

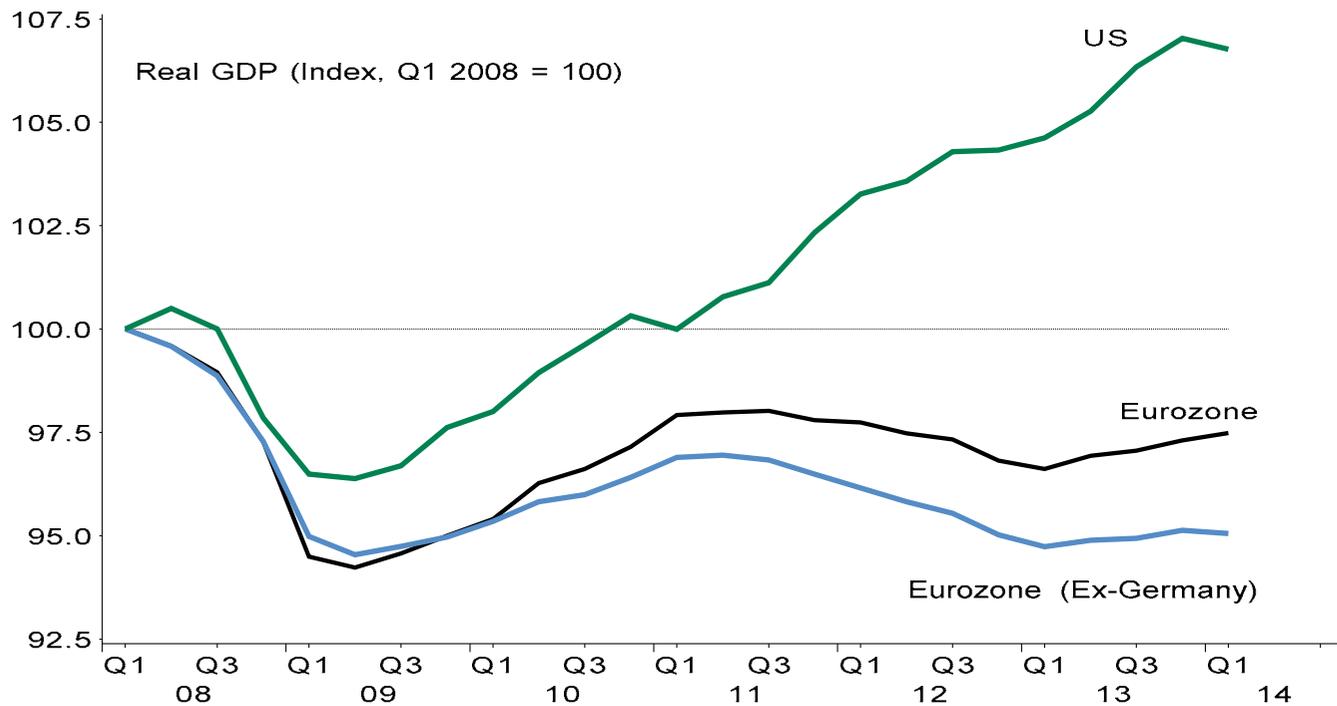
**Eurozone:
Different Path**

Evelyn Herrmann
Eurozone Economist

Eurozone growth: Progress report



GDP Levels



Source: Reuters EcoWin Pro

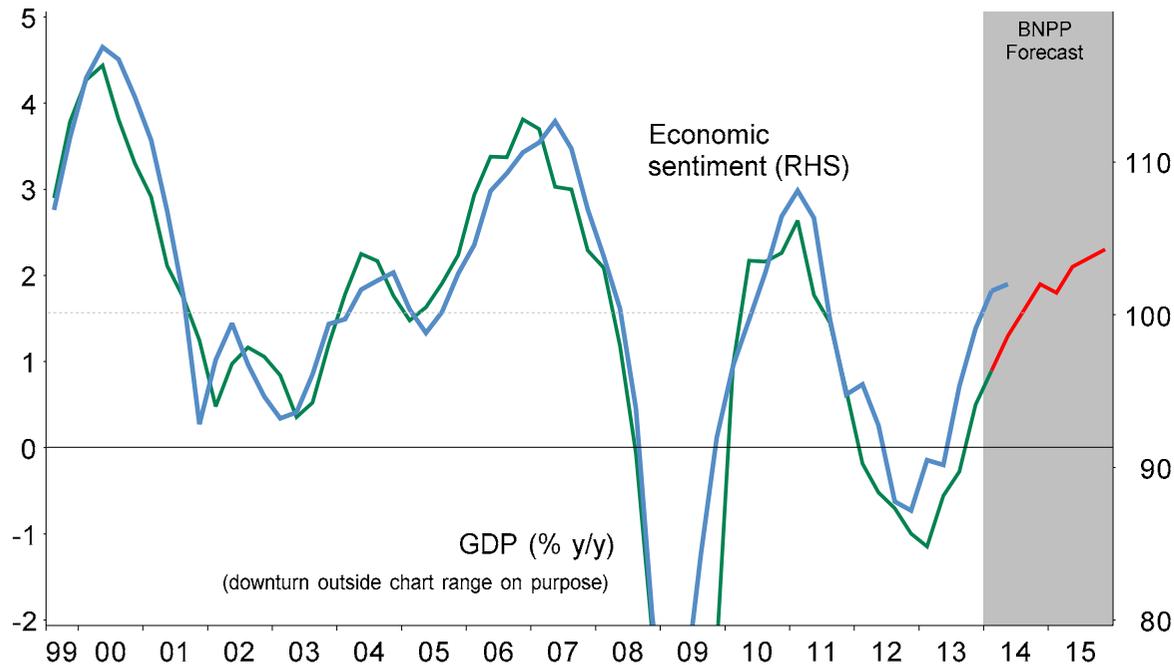
- The US recovery may be sluggish by past standards but in real terms, US GDP is over 6% higher than its pre-crisis level
- In the euro area, the level of real GDP is still 3% below its pre-crisis level...
- ...and excluding Germany, the gap is even larger, at more than 5%



Some perspective



Eurozone: Sentiment and growth



Source: Reuters EcoWin Pro

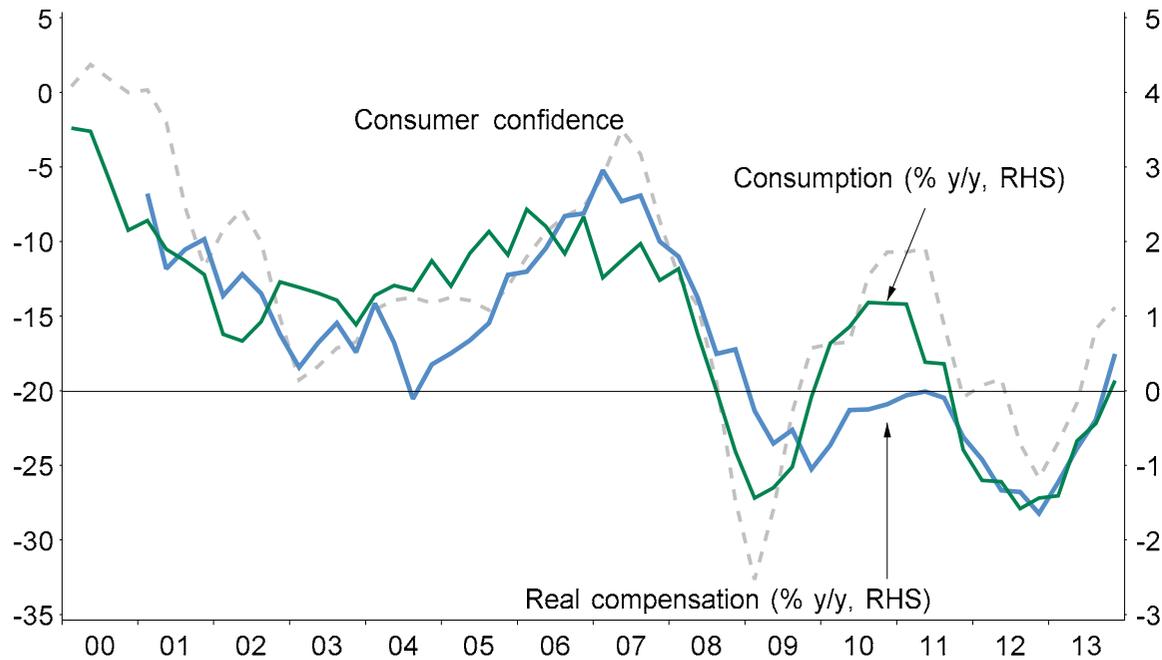
- A range of leading indicators point to an acceleration in eurozone growth
- The most reliable, the Economic Sentiment Index, suggests GDP growth is due some 'catch-up'



Positive signals



Eurozone: Domestic improvement...



Source: Reuters EcoWin Pro

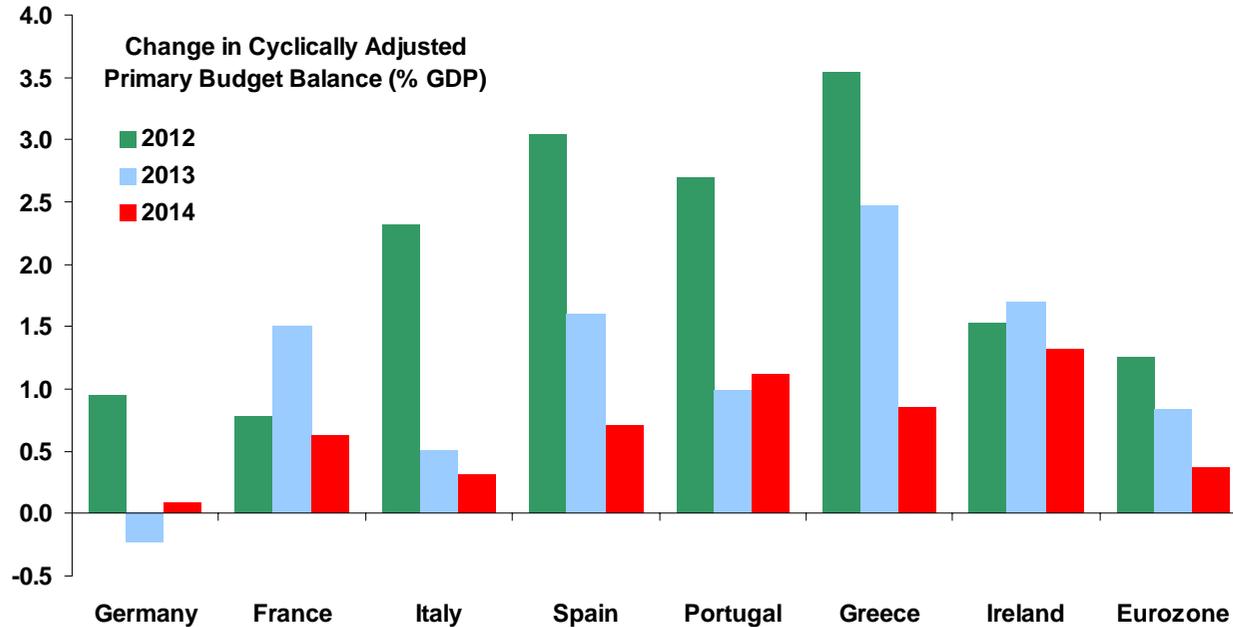
- Consumer demand is reviving
- Consumer confidence improved markedly, driven by a better outlook for employment and financial conditions
- Real compensation, while subject to nominal rigidities, benefits from slowing inflation



Getting better



Eurozone: Fiscal Policy



Source: Reuters EcoWin Pro, BNP Paribas

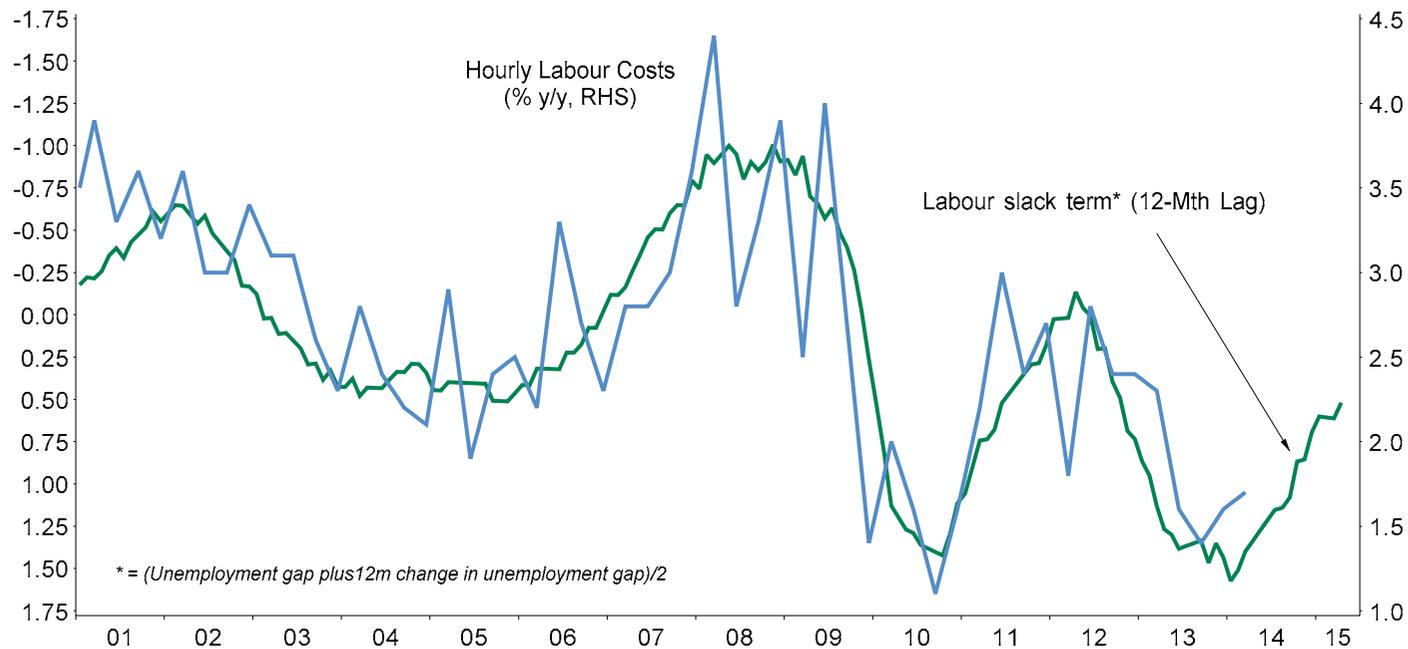
- The overall tightening in eurozone fiscal policy in 2013 was less pronounced than in 2012
- This was particularly true in southern Europe, while there were some exceptions, like France and Ireland
- The pace of tightening will moderate further in 2014



Less tightening, mostly



Eurozone: Wages



Source: Reuters EcoWin Pro

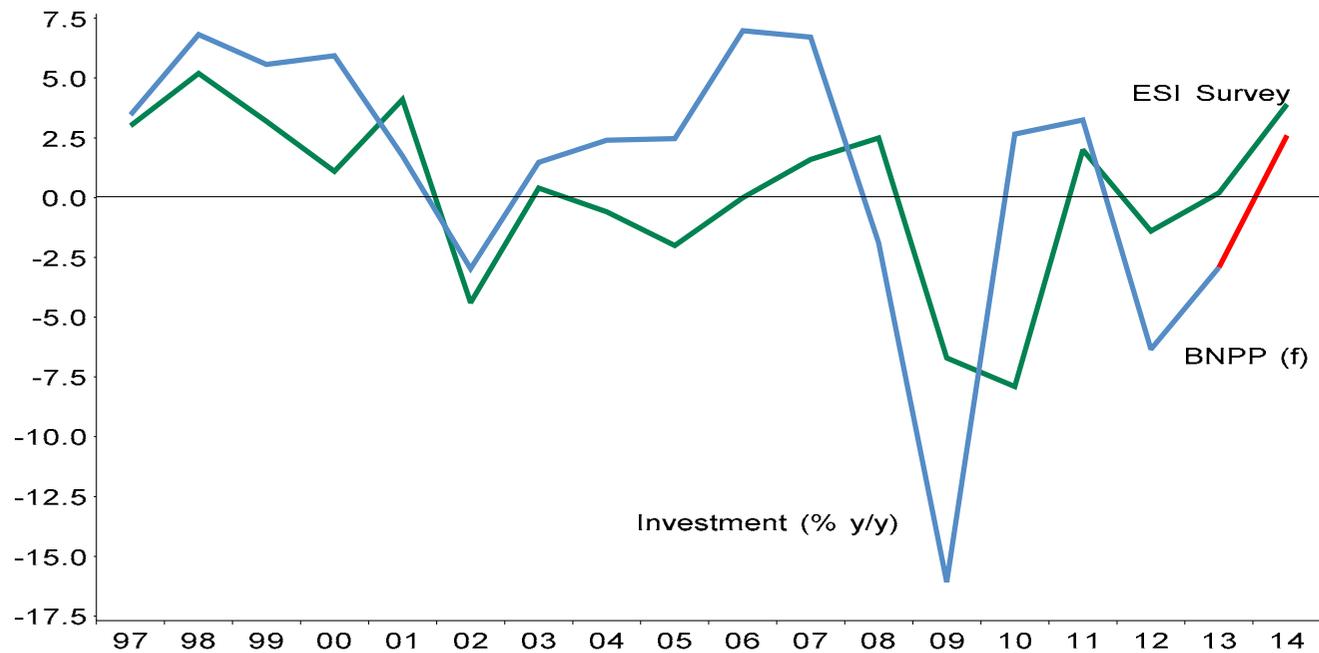
- The labour market turned slightly earlier than expected
- Although unemployment remains at very high level, the outlook for wages is improving
- This could help support consumer spending



One to watch



Eurozone: Investment Intentions



Source: Reuters EcoWin Pro, BNP Paribas

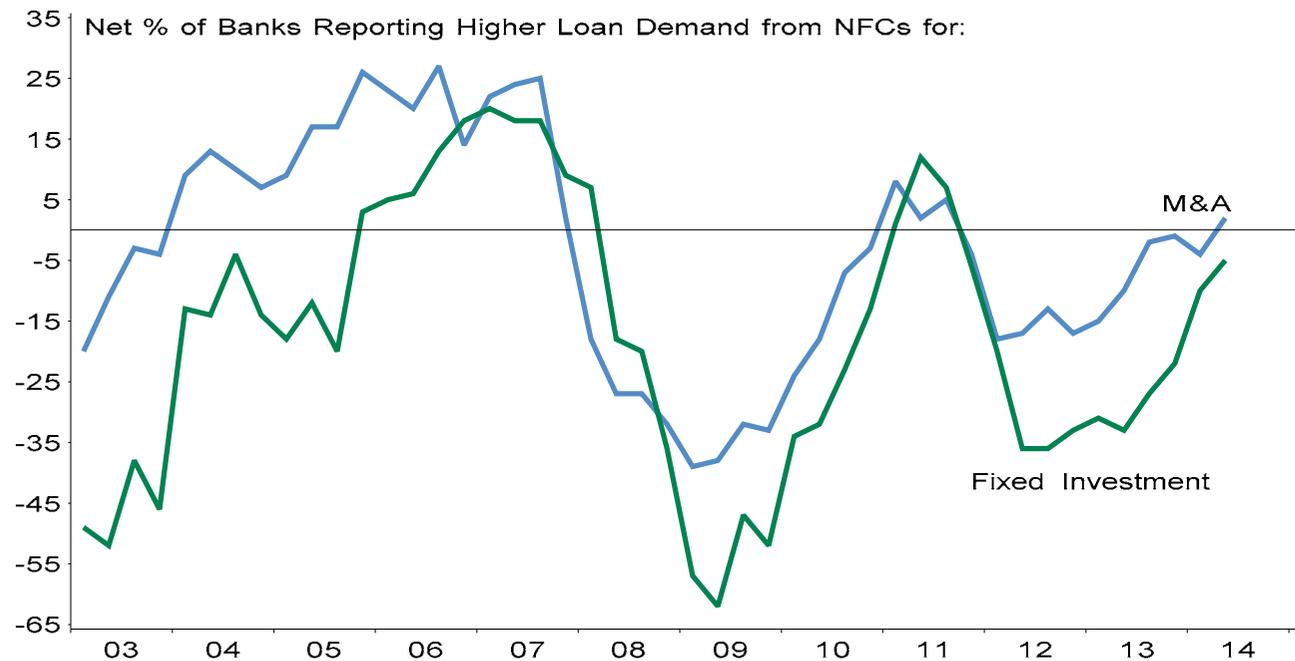
- The EC Investment Survey (part of the October/November ESI) shows investment spending expectations
- At eurozone level, the survey tracks cycle dynamics quite well and points to a pick-up in investment in 2014
- Typically, the survey underestimates swings in investment spending



Investment plans more positive



Eurozone: Demand for Loans



Source: Reuters EcoWin Pro

- The ECB Bank Lending Survey provides data on demand as well as supply conditions
- The net percentage of banks reporting higher demand for loans for fixed investment purposes has improved markedly...
- ...though it remains consistent with a lesser decline in demand rather than an increase



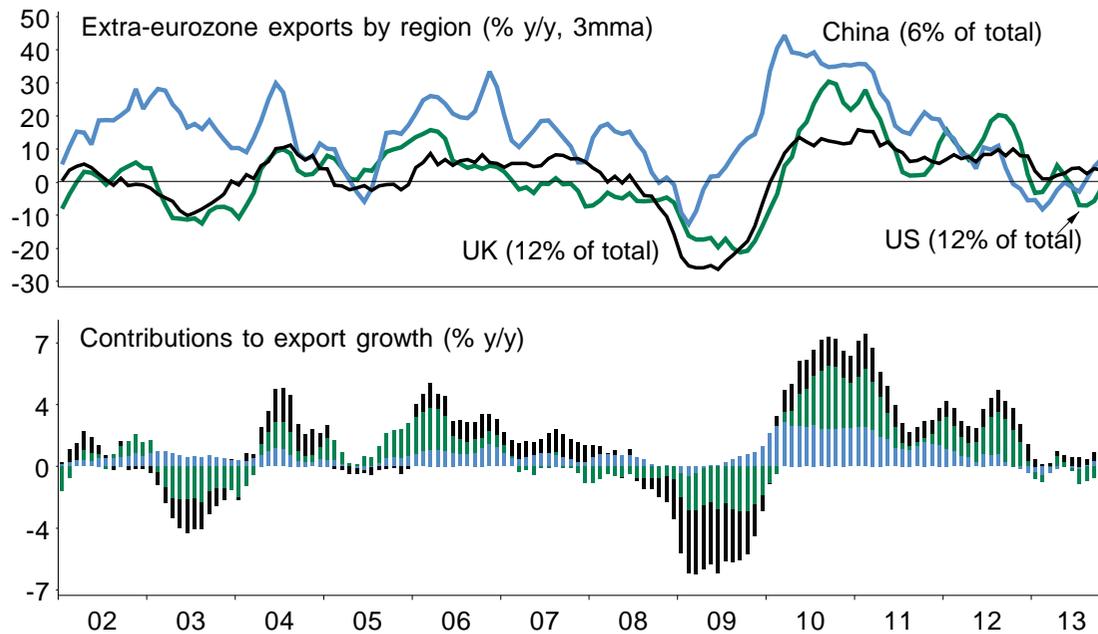
On the up



Eurozone risks: A lot of challenges remain



Eurozone exports: China



Source: Reuters EcoWin Pro

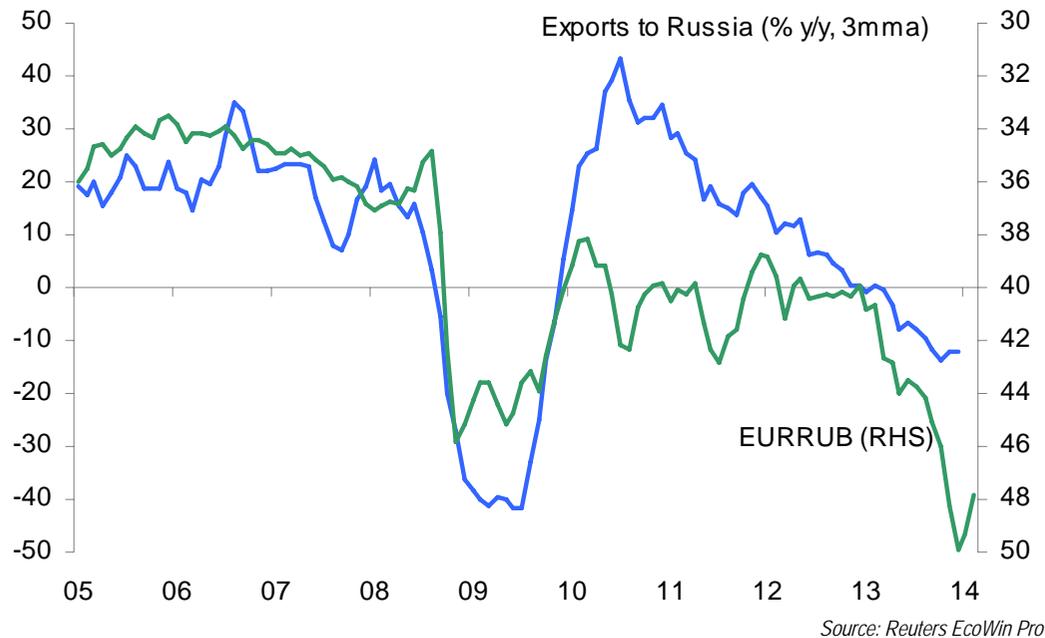
- Intra-eurozone exports have been flat since 2011, while extra-eurozone exports have done well
- In the latter category, the US and UK are the key markets, accounting for a quarter of overall extra-eurozone exports
- A China slowdown matters, but less than strength in the US and UK



China effect?



Eurozone exports: Russia



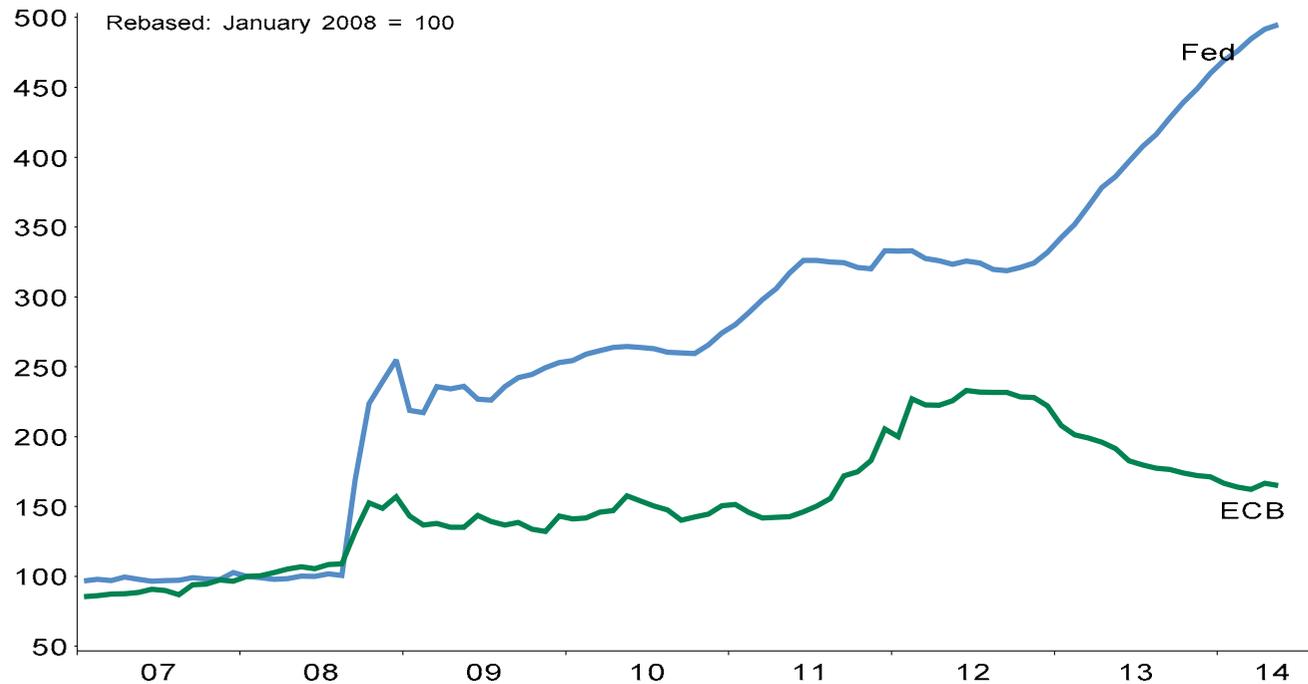
- Some 4-5% of extra-eurozone exports go to Russia, which is equivalent to around 1% of eurozone GDP
- Exports to Russia tend to be very exchange rate elastic. The RUB depreciation announces further declines in exports
- From Germany, Russia imports capital goods, such as cars, machinery and data processing equipments
- The eurozone depends on Russian energy supply to the tune of around 15%



Non-negligible export market



Central bank balance sheets



Source: Reuters EcoWin Pro

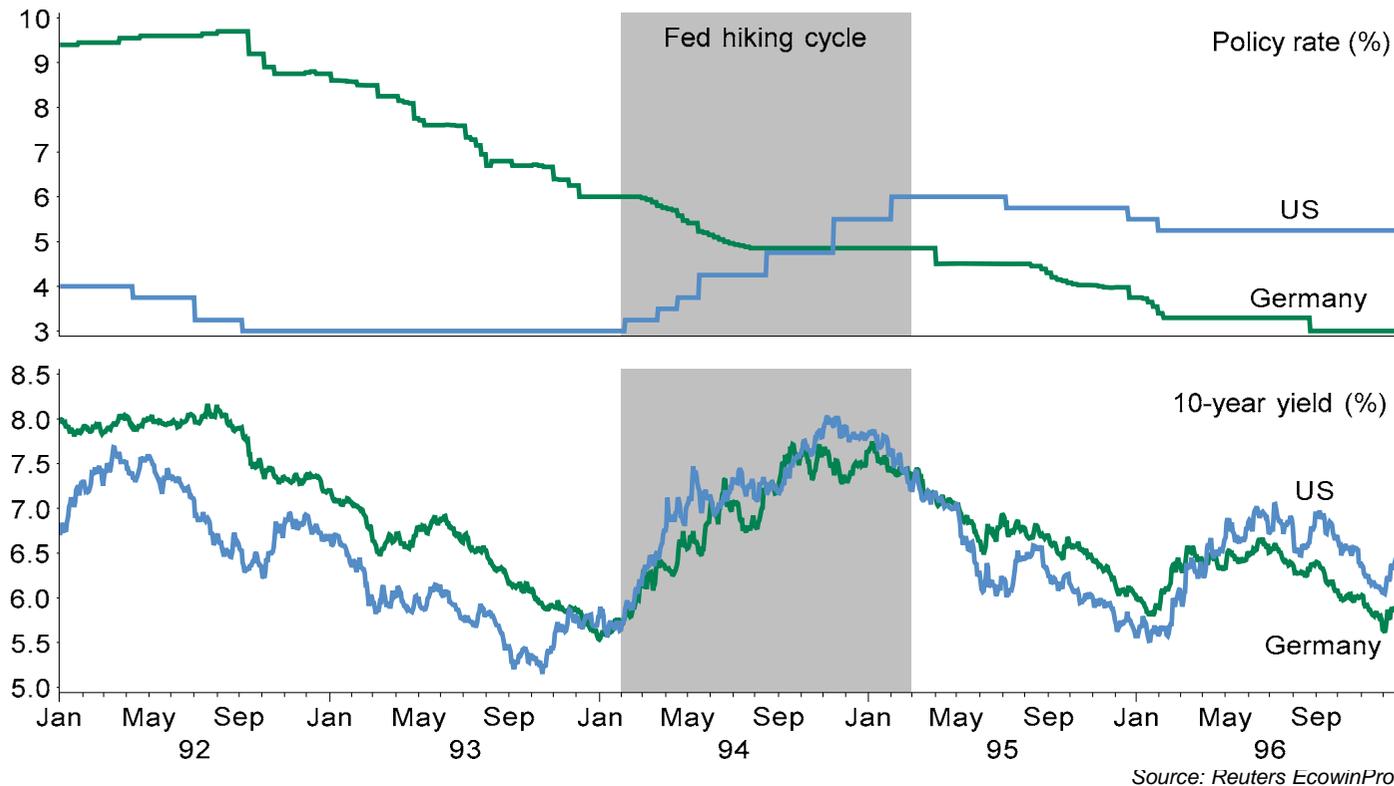
- The Fed's balance sheet is almost five times its size back in January 2008 and continues to grow
- In the absence of tapering, it would have carried on expanding at a rate of around 6% of US GDP per annum
- The ECB balance sheet is around 1½ times its size in 2008 and has been shrinking due to early repayment of 3-year LTROs



Divergence



Fed tightening cycles



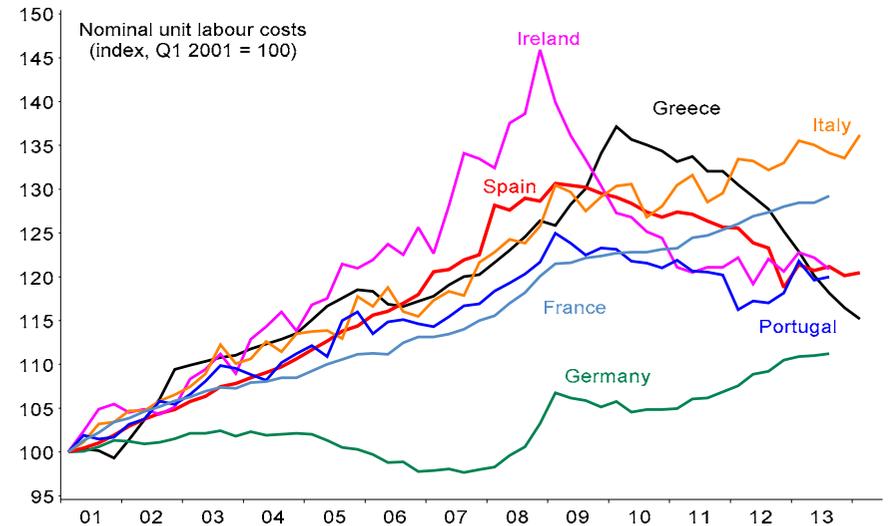
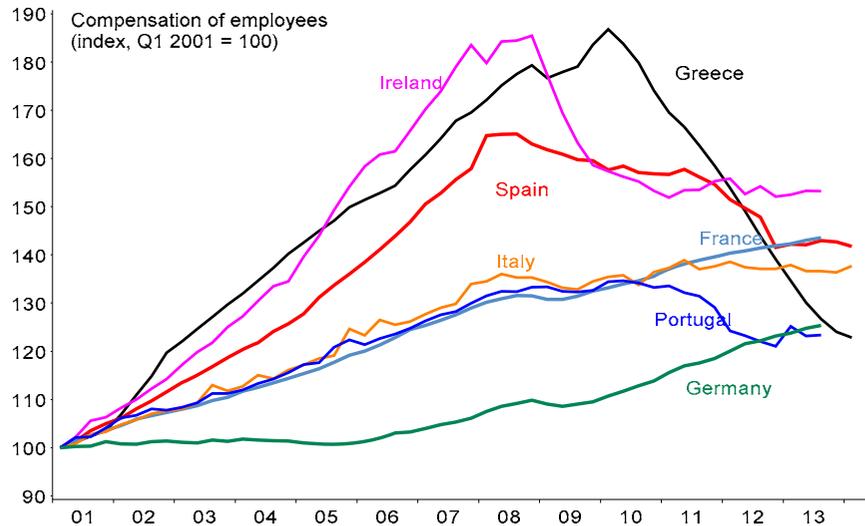
- The Fed embarked on a tightening cycle in February 1994
- The 10-year US Treasury yield responded by rising sharply
- In 1994 Buba was loosening monetary policy, but the 10-year Bund yield followed the movement of the US Treasury



Correlated



Eurozone: Competitiveness Adjustments



Source: Reuters EcoWin Pro, BNP Paribas

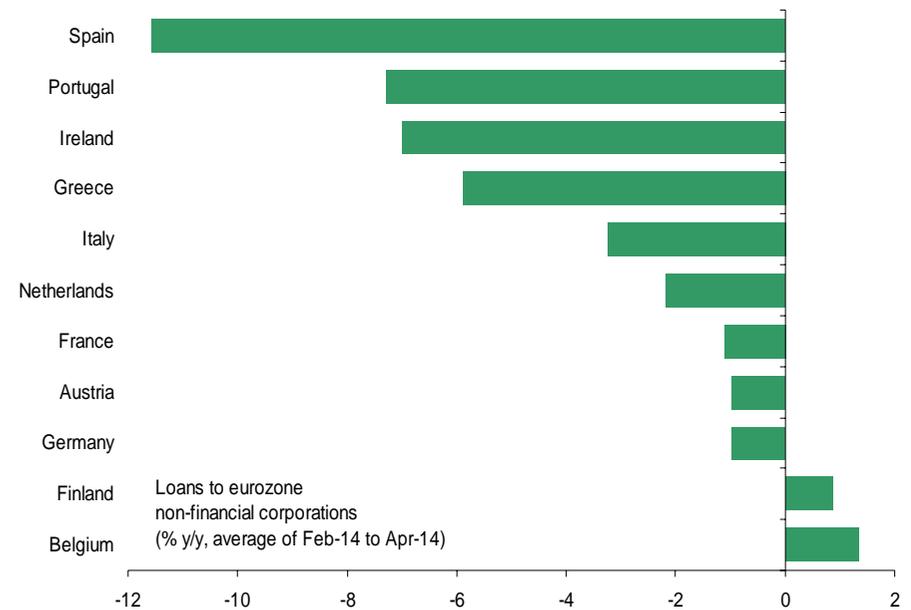
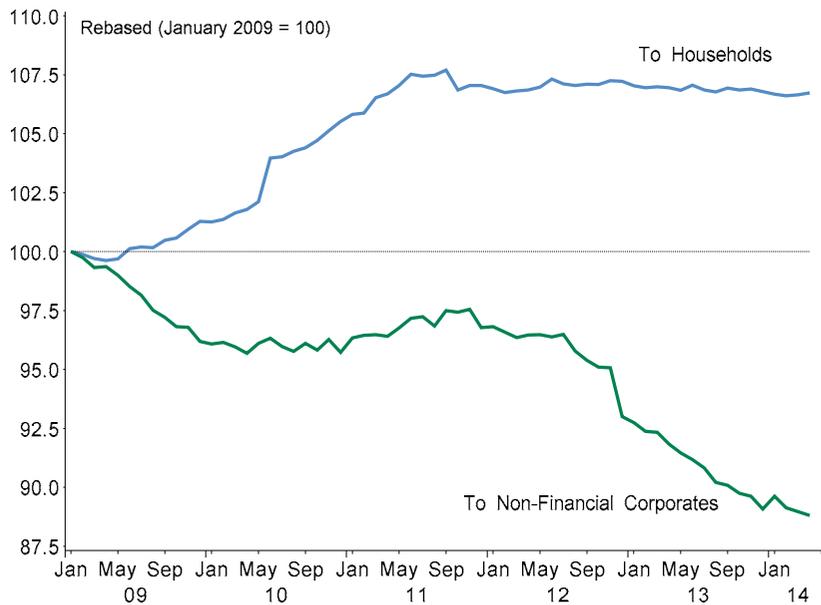
- The gap between compensation and unit labour cost trends in Germany and the periphery is closing...
- ... but the adjustment in unit labour costs varies considerably across countries
- Ireland, Greece and Spain are adjusting, in contrast to Italy and France



Some doing more than others



Eurozone: Bank Lending



Source: Reuters EcowinPro, BNP Paribas

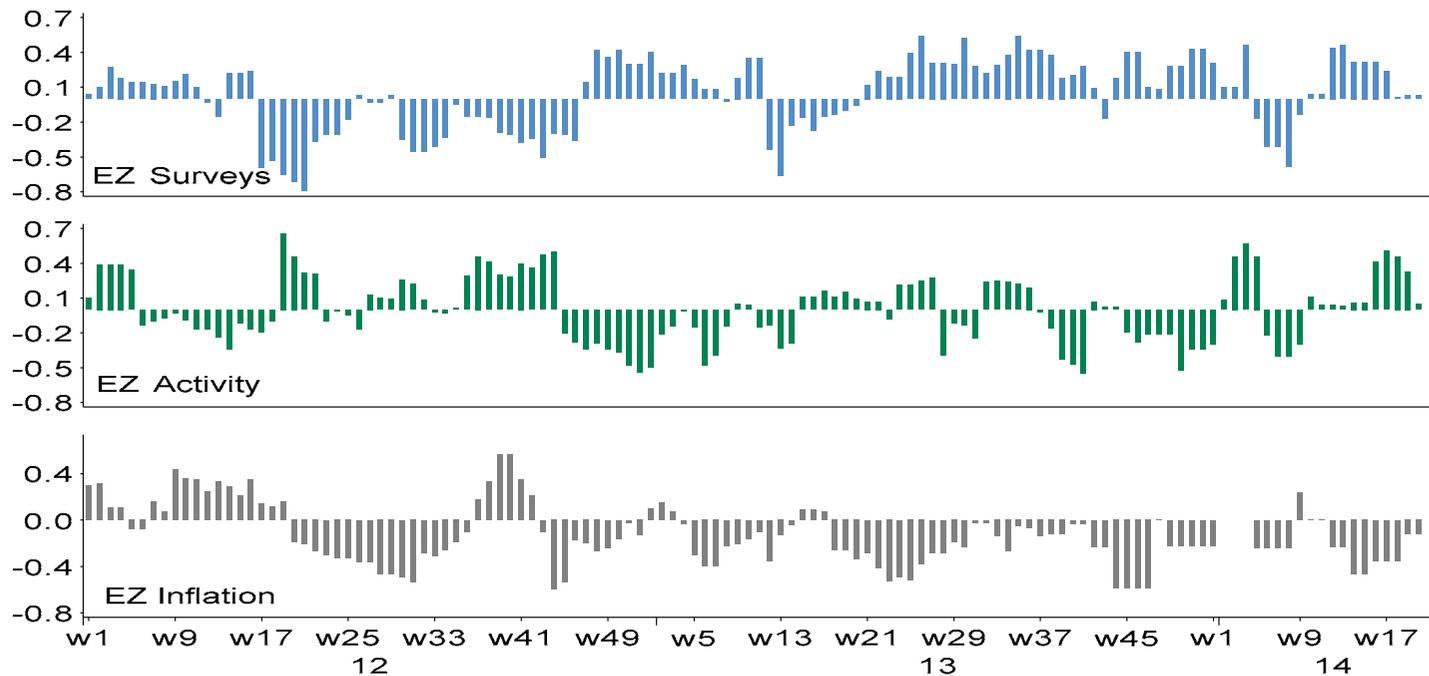
- The 'hard' lending data show a continued contraction in the stock of loans to non-financial corporates
- The weakness is broad-based across most eurozone member states
- The ECB's 'comprehensive assessment' of banks will improve the situation but this will take time



Credit constraints for corporates



Eurozone: BNPP Surprise Indicator



Source: Reuters EcowinPro, BNP Paribas

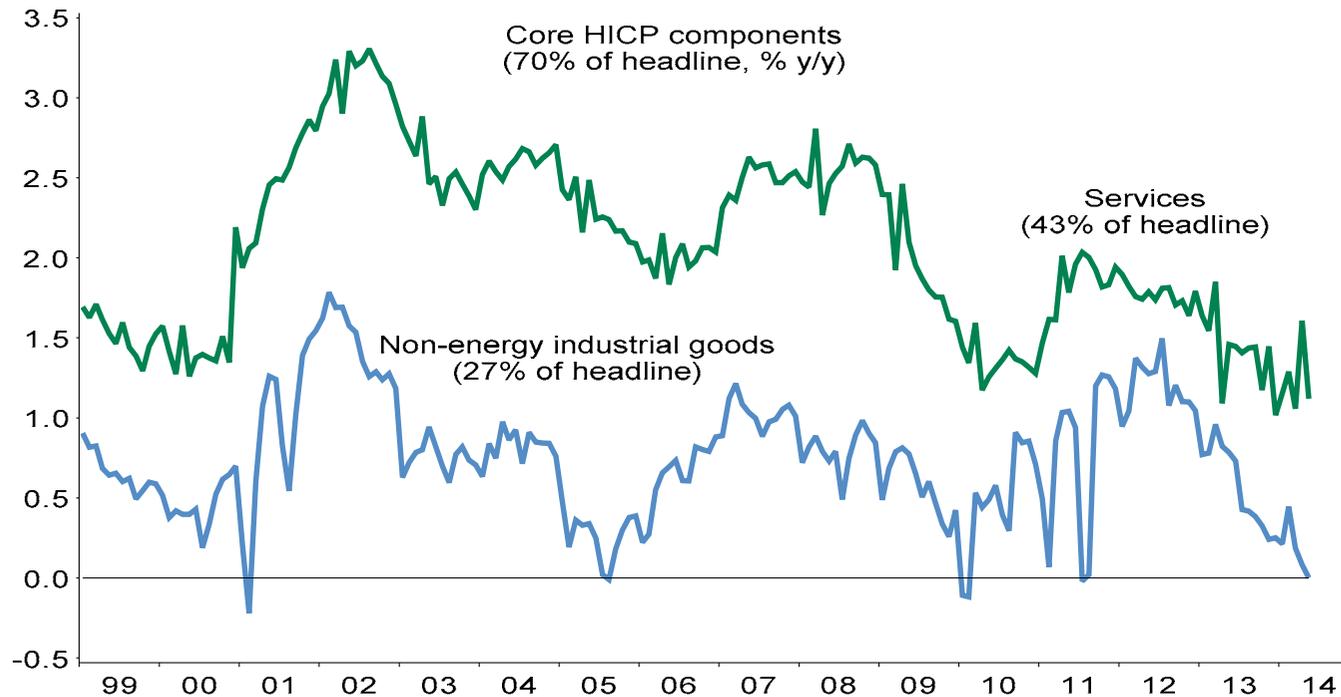
- BNPP surprise indicators show how data releases have fared relative to consensus expectations
- Sentiment data have generally been surprising to the upside
- Positive surprises on 'hard' activity data have also become more evident recently
- The most remarkable aspect of the data flow has been inflation persistently surprising to the downside



Downward surprises on inflation



Eurozone: Inflation by Sector



Source: Reuters EcoWin Pro

- Core goods price inflation is low and decelerating
- It is not just a food and energy price issue
- This is being accompanied by decelerating service sector inflation, which is typically higher and less volatile



Services slowing too



Case Study: Inflation & Output Gaps I

Country	Start	End	Length (quarters)	Average output gap	Trough output gap	Inflation (y/y) at the start	Inflation (y/y) at the end	GDP y/y growth at the start	GDP y/y growth at the end
Australia	30-Sep-82	31-Dec-84	10	-3.3	-6.5	12.4	2.5	5.5	2.3
	31-Mar-91	31-Dec-93	12	-3.1	-4.5	4.8	1.8	4.7	3.8
Belgium	31-Dec-85	31-Dec-87	9	-2.2	-2.3	4.1	1.6	1.5	3.1
Canada	31-Dec-81	31-Mar-84	10	-4.5	-7.4	12.4	5.2	6.0	3.3
	31-Mar-91	31-Mar-94	13	-3.2	-3.9	6.4	0.5	1.9	0.6
Eurozone	30-Sep-82	31-Mar-87	19	-2.2	-2.7	11.0	2.9	0.5	1.7
Finland	31-Dec-91	30-Sep-97	24	-5.0	-8.0	3.7	1.4	-6.0	7.1
France	30-Sep-83	30-Sep-87	17	-2.2	-2.7	9.8	3.4	1.1	2.2
Germany	31-Mar-03	30-Dec-05	12	-2.4	-3.2	1.1	1.7	-0.3	1.6
Greece	29-Dec-95	29-Sep-00	20	-2.4	-3.1	7.9	3.0	2.0	3.8
Ireland	31-Dec-85	30-Dec-88	13	-3.2	-4.9	4.9	2.7	1.8	6.8
	30-Sep-92	31-Mar-95	11	-3.5	-4.6	2.8	2.5	3.7	8.8
Italy	30-Jun-82	30-Jun-86	17	-2.6	-4.3	15.5	6.1	0.5	2.8
	31-Dec-92	30-Dec-94	9	-2.7	-3.7	4.9	4.0	-0.7	3.1
	31-Dec-74	30-Dec-77	13	-2.2	-3.2	23.4	6.3	3.0	4.7
Japan	31-Mar-83	31-Dec-84	8	-2.0	-2.6	2.2	2.4	5.5	1.5
	31-Mar-98	31-Dec-99	8	-2.5	-2.6	2.0	-1.0	2.4	-0.8
	29-Jun-01	31-Dec-03	11	-2.8	-2.6	-0.8	-0.3	1.7	2.1
Netherlands	30-Sep-81	29-Mar-85	15	-2.7	-5.6	6.6	2.3	0.4	1.6
	31-Mar-03	31-Mar-05	9	-1.8	-2.4	2.4	1.6	0.7	1.5
Norway	31-Dec-88	30-Sep-93	20	-2.7	-4.6	6.0	2.1	2.0	6.2
Portugal	31-Dec-85	31-Mar-88	10	-6.7	-10.0	16.3	9.0	3.9	7.4
Spain	31-Dec-85	31-Dec-87	9	-4.6	-6.6	8.3	4.6	3.2	7.9
	31-Dec-93	31-Dec-96	13	-1.5	-1.8	4.8	3.3	0.6	2.9
Sweden	30-Jun-81	30-Sep-83	10	-1.9	-2.2	13.1	9.2	1.5	1.8
	31-Mar-92	30-Sep-95	15	-3.6	-5.9	3.4	2.3	2.4	3.2
Switzerland	31-Dec-95	31-Dec-97	9	-1.9	-2.3	1.9	0.4	3.5	3.1
	30-Sep-80	31-Dec-83	14	-3.3	-4.5	16.4	5.1	1.7	3.6
UK	30-Sep-91	31-Mar-94	11	-2.8	-3.4	7.7	2.5	3.7	3.7
	30-Sep-74	31-Dec-76	10	-2.9	-4.9	11.4	5.1	5.0	6.7
US	31-Dec-81	31-Dec-83	9	-5.2	-7.2	9.5	3.3	7.8	4.3
	31-Sep-91	31-Dec-93	23	-2.4	-3.0	3.9	2.9	2.3	4.9

Note: A period of persistently large output gap is defined as at least eight consecutive quarters of negative output gaps exceeding 1.5% of potential GDP.

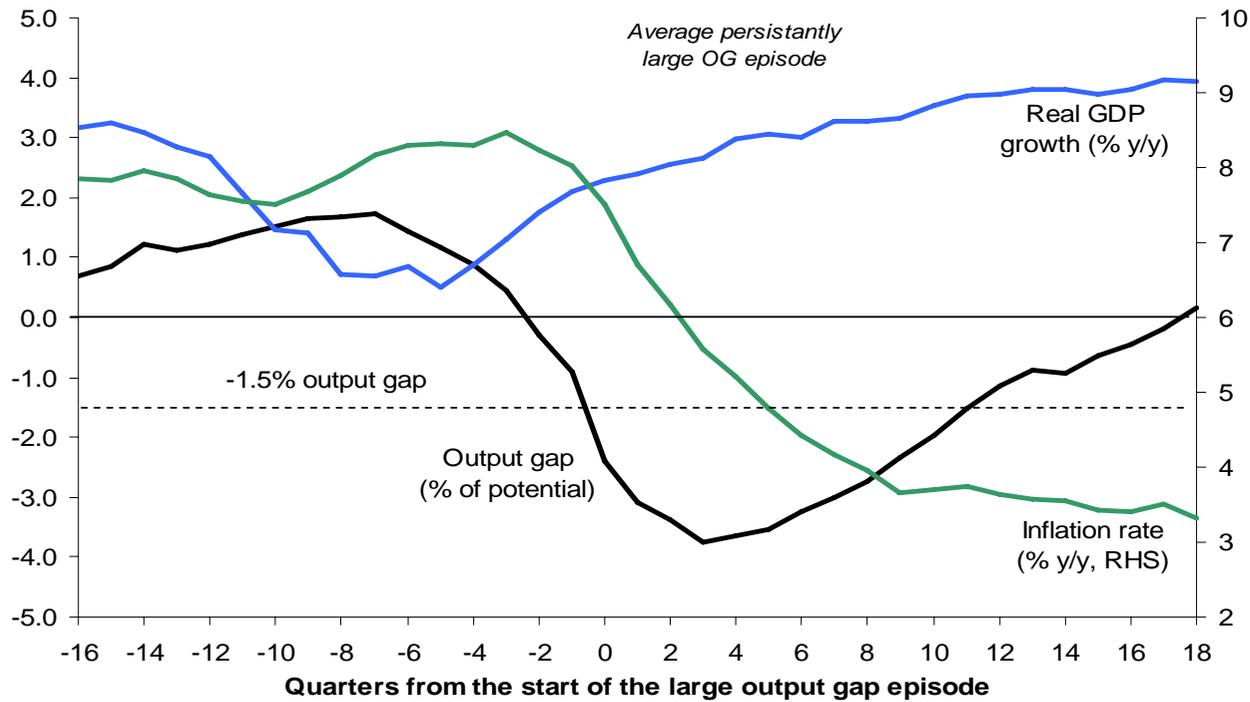
Source: Reuters Ecowin Pro, BNP Paribas



Persistent, large output gap episodes...



Case Study: Inflation & Output Gaps II



Source: Reuters EcoWin Pro, BNP Paribas

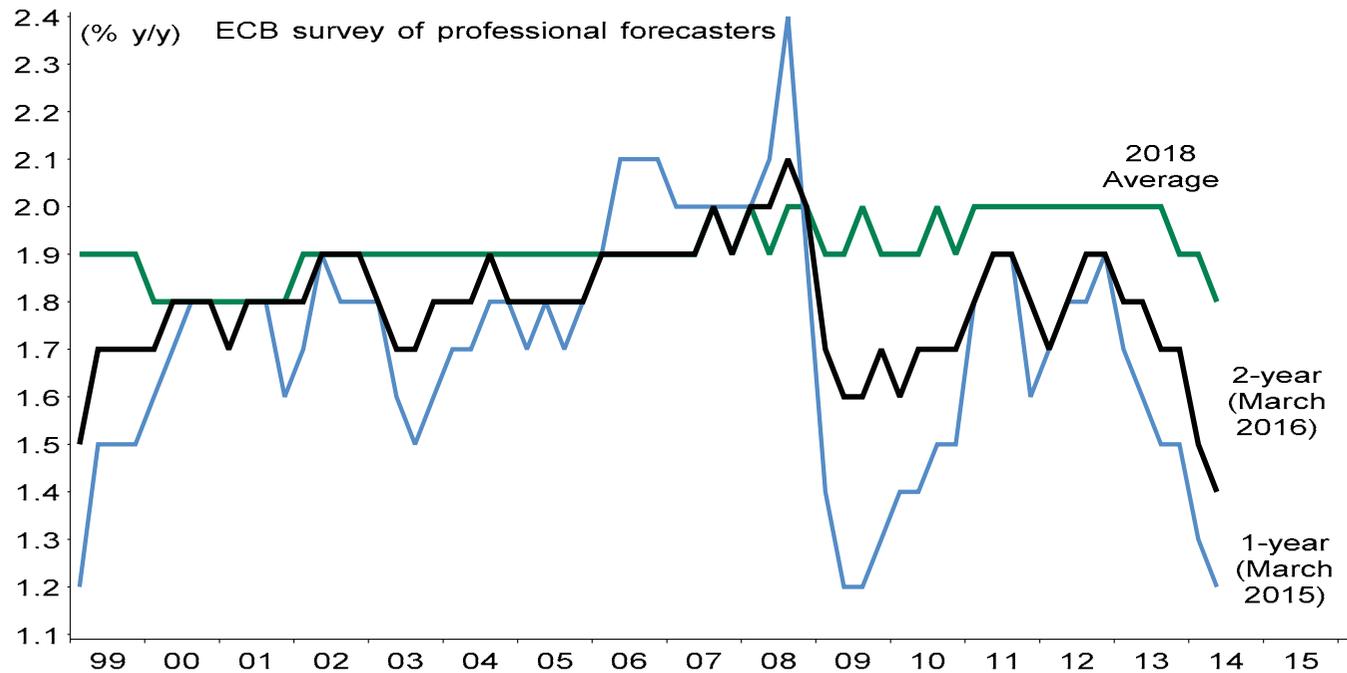
- Historical evidence suggests that inflation moderates on the back of a persistently large negative output gap
- A return to growth is not sufficient to turn inflation dynamics around
- Inflation only starts to accelerate once the output gap has closed



... imply persistent low inflation



Eurozone: SPF Inflation Expectations



Source: ECB and BNP Paribas

- The ECB's Survey of Professional Forecasters shows five-year inflation expectations sliding down from 2% in Q3 last year to 1.8% in the latest survey
- Shorter-horizons expectations are significantly lower, standing either at or below their trough during the crisis



Keeping a low (inflation) profile



ECB: Policy Response Framework

Extracts from Speech by Mario Draghi, 24 April 2014

"We have helped clarify our reaction function by laying out some contingencies that would warrant a policy reaction.

One contingency is an unwarranted tightening of the policy stance [which] could emanate from at least three sources;

- * Renewed tensions in short term money markets, to the extent that these are propagated to the medium-term curve;*
- * Developments in global bond markets that unduly spill over to the interest rate term structure in the euro area;*
- * A continued appreciation of the exchange rate.*

[These] can be addressed through a variety of more conventional policy measures [including]:

- * A further lowering of the interest rate corridor, including a negative deposit rate;*
- * A further extension of the fixed rate, full allotment procedure;*
- * New liquidity injections, including longer-term fixed rate operations.*

A [second] contingency would be further impairments in the transmission of our stance, in particular via the bank lending channel. [The policy response] could take several forms, including

- * A longer-term refinancing operation targeted towards encouraging bank lending;*
- * Or an ABS purchase programme, supported by the necessary regulatory changes.*

A [third contingency] would be a worsening of the medium-term outlook for inflation. Unlike the other contingencies, the objective here would not be to defend the current stance, but rather to increase meaningfully the degree of monetary accommodation.

The limited margin for manoeuvre that remains over short-term interest rates would not be sufficient. This would be the context for a more broad-based asset purchase programme."



Contingency planning



ECB: QE Option Left Open

Extracts from Press Conference by Mario Draghi, 5 June 2014

“For all practical purposes, we have reached the lower bound.

This doesn't exclude some little technical adjustments which could lead to lower interest rates in one or the other or both parts of the corridor. But I would consider having reached the lower bound today.

The introductory statement says that the Governing Council is ready to use also unconventional instruments. The broad-based asset purchase programme...is certainly one of these unconventional instruments

We think it's a significant package. Are we finished? The answer is no, we aren't finished here. If need be, within our mandate, we aren't finished here.”

Extracts from Speech by Vitor Constancio, 6 June 2014

“If some downward shock were to create a much deteriorated situation, then we will have to think about all sorts of unconventional policies.

In that circumstance, we would have to contemplate the use of a broader programme of asset purchases.

Only after the second tranche in December...of the new [TLTRO] will we then gauge the impact, because by then the comprehensive assessment [of banks] will be completed and banks will know what is their situation.”



QE the next step, if needed



ECB Asset Purchases: BNPP Assumptions

* **Timing : Q3 2014**

Key period is b/w June and September inflation projections; BNPP forecast of –ive depo rate in June argues for time to assess impact Draghi's 24 April framework, however, could be interpreted as increasing likelihood of combined rate cuts and asset purchases
Evolution of inflation (relative to ECB projections) and inflation expectations are key triggers

* **Scale : EUR 400bn**

Proposed scale is a weighted average of various calibrations using multiple methodologies (see slide)
May now look conservative on the basis of FAZ reports of EUR 1trn (or 11% of GDP) ECB model-based simulations
Programme of that scale would be far larger than those of other central banks initially, not in keeping with historical ECB conservatism

* **Objective : Price Stability**

Explicitly different goal than for SMP and OMT (“severe tensions” hindering “monetary policy transmission” and “effective policy”)
Staff projections in March 2014 barely consistent with ECB definition of price stability at longest horizon (inflation of 1.7% in Q4 2016)
Based on 24 April framework, worse inflation = more accommodation; rate cuts “insufficient”, implying “broad-based” asset purchases
Do not expect ECB to be clear in setting threshold of objective

* **Composition : Mix of Assets, Including Sovereign Bonds**

Legal decision for SMP states explicitly allowed buying of debt issued by public (in secondary market only) or private sector entities
ECB willing to buy ABS but levels outstanding for SME loans are modest, around EUR120bn including the UK (see slide);
Sovereign markets have depth and breadth, important both for balance sheet effects and legal issues
Draghi appeared to rule out corporate bond buying in Davos; supra-nationals would not meet Coeuré's criteria (see slide)

* **Methodology : Announce Quantity Ex-Ante**

QE programmes of other major CBs have stipulated a quantity of purchases; but Fed ‘open-ended’ QE3 did not have an upper limit
Under SMP, scale of buying was announced ex-post; Coeuré's comments about price not quantity (see slide) complicate matters
Sovereign buying across member states would adhere to single policy principle (capital key avoids favouring high debt countries)

* **Maturity : No Limit**

OMT limited to 1-3 year maturities; argument in favour is that assets roll off balance sheet earlier, facilitating an easier exit
SMP included all maturities: Coeuré's comments (see slide) suggest “intermediate to long” maturities maximise economic impact



Conclusion and forecasts



Conclusions

* **The economic recovery in the eurozone is gaining momentum**

The recovery has become more broad-based both by components (with an increasing contribution from domestic demand) and countries (as the outlook has improved in the periphery)

The labour market has turned earlier than anticipated

There is tentative evidence of improvement in credit conditions.

Our growth forecasts for both this year and the next are above the consensus

* **A number of risks remain**

Chinese growth has slowed considerably in Q1

We assume the authorities will react, with the aim of achieving the growth target of 7.5%

More of the old medicine, however, will exacerbate the economy's imbalances

The recovery in the US may lead to some "unwanted tightening in monetary conditions"

The outcome of the Ukrainian crisis is still very uncertain

* **Inflation will remain very low**

Economic slack is wide

The output gap will close only gradually

Inflation expectations may have already dis-anchored

In the event of an unforeseen shock, risks of deflation would not be negligible

* **QE is on the cards**

We expect the ECB to ease monetary conditions further...

...with rate cuts in June...

...followed by asset purchases later on in the year



Higher growth but persistently low inflation = QE



BNPP interest-rate and FX forecasts

Interest-rate forecasts (%)*

	Spot**	Q2 '14	Q3 '14	Q4 '14	Q1 '15	Q4 '15
US						
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.50
2-year	0.45	0.45	0.60	0.70	1.00	2.00
10-year	2.62	2.59	2.90	3.00	3.15	3.50
Eurozone						
Refi	0.15	0.15	0.15	0.15	0.15	0.15
2-year	0.04	0.05	0.05	0.05	0.05	0.20
10-year	1.33	1.40	1.50	1.55	1.60	1.75
Italy						
10-year vs Bund	1.48	1.30	1.00	1.00	1.00	1.20
Spain						
10-year vs Bund	1.40	1.30	1.00	1.00	1.00	1.20
Japan						
Call Rate	0.10	0.10	0.10	0.10	0.10	0.10
2-year	0.09	0.09	0.09	0.09	0.10	0.20
10-year	0.59	0.60	0.70	0.80	1.00	2.50
China						
Official interest Rate	3.00	3.00	3.00	3.00	3.00	3.00
Brazil						
SELIC Rate	11.00	11.00	11.00	11.50	12.00	13.00
UK						
Base Rate	0.50	0.50	0.50	0.75	1.00	1.75
2-year	0.90	0.70	1.20	1.30	1.50	2.25
10-year	2.74	2.65	2.90	2.90	2.85	2.95

Source: BNP Paribas (Market Economics, Interest Rate Strategy)

*End Period **Spot Rates as at 20 June 2014

FX forecasts*

	Spot**	Q2 '14	Q3 '14	Q4 '14	Q1 '15	Q2 '15	Q4 '15
EUR/USD	1.34	1.35	1.32	1.30	1.28	1.27	1.26
USD/JPY	102	108	109	110	112	115	124
USD/BRL	2.25	2.28	2.38	2.45	2.45	2.48	2.55
USD/RMB	6.23	6.19	6.25	6.20	6.17	6.25	6.15
GBP/USD	1.70	1.69	1.69	1.71	1.71	1.72	1.75

Source: BNP Paribas (FX Strategy) *End Period **Spot Rates as at 20 June 2014



BNP Paribas economic forecasts

Economic forecasts (% y/y)								
	2012	2013	2014	2015	2014			2015
					Q2	Q3	Q4	Q1
US								
GDP	2.8	1.9	2.1	2.8	2.3	2.0	1.9	2.8
CPI	2.1	1.5	2.1	2.0	2.1	2.3	2.4	2.3
Core CPI	2.1	1.8	1.9	2.0	1.9	1.9	2.0	2.1
Eurozone								
GDP	-0.6	-0.4	1.2	1.9	1.0	1.3	1.5	1.7
CPI	2.5	1.4	0.6	1.1	0.6	0.4	0.6	0.8
Core CPI	1.5	1.1	0.8	0.9	0.8	0.7	0.7	0.7
Germany								
GDP	0.9	0.5	2.2	2.4	2.0	2.2	2.3	2.1
CPI	2.1	1.6	0.9	1.4	1.0	0.8	1.0	1.2
France								
GDP	0.4	0.4	0.8	1.4	0.5	0.9	1.0	1.3
CPI	2.2	1.0	0.9	1.2	0.8	0.8	1.0	1.1
Italy								
GDP	-2.4	-1.8	0.3	1.3	0.1	0.6	0.8	1.3
CPI	3.3	1.3	0.4	1.1	0.4	0.3	0.6	0.8
Spain								
GDP	-1.6	-1.2	1.3	2.0	1.1	1.5	1.9	1.9
CPI	2.4	1.5	0.1	0.7	0.2	-0.2	0.3	0.6
Japan								
GDP	1.4	1.5	1.2	0.8	0.5	0.7	1.0	-0.3
Core CPI	0.0	-0.3	2.0	1.5	2.8	2.6	2.3	2.5
US-Like Core CPI	-0.1	0.4	2.6	2.0	3.3	3.0	3.0	3.1
China								
GDP	7.7	7.7	7.3	6.8	7.5	7.3	7.2	7.0
CPI	2.6	2.6	2.1	2.6	1.9	1.8	2.4	2.8
Brazil								
GDP	1.0	2.5	1.0	1.0	0.4	0.9	0.7	0.8
IPCA	5.8	5.9	6.5	7.0	6.6	6.9	6.5	6.2
Core CPI	5.6	6.0	6.3	6.4	6.5	6.6	6.3	6.1
UK								
GDP	0.3	1.7	3.4	3.0	3.5	3.4	3.6	3.4
HICP	2.8	2.6	1.7	2.1	1.7	1.7	1.8	2.0
Core CPI	2.4	2.1	1.7	2.2	1.6	1.7	1.7	2.1

Source: BNP Paribas



Disclaimer

IMPORTANT DISCLOSURES:

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