EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2018 and 2019

European 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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Highlights

- With advanced economies likely to face over-utilization of economic capacities in 2018 for the first time since the Great Recession, companies will further expand their investment activities. Price and wage dynamics will pick up globally, triggered by the recent increase in energy prices.
- A major risk for the world economy pertains to financial markets: measures for risk tolareance and valuations for many types of assets have approached levels last reached ten years ago, on the eve of the financial crisis. A sudden readjustment of asset prices and risk premia could worsen financial conditions globally and seriously affect the global economy.
- The cyclical upswing of the euro area economy continues. The recovery, under way since summer 2013, transformed into an upswing in autumn 2016 when demand from outside the euro area increased quite abruptly; higher exports and improved expectations have contrinuted to induce firms to invest more into equipment.
- Wage dynamics in the euro area appear to increase, but only slowly. An annual growth rate for hourly wage costs of about 2% is still not enough to put upward pressure on prices, but this will change eventually as the cyclical upswing is likely to continue. Inflation will, according to our forecast, reach the ECB's target of below but close to 2% in the second half of 2019.
- Conditions for further healthy growth in the euro area are in place, but employment dynamics might markedly lose momentum in some member countries in the second half of 2018, as the potential labour force is becoming more and more exhausted. Overall, we forecast euro area GDP to grow by 2.2% in 2018 and by 1.5% in 2019.

- Table 1 Economic outlook for the Euro area

	2015	2016	2017	2018: 1st half		2018: annual		2019: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.1	1.8	1.7	2.0	0.9 3.1	2.2	1.3 3.1	1.5	0.6 2.5
Potential Output	1.0	1.2	1.6	1.7	1.0 2.4	1.7	1.1 2.3	1.6	1.0 2.2
Private Consumption	1.8	2.0	1.7	1.7	0.8 2.6	1.7	1.1 2.5	1.4	0.6 2.2
Government Consumption	1.3	1.8	1.8	1.8	1.2 2.4	1.6	1.1 2.1	1.6	1.1 2.2
Fixed Capital Formation	3.3	4.5	2.8	4.2	1.6 6.9	4.8	2.6 7.1	2.9	0.4 5.5
Exports	6.4	3.3	2.4	4.6	2.5 6.6	4.7	3.1 6.5	3.9	2.1 5.8
Imports	6.7	4.7	3.0	5.6	3.5 7.7	5.9	4.1 7.6	4.5	2.5 6.5
Unemployment Rate	10.9	10.0	9.1	8.2	7.5 8.8	8.3	7.8 8.8	7.9	6.9 8.8
Labour Cost Index	0.8	0.8	1.3	2.8	2.3 3.4	2.2	1.8 2.7	3.0	2.3 3.6
Labour Productivity	0.9	0.4	0.7	0.9	0.1 1.8	0.8	0.1 1.6	0.6	-0.3 1.4
HICP	0.0	0.2	1.5	1.8	1.1 2.5	1.6	1.0 2.1	2.0	1.3 2.8
Industrial Production	2.2	1.5	2.7	0.9	-0.9 2.8	1.8	0.3 3.4	0.5	-1.2 2.2

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 2018 and 2019

The world economy: high growth in spite of many risks

In 2017 the global economy has gained strong momentum. The centers of the upswing are China, the USA and the euro area. The strength of the global economy is due to the combination of three main factors. First, extremely expansionary monetary policies have been supporting real economic activity for many years. Second, since 2015 the oil price has been, at about 50 USD per barrel Brent, less than half as high as in the four years before. Finally, Chinese demand for imported goods has contributed significantly to the revival of world trade. Oil prices have, however, recovered considerably in the second half of the year, to 63 USD in December, mainly due to high demand induced by stronger economic activity. The December 2016 agreement between OPEC and Russia to cut production and its prolongation in May and November 2017 as well as renewed political tensions in the Middle East have also played a role. A further marked increase of oil prices in 2018 is, however, not probable: US shale oil production nowadays quickly expands if prices rise, dampening oil price volatility. Moreover, the appreciation of the euro partly limited the negative effects in the euro area.

Consumer price inflation in the US, in the euro area, and in Japan is still below the central banks' targets, and, in spite of sound growth and high employment, upward trends of price dynamics are barely detectable. Thus, monetary policy will remain expansionary in 2018, albeit to a lesser extent than in the years before. The Federal Funds Rate in the US, now at 1.5% (upper limit), will be raised further, probably to 2.25% by the end of 2018. The ECB will leave interest rates untouched in 2018, but it has cut the volume of monthly asset purchases for the time until September 2018 and, if financial markets remain quiet, the program will probably be further reduced and come to an end by early 2019. Other central banks, notably the Bank of England as well as the Czech and the Korean central banks have begun raising their rates this year, but to levels that still are definitely expansionary. Fiscal policy in the advanced economies is slightly expansionary and markedly so in the US, where corporate taxes will be lowered drastically in 2018.

With advanced economies likely to face over-utilization of economic capacities on average for the first time since the financial crisis and the Great Recession, companies will have reason to extend capacities by further expanding their investment activities. We also expect that the price and wage dynamics will pick up, triggered by the recent increase in energy prices.

All in all, chances are good that the global cyclical upswing will continue in 2018, although it could be put at risk in various ways: political tensions between North Korea and the US are still high, as are multiple tensions in the Middle East. Moreover, world trade could still suffer if the US government turned its protectionist attitudes into concrete policy measures. A risk that has recently become more and more serious pertains to financial markets: measures for risk tolareance and valuations for many types of assets have approached levels last reached ten years ago, on the eve of the financial crisis. A sudden readjustment of asset prices and risk premia could worsen financial conditions globally and seriously affect the present cyclical upswing.

The euro area economy at the height of a cyclical upswing

The cyclical upswing of the euro area economy continues. Production has been expanding by about 2½% during 2017, much more than standard estimates of the potential growth rate that barely exceed 1 ½ %. The recovery, under way since summer 2013, transformed into an upswing in autumn 2016, when demand from outside the euro area increased quite abruptly.

Higher exports and improved expectations have induced firms to invest more into equipment, as capacity utilization has been above average for some time now, and financing costs are very low. Meanwhile, private consumption continues to expand with a trend rate of a bit less than 2% per year, although real incomes are no longer pushed up by falling energy prices. Instead, as employment rises healthily (by almost 2% in the first three quarters of 2017), so does labour income. All this is, remarkably, more or less true for all major economies of the euro area.

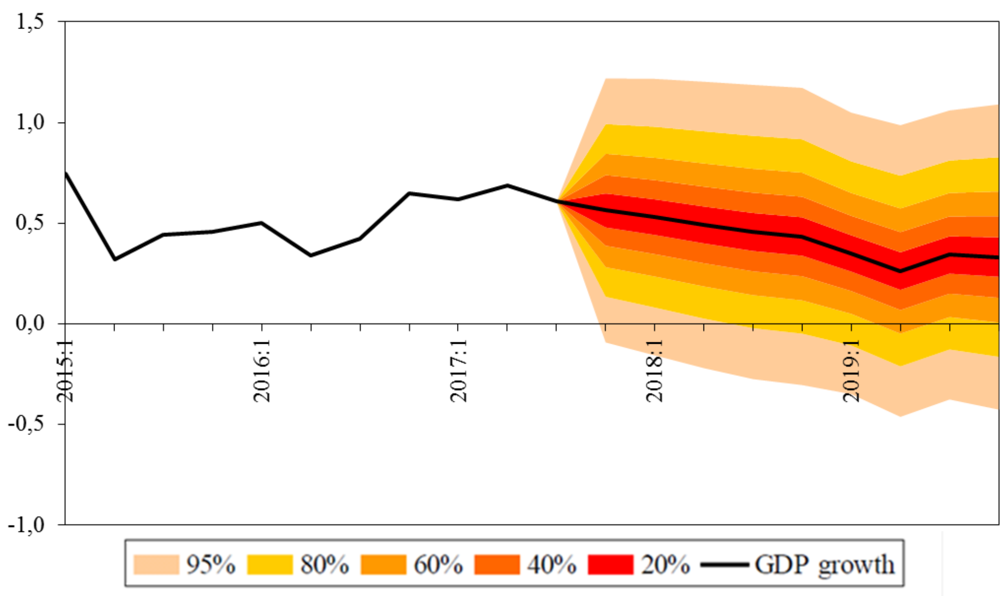
Not quite synchronized are, however, the dynamics of unemployment: for France and Italy it is still not clear whether the trend is downward, although employment in both countries, as in the rest of the currency union, has been expanding steadily in the past two years. The euro area unemployment rate has been falling constantly, to 8.8% in October, the lowest rate since January 2009. Vacancies have generally been going up during the past two years, but they appear high only in two of the larger economies, in Germany and in the Netherlands.

Wage dynamics in the currency area appear to start rising, but only slowly: while the annual growth rate for negotiated wages is still no more than 1.4%, hourly wage costs for the business economy are now 2% higher than in autumn 2016. This is still not enough to put upward pressure on prices: the core rate of consumer price inflation (excluding energy and unprocessed food) is at present slightly above 1%. As the cyclical upswing continues, however, the price and wage setting power of firms and unions will eventually increase. Inflation reaches, according to our forecast, the ECB's target of below but close to 2% in the second half of 2019. We do not expect the ECB to raise the key interest rate before this date, and monetary policy will continue to stimulate the economy well into the year 2019.

Fiscal policy is slightly expansionary in 2018: according to the most recent forecast of the European Commission, the cyclically adjusted primary public balance decreases by 0.3% relative to GDP.[1]

All in all, conditions for further healthy growth are in place, but employment dynamics will markedly lose momentum in some member countries in the second half of 2018, as the potential labour force is becoming more and more exhausted. Overall, we forecast euro area GDP to grow by 2.2% in 2018 and by 1.5% in 2019, though the uncertainty around these estimates is naturally still large (see Table 1). Figure 1 presents the expected evolution of the quarter on quarter GDP growth, while the respective contributions of domestic components and net exports to GDP growth are reported in Figure 2.

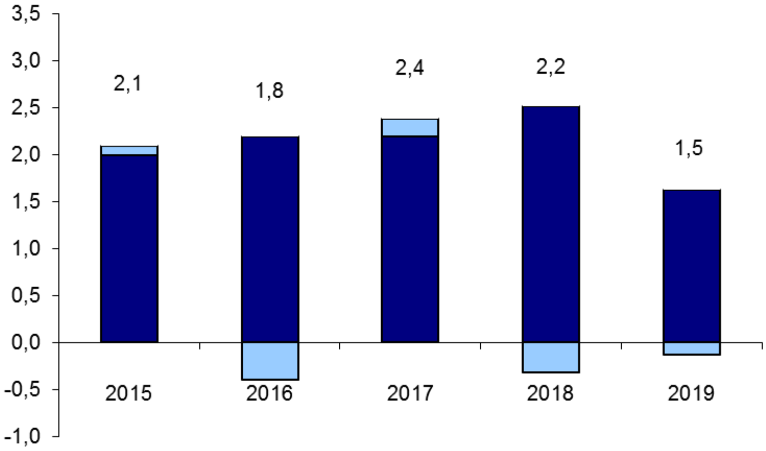
Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

[1] The Commission, in its November forecast, sees the fiscal stance in the euro area in 2018 as "broadly neutral", because the structural balance shrinks just a bit. This is, however, only the case because the interest expenditure, which is excluded from the primary budget balance, continues to go down.

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 other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The forecasts for 2018 are quite similar, but the EFN is quite optimistic concerning gross fixed capital formation. This result is mainly driven by our assessment that capital costs will stay at very low levels. For 2019 the EFN projection is relatively low for GDP growth, but high for consumer price inflation, as the over-utilization of capacity is then starting to bind. In addition, according to our outlook, the world economy loses momentum in 2019, we expect net exports to give a negative contribution to growth, and real financial costs of capital start to rise.

Table 2: Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2018	2019	2018	2019	2018	2019	2018	2019	2018	2019	2018	2019
GDP	2.2	1.5	2.1	1.9	1.9	na	2.3	1.9	2.2	1.9	2.1	na
Priv. Consumption	1.8	1.4	1.8	1.6	1.7	na	1.7	1.6	1.5	1.4	1.8	na
Gov. Consumption	1.6	1.6	1.5	1.3	0.9	na	1.2	1.2	1.3	1.4	1.4	na
Fixed Capital Form.	4.8	2.9	3.7	3.1	3.4	na	4.3	3.4	3.7	3.5	3.8	na
Unemployment rate	8.3	7.9	8.5	7.9	8.7	na	8.4	7.8	8.5	8.0	8.5	na
HICP	1.5	2.0	1.4	1.6	1.4	na	1.4	1.5	1.5	1.7	1.4	na

EU: European Commission, Economic Forecast, November 2017; IMF: World Economic Outlook, October 2017, ECB: December 2017 staff macroeconomic projections. OECD: Economic Outlook, November 2017; Consensus: Consensus Economics, Consensus Forecasts, December 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. We assume that the oil price, after its jump in December, will rise only slowly in 2018 and 2019. World trade will, according to this forecast, grow a bit faster than worrl production in 2018, and at about the same pace in 2019. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from December 2017 onward.

Table 3: Variables of the world economy

	2017	2018	2019
US GDP Growth Rate	2.3	2.5	2.1
US Consumer Price Inflation	2.1	2.1	2.1
US Short Term Interest Rate (December)	1.2	2.1	2.6
US Long Term Interest Rate (December)	2.5	3.0	3.3
Japan GDP Growth Rate	1.5	1.3	1.0
Japan Consumer Price Inflation	0.4	0.8	1.5
Japan Short Term Interest Rate (December)	0.0	0.0	0.1
Japan Long Term Interest Rate (December)	0.1	0.1	0.2
World Trade Growth Rate (CPB)	4.4	3.9	3.4
Oil Price (December)	63	64	65
USD/Euro Exchange Rate (December)	1.18	1.18	1.18
100Yen/Euro Exchange Rate (December)	1.33	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 rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.