Eurozone Outlook

Group Economics

Macro & Financial Markets Research

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Will politics derail the recovery?

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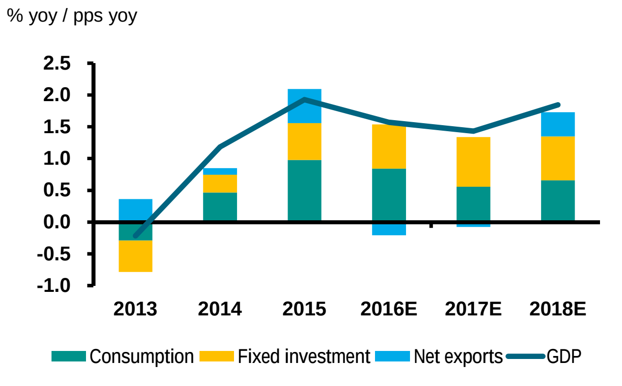
- **We expect that the eurozone recovery will gain some momentum in the coming quarters, on stronger exports and investment**
- **We judge upcoming votes will have relatively benign outcomes, but politial risks are large, and could lead to uncertainty and a tightening of financial conditions – so risks are to the downside**
- **We do not expect Trumpflation in Europe: fiscal policy is unlikely to be eased significantly meaning the recovery will remain moderate, given monetary policy is having less traction**
- **The inflation rate will rise due to higher energy price inflation, but core inflation will remain subdued for a while and will pick up materially only in the course of 2018**
- **The ECB is expected to extend its QE programme and not start tapering its asset purchases until around March 2018**

Improving growth momentum, but politics a major risk

We expect eurozone economic growth to firm over the coming quarters. Overall, GDP should expand somewhat above the trend growth rate of around 1-1.25% in 2017 and gain some further pace in 2018. Stronger export and fixed investment growth should underpin the recovery. However, a strong upswing is unlikely. Consumer spending growth will moderate, while a Trump-style fiscal stimulus is unlikely. Meanwhile, political risks remain elevated, implying that there are significant downside risks to our growth forecast.

GDP growth and contribution of main components



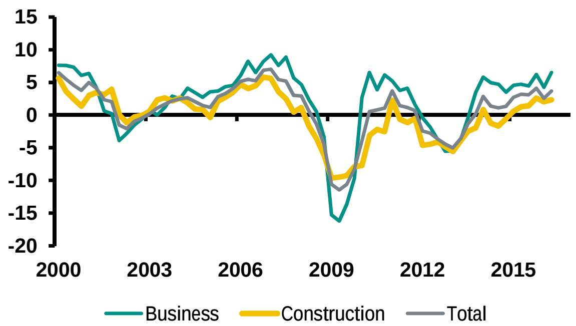
Source: Thomson Reuters Datastream, ABN Amro Group Economics

Fixed investment growth should pick-up somewhat …

We expect the eurozone recovery to be sustained by stronger investment and export growth in 2017-2018. Fixed investment growth has been growing steadily at a rate of around 3-3.5% since the end of 2014. During this period, growth in investment by non-financial companies went hand in hand with robust profit growth and rising business confidence. We expect business investment growth to pick up somewhat in 2017 (to an annual rate of around 4%) and to slow down modestly in the course of 2018 as the financial conditions are expected to tighten that year (higher bond yields). That said, the high level of political risks in the eurozone imply that there are significant downside risks to our outlook for business confidence and fixed investment growth. Meanwhile, construction investment should continue to be supported by a further improvement in housing markets throughout the eurozone.

Fixed investment growth

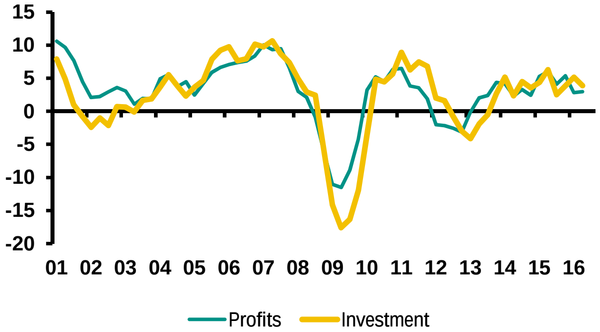
% yoy



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Non-financial companies, profits and investment

% yoy



Source: Thomson Reuters Datastream, ABN Amro Group Economics

… and net exports are expected to support growth again in 2017-18

Gradually rising global economic growth should support eurozone exports in the coming years. Indeed, we expect the global economy to expand at a somewhat faster pace in 2017-2018 than in 2016. Moreover, the fall in the trade-weighted euro exchange rate should support eurozone net exports in the coming years as well, although trade flows usually react to changes in the exchange rate with a delay. The trade-weighted euro has already depreciated by almost 2% since early November and we expect this trend to continue. Overall, we see the exchange rate depreciating by around 6.5% in 2017. This should lift net exports in the second half of 2017 and in the first half of 2018.

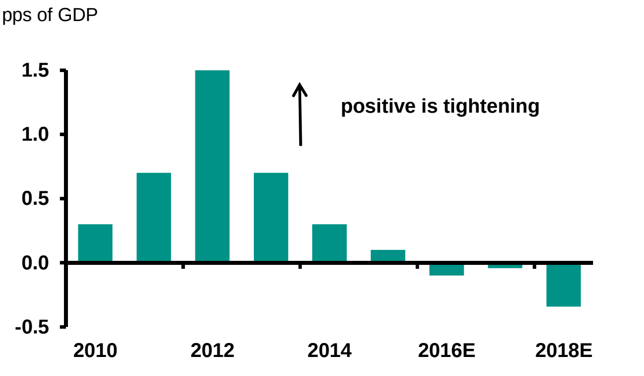
Private consumption to slow down next year …

There are also factors limiting the pace of recovery next year, though prospects are better in 2018. Private consumption, which was the main driver of growth in 2015 and 2016Q1 slowed down in Q2 and Q3 of 2016. We expect it to slow down further in 2017 due to a combination of higher inflation and moderate wage and employment growth. Wage growth has come down in Q2 after it was well above the inflation rate throughout 2015, implying that growth in real household income has declined. In 2018, consumption is expected to strengthen again, as wage and employment growth should increase, while inflation should rise only modestly. Meanwhile, in the eurozone as a whole, households still seem to be in a process of strengthening their financial balance. This is illustrated by the fact that households' net worth has risen significantly during the past 2.5 years, while the savings rate has remained stable, implying that the rise in net worth was not used for consumption.

…and no significant fiscal stimulus on the cards

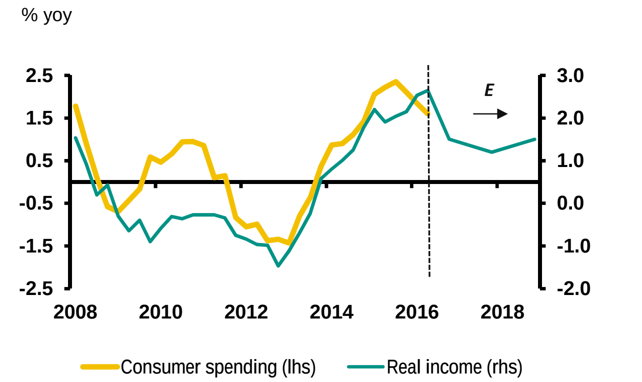
At the same time, a large fiscal stimulus in the eurozone is unlikely, meaning the recovery will remain moderate, given monetary policy is having less traction. The European Commission recently published a note in which it recommends that fiscal policy should be eased moderately in 2017-2018. According to the current country-specific recommendations of the EU, fiscal policy would be moderately tightened in 2017-2018 in the eurozone as a whole, after it was broadly neutral in 2016. This would be sub-optimal, according to the EC. It mentions that there is a case for fiscal stimulus of around 0.5% GDP in the eurozone as whole, given the "slow recovery and risks in the macroeconomic environment". Still, the countries with high budget deficits and/or high debt ratio's should tighten policy further, according to the EC.

Fiscal policy expected to be eased in 2018



Source: European Commission, ABN Amro Group Economics

Real disposable income and private consumption



Source: Thomson Reuters Datastream, ABN Amro Group Economics

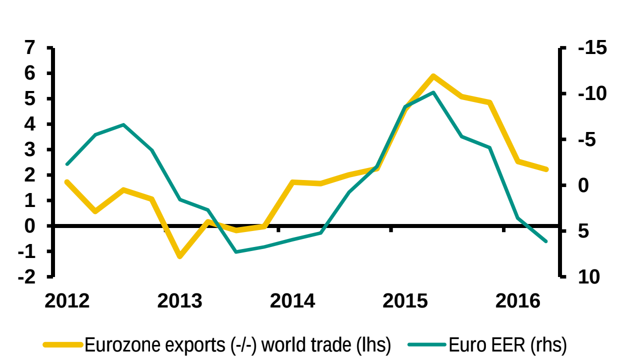
Germany and the Netherlands not playing ball

In practice, this leaves Germany and the Netherlands as the only two big member states that have the option to ease policy. Indeed, in their 2017 Budgets both Germany and the Netherlands plan to ease policy somewhat in 2017, when general elections are due in both countries (the Netherlands in March and Germany in the autumn). However, most other countries (besides Italy, which will violate the long-term objectives and will ease policy) plan to tighten policy further, implying that the overall fiscal stance will be roughly neutral in 2017. In 2018, we expect policy to be eased somewhat. Peripheral countries that suffer from austerity-fatigue and have a below average growth outlook probably will feel strengthened by the recommendations of the EC, while resistance among the core countries will probably ease following the elections in Germany.

Major political challenges ahead…

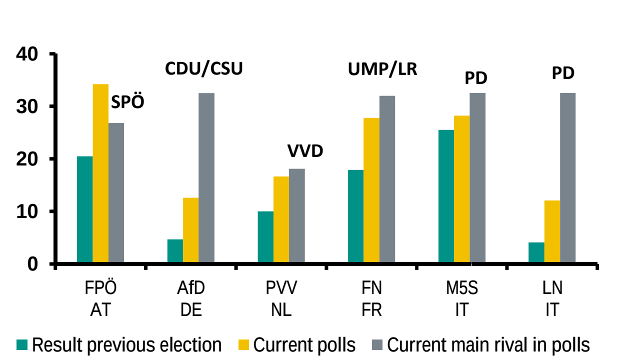
Several major political events are on the agenda in the eurozone during the rest of this year and in 2017 and 2018. They all entail significant risks and might result in a shift in power towards Eurosceptic parties, some of which have a euro referendum and a possible 'exit' on the agenda. To start with, on 4 December Italy's constitutional referendum and the second round of Austria's presidential elections are on the calendar. Next, presidential elections will be held in France in April-May 2017, general elections in the Netherlands on 15 March and in Germany in the autumn of 2017. In Italy, the next general election is due in the spring of 2018 and in Austria in the autumn of that year. In all these countries the popularity of Eurosceptic anti-establishment parties has risen sharply since the previous elections (see graph below). In Italy the M5S is neck and neck with the Democratic Party of prime minister Renzi. In the Netherlands the same holds for the PVV and the VVD of prime minister Rutte. Meanwhile, in Austria the Eurosceptic FPÖ has been leading the polls by a wide margin for more than a year and in France Marine Le Pen of the Front National is high in the polls for the next presidency. Finally, in Germany, the AfD is still significantly smaller than Angela Merkel's CDU/CSU, but it has gained support since the previous elections. Beside the abovementioned political risks in the eurozone, there still is the risk of a 'hard' Brexit where the UK and the rest of Europe clash and distorted trade relations become harmful to both parties.

Trade-weighted euro and net exports



Source: Thomson Reuters Datastream, ABN Amro Group Economics

Eurosceptic parties gain popularity



Source: various polling agencies

… we assume relatively benign outcomes, but risks are high

We have assumed that none of these political events will turn into a worst case scenario. For instance, in Italy, we have assumed that even in case of a 'No' vote in the referendum there will be no early elections, either because Mr Renzi will stay in office or because his party will appoint a new prime minister. Still, the risks of one of the aforementioned political events turning out badly are very high. In that case, the eurozone economy could be derailed by tightening financial conditions (as peripheral and credit spreads balloon and banks become more cautious) and heightened uncertainty. So the balance of risks to are baseline scenario are tilted to the downside.

Headline inflation will accelerate…

What is the outlook for ECB policy? Despite the ongoing moderate economic recovery, inflation has remained well below the central bank's medium price stability goal of close to but below 2%. Headline inflation will likely accelerate significantly in the coming months, to exceed 1% early next year, as annual energy inflation swings into positive territory. However, the ECB's focus is on a clear sustained rise in underlying inflation before starting to wind down its asset purchase programme.

…but core inflation will remain weak

Core inflation has been flat at 0.8% over recent months, and in the near term it will more likely trend down rather than up. One reason for that is wage growth has not only been weak, but it has also been on a downward trend. Although unemployment has been coming down, it remains high, meaning there is still slack in the labour market. This means employees do not have the bargaining power to demand higher wages. In addition, the continued undershoots of the ECB's inflation target likely means that relatively low rates of inflation are used as a starting point in labour negotiations. Most estimates suggest that unemployment in the eurozone will need to approach 9.5% (from the current 10%) before pushing up wage inflation. So even with the ongoing recovery, we do not expect a material rise in wage growth or core inflation to take shape until the turn of 2017- 2018.

QE exit not until 2018

Given this outlook for core inflation, we think that the ECB will not be in a position to wind down its QE programme until March 2018. So we expect the ECB to announce an extension of asset purchases at next month's meeting to September 2017 from March 2017 at the current pace of EUR 80bn. We subsequently expect the ECB to extend further to March 2018, before tapering asset purchases thereafter. At the December meeting, we also expect the ECB to take measures to expand the eligible universe of assets. We think it will decide to remove the restrictions on it buying bonds yielding below the deposit rates as well as those below a 2y maturity.

Bond yields to rise next year, spreads elevated

German government bonds should remain supported in the near term by the extension of ECB QE and weak underlying eurozone inflation – please see our Rates Outlook for more on this (for professional clients, see disclaimers in the document). The removal of the deposit rate floor for purchases will probably lead to a steepening of the yield curve, as short-end yields decline. In the latter part of next year, we expect a more significant rise in German 10y yields (to 0.8% by year end), as markets start to price in a tapering of asset purchases in early 2018. We see the US-Germany 10y spread peaking at 220bp in 2017Q3, before narrowing thereafter. Finally, we have generally built in more elevated peripheral spreads in our forecasts due to more pronounced political risks, and later on, tapering expectations.

EUR/USD to break through parity next year

We expect the EUR/USD to break through parity next year. This reflects monetary policy divergence between the Fed and ECB as well as European political risk. Looking further ahead, as soon as expectations of ECB tapering start to build in the market at the turn of 2017-2018, this will likely lead to a revival of the euro, with the EUR/USD moving back up.

Key forecasts for the economy of Eurozone

	2014	2015	2016e	2017e	2018e
GDP (% yoy)	1.2	1.9	1.6	1.4	1.8
CPI inflation (% yoy)	0.4	0.0	0.2	1.2	1.6
Core inflation (% yoy)	0.8	0.8	0.9	0.7	1.4
Budget balance (% GDP)	-2.6	-2.1	-1.9	-1.7	-1.8
Government debt (% GDP)	94	93	92	91	90
Current account (% GDP)	2.9	2.9	2.9	2.8	3.2
Unemployment (%)	11.6	10.9	10.1	9.7	9.0
EUR/USD	1.21	1.09	1.07	0.95	1.10
ECB deposit rate	-0.20	-0.30	-0.40	-0.40	-0.40
10yr yield (Bund)	0.5	0.6	0.2	0.8	1.2

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

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