

**Overview:** In this week's showCASE, our experts discuss the implications that could emerge from the United States' recent withdrawal from the Trans-Pacific Partnership. CASE also shares its opinion on how the recent increase in euro area inflation could shape monetary policy moving forward.

## Inflation is growing in the Euro area, as is the need for patience

By: [Paul Lirette](#)

With a recent increase in inflation and economic growth outpacing the United States for the first time since the global financial crisis, it would appear that the euro area economy is finally beginning to gain momentum. However, the diversity amongst the economies that form the monetary union is mirrored in the opinions on what policy should be pursued next. On January 31, the European Union's statistical office released its monthly euro area flash inflation expectations, forecasting annual headline inflation growth to rise to 1.8% in January 2017 from 1.1% in December 2016. Energy was reported as the main component driving the price level increase, while core inflation remained unchanged at 0.9% for the same period.

Euro area GDP growth also appears to be strengthening, [with a fourth quarter pickup](#), putting overall 2016 growth at 1.7%, just 1 p.p. higher than that of the United States for the same time frame.

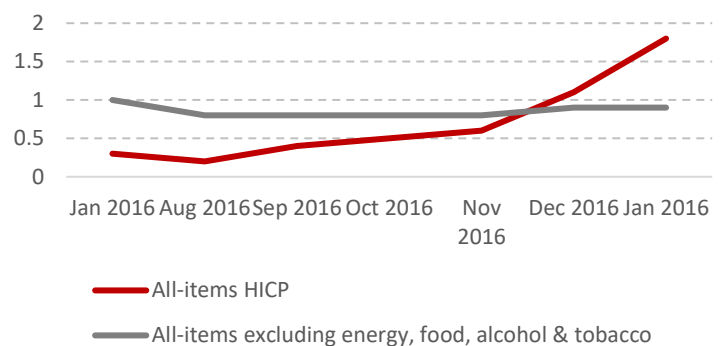
Hawkish observers, such as leading [German economists](#), advocate that inflation approaching the ECB's target has set the stage [for the European Central Bank to begin lifting interest rates](#) and to [discontinue its bond purchasing program](#) (recently extended until December 2017). This type of response seems natural for a current account surplus economy, such as Germany, given that negative interest rates and increasing inflation entails negative implications for its savers.

Other critics appear more sceptical of the durability of the euro area's newfound swagger. For instance, Bank of Italy Governor and ECB Council member, Ignazio Visco, cautions that a premature tightening of monetary policy could result in [unwanted deflation and increased price volatility](#). If such a policy materialized, this turmoil would also carry overall negative implications for the real economy, prolonging the euro area's economic recovery from past crises.

For now, it appears that the sluggish growth in core inflation will keep interest rates low in the euro area. ECB President Mario Draghi recently indicated that he is not convinced [the pickup in inflation is nothing more than transitory](#) and that monetary policy should remain accommodative until price developments are sustained. Indeed, whether or not non-core inflationary pressures will persist remains a topic of debate, with a [crude production glut growing in the US](#) balancing against [OPEC's pact to cut output](#) and a [weaker US dollar](#).

Nonetheless, keeping interest rates low for prolonged periods of time can impose damaging distortions on the real economy (by encouraging risky asset purchases and inflating housing bubbles). Further, with improving measures of [consumer and business sentiment in the US](#), the US Federal Reserve could normalize its monetary policy further in 2017. This divergence in monetary policy could weigh further on the euro-dollar exchange rate. Whether or not the ECB will hint that they plan to follow suit remains to be seen in the upcoming Governing Council meeting on February 9.

Euro area annual inflation and its components (%)



Source: Eurostat Flash estimate - January 2017

## The United States: TPP's weakest link?

By: [Katarzyna Mirecka](#)

On January 23rd, Donald Trump, the new President of the United States delivered on one of his key electoral promises by ordering the withdrawal of the US from the Trans-Pacific Partnership (TPP).

First signed in February 2016 by 12 countries<sup>1</sup>, the deal needs to be ratified by national parliaments in order to enter into effect. This ratification seemed to be certain until the election victory of Donald Trump, a vocal critic of global trade deals and trade in general.

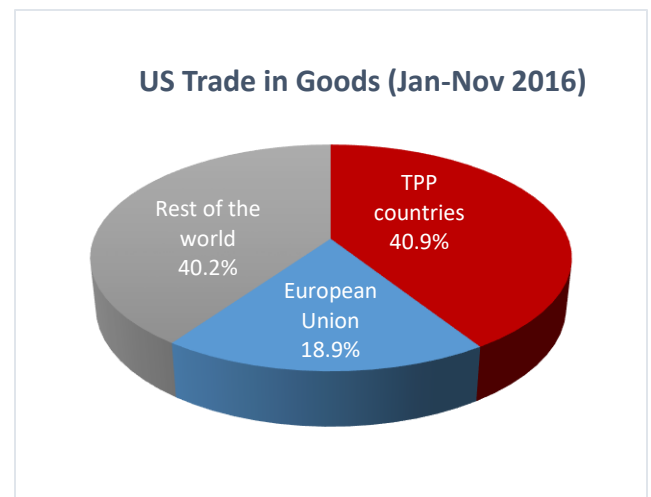
TPP was set to be the largest regional trade accord in history, gathering a dozen countries into a partnership that together represents [40% of the world's GDP](#), with hopes of eventually becoming a single market. [The most important aims](#) of the deal were to lower or remove tariff and non-tariff barriers on goods (which would have boosted American exports), as well as raise labour standards, ensure investor protection, and improve intellectual property rights. However, Trump has been declaring for months that this deal would lead to an outflow of jobs from the US to lower-wage countries.

Washington's abandonment of the agreement has resulted in protests from other signatories, leaving the future of the deal unknown. However, it appears that Pacific Rim countries are motivated to keep it alive, but under a different form – without the United States. As the deal was drafted in a way that allows other Asian nations to join further down the road, names of potential new partners, like [South Korea or China](#), are already being mentioned by representatives of the remaining countries.

Trump's move appears like a gift for China, who is currently absent from the signatories list. TPP was intended to harmonize regulatory and technological standards in all 12 countries and for Barack Obama, who initially signed the agreement, TPP was meant to signal a „pivot to Asia.“ Such a move would also have strengthened the position of the US on the continent. But now, the floor has been ceded to Beijing.

Paradoxically, the objection to TPP was the common denominator between Trump and his opponents, [Clinton and Sanders](#), who opposed it as well. Its rejection has also been welcomed by anti-trade groups such as unions, who have been [protesting](#) the agreement since its inception. The most common [objections](#) claimed in the US were that TPP would lead to domestic job losses, as firms moved manufacturing to low-wage countries. Some even argued that TPP would lead to an increase in prices for pharmaceuticals, especially in poor countries, by enforcing American patent standards.

Trump's biggest election promise was to “Make America Great Again”. However, the President's introduction of numerous protectionist measures, not only dismissing TPP but also notable moves on immigration, seems to be pushing the US into isolationism. This push is, ironically, likely to do little that is positive for America's economy and could instead lead to a loss of economic and geopolitical power.



Source: U.S. Census

<sup>1</sup> Japan, Malaysia, Vietnam, Singapore, Brunei, Australia, New Zealand, Canada, Mexico, Chile and Peru.

## At a glance



According to flash GDP growth estimates, published on January 31, the Polish economy grew by 2.8 % y-o-y in 2016. While private consumption increased by 3.6% for the same period, investment activity remained more subdued (-5.5%). Moreover, in contrast to the government's plan, VAT compliance declined in 2016. According to flash estimates of VAT revenue published last week by the Ministry of Finance, 2016 VAT compliance declined by 0.2% y-o-y. Increased social spending and poorer than expected tax compliance together resulted in a 46.3 bln PLN general government deficit in 2016. While the economy will likely maintain its pace of growth in 2017, high deficit levels caused by inflated social spending could likely lead to deficits exceeding the EU's three percent threshold, which, together with increasing policy uncertainty, may hamper future GDP growth.

↑ General government deficit increased to 46.3 bln PLN.

Real GDP forecast (%)	2017	2018
CASE	2.9	2.9
IMF WEO	3.4	3.3
OECD	3.2	3.1



Recent OECD forecasts show that, following two years of recession, the Russian economy is expected to return to growth in 2017. Russia's statistics service surprised economists by finding gross domestic product (GDP) contracted by only 0.2 percent in 2016. According to World Bank specialists, the essential part of Russia's return to sustainable and inclusive economic growth is investment in human capital and services, as well as increased productivity. Russian GDP contracted by 0.4% y-o-y in Q3 2016, the smallest contraction in 7 quarters. Russia's recent growth turnaround, according to Rosstat, is mainly due to high net export levels. Further, inflation continues to decrease, reaching 5.4% in December 2016 (its lowest rate since June 2012).

■ CBR key rate % unchanged at 10%

Real GDP forecast (%)	2017	2018
IMF WEO	1.1	1.2
OECD	0.8	1.0



The German economy retains a positive outlook for 2017, driven by a dynamic labour market and strong domestic demand (supported by rising household incomes). This week, attention has shifted to Germany's rising inflation (HICP prelim. y-o-y: 1.9% for January) and concerns regarding the country's banking sector. Across German regions, January's (prelim. y-o-y) inflation estimates ranged from 1.7% for Bavaria and Brandenburg to 2.4% for Hesse. However, rising price levels appear to be largely driven by increasing energy prices and packaged holiday costs. Worries about the country's banking sector have returned following Deutsche Bank's 1.9bn net loss over Q4 2016. Nevertheless, the latest [financial stability report](#) of the Bundesbank highlights that, despite a high degree of banking sector fragmentation, low interest rate pressures could be mitigated by Germany's "hidden and open reserves", which amounted to €119bn at the end of 2014.

↑ Jan. Manuf. PMI (prelim) up to 56.5 from 55.6 in Dec.

↓ Jan. Services PMI (prelim) index down to 53.2 from 54.3 in Dec.

Real GDP forecast (%)	2017	2018
IMF WEO	1.4	1.4
OECD	1.7	1.7

## At a glance



According to data published by the Ukrainian Central Bank, in 2016, exports of goods decreased by 5.2% to USD 33.6 billion, while imports of goods increased by 3.8% to USD 40.4 billion. As a result, the country's current account deficit rose to USD 3.4 billion. The Central Bank Board has announced that it will not change its key policy rate, which is currently at 14%, in a continued attempt to mitigate inflation. So far, headline inflation decelerated from 43.3% in 2015 to 12.4% in 2016. This was possible thanks to a high supply of raw foods, the government's effort to keep the fiscal deficit in check, and limited volatility of the hryvnia's exchange rate. Revised macroeconomic data for Q3 2016 released in December revealed a 2.0% real growth rate (y-o-y). Investments were the key driver of growth in the reference period, with gross fixed capital formation reaching 25% y-o-y.

↑ Current account deficit increases to USD 3.4 billion

Real GDP forecast (%)	2017	2018
IMF WEO	2.5	3.0
OECD	-	-



The Czech National Bank (CNB) upgraded both its forecast for real GDP growth for 2017 (from 2.5% to 2.6%) and its estimate for real GDP growth in 2016 (from 2.4% to 2.5%). Forecasts for 2018 remain unchanged, with an expected increase of 2.4%. The CNB has also confirmed that its interest rate will remain unchanged and reconfirmed its commitment to maintaining a fixed lower limit on the CZK/EUR exchange rate – a policy introduced in 2013 – at least until Q2 2017. Meanwhile, a new inflation forecast was released. The annual consumer price inflation is now expected to stand at 2.5% for Q1 2018 (up from 2.4%) and 2.3% for Q2 2018. In other news, the Czech government expressed interest in boosting economic ties with Iran. Banking and trade were two sectors mentioned during a meeting of Czech and Iranian delegations in Prague earlier this week.

↑ January manufacturing PMI climbs to 55.7 in January, up from 53.8 in December

Real GDP forecast (%)	2017	2018
IMF WEO	2.7	2.4
OECD	2.5	2.6

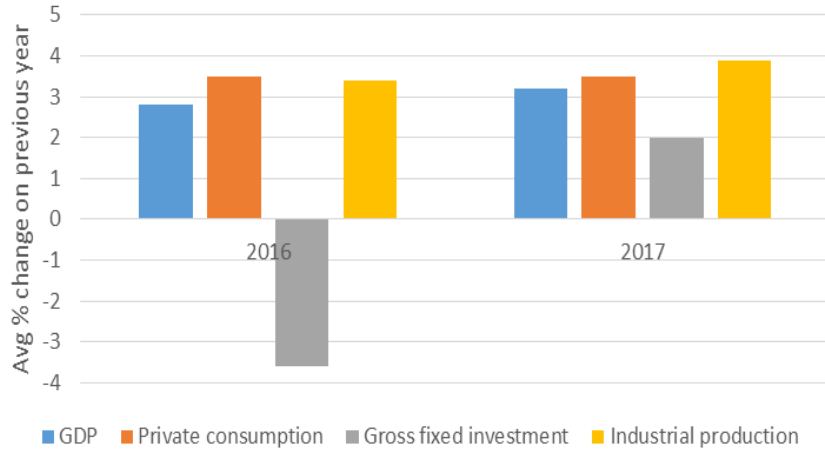


The Hungarian Central Statistical Office reports that the country's rolling average three-month jobless rate reached 4.4% in October-December, dropping from 4.5% in the previous period and 6.2% in the same period a year earlier. The National Bank of Hungary continues to hold its base rate unchanged at 0.9% and have signaled that they intend to keep the base rate on hold for "an extended period", indicating that they remain prepared to ease monetary conditions with unconventional instruments if necessary. The Hungarian economy is expected continue low but steady growth in 2017, estimated by both the IMF and OECD to be 2.5%. The main drivers of growth are expected to be EU structural funding, declining government debt burdens and waning external vulnerabilities.

↓ October-December rolling average unemployment drops to 4.4% from 4.5% in previous period

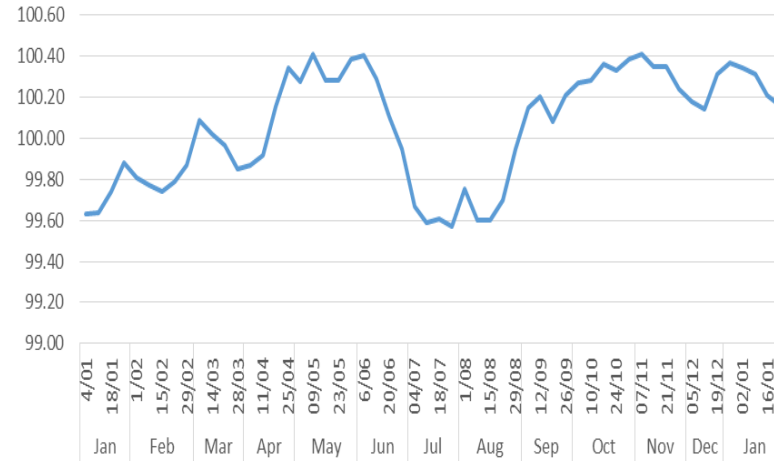
Real GDP forecast (%)	2017	2018
IMF WEO	2.5	2.4
OECD	2.5	2.2

### Polish Economy: CASE forecasts



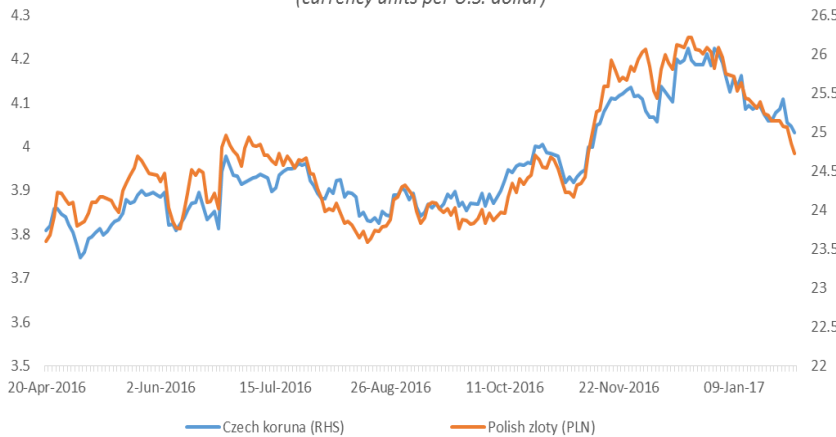
Source: CASE forecasts, forecast updated December 23, 2016

### Polish Online CPI



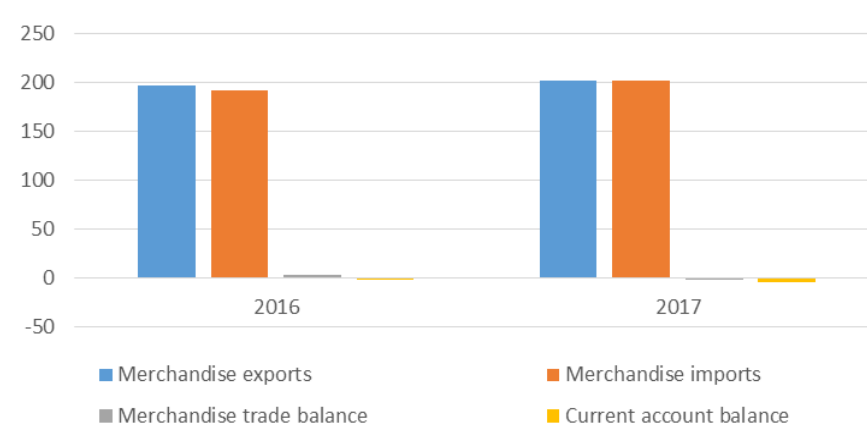
Source: CASE, most recent observation January 16, 2017

### Czech koruna and Polish zloty (currency units per U.S. dollar)



Source: IMF, most recent observation February 2, 2017

### Polish Trade: CASE forecasts US\$bn - annual total



Source: CASE forecasts, forecast updated December 23, 2016

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