EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2018 and 2019

Autumn 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

- Signs of a slowing world economy are piling up: Since the beginning of the year purchasing manager indices have been declining globally, in summer higher US interest rates led investors to withdraw capital from emerging markets, and as a consequence, capital costs rose and currencies depreciated in many emerging markets economies. In October stock prices decreased markedly worldwide including the US, despite the strong upswing in this country.
- As a consequence of the turmoil on financial markets, monetary conditions in many emerging economies are no longer favorable. What ultimately counts for the prospects of the global economy, is, however, the performance of the US, the Euro area, China and Japan. The upswing in the US appears stable enough to continue well into 2019. While at present the rest of the group appears to lose momentum, there is a good chance that production in each of these economies will still expand at rates that are close to their potential growth. Further protectionist rounds are the most important risk to this scenario.
- In the first half of the current year the euro area economy expanded at a markedly slower rate than in 2017, about 0.4% per quarter, but still substantial. Rising risk premia on Italian assets will probably force banks in this large country to tighten credit conditions, and a slowing world trade will dent export growth. All in all, we expect GDP growth in the euro area to go down from 2.4% in 2017 to 2.0% in 2018 and to 1.7% in 2019.
- Employment continues to expand and vacancy rates are at present higher than in 2017. As a consequence, wages rise more quickly: nominal compensations per employee started accelerating early in 2017, and negotiated wages followed at the beginning of 2018. Wage inflation of slightly below 2.5% and healthy growth in employment raise real labor incomes markedly.
- Our forecasts are based on the assumption that rating agencies will continue assigning investment grade to the Italian government debt, and that the Italian government and the European Commission will find a compromise about the draft budget of the country in the coming weeks. Another assumption is that the UK will not exit the EU in an unorderly way in March 2019.

Table 1 Economic outlook for the Euro area

	2015	2016	2017	2018: 2nd half		2018: annual		2019: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	2.1	1.9	2.4	1.8	1.5 2.1	2.0	1.9 2.2	1.7	1.3 2.2
Potential Output	1.1	1.5	1.7	2.1	2.0 2.2	2.1	2.0 2.2	1.7	1.5 2.0
Private Consumption	1.8	2.0	1.6	1.4	1.2 1.7	1.5	1.3 1.6	1.4	1.0 1.9
Government Consumption	1.3	1.8	1.2	1.1	0.9 1.3	1.1	1.0 1.2	1.4	1.2 1.7
Fixed Capital Formation	4.9	4.0	2.6	2.7	0.1 5.3	2.9	1.6 4.2	3.7	0.7 6.8
Exports	6.5	3.0	5.2	2.5	1.9 3.1	3.0	2.7 3.3	4.4	3.5 5.2
Imports	7.6	4.2	3.9	2.3	1.0 3.7	2.5	1.8 3.2	4.9	3.2 6.6
Unemployment Rate	10.9	10.0	9.1	8.1	7.9 8.2	8.3	8.2 8.4	7.7	7.4 8.0
Labour Cost Index	1.4	1.3	2.2	2.7	2.5 2.9	2.5	2.4 2.6	2.8	2.5 3.0
Labour Productivity	0.9	0.5	0.9	0.4	0.1 0.6	0.6	0.4 0.7	0.7	0.4 1.1
HICP	0.0	0.2	1.5	2.0	1.8 2.2	1.7	1.6 1.8	1.7	1.4 2.0
IPI	2.6	1.6	3.0	0.1	-0.5 0.7	1.4	1.0 1.7	1.0	0.2 1.8

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 2018 and 2019

The cyclical upswing is slowing everywhere, except – until now – in the US

In autumn 2018 signs of a slowing world economy are piling up: since the beginning of the year purchasing manager indices have been declining globally, particularly in the euro area, but in China and in Japan as well. Only the upswing in the US has been strengthening throughout the year, driven by last year's tax reform with strong temporary incentives for investment, but also by deregulations for energy producers and for the financial sector. In order to prevent the economy from overheating, the Fed continued raising interest rates. During summer, higher short and long term US interest rates led investors to withdraw capital from emerging markets, and as a consequence, capital costs rose and currencies depreciated in many emerging markets economies.

Particularly hard hit were Turkey and Argentina, where central banks had to drastically raise interest rates in order to stabilize their currencies. Argentina applied for support by the IMF in May, with a similar request following by Pakistan in October. At the same time, stock prices decreased markedly worldwide including the US, despite the strong upswing in this country. The fall was apparently triggered by a further increase of 10 years-government bond yields to 3.3%, a seven years high, at the beginning of October.

Investors might also be worried by the fact that world trade was stagnant during the first half of the year, and that the US administration implemented its protectionist trade policy step by step during the year. With different legal rationals US tariffs were raised repeatedly and to an ever greater extent, mainly on Chinese goods, and China reacted with retaliatory tariffs. The marked fall in Chinese stock prices and the depreciation of the Renminbi relative to the Dollar show that investors expect that the trade war will put a strain on the Chinese economy. While trade disputes of the US appear to have been settled with the EU in July and with its NAFTA partners in September, the first agreement is only temporary, and the second will lead to significantly higher non-tariff barriers to trade inside North America.

The losses such barriers cause might only be felt in the long run, but the US sanction against Iran had immediate consequences: they are, together with decreasing production in Venezuela and Mexico, the major cause for the hike of the oil price, which in mid October is, with about 80 USD for a barrel Brent, about 40% higher than one year ago.

As a consequence, consumer price inflation has risen globally, in the euro area to 2.1% in September. Core inflation, however, increased only in the US (to 2.2% in September), but is still stagnant in the euro area, at slightly more than 1%. Thus, while the

Fed will continue rising its key interest rate, and a roughly neutral level of about 3% could be reached at the end of next year in the US, the ECB communicates that it will keep its main interest rate at zero at least up to the summer of 2019. The central bank will, however, end its net purchases of assets at the end of this year. All in all, monetary conditions in the advanced economies will still be favorable in 2018 and 2019, although to a decreasing degree, and as a consequence of the turmoil on financial markets monetary conditions in many emerging economies are no longer favorable.

What ultimately counts for the prospects of the global economy, is, however, the performance of the largest economies, in particular the US, the Euro area, China and Japan. The upswing in the US appears stable enough to continue well into 2019. While at present the rest of the group appears to lose momentum, there is a good chance that production in each of these economies will still expand at rates that are close to their potential growth. Further protectionist rounds are the most important risk to this scenario.

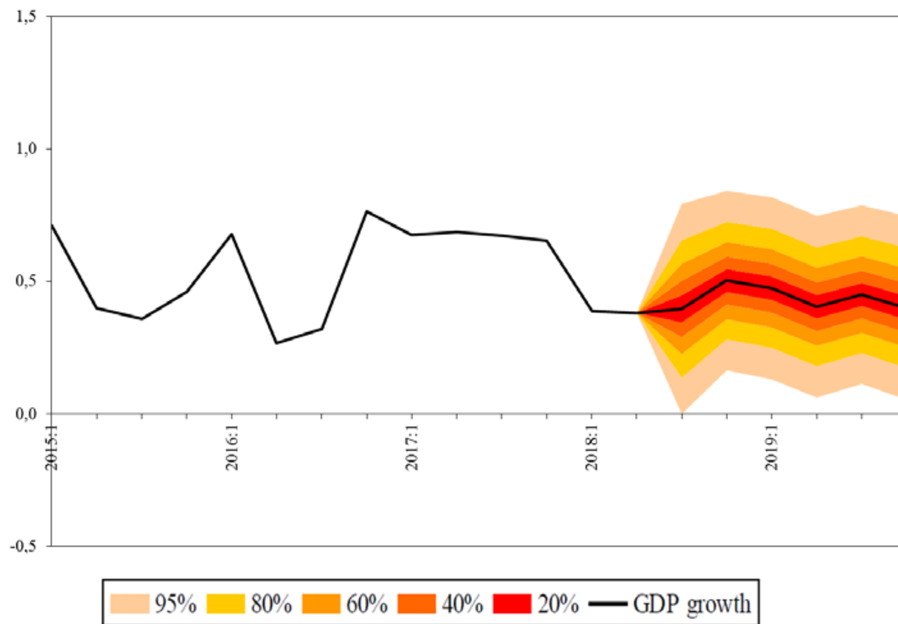
The upswing in the euro area has slowed, but is still alive

In the first half of the current year the euro area economy expanded, with about 0.4% per quarter, at a markedly slower rate than in 2017 (with about 0.65%), though still a bit faster than on average in the past. During 2018, investment and exports recovered in the second quarter from soft patches at the beginning of the year. Firms continue hiring, and employment has been expanding by about 1.5% per annum for 2 ½ years now. The unemployment rate slides; in August it was, with 8.1%, half a percentage point lower than at the beginning of the year, and vacancy rates are at present higher than in 2017. As a consequence, wages rise more quickly: nominal compensations per employee started accelerating early in 2017, and negotiated wages followed at the beginning of 2018. Wage inflation of slightly below 2.5% is still not high but, together with the growth in employment, enough to raise real labor incomes markedly. Other drivers of the current upswing are cheap bank credit and rising property wealth due to mostly sound housing markets.

In addition, fiscal policy will be slightly more expansionary than last year; in 2018 the stimulus mainly comes from Spain and the Netherlands, in 2019 from Germany and Italy.

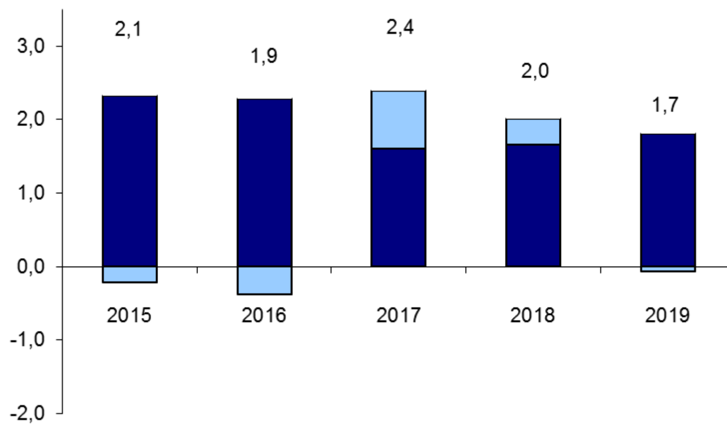
All that being said, managers have good reasons to be less optimistic than at the turn of the year: a slower world trade will dent export growth as well as corporate profits. This will ultimately result in fewer new jobs. Moreover, rising risk premia on Italian assets will probably force banks in this large country to tighten credit conditions offered to firms and households. All in all, we expect GDP growth in the euro area to go down from 2.4% in 2017 to 2.0% in 2018 and to 1.7% in 2019.

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

This forecast, however, is based on the assumption that the two main risk factors will not be realized: firstly we assume that the Brexit talks will not fail and the UK will not exit the EU in an unorderly way in March 2019. Otherwise serious consequences for all economic activities that link Britain with the continent would have to be expected. Sec-

ond, we assume that a crisis of confidence in the solvency of the Italian state can still be avoided, in spite of the new coalition’s fiscal plans that imply the public deficit rising to 2.4% in 2019. Risk premia for Italian government bonds have increased strongly, for the maturity of ten years to about 3.3 percentage points relative to German ones in mid October. Much depends on the question whether rating agencies will continue assigning investment grade to Italian government debt, and whether the Italian government and the European Commission will find a compromise about the Italian draft budget in the coming weeks.

Comparison with alternative forecasts

The forecasts presented above were obtained from the EFN macroeconometric model. Table 2 shows a comparison of the EFN forecasts for the main macroeconomic aggregates with other forecasts, notably those of the European Commission, the IMF, the ECB, the OECD, and Consensus Economics.

The EFN forecast is, like other more recent ones, a bit lower than those of early summer; but we still see quite a strong expansion of investment activities in 2019, since costs of capital stay low and public investment will increase markedly in some member countries. The flip side is that imports will grow faster than exports in 2019 (see Table 2). In addition, exports to economies outside the euro area are losing momentum as protectionist policies take their toll.

Table 2 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	2.0	1.7	2.3	2.0	2.0	1.9	2.0	1.8	2.2	2.1	2.0	1.8
Priv. Consumption	1.5	1.4	1.7	1.7	1.5	1.6	1.5	1.7	1.4	1.5	1.5	1.6
Gov. Consumption	1.1	1.4	1.4	1.3	1.2	1.2	1.4	1.4	1.3	1.3	1.1	1.4
Fixed Capital Form.	2.9	3.7	4.2	3.4	4.1	3.5	4.0	3.2	4.2	4.1	3.4	3.1
Unemployment rate	8.3	7.7	8.4	7.9	8.3	8.0	8.3	7.8	8.3	7.8	8.3	7.8
HICP	1.7	1.7	1.5	1.6	1.7	1.7	1.7	1.7	1.6	1.8	1.7	1.7
IP	1.4	1.0	na	na	na	na	na	na	na	na	1.6	1.7

EU: European Commission, Economic Forecast, May 2018; IMF world economic outlook, October 2018; ECB: Eurosystem staff macroeconomic projections for the euro area, September 2018, OECD: Economic Outlook, May 2018; Consensus: Consensus Economics, consensus mean, October 2018.

*In its interim projections (September 2018) the OECD forecasts euro area GDP growth of 2.0% in 2018 and 1.9% in 2019.

Variables of the world economy

Assumptions concerning the evolution of important variables related to the state of the world economy are shown in Table 3 below. The tax reform stimulates growth in the US, but world trade has lost momentum due to protectionist trade policies. We assume that the recent oil price hike will not be reversed, but that oil prices will rise moderately from their level at the beginning of October. The exchange rates of the dollar and the yen relative to the euro are assumed to be constant from July 2018 onward.

Table 3 Variables of the world economy

	2017	2018	2019
US GDP Growth Rate	2.2	2.9	2.6
US Consumer Price Inflation	2.1	2.5	2.3
US Short Term Interest Rate (December)	1.3	2.3	3.0
US Long Term Interest Rate (December)	2.4	3.2	3.4
Japan GDP Growth Rate	1.7	1.1	1.2
Japan Consumer Price Inflation	0.5	0.9	1.1
Japan Short Term Interest Rate (December)	0.01	0.1	0.1
Japan Long Term Interest Rate (December)	0.05	0.1	0.1
World Trade Growth Rate (CPB)	4.6	3.7	3.6
Oil Price (December)	64	82	84
USD/Euro Exchange Rate (December)	1.18	1.17	1.17
100Yen/Euro Exchange Rate (December)	1.33	1.32	1.32

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 rates: 10-year treasury bills. Japan short term interest rate: 3-month deposits (LIBOR). Japan long term interest rates: 10-year treasury bills.