Economic Research:

The Eurozone's Open Economy Makes It More Vulnerable To Escalating Trade Conflicts

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Key Takeaways

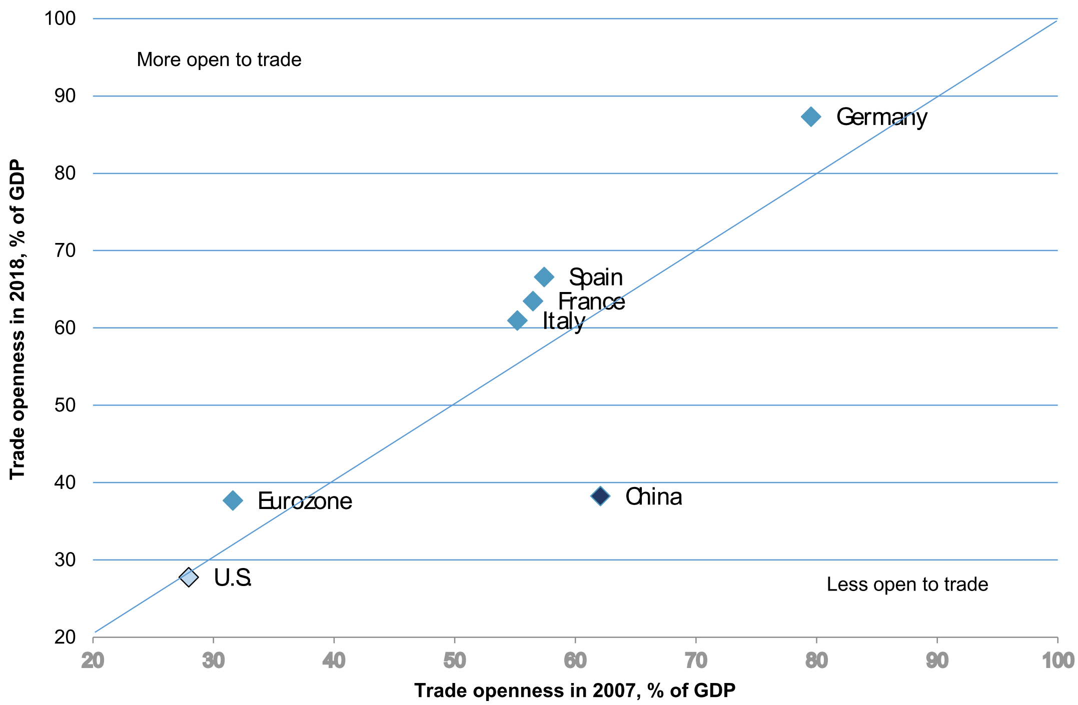
- The deceleration in global trade explains almost all of the slowdown in the eurozone economy since 2017.
- Global trade has slowed more because of a tightening of Chinese policy than because of rising trade protectionism. That may be starting to change.
- Internal demand remains strong in the eurozone but could start taking a hit from weakness in external demand if trade continues to grow slowly.
- We forecast eurozone GDP growth of 1.1% this year and 1.3% next year and continue to expect Germany and Italy to underperform due to their reliance on external demand.
- The ECB will have to adjust its forward guidance and keep rates on hold at least until second-quarter 2021 as downside risks persist. It could even ease financing conditions further if the economy and inflation disappoint.

Eurozone Economies Are More Exposed To Trade Than U.S. And China

The eurozone economy has been taking a hit from the slowdown in global trade. Almost all of the economic slowdown since 2017 stems from weaker exports. In contrast to the U.S., the eurozone economy is more open to trade (see chart 1). While China has sought to rely more and more on domestic demand for growth since the Great Recession, the eurozone has done the opposite, increasing its exposure to trade outside the European Monetary Union that is now almost equal to that of China (see chart 2). This greater integration in global value chains makes the eurozone economy more vulnerable to the global slowdown in trade. Indeed, S&P Global Ratings' economists forecast eurozone GDP growth of 1.1% this year and 1.3% next year and continue to expect Germany and Italy to underperform due to their reliance on external demand for growth (see table 1 at the end of the article).

Chart 1

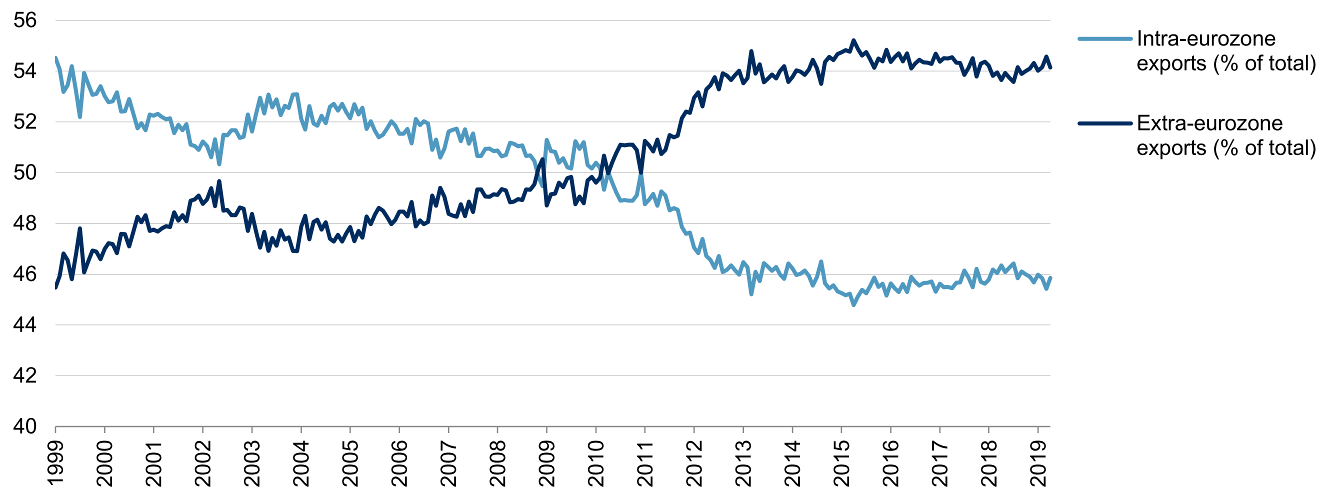
Europe Is Increasing Its Exposure To Trade, Unlike Its Main Trade Partners



Note: Trade openness is defined as the sum of imports and exports over GDP; for the eurozone, trade openness doesn't include intra-eurozone trade. Sources: Eurostat, Oxford Economics, S&P Global Ratings.

Chart 2

The Share Of Intra-Eurozone Trade In Total Exports Has Diminished



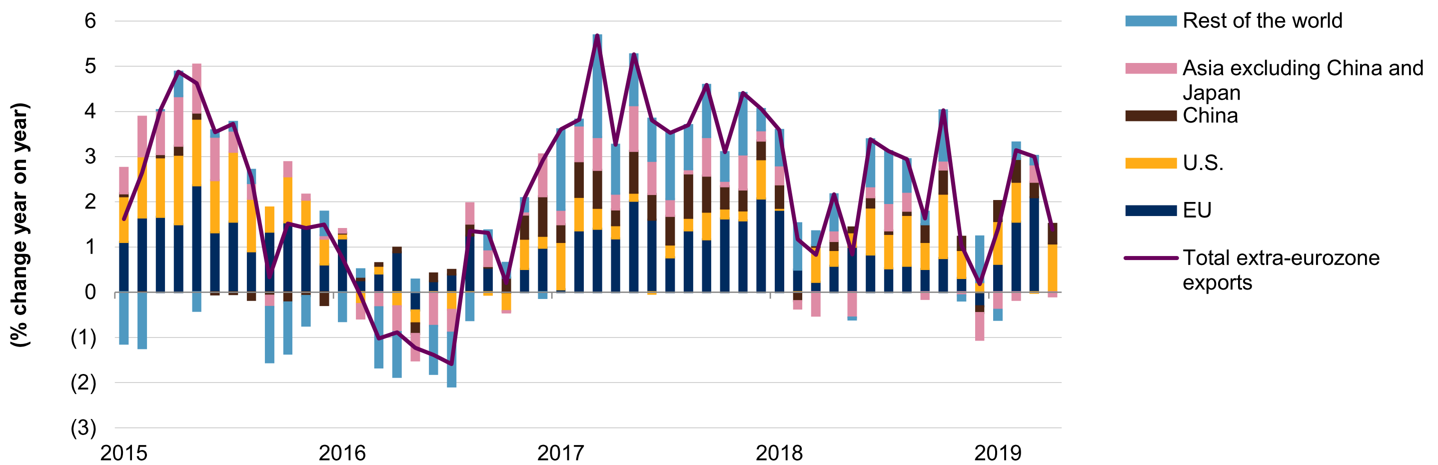
Sources: Eurostat, S&P Global Ratings.

U.S.-China Trade Tensions Are Not (Yet) Responsible For The Slowdown In Global Trade

So far, it is not higher trade tariffs between the U.S. and China but the slowing Chinese economy that has weighed on global trade. We see evidence for this by looking at which countries have contributed to the growth of eurozone exports (see chart 3). Faster economic growth in the U.S. actually helped dampen slowing demand from China in 2018.

Chart 3

The Slowdown In China Has Been The Main Driver Of Weaker External Demand
Contribution to growth in eurozone exports by destination



Sources: Eurostat, S&P Global Ratings

Nonetheless, the U.S. and China are the eurozone's two largest trading partners. If the direct effects of trade tensions have been benign, not least thanks to more dovish central banks, a further escalation of trade tensions could start dampening U.S. growth prospects as well, which could translate into weaker exports for the eurozone. As such, we are concerned that second-round effects from U.S. tariffs may be contributing to a weakening in U.S. business investment and consumer spending (see "For The U.S. Expansion, Are Trade Troubles "Just A Flesh Wound"?" June 25, 2019).

Surveys show that sentiment about eurozone industry and the Chinese economy are just stabilizing--not ticking up--suggesting we are unlikely to see a large rebound in global trade yet (see chart 4). Thus, external demand will more likely stabilize than strengthen in the eurozone this year. In this context, Germany and Italy will continue to underperform the eurozone, as they are more reliant on external demand for growth than France and Spain (see chart 5).

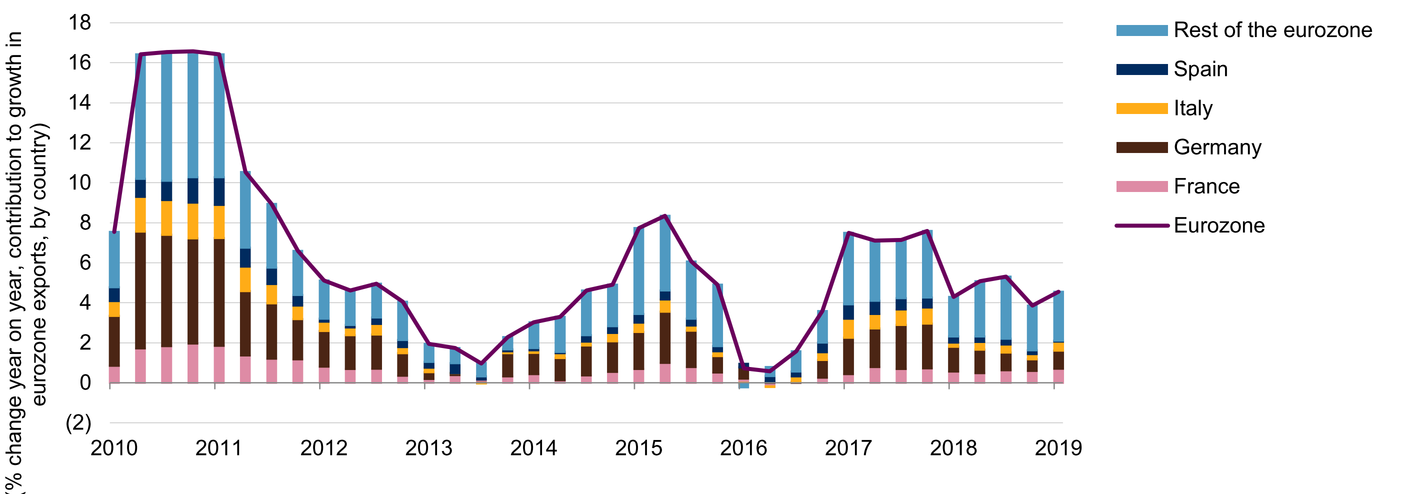
Chart 4

Survey And Activity Data Suggest World Trade Is Unlikely To Rebound This Year

Note: The forecast is based on a factor model using manufacturing survey indicators, commodity prices, financial market indices, the U.S. dollar and indices of global trade. Sources: CPB, Bloomberg, Datastream, S&P Global Ratings' calculations.

Chart 5

Germany Has Contributed To 30% Of Eurozone Export Growth Since 2010



Sources: Eurostat, S&P Global Ratings.

Eventually, A Weak Manufacturing Sector Will Hurt Domestic Demand

The slowdown in global trade occurred when the eurozone economy was overheating, which means that internal demand is set to continue supporting growth. The labor market has lost little of its dynamism, creating more than 500,000 jobs per quarter since 2018. Vacancy rates remain high and wages are rising at their fastest pace since 2011, all supporting household consumption. Companies continue to report above-average capacity utilization and equipment as a constraint to production. This suggests they should continue investing to expand production capacity amid loose financing conditions.

For now, we expect domestic demand to hold up. As a result, we see the eurozone expanding by 1.1% this year and 1.3% next year. But eventually, a weak industrial sector and external demand will translate into weaker internal demand. Adjusting to lower export prospects and continued uncertainty around global supply chains, exporters could start scaling down investment and job creation. We find that a 1% drop in exports leads to a 0.15% drop in domestic demand. Therefore, we find that the export slowdown shaved only 0.3 percentage point off domestic demand in 2018, and our forecast suggests it is set to dampen domestic demand by only 0.03 of a point this year.

The ECB Is Unlikely To Raise Rates Until Mid-2021 Amid Downside Risks To Growth

The ECB will maintain a dovish stance in an environment of downside risks to growth (for example, U.S.-China trade tensions, a possible increase in U.S. tariffs on EU cars, Brexit, and the Italian budget law) and low inflationary pressures (core inflation is still hovering around 1%). We think it won't raise rates until at least second-quarter 2021, which would thus delay the potential downsizing of its balance sheet to the end of 2022. Moreover, ECB President Mario Draghi's speech in Sintra last week highlighted that the ECB was ready to act if downside risks start materializing and inflation struggles to strengthen toward 2%. As such, we see a scenario where if the Fed cuts rates--as we, markets, and the Fed's dot plot expect--the ECB may have to move to ensure the euro does not strengthen markedly and acts a buffer to the external weakness we're seeing so that financing conditions remain loose.

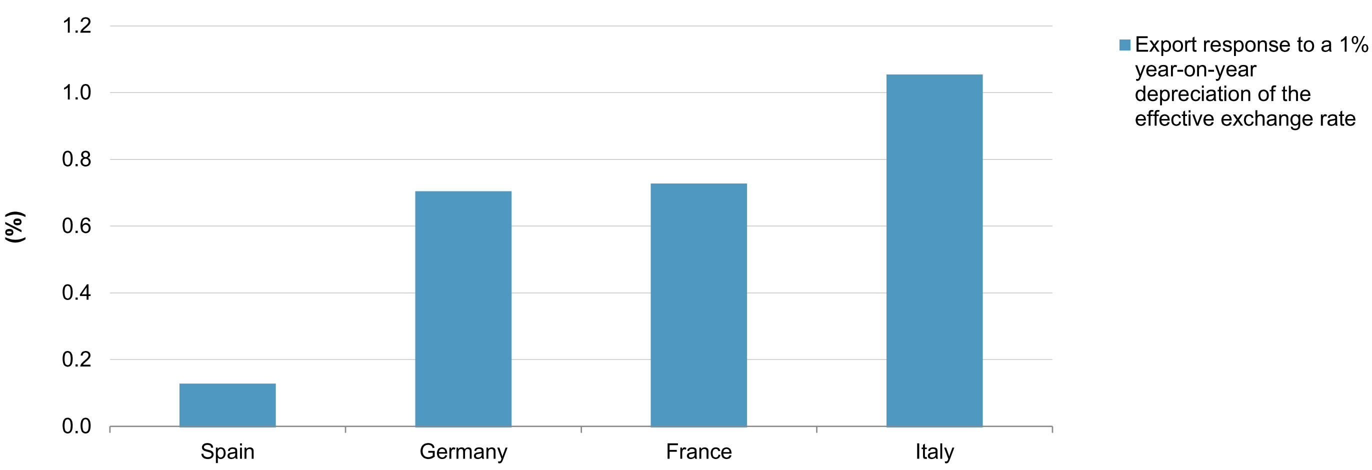
There are a couple of things the ECB could do:

- Adjust its forward guidance to delay rate hikes further out than mid-2020 or scrap a date element altogether.
- Cut rates by another 10 basis points and thus possibly introduce a tiering of the deposit rate for banks to limit the impact of negative interest rates on banks' profitability and with it, monetary policy transmission.
- Ease the terms of the third round of targeted longer-term refinancing operations (TLTRO III), by setting the lowest achievable interest rate equal to the deposit rate (it is currently at 10 basis points above).
- Launch a new round of quantitative easing, which would mean tweaking the 33% issuer limit so that the ECB does not run into low supply issues for specific sovereigns.

For now, we think the ECB will change its forward guidance and that amendments to the TLTRO III program and a rate cut are more likely if the economy, inflation, and financing conditions disappoint. Against this backdrop, we expect the euro to remain weak and offset some of the slowdown in external demand (see chart 6).

Chart 6

A Weak Euro As A Buffer: Eurozone Exports Respond Positively To A Weaker Euro



Sources: Oxford Economics, S&P Global Ratings' calculations.

Table 1

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

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2018	1.5	1.7	0.7	2.6	2.6	1.4	1.9	1.4	2.6
2019F	0.6	1.4	0.1	2.3	1.7	1.2	1.1	1.2	1.3
2020F	1.1	1.4	0.5	1.9	1.6	1.4	1.3	1.4	1.4
2021F	1.2	1.4	0.7	1.7	1.5	1.4	1.3	1.3	1.4
2022F	1.1	1.4	0.8	1.5	1.4	1.4	1.3	1.8	1.4
CPI inflation (%)									
2018	1.9	2.1	1.2	1.7	1.6	2.3	1.8	2.5	0.9
2019F	1.4	1.1	0.8	1.0	1.8	1.6	1.2	1.8	0.7
2020F	1.7	1.1	1.0	1.5	1.1	1.7	1.3	1.7	0.6
2021F	1.8	1.1	1.2	1.5	1.8	1.8	1.4	2.4	0.7
2022F	1.9	1.5	1.4	1.7	1.8	1.9	1.6	1.8	0.9
Unemployment rate (%)									
2018	3.4	9.1	10.6	15.3	3.8	6.0	8.2	4.1	2.6
2019F	3.2	8.8	10.3	13.8	3.3	5.7	7.7	3.8	2.7
2020F	3.2	8.8	10.1	13.0	3.2	5.7	7.5	4.2	2.8
2021F	3.1	8.7	10.0	12.3	3.2	5.6	7.3	4.5	2.8

Table 1

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

2022F	3.0	8.7	9.9	11.9	3.2	5.6	7.2	4.6	2.8
10-year bond yield (yearly average)									
2018	0.4	0.8	2.6	1.4	0.6	0.7	1.1	1.5	0.0
2019F	0.0	0.4	2.7	1.2	0.2	0.5	0.8	1.2	-0.3
2020F	0.4	0.9	2.8	1.6	0.6	0.9	1.2	1.6	-0.1
2021F	0.8	1.4	2.9	2.0	1.0	1.4	1.5	1.9	0.2
2022F	1.2	1.8	3.3	2.5	1.4	1.8	1.9	2.3	0.6

Central banks policy rates (yearly average)

	Eurozone	U.K.	Switzerland
	ECB	**BOE**	**SNB**
2018	0.00	0.60	-0.75
2019F	0.00	0.75	-0.75
2020F	0.00	0.91	-0.75
2021F	0.10	1.16	-0.50
2022F	0.50	1.41	0.00

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	1.13	1.29	1.14	1.00	1.13
2020F	1.15	1.31	1.14	1.00	1.16
2021F	1.20	1.40	1.16	0.97	1.17
2022F	1.24	1.47	1.18	0.94	1.17

F--S&P Global Ratings' forecast.

This report does not constitute a rating action.