

## ING's Eurozone Quarterly: A slower cruising speed

Economic growth in the Eurozone has slowed since the start of the year and inflation remains unusually low. This might be temporary but there are risks ahead- and the political landscape isn't helping. In our latest Eurozone Quarterly Update, we look at where the economy is heading now and what it could mean for monetary policy

### In this bundle



#### **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...

By Peter Vanden Houte

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#### **Germany**

#### **Germany: The flip side of being the best**

A weak start to the year does not make a fully-fledged downswing. However, boosting investments will be key to solving the current supply-side constraints

By Carsten Brzeski

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#### **France**

#### **France: Enjoying cyclical strength**

President Emmanuel Macron is everywhere, controlling every national reform while remaining very active on the international scene, where he still lacks a...

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## Italy

### Italy: The impact of a possible 5SM-League deal

Italy's anti-establishment Five Star Movement and the far-right League are close to a deal but they have yet to agree on a shared programme and a...

By Paolo Pizzoli

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## The Netherlands

### Netherlands: Still in sixth gear

The Dutch economy continues to grow above potential and the Eurozone average, but we think there is still ample room for more. Despite marginal wage rates...

By Marcel Klok

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## Spain

### Spain: Has growth peaked?

The Spanish economy has continued its strong growth in 2018 but a slowdown could well be on the horizon. Meanwhile, there are optimistic tunes around the...



## Belgium

### Belgium: Just not fast enough

For Belgium, 2017 was another recovery year which is definitively satisfactory but things could be much better. Yet, we don't see any signs of strong...

By Philippe Ledent

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## Austria

### Austria: Still on track

With the economy carrying most of last year's momentum into 2018, the main focus after the summer will be Austria's EU presidency

By Inga Fechner

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## Portugal

### Portugal: Some weakening after a strong cyclical push

Most indicators are moving in the right direction but burdens of the past are still a drag. We expect the Portuguese economy to slow down towards the end...



### **Eurozone: Low interest rates continue to support real estate**

Recovery of housing markets in the Eurozone continues and remains supported by low-interest rates. But we suspect 2018 will be another year of high house...



### **Ireland**

#### **Ireland: Celtic tiger continues to roar**

Ireland's economy expanded 7.8% in 2017, making it one of the fastest growing in the world. Much of this figure continues to be dominated by the...

By Bert Colijn



### **Greece**

#### **Greece: Looking through the end of the third programme**

Greece is rushing to complete prior actions to close the ESM programme. Some extra debt relief should be conceded at the end of it, but life after it will...

By Paolo Pizzoli

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Article | 17 May 2018

## Eurozone: Mixed feelings

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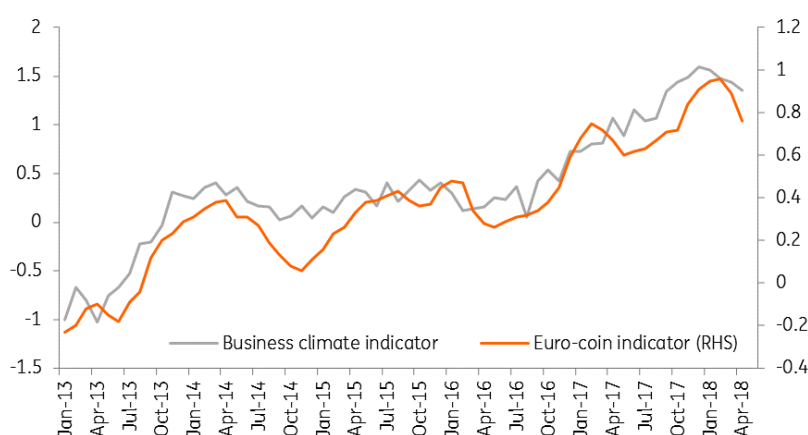
Source: Shutterstock

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.



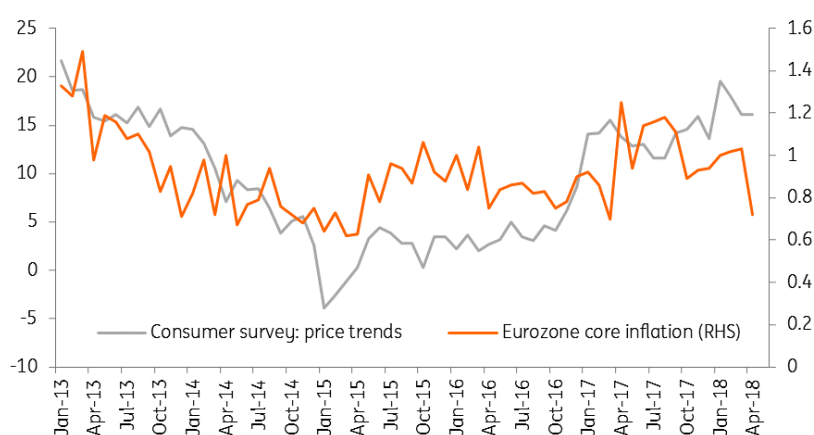
## Politics don't help

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.

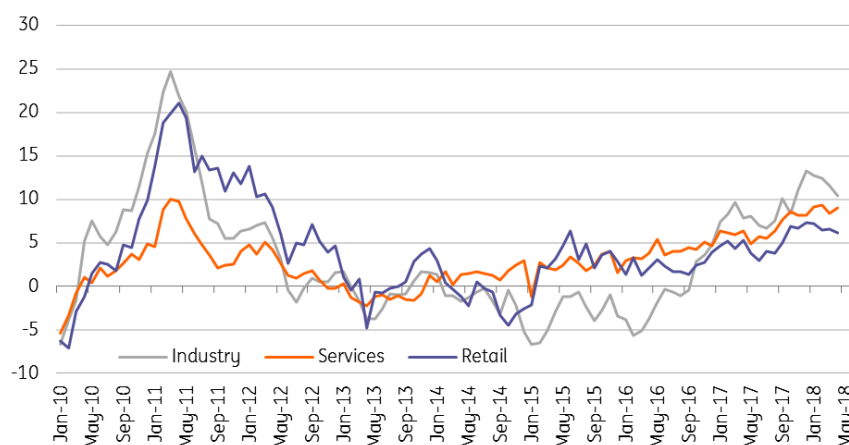


## ECB is not in a hurry

[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

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## Germany: The flip side of being the best

A weak start to the year does not make a fully-fledged downswing. However, boosting investments will be key to solving the current supply-side constraints



Source: Shutterstock

The German economy had an unexpectedly weak start to the new year. After a long period of superlatives and strong quarterly growth, a series of one-off factors like the winter weather, the timing of vacation, a flu epidemic and strikes in industry led to speculation about a possible cyclical downswing. In our view, this concern is premature. Sound fundamentals bode well for a rebound in the economy over the summer months. However, the German economy is increasingly suffering from the flip side of being the best: supply-side constraints, hampering future growth.

### Weak data at start of the year - no reason for concern?

Disappointing data, both soft and hard, since the start of the year, has cast doubt on the strength of the German economy and invited speculation about the beginning of a possible downswing of both the German and the Eurozone economy. Fortunately, hard data for the month of March brought some relief.

A closer look at the German economy shows promising signs of a rebound in the coming months. Despite some minor levelling off, capacity utilisation is still close to record highs, assured production in the industry is close to all-time highs and the high stock of orders and historically low inventories all bode extremely well for industrial production in the coming months. Also, loans to



the corporate sector are currently growing at higher rates than in the pre-crisis period.

## **Domestic side of economy is hampered by supply-side constraints**

The biggest domestic problem for the German economy is that it is almost literally coming apart at the seams. Demand is as insignificant a problem as in the first years after reunification. Instead, supply-side factors are increasingly hampering Germany's growth prospects. Both equipment and labour are currently at their highest levels ever and are limiting factors to production. Against this background, more investment seems to be the best and easiest way forward. It would increase production capacity and could lift the current speed limits.

In this regard, the recently presented long-term budget plan of the new government was not really encouraging. Although the coalition agreement put more emphasis on digitalisation, education and consequently investments, the numbers put on these plans and intentions could have been more ambitious. The coalition agreement foresees a total of around €30bn of new investments, some 0.2% of GDP per year, for the next four years. However, only one-third of this amount would go into future-oriented sectors and projects like digitalisation, high-speed internet etc. The budget plan presented in early May leaves a fiscal surplus, the so-called 'black zero', as the single most important policy target for the next few years. Investments would only increase in 2018 and 2019, before dropping again from 2020 onwards. Admittedly, these were only the plans for the federal government. As a big chunk of public investments has to come from the municipalities, there is still hope for public investments to surprise to the upside. At least the bar for a positive surprise has now been lowered.

## **External side of economy mainly at risk due to trade tensions**

While the biggest domestic challenge for the German economy is to solve the supply-side constraint problem and to finally boost investments (both in the public and private sector), the biggest external challenge currently stems from trade. Since President Trump stepped up his protectionist rhetoric and threats, the German export sector has become somewhat concerned. Rightly so.

In 2017, the US was Germany's largest export partner. The bilateral trade surplus vis-a-vis the US amounted to more than €50bn, with vehicles and machinery recording the largest bilateral surplus. At the same time, Germany runs a significant trade deficit with the US in agricultural products. The only comforting factor for Germany is that it has a very diversified export sector, particularly in terms of geographic diversification. In this context, however, it is noteworthy that the revival of the French economy under President Macron has so far hardly had any positive impact on the German economy. Since Macron's inauguration, the share of German exports going to France has remained the lowest since German reunification. For the time being, the US remains the most important export destination for Germany and sanctions would obviously hurt. And there is more. Even without US sanctions for EU products, Germany could become the first prominent victim outside of a trade war between the US and China. Any Chinese import tariffs on US-produced cars would immediately harm Germany as the single largest car exporting company in the US is in fact a German car manufacturer.

All in all, the German economy is currently in the middle of a difficult combination of negative one-

offs; dropping optimism and strong fundamentals. Despite increased downside risks, we stick to our upbeat growth outlook, counting on a further investment offensive in the coming years. These investments are crucial to solve current supply-side constraints and to free up more growth potential. Currently, the German economy is experiencing the flip side of strong growth over a longer period. There are worse positions to be in.

#### The German economy in a nutshell (%YoY)

	2017	2018F	2019F	2020F
GDP	2.2	2.2	1.9	1.7
Private consumption	2.1	1.0	1.5	1.3
Investment	4.0	2.8	3.7	2.5
Government consumption	1.6	1.5	1.5	1.4
Net trade contribution	0.2	0.4	0.2	0.1
Headline CPI	1.7	1.5	1.6	1.8
Unemployment rate (%)	4.1	3.9	4.1	4.2
Budget balance as % of GDP	1.1	0.7	0.4	0.2
Government debt as % of GDP	64.9	61.7	59.1	58.8

Source: Reuters, ING estimates

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## France: Enjoying cyclical strength

President Emmanuel Macron is everywhere, controlling every national reform while remaining very active on the international scene, where he still lacks a...



The first year of the Macron presidency is over. For him, this is not the time to analyse results but to persevere in producing them. It has been a busy year with several reforms, including initial labour and institutional reforms as well as the much-contested railway reform. Macron benefits from a 44% approval rating, which is higher than both Francois Hollande (25% after year one) or Nicolas Sarkozy (36%) and very close to Jacques Chirac. His popularity is highly concentrated in those who voted for him in the first round; he already lost some of the support he gained on the left in the second round. Despite being governed from the centre of the political spectrum, France is therefore as divided as last year, between those who call for reforms and others who prefer the status quo. Highly symbolic of this division is the dispute over railway reform (and subsequent strikes), which failed to gather enough street power to trigger any significant change (aimed at preparing the company for international competition and partly absorbing its debt of nearly 50 Bn€, roughly 2% of GDP).

## 2.1% Our expectation for French GDP growth in 2018, the highest since 2011

The current economic reform agenda remains heavy:

- **The housing market.** Low-interest rates and recovering prices, which have risen by 2% year on year on average since 2016 after eight years of stagnation (average price growth of 0% between 2008 and 2015) are boosting housing investments. The market should be helped by the reform of the housing tax (or €22bn of fiscal revenues for local collectivities) which should be scrapped by 2020, starting with a 30% reduction for 80% of households in 2018. There is also a €14bn plan to help households renovate their homes (to reduce carbon emissions), of which €1.8bn should go to public buildings while local collectivities will be able to levy €2.5bn more for their own buildings. The plan should allow for the renovation of 500,000 housing units per year.
- **The labour market.** A reform encouraging more flexibility is now being applied and the second part of this measure should be voted on in September, comprising €15bn of investment in training and apprenticeship. This should allow for the creation of a “training account” for each worker to help everyone keep pace with changes and replace the subsidised contract schemes of the Hollande era (which reached 500,000 people and an annual budget above €2bn at its peak). This should be in place before the end of the year, after tough negotiations over regional competencies. For now, the main areas still debated are the reform of unemployment allowances for independent workers and single-person companies and measures to curb the use of fixed-term contracts, which are seen by the government as a counterpart to the increased flexibility offered by the 2017 reform.
- **Pension reform.** Discussions will likely start this summer, with the view to a vote in the summer of 2019. The aim is to harmonise the 42 different pension regimes and set up a pension account with a Scandinavian touch.

All in all, year two should be busy, too. On that front, the main risks are reform fatigue (which can always happen if results are not showing quickly in unemployment figures), and a more cohesive opposition. During year one, both the right and the left were in disarray while unions never succeeded in talking with one voice. The second year of the presidency could see more opposition from Les Republicains (LR party) outside their main year one debate theme (immigration), especially on pension reform.

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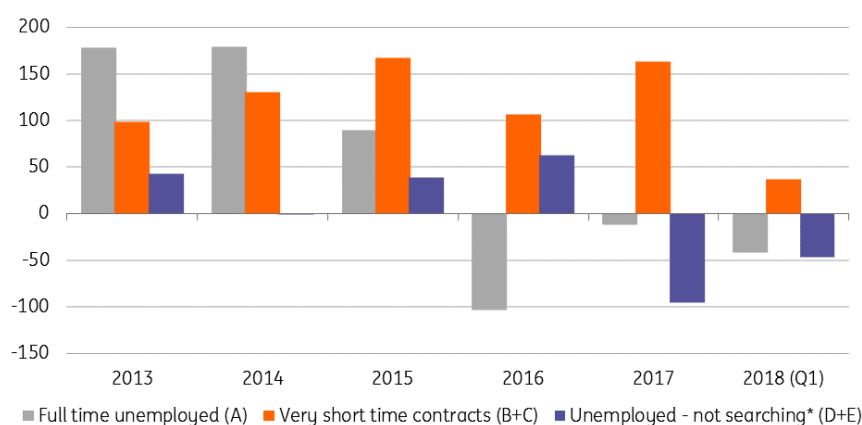
If the extreme Left seems to limit its parliamentary fights, former Presidential candidate Jean-Luc Mélenchon may organise resistance in the streets. He could be instrumental in reconciling the

main unions, a task that will be made easier by the end of the mandate of Jean-Claude Mailly (from Force Ouvrière) who has been a wiser and less confrontational negotiating voice in the last round of reforms than others, especially as Pascal Pavageau looks to be on a similar hard line as Philippe Martinez (CGT). It is therefore unlikely that opposition pressure will decrease in year two, although we do not think at this stage that they will be able to paralyse reforms. A condition to that would be that Macron is still supported by a dynamic economy.

## Confidence remains high across sectors

In the services sector, confidence has been stable in recent months, just below its January peak (109), at 107 in April. Hiring and investment intentions, in particular, remain upbeat at the start of the second quarter, boding well for the current trend of declining unemployment. Still, the last consumer confidence figures show only a slight rebound in April. It seems that the job market is not really the main worry, in fact, French consumers are still upbeat on the economic recovery. Instead, they fear for their own financial situation and their capacity to save. Nevertheless, purchasing intentions remain elevated and lower unemployment could transform these intentions into acts.

The main confidence slowdown comes from the manufacturing sector, as has been the case throughout Europe since the start of 2018. Confidence there was below its 12-month average in April while order books were still seeing inflows. We expect confidence to stabilise at these lower levels, showing a consolidation of growth prospects at a high level for 2Q, but without further acceleration. This was reflected in the industrial production figures of the first quarter which showed a 1.3% quarter on quarter drop, while the trend on a yearly basis remained stable at 2.3% year on year overall. Manufacturing has been slowing down from 2.8% growth on average in 2017 to 2% in 1Q18.



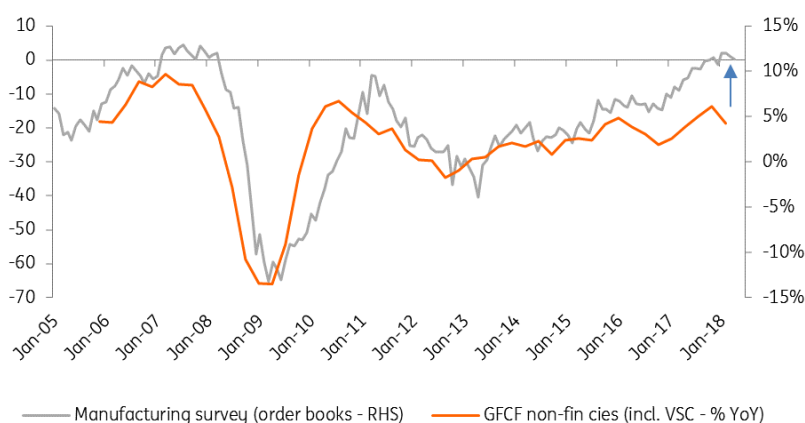
Source: \*on training, apprenticeship, subsidized jobs,... Source: Thomson Reuters, Pôle Emploi and Pôle Emploi nomenclature

## Investments should feed domestic demand dynamism in 2018...

This year, the first quarter GDP figures posted some unpleasant surprises in terms of domestic demand dynamism. First, private consumption came in below expectations, at a mere 0.2%, showing no sign of improvement for the last two years. Private consumption grew by only 1.3% in 2017. With such a weak start to the year, it is difficult to see 2018 consumption growth above 1.5%.

We believe that some acceleration should materialise this year with lower unemployment. The first quarter has sent positive signals on that front as the number of unemployed (all categories) declined by 51.7k (in 2017 the total increase was 55.6k) and although past subsidised contracts continued to decline (-47k in categories D and E which count unemployed people not looking for a job as they are on training, apprenticeship or some form of subsidised jobs), they were absorbed by new job creations, leading to a net decline of 41.6k in the main unemployed category (A). This has allowed the unemployed population to decline to 3422k (-2.2% YoY). 120k subsidised jobs should disappear in 2018, which means that weak readings in the unemployed population data do not necessarily reflect labour market weaknesses. We therefore continue to believe that improvements will be felt by French consumers this year, leading to somewhat higher private consumption growth in 2018 and decisively higher in 2019.

Non-financial companies' investments slowed down to 0.5% QoQ, their lowest speed since the end of 2016. However, given order book levels and high capacity utilisation (at 85.2%) we believe it should rebound and post an acceleration on 2017's 4.4% YoY growth. Finally, public investments grew by 0.9% QoQ, their strongest growth pace since 2011. This is only the second positive contribution to growth of public investments in the last 20 quarters. With regional elections looming in 2019, we expect this trend to continue.



Source: Source: Thomson Reuters

## ...and for once net exports should contribute positively to 2018 growth

France's competitiveness did not improve much in recent years, especially in relative terms (compared to Germany, the Netherlands or Spain). However, France is benefiting from the robust Eurozone demand recovery and a catch-up of its tourism exports (weakened by terrorist attacks in recent years) while weak private consumption is limiting imports. The phenomenon already favoured 2017 which showed a limited negative contribution to growth (-0.4pp after -0.8pp in 2016) and should bring a positive 0.3pp contribution to growth in 2018.

Currently, the government expects this positive contribution to be maintained through time. We think this is optimistic. Once private consumption is robust again and Eurozone demand softens, probably at the turn of 2019, the situation should reverse itself. Only if exporting companies make investments to boost competitiveness and lower production costs could France count on less negative net export contributions to growth. And this is without counting a number of risks.

## Main risks to the growth outlook

1. **Strikes.** There has been much debate so far in 2018 around the impact of rail and airline strikes on economic growth. In 1995, 22 days of general strikes had a 0.2pp impact on GDP growth. This year, only transport was hit, and workers have a greater ability to cope with it compared to 20 years ago. The most impacted sectors will be transportation services of course (as Air France and SNCF should endure a total of €500 to €650 million losses because of the strikes), and tourism, as the strike in both rail and air travel strongly affected the end of the Easter holidays and the long weekends of May. With the end of the movement in Air France and no more strikes announced at SNCF (beyond 28 June), the effect on 2Q18 GDP growth should be limited to 0.1pp at most.
2. **Oil prices.** In 2Q17, oil prices (Brent in EUR per barrel) were at €46.4. If oil prices stay above €60 in 2Q18 (which is not unlikely), energy costs on the year will be 30% higher, which is a strong acceleration. This could affect household purchasing power and delay the recovery in private consumption. It could also delay some business investments.
3. **A strong euro.** In recent weeks, stronger inflationary pressures in the US together with higher oil prices and disappointing first-quarter growth in the eurozone have brought the euro under 1.20 against the US dollar. This interrupted a strong EUR appreciation (from 1.05 to 1.25 over a few months) which could hurt French exporters, especially if it resumes before year-end. Our current forecasts incorporate the fact that the EUR/USD will go beyond the 1.25 level in 2019. If the appreciation were to start sooner in 2018, one cannot exclude a less positive contribution of net exports to growth than the 0.3pp currently pencilled in.

All in all, the picture has changed dramatically in France in one year. The conditions for an economic acceleration are there and it should not be long before consumers join the party. It is hard not to recognise the positive effects of the reform atmosphere the Philippe government has succeeded to install. Even if most measures will not take effect for some months, expectations can be built on stronger grounds. We expect reforms to continue in 2018, which should help GDP to reach 2.1% this year. There are risks, however, with the possibility of an appreciating currency, prolonged strike periods and persistently higher energy prices.

### French economy in a nutshell (% YoY)

	2017	2018F	2019F	2020F
GDP	2.0%	2.1%	1.9%	1.6%
Private consumption	1.3%	1.5%	2.0%	1.6%
Investment	3.8%	4.5%	5.1%	2.5%
Government consumption	1.6%	1.7%	1.9%	1.2%
Net trade contribution	-0.4%	0.3%	-0.6%	-0.7%
Headline CPI	1.0%	1.5%	1.6%	1.9%
Unemployment rate	9.6	9.1	8.5	8.3
Budget balance as % of GDP	-2.6	-2.4	-2.9	-2.6
Government debt as % of GDP	97	97.5	98	97

Source: Reuters, ING estimates

## Back on the European scene

A mix of low interest rates and higher GDP growth helped France to get its public deficit back at 2.6% of GDP in 2017, a figure that should improve further in 2018. In 2019, due to some fiscal changes, a temporary rebound is expected. This should allow France to see its debt decrease after 2019, without reaching 100% of GDP. For that reason, France has been allowed out of the excessive deficit procedure (EDP - where it was still together with Spain) despite the fact that the country did not comply with the structural deficit reduction asked year after year by the European Commission.

This probably makes official the return of France on the European political scene, Macron appears as the most powerful leader for now. However, in the middle of Brexit talks, with an Italian caretaker government and a weakened Spanish prime minister, there is little overall appetite for eurozone reforms. A roadmap towards completing the banking union should be decided upon in June, but France is unlikely to gain support on other initiatives. The June European Summit will be tough for President Macron, but will also illustrate how far he wants to go to push the eurozone forward.



# Italy: The impact of a possible 5SM-League deal

Italy's anti-establishment Five Star Movement and the far-right League are close to a deal but they have yet to agree on a shared programme and a...



Source: Shutterstock

## A possible 5SM-League tie-up

The 4 March elections resulted in a hung parliament, and the two-month long history of this new legislature has been marked by repeated unsuccessful attempts to break the political gridlock. Two rounds of consultations and two explorative mandates simply confirmed the staunch cross-vetoes which have prevented the formation of viable political alliances. The persistent gridlock persuaded President Sergio Mattarella to speed things up, putting political actors with their back to the wall. To this aim, he called a final one-day wrap-up consultation day, after which he would take the initiative. As no new unexplored solution emerged at the end of that day, Mattarella announced that he would soon launch a “neutral” government with a time-limit attached, bringing Italians back to the polls in early 2019 at the latest. Against this backdrop, Luigi Di Maio, the leader of the 5SM, and Matteo Salvini, the leader of the League, came up with a surprising last-minute attempt to strike a deal and form a government together. All this was made possible by the decision of Silvio Berlusconi, the leader of Forza Italia, to step aside and allow the League, its main coalition partner, to start coalition talks. The two parties together could count on a solid majority at the Chamber of Deputies (349 MPs with a majority threshold of 316) and a thinner one at the Senate

(169 MPs against a threshold of 158).

## Seeking a compromise

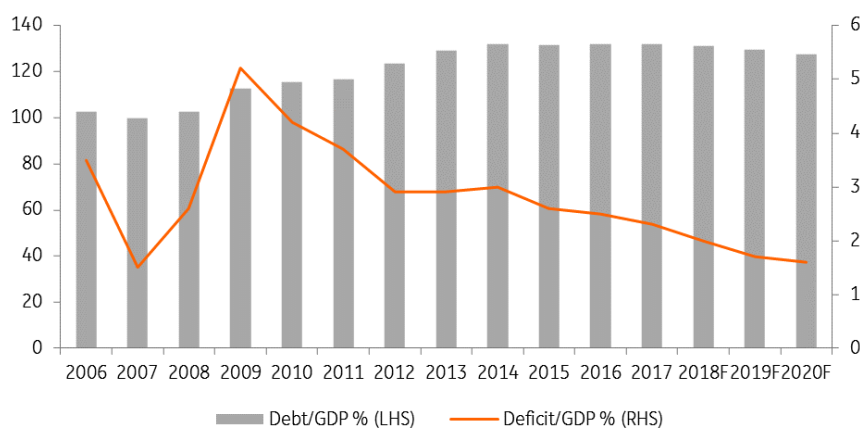
As we write, 5SM-League talks are ongoing. Building such an unprecedented alliance is not proving easy. Compromises must be made on a common programme and new prime minister- not an easy task for two parties that based their electoral campaigns on radical calls. The League had focused on the introduction of a flat tax system, the abolition of strict pension rules introduced by the Mario Monti government (the so-called Fornero reform) and on fighting illegal immigration while 5SM advocated for the introduction of a universal basic income. Both parties seem unwilling to backtrack on these calls, but will likely have to soften them to find a solution. On other issues, such as industrial policy, the reform of the public administration and the health service, programmes overlap enough to avoid serious tensions.

## Stance on Europe is biggest unknown

The big question mark relates to where the balance would lie on crucial issues such as the relationship with Brussels and fiscal discipline. Reconciling Salvini’s consistently critical attitude towards Europe and the euro with the (untested) pro-euro conversion of Di Maio might prove difficult. We believe that President Mattarella, before giving the mandate, will be very clear in recalling the existence of domestic and external constraints imposed by international treaties. Within the current institutional framework, abandoning fiscal discipline would not be an option. In our view, a 5SM/League government would at first try to change European governance “from within” while maintaining a very vocal critical attitude towards the European establishment. The forthcoming European Council meeting, due in late June, will offer any new government a timely opportunity to show how disruptive it wants to be (if at all) with regards to current European rules.

Should the ongoing 5SM/League attempt fail, Italy would be back to square one, with the prospect of a new “neutral” government named by Mattarella, which would bring the country back to the polls, more likely in the autumn.

## Would a 5SM/League government put fiscal consolidation at risk?



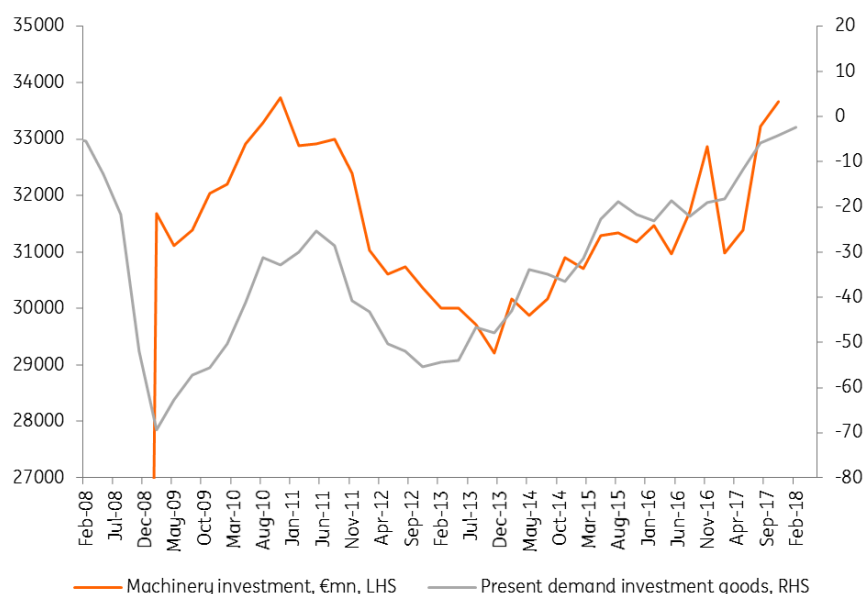
Source: Datastream, ING

## Domestic demand- Is it topping out?

The Italian post-election saga has unfolded at a time when the Italian economy has continued to expand at a moderate pace. In both 4Q17 and 1Q18, Italian GDP has grown 0.3% quarter on quarter, down from 0.4% in the two previous quarters. According to Istat, domestic demand, gross of inventories, was the main engine of quarterly growth in 1Q, while net exports were growth negative. While business confidence came in on the soft side, consumer confidence remained upbeat, helped by the return of employment to pre-crisis levels. The contraction of inactive workers resulted in a renewed expansion of the labour force in March, keeping the unemployment rate stable at 11%.

Looking ahead, there are signs from early 2Q data that domestic demand may slow down. Both manufacturing and services confidence fell in April, mainly due to softer orders. The deterioration in the manufacturing investment goods sub-index, a rock solid confidence driver over 1Q18, rang an alarm bell, possibly reflecting increasing unease about the political gridlock, in spite of existing tax incentives. Still, confidence in construction posted a comforting gain, suggesting that the sector is finally bottoming out. Consumer confidence, only marginally down, was close to recent highs. The positive mix of employment gains, bottoming out wage growth and low inflation is apparently helping households.

## Business investment recovery vulnerable to tax uncertainty



Source: Datastream

## Concern over how to fund spending

Would the installation of an unprecedented 5SM-League government have a substantial short-term impact on the Italian economy? If extreme calls are avoided, we believe the answer is no. Still, we see private investment as relatively vulnerable. Should the idea of a radical re-tuning of the tax system be pushed through, the related uncertainty about the sustainability of promised tax cuts might make businesses more prudent. With calls for a mini-budget already echoing from Brussels, and with the need to sterilise a VAT increase worth €12.4bn which has been budgeted for 2019, any ambitious spending plan would very soon meet the test of the relevant funding. President

Mattarella will have some preventive work to do.

#### The Italian economy in a nutshell (%YoY)

	2017	2018F	2019F	2020F
GDP	1.5	1.3	1.2	1.1
Private consumption	1.3	0.9	1.1	1.0
Investment	3.9	3.8	2.5	1.8
Government consumption	0.1	0.4	0.5	0.7
Net trade contribution	0.2	0.0	0.0	0.1
Headline CPI	1.3	1.0	1.4	1.5
Unemployment rate (%)	11.3	10.9	10.4	10.1
Budget balance as a % of GDP	-2.3	-2.0	-1.7	-1.6
Government debt as a % of GDP	131.8	130.9	129.3	127.6

Source: Reuters, ING estimates

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## Netherlands: Still in sixth gear

The Dutch economy continues to grow above potential and the Eurozone average, but we think there is still ample room for more. Despite marginal wage rates...

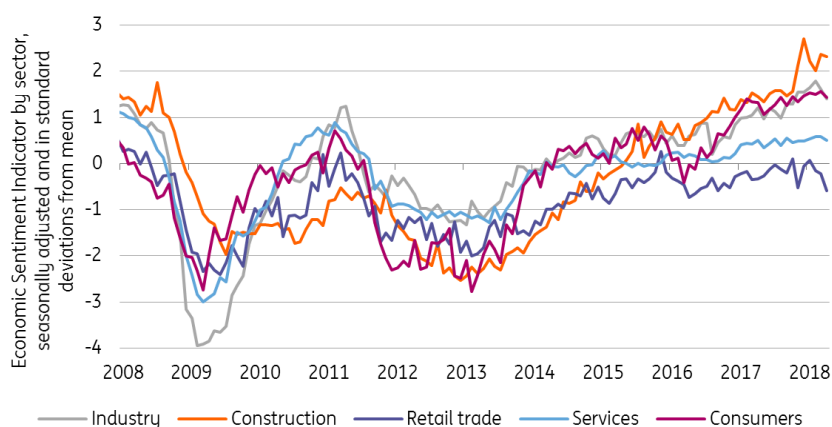


Source: Shutterstock

Despite the fact that some survey indicators have softened in recent months and a somewhat disappointing first-quarter GDP figure (0,5% quarter on quarter), possibly as the result of geopolitical tensions, the outlook for the Dutch economy for 2018 is still bright.

We forecast GDP growth of 2.8%, which means this will be the fifth year of growth above the Eurozone average and the fourth above the estimated potential rate. The drop in sentiment was seen especially in industry and retail in recent months, while confidence of consumers and commercial services hardly changed. While current production held up quite well, purchasing managers indices indicated that industry primarily turned less optimistic about export orders, pointing at downward risks for foreign demand.

## Softening in survey indicators



Source: Macrobond and DG ECFIN

2.8%

GDP growth rate

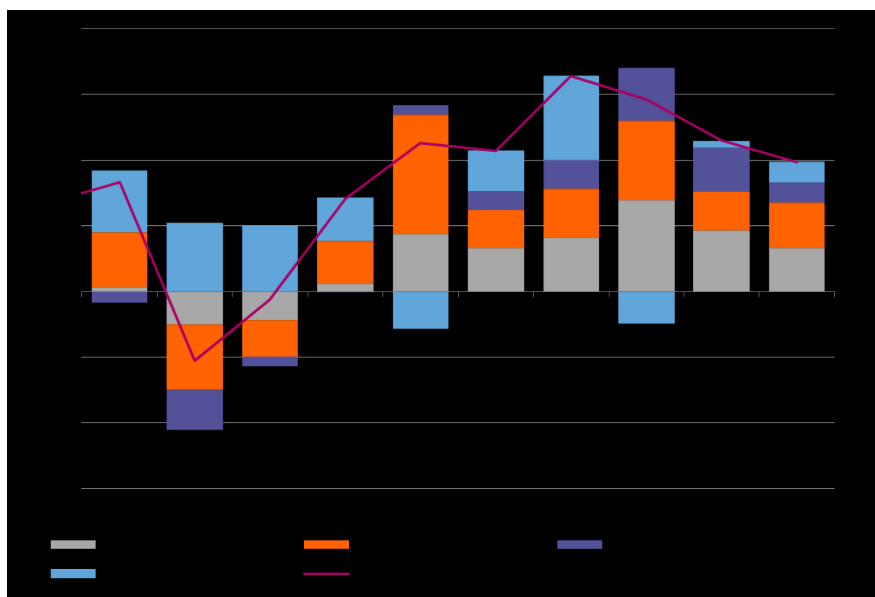
ING forecast for 2018 (YoY)

## Consumers are finally spending again

Retail surveys signalled a more pessimistic view on the current business situation. The latter might have suggested that consumers traumatised by the crisis, might still be cautious to spend. As a share of disposable income, consumption of households was hardly rising until the end of 2017. But in fact, private consumption set the highest growth rate since 1998 in the first quarter of 2018 (1,7% quarter on quarter). Finally!

And since the labour market continues to tighten during 2018, we expect consumers to continue being less thrifty during the rest of this year.

## Domestic demand driving high growth



Source: Macrobond and Statistics Netherlands, ING estimates for 2018-2020

## Import growth outpaces exports growth, large surplus remains

While Dutch exports are still expected to grow at the solid pace of 4.3% in 2018, the net contribution of foreign trade will decrease.

We project import growth to increase to 5.6%, as households spend more and the government restricts gas production in the earthquake-stricken province of Groningen.

All in all, exports will remain much higher than imports, maintaining a current account surplus of around 10% of GDP.

## Unemployment drop continues

Rising output levels have encouraged businesses to hire more people and they will continue to do so.

Employment rose by 2.1% year-on-year in the first quarter of 2018, while unemployment fell to 3.9%. As a result, unemployment has already dropped below the estimated natural rate. We forecast it to fall further during the year to 3.5%, reaching an annual average of 3.8% in 2018.

## At the margin, wage growth finally starts to accelerate

The persisting labour demand growth and increasing shortages in the labour market are starting to show in wages at the margin.

While wage growth remained very modest in recent years, recently agreed collective wage agreements show an increasing trend in wage growth since the start of 2018. The construction sector agreed on one of the highest pay rises, amounting to an annualised rate of 3.1%, much higher than the actual average collective wage rise of 1.8% realised in March 2018.

## Inflation remains subdued

Although labour shortages are rising and finally starting to affect wages, this is only the beginning. As a result, price pressure will increase, but with a considerable lag.

At 1.4%, consumer price inflation will remain subdued in 2018 and is very much in line with Eurozone inflation rates. Food, clothing and communication prices are expected to keep headline inflation at moderate levels.

## All industries growing, except gas

Sector-wise, growth has become broad-based, with only gas production declining. Gas production shaves off 0.1 to 0.2% points of growth in 2018, in line with previous forecasts.

Ambitions to further shut off the gas tap may cost between 0.5 and 1% of GDP beyond our forecast horizon. Commercial services, including IT and job agencies, construction and health care are the sectors that grow at the highest rates. The solid growth in commercial services, which is responsible for more than half of capital formation, contributes to the steady investment outlook of 6.2%.

## Public finances in line with European norms despite expansionary stance

After the fiscal balance improved to 1.1% of GDP in 2017, it will remain in surplus in 2018 for the third year in a row.

In years to come, the fiscal balance will continue to hover around 1% of GDP. The Rutte-III government uses additional cyclical tax revenues to offset falling gas revenues as well as to spend more and cut taxes rather than improving the primary balance. The procyclical additional spending on defence, education, R&D, civil service and infrastructure provides a contribution to GDP-growth of about half a percentage point in 2018. Government debt was 56.7% of GDP at the end of 2017, below the European norm of 60% GDP. It will continue to decrease as a result of cumulating surpluses and the assumed continuation of the sale of the ABN AMRO bank.

## Why we expect above potential growth in 2019

Beyond 2018, there is still ample room for the Dutch economy to grow for a number of years, considering the size of the output gap in previous business cycles.

We expect GDP growth in 2019 to come in around 2.4% and slowly normalise in the direction of the estimated potential annual rate of 1.7%. Fiscal policy will remain expansionary in 2019, mainly via decreasing labour taxes, boosting GDP-growth by roughly 0.3%-point. CPI inflation will be much higher in 2019, projected at 2.6%. This is mainly due to an increase of the reduced VAT-rate (from 6% to 9%), which most notably will affect prices of food items and some services almost one-to-one. Furthermore, cumulating wage pressure might start to affect prices in 2019.

[Read why we think there is a sunny outlook ahead for the Dutch economy](#)



**The Dutch economy in a nutshell (%YoY)**

	2017	2018F	2019F	2020F
GDP	3.2	2.8	2.4	2.0
Private consumption	1.9	3.3	2.2	1.6
Investment	5.6	6.2	3.7	2.5
Government consumption	1.2	2.2	2.3	1.8
Net trade contribution	1.2	-0.5	0.1	0.3
Headline CPI	1.4	1.4	2.6	2.0
Unemployment rate (%)	4.9	3.8	3.2	3.2
Budget balance as a % of GDP	1.1	1.1	1.1	1.3
Government debt as a % of GDP	56.7	53.3	49.9	46.9

Source: Macrobond, ING estimates

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## Spain: Has growth peaked?

The Spanish economy has continued its strong growth in 2018 but a slowdown could well be on the horizon. Meanwhile, there are optimistic tunes around the...



Source: Shutterstock

### Current activity is strong

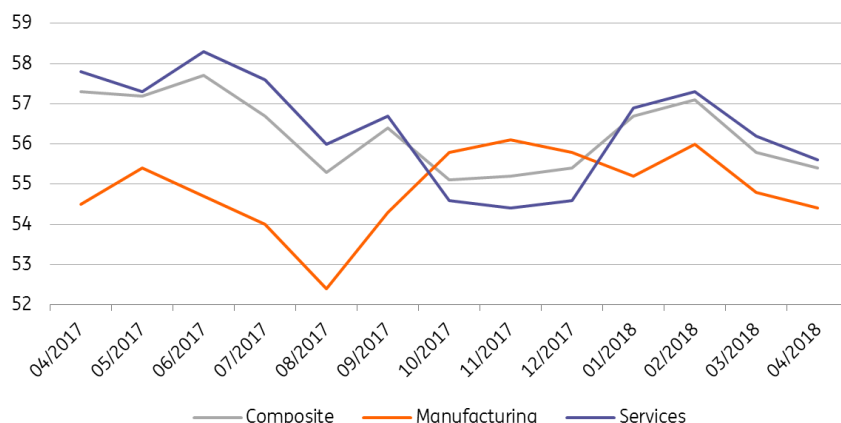
The Spanish economy continued its strong performance at the beginning of the year recording 0.7% quarter-on-quarter growth identical to third and fourth quarter growth in 2017. This figure was expected as the high-frequency data for the first quarter was overall optimistic. The average PMI for 1Q18 was higher than 4Q17's, the unemployment rate continued to decline and consumer confidence still remains at a considerably high level despite having dipped slightly.

### Cool down ahead?

Looking ahead, the Spanish economy could cool down a little.

The European Sentiment Indicator (ESI) for Spain increased from 109.0 in March to 110.6 in April, which is close to the recent peak of 110.9 in January 2018. Forward-looking indicators in the survey, such as order books and hiring intentions in manufacturing and employment and demand expectations in the service sector, however, decreased in April. Furthermore, PMIs declined for a second consecutive month in April. All this points to the fact that Spain is currently still on a strong growth path, but this could ease over the course of the year.

## PMIs drop for a second consecutive month in April



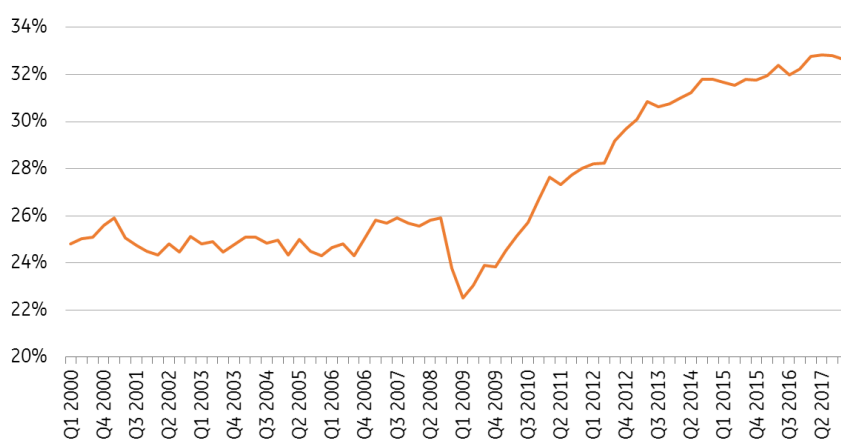
Source: Thomson Reuters

## Exports driving recovery

A remarkable feature of the Spanish economy today is the importance of exports.

The share of exports increased to 33%, compared to 25% before 2008. A few reasons include the decline in wages after the crisis followed by the labour market reforms which made it more business-friendly. Secondly, the crisis forced companies to broaden horizons and look towards foreign markets as the domestic market collapsed and finally the rise in productivity. Given that these changes were not temporary and the fact that Spanish exports are now more geographically diversified, it is likely that exports will continue to support the economy.

## Exports on the rise (as a percentage of GDP)



Source: Thomson Reuters

## Structural weaknesses in the labour market remain

The labour market continues its recovery as the unemployment rate continues to decline and employment growth remains firm.

This, of course, supports private consumption, but structural problems remain. The proportion of

employees on temporary contracts relative to total employment equalled 26.8% in 4Q17. Young and low-skilled workers often fail to secure permanent jobs, and this reduces the incentive to invest in training and lifelong learning, limiting potential human capital formation.

Broader measures of the labour supply also show some weakness. For example, underemployed part-time workers still account for 6.0% of the active population in 2017 while this is only 4.1% in the Eurozone.

## Optimistic tunes on the budget, but no symphony yet

On the political front, there seems to be a breakthrough concerning the 2018 budget. Last year, the approval of the budget had to be postponed as the Basque Nationalist Party (PNV) withdrew its support to protest against the government's management of the Catalan crisis. But now, there is initial parliamentary support for the budget from several political parties. The PNV agreed too after a deal with the government to boost public pension in 2018 and 2019.

However, the PNV continues to say it will not back the budget until the government removes its direct control over Catalonia. But there are also positive sounds on that front. Now that a new Catalan premier is elected, a new Catalan government is imminent. And once the new government is installed, the central government could lift Article 155.

Even though political uncertainty hasn't disappeared, it has eased compared to a few months ago, and the negative impact on the economy was also limited. The rating agency, Moody's recently upgraded Spain's long-term credit rating citing the low impact of the Catalan crisis but good economic performance and structural improvements in the banking sector also helped.

The three main rating agencies, Fitch, Standard and Poors and Moody's, have all upgraded Spain's long-term credit rating in 2018.

The Spanish economy in a nutshell (%YoY)

	2016	2017	2018F	2019F	2020
GDP	3.3	3.1	2.6	2.0	1.6
Private consumption	3.0	2.4	2.4	1.8	1.3
Investment	3.1	5.5	3.3	2.4	2.1
Government consumption	0.8	1.6	1.2	0.3	0.0
Net trade contribution	0.9	0.3	0.3	0.4	0.4
Headline CPI	-0.3	2.0	1.4	1.7	1.8
Unemployment rate (%)	19.6	17.2	16.1	15.0	14.0
Budget balance as a % of GDP	-4.5	-3.1	-2.6	-1.9	-2.0
Government debt as a % of GDP	99.0	98.3	97.2	96.3	95.2

Source: Thomson Reuters, ING forecasts

## Belgium: Just not fast enough

For Belgium, 2017 was another recovery year which is definitively satisfactory but things could be much better. Yet, we don't see any signs of strong...



Source: Shutterstock

### It could be better

The Belgian economy is sound, with positive growth in all sectors including solid job creation, growing household disposable income and company profit margins with high confidence levels. But despite all these positive elements, some disappointment remains.

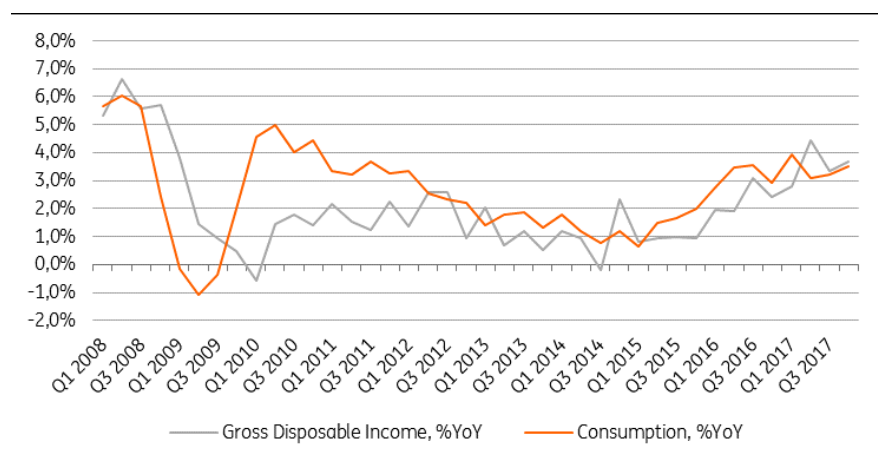
The current growth level stands clearly below its long-term average, while activity used to grow fast in a recovery period. Moreover, GDP grew by 3.2% in The Netherlands, 2.2% in Germany and even 1.8% in France over the same period, which means the Belgian economy performed worse than its neighbours and that is quite unusual. Finally, the GDP evolution was not in line with the (most better) evolution of soft data.

In the first quarter of this year, nothing seems to have changed: Belgian economic activity grew by 0.4% compared to the previous quarter and 1.6% year-on-year. Without any detail of the GDP components, it's difficult to explain why growth was, once again, so moderate. That said, with other Eurozone countries feeling some slowdown since the beginning of 2018, activity in the Belgian export sector could have been hit.

*The Belgian economy performed worse than Netherlands, Germany and even France and that is quite unusual*

More importantly, while Belgium has always been considered as a country of savers, the positive growth of private consumption has been supported between 2010 and 2016 by a decrease of the saving ratio (from 14.9% in 2010 to 11.3% last year), falling below the Eurozone average. As job creation has boosted disposable income since 2017, it seems that households preferred to keep their consumption moderate to save more. That's probably quite sound from a financial stability point of view, but the price to pay is softer domestic demand. Indeed, private consumption has, in 2017, shown some signs of weakness. The Q1 GDP number maybe reflects some further weakness from that side of the economy.

## Private consumption now grows at the same pace as disposable income, stabilising saving ratio



Source: NBB

## No strong acceleration ahead

The key question is if any strong acceleration is likely in the coming quarters? At this stage, the answer seems to be no.

First, the general sentiment about the economic situation in the Eurozone is more mixed than last year, and even if activity accelerated in the two coming quarters, we had to revise downward our full-year GDP growth forecast for the Eurozone. As a small open economy, Belgium will have some difficulties to boost its activity in a weaker global economic context. Secondly, higher oil prices have probably started to affect real disposable income, and as a consequence, any stronger recovery of private consumption could be somewhat postponed.

To be sure, we are far from expecting a recession. Even if most economic indicators have levelled off recently, they remain consistent with an activity expansion. In particular, the very high degree of capacity utilisation in the industry sector suggests that further investments could support domestic demand. All in all, economic growth is likely to remain in a 0.4% - 0.6% range in the coming quarters. But on the back of the first quarter figure and these expectations, we fear that

2.0% GDP growth for Belgium is, once again, out of reach, unless an unexpected positive shock sets in.

## Oil price driven inflation

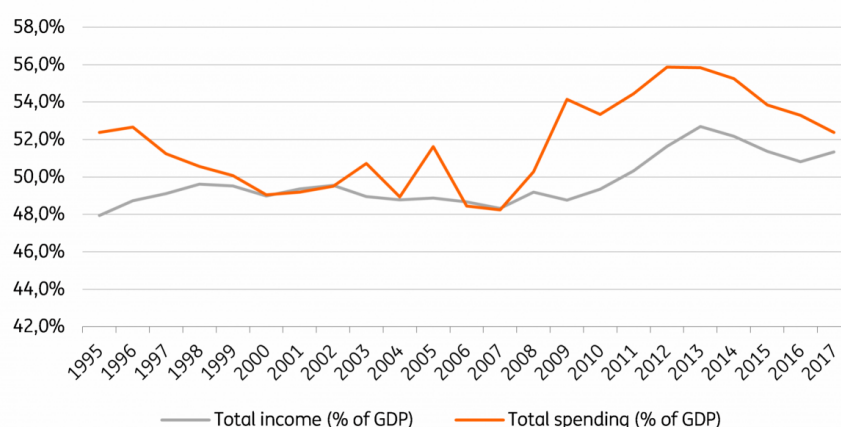
Headline inflation currently fluctuates around 1.5%. Its recent slight increase is mainly due to higher oil prices, affecting the cost of transport and the energy cost of housing. On top of that, there was also higher food price inflation, but this can be temporary as it depends on weather conditions. As a consequence, contrary to what headline inflation tends to show, the underlying dynamic of prices is probably decelerating. As an example, the inflation of services has decreased from 1.9% in March to 1.3% in April.

Looking ahead, moderate growth will probably not push inflation any higher which means oil price dynamics will mainly influence it. We, therefore, expect a full year inflation of 1.7% in 2018. In this context, an automatic wage indexation could happen in August, compensating households' disposable income for inflation, but increasing companies' labour cost by the same proportion.

## Budget balance still in doubt

The deficit reduction from -2.5% of GDP in 2016 to -1.0% of GDP in 2017 came as a good surprise. It seems that tax revenues combined with a decrease in total expenditures (from 53.3% of GDP to 52.4%) allowed the deficit to be reduced by more than expected. To be sure, public finances also benefited from the interest charge reduction thanks to the decreasing implicit rate on the total public debt.

## Public deficit declined thanks to a strong spending reduction



Source: NBB

Despite this good news, reaching a budget balance in 2019, as previously expected, remains doubtful.

One possible explanation for this is the necessity of taking additional structural measures to reach this target, while local elections this year and federal, regional and European elections next year make political consensus more difficult. Moreover, one has to remember that the cost of ageing increases each year and without any new measure, the public finances are structurally deteriorating. In its stability program, the government has further delayed significant structural

deficit reduction until 2020, when a new government will take the helm.

In the short run, we don't consider this as a big problem as the effort made in the past and the further positive economic growth allow the debt/GDP ratio to decrease. It could already decrease below the psychological threshold of 100% next year.

To conclude, we say the Belgian economy is doing well, but compared to what it was able to deliver in the past in terms of growth and inflation, it could be much better.

#### The Belgium economy in a nutshell (%YoY)

	2017	2018F	2019F	2020F
GDP	1.7	1.8	1.7	1.6
Private consumption	1.3	1.1	1.7	1.6
Investment	0.7	2.6	0.4	1.0
Government consumption	1.3	1.7	1.2	1.2
Net trade contribution	0.5	0.5	0.4	0.4
Headline CPI	2.1	1.7	1.6	1.7
Budget balance as % of	-1.0	-1.0	-0.8	-0.6

Source: Reuters, ING estimates

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# Austria: Still on track

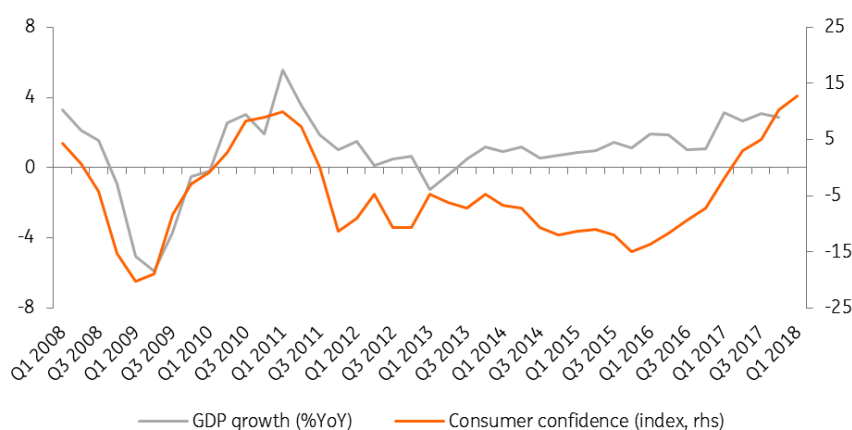
With the economy carrying most of last year’s momentum into 2018, the main focus after the summer will be Austria’s EU presidency



Source: Shutterstock

With first-quarter GDP growth coming in at a robust 0.8% quarter on quarter, it's still all systems go in Austria driven mainly by domestic demand but also foreign impulses. While we expect the current strong momentum to slow down this year, it will simply be a levelling off from recent highs rather than a significant downswing.

## Domestic demand remains the main growth driver



Source: Thomson Reuters

## A fiscal gamble

The current economic environment is also clearly benefitting from the government's attempt to square the circle by presenting fiscal plans which combine austerity and stimulus measures.

According to these plans, 2019 should be the first year with a small fiscal surplus since 1974. Thanks to the booming economy, public finances have clearly benefited from windfall revenues, and the declining number of refugees have also reduced expenditures more than expected.

However, last year the government expected a deficit of -0.5% GDP for 2019. Given that the government's forecasts are slightly higher than consensus forecasts selling these new plans to Brussels will not be an easy task.

## EU presidency to be the main focus

On the international stage, Austria will take over the six-month rotating presidency of the European Council as of July. Although Austria itself is too small to have a substantial impact on the discussion of the future of EU, expect a tough stance on migration and foreign policy as well as on EU's post-Brexit budget plans.

Add to that some caution towards further EU integration plans as nationalistic and protectionist tendencies persist, and the presidency might become a thrilling six-month matter.

The Austrian economy in a nutshell (%YoY)

	2017F	2018F	2019F	2020F
GDP	3.0	2.7	2.3	1.8
Private consumption	1.4	1.7	1.7	1.4
Investment	4.9	3.1	2.5	1.5
Government consumption	1.1	2.0	1.1	0.8
Net trade contribution	0.7	0.8	0.5	0.3
Headline CPI	2.2	2.0	2.0	2.1

Source: Thomson Reuters, all forecasts ING estimates

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# Portugal: Some weakening after a strong cyclical push

Most indicators are moving in the right direction but burdens of the past are still a drag. We expect the Portuguese economy to slow down towards the end...



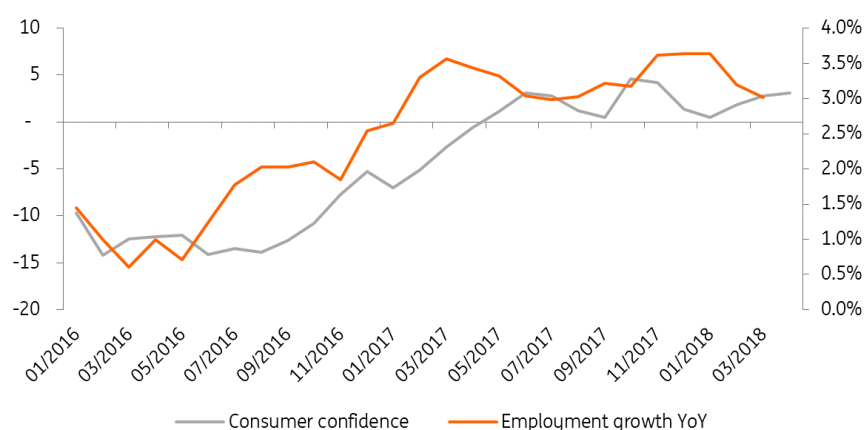
Source: Shutterstock

## Strong labour market

The strength of the Portuguese labour market in 2017 surprised us.

The unemployment rate fell below the Eurozone's and employment grew at a record rate of 3.3%. This strength continued in the first quarter of 2018 as the unemployment rate declined further and employment growth continued to be above the 3%-level. It's, therefore, no surprise there are now more optimistic consumers than pessimistic ones, and so private consumption remains a strong growth contributor.

## Strong employment growth with happy consumers as a result



Source: Thomson Reuters

Even though the strength of the labour market improved sharply during the recovery, there are still some structural weaknesses.

Broader measures of the labour supply have not fully recovered and are still higher compared to pre-crisis levels. Moreover, temporary employment remains at the highest level in the Eurozone (18.5% in 2017 compared to 12.7% in the Eurozone). Reducing the duality of the labour market should, therefore, remain an important objective for policymakers. These structural weaknesses could explain why wage growth remains moderate, growing at the same rate as consumer prices.

Even though we think the current labour market strength should weaken a bit by the end of the year, the strong figures might continue in the coming months. For example, employment expectations strengthened in the service sector, construction and retail, while they stabilised in the manufacturing sector.

So private consumption is most likely to continue to be strong in the first half of 2018.

### Burdens of the past

Most indicators in Portugal are moving in the right direction. But the burdens of past crises are still a drag for the economy. Public and private debt is still at elevated levels, and so higher nominal interest rates could cause difficulties for firms, households and the government.

Although declining, the share of non-performing loans also remains very high and is the third highest in the EU after Greece and Cyprus.

All in all, we expect the Portuguese economy to slow down towards the end of the year. We forecast an annual growth rate of 2.1% in 2018.

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Article | 17 May 2018

## Eurozone: Low interest rates continue to support real estate

Recovery of housing markets in the Eurozone continues and remains supported by low-interest rates. But we suspect 2018 will be another year of high house...



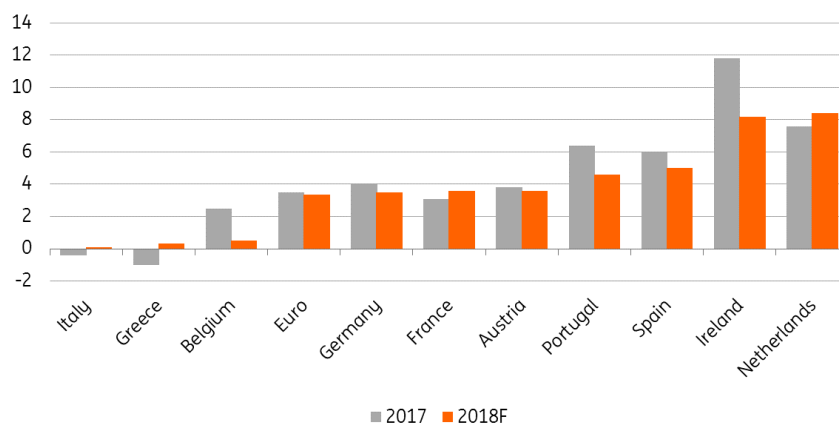
Source: Shutterstock

### Eurozone

2017 was an excellent year for the Eurozone economy, and so it isn't surprising that house prices grew at the rapid pace of 3.5%. The strong economy led to higher disposable incomes pushing prices upwards. The low-interest rate environment also maintained the purchasing power of consumers to buy houses.

Even though we think the Eurozone economy will cool down towards the end of the year, we suspect 2018 will be another year of high house price growth. Compared to January, our forecast remains constant at 3.3%. But it's worth remembering; the 3.3% expected growth figure is a weighted average of all the constituent countries of the Eurozone that can have very different individual situations.

## Housing price growth forecasts across the Eurozone (in %)



Source: ECB, ING forecasts

### France

Real estate prices continued to rebound in 2017, reaching 3.1%, after 0.9% in 2016.

The period of price declines came to an end in 2015, with a 4.5% drop compared to the price levels in 2007. We expect the rebound to continue, fuelled by low-interest rates and declining unemployment. The rebound should reach 3.6% in 2018, but unfortunately, this catch up is not widespread as large urban areas are mainly pushing the average up.

Over the last five years, the ten largest cities saw prices increasing by 5.2% (including Paris +9.2%) while rural zones saw price declining by an average of 6.8%. The trend seems to be confirmed in 2018, with Lyon taking the lead with house price growth nearing 9% YoY in the first quarter of 2018.

### Italy

Latest Istat house price data continues to show a divergence between existing homes (still on a YoY decline) and new homes (in 4Q17 flat on the quarter), suggesting that the residential housing market remains patchy and that broad-based price increases are not imminent.

In principle, the ongoing moderate recovery of disposable income, in conjunction with cheap mortgages, should continue supporting house purchases. However, the ample slack in the market should prevent a big short-run showing on prices. We expect house prices to increase only marginally in 2018 and to accelerate slightly in 2019.

### Spain

In 2017, the house price recovery was still supported by growing disposable incomes and low-interest rates, reaching 6.2% in 2017 after 4.6% in 2016. House prices, however, are still 25% below the peak of 2007, so there is still room to recover.

For 2018, we expect house prices to ease slightly and forecast a growth rate of 5.0%. As we think the economy will moderate, we forecast a lower rate than in 2017. Nevertheless, this is firmly above the Eurozone average of 3.3%

## Netherlands

Demand for housing remains strong in 2018, and new supply is not enough to counter foreseen household growth. Increasing wage growth, continuing employment growth and growing interest in buy-to-let investment also provides upward price pressure.

Interestingly, the Dutch housing market is starting to show changing regional patterns. As a result of supply drying up in urban areas, demand has started to shift to neighbouring regions, where the number of transactions, as well as price, has accelerated. In the largest cities, prices are far above their pre-crisis peaks, but the national average is still 1% below prior records. Nationwide, house prices rose by 9% year-on-year in 1Q18. Probably the rise peaks in the first half of 2019.

While we expect the price increase to decrease during the course of 2018, we project the annual price increase to accelerate from 7.6% on average in 2017 to 8.4 in 2018. Nationwide, existing homes sales have started to decrease in 1Q18, after record levels in 4Q17, and are expected to decrease to an annual number of 224,000 in 2018.

## Belgium

Home price growth has been subdued from a historical point of view since 2008: there was a 5.6% price correction between mid-2008 and mid-2009, which was recouped by 2010.

Prices then increased by 3.7% (equal to the inflation rate) in 2011. In 2012 and 2013, nominal prices increased by 2.3% per year, but growth scaled back to only 0.8% in 2014. Exceptional interest rate conditions brought a rebound of almost 4% in 2015 which was not repeated in 2016 and 2017 (respectively +0.8% and +2.6%) despite growing mortgages. Since 2008, the yearly growth average has been 2.6% while it was 9.2% in the decade 1998-2007.

Therefore, if the Belgian real estate market has proven to be resilient during the financial crisis and is continuously seen by many as a safe-haven investment opportunity, risks for the future are on the downside. Especially, for the 2019-2021 period which, we believe, will bring an unfavourable mix of investor discouragement, higher mortgage interest rates and a less favourable fiscal environment. In this context, we don't believe that the 1999-2008 historical price development will be repeated any time soon and that a moderate correction - in real terms - is likely on the current decade (2010-2020).

## Portugal

The domestic-demand based recovery of the Portuguese economy continues.

While credit conditions remain favourable for borrowers, lending activity has been hampered by the ongoing private sector deleveraging. In the short run, the real estate market seems strongly supported by the recovery in disposable income and, price-wise, by an insufficient construction rate. As employment growth is proving stronger than originally anticipated, we believe Portuguese house price developments to remain upbeat for most of 2018, and to decelerate after that as the very high elasticity of employment to GDP growth will start proving unsustainable.

## Greece

Signals of an economic turnaround are getting more consistent, but the recovery in disposable income is still at an early stage.

Despite the ongoing decline in the unemployment rate, slack in the labour market remains ample, and the delicate position of Greek banks on NPLs is still weighing on house-purchase related mortgage lending. Deleveraging is slowing down though: lending for house purchases was contracting at a 7.6% YoY in 4Q17 while the pace of contraction declined to 4.3% YoY in 1Q18. Nevertheless, in 4Q17 the contraction of house prices decelerated further to -0.3% YoY (-0.6% in 3Q17), signalling that stabilisation is possibly in sight.

We could see the YoY price contraction to end in 1H18 and to turn very marginally positive after that. This will very much depend on how Greece will be able to exit the third programme.



## Ireland: Celtic tiger continues to roar

Ireland's economy expanded 7.8% in 2017, making it one of the fastest growing in the world. Much of this figure continues to be dominated by the...



### Rapid growth

Ireland continues to show growth rates otherwise only seen in Africa and Asia. In fact, 2017 marks the third year out of four in which Ireland has grown faster than China. The impact of multinationals remains large and clouds the assessment of economic activity. Investment dropped by more than 20% in 2017, caused mainly by a swing in intellectual property investment which is dominated by multinational activity. Related to this, imports were also down, which had a large positive effect on net exports. The strong growth figures were therefore mainly attributable to net exports while consumption also had a healthy impact on growth.

The Irish Central Statistics Office “modified domestic demand” aims to provide a fairer view on domestic demand conditions. It strips out trade in aircraft by leasing companies and investment in intellectual property. While the official domestic demand data showed a decline of 9% in 2017, the modified numbers showed an increase of 3.9% over the year, which is a good indicator of the strength of the Irish economy. Unemployment fell to 5.9% in April- approaching its lows of the mid-2000s which were around 5%. This is far below the natural rate of unemployment, which is estimated by the OECD to be 8.5% this year, and as a result, wage pressures are increasing. Average hourly earnings grew by 2.1% in 2017, stronger than in any of the post-2008 years. 2018 will be a year of moderation, but growth is still likely to be well above 6% thanks to a massive carryover effect.

### Signs of overheating?

While GDP growth may overstate the strength of the Irish economy, the Celtic tiger does not just exist on paper. The Irish economy is indeed growing at a very rapid pace. This brings back the concerns of a boom-bust cycle still fresh in our memory. House prices continue to grow north of 10%, indicating a significant overheating of the market. Mortgage approvals have been slowing but

total transactions remain strong. This could indicate that more cash transactions are happening. As supply remains a large constraint on the market and residential construction activity remains slower than demand growth, tightness in the market continues to build.

## Risks ahead

The external environment provides the largest uncertainty to the outlook. With the US tax deal in place, movements of assets away from Ireland are to be expected. Lower Irish holdings of US treasuries are a sign that the US tax changes are having an impact. At the same time, the European Commission ruling that Ireland had given Apple unfair tax incentives has had an impact on its attractiveness as well. Even bigger uncertainty comes from Brexit, as it is still very much uncertain how the Irish border issue will be resolved. The current agreement, which guarantees economic and regulatory alignment between Ireland and Northern Ireland, is facing scrutiny as the UK wants to be able to make independent regulatory changes, while it also does not want any differences in regulation between Northern Ireland and the rest of the UK. This uncertainty means that the outlook for exports remains subdued. The harder the Brexit, the more burdensome it will be on Ireland.

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# Greece: Looking through the end of the third programme

Greece is rushing to complete prior actions to close the ESM programme. Some extra debt relief should be conceded at the end of it, but life after it will...



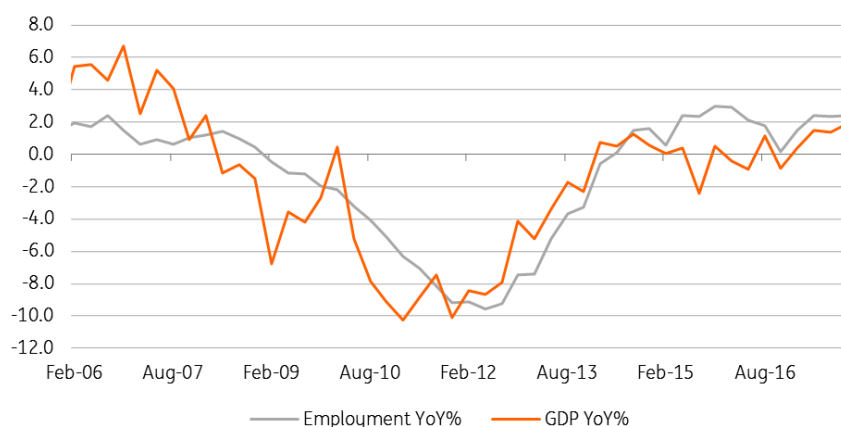
Source: Shutterstock

## Economic recovery driven by investment

The Greek economic recovery continues at a moderate pace, with a domestic demand drive.

Interestingly, as confirmed by 4Q17 data, investment has become by and large the main engine of Greek economic growth. On the flipside, the high import content of investments has compressed net exports. Despite an improving confidence backdrop and a solid 2.5% year on year expansion of employment, private consumption came in on the soft side. To be sure, ten years after the outburst of the global financial crisis, total employment is still 20% below pre-crisis highs, and the unemployment rate hovers around 20.8%.

## GDP recovery continues to support job creation

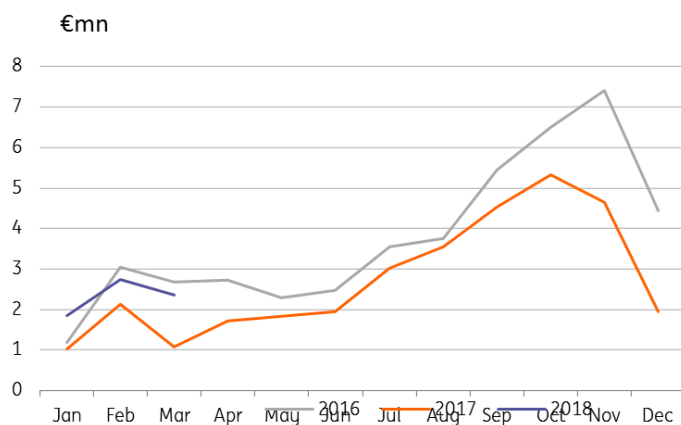


## Fiscal overperformance a political asset

Public finance developments over 2017 have been extremely positive, with Greece widely beating its 1.75% of GDP primary surplus target. The 4% primary surplus and the 0.8% headline surplus are a valuable political capital for Alexis Tsipras's government given the conclusion of the third programme.

How much of this will be spendable will crucially depend on whether lenders will deem the fiscal over-performance as non-recurring. This is possible, given the frequent resort to ever stricter spending controls to compensate persistent problems in tax collection.

## Cumulated state sector primary balance



Source: Datastream, ING

## Third programme close to its end

Looking forward, Greek economic developments will depend on a smooth conclusion to the third ESM stability support programme. To allow for an orderly August closure, the fourth and final review should ideally be completed before the 21 June Eurogroup meeting.

The positive conclusion of the accelerated bank stress test run as part of the review is certainly a

facilitator, but reported delays in the implementation of agreed 88 prior actions are putting at risk the preparation of a staff level agreement for May 24, when the Eurogroup will next convene.

## Additional debt relief set to come

After this, the focus is likely to shift to debt relief and the post-programme framework. Debt relief issues have so far been mainly relegated to technical conversations, and no consensus has been reached. If an additional lengthening of EFSF loan maturities and the transfer to Greece of profits on GGBs held by the ECB look now very likely, other measures are reportedly being explored.

These include the possible buying of remaining IMF loans by the ESM with undisbursed funds from the third rescue programme package and, more controversially, some action on GLF and ESM loans. In any case, as recently confirmed by Mario Centeno, the chief of the Eurogroup, eventual additional debt relief measures would be put in place only after the end of the programme.

## Greece won't escape strict post-programme surveillance

The other key issue yet to be settled is the post-programme framework for Greece. If the Greek Prime Minister Tsipras remains a long-time supporter of a clean solution with the least possible level of post-programme control, lenders seem keen to keep the grip on Greek fiscal and financial developments, possibly along the lines of the “enhanced surveillance” proposed by the EU Commission. On conditionality, opinions seem to diverge also among lenders. The clean solution would have a relevant drawback: in the absence of a programme, the rating waiver that allows banks access ECB funding using junk-rated GGBs as collateral would expire.

This is why the request by Greece of a precautionary credit line, part of the untapped toolkit of the ESM, has repeatedly been evoked by the Bank of Greece's governor Stournaras. In its Enhanced Conditions Credit Line version, which gives the ESM member requesting it the flexibility to request funds at any time during the availability period, it could be decently attractive, but admittedly politically costly.

## Type of exit to affect elections date

The choice of the type of exit could ultimately affect the timing of the next Greek parliamentary elections, due no later than 20 October 2019.

A clean exit might become a strong incentive for PM Tsipras to capitalise with a snap election after the summer. While a “dirty” one, could instead prompt him to wait for the economic recovery to strengthen, aiming for a vote in concurrence with European elections in May next year. Only time will tell.

**The Greek economy in a nutshell (%YoY)**

	2017	2018F	2019F	2020F
GDP	1.3	1.9	2.0	1.9
Private consumption	0.1	0.3	1.4	1.3
Investment	9.7	20.7	8.6	5.7
Government consumption	-1.2	0.9	1.3	1.3
Headline CPI	1.1	0.7	1.2	1.3

Source: Macrobond, ING

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