

## MACROECONOMIC CONDITIONS AND OUTLOOK

### 1.1 Introduction

After ending the year 2014 quite positively, the global economy actually weakened substantially during the first half of 2015. This was largely due to weak developments in emerging markets. The economies of Brazil and Russia suffered from an economic slowdown due to low oil prices and, in the case of Russia, international sanctions among other factors. Although economic growth in China has been continuously slowing for several years now, its weak development during the first half of 2015 in particular took the markets by surprise.

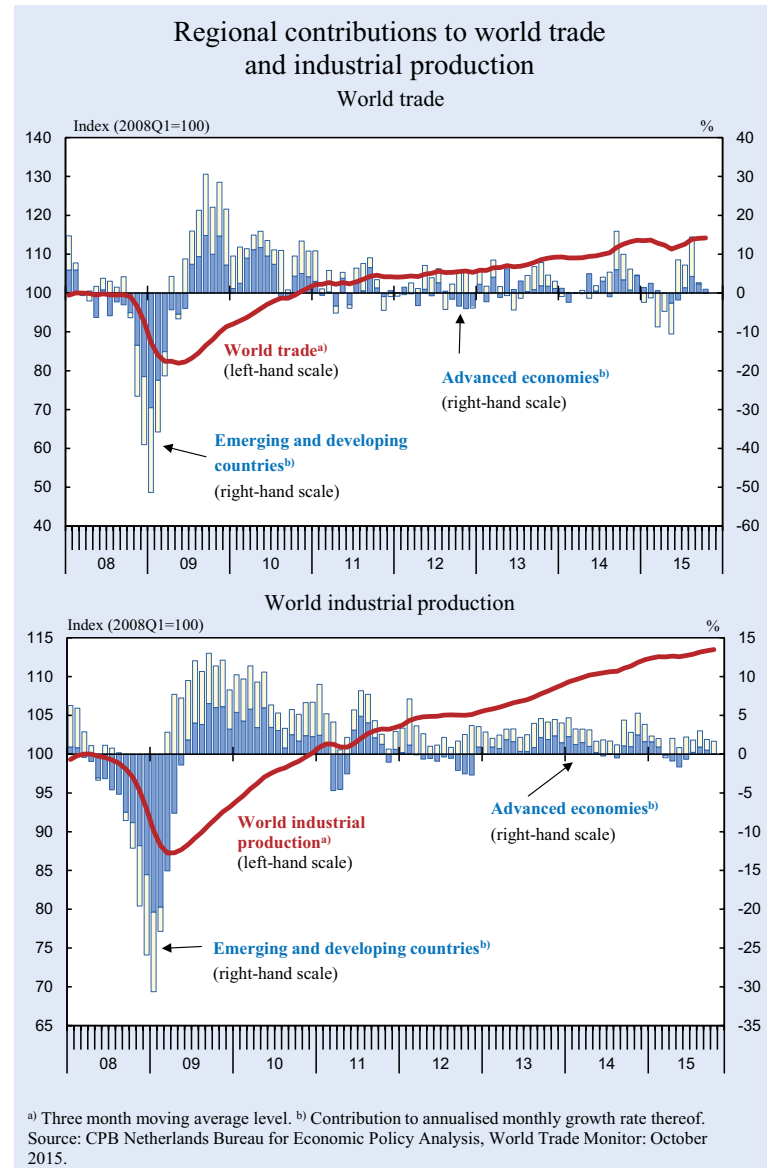
Although the US economy cannot decouple itself from the global economy, it depends more heavily on its own domestic demand than on foreign demand. By far the most important domestic demand component, private consumption, developed less dynamically over the summer half of the year. The recovery in the United States nevertheless continued in 2015, with growth rates hovering around or slightly above their potential. This allowed the US Federal Reserve to start increasing interest rates at the end of the year. The euro area also continued to recover in 2015 and this process is expected to continue in 2016, allowing its economy to grow gradually.

### 1.2 The current situation

#### 1.2.1 The global economy

World trade declined during the first half of 2015 (see Figure 1.1). This was especially the case of trade with and within emerging economies. Although world trade and industrial production did pick up somewhat during the second half of 2015, they did not manage

Figure 1.1



to exceed the moderate pace of expansion witnessed since 2011. During summer they recovered mainly due to the mitigation of negative trends in major commodity-exporting emerging markets, which had been suffering from the sharp decline in prices for crude oil and industrial and agricultural commodities since mid-2014. This short-lived recovery, however, only led to a modest acceleration in global economic expansion. The pace of economic growth in China and other major commodity-importing emerging economies was not affected markedly, i.e. it remained virtually unchanged and relatively moderate by historical standards. In addition, the increase in economic output in the United States slowed somewhat compared to early summer thanks to a slowdown in non-residential construction and inventory investments.

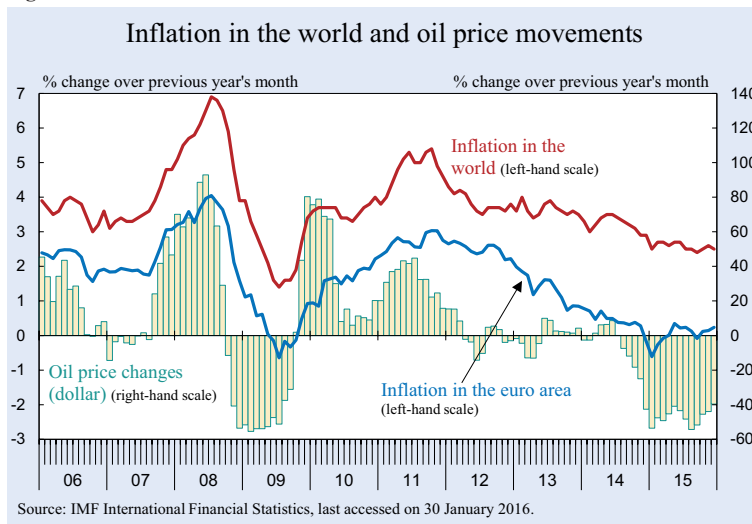
Despite the temporary slowdown during the first half of 2015, almost all advanced economies benefitted from developments in the commodity markets. The price of a barrel of Brent crude oil dropped by over 50 percent in the second half of 2014 from a level of almost 110 US dollars. After recovering slightly during the first quarter of 2015 to a little over 60 US dollars, it fell again by over 25 percent between May and August, reaching a trough of around 45 US dollars. Although the Brent price remained more or less steady at between 45 and 55 dollars during the autumn, the price of a barrel started falling again at the end of 2015, plunging to just over 35 US dollars at the start of 2016. Although not to the same degree as oil, the prices of other agricultural and industrial raw materials have also dipped noticeably since mid-2014. Whereas demand-side aspects can explain the fall in many of these ag-

ricultural and industrial raw material prices, in the case of oil the expansion of production in the United States (fracking) between 2012 and mid-2015 and in some Middle Eastern countries is also a driving force behind this development. Falling oil prices were reflected in a steady decline in inflation figures throughout 2015 (see Figure 1.2).

Economic developments among individual industrial countries have nevertheless remained very heterogeneous. The United States and the United Kingdom are currently experiencing an upswing. In both countries, real Gross Domestic Product (GDP) is already well above pre-crisis levels and production capacity is largely utilised. Among other things, this is indicated by unemployment rates which are already as low as in the boom year of 2007 in both economies. Although the competitiveness of both countries will be impacted by the strong appreciation of their currencies that began in summer 2014, their domestic economies, however, are strongly supported by the increasing improvement in the labour market, the financial situation of households and low energy prices.

The pace of economic expansion in the euro area and Japan, by contrast, is still considerably lower. Although the currencies of both economies have depreciated over the past year and a half, not least due to expansionary monetary policies, their improved international competitiveness has not yet translated into a clear upturn in growth rates. In the euro area in particular, production capacity is still under-utilised. Furthermore, both economies are still suffering from a large number of unresolved structural problems, leading to only a moderate long-term trend growth path.

Figure 1.2



In China and many East Asian emerging economies, domestic demand was also supported by the favourable development in oil prices in summer 2015. However, this was offset by a number of factors, which dampened growth in emerging economies. In China growth is slowing down gradually, reflecting a structural trend that has been going on for several years. Whereas the service sector is becoming increasingly important, growth rates, especially in commodity-intensive sectors like industry and construction, are fall-

ing noticeably. Since mid-2014, this demand-side effect, together with supply-side factors, has led to a decline in the prices of oil and other industrial and agricultural commodities, thereby contributing decisively to a sharp deterioration of the economic situation in Russia, Brazil, Indonesia and other emerging economies. As these countries depend on commodity exports, the price decline has led to painful losses in national income and has limited scope for expenditure by households and enterprises. In addition, the attractiveness of commodity-exporting countries as investment targets also diminished for international investors. Accordingly, many currencies such as those of Brazil, Russia and Indonesia, decreased in value over the past year. This accelerated inflation in these economies, prompting local central banks to tighten monetary policy considerably in some cases. Finally, fiscal policy in Brazil has also taken a noticeably more restrictive course, while Russia felt the effects of the economic sanctions imposed on the country in the wake of the political conflict with Ukraine. Accordingly, GDP shrank strongly in Russia and Brazil during the first half of 2015, before the recession slowed in the second half of the same year.

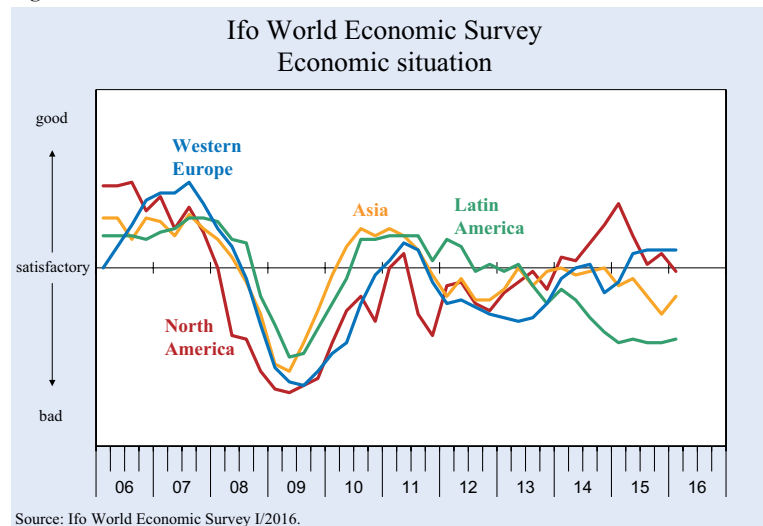
Strong turbulence in the Chinese stock market caused quite a stir last summer. The Shanghai Stock Exchange Composite – the most closely watched stock index of that country – lost about a third of its value between June and late August, before stabilising at a level that is still around 60 percent higher than on average during 2014. There are many indications that these fluctuations represent a desirable partial correction of previous, fundamentally unjustified exaggerations, which should leave no appreciable traces in the real economy. The exceptionally strong rise in share prices from July 2014 to June 2015 contrasted sharply to macroeconomic developments – the expansion pace of the Chinese economy has decreased trend-wise in recent years. However, the sub-text of “fundamentally unjustified exaggerations” may only be part of the story. An important long-term aspect is that the Chinese stock market itself is heavily subject to structural change, which may result in higher stock values despite ever weakening fundamentals. The stock market in China is nevertheless still far less important to the wealth position

of households, or as a financing tool for companies, than in the United States, for example.

Nevertheless, turmoil in the Chinese stock markets did have a direct negative impact on international financial markets. Uncertainty among capital market participants increased and led to a restructuring of emerging market portfolios that have particularly strong trade links with China. This hit at a time when many emerging countries were already suffering from the fall in commodity export prices. Although most stock indices appeared to be back on the road to recovery by the end of October 2015 and capital flight from China and other emerging markets appeared under control by that point, market participants lost confidence again this January, resulting in further losses.

This was helped by economic developments in China, which fared significantly better than expected by many market participants. Also the repeated deferment of the first policy rate increase in years in the United States did promote the attractiveness of many emerging economies as an investment target somewhat during this time. Finally, the Chinese government intervened with a series of measures that aimed to stabilise share prices and reduce the outflow of capital. For instance, strict trade restrictions for financial market participants were imposed, and the People’s Bank of China sold foreign exchange reserves. However, it seems doubtful whether the sometimes hasty intervention by the government and the central bank was actually required. At best, it contributed to effectively thwart a desirable market correction at the prize of having weakened the credibility of the Chinese leadership to gradually liberalise the financial sector.

Figure 1.3



All in all, whereas sentiment in Asia and Latin America decreased markedly during the last one and a half years, Western Europe and North America essentially remained on a recovery path, painting a diverging picture of the global economy (see Figure 1.3). World trade and world GDP are expected to have increased by 2.6 and 2.5 percent respectively last year (see Table 1.A.1).

### 1.2.2 United States

After a weak start to the year, the US economy initially rebounded to above potential before slowing down at the end of the year (see Figure 1.4). The weakness seen in the first quarter of 2015 was mainly due to temporary factors, such as the harsh winter and the dock-worker strikes. Logically, the second quarter was characterised by catch-up effects. During the second half of 2015, GDP increased by an annualised rate of about 2.1 percent compared to the first half of the year. Throughout the year, the largest growth contributions came from consumer spending, and, to a lesser extent, from investment in equipment, highlighting that the engine for growth was found in domestic demand.

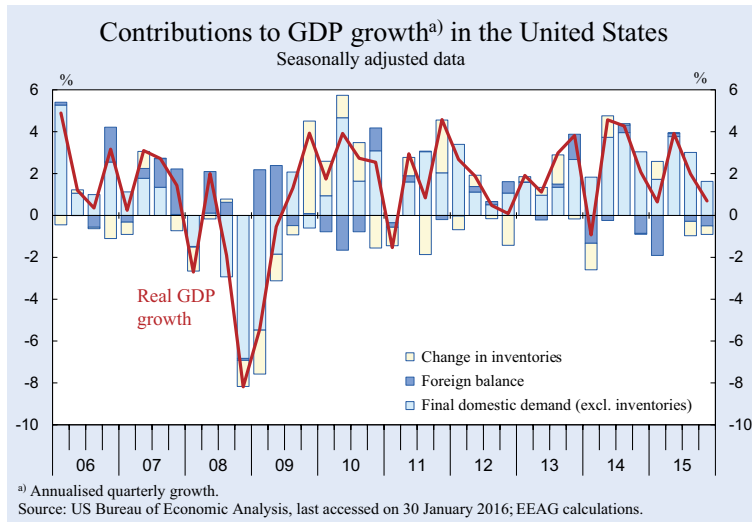
Favourable labour market conditions did not lead to an acceleration in wage growth last year. Hourly earnings before taxes in the private sector have increased by around 2 percent since the end of 2010. Nevertheless, the real disposable income of households has risen significantly in the face of low inflation and newly created jobs since the beginning of 2014. In October 2015 it was 3.9 percent higher than the previous year. Household assets also benefitted from rising real es-

tate and stock prices. All in all, and despite a weaker first quarter, this created an environment in which private consumption was able to grow at around 3 percent during the year (see Figure 1.5). Although private fixed investment did grow faster than private consumption, it nevertheless remained well behind the growth levels witnessed the years before. Overall, strong domestic demand and the appreciation of the US dollar has, via a strong rise in imports, led foreign trade to contribute negatively to GDP growth. Real GDP increased by 2.4 percent in 2015.

The labour market continued to develop positively. The unemployment rate fell from 5.7 percent at the beginning of the year to 5.0 percent in December, resulting in an average unemployment rate of 5.3 percent for 2015 (see Figure 1.6). During the year on average well-above 200,000 new jobs were created per month. Although this was less than in 2014, it clearly surpassed figures for the period from 2010 to 2013. At the same time, the share of part-time work declined and the drop in the labour force participation rate during recent years appears to have ground to a halt.

The sharp decline in oil prices and the strengthening of the US dollar even caused inflation rates to turn negative during the first trimester of the year. Despite very loose monetary policy, inflation just managed to hover above zero during the rest of the year, resulting in an average inflation rate of 0.1 percent for 2015 (see Figure 1.7). Taking food- and energy-related items out of the basket paints a different picture: the resulting core inflation rate steadily increased from 1.6 percent at the beginning of 2015 to 2.1 percent at its end.

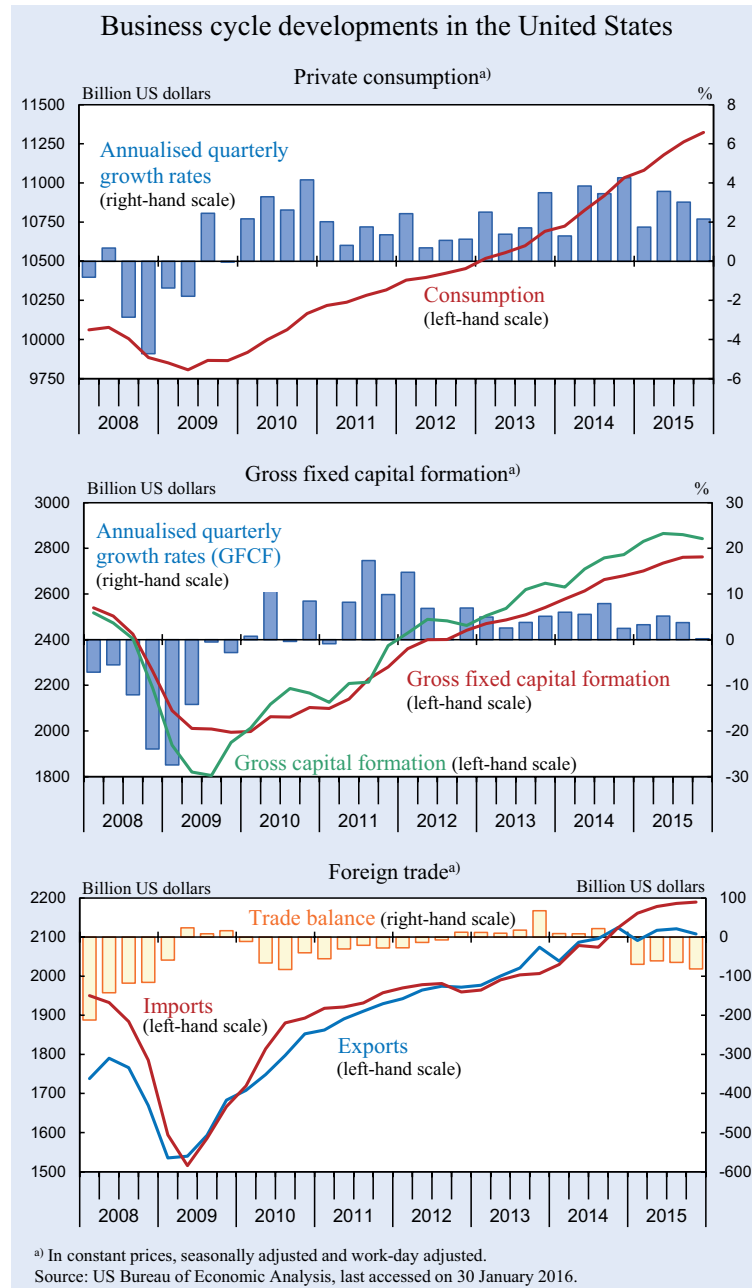
Figure 1.4



### 1.2.3 Asia

In *China*, the pace of expansion decelerated during 2015. After a relatively weak first quarter, real GDP grew in the second, third and fourth quarters of 2015 with annualised rates of, resp. 7.8, 7.4 and 6.6 percent compared to the previous quarter. This was significantly higher than expected by many market participants, since growth was only 5.3 percent in the first quarter of 2015. This nevertheless reflects the structur-

Figure 1.5



al slowdown seen in China's economy for several years. A key driver behind the robust expansion in the summer half of the year was the increase in private consumption, which benefitted from an increase in real disposable income and favourable earnings prospects. Last but not least, impetus was provided by fiscal policy via expanding the railway network, improving the water supply and public housing. Overall, real GDP did rise by 6.9 percent last year.

Strong turbulence in the Chinese stock markets in the summer of 2015 attracted a great deal of attention. After the speculative boom lasting from July 2014 to June 2015, during which the stock indices in Shanghai

and Shenzhen rose by over 150 percent, they have lost over a third of their value since mid-June 2015. The losses have increased uncertainty among international financial investors and led to an outflow of foreign capital. Fears of a hard landing of the Chinese economy also played a role. The net capital withdrawal from China amounted to around 350 billion US dollars during the first nine months of 2015. The relatively solid development of the Chinese economy together with market interventions by Chinese policymakers, like those of the domestic public pension funds, for example, which started to invest in Chinese stocks deemed too risky by private investors, as well as the restrictions imposed on currency derivatives, contributed to a stabilisation in autumn 2015. The jittery situation in financial markets all over the world, however, led Chinese stock market indices to plummet again in January of this year.

In view of the weakening economy during the first quarter, the increased uncertainty in Chinese financial markets in summer and the continuing low core inflation rate that remained below 2 percent, monetary policy was further eased throughout 2015. The key

interest rate has been lowered in several steps by a total of 265 basis points since November 2014, while bank reserve requirement ratios have decreased by 2.5 percentage points since February 2015. To stabilise real estate markets, the Chinese government also improved financing conditions and relaxed the conditions for acquiring second homes in some regions. All of these factors helped to push real estate prices back up again slightly.

Industrial production increased at historically low rates of around 6 percent last year. In some economic sectors, such as the cement and steel industries, production even declined slightly. By contrast, there were

Figure 1.6

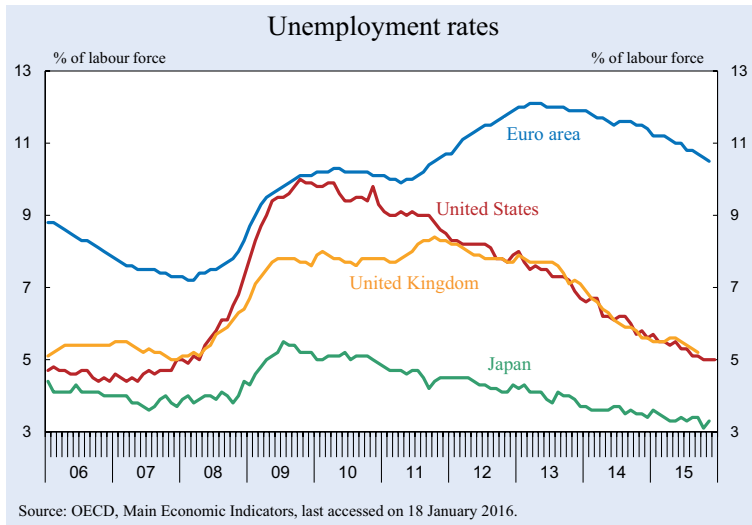
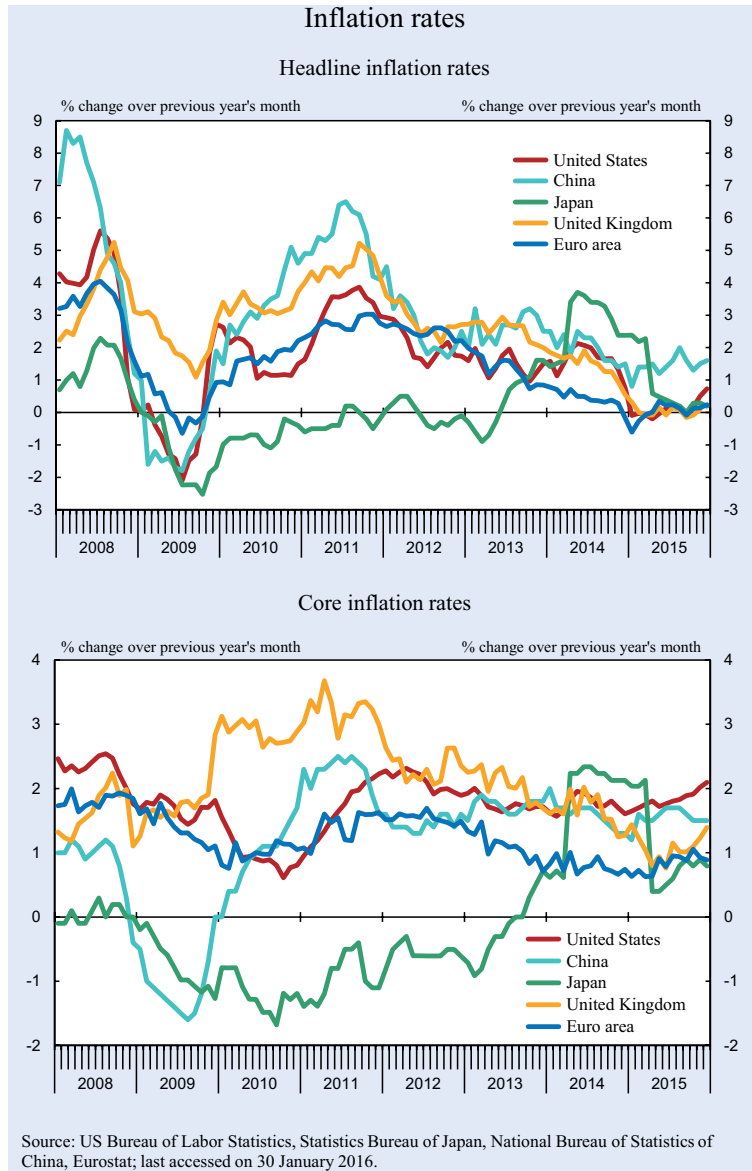


Figure 1.7



gains in the services sector, which has been developing more dynamically than the industrial sector since 2013. As production in the services sector is more labour intensive, the slowdown in industry did not have a negative impact on overall employment. Thus, 10.7 million new jobs were created in urban and sub-urban areas in the first nine months of 2015.

Economic developments in *Japan* deteriorated significantly during the course of last year. After a strong first quarter, which was marked by a sharp increase in investment and an increase in inventories, output only expanded weakly during the summer and fall period. The decrease in growth was mainly due to a slump in exports. Both exports to China and other Asian countries, as well as those to Europe and the United States, declined sharply during the second quarter of the year. Investment activity was also weak during the summer half. Despite the fall in oil prices, which in principle should support real income growth, private consumption grew sluggishly and remained weak. Overall, total economic output is expected to have risen by 0.6 percent last year.

Early 2015 inflation rates were still above 2 percent due to the VAT increase in April 2014. After this one-off effect faded, inflation dropped substantially, reaching 0 percent in September and slightly rising again since. Another driving force behind the decline during the summer half year was energy prices. Correcting for this, we saw a moderate increase to levels slightly below 1 percent by the end of last year. Core inflation has thereby remained in positive territory since autumn 2013. The

central bank also recently decided not to further expand its monetary policy for that reason. In addition, the depreciation of the yen, which in real effective terms amounted to almost 10 percent since summer 2014, or close to 30 percent since summer 2012, has gradually become noticeable in consumer prices. The average inflation rate for 2015 turned out to be 0.8 percent.

The labour market is very robust, despite the economic slowdown. Employment has risen over the course of the year and unemployment fell to 3.1 percent in October, its lowest level since summer 1995.

Unlike in previous years, real GDP growth in *India* managed to stay above 7 percent throughout 2015 in a year-over-year comparison, and is expected to result in an average growth rate of 7.3 percent. Positive impulses came from both private consumption and public investment. The mood among private households brightened, which was mainly due to moderate inflation developments. Consumer prices have been declining since the beginning of 2014, thereby strengthening the purchasing power of households. The slowdown in inflation mainly reflects the drop in energy prices, active control of food prices and the recently increased credibility of monetary policy. In addition, the government has increased its investment and also took first steps towards implementing a series of structural reforms. Among other things, it started to allow foreign direct investment to enter additional sectors, such as construction and railways. As a result, net FDI into India amounted to around 20 billion US dollars in the first six months of 2015. This corresponds to a growth rate of over 120 percent compared to the same period last year. At the same time, such investments plummeted in many other emerging economies during the same period.

In the other East Asian emerging markets (*Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore* and *Hong Kong*), economic momentum slowed down slightly during last year. Overall growth rates are still fairly comparable to those of previous years. The slight slowdown is mainly due to a decline in demand from Chinese industry for intermediate and capital goods from these countries. In addition, the slowdown in China has exerted downward pressure on international commodity prices, and commodity exporters like Indonesia have suffered as a result. All in all, real GDP is expected to have grown by

3.2 percent in these other East Asian countries last year.

#### 1.2.4 Latin America and Russia

Overall the GDP growth rate in Latin America (*Brazil, Mexico, Argentina, Venezuela, Colombia* and *Chile*) has declined steadily since 2010. The pronounced weakness in the region led to a –0.7 percent decline in real GDP in 2015. A major reason is the sharp drop in commodity prices, which have worsened the terms of trade of the region. In addition, Latin American currencies continued to depreciate. The Colombian peso and the Brazilian real, for instance, have lost around 30 percent of their value in real effective terms since mid-2014. For the Mexican peso, the loss also amounted to well over 10 percent. These currency depreciations firstly imply a burden on businesses and households indebted in foreign currency. Secondly, owing to these depreciations, inflation rates in most Latin American countries lie above the inflation targets of the respective central banks. While Brazil has raised interest rates several times since autumn 2014 in response, Colombia and Chile followed with two interest rate hikes last fall. In Mexico, on the other hand, inflationary pressures have eased up since spring last year and are now within the target range of the central bank.

In Brazil, the largest economy in the region, industrial production has been declining since the middle of 2014. The unemployment rate skyrocketed from approximately 5 percent at the beginning of last year to almost 8 percent by the end of it. Producer and consumer confidence are also down due to numerous corruption scandals and political crises. Last but not least, restrictive monetary and fiscal policies are having a dampening effect. The fiscal consolidation is being driven by subsidy cuts, tax increases and increases in regulated prices. As the primary balance of the central government, i.e. the fiscal position corrected for interest payments, slipped into the red in Brazil over the past year, investors were particularly critical of the worsening of the overall budget balance. Accordingly, the government's creditworthiness was downgraded over the year to as low as junk status by some rating agencies. Mexico, Colombia and Chile, by contrast, are in better overall economic shape. In these countries, industrial production continued to expand.

The economy in *Russia* has been in a recession since mid-2014. High interest rates and negative growth prospects have led to a substantial scale-back in lending to businesses and households since the beginning of 2015. The amount of non-performing loans has basically doubled since the start of the crisis. High inflation rates and falling real income levels caused a downright slump in retail sales. The rate of decline started to abate in the third quarter of 2015. This turnaround was due to a number of developments, especially in the industrial and

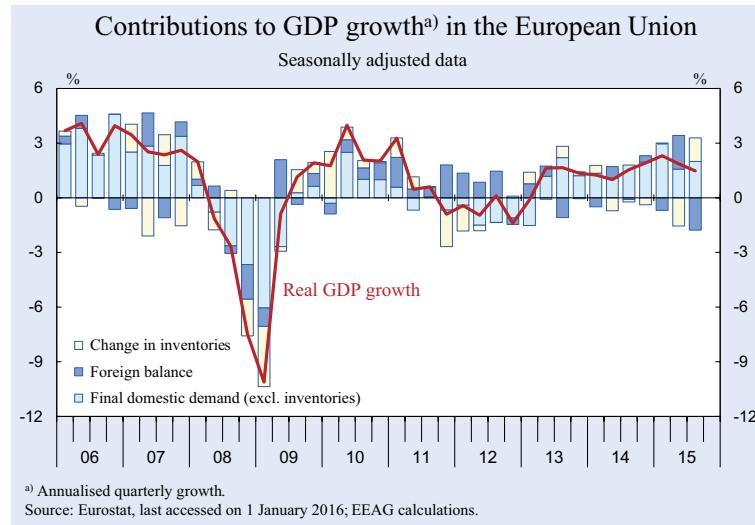
agricultural sectors. The ruble's depreciation improved profitability in certain export sectors (including in the mining, metal processing and chemical industries). Since mid-2014, the ruble has lost about half its value against the US dollar and a third of its value against the euro. Furthermore, some industries benefitted from production losses in Eastern Ukraine and larger government contracts related to defence and infrastructure spending. Agriculture and food producers benefitted from the ban on western food imports. The very fast and consistent implementation of a policy of import substitution gave Russian producers additional competitive advantages in 2015, especially in public tenders. Since many Western manufacturers were forced to protect their market shares by expanding production in Russia, foreign direct investment started increasing again in the non-banking sector. The capital flight appears to have ground to a halt and the exchange rate is likely to have stabilised. Despite the slump in commodity prices, Russia still has a positive trade balance. This, however, is also due to a sharp decline in imports. Overall GDP probably declined by –3.2 percent last year.

### 1.2.5 The European economy

#### The cyclical situation

The economic recovery in Europe continued throughout 2015. Since the end of the recession in the second quarter of 2013, the average annualised quarterly GDP growth rate in the European Union has amounted to 1.6 percent. Although the degree of expansion weakened slightly, particularly during the summer

Figure 1.8

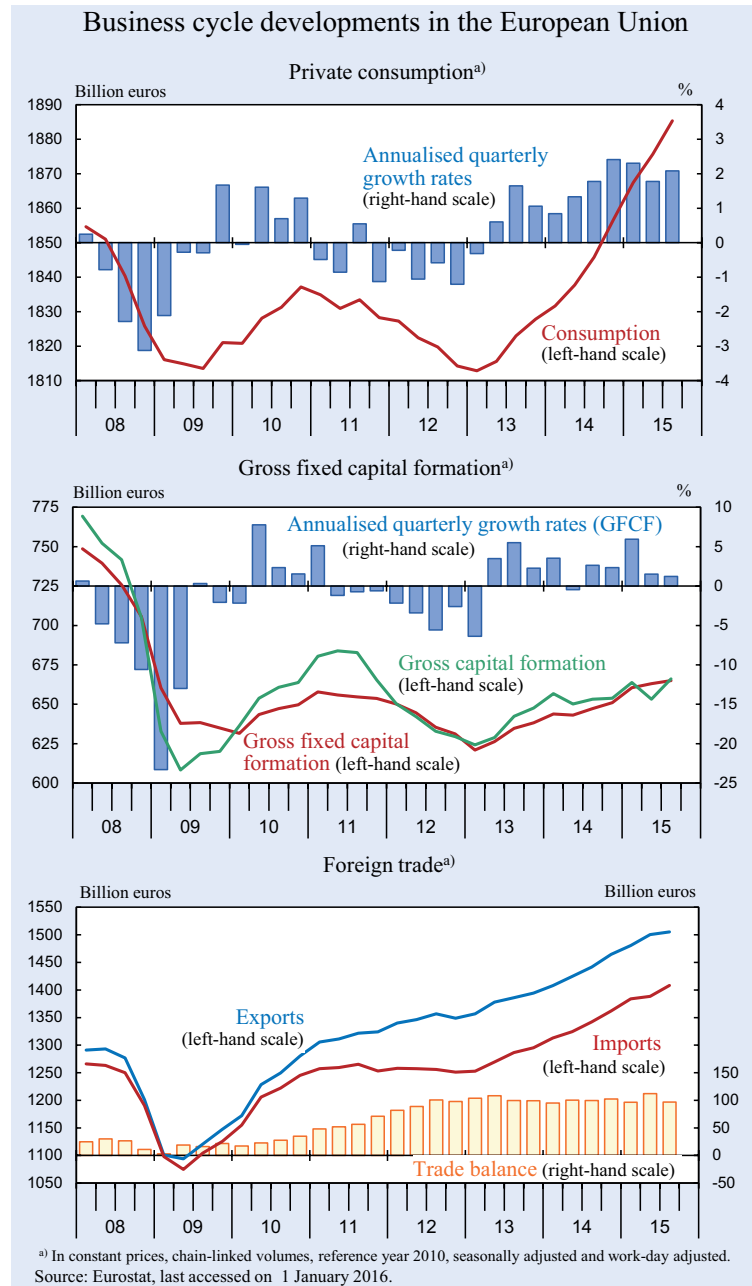


half of 2015, it still outperformed developments in 2014 (see Figure 1.8). One reason for the slowdown in the recovery was increased uncertainty about the growth prospects of the Chinese economy and the associated financial turmoil during the summer months. In addition, contributions from France and Italy were once again below average, which was also due to unresolved structural problems. Favourable developments continued from the strong devaluation of the euro against the US dollar and the relatively low price of crude oil. The financing conditions for private businesses and households are extremely advantageous in most European countries and are still improving in the crisis-inflicted nations. This has allowed overall credit demand to slowly start increasing again.

The recovery in Europe has mainly been supported by an increase in private consumption to date (see Figure 1.9). One reason for this is the improvement in the budget positions of households caused by the sharp decline in energy prices. In addition, increased real economic activity also led to an easing of labour market conditions. The unemployment rate in the European Union fell from its peak of 11 percent in early 2013 to 9.3 percent in October 2015. Employment also increased substantially last year, almost reaching its all-time high from early 2008. When focusing on the euro area, these figures point in the same direction, albeit in a clearly less pronounced manner. Here, only half of the job losses suffered in the wake of the financial and euro crises have so far been compensated for. In addition to the high level of structural unemployment, the rate of growth is still too low to bring about more rapid employment growth.



Figure 1.9



Firms have also benefitted from reduced energy costs and the depreciation of the euro. Their improved price competitiveness resulted in a further strengthening of exports. The contribution of foreign trade to overall growth was more or less neutral last year, since imports also continued to grow rapidly. Next to improvements in the competitiveness situation, capacity utilisation in the manufacturing sector has also reached a level that makes equipment investments look more attractive. Despite favourable refinancing conditions, only a moderate increase in equipment investments has occurred to date. With respect to construction investment, no noticeable revival has been observed.

at a rate of about 1.5 percent.<sup>1</sup> Overall capacity utilisation increased only slightly. In industry (excluding food and beverages), production capacity utilisation even declined somewhat, but is still well above its long-run average.

The moderate economic recovery was largely driven by domestic demand, and particularly by private consumption. Final consumption expenditure of house-

The existing overcapacity and continued decline in property prices in some European countries are the reasons behind this flat situation and are reflected in historically subdued business sentiment in the construction sector.

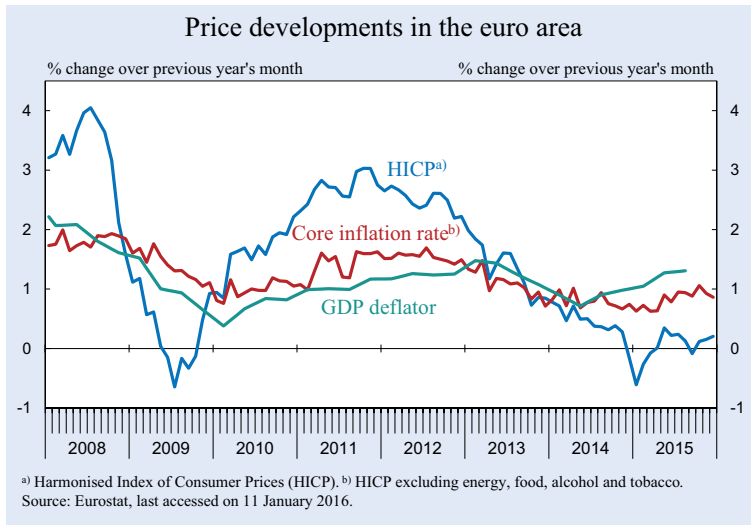
The general price increase was still extremely low last year. In the euro area, the total annual inflation rate in December 2015 was 0.2 percent and thus well below the medium-term target of the European Central Bank (ECB) of below, but close to, 2 percent (see Figure 1.10). This low inflation rate is largely due to the marked decline in energy and commodity prices since the middle of 2014. The core inflation rate (headline inflation excluding energy, food alcohol and tobacco) has gradually recovered from its all-time low of 0.65 percent in April last year and reached almost 1 percent by the end of the year. A similar picture emerges when looking at the GDP deflator. The increased utilisation of production capacities does give companies more scope for price increases.

**Differences across Europe**

Germany witnessed moderate, but stable growth during the course of last year. Its real GDP expanded

<sup>1</sup> Please note that we are using seasonally and working-day adjusted data wherever possible. Normally these numbers do not differ much from data that is only seasonally adjusted (and not working-day adjusted). However, in terms of 2015, it does make a difference for Germany. Using seasonally adjusted data, the German GDP growth rate was probably 1.7 percent last year.

Figure 1.10



holds expanded at a rate of 1.9 percent, fostered by higher real incomes, a further expansion of employment and the recent wave of refugee migration. The massive influx of people seeking help from countries in the Balkans, as well as from civil war regions of the Middle East, also led to a significant increase in government consumption spending. More had to be spent on the provision of accommodation and in kind social transfers.

Compared to consumption, the development of investment was relatively disappointing in 2015. After seemingly speeding up last winter, it started to subsequently falter again. Equipment investment declined during summer. Given the weak order intake, particularly from non-European countries, companies did not see scope for further expanding their investment activities. After a good start owing to favourable weather conditions, construction spending slipped into the red in spring last year. Investment in research and development in general fluctuates to a lesser extent than other investment types and thereby had a stabilising influence on aggregate investment.

Apart from a temporary increase in the second quarter of 2015, the contribution of foreign trade to real GDP was negligible in 2015. Thanks largely to the weakness of key emerging markets, exports basically kept pace with imports.

Labour demand remained relatively high, despite the introduction of a nationwide legal minimum wage. While the number of employed persons clearly increased over the year, unemployment continued to decline. Refugee migration has not yet impacted the

labour market to a significant degree.

*France* has been facing structural weaknesses for some time. The tax burden is well above average and a substantial amount of price competitiveness has been lost over the years. As of 1999, imports have continued to grow faster than exports, which has led to trade and current account deficits. Structural weaknesses are particularly evident in weak investment developments. Current gross fixed capital formation is also basically at a level witnessed

a decade ago. While private investment in machinery and equipment still provides a small positive contribution, private construction spending fell sharply last year. This is partly because real estate prices have been falling and there is excess capacity in the construction sector. Private and public consumption remained supportive last year, expanding at relatively strong rates. Of the larger economies, it is the only country in which the upward trend in unemployment rates has not yet been broken. Real GDP growth only accelerated to a level of 1.1 percent last year, while the inflation rate basically stagnated at 0.1 percent.

Albeit at a slightly lower pace, the upswing that started early in 2013 in the *United Kingdom* continued throughout last year. Important growth contributions came from consumer spending and investment in machinery and equipment. Gross fixed capital formation gained momentum as the year progressed. Investment activity has shifted more towards the service sector, while the oil and gas industry continues to suffer from the fall in oil prices. Foreign trade provided a negative contribution to growth. Although exports rose, imports rose much more steeply. One of the reasons for this was the development of the exchange rate. The value of the British pound rose substantially against the euro, while it depreciated somewhat against the US dollar. Given that the euro area is by far the most import market for British exports, the appreciation against the euro was not only stronger, it also weighed more on the economy. Whereas the unemployment rate remained largely unchanged at a level of 5.5 percent during the first half of the year, it started to decline again and reached 5.1 percent by October. In 2015, real GDP grew by 2.2 percent.

Table 1.1

Labour costs <sup>a)</sup>													
	Compensation per employee <sup>b)</sup>		Real compensation costs <sup>c)</sup>		Labour productivity		Unit labour costs		Relative unit labour costs <sup>d)</sup>		Export performance <sup>e)</sup>		
	1999 – 2009	2010 – 2015	1999 – 2009	2010 – 2015	1999 – 2009	2010 – 2015	1999 – 2009	2010 – 2015	1999 – 2009	2010 – 2015	1999 – 2009	2010 – 2015	2015
Germany	1.1	2.6	0.2	1.0	0.3	1.1	-1.2	-0.9	-1.2	-0.9	0.3	1.5	3.5
France	2.7	1.9	1.0	1.0	0.7	0.7	0.4	-1.2	0.4	-1.2	-2.2	0.4	3.9
Italy	2.4	0.8	0.0	-0.1	-0.4	-0.1	1.5	-1.4	1.5	-1.4	-3.9	0.0	2.0
Spain	3.6	-0.1	0.3	-0.3	0.4	1.0	2.1	-3.2	2.1	-3.2	-1.2	1.1	2.1
Netherlands	3.2	1.4	0.8	0.6	0.8	0.8	0.9	-2.1	0.9	-2.1	-0.3	0.3	1.1
Belgium	2.8	2.0	1.0	0.6	0.8	0.7	0.6	-1.1	0.6	-1.1	-1.1	0.4	0.8
Austria	2.3	1.9	0.6	0.3	0.9	0.3	-0.3	-0.3	-0.3	-0.3	-0.6	-0.6	-2.3
Finland	3.2	2.1	1.6	0.4	1.0	0.5	0.3	-1.1	0.3	-1.1	-0.5	-3.0	1.0
Greece	5.2	-2.7	2.1	-1.9	1.7	-1.0	2.5	-3.1	2.5	-3.1	0.0	-1.8	-2.1
Portugal	3.7	-0.3	0.7	-1.0	1.0	0.8	0.8	-2.2	0.8	-2.2	-1.3	2.4	3.0
Ireland	5.1	-0.1	2.7	-0.9	2.2	2.5	2.0	-5.4	2.0	-5.4	3.2	1.6	8.2
Slovakia	7.7	2.7	3.7	2.1	3.7	2.3	3.4	-1.1	3.4	-1.1	4.3	3.7	2.0
Slovenia	7.3	1.1	2.5	0.7	2.2	1.3	0.9	-2.7	0.9	-2.7	1.4	0.7	2.2
Estonia					4.2	2.2	4.0	-0.3	4.0	-0.3	-0.6	4.9	0.6
United Kingdom	4.2	1.8	1.9	0.0	1.2	0.9	-1.3	1.5	-1.3	1.5	-1.5	-1.6	-1.1
Sweden	4.0	2.6	2.2	1.3	1.5	1.2	-0.8	1.3	-0.8	1.3	-0.7	-0.2	1.0
Denmark	3.6	1.8	1.3	0.1	0.6	1.0	1.5	-1.6	1.5	-1.6	0.0	-2.2	-1.4
Poland	5.5	3.7	1.9	2.2	3.7	2.4	-0.7	0.1	-0.7	0.1	2.5	2.4	2.5
Czech Republic	5.9	2.0	3.5	1.2	3.0	1.3	3.8	-1.7	3.8	-1.7	4.5	2.3	3.3
Hungary	8.5	2.2	2.4	-0.4	2.6	0.5	3.3	-1.8	3.3	-1.8	5.5	1.4	4.9
Switzerland	1.7	0.6	0.7	0.8	0.8	0.2	0.3	3.7	0.3	3.7	-1.1	-0.9	-4.6
Norway	5.0	3.8	0.0	0.8	0.6	0.4	2.7	0.6	2.7	0.6	-3.3	-3.5	-0.6
Iceland	6.8	5.8	1.3	2.0	2.4	-0.1	-3.7	5.9	-3.7	5.9	1.4	0.1	4.9
United States	3.7	2.2	1.5	0.6	1.8	0.9	-1.6	1.4	-1.6	1.4	-1.8	-0.7	0.2
China							3.9	5.5	3.9	5.5	11.5	4.1	-3.2
Japan	-1.3	0.3	-0.1	0.6	0.7	1.2	-1.8	-5.7	-1.8	-5.7	-3.3	-0.7	0.2

<sup>a)</sup> Growth rates for the total economy. – <sup>b)</sup> Compensation per employee in the private sector. – <sup>c)</sup> Compensation per employee in the private sector deflated by the GDP deflator. – <sup>d)</sup> Competitiveness: weighted relative unit labour costs. – <sup>e)</sup> Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD, OECD Economic Outlook, Vol. 2015 Issue 2, November.

In view of low energy prices and the appreciation of the British pound, the price level remained virtually unchanged last year compared to 2014. Whereas the core inflation rate, which excludes energy, food, alcohol and tobacco, dropped markedly early on in the year, it subsequently started to increase again reaching 1.4 percent by the end of the year.

After having been in a recession since mid-2011, the *Italian* economy started growing again at the start of 2015. As elsewhere in Europe, this upswing was largely driven by an increase in private consumption. Some labour market reforms were also implemented. Protection against dismissal was relaxed and settlement rules were unified. This should particularly promote opportunities for younger generations to (re-)enter the labour market. The unemployment rate declined, albeit slowly, as of summer 2015. Since the measures undertaken apply only to new employment, it is no sur-

prise that the implemented reforms appear not to have made a big difference yet. Their impact is likely to become visible in the course of time. For the time being, the pace of recovery is much too slow to enable a rapid increase in employment. The relatively high tax burden for firms, in addition to rigid labour and product markets, still implies a rather low potential growth rate for the *Italian* economy. These structural weaknesses were largely responsible for the loss in price competitiveness in the past, which led to a marked decline in Italy's share of world trade in previous years. Last year was the first time in decades that Italy saw a sizeable increase in its market share (see Table 1.1). All in all, Italy's real GDP increased by 0.7 percent in 2015.

The *Spanish* economy was able to overcome its perennial recession in the summer of 2013 and subsequently expanded at rising rates. The upswing reached almost all sectors of the economy. In particular, private invest-

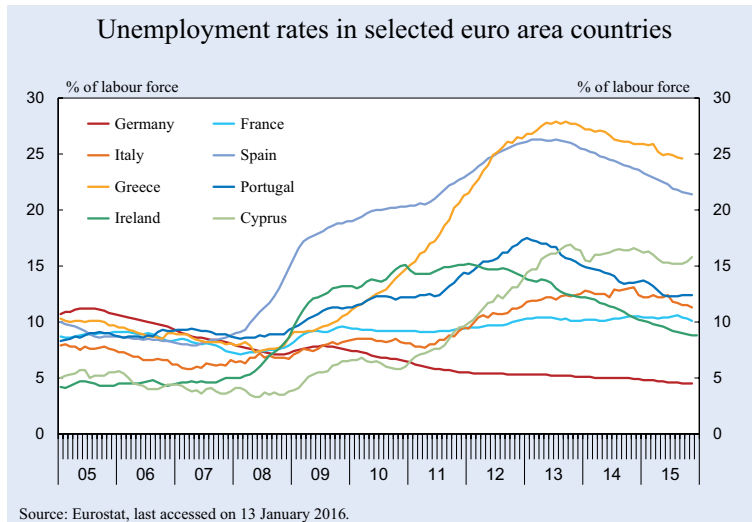
ment in machinery and equipment has been increasing vigorously for some time now. Low lending rates and an increased willingness on the part of banks to increase their lending portfolio have helped. In addition, external demand is high, not least because the price competitiveness of Spanish companies has improved. On the one hand, they benefitted from the significant depreciation of the euro against the US dollar. On the other hand, Spain has experienced one of the lowest inflation rates in the euro area for some time now. In addition, the private construction sector contributed positively again after a deep crisis and its recent reduction of immense overcapacities. Last but not least, private consumption supported the upswing, partly because Spanish households, due to their relatively high debt burden, benefitted significantly from the lower interest rates. Moreover, the favourable economic situation in association with the implemented structural reforms is having an increasingly positive effect on the labour market. The unemployment rate has declined by almost five percentage points since summer 2013 and the number of employees has increased substantially. Nevertheless, with an average unemployment rate of 22.2 percent in 2015, there is still ample room for further improvement (see Figure 1.11).

Of the crisis-inflicted countries, *Cyprus*, *Ireland*, *Portugal* and *Greece*, only Greece has not yet entered recovery mode. On the contrary, the election outcome early in 2015 created an environment in which uncertainty about future developments in Greece increased substantially. Up until the climax reached with the referendum and the subsequent setup of the 3rd bailout package with the European Union and the IMF in June and July, the increased uncertainty even supported eco-

nomical development somewhat, as it led to advanced spending by consumers amid fears of depositors suffering losses. During the second half of the year, the country slipped into recession as the negative consequences of the turmoil and the capital controls imposed became more apparent. Ireland, on the other hand, is in full recovery mode. Domestic demand and exports rebounded, resulting in a growth rate of 6.9 percent in 2015. Albeit clearly not as strongly, Cyprus and Portugal also managed to pull out of recession and grew last year by 1.4 and 1.5 percent, respectively.

In the Central and Eastern European member states of the European Union, the economy gained momentum throughout 2015. The region benefitted from the recovery in the euro area. Furthermore, cheap oil and low commodity prices acted as an additional economic stimulus. This led to a noticeable improvement in the labour market situation almost everywhere, which was accompanied by a significant drop in unemployment in many places. In addition, real household income increased, not least because the price level rose only slightly and even declined in some places. Accordingly, consumer spending delivered a strong contribution to economic growth. Gross fixed capital formation rose sharply almost everywhere. This was triggered by the positive economic outlook on the one hand, and significantly improved financing conditions on the other: interest rates remained extremely low throughout the year. In some countries exports also contributed positively to the economic recovery, which in line with the recovery of the euro area gained impetus somewhat. In Poland and the Baltic states on the other hand, exports developed less dynamically, because the recession in Russia was most noticeable in these countries.

Figure 1.11

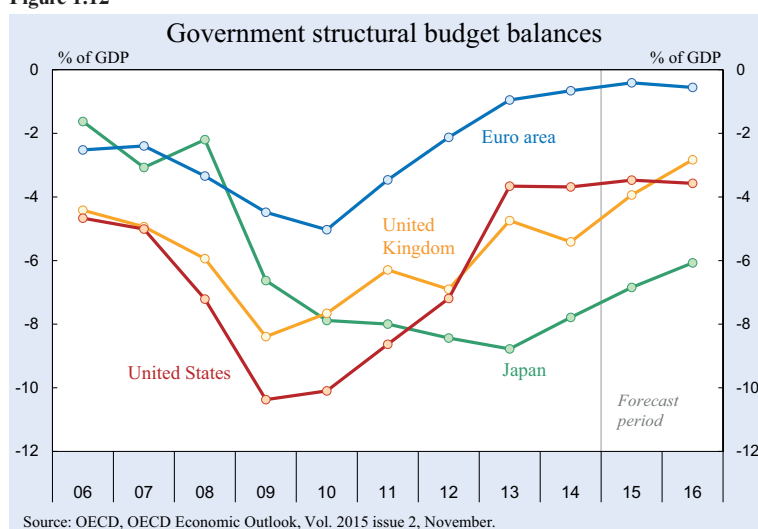


## 1.3 Fiscal and monetary policy

### 1.3.1 Fiscal policy

Compared to 2015, fiscal policy is likely to act more or less neutrally in most advanced economies in 2016 (see Figure 1.12). One clear exception is Japan. Here some large stimulus packages that were adopted in the years 2013 and 2014, as part of the “Abenomics” programme to boost economic growth and inflation, are being

Figure 1.12



phased out. In the United Kingdom, as measured by the change in the structural deficit, the fiscal stance also has been and will remain restrictive. The summer budget submitted to the lower house after the general elections assumes a continuation of fiscal consolidation and a surplus in the fiscal year 2019/2020. After the government budget deficit was 5.7 percent relative to GDP in 2014, it was reduced to 4.3 percent last year and is expected to decrease further this year to below the 3 percent threshold. Both cuts in social spending and a cap

Table 1.2

<b>Public finances</b>								
	Gross debt <sup>a)</sup>				Fiscal balance <sup>a)</sup>			
	1999– 2007	2008/ 2009	2010– 2014	2015	1999– 2007	2008/ 2009	2010– 2014	2015
Germany	62.3	68.8	78.3	71.4	-2.3	-1.7	-1.0	0.9
France	62.6	73.5	88.9	96.5	-2.5	-5.2	-4.9	-3.8
Italy	102.9	107.4	123.2	133.0	-2.9	-4.0	-3.3	-2.6
Spain	48.2	46.1	81.6	100.8	0.2	-7.7	-8.4	-4.7
Netherlands	49.0	55.5	64.6	68.6	-0.5	-2.6	-3.6	-2.1
Belgium	100.6	95.9	103.5	106.7	-0.5	-3.2	-3.6	-2.7
Austria	66.2	74.1	82.3	86.6	-2.2	-3.4	-2.6	-1.9
Finland	40.6	37.2	52.7	62.5	3.8	0.8	-2.3	-3.2
Greece	102.4	118.0	166.6	194.8	-5.3	-12.7	-9.3	-4.6
Portugal	59.6	77.6	118.6	128.2	-4.3	-6.8	-7.2	-3.0
Ireland	30.9	52.1	108.8	99.8	1.6	-10.4	-12.5	-2.2
Slovakia	40.5	32.1	48.8	52.7	-5.2	-5.1	-4.2	-2.7
Slovenia	25.7	28.1	58.0	84.2	-2.2	-3.6	-7.3	-2.9
Luxembourg	6.7	14.9	21.4	22.3	2.5	1.4	0.4	0.0
Lithuania	20.1	21.8	38.5	42.9	-1.7	-6.1	-4.5	-1.0
Latvia	12.2	27.7	42.3	38.3	-1.7	-6.6	-3.0	-1.5
Cyprus	59.1	49.5	82.4	106.7	-2.4	-2.3	-6.0	-0.7
Estonia	5.0	5.8	8.5	10.0	0.9	-2.4	0.3	0.2
Malta	65.5	65.3	68.6	65.9	-5.0	-3.7	-2.8	-1.7
<b>Euro area</b>	<b>69.0</b>	<b>75.0</b>	<b>89.8</b>	<b>94.6</b>	<b>-1.9</b>	<b>-4.2</b>	<b>-3.9</b>	<b>-2.2</b>
United Kingdom	39.7	58.7	83.6	88.3	-1.8	-7.9	-7.4	-4.3
Sweden	48.9	38.6	39.3	44.7	1.1	0.6	-0.8	-1.4
Denmark	43.6	36.9	45.0	40.2	2.3	0.2	-1.6	-3.3
Poland	42.7	48.2	53.6	51.4	-3.9	-5.5	-4.7	-2.8
Czech Republic	24.6	31.4	42.1	41.0	-3.7	-3.8	-2.9	-1.9
Romania	19.5	18.2	35.9	39.4	-2.6	-7.3	-3.8	-1.2
Hungary	58.7	74.8	78.5	75.8	-6.3	-4.1	-3.5	-2.3
Croatia <sup>b)</sup>	29.5	43.4	71.2	89.2	-2.7	-4.2	-6.0	-4.9
Bulgaria	45.1	13.3	18.7	31.8	0.5	-1.2	-2.5	-2.8
<b>European Union</b>	<b>61.8</b>	<b>67.6</b>	<b>84.2</b>	<b>87.8</b>	<b>-1.7</b>	<b>-4.6</b>	<b>-4.3</b>	<b>-2.4</b>
United States <sup>b)</sup>	47.2	79.4	101.2	104.9	-2.4	-9.9	-7.4	-3.8
Japan	167.0	201.0	234.2	245.9	-5.9	-7.3	-8.7	-5.9
Switzerland	60.6	48.3	47.6	46.2	0.1	1.1	0.1	-0.2

<sup>a)</sup> As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF. – <sup>b)</sup> Data on Croatia and the United States are only available from 2001 onwards.

Sources: European Commission, Autumn 2015; IMF World Economic Outlook, October 2015.

on wage growth for civil servants are in the pipeline. At the same time, via a reduction in corporate taxes an increase in international competitiveness of UK firms is to be achieved.

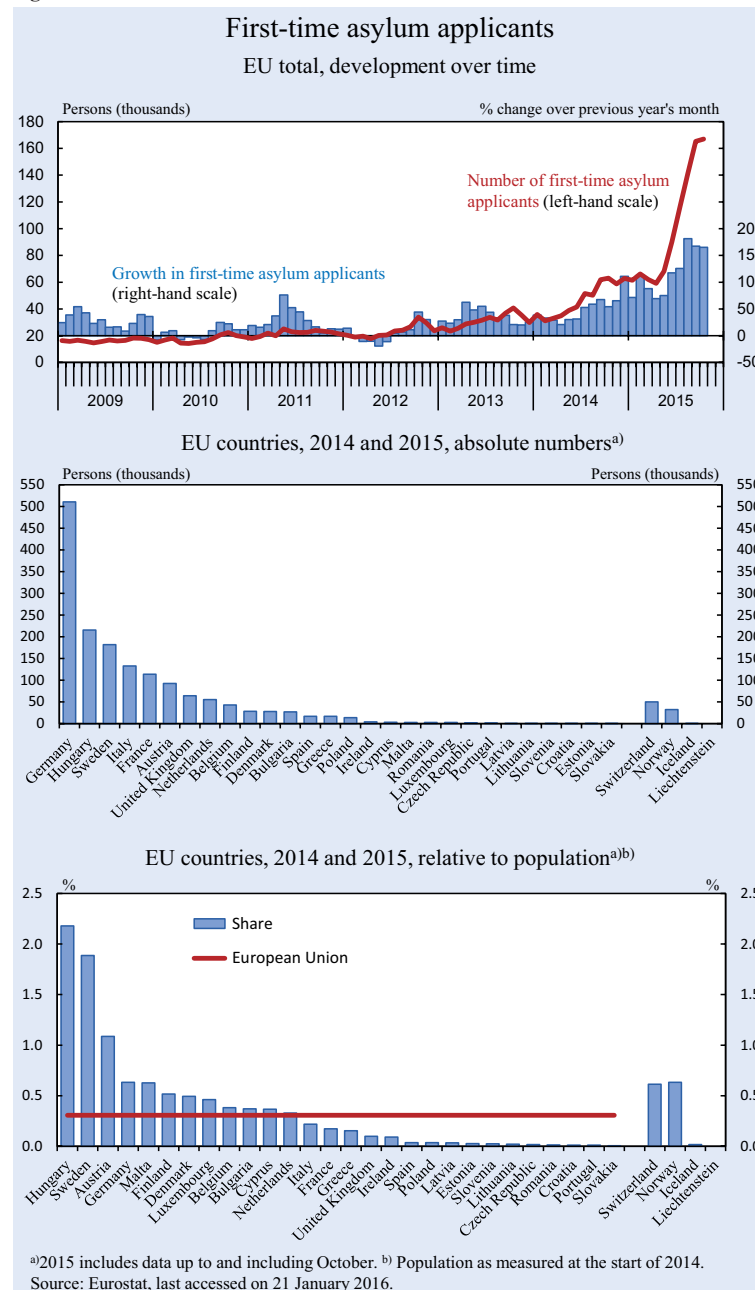
In the United States, a balancing act has enabled fiscal policy to support GDP growth on the one hand, while reducing the government budget deficit relative to GDP on the other. After the deficit surpassed 13 percent of GDP in 2010, its highest level since the second World War, it decreased continuously in the following years and is expected to have been 3.8 percent in 2015 (see Table 1.2). Additional spending on health care was offset by higher tax revenues and lower interest expenditure on government debt. Total government gross debt amounted to approximately 105 percent of GDP by the end of last year. After the debt ceiling for the federal level was reached in October Congress passed its repeal until March 2017. Political budgetary crises are therefore not to be expected this year.

In the emerging economies, fiscal policy is likely to be characterised by even greater heterogeneity than in previous years. In India and China public investment programmes will support the economy. Government spending programmes have also been launched in Russia that are intended to mitigate the recession. Furthermore, the Russian government finances its budget deficit via a reserve fund accumulated during times of high oil prices and which will run out in 2017, according to official projections. In Brazil, on the other hand, fiscal policy turned noticeably restrictive as early as last year. Cutbacks in social spending and subsidies, as well as various tax increases and the increase of many administered prices, have recently been adopted in Brazil. This year fiscal policy is projected to become gradually less restrictive, especially in the wake of the resignation of the pro-austerity finance minister in

December 2015 and his replacement by a less hawkish individual.

The geo-political consequences of the crises in the border regions of the European Union are becoming increasingly visible and are having an impact on the public finance situation in Europe. Not only is the fear of further terrorist attacks having direct consequences on state finance but also – and to an even greater degree – the strong inflow of refugees. The number of first-time applications for asylum has quadrupled within less than one and a half years (see Figure 1.13).

Figure 1.13



In the short run the increase in the inflow of refugees will trigger additional government spending, and will thereby stimulate internal demand. Additional funding has also been made available at EU and national levels to support countries of origin and transit. Several governments of member countries cited the additional inflow as a reason for exceeding fiscal targets as early as 2015. As early as last autumn Germany projected an additional 0.5 percent of GDP per annum of public spending in 2016 to meet the initial needs of the newly arrived immigrants and to integrate them into the labour market. Similar figures for Austria and Sweden are 0.3 and 0.9 percent of GDP, respectively. Estimates suggest that these near-term stimulus effects will amount to 0.1 or 0.2 percentage points of GDP growth for the European Union (see, e.g. OECD, 2015). Countries, however, are being hit quite differently. Whereas Germany is the country that has taken in by far the largest share of refugees, relatively to country size Hungary, Sweden, Austria and Malta have also seen a relatively strong surge in the number of first-time asylum applicants.

Over time the new migrants will enter the labour market and, depending on their skills, will start contributing to the welfare state. Over a horizon of a few years, the net contribution of these migrants is therefore unclear. However, the qualification structure of the refugees appears to be less than average. This is bound to reduce average wage income, and therefore average tax and social security contributions. This is further aggravated by a lower forecast of their labour force participation rate, especially among women. In the longer run, the extent to which refugees will be able to contribute to the sustainability of the welfare state will depend on many factors, including their ease of access to the labour market.

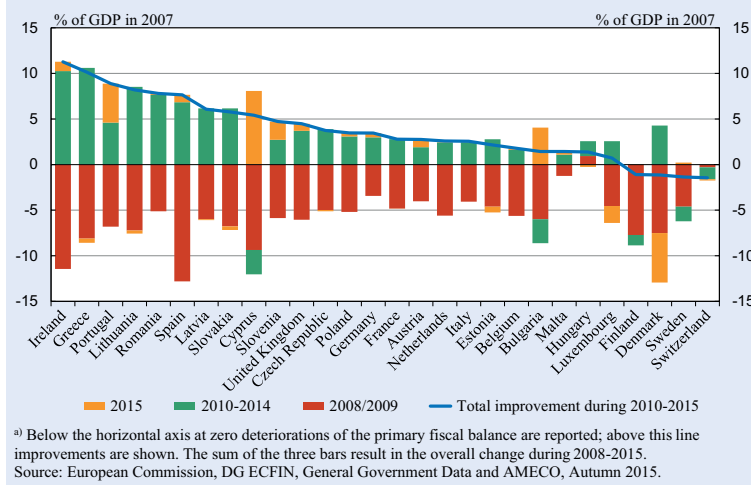
Europe's moderate recovery has allowed most member states to slowly reduce their public deficits. For the euro area the aggregate public deficit as a percentage of GDP has decreased by about 0.4 percentage points when comparing last year with 2014. For the European Union the same figure amounts to 0.6 percentage points. Comparing longer time horizons shows stronger declines. The number of countries that are still in the Excessive Deficit Procedure has been reduced to 9 at present, after 11 in early 2015 and 16 at the start of 2014. Two of these countries, namely Cyprus and Greece, are also following an economic adjustment programme.

The sharp fall in government bond yields in previous years has made it somewhat easier for governments to meet budget targets insofar as it has lowered refinancing costs. While the overall public deficit, for instance, continued to decline last year and is expected to continue to fall slowly, the primary balance, on the other hand, is expected to deteriorate slightly. The additional room to manoeuvre created by smaller interest rate payments is used to a fairly large extent to finance the additional costs associated with the increased inflow of refugees. However, unexpected drops in inflation can also make it harder for governments to meet their budgetary objectives, as revenues and expenditure are affected differently. Primary expenditure in general reacts less strongly to a change in inflation than revenues. Whereas, for instance, tax revenues are directly affected by the changing price level, most public spending is on service-related items that generally do witness relative price increases during phases of falling inflation rates, especially when these are unexpected.

Overall, however, the effects of lower inflation, through its impact on nominal interest rates, are probably having a positive effect on the public finance situation. Those countries with a larger debt burden are likely to benefit more from the lower interest rates than they stand to lose through the differing impact of lower inflation on revenues and expenditure. However, these very countries also face the highest risk should interest rates start to normalise again. These countries in particular need to increase their efforts in order to secure the sustainability of their public finances. The new interpretation of the Stability and Growth pact, as published early 2015 by the European Commission, is giving member states of the euro area somewhat more fiscal room to manoeuvre, thereby creating an environment favourable for more myopic governments.

Consolidation efforts varied across member states in 2015. The fiscal effort in 2015, as measured by the change in the primary balance, points to still a larger group of countries consolidating rather than loosening (see Figure 1.14). Consolidation ranged from over 4 percentage points of GDP in Cyprus, Portugal and Bulgaria to a loosening of over 1 percentage point in Denmark and Luxembourg. Of the remaining member states, most only saw small changes of below 0.5 percentage points in either direction. The aggregate improvement in the primary balance is largely due to the improved economic situation. From a structural point of view, hardly any improvement was noticeable for 2015, nor is any expected for this year.

**Figure 1.14**  
Changes in the primary fiscal balances relative to pre-crisis GDP<sup>a)</sup>



**1.3.2 Monetary conditions and financial markets**

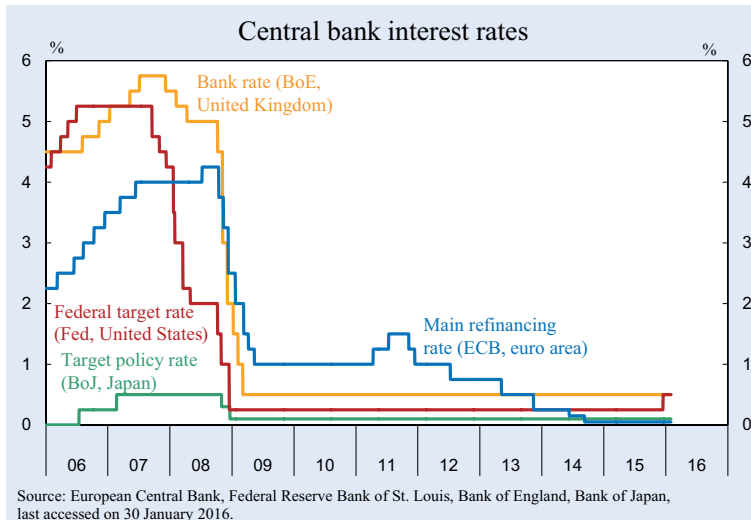
**Monetary conditions**

Although monetary policy in the major advanced economies remains accommodative, the degree of expansion continues to diverge. Whereas central banks in the United Kingdom and the United States stopped their programmes to buy securities as early as in mid-2012 and October 2014, respectively, the European Central Bank (ECB), in view of Europe’s far more moderate economic momentum and excessively low inflation, initiated a bond-buying programme in March 2015 that was extended in December last year to last until March 2017 at the very least. The Bank of Japan also continued its massive quantitative easing programme in 2015. These latter two central banks have signalled their willingness to leave their key inter-

est rates at their current level near zero until at least 2017. After several postponements, the US Federal Reserve increased its main policy rates by 25 basis points in December 2015 (see Figure 1.15). The Bank of England is expected to start increasing its interest rates early this year. As compared to the euro area, labour market conditions in both the United Kingdom and the United States are such that these turnarounds in monetary policy are clearly warranted, if not overdue. Nevertheless, it will still take a number of (further) interest rate hikes before the monetary policy stance in these countries can no longer be considered as expansionary.

The monetary policy stance also started to diverge in the emerging markets last year. The central banks of many Asian countries (China, India, Thailand, and South Korea) took advantage of the leeway afforded by moderate inflation dynamics to initiate interest rate cuts. In China in particular monetary policy was relaxed quite strongly during the year. The key rate was lowered in five steps by a total of 125 basis points from 5.6 percent in February 2015 to 4.35 percent in October 2015. At the same time, the minimum reserve requirements of commercial banks were reduced sharply in three steps by a total of 2.0 percentage points, releasing large amounts of extra cash for the Chinese financial system. In addition, the central bank extended the bandwidth within which it tolerates exchange rate fluctuations and allowed a depreciation of the yuan by about 5.5 percent against the US dollar in 2015.

**Figure 1.15**



In Brazil, on the other hand, monetary policy was tightened significantly in order to counteract strong downward pressure on the domestic currency and the associated increase in inflation. The key policy rate was increased in several steps by 325 basis points from October 2014 to 14.25 percent in July 2015. Besides fighting



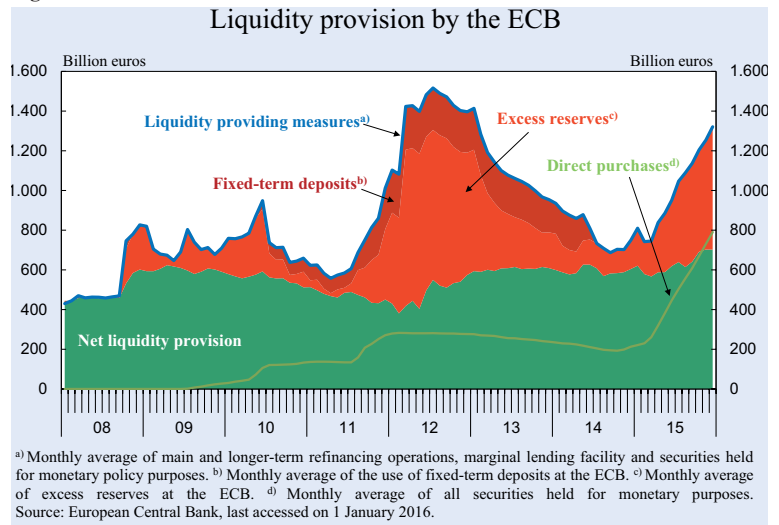
inflation, the Brazilian central bank is also trying to reduce the increase in the real value of foreign debt – predominantly denominated in US dollars – that constitutes an additional burden on the private and public sector. In the light of the interest rate decision by the Federal Reserve, the central banks in Mexico and Chile also increased their main policy rates in December 2015. In the case of Chile, the increase followed of an earlier hike in October.

In Russia, the relevant benchmark interest rate declined from 17 percent in early 2015 to 11 percent as of August. Given an inflation rate that is still close to 16 percent, monetary policy can therefore no longer be considered restrictive. After a recovery in spring, the rouble again faced strong downward pressure during the rest of the year. In addition to the economic burdens caused by low raw material prices, this was also due to the political rift between Russia and the West that prompted international investors to massively withdraw capital from Russia.

Monetary policy in the euro area is geared towards being persistently expansive. The ECB deems the overall inflation rate to be too low and fears a permanent deviation of inflation expectations from its medium-term target of close to, but below 2 percent. In addition, the ECB aims to revitalise lending and bring about a better utilisation of production capacity by increasing aggregate demand. It therefore decided early on in 2015 to have the euro system acquire government bonds, covered bonds and asset-backed securities for a total of around EUR 60 billion per month as part of its purchasing programme starting March 2015 (see Figure 1.16). At its meeting in December 2015, the Governing Council decided to extend these purchases by another six months, i.e. until at least March 2017, and thereby intends to increase the total assets of the euro system by about 1.5 trillion euros. In addition, the deposit interest rate that banks have to pay on their deposits and excess reserves at the ECB was reduced from –0.2 to –0.3 percent.

The adequacy of the additional expansionary measures adopted by the ECB in December 2015 can be questioned. Although price pressures in the euro area

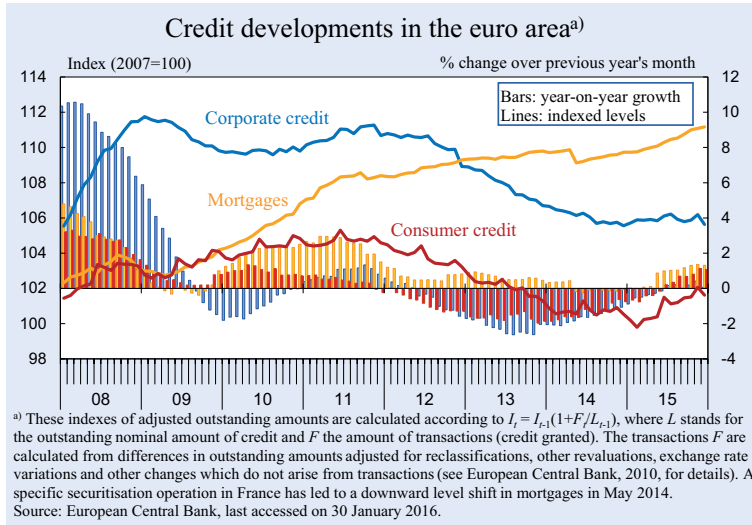
Figure 1.16



were, with an overall inflation rate of only 0.2 percent in November, extremely low, this was mainly due to the sharp fall in oil prices in mid-2015. The core inflation rate on the other hand has, after reaching its trough with 0.6 percent in January last year, slowly but steadily increased, reaching 0.9 percent in December. The still negative output gap is slowly going to be reduced further throughout the year, and the effects of lower commodity prices are likely to gradually phase out. The bank lending survey also conducted by the ECB at a quarterly frequency has already revealed for some time now that the borrowing conditions for households and businesses are continuing to ease, and that demand for loans is rising. The ECB's asset purchase programme, as well as its targeted longer-term refinancing operations (TLTROs), which are still running, were already supporting bank lending before the decision in December. Accordingly, core and total inflation could also have been expected to increase without additional monetary policy measures and would have reached a level that is compatible with the medium-term inflation objective of the ECB by the end of 2017.

On the other hand, however, a substantial share of professional forecasters still attach a historically high probability to a low inflation, or even deflationary scenario for the euro area. Furthermore, although mortgage loans have been steadily increasing for years now and consumer credit growth also seemed to have return to positive dynamics last year, looking at the hard data, loans to the corporate sector have merely been able to stabilise (see Figure 1.17). Hence, the improved situation in the banking sector and the further decline in lending rates have been insufficient to substantially

Figure 1.17



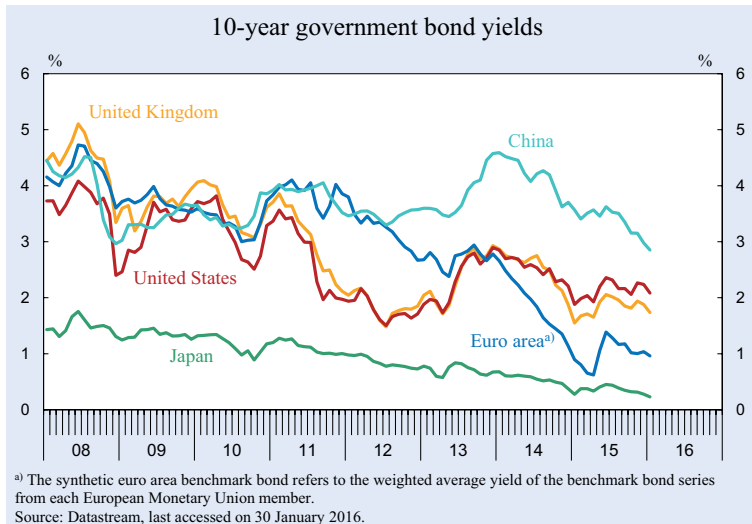
uplift credit aggregates to date. While the volume of outstanding loans increased only slightly in the euro area during 2015, those in the former crisis countries continued to fall.

**Bonds, stocks and foreign exchange markets**

After reaching troughs early last year, yields on bond markets in most advanced economies remain at historically low levels. The weaker than expected recovery during summer 2015 has, at least initially, brought the upward trend that had set early in the same year to a halt (see Figure 1.18).

In the euro area, the interest rates on government bonds with the highest credit rating (AAA) fluctuated between 0.2 and 1.1 percent during the year. With the

Figure 1.18



exception of Greece, the government bond yields and creditworthiness of weaker member states (Ireland, Italy, Portugal and Spain) showed no clear trend over the year. Their risk premium to AAA borrowers was about 1.1 percentage points on average. For Greece, the situation was different. The election results of January 2015 and the associated change in government led to a strong increase in uncertainty regarding its bailout programme and the continuation of Greece as a member of the euro area. Tensions escalated in June when

the Greek government unilaterally broke off negotiations and called for a national referendum to approve or reject the achieved preliminary negotiation results. The Greek stock market closed and access to bank accounts was limited. Early in July, a clear majority of Greek citizens voted to reject the bailout terms making a Greek exit from the euro more likely than ever before. This was prevented mid-July by reaching a provisional agreement on a third bailout programme to save Greece from bankruptcy. All this was reflected in a strong increase in the risk premium on Greek government bonds until July last year; although it did not, however, reach the levels seen in 2012, or cause any clear contagion of the yields on bonds issued by other crisis countries (see Figure 1.19).

During the course of 2015, the low funding costs of the banking sector also appear to have reached non-financial corporations in the crisis countries. In Italy, Portugal and Spain, the lending rates for non-financial corporations on new loans continued to fall during the year (see Figure 1.20). This suggests that the creditworthiness of many companies in those countries improved, and that the supply-side constraints caused by high inventories of impaired loans may have started to abate. Indeed, the economies in some former crisis countries staged major recoveries in 2015, increasing the profitability of local companies. According to several indica-

Figure 1.19

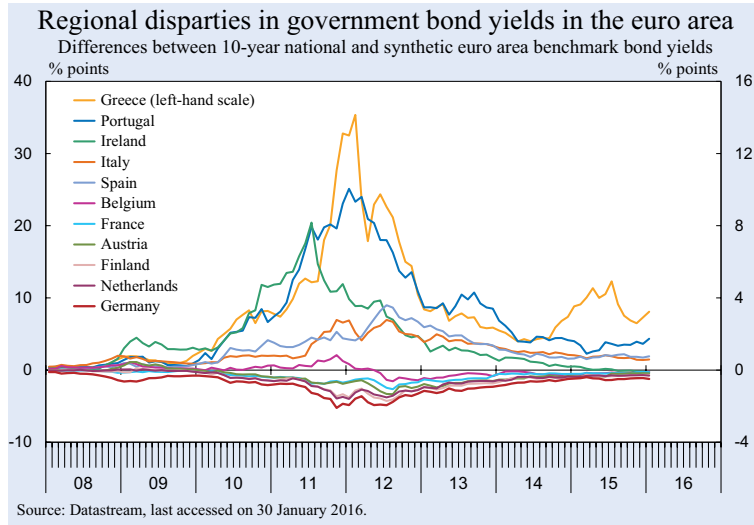


Figure 1.20

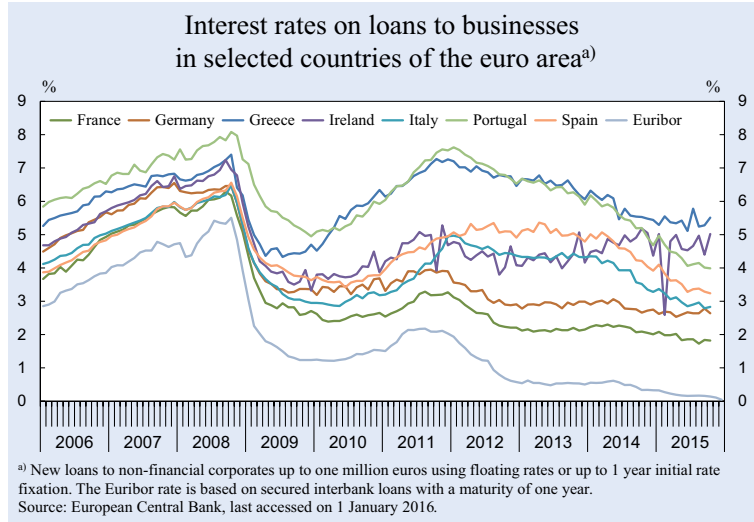
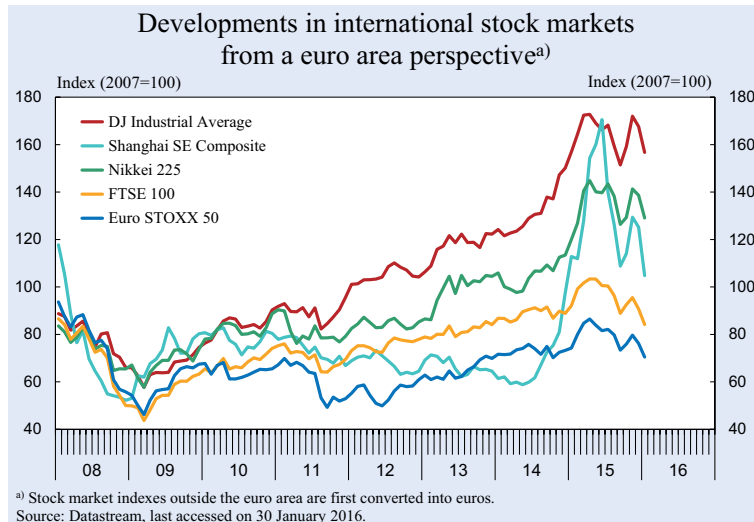


Figure 1.21



tors, the situation in the banking sector also improved. For example, in Ireland and Spain bank equity ratios were increased and the stock of loans at risk of default was reduced. From a monetary policy perspective, this implies that the disturbances in the monetary transmission mechanisms became significantly less pronounced over the year.

Given that the inflation rate is expected to gradually increase again, a moderate increase in government bond yields also appears likely this year. The ECB's bond-buying programmes will tend to limit the yield increases, since such programmes effectively reduce the supply of bonds available to the private sector.

Although monetary policy in the major advanced economies remained very expansionary last year, stock markets did not manage to benefit to the same extent as in 2014. On the contrary, most stock market indices experienced a bit of a roller coaster ride during 2015 and early this year. The Chinese stock market in particular saw markedly strong increases and falls stirring up financial markets all around the world. After having increased by a staggering 135 percent between May 2014 and June 2015 in local currency (or 190 percent measured in euros), the Shanghai Stock Exchange Composite fell by more than a third during the following three months and consequently started to increase until the end of the year to fall again in January. Over 2015, it nevertheless still gained 18.5 percent when measured in local currency. For the Nikkei 225 and the Euro STOXX 50, the increases were a mere 9.3 and 4.0 percent, respec-

tively. The Dow Jones industrial average and the FTSE 100 actually lost some ground and decreased by - 1.2 and - 5.8 percent, respectively. Given the appreciation of the US dollar and the British pound relative to the euro, some gains can still be reported from a euro area perspective in 2015 (see Figure 1.21).

Most stock market indices within the euro area are still well below the levels reached before the start of the financial crisis. By January the Athex (Greece) had returned to its low reached in June 2012, roughly 90 percent below the average value seen in 2007 and over 30 percent below its value at the end of 2014 (see Figure 1.22). The IBEX 35 (Spain) also lost ground during 2015 and fell by 6.4 percent. Although largely nullified this January the other major stock market indices for the crisis economies and the large euro area countries mostly increased by almost 10 percent in 2015. The ISEQ (Ireland) once again outperformed the others and gained approximately 30 percent in 2015.

All in all, financing conditions for the private sector should remain favourable this year. The degree of expansion of monetary policy is expected to remain high and corporate bond and lending rates low. The situation in the banking sector is likely to continue to improve and demand for corporate credit should moderately improve.

The divergence in monetary policy brought about significant changes in exchange rates last year. Whereas the euro and the Japanese yen continued to lose value when

Figure 1.22

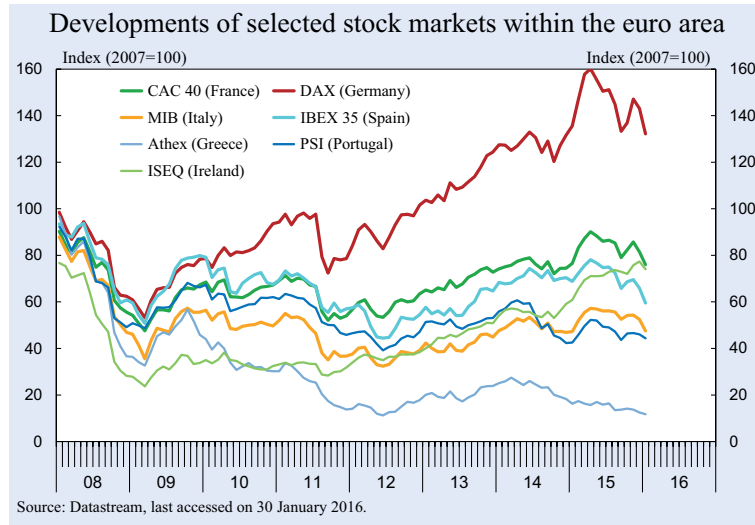


Figure 1.23

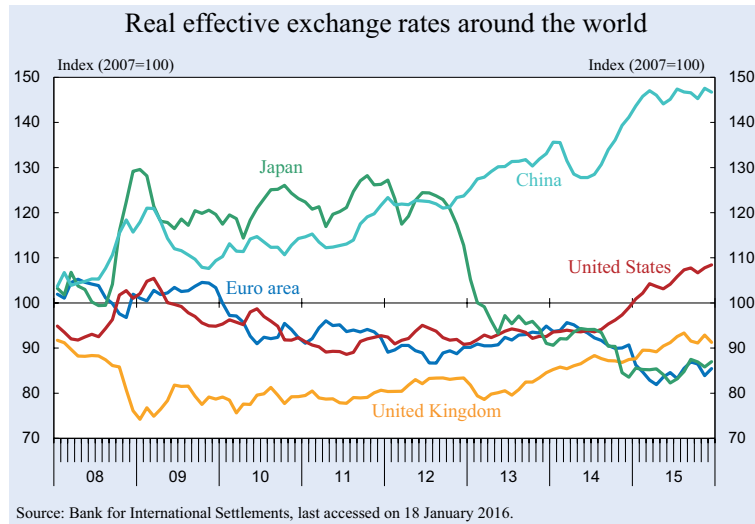
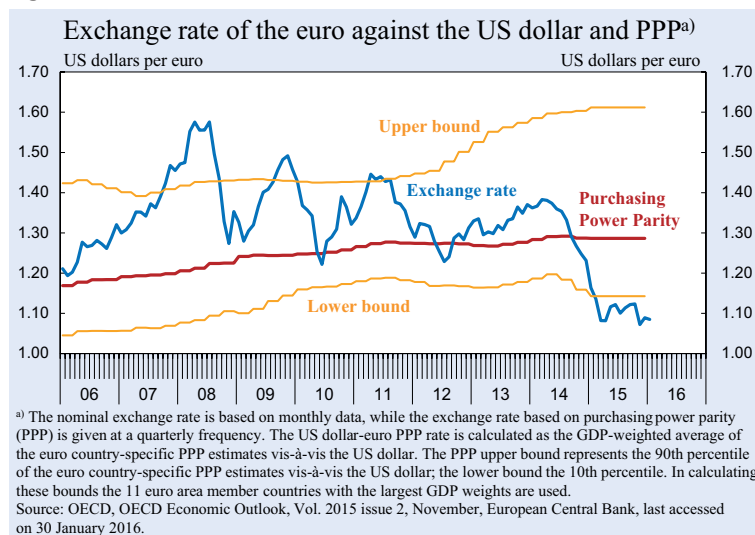


Figure 1.24



<sup>3)</sup> The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used. Source: OECD, OECD Economic Outlook, Vol. 2015 issue 2, November, European Central Bank, last accessed on 30 January 2016.

comparing 2015 with 2014, the US dollar and the British pound experienced a strong upward trend (see Figure 1.23).

As of mid-October 2015, the euro again depreciated considerably compared to the US dollar (see Figure 1.24). This was primarily due to the impression of financial market participants that the ECB would continue to increase its expansion plans as of the beginning of 2016. As the ECB has often managed to surprise markets on the upside in recent years, i.e. by boosting the expansionary stance of monetary policy more strongly than expected, market expectations were very upbeat regarding the Governing Council decisions of last December. In a sense, markets expected to be positively surprised again. Although monetary policy became clearly more expansionary thanks to the decisions taken in December, no real surprises were conveyed, which was interpreted as a negative surprise by many financial market participants, allowing the euro to recoup some of its losses during the last weeks of 2015.

#### 1.4 The macroeconomic outlook

##### 1.4.1 Assumptions, risks and uncertainties

The present forecast is based on the assumption that oil and energy prices will roughly remain at the levels seen early this year, which are substantially lower than those seen on average during 2015. Exchange rates are also assumed to remain fairly stable throughout the year and the status quo situation regarding world politics is maintained throughout the forecast.

Of course, these assumptions all entail risks for our outlook, and, as has become usual, these risks are tilted to the downside. A key risk for the global economy this year is founded on the political tensions in the Middle East and the unclear development of this conflict. Although the most recent attacks committed by one of these parties in Paris did not make a significant short-term economic impact (see Box 1.1), the resulting political reactions in France and other nations, however, do show how explosive the geopolitical situation in the Middle East is. A further escalation of the conflicts in that region could unsettle consumers, producers and investors around the world and thereby dampen worldwide economic activity considerably. Further terrorist attacks in Europe unfortunately cannot be ruled out ei-

ther. Besides all kinds of obvious social problems, such a scenario could lead to a surge in oil prices because many of the countries in the Middle East are still among the main suppliers of this raw material and might further increase the number of refugees entering Europe.

Risks also arise from the expected gradual tightening of monetary policy in the United States. Now that the Federal Reserve has made its first interest rate increase since June 2006 and is likely to continue increasing rates at a slow pace, the relative attractiveness of the United States for financial capital is increasing. This might attract portfolio shifts out of other regions. In extreme cases, this could again lead to substantial capital outflows from emerging markets, which could trigger strong financial turmoil or even exchange rate crises. This could particularly strongly affect those countries that have a relatively high foreign debt denominated in US dollars (like Brazil, Indonesia and Turkey). For commodity-exporting emerging economies such as Russia and many Latin American countries that have already been struggling with the negative effects of lower commodity prices, the problems could also spark crises if exacerbated.

The referendum on the United Kingdom's membership of the European Union is scheduled to take place before the end of 2017. It is already creating uncertainty, especially in the United Kingdom, but also in Europe; as a potential Brexit constitutes a major risk regarding future political and economic developments in Europe.

The adopted extension of the securities purchase programme by the ECB carries risks for economic development, and not only in the euro area. This provision of cheap money could create asset price bubbles, which, if they burst, could lead to painful upheavals in the financial markets inside and outside Europe. In addition, the ECB's government bond-buying programme generates disincentives for fiscal policy to limit deficits. A number of European governments, including those of Spain and Italy, are already able to emit bonds with negative interest rates. The resulting fiscal buffers are, however, often not used to further reduce government deficits, or even to reduce debt. For political reasons, this fiscal leeway is often used to increase spending or cut taxes. While these measures leave the current overall deficit in relation to GDP roughly unchanged, they do increase long-term structural deficits and thus permanently affect the debt situation in the public sector negatively. They thereby re-

## Box 1.1

## The economic impact of terrorist attacks

Terrorist attacks involving deaths and injuries represent human tragedies. They can also influence the everyday behaviour of agents in the goods, services and financial markets. It is conceivable that terrorist attacks lead to a significant increase in uncertainty amongst these actors. This, in turn, could have a significant negative impact on economic development, as consumer spending and investment are often postponed in times of heightened uncertainty. In addition, the risk premiums on the capital markets may increase, creating poorer financing conditions for businesses and households.

Here, in a purely descriptive manner, we compare the impact of different terrorist attacks on a set of aggregate economic indicators to get a feel for the potential impact on the economy of the country hit. Specifically, we consider the terrorist attacks of September 11, 2001 in the United States, those on a Madrid train station on March 11, 2004, the explosions on public transport in London on July 7, 2005 and the series of assassinations in Paris on November 13, 2015.

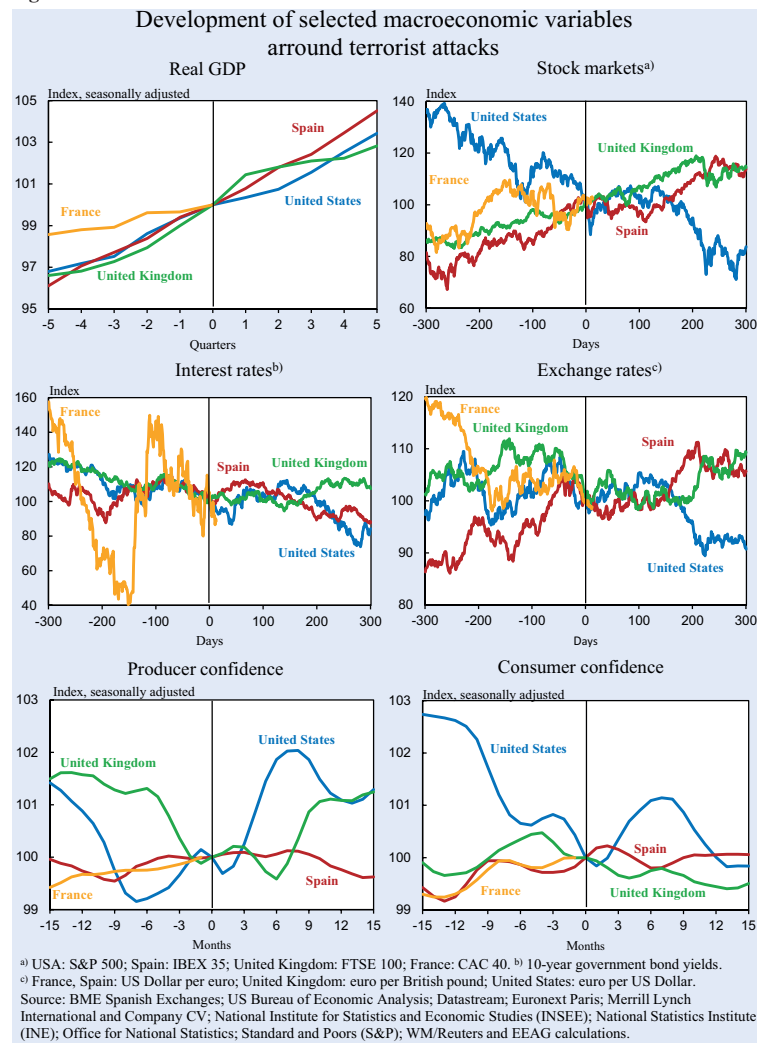
Figure 1.25 illustrates the development of key macroeconomic variables in a time window that extends over several months before and after each attack. Following the attacks on September 11, 2001, a Tuesday, the stock market opened again the following Monday. On this day, the S&P 500 fell by 4.9 percent. Exactly one month later, the index recovered and returned to its pre-attack level. Over a longer period of time, the downward trend was unbroken. On the day of the Madrid attack (March 11, 2004) the Spanish stock index lost 2.2 percent; within four weeks, however, the index regained its pre-attack level and continued its upward trend. The British index lost 1.4 percent before continuing its upward trend. On the Paris Stock Exchange, no significant effect was apparent after the attacks.

For capital market rates, qualitatively similar effects in the wake of the attacks can be observed in the four countries: while interest rates fell on the day of the attack, this neither altered their long-run trend nor led to a level shift. With the exception of the United States, some small depreciation in the local currencies was observed after the terrorist attacks, which was, however, corrected within a few days.

Similar qualitative effects were seen in consumer and producer confidence: as a result of the attacks neither a level shift nor a change in trend were observed. Although confidence in the short run declined more strongly in the United States, than in the other countries, it did return to its long-term course within a few months (see also Garner, 2002). In Spain and the United Kingdom, the confidence indicators continued their recent trend.

All in all, both financial market variables and confidence indicators showed only a slight reaction to the terrorist attacks. The observed effects are small and not exceptional in the context of their normal variation. In cases where effects are observed, these tend to be short-term. All indicators return to their historical trend after a relatively short period of time. Of course, this is merely a simple descriptive analysis in which it is notoriously difficult to really isolate the effects of the different attacks. As usual, many other changes occurred simultaneously for which no corrections were made in this analysis.

Figure 1.25



duce the future ability of many euro area countries to buffer adverse shocks through fiscal policy interventions and make them more vulnerable to the changing whims of international capital markets. The risk of new crises and a revival of the European debt crisis is growing with these measures.

#### 1.4.2 The global economy

Global economic expansion is expected to have continued this winter at a similar moderate pace as last summer. This was supported by the development of several coincident and leading indicators. Although these were mostly at above-average levels, the decline of the Ifo World Economic Climate during the second half of last year suggests that no acceleration of economic growth is to be expected these winter months (see Figure 1.26). During the first half of 2016, growth will increase again, partly because the positive effects of the fall in oil prices will materialise to a growing extent. The positive effect on the oil-importing countries through their higher willingness to spend is likely to be stronger than the economic burden falling on oil-exporting economies. Since these effects are due to expire slowly over the year, the global rate of expansion will subsequently subside somewhat.

Macroeconomic developments in the major advanced economies will also be shaped by nominal exchange rate movements. Whereas US export growth is bound to remain subdued due to the strengthening of the US dollar, the demand for goods and services from the euro area and Japan is, given the depreciation of the euro and the yen, likely to accelerate further. Nevertheless, the aggregate economic performance of the United States will improve more vigorously than that of the euro area and Japan respectively in 2016. Although the resulting costs associated with both reforms in the banking sector, as well as in labour and

product markets in many countries are gradually decreasing, economic development in the euro area continues to be weakened by a number of structural problems. Japan is also expected to expand only moderately this year. Although monetary policy is extremely expansionary, and the planned gradual commissioning of a number of nuclear power plants is likely to reduce the need for energy imports, restrictive fiscal policy as well as structural factors, such as a shrinking potential labour force and relatively low productivity growth, will prevent a stronger recovery.

Overall, the pace of expansion in emerging markets is unlikely to change significantly compared to last year. While Brazil and Russia will overcome their recessions in the course of the year, and the low oil price will pos-

Figure 1.26

#### World economic growth and the Ifo World Economic Climate

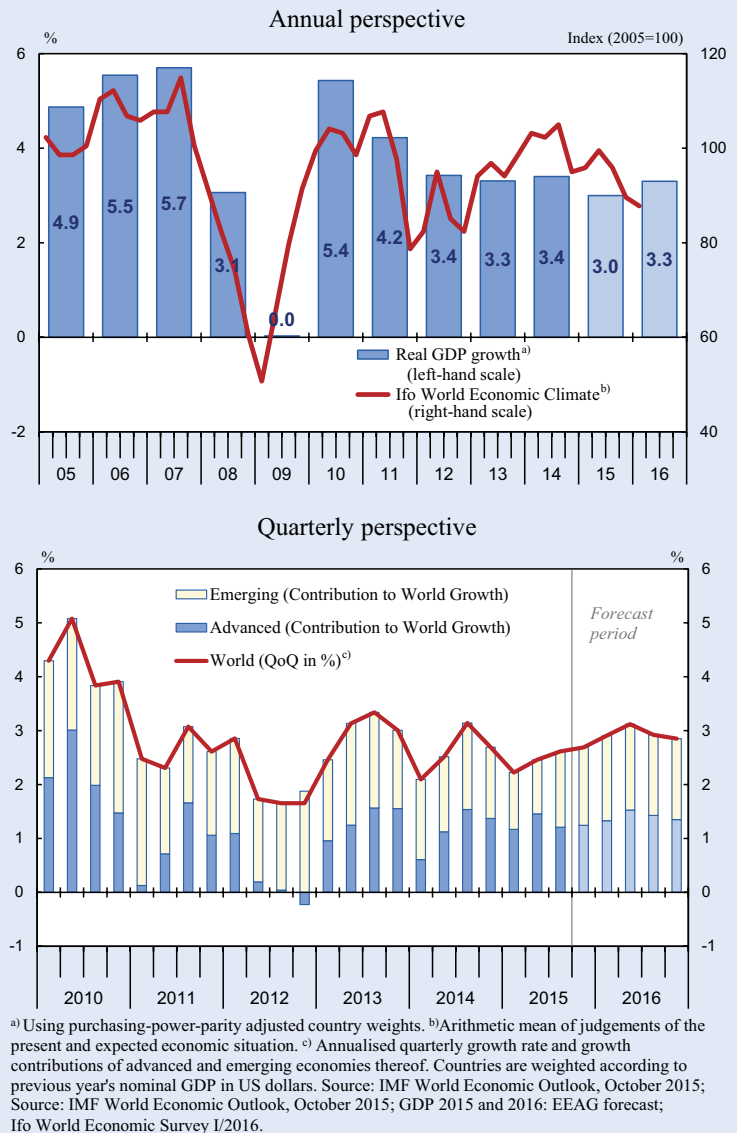
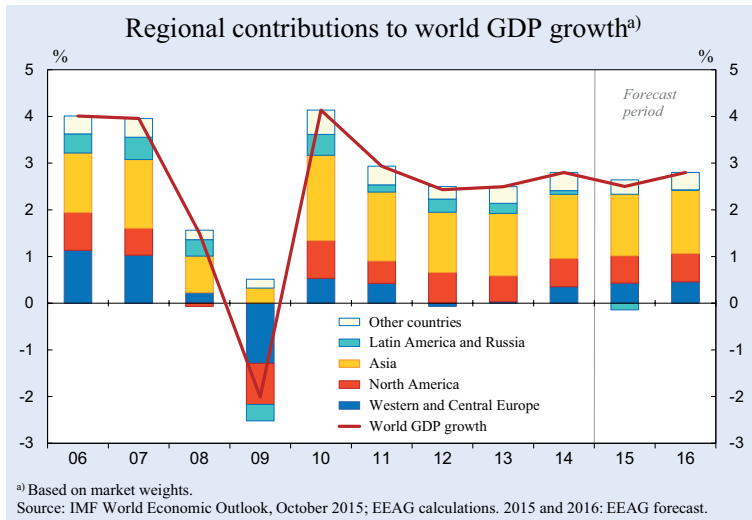


Figure 1.27



itively impact China, India and many other East Asian economies, this is likely to be offset by forces that are preventing a significant economic upturn. For instance, the structural slowdown of economic growth in China is likely to continue. Furthermore, slowly rising long-term interest rates, particularly in the United States, will deteriorate financing conditions for emerging markets. Nevertheless, the growth contribution made by emerging markets to world GDP will also outstrip that of advanced economies in 2016 (see Figure 1.27).

All in all, world GDP will pick up a little momentum in 2016 and is forecasted to grow at a rate of 3.3 percent, which is slightly higher than in previous years. World trade is expected to expand by 3.2 percent this year. The current account balances of most commodity-exporting emerging economies will deteriorate. Given the strong US dollar, exports are expected to expand significantly slower than imports in the United States. In the euro area and Japan, by contrast, the current account balance will improve.

**1.4.3 United States**

Not only have the expectations in the Ifo World Economic Survey for North America shown some volatility in recent quarters, but other indicators also paint a more mixed picture regarding this winter (see Figure 1.28). The Pur-

chasing Managers' Index (PMI) deteriorated in December for the sixth consecutive month in a row to 48.2 points. It thereby fell below the expansion threshold of 50 points for the first time in three years. In fact, industrial production in October decreased slightly compared to the previous month. New orders in manufacturing (excluding defence equipment) in October were also only 0.4 percent higher than a year before. The strong US dollar dampened signals coming from foreign trade. Furthermore, the United States is also not immune to the

recent economic slowdown in emerging markets. More importantly for the US economy, however, is the development of domestic demand. Although private consumption was weak during the autumn, the upturn in the United States will continue. Positive signs underpin private consumption; as reflected by increasing consumer confidence, it is supported by the increase in real disposable income and good labour market conditions. Overall, the available economic indicators suggest that the pace of economic growth will continue during the first half of this year.

In the current year, real GDP is expected to increase at a similar pace as last year, i.e. by 2.5 percent (see Figure 1.29), so the moderate upturn will continue. Since the dampening effects of the dollar appreciation will run out of steam and, as a result of increasing capacity utilisation, business investment will be able to expand more strongly again, economic devel-

Figure 1.28

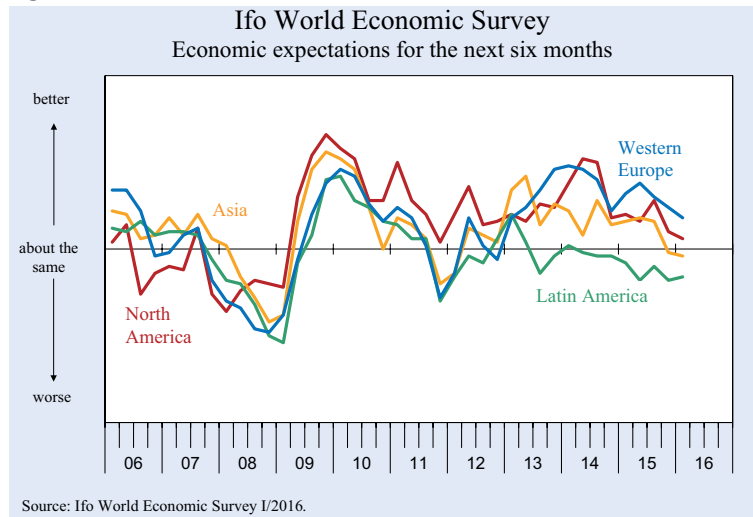
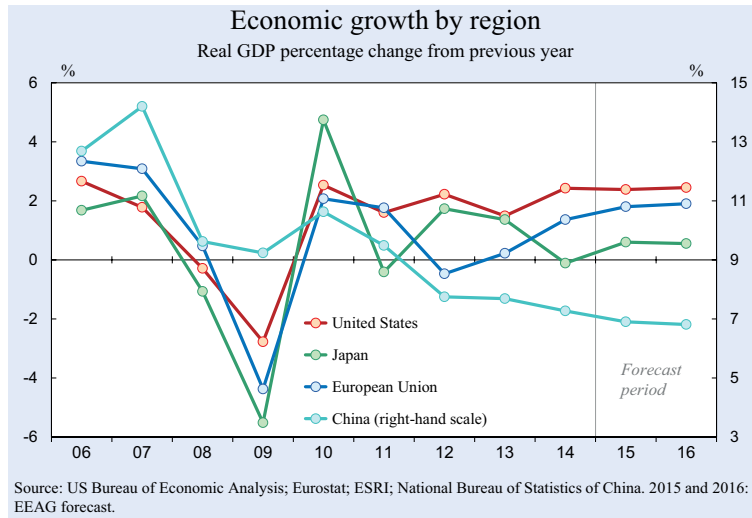




Figure 1.29



opment is expected to accelerate slightly during the summer of 2016. The unemployment rate has now fallen to what can be considered its long-run level. It will therefore only drop slightly to an average of 4.9 percent this year. As the effects of lower energy prices will abate wages will start rising somewhat faster; the inflation rate should increase to an average of 1.1 percent this year.

#### 1.4.4 Asia

This year, the central bank of *China* is likely to focus on limiting the build-up of debt in the corporate sector, without causing a noticeable economic slowdown. It will continue to limit lending in some targeted areas, while trying to reduce the current high costs of financing for smaller private companies.

Recent developments in industrial production and the purchasing managers' index suggest that aggregate output should expand at about the same pace in early 2016 as seen during the second half of 2015. The fall in energy and commodity prices also supports economic activity; but this effect is likely to fade gradually. Positive impulses are currently generated by fiscal policy. Additional investment in the rail network, as well as in environmental protection projects, will stimulate production this year. Should the development in housing and equipment investment unexpectedly deteriorate sharply, then it is highly likely that fiscal policy will provide additional impetus with further infrastructure projects. The turbulence in the stock market will barely slow down private consumption, and will thus have a marginal

impact at most on aggregate demand. The shrinking labour force due to demographics is likely to have a negative effect on the growth trend. The transition towards a more service-oriented economy will also continue. This implies a further slowdown in the growth rates of industrial production combined with accelerating momentum in the service sector. Overall, real GDP is expected to rise by 6.8 percent this year.

The low unemployment rate in *Japan* will lead to some upward pressure on nominal wages. Although an increasing share of the labour force has temporary contracts as opposed to permanent ones, which is constraining wage pressure somewhat, the labour market conditions do suggest that wages will rise slightly faster this year than in 2015. Despite the upward pressure that this implies for inflation dynamics, it cannot be ruled out that the Bank of Japan will loosen monetary policy further.

At the same time, fiscal policy remains restrictive against a backdrop of high public debt. Although a multi-stage reduction of corporate taxes has been implemented to promote the willingness to invest, this is more than compensated for by strong cuts in government spending. The biggest cuts are expected to be in public investments. These will steadily decrease from about 5 percent in relation to GDP in 2014 to about 3 percent in 2017. The decisive factor is the phasing out of large stimulus packages, which were adopted as part of the "Abenomics" programme to stimulate overall production and support lower income households. In addition, the VAT rate is to be increased from 8 to 10 percent again in April 2017, which will already lead to some anticipatory effects this year.

This year the Japanese economy will pick up slightly. The rising income of households is likely to fuel private consumption. In addition, companies will expand their investment given their high capacity utilisation levels. This is favoured by the reduction in corporate tax rates and record high profits. The gradual acceleration of economic growth in the East Asian emerging economies and the low external value of the Yen is ex-

pected to support demand for Japanese products and stimulate exports slightly. Structural factors, like a shrinking population, very rigid labour market conditions with lifelong employment guarantees, and over-regulation in many product and service markets, will hold back the increase in production. Overall, total economic output is expected to rise by around 0.6 percent this year. Inflation is expected to rise steadily to an average of 1.0 percent this year.

In *India*, recent developments in new orders in the manufacturing sector, industrial production and exports do not indicate a further acceleration of economic growth in the months ahead. During the rest of the year production is likely to expand at a slightly increasing pace due to firming domestic demand. Nevertheless, the stimulating effects of lower oil prices will gradually be phased out in the course of the year. In addition, owing to the large number of bad loans and the high level of indebtedness of many companies, investment growth will slow down. On the other hand, fiscal policy is still giving out positive impulses. The drop in oil prices has made it possible for the government to raise energy taxes and reduce different subsidies, such as those on fuel. However, substantial investments to improve the transport and energy infrastructure have been announced and do more than compensate for this. In addition, there are plans to reduce corporate taxes over the next four years from 30 to 25 percent in order to encourage private investment. All in all, real GDP will grow by 7.5 percent this year.

The outlook for the remaining East Asian economies (*Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore* and *Hong Kong*) is more optimistic compared to last year. In many places, domestic demand is expected to increase faster. Private consumption and investment is thereby going to benefit from an improved financial situation among households and businesses in the Asian Tiger economies (South Korea, Taiwan, Hong Kong and Singapore). In South Korea, the expansionary fiscal policy will support the economic situation. The government of Indonesia, which still has enough fiscal space to manoeuvre, plans to increase public spending. Moreover, exports will, especially in light of the expected slight acceleration of the world economy and the significant depreciation of the exchange rates of emerging economies, expand at a rapid pace. All in all, real GDP is expected to grow by 4.0 percent in these East Asian countries this year.

#### 1.4.5 Latin America and Russia

Over the course of the year, the *Latin-American region* will move out of recession. Whereas the recession is likely to continue in Brazil and Venezuela, the other countries of the region will manage to more than compensate for this. Indeed, the recession in Brazil will lose its sting during the year, but the return to positive annual growth is not expected until 2017. In Mexico, Colombia and Chile, by contrast, the robust labour market and growing consumer confidence presently point to strong domestic growth throughout the year. In addition, Mexico is likely to benefit from the positive economic outlook of its main trading partner, the United States. Overall, the region's real GDP will with a growth rate of – 0.1 percent basically stagnate this year.

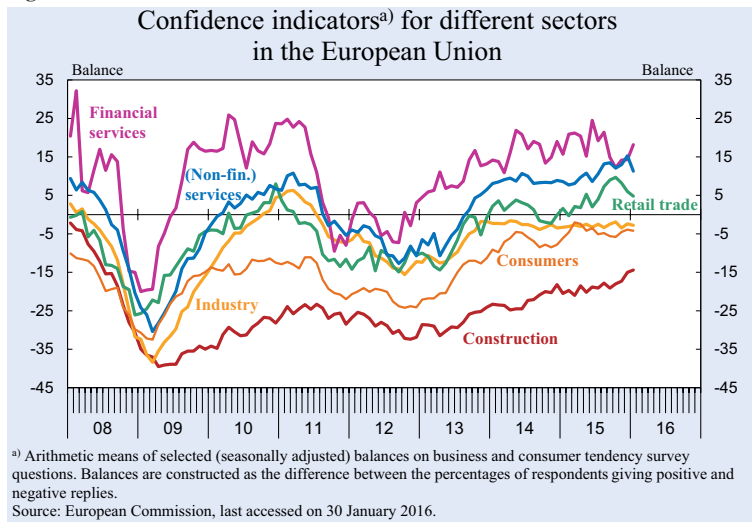
In *Russia*, business confidence stabilised at a low level. Even if the recession ended this winter, a quick recovery is not to be expected. Rising unemployment, falling real incomes and high inflation rates (of currently around 15 percent) have led to substantial losses in purchasing power. Although the key monetary policy rate, the CBR key rate, was gradually reduced from 17 percent at the end of 2014 by 6 percentage points during the first half of 2015, the cost of debt financing remains high. In addition, Russian banks still have very limited opportunities to refinance on international capital markets. Given the high inflation rate and poor financing conditions, private consumption and investment are hardly going to support growth. Positive impulses continue to result from the enforced import substitution programme that is funded through the State Reserve Fund and the National Prosperity Fund (the volume of both funds totals approximately 150 billion US dollars, and 12 percent of GDP). Through the weak ruble, foreign trade is expected to contribute positively to GDP growth. Overall the slight upward trend nevertheless results in a negative growth rate of – 0.2 percent for this year. However, much will depend on the evolution of commodity prices and the geopolitical situation. The downside risks therefore remain high.

#### 1.4.6 The European economy

##### The cyclical situation

Recent business and consumer tendency surveys indicate that real GDP in Europe is expected to increase at

Figure 1.30



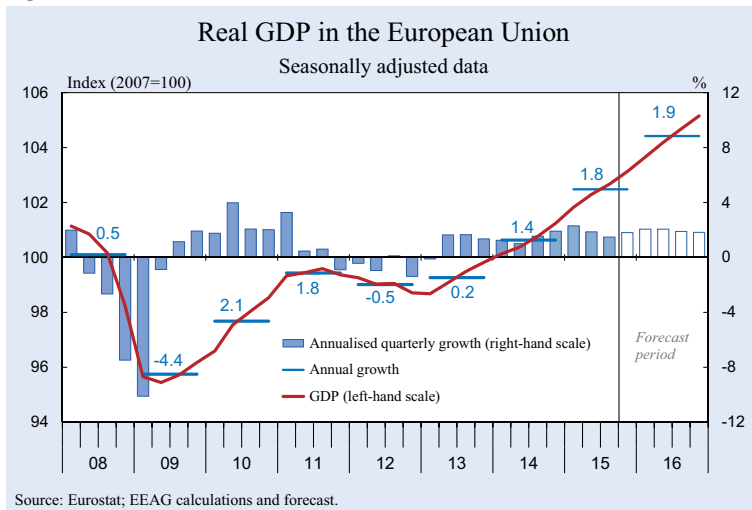
<sup>a)</sup> Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies. Source: European Commission, last accessed on 30 January 2016.

a slightly accelerated pace during the first half of the year (see Figure 1.30). Albeit at a slightly reduced pace, the recovery will continue throughout the remaining year and will allow the output gap to close slowly (see Figure 1.31).

Domestic demand, and in particular private consumption, will be the main driver behind the ongoing recovery (see Figure 1.32). Households continue to benefit from comparatively low energy prices and associated low inflation rates. Furthermore, the situation in the labour market is expected to improve further, making moderate wage increases possible. Employment will continue to grow and the unemployment rate will fall from an average of 9.5 percent in 2015 to 9.1 percent this year (see Figures 1.33 and 1.34). In addition to rising real incomes, low interest rates will contribute to a continuing revival of demand for consumer goods.

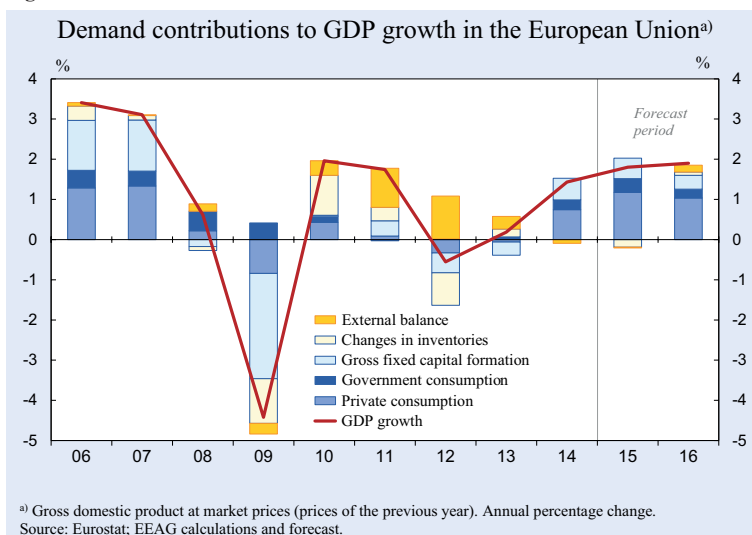
Fiscal policy, via additional public consumption and investment spending, is also likely to directly contribute to an increase in overall demand. Firstly, government bond yields are still very low and as such, loosen the budget constraints of European countries. Secondly, since the beginning of 2015, the EU Commission has started tolerating higher structural deficits if accompanied by increased public investment activities. Thirdly, some European countries have announced additional spending on military operations as well as terrorism prevention. Despite the ongoing recovery, budget deficits will only decline moderately, especially in the euro area. Whereas the total government deficit will fall from

Figure 1.31



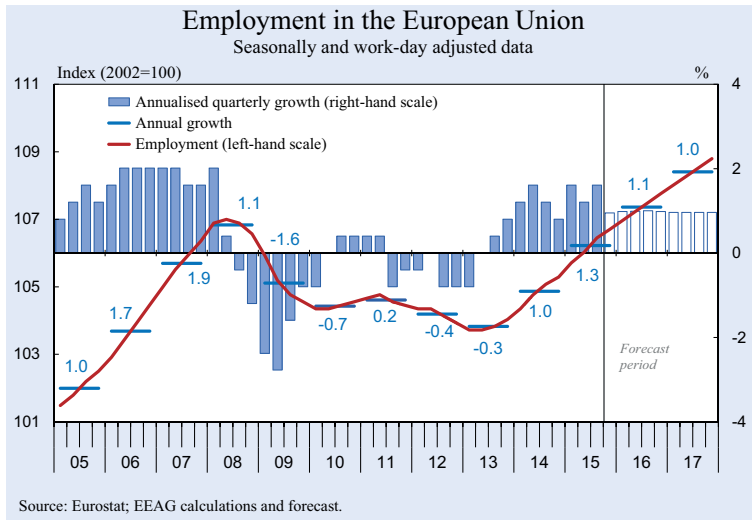
Source: Eurostat; EEAG calculations and forecast.

Figure 1.32



<sup>a)</sup> Gross domestic product at market prices (prices of the previous year). Annual percentage change. Source: Eurostat; EEAG calculations and forecast.

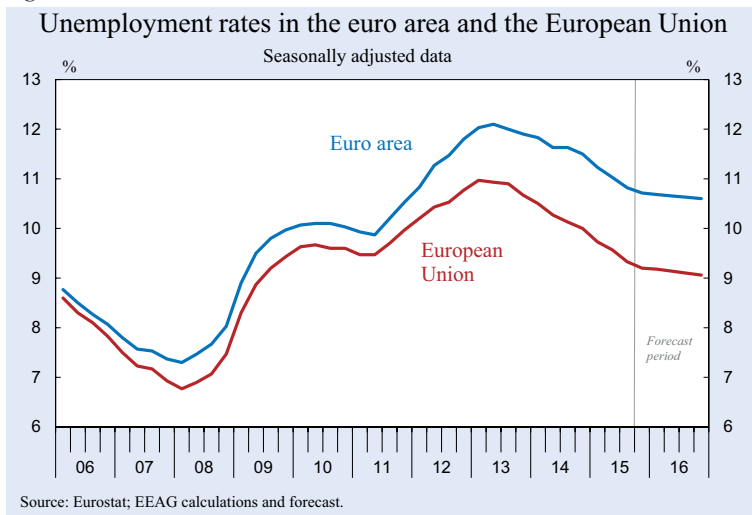
Figure 1.33



2.5 to 2.0 percent in the EU at large, it will only decline from 2.0 to 1.8 percent in the euro area this year.

Favourable conditions for private investment abound. Firstly, companies stand to benefit from the depreciation of the euro against the US dollar. This has improved cost competitiveness and sales prospects, particularly in the United States. Secondly, the oil price is still extremely low, so energy costs have dropped for many companies. Thirdly, the profitability of firms and their access to bank loans has improved. Lending rates are low and banks are increasingly willing to satisfy an increase in demand for credit. Last but not least, the increase in capacity utilisation and the closing of the output gap are gradually making investing in additional capacities more attractive. Nevertheless, no real investment boom is to be expected. Structural problems and related uncertainty over how to solve

Figure 1.34



them persists in many countries and areas within Europe, dampening the willingness of firms to invest.

Although the low value of the euro is supporting exports to the United States in particular, imports are due to the increase in domestic demand expected to rise as such that net exports will hardly contribute to European GDP growth. All in all, real GDP in the European Union is expected to grow by 1.9 percent this year. For the euro area this amounts to 1.7 percent.

Inflation is expected to gradually increase as the effects of sequential energy price drops will fade and the output gap closes. Assuming constant real energy and food prices and an unchanged exchange rate vis-à-vis the United States, the headline inflation is projected to average at 0.9 percent this year in both the euro area and the European Union (see Tables 1.A.3 and 1.A.4).

#### Differences across Europe

With the exception of Finland and Greece, the economies of the member states of the European Union are all on a recovery course. The pace of this recovery, however, differs from country to country. Whereas real GDP in Germany is increasing at a moderate rate, the recovery is somewhat bumpier in France and Italy.

Spain, on the other hand, is witnessing a strong upturn.

As indicated by coincident and leading indicators like the results of the Ifo World Economic Survey, the *German* economy is continuing to expand moderately throughout the winter. Domestic and foreign incoming orders are on the rise again. In addition, fiscal impulses owing to the strong influx of refugees and which are associated with an increase in government spending not backed up by additional revenues or spending cuts elsewhere therefore

do fully impact aggregate demand. In addition, the economy is still benefitting from terms-of-trade gains caused by the decline in crude oil prices. Economic expansion will be supported by the service, retail and wholesale trade sectors this winter; industrial activity, on the other hand, will continue to be weak given that order levels remain low. However, the Ifo Business Climate indicator for the manufacturing sector, and specifically fairly optimistic business expectations, also indicate a turn for the better here.

During the course of the year, the upswing will continue. Decisive in this respect are the continued favourable conditions faced by the German economy. Monetary policy continues to have an exceptionally expansionary impact, with interest rates that are expected to remain low. The financing conditions for new business and construction investments are therefore extremely advantageous. In addition, the government will increase its expansionary impetus, not least due to the significant rise in public consumption and transfers caused by refugee migration. Finally, consumers are still benefitting from low energy prices. This is another reason why private consumption is likely to remain the main pillar of the recovery, which is also promoted by rising labour and transfer income and a decline in the net tax burden of households. Furthermore, the export industry is only expanding at a moderate pace. Although exports will rise somewhat faster during the first half of this year, since the economic situation in major trading partner countries will improve and the impact of the strong depreciation in the euro during 2015 is still to be felt, the global economic expansion, and thus the average growth rates of German exports, will remain far behind those of previous upswings. As a result, investment in machinery and equipment will grow only modestly, despite favourable financing conditions and the largely normal capacity utilisation rates. Construction investment, on the other hand, should pick up again this year. As imports will grow stronger than exports, in view of the strong domestic demand forecast, impetus will mainly come from the domestic economy, rather than foreign trade this year. Overall, real GDP growth is expected to rise to 1.9 percent in 2016. This includes a significant growth contribution from the additional demand created by the inflow of refugees. The price-dampening effects of lower energy prices will wear out and homemade inflation will intensify gradually. Consumer prices are thereby expected to rise by 0.9 percent this year.

The inflow of refugees will have a substantial impact on the German labour market over time. Although companies' high demand for labour will continue, the labour supply will increase much faster through the increasing number of recognised asylum seekers entering the labour market. As the qualification level of the refugees is mainly low, there is likely to be a mismatch between demand and supply that is further aggravated by the nationwide minimum wage that was introduced in early 2015. As a result, unemployment is expected to rise again over the course of the year.

The *French* economy is expected to witness another year of below-average growth and only slowly declining unemployment rates. Previous attempts to reduce labour costs for businesses and to improve price competitiveness have by no means been sufficient to increase long-term growth potential and did not trigger positive short-term developments. Private and public consumption are the main drivers of growth. The latter are also on the increase as the government has initiated additional spending on military operations to counter terrorism.

Although leading indicators suggest a certain slowdown in economic momentum during this winter, the upturn in the *United Kingdom* is likely to continue and will mainly be supported by private consumption. Although nominal wage growth remains moderate from an historical perspective, real incomes are benefitting from stable prices. In addition, tax relief and the increase in the minimum wage in the context of the introduction of the "living wage" are primarily benefitting lower income groups. These have a relatively high propensity to consume.

As corporate profits, particularly in the service sector, have been picking up and borrowing costs remain low, investment should continue to gain momentum this year. The expected turnaround in policy interest rates is only going to be gradual, leaving the overall still expansionary monetary policy to further support economic growth throughout the year. However, fiscal policy will have a restrictive effect in 2016.

Overall, the *British* economy is likely to expand further in 2016 at a rate of 2.2 percent, which is moderate compared to previous years. The unemployment rate will continue to decline slightly. On average it will reach 5.1 percent this year. Due to rising wages and the expiring effects of fallen energy prices, the inflation rate will increase slightly to 1.0 percent this year.

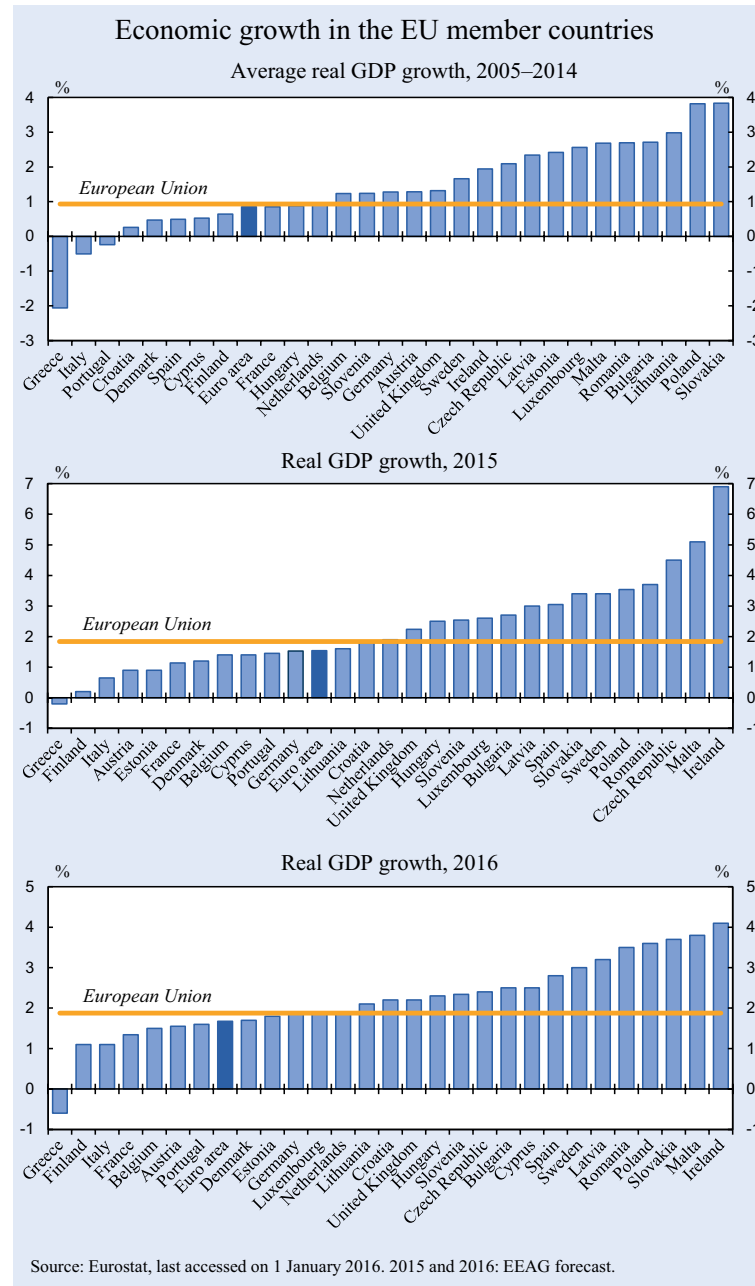
In *Italy* a wide-range of reforms regarding electoral law and the constitution are in the pipeline. These reforms aim to accelerate the political decision-making process considerably. However, they are merely one step towards implementing reforms that may lead to sustainably higher growth rates. The recovery of the Italian banking sector, for instance, has made little progress to date. The stock of non-performing loans, however, has increased markedly over the year and there are no signs that this will start falling soon. Previous attempts to relieve the banking sector through government intervention were mostly limited to smaller financial institutions. This was partly because the financial flexibility of the Italian state is – given the high level of government debt – limited and Italy has received no direct financial aid to date from the European Union. These structural problems do imply that Italy's recovery will continue to lag behind upturns in other European countries. GDP is expected to grow at 1.1 percent in 2016, which is well below the average for the euro area (see Figure 1.35).

This year, *Spain* is expected to continue to expand faster than the other large member states. This is partly because the banking sector is likely to gradually overcome its serious crisis. Thanks to the economic situation, the stock of non-performing loans has fallen substantially since the end of 2013. In addition, a substantial amount of very high-risk assets were outsourced to a bad bank back in 2012. Furthermore, financial aid has been granted by the European Union, allowing Spanish banks to increase their capital ratios significantly. With a forecast growth rate of 2.8 percent this year, labour market conditions continue to improve in Spain and the unemployment rate is expected to decline further to an average rate of 21.0 percent. Given persistent large overcapacities in the system, the in-

flation rate will remain subdued and should reach an average of 0.5 percent this year.

For *Greece*, the first glimmers of hope are on the horizon: early indicators pointing towards some expansion. Greece is still nevertheless a long way from recovery, with domestic and foreign orders still shrinking. Although the government intends to lift capital controls this spring, the country currently still clearly suffers from them. Amid negative carry-over effects from last year, the economy is still projected to contract by – 0.6 percent this year (see Table 1.A.2).

Figure 1.35



The conditions for a continuation of the economic recovery in *Central and Eastern Europe* are generally favourable. Inflation rates and exchange rates are stable, and interest rates remain low. Lending to businesses and households will gain momentum in many places (especially in Poland and the Czech Republic), which, in turn, can be expected to have a positive effect on domestic demand. Economic stimulus is also coming from the public sector, which in most countries is in a fiscally sound shape.

In addition, countries in the region are eligible to receive substantial funding from the five structural and investment funds of the European Union (ESIF) until 2020 (around 190 billion euros alone for the six countries outside the euro area: Poland, Romania, Hungary, Czech Republic, Bulgaria and Croatia). Since these funds are granted according to the principle of co-financing, they must be accompanied by public funds from the country applying. Accordingly, fiscal policy will tend to be expansionary, especially in the region's three major economies (Poland, the Czech Republic and Hungary).

Overall, the pace of expansion in the majority of Central and Eastern European EU member states should accelerate slightly this year. The economic outlook is only cloudier in the Baltic States (Lithuania, Latvia and Estonia); these economies are feeling the impact of Russian sanctions against the European Union and are more sensitive to the Russian import substitution programme.

### References

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Appendix 1.A  
Forecasting Tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries										
	Share of total GDP	GDP growth			CPI inflation			Unemployment rate <sup>d)</sup>		
		in %						in %		
		2014	2015	2016	2014	2015	2016	2014	2015	2016
<b>Industrialised countries:</b>										
EU 28	27.4	1.4	1.8	1.9	0.6	0.0	0.9	10.2	9.5	9.1
Euro Area	19.9	0.9	1.5	1.7	0.4	0.0	0.9	11.6	10.9	10.6
Switzerland	1.0	1.9	0.7	1.1	0.0	-1.1	-0.5	4.5	4.5	4.7
Norway	0.8	2.2	1.2	1.5	2.0	2.1	2.3	3.5	3.7	3.8
Western and Central Europe	29.2	1.4	1.7	1.9	0.6	0.1	0.9	10.1	9.4	9.0
US	25.8	2.4	2.4	2.5	1.6	0.1	1.1	6.2	5.3	4.9
Japan	6.8	-0.1	0.6	0.6	2.7	0.8	1.0	3.6	3.4	3.2
Canada	2.7	2.4	1.1	2.0	1.9	1.1	1.9	6.9	6.9	7.0
<b>Industrialised countries (total)</b>	<b>64.4</b>	<b>1.7</b>	<b>1.9</b>	<b>2.0</b>	<b>1.3</b>	<b>0.2</b>	<b>1.0</b>	<b>7.8</b>	<b>7.1</b>	<b>6.8</b>
<b>Newly industrialised countries:</b>										
Russia	2.8	0.6	-3.2	-0.2	7.8	15.7	10.8	.	.	.
China	15.4	7.3	6.9	6.8	2.0	1.5	2.2	.	.	.
India	3.1	7.1	7.3	7.5	7.2	5.1	5.6	.	.	.
East Asia <sup>a)</sup>	6.5	3.7	3.2	4.0	3.4	1.9	2.5	.	.	.
Latin America <sup>b)</sup>	7.9	0.9	-0.7	-0.1	10.9	19.4	12.6	.	.	.
<b>Newly industrialised countries (total)</b>	<b>35.6</b>	<b>4.7</b>	<b>3.7</b>	<b>4.3</b>	<b>5.1</b>	<b>7.0</b>	<b>5.5</b>	.	.	.
<b>Total<sup>c)</sup></b>	<b>100.0</b>	<b>2.8</b>	<b>2.5</b>	<b>2.8<sup>e)</sup></b>	.	.	.	.	.	.
<b>World trade growth in %</b>		<b>3.4</b>	<b>2.6</b>	<b>3.2</b>						

<sup>a)</sup> Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2013 levels of GDP in US dollars. – <sup>b)</sup> Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, Chile. Weighted with the 2013 level of GDP in US dollars. – <sup>c)</sup> Weighted average of the listed groups of countries. – <sup>d)</sup> Standardised unemployment rate. – <sup>e)</sup> 3.3 percent when using purchasing-power-parity adjusted weights.

Source: Eurostat, OECD, IMF, ILO, National Statistical Offices, 2015 and 2016: EEAG forecast.



Table 1.A.2

## GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth <sup>a)</sup>			Inflation <sup>b)</sup>			Unemployment rate <sup>c)</sup>		
		in %						in %		
		2014	2015	2016	2014	2015	2016	2014	2015	2016
Germany	20.8	1.6	1.5	1.9	0.8	0.2	0.9	5.0	4.6	5.1
France	15.6	0.2	1.1	1.3	0.6	0.1	0.8	10.3	10.4	10.3
Italy	12.0	-0.4	0.7	1.1	0.2	0.1	0.7	12.7	11.9	11.4
Spain	7.8	1.4	3.1	2.8	-0.2	-0.6	0.5	24.5	22.2	21.0
Netherlands	4.8	1.0	1.9	1.9	0.3	0.2	0.9	7.4	6.9	6.5
Belgium	2.9	1.3	1.4	1.5	0.5	0.6	1.6	8.5	8.3	7.7
Austria	2.4	0.4	0.9	1.6	1.5	0.8	1.3	5.6	5.7	5.7
Finland	1.5	-0.4	0.2	1.1	1.2	-0.1	0.5	8.7	9.4	9.4
Greece	1.3	0.7	-0.2	-0.6	-1.4	-1.1	0.1	26.5	25.1	24.9
Portugal	1.3	0.9	1.5	1.6	-0.2	0.5	0.7	14.1	12.7	12.1
Ireland	1.3	5.2	6.9	4.1	0.3	-0.1	0.7	11.3	9.4	8.7
Slovakia	0.5	2.5	3.4	3.7	-0.1	-0.3	1.0	13.2	11.5	10.1
Slovenia	0.3	3.0	2.5	2.3	0.4	-0.8	0.7	9.7	9.1	8.5
Luxembourg	0.3	4.1	2.6	1.9	0.7	0.0	0.9	6.0	6.2	5.7
Lithuania	0.3	3.0	1.6	2.1	0.2	-0.7	0.8	10.7	9.1	8.4
Latvia	0.2	2.4	3.0	3.2	0.7	0.2	1.1	10.8	9.9	9.6
Cyprus	0.1	-2.5	1.4	2.5	-0.3	-1.6	0.0	16.1	15.6	15.1
Estonia	0.1	2.9	0.9	1.8	0.5	0.1	1.0	7.4	6.1	6.0
Malta	0.1	4.1	5.1	3.8	0.8	1.2	1.4	5.9	5.4	5.1
<b>Euro area<sup>d)</sup></b>	<b>73.5</b>	<b>0.9</b>	<b>1.5</b>	<b>1.7</b>	<b>0.4</b>	<b>0.0</b>	<b>0.9</b>	<b>11.6</b>	<b>10.9</b>	<b>10.6</b>
United Kingdom	14.9	2.9	2.2	2.2	1.5	0.1	1.0	6.1	5.4	5.1
Sweden	3.2	2.3	3.4	3.0	0.2	0.7	1.3	7.9	7.4	7.0
Denmark	1.9	1.3	1.2	1.7	0.3	0.2	1.0	6.6	6.2	6.2
<b>EU 22<sup>e)</sup></b>	<b>93.5</b>	<b>1.3</b>	<b>1.7</b>	<b>1.8</b>	<b>0.6</b>	<b>0.1</b>	<b>0.9</b>	<b>10.5</b>	<b>9.8</b>	<b>9.6</b>
Poland	2.9	3.3	3.5	3.6	0.1	-0.7	0.9	9.0	7.5	6.7
Czech Republic	1.2	2.0	4.5	2.4	0.4	0.3	1.1	6.1	5.1	4.5
Romania	1.1	2.9	3.7	3.5	1.4	-0.4	0.6	6.8	6.8	6.4
Hungary	0.7	3.7	2.5	2.3	0.0	0.1	1.4	7.7	6.9	6.3
Croatia	0.3	-0.4	1.8	2.2	0.2	-0.5	0.5	17.3	16.6	16.2
Bulgaria	0.3	1.5	2.7	2.8	-1.6	-1.0	0.7	11.4	9.4	8.6
<b>New Members<sup>e)</sup></b>	<b>7.9</b>	<b>2.8</b>	<b>3.3</b>	<b>3.1</b>	<b>0.3</b>	<b>-0.4</b>	<b>0.9</b>	<b>8.9</b>	<b>7.9</b>	<b>7.2</b>
<b>EU 28<sup>d)</sup></b>	<b>100.0</b>	<b>1.4</b>	<b>1.8</b>	<b>1.9</b>	<b>0.6</b>	<b>0.0</b>	<b>0.9</b>	<b>10.2</b>	<b>9.5</b>	<b>9.1</b>

<sup>a)</sup> GDP growth rates are based on the calendar adjusted series except for Ireland, Slovakia and Romania for which Eurostat does not provide working-day adjusted GDP series. – <sup>b)</sup> Harmonised consumer price index (HICP). – <sup>c)</sup> Standardised unemployment rate. – <sup>d)</sup> Weighted average of the listed countries. – <sup>e)</sup> Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria.

Source: Eurostat, 2015 and 2016: EEAG forecast.

Table 1.A.3

## Key forecast figures for the European Union

	2014	2015	2016
	Percentage change over previous year		
Real gross domestic product	1.4	1.8	1.9
Private consumption	1.3	2.1	1.8
Government consumption	1.1	1.6	1.0
Gross fixed capital formation	1.4	2.6	1.7
Net exports <sup>a)</sup>	-0.1	0.1	0.2
Consumer prices <sup>b)</sup>	0.6	0.0	0.9
	Percentage of nominal gross domestic product		
Government fiscal balance <sup>c)</sup>	-3.0	-2.5	-2.0
	Percentage of labour force		
Unemployment rate <sup>d)</sup>	10.2	9.5	9.1

<sup>a)</sup> Contributions to changes in real GDP (percentage of real GDP in previous year). – <sup>b)</sup> Harmonised consumer price index (HCPI). – <sup>c)</sup> 2014 and 2015: forecasts of the European Commission. – <sup>d)</sup> Standardised unemployment rate.

Source: Eurostat; 2015 and 2016: EEAG forecast.

Table 1.A.4

## Key forecast figures for the euro area

	2014	2015	2016
	Percentage change over previous year		
Real gross domestic product	0.9	1.5	1.7
Private consumption	0.8	1.7	1.5
Government consumption	0.9	1.4	1.0
Gross fixed capital formation	1.3	2.2	1.3
Net exports <sup>a)</sup>	0.0	0.1	0.3
Consumer prices <sup>b)</sup>	0.4	0.0	0.9
	Percentage of nominal gross domestic product		
Government fiscal balance <sup>c)</sup>	-2.6	-2.0	-1.8
Unemployment rate <sup>d)</sup>	11.6	10.9	10.7

<sup>a)</sup> Contributions to changes in real GDP (percentage of real GDP in previous year). – <sup>b)</sup> Harmonised consumer price index (HCPI). – <sup>c)</sup> 2014 and 2015: forecasts of the European Commission. – <sup>d)</sup> Standardised unemployment rate.

Source: Eurostat; 2015 and 2016: EEAG forecast.

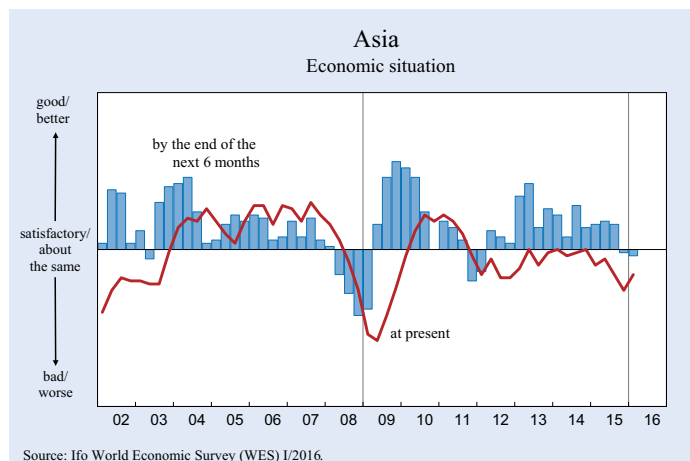
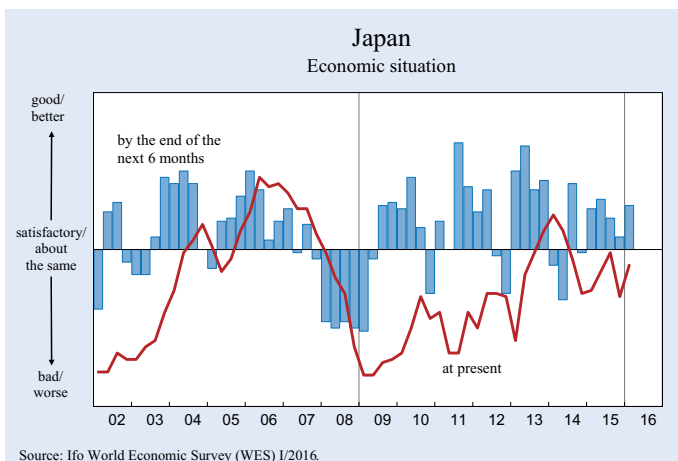
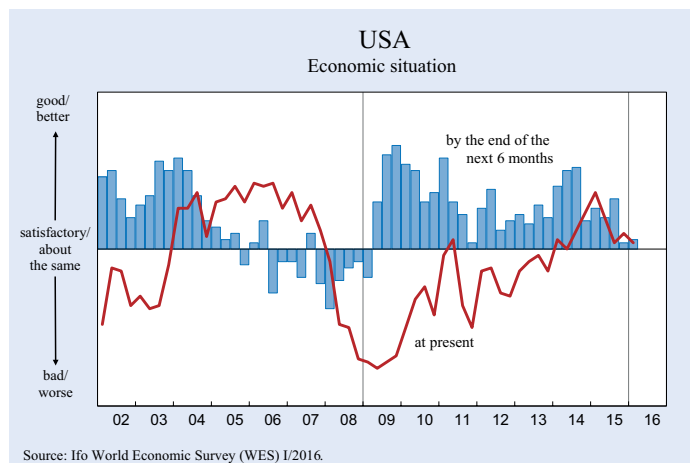
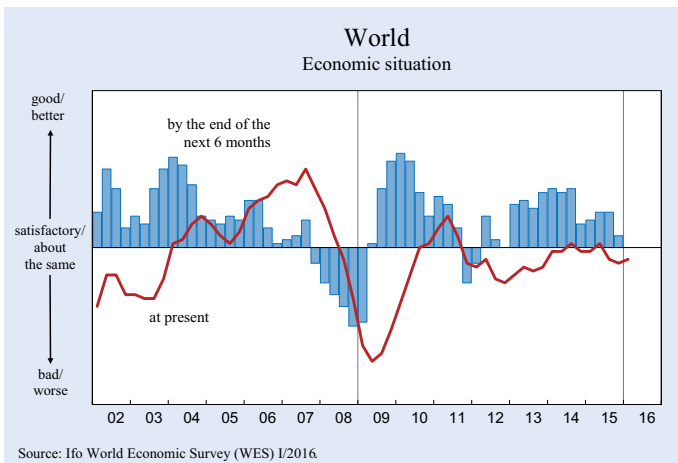
**Appendix 1.B**  
**Ifo World Economic Survey (WES)**

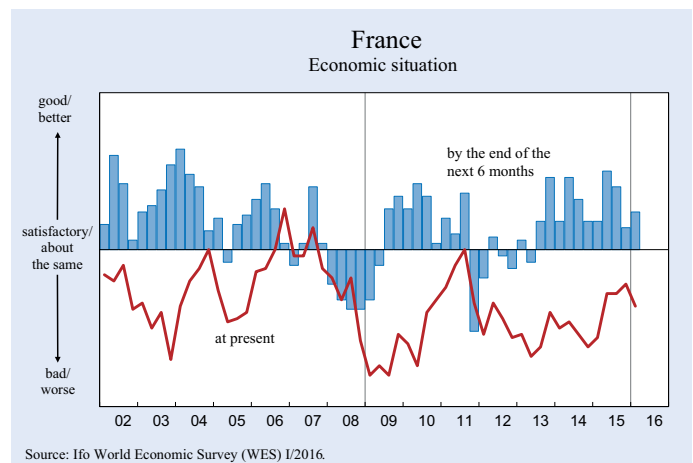
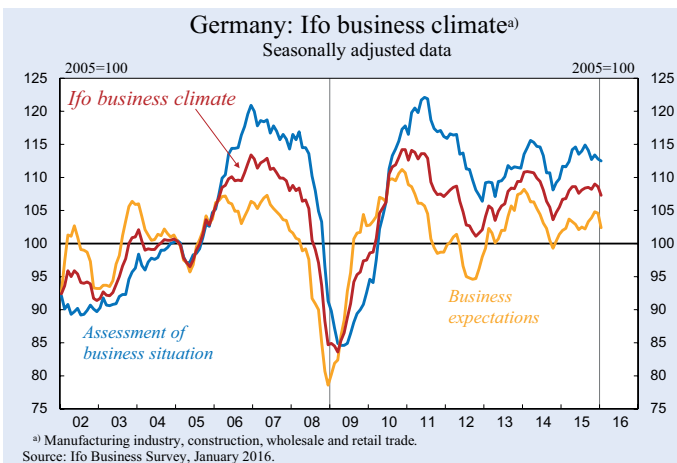
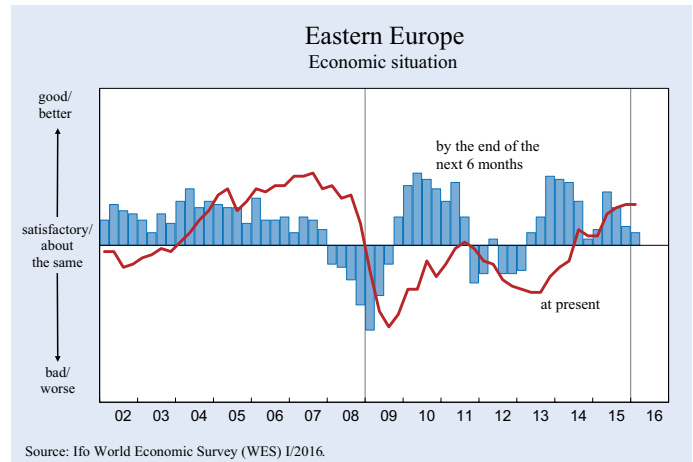
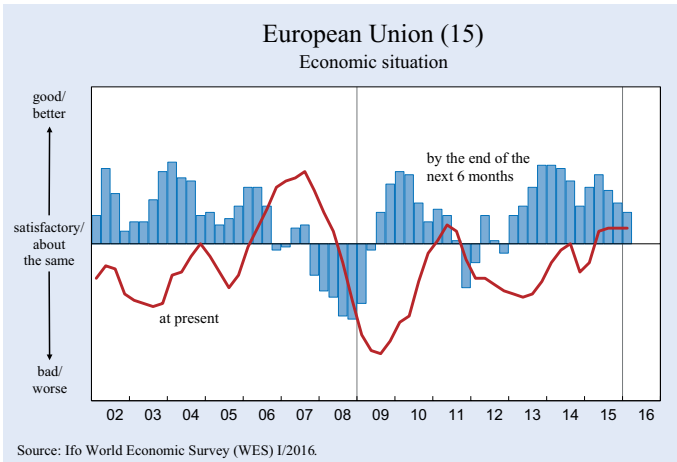
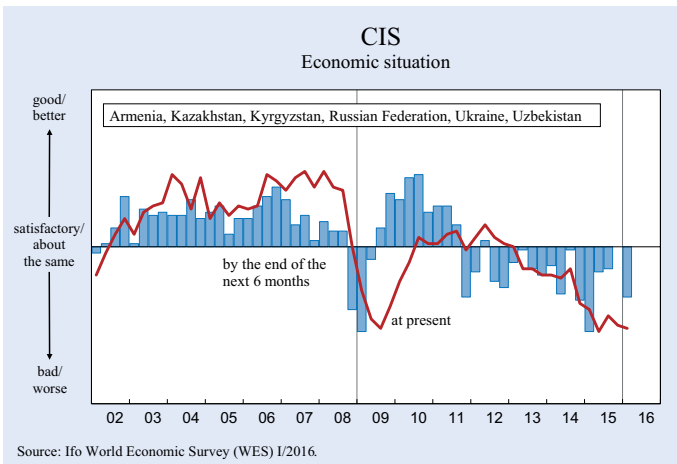
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organisations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2016, 1,085 economic experts in 120 countries were polled.

The survey questionnaire focuses on qualitative information: on assessment of a country’s general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool,

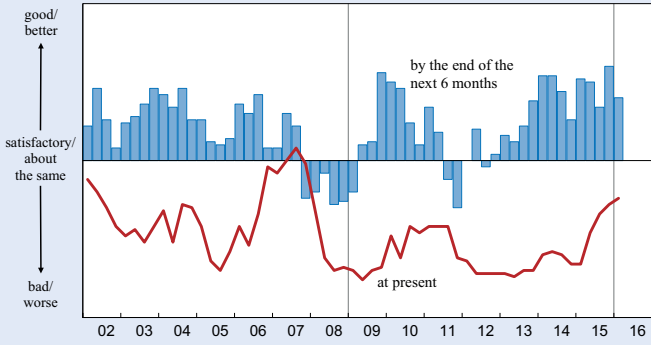
since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The “grading” procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country’s exports and imports in total world trade.

**Ifo World Economic Survey (WES)**



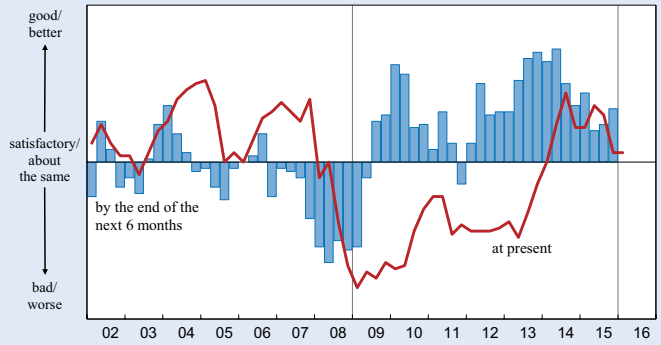


Italy  
Economic situation



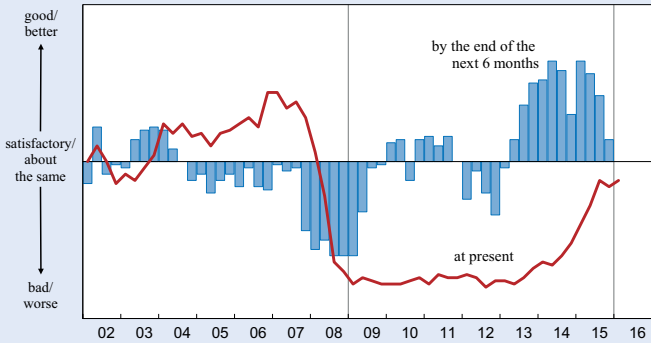
Source: Ifo World Economic Survey (WES) I/2016.

United Kingdom  
Economic situation



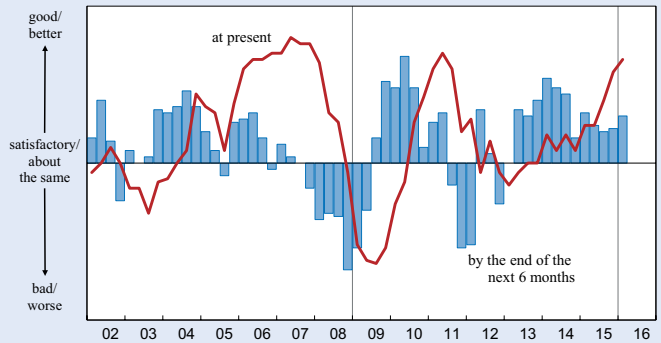
Source: Ifo World Economic Survey (WES) I/2016.

Spain  
Economic situation



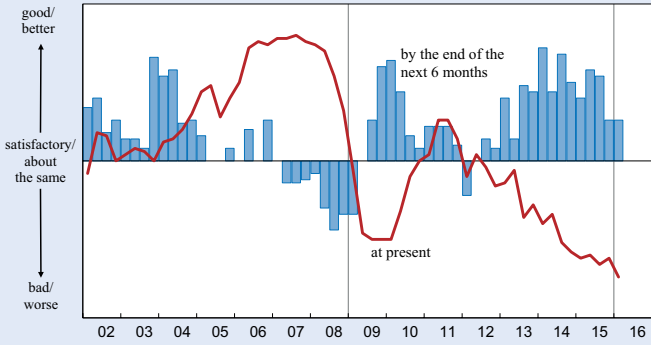
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Sweden  
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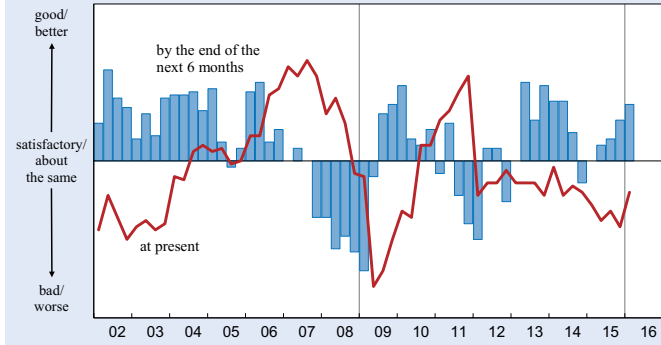
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Finland  
Economic situation

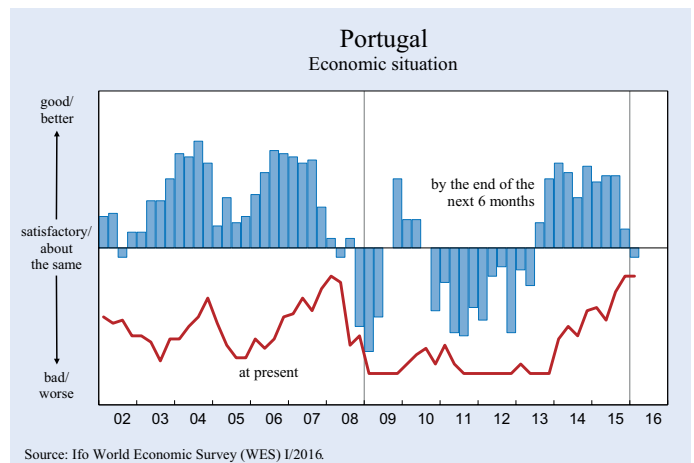
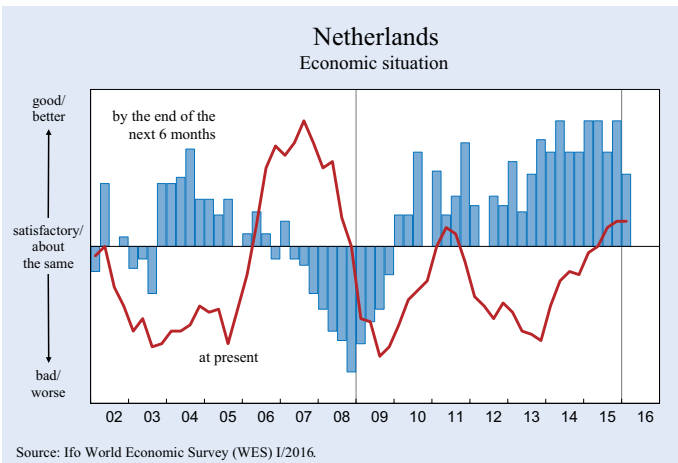
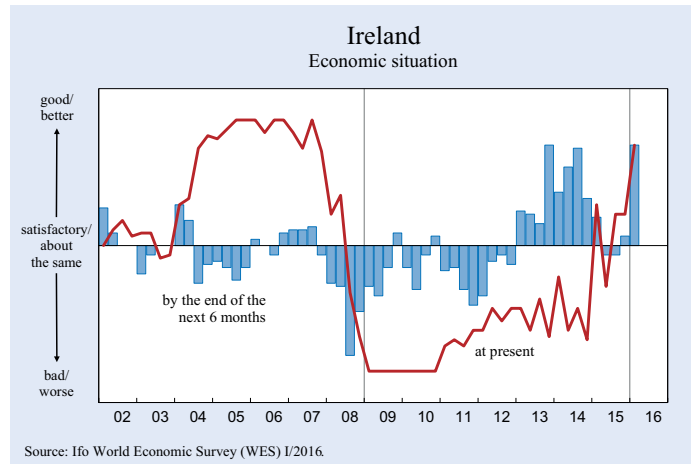
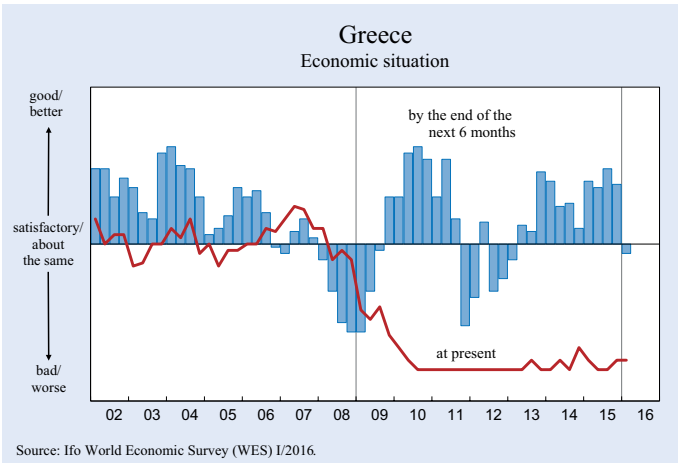
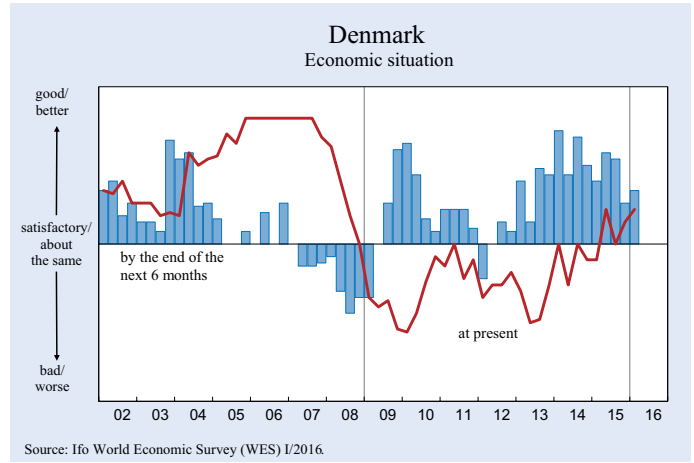
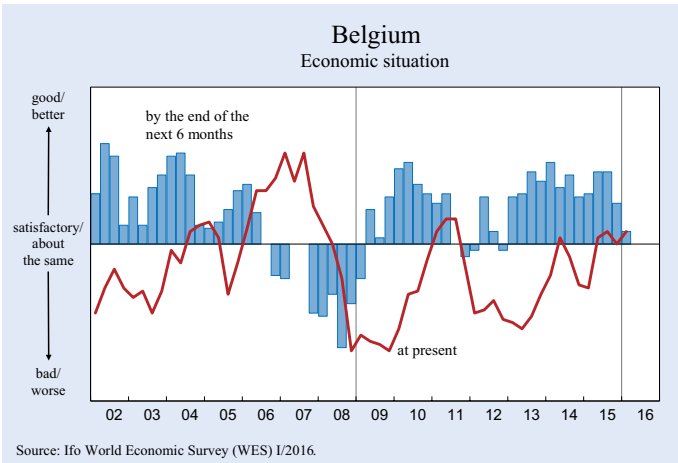


Source: Ifo World Economic Survey (WES) I/2016.

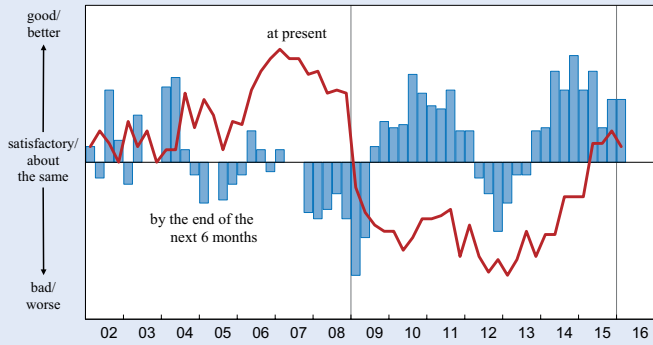
Austria  
Economic situation



Source: Ifo World Economic Survey (WES) I/2016.

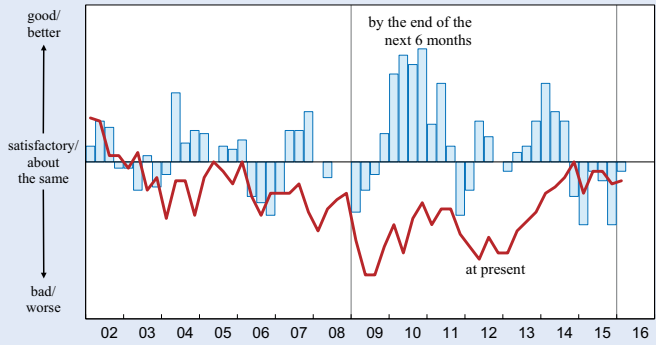


**Slovenia**  
Economic situation



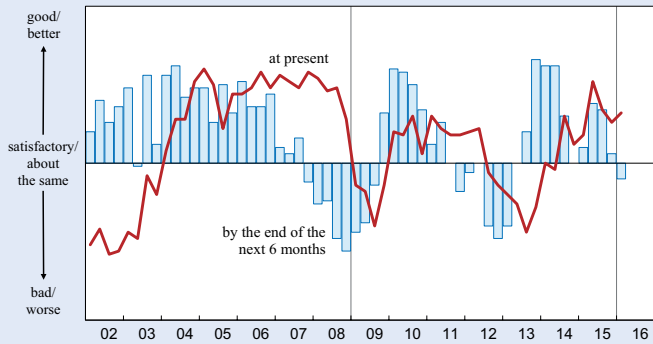
Source: Ifo World Economic Survey (WES) I/2016.

**Hungary**  
Economic situation



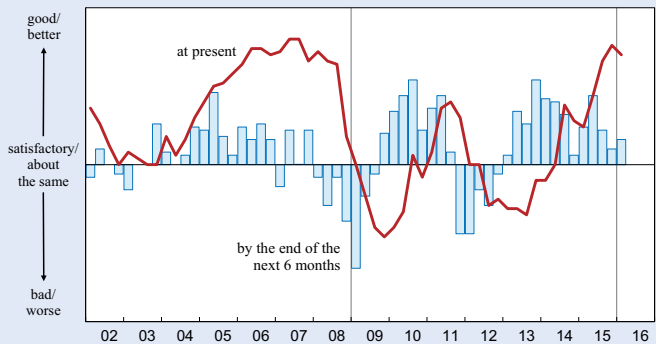
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**Poland**  
Economic situation



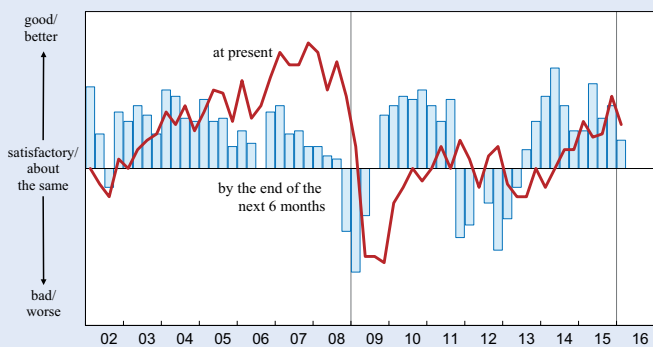
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**Czech Republic**  
Economic situation



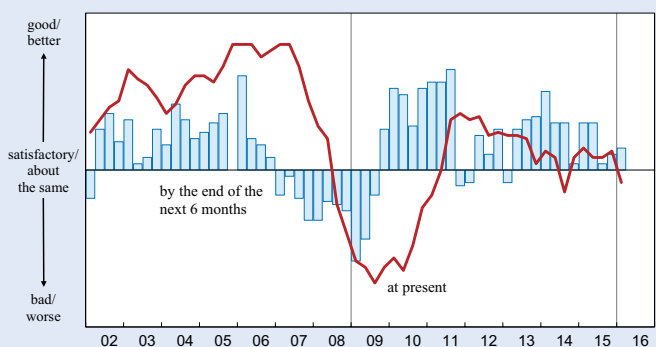
Source: Ifo World Economic Survey (WES) I/2016.

**Slovakia**  
Economic situation



Source: Ifo World Economic Survey (WES) I/2016.

**Estonia**  
Economic situation



Source: Ifo World Economic Survey (WES) I/2016.

