

5 reasons Eurozone growth could be even stronger than you think in 2018

The Eurozone was the global economy's Cinderella story of 2017. The question now: Was this a one-off performance or can it can maintain the pace? We think the latter



2017 surprised on the upside

Will the Eurozone be 2015 Leicester City or will it be Chelsea with continued strong performance thanks in part to a generous supply of money? We think the latter and we could even see a further acceleration of growth from here.

About a year ago, sentiment about the Eurozone was downbeat. People were still reeling from the UK decision to leave the EU and the US Presidential elections caused a lack of trust in political polling. This led to EU disintegration risk to top the list of investor worries with many Eurozone elections ahead.

We expect growth at 2.2% in 2018, well above trend

About a year later, things look very different. Europe's most boring election, in Germany, actually seems to have resulted in the largest uncertainty of all. Most governments formed have either maintained previous positions on Europe or become more euro-minded.

With so much focus on politics, acceleration of economic indicators went almost unnoticed at first. But a strengthening job market, weak inflation, exports profiting from improving global growth and decade highs for consumer confidence are causing the Eurozone economy to accelerate. This year, we expect GDP growth to come in at 2.3%, which would be a tie for strongest growth in a decade. There are few signs pointing to a slow start of 2018 either. We, therefore, expect growth at 2.2% in 2018, well above trend.

2.2% 2018 Eurozone growth
ING estimate

2018 will be off to a good start

Leading indicators for the Eurozone point to continued robust growth in the New Year. Recent strength in the labour market will fuel household consumption at the beginning of 2018 too. Credit standards have eased over recent years, although the past quarters have seen some stabilisation. Nevertheless, bank lending growth is slowly increasing, fueling further investment and providing a tail-wind to the housing market recovery. Despite a somewhat stronger euro than at the start of 2017, exports are likely to continue to be supported by the global recovery as the Eurozone's main export partners are, on average, expected to experience somewhat faster growth over 2018.

But that's not all. There are indicators that are even pointing to accelerating growth in the months ahead. Could it be that the Eurozone economy shifts into even higher gear?

New orders are pointing towards an acceleration in the economy. Order books have improved to levels previously seen at the top of the business cycle, suggesting an accelerating recovery of Eurozone industry. Industrial output had lagged the overall economy but is closing the gap with an annual growth rate of 3.3% in September. The recent surge in new orders could be a prelude an acceleration in Eurozone GDP growth.

With demand continuing to improve in the Eurozone, many businesses are now indicating they are reaching the limits of their production capacity. That requires expansion and causes corporate investment to increase. Given the current levels of capacity utilisation, it could well be that annual non-financial corporate investment growth increases to above 5%.

Businesses are not just reaching capacity in terms of capital; employment is increasing as new orders continue to grow and backlogs of work increase. Survey questions indicate that the labour market is roaring. The Eurozone PMI for November indicated that hiring is now at a 17 year high, while the European Commission shows that business expectations of employment are at the highest since the start of the indicator in 1985. As businesses are also reporting higher vacancy rates, there may even be an upside to wage growth in the year ahead. Improved employment

boosts average personal disposable income and is closely connected to consumption.

Related to the previous point, consumer confidence has reached the highest level since January 2001. In fact, outside of a few months in 2000 and January 2001, consumers have never been more confident. Even in the roaring nineties or around the fall of the Berlin Wall Eurozone consumers weren't this positive. This is mainly because their outlook for employment and personal finances is very good, which boosts their plans for consumption. The surge in expectations to buy durable goods could push annual consumption growth to around 2.5% YoY early next year.

We could even expect some government support next year. The effects of austerity measures are fading at the moment, causing government expenditure to improve. This year we expect the fiscal stance, the impact of government spending on economic growth, to be 0.2%, up from 0.1% in 2016. For next year, there is even more room for improvement as the French fiscal stance is likely to improve significantly.

So why not expect growth rates of 3% next year?

These exuberant indicators only paint part of the picture for the Eurozone. While there are indeed upsides to the outlook, some reasons for more modest expectations are compelling. Even though the labour market has been steadily improving, meaningful wage growth is still not expected for 2018. This has a dampening effect on consumption as it limits household income growth. Risks to export growth include our expectation of a somewhat stronger euro and possible increased trade barriers. And what about the diminishing support of the European Central Bank?

While the political climate in the Eurozone has remained stable since the 2017 elections, the aftermath might still have a sting to it. Uncertainty around a new German government will make ambitious Eurozone reform plans in the coming months even less likely. Moreover, significant German fiscal stimulus for 2018 seems to be too ambitious with a caretaker government in place. This will curb German growth potential for next year. Worried eyes will also land on Italy in 2018 with elections happening before the end of May. With the ECB reducing its asset purchases by 30 billion per month, the question is whether this will not cause delayed investments in the Eurozone's third-largest economy.

All in all, there remain enough side notes for us not to have 2018 as the best year since the inception of the Eurozone as our base case. Still, there are a lot of signs pointing towards a stellar start to the year. And with the Eurozone being the surprise of 2017, it is not unthinkable that another year of amazement at European data points is in the making.

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