Eurozone: Zigzagging towards stronger growth

The eurozone ended 2019 on a soft note, with growth decelerating to 0.1% quarter-on-quarter. While the stars are aligned to see a gradual, though subdued, growth acceleration, the coronavirus might delay the improvement a bit longer leading us to downgrade our 2020 growth forecast to 0.7%

President of European Central Bank Christine Lagarde

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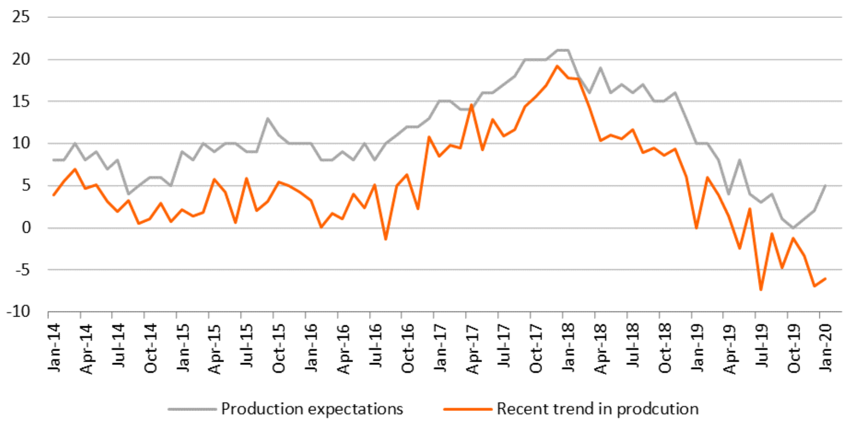
Inventory correction

The 0.1% quarter-on-quarter growth in the last quarter of 2019 was disappointing, with both France and Italy reporting negative GDP growth. In France, the inventory correction shaved 0.4 percentage points off fourth-quarter growth, which was probably also a negative factor for Italian growth. And while the GDP figures for Germany are not yet published, the 3.3% drop in retail sales in December shows that industrial weakness might eventually also affect consumption.

The good news is that with companies having cut back inventories in a number of member states, an uptick in demand will result in higher production. The €-coin index, a monthly estimate of the underlying growth pace, rose to 0.25 in January, the highest level since January 2019. The

European Commission's economic sentiment indicator for January increased markedly with production expectations picking up strongly. Confidence in the construction sector also improved, while it stabilised in the services sector. That said, the mood in the retail sector soured a little. However, with the unemployment rate falling to 7.4% in December, the lowest rate in 12 years, and employment plans improving in industry, the backdrop for consumption remains favourable.

Industry is expecting more production



Source: Refinitiv Datastream

Coronavirus will slow the improvement

However, we remain wary of the fact that the improvement is still weak and uneven. Moreover, there are still a number of uncertainties. The coronavirus, while for the time being relatively contained in Europe, is bound to have a dampening effect on growth in the first half of the year, all-be-it only because of lower exports to China. We also expect a significant impact on consumption, which is now only likely to grow by an annualised 0.4% in the first half of the year (0.7ppt lower than our previous estimate), though a limited catch-up effect in the second half could follow.

Political risks have somewhat diminished, although they certainly haven't disappeared entirely. The current Italian government more or less survived the regional elections, while Brexit has now happened (though there is still not much certainty on the future trade relationship). A temporary truce was reached in the trade row between France and the US on the digital tax. That said, President Trump might still fire a few warning shots in order to get a good trade deal with the European Union ahead of the US elections.

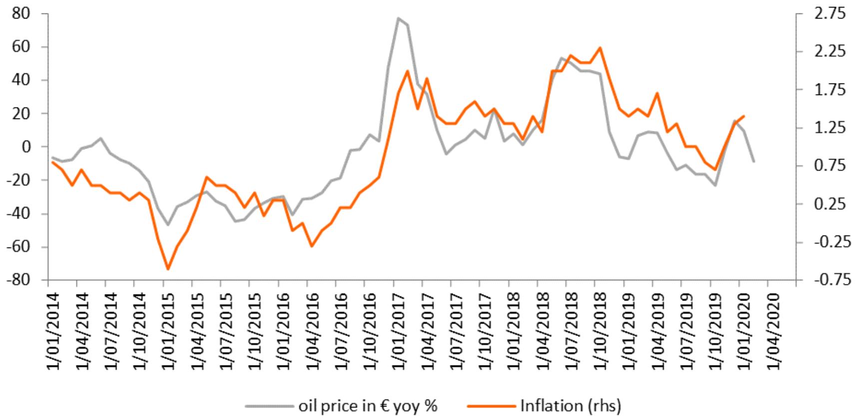
2020 will see slower growth, on average, than 2019

All in all, we don't see much reason to alter our view of some gradual growth improvement over the course of this year, although the first half is now likely to be hurt by the coronavirus fallout. Because of the weak base effect, we also deem it rather unlikely that 2020 will be better than 2019, on average. On the back of the downgrade to the growth profile in the first half of the year, we have lowered our GDP growth forecast for this year to 0.7%, while we pencil in 1.1% for 2021.

Inflation remains low

Eurozone inflation rose further to 1.4% in January. This was largely an oil story due to the fall in oil prices at the beginning of last year. However, this effect is bound to reverse over the coming months. More importantly, underlying inflation has fallen back to 1.1% from 1.3% in December, showing that the upward trend in core inflation remains muted. The fact that the powerful German trade union IG Metall is now proposing wage moderation in exchange for job security shows that an upward push to inflation from wages is not to be expected soon.

Oil prices will push inflation down again



Source: Refinitiv Datastream

ECB: Status quo

In these circumstances, not much is to be expected from the European Central Bank. Even the more hawkish President of the Bundesbank, Jens Weidmann, stated in a recent interview that "it is clear that the very low-interest rates cannot be permitted to persist indefinitely. Given the price outlook, though, we need to stay realistic: it will probably take a while for interest rates to pick up again".

The ECB president, Christine Lagarde has kickstarted the strategy review - the first in 16 years. The ECB expects the review to be concluded by the end of the year and will aim to look at the definition of price stability and the ECB's toolkit. It will also take into account how other factors like financial stability, employment and environmental sustainability could affect monetary policy and its goals.

However, any substantial changes including to the forward guidance, before the end of the strategy review looks unlikely.

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