Eurozone Outlook 2020

Group Economics
Financial Markets Research

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Sluggish growth a challenge for the ECB

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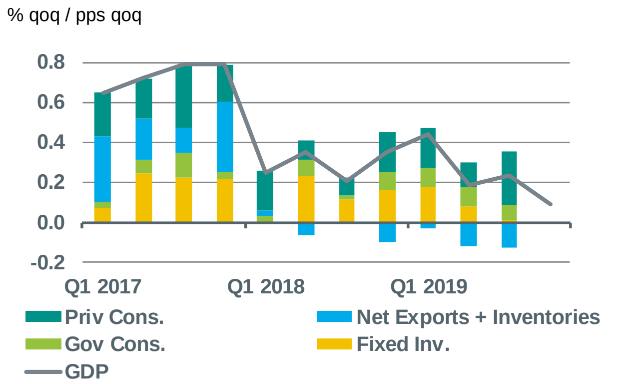
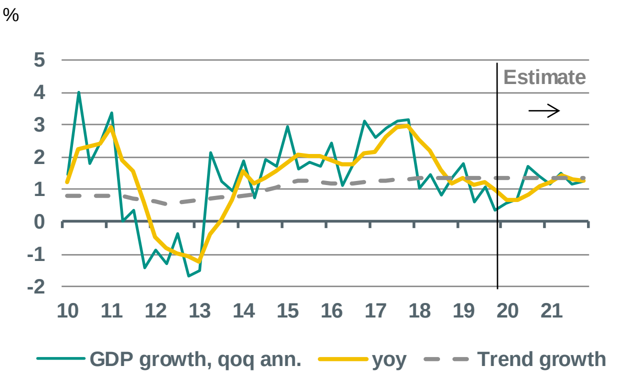
- **Growth in the eurozone has dropped to levels well below the trend rate, and the weakness is expected to continue in the first half of 2020**
- **The economy should regain some strength in the course of 2020, but the recovery will be moderate, with growth ending the year at around trend**
- **A recovery in global growth and world trade should result in accelerating exports and industrial production in second half of the year …**
- **… whereas fixed investment growth and private consumption growth will weaken due to depressed profitability and deteriorating labour market conditions**
- **Increasing labour market slack and low inflation expectations will limit wage growth, and core inflation is expected to edge lower in the course of 2020**
- **Only modest fiscal stimulus is expected, as European rules and domestic policy choices prevent a fiscal boost that could potentially lift growth to above trend levels**
- **The ECB is expected to ease policy further in coming months by cutting its deposit rate one more time and by stepping up the pace of asset purchases; we do not expect any moves to make policy less accommodative on our forecast horizon**
- **Bond yields are likely to be depressed in the coming months by the expected dovish policy shifts**

Eurozone GDP growth and main components *



* Corrected for the impact of investment in intellectual property
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

GDP growth versus the trend

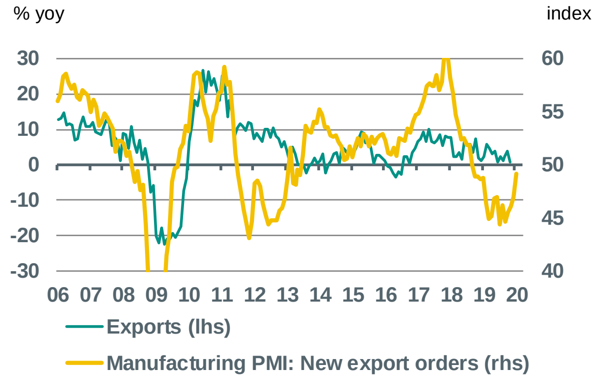


Source: Thomson Reuters Datastream, EC, ABN AMRO Group Economics

Weak growth moving into 2020, to be followed by a pick-up later in the year
The eurozone economy was lacklustre in 2019. Growth gradually fell from 0.4% qoq in the first quarter to merely 0.1% in the final quarter of last year. We expect growth to weak in the first half of 2020, as global trade and the global industrial sector remain subdued, while private consumption and fixed investment is expected to lose some momentum. Looking further ahead, we expect GDP growth to pick up around the middle of the year and rise towards levels close to the trend rate of around 0.3-0.4% qoq in 2020H2. Importantly, the global industrial sector and world trade seem to be bottoming out currently and are expected to regain strength from around the middle of the year onwards, although no spectacular acceleration is expected.

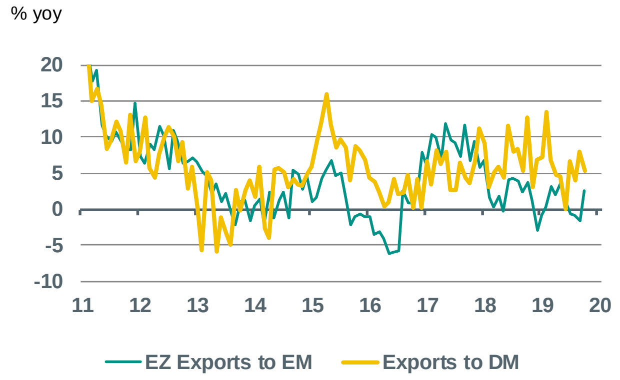
Exports and inventory building weighed down by contraction in global industry
In order to get a better view of the underlying strengths and weaknesses in the economy we have corrected the components of GDP for the distortions that are created by investment in intellectual property by foreign IT companies. These investments are extremely volatile (for instance, in 2019Q2, they grew by 25% qoq, lifting total quarterly fixed investment growth by almost 5pps), and are to a large extent driven by tax benefits - mostly in Ireland and the Netherlands. The resulting graph above-left illustrates that the weakness in the eurozone economy was mainly due to the ongoing weakness in global trade and contraction in the global industrial sector (the details of GDP in 2019Q4 have not yet been published). These factors have been depressing eurozone exports and inventory building since the start of 2018, with their negative impact on growth intensifying in 2019Q2 and Q3. Moreover, the weakness in exports and industry has resulted in a slowdown in fixed investment growth (excluding intellectual property), which contributed zero to growth in Q3.

Exports to remain weak for a while



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Exports to EM have slowed the most



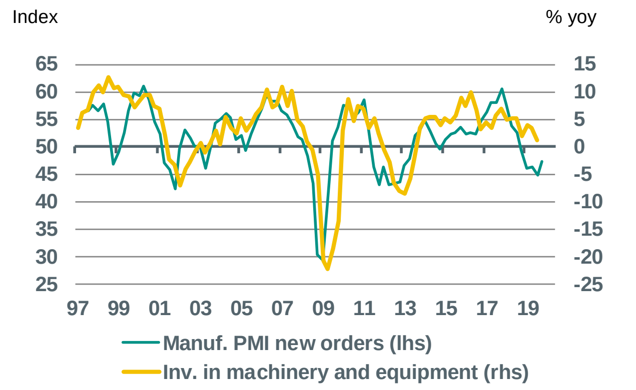
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Looking forward, we think that foreign trade and the global industrial sector are currently bottoming out, although it probably will take one or two quarters of ongoing weakness before the recovery sets in convincingly and the improvement is likely to remain rather lacklustre. In fact, global fiscal and monetary policy stimulus has been rather modest since the start of the global slowdown in early 2018 and is not expected to result in a sharp rebound of the global economy. Moreover, uncertainty related protectionism and the trade conflict continues to weigh on the global economy. The trade-weighted exchange rate of the euro has moved in a narrow range during the past two years and no significant changes are expected in 2020. Therefore, the exchange rate should not have a significant impact on the eurozone's competitiveness or trade flows. All in all, we expect net exports and inventory building to lift eurozone growth by around 0.3pps in 2020.

The recent outbreak of the novel coronavirus implies that global growth (including growth in the eurozone) will probably be even weaker in the first half of the year than in our current base line scenario, while the second half of the year would be stronger. This assumes a relatively temporary shock that is comparable to the impact of the outbreak of the SARS virus in 2003. In this scenario the virus would be brought under control in the next few months, but the level of uncertainty is of course high.

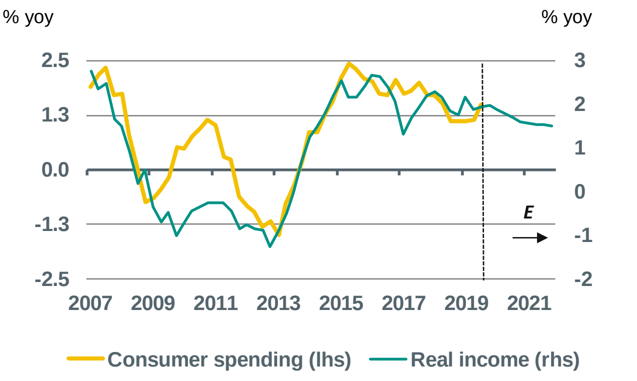
Fixed investment hit by contraction in industry, private consumption growth to slow
Growth in domestic demand is expected to slow down in 2020. Fixed investment (excluding intellectual property) was flat in 2019Q3 and is expected to contract in the next few quarters on the back of the drop in industrial production, weaker corporate profitability and falling business confidence. A decline in fixed investment in the coming quarters has also been pre-signalled by, for instance, the new orders component of the manufacturing PMI and a drop in sentiment in Germany's capital goods industry. Moreover, in the ECB's quarterly Bank Lending Survey (BLS) for 2019Q4, banks reported that demand for loans by companies stemming from fixed investment declined for the first time since 2015Q2. We think that a pick-up in exports and industrial production as from around the middle of 2020 onwards should result in a recovery in fixed investment growth around the end of this year.

Fixed investment hit by malaise in industry



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Consumption growth to slow, but remain positive



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

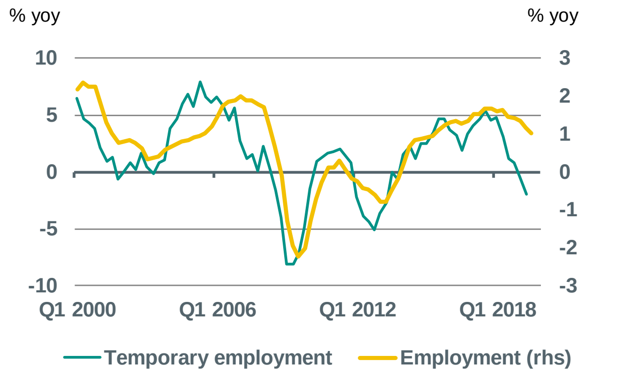
Private consumption growth picked up in 2019Q3, growing by 0.5% qoq following an expansion of 0.2% in Q2. We expect it to slow down again in the coming quarters and see it growing modestly throughout 2020. Importantly, labour market conditions have deteriorated in recent quarters. Employment growth has slowed down on the back of the weakness in growth and the unemployment rate has stopped falling. As a result consumer confidence has declined, with the component of the consumer confidence survey that measures the expectations about labour market conditions particularly weak (see graph below). Although nominal wage growth is expected to remain above inflation in 2020, the gap is expected to narrow as wage growth is expected to slow down (see below).

Unemployment to edge higher this year
The eurozone unemployment rate has been flat since March 2019, after it fell non-stop during a period of around six years. Employment growth has weakened to 0.1% qoq in 2019Q3

(1.0% yoy) and the employment component of the composite PMI has fallen to levels consistent with stagnation in employment..

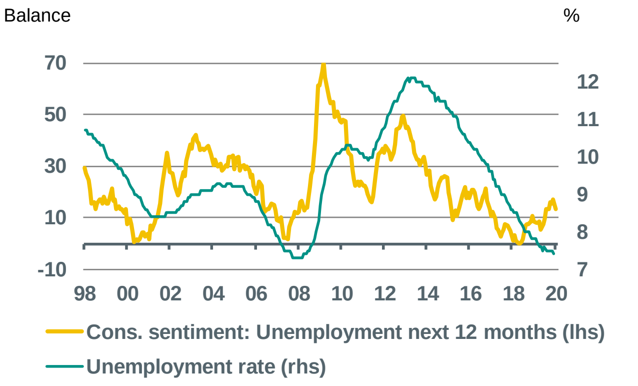
We expect the unemployment rate to start slowly moving higher in the coming quarters. As the labour market reacts to changes in economic conditions with a lag, the economic weakness since the start of 2018 will probably have a modest upward impact on the unemployment rate in the course of 2020. A rise in the unemployment rate has already been pre-signalled by a drop in temporary employment and the details of the European Commission's consumer sentiment report (see graphs below).

Temporary employment and total employment



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Consumers' assessment of labour market conditions



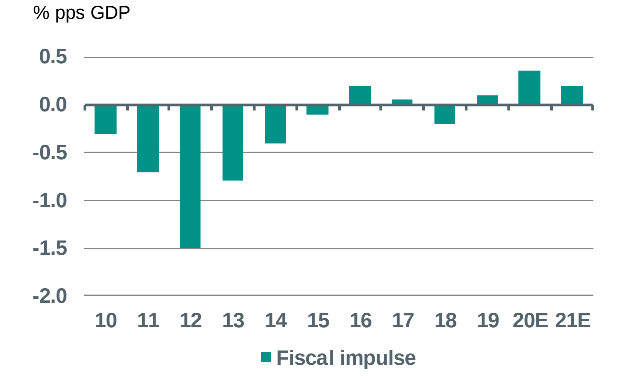
Source: EC, Thomson Reuters Datastream, ABN AMRO Group Economics

Modest fiscal stimulus ahead, monetary policy to remain supportive to growth
Despite a strong and repeated call for fiscal stimulus by the ECB, fiscal policy will be only modestly supportive to economic growth in 2020. European rules are preventing stimulus in a number of countries where policy-makers would like to spend more (e.g. Italy and Spain), whereas national policy choices have limited policy expansion in the countries that do have the room for stimulus (e.g. Germany and the Netherlands). The estimated fiscal impulse in the eurozone as a whole for 2020 is equal to around 0.4pps of GDP. According to our own calculations this stimulus could in theory be two to three times higher, if all countries that already meet the European Commission's criteria for the budget balance and government debt would ease policy to the extent that their debt ratios stabilise in the coming years instead of a projected decline. For instance, based on projection for Germany's primary budget balance (the budget balance excluding interest payments), nominal GDP growth and interest payments, Germany's debt ratio is estimated to fall by around 2.5pps of GDP in 2020. Therefore, in theory fiscal policy in Germany could be expanded by around EUR 80bn (which is equal to around 0.7% of eurozone GDP) while the debt ratio remained well below 60%.

Besides fiscal policy, monetary policy and the low level of interest rates will remain supportive to domestic demand growth in 2020, cushioning the slowdown in growth in consumption and investment. For instance, the results of the latest Bank Lending Survey (see graph below right) showed that banks on balance still report rising demand for mortgage loans and consumer credit. We expect the ECB to keep policy accommodative during the next couple of years. Indeed, we expect some further policy easing in 2020 (see below).

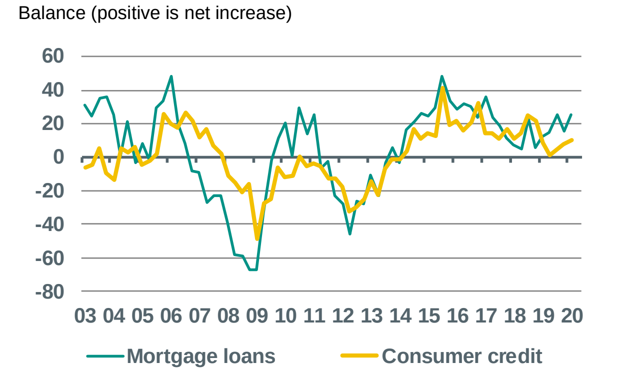
All in all, we expect GDP to expand by around 0.8% on average in 2020, which is somewhat below the current consensus forecast of 1.0% and also somewhat lower than the most recent forecasts of the ECB (1.1%), European Commission (1.2%) and OECD (1.1%).

Modest fiscal stimulus on the cards



Source: EC, ABN AMRO Group Economics

Domestic demand supported by low interest rates

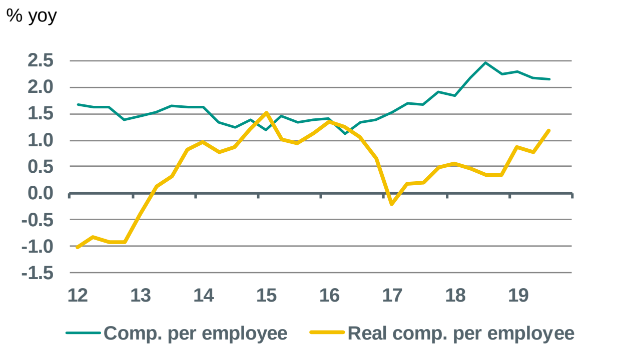


Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

Wage growth to slow

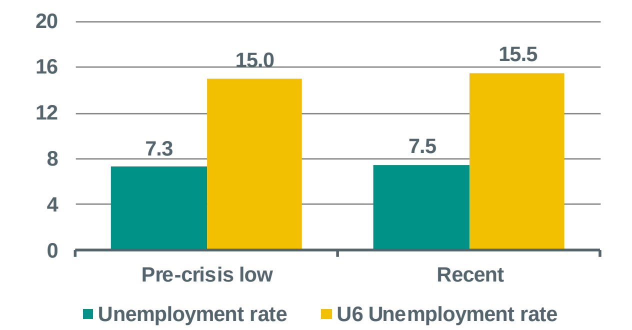
Wage growth has been slowing down since the middle of 2018. Compensation per employee peaked at 2.5% in 2018Q3 and has gradually slowed down to 2.1% in 2019Q3. Part of this slowdown is due to the one-off impact of changes in the labour tax system in France at the start of 2019, which will drop out of the equation in 2020Q1. More fundamentally, we think that the rise in nominal wage growth in the second half of 2017 and first half of 2018 mainly reflected payback for the (energy price driven) jump in headline inflation in 2017 and 2018, which resulted in a drop in real wage growth (see graph below on the left). As the graph below on the right shows, labour market conditions in the eurozone on aggregate cannot be considered to be tight, as the unemployment rate as well as the U6-indicator have remained slightly above their pre-crisis levels. Moreover, a wide number or eurozone countries have implemented labour market reforms in the past few years, which have lowered the level of unemployment that would trigger wage acceleration.

Wage growth expected to slow down further



Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

Eurozone labour market not tight on aggregate



Source: ECB, Thomson Reuters Datastream, ABN AMRO GE

Looking forward to 2020, we think that the slowdown in headline inflation and the deterioration in labour market conditions that started in the course of 2019, will result in a further slowdown in nominal wage growth. Indeed, we expect wages per employee to rise by around 1.8% in 2020, which is slower than the 2.2% recorded in 2019, but well above the expected inflation rate (see below).

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

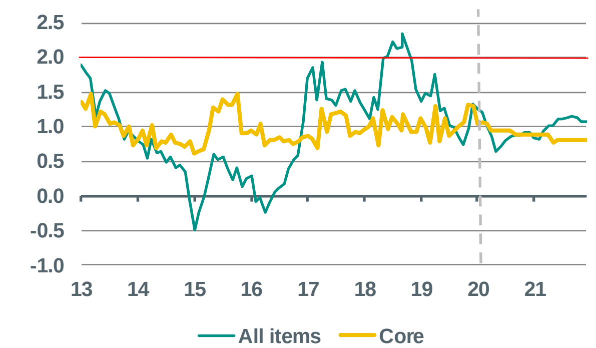
The core inflation rate (excluding food, energy, alcohol and tobacco) has been hovering around 1% since the start of 2017. In the final two months of 2019 it increased to 1.3% as services sector price inflation increased due to the temporary upward impact of the notoriously volatile price of package holidays. In January 2020, this effect unwound and core inflation returned to 1.1%. We expect underlying inflationary pressures to remain subdued as wage growth is expected to slow down (see above), while the recovery in global growth should not be strong enough to push the inflation rate of global industrial goods sharply higher. All in all, core inflation should slow down again to somewhat below the 1%-level in the course of 2020, which is about half the ECB's target rate.

Political risks remain elevated

The political landscape in the eurozone has remained fragmented. Mainstream political parties at the centre-right or centre-left of the political spectrum have continued to lose support in a large number of countries, while populist parties, green parties and/or parties at the extreme side of the political spectrum have gained support. Consequently, there are a number of minority governments in office (e.g. Spain, Portugal, Ireland) and coalition talks are still ongoing in Belgium following the general elections of May 2019. Also a number of elections or government changes in 2019, have resulted in coalitions consisting of a large number of parties (Finland - five) or parties that have never worked together before (Austria and Italy). As a result, implementing policy changes, including policies aimed at further European integration, or meaningful economic reforms has remained complicated, while the chances of early elections in these countries remains elevated. In 2020, Ireland is the only one of the bigger eurozone countries that plans to hold general elections. Having said that, we do not expect political instability to cause any significant rise in credit risk during our forecasting horizon.

ABN AMRO inflation projection

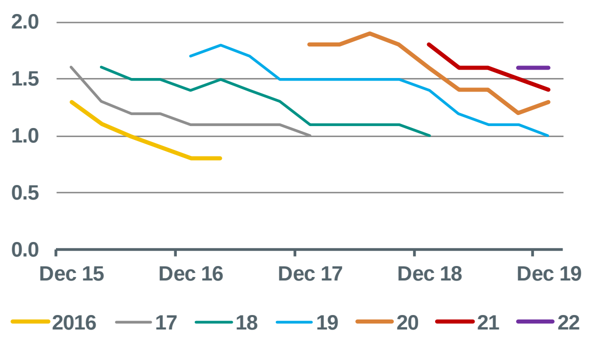
% yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

ECB forecast for core inflation has persistently fallen

ECB forecast for core inflation in year XX, % yoy



Source: December 2018 Eurosystem staff macroeconomic projections

ECB to ease policy further

In September 2019, the ECB implemented a package of policy stimulus. It restarted its asset purchase programme at a monthly pace of EUR 20bn as from 1 November 2019, after it had ended its first QE I programme in December 2018. In addition, it introduced the phrase that it plans the new round of purchases to 'run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates'. Next, it cut the deposit rate by 10bp to -0.50% (after it had kept interest rates unchanged during a period of 3.5 years). It also signalled that possibility that interest rates could be reduced further, saying that it expects the 'key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics'. Finally, it changed the conditions of its TLTROs (cheap ECB loans to banks) to make them more generous and mitigate some of the adverse effects on the banking system of negative rates.

Given our forecasts for GDP growth and inflation and considering that inflation expectations have become dislodged at a level well below the ECB's inflation target, we expect the central bank to ease policy further this year. We expect one final 10bp rate cut, a stepping up of the pace of asset purchases to EUR 40bn per month and a further increase in the maturity of the TLTROs. Our base case is that the package will be announce in March but the risks are skewed towards a somewhat later announcement.

Government bond yields likely to decline in the short-term and rise later in the year

We expect German government bond yields to fall in the next few months. The additional ECB stimulus is not priced in by financial markets. In the latter part of the year, we expect 10y Bund yields to rise as global growth picks up and the main global central banks will not announce further stimulus. Still, we expect German 10y yields to remain in negative territory as the first ECB rate hike is expected to be a long time ahead.

Key forecasts for the Eurozone

	2018	2019e	2020e	2021e
Economic outlook (% yoy)				
GDP	1.9	1.2	0.8	1.3
- Private consumption	1.4	1.3	0.8	1.0
- Fixed Investment	2.4	4.1	-1.2	2.0
- Net exports (contribution pps)	0.4	-0.3	0.5	0.1
Inflation	1.8	1.2	1.0	1.0
- Core inflation	1.0	1.0	1.0	0.9
World trade	4.0	0.0	1.0	2.0
Interest and exchange rates (eop)				
ECB deposit rate	-0.4	-0.5	-0.6	-0.6
3M Euribor rate	-0.3	-0.4	-0.6	-0.5
10yr yield (Bund)	0.25	-0.2	-0.4	-0.4
EUR/USD	1.14	1.12	1.16	1.20
Brent oil (USD/barrel)	54	66	60	65

Source: ABN AMRO Group Economics

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