Economics

DBS Flash

Eurozone: Growth and politics reinforce go-slow on policy normalisation

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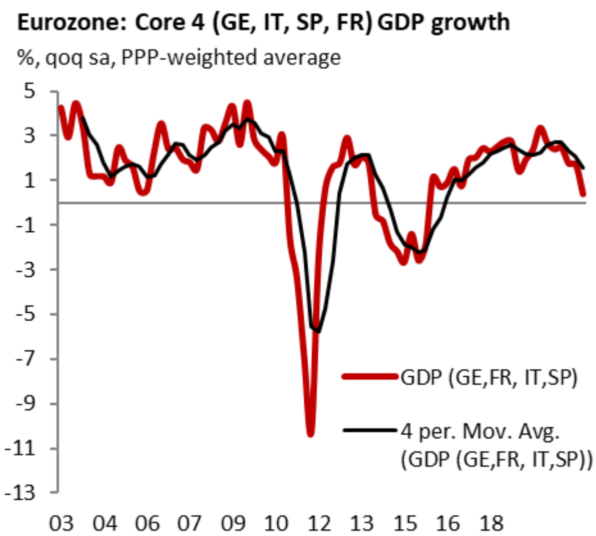
- *Eurozone growth disappointed in Q318 with the slowdown amplified by few transitory factors. A swift turnaround, however, will be a challenge. We revise down our already conservative full-year growth forecast for 2018 and next year.*
- *Political risks have resurfaced, particularly the rise of far-right politics in the bloc's largest economies, i.e. Italy and Germany. At the margin, uncertainty over Brexit and likelihood of a leadership change also hangs in the air.*
- *In this midst, supply-side factors have driven inflation to the 2% target, but core is benign.*
- *Against this backdrop, the European Central Bank is on track to cease asset purchases (besides reinvestments) by end-2018.*
- *Rate hikes will be slow to follow if the domestic economic and political environment remain challenging. This could be well delayed beyond Draghi's term, which ends in October 2019.*
- *Global developments, protectionist trade overtures and slowing EM/China, will also push normalisation talk to the backburner.*
- *Markets are giving less weightage to the ECB policy outlook, instead pre-occupied by shifting political and economic sands. DBS Currency Economist continues to look for further EUR downside. Rates volatility is localised for the time being but is likely to watch German Bund movements as a barometer of risk.*

Eurozone growth disappoints in Q318

The Eurozone economy slowed to 1.7% YoY (0.2% QoQ), falling below our and consensus expectations. This marks a step down from 2.3% in H118 and 2017's 2.5%. The breakdown will be available next month alongside the second GDP reading, but lead indicators point to a broad slowdown, alongside the impact of few transitory factors. A swift turnaround, however, will be a challenge.



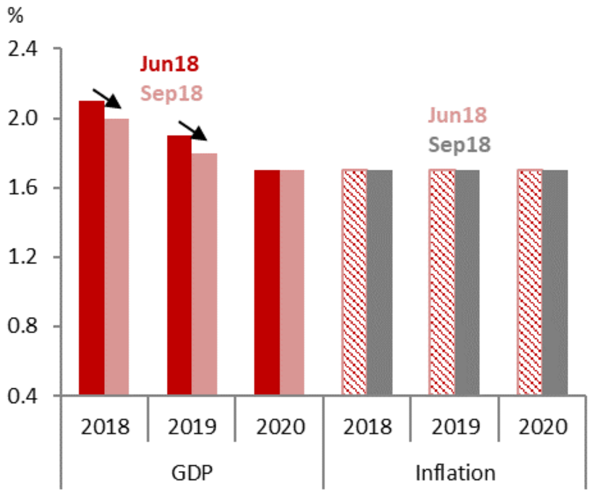
Nominal and negotiated wage growth improved in H218, though purchasing power was partly dented by high energy prices. Reflecting this, retail sales softened in July and August. Concurrently, industrial production was dragged by slower manufacturing, utilities and mining activity, despite better capacity utilisation rates. Composite PMIs, though in expansionary terrain, have eased to late 2016 levels. This caution spilled over to service sector activity as well, putting Q4 output on a weaker footing. Slowing construction activity is weighing on investment growth. Finally, exports are showing signs of slowdown into the second half of the year, while imports rise, narrowing the average Q3 goods trade surplus by ~20% vs H1 average.

Temporary factors akin to disrupted car production in Germany due to stricter emissions regulations hurt growth, weighing on the bloc as a whole. France fared better, but Italy stagnated, making the budget decisions even more tenuous. **In light of risks to the outlook and**

global uncertainties on the trade front, we lower our 2018 forecast to 1.9% from 2.2% previously. Next year is pegged at a slower 1.8%.

The European Central Bank has been cautious on the growth outlook, with staff forecasts revised down for 2018 and 2019 for a second successive time in September. Consensus, according to Bloomberg, has lowered the bloc's 2018 growth outlook multiple times this year, with the IMF and the European Commission also adopting a more cautious tone in recent economic assessments.

ECB staff projections - Growth lowered

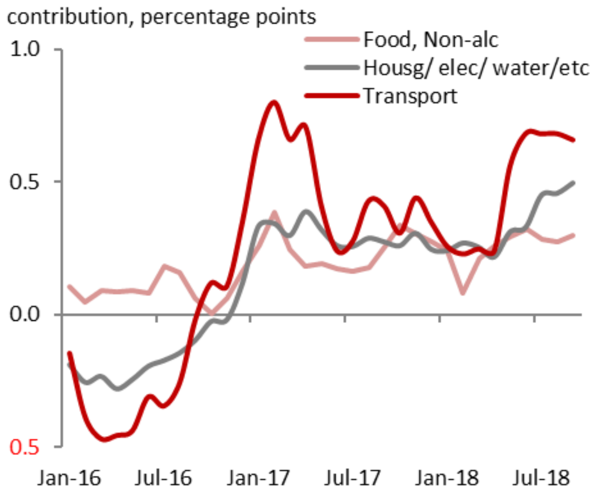


Inflation remains a mixed bag

Compared to stubbornly weak inflation last year, headline inflation is close to target this year. From 1.3% YoY in January 2018, Eurozone headline inflation has risen to 2% ECB target by Q3. While this fulfils the policy mandate, policymakers are likely to be concerned on two fronts.

Firstly, the rise in inflation is mainly due to cost-push forces i.e. energy prices (transport was the single biggest contributor to price increases) and utility costs. **Secondly,** core continues to flatline at 0.9% YoY in August-September, despite improving wage conditions. This implies two factors: a) firms are hesitant to pass on the burden of higher wages, impinging on their margins; b) impact of a weak euro is still to reflect on imported/ tradable inflation. **The year-to-date inflation average at 1.7% is in line with the ECB's projections for 2018 and 2019, leaving them comfortable with their loose monetary policy stance, yet setting the stage for withdrawal from QE.**

Inflation - index heavy-weights



Policy normalisation on the backburner

Given this growth and inflation backdrop, policymakers see a lower need to maintain crisis-era policy. Beyond halving of the monthly quantum in Q4, we expect QE purchases to cease by end-2018. The ECB is, nonetheless, likely to continue reinvesting proceeds from maturing bonds into 2019. Details on the size and duration of reinvestments might be made available at the December policy meeting. Monthly redemptions might amount to EUR5-20bn over the next 12 months, according to Reuters, bulk of which will be of the core economies of the bloc.

As QE comes to a stop, questions on the timing of rate hikes are likely to resurface. **Unlike withdrawal of asset purchases, policy normalisation will require a more confident economic outlook**. The ECB staff project slower growth and steady inflation over 2019-2020. Official communication still signals that rates will be held at their current levels at least until summer of 2019. With growth coming off highs in recent quarters and a smaller scope of a swift turnaround, hikes are likely beyond October 2019, after Draghi's term ends. Deterioration in the external environment and a tougher domestic political climate are other factors that will worry the central bank.

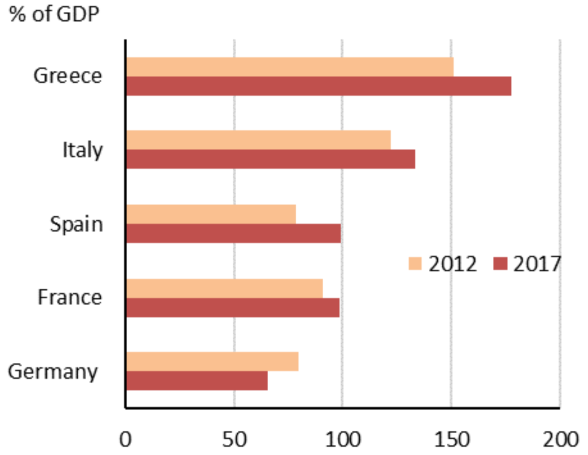
Tougher political climate lies ahead

Political risks have resurfaced, particularly the rise of far-right politics in the bloc's largest economies, i.e. Italy and Germany. At the margin, uncertainty over Brexit and likelihood of a leadership change also hangs in the air.

In Germany, the electoral defeat of the ruling coalition partners, the Christian Democratic Union and Social Democrats, in recent regional polls will see German Chancellor Angela Merkel step down as the party chief in the coming weeks. She will also not seek re-election when her political term ends in 2021. German politics has long been a stabilising influence for the region, providing policy certainty, supporting EU integration plans and pushing for the unity of the single market. With dominant parties likely to take a backseat, the domestic landscape is likely to turn more fragmented, particularly as the regional elections has given the far-right parties a bigger presence in the parliament. Besides the risk that the ruling government might be reduced to a lame-duck status for the next 2-3years, the economy's strong economic position, with a strong current account surplus, strong manufacturing base, fiscal austerity, is at threat if the far-right voices continue to gain momentum.

Rome is, meanwhile, on a collision course with the European Commission, as the new Italian government reneged on fiscal consolidation plans to raise deficit targets for next year (-2.4% of GDP for 2019 vs EU-mandated -0.8%). Tensions are likely to rise if the European Council launches an "Excessive Deficit Procedure" against Italy, which would require Italy to provide a plan of corrective action to rein in its large public debt, currently at 130% of GDP vs the 60% Maastricht rule. Rating agencies have sounded cautious on the Italy's fiscal spending plans. Moody's lowered Italy's rating to a notch above junk, with S&P following up with an outlook revision. With Italian growth stagnating in Q3, these talks are likely to get more acrimonious. A material fallout on the bond markets will necessitate the ECB's backstop, but the latter has reiterated that it will not get involved unless Rome officially seeks help through the assistance program, akin to OMT (Outright Monetary Transactions).

Italy's government debt is the highest, amongst the core-4



In more than two years since the Brexit vote, there is little clarity on the terms of the UK-EU relationship after UK exits the bloc. The risk of the government exiting the EU without a deal has increased dramatically in recent weeks, as the March 2019 deadline approaches. Finance Minister Hammond signaled that an emergency budget may be required, which will necessitate further public sector spending to cushion the economy. S&P raised the prospect that the economy might slip into a recession, with a sharp jump in inflation and unemployment in the case of a 'no-deal' exit. Prime Minister May is not only facing external resistance, but also parliamentary resistance to various Brexit scenarios, including the Northern Ireland border issue emerging as a key bone of contention.

For the EU, 2019 will also mark a crucial year on the institutional end, with a new head of the European Commission, election for the new European Parliament (May) and a new ECB Governor (October).

Against this backdrop, markets are giving less weightage to the ECB policy outlook, instead pre-occupied by shifting political and economic sands. DBS Currency Economist continues to look for further EUR downside, with the weakness yet far being along our expectations. Rates volatility is localised for the time being but will eye German Bund movements as a barometer of risk. We continue to look for the ECB to wait-out and not rush into policy normalisation next year.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).