# SPECIAL REPORT

## TD Economics

June 20, 2017


# EUROPE TURNS A CORNER, BUT ECB TIGHTENING STILL A WAY OFF

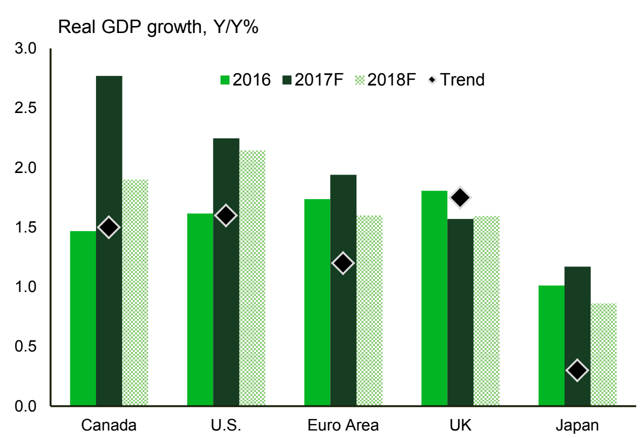
### Highlights

- Growth in the Euro Area economy has surpassed its estimated trend rate in each of the past six quarters, capping off its strongest period of growth since the initial recovery from the 2009 financial crisis. While the core countries have been leading the charge, the expansion appears to be broadening.
- While the recent pace is unlikely to be sustained, we expect growth to remain above-trend in the coming quarters. This economic progress will keep markets guessing about the timing of removal of extraordinary stimulus by the European Central Bank.
- However, with significant slack still evident in labor markets, and underlying inflation likely to remain well below target beyond 2018, the central bank will proceed with caution, keeping monetary conditions highly accommodative for some time yet.

The Euro Area's recovery from the Great Recession of 2009 has been a rocky road. After a brief recovery, the euro crisis of 2011-2012 not only sunk the region into a prolonged period of economic contraction, but also threatened the existence of the euro. However, since the second half of 2015, growth has picked up, and unemployment has been steadily falling. In fact, Euro Area growth managed to outpace that of the UK and the U.S. in 2016, with 1.7% growth second only to the UK (1.8%) among G7 economies.

The positive momentum has extended into this year, with Euro Area expansion likely clocking in at roughly 2.0% on an annualized basis over the first and second quarters, almost double the region's estimated trend rate of around 1.2%. While this brisk pace is unlikely to last beyond the near term, above trend growth is expected to persist through 2018 (Chart 1), leading to a steady absorption of slack and raising questions of what this means for monetary policy over the next several quarters. Given the lack of progress on underlying inflation pressures, it's likely that the ECB will remain cautious and maintain the high level of accommodation for some time to come.

**CHART 1: EURO AREA OUTPERFORMANCE EXPECTED TO CONTINUE**

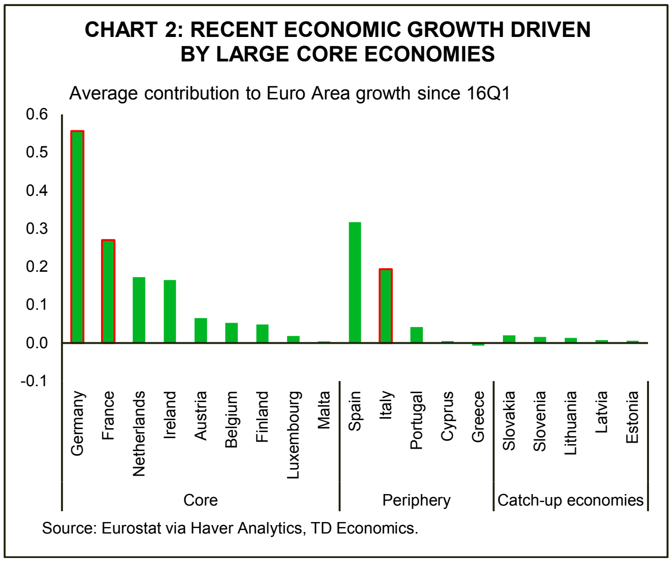


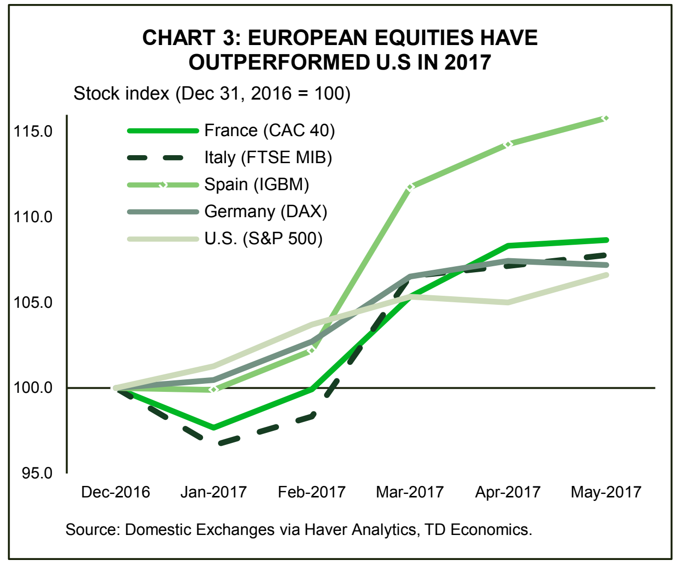

Source: 2016 Data by National Statistical Agencies, Forecasts for 2017-18 by TD Economics as at June 15, 2017

### Core surge driving the recovery

Although the recent uptick in economic growth in the Euro Area has been broad-based, strong growth in the three largest economies (Germany, France, and Italy) has greatly contributed to the recent outperformance (Chart 2). What's more, the Euro Area is likely to outperform the United States in the first half of 2017, although this is at least partly due to slower first quarter growth in the United


Fotios Raptis, Senior International Economist, 416-982-2556




States as highlighted in a recent note. This narrative of better than expected growth is helping drive interest in European assets, with European equities outperforming U.S. equities year-to-date (Chart 3), and leading to a firming in the euro against the U.S. dollar in trade-weighted terms.

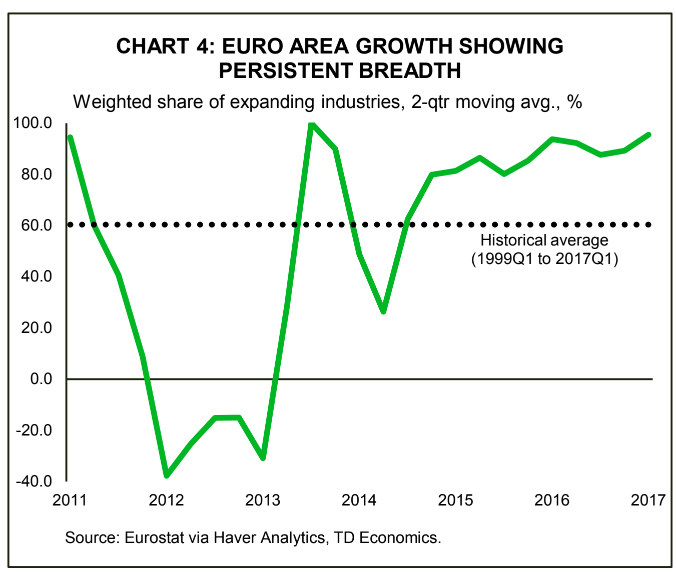
Strong growth in the Euro Area has industry breadth as well. Over 80% of Euro Area industries, including everything from agriculture to public services, have grown persistently since the second half of 2014 (Chart 4). Some of the fastest growing industries include professional science and technology, information and communications, and manufacturing.

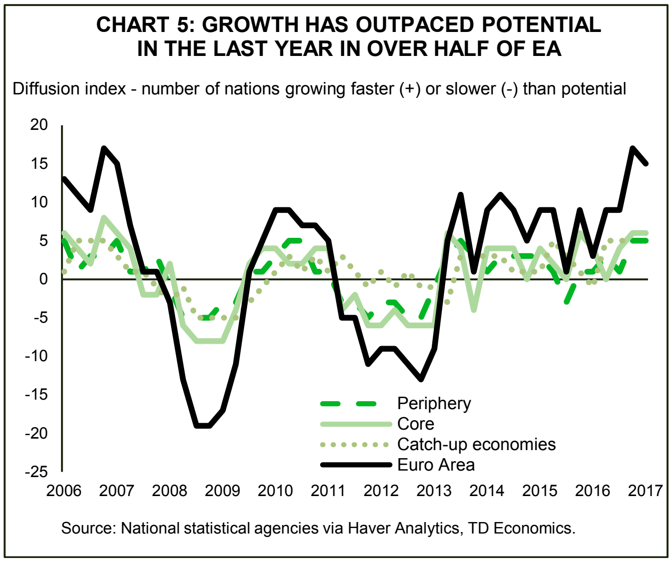
In order to better assess the extent to which improving breadth of growth is taking place along regional lines, we have established a diffusion index.[1] We have divided the block into three groups: the Core (Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, Malta, and the Netherlands); Periphery (Cyprus, Greece, Italy, Portugal, and Spain); and Catch-up economies (Estonia, Latvia, Lithuania, Slovenia, Slovakia). The Core of the Euro Area contains the wealthiest members of the Euro Area as measured by per capita GDP. The Periphery includes mostly Southern European nations at the core of the euro crisis and as such were hardest hit. The Catch-up group contains the newest and poorest members that are also growing the fastest, keeping them on track to eventually catch-up to the rest of the Euro Area in terms of wealth as measured by per capita output.

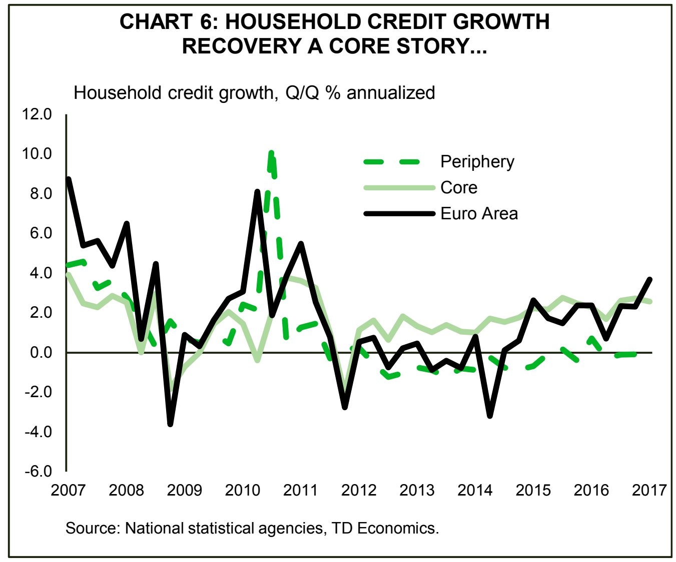
Chart 5 shows the outperformance of GDP growth in the Euro Area, driven largely by an uptick in both the Core and Catch-up economies that has persisted now for over a year. It's encouraging to see that over the last few quarters, economic activity has exceeded trend in about half of the Euro Area. Moreover, of the countries growing faster than trend, a quickening in the recent pace of expansion has been observed in all but three countries. This outperformance has been driven by a firming of domestic demand (consumption, investment, and fiscal spending).

## Easing credit conditions supporting growth

The extraordinary amount of monetary accommodation introduced by the ECB since 2014 has undoubtedly helped support the economic recovery in Europe. Interest rate sensitive categories such as business investment have begun to rebound strongly, as has household consumption. Bank lending in the Euro Area has picked up considerably since its extraordinary monetary policy measures began over






three years ago (Charts 6 & 7). A negative deposit rate has also helped by encouraging banks to lend rather than hold deposits with the ECB.

The positive credit impulses are likely to continue to flow in the near term and continue to benefit private sector spending activity. These impacts, together with the lift from modestly stimulative fiscal policies overall in the Euro Area, should help to support above-trend growth in the coming quarters.

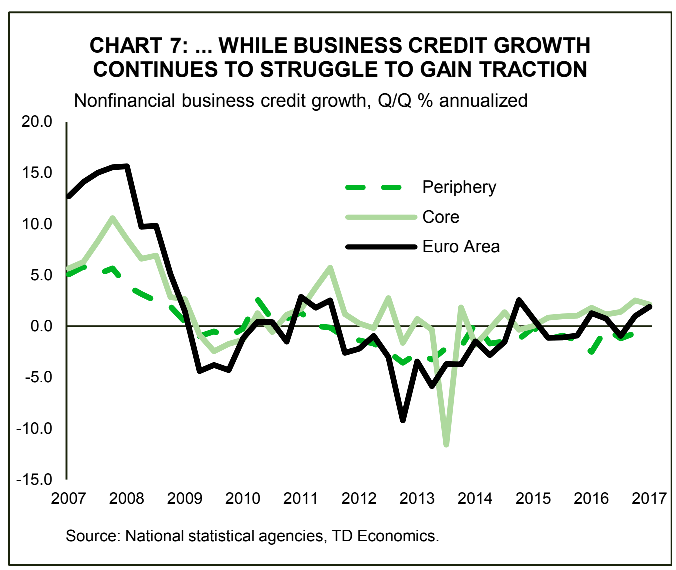
Still, some narrowing in the gap of actual growth relative to trend can be expected. In particular, business investment is unlikely to remain at elevated growth rates. For one, the strength in business investment at the end of 2016 was driven by a surge in intellectual property products – a noisy component of business investment that slowed in 17Q1. Furthermore, while business sentiment has proven resilient despite geopolitical events, elevated uncertainty from upcoming European elections and Brexit concerns should continue to hold back business investment somewhat for some time yet.

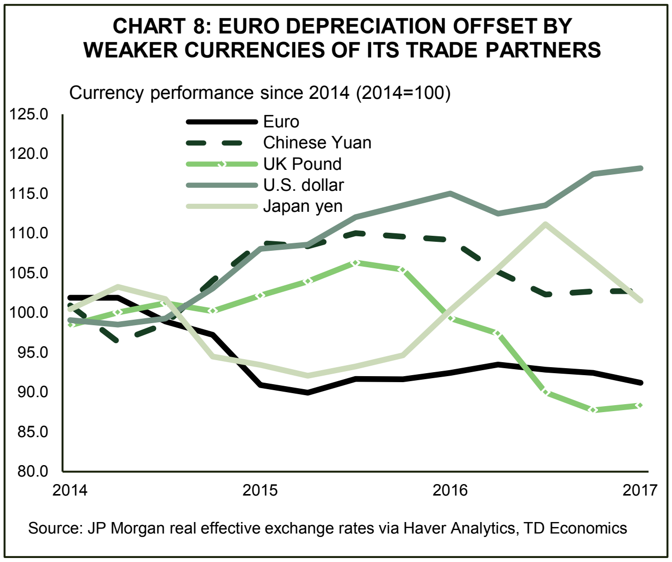
Although low interest rates helped fuel euro weakness, net trade has remained stubbornly subdued in the Euro Area as a whole. This was likely due to relative currency strength and weak foreign demand. Notably, the persistence of very weak inflation in the aftermath of the euro crisis implied higher real interest rates than its major trade partners, supporting a stronger currency and offsetting downward pressure from looser ECB monetary policy. However, the uptick in headline inflation over the last few quarters, albeit largely transitory in nature due to base-year effects from higher energy prices, helped keep the euro relatively flat in real terms while the currencies of some of its trading partners appreciated (Chart 8).

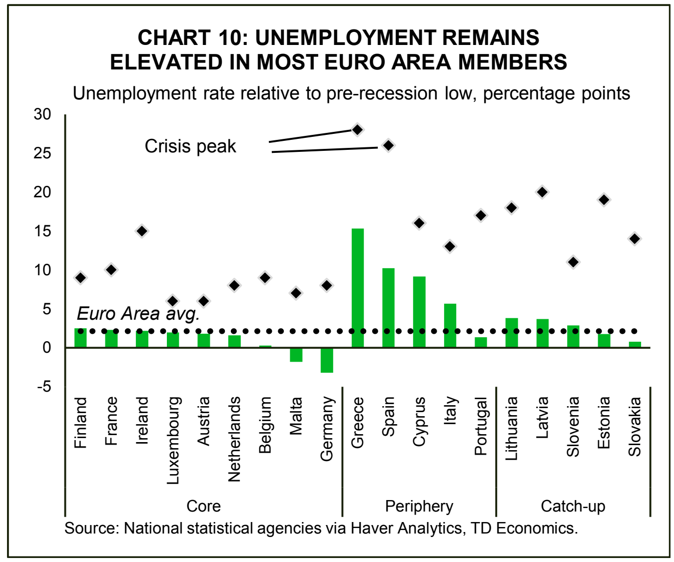
Going forward, the euro is unlikely to provide much in the way of stimulus to net trade as underlying inflation is expected to remain subdued and below the ECB's target through 2018. This suggests that the euro relative to the U.S. dollar in real terms has likely bottomed.

While strengthening global demand should provide some support to Euro Area exports, net trade will likely remain subdued while intra-trade imbalances, such as large current account surpluses in Germany, are expected to remain contentious.

Putting it all together, we believe that the positive domestic forces should continue to win out and help to sustain the recovery over the next six quarters. Indeed, our outlook for the Euro Area calls for above trend economic growth to






persist, with growth slowing from its current 2.0% annualized pace to about 1.6% in 2018. Consistent with this outlook is a view that unemployment will continue to fall, making progress toward pre-crisis levels, including in economies with significant economic slack.

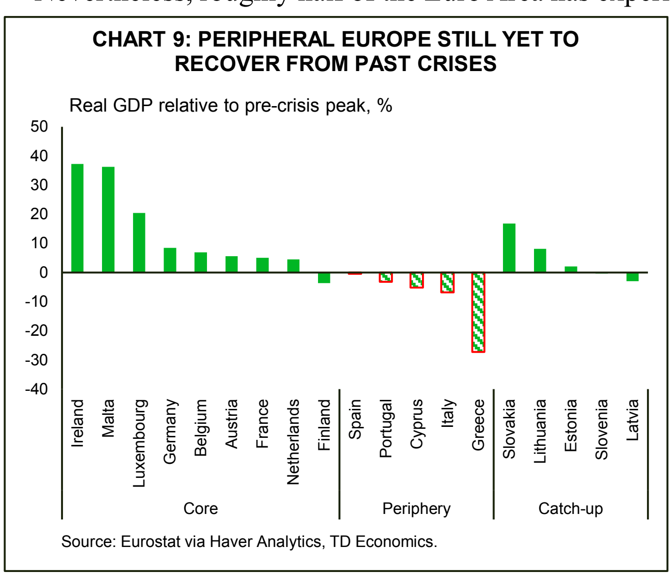
## Labor market has tightened

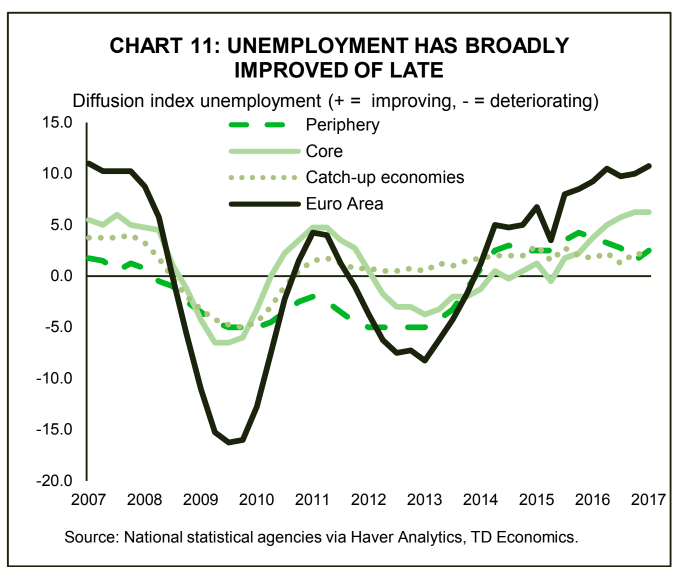
Above trend growth is a sign that economic slack is being quickly absorbed in the region. However, there are a number of regions in which a full economic recovery is still a way off (Chart 9), mainly those in peripheral Europe.

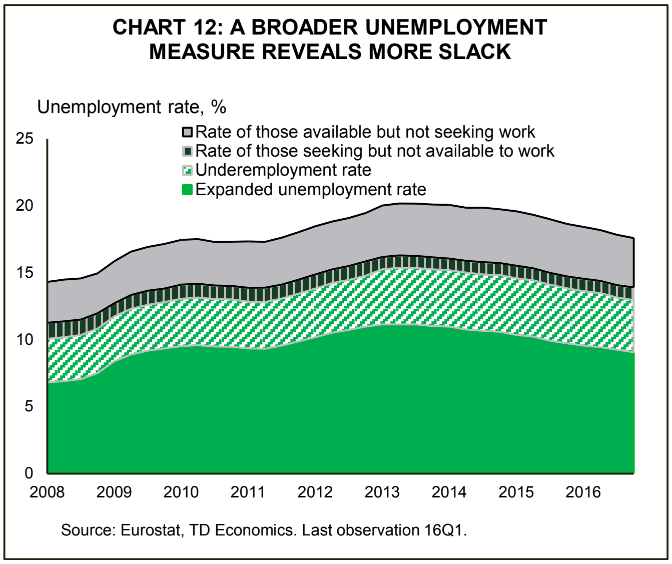
Labor market indicators serve to confirm that a material amount of slack remains. Unemployment remains above its pre-2009 financial crisis level in all but two markets: Germany and Malta (Chart 10).

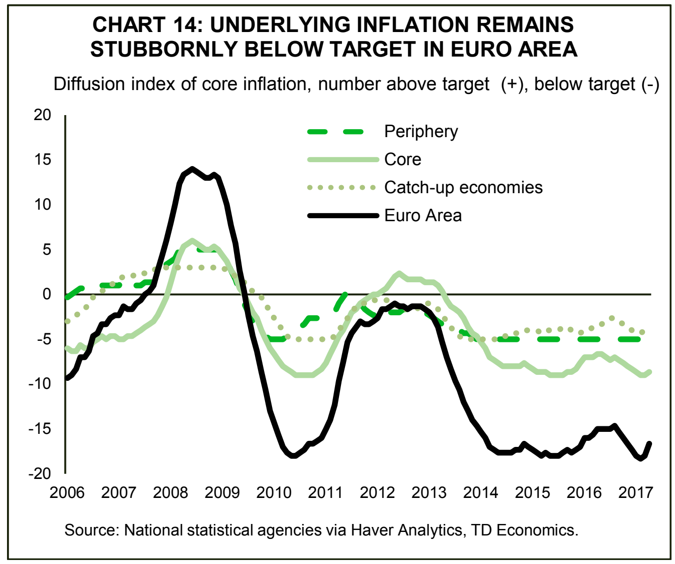
Nevertheless, roughly half of the Euro Area has experienced steady declines in unemployment over the past year (Chart 11). Much of the improvement has been concentrated in core economies, and although progress in the periphery has slowed of late, recent data suggest that unemployment rates in these countries have peaked.

Still, a broader measure of unemployment recently developed by researchers at the ECB and similar to the U.S. U-6 unemployment rate implies a more gradual recovery in labour markets than that signaled by the unemployment rate alone.[2] Chart 12 shows that the addition of underemployed and discouraged workers ('those available but not seeking work') raises the Euro Area unemployment rate to more than 17.5% by the end of 2016 – about 3 percentage points higher than at the start of 2008, and almost double the prevailing conventional unemployment rate of 9.3%.





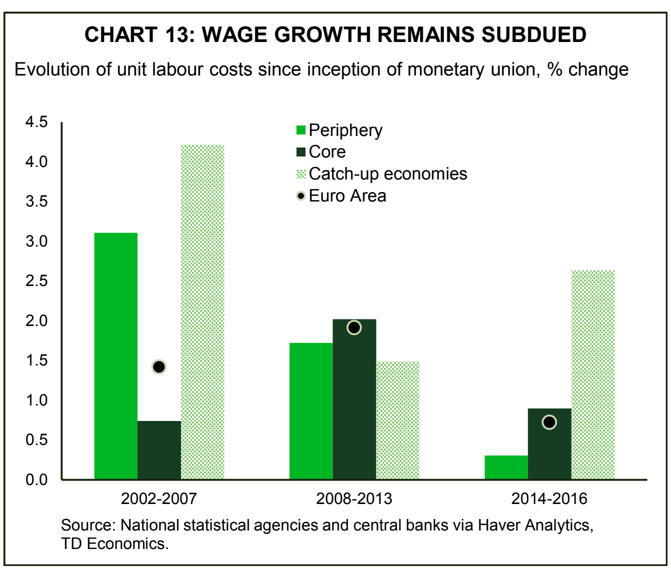

## But price pressures to continue lagging

Normally, gradually tightening labor markets result in a build-up of wage pressures, but this is something that has generally been absent in the Euro Area for much of the last decade (Chart 13). Unit labour costs – the broadest measure of wage growth – in the Core prior to the Great Recession (2002-2007) had been unusually weak despite strong labour productivity growth. Although certainly attributable to a number of idiosyncratic factors, this has been most commonly chalked up to firms keeping wage growth in check in order to remain competitive with lower wage regions such as China. Since 2014, wage growth remained relatively subdued in the core and periphery, but continued to soar in the catch-up economies. Wage growth of late has ticked up and should provide support to underlying inflation.

As has been a common theme across the G7, inflation continues to disappoint despite tightening labor markets. It's obvious that material labor market slack highlighted previously has acted to hold back wage growth in the Euro Area. Underlying inflation remains well below target in virtually all member states regardless of how close they are to full employment (Chart 14).

## ECB to cautiously remove emergency stimulus

The lack of underlying inflation pressures is a key concern preventing the European Central Bank (ECB) from removing emergency stimulus in the near term. Our outlook for underlying inflation is similar to that of the ECB's in that it will continue to gradually build but remain below target through 2018 (Chart 15). Nevertheless, over this period the gradual absorption of economic and labour market slack should ensure a steady build in wage and price pressures to



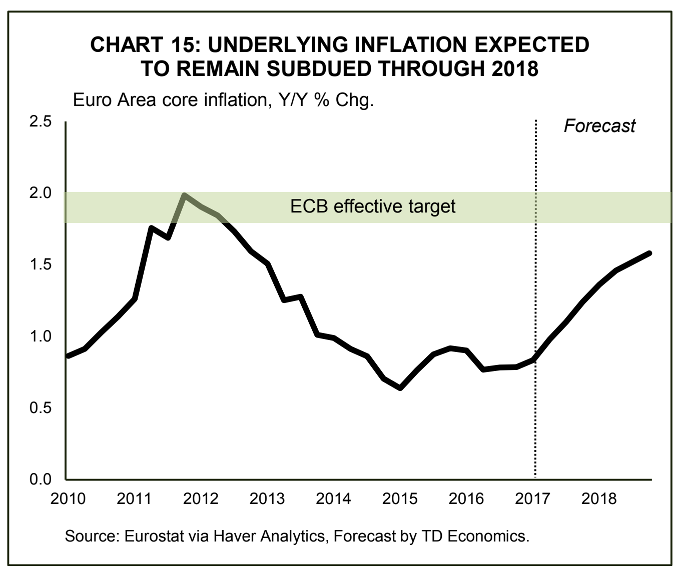
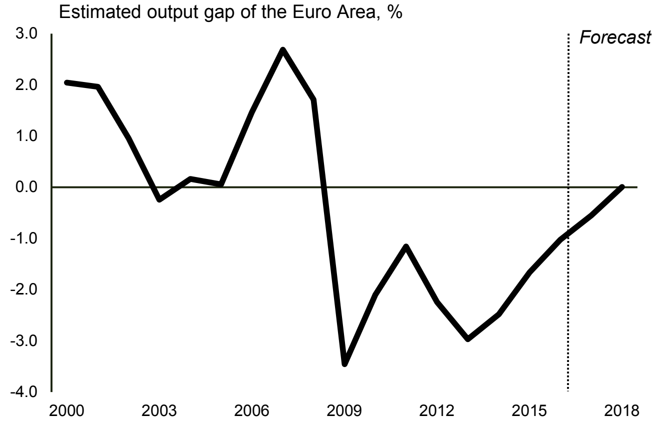



CHART 16: OUTPUT GAP SET TO CLOSE BY THE END OF 2018




Source: European Commission (as of February 2017), TD Economics.

necessitate the removal of emergency stimulus measures by the ECB. With an outlook that is consistent with a closing of the output gap by the end of 2018 (Chart 16), the ECB is likely to announce a tapering schedule for its asset purchases sometime in the second half of this year that should see a gradual reduction in asset purchases beginning early next year. Moreover, while an interest rate hike is unlikely over the next six quarters, if Euro Area growth surprises to the upside the case for a rate hike in the second half of 2018 will build.

**Risks to the outlook abound**

Although the Euro Area economy continues to strongly recover from past crises, a number of challenges could potentially derail the outlook and could forestall the removal of emergency stimulus by the ECB.

For one, the populist threat to the Euro Area presented by elections in the Netherlands and France has been virtually extinguished for the time being, reducing some political uncertainty. However, increased income inequality and high unemployment rates, particularly amongst youth, are still a potent combination that could keep fueling anti-establishment and anti-euro sentiment for some time to come.

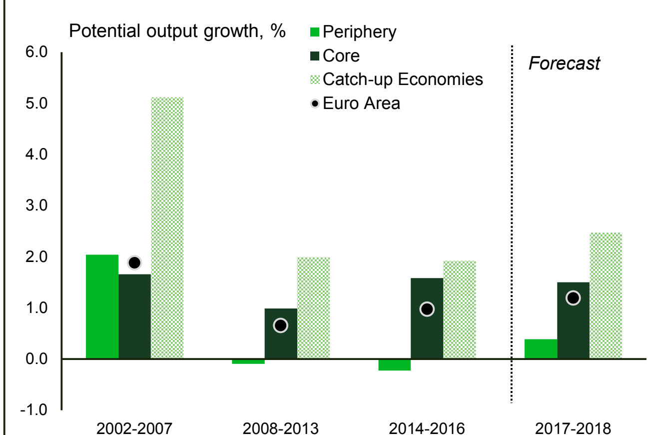
Another challenge relates to the health of the supply side factors for the Euro Area economy. Potential output is expected to remain subdued through 2018 – a marked decline from the 2.0% pace observed pre-2007 (Chart 17). Weaker trend growth is due to both a fall in productivity and labor input growth. Structural reforms, such as those proposed by newly elected and reform minded French President Emmanuel Macron, would go a long way to helping support long-run trend growth in the Euro Area. Indeed, a combination of corporate tax cuts, fiscal cuts complemented by stimulus programs, and a liberalization of labor laws should help the long-run potential growth of both the French and Euro Area economies.

Falling labor input growth has made it ever more important for Euro Area members to establish common immigration and integration policies to ensure that all immigrants can contribute constructively to the economy. The failure to establish these policies will not only put at risk the long-term running speed of the economy, but will also continue to feed xenophobia and nationalistic fervor, particularly in regions where unemployment remains elevated.

A third challenge is posed by elevated non-performing loans that continue to restrain lending in the European banking sector. While some countries have made progress on recapitalizing their banks, peripheral countries such as Italy are still struggling to reform and implement recapitalization plans. Given the political difficulty in pushing through much of the necessary reforms to rehabilitate the Euro Area's ailing banks, we anticipate slow, but steady progress on this front, with the sector's problems continuing to exert a drag on economic growth in the region for some time.

Lastly, protectionism remains a key threat to the outlook, including the potential for a more fragmented trading relationship with the UK. Although there are signs that protectionist rhetoric aimed at Europe by the new U.S. administration has waned, there is still a very real threat that Europe could have to contend with higher tariffs and experience a prolonged period of trade uncertainty with its major partners.

CHART 17: POTENTIAL OUTPUT GROWTH IS MARKEDLY WEAKER THAN PRE-CRISIS PERIOD




Source: European Commission (as of February 2017), TD Economics.

## Endnotes

1. Diffusion indexes were generally designed such that an increase in the indicator from the previous period was set equal to 1, set to zero if no change occurred, or set to -1 if the indicator declined from the previous period. Summing across all countries for the three sub-regions in each period, the result would then be interpreted as the number of countries that have seen an increase/decrease/no change in the economic indicator in that period.

2. See discussion in the ECB Economic Bulletin, Issue 3/2017 Assessing labour market slack, Box 3.
https://www.ecb.europa.eu/pub/pdf/other/ebbox201703_03.en.pdf