Eurozone 2019: A pessimist's view

'Eurozone growth could even exceed already high expectations'; that's what we wrote this time last year. 12 months on, the piece hasn't exactly aged well. Perhaps we should adopt a different approach this time around

The dog ate my recovery

It wasn't the sky which was the limit for Eurozone growth this year but rather a series of one-offs like harsh winter weather, abnormal sick-leave due to flu, capacity constraints, strikes and cars. If you think that this sounds pretty much like your teenage son explaining why he can't clean his room, you're right; one of the authors of this piece has such an example at home. Admittedly in the second half of the year, there's probably been more to that disappointing Eurozone growth story than only one-off factors; the slowdown of the Chinese economy and a list of downside risks have all become more prominent.

Either way, not to repeat last year's mistake of being overly optimistic, we stick to the ECB's well-tested strategy of erring to the downside and so we'll take a look at what could really go wrong in the Eurozone in 2019.

Be aware, we are sketching low-risk high impact events; unrealistic but not completely impossible.

1 Politics: the horror ending of muddling through

2019 marks the end of the often successful muddling through of Eurozone politics. However, it is hard to see that this is for the better.

Italy comes first with a further escalation of the controversy with Brussels. After the European Council signs off the European Commission's recommendation to start an Excessive Deficit Procedure based on too much Italian debt, the short deadline of only three months to present "effective measures" does not bring any change. As the European Council starts the next escalation level of the procedure, bringing Italy closer to a fine, Italian bonds are heavily sold off, leading to problems in the banking sector. Higher financing costs hurt Italian SMEs.

As a result, the Italian government falls and snap elections take place together with the European Parliamentary elections. Fears of an Italian exit from the monetary union reemerge. The snap elections bring big gains for the current coalition parties, which feel emboldened as far as their hard stance vis-a-vis Brussels is concerned. The negative fallout from market uncertainty starts to undermine the Italian public's support for the euro and as the Italian economy dips into recession, the government doubles down on fiscal stimulus. The government has trouble financing through markets at this point and introduces mini-BOTs. Fantasies of Italeave spook markets and the entire Eurozone economy again.

2 A new political vacuum

After severe losses of her CDU at the European Elections, German Chancellor Angela Merkel steps down and leaves the political stage for good. The German president announces snap elections before the end of the year. In the meantime, the new political vacuum at the European level leads to long-lasting negotiations and widely-spread nominations for the different European top jobs. The rise of anti-EU parties and the successful attempt to form one single anti-EU political group in the European Parliament complicates things still further. The new European Commission tries to revamp efforts for deeper and faster integration of the Eurozone but divisions within the Eurozone on the right way forward actually lead to more national approaches. Against the background of faltering economic fundamentals and the Italian attempt to leave the Eurozone, national elections in Greece in October are the next test case for the stability of the monetary union.

3 A Eurozone recession thanks to Brexit

As a parting gift, the UK manages to successfully bug Europe one last time as a chaotic Brexit process ends in a no deal scenario. Queues at the border grow rapidly and immediately cause large supply chain disruptions. Many SMEs that have not traded with third nations before turn out to be unprepared from an administrative side and cannot export to the UK anymore and face fines for not fulfilling contractual obligations.

While the UK faces a deep recession, Eurozone growth turns negative too. For an economy already facing weak growth, this can happen quite easily but the contraction due to initial problems is quite severe. A bounce back is to be expected, but the constraints at the border are not easily solved and drag on into the third quarter. As supply chains slowly pick up again, the economy recovers somewhat in the fourth quarter, but countries that are more dependent on trade with the UK like Ireland, Belgium and the Netherlands face a deeper recession.

Recoveries do die of old age

Political turmoil in Europe, as well as a new escalation of US-China trade tensions and new attempts by the US administration to introduce tariffs on European cars, lead to a further weakening of the Eurozone economy. A hard Brexit, snap elections in Italy and big gains of anti-EU parties at the European Elections push the Eurozone into a technical recession in 2Q and 3Q. As a result, the ECB decides to re-introduce a small QE floor of 15bn euro per month on top of the reinvestments at the September 2019 meeting.

To do this, the ECB stretches the issue limit further. ECB president Mario Draghi will have kept his promise to keep interest rates unchanged through the summer of 2019 but not as he had initially intended. Instead, the ECB also announces that rates will remain unchanged for as long as the new QE floor is in place. Draghi goes down in history as the first ECB or Bundesbank president who never hiked policy rates since Hans Tietmeyer (Bundesbank president between 1993 and 1999).

> The list of what could go wrong in Europe and the Eurozone has always been long, not only for next year. The biggest upside to our list is that up to now our 'exceeding expectations' notes have been a counter rather than a leading indicator for the Eurozone. In this regard, there is definitely hope for the Eurozone in 2019.

Author

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de