TD Economics

Euro Area Outlook: Hello Slow Growth My Old Trend

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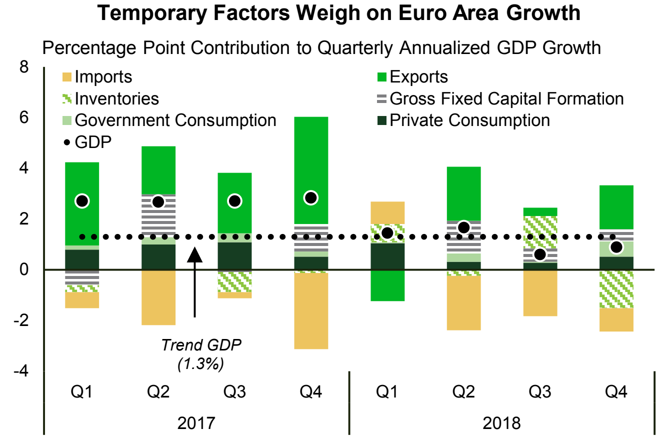
Highlights

- Economic growth in core European economies slumped over the last year. Much of the weakness has been concentrated in the manufacturing sectors in Germany and Italy. As temporary factors reverse, industrial activity is slowly recovering. However, Italy's idiosyncratic challenges suggest that its economic slowdown may persist.
- Three consecutive quarters of below trend growth has motivated the ECB to respond by pushing back any prospect of a rate hike into 2020 at the earliest, and extending its program of low interest rate lending to Euro Area banks into 2023. However, with interest rates at or below zero already, it's unclear how much stimulus this will provide this year. On the other hand, fiscal spending is expected to prove more constructive this year, and is estimated to lift Euro Area economic growth to the tune of 0.2 percentage points.
- Looking ahead, we anticipate growth to perk up in the Euro Area, led by consumer spending. However, slowing global demand and elevated economic and trade policy uncertainty will continue to weigh on the manufacturing and export sectors.
- Euro Area growth is likely to hold near 1.3% trend pace for the next three quarters. As a result of the weak momentum and start to the year, annual average growth will record a meagre 1.1% rate – much weaker than last year's 1.8% pace. With such a low potential rate of growth and limited policy supports, Europe will remain a source of downside risk to the global economic outlook.

The pace at which Euro Area growth decelerated in 2018 was unexpected, especially after recording two years of well above-trend growth. A global manufacturing slump, slowing foreign demand, and idiosyncratic factors were the primary drivers of this growth downturn. Nevertheless, a recent slowdown in service industries has raised the possibility of a more persistent malaise in core economies, while also stoking recession fears. At the moment, with the exception of Italy, there is little evidence that Euro Area economies have tipped into recession. The slowdown in service industries should prove temporary, as economic fundamentals remain supportive of growth.

The outlook for foreign demand is less positive. Reduced demand for Euro Area exports results in a diminished contribution to aggregate economic output relative to 2017 (Chart 1). Manufacturing output has slumped in Germany and Italy, but elsewhere there are signs that activity is staging a rebound. That said, we don't anticipate a material recovery until the second half of this year, as elevated levels of economic and trade policy uncertainty continues to weigh on sentiment.

Chart 1: Weaker Exports, Investment and Temporary Factors Weigh on Euro Area Growth



Source: Eurostat, TD Economics

At this point in the year it's unlikely that growth in the Euro Area will revisit the heady 2-3% rates of the past few years. But, the combination of firming domestic demand, a modest recovery in the manufacturing sector, and supportive fiscal and monetary policies are consistent with growth that should return to a 1.3% trend-pace by the second half of this year.

Return to Trend

After a fairly quick recovery following the 2009 financial crisis, growth in the Euro Area slipped back into recession in early 2011 as the euro crisis took hold. Since then, growth has struggled to keep up with trend.[1] With more than €2.7tn central bank asset purchases and hundreds of billions in bailout funds earmarked for the periphery, it wasn't until 2015 that growth began to accelerate noticeably.[2] Following the China-led global growth scare of late 2015, both monetary and fiscal policy became more stimulative. Lending to households and firms improved as ECB actions helped to keep a lid on economy-wide borrowing costs.

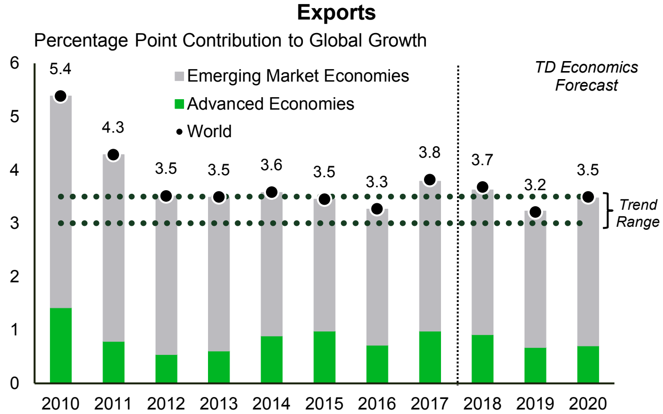
The subsequent recovery in global demand, together with a weaker euro, proved a boon to Euro Area exports. As both advanced and emerging market economies revved up at the same time, global growth accelerated to the high 3% mark for the first time since 2011 (Chart 2).

Unfortunately, the impulse from global stimulus did not last and by 2018, not only waned, but went into reverse. Early in the year, the prospect of higher interest rates in the U.S. triggered capital outflows from emerging market economies – a main market for Euro Area exports – setting off a chain of events that resulted in Argentina and Turkey falling into a balance of payments crisis. Later on, as trade tensions escalated between the U.S. administration and its trading partners, Chinese growth concerns provided yet another headwind to exports (Chart 3).

Chart 3: Euro Area Greatly Exposed to EM Economic Slowdown

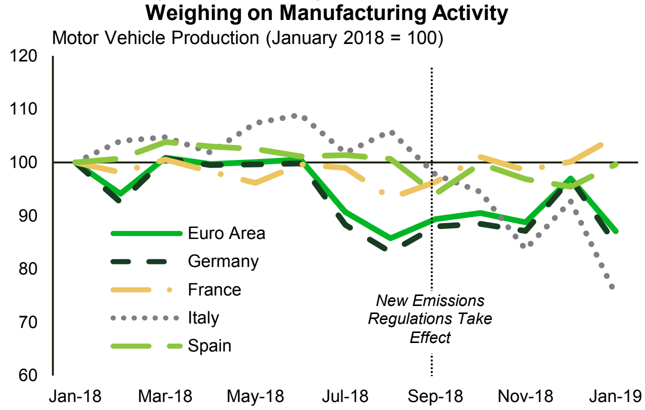
In addition, Europe was hit by a series of temporary factors that helped take further steam out of the economy. Early in the year, an unusually bad flu season and adverse weather negatively affected industrial production, which never really bounced back. Then last fall, a major setback from new automobile emissions regulations that saw deep cuts to production and sales. The new regulations required every model trim to be tested, creating a backlog that reverberated through the entire supply chain. Although the rout is lasting longer than anticipated, auto production and sales are slowly recovering (Chart 4).

Chart 2: Slowing Global Growth a Headwind to Euro Area Exports



Historical growth at purchasing power parity (PPP). Forecasts at 2017 PPP.
Source: IMF, Forecast by TD Economics as at March 2019.

Chart 4: Very Slow Recovery in Motor Vehicle Production Weighing on Manufacturing Activity



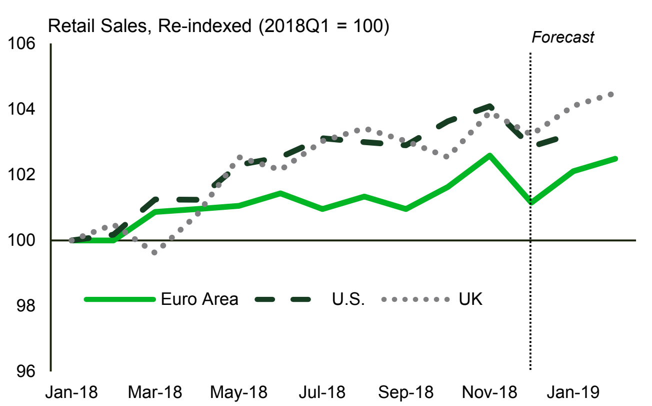
Source: ECB, National Automotive Manufacturing Associations, TD Economics
Last Observation: January 2019

Adding to manufacturing woes in the second half of 2018 was the low water level in the Rhine River, an essential mode of transportation for energy and pharmaceutical chemicals in central Europe, causing production disruptions. This exerted a drag on European economies dependent on the Rhine, particularly Germany, as there just wasn't enough trucking capacity available to offset lost by stranded ships. On a bright note, since December water levels have recovered, alleviating some production backlogs.

More concerning than the temporary factors plaguing the manufacturing sector is the downtick in the growth of service industries. The plunge in retail sales volumes in the fourth quarter is a phenomenon observed in a number of advanced economies. Outside of Europe, December retail sales volumes plunged in the U.S.,UK and Canada. Negative finanical market sentiment combined with declining consumer and business confidence appeared to have weighed heavily on domestic demand throughout advanced economies.

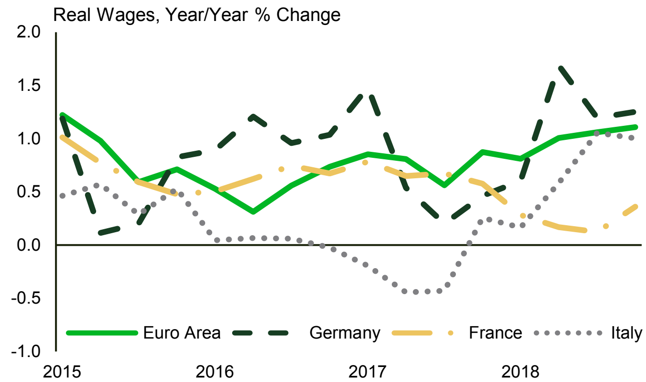
January's data suggests that this soft patch may prove temporary. Retail sales volumes rebounded in Germany and the Euro Area as a whole (Chart 5). Spending on services should continue to firm, supported by a recent acceleration in real wage growth, stable and high saving rates, and healthy job creation (Chart 6).[3] What's more, negative sentiment in financial markets has waned. Stock markets have recorded double digit gains year-to-date, and there is hope that the U.S. and China will strike a deal in the first half of this year that may lift some of the trade policy uncertainty weighing on the global manufacturing sector. That said, declining bond yields and steady commodity prices suggest lingering pessimism about the scope for a material rebound in economic growth later this year and next.

Chart 5: Retail Sales Volumes Recovering from a Dismal December



Source: National Statistical Agencies, TD Economics. Last Observation: January/February 2019

Chart 6: Strong Real Wage Growth Should Support a Rebound in Domestic Demand



Source: Eurostat, National Statistical Agencies, TD Economics
Last Observation: 2018Q4

Service industries are expected to perk up in much of the Euro Area, but France appears to be an outlier. Ongoing *gilets jaunes* protests, now in their twenty first week, continue to weigh on sentiment and activity in both manufacturing and service industries. Shopkeepers in Paris have resorted to boarding up on weekends to avoid damage, and the protests have kept tourists from the city centre. As a result, France is likely to experience a softer start to the year than its peers, growing about 0.5% quarterly annualized rate in the first quarter versus about 1% for Germany.

Government Spending To Support Growth

In addition to solid domestic fundamentals, more government spending is likely to help support growth this year (Chart 7). Primary balances should prove less positive, particularly in core Euro Area economies, suggesting that governments are set to loosen their purse strings somewhat this year. Current government budget plans are likely to provide an additional 0.2 percentage point boost to Euro Area GDP during fiscal 2019/20.[4] That said, if the economic downturn proves longer lasting, governments in countries with adequate fiscal space (for example, Germany, France, Netherlands, and Austria) may decide to boost spending further the following fiscal year to ensure that growth in economic activity is maintained.

Although debt burdens are high in some nations, most Euro Area members have been running primary budget surpluses over the past few years, with some exceptions. France has been deficits averaging about 1% of GDP, and Spain has also been posting a deficit averaging about 0.5% of GDP.[5] While EU fiscal rules typically frown upon running successive budget deficits, both France and Spain have been undertaking labour market and tax reforms that have impacted spending and revenues in the near-term.

As we highlighted late last year, Italy's coalition government has a now approved budget that sees a big increase in spending plans this year, resulting in a big decline in its forecast primary budget surplus. Although generally positive for near-term growth, longer-term debt sustainability concerns have driven up domestic interest rates since last summer. In turn, higher interest rates have weighed heavily on consumer spending and business investment. Add a steep drop in inventory accumulation at the end of the year, and Italy's economy did not grow at all in the second half of 2018. Making things worse is that the recent decline in global bond yields has not translated into materially lower spreads between Italian and German bonds. Persistently higher spreads is the difference between Italy's economy not growing at all in 2019 as forecast versus growth of 0.5%.[6]

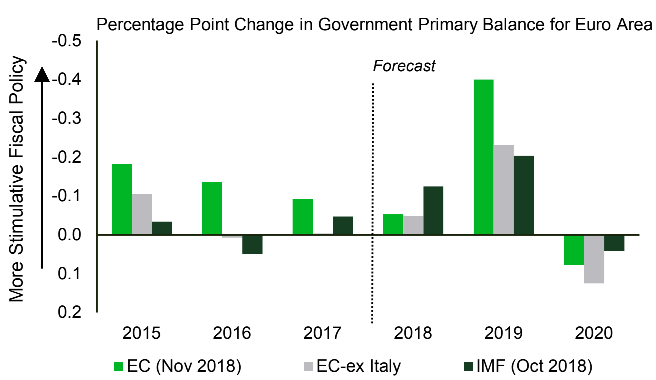
ECB Waiting for All Clear Before Hiking Rates

A disappointing few quarters for Euro Area growth has caused the ECB to change its normalization plans for interest rates. Although the ECBs asset purchase program came to an unceremonious end in December, policy interest rates have remained at historic lows and sovereign yields have plunged in response to weaker global growth.

Low interest rates have been instrumental in the Euro Area economic recovery. Since the 2016 round began, credit growth has strengthened for both households and firms. Economic activity responded in kind, leading to closing in the output gap by the end of 2017.

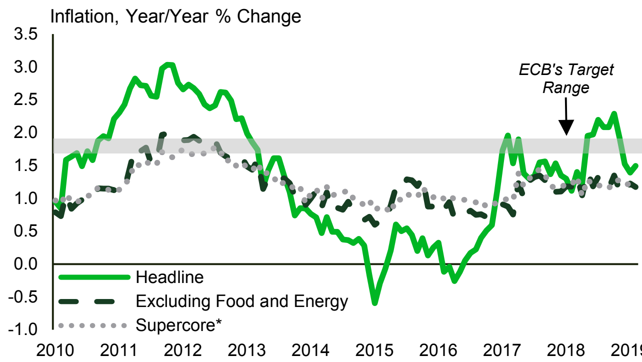
However, subdued inflation pressures (Chart 8) persistent, below-trend economic growth in the second half of last year and the corresponding elimination of small, positive output gap calls for lower, not higher, interest rates. Although household credit growth has remained firm, weaker confidence has helped take some steam out of it (Chart 9). Add a subdued inflation outlook into the mix, and the ECB was forced to reconsider plans to raise interest rates this year at its March 7th meeting. In addition to

Chart 7: More Stimulative Fiscal Policy Expected in 2019 for the Euro Area



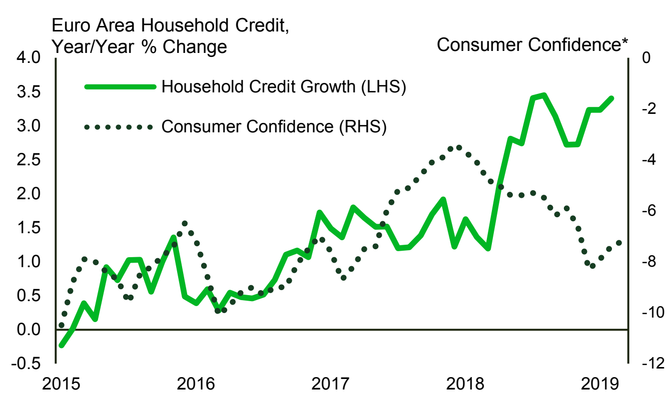
Note: Calculated as the change in the general government primary balance as a share of cyclically adjusted potential GDP.
Source: IMF Fiscal Monitor (Oct. 2018), European Commission (Nov. 8, 2018),TD Economics

Chart 8: Underlying Inflation Measures Have Remained Stubbornly Below Target



* The supercore index includes components that are deemed sensitive to changes in the output gap. It's reported as a 3-mth moving average.
Source: Eurostat, TD Economics. Last Observation: February 2019

Chart 9: Uncertainty Weighing on Consumer Durables and Home Purchases



* Percent of respondents reporting an increase less percent of respondents reporting a decrease.
Source: ECB, European Commission, TD Economics. Last Observation: February/March 2019

the change in forward guidance that eliminates any interest rate increases this year, the ECB announced an extension in its targeted long-term repo operations (TLTRO III) through 2023.[7] This program should ensure adequate bank credit to households and firms even as the ECB starts to move interest rates up.

Downward revisions in the ECB Staff's March economic projections suggest that the bar for even one rate hike has moved much higher than in December. Similar to its G7 peers, the ECBs pivot to patience at its March meeting reflects rising concerns about weaker domestic and foreign outlooks. Our recently updated forecast is consistent with the downwardly revised projections by the ECB (Table 1). Where we differ, however, is in our inflation outlook and growth next year. In terms of the former, we anticipate slightly firmer headline and core inflation this year, but are broadly in line with the ECB's forecast for next year. In terms of GDP growth, we differ only in our 2020 forecast. We are less optimistic than the ECB in terms of the rebound in growth, calling for 1.4% growth in 2020 – 0.2ppts weaker than the ECB's 1.6% forecast. This is due to divergent views on the strength in the recovery in business investment and exports next year. We anticipate that trade negotiations between the U.S. and EU, China and UK-related trade uncertainty will keep many firms from boosting investment substantially in the quarters ahead. Moreover, although we anticipate foreign demand to recover beginning in the second half of this year, an elevated level of trade policy uncertainty is likely to persist, weighing more on exports.

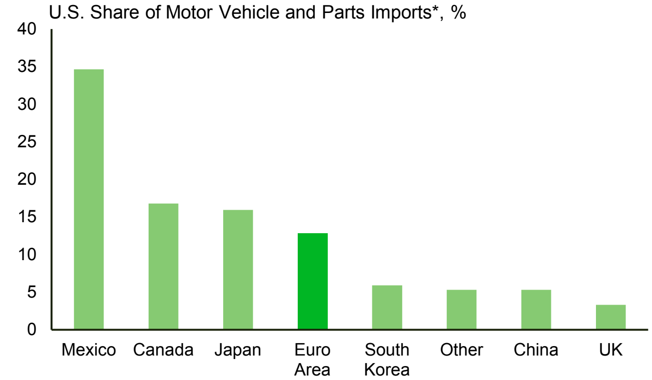
As a result, a rate hike by the ECB is unlikely to come before the second quarter of 2020 at the very earliest. This view is contingent on the ongoing constructive evolution of the labour market, robust wage growth persisting, and ultimately a sustained upward movement of underlying measures of inflation.

Table 1: 2020 Rebound Likely to Prove Weaker Than ECB Expects

		2018	2019	2020
GDP Growth, Year/Year %	TD Economics	1.8	1.1	1.4
	ECB	1.9	1.1	1.6
Unemployment Rate, %	TD Economics	8.2	7.8	7.7
	ECB	8.2	7.9	7.7
Headline Inflation, Year/Year %	TD Economics	1.8	1.3	1.4
	ECB	1.7	1.2	1.5

Source: ECB, TD Economics as at March 2019

Chart 10: U.S. Allies and Trade Partners Most at Risk from Auto Tariffs



* Includes motor vehicles, bodies and trailers, and parts.
Source: U.S. Census Bureau, TD Economics

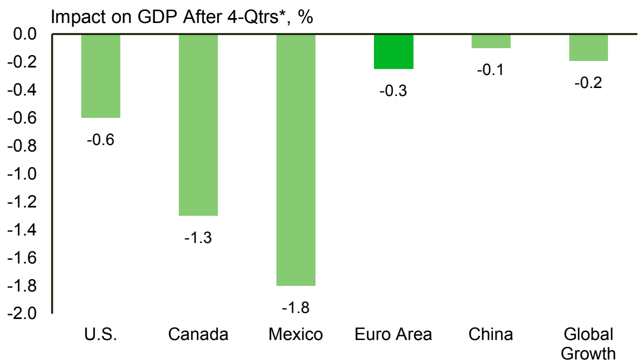
Downside Risks Call for Potentially Weaker Outlook

The recent intensification of downside risks has made economic forecasting more difficult than usual. Nevertheless, our Euro Area outlook is roughly balanced between the potential for stronger economic performances both abroad and in the Euro Area, and negative event risks. These include a hard-Brexit, a more prolonged global manufacturing slump, and more disappointment in economic growth of key trading partners.

On the downside, our outlook does not include the impact of threatened auto tariffs. More specifically, the U.S. administration has threatened tariffs of up to 25% on imported motor vehicle and parts (Chart 10). The Section 232 U.S. Trade Representative investigation concluded in mid-February, giving the U.S. President up to 90 days (until Mid-May) to act upon its recommendations. The report has not been made public yet, but the U.S. administration is likely to use the threat of tariffs as leverage during trade negotiations between the EU and Japan this year.

U.S. tariffs on automotive imports, with equivalent retaliation, would present a significant downside risk to global economic growth once implemented (Chart 11). As with the tariff spat with China, trade and supply chain disruptions are just one of three factors expected to weigh on global economic activity. A second factor is that higher auto prices would reduce the purchasing power of consumers. The third factor is the negative confidence and wealth effects from an escalation in trade tensions that could trig-

Chart 11: Mexico and Canada have the Most to Lose from 25% Auto Tariffs



* Assumes 25% tariff imposed on all automobile & parts imports into the U.S. & equivalent reciprocation by affected countries. Estimates include confidence and income effects.
Source: TD Economics

ger a broad selloff in equities, reinforcing a downward self-sustaining cycle of weaker business investment, employment, and ultimately household spending.

Bottom Line

A number of factors have contributed to the recent slowdown in Euro Area growth:

1. Slowing foreign demand, trade, and a global manufacturing slump;
2. Temporary factors weighing on the domestic manufacturing sector that have yet to fully rebound;
3. Elevated global economic and trade policy uncertainty that is weighing on service industries;

As temporary factors unwind Euro Area growth is set to rebound back to a 1.3% (annualized) quarterly trend-pace of expansion for the remainder of this year. This outlook anticipates a firming in domestic demand as fundamentals are expected to remain supportive:

- Low interest rates that is supportive of increased lending to households and firms;
- Ongoing modest job gains and persistence of robust real wage growth;
- A modest recovery in foreign demand.

The recent spell of weak domestic and global economic data has raised the bar for the ECB as to when it will be able to begin to raise interest rates. Growth near-trend and a slightly positive output gap are consistent with a more subdued outlook for underlying inflation. As a result, it will likely take until mid-2020 before underlying inflation perks up on a sustained basis, ticking the last box on the ECB's checklist for a rate hike.

That said, the combination of low potential growth and high impact negative event risks with little policy room to maneuver keeps the Euro Area as a potential downside risk to the global outlook. This outlook assumes that the world avoids an escalation in trade tensions. Auto tariffs threatened by the U.S. administration on some of America's major trading partners could set off a chain of events that would easily put another dent in global growth.

End Notes

1. Trend GDP is estimated using supply side factors of the economy, and includes TD Economics assumptions on the growth in trend labour input, capital deepening, and total factor productivity over history. Aging demographics has resulted in weakening labour input growth post crisis, while the slump in productivity growth has seen trend GDP growth in the Euro Area fall to 1.3% in 2016-2019 from a pre-2009 crisis high of 1.8%.
2. A combination of loans from the European Stability Fund and the IMF helped to stabilize government finances in Greece, Ireland, Portugal, Spain, and Italy. The ECB's actions during the euro crisis included asset purchases and reducing interest rates to zero and negative for bank deposit rate. The asset purchase program served two purposes: 1) to exert downward pressure on sovereign borrowing costs, bringing down average interest rates in Euro Area economies and limiting contagion from the periphery; 2) help banks recapitalize their balance sheets. On the other hand, targeted long-term repo operations were designed to give banks access to very cheap financing for several years on the condition that they increase lending to households and firms.
3. Unemployment rates across Europe remain near historical lows. However, an expanded measure for the Euro Area that includes the underemployed, people available to work but not seeking work, and those seeking work but not available is still about a percentage point above the 2008 level of 13.5%.
4. This estimate assumes that $1 dollar of government spending contributes to about $1 dollar of real economic activity (fiscal multiplier = 1). Although in the past the output gap for many countries has proven solidly positive, consecutive below trend GDP growth figures since the start of 2018 has greatly diminished the magnitude of positive output gaps in the largest Euro Area economies, suggesting that a fiscal multiplier close to one is reasonable. A smaller (<1) or larger (>1) assumption on the multiplier would result in a relatively smaller or larger impact on GDP, respectively.
5. Estimates based on the IMF's October 2018 Fiscal Monitor Database, general government cyclically adjusted primary balance. Historical revisions to GDP (the denominator) may change this estimates in the IMF's April forthcoming update.
6. As mentioned in our November note, we estimate that each 100bp increase in spreads shaves about 0.8ppts off growth. This implies that in the case of Italy the 125bp increase in the spread with 10-yr German bunds since early 2018 is likely exerting a 1ppt drag on GDP through the first half of 2019.
7. Quarterly targeted longer-term repo operations are set to begin in September 2019 and end in March 2021. Each series will have a maturity of two years. The exact details of the TLTRO III program have yet to be disclosed, but the parameters were broadly discussed by ECB President Mario Draghi at the March 7 2019 press conference (https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is190307~de1fdbd0b0.en.html).