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Country Economic Forecast
Eurozone

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Surveys continue to point to strong growth in Q3, but some of the hard data is a bit softer

- **While some of the hard data does not fully corroborate the strength shown by surveys, the Eurozone is set to experience another robust quarter in Q3. There is little evidence that the strong euro is yet affecting the industrial and the external sectors, but it will cause inflation to fall significantly in early-2018. We have made a small tweak to our monetary policy call and now expect the ECB to cut monthly QE purchases to €30bn per month from January next year.**
- The Eurozone economy probably reached its peak velocity in Q2, when GDP rose 0.6%. Surveys continue to suggest strong growth in the second half of the year. Following a jump in September, the average composite PMI for Q3 was only slightly below the peak in Q2, whereas the EC Economic Sentiment Indicator was actually higher than in Q2.
- Neither survey shows any evidence that the appreciation of the euro is having an adverse effect on the industrial sector, with industrial production having rebounded strongly in August in many Eurozone economies following a soft patch in earlier months. That said, both industrial output and retail sales data suggest softer growth in Q3 than suggested by the strong surveys.
- The ECB is expected to announce its next policy change this month. Although inflation will likely fall to 1% or lower early in 2018, this dip will only be transitory. We now expect QE purchases to be reduced to €30bn a month from January until September 2018. This does not materially change our view that the announcement will be accompanied by dovish rhetoric and a very slow pace of normalisation thereafter.
- Our GDP growth forecasts for 2017 and 2018 are unchanged from last month at 2.2% and 1.9% respectively, implying a sustained period of above potential GDP growth.

ECB to announce QE plans this month

Forecast for Eurozone

(Annual percentage changes unless specified)

	2016	2017	2018	2019	2020	2021
Domestic Demand	2.3	2.0	2.0	1.7	1.5	1.3
Private Consumption	2.0	1.8	1.7	1.4	1.3	1.2
Fixed Investment	4.3	2.5	3.0	2.5	2.2	1.8
Government Consumption	1.7	1.2	1.4	1.2	1.1	1.1
Net exports (% of GDP)	3.6	3.8	3.8	3.6	3.5	3.5
GDP	1.8	2.2	1.9	1.6	1.4	1.2
Industrial Production	1.5	2.3	1.8	1.4	1.3	1.3
Consumer Prices	0.2	1.5	1.2	1.7	1.9	2.0
Current Account (% of GDP)	3.5	3.1	2.9	2.6	2.4	2.3
Government Budget (% of GDP)	-1.5	-1.1	-0.9	-0.9	-0.9	-0.8
Short-Term Interest rate (%)	-0.26	-0.33	-0.34	-0.20	0.06	0.30
Long-Term Interest Rates (%)	0.86	1.17	1.57	1.92	2.14	2.37
Exchange rate (US$ per Euro)	1.11	1.14	1.20	1.20	1.21	1.21
Exchange rate (YEN per Euro)	120.3	127.3	136.5	139.5	140.5	141.0

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Forecast overview

Eurozone GDP growth probably peaked in Q2

The Eurozone economy probably reached its peak velocity in Q2, when GDP rose 0.6% q/q. The figures available for Q3 provide a bit of a diverging picture between soft and hard data. The composite PMI – which has been the best predictor for quarterly GDP growth – averaged 56 points in Q3, only slightly below the 56.6 in Q2. And the EC's Economic Sentiment Indicator was actually stronger in Q3 after reaching a new multi-year high in September.

But some of the hard data from the consumer side suggests a softer activity. In particular, retail sales have been surprisingly weak despite high consumer confidence and strong employment growth, but we suspect some weather-related effects have been partially responsible. Industrial production went through a soft patch in early-summer, but it rebounded strongly in August and is set to have another strong showing in Q3. More importantly, there are no clear signs yet that the strong euro is causing major problems for the industrial sector or adversely affecting sentiment. Our GDP indicator, which uses both soft and hard monthly data, suggests that growth will be around 0.5% in Q3, which coincides with our current forecast.

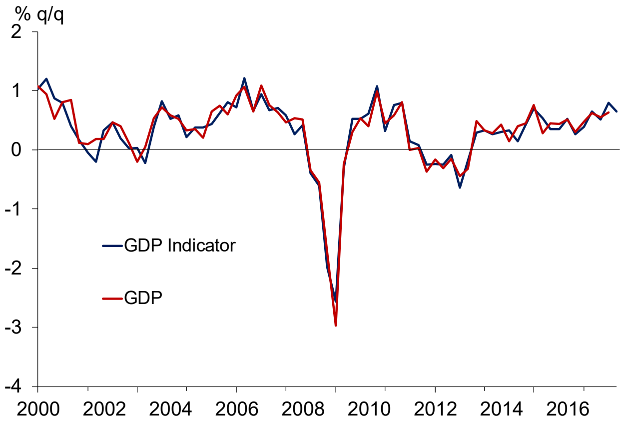
Good prospects for a sustained expansion

We remain confident that the Eurozone can sustain a further period of above-trend GDP growth in the coming quarters. Our forecast is driven by the following factors:

- **Strong consumer spending amid a healthy labour market recovery**: consumer spending has performed better than expected in the face of higher inflation this year, mainly a result of the strong employment growth in the Eurozone. The unemployment rate remains on a gradual downward path from its 2013 peak, and we are also witnessing rising workforce participation in a number of economies, a signal of healthy recovery in labour markets. We have not yet seen signs of strong wage growth despite the improving labour market, but the latest data indicate the trend may be changing. Furthermore, with inflation set to slow over the next six months, we expect solid real income growth, meaning that household spending grows by 1.8% this year and 1.7% in 2018.

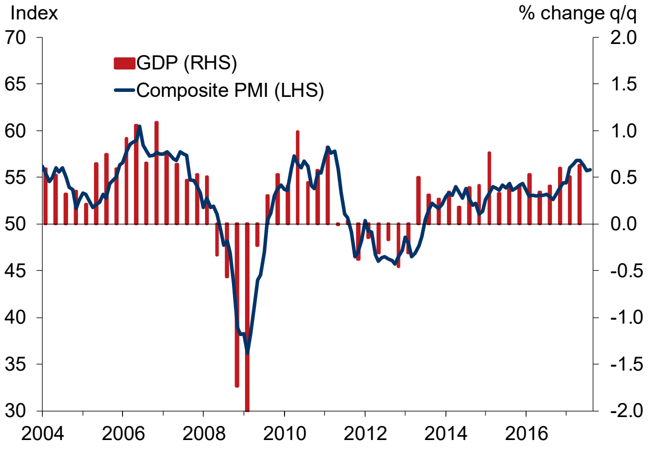
- **Investment joining the recovery**: the solid start to the year for investment is no great surprise given buoyant business sentiment, easing fears of populism and the

Euro area GDP indicator



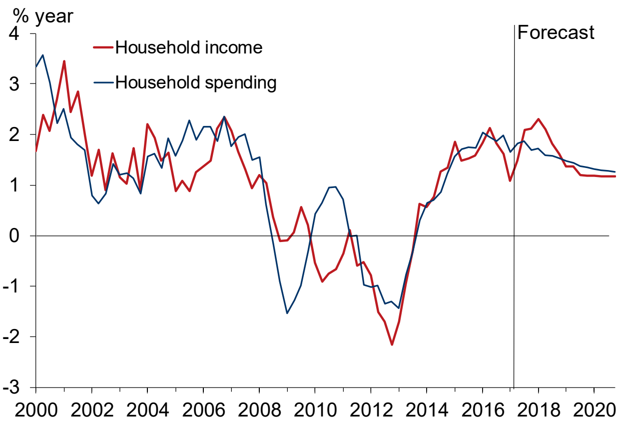
Source: Oxford Economics/Haver Analytics

Eurozone Composite PMI & GDP



Source : Oxford Economics/Haver Analytics/Markit IHS

Eurozone: Real household spending & income



Source : Oxford Economics/Haver Analytics continued strength of bank lending to firms, particularly at longer maturities. We also think the additional push from stronger external demand could mean upside risks to our investment forecasts in countries with a large share of capital goods in their export mix. Our view remains that investment growth will strengthen from 2.5% this year to 3.0% in 2018.

- **Stronger euro to trigger modest slowdown in export growth:** the rise in the euro has had a limited impact on exports so far. But with global trade growth expected to moderate in 2018 and the euro unlikely to surrender much of its recent gain – we see it remaining at around US$1.20 in the latter part of this year and in 2018 – export volume growth should gradually ease. We expect export growth to slow from 4.4% this year to 3.3% in 2018, but this would still be above the pace seen in 2016.

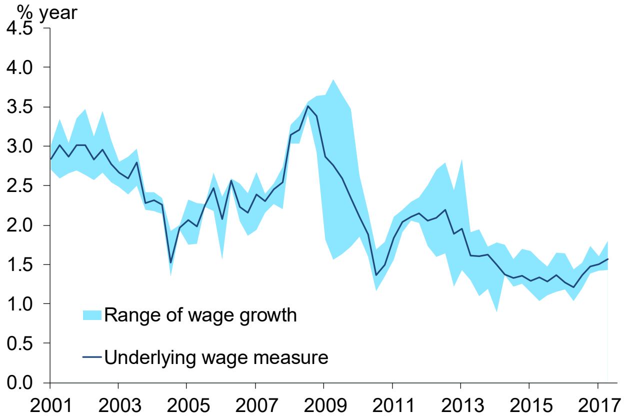
We continue to forecast GDP growth of 2.2% in 2017, mainly driven by the domestic sector but with some help from net trade as well. In 2018 and 2019, we see growth of 1.9% and 1.6% respectively, also unchanged from a month ago.

A tweak to our QE call

Prior to last month's ECB policy meeting, there had been some suggestions that any announcement of changes to monetary policy could be delayed until December, but it is now widely expected that changes will be revealed at this month's meeting. While it was noted that monetary policy will be partly determined by future exchange rate developments, the strength of the recovery and signs of a pick-up in underlying inflation mean we still expect the ECB to lower its QE purchases from January.

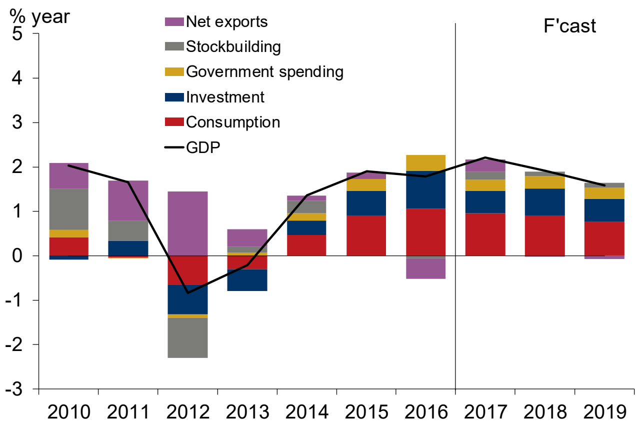
Following recent communications from the ECB, we now think that the Bank will cut its monthly asset purchases to €30bn a month for a nine-month period from January 2018 (from our previous call to a progressive reduction in purchases to €40bn and then to €20bn). The small tweak to our call does not alter the fundamental picture of a very gradual exit. We do not expect interest rates to rise anytime soon, with the deposit rate first being lifted in 2019 and no hike in the main refinancing rate until 2020.

Eurozone: Wage indicators



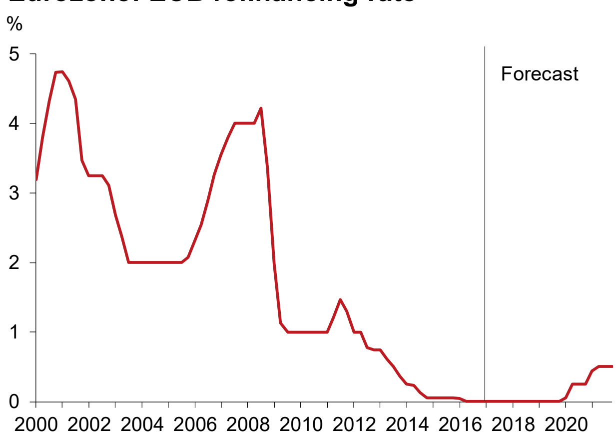
Source : Oxford Economics/Haver Analytics

Eurozone: Contributions to GDP growth



Source: Oxford Economics

Eurozone: ECB refinancing rate



Source: Oxford Economics

What to watch out for

Receding political uncertainty supports growth: stronger global demand and easing fears about the election of populist governments could prompt increasingly confident businesses to raise investment spending more sharply than assumed in our baseline.

Stronger euro stunts exports: the run of positive news from the Eurozone has prompted the euro to climb sharply this year and we expect further rises. While we assume that this acts as a drag on export growth, a sharper rise – particularly if policymakers abroad become more dovish – could mean net trade is a drag on GDP next year.

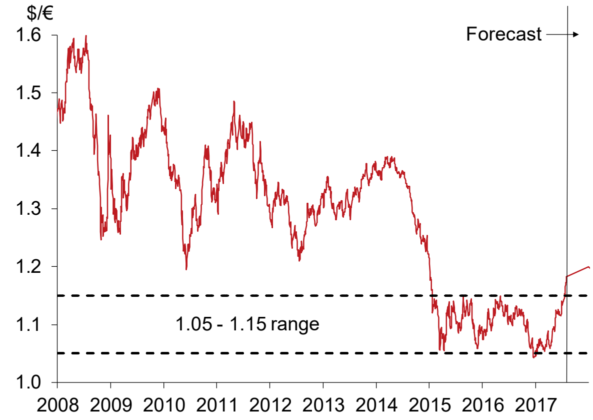
Monetary policy tightening: we expect the ECB to adopt a cautious approach to monetary tightening. But if underlying inflation pressures start to grow, the previously hawkish central bank could surprise markets to the upside, pushing bond yields and the euro higher, which in turn could slow growth.

Exposure to key global risks

Cyclical recovery in world trade: in this scenario, optimism over near-term growth prospects increases globally, as the strength of activity in China and the US supports a continuation of the resurgent growth in trade seen in recent months. Investment expenditure picks up accordingly and investor confidence in emerging markets improves too. Stronger external demand prompts Eurozone GDP growth of 2.6% next year and 2.4% in 2019. Within the currency bloc, the economies most open to trade should benefit the most from such a shock.

US policy errors: while recent US economic data have remained broadly upbeat, uncertainty persists around the policy stance of the Trump administration. In this scenario, we examine such a turn of events. With consumer spending slowing and impeachment risks rising, President Trump is frustrated in his attempts to implement pro-growth policies, such as deregulation and large-scale fiscal stimulus, and proceeds with immigration curbs and deportations. At the same time, he pushes through via executive order protectionist trade measures on Mexico and China, provoking these trading partners into the imposition of matching retaliatory tariffs on US exporters.

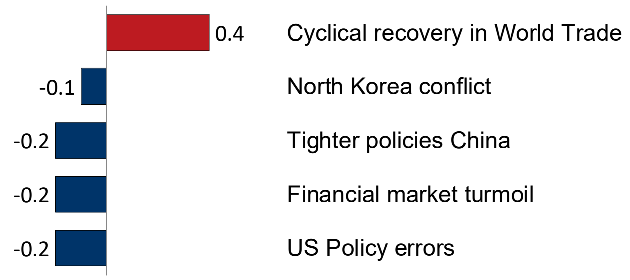
Dollar/Euro, including OE forecasts



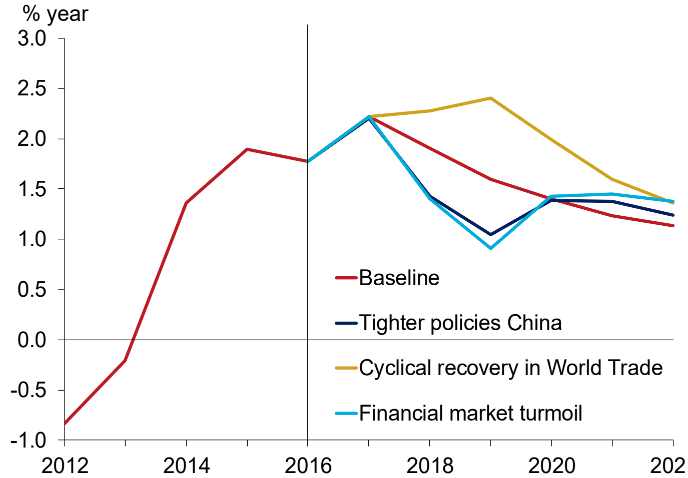
Source : Oxford Economics/Haver Analytics

Impact of scenarios on GDP growth

Average annual impact over the next 5 years (% points)



Impact of scenarios on GDP growth



Source : Oxford Economics

Long-term prospects

Very slow recovery from crises

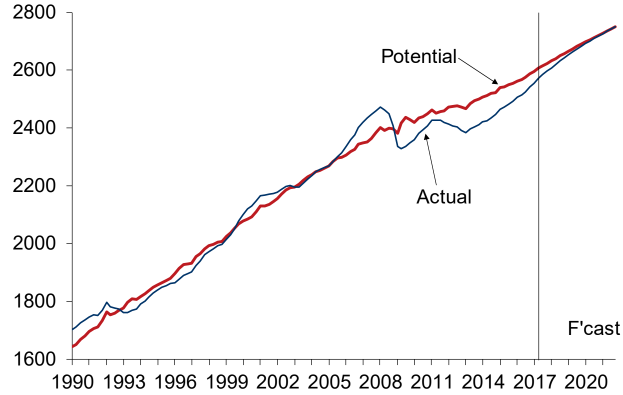
The global and Eurozone crises will leave their mark on growth for years to come. We now estimate that the Eurozone's potential growth rate is only 1.1%, similar to our estimate for the past decade but far lower than 1.8% in the ten years to 2008.

While credit availability is improving, it is unlikely to be as free-flowing as in the pre-crisis years, hindering investment and the efficiency of capital allocation in the economy. Moreover, high unemployment for a prolonged period, especially among the young, will have long-lasting negative effects on skill levels and the ability to work. Combined with a shrinking working-age population (despite increases in the retirement age), these factors imply that availability and quality of labour will be constrained compared with the pre-crisis period. These constraints will only be partly offset by further increases in the participation rate.

Some of the reforms implemented in the peripheral countries should help raise Eurozone productivity growth to at least what it was before 2008. But much more will be needed to offset other negative trends.

Eurozone: Actual & potential output

Euro bn 2010 prices



Source: Oxford Economics

Potential GDP and Its Components Average Percentage Growth	2007-2016	2017-2026
Potential GDP*	1.0	1.1
Employment at NAIRU	0.6	0.3
Capital Stock	1.3	1.2
Total Factor Productivity	0.2	0.6

*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)

Long-Term Forecast for Eurozone

(Average annual percentage change unless otherwise stated)

	2007-2011	2012-2016	2017-2021	2022-2026
GDP	0.5	0.8	1.7	1.1
Consumption	0.3	0.6	1.5	1.1
Investment	-1.4	0.6	2.4	1.3
Government Consumption	1.5	0.7	1.2	1.0
Exports of Goods and Services	2.3	3.8	3.2	2.3
Imports of Goods and Services	1.8	3.3	3.4	2.4
Unemployment (%)	9.0	11.2	8.2	7.1
Consumer Prices	2.0	0.9	1.7	1.9
Current Balance (% of GDP)	-0.3	2.5	2.7	2.1
Exchange Rate (US$ per Euro)	1.39	1.23	1.19	1.22
General Government Balance (% of GDP)	-3.8	-2.6	-0.9	-0.4
Short-term Interest Rates (%)	2.5	0.1	-0.1	1.3
Long-term Interest Rates (%)	4.1	2.2	1.8	3.1
Working Population	0.2	0.2	0.0	-0.2
Labour Supply	0.5	0.3	0.3	0.0
Participation Ratio	76.0	76.7	77.3	78.0
Labour Productivity	0.4	0.4	0.9	0.9

Background

Economic development

The creation of a single European currency was achieved in 1999, with notes and coins being introduced in 2002. The eleven initial members were Germany, France, Italy, Finland, Ireland, Netherlands, Belgium, Luxembourg, Austria, Portugal and Spain, with Greece joining European Monetary Union (EMU) in 2001 and introducing notes and coins at the same time as the other countries. Since then, Slovenia (2007), Malta (2008), Cyprus (2008), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015) have joined the currency bloc. During the early years of the single currency, the peripheral economies were the main drivers of growth, as lower interest rates fuelled credit and housing booms in some of the economies (e.g. Spain and Ireland), while others, most notably Greece, saw a surge in net government spending. Since the global financial crisis these economies have had to go through a painful period of restructuring. Germany, which went through its own restructuring following the formation of the Eurozone, has more recently been the main growth engine.

Structure of the economy

Like most developed economies, services is the dominant sector of the economy. Within the region there are large structural differences between countries, and generally the smaller northern economies are more open to trade than their southern counterparts.

Balance of payments and structure of trade

Prior to the global financial crisis, the Eurozone current account was broadly in balance. But the headline figure masked huge intra-area divergences. Surpluses in many core economies were offset by large deficits in the booming peripheral economies. Since the global financial crisis, the latter’s current account positions have improved, while the German current account surplus has widened, pushing the Eurozone surplus above 3% of GDP in 2015. There are strong trade linkages within the currency bloc; around 45% of exports remain within the Eurozone.

Policy

Member states have passed control of monetary policy to the European Central Bank (ECB), whose objective is to achieve price stability by targeting CPI inflation of “below, but close to, 2%”. While the ECB cut interest rates in the aftermath of the global financial crisis, it was rather more conservative than other central banks such as the US Federal Reserve and the Bank of England and expanded its balance sheet less aggressively. Since Mario Draghi became ECB President in 2011, the ECB has taken bolder action to support the economy and boost inflation. In January 2015, the ECB finally began its own QE programme.

National governments retain control of fiscal policy, although there are limits to their freedom in this area as specified in the Stability and Growth Pact (SGP), which essentially applies the fiscal requirements of the Maastricht Treaty on an ongoing basis. Economies have consistently flouted the rules and the rules have at various points been ignored or modified. A key criticism of the rules is that they have led to pro-cyclical fiscal policies.

The fall-out from the financial crisis, and in particular the troubled fiscal situation faced by Greece, Italy, Ireland, Portugal, Slovenia, Cyprus and Spain, showed the limitations of the fiscal framework behind the single currency. The possibility of a debt default by Greece, coupled with the threat of contagion to Italy and Spain, put Eurozone leaders under immense pressure to come up with a rescue plan that would prevent the collapse of the single currency. However, there remain significant differences of opinion among the largest members regarding who should carry the burden and what mechanisms should be used to provide financial support to the European banking system. Measures that have taken place are a move towards a banking union in a bid to sever the links between banks and their sovereigns. But political hurdles to closer integration and debt burden sharing remain very high, so changes to the Eurozone’s structure and institutions are likely to be slow at best.