

Euro Area Research

Growth tailwinds dominate headwind from EUR near term

The economic data released this week seems to be exactly what the ECB was hoping for ahead of its QE decision coming up in autumn – but the stronger euro is the ‘party pooper’. Data shows that the euro-area economy has been growing for 17 consecutive quarters and that the recovery continues to gain momentum, with the yearly growth rate at 2.1% which is the highest since 2011 (see Chart 1). Additionally, the unemployment rate in June declined to the lowest level since 2009 and core inflation in July also surprised slightly on the upside. This should be a perfect cocktail for the ECB to deliver a more hawkish stance, but the flipside is that this would fuel the strong and ongoing euro appreciation thereby putting downward pressure on the outlook for growth and inflation.

The stronger euro is a headwind to economic activity as it hurts price competitiveness thereby reducing exports and raising imports. Based on the *OECD’s new global model*, the 5.8% rise in the effective euro since the start of the year should bring GDP growth down by 0.4pp in 2018 and an accumulated 0.7pp in 2019. Due to the euro appreciation, we have lowered our GDP forecast for 2018 to 1.5% from 1.6% (consensus 1.7%) as we expect a weaker contribution from net exports. On the other hand, we have lifted our 2017 growth forecast to 2.0% from 1.7% (consensus 2.0%) due to a combination of a stronger-than-expected H1 and other factors still being supportive and likely to dominate the headwind from the stronger euro near-term. In particular, the need to modernise the capital stock and the favourable finance conditions should support activity.

Tailwinds to growth:

- Need to modernise the capital stock and accommodative finance conditions (see Charts 6 and 7)
- Fading political uncertainty and very strong sentiment (see Chart 3)
- Ongoing strong job creation (see Chart 5)

Headwinds to growth:

- Stronger effective euro together with an outlook for softer Chinese activity (see Chart 2)
- Lower real wage growth as inflation rises more than nominal wages (see Chart 4)

Key points

- Strong growth, falling unemployment and higher core inflation should be what the ECB hoped for ahead of its QE decision – but the stronger euro is the ‘party pooper’
- The headwind from the stronger euro should not derail the ongoing recovery but we expect a negative impact on activity in 2018
- The trigger for a more aggressive monetary policy seems to depend on the growth outlook which remains robust near-term
- The stronger euro keeps pressure on the ECB not to sound too confident when talking about the economic recovery

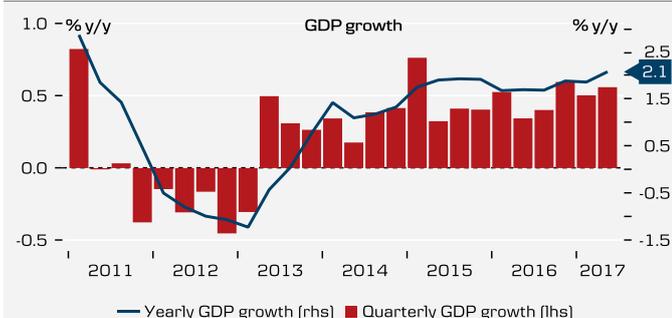
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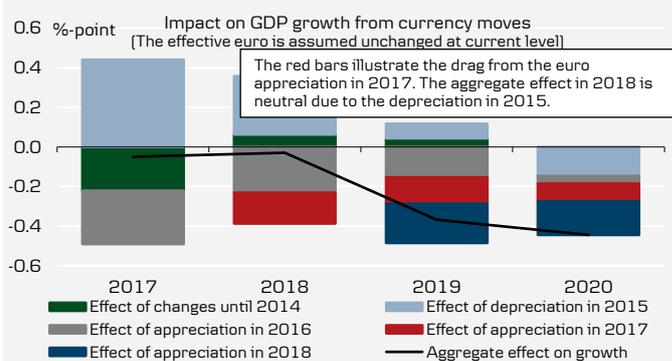
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Chart 1: Euro area economy has expanded for 17 quarters



Source: Eurostat, Danske Bank Markets

Chart 2: The stronger euro is a headwind to growth in 2018



Source: ECB, OECD, Danske Bank Markets

Based on our view that growth-supportive factors will dominate the headwind from the euro appreciation in the near term, the ECB should stick to its new hawkish thinking that the improving recovery will result in higher inflation eventually. The ECB's recent shift in focus to the stronger economic recovery and away from a lack of underlying price pressure suggests to us that a trigger for a more aggressive monetary policy currently hinges on a weaker growth outlook. But we believe it is probably a fine balance with the continued rapid euro appreciation which is currently dragging down the ECB's inflation forecast by 0.3pp to 1.3% in 2019, see *Euro Area Research: Stronger EUR keeping inflation far from the ECB's target*, 27 July 2017.

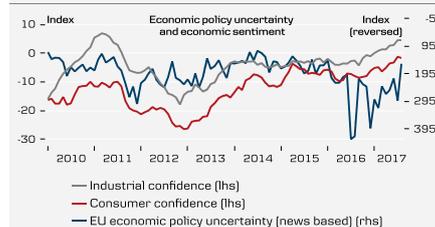
In the near-term, the stronger euro keeps pressure on the ECB not to sound too confident when talking about the economic recovery. At the July meeting where the effective euro was 2.3% stronger compared to the assumption in the ECB's projection from June 2017, Draghi said a financial tightening was 'the last thing' the ECB needs. Added to this, the ECB's dilemma of a recovery but at the same time tighter financing conditions got some attention at the ECB meeting in July, where Draghi said 'That is why this discussion we are going to have in the fall is multi-faceted.'

Longer term, the euro appreciation –which we expect will continue – supports our call for a very gradual exit from the ECB. We believe the ECB will continue its QE purchases, but at a reduced pace of EUR40bn per month in H1 18, and that it will announce this at the October meeting with some signalling of it in September.

Our expectations of a continuation of QE reflect that the underlying price pressure should remain very moderate. In the ECB's *Economic Bulletin* from August it concluded 'measures of underlying inflation are somewhat higher than at the end of last year but remain overall subdued'. Additionally, the ECB pays attention to why core inflation has increased, and in line with our view that the recent rise is driven by volatile components, it stated 'If, in addition to energy and food, the very volatile components clothing and footwear and travel-related items are excluded, HICP inflation shows only a modest uptick in recent months. Furthermore, most alternative measures of underlying inflation also do not indicate a pick-up yet.' We still expect modest core inflation and forecast 1.1% on average this year only, rising to 1.3% on average in 2018 (see table on page 3).

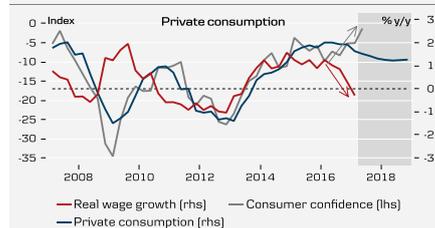
This implies that although the unemployment rate is now balancing around the European Commission's estimate of NAIRU (see Chart 5) there are no convincing signs of a sustained upward move in underlying inflation. While the unemployment rate could continue to decline with a robust growth outlook it should not result in higher wage pressure. In our view, the factors pointing to low wage growth are different measures of labour market slack, including a high share of underemployed and discouraged workers in the periphery countries, low inflation expectations, less impact from higher inflation as negotiated wages are already set and formal wage indexation has declined and new jobs mainly being created in sectors where productivity growth is low: *Euro area wage growth should stay subdued, not supporting core inflation significantly*, 5 May 2017.

Chart 3: Fading political uncertainty and very strong sentiment



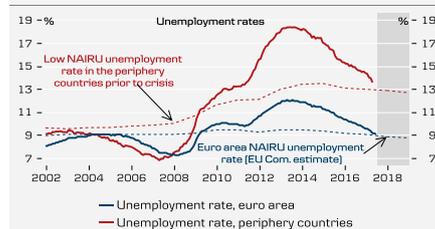
Source: Economic Policy Uncertainty, European Commission, Danske Bank Markets

Chart 4: Strong consumer sentiment but real wage growth is lower



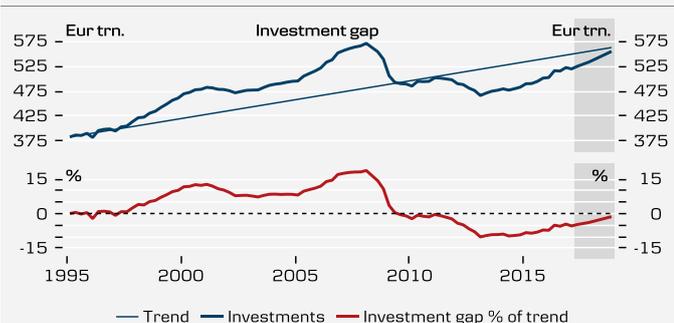
Source: ECB, European Commission, Eurostat, Danske Bank Markets

Chart 5: Unemployment rate is down at NAIRU but wage growth is still low



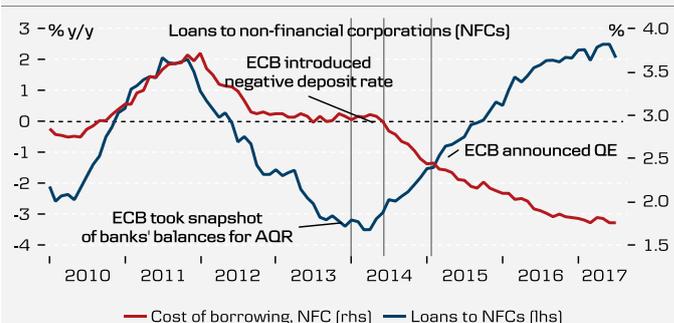
Source: European Commission, Eurostat, Danske Bank Markets

Chart 6: Investments are growing but there is still a gap



Source: Eurostat, Danske Bank Markets

Chart 7: Favourable finance conditions support investments



Source: ECB, Danske Bank Markets

Expectations for key figures over coming quarters

% Change q/q Annualised rate	2017				2018				Calendar year average		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2016	2017	2018
GDP	2.0	2.3	1.7	1.7	1.4	1.3	1.3	1.3	1.8	2.0	1.5
Private Consumption	1.4	1.8	1.2	1.2	1.2	1.3	1.3	1.3	2.0	1.5	1.3
Private Fixed Investments	-2.1	3.6	3.2	3.2	4.1	4.1	4.1	4.1	4.1	2.4	3.8
Public Consumption	1.3	1.0	1.0	1.0	1.4	1.0	1.0	1.0	1.8	1.1	1.1
Exports	4.9	3.6	3.6	3.6	3.0	3.0	3.0	3.0	3.3	4.3	3.3
Imports	2.0	3.2	3.6	3.6	4.3	4.3	4.3	4.3	4.6	3.9	4.0
Net exports ¹	1.4	0.3	0.1	0.1	-0.4	-0.4	-0.4	-0.5	-0.4	0.3	-0.2
Unemployment rate (%)	9.5	9.2	9.0	8.8	8.6	8.5	8.4	8.3	10.0	9.1	8.5
CPI (y/y)	1.8	1.5	1.4	1.3	1.0	1.1	1.2	1.1	0.2	1.5	1.1
Core CPI (y/y)	0.8	1.1	1.2	1.3	1.3	1.2	1.2	1.2	0.9	1.1	1.2
Public Budget ²									-1.5	-1.4	-1.4
Public Gross Debt ²									89.2	90.4	89.2
Current Account ²									3.5	3.0	2.9
ECB refi rate ³	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

1: Contribution to GDP growth, 2: Pct. of GDP, 3: End of period

Source: Eurostat, Danske Bank Markets

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This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of the research report are Pernille Bomholdt Henneberg, Chief Analyst, and Aila Mihr, First Year Analyst.

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