

European Economics Analyst

European Outlook – Recovery fatigue

GS MACRO OUTLOOK 2019

Andrew Benito
+44(20)7051-4004 |
andrew.benito@gs.com
Goldman Sachs International

- **Overview.** The impulse from past tailwinds to growth faded this year and the acceleration in Euro area activity is behind us. Slack, on traditional measures, has been almost fully absorbed, leaving less room to grow. A rotation from external to domestic demand is under way, but that rotation has been partial and so some 'recovery fatigue' has set in. The additional cost and price pressures that come from a more mature recovery are likely to emerge only slowly.
- **What has changed.** We expect the partial rotation from external to domestic demand to continue for the Euro area as a whole, but to falter in Italy. There, we expect financial pressures – including through wider sovereign spreads – to prevent the government's planned fiscal easing from supporting GDP growth. Italy is therefore the source of our downwardly revised 2019 outlook. Our Euro area growth forecast has been lowered by 0.2pp to 1.6% in 2019, and compares with annual growth of 1.9% in 2018.
- **What has not changed.** The fading impulse from the drivers of last year's acceleration in activity continues to shape the outlook, together with the narrowing margin of spare capacity. We expect sequential growth rates only marginally above the rate of growth of potential output, which we estimate at 1-1½% p.a. Our view of "stubbornly weak" core inflation also remains intact.
- **Subdued core inflation and the ECB.** Above-trend growth reassures the ECB that inflation will move back towards its target, sustainably. This hurdle of above-trend growth is still just about met in our forecasts. It justifies the ECB's forward guidance to keep interest rates on hold "through the summer of 2019". We believe this still points to a rate rise in 2019Q4, although the risk of delay into 2020H1 has increased with our downward revision to the outlook. We expect the ECB to cater for faltering demand growth in Italy, and funding pressure at some banks, by implementing a T-LTRO in 2019H1.
- **Economic risks to the downside.** Downside risks continue to apply from **Italy**, from global trade tensions and from **Brexit**. While we assume the **UK** and EU-27 will implement an orderly departure for the UK from the EU in end-March 2019,

political uncertainty is clearly high. An extension of the Article 50 negotiation may prove necessary and there remain risks of a disorderly Brexit. These risks have increased since the summer. The broader populist challenge to Europe's political mainstream will be ongoing – including at European Parliamentary elections in May. This makes the prospect of much deeper integration (and a more workable monetary union) a remote possibility through the year ahead, and indeed for some time beyond.

Exhibit 1: Our European outlook for GDP growth and inflation

	2018		2019		2020		2021		2022	
	Growth	Inflation	Growth	Inflation	Growth	Inflation	Growth	Inflation	Growth	Inflation
Euro area	1.9	1.8	1.6	1.3	1.6	1.2	1.5	1.4	1.4	1.4
Germany	1.7	1.8	1.9	1.4	1.6	1.4	1.3	1.6	1.2	1.6
France	1.6	2.1	1.7	1.3	1.6	1.2	1.7	1.3	1.8	1.2
Italy	1.0	1.3	0.4	1.1	1.1	1.2	1.0	1.2	1.0	1.2
Spain	2.5	1.8	2.3	1.3	2.1	1.3	2.0	1.4	1.5	1.4
UK	1.3	2.5	1.5	1.9	1.4	1.9	1.6	2.0	1.7	2.0
Sweden	2.5	2.3	2.3	2.3	2.2	2.0	2.0	2.2	1.9	2.1
Norway*	2.4	1.5	2.3	2.1	2.2	2.1	2.2	2.1	2.1	2.1
Denmark	1.0	0.8	1.9	1.2	1.8	1.4	1.5	1.6	1.5	1.8
Switzerland	2.8	1.0	1.3	0.6	1.6	0.9	1.9	1.1	1.8	1.4

*Mainland GDP

Source: Goldman Sachs Global Investment Research

European Outlook – Recovery fatigue

A decelerating recovery. Europe's acceleration in activity faded this year as the impulse derived from past growth tailwinds faded. The surprise in 2017 had been the length and strength of the growth 'sweet spot'. In 2018, GDP growth moved to a more sustainable pace of recovery and did so a little more quickly than we expected. While we have been especially cautious on prospects for Italy, our concerns there have mounted through the year.

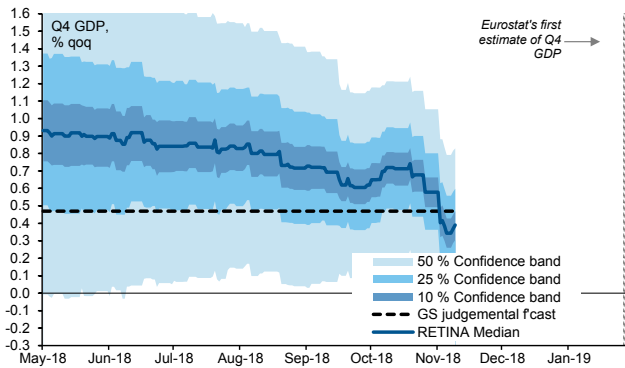
We revise lower our forecast for Euro area growth to 1.6% in 2019, from 1.8% previously. We continue to expect a similar pace of growth, 1.6%, in 2020 (Exhibit 1). The downward revision owes largely to our expectation that further market pressure will be needed to deliver a policy reversal in Italy – and this will weigh on domestic spending.

While underlying momentum has slowed, recent data also exaggerate the slowdown. At 0.2%qoq, area-wide GDP growth in Q3 was weaker than we (and consensus) expected. We expect some boost to Q4 growth from an unwinding of the erratic effect of adjusting to new auto sector regulations, which acted as a drag on German car industry output and area-wide activity in Q3. Underlying growth has, however, been persistently a little weaker than we expected through the past year.

Amid the global deceleration we expect next year, a rotation in the sources of Euro area growth – from external to domestic demand – is needed to maintain underlying GDP growth at this year's underlying pace. Outside Italy, credit availability supports some rotation to investment (consistent with survey data), while solid labour market improvements underpin consumer confidence and private consumption. The fiscal stance also remains moderately supportive for domestic demand. We expect these conditions to remain in place. That keeps the sequential pace of growth in 2019 similar to that seen in the first half of the year and should help to support an ongoing recovery. The pace of growth we forecast is short of the externally driven pace seen a year ago.

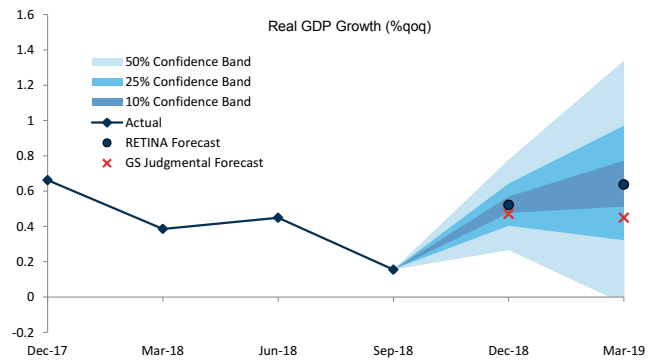
Italy is, however, an important exception to that rotation in demand, at the country level. It is also the source of downside news in our 2019 European Outlook (see Box). While we now expect Italy to flirt with recession around the turn of the year, we expect this to have a modest effect on broader European demand, provided the spillovers are restricted to traditional trade linkages.

Exhibit 2: Our tracking estimate of Euro area GDP growth has slowed significantly...



Source: Goldman Sachs Global Investment Research

Exhibit 3: ...although we believe subdued growth in Q3 exaggerates the underlying weakness in the Euro area



Source: Goldman Sachs Global Investment Research

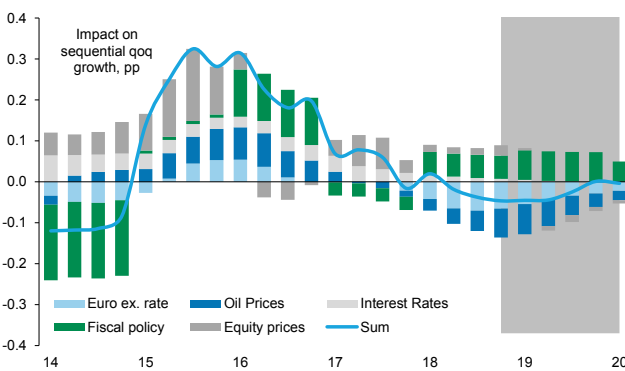
Growth in Q4 is tracking a similar pace to the first half of the year. Our tracking estimate of activity points to Q4 growth at 0.4%qoq, consistent with some bounce-back from a subdued Q3.

Overall, the Euro area recovery has matured as (i) slack on traditional measures has eroded and (ii) the sources of growth shift from the external factors that drove the past acceleration (including China and Asia demand) to being more domestically oriented.

Compared with the pace of growth witnessed a year ago, both aspects have involved a moderation in the pace of recovery; the second aspect has also weighed on underlying growth a little more than we had expected, along with an earlier rise in oil prices.

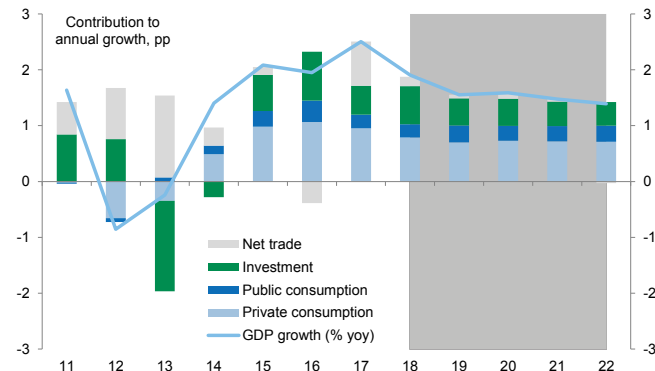
Looking ahead, the recent fall in oil prices results in a reduced drag on GDP growth. The recent weakening in the Euro will also cushion activity, although the trade-weighted Euro has held its level relative to a year ago and is stronger than two years ago, implying some drag from this source (Exhibit 4).

Exhibit 4: Growth tailwinds have faded and are becoming modest growth headwinds



Source: Goldman Sachs Global Investment Research

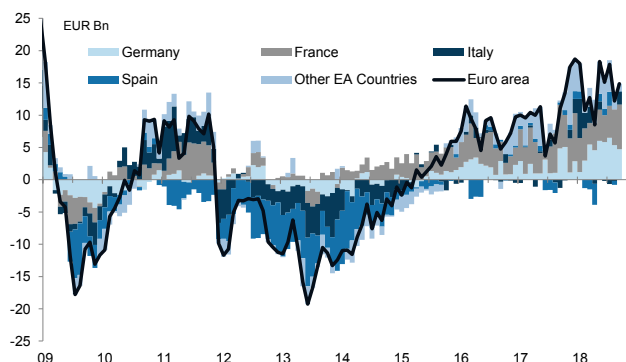
Exhibit 5: Net trade contributions to Euro area growth have waned; contributions from domestic investment have increased



Source: Eurostat, Goldman Sachs Global Investment Research

Exhibit 6: An improvement in Euro area credit flows is key to supporting domestic demand

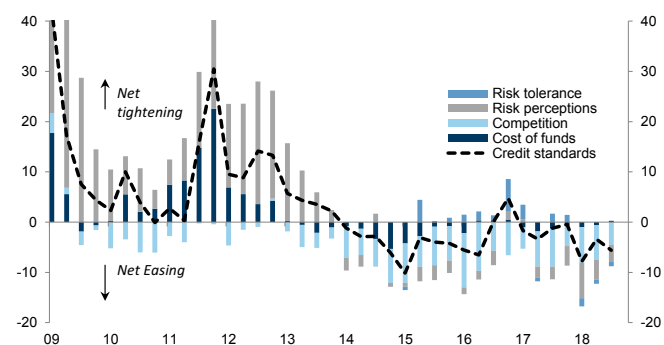
Flow of lending to non-financial corporations (NFCs) EUR bn, 3m average.



Source: ECB, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 7: Domestic credit conditions continue to ease, helping the rotation to domestic investment

Net % of respondents reporting tightening



Source: ECB, Haver Analytics, Goldman Sachs Global Investment Research

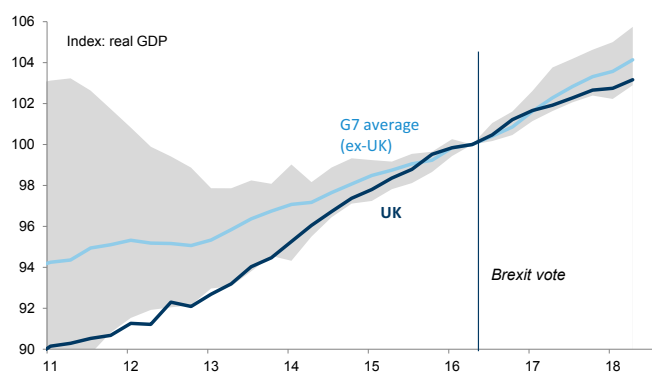
The balance of risks remains skewed to the downside

In addition to the risk from global trade tensions, economic risks in 2019H1 and beyond stem from two main sources: Italy and Brexit. We outline first their economics, and then their politics.

- Italy.** Despite incorporating downside risk into our central case, we continue to believe Italy poses further downside risks (see Box). This comes from two main sources: (i) the risk that a larger widening in BTP-Bund spreads is needed to convince the Italian government of the need for a more orthodox and credible fiscal plan that lowers debt/GDP; and (ii) the risk that spillovers to wider Europe extend beyond traditional trade linkages (that we allow for) and include financial channels (which we do not allow for). The economic impact of the latter, were they to crystallise, would make it difficult for the ECB to raise rates in late 2019.
- UK and Brexit.** Since the Brexit vote, UK GDP growth has underperformed that of advanced economies, while consumer prices have risen by more than elsewhere (Exhibits 8 and 9). That combination is a symptom of Brexit being a (prospective) negative supply shock. Weaker Sterling, the main source of the UK's inflation overshoot, anticipates a weaker supply side. Thus far, the economy has adjusted quite smoothly to that shock. While the UK's trading and institutional arrangements are as yet unchanged, the Brexit-induced fall in Sterling has squeezed household real income growth via higher inflation. But in keeping with the UK's relatively smooth adjustment, unemployment has continued to fall with little economic slack now remaining.

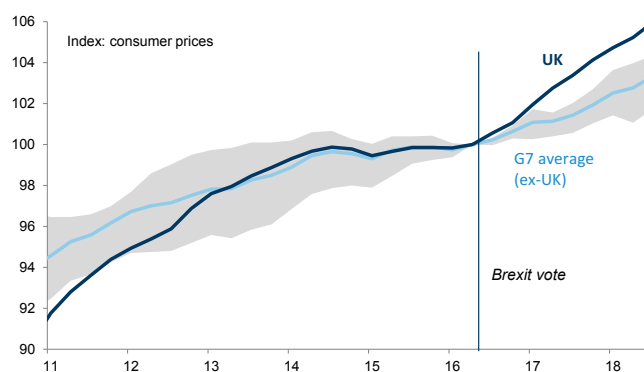
Overall, then, given time to adjust, the UK economy has adapted gradually to lower living standards. Consumers have "smoothed through" the real income squeeze, supported by a solid jobs market and easy credit conditions. We expect these conditions to remain in place, assuming there is an orderly Brexit for end-March 2019.

Exhibit 8: With Brexit being a negative supply shock, UK growth has underperformed the G7 since the Brexit vote...



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 9: ...while the rise in UK consumer prices has outstripped that in other advanced economies



Source: Haver Analytics, Goldman Sachs Global Investment Research

On balance, we assume the UK and EU-27 will agree a Withdrawal Agreement for the UK's orderly departure from the EU taking place in March. This would buy time for further ongoing adjustment to the UK's eventual departure from the EU Single Market. It would allow BoE policy normalisation to continue, including with a May 2019 rate rise. Assuming a Brexit deal, our Sterling rate path is steeper than the forwards curve. Some additional market volatility may be necessary to align parliamentary votes on the Brexit deal with this view (see below).

In the event of a 'crashing out' scenario, we would expect hikes to be priced out of the Sterling forward curve as the BoE holds Bank Rate rather than implementing policy rate cuts or reactivating QE.

If the UK fails to secure an orderly departure from the EU for end-March, then its time-frame for adjusting to a more sudden supply-side shock would be cut short. Rather than continuing to grow at around its diminished trend rate of 1.5% p.a. over the next two years, UK activity would weaken much more abruptly, and inflation would rise more rapidly. And with that would come a larger spillover for the rest of Europe, whose trading arrangements would also be impaired.

Politics and policy challenges. Europe's political mainstream will be subject to a populist challenge in the European Parliament elections in May. We expect the populist challenge to be ongoing, making the prospect of deeper integration that would make a more workable monetary union a remote possibility through the year ahead, and indeed for some time beyond.

There is an additional risk of snap elections in **Italy and the UK**. We have argued that elections in Italy could, ultimately, be a stabilising influence by facilitating a necessary reversal in fiscal policy (see Box).

Tensions about the Brexit end-state, and the path to it, have posed a threat to the UK government which lacks a parliamentary majority. Given those tensions, the path of least resistance in the Brexit negotiations has been for the UK to leave the EU in March 2019, on terms largely set by the EU-27, with a relatively narrow Canada-style free trade agreement to follow.

The technical agreement reached between the UK and EU-27 about Brexit follows this form.

UK domestic politics will likely shape whether and when the deal can be implemented. If the technical agreement is approved by Parliament, then an orderly Brexit would be implemented, consistent with our base case.

The political process poses several inter-related risks. Parliamentary arithmetic for supporting the deal is tight. If Parliament does not approve the agreement, then we would continue to believe that incentives and political process are aligned to avoid a 'crashing out', 'cliff-edge' Brexit. There is a majority in Parliament to avoid that outcome. The issue is how Parliament is able to express that view.

If PM May's deal fails on a first vote, then its chances of approval would increase on a second vote, especially if such a vote were seen as a choice between any deal versus a 'cliff-edge'. Asset prices would likely price in the additional risks in this scenario, although it would ultimately lead to an orderly departure and election risk would likely be averted.

If the Parliamentary arithmetic is the source of the impasse, than a general election would be necessary to change the basic arithmetic. While this could facilitate greater clarity on the form of Brexit, it could lead to a broader shift in economic policy. Clarity about Brexit could well require a new public mandate – either through an election or Second Referendum. Either case would involve reviewing the mandate given in the June 2016 Referendum.

In terms of process, should the UK need more time to clarify the public mandate, we believe that the EU would agree to extend the timeline beyond March under the Article 50 negotiation. Again, some political upheaval could be expected, with implications for asset prices, if Parliament does not initially approve the deal.

Overall, we continue to assume an agreed departure for March 2019 as the base case. A 'crashing out' scenario is a relatively low probability / high impact event, in our view. Some additional volatility in asset prices may, however, be implied by aligning the political process with economic incentives.

Globally, the threat of **protectionism** continues to weigh. While the visit to the White House by President of the European Commission Juncker in July reduced the risks of a further breakdown in the bilateral EU/US trade relationship, these could quickly resurface. Trade tensions have not dissipated. More generally, the dynamism of the Chinese-led Asian leg of global demand has moderated over the past six months. And although emerging market dislocations can still be viewed as largely idiosyncratic, country-specific events, the wider context of higher US rates and tightening global liquidity present a more challenging environment to EM and, through its openness and exposure, to Europe.

Box: Italy – additional market pressure needed to deliver more orthodox and credible fiscal policy

The Italian government has outlined a significant fiscal easing which – based on earlier analysis – is unlikely to stimulate real GDP growth. We believe a more orthodox and credible fiscal policy is needed to place Italy's public debt on a downward path, reducing the current vulnerability of the Italian economy which will weigh on banks' credit creation.

Fiscal risks are crystallising. From a macro and markets perspective, the key question is how much pressure is required to induce a policy reversal. We continue to believe that Portugal's experience in 2016 is informative and, on balance, more informative than Greece's experience in 2015. In Portugal, a widening of sovereign spreads over Germany to 400bp was sufficient to deliver a policy reversal and, ultimately, a more sustainable fiscal position that lowered its sovereign spread (Exhibit 10).

Some policy reversal is necessary. The government's 2019 Budget encompasses spending and tax commitments made by both the Five Star Movement and Lega. If a government of either the right-of-centre or left-of-centre were to revise the current budget, then this could lead to a fiscal plan focused on *either* tax cuts *or* transfers, which would limit the rise of the fiscal deficit and public debt relative to the existing plan (Exhibit 11). This would likely provide markets with more lasting relief beyond the temporary relief afforded by ratings agencies in recent weeks. It would involve some compromise between Italy and the European authorities. That said, we are clearly not yet on this path and, in our view, additional market pressure is needed for such a scenario to unfold.

We expect the ECB to cater for risks stemming from Italy by implementing a T-LTRO in 2019H1 in order to alleviate any funding pressures that may be faced by Italian regional banks. That said, allowing some funding tensions to build could have some influence on the Italian government, leading it to change its fiscal plan. Mr Draghi has already noted that two ECB Governing Council members have raised the prospect of a T-LTRO, implying that this could complement the ECB's existing guidance on interest rates and any intention to raise interest rates in late 2019.

Moreover, even a change in government would be unlikely to turn around the quality of many institutions, pass the necessary reforms to boost productivity or create the long-lasting virtuous circle required for a sizeable decline of the public debt-to-GDP ratio. Hence, on our base case, a resolution of the current stand-off would only allow Italy to muddle through.

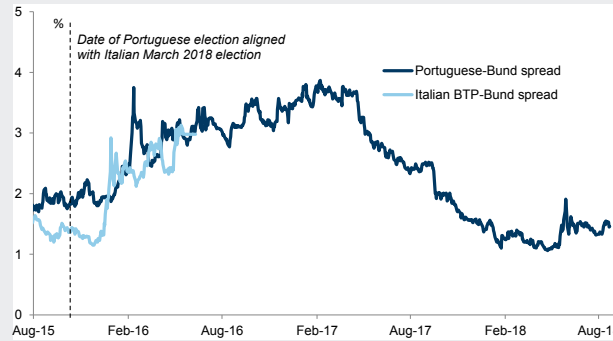
Risks, from Italy ... The main risk to our base case is that with more pressure, Italy could reach a political impasse and / or could be locked out of financial markets *before* an economic policy reversal occurs, leading to a self-fulfilling market dynamic that weighs on GDP growth further.

... and for wider Europe. In this variant scenario, spillovers to the wider Euro area could extend beyond the trade linkages that we incorporate in our base case to include financial channels leading to tighter financial conditions in the periphery. An ECB T-LTRO would be insufficient to cater for the economic fallout, and the ECB would likely delay its 2019Q4 rate hike.

Over our forecast horizon, through end-2022, we have argued that Italy will remain a member of the Euro area. Based on surveys (such as Eurobarometer) the majority of Italians favour the Euro and trust European institutions more than Italian institutions. These preferences reflect, in our view, a broad understanding that the costs of reintroducing a national currency would be significantly higher than any

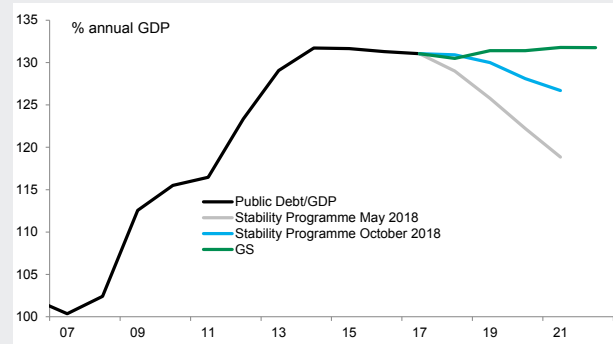
temporary and potentially elusive benefit that a nominal devaluation would have in boosting Italian exports. Ultimately, we therefore expect any Italian government to reflect these voter preferences in their policy choices.

Exhibit 10: Wider 10-year BTP-Bund spreads since the Italian election have tracked Portuguese spreads following its election, so far



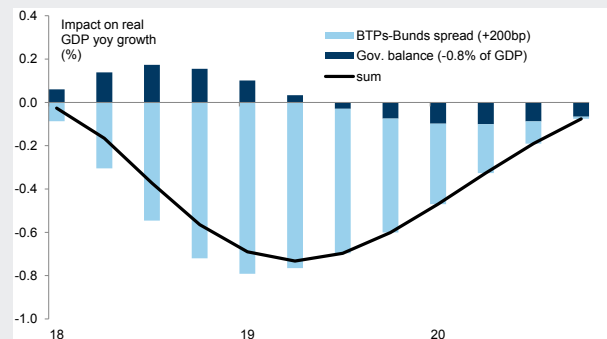
Source: Reuters, Goldman Sachs Global Investment Research

Exhibit 11: More orthodox and credible economic policies are required to place Italian public debt on a downward path



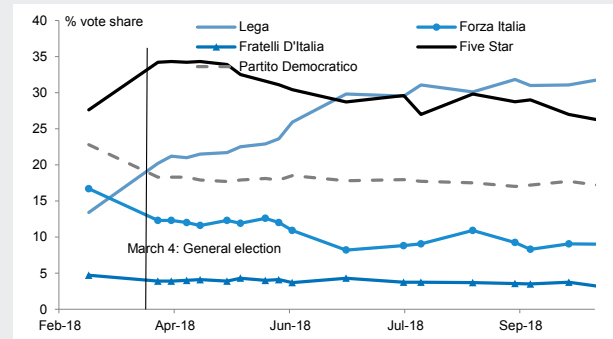
Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 12: We expect the direct effect of a fiscal easing in Italy to be 'crowded out' by higher sovereign yields



Source: Goldman Sachs Global Investment Research

Exhibit 13: On our base case, political support is likely to evolve towards a future government run either by the Five Star Movement or by Lega, in coalition with other parties
Opinion polling



Source: EMG, Index, IPR, Ipsos, SWG, Demopolis, Tence, Bidimedia, ScenariPolitici, Goldman Sachs Global Investment Research

Despite its recent softening, the recovery remains broad-based across the Euro area's largest economies

Germany. At -0.2%qoq, Q3 GDP growth was significantly weaker than we expected (before Euro area Q3 GDP had been published). That weakness was exaggerated by adjustment to new environmental regulations affecting the German auto sector and a growth pause in the construction sector. While growth has decelerated from last year's 2.5%yoy pace, these two factors exaggerate the weakness in Q3 and point to a Q4 rebound. Underlying resilience in domestic spending has been supported by a tight labour market (on traditional measures), easy financial conditions and a modest fiscal easing. Our 2019 annual GDP growth forecast is unchanged, at 1.9% after 1.7% in 2018.

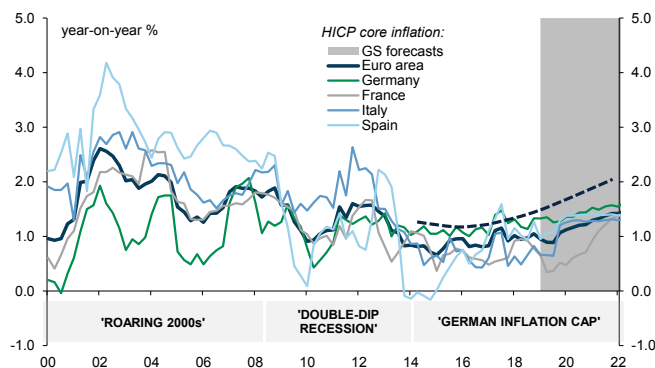
France. At 0.4%qoq, GDP growth in Q3 was in line after disappointments earlier in the year. The gain in momentum owed to an improvement in private consumption. We expect resilient domestic demand in France to maintain this recent momentum through next year, owing to a broad-based improvement in domestic demand. Our annual GDP growth forecast for 2019 is also unchanged, at 1.7%.

Italy. At 0.0%qoq, Q3 GDP growth was its weakest in almost four years, although it was only marginally softer than we expected. Q4 survey data have softened further. A deterioration in the fiscal outlook, and its likely market consequences, have led us to revise our 2019 outlook significantly lower (see Box). The growth impact of the planned loosening in fiscal policy will likely be crowded out by higher sovereign yields and weaker confidence, both of which will weigh on the banking sector and credit creation and imply Italy flirting with recession around the turn of the year (Exhibit 12). We have lowered our 2019 growth outlook by 0.6pp to 0.4%.

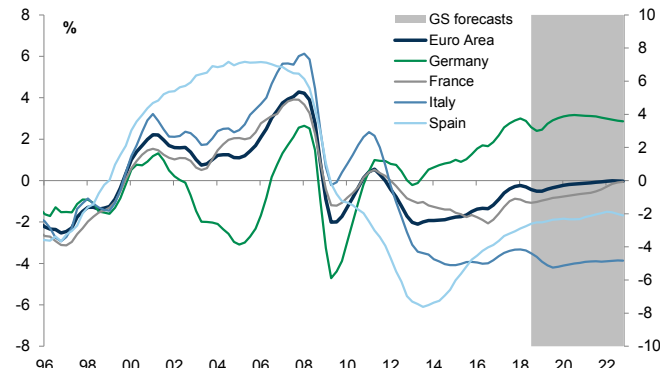
Spain. At 0.6%qoq, Q3 GDP growth was slightly firmer than we expected. While Spain's peak acceleration in activity is also behind it, past reforms and adjustment have supported external demand (via improved competitiveness) and domestic demand (as negative confidence effects have passed but had stored up some pent-up demand). Slack still leaves room to grow, although it is also narrowing on the continued falls in unemployment. Our GDP growth forecast is a little stronger at 2.3% in 2019 (up 0.1 pp).

In wider Europe, our macro update highlights:

- **UK** GDP growth has been bumpy through 2018 owing to idiosyncratic factors including weather; but the average sequential growth rate was similar to that in 2017. Our macro forecasts anticipate continued low unemployment and inflation being at target from around the turn of the year. Provided there is a Withdrawal Agreement for an orderly departure from the EU, that would leave the BoE continuing to normalise policy, narrowing the gap between its policy rate and neutral rate, including through a 25bp rate rise in May 2019. The policy mix would continue to shift towards less monetary accommodation and less fiscal consolidation than in the recent past as the fiscal stance becomes neutral. Our latest forecast changes are small, with GDP growth continuing around its diminished trend growth rate, at 1.5%, and inflation around its 2% target through 2019.
- **In Scandinavia**, growth was quite solid in Q3, although idiosyncratic factors (including weather) played a role. It remains robust on more recent indicators. We expect a 25bp rate rise from the Riksbank in December and a further two hikes in 2019. Having implemented a rate rise in September, as expected, we expect Norges Bank to raise rates again in Q1, followed by two further hikes in 2019. While GDP growth has also been solid in **Switzerland**, we expect the SNB to remain reactive to ECB policy, and to raise its policy rate in 2020Q1.

Exhibit 14: Euro area inflation is subject to a German 'inflation cap'

Source: Eurostat, Goldman Sachs Global Investment Research

Exhibit 15: On traditional measures, the area-wide output gap has almost closed
% of GDP

Source: Eurostat, Goldman Sachs Global Investment Research

A “stubbornly weak” view of Euro area core inflation

A disinflationary bias, slowly correcting. The Euro area’s disinflationary bias has been the counterpart to its GDP growth being dependent on external demand, until recently. The disinflationary bias is subsiding only slowly as domestic demand improves and domestic cost pressures emerge.

Headline inflation has been supported in the past year by global factors (and by energy prices, in particular), while Euro area core inflation has been stubbornly weak.

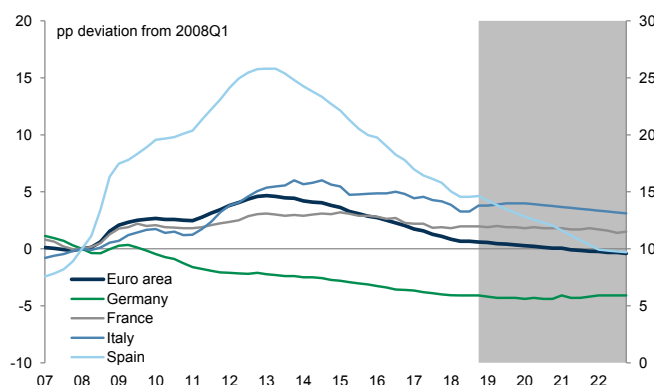
We believe headline inflation in October, at 2.2%, will mark the peak impact of higher energy prices. We expect headline inflation to weaken towards levels of core inflation around 1.0% over the course of the next year (Exhibit 14).

While the Euro area lacks an inflation cushion, wage growth has edged up. While we expect core inflation to move sideways over the coming quarters, we forecast it to average 1.2%pa in 2020 and 1.4% in 2021. That remains stubbornly below the ECB’s inflation objective.

The output gap (on traditional measures) is virtually closed (Exhibit 15). Despite the slowdown, GDP growth has remained above our estimate for potential growth of 1-1.5%p.a.

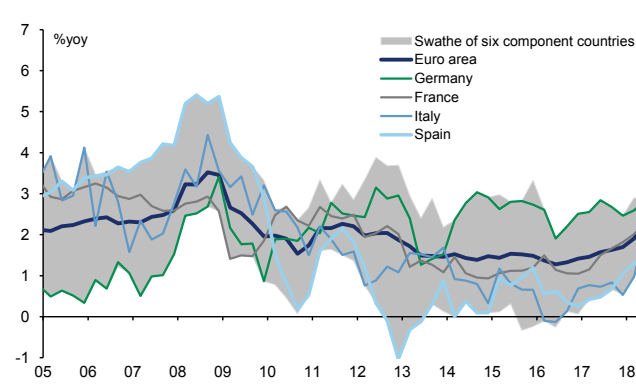
Lower unemployment has also led to a rise in wage growth. In Germany, where unemployment has fallen to a historical low, at 3.4%, and the economy appears to be near overheating on some dimensions, several structural factors have helped limit core inflation. This includes the role of immigration and Germany’s broader integration with Central and Eastern Europe. Nonetheless, wage growth has picked up from low levels in both Germany and France, providing the ECB some reassurance that slack has indeed reduced significantly as GDP growth itself has moderated (Exhibit 17).

Exhibit 16: Unemployment rates have largely reversed their post-crisis rise ...



Source: Eurostat, Goldman Sachs Global Investment Research

Exhibit 17: ... and wage growth has picked up from its lows
GS wage trackers



Source: Eurostat, Goldman Sachs Global Investment Research

The German inflation cap continues to hold in our forecasts, limiting inflation as the wider Euro area tries to restore its competitiveness relative to Germany. This constraint can be met by some combination of suppressing domestic demand (as in Italy) or through supply-side changes that encourage more external demand and stronger overall GDP growth (as in Spain).

ECB monetary policy – steady-handed, provided spillovers from Italy remain contained

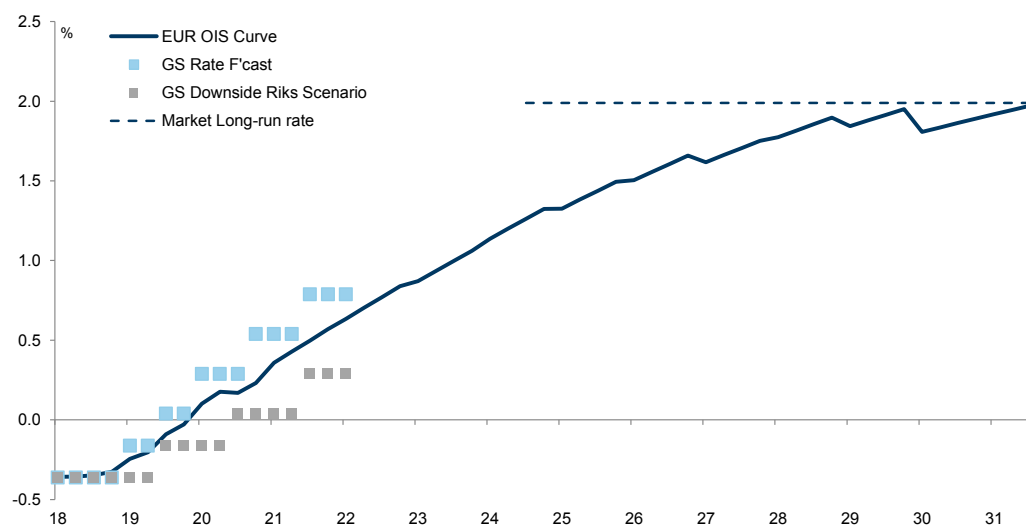
If, as we expect, subdued Q3 growth proves to be temporary and idiosyncratic (owing to local factors in Italy and sector-specific factors in the German auto sector), then underlying quarterly growth of around +0.4%qoq should be sufficient to bring down unemployment further in those parts of the Euro area where slack remains. We would then expect underlying price pressures to build gradually, providing the ECB with enough reassurance that inflation will rise to its target, sustainably.

We expect ECB net asset purchases to cease by year-end and a first (20bp) hike in 2019Q4 (most likely, in October). Our policy rate path has subsequent hikes every two to three quarters (of 20bp-25bp), placing the Deposit Facility Rate at +0.75% by end-2022. Our outlook is broadly consistent with the plan of the ECB Governing Council laid out at the June ECB meeting, including its expectation that rates remain on hold “at least through the summer of 2019”.

To address specific pockets of weakness – notably, in Italy – and to support broader bank funding and thereby ECB transmission of its easy stance, we expect the ECB to announce some form of T-LTROs in the first half of 2019. We also expect ECB reinvestments to continue in full throughout our forecast to end-2022.

We share the ECB’s ‘confidence’ that inflation will move back towards its target, but we believe even more ‘patience’ will be required for that to happen.

Forward guidance is the ECB’s marginal tool to shift its policy stance. Currently, forward guidance is consistent with our modal outlook for slightly above-trend growth at a point when slack has been almost fully absorbed, provided the ECB is confident enough that inflationary pressure will build over time.

Exhibit 18: Our monetary policy forecast and market pricing

Source: Bloomberg, Goldman Sachs Global Investment Research

For the ECB to revise its forward guidance and then implement a later first rate rise would require a weaker Euro area outlook, driven by weakness in domestic demand rather than binding supply constraints, and growth persisting below the rate of growth of capacity. Such a shift in the pace of growth would jeopardise the gradual rise in underlying, domestic price pressures. The risk of this alternative scenario has increased, but it remains away from our base case for as long as slack is being reduced.¹

ECB communication will evolve through the year. We believe the March meeting may feature an announcement of new T-LTROs. As a complement to rate increases, this would enable guiding markets to a hike after the summer. By contrast, if the economy has shifted to a weaker trajectory of below-trend growth by then, the ECB would likely implement a T-LTRO and update its forward guidance to indicate that a rate increase is not likely until some time the following year.

The market was pricing our modal path around a month ago. It is currently pricing a slightly lower path, with around 15bp of hikes by end-2019, 30bp by mid-2020 and around 80bp by end-2021 (Exhibit 15). Incorporating our downward revision to GDP growth, we would attach a 60%/40% probability split between our base case and alternative scenarios. The market seems close to pricing a two-thirds/one-third chance of our modal and alternative scenarios. Market pricing is therefore more hawkish than our 'average' view of future ECB policy.

Andrew Benito and Kavya Saxena*

* *Kavya is an intern in the European Economics team*

¹ In its November 2018 *Economic Bulletin*, the ECB estimated the Euro area's rate of growth of potential output at 1.5%. This may, therefore, be a reference value for the ECB in judging whether growth is "strong enough" next year.

Annex: Our GDP forecast changes (Previous forecast: September 7, 2018)

Exhibit 19: GS forecast changes

New forecast

GDP %yoy	2018	2019	2020	2021	2022
Euro area	1.9	1.6	1.6	1.5	1.4
Germany	1.7	1.9	1.6	1.3	1.2
France	1.6	1.7	1.6	1.7	1.8
Italy	1.0	0.4	1.1	1.0	1.0
Spain	2.5	2.3	2.1	2.0	1.5
UK	1.3	1.5	1.4	1.6	1.7
Sweden	2.5	2.3	2.2	2.0	1.9
Norway*	2.4	2.3	2.2	2.2	2.1
Denmark	1.0	1.9	1.8	1.5	1.5
Switzerland	2.8	1.3	1.6	1.9	1.8

*Mainland GDP

Previous forecast

GDP %yoy	2017	2018	2019	2020	2021
Euro area	2.5	2.1	1.8	1.6	1.5
Germany	2.5	2.0	1.9	1.7	1.5
France	2.3	1.8	1.7	1.7	1.8
Italy	1.6	1.0	0.9	1.0	1.0
Spain	3.0	2.6	2.2	2.1	2.0
UK	1.7	1.3	1.2	1.3	1.7
Sweden	2.4	2.7	2.3	2.4	2.3
Norway	2.4	2.4	2.4	2.1	2.0
Denmark	2.3	0.9	2.0	1.9	1.5
Switzerland	1.1	2.2	1.9	1.9	1.8

Source: Eurostat, Haver Analytics, Goldman Sachs Global Investment Research

Huw Pill
+44 20 7774-8736
huw.pill@gs.com
Goldman Sachs International

Alain Durré
+33 1 4212-1127
alain.durre@gs.com
Goldman Sachs Paris Inc. et Cie

Pierre Vernet
+44 20 7552-0428
pierre.vernet@gs.com
Goldman Sachs International

Silvia Ardagna
+44 20 7051-0584
silvia.ardagna@gs.com
Goldman Sachs International

Lasse Holboell Nielsen
+44 20 7774-5205
lasseholboell.nielsen@gs.com
Goldman Sachs International

Andrew Benito
+44 20 7051-4004
andrew.benito@gs.com
Goldman Sachs International

Adrian Paul
+44 20 7552-9958
adrian.paul@gs.com
Goldman Sachs International

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