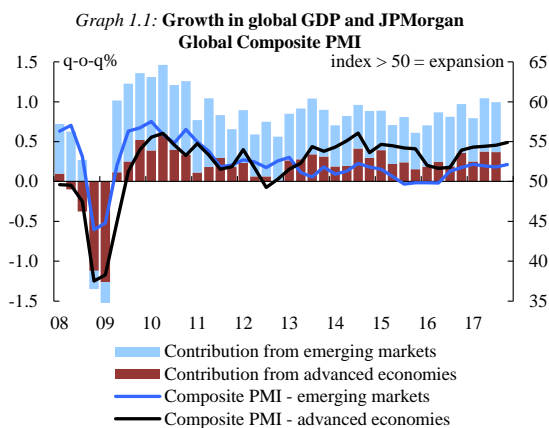


1. EA AND EU OUTLOOK

1.1. GLOBAL ECONOMY CONTINUES TO FIRM

Momentum in the global economy remains strong, as the broad-based cyclical upswing continues, buoyed by the rebound in investment and trade, still favourable financial conditions and a supportive policy mix. Higher commodity prices are also proving supportive for commodity exporters. The near-term outlook is slightly stronger than projected in autumn, with global GDP growth outside the EU now expected at 4.1% in both 2018 and 2019, compared to 3.8% in 2017. Upward revisions since the autumn are mostly concentrated in advanced economies, particularly the US, but growth prospects have also improved for some emerging markets, including China. Sustained, robust momentum in the near term is consistent with the broad-based strength in business and household confidence across most emerging markets and advanced economies (see Graph 1.1).

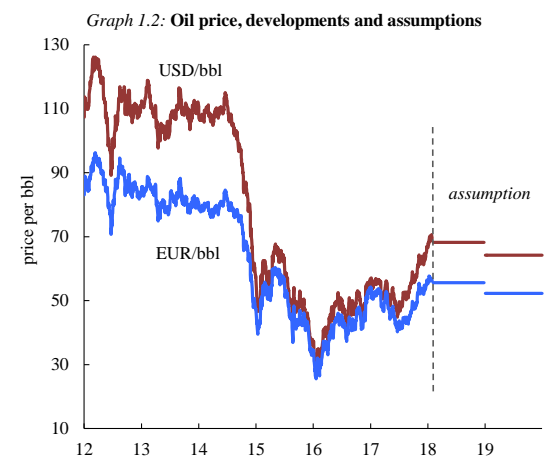


Sources: Macrobond, IMF and national statistical institutes for GDP, JPMorgan/Markit for PMI.

In the US, economic activity remains buoyant, supported by a number of benign factors, namely easy financial conditions, a weaker dollar, expansion in the energy sector, and strong external demand. The recent US tax reform is expected to add to this momentum, generating a fiscal stimulus of around 1½ pps. of GDP over 2018-2019, and boosting economic growth further in the near term due to higher business investment, as well as household spending. However, given the advanced stage of the cycle, some of the stimulus may be offset by faster monetary policy normalisation and higher interest rates than assumed earlier. Given the temporary nature and heavy frontloading of

some tax reform elements and the current above-potential growth, US growth might turn lower in the longer term.⁽¹⁾ As regards emerging markets, the near-term growth outlook has also improved slightly, including in commodity exporters and China, where export growth is buoyant and service sector momentum has strengthened.

Global import volumes (outside the EU) are expected to have grown by 4.6% (y-o-y) in 2017 (compared to 1.3% in 2016), driven by solid imports in advanced economies, and buoyant trade across Asia and most other emerging market economies. The momentum is expected to carry into 2018 and to moderate only slightly in 2019. Global import growth is expected to pick up by 4.7% in 2018 and 4.5% in 2019 (up from 4.1% for both years in the autumn forecast). This reflects an upward revision to the outlook for global GDP growth and a further uptick in the elasticity of trade, largely driven by stronger investment dynamics.



The extension of an agreement on production cuts between OPEC and Russia, as well as geopolitical tensions in the Middle East, lifted Brent oil prices to nearly 70 USD/bbl in January, considerably higher than assumed in the autumn forecast. Further price rises, however, are projected to be more limited as higher oil prices would weigh on global demand growth and non-OPEC producers (notably the US⁽²⁾) are expected to increase output. Based on futures markets, prices for Brent oil are assumed to increase by an average of 24.6%

⁽¹⁾ IMF (2018). World Economic Outlook Update, January.
⁽²⁾ See ECB (2017). 'The oil market in the age of shale oil'. *Economic Bulletin* 8, pp. 57–74.

to 68.3 USD/bbl in 2018 compared to 2017, before falling by 5.9% to 64.2 USD/bbl in 2019 (see Graph 1.2).

1.2. FINANCIAL CONDITIONS REMAIN SUPPORTIVE

Monetary policy divergence has increased...

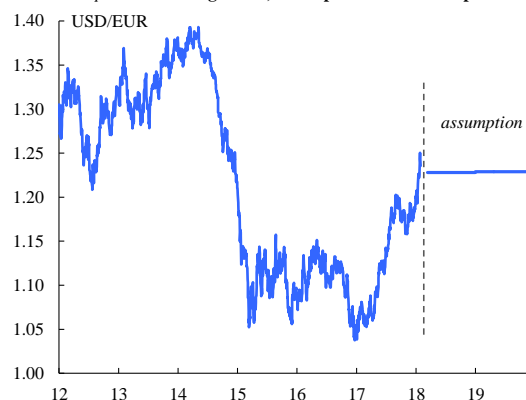
Since autumn, monetary policy divergence across advanced economies has widened. At its recent meetings, the ECB Governing Council decided to keep unchanged its forward guidance on policy rates. It also decided to recalibrate its asset purchase programme (APP), extending the expected duration of purchases to at least September 2018 and reducing the size of its monthly purchases to EUR 30bn from January 2018 onwards. In January 2018, the Governing Council confirmed that an ample degree of monetary stimulus remained necessary. In December, the Bank of Japan re-affirmed its strong commitment to its inflation target and decided to maintain its highly accommodative monetary policy stance.

By contrast, the US Federal Reserve (Fed) in December raised its target range for the federal fund rate for the third time in a year, to 1.25-1.50%. At their monetary policy meeting, US policymakers expected that three additional interest rate hikes would be warranted in 2018, signalling a somewhat faster pace of normalisation than expected by markets. As widely anticipated, the Bank of England raised rates for the first time in 10 years, delivering a 25bps. hike to 0.5%. Looking ahead, the Bank signalled that any future increases in the policy rate would likely be gradual and limited.

...and the euro exchange rate strengthened.

The euro has appreciated more than 2% in nominal effective terms since November 2017, driven by stronger-than-expected economic growth, lower political uncertainty, and expectations of a faster pace of monetary policy normalisation. At the same time, the euro has appreciated by about 7% against the US dollar (see Graph 1.3).

Graph 1.3: Exchange rates, developments and assumptions

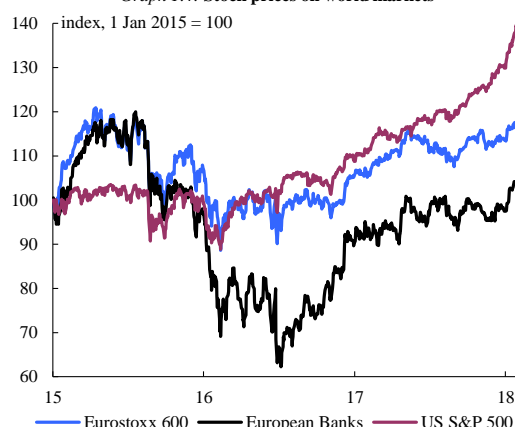


Optimism drove financial markets in the past months...

In the sovereign bond markets, benchmark yields in the EU have picked up since the turn of the year but remain very low. Most sovereign bond spreads have continued to narrow as the economic and fiscal outlook has strengthened. In the US, 10-year Treasury yields have moved up. In the EU, real yields, at least of the highest rated sovereigns, remain negative across the maturity spectrum.

European equity indices further strengthened but have underperformed global peers, as the appreciation of the euro has clouded the corporate earnings outlook (see Graph 1.4). US stock indices have recently dropped from the record highs they had reached on the back of the government's tax package and strong corporate earnings.

Graph 1.4: Stock prices on world markets



With the economic expansion broadening and interest rates persistently low, global investors remain in a search-for-yield mode. As a result, the compensation for inflation and credit risks has been squeezed. Consistent messaging from the Fed

and the ECB that the normalisation of monetary policy would be prudent, gradual and well communicated in advance has reassured risk-on investors.

Based on the most reliable valuation measures, US stocks seem pricy.⁽³⁾ While the low interest rate environment should *per se* favour high equity valuations, valuations have to be seen in the context of lower growth prospects in the medium term as the cycle matures and the impact of population ageing becomes stronger. At the same time, profit margins are unlikely to indefinitely remain as high as they are now. European stock markets, by contrast, appear more moderately valued.

...and lending conditions improved further.

Bank lending in the euro area has continued to expand. Last year, loans to households grew by 2.8% and loans to non-financial corporations by 2.9%. The January 2018 ECB Bank Lending Survey also provides positive signals consistent with the ongoing recovery in bank lending volumes, with competitive pressures and risk perceptions having an easing impact on credit standards. Looking towards 2018-Q1, banks expect a net easing of credit standards and increased net demand across all loan segments.

Market funding continued to expand in the euro area with positive monthly net issuance of both equity and corporate bonds. Despite strong corporate bond issuance volumes (+9.6% annual growth rate in November 2017), bank lending contributed slightly more than bonds to the overall funding of non-financial corporations (NFCs) over the last couple of months. This is unsurprising in the current stage of the economic cycle, even though NFCs seem to have generally adopted more market-oriented funding structures.

Overall, both households and NFCs are expected to continue benefitting from supportive financing conditions over the forecast horizon. Furthermore, the euro area corporate sector continues to generate sizeable internal funds, which could potentially be used to support investment spending.

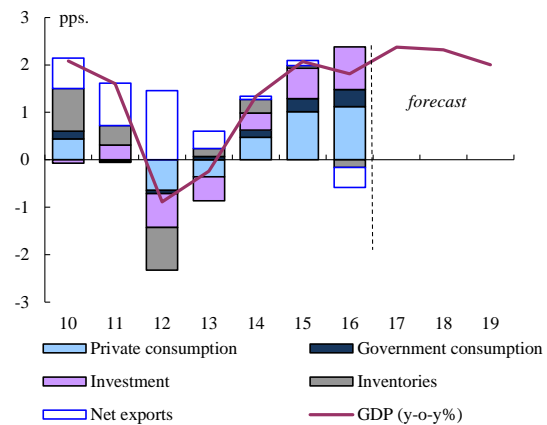
⁽³⁾ Shiller cyclically-adjusted price-to-earnings ratio (P/E), Market Capitalisation/Gross Value Added ratio, Market Capitalisation/GDP and Tobin's Q.

1.3. EXPANSION MAKING HEADWAY

Growth remained robust...

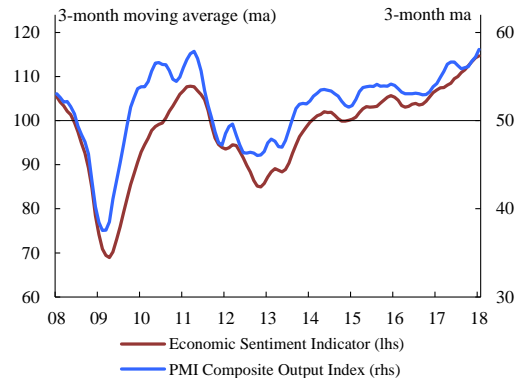
In 2017-Q3, GDP grew by 0.7% (q-o-q) in both the euro area and the EU, the same as in the previous quarter and slightly above earlier expectations. The y-o-y rate stood at its highest since 2011-Q1. According to Eurostat's preliminary flash estimate, the European economy ended 2017 on a strong note, growing by 0.6% (q-o-q) in the last quarter. The EU and euro area economies have now been growing by at least 0.6% for five consecutive quarters.

Graph 1.5: Real GDP and its components, euro area



For the year as a whole, GDP is estimated to have grown by 2.4% in both the euro area and the EU, higher than predicted in the autumn and the highest rate in 10 years. The upward revision reflects stronger-than-expected growth in the second half of the year, well above potential (see Graph 1.5).

Graph 1.6: Economic Sentiment Indicator and PMI Composite Output, euro area



Source: EC, Markit Group Limited

The robust and broad-based nature of the expansion, across sectors and countries, benefited

from high consumer and business confidence, an improving labour market, continued policy support, and stronger global output and trade (see Graph 1.6).

...and the expansion is increasingly broad-based...

Domestic demand remained the main growth engine over the first three quarters of 2017⁽⁴⁾ although net trade made the largest contribution in the third quarter (+0.5 pps. in the euro area). This development may be less significant than it seems, however, because domestic demand remains the main driver when highly volatile Irish data is excluded. Gross fixed capital formation in Ireland dropped by 36% (q-o-q) in 2017-Q3, which led to a contraction of euro area investment of 0.3% (q-o-q). Excluding Ireland, investment dynamics in the euro area would have remained strong, growing at a rate of at least 1% (q-o-q) for the third consecutive quarter. The annual growth rate of investment in the euro area, excluding Ireland, is estimated to have reached 4.5%, its highest since 2007-Q3.

Private consumption expenditure continued to benefit from the improved performance of the labour market, although it lost some momentum in the third quarter when growth slipped to 0.4% (q-o-q) compared to 0.6% in the preceding quarter. Expenditure on non-durable goods and services moderated appreciably whereas household consumption of durable goods picked up compared to the previous quarter. At the same time, government consumption growth remained stable in the euro area at 0.3%, staying in the range of 0.2% ±0.1 pps. for the sixth consecutive quarter.

Despite a stronger euro, euro area exports rose by 1.5% q-o-q in 2017-Q3 (after +1.1% in 2017-Q2), in line with the higher momentum in world trade. Importantly, it was also the highest annual rate since the first half of 2015. Imports increased by 0.5% (after +1.6% in 2017-Q2), also reflecting a sharp contraction of Irish imports (-10.9% q-o-q).

...with continued cyclical momentum ahead...

Signals from recent surveys are consistent with continued strong growth in the near term. The European Commission's Economic Sentiment Indicator (ESI) rose considerably in the fourth quarter of 2017, reaching its highest levels since

2000 in the euro area and the EU in October and August respectively. In January 2018, the ESI weakened slightly in the euro area and the EU for the first time in eight months. This softening was driven by lower confidence in services and retail trade. Despite this slight decline, the ESI remains above its 2017-Q4 average, its highest in 17 years. In parallel, the euro area Flash Composite Output Purchasing Managers' Index (PMI) increased in January to its highest reading in nearly 12 years, mostly on the back of the fastest acceleration of service sector growth since August 2007.

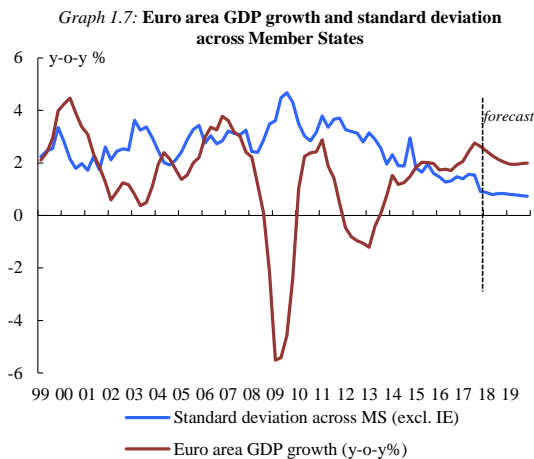
...on the back of increasingly solid fundamentals...

The growth outlook for 2018 has been revised upwards compared to the autumn forecast. Diminishing uncertainty, improving sentiment and the synchronous rebound outside Europe led to a stronger-than-expected expansion in the second half of last year. With a stronger carry-over from 2017 and continued growth momentum in early 2018, GDP is now expected to grow by 2.3% this year in both the euro area and the EU. While growth is still forecast to moderate gradually, this now looks likely to set in later than previously expected.

Over the forecast horizon, the expansion is set to remain solid, broad-based across sectors and countries, and increasingly self-sustained. As in autumn, it is expected to continue benefiting from a supportive policy mix, with monetary policy remaining overall accommodative, and a broadly neutral fiscal policy stance in the euro area as whole. Although the output gap is set to become positive, the remaining slack in the labour market offers scope for solid growth to continue. Moreover, all euro area countries are set to grow in the forecast years, with growth differentials narrowing further (see Graph 1.7).

Domestic demand is set to remain the main growth engine in 2018, with private consumption continuing to grow at a robust pace and investment continuing to recover. Exports are also expected to support the expansion going forward, on the back of strong external demand. With job creation expected to ease from its current brisk pace, the resulting slowdown in household purchasing power growth implies a slight moderation in momentum towards 2019.

⁽⁴⁾ GDP components are not yet available for 2017-Q4.



Given the ongoing negotiations over the terms of the UK’s 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. As in the autumn, this is for forecasting purposes only and has no bearing on the outcome of the talks underway in the context of the Article 50 process.

...with domestic demand to remain robust...

Private consumption should continue benefitting from high consumer confidence and labour market improvements this year and next, though at a slower pace. Lower deleveraging needs, as well as past increases in house prices could further support the near-term outlook.

Investment should continue to grow at a robust pace this year and next. According to the European Commission’s latest investment survey, investment volumes in the euro area manufacturing sector are expected to accelerate this year compared to 2017. Overall respondents report the best investment climate in 10 years. The pick-up in investment intentions is also underpinned by the continuing rise in capacity utilisation, which is now well above its long-term average and at its highest since 2008-Q2.

Favourable financing conditions, diminished uncertainty, strong sentiment, and increasing corporate profitability are all set to support business investment. The improved external demand outlook should further translate into a stronger impetus for equipment investment. As in the autumn, assuming that the overall monetary stance remains accommodative, market expectations of a steepening yield curve should only have a limited negative impact on investment.

Furthermore, the Investment Plan for Europe is expected to boost investment through improved access to finance. ⁽⁵⁾

...and exports benefiting from the strong momentum in world trade.

The strengthening external environment creates scope for European exports to perform even better than expected in the autumn. This is consistent with surveys showing an improvement in export order book expectations over the last three months. Despite the euro’s appreciation, ⁽⁶⁾ euro area export growth is expected to remain robust with imports following their historical elasticity to final demand.

Overall, euro area GDP is forecast to continue growing in 2018 at broadly the same pace as in 2017 (2.3%), before moderating to 2.0% in 2019. The expected gradual withdrawal of policy stimulus, the uncertainty around the Brexit transition agreement and the emergence of supply-side constraints are set to weigh on economic activity. The expected slowing of economic growth in 2019 is also consistent with a gradual convergence of actual growth towards potential growth in the medium term.

1.4. LABOUR MARKET CONDITIONS CONTINUE TO SHOW STRONG DYNAMICS

In the first three quarters of 2017, the euro area’s labour market improved further amid a solid economic expansion. Employment rose by 0.4% quarter-on-quarter in 2017-Q3, resulting in an annual increase of 1.6%. The number of employed persons currently stands at the highest level ever recorded. Yet the number of total hours worked in the economy remains below its pre-crisis level (by 3%) despite continuing to rise in line with job creation. This reflects the change in the composition of employment towards a higher share of part-time employment but also suggests that labour resources remain underutilised. Involuntary

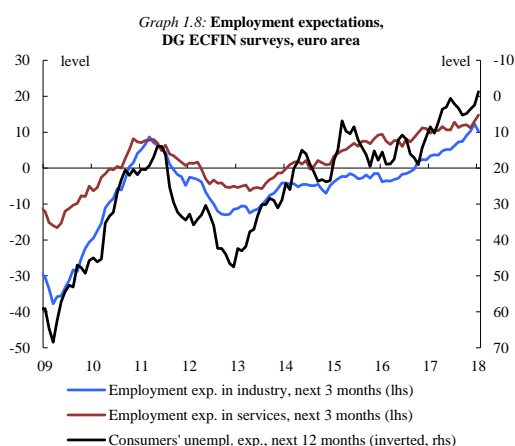
⁽⁵⁾ As of December 2017, operations approved under the Investment Plan for Europe, were expected to trigger 256.1 billion in investments. Around 539,600 small and medium-sized companies (SMEs) are expected to benefit from improved access to finance.

⁽⁶⁾ On the impact of an appreciation of the euro exchange rate see *European Economic Forecast – Autumn 2015*, European Economy Institutional Paper 63/2017, Section I.1, pp. 38–39).

part-time work - though diminishing - remains high. ⁽⁷⁾

In November 2017, the unemployment rate in the euro area stood at 8.7%, its lowest level since January 2009. The fall in unemployment has continued to be stronger than suggested by the pace of economic expansion. ⁽⁸⁾ Labour market conditions have improved across all Member States. Though significant differences remain, such improvements are reflected in a lower dispersion of unemployment rates. Although it continues to fall, long-term unemployment remains above its pre-crisis level.

Survey indicators of firm's employment expectations are consistent with continued job creation in the fourth quarter of last year and in the period ahead, with the unemployment rate set to continue falling. In January, hiring intentions in the manufacturing sector stood close to a 30-year high and are at their highest since early 2001 in the services sector (see Graph 1.8). At the same time, there are growing signs of labour shortages in some Member States and sectors, implying that employment growth is set to moderate over the forecast horizon. Both in the industry and services sectors, the percentage of firms mentioning labour as a factor limiting production has been increasing, particularly over the past two years.



⁽⁷⁾ Coeuré, B. (2017). 'Scars or scratches? Hysteresis in the euro area'. Speech at the International Center for Monetary and Banking Studies, Geneva, 19 May.

⁽⁸⁾ See, European Commission (DG Employment, Social Affairs and Inclusion) (2017). 'Labour Market and Wage Developments in Europe, Annual Review'.

1.5. THE OUTLOOK FOR INFLATION REMAINS SUBDUED

Despite the impact of higher energy prices, euro area inflation remained subdued in the fourth quarter of 2017, with headline inflation softening to 1.4% in December from 1.5% in November. Average inflation in the fourth quarter stood at 1.4%, marginally below what was expected in the autumn. This could be attributed to special factors within services inflation related to transport, packaged holidays and accommodation components which declined strongly. At the same time, non-energy industrial goods inflation remained broadly flat, whereas food price inflation increased notably in the last quarter of the year. The impact of energy inflation was positive given the increase in oil prices, although this was partly offset by base effects. ⁽⁹⁾

Mostly as a result of slowing services inflation, core inflation – which excludes volatile energy and unprocessed food prices – remained subdued at 1.1% throughout the fourth quarter, down from 1.3% in the preceding quarter. That core inflation remains subdued mostly reflects the lagged negative impact of a prolonged period of low inflation dragged by the past collapse in oil prices, and weak wage dynamics related to, among other things, ⁽¹⁰⁾ labour market slack.

Indeed, considering the sustained improvement in the labour market, wage growth has remained unusually contained. The annual growth of both nominal compensation per employee and negotiated wages stood stable in 2017-Q3 compared to the preceding quarter (at +1.7% and +1.5%, respectively), whereas hourly labour cost growth slipped to +1.6% (+1.8% in 2017-Q2). Overall, annual unit labour cost growth remained muted in the third quarter of the year, reflecting a cyclical improvement in productivity and moderate growth in compensation per employee.

All these factors are set to change course as the synchronised upswings in economic activity and oil prices are expected to exert a positive impact in both 2018 and 2019. Their effect, however, is

⁽⁹⁾ Base effects are defined as the contribution to the change in the year-on-year inflation rate in a particular month that stem from a deviation of the non-seasonally adjusted month-on-month rate of change in the same month of the preceding year from the usual seasonal pattern.

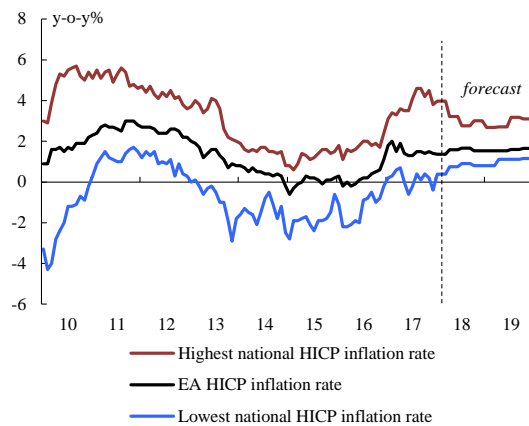
⁽¹⁰⁾ See M. Ciccarelli and C. Osbat (2017), eds. 'Low inflation in the euro area: Causes and consequences'. *ECB Occasional Paper Series* 181.

expected to be muted somewhat by the euro’s higher effective exchange rate. According to the Commission’s surveys, industry managers’ selling-price expectations reached their highest level since mid-2011, while service managers’ expectations are well above their historical average and have been on an upward trend since early 2013. Although still below the long-term average, consumers’ price expectations are now close to their highest level since early 2014. Furthermore, industrial price pressures at the producer level also crept up during the year.

Over the forecast horizon, headline inflation is expected to rise modestly although with a humped-shaped profile in 2018, mainly driven by the pass-through of oil price movements⁽¹¹⁾. Inflation differentials are also expected to narrow, with the lowest inflation rates forecast to converge gradually towards the euro area average, whereas the highest inflation rates - mainly in the Baltic States - reflect the robust economic growth of the respective countries and also move towards the euro area average rate (see Graph 1.9). Overall, headline inflation is forecast to average 1.5% over 2018, slightly higher than forecast in the autumn. Positive energy base effects are set to kick in materially in the second and third quarters of the current year. The implementation of a number of tax measures may further impact the shape of inflation developments. These include the increase in tobacco and fuel taxes in France in 2018 and higher indirect taxes in the Netherlands in 2019.

In 2019, with above-trend growth, the diminishing slack in the labour market is projected to lift domestic price pressures and to eventually reassert labour market-wage-inflation linkages.⁽¹²⁾ This should result in a gradual up-tick in core and headline inflation in the euro area despite the downward slope of the oil price futures curve (as of the cut-off date). Headline inflation is thus expected to stand at 1.6% in 2019, unchanged compared to the autumn forecast.

Graph 1.9: Inflation dispersion, euro area Member States



Market-based measures of inflation expectations⁽¹³⁾ have continued to recover and have risen gradually since autumn. At the cut-off date of this forecast, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at around 1.3%. Swap rates at the three-year forward three-year-ahead horizon imply an average inflation of close to 1.6%. On a longer horizon, the widely watched five-year forward five-year-ahead indicator suggests inflation of 1.8% (see Graph 1.10). Moreover, the ECB’s January 2018 Survey of Professional Forecasters includes inflation forecast means of 1.5% in 2018 and 1.7% in 2019 (up from 1.4% and 1.6% respectively in the 2017-Q4 exercise). Longer-term inflation expectations stood unchanged at 1.9%.

Graph 1.10: Inflation expectations derived from implied forward inflation-linked swap rates



⁽¹¹⁾ ECB (2016). ‘Oil prices and euro area consumer energy prices’. *Economic Bulletin* 2, pp. 9–11. Holm-Hadulla, F. and K. Hubrich (2017). ‘Macroeconomic implications of oil price fluctuations: a regime-switching framework for the euro area’. *ECB Working Paper Series* 2119.
⁽¹²⁾ Mersch, Y. (2017). ‘Challenges for euro area monetary policy in early 2018’. Speech at the 32nd International ZinsFORUM. Frankfurt am Main, 6 December.

⁽¹³⁾ Market-based inflation expectations such as inflation swap-rates are influenced by inflation risk and liquidity premiums, so the measured rate does not necessarily reflect underlying inflation expectations directly.

1.6. RISKS REMAIN BROADLY BALANCED

Overall, risks to the growth outlook remain broadly balanced. The risk factors in the short term and the medium term, however, are quite different.

On the upside, there is scope for growth to gather further momentum in 2018, triggered by positive feedback loops emerging from economic sentiment, investment and wage dynamics. However, should this happen, the expansion could run into supply-side constraints sooner than otherwise expected. In addition, clear progress on deepening the EMU could boost confidence and growth during the forecast years making the euro area more resilient in the face of possible asymmetric shocks.

Downside risks have also become more pronounced. The latter are mostly found on the

external side such as the possibility of tighter global financial conditions as well as the potential of a sharp correction in financial markets. Such an event could be triggered by, for example, a faster-than-expected tightening of US monetary policy (caused by e.g. stimulus-driven inflation surprises). Stretched valuations for some asset classes, including equity, combined with broadly-based low volatility and compressed risk premia suggest that global financial markets may be vulnerable to a re-assessment of fundamentals and risks.⁽¹⁴⁾ This could expose fragilities related to the debt overhang in a number of Member States. Also risks related to the outcome of Brexit negotiations remain, as do risks associated with a shift towards more inward looking and protectionist policies. The relevance of downside risks related to geopolitical tensions in the Middle East and the Korean peninsula appears to have increased.

⁽¹⁴⁾ See also, 'A paradoxical tightening', *BIS Quarterly Review*, December 2017; and, 'Higher future financial market volatility: potential triggers and amplifiers', *ECB Financial Stability Review*, November 2017.