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A Changing Europe Monitor

A dangerous tango

The softening of the European sentiment indices (ESI) since the turn of the year signal the eurozone has entered a soft growth patch and the critical question is how big will be the slowdown and whether it is the beginning of a major downturn. Historically, the peak of ESI has implied a real GDP growth moderation of 1p.p. or more. In our view, this time it may prove more moderate, of a magnitude of 0.4p.p., but it will come at the cost of a much economic and financial correction later on.

These are the factors that make us sceptical about a big economic and financial downturn in the very near term (ie a 2p.p. or more real GDP growth slowdown). We don't think the Trump trade policy strategy wants to trigger a global downturn, but aims to set the conditions for a narrowing of the US external deficit of USD100-200bn within few years. In fact, we continue to think that consensus projections underestimate the US growth outlook for 2019. In the eurozone, capacity constraints and profit developments suggest there is a case, and there is the funding, for improving investment growth. Indebtedness in the eurozone is high, but not much above what it used to be back in 2008 and to some extent the overall balance sheet position is stronger. Central banks around the world, including the ECB, do not appear genuinely keen to spoil the party, in fact we may see lower real policy rates going forward than in recent years. Last, but not least, the European parliamentary elections in June 2019 are a critical test for the future of the EU, providing one more reason to expect monetary policy to be accommodative.

In our view, the next downturn will be the result of a protracted disappointment in consumption growth relative to market expectations, notwithstanding the falling unemployment rate. We suspect this process will be slow: in the age of big data weaker than expected sales can be matched with small price cuts to revive demand. However, this is just going to be a temporary patch, as fundamentally as consumers need higher incomes or much cheaper services.

The "problem" in the real economy in our view is the growing inequality of profit in the corporate sector and related to the fact that overall inflation, in our view, is higher than we can capture in the published official estimates.

The appropriate policy response to these changes will need to come from a change in fiscal strategy, an improvement in industrial strategies, and greater regulatory scrutiny of mega-companies across sectors. In this respect, the upcoming negotiations for the EU Multiannual Financial Framework for 2021-27 should be monitored closely, in our view. Don't expect low interest rates to heal the economy over time, in fact smaller monetary tightening than previous cycles should suffice to trigger a recession.

Eurozone: let's recap

The European Commission's economic sentiment index (ESI) is a monthly indicator, available since 1985, which has proved to be a consistent leading/coincident indicator of EU/Eurozone growth. In the past 40 years, every time the index reached a peak in a historical context comparable to the previous business cycle, it signalled a slowdown of GDP growth of 2-4ppts (except in four instances, when the slowdown was only around 1ppt).

ESI has dropped for three consecutive months this year, suggesting some downside risks for our GDP growth forecast of 2.7% this year. At this stage, we have decided to reduce our projection by only 0.4ppts, reflecting a mild drop in investment and exports (due to the increasing trade tensions), taking our growth forecast to 2.3%, which is in line with the consensus estimates currently. For 2019E, we do not yet see a reason to cut our forecast of 2%, which already prices in some headwinds from Brexit. Even after these adjustments, the Eurozone is on track to grow above its potential rate, which we see at around 1.7%.

Forecasts

Eurozone	2017E	2018E	2019E	2017E cons	2018E cons	2019E cons
Real GDP growth	2.3%	2.3%	2.0%	2.3%	2.4%	2.0%
Inflation	1.5%	1.7%	2.3%	1.5%	1.5%	1.6%
Policy rate, eop	0.00%	0.00%	0.50%	0.00%	0.00%	0.25%
EUR/USD, eop	1.20	1.25	1.20	1.20	1.26	1.30
Fiscal balance in % of GDP	-1.1%	-1.0%	-1.1%	-1.2%	-1.0%	-1.0%
Current account in % of GDP	3.5%	3.0%	2.9%	3.5%	3.2%	3.0%

US	2017E	2018E	2019E	2017E cons	2018E cons	2019E cons
Real GDP growth	2.3%	2.7%	3.0%	2.3%	2.8%	2.4%
Inflation	2.1%	2.4%	3.0%	2.1%	2.4%	2.2%
Policy rate, eop	1.25%	2.00%	2.00%	1.50%	2.35%	2.95%
EUR/USD, eop	1.20	1.25	1.20	1.20	1.26	1.30
Fiscal balance in % of GDP	-3.4%	-3.3%	-3.3%	-3.4%	-4.0%	-5.0%
Current account in % of GDP	-2.4%	-2.7%	-2.7%	-2.4%	-2.6%	-2.6%

Source: Bloomberg, ADA economics estimates

Inflation undershot our forecast in the first quarter of this year, due largely to more modest commodities inflation than we had anticipated. We have recalibrated our estimates to 1.7% this year on average and 2.3% next year: remaining consistent, with a gradual pick-up above what the ECB expects.

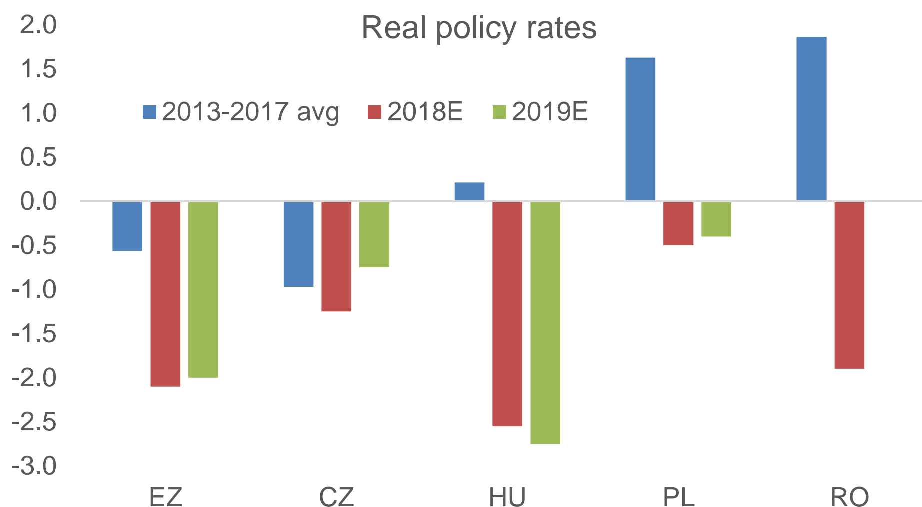
In our view, the impact of the higher US tariffs, primarily on aluminium and steel, has a negligible impact on average inflation projections, but is likely to accentuate a shift towards faster depreciation as a selling strategy.

Why aren't we more bearish? Lags, Lags, Lags

There are some good reasons to be very concerned about the economic and financial outlook for Europe and globally at this juncture, in our view. In the eurozone business surveys are close to their historical peaks and 10 years have passed since the last major downturn in 2008; historically, this is the common length of the business cycle in advanced economies. That said, in our view, the growth challenges that are beginning to emerge are too modest for now to trigger a full business cycle downswing at a time when the central banks remain keen to keep liquidity as abundant as possible.

In our view, this is a critical difference relative to previous business cycles: real borrowing costs may well be even lower going forward, notwithstanding the fact that economies have by and large completed the structural adjustments post 2008, real GDP growth is above potential pretty much everywhere and although inflation is not above the ECB's target (or above other European central banks' targets, bar Romania). We struggle to see the benefits of a protracted accommodative monetary stance and the longer it lasts, the bigger the economic imbalances inevitably resulting from it – but it appears to us that the key theme remains "hopefully, it will be somebody else's problem".

Average real policy rate in the eurozone and in central Europe: looks like conditions will get looser going forward regardless of the pace of expansion!



Source: ADA Economics estimates

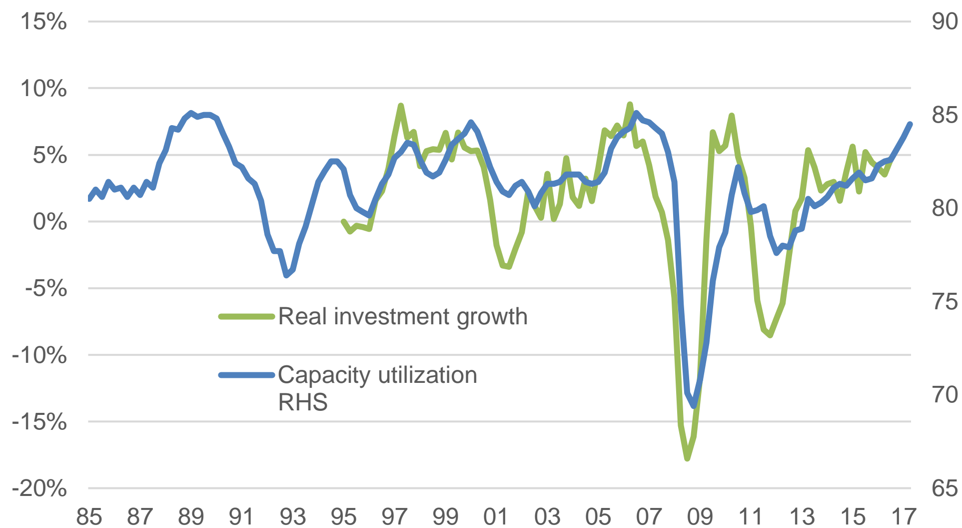
Investment: capacity constraints and attractive borrowing costs

Eurozone growth, in our view, should be able to count on a brisk investment outlook as capacity constraints have begun to bite, real borrowing costs are low, and profit growth has recovered. Looking at the balance sheet of non-financial corporations in the aggregate for the monetary unions shows that indebtedness is high, at 140% of GDP, but it has not accelerated significantly in recent years and, overall, the net financial balance (the difference between total financial assets minus debt) is large, positive and increasing.

The rise in the net financial balance (65% of GDP!) is due to high cash levels, well above what it was in 2008 (23% of GDP in Q317 vs 17% of GDP in Q308), and rising equity assets, probably reflective of the stock market gains and the debt for equity switches that were part of

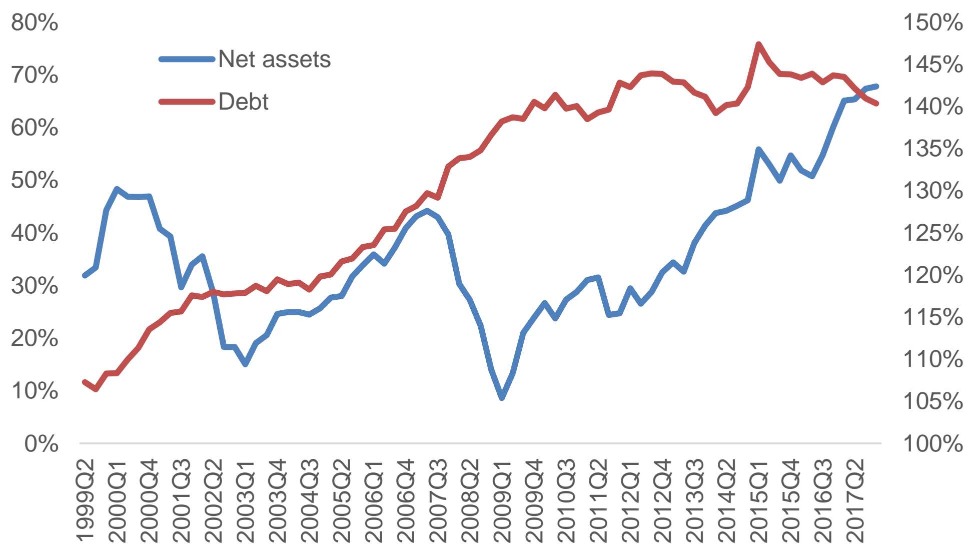
the balance sheet restructuring phase post-2008. High debt, *per se*, does not cause a recession, but it will slow the recovery after the next recession. In the meantime, the state of the corporate balance sheet appears consistent with a steady drop in the unemployment rate as long as global growth is buoyant.

Capacity utilisation in the eurozone is close to all time high



Source: Macrobond data ADA Economics

Eurozone non-financial corporations' debt and net financial assets, % of GDP



Source: Eurostat data on financial balance sheets on a consolidated basis, ADA Economics

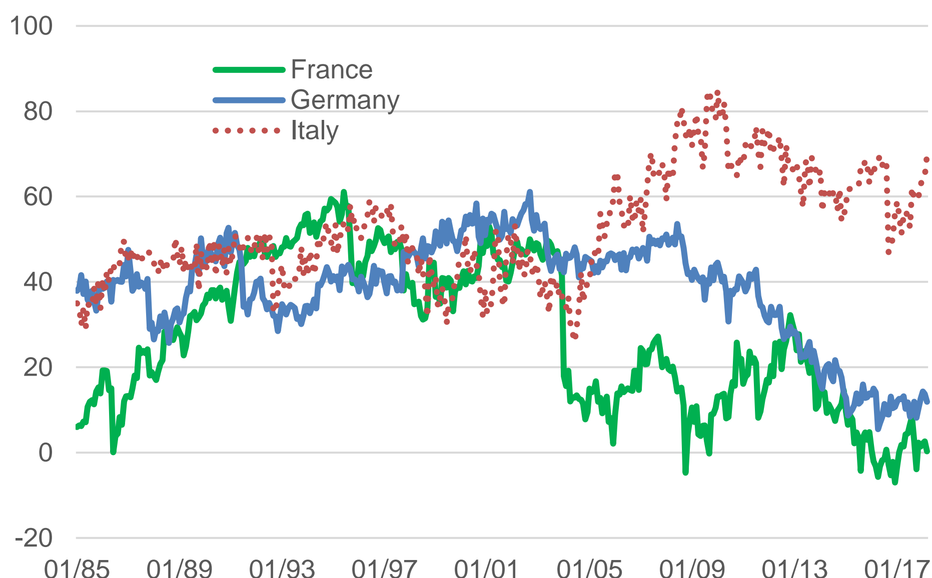
Consumption: rising, but not accelerating

The seeds of the next major downturn will lie in the consumption developments, in our view: if we are right that inflation is higher than we can measure with the consumer price index, then we are likely to see a disappointment in consumption, notwithstanding a recovery in the unemployment rate as real purchasing power is less buoyant than it appears. This should show in a rising appetite for savings, a moderation in the housing market recovery and actual consumption growth undershooting expectations.

We caution that this process may prove quite slow to have major market implications, but fundamentally we are concerned that the low borrowing costs will continue to support asset prices, while no major upside surprises to demand will create a very serious gap between expectations and reality. As big data and widening e-commerce allow companies to re-price their products frequently, initial signs of softening consumption will probably be matched with temporary price drops, to trigger a consumption revival. Similarly, in the housing market: as de facto it is no longer possible for households to access 100% value mortgages, when house prices rise too fast, demand slows as households need time to collect savings, which in turn should trigger a moderation of prices and a small consumption response. This “tango” may well last several quarters, but fundamentally cannot be resolved without sufficient increases in households’ purchasing power.

Recent household surveys have shown a rising appetite for savings across countries in the Eurozone. The European Commission provides an index for both the current perception of savings buffers and the desired level of savings going forward. In our view, there is a stark drop in the perceived current savings in Germany, France, the Netherlands and Greece. In Spain and Belgium, savings are lower than the pre-Euro era, but there has not been a huge change of trend since the last downturn in 2008. In Italy, savings have been picking up and, if we look outside the Eurozone, there have been major improvements in savings buffers in central Europe.

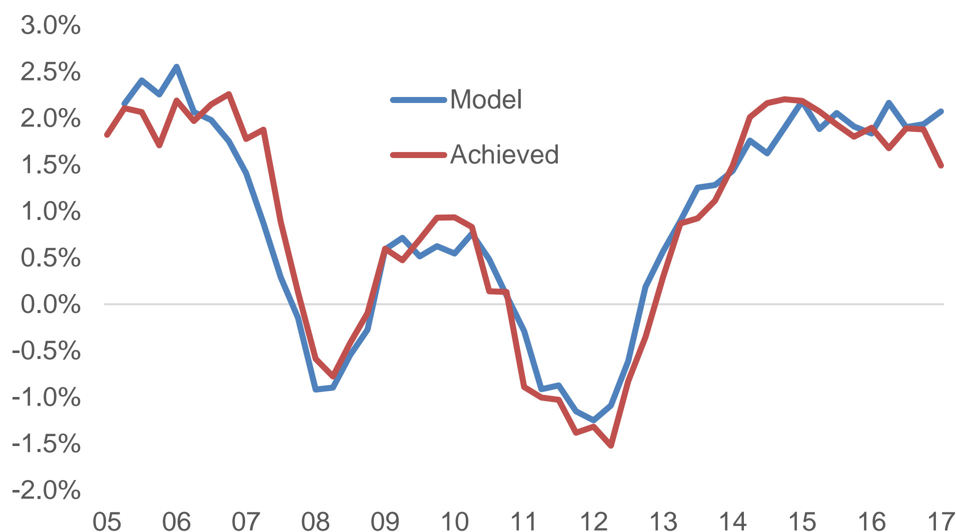
Households’ reported “perceived” current savings buffer index



Source: Macrobond, using European Commission surveys, ADA economics

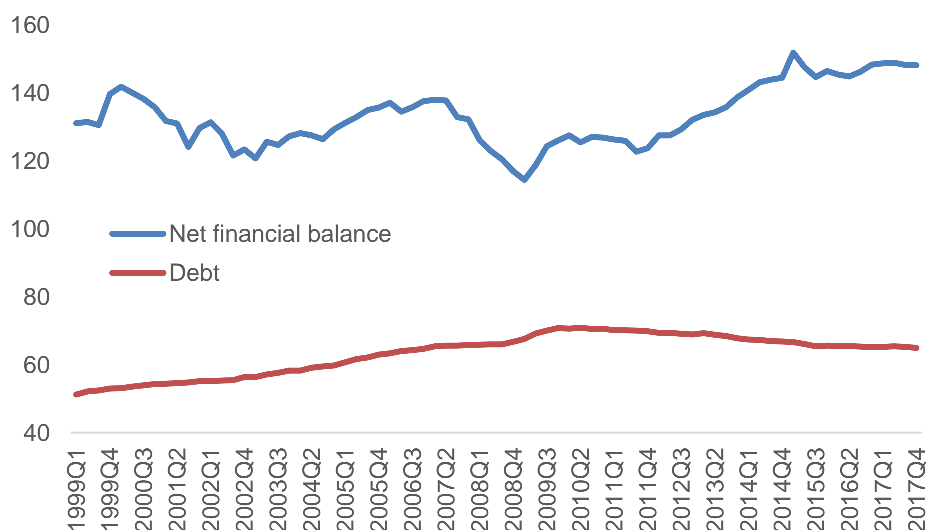
We have created a simple model for Eurozone household consumption growth (in volume terms) to highlight the key drivers of spending and to highlight whether consumption is indeed undershooting the dynamism that the labour market and the housing market would motivate. Actual consumption growth has undershot our model predictions by around 0.5ppts: of course, all models contain imperfections, so this should be seen only as indicative evidence to have a first assessment of the problem currently. The model also highlights inflation or perceived inflation in the past 12 months influence consumption meaningfully and, in our calculations, this detracted 0.5ppts from consumption yoy growth last year.

Eurozone real household consumption growth: achieved vs forecast



Source: Macrobond, ADA Economics calculations: OLS regression of quarterly data since 2006 with the following explanatory variables: constant, consumers expected financial position (1 point rise in the index is associated with 0.1p.p. faster consumption); the change in the unemployment rate (1 point drop in the rate is associated with 0.5p.p. faster consumption), house price inflation (1p.p. rise triggers 0.2p.p. faster consumption), consumers' perceived inflation in the last 12 months (a rise in the index of 1 point is associated with 0.1p.p. lower consumption) and the yoy change in vehicles registrations (10% rise is associated with 0.2p.p. faster consumption). All variables are significant at the 1% level bar the index for expected financial position which is significant at the 5% level.

Eurozone households debt and net financial assets % of GDP

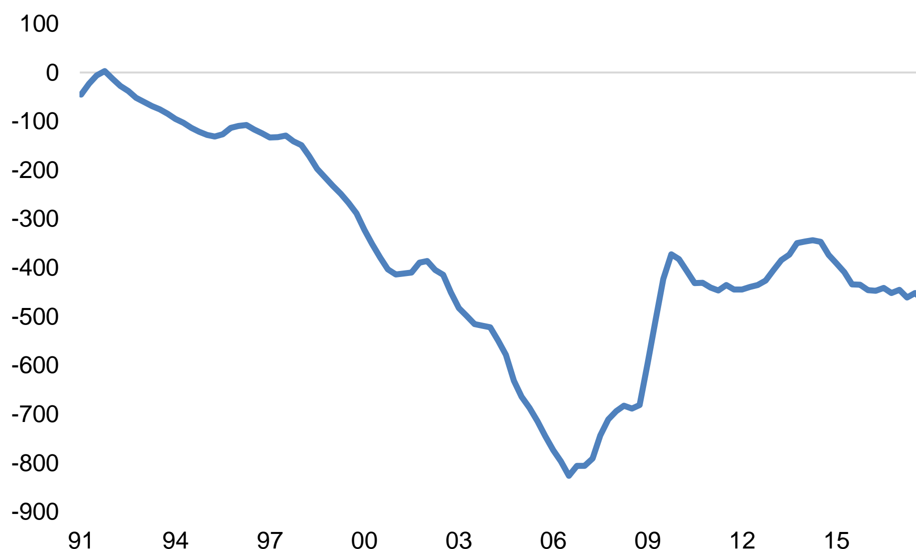


Source: Eurostat, ADA Economics

Trade disputes: rebalancing, not collapsing

Our interpretation of the ultimate goal of the Trump administration's trade strategy is that it aims to narrow the US trade deficit by at least USD 100bn in the relatively short term (in our view, two years) and by twice this for the current account deficit, splitting the burden between Asia (China in particular) and the eurozone (on a 12-m rolling basis the eurozone has a trade surplus with the US of approx. USD116bn as of early this year, which is twice what it used to be in 2008). In our view, President Trump's strategy is to put a stop to the deterioration of the current account deficit, including what could result from the tax changes, without triggering a major global slowdown. Such an adjustment in our view could support US growth by around 0.5p.p, while costing somewhat less than that to the eurozone. Importantly, for what concerns the eurozone, a continuation of the dollar depreciation path would probably be the least disruptive tactic, but we would not rule out an escalation of the tariff threats to more important sectors, such as the automobile.

US: 4-quarter rolling sums of the current account deficit, in USDbn



Source: Macrobond, ADA Economics calculations

Keep an eye on the upcoming EU budget negotiations

The European Commission is due to present its proposal for the new 2021-27 multiannual financial framework in May, which will officially kick off the political negotiations on the new budget size and its allocation. The current budget size is EUR 1trn, but the departure of the UK in 2019 or 2020 opens the door for many potential adjustments, ranging from shrinking the size of the budget to actually doubling it by widening the tax base that the EU will be entitled to and the wider use of leverage.

As well as the size of the new budget, a critical aspect will be the distribution of resources and other key decisions related to this, including the potential coordination/harmonization of corporate tax regulations. For the budget itself, there is a growing political push to redirect resources towards productivity-enhancing projects and in support of SMEs.

The EU Commission will present a detailed proposal by May 2018. Past budget negotiations have lasted a minimum of 10 months to a maximum of 22 (the 2007-13 was the slowest). It is reasonable to assume this budget round will last 15-17 months, in our view; EU Commission President Junker aims to have an initial decision by the member states by March 2019. If it drags on too long, the uncertainty will magnify the effect of Brexit, which will take place as of 29 March 2019, as things stand .

Five broad options have been put on the table, ranging from keeping the *status quo* to expand the remit and the resources of the EU budget, which is worth 0.98% of the EU's GNI currently and could range from approximately a low of EUR 800bn to a high of EUR 1trn over the full seven-year period.

The "slimming down" options would have three broad consequences: less money disbursed (not only for eastern Europe!; in fact, western Europe would suffer as well from lower cohesion funds eligibility and lower common agricultural policy funds), and a message that fostering economic convergence is losing priority status for the EU and may trigger greater fiscal burdens for local governments, which would/may need to step up if EU funds are reduced.

The "do everything plus even more" option appears unlikely, given the current circumstances, but a recalibration of all projects to make them more focused, maintaining the overall budget unchanged at 1% of GNI, in our view, if viable; in fact, it may be the most likely option. In this case, priorities will change towards youth support, R&D, SMEs support (including in agriculture), digital and interconnectivity.

The financing of the next EU budget maybe as important as its actual size. Options include: simplifying the current VAT-based own resource methodology already in use (EUR 105-140bn over seven years); widening the Emission Trading System contribution to the EU (EUR 7-105bn); introducing a common corporate tax base (EUR 21-140bn); and seigniorage (EUR10-56bn). Overall, "a wider use of financial instruments and budgetary guarantees could more than double the investments mobilised over the next Multiannual Financial Framework up to EUR 2 trillion" according to Commission President Juncker's speech from the 23rd of February. **Also note that access to the EU funds may also come with the condition that all the** member states that have committed to enter the Eurozone to do so: this would be a clear message for central Europe to avoid that those countries maintain competitiveness by repeated devaluations whilst benefiting from the EU membership and the cohesion funds all at the same time.

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