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Eurozone: A weak end to the year

While the dispute over Italy's budget has been resolved, trade wars and Brexit remain substantial risks to eurozone growth, which is already suffering from a slowdown. As the ECB's growth and inflation forecasts are likely to be disappointed, we see little incentive for the ECB to tighten monetary policy



Source: Shutterstock

Weak Eurozone growth in 4Q18 could persist into the start of 2019

The year 2018 ended on a weak note for the eurozone economy, with sentiment indicators still heading south and stock markets tanking. While there are still positive drivers that make it too soon to call the end of the expansion, growth in 2019 is likely to be lower than in 2018 with risks skewed to the downside.

After a strong start, the eurozone economy lost momentum throughout 2018. To be fair, with capacity constraints showing up, the eurozone could simply not maintain a growth pace above 2%. But there were other headwinds that explain the growth deceleration.

The uncertainty provoked by the trade wars, the strong euro exchange rate in effective terms, the

slowdown in the emerging world, the uncertain Brexit outlook and the clash between Italy and the European Commission all contributed to a loss of confidence. Not to mention some very specific problems in the German car industry that resulted in a GDP contraction in the third quarter there.

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Sentiment indicators have weakened further in December, with the eurozone manufacturing PMI falling to 51.4 from 51.8 in November. The social unrest in France, initiated by the so-called Yellow Vests, has probably shaved off 0.2 percentage points of French 4Q GDP growth.

Because of that, we expect eurozone 4Q GDP growth to be below 0.3% on a non-annualised basis. With export growth unlikely to accelerate much in the coming months, the first quarter is unlikely to see a significant pick-up. However, the labour market is still strong, with wage growth gaining traction. Combined with much lower energy prices, this should boost purchasing power and consumption in the first half of the year. On top of that, there is some fiscal loosening in the offing in the three biggest member states.

Politics still poses risks

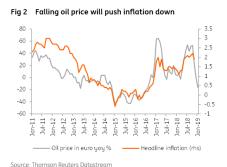
The Italian problem seems to be resolved for now as the Italian government and the European Commission reached a compromise, allowing for a budget deficit of 2.04% in 2019. The Excessive Deficit Procedure will be shelved for the time being.

We're convinced that not only the ECB's growth forecasts (1.7% for both 2019 and 2020) are too optimistic, but that inflation might also surprise to the downside

On the back of this agreement, there was a strong decline in Italian bond yields. However, on the trade front, there is still the risk that US President would want to impose import tariffs on European cars (the US Commerce Department is expected to issue a report on the strategic character of the automobile sector for the US economy by 17 February).

Finally, the risk of a hard Brexit is still there, something that could temporarily disrupt exports to the UK. All in all, we continue to forecast 1.4% in 2019 and 1.3% in 2020, but there are clearly some downward risks.





Source: Thomson Reuters Datastream

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ECB growth and inflation forecasts seem way too optimistic

We're convinced that not only the ECB's growth forecasts (1.7% for both 2019 and 2020) are too optimistic, but that inflation might also surprise to the downside. The strong fall in energy prices will have a downward impact on headline inflation in the coming months. And while higher wages could boost core inflation, we think tighter profit margins will partially neutralise this impact. In these circumstances, we see little incentive for the ECB to tighten monetary policy.

We still believe there could be a small hike in the deposit rate, say 15 to 20 basis points, in the fourth quarter of 2019, but we don't see any refi rate hike over the forecast horizon. This basically means that the money market rate will probably remain negative throughout 2020. A reason why bond yields, which are now depressed by the bout of risk aversion on financial markets, are unlikely to see strong upward pressure for some time to come.

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