EBF Economic Outlook Nr 43
May 2018

2018 SPRING OUTLOOK
ON THE EURO AREA ECONOMIES IN 2018-2019

ECONOMIC RECOVERY AT CRUISE SPEED

EDITORIAL TEAM:

Francisco Saravia (author), Helge Pedersen - Chair of the EBF Chief Economists' Group (editor) and Alison Bell (sub-editor).

ABOUT THE EBF ECONOMIC OUTLOOK

This bi-annual report is prepared with contributions from the European Banking Federation's Chief Economists' Group, comprising the chief economists of leading European banks and banking associations. This report reflects a consensus on the outlook for the Euro area economy, which is based on arithmetic averages.

ABOUT THE EUROPEAN BANKING FEDERATION

The European Banking Federation serves as the voice of the European banking sector, uniting 32 national banking associations in Europe that collectively represent some 3,500 banks - large and small, wholesale and retail, local and international - employing some two million people. Banks represented through the EBF together make in excess of €20 trillion available in loans to businesses and households across Europe. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.
Website: www.ebf.eu

THE EBF FORECAST FOR THE EURO AREA

- **The Euro area economic growth will expand at a steady pace.** We foresee the Euro area GDP growing by 2.4 percent in 2018 and by 2.1 percent in 2019.

- **European banks see inflation stable.** We expect consumer prices to increase by 1.5 percent annually over the coming years.

- **Public finances will continue to improve.** The Euro area's general government budget deficit will be 0.9 percent of GDP in 2018 and 2019, down from 1.5 percent in 2016.

- **Labour markets will continue to improve over the forecast horizon consolidating the economic recovery phase.** The jobless rate is forecast to be 8.4 percent in 2018 with a further improvement to 7.9 percent in 2019.

Main indicators of CEG consensus

year-on-year growth rates unless specified otherwise, in %

	2017	2018p	2019p
Gross domestic product	2.4	*2.4*	*2.1*
Private consumption	1.7	*1.7*	*1.8*
Public consumption	1.2	*1.4*	*1.4*
Gross fixed investment (GFCF)	2.9	*3.7*	*3.4*
Exports	5.1	*4.9*	*3.9*
Imports	4.3	*4.5*	*4.1*
Unemployment rate	9.1	*8.4*	*7.9*
Prices (HCPI)	1.5	*1.5*	*1.5*
General Government balance (% of GDP)	-0.9	*-0.9*	*-0.9*
General Government debt (% of GDP)	88.8	*87.3*	*84.9*

Source: Projections for 2018 and 2019 from EBF. European Commission data for previous year.

THE CHIEF ECONOMISTS' GROUP CONSENSUS

The Chief Economists' Group of the European Banking Federation expects economic growth in the Euro area to continue growing at a steady pace. The 19-country bloc will continue benefiting from supportive financial conditions, sustained global and domestic demand, and robust growth of global economy. While political uncertainty in Europe is less of a threat than in previous years, geopolitical tensions and escalation of a possible trade conflict remain downside risks. We expect the Euro area to expand, above potential, by 2.4 percent in 2018. The growth is expected to slacken slightly in 2019, when we foresee a GDP expansion of 2.1 percent.

DOMESTIC ECONOMY

Domestic demand remains the key driver for the expansion of the Euro area economy over the last few years, running as it does on the two engines of private consumption and investment, and sustained by job creations, slow return of inflation and improved profitability.

Private consumption continues to benefit from an improved labour market and easy financing conditions. For the sixth consecutive year, private consumption has maintained a healthy growth, albeit at a slightly lower pace, supporting the economic recovery of the Euro area. We expect private consumption to grow by 1.7 percent in 2018 and by 1.8 percent in 2019.

Public consumption started to expand, in 2013, after two years of contraction. After a slowdown in 2017, public consumption is forecast to rise by 1.4 percent in 2018 and 2019.

Fixed business investments will continue its recovery benefitting from favorable financing conditions, after a period of significant decrease mainly due to a wide range of uncertainties and cuts in bank lending in a number of countries, growing by 3.7 percent in 2018 and slightly moderating throughout 2019 to 3.4 percent growth.

GLOBAL ECONOMY

The global economy will continue to expand supporting external demand and boosting European exports despite the Euro appreciation. We expect exports to grow by 4.9 percent this year outpacing a 4.5 percent growth in imports. Export growth will however slow down in 2019, growing by 3.9 percent. European imports will increase in 2019 by 4.1 percent outpacing exports.

Although the US economy does not have the same effect on the global economy as in the last decades, its impact on global economic and financial developments remain particularly high. The strengthening of the recovery in the United States, for example, supports export demand for European and other countries and it is thus likely to be an important source of support for the growth prospects in the Euro area over the forecast horizon. European exports may be, for example, affected should the US administration impose protectionist trade policies. While the US administration has announced for the second time a month-long exemption, until 1 June 2018, of tariffs on EU steel and aluminium exports, EU exports and the growth outlook would be impacted negatively should the US repeal the exemption and impose tariffs on a wider range of goods including, for example, European car exports.

We expect the US economy to grow at a robust pace led by investment, tax reform and significantly higher government spending. The widening of the fiscal and current account deficits, however, poses risks for the US economic growth in the longer run. The Chief Economists' Group estimates that the US economy will grow by 2.6 percent this year and 2.4 percent in 2019.

A key factor for the inflation rate is the price of oil, which fell by some 75 percent during 2014 and 2015, and recently, reached its highest levels since November 2014 amid geopolitical tension. With OPEC countries expected to decide later this year whether to stick to their current production quotas, our consensus forecast for the oil price (Brent) in 2018 is around USD 66 and USD 65 in 2019.

FISCAL POLICY AND PUBLIC DEBT

The fiscal policy stance is expected to remain broadly neutral. Since the peak of the financial crisis, the deficit ratio has decreased mainly due to the low interest environment and the economic upswing. The Chief Economists' Group foresees the Euro area fiscal deficit to equal 0.9 percent of GDP in 2018 and 2019.

This, in combination with the economic recovery, will translate into a reduction of the debt to GDP ratio over the forecast horizon. We foresee this rate reaching a level of 87.3 percent by the end of 2018 and inching further downwards to 84.9 percent by the end of 2019. This is an encouraging development given that the debt to GDP ratio reached an all-time high of 94.5 percent in 2014. Nonetheless, public debt remains historically high and long-term plans are required to reduce public indebtedness towards more sustainable levels.

PRICE DEVELOPMENTS AND MONETARY POLICY

Despite momentum in the economy, lowest unemployment levels seen since 2008, and ECB's stimulus measures to boost inflation in the Euro area, inflation is still below the ECB's objective of price stability. That is, below, but close to 2.0 percent.

With still significant slack in the labour market limiting upward pressures on wages and prices, gains in the forecast horizon will be modest. After a slow start in 2018, temporary factors related to energy prices will play a major role in inflation developments as the base effect will add to inflation in H2 2018 and H1 2019. The overall rate of inflation is expected to come in at 1.5 percent both in 2018 and 2019 after increasing by 0.2 percent in 2016.

Core inflation (excluding volatile items like commodities, energy and non-processed food) will increase this year at a lower rate, 1.2 percent, due to weak labour market dynamics i.e. wage growth and lower import prices. For 2019, we forecast core inflation to reach 1.5 percent as the effect of past EUR appreciation evaporates. Core inflation and wage inflation are still strongly influenced by the important slack on the labour market. Structural factors due to changing labour markets have also reduced the responsiveness of wages to the fall in unemployment.

Monetary policy continues to be very accommodative. The key interest rates are at their historical low. The ECB expects them to remain at their present levels for an extended period of time, and well past the horizon of its net asset purchases, which are intended to run until end September 2018, or beyond, if necessary, and until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim.

Given the still moderated inflationary outlook, the Chief Economists' Group expects the ECB to remain cautious in its communication and action. While some countries represented in the Chief Economists' Group consider the ECB's easy monetary policy stance still justified, others recommend, with deflation no longer posing risks to the Euro area, the end of deflationary oriented monetary policy measures such as the QE-Programme and the negative interest rate.

LABOUR MARKET

Labour market conditions are expected to remain favourable over the forecast horizon driven by the economic upturn. With economic growth above potential, unemployment is improving and will continue this trend over the coming years. We foresee unemployment in the Euro area at 8.4 percent in 2018, with a further improvement to 7.9 percent in 2019, the lowest levels since 2008. These figures will continue, however, to mask uneven rates across the Euro area countries. The slack in the labour market will keep wage pressures contained. Our consensus view is that wages are expected to rise by 1.5 percent in 2018 and a slightly higher 1.6 percent in 2019.

THE EURO

A downward correction of the EUR against the USD in the short run is possible as the interest rate differential between the US and the Euro area rises. In the medium to long term, fundamentals point to a weakening of the USD against the EUR, due to: a higher inflation differential between both economies; the twin deficit problem in the US; and the threat of a US-induced trade war. Furthermore, the EUR is likely to appreciate as ECB tightens monetary policy i.e. an ECB announcement of a period of tapering beyond September 2018 will likely weigh on the EUR, and the current account gap remains hugely in favour of the Euro area.

The Chief Economists' Group's consensus forecast for the euro/dollar exchange rate at the end of 2019 is 1.26 with a relatively wide margin between 1.18 and 1.33.

RISK TO THE SCENARIO

The CEG's consensus remains surrounded by a number of both upside and downside risks.

A) UPSIDE RISKS

+ Solid growth of the world economy allowing the Euro area to continue growing above potential and making the 19-country bloc more resilient to external shocks.
+ Expectations for higher private consumption, good pace of growth for public consumption and the fixed gross capital formation. Also, stronger economic momentum leading to higher investments.
+ An even longer period than currently expected with extremely lenient monetary conditions.

B) DOWNSIDE RISKS

– Although the uncertainty related to the political events in Europe has diminished, geopolitical tensions have the potential to spark a period of instability disturbing buoyant global growth.

– Trade tensions between the US and China may trigger a trade battle that would harm the recovery of the global economy. The Euro area, that is relatively highly exposed to external trade, would be severely hit if EU-US trade frictions start and US tariffs are imposed on EU sectors.

– Although negotiations between the European Union and the United Kingdom seem to be progressing in the right direction with the conclusion of the first stage of negotiations, the final outcome and next stage i.e. trade negotiations, remain a major concern.

– Sudden increase in inflation leading to sooner than expected tightening of monetary policy.

The risks to the growth outlook are fairly balanced, according to the Chief Economists' Group

ANNEX 1:

SPRING POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2018

TABLE 1		2017	CEG Consensus 2018			Previous CEG Economic Outlook	European Commission Forecast
			2018 Mean	2018 Range		Autumn 2017	Spring 2018
1. Output and aggregate demand:	(Ann.% change)						
Gross domestic product (GDP)		2.4	2.4	1.6	2.8	1.9	2.3
Private consumption		1.7	1.7	1.4	1.9	1.7	1.7
Public consumption		1.2	1.4	1.2	2.0	1.3	1.4
Gross investment (GFCF)		2.9	3.7	2.8	4.9	3.7	4.2
Exports		5.1	4.9	3.7	5.9	3.8	5.4
Imports		4.3	4.5	3.3	5.1	4.4	5.2
2. Labour market and prices:	(Ann.% change)						
Unemployment rate (%)		9.1	8.4	8.0	9.0	8.7	8.4
Wages (Unit Labour Cost)		0.7	1.5	1.1	2.0	1.6	1.4
Prices (HCPI)		1.5	1.5	1.2	1.7	1.3	1.5
Core HCPI		1.0	1.2	1.1	1.4	1.2	
3. Public finances:	(% GDP)						
Government Balance		-0.9	-0.9	-1.7	-0.6	-1.2	-0.7
Government Debt		88.8	87.3	84.4	93.0	89.2	86.5
4. External sector:	(% GDP)						
Trade Balance		3.8	3.5	3.1	4.0	3.9	3.8
Current Account Balance		3.5	3.4	2.8	4.2	3.0	3.4
(p.m.) US growth	(Ann.% change)	2.3	2.6	2.2	3.0	2.3	2.9
(p.m.) Oil price (Brent)	(US$/bl)	54.8	66.0	60.0	75.0	56.5	67.7
5. Monetary and financial indicators:							
Interest rate on ECB's main	June	0.00	-0.07	-0.40	0.00	0.01	
refinancing operations	December	0.00	-0.08	-0.40	0.00	0.02	
3 month interest rate (EURIBOR)	(year-end)	-0.33	-0.30	-0.35	-0.27	-0.23	
10 year government bond yield (Bund)	(year-end)	0.42	0.96	0.63	1.30	0.99	
M3 growth	(annual growth)	4.6	4.26	3.90	4.70	4.50	
Credit to private sector (M3 definition)	(annual growth)	2.8	2.64	2.00	3.10	2.75	
Exchange rate USD/EUR	(year-end)	1.13	1.24	1.20	1.27	1.21	1.23

ANNEX 2:

SPRING POLL ON THE EURO AREA ECONOMIC OUTLOOK FOR 2019

TABLE 2		2017	CEG Consensus 2019			European Commission Forecast
			2019 Mean	2019 Range		Spring 2018
1. Output and aggregate demand:	(Ann.% change)					
	Gross domestic product (GDP)	2.4	2.1	1.8	2.3	2.0
	Private consumption	1.7	1.8	1.5	2.2	1.7
	Public consumption	1.2	1.4	1.0	2.0	1.3
	Gross investment (GFCF)	2.9	3.4	2.4	5.1	3.4
	Exports	5.1	3.9	2.5	4.4	4.4
	Imports	4.3	4.1	2.4	5.3	4.5
2. Labour market and prices:	(Ann.% change)					
	Unemployment rate (%)	9.1	7.9	7.2	8.8	7.9
	Wages (Unit Labour Cost)	0.7	1.6	1.2	2.1	1.0
	Prices (HCPI)	1.5	1.5	1.3	1.7	1.6
	Core HCPI	1.0	1.5	1.3	1.8	
3. Public finances:	(% GDP)					
	Government Balance	-0.9	-0.9	-1.7	-0.5	-0.6
	Government Debt	88.8	84.9	82.1	91.0	84.1
4. External sector:	(% GDP)					
	Trade Balance	3.8	3.3	3.0	3.6	3.8
	Current Account Balance	3.5	3.3	2.2	4.3	3.4
(p.m.) US growth	(Ann.% change)	2.3	2.4	2.0	2.9	2.7
(p.m.) Oil price (Brent)	(US$/bl)	54.8	64.5	59.0	75.0	63.9
5. Monetary and financial indicators:						
Interest rate on ECB's main	June	0.00	0.03	-0.40	0.25	
refinancing operations	December	0.00	0.17	-0.15	0.75	
3 month interest rate (EURIBOR)	(year-end)	-0.33	-0.02	-0.25	0.16	
10 year government bond yield (Bund)	(year-end)	0.42	1.31	0.85	1.70	
M3 growth	(annual growth)	4.6	4.03	3.00	5.00	
Credit to private sector (M3 definition)	(annual growth)	2.8	2.71	2.00	4.00	
Exchange rate USD/EUR	(year-end)	1.13	1.26	1.18	1.33	1.23