S&P Global Ratings

RatingsDirect®

Economic Research:

Low Growth And Lower Rates: The Eurozone In 2020

September 26, 2019

SENIOR ECONOMIST

Marion Amiot

London

+ 44 20 7176 0128

marion.amiot@spglobal.com

EMEA CHIEF ECONOMIST

Sylvain Broyer

Frankfurt

(49) 69-33-999-156

sylvain.broyer@spglobal.com

Key Takeaways

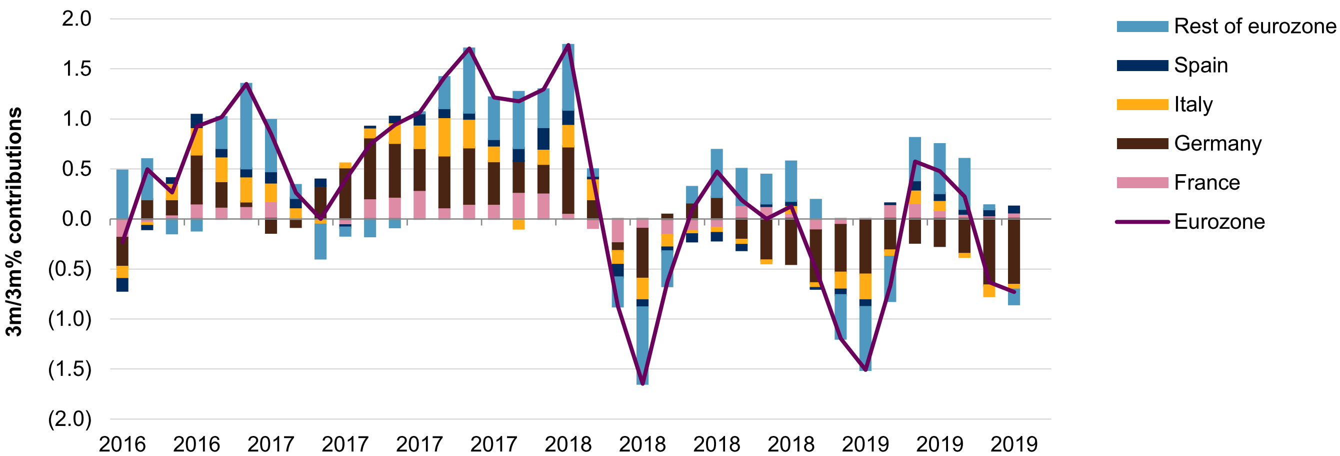
- We expect the eurozone economy to slow further in 2020, with growth of 1.1% in 2020, after 1.2% in 2019, on the back of weaker external demand.
- German Bund yields are set to remain in negative territory until 2022 given the secular stagnation in the eurozone and the ECB's monetary policy, which exacerbates the shortage of what investors consider safe assets.
- Parallel reduction in private- and public-sector debt since the eurozone crisis has been a key reason for weaker potential growth, but now that government yields are significantly below GDP growth, fiscal policy should come to the rescue.

S&P Global Ratings believes economic weakness in the eurozone is now set to extend into 2020 considering that we see no rebound in external demand. Global trade growth is hovering around zero, trade tensions persist, and Chinese GDP growth is likely to slow to below an annual 6%. The main pillar of growth in the eurozone remains consumption, thanks to tight labor markets and dynamic wage growth. Yet, the economy is slowly starting to feel the effects of the trade-related manufacturing slowdown. Capacity pressures and employment expectations are all easing, pointing at a deceleration in investment. (See the table at end of the report for S&P Global Ratings' economic forecasts.)

The divergence in the services and industry sector has worked as a sudden and unexpected asymmetric shock on the eurozone economy. Germany remains the most affected by the collapse of world trade due to its overreliance on exports for growth (see chart 1 and "Low Business Investment Is Weighing On German Economic Growth," published on Sept. 18, 2019). Italy is second in line, but a reduction in political uncertainty and sovereign risk premiums should lend some support to business confidence and boost domestic demand in 2020. France and Spain stand out as resilient so far because the trade slowdown affects them mostly through second-round effects—that is, the slowdown in growth of their large eurozone trade partners. Unlike Italy and Germany, they have also kept growth in unit labor costs in check over the past few years. In addition, French consumers are benefiting from supportive fiscal measures.

Chart 1

The Manufacturing Recession Continues, And Germany Is Most Affected
Eurozone industrial production



Sources: Eurostat, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

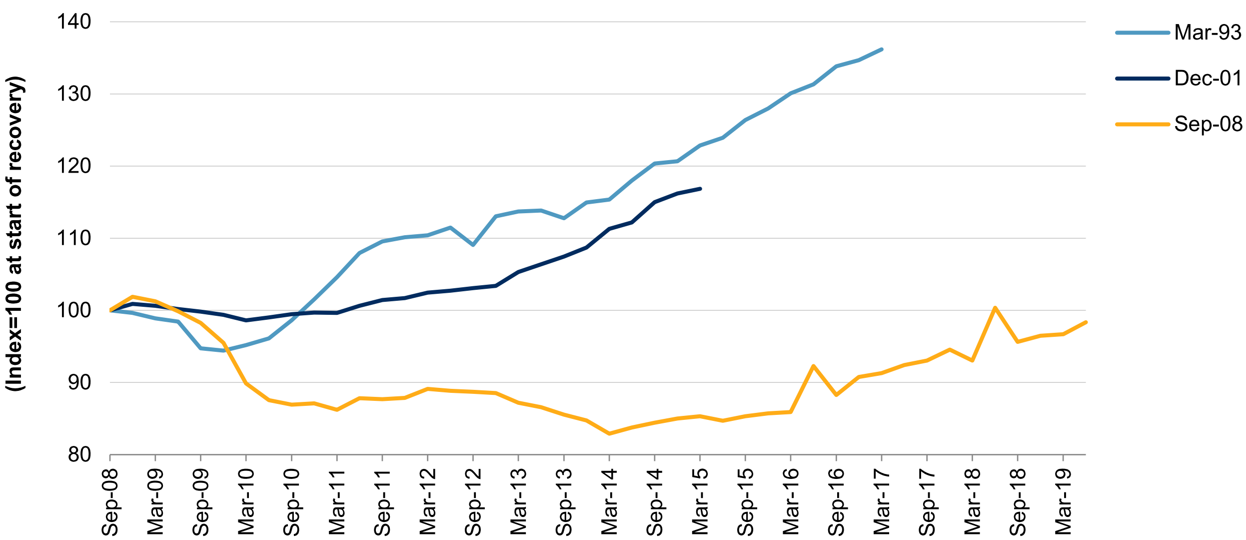
Amid the economic weakness, the European Central Bank has once more pulled all of its easing levers to support growth and inflation. It has pushed rates further below zero and ensured that government yields will continue to trade in negative territory for a while with the resumption of net asset purchases from November (see "New ECB Stimulus Package Is Likely To Keep Interest Rates Low Through 2023," published on Sept. 13, 2019). Looking at our inflation forecasts and the ECB's forward guidance, we don't expect any rate hikes before 2022.

Is the eurozone entering secular stagnation?

The eurozone has reached a state that looks a lot like secular stagnation: low growth and low inflation with plenty of interest rates in negative territory. With a current account surplus of close to 2.9% of GDP in 2018, the eurozone is also saving more than it invests in spite of negative rates. As such, eurozone investment has barely recovered from its pre-financial crisis peak in 2019 (mostly thanks to weak investment in Germany, see chart 2), negative real rates have yet to spur growth (see chart 3), and underlying inflation has been stuck at 1% for a while now.

Chart 2

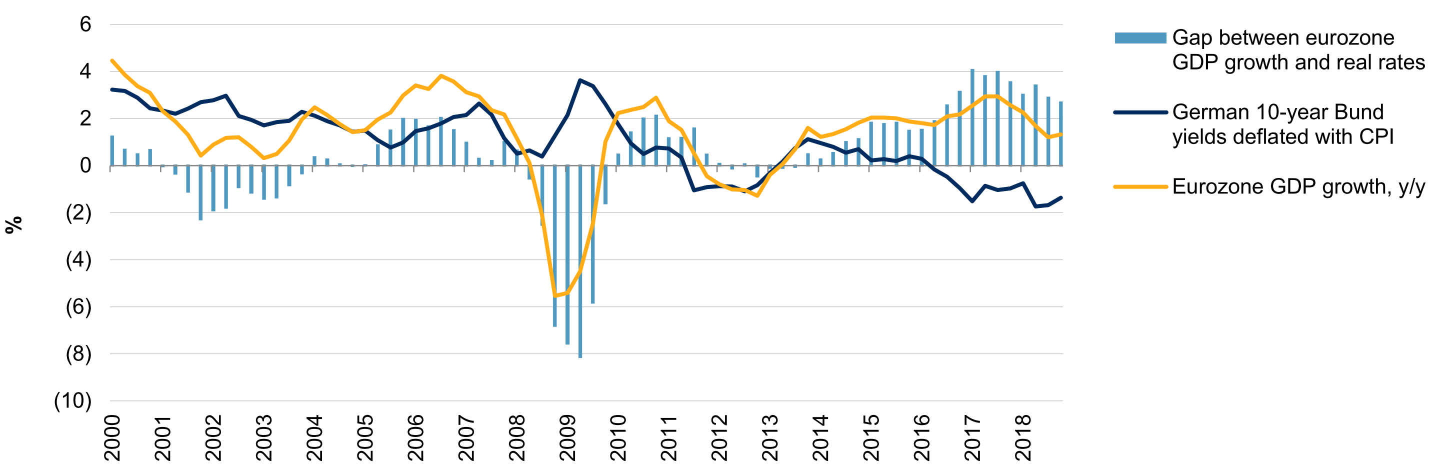
Still Waiting For The Investment Boom Despite Historically Low Real Interest Rates
The recovery in eurozone investment



Sources: Oxford Economics, S&P Global Ratings Research.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 3

The Gap Between GDP Growth And Real Rates Has Never Been So Large



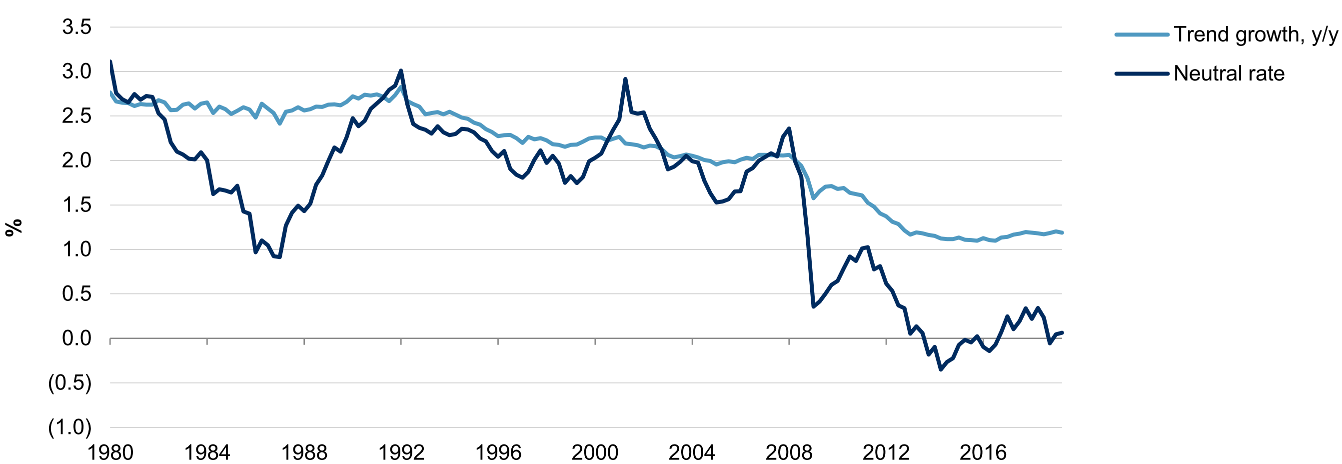
Sources: Thomson Reuters, Eurostat, S&P Global Ratings Research.
Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Granted, the current slowdown has come from an external shock, but there are also structural factors at play behind low growth and low rates.

- Potential growth in the eurozone has decreased from 2% between 2000 and 2008 to 1.3% since 2009. This is not just linked to a slow recovery in investment, but also meager improvements in total factor productivity (see chart 5) and a worsening demographic profile (see chart 6). Lower growth points to lower returns on investments, contributing to lower rates.
- Excess savings, combined with safe asset scarcity, is also pushing down rates. With a rising dependency ratio (the number of retirees compared to the working age population), we can even expect savings to rise further in the eurozone, especially in aging countries like Germany. Meanwhile, the supply of government bonds is set to remain constrained by two factors for the near future: the ECB's asset purchases and holdings as well as low sovereign bond issuance, as eurozone governments are still downsizing debt.
- The eurozone remains relatively highly leveraged, which acts as a constraint to both growth and rates. Since the financial crisis, firms have become wary of taking on more debt. In almost all eurozone countries except France, they have become net savers. Although less credit-fueled growth likely means the sources of growth are more sustainable, it also means there is less investment in the economy and thus lower potential growth.

Chart 4

Low Potential Growth Is Weighing On The Neutral Rate

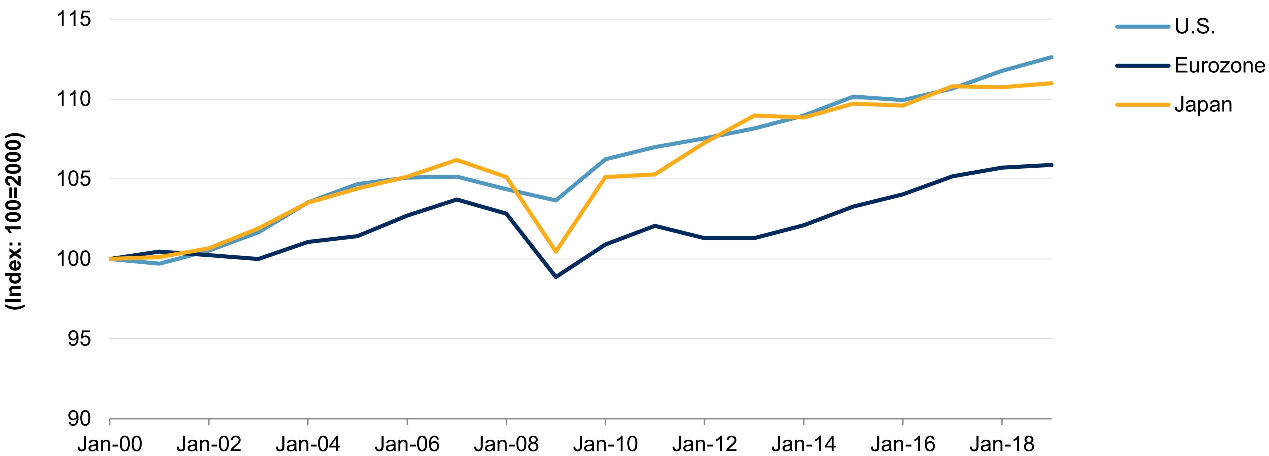


Sources: Holston, Laubach et al, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 5

Eurozone Total Factor Productivity Growth Has Lagged Behind That Of The U.S. And Japan



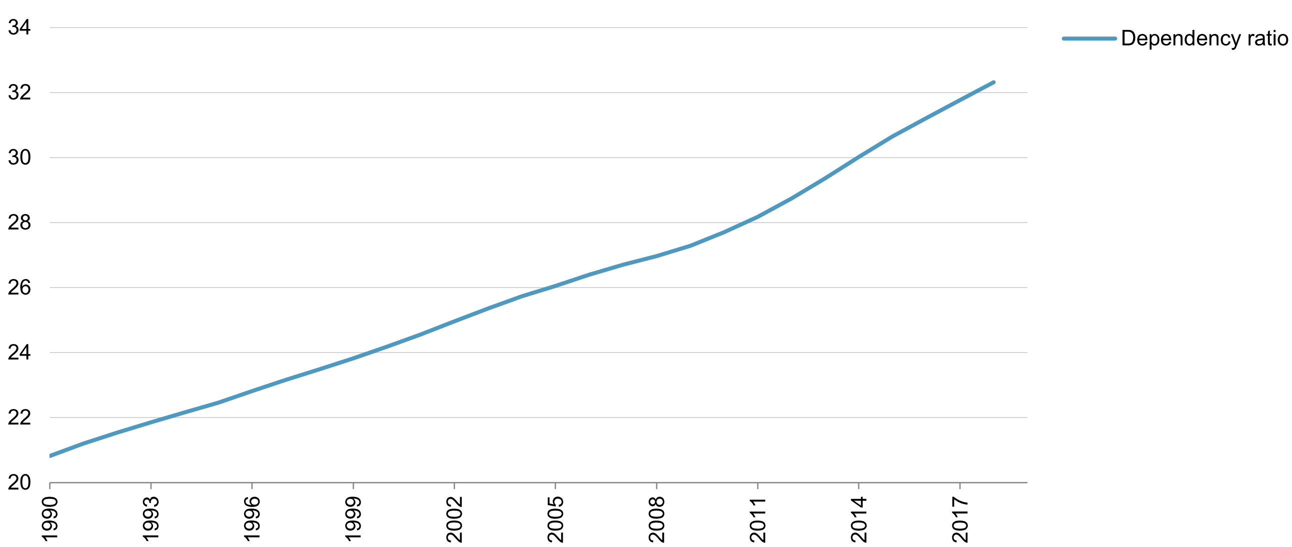
Sources: European Commission macro-economic database AMECO, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

Chart 6

The Eurozone Is Aging Rapidly

Ratio of population over 65 to working age population



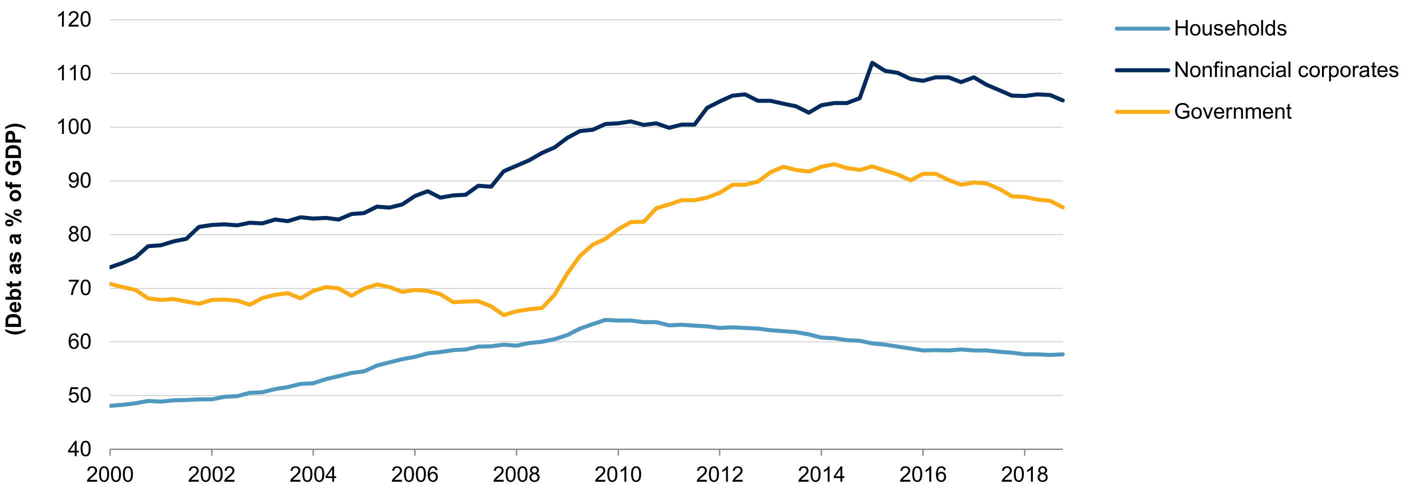
Sources: World Bank, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

All of these factors have pushed down the so-called neutral rate (the theoretical level that supports the economy at full employment or maximum output while keeping inflation constant) of the eurozone economy (chart 4). As a result of this and the ECB's new asset purchases from November, we now expect German Bund yields to remain negative until 2022 (see our forecasts at the end of this report).

Chart 7

High Leverage Remains A Constraint To Growth



Sources: BIS, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

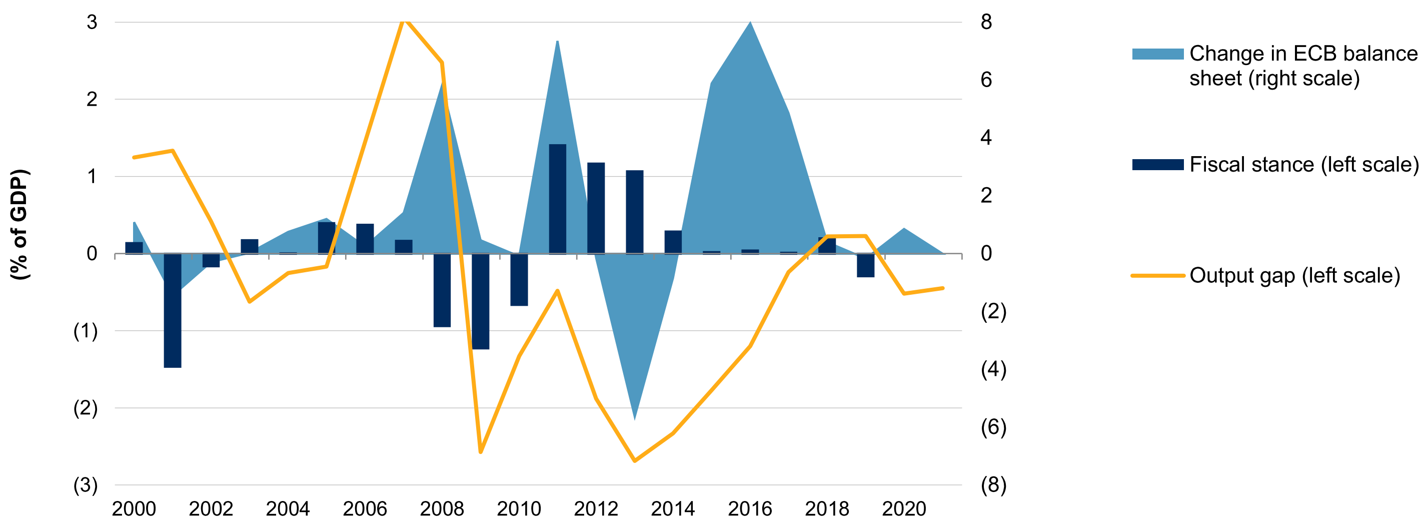
Secular stagnation does not have to be a trap: fiscal policy and structural reforms can help

Given all of the factors mentioned above, it would seem that secular stagnation has reached Europe. But some of it can be reversed. The parallel deleveraging of the private and public sector has been a key reason for weak investment and therefore weak productivity growth since the eurozone crisis. And, monetary policy has also been the only game in town (see chart 8). Yet, the effectiveness of monetary policy is decreasing.

While debt reduction was and still is necessary for some eurozone countries, others have regained enough fiscal space to use it to boost growth. Perhaps more importantly, the times are very different than in 2010. Interest rates on government bonds are significantly lower than nominal growth (see chart 3) and even negative on most parts of the yield curve for most countries. Therefore, it makes sense for governments to borrow more to finance growth-enhancing projects. One option already heard in the Netherlands or Germany is to use fiscal space to finance the transition to greener growth. Besides, governments have other tools than fiscal policy to boost growth. Structural reforms can have a positive impact on productivity by facilitating a more efficient reallocation of resources.

Chart 8

Monetary Policy In The Eurozone Is Still The Only Game In Town



Sources: European Central Bank, IMF, European Commission macro-economic database AMECO, S&P Global Ratings Research.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

S&P Global Ratings' European Economic Forecast, September 2019

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2018	1.5	1.7	0.7	2.6	2.5	1.4	1.9	1.4	2.6
2019F	0.5	1.3	0.1	2.2	1.7	1.2	1.2	1.2	1.1
2020F	0.5	1.3	0.4	1.7	1.3	1.2	1.1	1.1	1.2
2021F	1.0	1.3	0.6	1.7	1.5	1.3	1.3	1.3	1.4
2022F	1.1	1.4	0.7	1.5	1.5	1.4	1.3	1.4	1.4
CPI inflation (%)									
2018	1.9	2.1	1.2	1.7	1.6	2.3	1.8	2.5	0.9
2019F	1.6	1.3	0.8	1.1	2.4	1.6	1.3	1.9	0.5
2020F	1.5	1.0	0.7	1.4	1.4	1.5	1.1	2.0	0.4
2021F	1.4	1.2	0.8	1.4	1.4	1.6	1.2	2.4	0.5
2022F	1.7	1.6	1.2	1.6	1.6	1.8	1.6	2.0	0.6
Unemployment rate (%)									
2018	3.4	9.1	10.6	15.3	3.8	6.0	8.2	4.1	2.6
2019F	3.2	8.5	10.3	13.9	3.4	5.6	7.6	3.9	2.3
2020F	3.5	8.3	10.3	13.3	3.4	5.8	7.5	4.2	2.2

S&P Global Ratings' European Economic Forecast, September 2019 (cont.)

2021F	3.5	8.2	10.2	12.7	3.5	5.8	7.4	4.5	2.2
2022F	3.5	8.0	10.2	12.2	3.4	5.8	7.3	4.6	2.2
10-year bond yield (yearly average)									
2018	0.4	0.8	2.6	1.4	0.6	0.8	1.1	1.5	0.0
2019F	-0.4	0.0	1.8	0.6	-0.2	0.1	0.3	0.9	-0.5
2020F	-0.5	-0.2	0.9	0.2	-0.4	-0.1	0.0	0.8	-0.6
2021F	-0.3	0.1	1.2	0.5	-0.2	0.1	0.2	1.3	-0.4
2022F	-0.1	0.4	1.5	0.8	0.0	0.4	0.5	1.8	-0.2

Central bank policy rates (yearly average)

	Eurozone*	U.K.	Switzerland
	ECB	BOE	SNB
2018	-0.44	0.60	-0.75
2019F	-0.60	0.75	-0.75
2020F	-0.60	0.86	-0.75
2021F	-0.60	1.11	-0.75
2022F	-0.40	1.36	-0.50

Exchange rates

	Eurozone		U.K.	Switzerland	
	USD/EUR	USD/GBP	EUR/GBP	CHF/USD	CHF/EUR
2018	1.18	1.34	1.13	0.98	1.15
2019F	1.12	1.25	1.12	0.99	1.11
2020F	1.12	1.25	1.12	0.99	1.11
2021F	1.15	1.31	1.14	0.99	1.13
2022F	1.19	1.37	1.15	0.98	1.16

F--S&P Global Ratings Research forecast. *We show the deposit rate forecast.

This report does not constitute a rating action.

Copyright © 2019 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.