

September 20th, 2018

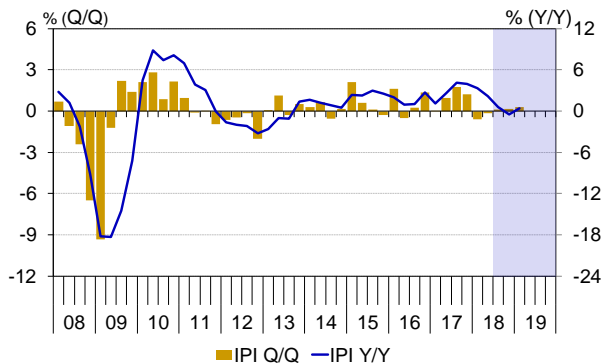
Moderate economic growth continues

- Economic growth is forecast to keep the pace registered in the first half of 2018. Gross fixed capital formation is expected to be the main driver of growth due to still favorable financing conditions and expectations on economic activity remaining positive.
- Annual inflation is expected to be around the ECB target of 2% until the end of the year, fueled by substantial increases in energy prices. Core inflation remains subdued.
- Risks to the outlook continue to originate from global trade tensions and an escalation of the currency crises in some developing economies.

Expansion continues steadily

Dragged down by weak foreign trade, euro area GDP increased by +0.4% in both Q1 and Q2, slowing down substantially compared to an average of +0.7% in 2017. Whereas a slight deceleration was common to most euro area countries, the slowdown was particularly severe in France.

FIGURE 1 | Eurozone Industrial Production Index
Seasonally and working day adjusted

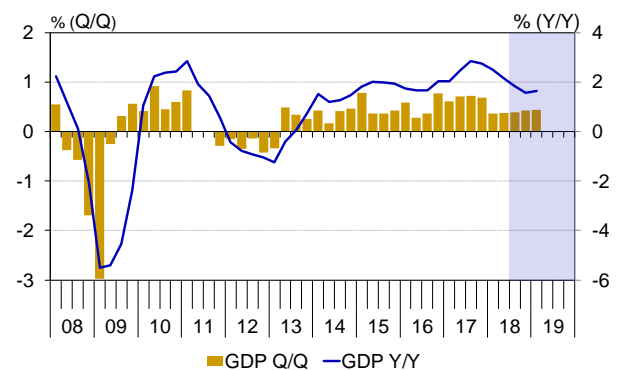


Source: Eurostat and Ifo-Istat-KOF Forecasts

This slowdown is also reflected in economic sentiment indicators. The economic sentiment indicator (ESI) declined also in August, mostly due to a drop in consumer confidence and sentiment in the services sector. Similarly, the purchasing managers index (PMI) has decreased from over 60 points at the beginning of the year to 54.4 in August. Despite this decline, the survey indicators are still above their long-term average.

Hard indicators showed a decline as well. Industrial production set a negative tone for Q3 with a contraction of -0.8% in July. Recently, retail trade has softened as well with a decline of -0.2% in July. On the other hand, production in the construction industry has recovered from unfavorable weather conditions in winter and has expanded steadily in Q2 (+1.3%).

FIGURE 2 | Eurozone GDP Growth
Seasonally and working day adjusted



Source: Eurostat and Ifo-Istat-KOF Forecasts

In the forecast horizon, the economy of the eurozone is expected to grow at the same pace as in the first half of 2018. This results in a steady expansion of GDP by around +0.4% in each quarter of the forecasting horizon.

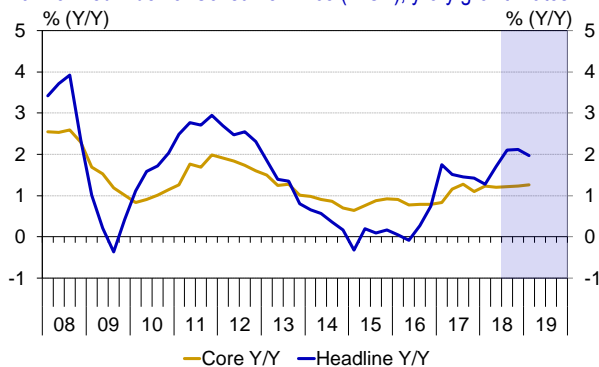
The main driver will be investments, as businesses take advantage of the still favorable financing conditions and solid demand. The high level of capacity utilization is also a positive signal for business investment in the near term. Gross fixed capital formation is projected to increase in Q3 and Q4 by +0.7% and then slightly decelerate in Q1 2019 (+0.6%). Private consumption expenditures are expected to expand by +0.3% in Q3 before picking up to +0.4% in the following quarters, supported by favorable labor market conditions. Industrial production (excluding construction) is forecast to grow at low but increasing rates over the forecast horizon (+0.1%, +0.2% and +0.3% respectively).

Energy prices drive inflation

Headline inflation, measured as annual changes in the Harmonized Index of Consumer Prices (HICP), was at +2.0% in August 2018, mainly due to the rise in energy prices since last year. Inflation is forecast to remain at 2.1% until the end of the year and then decline to +2.0% as the base effects from past energy price increases start to fade.

FIGURE 3 | Eurozone Inflation

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



Source: Eurostat and Ifo-Istat-KOF Forecasts

At the same time, core inflation is expected to hover around the +1.2% registered in August 2018. There is still no upward trend in price pressure, despite several potential drivers. Production factors appear increasingly used to capacity, the unemployment rate has fallen by one percentage point to 8.2% in the last twelve months and capacity utilization in the manufacturing industry stands close to all-time highs.

Risks from global environment

Risks to the outlook continue to originate from global trade tensions as the United States engage in aggressive trade negotiations. Even though the focus is currently on China, Canada and Mexico, a marked slowdown in global trade would be likely to have adverse effects on the euro area as well.

Another risk stems from the rapid tightening of monetary policy in the United States. The divergence in real interest rates has already led to a depreciation of most currencies against the US-Dollar. A further escalation could lead to a currency crisis in some developing economies such as Turkey and Argentina. This in turn would have repercussions in the global economy.

Table 1 | Forecast Overview

	2018	Q3 18		Q4 18		Q1 19	
		q/q	y/y	q/q	y/y	q/q	y/y
Industrial Production	1.4	0.1	0.6	0.2	-0.5	0.3	0.4
Gross Domestic Product	2.0	0.4	1.8	0.4	1.6	0.4	1.6
Private Consumption Expenditures	1.4	0.3	1.3	0.4	1.4	0.4	1.3
Gross Fixed Capital Formation	3.2	0.7	3.6	0.7	2.8	0.6	3.2
Headline Inflation	1.8	0.2	2.1	0.7	2.1	-0.3	2.0
Core Inflation	1.2	-0.1	1.2	0.4	1.2	-0.5	1.3

Change in % seasonal and working day adjusted

Source: ifo-Istat-KOF Forecasts

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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