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Eurozone
economic
outlook

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Expansion continues amid uncertainty

Economic expansion in the euro area will to continue over the forecast horizon, but at a slower pace than in 2017. In Q2 and Q3 2018, the economy of the Eurozone is expected to grow at the same rate as in Q1 2018 (+0.4%), before slightly accelerating to +0.5% in Q4 2018. The main driver behind this expansion in economic activity will be gross fixed capital formation, still driven by favourable financing conditions. Investment is projected to increase in Q2 2018 at the same pace as in Q1 2018 (+0.5%) and to slightly accelerate in the second half of 2018 (+0.6%). Private consumption expenditures are expected to modestly increase by +0.3% per quarter over the forecast horizon. Inflation is forecast to gain momentum over the forecast horizon, after picking up in Q2 due to energy prices. Risks have increased. Internal political tensions and spreading protectionist measures at the global level could hamper a prolonged expansion.

Global economy continues expanding

Growth in global economic activity remains strong and broad based, with global real GDP projected to increase by +3.8% in 2018 from +3.7% in 2017 according to OECD data. Global trade, a major driver of growth last year, is expected to continue to increase by +4.7% in 2018.

Weaker expansion than expected

In Q1 2018, GDP in the euro area increased by +0.4%, slowing down considerably compared to the growth rate registered in Q4 2017 (+0.7%). A wave of strikes and adverse weather conditions constrained the expansion in France and Germany, and weak public consumption expenditures were a drag on German growth.

In Q1 2018, private consumption and investment positively contributed to GDP growth (+0.3 and +0.1 percentage points respectively), whereas exports declined by -0.4%, after being the main driver of economic expansion in the euro area during 2017, only partially offset by lower imports.

TABLE 1 | Forecasts 2018

% Change, seasonally and working day adjusted

	Q2/2018		Q3/2018		Q4/2018		2018
	q/q	*y/y*	***q/q***	*y/y*	***q/q***	*y/y*	*Year average*
IPI	**0.1**	2.5	**0.3**	1.1	**0.4**	0.2	1.8
GDP	**0.4**	2.2	**0.4**	1.9	**0.5**	1.7	2.1
Consumption	**0.3**	1.4	**0.3**	1.3	**0.3**	1.4	1.4
Investment	**0.5**	2.1	**0.6**	3.0	**0.6**	2.2	2.7
Inflation		1.7		2.0		1.7	1.7

Source: ifo-Istat-KOF forecast

Coincident and leading business cycle indicators for the euro area depict a more uncertain and less optimistic picture of economic developments in the next quarters, though they are higher than in the past.

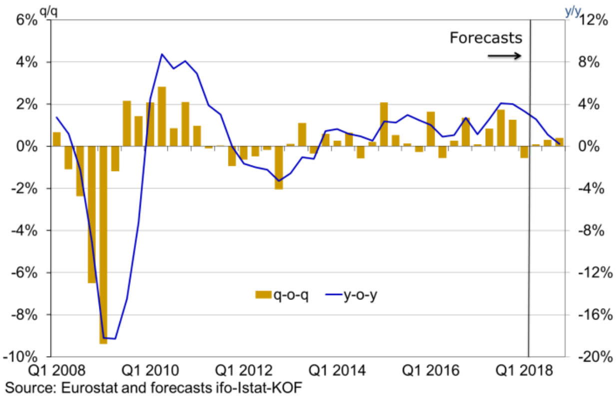
Industrial production (excluding construction) declined (m-o-m) in January and February 2018 (-0.6% and -0.9% respectively), then rose by +0.5% in March followed by a new decline in April (-0.9%). The industrial production index is forecast to grow at low but increasing rates over the forecast horizon (+0.1%, +0.3% and +0.4% in Q2, Q3 and Q4 2018 respectively). Production in construction increased by +1.8% in April following the decline of the first months of 2018.

The Purchasing Managers' Index (PMI) started declining in February 2018 after peaking in January, and it is still displaying a downward trend. Other sentiment indicators (industrial confidence and the economic sentiment) show a similar declining pattern since the beginning of 2018, whereas the consumer confidence indicator remains stable after a slight decline in the first months of 2018. Capacity utilization declined in Q2 2018, thus interrupting an upward trend started since the second half of 2016.

In the first months of 2018, labor market conditions continued to improve, with declining unemployment reflecting the favorable overall economic conditions. The unemployment rate was 8.5% in April, down from 8.6% in March. Employment kept an upward trend in 2017 and increased by +0.4% in Q1 2018.

FIGURE 1 | Eurozone Industrial Production Index

Seasonally and working day adjusted

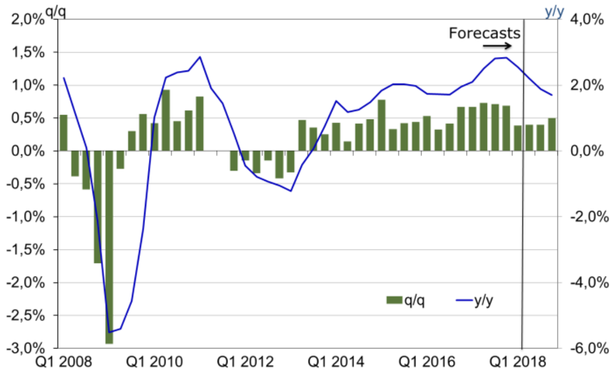


Source: Eurostat and forecasts ifo-Istat-KOF

Private consumption and investment are both expected to continue to expand over the forecast horizon, supported by improved economic, labor market and bank lending conditions in the euro area. Investment is projected to be the major driver of economic expansion.

FIGURE 2 | Eurozone GDP Growth

Seasonally and working day adjusted



Source: Eurostat and forecasts ifo-Istat-KOF

Overall, the growth of euro area economic activity is expected to continue at the same pace in in Q2 and Q3 2018 (+0.4%) with a small acceleration in Q4 (+0.5%).

Accelerating inflation

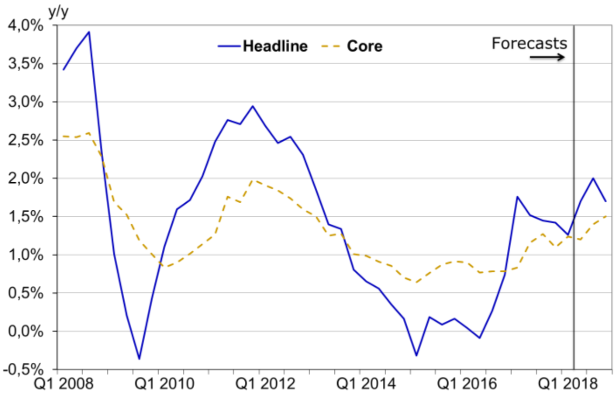
The harmonized index of consumer prices (HICP) picked up by +1.9% in May from +1.2% in April, mainly due to rising energy prices. Core inflation remained between +1.2% and +1.3% in the first months of 2018.

Headline consumer price inflation and core inflation are both expected to increase over the forecast horizon. Year-on-year HICP inflation is forecast to be 1.7% in Q2 2018 and to pick up to 2.0% in Q3, fueled by upward trending core inflation. In Q4, inflation is expected to decelerate again to 1.7%. Core inflation is projected to increase over the forecast horizon, with a marked acceleration in the second half of 2018, sustained by economic expansion.

The inflation forecast is based on the technical assumption that the Brent oil price remains stable at 75 USD per barrel and that the USD/Euro exchange rate stays at 1.17 over the forecast horizon.

FIGURE 3 | Eurozone Inflation

Harmonised Index of Consumer Price (HICP), y-o-y growth rates



Source: Eurostat and forecasts ifo-Istat-KOF

Risks to expansion drivers

The risks for the economic development in the euro area have increased.

The euro area could be especially vulnerable to ongoing trade tensions, due to its openness and the current relevance of investment and exports as drivers of the economic expansion. Increasing and spreading protectionist measures are likely to weaken external demand and negatively affect growth of investment. Moreover, the sizeable fiscal stimulus in the US could still lead to a stronger monetary policy reaction. Possible corrections in financial markets due to higher interest rates could lead to tighter financial market conditions, which would negatively affect investment.

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Methodological note

This quarterly publication is prepared jointly by the German ifo Institute, the KOF Swiss Economic Institute, and the Italian Istat Institute. The forecast results are based on consensus estimates building on common macroeconomic forecast methods by the three institutes. They are based on time-series models using auxiliary indicators from business surveys by national institutes, Eurostat, and the European Commission. The joint three-quarter forecast covers Eurozone industrial production, GDP, consumption, investment, and inflation. Further country-specific and global economic analysis is available by:

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