Eurozone

Cautious optimism

- **The economic situation in the eurozone continues to improve.**
- **Despite the economic improvement, however, the output gap accumulated since 2008 is significant and has resulted in very low inflation, especially if we exclude the most volatile elements from the figures.**
- **With this in mind we continue to expect monetary policy to remain accommodating for some time, featuring the extremely gradual withdrawal of non-conventional measures from January 2018.**

If we rely on the various confidence surveys conducted since the beginning of the year, then it seems clear that GDP growth in the eurozone is headed for acceleration. The latest 'hard' activity data, however, suggest that the prevailing optimism should be tempered. This was the case for February industrial production figures, which were particularly disappointing in France. Even so, eurozone growth is likely to continue to set a fairly strong pace – outpacing potential growth – in the first quarter of 2017, something that could not be taken for granted just a few months ago: between the Brexit vote, rising energy costs and the European electoral calendar, the risks seemed to be clearly on the downside.

This pleasant surprise should not, however, give rise to unbridled optimism. Indeed, caution informed the risk assessment produced by the ECB in early March: although less pronounced, the risks remain on the downside. It seems likely, however, that barring any accidents, the next forecasting exercise, due in June, will be an opportunity for the ECB to recognise a strengthening of the economic recovery and to upgrade its risk assessment from "tilted to the downside" to 'broadly balanced'. This would also be an opportunity to adjust the forward guidance by removing the reference to lower policy rates in future, as a latest stage in the extremely gradual process of monetary normalisation.

In the meantime, it will come as no surprise if next week's monetary policy meeting settles on maintaining the status quo. Mario Draghi will once again stress the absence of convincing signs of rising underlying inflation, which is a way of saying that, although the eurozone is unarguably doing better, the cumulative output gap since 2008 remains substantial: the recovery is not yet on the verge of an inflationary phase. Far from it. Stripping out volatile items reveals weak or non-existent inflationary pressures.

This analysis draws the fundamental distinction between GDP growth and the level of activity. For the central bank what is important is the change in the output gap between actual production and the potential level of production. It is generally expected that as an economy approaches its potential, and the first signs of inflation appear, the central bank will tighten monetary policy.

Wage growth (y/y, %)

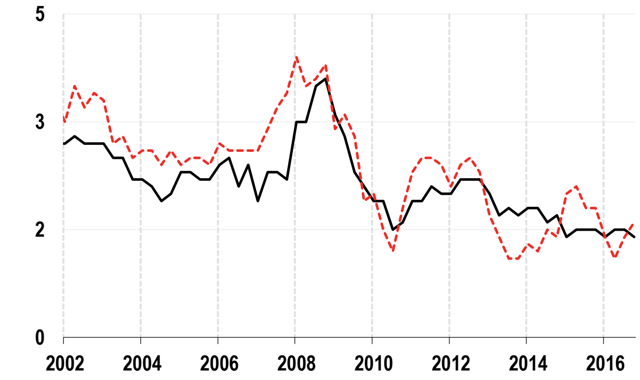

Chart 1 Sources: Eurostat, ECB

All the difficulty is that, unlike GDP, potential GDP is not observable: it has to be estimated using approaches and assumptions that can vary widely. As a result, there is rarely a consensus on its level. Wage growth, which has been trending downwards since 2009 and is currently not showing any convincing sign of recovery (see chart) suggests that it will take a long time to make up for lost ground. The experience of the US economy (whose cycle is significantly in advance of the eurozone) also suggests that after a major crisis the full recovery of the labour market can be an extremely slow process and can incorporate a number of discontinuities that extend the horizon for monetary normalisation.

With all of this in mind we continue to expect European monetary policy to remain accommodating for some time, featuring the very gradual withdrawal of non-conventional measures. Thus in September 2017 the ECB could announce that from January 2018 the monthly volume of purchases will be reduced (to say EUR 45 billion or EUR 40 billion) for a minimum 6-month period, before a new adjustment is made, but without announcing a predefined end date. Due to its direct effect on excess liquidity, any significant prolongation of QE, even on a scaled-back basis, could be accompanied by a narrowing of the corridor (a 10bp increase in deposit facility rates with the refi rate unchanged) before net asset purchases is brought to an end, potentially during the first half of 2018.