Schroders

Economics

TalkingEconomics: Europe forecast update - higher inflation to dampen growth

We have revised our eurozone growth expectations down slightly for 2017 but raised our forecast for 2018.

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Schroders Economics Team

In the UK, the Bank of England (BoE) is likely to remain on hold now given better growth, but the government has missed a great opportunity to boost public investment and long-term productivity growth.

We expect the European Central Bank (ECB) to resist calls to halt its stimulatory support and maintain its accommodative stance.

Our forecast for eurozone growth has been revised up slightly for 2016 from 1.5% to 1.6%. The 2017 forecast has been revised down to 1.2% as inflation is due to rise temporarily, from an annual average of 0.2% in 2016 to 1.3% (previously 1%) in 2017. We anticipate that growth will rise to around 1.8% in 2018, aided by looser fiscal policy, and stronger growth in the US, which should boost net exports.

ECB will have to defend its policy

We expect the ECB to hold firm in the face of rising pressure to scale back its stimuli programmes as inflation rises in the coming months. We anticipate that the deposit rate will be cut further to -0.5%, and that the authorities will extend QE for a further six months, with purchases tapering from Q4 2017 at the rate of €10 billion per month.

To extend the programme any further will be difficult but if it does, the ECB may have to look at its bond buying rules. A simple change in the share of issuance limits would help, or a move to buy equities (through exchange-traded funds) could also work, although the latter would be controversial.

UK forecast: counting the cost of Brexit

We have revised the UK growth forecast upwards for 2016 from 1.7% to 2.1%, and from 0.6% to 1.4% for 2017. Annual inflation is forecast to rise from 0.8% in 2016 to 2.9% in 2017, before easing back to 1.9% in 2018. The BoE is likely to remain on hold with regards to interest rates and QE for the foreseeable future.

Fiscal fumble: more slippage than a reset of policy

While the new UK chancellor has acknowledged Brexit's negative economic impact, he has decided to continue to tighten fiscal policy, which may prove to be a hawkish mistake in years to come.

He has a very rare opportunity to provide badly needed investment in public infrastructure at close to zero interest rates, yet his cautious approach means the additional spending announced barely moves the dial.

The government has missed a great opportunity to use its balance sheet to boost investment and long-term productivity.