EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 and 2018

Autumn 2017

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.

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Highlights

- In 2017 the world economy is in an upswing, but consumer price inflation is still surprisingly low in advanced economies, and central banks will therefore keep key interest rates very low and financial conditions favorable for the rest of the year and, probably, for 2018.
- Global growth, though, will moderate a bit, since expansive policy measures in China have been reduced. As an early consequence, imports of emerging Asia were no more than stagnant during summer.
- The upswing in the euro area is broad based, both regionally and with respect to the different components of aggregate demand, as investment has recently picked up markedly, partly due to construction of dwellings. From the production side, the level of capacity utilization in the manufacturing sector is clearly above its long-term average and rising further.
- Inflation will not have reached the ECB’s target rate of below but close to 2% at the end of 2018. The trend of a growing participation rate in labour markets and the amount of part-time and low quality jobs are some reasons why overall wage and price dynamics are still very moderate; the appreciation of the euro, the incorporation of technical innovations and a possible change in the consumer preferences for low-cost products could be other reasons.
- We forecast a GDP growth rate of 2.3% for 2017 and 1.9% for 2018. This year’s strong pickup of world trade means that net exports will, in spite of rather strong domestic demand, contribute positively to GDP growth in 2017, while the opposite holds for 2018, due to the significant appreciation of the Euro.

Table 1 Economic outlook for the Euro area

	2014	2015	2016	2017: 2nd half		2017: annual		2018: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.3	2.0	1.8	2.4	1.8 2.9	2.3	2.0 2.5	1.9	1.0 2.7
Potential Output	0.8	1.0	1.4	2.1	1.7 2.5	2.0	1.7 2.2	1.7	1.1 2.3
Private Consumption	0.8	1.7	2.1	2.0	1.4 2.4	1.9	1.6 2.1	1.8	1.0 2.6
Government Consumption	0.7	1.3	1.7	1.2	0.8 1.6	1.2	2.0 1.4	1.2	0.6 1.7
Fixed Capital Formation	1.7	3.1	4.4	4.3	2.2 6.4	3.6	2.6 4.6	4.9	2.4 7.3
Exports	4.6	6.6	3.2	5.2	4.0 6.5	4.8	4.2 5.5	4.5	2.8 6.3
Imports	4.7	6.8	4.6	5.0	3.6 6.4	4.7	3.9 5.4	5.5	3.7 7.4
Unemployment Rate	11.6	10.9	10.0	8.9	8.6 9.3	9.2	9.0 9.4	8.5	7.8 9.2
Labour Cost Index	1.3	1.6	1.4	1.9	1.6 2.3	1.8	1.6 1.9	2.2	1.7 2.8
Labour Productivity	0.8	0.9	0.4	0.7	0.2 1.2	0.6	0.4 0.9	0.7	0.0 1.4
HICP	0.4	0.0	0.2	1.4	1.0 1.7	1.5	1.3 1.7	1.3	0.7 1.9
IPI	0.8	2.2	1.4	2.3	1.1 3.4	2.1	1.6 2.7	1.1	-0.5 2.6

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.

Economic Outlook for 2017 and 2018

A vivid world economy

In 2017 the world economy is in an upswing. In the first half of the year, production in the US, in Japan, and in the euro area have grown faster than potential, and capacity in these economies is now either normally or over-utilized. The Chinese economy has, due to expansive policy measures, also gained momentum. Activity in countries specialized in producing commodities has been stimulated by more demand and higher prices. World trade has rebounded strongly between last November and March, mainly due to stronger demand from Asia, but also because investment activities that typically entail a lot of imports went up in advanced economies.

While US Dollar prices for crude oil and industrial raw materials are now (end of September) more than 15% higher than one year ago, consumer price inflation is still surprisingly low in advanced economies, with core rates of 1.7% for the US, 1.3% for the euro area, and 0.1% for Japan. Central banks will therefore normalize the stance of monetary policy even more slowly than widely expected in the first half of the year: the Fed will likely raise its key interest rate in December, but we think that no more than one or two steps will follow in 2018. The ECB will gradually decrease its asset purchase program, but interest rate hikes are not in sight for 2018. Thus, interest rates will continue to be very low and financial conditions will stay favorable for the rest of 2017 and for the year 2018.

Fiscal policy in advanced economies becomes a bit more expansive this year and in 2018, not least because the upswing as well as the low costs of debt service expand the fiscal space in the short run. In the euro area, this is in particular true for Italy and Germany.

All in all, chances are good that the global upswing will continue during the rest of the year and in 2018. The rate of expansion should, however, moderate a bit, since the strong dynamics in the first half of the year partly came from expansive policy measures in China that have already been reduced. Traces of this turn can be seen in slowing price dynamics in the Chinese property markets. A further consequence more directly linked to the global economy is that imports of emerging Asia were no more than stagnant during summer.

Political risks are substantial: the US administration still has a protectionist policy agenda, and prospects for the Brexit negotiations in Europe are still cloudy. There are also substantial geopolitical risks: the conflict between North Korea and the US has intensified, and the multitude of interwoven conflicts in the Middle East has not abated; indeed, risks for crude oil supply from that region are one of the causes for the increase in oil prices in autumn.

The euro area upswing continues

For about three years, forecasters have been talking about a recovering euro area economy, since production expanded by somewhat more than standard estimates of the potential growth rate of about 1.2%. Now, after three quarters with growth rates of more than 2%, and with capacities that no longer are significantly underutilized, it is time to call the recovery an upswing. It is a broad based one, both regionally and with respect to the different components of aggregate demand.[1] While private consumption, driven by rising real incomes due to lower oil prices, was the main driver in 2015 and 2016, more recently exports have expanded healthily, helped by the resurging world trade, and investment has picked up markedly. The latter is partly due to construction of dwellings, as house prices are generally increasing (with the exception of Italy, where they are still stagnant). In addition, confidence of firms is high and mostly rising. In the manufacturing sector, investment is motivated by a level of capacity utilization that is, according to surveys, clearly above its long-term average and rising further.

The unemployment rate, although with 9.1% (July) still high, is half a percentage point below its mean value since the monetary union started in 1999. Employment has been gaining pace, reaching more than 1.5% year-on-year growth in the second quarter 2017. Unemployed persons find jobs, and in addition, more people enter the labour markets. The trend of a growing participation rate is one reason why overall wage and price growth is still very moderate. Other reasons are the big amount of part-time workers and of workers with low quality jobs looking actively for full-time or better jobs. Still, the annual growth rate of the nominal compensation per employee has been rising from 1% in the second quarter of 2016 to 1.6% in the second quarter of the current year.

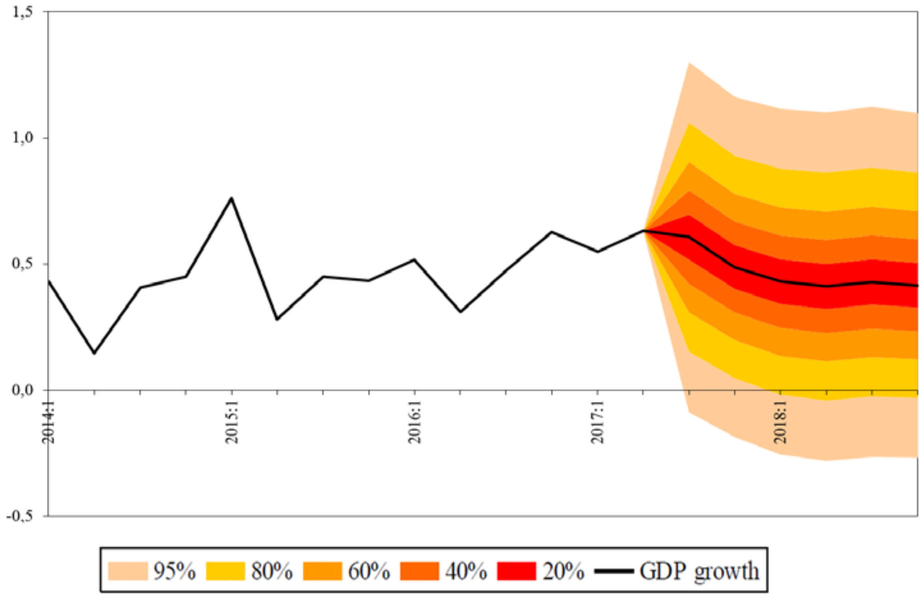
The core rate of consumer inflation (excluding energy and unprocessed food), that had been at slightly under 1% for two years, has picked up during summer to 1.3% in September. However, inflation will, according to our forecast, not reach the ECB's target rate of below but close to 2% in 2017 and 2018, and we do not expect the ECB to raise key interest rate for this time horizon. One cause for slow inflation dynamics in the coming quarters is that the strong appreciation of the Euro makes imported goods cheaper. Since the beginning of the year, the currency has gained more than 12% relative to the dollar and more than 5% in real effective terms. Other reasons could be the incorporation

[1] For some time now, interpreting and working with Eurostat data for the euro area has been complicated by erratic contributions from Ireland: big multinational firms relocate parts of their assets (aircraft for leasing purposes and intellectual property products in particular) or their registered business offices from countries outside the euro area to Ireland. A larger share of the value added by these firms as well as asset depreciations are now attributed to the Irish GDP, and the relocation of assets inflates imports and investment, to, e.g., Irish investment growth rates of 16% in Q2 2015, 100% in Q2 2016, and 40% in Q2 2017. The effects of these huge numbers on euro area data are sizable.

of technical innovations and a possible change in the consumer preferences for low-cost products.

Overall, we forecast a GDP growth of 2.3% for 2017 and 1.9% for 2018.

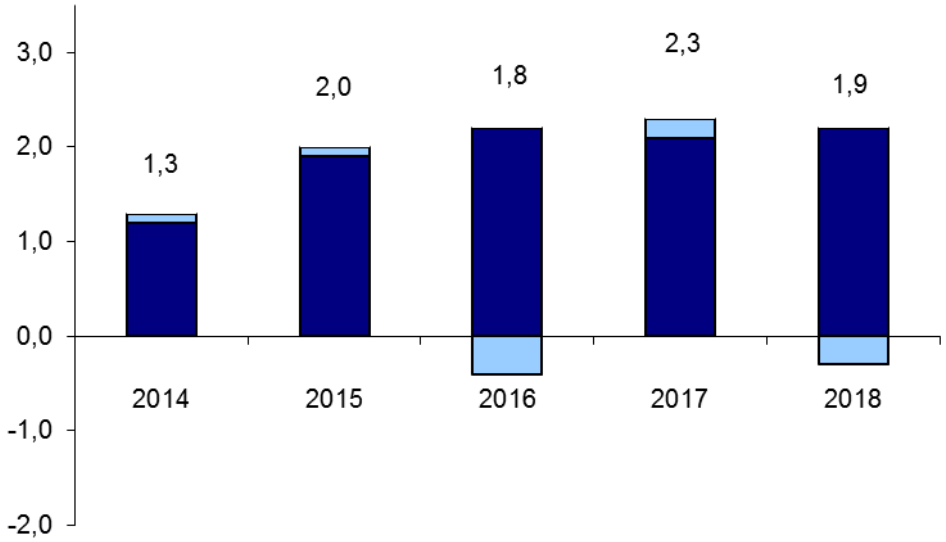
Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

The pickup of world trade means that net exports will, in spite of rather strong domestic demand, contribute positively to GDP growth in 2017 (Figure 2). The opposite holds for 2018, due to the appreciation of the Euro and our belief that world trade will lose momentum. This is the main reason why we forecast a somewhat lower growth rate in 2018. A major risk for the continuation of the current upswing in the euro area still comes from the normalization of monetary policy. It is not clear by how much long term interests will rise if the assets purchase program will be phased out, and whether higher borrowing costs will jeopardize the confidence of financial markets in the solvency of some public debtors in the euro area.

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



Domestic demand dark, net exports light area. Percentage points, figures above or below 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 those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The main difference with these alternative forecasts is that the EFN forecast is quite optimistic for investment activity in 2018. We think that financing costs will probably stay very low, while production capacities will be getting over-utilized. Annual growth rates of about 5% or more are not frequent in the euro area, but turned out in the years 1998 to 2000 and again in 2006/2007.

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	2.3	1.9	1.7	1.8	1.7	1.6	2.2	1.8	1.8	1.8	2.1	1.8
Priv. Consumption	1.9	1.8	1.5	1.6	1.5	1.5	1.7	1.8	1.4	1.4	1.7	1.6
Gov. Consumption	1.2	1.2	1.5	1.5	1.2	0.9	1.2	1.1	1.2	1.3	1.2	1.3
Fixed Capital Form.	3.6	4.9	2.9	3.5	2.7	2.7	4.0	3.9	3.4	3.3	3.1	3.1
Unemployment rate	9.2	8.5	9.4	8.9	9.4	9.1	9.1	8.6	9.3	8.9	9.2	8.7
HICP	1.5	1.3	1.6	1.3	1.7	1.5	1.5	1.2	1.7	1.4	1.5	1.3
IP	2.1	1.1	na	na	na	na	na	na	na	na	2.0	1.8

EU: European Commission, Economic Forecast, May 2017; IMF: World Economic Outlook, April 2017; ECB: ECB staff macroeconomic projections, September 2017; OECD: Economic Outlook, June 2016; Consensus: Consensus Economics, Consensus Forecasts, September 2017.
*According to the IMF world economic outlook update of July 2017, euro area growth will be 1.9% in 2017 and 1.7% in 2018.
** According to the OECD interim outlook of September 2017, euro area growth will be 2.1% in 2017 and 1.9% in 2018.

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. The oil price has risen significantly in September, and we assume that it will stay at its recent level, since the strong world economy will push demand for oil in the near future. World trade will grow faster in 2017 than during the past five years, but the high growth dynamics observed before the Great Recession will probably not come back, since the dispersion of production across countries appears to have slowed markedly. The dollar and the yen relative to the euro are assumed constant from September 2017 onward.

Table 3 Variables of the world economy

	2016	2017	2018
US GDP Growth Rate	1.5	2.2	2.4
US Consumer Price Inflation	1.3	2.0	1.9
US Short Term Interest Rate (December)	0.5	1.2	1.9
US Long Term Interest Rate (December)	2.5	2.5	3.0
Japan GDP Growth Rate	1.0	1.6	1.2
Japan Consumer Price Inflation	-0.1	0.5	0.8
Japan Short Term Interest Rate (December)	0.1	0.1	0.1
Japan Long Term Interest Rate (December)	0.1	0.1	0.1
World Trade Growth Rate (CPB)	1.4	3.8	3.0
Oil Price (December)	54	58	59
USD/Euro Exchange Rate (December)	1.05	1.18	1.18
100Yen/Euro Exchange Rate (December)	1.22	1.33	1.33

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 (2017). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rate: 10-year treasury bills. Japan short-term interest rate: 3-month deposits (LIBOR). Japan long-term interest rate: 10-year treasury bills.