The global economy and the euro area: increased uncertainty is dampening growth

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ABSTRACT

The political conditions for growth are currently dominated by increased uncertainty; this is particularly weighing on investment activity and slowing down the global economy. DIW Berlin is lowering its forecast slightly for this year and the next to 4.1 percent and 3.9 percent, respectively. However, global expansion appears to remain intact. In developed economies, primarily the good labor market situation is supporting consumption. In the United States, higher growth than at the beginning of the year is expected due to fiscal stimulus. The outlook for the euro area has deteriorated recently, however. Many emerging countries are also under greater pressure—in addition to domestic issues mainly caused by a tightening of international financial conditions. Over the course of the rest of the year, the rise in global interest rates, the first labor shortages in developed economies, and a further gradual deceleration of growth in China are expected to slow down the global economy more. The main risks for the continuation of the global upswing are primarily the United States' protectionism and political uncertainties in the euro area.

The global economy continued to lose momentum at the beginning of the year. The noticeable increase in uncertainty regarding economic policy is likely to have contributed to this. Moreover, financial conditions have worsened globally, particularly for emerging economies. In some major developed economies, extraordinary factors had an additional negative impact on growth.

Overall, however, global expansion appears to remain intact and global production is likely to rise more strongly again in the coming quarters, albeit not at the pace of the past years (Figure 1). In developed economies, the good labor market situation and the associated gains in household purchasing power support consumption. A return to higher growth is therefore to be expected, especially for the United States and Japan. However, the outlook for the euro area has deteriorated recently. On the one hand, energy prices have risen sharply, which is likely to weaken domestic demand. On the other hand, the euro has depreciated, so export demand should pick up somewhat.

The global increase in uncertainty should slow down international trade and businesses' investments, particularly this year. Furthermore, towards the end of the forecast period, higher interest rates and labor shortages—for example in the United States or the euro area—will become noticeable. In addition, there is a gradual deceleration of growth in China; thus, the pace of the global economy's expansion is likely to slow down further.

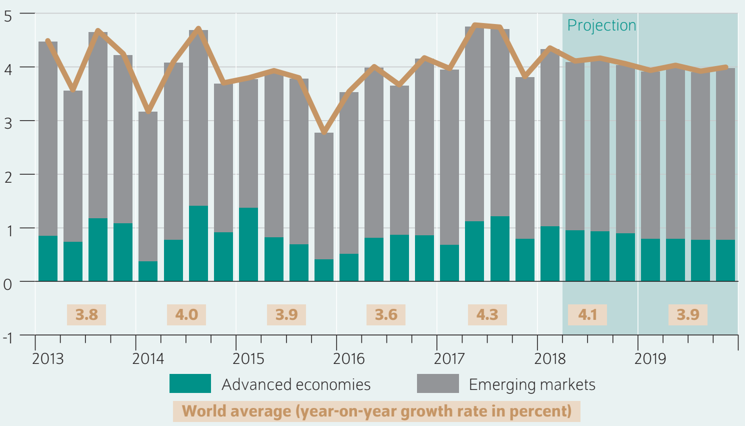
All in all, global production is expected to grow by 4.1 percent this year. Growth will then weaken slightly next year. Thus, compared to the Economic Outlook published in spring 2018, DIW Berlin is lowering its forecast slightly for both years (Table).

The monetary policy environment will be less expansionary globally. In the United States, the central bank is likely to raise the key interest rates further, but only gradually in light of moderate pressure on prices and wages. In the euro area, an end to net purchases this year is likely. A first key interest rate hike by the European Central Bank is expected for the second quarter of 2019. Fiscal policy is likely to become more expansionary globally. In the United States and some European countries, the measures adopted or announced should boost growth.

The risks for the global economy have increased. If the protectionism emanating from the United States increases, this will put a strain on international trade. It would also lead to a further tightening of global financial markets. An intensification of political uncertainties in southern Europe would also worsen financing conditions in the euro area and affect household and business sentiment. An increase in global uncertainty as well as intensifying political developments in Europe would weigh on investment activity.

Figure 1

World real gross domestic product growth
In percent



Sources: National statistical offices; DIW Economic Outlook Summer 2018.

Global economy is slowing down.

Table

Real gross domestic product, consumer price inflation, and unemployment rate of the world economy
In percent

	GDP				Consumer prices				Unemployment rate in percent			
	Change over previous year in percent											
	2016	2017	2018	2019	2016	2017	2018	2019	2016	2017	2018	2019
Euro area	1.8	2.5	2.0	1.7	0.4	1.4	1.9	1.8	10.0	9.0	8.2	8.0
without Germany	1.8	2.5	2.1	1.7	0.4	1.3	1.8	1.7	12.6	11.4	10.5	10.3
France	1.1	2.0	1.9	1.7	0.2	1.1	1.7	1.5	10.1	9.4	8.8	8.6
Italy	1.0	1.5	1.3	1.1	0.0	1.3	1.2	1.4	11.7	11.3	10.8	10.6
Spain	3.3	3.0	2.7	2.2	−0.2	2.0	2.2	2.3	19.7	17.2	15.9	15.4
Netherlands	2.1	3.3	2.7	2.3	0.1	1.3	1.5	1.8	6.0	4.8	4.1	4.0
United Kingdom	1.9	1.8	1.3	1.3	0.7	2.7	2.5	2.0	5.0	4.5	4.4	4.5
USA	1.5	2.3	2.8	2.5	1.3	2.1	2.6	2.1	4.9	4.4	3.9	3.5
Japan	1.0	1.7	1.1	1.0	−0.1	0.5	1.0	1.1	3.1	2.8	2.7	2.6
South Korea	2.9	3.1	3.0	2.7	1.0	2.0	2.0	2.7	3.7	3.7	3.2	3.0
Middle Eastern Europe	3.2	5.0	4.0	3.3	−0.2	1.7	2.3	2.8	5.7	4.6	4.0	3.8
Turkey	3.2	7.4	4.2	3.0	7.8	11.1	10.8	10.6	10.9	10.9	10.3	10.5
Russia	−0.2	1.7	1.8	2.2	6.6	3.5	2.3	3.8	5.5	5.1	4.7	4.6
China	6.7	6.9	6.5	6.3	1.6	1.7	2.0	2.4	4.1	4.0	4.0	4.0
India	7.9	6.3	6.6	5.8	3.0	4.0	5.3	6.1				
Brazil	−3.5	1.0	0.8	1.1	8.7	3.4	4.5	6.0	11.3	12.8	10.6	8.4
Mexico	2.6	2.3	2.1	2.0	2.8	6.0	4.1	3.2	3.9	3.4	4.8	4.8
Developed economies	1.6	2.3	2.3	2.0	0.8	1.8	2.2	1.9	5.9	5.3	4.8	4.6
Emerging markets	5.0	5.6	5.3	5.1	3.0	3.1	3.4	4.0	5.3	5.2	5.0	4.8
World	3.6	4.3	4.1	3.9	2.1	2.5	2.9	3.1	5.5	5.3	4.9	4.7

Sources: National statistical offices; DIW Economic Outlook Summer 2018.

Box 1

On the macroeconomic stability of Italy and its financial market situation

Since the general election in March, and especially since the coalition talks and formation of a government in May, concerns about Italy's macroeconomic stability have significantly increased. There are many fears that the new fiscal policy stance, combined with fragile macroeconomic conditions, could lead to tensions in financial markets, which in turn could jeopardize Italy's ability to remain in the monetary union.

However, the indicators used in the Macroeconomic Imbalance Procedure (MIP) of the European Union do not suggest a pronounced macroeconomic imbalance in Italy. A DIW Berlin index based on MIP indicators, which signals macroeconomic imbalances when certain threshold values are exceeded,[1] has improved significantly since 2015 and currently does not indicate a serious imbalance. This is due to significant improvements in both the external imbalances (such as the current account balance or export market shares) and the internal imbalances (such as private sector debt). Overall, unemployment has also developed favorably, though it is still at a high level.

A persistent problem exists primarily in connection with public debt. Accordingly, financial markets have reacted sensitively when the new government at least partially questioned repaying debts. In the days following the announcement of the joint government program on May 14, for example, the leading indices of European stock exchanges, in particular those traded on the Milan stock exchange, fell noticeably in value. The share prices of Italian banks were hit particularly hard; Italian-based financial institutions hold about half of Italy's outstanding public debt.

The subsequent uncertainty about the actual formation of the coalition intensified the price decline. Moreover, the erratic approach in forming a government led to greater fluctuations in stock market prices than before, even though volatility had already been increasing since the beginning of May. However, the news of a successfully formed government—in spite of the participating parties—contributed to the stabilization of stock markets.

Lastly, financial market uncertainty was reflected in the sharp rise in yields on Italian government bonds. It was striking that not only interest rates on long-term notes rose sharply, but also yields on securities with shorter maturities.[2] The increased uncertainty about the future repayment of Italy's public debt led investors to place more funds in securities perceived as more safe, such as German government bonds. After the government was formed, however, the situation relaxed again for the bond markets.

In light of the evaluated indicators, the macroeconomic conditions in Italy are more robust than often feared. At present, the main threat is political mismanagement of high public debt. If the debt level is gradually reduced—by maintaining the overall stability-oriented fiscal policy of recent years, but increasingly also by measures that are suitable for supporting (nominal) growth of the Italian economy—the macroeconomic indicators certainly suggest that Italy's economy can overcome the current tensions.

1 If the index is above 1, the indicators violate, on average, the limit values defined by the European Union. If the index is above 2, the macroeconomic imbalances have reached a level that is associated with a high risk of an overall economic crisis. The estimation procedure will be presented in detail in a DIW Berlin discussion paper that will be published soon.

2 Generally, the difference between the yields on short-term securities between the member states of the euro area is less when compared to long-term titles because the development of short-term interest rates depends particularly strongly on the European Central Bank's common monetary policy for all member states.

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