

# ECOWEEK

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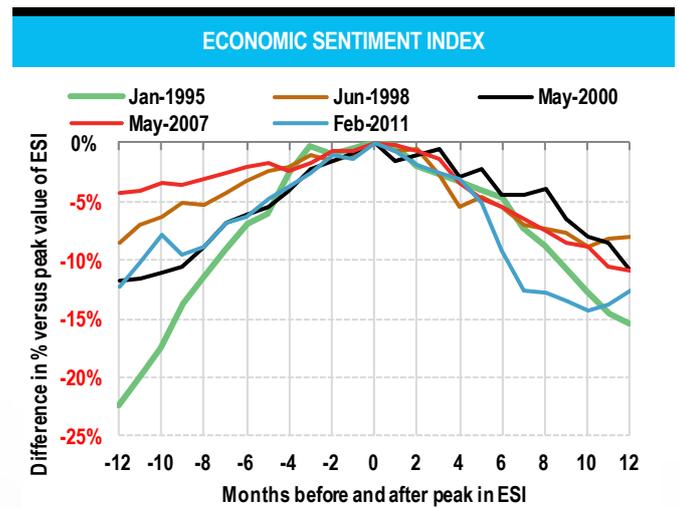
## What happens after the peak?

- The euro area Economic Sentiment Index is at its highest level since January 2001 and the growth outlook is robust.
- However, the historical experience of the ESI once the peak had been passed is quite diverse: weaker data not only reflect but also contribute to an increase in uncertainty.

Soft data reflect the assessment of households and companies of factors which influence their economic situation. Given the importance of psychological factors in spending decisions, these data are particularly useful and complement hard data like production or income. Over the past 12 months, soft data have improved significantly in the euro area. IHS Markit's manufacturing PMI reached an 80 month high in October and its employment component is at an all-time high. Another important indicator is the Economic Sentiment Index (ESI) of the European Commission. The reading for last month was 114.0 which is the highest level since January 2001 and only 5% below its historical peak of 119.0 reached in May 2000. Looking at the distribution of the data starting in January 1985, the observation for last month corresponds to the 96<sup>th</sup> percentile. How good can it get?

Clearly these data tell us nothing about the timing or the level of the next cyclical peak. New historical highs may very well be reached. This has been the case in Germany where the IFO business climate index hit a new high in October. Moreover, economic fundamentals look solid so the expansion should last. ECB policy remains expansionary, despite the scaling back of QE announced last week. The still negative output gap creates room for sustained above potential growth. The length and robustness of the expansion support confidence which in turn benefits spending. Job creation is another component of the self-reinforcing dynamics. Finally, the global environment is also a support factor.

Based on this, the case for being confident about the 2018 outlook is strong. Yet, having in mind a range of risks and uncertainties, the cautious decision maker may want to know what happens when the cycle turns. As illustrated by the chart, previous peaks of the ESI were followed in a subsequent 12 months by a decline of this indicator ranging between 8 and 15%. The difference is big and simulations based on the statistical relationship between the ESI and GDP, which admittedly is far from perfect, yield an outcome ranging between a mere slowdown towards potential growth or no growth at all. This helps to understand why a decline in soft data both reflects but also contributes to an increase in uncertainty.



Sources: European Commission, BNP Paribas

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