

Macroeconomic Conditions and Outlook

1.1 INTRODUCTION

The global economy has moved from recovery mode into a strong upturn. Supported by the robust development of private consumption and a marked increase in investment, in particular advanced economies made a major contribution to the current wave of global economic expansion. Output gaps in the euro area and the United States are expected to close soon or have already done so. Strong contributions are also coming from East and Southeast Asia. The Chinese economy and the Japanese economy expanded strongly, both fuelled by economic stimuli. In Latin America, the recovery was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. In India, the economy is regaining its footing after a banknote demonetisation and a VAT system reform.

Monetary divergence between the major economic regions continues. While the Japanese central bank continues to stick to its ultra-expansionary monetary policy, the US Federal Reserve is already on the path to normalisation. At the start of the year, the European Central Bank (ECB) halved its bond purchases and a first interest rate hike is expected in 2019. This slow pace is driven by experiences of past economic crises. These have shown that a hasty increase in interest rates can lead to excessive loan defaults and, as a result, to major distortions in financial markets. On the other hand, the low interest rate environment of recent years has promoted financial leverage and encouraged investors to go into riskier assets in search of higher yields. From a historical perspective, stock markets in some European countries and in the United States appear overvalued. Yields on highly speculative bonds are also extremely low at present. The gradual flattening of the yield curve in the United States indicates that there are concerns in financial markets about future developments. In the past, flat yield curves were reliable indicators of an imminent economic downturn. However, the size of default risk assets is nowhere near as high as it was prior to the last financial crisis in 2007. In addition, the financial system has become much more

resilient, which decreases both the likelihood and the impact of financial market crises. Moreover, given the experience of the Great Recession and the European debt crisis, central banks have a greater willingness to respond quickly in the event of financial turbulence.

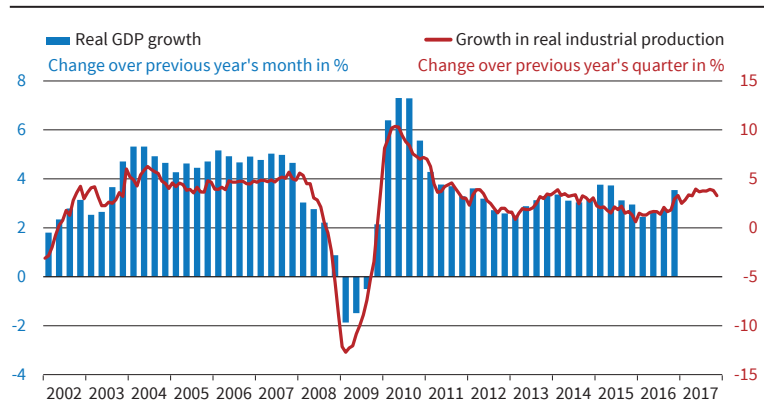
The global upturn is likely to continue for a while, and will gradually slow down. The expansion in Europe and North America will also weaken over the forecast horizon, as the factors of production in these regions will be increasingly over-utilised. This view is also supported by the results of the latest *ifo* World Economic Survey. In the advanced economies both the assessment of the current situation as well as the expectations for the upcoming six months regarding economic developments have continued to rise in recent quarters. Whereas some developing and emerging countries still assess their current situation negatively, they also look optimistically into the future. They are likely to benefit from a revival in world trade and the recovery in commodity prices.

1.2 CURRENT SITUATION

1.2.1 Global Economy

After the Great Recession and a swift initial recovery in 2010, the global economy remained in moderate growth mode until last year. Whereas in 2012/13 the euro crisis and in 2016 lower than expected growth in the United States and recessionary trends in commodity-exporting emerging economies like Russia and Brazil kept the world economy from growing faster, last year all major regions benefited from a global economic upswing. The pace of expansion increased

Figure 1.1
World Economic Growth^a and Growth in Industrial Production



^aPurchasing Power Parity (PPP) weighted aggregate year-over-year real GDP growth rate.

Source: IMF International Financial Statistics; CPB Netherlands Bureau for Economic Policy Analysis; last accessed on 27 January 2018.

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markedly during 2017 and real GDP increased in the second half of 2017 at an annualised change of about 3.5%, compared to a rate of just above 3% in the first half of the year. A main driver of the upturn is industrial production in both advanced economies and emerging economies (see Figure 1.1). After a pronounced period of weakness in 2015 and 2016, it accelerated significantly until early summer 2017, and has since expanded at largely unchanged high growth rates.

Global commodity trading gained momentum too. Although emerging markets were the main drivers of this recovery, the international exchange of goods also accelerated in the advanced economies. Despite a strong upturn at the end of 2016, trade growth has been well below industrial production growth in emerging and developing countries since 2011 (see Figure 1.2). This remarkable change as compared to the pre-crisis period and relative to the advanced economies, where an increase in industrial production goes hand in hand with a disproportionate increase in commodity trading, is most probably related to China: As it moves up in the global value chain, the foreign content of China's exports is diminishing. World trade and world GDP are expected to have increased by 4.4 and 3.2% respectively last year (see Table 1.A.1). Both figures imply a substantial increase as compared to 2016 (1.4 and 2.5%). This acceleration is almost equally due to emerging and advanced economies.

Economic growth has largely accelerated due to the waning importance of a large number of risks over the course of last year (see Figure 1.3). The long-feared slump in China, for example, has still not materialised, mainly because domestic demand has proven robust. The implementation of far-reaching economic policy measures in the United States has also failed to date for various reasons. Although the Brexit vote slowed economic development in the United Kingdom, there has not yet been any slide back into a

Figure 1.2
Trade and Industrial Production in Advanced and Emerging Economies

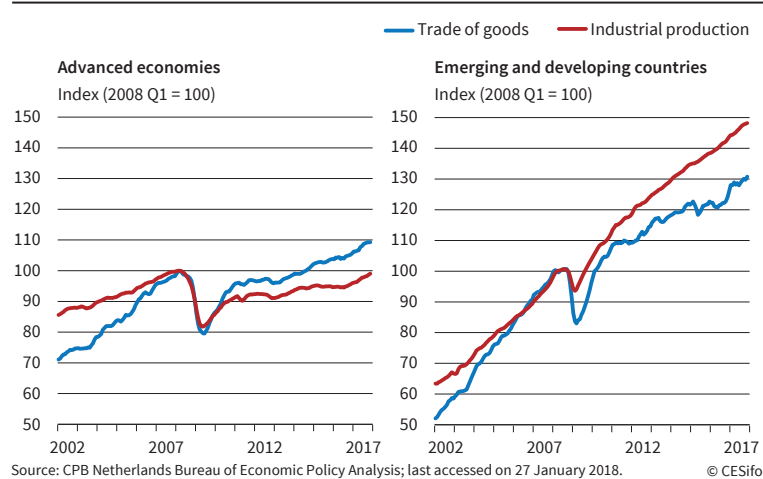


Figure 1.3
Global Economic Policy Uncertainty Index

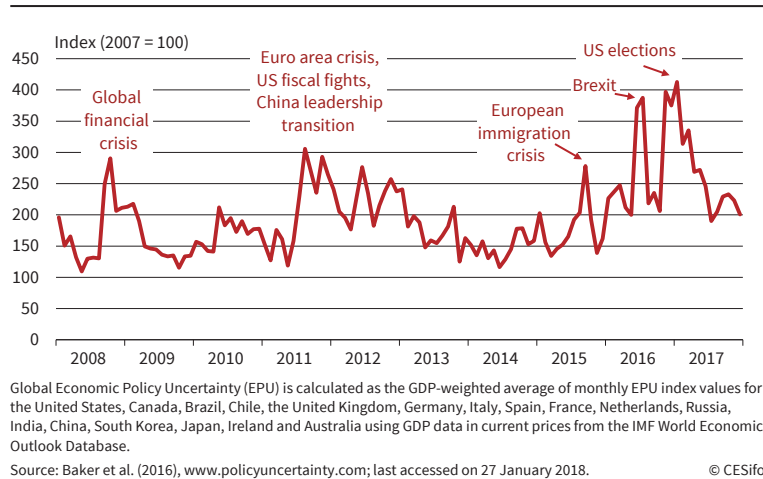
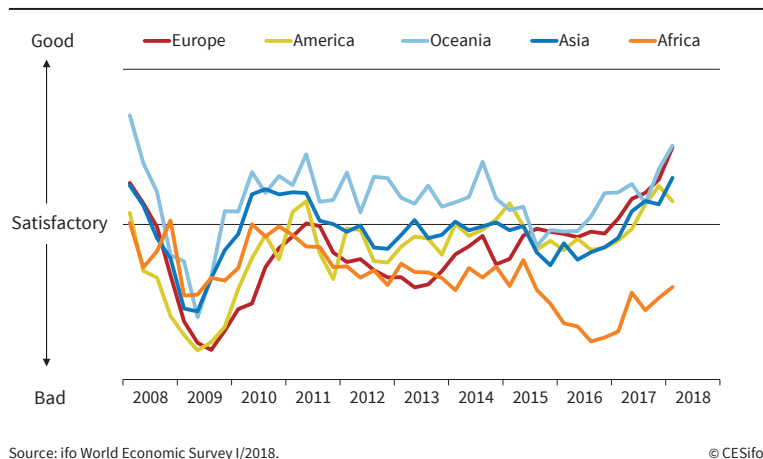


Figure 1.4
ifo World Economic Survey
Economic situation



recession or any clear negative feedback from major British trading partners. In the parliamentary elections in the Netherlands, France, and Germany, Eurosceptic parties won fewer votes than feared, meaning that the European Union did not suffer any further losses in political stability.

Against this background, companies and households' expectations have brightened more than originally anticipated and the global economic momentum has consolidated. By and large economic sentiment in most parts of the world improved clearly over the course of last year. With the exception of Africa, all continents are now clearly performing well above average indicating the excellent economic conditions that are prevailing in most parts of the world. Although the economic situation in Africa has improved, it is still at a historically low level (see Figure 1.4).

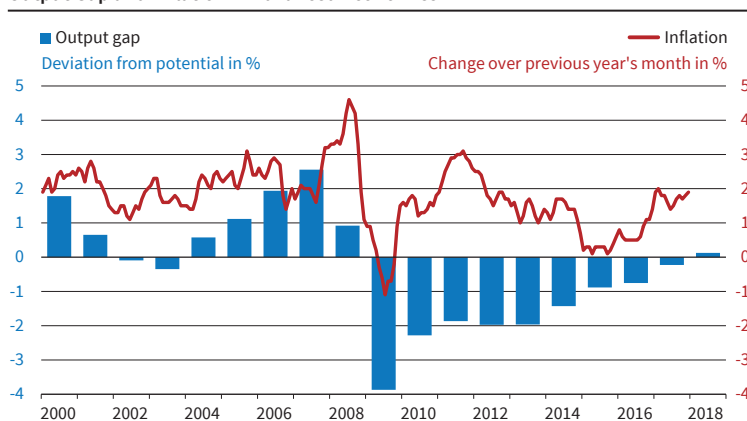
Inflation rates, albeit still moderate, picked up compared to the two preceding years. After falling into a trough in 2015, inflation rates in most parts of the world have increased steadily since. This is particularly true for the advanced economies. The recovery in inflation rates was mainly due to an increase in crude oil prices (see Figure 1.5), which was due to both restrictions imposed by OPEC countries on the supply side, and the global economic recovery on the demand side.

By contrast, core inflation rates, which measure the increase in consumer prices without taking the volatile energy and food price components into account, have more or less moved laterally in most advanced economies. There is a considerable amount of slack in inflation after the protracted period of capacity under-utilization following the Great Recession. The closure of output gaps in advanced economies last year has not yet put pressure on prices (see Figure 1.6).

1.2.2 United States

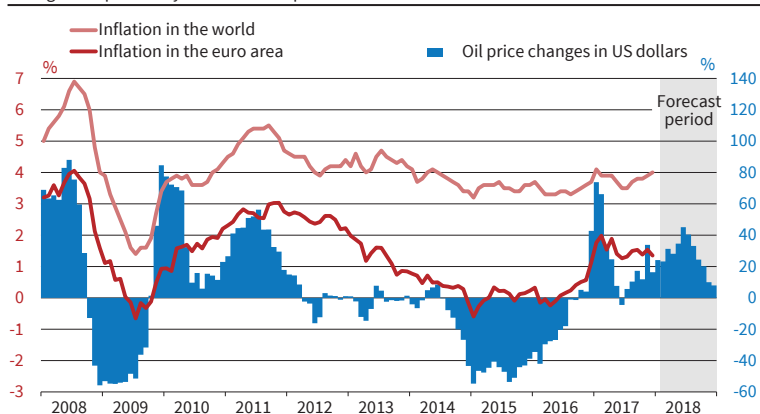
After weak growth during the winter 2016/17, the United States experienced a strong upturn during the summer half of 2017 with GDP growth rates of above 3% (see Figure 1.7). Although private consumption and investment activity were dampened in the third quarter by the impact of hurricanes in Texas and Florida, businesses steadily stocked up. In addition, the public sector intervened on

Figure 1.5
Output Gap and Inflation in Advanced Economies



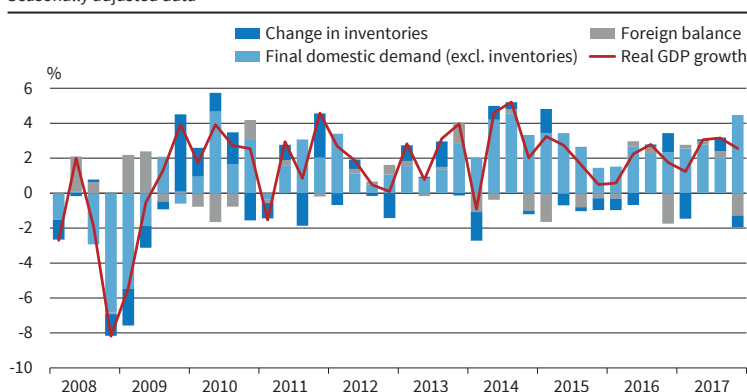
Source: IMF World Economic Outlook, IMF International Financial Statistics; last accessed on 27 January 2018. © CESifo

Figure 1.6
Inflation in the World and Oil Price Movements
Change over previous year's month in percent



Note: Forecast for 2018 based on the assumption that oil prices remain steady from January 2018 onwards. Source: IMF International Financial Statistics; last accessed on 27 January 2018. © CESifo

Figure 1.7
Contributions to GDP Growth^a in the United States
Seasonally adjusted data

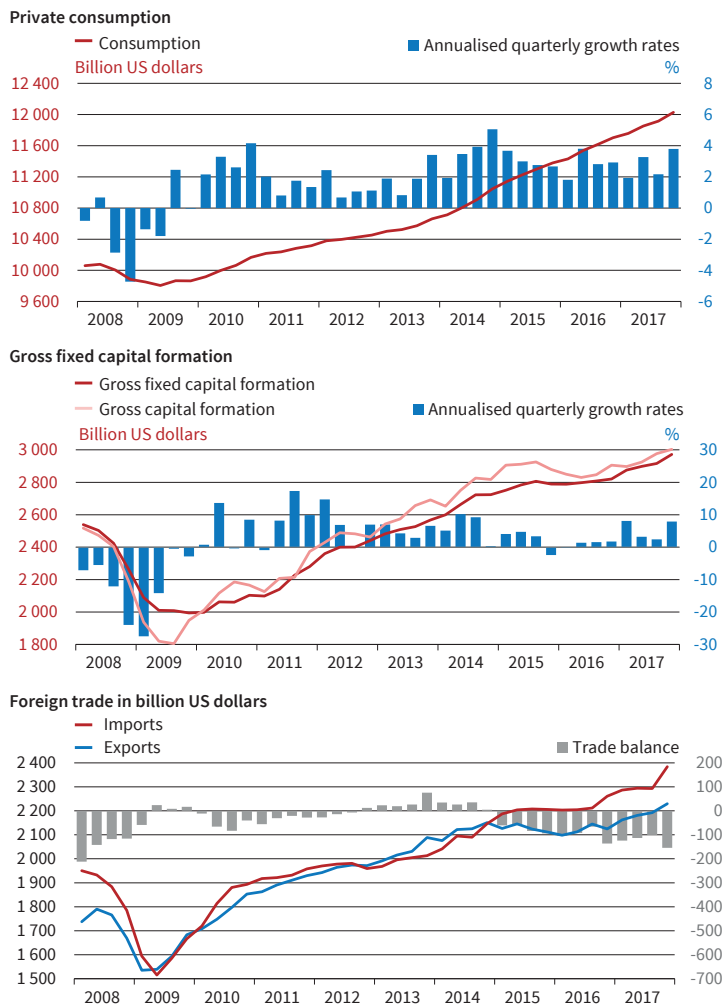


^a Annualised quarterly growth. Source: US Bureau of Economic Analysis; last accessed on 27 January 2018; EEAG calculations. © CESifo

a supporting basis. As a result, the output gap estimated by the Congressional Budget Office has closed and the US economy has entered a boom, reaching an overall growth rate of 2.3% in 2017.

Despite some volatility during the year, mainly due to the weather-related fall in demand in August

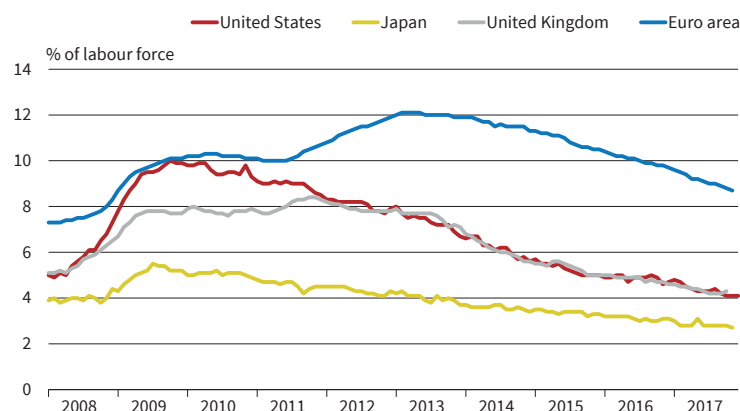
Figure 1.8
Business Cycle Developments in the United States
In constant prices, seasonally adjusted and work-day adjusted



Source: US Bureau of Economic Analysis; last accessed on 27 January 2018.

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Figure 1.9
Unemployment Rates



Source: OECD; last accessed on 27 January 2018.

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and subsequent greater demand for motor vehicles and spare parts, private consumption contributed strongly to overall growth last year. Public spending, on the other hand, basically stagnated throughout

2017. A strong uplift in national defence and disaster relief expenditure during the second half of the year and moderate increases in state and local government expenditure did not compensate for the austerity measures initiated by the Trump administration at the federal level.

Throughout the year, gross fixed capital formation increased by around 3%. However, clear differences emerged between its construction and equipment components. While equipment investment continued to perform strongly throughout the year, growth in both residential and commercial construction remained weak. Inventory investment increased during the second half of the year, mainly due to a strong build-up of inventories in wholesale trade. Although exports benefited from the weakening of the US dollar in spring, the strong domestic economy circumvented the trade balance from significantly improving during the course of the year (see Figure 1.8).

Despite natural disasters, the US labour market continued to tighten throughout the year. Unemployment rates fell from 4.8% at the beginning of 2017 to 4.1% at the end of the year, reaching the lowest level since the turn of the millennium (see Figure 1.9). Decreasing slack in the labour market is also visible in a stable labour force participation ratio, which occurs in spite of the demographic changes associated with an ageing and a slower-growing population. The high utilisation of the production factor labour is however still barely noticeable in wage dynamics.

Consumer prices have recovered from a short setback in the summer of 2017 during which inflation rates fell well below 2%. Although inflation

rates measured by both the CPI and the personal consumption expenditure deflator have subsequently recovered, this is not yet the case for the respective versions that exclude energy and food prices.

1.2.3 Asia

The *Chinese* economy overall continued to grow with rates hovering close, but below, 7% last year. The production side picture has remained stable: the manufacturing and transport sectors increased significantly. Both benefited from the fiscal stimulus initiated in the second half of 2016. By contrast, construction activity remained relatively weak as a result of more restrictive monetary policy and tighter housing market regulations, including those on the acquisition of second homes. Economic momentum in China only slowed slightly during the second half of the year. The manufacturing sector expanded somewhat more weakly than before, as did the transport sector, with fiscal stimulus lessening somewhat over time. However, this slowdown was offset by higher growth in other service sectors, notably in the financial sector.

With the expiry of stimulus measures adopted during the Great Recession, producer prices in the industrial sector turned clearly negative. The deflationary trend that started back in 2012 reflects both the ongoing productivity gains in some areas of the Chinese economy, as well as substantial overcapacities in many state-owned operations like the steel, coal, and cement industries. These falling producer prices helped keep consumer prices relatively low for emerging market standards. The renewed fiscal stimulus in 2016 not only resulted in a revival of the real economy, it also fuelled producer prices. Not least because of lower food prices at the beginning of 2017, which have temporarily slowed consumer price inflation noticeably, while the latter have only been affected slightly to date. Core inflation rose from around 1.5% in the first half of 2016 to 2.2% in December. Overall inflation lagged somewhat behind the core rate at 1.8% at the end of last year. For the year 2017 as a whole, the inflation rate turned out to be 1.5%.

The *Japanese* economy is also benefiting from the world economic upswing. Since the beginning of 2016 its GDP has been growing at an annualised average rate of 1.9%, resulting in an estimated GDP growth rate of 1.8% for 2017. Although public investment did play a part, private economic activity, both residential and non-residential investment activities, and strong export growth, were the main drivers behind this upswing. Private and public consumption remained subdued in this respect. Despite the strong economy, price pressure as measured by both the GDP deflator and consumer prices remained low. Core inflation even fell back to 0% early last year, before recovering slightly again during the second half of 2017.

During most of last year, the *Indian* economy was held back by special economic effects. A cash reform towards the end of 2016 led to liquidity bottlenecks in the heavily cash-based small business sector. The introduction of a nationwide Goods and Service Tax

(GST) system last June also hampered economic activity. Although the new GST system remains relatively complicated, both reforms are nevertheless likely to increase medium- to long-term growth potential. The massive monsoon rains in some regions put pressure on the economy in the form of crop failures and food price spikes during the second half of last year. All in all, this resulted in a below potential growth rate of 6.2% for 2017. Not only the relatively weak economy, but also a one-off drop in food prices in summer, lowered the annual inflation rate from 4.9% in 2016 to 3.3% last year.

GDP growth in the remaining East and Southeast Asian economies (*Hong Kong, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore, and Thailand*) has been strong since the end of 2016. While consumption rose sharply at the end of last year, investments are gradually flattening out. In Taiwan investment even fell for two quarters in a row last year. Exports, which had delivered high levels of expansion until the winter of 2016/17, remained weak or even declined significantly in the case of Indonesia. With the structural weakening seen in the Chinese economy since 2012, massive export growth appears to have become a thing of the past for this region.

1.2.4 Latin America and Russia

In Latin America, the upswing was dampened by the sluggish economic recovery in Brazil and the aftermath of the devastating earthquakes in Mexico. The regional economy nevertheless gained momentum and the recovery started to become more broadly based. Whereas the business situation and consumer confidence in *Mexico* were able to quickly recover from the setback following the US presidential election and the significant appreciation of the Mexican peso, two major earthquakes in September caused a negative growth rate for the third quarter of 2017. The increased inflation dynamics forced the Banco de Mexico, the central bank of Mexico, to increase its overnight interbank rate in five steps from 5.75% at the beginning of 2017 to 7.25% by the end of the year. The inflation rate nonetheless more than doubled from 2.8% in 2016 to 6% last year. The economies of *Colombia, Ecuador, Peru, Bolivia, and Chile* regained some momentum following a weak beginning to the year. The continued subdued development of prices for industrial metals and agricultural goods has held these countries back in their expansion. *Brazil* finally came out of a two-year recession in spring of last year. The recovery is largely due to foreign trade and consumer spending, which benefited from a slight improvement in the labour market and stronger consumer sentiment. The recovery, however, is still shaky. Any renewed allegations of corruption against the government could raise political uncertainty, curbing consumer confidence and deterring foreign investors. GDP growth is expected to have been 1.1% last year.

At the end of 2016, the *Russian* economy moved out of recession and gained momentum until mid-2017. During the second half of the year, the economic recovery decelerated. This slowdown was mainly due to developments in the health sector, social services and the construction sector, as well as the manufacturing industry. Nevertheless, after two years of negative growth rates, the Russian economy is likely to have expanded again at a growth rate of 1.9% last year.

1.2.5 Europe

Cyclical Situation

As of the fourth quarter of 2016, the European economy shifted into a higher gear. Up until then, annualised GDP growth rates averaged less than 2% since the end of the recession in the second quarter of 2013. Looking at the last four quarters, this average increased to 2.6%. Hence, the European economy moved from recovery into a strong upswing mode (see Figure 1.10). Although domestic demand's contribution to growth increased, the turnaround in external trade was largely responsible for this acceleration. While import growth on average surpassed export growth between 2013 and 2016, indicating a largely domestically-driven recovery, this has changed in recent quarters. Both the booming world economy and the low valuation of its currencies have created an environment in which foreign trade is contributing positively to economic growth in the European Union.

In addition to foreign demand, the economic upswing continues to be fuelled by private consumption and especially investment (see Figure 1.11). Slow progress with reforms of the European Union and member state specific labour and product markets, the only gradually improving budgetary situation of EU governments, as well as concerns about Brexit, migration flows, and populist movements all no longer appear to be having

Figure 1.10
Contributions to GDP Growth^a in the European Union
Seasonally adjusted data

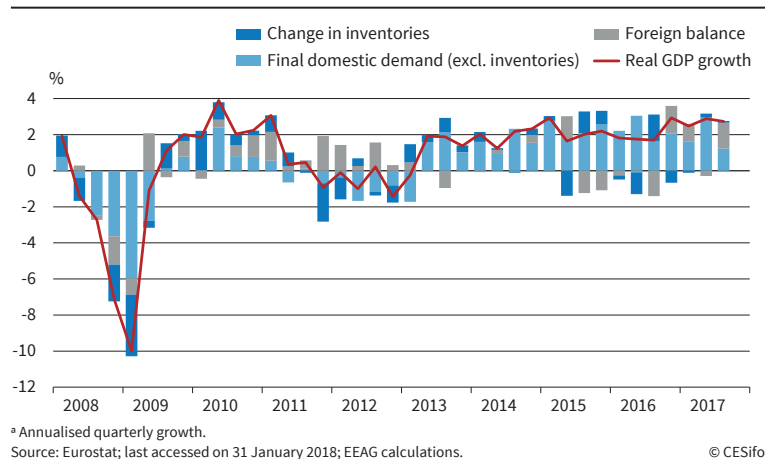
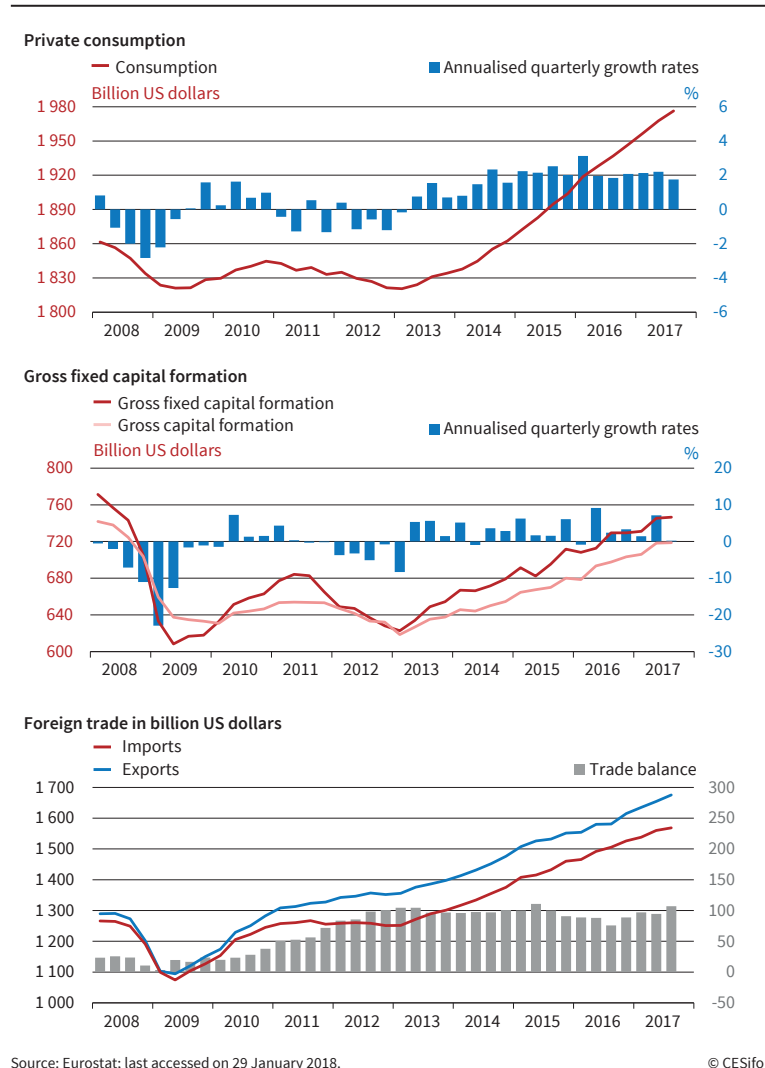
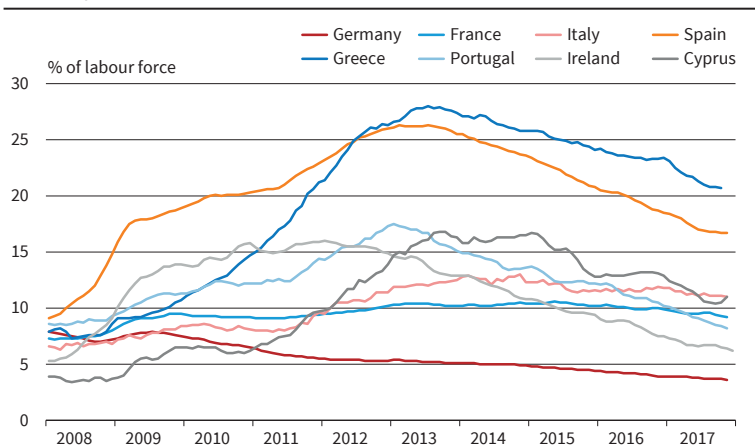


Figure 1.11
Business Cycle Developments in the European Union
In constant prices, seasonally adjusted and work-day adjusted



a strong negative impact on business confidence in Europe. Almost full use of production potential and a bright economic outlook within a still very low interest rate environment is now sparking a willingness

Figure 1.12
Unemployment Rates in Selected Euro Area Countries



Source: Eurostat; last accessed on 27 January 2018.

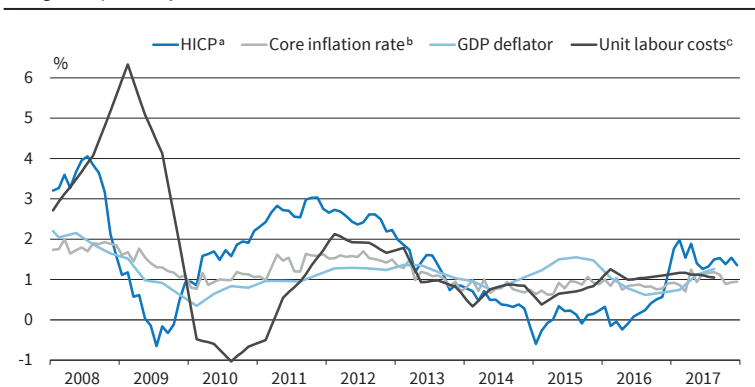
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among firms to invest. Although public consumption continued to contribute positively, its growth rates have moderated slightly in recent quarters.

The gradual downward trend in European unemployment continued throughout 2017. The unemployment rate in the euro area and the European Union stood at 8.7 and 7.3% respectively in November 2017, and was thereby about one percentage point lower than a year before. During the first half of 2017 in particular, employment levels increased substantially with annualised growth rates of around 2%. In the euro area employment developments have been very similar. Here too, employment levels have now clearly surpassed their pre-crisis levels. Although the unemployment rates fell in all member states, there are still major differences in levels. In Spain, 16.7% of the employment force was registered as unemployed in November, while the rates in Germany (3.6%) and the Netherlands (4.4%) were much lower. Italy and France were in the midfield, with rates of 11.1 and 9.4% (see Figure 1.12).

With the start of last year, inflation, as measured by the harmonised index of consumer prices, jumped

Figure 1.13
Price Developments in the Euro Area
Change over previous year's month



^a Harmonised Index of Consumer Prices (HICP). ^b HICP excluding energy, food, alcohol and tobacco.

^c Nominal compensation of employees per unit of real GDP.

Source: Eurostat; last accessed on 27 January 2018.

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to values of just over 1.5% on average (see Figure 1.13). Initially this development was mainly due to energy price effects. After hovering between 0.5 and 1% between the end of 2013 and early 2017, euro area core inflation that excludes volatile energy and food prices, however, also rebounded to above 1% for prolonged periods in 2017. At the same time, wage development also continues to be subdued. For over four years now, the annualised increase in unit labour costs has on average in the euro area hovered around 1%.

Price developments across European countries, however, vary considerably. Whereas wages have clearly increased since 2014 in Germany to the extent that they have reduced competitiveness as measured by relative unit labour costs there, the opposite is the case for most other European countries (with the exception of Slovakia and Estonia, see Table 1.1). The stronger economic momentum in Germany compared to most other European countries is behind this, which in itself can be seen as a natural adjustment process. In both Italy and France, for instance, inflation has been comparatively moderate in recent years.

Differences across Europe

Albeit to different degrees, all member states contributed to the strong expansion. Among the five largest economies, Spain and Germany recorded the highest growth rates last year with 3.1 and 2.6% respectively, followed by France (1.8%), Italy (1.6%), and the United Kingdom (1.6%). Although the former smaller crisis countries Greece and Portugal also benefited from the general upswing, their growth performance still lagged behind that of the rest of Europe. Cyprus and Ireland, on the other hand, again posted above-average growth rates in 2017.

The upturn in *Germany's* economy that started in 2013 accelerated markedly last year. Aggregate output is expanding almost twice as fast as current estimates of the potential rate suggest. Accordingly, the over-utilisation of the German economy has increased significantly, and the construction industry in particular seems to have reached its capacity limits. As compared to other sectors, the German industry expanded at above-average rates last year, and thereby significantly contributed to the overall acceleration. It

Table 1.1

Labour Costs^a

| | Compensation per employee ^b | | Real compensation | | Labour productivity | | Unit labour costs | | Relative unit labour costs ^d | | Export performance ^e | | |
|----------------|--|-----------|-------------------|-----------|---------------------|-----------|-------------------|-----------|---|-----------|---------------------------------|-----------|------|
| | 1999–2013 | 2014–2017 | 1999–2013 | 2014–2017 | 1999–2013 | 2014–2017 | 1999–2013 | 2014–2017 | 1999–2013 | 2014–2017 | 1999–2013 | 2014–2017 | 2017 |
| Germany | 1.3 | 2.5 | 0.4 | 0.8 | 0.6 | 0.8 | 0.8 | 1.9 | -1.2 | 0.7 | 0.5 | 0.3 | 0.0 |
| France | 2.4 | 1.3 | 1.0 | 0.5 | 0.7 | 0.6 | 1.7 | 0.6 | 0.0 | -0.7 | -1.5 | -0.6 | -1.5 |
| Italy | 1.8 | 0.6 | -0.1 | -0.1 | -0.3 | 0.1 | 2.3 | 1.1 | 0.5 | -0.1 | -2.8 | 0.1 | 0.2 |
| Spain | 2.4 | 0.6 | 0.2 | 0.3 | 0.6 | 0.6 | 2.1 | 0.4 | 0.4 | -0.8 | -0.6 | 0.8 | 1.2 |
| Netherlands | 2.6 | 1.1 | 0.7 | 0.5 | 0.7 | 1.2 | 1.8 | -0.1 | 0.1 | -1.3 | -0.2 | 1.0 | 1.1 |
| Belgium | 2.5 | 0.7 | 0.9 | -0.7 | 0.8 | 0.5 | 1.9 | 0.1 | 0.2 | -1.1 | -1.0 | 1.1 | 0.6 |
| Austria | 2.0 | 2.1 | 0.5 | 0.3 | 0.7 | 0.5 | 1.4 | 1.8 | -0.3 | 0.4 | -0.5 | -0.3 | 0.6 |
| Finland | 2.8 | 1.0 | 1.2 | -0.4 | 0.8 | 1.0 | 2.0 | 0.1 | -0.3 | -0.5 | -1.4 | -1.0 | 2.8 |
| Greece | 2.6 | -0.8 | 0.7 | 0.1 | 0.7 | -0.6 | 2.7 | 0.1 | 0.6 | -0.7 | -1.0 | 0.3 | 1.1 |
| Ireland | 3.3 | 2.2 | 1.6 | 0.2 | 2.0 | 7.8 | 1.5 | -4.8 | 0.1 | -6.4 | 2.0 | 10.1 | -0.6 |
| Portugal | 2.5 | 0.5 | 0.3 | -0.9 | 1.0 | -0.1 | 1.8 | 1.1 | 0.0 | 0.0 | -0.2 | 1.5 | 3.2 |
| Slovakia | 6.1 | 2.7 | 3.1 | 2.7 | 3.3 | 1.3 | 2.3 | 1.9 | 1.9 | 0.7 | 4.3 | 0.3 | -1.3 |
| Slovenia | 5.3 | 2.1 | 1.9 | 0.9 | 1.8 | 1.7 | 3.4 | 0.6 | -0.1 | -0.6 | 0.9 | 2.8 | 4.1 |
| Estonia | | 5.3 | | 3.2 | 3.6 | 1.4 | 4.7 | 3.6 | 2.1 | 3.2 | 1.1 | -0.2 | -2.0 |
| United Kingdom | 3.4 | 1.9 | 1.5 | 0.3 | 1.0 | 0.5 | 2.3 | 1.1 | -1.0 | -0.9 | -1.5 | -1.6 | 1.1 |
| Sweden | 3.4 | 2.5 | 1.9 | 0.6 | 1.3 | 1.6 | 2.2 | 1.2 | 0.4 | -2.4 | -0.7 | 0.9 | -0.5 |
| Denmark | 2.9 | 1.5 | 0.9 | 0.6 | 0.9 | 0.4 | 2.1 | 1.2 | 0.2 | 0.3 | -0.5 | -0.8 | 0.2 |
| Poland | 4.9 | 3.0 | 1.9 | 2.2 | 3.2 | 2.1 | 2.0 | 1.4 | -0.5 | 0.0 | 2.3 | 3.1 | 0.3 |
| Czech Republic | 4.5 | 4.2 | 2.8 | 2.8 | 2.3 | 2.5 | 2.0 | 1.8 | 2.4 | 0.3 | 3.4 | 2.4 | 2.1 |
| Hungary | 6.4 | 2.7 | 1.5 | 0.2 | 2.0 | 0.6 | 4.9 | 2.3 | 1.7 | 0.0 | 3.5 | 3.4 | 3.2 |
| Switzerland | 1.4 | -0.3 | 0.7 | 0.0 | 0.6 | 0.0 | 1.0 | 0.0 | 1.0 | 1.2 | -0.1 | -2.9 | -4.0 |
| Norway | 4.5 | 2.4 | -0.1 | 2.5 | 0.5 | 1.1 | 4.1 | 1.3 | 2.9 | -4.0 | -3.4 | -2.2 | -1.9 |
| Iceland | 6.1 | 6.5 | 1.4 | 3.8 | 1.5 | 1.7 | 4.9 | 4.1 | -1.4 | 11.2 | 0.7 | 3.4 | 2.6 |
| United States | 3.1 | 2.1 | 1.1 | 0.6 | 1.5 | 0.6 | 1.6 | 1.6 | -1.6 | 4.8 | -1.4 | -1.1 | -1.3 |
| China | | | | | | | | | 3.8 | 2.4 | 9.4 | 0.1 | 3.2 |
| Japan | -0.7 | 0.7 | 0.3 | -0.2 | 0.9 | 0.2 | -1.2 | 0.9 | -2.5 | -1.0 | -2.7 | 1.1 | 0.6 |

^a Growth rates for the total economy; ^b Compensation per employee in the private sector; ^c Compensation per employee in the private sector deflated by the GDP deflator; ^d Competitiveness: weighted relative unit labour costs; ^e Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD Economic Outlook, November 2017.

was thereby able to provide a broader basis for the upswing. While domestic demand components, with the exception of public consumption, also increased faster, impulses from abroad intensified. This benefited export-oriented German companies, which recruited more staff and expanded their capital stock. Despite growing tensions in the labour market, real wages have remained in line with productivity to date. The extraordinary increase in wages and prices, which one could expect in a boom phase, has therefore failed to materialise to date. Wage agreements still seem to have been driven by low inflation rates in previous years and/or continued low inflation expectations. After a period of collective wage moderation and the gradual introduction of labour market reforms adopted in 2002, unemployment in Germany declined from 2005 onwards. The Great Recession only briefly interrupted this downward trend in 2008 and 2009.

In contrast to the German economy, the expansion in *France* was largely internally driven and marginally supported by gradual labour market and tax reforms implemented under the Hollande government. Despite increased export growth, even stronger imports led to a negative growth contribution from external trade. The labour market is continuing to recover and private employment rose sharply last year. This supports private consumption and investment, which also grew strongly due to exceptionally low interest rates.

Although production growth accelerated somewhat during the second half of last year, in general the economy of the *United Kingdom* is moving slowly, compared to the world economic upswing. A key driver of slightly higher growth in the second half of the year

was a stronger expansion of private consumption due to a rebound effect following the introduction of a car tax in April. However, this effect is only temporary and current car sales figures do not indicate a rapid recovery in private consumption. In addition, price increases due to the depreciation of the pound probably led to lower consumption dynamics. Both effects also explain the stagnation of investment in transport in the second half of the year. As far as other investments are concerned, non-residential construction also declined, while only residential construction continued to grow. Overall, foreign trade had a negative impact on production, particularly due to the poor demand for British goods from non-EU countries. The weak pound has not been reflected in stronger export figures to date. Despite the slightly accelerated pace of growth in the second half of the year, the figures paint a rather weak picture of the UK economy. GDP growth eased to 1.6% in 2017. This was made even clearer by the recent revision of official statistics. The economy appears to have been hit harder by the Brexit decision than initial figures suggested back in 2016. From today's perspective, machinery and equipment investment declined significantly one year ago, while muted business sentiment and the uncertainty triggered by the referendum is now showing more clearly than previously. On the other hand, the unimpressed attitude of private households is also more clearly reflected in the rise of residential investment, which has been sharply revised upwards.

The *Italian* economy was able to build on the positive developments abroad and expanded by 1.6%

last year. Although foreign trade generated stronger momentum in the past year than in 2016, growth was mainly supported by domestic demand. The recovery in Italy is still hampered by its ailing financial sector and weak lending. Italian banks are lagging behind in the process of reducing their debt. While loans at risk of default have been removed from bank balance sheets in many former crisis countries, their share of total lending in Italy has tripled since 2007. As a result of the sheer size of the Italian financial sector, this means that around one third of euro area non-performing loans now lie in Italy. Weak capitalisation, as measured by core capital relative to risk-weighted assets, could pose a problem if the ECB were to raise interest rates unexpectedly. Another risk factor is the large amount of Italian government bonds in domestic bank balance sheets. At around 10%, this share is more than twice as high as the euro area average. If a renewed public budget imbalance leads to a decline in the value of Italian government bonds, the financial system will inevitably be damaged. In the meantime, the labour market is showing only modest improvements despite the economic recovery. Given its high starting level, and compared to other European countries, the decline in the unemployment rate from an average of 11.7% in 2016 to 11.5% last year is only modest. Due to comparatively low capacity utilisation, at an annual rate of 1.3%, inflation hardly accelerated last year.

Economic growth in *Spain* remains strong and robust. Overall, the political crisis in Catalonia did not have a significant negative impact on economic activity. At a growth rate of 3.1% last year, Spain outperformed most other EU countries for the third consecutive year. Both domestic and external demand contributed to growth, underlining a more balanced growth pattern than in the run-up to the Great Recession. Strong job growth supported household income and consumer spending. Business investment, supported by stronger confidence and improved profit margins, continued to rise. Construction investment has increased, reflecting improved labour market and favourable financing conditions for households and non-financial corporations. Strong demand from trading partners and structural reforms have helped to improve competitiveness and support export growth.

Of the smaller former crisis economies, Cyprus, Portugal, and Ireland fared well. All three have been back on a steady growth path since at least early 2015. With an annual growth rate of 1.1% last year, only Greece is having problems finding its way back to persistent growth. Despite low growth, Greece has also seen a noticeable turnaround in its labour market. Unemployment has been steadily falling in all four economies since at least 2015 (see Figure 1.11).

The recovery in the *Central and Eastern European* member states of the European Union continued and gathered pace again. This was mainly due to stronger

external demand, including that from the euro area. Domestic demand was robust almost everywhere. Real household income increased, not least because inflation remained low (although higher than the year before). Equipment investment also made an overall positive contribution to the increase in GDP in the region. Its expansion was facilitated by interest rates, which remained low throughout the year. All of this led to a further noticeable improvement in the labour market situation everywhere, which was accompanied by a significant drop in unemployment rates in all countries.

Increasingly driven by favourable overall economic conditions in the world, the gaps between these Central and Eastern European countries started to close. While Croatia was the only country reporting a growth rate of slightly below 3%, Estonia, Latvia, Slovenia, and in particular Romania reported growth rates of well above 4%. The Baltic states in particular benefited from the recovery of the Russian economy.

1.3 FISCAL AND MONETARY POLICY

1.3.1 Fiscal Policy

Except for the *United States*, fiscal policy is unlikely to play an important role for the economic developments in most advanced economies in 2018. There, however, the recently approved tax reform will not only generate some economic impulses for this year, it will also lead to a further increase in the already high US fiscal deficit (see Box 1.1).

In *Japan*, government debt surpassed 240% of GDP last year (see Table 1.2). The Bank of Japan now owns over 40% of the outstanding public debt stock. Historically low interest rates are currently still limiting the debt burden. It nevertheless poses a serious risk. The stimulus measures launched at the beginning of last year supported output growth, but also kept the deficit-to-GDP ratio above the 4% mark last year at the same time. Fiscal consolidation is set to gradually resume this year; another supplementary budget adopted in December 2017 was not the same size as previous supplementary budgets. However, achieving fiscal sustainability in a low growth environment in the face of a further ageing society is certainly a challenging task.

After the consolidation phase of the years 2011 to 2015, the fiscal stance as measured by the change in the cyclically adjusted deficit has turned more or less neutral in the *euro area*. Although the overall deficit in the euro area continued to decline for the eighth consecutive year in a row, the latest improvements have only materialised through increased revenues triggered by higher economic growth and lower interest payments due to historically low interest rates. Coming from a much higher level, the structural deficit of the *United Kingdom* has been substantially reduced further last year (see Figure 1.14).

Box 1.1

On the Effects of the Tax Reform in the United States

A key element of the US tax reform signed into law on 22 December last year is an income tax cut. The highest income tax rate will go down from 39.6% to 37%. The top rate will be levied on income of over 500,000 US dollars raised from the long-held level of 427,000 US dollars. The standard deduction is almost doubled (while personal exemptions are eliminated) and the tax rate is flattened overall. High income earners stand to benefit the most. Whereas those in the lowest-earning fifth of the population will, according to the Tax Policy Center, see their after tax income increase by 0.4%, the biggest increase of 2.9% will go to those in the top-earning fifth – the highest 1% of incomes are even estimated to gain 4.5%. These figures exclude any growth effects of the reform, as well as the consequences of future spending cuts or future tax increases that could be required to cover any tax revenue losses.

The maximum corporate tax rate will be reduced from 35 to 21% and there will be an immediate write-off of capital goods. The profits earned by American companies abroad are exempt from US taxation. To date, these profits were taxable if they were transferred to the United States. Although taxes paid abroad were credited against domestic tax liability, the high US tax rate made it worthwhile to let the money remain abroad. By the end of 2016, US companies had hoarded 1,300 billion euros abroad. In addition, a growing number of US companies have relocated abroad to avoid US taxation altogether. As part of the tax reform, profits hoarded abroad are to be subjected to one-off taxation, regardless of whether or not they are transferred to the United States. Future foreign profits are to be exempt from taxation in the United States. The United States is thus following a global trend (see Chapter 4 of this report). In the United Kingdom, for example, the taxation of foreign profits was abolished in 2009, in Germany and in most other OECD countries these profits are exempt from domestic taxation. However, the reform not only provides relief, but also tightening. Above all, the deductibility of interest rates is restricted in order to prevent tax avoidance through debt financing.

Three aspects of this corporate tax reform should be highlighted. Firstly, the US government has abandoned its original plans to introduce country-by-country corporate taxation. That would have marked a radical change of system in which company taxation is similar to VAT. The effort of conversion and the uncertainty associated with the system change were apparently too large. Secondly, with this reform, the US government is following the internationally established trend towards lower tax rates, the exemption of foreign profits, and unilateral measures against profit shifting for tax avoidance. Thirdly, this reform will dramatically increase international tax competition. The combination of massive tax cuts and improved tax depreciation creates significant incentives to relocate US investment. Other industrial locations will have to react in order to remain attractive. In addition, tax havens are being pressured to concede that they did incentivise US companies to avoid high profit taxes at home.

As a result of the US tax reform, real GDP is likely to be, at least temporarily, stimulated through growing investment, rising consumer spending and increased labour supply. The sum of these effects is controversial. The US Senate expects somewhat restrained effects (see Joint Committee on Taxation, 2017). According to the report, real GDP is expected to be 0.8% higher in the next ten years on average than would be achievable without the reform. Another study concludes that GDP will increase by 0.7 and 0.6% in 2018 and 2019 respectively, and by 0.4 to 0.5% in the years until 2025 (see Tax Policy Center, 2017). A study by the US Tax Foundation is more optimistic and expects a long-term increase in US gross domestic product of 3.7% (see Tax Foundation, 2017). The difference to the first two estimates can mainly be explained by the fact that this study expects stronger investment effects and a slower rise in interest rates.

The expected tax revenue losses largely depend on the projected growth effects of the tax reform. The US Senate estimates that only around one sixth of the tax cut will be offset by growth effects. The bottom line is an increase in the government deficit of about 1.1 percentage points of 2016 GDP by 2020. The Tax Policy Center expects this figure to be in the same ballpark at 1.25 percentage points. By contrast, with the far more optimistic growth spurt expected by the US Tax Foundation, the reform would be self-financing in the long term after some initial, but temporary, revenue losses.

In the short term, the positive economic stimulus will probably boost exports to the United States and thus the global economy. This will also benefit Europe's economy. At the same time, Europe is likely to respond to increased tax competition and further reduce corporate taxes. The United States is currently in an upswing. In this environment, large-scale tax cuts are leading to increased upward pressure on prices, forcing the US Federal Reserve to tighten its monetary policy sooner than expected and raise rates more quickly. This would remove part of the positive effects of the tax reform. At the same time, the spread between the United States and the rest of the world would increase. To the extent that this is not due to a higher risk premium, this could lead to increased capital shifts to the United States and force central banks around the world to raise interest rates earlier than expected to date.

Table 1.2

Public Finance

| | Gross debt ^a | | | | Fiscal balance ^a | | | |
|----------------------------|-------------------------|-------------|-------------|-------------|-----------------------------|-------------|-------------|-------------|
| | 1999–2007 | 2008/2009 | 2010–2016 | 2017 | 1999–2007 | 2008/2009 | 2010–2016 | 2017 |
| Germany | 62.3 | 68.9 | 75.8 | 64.8 | -2.3 | -1.7 | -0.5 | 0.9 |
| France | 62.5 | 73.5 | 90.9 | 96.9 | -2.5 | -5.2 | -4.5 | -2.9 |
| Italy | 102.9 | 107.5 | 125.7 | 132.1 | -2.9 | -4.0 | -3.1 | -2.1 |
| Spain | 48.2 | 46.1 | 87.1 | 98.4 | 0.2 | -7.7 | -7.5 | -3.1 |
| Netherlands | 49.3 | 55.8 | 64.2 | 57.7 | -0.5 | -2.6 | -2.8 | 0.7 |
| Belgium | 100.7 | 96.0 | 104.4 | 103.8 | -0.5 | -3.2 | -3.4 | -1.5 |
| Austria | 66.1 | 74.0 | 82.7 | 78.6 | -2.2 | -3.4 | -2.4 | -1.0 |
| Finland | 40.6 | 37.2 | 56.1 | 62.7 | 3.8 | 0.8 | -2.3 | -1.4 |
| Greece | 103.8 | 118.1 | 170.3 | 179.6 | -6.3 | -12.7 | -7.5 | -1.2 |
| Portugal | 59.6 | 77.6 | 121.8 | 126.4 | -4.3 | -6.8 | -6.1 | -1.4 |
| Ireland | 30.9 | 52.0 | 98.5 | 69.9 | 1.6 | -10.4 | -9.3 | -0.4 |
| Slovakia | 40.6 | 32.4 | 49.9 | 50.6 | -5.2 | -5.1 | -3.8 | -1.6 |
| Slovenia | 25.7 | 28.2 | 64.4 | 76.4 | -2.2 | -3.6 | -5.9 | -0.8 |
| Luxembourg | 7.1 | 15.3 | 21.4 | 23.7 | 2.5 | 1.3 | 0.8 | 0.5 |
| Lithuania | 20.1 | 21.3 | 39.3 | 41.5 | -1.7 | -6.1 | -3.2 | 0.1 |
| Latvia | 12.0 | 27.0 | 41.2 | 39.0 | -1.6 | -6.7 | -2.5 | -0.9 |
| Cyprus | 58.7 | 49.4 | 89.5 | 103.0 | -2.4 | -2.3 | -4.4 | 1.1 |
| Estonia | 5.0 | 5.8 | 8.9 | 9.2 | 0.9 | -2.4 | 0.2 | -0.2 |
| Malta | 65.5 | 65.1 | 65.1 | 54.9 | -4.9 | -3.7 | -1.8 | 0.9 |
| Euro area | 67.8 | 73.5 | 90.5 | 89.3 | -1.9 | -4.2 | -3.3 | -1.1 |
| United Kingdom | 38.1 | 57.0 | 84.4 | 86.6 | -1.6 | -7.6 | -6.2 | -2.1 |
| Sweden | 49.6 | 39.6 | 41.0 | 39.0 | 1.2 | 0.6 | -0.4 | 0.9 |
| Denmark | 43.8 | 36.7 | 42.7 | 36.1 | 2.3 | 0.2 | -1.5 | -1.0 |
| Poland | 42.6 | 47.9 | 53.2 | 53.2 | -3.9 | -5.4 | -4.1 | -1.7 |
| Czech Republic | 24.5 | 30.9 | 40.8 | 34.6 | -3.7 | -3.7 | -2.0 | 1.2 |
| Romania | 19.5 | 18.2 | 36.3 | 37.9 | -2.5 | -7.5 | -3.3 | -3.0 |
| Hungary | 58.3 | 74.1 | 76.7 | 72.6 | -6.3 | -4.1 | -3.1 | -2.1 |
| Croatia ^b | 38.5 | 44.3 | 75.7 | 80.3 | -3.6 | -4.4 | -4.9 | -0.9 |
| Bulgaria | 45.3 | 13.4 | 20.9 | 25.7 | 0.5 | -1.2 | -1.8 | 0.0 |
| European Union | 64.8 | 68.4 | 84.5 | 83.5 | -1.7 | -4.3 | -3.6 | -1.2 |
| United States ^b | 61.0 | 80.3 | 103.1 | 108.1 | -3.1 | -9.9 | -6.4 | -4.3 |
| Japan | 162.9 | 199.9 | 234.7 | 240.3 | -5.7 | -6.9 | -6.8 | -4.1 |
| Switzerland | 54.9 | 46.0 | 44.3 | 42.8 | -0.4 | 1.2 | 0.5 | -0.1 |
| Japan | -0.7 | 0.7 | 0.3 | -0.2 | 0.9 | 0.2 | -1.2 | 0.9 |

^a As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF; ^b Data on Croatia and the United States are only available from 2001 onwards.

Sources: European Commission, Autumn 2017; IMF World Economic Outlook, October 2017.

According to OECD estimates, the fiscal impulse as measured by the change in the cyclically adjusted primary deficit was 0.25 percentage points of GDP in the euro area last year. Italy (0.5 percentage points), Germany (0.4 percentage points) and Spain (0.4 percentage points) were the main drivers. By contrast, the cyclically adjusted primary surplus in the United Kingdom improved by 1.1 percentage points last year. Fiscal policy measured in this way was also slightly restrictive in France and Ireland.

This year, the fiscal stance is likely to remain fairly loose in the euro area. The upswing is therefore not being used to comply with the rules of the European fiscal compact. In most countries the debt-to-GDP ratio is still (well) above the 60% mark, and countries like France, Italy, Spain, Belgium, Finland, Ireland, and Portugal are also unlikely to meet the lower limit of a structural deficit of 0.5% of GDP this year. With the exception of Ireland, fiscal policy in all of these countries is thereby likely to be pro-cyclical. Apparently, these fiscal rules are still not having a strong disciplinary effect. Against the background of an expected

normalisation in monetary policy and the associated increase in capital market rates, some countries could come under pressure again.

1.3.2 Monetary Conditions and Financial Markets

Monetary Conditions

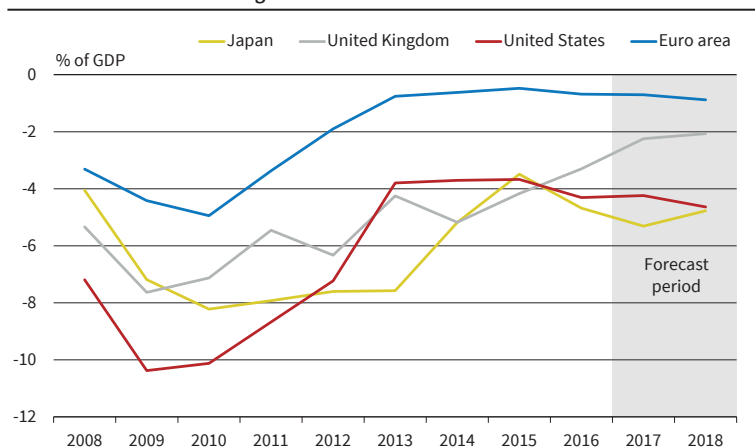
Although a number of mainly smaller countries like Mexico, South Korea, the Czech Republic, and Canada increased central bank policy rates in 2017, global monetary policy is still expansionary on the whole. Even the policy of the US Federal Reserve can – after five interest rate hikes since the end of 2015 – still be considered as accommodative.

The new governor of the Fed, Jerome Powell, is going to continue with the stepwise normalisation of monetary policy. Three additional 25 basis point hikes of the main refinancing rate are likely to be implemented over

the course of this year. Furthermore, slow reductions in the strongly expanded Federal Reserve's balance sheet initiated last October will continue throughout the year. This balance sheet amounted to around 4.4 trillion US dollar by the end of 2017, and there are plans to reduce it by about 400 billion US dollars by the end of this year through lower reinvestment of maturing bonds (see Figure 1.16).

At its meeting in October 2017, the ECB decided to further develop its extended Asset Purchase Program (APP). Bond purchases amounting to 60 billion euros

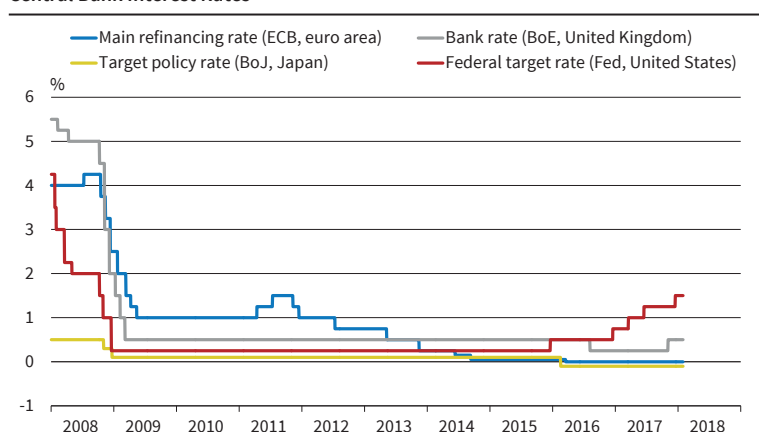
Figure 1.14
Government Structural Budget Balances



Source: OECD Economic Outlook, November 2017; 2017 and 2018: EEAG forecast.

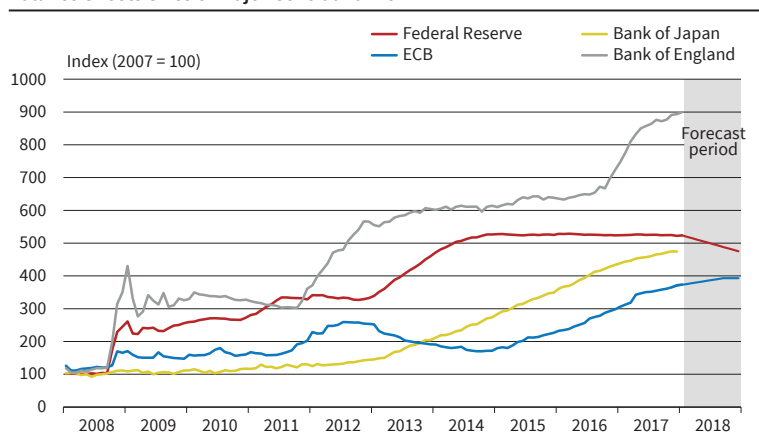
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Figure 1.15
Central Bank Interest Rates



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan; last accessed on 27 January 2018. © CESifo

Figure 1.16
Balance Sheets Sizes of Major Central Banks



Source: Federal Reserve; Bank of Japan; European Central Bank; Bank of England; Swiss National Bank; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

per month by the end of last year will continue this year at a monthly volume of 30 billion euros until at least the end of September 2018. By December last year, the ECB's holdings of securities for monetary policy purposes amounted to 2,364 billion euros. For the period after September 2018, a further reduction in bond purchases by the ECB is expected, before they are reduced to zero by the beginning of 2019 at the latest.

Since March 2016, the ECB has kept its main refinancing rate at 0%, the marginal lending rate at 1.25% and the deposit rate at -0.4%. With the continued excess liquidity of the banking system, money market rates for overnight money (EONIA) and three-month money (EURIBOR) remained below -0.3% and thus close to the deposit rate. The key policy rates are likely to remain at their current level until mid-2019.

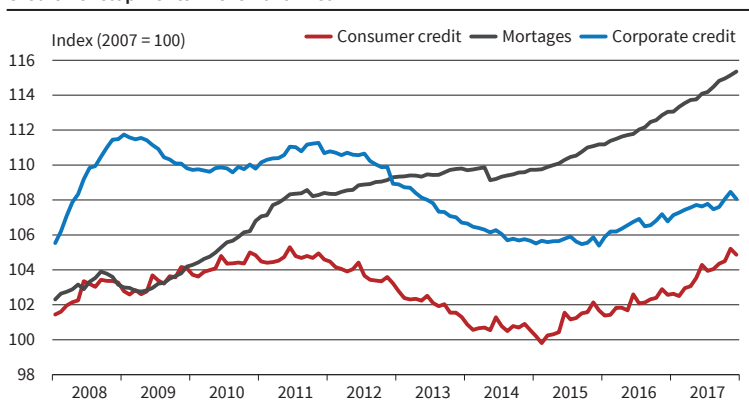
Overall, the ECB is thus continuing its strongly expansionary monetary policy course. Although the volume of planned loan purchases was cut in half, it was extended far into 2018 at the same time. This also gives the 'forward guidance' that policy rates will remain at a low level for a longer period of time, well beyond the end of the APP, additional credibility.

Interest rates are not expected to rise before mid-2019. Continuing refinancing via full allotment gives banks medium-term planning security with regard to the costs of their liquidity management. Reinvesting matured securities, even after the (still undefined) end date of the APP, implies a medium to long-term central bank balance sheet that may also impact long-term interest rates through the euro system's portfolio of securities. At the same time, increased liquidity in the banking system as a result of the APP and the targeted longer-term refinancing operations (TLTROs) should keep money market rates near the (negative) deposit rate (-0.4%) in the medium term. For the time being, the ECB's hesitant exit from unconventional measures is avoiding distortions in bond markets of the kind that arose when the Federal Reserve started communicating its tapering process in 2013. Back then the Fed's announcement that its bond purchases programme was due in January 2014 sparked a shock wave in global financial markets. US Treasury yields rose sharply and prices tumbled in some emerging markets. Against this background, ECB President

Mario Draghi has repeatedly emphasized that there is no fixed end date for the unconventional policy that the ECB is currently carrying out.

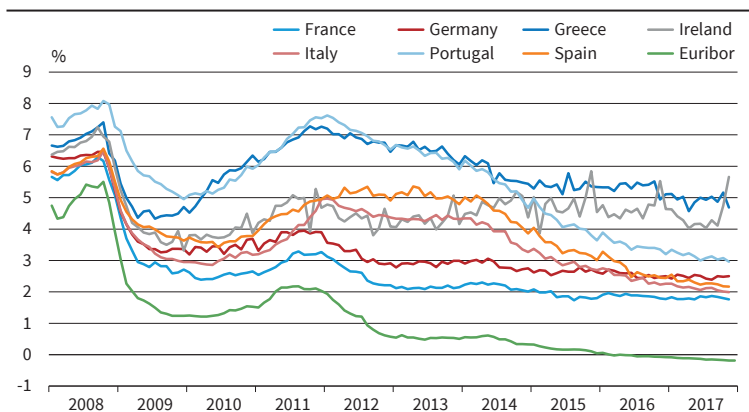
From a monetary perspective, the massive monetary expansion of the ECB since 2014 should have led to an increase in inflation. Inflation developments, however, appear more compatible with a (New) Keynesian view, whereby inflation depends on capacity utilisation rates in the economy. In the wake of both the Great Recession and the euro crisis, the economies of the euro area were clearly under-utilised up until recently. Furthermore, the ECB was worried that energy prices, which had plummeted in the period from 2014 to 2016, would manifest themselves in core inflation or inflation expectations through second-round effects; and thus generate permanently lower inflation. Indeed, according to the ECB Survey of Professional Forecasters that polls experts affiliated with financial or non-financial institutions based within the European Union, the probability assigned to having an inflation rate below 1.5% in five years' time increased from just above 20% in 2011 and 2012 to between 30 and 35% as of the second half of 2014. This probability only fell for

Figure 1.17
Credit Developments in the Euro Area^a



^a These indices of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1 + F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details).

Figure 1.18
Interest Rates on Loans to Businesses in Selected Countries of the Euro Area^a



^a New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year. Source: European Central Bank; last accessed on 27 January 2018. © CESifo

the first time again just below the 30% mark in the most recent survey (October 2017).

Although credit growth has picked up in the euro area since 2015, the pace at which this is happening is still to be considered modest in the light of historically low interest rates and the huge amount of liquidity that the ECB is injecting into the system. Mortgage loans have been steadily increasing for years now and increased by 1.9% in 2017. Consumer credit growth turned positive again in 2015 and registered 1.6% growth in 2017. As of 2016, loans to the corporate sector also started growing again, reaching a growth rate of just above 1% in 2017 (see Figure 1.17). By comparison, while M1 grew by around 9%, M3 increased by approximately 4.7% last year.

One explanation for this subdued recovery in banking credit are the still relatively high lending rates that apply to

non-financial corporations (see Figure 1.18). While the overall funding costs of the banking sector continued to fall even further into negative territory last year, bank lending rates were, in contrast to the preceding years, left behind in many cases.

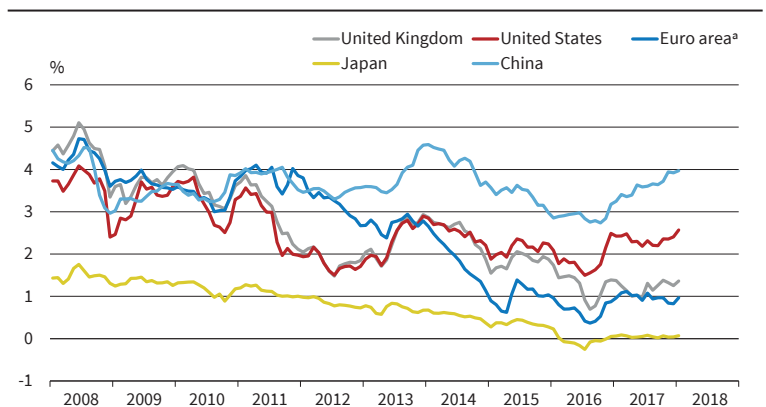
Bonds, Stocks, and Foreign Exchange Markets

Except for China, long-term government bond yields largely moved laterally in all major economies during 2017 (see Figure 1.19). Given the mostly clear increases that occurred at the end of 2016, this implies that the US and euro area long-term rates did, on average, turn out to be, respectively 45 and 30 basis points higher than in 2016. In China, these government bond yields continued to increase throughout the year, increasing the year-on-year difference to 70 basis points. Japan and the United Kingdom were the only countries in which no significant changes in these averages occurred.

The lateral movement of long-term government bond yields together with the policy rate hikes implemented by the Federal

Reserve implies that the yield curve in the United States clearly flattened. A comparison of short-term interbank rates with returns on long-term government bonds shows that their differences also declined during 2017 for the euro area (see Figure 1.20). This neither holds for the United Kingdom, nor Japan. In

Figure 1.19
10-Year Government Bond Yields

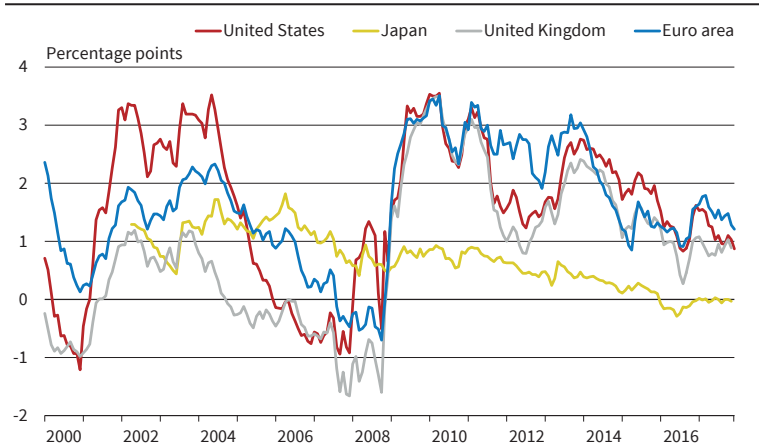


^a The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each Economic and Monetary Union member.

Source: Datastream; last accessed on 27 January 2018.

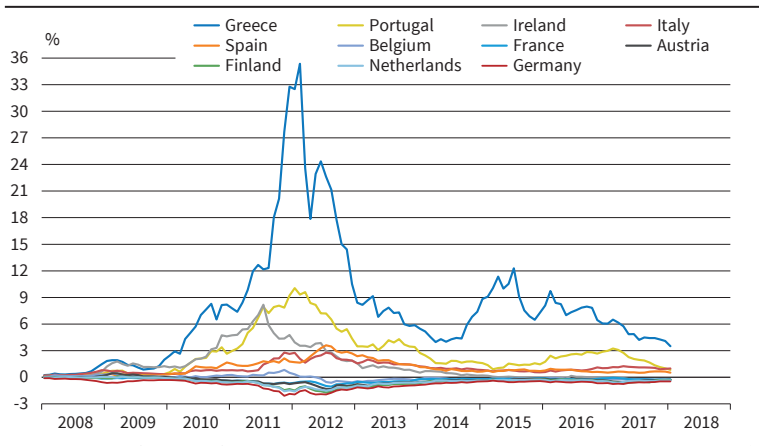
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Figure 1.20
Differences between 10-Year Government Bond Yields and 3-Month Interbank Rates



Source: OECD; last accessed on 27 January 2018. © CESifo

Figure 1.21
Regional Disparities in Government Bond Yields in the Euro Area
Differences between 10-year national and synthetic euro area benchmark bond yields



Source: Datastream; last accessed on 27 January 2018. © CESifo

the latter case, this reflects the clearly communicated targets of the Bank of Japan of maintaining its short-term interest rate at -0.1% and the target for the 10-year government bond yield at 0%.

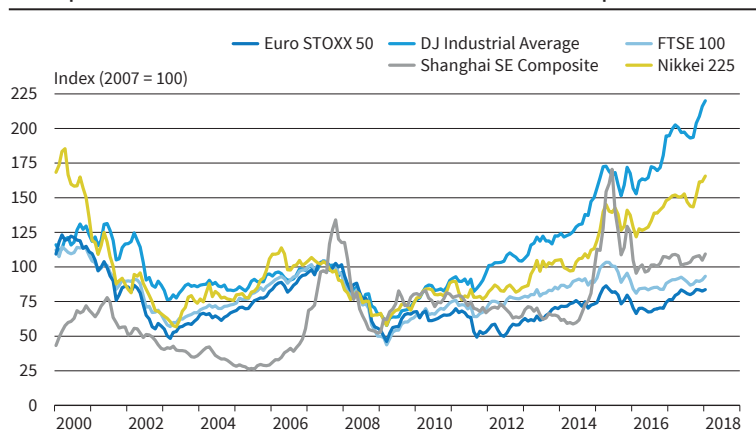
In the United States in particular financial market analysts have started worrying about the underlying flattening of the yield curve and discussing whether this may be a sign that the next recession is imminent. Although an inverted yield curve has indeed often preceded a recessionary period in the past, the differences between long- and short-term yields are still not comparable to those seen in 1989, 2000, or 2006/7, for example. Current spreads are more in line with levels seen during the entire second half of the 1990s. Furthermore, this time around, the environment is largely determined by ongoing quantitative easing

programmes in Japan and the euro area in particular. With interest rates on safe assets of different maturities in these parts of the world still be near or at their effective lower bounds, US treasuries can still be considered relatively attractive. Of course, the Federal Reserve's forthcoming policy hikes will tend to reduce these spreads even further. On the other hand, the reduction of the Fed's balance sheet and US tax cuts are going to put upward pressure on longer-term yields.

Within the euro area, the risk premiums on both Greek and Portuguese government bonds clearly declined last year (see Figure 1.21). The economic outlook for these countries has started to improve. Although the economies of Italy, and especially Spain, are benefiting from the overall boom too, the difference between their government bond yields and a synthetic euro area average has hardly moved throughout the year. As a result of the reduction of yields on Portuguese and Greek bonds, nearly all other euro area country yields have moved towards the synthetic average.

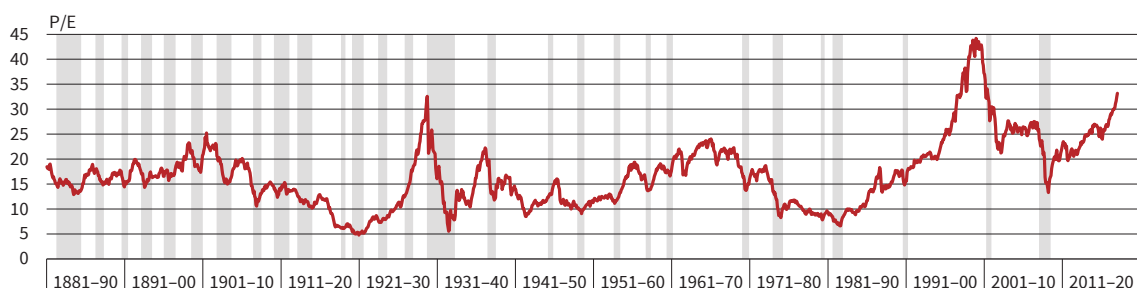
In contrast to the development of interest rates relevant to the private sector, and despite a dip during the summer, stock markets in general developed strongly last year (see Figure 1.22). From a euro area perspective, both the Euro STOXX 50 and the Dow Jones Industrial were about 11% higher last December compared to the previous

Figure 1.22
Developments in International Stock Markets from a Euro Area Perspective^a



^aStock market indices outside the euro area are first converted into euros. Source: Datastream; last accessed on 27 January 2018. © CESifo

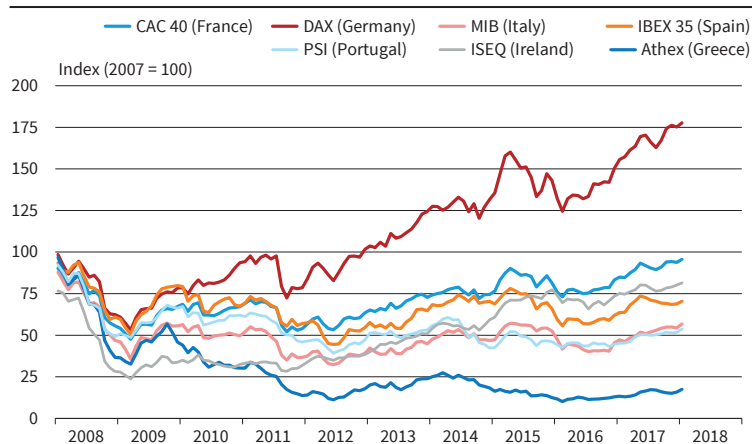
Figure 1.23
Shiller Price Earnings Ratio



Note: Grey areas indicate recession periods according to the NBER classification.
Source: Datastream; <http://www.econ.yale.edu/~shiller/data.htm>; last accessed on 27 January 2018.

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Figure 1.24
Developments of Selected Stock Markets within the Euro Area



Source: Datastream; last accessed on 27 January 2018.

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year. When measured in US dollars, the latter even showed an increase of almost 25%. The difference is explained by the clear appreciation of the euro over this time period. By contrast, for the Shanghai Stock Exchange Composite, the increase was a mere 4.4% when measured in local currency. Taking the depreciation of the Chinese renminbi into account, this even implied a decline of 2.3% from a euro area perspective.

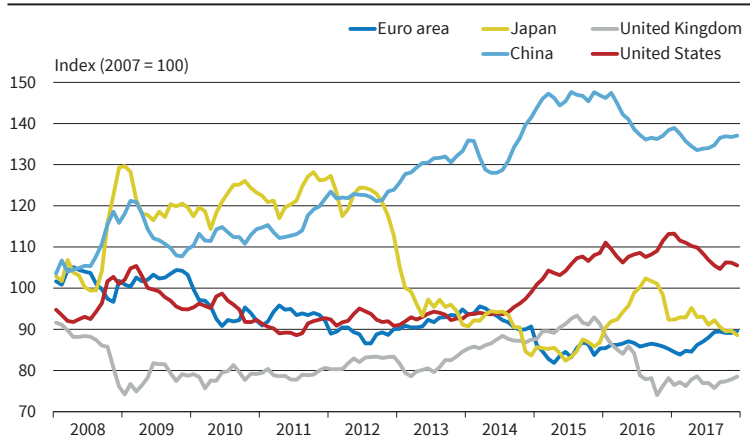
From a longer-term perspective, US stock markets have also reached historically high levels. The real Shiller Price/Earnings ratio for the Standard & Poor's 500, which is based on average inflation-adjusted earnings from the previous 10 years, has reached a level that is again very close to that seen shortly before the outbreak of the Great Depression in 1929 (see Figure 1.23). It thereby stands substantially above the levels reached before the start of the Great Recession in 2008. That said, the monetary environment is also still exceptional at the moment. We have never had

this much liquidity being placed in the financial systems of major economic regions and interest rates that remained persistently at such low levels. A clear consequence of loose monetary policy in recent years is that investors are moving into stock markets. The intention is that, through both the so-called Tobin's q and balance sheet channels, the private economy is increasing its demand for durable goods and services in particular. A strong and very swift change in the monetary policy environment could trigger a bursting of these asset market bubbles. On the

other hand, the longer central banks wait, the larger the potential bubble will turn out to be. The next few years will be marked by this balancing act on the monetary policy side.

Whereas US stock markets have reached historically high levels, the same cannot necessarily be said of those in Europe. Of the larger economies, only the German DAX has already surpassed pre-crisis levels (see Figure 1.24) since 2013. All of the

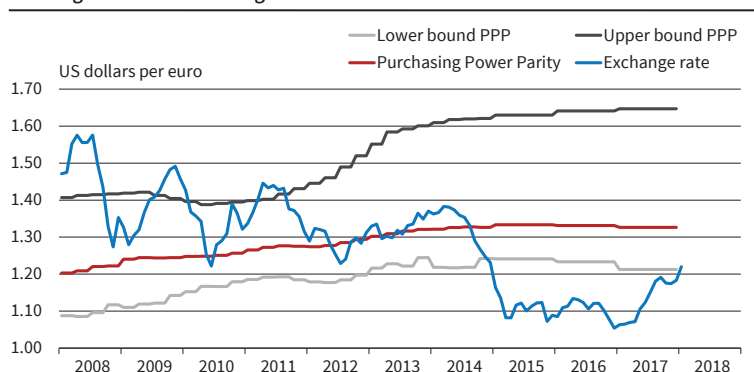
Figure 1.25
Real Effective Exchange Rates around the World



Source: Bank for International Settlements; last accessed on 27 January 2018.

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Figure 1.26
Exchange Rate of the Euro against the US Dollar and PPP^a



^a The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used.

other stock markets are, despite their improvements in recent years, still below their respective 2007 levels.

Although the ECB is in the process of tapering its asset-buying programme and long-term interest rates are likely to rise, financing conditions for the private sector will remain favourable for some time to come. The situation in the banking sector and the demand for corporate credit are likely to continue to improve.

After a strong reduction in its real value following the Brexit decision, the British pound has stabilised at a lower level. Over the course of 2017, the real effective value of the euro increased by 5% (see Figure 1.25). This appreciation was both driven by a much stronger economy than expected and the start of the tapering of the ECB's quantitative easing programme. All other major currencies have weakened somewhat.

Taking a purchasing power parity perspective, the undervaluation of the euro relative to the US dollar largely disappeared during 2017 (see Figure 1.26).

1.4 MACROECONOMIC OUTLOOK

1.4.1 Assumptions, Risks, and Uncertainties

The forecast is based on the assumption that a barrel of Brent crude oil will, on average, cost around 67 US dollars this year. The exchange rate between the euro and the US dollar is assumed to be 1.20.

The risks to global economic developments are largely balanced. It is assumed that the Brexit negotiations between the United Kingdom and the European Union will not fail and a 'hard Brexit' will be avoided. The latter would have significantly negative economic effects, especially for the United Kingdom, but also for the European Union (see Felbermayr et al., 2017). Should trade between these two regions in the future be carried out on the basis of WTO rules, GDP per capita for the United Kingdom would be 1.4%

lower, while that of the European Union would fall by 0.25% in the long run.

Financial fragilities in *China* pose another risk to the world economy, as corporate debt increased massively in recent years and is now at a very high level by international comparison. This increases the risk of financial instability. As a result, a faster than currently expected normalisation of US monetary policy could, despite the existence of capital controls, trigger increased capital outflows from *China* placing the Chinese financial system at risk.

The tax plans of the US government, negotiated between the Senate and the House of Representatives at the end of last year, could trigger a faster lifting of key interest rates in the *United States*. The tax reform represents a significant upside risk for the US economy, which could – in the short term at least – be significantly stimulated by the planned tax cuts. At the same time, however, government debt in the United States is likely to increase sharply, which in itself should lead to an increase in global capital demand and hence capital market interest rates (see Box 1.1).

The risks that could cause the economic forecast for the *euro area* to deviate upwards or downwards are largely balanced. The consistently positive assessments by companies, households, and financial markets of the current economic situation and the outlook for the forthcoming quarters may lead the euro area economy to expand significantly faster, especially in the short term, than assumed in this forecast. The successful implementation of further structural reforms in its member states could also improve the labour market situation even more swiftly and generate higher inflationary momentum.

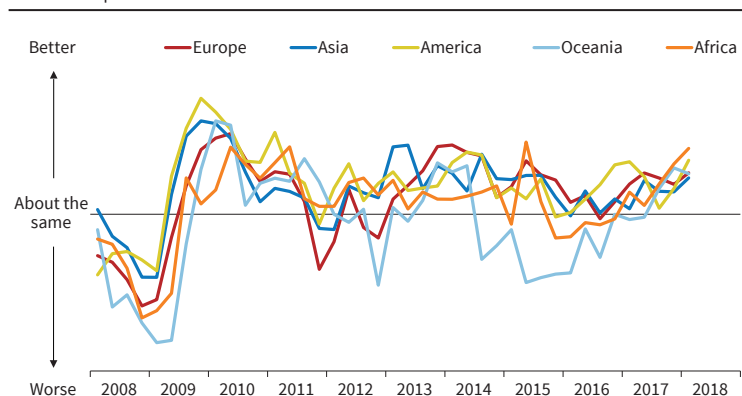
However, the Brexit negotiations, the fragile situation in the banking sector in some member states, and rising long-term interest rates pose downside risks to the outlook. Albeit to a lesser extent than a year ago, problems in the European, and particularly in the Italian banking sector, persist. In the meantime, some Italian banks have been successfully recapitalised or liquidated. The share of non-performing loans fell by almost 5 percentage points as a result. The current share of just under 12% is nevertheless still fairly high and continues to pose a risk to financial stability. Finally, abrupt changes in monetary policy are a risk for countries with high public debt shares. This is demonstrated by debt sustainability in Italy, where, due to the political constellation, no further structural reforms can be expected in the medium term and the debt-to-GDP ratio averaged 132% last year (see Table 1.2).

A further increase in key interest rates by 1 percentage point in both 2018 and 2019 would make it even more difficult to reduce public debt in Italy. The public debt to GDP ratio would continue to rise to just under 134%, instead of falling to 130%. This limits monetary policy's scope for manoeuvre and could lead to a resurgence of the confidence crisis in the euro area.

1.4.2 Global Economy

Following up on the strong summer of 2017, the world economy is likely to continue on an expansion path at above-average growth rates in the winter months of 2017/18. After some moderate improvements in the ifo World Economic Climate during the second half of last year, another boost was registered in the most recent survey (see Figure 1.27). Both the underlying assessments of the situation as well as the expectations for the upcoming six months

Figure 1.28
ifo World Economic Survey
Economic expectations for the next 6 months



Source: ifo World Economic Survey I/2018.

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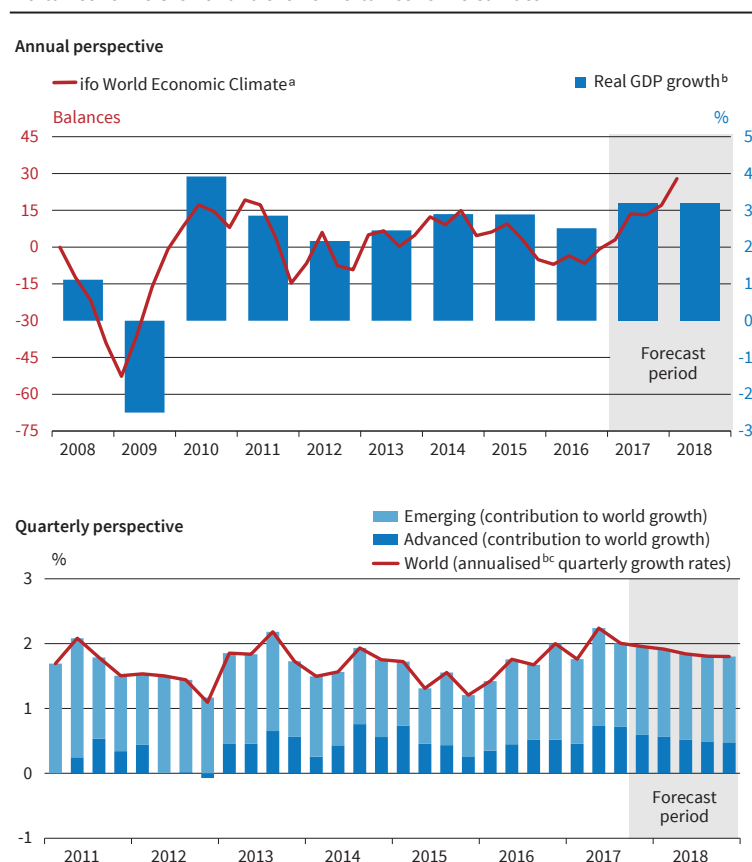
are still improving in many parts of the world (see Figure 1.28).

In line with other indicators, the general expectation is that across continents economic conditions are going to improve further in the months ahead. A major exception to this rule amongst the more advanced economies is the United Kingdom. A lack of confidence in the government's economic policy, and particularly in the outcome of the Brexit negotiations, remains a drag on growth.

Despite a slight loss of impetus, the current upswing is likely to continue during the rest of the year. Output gaps will close in all major economies as a result, while capacity increases in many advanced economies will give a further boost to global investment activity. No further stimulus is to be expected from China. Its economy is likely to expand at a similar pace as last year, while facing more restrictive monetary policy, lower fiscal impulses, and high corporate sector debt restricting further debt-financed growth. This contrasts with the invigorating economic recovery processes in India and increasingly in Brazil too.

Overall, the total economic output of the world is forecast to grow by 3.2% this year. The current upswing in the world economy will thereby be the longest in the post-war period. This upturn, however, also followed its strongest fall and has been relatively weak until recently.

Figure 1.27
World Economic Growth and the ifo World Economic Climate

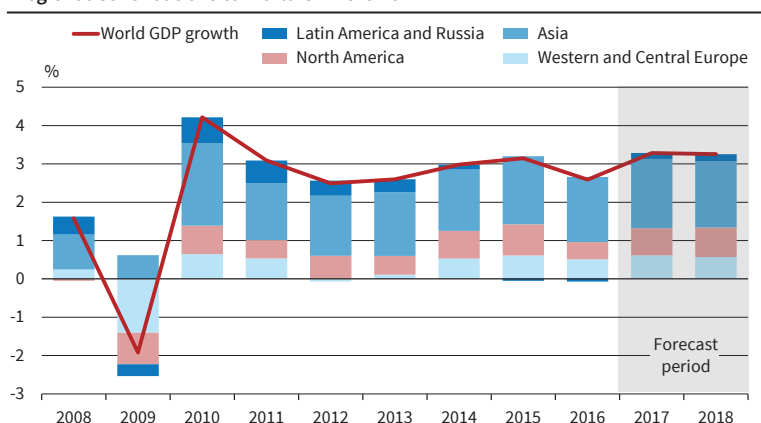


^a Arithmetic mean of judgements of the present and expected economic situation; ^b Countries are weighted according to previous year's nominal GDP in US dollars; ^c Growth contributions of advanced and emerging economies thereof.

Source: IMF World Economic Outlook, October 2016; GDP 2017 and 2018: EEAG forecast; ifo World Economic Survey I/2018.

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Figure 1.29
Regional Contributions to World GDP Growth^a



^a Based on market weights.

Source: IMF World Economic Outlook, October 2017; EEAG calculations and forecast.

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The world inflation rate is expected to be 2.2% this year. Like last year, some of this is a result of the rise in energy prices. Assuming that oil prices remain more or less stable during the remainder of the forecasting horizon, these positive impulses for consumer prices are likely to fade out during the second half of this year. The dynamically expanding world economy will lead to an increasing capacity utilisation, gradually creating upward pressure on prices too.

The strong dynamics seen in world trade by the middle of last year will weaken. This is indicated by the decline in leading indicators of international goods traffic. The RWI/ISL Container Throughput Index and the World Trade Expectations of the Ifo World Economic Survey, for example, recently declined somewhat after several at times steep increases during 2017. However, world merchandise trade will continue to be an important driver of the international economy. Overall, world trade is expected to expand by 4.2% after 4.4% last year. World trade is thereby growing more than twice as fast as during the years 2012 to 2016.

The stronger momentum of world trade is not only directly due to the recovery in the global economy, but also reflects an increase in the elasticity of world trade, defined as the ratio of world trade to world production. Whereas this elasticity has been lower than usual during the post-financial crisis period, the pick-up in global investment activity is likely to normalise this elasticity. Investment goods are generally rather trade-intensive, with higher import content than consumer goods (see Bussière et al., 2013).

The major regions will develop more homogeneously than in the past years. The US economy will nevertheless grow more strongly than that of the euro area and Japan. In the United States, the output gap is closed and real GDP will grow at trend levels, or slightly above them, in the quarters ahead. The euro area economy has recently seen a closing of its output gap. It is nevertheless still characterised by structural differences across its member countries, as indicated

by, for example, the still large volume of non-performing loans on bank balance sheets in Greece, Italy, and Portugal, as well as the lack of competitiveness of the French and Italian economies. The recovery has, however, gained pace, supported by the ECB's extremely accommodating monetary policy. As monetary policy is highly expansionary and fiscal policy will remain supportive, the Japanese economy will continue to expand. The stimulus from monetary and fiscal policy, and in particular a buoyant world economy, is partly offset by a shrinking labour force, a rising

old-age dependency ratio and tight immigration controls.

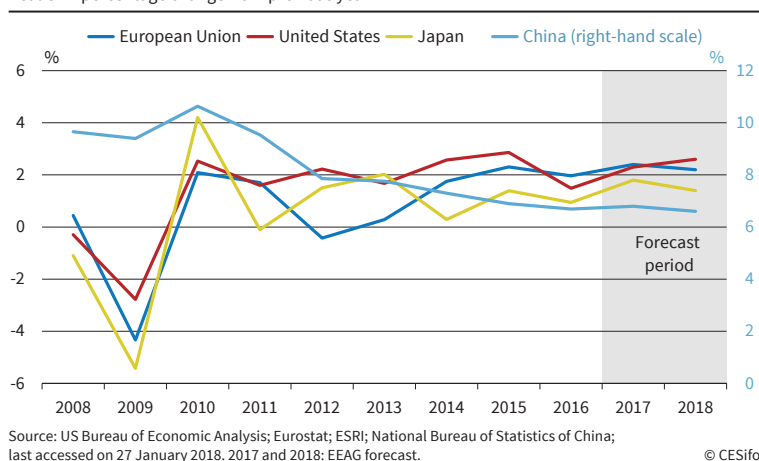
The pace of expansion in emerging markets will hardly change over the forecast period. In view of higher oil prices and the slight recovery in the prices of other raw materials, Brazil and Russia will continue along their recovery path. India is likely to expand rapidly. However, these positive impulses are offset by a slowdown in Eastern European countries. China's economy will continue to grow at a similar pace as last year. To achieve this, the Chinese economy will need to perform a balancing act between expansionary and contractionary measures. It is probable that those sectors in which a cooling emerges will be supported, while those sectors that risk overheating will be exposed to contractionary economic policy interventions. Finally, rising interest rates in the United States are likely to negatively impact financing conditions in emerging economies. Growth in emerging markets is nevertheless still twice as high as that in advanced economies.

1.4.3 United States

Supported by the tax reform, the short- to medium-term outlook for the US economy looks good. Consumer confidence, as measured by the Conference Board's sentiment surveys, is at its highest level since the beginning of the new millennium, indicating continued strong consumer momentum. Investment activity, which has recovered from its weakness in 2016, is expected to provide a high level of expansion for some time to come. However, stagnating house prices and a declining number of building permits indicate that there will be no impetus from residential construction. For the current year, GDP is expected to expand by 2.6% (see Figure 1.30).

Last year's change in consumer prices amounted to 2.1%. With core inflation picking up, but the contribution from energy and food prices abating, this year's inflation rate is also expected to end up being

Figure 1.30
Economic Growth by Region
 Real GDP percentage change from previous year



2.1%. Jerome Powell, who took over the chairmanship of the US Federal Reserve at the beginning of this year, will continue along the path of a gradual normalisation of monetary policy. Accordingly, the Fed is likely to raise its Federal Funds rate target range three times this year to achieve a federal funds target rate of 2.25% by the end of the year. The reduction in the balance sheet of the Fed, which began in October last year, should also exert some upward pressure on long-term interest rates.

1.4.4 Asia

While for *China* the Markit Purchasing Managers' Index (PMI) is still in the expansion zone, it fell to its lowest level in five months in November. On the other hand, the less appreciated PMI of the Chinese Bureau of Statistics and the leading indicator of the OECD for China paint a somewhat more optimistic picture for the winter half of 2017/18. Given the boost in consumer confidence, the Chinese economy will also be able to keep its current momentum for the time being. For this year, GDP growth is forecast to be 6.8%. At the Party Congress of the Chinese Communist Party, the position of party and state leader Xi Jinping was strengthened. In the past, Xi favoured a state- and stability-oriented economic policy over a market-oriented policy. The Chinese leadership will therefore continue to strive to maintain economic momentum through state intervention if necessary. This, however, delays the reduction of imbalances in the Chinese economy, which in turn increases the risk of a sudden economic collapse. The already materialised increase in producer price inflation will also increasingly be reflected in consumer prices. After 1.5% in 2017, an inflation rate of 2.1% is expected for this year.

This year, the *Japanese* economy is likely to weaken somewhat. Firstly, fiscal stimulus, which has recently stimulated domestic demand, will gradually diminish. Secondly, demand from abroad is likely to slow somewhat. GDP growth is likely to fall to a still

well-above potential rate of 1.4%. Although the economy is running above potential, the output gap is on the verge of being closed (IMF) or has already closed (Japanese Cabinet Office) and companies are finding it increasingly difficult to fill vacancies. Against this background a tightening of ultra-expansive monetary policy is not to be expected given the still stubbornly low inflation rate. The good economic situation, however, will allow the inflation rate to pick up and reach 1.0% this year.

After a weak year for *India*, triggered by different structural reforms and one-off events, a gradual increase in its growth rate is expected. In the medium term, the current implementation of several structural reforms will help to push growth above the 8%-mark. For 2018, an overall growth rate of 7.6% is expected.

For the remaining East and Southeast Asian region (*South Korea, Indonesia, Taiwan, Thailand, Hong Kong, Malaysia, Singapore, and the Philippines*) current growth dynamics will remain steady. In the medium run, the slowdown of growth in China will have a dampening effect on the entire Asian region. In the short run, however, stronger international trade will also benefit this region. Although remaining favourable overall, the economic climate in many of these countries has deteriorated in recent months. All in all, real GDP is expected to grow by 3.7% in these East Asian countries this year.

For the largest economy of this region, *South Korea*, stronger fiscal support should also keep GDP growth at around 3% this year. At the same time, construction investment will slow down following the tightening of regulations in residential construction and mortgage lending. Weak employment growth is also dampening private consumption. In the light of the first step towards tightening monetary policy taken at the end of November last year, inflation is also expected to stay at just under 2% this year, and thereby below the regional average.

1.4.5 Latin America and Russia

Although in the commodity-exporting countries of *Brazil, Russia, and Mexico*, assessments of the current situation are still negative, expectations are turning increasingly positive. The fundamentals for the *Mexican* economy are looking favourable, although the two major earthquakes in September last year will hold back the overall growth rate for this year. In *Brazil*, the now historically low interest rates set by its central bank, together with an overall flourishing world economy, will support the country's economic recovery. With a

growth rate of 1.9%, a moderate upswing is about to set in.

The prospects for *Argentina* are good. Following a deep recession caused by radical market-oriented structural reforms in recent years, its economy returned to strong growth in 2017. Whether the abolition of foreign exchange controls and the reduction of trade barriers will suffice to lead the country to sustainable growth after years of economic stagnation remains to be seen. In order to attract more foreign investors, Argentina will need to reduce its high tax burden on companies and reduce its excessive state budget deficit. It is important to bring its high inflation rates under control, which have ‘skyrocketed’ as a result of the massive devaluation of the Argentinian peso and the elimination of subsidies for electricity and gas.

Macroeconomic imbalances, unorthodox policies, rising inflation and lack of investment are keeping *Venezuela* in a serious economic crisis. A default on government foreign debt could cause creditors to confiscate foreign assets and thereby pose a huge risk to the already paralysed economy. The currency traded in the parallel market is crashing from one record low to the next. Its drastic slump came after the announcement in December that the country was trying to restructure its foreign debt, without clarifying how. Successful restructuring is critical as over 9 billion US dollars in debt will mature this year.

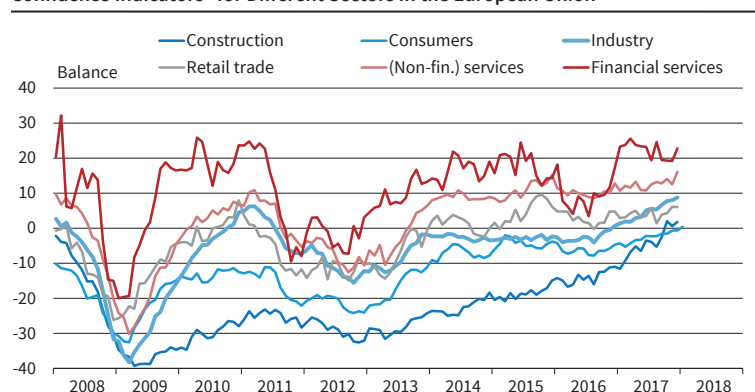
In *Russia*, the overall robust growth observed last year has the potential to be sustained in the quarters ahead. In particular, improving consumer demand, lower inflation and looser monetary policy together with improved oil prices will lay the foundation for a prolonged recovery. On the downside, the potential of an expansion of Western sanctions remains a key downside risk to economic growth. Growth is forecast to be 2.0% this year.

1.4.6 Europe

Cyclical Situation

Fuelled by low macroeconomic and political uncertainties, the business confidence indicators for the European Union all report positive balances for the first time since 2007 (see Figure 1.31). Even

Figure 1.31
Confidence Indicators^a for Different Sectors in the European Union

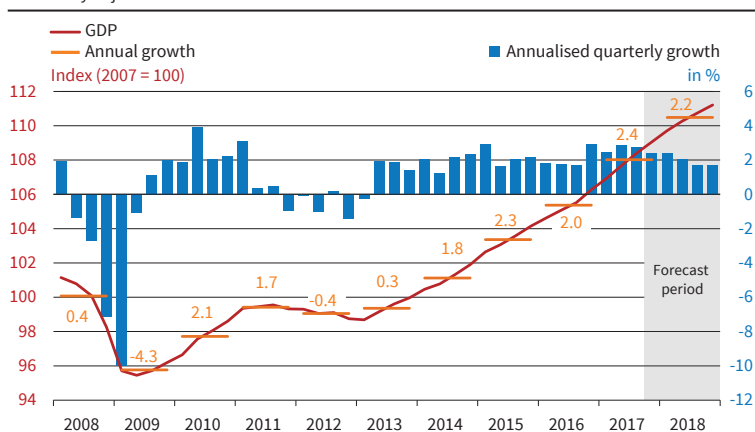


^a Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.

Source: European Commission; last accessed on 27 January 2018.

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Figure 1.32
Real GDP in the European Union
Seasonally adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast.

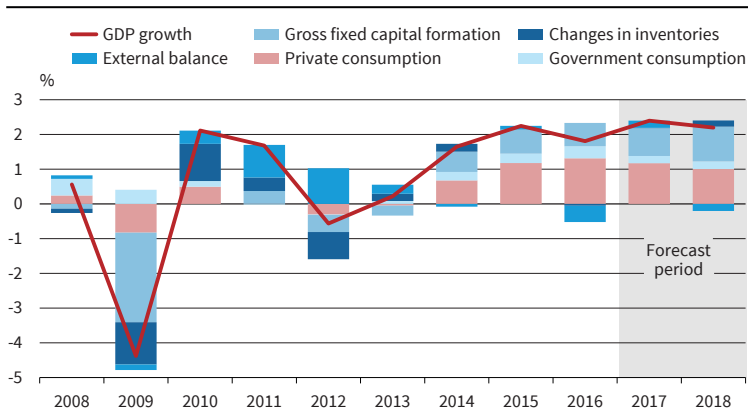
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the consumer confidence indicator published by the European Commission has basically reached zero, which historically happened in early 2001 for the last time. Other leading economic indicators also remain consistently positive for the European Union and the euro area in particular, and point to a continuation of the upturn this year.

In line with last year's growth performance, GDP expansion rates are likely to remain near or slightly above an annualised 2%. After an overall growth rate of 2.4% last year, real GDP is forecast to grow by 2.2% this year (see Figure 1.32). With the output gap closed by the end of last year and growth still above potential, the former is going to open up over the course of the year.

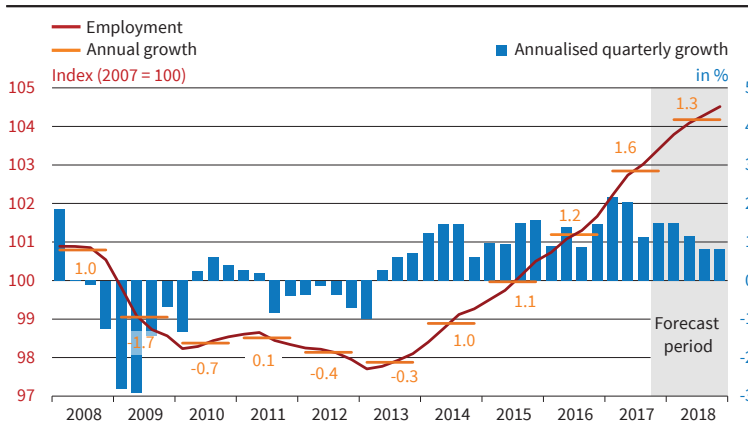
Improvements in the labour market and favourable lending conditions are likely to further stimulate domestic demand, while the positive outlook for the global economy will boost export demand. However, since imports into Europe are also expected to grow somewhat more strongly, the growth contribution of net exports will remain modest and significantly short of the figures in previous recoveries (see Figure 1.33).

Figure 1.33
Demand Contributions to GDP Growth in the European Union^a



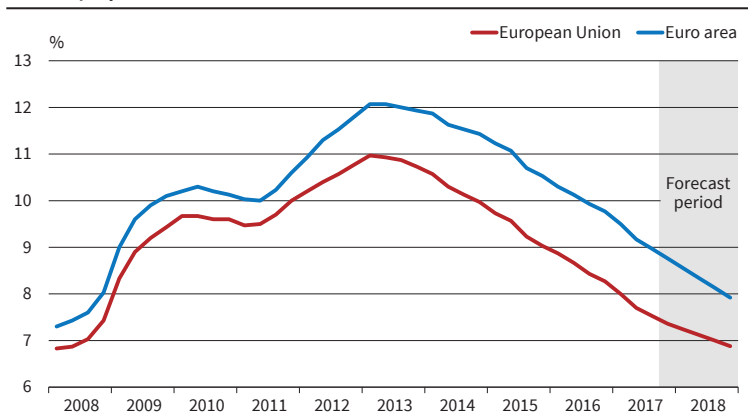
^a Gross domestic product at market prices (prices of the previous year). Annual percentage change. Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Figure 1.34
Employment in the European Union
Seasonally and work-day adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Figure 1.35
Unemployment Rates in the Euro Area and the European Union
Seasonally adjusted data



Source: Eurostat; last accessed on 27 January 2018; EEAG calculations and forecast. © CESifo

Whereas in previous years, private consumption was in the driver's seat of the economic recovery, lower gains in purchasing power will result in consumption growth rates this year being somewhat lower than last year. More in line with previous upswings, gross fixed capital investment has become an important

driver. Favourable financing conditions, less uncertainty and increases in capacity utilisation are encouraging firms to ramp up their investment.

In this upward spiral, the recovery will allow for the further creation of additional jobs (see Figure 1.34). Although employment growth of 1.3% will not reach the rate seen for last year (1.6%), it will still be sufficient to further reduce the overall unemployment rate in both the European Union and the euro area.

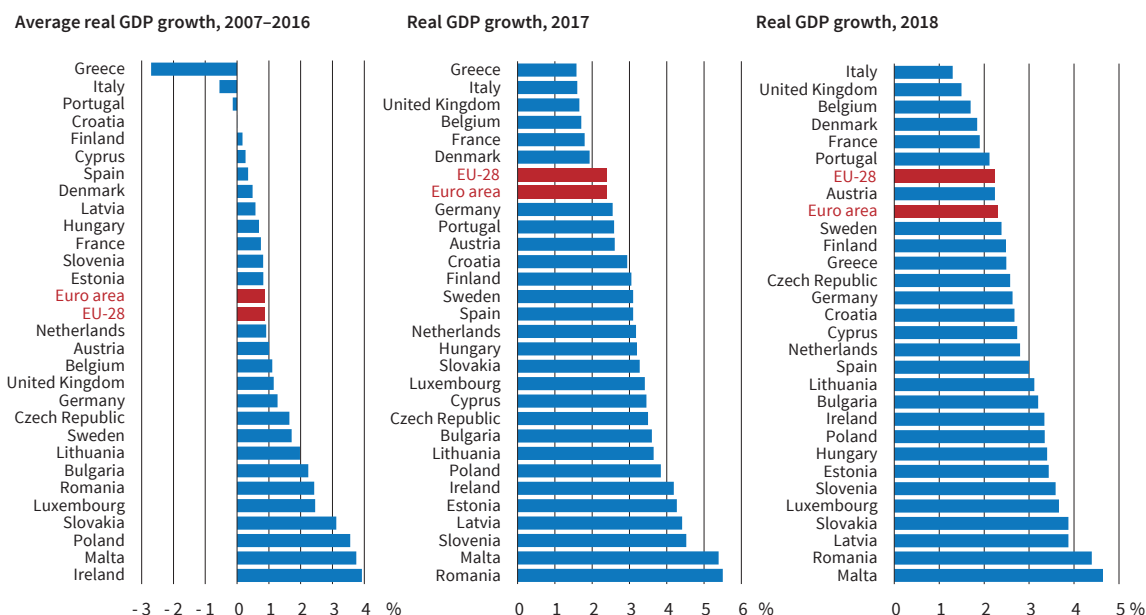
For this year, an average 7.1% of the working population in the European Union will be registered as unemployed. By the end of the year, the unemployment rate for the European Union will have returned to its pre-crisis levels (see Figure 1.35). Although the reduction in the euro area will be similar, it will still be about 1 percentage point above that seen before the start of the Great Recession by the end of the year.

The inflation rate is likely to pick up this year as a result of the closed output gap, the improved labour market situation and stronger wage growth. This is also indicated by the growing share of companies reporting plans to increase their prices in the months ahead in business tendency surveys performed by the European Commission. The initial rise in consumer prices is also being driven by higher energy prices. Under the assumption of relatively stable oil prices, this effect, however, will abate over the course of the year. In the euro area as a whole, inflation will therefore remain at 1.5% this year.

Differences across Europe

The economic recovery has reached all member states, reducing differences in GDP growth rates (see Figure 1.36). The expansion rates of Germany and France are estimated to be 2.6 and 1.9% in 2018. Among the five largest economies, Spain has the best growth prospects (3.0%). Both Italy's and the United Kingdom's growth rates will remain, at 1.3 and 1.4% respectively, well below the euro area

Figure 1.36
Economic Growth in EU Member Countries



Source: Eurostat; last accessed on 27 January 2018; 2017 and 2018: EEAG forecast.

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average of 2.5%. Hence, although Spain is back on a convergence path, the same cannot be said for Italy. With well-above average growth rates overall, the eastern parts of Europe are continuing to catch up with their western counterparts.

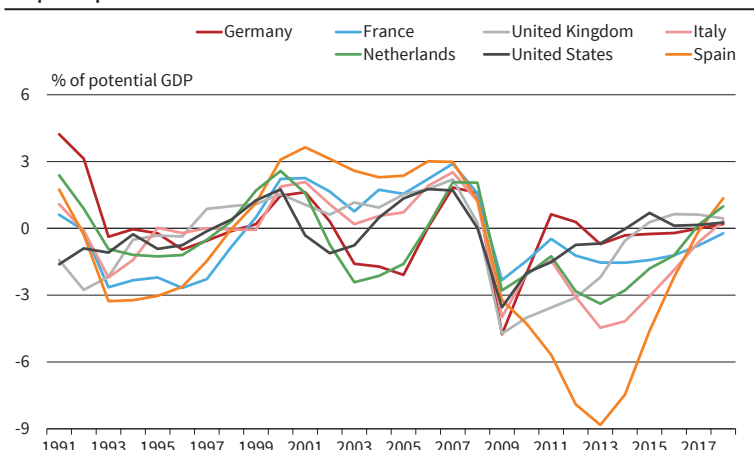
The differences in price developments remain significant across the euro area countries. They reflect the different rates of economic recovery and heterogeneous labour market conditions. According to estimates by the European Commission, this further improved environment will allow most European countries to experience a closed output gap this year (see Figure 1.37). Germany, the Netherlands, and Spain will face the highest inflation rates (1.9, 1.5, and 1.5%, respectively); in France and Italy, these rates will be significantly lower (0.9 and 1.2%, respectively, see Table 1.A.2).

Prospects for the labour market are likely to improve further and unemployment rates across the European Union should continue to decline. While the unemployment rate is likely to fall in each of the five largest economies, it will do so from very different levels. This year, the unemployment rate in Germany is likely to fall to 3.6%, while in Spain, Italy, and France, it will only drop to 15.2, 11.,2 and 9.4%. In Spain, the labour market is expected to develop most dynamically. The opposite holds for the United Kingdom where the unemployment rate is likely to more or less remain at its already low level.

Although GDP growth in *Germany* has likely remained above potential this winter, some slowdown in dynamics seems likely. This is supported by a current business situation that has not really improved further and less dynamic developments in industrial production.

Nevertheless, all of the signs still indicate a booming economy. The upswing in Germany will continue in 2018 as a result, boosted by domestic demand and exports. Private consumption will expand strongly, driven by rising effective wages, increasing transfer income, and rising employment. Like last year, public consumption remains significantly weaker than in 2015/16; which reflects markedly reduced migration inflows. As capacity utilisation increases further, business investment will continue to expand strongly. Growth in both commercial and residential

Figure 1.37
Output Gap Estimates in Selected Countries



Source: Eurostat; last accessed on 27 January 2018.

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construction, however, will gradually slow down. This is indicated by the decline in building permits. Even though growth will remain considerably high in view of the strong global economic momentum, exports are unlikely to rise quite as strongly as in 2017. All in all, German GDP is expected to increase by an average of 2.6% this year. As a result, the output gap, which has been positive since 2016, will grow noticeably. Overall, job market prospects remain good, but the currently strong growth in employment will gradually slow down. In light of the continued buoyant economy, consumer prices are expected to increase by 1.9% this year. The shortages in employment supply will lead to higher labour market tensions. Earnings per employee are expected to rise by 3.4% this year.

Economic growth in *France* will remain robust at an annual pace of 1.9% this year. Strong external demand, a rebound in tourism, robust business confidence, job creation, and the initiated labour market reforms will all support the upswing. Last year's labour market reform facilitates enterprise-level negotiations, especially for small businesses, and simplifies the complex management of employee representation. The reform is likely to make the French economy more competitive and to stimulate investment and growth, especially for small and innovative companies. The government also plans to invest heavily in training, to simplify the overly complex education system and strengthen apprenticeship training. All this will help to improve the labour market outcomes of less skilled workers. A ceiling on compensation to be set by courts to compensate workers for dismissals should encourage the use of permanent contracts. Implementing the plan to increase social contributions for companies that rely excessively on short-term contracts is likely to have a similar effect. All and all, these reforms have the potential to improve access to more secure jobs and lead to more training for many workers.

In the *United Kingdom*, uncertainty for companies and households remains high. Uncertainty regarding the outcome of the Brexit negotiations means that UK GDP is set to grow only slowly this year. Overall, 1.4% growth is expected for 2018. Both private consumption, investment, and foreign trade should contribute positively to the overall economic expansion. As both private consumption and investment activity slow down, foreign trade will become the main economic driver. However, this pace of growth will not be sufficient to warrant a further decline in the unemployment rate. Inflation remains at 2.6% this year, well above the inflation target of the Bank of England. This outlook triggered an interest rate hike of 25 basis points in November last year. Given the economic situation, the Bank of England will probably not initiate a further interest rate step this year. Further steps may only follow when the economic effects of the negotiations with the European Union will become more apparent.

According to the available leading indicators, the economic momentum in *Italy* is expected to gradually level off in the quarters ahead. Domestic demand will continue to expand. The expected flattening of private consumption will be compensated for by increased investment activity. For the current year, the Italian economy is forecast to expand at an overall rate of 1.3%. A downside risk to the forecast stems from the parliamentary elections in Italy, which will be held on 4 March 2018. Opinion polls indicate a significant shift to the right. The populist and immigration-critical 5-star movement is on a par with the Democratic Party, which is currently in government. Difficult government formation would lead to higher risk premiums on Italian government bonds, which, in turn, would negatively impact the financial sector and the economy.

As growth in domestic demand slows somewhat, GDP growth in *Spain* will drop slightly to 3% this year. The expansionary effect of corporate and household spending on pent-up demand and temporary supportive factors like low oil prices and lower taxes is expected to gradually decline. However, continued job creation and favourable financing conditions will continue to support private consumption and business investment. The contribution of net exports to growth will gradually decline. The unemployment rate should fall to 15.2% this year, which is still well above the European average. Inflation will remain at a similar level to last year at 1.5%.

After Ireland, Portugal, and Cyprus, *Greece* will also finally pull out of its GDP trough and continue to grow on a stable path. The Greek economy is forecast to grow by 2.5% and is thus starting to recover at a rate comparable with the economies of Portugal, Cyprus and Ireland. Their growth rates are forecast to be 2.1, 2.7, and 3.3% respectively.

The economies in the *Central and Eastern European* region will continue to grow, albeit at a pace that is somewhat lower than last year in almost all of these countries. Some stimuli in foreign trade are to be expected from the ongoing recovery in the euro area and Russia. As the decline in unemployment is not going to be as strong as last year, the positive impulses from domestic demand are expected to decline somewhat. Historically low interest and inflation rates will continue to support investment dynamics in the region.

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APPENDIX 1.A

Forecasting Tables

Table 1.A.1

GDP Growth, Inflation, and Unemployment in Various Countries

| | Share of total GDP in % | GDP growth | | | CPI inflation | | | Unemployment rate ^a | | |
|---|-------------------------|------------|------------|------------|---------------|------------|-------------|--------------------------------|------------|------------|
| | | in % | | | | | | | | |
| | | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| Industrialised countries: | | | | | | | | | | |
| EU-28 | 24.9 | 2.0 | 2.4 | 2.2 | 0.3 | 1.7 | 1.7 | 8.3 | 7.6 | 7.1 |
| Euro area | 18.1 | 1.8 | 2.4 | 2.3 | 0.3 | 1.5 | 1.5 | 10.0 | 9.2 | 8.6 |
| Switzerland | 1.0 | 1.4 | 1.0 | 2.3 | -0.4 | 0.5 | 0.5 | 4.9 | 4.8 | 4.6 |
| Norway | 0.6 | 1.1 | 2.1 | 1.8 | 3.6 | 2.0 | 1.8 | 4.7 | 4.1 | 3.9 |
| Western and Central Europe | 26.5 | 0.5 | 0.6 | 0.6 | 0.1 | 0.4 | 0.4 | 8.2 | 7.5 | 7.0 |
| US | 28.2 | 1.5 | 2.3 | 2.6 | 1.3 | 2.1 | 2.1 | 4.9 | 4.4 | 4.0 |
| Canada | 2.3 | 1.5 | 2.9 | 2.1 | 1.4 | 1.6 | 1.9 | 7.0 | 6.4 | 6.2 |
| Japan | 7.5 | 1.0 | 1.8 | 1.4 | -0.1 | 0.4 | 1.0 | 3.1 | 2.9 | 2.8 |
| Industrialised countries (total) | 64.5 | 1.0 | 1.5 | 1.5 | 0.5 | 1.1 | 1.1 | 6.7 | 6.1 | 5.7 |
| Newly industrialised countries: | | | | | | | | | | |
| China | 17.0 | 6.7 | 6.8 | 6.6 | 2.0 | 1.5 | 2.1 | . | . | . |
| India | 3.4 | 7.1 | 6.2 | 7.6 | 4.9 | 3.3 | 4.7 | . | . | . |
| Russia | 1.9 | -0.2 | 1.9 | 2.0 | 7.0 | 3.0 | 3.5 | . | . | . |
| East Asia ^b | 6.8 | 3.4 | 3.8 | 3.7 | 1.6 | 2.3 | 2.3 | . | . | . |
| Latin America ^c | 6.3 | -2.0 | 0.8 | 1.6 | 21.1 | 43.9 | 138.8 | . | . | . |
| Newly industrialised countries (total) | 35.5 | 1.5 | 1.7 | 1.8 | 2.1 | 3.3 | 9.5 | . | . | . |
| Total^d | 100.0 | 2.5 | 3.2 | 3.2 | 2.6 | 4.4 | 10.6 | . | . | . |
| World trade growth in %^e | | 1.4 | 4.4 | 4.2 | | | | . | . | . |

^a Standardized unemployment rate; ^b Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore, and Hong Kong. Weighted with the 2016 levels of GDP in US dollars; ^c Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, and Chile. Weighted with the 2016 level of GDP in US dollars; ^d Weighted average of the listed groups of countries; ^e Trade of goods.

Source: EU; OECD; IMF; ILO; National Statistical Offices; CPB. 2017 and 2018: EEAG forecast.

Table 1.A.2

GDP Growth, Inflation, and Unemployment in EU Countries

| | Share of total GDP in % | GDP growth | | | Inflation ^a | | | Unemployment rate ^b | | |
|--------------------------------|-------------------------|------------|------------|------------|------------------------|------------|------------|--------------------------------|------------|------------|
| | | in % | | | | | | | | |
| | | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| Germany | 21.1 | 1.9 | 2.5 | 2.6 | 0.4 | 1.8 | 1.9 | 4.1 | 3.8 | 3.6 |
| France | 15.0 | 1.2 | 1.9 | 1.9 | 0.3 | 1.1 | 0.9 | 10.1 | 9.7 | 9.4 |
| Italy | 11.3 | 0.9 | 1.6 | 1.3 | -0.1 | 1.3 | 1.2 | 11.7 | 11.5 | 11.2 |
| Spain | 7.5 | 3.3 | 3.1 | 3.0 | -0.3 | 1.7 | 1.5 | 19.6 | 17.2 | 15.2 |
| Netherlands | 4.7 | 2.2 | 3.2 | 2.8 | 0.1 | 1.3 | 1.5 | 6.0 | 4.9 | 4.5 |
| Belgium | 2.8 | 1.5 | 1.7 | 1.7 | 1.8 | 2.2 | 1.5 | 7.8 | 7.3 | 7.0 |
| Austria | 2.4 | 1.5 | 2.6 | 2.2 | 1.0 | 1.9 | 1.9 | 6.0 | 5.5 | 5.3 |
| Finland | 1.4 | 1.9 | 3.0 | 2.5 | 0.4 | 0.9 | 1.4 | 8.8 | 8.7 | 8.3 |
| Portugal | 1.2 | -0.2 | 1.6 | 2.5 | 0.0 | 1.2 | 1.0 | 23.6 | 21.9 | 20.5 |
| Greece | 1.2 | 1.5 | 2.6 | 2.1 | 0.6 | 1.5 | 1.5 | 11.2 | 9.4 | 8.5 |
| Ireland | 1.8 | 5.1 | 4.2 | 3.3 | -0.2 | 0.3 | 1.2 | 8.4 | 6.3 | 5.8 |
| Slovakia | 0.5 | 3.3 | 3.3 | 3.9 | -0.5 | 1.3 | 1.7 | 9.7 | 8.2 | 7.5 |
| Luxembourg | 0.3 | 3.1 | 4.5 | 3.6 | -0.2 | 1.6 | 1.6 | 8.0 | 6.8 | 6.0 |
| Slovenia | 0.4 | 3.1 | 3.4 | 3.7 | 0.0 | 1.8 | 1.7 | 6.3 | 6.0 | 5.7 |
| Lithuania | 0.3 | 2.3 | 3.6 | 3.1 | 0.7 | 3.7 | 2.6 | 7.9 | 7.2 | 6.6 |
| Latvia | 0.2 | 2.1 | 4.4 | 3.9 | 0.1 | 2.9 | 2.9 | 9.6 | 8.7 | 8.3 |
| Estonia | 0.1 | 3.0 | 3.5 | 2.7 | -1.2 | 0.9 | 0.9 | 13.0 | 11.4 | 10.3 |
| Cyprus | 0.1 | 2.1 | 4.3 | 3.4 | 0.8 | 3.7 | 3.2 | 6.8 | 7.4 | 8.1 |
| Malta | 0.1 | 5.5 | 5.4 | 4.6 | 0.9 | 1.3 | 1.6 | 4.7 | 4.3 | 4.3 |
| Euro area^c | 72.4 | 1.8 | 2.4 | 2.3 | 0.3 | 1.5 | 1.5 | 10.0 | 9.2 | 8.6 |
| United Kingdom | 16.1 | 1.9 | 1.7 | 1.5 | 0.6 | 2.6 | 2.6 | 4.8 | 4.4 | 4.4 |
| Sweden | 3.1 | 3.2 | 3.1 | 2.4 | 1.1 | 1.6 | 1.6 | 6.9 | 6.6 | 6.3 |
| Denmark | 1.9 | 2.0 | 1.9 | 1.8 | 0.0 | 1.0 | 1.4 | 6.2 | 5.8 | 5.8 |
| EU-22^c | 93.4 | 1.9 | 2.3 | 2.2 | 0.3 | 1.7 | 1.7 | 9.0 | 8.3 | 7.8 |
| Poland | 2.9 | 2.9 | 3.8 | 3.3 | -0.2 | 1.9 | 2.3 | 6.2 | 4.8 | 4.0 |
| Czech Republic | 1.2 | 2.6 | 3.5 | 2.6 | 0.6 | 2.3 | 1.8 | 4.0 | 2.8 | 3.0 |
| Romania | 1.1 | 4.8 | 5.5 | 4.4 | -1.1 | 1.1 | 3.3 | 5.9 | 5.3 | 5.2 |
| Hungary | 0.8 | 2.2 | 3.2 | 3.4 | 0.4 | 2.5 | 3.2 | 5.1 | 4.4 | 4.3 |
| Bulgaria | 0.3 | 3.2 | 2.9 | 2.7 | -0.6 | 1.1 | 1.2 | 13.4 | 13.9 | 13.5 |
| Croatia | 0.3 | 3.9 | 3.6 | 3.2 | -1.3 | 1.1 | 1.4 | 7.6 | 6.6 | 6.4 |
| New Members^d | 8.0 | 3.1 | 3.9 | 3.4 | -0.2 | 1.9 | 2.3 | 6.1 | 5.1 | 4.8 |
| EU-28^c | 100.0 | 2.0 | 2.4 | 2.2 | 0.3 | 1.7 | 1.7 | 8.3 | 7.6 | 7.1 |

^a Harmonised consumer price index (HICP); ^b Standardised unemployment rate; ^c Weighted average of the listed countries; ^d Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria

Note: GDP growth rates are based on the calendar adjusted series except for Ireland, Slovakia and Romania for which Eurostat does not provide working-day adjusted GDP series.

Source: Eurostat; 2017 and 2018: EEAG forecast.

Table 1.A.3

Key Forecast Figures for the European Union

| | 2016 | 2017 | 2018 |
|--|--------------------------------------|------|------|
| | Percentage change over previous year | | |
| Real GDP | 1.9 | 2.4 | 2.2 |
| Private consumption | 2.3 | 2.0 | 1.8 |
| Government consumption | 1.6 | 1.0 | 1.1 |
| Gross fixed capital formation | 3.6 | 3.4 | 4.2 |
| Exports of goods and services | 3.5 | 5.2 | 4.3 |
| Imports of goods and services | 4.8 | 4.4 | 4.6 |
| Net exports ^a | -0.4 | 0.5 | 0.0 |
| Consumer prices ^b | 0.3 | 1.6 | 1.7 |
| | Percentage of nominal GDP | | |
| Government fiscal balance ^c | -1.7 | -1.2 | -1.1 |
| | Percentage of labour force | | |
| Unemployment rate ^d | 8.6 | 7.6 | 6.7 |

^a Contributions to changes in real GDP (percentage of real GDP in previous year);
^b Harmonised consumer price index (HICPI); ^c 2017 and 2018: forecasts of the European Commission; ^d Standardised unemployment rate

Source: Eurostat; 2017 and 2018: EEAG forecast.

Table 1.A.4

Key Forecast Figures for the European Area

| | 2016 | 2017 | 2018 |
|--|--------------------------------------|------|------|
| | Percentage change over previous year | | |
| Real GDP | 1.8 | 2.4 | 2.3 |
| Private consumption | 2.0 | 1.8 | 1.6 |
| Government consumption | 1.7 | 1.1 | 1.2 |
| Gross fixed capital formation | 4.5 | 3.2 | 3.6 |
| Exports of goods and services | 3.3 | 5.0 | 4.4 |
| Imports of goods and services | 4.7 | 4.2 | 4.0 |
| Net exports ^a | -0.5 | 0.5 | 0.3 |
| Consumer prices ^b | 0.3 | 1.5 | 1.5 |
| | Percentage of nominal GDP | | |
| Government fiscal balance ^c | -1.5 | -1.1 | -0.9 |
| | Percentage of labour force | | |
| Unemployment rate ^d | 10.0 | 9.2 | 8.6 |

^a Contributions to changes in real GDP (percentage of real GDP in previous year);
^b Harmonised consumer price index (HICPI); ^c 2017 and 2018: forecasts of the European Commission; ^d Standardised unemployment rate

Source: Eurostat; 2017 and 2018: EEAG forecast.