percent this year.** There remain large differences between the labour markets of the various Member States. While an unemployment rate of 4.9 percent is forecast for Germany, Greece and Spain are likely to be saddled with unemployment of 24.0 percent and 20.4 percent respectively.

- **ECB monetary policy remains expansive.** The downward trend in prices has been successfully transformed into a modest rise. Fiscal policy is expected to remain largely neutral in 2016, with debt as a proportion of GDP falling slightly to 86.9 percent in the EU and 92.7 percent in the Euro area.

Content

Modest recovery in Europe continues

Europe's economic development remains on an upward trajectory. The recovery in Europe will continue its slow but steady progress this year, aided by strong domestic demand; an uptick in the global economy, mainly attributable to the industrialised countries; and further monetary and fiscal policy easing in Europe. Rising employment and the drop in oil prices are boosting consumption and counterbalancing companies' weakening export performance as global demand slows, particularly in the emerging markets. However, economic development is being hindered by structural problems in certain European countries, which are proving very persistent in some cases.

The European Commission (2016) is predicting that the European Union will experience real GDP growth of 1.9 percent this year and 2.0 percent in 2017, and 1.7 percent and 1.9 percent respectively for the Euro area. According to the latest IMF estimates (2016), the Euro area will grow 1.7 percent in both 2016 and 2017. The OECD (2016) is forecasting slightly weaker growth of 1.4 percent and 1.7 percent for these two years. The Confederation of European Business BUSINESSEUROPE (2015) is predicting 2.0 percent growth for the EU and 1.8 percent for the Euro area in 2016.

Regional growth rates vary widely

The global economy grew last year, though it lost some momentum. With GDP growth of 3.1 percent, global production recorded its smallest increase since the crisis year of 2009. For 2016 the European Commission is forecasting growth of 3.3 percent, the IMF anticipates 3.4 percent and the OECD is less optimistic with an estimate of 3.0 percent. The weakening Chinese economy, low energy and commodity prices and the tightening of monetary policy in the United States are currently shaping global economic development. In addition, geopolitical tensions are causing greater uncertainty.

In the developed economies the recovery continued at a modest pace in 2015, though the degree of progress varied between individual countries and regions. The US economy improved slightly, with real GDP rising by 2.5 percent. This trend is likely to continue, though it is not showing any signs of picking up significant momentum. The US economy's current development is shaped, on the one hand, by the continuously improving labour market and an upward trend in consumer spending, and on the other hand, by modest investment from many companies due to the low oil price and a strong dollar. Japan's economy is faltering and struggling with the lack of demand from the emerging market countries. A relaxation of monetary policy and favourable financing conditions should provide fresh impetus for economic growth. Further information on Japan can be found in the BDI Country Report (Deutsch, Keichel 2015). The IMF forecasts annual growth of 2.1 percent for the developed economies in 2016 and 2017.

Emerging market countries facing great challenges

The emerging market countries appear to be in a critical situation, with growth rates having fallen for the fifth year running. Low commodity prices and structural problems are taking their toll. China's economic motor has stalled; economic growth in the country is at its lowest level in 25 years. Many industrial sectors are experiencing a significant slowdown and battling with considerable excess capacities. However, the increasingly robust service sector can at least compensate for some of industry's struggles. The structural transformation of the Chinese economy that policymakers are pursuing is leaving its mark (see Deutsch, Müller 2015). Brazil continues to struggle with a deep recession and a restrictive policy to curb inflation and government debt. Russia also finds itself in a recession; the strains of economic sanctions imposed by the West and the collapse of oil prices are having a major impact on the once booming emerging economy. The IMF forecasts growth of 4.3 percent in 2016 and 4.7 percent in 2017 in the emerging market countries. Compared to the long-term average, this is only a very modest increase.

European forecast 2016 in percent

	GDP growth		Inflation	Unemploy-ment rate	Current ac-count balance
	Actual value 2015				
Germany	1.7	1.8	0.5	4.9	8.6
France	1.1	1.3	0.6	10.5	-1.5
Italy	0.8	1.4	0.3	11.4	2.1
Spain	3.2	2.8	0.1	20.4	1.4
Netherlands	2.0	2.1	0.9	6.6	9.9
Belgium	1.3	1.3	1.4	8.0	2.1
Greece	0.0	-0.7	0.5	24.0	-1.4
Ireland	6.9	4.5	0.6	8.5	3.7
Austria	0.7	1.7	0.9	6.2	3.5
Portugal	1.5	1.6	0.7	11.7	1.1
Slovakia	3.5	3.2	0.3	10.3	-2.2
Slovenia	2.5	1.5	-0.3	8.8	7.2
Finland	0.0	0.5	0.1	9.4	0.4
Euro area	**1.6**	**1.7**	**0.5**	**10.5**	**3.6**
Bulgaria	2.2	1.5	-0.1	9.4	2.2
Denmark	1.2	1.7	0.9	5.8	7.3
United Kingdom	2.3	2.1	0.8	5.0	-4.7
Poland	3.5	3.5	0.6	7.0	-0.7
Romania	3.6	4.2	-0.2	6.6	-0.1
Sweden	3.6	3.2	1.1	6.9	5.3
Czech Republic	4.5	2.3	0.4	4.8	-2.0
Hungary	2.7	2.1	0.3	6.0	5.6
EU	**1.7**	**1.9**	**0.5**	**9.0**	**2.1**

Source: European Commission

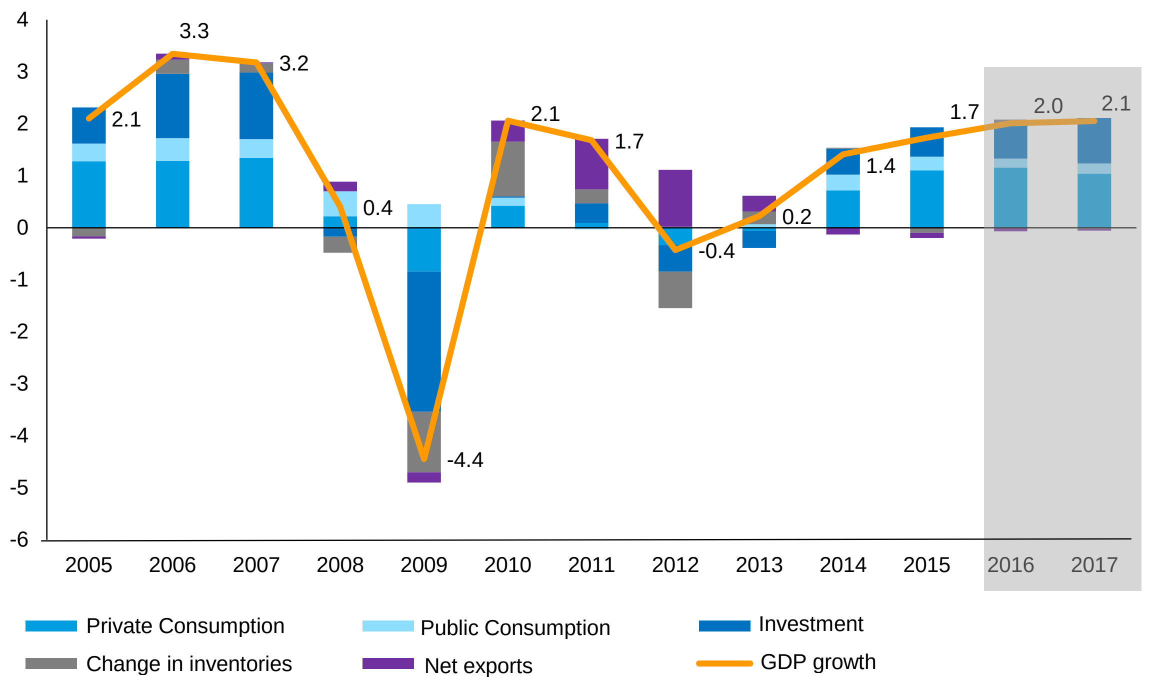
Consumption remains key growth driver in Europe

Last year real GDP rose 1.7 percent in the European Union and 1.6 percent in the Euro area. Consumption was the key growth driver, with consumer spending up 2.0 percent in 2015 year-on-year on an inflation-adjusted basis while public spending rose 1.5 percent. This added 1.4 percentage points to the growth figure, a solid contribution. Capital expenditure increased by 2.9 percent, contributing 0.6 percentage points to growth. A considerable rise in capital expenditure, typical of a recovery phase, was only seen in a few European countries, including Spain, Ireland and the Netherlands. Exports rose 5.1 percent, imports 5.6 percent. Net exports made a slightly negative contribution to growth (–0.1 percentage points). Weak demand from emerging markets remains a risk factor for foreign trade.

For this year the European Commission expects continuing moderate growth, with a slight increase in the contribution of all components. The main economic driver will again be consumption, buoyed by another dip in oil prices and higher incomes. Public spending can also be expected to increase as a result of the refugee and migrant situation.

Corporate financing conditions will remain favourable this year due to low interest rates on bonds and loans, indicating potential for a rise in capital expenditure, which could somewhat offset lower exports.

Contributions to growth in the European Union

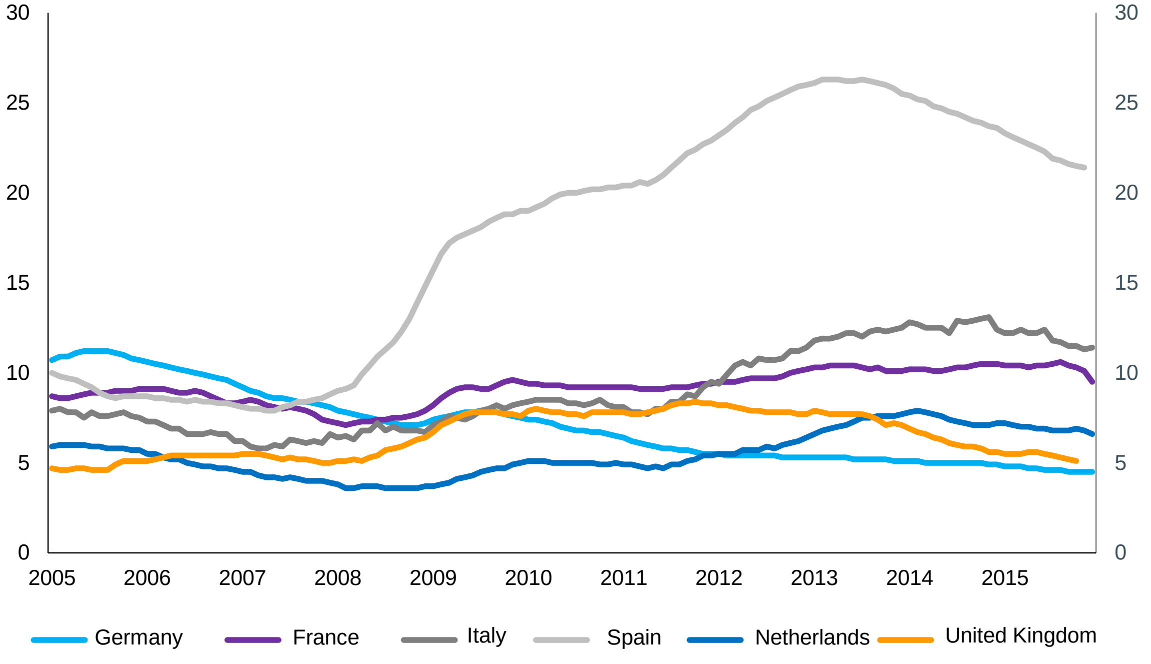


Source: AMECO, Forecast for 2016 and 2017

Further labour market improvement, youth unemployment remains an obstacle

The European labour market continues to improve, although there are still large differences among Member States. Unemployment has fallen steadily since 2013 to its present level of 9.0 percent (as of December 2015) – the lowest figure since July 2009. Germany and the Czech Republic recorded the lowest unemployment rate of all the 28 EU Member States (4.5 percent). The highest rate was 24.5 percent in economically battered Greece, followed by 20.8 percent in Spain. Youth unemployment remains especially high, particularly in Greece (48.6 percent) and Spain (46.0 percent). A further easing of the labour market situation is expected in 2016.

Unemployment rate in percent

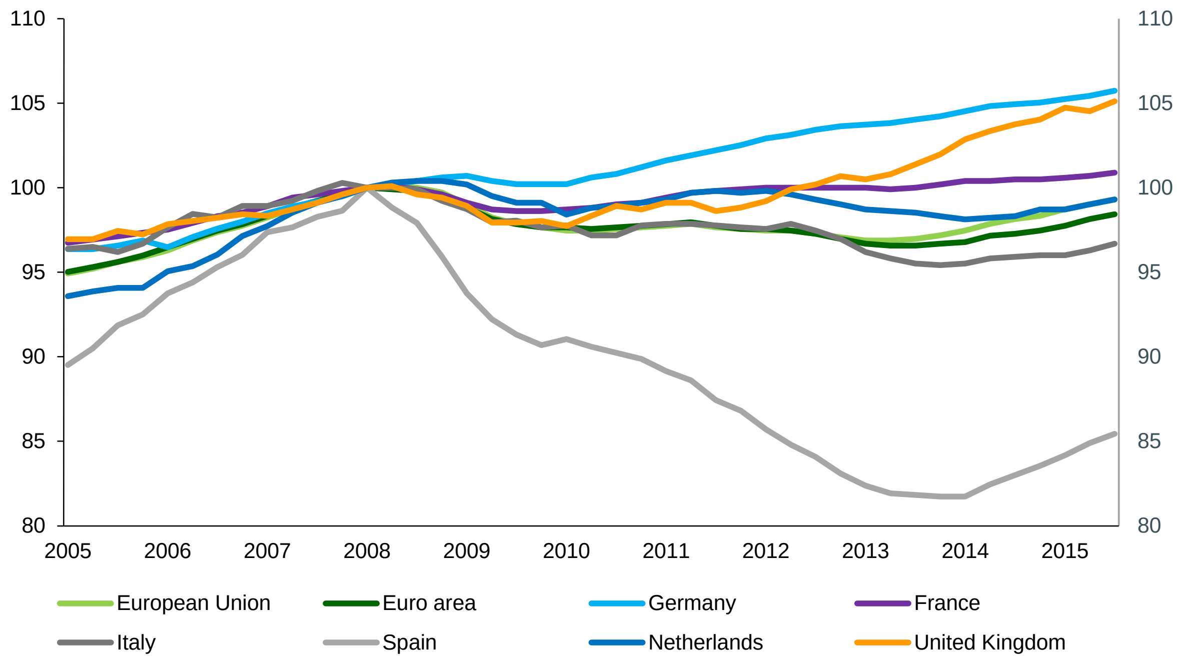


Source: AMECO

The rate of employment rose slightly to around 65 percent in 2015, yet it still has a long way to go to reach the Europe 2020 target of 75 percent. Only a few Member States have managed to get close to or exceed the target. Many countries are battling with employment rates of under 60 percent. The situation is grimmest in Greece, with just under 50 percent, and Spain, with 56 percent. However, further progress is expected even in these countries.

As for the overall employment situation, both the EU and the Euro area are below their highest levels from before the crisis. Only Germany, the Netherlands and France have reached a higher employment rate than that recorded in 2008. In Spain employment is almost 15 percent short of its pre-crisis level.

Employment in Europe



Source: Eurostat, 1. Quarter 2008 = 100 (based on persons), seasonally and working-day adjusted (France: not-working day adjusted)

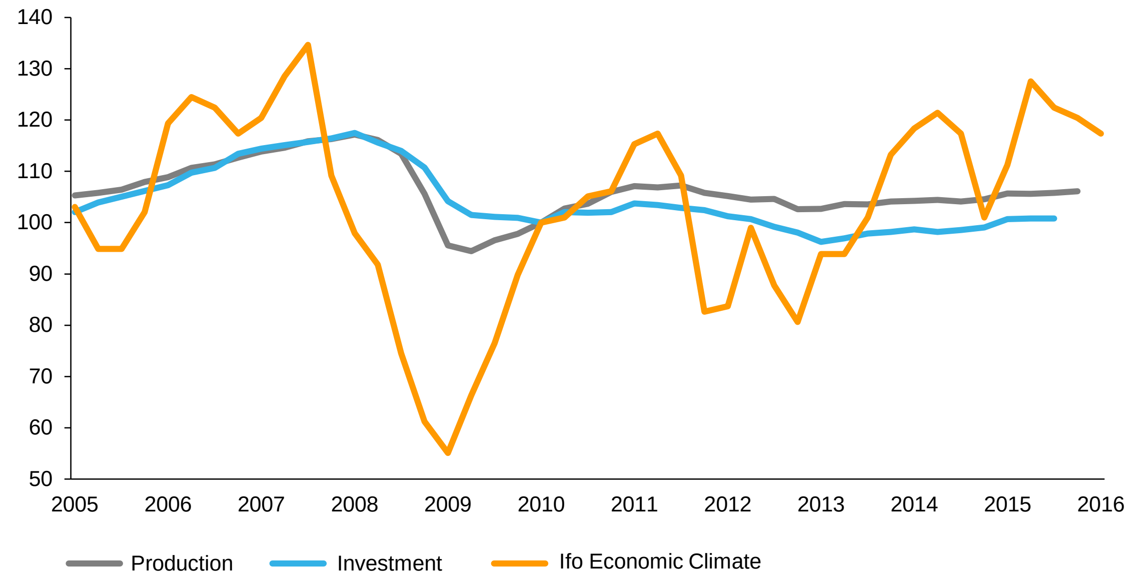
Confidence at a high level, production rising slowly, investment lagging behind

After reaching a temporary high in the second quarter of 2015, the Ifo index for the economic climate in the Euro area fell slightly in the following quarters. This essentially constitutes a correction after the rapid rise in the previous quarter. With a value of 118.9 in the first quarter of 2016, the indicator is in the region of the boom years prior to the crisis (CES Ifo 2016).

Industrial production in the Euro area is less dynamic and is currently 10 percent below its highest level from the first quarter of 2008. In particular, slumps in energy production are dampening development, whereas production of durable and non-durable consumer goods is experiencing a particularly strong rise, driven by high consumption. Among the large Member States, positive impetus in 2015 came from Spain, France and Italy, while Germany and the Netherlands performed modestly. This represents a catch-up effect, particularly since German industrial production had grown significantly in the previous years.

Despite a slight increase in the final months of 2015, investment is still the problem child in the Euro area. From 2005 up to the crisis investment and production developed in parallel, but since at least 2010 a persistent wedge has been driven between these two indicators. This gap in investment is increasingly leading to an ageing of production capital and a creeping loss of competitiveness. The investment requirements for European energy grids and the digitisation of the economy are particularly high, at 100 billion and 55 billion euros respectively (EIB 2015). This is why the Investment Plan for Europe, including the European Fund for Strategic Investment (EFSI), has been set up to enable investments totalling 315 billion euros in the coming years. The initiative from the European Commission and the European Investment Bank was launched in mid-2015 and has enabled 50 billion euros of investment in 22 of the 28 Member States up to the start of this year. The plan's future success will largely depend on how effectively non-financial investment hurdles can be removed and whether the Capital Markets Union can be implemented in a targeted manner (Eichert, Kudiß 2015).

Industrial activity in the Euro area



Sources: Eurostat, ifo Institute 2016, 2010 = 100

Weaker euro benefits exports, renminbi causes market volatility

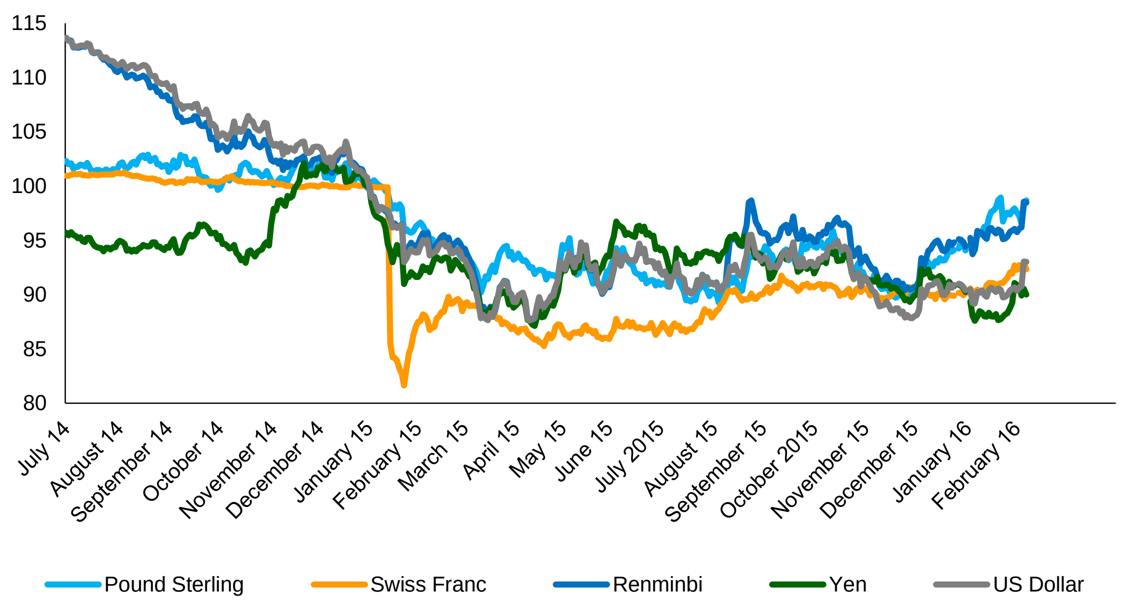
There are various factors currently affecting the major global currency rates. Firstly, the expansive monetary policies of the ECB and the Bank of Japan are weakening the external values of the euro and the yen respectively. Secondly, China's lower growth prospects are causing volatility in the value of the renminbi. Thirdly, expectations of interest rate hikes by the US Federal Reserve and the actual rate increase at the start of 2015 have boosted the value of the US dollar.

The nominal euro-dollar exchange rate is still on a downward trend. Before the ECB Governing Council meeting at the start of December 2015, the markets had anticipated a larger expansion of quantitative easing, which meant there was a slight upward correction in the value of the euro after the decision on 3 December 2015. Since then, the euro has lost around 1 percent in value relative to the US dollar. The euro has performed similarly relative to the yen since the ECB's decision.

Compared to the renminbi and the pound sterling, the euro recently gained in value. For the renminbi this can be attributed to the decoupling from the US dollar and the transformation of the Chinese economy. These two factors, along with the stock market turbulence in China, have contributed significantly to the price fluctuations of the renminbi. As for the euro's slight increase in value relative to the British pound, the downward revision in UK growth and stable growth in the Euro area both play a role. Following the Swiss National Bank's decision and the strong rise in the value of the Swiss franc in January 2015, the euro-franc exchange rate has shown little volatility since mid-2015.

The weakness of the euro relative to most currencies is favouring Euro area exports considerably. Particularly the countries that are largely price competitive are benefiting from this development. Compared to the first quarter of 2014, the nominal effective exchange rate of the euro against 19 trading partners of the Euro area has fallen around 10 percent. For 2015 the Euro area is likely to record a current account surplus of 390 billion euros, or 3.7 percent of GDP. Germany and the Netherlands alone account for 2.5 percent and 0.7 percent of this expected surplus respectively (European Commission 2015c).

Nominal exchange rates



Source: Eurostat, 1 January 2015 = 100

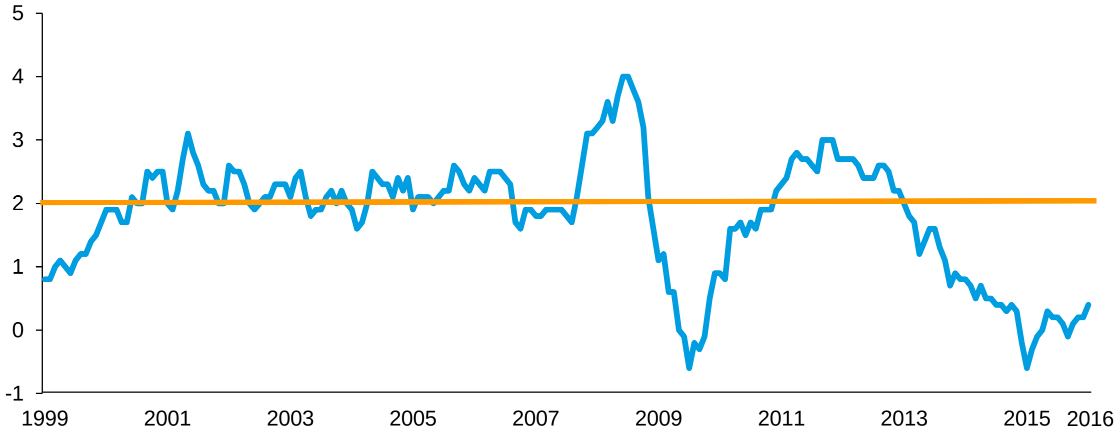
The ECB keeps the printing press running

Monetary policy in Europe remains very expansive and there is no sign of this strategy changing. Key interest rates are at a historically low level, and the ECB has taken further unconventional monetary policy measures with its asset purchase programmes. One year after this strategy was initiated its impacts and provisional successes are becoming apparent. The rate of inflation in the Euro area has stabilised and stood at 0.4 percent in January 2016.

Deflation worries averted for the time being, but inflation remains weak

From December 2014 to March 2015 the rate of inflation was negative, averaging -0.3 percent. From May 2015 onwards, with the exception of September, it remained above zero, resulting in an overall average rate of 0.0 percent and therefore in price stagnation in 2015. For 2016 the ECB's December forecast predicted an inflation rate of around 1 percent (ECB 2015). By February 2016 this estimate had already been revised downward in light of lower oil prices and a levelling-off of the global economy (ECB 2016). The rate of inflation is therefore likely to be in line with the European Commission's forecast in February, which estimates that prices will rise 0.5 percent this year. The current forecast for 2017 is 1.5 percent.

Inflation rate in the Euro area, in percent



Source: ECB

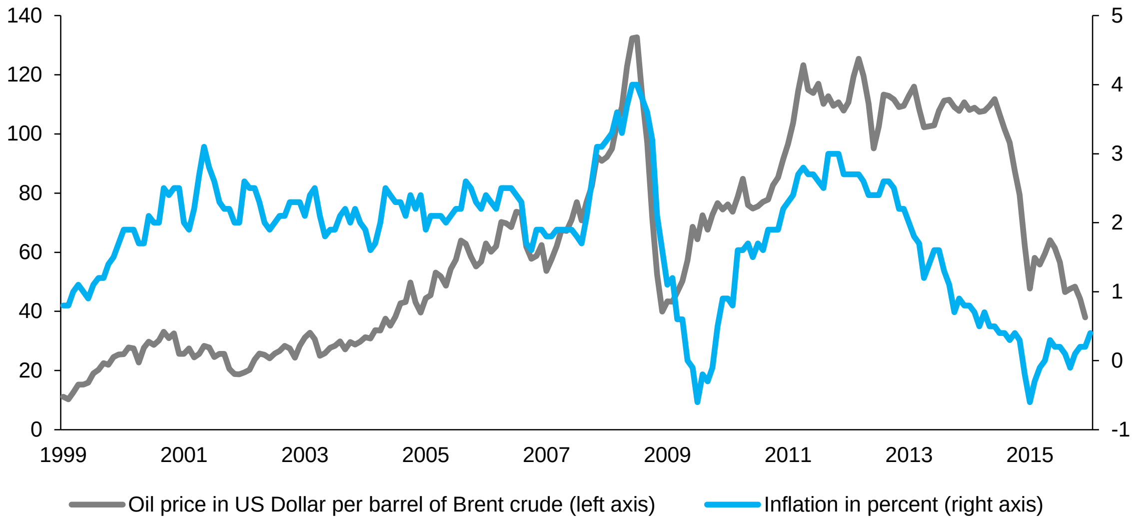
ECB monetary policy played a major role in the reversal of the price trend. After the interest rate cuts from 1.5 percent to 0.05 percent between 2011 and September 2014 had little effect on inflation rates, in January 2015 the ECB launched its extended Asset Purchase Programme (APP). This involved monthly purchases of government bonds and bonds of supranational institutions with a volume of 60 billion euros. The APP was originally intended to run to at least September 2016, but at the ECB Governing Council meeting in December 2015 it was extended to at least March 2017. Decisions were also made to extend the bond purchases to regional and federal issuers, and to invest the interest income from the programme. In addition, the ECB lowered the deposit rate by ten basis points to –0.3 percent.

The stabilisation of the inflation rate confirms the assessment made in the autumn edition of this publication (Eichert, Jäger 2015, p.14). The ECB's expansive strategy is now starting to bear fruit. Lending is slowly but surely taking off and price competitiveness in the Euro area has improved, thanks to the favourable exchange rate. Fears expressed by critics of this monetary policy strategy have so far not materialised. House price appreciation rates are within historic averages and property market bubbles have not formed (Praet 2016). Nevertheless, it remains important to continue developing strict macroprudential monitoring and to detect risks in the financial sector at an early stage. For the early identification and prevention of property bubbles, some countries have already introduced borrower-specific macroprudential instruments that target loan-to-value and loan-to-income ratios. It would appear sensible to introduce solutions of this kind throughout the Euro area.

Inflation driven primarily by oil prices

Since 2008 inflation in the Euro area has been particularly driven by changes in oil prices. While there was no significant correlation (0.13) between the rate of inflation and the price of oil based on monthly data over the whole period from 1999 to 2015, the period from 2008 to 2015 reveals a correlation of 0.64. Inflation is therefore being influenced significantly by energy prices. In 2015 the ECB was able to counteract this correlation with its monetary policy: while oil prices continued to fall, the inflation rate was increased from -0.6 to a positive value. In 2015 the correlation value is 0.08 and therefore no longer significant. Due to the limited data available, however, this finding should not be overestimated and will only become clear in the course of this year.

Oil price and inflation

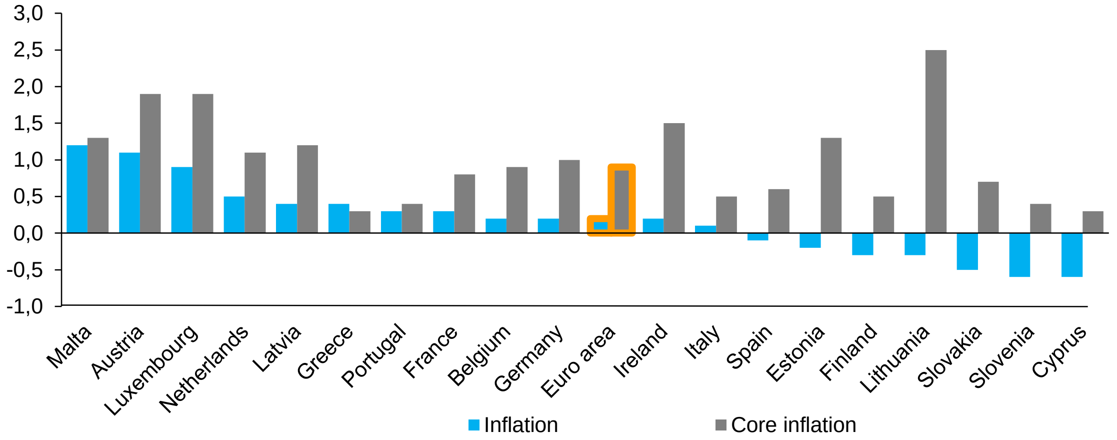


Quellen: EZB, EIA

The Euro area's core inflation rate (excluding energy, food, alcohol and tobacco) for December 2015 was 0.9 percent, which is 0.7 percent higher than the general inflation rate of 0.2 percent. This discrepancy illustrates the strong influence that energy prices have on inflation. In December 2015 the price index for energy in the Euro area was down around 7 percent versus December 2014.

There is significant variation in how general and core inflation rates have developed in different countries. Most of the countries particularly affected by the crisis still have negative inflation, whereas some other countries are already on the path towards normalisation. The considerable differences also illustrate the difficulties the ECB is having in pursuing a single monetary policy for 19 countries with contrasting economic policies. It therefore seems all the more important to continue systematically developing the proposals from the Five Presidents' Report (European Commission 2015a) and to strengthen coordination of economic policy in the Euro area (Eichert 2015).

Inflation rate and core inflation in December 2015



Source: Eurostat, data compared to the previous year quarter

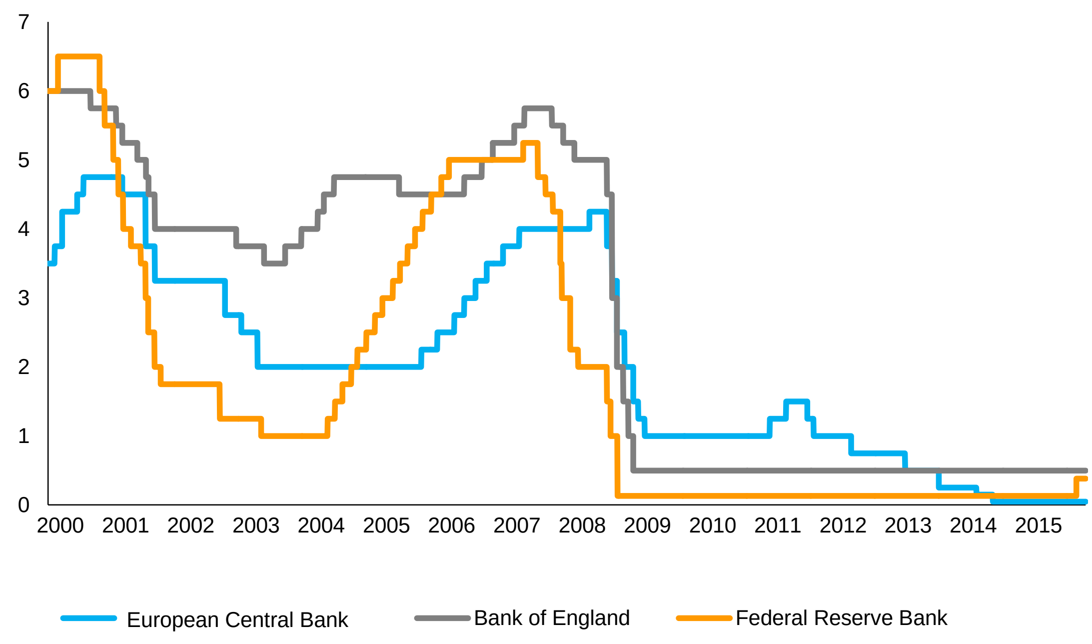
Federal Reserve initiates rate reversal in the US

Whereas most central banks are currently pursuing an expansive monetary policy, the US Federal Reserve (Fed) raised key interest rates for the first time since 2006 on 16 December 2015. They have increased by 25 basis points from a band of 0 to 0.25 percent to a band of 0.25 to 0.5 percent. This step was preceded by numerous prior announcements by Fed Chair Janet Yellen to prepare the markets. The Fed has raised the prospect of further increases in 2016, so rates can be expected to rise gradually. Weaker economic data in February currently suggest the increase may be implemented more slowly than first planned.

The Fed's decision is supported by solid economic data from the US. According to the OECD (2015b), the US economy is likely to record annual growth of around 2.5 percent in 2016 and 2017, with an unemployment rate of under 5 percent in both years. Based on these initial values, the OECD also predicts that the Fed will raise its key interest rates in several steps to 2 percent by the end of 2017. Under these assumptions, the rate of inflation is forecast to reach 1.3 percent and 1.7 percent in 2016 and 2017 respectively.

By proceeding gradually, the Fed appears to have found the right approach to avoid financial market upheavals. The increase in US interest rates harbours the risk that capital will abruptly flow out of the emerging market countries as a result, leading to global turbulence. In the worst case, numerous emerging market countries could be thrown into deep crises that could rapidly spill over into the global economy.

Key interest rates in selected countries



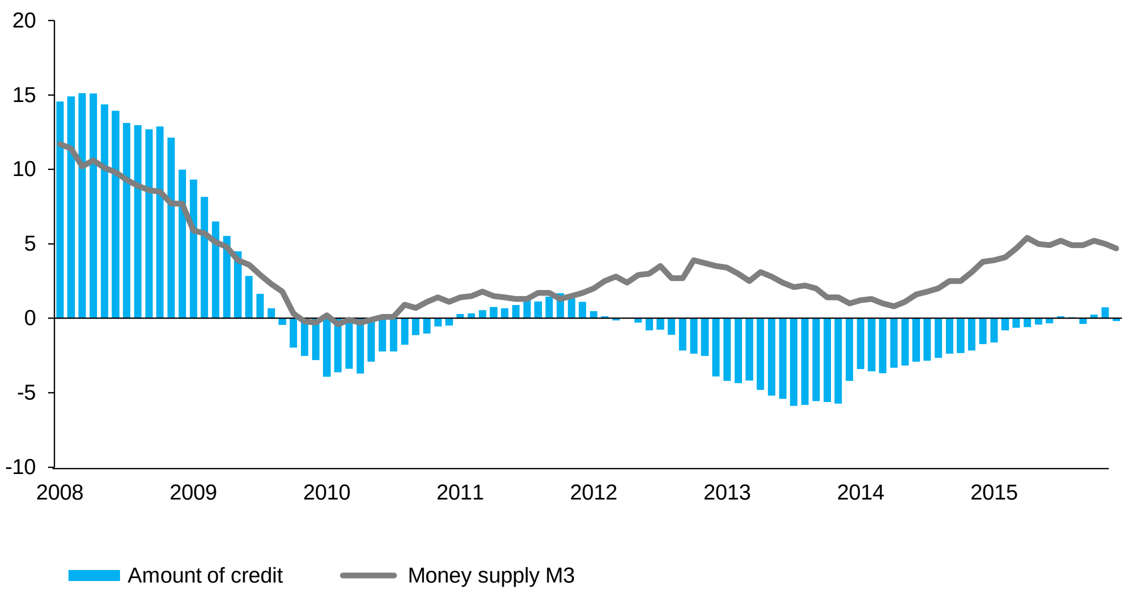
Sources: ECB, BoE, Fed

Corporate lending gradually gathers momentum

From mid-2012 to mid-2015 the volume of credit to non-financial companies declined continuously. This was due to factors on both the supply and the demand side. Regulatory provisions and the necessity to build equity diminished the credit supply from the banking sector. This was compounded by heightened risk aversion and uncertainty, which was particularly damaging to SMEs and young businesses. On the demand side there was a reluctance to invest in the corporate sector, which can also be attributed to factors including uncertainty and low productivity growth. Since July 2015 corporate loans have started rising again for the first time, and monetary growth has levelled off at around 5 percent since the APP began.

There is a lot of variation between the financing situations of the different Member States. While Germany typically has few barriers to credit financing, the southern countries in particular are facing bottlenecks. Non-performing loans are still placing a strain on many bank balance sheets and causing a credit crunch. In almost all Euro area countries there is still further potential for venture capital and start-up financing. Consequently, the European Commission has put an investment plan in place. In any case, the monetary strategy of the ECB means there is a favourable environment for stimulating investment activity in the Euro area.

Credit and monetary growth in the Euro area, year-on-year, in percent



Source: ECB

Debt levels slightly lower, enthusiasm for reform is limited

The current economic situation, with low but constant growth, expansive monetary policy and cheap oil, offers ideal conditions for budget stabilisation and structural reforms. In terms of fiscal consolidation the Member States' efforts are beginning to show the first signs of success. However, commitment to reforms of the labour, product and service markets remains limited.

In the cycle of the European Semester for coordinating European economic and monetary policy, the European Commission (2015c and 2015d) recently presented its report on the Member States' budget planning for 2016 and its Annual Growth Survey and Alert Mechanism Report. These documents form the basis for identifying macroeconomic imbalances and for deriving country-specific recommendations, both of which are published each spring. This year the European Commission once again perceives risks that the Member States will not meet the budget targets they have set. It is also concerned that new macroeconomic risks will emerge. A new feature of the current European Semester is that greater attention is given to the Euro area's aggregate fiscal stance. This is in line with the Five Presidents' Report (European Commission 2015a) on the completion of the Economic and Monetary Union, which underlines the central role of the Euro area. This year's Annual Growth Survey focuses on three similar priorities to last year: (i) restoring investment activity, (ii) continuing with structural reforms to modernise the economy and (ii) achieving and maintaining responsible fiscal policies.

Budget consolidation in the Euro area driven largely by Germany

The budget deficit in the Euro area will decline slightly from 2.2 percent of GDP in 2015 to 1.9 percent in 2016. The impetus of the fiscal stance throughout the Euro area is regarded as neutral to slightly positive and appropriate overall; the European Commission recommends maintaining this strategy. The debt level is likely to fall to 92.7 percent in 2016, following its peak of 94.5 percent in 2014. Germany is largely responsible for this development. Without Germany, the level of government debt in the Euro area would actually increase slightly from 2015 to 2016, reaching approximately 100 percent of GDP. For the 2016 budgets the European Commission granted the euro Member States generous exemptions related to the Stability and Growth Pact (European Commission 2015d). Among other measures, the Commission announced that it would accept additional expenses due to refugees being regarded as special effects. This will happen ex post if a country does not attain its targets in 2016.

European forecast in percent of GDP

	Budget balance		Debt balance	
	2015	2016	2015	2016
Germany	0.5	0.1	71.6	69.2
France	-3.7	-3.4	96.2	96.8
Italy	-2.6	-2.5	132.8	132.4
Spain	-4.8	-3.6	100.7	101.2
Netherlands	-2.2	-1.8	66.8	66.2
Euro area	**-2.2**	**-1.9**	**93.5**	**92.7**
United Kingdom	-4.4	-3.1	88.6	89.1
EU	**-2.5**	**-2.2**	**87.2**	**86.9**

Source: European Commission

Some euro countries could fail to meet their budget targets

On the euro Member State level the European Commission perceives risks that certain countries could fail to meet the targets of the Stability and Growth Pact (SGP). According to the SGP, euro countries must keep their deficits below three percent of GDP and adjust them so that their debt level falls to 60 percent of GDP in the medium term. Countries that do not meet these targets move from the preventive to the corrective arm of the SGP and are subject to stricter controls. Of the twelve countries in the preventive arm of the SGP, Italy, Austria and Lithuania present risks. Of the five countries in the corrective arm, Spain is in danger of not meeting its targets, as is Portugal, which submitted its draft budget late, in February 2016. Had the Maastricht deficits not been so generously defined, the number would be even higher. France and Italy have negotiated margins of up to 1 percent of GDP on the basis of structural reforms and investment programmes as one-off factors. Greece and Cyprus, as “programme countries”, are not subject to the European Semester because strict inspections are taking place via the national macroeconomic adjustment programme.

Furthermore, the European Commission is critical of the fact that deficits are not being reduced in a manner that is conducive to growth. Nor is the reduction of the tax burden on labour particularly ambitious. Success has also been limited when it comes to the implementation of country-specific recommendations. Judged in the manner of a school report card, none of the countries are graded “very good” or even “good”. Nine Member States receive “satisfactory” reports, while six are only “sufficient”.

Macroeconomic imbalances in almost all Member States

There is an imbalance throughout the Euro area in the current account surplus, which is likely to be 390 billion euros or 3.7 percent of GDP. Germany alone is expected to account for 2.5 percentage points; the Netherlands 0.7 percentage points. The European Commission also takes a critical view of the public and private debt levels. Only gradual progress is being made with debt reduction in some Member States, and non-performing loans are placing a strain on corporate sector financing conditions.

Belgium, Bulgaria, Germany, Finland, France, Ireland, Italy, Croatia, the Netherlands, Portugal, Romania, Sweden, Spain, Slovenia, Hungary and the United Kingdom exhibited macroeconomic imbalances in 2015. The European Commission will therefore compile detailed analyses of these countries again this year to assess whether these imbalances are still present. It will also carry out detailed examinations of Estonia and Austria for the first time. Only Denmark, Luxembourg, Latvia, Lithuania, Malta, Poland, Slovakia and the Czech Republic do not require closer scrutiny in the eyes of the European Commission. The results of these detailed analyses will be published in the spring.

An overview of last year’s European Semester cycle, including country-specific recommendations, can be found in the autumn edition of this publication (Eichert, Jäger 2015). A thorough account of the recommendations for 2016 will once again be presented in autumn. Information on individual Member States can also be found in the relevant BDI country reports. So far reports are available for France (Killian 2015) and Italy (Ross 2015).

Conclusion and outlook

The European economy will continue its modest recovery in 2016. Growth is not yet self-sustaining and is being supported by low oil prices and expansive monetary policy. However, the increase in economic activity is not yet sufficient to bring unemployment back down to its pre-crisis level in the foreseeable future. A positive development is that the European economy has been able to defy the global slowdown, which we are witnessing particularly in the emerging market countries. Domestic demand has been strong enough to largely compensate for the levelling-off of global trade flows.

The future development of the global economy poses a considerable risk for Europe. So far falling oil prices have impacted Europe positively, yet this effect could switch direction in the future. Commodity exporting countries are now under huge pressure due to the price collapse and are limiting their imports. Europe's export economy will therefore not be able to contribute to GDP growth. China's slowdown induced corrections on global financial markets. It is possible that these turbulences will affect the real economy more severely than expected.

On the financial markets there are risks due to the divergence of monetary policy in the United States compared to that of most other major economies. The Fed's raising of interest rates is likely to cause significant capital flows into the US. Even if the increase happens gradually, turbulence on the financial markets cannot be ruled out. Critics of the ECB's expansive monetary policy are particularly concerned about bubbles forming on the stock and property markets. Currently there are no signs of such developments. However, a further expansion of the Asset Purchase Programme could encourage the formation of market bubbles. Macroprudential monitoring in the Euro area will take on further significance.

Which direction the economy is headed in the future depends largely on whether investment activity can be sufficiently stimulated. Private consumption is already making an over-proportionate contribution to GDP growth, while the high debt level means there is little leeway in terms of public spending. Due to weak global growth, the trade balance will hardly contribute to growth either. As such, private and public investments remain the sources of hope for the economy in the coming years. Investments would also strengthen the growth potential of Europe's economy and boost its weak productivity performance.

The flow of refugees into Europe will impact the economy in ways that are difficult to foresee. In the short term, as has already been observed in the second half of 2015, additional public spending at the cost of higher deficits results in a positive economic stimulus. In the medium to long term the effects will depend on the refugees' rapid integration into the labour market. This question, along with other issues such as the United Kingdom's future as part of the EU, pose a major political risk, since there is no concerted European strategy for tackling key challenges.

Sources

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Imprint

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This report is a translation based on „Wachstumsausblick Europa“ as of 23 February 2016.