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EUROZONE: A FIRMER ECONOMIC RECOVERY

Berenberg Macro Flash

THE FRENCH FACTOR: STRONGER GROWTH AHEAD

Life is full of risks. Politics could still go badly wrong in France. But with Macron in the pole position to be the next French president, the tail risks in the Eurozone have receded further. Having emphasised for a while that growth may surprise to the upside, we now raise our GDP forecasts for France from 1.2% to 1.4% for 2017 and from 1.3% to 1.5% for 2018. For the Eurozone, we now expect 1.8% instead of 1.7% growth for this year and 1.7% instead of 1.6% for next year. See our Forecasts at a glance for details. More noteworthy than the modest scale of this revision is the growing evidence that the upswing is broad-based and self-sustaining. Significant gains in employment (up 1.3% in 2016) support real income growth and consumer confidence. Having partly saved the oil price windfall in early 2016, consumers now seem ready to offset the fading of the oil price tailwind by reducing their savings rate a little. The broad nature of the recovery shows up in three different ways:

First, all major aspects of economic policy are supporting growth:

- **Monetary policy** remains highly accommodative. Deflated by the average core CPI so far this year, the real ECB refinancing rate stands at -0.8%. In response, credit growth is picking up gradually. Loan growth to the private sector averaged 2.3% yoy in January and February 2017, up from 0.8% in Q1 2016.
- **Fiscal policy** is adding a modest stimulus of 0.1ppt of GDP to demand growth per year. Austerity has been over since 2015.
- The **exchange rate** is helping a little. The real effective exchange rate versus 38 major trading partners remains 3% below its five-year average.
- Parts of the Eurozone are reaping the benefits of recent **structural reforms.** While this holds especially for Spain, Cyprus and Ireland, there are some signs that Italy and – to a lesser extent – France are also benefitting from recent reform progress.

Second, GDP is expanding in almost all Eurozone countries with the exception of Greece where the government does not yet implement the required reforms energetically enough to rebuild the confidence that Tsipras and Varoufakis shattered in 2015.

Third, all major pillars of demand are contributing to the upswing. Private consumption is increasing at an annual rate around 1.5% in the Eurozone, government consumption continues to expand at a similar rate, reflecting the modest fiscal stimulus. Construction and machinery investment are also rising. Economic fundamentals and confidence surveys signal a chance of modestly firmer gains ahead. After some volatility in early 2016 caused by the emerging market crisis and some temporary concerns about US growth, the export outlook has improved. In the EU Commission's sentiment survey, the sub-index for export orders in manufacturing rose to -6.9 in March. That is well above the long-term average of -18.8 and the best reading since July 2011.

Because the upswing is broad based and well entrenched, it would take a major external shock to derail it. The first round of the French presidential election has reduced the political tail risk. Instead, we now have a greater chance that structural reforms will raise trend growth by 0.3 percentage points in France and hence by almost 0.1 ppt in the Eurozone over time if Macron wins on 7 May and implements some significant supply-side changes once he has forged a pro-growth coalition after the parliamentary elections on 11 and 18 June.

MODEST INFLATION, SUPPORTIVE ECB

Not too hot, not too cold. For the time being, inflation poses no major risk to this outlook. While an oil price base effect, higher food prices and the late timing of the expensive Easter travel season have caused some headline-grabbing gyrations in headline inflation recently, core inflation (excluding energy and food) continues to fluctuate around 0.9%, as it has been for the last three years. Even in Germany with its record level of employment, the first major wage deals this year were moderate with an increase in wage costs of roughly 2.5% per year for 2017 and for 2018. This suggests that core inflation will pick up only gradually in the Eurozone in coming years beyond an updrift in housing rents and some short-term impact from oil prices on the costs of transport services included in the core inflation measure. To the extent that potential Macron reforms in France would augment the country's supply potential, they would also help a little to keep inflation under control.

We look for the ECB to drop its dovish guidance ("risks tilted to downside") in mid-2017 and announce in autumn 2017 a gradual reduction of asset purchases starting in January 2018. After the likely end of such purchases in the autumn of 2018, the first ECB hike in the refinancing rate may follow in 2019. If bank lending continues to edge up, the ECB may see less need to penalise banks for parking liquidity at the ECB. If so, the ECB could ease the penalty rate on such bank deposits from -0.4% to -0.25% in late 2017. This Thursday, the ECB will probably not want to send strong new signals ahead of the second round of the French election. Instead, the ECB may merely acknowledge that downside risks to growth have receded further without changing the overall assessment yet that the risks are still tilted slightly to the downside.

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