Economic Research:

Monetary Policy Normalization In The Eurozone: Will One Size Fit All?

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SENIOR ECONOMIST

Marion Amiot
London
+ 44 20 7176 0128
marion.amiot
@spglobal.com

SENIOR ECONOMIST, EUROPE, THE MIDDLE EAST, AND AFRICA

Jean-Michel Six
Paris
(33) 1-4420-6705
jean-michel.six
@spglobal.com

The European Central Bank announced this month that it will take one more step toward normalization of its monetary policy. As we expected, the central bank intends to stop buying additional assets--sovereign and corporate bonds--by the end of the year, thus putting an end to additional quantitative easing (QE). Recent price developments in the European Monetary Union have increased the ECB's confidence that it can gradually phase out QE, followed by rate hikes, the first of which we expect to occur in the second half of 2019. However, deceleration in first-quarter GDP growth suggests that the region's economy might be more vulnerable to external shocks than thought at the start of the year.

Rising uncertainties about the economic outlook are visible in the broad-based drop of sentiment indicators. If downside risks materialize, such as a full-blown trade war, countries in a less advanced phase of the economic cycle like Italy will likely take a bigger hit. This will make the ECB's task of striking the right normalization policy all the more difficult given the "one-size-fits-all" nature of the monetary union. This is why we expect the ECB to maintain a dovish stance regarding the path of interest rates.

Key Takeaways

- The ECB plans to take one more step toward normalization, ending net asset purchases in December 2018, as inflation pressures become more visible.
- Inflation is rising not only on the back of higher oil prices and a weaker euro, but also increasingly because of capacity constraints feeding into higher wages and output prices.
- The central bank's next challenge will be to reconcile differences in inflation rates and economic cycles across countries, so that tighter money doesn't choke growth, especially on the eurozone's periphery.
- The end to net asset purchases will result in some tightening of financing conditions in the eurozone, through less downward pressure on yields--especially for more risky assets. Yet, we expect normalization to proceed slowly, preventing an abrupt rise in borrowing costs.

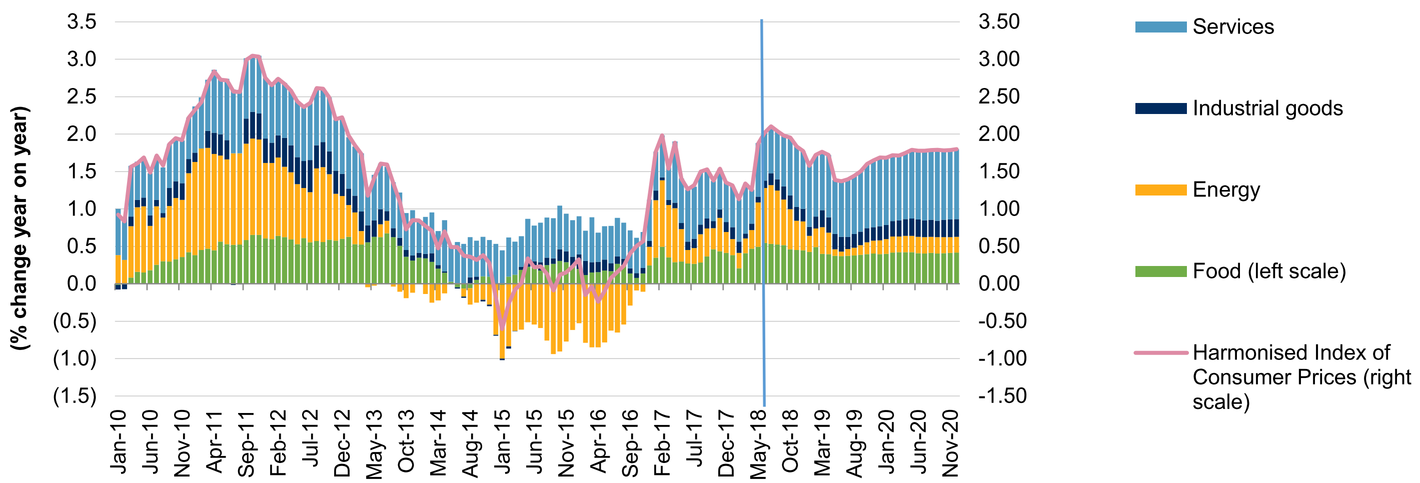
Inflation Has Been Building Up

Notwithstanding the deceleration in economic growth at the start of the year, inflation has accelerated in the eurozone, reaching an annual 1.9% in May, which is in line with the ECB's target of "close to but below 2%." Admittedly, temporary factors drove most of this increase, with higher oil prices and a weaker euro both easing, so to speak, the ECB's task of lifting inflation (see chart 1). Yet, this is not the chief reason for the ECB to announce the end of QE. Much more important is the reason behind accelerating inflation: price pressures have been slowly building because of capacity constraints. We find that so-called "supercore inflation" (price components more closely linked with the output gap) shows a much clearer upward trend (see chart 2).

Chart 1

Inflation Will See A Boost From Higher Oil Prices And A Weaker Euro This Year

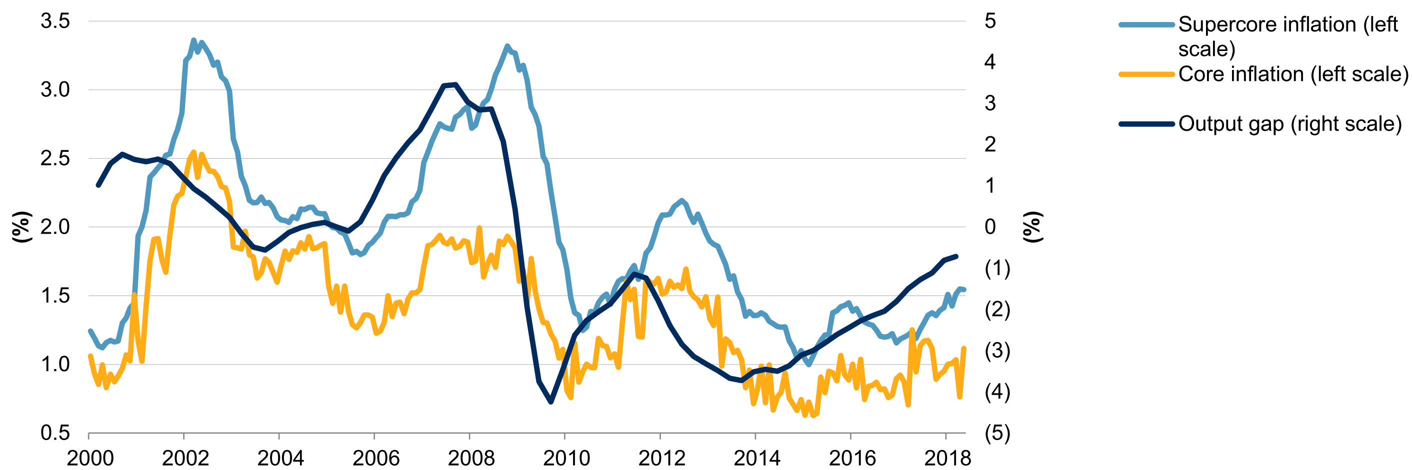
We forecast 1.6% inflation in fourth-quarter 2018 and 1.5% in fourth-quarter 2019 as of June 2018



Sources: Eurostat, S&P Global Ratings.

Chart 2

The Recent Uptick In "Supercore" Inflation Shows The Economy Is Ripe For Monetary Tightening



Note: The supercore inflation measure includes subcomponents of headline inflation significantly correlated with the output gap. Sources: Eurostat, Oxford Economics, S&P Global Ratings author's calculations.

Supplyside constraints have increased further in the eurozone, suggesting they have played a role in the deceleration of economic growth at the start of the year. The eurozone output gap seems to have closed, confirming our view that the economy is unlikely to return back to last year's growth rates (see "The Eurozone Has Reached Cruising Altitude," published on March 28, 2018) and that inflationary pressures are building. Further reductions in labor market slack are feeding into higher wages. Compensation per employee was up by an annual 1.9% in first-quarter 2018, its highest pace since mid-2012. Plus, recent wage agreements in Germany and France point to further wage increases. What's more, firms are increasingly citing equipment as a key factor limiting production, while demand constraints are at their lowest since 2001. In the European Commission's business sentiment survey, firms also report an improvement in their domestic competitive position, indicating they might now be in a better position to raise prices. Finally, five-year inflation expectations have rebounded to about 1.7%-1.8%. With energy prices rising this year, we now forecast inflation to reach 1.7%, 1.6% next year, and1.7% in 2020, giving the ECB enough confidence to raise rates in third-quarter 2019 (see "What Can The ECB Take From The Fed's Policy Playbook?" April 25, 2018).

The Problem Of One Size Fits All

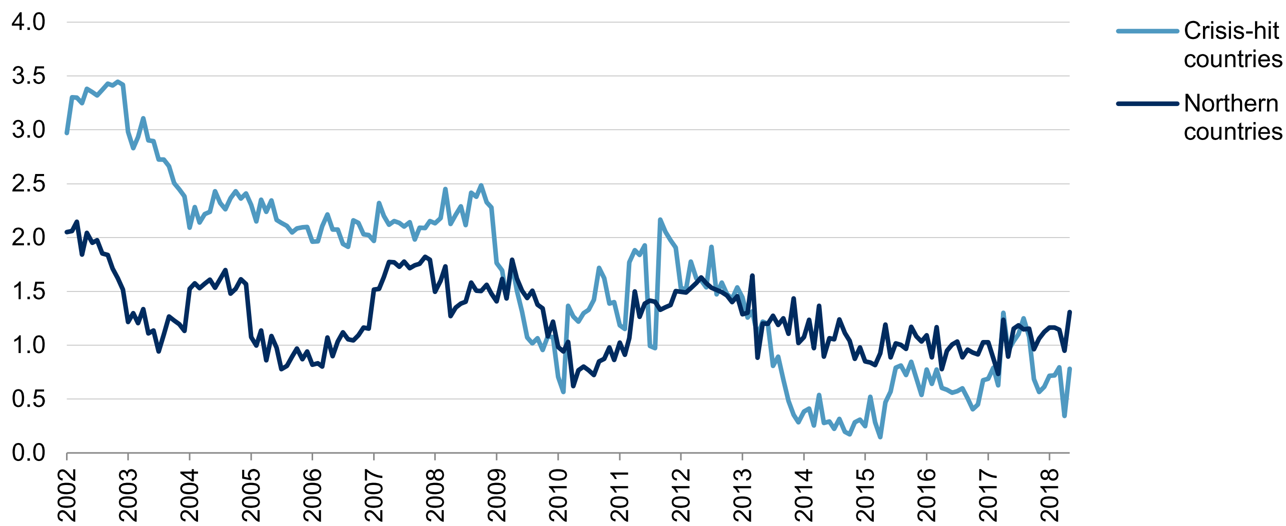
As eurozone inflation converges toward close to but below 2%, the ECB's next challenge will be to reconcile differences in inflation rates and economic cycles across countries. After converging since the start of the asset purchase programme, inflation divergence seems to have increased again, starting in 2017. This mostly reflects lower core inflation rates in crisis-hit countries (see chart 3), where the output gap and slack remain large. Meanwhile, capacity constraints and therefore higher price pressures are already visible in northern economies like Germany and the

Netherlands.

The "one-size-fits-all" nature of eurozone monetary policy means that tightening will inevitably come too early for southern countries, such as Italy and Greece where the output gap is still large, and too late where it has been positive for some time like in the Netherlands and Germany (see chart 4). What's more, countries where the economic recovery is at an earlier stage are also those more vulnerable to external shocks. These reasons and the rising uncertainties about the economic outlook will lend some support to the ECB's very gradual path to tightening monetary policy.

Chart 3

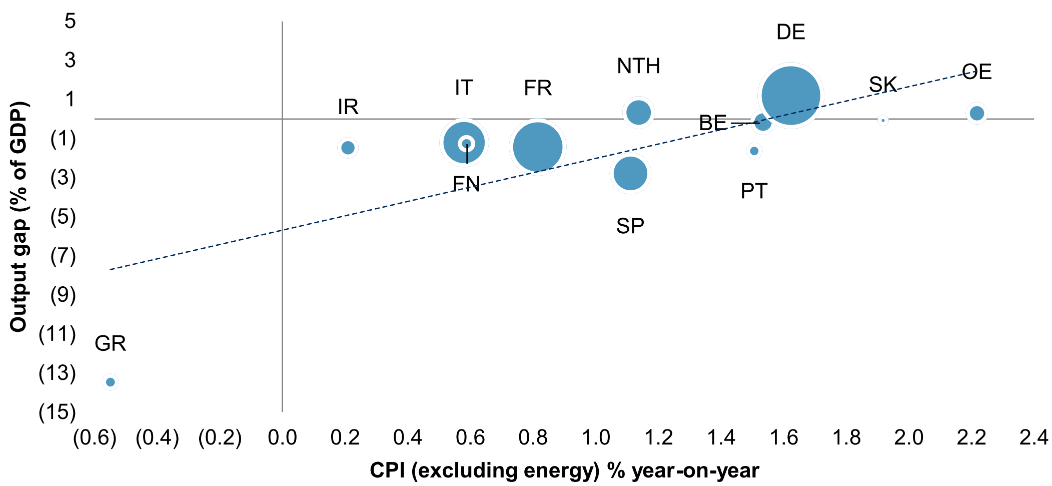
Lower Core Inflation Rates In Crisis-Hit Countries Reflects Higher Output Gaps



Note: Crisis-hit countries include: Italy, Spain, Ireland, Cyprus, Greece, Portugal. Northern countries include: Germany, France, Austria, Luxembourg, The Netherlands, Belgium. Sources: Eurostat, S&P Global Ratings author's calculations.

Chart 4

"One Size Fits All" Means Tightening Is Likely To Be Premature In The Periphery

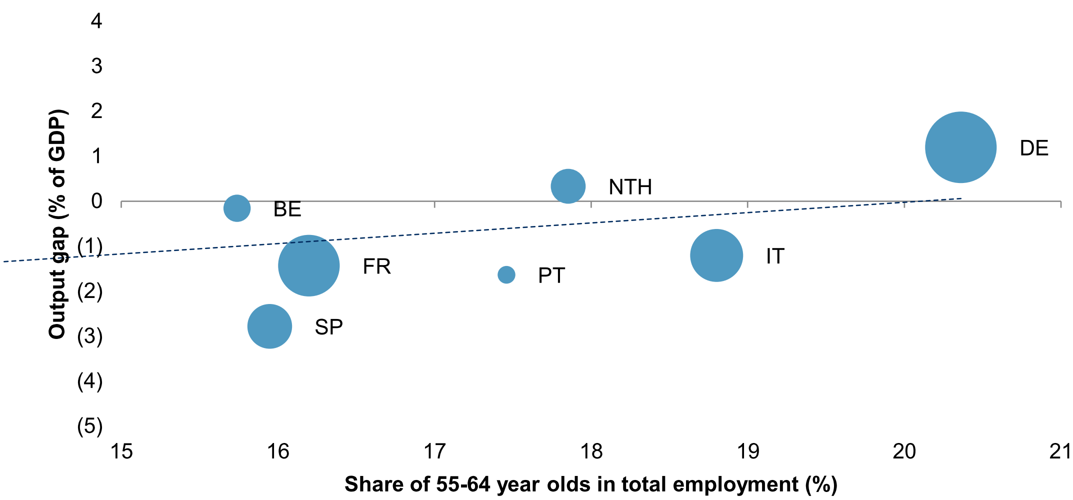


Data as of fourth-quarter 2017, bubble size reflects size of the economy. Sources: Eurostat, OECD, Oxford Economics, S&P Global Ratings.

Interestingly, demographic developments might work in favor of eurozone countries on the periphery during this tightening cycle. More pronounced aging trends in overheating economies are likely to dampen wages and inflation. In Germany and the Netherlands, the share of senior workers (aged 55-64) is among the highest in the eurozone (see chart 5). Data show wage growth starting to stagnate or even decrease in upper age brackets of the workforce (see chart 6), as workers have already reached senior levels and tend to prefer part-time jobs. This should give a little bit more time for periphery economies, which have better demographic profiles apart from Italy, to close their output gaps.

Chart 5

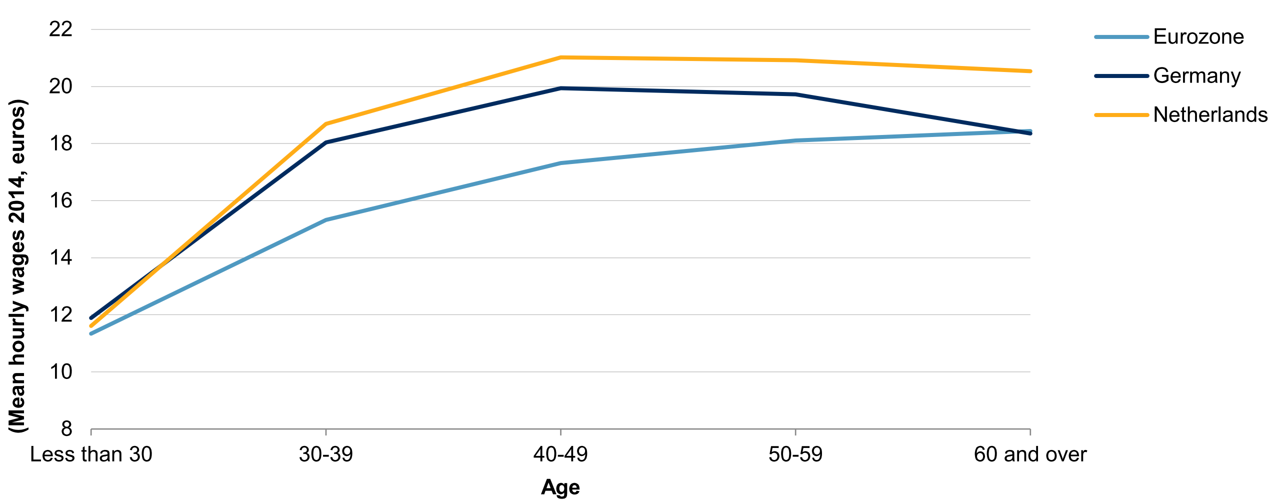
Overheating Economies Have A Higher Share Of Senior Workers In Employment



Data as of fourth-quarter 2017, bubble size reflects size of the economy. Sources: Eurostat, OECD, Oxford Economics, S&P Global Ratings.

Chart 6

Senior Workers Get Lower Pay Rises, Putting Downward Pressure On Inflation



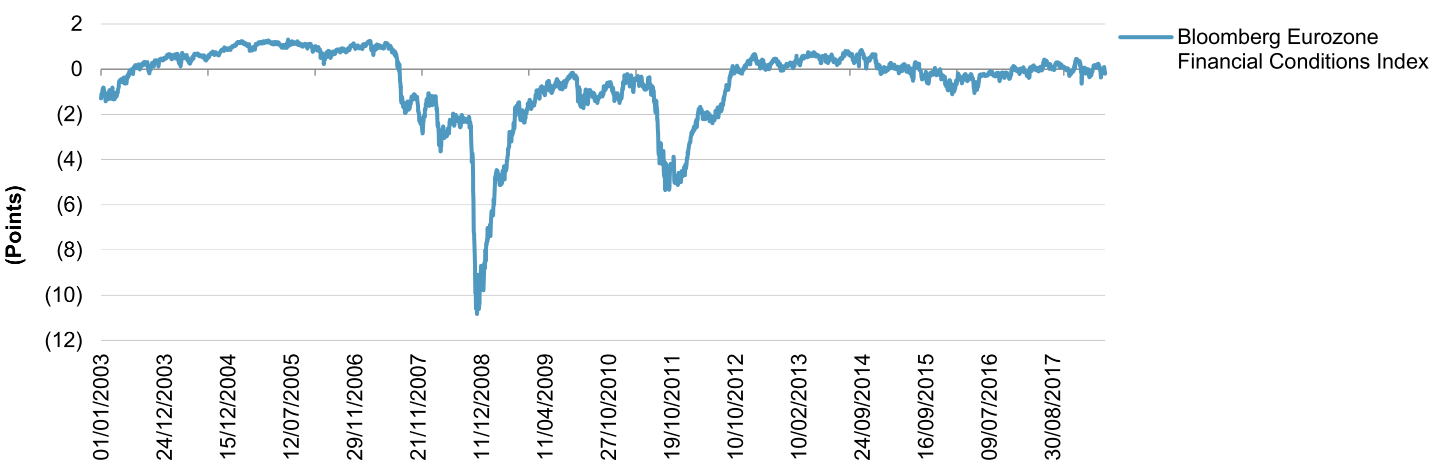
Sources: Eurostat, S&P Global Ratings.

Borrowing Costs Should Rise Slowly

The end of the ECB's net asset purchases will lead to some tightening of financing conditions in the eurozone (see chart 7). We are likely to see less downward pressure on yields, especially for more risky assets, as investors rebalance their portfolios back to safer assets. That said, even if the ECB stops its net purchases, we expect it will continue to reinvest maturing securities at least until the end of 2020, keeping a large stock of assets on its balance sheet. That means that safe assets will continue to be scarce especially as eurozone governments reduce their bond issuances (see "Sovereign Debt 2018: Eurozone Sovereigns To Decrease Commercial Borrowing By 9% To EUR850 Billion In 2018," Feb. 22, 2018). In turn, term premiums (the excess yield investors want to commit to holding a long-term instead of a shorter-term bond) will remain narrow and as a result, bond yields are likely to rise only very gradually (see our forecasts in the table at the end of this article).

Chart 7

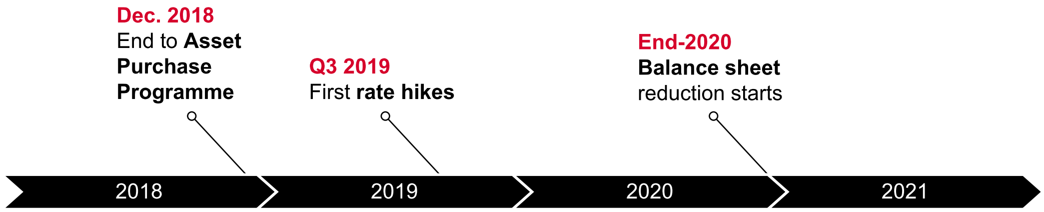
As The ECB's Normalizes Monetary Policy, Financial Conditions Are Likely To Tighten



Note: A positive value corresponds to easing. Sources: Bloomberg, S&P Global Ratings.

Similarly, interest rates will stay at their current level "through the summer of 2019," as the ECB puts it. We pencil in a first rate hike in third-quarter 2019 and expect further increases to be few and far between as the central bank keeps an eye on still highly leveraged companies and governments in the currency union. Against this backdrop, borrowing costs are unlikely to rise too fast in the coming years.

Our Timeline For The ECB's Exit



Source: S&P Global Ratings.

Table 1

S&P Global Ratings' European Economic Forecast, June 2018

Central forecast

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2016	1.9	1.1	1.0	3.3	2.1	1.4	1.8	1.9	1.4
2017	2.5	2.3	1.6	3.0	3.3	1.7	2.6	1.8	1.1
2018(f)	2.0	1.7	1.3	2.8	2.7	1.6	2.1	1.2	2.2
2019(f)	1.8	1.6	1.2	2.3	2.3	1.6	1.7	1.4	1.7
2020(f)	1.5	1.7	1.0	2.1	1.8	1.4	1.6	1.6	1.5
2021(f)	1.3	1.6	0.8	1.8	1.5	1.3	1.4	1.3	1.4
CPI inflation (%)									
2016	0.4	0.3	0.0	-0.3	0.1	1.8	0.2	0.6	-0.4
2017	1.7	1.2	1.3	2.0	1.3	2.2	1.5	2.7	0.5
2018(f)	2.0	1.8	1.3	1.8	1.6	2.1	1.7	2.5	0.9
2019(f)	1.9	1.4	1.3	1.6	1.7	2.1	1.6	1.9	0.9
2020(f)	1.9	1.6	1.6	1.6	1.8	1.9	1.7	1.8	1.2
2021(f)	2.0	1.7	1.8	1.6	1.9	1.6	1.8	2.6	1.3
Unemployment rate (%)									
2016	4.2	10.1	11.7	19.6	6.0	7.9	10.0	4.9	3.3
2017	3.7	9.4	11.3	17.2	4.9	7.1	9.1	4.4	3.2
2018(f)	3.4	9.0	10.9	15.6	3.9	6.2	8.4	4.3	2.9
2019(f)	3.0	8.5	10.6	14.5	3.7	6.2	7.9	4.4	2.7
2020(f)	2.9	8.2	10.2	13.9	3.5	5.9	7.7	4.5	2.7
2021(f)	2.8	8.0	10.0	13.5	3.5	5.8	7.4	4.6	2.6
10-year bond yield (yearly average)									
2016	0.1	0.5	1.5	1.4	0.3	0.5	0.9	1.3	-0.3
2017	0.4	0.8	2.1	1.6	0.5	0.7	1.1	1.2	-0.1
2018(f)	0.6	0.9	2.5	1.5	0.8	1.0	1.2	1.6	0.1

Table 1

S&P Global Ratings' European Economic Forecast, June 2018 (cont.)

2019(f)	1.2	1.5	3.5	2.4	1.4	1.7	1.9	2.4	0.6
2020(f)	1.6	2.0	3.9	3.0	1.9	2.1	2.4	3.1	1.0
2021(f)	1.9	2.4	4.1	3.4	2.2	2.5	2.7	3.4	1.2
Central banks policy rates (yearly average)									
	Eurozone	**U.K.**	**Switzerland**						
2016	0.01	0.40	-0.75						
2017	0.00	0.29	-0.75						
2018(f)	0.00	0.59	-0.75						
2019(f)	0.08	0.84	-0.69						
2020(f)	0.44	1.31	-0.44						
2021(f)	0.71	1.59	-0.13						
Exchange Rates									
	USD/EUR	**USD/GBP**	**EUR/GBP**	**CHF/USD**	**CHF/EUR**				
2016	1.11	1.35	1.22	0.99	1.09				
2017	1.13	1.29	1.14	0.98	1.11				
2018(f)	1.20	1.36	1.14	0.97	1.17				
2019(f)	1.26	1.43	1.14	0.94	1.18				
2020(f)	1.25	1.45	1.16	0.93	1.17				
2021(f)	1.25	1.47	1.17	0.93	1.16				

S&P Global Ratings.