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OXFORD ECONOMICS

Country Economic Forecast
Eurozone

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Q1 GDP growth of 0.4% in line with expectations…

- **Eurozone GDP growth slowed to 0.4% q/q in Q1, in line with our expectations. There will be no detailed breakdown until next month, but available figures suggest that both household spending and exports were the main causes of the slowdown. We expect some of this weakness to be transitory, so we maintain our 2018 GDP growth projection of 2.2%, but we are conscious of the increasing risks to the outlook. Growth is seen slowing to 1.7% in 2019 (from 1.8% before).**
- GDP grew 0.4% on the quarter in Q1 according to the flash estimate. This was well below the 0.7% rise in Q4 but in line with our expectations. Given the weakness in retail sales and the available monthly data for trade, we think that private consumption and exports were the likely cause of the slowdown.
- But the stabilisation of some key surveys in April and May reinforce our view that the eurozone will regain some of its lost momentum in Q2. Despite recent falls, manufacturing surveys remain elevated across most of Europe and point to capacity constraints rather than demand weakness, while services surveys still indicate robust levels of job creation. We project q/q GDP growth to settle at a cruising speed of around 0.5% for the rest of the year.
- Inflation fell to 1.2% in April as the effect of one-off calendar effects from March faded. More troublingly, core inflation tumbled to 0.7%, indicating that the Eurozone is still far from showing convincing signs of upward price pressures. That said, the decline in core prices was exacerbated by temporary factors, while the renewed rise in oil prices should give an additional boost to inflation in the coming months. We expect both headline and core inflation to rise gradually as the year moves on, but this should still leave plenty of room for the ECB to maintain a slow exit strategy.

…so our 2018 GDP growth forecast remains unchanged at 2.2%

Forecast for Eurozone
(Annual percentage changes unless specified)

	2016	2017	2018	2019	2020	2021
Domestic Demand	2.4	2.0	1.9	1.8	1.6	1.4
Private Consumption	1.9	1.8	1.4	1.5	1.3	1.2
Fixed Investment	4.5	3.2	3.4	2.8	2.3	1.8
Stockbuilding (% of GDP)	0.2	0.2	0.2	0.3	0.4	0.4
Government Consumption	1.8	1.2	1.4	1.3	1.2	1.2
Exports of goods and services	3.4	5.4	4.8	3.6	3.2	2.8
Imports of goods and services	4.8	4.5	4.3	4.0	3.4	3.0
GDP	1.8	2.5	2.2	1.7	1.5	1.3
Industrial Production	1.7	2.9	3.1	2.1	1.6	1.3
Consumer Prices, average	0.2	1.5	1.5	1.7	1.9	1.9
Current Balance (% of GDP)	3.6	3.5	3.2	3.0	2.9	2.8
Government Budget (% of GDP)	-1.5	-0.9	-0.8	-0.8	-0.8	-0.8
Short-Term Interest Rates (%)	-0.3	-0.3	-0.3	-0.1	0.3	0.6
Long-Term Interest Rates (%)	0.9	1.1	1.2	1.7	2.2	2.7
Exchange rate (US$ per Euro), average	1.11	1.13	1.23	1.29	1.28	1.26
Exchange rate (YEN per Euro), average	120.3	126.7	134.5	146.1	145.8	144.3

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Forecast overview

Q1 GDP numbers confirm soft patch

The Q1 flash estimate confirmed the Eurozone economy went through a soft patch in Q1, as q/q GDP growth slowed to 0.4% from 0.7% in Q4. Thus, GDP figures corroborated the negative signals sent by the broad fall in survey indices and the disappointing hard data so far this year. We expect the probable decline in industrial production in Q1 was the main reason behind the slowdown. But from the demand side, weak retail sales and trade data suggest that both household spending and exports contributed to the slowdown.

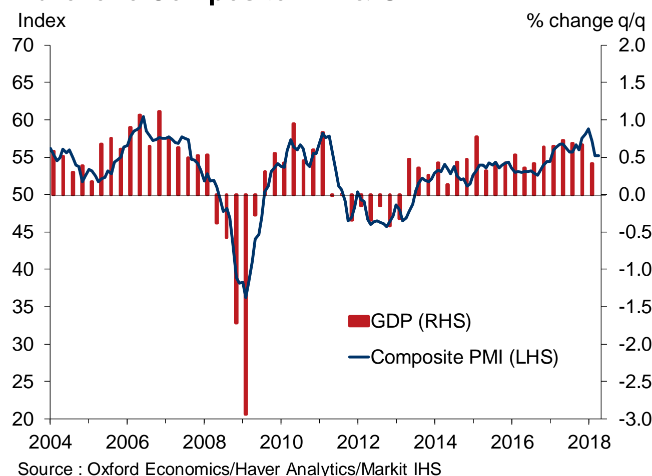
However, the stabilisation of some key survey indices in April and May suggests that the Eurozone economy will regain some of its lost momentum, as the temporary factors that depressed growth in the first quarter fade. Despite the recent declines, manufacturing activity remains strong in most countries, with surveys pointing to capacity constraints rather than demand factors as the main cause of the slowdown. However, the threat of rising protectionism and possible trade wars are clear risks. Meanwhile, the services sector continues to show robust employment growth. We expect q/q GDP growth to stabilise at around 0.5% for the rest of the year.

As Q1 was in line with our forecast, we maintain our 2.2% GDP growth forecast for this year. This would still make 2018 the second-best year for growth in a decade after 2.5% in 2017.

A sustained period of above-trend growth

Despite the disappointing Q1 figures, we still think that the Eurozone will maintain above-trend GDP growth in 2018. The following factors underpin our forecast:

- **A strong labour market**: consumer spending was resilient in the face of higher inflation in 2017 due to strong employment growth. Although the unemployment rate is at a nine-year low, we think it can fall further as structural unemployment is declining as well. We are also witnessing rising workforce participation in a number of countries, a signal of healthy recovery in labour markets. We are yet to see signs of strong wage growth, but there are indications that this trend may be changing. And with inflation forecast at a moderate 1.4% this year, this should help support household purchasing power. We



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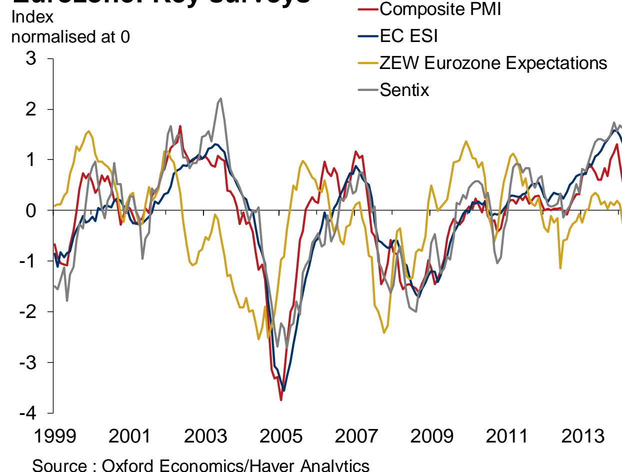

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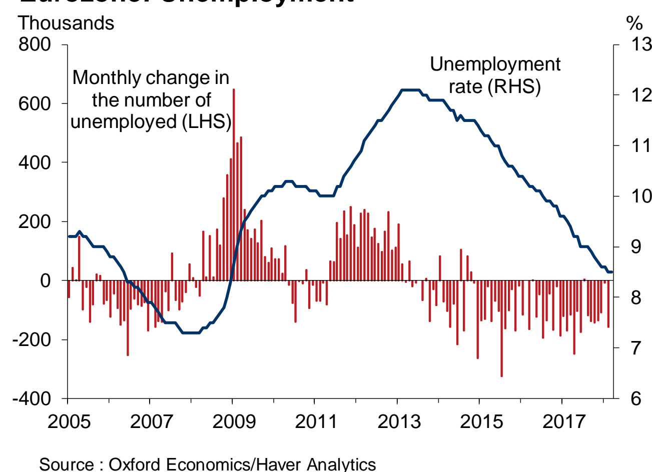


Source : Oxford Economics/Haver Analytics

expect private consumption to grow by 1.5% this year and 1.6% in 2019.

- **Solid outlook for investment**: fixed investment had a solid 2017, in particular machinery and equipment spending (up 4.9%), supported by buoyant business sentiment, tight capacity and the continued strength of bank lending to firms. We also think the push from stronger external demand could mean an additional boost to investment in those countries with a large share of capital goods in their export mix. Finally, construction and real estate activity is also picking up strongly across many areas, driving total investment up. We expect capital spending growth to accelerate to 3.5% this year from 3.2% in 2017.

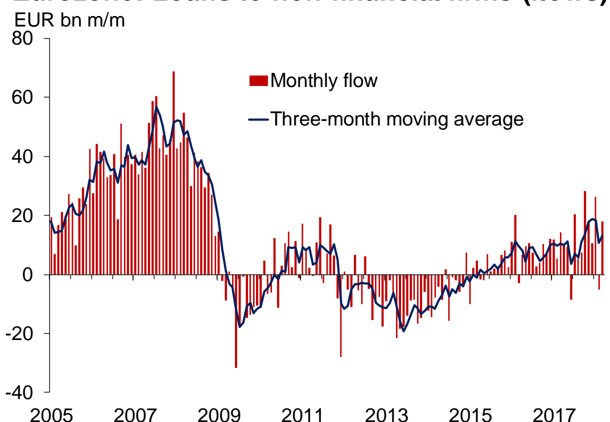
- **Mild slowdown in exports**: European exports had a stellar year in 2017 despite the stronger euro, expanding 5.4%. But with global trade growth expected to moderate and the euro at levels well above those seen last year, we expect export growth will ease to a still-solid 4.8% in 2018. The increasing threat of protectionism and a global trade war are the main risks to our forecast.

Growth this year will be driven mainly by the domestic sector, but net trade will also make a positive contribution for a second year in a row. For 2019, we see GDP growth at 1.7% in 2019 compared to our previous 1.8%.

ECB likely to wait until July

The ECB took a first small step towards the normalisation of monetary policy in March, removing the explicit pledge to increase or extend asset purchases from its communication. This signals that it may now confident enough about the inflation outlook to end its QE programme later this year.

The ongoing debate within the ECB about the shape, timing and speed of policy normalisation will continue in the coming months. We see this as a precursor to an eventual end to the QE programme, probably in December, following a quick taper from September. But the recent weakness in inflation, coupled with the increased uncertainty around the economic outlook means the ECB is likely to wait until its July meeting to make further announcements of future policy moves. Our expectation of a very gradual exit remains unchanged. Despite strong economic growth, the weak inflation outlook means the ECB will remain very cautious about withdrawing monetary support. As such, we do not expect interest rates to rise until H2 2019.



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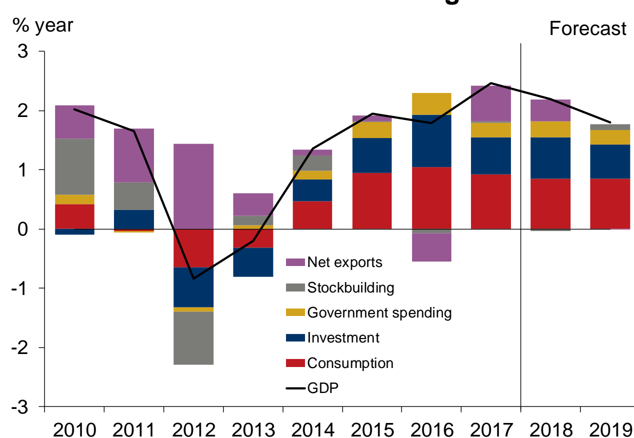

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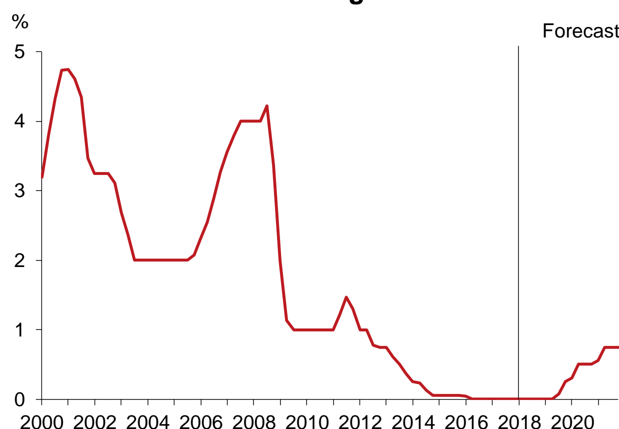


Source: Oxford Economics

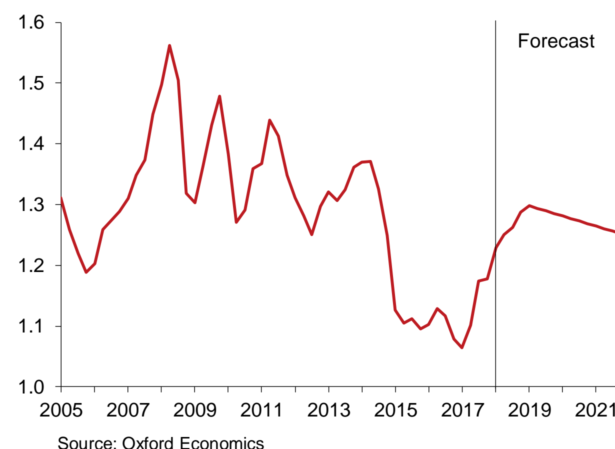
What to watch out for

Receding political uncertainty supports growth: stronger global demand and easing fears about the election of populist governments could prompt increasingly confident businesses to raise investment spending more sharply than assumed in our baseline. But political risks are never far away in Europe: a populist government in Italy, the possibility of a hard Brexit or the Catalan independence crisis in Spain are only a few examples.

Trade worries: exports have been a key component of European growth. While the impact of the stronger euro on export growth has been limited so far, a sharper rise in the euro – particularly if policymakers abroad become more dovish – could mean that net trade becomes a drag on GDP. A hypothetical global trade war could also be very damaging for Eurozone growth prospects.

Monetary policy tightening: we expect the ECB to adopt a cautious approach to monetary tightening. But if underlying inflation pressures start to grow, the central bank could surprise markets to the upside, pushing bond yields and the euro higher, which in turn could slow growth.

Eurozone: Exchange rate US$ per €



Source: Oxford Economics

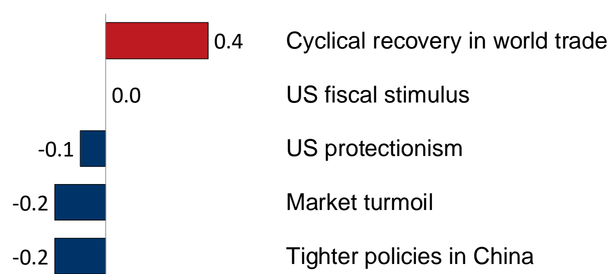
Exposure to key global risks

Cyclical recovery in world trade: in this scenario, optimism over near-term growth prospects rise globally, as the strength of activity in China and the US supports a continuation of the resurgent growth in world trade seen in 2017. Investment expenditure picks up accordingly and investor confidence in emerging markets improves too. Stronger external demand prompts eurozone GDP growth of 2.6% in 2018 and 2.4% in 2019. Within the currency bloc, the economies most open to trade should benefit the most from such a shock.

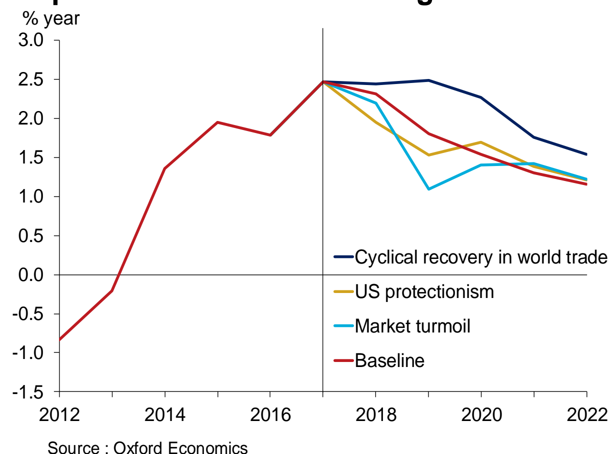
Market turmoil: in this scenario, rising inflationary pressures in the late-cycle US economy trigger a sell-off in equity and bond markets, which then spill over to the broader economy. Headline and core inflation rise above 3% during 2018, prompting the Federal Reserve to raise the Fed funds rates more quickly and signal further significant tightening ahead. The market sell-off then gathers pace as markets reassess their expectations for the future path of US policy rates. Amid the turmoil, the recovery in the world economy falters.

Impact of scenarios on GDP growth

Average annual impact over the next 5 years (% points)



Impact of scenarios on GDP growth



Source : Oxford Economics

Long-term prospects

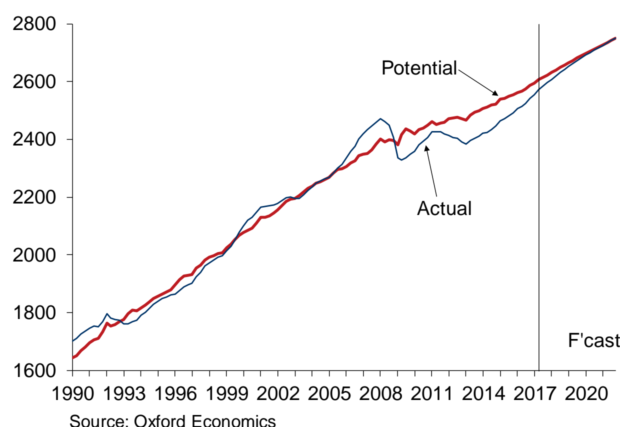
Slow recovery from crises

The global and eurozone crises will leave their mark on growth for years to come. We now estimate the Eurozone's potential growth rate at only 1.2%, similar to our estimate for the past decade but far lower than 1.8% in the decade prior to 2008.

While credit availability is improving, it is unlikely to be as free-flowing as during pre-crisis years, hindering investment and the efficiency of capital allocation in the economy. Moreover, prolonged high unemployment, especially among the young, will have long-lasting negative effects on skill levels and the ability to work. Combined with a shrinking working-age population (despite increases in the retirement age), these factors imply that availability and quality of labour will be constrained compared with the pre-crisis period. These constraints will only be partly offset by further increases in the participation rate.

Some of the reforms implemented in the peripheral countries should help raise eurozone productivity growth to at least what it was before 2008. But much more will be needed to offset other negative trends.

Eurozone: Actual & potential output



Source: Oxford Economics

Potential GDP and Its Components Average Percentage Growth	2007-2016	2017-2026
Potential GDP*	1.0	1.2
Employment at NAIRU	0.6	0.4
Capital Stock	1.3	1.3
Total Factor Productivity	0.2	0.6

*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)

Long-Term Forecast for Eurozone
(Average annual percentage change unless otherwise stated)

	2007-2011	2012-2016	2017-2021	2022-2026
GDP	0.5	0.8	1.9	1.1
Consumption	0.3	0.6	1.5	1.1
Investment	-1.4	0.7	2.7	1.3
Government Consumption	1.5	0.8	1.2	1.0
Exports of Goods and Services	2.3	3.8	4.0	2.3
Imports of Goods and Services	1.8	3.3	3.9	2.4
Unemployment (%)	9.0	11.2	8.0	6.9
Consumer Prices, average	2.0	0.9	1.7	2.0
Current Balance (% of GDP)	-0.4	2.6	3.1	2.6
Exchange Rate (US$ per Euro), average	1.39	1.23	1.24	1.25
General Government Balance (% of GDP)	-3.9	-2.5	-0.8	-0.6
Short-term Interest Rates (%)	2.5	0.1	0.0	1.5
Long-term Interest Rates (%)	4.1	2.2	1.8	3.4
Working Population	0.2	0.2	0.0	-0.2
Labour Supply	0.5	0.3	0.4	0.0
Participation Ratio	76.1	76.7	77.7	78.6
Labour Productivity	0.4	0.4	0.9	1.0

Background

Economic development

The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Since then, Slovenia (2007), Malta (2008), Cyprus (2008), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015) have joined the currency bloc. During the early years of the single currency, the peripheral economies were the main drivers of growth, as lower interest rates fuelled credit and housing booms in some of the economies, while others, most notably Greece, saw a surge in net government spending. Since the global financial crisis, these economies have had to go through a painful period of restructuring. Germany, which went through its own restructuring in the 2000s, has recently been the main growth engine.

Structure of the economy

Like most developed economies, services is the dominant sector of the economy. Within the region there are large structural differences between countries, and generally the smaller northern economies are more open to trade than their southern counterparts.

Balance of payments and structure of trade

Prior to the global financial crisis, the Eurozone current account was broadly in balance. But the headline figure masked huge intra-area divergences. Surpluses in many core economies were offset by large deficits in the booming peripheral economies. Since the global financial crisis, the latter's current account positions have improved, while the German current account surplus has widened, pushing the Eurozone surplus above 3% of GDP in 2015. There are strong trade linkages within the currency bloc; around 45% of exports remain within the Eurozone.

Policy

Member states have passed control of monetary policy to the European Central Bank (ECB), whose objective is to achieve price stability by targeting CPI inflation of "below, but close to, 2%". While the ECB cut interest rates in the aftermath of the global financial crisis, it was rather more conservative than other central banks such as the US Federal Reserve and the Bank of England and expanded its balance sheet less aggressively. Since Mario Draghi became ECB President in 2011, the ECB has taken bolder action to support the economy and boost inflation. In January 2015, the ECB finally began its own QE programme which is expected to last until, at least, September 2018.

National governments retain control of fiscal policy, although there are limits to their freedom in this area as specified in the Stability and Growth Pact (SGP), which essentially applies the fiscal requirements of the Maastricht Treaty on an ongoing basis. Economies have consistently flouted the rules, which have at various points been ignored or modified. A key criticism of the rules is that they have led to pro-cyclical fiscal policies, but an attempt to prevent that was made by switching to structural fiscal deficit as the key target variable.

The fall-out from the financial crisis, and in particular the troubled fiscal situation faced by Greece, Italy, Ireland, Portugal, Slovenia, Cyprus and Spain, showed the limitations of the fiscal framework behind the single currency. The possibility of a debt default by Greece, coupled with the threat of contagion to Italy and Spain, put Eurozone leaders under immense pressure to come up with a rescue plan that would prevent the collapse of the single currency. However, there remain significant differences of opinion among the largest members regarding who should carry the burden and what mechanisms should be used to provide financial support to the European banking system. Measures have been taken to move towards a banking union in a bid to sever the links between banks and their sovereigns. But political hurdles to closer integration and debt burden sharing remain very high, so changes to the Eurozone's structure and institutions are likely to be slow at best.