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Economic Research:

The Eurozone Has Reached Cruising Altitude

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CHIEF ECONOMIST, EUROPE, THE MIDDLE EAST, AND AFRICA

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

SENIOR ECONOMIST, EUROPE, THE MIDDLE EAST, AND AFRICA

Marion Amiot
London
marion.amiot@spglobal.com

Global momentum has lifted the eurozone's economic prospects, and it now appears to have reached cruising altitude. The economic and monetary union closed 2017 on a high note, with GDP growth at 2.5%, its fastest pace in a decade. The chief reason for this is the revival of world trade, which has put the eurozone's industries back in motion. Capacity utilization was just short of its 2007 high, triggering stronger investment and boosting industry prospects for this year.

However, the general fall in sentiment surveys at the start of 2018 indicates that eurozone growth is leveling off. Firms are increasingly reporting that supply constraints, rather than demand, are a drag on output. Nonetheless, for now, we expect the growth momentum will stay solid, thanks to the broad-based economic expansion and strong domestic fundamentals.

Key Takeaways

- Strong fundamentals in the eurozone suggest that economic expansion will continue at a brisk pace, and we have raised our GDP growth forecasts for the region to 2.3% this year and 1.9% in 2019.
- We've also raised our euro-dollar exchange rate forecast to $1.27 in 2018 and $1.3 in 2019, since we expect the dollar's weakness will persist.
- The current growth cycle appears to have peaked, but the remaining slack in the labor market and productivity rebound will keep inflationary pressures in check until the end of 2019.

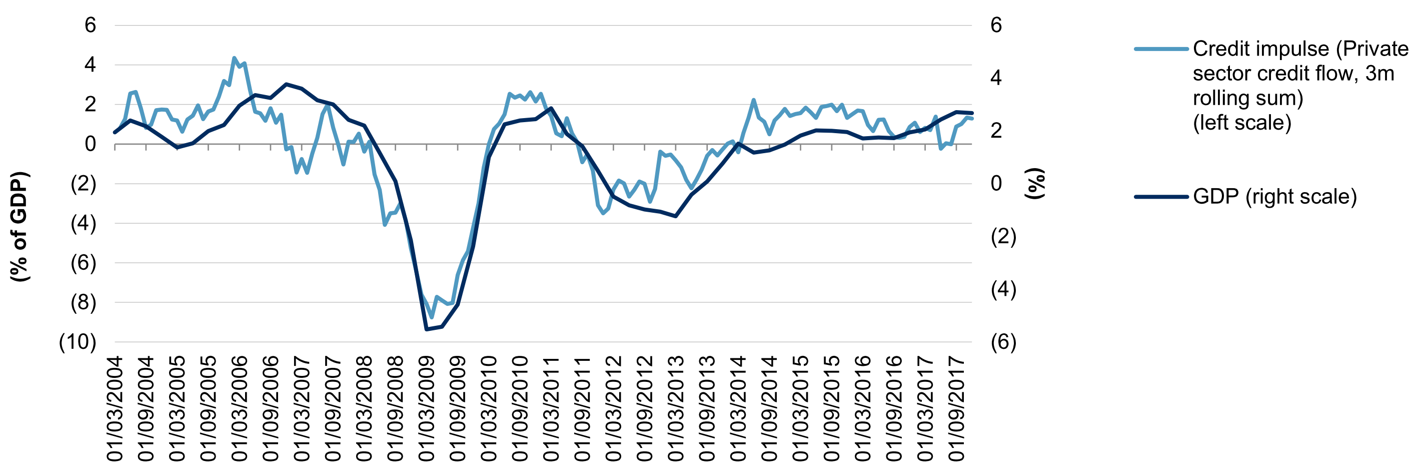
Some Turbulence Ahead?

We expect GDP growth will decelerate only slowly to 2.3% this year and 1.9% next. In this environment, the labor market will continue to create jobs, and falling unemployment will likely start putting more upward pressure on wages from the end of this year. Meanwhile, with inflation still below the European Central Bank's (ECB's) target, monetary policy will continue to support higher investment. By contrast, export growth could face headwinds from the stronger euro dollar exchange rate. Therefore, in our view, risks to the eurozone outlook are mainly external. Trade tensions, a sharp drop in the value of financial assets, or faster monetary policy normalization in the U.S. could all weigh on growth.

Risks to growth are largely external.

Chart 1

Credit Impulse Indicates Robust Eurozone Economic Growth At The Start Of 2018



Source: ECB, Eurostat, and S&P Global Ratings' calculations.

The Greenback Will Likely Remain Weak

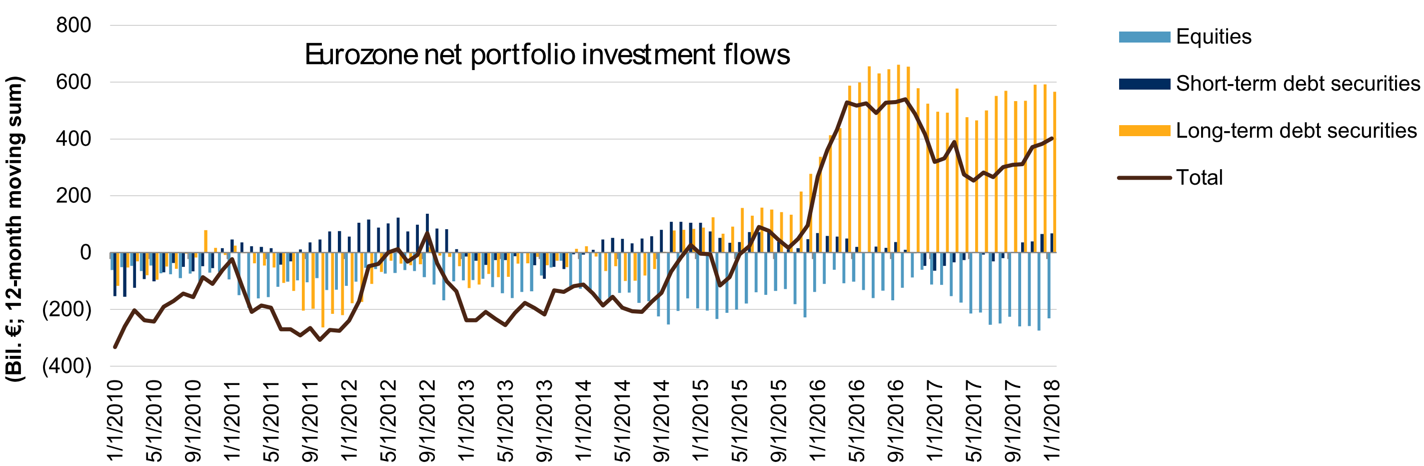
The U.S. dollar's weakness since the beginning of 2017 has intrigued market participants. In early April last year, the exchange rate to the euro was $1.06, and almost a year later, on March 23, 2018, it was $1.226, after a 15.6% drop. The dollar also lost ground against other major currencies (the Canadian dollar, yen, pound, Swiss franc, Australian dollar, and Swedish krona); in trade-weighted terms its value fell 7.8% in the 12 months to March 16. An accurate forecast for the euro-dollar exchange rate in the coming three years is important for multiple reasons: The exchange rate affects overall competitiveness of a country or region, and it plays a key role in determining headline inflation, via the price of imports. For the eurozone, this is particularly important, since headline inflation remains stubbornly below the ECB's target of "close to but below 2%," despite the acceleration of overall GDP growth.

The main cause for perplexity about the dollar's weakness has to do with the diverging monetary policy trends between the U.S. and the eurozone. On March 23, 2018, the U.S. 10-year bond yield reached 2.908, up 47 basis points (bps) from the previous year. The rise has led to a steepening of the U.S. yield curve, with the gap between 10-year and two-year yields widening since January of this year, for the first time since July 2016. Meanwhile, the German 10-year bund yield has registered a modest increase of 12bps in the past 12 months. Consequently, the spread between U.S. and German yields climbed to 2.33% from 1.97% a year earlier. For several months, markets have anticipated at least three rate increases by the U.S. Federal Reserve this year. We now forecast four hikes this year, as U.S. economic growth accelerates thanks to a hefty fiscal stimulus. Clearly, the Fed is now in tightening mode. By contrast, the ECB remains more dovish, with its forward guidance ruling out a rise in interest rates before 2019 and suggesting a very gradual tapering of its quantitative easing program from September 2018. Yet those diverging trends have done little to support the greenback.

One would expect the ECB's expanded asset purchase program (quantitative easing; QE), launched in 2015, to lead to weakening of the euro. The central bank does not release statistics about the proportion of foreign (non-euro) investors holding QE-eligible sovereign debt. Market estimates suggest they could represent about 25% of the total. What's clear, however, is that capital outflows have increased dramatically since the ECB's QE program started in March 2015 (see chart 2).

Chart 2

Capital Outflows Have Risen Under The ECB's QE Program



Note: A positive (negative) number indicates net outflows (inflows) from (into) the euro area. Source: European Central Bank.

Theoretically, the stronger outflows should correspond to a weaker euro (due to sales of euros), but this has not been the case. In a speech delivered on Nov. 3, 2017, Benoit Cœuré, a member of the ECB's Executive Board, offered an interesting explanation of this apparent conundrum. In short, according to Mr. Cœuré, the exchange rate effect takes place as soon the asset purchase program is announced, since "central banks' asset purchase programmes can be anticipated by investors. This means that exchange rates should adjust in a way that clears the expected future supply to meet the demand for currency resulting from anticipated cross-border capital flows."

Mr. Cœuré went on to state that "the moment the ECB announced its credit easing programme in June 2014, which many observers considered to be a harbinger of sovereign bond purchases [], the dollar started to appreciate significantly against the euro. In less than two and a half months the euro lost nearly 10% in value." In other words, foreign exchange market investors seem to be ahead of bond market investors, with the former anticipating depreciation of the euro (before the start of the QE program) followed by strengthening (before the program ends and the ECB starts reducing bond purchases).

Cyclical factors appear to support the euro.

This explanation is quite compelling. But other factors have undoubtedly also contributed to the dollar's recent decline, and one is structural. Foreign exchange reserves in euros shrank during the European sovereign debt crisis, with the share of global reserves in euros falling to 20% from 25%. As confidence in the eurozone's long-term viability returns, foreign exchange reserve managers are slowly rebuilding their holdings in euro, providing support to the currency. In addition, cyclical factors seem to favor the euro (or rather, disfavor the U.S. currency). Stronger growth in the U.S. has been associated with a rise in the twin deficits (fiscal and current accounts). In the eurozone, the reverse is true. The U.S. fiscal deficit could widen to 5% of GDP over the next few years, while the consolidated fiscal deficit in the eurozone will likely be less than 1% of GDP in 2018 compared with 1.5% in 2016. The prospects of U.S. bond price erosion in the coming year may lead foreign investors, especially from Asia, to trim their holdings of U.S. assets. Second, and even more crucially, an increasing U.S. current account deficit will continue to weigh on the exchange rate. In the fourth quarter (Q4) of last year, the U.S. current account deficit was up $27 billion to $128.2 billion, or 2.6% of GDP. Meanwhile, the eurozone current account surplus rose to 3.6% of GDP this January from 3.3% a year earlier.

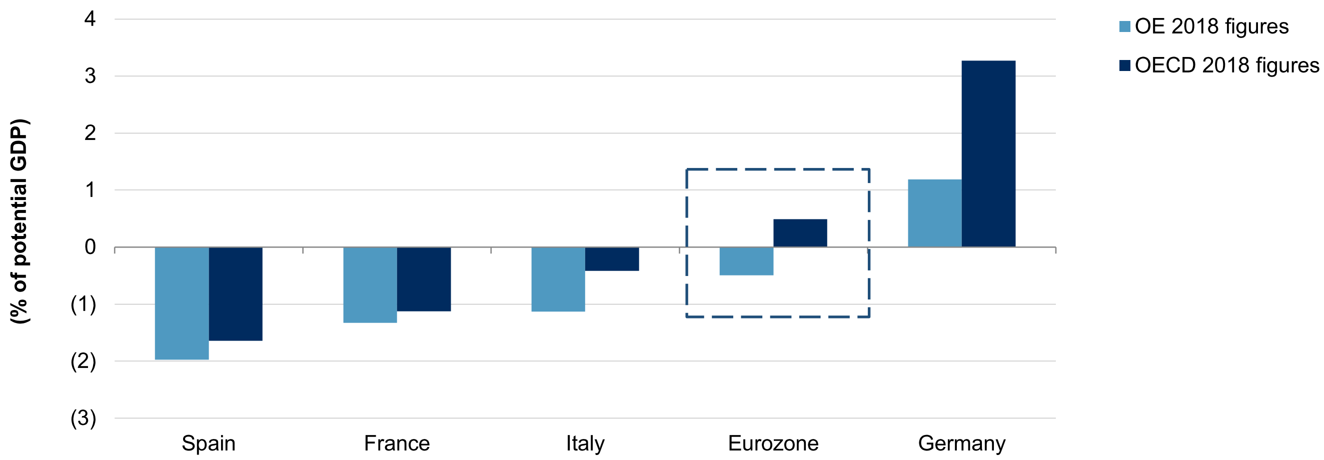
On balance, we believe the dollar's value will continue to slide downward. Our base-line forecast has the euro against the dollar at $1.30 in Q4 of 2018 and $1.28 a year later. Given the intricacy of conflicting factors, the path toward an even stronger euro may not be straightforward and we foresee short-lived rebounds of the greenback along the way. But the direction of travel seems well established.

Has The Eurozone Reached Its Full Potential?

The decline in eurozone sentiment surveys since the start of 2018 is not a major concern, since the indicators remain high and therefore still point to healthy growth. However, the dip in numbers shows that this part of the cycle has likely reached a peak, and the economy is transitioning from recovery to a more mature phase. Now that the output gap is closing (see chart 3), supply-side factors are becoming more important determinants of economic growth than demand catch-up. Hence, the key question now is: What is the eurozone's potential output? The answer to that will provide valuable insight into how fast tensions will build up in the economy and how quickly they translate into price pressures, driving the speed of monetary policy normalization.

Chart 3

The Eurozone's Output Gap Is Almost Closed

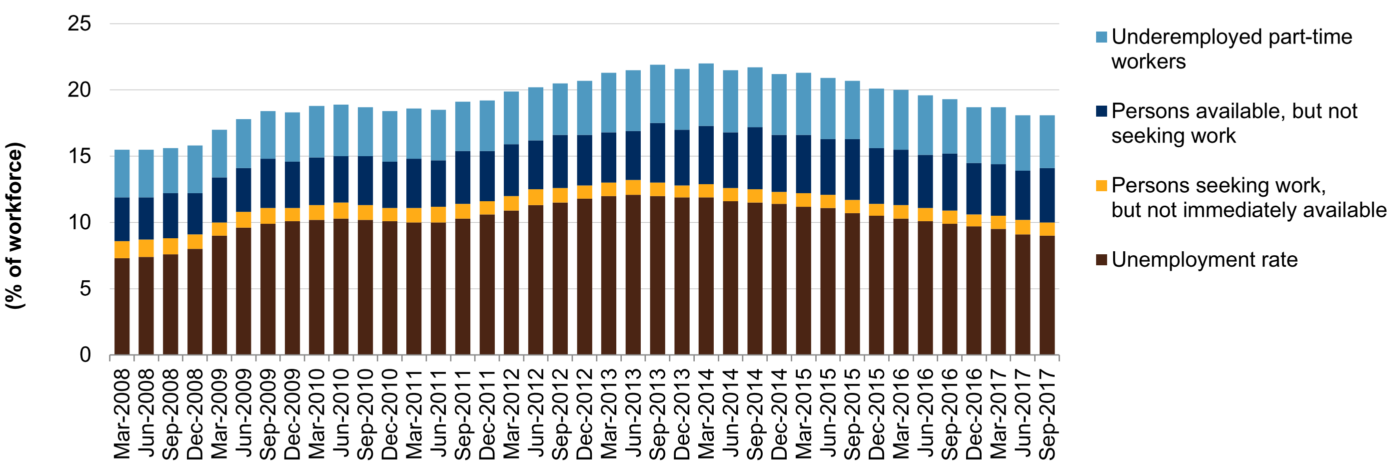


Note: The output gap is the deviation of actual GDP from potential GDP. Sources: OE (Oxford Economics), OECD (Organization for Economic Cooperation and Development).

Yet potential output is difficult to gauge, mainly because measures of potential output and the output gap are subject to many uncertainties. To begin with, since the crisis, eurozone countries have engaged in a number of supply-side reforms that have obscured the degree of slack, especially in labor markets. Although the unemployment rate is now below its pre-crisis average, underemployment is still higher than before the crisis. What's more, long-term unemployment has decreased steadily since 2014, suggesting that the unemployment rate still has further to fall (see chart 4). At the same time, pension reforms and the rising participation of women in the labor force have increased the labor supply, offsetting the negative effects of poor demographics. With the female participation rate still 10 percentage points below male participation, and the employment rate among 55-64 year olds below 60%, this trend will continue in the coming years.

Chart 4

Eurozone Unemployment Still Exceeds Precrisis Levels*

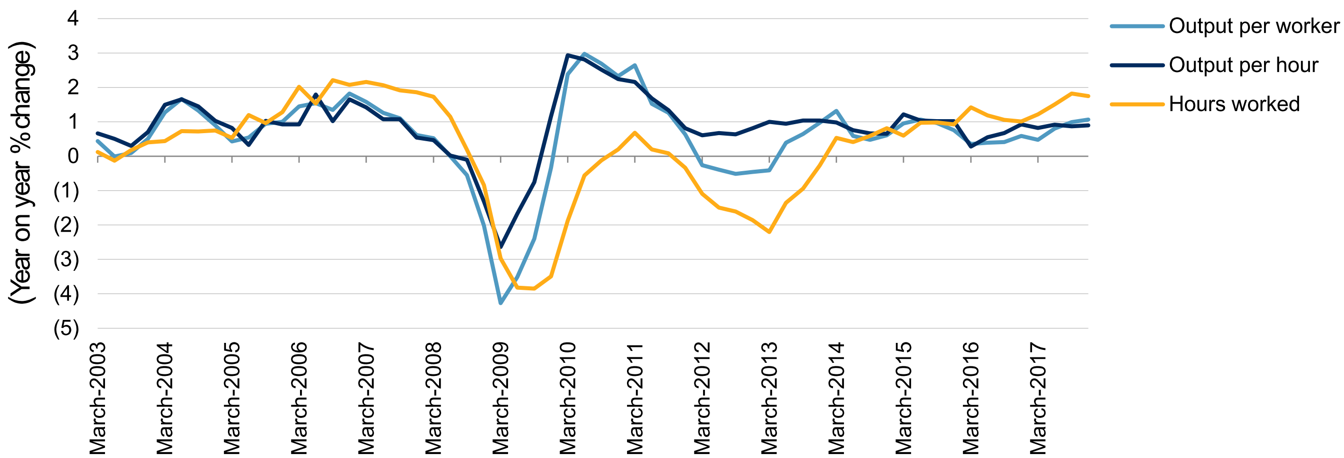


*According to the so-called "U6" indicator, the eurozone's broad measure of unemployment. Sources: Eurostat and S&P Global Ratings.

In the meantime, productivity improvements have been meagre since the crisis, with output per worker only 4.4% higher at the end of 2017. Yet, at this stage of the cycle, we typically see an uptick in productivity. While it is still unclear how much recent structural reforms will reduce capital misallocation, we can already see that stronger demand has been beneficial for productivity growth (see chart 5). In the short term, stronger investment and longer working hours will continue to boost output per worker. However, in the longer term, the weak diffusion of innovation between frontier and non-frontier firms (a key source of low productivity according to the OECD) will remain a challenge. Normalization of monetary policy from next year will put some pressure on lower-productivity firms, but only marginally in the medium term, since we expect rate increases will be very gradual.

Chart 5

Some Productivity Gains This Year On Steady Demand



Source: European Central Bank.

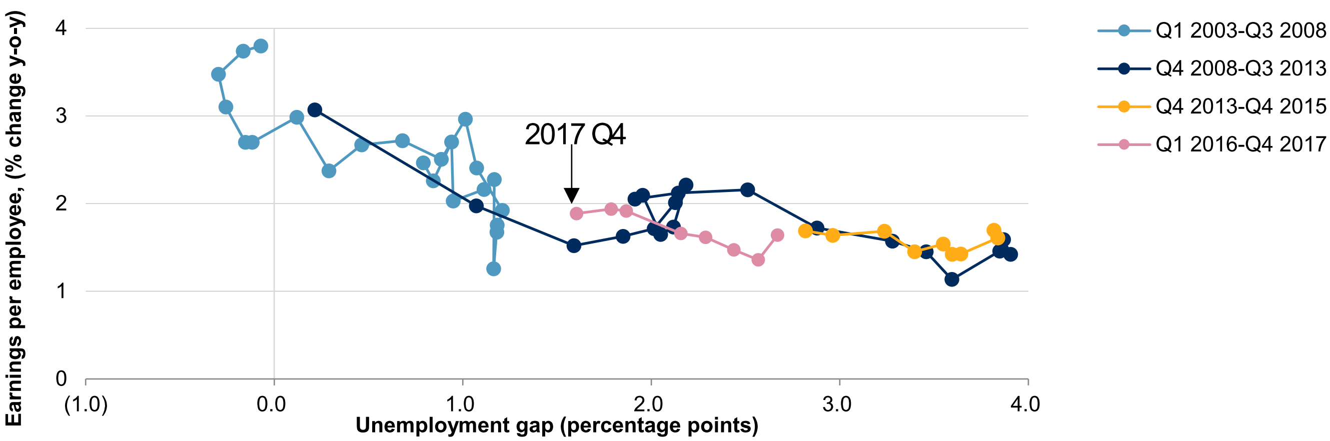
On balance, we consider that potential growth in the eurozone is picking up, but the increase will likely be closer to 1.5% than the 2.3% GDP growth we project this year. This means capacity pressures will continue to mount. However, for several reasons, we expect underlying price movements to remain relatively subdued this year and next, with annual inflation at around 1.4%:

- First, significant slack in the labor market suggests that wage growth will be slow to gather pace. In Germany, where the unemployment rate is at a historical low, trade unions have only now achieved a 4% wage rise.
- Second, wage inflation will not immediately translate into inflation if it reflects productivity increases. Last year, output per worker increased by 0.8%; therefore, core inflation remained at about 1.2% even though earnings grew by almost 2%.
- Third, Germany has placed a cap on unit labor costs growth since the crisis, with countries on the region's periphery seeking convergence of these costs with the eurozone average. It is only now that earnings are rising there.

The slow rise in inflation means it will take longer to tighten monetary policy. Because inflation will likely remain subdued this year, we expect the ECB will only gradually wind down its asset purchase program from September until the end of this year. Nonetheless, the relationship between unemployment and wages (the Phillips curve) is alive and well (see chart 6). As the gap between structural and real unemployment diminishes, earnings growth will accelerate . Thus, we think underlying inflation is set to move closer to the ECB's target at the end of 2019, giving the ECB enough leeway to raise rates in Q3 2019.

Chart 6

The Phillips Curve Is Alive And Well



Source: Eurostat, Oxford Economics, S&P calculations

Main European Economic Indicators March 2018

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2016	1.9	1.1	1.0	3.3	2.1	1.5	1.8	1.9	1.4
2017	2.5	2.0	1.5	3.0	3.2	1.7	2.5	1.7	1.0
2018f	2.4	2.2	1.5	2.7	2.8	1.8	2.3	1.3	2.3
2019f	1.9	1.8	1.3	2.3	2.2	1.6	1.9	1.5	1.7
2020f	1.5	1.7	1.2	2.0	1.9	1.6	1.7	1.6	1.6
2021f	1.3	1.4	1.0	1.8	1.5	1.6	1.4	1.4	1.6
CPI (%)									
2016	0.4	0.3	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
2018f	1.7	1.4	1.2	1.4	1.6	1.7	1.4	2.3	0.7
2019f	1.8	1.2	1.3	1.5	1.8	1.7	1.4	1.9	0.9
2020f	1.9	1.6	1.6	1.6	1.9	1.8	1.7	1.9	1.3
2021f	2.0	1.8	1.8	1.8	1.9	1.9	1.9	2.5	1.3
Unemployment rate (%)									
2016	4.2	10.0	11.7	19.6	6.0	7.9	10.0	4.9	3.3
2017	3.8	9.4	11.3	17.2	4.9	7.2	9.1	4.4	3.2
2018f	3.5	8.8	10.8	15.1	4.1	6.4	8.2	4.5	3.0

Main European Economic Indicators March 2018 (cont.)

2019f	3.4	8.4	10.3	14.1	3.7	6.2	7.8	4.6	2.9
2020f	3.3	8.1	9.9	13.4	3.5	5.9	7.5	4.6	2.7
2021f	3.2	7.8	9.7	12.9	3.5	5.8	7.2	4.7	2.7
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)
2018f	0.8	1.2	2.3	1.8	1.0	1.1	1.4	1.8	0.3
2019f	1.3	1.7	3.2	2.6	1.5	1.7	1.9	2.5	0.7
2020f	1.6	2.1	3.6	3.0	1.9	2.1	2.3	3.1	1.0
2021f	1.8	2.4	3.9	3.3	2.1	2.4	2.6	3.5	1.2

Central banks policy rates (yearly average)

	Eurozone ECB	U.K. Bank of England	Switzerland SNB
2016	0.01	0.40	(0.75)
2017	0	0.29	(0.75)
2018f	0	0.69	(0.75)
2019f	0.08	1.13	(0.69)
2020f	0.45	1.44	(0.44)
2021f	0.70	1.72	(0.19)

Exchange rates

	--Eurozone--		U.K.	--Switzerland--	
	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
2018f	1.27	1.41	1.11	0.91	1.16
2019f	1.30	1.47	1.13	0.91	1.17
2020f	1.25	1.42	1.13	0.94	1.18
2021f	1.25	1.40	1.12	0.94	1.18

CPI--Consumer price inflation. f--S&P Global economists' forecasts.

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