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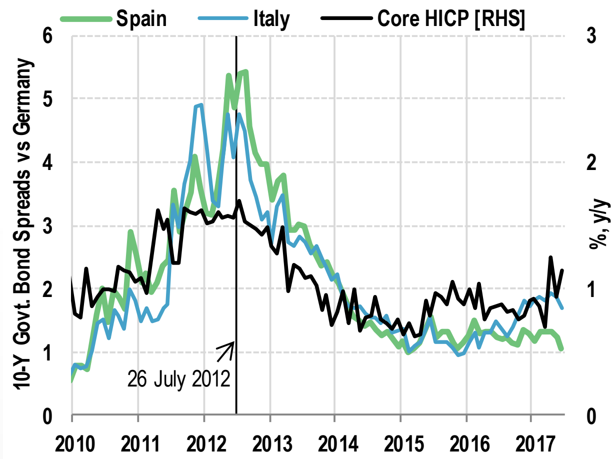
From "Believe me it will be enough" to "Believe me it will be slow enough"?

■ Mario Draghi's speech on 26 July 2012 was instrumental in calming down markets ■ The dominating concern today is how to bring monetary policy normalisation without creating market disruption

Using a search engine reveals that Mario Draghi's famous London speech on 26 July 2012 is celebrated every year since. Several factors explain its importance and the enduring admiration. On a practical note, the message was punchy and hence easy to remember. Moreover, the timing was great with market nervousness rising exponentially in the weeks and days before. Finally and most importantly, the speech offered a credible 'open envelope' promising "whatever it takes". The concrete action plan was communicated after the Governing Council meeting of 6 September which saw the creation of the Outright Monetary Transactions instrument. It would enable the ECB to address severe distortions in bond markets by buying sovereign bonds with a maturity of between one and three years, without ex ante quantitative limits but under the condition of "strict and effective conditionality attached to an appropriate EFSF/ESM programme".

The huge subsequent narrowing of peripheral spreads versus Bunds was driven by a dual belief that countries would accept the conditionality and that the ECB under these circumstances would deliver on its promises. Credibility was such that OMT never had to be used. The speech proved sufficient to calm down markets but insufficient to address persistent economic imbalances (ongoing deflation worries, fragmentation of bank credit markets). This eventually led to a negative deposit rate, QE and an effective lower bound of nominal market interest rates well below zero.

EUROZONE: SPREAD VERSUS 10 YEAR BUND YIELD AND CORE INFLATION



Sources: Datastream, BNP Paribas

The Eurozone is now in the process of achieving several years of above potential GDP growth. This should lead to a closing of the still negative output gap, a slow pick-up of trend inflation and eventually the start of policy normalisation. However, relief about macroeconomic performance comes with market concern: given the ECB's past influence on financial markets, in particular sovereign and corporate bonds, the normalisation process will be a tricky one. Paraphrasing the London speech, investors would love to hear "on normalisation, believe me it will be slow enough"...

William De Vijlder

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Eco WEEK

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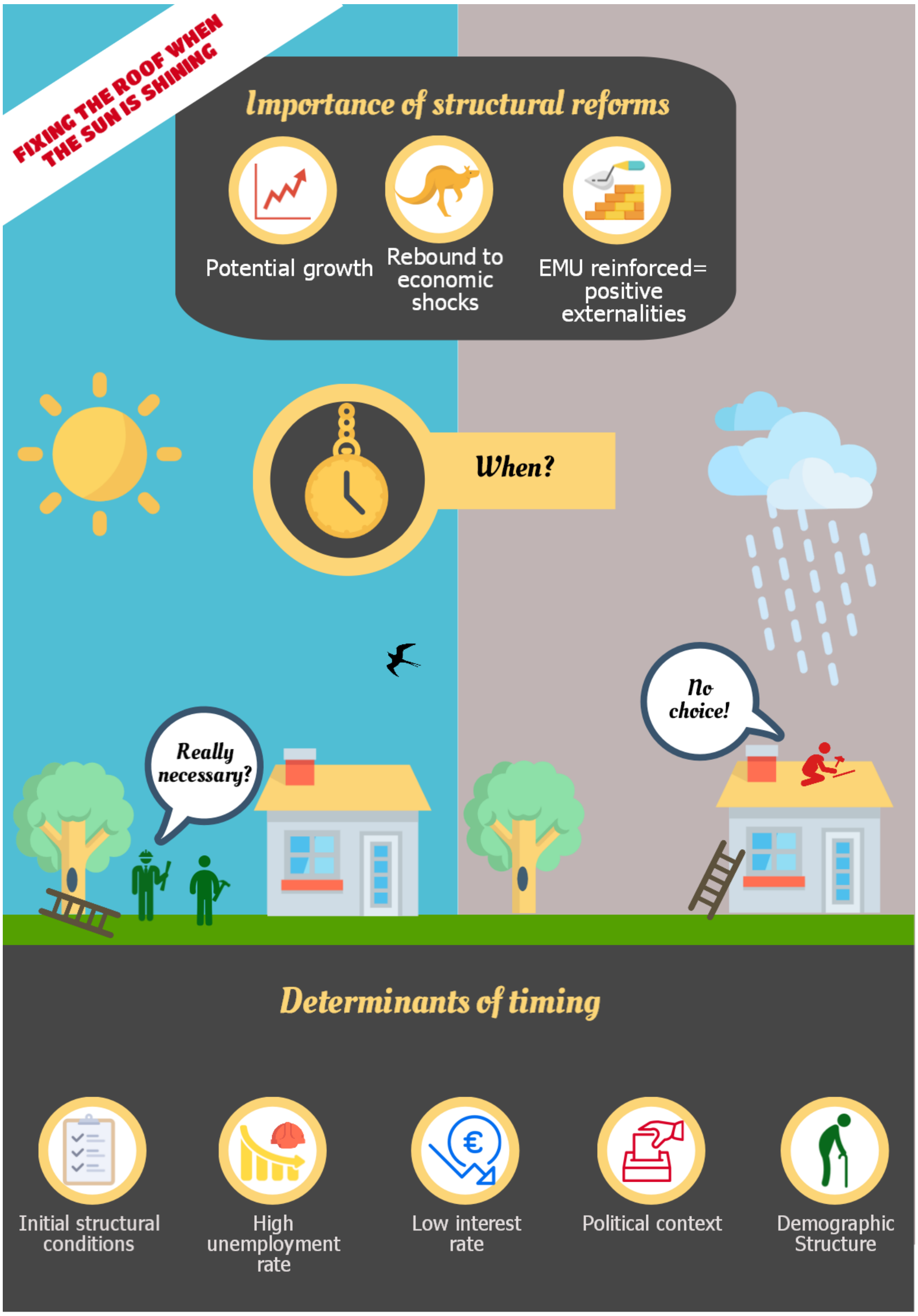
The bank for a changing world

Recommended reading

Fixing the roof when the sun is shining: on the timing of structural reforms



■ Structural reform is important but often seems to be undertaken reluctantly which would explain why it tends to occur when economic times are tough or when there is external pressure ■ Reforms would benefit from a favourable cyclical environment and low interest rates

Structural policy, which aims to "permanently and positively alter the supply-side of the economy" is important yet complex. The range of factors influencing structural performance is huge - the OECD in its annual Going for Growth report produces charts on 31 indicators - and so is the list of possible measures.In addition, the short run effects may be different from the long term ones and the effects may differ whether measures are taken in isolation or as part of a broader package.

Nevertheless, the importance of structural policy is unquestionable.This was clearly explained by Mario Draghi at the ECB Conference in Sintra in 2015: *"Structural reforms… lift the path of potential output, either by raising the inputs to production… or by ensuring that those inputs are used more efficiently, i.e. by raising total factor productivity (TFP)… they make economies more resilient to economic shocks by facilitating price and wage flexibility and the swift reallocation of resources within and across sectors"*. The importance is even bigger in a monetary union: it avoids an increase in economic divergence, which ultimately could become destabilising, and by adopting the right measures, it creates positive externalities by making the union more solid for all of its members.

The appropriate timing

Another element of complexity concerns the appropriate timing for structural reform. Common sense would dictate that when the roof of a house needs fixing, it is better to do it when the sun is shining rather than waiting until it starts to rain. Does this apply to reform policy as well? An often heard argument is that in good economic times, the willingness to reform will be low because of the perception there is no need to. Convincing the voters of the need may be difficult and put in jeopardy the chances of being re-elected. However, research by Buti, Turrini and van den Noord covering 21 OECD countries over the period of 1985-2004 shows that the *"odds of re-election are larger for reformist than non-reformist governments"* if there is an effectively working financial system and an efficient social safety net: risk-sharing and consumption smoothing will allow voters to cope more easily with the possible negative short-term consequences of reform policies.

Reform may also be resisted because of a perception that costs and benefits are unevenly distributed[1]. Reforming when the economy is weak raises the concern that it would be counterproductive by weighing on the effectiveness of an expansionary monetary policy[2]: reform measures seeking to increase aggregate supply could lower inflation expectations and increase real interest rates. This would call for combining product market reforms with labour market reforms[3].

Certain measures could increase job insecurity and weigh on consumer confidence and spending. According to Draghi (2015) "*there is some empirical foundation to these concerns. For example, research suggests that reforms that increase employment flexibility, such as reducing employment protection, are more likely to depress demand during downturns*." However, the impact of reforms not only depends on the timing but also on the types of measures, the credibility and the interaction with other policy measures. "*If structural reforms are well-designed along these parameters, they can, in fact, have a largely neutral, if not positive impact on short-term demand – even in adverse cyclical conditions*."

Domestic and external determinants

In a recent ECB paper Antonio Dias Da Silva, Audrey Givone and David Sondermann (2017) analyse possible determinants of structural reform.

On the domestic side, they consider:

- Initial structural conditions: how far away is a country from best practices
- Macroeconomic conditions: a high level of unemployment may create a sense of urgency and reduce the resistance to change
- Fiscal and monetary policies. Lower interest rates could facilitate reform but also reduce the (market) pressure for reform
- The general political environment (distance to the next elections)
- The demographic structure (a high old-age dependency ratio could weigh on the reform efforts).

External pressures could come from

- Financial markets
- Inter-governmental agreements (think of EU governance)
- Being under a financial assistance programme

Small and very open economies could face more external pressure (via international trade).

Structural reforms tend to occur in crisis times

Covering 40 OECD countries over three decades, they conclude that structural reforms happen more often when economic conditions are difficult, when a country is far away from best practices or when it is subject to a financial assistance programme. Low interest rates tend to promote structural reforms. Financial markets did not seem to create significant pressure for reform and there is no clear correlation between fiscal consolidation and structural reform. Having one party with majority in all houses increases the likelihood of reform implementation. The proximity to national elections or the political orientation of the government does not appear to influence reform implementation. Unsurprisingly, the European Single Market has facilitated product market reforms. In euro area countries, the drivers of reforms are broadly similar to those obtained for the entire sample. However the unemployment rate and lower interest rates seem even more important triggers of reform.

[1] Antonio Dias Da Silva, Audrey Givone and David Sondermann, *When do countries implement structural reforms?*, ECB Working Paper 2078, June 2017
[2] What follows is based on Draghi (2015)
[3] Luc Everaert and Werner Schule, *Why it pays to synchronize structural reforms in the euro area across markets and countries*, IMF Staff Papers, Vol. 55, No. 2, 2008

Christian Ebeke[4] summarises the empirical literature as follows: "*most structural reforms tend to occur in crisis times; associated costs are frontloaded but the gains come later; the environment prevailing at the start of reforms matters – reforms implemented in good times and/or with additional support from demand policies (fiscal and monetary) lead to superior economic outcomes.*"

He then analyses the reaction of investors to structural reform. Over time reform reduces bond yields and improves the credit rating, in particular in stressed countries, where reform is needed most, and when it is launched in good times. Some fiscal stimulus helps in lowering yields provided debt levels are low. As expected, reforms followed by social discontent cause a short-run overshooting of yields.

To summarise, structural reform is important but often seems to be undertaken reluctantly which would explain why it tends to occur when economic times are tough or when there is external pressure (programme countries). Reforms would benefit from a favourable cyclical environment and low interest rates. The reform effort should be rewarded by financial markets and could under certain conditions increase the odds of re-election.

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[4] Christian Ebeke, *Who Dares, Wins: Labor Market Reforms and Sovereign Yields*, IMF Working Paper, June 2017

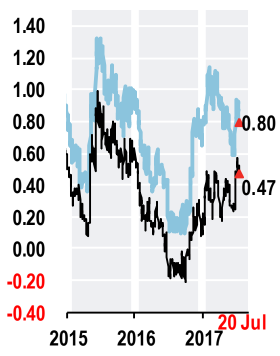
Markets overview

The essentials

Week 14-7 17 > 20-7-17

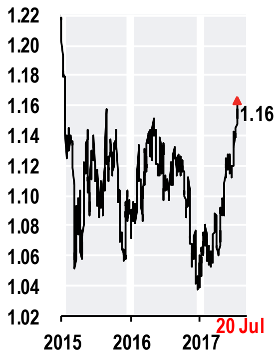
↘	**CAC 40**	5 235	▸ **5 199**	-0.7	%
↗	**S&P 500**	2 459	▸ **2 473**	**+0.6**	%
↗	Volatility (VIX)	9.5	▸ 9.6	+0.1	%
↘	**Euribor 3M (%)**	-0.33	▸ **-0.33**	**-0.1**	bp
↗	Libor $ 3M (%)	1.30	▸ 1.31	+0.4	bp
↘	OAT 10y (%)	0.86	▸ 0.80	-6.9	bp
↘	Bund 10y (%)	0.53	▸ 0.47	-5.6	bp
↘	US Tr. 10y (%)	2.32	▸ 2.26	-6.4	bp
↗	**Euro vs dollar**	1.14	▸ **1.16**	**+1.6**	%
↗	Gold (ounce, $)	1 228	▸ 1 246	+1.5	%
↗	**Oil (Brent, $)**	48.7	▸ **49.6**	**+1.9**	%

10 y bond yield, OAT vs Bund

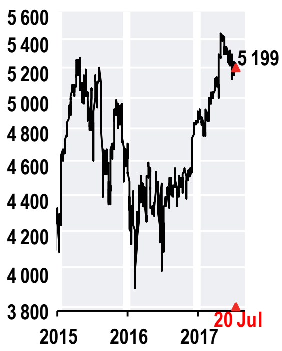


— Bunds — OAT

Euro-dollar



CAC 40



Money & Bond Markets

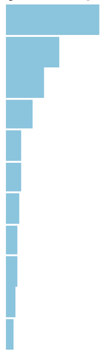
Interest Rates		highest' 17		lowest' 17	
€ ECB	**0.00**	0.00	at 02/01	0.00	at 02/01
Eonia	**-0.36**	-0.33	at 02/06	-0.37	at 05/06
Euribor 3M	**-0.33**	-0.32	at 02/01	-0.33	at 10/04
Euribor 12M	**-0.15**	-0.08	at 02/01	-0.16	at 23/06
$ FED	**1.25**	1.25	at 15/06	0.75	at 02/01
Libor 3M	**1.31**	1.31	at 19/07	1.00	at 02/01
Libor 12M	**1.73**	1.83	at 15/03	1.68	at 06/01
£ BoE	**0.25**	0.25	at 02/01	0.25	at 02/01
Libor 3M	**0.29**	0.37	at 05/01	0.29	at 21/06
Libor 12M	**0.63**	0.78	at 09/01	0.61	at 14/06

At 20-7-17

Yield (%)			highest' 17		lowest' 17	
€	AVG 5-7y	**0.43**	0.68	at 17/03	0.18	at 21/06
	Bund 2y	**-0.69**	-0.60	at 27/06	-0.96	at 24/02
	Bund 10y	**0.47**	0.57	at 06/07	0.09	at 02/01
	OAT 10y	**0.80**	1.14	at 06/02	0.59	at 14/06
	Corp. BBB	**1.36**	1.65	at 01/02	1.29	at 26/06
$	Treas. 2y	**1.35**	1.41	at 03/07	1.14	at 24/02
	Treas. 10y	**2.26**	2.61	at 13/03	2.14	at 26/06
	Corp. BBB	**3.47**	3.90	at 14/03	3.46	at 14/06
£	Treas. 2y	**0.25**	0.33	at 29/06	0.01	at 28/02
	Treas. 10y	**1.26**	1.51	at 26/01	0.87	at 14/06

At 20-7-17

10y bond yield & spreads



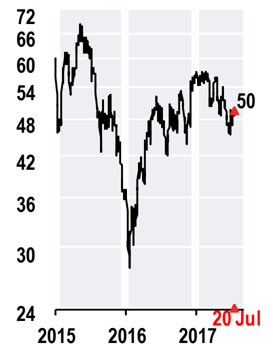
5.25%	Greece	478 pb
3.01%	Portugal	254 pb
2.13%	Italy	165 pb
1.50%	Spain	102 pb
0.82%	Belgium	35 pb
0.82%	Ireland	34 pb
0.80%	France	32 pb
0.67%	Netherland	19 pb
0.61%	Austria	14 pb
0.52%	Finland	4 pb
0.47%	Germany	

Commodities

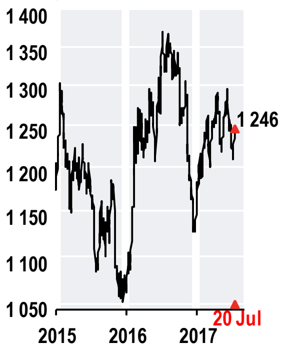
Spot price in dollars		lowest' 17			2017(€)
Oil, Brent	**50**	46	at	26/06	**-20.7%**
Gold (ounce)	**1 246**	1 156	at	03/01	**-2.4%**
Metals, LMEX	**2 849**	2 639	at	03/01	**-2.9%**
Copper (ton)	**5 925**	5 462	at	08/05	**-2.7%**
CRB Foods	**372**	325	at	24/04	**-0.6%**
wheat (ton)	**187**	146	at	24/04	**+15.7%**
Corn (ton)	**141**	130	at	23/03	**-3.4%**

At 20-7-17 *Variations*

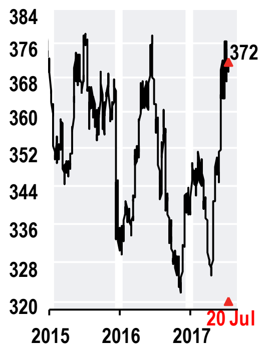
Oil (Brent, $)



Gold (Ounce, $)



CRB Foods



Exchange Rates

1€ =		highest' 17		lowest' 17			2017
USD	**1.16**	1.16	at 20/07	1.04	at	03/01	**+10.3%**
GBP	**0.90**	0.90	at 20/07	0.84	at	19/04	+5.0%
CHF	**1.11**	1.11	at 20/07	1.06	at	08/02	+3.2%
JPY	**130.04**	130.72	at 11/07	115.57	at	17/04	+5.7%
AUD	**1.46**	1.52	at 01/06	1.37	at	23/02	+0.3%
CNY	**7.87**	7.87	at 20/07	7.22	at	03/01	+7.4%
BRL	**3.65**	3.78	at 06/07	3.24	at	15/02	+6.3%
RUB	**68.51**	69.39	at 11/07	59.66	at	17/04	+6.4%
INR	**74.96**	74.96	at 20/07	68.18	at	07/04	+4.7%

At 20-7-17 *Variations*

Equity indices

	Index	highest' 17			lowest' 17			2017	2017(€)
CAC 40	**5 199**	5 432	at	05/05	4 749	at	31/01	+6.9%	**+6.9%**
S&P500	**2 473**	2 474	at	19/07	2 239	at	02/01	+10.5%	**+0.2%**
DAX	**12 447**	12 889	at	19/06	11 510	at	06/02	+8.4%	**+8.4%**
Nikkei	**20 145**	20 230	at	20/06	18 336	at	14/04	+5.4%	**-0.3%**
China*	**77**	77	at	19/07	59	at	02/01	+31.7%	**+18.8%**
India*	**561**	563	at	19/07	445	at	03/01	+19.2%	**+13.8%**
Brazil*	**1 850**	2 001	at	22/02	1 639	at	21/06	+6.7%	**+0.3%**
Russia*	**530**	622	at	03/01	497	at	22/06	-14.5%	**-20.2%**

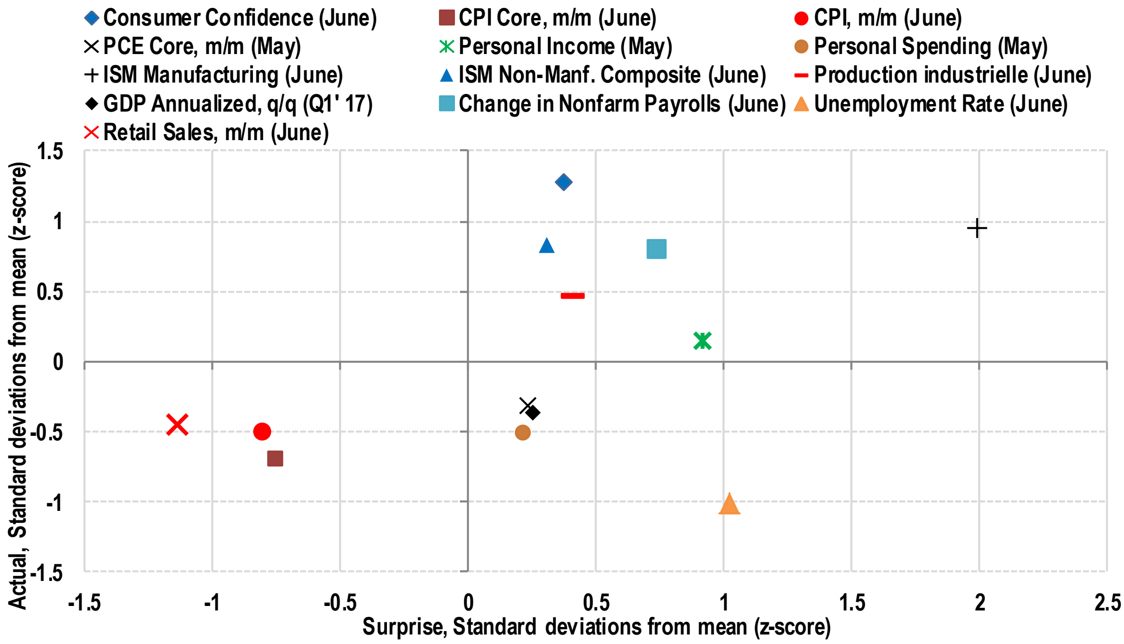
At 20-7-17 *Variations*

* MSCI index

Pulse

United States: Steady growth

In the US, most recent indicators have surprised to the upside (horizontal axis) with the exception of retail sales and inflation. The picture is more mixed in comparison with the long term average (vertical axis): the labour market is doing fine (job creation above average, unemployment below) but inflation, spending, retail sales and GDP growth are below the average.



Note: z-score is a score which indicates how many standard deviations an observation is from the mean: z=(x-μ)/σ where x: observation, μ: mean, σ: standard deviation.
On the X-axis, x corresponds at the last known surprise for each indictor represented on the graph, μ and σ corresponds respectively to the mean and the standard deviation of the last 24 value for monthly data and the last 8 quarters for quarterly data.
On the Y-axis, x corresponds at the last known value of indicator, μ and σ corresponds respectively to the mean and the standard deviation for this indicator since 2000.

Sources: Bloomberg, Markit, BNP Paribas

Indicators preview

The focus will be on the US with a lot of data and the FOMC meeting. France will see the release of Q2 GDP growth.

To watch from 24 to 28 July 2017

Date	Country	Event	Frequency	Period	Prior	Survey
25/07/2017	Germany	IFO Business Climate		(Jul)	115,1	
	UK	CBI monthly industrial trends		(Jul)	16	
	US	Conf. Board Consumer Confidence		(Jul)	118,9	117,3
26/07/2017	UK	GDP, %	q/q	(Q2)	0,2%	0,3%
	US	New home sales K		(Jun)	610 000	610 000
	US	FOMC Rate Announcement, %			1,125%	1,125%
27/07/2017	US	Durable goods orders (Preliminary), %	m/m	(Jun)	-0,8%	2,7%
28/07/2017	France	GDP (flash) %	q/q	(Q2)	0,5%	
	France	HICP (Preliminary), %	m/m	(Jul)	0,0%	
	Eurozone	Economic Confidence		(Jul)	111,1	
	Germany	HICP (Preliminary), %	m/m	(Jul)	0,2%	
	US	GDP Annualized, %	q/q		1,4%	2,6%
	US	Michigan Sentiment (final)		(Jul)	93,1	93,2
	UK	Gfk Consumer Confidence		(Jul)	-10	

Economic scenario

UNITED STATES

- GDP growth keeps on a decent 2% pace and may have picked-up in Q2. However the fiscal outlook remains uncertain. A fiscal stimulus still is possible, but it would not be implemented before end-2017. Potential effects are thus uncertain.
- The labour market is buoyant than ever. Still, the support to households' disposable income is not as strong as it looks as wage inflation remains limited.
- With inflation relatively muted at this stage of the cycle, the Fed is in no rush to increase rates.. We forecast the Fed Funds target rates to come at 1.25/1.50% by year-end, 2/2.5% by mid 2018.

Annual growth, %	2016	2017 e	2018 e
GDP	**1.6**	**2.3**	**2.6**
Private consumption	2.7	2.8	2.8
Gross Fixed Capital Formation	-0.5	5.0	5.5
Exports	0.4	3.0	2.6
Consumer Price Index (CPI)	1.3	1.9	2.3
CPI ex food and energy	2.2	2.1	2.7
Unemployment rate	4.9	4.6	4.2
Current account balance	-2.6	-2.8	-3.1
Fed. Govt. Budget Balance (% of GDP)	-3.1	-2.9	-3.5
Gross Fed. Govt. Debt (% GDP)	75.9	76.2	76.8

CHINA

- After a period of stabilisation since Q2 2016, growth is expected to slow down moderately in the short term.
- Exports should continue to rebound and infrastructure projects will continue to drive investment. However the downside risks are high due to the reduction in industrial production capacity, risks of a downturn in the real estate market and greater financial instability, and slow growth of household revenues.
- The authorities are expected to maintain an expansionist fiscal policy, while the central bank continues to tighten monetary conditions very cautiously.

Annual growth, %	2016	2017 e	2018 e
GDP	**6.7**	**6.6**	**6.4**
Industrial output	6.0	6.5	6.0
Gross Fixed Capital Formation (nominal)	8.1	8.5	8.0
Exports (nominal)	-7.7	6.0	5.0
Consumer Price Index (CPI)	2.0	1.8	2.3
Producer Price Index (PPI)	6.0	6.5	6.0
Current account (% GDP)	1.8	1.4	1.1
Gen. Govt. Balance (% of GDP)	-3.8	-3.2	-3.0
Foreign reserves ($bn)	3 011	3 024	3 072

EUROZONE

- The recovery is getting stronger and broader: the dispersion of economic performances among member states is receding.
- Despite the cyclical recovery, core inflation still shows no sign of a convincing upward trend. For the recovery to enter its inflationary phase the economy has to improve further, until the point at which wages will tend to increase.
- The level of slack remains uncertain though. Broader measures of labor underutilization reach 18%, double the level of the current unemployment rate. The ECB is expected to remain cautious.

Annual growth, %	2016	2017 e	2018 e
GDP	**1.7**	**2.1**	**1.6**
Private consumption	1.9	1.5	1.4
Gross Fixed Capital Formation	3.5	1.9	2.6
Exports	2.9	4.5	3.9
Consumer Price Index (CPI)	0.2	1.5	1.3
CPI ex food and energy	0.9	1.1	1.4
Unemployment rate	10.0	9.3	8.8
Current account balance	3.3	3.6	3.5
Gen. Govt. Balance (% of GDP)	-1.5	-1.4	-1.3
Public Debt (% GDP)	91.3	90.3	89.0

FRANCE

- A clear growth acceleration is underway. Higher rates of growth should resume. Households' consumption is supported by the jobs recovery but restrained by the upturn in inflation. Investment and exports dynamics are favourable. Risks lie slightly on the upside.
- We expect the output gap to slowly narrow and the unemployment rate to progressively decline, containing the rise in inflation.
- Fiscal policy should continue to combine growth supportive measures and consolidation ones. The fiscal deficit should not be a lot more reduced but it should remain below the 3% threshold.

Annual growth, %	2016	2017 e	2018 e
GDP	**1.1**	**1.6**	**1.6**
Private consumption	1.8	1.4	1.6
Gross Fixed Capital Formation	2.7	2.4	3.1
Exports	1.2	2.9	3.7
Consumer Price Index (HCPI)	0.3	1.3	1.0
CPI ex food and energy	0.6	0.7	0.9
Unemployment rate	10.1	9.6	9.3
Current account balance	-0.9	-1.1	-0.9
Gen. Govt. Balance (% of GDP)	-3.4	-3.0	-2.8
Public Debt (% GDP)	96.3	96.3	96.2

Sources: BNP Paribas Group Economic Research, European Commission ;e: Estimates and forecasts

Economic forecasts

%	GDP Growth 2016	GDP Growth 2017 e	GDP Growth 2018 e	Inflation 2016	Inflation 2017 e	Inflation 2018 e
Advanced	**1.7**	**2.0**	**2.0**	**0.8**	**1.6**	**1.8**
United-States	1.6	2.3	2.6	1.3	1.9	2.3
Japan	1.0	1.2	1.0	-0.1	0.4	0.7
United-Kingdom	1.8	1.5	1.0	0.6	2.8	2.8
Euro Area	**1.7**	**2.1**	**1.6**	**0.2**	**1.5**	**1.3**
Germany	1.8	2.0	1.9	0.4	1.8	1.7
France	1.1	1.6	1.6	0.3	1.3	1.0
Italy	1.0	1.2	0.6	-0.1	1.6	1.2
Spain	3.2	2.8	2.2	-0.3	2.1	1.6
Emerging	**4.1**	**4.6**	**4.8**	**4.4**	**3.2**	**3.5**
China	6.7	6.6	6.4	2.0	1.8	2.3
India	7.1	7.5	7.9	4.5	4.6	4.9
Brazil	-3.6	0.5	3.0	8.8	3.6	4.0
Russia	-0.2	1.4	1.6	7.1	4.5	4.5
World	**3.1**	**3.6**	**3.6**	**2.8**	**2.5**	**2.8**

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

Financial forecasts

Interest rates, % End of period		2017 Q1	2017 Q2e	2017 Q3e	2017 Q4e	2018 Q1e	2018 Q2e	2018 Q3e	2018 Q4e	2016	2017e	2018e
US	Fed Funds	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	0.75	1.50	2.50
	Libor 3m $	1.15	1.20	1.50	1.75	1.90	2.05	2.25	2.45	1.00	1.75	2.45
	T-Notes 10y	2.40	2.20	2.60	3.00	3.10	3.25	3.25	3.25	2.45	3.00	3.25
Ezone	Taux "refi" BCE	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.00	0.00	0.25
	Euribor 3 mois	-0.33	-0.33	-0.36	-0.36	-0.36	-0.36	-0.16	0.05	-0.32	-0.36	0.05
	Bund 10y	0.33	0.29	0.60	0.80	1.00	1.20	1.40	1.50	0.11	0.80	1.50
	OAT 10y	0.97	0.74	1.05	1.25	1.45	1.65	1.80	1.90	0.69	1.25	1.90
UK	Base rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.25	0.25	0.50
	Gilts 10y	1.07	1.00	1.10	1.25	1.40	1.55	1.80	2.00	1.24	1.25	2.00
Japan	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.06	-0.10	-0.10
	JGB 10y	0.07	0.06	0.07	0.08	0.08	0.08	0.08	0.08	0.05	0.08	0.08

Exchange Rates End of period		2017 Q1	2017 Q2e	2017 Q3e	2017 Q4e	2018 Q1e	2018 Q2e	2018 Q3e	2018 Q4e	2016	2017e	2018e
USD	EUR / USD	1.07	1.10	1.07	1.04	1.05	1.06	1.08	1.10	1.05	1.04	1.10
	USD / JPY	111	115	117	120	118	116	114	112	117	120	112
	GBP / USD	1.25	1.31	1.30	1.30	1.30	1.29	1.29	1.29	1.24	1.30	1.29
	USD / CHF	1.00	1.00	1.05	1.08	1.07	1.06	1.04	1.05	1.02	1.08	1.05
EUR	EUR / GBP	0.86	0.84	0.82	0.80	0.81	0.82	0.84	0.85	0.85	0.80	0.85
	EUR / CHF	1.07	1.10	1.12	1.12	1.12	1.12	1.12	1.15	1.07	1.12	1.15
	EUR / JPY	119	127	125	125	124	123	123	123	123	125	123

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

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