Eurozone Outlook 2019

Group Economics
Financial Markets Research

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Slow growth puts ECB on ice

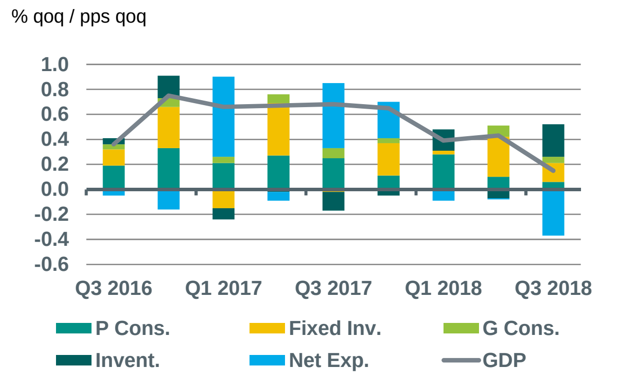
Aline Schuiling
Senior Economist
Tel: +31 20 343 5606
aline.schuiling@nl.abnamro.com

- **We expect the eurozone economy to grow only modestly and below consensus forecasts in 2019 …**
- **…exports will remain weak as the global economy has lost momentum on the back of tightening financial conditions, while the US economy will cool off when the impact of the fiscal stimulus fades away in the course of 2019**
- **Fixed investment growth will weaken in sync with exports, but private consumption growth should pick up thanks to declining inflation, modest fiscal stimulus and low interest rates**
- **There is still significant slack in the labour market and wage growth and core inflation will remain subdued for a considerable time**
- **Political risks remain elevated, with the political landscape fragmented in most eurozone countries, which has resulted in minority governments, caretaker governments and fragile coalition governments, and which hinders policy making and economic reform**
- **The ECB has ended its asset purchases, but is expected to keep interest rates unchanged throughout 2019**
- **We expect a first ECB hike in March 2020 but the risks are skewed towards even later**
- **Bond yields are likely to be depressed in the coming months by dovish policy shifts, but could rise modestly towards year-end as markets anticipate ECB rate rises**

Weak growth in 2018H2 and the start of 2019, to be followed by a modest pick-up
The eurozone economy lost significant momentum in 2018, with growth falling from rates of around 0.7% qoq in 2017, to rates of around 0.4% in 2018Q1-Q2. In 2018Q3, growth dropped to merely 0.2% as the economy received an extra blow from temporary problems in the car industry, which seem to have lingered in Q4. Early indicators suggest that growth remained well below the trend rate of around 1.5% annualized in 2018Q4 and 2019Q1. Indeed, exports and industrial production probably contracted during these two quarters as the global economy and world trade lost further momentum, while growth in France was temporarily disrupted by strikes and street protest. Looking forward, we expect GDP growth to pick up somewhat after 2019Q1 and settle down at around 0.3-04% qoq, which is close to the trend growth rate. Importantly, the temporary factors that depressed growth in 2018Q3-2019Q1 will unwind. Moreover, we expect modest growth in industry and exports on the back of some

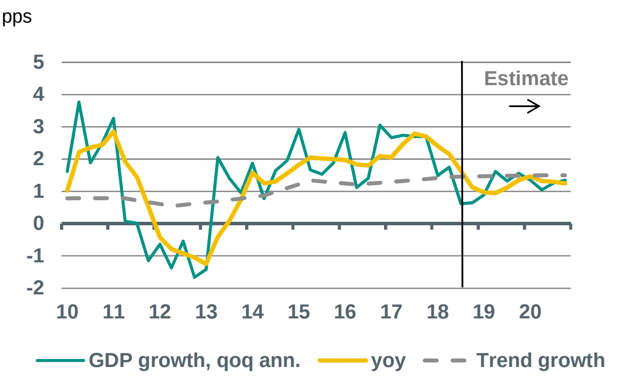
improvement in global trade growth in the second half of the year, and a pick-up in private consumption and government spending in the eurozone.

Eurozone GDP growth and main components



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

GDP growth versus the trend

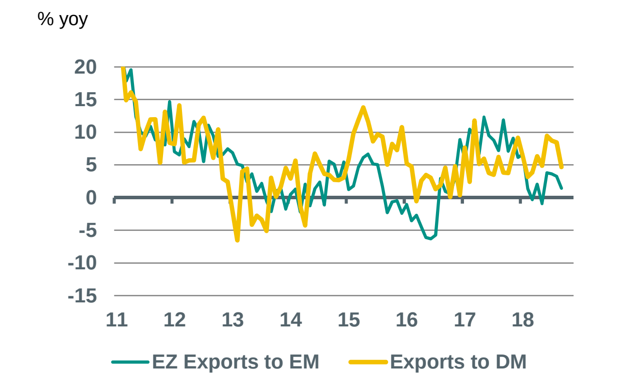


Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Exports weighed down by softer global growth

The main factor that depressed growth in 2018 was a drop in the contribution of net exports, largely because of a sharp slowdown in exports to emerging markets (see graphs above and below). Looking forward, our outlook for the global economy and world trade suggest that eurozone exports will continue to contract in 2018Q4-2019Q1 and grow modestly thereafter. Importantly, we expect policymakers to facilitate a modest recovery in world trade growth. The FOMC seems less fixed on further interest rate hikes, the ECB may keep interest rates on hold for even longer, while China's policymakers have stepped up stimulus. Moreover, we have assumed that there will be no escalation of protectionism, although uncertainty related to protectionism will continue to linger. As the trade-weighted exchange rate of the euro has been moving in a narrow range since the summer of 2017, it is not expected to have a significant impact on competitiveness or trade flows. All in all, we expect net exports to reduce overall GDP growth by around 0.3pps in 2019.

Exports weighed down by EM



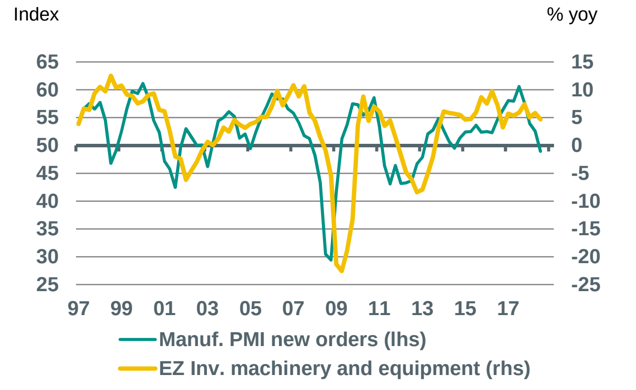
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Exports and fixed investment move in sync

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

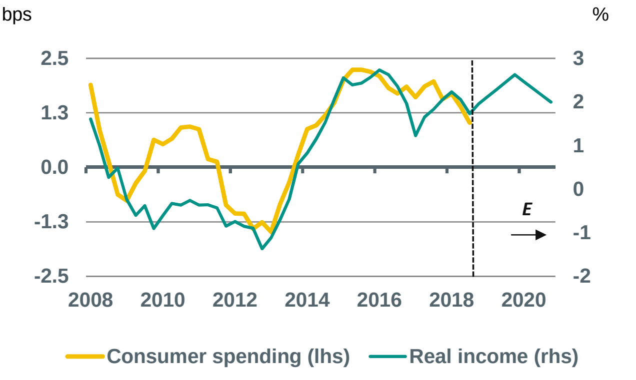
Fixed investment hit by weaker exports, private consumption to strengthen
Domestic demand should continue to grow solidly in 2019. Within domestic demand strength should shift from fixed investment, which is expected to slow down somewhat, towards private consumption growth, which should pick-up. The slowdown in export growth is likely to weigh on investment in machinery and equipment, as these two components of GDP tend to move in sync. Moreover, financial conditions have tightened in 2018 due to weaker equity markets and rising corporate credit spreads. This should also weigh on investment growth.

Signs of fixed investment slowing further



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

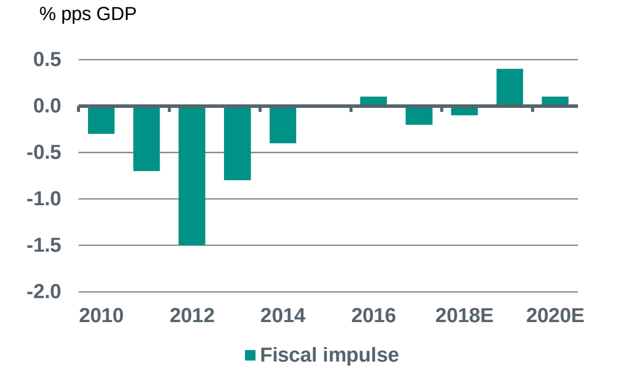
Consumption supported by real income growth



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

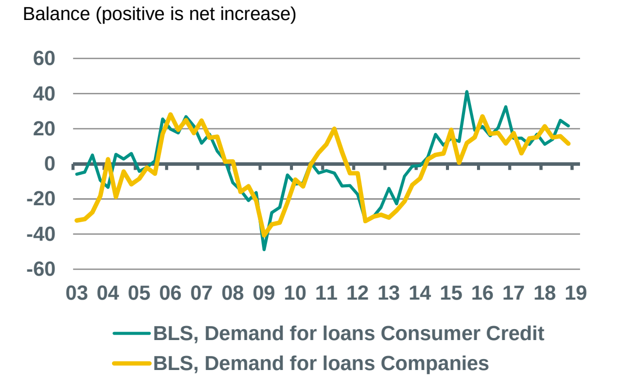
Private consumption growth weakened in 2018Q2-Q3 due to the rise in headline inflation on the back of higher energy prices, but we expect it to strengthen in 2019. This will be largely thanks to headline inflation dropping lower on the back of plummeting energy price inflation. Moreover, expected further modest growth in employment will support household income. Having said that, nominal wage growth is expected to ease somewhat as there still is slack in the eurozone labour market (see below). Consumer confidence has declined in the second half of 2018, but from a historical perspective it is still at a high level, consistent with ongoing growth in consumption.

Fiscal stimulus on the cards



Source: EC, ABN AMRO Group Economics

Domestic demand supported by low interest rates



Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

Modest fiscal stimulus ahead, monetary policy to remain supportive to growth
Although fiscal policy will, on balance, be positive to growth in domestic demand, the upward impact will not be strong enough to compensate for the slowdown in exports and investment. European rules and national policy choices have limited the size of fiscal policy easing. Recent events in Italy (the government toned down its original fiscal expansion plans for 2019 and lowered the target for its 2019 budget balance from -2.4% to -2.04%) have shown how pressure from the European Commission is limiting fiscal impulses in countries that have relatively high structural budget deficits and/or high government debt ratios. On the other hand, national policy choices have limited the size of the fiscal impulse in countries that have relatively large surpluses on the structural government balance and/or low levels of government debt (Germany, the Netherlands, Austria, Finland and Ireland). The estimated fiscal impulse in the eurozone as a whole for 2019 is equal to around 0.4pps of GDP. To compare, the fiscal impulse of the Trump administration in the US was around four times as high.

Besides fiscal policy, monetary policy and the low level of interest rates will also remain supportive to domestic demand growth in 2019. Indeed, the results of the latest Bank Lending Survey showed that banks on balance still report significant increases in demand for bank loans. We do not expect the ECB to hike interest rates before March 2020 (see below) and although the QE programme has ended, reinvestment of maturing assets held by the ECB means that interest rates will remain subdued for a while (see below).

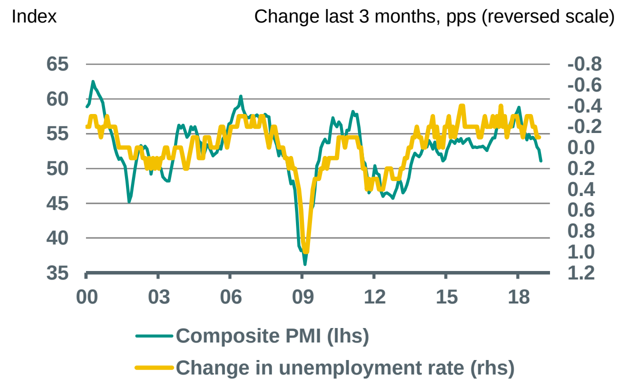
All in all, we expect GDP to expand by around 1.1% on average in 2019, which is below the current consensus forecast of 1.6% and also lower than the most recent forecasts of the ECB (1.7%), European Commission (1.9%) and OECD (1.8%).

Pace of decline in unemployment has slowed down; still slack in the labour market
The slowdown in economic growth since the start of 2018 has already translated into a slower pace of decline in the unemployment rate. The decline in the unemployment rate compared to the rate three months before fell from -0.3 pps in the middle of 2018, to -0.1 in November.

We expect the unemployment rate to move roughly sideways in 2019. As the labour market reacts to changes in economic conditions with a lag, the economic weakness in the second half of 2018 and start of 2019 will probably have a modest upward impact on the unemployment rate in the course of 2019. However, working in the opposite direction the ongoing process of labour market reforms (including labour market related taxes and social security systems) should continue to have a more structural downward impact on the unemployment rate.

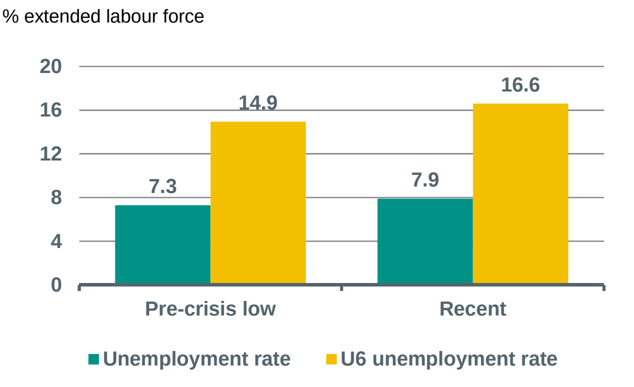
On balance, the unemployment rate is therefore expected to remain close to the current levels. At its current level of 7.9% (November 2018) it is still is well above the pre-crisis low. Moreover, the U6-indicator for labour market slack, which also includes people that are involuntarily working part-time and people that are marginally attached to the labour market, is still significantly higher than the pre-crisis low (16.6% in 2018Q2 versus 14.9% in 2008Q1).

Decline in unemployment has slowed down …



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

… while there is still slack in the labour market

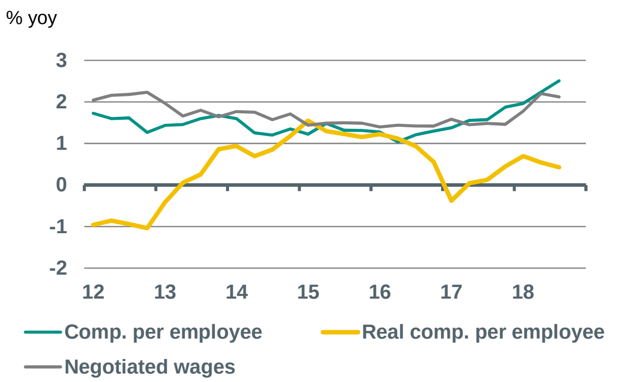


Source: EC, Thomson Reuters Datastream, ABN AMRO Group Economics

Wage growth to slow down in the course of 2019

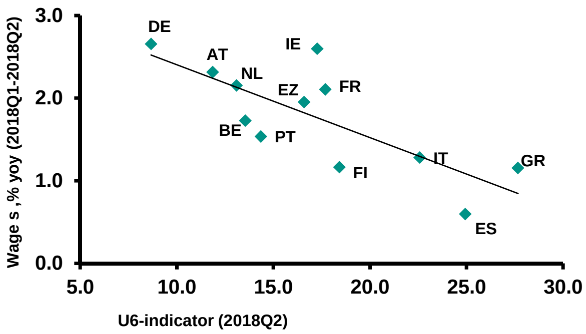
Despite the fact that there is still slack in the labour market, wage growth has picked up since the start of 2018. Compensation per employee rose by 2.5% yoy in 2018Q3, up from 1.9% in 2017Q4. Considering that real wages contracted in 2017 due to an unexpectedly sharp rise in the headline inflation rate on the back of higher energy prices, we think that the pick-up in nominal wage growth since the start of 2018 merely was compensation for this. Consequently, we expect nominal wage growth to decline somewhat in 2019. Nevertheless, it should remain higher than the inflation rate. An early indicator for somewhat slower wage growth seems to be that growth in negotiated wages (which according to comments made by ECB President Mario Draghi is the ECB's preferred measure of wage growth) edged lower from 2.2% in 2018Q2 to 2.1% in 2018Q3.

Rise in wage growth to compensate for 2017



Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

… wage growth reflects differences in slack



Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

Core inflation to remain well below the ECB's target in the next few years

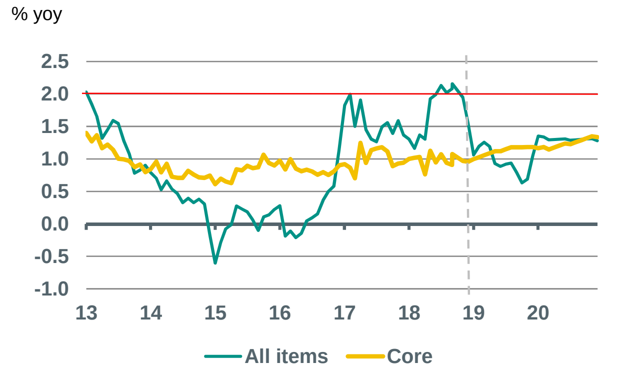
The core inflation rate (excluding food, energy, alcohol and tobacco) has been hovering around 1% since the start of 2017. We expect it to continue to remain close to this level during 2019. As mentioned above, we see underlying inflationary pressures stemming from the labour market remaining subdued, as we expect wage growth to slow down somewhat. However, productivity growth should decline as well, with employment growth reacting to the weakening in output growth with a delay. Therefore, the rise in unit labour costs should be more stable. Besides the lack of inflationary pressures stemming from the labour market, we think that the impact of import prices on the inflation rate, on balance, should also remain subdued. The weakening of the global economy should reduce the inflation rate of global industrial goods, while an expected appreciation of the euro exchange rate will have a downward impact on import price inflation as well. All in all, core inflation should remain close the to 1%-level throughout 2019, which is about half the ECB's target rate.

Political risks remain elevated

The political landscape in most of the individual eurozone countries has remained fragmented in 2018. Traditional political parties at the centre-right or centre-left of the political spectrum have continued to lose support, while populist parties or parties at the extreme side of the political spectrum have gained support. This has meant that there are now a number of minority governments (e.g. Spain, Portugal, Ireland), a caretaker minority government (Belgium) and some instable or fragile coalition governments (Finland, Italy, the Netherlands, Greece). As a result, implementing significant policy changes, including policies aimed at further European integration, or meaningful economic reforms has become complicated in a large number of eurozone countries.

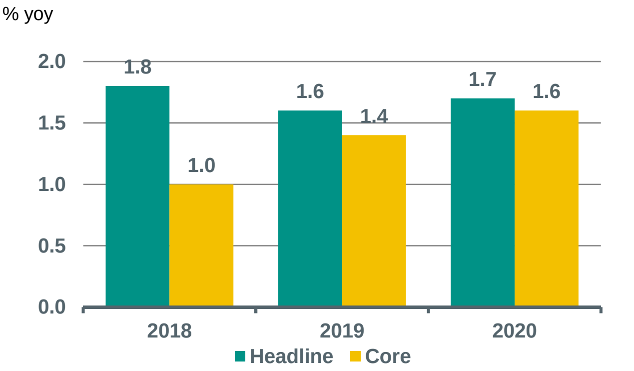
In 2019, general elections are scheduled in Finland (14 April), Belgium (26 May), Portugal (6 October) and Greece (20 October). Moreover, it cannot be excluded that early elections will be held in Italy (currently governed by an all populist coalition of the centre-right Lega and left-wing, populist M5S), Spain (currently governed by a minority government led by Prime Minister Pedro Sánchez of the centre-left social democratic PSOE, which holds less than 25% of the seats in parliament).

ABN AMRO inflation projection ...



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

... well below the most recent ECB projection



Source: December 2018 Eurosystem staff macroeconomic projections

ECB to keep interest rates unchanged in 2019

The ECB kept its policy rates unchanged throughout 2018. It's current forward guidance on interest rates is that rates will 'remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are in line with the ECB's target over the medium term'. Meanwhile, the central bank has ended its net asset purchases under the APP programme in December, but it has enhanced its guidance on its reinvestment policy. It intends to 'continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates'.

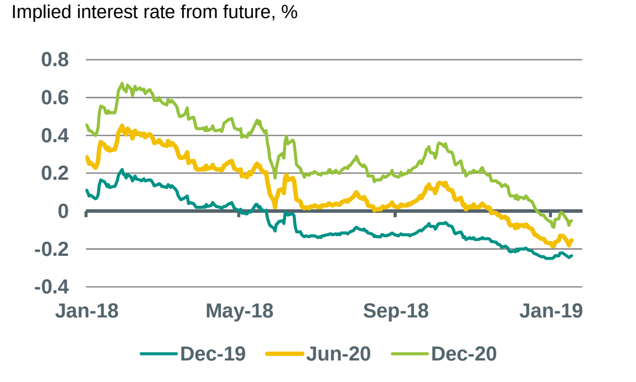
Given that our forecasts for GDP growth and inflation are well below those of the ECB, we expect the ECB to keep interest rates on hold in 2019. We expect the forward guidance on interest rates to change following further downgrades to the outlook, and we think that the central bank will signal that interest rates will be left on hold through 2019 by the June meeting. We expect a 10bp hike in all the policy rates in March 2020 and a second 10bp increase in September 2020. Given the subdued macro environment, we think that the risks are skewed towards even later rate hikes. We do not expect the ECB to end reinvestments until late in 2021.

Finally, we expect a TLTRO extension to be announced in March 2019. With regard to other policy instruments, ECB president Mario Draghi has mentioned that the ECB intends to keep liquidity as available as it needs to be, that the ECB is aware of the factors that will affect liquidity in the next couple of years, and that it will discuss this at some point in future. We expect the ECB to make changes to the TLTRO programme in March, to allow banks to repay the funds over a longer period than currently.

Government bond yields likely subdued in coming months, but to rise later in the year
Government bond yields fell during the course of 2018 as financial markets scaled back their expectations of ECB interest rate hikes. One way to see this is looking at the implied interest rate from Euribor futures at various time horizons in the future (see chart on the left), which have a close link to 10y Bund yields (see chart on the right). In first half of 2019, we think Bund yields will likely drift lower. This reflects the dovish policy shifts at the ECB and markets catching up with likely downgrades to growth and inflation forecasts.

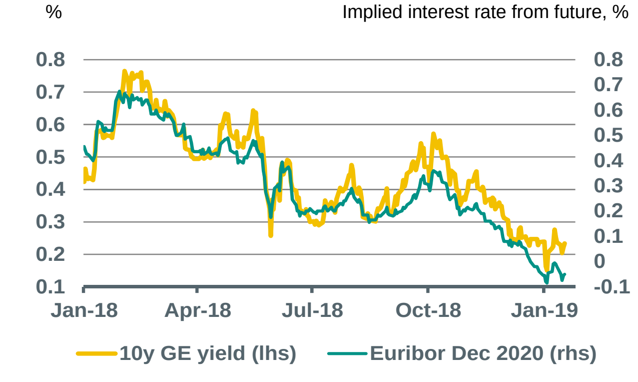
In the latter part of the year, we expect 10y Bund yields to rise as the first ECB rate hike approaches in March 2020. However, as noted above, we think the balance of risks to our ECB base case is tilted towards an even longer period of unchanged policy rates.

Interest rate expectations collapsed in 2018



Source: Bloomberg, ABN AMRO Group Economics

Bund yields have fallen on ECB repricing



Source: Bloomberg, ABN AMRO Group Economics

Key forecasts for the Eurozone	2017	2018e	2019e	2020e
Economic outlook (% yoy)				
GDP	2.5	1.8	1.1	1.3
- Private consumption	1.7	1.3	1.7	1.7
- Fixed Investment	2.9	3.0	1.6	1.8
- Net exports (contribution pps)	0.8	0.2	-0.3	-0.1
Inflation	1.5	1.8	1.0	1.3
- Core inflation	1.0	1.0	1.1	1.2
World trade	4.3	4.0	3.5	3.5
Interest and exchange rates (eop)				
ECB deposit rate	-0.4	-0.4	-0.4	-0.2
3M Euribor rate	-0.3	-0.3	-0.3	-0.1
10yr yield (Bund)	0.42	0.25	0.5	0.8
EUR/USD	1.20	1.15	1.25	1.30
Brent oil (USD/barrel)	67	53	70	80

Source: ABN AMRO Group Economics

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