Eurozone

Patient optimism

The economic situation in the eurozone continues to improve: confidence surveys point to a very positive trend, although the latest "hard" economic data suggest that the prevailing optimism should be tempered somewhat. Our growth forecasts have been upgraded since the end of 2016. Yet, despite the economic improvement, labour market slack remains significant and results in very low inflation 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, characterised by an extremely gradual withdrawal of non-conventional measures from January 2018.

The eurozone economic situation is improving. After growth of 0.5% q/q in Q4 2016, the various confidence surveys conducted since the beginning of the year have suggested that growth will continue at a similar or perhaps even stronger rate in the first quarter of 2017. It is nevertheless important to note the recent appearance of a gap between the very positive image created by surveys and the more mixed picture painted by "hard" economic data (see chart). In particular, the industrial production figures for February were disappointing, notably in France.

It therefore remains to be seen to what extent GDP figures, the first estimate of which will be published on 28 April, confirm the general mood of optimism. Even so, barring any accidents, eurozone growth is likely to continue to set a fairly strong pace, something that was far from assured just a few months ago: between the Brexit vote, rising energy prices and the European electoral calendar, the risks seemed to be clearly on the downside. This positive surprise should not, however, give rise to unbridled optimism. Despite the economic improvement, the lag in production accumulated since 2008 is significant and has resulted in very low inflation 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.

GDP growth and output gap

A common error when looking at the economic performance of a country (or in this case the whole eurozone) is to confuse GDP growth with economic output level. Of course, observers have an interest in GDP growth figures, but the fundamental issue for the 'health' of an economy is the gap between the actual level of output and the potential output. An overheating economy is one where actual output exceeds potential, resulting in inflationary pressures. In an underperforming economy, actual output is below potential and inflation tends to slow.

The difficulty in economic analysis is that, unlike GDP, potential GDP cannot be observed: it has to be estimated using approaches and assumptions that can vary widely. As a result, there is rarely a consensus on its level. For example, the OECD put the output gap for the eurozone at -1.9% of potential GDP at the end of 2016, whilst the IMF put the figure at -1.2% and the European Commission had it at -1%.

One of the main reasons for these differences is the estimated impact of the economic crisis on potential output. In concrete terms, the question is whether or not there has been a permanent, unrecoverable loss of output and employment. The European Commission, which has the most conservative estimate of the output gap, believes that the structural unemployment rate, estimated at 7.5% in 2008, is now 9%.

The structural unemployment rate is the level of unemployment recorded when the output gap is closed, that is to say when the economy is performing at potential. It is also the level of unemployment around which wage growth starts to accelerate. As a result, the estimate of structural unemployment has significant consequences for inflation expectations and hence for expectations of future monetary policy. Indeed, 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.

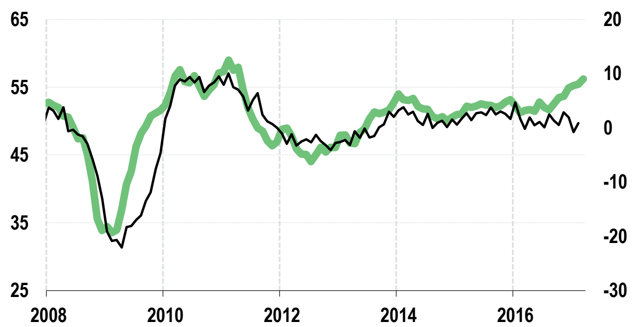
1- Summary of forecasts

Annual growth, %	2016 e	2017 e	2018 e
GDP	**1.7**	**1.6**	**1.6**
Private consumption	1.8	1.3	1.5
Gross Fixed Capital Formation	2.5	2.1	2.4
Exports	2.4	3.9	4.2
Consumer Price Index (CPI)	0.2	1.8	1.4
Unemployment rate	10.0	9.4	9.1
Current account balance	3.4	3.0	3.1
Gen. Govt. Balance (% of GDP)	-1.7	-1.4	-1.2
Public Debt (% GDP)	89.4	88.5	87.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- A growing gap

Industrial production y/y; Manufacturing PMI (lhs)



Sources: Eurostat, Markit

In February the eurozone unemployment rate fell to 9.5%, its lowest level since 2009. If we take the European Commission's estimate of structural unemployment there are therefore 795,000 'missing' jobs in the eurozone: at unchanged participation rates this represents between two and three quarters of job creation at its current pace. On this view, the ECB would be nearing the point where it tightens financial and monetary conditions to head off overheating. On the other hand, if we use the OECD's estimates instead, the shortfall in jobs is 1.3 million, rising to 3.2 million on the basis of pre-crisis structural unemployment. On these figures, continued monetary support is required.

The eurozone is still convalescing

Current inflation dynamics in the eurozone suggest that substantial production capacity remains idle. The uptick in inflation seen since the beginning of 2017 is due primarily to increases in energy and food prices, which are subject to powerful base effects. Stripping out these volatile items reveals weak, or non-existent inflationary pressures. Underlying inflation remains below 1% and is showing no sign of rising (see chart). This situation stems primarily from the lack of vigour in wage growth: although the details vary from one country to the next, average wage growth has been on a downward trend since 2009 and recent developments have shown no sign of an upturn. This implies that the European Commission's estimates of the output gap and structural unemployment are probably too restrictive. In short, although it is recovering, the eurozone economy remains damaged and has not yet moved into its inflationary phase.

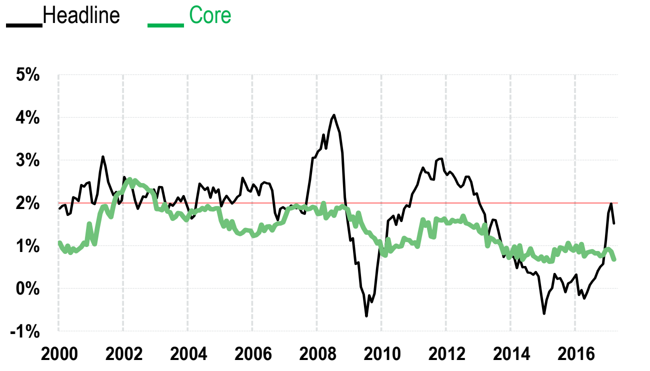
The experience of the US economy (whose cycle is significantly in advance of the eurozone) also argues for caution: the lesson is that after a major crisis the full recovery of the labour market can be extremely slow. Despite a very low unemployment rate – in reality already below the estimated structural level – US wage growth remains modest. One explanation is that underemployment goes beyond the unemployed: it is important to take account of part-time workers as well as "shadow unemployment" (those people who would take a job even though they are not actively looking for one). The unemployment rate only gives a partial picture of the economic situation. Thus in order to be complete, economic analysis must take account of a number of discontinuities which push back the horizon for monetary normalisation.

Prolonged monetary support

As part of its quantitative easing programme, the ECB has scaled back the monthly rate of asset purchases from EUR 80 bn to EUR 60 bn from April 2017 through to the end of the year. We expect a similar type of change to QE from January 2018: a reduction in monthly purchases but with no announcement of a pre-determined end date. 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, and so forth. Monetary normalisation will be gradual, with the ECB making a series of re-evaluations, and thus retaining a significant degree of flexibility.

Due to the direct effect on excess liquidity of a significant prolongation of QE, even on a scaled-back basis, it can but feed into

3- Inflation
Consumer price y/y



Source: Eurostat

speculation on the possibility of an increase in the deposit facility rate from its current level of -0.40%. Indeed, the combination of QE and a negative deposit facility rate puts bank profits under pressure, which could over time disrupt the transmission of monetary policy. Clearly this issue will get increasingly acute the longer QE lasts, which is why we expect the ECB to narrow the corridor (raising the deposit rate by 10bp, whilst leaving the *refi* rate unchanged) before ending net purchases of assets, perhaps in the first half of 2018.

Such a measure could also help satisfy the more hawkish members of the Governing Council, although it should be emphasised that QE itself is the main topic of debate at the central bank. More generally, the heterogeneity of EMU member states, which is being expressed increasingly openly in statements from different members of the Governing Council, could muddy the ECB's communication as we go forward. However, we would underline that such ambiguity over the direction of monetary policy does have the positive effect of avoiding too abrupt a transition from a resolutely accommodating ECB (as has been the case since mid-2014) and an ECB equally resolutely committed to the path to normalisation (which would seem premature). It is therefore probably the best type of communication at present, given the halfway position in which the monetary union finds itself at present.

Thibault Mercier
thibault.mercier@bnpparibas.com