# Eurozone: Signs of stability

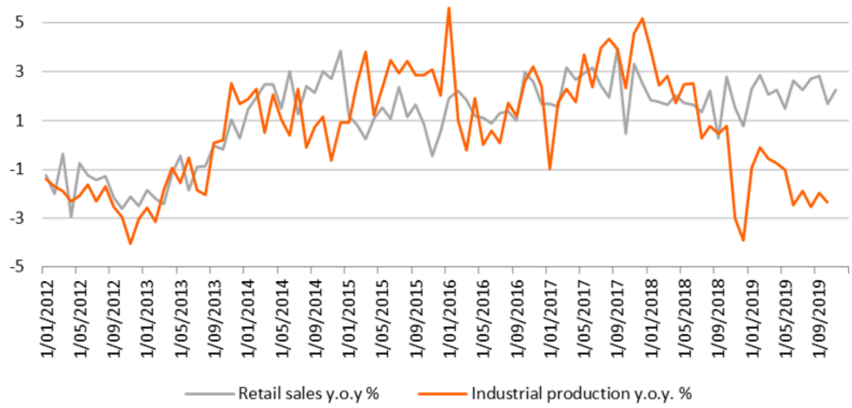
The jury is still out on whether the eurozone slowdown is coming to an end or is merely on hold. The main culprit, the manufacturing sector, was still in recession in December, probably signalling weak fourth quarter growth. While there's hope for improvement, this won't be enough to prompt the European Central Bank to raise interest rates


## Could a trade deal stop the bleeding in manufacturing?

Judging from the final reading of the Manufacturing PMI in December, the bleeding hasn't stopped yet. The PMI came in at 46.3 from 46.9 in November. The worrying thing is that new orders continued to deteriorate markedly, a sign that output is bound to stay weak for some months to come. Moreover, the rate of job losses last month in manufacturing was the sharpest since the start of 2013. But bear in mind that this is in industry, not in the economy as whole, although manufacturing captures changes in the economic cycle earlier than services.

The impending US-China trade deal could offer relief as it takes away some of the uncertainty that has weighed on business investment. Indeed, apart from the intermediate goods sector, the weakest PMI numbers were recorded in the investment goods sector, an illustration that economic uncertainty has played an important role in the current slowdown. So, if the mood turns and firms start to invest more, aided by still very favourable financing conditions, the deceleration might reverse in the course of this year. At the same time, the European services sector is holding up well, with the PMI index in December rising to the highest level in four months. And with retail sales rising by 1% month-on-month in November, the consumer is still very much alive.

## Divergent trends: consumer versus industry




Source: Refinitiv Datastream

## Still plenty of risks

In any case, a strong upturn seems unlikely, as risks continue to lurk in the background:

- The Trump administration could decide to start a trade fight with Europe now that a truce has seemingly been reached with China. There are already tensions between France and the US on the French digital tax. We don't expect any escalation on this front, but the risk is certainly there.
- Even though we are now quite sure that Brexit is going to happen imminently, a lot can still go wrong in the negotiations to reach a trade deal.
- Italian politics will likely be less calm when important regional elections are held at the end of this month.
- Social unrest on the back of (planned) pension reforms continues in France at a time when the country is experiencing better economic growth than the European average.
- Finally, the unrest in the Middle East, which has pushed up oil prices, could weigh on European consumers' purchasing power, if it continues.

## Structurally slow growth

We have slightly upgraded our GDP forecast for 2020 to 0.8% (from 0.7%), but we remain at the lower end of expectations (the European Central Bank is still pencilling in 1.1% GDP growth this year, a scenario that relies on a swift recovery). Be aware that GDP growth forecasts for 2020 might differ, depending on whether or not forecasters take into account working day adjustments. Most eurozone countries will have more working days in 2020 than in 2019. The eurozone economy has seen an average growth rate of 1.4% over the last decade and it doesn't look as if the next decade will top that. On the contrary, an ageing population and lacklustre productivity growth imply potential growth very close to 1%. That is why we see growth picking up to 1.0% in 2021, but anything more than that will be difficult to achieve.

## Inflation in a subdued upward trend


Source: Refinitiv Datastream

## Slightly higher inflation

Inflation has been picking up recently on the back of rising oil prices. However, core inflation is also creeping higher, as we expected. In December, both headline and underlying inflation were reported at 1.3%. That said, we are still far from a self-reinforcing wage-inflation dynamic. In fact, some of the wage metrics, which were in an uptrend, have been moderating recently. So while we do believe that inflation has troughed, we are likely to see only a slow upward move from here.

## ECB on hold

A lot has been written about the Swedish Riksbank's decision to increase interest rates in the face of a slowing economy. The Riksbank has cited the negative side effects of interest rates below 0%. Commentators have considered this move to be a potential template for the European Central Bank. However, the ECB has put in place a tiering system for excess liquidity, which softens the negative impact on the banking system. Moreover, clear forward guidance has been given, which stipulates that the inflation outlook must converge robustly with the objective of below but close to 2%, before interest rates will be raised. Even though inflation is now rising a bit, we are still some time away from this condition being fulfilled. In the course of 2021, however, markets will start to anticipate a change in monetary policy, which could push money market rates slightly higher in the second half of that year.

### Author

**Peter Vanden Houte**
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com