EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 AND 2018

Winter 2016/17

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Schuman Centre at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/Projects/EFN/Home.aspx.

Participating Institutions:

European University Institute, Robert Schuman Centre for Advanced Studies (*Coordinator*)
Team Leader: Massimiliano Marcellino (massimiliano.marcellino@eui.eu)

Centre d´Etudes Prospectives et d´Informations Internationales (CEPII)
Team Leader: Lionel Fontagné (fontagne@cepii.fr)

University of Birmingham, Department of Economics
Team Leader: Anindya Banerjee (a.banerjee@bham.ac.uk)

The Halle Institute for Economic Research (IWH)
Team Leader: Axel Lindner (Axel.Lindner@iwh-halle.de)

Universitat de Barcelona, Anàlisi Quantitativa Regional (AQR-IREA)
Team Leader: Jordi Suriñach (jsurinach@ub.edu)

Universidad Carlos III, Instituto Flores de Lemus (IFL)
Team Leader: Antoni Espasa (espasa@est-econ.uc3m.es)

University of Cambridge, Faculty of Economics
Team Leader: Sean Holly (sean.holly@econ.cam.ac.uk)

Coordinator of the Report: Massimiliano Marcellino

Report closed on January 13th, 2017

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Highlights

- Global economic activity has revived since autumn, and equity markets have rallied at the end of the year. Apparently, some of the measures proposed during the US election campaign by the president elect, such as financial market deregulation, economic stimulus, tax cuts and infrastructure are expected to support the economy in the US and beyond. However, this stimulus bears considerable risks already for the near future: other economies could face considerable problems due to a further appreciation of the dollar, rising financing costs and the withdrawal of capital towards the US.
- In the euro area, as monetary policy continues its expansive course, financing costs will stay very low in 2017, and fiscal policy will be mildly expansive, although a bit less so than in 2016. Confidence of firms and private households has strengthened in recent months, as has the mood on financial markets. We expect that the recovery will continue at about the pace of 2016. GDP will, according to our forecast, increase by 1.6% in 2017 and by 1.7% in 2018.
- However, the crisis in the Italian banking sector has intensified. It might also trigger another crisis of confidence in European institutional arrangements: according to the Bank Recovery and Resolution Directive, banks may only be saved with public money if owners and creditors of these banks have contributed to the rescue. At present it seems doubtful whether it would be politically feasible to respect this rule.
- Regarding inflation, our forecast for 2017 is 1.2%. Although energy prices have risen significantly, price pressures are still low.

Table 1 Economic outlook for the Euro area

	2014	2015	2016	2017: 1st half		2017: annual		2018: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.2	2.0*	1.7	1.7	0.7 2.7	1.6	0.8 2.4	1.7	0.7 2.6
Potential Output	0.7	0.9	1.5	1.4	1.0 1.8	1.4	1.1 1.7	1.3	0.9 1.8
Private Consumption	0.8	1.8	1.7	1.4	0.6 2.3	1.4	0.7 2.1	1.4	0.6 2.2
Government Consumption	0.6	1.4	1.8	0.8	0.1 1.4	0.9	0.4 1.4	0.9	0.3 1.5
Fixed Capital Formation	1.4	3.2	2.8	3.5	1.0 6.2	3.1	0.6 5.5	4.0	1.4 6.6
Exports	4.5	6.5	2.4	4.5	2.3 6.6	3.8	1.8 5.7	4.8	2.8 6.8
Imports	4.9	6.4	3.0	4.7	2.7 6.8	3.9	2.2 5.6	5.4	3.4 7.3
Unemployment Rate	11.6	10.9	10.1	9.5	8.9 10.0	9.6	9.2 9.9	9.1	8.3 9.9
Labour Cost Index	1.3	1.6	1.3	2.4	1.9 3.0	2.2	1.8 2.6	2.3	1.7 2.9
Labour Productivity	0.6	0.9*	0.4	0.9	0.1 1.8	0.8	0.1 1.6	1.0	0.1 1.8
HICP	0.4	0.0	0.2	1.2	1.0 1.4	1.2	0.5 1.9	1.1	0.0 2.0

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

* In July 2016 Eurostat revised euro area growth for 2015 upwards, from 1.7% to 2.0%, because some big economic operators were relocated from countries outside the euro area to Ireland. As a consequence, parts of their sales and investments are now counted as Irish exports and gross capital formation. This pushes up labour productivity as well.

Economic Outlook for 2017 and 2018

The world economy: higher pace of growth for now, but increasing political risks

The British vote for leaving the EU and the victory of a declared opponent to free trade in the US presidential elections have the potential to damage international economic relations sooner or later. Nevertheless, global economic activity has revived in autumn: in the third quarter, production in the US has, for the first time for over a year, expanded by more than the trend rate of about 2%; Japanese production also accelerated, helped by strong exports. Chinese demand is growing, with a year-on-year- rate of 6.7%, according to the target set by the government, supported by public investment in infrastructure and strong private consumption. Higher prices for oil and other commodities stimulated the economy in Russia and in another commodity-exporting countries. Surprisingly robust is the British economy; in the first quarter after the Brexit decision, it grew by an annualized rate of 2%, which is about the long run trend rate. The euro area recovery continued. World trade in goods, having contracted in the first half of 2016, was stagnant in autumn.

At the turn of the year, equity markets have rallied. At the same time, the US dollar has appreciated markedly relative to most currencies (by about 6% relative to the Euro), and yields on fixed income securities have grown significantly, particularly, but not only in the US. Apparently, financial market deregulation, economic stimulus, tax cuts and infrastructure programs that have been proposed during the US election campaign are expected to support the economy and to boost inflation. The Federal Reserve Board increased key interest rates in December, and members of the Open Market Committee now think that three further interest rate steps upwards are likely for next year. Fiscal policy will support economic activity in 2017 not only in the US, but also in Japan, and the UK government has lowered its targets for fiscal consolidation in the coming years. In the euro area, fiscal policy will be expansive, but only slightly and less so than in 2016. The strongest stimulus comes from China, where publicly controlled firms with low financing costs will continue to invest heavily.

Thus, world production is likely to preserve the momentum picked up in the third quarter throughout this winter. In the further course of 2017, the effects of the real income gains from the 2014-15 oil price slump will be phasing out in the energy importing countries, which should cause the expansion of global demand to slow down a bit. Additional risks for the near future come from the intended fiscal stimulus in the US: other economies could face considerable problems due to a further appreciation of the dollar, rising financing costs and the withdrawal of capital towards the US. The strong political headwinds for trade are, of course, an additional risk factor for the near future, but it appears more probable that they will be a drag on the long term trend growth of the world economy.

The euro area recovery continues

Since summer 2013, the euro area economy has been growing by an annualized rate of a bit under 1.5%. The main drivers of this recovery are private and public consumption and, to a lesser extent, fixed investment, while net exports have been mostly declining since the second half of 2015. Geographically, the recovery is broad based: in the third quarter of 2016 production expanded in all member countries. The housing sector appears to strengthen in almost all economies since summer 2016, including France, where construction had been contracting for many years.

The only larger member state where the recovery does not appear to be robust is Italy: here, house prices are still sliding downwards, as is (during summer and autumn) construction. The Italian unemployment rate is the only high rate in the euro area that, at the end of 2016, is not markedly lower than at the beginning. Employment stagnated in autumn, although the number of hours worked still increased. In the euro area as a whole, a healthy increase in employment (by more than 1% per year) is a major factor supporting income and private consumption.

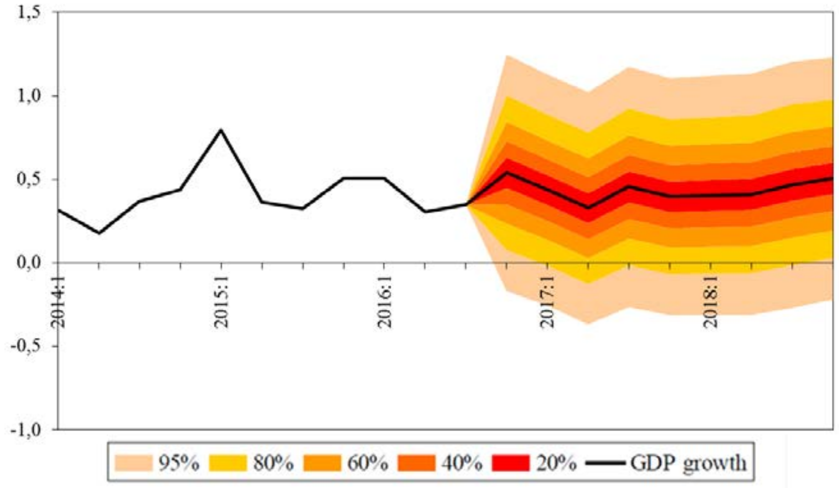
A lot of these positive trends are ultimately due to stimulating economic policies: credit costs have further gone down, most certainly as a consequence of the expansive monetary policy of the ECB. As the Eurosystem will continue to make purchases (although in somewhat smaller volumes), it is safe to assume that financing costs will stay very low. Ultra-low government financing costs have made it possible for most euro area governments to conduct a mildly expansive fiscal policy in 2016, and this will also be true for 2017, although the degree of the stimulus will be a bit less. Another small stimulus comes from a slightly stronger international competitive position of euro area producers, since the fall of the currency relative to the US dollar has lowered the real effective exchange rate. On the other hand, gone is the strong tail wind in 2015 and 2016 coming from markedly lower energy costs. After OPEC and non-OPEC producers have agreed on a coordinated cut in supply in November, the oil price is, with 56 US dollar (Brent), about 50% higher than it was a year ago.

Still, we forecast consumer price inflation in 2017 to be no more than 1.2% in the euro area, since price pressures are still low. Such inflation prospects are not scary for consumers, and indeed confidence of private households has, according to the Commission’s Sentiment Indicator, increased in recent months, as has confidence of nonfinancial firms and on financial markets.

All in all, we expect that the recovery will continue at about the pace of the previous year. Gross domestic product has increased by 1.7% in 2016 and, according to our forecast, it will do so by 1.6% in 2017 and again by 1.7% in 2018.

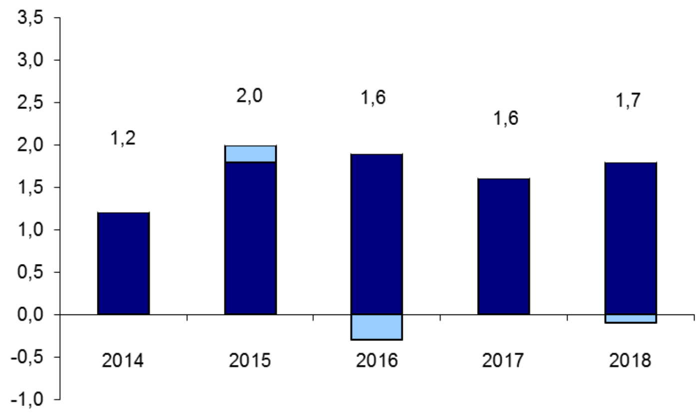
We see the main risk to the European recovery in Italy. The crisis in the Italian banking sector appears to intensify at the end of the year. It might also trigger another crisis of confidence in European institutional arrangements: according to the Bank Recovery and Resolution Directive, banks may only be saved with public money if owners and creditors of these banks have contributed to the rescue. At present it seems doubtful whether it would be politically feasible to respect this rule.

Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above the columns indicate overall GDP growth

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 2 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The forecasts are quite similar, but the EFN forecast is relatively optimistic concerning gross capital formation in 2017. This result is mainly driven by our assessment that capital costs will stay at very low levels.

Table 2 Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018
GDP	1.6	1.7	1.5	1.7	1.5	na	1.7	1.6	1.6	1.7	1.4	na
Priv. Consumption	1.4	1.4	1.4	1.5	1.5	na	1.5	1.5	1.4	1.5	1.4	na
Gov. Consumption	0.9	0.9	1.3	1.3	1.1	na	1.3	1.1	1.3	1.2	1.3	na
Fixed Capital Form.	3.1	4.0	3.1	3.5	2.5	na	3.1	3.1	2.5	3.0	2.2	na
Unemployment rate	9.6	9.1	9.7	9.2	9.7	na	9.5	9.1	9.5	9.1	9.7	na
HICP	1.2	1.1	1.4	1.4	1.1	na	1.3	1.5	1.2	1.4	1.3	na

EU: European Commission, Economic Forecast, November 2016; IMF: World Economic Outlook, October 2016, ECB: December 2016 staff macroeconomic projections. OECD: Economic Outlook, November 2016; Consensus: Consensus Economics, Consensus Forecasts, December 2016

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 3 below. We assume that the oil price, after its jump in December, will rise only slowly in 2017 and 2018. We assume that world trade, having almost stagnated in 2016, will not grow faster than world production in the coming years. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from December 2016 onward.

Table 3 Variables of the world economy

	2016	2017	2018
US GDP Growth Rate	1.6	2.3	3.0
US Consumer Price Inflation	1.3	2.3	2.3
US Short Term Interest Rate (December)	0.6	1.2	1.9
US Long Term Interest Rate (December)	2.6	3.0	3.2
Japan GDP Growth Rate	0.7	1.0	0.8
Japan Consumer Price Inflation	-0.2	0.5	1.0
Japan Short Term Interest Rate (December)	0.0	0.0	0.1
Japan Long Term Interest Rate (December)	0.0	0.0	0.1
World Trade Growth Rate (CPB)	0.8	1.9	2.8
Oil Price (December)	54	54,8	55,9
USD/Euro Exchange Rate (December)	1.04	1.04	1.04
100Yen/Euro Exchange Rate (December)	1.22	1.22	1.22

Apart from the development of world trade, long term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2016). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.