

Where next for Europe in 2018?

Will the Eurozone continue to be the star performer this year? Here's a round-up of what our analysts are thinking

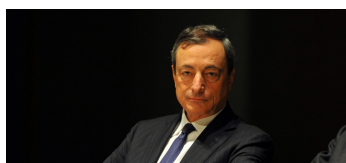
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The Eurozone recovery seems to be going into overdrive. For how long can that continue?

By Peter Vanden Houte



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Article | 5 January 2018

The Eurozone: Going into overdrive

The Eurozone recovery seems to be going into overdrive. For how long can that continue?



Source: istock

Eurozone indicators close to historical highs

The Eurozone recovery seems to be going into overdrive. The €-coin indicator, a proxy for the underlying growth momentum, hit 0.91% in December, suggesting an above 3% annualised growth pace. While we doubt that this pace will be maintained throughout the year, we believe that GDP growth in 2018 will be at least as good as in 2017.

With employment rising 0.4% in the third quarter, consumer confidence in December hit its highest level since January 2001, boding well for consumer expenditure. Rising supply constraints and generous financing conditions are likely to continue to underpin the business investment revival. Notwithstanding the strong euro, export perspectives remain upbeat. The rebound in global investment is particularly helpful for Eurozone exports. No wonder that most cyclical indicators are close to historical highs. The PMI indicator for the manufacturing industry in December hit the highest level since the series started in mid-1997.

+3% Eurozone annualised growth rate

2018 growth at least as good as 2017

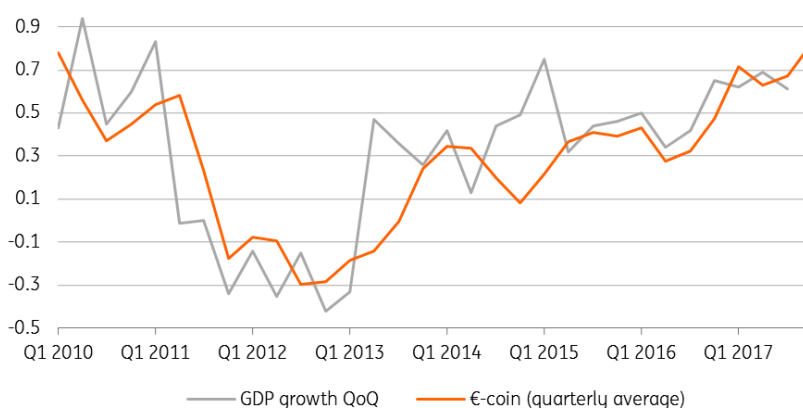
The political conundrum

True, politics could still cause upsets, but probably not enough to spoil the growth party, we believe. With the pro-independence parties still holding a majority after the regional elections in Catalonia, the problem is not going to be solved rapidly, though we don't think that the Spanish economy will suffer significantly from the current stalemate. That said, some negative impact cannot be avoided. The budget for 2018 has still not been approved, as the Basque National Party is refusing to support the draft budget of Rajoy's minority government, as long as the Catalan issues have not been settled.

In Germany, there is still no new government, which is quite unusual for the country. It is still unsure whether the SPD party members will give the green light to another grand coalition. The biggest problem that the current power vacuum creates is European, as in the current circumstances Chancellor Merkel doesn't have a mandate to support. Emmanuel Macron's ambitious reform plans for the Eurozone.

Finally, 4 March has been set as the date for the Italian general elections. For now, it looks likely that there will be no clear winner, making the formation of a workable coalition difficult, but we consider the likelihood of an anti-European coalition to be quite small (about 10%).

Eurozone growth pace continues to accelerate



Source: Thomson Reuters Datastream

Growth momentum and solid base effects

Of course, we cannot exclude sudden shocks in financial markets, which could also temper the growth momentum. Indeed, it would be a surprise if the current low volatility and depressed risk premia remained in place for the whole of the year. In that regard, it still looks wise to not overdo the expectation of continuing above-potential growth. That said, we now believe that 2018 GDP growth will come out at an above-consensus 2.4%, on the back of a strong base effect and the

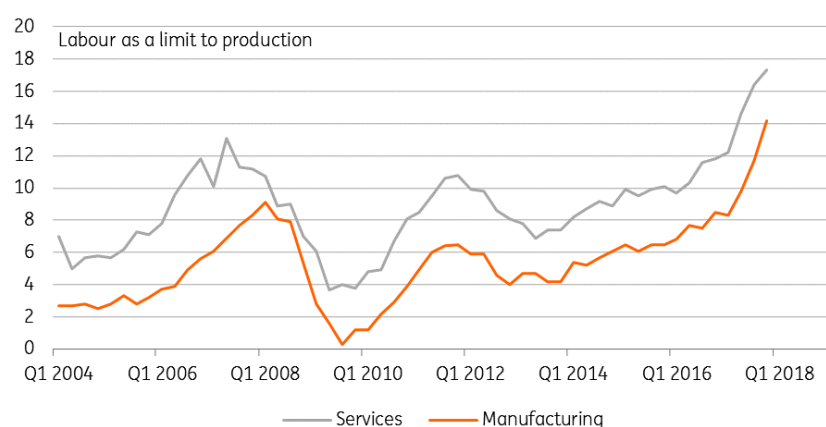
current growth momentum.

From the second half of the year growth is likely to start converging gradually towards the longer-term growth potential, which for the Eurozone is below 2%. With supply constraints getting more important, it looks as if wage growth will start to pick up in the course of 2018. In the PMI Manufacturing Survey businesses reported higher rates of inflation in both output prices and input costs as supply chain pressures increase, with average vendor lead times lengthening to one of the greatest extents on record. But even then, the European Central Bank's consumer price inflation target is unlikely to be reached in 2018, so justifying its loose monetary policy.

However, on the back of the stronger growth and increasing inflation, the calls to end the quantitative easing (QE) bond-buying programme in September 2018 will grow louder. We maintain our belief in a short extension, but in December the net asset buying should have ended. Excess liquidity is likely to hit €2000 billion in the course of 2018 and start only to decline very slowly in 2019, keeping money markets interest rates in negative territory until the summer of 2019.

This article comes from our Monthly Economic Update. [Download the full report here.](#)

Labour could limit Eurozone production



Source: Thomson Reuters Datastream

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Report | 9 January 2018

European musical chairs

Why Draghi succession is not the most interesting ECB vacancy of the next two years Download our report below now



Source: Shutterstock

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EUR: Embrace the strong euro

As the key EUR driver, we continue to focus on the ECB's two-step exit strategy from its current ultra-loose unorthodox policy stance, translating into two discrete jumps in EUR/USD higher



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A year of tough decisions for the UK

Several challenges lie ahead for Brexit, leaving the Bank of England with a conundrum



Source: Shutterstock

December's breakthrough helps unlock a transition period agreement

As a turbulent 2017 finally drew to a close, politicians on both sides of the channel were finally able to breathe a sigh of relief. After months of deadlock, an agreement was reached on the UK's financial liabilities, citizens' rights, and ultimately most contentiously, the Irish border.

December's breakthrough means that a transition period looks set to be agreed by the end of the first quarter. Admittedly such an agreement won't be legally binding until the full exit treaty is ratified later this year. But a firm commitment by both sides that there will be a 'status quo' transition period until late 2020/early 2021 should be enough to prevent firms enacting their 'no deal' contingency plans.

Plenty of challenges to overcome - and the clock is ticking

Firms could remain cautious when it comes to investment

Of course, there are still plenty of challenges looming this year – perhaps the biggest of which is whether a trade deal can actually be agreed in full before March 2019. Trade talks are unlikely to

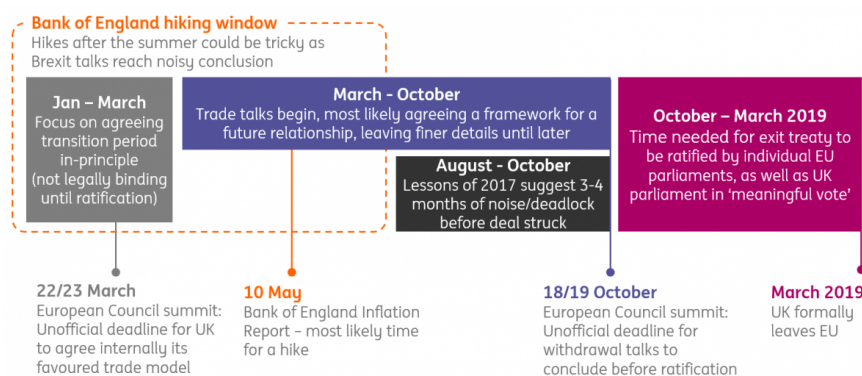
begin before March, before which time the UK will internally agree on the trade model it's aiming for. The talks will need to be wrapped up by October's European Council summit, to allow time for each member state to ratify a deal as well as for the UK parliament to hold it's 'meaningful' yes/no vote on what is agreed.

That leaves an extremely narrow six-month timeframe for trade negotiations, which makes it more likely that only the broad framework of a trade deal will be agreed before the UK exits the EU. This implies that the finer details would then be thrashed out during the transition phase.

This raises the question of whether a two-year transition period will be long enough for businesses, or indeed the customs infrastructure, to adjust to the new relationship. It's also possible that, without knowing the finer details of the UK's future trading relationship, firms could remain cautious when it comes to investment (particularly that with a longer-term horizon).

Read [Brexit: Seven big questions looming in 2018](#)

2018 Brexit timeline



Source: ING

The odds of a rate hike rely a lot on wage growth

This is one reason why economic growth is likely to remain reasonably sluggish this year. Consumer spending is also set to remain under pressure, with disposable incomes likely to be (at best) flat. This will limit growth to around 1.4% this year, giving the Bank of England a conundrum when it comes to deciding whether to hike rates again this year.

Wage growth may not take-off quite as much as the Bank of England hopes

Ultimately, wage growth will be pivotal to the decision. There has been some slightly better news on this front, with signs that skill shortages in certain sectors are prompting firms to boost salaries to retain staff. To take one example, the shortage of UK lorry drivers increased by 49%^[1] in 2017 as the pool of talent shrinks, which led to firms to offer up to 20% premiums on hourly rates.

That said, with the cost of raw materials and energy picking up, and demand still fairly anaemic in

many sectors, some firms are likely to take a more conservative approach with an eye on maintaining margins. The Bank of England is optimistic about wage growth, although we still feel it may not take-off quite to the extent its forecasts assume.

[1] According to [Manpower/Freight Transport Association](#)

A rate hike this year isn't guaranteed

So with growth likely to remain sluggish and uncertainty over the path of wage growth, we still think a rate hike this year cannot be guaranteed, though this is increasingly a close call. But whatever policymakers decide, we think they have a fairly narrow window before the summer if they want to squeeze in another rate rise. The lessons of the past few months tell us that, before some deal being struck in October, there could be 3-4 months of deadlock and noisy negotiations. This leaves February, or more likely May, as possible candidates for another rate hike this year.

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Eurozone economy ends 2017 with a bang

The Economic Sentiment Indicator ends 2017 on a high note but the inflation picture still remains muted



The Eurozone economy is going from strength to strength. The European Commission's economic sentiment indicator (ESI) surged to 116 in December from 114.2 in November, which is way above the 114.8 consensus expectation. The Business Climate Indicator rose to 1.66, hitting its highest level since 1985.

With the growth picture looking very strong, calls to end the ECB's expansionary monetary policy will only grow louder

There was a sentiment improvement in all sectors (industry +1.0, services +2.0, retail trade +1.9, construction +1.2 and consumer confidence +0.5). But the country breakdown revealed a strong increase in sentiment in Germany +1.6 and France +2.3.

Amongst the other large euro-area economies, the ESI rose in the Netherlands (+0.7), while it remained unchanged in Italy (0.0) and slightly decreased in Spain (-0.8). One should also note that

the sentiment indicator is now above its long-term average in Greece.

The Eurozone economy is definitely gaining momentum and a GDP growth figure this year at or above 2017's expected 2.4% cannot be dismissed as a fairy tale. However, the inflation story remains more of a mixed bag.

As we saw last week, core inflation still remains too low to get comfortable, and the Economic Sentiment Indicator doesn't shed any more light on this matter. Some pipeline inflation is starting to show as selling price expectations increased strongly in the industry and to a lesser extent in construction. But at the same time selling expectations fell slightly in services and retail sales, while the consumer is also pencilling in fewer price increases over the next 12 months.

With the growth picture looking very strong, the calls to end the ECB's expansionary monetary policy will grow louder.

On Sunday the president of the Bundesbank, Jens Weidmann in an interview with the Spanish daily El Mundo said that the ECB should set an end date for its asset-buying program. That said, a majority within the Government Council will want to avoid the repeated mistake of premature tightening, certainly given the stubbornly subdued inflation dynamics.

We still expect a short lengthening of the asset purchase program until December 2018, to allow further tapering. While net asset purchases will definitely have ended in the first quarter of 2019, a first rate hike might have to wait until next years summer.

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