

**JAKE SIEWERT**

This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today's episode is all about what's ahead for Europe's economy in 2020. We're joined by Jari Stehn, head of European Economics for Goldman Sachs Research. Jari and his team recently published their 2020 Outlook. So we'll talk through their forecast and the drivers behind them. Jari, welcome to the program.

**JARI STEHN**

Great. Thanks for having me.

**JAKE SIEWERT**

So, you know, this time of year you published ...

your 2020 Outlook this year was called, Through the Trough. Sounds optimistic. Christine Lagarde's taken over the president of the ECB, the European Central Bank. What awaits her and, more generally, the European area economy in terms of growth next year?

JARI STEHN

Well, we think 2020 is going to be a better year for Europe than 2019. So we expect growth to be 1.1 percent next year, which is a bit above consensus, and is certainly notably above where the current numbers are running.

I think, you know, the reasons for the pickup, that the world environment looks a bit more friendly. The global economy looks like it's regaining a bit of momentum, we think. A number of risks have diminished around the world regarding the trade war, regarding Brexit. And, also, domestically, we think there's some resilience, particularly in

consumption. So wage growth has been fairly resilient. Fiscal policy is providing a bit more of a boost, we think, in 2020 than in 2019. And you're also seeing some of the high-frequency data points starting to pick up. So I think, so far, that's focused mainly on the more forward-looking indicators.

Whereas the, if you like, the spot data has remained weak. But it does give us some confidence that we are moving, as we said, through the trough here.

Now, at the same time, I think it's important to keep in mind that there are a bunch of issues that are going to keep the turnaround in growth a bit more gradual than what we saw in 2017. So the starting point is a lot weaker. The industrial sector is still in recession. So we think that will take a bit of time to turn around. We've also seen some collateral damage from the weakness in the industrial sector. So, for example, German employment growth has

slowed quite a lot. And, again, that could act as a bit of a break on the speed of the turn round. And then I think on some of these risks that I mentioned, we have seen progress, but we haven't seen resolution on those risks.

So if we take that together, you know, we are expecting a pickup in growth, but we think it will be relatively gradual. So we have growth close to trend in the first half of 2020, and then we'll clearly above trend in the second half. So it's a bit of a back-loaded story, but certainly a more optimistic one than for 2019.

#### QUESTION

So what about inflation? I mean, unemployment rates are low in Europe, but wage growth has moved up a bit in the last few years, but core inflation is just stuck at one percent, a little below what policymakers would like to see. What's the dynamic there and what's ahead?

**JARI STEHN**

That's right. So inflation has basically been stuck at around one percent for a couple of years now, and we expect that to remain the case over the next year before inflation then drifts up slowly afterwards. And we think that's because inflation is subject to a number of cross currents. So, on the one hand, as you say, there's been quite a lot of labor-market improvement. So the unemployment rate is back to 2008 levels. Wage growth has picked up quite nicely across the euro area.

But, at the same time, firms have been very reluctant to pass on that increase in labor costs, and inflation expectations, which ultimately anchor where inflation is headed, have been drifting down in Europe, particularly when you look at survey measures of inflation expectations. And so when we take that together, we think in the near term there's little upward pressure on inflation, but over

a longer period of time we then think inflation should drift higher slowly. So we have inflation currently around one percent. I think it will stay here for a while and then drift up very gradually in the years after that.

JAKE SIEWERT

So, Jari, to the layperson, this debate among central bankers around one percent inflation, two percent inflation may seem somewhat obscure. Like what's the significance of trying to push inflation up a little bit higher within Europe?

JARI STEHN

Yes, I think it really is about anchoring inflation expectations at the ECB's target, and I think that matters a lot because that will ultimately determine where inflation ends up over the longer term and the closer inflation is to zero, the higher the risk of deflation. And so we know from the experience in Japan that deflation can be very dangerous for

economies. Because, basically, consumers expect prices to fall, they put off purchases and you can get a lot of economic weakness as a result of that.

So I think it's really about that downward drift in inflation expectations that we've seen in Europe and the importance to push against that and make sure that inflation expectations stabilize closer to two percent. And that's where I think a more symmetric and clearer two percent inflation target would be helpful because it would really signal that policymakers take that target seriously and would provide more of an anchor for households in terms of their expectations where inflation is headed.

JAKE SIEWERT

And keep you further away from that risk of falling into a deflationary cycle.

JARI STEHN

That's right. Exactly. And I think, you know, Japan is the key experience here to keep in mind,

because once you hit that deflationary trap, it's quite hard to then get out of it.

JAKE SIEWERT

So the dynamics you're describing -- relatively low unemployment, relatively stable, but low inflation -- they sound pretty benign at some level, but how much of those are euro-specific dynamics and how much is that a global phenomenon?

JARI STEHN

Yes, I think that differs a bit between growth and inflation. So I think the expected growth pickup has an important global component, because Europe, of course, is a very open economy. It's quite exposed to the global trade cycle, and so the improvement that we expect in world growth should lift European growth. So I think that has an important global component.

Whereas, I think on the inflation side, I think the issues are a bit more euro-area specific, because if

you look at the U.S., if you look at the UK, inflation is around two percent, significantly higher than the one percent we're seeing in the euro area. And I think that has to do importantly with a starting point. After the great financial crisis, of course, the euro area then ran into the debt crisis in Europe and everything took longer to rebound, and we still think there's some slack in Europe, and, as we said earlier, inflation expectations have been drifting down. And I think that is different to many other advanced economies around the world, and it's going to take the euro area some time to catch up until inflation gets closer to two percent.

#### QUESTION

So obviously we love to talk about Europe as a whole, but it's a much more complex picture when you're sitting there. What countries are above consensus? What countries are doing a little bit better and what countries are below consensus? Who are the over-achievers, as it were, as you look

ahead to 2020?

JARI STEHN

Yes, I think that's an interesting split. So we are above consensus for Germany, for France and for the UK, but, interestingly, for slightly different reasons. So the German story is basically a global story, an industrial story, because the German economy is highly exposed to the global cycle, and as we said earlier, we think that will get a bit better in 2020. Whereas, France is much more about domestic sources of growth.

France didn't decelerate as sharply as Germany did, and household spending, for example, held up pretty well in France, and we expect that to be the case also in 2020. So, in particular, some of the labor-market reforms that have been undertaken over the last few years, we see some scope that those are supporting the labor market, and, in turn, will generate income for households to spend. So

the reason we are above consensus for France is much more of a domestic story, rather than a foreign one.

Now, for Italy and Spain, we're basically in line with consensus. I think in Italy there should be some boost from the improvement in the global cycle, improvement in German manufacturing, because Italy is quite closely linked to Germany, particularly by the north of Italy, but, at the same time, Italy still faces a number of important challenges. So we think, on the political side, even though things have been more stable, there is a risk of new elections in 2020, and you're still seeing a number of structural challenges that Italy has. They're quite familiar, of course -- high debt, low potential growth -- but we think that mix is going to keep a bit of a dampener on growth.

Where Spain, of course, did very well for much of

the last couple of years, growth there held up much better than in Germany, but, in Spain, we've also recently seen a deceleration in growth, and we have seen some political fragmentation. So there was a repeat election in November, which led to yet another hung Parliament. And so we think some of that political uncertainty will also act as a bit of a dampener in Spain into next year. So you're kind of seeing a bit of a split here between the core countries where we are somewhat above consensus and then countries in the periphery where we're closer to consensus.

#### QUESTION

Now, let's talk about the UK for a moment. You see a pretty compelling case for a bit of a bounce back in the UK in above-trend growth there. What is making you more optimistic about the British economy?

#### JARI STEHN

Yes, it's really two things. The first is that we think

Brexit resolution is quite likely in 2020. So if the polls are right and the Conservative Party will form the next government, then we think there's a good chance that the withdrawal agreement will pass relatively quickly, before the end of January. And we have found in our work that the uncertainty around Brexit has been an important drag on UK growth over the last couple of years, mainly via investment, because firms have been reluctant to invest. So I think if you get Brexit resolution along that dimension, then that should be quite supportive for growth in 2020.

The second is on the fiscal side where both the Conservatives and the Labour Party have put forward pretty sizeable spending plans, and ...

JAKE SIEWERT

As one does in an election year.

JARI STEHN

As one does in an election year, exactly. And we

think those would provide a pretty significant boost to growth. Now, that might take a little bit longer to ramp up. So we think the fiscal boost wouldn't come until the second half of 2020 and then go into 2021 and 2022, but I think that's another important reason. And so I think that mix is quite interesting, that currently growth momentum in the UK is very weak, but we see a pretty compelling case for pick up there in the second half of 2020 and then into 2021, and it raised our numbers for the UK.

#### QUESTION

So let's talk about the European Central Bank. Obviously, a big, big change, at least in personalities, from Mario Draghi to, now, Christine Lagarde. What do you think the challenges are ahead for the ECB under Lagarde's leadership?

#### JARI STEHN

So the big challenge, of course, is going to be to get inflation closer to the inflation aim. As we said earlier, inflation is stuck around one percent, and

they would like inflation to be closer to two percent. Now, in the near term, we don't expect much action from the ECB, and that's really because of the expected growth pickup we talked about earlier. So even though inflation is low and it's below where they would like it to be, as long as growth is expected to pick up, I think that takes away the urgency for them to act.

0

Now, I think the risk in 2020 is still towards easing, and we would expect that if growth disappoints and growth doesn't pick up, then we would expect them to ease, and I think the most likely way for them to ease is to cut the interest rate further. But, as I said, that's not the baseline, given the signs that we might see a bit of a pickup in growth.

Instead, we think 2020 is going to be all about the strategy review that President Lagarde is likely to initiate soon, and we think that review will end up

with a clearer objective for the ECB with a symmetric two percent inflation target instead of the rather fuzzy formulation that they have at the moment, where they say they want inflation to be below, but close to two percent. And so we think they will clarify that and go to two percent symmetric inflation target.

I think the main implication of that is going to be that it will underscore the need for them to remain highly accommodative for quite some time. It will crystalize that one percent inflation is significantly below that two percent target. And so we think they will keep the QE purchase program -- the 20 billion per month -- we think they will keep that running for a couple of years, until the end of 2021, and we think they will be quite patient with raising interest rates, so we don't have a rate hike all the way until the end of 2022.

JAKE SIEWERT

So, Jari, there has been a lot of criticism of European Central Bank policy and the negative interest rate sort of cycle there. And what is the response of the ECB to those who say that these rates have just gotten too low and really have no room to go lower?

JARI STEHN

Yes. The response has been that, on net, negative interest rates have been effective. So ECB officials have argued that the negative rates have been passed on by banks into retail lending rates and that you are even starting to see some of those retail deposit rates go negative and that this is welcome because it aids the transmission mechanism of monetary policy. At the same time, there is an acknowledgement, of course, that negative interest rates and very low rates come with costs, so, in particular, that they weigh on bank profitability, which ultimately might undercut

that transmission mechanism that I just talked about.

So the view is that there is a, as we say, lower bound on interest rates in Europe, but most ECB officials have argued that we are not yet at that lower bound and that there still is room for them to cut interest rates if they need to, and we agree with that assessment. So our own estimates point to a lower bound at around minus one percent, which would still give the ECB a little bit of room to cut, not an awful lot, but 50 basis points of cuts before you hit the point where negative interest rates become counterproductive.

#### QUESTION

So, obviously, there's not a lot of ... I mean, there's some room, but not a lot of room on interest-rate policy, given the last decade of low interest rates. Without much room for maneuvering on the

monetary side, there's obviously some potential for fiscal policy, and this has always been a big debate in Europe, how much some of the healthier and bigger economies can stimulate the economy on the fiscal side. What's your outlook there for fiscal policy? We talked about it in the case of the UK, but how about for the Continent?

**JARI STEHN**

Yes, in the Continent, we think it's going to be more modest. So we have a modest tailwind from fiscal policy over the next couple of years, but not the big bang that some people have hoped for. So budget plans across the euro area have turned more expansionary. So that includes Germany, France, also Italy. And we think that it's going to boost growth in 2020 by three-tenths. So you might say that's not very much, but I think given that potential growth in Europe is only at about one percent, I think it's not, you know, it's not insignificant as a growth source.

Now, beyond that, there is quite a bit of space for additional fiscal expansion in Germany, but we don't currently see the political support for that to be activated. So on our estimates, there's about 1-1/2 percent of GDP available within the domestic fiscal rules, and then about another 1-1/2 percent available under the European fiscal rules. So really quite a lot to be used, but the political situation is such that we're skeptical that a lot of that will be used in addition over the next couple of years.

So I think the SPD leadership election over the weekend, which brought in a new leadership pair, raises the risk that we are going to get a little bit more fiscal, but we are not particularly hopeful that we're going to see a big turnaround, at least not in 2020. So we think that would require, for the catalyst, either a lot more economic weakness -- you know, a sharp downturn -- or an election, but

an election, to us, still seems more to be a 2021 event rather than a 2020 event.

**JAKE SIEWERT**

So you've mentioned two of the big overhangs on the European economy and the markets there -- Brexit and the trade wars, which mostly center around the U.S. and China, to some extent, but increasingly global. What's your take on how those issues might look, you know, in the next year?

**JARI STEHN**

We expect progress on both of those risks over the next few months. So in the UK, the polls for the election point to a Conservative majority, and we think that if that turns out to be the case, we think that the withdrawal agreement would be passed pretty quickly. The withdrawal agreement Prime Minister Johnson negotiated with the EU would be passed pretty quickly by the end of January. So that would be helpful in lifting some of the uncertainty.

QUESTION

Uncertainty. Yes.

JARI STEHN

It's probably not going to lift all of the uncertainty straightaway, because the UK, of course, needs to negotiate a free-trade agreement with the EU and is in the transition phase, under current rules, only until the end of 2020. And so there is another, if you like, cliff edge(?) coming up through those negotiations. But we think the hurdle for extending that transition phase is a lot lower than the hurdle was for extending the Article 50 deadline. And so we think that, in the end, there is going to be an extension there to create more time to negotiate a free-trade agreement.

Now, on the global trade war, we also see some progress. Obviously, there's still quite a lot of uncertainty here, but our base case is that there will be a phase-one agreement between the U.S.

and China with probably a partial role back of some of the recent tariffs, and I think that should be helpful for global trade. And, of course, Europe being exposed to that trade, that should be helpful.

But I think at least as importantly is the issue of auto tariffs, of course, for Europe, and I think here the risk of auto tariffs now seems pretty low, and I think that's positive for Europe, and Germany in particular, because that uncertainty had been hanging in the background and I think had been an important source of some of the industrial weakness that we've seen, particularly in Germany.

JAKE SIEWERT

So trade and Brexit get a lot of headlines. What are some of the other risks that are talked about a little less frequently for the euro region next year?

JARI STEHN

Yes, I think an important one to keep an eye on is

---

the Italian political situation in 2020. Now, generally, the political situation in Italy looks a lot more stable than it did last summer when, of course, the government broke up and markets were positively surprised by the speed at which a new government was formed between the Five Star Party and the Democratic Party under Prime Minister Conte.

00:20:15

Now, our base case is that that government will stay together in 2020, but I think there is a risk around the regional elections in early 2020 that there could be a change to the government or that there could be new elections that could bring in a more Europe-skeptical government. So I think that's an important risk to keep an eye on in 2020.

So we like to talk about risks here at Goldman, but is there anything that could provide a catalyst to growth next year that we're not as focused on?

**JARI STEHN**

I think the main upside risk for the euro area is that if global growth gets better, if the global industrial and trade cycle turns, that Europe turns more quickly than we anticipate. And that, of course, is particularly the case in Germany, which is, if you like, a high (Inaudible) economy relative to the global industrial cycle. As I said earlier, I think the baseline for us is that this turnaround happens slowly, but you could see how this would happen more quickly, how you're starting from a very low base here and how those things will turn around more quickly. So I think that's the main upside risk to be focused on, and, of course, that we would see in the industrial data. And I think that's a key area for us to watch very closely over the next few months.

**JAKE SIEWERT**

So, Jari, thanks for joining us today and covering a

pretty wide range of topics surrounding Europe.

What are you personally looking forward to next year?

**JARI STEHN**

Well, it's a big year for our family because we have a six-month-year-old daughter and next year's going to be, you know, a big year in showing us a number of big steps here. Looking forward to see her walk, see her talk, and that's going to be exciting.

**JAKE SIEWERT**

All right. Well, you can join us next year and talk about that and give us an update on her progress.

**JARI STEHN**

Yes, sounds good.

**QUESTION**

Thank you so much for joining us today.

**JARI STEHN**

Thanks for having me.

**JAKE SIEWERT**

All right. Well, that concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed the show, we hope you subscribe on Apple Podcasts and leave a rating or a comment. And more from Goldman Sachs experts, as well as influential policymakers, academics and investors, on market-moving topics, be sure to check out our new podcast, Top of Mind at Goldman Sachs, hosted by Allison Nathan, a senior strategist in the firm's Research Division. Thank you.