Investment Research
The Big Picture
18 June 2018
Section Euro Area

Euro area

Soft landing – cautious ECB

- We expect the euro area economy to expand by 2.1% in 2018, 1.7% in 2019 and 1.6% in 2020, driven by stronger domestic demand, while net exports are likely to become a moderate drag in 2019 and 2020. Risks to the growth outlook loom from the trade war/protectionism and a shortage of skilled labour.
- Despite the narrowing output gap and continued employment gains, we expect wage growth to stay below the long-term average due to significant slack in the labour market.
- We expect core inflation to pick up gradually until end-2019, while headline inflation should stay below target without a lift from energy prices.
- We expect the ECB to end its QE programme in December 2018, before embarking on a slow hiking cycle starting in December 2019.

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Moderation recently, but still solid growth

While growth is expected to accelerate to 2.1% in 2018, according to our projections, well above its potential growth rates, we expect a soft landing in 2019 of 1.7% and 2020 of 1.6% (forecasts are broadly unchanged from December's Big Picture although here we include our 2020 forecast). The expansion will be driven primarily by domestic demand (private consumption and investments). In Q1 18, the euro area economy expanded by 0.4% from the previous quarter, likely to have been driven by domestic demand but with less support from net exports. Although temporary factors have been at play, we also see increasing arguments for why the recent moderation is more than just a soft-patch and more permanent factors are at play, in particular capacity constraints such as a shortage of skilled labour.

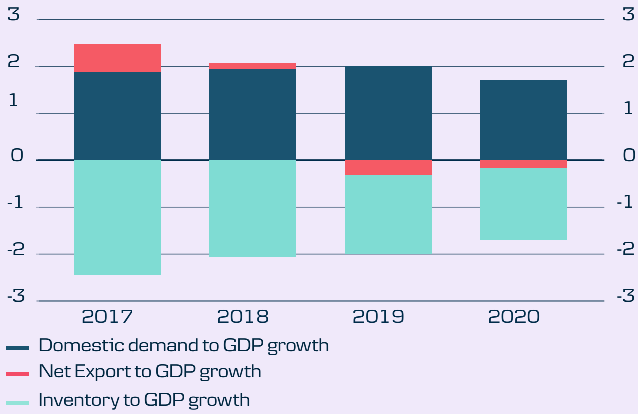
The combination of low borrowing costs and continuing employment gains means that we are still positive on the outlook for private consumption in the euro area. However, US protectionism/trade war intentions have hampered confidence. Some weakness spilling over via the trade channel in coming quarters is also possible. Import growth rates are expected to slow marginally, but still grow to record high levels, driven by stronger domestic demand. This means that the contribution from net exports to GDP growth will turn negative form 2019. For 2019 and 2020, we expect GDP growth to moderate to 1.7% and 1.6% respectively, staying well above potential growth, which the European Commission (EC) estimates at 1.5%. Hence, the output gap is expected to turn positive this year, supported by a continued fall in the unemployment rate from its current level of 8.5% to 8.4% by end-2018 and 7.9% by end-2019.

However, uncertainties regarding the slack in the labour market are high. The broader unemployment measure, the so-called U6, indicates that there is still a fair amount of slack in the labour market. The EC estimates NAIRU at 8.3% in 2018. We expect the unemployment rate to fall below the NAIRU in late 2018/early 2019, meaning that wage growth will stay muted despite the recent modest acceleration in certain jurisdictions.

The political landscape in Europe has changed recently. In particular, there are concerns about Italy remaining the most fragile among the big eurozone countries due to a combination of banking sector weaknesses, a high public debt burden combined with a weak growth outlook and political risks. The appointment of a populist government between Five Star Movement and League has brought Italian risks back into the spotlight. Their policy programme, which envisions a big fiscal expansion in clear violation of EU budget rules, has spooked financial markets given Italy's high public debt burden. Although we see the risk of a pro-longed stand-off between the populist government and the EU, our base case remains that it will eventually abide by EU rules. We assess the risk of Italy exiting the single currency as very low, not only due to constitutional hurdles, but also because a majority of the population is still in favour of the euro (see also Italian Election Monitor, 1 June 2018).

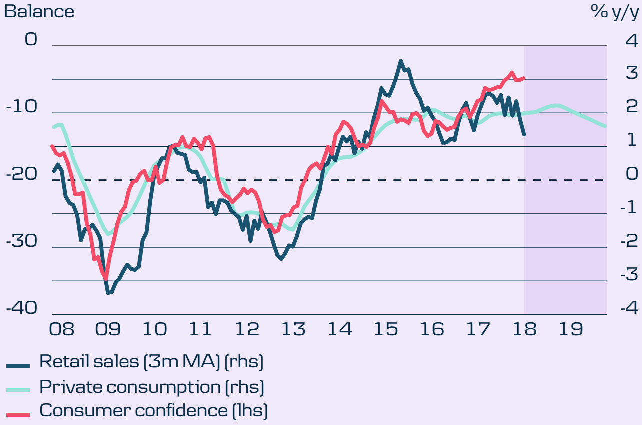
At the same time, calls for deeper EU integration led by France's President Emmanuel Macron have been met with opposition from Germany's more reluctant stance. The main differences in view related mainly to increased risk sharing

Domestic demand set to drive the economic expansion while inventories will drag



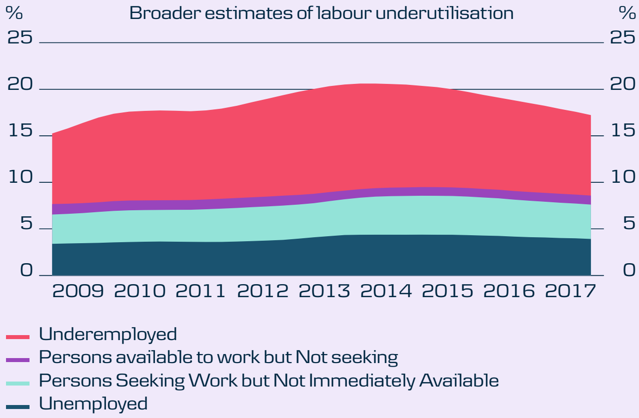
Source: Eurostat, Macrobond Financial, Danske Bank

Private consumption growth to accelerate in 2018 and to moderate in 2019



Source: Eurostat, EC, Macrobond Financial, Danske Bank

Broader unemployment measures indicate slack in the economy (% of extended labour force)



Source: Macrobond Financial, Danske Bank

(France's view) and the risk reduction view (Germany's view). The EU summit in late June has long been the key event for embarking on further integration; however, we expect only cosmetic initiatives, in particular given the strong resistance from Germany.

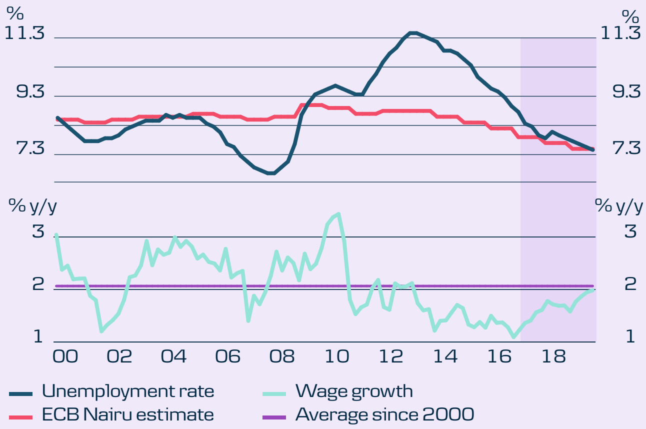
The ECB 'will cross the bridge when it gets there'

In March 2018, the ECB took its latest step in gradually removing its very accommodative monetary policy stance, when it removed its QE flexibility of being ready to scale up the purchase volume again. That means that the ECB's purchases programme will continue at least until September at EUR-30bn/month, a purchase rate it commenced in January 2018. We expect a further reduction in the purchase rate in Q4 18 to EUR15bn/month, before the last bond under the government bond purchase programme is bought by the end of the year. Overall, we expect the ECB to adopt a cautious stance on normalising monetary policy in which it will be reactive and not proactive in removing its stimuli measures. While any discussion of the first rate hike is premature in the ECB's view, we expect the first 20bp rate hike in the deposit rate to come in December 2019. See also, Not on Draghi's watch, 20 April 2018. Markets have started speculating on this, in particular given the uncertainty prevailing about the size of the hike. We reflected on this in 10bp, 20bp or ...? ECB in uncharted waters, 20 March 2018, although the ECB will only communicate on this at a relatively late stage.

The ECB's reinvestment policies will gain more importance in its guidance going forward. With reinvestments set to average around EUR10bn/month over the next year, the accommodative monetary policy stance will be ensured. This also supports the ECB's very conscious approach to a gradual normalisation. The ECB seems content with moderately higher yields, but the pace of a potential sharp rise in yields is a concern to it. We believe the ECB is too optimistic on its growth outlook, where the March staff projections pointed to 2.4% in March. With the recent moderation in both soft and hard data, we expect the ECB to revise this figure down closer to our estimate of 2.1%. See Research: Global business cycle is moving lower, 19 April 2018.

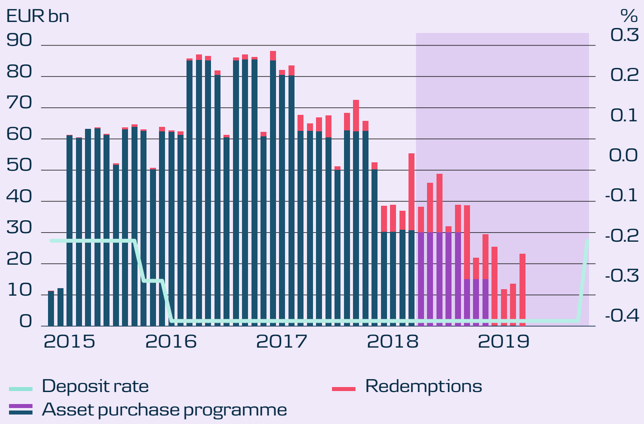
While price stability, according to the ECB's definition, is headline inflation 'below but close to 2%', the key inflation metric to assess is the core inflation, i.e. inflation excluding the volatile food and energy prices, as the ECB also wants a self-sustained inflation path. However, with core inflation only reaching 1.5% by the end of next year, from its current level of around 1%, there is still some way to go. Wage growth in certain jurisdictions will provide some upward pressure on core inflation in particular in 2019. However, at the same time, slack in other parts of the euro area will restrict core inflation from rising markedly in the near future.

Wage growth to slowly converge to long-term average by end-2019, amid continuing employment gains



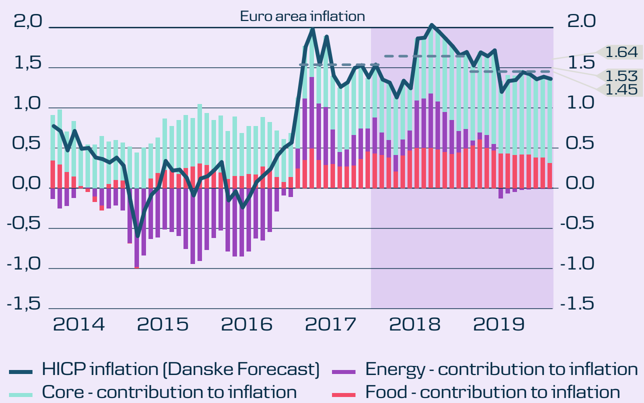
Source: Eurostat, EC, ECB, Macrobond Financial, Danske Bank

We expect the ECB to end PSPP purchases in Q4 18 and hike the deposit rate in December 2019



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Inflation set to pick up in 2019 but stay below target without a lift from energy prices



Source: ECB, Macrobond Financial, Danske Bank

Expectations for key figures and central banks over coming quarters

% Change q/q	2018				2019				Calendar year average			
Annualised rate	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019	2020
GDP	1.7	1.6	1.6	1.6	1.8	1.8	1.7	1.7	2.5	2.1	1.7	1.6
Private Consumption	1.6	1.8	1.8	1.8	1.8	1.8	1.6	1.6	1.7	1.5	1.8	1.6
Private Fixed Investments	4.5	4.5	4.5	4.5	3.2	3.2	3.2	3.2	3.2	4.0	3.7	2.9
Public Consumption	1.4	1.4	1.4	1.4	1.2	1.2	1.2	1.2	1.2	1.4	1.3	1.1
Exports	3.2	3.2	3.2	3.2	3.4	3.4	3.4	3.4	5.4	4.9	3.4	3.4
Imports	4.9	4.9	4.9	4.9	4.1	4.1	4.1	4.1	4.5	5.0	4.4	4.1
Net exports[1]	-1.6	-1.6	-1.6	-1.6	-0.6	-0.6	-0.6	-0.6	0.9	-0.2	-1.0	-0.6
Unemployment rate (%)	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.8	9.1	8.4	8.0	7.6
CPI (y/y)	1.3	1.7	1.9	1.7	1.6	1.4	1.4	1.4	1.5	1.6	1.5	1.6
Core CPI (y/y)	1.0	1.0	1.2	1.3	1.4	1.4	1.4	1.4	1.0	1.1	1.4	1.5
Public Budget[2]									-0.9	-0.7	-0.6	-0.5
Public Gross Debt[2]									88.8	86.5	84.1	82.0
Current Account[2]									3.5	3.4	3.4	3.4
ECB deposit rate[3]	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.2	-0.4	-0.4	-0.2	0.5

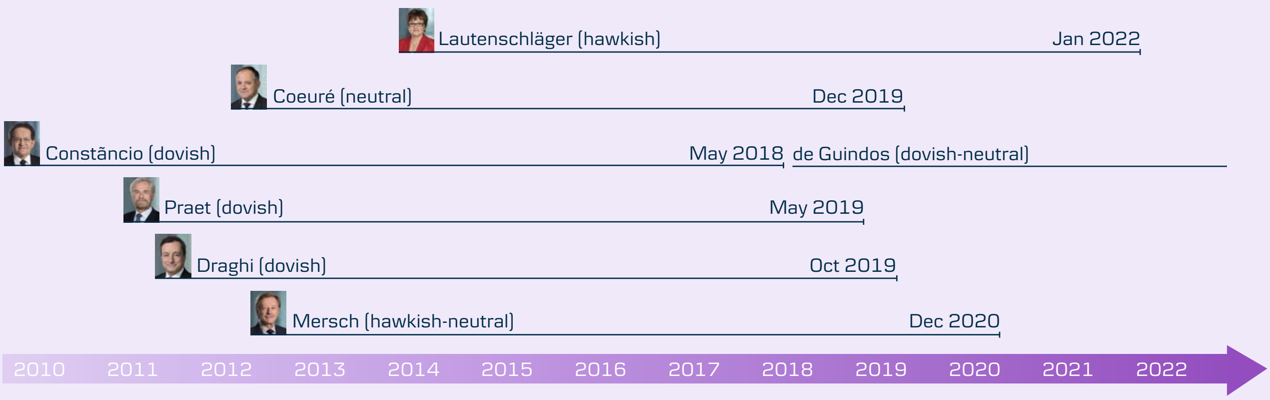
1. Contribution to GDP growth
2. Pct. of GDP
3. End of period
Source: Eurostat, Danske Bank estimates

Changing composition of the ECB board

By the end of December 2019, the ECB's board (GC) will have undergone a marked change in its composition. The ECB's president Mario Draghi, Vice-president Vitor Constancio, Chief economist Peter Praet and head of market operations Benoit Coeuré will all be replaced. While VP Constancio's replacement has been announced, the verdict is still out on who will succeed the other three candidates. Spain's Luis de Guindo will take the VP position on 1 June.

The changing composition, which is likely to lead to a slightly more hawkish ECB, could also change its overall tone – but only towards the end of 2019.

The selection of new board members is not a straightforward exercise and this process will be part of a bigger horse-trading exercise alongside the European Parliament elections next year. Germany's Bundesbank President Weidmann is often mentioned as a frontrunner for the position. However, with the current German political landscape, Chancellor Merkel may want to use the political capital elsewhere. Adding to the complexity of the discussions, unwritten rules about country of origin and the European Parliament's continued call for a better gender balance should not be underestimated.



Source: ECB, Danske Bank

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