THIS MONTH'S TOPIC

Eurozone: a mere dip or a sustained slowdown?

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The essential

After a long series of disappointments in 2018, Eurozone economic figures have remained very mixed so far in 2019. However, the situation should improve over the coming quarters, thanks to a combination of robust household income, heavy fiscal support, and global trade that is a little weaker than it has been in recent months. Even if there is a slight improvement, there will be no return to the growth figures of 2017, and it won't happen if serious risks, such as a no-deal Brexit and the imposition of US trade tariffs on European auto imports, come into play. Moreover, the domestic political situation will remain volatile in some EU member-states.

Hopes were high a little more than a year ago, after a tremendous 2017, but the Eurozone economy has delivered disappointment after disappointment since the start of 2018. In last year's four quarters, GDP expanded by just 1.1% (including just 0.3% in the second half), down from 2.7% in the four previous quarters. Italy slipped back into a slight recession in the second half, and Germany almost did so. Despite a few positive surprises, early-2019 figures are pointing to another lacklustre first quarter.

The economy has been undermined by several factors

- **Each of the Eurozone's three largest economies has faced their own particular challenges**. The **German** auto industry was hit hard by a change in emission testing standards just as Q3 gave way to Q4 (the GDP growth impact was about 0.5% for all of 2018). **Italy** was hit by serious political uncertainty when an "anti-system" governing coalition came to power in spring. And, after already a number of strikes at the beginning of the year, **France**'s household consumption was brought to a halt in Q4 by the "yellow vest" movement (for a total impact estimated at 0.1% of GDP).
- **But the main hit to the Eurozone was from the slowdown in global trade**, due in part to various direct factors (disruption of the value chain and the Chinese economy) and indirect ones (uncertainty shock) from protectionist measures. This slowdown hit European manufacturers hard even though the measures taken against Europe were very moderate (limited to customs duties on steel and aluminium, with the US having suspended its threats against the auto industry in summer 2018). Moreover, exports to two important markets, Turkey and the UK, were affected by events specific to those two countries; the euro's strength in early 2018 also probably took a toll; and exceptionally strong exports in 2017 were followed by a negative payback the following year. All in all, the contribution of exports to Eurozone GDP growth fell from 3.1pp in the four quarters of 2017 to 0.75pp in the four quarters of 2018, which also revealed a clear split between, on the one hand, Italy and Germany, which are heavily exposed to global manufacturing cycles, and, on the other hand, France and Spain, which are less affected by these external developments, as their manufacturing sectors are smaller.
- **Lastly, oil prices were far higher than one year previously, and this also had a negative impact.** Despite a sharp late-year drop, Brent averaged 25% more in euro terms in 2018 than in 2017.

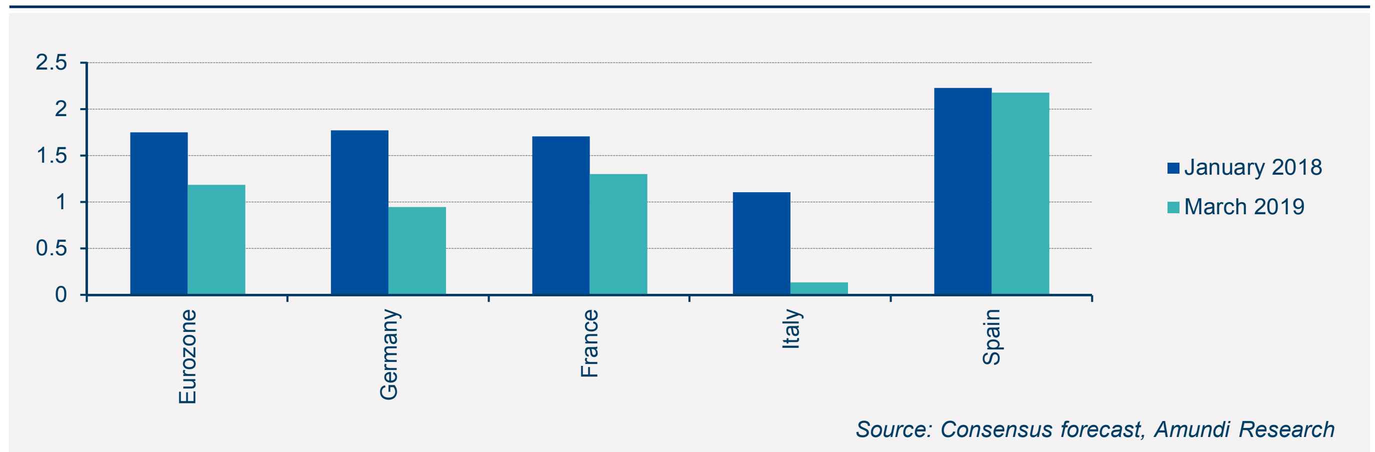
Now that some of these shocks are behind us, several factors are pointing to a moderate re-acceleration in growth in the coming quarters, as long as certain serious risk factors do not come into play.

First of all, some of the factors that were highly negative in 2018 are temporary and likely to fade. While the **German auto industry** faces very serious challenges in the medium and long terms , production should return to normal (if by "normal" we mean overcoming the specific impact of the 2018 changes in standards) by the start of

Q2. Similarly, the easing of the Q1 social unrest in France (although it would be premature to say that the crisis is completely over) should mean a rebound in consumer spending.

Moreover, household income in recent quarters has been on a steep upward trajectory, with the impact in real terms likely to be amplified in 2019 by the receding in inflation. Even as bad news was piling up on GDP and other economic indicators, the unemployment rate kept declining (to 7.8% in January 2019 from 8.6% 12 months earlier); employment remained strong, albeit slightly less so (1.3% in the four quarters of 2018 vs. 1.7% in the four quarters of 2017); and, most importantly, wages rose by about another 2% last year. All of these figures should mean an increase in real household consumption far above last year's 1.2%, while year-on-year inflation recedes rapidly under the the base effects of energy prices (even when assuming a slight increase in oil prices this year).

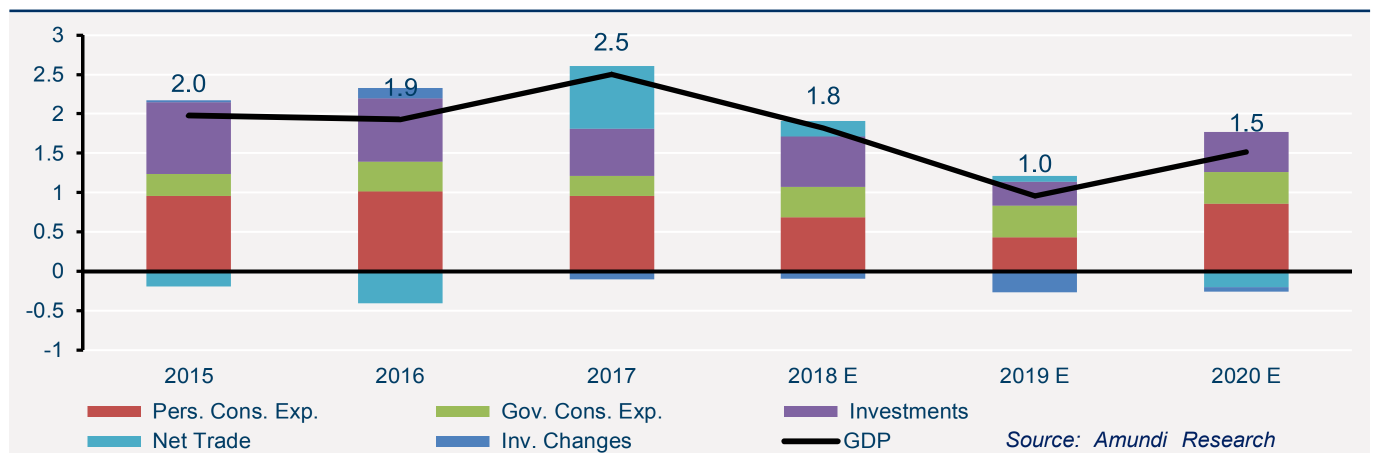
1/ **2019 GDP growth forecast: change in consensus forecast between Jan 2018 and March 2019**



In addition to solid household income, fiscal stimulus is expected to have a significant impact on growth this year

- It is true that fiscal support is likely to remain modest in **Italy**, where ambitions had to be revised downward after negotiations with the European Union and where what can be gained in growth through wider public deficits is likely to be cancelled out in part by the market's concerns and downgraded market financing terms.
- The situation, however, is different in **France**, where household tax cuts in effect since the end of 2018 (particularly in payroll taxes) will come with other measures announced in December in an attempt to calm down social unrest (a total stimulus of about 0.5% of GDP, most of which is targeted at lower-income households with a high propensity to consume).
- After an unvoluntary fiscal tightening in 2018 (caused by the long search for a viable governmental coalition, and, hence, by delays in implementing some public policies), **Germany** is likely to see some positive compensation in 2019 that, when adding new targeted spending in pensions, family policy and investment, is estimated at about 0.7% of GDP.
- Lastly, **Spain**'s failure to obtain parliamentary approval of its 2019 budget, which had included several tax hikes, is generating, *de facto*, a slight stimulus in the country.

2/ **EMU GDP Contributions, annual average, %**

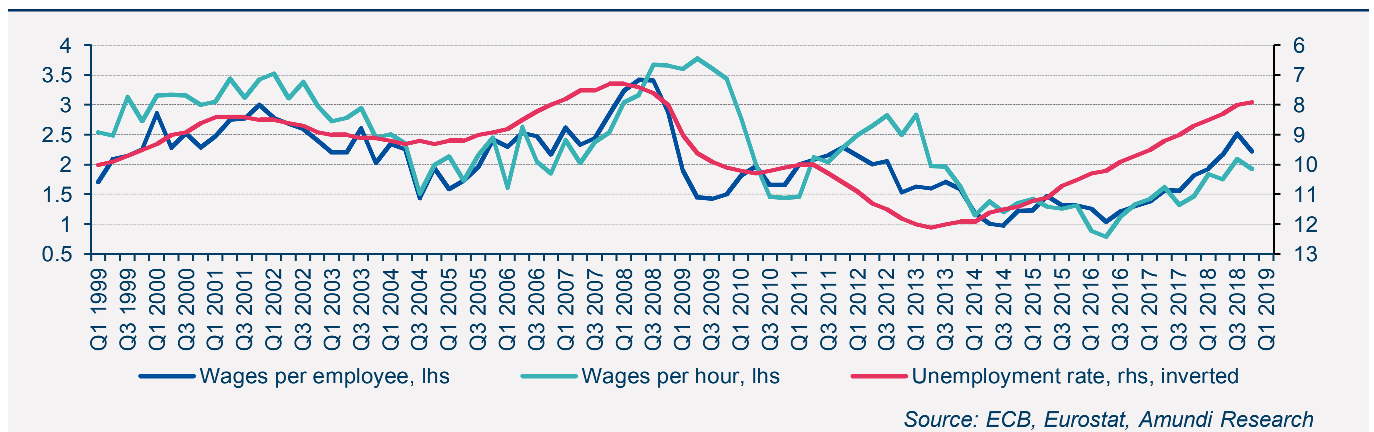


All in all, fiscal support (as measured by the widening in the primary structural deficit) is likely to amount to about 0.5% of GDP for the Eurozone as a whole. As fiscal support is in the form of various measures taken in 2018 in response to each major country's specific challenges, it will not be as effective as a coordinated stimulus plan. Even so, if we assume a conservative multiplier of a little less than 50%, it should result in an additional 0.2pp of GDP in 2019. However, the effect is likely to fade in 2020, as maintaining such a heavy fiscal boost is not possible under current projections in all countries.

Regarding export momentum, to which the Eurozone is far more exposed than the United States (27% of its GDP vs. 13%, goods and services combined), a slowdown as great as the one in 2018 is unlikely. Our baseline scenario does assume a slowdown in the two major economies and export markets of China and the US, but their growth is still likely to remain much stronger than in the Eurozone. Most importantly, we believe that tensions are more likely to ease than to worsen (at least on the strictly trade front) between these two countries, and that there will therefore be fewer disruptions and uncertainties in global value chains. Lastly, and unlike the previous year, the very poor 2018 figures could give way to a positive payback, notably via restocking.

However, this baseline scenario does not reflect a number of risk factors, which, if they come to pass, could make economic agents more cautious and thus easily cancel out the expected benefits from both gains in household purchasing power and a stabilisation in foreign demand.

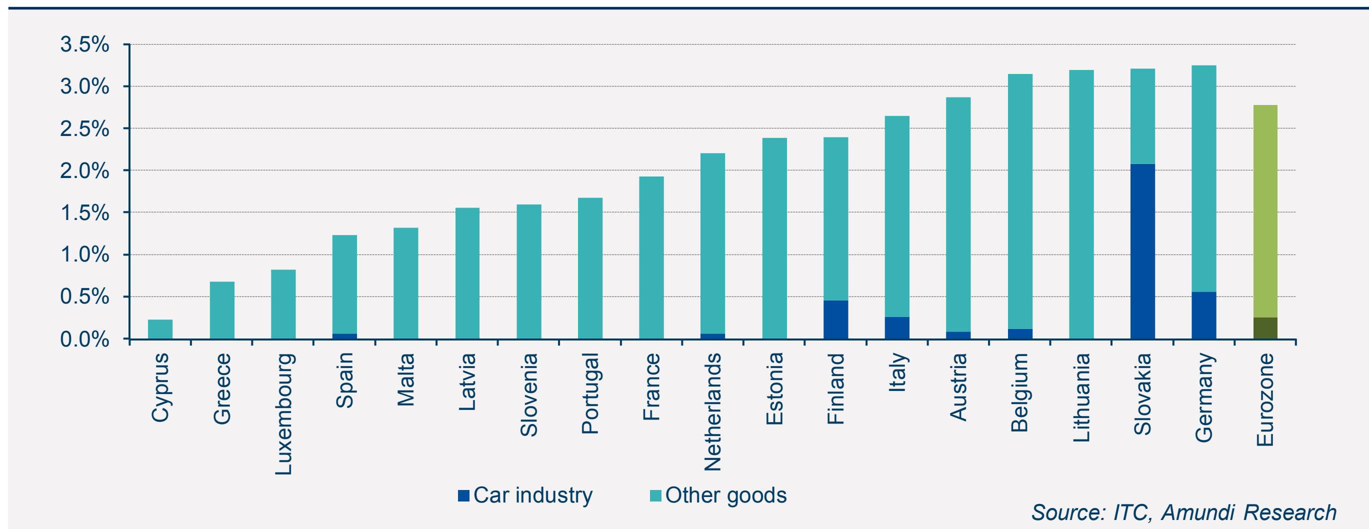
3/ Eurozone employment and wages



Source: ECB, Eurostat, Amundi Research

- **The first clear risk factor is Brexit**: at this writing, while the positive economic scenarios of a soft Brexit or a long extension in the deadline are still possible, **the risk of a hard Brexit** in the coming weeks **cannot be completely ruled out** (we assign it a probability of about 20%). The macroeconomic consequences of such an event would depend closely on possible 11th-hour mitigation measures (in addition to those already explicitly planned). However, such consequences would very probably lead us to at least slightly lower our Eurozone growth forecasts (albeit far less than for the UK).
- **A second risk factor is the persistent threat of customs duties on the European auto industry.** Following the investigation conducted in February under Section 232 of the Trade Expansion Act of 1962, the US president must make a decision by mid-May. We don't expect the customs duties to go through, as that would trigger a tit-for-tat that would backfire on the US economy just as signs of economic slowdown are already perceptible there and as the Republican administration will soon begin campaigning for the 2020 elections. What is possible, however, is that this threat will continue hanging over the economy for several quarters, for example, via a **theoretical activation along with a renewable grace period**, in order to use them as a means of pressuring the EU into broader trade negotiations (one of the EU's challenges will be reaching a common ground, given that exposure to auto exports to the US varies greatly from one member-state to another). Thus, the real medium-term danger of customs duties would be that they would continue to undermine confidence in European manufacturing. If, however, contrary to our expectations, the duties are put through, we would have reason to lower our forecasts for Germany and countries intertwined in the value chains of German automakers.
- **Lastly, best to be alert to a possible resurgence in domestic political risks.**
  - Opinion polls suggest that the **European elections** – the major mid-year event – are unlikely to see a landslide victory by "anti-system" parties (although things could be made more complicated if the UK ends up taking part). The two "traditional" groups – the Christian Democrats and the Social Democrats – are likely to lose the majority they have held in the European Parliament since it was founded in 1979, but they should be able to form another majority (albeit with some additional negotiations and foot-dragging), with other, pro-institutional forces, such as the Greens or the Liberals.

4/ **Exports of goods to the US, % of GDP**



Source: ITC, Amundi Research

- However, the **political situation is still volatile in Italy**. Yes, early elections could bring good news for the economy and the markets, as they could lead to the emergence of a new governing coalition uniting the Northern League and the traditional right. But even if this happens (or if the current coalition stays in place), it would not necessarily head off a new confrontation with EU institutions when the 2020 budget is negotiated (scheduled for late this year). Moreover, Italy is still exposed to risks of sovereign debt downgrades.
- Lastly, while other countries holding general elections in 2019 (including Finland, Spain, Belgium, Portugal and Greece) do not appear to pose systemic risks to the Eurozone, social unrest that began in November 2018 in **France** has still not been put down fully. The movement reminds us that the government's very solid parliamentary majority is not enough to shield France from risks of instability.

In light of the above, the Eurozone's economic outlook as Q1 2019 draws to a close is, in our view, more positive on the whole than suggested in recent months' very poor figures. The most likely scenario is a rebound based mainly on household consumption, which itself will be supported by improved resilient job market and fiscal stimulus, and on less negative (while not positive) trends in foreign demand. However, the rebound is likely to remain modest. We forecast GDP growth of 1.2% between Q4 2018 and Q4 2019 and 1.6% during the four quarters of 2020. A return to 2017-like numbers would require a very strong surge in exports – unlikely under current global conditions. Most important, the rebound is exposed to many risks (beginning with Brexit, US protectionism and domestic political uncertainties) on which visibility could be limited over the next few months. What's more, under a negative scenario, few major instruments of stabilisation seem to be immediately available – the ECB's rates are already zero or negative; and a coordinated fiscal response would be hard to organise.

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