ING's Eurozone Quarterly: Avoiding a more serious slowdown

There are still underlying growth drivers in the eurozone, but the expansion is losing steam. That's the main theme for our Eurozone Quarterly. From Germany to Greece, France to Finland, we give our assessment of what's really going on right now in the region... and what we think is going to happen next

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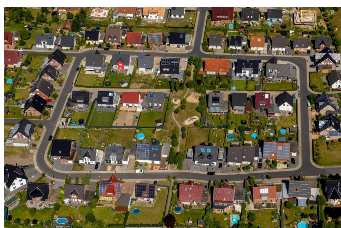

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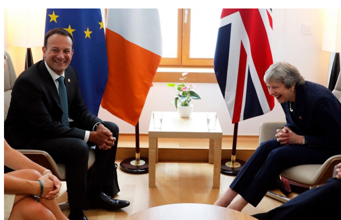

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By Bert Colijn

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Eurozone: Avoiding a more serious slowdown

There are still some underlying growth drivers in the eurozone, but the expansion is losing steam. A multitude of potential adverse shocks could add to the downside risks. Inflation expectations are falling to an uncomfortably low level. So it's no surprise the ECB has suggested interest rates will be cut again

ECB President, Mario Draghi

Just when it seemed that the eurozone economy was starting to look better again, the escalation of the trade war between the US and China soured the mood. We shouldn’t forget that Europe (especially Germany) is very exposed to international trade. Any trade slowdown will leave its mark on the eurozone economy. While some might argue that Europe could benefit from the US-China conflict through trade diversion, we think that the overall negative effect on world growth will be more important. What’s more, Europe itself is likely to be in the line of fire if President Trump decides to impose import tariffs on cars later this year. No wonder ECB President Mario Draghi has now clearly Indicated that more easing is underway.

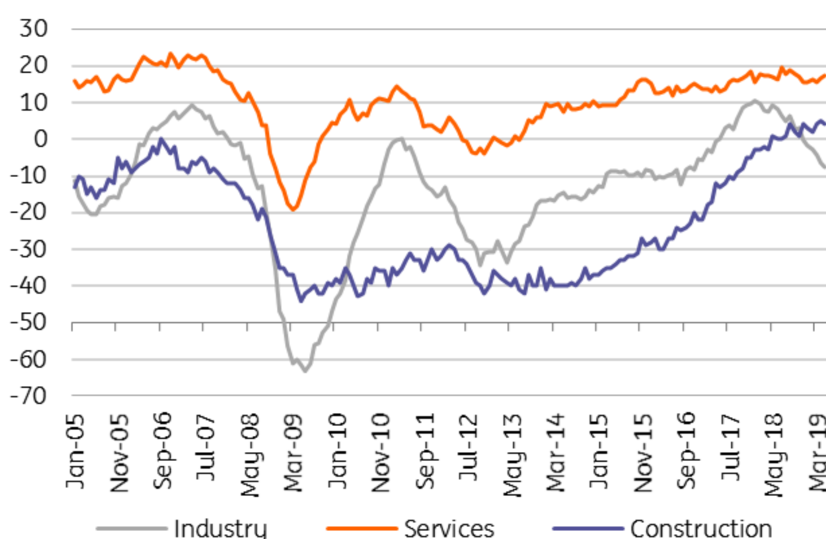
Consumption in the driving seat

The strong drop in German exports in April was a testament to the fact that international trade was not strong even before President Trump decided to tweet about additional import tariffs. However, the weakness was probably exaggerated because of the end of stockpiling in the UK after the Brexit date was delayed until the end of October. To be sure, domestic demand has done rather well on the back of a strong service sector and decent construction activity. Indeed, unemployment continues to fall and the pick-up in wages continues. Passenger car registrations rose by a healthy 4.7%, month on month in April, continuing the rebound witnessed in the first quarter.

The eurozone economy seems to be in a soft patch rather than on the verge of a recession

This clearly shows that household consumption will continue to be an important driver in this phase of the expansion, even though the decline in consumer confidence in June illustrates that we are certainly not looking at accelerating consumption expenditure. As for business investment, the worry is that economic and political uncertainty will have a dampening effect even in an environment of rock bottom interest rates. According to the ECB's New Multi Country Model, a stabilisation of the Economic Sentiment Index at its May 2019 level, already points towards a modest negative contribution of confidence to investment growth in 2019.

New orders signal some deceleration



Source: Thomson Reuters Datastream

Soft patch?

For the time being the eurozone economy seems to be in a soft patch rather than on the verge of a recession. The flash composite PMI rose for a second month in a row in June, although the manufacturing sector continues to languish. While inflows of new work in the service sector improved, there was another steep fall in new orders for manufactured goods, deteriorating at one of the sharpest rates seen over the past six years, Export orders for both goods and services fell again in June. So there is no economic standstill for the time being, but the subdued growth pace makes the eurozone economy quite vulnerable to shocks. There is also the fear that weakness in manufacturing might ultimately spread to the rest of the economy.

We now look at GDP growth at 1.0% for this year and 1.1% for 2020. A small wildcard though for next year is the fact that, in several European countries, the number of working days will be 2 to 4 days higher than in 2019, something that is likely to mask the underlying deceleration in growth.

More politics

The European elections results were not really a shocker; there were some interesting local results, with the most direct consequence the announcement of a snap election in Greece. To be sure, political uncertainty has not disappeared. Brexit is far from resolved and the story is likely to linger on for a while, potentially weighing on business investment. At the same time, things are heating up again in Italy, now that the European Commission recommended to start up an excessive deficit procedure against the country. A final decision on this matter is likely to be taken at the Ecofin meeting on the 9th of July, though we might see a delay.

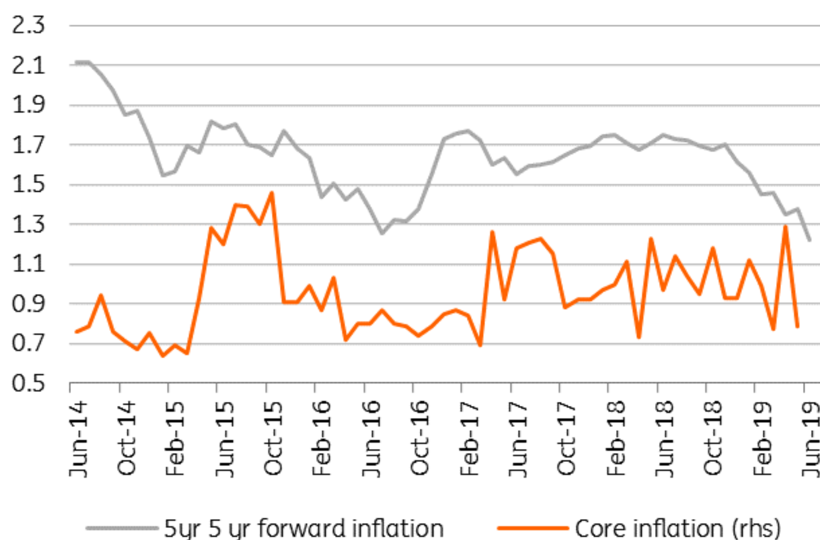
In any case, this is sure to create tensions within the Italian government, certainly if it necessitates the scrapping of a number of election promises. We, therefore, think that the likelihood of early elections in September has significantly increased, especially now that Lega strongman Matteo Salvini might be keen to capitalise on his very strong result in the European elections

Cry wolf

After the artificially higher inflation readings for April because of late Easter holidays, inflation fell back in May. Underlying inflation actually declined to only 0.8% in May with the closely followed 5yr 5yr forward break-even inflation rate now at the lowest level in years. According to the PMI survey Input Cost inflation moderated to the lowest level since September 2016 in June, in turn alleviating upward pressure on selling prices. Average prices charged for goods and services printed the smallest increase since November 2016. With oil prices having declined lately, headline inflation is also likely to fall again in the coming months.

We expect headline inflation to average 1.2% in 2019 and 1.4% in 2020, which remains too low. The ECB, that has continuously been forecasting higher inflation rates, has seen itself confronted with a core inflation rate that remained on average below 1% over the last five years.

Inflation remains too low



Source: Thomson Reuters Datastream

ECB to ease again

Knowing that an inflation rate of below but close to 2% is the prime objective of the central bank (and we're still far away from that level), it was not totally surprising that after the June meeting of the Governing Council of the ECB suggested an easing bias. The new TLTROs were announced with a rather generous (though conditional) interest rate of deposit rate + 10 Bp. At the same time, the forward guidance of keeping interest rates unchanged was lengthened through the first half of 2020.

But at the ECB's conference in Sintra Mario Draghi went even further, strongly hinting at a further rate cut (the subsequent depreciation of the euro triggered a new tweet from president Trump, actually accusing Draghi of currency manipulation). We, therefore, believe that a 10 basis point cut is now on the cards in the second half of this year. It could come as soon as July, although the September meeting would be more logical since the ECB will then present the new staff forecasts. So it will pretty much depend on the economic data flow in July.

Given that a lower negative deposit rate for a longer time to come will increasingly become a burden on bank profitability, a tiering system for excess liquidity is likely to be introduced a bit later. And we wouldn't be surprised if the ECB would suggest the potential of restarting net asset purchases if the economy fails to show signs of improvement in the second half of this year.

Amongst the likely options, a new corporate bond purchase program would seem a sure bet, potentially also including senior bank bonds. As for sovereign bonds, we still think there is some potential, though it is unlikely that the maximum threshold on sovereign exposure would be altered (if the ECB were to cross the 33% threshold, it becomes a preferential creditor and could block all debt restructuring). We believe that the ECB would be more likely to diverge from the capital key, no longer buying in jurisdictions where it already reached the threshold.

This article is taken from the Eurozone Quarterly, which you can find here

The eurozone economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP	1.9	1.0	1.1	0.9
Private consumption	1.1	1.6	1.4	0.9
Investment	3.7	1.5	0.4	-0.3
Government consumption	1.0	1.2	1.4	1.0
Net trade contribution	-0.1	-0.2	0.0	0.0
Headline CPI	1.8	1.2	1.4	1.4
Budget balance (% GDP)	-0.5	-0.9	-0.8	-0.7
Refi rate (eop)	0.0	0.0	0.0	0.0
10yr Bund (eop)	0.24	-0.10	0.10	0.20

Source: Thomson Reuters, all forecasts ING estimates

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Germany: Beyond the two Ms of Merkel and manufacturing

Could it be different this time or will the lacklustre performance of the German manufacturing sector eventually hit the entire economy?

German Chancellor, Angela Merkel visits a car battery factory in 2017

You needn't worry if you've no reputation to lose. This seems to be the red line in the recent growth performance of the eurozone's largest economy. The sharp drop in sentiment indicators since the summer of 2018 as well as the lacklustre performance of the manufacturing sector pushed the German economy close to the recessionary territory in the second half of 2018. While concerns and risks have hardly disappeared since the start of the year, GDP growth in the first quarter surprised on the upside and could continue doing so throughout the rest of the year. Downbeat assessments of the German economy are often derived from the continuing weakness in the manufacturing sector, thereby overlooking strong domestic demand and chances that there could be life (of economic growth) in Germany after manufacturing.

Manufacturing downswing continues

At first glance, the industrial outlook is anything but rosy. New orders have been deflating since last summer and business sentiment has nosedived. Industrial production had a disappointing start to the second quarter as global trade tensions, as well as temporary problems in the automotive

sector and chemical industry, left their marks. One-off factors should have disappeared by now and even turned into temporary positives. Yet the experience of the last few years shows that there is almost always another disruptive one-off factor waiting around the corner. At the same time, the export sector also continues to suffer from the trade conflict and Brexit uncertainty.

It's not all doom and gloom

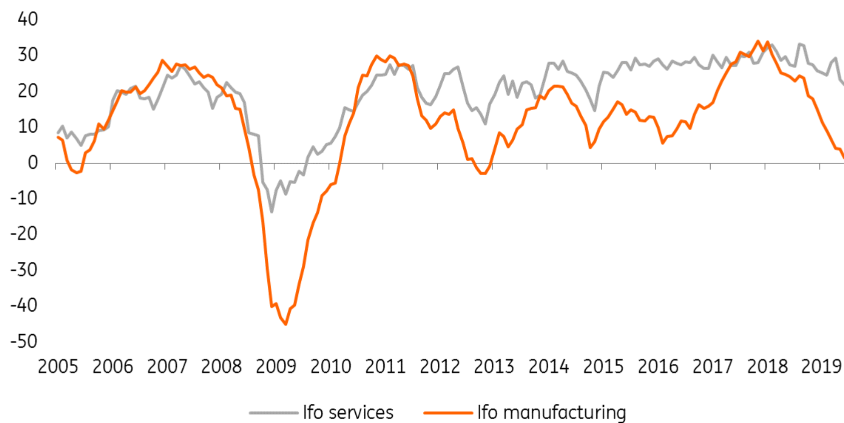
However, it's not all doom and gloom. Despite the order book deflation since last summer, businesses still report filled pipelines of assured production. In fact, German exporters almost sold as much to the UK as to China over this period. Also, the share of exports going to the US slightly increased, this could be a double-edged sword as it shows how vulnerable the German economy is to possible US tariffs. At the same time, the weakening of the effective exchange rate since September 2018 should have partly cushioned the negative impact of global trade tensions. Currently, the effective exchange rate is below its 2018-level, providing some tailwinds for exports in the months ahead.

All of this means that the industry will continue to fluctuate between, on the one hand, low interest rates, high capacity utilisation and a strong need for new investments, particularly in digitalisation, which eventually should be growth-supportive. On the other, there's disruption from trade tensions as well as structural changes in the manufacturing sector.

Beyond manufacturing

In a German context, talking about anything “beyond manufacturing” sounds crazy. Germany is an economy, in which the automotive sector - taking second and third round effects into consideration - accounts for some 7% to 8% of the total economy. Roughly one-third of all German R&D spending is related to the automotive sector. Still, it is also an economy in which more than 75% of it thrives on non-manufacturing activities. Always be cautious when economists talk about “this time could be different”, but the last five years have demonstrated that activity in both the manufacturing and services sector no longer moves in parallel.

Decoupling of manufacturing and services



Source: Refinitiv (formerly Thomson Reuters)

The reason for this decoupling could be a structural transition towards more services-driven economies. Only time will tell whether this decoupling is for real or whether the old pattern of the manufacturing sector eventually leading the service sector still holds. In any case, strong domestic demand on the back of low unemployment, high employment, higher wages and low inflation remain the best recession insurance for the German economy. In fact, the ongoing boom in the construction sector, combined with government consumption and more investments could still tilt German growth to a positive surprise this year. Only an uncontrollable negative sentiment loop would push the economy close to – if not into – recessionary territory.

Investments and politics

To move beyond manufacturing, more fiscal stimulus would definitely help. This never-ending debate on the Black Zero and why German fiscal policies cannot move towards more investments in times of record low-interest rates could finally enter a new chapter. In fact, according to our own estimates, the German government could run fiscal deficits, instead of surpluses, of around 2% of GDP every year for the next five years and the debt-to-GDP-ratio would still remain stable at 60%. Plenty of room for fiscal stimulus. However, the economic situation is not severe enough for the government to really get into action. Instead, the ongoing tension within the governing coalition makes any agreement on a significant new fiscal stimulus rather unlikely. A subtle shift towards somewhat more spending is possible, a significant game changer rather not.

A subtle shift towards somewhat more spending is possible, a significant game changer rather not

Talking of politics, the results of the European Elections confirmed our tail risk scenario of a possible fall of the government towards the end of the year. The coalition parties have not only lost further electoral support since the 2017 federal elections, but unrest in both coalition partners has also

increased. The key factor to watch here will be the SPD, which again has to find a new party leader, while at the same time developing a strategy on how to regain voters, be it within or outside government.

Also, the CDU has not solved the question of who could eventually succeed chancellor Angela Merkel, which could lead to some political tensions in the coming months. With the recent successes of the Greens, any fall of the government would, in our view, lead to snap elections, not just a simple reshuffling of coalition partners. The Greens have become too strong to simply go into a government with the CDU as a small junior partner. According to the latest polls, the CDU and Greens could almost form a government of near equals. It could be a government, providing new fiscal stimulus.

Beyond the two Ms

The German economy might have lost its stellar performance but strong domestic demand is still a very powerful shield against recessionary fears. Don't count the German economy out, yet. In the longer run, the big question is what comes beyond the two M's: Merkel and manufacturing.

This article is taken from the Eurozone Quarterly, which you can find here

The German economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP	1.5	1.1	2.1	1.6
Private consumption	1.1	1.8	1.6	1.2
Investment	2.7	3.4	3.5	3.0
Government consumption	1.1	1.2	1.6	1.6
Net trade contribution	-0.4	-0.5	0.3	0.2
Headline CPI	1.9	1.7	1.8	1.8
Unemployment rate (%))	3.5	3.4	3.4	3.4
Budget balance as % of GDP	1.6	1.3	0.9	0.9
Government debt as % of GDP	60.8	58.0	57.4	55.0

Source: Thomas Reuters. All forecasts ING estimates

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France: Act II, Scene 1

After decent EU election results, President Macron's reform announcements for the second act of his mandate helped his approval rating to recover to above 30%. Scene I of Act II, however, begins with France's economic outlook looking less supportive and a renewed focus on further change

All the world's a stage for French President, Emmanuel Macron

1.3% French GDP growth in 2019

Our expectations

EU elections could have been better for Macron

The EU election results confirmed that President Macron's party was facing a very weak opposition as the left lost votes to the greens, and the traditional right registered its worst results ever. At only 8.5%, it triggered the departure of senior members of the LR party, including its leader Laurent Wauquiez. The extreme left failed to progress. The French political divide remains, which resulted from the 2017 Presidential election, putting the centre of the political spectrum face to face with its extreme right (Mrs Le Pen's RN gathered slightly more votes than LREM, or 23.3%, but showed no

significant progression in its EU results compared to 2014).

An embarrassing personal setback for Macron

The results could have been even better for Macron's LREM, but the party's list leader, Mrs Loiseau, proved to be a very bad strategic choice. After she failed to gather momentum during the campaign, she also had to abandon her bid to be elected as the ALDE group president in the European Parliament given a perceived lack of diplomacy towards her fellow MEP's. The French ambitions about the pivotal role of the new centrist group (and the central role of French MEPs in it), make this miscasting an embarrassing personal setback for Macron himself. The choice of the former Europe minister to lead his party's electoral list was entirely the president's, who is therefore solely responsible for the obvious miscasting of Loiseau, both as a campaigner and as a leading MEP. This, and the fact that Renew Europe (ex-ALDE) remained the third non-Eurosceptic party in parliament, is likely to downsize Mr Macron's ambitions to influence decisively the European Parliament.

A new national programme is set to restart reform efforts

After some difficult months during which attention was monopolised by the "yellow vest" crisis rather than reforms, PM Philippe delivered his government's intentions for the second half of his mandate on June 12th. It confirmed the Government's ambitions to go forward on the pension reform (aimed at pushing the effective retirement age towards 64 against 60 currently, the lowest in the OECD), on bioethics and on the last part of its labour market reform. The latter, aimed at cutting the costs of the unemployment benefits system, was announced on 18th June (see below). PM Philippe also confirmed the tax cut measures taken for households earlier this year to appease the "yellow vest" fever. In total, household taxes should be lowered by €27bn during his mandate (most of which will come from lower housing taxes but €5bn are new, specifically income tax related measures starting to have effect in 2020), or 1.1% of GDP.

The stark progress of the Greens in the EU parliamentary election prompted an attempt to break "the Green monopoly" as PM Philippe put it. However, as the first part of Mr Macron's mandate ended up in the bitter resignation of the popular Environment Minister Mr Hulot, the Government's credentials on the topic are still low. Most of the announced intentions (such as a 100% recycling of plastic wastes by 2025) still have to be translated into concrete measures. This should come as early as July in a Circular Economy law and later, probably in 2020, in a greener housing support bill. In the no-confidence vote that followed Philippe's speech, he got 363 votes, which was only slightly lower than the 370 he received at the beginning of Emmanuel Macron's presidency in 2017.

Low interest rates to the rescue

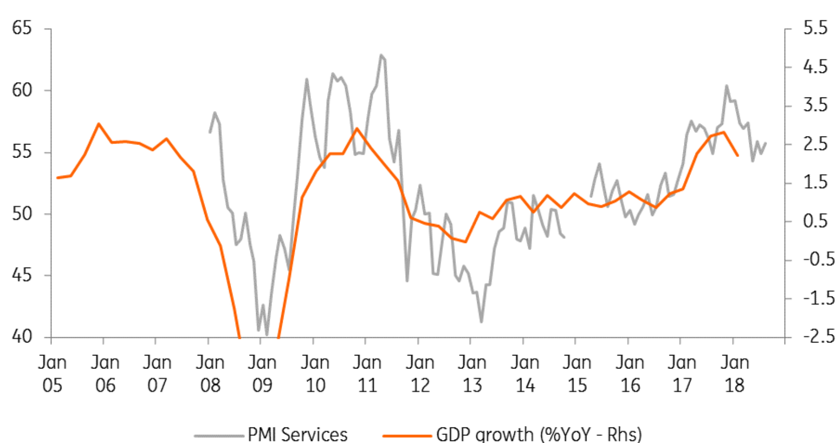
A key component of President Macron's programme was to lower both expenditures and revenues in % of GDP. The current finance law continues seeing expenditure going from 56.1% of GDP in 2017 towards 51.6% in 2022 with increasing efforts in 2020-2022. The structural effort is also three times higher on 2020-2022 than in 2017-2019 (1.4 pp compared to 0.5pp over 3 years). It could

well be that the upcoming economic downturn slows down the effort and the deficit should still remain below the 3% threshold after 2019. In particular, the planed corporate tax cuts (from 33% to 25% over five years) have been slowed down. In 2019, it went from 33.3% to 31% only for companies with a turnover below €250m. They should benefit from further cuts to 28% in 2020 and 25% in 2021 while larger companies will see their tax rate decline more slowly (if ever).

> *France will be allowed to pretend it is back among European fiscal role models*

Moreover, lower debt service costs will continue to help: they have decreased by €15bn since 2008 while the average maturity of the public debt increased from 8 to 10 years. The recent wave of central banker activism even pushed the 10-year yield of the reference government bond into negative territory for a few minutes in June. All in all, we think that 2020 will probably be too soon for Brussels to put into question the current French plans. As long as the debt-to-GDP ratio remains on a downward trend, France will be allowed to pretend it is back among European fiscal role models.

Net interest payments are now less than 1% of GDP thanks to ultra-low rates



Source: Thomson Reuters, Bloomberg

Private consumption growth is set to accelerate in 2H19

After the dip in both consumer confidence and spending during the fourth quarter in the midst of the "yellow vest" crisis, private consumption had a tepid beginning of the year. It was up by 0.4% in 1Q19 and it was growing by only 0.8% on the year, the fourth quarter below 1%.

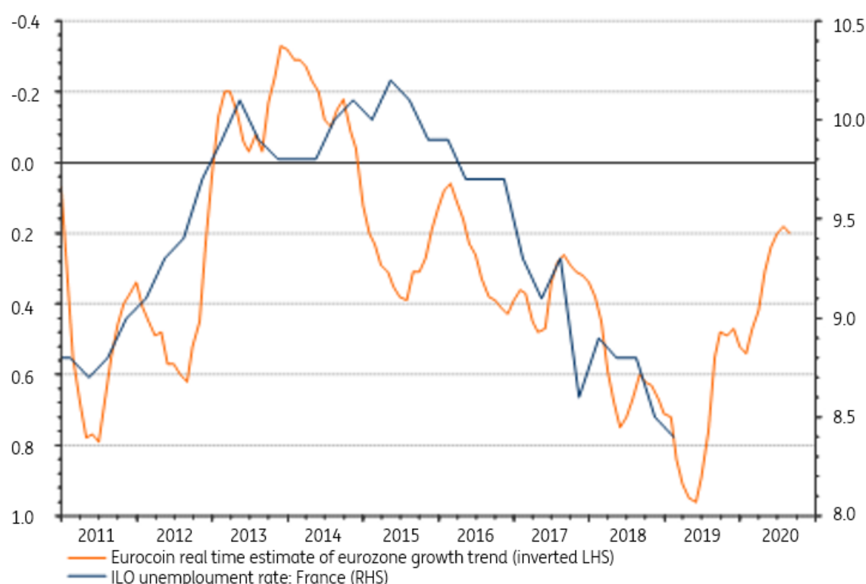
Given the strong preference for savings that consumer surveys have been showing since last October, we expect that the tax cuts announced as a conclusion of the "Big Debate" will not entirely be translated into higher spending. However, the announced €27bn tax cut package (over

5 years) should keep supporting private consumption growth in the second half of the year and in 2020. That said, because of high saving intentions and a negative base effect stemming from the second half of 2018, private consumption growth in 2019 should be barely above 1%, after only 0.9% last year. It is probably only when households feel they have rebuilt their savings that these measures will have a stronger acceleration effect on private consumption, which is why we expect it to grow by 1.4% in 2020.

The current economic downturn bodes ill for the jobs market

A stronger labour market could help in this regard. In the four first months of the year, the unemployed population declined by 47.5k, twice the drop registered during the same period last year. In 1Q19, the unemployment rate was 8.7%, 0.5pp below its 1Q18 level. Unemployment in metropolitan France was 8.4% and we think it should continue to decrease and briefly go below 8% at the end of next year. However, the current economic downturn bodes ill for the jobs market (see Figure 2) and we expect it to come up again in the second half of next year. An element that could hold it back is the unemployment benefits reform just approved by the government, which should bring back some active people into employment.

Unemployment should continue to go down in the short term



Source: Thomas Reuters Datastream, ING

Labour market reforms

Under the new law, which should save the current system €3.4bn a year, beneficiaries will have to have worked 2 months more than before (6 out of last 24 instead of 4 of last 28) to benefit while that social security will be cut after 6 months for the 10% highest-earners (above €4,500/month gross). The aim is to push parts of the unemployed population back towards the jobs market,

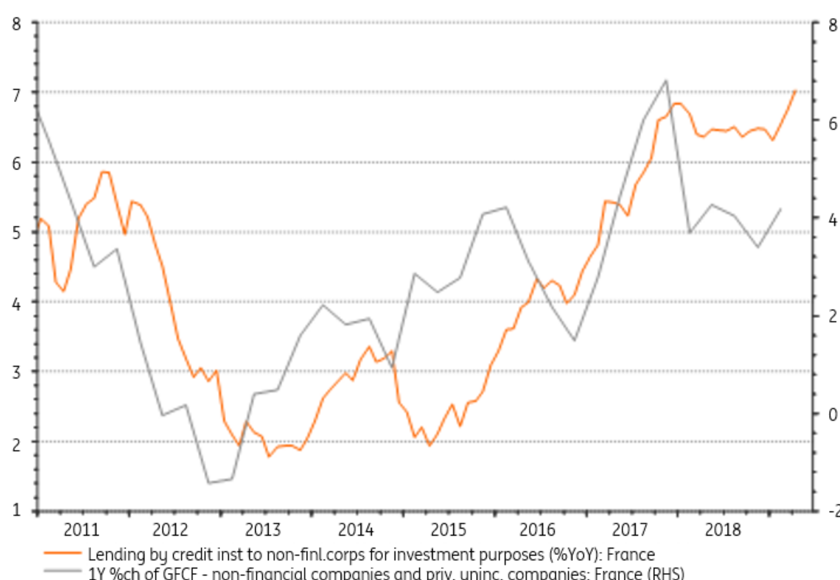
especially those who earn more from employment benefits than on their previous jobs (estimates of these cases go as far as 20% of the currently unemployed population). Finally, the government acted on its intention to increase social charges for short-term contracts to make long-term contracts more popular again. Since it made it safer and easier to dismiss workers in a previous reform, the government now clearly wants companies to shift away from short-term contracts which made up to 85% of all new contracts at the peak of the crisis.

On the investment side, households' investments in new construction stagnated in 1Q19 after the 0.3% contraction registered in the last quarter of 2018. Compared to the 6.6% growth registered in 2017, 2018's 2% growth look pale. Given the extremely low levels of mortgage interest rates across the French market, we expect household investments to rebound in 2019 and 2020. However, they remain 10% below their early 2008 levels and are unlikely to catch up fully in the next two years.

Business investments remain the stronghold of French growth

Supported by affordable financial conditions and growing credit (credit to non-financial businesses was growing by 7% on the year in April), business investments continued to grow despite the confidence dip registered during the "yellow vest" crisis. They were up in 1Q19, by 0.7% after 0.8% in 4Q18. This brings their growth to 4.2% on the year, which is very positive given the weakness of domestic demand. We do not expect a major drop in the pace of investment growth in 2019, which should still reach 3.5% after 3.9% in 2018 and a peak of 5% in 2017. Indeed, financial conditions are set to remain attractive and there are only partial signs of weakening from the industrial side. If some sectors suffered from the "yellow vest" crisis, especially the consumer goods segment, manufacturing production rebounded by 1.1% QoQ in 1Q19 and capacity utilisation was only marginally lower. Recent surveys also point to lower inventories and better order books, which should support a high rate of capacity utilisation and new investments.

A dynamic credit cycle should continue to support investments



Source: Thomas Reuters Datastream, ING

External demand to the rescue of order books

External demand has been supportive of French industrial production in the last few quarters, compensating somewhat for the lower domestic demand in companies' order books. Despite the trade wars and the slowdown in global export growth, French exports have benefited from the USD strength: exports to the US in April were 12% above their 24-month average. Exports towards the eurozone are broadly stable. However, we note a sharp slowdown of exports towards the UK in April as the inventory build-up that took place before the previous Brexit deadline (boosting French exports) faded. Net exports nevertheless shaved off 0.3pp of GDP growth in the first quarter, the first negative contribution in more than a year, as imports recovered on the back of a somewhat stronger domestic demand.

While net exports had a particularly high contribution to growth in 2018 (0.6pp was the highest since 2012), we do not think it can be repeated in 2019 as we expect a slightly negative effect of foreign trade on growth. Indeed, the slowdown in world trade and Eurozone growth will have an impact on French external demand. Also, the expected recovery in domestic demand should continue to support imports. Finally, the recent gains in export growth do not seem to stem from a particular improvement of the competitive position of France which has, at best, stabilised over the last two years; it's rather down to temporary exchange rate effects.

2019 starts in minor mode

Looking at the first quarter figures, it seems that domestic demand will still need some time to recover from the abnormal levels of anxiety recorded at the turn of the year in consumer surveys. They still show a strong preference for savings and higher fears of unemployment than last year despite the resumption of job creation. Given the expected slowdown of the economic environment in Europe in 2019 and 2020, GDP growth should remain in these two years at a level close to its potential (1.3%) before slowing down in 2021 when we expect the effects of a more global downturn to be felt throughout Europe.

This article is taken from the Eurozone Quarterly, which you can find here

The French economy in a nutshell (% YoY)

	2018	2019F	2020F	2021F
GDP (%)	1.7	1.3	1.2	1.0
Private consumption (%)	0.9	1.1	1.4	1.1
Investment (%)	2.8	2.9	2.4	1.8
Government consumption (%)	0.8	1.2	1.3	1.0
Net trade contribution (%)	0.7	-0.2	-0.5	-0.2
Headline CPI (%)	1.9	1.1	1.3	1.4
Unemployment rate	9.1	8.4	8.5	9.0
Budget balance as % of GDP	-2.5	-3.3	-2.3	-2.2
Government debt as % of GDP	98.4	99	98	97.5

Source: Thomas Reuters. All forecasts ING estimates. Unemployment rates according to ILO definition

Italy: Salvini's political dilemma

A big success in European elections created a strong incentive for Italy's Deputy Prime Minister Matteo Salvini to cash in and pull the plug from the government coalition. The window for such a decision is relatively narrow and broadly coincides with that on the excessive deficit procedure

Italy's Deputy Prime Minister Matteo Salvini

Out of a short-lived technical recession...

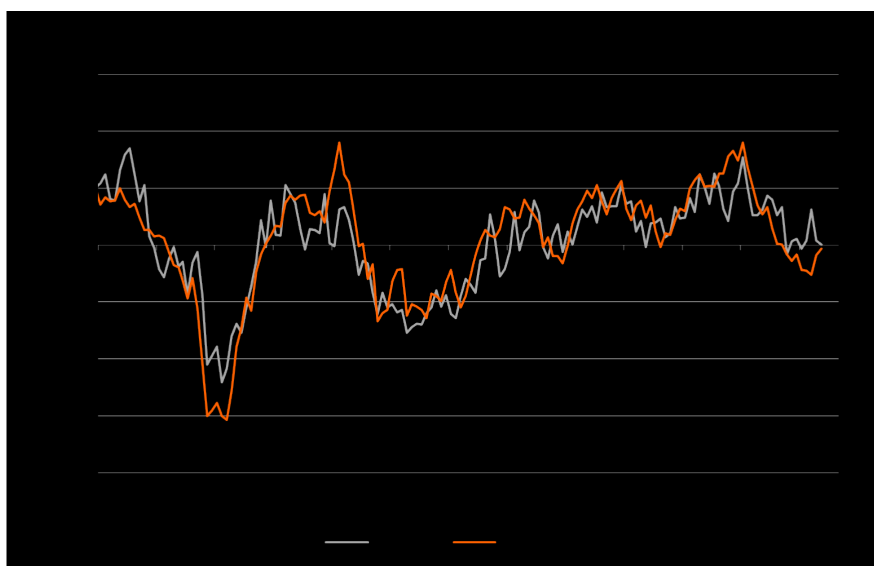
Having exited a short-lived technical recession in 2H18 with a meagre 0.1% quarter-on-quarter GDP growth rate in 1Q19, the Italian economy is still struggling to find firmer ground. The 1Q19 expansion was built on a 0.5% net export drive, supported by import hoarding in the UK ahead of the March Brexit deadline, which is unlikely to be repeated. Equally, Istat's inventory report suggests that the marked 0.7% inventory drag is not sustainable. Meanwhile, domestic demand ex inventories has chugged along with private consumption and gross fixed capital formation together adding 0.2% to quarterly growth.

...the Italian economy should trudge along in 2Q19

The data flow on 2Q19 looks consistent with a continuation of the economic soft patch.

- Confidence indicators have broadly stabilised over the Apr-May period, with a slight uptick in manufacturing not matched by the service sector. The PMIs were broadly consistent, with the manufacturing index improving to 49.7 and services receding to 50. Consumer confidence in May interrupted a streak of six consecutive declines.
- On the hard data front, the evidence has been mixed. The poor April reading of industrial production was attenuated by a decent labour market report. In April, employment confirmed 1Q19 gains, and for the first time proved to be resilient to previous soft growth conditions. Detailed 1Q19 labour market data signalled a substantial conversion of temporary contracts into open ended contracts, possibly as a consequence of the introduction of the so-called "dignity decree". This, against a decelerating inflation backdrop, should in principle help to support private consumption over 2Q19.
- Investment developments look more uncertain. Year to date, bank lending to non-financial corporations (NFCs), adjusted for sales and securitisations, has consistently contracted in YoY terms. In the April Bank lending survey, Italian banks signalled a marginal tightening of credit standards to NFCs in 1Q19 and, more worryingly, projected a softening in credit demand from businesses over 2Q19. For the time being it seems that Italian firms, rather than being credit-rationed, are instead more reluctant to borrow. We believe this has to do with lingering uncertainties on the international stage and, crucially, the lack of visibility on domestic political and fiscal developments. We are now tentatively pencilling in flat GDP growth in 2Q19 and a very modest 0.1% for the whole of 2019, as the potential small boost to 2H19 consumption from the introduction of the so-called "citizenship income" is being outweighed by a relatively low take-up of the scheme.

PMIs point to flat 2Q19 QoQ GDP growth



Source: Reuters Datastream, ING

Shift of focus in the government after the European vote

Economic developments over 2H19 will likely be affected by what happens on the domestic political front. The European election proved to be a repeat of the 4 March 2018 political election, albeit with inverted roles. The League came first with 34.3% of the vote while 5SM came third,

at 17.1%. The gap between the two was wider than any poll had predicted since last year's legislative vote. This is a big temptation for Salvini to pull the plug and cash in his political capital. So far, he has chosen not to, preferring to try to force the government's agenda to suit the League's. Having targeted the migration/security themes throughout his first year in power, Salvini has now switched to a new flagship slogan: a tax shock via the extension of a broad-based flat tax system for personal income tax. Meanwhile, 5SM's battered leader Luigi Di Maio is proposing a minimum wage for the private sector to attract the non-farm workers, which make up his base. These two themes could put government members on a collision course sooner rather than later in a three-party challenge, with the EU Commission the third key player.

Negotiations to avoid a debt-driven excessive deficit procedure continue

The possible opening of a debt-driven excessive deficit procedure (EDP) against Italy following its breach of EU budget rules has taken centre stage in the domestic political debate. The measure is deemed justified by the EU Commission and has been backed by the Economic and Financial Committee (EFC) but still needs to be agreed by the EU Commission and, eventually, rubber stamping by Ecofin. Negotiations between the two parties to avoid disciplinary steps are still open and uncertainty on the final outcome remains high.

PM Conte formally took the lead in negotiations

With Salvini and Di Maio taking a challenging stance towards Europe, Prime Minister Giuseppe Conte has taken the lead in negotiations. In a letter to the EU Commission sent just before the meeting of the EU Council, he re-affirmed the case for reform of the eurozone "from within", confirming that as long as fiscal rules are in place they must be followed by all member states. However, he devoted the bulk of the letter to a heartfelt solicitation to amend these rules and to align renewed European governance with citizens' social and economic needs. It is not clear if this process implies "more" or "less" Europe. The rest of the letter dealt with an explanation of why the 2019 deficit data will likely turn out to be lower than expected, implying that a dedicated stop-gap mini budget would not be needed. Conte believes the deficit will be lower due to a combination of higher tax revenues and lower expenditures amid a limited take-up of the citizens' income and "level100" pension reform measures.

Visibility on 2020 fiscal plans needed, to increase chances Italy will get off the hook

Even if in principle, with some leeway and more material commitments, the Commission deems the incidental 2019 deficit reduction to be enough to fulfil the structural adjustment requirement, we suspect that a clearer commitment about the 2020 budget would be needed for the EDP to be averted. Here, the starting point is not particularly encouraging.

The government's latest stated plans for 2020 hardly fit with the deficit target set in the Treasury's Economic and Financial Document (DEF). As we write, the League is betting on the flat tax plan, which could cost between €8 and €17 billion and both government parties are currently ruling out that the VAT safeguard clause- already budgeted and worth some €23.5 billion- will be activated.

This leaves some €31-40 billion of fresh resources to be found for the incremental measures to be funded by vague expenditure cut promises. The road to a headline deficit target of 1.8% of GDP, recently confirmed by finance minister Giovanni Tria, seems very steep.

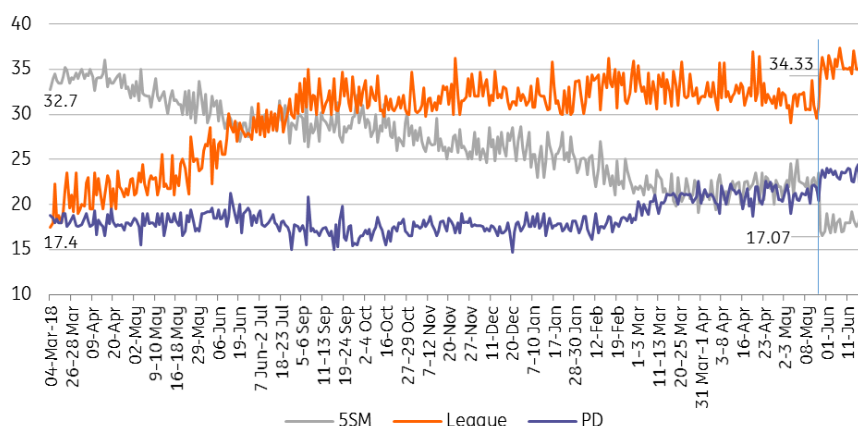
To pull or not to pull the plug?

Will Salvini agree to give in and backtrack on the tax cut call or will he blame the EU for placing Italy in a fiscal straitjacket and go for elections? Judging by his latest statements, it seems he is still sitting on the fence. Should he decide to continue in his current position, he may have little alternative but to downsize his tax call, possibly combining it with a partial kick-in of the VAT clause.

A "rush to the polls" alternative has never been as attractive, with opinion polls pointing to the distinct possibility of a right-centre alternative including the League, Fratelli d'Italia and Forza Italia garnering as much as 50% of the vote. In taking his decision, Salvini will have to take into account that the window for an early vote is fairly narrow. As President Sergio Mattarella is reportedly determined to avoid a situation where new elections put the next budget season at risk, it is now understood that the dissolution of the current parliament should not happen later than the 15 July. This would accommodate new elections sometime over the second half of September.

This article is taken from the Eurozone Quarterly, which you can find here

Latest opinion polls reinforcing Salvini's incentive to pull the plug



The Italian economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	0.9	0.1	0.5	0.6
Private consumption (%)	0.6	0.2	0.5	1.5
Investment (%)	3.2	6.0	2.7	0.7
Government consumption (%)	0.2	0.1	0.1	0.3
Net trade contribution(%)	-0.1	0.3	-0.2	-0.1
Headline CPI (%)	1.2	1.0	1.1	1.3
Unemployment rate (%)	10.6	10.5	10.6	10.4
Budget balance (% of GDP)	-2.1	-2.3	-2.5	-2.2
Government debt (% of GDP)	132.2	133.5	134.2	133.9

Source: Thomas Reuters, all forecasts ING estimates

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Spain: Staying strong

After a stronger than expected first half of the year, we expect a modest easing of growth in Spain. We raised our 2019 GDP forecasts to 2.2% from 2.0%, but we continue to forecast 1.5% for next year

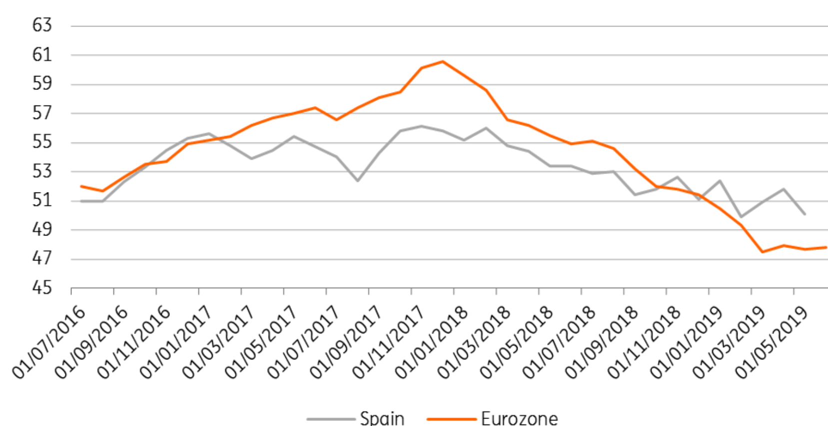
Spanish Prime Minister, Pedro Sanchez, is still trying to form a government

First-half growth surprised

The first half of the year surprised to the upside in Spain. First quarter growth increased to 0.7% quarter-on-quarter, from 0.6% in 4Q of 2018. High-frequency data of the second quarter also points to solid growth. Unemployment continues to decline, supporting consumption, and consumer sentiment stabilised after a fall at the beginning of 2018.

Businesses, however, see it a little less rosy. The manufacturing sector in particular flirts with contraction as the PMI for the manufacturing sector is close the 50. The weakness mainly lies in the investment goods sector, while growth in the consumer goods sector is still solid. A weaker overall manufacturing sector, however, is not only a Spanish problem as we see this phenomenon in many Eurozone countries.

A weaker manufacturing sector



Source: Thomson Reuters

Unemployment, debt and fractured politics

For the second half of the year, we expect an easing of economic growth compared with the first. Confidence in the future by businesses edged lower over the past few months and there are signs of faltering demand. Uncertainty also remains high, given the domestic political situation, Brexit and the trade war. Given the strong start of the year, however, we do revise our annual growth forecast for 2019 to 2.2% from 2.0%. For 2020 we continue to forecast 1.5% growth.

Compared with the eurozone as a whole, the macroeconomic situation in Spain is quite rosy as it remains one of its fastest growing economies.

The two key macroeconomic problems that continue to plague Spain are the high level unemployment and government debt. These two indicators are moving in the right direction, but they're still high compared to other eurozone countries and when you look at pre-2008 levels.

Concerning fiscal policy more broadly, the European Commission recently decided the excessive deficit has been corrected and that Spain now enters the preventive arm of the Stability and Growth Pact. It should therefore continue its efforts to reduce the debt level at a sufficient pace and to respect the expenditure benchmark. Under unchanged policies, Spain is not projected to comply with the requirements of the transitional debt rule in 2019 and 2020. It is therefore important that a new government could tackle this issue. But since the general elections in April, a new government still has to be formed.

We don't rule out another election

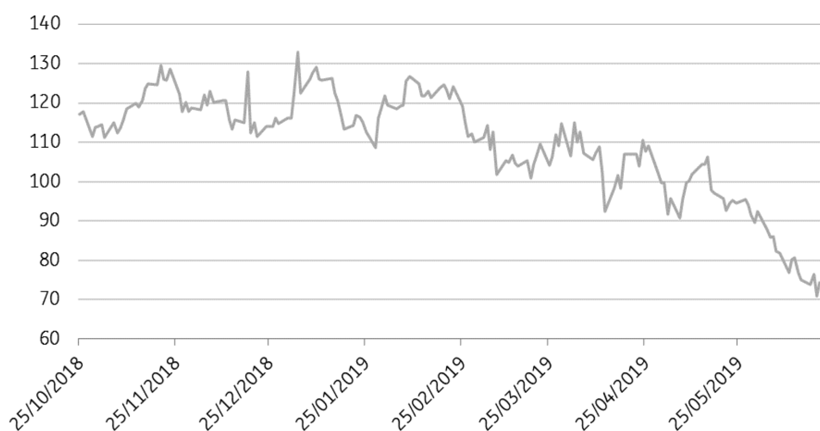
Currently, Pédro Sanchez, the Socialist Prime minister and the winner of the elections, is talking to other political parties. There are a number of options. He could lead a minority government, with or without Unidas Podemos with case-by-case support. There is also talk of a coalition with the liberal Ciudadanos. This set-up would have enough seats to form a majority, but so far we judge this as

unlikely. The Ciudadanos leader, Albert Rivera, said that Sanchez should form a government with his partners, such as Unidas Podemos and small regional parties.

Given all this highly uncertain political environment, we don't rule out new elections should Sanchez fail to form a new government. Businesses don't like this situation but financial markets are yet to appear too concerned. The 10Y government bond spread with Germany, for example, declined fairly substantially after the April elections.

This article is taken from the Eurozone Quarterly, which you can find here

10Y government bond spread with Germany declined



Source: Thomson Reuters

The Spanish economy in a nutshell (%YoY)

The Spanish economy in a nutshell

	2018	2019F	2020F	2021
GDP	2.6	2.2	1.5	1.3
Private consumption	2.4	2.2	1.6	1.5
Investment	6.0	3.4	2.3	2.0
Government consumption	2.0	1.7	1.2	0.7
Net trade contribution	-0.3	-0.2	-0.1	-0.2
Headline CPI	1.7	1.1	1.3	1.5
Unemployment rate (%)	15.3	13.6	13.0	12.5
Budget balance as a % of GDP	-2.5	-2.3	-2.2	-2.1
Government debt as a % of GDP	97.1	96.3	95.9	95.4

Source: Thomson Reuters, ING forecasts

The Netherlands: Past the growth peak

Amidst a weak trade environment, Dutch domestic demand normalises but remains solid. A cooling housing market and lower employment growth cause a slowdown to a more normal GDP-growth rate of 1.7% in 2019. Wages accelerate, but not vibrant enough for inflationary pressure in 2019. Prices rise mainly due to higher VAT and energy taxes

Dutch Prime Minister, Mark Rutte

Growth normalising from high level

After twenty quarters of positive economic growth in a row, the Dutch economy continues to expand. But growth is normalising to a more moderate speed. We forecast it to decline from 2.6% in 2018 to 1.7% in 2019 and 1.6% 2020. In 2021 it may gradually slow down in line with the potential growth rate.

See here for our assessment of the GDP-figures of 1Q 2019.

1.7%

Netherlands GDP growth

ING forecast for 2019

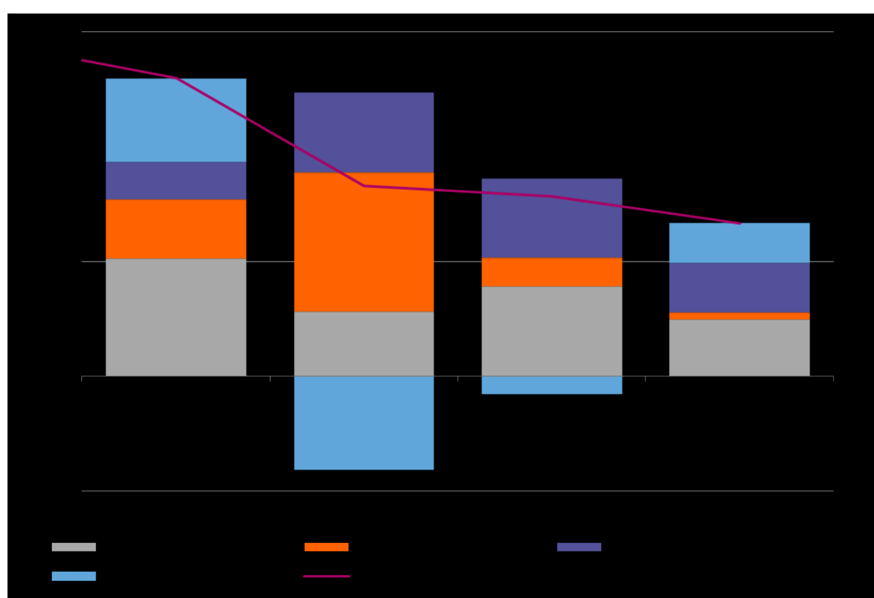
Downward revisions with meagre export outlook

2019 started in line with earlier expectations. Growth in 1Q19 was still very solid, with 0.5% QoQ. Early monthly but volatile figures for 2Q19 for Dutch exports, imports and retail are supportive of growth. Nevertheless, we revised the 2019 GDP figure downwards since January 2019 (from 2.0%), because of the international outlook and disappointing government spending. Indeed, the export-sensitive manufacturing sector started 2Q19 with an outright decline. Also, major risks for even less growth remain external, most notably Brexit and the US potentially raising taxes on European imports.

We revised 2019 GDP growth downwards

For 2019, export growth is forecast far below historical averages, in line with a slowly growing European export market, trade war escalation and growth moderation in China. While imports are likely to outpace exports and the fact that the Netherlands recently turned from a net exporter of natural gas into a net gas importer, the current account surplus is still expected to remain around 10% of GDP. All in all, we project the net contribution of foreign trade to be substantially negative (using the simple method of subtracting the contribution of imports from the export contribution).

Domestic demand main growth engine



Source: Statistics Netherlands via Macrobond, ING estimates for 2019-2021

Cooling housing and labour markets limit solid domestic demand

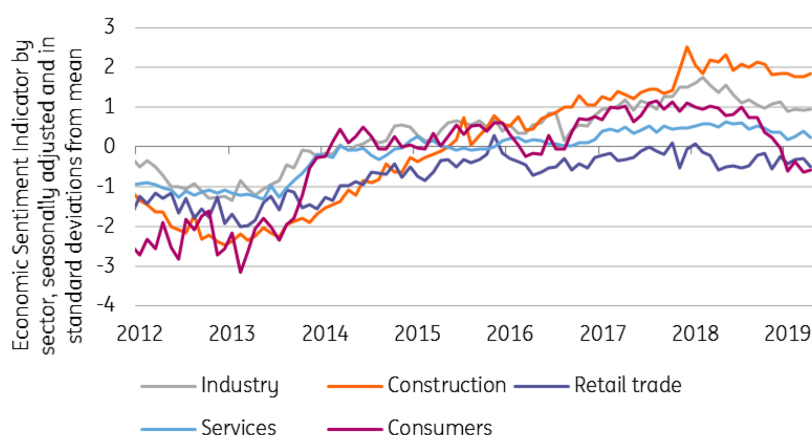
Domestic momentum currently remains solid, solid enough to prevent a recession in case of minor external shocks. Consumption of households again provides a substantial contribution to GDP growth, but slightly less so than last year as a result of lower confidence and notably slower employment growth. Most important factors normalising domestic demand growth, which were already expected, are the fall in home sales and increasing labour market tightness. Growth in investment remains significantly positive, and commercial buildings and infrastructure particularly still show strong growth.

Unemployment is forecast to come in at 3.4% in 2019 and stay around this low rate in 2020 and 2021. Some vacancies can still be filled by people currently outside the labour force, but this reservoir is drying up. A shortage of workers has become one of the main factors limiting business production. The number of unemployed people per open vacancy has never been lower. As a result, hourly collective wage (including bonuses) growth was increasing from 1.4% in 2017 to 2.1% in 2018 and will increase further this year.

Falling sentiment now stabilising

Sentiment among consumers is slightly below historical averages and stabilised, after half a year of increasing pessimism. The drop was widespread among different consumer groups, but could nevertheless hardly be explained by fundamentals, leaving the impression that general international uncertainty and the very visible increase in VAT and energy taxes might have had an impact. Industry initially turned more pessimistic about exports but sentiment is stabilising with respect to export orders. Commercial services are still steady in their moderately positive judgement of the economic situation, while construction is historically still very optimistic.

Survey indicators stabilising after declines



Source: DG ECFIN via Macrobond

Inflation, wages and construction

Inflation jumped, as the result of an increase of the reduced VAT rate (from 6% to 9%) and higher energy taxes, from a moderate 1.6% in 2018 to a significant 3.0% year-on-year in April 2019. Wage growth has been on the rise but is still rather moderate for the maturity of the business cycle. CPI-inflation is forecast at 2.5% for 2019, and we expect it to fall back to 1.7% in 2020.

Construction will grow around 5.5%, remaining the sector with the largest expansion. Health care, thanks to policy and demographics, commercial services and IT services and job agencies follow with 3% to 3.5%. Almost all sectors are experiencing a slowdown, with health care and agriculture being the exceptions.

Expansionary intentions are not yet delivered in full

Public finances are largely in check, with continuing fiscal surpluses and falling government debt. Government debt stood at 51% of GDP in 1Q19, clearly below the European norm of 60% GDP, and will continue to drop with the government budget balances hovering around 1% GDP. The government is using cyclical tax revenues for additional spending, as well as tax cuts.

In 2018 the government failed to execute its spending intentions, in part because of difficulties in finding personnel and delays with infrastructure projects. That is a risk for spending for 2019 too, both to the down and upside. Labour taxes were lowered at the start of 2019, while energy taxes and healthcare premiums rose, with a net positive effect for the bulk of households. Also, 2020 brings tax relief for households. Taxes for business are raised in 2019 and will be followed by partial relief in 2020. The increase in 2019 mainly results from higher unemployment premiums and energy taxes and the broadening of the corporate income tax base.

This article is taken from the Eurozone Quarterly, which you can find here

The Dutch economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	2.6	1.7	1.6	1.3
Private consumption (%)	2.3	1.3	1.8	1.1
Investment (%)	3.2	6.0	2.7	0.7
Government consumption (%)	1.6	2.0	2.7	1.7
Net trade contribution (%-point)	0.7	-0.7	-0.2	0.3
Headline CPI (%)	1.7	2.5	1.7	1.8
Unemployment rate (%)	3.8	3.4	3.4	3.4
Budget balance (% of GDP)	1.5	1.7	1.1	1.0
Government debt (% of GDP)	52.4	50.5	48.8	47.7

Source: Macrobond, all forecasts ING estimates

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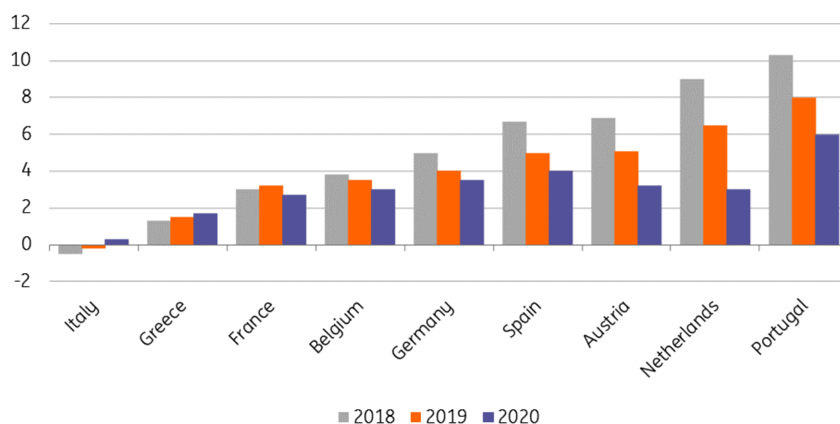
Article | 26 June 2019

Residential real estate market cools in the eurozone

House price growth was quite strong in many eurozone countries in 2018. For this year and next, we forecast that growth rates will ease in most countries

ING house price growth forecasts



Source: ING Economic Research

Germany

German property prices and rents have been on the rise for a number of years now. House prices, as measured by the House Price Index (HPI) from Destatis, rose by 5% in 2018 compared to the year before. Since 2013, house prices have increased by almost 30%. Individual cities have seen much bigger price jumps. The sharpest price increases were recorded in Stuttgart, Munich, Berlin and Frankfurt.

Despite the price increases, loan-to-value ratio levels remain relatively well-behaved, suggesting that there still is room for prices to rise and the risks of a textbook bubble are limited. At the same time, recent political developments in the Berlin real estate market show that rents have become unaffordable for parts of the population. Caps on rent or new construction of social housing could dampen price increases.

France

In France, real estate prices continued to grow in 2018 at the same pace as in 2017 (3%). Existing house prices were still growing at 2.9% in the first quarter of the year. Outside Paris, prices have been growing at a steady 2.5% in the last two years while Paris has shown a deceleration since 4Q17, with prices slowing down from 4.7% to 3.9% YoY since then. On average, nominal prices are only 17.8% higher than 10 years ago, which shows a rather tepid catch up, especially outside the largest urban zones. Low interest rates are supporting prices, but not as much as one might have expected from a 150bp mortgage interest rate drop since 2015. In the new building market, household investments are still 10% below their 2008 levels and existing housing still lacks dynamism in the country as a whole. After rising by an estimated 3% in 2019, we think price growth could decelerate in 2020 and 2021 along with the economic downturn while remaining well above the rate of inflation.

Italy

A deceleration in the pace of economic growth is taking a toll on house prices. But very favourable market conditions- as confirmed by low price-to-rent and price-to-income ratios- continue to make the purchase option attractive, fuelling transactions. In 1Q19, house transactions grew at a 9.6% YoY pace (up from 8.1% in 4Q18). Given the high percentage of purchases funded via mortgages, credit availability remains a key determinant of market developments. Recent evidence from the BoI Bank Lending Survey points to the first tentative sign of tighter conditions: this bears attention, given the uncertain macroeconomic backdrop. The May 2019 BoI-Tecnoborsa survey signals an increasing share of real estate agents expecting prices to stabilise, while that of those expecting prices to rise remains stable. Declining selling times and average final discounts offered by sellers on the original price, in principle, suggest that excess supply might now start to clear but not enough to push average 2019 house price inflation back into positive territory.

Spain

The housing market was strong again in 2018, with price growth of 6.7% compared to 6.2% in 2017. Slower economic growth did not seem to have a negative impact on house price growth. According to the Spanish National Bank, the weighted average of mortgage rates continues to

hover around 2.6%. The average term of new mortgages, however, increased again in 2018 (to 283 months, from 277 in 2017 and 280 in 2018), according to the European Mortgage Association. This helped to support the purchasing power of consumers. For 2019 and 2020, we think growth in house prices will ease and forecast 5% growth in 2019 and 4% in 2020.

Netherlands

We expect home sales to continue to decline, with a total of 210,000 sales in 2019 and 195,000 in 2020 (2018: 218,000). During the first quarter of 2019, home sales declined by 9.0% compared to the year before. The sales drop is partly due to continuing price increases, which are eroding affordability. At the same time, the catch-up effect of households that postponed moving plans during the crisis and have pushed up housing transactions since 2013 is now marginal. In addition, confidence in the housing market (the home owners confidence index as measured by the Homeowners' Association VEH, and the Delft University of Technology) is decreasing and turned negative for the first time in four-and-a-half years this year. In this light, it is not surprising that house price increases are flattening compared to 2018 (when prices increased by 9.0% on average). For 2019 and 2020, we expect average price increases of 6.5% and 3.0%, respectively. Upward price pressure is expected to persist due to the tightness of the housing market. The construction of new-build homes in the next couple of years will not be sufficient to change this tightness in the housing market, in our view. Low mortgage rates and increasing household income leave room for further price increases.

Belgium

House prices grew by 3.6% in 2018. Relatively good activity figures and low interest rates will continue to support the real estate market in the coming quarters. Recent high frequency data for the first quarter of 2019 supports this thesis. Belgium's central bank, however, estimates that residential house prices are about 6% overvalued and is also concerned about rising private debt levels. New macroprudential measures are therefore a possibility. We forecast growth of 3.5% and 3.0% in 2019 and 2020, respectively.

Austria

Domestic demand and demand for gross fixed capital investment remain Austria's economic growth drivers, with construction investment providing a particularly positive impetus. However, vigorous building activity and excessive demand has caused prices to rise, with residential property price increases being more pronounced in 2018 than in 2017 (+6.9% compared to 3.8%). Construction has become significantly more expensive, not only in 2018, but also in the first quarter of 2019, indicating that residential property prices remain at elevated levels for the time being. Yet, with building permits declining by 14% in 2018, there should be a gradual phase-out of construction activity and prices in the medium term.

Portugal

Portuguese residential real estate grew by 10.3% in 2018, which is even higher than the 9.2% growth in 2017. Strong macroeconomic conditions coupled with foreign demand underpin these strong growth figures. We expect strong price growth to continue, but at a slightly lower pace. We

are looking for house prices to grow by 8% in 2019 and 6% in 2020.

Greece

The economic recovery, which has accompanied Greece's exit from its third ESM programme, is still in place, although the rate of growth is decelerating. Over 1Q19, employment expanded by 2.2% YoY, further fuelling consumer confidence gains. Non-performing loan disposal initiatives from the main systemic banks should, in principle, help to improve lending conditions, but so far this has failed to show up in lending data: lending for house purchases was still contracting at a 3.9% YoY clip in April 2019. The reduction in the ANFIA taxation on real estate assets included in the 2019 budget remains a market positive, though. Even though external factors pose a downside risk to GDP growth, we still expect last year's recovery in Greek house prices to continue at a slightly quicker pace in 2019.

This article is taken from the Eurozone Quarterly, which you can find here

Austria: Business as usual

Despite political chaos and external uncertainties, the Austrian economy remains on a solid growth path thanks to private consumption and gross fixed capital formation

Source: Shutterstock

Austrian Federal Chancellor Brigitte Bierlein

Austrian growth revised downwards

First quarter growth in Austria came in at a solid 0.4% quarter on quarter, with domestic demand and investment in equipment and construction expanding nicely. However, exports and imports reflect a slowing dynamic, with the cooling world economy and Europe's industrial slowdown starting to leave its mark on the country.

While we have revised down our growth forecasts, from 2.2% to 1.9% for this year, with risks skewed to the downside, overall the Austrian economy remains on a solid growth path with a robust labour market and persistently strong consumption.

Once again, politics take the spotlight

While the economy is running smoothly, the political scandal around the released tape of the ex-vice-chancellor Heinz-Christian Strache, showing him talking about public contracts for campaign-support, has led to the resignation of Strache, snap elections in September, the dismissal of FPÖ's interior minister Herbert Kickl, the subsequent resignation of all FPÖ government members, and a successful motion of no confidence against Chancellor Sebastian Kurz and the ÖVP's government members. An interim cabinet is now in charge until new elections in September, featuring Austria's first female chancellor, Brigitte Bierlein.

The current political uncertainty should not have any impact on the economy for the time being

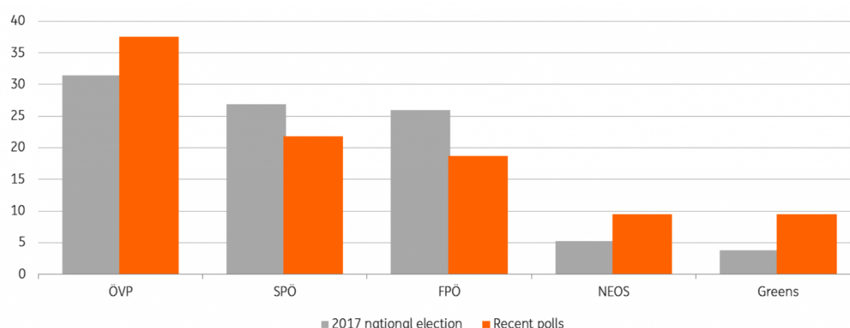
So far, the political mess seems to have benefited former Chancellor Kurz' ÖVP, while it has left its mark on former junior coalition partner FPÖ, according to recent polls. The Green party, currently not in parliament as it failed to cross the 4% threshold in 2017, could make a comeback.

Despite all this, the current political uncertainty should not have any impact on the economy for the time being given sound public finances and solid economic fundamentals. With three months to go until elections, and a technocrat government not taking any new initiatives, it is more or less business as usual for Austria's economy.

However, it remains to be seen if the planned measures around tax reform made by the former government will still be maintained. The proposed tax relief measures, which would have amounted to €6.5 billion until 2022 or 1.7% of GDP, would have been a welcome dose of fiscal stimulus.

This article is taken from the Eurozone Quarterly, which you can find here

The ÖVP leads in the election polls (%)



Source: Neuwal, simple average of last six polls between 01/06/19 and 19/06/19.

The Austrian economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	2.7	1.9	1.6	1.6
Private consumption (%)	1.7	1.6	1.3	1.1
Investment (%)	3.4	2.9	2.1	2.0
Government consumption (%)	0.4	0.9	1.1	1.1
Net trade contribution(%)	0.8	0.3	0.2	0.1
Headline CPI (%)	2.1	1.8	2.0	2.0

Source: Thomas Reuters, all forecasts ING estimates

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Greece: An election test amid competing tax cut promises

Domestic demand is now the main growth driver in Greece as the external environment deteriorates. With legislative elections due in July, tax cuts are dominating the campaign

Alexis Tsipras, the Greek Prime Minister

Domestic demand drive in 1Q19, with net exports dragging

After out-performing most Eurozone countries over 2018 on an exports drive, the Greek economy lost some steam as the year turned. In 1Q19 Greek GDP expanded 0.2% QoQ (1.3% YoY), with the domestic demand drive more than compensating for the net exports drag. On the domestic demand front, private consumption continued to benefit from underlying improvements in employment, which continued expanding at a healthy 2.2% YoY clip over the quarter. This, in conjunction with the rise in the economy-wide minimum wage, likely contributed to the improvement in consumer confidence. A VAT reduction legislated in May also helped, as did the reinstatement of the '13th month' pension which should also help drive private consumption throughout the second half of the year.

The gross fixed capital formation rebound was mainly driven by the non-residential and residential construction components, with a non-negligible contribution coming from the transport

component. Developments in the external channel reflected both the negative impact on Greek exports of a softer international demand backdrop and, very likely, the high import content of gross fixed capital formation expenditure.

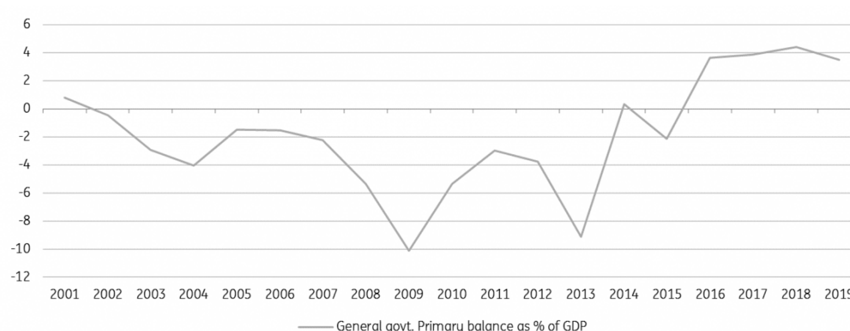
Consumer confidence is now close to its pre-crisis level

Looking ahead, business and consumer confidence indicators continue to point to a degree of optimism for short term Greek economic developments. Consumer confidence is now close to its pre-crisis level, and manufacturing has managed to reverse a declining trend which began in August 2018. Confidence in the service sector also improved of late, possibly reflecting a good demand flow for tourism-related businesses. A continuation of the investment recovery will be essential to meet growth targets. This remains vulnerable to developments on the credit front; Greek banks continue to offload non-performing exposures at an impressive rate, but the NPL ratio remains very high.

Expansionary budget and handouts not enough to boost Syriza in European vote

Final government data for 2018 proved to be even better than expected. The primary surplus came in at 4.3% of GDP, improving for the third year in a row the 3.5% maximum target set in the Enhanced Surveillance Framework. The fiscal over-performance resulted from a combination of effective primary expenditure control and of a surplus in the social security system. It over accommodated for the mildly expansionary 2019 budget and likely prompted the Greek government to risk launching a new set of expansionary measures in May, consisting mainly of VAT rate cuts for some processed food and non-alcoholic beverages, restaurant services and for electricity and gas, and also in the permanent reinstatement of the 13th month pension. The package, clearly timed with an eye on the 25 May European election, proved not enough to hand PM Tsipras assured electoral success.

Electoral cycle threatens 3.5% primary balance target



Source: Reuters Datastream

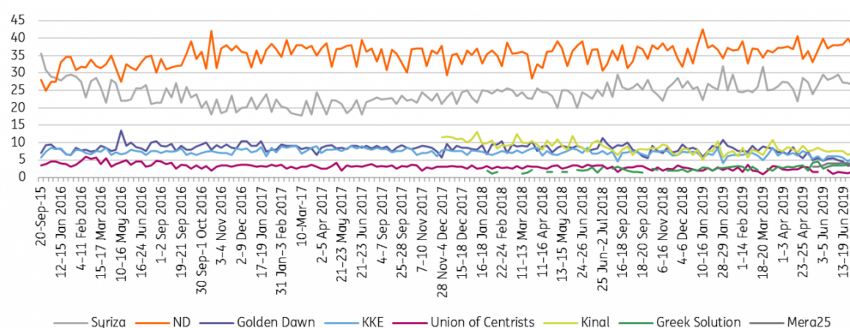
A parliamentary election to follow on 7 July

The verdict of the polls, which followed an inward-looking campaign, was unambiguous: Mitsotakis' New Democracy (ND) party beat Tsipras' Syriza by a 9pp+ margin and also won in 12 out of 13 regions where a local election was jointly held. Having missed his electoral targets, PM Tsipras had little alternative to call snap elections, which will take place on 7 July. In order to avoid the end of June tax payments date to be too close to polling day, the government decided to grant a one-month delay for the filing of tax declarations.

Tax cuts dominate the campaign battlefield

Since the start of the political election campaign, it has become apparent that the big theme would be the economy and, more specifically, reducing the tax burden. PM Tsipras took the initiative first, announcing that he would introduce an amendment before the vote cancelling a lower threshold for income tax, which was due to come into force in January 2020. It was worth an estimated 1% of GDP. The same thing had been proposed by New Democracy before the European elections and, with both parties promising additional tax relief, it's quite clear that the 3.5% primary surplus target will soon be under threat.

Opinion polls confirm European elections ND lead margin over Syriza



Source: Wikipedia, ING

Opinion polls point to ND victory

The latest opinion polls indicate that ND might get around 37.5% of votes, with a 9pp lead over Syriza. Such a result might in principle put ND very close to obtaining an absolute majority in the new Greek Parliament, but we believe Mr Mitsotakis would search for wider parliamentary support to launch his ambitious supply-side tinged reform plans. We do not expect a new Mitsotakis government would aim at a revision of fiscal targets for the 2020 budget but would eye 2021 instead… food for thought for the new EU Commission.

The outgoing Commission, meanwhile, has preferred not to impose itself in the Greek election campaign. In its third enhanced surveillance report on Greece (closed before the last batch of measures were announced), it simply pointed out the risk that, after the recent measures, the

3.5% primary surplus target would not be met, while also noting a slowdown in reforms. This will likely be on the agenda at the 13 September Eurogroup meeting.

This article is taken from the Eurozone Quarterly, which you can find here

The Greek economy in a nutshell (%YoY)

	2022	2023F	2024F	2025F
GDP	6.0	1.7	1.6	1.7
Private consumption	7.9	3.3	1.4	1.4
Investment	11.6	7.1	4.8	4.1
Government consumption	-1.5	1.7	0.4	0.4
Net trade contribution	-2.8	2.3	-0.5	-0.2
Headline CPI	9.3	3.7	2.0	2.0
Unemployment rate (%)	12.4	10.8	11	10.9
Budget balance as % of GDP	-2.3	-1.8	-1.0	-0.8
Government debt as % of GDP	171.3	165.4	160.6	156.5

Source: Datastream, all forecasts ING estimates

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Belgium: Political situation remains murky

As the overall economic context darkens, the Belgian economy continues to grow at a moderate pace. After elections in May, the process of forming a new government will take a while and that will prevent any policy action this year

The interim Belgian Prime Minister, Charles Michel, voting in May's elections. A government still hasn't been formed.

Slower growth

Considering the 1.2% year-on-year growth in the first quarter of this year and the creation of nearly 19,000 new jobs, we really can't say the Belgian economy is not doing well. However, we are convinced that the growth momentum remains unsatisfactory.

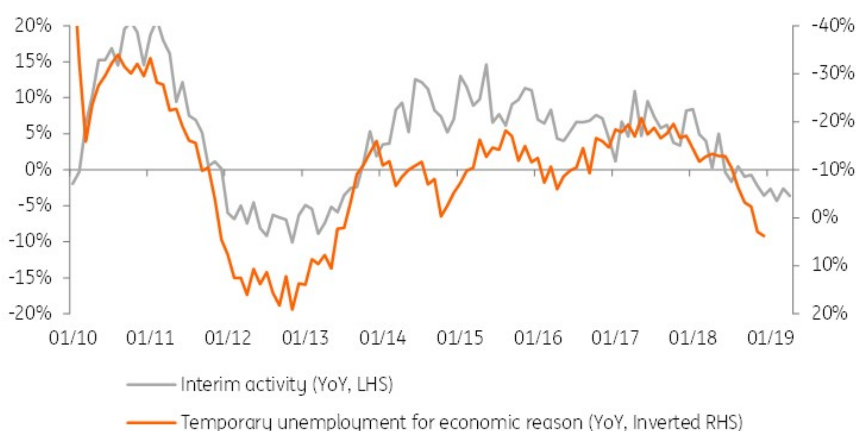
Real growth in household consumption remains particularly weak. Over a year, it only grew by 0.4%. Strong job creation helped to support household disposable income (it increased by 3.8% in 2018). However, relatively high inflation (2.1% in 2018) erased a large part of this growth. In addition, the decline of household confidence was reflected in a slight increase in the savings rate, to the detriment of consumption growth.

Corporate confidence is declining

Despite an investment dynamic that remains positive (corporate investment grew by 2.9% last year in real terms), companies active in foreign markets seem to be feeling the effects of slowing growth in the eurozone economy and of global trade tensions. As a result, corporate confidence is declining, especially in the manufacturing sector, which has the most exposure to global trade.

Lower confidence among managers in a context of economic slowdown and trade and geopolitical tensions are expected to maintain this subdued growth momentum. To be sure, economic indicators remain compatible with positive economic growth, but that should be limited to 0.2% to 0.3% per quarter. In this context, it is unlikely that job creation will remain as dynamic as it has been in the past three years. Indeed, one can observe a decrease of nearly 4% of activity in the temporary work sector over the last year. Similarly, temporary unemployment for economic reasons has increased by 4% over the same period. As these are two leading indicators of the labour market, job creation will at best offset the increase in the labour force, which should stabilise the unemployment rate at the current level (around 6%).

Leading indicators of the Belgian labour market aren't looking that great

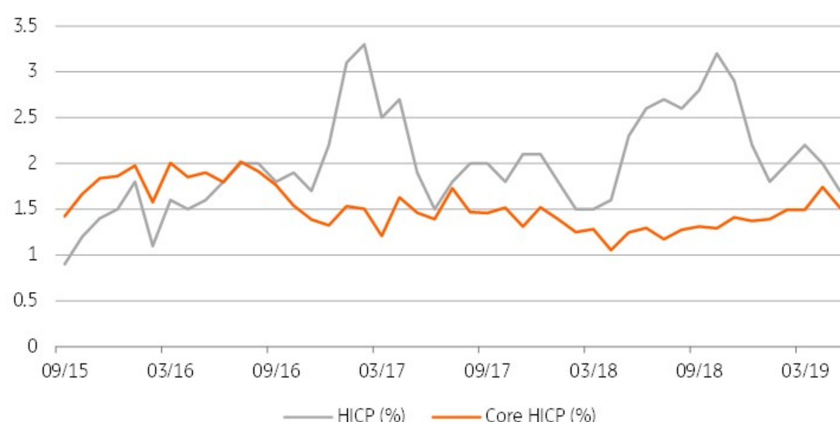


Source: NBB, ING

The inflation conundrum

In terms of inflation, two elements must be noted: first, general inflation remains above the average of the euro area, and it's been like this since 2015. No single element can explain this phenomenon. It is more a combination of elements, including a lack of competition in some sectors, but also probably the automatic wage indexation that pushes business costs up. Secondly, it should be pointed out that underlying inflation is creeping up slowly and reached 1.5% in May 2019. At the beginning of 2018, it was limited to 1.1%

Core inflation is seemingly gaining traction



Long negotiations in sight

A month after the federal and regional elections, the country's political situation remains murky. At the federal level, consultations between political parties are ongoing with complete discretion, and no majority or even the beginning of negotiations between different parties seem to be taking shape. Political parties seem to be waiting for the situation to clear up at the regional level before moving forward at the national level. The opposite scenario would have been worse: the negotiations were likely to go in opposite directions at national and regional levels, which could have created a complete blockage.

At that regional level, the process of forming majorities is likely to take time, except in the Brussels region, where negotiations between the PS (Socialists), Ecolo (Greens) and Défi (centre of the political spectrum, with a focus on defending the interests of French-speaking people) have begun.

> *We're not really expecting a working government in Belgium before the second half of this year*

In the other two regions (Flanders and Wallonia) majorities could easily be formed. But it would not really take into account some signals sent by voters during elections. Therefore, the dominant parties are exploring other ways:

In Flanders, while the majority previously in place could be renewed, the sharp increase of the Vlaams Belang (extreme right-wing party and Flemish nationalist) electoral score disturbs the process of seeking a majority. Therefore, the discussions between the parties are prolonged. Although the likelihood of Vlaams Belang's accession to the next government remains very low, the party is currently associated to the talks.

In Wallonia, two parties have up to now been excluded from the discussions: the Cdh (at the centre of the political spectrum, which decided to withdraw from the discussions) and the PTB (far left

party). The only possible majority is, therefore, an alliance between the PS and the MR (liberals), to which could be added Ecolo. Nevertheless, Ecolo wishes to avoid any alliance with the MR. Discussions are therefore continuing only between the PS and Ecolo, with a view to forming a regional minority government. However, this scenario has little chance of success.

We need to be patient, again

Given the constraints and requirements of the various parties, in our view, the scenario which looks the most probable remains an alliance between the N-VA (nationalist), the VLD (liberals) and the CD & V (center) in Flanders (renewal of the previous majority) and an alliance between the PS, the MR and Ecolo in Wallonia. These majorities would pave the way for a federal majority composed of all these parties with the exception of Ecolo. But again, given the signals by voters, the formation of such majorities will take time.

So, we're not really expecting a working government in Belgium before the second half of this year. As the 2020 budget has to be negotiated in October, this means no change will be made to the budget of 2019. So we should expect nothing in terms of economic policy and budget effort this year. Nevertheless, the public deficit is expected to be limited to 1.4% of GDP, which would be more than enough to reduce the debt ratio below 100% of GDP this year.

For next year, budgeting will depend heavily on the composition of the government, but it's worth noting that no political party included in the current discussions wants to deviate from European budgetary rules, which should maintain a strict framework for further budget negotiations, especially given the fact that without any corrective measure the deficit is expected to rise again in 2020.

This article is taken from the Eurozone Quarterly, which you can find here

The Belgium economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	1.4	1.0	1.0	0.9
Private consumption (%)	1.0	0.6	1.1	1.1
Investment (%)	2.9	3.2	1.3	0.8
Government consumption (%)	0.9	0.7	1.2	1.5
Net trade contribution (%)	0.3	0.3	0.4	0.0
Headline CPI (%)	2.1	1.8	1.7	1.6
Budget balance (% of GDP)	-0.7	-1.4	-1.4	-1.5

Source: NBB, ING estimates

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Portugal: Growth remains decent, but political risks remain

Economic activity in Portugal is expected to slow in the coming months, but the pace is still decent. However, political unrest could affect growth negatively. For 2019, we believe the economy will grow by 1.6% and 1.4% in 2020

Portugal's Prime Minister Antonio Costa

Portugal's quarterly growth rate in the first quarter of 2019 came in at 0.5%, compared to 0.4% in 4Q18 and 0.3% in 3Q18. This is a slight acceleration, but we see it as a temporary phenomenon. In the first quarter of 2019, investment grew by 10.4% quarter-on-quarter, mainly due to construction and investment in machinery and equipment which is unsustainable in the long-run.

Moreover, we think consumption growth will also be softer, as we've already seen in the first quarter of 2019. Indeed a weaker labour market limits consumption growth. Unemployment has stopped its downward trend since September 2018 and even edged 0.1 percentage point higher in April to 6.7%, while employment growth keeps edging lower.

The unemployment rate has stopped falling

Source: Thomson Reuters

There is also some political unrest that could hurt sentiment. Recently, fuel-tanker drivers went on a strike for better pay and working conditions and unrest is also growing with public sector workers in the health and education sector as they also want higher wages. Further strikes over the summer could harm the tourism sector.

Further political unrest could hurt sentiment

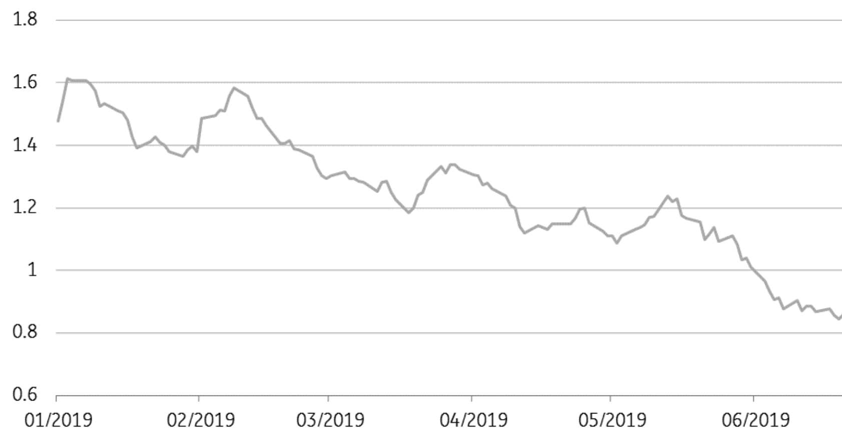
All these problems undermine the reputation of the Socialist minority government, led by Antonio Costa and backed by the Left Block, the Portuguese Communists party and the Greens. Opinion polls for the October 2019 general elections show that the Socialists would still be the largest party, but could fall short of a majority.

On fiscal policy, the government plans a deficit of 0.2% of GDP in 2019 and a surplus of 0.3% in 2020. Government debt will also continue its downward trend. In March, the rating agency S&P upgraded the ratings from BBB- with a positive outlook to BBB with a stable outlook while Fitch, another rating agency kept its rating fixed at BBB, but upgraded its outlook from stable to positive.

Markets have been interpreting all of this quite positively as the perceived riskiness of Portuguese government bonds reaches new lows.

This article is taken from the Eurozone Quarterly, which you can find here

Spread with the 10-year German government bond edges lower



Source: Thomson Reuters

Ireland: Defying Brexit uncertainty

Brexit, what Brexit? The impact all the uncertainty surrounding the UK's departure from the European Union on Ireland's economy has been very limited so far

Irish Taoiseach Leo Varadkar shares a joke with the outgoing British Prime Minister, Theresa May in June

Ireland's domestic economy's in great shape

The UK's departure from the European Union is a huge worry for Ireland as the latest deadline of 31 October approaches. So far, however, the country's economy is holding up pretty well. While GDP data for Q1 has not been released yet, employment growth has been much better than many had expected given the concerns around a possible no-deal Brexit scenario. Delayed investment may have occurred to some degree, but the domestic economy continues to perform very well, dampening the impact from all the uncertainty for now.

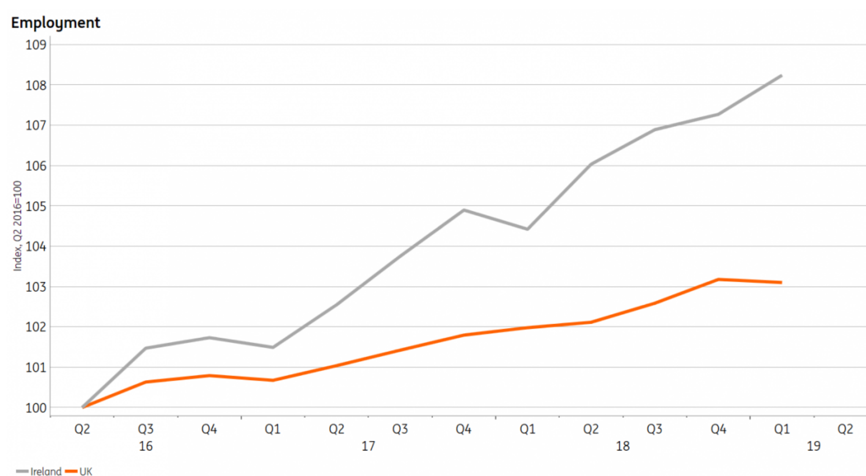
Ireland's domestic economy remains in great shape

Still, Brexit is not going away for the moment and even though the domestic economy seems to be in good health, the external environment is filled with downside risks. The chance of a no deal Brexit has not diminished and uncertainty about the negotiation outcome remains high given the

current governing Conservative Party leadership race in the UK. For now, it looks like the extension to Article 50 has only provided prolonged uncertainty, but not much clarity. On top of that, as a small open economy, Ireland will be impacted by the global trade conflict given its interconnectedness with the global supply chain.

The domestic economy remains in great shape though, which shows that the strong growth rates that Ireland boasts are not just about multinational accounting. Employment continues to grow quickly, which supports consumption growth in an uncertain global economy. Local investment in construction is also picking up as Ireland tries to battle its housing shortage problems. These factors cause the domestic economy to perform well and counteract issues from Brexit and other trade-related issues.

Employment in Ireland continues to grow rapidly despite Brexit concerns



Migration is key for Ireland's longer-term growth

If we are to put all of the external risks aside for a bit and look at the structural shape of the Irish economy, the question is for how long Ireland can maintain its robust growth pace. According to estimates by the OECD, Ireland currently has the largest positive output gap of all Eurozone economies. This means that it is growing well above potential at the moment and that more capital and labour are needed not to run into supply-side reasons for declining growth. Unemployment was as low as 4.4% in May and this unemployment rate resembles that of the Celtic Tiger years prior to the 2008 financial crisis. This was a period that required significant inward migration to sustain the rapid growth in demand for labour. With net migration only recently picking up to levels seen during those years, the question is whether Ireland will be able to use migration as a growth buffer the same way it did in the 2000s.

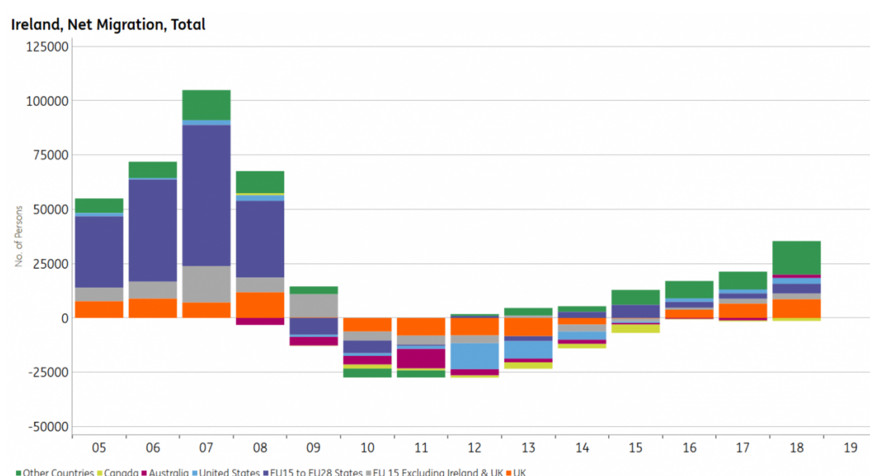
Ireland is growing well above potential at the moment

While natural population growth continues to deliver a positive contribution to the labour force – this is not the case in all Eurozone economies – it is likely that continued strong GDP growth would require strong inward flows for the years ahead. The difference between the late 2000s and the current situation is that the pickup in recent immigration has not been dominated by an inflow of people from Central and Eastern European countries. Relatively cheap labour boosted economic growth back then, which does not seem to be the case at the moment. Is this model for Irish growth therefore not to be repeated?

While labour shortages and wage growth in many CEE economies have been rising significantly, recent years have still seen significant outward migration to other EU countries. It seems that the demand for new workers in Ireland from the rest of the EU has just remained subdued for the moment as the labour shortages have yet to resemble those of the mid-2000s. If the Irish economy maintains a strong growth pace and maintains the pace on the construction of new housing, it could well be that some inward migration from CEE countries increases again to sustain labour demand.

This article is taken from the Eurozone Quarterly which you can find here

Migration inflows now are different from the Celtic Tiger era



The Irish economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	6.7	3.3	2.8	2.7
Private consumption (%)	3.0	2.1	2.0	2.0
Investment (%)	9.7	3.9	3.5	3.4
Government consumption (%)	5.8	5.5	1.5	1.5
Net trade contribution(%)	4.3	0.4	0.2	0.4
Headline CPI (%)	0.7	1.2	1.2	1.4

Source: Macrobond, all forecasts ING estimates

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Article | 26 June 2019 Finland

Finland: What can we learn from the new coalition?

Finland's new government reflects quite a few bigger European trends. It has an ambitious agenda that keeps the country ahead of the curve on green issues, but can this be done without increasing debt ratios?

The Finnish Prime Minister Antti Rinne

First of all, political fragmentation. The elections earlier this year resulted in a narrow victory for the Social Democrats (SDP) over the Finns Party. No party won more than 20% of the vote though, which has resulted in a government with no fewer than five parties participating. The Central Party - which led the previous government that fell in March - and the Swedish People Party represent the centre, and the Greens and the Left Alliance adding more left-wing flavours to the SDP led government. This results in doubts about how effective the new government can actually be, but there does not seem to be a lack of ambition at the start.

> *There are doubts about how effective the new government can be*

Antti Rinne is the first Social Democrat to take the prime minister's office in 16 years and has vowed to end austerity policies that characterised the previous government. Indeed, the coalition agreement states there will be increases in government spending of 1.2 billion euros per year, which would mainly go to education, pensions and social services. There will also be one-off investments that amount to 3 billion euros – of which a large amount will go to rail infrastructure - over the four-year term of government.

This will be partly funded by increased taxes – fossil fuels are likely to bear a large burden - and there are plans for selling government assets. With growth around 2% per year, this should not cause debt to go up in the coming years as the government has mentioned. The question is whether this is realistic given global economic weakness and poor Finnish trend growth. It could well be that 2% growth is too much to ask, causing the government debt-to-GDP ratio to go up.

With the Greens in government, there is an important shift in focus for Finland. That focus on a return to economic competitiveness of the previous government has been replaced by a government targeting sustainability much more head on. The ambition is to become carbon neutral by 2035, which will require large investments in renewable energy, cutting back logging investments and will, in part, come from the higher fossil fuel taxes.

The ambition is to become carbon neutral by 2035

The success of this ambitious government agenda depends to a certain degree on the economy as it has made clear that the expansionary agenda will not cause debt levels to increase if the economy maintains a pace of around 2%. While GDP growth was indeed 2.3% in 2018, expectations of a weakening growth pace seem realistic. Finnish growth peaked at 2.8% in 2016 and uncertainty about the global economy is likely to cause GDP growth to fall further. Our estimates of growth of just over 1% would not be sufficient to bring down debt levels as government spending is set to increase.

Growth slowed to 0.2% QoQ in the first quarter, which came as a disappointment. Even though purchasing power has been improving on the back of a strengthening labour market, household consumption contracted in the first quarter. Net exports contributed positively to the modest growth pace, which was mainly due to contracting imports. That picture is set to change for the rest of the year though. The consumption outlook is at least decent and domestic demand will likely be the most important driver of growth this year as the external environment continues to provide a significant risk to the outlook.

This article is taken from the Eurozone Quarterly, which you can find here

Finnish economy in a nutshell (% YoY)

	2018	2019F	2020F	2021F
GDP (%)	2.3	1.2	1.1	1.3
Private consumption (%)	1.4	1.1	1.6	1.5
Investment (%)	3.2	2.9	2.4	1.0
Government consumption (%)	1.4	1.6	1.6	1.5
Net trade contribution (%)	-1.0	-0.3	-0.5	0.1
Headline CPI (%)	1.2	1.2	1.5	1.5

Source: Thomas Reuters, all forecasts ING estimates.

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