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# **Descending Economic Expectations - IW Economic Forecast Autumn 2018**

IW Research Group Macroeconomic Analysis and Forecast

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# Descending Economic Expectations - IW Economic Forecast Autumn 2018

IW Research Group Macroeconomic Analysis and Forecast, September 2018

## Abstract

The global economy is not immune to a resurgence of protectionism. Trade in goods in particular has stagnated in the year to date while global investment growth is slowing again. Economic activity is being further hobbled by institutional problems in a number of emerging economies and by rising energy prices. This has put some expectations of growth on a downward trajectory, albeit with no anticipation of a crash landing. The subdued global environment has slowed down exports and industrial production in Germany as well, significantly reducing expectations for them in the 2018 and 2019 forecast period. As a result, investment activity in Germany is also losing momentum. On the other hand, persistently robust private and public consumption are keeping the risk of stagnation at bay. Nevertheless, the slight slowdown in the labour market and a steeper rise in consumer prices are making themselves felt. While real gross domestic product is expected to grow by 1.8 per cent in 2018, next year economic growth will amount to only 1.4 per cent. This is enough to keep unemployment falling. With lower interest obligations and employment-driven revenue growth, the public sector budget will continue untroubled.

Keywords: business cycle, labour market, government budget, financial markets

JEL classification: E2, E3, E5, E6

### World trade not immune to protectionism

The world economy is not immune to the *protectionist* political environment. New tariffs, tariff threats and other trade-restrictive measures by the US nearly brought the world to the brink of a trade war that could have provoked a crash in the world economy. In mid-2018, the tensions in the transatlantic trade relations appear to have eased. But the escalation of the trade dispute between the US and China seems to be progressing. The unpredictability of the US administration remains a significant political and economic risk to the global economy. The political situation in a number of emerging economies has also put pressure on their economic prospects and made them more vulnerable to crises. Political uncertainties are omnipresent.

This also means that the *robustness of the financial markets* is once again under scrutiny. Financial instability has the potential to adversely affect the economic situation via three channels:

- The currency crisis in Turkey could intensify, leading to significant spill-overs to other emerging economies and, in the event of an escalation, also affecting European banks.
- Italy's high public debt and the policy course of the Italian government may lead to a resurgence of the banking and sovereign debt crisis in the euro area. The markets already reacted with minor turbulences to statements by the Italian government. Overall, there is no acute but a latent risk that investors lose their confidence in Italy's financial sustainability.
- For the stability of financial markets there is also the risk of a disorderly Brexit. It is still unclear to what extent existing financial relationships of EU companies to the City of London will remain intact after Brexit. This affects derivatives contracts and credit relationships as well as benchmark interest rates and ratings that have been issued in the UK and that may no longer remain valid in the EU (IW-Forschungsgruppe Konjunktur, 2018, p. 12 ff.). In addition, a no-deal Brexit would also disturb the trade flows and could impact negatively on the real economy of the affected trade partners.

Against this background, the economic risks for the world economy have risen again and the *global economic policy outlook* has deteriorated somewhat since the

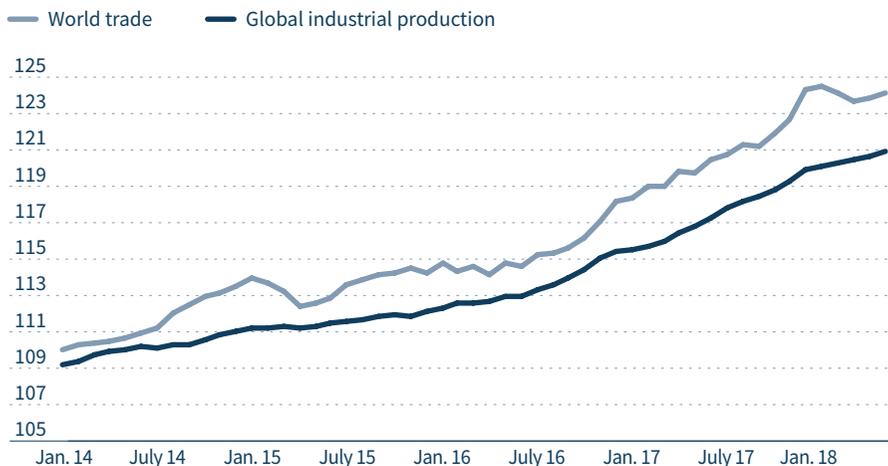
spring of 2018. Global economic policy uncertainty is high – with the index average of May to July 2018 being more than 90 per cent higher than the 1997–2015 long-term average (Economic Policy Uncertainty, 2018). The ifo World Economic Climate indicates a sharp decline in the third quarter of 2018 and expectations fell to their lowest level since 2011 (ifo, 2018). The deteriorated outlook is prevalent in almost all regions of the world - in the European Union, in North and Latin America as well as in the emerging and developing Asian countries, including China. A particular source of concern is the escalation of the trade conflict between the US and important trading partners since March 2018. The protectionist measures and the resulting uncertainty have led to an impairment of trade flows and to trade diversion. After a temporarily accelerated momentum towards the end of 2017, global trade activity slowed significantly in the course of 2018 (Figure 1). Still, the level of world trade in the first half of 2018 was on average 4.0 per cent higher year on year. But the increase is mainly due to the high trade level already reached at the end of 2017. Also, global investment activity is likely dampened by the decline in trade growth and the heightened uncertainty in the global trading environment.

Another dampening economic effect relevant for the global economy comes from the renewed *rise in oil prices* as a result of heightened tensions in the Middle East.

### World trade and global industrial production

Figure 1

Three-month moving averages; price and seasonally adjusted, 2010 = 100



Sources: CPB; Institut der deutschen Wirtschaft

Figure 1: <http://dl.iwkoeln.de/index.php/s/HPpk4G6z3LwL8AN>

The Brent oil price was just under \$ 75 per barrel in the second quarter of 2018. This represents an increase of almost 50 per cent year on year. Should this upward trend continue, economic growth will decline in many countries. To assess the effect, scenario analyses were conducted with the Oxford Economics Global Economic Model allowing for an oil price increase up to \$ 80 per barrel in the course of 2018 and a continuation at that level in 2019. As a basis for comparison a further scenario was developed with an oil price decrease to \$ 60 in 2018 and staying at that level in 2019 – i.e. around the level reached one year ago. On average, for major advanced countries such as Germany and oil-importing emerging markets, negative GDP effects due to the assumed higher oil prices can be as high as about a quarter of a percentage point.

### Global economy has lost momentum

Signs of *slightly subdued dynamics* have already been evident in many countries (Table 1). Economic recovery following the economic crisis in countries like Spain and Portugal has increasingly been replaced by recurring normality. In France, the stable economic momentum still remains somewhat below the expectations of many economic agents, so that the forecasts have been revised downwards in the course of 2018. In Italy, political uncertainty since the elections and the lack of structural reforms have slowed down economic development. The UK continues to benefit from the global economy. However, uncertainty about a possible no-deal Brexit dampens economic momentum and leaves it well below the pace of growth prior to the referendum.

In the second quarter of 2018, the *United States* recorded the highest quarterly economic growth in nearly four years, at 1.0 per cent. But the economy starts to reach its capacity limits. Positive effects come from fiscal policy, which however also contributes to the overheating tendencies. The Federal Reserve therefore envisages a further tightening of the monetary policy stance until the end of 2018 and in the course of 2019. In the euro area, on the other hand, monetary policy will be supportive. On 26 July 2018, the Governing Council of the ECB decided to keep interest rates at the current extremely low level at least until the summer of 2019. The net acquisition of public and private bonds is expected to end by the end of 2018. However, returns from expiring bonds are to be reinvested, so that monetary policy in the euro area will continue to be expansionary for some time. The diverging

**IW world economic outlook autumn 2018**

Table 1

Year-on-year change in real GDP in per cent

	2017	2018	2019
Germany	2.2	1.8	1.4
France	2.3	1 ¾	1 ¾
Italy	1.5	1	1
Spain	3.1	2 ¾	2 ¼
Netherlands	2.9	2 ¾	2 ¼
Belgium	1.7	1 ¾	1 ½
Austria	3.0	2 ¾	2
Ireland	7.2	5	3 ½
Finland	2.6	2 ¼	2
Portugal	2.7	2 ¼	2
Greece	1.4	2	2
<b>Euro countries<sup>1) 2)</sup></b>	<b>2.4</b>	<b>2</b>	<b>1 ¾</b>
USA	2.2	2 ¾	2 ½
Japan	1.7	1 ¼	1
United Kingdom	1.7	1 ¼	1 ½
Canada	3.0	2 ¼	2
Switzerland	1.1	2 ¼	1 ¾
<b>Advanced economies<sup>1) 3)</sup></b>	<b>2.1</b>	<b>2 ¼</b>	<b>2</b>
China	6.9	6 ½	6 ¼
India	6.7	7 ½	7
Brazil	1.0	2	2 ½
Russia	1.5	1 ¾	1 ¾
<b>BRIC<sup>1)</sup></b>	<b>5.8</b>	<b>5 ¾</b>	<b>5 ½</b>
<b>World economy</b>	<b>3.7</b>	<b>3 ½</b>	<b>3 ¼</b>
World trade	4.6	4	3 ½

1) Weights: GDP, 2017. 2) Without Slovakia, Slovenia, Malta, Cyprus, Luxembourg and Estonia.

3) Weighted average of advanced economies listed above beyond the euro countries.

Sources: Consensus Forecasts; CPB; IWF; Oxford Economics; Institut der deutschen Wirtschaft

Table 1: <http://dl.iwkoeln.de/index.php/s/W8dwCiSMMp6Gy9>

monetary policies are expected to favour the price competitiveness of the euro area.

Economic development in *emerging markets* remains highly differentiated. Supported by government spending and other policy measures, economic growth remains above 6 per cent in China, despite the trade conflict with the most important export destination USA. Oil exporters have benefitted from oil price increases. Brazil is struggling with political uncertainty in the country and Mexico's economy is being weighed down by the uncertainty surrounding renegotiation of the NAFTA

free trade agreement. Some emerging economies, such as Turkey, have faced the problem of increasing capital flight – a trend resulting from re-evaluation of the risks by economic agents, which is likely to be exacerbated by monetary policy in major advanced economies (Matthes, 2018). A broad-based and profound emerging market crisis is not expected in this forecast.

Overall, the *renewed global uncertainty* is leaving its mark on the global pace of expansion. While the development of the global economy remains on the upside, economic momentum will ease slightly over the forecasting period. Global output is expected to grow at 3 ½ per cent in 2018 and 3 ¼ per cent in 2019. In view of the US trade conflict with China and other trading partners, world trade growth is likely to slow down to 3 ½ per cent in the coming year – after 4 per cent this year. The underlying assumption of this forecast is that risks such as a no-deal-Brexit or a further escalation of the trade conflict between the USA and other important trading partners will not materialise.

### **Germany: consumption robust, investment vulnerable**

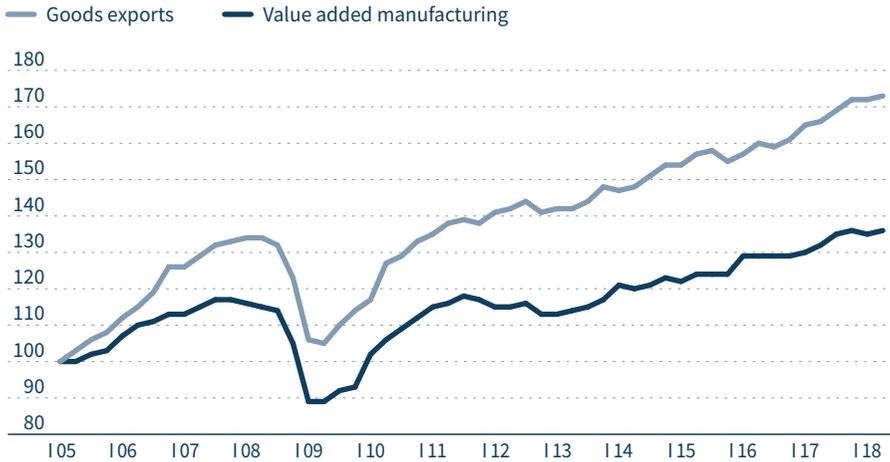
In this weaker international environment, the German economy performed comparatively well in the first half of 2018. In price-adjusted terms, exports exceeded the corresponding figure of the previous year by 3.2 per cent. At the same time, real imports increased by 3.4 per cent. The main contributor to GDP growth of just under 1.9 per cent was still booming domestic demand. Both, private consumption (+1.3 per cent) and government consumption (+0.9 per cent) provided significant impetus. Investments also rose sharply year-on-year. Investment in machinery and equipment even recorded a plus of 5 per cent year on year. However, this was mainly due to the upturn in the first quarter of 2018. Possibly, the resurging uncertainty in the second quarter had a dampening effect. Construction investment increased by 2.4 per cent. Consumption and housing continue to feel the persistently good labour market conditions.

However, this encouraging year-on-year comparison for the first half of 2018 somewhat hides a sagging economic momentum. In the first quarter of 2018, price, season and working day adjusted GDP increased by almost 0.4 per cent compared with the previous quarter. In the second quarter, the plus was just under 0.5 per cent due to extremely high inventory investments. However, on average for 2017,

### German goods exports and manufacturing added value

Figure 2

Price, seasonally and working day adjusted values; Index: 1st quarter 2005 = 100



Sources: Statistisches Bundesamt; Institut der deutschen Wirtschaft

Figure 2: <http://dl.iwkoeln.de/index.php/s/ZbP9s0ppog9ROd4>

quarterly growth was 0.7 per cent. The noticeably weaker growth in German goods exports and in terms of the GDP output approach in manufacturing value added is clearly visible (Figure 2). This is a reflection of international developments (see Figure 1) and concerns about an international trade war. While German exports of goods, which were adjusted for price, season and working day, showed quarterly growth of 1.8 per cent in each of the quarters in 2017 compared to the previous quarter, this was considerably weaker in the first half of 2018, at just under 0.3 per cent. Manufacturing grew by an average of 1.3 per cent in 2017 from quarter to quarter. But manufacturing value added stagnated in the first half of 2018. Based on the national accounts data, the export and industrial dynamics made the second quarter somewhat better than the first quarter of 2018. However, the high inventory investment and the slightly weaker dynamics based on value added according to the output approach of GDP also make a later downward revision possible.

In view of the international environment and the initial situation in the first half of 2018, the following developments are now expected for the forecast period 2018 and 2019 (Table 2):

**Expenditure approach of GDP in Germany**

Table 2

Change versus previous year in per cent and growth contributions in percentage points; price-adjusted values

	Growth rates in per cent		Growth contributions in percentage points	
	2018	2019	2018	2019
Private consumption	1.3	1.4	0.7	0.7
Public consumption	1.3	1.5	0.3	0.3
Total consumption	1.3	1.4	1.0	1.0
Gross fixed capital formation	2.8	2,5	0.6	0.5
Machinery/equipment	4.5	3.6	0.3	0.2
Other investments	2.0	2.0	0.1	0.1
Construction	2.0	1.5	0.2	0.1
Changes in inventories	-	-	0.2	-0.2
Domestic demand	1.9	1.5	1.7	1.4
Balance of exports and imports	-	-	0.0	0.1
Exports	3.0	3.5	1.4	1.7
Imports	3.5	4.0	-1.4	-1.6
Gross domestic product (GDP)	1.8	1.4	-	-

Sources: Statistisches Bundesamt; Institut der deutschen Wirtschaft

Table 2: <http://dl.iwkoeln.de/index.php/s/ChnrDaSyWd4u0K3>

German *foreign trade* will experience little additional momentum in the second half of 2018. This is signaled by orders and sentiment indicators. Due to the moderate global economy in the coming year, the slowdown in world trade and in global investment activity, the pace of German exports will remain subdued. Real exports will increase by 3 per cent in 2018 and by 3.5 per cent in 2019. Because imports are rising faster due to the good domestic economy, net exports are not generating growth momentum. The nominal current account surplus declines slightly.

*Investment* in equipment is still expanding. However, the momentum has already slowed down and the investment climate remains marked by prudence and susceptible to uncertainty despite favourable financing conditions and well-utilised capacities. In real terms, growth of 4.5 per cent is expected for 2018, and an increase of 3.6 per cent is forecasted for 2019. Construction investment will expand by 2 per cent this year and 1.5 per cent next year.

Conditions regarding private *consumption* have hardly changed since spring 2018. Employment prospects remain good despite declining momentum and consumer sentiment is confident, albeit regressive. For this year, an increase in real private consumption of just over 1.3 per cent is forecasted. Higher inflation rates because of rising energy costs are also having a dampening effect. Real private consumption will increase by around 1.4 per cent in 2019.

The high growth contributions of private and public consumption of around 1 percentage point in 2018 and 2019 keep the momentum of real GDP well out of economic crash-landing territory. Foreign trade is neutral for growth in both years. The growth contribution of investment in fixed assets is more than ½ percentage point this year, slightly higher than in the coming year. Inventory investment in 2018 are expected to provide significant growth momentum, but they will probably decrease momentum by the same extent next year. Real GDP will grow by 1.8 per cent in 2018 and by 1.4 per cent in 2019. Compared to the spring forecast 2018 (IW-Forschungsgruppe Konjunktur, 2018), the foreign trade and investment forecast was noticeably revoked. This is a result of the weaker global economy due to the trade conflict between China and the US and higher oil prices.

### Employment growth continues

The slight deterioration of expectations for economic growth compared to the spring forecast (IW-Forschungsgruppe Konjunktur, 2018) will affect the labour market only marginally. Prospects for employment foresee continued substantial growth. At the beginning of the year, the seasonally adjusted employment was already 0.9 per cent higher than the yearly average in 2017 and has since increased even further. This overhang will contribute to an average yearly employment growth rate of 1.2 per cent, even if the labour market will start to slow down somewhat in the second half of the year (Table 3).

Reduction of unemployment will continue, albeit without matching the number of newly created jobs. Immigrants and workers entering the labour force will take most new jobs. In the next year, employment growth will slow down to 0.8 per cent, in part because of a lesser impact of the overhang effect. Nevertheless, an additional 360.000 jobs will be created. Unemployment continues to fall, but at reduced speed.

## Labour market and production account

Table 3

	2017	2018	2019	2018	2019
	Absolute values			Per cent change to previous year	
Employment (1,000 persons)	44,269	44,820	45,180	1.2	0.8
Working time (hours)	1,360.4	1,357.5	1,357.0	-0.2	0
Labour volume (billion hours)	60.22	60.87	61.35	1.0	0.8
Real GDP	-	-	-	1.8	1.4
Real GDP per person	-	-	-	0.6	0.6
Real GDP per hour worked	-	-	-	0.8	0.6
ILO unemployment (1,000 persons)	1,633	1,512	1,428	-	-
ILO unemployment rate (per cent)	3.6	3.3	3.1	-	-
Registered unemployment (1,000 persons)	2,533	2,352	2,247	-	-
Registered unemployment rate (per cent)	5.7	5.2	5.0	-	-

Sources: Bundesagentur für Arbeit; Statistisches Bundesamt; Institut der deutschen Wirtschaft

Table 3: <http://dl.iwkoeln.de/index.php/s/egEIN1VEPbKpHP2>

### Persistently comfortable budget situation

In the first half of 2018, public revenues in Germany were 48.1 billion euros higher than public expenditures, according to national accounts (Statistisches Bundesamt, 2018). Regarding fiscal balance, the first half year was already better than the entire year 2017, in which the surplus amounted to just over 38 billion euros.

While revenues have once more exceeded expectations, two special factors were decisive on the expenditure side: First, interest expenditures paid by the federal states and the municipalities fell by almost 10 per cent because of debt repayments in 2017. And secondly, the delay in forming a new federal government after national elections in 2017 led to a forced postponement of planned disbursements. These have meanwhile been authorised and revised upwards in the setup of the new federal financial plan (Beznoska/Hentze, 2018) and will show up in the books in the second half of the year. The mid-year surplus of 19.5 billion euros on the federal government level is thus likely to shrink during the second half of 2018. The minor economic cool-down expected for the second half of the year will contribute to keeping the predicted record surplus of 53 billion euros not too far above the half-year mark (Table 4).

## Government account for Germany

Table 4

	2017	2018	2019
in billion euros			
<b>Revenues</b>	<b>1,473</b>	<b>1,544</b>	<b>1,592</b>
Taxes	766	802	823
Social security contributions	548	570	590
<b>Expenditures</b>	<b>1,435</b>	<b>1,491</b>	<b>1,554</b>
Compensation of employees	246	254	260
Social benefits	784	818	858
Subsidies	28	29	30
Gross investments	70	78	82
<b>Fiscal balance</b>	<b>38</b>	<b>53</b>	<b>37</b>
in per cent of GDP			
Public expenditure quota <sup>1)</sup>	44.0	44	44 ½
Tax and contribution ratio <sup>2)</sup>	39.9	40	40
Tax ratio <sup>3)</sup>	23.8	24	24
Fiscal balance	1.2	1 ½	1

1) Public expenditure. 2) Taxes (including taxes to EU) and social security contributions (without imputed social security contributions of civil servants). 3) Tax revenue of federal government, federal states and municipalities (including taxes to EU).

Sources: Statistisches Bundesamt; Institut der deutschen Wirtschaft

Table 4: <http://dl.iwkoeln.de/index.php/s/8smfi0gR4fltqcX>

In 2019, additional granted benefits in the statutory pension insurance, which has been promised by the federal government, will accelerate the already high growth in public spending. The expected return of the public balance to the surplus level of 2017 to the tune of 37 billion euros will mostly be due to the economic slow-down, which will result in an approximately 1 ½ percentage point weaker revenue growth next year.

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**IW forecast for Germany 2018 and 2019**

Change compared to previous year in per cent

	2017	2018	2019
<b>Output approach of GDP</b>			
Persons in employment	1.4	1.2	0.8
Unemployment rate <sup>1)</sup>	5.7	5.2	5.0
Labour volume	1.3	1.0	0.8
Productivity <sup>2)</sup>	0.9	0.8	0.6
Gross domestic product	2.2	1.8	1.4
<b>Expenditure approach of GDP</b>			
Private consumption	1.8	1.3	1.4
Public consumption	1.6	1.3	1.5
Gross fixed capital formation	2.9	2.8	2.5
Machinery/equipment	3,7	4.5	3.6
Other investment <sup>3)</sup>	1.3	2.0	2.0
Construction	2.9	2.0	1.5
Domestic demand	2.0	1.9	1.5
Exports	4.6	3.0	3.5
Imports	4.8	3.5	4.0
Gross domestic product	2.2	1.8	1.4
<b>Prices</b>			
Consumer prices	1.8	1.9	1.9
<b>Government</b>			
Fiscal balance <sup>4)</sup>	1.2	1.5	1.0

1) Registered unemployed as a percentage of the labour force.

2) Real GDP per hour worked.

3) Intellectual property products.

4) As a percentage of nominal GDP.

Sources: Statistisches Bundesamt; IW autumn forecast, September 2018

Table 5: <http://dl.iwkoeln.de/index.php/s/vWTQZQenChPiaQx>

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