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Economics Group

Special Commentary

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Eurozone Economic Outlook: Does Monetary Tightening Lie Ahead?

Executive Summary

The economic expansion in the Eurozone is firmly underway, with real GDP increasing 2.7 percent in Q4 year over year. Although a breakdown of the GDP data into its underlying demand components is not yet available, monthly economic data suggest that the expansion is strengthening and likely self-sustaining. In this report, we highlight the solid growth seen across multiple sectors of the Eurozone economy at present, as well as discuss the European Central Bank's (ECB) transition towards policy normalization and eventual tightening.

Although the economic data have been indicative of increasingly self-sustaining growth, inflation in the Eurozone remains benign. CPI inflation fell significantly from 2012-2015, causing the ECB to cut policy rates and implement a quantitative easing (QE) program. As inflation slowly begins to pick up and growth remains solid, the Governing Council is now tasked with ending its QE program and eventually beginning to hike rates. We look for the ECB to gradually begin to raise rates in H1-2019 by first hiking its deposit rate, while keeping the overnight interbank rate and two-week refinancing rate unchanged. In the midst of a slow path toward policy normalization, our currency strategy team looks for the euro to appreciate against the dollar as the greenback weakens over the coming quarters and the ECB gradually begins to tighten. Although growth is increasingly broad-based, we also acknowledge several risks to our outlook, including political uncertainties in Germany and Italy or the potential for another sovereign debt crisis like the one seen in 2010-2012. That said, we see these risks as largely manageable at present, and look for real GDP to increase 2.2 percent in 2018 and 2.0 percent in 2019.

In this report, we highlight the solid growth seen across multiple sectors of the Eurozone economy at present.

Q4 GDP Growth Supportive of Broad-Based Expansion

Preliminary data that were released today showed that real GDP in the Eurozone rose 0.6 percent (2.3 percent on an annualized basis) in Q4-2017 relative to the previous quarter (Figure 1). On a year-ago basis, Q4 growth matched consensus estimates at 2.7 percent, and the Q3 data were also revised upward to 2.8 percent year over year.

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Figure 1

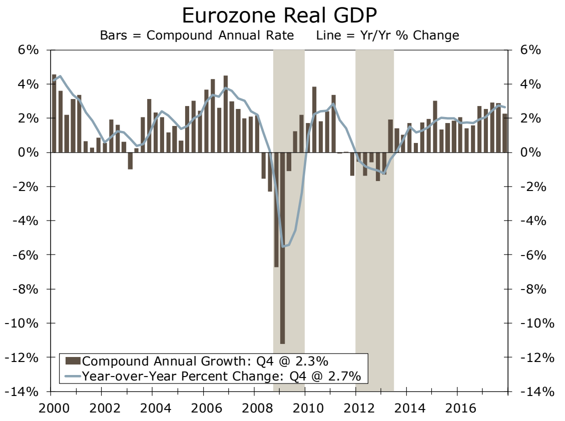
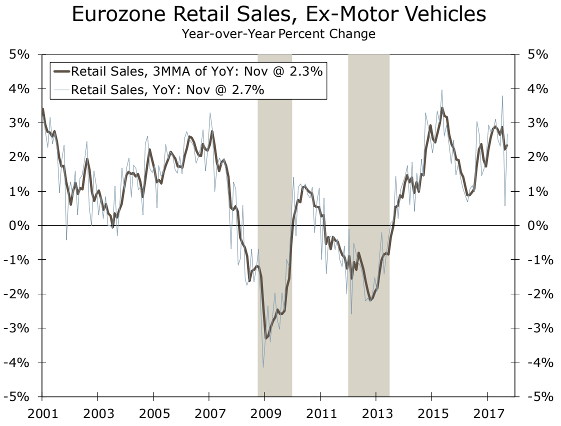


Figure 2



Source: IHS Global Insight and Wells Fargo Securities

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Consumer spending as measured by real retail sales remains solid in Q4.

The breakdown of the Q4 GDP data into its underlying demand components will not be available until February 14, but monthly economic indicators and disaggregated data from past quarters reveal the solid nature of the expansion at present. Consumer spending as measured by real retail sales remains solid in Q4. Real retail sales rose 0.1 percent (not annualized) through the first two months of Q4 relative to Q3, and they were up 2.7 percent in November on a year-ago basis (Figure 2). Businesses are hiring—employment was up 1.7 percent in Q3 relative to the same quarter in 2016—and higher employment is creating more disposable income which is supporting consumer spending. The unemployment rate in the Eurozone currently stands at 8.7 percent (Figure 3). Although this rate is elevated relative to its low in 2007, it has receded significantly over the past five years from its record high of 12 percent. Low inflation—the overall CPI is up just 1.4 percent—is also supportive of growth in real income (Figure 4).

But real PCE is not the only area of spending that is growing in the euro area at present. Solid growth in the rest of the world is boosting real exports of goods and services. Real exports for the first two months of Q4 were up 0.5 percent relative to Q3, and on a year-ago basis are up more than 5 percent. We do not have any direct monthly indicators for capital expenditures or government spending; however, the disaggregated data available from the Q3 GDP report support the expansion currently in place. Real investment spending was up 4.2 percent year over year in Q3, and real government expenditures grew 1.1 percent. These increases in spending across the spectrum are a good sign because real GDP growth that is broad-based tends to be self-sustaining, everything else equal.

We forecast that real GDP in the Eurozone will expand another 2.2 percent this year and 2.0 percent in 2019.

Indeed, we forecast that real GDP in the Eurozone, which grew 2.5 percent in 2017, the strongest annual rate since 2007, will expand another 2.2 percent this year and 2.0 percent in 2019. Because these forecasted growth rates exceed estimates of long-term potential growth rates in most Eurozone countries, the unemployment rate in the euro area should continue to recede in the next two years.

Figure 3

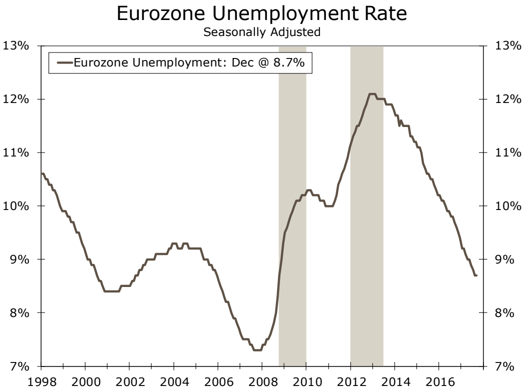
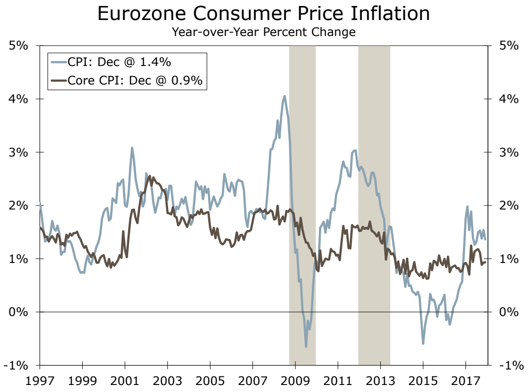


Figure 4



Source: IHS Global Insight and Wells Fargo Securities

The ECB: In Transition from Easing to Tightening

The ECB is in the process of dialing back its QE program.

The European Central Bank has a single mandate, namely, "price stability" that it defines as a CPI inflation rate below, but close to 2 percent over the medium term. As the inflation rate fell further and further below target between 2012 and 2015 (Figure 4), the ECB ramped up policy accommodation. Not only did it slash its three main policy rates, but it implemented a QE program beginning in early 2015 that caused the ECB's balance sheet to swell markedly as it bought bonds (Figure 5).

With the economic expansion in the Eurozone becoming increasingly self-sustaining and with the risk of a deflationary spiral receding, the ECB is in the process of dialing back its QE program. Last year at this time, the ECB was buying €80 billion worth of bonds per month. It subsequently reduced its monthly purchase rate to €60 billion in April, and it cut it further to €30 billion in

January 2018. The Governing Council has publically stated its intention to maintain the monthly purchase rate at €30 billion until at least September 2018. If, as we forecast, real GDP growth in the euro area remains solid and the outlook for inflation improves, then we believe that the Governing Council will eventually decide to end its QE program in late 2018.[1] The ECB's balance sheet likely will remain bloated for years, however. The ECB likely will continue to reinvest the proceeds of its maturing bond portfolio for the foreseeable future, just as the Fed did between 2014 and 2017.

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Figure 5

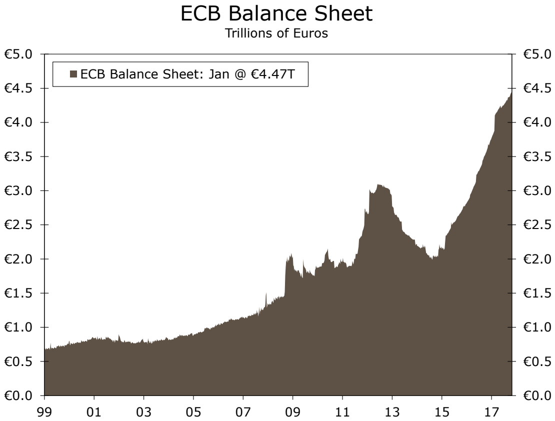
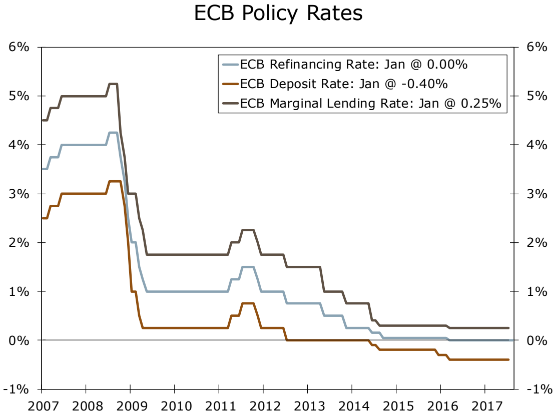


Figure 6



Source: Bloomberg LP and Wells Fargo Securities

Traditionally, the ECB has conducted monetary via its three main policy rates (Figure 6). The deposit rate is the rate that the ECB pays commercial banks for holding reserves at the central bank, and it sets the lower bound for the overnight interbank lending rate. At present, the deposit rate is -0.40 percent. That is, commercial banks must pay the ECB 40 bps to park their reserves at the central bank. The upper bound for the overnight interbank rate is set by the marginal lending rate, which is the rate that the ECB charges commercial banks for overnight borrowing if they cannot obtain adequate liquidity from other banks. That rate is currently 0.25 percent. Therefore, the range in which the overnight interbank rate can move is -0.40 percent to 0.25 percent.

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The Governing Council slashed its deposit rate into negative territory and it took the marginal lending rate to unprecedented lows in order to push market interest rates as low as possible. For example, the overnight interbank rate is currently near the bottom of its potential range at -0.38 percent. The composite cost-of-borrowing indicator for new loans to businesses that the ECB calculates for information purposes is only 1.70 percent at present. The comparable indicator for the household sector is only 1.87 percent.

The third main policy rate—the two-week refinancing rate—was historically the most important of the three main policy rates as it represented the interest rate at which the ECB supplied the majority of its liquidity to the banking system. That rate has become less important in recent years as the ECB has employed new programs to pump the banking system full of liquidity. The two-week refinancing rate has been 0.00 percent since March 2016.

The Governing Council has said that it expects to maintain its policy rates at their current levels for "an extended period of time," and it has pledged not to raise them until the QE program ends. In other words, the ECB will not be raising rates anytime soon. That said, we believe that conditions will be in place in the first half of 2019 for the Governing Council to commence a slow process of raising rates. Specifically, we look for the Governing Council to raise its deposit rate from -0.40 percent to -0.20 percent in H1-2019 but to keep its other two policy rates unchanged at

The Governing Council has said that it expects to maintain its policy rates at their current levels for "an extended period of time."

[1] We feel fairly confident that the Governing Council will end the QE program in late 2018, but we are uncertain about the exact timing. The ECB could "taper" its purchases one more time to, say, €15 billion per month through the end of the year, or it could end the QE program altogether in September. The decision will depend on the incoming data in coming months.

that time. This increase in the deposit rate will push the overnight interbank rate higher and it will signal that more rate hikes will eventually be on the way.

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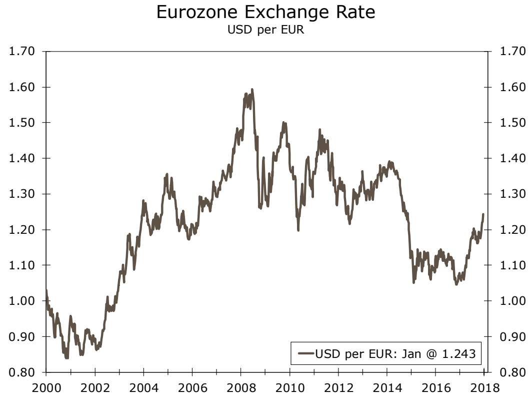
The next move (sometime in mid-2019) will be to raise the deposit rate to 0.00 while also hiking the marginal lending rate and the two-week refinancing rate. While we believe that the first hike in the refinancing rate and the marginal lending rate will be less than 25 bps (maybe 10 bps or 15 bps), we acknowledge that the Governing Council could clearly opt for full 25 bps moves in both rates. We look for another rate hike or two in H2-2019, but we believe that the pace of tightening will remain slow as long as inflation remains largely benign.

Currency Outlook: Further Euro Appreciation Ahead

The euro fell about 25 percent versus the U.S. dollar between mid-2014 and late 2016 as market participants started to price in expected Fed rate hikes (Figure 7). However, the 75 bps of tightening that the FOMC implemented in 2017 seems not to have helped the greenback much as the euro rose 15 percent versus the dollar over the course of the year. Looking forward, Wells Fargo's currency strategy team expects that the euro will continue to trend higher vis-à-vis the greenback in coming quarters, as market participants start to price in the expected tightening measures by the ECB that we highlighted previously.

Figure 7



Source: IHS Global Insight and Wells Fargo Securities

How Could the Eurozone Economy Get in "Trouble"?

In general, we have a fairly constructive outlook for the Eurozone economy over the next two years. So what could conceivably go wrong? The Eurozone economy faces many of the potential downside global risks that we highlighted in a recent report.[2] Namely, growth in the euro area could weaken more than we expect if interest rates were to rise faster than expected or if stock markets around the world were to swoon. And of course there are a myriad of geopolitical risks that at any time could trip up growth prospects, not only in Europe but in most other countries as well.

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But the Eurozone also faces its own idiosyncratic risk. The episodes of the European sovereign debt crisis from 2010-2012 exposed the design flaws of the European Monetary Union. Financial market volatility and economic weakness could resume if market participants should once again question the long-run viability of the monetary union. Potential catalysts for renewed jitters include political uncertainty in Germany, where Chancellor Merkel has yet to form a new government after the September 24 elections, and Italy, where voters head to the polls on March 4 for a general election.

The Eurozone is less unstable today than it was at the height of the sovereign debt crisis. The €500 billion European Stability Mechanism, which can be used as a bailout fund, is now capitalized and operational, and the ECB has shown its willingness "to do whatever it takes to preserve the

[2] See "The Global Economic Expansion: Mind the Risks" (January 2, 2018), which is posted on our website.

euro."[3] In our view, the probability of another European sovereign debt crisis in the foreseeable future is low, but it is not zero.

Conclusion

Economic growth in the Eurozone continued in Q4, with real GDP up 2.7 percent from a year ago. The broad-based expansion is firmly underway, with consumer, investment and government spending all posting solid gains this year. Unemployment has declined in recent months, and disposable income should continue to grow as businesses expand and inflation remains benign. This acceleration in economic activity has convinced the Governing Council that it can dial back its QE program, and we look for the ECB to end its bond buying in late 2018. The Governing Council has stated it will only begin to hike rates after the QE program ends. Accordingly, we look for the ECB to hike its deposit rate in H1-2019 while keeping the overnight interbank rate and 2-week refinancing rate unchanged initially. We forecast that the ECB will then begin a slow process of raising all three policy rates in H2-2019.

The broad-based expansion is firmly underway, with consumer, investment and government spending all posting solid gains this year.

As the ECB gradually begins to tighten, our currency strategy team looks for continued euro appreciation against the dollar over the coming quarters amid general greenback weakness and eventual monetary policy tightening. While the Eurozone economy is experiencing an upswing in line with the overall global expansion, we must also acknowledge risks to our outlook, including political uncertainty in Germany and Italy, or another sovereign debt crisis similar to the one witnessed in 2010. Although risks are present and policy normalization will likely be slow, we look for the expansion to continue over the next two years, with real GDP rising 2.2 percent in 2018 and 2.0 percent in 2019.

[3] **Speech given by ECB President Draghi at the Global Investment Conference in London on July 26, 2012.**

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