

ECONOMIC VIEWPOINT



Euro Zone: An Alarming Slowdown

After a very strong performance in 2017, the euro zone's economy slowed down considerably in 2018. The euro's previous rise in value, increased protectionism, a restructuring of certain industries and political uncertainty were among the factors that took a toll on Euroland's economy. However, there is still hope that the situation will improve soon. If not, things could get particularly complicated for the European Central Bank (ECB) which is already short on ammunition.

Did the Growth Cycle Peak in 2017?

The euro zone's real GDP posted annual growth of 2.5% in 2017, the healthiest increase since 2007. It was the sixth strongest gain since the euro zone started compiling statistics in 1996. It also came after two years of growth just under 2.0% in 2015 and 2016. The progress of the euro zone's economy in 2017 was even more remarkable because it was way ahead of the estimated growth of potential GDP (long-run GDP trend consistent with price stability). According to the European Commission, potential GDP growth was 1.4% in 2017, whereas the Organisation for Economic Co-operation and Development (OECD) valued it at 1.3%.

The 2018 Slowdown

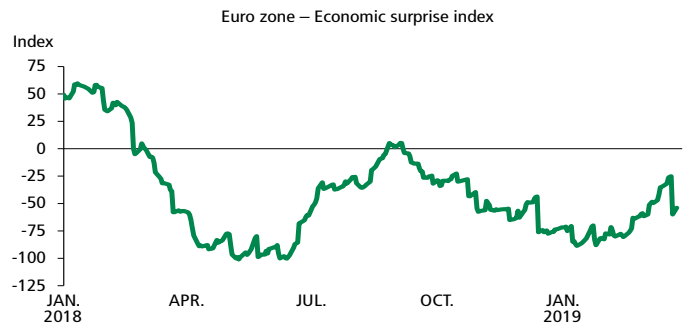
Official 2017–2018 forecasts for the new year were generally favourable. In the fall of 2017, the European Commission forecast a 2.1% increase in real GDP in 2018. In November 2017, the OECD called for a 2.2% gain. The International Monetary Fund (IMF) also anticipated a 2.2% increase in January 2018, as did the consensus of private forecasters compiled by Bloomberg, which climbed to 2.4% in March 2018.

Things were looking up for Euroland's economy, but over the year, the situation changed. Economic results failed to meet expectations, and it began early in 2018. This could be seen in the reversal of the economic surprise index, which fell into negative territory starting in the first quarter of 2018, meaning an increasing number of economic indicators had posted results that were below consensus expectations (graph 1). That index fell even further during most of 2018.

Most of the confidence indexes were among the indicators that did poorly at the beginning of last year. They generally peaked

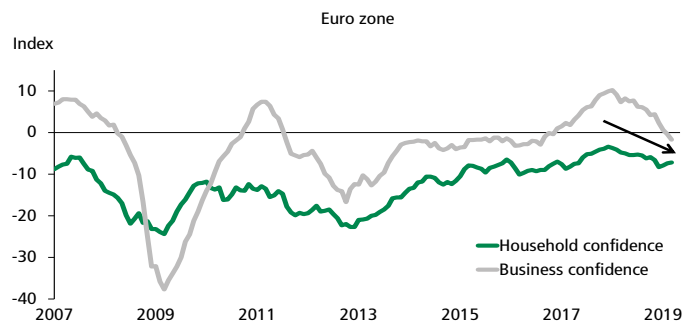
in late 2017. That was the case for household and business confidence indexes (graph 2).

GRAPH 1
The economic surprise index started falling in the first quarter of 2018 and has remained negative since



Sources: Datastream, Citigroup and Desjardins, Economic Studies

GRAPH 2
Confidence has deteriorated since late 2017



Sources: European Commission and Desjardins, Economic Studies

François Dupuis, Vice-President and Chief Economist • Mathieu D'Anjou, Deputy Chief Economist • Francis Généreux, Senior Economist

Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

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These poor indicators were eventually reflected in the euro zone’s real GDP growth, which posted an annualized increase of just 1.5% in the first quarter of 2018. At the time, it was the worst result since summer 2016. Growth improved slightly, edging up to 1.7% in the spring. However, it worsened again in the second quarter when even the euro zone’s leading economy showed obvious signs of weakness. In the summer of 2018, Germany posted an annualized contraction of 0.8%, its worst downturn since winter 2013. Italy also recorded a negative change in real GDP in the third quarter. Overall, Euroland’s growth was only up 0.6%. The gain was a bit better at the end of 2018, with an annualized increase of 0.8% in real GDP. The year ended with annual real GDP growth of 1.8%, swelled by growth in late 2017.

What Caused the Recent Slowdown in the Euro Zone?

The European economy lost traction at the same time as international trade slowed down. In 2017, international trade posted its strongest annual growth since 2011. However, it has been declining fairly steadily since then, even posting negative annual changes at the end of 2018. Trade in Euroland also deteriorated at the same time (graph 3).

Eastern European countries and Turkey (which is having its own political and economic problems) also declined.

The value of the euro was another contributor to the slowdown of exports. Thanks to the positive economic situation in Europe, the currency appreciated 9.0% from winter 2017 to winter 2018. In March of last year, it reached its highest peak since summer 2014. That increase made the euro zone’s businesses less competitive.

Much of the weakness in the euro zone’s internal trade is due to the difficulties facing certain industries. It has been hard for the automobile sector to adjust to new, stricter environmental rules. The whole value chain issue also tends to undermine internal trade when demand is lower, especially since industrial integration is more important in Europe than elsewhere.

Internal trade was also negatively affected by the weakness of domestic demand in some euro zone countries. Final consumption growth was lower in 8 of the 19 euro zone countries (representing 75.8% of the euro zone) in 2018. The most serious declines were in Germany and Italy.

The Problems with Germany’s Industries

Germany’s economic problems stem from its status as Europe’s manufacturing giant. It should be noted that Germany is still very focused on manufacturing. In terms of added value for the national economy, only Korea’s manufacturing sector exceeds Germany’s among the developed countries (graph 4). Manufacturing also accounts for 19.0% of Germany’s total employment, a much higher percentage than that of the OECD, which is 13.8%.

GRAPH 3
International trade slowed down in 2018, including for the euro zone

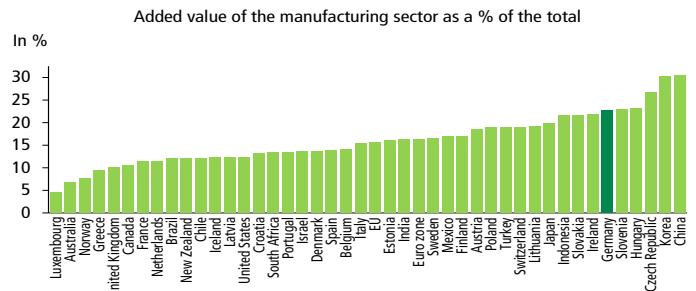


Sources: CPB - Netherlands Bureau for Economic Policy Analysis and Desjardins, Economic Studies

It is interesting to note that the loss of traction in the euro zone is due to both external and internal trade. There are several factors behind the weakening of external trade. Both U.S. protectionism and the European Union’s (EU) reprisals likely put a brake on trade between the two partners. An estimated 2.5% of exports from the EU to the United States were affected by the special U.S. tariffs imposed last year. That percentage is low compared to China, where 50.5% of exports to the United States were affected. The extent of European reprisals on imports of some 200 different goods from the United States is valued at US\$3.7B. U.S. exports subject to the countervailing tariffs dropped close to 40%.

Euroland exports to other countries also slowed down. This is the case for China, where the gradual slowdown seems to have affected its trade with Europe. Exports to emerging

GRAPH 4
The manufacturing sector is particularly important for Germany



EU: European Union
Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

This bias toward the production of goods also makes the German economy turn outward, with exports accounting for 45.0% of its GDP (the OECD average is 28.2%). When international trade speeds up, the substantial German industry can drive that economy, but when it slows down it can act

as a brake. The growing importance of the service sector has been a stabilizing factor in most developed countries. However, Germany's unique situation makes it more sensitive to the vagaries of the global economic situation.

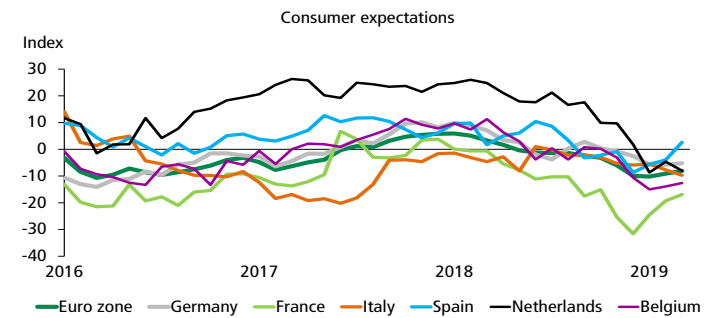
This is especially true when the automobile sector is affected. Some 20% of German manufacturing is dedicated to automobiles. In 2017, Germany produced 5.5 million passenger vehicles, making it by far the largest manufacturer in Europe. (Spain ranked second with 2.3 million units.) Nearly 80% of the automobiles manufactured in Germany are intended for export (including to other EU countries). However, the scandal over environmental tests for diesel-fuelled vehicles was a major blow to the German automobile industry. Higher environmental standards coupled with new, more stringent tests in 2018 had serious consequences. There was a push to speed up vehicle production before the new standards kicked in, followed by a severe decline (graph 5). The automobile sector was also shaken by costly investments associated with the switch to electric vehicles, in addition to slower Chinese demand. However, automobiles are not the only source of problems, and other industrial sectors have also suffered setbacks (graph 6).

German manufacturing has not seen the last of its difficulties. While industrial production rose in the euro zone in January, it fell again in Germany. The PMI manufacturing index dipped below 50 (usually the cut-off points between expanding and contracting activity) in January, and has stayed there since. This suggests that there is no improvement yet.

Confidence and Political Factors

Among the factors affecting the euro zone internal economy were several elements that may have chipped away at confidence, including some of a political nature. Household confidence was considerably shaken in several euro zone countries during 2018 (graph 7).

GRAPH 7
Confidence dropped in several euro zone countries, but seems to be stabilizing



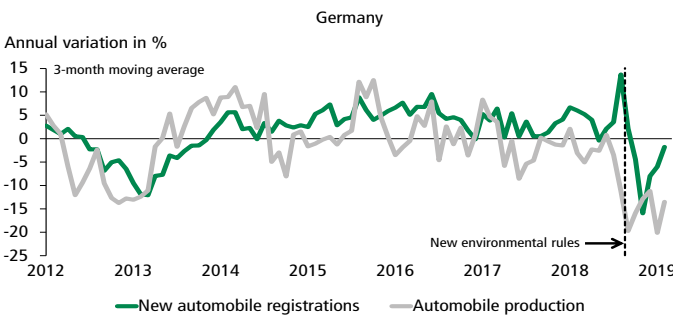
Sources: European Commission and Desjardins, Economic Studies

In Italy, the general election on March 4, 2018 brought in a right wing/populist coalition that is having a hard time working together. The contradictory elements of both parties program and their tendency to fuel anti-European sentiment have hurt investment and the overall economic situation. Real GDP declined during the last two quarters of 2018, indicating that Italy is in a technical recession. The unemployment rate also rose compared to last August's low point.

In France, there is some dissatisfaction with Emmanuel Macron's centrist government. That sentiment has come to a head with the "gilets jaunes" crisis. Even though France's real GDP is growing faster than Germany's or Italy's, it posted slower growth in household consumption and business investment in the fourth quarter of 2018.

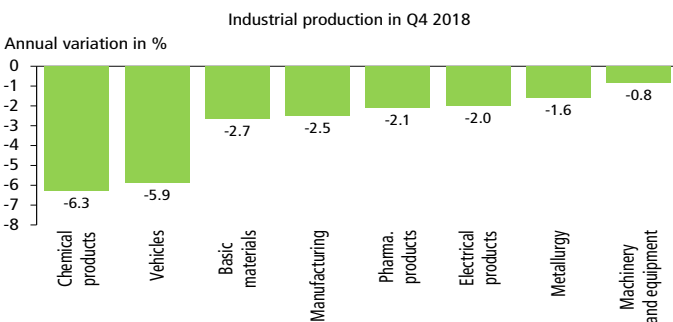
Germany's political situation is also less certain. Chancellor Angela Merkel confirmed that this would be her last term. Debates surrounding immigration and the country's current economic difficulties are fuelling political resentment.

GRAPH 5
New environmental rules upset Germany's automobile industry



Sources: Datastream and Desjardins, Economic Studies

GRAPH 6
Germany's manufacturing problems are widespread



Sources: Federal Statistical Office and Desjardins, Economic Studies

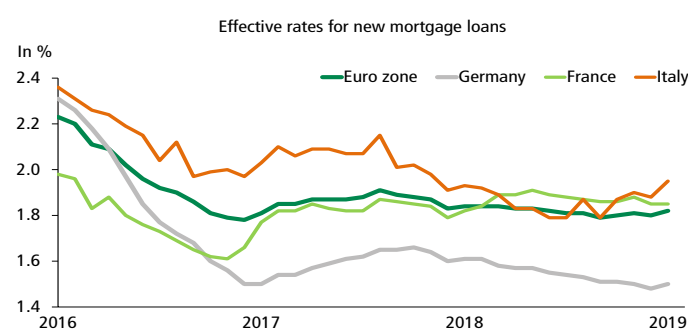
Uncertainty about Brexit is also a disruptive element as the euro zone’s main trading partner tries to leave the EU. The possibility of regulatory and tariff barriers between the United Kingdom and the EU could only be harmful, muddying the outlook for businesses and disturbing existing value chains.

A Cycle with No Monetary Tightening

Some of the recent problems facing the Canadian and U.S. economies, particularly with regard to residential investment and the consumption of durable goods, are linked to the rise in interest rates and the monetary policies of the Federal Reserve (Fed) and the Bank of Canada. The same cannot be said of the European economy, however. Interest rates have remained very low in the euro zone, especially in Germany (graph 8). Italy may be an exception, with some interest rates having increased due to higher risk premiums since the coalition government came in. The ECB’s key rate has been in negative territory since June 2014, and it only stopped buying securities last December. Growth of the money supply and credit in the private sector is fairly stable, so it would be hard to attribute the decline of the European economic situation to the ECB’s decisions. However, the ECB seems quite worried about the current situation. It recently announced a new long-term lending program, in addition to signalling that it would be keeping its key rates unchanged at least until the end of 2019.

Household and business confidence is low, but still far from what it was then, and it may even be stabilizing. This is also the case for the Germany’s Ifo business confidence indexes, which started climbing again in March (graph 9). Nor does the euro zone’s composite PMI index, weak though it is, signal a stronger reversal of GDP (graph 10).

GRAPH 8
No major interest rate hikes for European households



Sources: European Central Bank and Desjardins, Economic Studies

The ECB’s caution and that of the other main central banks, led by the Fed, has led to easier credit conditions. Bond yields have dropped in recent weeks, and several long-term debt maturities are back in negative territory. At time of writing, bond yields were negative up to ten years in Germany, nine years in the Netherlands, six years in France and four years in Spain.

Could Things Get Even Worse?

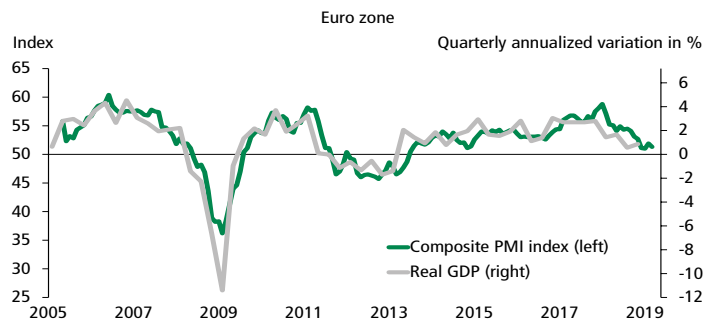
It is clear that the current economic situation in Euroland is fragile. Several indicators continue to point downward. However, even those less-than-stellar signs paint a more positive picture than during the recessions of 2008–2009 and 2011–2013.

GRAPH 9
Has the Ifo index stopped its decline?



Sources: Ifo - Institute for Economic Research, Federal Statistical Office and Desjardins, Economic Studies

GRAPH 10
The PMI index does not suggest a serious deterioration of Euroland’s economy

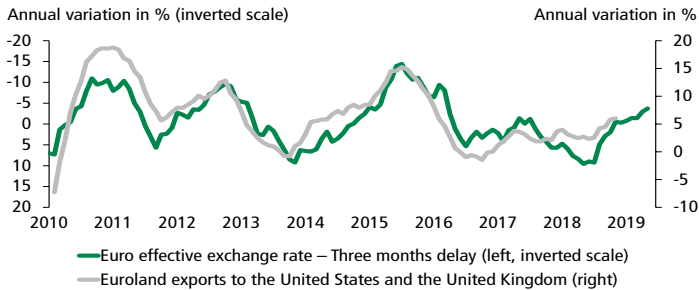


Sources: IHS Markit, Eurostat and Desjardins, Economic Studies

We should point out that the labour market has hardly been affected by the current weakness. Except for Italy, unemployment rates continued to drop in the euro zone’s major countries, including Germany, in 2018. Provided the current period of weakness does not bring massive job cuts, the growth cycle could continue.

Among the factors that hurt the European economy, we mentioned the euro’s previous rise in value. Now we have to take into account the fact that the common currency depreciated in recent quarters. The euro’s slide could boost exports, especially to the United Kingdom and the United States, the EU’s major trading partners (graph 11 on page 5).

GRAPH 11
The euro's decline should soon help exports



Sources: European Central Bank, Eurostat and Desjardins, Economic Studies

Of course, Brexit could be a game-changer, especially if the United Kingdom has to leave without an agreement when the current delay expires. At the same time, a new protectionist salvo from the Trump administration could hurt European trade. If that happens, the targeting of U.S. automobile imports could be particularly harmful to Germany. Lastly, a more marked slowdown in the Chinese economy could also cause problems for Euroland's economy. The OECD has estimated that a 2.0% slowdown in Chinese domestic demand could shave close to 0.15% off the euro zone's annual real GDP growth.

Not Much Room to Manoeuvre If the Situation Deteriorates

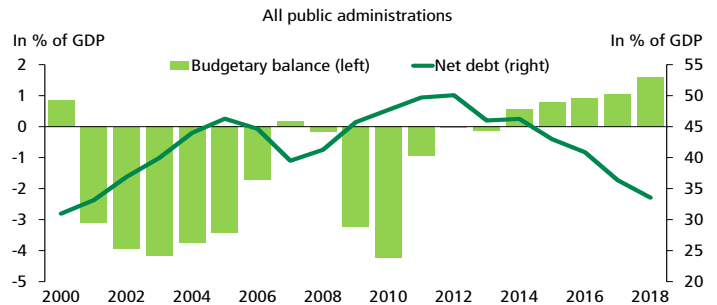
Despite signs of fragility, the baseline scenarios do not include an imminent recession for the entire euro zone. The most recent Bloomberg survey of forecasters gives an average likelihood of 20% for a recession in the euro zone in the coming year, which is lower than for the United States (25%) or Canada (23%).

If the risks increase and start to seriously undermine economic activity, it will be interesting to see what the political and monetary authorities are able to do about it.

The ECB has practically no more room to manoeuvre. It never managed to begin normalizing its monetary policy, so key rates have stayed way down, i.e., in negative territory. It would be difficult to lower them any further, and doing so could upset the money market and savings. Even resorting to new quantitative measures to boost its balance sheet could be complicated, unless the ECB's operating rules are changed.

Fiscal policy might help, but fears of a return to the sovereign debt crisis of the early 2010's could give politicians cold feet. This would be particularly true for countries whose deficits have piled up throughout the cycle and where debt has remained high.

GRAPH 12
Germany's public finances have improved in recent years



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

The main lifeline could come from Germany, where budgetary surpluses have been accumulating since 2014 (graph 12) and government debt as a proportion of GDP is one of the lowest of the advanced countries. Maybe, the German economy's current problems should already be prompting the government to make use of that room to manoeuvre.

Francis Généreux, Senior Economist