Good is not good enough

Putting the Eurozone's current upswing into perspective

With political risks melting away like snow in the sun, the Eurozone economy could become the positive growth surprise of the global economy. However, to ensure that this surprise is structural rather than simply short-lived, more effort will be needed.

What a difference two elections can make. While at the start of the year, political risks in the Eurozone were haunting financial markets and many observers, the elections in the Netherlands and France have shown the limits of anti-euro and anti-European populism. At least for now, as Italian elections next year might reignite fears about the euro. Under the surface of political risks, the Eurozone economy has gradually strengthened further. In fact, Tuesday's GDP data should confirm that the Eurozone economy has grown faster than the economies of the US or the UK during the first quarter of this year; a period in which political risks and uncertainties were still considered to be high.

We expect GDP growth in the Eurozone to come in at just under 2% this year, which would be the second-strongest year in a decade. Contrary to earlier stages of the recovery, growth is no longer exclusively driven by a few (or only one) strong countries. The recovery is broadening across all Eurozone countries. While Germany is still – and even a bit surprisingly given the lack of structural reforms – going strongly, other countries which have rapidly recovered from deep crises are also contributing positively to a recovery; just think of Spain, Portugal, Ireland and the Netherlands. More generally, the Eurozone economy is clearly benefiting from low interest rates, a weak euro and low oil prices.

While the Eurozone should continue to enjoy supportive tailwinds and a cyclical recovery, to a large extent reflecting a catching up process, the upside to this recovery seems limited due to several structural factors: the ageing population is weighing on growth, the capital stock has not been growing rapidly, the amount of structural unemployment in the economy is still high and innovation has not been translating to stronger productivity growth.

All of this means that with fading political uncertainty and a continuing cyclical upswing, the ECB will have very little reason not to start thinking about a very gentle exit from its ultra-loose monetary policies. The risk of deflation, which stood at the start of the QE programme, has clearly disappeared. At the same time, however, the structural problems and weaknesses of the Eurozone will prevent the ECB from changing its monetary stance drastically. In fact, tapering will not mean tightening. Therefore, we expect the ECB to start a gradual process towards tapering as early as at the June meeting. This process could take several months and could consist of language tweaks, changes to the risk assessment and tasking technical committees before the official announcement of a reduction of the asset purchasing programme for 2018 would follow. Rate hikes will only follow towards or after the end of QE.
Tomorrow’s GDP growth data for the first quarter should confirm the strengthening and broadening recovery of the Eurozone economy. With growth at 1.7% YoY, the economy is proving to be resilient to uncertainty. Private consumption has grown strongly over the past two years as the labour market has recovered at a rapid pace. At the end of last year, investments also started to grow more quickly and it seems that this has continued in 2017. The fiscal stance has also become somewhat more positive and while the outlook for exports is clouded by some uncertainty, it does look like the Eurozone economy is firing on (almost) all cylinders at the moment. The recovery is also broadening as more countries are now experiencing stronger growth than during the first years of the recovery. Take Spain, the Netherlands and Ireland for example, where growth has picked up significantly. We expect growth to continue at a robust pace for the rest of the year, with year-on-year growth coming in at around 2%.

With growth strengthening and downside risks to growth decreasing, it is a good time to put the current recovery into perspective. The current cyclical upswing is not only the result of favourable external conditions and very accommodative monetary policies, it also goes hand in hand with structural improvements in several countries. Countries like Spain and Portugal have started to close the gap with the leading Eurozone economies when it comes to broader competitiveness indicators (eg, the Doing Business indicator). Also, some rebalancing has taken place with regards to relative unit labour costs. The declining real wages in some of the periphery countries, together with a temporary recovery of productivity growth due to the drop in employment, has made them more cost competitive. Needless to say that despite the recent improvement, the process of structural reforms and Eurozone rebalancing is far from being over. Countries like Italy and Greece are still lagging behind in terms of modernising their economies, but reforms at a supranational level are also key to future economic success.

Looking beyond the current cyclical upswing, the output gap could be closed by 2018 or 2019 at the latest. However, even a closed output gap will not be a reason to be overly cheerful, given that such a moment would also be the result of weaker structural growth. When looking at the developments in trend growth, we see that it has been decreasing over recent decades. It has now fallen to around 1%, from 2.2% on average in the 1990s. In the years ahead, the biggest challenge for the Eurozone will be to increase structural growth. Factors that could possibly increase structural growth are, for example, the number of hours worked, an increase in employment and full
exploitation of the potential of the labour market, the amount of capital in the economy and the trend in productivity.

How to increase structural growth

One of the structural factors with the most lasting impact on growth is working age population. In the Eurozone, the decline of the working age population has left its mark on structural GDP growth. The decline is mostly due to the generation of baby boomers retiring. While for now there is still a trend towards later retirement, dampening the effect on growth, this will not mitigate the full effect. Japan is a dire example in this regard, as it has struggled with an ageing population for about a decade longer than Europe has.

There are several ways to counter the drop in working age population: immigration, higher productivity or a reactivation of the available and hidden workforce. Regarding the latter, the recent improvement in unemployment rates across the Eurozone countries should not distract from the fact that the crisis has damaged the current and future workforce. When looking at a broader measure of unemployment, including people outside the labour force who actually want to work, and part-time employees that want to work full time, it shows that there are still many more people out of work than pre-crisis. This is particularly the case in Italy, which has the highest share of “broad unemployed”. Italy also has the highest share of people aged 15-29 that are not in education, employment or training at more than 25%. These so called “NEETs” have a high risk of not (re-)entering the job market any time soon.

The capital stock is another factor that currently limits the Eurozone’s growth potential. Growth in the capital stock has almost come to a halt since the start of the crisis as it came down from 2.3% between 1997 and 2007 to about 1% per year between 2007 and 2017. In countries like Greece, Portugal and Italy, it has stagnated or even shrunk. This is due to the decline in investment, which is still 7% lower than at peak before the 2008 crisis in the Eurozone.
To tackle the problem of shrinking capital stocks several solutions are plausible. The European investment initiative, also known as the Juncker plan, is a small first step. Other possible options are looser fiscal policies to enable governments to either start public investments or at least create investment incentives for the private sector. Lastly, institutional reforms of the Eurozone, aimed at making the monetary union more sustainable, could further reduce the risk of a break-up, increasing the attractiveness of the Eurozone for foreign investors.

Hidden unemployment and a low capital stock mount into weak productivity.
coming years show continued weak productivity growth due to a lack of investment in recent years.

**Structural weaknesses make monetary policy changes gradual and slow**

Now that growth has picked up and the deflationary risks have faded, pressure on the ECB to reverse its very accommodative monetary policy is increasing. Political risks, mentioned by ECB-president Mario Draghi as a limiting factor to policy changes, have also subsided now that the Dutch and French elections have not resulted in a more Eurosceptic stance, although Italian elections in 2018 could cause political risks to increase again. With the risks becoming less tilted towards the downside and more balanced, we expect the ECB to start a gradual process of changes in its official language (think of the risk assessment or the phrase that rates will remain low or lower), indirect hints and tasking working committees. This process could already start at the June meeting and should cumulate with an announcement of a tapered lengthening of the QE programme for 2018 at the September meeting. In our view, tapering would come in the form of a gradual reduction of bond purchases in the first half of 2018. Towards or after the end of QE, a deposit rate hike would be the next step.

Most interesting is what will happen after that. Given the weak economic prospects in the medium term, it seems unlikely that a hike cycle will start like the one the Federal Reserve is currently working on. The ECB could raise rates somewhat further, but it seems unlikely that significant monetary tightening will happen in the years ahead. Growth potential simply remains too weak for that. In fact, a recent study by the Federal Reserve Bank of San Francisco confirms that the natural rate of interest in the Eurozone has been declining significantly over recent decades.

**The price for monetary tightening: government action**

All of the above means that despite justified joy about the current economic upswing, a good portion of realism is well-placed. The current recovery finally seems to be the result of a decent cyclical recovery. It is a temporary surge before growth falls back to a slower pace. To bring the Eurozone from a cyclical recovery to a structural recovery, monetary policy alone will be rather ineffective. Key to further improvements in Eurozone growth potential are a looser fiscal stance, more cross-border investments along the lines of the Juncker investment plan, continued structural reforms, steps towards the completion of the single services market and a further deepening and strengthening of the monetary union.
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