ECOWEEK

No. 19-16, 19 April 2019

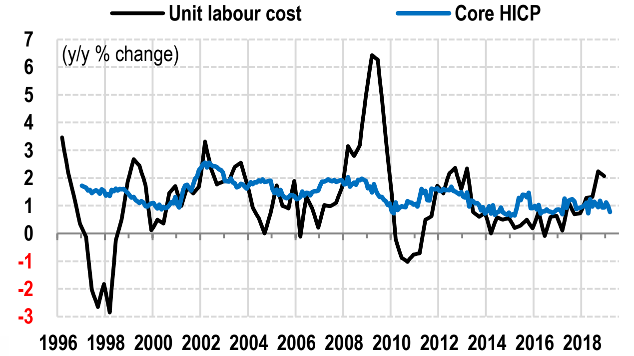
ECB: easing of inflation raises pressure

■The pass-through of wage growth to prices is stronger and faster when inflation is higher to start with ■The low inflation in the Eurozone has slowed down the transmission ■The considerable growth slowdown, on the back of adverse foreign demand and uncertainty shocks, impairs this process even more ■This raises pressure on the ECB to take action in order to dislodge core inflation, which remains stuck well below its objective

At a conference in Frankfurt last November, Mario Draghi explained in great detail how faster wage growth tends to lead to higher inflation[1]. As demand for goods and services rises and production increases, productivity picks up, giving a boost to corporate profitability. Eventually, wages increase, all the more so when companies recruit more staff and the competition for talent intensifies. Unit labour costs rise, putting pressure on profit margins. Sustained strong economic growth ends up providing companies with enough confidence to raise their prices in order to protect their margins.

These lags, which are perfectly normal, allow the central bank to maintain a very accommodative policy, even though growth is already robust. ECB research has shown that the pass-through from wage growth to inflation is faster and stronger in periods of higher inflation. This implies that when inflation has been low, like in the eurozone, the process will take more time[2]. It is of course essential that in the meantime growth remains on track: "*if firms start to become more uncertain about the growth and inflation outlook, the squeeze on margins could prove more persistent. This would affect the speed with which underlying inflation picks up and therefore the inflation path that we expect to see in the quarters ahead.*"[3]

EUROZONE: UNIT LABOUR COSTS AND CORE INFLATION



Source: Eurostat, BNP Paribas

Five months later, it turns out these words of the ECB President were very much prescient. Growth has slowed significantly for a host of reasons (slowdown of the global capex cycle, slower world trade growth, slower growth coming from China, country-specific factors in Germany, Italy and France, a prolonged period of pervasive uncertainty, etc.). As a consequence, labour market bottlenecks, whilst remaining tight, have eased. Moreover, growth of compensation per employee, which is still strong, has declined slightly, though it remains to be seen whether this is the beginning of a new trend. This provides a challenging environment to generate the necessary pass-through from wages to inflation so as to have the latter converging to the ECB's policy objective. This is confirmed by the latest inflation data with core HICP up 0.8% in March versus last year. There is something tragic in the observation that the combination of an imported growth slowdown and imported uncertainty shocks have shortened the phase of very strong growth in the eurozone and triggered a premature slowdown. This in turn has reduced the effectiveness of an expansionary monetary policy, leaving the ECB no choice but to start working on more of the same. The details on the new TLTRO are eagerly awaited.

William De Vijlder

[1]ECB, Mario Draghi, *The outlook for the euro area economy*, speech at the Frankfurt European Banking Congress, Frankfurt am Main, 16 November 2018 [2]Elena Bobeica, Matteo Ciccarelli, Isabel Vansteenkiste, *The link between labor cost and price inflation in the euro area*, ECB Working Paper 2235, February 2019 [3]Mario Draghi, op. cit

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Eco WEEK

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BNP PARIBAS

The bank for a changing world

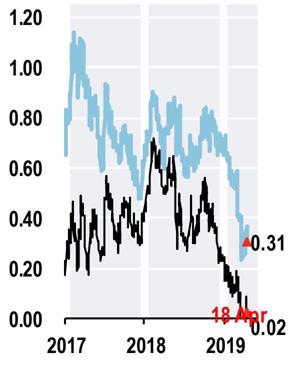
Markets overview

The essentials

Week 12-4 19 > 18-4-19

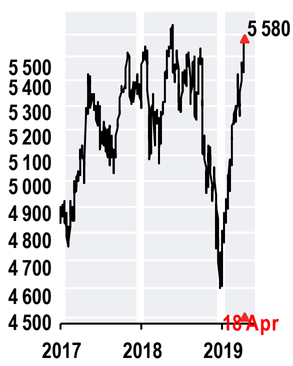
↗	**CAC 40**	5 503	▸	**5 580**	**+1.4**	%
↘	**S&P 500**	2 907	▸	**2 905**	**-0.1**	%
↗	Volatility (VIX)	12.0	▸	12.1	+0.1	pb
↘	**Euribor 3M (%)**	-0.31	▸	**-0.31**	**-0.1**	bp
↘	Libor $ 3M (%)	2.60	▸	2.59	-1.0	bp
↘	OAT 10y (%)	0.35	▸	0.31	-3.9	bp
↘	Bund 10y (%)	0.06	▸	0.02	-3.1	bp
↘	US Tr. 10y (%)	2.56	▸	2.56	-0.1	bp
↘	**Euro vs dollar**	1.13	▸	**1.12**	**-0.6**	%
↘	Gold (ounce, $)	1 292	▸	1 275	-1.3	%
↗	**Oil (Brent, $)**	71.7	▸	**71.9**	**+0.3**	%

10 y bond yield, OAT vs Bund



Euro-dollar

CAC 40



Money & Bond Markets

Interest Rates		highest' 19		lowest' 19	
€ ECB	**0.00**	0.00	at 01/01	0.00	at 01/01
Eonia	**-0.37**	-0.36	at 01/01	-0.37	at 26/02
Euribor 3M	**-0.31**	-0.31	at 24/01	-0.31	at 28/03
Euribor 12M	**-0.11**	-0.11	at 06/02	-0.12	at 02/01
$ FED	**2.50**	2.50	at 01/01	2.50	at 01/01
Libor 3M	**2.59**	2.81	at 01/01	2.58	at 09/04
Libor 12M	**2.76**	3.04	at 21/01	2.68	at 27/03
£ BoE	**0.75**	0.75	at 01/01	0.75	at 01/01
Libor 3M	**0.83**	0.93	at 29/01	0.82	at 08/04
Libor 12M	**1.10**	1.19	at 11/01	1.05	at 02/04

At 18-4-19

Yield (%)			highest' 19		lowest' 19	
€	AVG 5-7y	**0.41**	0.68	at 09/01	0.36	at 12/04
	Bund 2y	**-0.57**	-0.53	at 05/03	-0.63	at 27/03
	Bund 10y	**0.02**	0.25	at 01/01	-0.08	at 27/03
	OAT 10y	**0.31**	0.73	at 08/01	0.24	at 27/03
	Corp. BBB	**1.36**	2.15	at 08/01	1.36	at 18/04
$	Treas. 2y	**2.39**	2.62	at 18/01	2.22	at 27/03
	Treas. 10y	**2.56**	2.78	at 18/01	2.37	at 27/03
	Corp. BBB	**4.03**	4.65	at 01/01	3.98	at 27/03
£	Treas. 2y	**0.78**	0.83	at 27/02	0.63	at 02/04
	Treas. 10y	**1.20**	1.35	at 18/01	0.99	at 25/03

At 18-4-19

10y bond yield & spreads

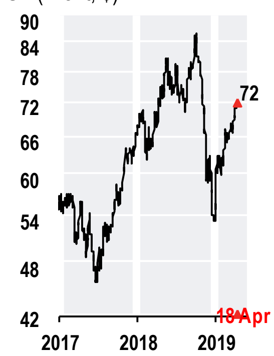
3.84%	Greece	381 pb
2.45%	Italy	242 pb
1.17%	Portugal	114 pb
1.06%	Spain	103 pb
0.47%	Belgium	44 pb
0.31%	Austria	28 pb
0.31%	France	28 pb
0.25%	Finland	22 pb
0.20%	Netherland	17 pb
0.15%	Ireland	12 pb
0.02%	Germany	

Commodities

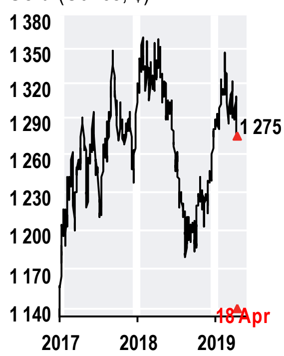
Spot price in dollars		lowest' 19			2019(€)
Oil, Brent	**71.9**	53.1	at	01/01	**+37.6%**
Gold (ounce)	**1 275**	1 274	at	17/04	**+1.2%**
Metals, LMEX	**3 025**	2 730	at	03/01	**+9.8%**
Copper (ton)	**6 461**	5 714	at	03/01	**+10.4%**
CRB Foods	**345**	324	at	07/03	**+8.1%**
wheat (ton)	**176**	168	at	11/03	**-9.3%**
Corn (ton)	**133**	130	at	29/03	**-0.7%**

At 18-4-19 *Variations*

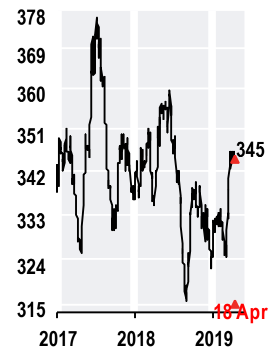
Oil (Brent, $)



Gold (Ounce, $)



CRB Foods



Exchange Rates

1€ =		highest' 19			lowest' 19			2019
USD	**1.12**	1.15	at	10/01	1.12	at	02/04	-1.6%
GBP	**0.86**	0.90	at	03/01	0.85	at	14/03	-3.7%
CHF	**1.14**	1.14	at	05/02	1.12	at	02/04	+1.1%
JPY	**125.80**	127.43	at	01/03	122.54	at	03/01	+0.3%
AUD	**1.57**	1.63	at	03/01	1.57	at	18/04	-3.2%
CNY	**7.54**	7.87	at	09/01	7.52	at	02/04	-3.9%
BRL	**4.44**	4.46	at	28/03	4.18	at	31/01	+0.2%
RUB	**71.94**	79.30	at	01/01	71.94	at	18/04	-9.3%
INR	**77.97**	82.00	at	04/02	76.84	at	03/04	-2.3%

At 18-4-19 *Variations*

Equity indices

	Index	highest' 19			lowest' 19			2019	2019(€)
CAC 40	**5 580**	5 580	at	18/04	4 611	at	03/01	+18.0%	**+18.0%**
S&P500	**2 905**	2 907	at	12/04	2 448	at	03/01	+15.9%	**+17.8%**
DAX	**12 222**	12 222	at	18/04	10 417	at	03/01	+15.8%	**+15.8%**
Nikkei	**22 090**	22 278	at	17/04	19 562	at	04/01	+10.4%	**+10.0%**
China*	**86**	86	at	09/04	68	at	03/01	+22.2%	**+24.2%**
India*	**602**	606	at	02/04	530	at	19/02	+7.2%	**+9.7%**
Brazil*	**2 026**	2 304	at	04/02	1 944	at	01/01	+6.2%	**+6.0%**
Russia*	**672**	674	at	10/04	572	at	01/01	+9.6%	**+19.5%**

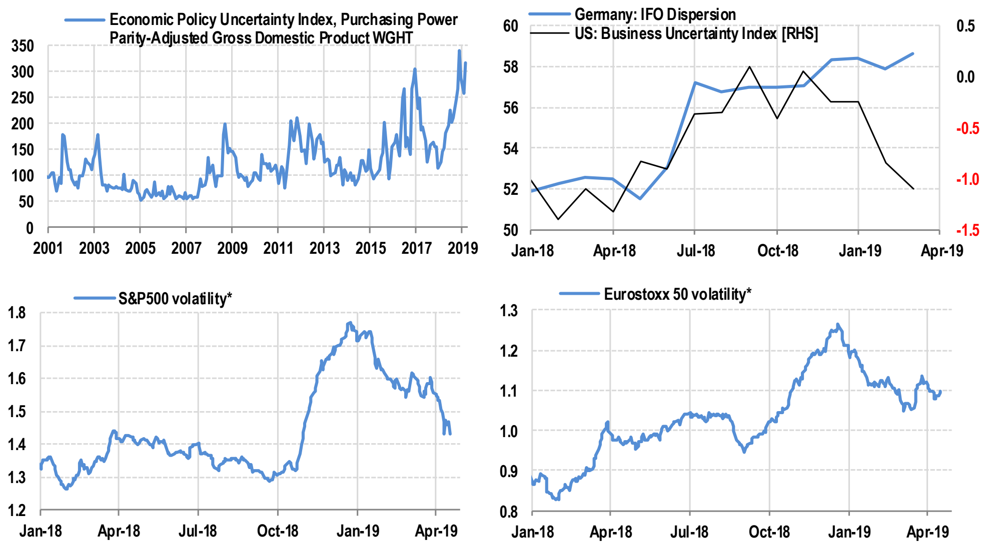
At 18-4-19 *Variations*

* MSCI index

Pulse

Uncertainty: mixed signals

The different uncertainty measures are sending mixed signals. The Economic Policy Uncertainty Index, which is based on media coverage about policy uncertainty, is no longer increasing but a downward trend has not yet started. The top right chart shows uncertainty based on company surveys. In Germany, uncertainty remains very high and the latest report shows another, albeit small, increase. US companies on the other hand feel less and less uncertain. Finally, uncertainty based on the dispersion of the share price performance of individual companies is on a declining trend in the US and the eurozone. In case of the latter, the level remains well above that seen one year ago.



*volatility = 60-day moving average of the cross-sectional standard deviation of daily returns of the index constituents
Source: Economic Policy Uncertainty, Bloomberg, IFO, Atlanta Fed, BNP Paribas

Indicators preview

Data for April will be eagerly awaited next week with business confidence and consumer confidence in France, the IFO business climate index in Germany, eurozone consumer confidence and UK order books. In the US we have existing home sales, new home sales, durable goods orders, first quarter GDP, university of Michigan sentiment. The Bank of Japan will decide on monetary policy.

Date	Country	Event	Period	Surv(M)	Prior
04/22/19	United States	Existing Home Sales MoM	March	-4.7%	11.8%
04/23/19	Eurozone	Consumer Confidence	April	--	-7.2
04/23/19	United States	New Home Sales MoM	March	-5.6%	4.9%
04/24/19	France	Business Confidence	April	--	104
04/24/19	Germany	IFO Business Climate	April	--	99.6
04/25/19	United Kingdom	CBI Trends Total Orders	April	--	1
04/25/19	United States	Cap Goods Orders Nondef Ex Air	March	--	-0.1%
04/25/19	Japan	BoJ 10-year Yield Target	April 25	--	0.000%
04/25-05/11/19	Eurozone	EU Commission Economic Forecasts			
04/26/19	France	Consumer Confidence	April	--	96
04/26/19	United States	GDP Annualized QoQ	1Q	1.6%	2.2%
04/26/19	United States	Core PCE QoQ	1Q	--	1.8%
04/26/19	United States	University of Michigan Sentiment	April	--	--

Source: Bloomberg, BNP Paribas

Economic scenario

UNITED STATES

- Growth is expected to slow to 2.3% this year. Trade war uncertainty acts as a drag, the housing market is softening, corporate investment should slow, as well as exports in reaction to the past strengthening of the dollar against a broad range of currencies.
- Core inflation remains well under control and has eased a bit.
- Following the dovish message from the January FOMC meeting, markets are pricing in a policy easing in the course of 2020.

CHINA

- Economic growth continues to slow, with an export outlook severely darkened by US tariff hikes.
- The central bank is easing liquidity and credit conditions, though the reduction in financial-instability risks via regulatory tightening should remain a priority. Fiscal policy has also turned expansionary through increased infrastructure spending and a rising number of household/corporate tax cuts.
- In the short term, private domestic demand should be affected by the knock-on effect of weakening exports and the continued moderation in the property market. Fiscal measures should support consumer spending.

EUROZONE

- The slowdown is becoming increasingly evident, especially in the German economy, which has suffered from one-off factors but also from a slowdown of exports to China. Capacity constraints also play a role. Business climate in the manufacturing sector continues to decline. Italy has now entered a technical recession with quarterly growth negative in the third and fourth quarter of 2018.
- Inflation is now expected to decrease following the past drop in the oil price, while core CPI is hardly moving. The activity slowdown also implies that the pick-up in core inflation should be slower than expected until recently. We do not expect the ECB to move rates this year (see below).

FRANCE

- Growth is slowing although the economy should show some resilience. Households' consumption should get a boost from the tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

- In the US, the Fed has announced to be patient before deciding on any change in its policy. We expect key rates to stay on hold. We have changed the forecast for 10 year treasury yields and now expect a yield of 2.80% by mid-year and 2.70% at the end of the year.
- As the ECB confirmed that key rates won't change this year, the forecast for 10 year Bund yields and now expect a yield of 0.30% by mid-year and 0.40% at the end of the year.
- No change expected in Japan.
- The prospect of a narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

	GDP Growth			Inflation		
%	2018	2019 e	2020 e	2018	2019 e	2020 e
Advanced	**2.2**	**1.5**	**1.3**	**2.0**	**1.4**	**1.6**
United-States	2.9	2.3	1.8	2.4	1.7	2.0
Japan	0.8	0.2	0.3	1.0	0.5	0.5
United-Kingdom	1.4	1.1	1.5	2.5	2.0	1.9
Euro Area	**1.8**	**0.9**	**1.0**	**1.8**	**1.2**	**1.4**
Germany	1.4	0.7	0.9	1.9	1.4	1.7
France	1.6	1.2	1.2	2.1	1.2	1.7
Italy	0.8	0.0	0.5	1.3	0.9	1.2
Spain	2.6	2.1	1.7	1.7	1.0	1.4
Emerging	**4.5**	**4.4**	**4.7**	**4.8**	**4.6**	**4.2**
China	6.6	6.2	6.0	2.1	1.6	2.0
India*	7.4	7.6	7.8	3.4	3.3	4.1
Brazil	1.1	2.0	3.0	3.7	3.8	3.6
Russia	2.3	1.5	1.7	2.9	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

* Fiscal year from April 1st of year n to March 31st of year n+1

Interest rates, %		2019						
End of period		Q1	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
US	Fed Funds	2.50	2.50	2.50	2.50	2.50	2.50	2.50
	Libor 3m $	2.60	2.60	2.60	2.60	2.81	2.60	2.50
	T-Notes 10y	2.42	2.80	2.75	2.70	2.69	2.70	2.50
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.31	-0.30	-0.30	-0.30	-0.31	-0.30	-0.30
	Bund 10y	-0.07	0.30	0.30	0.30	0.25	0.30	0.40
	OAT 10y	0.26	0.65	0.65	0.60	0.71	0.60	0.70
UK	Base rate	0.75	1.00	1.00	1.25	0.75	1.25	1.25
	Gilts 10y	1.00	1.85	2.00	2.10	1.27	2.10	2.10
Japan	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.07	-0.10	-0.20
	JGB 10y	-0.09	-0.03	-0.05	-0.05	0.00	-0.05	-0.20

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019						
End of period		Q1	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
USD	EUR / USD	1.12	1.17	1.18	1.20	1.14	1.20	1.25
	USD / JPY	111.0	108.0	105.0	100.0	110.0	100.0	90.0
	GBP / USD	1.30	1.38	1.40	1.45	1.27	1.45	1.51
	USD / CHF	1.00	0.97	0.97	0.97	0.99	0.97	0.93
EUR	EUR / GBP	0.85	0.85	0.84	0.83	0.90	0.83	0.83
	EUR / CHF	1.12	1.14	1.15	1.16	1.13	1.16	1.16
	EUR / JPY	124.0	126.0	124.0	120.0	125.0	120.0	113.0

Source : BNP Paribas GlobalMarkets (e: Forecasts)

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