



easing moves of the cycle. The outlook for economic recovery is not strong, but modestly above-trend economic growth means a gradual narrowing of the output gap and hence a gradual normalisation of core inflation. We expect that roughly a year from now the ECB will have to think about whether to extend QE again or to taper in 2017. It may be slightly more marginal after what happened on 3 December, but the balance of probabilities suggests that a tapering discussion is likely to take place.

On current expectations, core inflation will have risen to within a couple of tenths of its historical average in H2 2016 and will be on course for a further correction upwards in 2017 and 2018. The ECB has tended to announce new unconventional policy measures when the two-year ahead consensus headline inflation forecast is 1.6% or lower and tighten policy when it is 1.9% or higher. If our forecasts for core and non-core inflation are correct – in particular our expectation for rise in oil prices in 2017 – headline inflation ought to satisfy the criterion for tightening policy.

Mario Draghi is likely to be cautious. A sustainable correction in inflation is the objective – this means more than just reaching the inflation target for one year. The ECB will be nervous of creating its own 'taper tantrum'. We expect the ECB to taper its QE purchases, meaning that purchases will continue after the current scheduled end date of March 2017 at a declining rate. A decision to taper is the first step towards exit and that is likely to result in a euro fixed income market correction/normalisation later in 2016, tightening financial conditions. We see the first ECB policy rate hike only at the end of 2018.

The risk is that oil prices continue to decline in the near term and weigh on headline inflation. If this weakens medium-term inflation expectations, the late-2016 tapering risk will dissipate and the pressure for further ECB easing will grow.

Political risks to rise into 2017

In Spain we think the tail risk of a radical party having a position of influence within the new government is low. Beyond that, however, the euro area is dotted with potential risks. Portugal's minority Socialist government looks unlikely to survive a major test, particularly if it requires more austerity and reform. The Catalan independence bid is a source of uncertainty. Ireland's outgoing coalition has a tailwind from strong GDP growth but is short of majority on current polls. Italy is the peripheral with the largest proportion of votes going to eurosceptic and populist parties. The risk is that the 2018 Italian election is brought forward one year. Opinion polls leave the UK referendum on EU membership – possibly in late 2016 – too close to call for now.

The greatest political tests for Europe next year come from the refugee and terror crises. The conservative backlash in Germany against Merkel's initial welcoming is very gradually narrowing differences across countries on how best to address the refugee wave. The new terror dimension to the refugee crisis we believe will more likely than not lead Europe to a more unified stance. Germany may be more willing to compromise on otherwise more divisive issues like Greece debt and fiscal easing to secure a better deal for refugees, for example, or more funds to deal with the crisis 'at source'.

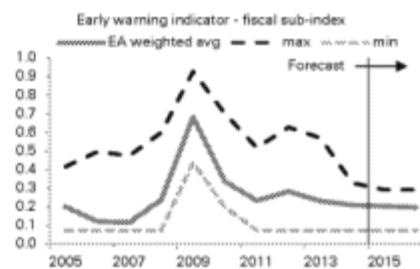
However, we do not expect any real progress on euro area integration – greater fiscal autonomy as a compromise for Catalonia would be the opposite of what a stronger euro area requires – nor do we expect the unified stance to last into 2017. The closer we get to the German, French and Dutch elections in 2017, the more disharmonious Europe is likely to sound. Political uncertainty will likely be another hurdle to growth in 2017 while elections create reasons for further delays to structural reforms.

Figure 8: Balance of probabilities points to initial ECB tapering discussion in late 2016



Source: Deutsche Bank Research, ECB

Figure 9: Fiscal risk get more worse in 2016; it is political risk we need to focus on



0.0 indicates none of the components are above the crisis threshold level, 1.0 indicates all are above the crisis threshold level
Source: Deutsche Bank Research

Figure 10: Other indicators & financial forecasts: Euro area

	2014	2015F	2016F	2017F
GDP growth, % yoy eop	3.7	4.7	5.5	5.2
Fiscal balance, % of GDP	-2.6	-2.2	-2.0	-1.6
Public debt, % of GDP	94.5	94.6	94.0	92.8
Trade balance, EUR bn	241.8	308.0	295.8	256.3
Trade balance, % of GDP	2.4	3.2	2.8	2.3
Current account, EUR bn	245.6	308.0	290.8	251.3
Current account, % of GDP	2.4	3.0	2.7	2.3
Financial forecasts				
Official	0.05	0.05	0.05	0.05
3M rate	-0.11	-0.15	-0.15	-0.15
10Y yield	0.69	0.65	0.60	1.10
USD per EUR	1.09	1.01	0.97	0.90
JPY per EUR	134	128	124	115
GBP per EUR	0.72	0.71	0.71	0.71

Source: National authorities, Deutsche Bank Research, as of December 07