Why is the euro area slowing?
My Weekly column

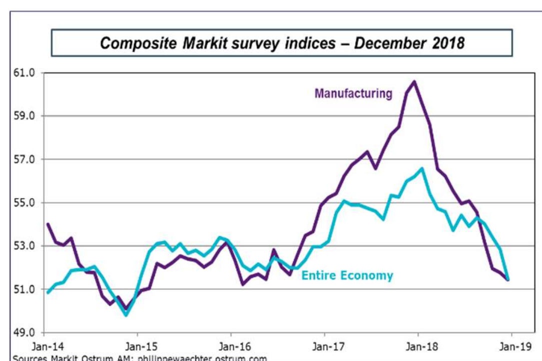
The euro area economy is slowing and could even see a contraction around the end of 2018 due to recessions in Germany and Italy, along with very weak momentum in France. The trend has changed at a faster pace than had been expected at the start of 2018, when the consensus was for similar trends to the very robust growth in 2017 i.e. no acceleration but continued swift economic growth. This pointed to expectations of more self-sustaining growth via jobs, income and investment, thereby driving a more independent trend that could safeguard some of the euro area's economy against potential external shocks.

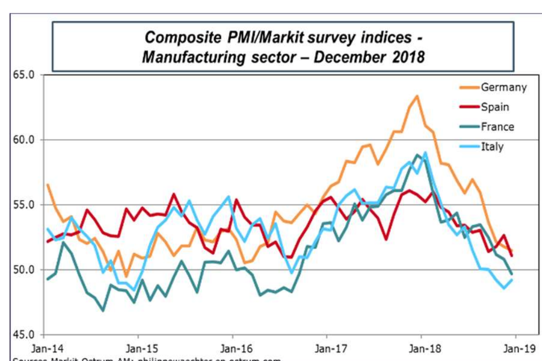
This quickening decline is worrying as the situation in a number of countries has gone from solid to shaky, for example Germany, where external trade is now hampering growth, along with Italy and France where domestic demand is no longer on the desired trend.

Why this perception of a swift deterioration in the euro area economy?

The first harbinger that all economic observers picked up on is the very swift deterioration in economic indices as measured by business leaders surveys. From a peak in the last quarter of 2017, the composite index slid swiftly and steadily right throughout 2018, failing to display a recovery. This trend is revealed in the euro area Markit manufacturing sector index, which slowed severely and sustainably in sync with world trade, with an accompanying drop in domestic and external orders.

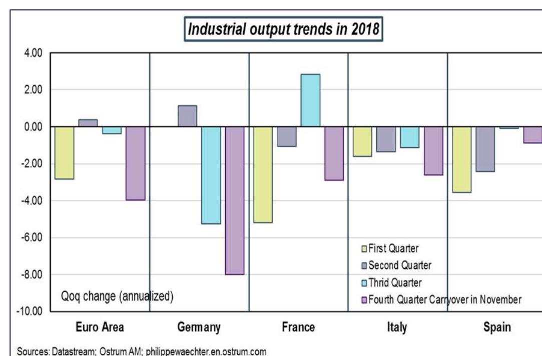
This is a real red flag considering the role the manufacturing industry plays in economic cycle momentum, acting as a source of impetus for the entire economy – a role that services do not play. This explains why economists focused so intently on this type of index right throughout 2018. We also see similar showings on individual country Markit surveys, but also on national surveys, such as INSEE and Ifo. Over the last part of the year, concerns heightened with the Italian Markit survey index moving into negative territory, followed by the French figure which went down the same path in December.





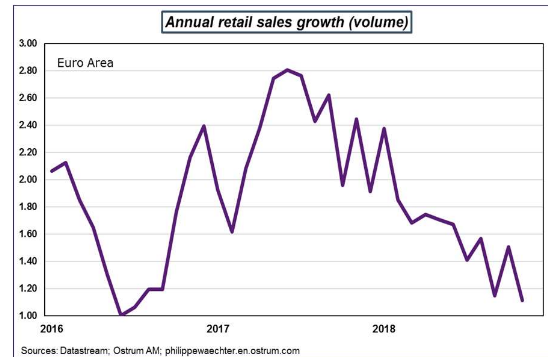
What about observed economic stats?

These surveys have not been overturned by concrete data. Each country's industrial output indicators declined – some of them severely – over the last quarter of the year i.e. October and November figures. Carryover growth for the last quarter in Germany at the end of November stood at -8% on an annualized basis, which is substantial. We can see on the chart that all countries saw a hefty drop in industrial activity right throughout the year, with local situations sometimes further exacerbating these effects e.g. the very swift drop in capital goods orders in France since November with uncertainties resulting from the country's social unrest.



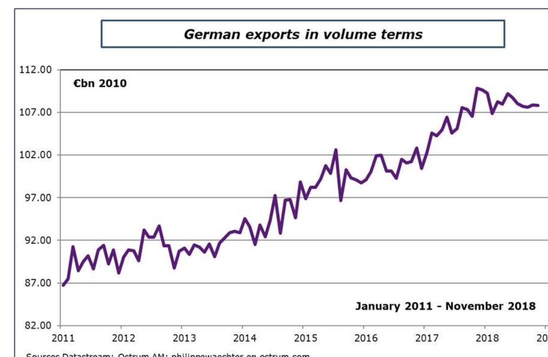
What about consumers?

At the same time, consumers are less optimistic, and spending is losing some of its spark as time goes on. After a high at the start of spring 2018, the consumer confidence indicator has dipped. It still stands above its historical average, but is now on a steep downward trend. Meanwhile household spending saw an acceleration in the first half of 2017 and the pace of growth has since slowed sharply to 1.1% yoy vs. 2.8% in mid-2017.



Does current behavior already reflect the slowdown in world trade?

We can see the downturn in external demand in German export trends. On this chart, we can see the impact of slowing world trade and the effects of factors denting international trade. External trade is hampering growth in volume terms in both the euro area and Germany.

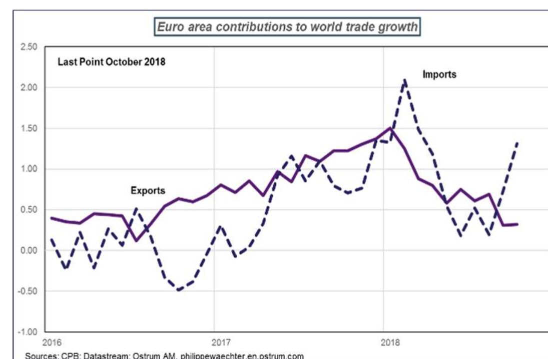


In other words, signs are all pretty much pointing in the same direction, showing that economic activity is not recovering?

Yes, absolutely.

What are the driving forces behind this change in pace?

The first is that growth in the euro area hit a peak at end-2017, and since then the pace has been slowing as it is unable to continue at the same rate. More sluggish economic activity therefore trimmed the bloc's contribution to world trade growth. Euro area exports hit a high in February 2018, then their contribution to world trade slowed drastically, and a less buoyant market meant fewer opportunities for countries in the area. Meanwhile the high for imports was in March 2018, so in other words, Europe's impact on world trade decreased right throughout the past year – the improvement enjoyed in 2017 was a thing of the past. This means that the euro area's trend was weaker, but other countries did not make up for this slower momentum either.



Did oil prices not play a part?

Rising oil prices played a key role in purchasing power trends. Energy's contribution to inflation in the euro area went from a negative -0.4% in 2016 to a positive 0.62% in 2018, while at the same time, core inflation remained flat at around 1%. So all inflation volatility was a result of energy prices, therefore making purchasing power highly dependent on oil prices.

Were any other factors involved?

The international climate also severely dragged down economic growth, with threats to world trade after US sanctions on Russia and Iran, as well as higher US tariffs, which triggered the risk of a trade war. Other events also hampered economic perception. The situation for many emerging markets changed in spring 2018, when the dollar's rise hit several countries in this category, while the slowdown in the euro area also had a knock-on effect as Europe is a key partner for many of them. Crises in countries with dollar-denominated debt weighed on trade momentum, thereby creating a feeling of higher risk worldwide.

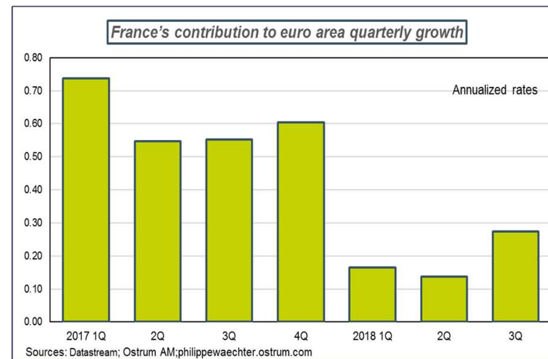
Everyone was on the same path in 2017 and there was a degree of coordination right across the world – albeit implicit. But throughout the year, this more coordinated and cooperative approach began to fall apart.

Beyond the fact that economic activity cannot go any faster due to technical factors, what are the reasons behind this faster-than-expected dip?

European growth was robust but very quickly ran up against physical limitations, which in France meant production capacity utilization rates. The striking point is that no attempts were made to shore up this momentum by coordinated policy across the euro area.

In this respect, France is an interesting example. At the start of 2018, the government decided to postpone part of the cut in employee payroll deductions for budget reasons.
Initially the increase in the CSG levy for employees in the country (which contributes to social security financing) was supposed to be more than offset by lower payroll deductions. But this obviously had a cost in budget terms, so the government decided to reduce these payroll deductions in two stages, firstly in January and then October. The immediate effect of this decision was a very severe drop in purchasing power in the first quarter of 2018.

The government's hypothesis, which was then confirmed by the upgrade in 2018 growth projections to 2%, was that the international context was sufficiently robust in the euro area to offset the hit from France. However, French growth slowed sharply in the first quarter, thereby dragging down growth across the entire area: by way of indication, the French economy's contribution to quarterly GDP growth fell from 0.6% (annualized) on average over the four quarters of 2017 to 0.16% in the first quarter of 2018. France thought that European momentum would see it through, and that it could hit two birds with one stone – benefit from growth and bolster its budget at the same time – but it did not work out this way as growth across all euro area countries was too swift at the end of 2017 as compared to capacity.



A number of other concerns then further hampered the situation in the euro area, with a new Italian government in May, providing a major source of stress as the change in perception of the Italian situation led to a swift rise in interest rates in the country and pushed Italy/Germany spreads wider. The economic situation in Italy deteriorated from summer 2018 onwards, especially on the labor market.
This trend recently got even worse with the decline in German trade as mentioned above. German trade opportunities dwindled, dragged down by the slowdown in world trade and most certainly by the effects of border tariffs, and Germany was no longer able to drive the impetus it previously had.
The three major economies in the area suffered problems that dented their economies right throughout 2018, and in the absence of sufficient contracyclical moves, shocks built up and made the economic decline even more severe.

How can economic policy be used to offset these trends?

Monetary policy continued to accommodate but there were no additional measures, while the approach was even restrictive at times, with the ECB announcing the end of QE for December 2018 and the beginnings of interest rate normalization by the fall of 2019.
Meanwhile looking to fiscal policy, the euro area public deficit continued to decrease from 1% of GDP in 2017 and move towards a balanced budget in 2018. The figure stood at 0.1% in the second quarter of 2018, and in its projections in the fall, the European Commission projected a public deficit of 0.7% of GDP.
The policy mix in the euro area is fairly restrictive as it does not fuel immediate demand to prop up economic growth.

What could happen now?

The first point is that the uncertainties weighing on the euro area have not disappeared. The issues of Brexit, growth and fiscal policy in Italy, the slowdown in world trade and more recently the extended US government

shutdown and social unrest in France all still remain, and we will need to keep a careful eye on these issues as uncertainty prompts investors to sit tight and wait.
The second point is that falling oil prices will lead to the transfer of purchasing power to households and companies, and this will help shore up economic activity. However, oil prices have only fallen moderately, and the $60 mark remains lofty compared with trends over the past five years – only 2018 saw higher prices.
The third point is that despite a robust dollar, the euro area economy's competitiveness has not really improved. Real exchange rates remained relatively flat and the strong impact on competitiveness in the euro area was limited.
The other point worth noting is that euro area growth is moving towards its potential rate. According to the ECB, the area's potential growth pace is around 1.5% – we are moving towards this figure. The real task now is to work out how to push beyond this rate on a long-term basis.
This also applies to France, where potential growth stands at around 1.3-1.4%, implying that purchasing power momentum cannot move beyond this figure on a long-term basis, so economic policy must remove this barrier to fuel higher growth on a sustainable basis and drive stronger job and income momentum. We can use income redistribution to a small degree, but France is already very egalitarian so there is not a great deal of scope for much more redistribution.
Economic policymakers have to choose between doing the utmost to improve potential growth in the future, or redistributing income that does not exist in the here and now with the risk that potential growth will remain too sluggish.

So we thought that growth in 2017 was the norm, but in fact the norm is more like 2019 than 2017?

Exactly! No answers have been found to the questions raised since then, and in the meantime fresh questions have emerged – uncertainty on a world scale, such as tension between China and the US on technological leadership, and local questions such as the impact of weaker growth in Europe and the lack of any real policy to address the issue.
As shown by Joachim Voth, phases of restrictive economic policy are marked by social unrest, which is why it is important to set the stage for stronger growth in the long term. This obviously requires innovation, but first and foremost it requires training and improved skills, and these are vital if Europe is to remain relevant in a world where it needs to be present but where it is gradually losing its grip.
Economic policy must aim to achieve the wherewithal to maintain growth around its potential rate, even if that means paying a bit less attention to cutting back the public deficit. Austerity is never a good bedfellow when the macroeconomic situation is shaky.

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