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Forecast Update

Fundamentals vs. Risks

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The constraints that forced a rapid slowing of euro area GDP growth momentum from 3% to 2% annualized in H1 — the pass through of earlier FX appreciation, the slowing of exports to China, the rise of the oil price — have eased or reversed somewhat, helping stabilize the economy through mid-year. Whether this can be maintained is a function of still-robust fundamentals (cyclical and structural drivers) vs. accumulating risk factors.

There was an increasing sense over 2016-2017 that the euro area economy was going ‘post-crisis’. The drivers of growth had rotated from monetary stimulus and lower oil prices to trade, jobs and investment. 2018 was supposed to be about the next stage of post-crisis normalization, with confidence in the sustainability of economic growth feeding confidence in the normalization of inflation, leading the ECB out of QE and into a tightening cycle.

But economies do not move in straight lines. Our SIRENMomentum indicator implied 3% annualized growth at the start of 2018. Growth at twice the trend rate was never sustainable. The inevitable capacity constraints kicked in, along with a number of transitory headwinds like rising oil prices. If that were the whole story, we could chalk H1 up to normal macro volatility and the path through the cycle – from growth to inflation to monetary exit — would be clear. However, just as the transitory factors started to reverse, a series of risk factors began to accumulate.

Risks may be subsiding: Italy appears less confrontational on fiscal policy, the US and EU have agreed a truce on auto tariffs, the EU has signaled a lower hurdle to a transitional Brexit deal and EM stresses appear more idiosyncratic than systemic. The view of ongoing moderately above-trend growth remains essentially unaltered – 2.0% in 2018, 1.7% in 2019. Core inflation should rise to 1.5% in 2019 and justify the ECB's first policy rate hike.



Cyclical. The drag from WLTP emission regulations on car production should be temporary. We see the cyclical fundamentals supporting ongoing moderately above-trend growth. Global growth expectations are fairly resilient. Despite higher inflation, real disposable income growth benefits from strong employment growth, rising wage inflation and an easier fiscal stance. Financial conditions remain easy and relatively stable. Credit conditions have improved, especially for households.

Structural. The economic cycle could be sustained for longer if trend growth were to improve. We think care needs to be taken not to over-estimate trend. First, reforms have been limited, both within and across countries. Second, the rise in participation rates lately may be only a temporary catch-up to the more modest pre-crisis trends. Third, Germany, the zone's largest member state, is on the verge of seeing the drag from ageing on a year-by-year basis. Assuming euro area trends in the 1.25-1.50% range, capacity constraints should remain binding, promoting investment spending on the one hand and sparking some pricing power and wage inflation on the other.

Risks. The primary concern is that the euro area has accumulated several sources of economic uncertainty over the last six months, including trade war, the policy choices of the new populist Italian government and talk of crash Brexit. The weakness of euro area capex orders and the recent rise in household fear of unemployment could be signs that the accumulating risks are affecting confidence and behaviour.

We include individual outlooks for the main European economies. The period ahead – Q4 2018 and 2019 — will still be intensely political even under our baseline assumptions that Italy adopts a less confrontational stance on fiscal policy and that crash Brexit is avoided. There is event risk and political equilibrium may be fragile. Macron's capacity to deliver his domestic reform agenda will in part be a function of his achievements with EU reforms, which are constrained by Merkel's limited room for manoeuvre in domestic politics. European Parliament elections next spring will be a litmus test for political stability. An early election in Italy is a risk, while Spain is probably on course for an election later in 2019. The latter will hope to continue differentiating itself from the former with a cooperative approach to Brussels and with the Catalan question only in the background. EU migration policy remains a key challenge.

If we are wrong and the risks materialise, Europe could slip onto a much weaker path as the loss of cyclical momentum exposes the underlying structural vulnerabilities. A substantive shock could trigger a chain reaction. First, the market might question the ECB's ability to lean against another large shock. Second, a growth shock could expose Italy's precarious public finances. Third, a further extension of low policy rates could impair banks' ability to support the recovery. Fourth, persistent weak growth could drive more voters to anti-EU populist parties.

We have shaved 0.1pp off our 2018 euro area GDP forecast, though we believe the macro outlook is essentially unchanged. Income growth (jobs and wages) remains solid and financial conditions easy. We assume the various



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risks from trade do not materialize in any substantive way. Several may linger, but peak uncertainty may be behind us for now, and we expect modestly above-trend but gradually slowing growth to continue into 2019.

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