Macroeconomic Conditions and Outlook

1.1 INTRODUCTION

Following the cyclical peak in 2017 and the associated increase in capacity utilisation, the global economic momentum slowed noticeably last year. As a result of persistently high debt levels, only partially resolved structural problems since the Great Recession and great political uncertainties, the expansion of the physical capital stock was relatively small and bottlenecks in production started to appear. The global economy has entered a cyclical cooling phase. In addition, the economy in some emerging markets is being adversely affected by capital outflows in the face of more restrictive monetary policy by the US Federal Reserve.

Global economic momentum will continue to level off this year. While the US economy is currently still benefiting from fiscal stimuli, the euro area and important Asian economies have already entered a cooling phase. In the United States, the high economic momentum seen last year should subside to normal levels in 2019. Whereas the strong impetus provided by tax cuts and additional government spending will abate, private consumption will continue to benefit from the favourable labour market situation and real wage increases. Economic momentum is also weakening in China, despite looser monetary policy and fewer measures to tackle financial and debt risks. In Europe, the high utilisation of macroeconomic capacities in important parts of the economy does not allow for major economic leaps. On the contrary, political developments such as the trade tensions with the United States, the possibility of a hard Brexit and simmering financial market risks in Italy are increasingly putting pressure on companies' propensity to invest. Economic growth in many emerging markets will be dampened by liquidity outflows and currency devaluations. As a result, foreign trade in the current year will give weaker impulses to the European economy.

At present it is still unclear whether the global economy will experience a significant downturn or a gradual deceleration this year. To date, signs of a relatively soft landing with locally limited turbulence predominate. However, the risk of a rapid downturn has recently increased. Overall, we forecast an increase in world production of 3.2 percent in 2018 and 3.0 percent in 2019.

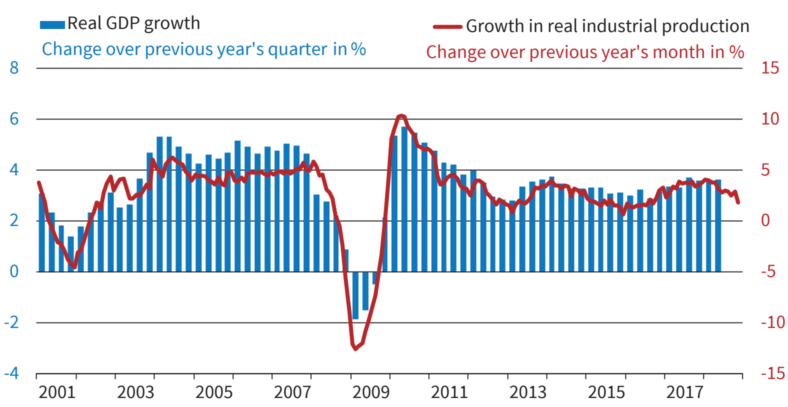
Within Europe, the slowdown was, and will continue to be particularly pronounced in the big four economies: namely Germany, the United Kingdom, France and Italy. Each of these countries faces specific challenges that are burdening their economic climate. While the United Kingdom is nervously preparing for Brexit, both Italy and France need structural reforms that are not considered necessary by either their governments or electorates. As an exporting nation, Germany is facing a slowdown in world trade and fears the consequences of the ongoing trade war.

1.2 CURRENT SITUATION

1.2.1 Global Economy

After a strong 2017, the global economy recorded weaker growth last year and industrial production in particular expanded more slowly (see Figure 1.1). Whereas industrial production in emerging and developing countries picked up again during the second half of last year, it almost stagnated in the advanced economies (see Figure 1.2). Despite the slowdown in industrial production, the global economy as a whole (and particularly in services) was still considered to be in an upswing. Overall capacity utilisation continued to rise in most countries.

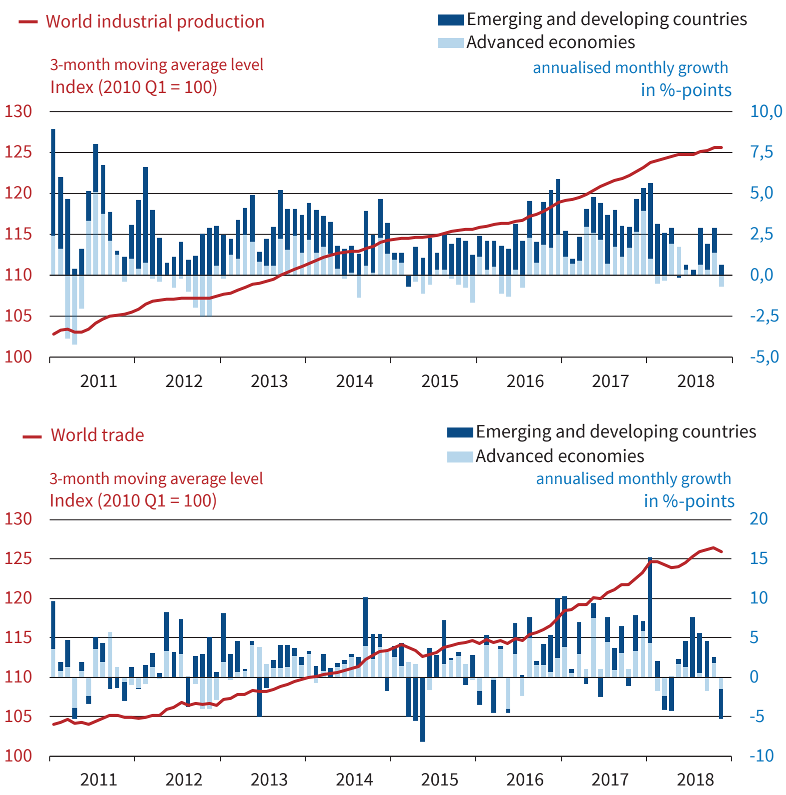
Figure 1.1
World Economic Growth[a] and Growth in Industrial Production



[a] Purchasing Power Parity (PPP) weighted aggregate year-over-year real GDP growth rate.
Source: IMF International Financial Statistics; CPB Netherlands Bureau for Economic Policy Analysis; last accessed on 3 February 2019.
© CESifo

EEAG (2019), "Macroeconomic Conditions and Outlook", *EEAG Report on the European Economy,* CESifo, Munich, pp. 10–37.

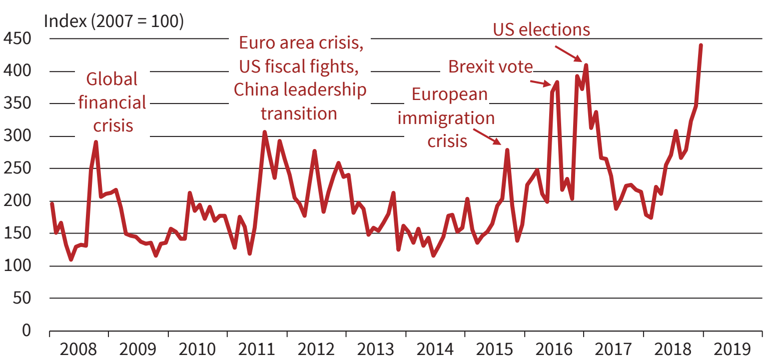
Figure 1.2
Regional Contributions to Industrial Production and World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis; last accessed on 3 February 2019; EEAG calculations.

World trade failed to keep up the pace set in 2017 last year too. This may already reflect a deterioration in the trade policy environment. Over the course of 2018, the US government took a number of protectionist measures. Customs duties were increased for a wide range of goods and import quotas were introduced. As a reaction to US measures, China, the European Union and some other countries imposed retaliatory tariffs on US products. However, the new trade barriers alone cannot fully explain the weak dynamics of world trade. Trade declined sharply at the beginning of 2018, while the aforementioned trade policy measures essentially did not came into force until summer. Moreover, the tariff increases by the United States since the beginning of 2018, and the resulting counter-tariffs levied by its trading partners include, at the current stage, goods worth around 450 billion US dollars, which still accounts for a relatively small 2.5 percent share of the total world trade volume. Finally, since the beginning of the trade conflict, the currencies of the economies affected by the US tariffs have mostly depreciated quite sharply against the US dollar. This depreciation, which is largely related to the continued tightening of US monetary policy and the weaker global economic outlook, counteracts the loss of price competitiveness associated with the tariff increase. Overall, the economic impact of the trade conflict has therefore been estimated to be low to date (see European Commission 2018, OECD 2018, Joint Economic Forecast 2018). This is also supported by the fact that trading activity in emerging Asia, which accounts for almost 70 percent of emerging market trade, remained buoyant during most of the year (see Figure 1.2). On the other hand, at the end of last year we have seen a clear decline in world trade and throughout 2018 there has been hardly any growth in trade activity in the advanced economies. The latter is largely due to a slowdown in intra-European cross-border trade. In addition to the weakening economic activity in some member states of the European Union, this slowdown is also related to temporary production disruptions in the German automotive industry.

Figure 1.3
Global Economic Policy Uncertainty Index



Global Economic Policy Uncertainty (EPU) is calculated as the GDP-weighted average of monthly EPU index values for the United States, Canada, Brazil, Chile, the United Kingdom, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland and Australia using GDP data in current prices from the IMF World Economic Outlook Database.

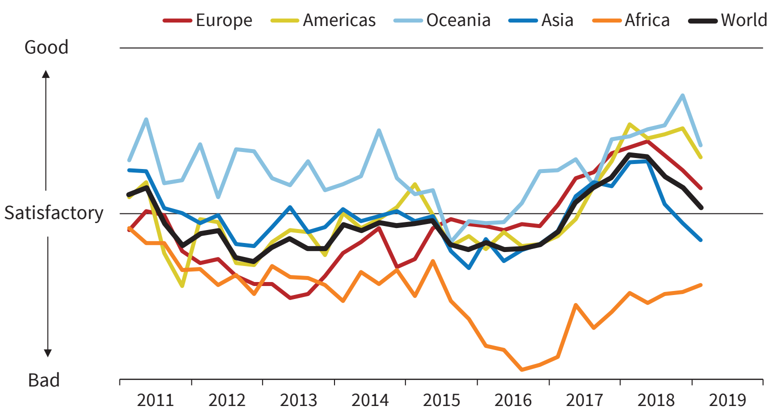
Source: Baker et al. (2016), www.policyuncertainty.com; last accessed on 3 February 2019.

Although the direct impact of the global trade dispute has probably been quite low, it is one of the reasons why overall levels of economic policy uncertainty have been rising throughout the year and reached a new all-time high at the end of last year (see Figure 1.3). The associated uncertainties are slowing business investment, in terms of setting up or expanding export structures, for example. Other reasons for increased uncertainty, especially in Europe, include, for example, the increased likelihood of a so-called ‘hard Brexit’, uncertainty regarding the budgetary course of the Italian government that took office in May last year, and the riots in France. Another reason for higher uncertainty is that investors are increasingly worrying about the sustainability of high stock market valuations given a weaker global economic outlook and less expansionary monetary policies. In fact, stock prices have already substantially declined over the past year with negative feedback effects on the real economy.

Against this background, the assessment of the world economic situation by experts has deteriorated particularly during the second half of last year (see Figure 1.4). Nevertheless, the overall sentiment is still positive. The decline is particularly driven by the assessments in Asia and Europe. Only Oceania did until recently buck the trend; it saw a clear improvement in the assessment of the economic situation during 2018. In particular Africa, but to quite some extent also the Americas stabilised at levels prevailing at the beginning of 2018. While this implies a clear booming economy in the Americas, the African economy remained subdued.

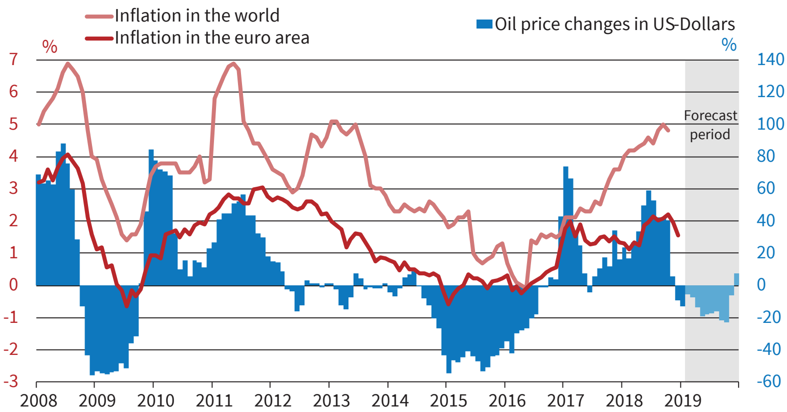
Inflation rates rose worldwide in the summer half of the year. This price surge can primarily be attributed to both the sharp rise in crude oil prices between July 2017 and September 2018 and to GDP surpassing its potential in the advanced economies (see Figu-

Figure 1.4
ifo World Economic Survey
Economic Situation



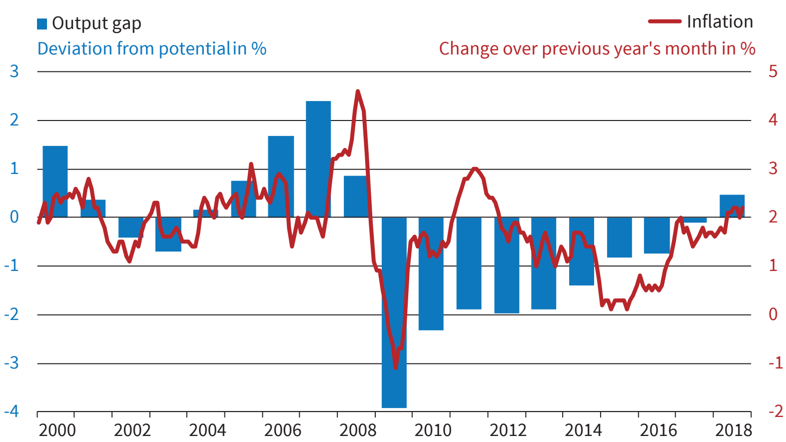
Source: ifo World Economic Survey I/2019. © CESifo

Figure 1.5
Inflation in the World and Oil Price Movements
Change over previous year's month in %



Forecast based on the assumption that oil prices remain steady from January 2018 onwards.
Source: IMF International Financial Statistics; last accessed on 3 February 2019; EEAG calculations. © CESifo

Figure 1.6
Output Gap and Inflation in Advanced Economies

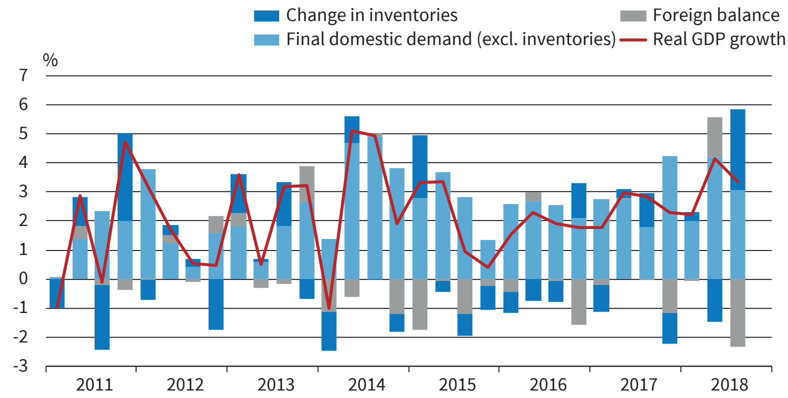


Source: IMF World Economic Outlook, IMF International Financial Statistics; last accessed on 3 February 2019. © CESifo res 1.5 and 1.6). The surge in oil prices has been partly the result of the strong global economy in 2017 (see Grimme and Güntner, 2018 and Groen and McQuillan, 2018). But supply effects have also played a role: the sanctions against Iran related to the termination of the nuclear agreement in May last year resulted in significantly less Iranian crude oil entering the world market. In addition, oil supply from Venezuela and Mexico has also declined. These are additional reasons why the price of oil rose sharply into autumn 2018. The cooling down of the global economy and the lower-than-feared reduction in oil supply subsequently caused substantial fall in crude oil prices.

Figure 1.7

Contributions to GDP Growth[a] in the United States

Seasonally adjusted data



[a] Annualised quarterly growth.

Source: US Bureau of Economic Analysis, last accessed on 3 February 2019; EEAG calculations.

Core inflation rates, which measure consumer price inflation excluding energy and food components, remained unchanged at around 1.5 percent in the advanced economies. These rates, however, reflect different developments. The core inflation rate in the United States has now risen to just under 2 percent, reflecting the wage pressure associated with strong employment growth. In the United Kingdom, the rate has been moving moderately below the 2 percent target of the British central bank for several months now, after higher price increases last year due to the strong depreciation of the British pound. In the euro area, core inflation remains at around 1 percent, and in Japan it is even below 0.5 percent. In the emerging markets, both core and actual inflation accelerated over the summer. The main reason for this, however, is the sharp rise in the Turkish inflation rates, which was accompanied by a sharp depreciation of the Turkish lira. The strong rise in energy prices from mid-2017 until autumn last year pushed headline inflation rates up to 2.1 percent and 2.5 percent in the industrialised and the newly industrialised countries last year respectively (see Table 1.A.1).

1.2.2 United States

In the United States, strong fiscal impulses generated a boost in economic activity, particularly during the summer half of 2018 (see Figure 1.7). The tax breaks introduced stimulated private consumption and investment. Private consumption spending also caught up strongly after a weak start in 2018 (see Figure 1.8). Gross fixed capital formation, and in particular non-residential investment, which built on the strong momentum of previous quarters, made a large contribution. While residential construction investments more or less stagnated, investments in infrastructure projects that were neglected for a long time, such as roads, energy and water supply, have increased again recently. The reallocation of resources within the public sector leads to stagnating expenditure for public goods such as education, health care and social security.

Over the course of the year, the contribution of foreign trade to overall growth was negative. Although the US dollar appreciated significantly against the currencies of its major trading partners, exports increased significantly. However, the increase was even more pronounced for imports. As a result, the trade balance continued to deteriorate. The strong economy, resulting in an annual GDP growth rate of 2.9 percent in 2018, is increasingly reaching its capacity limits.

On the labour market, a record low unemployment rate of 3.8 percent on average in 2018 and a sharp rise in job vacancies since the beginning of 2018 have led to a gradual acceleration in nominal wage growth. This gave further impetus to the already dynamic rise in prices. The core deflator of private consumer spending, the US Federal Reserve's preferred measure of inflation, peaked at 2.4 percent last summer, before gradually slowing to slightly below the target of 2 percent by the end of last year. Due to the rise in oil prices last year, the increase in consumer prices last summer was even as high as 2.9 percent. This resulted in an average inflation rate of 2.4 percent for 2018.

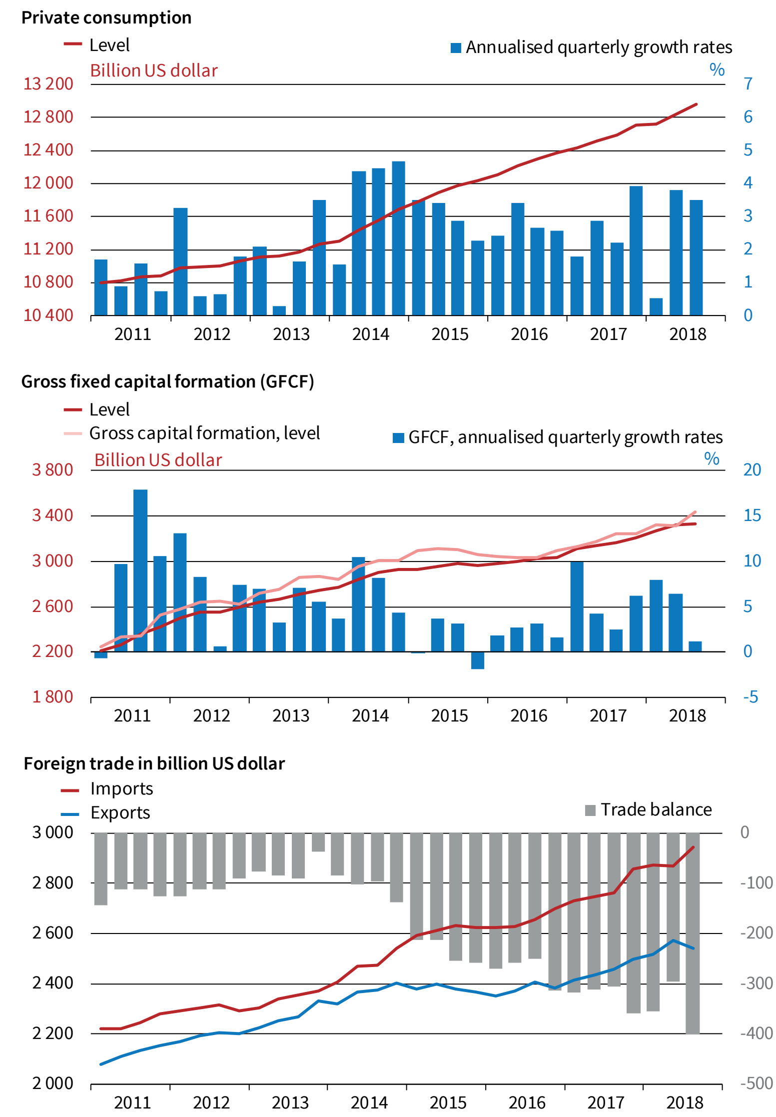
Meanwhile, the strong increase in employment has continued, whereas the labour force participation rate has continued to increase only marginally (see Figure 1.9). The unemployment rate, long-term unemployment and the so-called involuntary part-time employment continued to decline.

1.2.3 Asia

In *China*, the gradual cooling of the economy has continued into this winter. Concerns about the effects

Figure 1.8

Business Cycle Developments in the United States
In constant prices, seasonally adjusted and work-day adjusted

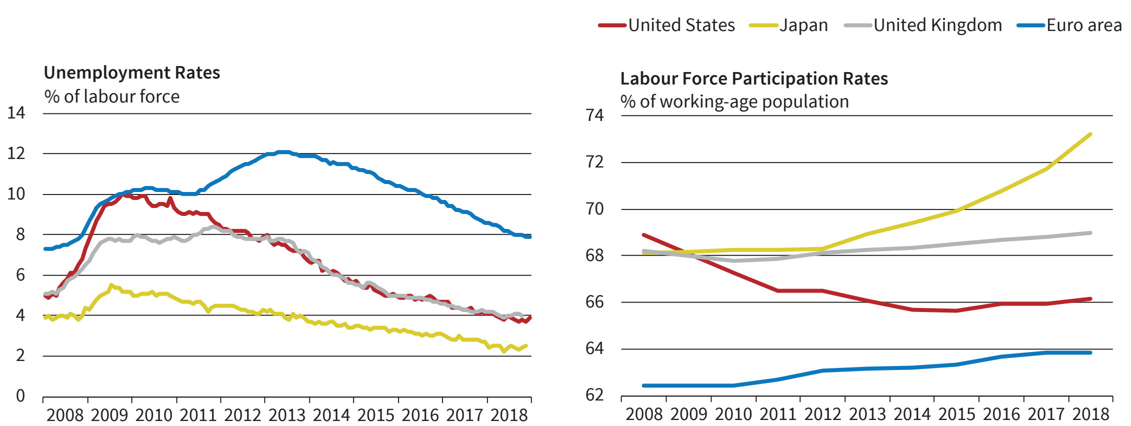


Source: US Bureau of Economic Analysis; last accessed on 3 February 2019. © CESifo

of the trade conflict with the United States on the export economy were prominent last year. Share prices have fallen throughout the year, and the mood among companies and consumers has deteriorated. Chinese economic policy intends to counteract this development. While the focus until spring 2018 was on curbing excessive credit growth, e.g., through tighter credit regulations, the financial system has since seen an increased liquidity supply. For example, the reserve retention rates were reduced in October for the third time in 2018. Fiscal counter-impulses are also increasingly being provided. Various taxes have been reduced, tax allowances increased and depreciation allowances extended. Further tax relief is planned for this year. In addition, Chinese policy has relieved domestic companies by lowering import duties and increasing value added tax (VAT) refunds for companies with high import content as a reaction to the US tariff measures. The depreciation of the yuan in summer has also partially offset the introduced US tariff increases. In addition, at least some Chinese companies are likely to react to the duty increases by circumventing duties. Overall,

Figure 1.9

Unemployment Rates and Labour Force Participation Rates



Source: OECD Main Economic Indicators; OECD Economic Outlook; last accessed 3 February 2019. © CESifo the Chinese economy is expected to have expanded by 6.6 percent last year. Inflation turned out to be 2.1 percent last year.

The *Japanese* economy is suffering from the slowdown in China and the world economy in general. After a relatively high growth rate of 1.7 percent in 2017, last year's growth is projected to have fallen to 0.8 percent, whereby declining economic activity was reported in the first and third quarters. The strongest negative impulses came from both private residential and public investments. Employment has been rising strongly for some time and the unemployment rate has now fallen to a level last seen in the early 1990s. The strong labour market situation, combined with structural changes such as a better integration of women into the labour market and albeit moderately increasing immigration, has caused labour force participation rates in Japan to increase to unprecedented high levels. Despite the apparently high level of capacity utilisation in the economy as a whole, core inflation remained with levels of about 0.3 percent low. In particular, oil price developments managed to push the average overall inflation rate up to 1 percent last year.

After a weak 2017, the structural reforms implemented in *India*, like the introduction of a nationwide Goods and Service Tax system, an inflation-targeting framework, the Insolvency and Bankruptcy Code, and steps to liberalise foreign investment and make it easier to do business, and helped to push growth upward in 2018. These structural reforms strengthened both investment and private consumption. Furthermore, the increase in GDP growth from 6.2 percent in 2017 to an expected 7.6 percent last year reflects a rebound from transitory shocks, like the cash reform and massive monsoon rains in some regions. Both headline and core inflation have risen to levels of 4 percent as a result of a narrowing output gap and pass-through effects from higher energy prices and exchange rate depreciation.

GDP growth in the remaining East and Southeast Asian economies (Hong Kong, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore and Thailand) continued to register strong growth. The business cycles in most of these countries, however, have surpassed their peaks and growth rates tended to decrease over the course of last year. In particular, the cooling down of the global economy, and especially China, is weighing on these countries.

1.2.4 Latin America and Russia

The economic situation in Latin America (Brazil, Mexico, Argentina, Venezuela, Colombia, and Chile) has deteriorated during the course of 2018, partly as a result of the withdrawal of international financial investors. Brazil, Argentina and, above all, Venezuela were particularly affected due to country-specific problems. A nationwide truckers' strike disrupted production in Brazil. This temporary set-back, however, did not stop the overall economic recovery. In Argentina, a strong drought slashed the harvests of soybeans and corn, which are major export goods. Doubts on the government's ability to control the already high level of inflation triggered foreign investors to withdraw further from the country. The Argentinian currency depreciated sharply and, as a result, inflation rose even further, despite interest hikes by the central bank. All this led to a sharp contraction of real economic activity as of spring 2018. To prevent a stronger currency and economic crisis, Argentina applied for an exceptional access Stand-By Arrangement at the IMF. This was approved in June and implies access to 57 billion US dollars during three years. Driven by plummeting oil production, hyperinflation, and social instability, Venezuela's economy continued to decline for the fifth consecutive year.

Mexico, Colombia and Chile were significantly less affected by tighter financial conditions. In Mexico, the picture even brightened as the uncertainties surrounding US trade policy have been reduced by the signature of the trilateral USMCA free trade agreement; and the country could continue to benefit from the buoyant US economy. Slumping commodity prices and the slowdown in the world economy pushed growth in Colombia and Chile down a gear in 2018.

In Russia, GDP rose by 1.6 percent in 2018. Improving consumer demand, lower inflation and looser monetary policy together with improved oil prices, and the associated increase in export earnings, laid the foundation for this growth. Investments also accelerated in the first half of the year. Since summer, inflation has been picking up again, triggering two interest rate hikes by the Russian central bank to date. At the same time, growth rates have started to decline. Falling oil prices and a VAT increase by 2 percentage points in January are exerting downward pressure on the economy once again.

1.2.5 European Economy

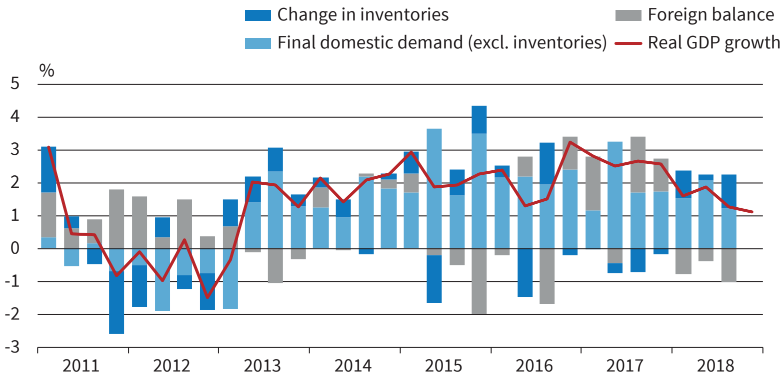
Cyclical Situation

After five consecutive quarters of annualised GDP growth rates well above 2 percent, the European economy shifted down a gear at the beginning of 2018. Annualised growth rates stayed below 2 percent, but still around, and even above potential during the first half of 2018. The European economy suffered a further setback in the second half of the year (see Figure 1.10). The weak growth in the third quarter is mainly attributable to special effects in German automobile production. The new Worldwide Harmonized Light Vehicles Test Procedure (WLTP) has been in force in the European Union since September. As many vehicle types had no certification as of the reporting date, inventories were drastically increased and production was even temporarily interrupted.

Figure 1.10

Contributions to GDP Growth[a] in the European Union

In constant prices, seasonally adjusted and work-day adjusted



[a] Annualised quarterly growth. The investment and imports data for the 2nd quarter of 2015 are corrected for a 22 billion euro purchase of intellectual property from abroad by a subsidiary of a large international company resident in the Netherlands (see Statistics Netherlands, 2018).

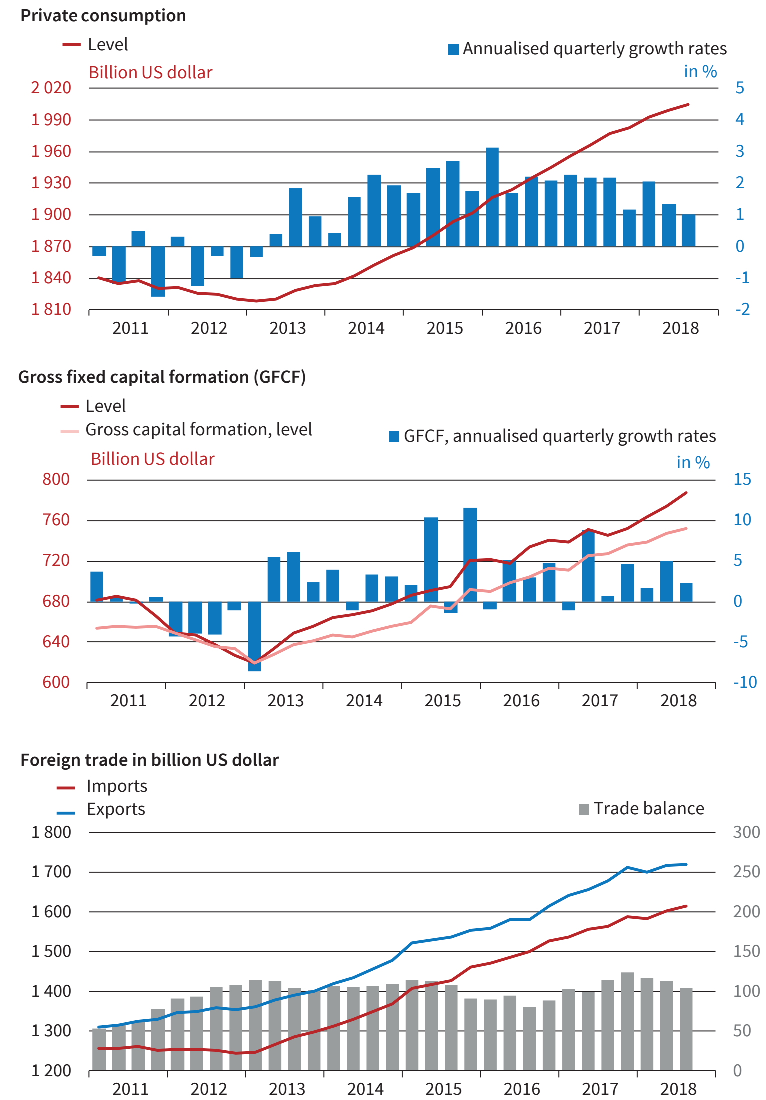
Source: Eurostat; last accessed on 3 February 2019; EEAG calculations.

© CESifo

Figure 1.11

Business Cycle Developments in the European Union

In constant prices, seasonally adjusted and work-day adjusted



[a] The investment and imports data for the 2nd quarter of 2015 are corrected for a 22 billion euro purchase of intellectual property from abroad by a subsidiary of a large international company resident in the Netherlands (see Statistics Netherlands, 2018).

Source: Eurostat, last accessed on 3 February 2019.

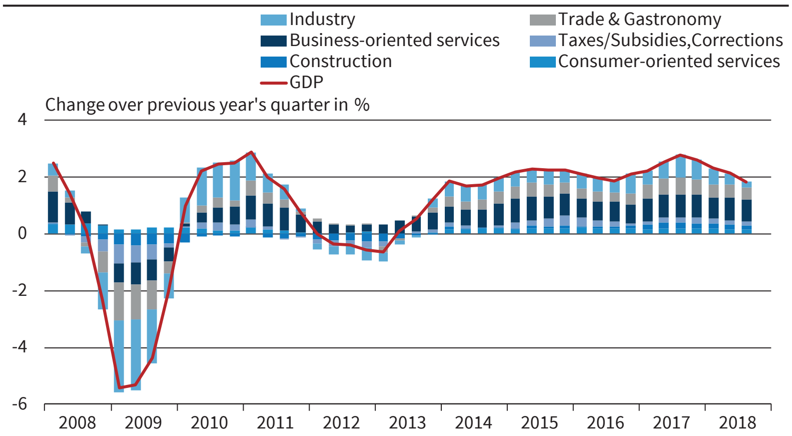
© CESifo

Although both private consumption and investment levelled off, both still continued to support overall growth (see Figure 1.11). Assessments of order backlogs and incoming orders by firms, particularly in the export sector, have deteriorated since the beginning of the year. The ongoing discussion about the introduction of tariffs on certain European export goods and about the EU's future economic relation with the United Kingdom is likely to have weighed on the mood of companies in the euro area and increased uncertainty. In addition to the aforementioned special effects in the German automotive sector, all this probably contributed to a weaker increase in investments and a flattening of exports. The latter may also be due to the global slowdown. This particularly dampened foreign trade on balance. This means that the boom phase supported by exports, which the euro area was experiencing especially in 2017, has come to an end for the time being.

The flattening of exports also implies that the demand for industrial goods has weakened. This is not only supported by the strong expansion of inventories since the beginning of the year, but a look at the production side of the system of national account reveals that the weakening of the European economy is indeed largely driven by the lowering of the growth contribution of the industry sector (see Figure 1.12). From a business cycle perspective this is not unusual: industry is the sector that delivers the most volatile contribution to overall growth and is generally considered to be the driver of the business cycle, both during up- and downturns.

As the economy weakened, the decline in the unemployment rate in the European

Figure 1.12
Sector Contributions to GDP Growth[a] in the European Union



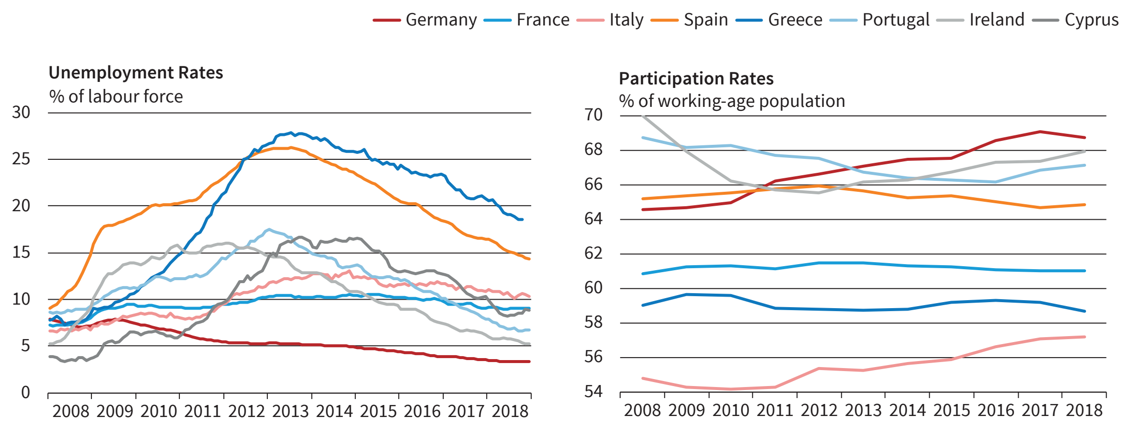
[a] Gross domestic product at market prices (prices of the previous year). Annual percentage change and growth contributions. Sectors are sorted by the volatility in their growth contributions.
Source: OECD, last accessed on 3 February 2019; EEAG calculations.

Union started to flatten out, reaching the lowest level registered this century at 6.7 percent in November 2018. Although differences across member states are diminishing, but they are still large (see Figure 1.13). In Spain, 14.7 percent of the employment force was registered as unemployed in November, while the rates in Germany (3.3 percent) and the Netherlands (3.5 percent) were much lower. As one of the few exceptions, the unemployment rate in Italy started to rise again and reached 10.5 percent in November. Differences in unemployment rates are not only large, participation rates also vary substantially across member states. Although there has been a slight tendency for participation rates to rise in recent years, the across-country variation has thereby hardly fallen. Italy remains a country with a relatively low participation rate; while the opposite is the case for Germany.

During the first half of 2018 in particular, employment levels in the European Union as a whole increased substantially at an annualised growth rate of 1.7 percent. In the euro area employment developments were very similar (1.6 percent). Employment growth appears to have abated somewhat during the second half of the year, although the underlying trend still appears to be positive.

During the upswing that Europe has been experiencing since 2014, the additional job positions were largely created in the business-oriented services sector. The employment growth rate in this part of the economy has been about twice as high as the overall level. Whereas employment growth rates have all been around 6 percent for construction, wholesale trade, retail trade and gastronomy as well as other consumer-oriented services, in net terms hardly any new positions have been created in the industry sector (see right hand side of Figure 1.14). Nevertheless, cumulative production growth in industry has been strong during the same period. Growth in industry has been achieved through higher labour productivity (see lower part of Figure 1.14). On the other hand, labour productivity in the producer- and consumer-oriented services have basically stagnated for at least 10 years now. Given the increased weight of these sectors in the overall economy, the frequently discussed slower growth of productivity ('secular stagnation debate') can partly be explained this way, i.e. in the European case the question needs to be answered as to why these service sectors have hardly reported any productivity gains since the Great Financial Crisis. Whether this is a measurement problem, or whether it is simply difficult to achieve (further) productivity gains in these sectors remains an open question.

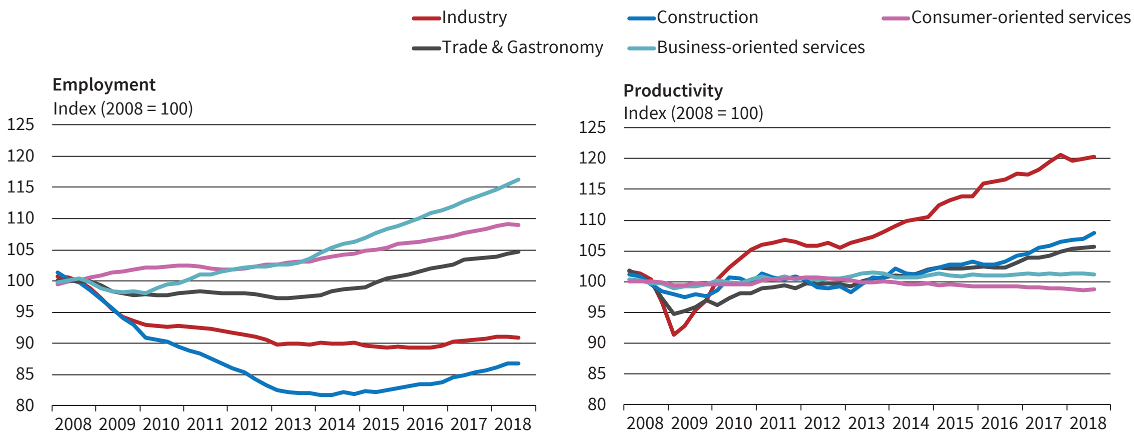
Figure 1.13
Unemployment Rates and Participation Rates in Selected Euro Area Countries



Source: Eurostat; OECD Economic Outlook; last accessed 3 February 2019.

Figure 1.14

Employment and Productivity Developments of Sectors in the European Union



Source: OECD, last accessed 3 February 2019; EEAG calculations.

© CESifo

Even though capacity utilisation has not increased further during the year, it stands well-above normal. Supply-side bottlenecks continue to play a role in many industries. According to European Commission surveys, manufacturing companies are still reporting production constraints due to a shortage of skilled labour and technical capacity. These production constraints are particularly pronounced in Germany, the Netherlands and France.

Although unemployment is still worryingly high in some countries, the general shortage in the European labour market is increasingly reflected in wages. Unit labour costs started to grow more dynamically last year (see Figure 1.15 and Table 1.1). Inflation in the euro area has also increased, particularly during summer 2018. Between July and October it reached its highest level since 2012 with a rate of 2.2 percent. Energy prices were the decisive factor for the strong upswing and also explain the slight reduction at the end of the year. Core inflation in the euro area has been hovering slightly above 1 percent for some time now.

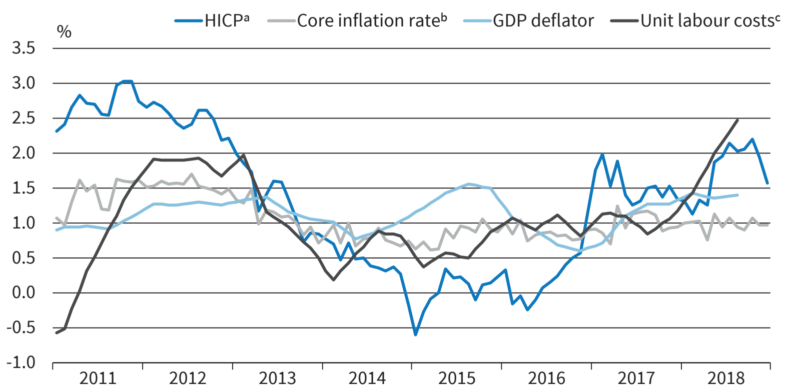
Developments in Selected Member States

The *German* economy is cooling down. Part of the weakness can be explained by supply-side difficulties. In addition to the strike and sickness-related production stoppages in the first few months of 2018, the summer also saw serious problems for the German automotive industry. The certification of new cars in accordance with the new WLTP exhaust emission procedure, which was introduced in the European Union on 1 September 2018, is the main reason for the decline in overall economic production in the third quarter. However, the high overall economic capacity utilisation, which was accompanied by a pronounced shortage of manpower and delays in supply chains, also stood in the way of a more vigorous expansion of production, which could have been expected given the high order backlog in German industry at the beginning of 2018. In addition, the overall picture of economic indicators suggests that demand for German products has declined during the year. New orders in the manufacturing sector, both from Germany and abroad, fell throughout 2018 and the export of industrial products stagnated. Falling export expectations and a declining export climate indicate that foreign demand for German goods has weakened significantly, especially compared to the boom year 2017. However, there are no indi-

Figure 1.15

Price Developments in the Euro Area

Change over previous year's month



[a] Harmonised Index of Consumer Prices (HICP). [b] HICP excluding energy, food, alcohol and tobacco.
[c] Nominal compensation of employees per unit of real GDP.

Source: Eurostat; last accessed on 3 February 2019.

© CESifo

Table 1.1

Labour Costs[a]

	Compensation per employee[b]			Real compensation			Labour productivity			Unit labour costs			Relative unit labour costs[d]			Export performance[e]		
	1999–2013	2014–2018	2018	1999–2013	2014–2018	2018	1999–2013	2014–2018	2018	1999–2013	2014–2018	2018	1999–2013	2014–2018	2018	1999–2013	2014–2018	2018
Germany	1.3	2.6	2.9	0.4	0.9	0.7	0.6	0.8	0.3	0.8	2.1	3.0	– 1.2	1.2	3.3	0.5	0.1	– 0.9
France	2.4	1.4	2.2	1.0	0.7	0.4	0.7	0.7	0.7	1.6	0.7	1.6	– 0.1	– 0.3	1.5	– 1.4	– 0.2	0.0
Italy	1.8	0.7	1.7	– 0.1	– 0.2	– 0.7	– 0.3	0.1	0.2	2.3	1.1	1.8	0.5	0.3	2.4	– 2.8	– 0.4	– 3.0
Spain	2.4	0.7	1.4	0.2	0.1	– 0.3	0.6	0.5	0.4	2.1	0.5	1.5	0.4	– 0.3	1.7	– 0.6	0.2	– 1.4
Netherlands	2.5	1.2	1.6	0.7	0.2	– 1.1	0.7	0.9	0.2	1.8	0.4	1.7	0.1	– 0.6	1.7	– 0.2	0.3	– 0.4
Belgium	2.5	1.1	2.0	0.9	– 0.3	– 0.6	0.8	0.5	0.3	1.9	0.5	1.5	0.3	– 0.4	1.8	– 1.0	0.9	0.1
Austria	2.0	2.0	2.4	0.5	0.3	0.4	0.7	0.6	0.9	1.4	1.7	2.0	– 0.3	0.4	1.1	– 0.5	– 0.3	0.1
Finland	2.8	0.8	1.7	1.2	– 0.5	– 0.7	0.8	0.8	0.4	2.0	0.0	1.4	– 0.3	– 0.3	2.1	– 1.4	– 0.7	– 0.5
Greece	2.6	– 0.7	1.8	0.7	– 0.4	– 1.2	0.7	– 0.4	0.5	2.7	0.2	2.4	0.6	– 0.2	3.5	– 1.0	1.1	4.6
Ireland	3.3	1.7	2.8	1.6	0.3	1.5	2.0	6.7	2.7	1.6	– 4.3	0.0	0.2	– 5.5	0.4	1.8	9.3	2.2
Portugal	2.5	0.8	1.9	0.3	– 0.7	– 0.6	1.0	– 0.1	0.0	1.8	1.4	2.4	0.0	0.6	2.1	– 0.2	1.9	2.9
Slovakia	6.1	3.6	6.2	3.1	3.0	1.2	3.3	1.5	2.3	2.3	2.6	4.4	1.9	1.4	3.1	4.3	0.7	1.7
Slovenia	5.3	2.6	4.4	1.9	1.4	0.5	1.8	1.7	1.7	3.4	1.2	3.1	– 0.1	0.2	2.7	0.9	3.2	4.4
Estonia		5.2	5.1	– 4.9	2.7	1.6	3.6	1.8	2.4	4.7	4.0	4.8	2.1	3.8	5.1	1.1	– 0.1	0.9
United Kingdom	3.4	1.9	2.0	1.5	0.3	0.0	1.0	0.5	0.2	2.2	1.3	2.1	– 1.1	– 0.4	1.5	– 1.5	– 1.6	– 1.6
Sweden	3.4	2.7	4.1	1.9	0.7	0.5	1.3	1.1	0.9	2.2	1.8	3.3	0.4	– 2.4	– 3.4	– 0.7	0.5	0.1
Denmark	2.9	1.6	2.3	0.9	0.8	1.3	0.9	0.5	– 0.4	2.1	1.2	2.8	0.2	0.5	2.8	– 0.5	– 1.2	– 3.7
Poland	4.9	4.4	7.2	1.9	3.6	3.8	3.2	2.8	4.2	2.1	1.9	2.9	– 0.5	0.7	2.1	2.3	3.7	2.8
Czech Republic	4.5	4.7	7.8	2.8	3.1	2.9	2.3	2.3	1.6	2.0	2.8	6.7	2.4	2.0	8.9	3.4	1.9	0.7
Hungary	6.4	4.1	10.9	1.5	1.2	– 0.4	2.0	0.9	2.7	4.9	3.3	7.9	1.7	0.8	4.2	3.5	2.9	4.7
Switzerland	1.4	0.2	1.5	0.7	0.5	– 0.5	0.6	0.6	1.9	1.0	– 0.3	– 0.7	1.1	– 0.1	– 4.6	– 0.2	– 2.9	– 2.2
Norway	4.5	2.5	3.1	– 0.1	1.3	– 3.4	0.5	0.8	– 0.1	4.1	1.8	3.1	2.9	– 3.1	0.5	– 3.4	– 2.1	– 2.2
Iceland	6.1	6.9	4.5	1.3	4.1	4.7	1.6	1.7	1.5	4.9	4.4	1.5	– 1.4	8.8	– 3.8	0.7	2.4	– 0.2
United States	3.1	2.4	3.0	1.2	0.8	0.2	1.6	0.7	1.3	1.5	1.8	1.6	– 1.6	3.8	– 1.4	– 1.1	– 1.0	– 0.2
China													3.9	2.4	2.7	9.3	0.6	1.2
Japan	– 0.7	0.8	0.8	0.4	0.0	0.9	0.9	0.0	– 1.0	– 1.2	1.0	2.0	– 2.5	– 0.6	1.1	– 2.8	0.4	– 2.3

[a] Growth rates for the total economy; [b] Compensation per employee in the private sector; [c] Compensation per employee in the private sector deflated by the GDP deflator; [d] Competitiveness: weighted relative unit labour costs; [e] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares.

Source: OECD Economic Outlook No. 104, November 2018.

cations to date that the trade conflict originating in the United States had a negative impact on German exports; as European sales markets were primarily responsible for the export weakness.

Although employment and labour income continued to expand strongly, private consumption weakened, as indicated by declining retail sales and new vehicle registrations since the spring. On the other hand, corporate investment, which continued to grow despite problems in the German industry, proved fairly robust in 2018. Strong capacity constraints and favourable financing conditions appear to have contributed to this development, although growth rates in the first three quarters of 2018 were somewhat weaker than in 2017. Investments in residential construction also expanded strongly last year. High demand for residential space in conurbations, low interest rates and good income prospects boosted the construction sector. The high level of over-utilisation of capacities evidently did not stand in the way of a continuous expansion of construction output, although it did cause construction prices to rise sharply.

Last year, the economic development of the *United Kingdom* was characterised by both weather-related disruptions early in the year and, more importantly, uncertainty over Brexit. The unresolved situation has had a negative impact on the investment activity of companies. The willingness of firms to invest in an environment in which economic arrangements between the United Kingdom and the rest of the European Union remain unclear has deteriorated markedly. Despite attempts to replenish stocks before the supply bottlenecks feared in the case of a hard Brexit, and the relatively weak value of the British pound, international trade has also lost considerable momentum already. The core inflation rate declined during 2018: on the one hand, the pass-through effects of the pound depreciation in 2016 did fade. On the other hand, however, growth has been falling below potential (which itself has been reduced by the Brexit decision), resulting in weaker price pressure. Headline inflation did not fully follow this decline in core inflation because of energy prices, which continued to rise until October of last year. Headline inflation has edged down to 2.3 percent in 2018, from 2.7 percent in 2017.

The economy of *France* lost momentum last year. In addition to weaker exports and investments, this was attributable to a noticeably slower growth in consumption. During the first part of the year, the latter was related to extensive labour disputes in the transport sector. Since November, the yellow vest (gilets jaunes) movement has not only challenged the ongoing structural reforms that were set in motion in 2017, the associated unrests have also damaged retail trade sales. Although most economists would agree that the implemented reforms have the potential to reduce high structural unemployment and increase potential GDP growth, and the yellow vests movement was initially directed only against high fuel prices and the planned eco-tax on diesel, it increasingly turned into a protest against the government's entire reform agenda. All in all, each of the major demand components underlying GDP weakened in 2018 compared with the previous year, which has resulted in a growth rate of 1.5 percent.

In *Italy*, economic growth also slowed in 2018. After 1.7 percent in 2017, the Italian economy is projected to have grown by only 0.8 percent in 2018. More specifically, the expansion of production was dampened by almost stagnating exports. Of the broader demand components, only investment provided a relatively strong impetus for overall growth. It was supported by tax incentives and slowly rising bank loans to non-financial corporations. The amount of non-performing loans on banks' balance sheets has declined significantly over the past two years and the ratio of new non-performing loans to outstanding loans has declined. Italian systemic banks appear to be well capitalised, while some smaller banks are still struggling. Furthermore, the share of Italian government bonds in banks' total assets has risen from 9 to 10 percent since the end of 2017, strengthening the link between the state of public finances and bank health. This is aggravated by the uncertain fiscal stance of the new government, which took office in June. If all new Italian government's plans, announced after it came to power, were to be implemented, a heavy burden would be placed on the government budget. This has already led to a sharp increase in risk premiums on Italian government bond yields.

Whereas the four largest countries in the European Union saw their growth rates decline to 1.5 percent or lower, all other EU member states apart from Denmark and Belgium kept growing at rates of 2 percent or (well) above. This also holds for the former crisis countries, Spain, Ireland, Portugal, Greece, and Cyprus. In addition, Greece was finally able to pull itself out of its trough last year and appears to be on a weak, but stable recovery path. The improved labour market situation and structural reforms implemented, aimed at increasing flexibility of product and labour markets, laid the foundation for relatively strong domestic demand in each of these economies. Furthermore, as interest rates have been low for several years now, governments' interest payments on public debt declined, as old debt was continuously rolled over to newly issued bonds. Governments took advantage of the option of bringing an end to austerity without incurring increases in public deficits. A more expansionary fiscal stance was another reason why growth remained relatively high. Insofar as growth weakened, this was largely due to a lowering of external, and particularly of European demand.

The Central and Eastern European countries continued on their growth path last year, albeit at a slower pace, and registered growth rates of between 3 percent and 5 percent in 2018. Whereas external demand was weakening, domestic demand remained robust almost everywhere. With the exception of Estonia, unemployment rates in other central and eastern European countries kept declining last year, but at a slower pace than in 2017.

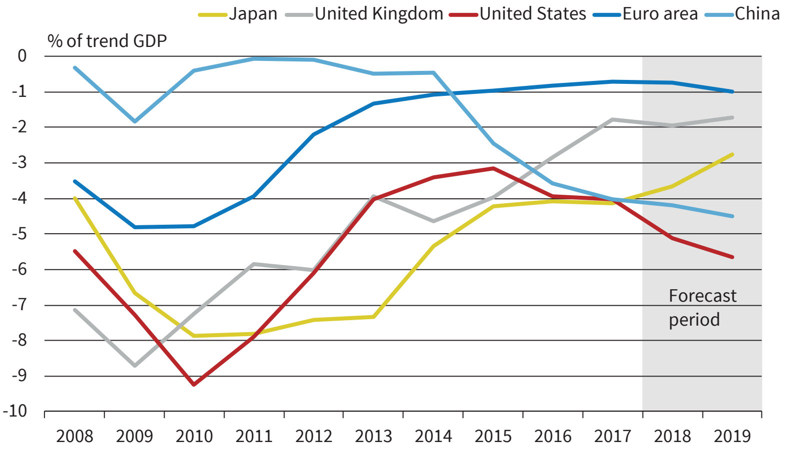
1.3 FISCAL AND MONETARY POLICY

1.3.1 Fiscal Policy

Fiscal policy was expansionary in the United States and China during the forecast period (see Box 1.1). The United States in particular provided a strong impulse with its tax reform at the beginning of last year. However, fiscal policy in China also became more expansionary as further measures were taken in the form of higher tax allowances and further tax deduction options in order to support those companies that were affected by the trade war in particular. As a result, the structural fiscal deficits in the world's two largest economies will continue to deteriorate (see Figure 1.16).

In Japan, on the other hand, fiscal consolidation has gradually resumed. The deficit was reduced by over half a percentage point of GDP last year. Even although the Bank of Japan owned about half of the outstanding government bonds by the end of 2018, a public debt level of approximately 240 percent of GDP poses a serious risk. An expansive monetary policy is keeping money market rates and returns on long-term government bonds at zero, which is buying time. The next major step in the fiscal consolidation is the 2 percentage-point increase in the consumption tax scheduled for October this year. Together with other measures, a reduction of the deficit by about one percentage point of GDP is likely to be achieved this year. For the first time in over a

Figure 1.16
Government Structural Budget Balances



Source: IMF World Economic Outlook, November 2018; last accessed on 3 February 2019.

© CESifo

Box 1.1

The Impact of a Reduction in the Corporate Tax Burden in Non-Euro Area Countries

The year 2018 saw a worldwide trend towards tax relief for companies. In large economies outside the euro area in particular, corporate tax cuts were either implemented or at least planned. The most prominent example is the United States, where the Tax Cuts and Jobs Act, adopted in December 2017, not only lowers the federal profit tax rate, but also makes it possible to write off equipment investments immediately. The People's Republic of China will follow a similar path. Chinese authorities have announced significant corporate tax cuts for 2019 in response to the trade dispute with the United States and the economic slowdown. In addition, the United Kingdom is likely to seize the opportunity to reinvent itself economically after Brexit. It is expected that changes in the tax law will be introduced to give companies in the United Kingdom a locational advantage.

The effects of such corporate tax reductions can be simulated using the ifo-DSGE model. A stylized scenario was used for the simulation, in which China, the United States and the United Kingdom permanently reduce their corporate tax burden by one third. These three countries have a weight of 64 percent in the country block describing the world outside the euro area. The magnitude of the simulated reform roughly corresponds to the Tax Cuts and Jobs Act, whose enactment reduced the effective average corporate tax rate from 37 percent to 23 percent (see Spengel et al., 2018). The model describes the impact on countries outside the euro area and spill-over effects on the euro area.

During the simulation, the usual assumptions of active monetary policy and passive fiscal policy are made. Thus, the central bank controls inflation and the government stabilises the national debt. The budget gap opened by the corporate tax cut will be closed by a combination of new debt and transfer cuts. In view of the fact that the players in this model behave according to Ricardian equivalence, the division between new indebtedness and transfer cuts is irrelevant.

The simulated decline in taxation in China, the United States and the United Kingdom offers companies located in these countries the opportunity to charge their customers lower prices and thus gain international competitiveness. Therefore, realised inflation in countries outside the euro area in the first quarters after the tax reform is below the trend inflation rate. Lower prices immediately lead to an expansion of exports to the euro area; countries outside the euro area expand their exports by 1 percent compared with the baseline scenario. Price restraint is boosting domestic demand in China, the United States and the United Kingdom. To satisfy the higher demand, it is therefore necessary to increase production in those countries. The corporate tax reform will give them an increase in economic output of up to 3 percent compared to the baseline scenario without tax changes. Due to increased production, companies are demanding more labour and capital. Thanks to the good situation in the labour market, trade unions are able to negotiate better collective wage agreements. The strong demand for capital is stimulating investment activity, which is over 7 percent higher than the baseline scenario and is reflected in an increase in imports from the euro area.

The simulated corporate tax cuts trigger negative spill-over effects on investments in the euro area, which are up to 4 percent lower than in the baseline scenario. Instead of investing in the euro area, investments are being made in the rest of the world. As a result, resources are shifting to more attractive investment locations.

decade, this should lead to a slight reduction in the debt-to-GDP ratio.

In both the euro area and the United Kingdom, fiscal policy did not provide any expansionary impetus last year. On average across all EU countries, the cyclically-adjusted primary fiscal balance remained at 0.8 percent of trend GDP (see Table 1.2). After a consolidation phase in the years 2011 to 2013, the cyclically adjusted primary deficit has hardly changed in the European Union. Nevertheless, fiscal deficits have been reduced overall. This reduction can therefore largely be attributed to the economic upswing and lower interest payments resulting from refinancing maturing government bonds in the prevailing low interest rate environment. For the European Union, the latter have accounted for about one third of the reduction in budget deficits since 2013.

This year, the fiscal policy stance in the euro area will become slightly looser. For most countries, structural deficits are likely to remain largely unchanged. However, fiscal policy will become substantially more expansionary in highly indebted Italy. Against a background of the expected normalisation of monetary policy and the associated increase in capital market interest rates, Italy could therefore come under renewed pressure from the financial markets. Nevertheless, the populist Italian government is targeting a significant increase in the budget deficit in 2019, which triggered a budget dispute with the EU Commission back in autumn 2018. The plans of the previous government, which were presented to the EU Commission in May 2018, aimed for a budget deficit of 0.8 percent. According to the compromise agreement, this figure should now rise to 2.04 percent. In

Table 1.2

Public Finances

	Gross debt[a]			Fiscal balance[a]			Primary fiscal balance[a]			Cyclically- adjusted primary fiscal balance[a]		
	2009–2012	2013–2017	2018	2009–2012	2013–2017	2018	2009–2012	2013–2017	2018	2009–2012	2013–2017	2018
Germany	78.0	70.9	60.1	– 2.1	0.6	1.6	0.4	2.1	2.5	1.1	2.2	2.2
France	86.7	96.1	98.7	– 6.0	– 3.6	– 2.6	– 3.5	– 1.5	– 0.8	– 2.9	– 1.0	– 0.8
Italy	117.0	131.0	131.1	– 4.0	– 2.7	– 1.9	0.6	1.6	1.7	1.0	2.6	1.7
Spain	67.0	98.4	96.9	– 10.1	– 5.2	– 2.7	– 7.9	– 2.1	– 0.3	– 7.6	– 0.4	– 0.7
Netherlands	61.0	63.8	53.2	– 4.7	– 1.2	1.1	– 2.8	0.1	1.9	– 2.5	1.3	1.5
Belgium	101.5	105.8	101.4	– 4.5	– 2.4	– 1.0	– 0.8	0.6	1.4	– 0.6	1.0	1.4
Austria	81.7	82.3	74.5	– 3.6	– 1.6	– 0.3	– 0.7	0.6	1.3	– 0.4	1.4	1.0
Finland	47.8	60.9	59.8	– 2.1	– 2.2	– 0.8	– 0.7	– 1.1	0.1	– 0.2	0.4	0.0
Greece	151.2	177.4	182.5	– 11.4	– 4.2	0.6	– 5.6	– 0.7	3.9	– 5.8	1.9	4.5
Portugal	104.4	128.5	121.5	– 8.5	– 4.3	– 0.7	– 4.7	0.2	2.7	– 4.7	1.5	2.3
Ireland	94.6	88.5	63.9	– 16.7	– 2.5	– 0.1	– 13.6	0.5	1.5	– 9.8	1.3	– 2.0
Slovakia	43.3	52.6	48.8	– 6.0	– 2.2	– 0.6	– 4.6	– 0.5	0.7	– 4.6	0.2	0.9
Slovenia	43.4	77.2	70.2	– 5.5	– 5.0	0.5	– 3.8	– 2.1	2.4	– 3.3	– 0.3	1.7
Luxembourg	19.1	22.5	21.4	– 0.1	1.3	1.3	0.3	1.7	1.7	1.5	1.9	1.5
Lithuania	35.3	40.2	34.8	– 7.0	– 0.5	0.6	– 5.3	0.9	1.5	– 3.2	1.3	1.1
Latvia	41.6	39.4	37.1	– 5.8	– 0.9	– 0.8	– 4.2	0.3	– 0.1	– 1.7	1.2	– 0.6
Cyprus	64.3	104.1	105.0	– 5.3	– 2.7	2.8	– 3.0	0.4	5.5	– 4.5	3.1	5.5
Estonia	7.3	9.7	8.0	– 0.3	0.0	0.5	– 0.1	0.1	0.6	2.8	0.7	– 0.2
Malta	68.2	59.6	47.9	– 2.9	– 0.1	1.3	0.2	2.2	2.9	2.0	2.4	1.5
Euro area	**85.7**	**92.0**	**86.9**	**– 5.1**	**– 2.0**	**– 0.6**	**– 2.2**	**0.3**	**1.2**	**– 1.7**	**1.1**	**0.9**
United Kingdom	76.0	87.1	86.0	– 8.7	– 3.9	– 1.3	– 6.1	– 1.4	1.1	– 4.5	– 1.4	0.7
Sweden	39.0	42.7	37.8	– 0.5	0.0	1.1	0.6	0.5	1.3	1.7	0.9	0.8
Denmark	43.4	40.4	33.3	– 2.8	– 0.2	0.2	– 0.9	1.3	1.2	0.4	1.7	1.0
Poland	52.6	52.4	49.2	– 5.8	– 2.8	– 0.9	– 3.3	– 0.9	0.6	– 3.9	– 0.2	0.2
Czech Republic	38.8	39.7	33.2	– 4.1	– 0.3	1.4	– 2.8	0.7	2.1	– 2.6	1.7	1.8
Romania	30.8	37.4	35.1	– 6.3	– 2.0	– 3.3	– 4.7	– 0.4	– 1.9	– 4.1	0.3	– 2.4
Hungary	79.2	75.9	72.9	– 4.2	– 2.2	– 2.4	0.1	1.4	0.1	1.8	2.4	– 0.5
Croatia	59.7	81.1	73.5	– 6.3	– 2.8	0.2	– 3.7	0.4	2.7	– 3.1	2.0	2.5
Bulgaria	15.2	25.1	23.3	– 2.4	– 1.2	0.8	– 1.6	– 0.4	1.5	– 2.0	0.4	1.6
European Union	**79.9**	**85.9**	**81.4**	**– 5.5**	**– 2.2**	**– 0.7**	**– 2.7**	**0.1**	**1.2**	**– 2.0**	**0.7**	**0.8**
United States	96.4	105.3	106.1	– 10.1	– 3.7	– 4.7	– 8.5	– 2.2	– 2.9			
China	34.0	41.8	50.1	– 0.6	– 2.4	– 4.1	– 0.2	– 1.8	– 3.1			
Japan	215.0	234.6	238.2	– 9.4	– 5.1	– 3.7	– 8.4	– 4.4	– 3.3			
Switzerland	43.3	42.5	40.2	0.5	0.2	0.6	0.9	0.4	0.8			

[a] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, China, Japan and Switzerland, definitions are according to the IMF.

Source: European Commission, Autumn 2018; IMF World Economic Outlook, October 2018.

fact, the deficit may well turn out to be significantly higher, as the agreement makes rather optimistic assumptions about GDP growth in 2019; Albeit to a lesser extent, French and German fiscal policy is also likely to be expansionary this year. Whereas in France in particular the revenue side is to be stimulated by the gradual introduction of tax reliefs, the reduction in the contribution to unemployment insurance will have an expansionary effect in Germany.

1.3.2 Monetary Conditions and Financial Markets

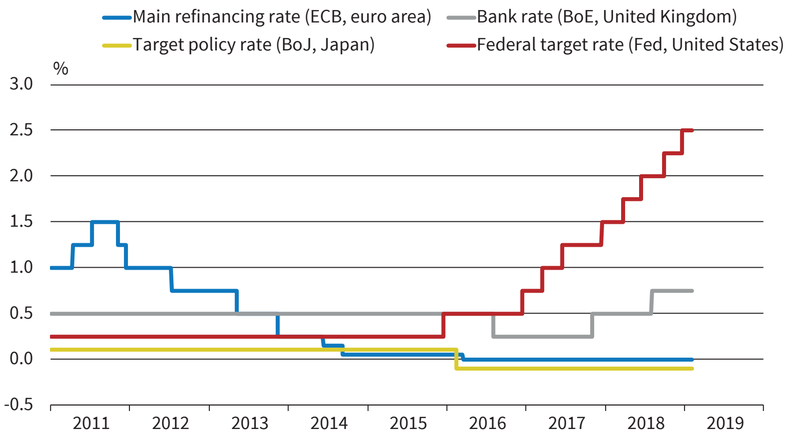
Monetary Conditions

Monetary policy remains expansionary worldwide. However, the differences in the degree of expansion, especially between the United States and the rest of the world, are becoming ever greater. The US Federal Reserve is continuing to reduce its expansionary measures in view of the fiscal impulses and the inflation trend; the Federal Funds Target Rate is at 2.5 percent (see Figure 1.17). On the other hand, the central banks in the euro area and in Japan kept interest rates at zero or slightly negative levels. The Bank of England raised its key interest rate last summer, but it is still at a low level of 0.75 percent. By contrast, the policy of China's central bank became more expansionary. Despite its pledges to pursue a neutral monetary policy, it has lowered minimum reserve rates for commercial banks to support smaller private companies experiencing financing difficulties.

While the European Central Bank (ECB) stopped its monthly net purchases of bonds by the end of last year,

Figure 1.17

Central Bank Interest Rates



Source: European Central Bank; Federal Reserve Bank of St. Louis; Bank of England; Bank of Japan; last accessed on 3 February 2019.

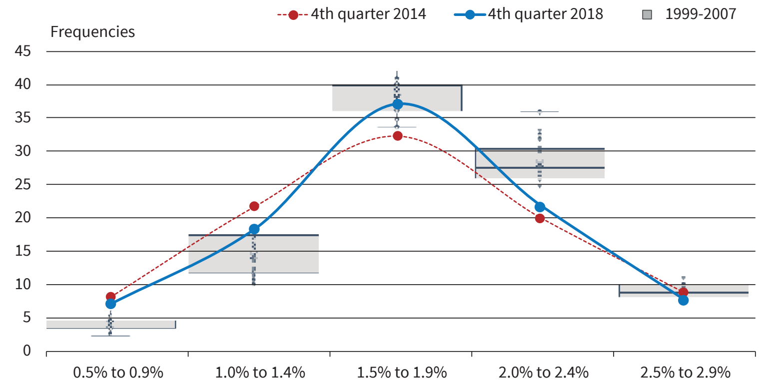
the Bank of Japan continues to control the yield curve through bond purchases. In July 2018, the Bank of Japan modified its yield curve control policy to allow wider deviations from the benchmark 10-year yield around an unchanged target of around zero percent. The Bank of Japan also introduced forward guidance on maintaining ultra-low policy rates for an extended period of time.

During the forecast period, the ECB should gradually tighten its monetary policy somewhat. Thanks to the persistently low core inflation rate, the ECB sees no reason to quickly raise interest rates in the near future. However, a normalisation of the monetary policy provides the ECB with greater room for manoeuvre in the event of a renewed crisis. Since March 2016 it has left the main refinancing rate unchanged at 0.0 percent, the marginal lending facility at 0.25 percent and the deposit rate at – 0.4 percent. While the ECB is expected to raise the deposit rate by 15 basis points in the second half of 2019 to restore the symmetry of the interest band, an increase of 25 basis points is expected for the main refinancing rate at the turn of the year.

The ECB made its last net purchases under the expanded Asset Purchase Program (APP) in December 2018. By the end of last year, the ECB was holding securities under the APP worth about 2,570 billion euros. The reinvestment of funds from maturing securities will continue for an indefinite period. This will keep the balance sheet size of the ECB at more or less its current level (see Figure 1.18). The US Fed, on the other hand, will allow 50 billion US dollars to run off its balance sheet each month.

Figure 1.19

Distribution[a] of Medium-Term Inflation Expectations in the Euro Area

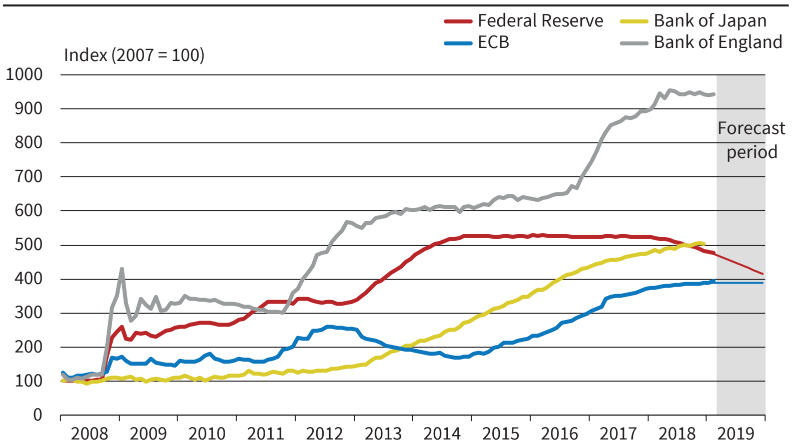


[a] For the ranges of values indicated on the horizontal axis, the box plots represent the distribution of the frequencies of the five-year inflation expectations of the Survey of Professional Forecasters in the period from 1999 to 2007. The cross indicates the mean value, the horizontal line in the box the median, the upper and lower edges of the box the quartiles.
Source: ECB; EEAG calculations.

One justification for the APP at the end of 2014 was the threat of inflation expectations in the medium term becoming less anchored to the ECB's target value of below but close to 2 percent. This would have massively undermined the credibility of the central bank and fundamentally questioned its policy. In fact, average medium-term expectations for euro area inflation, as measured by the Survey of Professional Forecasters, fell slightly to 1.8 percent in 2014, after fluctuating between 1.9 percent and 2.0 percent in previous years. More importantly, the distribution of inflation expectations as measured by the Survey of Professional Forecasters had shifted compared to the pre-crisis period, meaning that an ever-rising proportion of respondents considered inflation rates of between 1.0 percent and 1.4 percent, i.e. well below 2.0 percent, in the medium term – and thus a de-anchoring – to be probable (see Figure 1.19, red line). Over the last two years, however, the distribution of inflation expectations, especially for the range between 1.0 percent and 1.4 percent, has shifted once again significantly in the direction of the pre-crisis distribution (see Figure 1.19, blue line). Although expectations ranging between 1.5 percent and 1.9 percent are still cited less frequently than the 1999–2007 average, the current distribution is much more symmetrical, as an overshooting of the inflation target is considered less likely than in the pre-crisis period. In addition, the mean value of five-year inflation expectations returned to 1.9 percent as of the end of 2017. From these figures it can be concluded that the experts surveyed consider the ECB's

Figure 1.18

Balance Sheets Sizes of Major Central Banks



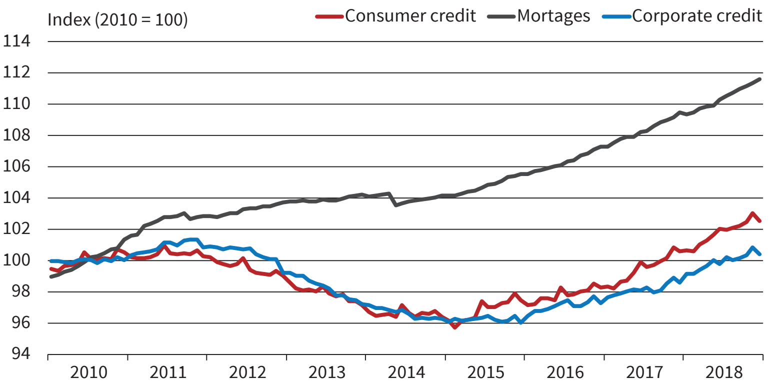
Source: Federal Reserve; Bank of Japan; European Central Bank; Bank of England; last accessed on 3 February 2019; EEAG calculations and forecast.

inflation target of just under 2 percent to be achievable in the medium term, and that the probability of deflation has significantly decreased.

Although the monthly APP purchase volume did substantially decline from 60 billion euros at the end of 2017 to 30 billion by the end of September 2018 and was just 15 billion euros during the last months of 2018, the pace at which credit growth has accelerated since 2015 has hardly changed. It is still considered slow given the historically low interest rates and enormous liquidity injected by the ECB into the system. Average interest rates for new corporate and real estate loans remained stable. Overall, financing conditions in the euro area remain very favourable. In the SAFE (Survey on the Access to Finance of Enterprises) survey conducted in autumn 2018, small and medium-sized enterprises stated that their access to debt financing had further improved. This assessment is consistent with the latest Bank Lending Survey. Accordingly, the lending standards for corporate loans were relaxed again in the third quarter, after a slight deterioration in the previous quarter; those for real estate loans remained largely unchanged in the third quarter of 2018. Mortgage lending has been growing steadily for years, rising by 1.9 percent in 2018. Growth in consumer credit has been positive since 2015 and hit 2.3 percent in 2018. Since 2016, loans to the corporate sector have also been increasing, reaching a rate of 1.8 percent last year (see Figure 1.20). By comparison, while M1 increased by almost 7 percent, M3 grew by around 3.7 percent last year.

Figure 1.20

Credit Developments in the Euro Area[a]



[a] These indexes of adjusted outstanding amounts are calculated according to $I_t = I_{t-1}(1+F_t/L_{t-1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details). A specific securitisation operation in France has led to a downward level shift in mortgages in May 2014.

Source: European Central Bank; last accessed on 3 February 2019.

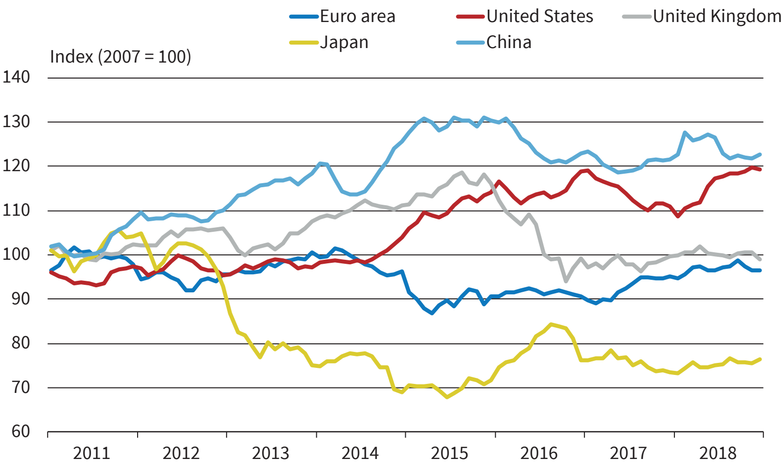
© CESifo

The increasing differences in monetary policy stance has led to a divergence between long-term interest rates in the United States and the rest of the world accompanied by a significant effective appreciation of the US dollar (see Figure 1.21). As a result, the euro depreciated vis-à-vis the US dollar again in 2018. From a purchasing power parity perspective, the euro has now been undervalued for four years in a row (see Figure 1.22). Nevertheless, the real effective external value of the euro, but also that of the British pound and Japanese yen, remained almost unchanged last year as a number of emerging market currencies depreciated. The normalisation of monetary policy in the United States made emerging markets less attractive for investments, leading to a decline in capital inflows to emerging markets. Over the summer months, Turkey and Argentina in particular became the focus of financial markets due to their high current account deficits and high foreign debt levels, resulting in a sharp depreciation in their currencies. In the meantime, the Turkish lira has recovered somewhat and the devaluation of the Argentine peso has halted for the time being, probably partly because the central banks of these countries intervened with strong interest rate hikes and sales of foreign exchange reserves. In the case of Argentina, the exceptional Stand-By Arrangement of the IMF was also helpful.

Whereas in the United States long-term government bond yields tended to rise particularly at the beginning of 2018, the opposite was the case for China. Triggered by the stronger than expected weakening of its economy, Chinese government

Figure 1.21

Real Effective Exchange Rates around the World

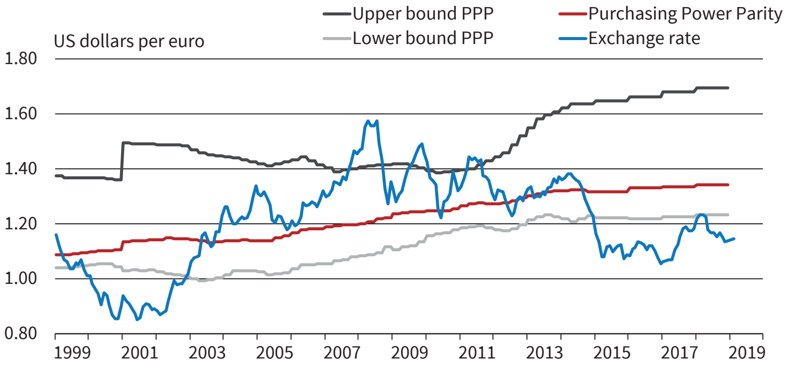


Source: Bank for International Settlements; last accessed on 3 February 2019.

© CESifo

Figure 1.22

Exchange Rate of the Euro against the US Dollar and PPP [a]

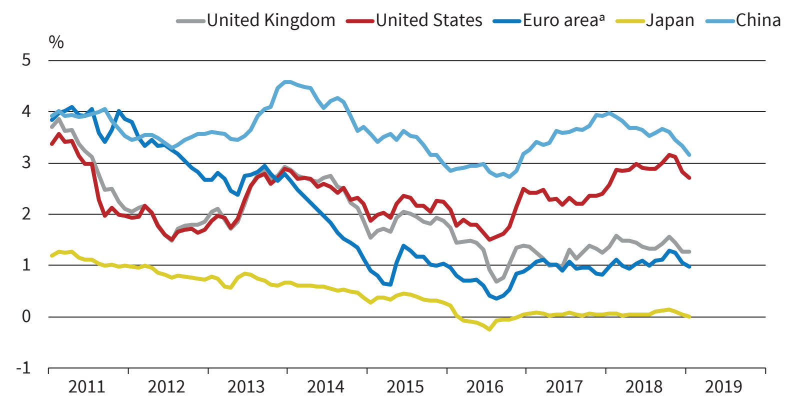


[a] The nominal exchange rate is based on monthly data, while the exchange rate based on purchasing power parity (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used.

Source: OECD, OECD Economic Outlook, Vol. 2018 issue 2, November; European Central Bank; last accessed on 3 February 2019.

Figure 1.23

10-Year Government Bond Yields



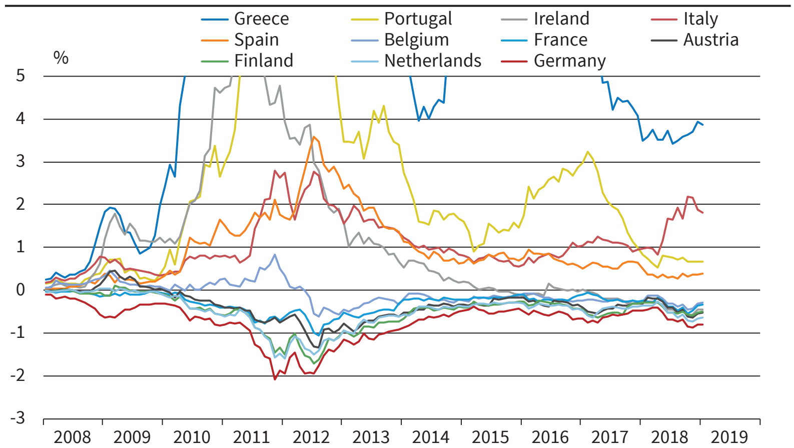
[a] The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each Economic and Monetary Union member.

Source: Datastream; last accessed on 3 February 2019.

Figure 1.24

Regional Disparties in Government Bond Yields in the Euro Area

Differences between 10-year national and synthetic euro area benchmark bond yields



Source: Datastream; last accessed on 3 February 2019.

bond yields continued to decrease throughout the year, losing a total of almost 100 basis points. In Japan, the United Kingdom and the euro area, long-term government bond yields largely moved laterally during 2018 (see Figure 1.23).

With the exception of Italy, government bond yields within the euro area hardly changed during 2018 either (see Figure 1.24). The election of a new Italian government that is aiming for a significant increase in its budget deficit led to a strong increase in risk premiums on Italian government bonds in May last year (see Box 1.2). The decline in risk premiums on Greek, Portuguese and Spanish government bonds ground to a halt last year. The economic situation in these former crisis countries has clearly improved in recent years. However, the increased risk of contagion triggered by the Italian government is immediately noticeable. Unlike the yields of Greece, Portugal and Spain, nearly all other euro area country yields have slightly moved away from the synthetic euro area average.

Monetary policy has only become significantly less accommodative in the United States, which could possibly have led to corrections in its equity markets. The loss of the Dow Jones Industrial Average in 2018 of 5.6 percent was relatively small compared to market declines in all other major regions, and particularly those in the euro area and China. Whereas these other markets hardly saw any uplift during the year, those of the United States experienced a bit of a roller coaster ride last year. After increasing by 5.6 percent between January and April, the Dow Jones increased by almost 8 percent until September, only to drop by over 9 percent by the end of the year. From a euro area perspective, the appreciating dollar cushioned the fall and boosted the rise somewhat (see Figure 1.25). Measured in euros, the overall decline of the Dow Jones Industrial Average turned out to be only 0.6 percent

Box 1.2

On the Risk of the Euro Crisis Flaring up Again

The budget plans of the populist Italian government formed in May 2018 and the associated dispute with the EU Commission have led to a significant increase in risk premiums for Italian debt instruments. While the yield gap to German government bonds with a residual maturity of ten years was relatively stable at an average of 1.3 percentage points between January and April 2018, it rose sharply on 18 May 2018, when the coalition agreement of the current Italian government was signed, and reached its temporary high of 3.3 percentage points on 20 November 2018. Since then, risk premiums have fallen again, as the Italian government has signalled its willingness to make changes to the draft budget. The premiums of credit default swaps (CDS), which are traded over-the-counter and serve as a measure of the probability of default of a specific debtor within a specified period, show a very similar trend. For the five-year protection against insolvency of the Italian federal state, they rose from an average of 52 basis points in the first four months of 2018 to 136 basis points on 20 November 2018.

The main creditors of the Italian state are Italian commercial banks. By mid-2018 they held about 18% (353 billion euro) of the outstanding government bonds. As the rise in yields forced creditors to book losses on the Italian state's securities, which reduced the banks' equity and thus increased their probability of default, risk premiums for loans to Italian banks increased at the same time as risk premiums for the Italian state rose. Since the beginning of the year, the average premium required by investors to insure loans to Italian banks for a term of five years has quadrupled. However, foreign commercial banks also hold a significant proportion of Italy's public debt. In mid-2018, the claims of French and Spanish commercial banks on the Italian state amounted to 55 billion euro and 41 billion euro respectively. Since May 2018, their risk premiums have almost doubled as a result of the price losses of Italian government bonds.

An escalation of the budget dispute thus not only endangers the stability of the Italian banking system, which is already weakened by its above-average share of loans at risk of default at the total loan volume. It may also be transferred to the banking systems of other countries, which hold claims against the Italian state or against Italian banks. If banks get into financial difficulties, there is a danger that the risks associated with a bank rescue are transferred to the state in which the banks are located. During the global financial crisis and the euro crisis, it was precisely this vicious circle that led to a worsening of the European sovereign debt crisis. The banking union, which effectively started with the ECB's takeover of the Single Supervisory Mechanism (SSM) in November 2014, was supposed to sever the risk association between states and commercial banks. In particular, the losses arising from the liquidation of a distressed bank should, in future, be borne primarily by the shareholders and creditors of a bank and no longer by the state, and thus by taxpayers. From the significantly lower correlation between the CDS premiums of banks and government within countries immediately after the SSM came into force, it can also be concluded that this project initially appeared credible.

However, the increasing synchronisation indicates that this credibility has been gambled away. The liquidation of the two Italian banks Veneto Banca and Banca Popolare di Vicenza in June 2017, for whose liquidation the Italian state provided aid in the form of guarantees (12 billion euro) and capital injections (5 billion euro) (European Commission, 2017), probably contributed significantly to this development. Although these measures did not conflict with the rules of the Banking Union – the European Banking Supervision delegated responsibility for settlement to national Italian supervisory institutions due to the non-systemically relevant size of the two banks – the measures still contradicted the spirit of the rules. The case shows once again that the rules drawn up by the European Union to achieve a more stable monetary union offer sufficient loopholes.

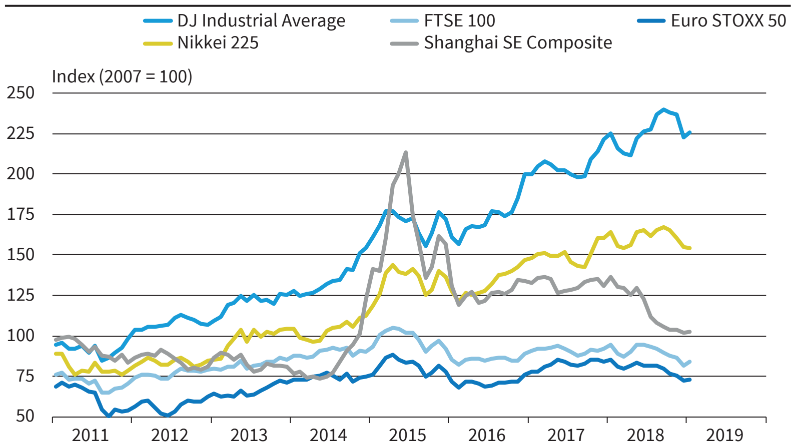
during 2018. The disappointing economic data for the euro area in particular and China, but also the United Kingdom, led to overall stock market losses of the Euro STOXX 50, Shanghai SE Composite and FTSE 100 of respectively 14.3 percent, 24.6 percent and 12.5 percent during the year. The decline in Japan set in somewhat later, but nevertheless resulted in an overall loss of 12.1 percent for the Nikkei 225.[1]

Many of the stock market indices within the euro area are still well below the levels reached before the start of the financial crisis. By the end of 2015, the Athex (Greece) had almost returned to its low reached in June 2012, roughly 90 percent below the average value seen in 2007 and about 30 percent below its value at the end of 2014 (see Figure 1.26). Whereas the Greek Athex saw the strongest decline last year of 23.6 percent, all others also registered double-digit losses, ranging between 11 percent for the CAC 40 (France) to 22.1 percent for the ISEQ (Ireland).

[1] In euros, these declines were, respectively 14.3 percent, 25.0 percent, 13.6 percent and 4.2 percent, respectively.

Figure 1.25

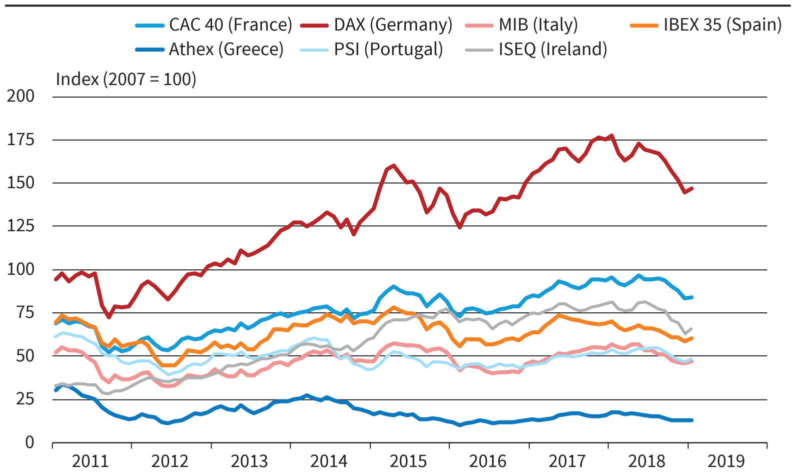
Developments in International Stock Markets from a Euro Area Perspective[a]



[a]Stock market indices outside the euro area are first converted into euros.
Source: Datastream; last accessed on 3 February 2019. © CESifo

Figure 1.26

Developments of Selected Stock Markets within the Euro Area



Source: Datastream; last accessed on 3 February 2019. © CESifo

increasing labour market tensions, the US Federal Reserve would raise interest rates faster than currently expected. This forecast assumes that the resulting turbulence in the emerging markets will remain locally limited.

The forecast is based on the assumption that the price of a barrel of Brent crude oil will be on average 56 US dollar in 2019. It is also assumed that the euro will cost on average 1.14 US dollar this year.

The global economy is currently exposed to considerable economic risks. The United States has imposed tariffs on a large number of imports, followed by countermeasures from China and the European Union. The present forecast assumes that the measures will not be extended. However, there is a risk that the trade conflict will intensify and further trade barriers will be introduced. In the event of an escalation, the global exchange of goods and overall economic production are likely to suffer a considerable setback.

As a result of the trade dispute, higher import prices could also lead to a faster rise in inflation rates. Central banks may be forced to adopt a more restrictive stance at a time when macroeconomic activity is weakening. Should the central banks in the advanced economies have to take more restrictive measures than currently expected, capital outflows from the emerging markets could again occur with a corresponding devaluation of their exchange rates. Since many of these countries hold a portion of their debt in US dollars, interest payments and thus the indebtedness of the public and private sectors would rise significantly, weakening overall economic activity (see Joint Economic Forecast, 2018, and Council of Economic Experts, 2018). Some of these countries are already heavily indebted, making defaults and financial market turbulence more likely. The recent events in Argentina and Turkey are a warning example.

The risks to the economic outlook in Europe continue to outstrip the opportunities. These risks include a 'hard Brexit', the still subliminal budget dispute between Italy and the European Commission, and risks related to the global trade dispute and the afo-

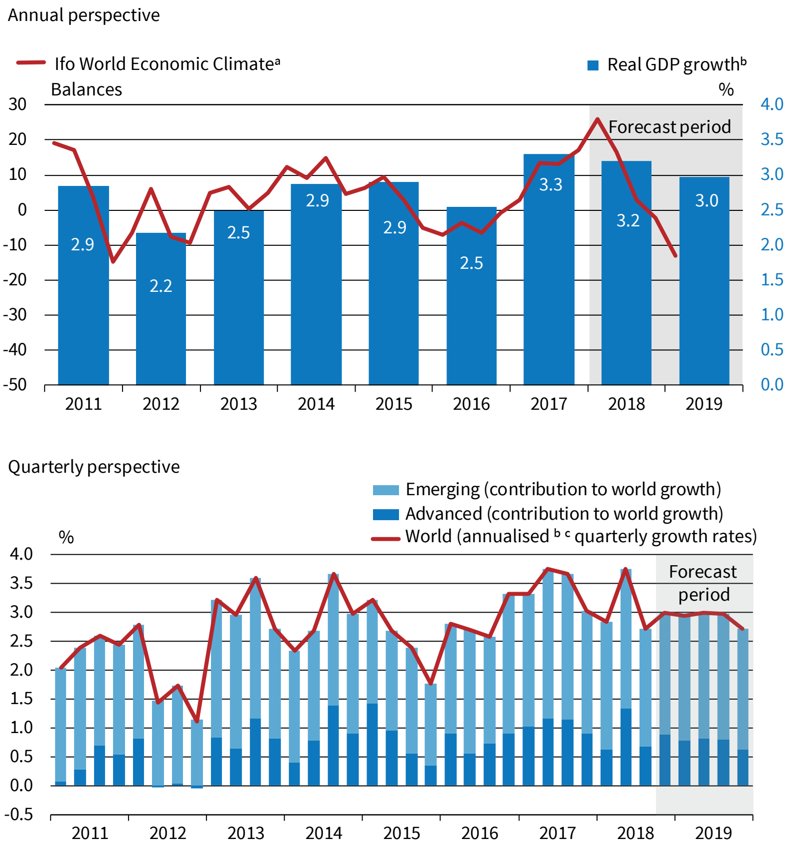
1.4 MACROECONOMIC OUTLOOK[2]

1.4.1 Assumptions, Risks and Uncertainties

At the beginning of December, the United States and China agreed to temporarily suspend further tariff increases for three months. Negotiations are now ongoing to reach a comprehensive agreement on intellectual property, non-tariff measures and cyber theft, among other things by early March. This forecast is based on the assumption that the status quo in the US trade disputes with China and the European Union will not change. Furthermore, the present forecast is based on the assumption that the settled budget dispute between Italy and the European Union will not revive and lead to further economic distortions. In addition, the forecast assumes that there will be no "hard Brexit". If inflation in the United States were to rise more sharply than currently expected in view of

[2] The forecasts presented are updates of ifo (2018) and Abberger et al. (2018).

Figure 1.27
World Economic Growth and the ifo World Economic Climate



ᵃ Arithmetic mean of judgements of the present and expected economic situation.
ᵇ Countries are weighted according to previous year's nominal GDP in US dollars and market exchange rates.
c Growth contributions of advanced and emerging economies thereof.

Source: National statistical offices; Ifo World Economic Survey I/2019; EEAG calculations; GDP 2018 and 2019 EEAG forecast.

rementioned vulnerability of the emerging markets. Nevertheless, there is a possibility that future economic developments are better than projected in this forecast. One reason for this could be, for example, the economically stimulating effect of the recent sharp drop in oil prices.

Initially, the vote on the Brexit agreement scheduled for 11 December in the House of Commons seemed to secure the United Kingdom's retention in the EU Customs Union until 2020. With the clear rejection of the prime minister's Brexit deal in mid-January, the likelihood of a 'hard Brexit' and possible distortions in trade between the United Kingdom and the European Union have increased significantly again, leading to a substantial further increase in uncertainty. The present forecast assumes that the United Kingdom will leave the European Union on 29 March 2019 in an orderly fashion and that there will be no restrictions on the cross-border movement of goods. If, on the other hand, the United Kingdom were to leave the European Union in a disorderly manner, the reintroduction of border controls and customs duties would have serious consequences for the British economy, and thus also for the rest of the European Union. International production and supply chains would be affected, leading to short-term distortions and a slump in industrial production in Europe that would be difficult to quantify.

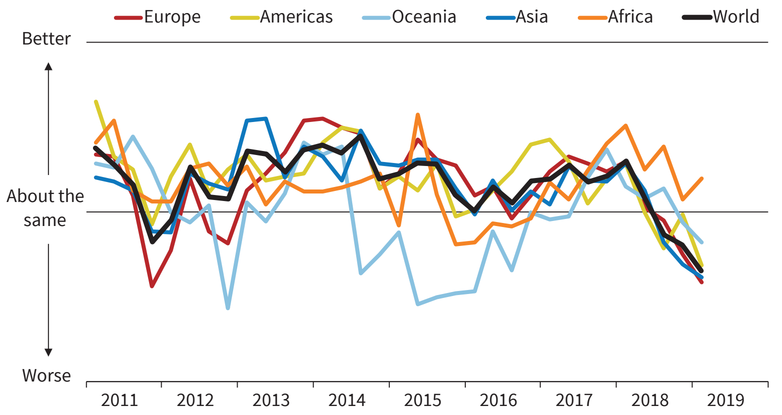
Another risk is reflected in the high risk premiums on Italian government bonds that investors have been demanding since the new Italian government took office in May. This has made the Italian financial sector, which had become more resilient until recently, more vulnerable again. If the budget dispute between Italy and the European Commission were to flame up again and the risk premiums do not recede, the solvency of the highly indebted Italian government could be called into question. Since Italian government bonds are held not only by Italian banks, but also by banks outside Italy, and Italian banks are interlinked with other European financial institutions, a further fall in the price of Italian securities could also affect financial institutions in other euro area member states (see Box 1.2).

1.4.2 Global Economy

This winter, the global economy is likely to have lost further momentum, which is indicated by the majority of global sentiment indicators. Due to pessimistic expectations, the ifo World Economic Climate deteriorated for the fourth time in a row in the first quarter of 2019 (see Figure 1.27). With the exception of Africa, the economic expectations of experts have deteriorated across all continents (see Figure 1.28). In particular, the outlook in Europe, Asia and the Americas has turned more pessimistic.

The recovery and upswing in recent years has already lasted for a decade. Given the duration of previous cycles, it may simply be time for a recession. When measuring the business cycle from trough to trough, the current upturn in the world's advanced economies started in 2009 and is already lasting much longer than the previous three (see upper panel of Figure 1.29), which only lasted four to seven years. However, the previous downturn, i.e. the Great Financial Crisis, was exceptionally strong, causing an unusually large negative output gap. In addition, the Euro Area Sovereign Debt Crisis that followed soon after the

Figure 1.28
ifo World Economic Survey
Economic expectations for the next 6 months

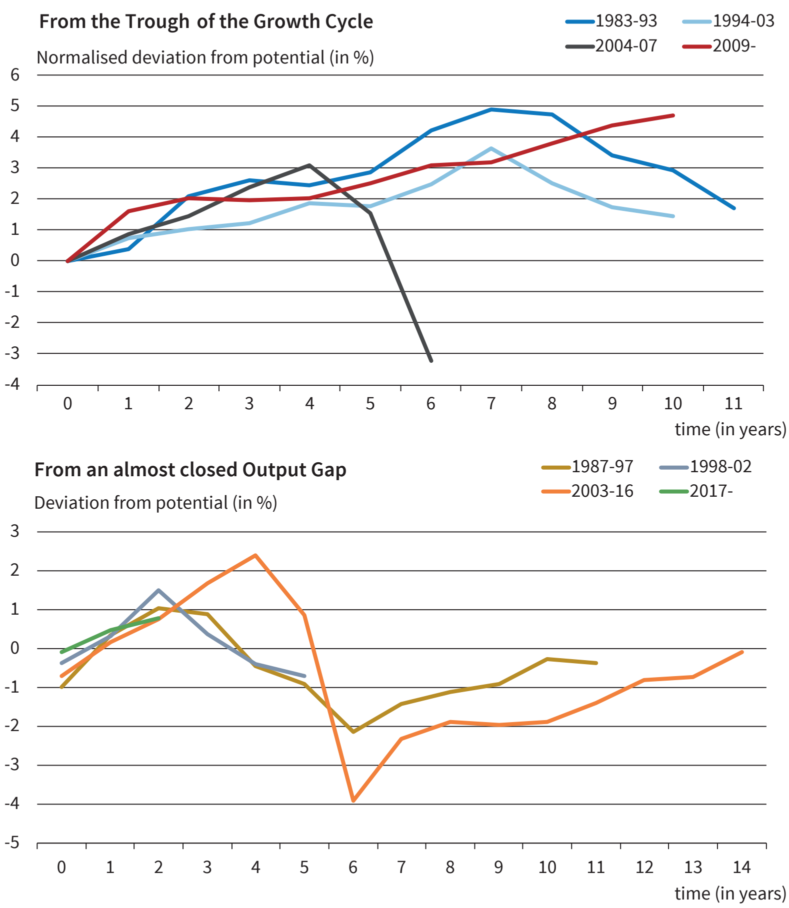


Source: ifo World Economic Survey I/2019. © CESifo

Great Financial Crisis made the output gap in Europe even more negative. When measuring a cycle starting from the situation in which output is more or less at potential, it is less obvious that the next recession has been long due (see lower panel of Figure 1.29). Output did not return to more or less potential until 2017 and, measured as such, we have just entered the second year of this cycle. Nevertheless, this comparison does suggest that a slowdown at this stage would not be exceptional.

In the further course of the year, world output is expected to increase at lower rates than in previous quarters. While growth is initially expected to be slightly above potential, it will gradually fall below this level. The slowdown in the global economic upswing can be partly explained by the fact that, in a number of advanced economies, production capacities are over-utilised and there is a shortage of suitable labour. Despite expansionary monetary policy overall, political and economic uncertainty are still curbing investment. Furthermore, the gradually more restrictive monetary policy in the United States is likely to lead to a significant deterioration in financing conditions, particularly in Latin America, thus slowing economic expansion. In addition, positive impulses from the US tax reform will slowly fade out, meaning that investment and consumer spending in the United States will probably increase less dynamically than before. This should also dampen US demand for foreign goods and services. The economy in the euro area is likely to lose considerable momentum due to weakening activity in the manufacturing sector and, as a result, weaker investment and export dynamics. The Chinese economy is expected to expand at declining but, from a European perspective, still strong rates this year. Monetary impulses from lower banking reserve requirements and fiscal impulses from, e.g., tax reductions are offset by the dampening effects of tighter financial regulations, and by a general burden on economic activity stemming from the very high indebtedness of the corporate sector. The trade restrictions that have already been introduced are unlikely to have much of a dampening

Figure 1.29
Comparing Growth Cycles in Advanced Economies

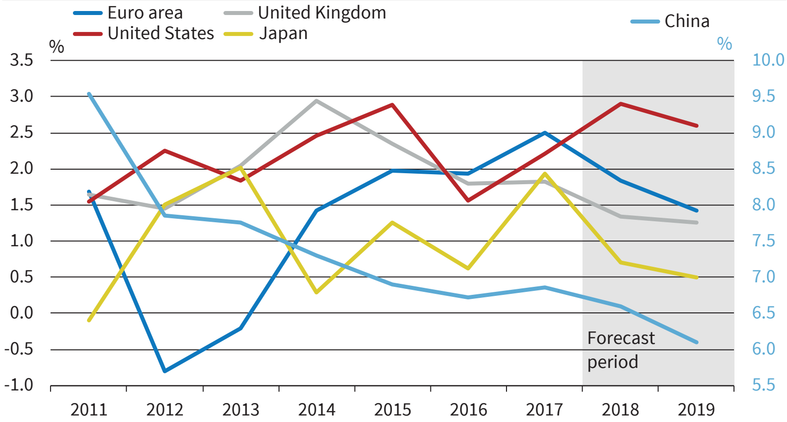


Source: IMF World Economic Outlook, November 2018; last accessed on 3 February 2019; EEAG calculations. © CESifo effect on the global economy themselves, as their scope has been limited to date. However, uncertainty over the introduction of further tariffs is likely to weigh on global economic activity. In addition, and despite anticipatory demand effects, the UK economy continues to be weighed down by uncertainty over exit arrangements from the European Union. Overall, world GDP is expected to grow by 3.0 percent in 2019.

Figure 1.31

Economic Growth by Region

Real GDP percentage change from previous year



Source: US Bureau of Economic Analysis; Eurostat; ESRI; National Bureau of Statistics of China; last accessed on 3 February 2019; EEAG forecast.

© CESifo

Whereas the drop in crude oil prices in recent months will reduce price pressure, higher wage inflation caused by highly utilised capacities, will do the opposite. For the advanced countries, this will result in a headline inflation rate similar to that of last year. In the emerging markets inflation, on the other hand, is likely to continue to rise this year. The depreciation of emerging market currencies in recent months will also put upward pressure on (imported) prices. As regards China, the decision by central bank to lower the minimum reserve requirements for commercial banks and continued expansionary fiscal policy are likely to put upward pressure on prices while continued economic softening will have the opposite effect.

World trade will slow down further his year. This is indicated by the steady decline in world trade expectations in the ifo World Economic Survey and the subdued RWI/ISL Container Throughput Index. Overall, international trade increased by 3.5 percent last year in real terms and will do so by 3.0 percent this year.

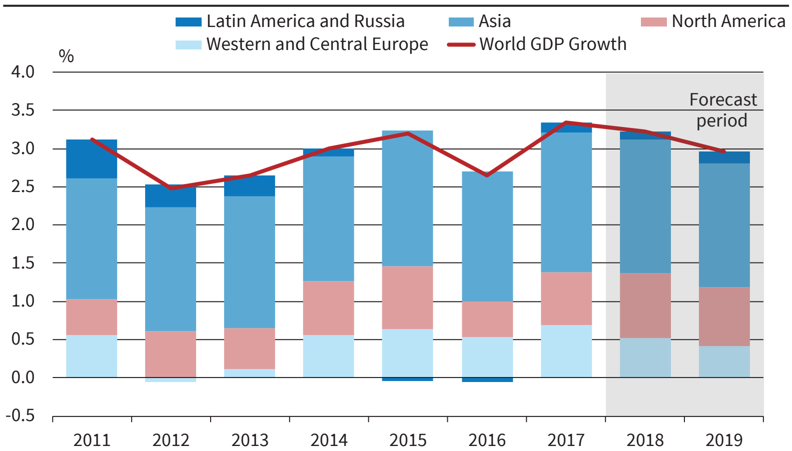
Among the major regions, only the growth contribution coming from Latin America and Russia is expected to increase compared to last year (see Figure 1.30). Most world regions will see declining growth rates, albeit starting from quite different levels. The strongest impulse will continue to come from Asia. Its contribution will again be larger than the combined contribution of North America and Europe together. The US economy will continue to grow more strongly than that of the euro area, and particularly than the Japanese economy (see Figure 1.31).

1.4.3 United States

This year, the strong momentum seen in the US economy in 2018 will normalise as the effects of the fiscal impulses abate, while private consumption will continue to benefit from the good labour market situation and real wage increases at the same time. Although the US economy will not be able to build on last year's strong expansion, it should still expand at rates above potential growth this year. Despite rising prices, private consumption will develop robustly due to strong growth in disposable income and high consumer confidence. A lengthy partial shutdown of the federal government at the beginning of this year will have a negative impact on public consumption expenditure. Overall capacity utilisation is already very high and the degree of monetary expansion is likely to be further reduced in view of rising wages and prices. Together with uncertainty over the future shape of cross-border value chains due to trade distortions, this will have a dampening effect on investment. Foreign trade is likely to lose

Figure 1.30

Regional Contributions to World GDP Growth[a]



[a] Based on market weights.

Source: National statistical offices; EEAG calculations and forecast.

© CESifo

momentum. GDP growth of 2.6 percent is expected for this year.

Last year's change in consumer prices amounted to 2.4 percent. With core inflation picking up slightly, but the contribution from energy prices abating, this year's inflation rate is expected to end up being 2.1 percent. After four rate hikes in 2018, the US Federal Reserve will proceed more cautiously in order not to stifle the economy. It will, however, continue along the path of a gradual normalisation of monetary policy, and raise its Federal Funds rate target range twice this year to achieve a federal funds target rate of 3 percent by the end of 2019. The US Federal Reserve has communicated that it will allow 50 billion US dollars each month to run off the balance sheet, which is largely a portfolio of bonds that the central bank purchased to stimulate the economy during and after the financial crisis. This, however, might turn out to be an upper limit in case of a further weakening of the economy and disruptions in financial markets.

1.4.4 Asia

While market sentiment in *China* has weakened in recent months, consumer confidence is still at historically high levels. Like the markets, China's government also appears to fear a slowdown in economic activity and has taken expansionary fiscal measures and loosened monetary policy. China's leaders are, as in the past, likely to continue to strive to maintain economic momentum through state intervention. The aim of reducing the minimum reserve ratios is to provide financial institutions with more funds so that claims against non-performing debtors can be converted into participations and the very high level of indebtedness of companies can be reduced in an orderly fashion. Nevertheless, high debt levels remain a risk for the economy and further delays in reducing imbalances in the Chinese economy are increasing the risk of a sudden economic collapse. Even although the risk of a sharp downturn has increased, signs of a soft landing still prevail. In this environment, the expansion of the Chinese economy is likely to slow gradually over the forecast period, falling from 6.6 percent last year to 6.1 percent this year. Inflation is forecast to pick up to 2.4 percent this year, after 2.1 percent in 2018.

In *Japan*, foreign trade impulses will continue to decline this year, especially since the economy of important trading partners will weaken. On the other hand, preparations for the 2020 Olympic Games in Tokyo will increase public investment. The private domestic economy is likely to expand at a similar pace as last year. Overall, the pace of expansion can be expected to slow slightly. After expected GDP growth of 0.8 percent last year, the expansion rate is forecast to be 0.7 percent this year. The Bank of Japan has lowered its inflation forecast for the period up to 2020 and is likely to maintain its expansive monetary policy course. A long-delayed increase by two percentage points in Japan's consumption tax will take effect in October 2019. After the previous hike in April 2014, this measure is supposed to be the next act in initiating fiscal consolidation in the years ahead, which in light of a public debt of almost 240 percent of GDP, is desperately needed. This will have a temporary, but clear impact on inflation dynamics. Inflation is likely to rise to 1.2 percent after 1.0 percent in 2018.

India's medium-term growth prospects remain strong. Benefiting from fiscal impulses in face of the national parliamentary elections in spring 2019 and from ongoing structural reform, the domestic economy continues to perform well. India will nevertheless also feel the impact of the global economic slowdown. For 2019, an overall growth rate of 7.3 percent is expected. Inflation, on the other hand, is expected to pick up to 5 percent this year. The higher inflation rate is a result of a narrowing output gap, pass-through effects from higher energy prices and the exchange rate depreciation witnessed last year.

For the remaining East and Southeast Asian region (South Korea, Indonesia, Taiwan, Thailand, Hong Kong, Malaysia, Singapore and the Philippines) growth dynamics will continue to slow down somewhat. In particular, the slowdown of growth in China will have a dampening effect on the entire Asian region.

General elections will be held in Indonesia in April. For the first time in Indonesian history, the president, the vice president, and members of the People's Consultative Assembly, will be elected on the same day. Should a religious fundamentalist win these elections and replace the current moderate and pragmatic government, Indonesia might be heading to a currency crisis and thereby though economic future, as investors are likely to leave the country. The Rupiah has already witnessed an effective depreciation of more than 6 percent last year.

1.4.5 Latin America and Russia

The Latin American economy (Brazil, Mexico, Argentina, Venezuela, Colombia, and Chile) is improving, but forecasts remain cautious. Despite the ongoing recovery, the medium-term outlook for commodity exporters is generally subdued. Growth in Mexico is expected to increase as it is supported by the good economic situation in the United States. However, continuing uncertainty in the trade sector has somewhat weakened the outlook for domestic demand. Brazil's recovery is picking up speed. More specifically, the recovery of private demand will allow the output gap to be gradually closed. However, tighter external financial conditions and the unclear economic agenda of the new government elected last year are a source of risk for this outlook. The recent turmoil in the financial markets, high real interest rates and faster fiscal consolidation under the IMF Stand-By-Agreement approved last June mean that Argentina's economy will remain in recession this year. However, the light at the end of the tunnel is visible; the continued implementation of reforms and the return of confidence will improve trend growth throughout the year. There is still no end in sight to the economic crisis in Venezuela. Its economy is expected to shrink for the fifth consecutive year. For the region as a whole, but excluding Venezuela because of extraordinary high inflation rates, the increase in aggregate production will accelerate to 1.9 percent after 1.2 percent last year. In view of the depreciation against the US dollar, a stronger rise in prices and a tightening of monetary policy are expected in most of these countries.

The Russian economy was somewhat stimulated last year by the rise in oil prices and the associated increase in export earnings. In turn, the fall in oil prices is now putting a drag on the economy. A VAT increase from 18 percent to 20 percent in January will also dampen private consumption in the quarters ahead. By contrast, industrial production growth will remain stable. Overall, GDP will increase by 1.4 percent this year after 1.6 percent in 2018.

1.4.6 European Economy

Cyclical Situation

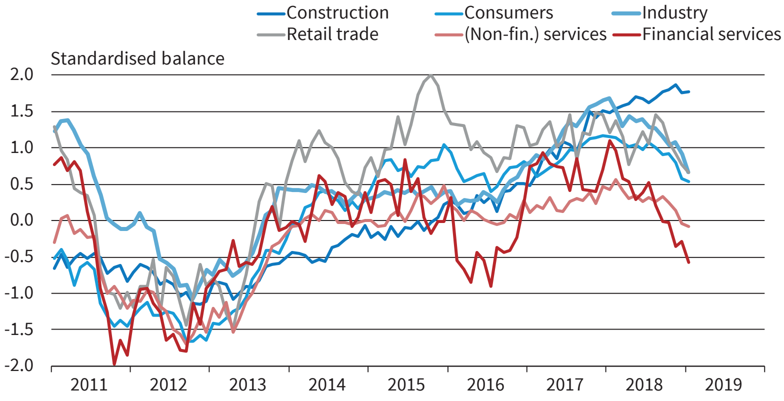
Most economic indicators for the European Union have fallen continuously in recent months. For instance, the Economic Sentiment Indicators of the European Commission for both the euro area and the European Union reached their peaks in December 2017 and have since almost continuously declined gradually, although remaining above their long-run averages. A similar picture emerges from the confidence indicators of the European Commission. Except for the construction sector, all sector-specific confidence indicators, as well as consumer confidence, are declining. Financial services in particular have seen a substantial change for the worse during 2018 (see Figure 1.32). At the end of last year, the confidence indicator for this sector fell below its long-term average. Only the construction sector is bucking the general trend. The confidence indicator for this sector hit an all-time high.

Business surveys indicate that the deterioration in sentiment was mainly due to a clouding over of export expectations and a poorer assessment of order backlogs. As the economy weakens, the pace of investment, and exports in particular, is likely to slow down. Consumer confidence is also declining. Private consumption is nevertheless expected to remain the mainstay of the economy this year, not least as a result of the good situation in the labour market (see Figure 1.33).

This winter, GDP in the European Union is likely to gain some momentum again, driven by catch-up effects. The economy is expected to slowly weaken in the subsequent quarters. The reason for this is partly that the increasing over-utilisation of macroeconomic production capacity no longer permits any

Figure 1.32

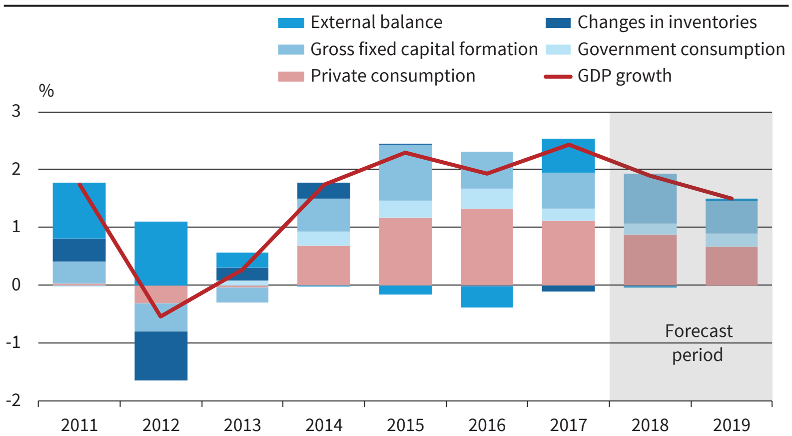
Confidence Indicators[a] for Different Sectors in the European Union



[a] Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are the differences between the percentages of positive and negative replies. These are subsequently normalised to have an average of 0 and variance of 1 for the period from 1985 onward.
Source: European Commission; last accessed on 3 February 2019; EEAG calculations.

Figure 1.33

Demand Contributions to GDP Growth in the European Union [a]



[a] Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; last accessed on 3 February 2019; EEAG calculations and forecast.

major leaps. The weakening is also partly due to political developments like the international trade conflict, the risk of a revival of the dispute over Italy's budget and associated financial market risks, which are increasingly putting pressure on companies' propensity to invest. In addition, as the economy weakens, risk sensitivity normally increases, which has a negative impact on the economy. Rising wages and continued good consumer sentiment should nevertheless ensure robust growth in private consumption. Fiscal impulses in Germany and Italy will also have a supporting effect. Overall, we forecast GDP growth of 1.5 percent for the European Union this year (see Figure 1.34).

As a result of the economic slowdown, the outlook for the labour market is not likely to improve much further. Employment is projected to increase at rates close to 1 percent, which is significantly below the rates generally experienced over the last four years (see Figure 1.35), but will still be sufficient to reduce unemployment rates somewhat further.

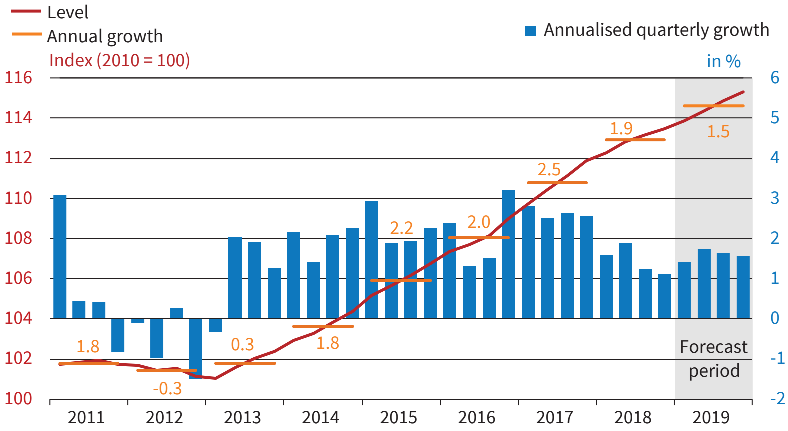
The unemployment rate is expected to fall to 6.3 percent this year, after 6.9 percent in 2018 (see Figure 1.36). The differences between the EU member states remain substantial. Greece, Spain, and Italy will continue to have the highest unemployment rates. In Germany and the Netherlands only minor declines can be expected due to the largely exploited labour force potential.

As in 2018, the average inflation rates for the euro area and the European Union are expected to be 1.7 percent and 1.8 percent respectively. On the one hand, the recent fall in energy prices will put downward pressure on inflation. At the beginning of the year, Brent crude oil cost around 55 US dollars per barrel, significantly less than in October when it peaked at 85 US dollars per barrel. On the other hand, high capacity utilisation, rising employment and stronger wage increases will lead to an increase in core inflation, i.e. the inflation

Figure 1.34

Real GDP in the European Union

Seasonally adjusted data

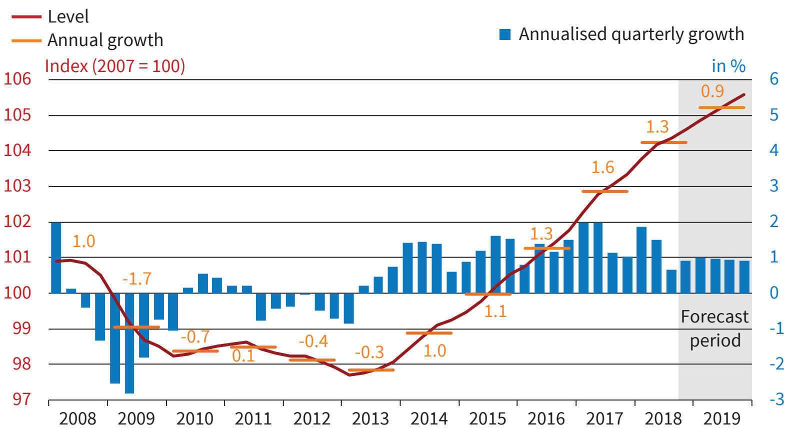


Source: Eurostat; last accessed on 3 February 2019; EEAG calculations and forecast. © CESifo

Figure 1.35

Employment in the European Union

Seasonally and work-day adjusted data

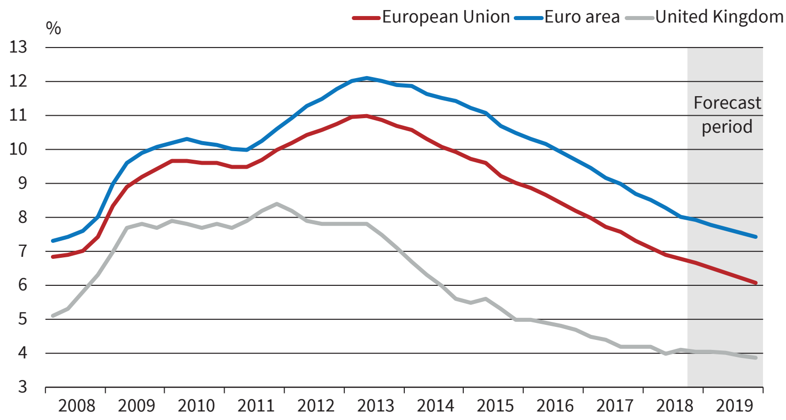


Source: Eurostat; last accessed on 3 February 2019; EEAG calculations and forecast. © CESifo

Figure 1.36

Unemployment Rates in the Euro Area, the United Kingdom and the European Union

Seasonally adjusted data



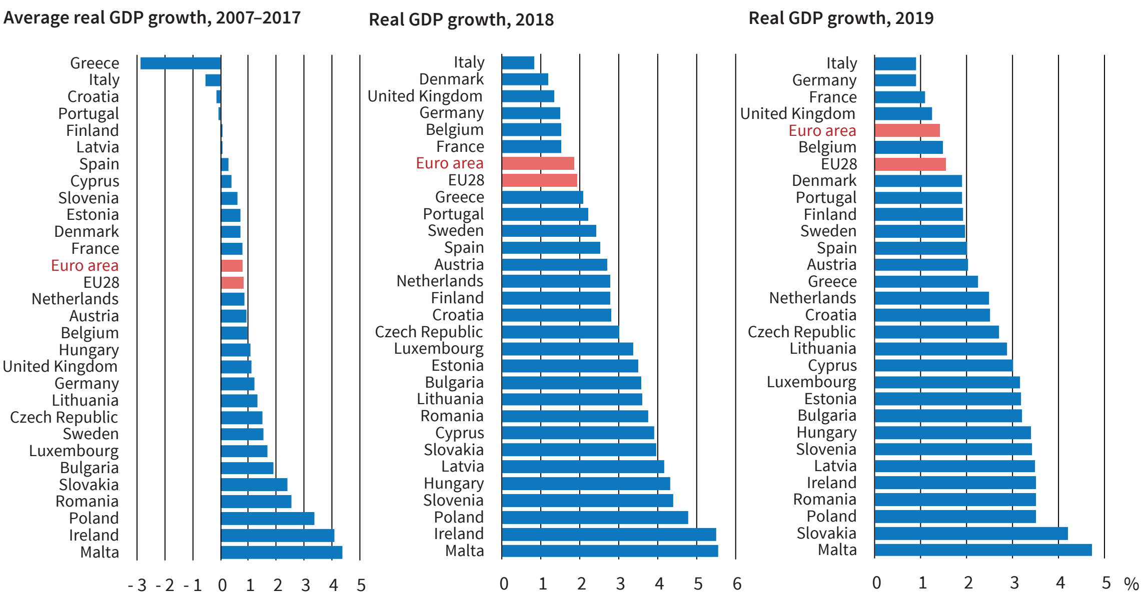
Source: Eurostat; last accessed on 3 February 2019; EEAG calculations and forecast. © CESifo rate excluding energy and food prices. The core rate in the euro area is expected to average 1.2 percent this year, after just 1.0 percent last year. There are still differences between the largest euro area countries. The general price increase in Germany is expected to be the strongest. France and Spain form the midfield. Inflation in Italy is likely to remain low due to the weak economy and comparatively high unemployment.

Developments in Selected Member States

As for most countries, the downside risks for *Germany* also currently outweigh the upward opportunities. In addition to the international risks already mentioned (trade dispute and emerging markets) and Europe-specific risks (Brexit and the latent budget dispute between Italy and the European Union), there is uncertainty about the further development of the German automotive industry in which traditional, but nowadays disreputable diesel combustion engines still play an important role. However, economic sentiment has also deteriorated in other sectors of the economy. This year, GDP is expected to initially expand at slightly higher rates than at the end of last year. The fiscal side in particular should stimulate public and private consumption. The manufacturing sector is not expected to provide an above-average stimulus for the German economy in the further course of the year, as foreign sales markets are slowly losing momentum. The German economy has thus left the export-led boom behind and entered a phase of cooling. There is no recession in sight, however, as domestic economic forces remain intact. The expansion will be supported by the economic situation in the construction industry, which remains favourable, and by household consumer spending, which will continue to benefit from the very good labour market situation, expanding real incomes and favourable financing conditions. The cooling of the German economy will be accompanied by declining over-utilisation, with overall economic production expanding at a slower rate than production potential. German GDP is expected to increase by only 0.9 percent this year (see Figure 1.37). Employment growth will weaken not only due to slower growth, but also as labour supply is becoming increasingly scarce. In view of the slower rise in employment and the subdued development of macroeconomic output, the decline in unemployment will continue at a slower pace. Inflation is, for German standards, expected to remain strong. The annual average inflation rate will rise from a projected 1.7 percent last year to 2.1 percent this year. Rising wage costs due to ongoing tensions in the labour market are likely to aggravate price pressures.

In the *United Kingdom*, inflation should gradually weaken from a projected 2.3 percent last year to 2.0 percent this year. Due to the stabilised price situation, there is currently no hurry for the Bank of England to raise interest rates. In line with the ECB, it will probably carry out its next rate hike in the winter of 2019/2020. Developments in the UK economy have been significantly influenced by whether, and in what form the country will leave the European Union. This forecast is based on the assumption that the United Kingdom will still have full access to the European single market from 30 March 2019 onwards. The current uncertainty about Britain's future relationship with the European Union is also expected to disappear in spring 2019, leading to catch-up effects in investment. The economy is also supported by an expan-

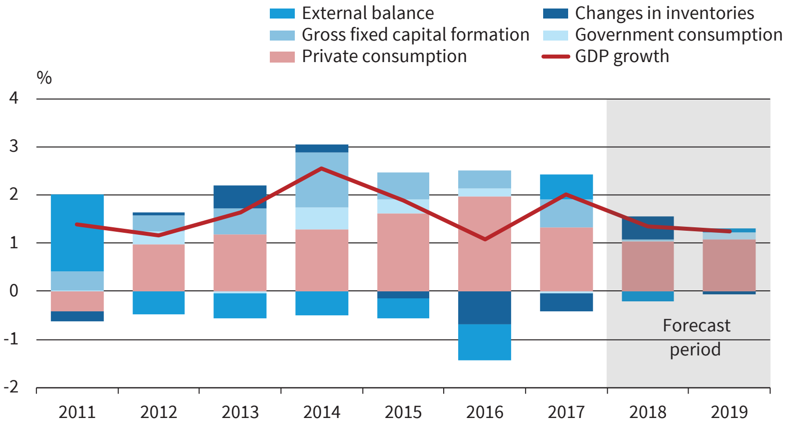
Figure 1.37
Economic Growth in EU Member Countries



Source: Eurostat; last accessed on 3 February 2019; 2018 and 2019: EEAG forecast.

Figure 1.38

Demand Contributions to GDP Growth in the United Kingdom [a]



[a] Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; last accessed on 3 February 2019; EEAG calculations and forecast.

sive fiscal policy. Overall, GDP is forecast to expand by 1.3 percent, after a projected 1.3 percent last year. The demand component with the largest contribution to overall growth and, therefore, the stabilising factor of the economy is again going to be private consumption (see Figure 1.38). Although tariffs on trade with the European Union are assumed to remain at zero in our forecast, non-tariff costs are likely to increase moderately reducing the country's medium-term prospects for growth.

In a response to the House of Commons Treasury Committee, the Bank of England has outlined the possible consequences for the United Kingdom of a chaotic "hard Brexit". In this case, tariffs and other trade barriers will apply at the border after March 2019. Large queues will arise, because the British and European border infrastructure is not yet able to handle the extra and unclear customs requirements smoothly. According to the Bank of England, in a scenario in which interest rates and risk premiums would also increase and productivity would be affected negatively, the UK's GDP will fall by around 8 percent in the second quarter of 2019.[3] By comparison, during the winter of the financial crisis in 2008/2009, the GDP loss in the United Kingdom was around 4 percent. Whereas the rise in trade barriers between the United Kingdom and the European Union would imply sizable losses for the UK economy, it would, albeit to a lesser extent, have negative impacts on its trading partners as well.

The yellow vests movement in *France* is likely to have a negative impact on France's further economic development. Not only will it lead to slower structural reforms of the French economy, it will also directly damage France's economic image. Both foreign investors and tourists are being deterred by the recordings of violent protests that have gone around the world. On the other hand, the fiscal measures announced by the government to appease the protesters are likely to have a small, but positive short-term effect on consumption. Furthermore, household purchasing power has increased as employment growth remains strong and the reduction in housing tax and some social contributions has taken effect. The unemployment rate is falling and the dependence on subsidised jobs and fixed-term contracts has been reduced. All this is supporting private consumption. Shortages of highly-skilled labour are increasing and wage growth has accelerated. However, the unemployment rate is still high. Last year's labour market reforms will help reduce the structural unemployment and improve the integration of low-skilled workers. Together with tax reforms, this will support business investment and exports. At the same time, however, weaker international dynamics will have a negative impact on economic activity. Overall, economic growth is forecast at 1.1 percent this year.

Despite expansionary fiscal policy, growth in the Italian economy is likely to remain below 1 percent this year. High uncertainty and rising interest rates will lower the propensity of households and firms to consume. In addition, slower growth among Italy's main trading partners will hinder export growth. The investment recovery, although moderate, will continue to support growth. Inflation in Italy is likely to remain low due to its weak economy and comparatively high unemployment rate.

Each of the four largest economies of the European Union is expected to grow below 1.5 percent, which will weigh on overall European growth. All other EU countries will grow at a faster pace this year, i.e. by 1.5 percent or more (see Figure 1.37). In addition, the economies of Central and Eastern Europe will continue to grow, albeit in almost all of these countries at a slightly slower pace than last year due to weaker momentum coming from Europe and the rest of the world. Since unemployment is decreasing more slowly than previously, the positive impetus from domestic demand will also decline somewhat. Interest rates, which remain low, will continue to support investment dynamics.

REFERENCES

Abberger, K., Y. Abrahamsen, M. Anderes, F. Chatagny, A. Dibiasi, F. Eckert, A.K. Funk, M. Graff, F. Hälg, H. Mikosch, S. Neuwirth, A. Rathke, P. Sandqvist, S. Sarferaz, M. Siegenthaler, A. Stücker and J.-E. Sturm (2018), "Konjunkturanalyse: Prognose 2019/2020. Schweizer Konjunktur verliert an Schwung", KOF Analysen, 2018(4), Zurich: KOF Swiss Economic Institute, 1–23.

[3] See https://www.bankofengland.co.uk/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability.

Council of Economic Experts (2018), "International Konjunktur: Nachlassendes Expansionstempo bei hohen Risiken", Annual Report: Chapter 2, Wiesbaden 2018.

European Commission (2017), "State Aid: Commission Approves Aid for Market Exit of Banca Popolare di Vicenza and Veneto Banca under Italian Insolvency Law, Involving Sale of Some Parts to Intesa Sanpaolo", press release, 25 June 2017.

European Commission (2018), "European Economic Forecast, Autumn 2018", Institutional Paper No. 089, Brussels.

Grimme, C. and J. Güntner (2018), "Ursachen des Rohölpreisanstiegs seit 2016", Wirtschaftsdienst 98(8), 605–607.

Groen, J. and C. McQuillan (2018), "Oil Price Dynamics Report, Updated: December 3, 2018", Federal Reserve Bank of New York.

ifo (2018), "ifo Konjunkturprognose Winter 2018: Deutsche Konjunktur kühlt sich ab", 13 December 2018, Munich.

Joint Economic Forecast (2018), "Aufschwung verliert an Fahrt – Weltwirtschaftliches Klima wird rauer", Autumn 2018, Essen.

OECD (2018), "OECD Economic Outlook", Volume 2018 Issue 2, Paris.

Spengel, C., M. Olbert and K. Stutzenberger (2018), "US-Steuerreform: Chancen und Risiken: Wer gewinnt – wer verliert?", *ifo Schnelldienst* 71(4), 3–6.

Statistics Netherlands (2018), "National Accounts 2015 Benchmark Revision", The Hague.

APPENDIX 1.A
Forecasting Tables

Table 1.A.1

GDP Growth, Inflation, and Unemployment in Various Countries

	Share of total GDP in %	GDP growth			CPI inflation			Unemployment rate [a]		
		in %								
		2017	2018	2019	2017	2018	2019	2017	2018	2019
Industrialised countries:										
EU 28	24.8	2.5	1.9	1.5	1.7	1.8	1.8	7.6	6.9	6.3
Euro area	18.1	2.5	1.9	1.4	1.5	1.7	1.7	9.1	8.2	7.6
United Kingdom	3.8	1.8	1.3	1.3	2.7	2.3	2.0	4.4	4.1	4.2
Switzerland	1.0	1.7	2.6	1.6	0.5	0.9	0.6	4.8	4.5	4.1
Norway	0.6	1.9	1.7	2.0	1.9	2.8	2.1	4.2	3.7	3.6
Western and Central Europe	26.3	2.5	2.0	1.6	1.7	1.8	1.8	7.5	6.8	6.2
US	27.9	2.2	2.9	2.6	2.1	2.4	2.1	4.4	3.8	3.5
Canada	2.4	3.0	2.1	2.0	1.6	2.3	2.1	6.3	6.0	6.0
Japan	7.0	1.7	0.8	0.7	0.5	1.0	1.2	2.9	2.6	2.6
Industrialised countries (total)	**63.5**	**2.3**	**2.2**	**1.**	**1.7**	**2.0**	**1.9**	**6.1**	**5.5**	**5.1**
Newly industrialised countries:										
China	17.2	6.9	6.6	6.1	1.6	2.1	2.4			
India	3.7	6.2	7.6	7.3	3.3	4.0	5.0			
Russia	2.3	1.5	1.6	1.4	3.7	2.8	4.0			
East Asia [b]	7.0	4.0	3.9	3.6	2.2	2.1	2.3			
Latin America [c]	6.3	1.6	1.2	1.9	7.3	7.9	8.0			
Newly industrialised countries (total)	**36.5**	**5.0**	**4.9**	**4.7**	**3.0**	**3.3**	**3.7**			
Total [d]	**100.0**	**3.3**	**3.2**	**3.0**	**2.2**	**2.5**	**2.5**			
World trade growth in % [e]		**4.7**	**3.5**	**3.0**						

[a] Weighted average of Indonesia, Korea, Malaysia, Tawain, Thailand, Philippines, Singapore, and Hong Kong. Weighted with the 2017 levels of GDP in US dollars; [b] Weighted average of Brazil, Mexico, Argentina, Colombia, and Chile. Weighted with the 2017 level of GDP in US dollars; [c] Weighted average of the listed groups of countries; [d] Standardised unemployment rate; [e] Trade of goods.

Source: EU; OECD; IMF; ILO; National Statistical Offices; CPB. 2018 and 2019: EEAG forecast.

Table 1.A.2

GDP Growth, Inflation, and Unemployment in EU Countries

	Share of total GDP in %	GDP growth			Inflation[a]			Unemployment rate[b]		
		in %								
		2017	2018	2019	2017	2018	2019	2017	2018	2019
Germany	21.3	2.5	1.5	0.9	1.7	1.7	2.1	3.8	3.4	3.1
France	14.9	2.3	1.5	1.1	1.2	2.1	1.6	9.4	9.0	8.6
Italy	11.2	1.7	0.8	0.9	1.3	1.2	1.2	11.2	10.6	10.4
Spain	7.6	3.0	2.5	2.0	2.0	1.7	1.6	17.2	15.4	13.3
Netherlands	4.8	3.0	2.8	2.5	1.3	1.6	2.0	4.9	3.9	3.5
Belgium	2.9	1.7	1.5	1.5	2.2	2.2	1.9	7.1	6.0	6.3
Austria	2.4	2.7	2.7	2.0	2.2	2.0	2.0	5.5	4.9	4.7
Finland	1.9	7.3	5.5	3.5	0.3	0.7	1.2	6.7	5.3	5.1
Portugal	1.5	2.8	2.8	1.9	0.8	1.2	1.5	8.6	7.6	7.2
Greece	1.3	2.8	2.2	1.9	1.6	1.2	1.6	9.0	7.0	6.5
Ireland	1.2	1.5	2.1	2.2	1.1	0.8	1.2	21.5	19.5	18.0
Slovakia	0.6	3.2	4.0	4.2	1.4	2.5	2.4	8.1	6.6	6.5
Luxembourg	0.3	5.3	4.4	3.4	1.6	1.9	2.2	6.6	5.3	5.3
Slovenia	0.4	1.6	3.4	3.2	2.1	2.0	1.9	5.6	5.3	5.2
Lithuania	0.3	4.2	3.6	2.9	3.7	2.5	2.2	7.1	6.2	6.2
Latvia	0.2	5.0	4.2	3.5	2.9	2.6	2.5	8.7	7.4	7.2
Estonia	0.2	4.8	3.5	3.2	3.7	3.4	2.9	5.8	5.6	6.4
Cyprus	0.1	4.2	3.9	3.0	0.7	0.8	1.6	11.1	8.8	7.1
Malta	0.1	6.7	5.5	4.7	1.3	1.7	2.0	4.0	3.8	4.0
Euro area[c]	**72.9**	**2.5**	**1.9**	**1.4**	**1.5**	**1.7**	**1.7**	**9.1**	**8.2**	**7.6**
United Kingdom	15.2	1.8	1.3	1.3	2.7	2.3	2.0	4.4	4.1	4.2
Sweden	3.1	2.4	2.4	2.0	1.9	1.9	1.8	6.7	6.3	6.2
Denmark	1.9	2.3	1.2	1.9	1.1	0.7	1.6	5.7	4.9	5.1
EU 22[c]	**93.0**	**2.4**	**1.8**	**1.4**	**1.7**	**1.8**	**1.8**	**8.2**	**7.5**	**7.0**
Poland	3.0	4.8	4.8	3.5	1.6	1.2	2.7	4.9	3.9	3.4
Czech Republic	1.2	4.6	3.0	2.7	2.4	1.9	2.3	2.9	2.2	2.6
Romania	1.2	6.8	3.8	3.5	1.1	4.0	3.1	4.9	4.2	4.5
Hungary	0.8	4.4	4.3	3.4	2.4	2.8	3.3	4.2	3.7	3.3
Bulgaria	0.3	3.8	3.6	3.2	1.2	2.6	2.2	6.2	5.4	5.7
Croatia	0.3	3.0	2.8	2.5	1.3	1.6	1.5	11.1	8.6	9.4
New Members[d]	**8.4**	**4.8**	**4.1**	**3.3**	**1.8**	**2.2**	**2.6**	**4.9**	**4.1**	**4.0**
EU 28[c]	**100.0**	**2.6**	**1.9**	**1.5**	**1.7**	**1.8**	**1.8**	**7.6**	**6.9**	**6.3**

[a] Harmonised consumer price index (HICP); [b] Standardised unemployment rate; [c] Weighted average of the listed countries; [d] Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria.

Note: GDP growth rates are based on the calender adjusted series except for Ireland, Slovakia and Romania for which Eurostat does not provide working day adjusted GDP series.

Source: Eurostat; 2018 and 2019: EEAG forecast.

Tab 1.A.3

Key Forecast Figures for the European Union

	2017	2018	2019
	Percentage change over previous year		
Real GDP	2.5	1.9	1.5
Private consumption	2.1	1.6	1.2
Government consumption	1.0	0.9	1.0
Gross fixed capital formation	2.5	4.3	2.7
Exports of goods and services	5.6	2.6	2.6
Imports of goods and services	4.4	2.8	2.7
Net exports[a]	0.6	0.0	0.0
Consumer prices[b]	1.7	1.8	1.8
	Percentage of nominal GDP		
Government fiscal balance[c]	– 1.0	– 0.7	– 0.8
	Percentage of labour force		
Unemployment rate[d]	7.6	6.9	6.3

[a] Contributions to changes in real GDP (percentage of real GDP in previous year); [b] Harmonised consumer price index (HCPI); [c] 2018 and 2019: forecasts of the European Commission; [d] Standardised unemployment rate

Source: Eurostat; 2018 and 2019: EEAG forecast.

Table 1.A.4

Key Forecast Figures for the European Area

	2017	2018	2019
	Percentage change over previous year		
Real GDP	2.5	1.9	1.4
Private consumption	1.7	1.3	1.2
Government consumption	1.2	1.0	1.2
Gross fixed capital formation	2.9	3.2	2.4
Exports of goods and services	5.4	3.0	3.0
Imports of goods and services	4.1	2.9	3.1
Net exports[a]	0.8	0.2	0.1
Consumer prices[b]	1.5	1.7	1.7
	Percentage of nominal GDP		
Government fiscal balance[c]	– 1.0	– 0.6	– 0.8
	Percentage of labour force		
Unemployment rate[d]	9.1	8.2	7.6

[a] Contributions to changes in real GDP (percentage of real GDP in previous year); [b] Harmonised consumer price index (HCPI); [c] 2018 and 2019: forecasts of the European Commission; [d] Standardised unemployment rate

Source: Eurostat; 2018 and 2019: EEAG forecast.