Kiel Institute
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Euro Area: Uncertainty weighs temporarily on recovery

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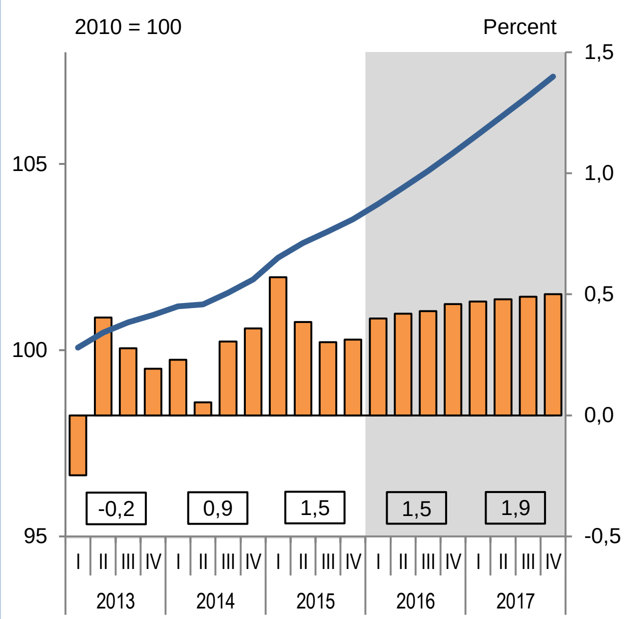
Economic Recovery in the Euro Area has lost momentum in the second half of 2015. Due to dampening effects from the world economy and a marked increase in political uncertainty, a number of sentiment indicators also point downwards. Nevertheless, domestic demand increased rather strongly, while the labor market situation kept improving. Therefore, we consider the minor slowdown of the past months to be temporary. Supportive factors such as low interest rates and a low external value of the currency encounter a slightly expansionary fiscal policy stance over the forecast horizon. As a result, economic activity is expected to gain grip in 2016.

- **We expect GDP to expand at a rate of 1.5 percent in the current year and 1.9 percent in 2017**. GDP growth in the Euro area excluding Germany is forecast at 1.4 percent (2016) and 1.7 percent (2017).

GDP in the Euro Area 2013-2017



Quarterly data, price, seasonally and calendar adjusted, qoq-change. Boxes: Annual rate.

- **Inflation will return to positive rates by the second half of this year.** Consumer price inflation recently went negative again as a result of the further decline in energy costs, but is expected to turn positive in the second half of the year. For 2016 and 2017, we expect annual inflation rates of 0.2 percent and 1.3 percent, respectively.

- **TARGET II balances have been increasing again since mid-2014.** Different factors triggered liquidity and capital movements in the Euro area once again. Capital controls and cash restrictions that were introduced in Greece last summer undermined confidence in the banking system. The new Bank Recovery and Resolution Directive (BRRD), which allows for a bail-in of credit balances above 100 000 Euro, may have induced money flows to less fragile banks in core countries. Finally, the asset purchasing program of the ECB might as well have played a role. Excess liquidity from the purchase of low-risk sovereign bonds is likely to have been reinvested in other low-risk securities. To the extent that these alternative securities with a high credit rating have been relatively more abundant in core countries than in the periphery, liquidity flows to the core were triggered. Thus, central banks of surplus countries are again forced into financing balance of payments deficits, which is reflected in growing TARGET II imbalances (see box „Zum Wiederanstieg der TARGET-Salden“).

- **The situation on the labor markets is expected to improve further**. The unemployment rate continue to to decline, from currently 10.3 percent in January to an annual average of 9.6 percent in 2017.

- **High youth unemployment in the periphery is gradually declining.** The unemployment rate, which relates to the labor force below 25 years, is, however, rather misleading. A large proportion of this age group is still in education and training which is reducing the age-specific labor force. A closer analysis of the age group reveals that while the share of young people in employment has declined sharply during the crisis, the share of unemployed and of people in education increased. Especially in Spain and Ireland, this „flight" into the education system seems to have been significant (see box „Jugendarbeitslosigkeit im Euroraum").

- **Fiscal consolidation has ended.** The expected slight reduction of budget deficits is mainly driven by declining interest rate payments and the economic recovery rather than consolidation. Over the forecast horizon, fiscal policy is expected to be increasingly expansionary.

Key Economic Data for the Euro Area, 2014–2017

	2014	2015	2016	2017
Real GDP[a]	0,9	1,5	1,5	1,9
without Germany[a]	0,6	1,4	1,4	1,7
Consumer prices (HICP)[b]	0,4	0,0	0,2	1,3
Unemployment rate[c]	11,6	10,9	10,1	9,6
Budget balance[d]	-2,6	-2,2	-2,1	-1,9

[a]Change of price- and calendar adjusted GDP in percent. — [b]Change over previous year in percent. — [c]In percent of labor force. — [d]Percent of nominal GDP. — Shaded: IfW forecast.

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