EUROPEAN ECONOMICS FOCUS
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Can the euro-zone weather the global headwinds?

- **The euro-zone has proved relatively resilient in the face of global headwinds, but the region still has to contend with significant domestic problems. And with fiscal policy unlikely to provide a big boost to growth, the onus will remain firmly on the ECB to nurture the economic recovery.**
- Two of the biggest overseas challenges facing the euro-zone are the risk of a slowdown in China and the influx of refugees into the region as a result of crises elsewhere. But on both fronts the euro-zone is well protected. First, given the region's limited trade and financial links with China, the effects of a slowdown would be small. Second, the euro-zone looks able to cope with the arrival of refugees, which hopefully won't be sustained as the crises from which they are fleeing abate.
- **However, the euro-zone still faces significant domestic problems. For a start, its recovery has been boosted by two temporary tailwinds – namely the previous depreciation of the euro and falls in oil prices – which are already fading. And the threat of a Greek euro-zone exit has not vanished.**
- One glimmer of hope is that the period of austerity appears to be drawing to a close. Indeed, the European Commission expects there to be a small fiscal *loosening* in 2016 and 2017. **But this will only reverse a fraction of the tightening that euro-zone countries have endured.**
- **As a result, we remain sceptical that fiscal policy will provide a substantial economic boost. The recovery will therefore remain dependent on continued support from the ECB.** The stimulus already in place has had some positive effects but it is not clear that it has transformed the outlook.
- **After failing to live up to its own hype last week, we think that the ECB will eventually need to do more.** With a limit on how much lower its deposit rate (now -0.3%) can go, it will also have to beef up its asset purchase programme and *expand* rather than just *extend* it. It may also need to alter its inflation target to make it symmetric around a central figure of 2%.
- **Overall, the fall in the euro, lower oil prices and the ECB's policy stimulus, this year's GDP growth of about 1.5% is disappointingly weak. What's more, we see growth slowing to 1% in 2016, too slow to bring inflation swiftly back up to the ECB's 2% ceiling. In contrast to the US, monetary policy is likely to become even more expansionary in the euro-zone.**

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Can the euro-zone weather the global headwinds?

This Focus is an adapted version of a presentation given at the Capital Economics Developed Markets Forecast Forum in London on 1st December 2015.

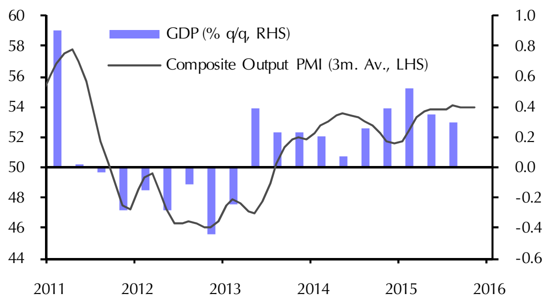
The euro-zone escaped relatively unscathed from the summer panic that a renewed global recession might be just around the corner. But does this suggest that the currency union is now strong enough to withstand shocks from overseas? And have the domestic weaknesses that have plagued the region diminished significantly?

We will start by considering whether global headwinds could derail the euro-zone's recovery and whether the greater risks may lie rather closer to home. Then, we will address whether, after nearly five years of growth-sapping austerity, fiscal policy might be able to inject some life into the region's sluggish recovery. And finally, we will ask if the ECB will need to reinforce its monetary policy support and, if so, how it might go about it.

Sheltered from global headwinds?

Fears over the summer that a dramatic slowdown in China would tip the world back into recession did not overly damage the euro-zone's economic recovery. Admittedly, quarterly GDP growth slowed again in Q3. But activity surveys such as the composite PMI have held up fairly well. Indeed, they provide some hope that GDP growth might pick back up in Q4. (See Chart 1.)

CHART 1: EURO-ZONE GDP & COMPOSITE PMI



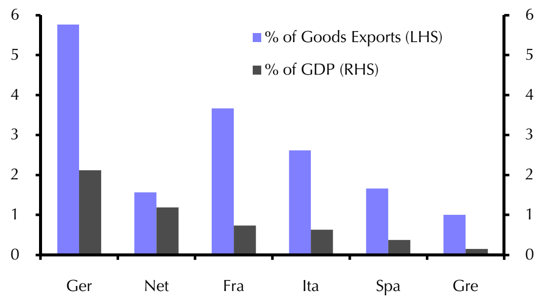
Sources – Thomson Datastream, Markit

Of course, this may be partly due to the fact that the panic about China was overblown. A more substantial slowdown there would certainly pose a greater risk.

In such a scenario, the euro-zone would not be immune but the *direct* effect would be limited, given its relatively small trade and financial links with China. After all, only 7% of the euro-zone's goods exports, or about 1% of GDP, went to China in 2014 – about the same as for the US. Chart 2 shows that, even in Germany, which is the most exposed member state, goods exports to China last year were worth only about 2% of its GDP.

Even when the *indirect* effects are taken into account, the impact is still likely to be small. The ECB estimates that if Chinese real GDP growth were to slow by one percentage point, then this might knock just 0.1 percentage points off the level of euro-zone GDP over two to three years.

CHART 2: GOODS EXPORTS TO CHINA (2014)



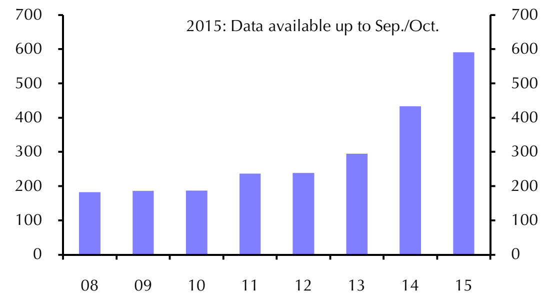
Source – Thomson Datastream

A sharp slowdown in China might also have some *positive* effects. Commodity prices, including oil, would probably remain low. As a net energy importer, the euro-zone would benefit.

The second possible headwind is a continuation of the recent influx of refugees into Europe. As Chart 3 shows, the number of first-time asylum applicants so far this year is already two to three times higher than experienced only five years ago.

This has put euro-zone countries under social, political and financial strain.

CHART 3: FIRST-TIME ASYLUM APPLICANTS IN THE EURO-ZONE (000S)



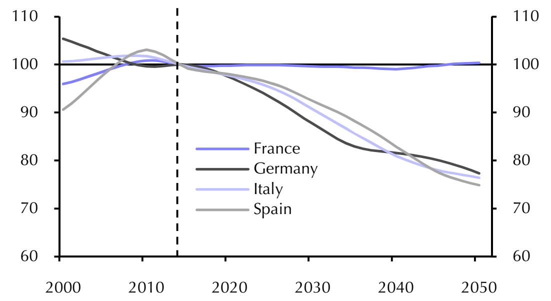
Sources – Thomson Datastream, Capital Economics

The official figures may well underestimate the true number arriving. Note that almost a million refugees (which includes repeat asylum applications) have registered with the German Government this year alone, representing about 1% of the population. **Nonetheless, we doubt that this will have substantial adverse economic effects. First and foremost, it is to be hoped that the recent inflows will not be sustained as the crises from which these people are fleeing abate.**

Furthermore, the financial costs are seen as manageable. The German Government has announced a 5 billion euro increase in public spending next year because of costs relating to asylum seekers. This is worth around 0.2% of GDP. The extra spending might boost overall domestic demand since all of the handouts are likely to be spent.

Meanwhile, these refugees are largely of working age so they might help to solve the huge long-term challenge posed by the region's ageing population. Chart 4 shows the United Nations' working age population projections for the four biggest euro-zone countries. As things stand, only France will have a similar-sized potential workforce by 2050. Germany, Italy and Spain will all see big declines. And the dependency ratios in all four will deteriorate substantially.

CHART 4: WORKING AGE POPULATION (2014 = 100)

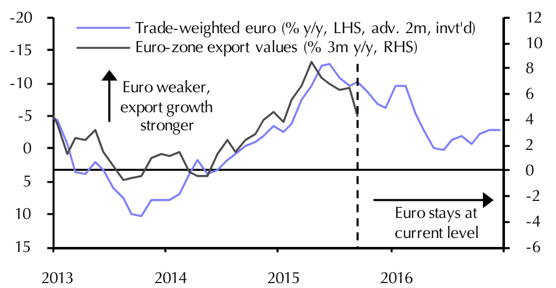


Sources – United Nations, Thomson Datastream

The upshot is that the euro-zone appears relatively sheltered from major external headwinds. But in our view, the greater risks to the recovery lie closer to home.

For a start, the recovery has been boosted by two temporary tailwinds –the previous depreciation of the euro and falls in oil prices – which are already fading. The fall in the euro in annual terms between late 2013 and the spring of 2015 had a clearly positive effect on euro-zone exports. But as Chart 5 shows, the pace of the euro's depreciation has already slowed and the growth of exports with it. Unless the euro falls a lot further, this less favourable trend will continue.

CHART 5: TRADE-WEIGHTED EURO & EURO-ZONE EXPORT VALUES



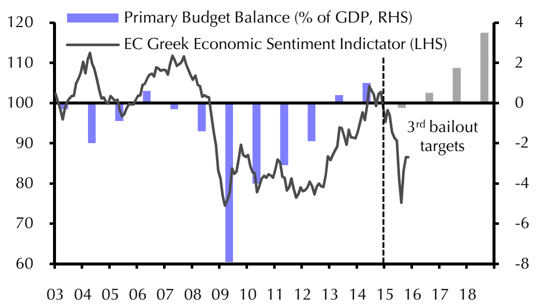
Sources – Thomson Datastream, Capital Economics

Meanwhile, the threat of a Greek euro-zone exit has not vanished. Admittedly, the news has improved, with Greece receiving its latest bailout tranche. But significant challenges still lie ahead.

Against the backdrop of violent protests, further austerity measures will be required.

Furthermore, Greece still faces very onerous fiscal targets, with a primary surplus of 3.5% required in 2018. This will be difficult to meet given the deterioration in economic sentiment. (See Chart 6.) And finally, there is no obvious solution to Greece's unsustainably high debt burden.

CHART 6: GREECE PRIMARY BUDGET BALANCE & EC ESI



Sources – EC, Thomson Datastream

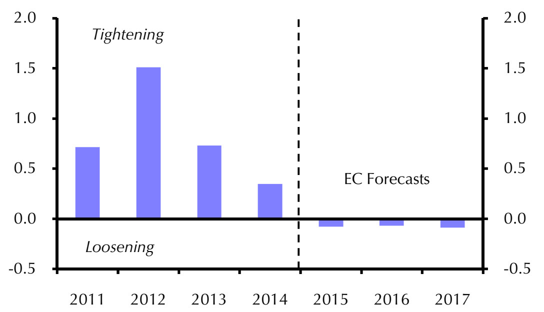
In short, global headwinds are unlikely to derail the euro-zone's recovery completely and they may even have some positive side effects, for example, via lower commodity prices. But the euro-zone has bigger problems to contend with closer to home, notably the fading boosts to growth from the weaker euro and lower oil price as well as the threat of a Greek euro exit.

Can fiscal policy start to support growth?

One glimmer of hope is that the long period of austerity in the currency union appears to be drawing to a close. The euro-zone has endured significant belt-tightening as member states sought to put their public finances in order. Some austerity was necessary, but we have long argued that the pace of fiscal tightening – particularly in the periphery – has been detrimental to growth.

Chart 7 shows the annual change in the euro-zone's structural fiscal balance, which adjusts the headline balance for the economic cycle and one-off factors. After substantial tightening from 2011 to 2014, the European Commission expects there to have been a small *loosening* this year, which will be repeated in 2016 and 2017. On the face of it, this shift ought to be good news as fiscal policy is no longer an obvious drag on economic growth.

CHART 7: CHANGE IN EURO-ZONE STRUCTURAL BUDGET BALANCE (%-PTS OF POTENTIAL GDP)



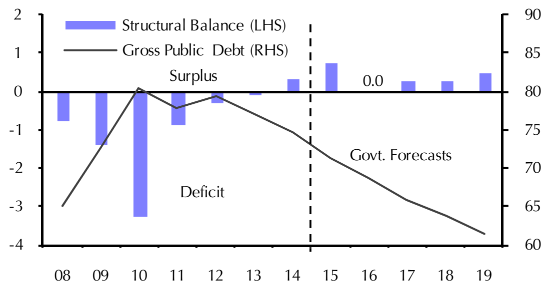
Sources – EC, Thomson Datastream

But most euro-zone countries will still be feeling the lagged and cumulative effects of the previous tightening. The forecast fiscal loosening will reverse only a fraction of this. Moreover, some of the countries that plan to loosen fiscal policy are those where there are still big concerns about debt sustainability, notably Italy and Portugal. Indeed, given their high debt burdens and weak nominal growth, any loosening of fiscal policy there could well provoke renewed market worries, especially in the context of Fed policy tightening.

And those that arguably can loosen fiscal policy are reluctant to do so. The German Government still plans to run a structural budget surplus over the next five years, far more frugal than required by Brussels and which will reduce its public debt sharply, to almost 60% of GDP by 2019. (See Chart 8.)

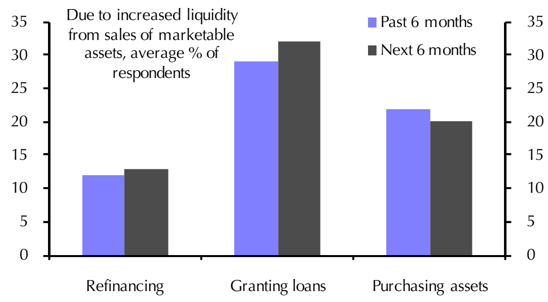
Yet Germany's economic growth is already slowing and public sector investment accounts for only 2% of GDP, which is low by international standards. With the Government's long-term borrowing costs so low, now is surely an ideal time to increase capital spending.

CHART 8: GERMAN STRUCTURAL BALANCE & GROSS GOV'T DEBT (% OF GDP)



Sources – German Finance Ministry, Thomson Datastream

CHART 9: USE OF ADDITIONAL LIQUIDITY FROM ASSET PURCHASE PROGRAMME (%) (Q3 2015)



Sources – ECB, Capital Economics

Overall, it is encouraging that austerity is generally not being increased. But most countries are not going to see considerable fiscal easing, even those that can afford to. As a result, we remain sceptical that fiscal policy will provide a substantial economic boost.

What more will the ECB do?

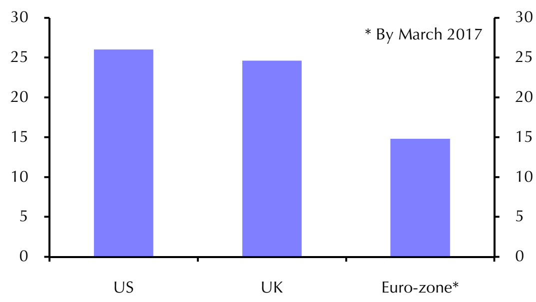
With fiscal policy unlikely to transform the outlook, the onus will remain on monetary policy to boost the economy. The ECB has already offered more cheap long-term loans to banks, lowered its deposit rate below zero and is buying €60bn of assets every month.

This has had some positive results. Since the ECB first floated the idea of quantitative easing 18 months ago, bond yields have fallen and banks' funding costs have also declined, encouraging them to lend. According to the ECB's latest Bank Lending Survey, in the six months to October, banks preferred to use the additional funds received as a result of the ECB's QE programme to grant loans rather than buying assets or refinancing (e.g. rolling over debt). And more banks expected to grant loans in the subsequent six months. (See Chart 9.)

There has also been a welcome weakening of the euro – the ECB reckons that as much as 60% of the euro's fall against the dollar since May 2014 has been due to its asset purchases.

But while the ECB has done a lot, it was much slower to react than other major central banks. The ECB's QE programme is also smaller than those of the Fed and the Bank of England as a share of GDP. (See Chart 10.)

CHART 10: CENTRAL BANK ASSET PURCHASES (AS % OF GDP)

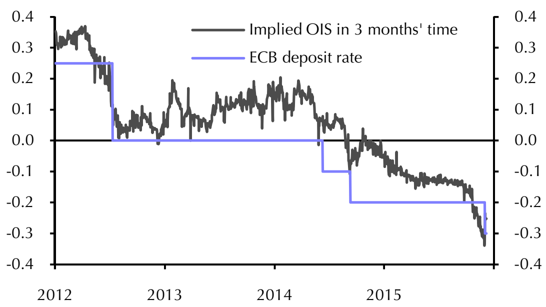


Sources – Thomson Datastream, Capital Economics

It is not clear that this monetary stimulus has transformed the outlook. GDP growth is sluggish, as is bank lending growth. And inflation remains very low. In November, the headline rate of inflation was unchanged at just +0.1%, while the core rate (excluding food and energy) dropped from +1.1% to +0.9%, well below the ECB's target of "below, but close to, 2%".

Against this backdrop, the ECB had primed the markets to expect additional policy stimulus to be announced in December. This caused the five-year, five-year inflation swap rate, which is the ECB's preferred measure of inflation expectations, to rise to almost 1.8% just before the meeting. Meanwhile, after ECB President Mario Draghi had put the option back on the table in October, market participants were expecting a further cut to the deposit rate from the prevailing rate of -0.2%, with the implied overnight rate in three months' time falling to around -0.35%. (See Chart 11.)

CHART 11: EURO-ZONE INTEREST RATES (%)

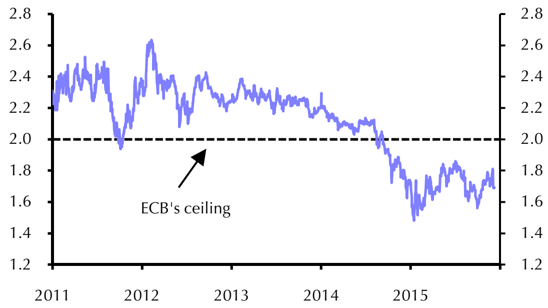


Sources – Bloomberg, Thomson Datastream

The pressure was therefore on the ECB to match its words with actions if it was to avoid a renewed fall in inflation expectations and an unwelcome strengthening of the euro. But unfortunately, true to type, it failed to do so. Admittedly, it did cut the deposit rate further last week, by 10bp to -0.3%. But this was not quite as big as the markets had been expecting. And its changes to its asset purchase programme – a six-month extension to March 2017, the reinvestment of principal payments and the inclusion of regional bonds – fell short of the *expansion* that the market had been expecting. As a result, the five-year, five-year inflation swap rate has fallen back since the ECB announcement, to below 1.7%. (See Chart 12.) The implied overnight rate in three months' time has also risen, to -0.25%.

Evidence from Sweden, Switzerland and Denmark, which have lower policy rates than the euro-zone, indicate that the ECB could (and perhaps should) have been bolder in cutting its deposit rate. There is no evidence so far that negative rates have caused wholesale disruption to financial markets or prompted banks to start charging most of their customers.

CHART 12: FIVE-YEAR, FIVE-YEAR FORWARD INFLATION SWAP RATE (%)

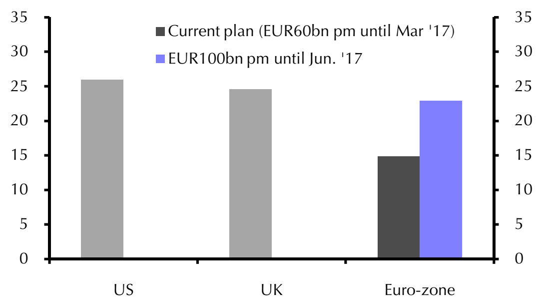


Sources – Bloomberg, Capital Economics

It should also have done more in terms of its *unconventional* policy support. For a start, the announcement that its asset purchase programme would be extended by six months to March 2017 hardly came as a shock. After all, we had long argued – even when others were predicting the opposite – that the ECB would extend QE beyond the original scheduled end-date of September 2016. And market participants had come round to our view in recent months. Furthermore, we still doubt that a mere six-month extension would have the effect that the ECB desires.

Accordingly, we still think that it must up the monthly pace of asset purchases. Chart 13 shows that to match other major central banks, the ECB would have to at least raise the monthly amount to €100bn *and* extend the programme to June 2017.

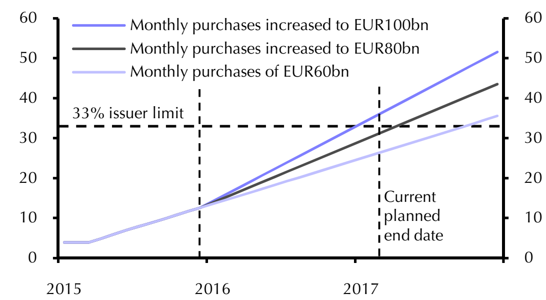
CHART 13: CENTRAL BANK ASSET PURCHASES (% OF GDP)



Sources – Thomson Datastream, Capital Economics

Opponents of more QE worry that the ECB will run out of assets to buy, given that it cannot hold more than 33% of any government's eligible bonds. **But we think such fears are unfounded.** Under the existing plan of €60bn euros a month, the ECB wouldn't hit the limit for almost another two years. And even if it were to expand its QE programme to €100bn a month, it wouldn't hit the limit until the start of 2017. (See Chart 14.)

CHART 14: ECB GOVERNMENT BOND HOLDINGS (% OF EURO-ZONE STOCK, 2-30 YEARS)



Sources – Thomson Datastream, Capital Economics

Granted, some assets, notably short-dated German Bunds, cannot currently be bought because they yield less than the deposit rate. But the ECB has shown that it can and will alter the parameters of the programme. For example, last week it expanded the list of eligible assets to include regional debt. It seems plausible to think that the ECB could overcome most technical difficulties.

With the ECB's current policy support unlikely to induce an improvement in the region's growth and inflation outlook, we think that it will still have to expand its QE programme. For now, we are pencilling in an increase to €80bn a month, perhaps in Q2 next year.

There is one other bolder option for the ECB. Treaties state that its primary objective is to "maintain price stability". The ECB's Governing Council announced in October 1998 that it would define this as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". This is usually shortened to "below, but close to, 2%" in ECB communication.

So far, the ECB has rigidly stuck to this interpretation of its price stability mandate, creating a deflationary bias in the ECB's thinking and willingness to act, which may explain why core inflation has hovered around 1%.

But if the ECB's Governing Council really wants to commit to boosting inflation, it could re-define its mandate and remove that asymmetry without changing any Treaties and aim simply for 2%, like many other major central banks.

This might well be anathema to the Bundesbank, which may argue that doing so would undermine the ECB's credibility. But with inflation so low, its credibility is already at risk. And a shift in the ECB's approach is surely needed if it is to tackle the threat of deflation and avoid a Japanese-style future.

Conclusions

To conclude then, while the euro-zone is relatively sheltered from global headwinds, it still faces significant problems at home. Granted, the recovery has gained some pace this year, with annual GDP growth of about 1.5%.

But this is disappointingly weak given the boosts from the weaker euro and lower oil prices as well as the ECB's policy stimulus. And we see GDP growth slowing to 1% next year, as the euro and oil tailwinds fade, and as fiscal policy provides little meaningful support.

This will simply not be fast enough to bring inflation swiftly back up to the ECB's 2% ceiling. As a result, the ECB is likely to have to increase its stimulus and may have to be more radical, just as the US Fed is gearing up to tighten policy. Even then, we still think that inflation will average only a little more than 1% in 2017.