European Economic Outlook 2018-2022

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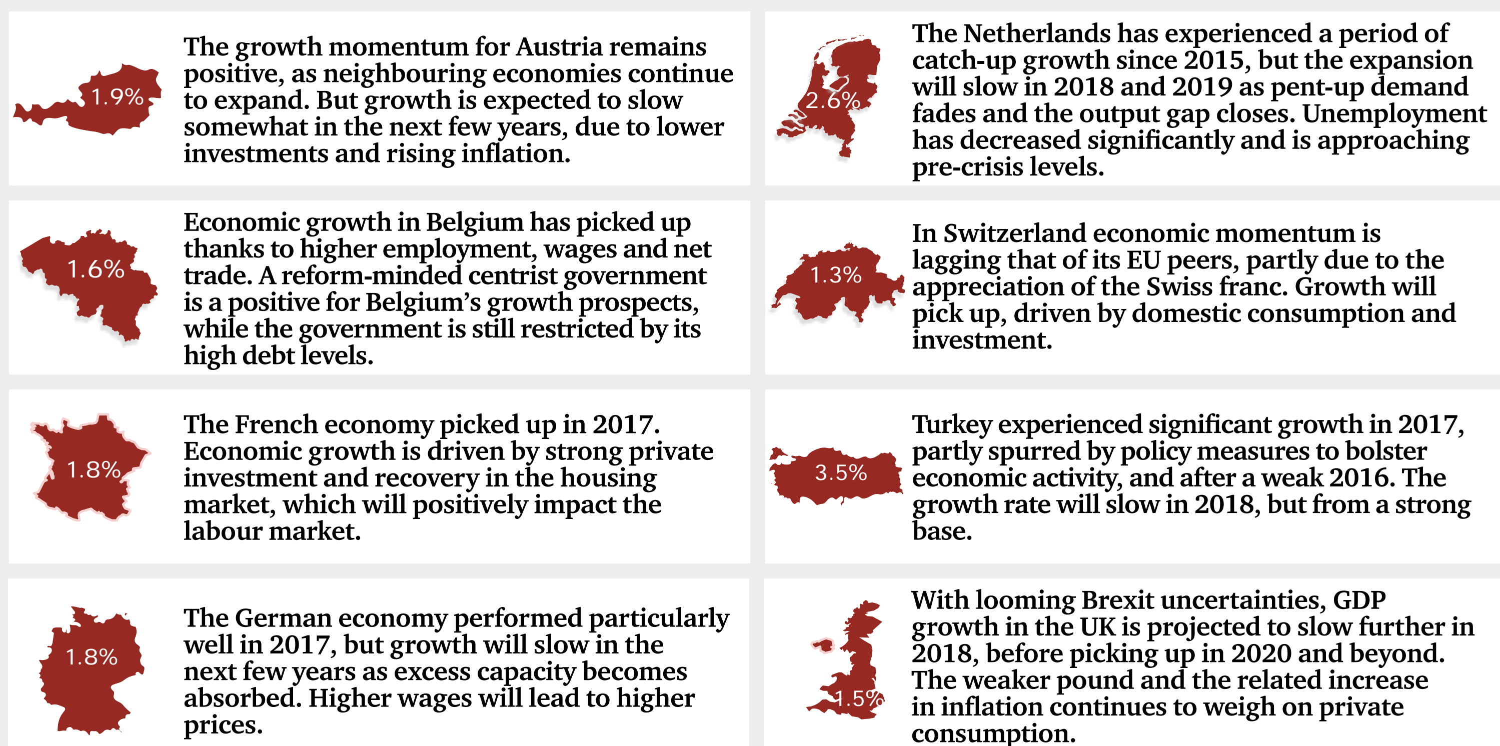
European Economic Outlook 2018

The economic recovery in Europe is expected to continue in 2018 and beyond, albeit at a slower pace, as many economies are approaching full capacity. Nonetheless, consumer spending, which has been the bedrock of Eurozone recovery, is expected to continue to grow in 2018 driven by improvements in the labour markets. In the euro area[1], Austria, Germany, Ireland, Luxembourg and the Netherlands performed particularly well in the past year. Outside the EU, Turkey is expected to see considerable growth and outperform its peers in Europe.

Figure 1: *GDP growth forecasts in 2018, per country*



Source: IMF, World Economic Outlook, October 2017; European Economic Forecasts, Autumn 2017; PwC analysis. Note: The percentages in the map represent the year-on-year GDP growth forecast in 2018.

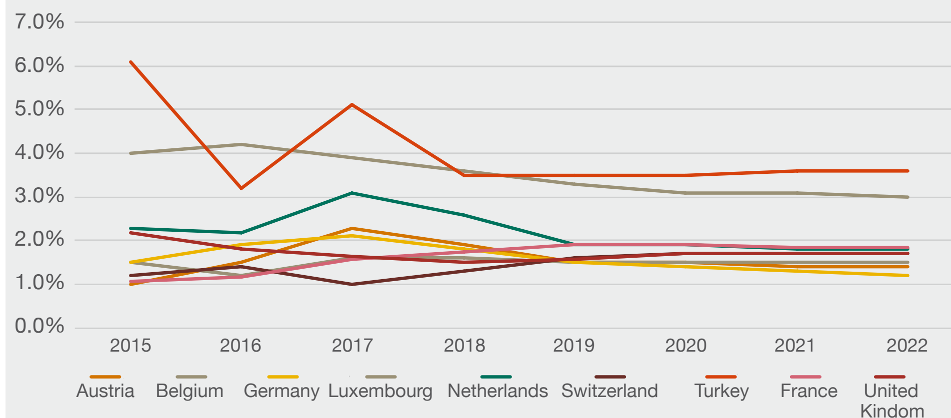
[1] Excluding the newer members to the European Union after 2004.

Macroeconomic outlook for Europe

The EU – positive trend continues but at a slower pace

In 2017, all EU countries experienced an economic recovery and improvements in their labour markets, compared to the crisis years. The improved conditions reflects a global upswing in advanced economies and emerging markets alike. At 2.3%, EU GDP growth in 2017 surpassed expectations[2]. Germany, Ireland, Luxembourg and the Netherlands are doing particularly well, while Belgium and the UK are lagging their peers.[3]

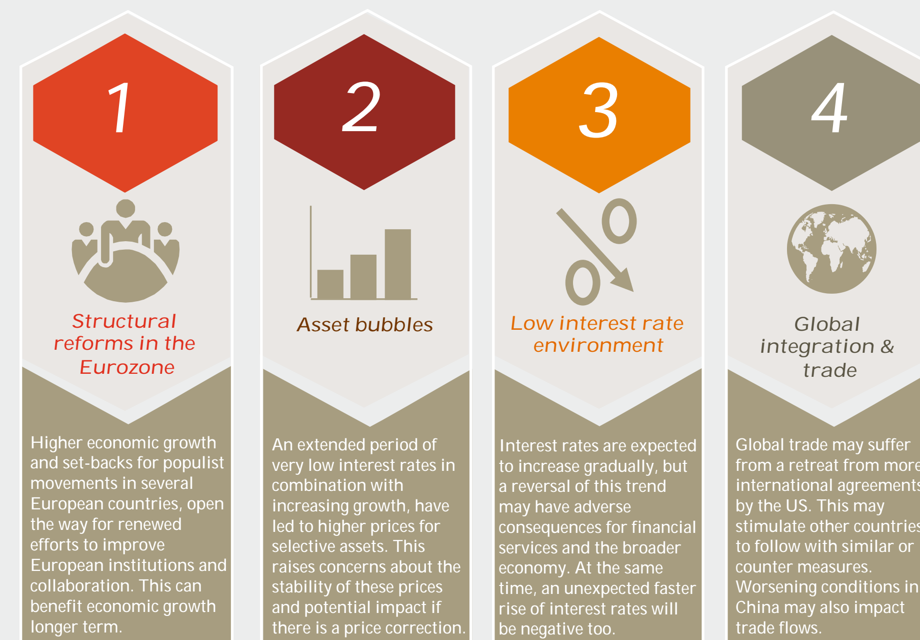
Figure 2: *GDP growth year on year per country including projections for the period 2018 – 2022*



Source: IMF, World Economic Outlook, October 2017

The ongoing recovery is expected to continue in the near to medium term, but the slowing pace of job creation and household purchasing power growth will mean a slight decrease in momentum over the next two years. Growth is expected to slow to 2.1% in 2018 and 1.9% in 2019[4], as output gaps close, and latent demand is increasingly met. Other factors that may slow down economic growth in the region in the medium term are mainly the lack of structural reform in the Eurozone, including fiscal fragilities stemming from the crisis and, in some countries, a public and private debt overhang. There is also a risk of potential asset bubbles, risks related to the reversal of extremely low interest rates or a retrenchment in global integration and trade. Additionally, in the longer term, adverse demographics continue to weigh on the EU with particularly hard felt effects in some countries, especially if coupled with low productivity growth and, potentially, insufficient R&D funding.

Figure 3: *The 4 main developments that could risk the ongoing European recovery*



Source: PwC analysis

[2] IMF, World Economic Outlook, October 2017.

[3] European Commission, European Economic Forecast, Autumn 2017 and IMF, World Economic Outlook, October 2017.

[4] European Commission, European Economic Forecast, Autumn 2017. IMF estimates are similar for 2018 and slightly lower for 2019.

Moreover, the reductions in unemployment are expected to slow down, which will likely continue to constrain wage growth and, as a result, moderate private consumption. And, finally, inflation will remain low but move closer to the European Central Bank's (ECB) target rate of 2% in the medium-term. In 2019 inflation will be approaching 2% in several countries, while for the euro area as a whole, this adjustment is estimated to take until 2022[5].

The European consumer: a main contributor to growth

Consumer spending has been the principle driver of the economic recovery in the EU since 2013 and has played an particularly important role for the improved growth figures in 2017. The recovery in employment is the main reason for this trend, helped by recent structural reforms to contain wages or to encourage job creation, in Belgium, France and Italy among others. Yet, unemployment rates in the EU remain high by comparison – forecast at 7% in 2019[6]. In addition, employees work relatively few working hours compared to the pre-crisis level or 'involuntary' work part-time. Naturally, this slack impacts the level of wealth and consumer spending. While remaining a main driver of growth, private consumption is expected to slow in 2018 and beyond.

Other contributors are corporate investments, exports and a favourable monetary policy

Higher demand expectations and supportive financing conditions, have provided a healthy climate for corporate investments. Strong business sentiment, high capacity utilisation rates and corporate profitability, as well as modernisation needs mean that this trend will continue.

Likewise, exports were strong in the euro area in 2017, and are expected to remain robust in 2018 and 2019, despite the euro's appreciation, and thanks to continued strong global demand. In spite of robust import growth, net trade is projected to make a slight positive contribution to growth.

But as a result of the slack in the labour markets and the low wage growth, GDP growth will remain dependent on a favourable monetary policy. Although several central banks have started increasing their nominal interest rates, the ECB has kept its rate at zero while starting to wind down its asset purchases to €30 billion monthly. In a balancing act, a first interest rate increase is expected in 2019, as the ECB seeks to balance growth in the majority of Eurozone countries without destabilising the recovery in the weaker economies.

[5] The IMF forecasts Eurozone inflation to reach 1.9% in 2022.

[6] European Economic Forecast, Autumn 2017.

High performers: Austria

Austria outperformed Germany, its closest trading partner in the region, in 2017 with a GDP growth at 2.3% mainly as a result of higher external and domestic demand. Austrian GDP growth is expected to continue on this trend in 2018 with a GDP growth of 1.9%. Austria can continue to outperform the Eurozone average if the current government implements reform measures that increase productivity. Its close integration with both the Central and Eastern European regions and the Southern European regions provide positive growth prospects for Austrian exports. Similar to the other EU countries, growth figures are expected to moderate in the period 2019-2022.

High performers: Germany

After solid growth in 2017, the expansion of the German economy is expected to slow down as the output gap closes. In the coming years domestic consumption will continue to play a bigger role in driving economic growth, which in turn will boost imports and reduce the net trade contribution to GDP growth. See further our chapter on Germany on page 8.

High performers: the Netherlands

The past couple of years the Netherlands have been experiencing a period of catch-up growth after the great recession and financial crisis. In 2018 growth is expected to remain substantial: 2.6%. After 2018, GDP growth is expected to stabilise just below 2% until 2022. The expansion of the economy is broad based, supported by private consumption, net trade, investments and government expenditure. Productivity is expected to decline in the coming years, as the working-age population declines and labour becomes scarcer.

Outside the EU: Switzerland

Outside the EU, Switzerland's economic momentum is lagging that of its EU peers. GDP growth for 2018 is expected to be around 1.3%[7]. This is partly due to the appreciation of the Swiss franc. However, growth is expected to pick up in the next few years, driven by domestic consumption and investment. In addition, stronger economic growth in the EU and in emerging markets will support export.

Outside the EU: Turkey

The Turkish economy experienced robust economic growth in 2017 with GDP growth above 7% in the first three quarters of 2017, and a double digit growth of 11.1% in the third quarter. Solid GDP growth was mostly a result of policy measures taken to bolster economic activity, as well as the base effect of low growth in 2016. In 2018, the growth rate is forecasted to slow but Turkey will continue to outperform its emerging market peers in Europe.

Inflation skyrocketed and reached more than 11.9% (CPI, consumer price index) in 2017, mostly due to currency depreciation and cost pressures. The Turkish Central Bank tightened its policy stance via unorthodox tools which did not induce a significant drop in the annual inflation rate. The CPI is not projected to decline to single digit until the end of Q1 2018, but high GDP growth rates may make it easier for the Central Bank to justify tightening its monetary stance further, in order to achieve price stability.

Furthermore, the development of the geopolitical events and the campaigns for the 2019 elections will have an influence on Turkish economy in 2018 where markets are going to watch the normalisation in the monetary policies of leading Central Banks (the Federal Reserve, the ECB and the Bank of England).

[7] IMF, World Economic Outlook, October 2017.

Industries outlook

In the next five years, the economic recovery in Europe is expected to continue – albeit at a slower pace. This creates a favourable economic climate where companies can grow their business. Some specific industries outperform others. Projected growth figures for specific industries show that in most countries consumer markets and industrial manufacturing & automotive are the two sectors expected to contribute most to national GDP. The highest growth rates, however, are expected in the services sector, technology, media & entertainment (TMT) and in financial services.

Consumer markets the main driver of GDP, followed by the industrial manufacturing & automotive sector

In most of the economies in scope, except for Germany, consumer markets are expected to have the highest value added in 2018 – contributing most to the national GDP (see figure 4). In most of these countries, industrial manufacturing & automotive is the second largest contributor to GDP. For the period 2018- 2022 both sectors are expected to show moderate growth (see figure 5).

Growth rates in the consumer markets will be stable around 1.5%, except in Turkey where the growth is expected to be more than double that (3.1%). Online retailers will be the main drivers of growth in the forecasted period, including online grocery shopping and prepared food delivery. Major retailers are already expanding their online food offerings and food delivery services. Industrial manufacturing & automotive is expected to show moderate growth, with 1.4% in Switzerland and Austria, and slightly lower growth rates in the other economies.

Figure 4: *Overview of expected value added[8] per industry in 2018 as percentage of total value added per country for six selected EU economies, Switzerland and Turkey*

	Austria	Belgium	France	Germany	Netherlands	Switzerland	Turkey	United Kingdom
Consumer Markets	24.6%	20.3%	22.2%	17.3%	22.4%	22.6%	35.3%	21.2%
Industrial Manufacturing & Automotive	23.3%	16.9%	13.7%	24.3%	15.0%	22.6%	20.8%	14.4%
Services	9.6%	14.8%	12.4%	10.9%	13.3%	9.8%	6.6%	14.7%
Government & Public Sector	12.5%	15.6%	16.0%	14.0%	13.5%	19.2%	9.3%	13.4%
Health Industries	6.0%	7.5%	9.1%	7.3%	9.3%	7.9%	2.2%	7.6%
Technology, Media & Telecommunications	3.4%	4.5%	4.9%	5.0%	5.3%	3.8%	3.0%	6.8%
Energy, Utilities & Resources	6.1%	5.1%	3.2%	5.4%	7.1%	2.6%	5.4%	4.5%
Financial Services	4.6%	6.6%	5.1%	4.4%	6.8%	10.5%	5.6%	6.8%

Source: PwC analysis; IHS, Invest Europe 2017

[8] Gross value added is sales revenue, less cost of purchases of inputs and supplies. Conceptually, the sum of value added from all sectors equals national GDP. As such, sector value added is also referred to as sector GDP.

High performers: technology, media & entertainment, services sector and financial services

Technology, media & entertainment (TMT), the services sector and financial services are expected to be among the high performing industries in the period 2018- 2022, with TMT as the number one growth sector. Although this sector is relatively small in most European economies, growth is expected in the range of 2.2% (Austria) to 3.1% (the UK). Within the TMT sector, technology - and more specifically software - is the largest growth area. Steady growth is forecasted for cloud computing, IT security and big data and analytics technologies.

Professional and administrative services is also a high performing industry, with a compound annual growth rate (CAGR) of more than 2% in many countries. These positive growth figures are a result of the economic recovery which enables companies in other industries to increasingly outsource and out-task their non-core business processes. The highest growth rates are expected in the UK, the Netherlands and Belgium, where the services sector is already relatively large.

The financial services sector contributes 4-7% value-added to the major European economies. In Switzerland, the value added of the financial services sector peaked at 10.5% in 2017. For the financial services sector high growth rates are expected in the UK, Germany, Austria and Turkey. As these economies are all expected to see further growth, lending to the private sector, mortgage borrowing and consumer credits are likely to increase. Moreover, the German financial sector may be positively impacted by Brexit, which could offer new opportunities for financial services firms especially in Germany's domestic financial services hub in Frankfurt.

Healthcare cost cutting measures to contain increasing health care spending

Demographic and technological trends are putting pressure on healthcare systems in most European countries. In previous years, healthcare spending has increased considerably and has been one of the high performing industries as a result of aging, a growing burden of chronic disease and expensive new diagnostic technologies. However, many countries are struggling to contain rising healthcare spending and have adopted cost-cutting measures. Accordingly, the healthcare sector is expected to continue to grow, but at a slower pace. The healthcare sector, which varies in size between 6- 9% of GDP in most major European economies, is expected to grow at 1.4 - 1.9% in these countries between 2018 and 2022.

Figure 5: *Overview of expected compound annual growth rates (CAGR) for the period 2018 - 2022 per industry, based on gross value added, for six selected EU economies, Switzerland and Turkey.*

	Austria	Belgium	France	Germany	Netherlands	Switzerland	Turkey	United Kingdom
Consumer Markets	1.5%	1.7%	1.4%	1.5%	1.9%	1.4%	3.1%	1.5%
Industrial Manufacturing & Automotive	1.4%	1.3%	1.3%	1.2%	1.0%	1.4%	3.0%	1.1%
Services	2.3%	2.6%	2.3%	2.0%	2.7%	1.5%	4.1%	3.2%
Government & Public Sector	1.1%	0.6%	1.10	1.3%	1.5%	1.1%	3.8%	1.3%
Health Industries	1.4%	1.4%	1.6%	1.8%	1.4%	-0.1%	3.7%	1.9%
Technology, Media & Telecommunications	2.2%	2.6%	2.8%	2.6%	2.7%	1.7%	4.3%	3.1%
Health Industries	0.6%	1.2%	1.1%	0.7%	0.7%	0.9%	3.8%	-0.6%
Financial Services	2.1%	1.2%	1.5%	2.1%	1.7%	1.9%	4.1%	2.8%

Source: PwC analysis; IHS, Invest Europe 2017

Germany

Current situation and short-term outlook

In 2017, the German economy grew with a solid expansion of 2.1%. However, the growth rate of the real GDP is expected to slow down slightly to 1.8% in 2018. This is however higher than the potential growth of 1.5%, meaning that the German economy shows a positive output gap. Thus, the German economy is outperforming itself, i.e. it is managing a higher actual output than the economy's recognised maximum capacity output.

Apart from exports (3.5%) and construction investments (4.3%) also private (1.8%) and government (1.6%) consumption spending increased in 2017. Since the beginning of 2017, the industrial sector has been one of the most dynamic, and performed particularly well in August when it grew by 3.2% (adjusted for seasonal effects). Moreover, consumers spending remained high according to the Federal Ministry of Economics and Technology (Bundesministerium für Wirtschaft und Energie), as unemployment continued to decrease.

The German Federal Labour Office recently published its figures for November 2017, showing that the unemployment rate is at an all-time low since the German reunification - 5.3%, and less than 2.5 million unemployed people. The job boom of recent months however, is likely to ease in 2018. In 2017, foreign trade, i.e. export growth, which profited from the recovery in the world economy, was a large factor in the number of jobs created. However export growth is likely to slow down in the coming months as the positive output gap closes.

Despite the recent positive trend, the strong economic situation also means some risks and challenges for Germany. For instance, Germany already lacks skilled labours in certain sectors. A possible skilled-labour shortage could be counteracted by labour related migration for professionally qualified workers.

According to the German Institute for the World Economy (Institut für Weltwirtschaft), the positive output gap may also become a challenge for Germany as the economy could become overheated. Other challenges, or risks, may be Brexit related or related to economic policy in the US, if protectionist measures hamper foreign trade. As these are expected to impact German exports negatively, both aspects may put pressure on the German economy.

Medium-term economic outlook

After solid growth in 2017, the expansion of the German economy is expected to slow down as the output gap closes. As a result, prices and wages are forecast to rise only moderately and productivity growth will be restrained. Due to the German current account surplus, which reflects chronically low domestic spending, economic policy is expected to try to bolster domestic demand in the future. Thus, domestic consumption will continue to play a bigger role in driving economic growth, which in turn will boost imports and reduce the net trade contribution to GDP growth. However, exports will remain a major driver of the German economy also in the future.

Additionally, the government's commitment to fiscal prudence means that public expenditure, through significant investments in infrastructure or other projects, will not boost growth. Despite the economy operating near full employment, German inflation is predicted to remain anchored around 2% in the short term, alleviating domestic concerns about the impact of the ECB's unorthodox monetary easing programme.

Socio-political outlook

In the general election in September 2017, the centre-right Christian Democratic Union (CDU) won the largest share of the vote. Angela Merkel was expected to head a broad coalition including CDU's Bavarian sister party, the Christian Social Union (CSU), the Free Democrats (FDP) and the Greens, for her fourth term as chancellor. Due to the parties' colours the likely coalition was dubbed the 'Jamaica coalition'. However, the Free Democrats' chairman Christian Lindner announced after four weeks of exploratory discussions that the FDP is not willing to join the Jamaica coalition due to non-satisfactory negotiations with the other parties. Accordingly, the German government faces new challenges now with different possible outcomes.

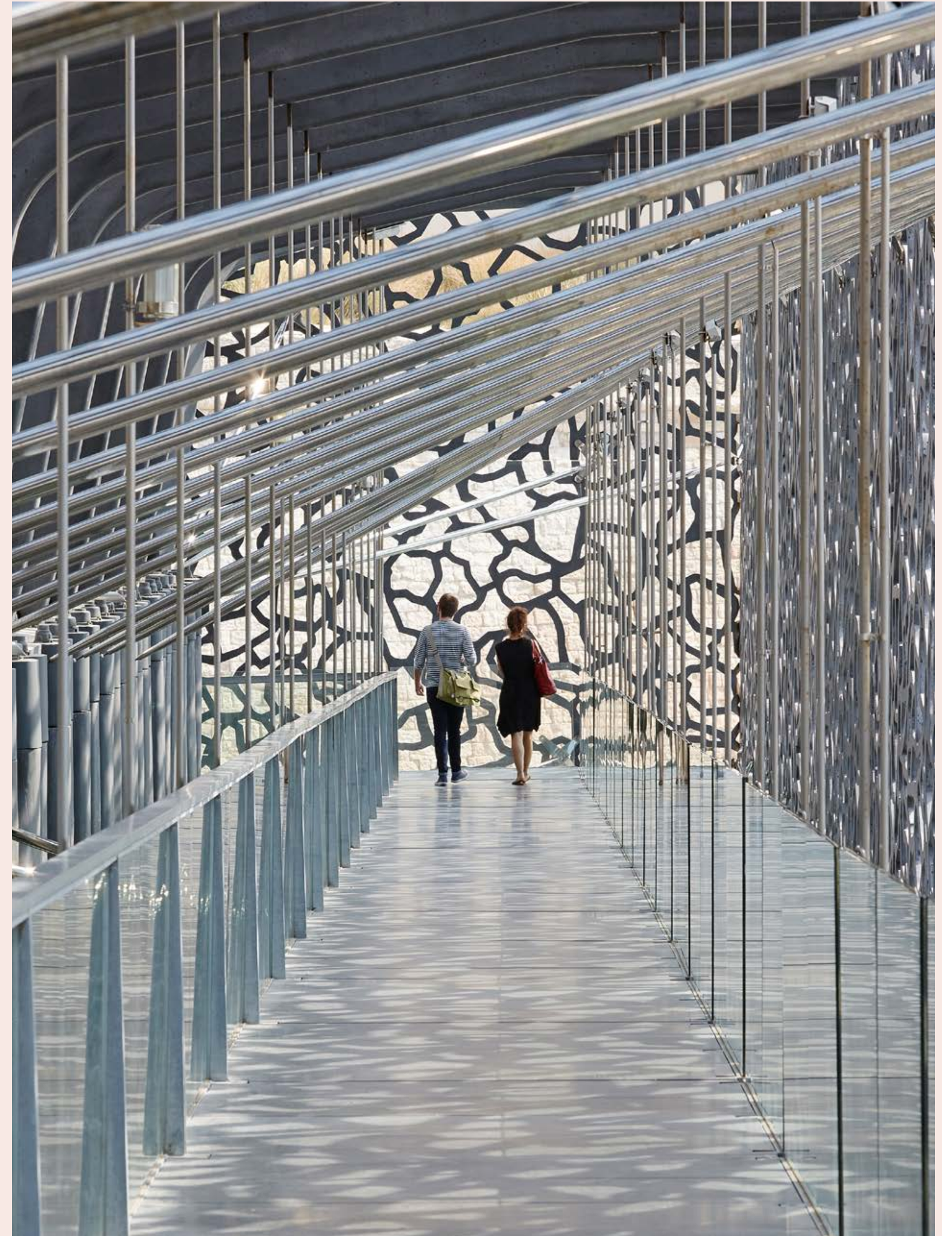
The three most likely scenarios are the following: Firstly, the grand coalition of the CDU/CSU and the Social Democrats (SPD) could, at least in theory, return. A second possible outcome is a minority government. For a coalition of the CDU/CSU with the FDP 29 other seats are needed in order to pass a law and for a coalition with the Greens it would be even 42. Hence, a minority government would depend on the support of the other parliamentary groups. The third

scenario would be new elections. Yet, the path to new elections is rather difficult due to provisions in the German constitution. However, coalition talks are still ongoing, which makes it difficult to predict an outcome.

Despite continuity in the office of the chancellor, the German political system is more fragmented than before. The two largest parties, the CDU/CSU and the SPD, were severely weakened and Germany has never seen the need for a four-party coalition before. The Bundestag will for the first time also face the far-right populist Alternative for Germany (AfD) in parliament.

Demographic outlook

However, not only the political situation in Germany poses new challenges. Also the socio-demographic developments pose a challenge: Germany faces a major demographic challenge since the country has one of the fastest declining working age populations in the OECD and also one of the fastest growing pension age populations. This puts pressure on Germany's social security system and fiscal position. One option to alleviate this pressure, would be to work to integrate immigrants into the German labour market in an efficient way.



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