EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 and 2018

Spring 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.

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 April 21st, 2017

EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2017 and 2018

Highlights

- Global economic activity appears to be expanding rapidly during spring 2017. Confidence among managers is either strong or has improved in all major regions, and world trade and industrial production have, after two years of weakness, picked up markedly during last winter.
- For 2 ½ years, the euro area economy has now been constantly expanding at an annual rate of about 1.6%, slightly above potential. Employment has also been expanding steadily. Production and employment have been recently rising almost everywhere, including countries such as France and Italy where unemployment rates still do not appear to be on a downward trend.
- Official investment data for 2015 and 2016 appear to be distorted: 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. As a consequence, reported gross fixed capital formation in Ireland expanded by 33% in 2015 and by 45% in 2016. Without this effect, investment growth in the euro area is about one percentage point lower in 2015 and 2016.
- Headline inflation hit 2% in February, but this was only the effect of higher world oil prices. The core rate is stubbornly at slightly below 1%, and wages rise annually by scarcely 1.5%. The revival of the economy will have to continue for considerably more time until inflation will come close to the ECB target zone.
- As monetary conditions continue to support growth, financial policies will be slightly expansive, and a certain external stimulus should come from the apparent recovery of world trade.
- Overall, we forecast euro area GDP to expand by 1.7% in both 2017 and 2018. However, policy uncertainty is substantial and could have a negative effect. In particular, elections in member states might give power to movements that aim at disintegrating Europe. Such a turn could rapidly undermine confidence, in particular in the financial strength of highly indebted member states.

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	1.6	1.1 2.2	1.7	1.0 2.4	1.7	0.8 2.6
Potential Output	0.8	1.0	1.4	1.3	1.1 1.6	1.3	1.0 1.7	1.3	0.9 1.8
Private Consumption	0.8	1.8	2.0	1.4	0.9 1.8	1.4	0.8 1.9	1.4	0.5 2.2
Government Consumption	0.6	1.3	1.9	1.0	0.5 1.4	0.9	0.4 1.4	0.9	0.3 1.4
Fixed Capital Formation	1.5	3.2	3.7	1.8	-0.3 3.9	3.1	0.8 5.5	5.1	2.4 7.8
Exports	4.4	6.5	2.9	4.4	3.2 5.7	4.9	3.4 6.4	5.0	3.2 6.9
Imports	4.9	6.5	4.0	4.5	3.2 5.8	5.3	3.7 6.9	5.9	4.0 7.8
Unemployment Rate	11.6	10.9	10.0	9.5	9.2 9.8	9.4	9.0 9.7	8.9	8.1 9.6
Labour Cost Index	1.0	1.4	1.4	2.0	1.6 2.3	2.2	1.8 2.6	2.3	1.7 2.9
Labour Productivity	0.6	0.9	0.4	0.6	0.1 1.1	0.6	0.0 1.2	1.0	0.2 1.8
HICP	0.4	0.0	0.2	1.7	1.3 2.0	1.7	1.3 2.1	1.6	0.9 2.2
IPI	0.8	2.2	1.4	1.7	0.6 2.8	1.7	0.3 3.0	1.2	-0.5 3.0

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.

Economic Outlook for 2017 and 2018

The world economy: gaining broad based momentum

Global economic activity appears to be expanding rapidly during spring 2017. Confidence among managers is either strong or has improved in all major regions. World trade and industrial production have, after two years of weakness, picked up markedly during last winter. The current upswing began some time ago: in China, growth picked up since spring 2016, mainly driven by expansive policy measures. The US economy has strengthened since previous summer. Both the euro area and Japan have been on a moderate upturn for some time. As a further sign of increased activity, commodity prices have been on an upward trend for about a year now. Higher energy prices are the main reason for a significant acceleration of consumer prices in the advanced economies. Core inflation rates (excluding energy and food prices) however are still moderate. Since potential oil production from unconventional sources should limit further oil price increases, it is probable that headline inflation rates in many countries will come down again a bit in the course of this year.

While the outcome of the US presidential elections in November has not caused the pick-up, it apparently strengthened expectations regarding growth perspectives, at least among financial market participants: in the US, but also beyond, stock market valuations went up markedly, as did long term interest rates, as well as expected real ones. Bond yields, however, have stopped rising during winter, although the Fed increased key interest rates in mid-March and signalled that further increases will follow; but this move was no surprise for markets. Real interest rates will probably stay negative in this year and in 2018 in the US and indeed in almost all advanced economies, supporting economic activity. Spring brought, however, other important news when it became apparent that the US administration might be unable to implement important reform projects that were promised during the election campaign. Thus, we do not expect a strong fiscal stimulus anytime soon: the effects of fiscal policy on global economic activity are likely to be low during this and the upcoming year.

The majority of indicators points to world economic growth in 2017 that is above the average rate since the world financial crisis. Of course, risks remain, particularly concerning uncertainty about the economic policy framework. The economic agenda of the new US government and its impact on the world economy are still unclear. On the one hand, the fiscal stimulus in the US could be significantly larger than expected in this forecast. On the other hand, the US government has indicated to pursue a protectionist agenda whose implementation would surely have a negative impact on global trade and production. Political developments and their impacts are also difficult to predict in Europe, where, for example, the course of the Brexit negotiations remains unclear.

The euro area economy: on expansion course

For 2 ½ years, the euro area economy has now been constantly expanding at an annual rate of about 1.6%, slightly above potential. Employment has also been expanding steadily, in 2016 at an annual rate of about 1.3%. The unemployment rate decreased to 9.5% in February 2017 and thus to its mean since the common currency was introduced in 1999. If labour as a factor of production is still markedly underutilized, which is probably true, this has been the case for most of the time the euro area existed. Possibly the gap between labour qualifications and the needs in the firms is not narrowing and it could be so for some time.

Although the dynamics differ among the member states, production and employment have been recently rising almost everywhere (Greece being the exception), including countries such as France and Italy where unemployment rates still do not appear to be on a downward trend. Growth was mainly driven by private consumption, which last year has been expanding at a slightly faster rate than overall GDP. This was mainly caused by substantial increases in real disposable income, due to growing employment and the collapse of oil prices that lowered bills for energy consumption. During 2016, a decline of the saving rate of private households (from 12.7% to 12% relative to disposable income) also contributed to consumption growth.

According to data from Eurostat, gross fixed capital investment, as seems fitting for an upswing, has expanded even more, by 3.2% in 2015 and 3.7% in 2016 respectively. These data, however, are distorted: big multinational firms relocated, surely in order to minimize their tax bill, 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 of 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. As a consequence, Irish GDP grew, according to official numbers, by 26% in 2015, and gross fixed capital formation by 33% in 2015 and by 45% in 2016. This is a measurement challenge for the Irish economy[1], but also for the euro area: here investment growth in the euro area was only about 2 ½ % in both years 2015 and 2016 if Ireland is taken out and thus about a percentage point lower than if Ireland is included. Therefore, in reality, investment is still not strong in the euro area.

---

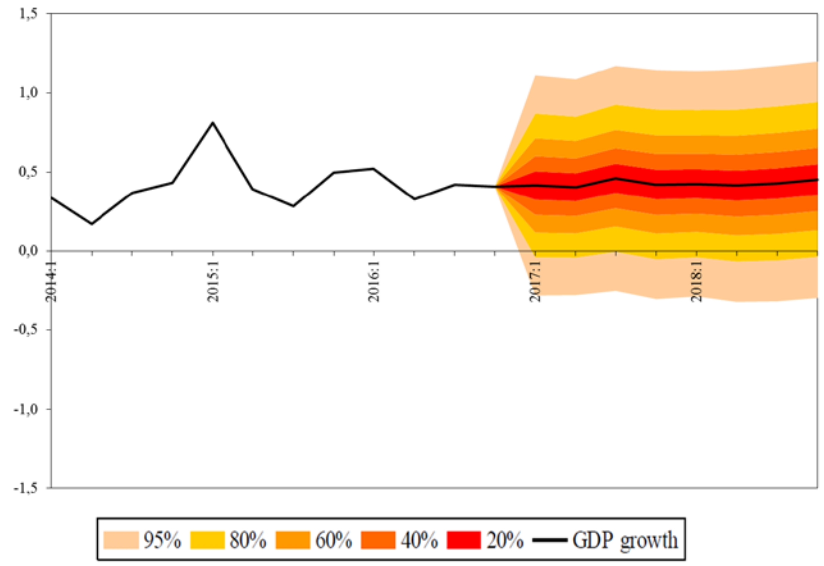
[1] See International Monetary Fund (spring 2017), World Economic Outlook, Box 1.2

Only moderate investment activity suggests that production capacities are still ample. The same can be deduced from low price dynamics: headline inflation hit 2% in February, but this was only the effect of higher world oil prices. The core rate is stubbornly at slightly below 1%, and wages rise annually by scarcely 1.5%. Long-term inflation expectations measured by inflation linked swaps rose markedly in past winter (from 1.2% to 1.7%), but have decreased during spring (to 1.5%). Thus, the revival of the economy will have to continue for considerably more time until inflation will come close to the ECB target zone. However, if a low-cost culture is expanding in the society, the quality of consumer products could be decreasing and then the measures of inflation could not properly reveal the actual inflation situation.

Given the observed and expected inflation values, we do not expect the ECB to raise key interest rates during the forecast period. Bond purchases, however, are likely to be phased out next year. Long term interest rates have increased from their ultra-low levels of last autumn (for Italian government bonds by more than 100 basis points), but are still low, as are banks' composite costs of debt financing and borrowing costs for non-financial firms and private households, both of which are probable to move little in the near future. Low interest rates also support asset prices: house prices are rising in all major member states except Italy. In the euro area as a whole they were, according to Eurostat, 4.1% higher at the end of 2016 than one year ago. Accordingly, construction activity is rising. All told, monetary conditions continue to support growth. Financial policies will be slightly expansive, and particularly so in Italy and Germany. A certain external stimulus might come from the apparent recovery of world trade.

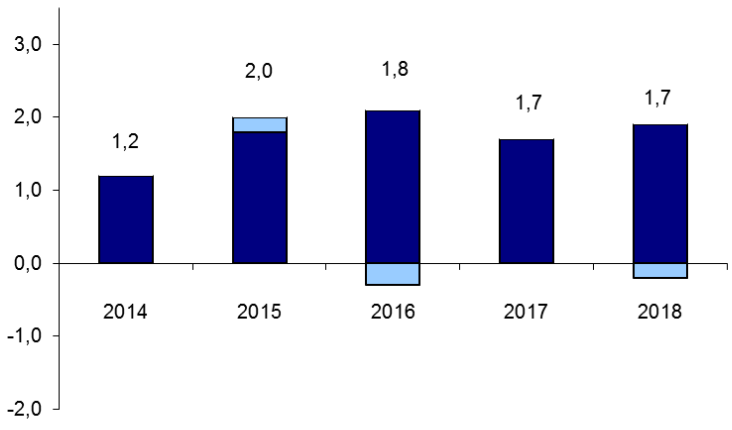
Overall, we forecast euro area GDP to expand by 1.7% in both 2017 and 2018 (see Figure 1), mainly driven by internal demand (see Figure 2). This is a cautious forecast, given that some confidence indicators improved markedly in spring. Increasing dynamics, however, are not probable, since the important stimulus from lower energy prices is already fading away. Moreover, policy uncertainty is, as in the rest of the world, substantial. In particular, elections in member states might give power to movements that aim at disintegrating Europe. Such a turn could rapidly undermine confidence, in particular in the financial strength of highly indebted member states.

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 forecasts are quite similar, but the EFN forecast is particularly optimistic concerning investment in 2018. This is so because financing costs will probably stay very low, while production capacities will be getting over-utilized. Annual growth rates of more than 5% 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	1.7	1.7	1.6	1.8	1.7	1.6	1.8	1.7	1.6	1.7	1.7	1.5
Priv. Consumption	1.4	1.4	1.5	1.6	1.5	1.5	1.4	1.4	1.4	1.5	1.5	1.4
Gov. Consumption	0.9	0.9	1.4	1.4	1.2	0.9	1.1	1.0	1.3	1.2	1.4	1.2
Fixed Capital Form.	3.1	5.1	2.9	3.4	2.7	2.7	2.8	3.2	2.5	3.0	2.4	2.7
Unemployment rate	9.4	8.9	9.6	9.1	9.4	9.1	9.4	8.9	9.5	9.1	9.5	9.1
HICP	1.7	1.6	1.7	1.4	1.7	1.5	1.7	1.6	1.2	1.4	1.6	1.4
IP	1.7	1.3	na	na	na	na	na	na	na	na	1.8	1.7

EU: European Commission, Economic Forecast, February 2017; IMF: World Economic Outlook, April 2017; ECB: ECB Economic Bulletin, March 2017, OECD: Economic Outlook, November 2016; Consensus: Consensus Economics, Consensus Forecasts, April 2017. ECB figures correspond to their macroeconomic projections.

* Euro area GDP growth will, according to the interim assessment of the OECD of March 2017, be 1.6% both in 2017 and 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. We assume that the oil price will rise in 2017 and 2018, but only slowly. Growth rates for world trade of little more than 3% appear to be the new normal. 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	2.5	2.3
US Short Term Interest Rate (December)	0.5	1.2	1.9
US Long Term Interest Rate (December)	2.5	3.3	3.5
Japan GDP Growth Rate	1.0	1.3	1.0
Japan Consumer Price Inflation	-0.1	0.7	1.0
Japan Short Term Interest Rate (December)	0.1	0.0	0.1
Japan Long Term Interest Rate (December)	0.1	0.1	0.1
World Trade Growth Rate (CPB)	1.2	3.2	3.2
Oil Price (December)	54	55	56
USD/Euro Exchange Rate (December)	1.05	1.07	1.07
100Yen/Euro Exchange Rate (December)	1.22	1.21	1.21

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 rate: 10-year treasury bills. Japan short-term interest rate: 3-month deposits (LIBOR). Japan long-term interest rate: 10-year treasury bills.