EFN REPORT

ECONOMIC OUTLOOK FOR THE EURO AREA IN 2019 and 2020

Winter 2018/19

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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Report closed on 20 December 2018

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Highlights

- The cyclical upswing of the world economy comes to an end, since expansionary policies in the US are expected to peter out in 2019, and the protectionist course of the US government clouds the perspectives for world trade.
- However, if a major trade conflict can be avoided, chances are good that world production growth will be close to the long-run average of a bit more than 3%, with trade expanding at a similar pace.
- Slowing exports, in particular to China, can partly explain the setback, while domestic conditions still appear favourable: firms continued hiring, albeit by less than before, tight labour markets in many member countries have caused wages to rise more quickly, and house prices continue to increase markedly.
- Since a trend to higher inflationary dynamics is still not detectable, the ECB is likely to either keep key interest rates unchanged in 2019 or raise them very carefully at the end of the year.
- All in all, we expect the euro area growth rate to come down from 1.9% in 2018 to 1.5% in 2019 and 1.8% in 2020, and inflation to slightly slow down from 1.8% in 2018 to 1.6% in 2019 and 1.5% in 2020.

Table 1 Economic outlook for the Euro area

	2016	2017	2018	2019: 1st half		2019: annual		2020: annual	
				Point Forecast	Interval Forecast	Point Forecast	Interval Forecast	Point Forecast	Interval Forecast
GDP	1.9	2.4	1.9	1.8	0.7 2.7	1.5	0.7 2.4	1.8	0.9 2.7
Potential Output	1.6	1.8	2.0	1.7	1.1 2.3	1.8	1.3 2.3	1.7	1.1 2.2
Private Consumption	2.0	1.6	1.3	1.7	0.7 2.6	1.4	0.6 2.2	1.6	0.7 2.5
Government Consumption	1.8	1.2	1.0	1.6	1.0 2.2	1.5	1.0 2.0	1.6	1.0 2.2
Fixed Capital Formation	4.0	2.6	3.1	3.4	-1.0 6.8	3.3	0.3 6.4	2.7	-1.4 5.8
Exports	3.0	5.2	2.8	4.3	2.3 6.3	3.6	2.0 5.3	4.0	2.0 5.9
Imports	4.2	3.9	2.4	4.7	2.1 7.3	4.0	1.9 6.2	4.5	1.2 6.9
Unemployment Rate	10.0	9.1	8.2	7.8	7.1 8.5	7.9	7.3 8.4	7.4	6.4 8.5
Labour Cost Index	1.3	2.2	2.5	2.8	2.3 3.3	2.8	2.4 3.2	2.5	1.9 3.1
Labour Productivity	0.5	0.9	0.5	1.0	0.0 1.8	0.7	0.0 1.4	1.0	0.2 1.8
HICP	0.2	1.5	1.8	1.6	0.8 2.4	1.6	0.8 2.4	1.5	0.7 2.4
Industrial Production	1.6	3.0	1.5	1.0	-1.1 3.0	0.8	-1.0 2.5	0.8	-1.1 2.6

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 2019 and 2020

The cyclical upswing of the world economy comes to an end

At the end of the year 2018, many indicators point to a slowdown of the international economy. Purchasing manager indices as well as the OECD leading indicators have been declining since the beginning of 2018 and are now at long-term average levels. Stock market valuations in Europe and Asia have also been declining for much of the year, and since October stock prices in the US have been down as well. Managers and participants at financial market have turned cautious because expansionary policies in the US are expected to peter out in 2019, and because the protectionist course of the US government clouds the perspectives for world trade. In addition, capacity constraints in some sectors, notably construction, cause expanding demand in the US, Britain, and Germany now tends to raise mainly prices instead of real output.

Regarding "hard" data on production, not all news have been disappointing recently: while world industrial production has been losing steam since summer, data on world trade were less conclusive. In the third quarter, US production continued to expand strongly, and activity in China slowed only slightly. Expansion in the euro area, however, was slow, and in Japan, mainly due to the effects of natural disasters, it even declined.

All these short-term moves of production had little impact on wage and price movements. Wage growth has been moderately risen during the year, in the US as well as in the euro area and in Japan, but consumer price inflation is basically flat, if the impact of energy prices is filtered out: at about 2% in the US, a bit more than 1% in the euro area, and about 0.3% in Japan. Headline inflation rates have been markedly higher recently, but will come down as oil prices have fallen, since October from 85 US-Dollars (Brent) to 60 US-Dollars in mid-December. This fall is partly caused by more cautious expectations for energy demand in the coming years; in addition, US sanctions on Iranian oil exports now appear less strict than expected.

No change can be detected regarding the policy of the US government on trade: although the US, Mexico and Canada agreed on a free trade agreement succeeding NAFTA in September, and the US made a standstill agreement for three months with China in November, this conflict and that with the EU might soon escalate again. The threat of massive US tariffs to the Chinese export industry has weakened the Renminbi by about 7% relative to the US-Dollar since early 2018. A striking domestic indicator for a coming slowdown in China is the decreasing rate of money growth (in particular M1). The government appears to react by steering a slightly more expansionary course. In the advanced economies, however, policy will be less expansionary than in 2018.

This is particularly true for the US: the tax reform stimulated the economy in 2018 much more than it will do so in 2019.

As to monetary policy, the federal funds target rate is, with 2.25-2.5% at the beginning of 2019, markedly (by ¾ percentage points) higher than a year ago. In late summer the strong rise in American interest rates had caused bond yields to hike and currencies to devalue in quite a few emerging markets countries, and although financial markets have calmed down since then, financial conditions in emerging markets are now clearly less favourable than before last summer.

Overall, the odds are high that the upswing of the international economy will end in 2019. However, if a major trade conflict can be avoided, chances are good that world production growth will be close to the long-run average of a bit more than 3%, with trade expanding at a similar pace.

Slowdown in the euro area

In the third quarter of 2018 the euro area production expanded by only 0.16%, the lowest quarterly rate for more than five years. Problems in the automotive industry explain the loss of about 0.1 percentage points: many vehicle types could not be sold because they were not certified according to the new emission test method. Although many cars were put to inventories (with the change in inventories contributing about 0.3 percent to the GDP growth rate), parts of the production had to be stalled. Aside from this specific effect, weakness of demand was wide spread: private consumption and investment expanded about as slowly as overall production, and exports even declined a bit. From a regional perspective, while holding up well in France and Spain, production shrank in Germany, where the automotive industry is a particularly important part of the economy, and also in Italy.

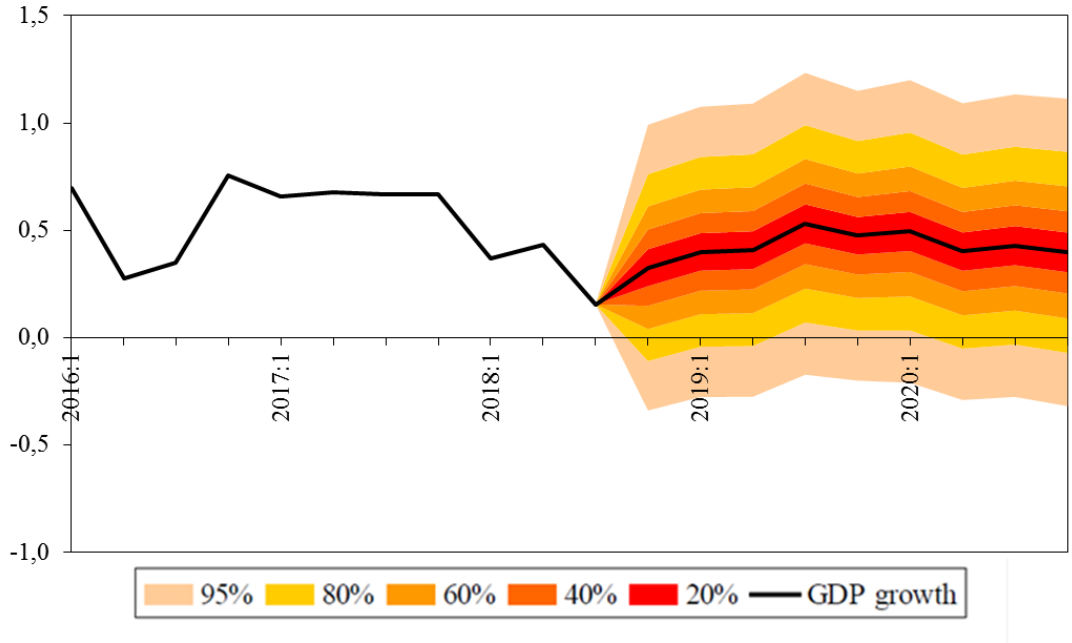
Slowing exports, in particular to China, can partly explain the setback, while domestic conditions still appear favourable: confidence, according to the European Commission's indicator, though declining since the beginning of the year, is still clearly above the long-term average, for private households as well as for firms. Hours worked have continued to expand in the third quarter (by an annualized rate of 1.9%), and firms continued hiring, albeit by less than before. Unemployment, however, has stopped falling, and the vacancy rate is no longer rising. Still, tight labour markets in many member countries have caused wages to rise more quickly, with an annual rate of about 2.5%, and real labour incomes continue to rise. House prices continue to increase

markedly (by more than 4% annually on average). Thus, important conditions for a healthy growth in private consumption and construction of dwellings are in place. Financial conditions also look still favourable, though a bit less so than at the beginning of the year: bond yields have significantly increased not only for the Italian state, but also for private debtors, in particular those with lower ratings. Interest rates for credit to nonfinancial corporations are slightly higher than at the beginning of the year, but they are still very low relative to the long-run average. Since a trend to higher inflationary dynamics is still not detectable, it seems probable that the ECB will either keep key interest rates unchanged in 2019 or raise them very carefully at the end of the year. Fiscal policies will become expansionary: this is quite certain for Germany and Italy, and it is probable for France, because at the end of the year the French government reacted to social protests by promising to increase social spending.

Overall, if foreign demand does not weaken markedly, domestic conditions should be favourable enough to prevent the third quarter slowdown to continue during winter and beyond. The upswing of the euro area economy, however, is over, since the trade conflicts dent export growth as well as corporate profits. This will ultimately result in fewer new jobs. We expect GDP growth in the euro area to go down from 1.9% in 2018 to 1.5% in 2019 and 1.8% in 2020, thanks to an improvement of internal demand.

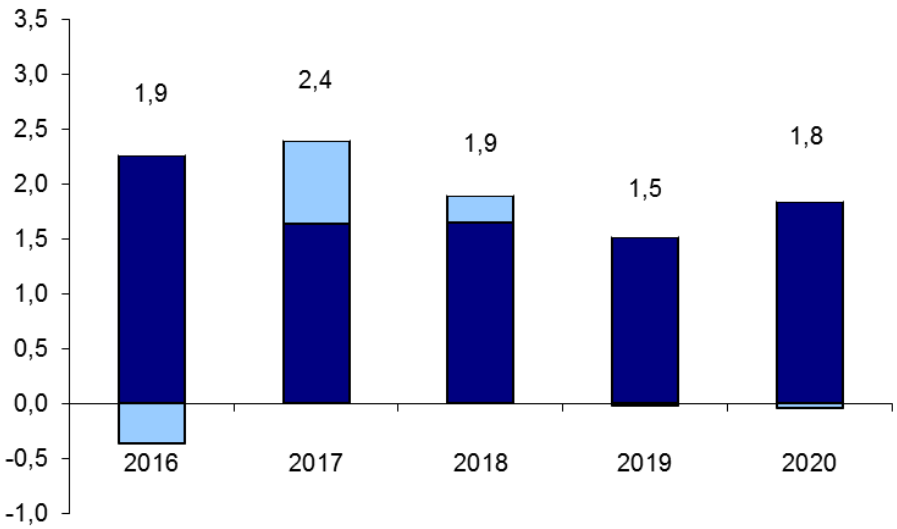
This forecast is based on the assumption that the two main risk factors for the European economies will not be realized: firstly, we assume that the UK will not exit the EU in an unorderly way in March. Second, we assume that a crisis of confidence in the solvency of the Italian state can be avoided. Recent developments have made this assumption look a bit more realistic: while long-term yields had risen to about 3.5% in October, in December they have come down to 3% after the government communicated some willingness to reach an agreement with the Commission.

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 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 relatively cautious for 2019, in particular for private consumption, since the decline in unemployment, an important driver of consumption has slowed markedly. We are, however, quite optimistic concerning gross fixed capital formation. This result is mainly driven by our assessment that capital costs, albeit rising a bit, still stay at low levels.

Table 2: Comparison of EFN forecasts with alternative forecasts

	EFN		EU		IMF		ECB		OECD		Consensus	
	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020
GDP	1.5	1.8	1.9	1.7	1.9	na	1.7	1.7	1.8	1.6	1.6	na
Priv. Consumption	1.4	1.6	1.8	1.6	1.6	na	1.7	1.6	1.6	1.5	1.4	na
Gov. Consumption	1.5	1.6	1.6	1.3	1.2	na	1.6	1.4	1.5	1.1	1.4	na
Fixed Capital Form.	3.3	2.7	3.0	3.0	3.5	na	3.3	2.6	3.1	2.8	2.7	na
Unemployment rate	7.9	7.4	7.9	7.5	8.0	na	7.8	7.5	7.6	7.2	7.8	na
HICP	1.6	1.5	1.8	1.6	1.7	na	1.6	1.7	1.9	1.9	1.6	na

EU: European Commission, Economic Forecast, November 2018; IMF: World Economic Outlook, October 2018, ECB: December 2018 staff macroeconomic projections. OECD: Economic Outlook, November 2018; Consensus: Consensus Economics, Consensus Forecasts, December 2018

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 cyclical upswing in the US, according to this forecast, is ending in 2019, while short and long term interest rates, in line with the Fed target rate, still go up by half a percentage point. We assume that trade conflicts will cause world trade, with rates of about 3.4% in the coming two years, grow by less than on average since the beginning of the century (3.6%). The oil price, after its jump in December, is assumed to rise only slowly in 2018 and 2019. This forecast keeps the exchange rates of the dollar and the yen relative to the euro constant from December 2018 onward.

Table 3: Variables of the world economy

	2018	2019	2020
US GDP Growth Rate	2.9	2.6	2.1
US Consumer Price Inflation	2.4	2.1	2.4
US Short Term Interest Rate (December)	2.3	2.9	2.9
US Long Term Interest Rate (December)	3.1	3.5	3.5
Japan GDP Growth Rate	0.9	1.1	0.7
Japan Consumer Price Inflation	1.0	0.9	1.9
Japan Short Term Interest Rate (December)	0.0	0.0	0.2
Japan Long Term Interest Rate (December)	0.1	0.2	0.3
World Trade Growth Rate (CPB)	3.5	3.4	3.3
Oil Price (December)	62	64	66
USD/Euro Exchange Rate (December)	1.14	1.14	1.14
100Yen/Euro Exchange Rate (December)	1.29	1.29	1.29

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.