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Eurozone: Mixed feelings

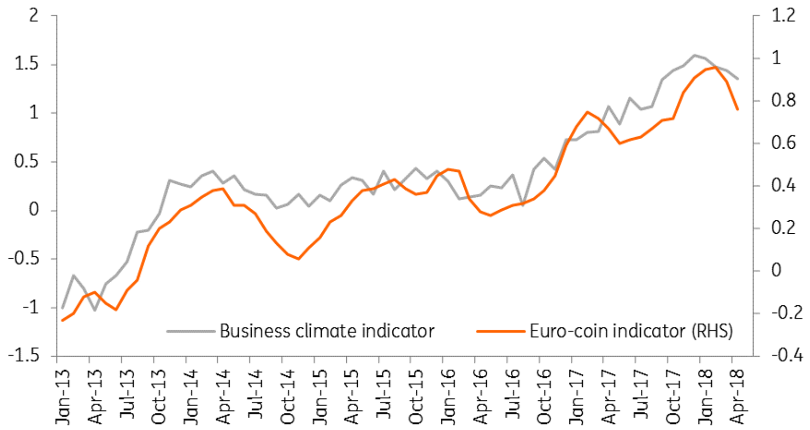
Eurozone growth has slowed since the beginning of the year, with inflation remaining unusually low. While both phenomena might be temporary, it looks as if a first rate hike is now not to be expected before the second half of 2019

Source: Shutterstock

After a robust 2017, growth has somewhat slowed since the beginning of the year. While the first quarter has been affected by a number of one-off effects and underlying fundamentals remain supportive, we still feel that peak growth is now behind us. At the same time, core inflation has unexpectedly fallen back to only 0.7%, which increases the probability that monetary policy will stay loose for longer.

First quarter GDP growth came in at 0.4% quarter-on-quarter, a clear deceleration from the 0.7% pace seen in the last quarter of 2017. There have certainly been one-off effects dragging down growth. An unusual cold spell in March might have negatively affected construction activity in the first quarter. At the same time, the European Centre for Disease Prevention and Control reported an unusual long influenza season this year, probably also hurting activity and consumption. Apart from that, strikes in Germany and the timing of the Easter holiday period, which was earlier than usual in several countries, had a dampening effect. The high oil price, which turned out to be more persistent than we anticipated, probably weighed on consumption. As 10% permanent moves in crude oil prices have close to a 0.2% effect on Eurozone consumption, the 15% higher crude price we had so far in the second quarter, is likely to shave off another 0.30% from household consumption this quarter. While we don't think oil prices will remain as high as today in the rest of the year, one has to acknowledge that with the Iran nuclear deal now close to collapse, tensions on the oil market could linger a bit longer. This means that the negative impact on consumption is not likely to disappear in the near term.

In that regard, we don't expect the second quarter to accelerate again towards the 0.7% growth pace we saw in the last quarter of 2017. Initial indicators for the second quarter hardly point to stronger growth momentum. Actually, some of the more forward-looking components of the confidence indicators like new orders, have softened, signalling that a somewhat slower cruising speed seems a more realistic assessment or that it could take a bit longer before a rebound emerges. A year-on-year growth of 2.8%, like we saw in the last quarter of 2017, looks difficult to emulate. That said, it would certainly be too soon to worry about a significant further weakening. Indeed, job growth remains satisfactory, boosting households' income. While potential trade conflicts have become an important worry for European companies, business investment should continue to be supported by increasing supply constraints and accommodative financing conditions. According to the European Commission's bi-annual investment survey carried out in March/April, real investment in the manufacturing industry is expected to increase by 7% this year, a significant upward revision from the 4% growth managers had expected in the previous survey of October/November 2017. Taking into account these elements and without any major upset, a quarterly growth rate hovering around 0.4% to 0.5% seems likely for the next six quarters. This amounts to 2.2% GDP growth this year and 1.8% in 2019.

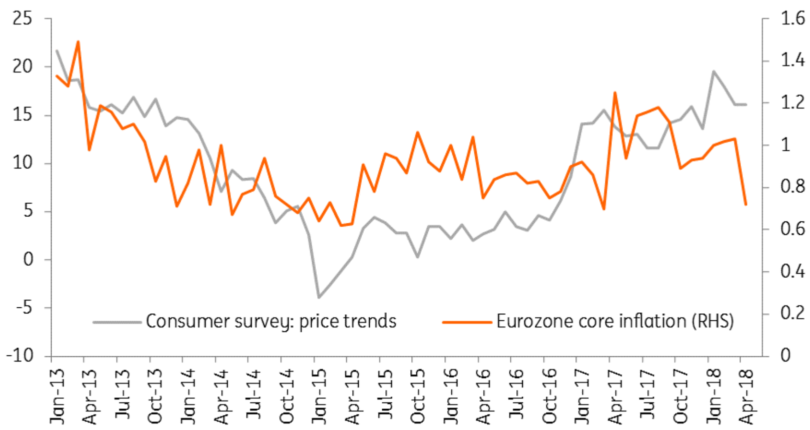


Politics don't help

Politics remains an area of potential upset. French President Emmanuel Macron struggles with protests at home against his reform plans, while his ambitious agenda for Eurozone reform doesn't resonate much with the new German government. It seems as if the current economic upturn is not going to be used to strengthen the set-up of the Eurozone. While this is not going to have a major impact now, it could spell trouble when the next serious downturn arrives. The thorny path to a new government in Italy is unlikely to lead to a government willing to tackle some of the structural weaknesses of the peninsula, on the contrary. While Greece has been overperforming in terms of budget consolidation, there has been no decision yet on further debt relief, though we still see it likely before the programme ends in August. According to recent reports, Greece could still fall short in implementing all required measures before exiting the bailout.

Inflation remains too low

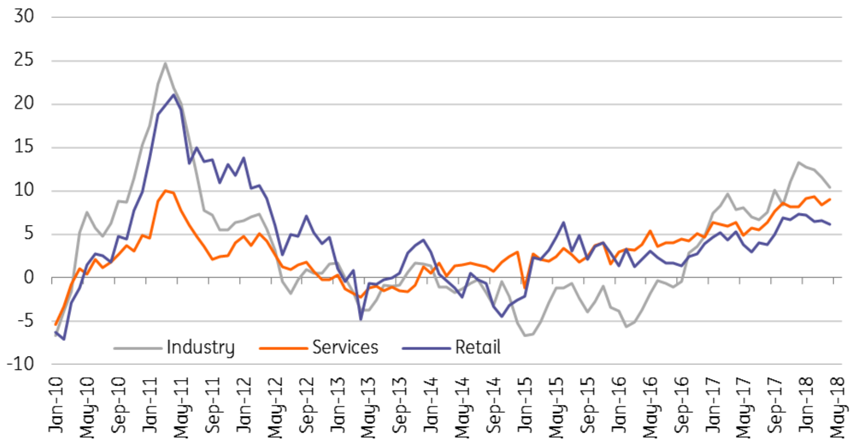
From an economic point of view, the real shocker was the inflation report for April, with core inflation falling back to a mere 0.7%. To be sure, some decline was expected because of the early Easter holidays, which drove up prices in March. But if we take the average of March and April to correct for this distortion, we still wind up with core inflation below 1.0%. Even if higher oil prices and the somewhat weaker euro could lead to higher headline inflation forecasts for 2018 and 2019 in the next ECB staff projections in June, it remains clear that the ECB's Governing Council expectation that inflation will sustainably converge to target in the medium run is ambitious. Looking at the indicators of price expectations in the European Commission's survey, it seems as if some of the pipeline pressures have been abating slightly since the beginning of the year, especially in industry and the retail sector. Actually, the minutes of most recent meetings of the Governing Council show that the Council members themselves see plenty of reasons why inflation might undershoot. Core inflation is likely to end the year at 1.5% at best, which is still significantly lower than the ECB's target value.



ECB is not in a hurry

Recent research from the ECB makes the case for gradualism and to keep the policy rate low for longer than is warranted by the dynamics of output and inflation alone. In that regard, we believe that, even though the net purchase of bonds might still end in December, the probability of a rate hike in June 2019 is getting smaller. Governing Council member François Villeroy de Galhau mentioned September or December (our call) as the likely end point of quantitative easing and that a first rate hike could come quarters, not years, after the end of asset purchases. This is compatible with our new call for a first rate hike in September 2019. At the same time, the ECB is likely to put more emphasis on the reinvestment programme of maturing bonds. Given the fact that the bank has been closely monitoring the unwinding of the QE programme in the US, it seems likely that the ECB will keep its reinvestment programme in place for another three years after the end of the net purchases. Incidentally, in his farewell interview to the Financial Times, ECB Vice President Vítor Constâncio, mentioned that unconventional policies are now part of the ECB's toolkit (and have therefore become conventional). He also suggested that in the future, if need be, the ECB might follow the Japanese example and go into yield curve control, meaning targeting specifically some interest rates for longer-term maturities.

It comes as no surprise that with the expectation of a first interest rate hike being pushed out further, European bond yields have not followed entirely the US upward bond yield trend since March. As a consequence, the bond yield spread with the US has now reached the highest level since the start of the Monetary Union, potentially giving some temporary support to the dollar. Interestingly, the ECB staff has tried to quantify the impact of its unconventional policy on the 10-year bond yield. For 2018, this drags down long yields by about 110bp. For 2021, the ECB still sees a downward impact of about 75bp, meaning that the upward pressure of unwinding QE will only be very gradual.



Source: Reuters Datastream

The Eurozone economy in a nutshell (%YoY)

	2016	2017F	2018F	2019F
GDP	1.8	2.4	2.4	1.7
Private consumption	2.0	1.9	2.2	1.9
Investment	4.5	4.0	3.9	2.0
Government consumption	1.7	1.1	1.3	1.3
Net trade contribution	-0.5	0.2	0.0	0.0
Headline CPI	0.3	1.5	1.4	1.7
Budget balance (% GDP)	-1.5	-1.3	-1.2	-1.0
Refi rate (eop)	0.0	0.0	0.0	0.25
10yr Bund (eop)	0.30	0.42	0.75	1.10

Source: Reuters, ING estimates

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

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