

# Eurozone

## 2020: the year the economy begins to pick up?

*Will the year 2020 be marked by a rebound in eurozone economic growth? More favourable signs seem to be emerging, although they have yet to show up clearly in hard data. In any case, eurozone growth is bound to remain low. In this environment, inflationary pressures will probably fall short of the central bank's target. Beyond that, the ECB Governing Council will be tackling new issues in 2020. Christine Lagarde announced a strategic review for the Frankfurt-based monetary institution. On the agenda: cryptocurrencies, climate change, technological progress, and inequalities.*

Without signalling a strong rebound, several factors seem to suggest that growth is beginning to stabilise: survey indicators are no longer deteriorating in the manufacturing sector; some progress is being made concerning US-China trade talks and *Brexit*; financing conditions will remain very accommodative; and the labour market remains relatively resilient, despite signs of weakness.

### ■ Growth fails to rebound

In 2019, the eurozone was hit by a sharp economic slowdown. Difficulties in the manufacturing sector that first appeared in the second half of 2018 persisted in 2019. Growth displayed a robust 0.4% in Q1 2019 but then decreased to 0.2% for the next two quarters. For the full year, our forecast calls for eurozone growth to average 1.1%, compared to 1.9% in 2018.

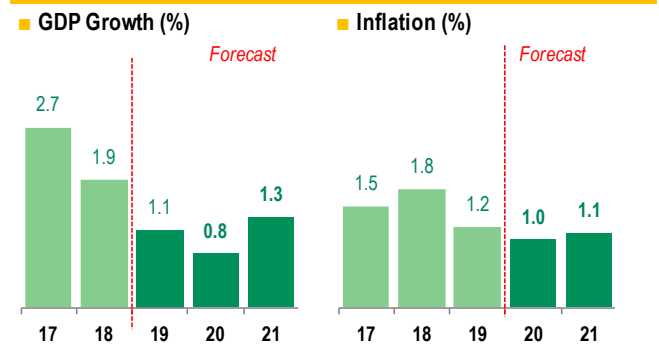
Cyclical and leading indicators nonetheless point to a certain stabilisation. The Purchasing Managers Index (PMI) in the manufacturing sector is clearly holding below 50, the threshold that separates expansion from recession, but at 46.3 in December 2019, it no longer seems to be deteriorating. The PMI in services rose to 52.8 in December, and is robustly holding in expansion territory. So far, fears that the manufacturing sector's troubles will spread to the services sector have failed to materialise. In the months ahead, the horizon could clear up somewhat. Real M1 money supply growth, the "narrow" money supply aggregate that provides relevant information on the potential for an economic recovery<sup>1</sup>, is looking upbeat (see chart 2).

All in all, eurozone growth is expected to decrease to 0.8% in 2020 before rebounding in 2021 and converging towards its potential (see chart 3). Although household consumption is slowing, it should remain relatively robust at a time of ongoing wage growth. On the corporate side, investment is still going strong, buoyed notably by very favourable financing conditions. Note that the recent upturn in long-term rates reflects the renewed confidence of economic agents, especially concerning the reduced risk of recession. Yet the upturn in interest rates should remain mild in the face of low inflationary pressures (around 1% in both 2020 and 2021). As in 2019, eurozone fiscal policy is expected to be slightly expansionist at the aggregate level in 2020, providing only a timid boost to growth<sup>2</sup>.

<sup>1</sup> R. Fendel et al., *Predicting recessions using term spread at the zero lower bound: The case of the euro area*, VOX CEPR, January 2019

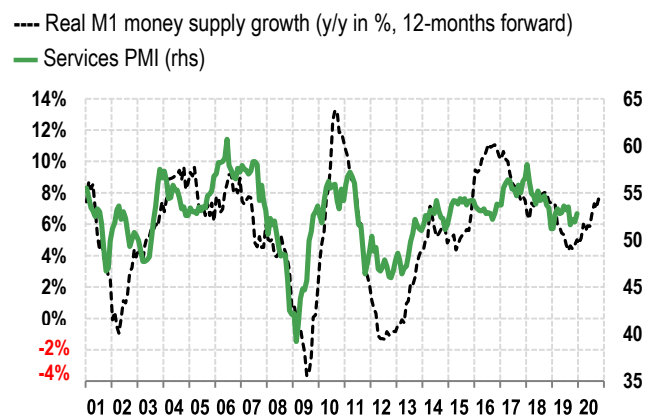
<sup>2</sup> European Commission, *European Economic Forecast - Autumn 2019*, November 2019

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2-Inflation and monetary policy



Source: ECB, Markit

Note: M1, the narrow money supply aggregate, is comprised of bills, coins and demand deposits.

This scenario presents several risks, and certain indicators will have to be monitored closely in 2020. First, as we have pointed out for several months now, it is crucial for the labour market to remain resilient at a time of slowing activity. Although the sector has been hit by a major negative shock for several quarters, industrial employment seems to be less dynamic, but continues to progress at an annualised rate.

Eurozone exports must also operate in a persistently weak global environment. International trade failed to regain momentum, and in



October, the volume of global trade contracted for the 5<sup>th</sup> consecutive month. In China, a major trading partner for the eurozone, economic activity is unlikely to begin accelerating again until the second half of 2020.

Lastly, we cannot rule out an external shock. Rising tensions in the Middle East could drive up energy prices, for example, while new tariffs could erode domestic demand.

■ **ECB: a new era**

Shortly after taking the helm as the new president of the European Central Bank (ECB), Christine Lagarde has already made her mark. The 12 December speech confirmed our previous expectations: ECB monetary policy will probably remain unchanged throughout our forecast horizon.

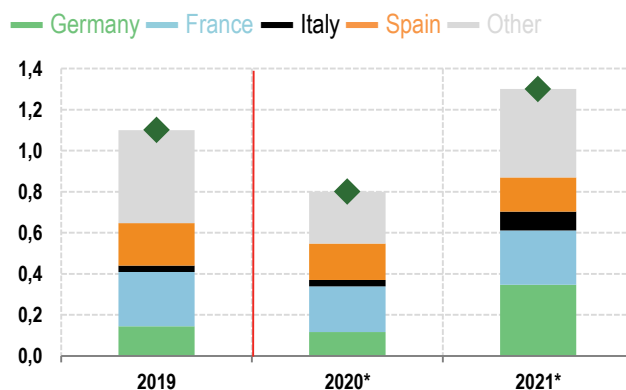
According to the ECB's latest projections, eurozone growth will remain weak in the short term, despite recent signs of stabilisation. In the medium term, although there are still high risks surrounding growth momentum, ECB staff points out that some of these risks could dissipate at least in part (notably concerning US-China trade talks). A slight upturn in activity and persistently strong wage growth could partially filter through in a pick-up in inflation, and core inflation could reach 1.6% in 2022 according to the ECB<sup>3</sup> (see chart 4). Yet Ms. Lagarde insisted that this inflation rate would not be considered as a "reached target", which reinforces our hypothesis that monetary conditions will not be tightened for a relatively long period of time.

In 2020, a key issue to follow will be the opening of the ECB's strategic review, as announced by president Lagarde. Like the US Federal Reserve, the ECB is launching a strategic review of its monetary policy targets and instruments (at a time when it has very little manoeuvring room), but the scope of the review is much broader. The Governing Council's agenda will also look into issues relating to cryptocurrencies, climate change, technological progress and inequalities. Scheduled to last a year, this strategic review will largely dominate discussions between observers.

It could also come up against the divisions that have appeared within the ECB in recent months, which Ms. Lagarde will have to address. The next monetary policy meetings will surely reveal more details on these issues.

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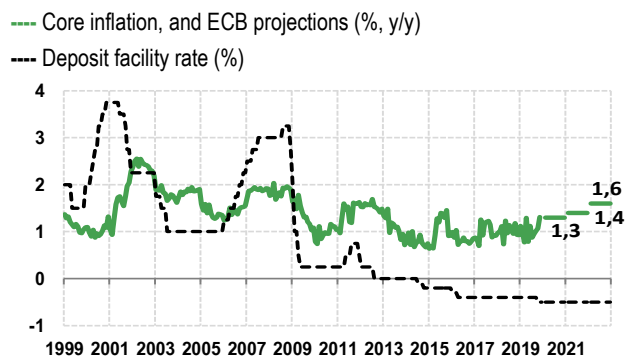
**3-Contribution to eurozone growth by country (% point)**



Source: Eurostat

\* = forecast

**4-Core inflation and interest rates**



Source: European Central Bank (ECB)

Note = The horizontal green lines represent the ECB's average annual core inflation projections for the years 2020, 2021 and 2022.

<sup>3</sup> European Central Bank, *Eurosystem staff macroeconomic projections for the euro area*, December 2019