Eurozone

The European Commission's case

- **According to survey data, economic activity seems to be holding up well in the year-end period. Even so, growth is likely to slow in 2017.**
- **With monetary policy overburdened, fiscal policy has once again become the focus of attention.**
- **The European Commission is arguing for veritable policy coordination to orchestrate fiscal expansion at the eurozone level of about half a point of GDP next year.**
- **In the short term, the member countries with fiscal manoeuvring room are likely to turn a deaf ear, while the Commission will continue to be lenient with those in tighter situations.**

The economic recovery is continuing in the eurozone, albeit at a very feeble pace. The breakdown of detailed Q3 national accounts confirms that GDP rose only 0.3% q/q in Q3, and held to a surprisingly stable cruising speed of 1.7% y/y [1]. Household consumption held fairly firm in Q3 (at 0.3% q/q), while private investment and foreign trade both eased up during the summer months (+0.1% to 0.2%) after a strong Q2 rebound (both up 1.2% q/q).

The most recent survey data suggest that the economy is still going strong in the year-end period, and has even accelerated. Purchasing manager surveys signal solid growth in activity in November, probably in line with a slight acceleration in Q4 GDP, to nearly 0.4% q/q. The surveys also suggest stronger employment trends and sales pricing pressures, which are signs of a consolidating recovery. This tendency is confirmed by the European Commission's aggregated survey data, which are less volatile, with confidence indicators trending upwards in recent months in all sectors of activity.

Even so, several factors argue for a slowdown in the quarters ahead: after boosting consumption in 2016, oil pricing trends will no longer be a support factor; the UK economy is expected to slow down; fiscal policies will be less favourable in certain eurozone countries (notably Spain) while others face high political uncertainty due to upcoming elections, which is bound to strain confidence and investment. The big question is to what extent the favourable momentum now visible in the economic and survey data will be able to withstand these headwinds. We are currently looking for a slowing trend next year, with GDP growth easing towards 1.2% in 2017 (vs. 1.6% in 2016), mainly due to a slower increase in private consumption. In its latest economic outlook, the OECD expects growth to hold at the current pace (1.6% in 2017, vs. 1.7% in 2016).

Growth engines

--- GDP growth (%, q/q) and contribution to GDP: Private consumption | Public consumption | Change in inventory | Net external trade | Investment

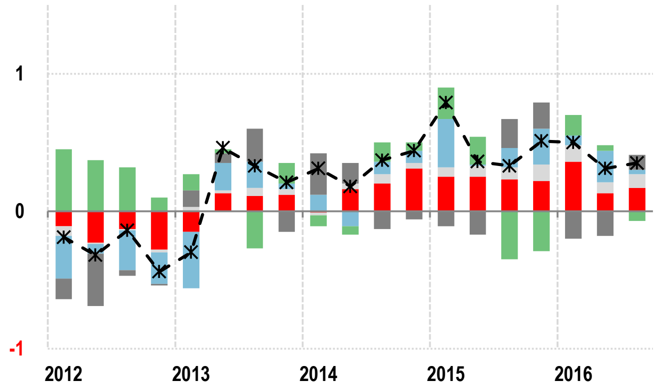

Chart 1 Source: Eurostat

Outlook for the eurozone

Annual growth, %	2016 e	2017 e	2018 e
GDP	**1,6**	**1,2**	**1,5**
Private consumption	1,6	1,1	1,3
Gross Fixed Capital Formation	2,9	2,1	2,3
Exports	2,3	2,8	4,4
Consumer Price Index (CPI)	0,2	1,2	1,3
CPI ex food and energy	0,8	0,9	1,2
Unemployment rate	10,1	9,9	9,6
Current account balance	3,2	2,9	2,9
Gen. Govt. Balance (% of GDP)	-1,8	-1,6	-1,4
Public Debt (% GDP)	89,4	88,9	88,1

Table Source: BNP Paribas

Somewhat sluggish growth is bound to have only a limited gearing effect on employment and pricing trends. Job growth peaked at 1.4% in H1 2016. Spain and Italy made big contributions to the acceleration observed in 2015 and early 2016, but these economies are poised to slow in the quarters ahead. The unemployment rate, which recently fell to 9.8% of the work force, albeit with wide disparities between countries, could decline by less than 0.5 percentage points (pp) over the next year, compared to an average improvement of 0.8-0.9 pp a year over the past two years. Inflation is also holding well below the price stability target. It is currently picking up, driven by two factors: the base effects of energy prices, which could prove to be even stronger than expected so far, especially if oil prices maintain their recent momentum since the recent OPEC agreement (USD 54 a barrel at 8th of December), and the weakening of the euro since the US elections (USD 1.06). Unfortunately, given its negative impact on household purchasing power and consumption,

[1] At first reading, aggregated data for the eurozone seem to suggest that growth exceeded 1.9% in 2015 before slowing in 2016. Yet this is largely due to the distortion caused by Irish GDP, which rose more than 26% in 2015 due to accounting changes (see "Ireland: Beyond revisions", Ecoweek, 18 November 2016). If we restrict our observation to the eurozone's seven main countries (FR, GE, IT, SP, NL, PT, BE), growth has held at between 1.5% and 1.7% year-on-year since spring 2015.

robust energy prices are apparently having a direct negative impact on core inflation (0.8% in November) and medium-term price stability, the ECB's real inflation target.

Against this backdrop, all eyes were turned towards the December Governing Council meeting (see our detailed analysis on page 2 of this week's Ecoweek). Even so, it was clearly understood that the ECB no longer has much manoeuvring room, caught between the desire, on the one hand, to pursue its action as long as there has not been a decisive upturn in inflation prospects, and on the other, the increasingly vocal doubts about its quantitative easing policy, and the adjustments needed to cope with the risk of a shortage of eligible securities[2].

The long and winding path towards fiscal policy coordination

Once again, fiscal policy has become the focus of attention, and the big question is whether it can still provide any additional support, and under what conditions. After several international organisations raised this point (notably the OECD and IMF), the European Commission recently began making this argument as well. As part of the European Semester and its assessment of the member states' 2017 draft budget proposals, the Commission is recommending for the first time that EMU as a whole should benefit from an expansionary fiscal policy of 0.5% of GDP in 2017-2018.

The arguments developed in the Commission's recommendation can be summarised as follows: in the eurozone, as elsewhere, fiscal policy must be conducted in an environment that implies hedging between a target of stabilising the economic environment (the hysteresis effects of a persistently negative output gap erode growth potential, justifying an expansionary policy) and a target of sustainable public finances (restrictive policies need to continue to improve sustainability). Currently, the Commission seems to think the first target of economic stability should be given priority, considering 1) the adjustment efforts that have already been made (EMU fiscal policy has been only slightly expansionary since 2015, after 4-years of restrictive policies); 2) the urgent need to halt the deterioration of the eurozone's growth potential, and 3) the need to ease the burden of a single monetary policy, which alone cannot be expected to stabilise economic activity.

Yet Europe's fiscal rules are asymmetrical, and biased towards each members' public finance sustainability target. Although member states that have not met their fiscal adjustment targets (based on the value of the nominal deficit, the medium-term structural target or the pace of reducing the debt ratio) are demanded to pursue their efforts, the Council can only *recommend* that the countries already in compliance pursue cyclically accommodating policies. In the end, these rules can be problematic, since they do not always make it possible to set up the optimal policy for the eurozone as a whole. The authors of the report esteem that "in light of the latest economic and budgetary data, a full delivery of the fiscal requirements contained in the country-specific recommendations of the Council would lead, on aggregate, to a moderately restrictive fiscal stance for the euro area as a whole in 2017 and 2018, while the economic situation would seem to call for an expansionary fiscal stance in the present circumstances."[3]

This is a remarkable shift in the Commission's stance, because it illustrates the change of focus: previously, it was enough to evaluate on a country-specific basis whether a country complied with Europe's fiscal rules. Immediately after the text was released, Wolfgang Schaüble publically requested that the EC services revert to the good old practices of the past. Given Europe's institutional structure and total absence of any political will in most member states to move this project forward, fiscal policy stances will continue to be largely decentralised in the near future. In the end, growing political tensions and upcoming elections are most likely to ease fiscal restrictions at a time when the Commission is more lenient towards member countries that officially have little manoeuvring room.

Fiscal expansion in the eurozone

Change in the primary structural balance (% of potential GDP), inverted scale. — Member States draft budgetary plans — EC autumn forecast — Member States Stability programmes - - - preferable, according to EC

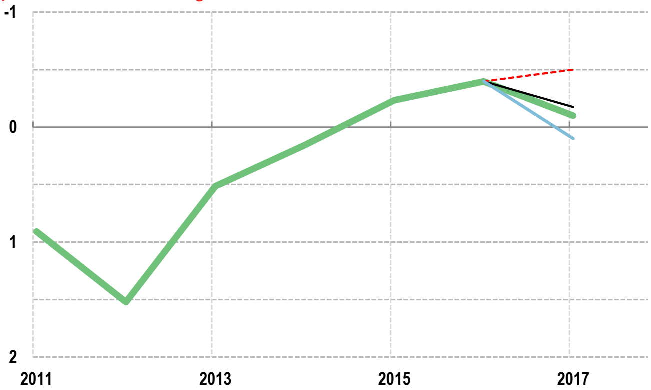

Chart 2 Sources: Ameco, Commission services

[2] Although the recent increase in long-term rates makes QE easier to implement.

[3] "Towards a positive Euro Area fiscal stance", European Commission communication, 16 November 2016.