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EUROZONE GDP: A FIRMER AND LASTING RECOVERY

Berenberg Macro Flash

Eurozone GDP, Q2 (qoq, in %)

Actual:	**0.6**
Previous:	0.5
Consensus:	0.6
Berenberg:	0.5

A recovery above trend: The Eurozone enjoyed its 17th consecutive quarter of growth in Q2. GDP growth accelerated to 0.6% (0.56%) after 0.5% (0.51%) in Q1, in line with consensus expectations. In the first half of 2017, the annualised above-trend pace of Eurozone growth was 2.1%, putting the region ahead of both the US and the UK for the first time in many years. And the outlook seems more encouraging than it has been for almost a decade. Although serious risks remain, the Eurozone looks set to enjoy resilient growth at around 2% and low inflation – a Goldilocks era dawns on the Eurozone. This is good news for the currency union that needs further years of economic recovery, structural reforms and political stability.

The Eurozone recovery firms across countries: Eurostat's advance reading of Eurozone GDP (first of three releases) does not come with separate readings for Eurozone countries. Country readings published by national institutions for Q2 so far look positive. French GDP expanded by 0.5% for the third quarter in a row, providing President Macron with a tailwind to deliver his planned labour market reforms and some promised tax cuts while at the same time helping France to meet the EU's fiscal deficit rules. Spain reported buoyant growth of 0.9% qoq, an acceleration from the already strong Q1 number (0.8%). Austria also showed encouraging strength with GDP growing by 0.9%, after 0.7% in Q1. In Belgium activity decelerated in Q2 to 0.4%, after GDP had increased by 0.6% in Q1. Germany will report its first reading on 15 August, and Italy on 16 August. We expect growth in Germany to have held up at 0.6%, while it likely slowed in Italy (0.2%) after the – by Italian standards – stellar Q1 performance of 0.4%. Differences remain in the Eurozone with annualized rates of GDP growth ranging from 0.8% (Italy) to 3.6% (Spain) in Q1. But the upswing is gathering pace across the currency union, with GDP expanding in all countries including Greece. In addition to the benefits from the cyclical recovery across the globe, some parts of the region are reaping the benefits of structural reforms of the past. Notwithstanding, the adjustment remains incomplete. More work needs to be done to raise productivity and trend growth and prepare the Eurozone for the next crisis. The election of the staunchly pro-European reformer Emmanuel Macron as the new French president has promoted renewed hopes of institutional reforms and stronger trend growth.

Recovery broad-based across pillars of demand and sectors: While today's GDP reading does not disaggregate the overall growth rate, we expect the details to show a broadly balanced growth with all major pillars of domestic demand contributing to growth. Surveys and data from some Eurozone member countries point that way. The improving labour market drives private consumption. Unemployment, while still elevated at a rate of 9.1% in June compared to the current sub-5% rates in the US and UK and the sub-8% rates before the financial crisis in the Eurozone, has come down from a peak of 12.1% in April 2013. Employment gains (6 million jobs in the last 4 years) raise disposable income, confidence and household spending. Retail sales have increased by 0.7% comparing the average of April and May with the Q1 level. Business investment likely also provided a positive contribution to growth. Activity among manufacturers has rebounded and shows a clear upward trend. Based on April and May, the industrial production picked up by 1.2% versus Q1 and order books are now as full as before the euro crisis. Businesses continue to benefit from very favourable financing conditions thanks to monetary policy keeping borrowing costs low. As they face more demand, with backlogs of work rising despite higher levels of employment according to survey data, they are increasingly believing in a lasting upswing and invest in bigger, longer-dated purchases. Demand not only comes from the Eurozone, but also from abroad, as the recovery gains traction globally. Stronger demand from elsewhere may possibly cushion the recent loss of cost competitiveness amid a less weak euro (the euro versus the dollar is up by more than 12% ytd, with gains of 11% from the start of Q2). Government consumption has also turned from being a drag into a driver. Fiscal budgets rebalance as outlays for unemployment benefits drop and tax revenues increase. As a consequence, countries can afford to loosen their fiscal stance slightly. Against the backdrop of low and only very gradually rising underlying inflation, ECB monetary policy will remain accommodative for the time being as real policy rates continue to be negative and any normalisation in the policy stance will happen only very gradually.

Risks remain, but are unlikely to derail the recovery in the short-term: A potential Chinese debt crisis or a surge in US wage inflation that may cause the Fed to tighten much quicker would send shivers across the globe. However, these risks are unlikely to materialise over the next two years. In much of continental Europe, the pro-European mainstream is re-asserting itself in the wake of last year's Brexit vote and the rise of Trump. In Italy, the radical Five Stars movement remains strong ahead of new elections to be held before May 2018. However, key members of the Five Stars are mellowing over time, discussing whether a call for a euro referendum would really win them votes. A firmer recovery in the Eurozone should help to defuse the Italian risk further. Despite residual political risks, chances are that the Eurozone can continue to enjoy resilient growth at low inflation. Not too hot, not too cold.

Eurozone GDP (in %)

	Q2 17	Q1 17	Q4 16	Q3 16	Q2 16	Q1 16
qoq	**0.6**	0.5	0.6	0.4	0.3	0.5
yoy	**2.1**	1.9	1.9	1.7	1.7	1.7

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