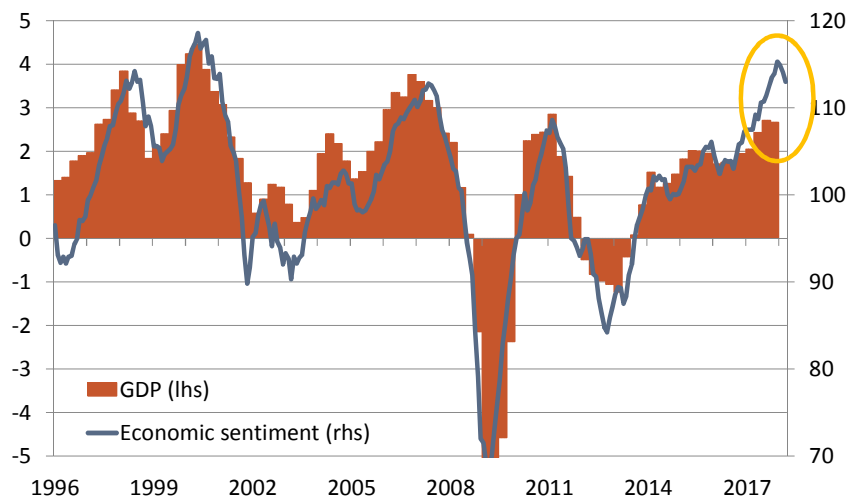


23 March 2018

## Trade trouble hits Eurozone confidence: a risk to growth?

### Eurozone sentiment is coming down to earth to realign with GDP growth



Annual growth rate of real Eurozone GDP, in %, left-hand scale, and Eurozone economic sentiment, right-hand scale, March 2018 Berenberg forecast. Sources: Eurostat, European Commission, Berenberg

- **A hit to confidence:** In late 2017, economic sentiment in the Eurozone surged to its strongest level in 18 years, far outpacing the concurrent acceleration in economic growth (see chart). That has made sentiment vulnerable to a setback. US president Donald Trump's misguided threat to impair global trade with some punitive new import duties has provided a trigger for such a correction. Eurozone businesses, which do not benefit from a major domestic stimulus and are often more outward-looking than most US companies, will likely react much more sensitively to the trade war rhetoric than their counterparts in the US, even if Europe is not (yet) directly affected by actual US measures. Confidence can be fickle. We look for a further drop in Eurozone economic sentiment in March.
- **Not much to worry about – yet:** For three reasons we do not expect less exuberant sentiment to cause a major dent in output growth. First, a limited correction in confidence would be just a return to a more normal level that would still be compatible with solid growth. Second, many companies in core Europe are facing capacity constraints as a lack of skilled labour limits the pace of output growth. Even if confidence falls back somewhat, they will continue to work on their significant backlog of orders. Third, companies will likely notice over time that, due to strong demand from the US and elsewhere, their exports will likely continue to rise significantly in 2018, despite the noisy trade disputes. We look for Eurozone business sentiment to rebound during the summer.
- **A misguided focus:** The US and Europe have legitimate concerns about Chinese trade and investment practices and an insufficient protection of intellectual property rights. However, President Trump's focus on current account balances is misguided and potentially very dangerous. Due to its significant fiscal stimulus, elevated consumer confidence and strong corporate investment intentions, US domestic demand is firing on all cylinders, outpacing gains in most trading partners. As a result, the US external deficit looks set to widen. The only ways to prevent that would be to impede imports on a massive scale, to dramatically devalue the US dollar or to throttle US demand growth. In all three cases, US consumers would be major losers through higher prices and/or major job losses.
- **Trade war risk remains small:** Our call that trade tensions will not escalate to such a highly disruptive extent to really matter beyond a near-term confidence effect, is based on the view that Trump will eventually settle for some "deal" that will give him "results" on some micro issues, without affecting the US current account in a meaningful way. If he were to pursue his misguided approach to its logical conclusion, and if Congress would allow him to do so, the outlook would be bleaker. Reacting to the Trump tariffs three weeks ago, we changed the risks to our Eurozone outlook from tilted to the upside to balanced. As we view the risk of a trade escalation as a small tail risk, we did, however, not change our actual forecasts. We still look for 2.5% Eurozone GDP growth in 2018, as in 2017.

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