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Economics Group

Special Commentary

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Is ECB Policy Tightening Coming Into View?

Executive Summary

Real GDP in the Eurozone rose 0.5 percent in Q4-2016, the 15th consecutive quarter in which growth has been positive on a sequential basis. But because economic growth has been generally sluggish over that period, inflation has remained well below the ECB's target of "below, but close to, 2 percent." Consequently, ECB monetary policy has turned even more accommodative over the past few years.

We forecast that the pace of economic activity in the euro area will gradually gain traction as exports accelerate and as the effects of monetary accommodation make their way through the economy. In our view, the ECB will deem that further policy accommodation is not needed as inflation slowly creeps higher. But it will also conclude that policy tightening is not needed either, at least not in the foreseeable future. In other words, we believe that the ECB will be on hold for a considerable period of time, as the Fed was between October 2014, when it finally ended its own QE program, and December 2015, when it hiked rates for the first time in nine years. Of course, any downside shocks that materialize, such as the potential election of Marine Le Pen as the next president of France, could weaken growth and cause the ECB to administer further policy accommodation.

Economic Growth Firming in Eurozone

Preliminary data that were released today showed that real GDP in the Eurozone rose 0.5 percent (2.0 percent at an annualized rate) on a sequential basis in Q4-2016 (Figure 1). Real GDP in the Eurozone grew 1.7 percent in calendar year 2016, a slight slowdown from the 1.9 percent pace registered in 2015. However, as the individual portions of the regional market begin to recover slowly, we look for the Eurozone to expand 1.7 percent and 2.0 percent in 2017 and 2018, respectively.

The Eurozone's recent improvement in its industrial sector is consistent with its pickup in exports.

Growth in industrial production in the Eurozone strengthened in Q4, rising 2.0 percent on a year-ago basis in the first two months of Q4, up from the 1.2 percent rate notched in Q3-2016 (Figure 2). Although we do not yet know the exact reasons why industrial production picked up in Q4, the trend is consistent with the pickup in Eurozone exports over the same period. Likewise, retail sales in the region seem to be gaining momentum, further evidence that consumer demand is picking up. Retail sales volumes rose 2.7 percent on a year-ago basis in the first two months of Q4-2016, compared to 1.4 percent growth rate that was registered in Q3.

Country-specific growth data reveal that Spain grew 0.7 percent in Q4 and 3.0 percent year over year, outpacing its neighbors of France and Germany. France's economy grew 0.4 percent on a sequential basis in Q4-2016 and 1.1 percent year over year, notably below the larger region's pace. Germany, on the other hand, reported economic growth of 1.9 percent in 2016, up from 1.7 percent in 2015. Germany does not report Q4-2016 data until February 14.

Figure 1

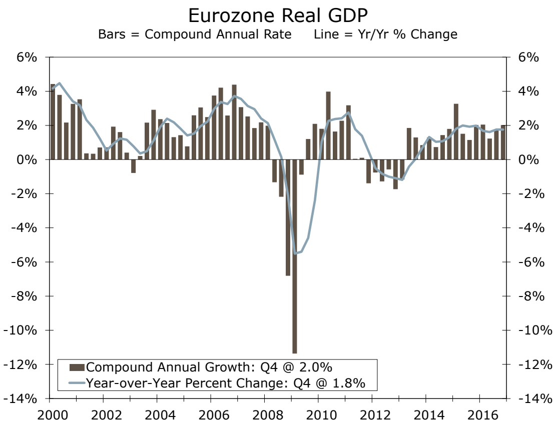
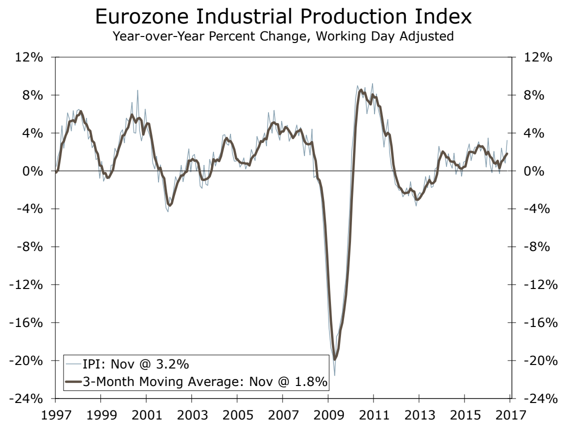


Figure 2



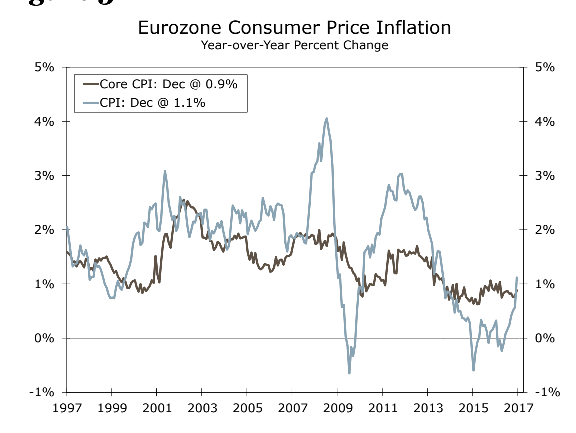
Source: IHS Global Insight and Wells Fargo Securities

Lack of Inflation = Monetary Policy Accommodation

The core rate of inflation in the Eurozone remains stubbornly below 1 percent.

As shown in Figure 1 above, real GDP in the euro area has been growing continuously since Q2-2013. Unfortunately, growth has not been strong enough over that period to lift inflation to any significant extent. Energy prices have rebounded over the past year, which has caused the CPI inflation rate in the overall Eurozone to return to positive territory in recent months (Figure 3). That said, the core rate of inflation, which excludes food and energy prices and which is more reflective than the overall rate of inflation of underlying inflationary momentum in the economy, has been trendless and remains stubbornly below 1 percent. In other words, there are very few inflationary pressures in the euro area at this time.

Figure 3



Source: HIS Global Insight and Wells Fargo Securities

The ECB has guided short-term interest rates lower by cutting its three major policy rates to unprecedented lows.

The European Central Bank has a sole mandate, namely "price stability," which it defines as an overall inflation rate that is "below, but close to, 2 percent." Because inflation has been well below the ECB's target for more than two years, it has increased its degree of monetary accommodation over that period. The ECB's Governing Council has guided short-term interest rates lower by cutting its three major policy rates to unprecedented lows (Figure 4). The Governing Council took its deposit rate into negative territory in June 2014 and it remains there today. At present, the ECB charges commercial banks 40 bps on the overnight deposits they make at the ECB. This reduction in policy rates has taken most interbank lending rates into negative territory as well. For example, the 3-month interbank rate in the Eurozone is currently -0.34 percent. Consequently, borrowing costs for consumers and businesses, although in positive territory, have declined markedly over the past few years.

Figure 4

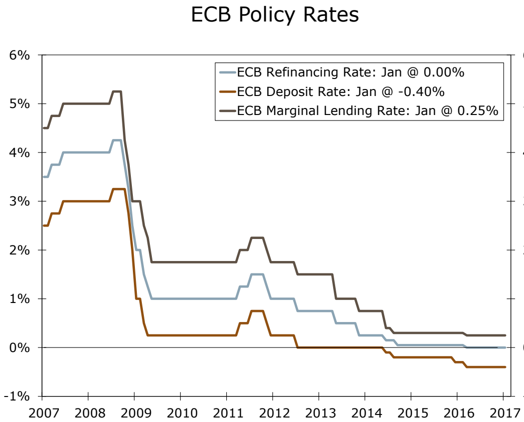
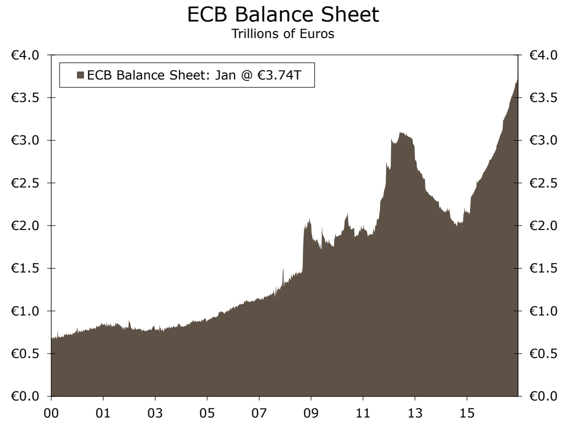


Figure 5



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

In addition, the ECB has adopted a quantitative easing (QE) program that has swelled the size of its balance sheet (Figure 5). At its policy meeting on December 8, the Governing Council decided to reduce its monthly purchase rate from €80 billion at present to €60 billion, effective in April. But it also decided to extend the QE program, which had been slated to end in March 2017, "until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim."

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Outlook for Eurozone Economy and ECB Monetary Policy

So what will happen to the Eurozone economy and ECB monetary policy this year? As noted above, real GDP grew 1.7 percent in the euro area in 2016. Our forecast looks for 1.7 percent growth in 2017 and 2.0 percent in 2018. In other words, we project that economic activity in the euro area will slowly gain more traction going forward. For starters, the real effective exchange rate, which measures the price-level adjusted value of the euro vis-à-vis the currencies of the Eurozone's major trading partners, has fallen roughly 10 percent over the past three years. In other words, the price competitiveness of goods and services that are produced in the euro area has improved by approximately 10 percent over that period. This real depreciation of the exchange rate coupled with some modest acceleration in global economic activity should lead to stronger export growth going forward. In that regard, real export growth in the euro area has already started to edge higher (Figure 6).

Stronger export growth in the Eurozone should help overall economic activity gain traction going forward.

Figure 6

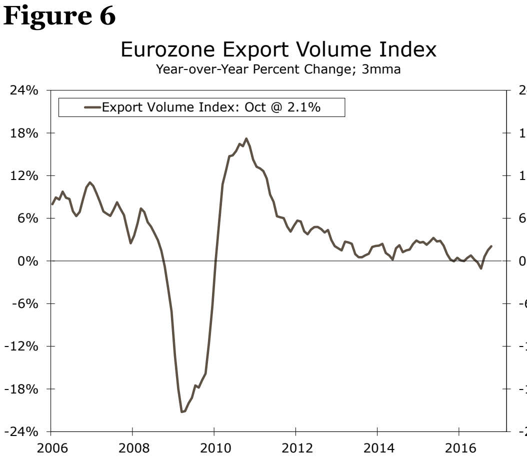
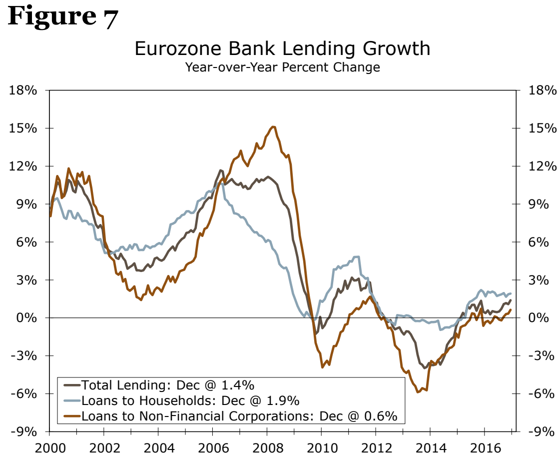


Figure 7



Source: IHS Global Insight and Wells Fargo Securities

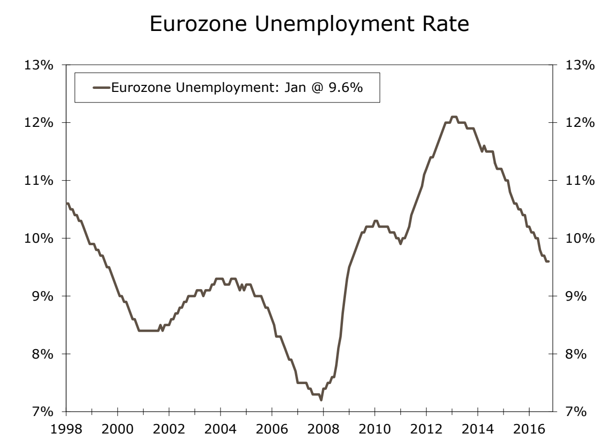
In addition, policy measures that the ECB has undertaken are leading to some pick-up in bank lending (Figure 7). Even lending to non-financial businesses, which has been depressed in recent years, is starting to edge higher. Banks in the euro area are flush with liquidity at present, and we look for bank lending to strengthen further in coming months, which should be supportive for fixed investment spending and consumer purchases of durable goods.

We believe that the ECB will not ease policy further this year.

Therefore, we believe that the ECB will not ease policy further this year. Specifically, we do not believe the Governing Council will sanction more reductions in the ECB's three policy rates (Figure 4) nor do we look for it to expand its QE program further. As noted above, the Governing Council has already announced a "tapering" of its monthly purchases from €80 billion at present to €60 billion, effective in April. We look for the ECB to maintain its €60 billion/per month rate of bond purchases through the summer, and then ratchet the purchase rate down further in the autumn. The QE program may not cease in December 2017 exactly, but we think it will come to an end in early 2018, if not in December of this year.

That said, the probability of policy tightening in the foreseeable future appear to be slim. The unemployment rate in the overall euro area has dropped from its peak of 12 percent in 2013, but at 9.6 percent in January it remains elevated in a historical context (Figure 8). Consequently, there is not much wage pressure generally in the Eurozone at present, and a sharp move higher in the inflation rate is not likely if wages do not accelerate significantly. Although we forecast that the inflation rate will drift higher as economic growth firms we believe inflation will remain under 2 percent through the end of 2018, which will keep policy tightening at bay. Of course, the ECB could provide further policy accommodation if downside risks to the outlook were to materialize.

Figure 8



Source: HIS Global Insight and Wells Fargo Securities

The French presidential election, presents one notable downside risk to our forecast for the overall euro area this year.

In that regard, the French presidential election, which will be held in late April and early May, presents one notable downside risk to our forecast for the overall euro area this year.[1] Marie Le Pen, who is the leader of the nationalist National Front, continues to lead in the polls with roughly one-quarter of the voters saying that they intend to cast a ballot for her in the first round of the presidential election. Many analysts concede that Le Pen likely will make it into the second round, but they believe she will then be defeated by her second-round challenger, whoever that may be. But if political events since last June have taught us anything it is that pre-referendum/pre-elections polls can be widely off the mark. In our view, the probability that Marie Le Pen becomes the next president of France is not insignificant.

[1] **The first round of the presidential election will be held on April 23. If no candidate secures a majority of the votes in the first round, the top two vote getters will square off in the second round on May 7. Whoever wins that round will become the next president of France.**

Le Pen favors French withdrawal from the European Union. The French president cannot unilaterally take France out of the EU. Withdrawal would require a change to France's constitution, which does not seem very likely, at least not at this time. However, a victory by a nationalist like Le Pen would raise concern about the long-run viability of the European Union, which would stoke uncertainty and could weigh on investment spending. We would need to reconsider our forecasts for the Eurozone economy and ECB monetary policy should Madame Le Pen become the ninth president of the Fifth French Republic.

Conclusion

Real GDP in the Eurozone rose 0.5 percent in Q4-2016, the 15th consecutive quarter in which growth has been positive on a sequential basis. But because economic growth has been generally sluggish over that period, inflation has remained well below the ECB's target of "below, but close to, 2 percent." Consequently, ECB monetary policy has turned even more accommodative over the past few years.

We forecast that the pace of economic activity in the euro area will gradually gain traction as exports accelerate and as the effects of monetary accommodation make their way through the economy. In our view, the ECB will deem that further policy accommodation is not needed as inflation slowly creeps higher. But it will also conclude that policy tightening is not needed either, at least not in the foreseeable future. In other words, we believe that the ECB will be on hold for a considerable period of time, as the Fed was between October 2014, when it finally ended its own QE program, and December 2015, when it hiked rates for the first time in nine years. Of course, any downside shocks that materialize, such as the potential election of Marine Le Pen as the next president of France, could weaken growth and cause the ECB to administer further policy accommodation.

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