



# CaixaBank

---

*Research*

Article

---

Activity & growth

## Another good year ahead for

# the euro area economy

Content available in  
Spanish Catalan

---

The pace of euro area economic activity remains firm. The euro area's economy expanded much faster than expected in 2017. According to the CaixaBank Research scenario, the region will have grown by 2.4% in 2017, while at the beginning of the year the GDP growth forecast was 1.7%. In 2018, we expect GDP growth to remain robust, at 2.2%, above potential, supported by favourable financial conditions, improvements in the labour market and the global economic recovery. The ECB's view is very similar, and in its latest quarterly macroeconomic update it highlighted the euro area's strong performance in recent quarters and revised its 2017 growth forecast upwards to 2.4% (+0.2 pp) and to 2.3% (+0.5 pp) for 2018. Despite the strong recovery in activity, inflation will lag behind, as prices are forecast to increase by 1.5% in 2018 and 1.8% in 2019. The ECB also revised its 2018 inflation forecast slightly upwards to 1.4% (+0.2 pp) while keeping its 2019 forecast at 1.5%, below the central bank's target (below but close to 2%). On the political front, the first phase of Brexit negotiations has successfully concluded with a pre-agreement between the EU and UK on the terms of separation. The UK's Brexit financial bill is estimated to be between EUR 40 and 45 billion. This breakthrough heralds the second phase of negotiations on the future trade agreement, discussed at length in the Focus: «What will the future EU-UK relationship be like?» in this Monthly Report.

Domestic demand drives euro area growth. Eurostat confirmed that euro area GDP growth in Q3 2017 was 0.6% quarter-on-quarter (2.6% year-on-year). Domestic demand contributed significantly to quarterly growth (0.5 pp), mainly supported by private consumption and investment. Foreign demand also contributed positively

to growth (0.1 pp). Over the next quarters, we expect domestic demand to continue to drive euro area growth, partly supported by favourable credit conditions, although external demand will also play a part.

The European Commission proposes new measures to advance towards further European integration. The EC recently published a strategic plan with concrete measures to promote further economic and monetary integration. These include proposals such as transforming the European Stability Mechanism (ESM) into a European Monetary Fund (which would be responsible for any bail-out programme); the creation of a euro area budget (which would have a stabilising role); and setting up a European Ministry of Economy and Finance. In this context, it is worth highlighting that the European project is in good shape, even though Eurosceptic voices have come to the fore in recent years. In particular, according to the October 2017 Eurobarometer, support for the euro remains high: the percentage of respondents who believe that having the euro is a good thing for their country increased by 8 pp when compared to the 2016 survey, and reached 64%, the highest level since it was first published (2002).

Business sentiment indicators point to strong growth in Q4. In particular, the composite PMI index for the euro area stood at 57.2 points in Q4, above the previous quarter's figure (56.0) and in the expansionary zone (above 50 points). Across countries the acceleration was led by France, whose composite PMI reached 59.2 points (56.0 in Q3). Germany also performed well, with a PMI that increased to 57.5 points (56.1 in Q3). All this points to stronger economic growth in the last quarter of 2017.

Private consumption slows down temporarily. October's retail sales rose by 0.7% year-on-year, way below the figure of the previous month (3.7%) and the year average (2.6%), but the slowdown is due to temporary factors. In particular, sales of clothing and footwear were negatively affected by unseasonably warm weather. However, the rise in the consumer confidence index to its highest levels since 2001 (+0.1 pp in November and +0.5 in December) suggests that retail sales picked up again in November and December. By 2018, we expect household consumption to remain sound, supported by the improved economic outlook and labour market prospects and low interest rates.

The labour market benefits from the dynamism of economic activity. Euro area employment increased by 0.4% quarter-on-quarter in Q3 2017, and the total number of employees increased to 156.3 million, an all-time high. Employment growth was widespread across countries, particularly in Spain (0.7%) and Portugal (0.6%) while in Germany, France and Italy employment growth was slightly lower (0.3% on average). This improvement in employment is gradually pushing up wages. In Q3 2017, hourly wage costs for the euro area as a whole rose by 1.6% year-on-year, a similar increase as the one in H1 (1.8%). Across countries, wage costs rose sharply in Germany (2.2% year-on-year) and France (2.1%) while in Italy and Spain wage growth was weak (0.3% and 0.1% year-on-year, respectively). In Portugal, hourly wage costs fell (-1.2% year-on-year) due to a change in the distribution of supplementary payments for public sector workers.

## PORTUGAL

Growth remains steady. After closing 2017 with an estimated GDP growth above 2.5%, analysts and major international institutions forecast a slight slowdown in the growth rate in 2018. According to CaixaBank Research forecasts, GDP growth will remain at high levels, at 2.2%, supported by a favourable external environment (particularly in the euro area, where Portugal's main trading partners are located), accommodative financial conditions and improved confidence. Banco de Portugal's forecasts in its December economic bulletin are very similar, as they expect GDP growth to remain above potential over the forecast period, albeit at a slightly slower pace than in 2017 (2.3% in 2018 and 1.8% in 2019).

Public finances benefit from the favourable economic outlook. Public deficit stood at 0.1% of GDP (12-month cumulative) in Q3, which implies a significant correction with respect to the figure of Q3 2016 (3.7%). This improvement was due to both higher revenue growth (+2.7% year-on-year) and a reduction in expenditure (+0.1%). This positive development should enable the 2017 deficit to be below the government's target (1.4% of GDP). The lower public deficit, together with sustained GDP growth will continue to support a gradual decline in the government debt ratio, which we estimate reached 127.3% of GDP at the end of 2017. Against this backdrop of improving public finances and positive growth prospects, Fitch revised Portugal's sovereign rating from BB+ to BBB, taking it

back to investment grade. This announcement, in the wake of S&P's announcement in September, was widely expected, as reflected by the fall in the country's sovereign risk premium since late October to 150 bp.

The current account balance remains positive. The current account surplus (12-month cumulative) reached EUR 457.6 million in October (or 0.2% of GDP), below the EUR 1,359 million of October 2016. In terms of composition, this deterioration was caused by a larger deficit in the goods balance, despite the larger surplus in services and the smaller deficit in the income balance. The deterioration of the trade balance has been due to the sharp rise in imports, as a result of higher oil prices and the recovery in investment, even though exports have remained very dynamic.





*Research*



*Research*



*Research*



*Research*



*Research*



*Research*





*Research*



*Research*