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Economic Research:

Flying On One Engine: The Eurozone Economy Is Fighting For Altitude

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Table Of Contents

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Flying On One Engine: The Eurozone Economy Is Fighting For Altitude

A nosedive in financial conditions at the start of the year has taken some wind out of the eurozone economy. The sudden decompression was a reaction to an underlying deterioration in the world's major economies that was on the radar in the final months of 2015. The sharp fall in equity prices expressed fears about slower growth in emerging markets, especially China, and possibly in the U.S. as early as the second half, while the eurozone's recovery was running on only a single engine--consumer demand. Yet, since the end of February, global market sentiment has started to improve again; and in Europe, the set of new accommodative measures that the European Central Bank (ECB) announced was well-received.

Because of the downdraft, we have trimmed our growth projections for the eurozone economy for this year and next. Specifically, we now expect the eurozone economy to grow 1.5% this year, against 1.8% in our November projections, and by 1.6% in 2017. We made more substantial revisions to our headline inflation forecast, now down to 0.4% for this year (versus 1.1% previously) that we believe will reach 1.4% next year (1.5%). We continue to think that the recovery's underlying fundamentals are more resilient than the financial markets have recently suggested, but not so strong as to bring growth back to its pre-crisis flight path. In addition, we stress that central bank actions are having a diminishing impact on inflation and growth prospects, partly because some of the battles they're trying to fight are beyond their reach (low commodity prices, erratic swings in emerging markets currencies), and partly because they lack "air support" from governments, such as structural reforms to boost competitiveness and the efficiency of labor markets.

Overview

- The current upswing in the eurozone essentially has been a one-engine, consumer recovery. But we believe the fundamentals underlying consumer spending remain strong.
- Employment in particular should rise more meaningfully across the region in 2016 and 2017. We forecast the eurozone unemployment rate to average 10.2% this year (10.9% in 2015) and 9.7% in 2017.
- Pessimism about business investment is partly deceptive, as recent trends show a pickup in most countries, except in Italy. We expect the recovery in nonconstruction investment to be less strong than in previous cycles as deleveraging remains a hurdle, but should grow 3.6% this year (3.1% in 2015) and 3.7% in 2017.
- The ECB's latest decisions indicate a shift in priorities, with more emphasis on the portfolio rebalancing channel and less on the exchange rate. This suggests the euro is now close to a bottom against the U.S. dollar.

Strong Consumer Demand Fundamentals

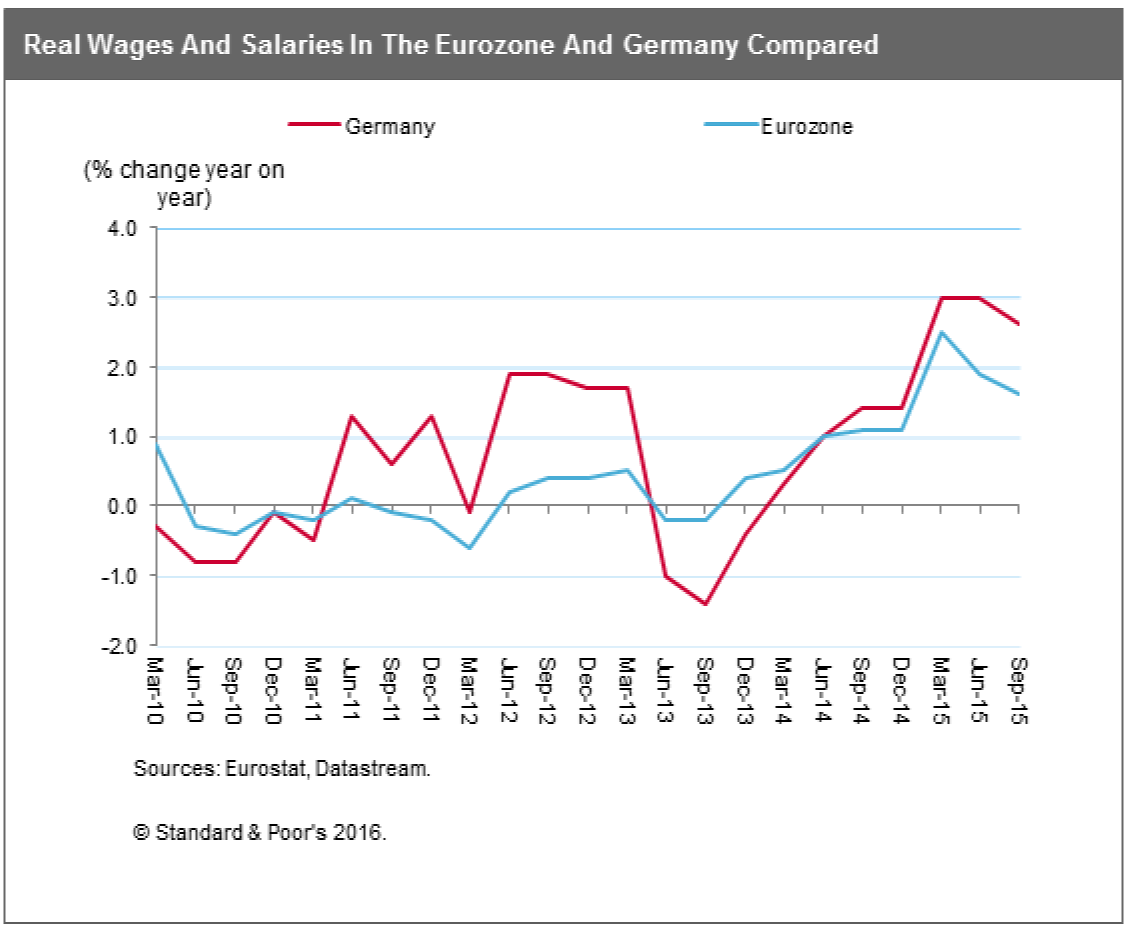
The current upswing in the eurozone had a sluggish start in the middle of 2014, and has since been gathering momentum. But it's been essentially a single-engine, consumer recovery. Consumption, which represents 55% of the region's GDP, has accounted for a whopping 72% of economic growth since 2014. What's more, this recovery in consumption is at different stages across countries: In the fourth quarter of 2015, consumer spending was still 4.8% below its 2008 average in Italy and below 6.7% in Spain, while it was up 7.2% in Germany.

A recovery that mainly relies on one cylinder is by definition suspicious: It could quickly grind to a halt, as it did in the previous cycle in 2010-2011. Or, it could be a flash in the pan, caused simply by a one-off drop in household energy bills. Although these concerns are valid, our view is that the fundamentals supporting the current upswing in consumer spending should prove resilient this year and next, held aloft by a pickup in wage growth and job creation, and ECB policy--to an extent.

Steadily Rising Wage Income

Wage growth, which directly feeds purchasing power, has been steadily rising since the end of 2013 in terms of hourly labor costs. Growth in nominal compensation per employee edged down in the eurozone in 2015 (to 1.2% from 1.4% in 2014), but was markedly above consumer price inflation (0% last year; see chart 1). We expect it will rise 1.5% in 2016, still comfortably above headline inflation, which we forecast to average 0.4%.

Chart 1



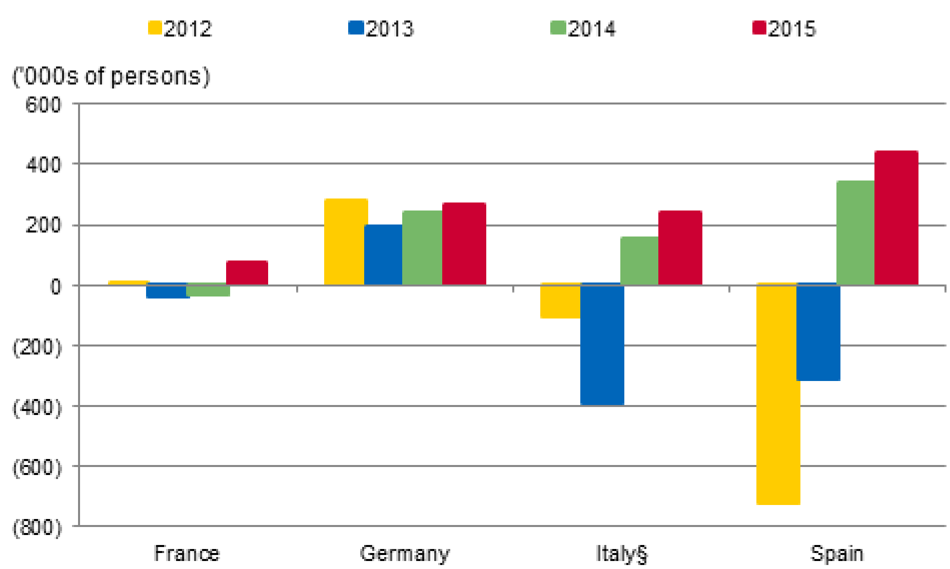
Real wage growth has been particularly robust in Germany, where a tight labor market (unemployment reached 4.6% in 2015) has led to a steepening of the Philips curve, suggesting that inflation may start to rise as well. Real growth has also been picking up in the Netherlands, France, and Spain, and to a lesser extent in Italy. Looking ahead, the continued improvement in labor markets, combined with persistently low inflation, will support additional gains in real income growth in 2016 and beyond.

A Pick-Up In Job Creation

In January, the unemployment rate came in at 10.3%, the lowest level since August 2011. What's encouraging is that job creation has picked up in the private sector in most countries since 2013, partly as a result of reforms introduced to boost hiring, such as in Italy and Spain (see chart 2). In contrast, France shows only modest gains in private-sector job creation through 2015--a total of 77,000 jobs on economic growth of 1.1%. Over the same period, Italy's private sector created 238,000 new jobs on GDP growth of 0.6%. However, measures recently introduced in France to reduce employers' social contributions and reform employment contracts should start to have more positive effects starting this year. Overall, we expect the eurozone jobless rate to come down to 10.2% and 9.7% in 2016 and 2017 from 10.9% in 2015.

Chart 2

Net Job Creation In The Eurozone Excluding The Public Sector*

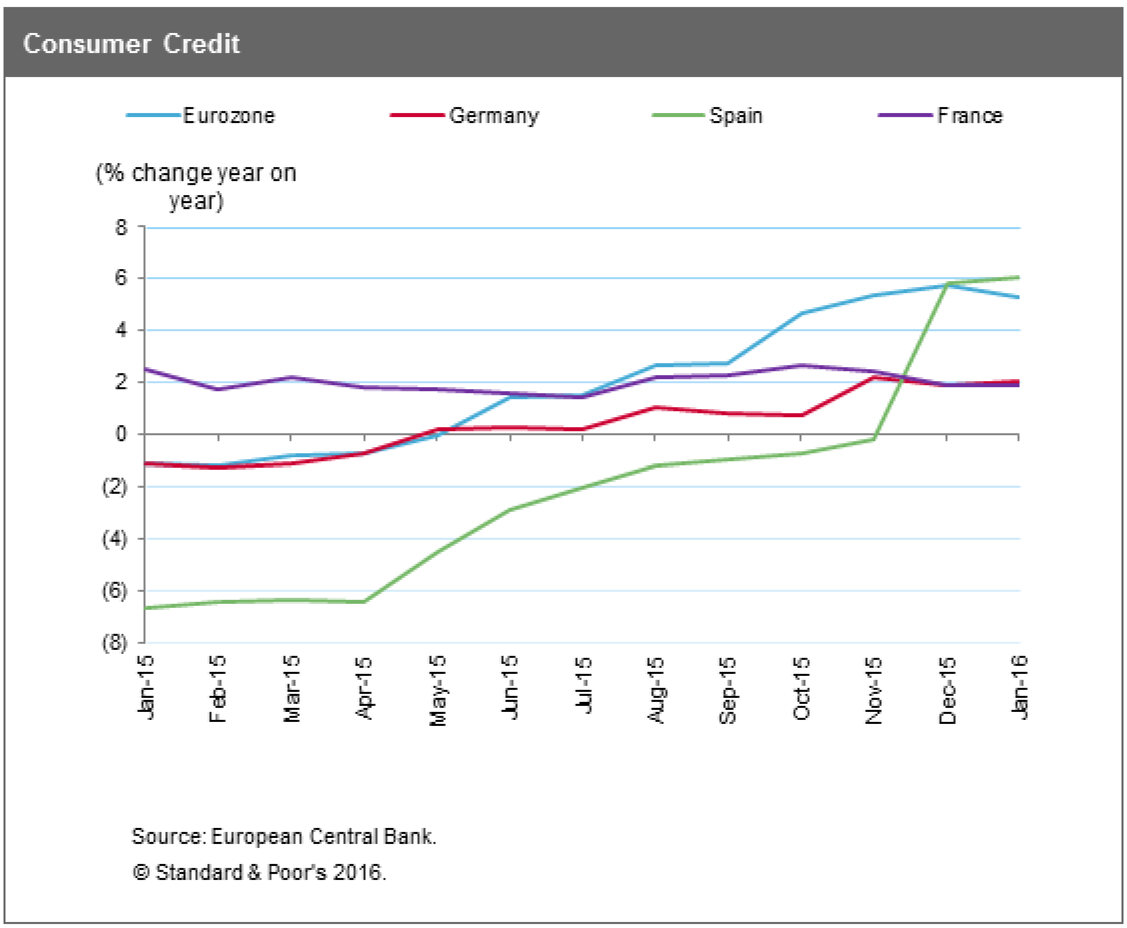


*Public sector comprises public administration, defense, education, human health and social work activities. §Italy until 3Q2015. Sources: Eurostat, Standard & Poor's.

Monetary Policy Multipliers: Help For The Household Sector

The ECB's accommodative monetary policy is also having positive effects on consumer demand via two major channels: The first is indirectly via extremely low interest rates, which have set the stage for a gradual recovery in residential real estate markets (see "European Housing Markets Continue To Heal As Mortgage Rates Stay Low," published on March 2, 2016, on RatingsDirect). Housing market conditions go a long way in influencing consumer sentiment. Very low interest rates have also created opportunities for households to refinance their existing housing debt and reduce their monthly debt service, releasing a bigger share of their budgets for spending. The second channel of transmission is directly through consumer credit growth (see chart 3). The latter has been picking steam in the past year in most countries. In Italy, consumer credit was up 35% in the 12 months to January 2016. Other countries have reported less spectacular but nevertheless positive increases as well, with the exception of The Netherlands where consumer credit has remained fairly anemic.

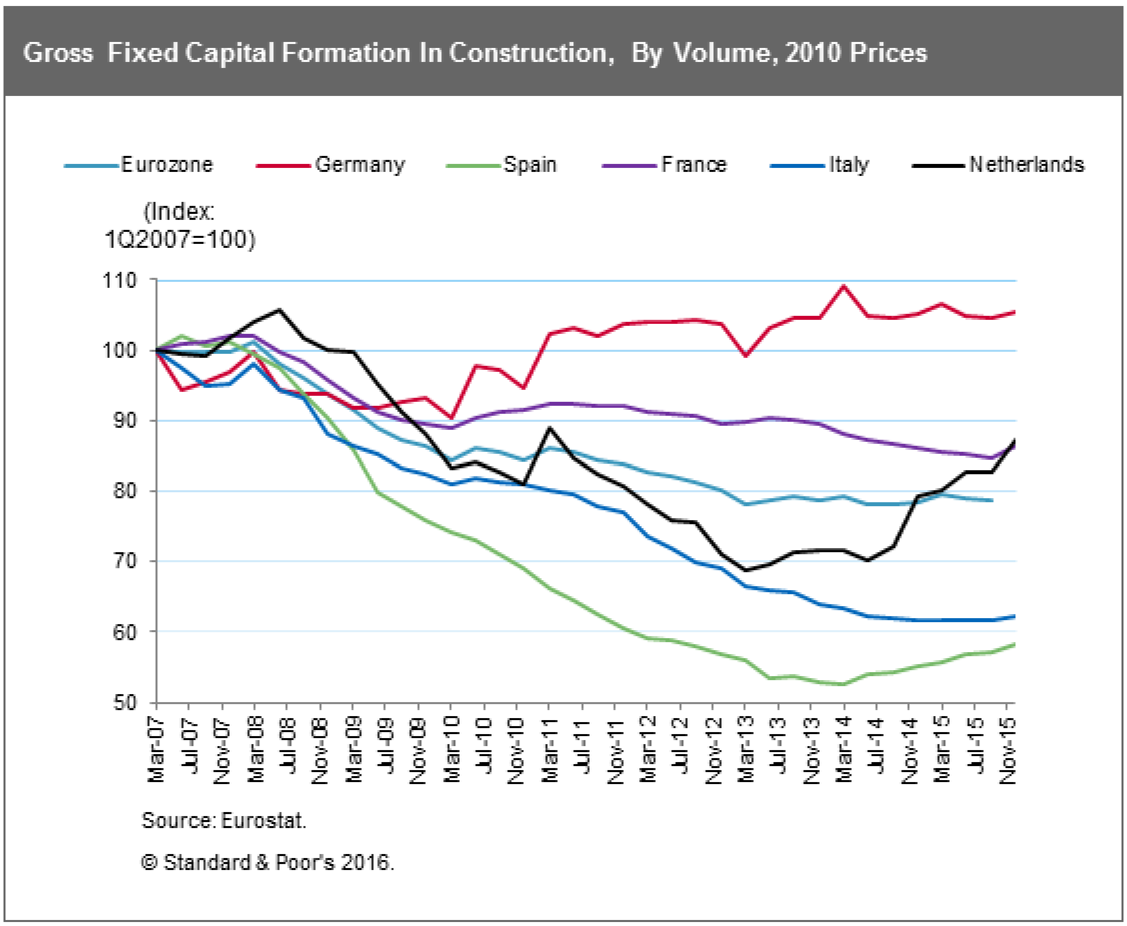
Chart 3



Gradually Improving Capital Formation

Resilient consumer demand is supporting eurozone growth, but it is not going to be sufficient for a broad recovery. Typically for that to occur, consumers would have to pass the growth baton to the corporate sector, which would respond to demand with an increase in capital formation. Instead, investment in the past five years has been muted compared with past economic cycles. But a closer look at recent trends unveils a more positive picture. First, a key factor that's been depressing overall investment is capital formation in construction. In France and Italy in particular, the contraction in that key sector goes a long way in explaining their weak economic performances (see chart 4). Looking ahead, the stabilization recorded at the end of last year should morph into a gradual recovery in the next year and a half. The pickup will not be as meaningful as in Germany, however. Here labor migration to Germany and the influx of migrants are likely to add to excess demand for housing. Demand is also likely to be fueled by hefty gains in disposable incomes. As a result, construction investment growth will likely reach 3% in the eurozone's largest economy in 2016.

Chart 4



Secondly, recent trends in investment excluding construction point to an improvement since 2014. Capital spending was back above its 2007, precrisis levels in fourth-quarter 2015 in the Netherlands, France, Germany, and Spain (see

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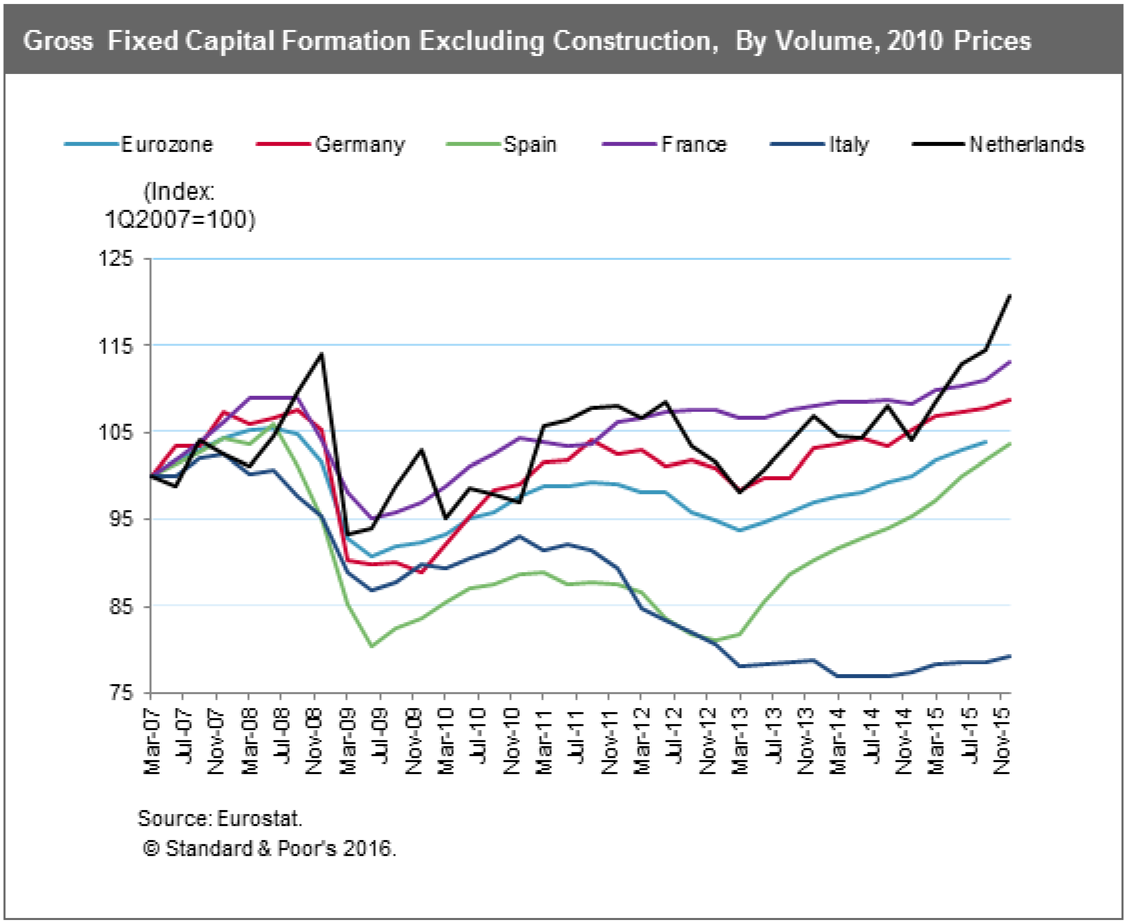
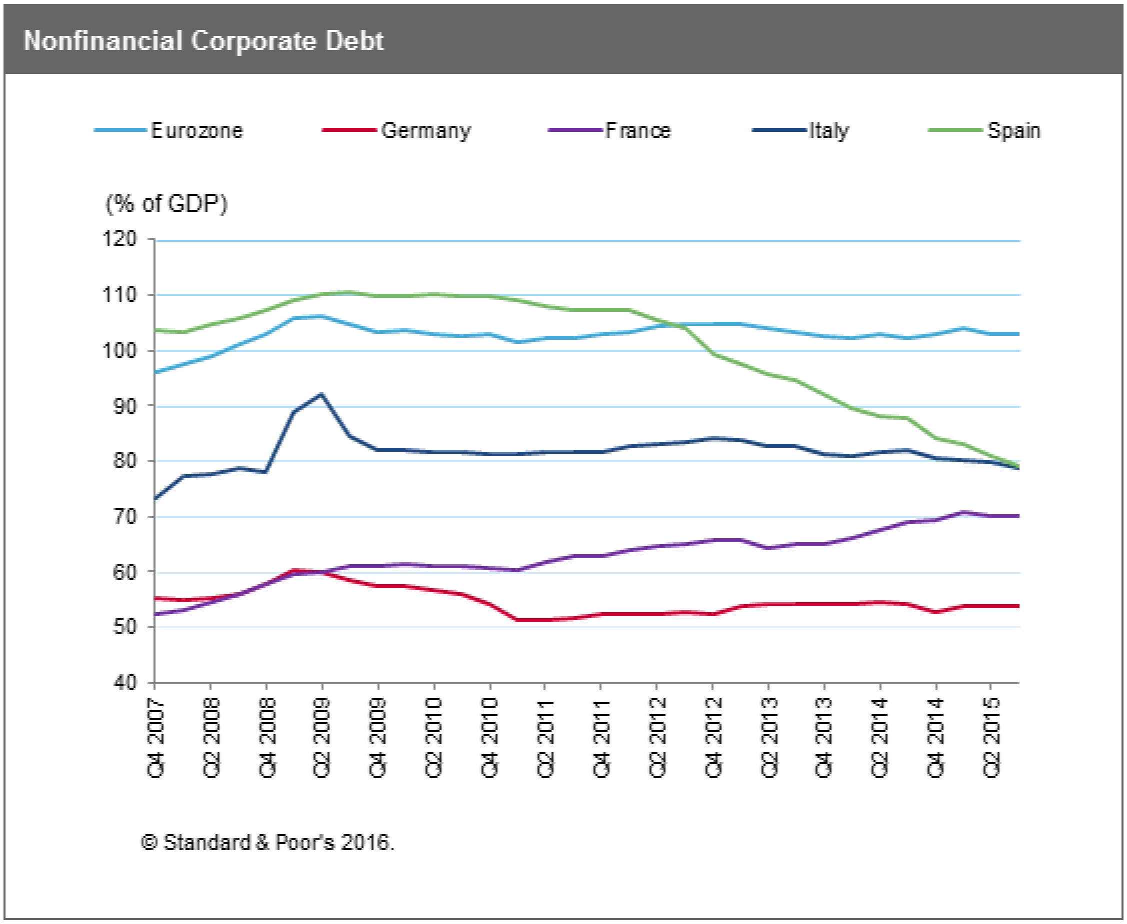
chart 5). The only major eurozone economy that's underperformed is Italy, where investment remains worryingly depressed.

Chart 5



Although business investment is showing signs of a revival, some headwinds remain. One is the slow deleveraging process that started with the global financial crisis. In most countries, with the exception of Spain and Germany, nonfinancial corporate debt, expressed as a percentage of nominal GDP, is still above its 2007 levels (see chart 6). Very low real interest rates, resulting from the ECB's accommodative policy and very weak inflation, may dampen the deleveraging process, but so far we see few signs of this happening.

Chart 6

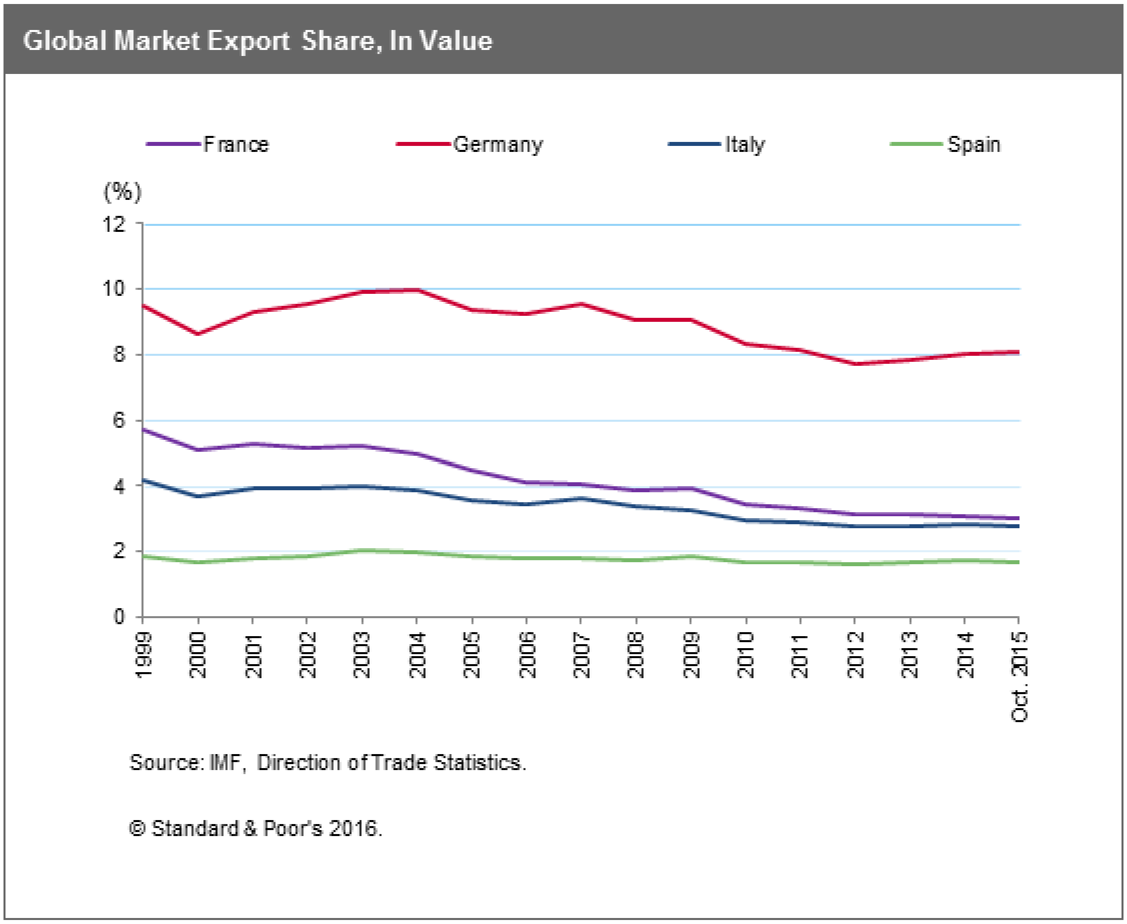


The lack of confidence is another headwind. The turmoil on financial markets earlier this year came as a reminder that concerns about the global economic outlook are still with us. Though confidence clearly remains fragile, business surveys, such as the IFO and ZEW in Germany or the one by France's INSEE, haven't signaled a sharp deterioration in sentiment.

Little Relief From Foreign Trade

Compared to today's recovery, the upswing that took place in 2010-2011 had two legs: consumption and foreign trade. Demand from emerging markets, led by China, was buoyant. That's not as much the case this time. For sure, the trade picture is not entirely dark: almost 60% of eurozone exports are shipped within the EU, which means that the uplift in European domestic demand will benefit exporters in each country. But the collapse in commodity prices has hurt commodity-exporting countries worldwide, while growth in China, albeit still robust, is less spectacular than five years ago. We expect foreign demand for eurozone products to grow a bit less than 3% in volume in 2016, well below its long-term average (see chart 7). Against this difficult background, eurozone exports received some help from the lower euro exchange rate in 2015, boosting their price competitiveness. German exporters performed particularly well, as they succeeded in slightly increasing their global market share.

Chart 7



The boost from a more competitive exchange rate is unlikely to be as strong in 2016, however. The euro has strengthened against some developed markets' currencies, such as the pound sterling, and has stabilized against the U.S. dollar. The fall in emerging-market currencies added to that strengthening. Overall, we expect net foreign trade to contribute negatively to eurozone growth in 2016 and 2017.

The Inflation Target Moves Off To The Distance

The case for the ECB's easing measures at its March 10 meeting was supported by meaningful revisions to its macroeconomic projections. In particular, the bank staff slashed its inflation forecast to 0.1% for 2016 versus 1% in its December forecast, and to 1.3% for 2017 from 1.6%. Its initial estimate for 2018 has inflation still well below its 2% target, at 1.6%. It was not clear whether these estimates took into account the potential effects of the new accommodative measures. These include a 10 basis point cut to the deposit rate to -0.4% and, starting in June 2016, four new longer-term targeted refinancing operations (TLTRO II) with four-year maturities. Strikingly, borrowing conditions for these operations can now be as low as the interest rate on the deposit facility (-0.4%) for banks extending more loans than a set benchmark. In other words, the ECB is now prepared to remunerate banks that increase their loan books!

Plus, the ECB included, in the list of assets eligible for regular purchases, investment-grade euro-denominated bonds issued by non-bank corporates "established in the eurozone." Current estimates put the outstanding amount of eligible corporate bonds at about €500 billion. The bank did not mention that it would impose any geographic quotas on issuers, as it did with sovereign bonds.

Corporate bond markets rallied on the news, as investors rushed to invest their liquidities before the beginning of the ECB purchase program in June. The new corporate sector purchasing program will benefit large companies that rely on market financing by reducing their borrowing costs. To what extent it will result in additional borrowing from them remains to be seen, however. In recent years, the eurozone's corporate bond market has suffered more from a lack of borrowers than from a lack of lenders. The deleveraging process we previously mentioned remains an obstacle to a surge in demand.

Looking at these new measures as a whole, we see an important shift. Since June 2014, the ECB has emphasized the exchange rate as a channel of transmission for its policy to the real economy. Negative deposit rates were aimed, among other things, at lowering the euro exchange rate. At the March press conference, ECB President Mario Draghi signaled that the bank's interest rates were now most likely as low as they could go. In addition and even more importantly, the bank refrained from adopting a two-tier scheme for negative deposit rates similar to what the Bank of Japan did a month earlier when it attempted to curb the rise of the yen exchange rate. At the time, the move in Tokyo was seen in the market as the possible start of a series of competitive devaluations across developed economies. The ECB announcements indicate that the bank no longer targets a weaker euro to lift inflation, suggesting that the euro is likely to be now close to a bottom against the U.S. dollar. At the end of its meeting in Shanghai in February, the Group of 20 nations (G20) announced that members "will refrain from competitive devaluations and will not target [their] exchange rate for competitive purposes" and indeed since then major cross rates have stabilized. The ECB is now re-emphasizing the portfolio rebalancing channel by increasing and extending its asset purchase program.

Fluctuations have been much larger in the headline inflation rate than in core inflation, which excludes volatile components such as energy (see chart 8). Core inflation is therefore much more dependent on the level of activity in the real economy (compared with potential growth) and on wage pressure. As we saw, both variables have been increasing incrementally in the past 18 months and will continue on their gentle rise in 2016 and 2017. In other words, don't expect a rapid take-off for inflation.

Chart 8

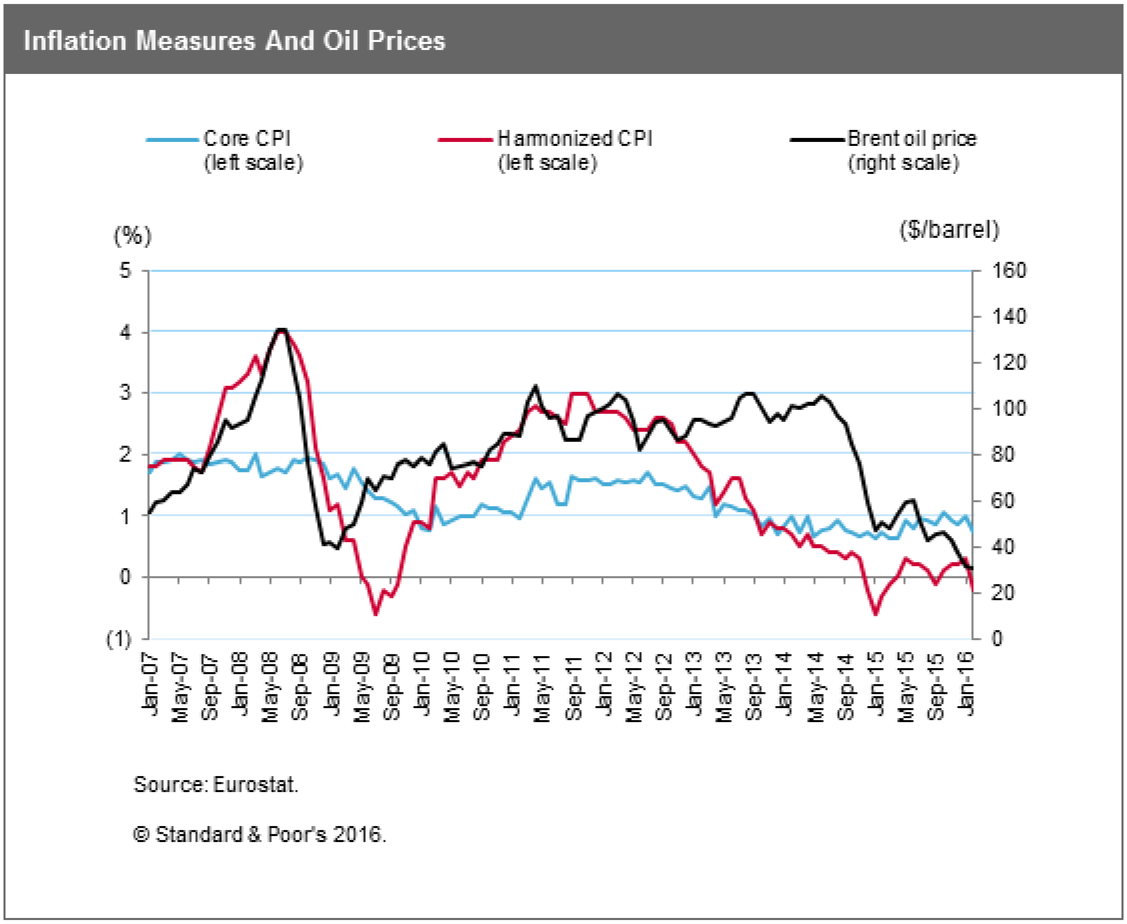


Table 1

Standard & Poor's Main European Economic Indicators--March 2016

Central forecast

	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2014	1.6	0.2	-0.3	1.4	1.0	1.3	0.9	2.9	1.9
2015	1.5	1.1	0.6	3.2	1.9	1.4	1.5	2.2	0.9
2016(f)	1.6	1.3	1.1	2.6	1.7	1.4	1.5	2.0	1.1
2017(f)	1.7	1.5	1.3	2.3	1.9	1.6	1.6	2.2	1.7
CPI inflation (%)									
2014	0.8	0.6	0.2	-0.2	0.3	0.5	0.4	1.5	0.0
2015	0.1	0.1	0.1	-0.6	0.2	0.6	0.0	0.1	-1.1
2016(f)	0.5	0.4	0.2	0.0	0.4	1.2	0.4	0.5	-0.7
2017(f)	1.5	1.4	1.2	1.1	1.1	1.6	1.4	1.6	0.5
Unemployment rate (%)									
2014	5.0	10.3	12.7	24.5	7.4	8.5	11.6	6.2	3.2
2015	4.6	10.4	11.9	22.1	6.9	8.3	10.9	5.4	3.3

Table 1

Standard & Poor's Main European Economic Indicators--March 2016 (cont.)									
2016(f)	4.5	10.0	10.9	19.9	6.5	7.7	10.2	5.0	3.6
2017(f)	4.5	9.9	10.2	18.5	6.2	7.5	9.7	5.2	3.7
10-year bond yield (yearly average)									
2014	1.2	1.7	2.9	2.7	1.5	1.7	2.0	2.6	0.7
2015	0.5	0.8	1.7	1.7	0.7	0.9	1.2	1.9	-0.1
2016(f)	0.3	0.8	1.5	1.7	0.4	0.8	1.0	1.6	-0.3
2017(f)	0.7	1.4	2.0	2.2	1.1	1.2	1.5	2.0	0.3
Central banks policy rates (yearly average)									
	ECB	**BOE**	**SNB**						
2014	0.2	0.5	0.0						
2015	0.1	0.5	-0.8						
2016(f)	0.0	0.5	-0.8						
2017(f)	0.0	0.7	-0.8						
Exchange rates									
	Eurozone	**U.K.**		**Switzerland**					
	USD/EUR	**USD/GBP**	**EUR/GBP**	**CHF/USD**	**CHF/EUR**				
2014	1.3	1.6	1.2	0.9	1.2				
2015	1.1	1.5	1.4	1.0	1.1				
2016(f)	1.1	1.4	1.3	1.0	1.1				
2017(f)	1.1	1.5	1.4	1.0	1.1				

f--Standard & Poor's forecast.

Related Research

- European Housing Markets Continue To Heal As Mortgage Rates Stay Low, March 2, 2016