



The investment spending recovery is losing momentum and turning volatile. Financing conditions should remain supportive – most visible to date in construction spending – but sluggish export demand and geopolitical risks will likely weigh. The euro area labour market has improved more rapidly than the historic Okun coefficient would have implied. This is consistent with weaker post-crisis productivity. Limited prospective returns may be dampening the investment recovery. The Juncker investment plan (European Fund for Strategic Investments or EFSI) will help to lean against this trend.

Sovereign QE began in early 2015. The principal transmission channel was a weaker exchange rate but the benefits were squeezed by the 7% appreciation of the euro trade-weighted index between March and September, reversing half the decline that preceded QE. This knocks 0.1% off 2016 GDP growth. There are also domestic transmission channels for QE. Real economy credit conditions have improved to pre-crisis levels. The average interest rate on bank loans to the non-financial corporate sector has fallen 80bp from the peak. Lower interest rates supported asset prices and 2015 saw collateral values play a role in easing lending standards for the first time since 2007.

Policy stance to benefit from joint monetary/fiscal policy push
 Financial conditions remain close to the easiest levels of the cycle even after the miscommunication ahead of the December ECB meeting that left the market disappointed with the outcome. What the ECB announced was nevertheless close to our original expectations. We have not changed the FX assumption underlying our economic forecasts that the euro falls by 5% in trade-weighted terms between 2015 and 2016.

The ECB appears confident its unconventional policies are working, for example, through the bank lending channel. There are challenges, however. First, it may prove difficult to accelerate the credit impulse in 2016. The credit impulse is based on the second derivative of bank credit. The credit impulse improved in 2015 from the transition from deleveraging to credit expansion; for some large countries like Spain, there was only a slower pace of deleveraging. Maintaining the credit impulse at the same level in 2016 requires lending to accelerate. With high debt ratios in several countries, this will be challenging, not least in Spain. Second, the ECB is concerned about the high level of NPLs and the slow pace of dealing with them. The flattening in the rate of GDP growth could raise banks' caution. The flattening yield curve will also reduce banks' incentive to lend.

The euro area benefited more from a combined monetary/fiscal stimulus in 2015 than had been anticipated with the fiscal stance supportive of economic growth for the first time since 2010. This should continue in 2016. The bottom-up aggregation for the fiscal stance looks no stronger than 2015 but is probably an underestimate (e.g., higher refugee and security-related public spending).

We do not believe the joint policy push will persist. We are concerned that the Commission's flexibility on the fiscal rules will reverse. Our early warning indicator of fiscal crisis risk is below the levels it reached for the peripherals in 2009-2010. A moderate slippage in fiscal performance over the next year won't change this assessment; the fiscal risk sub-index should be no worse in 2016 than in 2014. Our concern is more that idiosyncratic national political risks materialise and amplify market concerns, for example, in Portugal (see below).

End 2016 could see the first ECB tapering discussion
 If growth and inflation perform in line with our baseline forecasts, the measures announced by the ECB on 3 December ought to be the last major

Figure 5: Unexpected 2015 euro appreciation dampens 2016 GDP growth



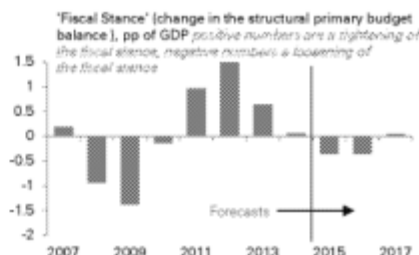
Source: Deutsche Bank Research, ECB

Figure 6: Financial conditions are easy



Source: Deutsche Bank Research, Bloomberg Finance LP, Haver Analytics LP

Figure 7: Bottom-up fiscal stance estimates underestimating extent of fiscal easing in 2016



Source: Deutsche Bank Research, European Commission