EUROZONE: THE GROWTH OUTLOOK THROUGH THE LENS OF SURVEY DATA

Inflation in the Eurozone is declining and recent survey data point towards a possible stabilisation of economic activity. However, inflation remains well above target and business sentiment has reached a (very) low level. Based on the historical relationship, the current level of the S&P Global composite PMI and the economic sentiment index of the European Commission point towards, at best, a stagnation of activity in the coming months. Whether growth will turn out to be higher or lower will largely depend on how the environment will change. Downside risks are the delayed effect of past monetary tightening and, to a lesser degree, the recent rise in energy prices and the weaker growth environment in China. Disinflation and the start of monetary easing, which we expect in the second quarter of next year, should be growth supportive. On balance and considering the (very) low levels of survey data, one understands why in the communication of the ECB, the emphasis has shifted from raising rates to keeping rates at the current level long enough. It reflects a growing concern of hiking too much.

For analysts covering the Eurozone, the latest data have brought a little relief. The flash estimate for inflation in September showed a decline to 4.3% y/y (5.2% in August) and core inflation was also significantly lower (4.5% versus 5.3% the previous month). In both cases, inflation was lower than expected by the Bloomberg consensus forecast[1]. Besides, the flash estimate of S&P Global's composite PMI edged slightly higher in September, from 46.7 to 47.1. Based on its latest business and consumer survey, the European Commission reported that economic sentiment was "*mildly lower*" in September, but the employment expectations indicator picked up slightly and remains well above its long-term average. The inflation data increase the likelihood that the ECB will no longer raise its policy rate, whereas the survey data could be interpreted as signaling a stabilization in sentiment after the significant decline that started early last year.

Relief about the *change* of an economic number should not make us forget that the *level* also matters, if not more. In this respect, the situation remains problematic. Inflation remains well above the ECB's 2.0% target and sentiment levels are in the left tail of the historical distribution (chart 1 and 2). This is in particular the case for the composite purchasing managers' index. The latest reading for the economic sentiment index (ESI) of the European Commission is less extreme, but still very low.

What might this imply for third quarter GDP growth? Do the sentiment data provide insight in the growth outlook for the next several quarters? To explore this, quantile regressions were performed[2] to account for the possibility that the relationship between the explanatory variable -the PMI or the ESI- and real GDP growth would be non-linear. Very weak survey data may cause heightened uncertainty, which could represent an additional drag on growth. The opposite may occur when the survey data are very good, creating a feeling of euphoria that could boost growth. The results are shown in charts 3 and 4 and show for low quantiles -i.e. low scores of the PMI and the ESI- a slightly nonlinear relationship with real GDP growth[3]. Based on the survey data for the third quarter[4], charts 5 and 6 provide an estimate for the quarterly growth of real GDP in the third quarter (T0) as well as for the average quarterly growth over the next several quarters[5]. Given the low score for the PMI, quarterly growth is estimated to be negative over the different horizons. The estimates based on the ESI, which has a less extreme value, point towards a stagnation of activity.

1 For headline inflation the consensus forecast was 4.5%, for core inflation 4.8%. Source: Bloomberg
2 Thanks to Tarik Rharrab for the econometric work.
3 The confidence interval is based on the standard error of the estimated coefficient. A wide interval implies a higher degree of uncertainty about the quality of the estimate. For the first quantile, the range is exceptionally wide and difficult to rationalize purely on economic grounds.
4 Based on the average of the monthly observations, in the third quarter the PMI is at the 10th percentile and the ESI at the 20th percentile.
5 T01 corresponds to the estimated average growth in the third and fourth quarter of this year, T012 shows average quarterly growth over three quarters, etc.

DISTRIBUTION OF PMI COMPOSITE (QUARTERLY AVERAGE)*

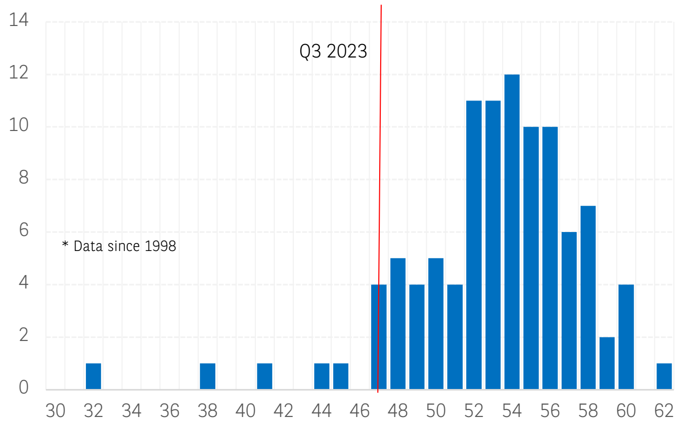

CHART 1

SOURCE: S&P GLOBAL, BNP PARIBAS

DISTRIBUTION OF ECONOMIC SENTIMENT INDICATOR (ESI) (QUARTERLY AVERAGE)*

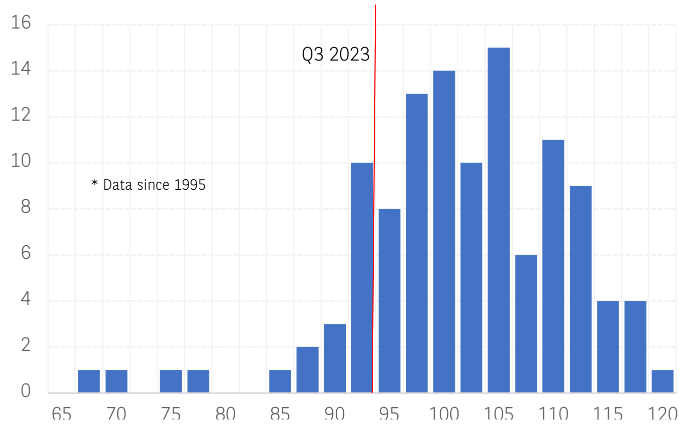

CHART 2

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

EDITORIAL

When using these results, several caveats should be kept in mind. It is a very simple model with only one explanatory variable so it doesn't take into account the dynamic interaction with other variables such as interest rates -the delayed effect of past rate hikes- or inflation -disinflation should have a positive impact on consumer spending. Although the coefficients of the quantile regressions are statistically significant, the R^2 are low [6] so a considerable part of the fluctuations in growth is left unexplained by the model. With these limitations in mind, the results are nevertheless useful because they provide a reference point, an a priori. If nothing were to change in the coming months, one would expect, purely based on the statistical relationship, at best stagnating activity in the Eurozone. However, the environment will change and may cause the outcome to be (very) different from the simple estimation.

This makes it important to identify factors that could lead to a better or worse outcome. Concerning the latter, the delayed effect of past monetary tightening is the key factor. Other attention points are the recent rise in energy prices and the weaker growth environment in China, which weighs on the outlook for European exports. Concerning the former, disinflation should support household confidence and also bring relief to companies in terms of their cost base. The start of monetary easing, which we expect in the second quarter of next year, should also be growth supportive. On balance and considering the (very) low levels of survey data, one understands why in the communication of the ECB, the emphasis has shifted from raising rates to keeping rates at the current level long enough. It reflects a growing concern of hiking too much.

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6 Less than 20% for the model based on the ESI, between 20% and 30% for the PMI-based models. For longer horizons the R^2s are lower.

QUANTILE REGRESSION OF REAL GDP GROWTH AS A FUNCTION OF COMPOSITE PMI

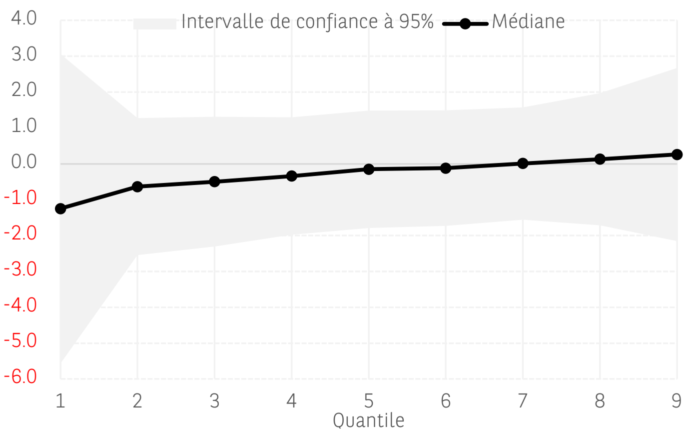

CHART 3

SOURCE: S&P GLOBAL, BNP PARIBAS

QUANTILE REGRESSION OF REAL GDP GROWTH AS A FUNCTION OF ESI

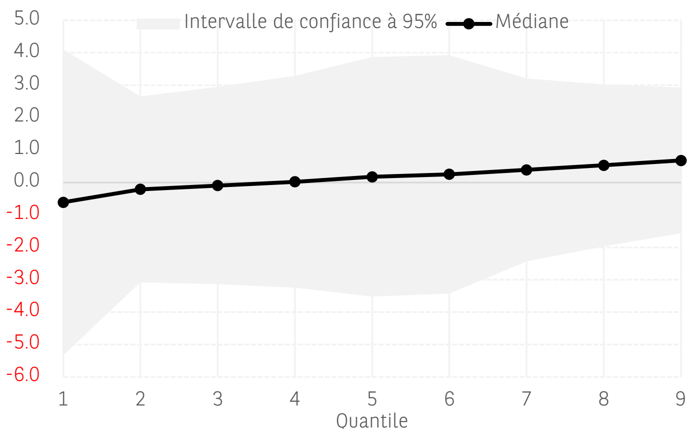

CHART 4

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

ESTIMATE OF REAL GDP GROWTH (QUARTERLY AVERAGE) (FIRST QUANTILE)*

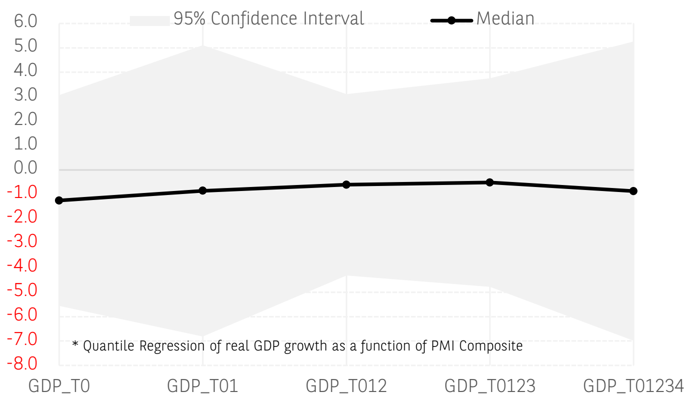

CHART 5

SOURCE: S&P GLOBAL, BNP PARIBAS

ESTIMATE OF REAL GDP GROWTH (QUARTERLY AVERAGE) (SECOND QUANTILE)*

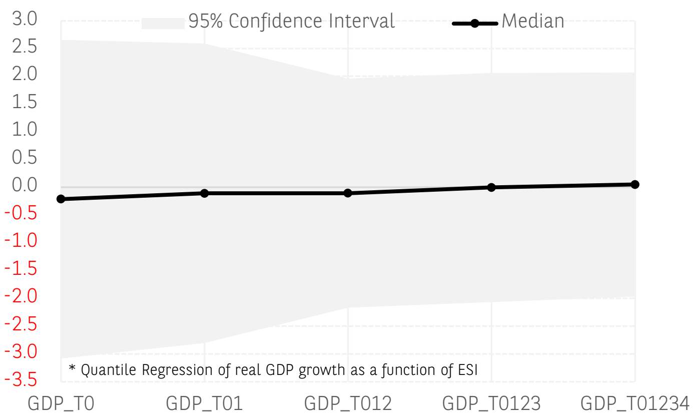

CHART 6

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS CALCULATIONS