ECONOMIC OUTLOOK · The euro area improves its tone at the end of the year

In spite of Brexit, the euro area continues to recover at a moderate pace, supported by the ECB's expansionary monetary policy, the fall in oil prices and the depreciation of the euro. The impact of Brexit on growth has been more subdued than initially expected, as the widespread improvement in economic indicators over the last few months shows. Moreover, the European Commission Autumn forecasts for 2016 and 2017 do not include any substantial changes. For 2016, euro area growth is expected to be 1.7%. For 2017, the Commission forecasts a slightly lower but similar rate of growth (of 1.5%, almost in line with the 1.4% forecasted by CaixaBank Research), due to lower support from favourable tailwinds (such as the recovery in oil prices) and increased political uncertainty derived from the upcoming elections in France, the Netherlands and Germany. The Commission also stressed that its forecast scenario is still highly dependent on a favourable resolution of external risks such as slower global growth, weaker world trade and a worsening of geopolitical tensions.

Growth continues to vary considerably across countries, and the periphery's growth stands out. Eurostat confirmed euro area Q3 GDP growth at 0.3% quarter-on-quarter, the same rate as in the previous quarter. Across countries, strong growth was posted by Portugal (0.8%, a 0.5 pps improvement with regards to Q2), as well as by Spain and Greece. Although Germany grew less than expected (0.2% quarter-on-quarter), the increase in domestic demand, with a contribution to growth of 0.4 pps, suggests that the underlying trend is still positive. For the coming quarters, we expect the euro area as a whole to maintain a similar rate of growth, of between 0.3% and 0.4% quarter-on-quarter, although with significant differences across countries.

Temporary growth slowdown in Emerging Europe. GDP data for Q3 show that growth remained strong, albeit at a slower pace than in Q2. Across countries, Romania and Slovakia continue to stand out with growth rates above 4% and 3% year-on-year, respectively, while Poland, Hungary and the Czech Republic disappointed with lower growth than expected. Nevertheless, in line with a scenario of continued euro area recovery, the growth outlook of these economies is positive. Growth is expected to be around 3.0% in most of these countries, both in 2016 and 2017.

Business indicators point to a slight acceleration in the fourth quarter. This is reflected in the PMI composite index which has remained comfortably in the expansionary zone (above 50 points) and in November it accelerated to 54.1 points, the highest level in the past 11 months, while the economic sentiment index (ESI) for Q4 has

Euro area: European Commission GDP forecasts

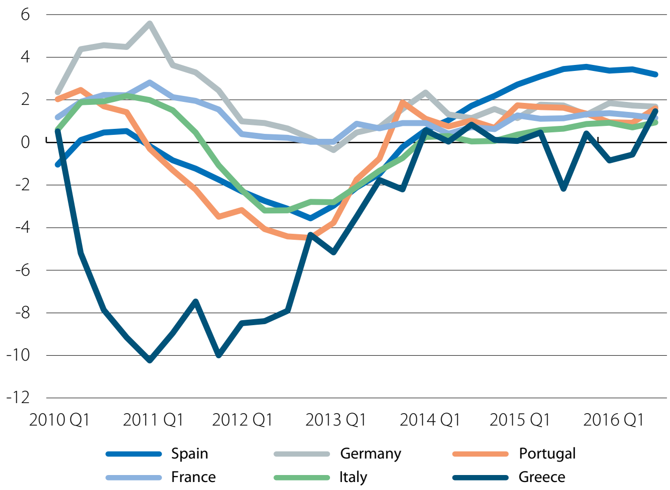
Annual change (%)

	Forecast			Change compared with May 2016 forecast	
	2016	2017	2018	2016	2017
Euro area	1.7	1.5	1.7	▲ 0.1	▼ 0.3
Germany	1.9	1.5	1.7	▲ 0.3	▼ 0.1
France	1.3	1.4	1.7	=	▼ 0.3
Italy	0.7	0.9	1.0	▼ 0.4	▼ 0.4
Spain	3.2	2.3	2.1	▲ 0.6	▼ 0.2
Portugal	0.9	1.2	1.4	▼ 0.6	▼ 0.5

Source: *CaixaBank Research, based on data from the European Commission (European Economic Forecast, autumn 2016).*

GDP

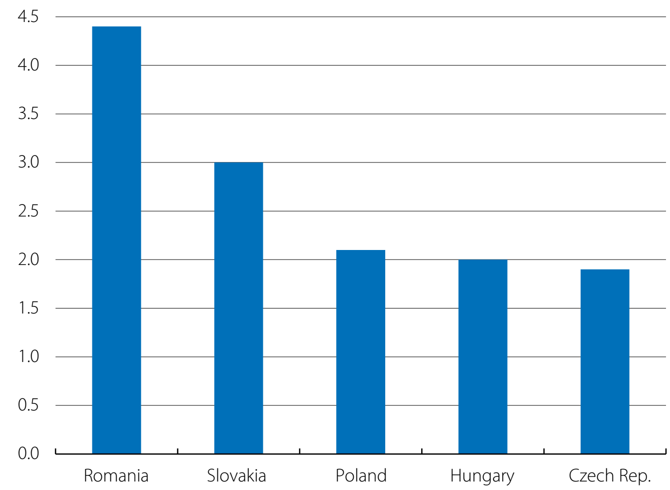
Year-on-year change (%)



Source: *CaixaBank Research, based on Eurostat data.*

Emerging Europe: GDP in 2016 Q3

Year-on-year change (%)



Source: *CaixaBank Research, based on Eurostat data.*

remained at its annual peak (106.5 points). Across countries, Germany stands out with an average PMI for October and November of 55 points and an IFO business sentiment indicator that in November reached its highest level in the past three years.

Domestic demand is still driving the economic recovery. Retail sales rose by 1.3% year-on-year in September, and the Q3 average stood at 1.5% year-on-year. This advance, although slightly smaller than the figure for Q2 (1.9%), continues to make private consumption one of the main drivers of the economic recovery in the euro area. The consumer confidence index for the euro area as a whole rose considerably in November, reaching –6.1 points (–8.0 in October), the highest level in 2016. Over the coming months, household consumption is expected to remain strong, supported by the improvements in the labour market and low interest rates, helping to push up inflation.

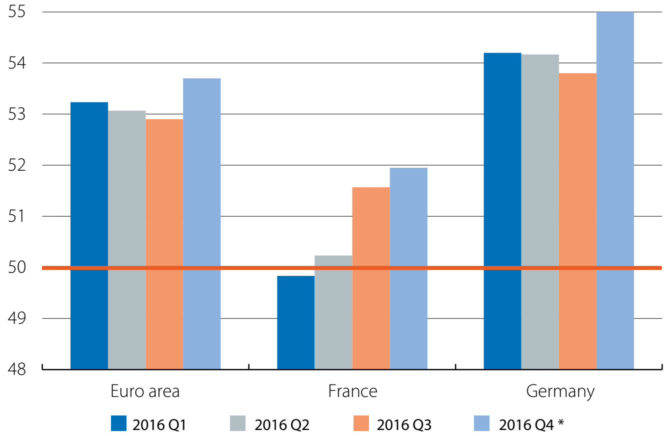
Inflation no longer in the red. Euro area headline inflation, as measured by the harmonised index of consumer prices (HICP), stood at 0.6% in November, 0.1 pps above October's figure (0.5%), while core inflation speeded up slightly to 0.8%, an increase of 0.1 pps. Over the coming months, we expect headline inflation to continue to recover as oil prices increase, and core inflation to rise gradually along with the growth in activity. In this respect, the recovery in inflation expectations for the euro area is a particularly encouraging sign.

The euro area's current account balance remains positive. The euro area current account surplus (cumulative over 12 months) amounted to 337 billion euros (3.2% of GDP), above the 322.5 billion euros recorded in September 2015. This increase is mostly due to a larger surplus in the balance of goods (368.1 billion euros, equivalent to 3.5% of GDP), boosted by low oil prices and the depreciation of the euro. For the coming quarters, we expect the external surplus to gradually decline as oil prices recover and imports increase with the recovery in investment in the euro area.

The European Commission asked countries that have fiscal space to use it appropriately and provide more support to the ECB's monetary policy. The Commission recommended a moderately expansionary fiscal stance in the euro area as a whole in order to support the recovery. Moreover, the Commission stressed that it is important that countries that have fiscal space use it in order to boost growth, while asking those which do not have fiscal space to improve their public finances so as to support public and private investment and to use the resources available to improve the economy's growth potential. However, the European Commission's message has been received with some scepticism. The euro area fiscal stance in 2017 is expected to be neutral again, after the mild expansion of 2016. In fact, the Commission expects the euro area public deficit to continue to fall, from 1.8% in 2016 to 1.5% in 2017, and public debt to shrink from 91.6% of GDP in 2016 to 90.6% in 2017. It is worth mentioning that the

Euro area: composite PMI activity indicator

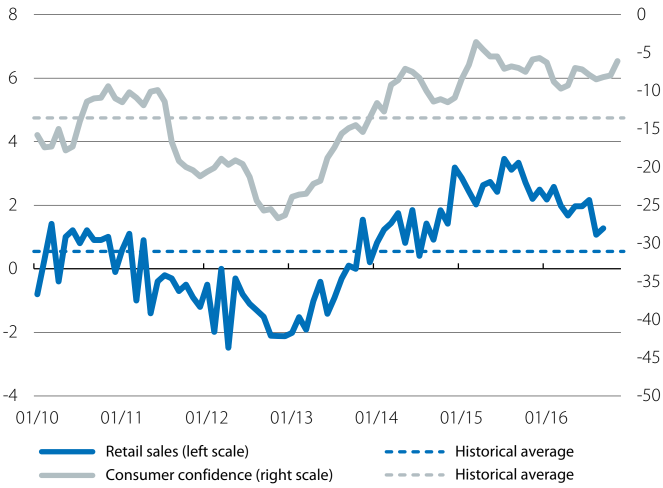
Level



Note: ** 2016 Q4 includes data from October and November.*
Source: *CaixaBank Research, based on data from Markit.*

Euro area: consumption indicators

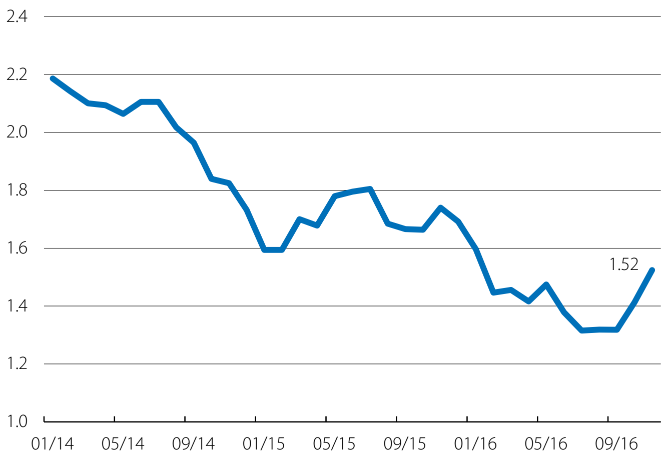
Year-on-year change (%) *Level*



Source: *CaixaBank Research, based on data from Eurostat and the European Commission.*

Euro area: inflation expectations *

(%)



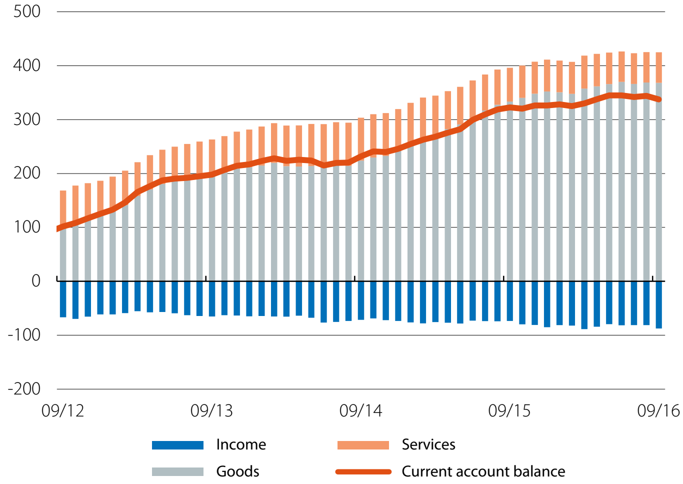
Note: ** Market expectations regarding the average level of inflation at 5 years in 5 years' time (5Y5Y inflation swap).*
Source: *CaixaBank Research, based on Bloomberg data.*

Commission, on analysing the budgets of the member states, asked Spain to make an additional effort in order to meet its deficit target for 2017 and warned Italy and Portugal of the importance of maintaining a credible medium-term budgetary plan given their high level of public debt. On the other hand, the Commission asked Germany to increase its investment spending on infrastructure, education and R&D since the country has the fiscal space to do so.

France: a slow recovery before the Presidential elections. The French economy's growth is still modest and the composition is both fragile and vulnerable to shocks. Specifically, domestic demand has remained positive but muted, and both private and public consumption have continued to show signs of weakness. On the other hand, investment, after a long period of lethargy, is finally starting to show some signs of recovery. Given that indicators have improved, growth in the fourth quarter is expected to increase slightly, resulting in 1.2% growth by the end of the year. For 2017, and in line with euro area forecasts, most evidence suggests that growth will continue at a similar pace. France's economic situation therefore makes it more important than ever for a President to be chosen in next year's elections with an ambitious agenda of reforms in order to improve the country's long-term growth capacity. However, greater fragmentation of vote means that the outcome is highly uncertain, at least at present, and not all those candidates who are most likely to win have economic agendas that contain such priorities. In this respect, the rise of the National Front stands out, which endorses a protectionist economic policy both in the area of import tariffs and immigration, as well as wanting to hold a referendum on France leaving the euro. It will therefore be very important, over the coming months, to see how the main candidates firm up their economic agendas, as well as monitoring any developments in the polls, although these have not been very reliable in other recent elections.

Euro area: current account

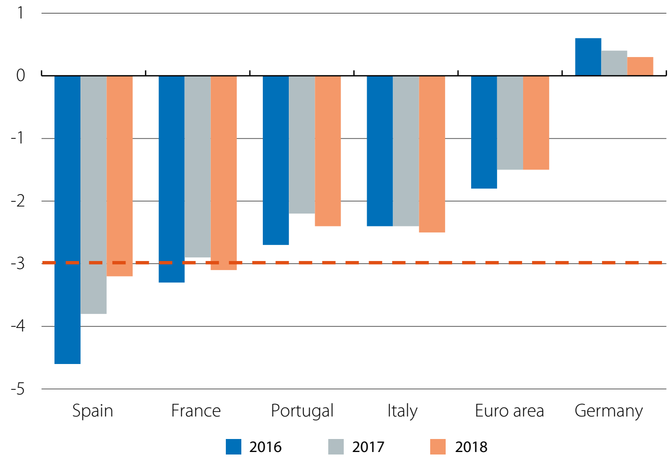
Cumulative over 12 months (billion euros)



Source: *CaixaBank Research, based on data from the ECB.*

Euro area: forecasts of a public surplus (+) or deficit (–) by the European Commission

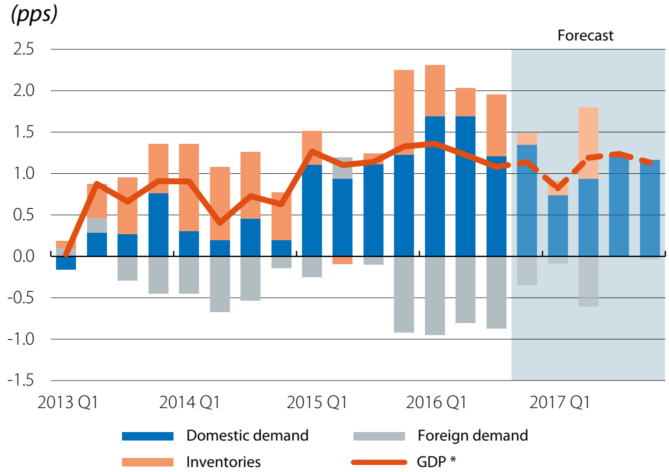
(% of GDP)



Source: *CaixaBank Research, based on European Commission data.*

France: contribution to year-on-year growth in GDP

(pps)



Note: ** Year-on-year change.*
Source: *CaixaBank Research, based on Eurostat data.*