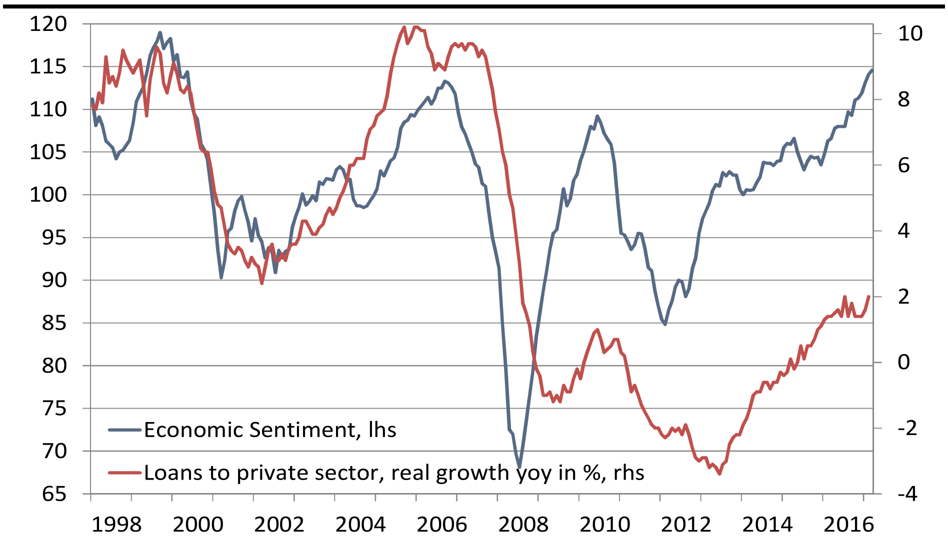
Eurozone outlook: how hot can it get?

- **Mounting momentum at home and a US fiscal stimulus can keep Eurozone economic growth well above the 1.5% trend rate for the foreseeable future. The risks to our above-consensus calls for 2.4% growth in 2018 and 2.1% in 2019 are still more to the upside than to the downside.**
- **The strong demand dynamics raise three key questions: How hot can it get? How long can the good times last? And how will the European Central Bank (ECB) react?**
- **We do not expect growth to accelerate much further and look for at least two more years of solid growth in the Eurozone. We now expect the ECB to raise its refinancing rate twice rather than just once in 2019.**
- **No upswing lasts forever. In one key respect, this recovery is different, though. It is much less credit-driven than previous upturns. As a result, it will take longer than usual until the excesses of the good times have built up to such an extent that they will need to be cleansed by a corrective recession.**
- **Because the cycle is more mature in the US than the Eurozone, the party will likely give way to a hangover in the US well before the Eurozone itself has reached the stage of maximum exuberance. It could thus be a US recession rather than a domestic imbalance within the Eurozone that may eventually interrupt the Eurozone's recovery.**
- **Even the US cycle probably has at least two more good years to run before it may eventually come to an end. As the good times have only just started, it is still too early to focus on the hangover after the party.**

Drivers of the Eurozone upswing

The Eurozone is enjoying a broad-based recovery: all countries and all major sectors are contributing to the vigorous expansion of demand. The major underlying theme is a gradual return to normal. In the wake of the financial crisis of 2008/2009 and the euro crisis of 2011/2012, the region had languished in an age of caution from 2013 to 2016: companies were more reluctant to invest, households were more hesitant to spend and both were much less eager to ask for a credit than usual in a cyclical recovery, preferring to build up precautionary liquid balances instead.

Chart 1: Mind the gap – this boom is not (yet) driven by credit



Eurozone economic sentiment, left-hand scale, loans to private sector (adjusted), deflated by core CPI, yoy change in %, right-hand scale. Sources: European Commission, Eurostat

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As time goes by, households and companies become less cautious again

As a result, the ongoing upswing did not accelerate very much until 2017. However, as time goes by, companies and households are becoming more confident again that no new mega crisis is lurking right behind the next corner. They now dare to invest, spend and borrow a little more. Chart 1 shows the still very hesitant but visible rebound in credit demand. The same monetary stimulus that was needed to support moderate growth in the past is now feeding through to the real economy more strongly, boosting the rise in demand well above its trend rate. The switch from severe austerity until 2014 to a mild fiscal stimulus of 0.2% of Eurozone GDP per year since 2015 is accentuating the monetary stimulus.

No major drag from abroad for the time being

In 2015 and early 2016, a major correction in emerging markets and a temporary dip in US non-residential investment after a plunge in oil prices had obscured the underlying improvement. These mini-shocks faded over the course of 2016, a new external shock does not seem imminent. Despite the recent modest rise, oil prices are at a level that is bearable for consumers and conducive for oil-dependent investment and oil-dependent emerging markets. The cyclical outlook is unusually bright.

How hot can it get?

Survey data project even faster growth ahead

The Eurozone economy has expanded at an average annualised pace of 2.5% in the past four quarters. Survey data capturing the current momentum or the outlook for the next few months such as the purchasing managers' indices and the European Commission's economic sentiment index surged to their highest level in almost seven years (composite PMI) or even since 2000 (ESI) in November (see Chart 1 on page 1). They project even stronger growth ahead. Our favourite lead indicator for the outlook three quarters ahead, the growth of real M1 money supply, looks less buoyant but is still compatible with real GDP growth around current rates. The ECB has provided enough liquidity while households and companies have built up enough liquid reserves to finance a robust expansion of demand. The risks to our call for 2.4% Eurozone growth in 2018 are still tilted to the upside.

The last two cycles peaked at 4.0% and 3.3% growth. It will not get that hot this time

In the past two cycles, Eurozone annual growth peaked at 4.0% in 2000 and at 3.3% in 2006. In the first of these two cycles, growth slowed sharply after the peak from Q2 2001 onwards; in the second cycle, the expansion remained robust for longer, that is until early 2008, before the correction of excesses set in that culminated in the great financial crisis of late 2008 and early 2009. We do not expect demand growth to reach the peak rates of the previous cycles. While the age of caution is over, we do not look for households and consumers to move straight from caution to exuberance. Instead, continuing the trends of 2016 and 2017, the readiness to spend, invest and borrow will likely edge up only gradually. If that call is wrong, that is if economic agents swing from one extreme (caution) to the next (exuberance) without a major interlude, the cycle could become much hotter and end much earlier than we project. That is the key risk to our forecasts. See also Beyond inflation: spotting the signs of excess.

Signs of exuberance?

The three things that can kill an upswing

Ups and downs are part of life. Three things can kill a cyclical upswing: (i) inflation may take off to such an extent that the central bank decides to step on the brakes sharply, creating the extra unemployment needed to push wage inflation down again; (ii) real estate markets and/or businesses may throw such a party that the bursting of a big bubble and/or a sudden correction of overcapacities catapults the economy into recession; and (iii) even without the need to cleanse the economy of domestic excesses, an external shock can derail the expansion of demand for a while. We look at these three issues in turn.

Inflation will not force the ECB to trigger a recession within in the next three years

Inflation will not force the ECB to end the upswing within the next three years, in our view. Core inflation remains well behaved, having drifted up merely to 1% so far this year from an average of 0.9% for the four years before (see Chart 2). Hourly compensation of workers has risen by 1.6% yoy in the first half of 2017, up only modestly from the 1.4% average for the three years before. Even in Germany's tight labour market with a record number of vacancies (767,000 in November 2017), wage inflation is not accelerating very much yet (labour costs rose 2.2% yoy in H1 2017). Globalisation and technological change including the rise of robots are keeping wage settlements in check; see Notes on the inflation puzzle. Judging by very strong readings for confidence in manufacturing, businesses will likely step up investment in 2018. This should show up in faster gains in productivity. In turn, this should contain the rise in unit labour costs modest even if wage inflation rises gradually. The Eurozone has a long way to go before wage inflation may accelerate to rates around or above 3.5% which could put the ECB's definition of price stability at risk. For the time being, the rise in the nominal effective exchange rate of the euro (up 4.4% in November on the 2016 average) can also help to keep inflation subdued.

No sign of excess investment yet

Investment has picked up on trend in the Eurozone since spring 2013. However, the 3.7% yoy growth rate of gross fixed capital formation in 1H 2017 remains well below the previous credit-fuelled peaks of 5.8% in 1999 and 2006. We detect no sign of industrial overcapacities or a new surplus of houses built up in an exuberant rush. Unlike the situation in the US and the UK, house price wealth effects are no major driver of consumer demand in the Eurozone. While real house prices have recovered by 7% from their trough in early 2014, they still fall 6.2% short of their peak in early 2008 (see Chart 3). At the current rate, house prices would reach their previous peak at the end of 2019. Would that spell trouble? Probably not yet. In growing economies, house prices tend to rise faster than consumer prices over time. Good locations are a scarce resource. As a result, a new cyclical peak in house prices should usually be above the previous ones. Seen from this angle, the Eurozone housing market seems to still have significant upside before it may reach the red-hot danger zone. Of course, the situation in individual regions such as parts of Germany may well be different soon, potentially requiring the use of macro-prudential tools on the regional level.

How about an external shock?

This leaves a potential external shock as the most likely risk to the Eurozone recovery within the next three years.

External shock?

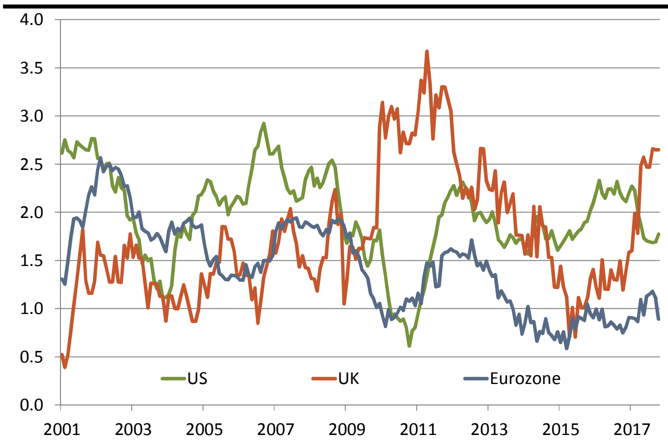
The upswing mature in the Eurozone than in is much less the US

Because the Eurozone let the euro crisis interrupt its post-Lehman recovery in 2011/2012, the upswing is much less mature in the Eurozone than in the US. In Q3 2017, US GDP surpassed its end-2007 level by 14.5% versus a gain of a mere 4.6% for the Eurozone. Even adjusting for faster population growth in the US, which can explain c3 percentage points of the 10-point gap, the Eurozone has much more room to grow into than the US without creating dangerous overcapacities or other strains. Exuberance, excess capacities and inflationary pressures will likely build up in the US much earlier than in the Eurozone. At some stage, an eventual correction of US excesses will probably hit the Eurozone well before it may have developed its own need for a cleansing recession. If the US turns down, the Eurozone will not be able to escape the fallout. In a similar vein, if markets sniff a potential end to the US recovery, Eurozone markets will be affected at least as much as US markets themselves. In a risk-off environment, capital from emerging markets will likely flow more into the US than into the Eurozone.

The US stimulus can shorten the cycle a little

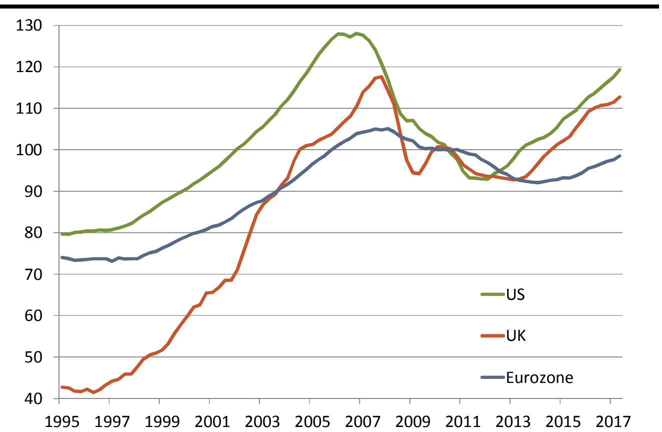
The US fiscal stimulus, which we expect to be enacted shortly, will add extra momentum to the US upswing and shorten the period until eventual excesses of demand over supply could propel the US into the danger zone. From a European perspective, this is unfortunate. On its own, the US stimulus may add up to 0.1 percentage points to the Eurozone growth rate in the next two years through confidence and trade effects. However, an unnecessarily early end of the Eurozone recovery caused by an early US correction would be more expensive.

Chart 2: Core inflation in the US, the UK and the Eurozone (yoy, %)



Consumer prices excluding energy and food, yoy change in %. Sources: BLS, ONS, Eurostat, Berenberg calculations

Chart 3: Real house price index (2010 Q1 = 100)



House prices adjusted for the personal consumption deflator. Source: OECD

The consolation in this should be that, in the absence of major home-grown imbalances, the Eurozone will probably suffer no more than a shallow correction if the US goes into reverse gear eventually. And judging by US investment, inflation and credit growth, the US itself is nowhere near the excesses yet that would require a correction soon. Even the US probably has at least two more years of solid growth even with a coming fiscal stimulus before the party may be over. As long as this remains the case, the Eurozone should be safe.

A credit-poor recovery can last longer and need not be followed by a major downturn

That the vigorous economic recovery is not (yet) fuelled by credit has two major advantages. First, it will take longer until excesses can develop. Overinvestment in capacity and real estate or bubbles in house prices are usually driven by credit. Second, the less any excess has been built on credit, the less painful the following correction. Beyond, say, a required period of less investment and/or less home building after the end of a boom, it is usually the credit problems exposed in a cyclical downturn that exacerbate the recession. After a low-credit boom, the correction will likely be shallower.

ECB: rock-bottom rates at above-trend growth?

Expect two ECB hikes in the refi rate in 2019

For the ECB, subdued core inflation and the mediocre credit dynamics make life easy. Although the bank will almost certainly need to raise its projections for growth again on 14 December 2017, it can still stick to its policy guidance: the ECB will buy €30bn of bonds at least through September 2018 and will keep its rates at current levels until well after the end of these asset purchases. But with growth well above trend, even the doves at the ECB will feel uneasy about extending asset purchases beyond September 2018 and maintaining a negative deposit rate in 2019. While the ECB can possibly reduce the penalty on bank deposits at the ECB from -0.4% to, say, -0.25% perhaps in March 2019, it cannot put the deposit rate back to zero without lifting its main refinancing rate from its current 0.0% as well. Otherwise, there would be no corridor between the two rates. In line with the revision of our Eurozone growth forecasts from 2.2% to 2.4% for 2018 and from 1.9% to 2.1% for 2019, we now project that the ECB will raise its refi rate for the first time in this current cycle in June 2019, followed by a further move in December 2019. So far, we had projected one 25bp move for September 2019.

For a detailed set of forecasts, see our Forecasts at a glance: Firm growth, no exuberance yet

Table: Eurozone economic forecasts

		2016	2017	2018	2019	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
GDP	% y/y	**1.8**	**2.3**	**2.4**	**2.1**	2.0	2.3	2.5	2.5	2.5	2.4	2.3	2.2	2.2	2.1	2.1	2.1
	% q/q					0.6	0.7	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5
	%q/q ann.					2.2	2.6	2.5	2.5	2.3	2.2	2.2	2.1	2.1	2.1	2.1	2.1
Private Consumption	% y/y	**2.0**	**1.8**	**2.1**	**2.0**	1.6	1.8	1.9	2.0	2.2	2.2	2.2	2.1	2.1	2.0	2.0	2.0
	% q/q					0.4	0.5	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Government Consumption	% y/y	**1.7**	**1.3**	**1.6**	**1.6**	1.0	1.2	1.4	1.5	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6
	% q/q					0.2	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Investment	% y/y	**4.5**	**3.5**	**3.1**	**2.8**	4.0	3.3	3.8	3.0	4.0	2.6	2.8	2.8	2.8	2.8	2.8	2.8
	% q/q					-0.2	2.0	0.5	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Final Domestic Demand [1]	% y/y	**2.4**	**2.1**	**2.2**	**2.1**	2.0	2.0	2.2	2.1	2.4	2.1	2.2	2.1	2.1	2.1	2.1	2.1
	% q/q					0.2	0.8	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Net Exports [1]	% y/y	**-0.5**	**0.3**	**0.1**	**0.0**	0.1	0.2	0.3	0.4	0.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0
	% q/q					0.4	-0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stockbuilding [1]	% y/y	**-0.1**	**0.1**	**0.1**	**0.1**	0.0	0.2	0.1	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1
	% q/q					-0.1	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Account Balance	EUR bn	**359**	**342**	**318**	**294**	84.1	74.1	102.8	81.3	78.1	68.1	96.8	75.3	72.1	62.1	90.8	69.3
	% of GDP	**3.3**	**3.1**	**2.7**	**2.4**												
Industrial Production [2]	% y/y	**1.5**	**2.6**	**2.0**	**1.6**	1.4	2.7	3.5	2.7	3.0	2.1	1.4	1.6	1.6	1.6	1.6	1.6
	% q/q					0.1	1.2	1.1	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Unemployment Rate [2]	%	**10.0**	**9.1**	**8.3**	**7.7**	9.5	9.1	9.0	8.7	8.5	8.4	8.2	8.1	7.9	7.8	7.6	7.5
CPI [2]	% y/y	**0.2**	**1.5**	**1.5**	**1.7**	1.8	1.5	1.4	1.4	1.3	1.5	1.6	1.6	1.6	1.7	1.8	1.8
General Govt. Balance	% of GDP	**-1.5**	**-1.2**	**-1.0**	**-0.8**												
General Govt. Debt	% of GDP	**88.9**	**87.2**	**85.2**	**83.0**												
ECB main refinancing rate [3]	%	**0.00**	**0.00**	**0.00**	**0.25**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.50

[1] Contribution to GDP growth [2] Period averages [3] End of period

Source: Eurostat, Berenberg forecasts

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