ECONOMICS: EUROPEAN PERSPECTIVES

EMERGING-MARKET WOES UNLIKELY TO DERAIL EURO-AREA RECOVERY

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Although the global backdrop has darkened, we expect the euro-area recovery to remain on track, helped by low oil prices and supportive monetary conditions. The ECB is unlikely to provide fresh stimulus at this stage. But persistent downward pressure on inflation should keep the central bank in dovish mode and could make additional asset purchases after September 2016 a real possibility.

Rising investor fears about the outlook for emerging markets, especially China, and falling global equity markets have raised concerns about growth prospects in the euro area. At this stage, we don't think these developments warrant significant changes to our forecasts. Nor, unless the situation deteriorates rapidly from here, should we expect a policy response from the European Central Bank (ECB).

One of the reasons for this is that the economy has strengthened over the past year and is now better placed to handle (minor) external shocks. Recent survey data have been particularly encouraging, with the composite Purchasing Managers' Index and economic-sentiment indicator either at or close to four-year highs, and consistent with annualized economic growth of 1.5% or so.

Importantly, the recovery is not dependent upon external demand. Instead, it's being driven by domestic demand, currently growing faster than the overall economy for the first time since 2009. Consumption and investment are being underpinned by improving monetary and credit conditions. This was evident in July monetary data, released this week, which showed annual M3 growth rising to 5.3%, real M1 growth at 11.8% and bank lending growth at 1.4%. The latter is hardly strong, but is a big improvement on the sustained declines seen in recent years. As we have pointed out in recent issues, the ECB's ultra-loose monetary policy is starting to gain traction.

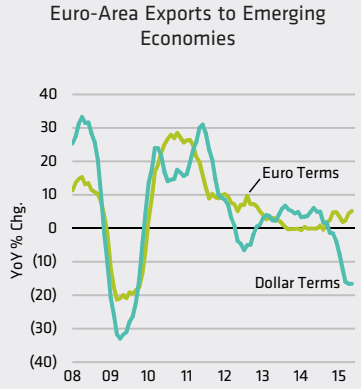
This does not, of course, mean that the euro area won't be affected by a slowdown in emerging-market (EM) growth—in fact, the euro-area countries are more dependent on emerging-market demand than the US, the UK or Japan (*Display 1*). But it does point to greater resilience. Indeed, the recovery in the euro area over the past year has taken place against a backdrop of weak demand from emerging economies (*Display 2*).

There are two main reasons for this. First, the euro's depreciation has helped boost exports to developed economies. Second, the economy has been helped by lower oil prices. In this respect, it's important to note that the oil price has fallen by over 25% in euro terms since the beginning of July. In coming months, this should push inflation lower, boost real incomes and support consumption, just as it did to such telling effect around the turn of the year.

Display 1
Vulnerable to EM Slowdown

As of December 31, 2014
Source: Haver Analytics

Display 2
EM Demand Already Weak



As of May 31, 2015
Source: Haver Analytics

While downside risks have therefore risen, we do not believe that recent developments warrant a change to our view that the euro area is on a sustainable (though modest) recovery path, driven by domestic demand and underpinned by increasingly supportive monetary and credit conditions. And we expect the ECB to reach a similar conclusion at next week's Council meeting. In which case, it's unlikely to announce any new policy measures: especially as there's already so much stimulus in the pipeline.

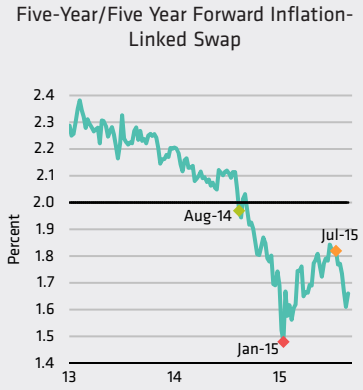
But this does not mean the ECB will be unconcerned about recent developments. Since its July Council meeting, the global outlook has deteriorated, the oil price has fallen and the euro has risen. And while the net impact of all these changes might be ambiguous for economic growth, they all point in the same direction for inflation: lower, especially in the near term.

The deteriorating outlook for inflation is captured by recent changes in market-based measures of inflation expectations. A year ago, at the US Federal Reserve's annual Jackson Hole symposium, ECB president Mario Draghi spoke of his alarm at falling medium-term inflation expectations. And it was this intervention that started the countdown to the launch of quantitative easing (QE) earlier this year.

In last year's speech, Draghi singled out the five-year/five-year forward inflation linked swap which, at the time, had fallen just below 2.0% (*Display 3*). Today, this key measure stands at 1.66%, above the low reached in January (1.48%), but below levels seen around the time of the July Council meeting (1.82%) and well below the ECB's definition of price stability (an inflation rate below, but close to, 2.0%).

So while we don't expect any policy action from the ECB at next week's Governing Council meeting, we do expect a very dovish message. It's still too early, in our view, for the ECB to start thinking about extending its QE program beyond September next year, but the risks are moving in that direction.■

Display 3
Still Well Below Target



As of August 28, 2015
Source: Bloomberg