Eurozone

An anniversary against the background of a slowdown

After an eventful first twenty years, the eurozone is moving into a new phase of uncertainty. Growth has slowed markedly, and economic indicators have deteriorated. With temporary shocks and structural drags on growth, 2019 brings numerous risks. Against this background, and faced with underlying inflation that remains too low, the European Central Bank (ECB) is taking a cautious approach to this new year.

2017 already seems a long time ago. Since 2018 began eurozone growth has been slowing, and recent economic data suggest that the slowdown is becoming both more prolonged and more widespread.

Growing uncertainty

GDP grew by 0.2% q/q in Q3 2018, from 0.4% in the first half of the year and an average of 0.7% in 2017. International trade was responsible for a substantial share of this disappointing performance, having made a significant contribution to growth in 2017. The zone's four biggest economies (Germany, France, Italy and Spain) have all been affected by the slowdown, albeit to varying degrees. Germany and Italy saw negative growth in Q3 2018 (of 0.2% and 0.1% respectively), whilst Spain has retained some momentum.

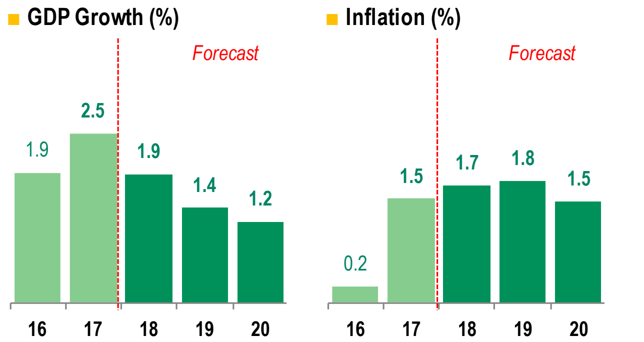
There are several factors to explain this slowdown. First, there is an expected and mechanical effect after a particularly buoyant 2017. Then there have been temporary localised effects, particularly in the German motor industry which has been held back by the introduction of new environmental standards. In addition, the climate of political uncertainty, particularly with reference to Brexit, is affecting both internal and external demand. Lastly, there are emerging supply side constraints, with the output gap virtually closing in 2017 and an unemployment rate close to its structural level. Many companies, especially in Germany, are facing growing difficulties in hiring staff.

The latest economic data suggest that the slowdown is set to continue. The purchasing managers' index for the eurozone (composite PMI) hit a 3-year low in December 2018, at 51.1. Although it remains in expansionary territory (i.e. above 50), its services component, which had held up well up until now, has been falling for a number of months.

All the major economies saw their PMIs slip during 2018 (Chart 2). In particular the French PMI fell very sharply in December in response to the 'gilets jaunes' protest movement. Meanwhile, industrial output fell in November in many eurozone countries, most notably in Germany (down 1.9% m/m).

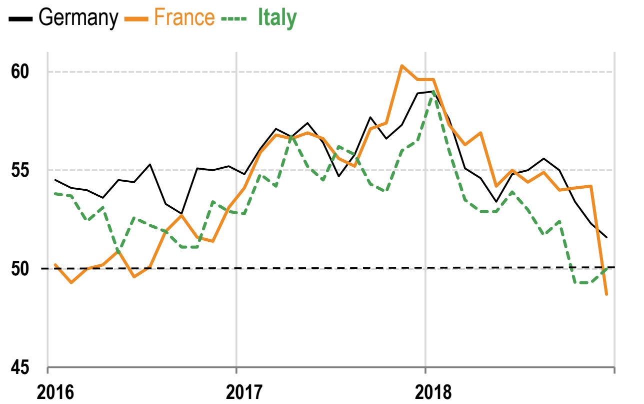
The economic gloom at the end of 2018 and rising levels of uncertainty threaten a sluggish 2019 and a forecasting picture ringed around with unknowns. On the trade front, an extension of increases in US tariffs, particularly on vehicles imported from the

1- Growth and inflation



Source: National accounts, BNP Paribas

2-Composite PMI



Source: Markit

European Union, will hold back growth a little more[1]. A prolonged slowdown in growth in China, which remains an important export market for the German economy, would also be damaging. Germany has contributed nearly half of the eurozone's growth since 2010. The main source of support for economic growth is, in the end, likely to come from private consumption. Unemployment rates are at their lowest for ten years, employment rates are rising and wages are continuing to gain ground, albeit at a slower pace than in 2018.

[1] A. Berthou et al, *Costs and consequences of a trade war: a structural analysis,* Rue de la Banque, Banque de France, n°72, December 2018

These trends will support growth through consumer spending, which is itself a significant generator of employment[2].

The ECB remains cautious

Against this uncertain background the European Central Bank (ECB) remains cautious and flexible. Having ended net asset purchasing at the end of 2018 and undertaken to reinvest maturing securities for a prolonged period, the bank is not putting a stop to Quantitative Easing. By maintaining its balance sheet unchanged, at around 40% of eurozone GDP, through its reinvestment programme, the ECB will maintain a 'stock effect' that will continue to put downward pressure on long-term interest rates [3]. Monetary conditions will therefore remain accommodating.

The probability of a rate increase in 2019 is low and remains dependent on the sustainable convergence of inflation towards its target of 2%. In fact, inflation has fallen (to 1.6% y/y in December 2018, from 1.9% in November, Chart 3), in the wake of lower oil prices. The underlying inflation figure has struggled to get above 1% and for the time being seems unaffected by the marked upturn in eurozone wage growth of the past two years.

A brief look back at the expansionist monetary policy pursued since 2014 suggests that it has been positive overall. In particular, the risks of deflation, which were very real in late 2014 and early 2015, have been avoided. The ECB's use of non-conventional monetary policies and the strengthening of its forward guidance have helped consolidate the credibility of its actions and support economic activity in the eurozone, notably through the resulting reduction in financing costs and support for lending.

20 years on: a difficult convergence

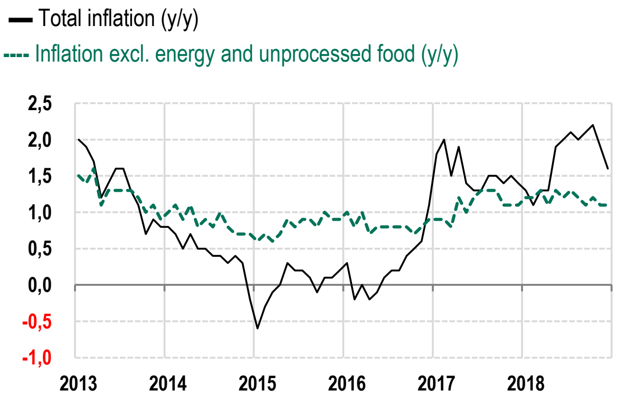
Although monetary policy has helped mitigate the impact of shocks since the creation of the single currency 20 years ago, challenges remain, notably in the area of real convergence.

Since its creation, the eurozone has seen average annual GDP growth of 1.4%, but this figure hides some disparities. Germany and France have seen similar levels of growth (around 1.4%), whilst Spain has grown faster (1.8%) and Italy has struggled (0.4%).

Despite two deep economic crises, the majority of eurozone member countries have significantly higher real per capita GDP than in 1999. However, convergence between member states has been more mixed. All other things being equal, and using Germany as our reference point, per capita wealth has tended to diverge since the introduction of the euro (Chart 4). The trend is somewhat different for the member states that joined more recently and are still catching up economically.

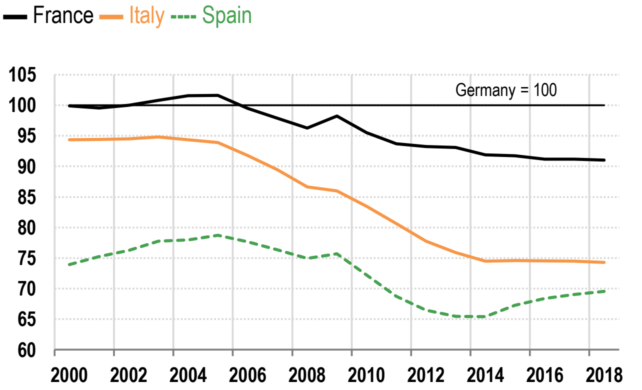
The divergence relative to Germany nevertheless needs to be seen in context. Over the past twenty years German population growth has been virtually nil, whilst the populations of France and Spain have continued to grow strongly. In Italy, despite modest population growth over the period, per capita GDP has been pretty much stagnant on average.

3- Inflation



Source: Eurostat

4- Per capita GDP in real terms (as % of German per capita GDP)



Source: Eurostat, AMECO, BNP Paribas
Note: For the 2018 annual growth figure accrued growth to end Q3-2018 has been used.

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[2] R. Anderton et al., *Disaggregating Okun's law - Decomposing the impact of the expenditure components of GDP on euro area unemployment*, ECB, Working Paper Series n°1747, December 2014

[3] J. Dalbard, et al, *The end of net asset purchases does not put a stop to quantitative easing,* Banque de France, December 2018