Eurozone economic outlook

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Investment Is Driving Growth

The economy in the euro area continues to grow strongly. Real GDP is expected to increase by +0.6% in Q4 2017 and Q1 2018, thus maintaining the same pace of expansion as in the four quarters before. A slight slowdown to +0.5% is expected only in Q2 2018. The drivers of expansion are investments. Private consumption is also rising sharply, but at slower pace compared to the first half of 2017. Inflation in the euro area is expected to drop from 1.4% in Q4 2017 to 1.2% in Q1 2018. This is due to base effects resulting from increases in energy and food prices last winter. In Q2 2018 inflation is projected to pick up again to 1.4%. Risk premia compression and increased financial investors' risk-taking behaviour in particular asset markets could lead to large asset price corrections. Turmoil and substantial losses in financial markets would have negative consequences for the real economy as well.

Global economy expands strongly

The strong global expansion continued in Q3 2017. World GDP is expected to continue to grow strongly in Q4 2017, Q1 2018 and Q2 2018. Simultaneously, world trade has seen a strong expansion in Q3 2017 and is projected to slow down only gradually over the forecast horizon.

Investment-driven upswing in the euro area continues

Euro area GDP kept growing in Q3 2017 by 0.6%, marking the fourth consecutive expansion by 0.6% or above. Growth was still driven by a strong expansion in investment with a positive contribution of foreign demand. In contrast, private consumption expanded at lower pace than in the previous quarters due to surprisingly weak consumption dynamics in Germany.

TABLE 1 | Forecasts 2017/18

% Change, seasonally and working day adjusted

	Q4/2017		Q1/2018		Q2/2018		2017
	q/q	*y/y*	***q/q***	*y/y*	***q/q***	*y/y*	*Year average*
IPI	**0.9**	3.5	**0.8**	4.2	**0.7**	3.6	2.7
GDP	**0.6**	2.5	**0.6**	2.5	**0.5**	2.3	2.4
Consumption	**0.4**	1.8	**0.4**	1.7	**0.4**	1.5	1.8
Investment	**1.1**	4.3	**1.0**	5.4	**0.9**	4.1	4.0
Inflation		1.4		1.2		1.4	1.5

Source: ifo-Istat-KOF forecast

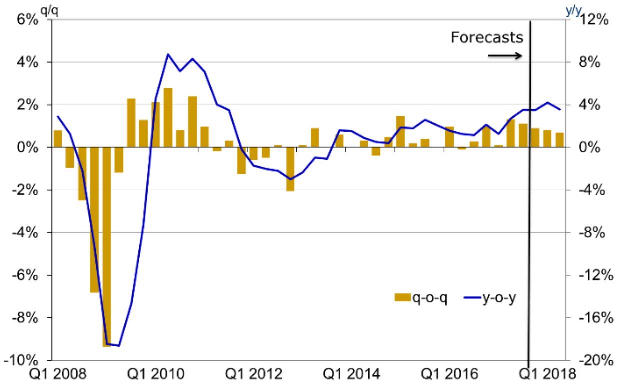
Industrial production (excluding construction) increased by 1.1% in Q3 2017, at a slightly slower pace than in Q2 2017. The increase in Q3 was driven by the production of capital goods which corroborates the strong growth in investment. In addition, high business confidence in manufacturing confirms the positive trend registered for the last two years indicating a further expansion.

Nevertheless a slight deceleration is expected in industrial production (+0.9% in Q4 2017, +0.8% in Q1 2018 and +0.7% in Q2 2018). Notably, these growth rates are still substantially above long-term average.

Consumer confidence continued to strengthen during the past months in line with the continuing improvement in labour market conditions. Growth in private consumption expenditures is expected to continue on a stable path (+0.4% in Q4 2017 and the two following quarters). These growth rates constitute a pick-up as compared to Q3.

FIGURE 1 | Eurozone Industrial Production Index

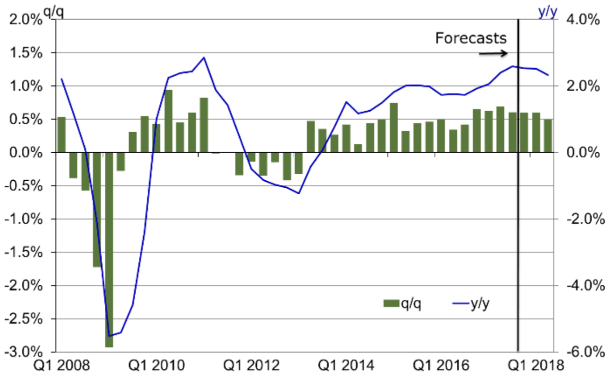
Seasonally and working day adjusted



Source: Eurostat and forecasts ifo-Istat-KOF

Investment growth has been weak for a protracted period of time after the euro crisis when firms deleveraged and reduced risk positions. Supported by the ECB's monetary expansion, the investment cycle picked up in 2016 and high growth rates are expected in Q4 2017 (+1.1%) and in Q1 2018 (+1.0%). We expect a slight slowdown in investment dynamics in Q2 2018 (+0.9%). The investment outlook remains positive due to favorable financing conditions.

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



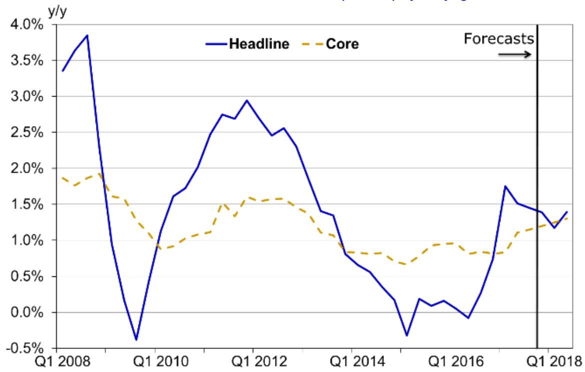
Source: Eurostat and forecasts ifo-Istat-KOF

Overall, the economic expansion in the euro area is expected to continue at a relatively fast pace in the short term and to flatten only gradually over the forecast horizon (+0.6% in Q4 2017, +0.6% in Q1 2018 and +0.5% in Q2 2018). GDP in 2017 is expected to grow by 2.4% - the highest annual growth rate since 2007.

Inflation drops and picks up again

The harmonized index of consumer prices (HICP) increased by +1.5% year-on-year in Q3 2017. The increase in energy prices since June 2017 pushes consumer prices up. However, in Q4 2017 and Q1 2018 this effect gets outweighed by a fading base effect from past energy price fluctuations. We forecast HICP inflation to be 1.4% in Q4 2017 and 1.2% in Q1 2018. In Q2 2018 inflation will pick up again as the aforementioned energy price effect starts to dominate (1.4%). During the year 2018 the economic upswing will result in gradually increasing core inflation rates. The inflation forecast is based on the technical assumption that the Brent oil price remains stable at 67 USD per barrel and that the USD/Euro exchange rate stays at 1.20 over the forecast horizon.

FIGURE 3 | Eurozone Inflation
Harmonised Index of Consumer Price (HICP), y-o-y growth rates



Source: Eurostat and forecasts ifo-Istat-KOF

Risks have increased

Low interest rates and high liquidity provision during the past years have led to increasing leverage in specific sectors and markets. Increased risk-taking in financial markets could have adverse consequences in the case of an abrupt and sizeable repricing in risk premia, which may lead to a tightening of financial market conditions. The term structure of interest rates in the United States has flattened, which has been a reliable indicator for economic slowdowns in the past. However, the financial sector is more resilient today in comparison to 2007 and central banks are nowadays readier to intervene quickly.

Downside risks for the outlook also stem from the fragile albeit improving situation of the banking sector of some member countries, mainly due to the still high level of non-performing loans. On the upside, the current positive momentum, as signaled by favorable economic and financial market sentiment, increases the chances of a stronger than expected economic expansion in the Euro Area, particularly in the short term.

Methodological note

This quarterly publication is prepared jointly by the German ifo Institute, the KOF Swiss Economic Institute, and the Italian Istat Institute. The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the three institutes. They are based on time-series models using auxiliary indicators from business surveys by national institutes, Eurostat, and the European Commission. The joint three-quarter forecast covers Eurozone industrial production, GDP, consumption, investment, and inflation. Further country-specific and global economic analysis is available by:

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