BDI
The Voice of
German Industry

EUROPEAN GROWTH OUTLOOK

European economy holds up.

Growth stimuli needed

November 2016

- **The economy of the European Union is set to grow by 1.7 percent in 2016; the economy of the Euro area by 1.6 percent.** The recovery in the labour market is boosting private consumption, which is still the biggest driver of growth. Investments are treading water at below the pre-crisis average. With global trade stagnating, net exports are actually tugging GDP down a peg.

- **Brexit initially threw the markets off course, setting off a wave of volatility.** The ensuing slumps on the financial markets have now balanced out, and there should be no noticeable impact on the economy in 2016. The British pound has lost around 20 percent of its value since the result of the Brexit vote was announced. This is likely to put a slight damper on exports from the EU member states to the United Kingdom. The long-term impact of Brexit will depend on the terms of future EU-UK trade relations.

- **The ECB's monetary policy is increasingly reaching its limits.** The impact of the unconventional measures is waning. The stimulus created by the monetary policy will trickle away if it is not supported by structural and fiscal policy. The low interest rates are helping to reduce public debt levels, which should drop from 86.8 percent of GDP in 2015 to 84.4 percent in 2016.

- **An ambitious set of economic policy measures needs to be taken now to counter weak global growth.** Fiscal policy must make use of available policy space to spur growth and productivity. On a national level, we need to see more stimulus from industrial and innovation policy. This could be achieved by three or four large member states without a full vote in the EU bodies.

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European economy is chugging along slowly but surely

The European economy is still growing at a steady pace, with no steep acceleration in sight. The European Commission (2016) forecasts that the EU will grow by 1.7 percent in 2016 and 1.4 percent in 2017. The projected growth rates for the Euro area are 1.6 and 1.4 percent respectively. The International Monetary Fund has also updated its forecasts, predicting growth for the EU of 1.9 and 1.7 percent (2016/17), and 1.7 and 1.5 percent for the Euro area. Europe may be experiencing an upturn but there are no signs of an economic boom on the horizon. This growth is still based mainly on private and public consumption. Investments would need to make a greater contribution to growth to cause a substantial pick-up in economic momentum. A more buoyant world trade would also be needed.

The driving factors behind these trends are still the improved situation on the labour market and the expansive monetary policy. The impact of low oil prices is gradually petering out. Rising employment and falling unemployment are boosting private consumption and creating strong domestic demand within the EU. A weak euro is holding up exports despite declining external demand for exports, and low interest rates are giving the public sector more policy space by bringing down public debt servicing costs. However, the low interest rate environment is not stimulating corporate investments, which are being held back by global uncertainty. Another impediment to growth is the sluggish pace of structural reform in the member states.

Global economy is cooling down

The global economy is treading water. Growth in 2015 came in at 3.2 percent, while in 2016 GDP is set to dip only slightly to 3.1 percent, mainly because the US economy is not performing as well as expected (IMF 2016). These are the lowest growth rates since the crisis in 2009. The developed economies should see GDP grow by 1.6 and 1.8 percent in 2016 and 2017 respectively. Growth for the US economy is forecast at a modest 1.6 and 2.2 percent for the same period. Japan is still struggling to pick up pace and is set to grow just 0.5 percent in 2016. In such difficult conditions, Japan's central bank monetary policy measures and the Abe government's financial and structural policy measures are having very little effect. Japan's economic recovery will stay stuck in a growth corridor of between 0.5 and 1.0 percent throughout this and the coming year.

For the emerging and developing countries, the IMF expects growth rates of 4.2 and 4.6 percent for this year and next year respectively. Fears that the Chinese economy is heading for a crash have not yet materialised. Following GDP growth of 6.9 percent in 2015, the Chinese economy is projected to grow by between 6.5 and 6.75 percent this year. The transformation from an investment to a more consumption-driven economy is progressing well, although there are still numerous challenges on the way. More detailed information on China is available in the BDI Country Report (Deutsch & Müller 2015). Russia is still stuck in recession and is heading for a drop in GDP of around 0.8 percent in 2016. The IMF expects the Russian economy to turn around in 2017 and grow by around 1 percent. The situation is similar in Brazil. The economy is forecast to contract by 3.3 percent in 2016 and then expand again in 2017 by 0.5 percent. India is still the global shooting star and is set to grow by 7.6 percent in both 2016 and 2017.

Where's Europe in the economic cycle – upturn, boom or downturn?

The corrections in the global economy and Brexit have so far had surprisingly little impact on the European economy. The European Commission, the ECB and the IMF (all 2016) have all downwardly revised their forecasts for 2016 and 2017 by between 0.1 and 0.3 percentage points. A good four months after the referendum on 23 June 2016, the widely feared recession has not yet set in. That said, the European economy is very far from a boom. Following the gradual increases in growth rates recorded from 2013 onwards, one could expect the economic cycle to hit its peak in 2016 or 2017. The current growth rates would be on a historically low level for a boom, though. The big question now is whether we are experiencing the "new normal" and are in the much-talked-about age of secular stagnation characterised by a prolonged period of low growth.

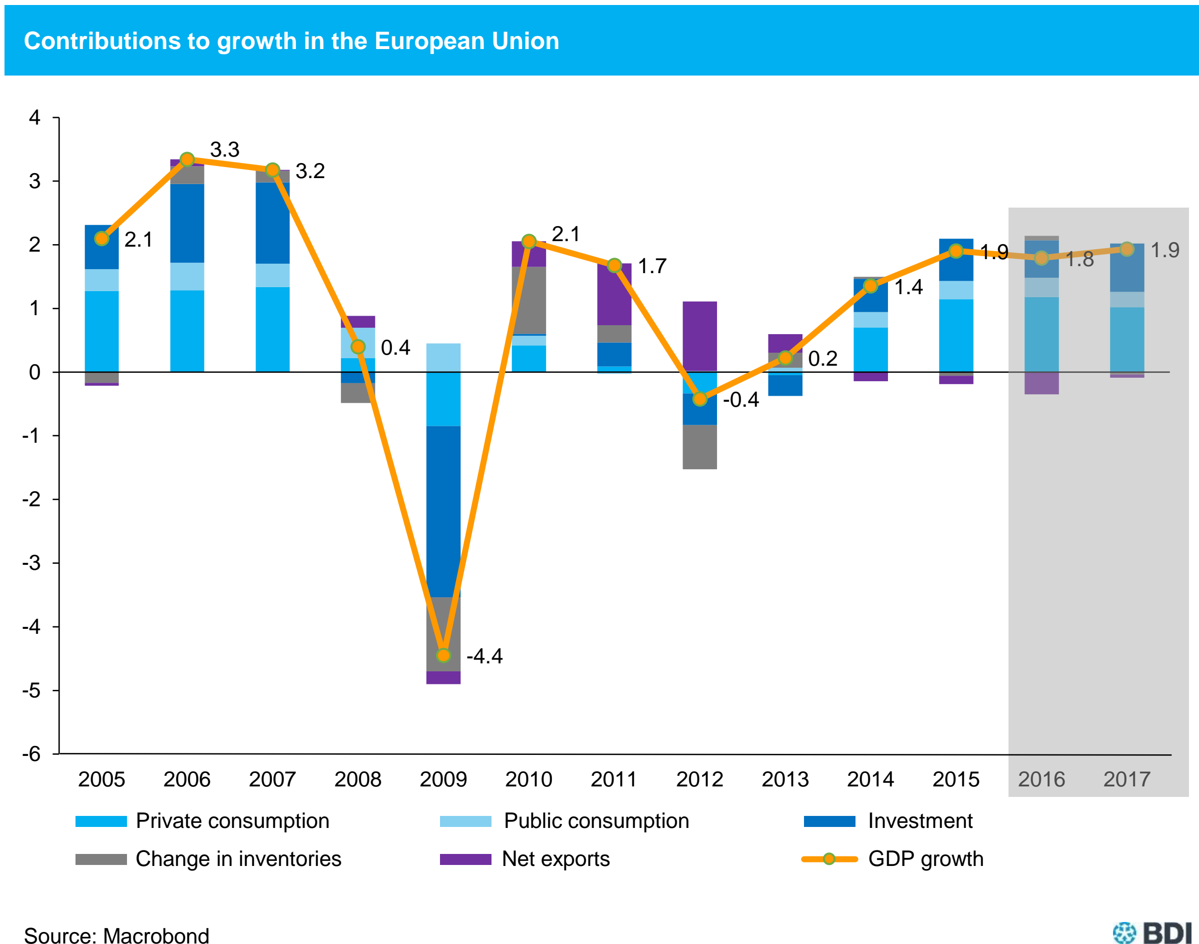
European forecast 2016 in percent

	GDP 2016	GDP 2017	Inflation	Unemploy-ment rate	Current ac-count balance
Germany	1.6	1.6	0.3	4.6	8.4
France	1.3	1.7	0.1	10.2	0.6
Italy	1.1	1.3	0.2	11.4	2.3
Spain	2.6	2.5	-0.1	20.0	1.9
Netherlands	1.7	2.0	0.4	6.4	10.6
Belgium	1.2	1.6	1.7	8.2	0.5
Greece	-0.3	2.7	-0.3	24.7	-0.2
Ireland	4.9	3.7	0.3	8.2	4.0
Austria	1.5	1.6	0.9	5.9	3.6
Portugal	1.5	1.7	0.7	11.6	0.9
Slovakia	3.2	3.3	-0.1	10.5	-1.0
Slovenia	1.7	2.3	-0.2	8.6	7.6
Finland	0.7	0.7	0.0	9.4	0.0
Euro area	**1.6**	**1.8**	**0.2**	**10.4**	**3.5**
Bulgaria	2.0	2.4	-0.7	8.6	1.7
Denmark	1.2	1.9	0.3	6.0	6.6
United Kingdom	1.8	1.9	0.8	5.0	-4.3
Poland	3.7	3.6	0.0	6.8	-1.8
Romania	4.2	3.7	-0.6	6.8	-1.7
Sweden	3.4	2.9	0.9	6.8	5.8
Czech Republic	2.1	2.6	0.5	4.5	0.6
Hungary	2.5	2.8	0.4	6.4	5.4
EU	**1.8**	**1.9**	**0.3**	**8.9**	**2.5**

Source: Macrobond (data from the European Commission before the British referendum) BDI

Employment recovery boosts consumption

As in 2015, growth in the EU in 2016 is emanating largely from private consumption. In the crisis years of 2008 to 2013, private consumption contributed almost nothing to growth. It was only in 2014 when the situation on the labour market gradually improved that private consumption started to pick up. And it has been the dominant factor driving growth ever since. The contribution of investments to growth is increasing at a much slower pace and makes up a much smaller percentage than in the years before the crisis. The much-needed pick-up in investments would have a positive impact on productivity and growth potential on top of the positive short-term economic impact. Foreign trade is not looking like it will contribute positively to growth in 2016. The expansion in global trade has slowed considerably since the crisis, with global economic growth following suit. Furthermore, rising labour income is pushing up domestic demand and thereby increasing imports. In view of the current account surpluses of the EU (2.5 percent of GDP) and the Euro area (3.5 percent of GDP), it would be good if this imbalance was evened out. The Netherlands and Germany, in particular, are persistently recording surpluses.

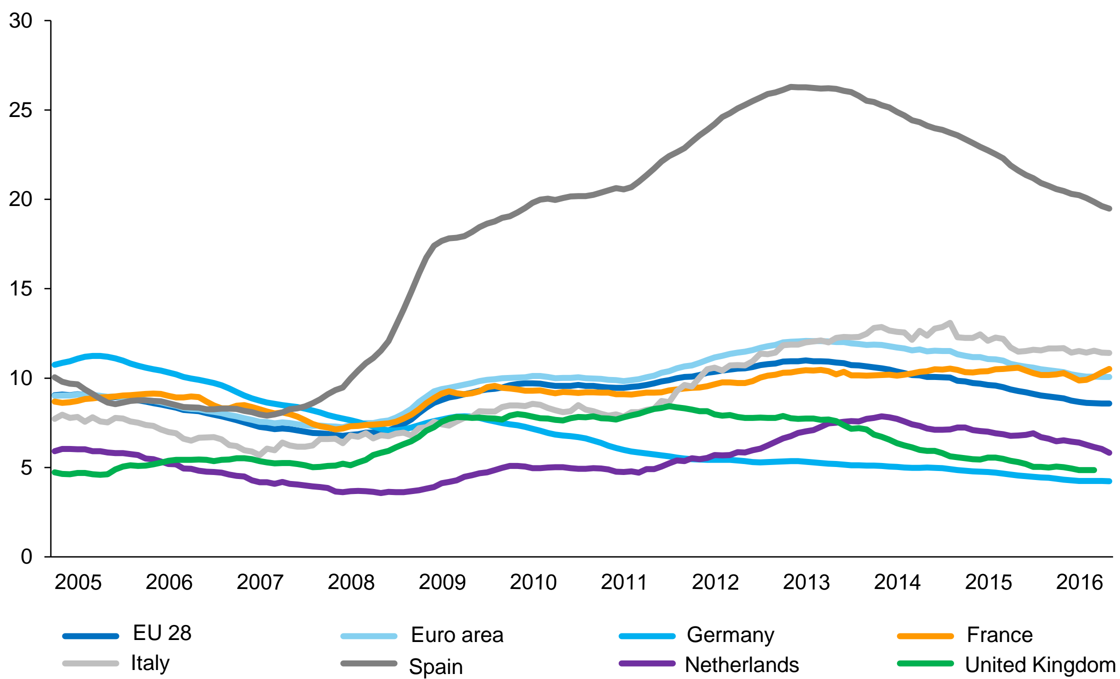


Source: Macrobond

Unemployment still pointing down, but remains higher than before the crisis

In July 2016, the unemployment rate stood at 8.6 percent in the EU and 10.1 percent in the Euro area. In both cases, unemployment is therefore substantially lower than the respective record highs of 11.0 and 12.1 percent in April 2013. While unemployment figures have decreased steadily since then, they are still considerably higher than the pre-crisis levels of under seven percent for the EU and under eight percent for the Euro area. The labour market has therefore only reached the halfway point to pre-crisis recovery. A good sign is that unemployment is now pointing down in all large countries of the EU. In Spain, too, unemployment has also dropped consistently since late 2014, going from over 25 percent to 19.6 percent in July 2016. The decrease in the unemployment rate is likely to taper off in the future. A considerable number of immigrants are flowing into the European labour markets. Not speaking the national language well and lower educational attainment levels in some immigrant groups are impeding the integration of immigrants into the labour markets. The ECB (2016) is predicting the unemployment rate in the Euro area will drop to 9.9 percent in 2017 and further fall to 9.6 percent in 2018. The improved situation on the labour markets is increasing labour income. The income per employee increased by 1.3 percent in 2015 and is expected to increase further in the next two years by 1.8 percent and 2.2 percent respectively. This will boost private consumption considerably.

Unemployment rate in percent

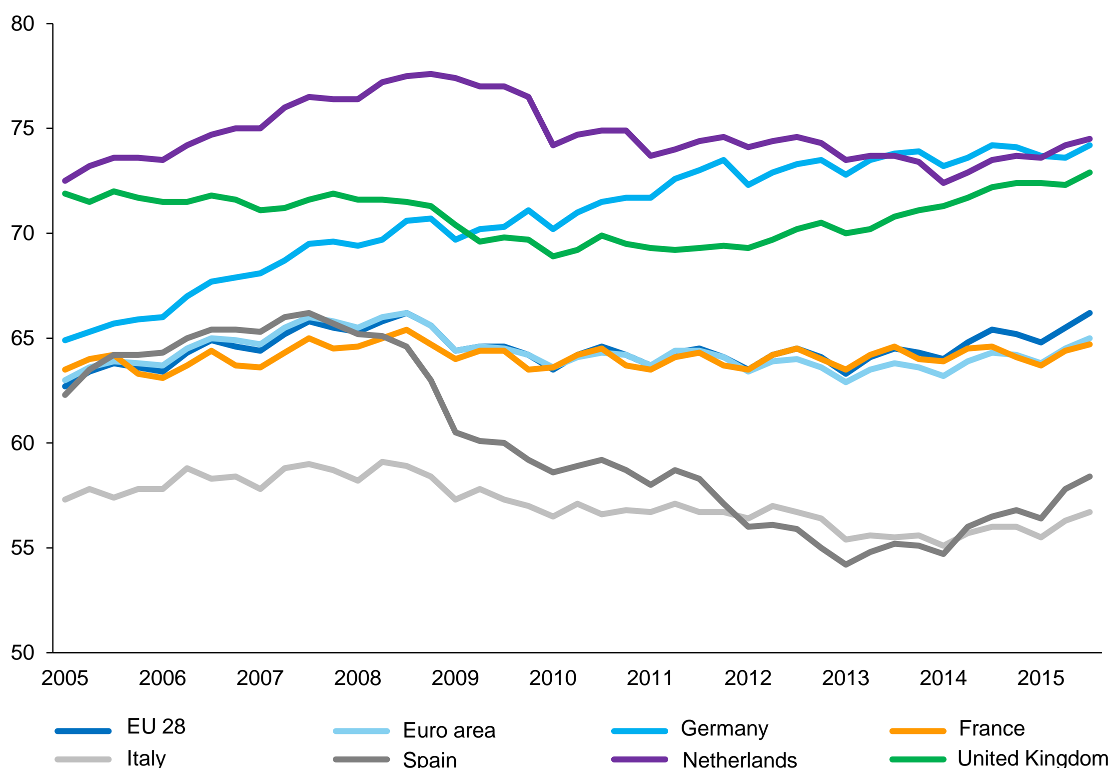


Source: Macrobond

Employment rates still vary widely

In Germany and the Netherlands around 75 percent of persons aged between 15 and 64 are gainfully employed, while in Spain and Italy this figure is around 57 percent. The EU and Euro area average of about 65 percent is equal to that of France. Low levels of employment put a huge strain on the social welfare state. Employed persons also maintain persons that are not gainfully employed. The divergence between the large member states is the result of several factors. One big factor is the retirement age and the associated employment rate of older employees, as well as the participation of women in the labour market. The integration of immigrants will play a larger role in the future.

Employment trend in Europe



Source: Macrobond

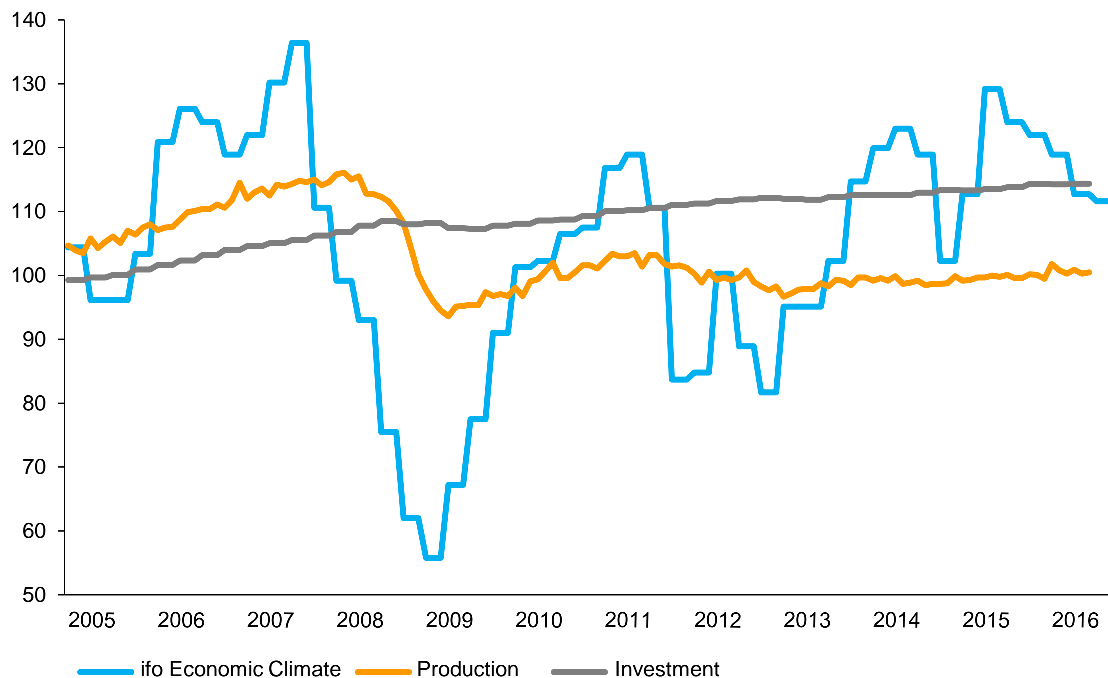
The size of the labour force in absolute numbers, as published by Eurostat, increased in the EU and the Euro area by 1.5 and 1.4 percent respectively in the second quarter of 2016 compared to the same quarter in 2015. The number of workers rose in all EU countries apart from Croatia. It is also gratifying that Spain registered an especially big increase of 2.7 percent. In terms of general economic sectors, increases were recorded in all sectors apart from “Agriculture, forestry and fishery”.

Business climate has clouded over, with production and investments moving sideways

The Ifo Business Climate Index for the Euro area has been sliding continuously from its interim high in the third quarter of 2015 at 126.2 points, down to 111.6 points in the third quarter of 2016 (CES Ifo 2016). That represents a decrease of around 14 percent, but is still above the long-term average. The downturn is a reflection of the developments in the past twelve months, such as the faltering global economy and the Brexit vote.

Industrial production in the Euro area has moved sideways over the past year. In July 2016, the production index stood at 103.3 points after calendar and seasonal adjustments, for a year-on-year decrease of 0.5 percent. Eurostat registered a decline of 1.2 percent in capital goods. Energy was the main driver of the downturn, nosediving 5.9 percent. Intermediate goods increased (0.3 percent), as did consumer nondurables (1.3 percent) and, particularly, consumer durables (2.6 percent). This is to be expected from our currently consumption-driven economy. Production pointed down in the large EU member states of Germany, France, Italy, Spain and the Netherlands, while Denmark, Slovenia and Finland all saw production increase by around seven percent compared to July 2015. Ireland upped its industrial output by five percent and Greece also managed an increase of over four percent, albeit at a low level.

Industrial activity in the Euro area



Source: Macrobond

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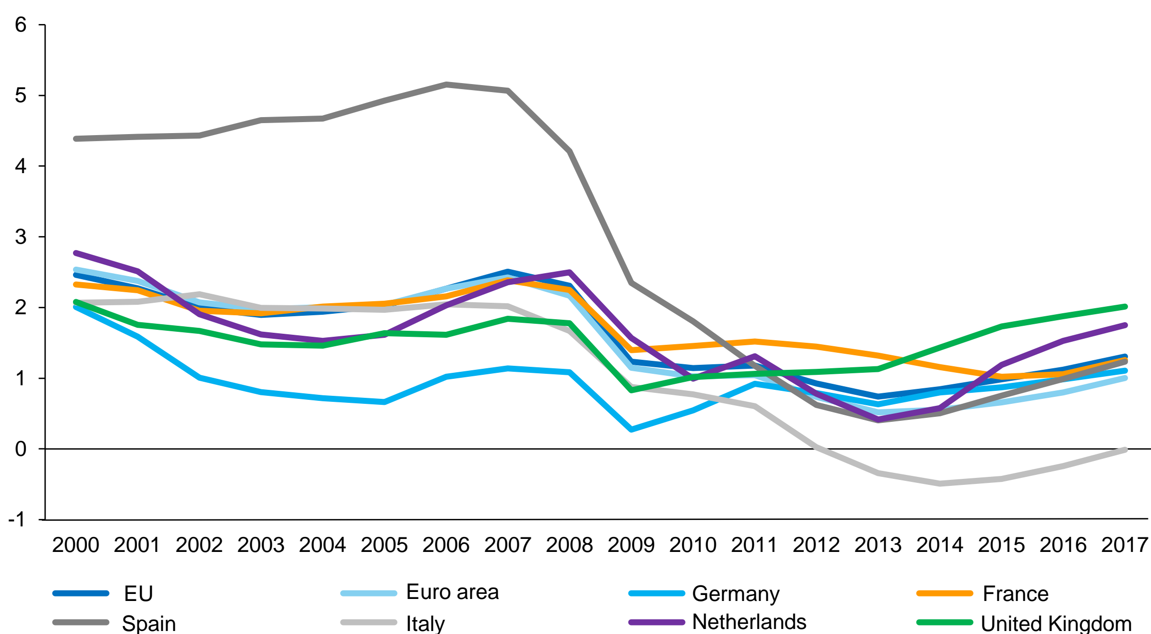
Gross fixed capital formation was restrained. The index value (2010 = 100) in the second quarter of 2016 stood at 105.2 points after calendar adjustments. Although growth has accelerated slightly in the last few quarters, it is still below expectations. It is still too early in the day to assess the impact of the Investment Plan for Europe. The European Fund for Strategic Investment is just one piece of the puzzle needed to spur investment activity. It is not just the financial end, but primarily non-financial factors that are standing in the way of investment. The high degree of global insecurity, exacerbated by Brexit, is curbing growth considerably, as is the inadequate pace of structural reform in the member states.

Net capital stock in the Euro area has only managed annual growth of around one percent since the crisis, compared to about two percent per year between 2000 and 2008. This corresponds to one of Nicholas Kaldor's "stylised facts" on economic growth, according to which the capital-output ratio is roughly constant in the medium term. In parallel to the under-proportionate growth of capital since 2009, labour productivity increases have also diminished. The low productivity increases are currently the subject of much academic and economic policy debate. An overview of the situation with a focus on Germany is provided in another report (Eichert 2016).

Growth of net capital stock in percent



Source: Macrobond

Looking at the largest member states, Spain recorded above-average increases in capital stock in the early 2000s. The capital stock increases were largely caused by non-sustainable investments in construction, which culminated in the property bubble that threw Spain into a deep recession. The capital stock in crisis-stricken Italy has been on the decline since 2012, with GDP at around seven percent under pre-crisis levels. The question of causality here is a difficult one, a chicken and egg situation. Has low growth made investments drop or is the slow build-up of capital stock responsible for meagre GDP growth? In view of the current debate on investment in Europe, long-term divestment would be too high risk. In the economic cycle, the Euro area is well clear of recession, but the investment level is at a historic low. The reasoning that less physical capital is needed in this new era of digitisation, lacks credibility given the sluggish rise in labour productivity.

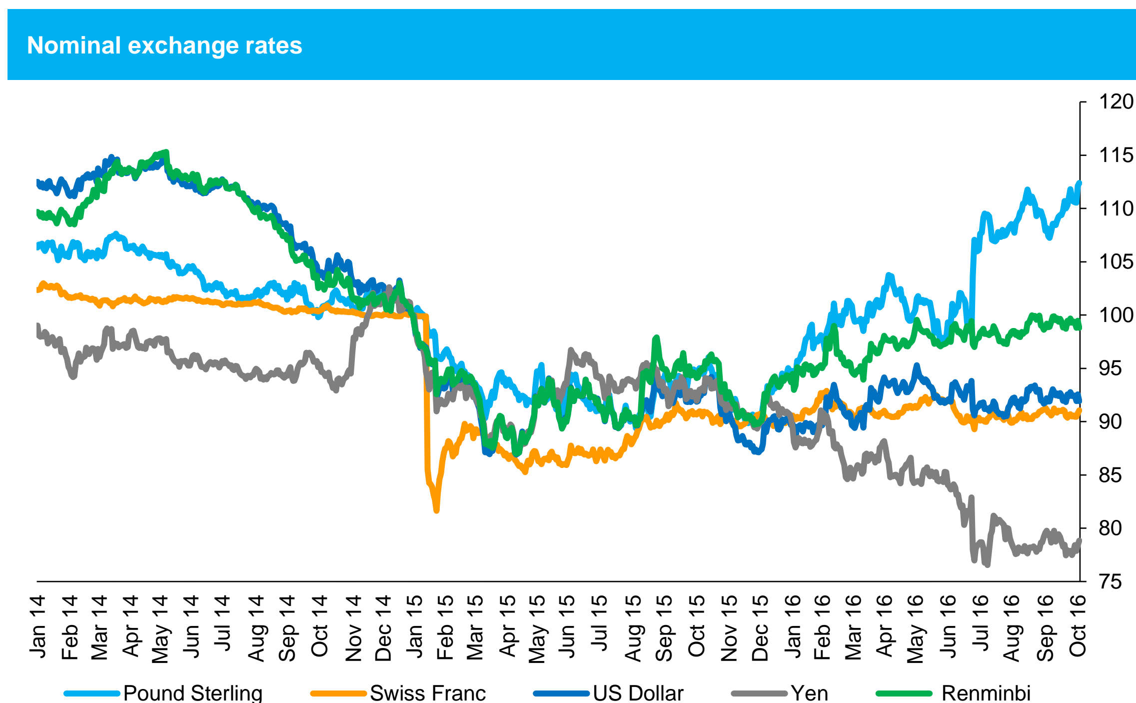
Major global currencies are drifting apart

Following the appreciation of the Swiss franc in January 2016, the major global currencies have developed at a roughly equal pace. Early 2016 saw the first massive devaluation of the British pound. The markets already factored in the anticipated impact of Brexit early on in the year, triggering the downslide of the pound. The vote to exit the EU on 23 June 2016 led to a second huge devaluation, with the British pound losing around 20 percent of its value compared to late 2015. Secondly, the renminbi also devalued somewhat, caused by its decoupling from the US dollar and the stronger market influence on the exchange rate. Prior to this point, the Chinese currency had been undervalued on account of central bank interventions to boost foreign trade. Thirdly, the yen appreciated substantially against the euro in nominal terms. This was largely the outcome of ECB's expansive monetary policy.

Since the beginning of the year, the US currency has traded at around 1.12 US dollars against the euro with slight fluctuations. The quantitative easing in the Euro area would theoretically encourage a devaluation of the euro, but this effect has been cancelled out by the disappointing performance of the US economy. Early on in the year, following the interest rate hike in December 2015, further increases were expected but have not materialised. The exchange rate of the Swiss franc has also remained largely constant.

The weak euro against most currencies is advantageous to exporters in the Euro area, even though 2016 has not seen any other devaluations apart from the yen. Exports to the United Kingdom will drop considerably. In September, the ECB (2016) predicted that Euro area exports would increase by 2.6 percent in 2016, down from its June forecast of 3.2 percent. The current account surplus for 2016 is expected to stand at around 3.5 percent of GDP, even though the impact of ECB's expansive monetary policy is gradually petering out.

The euro exchange rate, in both nominal and real effective terms, has increased by around 1.8 percent since the beginning of the year against the twelve most important global currencies. This is a reflection of the solid economic growth registered in the Euro area in contrast to the disappointing level of growth in other economies. The positive impact this will have on price competitiveness is likely to continue fading out.



Source: Macrobond, 01.01.2015=100

ECB's expansive monetary policy is running up against its limits

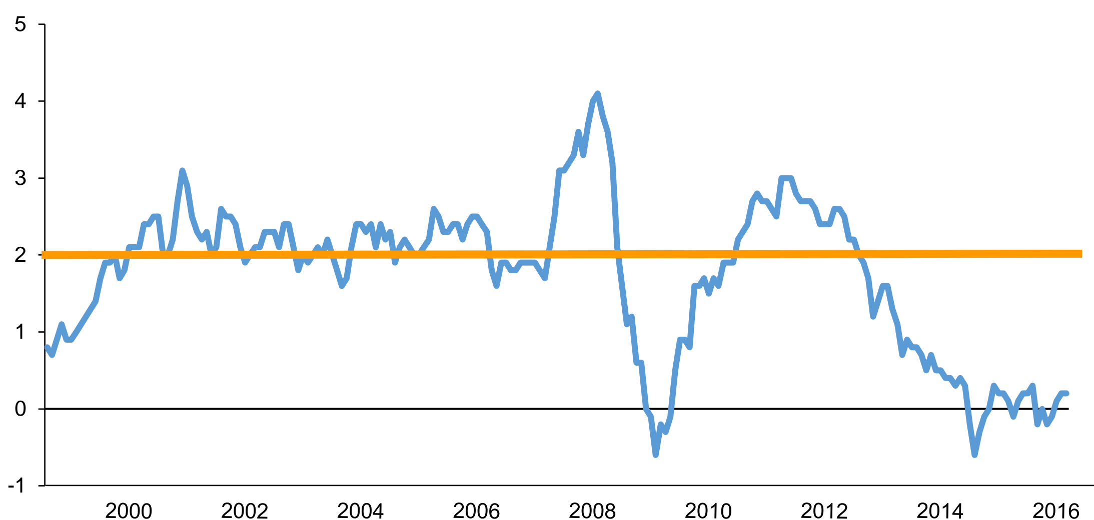
On 10 March, in response to the continuing fall in prices and the sluggish economic development in the Euro area, the ECB further eased its monetary policy. The ECB announced that it would increase its monthly asset purchases from 60 to 80 billion euros and start buying high-quality corporate bonds. It also cut the key interest rate from 0.05 to zero percent. Interest on deposits were reduced further from minus 0.3 to minus 0.4 percent. In addition, the ECB also launched a new series of targeted longer-term refinancing operations (TLTRO II). The new operations will have a maturity of four years.

Financial stability is improving, but non-performing loans are still a problem

The ECB's package of measures will especially help countries – like Italy, Portugal and Spain – whose banking sectors are saddled with problems. The good refinancing options should see stability risks and panic over bank bonds go down. The programme also helps banks reduce the bad loans on their balance sheets by extending the term. Italy in particular is still suffering greatly from bad debts, as highlighted by this summer's debate on Banca Monte Siena dei Paschi and the Italian rescue fund (dubbed "Atlante" or "Atlas"). Solving these problems will likely take some time yet. Without the ambitious measures of the ECB, the pressure on the restructuring banks and the risk of financial market instability would be considerably greater. It cannot be ruled out that this will have negative effects on the real economy.

It is becoming increasingly apparent that the marginal returns of ECB's expansive monetary policy are slimming down. The low interest rate environment is a problem for insurers in particular. The situation is also challenging for banks that rely on the traditional business model of deposits and loans. The ECB has stepped up its micro- and macro-prudential oversight of price trends on the property market and other asset markets in an effort to pre-empt the formation of market bubbles. The policy of making money cheap has not yet triggered any distortions but the risk is there. ECB President Mario Draghi rightly emphasised that the ECB cannot solve the problems of the Euro area alone. He again repeated his call for increased structural reforms and more growth-friendly policies in the member states. The scope of monetary policy is limited if it is not accompanied by economic and fiscal policy efforts.

Inflation rate in the Euro area in percent



Source: Macrobond

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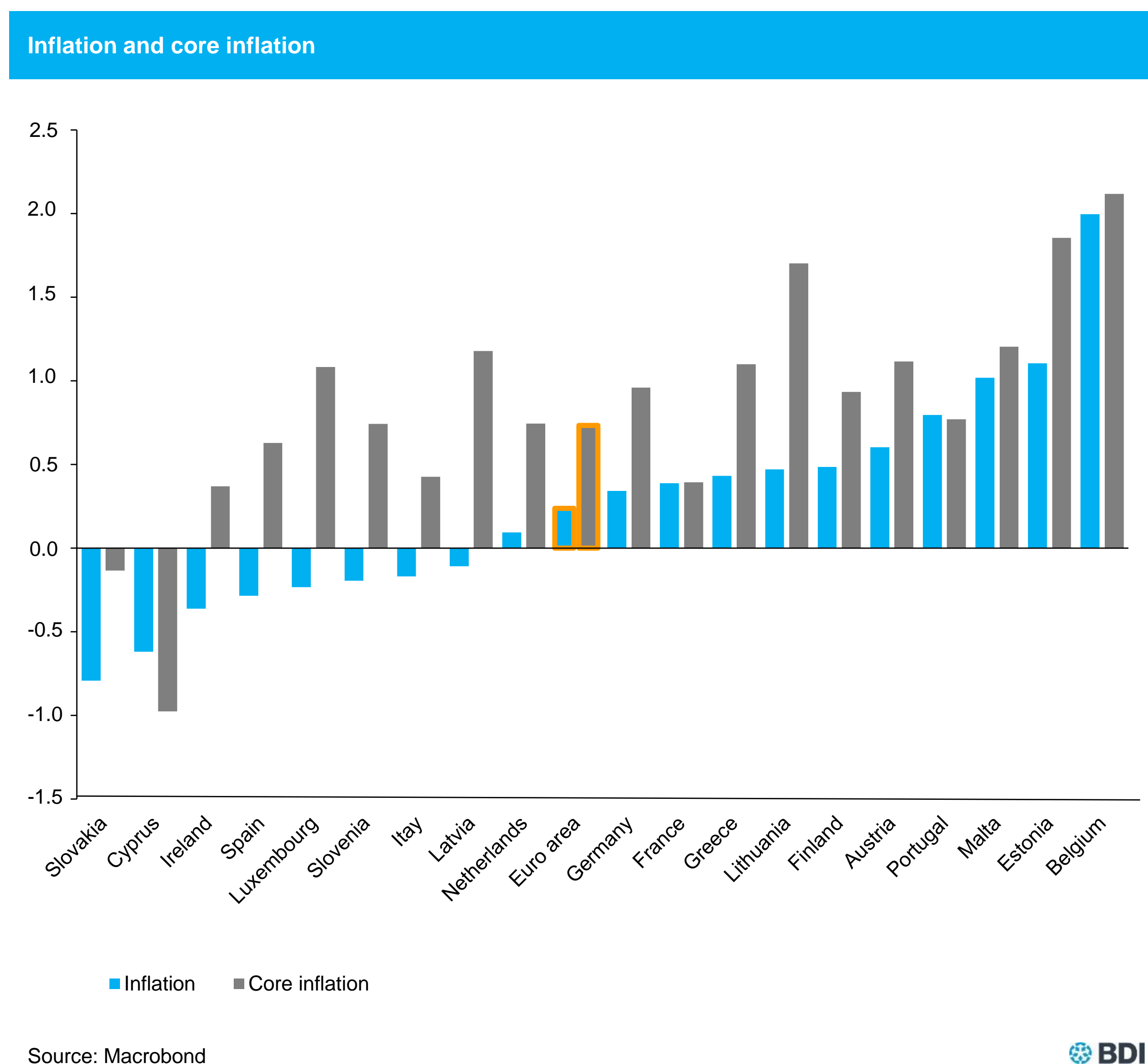
Inflation remains low, but has been back in positive territory since April

In August 2016, the inflation rate in the Euro area was at 0.2 percent with no clear trend. According to the ECB (2016), the upwind in prices should level off at 0.2 percent in 2016 and increase to 1.2 percent in 2017 and 1.6 percent in 2017. The ECB predicts substantial fluctuation around these average values. The improved performance of the labour market should push up prices, as will the anticipated hike in oil prices. Different oil price scenarios are the biggest uncertainty factor affecting inflation forecasts.

The heterogeneous trends in inflation in the different member states is a challenging situation for the ECB. In August 2016, inflation in the Euro area ranged between minus 0.8 percent in Slovakia and plus two percent in Belgium. The divergence between headline inflation and core inflation (excluding energy and seasonal foods) is also impeding the work of the ECB, as energy is largely imported. The ECB has little influence on the price development of these goods. This makes a more convergent economic policy between the member states all the more important. The Five Presidents' Report (European Commission 2015) contains recommendations for how to make this happen (see Eichert 2015).



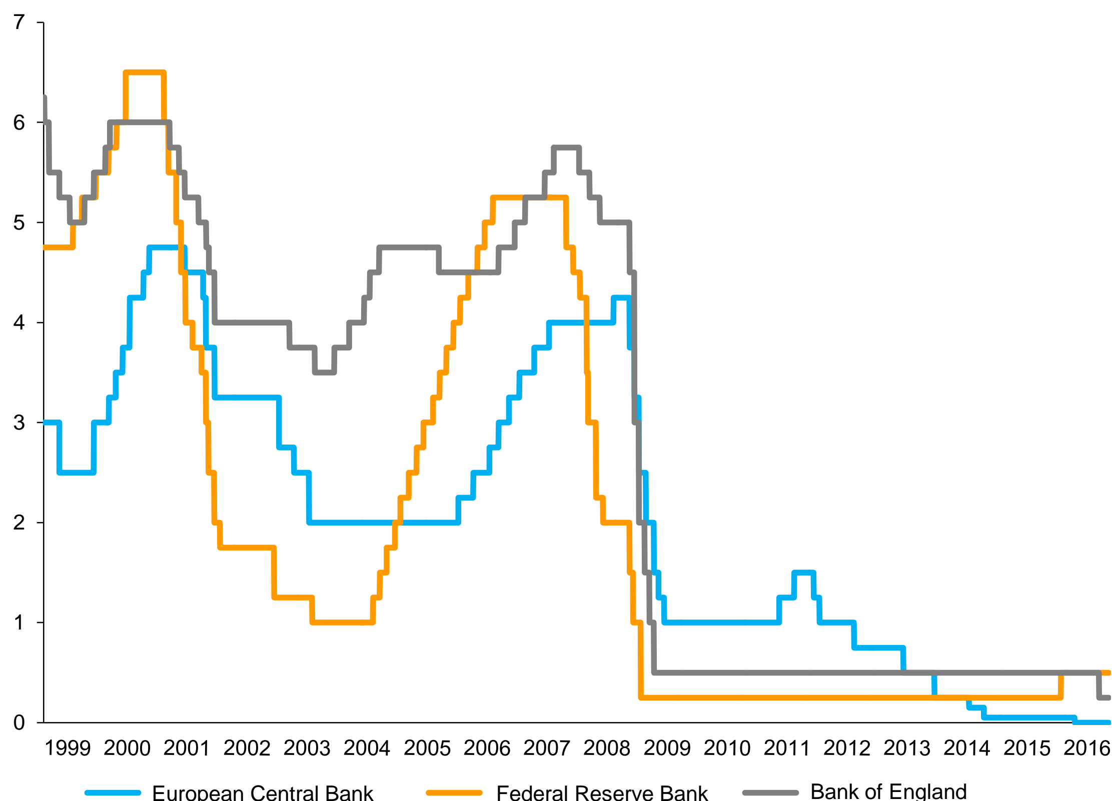
Federal Reserve postpones interest rate hike

The US Federal Reserve (Fed) increased interest rates marginally in December 2015 by 25 basis points, up from zero to 0.25 percent to 0.25 to 0.5 percent, the first increase seen since 2006. At that time, further increases were anticipated to take place over the course of 2016 to successively get back to a more normal monetary policy. The OECD (2015) was also forecasting growth rates of around 2.5 percent for the US economy in 2016 and 2017. In September, the OECD downwardly revised these forecasts (OECD 2016) to 1.4 percent for 2016 and 2.1 percent for 2017. In response to these developments, no further interest hikes have taken place as yet. The Fed has, however, signalled that it may decide on a hike in the Federal Open Market Committee's meeting this December. The increases in interest rates will be very gradual, if at all.

In reaction to Brexit, the Bank of England (BoE) cut its interest rates from 0.5 to 0.25 percent in an effort to counteract any financial market instabilities and to demonstrate its capacity to act.

The ECB, the Fed and the BoE are all in a very complicated position. The ECB has ventured into new territory with its unconventional monetary policy measures and is unlikely to change course in the near future. The consequences are not yet foreseeable. The Fed is at a crossroads in its interest rate policy. Several factors provide grounds for an increase in interest rates, while other considerations support holding interest rates steady. Any move on this front will therefore be based on considerable uncertainty. The BoE is also having to deal with changed parameters on account of the Brexit announced by Prime Minister May. The extent of corrections that this will trigger in the economy is still uncertain, in effect reducing any debate on the necessary expansion of monetary policy to mere speculation.

Key interest rates in selected countries



Source: Macrobond

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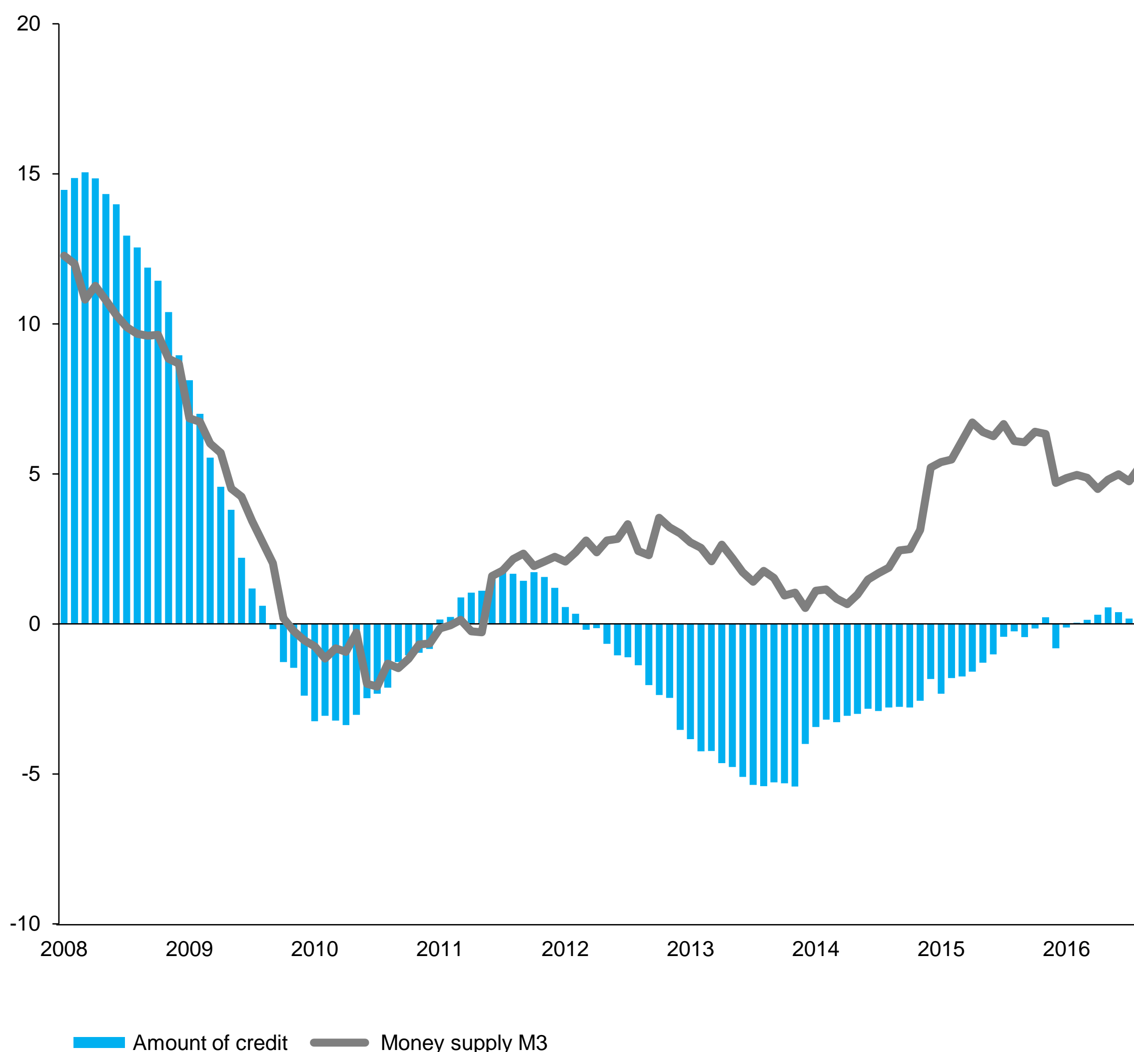
Lending to companies still not keeping apace with the increased money supply

Corporate lending in the Euro area has not really picked up yet. While the increase in money supply (M3) between 2008 and 2011 trended in line with the increase in lending, these two factors have since diverged. The increase in lending to non-financial companies is currently at around five percentage points below the increase in money supply, as illustrated by the diagram below. The situation has improved slightly since the middle of 2013. Loans have gathered some momentum, though, aided among other factors by the ECB's monetary policy and the expansion of its balance sheet. At the same time, the expansive monetary policy is yielding decreasing marginal returns. Since early 2015, the ECB balance sheet has grown considerably.

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

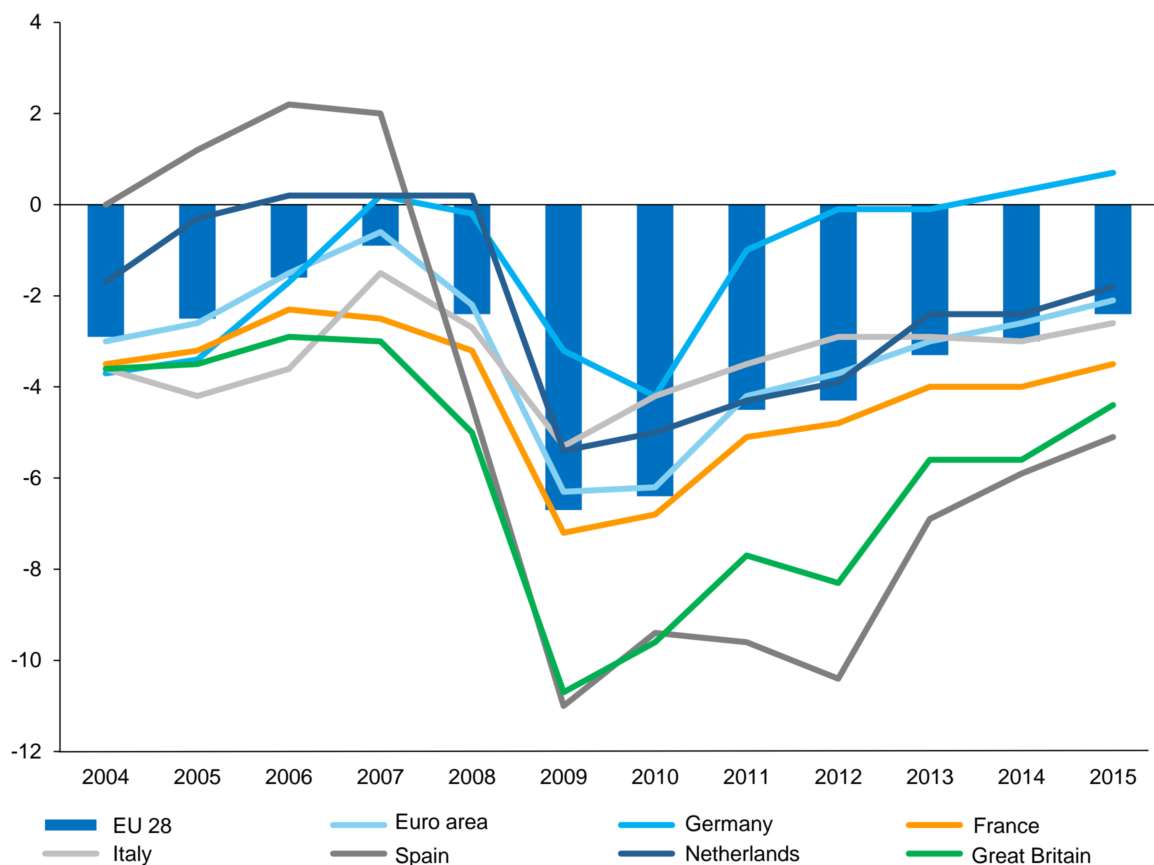


Source: Macrobond

Public deficits are shrinking, though debt levels remain high

Public deficits are on the road to fiscal consolidation in many countries. New public debt in the EU stood at 2.5 percent of GDP in 2015, well under the record levels of over six percent of GDP. Some of the larger member states, though, recorded significantly higher deficits. According to its spring forecast, the European Commission is anticipating a deficit of 2.1 percent for the EU and 1.9 percent in the Euro area for 2016. The negative outcome of the British referendum will probably not affect these forecasts very much. The United Kingdom is, however, showing signs of changing course in its fiscal policy, with higher public expenditure and a slower path towards the consolidation of public finances.

Public debt as a percentage of GDP



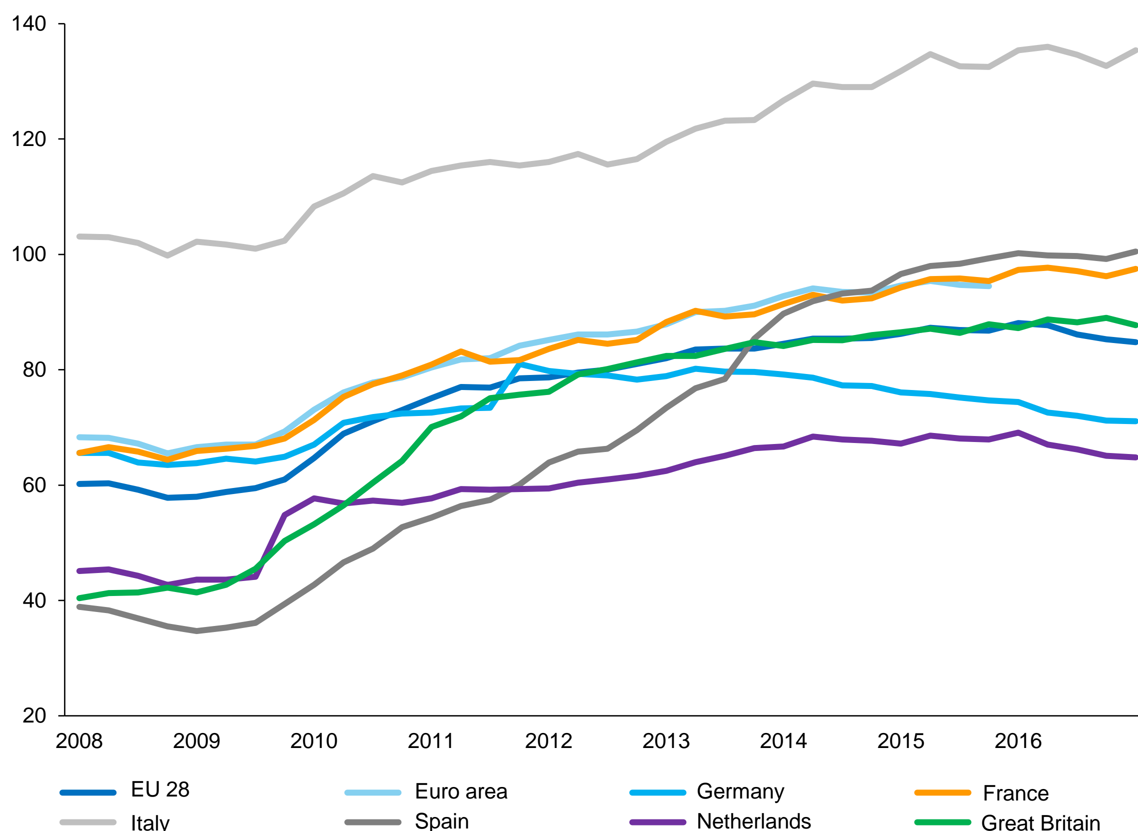
Source: Macrobond

Pace of fiscal consolidation varies widely by country

Even if the levels of public deficit are on the decrease, the reduction of debt levels as a percentage of GDP has only gone down minimally. The low rate of real growth paired with scant inflation is a big obstacle to cutting public debt. In 2015, the level of public debt in relation to GDP for the EU totalled 86.8 percent. A slight drop down to

84.4 percent is expected for 2016. Italy remains the worst performer in this regard, with public debt at 135 percent of GDP.

Public debt levels as a percentage of GDP



Source: Macrobond

The path to debt reduction begins with forward-looking fiscal policy and GDP growth

Public debt cannot be reduced without stepping up real economic growth. Growth not only increases the space for fiscal policy but also reduces the proportion of debt to GDP. A higher rate of inflation also reduces the percentage of public debt compared with nominal GDP. Deflationary tendencies, in contrast, would increase this percentage. This also explains the expansive monetary policy practiced by the ECB to get inflation to the target level of close to but below two percent in the medium term.

Almost all member states could revamp their fiscal policy to make it much more forward-looking and pro-growth. This should involve rebalancing expenditures within public budgets from consumption spending to investment spending. Investment in education, research and development as well as infrastructure substantially increases productivity in the medium term. It is not even absolutely necessary to reduce public spending overall to achieve this; instead, budget allocations could be restructured.

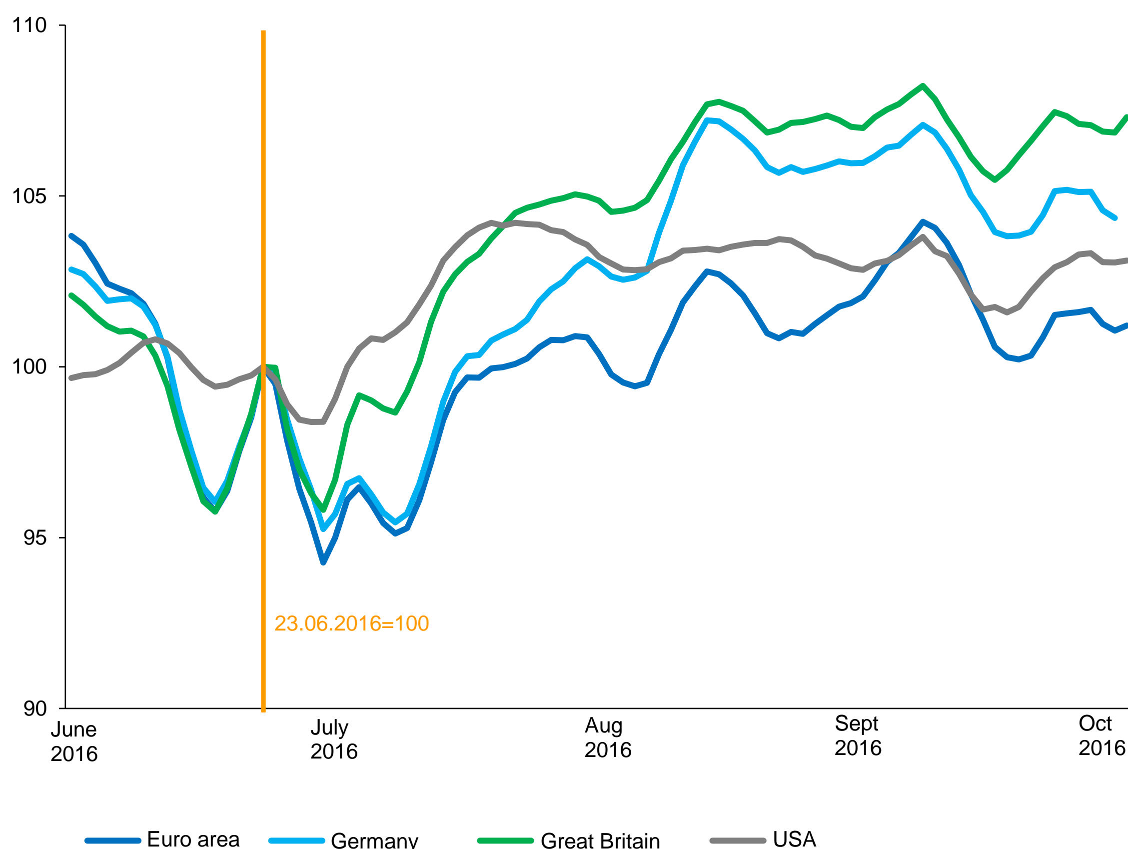
Special topic: how will Brexit impact the economy?

The European markets were initially thrown off course by the UK vote to exit the EU on 23 June 2016. In the short and medium term, the heightened uncertainty has held back investments. The long-term consequences will depend on what modalities are agreed on for future trade relations.

Share prices initially slumped before recovering

The uncertainty on the markets was clearly visible in the days following the UK referendum on EU membership. UK's share index FTSE 30, the German DAX 30 and the Eurostoxx 50 all lost around five percent in value. All indexes had recovered by October 2016 and are now even trading above pre-referendum levels. Following the initial volatility, the stock markets have since calmed down in view of the fact that Brexit is not officially an exit according to Article 50 of the Treaty of Lisbon. On 2 October 2016, Prime Minister May did, however, announce in a speech at the Tory party conference that Article 50 would be triggered by March 2017 at the latest.

Share indicies



Source: Macrobond

British pound started to slide well in advance of the referendum

The announcement of the referendum already triggered a massive devaluation of the British pound. From the end of 2015 up to the referendum, the UK currency lost around ten percent of its value against the euro. Another sharp downward correction of around five percentage points followed immediately after Brexit. The pound lost another five percentage points between then and October 2016, amounting to a total devaluation of just under 20 percent. The weak pound will only help the UK export industry in the short term but has managed to cushion the negative impact on the UK economy to some extent. The other member states in the EU are likely to see their exports fall slightly. In 2015, Germany exported goods valued at around 89 billion euros and services worth over 24 billion euros to the United Kingdom. Even though German exports are largely competitive in terms of quality rather than price, we are likely to see the volume of exports trend downwards slightly over the course of the next year.

Between January and July 2016, British imports increased from 47 to around 48.3 billion pounds. In view of the devaluation of the British pound, we are seeing a decrease in imports from the United Kingdom in volume. Exports increased in the same period, rising from 42.4 to 43.8 billion pounds. This is the reverse effect, with British exports growing in terms of volume. It is too early to make a definite assessment of future trends. Equally unclear is the impact the weak pound will have on the City of London. A more extensive assessment will be included in the next instalment of this series.

Investments are being postponed or even cancelled due to the lack of clarity surrounding the future status of the United Kingdom. While this effect has been relatively weak in 2016, it is gearing up to make UK growth slump from 2017 onwards. In July 2016, the European Commission (2016) estimated UK growth will slide from 1.9 percent down to between 1.1 percent (mild scenario) and minus 0.3 percent (severe scenario). In September 2016, the OECD (2016) revised its forecast for UK growth in 2017 from two percent down to one percent. The IMF, too, is forecasting growth of only 1.1 percent for next year.

Growth prospects for the Euro area are looking dimmer

The European Commission, the OECD and the IMF have all revised their growth forecasts for Germany and the Euro area for 2017 on account of declining exports and the heightened uncertainty across the board. German economic growth could suffer a bit from the developments in the UK over the course of the next year and their adverse effect on trade, production, financial markets, uncertainty and confidence. It will only be possible to gauge how much it will impact the German economy once the British government has presented its ideas on the modalities of its exit and future relations between the European Union and the United Kingdom, including any transitional arrangements, have been decided on. Slight corrections are also expected for the Euro area. The United Kingdom has particularly strong trade relations with Belgium, the Netherland, Cyprus, Malta and, of course, Ireland. These countries are likely to feel the brunt of Brexit more than other countries. The situation should become clearer in March 2017 once Article 50 has been triggered.

Long-term consequences will depend on the future structure of economic relations

A number of models are conceivable for the future relations between the European Union and the United Kingdom. Access to the single market will be a crucial factor in determining how severe the economic impact will be. Quantitative estimates on possible effects are extremely uncertain. Major political decisions have not yet been made. Decisive factors for a more favourable investment climate will be reducing political uncertainty and defining clear parameters for future cooperation with the UK.

Conclusion and outlook

The European economy has so far held its ground well throughout the turbulence of this year. Brexit, the influx of refugees and the volatility in the banking sector have not left a visible mark, but there are still challenges ahead.

Falling unemployment is driving up private consumption and domestic demand is still the biggest engine of growth. Investments in some EU member states are only picking up pace very slowly. Global trade is stagnating, and European net exports are not making anything more than a negligible contribution to growth. The impact of low oil prices and the expansive monetary policy is likely to peter out in 2017. The weaker than expected growth in the United States is also slightly curbing momentum in Europe. The transformation of the Chinese economy, on the other hand, has not led to any significant upheavals – at least not yet. The medium-term risks of a substantial cool down of the Chinese economy in 2018 and 2019 are still considerable on account of growing debt problems in the corporate sector. The packages initiated to stimulate Chinese lending have triggered an increase in lending of more than 20 percent annually.

Third quarter growth in the EU and in the Euro area is expected to be modest, but should gather momentum slightly in the fourth quarter of 2016. The business climate in the Euro area is pointing down slightly, albeit on a high level. According to the latest Ifo Business Climate Index for Germany from September 2016, sentiment is pointing up again. This should have a positive impact on the European economy as a whole. The situation on the labour markets should continue to improve gradually and lead to further increases in labour income.

Political uncertainty will drag on into 2017, what with the continuing lack of clarity on the status of the United Kingdom and the upcoming elections in Germany and France. The three largest economies in the EU are thus facing major political change in the next year. The political situation is likely to lessen the clout of European economic policy. Furthermore, the ECB's expansive monetary policy is increasingly running up against its limits. Any further steps taken with respect to the unconventional measures will have a diminishing impact on the monetary policy targets. Mario Draghi must work towards upholding confidence in the ECB and in the effectiveness of its policy in order to maintain the smooth functioning of the Euro area. He is not likely to get much support from structural and fiscal policy in 2017, either.

In the medium and long term, Europe will face a productivity problem. Unfavourable demographic change with contracting and ageing populations will pose a number of major problems for many economies. The social security systems, in particular, will come under increasing strain. They were structured on the assumption that the workforce would remain constant or increase and that productivity would rise at a medium to high rate. But this is not what we are seeing in Europe at the moment. With that in mind, economic policy needs to become more focused on increasing the productivity of labour.

Conclusions for economic policy

Dark clouds are on the horizon all across Europe. The moderate rate of growth should not blind us to the urgency of taking decisive action on the economic policy front. The most recent economic reports of the OECD (September 2016) and the IMF (October 2016) paint a very clear picture. The global economy is in equilibrium with low growth. Weak future prospects are putting a lid on investments and trade, keeping them at low levels. The increased uncertainty caused by the British referendum is exacerbating this trend. Without interventions, the economy will likely continue to stagnate in the Euro area. In view of the general turmoil, ambitious action needs to be taken now.

Monetary policy cannot trigger a turnaround by itself and will only create further risks if it is not supported by fiscal and structural policy. Structural reforms need to take place as soon as possible and should be directed towards bolstering growth and trade. These measures can be reinforced by increasing overall economic demand. Fiscal policy so far has not been focused sufficiently on growth, and available fiscal policy space has not been put to use. It is also becoming apparent that the implementation of the European Semester has been half-

hearted at best in the last few years. The country-specific recommendations, largely designed to promote investment, research and development, are hardly being implemented at all.

The financing conditions in numerous member states are still very poor. The financial market policy must be brought back to a sensible course to meet corporate financing needs as well as establishing financial market regulation that does not lead to international disadvantages. The Capital Markets Union is only progressing sluggishly and coming up against contradictory regulations. The European capital market needs to be made much stronger to ensure that the EU and the Euro area become more crisis resistant. Alongside the deepening of the single market, the Banking Union needs to be completed at long last and a solid backstop must be provided.

The EU-27 Summit in Bratislava gave member states an opportunity to agree on a corresponding package. Unfortunately, nothing came of it. As has become apparent in the past, consensus is seldom reached on these topics at the EU-28 respectively EU-27 level. A stronger emphasis should therefore be put on the alternative of forming coalitions of three to four large member states to jointly spur growth by launching a modern industrial and innovation policy to support monetary and fiscal policy instruments. The effects of such coalitions would be big enough to have an impact on the whole of the EU. It is up to Germany, France and Italy to take action on this front and unleash the powerful momentum that can be generated through the right industrial and innovation policy. Good approaches have been started across the board. It is now time to pursue these approaches wholeheartedly so that they can start to work. It is obvious what needs to be done, even in Washington.

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