Europe

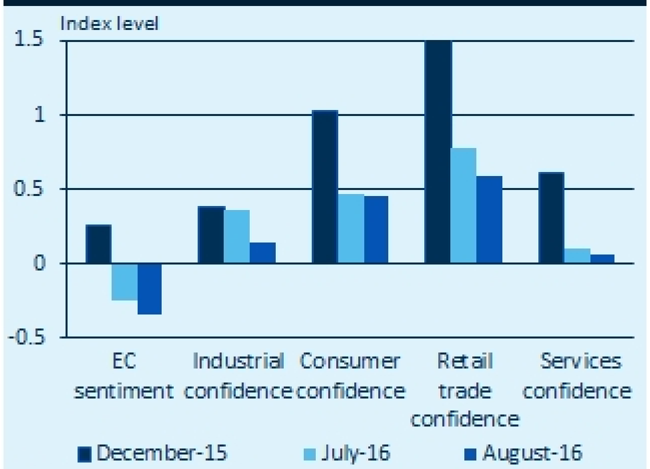
Wobbling?

The Eurozone economy continued to trundle along over the first half of this year. GDP growth in Q2 came in at a solid 0.3% quarter-on-quarter (q/q), slightly below the average 0.4% q/q rate achieved over the past two years. While this may sound unspectacular from an international perspective, 1.6% annualised growth is comfortably above potential in the Eurozone. **However, there have been some signs over the summer that this slow-but-steady recovery story might be faltering slightly**. This has been apparent in survey data, which indicate a moderation in private sector activity (see Chart 6). The EC Economic Sentiment indicator slipped in August to 103.5 and is now noticeably weaker than the 106.6 reading at the end of last year. Examining the subcomponents, consumer confidence has fallen with households seemingly less upbeat around the economic outlook. Industrial and business confidence has tracked sideways, but retail sales sentiment has clearly soured. The one bright spot is construction confidence, which continues to track steadily higher. Perhaps most ominous from a Eurozone perspective is that the steady decline in unemployment has stalled at 10.1% (see Chart 7). This will surely be a concern for the European Central Bank (ECB), with idle capacity in the labour market keeping inflation uncomfortably low. Unit labour cost growth has been running at less than 1% year-on-year over the past two years, growth that is clearly inconsistent with the ECB's mandate.

It is hard to isolate exactly what has caused this weakness. An obvious culprit might be the uncertainty shock in the UK following the EU referendum. However, the reaction in Eurozone survey data in the immediate aftermath of this surprise was fairly muted. **Nevertheless, there could be a slow burn effect taking hold**, with the UK a major trading partner for many Eurozone economies. Similarly the vote may have underscored the political risk in many parts of the continent ahead of the Italian constitutional referendum later this year, German and French elections next year, and the continued inability to form a government in Spain. Meanwhile, the apparent softening in the manufacturing sector, and in particular export orders, is disappointing given tentative signs that the global production cycle has been improving. **One trigger could be that the boost to consumers from lower oil prices could be starting to fade**. This might explain the deterioration in retail sentiment and consumers perceptions over their personal finances over the next 12 months.

It is important to emphasise that we are seeing signs of softening, rather than a stall, in growth. However, policymakers should not be complacent. The trend in Eurozone inflation has been disappointing, despite the ongoing recovery. Sustained above trend growth is essential to help inflation back to target. At present it looks difficult for the ECB to achieve its core inflation forecasts either this year or next year. There has been increased speculation that the central bank will stand pat at its meeting this week. **However, we think it should act and may do so as soon as September, extending its Asset Purchase Programme until at least September 2017 and reiterating its willingness to do more**. This may require some change in the parameters of the programme due to liquidity constraints and the most sensible step at present would be to drop issue limits.

Chart 6: Sentiment stuttering?



* indicators normalised

Source: EC, Haver (as of August 2016)

Chart 7: An unwelcome pause

Source: EC, Haver (as of July 2016)