Euro zone heading toward more moderate expansion

After a remarkable year in 2017, economic growth in the euro zone was slower over the first half of 2018 overall. The expansionary cycle is continuing, albeit at a more moderate pace but still higher than trend growth. Tougher monetary policies and protectionist trade measures are weighing on foreign demand prospects.

A slowdown in the first half of the year

Euro-zone GDP rose 0.4% over one quarter in the 2nd quarter of 2018, posting the same performance as the previous quarter. Over the first half of 2018, the growth rate was well below that for last year (+0.7% on average per quarter), but remains higher than the historical trend observed since the recovery in 2013 (+0.3% per quarter).

Data is not yet available for all Member States, but already contrasting trends can be seen in the three leading euro-zone economies. Germany delivered a pleasant surprise, with 0.5% growth over one quarter, higher than suggested by the negative signals coming from German entrepreneurs and disappointing industrial output results. Germany is rightly concerned about the tensions weighing on global trade because its exports have made a huge contribution to its expansion in recent years. However, in the 2nd quarter, German domestic demand seems to have been the main driver, boosted by private1 and public consumption spending and by the resilience of the construction sector.2

The results for France and Italy were more disappointing, with GDP growth just 0.2% over one quarter. France, where growth had already slowed significantly in the 1st quarter (also +0.2%), is in a downturn. Household consumption has suffered from a number of tax measures3 which, combined with energy price hikes, weighed on purchasing power. In Italy, post-electoral uncertainties (on the economic policy of the new government, the formation of which was somewhat turbulent) are likely to weigh on growth for longer.

Growth remains in place but downside risks are materialising

Despite the slowdown over the first half of 2018, most economic markers in the euro zone remain solid. Confidence indicators for businesses and households have fallen somewhat but remain above their long-term average. GDP growth will certainly be lower this year than last year but the end of the expansionary cycle is not yet in sight.

In fact, certain downside risks – tougher monetary policies and increasing protectionism on a global scale – have materialised. The upswing in the US dollar, linked particularly to the fact that the ultra-expansive US monetary policy has brought the prospect of inflation and hence more monetary tightening than expected, is putting pressure on many emerging countries (see below). After strong expansion in 2016 and 2017, the volume of global trade now seems to be entering a stagnant phase.4 The prospects for foreign demand for euro-zone exports plus the uncertainties related to the Brexit negotiations – which have proven difficult – thus seem less favourable now.

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1 German household consumption has benefited from negotiated wage increases and from the ongoing fall in unemployment.
2 First-quarter German growth was revised upward (from 0.3 to 0.4%).
3 The effect of which should be transitory and is set to reverse over the 2nd part of the year.
4 by the Dutch CPB [available up to June 2018].
Confidence and results on the cards

Confidence among manufacturing and construction companies remained high over the summer of 2018. Luxembourg manufacturers were less confident about the first months of the year, worried in particular about short-term output prospects. They have regained their optimism since then and the latest survey (July 2018) attests to much more favourable opinions regarding the order books. Over the 1st half of 2018, Luxembourg industrial output was up almost 5% over one year (compared to a little under 3% in the euro zone).

In construction, business owners remained upbeat at the start of the 3rd quarter. Output in this sector rose more than 5% over one year, compared to 2% in the euro zone. At European level, this is one of the only sectors where economic surveys have not recorded a fall in confidence this year.

Manufacturing and construction still account for about 20% of total employment in Luxembourg (and 13% of added value in the total economy).

Insurance: shift towards guaranteed returns

In the 2nd quarter of 2018, premiums collected by insurance companies fell 17% over one year, a slowdown that comes after a particularly profitable year in 2017. The fall only affected premiums on unit-linked life products (-31% over one year), which were hit by the stock market correction at the start of the year and are now not as popular as last year. The 2nd quarter of 2017 saw exceptional growth in premiums on these products, which became highly attractive thanks to strong stock market valuations and low interest rates generating low returns on other life insurance products. In contrast, premiums collected on conventional life insurance products rose 14% on last year, boosted by the development of significant activity in protection products.

Non-life insurance continues to benefit from the positive impact of British companies relocating operations in the run-up to Brexit (+9% over one year).

Private sector loans remain buoyant for resident customers

Loans granted to the non-financial private sector were up slightly in the 2nd quarter (+2.2% over one year). They increased strongly between 2014 and 2016, essentially driven by the demand of foreign companies, but this movement comes to an end. The credits to foreign non-financial corporations have decreased by 4.9% over one year.

However, loans to residents remain dynamic, on the businesses side (+11.3% over one year in the 2nd quarter) and on the households side (+6.5%). For these latter, the rise in loans comes from mortgage credits (+8.2% compared to +4.1% for consumer credits).
Labour market

RESIDENT AND CROSS-BORDER WORKERS

Dynamic rise in cross-border employment

In the 2nd quarter of 2018, domestic paid employment rose 3.9% over one year, compared to 3.8% and 3.7% over the two previous quarters. Much of this momentum is down to cross-border employment (+4.8% in Q2, compared to 4.6% and 4.3% over the two previous quarters). Most of this trend involves French cross-border workers (+5.0% growth in 2017, compared to about +3% for cross-border workers from Germany and Belgium), which could be linked in part to the fact that economic growth in France remains below that of the euro zone as a whole.

However, contrary to cross-border employment, national employment growth (over 3% in recent quarters) has exceeded its long-term average for the last two years (+1.6% on average between 1996 and 2017). It is particularly high among foreign residents, particularly non-Europeans (+13.7% in 2017) and non-EU28 Europeans (+5.6%). In national employment, Luxembourgers are still taking up most of the new positions created (30%).

Prices 1/2

RAW MATERIALS: PRICE OF INDUSTRIAL METALS

Trade tensions weigh on metal prices

The introduction by the United States of new taxes on aluminium and steel imports on 1 June and the failure of the G7 summit some days later drove metal prices down. Since then, they have fallen 14% (aluminium -9%, nickel -12%, copper and lead -16%, zinc -21%) wiping out the gains over the last 12 months. Increasing trade risks have sparked fears about global growth, particularly in China, the source of about 50% of global demand for metals. However, many analysts see the falling prices as the result of a speculative wave and expect prices to recover, as the fundamentals remain good for the moment.

Generally, the prices of many raw materials have been showing signs of weakness in recent months. They are suffering partly from exchange rate movements, with the greenback strengthening and the shock to the Turkish lira (which triggered the depreciation of other emerging currencies). Breaking with the upward trend that started last summer, oil prices have lost ground since the end of May (−4 USD per barrel).

Prices 2/2

OBSERVED AND FORECAST INFLATION

Underlying inflation bottoming out

Underlying inflation was just 0.7% over one year in July but is set to rise considerably over the next few months. The disappearance of a number of bullish effects relating to 2017 were behind this low rate recently. Falling crèche prices will continue to drag underlying inflation significantly lower into November. Starting in August, underlying inflation is expected to recover, given the upward pressures exercised by the wage indexation adjustment on service prices.

Despite this recent weakness in underlying inflation, the overall rate has been rising since May. It is largely sustained by oil prices, which have been rising since the summer of 2017. If these prices stabilise at early August levels, the impact should gradually dissipate. On foot of the expected strengthening in underlying inflation, the inflation rate should continue to rise and – according to the latest forecasts from STATEC – should reach 2% by the end of the year. Inflation will be 1.4% over 2018 as a whole and 1.8% in 2019.
Turkey under US pressure

The greenback’s appreciation is putting pressure on countries whose debts are denominated in dollars. The situation in Turkey has considerably worsened recently. Conflict between the government and the central bank triggered a wave of reactions, including slumps on the Istanbul stock exchange and the downgrading of Turkish banks and borrowings. The United States’ announcement of sanctions against Turkey following the arrest of an American pastor aggravated the situation. Since early 2018, the Turkish lira has fallen 60% against the dollar, considerably reducing the country’s solvency. Because of this depreciation, Turkish debts in foreign currencies – about 50% of GDP in early 2018 – are now reportedly close to 80% of GDP. The current account deficit is said to exceed 8% of GDP.

This situation is not without risks from a European perspective. Turkey’s largest external creditors are European banks, particularly German banks, which will be affected by a default of payment. Furthermore, the risk of contagion to currency-exchange markets is potentially destabilising on a global scale because emerging currencies tend to fluctuate at the same time.

## International

**EXCHANGE RATE – EMERGING ECONOMIES VS. US DOLLAR**

![Chart of exchange rates between emerging economies and US dollar]

Source: Macrobond

## Trend chart

**Activity**
- Industrial output per working day, in volume: 8.7% (2017 Q4), 7.0% (2018 Q1)
- Construction output per working day, in volume: -1.2% (2017 Q4), 3.6% (2018 Q1)
- Turnover by volume of total retail trade: 5.9% (2017 Q4), 1.6% (2018 Q1)

**Prices, wages**
- Consumer price index (NCPI): 1.5% (2017 Q4), 1.3% (2018 Q1)
- Underlying inflation: 1.2% (2017 Q4), 0.9% (2018 Q1)
- Oil product index: 8.6% (2017 Q4), 12.2% (2018 Q1)
- Industrial producer price index: 4.1% (2017 Q4), 2.0% (2018 Q1)

**Foreign trade**
- Exports of goods (volume): 7.1% (2017 Q4), 7.0% (2018 Q1)
- Imports of goods (volume): 0.2% (2017 Q4), -0.6% (2018 Q1)

**Employment, unemployment**
- Domestic number of employees: 3.8% (2017 Q4), 3.8% (2018 Q1)
- National employment: 3.1% (2017 Q4), 2.9% (2018 Q1)
- Unemployment rate (% of working population, seas. adj.): 5.7% (2017 Q4), 5.6% (2018 Q1)

Source: STATEC

Data coloured are estimates

1 Estimations based on half-yearly data

## Indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2017 Q1</th>
<th>2017 Q2</th>
<th>2017 Q3</th>
<th>2017 Q4</th>
<th>2018 Q1</th>
<th>2018 Q2</th>
<th>Average over the last three months</th>
<th>Same period previous year</th>
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<tbody>
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<td>Eurozone - Growth in volume of GDP (European Commission)</td>
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<td>Luxembourg - Growth in volume of GDP (STATEC)</td>
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<td>GDP at current prices 2017: EUR 55 378 million</td>
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<td>Minimum monthly salary (since 01/08/2018): EUR 2 048.54</td>
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<td>Current account balance (2017 Q4): EUR 1 045 million</td>
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<td>Resident population (01/01/2018): 602 005</td>
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<td>Consumer price index (July) - base January 1st 1948: 851.56</td>
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<td>Half-yearly average of the index linked to base as at January 1st 1948: 853.38</td>
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<td>Estimated deadline for next salary indexation: 4th quarter 2019</td>
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