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EUROZONE GDP: AN ECONOMY OF TWO WORLDS

Berenberg Macro Flash

Eurozone GDP, Q4 2018 (in %)

	qoq	yoy
Actual:	**0.2**	**1.2**
Previous:	0.2	1.6
Consensus:	0.2	1.2
Berenberg:	0.2	1.2

Tepid finish: In its 23rd consecutive quarter of growth Eurozone GDP expanded by 0.2% qoq (0.22%). Overall, Eurozone growth disappointed in 2018, relative to early expectations. Instead of merely softening to a more sustainable annual pace of close to 2% over the course of the year, growth sank from almost 3% yoy in late 2017 to 1.2% in Q4 2018 – below the 1.5% trend rate (see chart 1).

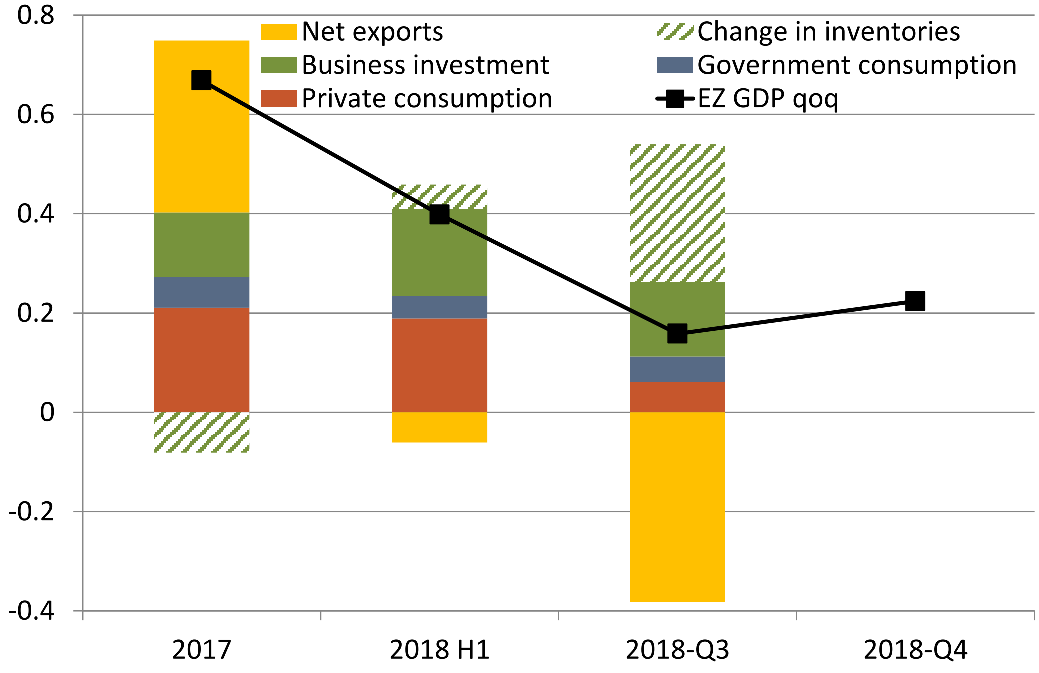
Two worlds: Eurostat does not provide an expenditure-based breakdown of the GDP data until the third reading (published on 7 March). Without the breakdown of spending, we can only go by the trends in other data series and surveys to judge beyond the headline growth rate exactly how the underlying components of the Eurozone did in the final quarter. These data show two worlds within the Eurozone economy, one which is currently struggling and another that is doing ok. Businesses that are selling stuff overseas, big-ticket items, and manufacturing goods are faring badly. In Q4, industrial production probably fell by 1% qoq and imports likely outpaced exports. The other part of the economy that depends on domestic consumption and provides services is holding up. We expect retail sales to have increased by 0.8% qoq and consumers' expenditures by more than the overall economy.

The economic logic is clear: Throughout 2018 the number of external shocks, political risks and home-grown problems (weather, flu, US-Chinese trade tensions, oil, EM weakness, Chinese slowdown, hard Brexit risk, Italian budget woes, German car sector, French yellow vest) only increased. This has caused the Eurozone business cycle to slow down. Sentiment has turned dimmer and the risk is that negative animal spirits begin to spiral further downward dragging the Eurozone into a serious, protracted downturn. Some of these headwinds blow more forcefully than ever before, while others have started to wane, most noticeably the oil price which has turned into a mild tailwind recently. Lower oil prices should give domestic demand, especially private consumption a kicker. Domestic demand has remained more robust throughout 2018 thanks to the smoothing nature of consumption and the strong labour market that drives disposable incomes higher. The Eurozone labour report for December showed that the unemployment rate was steady at its 10-year low of 7.9% while the number of unemployed workers continues to fall at a steady rate.

Italian recession: On a country basis, Germany and Italy have been a drag to the rest of the Eurozone. Germany's car sales problem seems more of a temporary nature, though, with the domestic fundamentals looking still very solid. The more than 4% mom drop in December retail sales is an eye-catcher, but should not be overstated as the monthly data is very volatile. Also, the mom December change has been revised by about 2.5ppt on average. The German economy probably rebounded a bit to growth of 0.1% qoq after an 0.2% contraction in Q3. Meanwhile, Italy's slide into a recession – GDP data showed the economy declined by 0.2% qoq in Q4 after a contraction of 0.1% in Q3 already – is much more worrisome, particularly as the outlook does not look sunny, to put it mildly. For Italy, the on-going recession is the third recession in 10 years. The country's radical government clearly adds to the challenging external environment. Portugal and Spain held up well despite the softness elsewhere. Spanish real GDP growth accelerated from 0.6% qoq in the first three quarters to 0.7% in Q4. The French economy largely grew at Eurozone trend, with a positive trade-driven surprise in Q4.

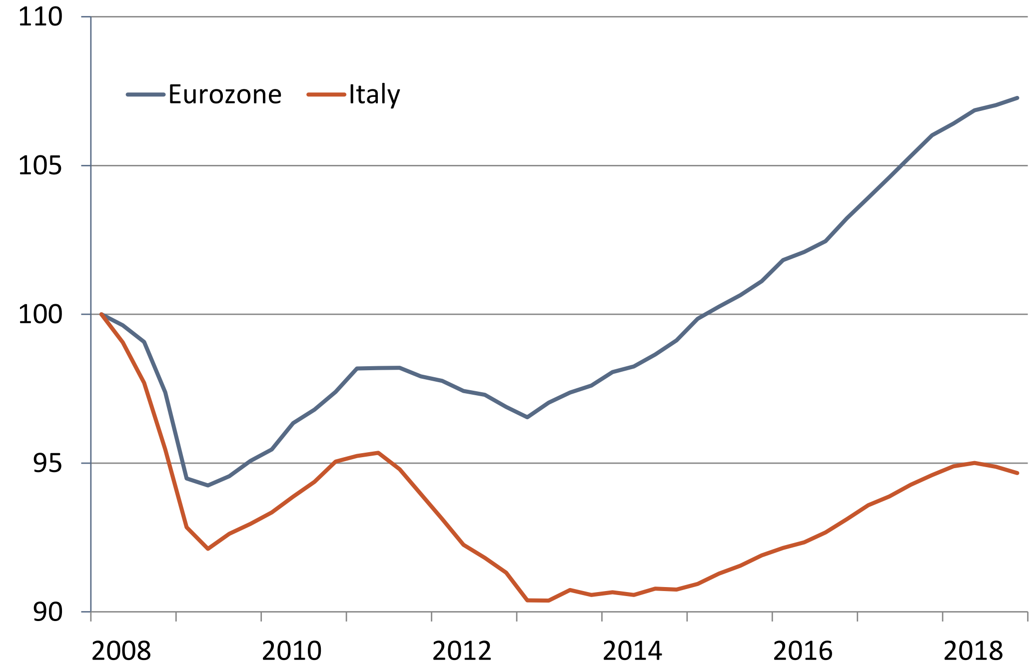
Going forward – slowdown or recession? A longer and deeper than expected slowdown remains the most likely scenario for the Eurozone economy, but it probably gets worse before it gets better. The Eurozone PMIs, German Ifo and other indicators of sentiment and activity will likely be downbeat, and, thus, also GDP in Q1 – we forecast a mere 0.1% qoq for growth. But a brighter spring could follow a grey winter. If by spring the current headwinds start to fade and make way to the still-solid domestic fundamentals, Eurozone growth could return to a healthier rate of around 0.4% qoq from Q2 or Q3 onwards. But for now, the risks are tilted to the downside.

Chart 1: GDP growth and its contributions to growth



Qoq GDP growth in %, contributions in %-points. No breakdown for Q4 2018. Source: Eurostat

Chart 2: Eurozone vs. Italian GDP since peak of previous cycle



Indexed at Q1 2008 = 100. Source: Eurostat

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