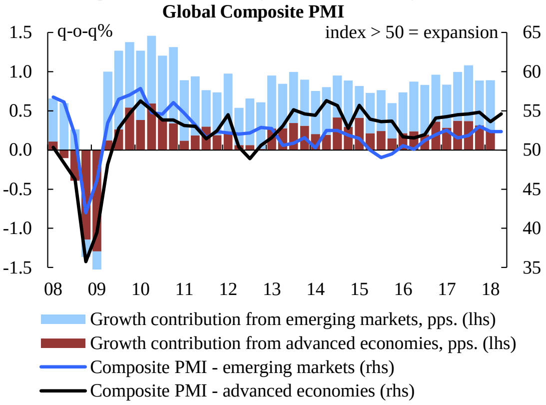
1. EURO AREA AND EU OUTLOOK

1.1. GLOBAL GROWTH BECOMING LESS SYNCHRONISED

Global economic activity remains solid overall but growth rates are becoming more differentiated across countries and regions and downside risks are rising. GDP data for the first quarter of 2018 indicate that growth momentum remains strong, with global growth advancing by 0.9% (q-o-q), unchanged from the previous quarter (see Graph 1.1). Growth slowed somewhat in advanced economies but picked up in emerging markets, with robust growth in emerging Asia, led by China and India. At the same time, several other emerging markets surprised on the downside (e.g. South Africa, Brazil). High-frequency indicators point to a weakening momentum in global manufacturing output, which has so far been compensated by a rebound in the service sector.

Graph 1.1: **Global GDP growth and JPMorgan Global Composite PMI**



Sources: Data Insight, IMF and national statistical institutes for GDP, JPMorgan/Markit for PMI.

The outlook for global growth outside the EU remains unchanged at 4.2% for 2018, despite sizeable downward revisions for Latin America. Global growth outside the EU is projected to moderate somewhat to 4.1% in 2019, slightly weaker than projected in the spring, as economic activity is expected to slow in both the US and China (see Table 1.1).

The US economy continues to benefit from several tailwinds, including a strong labour market, strong sentiment and fiscal stimulus. However, this highly pro-cyclical loosening of fiscal policy entails significant risks and is expected to further widen the US current account deficit in the near term, which could reinforce protectionist tendencies. The protectionist measures now beginning to materialise are likely to weigh on business confidence and investment in the US. In emerging markets, economic performance is forecast to diverge somewhat. The financial market turmoil experienced by some of the more vulnerable countries in recent weeks (e.g. in Argentina and Turkey) implies lower growth over the forecast horizon, while other emerging markets are expected to post solid growth (emerging Asia) and some are set to benefit from higher oil prices (Russia and OPEC countries).

Global import volumes (outside the EU) are expected to increase by 4.9% in 2018, moderately less than in 2017 and less than expected in the spring forecast. The first quarter of 2018 retained the strong momentum from the previous year, boosted by strong imports in emerging Asia (including China) and Latin America and solid imports in most advanced economies. Trade growth will, however, likely level off and decelerate later this year and in 2019, when global import growth (outside the EU) is expected to settle down to a still-solid 4.4%. This deceleration reflects increased trade tensions following the measures implemented so far and rising uncertainty over global growth in the medium term. The trend has already been signalled by a gradual worsening of high-frequency trade indicators, although these mostly remain above their historical averages.

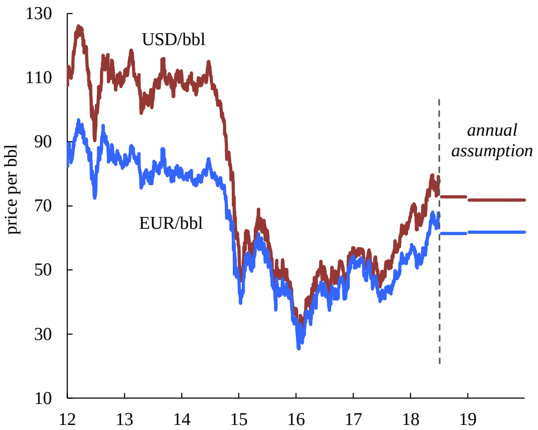
Table 1.1:
International environment

(Annual percentage change)				Summer interim 2018 forecast			*Spring 2018 forecast*		
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	***2017***	***2018***	***2019***
				Real GDP growth					
World (excl.EU)	3.8	3.5	3.4	**3.9**	**4.2**	**4.1**	*3.9*	*4.2*	*4.2*
				Merchandise trade volumes					
World (excl.EU) exports of goods and services	3.2	1.3	1.7	**4.7**	**4.2**	**4.1**	*4.7*	*4.4*	*4.1*
World (excl.EU) imports of goods and services	3.4	0.6	1.1	**5.3**	**4.9**	**4.4**	*5.3*	*5.1*	*4.5*

Futures markets suggest higher oil prices

The oil price surges in May, driven by strong demand and tightening supplies, levelled off temporarily in June after OPEC (and Russia) signalled their willingness to increase oil supplies with immediate effect. These additional supplies are expected to partly compensate for the continuing supply disruptions in Venezuela and the risk of lower supply from Iran in the wake of US sanctions. Price volatility around current levels is expected to persist for the remainder of 2018, as geopolitical tensions and potential supply disruptions remain unpredictable and existing stocks have declined. As higher oil prices weigh on oil demand growth and additional supplies from the US should become available in 2019, oil prices are projected to edge down, mainly in the second half of 2019. Overall, based on futures markets, an average price of 72.8 USD/bbl is assumed in 2018 – equivalent to a 33% increase from 2017 and 5.6% higher than assumed in the spring forecast – and 71.8 USD/bbl for 2019. In euro terms, given the euro’s recent depreciation vis-à-vis the US dollar, upward revisions compared to the spring are higher, amounting to 9.9% in 2018 and 16.6% in 2019 (see Graph 1.2).

Graph 1.2: **Oil price, developments and assumptions**



Downside risks to the global growth outlook have intensified since the spring forecast, most notably those related to the rise in trade protectionism. Some trade-related risks have already materialised: the US imposed tariffs on steel and aluminium from China, the EU, Canada and Mexico; and selected imports from China; and launched an investigation into automobile imports on national security grounds. Several US trading partners, including the EU, have responded with counter-measures (see technical box for an overview of the implemented measures). While the direct macroeconomic effect of the measures implemented so far are likely to be rather limited, [1] the broader impact on confidence and investment decisions could be much more significant and immediate. The central scenario for global growth and trade does not incorporate a further escalation in trade protectionism but this remains a serious downside risk that could derail global growth over the forecast horizon and beyond.

Financial vulnerabilities in several emerging markets linked to high debt and leverage present another downside risk to the global outlook. Emerging market currencies have been increasingly coming under pressure in recent weeks as the monetary policy normalisation in the US and a stronger US dollar have shifted investor interest away from riskier assets in more vulnerable emerging market economies. Although the ongoing tightening of global financial conditions has not had a material impact on growth and financial stability so far (with the exception of isolated cases such as Argentina), the pressure on emerging markets is clearly increasing and could result in unforeseen disruptions going forward. Among them, China is vulnerable due to its high financial leverage and exposure to protectionist measures.

1.2. EUROPEAN FINANCIAL MARKETS SHOW RESILIENCE TO RISKS

Increasing monetary policy divergence…

Monetary policy divergence between the euro area and the US has increased further. While the ECB signalled in June that it will maintain an accommodative monetary policy stance, the US Federal Reserve has increased its target range for the federal funds rate by 25 bps to 1.75%-2.00%. Moreover, the Fed has indicated that another two interest rate hikes may be required in 2018, compared to just one previously, and that three interest rates hikes may be necessary next year. The resulting divergence in expected future policy rates between the US and the euro area has been further magnified by the introduction of an enhanced ECB forward guidance on policy rates, according to which key ECB interest rates are expected ‘to remain at their present level at least

(1) ECB (2018). ‘Implications of rising trade tensions for the global economy’. *ECB Economic Bulletin* 3, pp. 21-25. (see Box 1)

through the summer of 2019'. Although net asset purchases are anticipated to end in December 2018 [(2)], this is subject to incoming data confirming the medium-term inflation outlook.

...reflected in a weakening euro.

The euro has weakened by more than 5% against the US dollar since mid-April this year in a context of fiscal stimulus and an improved economic outlook in the US; and weakening economic momentum and rising political uncertainty in some euro area Member States. In nominal effective terms, the euro has depreciated by 1.5%.

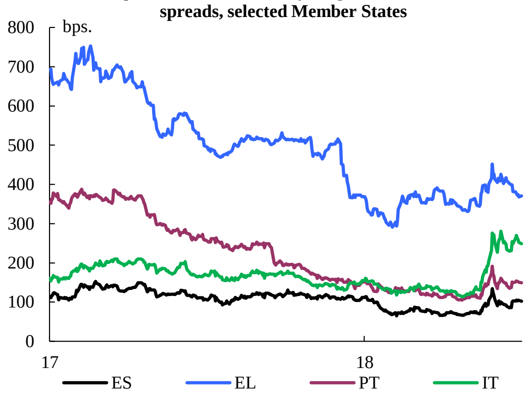
Financial markets have taken a more cautious tone recently...

Prices on global financial markets are increasingly reflecting investor concerns about the adverse effects of trade tensions. The upside pressure on oil prices and the further expected rise in US interest rates have also led global investors to take a more cautious stance, particularly in emerging markets. In the EU, political developments in some Member States have weighed on investor sentiment.

Benchmark yields for some euro area Member States have fallen back in the past few months amid weaker-than-expected economic data in the euro area, renewed risk aversion, and accommodative monetary policy. Italian bond yields spiked briefly over political stability and fiscal sustainability concerns but quickly stabilised below 3% (for 10-year bonds), and the initial contagion to other sovereign bonds proved brief (see Graph 1.3). In the US, Treasury yields oscillated around 3% before declining somewhat, as fragilities in some emerging market economies triggered higher risk aversion and pushed investors back to safe-haven sovereign bonds.

EU stock markets continued to oscillate without clear direction. While the depreciation of the euro vis-à-vis the US dollar has been supportive to euro area stocks, weaker economic indicators compounded with an escalation of trade tensions and the increase in oil prices weighed on EU equity markets. European bank shares underperformed as yield curves flattened. Corporate bond yields have risen over the past few months, but, taken in historical perspective, risk premia are still compressed in many segments. Corporate bond issuance volumes have been strong, particularly in the high-yield segment.

Graph 1.3: **Benchmark 10-year government bond spreads, selected Member States**



Source: Macrobond

Meanwhile, macro-financial vulnerabilities are building up in several parts of the global financial system. Globally, valuations of certain financial (and real) assets continue to seem stretched. Markets appear to be pricing in expectations that the unwinding of unconventional monetary policy measures in major regions of the world will lift risk-free interest rates in an orderly and moderate way.

...but funding flows remain strong.

Bank lending continued to expand over the last few months in the euro area. Net lending growth stood at 3.6% for non-financial corporations (NFCs) and 2.9% for the household sector in May. The April 2018 ECB Bank Lending Survey points to further easing of credit standards in 2018-Q2. Demand for bank loans has been supported by the low level of interest rates and interest rate differentials between euro area Member States have narrowed further over the last couple of months for both households and NFCs, except in some Member States. Market funding for NFCs continued to expand in the euro area.

Overall, households and NFCs are expected to remain unconstrained financially, with benign financial conditions assumed over the forecast horizon. In addition, the euro area corporate sector continues to run funding surpluses generating substantial internal funds, which could potentially be used to boost investment.

(2) To be precise, the ECB announced that: "the Governing Council anticipates that, after September 2018, subject to incoming data confirming [its] medium-term inflation outlook, the monthly pace of the net asset purchases will be reduced to EUR 15 billion until the end of December 2018 and that net purchases will then end."

1.3. EXPANSION CONTINUES IN LOWER GEAR

Growth momentum diminished at the start of the year…

In mid-2018, the European economic outlook remains solid but has moved into a lower gear compared to last year. In the first quarter of the year, GDP grew by 0.4% (q-o-q) in both the euro area and the EU, following 0.7% (q-o-q) growth in the five preceding quarters in both areas. All in all, this represents the 20th consecutive quarter of expansion. The weaker outturn may reflect some adjustment given that growth has been running above its long-run rate for some time. Temporary factors [3] such as unusual weather conditions, strikes in some Member States, the timing of Easter and a wave of influenza-related sick leaves are also likely to have played a role, but are hard to quantify. Despite the soft patch, GDP expanded in the first quarter in all reporting Member States except Romania and Estonia.

…amid a marked shift in growth composition…

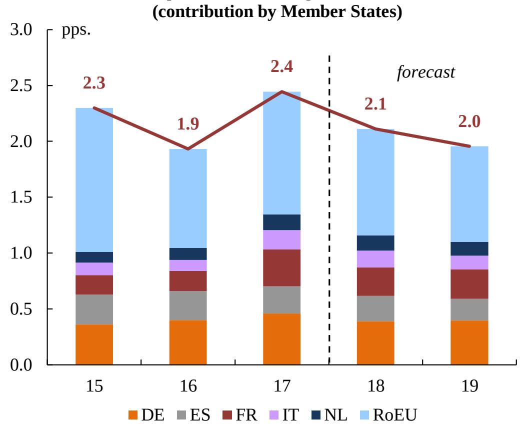
The GDP breakdown for 2018-Q1 shows that the expansion in the euro area was mainly supported by private consumption and investment, whereas the contribution of public consumption was neutral. At the same time, net exports became a drag (-0.2 pps.), following two consecutive quarters of positive contributions to GDP growth.

Private consumption gained some momentum in the first quarter (from 0.2% q-o-q to 0.5%), as labour markets continued to improve and consumer confidence remained higher than average. The pick-up was broad-based across most of the large euro area economies.

Investment growth receded somewhat to 0.5% in the first quarter (after 1.2%), with investment expanding across the largest euro area economies, apart from Italy. The contribution of changes in inventories to GDP growth turned positive, preventing an even sharper slowdown. The assets breakdown indicates that the slowdown was due to non-construction spending.

After 20 consecutive quarters of expansion, including growth of 2.2% in the last quarter of 2017, exports of goods and services contracted by 0.4% (q-o-q) in the first quarter of this year. The decline in exports was broad-based across the largest euro area economies, apart from Spain, and particularly marked in Italy and Germany. According to Eurostat's international trade data, extra-EU exports of goods fell by 0.3% (q-o-q) (+2.1% q-o-q in 2017-Q4) whereas intra-EU exports fell by 0.6% (following +0.9% in the preceding quarter). Imports contracted as well, but the fall was more muted than that of exports.

Graph 1.4: **Real GDP growth, EU28 (contribution by Member States)**



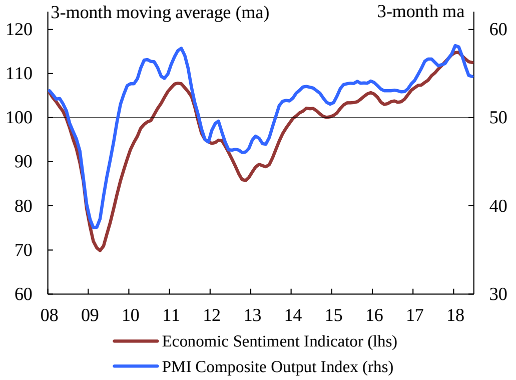
…and available data signal continued moderation in the second quarter…

Incoming data on activity and sentiment provide more evidence that the soft patch in euro area activity extended into the second quarter. While the impact of temporary factors has largely waned, activity and sentiment have so far failed to recover.

In June, the Commission's Economic Sentiment Indicator (ESI) remained broadly unchanged in the euro area for the third consecutive month, while the Eurozone Flash Composite Output Purchasing Managers' Index (PMI) rose from an 18-month low in May, driven by the service sector (see Graph 1.5). Meanwhile, sentiment in manufacturing continued to deteriorate, falling to a 18-month low. Weaker output and order books have been linked to intensifying trade and political concerns.

(3) On whether the moderation has any bearing on medium-term growth see Draghi, M. (2018). 'Monetary policy in the euro area'. Speech at the ECB Forum on Central Banking, Sintra, 19 June.

Graph 1.5: **Economic Sentiment Indicator and PMI Composite Output, euro area**



Source: EC, Markit Group Limited

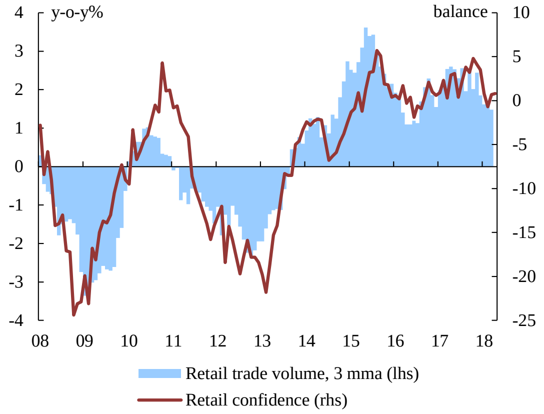
The momentum in euro area industrial production deteriorated further in April to -1.2% (3m-o-3m) (from -0.6% in March), with momentum of new industrial orders falling from -1.0% in March to -2.2% in April.

Available high-frequency indicators are consistent with a moderation of private consumption expenditure in 2018-Q2. After moving up in 2018-Q1, consumer confidence edged downwards again in 2018-Q2. At the same time, the Commission's Retail Trade Confidence Indicator also decreased in the euro area and the EU in the second quarter, although it remains at historically high levels.

By contrast, the momentum in retail trade volumes geared up in May (+0.6% 3m-o-3m), following an unchanged level in the first quarter (see Graph 1.6), whereas car registrations fell markedly over the same period (-1.0% 3m-o-3m, following +1.4% in 2018-Q1). Loans to euro area households for consumption purposes recorded an annual increase of 7.2% in May, close to its highest growth rate since late 2006. [(4)]

At the same time, high-frequency indicators of business investment have been more benign. The industrial production of capital goods rose in April (+1.9% m-o-m), following a contraction in 2018-Q1 (-2.0%). The capacity utilisation rate in manufacturing is close to its highest since 2008, which suggests a growing obsolescence of the capital stock, with equipment increasingly mentioned as a factor limiting production. Furthermore, May 2018 saw the strongest annual growth of loans to non-financial corporations in nine years, [(5)] which bodes well for business investment spending.

Graph 1.6: **Retail trade volumes and retail confidence, euro area**



This positive momentum is also visible in the Commission's Construction Confidence Indicator, which reached its highest level since early-1990 in 2018-Q2. Construction output in April increased by 1.8% (m-o-m) in the euro area (+1.2% in the EU) after remaining unchanged in 2018-Q1 (-0.4% in the EU). At the same time, loans for house purchases grew at an annual rate of 3.1% in May, close to the 3.3% reached in December 2017, which was the highest rate since September 2011.

Exports are expected to have remained subdued in the second quarter. The assessment of export order books in the Commission's manufacturing survey has fallen from the post-crisis high reached in 2018-Q1. The IHS Markit's Manufacturing PMI new export orders index points to a continued underperformance in both April and May. And data from the Centraal Planbureau (CPB) on the volume of trade in goods in the euro area shows that the growth momentum (3m-o-3m) moved further down to -1.4% in April (-0.7% in March).

…as the outlook is clouded by lower sentiment and uncertainty…

The recent spell of weak data, coupled with fading tailwinds and an increasing number of headwinds suggest that the European economy is unlikely to regain the strong momentum it enjoyed in 2017.

Rising headwinds include first and foremost the fall-out from ongoing trade tensions [(6)]. The central

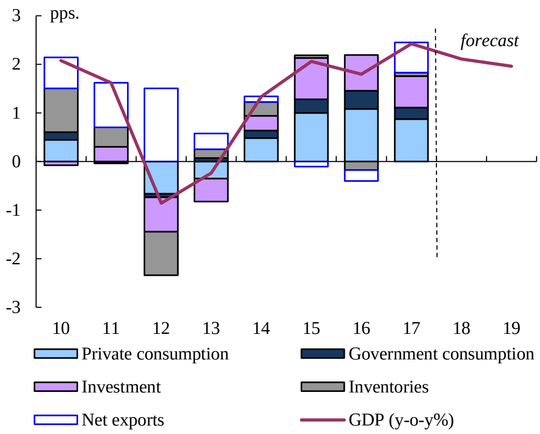
(4) For an up-to-date statistical picture of economic conditions for the household sector see ECB (2018). 'Household sector report'. May 2018.

(5) Loans adjusted for sales and securitisation.

(6) See ECB (2018). 'Implications of rising trade tensions for the global economy'. *ECB Monthly Bulletin* May 2018, pp. 21-5 (Box 1) and A. Barattieri, M. Cacciatore and

scenario takes into account only the actions that took place before the cut-off date (3 July), and does not incorporate any further escalation of trade tensions. The direct economic impact of the policy measures implemented so far has been limited, but their indirect effects on confidence are set to weigh on investment decisions, particularly in export-oriented sectors and countries (see technical box). These concerns come on top of the recent de-synchronisation of global momentum and in a context where the liquidity provided by major central banks is about to peak, and global yields have started to rise. Furthermore, the recent bout of political uncertainty in a number of Member States and the increase in oil prices are set to weigh on economic activity. Moreover, capacity constraints are expected to become progressively more binding in a number of Member States, dampening the growth outlook.

Graph 1.7: **Real GDP and its components, euro area**



…but fundamentals remain sound…

However, the fundamentals for above-potential growth remain in place. The European economy continues to benefit from supportive monetary conditions, with low financing costs for companies and governments despite the gradual withdrawal of monetary stimulus; brightening labour market conditions; as well as improving corporate and household balance sheets. Unless business sentiment changes significantly, rising labour utilisation should lead firms to focus on additional capital spending in order to increase supply. Even though tighter labour markets in a number of Member States may limit the pace of employment growth, they are likely to spur investment in technology and training and thereby support productivity growth.

…with domestic demand remaining robust…

Domestic demand is set to remain the main growth engine. Looking ahead, private consumption is forecast to continue expanding at a solid pace. The improvement in labour market conditions, as reflected in continued employment gains and higher wages, are set to continue bolstering household disposable income. Furthermore, the aggregate household balance sheet remains in solid shape with net worth levels rising on the back of rising house prices and past stock market gains. [7] However, household spending growth is expected to slow, as labour market improvements moderate this year and next and oil prices rise.

Investment growth is expected to remain robust but to moderate gradually. Favourable financing conditions, increasing capacity constraints and corporate profitability will continue to support business investment. The continued dynamism in housing markets should further support residential investment, driven by increasing real house prices, favourable income prospects and low nominal interest rates, despite the challenges posed by demographic factors. [8] Also, the Investment Plan for Europe should continue to boost business investment by improving access to finance. [9] The impact of these supportive factors, however, is likely to be partially offset by uncertainty regarding the external environment, through both its direct impact on current demand, as well as on future demand prospects. [10]

F. Ghironi (2018). ‘Protectionism and the business cycle’. *NBER Working Paper* 24353. February.

(7) C. Guerrieri and C. Mendicino (2018). ‘Wealth effects in the euro area’. *ECB Working Paper Series* 2157. June.

(8) Its leading properties to the economic cycle give increased backing to the narrative on the economic outlook. See E. Kholscheen, A. Mehrotra and D. Mihaljek (2018). ‘Residential investment and economic activity: evidence from the past five decades’. *BIS Working Papers* 726. June. and E. Monnet and C. Wolf (2017). ‘Is demographics the housing cycle?’. Banque de France, *Rue de la Banque* 41. April.

(9) As of June 2018, operations approved under the Investment Plan for Europe were expected to trigger €294 billion in investments. Around 644,000 small and medium-sized businesses are expected to benefit from improved access to finance.

(10) Uncertainty arises when economic agents cannot reasonably assess the likelihood of all possible future states of nature or characterise the probability distribution of their possible impacts. The real options channel suggests that the option value increases with uncertainty in the case of irreversible investment or consumption decisions. See ECB (2016). ‘The impact of uncertainty on activity in the euro area’. *Economic Bulletin* 8. December.

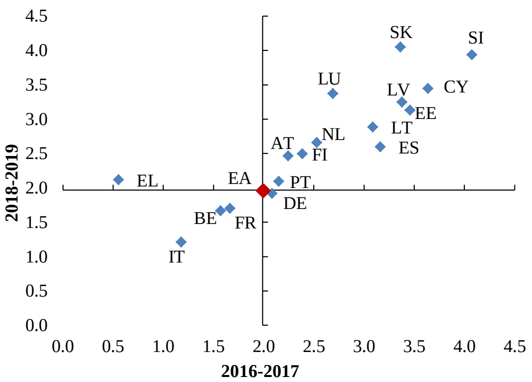
…despite rising risks.

Assuming no further escalation of trade tensions, euro area export growth is expected to slow down gently. Overall, global GDP is still expected to expand at a robust pace, and world import growth is still likely to ease only modestly. The lagged impact of the past appreciation of the euro since early-2017, however, is likely to constrain further market share gains.

Overall, euro area GDP is forecast to continue growing in 2018 but at a slightly slower pace compared to 2017 (2.1% and 2.4% respectively) and to the pace expected in spring. It is set to moderate further to 2.0% in 2019 as supply-side constraints gradually dent the growth momentum, foreign demand slows, and the uncertainty surrounding the outcome of the Brexit transition agreement weighs on confidence.

While all Member States are forecast to continue experiencing an economic upswing, those that have grown at above-average rates over the last two years are set to continue outperforming, whereas the remaining countries are forecast to continue expanding at below-average rates, with the notable exception of Greece, which is forecast to grow much above its previous average [11] (see Graph 1.8).

Graph 1.8: **Real GDP growth, euro area and Member States, 2016-2017 versus 2018-2019**



Note: MT and IE are excluded from the calculation of the euro area average and are not displayed.

[11] Greece will conclude its ESM programme on 20 August. See Eurogroup (2018). 'Eurogroup statement on Greece'. *Press release* 390/18. June.

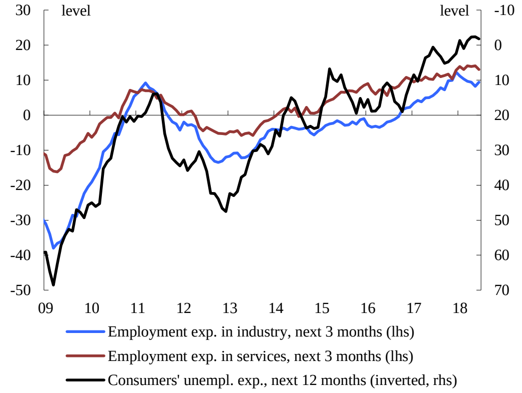
1.4. LABOUR MARKET CONDITIONS SET TO CONTINUE IMPROVING

The labour market situation in the euro area continued to improve in the first half of 2018. Employment rose by 0.4% quarter-on-quarter in 2018-Q1 and was 1.4% higher than one year ago. The number of employed persons reached a new historical high. The long period of employment growth was accompanied by a rebound in the number of total hours worked in the economy. In 2018-Q1 they increased by 0.2% quarter-on-quarter to the highest level since 2008-Q4. The slower growth of hours worked as compared to persons employed reflects the rise in part-time workers over recent years, but also changes in the composition of employment due to structural shifts across sectors. Many part-time workers have identified themselves as involuntarily working less than full time, which is reflected in developments of broader underemployment indicators that continue to suggest that some slack remains in the labour market. Labour market slack has been receding as the market has improved and labour shortages have arisen in several sectors in some Member States. Labour shortages have also become visible in the job vacancy rate, which moved up in the first quarter to 2.1%, its highest level in the history of the series (since 2006). Reflecting the gradual tightening of the labour market, the unemployment rate in the euro area declined to 8.4% in April 2018 and stabilised at that level in May, its lowest level since December 2008.

Employment creation continued to be strong considering the pace of economic expansion. Both in terms of employment and unemployment, labour market conditions have improved across all Member States. Nevertheless, significant differences remain.

Survey indicators of companies' employment expectations retreated somewhat in early 2018 but remain well above their long-term averages (see Graph 1.9). In June, the readings in the Commission's Business and Consumer Surveys were consistent with continued job creation in the coming months, with the unemployment rate set to continue falling. The marginally slower pace of economic growth now expected should have little impact on the labour market outlook.

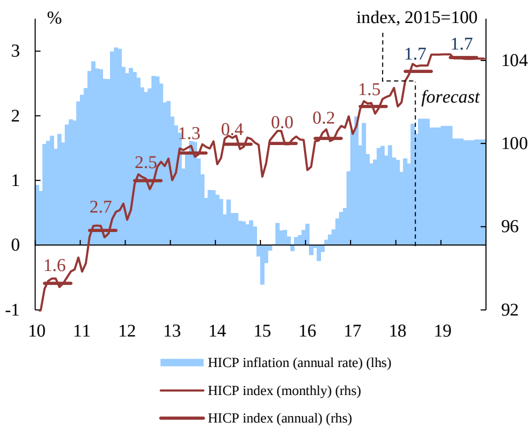
Graph 1.9: **Employment expectations, DG ECFIN surveys, euro area**



1.5. ENERGY PRICES DRIVE INFLATION HIGHER IN THE NEAR TERM

Headline inflation in the euro area edged up, particularly in the second quarter 2018, on the back of higher energy prices. Inflation jumped to 1.9% in May and is estimated at 2% in June. This was a substantial pick-up from the average of 1.3% in the first quarter of 2018 (see Graph 1.10). Although this was to an extent expected, given base effects from last year's energy price developments, the continued rise in oil prices and the drop in the euro exchange rate against the dollar have added further upward pressure on energy prices and led to higher-than-expected inflation. Indeed, energy inflation is estimated at 8% in June, compared to 6.1% in May. The second quarter figures were also driven higher by unprocessed food prices, in particular major cereals and dairy.

Graph 1.10: **HICP, euro area**



Figures next to horizontal bars are annual inflation rates.

On the other hand, core inflation – which excludes energy and unprocessed food prices – has remained muted with no discernible trend so far in 2018. It averaged 1.2% in the first quarter and was estimated at the same rate in June. Services inflation exhibited some volatility due to the timing of Easter (in late March vs. April last year), which affected the prices of package holidays, accommodation and transport. On the whole, non-energy industrial goods inflation has remained stable so far this year. The muted underlying inflation rate reflects the lagged negative impact of a prolonged period of low inflation and weak wage dynamics.

Recent wage developments show a pick-up…

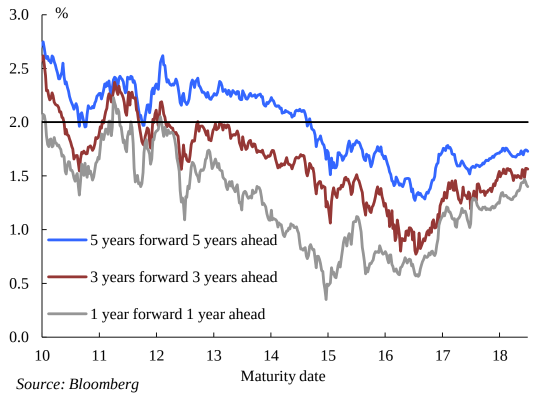
Recent wage indicators in the euro area, however, show signs of a gradual pick-up. The annual growth of both nominal compensation per employee and negotiated wages registered notable increases in the first quarter of 1.9% and 1.8% respectively. Compensation per hour worked also increased strongly, from 1.5% in 2017-Q4 to 1.9% in 2018-Q1. Meanwhile, prices along industrial supply chains are also contributing to rising pressure in underlying inflation, with the growth of industrial producer prices having edged up to the 3% mark in May.

…supportive of a gradual increase in core inflation.

Headline inflation in the euro area is forecast to remain around current levels in 2018, provided that oil prices remain close to the current assumptions based on futures markets. Overall, headline inflation is forecast to average 1.7% over 2018, 0.2 pps. higher than in the spring forecast. Then, in 2019, the impact of energy inflation should slowly taper out, leading to some moderation in the headline rate in the first half of the year. Underlying inflation is then expected to gradually gather pace, as labour markets progressively tighten and wages rise. In fact, recent developments in wage growth underpin and drive a good part of the inflation outlook, as wage growth is a key determinant of domestic price pressures, especially services inflation, which has been subdued until recently. In 2019, headline inflation is expected to average 1.7%, also slightly higher than previously expected.

Market-based measures of inflation expectations have continued to recover since spring and the beginning of the year, but mainly in the short-term spectrum. At the cut-off date of this forecast, inflation-linked swap rates at the one-year forward one-year-ahead horizon stood at around 1.4%. Swap rates at the three-year forward three-year-ahead horizon imply an average inflation of close to 1.6%. On a longer horizon, the widely watched five-year forward five-year-ahead indicator suggests inflation of 1.7% (see Graph 1.11). Moreover, the ECB's April 2018 Survey of Professional Forecasters includes inflation forecast means of 1.5% in 2018 (unchanged, compared to the 2018-Q1 exercise), 1.6% in 2019 (down by 0.1 pps.) and 1.7% in 2020 (down by 0.1 pps.). Longer-term inflation expectations stood unchanged at 1.9%.

Graph 1.11: **Inflation expectations derived from implied forward inflation-linked swap rates**



Source: Bloomberg

1.6. RISKS TILTED TO THE DOWNSIDE

Overall, even though some of the risks identified in April have materialised, the balance of risks remains clearly tilted to the downside. This is particularly the case beyond the very short term, as some downside risks have increased, notably those related to escalating trade protectionism.

On the upside, rising supply constraints could trigger additional investment and efforts to increase productivity; and additional labour supply could emerge from among the underemployed and the inactive. Given the prominent role played by supply-shocks in driving oil prices over the previous year [12], oil prices could turn out lower than assumed on the back of a recent OPEC agreement and the price-responsiveness of US shale oil production.

Downside risks to the growth outlook, however, clearly dominate. They are mainly on the external side and concern the dangerous nexus between a possible further escalation of trade disputes driven by the US, the potentially disruptive effect of tighter financing conditions, and increased imbalances stemming from the highly pro-cyclical fiscal policy in the US.

Since the spring, trade tensions have further escalated. This forecast takes into account what is already implemented, but several additional protectionist measures are being considered and would probably trigger retaliation if implemented. Further escalating trade conflicts would negatively affect welfare in all countries involved. Restrictions to foreign trade and foreign direct investment would lower productivity. A disruption of global supply chains could have a highly non-linear effect on world trade volumes. In the near term, trade disputes could have a sizeable indirect impact on domestic investment through confidence effects – already seen to some extent in the tradable goods sector in the first half of 2018 - and increased uncertainty. In the longer term, the European and global economy would also likely suffer from a further undermining of open rules-based multilateralism.

The expected further divergence of monetary policies in 2019 may not be fully priced in by financial markets yet, and could lead to a sharper tightening of global financial conditions. Volatility in global financial markets could increase further in a context of relatively high equity valuations and rising treasury yields, impacting financing conditions also in the euro area. [13] If this were to lead to diminished risk appetite globally, there could be significant spillovers in terms of capital flows and financial market stability. As shown over the second quarter of the year, emerging market economies [14], including China, where public and private leverage [15] have increased markedly in recent years, would be particularly vulnerable to changing market conditions.

Also, political and policy uncertainty in a number of EU countries remains an important downside risk to the forecast. This includes the risks related to the outcome of the negotiations on the terms of the UK's withdrawal from the EU in March

(12) ECB (2018). 'Are the recent oil price increases set to last?'. *ECB Economic Bulletin* 2, pp. 36-40, March. (Box 1)

(13) BIS (2018). 'The risks ahead'. *Annual Economic Report*, pp. 12-20. June.

(14) L. Menna and M. Tobal (2018). 'Financial and price stability in emerging markets: the role of the interest rate'. *BIS Working Papers* 717. May.

(15) See World Bank (2018). 'Corporate debt: financial stability and investment implications'. *Global Economic Prospects*. June.

2019 [16], in particular if the outcome differs meaningfully from the technical assumption of status quo in terms of trading relations between the EU27 and the UK for 2019.

The relevance of downside risks related to geopolitical tensions in the Korean peninsula appears to have faded, although they remain high in the Middle East. Were these risks to increase, supply-side pressures on oil prices could intensify.

(16) See Box 1 on .the technical assumption regarding trading relations between EU27 and the UK for the current forecast.