EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2018 and 2019

Spring 2018

About the European Forecasting Network

The European Forecasting Network (EFN) is a research group of European institutions, founded in 2001 under the auspices of the European Commission, and currently partly financially supported by the Schuman Centre at the European University Institute. The objective of the EFN is to provide a critical analysis of the current economic situation in the euro area, short-term forecasts of the main macroeconomic and financial variables, policy advice, and in-depth study of topics of particular relevance for the working of the European Economic and Monetary Union. The EFN publishes four quarterly reports. Further information on the EFN can be obtained from our web site, http://www.eui.eu/Projects/EFN/Home.aspx.

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Highlights

- The world economy is booming. The global upswing is investment-driven, and since investment goods usually have a large import content, it is no surprise that world trade has been buoyant during winter. The very expansionary US fiscal policy (tax reform and lifting of spending caps) could give an additional short-term stimulus for the world economy.
- However, we forecast world trade to slow down during 2018. The US administration's announcement of high tariffs on steel and aluminium comes close to triggering a spiral into a broader trade conflict. Moreover, the globalization of value chains has been slowing down since the financial crisis due to the industrial upgrading in China and in other emerging economies that has declined processing trade. In addition, some types of manufacturing jobs have returned to source countries (reshoring) in response to technology innovation and lower labour costs differentials.
- The euro area is in the middle of a broad based cyclical upswing. Higher exports and improved expectations have induced firms to invest more into equipment, as capacity utilization has been above average for some time now and is still increasing, and financing costs are very low. However, recent soft indicators, but also industrial production have been surprisingly downbeat, and there was some turbulence in financial markets, which suggests some caution.
- The ECB will probably stop its asset purchase program at the end of 2018, but only later in 2019 start raising interest rates. Fiscal policy in the euro area is slightly expansionary this year, and a notable fiscal stimulus in France and in Germany is to be expected for 2019.
- Overall, we forecast euro area GDP to expand by 2.2% in 2018 and by 1.6% in 2019. Accelerating wage dynamics will, together with higher price setting powers of firms and the recent increase in oil prices, cause consumer price inflation rising to nearly to 2% in 2019. Uncertainty, is however substantial, as a slight slowdown cannot be ruled out, which would also impact inflation dynamics.

Table 1 Economic outlook for the Euro area

	2015	2016	2017	2018: 1st half		2018: annual		2019: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.1	1.8	2.4	2.4	1.9 3.0	2.2	1.4 2.9	1.6	0.6 2.6
Potential Output	1.0	1.3	1.7	1.7	1.4 2.1	1.7	1.1 2.2	1.7	1.1 2.4
Private Consumption	1.8	2.0	1.7	1.3	0.9 1.7	1.4	0.9 2.0	1.4	0.6 2.2
Government Consumption	1.3	1.8	1.2	1.7	1.3 2.1	1.7	1.3 2.2	1.9	1.4 2.5
Fixed Capital Formation	3.3	4.6	2.9	3.7	1.6 5.8	4.1	1.6 6.6	4.0	1.4 6.7
Exports	6.4	3.4	5.1	5.8	4.6 7.0	5.1	3.4 6.6	3.8	1.9 5.6
Imports	6.7	4.8	4.3	5.5	4.1 6.9	5.6	3.8 7.4	4.9	2.8 7.1
Unemployment Rate	10.9	10.0	9.1	8.5	8.3 8.8	8.4	8.0 8.8	8.0	7.1 8.8
Labour Cost Index	1.4	1.5	2.0	2.1	1.8 2.4	2.4	2.1 2.7	2.8	2.4 3.3
Labour Productivity	0.9	0.4	0.8	1.2	0.6 1.7	1.0	0.4 1.7	0.8	-0.2 1.7
HICP	0.0	0.2	1.5	1.3	1.0 1.7	1.6	1.1 2.0	1.9	1.2 2.6
IPI	2.6	1.6	3.0	3.9	2.6 5.3	2.4	0.7 4.1	0.2	-1.3 1.6

Percentage change in the average level compared with the same period a year earlier, except for the output gap that is the deviation of actual GDP from potential GDP as a per cent of potential GDP and except for the unemployment rate. Point forecasts and 80% confidence bounds are taken from EFN forecasting model and based on 2000 stochastic simulations.

Economic Outlook for 2017 and 2018

Strong global growth, but trade put at risk by conflicts

The world economy is booming. In 2017, production in the US, the euro area, and in Japan have expanded much faster than potential, and this year output gaps will, according to the OECD economic outlook, be positive in all three economies. The 2017 growth rate in China was, for the first time in this decade, higher than a year earlier, and Chinese economic activity at the first quarter of 2018 was only slightly less dynamic than before. The global upswing is investment-driven: gross fixed capital accumulation of private firms in the G7 economies has been rising to about 5% (year on year) in the final quarter of 2017. Since investment goods usually have a large import content, it is no surprise that world trade has been buoyant during winter. As a further sign of increased activity, commodity prices, oil and many metals in particular, have been on an upward trend for about a year now, which helps major producers of these goods such as Russia and Brazil. Core inflation rates, however, are in general still moderate.

The single most important driver for the global upswing is still monetary policy, as short and long-term interest rates in the main advanced economies have stayed at their historical minima for some years now. Policy of central banks will little change in the euro area and in Japan for some time to come, and even the federal funds rate in the US, in spite of continuous tightening by the Fed, will stay below the neutral interest rate throughout 2018. Moreover, politics that in the recent past appeared capable to unsettle investors and dampen activity have not, up to now, had any such effect: the Brexit decision harmed growth in the UK, but apparently not much elsewhere, and economic sentiment in the US has even been rising during the Trump presidency, in spite of his protectionist agenda. The decisions about very expansionary US policy measures in December (tax reform) and in February (lifting of spending caps) could give an additional short-term stimulus for the world economy.

Latest indicators, however, in particular from financial markets, were disappointing: stock market valuations decreased in February and March, and implied stock market volatilities, that had been very low throughout 2017, rose to more normal levels in February. Moreover, sentiment of non-financial firms in most regions has recently cooled down a bit. Thus, the global upswing might very well have peaked. In particular, financial markets seem to reflect the risk that high capacity utilization in the US prevents the strong fiscal stimulus from expanding real production; instead, inflation might quickly rise, and the Fed might be forced to tighten monetary policy faster than expected. A more obvious threat to the global upswing comes from US trade policy: the administration’s announcement of high tariffs on steel and aluminium in March comes close to triggering a spiral into a broader trade conflict that has the potential of damaging the network of trade agreements on which the present global division of labor depends. For a realistic assessment of trade prospects it is also noteworthy that the globalization of value chains (GVCs) has been slowing down since the financial crisis and it is not clear how this trend will evolve during the next years. Among the factors behind the different evolution of GVC's, there are political factors such as the increase in protectionism after the financial crisis, but also other reasons such as the industrial upgrading in China and in other emerging economies that has declined processing trade and the fact that some types of manufacturing jobs have returned to source countries (reshoring) in response to technology innovation and lower labour costs differentials. All in all, while chances are good that global production will continue expanding healthily in the near future, we forecast world trade to slow down during 2018.

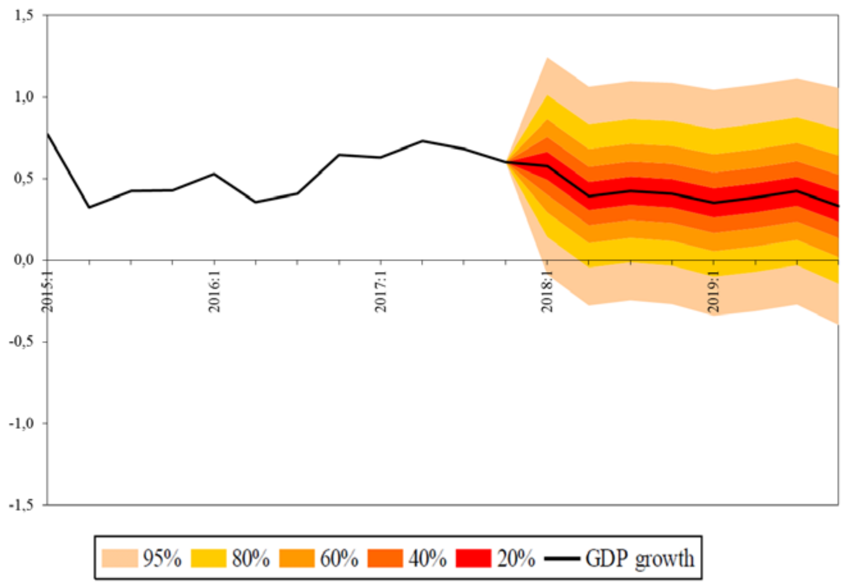
The euro area upswing at its peak

The euro area is in the middle of a strong and broad based cyclical upswing. Production has been expanding by about 2½% during 2017, which is much more than standard estimates of the potential growth rate of about 1 ½ %. The recovery, under way since summer 2013, transformed into an upswing in autumn 2016, when demand from outside the euro area increased quite abruptly. Higher exports and improved expectations have induced firms to invest more into equipment, as capacity utilization has been above average for some time now and is still increasing, and financing costs are very low. House prices, though stagnant in Italy, are in general on the rise, on average by about 4% per year, stimulating construction and strengthening confidence of private households. The same effect has the decrease in the unemployment rate, by one percentage point to 8.5% in the year to February. Consequently, private consumption expands healthily (at 1.7% in 2017). All major economies participate in this upswing, though Italy to a lesser extent. Monetary and fiscal policy will not put this upswing at risk in the near future: the ECB will probably stop its asset purchase program at the end of 2018, but only later in 2019 start raising interest rates. Fiscal policy is slightly expansionary this year, and a notable fiscal stimulus in France and Germany is to be expected for 2019.

For all these favourable conditions, recent indicators have been surprisingly downbeat: while global financial markets jittered in February, the mood of purchasing managers in the euro area has cooled down markedly, in particular in the manufacturing sector, where production was weak in both January and February. Temporary factors such as bad weather and a wave of influenza might have played a role here, but in the current state of the upswing, it is probably no longer possible to compensate losses by more production in the coming months: free capacities might simply not be available in important member countries. High vacancy numbers are evidence for a scarcity of labour in Germany and in the Netherlands in particular; in France, vacancies are worryingly many, given that the unemployment rate in the country is still at 9%. The slow increase in euro area wage dynamics that started in summer 2016 will therefore accelerate in 2018 and 2019. We expect that this, together with a higher price setting power of firms and the recent increase in oil prices, will cause consumer price inflation rising to nearly 2% in 2019.

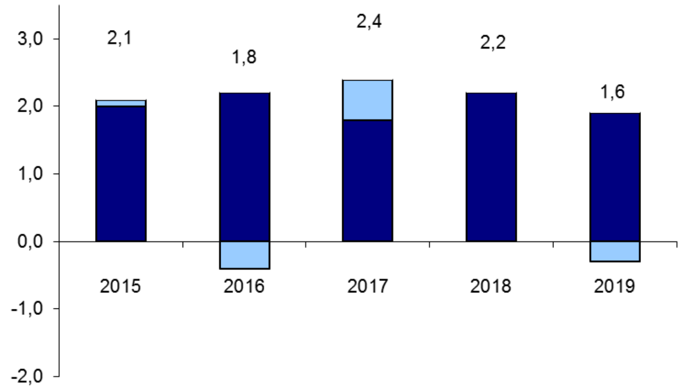
Employment dynamics will markedly lose momentum in some member countries, as the potential labour force is becoming more and more exhausted. In addition, foreign demand will lose a bit of momentum, not least because the euro has appreciated markedly (by about 10% according to the real effective exchange rate) during 2017. Overall, we forecast euro area GDP to grow by 2.2% in 2018 and by 1.6% in 2019, though the uncertainty around these estimates is naturally still large (see Table 1), and a slight slowdown cannot be ruled out, which would also impact inflation dynamics. Figure 1 presents the expected evolution of the quarter on quarter GDP growth, while the respective contributions of domestic components and net exports to GDP growth are reported in Figure 2.

Figure 1 Quarterly GDP growth rates and confidence bands



Percentage change over previous quarter

Figure 2 Contributions of domestic components and net exports to GDP growth



Domestic demand dark, net exports light area. Percentage points, figures above or below the columns indicate overall GDP growth

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model, described in detail in the EFN Spring 2002 report. Table 3 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The forecasts are quite similar for 2018, but the EFN growth forecast is on the pessimistic side for 2019, while its prediction for inflation is higher than in alternative forecasts. This is mainly so because we think that capacity constraints will become binding, and also because the present cyclical upturn in world trade will lose momentum, lowering growth and pushing up prices, as protectionist policies will take their toll.

Table 3 Comparison of EFN forecasts with alternative forecasts

	EFN		EU*		IMF		ECB		OECD**		Consensus	
	2018	2019	2018	2019	2018	2019	2018	2019	2018	2019	2018	2019
GDP	2.2	1.6	2.1	1.9	2.4	2.0	2.4	1.9	2.2	1.9	2.4	1.9
Priv. Consumption	1.4	1.4	1.7	1.5	1.8	1.6	1.7	1.7	1.5	1.4	1.6	1.7
Gov. Consumption	1.7	1.9	1.6	1.4	1.4	1.1	1.2	1.2	1.3	1.4	1.4	1.3
Fixed Capital Form.	4.1	4.0	3.9	3.3	4.4	3.5	4.4	3.4	3.7	3.5	3.5	3.2
Unemployment rate	8.4	8.0	8.5	7.9	8.4	8.3	7.7	8.9	8.5	8.0	8.3	7.9
HICP	1.6	1.9	1.4	1.6	1.5	1.6	1.4	1.4	1.5	1.7	1.5	1.5
IPI	2.4	0.2	na	na	na	na	na	na	na	na	3.1	2.1

EU: European Commission, Economic Forecast, November 2018; IMF: World Economic Outlook, April 2018; ECB: ECB Staff Macroeconomic Projections for the Euro Area, March 2018, OECD: Economic Outlook, November 2017; Consensus: Consensus Economics, Consensus Forecasts, April 2018.

* Euro area GDP growth will, according to the interim assessment of the European Commission of February 2018, be 2.3% in 2018 and 2.0% in 2019.

** Euro area GDP growth will, according to the OECD interim economic outlook of March 2018, be 2.3% in 2018 and 2.1% in 2019.

Variables of the world economy

Table 4 below shows assumptions concerning the evolution of important variables related to the state of the world economy. Growth in the US gets a new stimulus from fiscal policy. Oil prices are assumed to recede a bit from their levels reached in mid April. According to this forecast world trade will lose a bit of its present strong momentum.

Table 4 Variables of the world economy

	2017	2018	2019
US GDP Growth Rate	2.3	2.8	2.6
US Consumer Price Inflation	2.1	2.5	2.1
US Short Term Interest Rate (December)	1.3	2.2	2.7
US Long Term Interest Rate (December)	2.4	3.2	3.3
Japan GDP Growth Rate	1.7	1.4	1.1
Japan Consumer Price Inflation	0.5	1.0	1.0
Japan Short Term Interest Rate (December)	0.01	0.1	0.1
Japan Long Term Interest Rate (December)	0.05	0.1	0.2
World Trade Growth Rate (CPB)	4.5	4.0	3.5
Oil Price (December)	64	70	72
USD/Euro Exchange Rate (December)	1.18	1.23	1.23
100Yen/Euro Exchange Rate (December)	1.33	1.31	1.31

Apart from the development of world trade, long-term interest rates and nominal exchange rates, all variables are exogenous to the EFN forecast, mostly close to those of Consensus Economics (2018). The oil price is in US dollar per barrel (Brent). US short term interest rate: 3-month treasury bills. US long term interest rate: 10-year treasury bills. Japan short-term interest rate: 3-month deposits (LIBOR). Japan long-term interest rate: 10-year treasury bills.