CENTRE FOR EUROPEAN REFORM

Can the eurozone shake off the global gloom?

by Simon Tilford

The outlook for the global economy is worsening quickly, raising question marks over the eurozone's recovery. Will consumption and investment rise by enough to offset the likely weakening of eurozone exports, or will the recovery peter out? What does the deteriorating global environment mean for the ECB's attempts to raise inflation and to ward off threats to the debt sustainability across the eurozone? The currency union is at no risk of falling back into recession in 2016, but last year might turn out to have been as good as it's going to get.

The eurozone economy expanded by around 1.5 per cent in 2015, and hence by considerably less than the US or the UK. The weakness of eurozone activity was one reason why inflation across the currency bloc fell to zero. While economic recovery accelerated in some member-states, notably in Spain and Ireland, the French and Italian economies remained weak, and German growth disappointed yet again, coming in at 1.5 per cent. Had the eurozone rebounded from the downturn and then growth had slowed to 1.5 per cent, that level of growth would have been less disappointing. But the currency union has barely recovered pre-crisis levels of activity. Indeed it is a testament to diminishing expectations that the eurozone's 2015 growth performance is seen as something of a success. With interest rates at just 0.5 per cent, the fiscal position across the currency union as a whole neutral and big falls in the prices of oil and commodities boosting households' purchasing power, it is disappointing that growth was not stronger.

Will the recovery gain momentum or stall in 2016? On the plus side, the ECB will leave interest rates at close to zero and charge banks more to deposit funds with it, in an attempt to get them to increase their lending. In all likelihood, the ECB will also persist with quantitative easing – the practice of central banks electronically creating new money and buying financial assets, such as government bonds – in an attempt to boost economic activity and inflation. Fiscal policy across the eurozone as a whole is likely to be mildly expansionary, not least because of refugee related expenditure in Germany. Credit conditions for businesses have improved across the eurozone as a whole. And the further steep fall in oil and other commodity prices should provide an additional fillip to consumption, at least in the short term.

The biggest negative for the eurozone's growth outlook is the rapidly worsening external environment. First, all the major emerging markets bar India are slowing simultaneously, with the outlook for the pivotal Chinese economy highly uncertain. The best case scenario is that China manages the transition to slower growth without a major crisis. Just as likely, however, is that the Chinese economy buckles under the weight of massive debt and surplus industrial capacity, opening the way for a full-blown crisis. The IMF estimates that a 1 per cent fall in the growth of emerging markets will knock 0.2 per cent off growth in developed markets, and more for economies – such as Germany – that do a lot of trade with emerging economies. Second, slower growth in emerging markets, especially China, is a major factor behind the weakening of commodity prices which is hitting the Russian and Middle-Eastern economies hard. Finally, growth is falling back in the US and the UK. Altogether, this points to a slowdown in the pace of global expansion and a weakening of trade.

Eurozone policy-makers had been banking on a weak euro driving demand for the currency bloc's exports and boosting eurozone inflation by increasing the prices of imported goods. But with the likelihood of interest rate rises in the US and UK receding quickly (and with it the incentive for investors to buy dollars and pounds) and the Chinese almost certain to devalue the renminbi, there is little probability of the euro weakening much further. In all likelihood, foreign trade will subtract – perhaps substantially – from eurozone growth in 2016. And with Chinese and other emerging economy goods getting cheaper, and oil and commodity prices falling, the currency union will be importing deflation rather than exporting it.

This risks aggravating the other big negative facing the eurozone: low inflation. Rapidly declining inflation gives a one-off boost to consumption, but poses a raft of economic challenges. The longer inflation remains very low, the greater the risk that firms hold off on investment (in the expectation that investment will get cheaper) and that firms stop raising wages. Low inflation also aggravates debt sustainability problems: countries need some inflation in order to erode the real value of their debts. The fall in the headline rate of eurozone inflation in 2016 reflected falling commodity prices. But 'core' inflation – which excludes movements in the prices of energy and raw materials – also remained very weak, hovering around 1 per cent and hence far short of the ECB's target of close to 2 per cent. And with producer prices (so-called 'factory gate' prices) declining rapidly and average eurozone wage settlements falling back in line with the declining headline rate of inflation, there is little reason to expect a rise in the core measure of price increases.

Domestic demand in the eurozone did pick up in 2015, with the result that economic growth was largely driven by domestic sources; by contrast, exports accounted for all the growth in the eurozone economy in the 2009-14 period. The question is whether domestic demand will strengthen by enough in 2016 to offset the slowing of exports and the weakness of import prices. For that to happen, private consumption will need to pick up further. In all likelihood, employment levels will continue to recover. Average wages should grow in real terms in 2016, but by less than last year as low inflation expectations bring down wage settlements. As a result, private consumption is likely to expand by around 1.5 per cent, assuming a global crisis does not spook eurozone consumers into saving more.

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The outlook for investment is more uncertain. A sustained recovery in the eurozone economy requires investment spending to recover ground (it is still around 15 per cent below 2007 levels), as only that will lift productivity growth and support higher wages. Business investment across the eurozone did pick up slightly in 2015, but not by enough to make a significant contribution to economic growth. The gradually improving eurozone labour market, moderate pick-up in consumption and improved bank credit conditions should encourage some firms to step up investment. But the worsening external environment will hit business confidence, as will the steep decline in share prices; January 2016 was the worst start to a year for European equities since 1973. Very weak inflation expectations could also cause firms to delay investment. Eurozone governments, meanwhile, are not going to embark on a public investment spree.

The global economy has shifted from being the potential saviour of the eurozone economy to an additional source of uncertainty for it. 2016 will determine whether the currency union's recovery has legs or whether it peters out. The risk is on the downside.

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