

ECOWEEK

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Eurozone: what does weakening sentiment tell us about growth?

■ The European Commission now expects 1.3% growth for the eurozone this year, down from 1.9% in its previous forecast ■ This downward adjustment doesn't come as a surprise, considering the declining trend of several survey indicators ■ The recent performance of these indicators in tracking GDP growth is mixed, which makes the assessment of the current growth momentum challenging

The European Commission has joined the IMF and private sector forecasters in revising downwards the growth outlook for the eurozone this year. GDP is now expected to grow 1.3% versus a previous forecast of 1.9%. The revision is significant and reflects, amongst other factors, trade tensions, slower foreign growth, in particular in China, Brexit uncertainty. By coincidence, on the very same day that the Commission published its Winter Forecast, the Bank of England cut its forecast for UK growth this year from 1.7% to 1.2%, which corresponds to the weakest level since 2009. The cost of Brexit uncertainty becomes increasingly visible. These forecast revisions don't come as a surprise: after all, survey indicators had been declining for several months in a row. This is illustrated in the charts which show three important indicators for the eurozone: the European Commission economic sentiment index (ESI), the Markit purchasing managers index for the manufacturing sector (PMI) and the IFO economic climate, which reflects the sentiment of economic experts. Part of the disappointment of the downward adjustments may come from expectations which simply had risen too high: at the end of 2017, there was increasing concern about a possible gap between soft data (survey indicators) and hard data (GDP). In order to assess this, a GDP estimate has been constructed based on the historical relationship between survey indicators and realised GDP. In this respect, chart 1 shows that the European Commission's ESI overestimated growth in 2017 and 2018.

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Economic scenario

ECONOMIC RESEARCH DEPARTMENT

EUROZONE ECONOMIC GROWTH AND SENTIMENT (ESI)

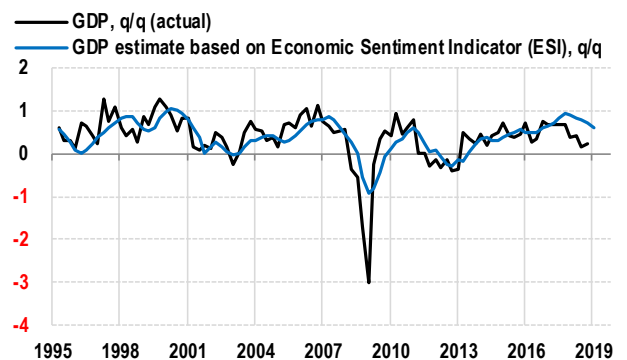


Chart 1

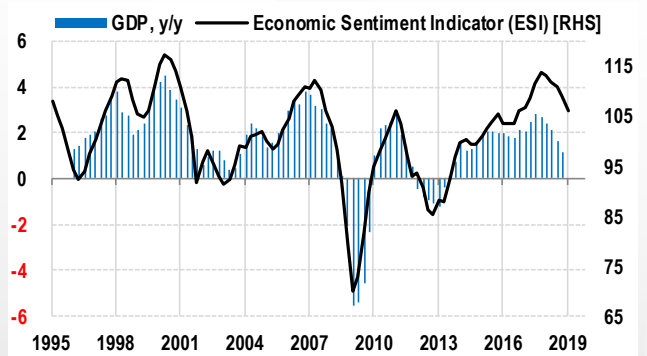


Chart 2

Source: Datastream, DG ECFIN, BNP Paribas

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A similar conclusion applies when using the PMI (chart 3) although the gap has now closed. The IFO indicator tracked growth pretty well in 2018 (chart 5)

These relationships help to put the recent survey indicators into perspective. Despite its decline since the end of 2017, the ESI is still at a rather high level but its recent tendency to overestimate growth implies that we shouldn't be too upbeat about the still high level of the index. Following its big drop last year, the IFO index has now reached a particularly low level, which would not bode well for growth at the start of this year. On the other hand, the current level corresponds to the one last seen during the eurozone sovereign crisis. Clearly, the determinants of final demand and the financial and monetary conditions were then far worse compared with today. This provides hope that sentiment would start to stabilise although this essentially

depends on whether the external headwinds (Brexit, trade, China) will start to lose power. Finally, it is worth referring to recent research by the Bank of England which suggests "that during periods of high uncertainty the relationship between survey responses and GDP growth weakens"¹. This would imply that in the current environment, which is characterised by a high level of uncertainty, greater caution is needed when interpreting the signal coming from survey data.

William De Vijlder

¹ Bank of England, Inflation Report February 2019, p. 11

EUROZONE ECONOMIC GROWTH AND PMI MANUFACTURING

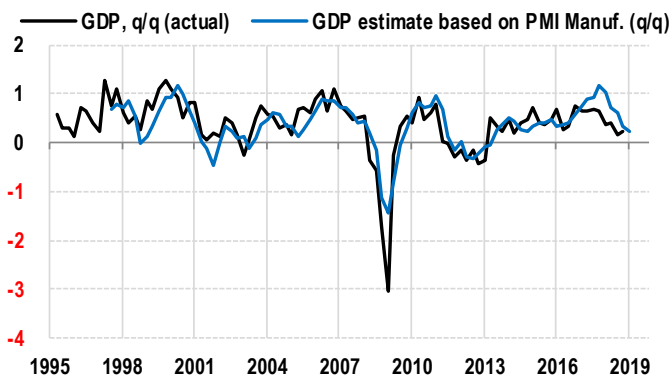


Chart 3

EUROZONE ECONOMIC GROWTH AND EUROZONE IFO

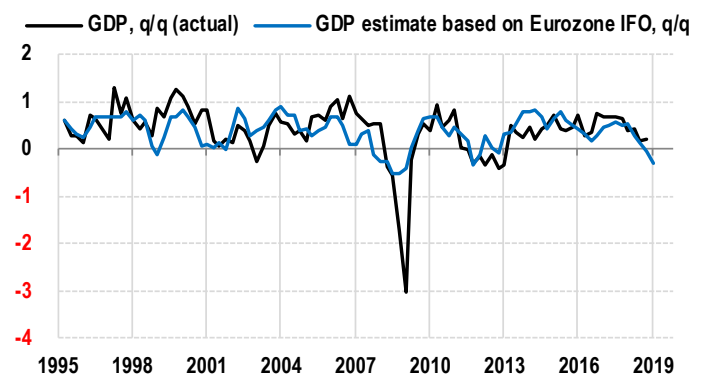


Chart 5



Chart 4

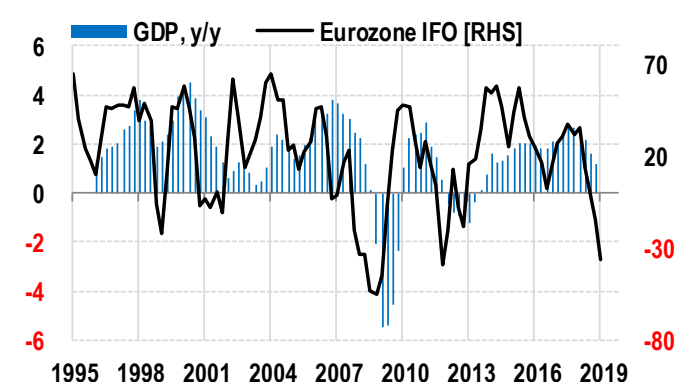


Chart 6

Source: Datastream, Markit, BNP Paribas

Source: Datastream, IFO Institute World Economic Survey, BNP Paribas

