QNB Economics
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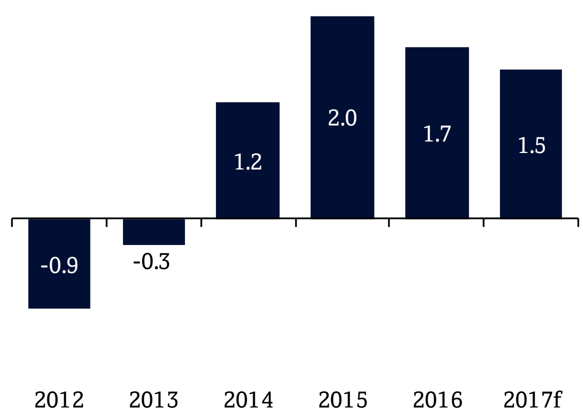
Euro Area growth to ease in 2017

The European Central Bank (ECB) kept policy unchanged at its latest monetary policy meeting on March 9th but ECB President Mario Draghi struck a decidedly optimistic tone about the progress of the Euro Area economy in remarks after the meeting. Steadily falling unemployment, rising activity data and improving economic sentiment were hailed as evidence of the success of monetary policy. These developments, combined with above trend growth over the past two years (2.0% in 2015 and 1.7% in 2016) have fuelled an upbeat outlook for the Euro Area in 2017. However, we are less sanguine about Euro Area growth. Although we still expect above-trend growth of 1.5% in 2017, we project that growth will ease compared to the last two years as some supporting tailwinds fade. Moreover, our view is that recent optimism eschews emerging political risks that cloud the currency union's future.

There are three key factors affecting growth in the Euro Area. First, higher oil prices should slow consumption, a key driver of overall growth over the past two years. Consumption added an average of 1.1 percentage points (pps) to growth in 2015 and 2016, or approximately 60% of growth. This was largely due to low oil prices which boosted real disposable income and profits. With oil prices forecast to rise from USD45/b in 2016 to USD55/b in 2017, we expect this will impose a drag on growth of around 0.3 pps relative to the previous year.

Second, the support to growth from monetary policy is expected to diminish in 2017. Monetary easing has helped lift domestic demand over the past two years by reducing short-term lending costs, which in turn, increased investment and aided the recovery in the labour market. But most of the easing has already occurred and debate has in fact shifted to when the ECB will begin to taper its asset purchasing programme and increase rates. In addition, longer-term interest rates are expected to gradually rise, because of higher US rates, and this will pass-through to mortgages and other long-term borrowing costs in the Euro Area. Overall, the support from the ECB's current easing stance is expected to be limited and offset by slightly higher long-term rates in 2017, leaving the impact of monetary policy on growth as neutral.

Euro Area real GDP growth
(%, year over year)



Sources: Statistical Office of European Communities; Haver Analytics and QNB Economics

Third, we expect weakness in the euro to boost net exports but this will be partly offset by weaker external demand from the Euro Area's key trading partners. Diverging monetary policy between the ECB and Federal Reserve will widen interest rate spreads between the US and Europe, attracting inflows into the US and increasing the value of US dollar relative to the euro. The weaker exchange rate will boost the competitiveness of the Euro Area's exports while providing impetus to slow import growth. Current market expectations are for the EUR/USD to depreciate from an average of 1.10 in 2016 to 1.05 in 2017, or a decline of 4.5%. But export growth is likely to be curtailed by weaker external demand from the UK, as a result of the sharp fall in the pound, and China, where growth continues to slide. The UK and China represent over 20% of the bloc's goods exports together. We expect net exports to only increase growth by 0.1 pps compared to the previous year.

In addition, the Euro Area outlook faces major downside risks from a busy political calendar in 2017. The imminent triggering of Brexit by the British government to begin negotiations with the EU on exit terms looms on the outlook. If the end result is indeed a 'hard Brexit', this could hurt the Euro Area as export-oriented firms delay investment and start to re-orient away from the UK in anticipation of higher trade barriers. Additionally, key elections in 2017 in the France and Germany could bring populist leaders into power, intensifying anti-EU sentiment and raising the spectre of a breakup of the Euro Area itself.

Monetary policy has been the mainstay supporting growth in the Euro Area over the past few years but appears stretched to its limits. Combined with receding tailwinds from oil prices and external demand, policy makers may rotate towards fiscal policy to support growth in the event of a major shock from Brexit or another political crisis. But one way or another, growth is expected to slow and Euro Area leaders will be pressed to find new ways to boost growth.

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