

ECONOMIC OUTLOOK · Euro area growth gains momentum

The European economy continues to perform well in the face of uncertainty. GDP growth in the euro area has managed to withstand the episodes of financial instability and political shocks of 2016, as the widespread improvement in activity indicators over the past few months shows. This has resulted in upgraded growth forecasts. CaixaBank Research now forecasts 2017 growth at 1.7%, 0.2 pps higher than its previous forecast. The European Commission has also slightly raised its forecast to 1.6%. However, the outlook is still assailed by political risks (Brexit negotiations and elections in the Netherlands, France, Germany and Italy). Adding to this domestic uncertainty are risks stemming from the US (uncertainty regarding the fiscal stimulus announced by the Trump administration, possible changes in trade policy and the Fed's monetary policy normalisation). Nevertheless, the euro area's recovery could gain further momentum if such risks dissipate.

The economic recovery has spread to a larger number of countries. Eurostat confirmed euro area Q4 GDP growth at 0.4% quarter-on-quarter, the same rate as in the previous quarter. GDP growth for the whole of 2016 stood at 1.7%. Across countries, strong growth was posted by Spain (0.7% quarter-on-quarter, the same rate as in Q3), and Portugal (0.6%, 0.5 pps above the Q1-Q3 average). Q4 GDP growth in France and Germany was 0.4% quarter-on-quarter, 0.2 and 0.3 pps above the figure from the previous quarter, respectively. On the other hand, Italy posted weak GDP growth (0.2% quarter-on-quarter). Over the coming quarters, we expect euro area growth to maintain a similar rate of growth, of between 0.4% and 0.5% quarter-on-quarter.

Emerging Europe is still growing, albeit unevenly. Q4 GDP data show that growth in Emerging Europe remained strong, and at a higher pace than in Q3 in most cases. Across countries, Romania and Slovakia continued to stand out with growth rates above 4.5% and 3.0% year-on-year, respectively. On the other hand, Poland's GDP growth surprised to the upside (3.1% year-on-year vs. 2.1% in Q3), while Hungary and the Czech Republic disappointed with lower than expected growth. In 2017, GDP growth for the majority of these countries is expected to be around 3%, given the euro area economic performance (their main market) and a more dynamic domestic demand.

Euro area activity remains strong in Q1, as shown by the composite PMI index, which in February remained comfortably in the expansionary zone (above 50 points) and rose to 56 points, the highest level since April 2011, while the economic sentiment index (ESI) edged up to 108 points. Across countries, France's composite PMI increased the most and stood at 56.2 points (54.1 in January), while in Germany it reached 56.1 points (54.8 in the previous month) for the first

Euro area: European Commission GDP forecasts

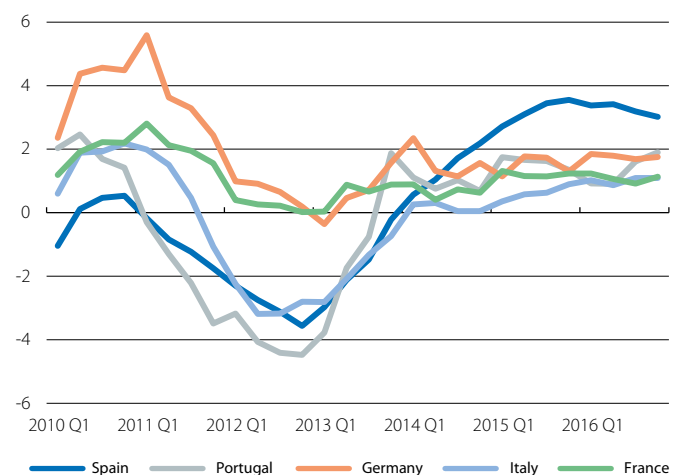
Annual change (%)

	2016	Forecast		Change regarding autumn 2016 forecast	
		2017	2018	2017	2018
Euro area	1.7	1.6	1.8	▲ 0.1	▲ 0.1
Germany	1.9	1.6	1.8	▲ 0.1	▲ 0.1
France	1.2	1.4	1.7	=	=
Italy	0.9	0.9	1.1	=	▲ 0.1
Spain	3.2	2.3	2.1	=	=
Portugal	1.3	1.6	1.5	▲ 0.4	▲ 0.1

Source: CaixaBank Research, based on data from the European Commission (European Economic Forecast, Winter 2017).

GDP

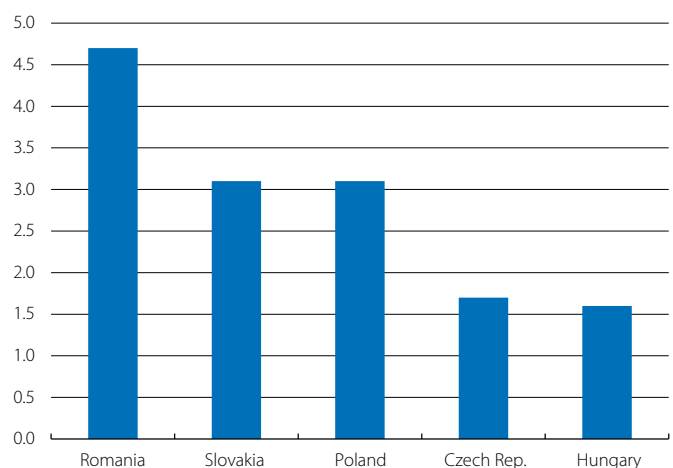
Year-on-year change (%)



Source: CaixaBank Research, based on data from Thomson Reuters Datastream.

Emerging Europe: GDP in 2016 Q4

Year-on-year change (%)



Source: CaixaBank Research, based on Eurostat data.

time since 2014, and the IFO business sentiment indicator stood again at the highest level of the past three years. These figures point to a slight acceleration in the euro area in 2017 Q1.

Private consumption continues to drive the recovery. Retail sales were up 1.4% year-on-year in December and the 2016 Q4 average stood at 2.3% year-on-year, above the Q3 figure (1.5%). Therefore, private consumption remains one of the main drivers of the economic recovery in the euro area. On the other hand, the consumer confidence index for the euro area as a whole stood at -6.2 points, slightly below January's figure (-4.9) but far above the 2016 average (-7.7). Over the coming months, household consumption is expected to remain robust, supported by the improvements in the labour market and low interest rates, which should help to push up core inflation.

Inflation in the euro area strengthens. Eurostat confirmed that euro area headline inflation, as measured by the harmonized index of consumer prices (HICP), was 1.8% in January, 0.7 pps above December's figure, owing to a larger contribution from the energy component and unprocessed food. On the other hand, core inflation was confirmed at 0.9% in January. Over the coming months, we expect headline inflation to continue to recover as oil prices increase, and core inflation to rise along with the growth in activity and the improvements in the labour market. In this respect, the recovery in inflation expectations since mid-2016 is particularly encouraging and reflects the considerably lower risk of deflation in the euro area.

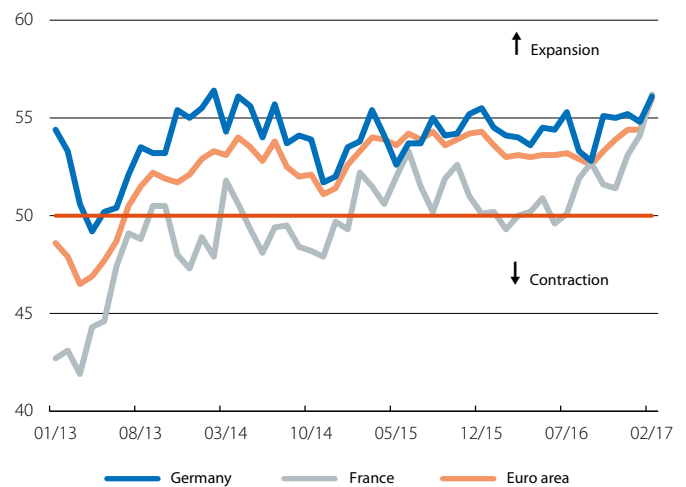
Euro area current account surplus reached an all-time high. The euro area's current account surplus (cumulative over 12 months) totalled 364.7 billion euros in December, or some 3.4% of GDP, and above the 319.4 billion euros recorded in December 2015. This increase is mostly due to a larger surplus in the balance of goods (372.2 billion euros, or 3.5% of GDP), driven by the depreciation of the euro. Over the coming quarters, we expect the external surplus to gradually shrink with the euro area's continued recovery and higher oil prices.

Greece's recovery continues to stutter and the bailout saga begins a new chapter. The Greek economy returned to growth in 2016 after the decline of 2015. However, growth remained weak, at 0.3% year-on-year, and GDP is still 26% below its pre-crisis level. On the other hand, an agreement on the next bailout loan tranche is yet to be reached. Nevertheless, the different institutions involved (European Commission, ECB, IMF and ESM) have decided to return to Athens to negotiate an additional package of structural reforms, focusing on improving the tax system, labour market regulation and the pension system. In this respect, the effective implementation of any of the reforms agreed will be key to boosting Greece's economic growth and ensuring the sustainability of its public debt.

Portugal's outlook improves. The Portuguese economy in Q4 2016 grew faster than most analysts expected (2.0% year-on-

Euro area: PMI composite activity indicator

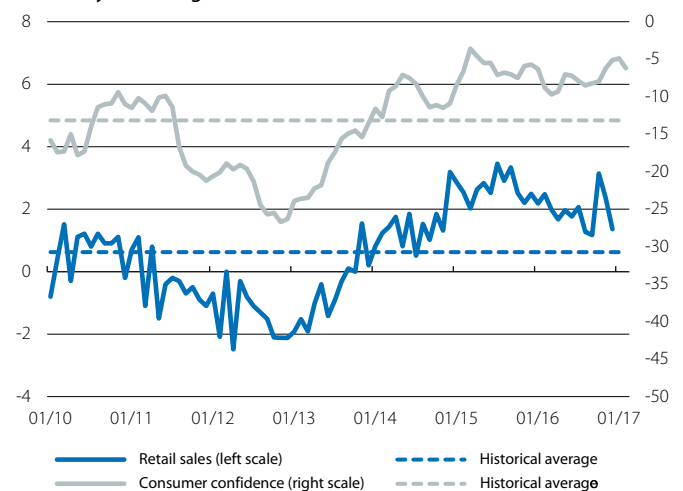
Level



Source: CaixaBank Research, based on data from Markit.

Euro area: consumption indicators

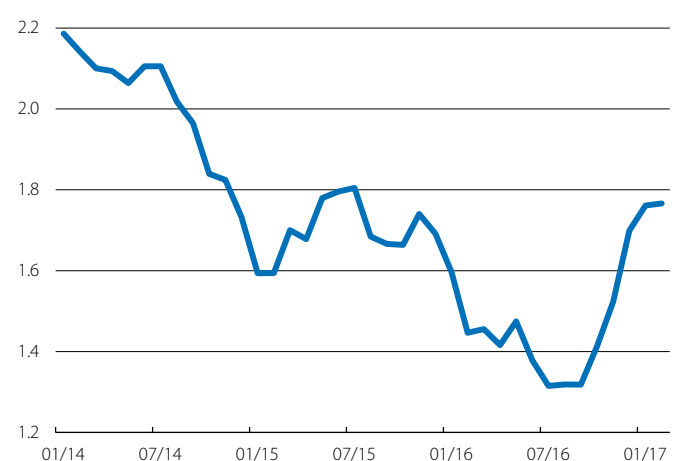
Year-on-year change (%)



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

Inflation expectations: euro area *

(%)



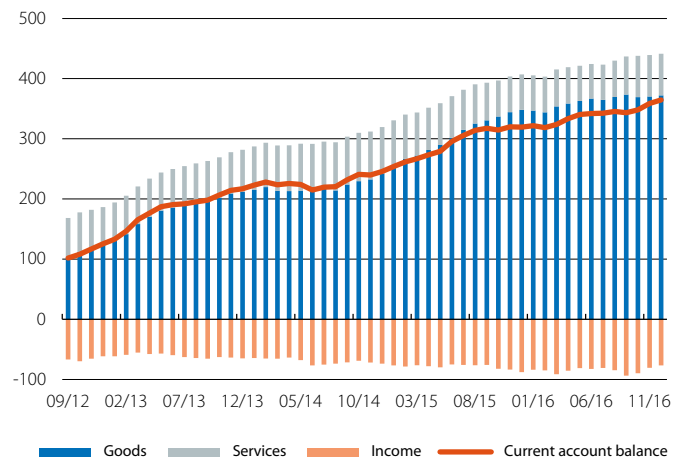
Note: * Inflation Swap Forward 5Y5Y.

Source: CaixaBank Research, based on data from Bloomberg.

year, vis-à-vis the 1.6% forecast), supported by a more dynamic domestic demand, especially investment, and by exports. Growth in 2016 stood at 1.4% year-on-year. Over the coming quarters, the economy is expected to continue to grow at a similar pace. This is reflected in the consensus forecast for 2017 (1.5%) and 2018 (1.4%), in line with the CaixaBank Research forecast. Nevertheless, Portugal's debt financing costs remain high. On the one hand, this is due to investor concerns regarding the country's banking sector and public finances. Adding to these idiosyncratic risks is the political uncertainty that is currently assailing the euro area, although we expect this uncertainty to dissipate over the year. Regarding the Portuguese banks, considerable progress has been made over the past few months to dispel the uncertainty hovering over the sector, which should help to push down the risk premium. Regarding public finances, the 2016 fiscal deficit looks set to be below 3% of GDP, which should allow Portugal to exit the Excessive Deficit Procedure with the European Commission. In fact, the Commission has already downgraded its public deficit forecast for 2016 from 2.7% of GDP to 2.3%. Nevertheless, public debt remains high, at around 130% of GDP, so Portugal cannot let its guard down.

Euro area: current account

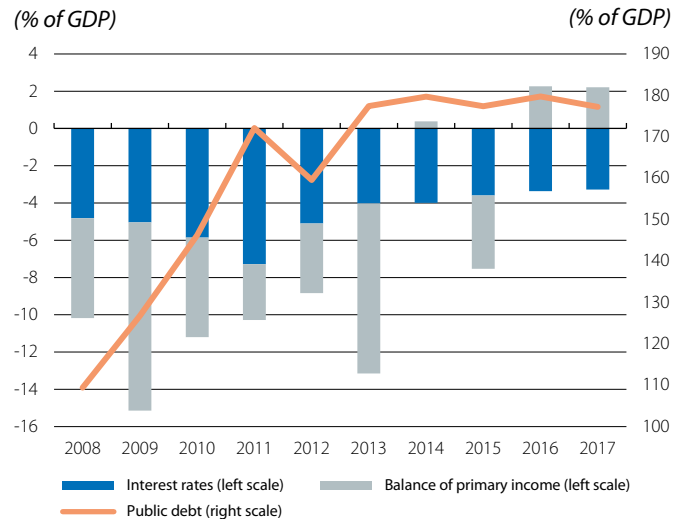
Cumulative over 12 months (billion euros)



Note: Series seasonally adjusted.

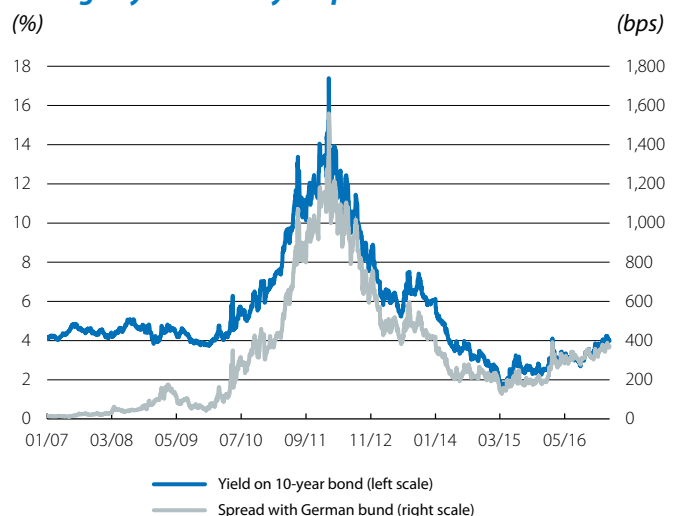
Source: CaixaBank Research, based on data from the ECB.

Greece: balance of primary income, interest rates and public debt



Source: CaixaBank Research, based on data from AMECO.

Portugal: yield on 10-year public debt



Source: CaixaBank Research, based on data from Bloomberg.