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Article

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The global economy and the euro area: so far trade disputes have had only limited effects on global growth

By Claus Michelsen, Guido Baldi, Geraldine Dany-Knedlik, Hella Engerer, Stefan Gebauer, and Malte Rieth

ABSTRACT

After a strong second quarter, the global upturn appears to remain intact, economic and political turmoils notwithstanding, especially in the United States and the euro area. Therefore, DIW Berlin is slightly raising its forecast for the global economy this year to 4.2 percent. Over the course of the rest of the year, however, non-recurring effects are likely to disappear in the United States, causing growth to slow down somewhat. Thus, for the coming year, DIW Berlin is remaining with its forecast from early summer, which estimated growth of 3.9 percent. Due to the improving labor markets, private consumption continues to be the most important support of the upturn in the global economy. Monetary policy remains expansionary for the time being but this will gradually change. Uncertainties regarding US trade policy are a risk to global trade, which will likely dampen investment in the further course of the forecast period. Further risk factors are the economic policies of the new Italian government and the threat of a hard Brexit. The turbulence in Turkey, on the other hand, is unlikely to have a major impact.

The pace of the global expansion picked up significantly in the second quarter. The economy was faring significantly better than at the beginning of the year, especially in developed market economies. However, non-recurring effects are likely to disappear in the United States over the course of the rest of the year, causing global production to grow somewhat more slowly in the forecast period.

Increased uncertainty due to US trade policy depressed corporate sentiment and affected world trade. This uncertainty will continue, dampening investment activity and foreign trade. For the euro area and the United Kingdom, the recent increase in uncertainty resulting from the Brexit negotiations is an additional factor, as the likelihood of a hard exit has recently increased.

However, overall, the global upturn remains intact (Figure). Solid production growth is expected to continue, especially in the United States and the euro area, even if the pace of the second quarter cannot be maintained in the United States. As before, private consumption remains the mainstay of the upturn. The continuous improvement of the labor market situation together with moderate price increases are bolstering consumer confidence and result in income gains. Wage developments are also picking up some momentum, but prices and wages are not expected to strongly overshoot in the United States, euro area, or Japan.

The expansion in the emerging markets will also continue at a somewhat slower pace. Commodity prices are expected to remain high, and the recent capital market turbulence in the wake of the Turkish crisis has so far only slightly worsened international financing conditions. Over the further course of the year, however, the continued hike in US key interest rates is likely to tighten credit conditions. The crisis in Turkey will, however, barely have an effect on developed market economies and the European banking sector in particular (Box).

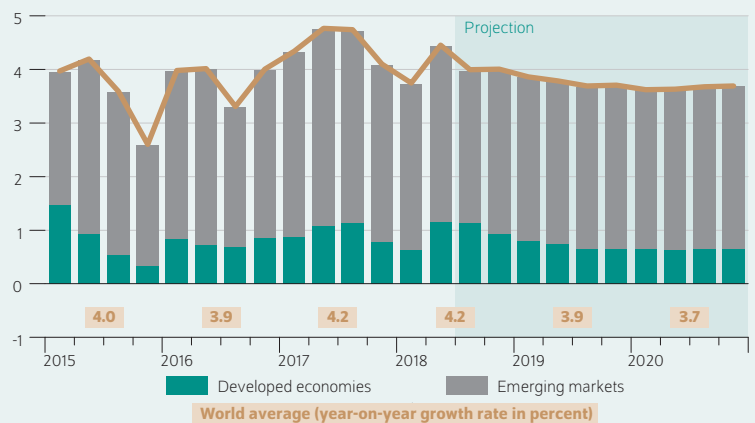
Monetary policy will remain expansionary globally, but its degree of accommodation will be reduced. In the United States, further interest rate hikes are expected for this year and the next. The European Central Bank will complete its

net purchases of securities by the end of the year. An interest rate increase is expected for the second half of 2019, with the next steps following in 2020. However, fiscal policy will provide stimuli globally. Tax relief and spending increases, especially in the United States and in some euro area countries, will support the global economy. In the coming years, these stimuli are likely to run out and, together with a less expansionary monetary policy, will lead to a slowdown in the pace of expansion. Increasing shortages in labor supply in the United States and some European countries will also weigh on growth. All in all, global economic output this year and the next is expected to grow by 4.2 and 3.9 percent, respectively. In 2020, the economy will slow down further to 3.7 percent (Table).

The global economy is facing a series of risks. The trade disputes emanating from the United States have the potential—if the situation is aggravated further—to weigh on consumer and business confidence and investment activity. Similarly, the increasingly likely no-deal Brexit would have a negative impact on investment and growth. The Italian government's economic policy also carries the risk that the financing conditions for companies and consumer confidence in the country will deteriorate and weigh on already low growth.

Figure

World real gross domestic product growth In percent



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

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Global economic growth has only been slightly affected to date.

Table

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

	Gross domestic product				Consumer prices				Unemployment rate in percent			
	Change over previous year in percent											
	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020
Euro area	2.5	2.0	1.7	1.5	1.4	1.8	1.8	1.8	9.0	8.3	8.0	7.8
without Germany	2.6	2.1	1.7	1.5	1.3	1.7	1.6	1.7	11.4	10.6	10.3	10.2
France	2.3	1.7	1.7	1.6	1.1	1.8	1.6	1.8	9.4	9.0	8.6	8.5
Italy	1.6	1.2	1.1	1.0	1.3	1.2	1.4	1.5	11.3	10.9	10.5	10.4
Spain	3.0	2.7	2.3	1.8	2.0	1.8	1.8	1.8	17.2	15.5	15.2	15.1
Netherlands	3.0	2.7	2.2	1.9	1.3	1.5	1.8	1.9	4.8	4.0	3.9	3.8
United Kingdom	1.7	1.3	1.3	1.4	2.7	2.5	2.0	2.0	4.5	4.3	4.5	4.5
USA	2.2	3.0	2.7	2.0	2.1	2.6	2.3	2.2	4.4	3.9	3.6	3.5
Japan	1.7	1.0	1.1	0.8	0.5	1.0	1.2	1.2	2.8	2.6	2.6	2.6
South Korea	3.1	2.9	2.8	2.4	2.0	1.7	2.6	2.7	3.7	3.4	3.0	3.0
Middle Eastern Europe	4.9	4.1	3.4	3.2	1.7	2.4	3.0	2.9	4.6	3.8	3.5	3.4
Turkey	7.4	5.0	2.5	3.2	11.1	14.2	13.2	4.8	10.9	10.8	10.6	10.1
Russia	1.6	1.6	1.8	2.0	3.5	2.7	3.4	3.7	5.1	4.8	4.7	4.5
China	6.9	6.5	6.3	6.0	1.4	1.8	2.3	2.4	4.0	4.0	4.0	4.0
India	6.3	6.6	5.9	5.7	4.0	5.3	6.1	6.1				
Brazil	1.0	1.2	0.9	1.3	3.4	4.1	6.0	6.5	12.8	10.9	8.4	6.2
Mexico	2.3	2.4	2.2	1.8	6.0	5.0	3.2	3.2	3.4	4.4	4.8	4.8
Developed economies	2.2	2.4	2.2	1.7	1.8	2.1	2.0	2.0	5.3	4.8	4.6	4.5
Emerging markets	5.6	5.4	5.0	4.9	2.9	3.5	4.1	3.8	5.2	5.0	4.8	4.5
World	4.2	4.2	3.9	3.7	2.5	2.9	3.2	3.1	5.3	4.9	4.7	4.5

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

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Box

Economic consequences of the Turkey crisis

The current economic situation in Turkey is extremely fragile and could develop into a crisis similar to that of 2001. The United States' increase in import duties in mid-August dramatically accelerated the devaluation of the lira. Foreign investors in particular lost confidence in the currency.

To estimate the economic consequences of the current crisis, a dynamic-stochastic general equilibrium model was developed and estimated with data for Turkey. The model simulates an increase in the foreign financing costs of the private sector through an exogenous increase in the private risk premium. The shock is calibrated in such a way that the lira depreciates nominally by around 20 percent due to the rise in the price of foreign capital immediately after the shock occurs. This roughly corresponds to the depreciation of the lira against the US dollar or the euro in August 2018. The further course of the exchange rate and the reaction of the other variables are determined by the model. They can be seen as a forecast of Turkey's economic development in the coming quarters—assuming that no further shocks have occurred or will occur—and relative to the development that would have taken place without the recent escalation.

The rise in external financing costs is leading to an immediate economic slump (Figure). Consumption as well as investment are falling relative to their trends. The output gap amounts to one percent and will increase further throughout the course of the year. As a result, the government balance is deteriorating and the expected default rate for Turkish government bonds is rising. The Turkish currency is depreciating massively, accompanied by a real devaluation. While this improves the trade balance, it increases inflation.

How do these model simulations relate to the actual figures and leading indicators for Turkey?

After a strong first quarter, the recently declining business climate indices and gloomy consumer confidence point to growth momentum weakening significantly, which has so far been supported by private consumption. Wages continued to increase and the unemployment rate fell in the first quarter of 2018. As a result of high domestic demand, the import surplus and the current account deficit have increased significantly. With the devaluation of the lira, however, imports have become considerably more expensive since the beginning of the year. This has been noticeable in prices as well; the price increase reached 18 percent in August. The situation will remain fragile without consistent economic policy measures.

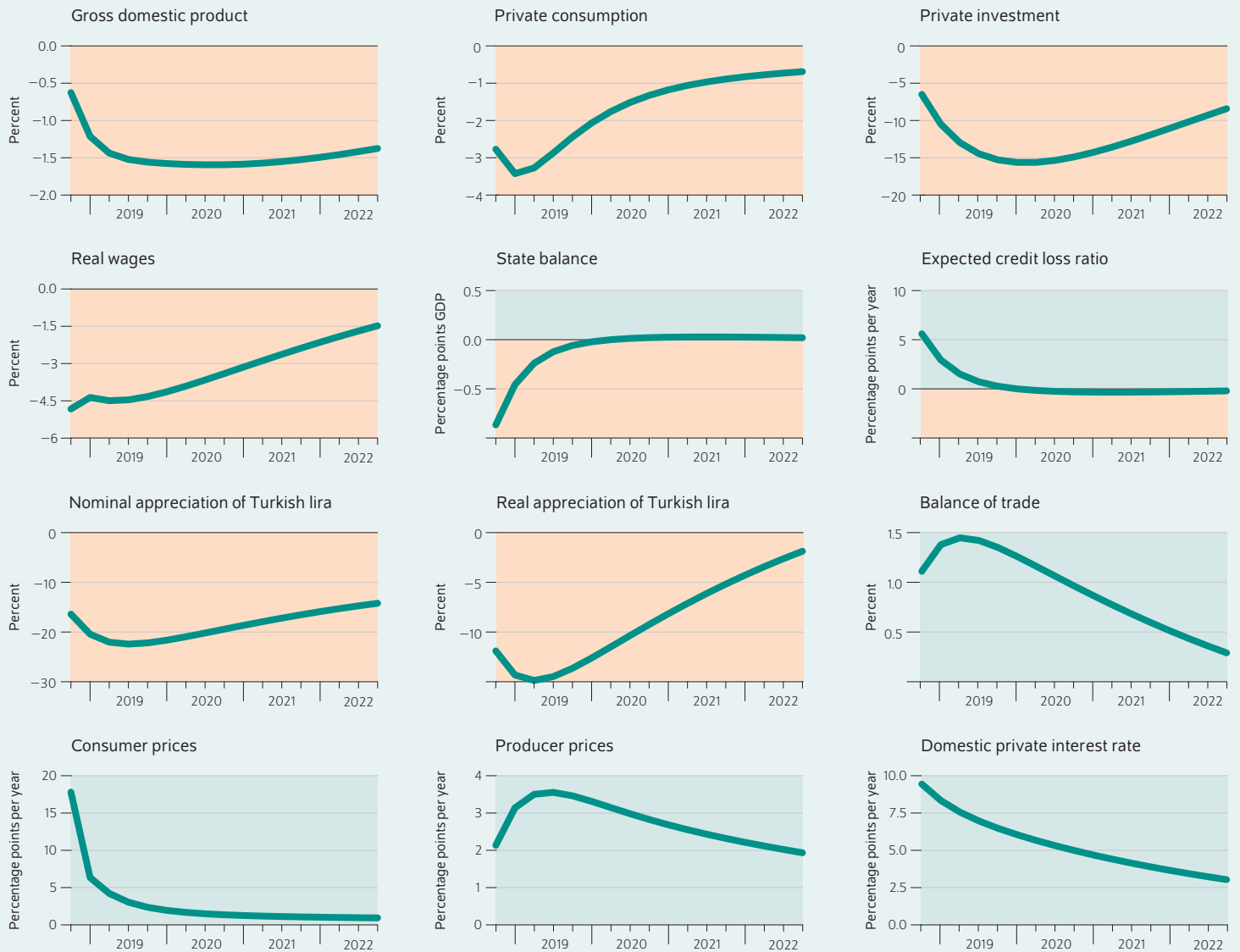
What does the Turkish crisis mean for other countries?

According to the Bank for International Settlements, Spanish and French banks in particular have debt claims against Turkish borrowers at 80 and 35 billion USD, respectively. With outstanding loans of 13 billion USD, German banks are comparatively less involved. In case that payment defaults occur due to the sharp devaluation of the lira and a possible economic slump, this will have painful consequences for some Spanish and French banks. However, a general destabilization of the European banking sector is not expected due to the rather low exposure to Turkey in relation to its total balance sheet. Regarding the real economy, a significant slowdown in Turkey's economy is likely to have only minor consequences for the euro area, as exports from the euro countries to Turkey account for just under three percent of total exports.

Figure

Impact of recent currency crisis

Level change compared to trend if the foreign risk premium increases by five percentage points



Source: Authors' own calculations.

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In the coming year, Turkey will continue to suffer heavily from the ongoing crisis. Indicators are expected to improve in the long term.

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