



ECONOMIC RESEARCH DEPARTMENT

Summary

Eurozone

Inflation in sight?

Should we believe in inflation recovery by year-end?

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Fashioning green

Ireland is dramatically improving its economic situation. The country borrows at the same cost as France on the markets.

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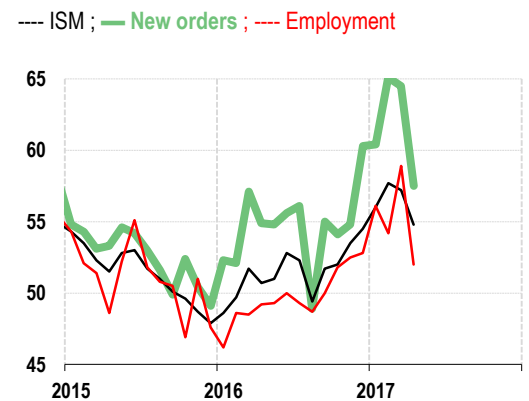


A calm revival

■ In the US manufacturing output jumped in April ■ Still the recovery remains unimpressive ■ Will low oil prices support or slow the revival?

The rebound in the US manufacturing sector was confirmed in April with a monthly jump of 1%. Still, on a 3-month annualised basis, the performance is quite unimpressive (at +2.7% in April), especially when compared with sentiment indicators. The manufacturing ISM index was indeed as high as 57 points on average during the first quarter of this year. If the hard data are a bit disappointing when read through what soft data were announcing, prospects are also softening. In April, the ISM index was down 2.4 points (at 54.8), a decrease led by the components for new orders (down 7 points to 58.6) and employment (down 6.9 points to 52.0). The deterioration of the manufacturing sector was confirmed this week by the New York Fed index for May. Once recalculated to make the comparison with the ISM clearer, that index was down 1.5 points and back below the 50-mark that separates contraction from expansion. News from the Philadelphia Fed was more upbeat (with an ISM-like index stable above 57), though. The renewed depreciation of the dollar is welcome, even more so that labour productivity has been slowing and unit labour costs accelerating despite the absence of wage inflation. As for low oil prices, the recent past taught us to be cautious in considering them as a net positive...

US MANUFACTURING SENTIMENT



Source: ISM

THE WEEK ON THE MARKETS

Week 12-5 17 > 18-5-17

↘ CAC 40	5 405	► 5 290	-2.1 %
↘ S&P 500	2 391	► 2 366	-1.1 %
↗ Volatility (VIX)	10.4	► 14.7	+4.3 %
↘ Euribor 3M (%)	-0.33	► -0.33	-0.2 bp
↘ Libor \$ 3M (%)	1.18	► 1.18	-0.1 bp
↘ OAT 10y (%)	0.84	► 0.81	-3.5 bp
↘ Bund 10y (%)	0.40	► 0.36	-4.0 bp
↘ US Tr. 10y (%)	2.34	► 2.24	-10.3 bp
↗ Euro vs dollar	1.09	► 1.11	+1.9 %
↗ Gold (ounce, \$)	1 230	► 1 254	+2.0 %
↗ Oil (Brent, \$)	50.6	► 52.6	+3.8 %

Source: Thomson Reuters

Eurozone

Inflation in sight?

- Despite the cyclical recovery, core inflation has not shown any convincing signs of picking up yet.
- Based on current estimates of structural unemployment and recent job market trends, however, inflation is bound to pick up fairly soon: the European economy should enter an inflationary phase between Q4 2017 and Q1 2018.
- Yet the jobless rate might be giving only a partial picture of labour underutilisation.
- Using a broader measure – including involuntary part-time workers and “shadow unemployment” – excess capacity might be twice as high as the official unemployment rate.

Despite the GDP recovery, inflation pressures in the eurozone are still weak. Indeed, core inflation has not shown any convincing signs of an upward trend yet. Although it surged by 0.5 points to peak at 1.3% in April, this was mainly due to a calendar effect (the Easter holiday occurred in March last year and in April this year).

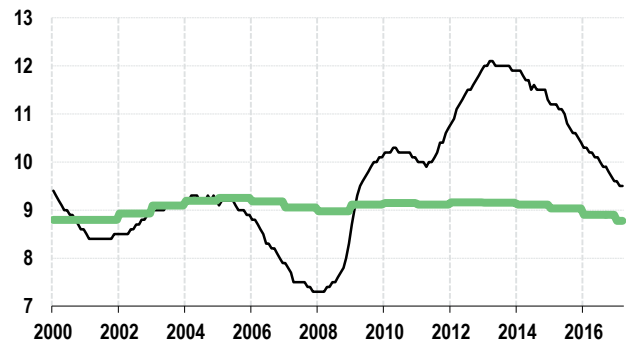
Fundamentally, the weakness of inflation in the eurozone is due to the activity and jobs deficit that still characterizes the Eurozone despite the recovery. This translates into a sluggish pace of wage increases. For the recovery to enter an inflationary phase, the job market situation must improve further, to the point where labour shortages push wage negotiations towards real wage increases. Household purchasing power gains would then help boost demand, which in turn would make it easier for companies to pass higher production costs to sales prices, which would again fuel further wage increases, etc.

In principle, this price-wage loop begins to form as the unemployment rate approaches the NAIRU, the non-accelerating inflation rate of unemployment, which is also known as the structural unemployment rate. The NAIRU cannot be observed *ex ante*. Actually one can tell when an economy is approaching or has past the NAIRU, because wages begin to accelerate. This does not prevent most of the economic institutions from trying to estimate the structural unemployment rate. Their estimates are based on past statistical relations between wage trends and the unemployment rate, while trying to incorporate any changes in the economy's structure, due to institutional factors (wage bargaining, degree of competition in the markets for goods and services, etc.) or technological ones (higher productivity gains, for example, tend to reduce structural unemployment by allowing real wages to be raised without generating inflation).

The OECD calculates the eurozone's structural unemployment rate at 8.8% in 2017, which is 0.7 points below the current jobless rate. Based on this estimate and assuming that the unemployment rate continues to trend downwards at the current pace, the Eurozone

Closing the gap

Eurozone: — NAIRU; — Unemployment rate



Chart

Sources: Eurostat, OECD

economy should enter a reflationary phase between Q4 2017 and Q1 2018 (see chart).

Under this scenario, it is normal that the European Central Bank (ECB) begin to explore ways to withdraw its economic support measures.

Yet, some elements suggest that it might take longer for inflation to pick up. In a recent article published in the ECB's monthly bulletin¹ economists ask why wage growth remains so subdued at this phase of the cycle.

According to them, the unemployment rate is providing only a partial picture of labour underutilisation. Taking into account involuntary part-time employment (part-time workers who are working fewer hours than they would like) and people without jobs but not classified as unemployed (i.e. those who would accept a job but are not actively seeking work, also known as “shadow unemployment”), they found that the real level of slack is closer to 18%, twice as high as the official unemployment rate.

Of course, it is a highly uncertain measure. As the authors point out, part of the “shadow unemployment” might be comprised of people who are not suitably skilled to find a job. Even using a narrower definition, the authors still estimate the underutilisation of labour capacity at 15%. If this were the case, then the full recovery of the job market and the normalisation of monetary policy are both likely to proceed much more gradually a phenomenon which would be in line with the experience of the US economy (whose cycle is significantly in advance of the eurozone).

¹ https://www.ecb.europa.eu/pub/pdf/other/ebbox201703_03.en.pdf

Note: the opinions expressed in this article are not necessarily those of the members of the ECB Governing Council.



Ireland

Flashing green

- The Irish economy is doing well since it has successfully exited the financial assistance program in 2013.
- The sovereign risk has considerably abated, and Ireland is now able to borrow on the markets at very cheap cost.
- The improvement in public fiscal stance is impressive, but largely due to multinational enterprises decision to account for a bigger part of their activities in Ireland.
- Credit risk is receding; property market is doing better.

Ireland has successfully exited the financial assistance program in 2013 and the sovereign risk has constantly decreased since then. The Country's sovereign spread (against German bund) has come down to its lowest level since ten years (chart). Risk about capacity of Ireland to repay official creditor appears to be very limited according to the latest European Commission's report (PPSR, November 2016).

Indeed, the Irish Economy keeps on a good track. GDP growth is seen above 3% both in 2017 and 2018 despite challenges represented by the Brexit. The fall in the Sterling as well as possible weaker demand from UK (15% of total merchandise trade) may hamper exports. However, British investment to Ireland may also improve, as corporates could relocate to Ireland in order to maintain access to the EU Single Market.

Fiscal "miracle"

A complete re-assessment of Ireland's macroeconomic imbalances occurred in 2015, when several multinational enterprises (MNEs) restructured geographically their accounting methods, with the result of re-locating substantial part of global value chains in the Country (see Box).

Along with the GDP (up +26% in 2015), this caused the annual corporate tax revenues to surge (+49% in 2015), resulting in a substantial decrease in the central government deficit. The gross debt ratio fell also substantially, to around 73% of GDP in 2017, from 119% of GDP in 2013.

The improvement in Ireland's fiscal position is impressive but mainly due to a one-off factor. Here is the main source of vulnerability identified by the Commission: "Given [corporate tax receipts] now sizeable share in tax revenue and their inherently volatile nature, being subject to abrupt decisions by a small number of large MNEs, it is crucial to clarify the underlying drivers and to assess the durability of the strong revenue" (PPSR, November 2016).

Credit risk is abating

The systemic credit risk is abating somewhat. Banks have reinforced their capital base - their average Common Equity Tier One (CET1) ratio stood at 15% by end Sept. 2016 - while NPLs tend to decline. However, at around 9% of total loans by the end of 2016, they are still high by historical standards as well as compared to the Eurozone

Ireland's sovereign spread



Chart

Source: Thomson Datastream

End of the "Double Irish" tax avoidance scheme

MNEs account for 80% of corporate tax revenues in Ireland. Since January 1, 2015, they are no more allowed to use the so-called "Double Irish" optimization scheme, whereby their affiliate companies registered in Ireland could be tax residents elsewhere, including in tax havens. Moreover, the "country-by-country" guidance, taken under the OECD Base Erosion and Profit Shifting (BEPS) initiative, now requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction, and to provide an indication of the business activities each entity engages in. As a result, several MNEs decided to re-locate revenues in Ireland, where corporate tax, though higher than in several tax havens, is still low by European standards (12.5%).

Box

Source: European Commission

average (5.4%). Despite measures undertaken by authorities (like the Mortgage Arrears Resolution Targets for banks or the Personal Insolvency Act), dealing with such a stock will take time, as noticed by the latest IMF Financial System Stability Assessment.

The high level of corporate debt, especially among small and medium size enterprises (SMEs), is another cause of vigilance. The 2016 H2 SME market report provided by the Central Bank of Ireland actually shows that SME default rate, though declining, is still one of the highest in EU, after Italy. Credit outstanding to SMEs has not really recovered, and capacity of domestic firms to service their debt looks vulnerable to changes in interest rates (EC, PPSR, November 2016).

Recovery in property market

Finally, a good trend is seen in residential property prices, which are on the rise (+8% in 2016), along with completions (+19% in 2016). Price increases are not driven by excessive credit extension (cash transactions account for approximately 45 % of the total) and the Commission analysis does not yet point to significant overvaluation.



Markets overview

The essentials

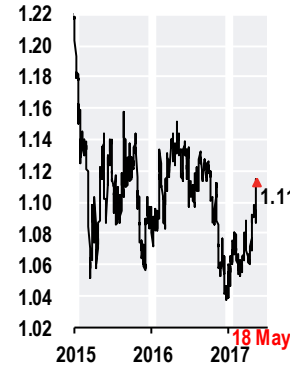
Week 12-5-17 > 18-5-17

Table with market indicators: CAC 40, S&P 500, Volatility (VIX), Euribor 3M, Libor \$ 3M, OAT 10y, Bund 10y, US Tr. 10y, Euro vs dollar, Gold, Oil (Brent).

10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

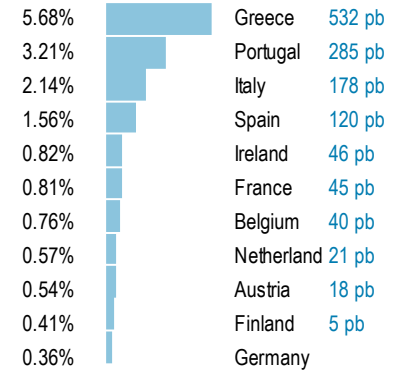
Table of interest rates for ECB, FED, and BoE across various maturities.

At 18-5-17

Table of yields for various bonds including AVG 5-7y, Bund 2y, Bund 10y, OAT 10y, Corp. BBB, Treas. 2y, Treas. 10y, and £ Treas. 2y/10y.

At 18-5-17

10y bond yield & spreads



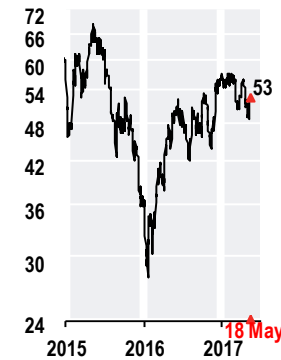
Commodities

Table of spot prices in dollars for Oil, Gold, Metals, Copper, CRB Foods, wheat, and Corn.

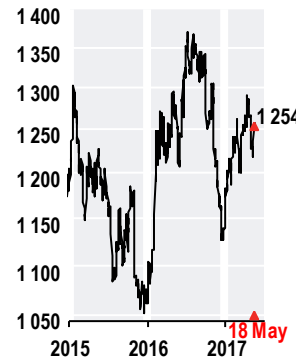
At 18-5-17

Variations

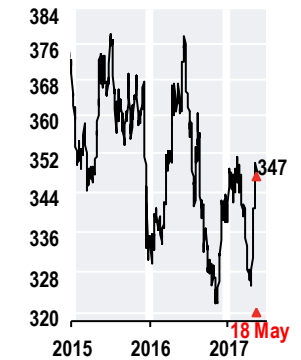
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

Table of exchange rates for various currencies against the Euro.

At 18-5-17

Variations

Equity indices

Table of equity indices including CAC 40, S&P500, DAX, Nikkei, China, India, Brazil, and Russia.

At 18-5-17

Variations

* MSCI index



Economic forecasts

En %	GDP Growth			Inflation			Curr. account / GDP			Fiscal balances / GDP		
	2016 e	2017 e	2018 e	2016 e	2017 e	2018 e	2016 e	2017 e	2018 e	2016 e	2017 e	2018 e
Advanced	1.6	2.0	2.1	0.8	2.0	1.9						
United States	1.6	2.1	2.6	1.3	2.4	2.6	-2.5	-2.4	-2.4	-3.4	-4.2	-5.0
Japan	1.0	1.2	0.9	-0.1	0.6	1.0	3.8	4.2	4.6	-4.7	-4.4	-4.1
United Kingdom	1.8	1.8	1.1	0.6	2.7	2.6	-4.7	-4.1	-3.2	-3.0	-2.7	-3.1
Euro Area	1.7	1.6	1.6	0.2	1.8	1.3	3.4	3.0	3.1	-1.7	-1.4	-1.2
Germany	1.8	1.8	2.0	0.4	1.9	1.7	8.8	8.3	8.5	0.6	0.7	0.6
France	1.1	1.3	1.5	0.3	1.4	1.0	-0.9	-0.9	-1.1	-3.4	-3.0	-2.7
Italy	1.0	0.6	0.6	-0.1	1.7	1.0	2.1	2.2	2.1	-2.4	-2.4	-2.5
Spain	3.3	2.6	2.0	-0.3	2.3	1.5	1.8	2.1	2.1	-4.6	-3.6	-3.0
Netherlands	2.1	2.1	1.6	0.1	1.2	1.4	8.7	8.7	8.3	-0.5	0.0	0.3
Belgium	1.2	1.4	1.5	1.8	2.1	1.9	0.7	0.5	0.5	-3.0	-2.3	-2.2
Emerging	4.2	4.5	5.0	4.8	4.6	4.4						
China	6.7	6.2	6.4	2.0	2.7	2.5	1.9	1.6	1.4	-3.0	-3.5	-3.3
India	7.5	7.3	7.8	4.9	4.9	5.2	-1.1	-0.8	-1.7	-3.8	-3.5	-3.2
Brazil	-3.5	1.0	3.0	8.8	4.1	4.3	-1.2	-1.4	-2.1	-8.9	-9.6	-8.3
Russia	-0.6	1.2	2.0	7.1	4.2	4.3	1.9	3.4	3.2	-3.7	-2.7	-2.1
World	3.1	3.4	3.8	3.1	3.5	3.3						

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

Financial forecasts

Interest rates		2016				2017				2016	2017e	2018e
		Q1	Q2	Q3	Q4	Q1	Q2e	Q3e	Q4e			
US	Fed Funds	0.25-0.5	0.25-0.5	0.25-0.5	0.5-0.75	1	0.75-1.00	1.00-1.25	1.25-1.50	0.5-0.75	1.25-1.50	2.25-2.50
	3-month Libor \$	0.63	0.65	0.85	1.00	1.15	1.25	1.50	1.75	1.00	1.75	2.50
	10-year T-notes	1.79	1.49	1.61	2.45	2.40	3.00	3.25	3.50	2.45	3.50	4.00
EMU	Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25
	3-month Euribor	-0.24	-0.29	-0.30	-0.32	-0.33	-0.33	-0.30	-0.30	-0.32	-0.30	-0.05
	10-year Bund	0.16	-0.13	-0.19	0.11	0.33	0.50	0.75	1.00	0.11	1.00	1.60
	10-year OAT	0.41	0.20	0.12	0.69	0.97	0.95	1.15	1.45	0.69	1.45	2.00
	10-year BTP	1.23	1.35	1.19	1.84	2.13	2.20	2.60	3.00	1.84	3.00	3.40
UK	Base rate	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	3-month Libor £	0.59	0.56	0.38	0.37	0.34	0.40	0.40	0.40	0.37	0.40	0.40
	10-year Gilt	1.42	1.02	0.76	1.24	1.07	1.55	1.75	1.90	1.24	1.90	2.50
Japan	Overnight call rate	-0.00	-0.06	-0.06	-0.06	-0.06	-0.10	-0.10	-0.10	-0.06	-0.10	-0.10
	3-month JPY Libor	0.10	0.06	0.06	0.06	0.06	0.05	0.05	0.05	0.06	0.05	0.05
	10-year JGB	-0.04	-0.23	-0.08	0.05	0.07	0.10	0.10	0.30	0.05	0.30	0.40

Exchange rates		2016				2017				2016	2017e	2018e
		Q1	Q2	Q3	Q4	Q1	Q2e	Q3e	Q4e			
USD	EUR / USD	1.14	1.11	1.12	1.05	1.07	1.02	1.02	1.00	1.05	1.00	1.06
	USD / JPY	112	103	101	117	111	121	124	128	117	128	130
EUR	EUR / GBP	0.79	0.83	0.87	0.85	0.86	0.82	0.82	0.80	0.85	0.80	0.82
	EUR / CHF	1.09	1.08	1.09	1.07	1.07	1.10	1.12	1.12	1.07	1.12	1.15
	EUR/JPY	128	114	114	123	119	123	126	128	123	128	138

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



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