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EUROZONE ECONOMIC OUTLOOK: RESILIENT RECOVERY

Berenberg Macro Flash

A BROAD-BASED UPSWING

Forget all the political risks for a moment. Economic fundamentals look quite encouraging for the Eurozone. The region is enjoying an upswing that is broad based and resilient. It would take a major external shock to derail it. The broad nature of the recovery shows up in three different respects:

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

- **Monetary policy** remains highly accommodative. Deflated by the core CPI, the real ECB refinancing rate stands at -0.9%. In response, credit growth is picking up gradually. The yoy rate of bank lending to households and companies edged up further to 2.4% in January from 2.2% last November and 1.1% in Q1 2016.
- **Fiscal policy** is adding a modest stimulus of 0.1% to 0.2% of GDP to demand 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 stands 3.5% 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 may also benefit from recent reform progress.

Second, GDP is expanding in almost all Eurozone countries with the possible exception of Greece and Finland where the recent quarterly data have been too volatile to provide a clear picture.

Third, all major pillars of demand are contributing to the upswing. Private consumption is increasing at a rate close to 1.5%, somewhat below the 2% gain early last year which had been inflated by the tailwind from unusually low oil prices. Government consumption continues to expand at a real rate of 2%, reflecting the modest fiscal stimulus. Construction and machinery investment are also rising. 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 subindex for export orders in manufacturing rose to -7.1 in February. This is well above the long-term average of -18.8 and the best reading since July 2011.

UPSIDE POTENTIAL

Shortly after the European Central Bank had stopped the irrational panic known as the "euro crisis" with its "do whatever it takes" promise in the summer of 2012, the Eurozone economy started to rebound at an average annualised rate of 1.3% from spring 2013 onwards. Helped by the end of austerity and a more determined ECB stimulus, growth has accelerated to an average annualised pace of 1.6% since early 2015. For the next few years, we expect more of the same. But for once, the risks to our forecast of steady GDP gains of 1.6% in 2017 and 2018 are at least as much to the upside than to the downside.

Three major reasons could contribute to a modest upside surprise:

First, over time, businesses and households are likely to shed some of the caution that has characterised their behaviour since the double whammy of the post-Lehman mega-recession and the euro confidence crisis. As steady gains in demand and employment encourage them to spend and invest a little more, the upswing can gain some momentum.

Second, some of the US stimulus to come can spill over into the Eurozone via more demand for Eurozone exports and – probably more importantly – via a positive confidence effect. Driven by the reform agenda of the US Congress, we look for US growth to accelerate to annualised rates of close to 3% from late 2017 onwards as a thorough US corporate tax reform, some deregulation initiatives and a fiscal stimulus kick in. For the Eurozone, which earns 2.6% of its GDP through exports of goods to the US, this could add 0.1 ppt to the yoy rate of GDP growth in late 2017 and 2018.

Third, structural reforms could raise trend growth by 0.3 percentage points in France and hence by almost 0.1 ppt in the Eurozone if a reformer (Macron or Fillon) wins the French presidential election and implements some significant supply-side changes afterwards.

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 and higher food prices have driven headline inflation to 1.8% in January, core inflation (excluding energy and food) remains stable at 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 deal this year has been moderate with an increase in wage costs of roughly 2.5% per year for 2017 and for 2018 for parts of the public sector. 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 CPI measure. The ECB will have little need to revise its staff projections for growth (1.7% for 2017 and 1.6% for 2018) and for inflation (1.3% for 2017 and 1.5% for 2018). As a result, the ECB will not have to rethink the thrust of its policies.

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 September 2019, that is shortly before Draghi's eight-year term ends in late October 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 may consider easing the penalty rate on such bank deposits from -0.4% to -0.25% as early as June this year, that is once the French presidential election and the risks associated with that election are out of the way.

As we have discussed at length in recent months, political risks loom unusually large. For the first time ever, the very existence of the EU or the euro as we know them could be at stake if the French elections go badly wrong. But it would probably take a major shock emanating from the US, a surge of Marine Le Pen to power in France or an Italian decision to leave the euro to really derail the well-entrenched economic recovery. Fortunately, these tail risks remain small. A mere political hiccup in, say, the Netherlands (unlikely) or a renewed confrontation between Greece and its creditors as in 2015 (also not likely) would probably not scare households and companies across the Eurozone badly enough to cause a major dent to growth. The recovery looks too resilient for that.

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