

OVERVIEW: CONTINUED GROWTH IN A CHANGING POLICY CONTEXT

Euro area labour market is strong but slack remains

The European economy performs well...

The pace of economic growth in Europe surpassed expectations in the first half of this year, propelled by resilient private consumption, increasing support from a global upswing, loose financing conditions and healthy improvements in the labour market. Investment, which had been lagging, also shows signs of a broad-based pick-up. Very strong consumer and business sentiment, in a context of diminished uncertainty, suggests that this robust economic performance should continue in the near-term.

...but the recovery is still incomplete...

Nevertheless, the cyclical recovery that has now been underway for 18 uninterrupted quarters, still remains incomplete. It is also atypical given its dependence on policy support, the continuing presence of fiscal and financial fragilities stemming from the crisis, and the relatively subdued strength of domestic demand compared to past recoveries. Remaining slack in the labour market and slow productivity growth are among the factors that continue to constrain wage dynamics and dampen inflation.

...suggesting room to expand further.

The recovery in the euro area is less advanced than in other advanced economies such as the US, suggesting that there may be scope for robust growth to continue without inflationary pressures, even though the output gap is set to become positive. A more pronounced acceleration in wages,

Table 1:

Overview - the autumn 2017 forecast

	Real GDP			Inflation			Unemployment rate			Current account			Budget balance		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
Belgium	1.7	1.8	1.7	2.2	1.4	1.6	7.3	7.0	6.8	-1.0	-1.1	-0.9	-1.5	-1.4	-1.5
Germany	2.2	2.1	2.0	1.7	1.5	1.6	3.7	3.5	3.2	7.8	7.5	7.2	0.9	1.0	1.1
Estonia	4.4	3.2	2.8	3.7	3.0	2.7	6.9	7.7	8.5	2.3	2.3	2.4	-0.2	-0.4	-0.5
Ireland	4.8	3.9	3.1	0.3	0.8	1.2	6.1	5.5	5.3	2.9	2.5	2.3	-0.4	-0.2	-0.2
Greece	1.6	2.5	2.5	1.2	0.8	1.3	21.8	20.4	18.7	-0.2	0.4	1.0	-1.2	0.9	0.8
Spain	3.1	2.5	2.1	2.0	1.4	1.5	17.4	15.6	14.3	1.7	1.9	1.9	-3.1	-2.4	-1.7
France	1.6	1.7	1.6	1.1	1.2	1.5	9.5	9.3	8.9	-3.0	-2.8	-2.6	-2.9	-2.9	-3.0
Italy	1.5	1.3	1.0	1.4	1.2	1.5	11.3	10.9	10.5	2.5	2.5	2.3	-2.1	-1.8	-2.0
Cyprus	3.5	2.9	2.7	1.0	1.1	1.4	11.0	10.0	9.3	-5.4	-6.2	-6.8	1.1	1.4	1.9
Latvia	4.2	3.5	3.2	2.9	2.8	2.9	8.4	7.9	7.3	-1.4	-1.6	-1.2	-0.9	-1.0	-1.1
Lithuania	3.8	2.9	2.6	3.8	2.9	2.5	7.3	6.8	6.4	-0.7	-0.3	-0.4	0.1	0.2	0.2
Luxembourg	3.4	3.5	3.3	2.1	1.7	1.9	6.1	5.9	6.0	4.6	4.8	4.7	0.5	0.3	0.4
Malta	5.6	4.9	4.1	1.3	1.5	1.8	4.2	4.0	4.0	9.6	9.4	9.8	0.9	0.5	0.5
Netherlands	3.2	2.7	2.5	1.3	1.5	2.2	4.8	4.0	3.5	9.1	8.7	8.4	0.7	0.5	0.9
Austria	2.6	2.4	2.3	2.0	1.6	1.7	5.6	5.5	5.4	2.2	2.9	3.7	-1.0	-0.9	-0.6
Portugal	2.6	2.1	1.8	1.5	1.4	1.5	9.2	8.3	7.6	0.1	0.2	0.2	-1.4	-1.4	-1.2
Slovenia	4.7	4.0	3.3	1.6	1.5	1.8	6.8	5.9	5.2	5.9	5.4	4.9	-0.8	0.0	0.4
Slovakia	3.3	3.8	4.0	1.3	1.7	2.0	8.3	7.4	6.6	0.8	0.7	1.3	-1.6	-1.0	-0.2
Finland	3.3	2.7	2.4	0.9	1.3	1.7	8.6	8.3	8.0	-1.1	-0.3	0.4	-1.4	-1.2	-0.8
Euro area	2.2	2.1	1.9	1.5	1.4	1.6	9.1	8.5	7.9	3.0	3.0	2.9	-1.1	-0.9	-0.8
Bulgaria	3.9	3.8	3.6	1.0	1.5	1.6	6.4	6.0	5.7	3.0	2.4	2.3	0.0	0.0	0.2
Czech Republic	4.3	3.0	2.9	2.4	2.1	2.0	3.0	2.9	2.9	-0.2	-0.3	-0.6	1.2	0.8	0.6
Denmark	2.3	2.0	1.9	1.0	1.4	1.7	5.9	5.6	5.5	8.4	8.3	8.2	-1.0	-1.0	-0.9
Croatia	3.2	2.8	2.7	1.3	1.5	1.6	11.1	9.2	7.5	3.1	1.9	1.9	-0.9	-0.9	-0.7
Hungary	3.7	3.6	3.1	2.3	2.6	3.0	4.2	4.0	4.0	4.3	3.3	3.2	-2.1	-2.6	-2.3
Poland	4.2	3.8	3.4	1.6	2.1	2.8	5.0	4.2	4.0	1.0	0.3	0.1	-1.7	-1.7	-1.9
Romania	5.7	4.4	4.1	1.0	2.9	3.0	5.3	5.1	5.0	-3.1	-3.2	-3.4	-3.0	-3.9	-4.1
Sweden	3.2	2.7	2.2	1.8	1.6	1.7	6.6	6.4	6.3	4.9	5.0	5.1	0.9	0.7	0.6
EU27	2.4	2.2	2.0	1.6	1.5	1.8	8.2	7.7	7.2	3.0	2.9	2.9	-1.1	-0.9	-0.8
United Kingdom	1.5	1.3	1.1	2.7	2.6	2.1	4.5	4.7	4.8	-5.1	-4.6	-4.4	-2.1	-1.9	-1.5
EU28	2.3	2.1	1.9	1.7	1.7	1.8	7.8	7.3	7.0	1.7	1.8	1.8	-1.2	-1.1	-0.9
USA	2.2	2.3	2.1	2.0	2.1	2.2	4.5	4.3	4.1	-2.7	-2.8	-2.9	-5.0	-4.9	-5.1
Japan	1.6	1.2	1.0	0.4	0.8	1.2	2.9	2.8	2.7	3.9	4.1	4.0	-4.3	-3.8	-3.1
China	6.8	6.5	6.2	:	:	:	:	:	:	:	:	:	:	:	:
World	3.5	3.7	3.7	:	:	:	:	:	:	:	:	:	:	:	:

supported by productivity gains, would be an important signpost signalling the ability of the expansion to continue at a robust pace. The broad-based expansion of the European economy is expected to continue over the forecast horizon but the slowing pace of job creation and household purchasing power growth implies a slight moderation in momentum over the next two years. After climbing to 2.2% this year, the highest growth rate in 10 years, euro area GDP growth is forecast to moderate marginally to 2.1% in 2018 and to ease slightly to 1.9% in 2019. Given the ongoing negotiation on the terms of the UK withdrawal from the EU, projections for 2019 are based on a purely technical assumption of status quo in terms of trading relations between the EU27 and the UK. This is for forecasting purposes only and has no bearing on the talks underway in the context of the Article 50 process.

A broad-based acceleration of global economic activity...

During the second quarter of this year, global economic activity accelerated to its strongest pace in seven years, with relatively well synchronised improvements across both advanced economies and emerging markets. Growth in China outperformed expectations, while the ongoing recovery in economies that were previously in recession (Russia and Brazil) has also been stronger than anticipated so far in 2017, helped by the increase in commodity prices. Global growth (excluding the EU) is projected to pick up to 3¾% in 2017 and to increase further to 4% in 2018 and 2019. The economic recovery in emerging markets is expected to continue over the forecast horizon, driven by rebounding trade, benign financing conditions and firmer activity in advanced economies. The pace of economic growth in advanced economies is expected to peak over 2017 and to moderate thereafter as their economic cycles mature. This is particularly the case in the US, where the progressively tighter labour market should eventually boost wage growth. Like other advanced economies, the US economy should benefit from a rebound in investment and trade. Earlier assumptions about a boost to growth from a potential fiscal stimulus in 2018 have been downgraded from modest to negligible. Overall, the US growth outlook remains largely unchanged, at around 2¼% over 2017 and 2018 before easing marginally in 2019.

...triggers a virtuous circle of trade and investment...

The robust momentum in global trade that started mid-2016 looks to have continued in the three first quarters of this year. World imports of goods and services (excluding the EU) are therefore projected to increase by more than 4% per year between 2017 and 2019, which is substantially stronger than expected back in the spring. This upward revision is predominately due to firming global growth but also to the assumption of a faster than previously-expected recovery in trade elasticity as a result of the projected pick-up in investment, which is the most trade-intensive component of domestic demand.

...and supports financial markets...

Financial markets have shown resilience since spring, supported by the strengthening of the global economic recovery, still accommodative monetary policies at the global level and investors' continued search for yield. In the US, strong equity valuations have also been driven by robust corporate earnings growth and expectations of corporate tax reform. European stock markets temporarily underperformed, amid concerns related to the euro's appreciation, but the combination of positive macroeconomic developments and expectations that monetary policy will remain accommodative revived sentiment. On the bond market, euro area benchmark sovereign bond yields have risen only marginally since spring, while the broadening economic recovery has translated into a further narrowing of spreads.

...as monetary policy is on the road to normalisation.

A normalisation process of monetary policy is underway in advanced economies. The US Federal Reserve raised interest rates for the second time this year in June and restated its view that rates should continue to normalise as the recent subdued inflation is seen as transitory. In the euro area, the ECB has kept its monetary policy very accommodative. Market participants expect a first interest rate increase in 2019. Despite increased monetary policy divergence between the euro area and the US, the euro has strengthened since spring against the US dollar and its major counterparts against the backdrop of a solid economic performance and fading political uncertainty in Europe. The euro's nominal effective exchange rate is now assumed to appreciate by about 6% over this year and next.

Euro area firms are diversifying their sources of funding

Bank lending to the private sector continued to rise in the euro area with banks offering persistently very low interest rates. Bank lending is expected to expand as banks ease their credit standards further and the net demand for loans increases. Furthermore, the lending capacity of banks generally has improved amid a further strengthening of their capital positions. But low profitability, non-performing loans (NPLs) and overcapacity in some segments of the European banking sector remain an issue. Meanwhile, market funding also continued to expand. Remarkably for this phase of the cycle, they contributed as much as bank lending to NFCs overall debt funding in recent quarters. As the corporate sector is running surpluses generating substantial internal funds, access to funding does not appear to be a barrier to new investment and there is room to expand it further.

Private consumption is expected to remain the key driver of growth...

Private consumption gathered further momentum in the first half of 2017. The nominal disposable income of households is set to increase strongly this year due to higher labour and non-labour incomes consistent with improved labour market conditions and corporate profits respectively. But higher inflation compared to last year is dampening the purchasing power of households and this effect is likely to be only partially mitigated by lower savings. Accordingly, private consumption growth is expected to decrease from the solid pace recorded last year. Over the next two years, as employment growth is projected to slow, wages to accelerate somewhat and non-labour incomes to continue their upward trend, growth in the nominal disposable income of households should be fairly stable. Reflecting the slight moderation in inflation expected in 2018 and the mild uptick in 2019, as well as a broadly unchanged household saving ratio, private consumption growth should slightly moderate next year before easing in 2019.

...while investment is picking up...

In the first half of the year, investment gained momentum and even surprised on the upside. The outlook for corporate investment has further improved. Higher demand expectations, supportive financing conditions, diminished uncertainty, strong business sentiment, high capacity utilisation rates and increasing corporate profitability, as well as modernisation needs, all contribute to a positive setting for corporate investment. The Investment Plan for Europe is also expected to boost investment. The high stock of NPLs in some countries and the need for further deleveraging could continue to dampen investment growth but to a lesser extent, as both are gradually receding. Assuming the overall monetary stance remains accommodative, market expectations of a steepening of the yield curve should only have a limited negative impact on investment over the forecast horizon. Equipment investment is likely to accelerate next year while the near-term outlook in the construction sector, whose recovery only started last year, is also positive. Differences in the phase of the housing cycle, however, are more pronounced across countries, with some Member States experiencing signs of

overheating. Overall, investment is expected to grow at a robust pace this year and next before slowing somewhat in 2019.

...and net trade should contribute marginally to growth.

Euro area exports are set to accelerate strongly in 2017, in line with the rebound in euro area foreign demand. In 2018 and 2019, export growth is expected to remain robust, supported by the health of foreign demand. Despite the euro's appreciation, the euro area's exports are set to see only a marginal loss in market shares, which could, to some extent, be explained by exporters absorbing the euro's appreciation in their profit margins. Notwithstanding robust import growth, net trade is projected to make a slightly positive contribution to growth over the forecast horizon. The euro area's current account surplus is forecast to fall from 3.3% of GDP in 2016 to 3% this year, as the rise in oil prices contributes to a worsening in the terms of trade. It is expected to broadly stabilise at that level in the outer forecast years.

Job creation continues at a robust pace...

As a result of robust growth dynamics, employment continued to expand strongly in the first half of the year, increasing the number of employed persons in the euro area to the highest level ever recorded and bringing the unemployment rate to its lowest level since early 2009. In 2018 and 2019, employment creation should continue to benefit from the sustained domestic-demand driven expansion, still moderate wage growth, as well as structural reforms implemented in some Member States. However, job creation is set to moderate as a result of the fading of temporary fiscal incentives in some countries and skilled-labour supply shortages in others. Furthermore, the current relatively high elasticity between employment and GDP growth is expected to decrease with a strengthening of labour productivity. With net job creation still significantly outpacing labour force growth, the unemployment rate in the euro area is set to drop from 10% in 2016 to just below 8% in 2019, with nearly half of this decline taking place this year. However, other labour market indicators, such as the relatively low level of working hours per employee, compared to its pre-crisis level, and the relatively high level of 'involuntary' part-time work, suggest persistent, but diminishing, labour market slack.

...but the outlook for inflation remains subdued.

Euro area inflation has oscillated between 1.3% and 2.0% in the first nine months of 2017, mainly as a result of energy base effects. Core inflation, which excludes volatile energy and unprocessed food prices, has remained subdued, but has been gradually rising due to increasing pipeline pressures. The fact that core inflation remains subdued reflects the lagged negative impact of a prolonged period of low inflation, as well as remaining labour market slack and weak wage growth. Headline inflation is projected to dip slightly at the start of 2018 dragged down by negative base effects in energy and unprocessed food prices but also as a result of the euro's appreciation, which should result in lower import prices. Given that oil prices are assumed to remain broadly flat over the forecast horizon, inflation is projected to pick-up gradually in the remainder of 2018 and throughout 2019. Headline inflation is then forecast to slow down from 1.5% this year to 1.4% in 2018 and to tick slightly higher to 1.6% in 2019. While this slight upward trend is consistent with a projected positive output gap in 2019, the rather subdued inflation outlook is mainly related to the projection of increasing but still weak wage growth.

Public finances benefit from improved cyclical conditions...

The euro area's general government deficit is expected to improve this year by more than expected in the spring forecast, since the economy is also expected to grow more strongly. Further, smaller, declines in the euro area deficit are projected in 2018 and 2019, driven by lower interest expenditures and lower spending on unemployment benefits as labour markets continue to improve. The improved outlook for nominal GDP growth and historically low level of interest rates translate into more favourable snowball effects that support the deleveraging of the public sector, with debt-to-GDP ratios projected to be on a downward path in almost all Member States. Under a no-policy-change assumption, the euro area deficit-to-GDP ratio is expected to fall to 0.8% in 2019, while the gross debt-to-GDP ratio is forecast at 85% of GDP.

...while macroeconomic policies are set to remain supportive...

The fiscal policy stance, as measured by the change in the structural balance, is expected to stay broadly neutral in the euro area as a whole over the forecast horizon, even though the fiscal stance is expected to be slightly expansionary in a number of Member States in 2018. Monetary conditions in the euro area are expected to remain accommodative. Short-term money market rates are assumed to increase gradually in 2019 but should remain supportive in real terms. Nominal long term rates are assumed to trend up modestly, but a renewed gradual increase in long-term inflation expectations should keep real long-term financing costs in negative territory.

...and risks have become balanced.

Risks surrounding the economic outlook are broadly balanced. Downside risks are mainly external and mostly come from elevated geopolitical tensions (e.g. on the Korean peninsula) and potentially tighter global financial conditions. A faster or stronger-than-assumed monetary tightening in the US, or an increase in global risk aversion, would not only have important spillovers for countries with elevated leverage but could also impact negatively on Europe. In the medium term, relative high and rising corporate debt in China is increasing financial fragilities and the risk of disorderly adjustment, while more inward-looking policies in the US and elsewhere could have a marked detrimental impact on the global economy. At home, depending on the outcome of the Brexit negotiations, the transition may not be as smooth as technically assumed in this forecast. A stronger-than-assumed appreciation of the euro, especially if not driven by improved economic fundamentals, and a faster-than-assumed steepening of the yield curve would also constitute downside risks. On the upside, sustained diminishing uncertainty, improving sentiment, a faster completion of EMU and the synchronous rebound outside Europe could all result in a more durable and stronger-than-expected expansion in Europe.