EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 and 2018

€uropean
Forecasting
Network

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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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ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 and 2018

Highlights

- Worldwide economic activity is vivid in summer 2017. Data on production for the first quarter of the year were only mixed: in the euro area quarterly growth was accelerating, but it went down in the US, Japan, and China. Other basic indicators, however, suggest that these economies continue expanding healthily.
- Risks concerning the international economic policy framework remain, in particular since the economic agenda of the US government is still unclear, and no one knows whether the Brexit negotiations will lead the way to an orderly separation of Britain from the EU.
- Production in the euro area has been expanding by more that 1 ½ % per year for almost three years now; since summer 2016, this expansion has even gained a bit of pace, mainly due to a expansion in France and, to a lesser extent, in Italy.
- The ECB's cautious hints at a coming normalization of monetary policy were enough to have a discernible effect on financial conditions at the end of June: yields for long term bonds rose, and the euro appreciated. That said, the common currency is still relatively cheap, and borrowing costs for non-financial firms and private households are still low.
- Overall, we raise our GDP forecast for 2017 from 1.7% (spring report) to 2.1% and for 2018 to 1.8% (spring: 1.7%). We expect HICP inflation to remain well below the ECB target both in 2017 and 2018.
- A major risk for the continuation of the current upswing in 2018 comes from the normalization of monetary policy: it is not clear by how much long term interests will rise and whether higher borrowing costs will jeopardize the confidence of financial markets in the solvency of some public debtors in the euro area.

- **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	1.8	2.1	1.8 2.3	2.1	1.7 2.5	1.8	1.0 2.7
Potential Output	0.8	0.9	1.4	2.1	1.9 2.3	2.3	2.0 2.6	1.7	1.3 2.1
Private Consumption	0.8	1.8	2.1	1.3	1.5 1.7	1.5	1.1 1.9	1.5	0.7 2.3
Government Consumption	0.7	1.3	1.8	1.0	0.8 1.2	1.1	0.7 1.4	1.1	0.5 1.7
Fixed Capital Formation	1.6	3.2	3.7	3.0	2.0 4.0	3.9	2.2 5.6	4.8	2.3 7.3
Exports	4.4	6.2	3.0	4.6	4.0 5.1	4.9	3.8 5.9	4.8	2.9 6.7
Imports	4.9	6.3	4.1	4.8	4.1 5.4	5.2	4.0 6.3	5.4	3.6 7.2
Unemployment Rate	11.6	10.9	10.0	9.3	9.1 9.5	9.2	8.8 9.5	8.6	7.7 9.4
Labour Cost Index	1.3	1.5	1.3	1.5	1.4 1.7	1.7	1.5 2.0	1.9	1.3 2.6
Labour Productivity	0.7	0.9	0.4	0.6	0.4 0.8	0.7	0.3 1.1	0.8	0.1 1.5
HICP	0.4	0.0	0.2	1.7	1.6 1.9	1.7	1.4 2.0	1.4	0.8 2.1
IPI	0.8	2.2	1.4	1.5	1.0 2.0	1.4	0.3 2.4	1.0	-0.7 2.8

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

The world economy in broad-based expansion

Worldwide economic activity is vivid in summer 2017. Purchasing manager surveys have been indicating since autumn of past year, an expansion that is a bit faster than its trend during the past decade. Data on actual production for the first quarter of the year, however, were only mixed: in the euro area quarterly growth was accelerating (to 0.6%), but it went down a bit in the US (to 0.35). Other basic indicators for the US, in particular employment and industrial production, suggest that the economy is moderately picking up. Similarly, while growth eased a bit in Japan as well (to 0.25%), strong data on industrial production and exports in the first half of 2017 show that Japan is actually in an upswing. The slide of quarterly growth in China (starting from the very high rate of 1.9% in the second quarter 2016 to 1.3% at the first quarter of 2017) should be seen as part of a longer trend that is going to continue, but monthly indicators such as foreign trade or electric power consumption indicate a reasonably strong and stable activity. To some extent last year's stimulative policy measures in China might have contributed to the strong recovery in Asian trade that, by itself, explains most of the significant growth in world trade starting in autumn 2016. More importantly, since highly cyclical manufacturing industries play a large role for the East Asian economies, this region benefits particularly from the current upswing.

Monetary conditions have favored world economic activity for a long time now. Key interest rates are still very low in all advanced economies, although the Federal Reserve has indicated a further gradual tightening of monetary policy in the US, and recent communication from the ECB suggests that a gradual normalization of monetary policy will start in autumn 2017 and will continue next year. As a result, yields for longer term French and German government bonds have increased by about 30 basis points at the end of June, to still very low 0.7% and 0.5% respectively, while yields of US and British government bonds have little moved. Share prices have been going up quite steadily during 2017, completing the set of favorable financial conditions.

Consumer price inflation and wage dynamics in particular are still low in most advanced economies, indicating that supply side restrictions are some way off, although employment rates are now quite high in large economies such as the US, Japan, and Germany. Thus, the majority of indicators still points to world economic growth in 2017 that is above the average rate since the world financial crisis. A bit irritating is the slide in prices for oil and industrial commodities since March, possibly caused by less buoyant investment activity China. Overall, however, chances are good that the world economy will continue expanding healthily in the second half of 2017 and in 2018, although we do not expect a further acceleration. Of course, risks concerning the economic policy framework remain, in particular since the economic agenda of the US government is still unclear, and no one knows whether the Brexit negotiations will lead the way to an orderly separation of Britain from the EU.

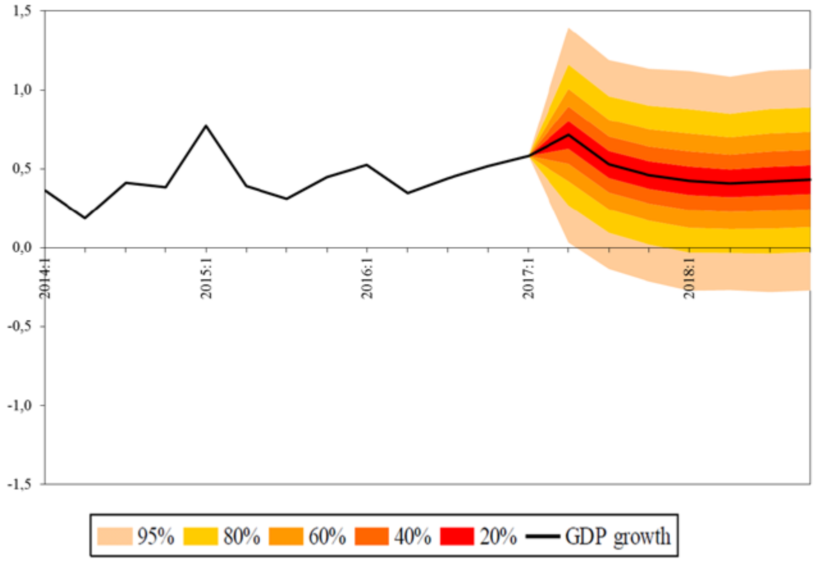
The euro area economy in an upswing

Production in the euro area has been expanding by more that 1 ½ % per year for almost three years now, which is somewhat faster than standard estimates of the potential growth rate; since summer 2016, this expansion has even gained a bit of pace; in the first quarter of 2017 it reached 2.2% at an annual rate. Form a regional perspective, this acceleration comes mainly from the two big laggards of the recovery, from France, where the construction industry turned from recession into expansion during the past year, and, to a lesser extent, from Italy. The upswing is balanced with respect to components of demand: investment picked up markedly in the past two quarters (even if the distorted data from Ireland are put aside)[1], and exports have expanded healthily as well, helped by the resurging world trade. What mainly drives the upswing is, however, private consumption, as real disposable income has substantially increased. While the stimulative effects of lower oil prices are fading, employment keeps on expanding by almost 1.5% per annum, and compensation of employees by close to 3%. The unemployment rate is, with 9.3% in May, now a bit lower than its mean value since the monetary currency started in 1999. Labour scarcities are certainly becoming relevant in a few regions and sectors, but overall wage growth has been at no more than 1.3% for two years now. Interestingly, however, the core rate of consumer inflation (excluding energy and unprocessed food), that had been at slightly under 1% for two years, has picked up to 1.2% in June. It remains to be seen whether this is a temporary blip or an early sign of increasing price dynamics in the euro area. As long as the evidence for such a turn is weak, we do not expect the ECB to raise key interest rates in 2017 and 2018. Still, the ECB's cautious hints at a coming normalization of monetary policy were enough to have a discernible effect on financial conditions at the end of June: yields for long term bonds rose, and the euro appreciated. Since the beginning of the year, the euro has appreciated by about 8% relative to the dollar. That said, the common currency is still relatively cheap, supporting the international competitive position of euro area firms, and borrowing costs for non-financial firms and private households are still low. Financial policies will be slightly expansive, and particularly so in Italy and Germany.

[1] In 2016 big multinational firms relocated parts of their assets (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, although real economic activity has scarcely been affected.

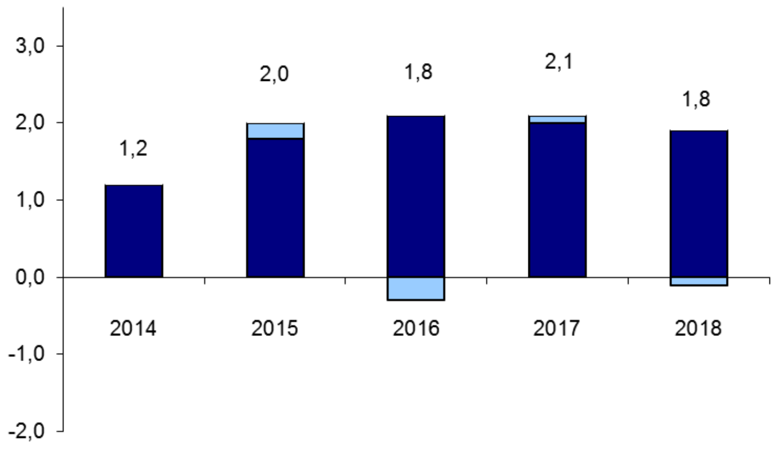
Overall, we raise our GDP forecast for 2017 from 1.7% (spring report) to 2.1% and for 2018 to 1.8% (spring: 1.7%). All that is needed for growth of more than 2% this year is relatively vivid activity in the rest of the summer, which seems probable given the recent strong confidence indicators, and a stable expansion thereafter (Figure 1). The pickup of world trade means that net exports will, in spite of rather strong domestic demand, not turn significantly negative (Figure 2). A major risk for the continuation of the current upswing in 2018 comes from the normalization of monetary policy: it is not clear by how much long term interests will rise and whether higher borrowing costs will jeopardize the confidence of financial markets in the solvency of some public debtors in the euro area.

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 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 EFN forecast is quite optimistic for this year and 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	2.1	1.8	1.7	1.8	1.7	1.6	1.9	1.8	1.8	1.8	1.8	1.6
Priv. Consumption	1.5	1.5	1.5	1.6	1.5	1.5	1.5	1.6	1.4	1.4	1.5	1.5
Gov. Consumption	1.1	1.1	1.5	1.5	1.2	0.9	1.2	1.2	1.2	1.3	1.3	1.2
Fixed Capital Form.	3.9	4.8	2.9	3.5	2.7	2.7	3.7	3.4	3.4	3.3	4.2	2.8
Unemployment rate	9.2	8.6	9.4	8.9	9.4	9.1	9.4	8.8	9.3	8.9	9.3	8.9
HICP	1.7	1.4	1.6	1.3	1.7	1.5	1.5	1.3	1.7	1.4	1.6	1.4
IP	1.4	1.0	na	na	na	na	na	na	na	na	1.8	1.7

EU: European Commission, Economic Forecast, May 2017; IMF: World Economic Outlook, April 2017; ECB: ECB Economic Bulletin 4 2017, OECD: Economic Outlook, June 2016; Consensus: Consensus Economics, Consensus Forecasts, June 2017.

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 fallen significantly early in summer, and we assume that it will only slowly recover. World trade has gained pace since autumn and will probably grow faster in 2017 than during the past five years. The exchange rates of the dollar and the yen relative to the euro are assumed constant from April 2017 onward.

Table 3 Variables of the world economy

	2016	2017	2018
US GDP Growth Rate	1.6	2.2	2.4
US Consumer Price Inflation	1.3	2.3	2.2
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	1.4	1.1
Japan Consumer Price Inflation	-0.1	0.6	0.8
Japan Short Term Interest Rate (December)	0.1	0.0	0.0
Japan Long Term Interest Rate (December)	0.1	0.1	0.1
World Trade Growth Rate (CPB)	1.4	4.2	3.2
Oil Price (December)	54	50	52
USD/Euro Exchange Rate (December)	1.05	1.12	1.12
100Yen/Euro Exchange Rate (December)	1.22	1.23	1.23

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.