EUROZONE UPDATE

Gus Faucher Chief Economist
Stuart Hoffman Senior Economic Advisor
William Adams Senior Economist
Kurt Rankin Economist
Mekael Teshome Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

ECB SET FOR MOLASSES-SLOW TAPER OF QUANTITATIVE EASING IN 2018; EURO INTEREST RATES TO STAY LOWER FOR LONGER

A virtuous cycle of recovery is lifting economic growth

The Eurozone's expansion has gained traction. Real GDP grew 1.9 percent in year-ago terms in the first quarter of 2017, little changed from the full year of 2016's 1.7 percent growth. Several tailwinds are supporting this stronger growth which, while modest, is still more than double the Eurozone's 0.7 percent annual average during the crisis years between 2010 and 2015. The EU's "carrot and stick" approach to the sovereign debt crisis decisively ended that period's financial turmoil: The European Central Bank supplies the carrot, a commitment to do "whatever it takes" to backstop the Eurozone's financial system, support private consumption and investment with low interest rates, and boost asset prices though quantitative easing. The European Commission supplies the stick, enforcing limits on deficits and debt in the Eurozone's crisis economies, and bolstering the Eurozone's credibility as an economic union. The vicious cycle of crisis has yielded to a virtuous cycle of recovery: Stronger output and employment boost government tax revenues and reduce cyclical social spending, in turn freeing countries from making additional spending cuts to retain market confidence. As a result, austerity has ceased to be a headwind to economic growth. Just as importantly, the euro's weakness against the US dollar has boosted Eurozone net exports and manufacturing activity. Faster growth lowered the Eurozone's unemployment rate to 9.3 percent in April 2017 from a peak of 12.1 percent in March and April of 2013.

Many reasons to expect inflation to undershoot the ECB target medium-term

Despite this clear cyclical recovery, the Eurozone economy has transformed over the last decade in ways that will prevent the European Central Bank from rapidly increasing interest rates (See Chart 1). The Eurozone has become a low GDP growth, low wage growth, low inflation economy. As its population ages and traditional gender roles change, women and older workers comprise an increasing share of the Eurozone's workforce – a change apparent in the increase in overall labor force participation at the same time that participation is falling among men in prime working years (again see Chart 1). Other advanced economies that have experienced similar

CHART 1: THE RECOVERY IS REAL, BUT A LONG-TERM SHIFT TO A LOW GDP GROWTH, LOW WAGE GROWTH, LOW INFLATION ECONOMY WILL PREVENT THE ECB FROM RAISING INTEREST RATES RAPIDLY

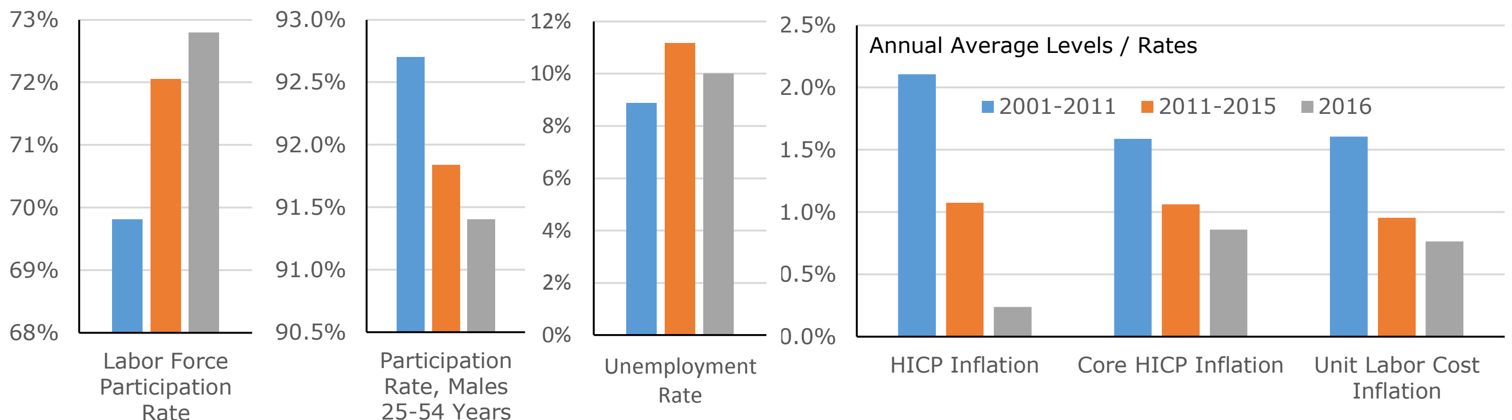

Chart sources: Eurostat, CEIC, The PNC Financial Services Group

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Demographic changes slow GDP growth, wage growth, inflation

demographic changes have seen trend nominal wage growth slow, and have also seen growth in real wages slow relative to growth in output per worker. This metric of “wage-push” labor cost inflation, also called unit labor costs, is closely correlated with core consumer price inflation over time (right-most two sets of bars in Chart 1), and recent slow increases in unit labor costs mean inflationary pressure will be less intense in coming years than in the first decade of the 21st century. In addition, the deregulation of labor markets in the sovereign debt crisis countries, Greece, Portugal, and Spain, and to lesser extents in France and Italy, will slow wage growth and inflation in the same way that falling union membership in the United States has slowed wage growth and inflation since the 1980s. The Eurozone’s crisis countries account for half of Eurozone GDP and 55 percent of its employment, and so their labor market reforms will put downward pressure on overall Eurozone inflation.

ECB’s withdrawal of stimulus in 2018 and 2019 will be molasses-slow

These headwinds to inflation make the ECB likely to withdraw monetary stimulus extremely slowly in 2018 and 2019. The ECB in June 2017 reiterated its expectation that it would continue to purchase government and private-sector assets at a pace of €60 billion per month between April and December 2017 (“quantitative easing”), and maintain interest rates at present levels “well beyond the horizon” of the conclusion of a taper of the QE program. They were silent about expectations for quantitative easing in 2018 and beyond, suggesting that Governing Council members are undecided about whether to undertake a US-style taper of purchases or to reduce them even more slowly than the Federal Reserve did. In the base case, the ECB could reduce its asset purchases by €5-10 billion euros per month beginning in January, and complete a taper of purchases between July and December, 2018. Waiting “well beyond the horizon” of the conclusion of a taper would mean an initial increase in the ECB’s deposit rate, the benchmark short-term interest rate, from its current negative 0.40 percent is unlikely to occur before 2019. If the ECB allows a full year to elapse between the conclusion of quantitative easing and an initial policy rate hike, following the precedent of the Federal Reserve’s very gradual normalization of US interest rates in 2014 and 2015, short-term benchmark interest rates in the Eurozone are likely to be negative when ECB President Mario Draghi’s term concludes in October 2019. In the interim, if an electoral upset creates doubt about political support for the European Union or Brexit negotiations increase downside risks to Eurozone growth, the ECB is likely to withdraw stimulus even more slowly than in this forecast.

Strong dollar, weak euro era is not over yet

The euro strengthened modestly in the first half of 2017 as the ECB’s taper has drawn nearer and as financial markets have scaled back expectations for fiscal stimulus in the US, pushing down yields on medium- and long-term US bonds, which are closely correlated with the dollar’s exchange rate. Looking forward, interest rates on US assets are likely to rise faster than interest rates on comparable Eurozone assets in 2017 and 2018, fueling a partial reversal of the euro’s early 2017 appreciation in the second half of 2017 and in 2018 (see Chart 2). The era of the strong dollar and weak euro is not over yet.

CHART 2: THE ERA OF THE STRONG DOLLAR AND WEAK EURO IS NOT OVER YET

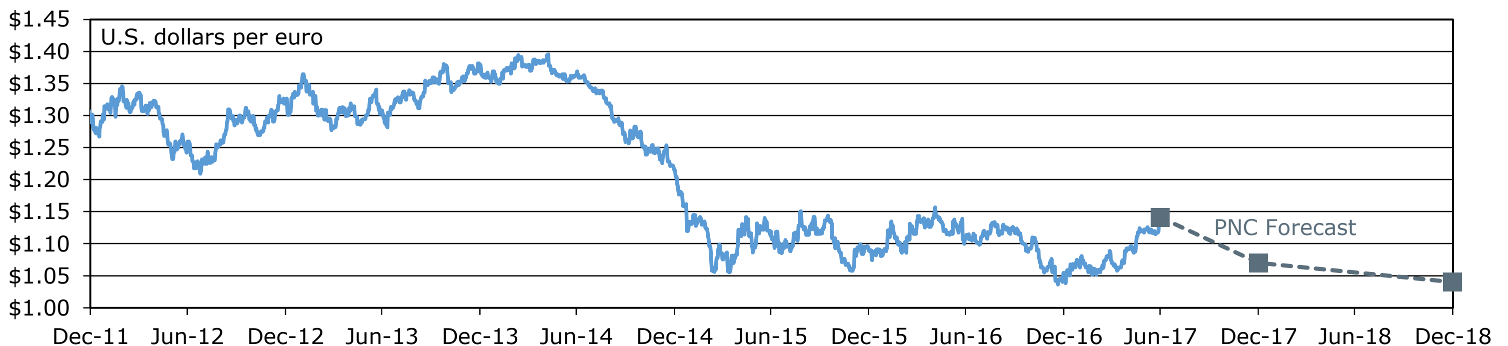

Chart sources: European Central Bank, CEIC, The PNC Financial Services Group

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