European Economic Outlook 2020

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Foreword

Where do we stand ten years after the global financial crisis?

At a time when stagnation seems ever more likely in developed economies, a focus on economic growth and other key macroeconomic metrics persists, albeit with a lot more nuanced views on what these metrics should capture.

Historically, we have come to equate GDP growth with well-being. Recently, however, we have become ever more aware that important 21st century phenomena such as climate change, inequality, and digitalization are at best not well captured and at worst not considered at all in the GDP. With countries such as New Zealand and Iceland prioritizing well-being over GDP, one is left to wonder whether our traditional metrics cover what they should and whether they cover them correctly.

On a similar note, we have become blinded by an inflation target of below but close to 2%, with any minuscule deviation in inflation having such a bearing on market sentiment that central banks do not dear to tighten their easing policies. Whether an inflation target of 2% is appropriate is beyond the scope of this publication, but it is still important to acknowledge the rising trend of questioning what traditional inflation measures assess and what the inflation target means. At a time of constantly undershooting our inflation target in the Eurozone, asset prices have been steadily rising. The debate over whether asset prices should be included in inflation statistics has reignited, with recent research pointing to an underestimation of the "correct" inflation because of the exclusion of assets such as houses, equities, and bonds.

This rethink of key macroeconomic metrics follows from the acknowledgement that we now live in a different or new economy. What does the future hold?

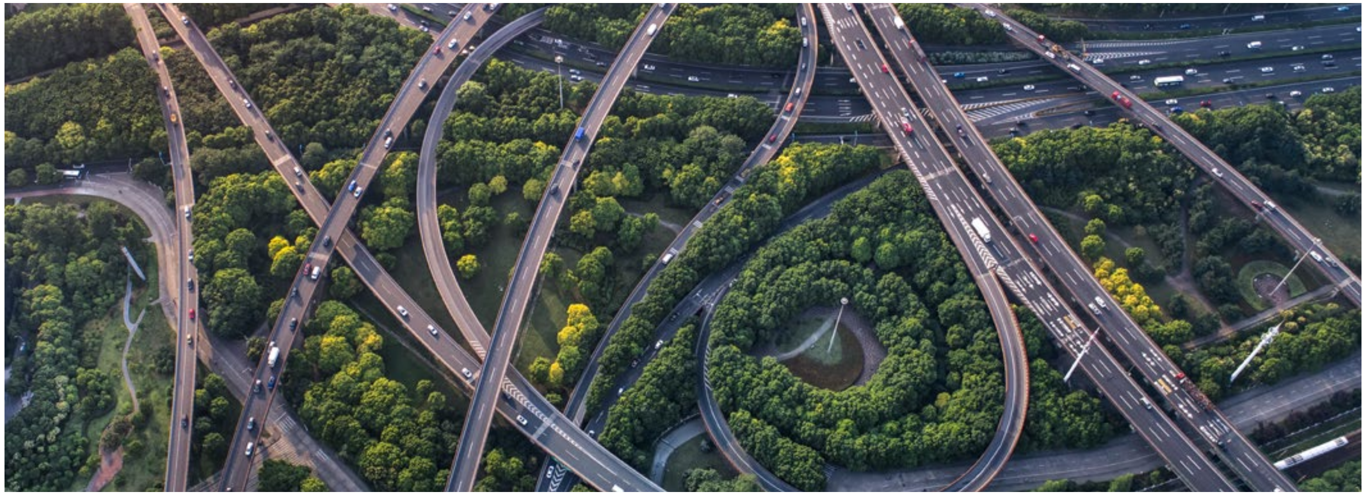
Technological innovation and its adoption seem to be the answer to cries for growth of the developed world. Technology has this potential not only because it enables us to use what we know is possible, but also because it enables us to rethink what is possible and to untap its potential. Technologies in robotics, artificial intelligence (AI), bioengineering, innovative materials and innovative energy sources have the potential to achieve growth without the externalities of waste and pollution.

Investment in fixed capital and R&D spending are crucial to untap the potential of new productive capabilities. Historically, the sector of the economy in which we have enhanced our productive capabilities the most is the manufacturing sector. The increasing share of services in GDP and employment does not tell a story of decline in manufacturing, but rather a story of manufacturing becoming much more efficient in the aftermath of the industrial revolution, and therefore allowing us to expand service offerings.

Investment in productive capabilities, rather than reliance on finite natural resources, is the way forward for developing countries that need to sustainably lift parts of their population out of poverty. In developed economies, welfare levels can be increased in a responsible way that counters climate change by reducing material consumption and changing consumption patterns. In developed economies, enhanced productive capabilities can allow for shorter working days rather than persistent increases in consumption. Sharing of productive capabilities among countries is key, especially in the area of green technologies aimed at tackling climate change.

The aging population on most continents poses a threat not only to healthcare and pension systems, but also to the job market. With women and the elderly increasingly being part of the workforce in most countries, future increases in labour supply will only result from younger generations entering the workforce. Aging will result in a constantly decreasing supply of labour and higher old-age dependency ratio, which could hold back growth. However, in the near-term aging and pension reforms have resulted in a change in the composition of the workforce; a positive labour supply shock, caused by an increase in the participation of baby-boomers that postpone their retirement, is one of the determining factors of the lower-than-expected wage increases and inflation.

Issues such as increases in populism and inequality have a detrimental effect on our well-being, thereby affecting our main factor of production, human capital. They are not only a potential source of social unrest but also make it difficult for a growing part of the



population to reach and maintain a quality of life that can be associated with well-being. Other issues such as decreasing social trust also spell trouble for the economy. Trust is not only at the basis of all human relationships but also affects welfare as it facilitates trade and transactions and encourages activity that can add economic value.

Fiscal policy is at a crossroads. Governments have to decide whether to increase their heightened debt levels in an attempt to stimulate productivity or improve well-being by means of focussed investments, or whether to err on the side of caution and maintain some fiscal leeway for when the economic situation worsens.

Monetary policy is still expansionary ten years after the crisis. While this has resulted in lower interest rates, which are supposed to encourage borrowing and spending and therefore boost the economy, the monetary policy target of below, but close to, 2% inflation is still to be achieved consistently in many developed economies, including the Eurozone. This continuous easing has resulted in unprecedented central bank balance sheet expansions, low profitability of financial sector entities and distorted financial markets. This, while the inflation target of 2% is being revisited in an environment of slower growth, digitalization, and lower prices.

Given the human tendency of overestimating short term and underestimating long term phenomena, we urge our readers to read this year's European Economic Outlook while bearing in mind the longer-term bigger-picture as shortly summarized above.

Macroeconomic themes

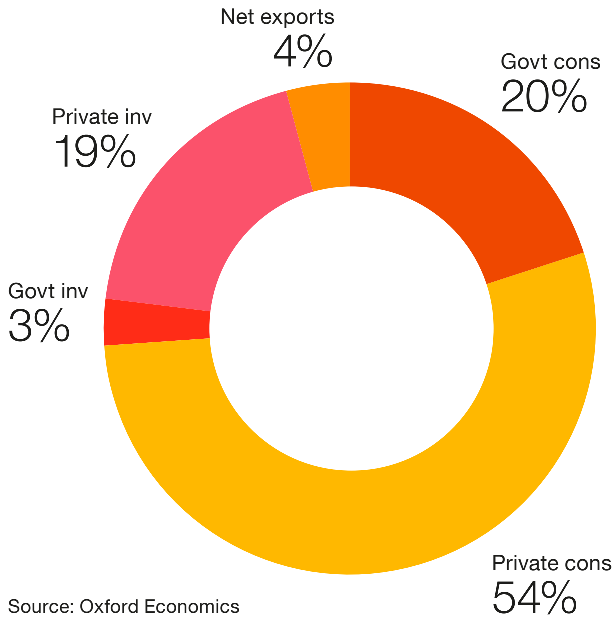
Subdued growth

The global economy is in a synchronized slowdown, with subdued GDP growth rates compared to 2018. Global trade uncertainty and protectionism as well as a decline in industrial manufacturing are the main culprits of the growth slowdown. Their mutually reinforcing character is all the more troubling. Global trade uncertainty reduces foreign demand and consequently hampers exports. Domestically, trade uncertainty affects corporate confidence and hinders investment. A decline in manufacturing means a decrease in long-term spending and investment, which affect trade insofar as machinery and equipment are internationally traded. *(Figure 1)*

Global trade uncertainty is pervasive because it affects global confidence and subsequently reduces trading flows. In the Eurozone, GDP is made up of the following components in order of magnitude: private consumption, government consumption, private investment, net exports (i.e. exports less imports), and government investment. A slowdown in trade directly affects the net export balance of exporting countries. The effect is most pervasive in countries with small domestic economies and/or large dependence on exports, such as Germany, the Netherlands and Switzerland. *(Figure 2)*

In terms of contributions to growth, private consumption and private investment have been the driving force, while net exports have been the main restraint in 2019. Private consumption has been supported by record low unemployment levels,

Figure 2 GDP components: Eurozone 2019



Source: Oxford Economics

even though wage increases have been limited, especially in nominal terms. For 2020, net exports are expected to turn slightly positive in the face of diminishing trade uncertainty, partly because of expected clarity around Brexit. A lagged effect of trade uncertainty is the diminishing private investment expected in 2020. Fiscally stronger countries are expected to make up for the decrease in private investment by increasing government spending in an effort to stimulate growth. *(Figure 3)*

Figure 1 Real GDP year-on-year percent change Source: Oxford Economics

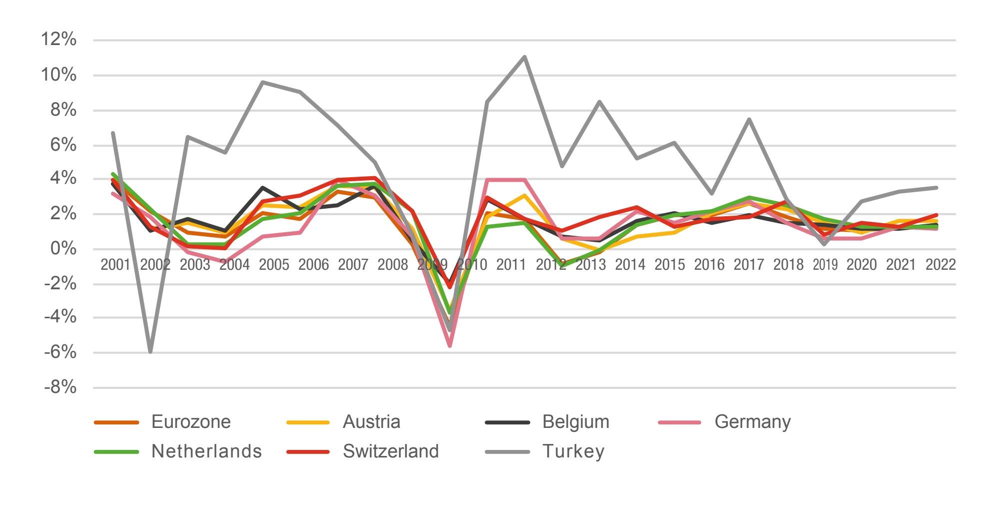


Figure 4 GDP manufacturing year-on-year percent change Source: Oxford Economics

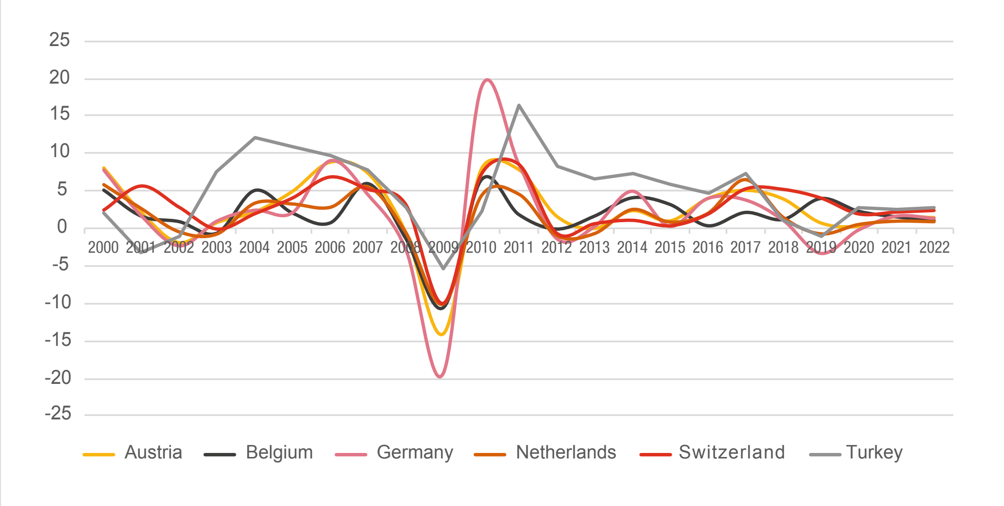
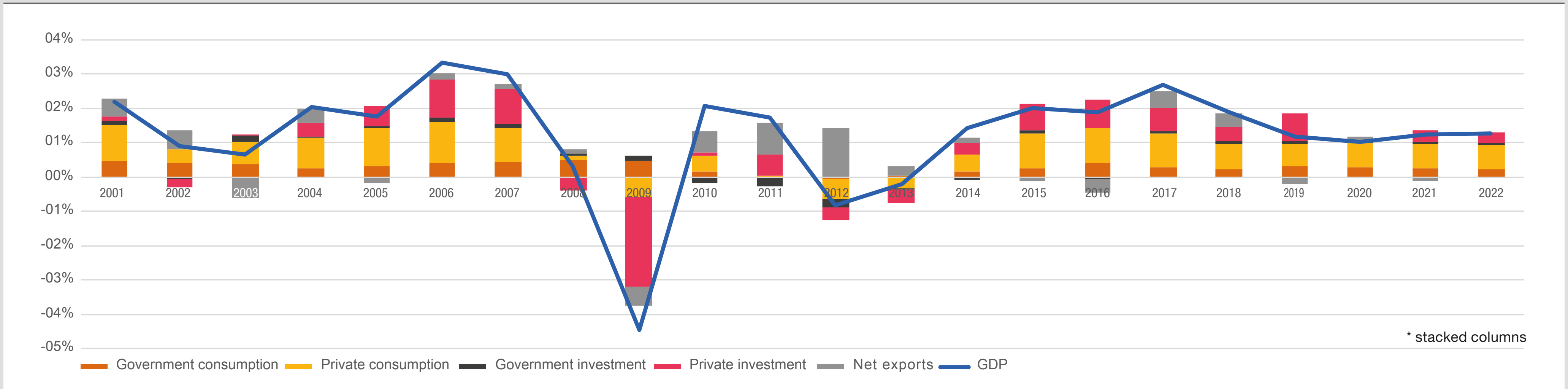


Figure 3 Eurozone GDP volume growth split per component Source: Oxford Economics



Manufacturing has contracted, i.e. experienced negative growth rates in Germany, the Netherlands, and Turkey during 2019. The Purchase Manager Index (PMI) for Eurozone shows a similar picture, with the index undershooting the neutral value of 50 in the first three quarters of 2019 . For the Netherlands and Belgium, a decline in manufacturing also means a reduction in exports. Austria has performed somewhat better, benefiting from its diversification of exposures away from Germany and into the relatively faster growing economies of Eastern Europe. Given that part of the slowdown in manufacturing in Germany was a consequence of domestic one-off events, such as new emission test regimes for the automotive sector introduced in the end of 2018, manufacturing production is expected to slowly rebound in absence of escalating trade tensions. *(Figures 4 and 5)*

The decline in manufacturing, especially when caused by weaker demand, is all the more important because of the potential spill over to services. While this remains a worry, an effect on services is as of now not noticeable. Insofar as global trade uncertainty diminishes and domestic demand continues at its current pace, the services sector is expected to perform well. The services sector—comprised of both private and public services—is so pivotal to economic activity because it makes up the lion's share of GDP, with more than 50% for Eurozone economies, Switzerland, and Turkey. *(Figure 6)*

1 An index value below 50 indicates a contraction of economic activity, while a value above 50 signifies expansion.

Eurozone unemployment has been on a decreasing trend since 2013 and is currently near an all-time low at 7.6%, with countries such as the Netherlands and Austria showing unemployment rates of below 5%. It is however important to bear in mind that employment conditions are not so favourable for all Eurozone countries, notably the Southern ones. Swiss unemployment levels are expected to remain at their historical levels of consistently below 4%. The Turkish currency crisis of 2018 has resulted in an increase in unemployment during 2019, which is expected to slightly decrease in 2020 as inflation and the Turkish lira stabilise. *(Figure 7)*

The low-unemployment and all-time high vacancy rates point to labour shortages. The good news is that countries with labour shortages can fall back on immigration insofar as there is a match between the skills demanded and those supplied. This would alleviate friction between supply and demand of labour, as well as reduce upward wage pressures. *(Figure 8)*

The rise in employment in the Eurozone for 2019 was weaker than in the previous year. Germany and Belgium have suffered a sharp decrease in employment in the end of 2019, most likely because of a hit to German manufacturing and uncertainty pertaining to Brexit. Carmakers in Germany, US and UK have announced that they will shed around 80,000 jobs in the coming years because of trade tensions, higher tariffs and a reassessment of the workforce in a changing industry headed towards electric, autonomous, or shared driving. We expect the rise in employment to be even slower in 2020, as employment typically follows economic activity with a lag. Nevertheless, lower economic growth is not expected to curb employment; a shift into the low-productivity service sector allows growing employment to coexist with slow growth. *(Figure 9)*

Youth unemployment paints a slightly different picture. While Eurozone youth unemployment shows a decreeasing trend from 2013 onwards—in line with total unemployment—it is still not lower than that of the early 2000s. In Switzerland and Turkey, youth unemployment is also in line with the trend in total unemployment and remains more elevated than the level experienced in the early 2000s. *(Figure 10)*

The unemployment level of self-employed workers is insightful, as it responds rapidly to changes in economic conditions. In 2019, Eurozone has experienced a decrease in the number of self-employed workers. Given the decrease in unemployment, there is reason to believe that previously self-employed people are now working as non-self-employed or have left the workforce. In countries such as the Netherlands, the high share of flexible, part-time, or self-employed workers means that larger parts of the population are more vulnerable in times of economic downturn. *(Figure 11)*

Figure 5 PMI Index Eurozone Source: Markit Economics

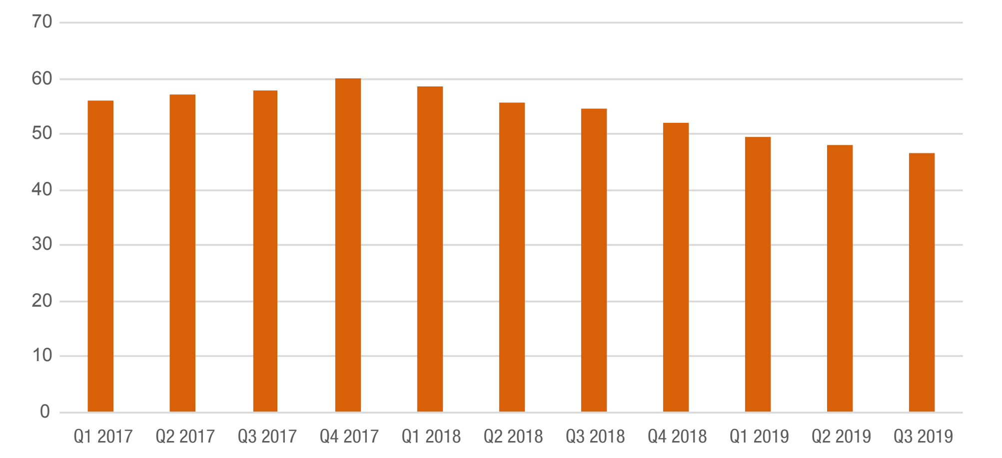


Figure 6 GDP: share of economic sectors in 2019 Source: Oxford Economics

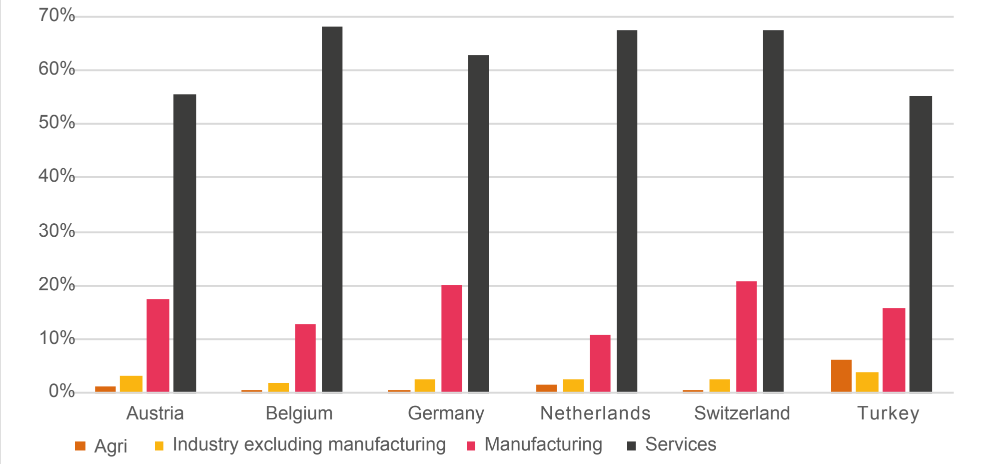


Figure 7 Unemployment rate Source: Oxford Economics

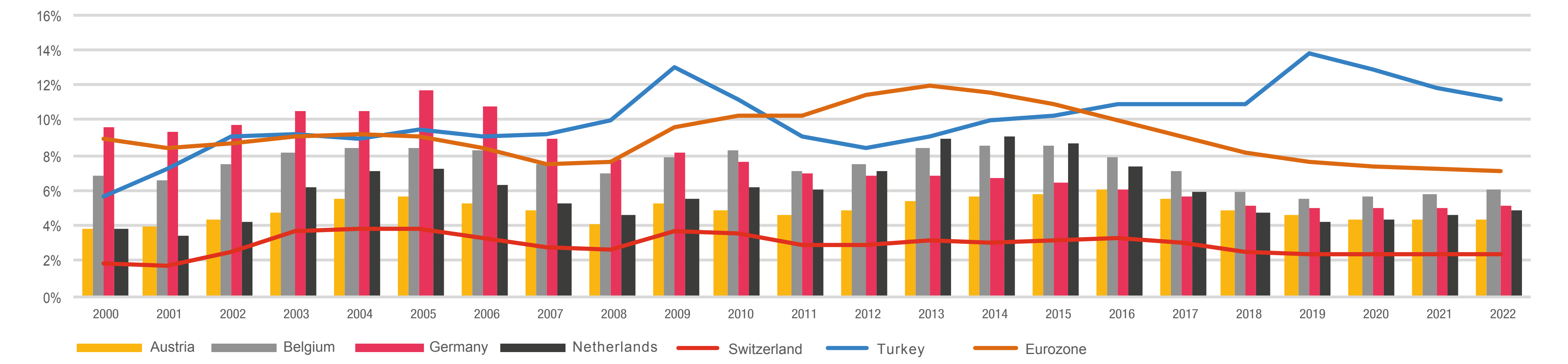
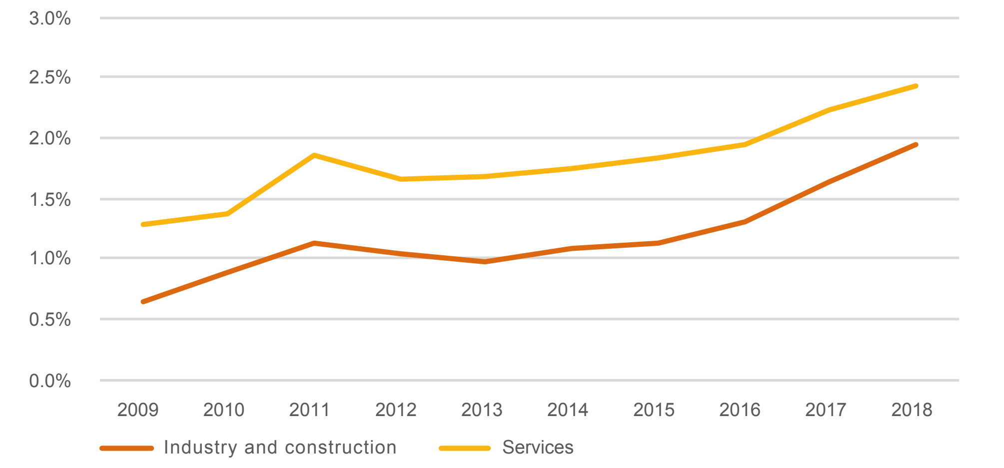


Figure 8 Vacancy rate in Eurozone

Source: Eurostat



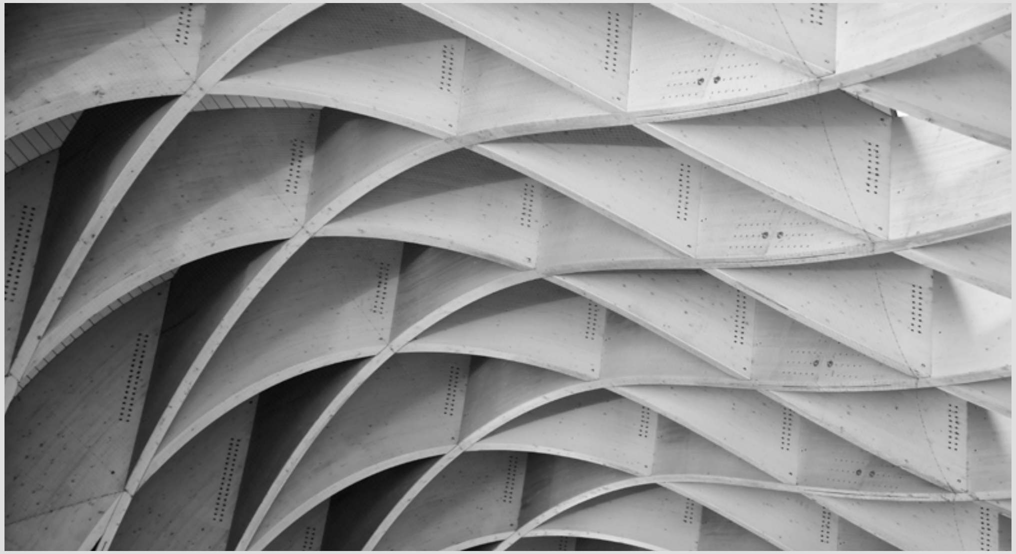


Figure 9 Employment quarter-on-quarter change, seasonally adjusted

Source: Oxford Economics

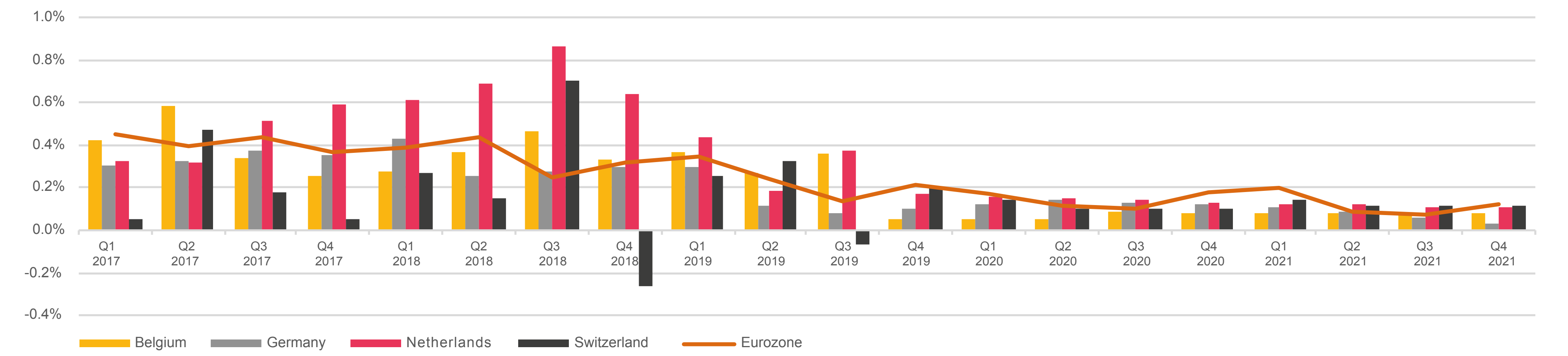


Figure 10 Youth unemployment as a percentage of total labor force aged 15-24 Source: World Bank

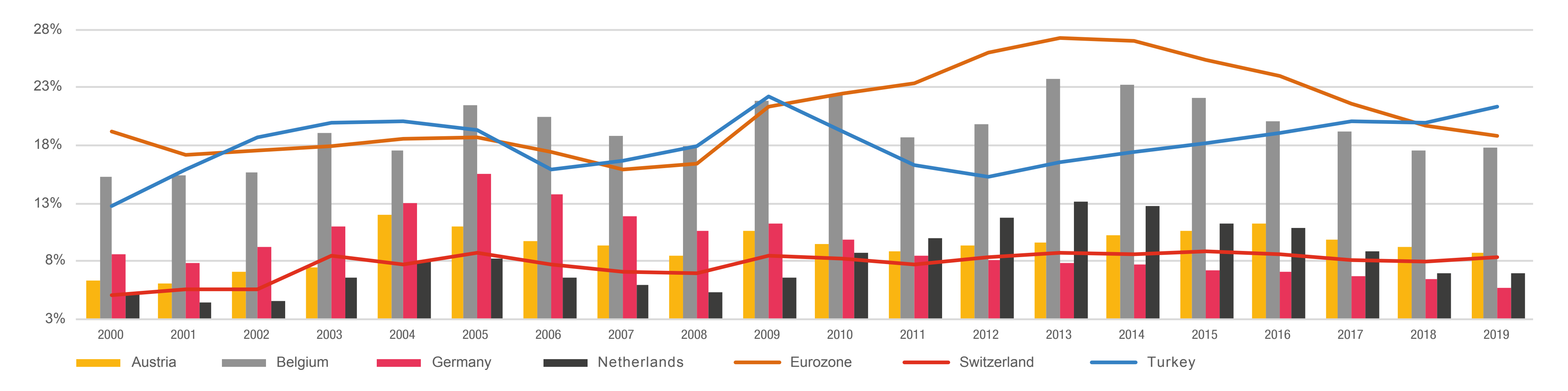
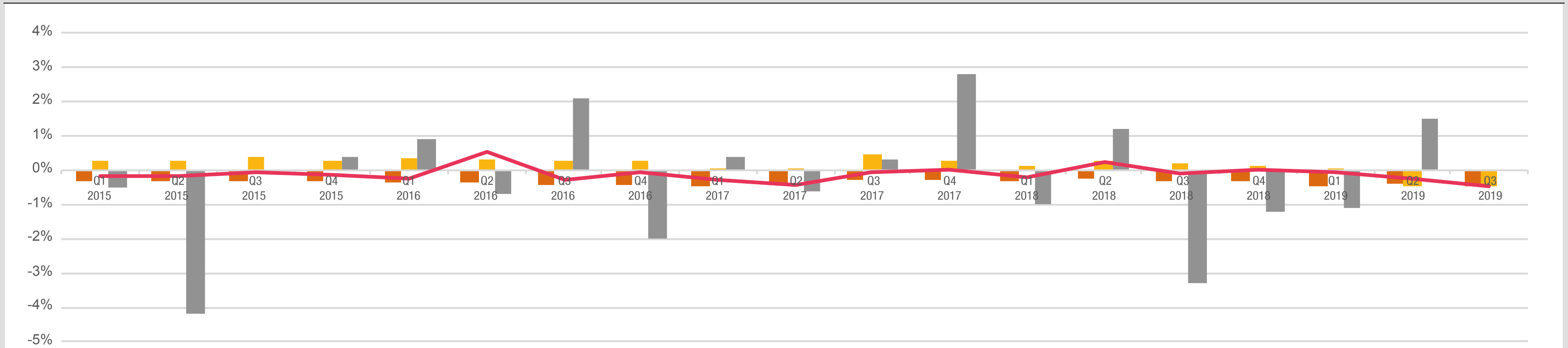


Figure 11 Self-employed quarter-on-quarter change Source: Oxford Economics, Eurostat, European Central Bank



Data for Germany and the Netherlands is not seasonally adjusted; data for Switzerland and Eurozone is seasonally adjusted.
Data for Switzerland is available until Q2 2019.

Loose monetary policy

Monetary policy, which has been equivalent to monetary easing in the past years, has proved to be one of the most controversial topics of 2019.

The ECB's policy target is to achieve price stability, which it has translated into an inflation target of below, but close to, 2%. In September 2019, the ECB's Governing Council decided to continue its long-lasted expansionary policy by agreeing on a comprehensive easing package comprised five measures: lowering the deposit facility rate, strengthening the forward guidance on the likely path of policy rates, restarting the net asset purchases within the asset purchase programme, changing the terms of the third series of targeted longer-term refinancing operations (TLTRO III) and introducing a two-tier system for reserve remuneration. These measures were left unchanged in the December 2019 meeting. The reasoning behind them was reportedly two-fold: continuously undershooting inflation expectations and downward revisions to previous expectations of both GDP and inflation. *(Figure 12)*

Eurozone inflation for 2019 has been around 1.3%, partly because of decreasing oil prices. The Netherlands has been an outlier in this regard, mainly because of recent value added tax increases. Even though for some countries in the Eurozone the ECB's monetary policy stance is too lose, the ECB manages the inflation target considering inflation differentials across Eurozone countries. *(Figure 13)*

The Swiss National Bank (SNB) is also following an expansionary monetary policy, which is expected to stay so beyond 2020, given the low inflation levels of around 0,4% and the risk of a Swiss Franc appreciation.

The new head of the Turkish central bank has slashed interest rates in 2019, after signs of receding inflation. In 2020, the Turkish central bank will continue to face the dilemma of whether to lower interest rates in an effort to stimulate growth or to increase interest rates in order to rein in inflation and keep the lira from depreciating in 2020.

Many are wondering how effective this long-lasting monetary loosening has been. To that end, the ECB has published recent research that shows the impact of its unconventional monetary policy tools on the euro area sovereign yield curve. The yield curve plays a key role for the transmission of monetary policy. A lower and flatter yield curve eases financing conditions, given that borrowing is less costly, and therefore supports spending and subsequently economic activity. ECB research shows that its unconventional measures, namely negative interest rate policy (NIRP), forward guidance (FG), and asset purchase programs (APP), have brought down the Eurozone sovereign yield curve by 0,9% for bonds with a two-year maturity and 1.4 % for those with a ten-year maturity. The current Euro area par yield curve for AAA sovereign bonds shows that governments from this area can borrow for free until a maturity of 15 years. *(Figures 14 and 15)*

Figure 12 ECB key interest rates Source: European Central Bank

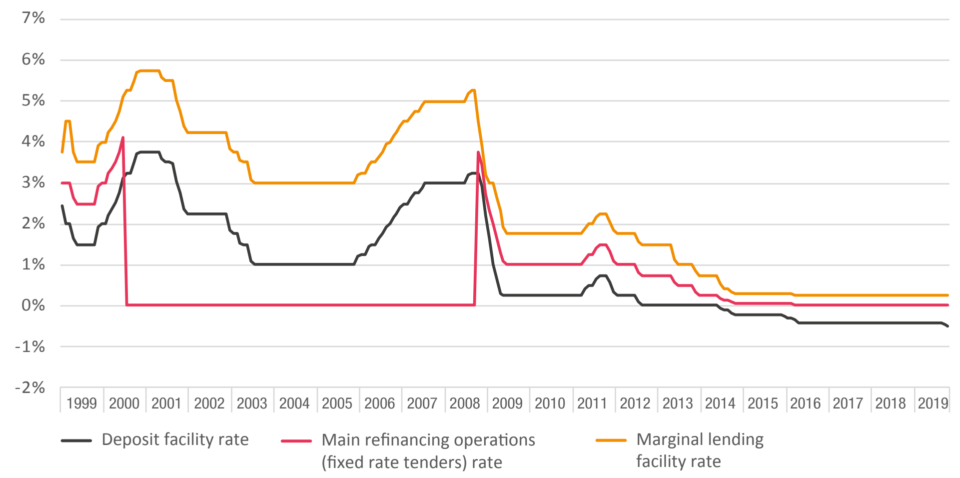


Figure 13 Inflation year-on-year percent change Source: Oxford Economics

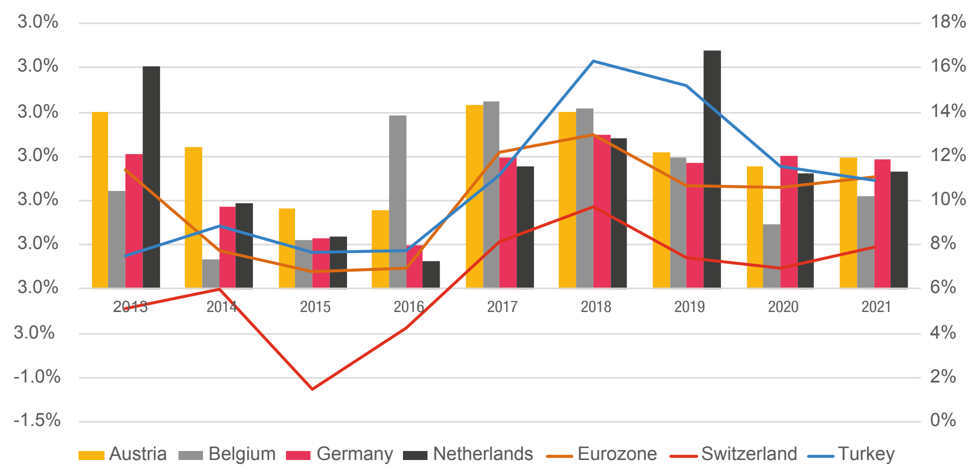
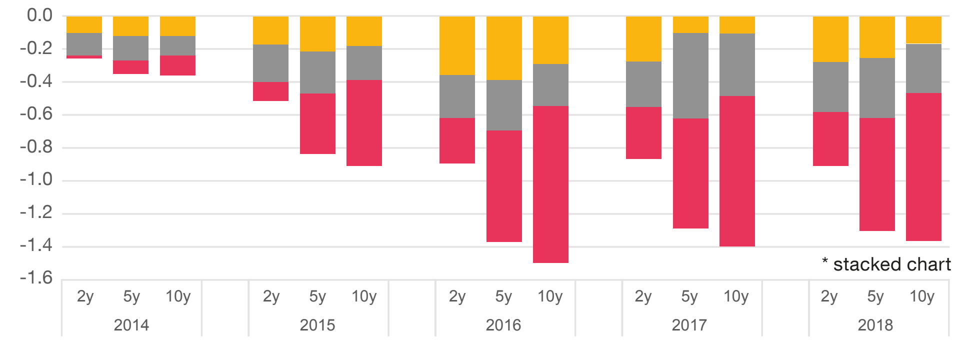


Figure 14 Compression of euro area sovereign yield curve due to ECB's non-standard measures



Source: European Central Bank

Notes: The impact of NIRP (negative interest rate policy) and FG (forward guidance) on sovereign yields works via the short-term rate and the OIS forward curve, and the impact of the APP operates via term premia.

Figure 15 Euro area yield curve Source: European Central Bank

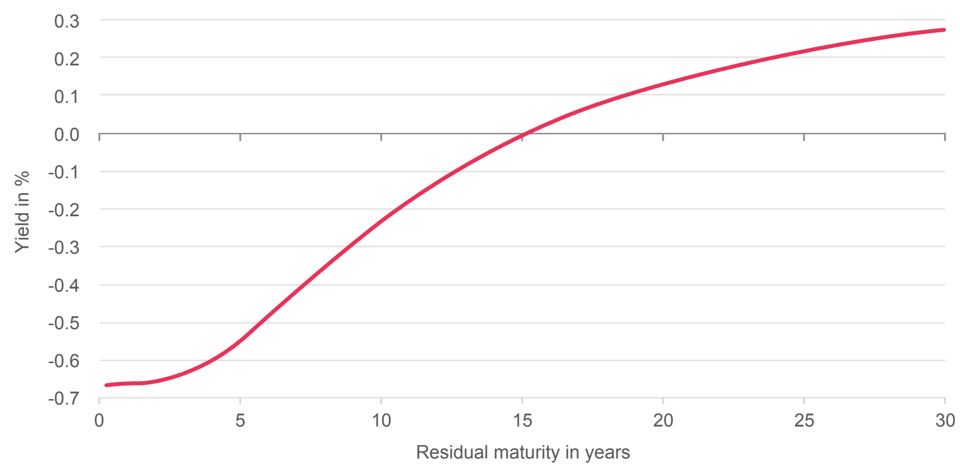


Figure 16 Central bank balance sheets as a percentage of GDP

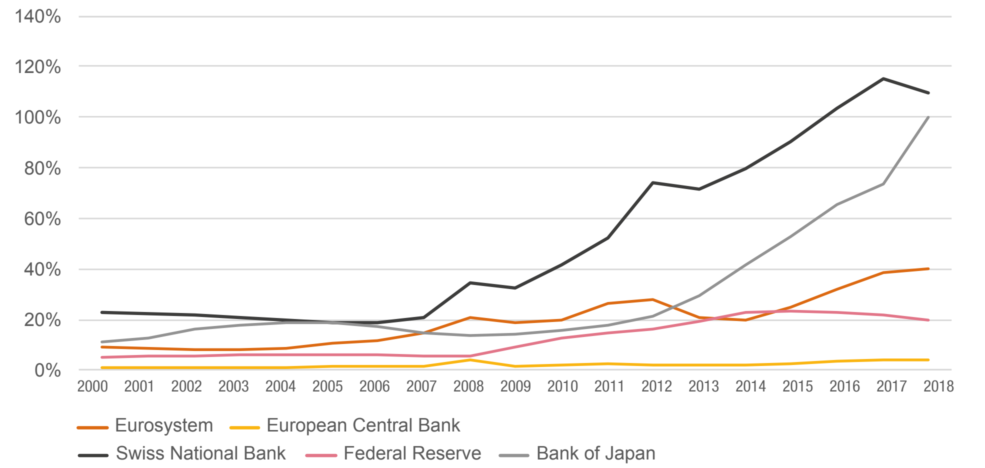


Figure 18 Government debt to GDP

Source: Oxford Economics

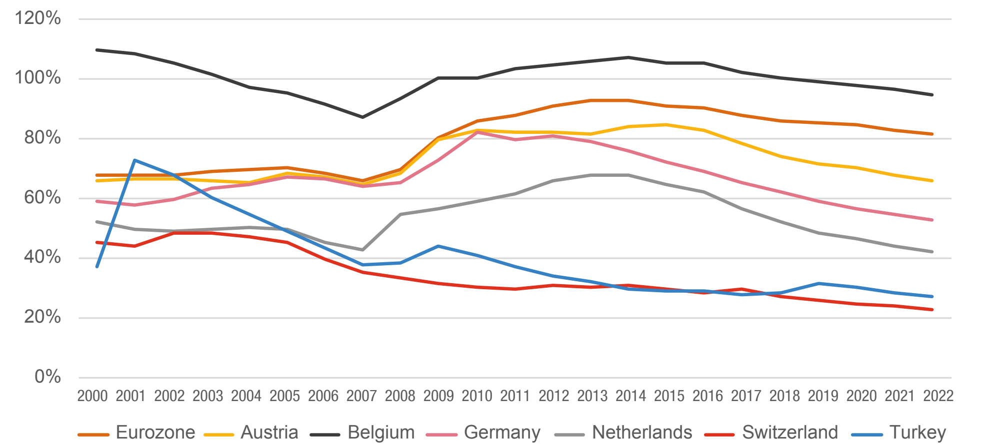
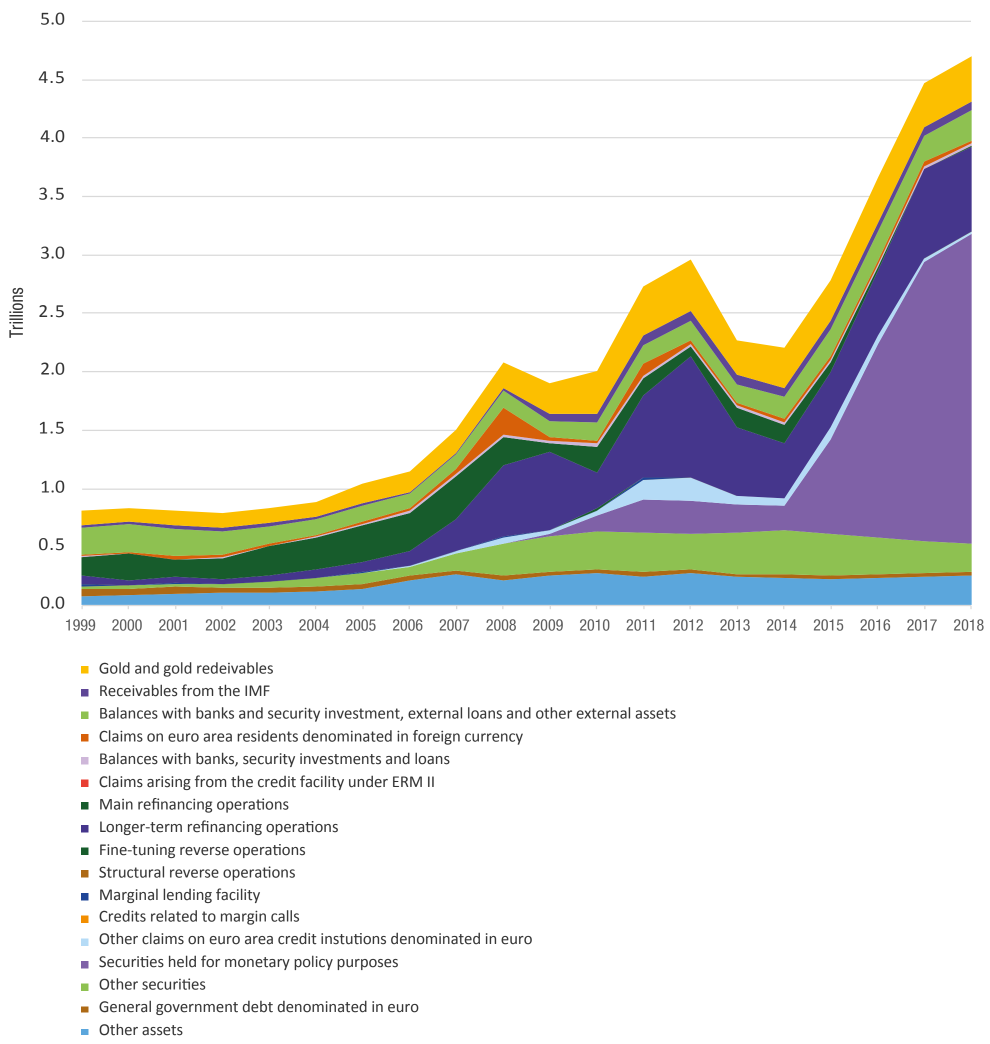


Figure 17 Annual consolidated balance sheet of the Eurosytem: Assets



This level of monetary easing has however resulted in a bigger Eurosystem balance sheet with a different asset composition[2]. The most noticeable development has been the jump in the amount of securities held for monetary policy purposes. These securities have been acquired as part of ECB's public sector purchase programme, corporate sector purchase programme, covered bond purchase programme, and asset-backed securities purchase programme. This is by no means limited only to the Eurozone, as the Swiss National Bank, the Fed, and the Bank of Japan have followed similar a similar route. *(Figures 16 and 17)*

Financial stability repercussions of monetary policy

Given the unprecedented character of the unconventional monetary policies, the ECB accepts that the longer-term effects are still unknown. Nevertheless, there are already signs that the current and most probably the future level of monetary easing has repercussions on financial stability. The following are a few of the externalities of such loose monetary policy: an increase in risk-taking as institutions search for yield, both from a credit-risk and a duration risk perspective; lower profitability of financial service entities that rely on interest bearing assets; inflated values of liabilities (and therefore smaller capitalization) for life insurers and pension funds; inflated values of assets; hampered price discovery and risk underpricing.

2 The Eurosystem is comprised of the European Central Bank and the national central banks of euro area Member States.

An expectation of ever-looser monetary policy is however not sustainable, given the existence of an effective lower bound on interest rates, a limit on ECB sovereign debt holdings of 33% per country, and the risk of market distortion. The ECB is expected to continue this path of monetary loosening, even though Lagarde is due to review ECB's monetary policy stance. An additional outcome of this review can be the inclusion of climate change considerations in ECB's monetary policy strategy, for which Lagarde is a proponent. Greener asset purchases or a favourable acceptance of green assets as collateral is a possible future outcome. The SNB is also expected to further loosen its monetary policy among fears of deflation and swiss currency appreciation.

Fiscal potential

With monetary policy reaching its limits, fiscal policy is increasingly seen as the way forward for boosting growth. The new ECB president, Christine Lagarde, has called for solidarity and a Keynesian fiscal expansion from the part of European member states that have fiscal leeway. As she acknowledges, there is a need for government investment "in a common future that is more productive, more digital and greener".

Government indebtedness in the Eurozone has been a hot topic since the European sovereign debt crisis and continues to be so. The proponents of fiscal expansion argue that it is the only way forward in an environment of trade uncertainty and low growth. The proponents of fiscal tightening argue that government debt levels are already too high and that higher government indebtedness will only add to the fragility of the real economy and financial system. The Stability and Growth Pact of the EU sets two hard limits on EU Member States: a budget deficit that cannot exceed 3% of GDP and national debt that cannot exceed 60% of GDP. While it is important to note the decrease in government debt that has taken place since 2015, Eurozone government debt to GDP levels are already breaching the 60% of GDP limit. The expected deleveraging of European governments in 2020 and beyond is supported by economic growth levels that exceed the interest rates payable on their outstanding debt. *(Figures 18 and 19)*

The case for an increase in government debt is only becoming stronger because of ultra-low government bond yields, which drive down debt service costs. This is especially important as fiscally stronger countries can raise debt at very low interest rates, while the resulting government spending can boost the Eurozone economy beyond these countries and therefore lessen the burden of fiscally weaker countries that would have to raise the same debt at more punitive interest rates. *(Figure 20)*

The Eurozone budget deficit levels, contrary to debt levels, are compliant with the Stability and Growth Pact limit of 3% of GDP. In fact, Eurozone countries such as Germany and the Netherlands, and Switzerland have had budgetary surpluses in 2019 and are expected to maintain these surpluses in 2020. Austria has managed to virtually eliminate its

Figure 19 Government debt to GDP year-on-year percent change

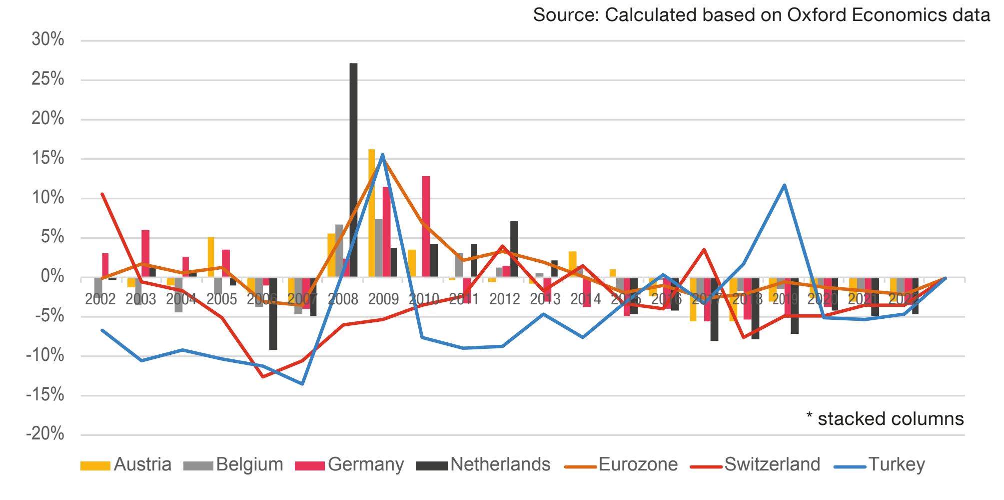


Figure 20 10 year government bond yield

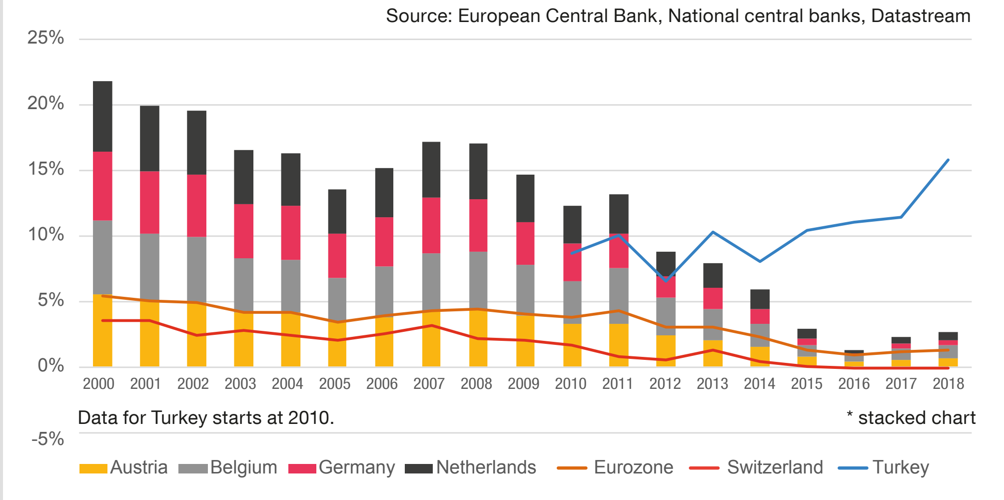


Figure 21 Government balance to GDP Source: Oxford Economics

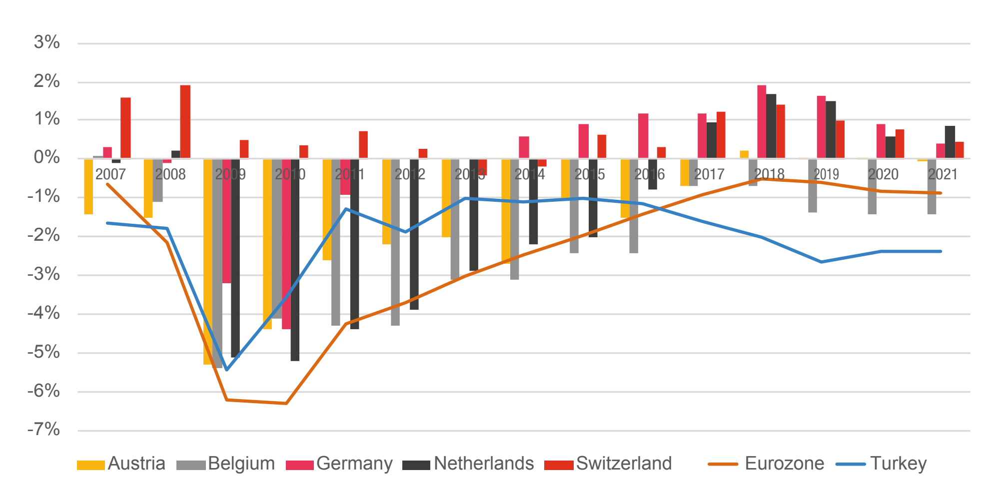


Figure 22 Current account balance to GDP Source: Oxford Economics

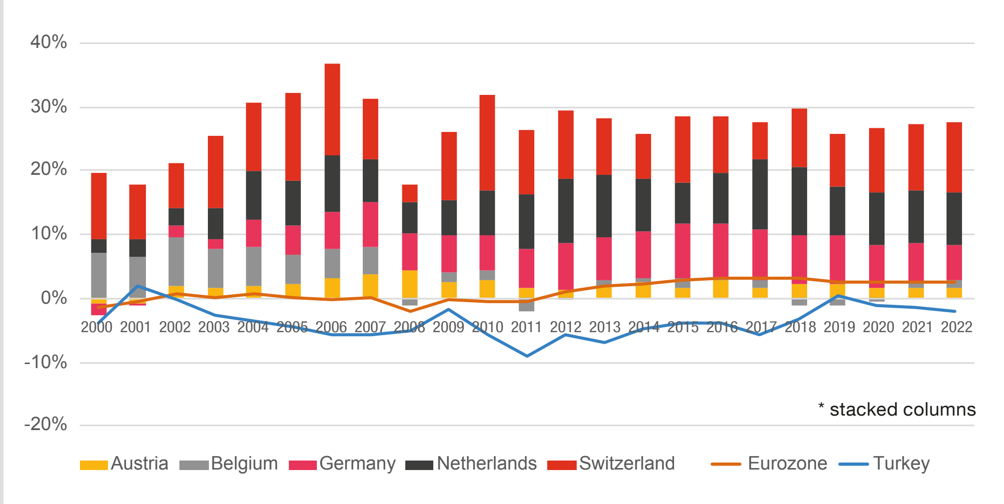


Figure 23 Credit to private non-financial sector as a percentage of GDP

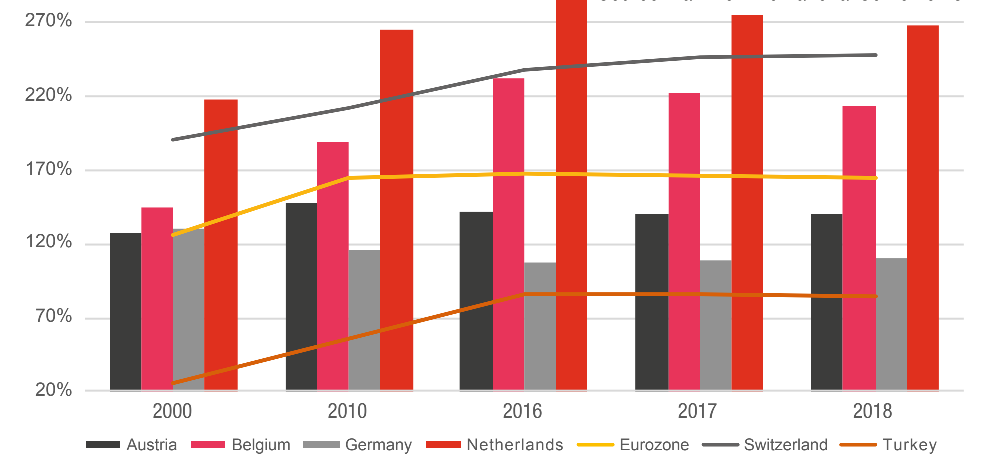


Figure 24 Household debt to income

Source: Eurostat, Central Bank of France

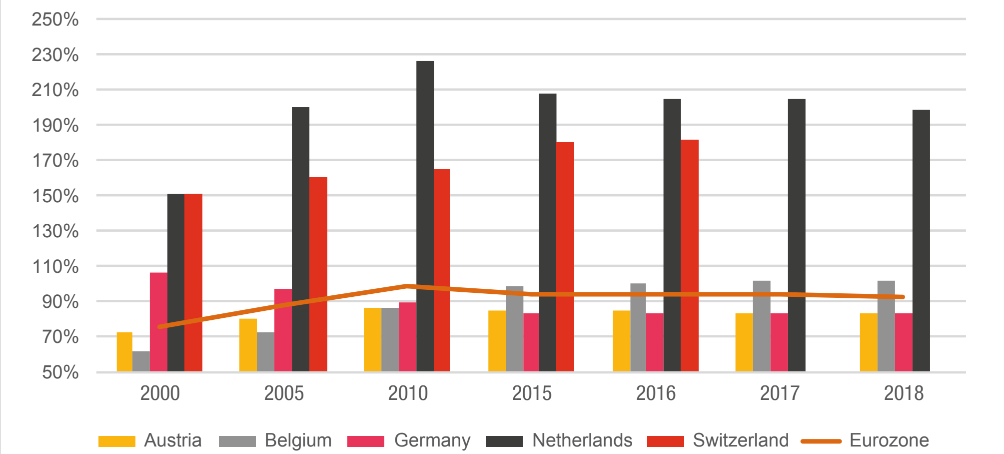


Figure 25 Household debt to income year-on-year percent change

Source: Calculated based on data from Eurostat and Central Bank of France

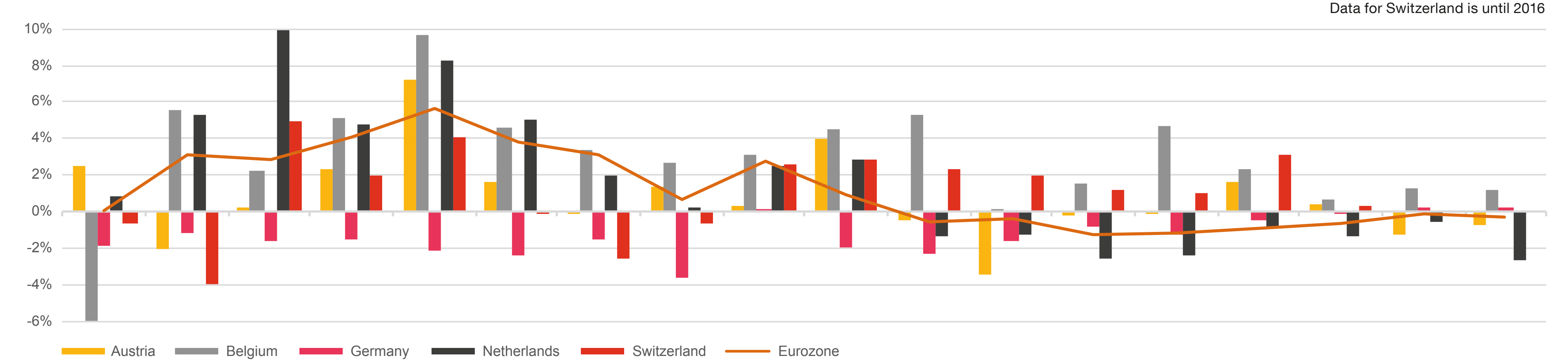


Figure 26 Household outstanding debt as a percentage of GDP

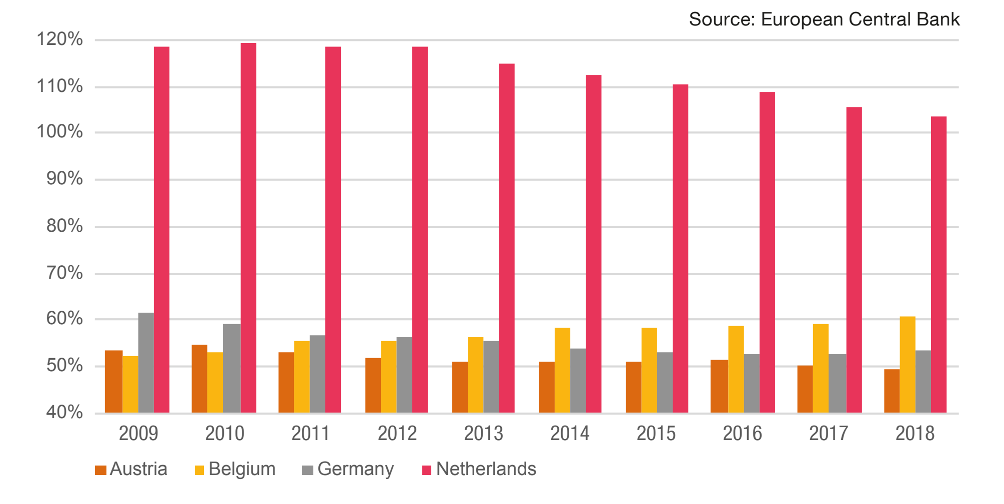
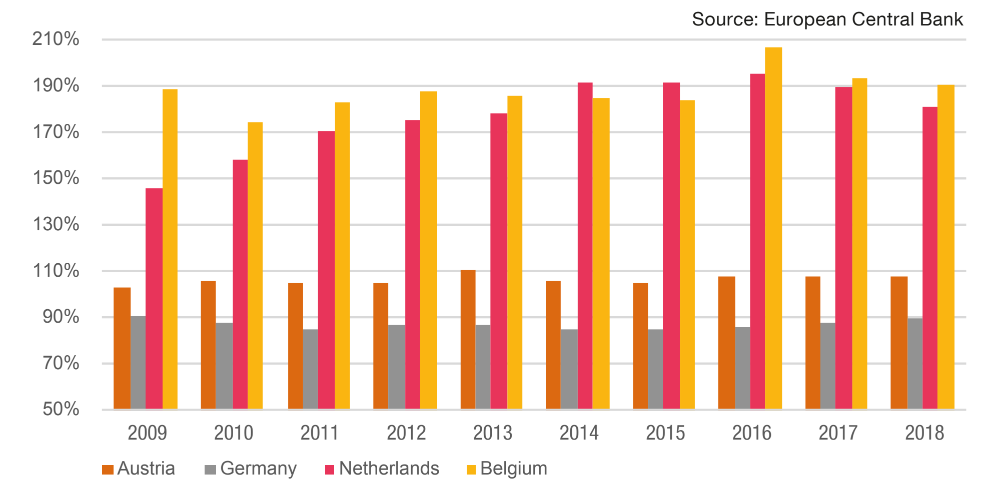


Figure 27 Non-financial corporation outstanding debt as a percentage of GDP



public deficit for the first time in decades. In countries such as Belgium, however, high levels of government debt and budget deficit do not leave much room to counter a crisis through fiscal expansion. Given the synchronized slowdown in growth, 2020 is expected to see increases in government spending, resulting in same or more (less) elevated levels of government deficit (surplus). Countries with a budgetary surplus, such as Germany and the Netherlands, already have 2020 spending plans on infrastructure and for social purposes. *(Figure 21)*

Positive current account balances for most Eurozone economies do not seem to have suffered much from the current global trade uncertainty and slowing global demand. For Turkey, a weaker lira and soft domestic demand are reducing imports while currency depreciation is boosting exports, thereby reducing its current-account deficit. Nevertheless, volatile capital inflows and high external repayment obligations still pose a risk in 2020. *(Figure 22)*

Looking ahead, aging populations with higher needs for healthcare and pensions could worsen the fiscal outlook of even fiscally robust countries.

Non-financial private sector indebtedness

While the stances on fiscal and monetary policy spark opposed views, the indebtedness of the non-financial private sector is more unanimously viewed as problematic and as something that needs to be contained. The existing low interest rate environment benefits most borrowers, as opposed to savers, and thereby encourages companies and individuals to borrow. The result is an increase in leverage, which intensifies vulnerabilities in downturns for both the borrowers and the creditors who must shoulder the losses.

Credit to private nonfinancial sector stands at historically high levels and relatively constant since 2016. While Eurozone credit to GDP stands at just above 160%, the Netherlands shows the highest ratio of around 270% and Germany shows the lowest ratio at around 110%. For Turkey the ratio is much lower. *(Figure 23)*

The household sector shows the most indebtedness in the Netherlands, with debt to income levels of around 200% and household outstanding debt to GDP levels of above 100%. Household debt to income has remained relatively constant since 2015. The Eurozone average debt to income level has stood at slightly below 100% since 2015. In the Netherlands, the high indebtedness can be partly explained by the existence of mortgage-linked savings accounts that can be used for mortgage repayment at maturity. This structure separates debt from down payments until the debt matures. Another important contributing factor is that 100% of a house price can be financed by means of a mortgage. *(Figures 24, 25 and 26)*

The non-financial corporate sector shows heightened levels of outstanding debt to GDP in the range of 190% for the Netherlands and Belgium, with a decreasing trend since 2016. Outstanding debt levels for corporates in Austria and Germany stand at half that range. *(Figure 27)*

The high levels of indebtedness may spell trouble, given that leverage accentuates vulnerabilities during an economic downturn or in times of crisis. High leverage levels also make it difficult for policymakers to decide on an increase in interest rates, which would most likely have the borrowers refinance at much higher rates and could lead to higher levels of defaults and economic challenges stemming from that. We expect that the leverage levels of the private non-financial sector will remain heightened in 2020, fuelled by ever lower interest rates caused by the sustained easing of monetary policy. Nevertheless, macroprudential policies aimed at financial stability are expected to tighten the limits on household indebtedness through the implementation of lower loan-to-value and debt-service-to-income ratios. ■

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