# OVERVIEW: STEADY GROWTH RATES AHEAD

## The euro area economy enters fifth year of expansion

The policy-supported economic recovery is continuing…

The European economy is performing well despite a number of challenges. The economic expansion has continued into 2017, thereby completing four years of moderate, uninterrupted GDP growth. Concerns about elevated uncertainty are giving way to improving economic sentiment although this has yet to be reflected in hard economic indicators. Recent data show economic growth continuing at a steady pace, supported by macroeconomic policies, robust job creation, strong confidence, a gradual improvement in world trade, and the euro's relatively low exchange rate.

…but for the upswing to be sustained, investment and wages need to rise more strongly.

But the conditions for an acceleration of economic activity are not yet present, as investment and wages are still constrained by lingering legacies of the crisis. Wage growth remains constrained by the continued presence of slack in the labour market. Hence, healthy net job creation is unlikely to fully offset the negative impact of temporarily rising inflation on household purchasing power. At the same time, investment is still dampened by the high level of public and private debt and the fact that banks and companies still need to adjust their balance sheets. Even if policy uncertainty continues to fade with the completion of elections in a number of EU countries, its impact on investment is set to dissipate only very gradually. Overall, after 1.8% in 2016, euro area GDP growth is set to remain fairly steady at 1.7% in 2017 and 1.8% in 2018.

*Table 1:*

**Overview - the spring 2017 forecast**

| | Real GDP | | | Inflation | | | Unemployment rate | | | Current account | | | Budget balance | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| Belgium | 1.2 | 1.5 | 1.7 | 1.8 | 2.3 | 1.5 | 7.8 | 7.6 | 7.4 | 1.2 | 1.5 | 1.7 | -2.6 | -1.9 | -2.0 |
| Germany | 1.9 | 1.6 | 1.9 | 0.4 | 1.7 | 1.4 | 4.1 | 4.0 | 3.9 | 8.5 | 8.0 | 7.6 | 0.8 | 0.5 | 0.3 |
| Estonia | 1.6 | 2.3 | 2.8 | 0.8 | 3.3 | 2.9 | 6.8 | 7.7 | 8.6 | 2.0 | 1.1 | 1.2 | 0.3 | -0.3 | -0.5 |
| Ireland | 5.2 | 4.0 | 3.6 | -0.2 | 0.6 | 1.2 | 7.9 | 6.4 | 5.9 | 4.7 | 4.8 | 5.0 | -0.6 | -0.5 | -0.3 |
| Greece | 0.0 | 2.1 | 2.5 | 0.0 | 1.2 | 1.1 | 23.6 | 22.8 | 21.6 | -0.5 | -0.5 | -0.3 | 0.7 | -1.2 | 0.6 |
| Spain | 3.2 | 2.8 | 2.4 | -0.3 | 2.0 | 1.4 | 19.6 | 17.6 | 15.9 | 1.9 | 1.6 | 1.6 | -4.5 | -3.2 | -2.6 |
| France | 1.2 | 1.4 | 1.7 | 0.3 | 1.4 | 1.3 | 10.1 | 9.9 | 9.6 | -2.3 | -2.4 | -2.5 | -3.4 | -3.0 | -3.2 |
| Italy | 0.9 | 0.9 | 1.1 | -0.1 | 1.5 | 1.3 | 11.7 | 11.5 | 11.3 | 2.6 | 1.9 | 1.7 | -2.4 | -2.2 | -2.3 |
| Cyprus | 2.8 | 2.5 | 2.3 | -1.2 | 1.2 | 1.1 | 13.1 | 11.7 | 10.6 | -5.7 | -5.9 | -6.3 | 0.4 | 0.2 | 0.7 |
| Latvia | 2.0 | 3.2 | 3.5 | 0.1 | 2.2 | 2.0 | 9.6 | 9.2 | 8.7 | 1.9 | -0.9 | -2.6 | 0.0 | -0.8 | -1.8 |
| Lithuania | 2.3 | 2.9 | 3.1 | 0.7 | 2.8 | 2.0 | 7.9 | 7.6 | 7.2 | -1.1 | -2.0 | -1.9 | 0.3 | -0.4 | -0.2 |
| Luxembourg | 4.2 | 4.3 | 4.4 | 0.0 | 2.4 | 1.8 | 6.3 | 6.1 | 6.0 | 4.7 | 4.5 | 5.0 | 1.6 | 0.2 | 0.3 |
| Malta | 5.0 | 4.6 | 4.4 | 0.9 | 1.6 | 1.8 | 4.7 | 4.9 | 4.9 | 7.9 | 6.5 | 9.0 | 1.0 | 0.5 | 0.8 |
| Netherlands | 2.2 | 2.1 | 1.8 | 0.1 | 1.6 | 1.3 | 6.0 | 4.9 | 4.4 | 7.9 | 7.4 | 7.1 | 0.4 | 0.5 | 0.8 |
| Austria | 1.5 | 1.7 | 1.7 | 1.0 | 1.8 | 1.6 | 6.0 | 5.9 | 5.9 | 2.1 | 2.0 | 2.2 | -1.6 | -1.3 | -1.0 |
| Portugal | 1.4 | 1.8 | 1.6 | 0.6 | 1.4 | 1.5 | 11.2 | 9.9 | 9.2 | 0.5 | 0.5 | 0.5 | -2.0 | -1.8 | -1.9 |
| Slovenia | 2.5 | 3.3 | 3.1 | -0.2 | 1.5 | 1.8 | 8.0 | 7.2 | 6.3 | 7.0 | 6.2 | 5.8 | -1.8 | -1.4 | -1.2 |
| Slovakia | 3.3 | 3.0 | 3.6 | -0.5 | 1.4 | 1.6 | 9.7 | 8.6 | 7.6 | 0.2 | 0.1 | 0.4 | -1.7 | -1.3 | -0.6 |
| Finland | 1.4 | 1.3 | 1.7 | 0.4 | 1.0 | 1.2 | 8.8 | 8.6 | 8.2 | -1.3 | -1.8 | -1.6 | -1.9 | -2.2 | -1.8 |
| **Euro area** | **1.8** | **1.7** | **1.8** | **0.2** | **1.6** | **1.3** | **10.0** | **9.4** | **8.9** | **3.4** | **3.0** | **2.9** | **-1.5** | **-1.4** | **-1.3** |
| Bulgaria | 3.4 | 2.9 | 2.8 | -1.3 | 1.3 | 1.5 | 7.6 | 7.0 | 6.4 | 4.2 | 2.4 | 1.8 | 0.0 | -0.4 | -0.3 |
| Czech Republic | 2.4 | 2.6 | 2.7 | 0.6 | 2.5 | 2.0 | 4.0 | 3.5 | 3.5 | 0.3 | 0.0 | -0.2 | 0.6 | 0.3 | 0.1 |
| Denmark | 1.3 | 1.7 | 1.8 | 0.0 | 1.4 | 1.7 | 6.2 | 5.8 | 5.7 | 8.1 | 7.8 | 7.7 | -0.9 | -1.3 | -0.9 |
| Croatia | 2.9 | 2.9 | 2.6 | -0.6 | 1.6 | 1.5 | 13.3 | 11.6 | 9.7 | 2.6 | 2.9 | 1.3 | -0.8 | -1.1 | -0.9 |
| Hungary | 2.0 | 3.6 | 3.5 | 0.4 | 2.9 | 3.2 | 5.1 | 4.1 | 3.9 | 5.0 | 3.5 | 2.8 | -1.8 | -2.3 | -2.4 |
| Poland | 2.7 | 3.5 | 3.2 | -0.2 | 1.8 | 2.1 | 6.2 | 5.2 | 4.4 | 0.2 | -0.6 | -1.2 | -2.4 | -2.9 | -2.9 |
| Romania | 4.8 | 4.3 | 3.7 | -1.1 | 1.1 | 3.0 | 5.9 | 5.4 | 5.3 | -2.4 | -2.8 | -2.9 | -3.0 | -3.5 | -3.7 |
| Sweden | 3.3 | 2.6 | 2.2 | 1.1 | 1.4 | 1.4 | 6.9 | 6.6 | 6.6 | 4.9 | 5.2 | 5.4 | 0.9 | 0.4 | 0.7 |
| United Kingdom | 1.8 | 1.8 | 1.3 | 0.7 | 2.6 | 2.6 | 4.8 | 5.0 | 5.4 | -4.4 | -3.9 | -3.2 | -3.0 | -3.0 | -2.3 |
| **EU** | **1.9** | **1.9** | **1.9** | **0.3** | **1.8** | **1.7** | **8.5** | **8.0** | **7.7** | **2.1** | **1.9** | **1.9** | **-1.7** | **-1.6** | **-1.5** |
| USA | 1.6 | 2.2 | 2.3 | 1.3 | 2.2 | 2.3 | 4.9 | 4.6 | 4.5 | -2.5 | -2.8 | -3.3 | -4.8 | -4.7 | -5.2 |
| Japan | 1.0 | 1.2 | 0.6 | -0.1 | 0.4 | 1.0 | 3.1 | 3.1 | 3.0 | 3.9 | 4.1 | 4.2 | -3.7 | -4.2 | -3.6 |
| China | 6.7 | 6.6 | 6.3 | : | : | : | : | : | : | : | : | : | : | : | : |
| **World** | **3.0** | **3.4** | **3.6** | : | : | : | : | : | : | : | : | : | : | : | : |

A synchronised pick-up in emerging markets and advanced economies...

Global economic momentum gathered pace in late 2016 and early 2017 in a relatively well synchronised way across advanced economies and emerging markets. Global growth (excluding the EU) is projected to pick up gradually from a seven-year low of 3.2% in 2016 to 3.7% in 2017 and 3.9% in 2018. This improvement should be largely driven by a firming, though still fragile, recovery in emerging markets over the course of this year and next, supported by a gradual increase in commodity prices, the expected return to positive growth in Brazil and Russia, resilient near-term growth in China, and recovering demand from advanced economies.

Growth in advanced economies outside the EU is expected to rise slightly above 2% in 2017 and to stabilise at this pace in 2018. The US growth outlook remains largely unchanged compared to the winter, at around 2¼% in both years. With the US economy performing close to potential and only limited remaining slack, the boost to growth assumed from the new administration's fiscal stimulus promises is likely to be relatively modest. Many observers have now scaled back their initial expectations regarding the overall size and timing of this stimulus, while the uncertainty surrounding the administration's economic policy plans remains high.

...triggers a rebound in world trade.

Reflecting firming global growth, world trade has also been rebounding strongly since the second half of last year. After having grown by a meagre 0.8% in 2016, world imports of goods and services (excluding the EU) are projected to increase by 3.1% in 2017 and 3.8% in 2018, which is marginally stronger than expected back in the winter. This bounce-back also reflects the expected rebound of import elasticity, which is underpinned by the projected cyclical pick-up in import-intensive investment in advanced economies and the gradual fading of various factors that weighed on trade in 2016.

Financial markets eventually turned more cautious...

Despite the relatively robust momentum of the global economy, the strong optimism which has reigned over financial markets since the autumn has been waning since early March. In the US, the strong upward momentum of equities faded as investors reassessed their expectations of the new administration's fiscal stimulus plans. In Europe, by contrast, equity prices have continued to rise, supported by improving economic conditions and sentiment. The general increase in bond yields that had been underway since autumn reversed in March following the decline in global risk appetite, the downward revision of inflation expectations, and the growing expectations of a more gradual pace of monetary policy tightening in the US. German bund yields also fell back, whereas the sovereign bond spreads of some euro area Member States widened somewhat amid heightened political risks.

...amid a further increase in monetary policy divergence...

Monetary policy divergence between the euro area and the US increased further after the US Federal Reserve raised the target range for its policy rate in March while the ECB kept its monetary policy unchanged. Meanwhile, since the beginning of the year, the euro-dollar exchange rate has moved without a clear direction amid uncertainty surrounding both US policy plans and the outcomes of elections in a number of euro area Member States.

...and a continuation of monetary policy pass-through to the euro area banking sector.

Overall, bank lending rates have remained at low levels since the beginning of the year amid somewhat higher corporate bond yields. Bank lending in the euro area as a whole is expected to expand further due to increasing demand and the fact that the lending capacity of banks generally has improved by strengthening their capital positions and reducing the risk on their balance sheets. The economic cycle is thus expected to be accompanied by supportive funding conditions from both banks and market sources. However, in some

Member States, the banking sectors still face balance sheet constraints and low profitability which may limit their capacity to accompany a more substantial pick-up of investment demand once it occurs.

Domestic demand is expected to slow somewhat as consumption moderates…

Private consumption has been the main growth driver over the past few years, growing at its fastest rate in 10 years in 2016. Over recent months, continued improvements in the labour market situation have fuelled consumer confidence, suggesting that the short-term outlook remains favourable. Employment growth is expected to continue at a robust pace over the forecast horizon. Private consumption growth, however, is forecast to moderate this year, as the temporary rise in consumer inflation is set to eat into the purchasing power of households, while saving rates remain almost unchanged. Private consumption should pick up again slightly next year as inflation recedes.

Last year, government consumption expenditure was temporarily boosted by spending related to security and asylum-seekers in some Member States. It is projected to slow down this year and to grow at an unchanged pace next year under a no-policy-change assumption.

…and investment holds steady rather than picking up markedly.

The underlying investment momentum in the euro area, abstracting from very volatile Irish data, slightly strengthened at the end of last year. As the recovery progresses, investment determinants are indeed becoming more promising: global demand is picking-up, capacity utilisation rates are above average and corporate profitability is increasing. Financing conditions are very favourable and policy efforts to support investment have been strengthened e.g. with the Investment Plan for Europe and tax incentives in several Member States. However, in spite of this generally good framework, investment growth is not expected to rise markedly over the forecast horizon, as policy uncertainty, the modest medium to long-term demand outlook, and remaining deleveraging needs, continue to weigh on investment decisions.

The contribution of net exports to growth should turn neutral

The gradual recovery in world trade and a continued adjustment of relative unit labour costs should spur euro area exports in line with their external markets. Given the strengthening final demand, import growth is expected to slightly outpace export growth. The contribution of net exports to euro area GDP growth is thus likely to turn neutral this year and next. The current account surplus of the euro area is set to recede gradually over the forecast horizon from its peak of 3.4% of GDP in 2016, as the earlier positive effects of the euro's depreciation and of the low oil price fade away and the investment-savings balance improves somewhat.

Job creation is likely to ease but remains robust…

Employment in the euro area grew by 1.4% in 2016, its best performance in eight years. Over this year and next, employment creation should continue benefitting from growing domestic demand, relatively moderate wage growth, as well as past structural reforms and specific policy measures in certain countries. While the upward trend in part-time work should also continue feeding net job creation, the still high share of involuntary part-time work continues to reflect slack in the labour market. In the euro area, employment is projected to carry on expanding at a solid pace of over 1%, although some loss of momentum is expected. In the EU, this trend is expected to be more pronounced, as employment growth is forecast to fall from 1.3% in 2016 to 0.9% this year and next. With job creation significantly outpacing labour force growth, unemployment rates in both the euro area and the EU are set to continue declining. In 2018, the unemployment rate is expected to fall to its lowest level since 2008 in both areas, but this would still be above pre-crisis levels.

...while underlying price pressures remain muted...

Inflation has risen significantly in recent months, mainly driven by the temporary positive impact of energy base-effects and the recovery of oil prices. Core inflation, which excludes volatile energy and unprocessed food prices, by contrast, has remained broadly stable at a level substantially below its pre-crisis average. Headline inflation is expected to have peaked in the first quarter of 2017 and is forecast to gradually recede as oil prices are assumed to remain almost flat over the forecast horizon and the temporary impact of their past increase fades away. Euro area headline inflation should continue to be largely driven by energy prices and base effects, rather than by a durable and self-sustained momentum. It is forecast to rise from 0.2% in 2016 to 1.6% in 2017 and to slow down to 1.3% next year, as the modest expected pick-up in core inflation should not completely offset the fading impact of energy prices.

...as wage growth remains constrained.

The pick-up of core inflation is set to be conditional on an intensification of cost pressures. But wage growth, which has been constrained so far by the prolonged period of low inflation, weak productivity growth and labour market slack, is only expected to pick up somewhat over the forecast horizon.

Public finances are set to continue improving...

The euro area's general government deficit-to-GDP and gross debt-to-GDP ratios are projected to continue declining over the forecast horizon, albeit at a slower pace than in previous years. Under a no-policy-change assumption the deficit-to-GDP ratio is expected to fall to 1.3% in 2018, while the gross debt-to-GDP ratio is forecast at 89.0% of GDP. The reduction in the deficit-to-GDP ratio is set to be mainly driven by lower interest payments, one-off and temporary measures and wage bill moderation in the public sector. Automatic stabilisers are also expected to play a role, as the ongoing economic recovery and falling unemployment should reduce expenditure on social transfers as a percentage of GDP. The reduction of the debt-to-GDP ratio should find its roots both in primary surpluses and in a progressively more favourable snowball effect, driven by modest but steady real GDP growth, the uptick in inflation, and reduced average interest rates.

...while macroeconomic policies should remain supportive...

The euro area's fiscal policy stance, measured by changes to the fiscal structural balance, is expected to stay broadly neutral over the forecast horizon under a no-policy-change assumption. Monetary conditions in the euro area are expected to remain accommodative, as the continued implementation of the set of monetary policy measures introduced in recent years, and the gradual increase in long-term inflation expectations, should keep real long-term financing costs in negative territory, despite the assumption of a gradual and modest rise in the nominal long-term interest rate.

...and risks appear more balanced, but still on the downside.

The risks surrounding the economic outlook and the still-fragile global recovery appear more balanced than in the winter but are still tilted to the downside. Whereas there are both upside and downside risks associated with the eventual package of US fiscal stimulus, its interplay with the pace of monetary policy normalisation, as well as any major shift in US trade policy could trigger downside risks for financial market stability, emerging markets and global growth. Geopolitical tensions in the Middle East and East Asia have been mounting in recent months, partially reinforcing vulnerabilities in emerging market economies, whilst the long standing risk of a disorderly adjustment in China remains.