Eurozone economic outlook

March, 26th 2018

Robust growth continues

The expansion in the euro area economy is set to continue, buoyed by global economic activity growth and export demand. In Q1 and Q2 2018 the Eurozone economy is expected to grow at a similar pace compared to the end of 2017 (+0.6%), then slightly slower in Q3 (+0.5%). The main force behind the expansion in economic activity will be investment, driven by favourable financing conditions and still upward trending capacity utilization. Investment is forecast to strengthen in Q1 2018 with a slight deceleration in Q2 and Q3. Private consumption expenditures are expected to grow robustly still supported by the improvements in the labour market. Inflation is set to rise only in the second part of the year.

Strong growth in global economy

Growth in global economic activity continues to maintain strong, supported by a marked development in world trade. Worldwide economic growth has been broad based. According to OECD data for 2017 as a whole, real GDP increased by 3.8% in the G20 area from 3.2% in 2016. Growth prospects remain positive for advanced economies and have also improved for some emerging market economies, including China.

Growth remains robust driven by investment

In Q4 2017 Euro area GDP increased by 0.6%, slightly decelerating compared to the previous quarters (+0.7% in Q2 and Q3). GDP growth was driven by exports and investments, which have contributed by +0.9 and +0.2 percentage points respectively. In contrast, private consumption increased at lower pace than in the previous quarters.

TABLE 1 | Forecasts 2018

% Change, seasonal and working day adjusted

	Q1/2018		Q2/2018		Q3/2018		2018
	q/q	*y/y*	**q/q**	*y/y*	**q/q**	*y/y*	*Overhang*
IPI	**0.9**	5.1	**0.7**	4.4	**0.5**	3.7	3.8
GDP	**0.6**	2.6	**0.6**	2.5	**0.5**	2.3	2.3
Consumption	**0.5**	1.5	**0.5**	1.5	**0.4**	1.6	1.5
Investment	**1.0**	3.4	**0.9**	2.6	**0.7**	3.5	3.0
Inflation		1.3		1.6		1.7	1.4

Souce: Ifo-Istat-KOF forecast

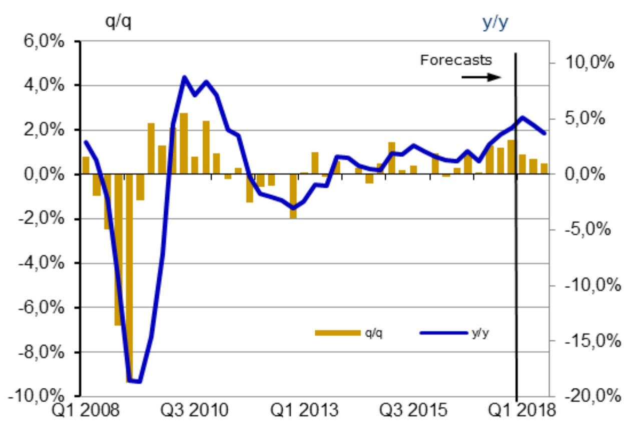
In February, the Economic Sentiment Indicator (ESI) declined slightly in the euro area as a result from a decrease across all sectors except for services. The decline in industry confidence was mainly due to a strong reduction in managers' production expectations.

Industrial production (excluding construction), after the strong growth in fourth quarter 2017 (+1.5% q-o-q), decreased by 1% in January 2018, due to a fall in production of energy, durable consumer good and intermediate goods, while production of capital goods rose strongly. The industrial production index is expected to grow at a lower pace over the forecast horizon compared to the previous quarters (+0.9% in Q1 2018, +0.7% in Q2 and +0.5% in Q3).

Consumer confidence dropped markedly in February following a strong uptick in January, whereas consumers' views on the future general economic situation and on households' future financial situation deteriorated only slightly. Nevertheless, consumer confidence remains still clearly above its long-term average, supported by improving labour market conditions. The number of persons employed increased by 0.3% in the fourth quarter of 2017 and unemployment remains at the lowest rate since December 2008 (8.6%). A stable expansion of private consumption expenditures is expected over the forecast horizon (+0.5% in Q1 and Q2 and +0.4 in Q3).

FIGURE 1 | Eurozone Industrial Production Index

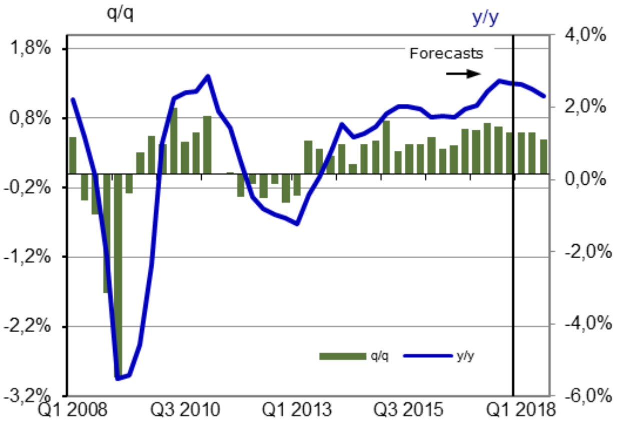
Seasonally and working day adjusted



Source: Eurostat and forecast Ifo-Istat-KOF

Bank lending conditions in the euro area have continued to improve and the most recent ECB Bank Lending Survey provides still positive signals towards expansion in investment. Supported by the ECB's monetary expansion and a continuing rise in capacity utilization in the manufacturing industry, investment should continue to grow at a robust pace over the forecast horizon: higher growth rate is expected in Q1 2018 (+1%) with a deceleration in the following quarters (+0.9% and +0.7% respectively in Q2 and Q3).

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



Source: Eurostat and forecasts Ifo-Istat-KOF

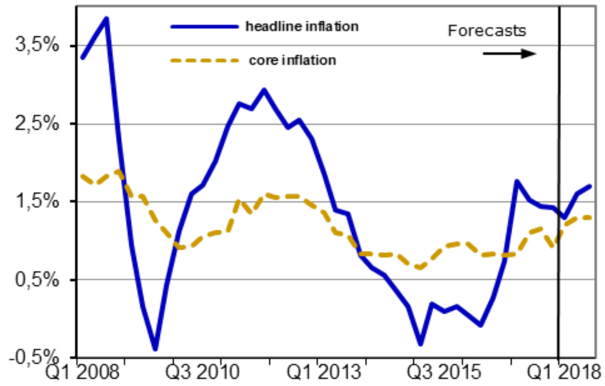
Overall, the growth in euro area economic activity is expected to continue at the same pace in in Q1 and Q2 (+0.6%) with a small reduction in Q3 (+0.5%).

Inflation is expected to accelerate

The harmonized index of consumer prices (HICP) inflation decreased steadily to 1.1% in February 2018, after peaking in November 2017. In the first months of 2018 core inflation without energy and unprocessed food remained at 1.2% and is projected to steadily increase along the forecast horizon, sustained by economic expansion. According to the EU Commission's surveys, industry manager's selling-price expectations remained stable on a high level in February. Also consumer's price expectations, following the strong increase in January showed only a small reduction in February.

Year-on-year HICP inflation is forecast to be 1.3% in Q1 2018 and to pick up to 1.6% in Q2. In Q3 inflation is expected to rise modestly reaching a rate of 1.7%. The inflation forecast is based on the technical assumption that the Brent oil price remains stable at 66 USD per barrel and that the USD/Euro exchange rate stays at 1.23 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 to drivers of growth

Interest rate normalization may create tensions in the financial markets and potentially deteriorate credit conditions, which could negatively influence the recovery of investment. Besides investment, GDP growth is supported by a strong impulse from international trade. However the recent introduction of import duties on raw materials by the US government and possible countermeasures by its main trading partners could hit world trade. As well, the appreciation of the euro since the beginning of last year could dampen export growth.

Some risks associated with political uncertainty remain, like the process of Brexit negotiations as well as the recent results of the elections in Italy and geopolitical tensions in the Middle East.

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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