EUROPEAN ECONOMICS WEEKLY

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CAPITAL ECONOMICS

Editors: Roger Bootle and Jonathan Loynes

Draghi's criteria for further easing already met

- Last week, January's ECB minutes were published, revealing that all members of the Governing Council thought that it was necessary to reconsider the monetary stance. Separately, President Draghi set out two criteria that would inform the Council's decision: the pass-through of low imported inflation and the transmission of monetary policy via banks. We think that both of these criteria suggest that the ECB will significantly increase its monetary stimulus next month.
- Meanwhile, any hopes that the euro-zone's beleaguered construction sector will soon start to perform strongly were dealt a fresh blow by December data published last week. The big picture is that the sector is still very weak and is set to remain so given the sluggish economic growth in the region.
- This week, the focus will undoubtedly be on the fallout from last week's negotiations on Britain's position in the EU. Meanwhile, euro-zone survey data are likely to show a deterioration in business and consumer confidence as well as a slowdown in activity in February, boding ill for Q1 GDP growth. In Ireland, opinion polls suggest that Friday's general election will result in another coalition.

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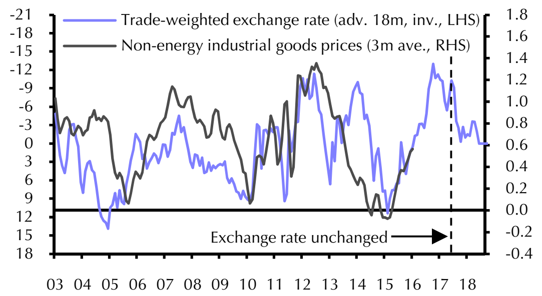
Draghi's criteria for further easing already met

Last week, the publication of January's ECB minutes revealed that *all* members of the Governing Council saw fit to "reconsider" the stance of monetary policy in March. Of course, the ECB has a track record for raising, and later dashing, expectations. **But last Monday, President Mario Draghi suggested two areas on which the Council would focus its attention, both of which we think suggest that the ECB *will* loosen policy substantially in March.**

First, he stated that the Council will examine the pass-through of low imported inflation to domestic prices and inflation expectations. Chart 1 suggests that exchange rate movements influence non-energy industrial goods prices with about an 18-month lag. On this basis, non-energy industrial goods inflation might pick up from 0.7% in January to 1.4% later in the year, adding about 0.2%-points to headline inflation. But unless the euro weakened further, this effect would entirely reverse next year.

CHART 1: EURO EXCHANGE RATE & NON-ENERGY INDUSTRIAL GOODS PRICES (% Y/Y)

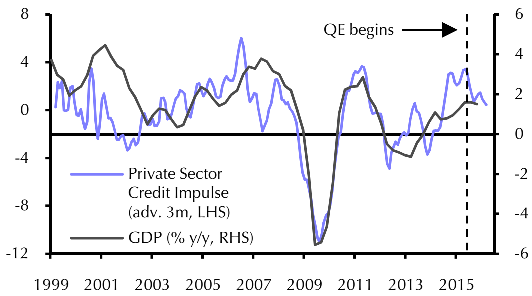


Source – Thomson Datastream

Meanwhile, inflation expectations are weak. The EC's measures of consumer and business inflation expectations are below their long-run averages. And the 5-year 5-year inflation swap rate – the ECB's preferred measure of long-term expectations – ended last week at 1.45%, close to an all-time low.

Second, Mr Draghi said that the Council would focus on the transmission of monetary policy by banks. Despite extra stimulus, the "credit impulse", which puts bank lending on a comparable basis with GDP, *fell* last year. On past form, it points to growth of below 2%, too slow to put much upward pressure on inflation. (See Chart 2.)

CHART 2: CREDIT IMPULSE & GDP



Source – Thomson Datastream

Admittedly, if an interest rate cut by the ECB fuelled concern about banks' profitability and pulled their equity prices down, lending might fall. But the ECB could also expand QE, which might be good for banks. Indeed, between the ECB cutting its deposit rate below zero in June 2014 and announcing its QE programme in January 2015, the Eurostoxx Banks index fell, while the overall Eurostoxx index *rose*. After QE was announced, equity prices rose, but the effect was *greater* for banks' shares.

That said, some members of the Governing Council last week suggested that they will oppose further easing. Jens Weidmann stated that QE was "no longer necessary". And Ewald Nowotny warned against speculating about policies "that are simply institutionally and technically impossible".

Mr Nowotny's comments might have been referring to speculation last week that the ECB would buy Italian securitised non-performing loans. But even if there were *currently* technical constraints on the expansion of QE, January's minutes stated that work would be carried out to ensure that "all the technical conditions were in place" for further easing, if needed. **What's more, Mr Weidmann will not have a vote in March's meeting.**

The upshot is that we think the euro-zone economy needs more monetary stimulus, and concerns about the impact on banks do not change that view. **We continue to forecast a deposit rate cut, perhaps by as much as 20 basis points, and an increase in monthly QE purchases to €80bn in March.**

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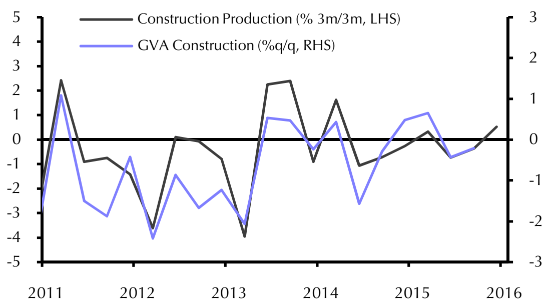
Recovery in construction far from assured

Any hopes that the euro-zone's beleaguered construction sector will soon start to perform strongly were dealt a fresh blow by December data published last week. The big picture is that the sector is still very weak and is set to remain so given the sluggish economic growth in the region.

The 0.6% monthly fall in construction output in December was disappointing after healthy rises in October and November. The country breakdown revealed that construction fell particularly sharply in France but also declined in Germany and the Netherlands.

Admittedly, despite December's drop, euro-zone construction production still increased during Q4 as a whole. **On a quarterly basis, it rose by 0.5% in the final three months of 2015, much better than Q3's 0.4% *fall*.** While the relationship between the monthly data and the construction component of the national accounts is far from perfect, it seems likely that the sector contributed to the 0.3% quarterly rise in overall GDP in Q4. (See Chart 3.) The GDP breakdown by sector will not be published until next month.

Chart 3: Construction Prod. & GVA Construction

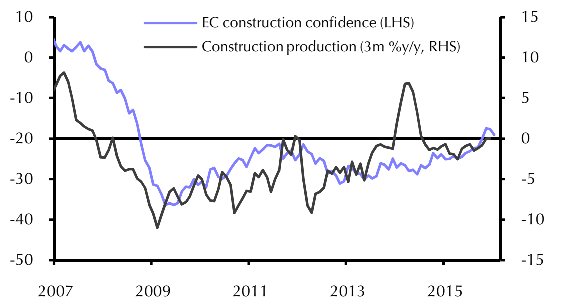


Source – Thomson Datastream

However, the renewed drop in December is a reminder that the sector continues to struggle. Although annual construction growth has been on an improving trend since last April, the three-month average was zero at the end of 2015. **And we do not expect conditions to improve substantially.**

For a start, the surveys do not point to a strong pick-up in construction activity. While it is encouraging that the headline construction PMI nudged just above the 50 "no-change" level in January for the first time since April 2011, we would caution that this still implies only very weak growth. Meanwhile, the EC's measure of confidence among construction firms actually deteriorated in January for the second consecutive month. On the basis of past form, this points to construction production continuing to stagnate. (See Chart 4.) Note, too, that the number of residential building permits issued is still well below its pre-crisis level.

Chart 4: Construction Prod. & EC Construction Confidence



Source – Thomson Datastream

Furthermore, the sector is unlikely to receive much support from a general improvement in economic conditions. As the boosts from lower oil prices and the weaker euro fade, we expect euro-zone GDP growth to slow this year. **And finally, although lending rates are set to remain at record lows, credit standards remain historically tight, suggesting that firms may still struggle to finance construction projects. The upshot is that while the construction sector is in better shape than it was, that is not saying much. It is still very fragile and a strong recovery seems unlikely any time soon.**

The week ahead

This week, the focus will undoubtedly be on the fallout from last week's negotiations on Britain's position in the EU. Meanwhile, euro-zone survey data are likely to show a deterioration in business and consumer confidence as well as a slowdown in activity in February, boding ill for Q1 GDP growth. Euro-zone money growth probably remained slow by past standards in January. In Ireland, opinion polls suggest that Friday's general election will result in another coalition. But there is the potential for uncertainty while the parties negotiate.

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Data Preview – Euro-zone Flash PMIs (Feb.) 09.00 GMT Mon 22nd Feb.

Forecasts	Previous	Median	Capital Economics
Composite PMI	53.6	53.3	53.2

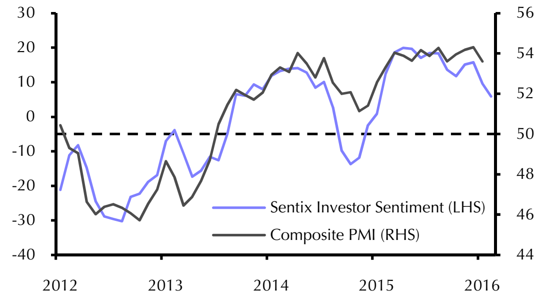
PMI probably slid a little lower

We suspect that the euro-zone Composite PMI dipped again in February, showing little sign of a pick-up in GDP growth in the first quarter of 2016.

In January, the index dropped from 54.3 to 53.6 – slightly below 2015's average. The new orders index fell once more, suggesting that subsequent output growth might slow. Indeed, it seems likely that firms will have been negatively affected somewhat by the trade-weighted euro being at its strongest since January 2015. The Sentix measure of investor sentiment, which has a decent relationship with the Composite PMI, suggests that it could have fallen towards 52. (See Chart 1.)

The Composite PMI will probably not have fallen that far. The index measures output, rather than sentiment, so is less sensitive to market turbulence. Besides, fears about weakening global demand are most probably overdone. On balance, we think that February's Composite PMI will have fallen slightly, to around 53.2, leaving it a decent margin below Q4 2015's average of 54.1. On past form this would point GDP growth of around 0.3% q/q in Q1. However, the survey overestimated growth in the second half of last year.

CHART 1: EURO-ZONE COMPOSITE PMI & SENTIX INVESTOR SENTIMENT INDEX



Sources – Thomson Datastream, Markit

Data Preview – German Ifo Survey (Feb.) 09.00 GMT Tue. 23rd Feb.

Forecasts	Previous	Median	Capital Economics
Business Climate Indicator	107.3	107.0	106.8

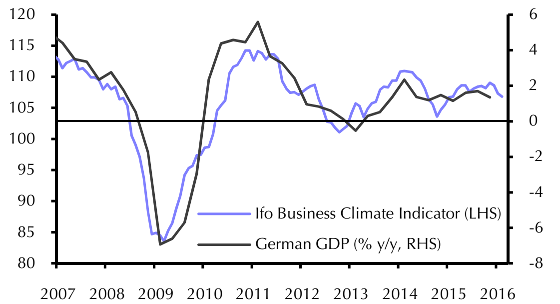
Further weakness

We think that the Ifo Business Climate Indicator (BCI) may have fallen again in February, supporting our view that the German recovery is slowing.

The BCI fell for the second month running in January, dropping from 108.6 to 107.3, in part reflecting increased worries about the global economy. With those fears persisting, we expect that it declined in February. Admittedly, firms may have been reassured by better-than-expected German GDP growth in Q4. However, this may have been more than offset by worries about the potential adverse effect of the recent rise in the euro. Note, too, that the Sentix and ZEW measures of investor sentiment for the same month both fell.

Accordingly, we expect the BCI to fall to around 106.8, which would be below Q4's average of 108.6 and consistent on the basis of past form with annual GDP growth no better than Q4's 1.5%. (See Chart 1.) What's more, with the boost from both lower oil prices and the weaker euro set to fade, we think growth is likely to slow further this year.

CHART 1: GERMAN IFO BCI & GDP



Source – Thomson Datastream

Data Preview – Euro-zone M3 (Jan.)

09.00 GMT Thu. 25th Feb.

Forecasts	**Previous**	**Median**	**Capital Economics**
M3 (y/y)	(+4.7%)	(+4.7%)	(+5.0%)

Money growth remained slow

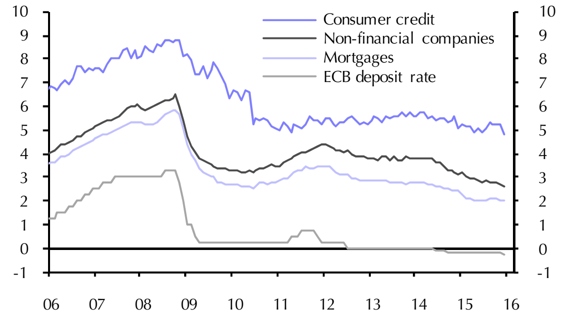
We suspect that euro-zone broad money growth remained slow by past standards in January.

The annual growth of broad money (M3) slowed from 5.0% in November to 4.7% in December – its weakest rate since March. This was partly a result of slower bank lending growth.

The ECB's latest Bank Lending Survey showed that over the past three months banks loosened their lending standards and experienced rising demand for credit. And interest rates on bank lending edged down in December, probably in response to the ECB's deposit rate cut. (See Chart 1.) However, with economic activity still weak, we doubt that lending will have surged.

Our best guess is that annual M3 growth picked up to about 5.0%. This would still be weak compared to the 1999 to 2007 average of 7.2%, so further ECB stimulus is needed.

CHART 1: EURO-ZONE INTEREST RATES (%)



Source – Thomson Datastream

Data Preview – EC Economic Sentiment (Feb.)

10.00 GMT Fri. 26th Feb.

Forecasts	**Previous**	**Median**	**Capital Economics**
Economic Sentiment Indicator	105.0	104.5	104.0

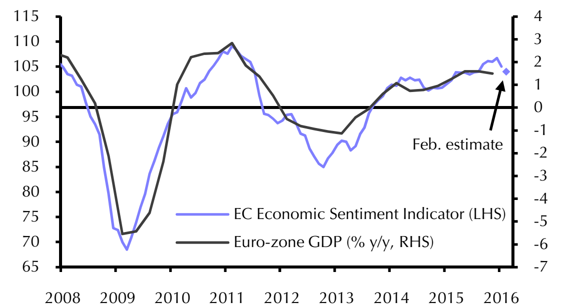
Sentiment probably dropped further

We suspect that the EC's Economic Sentiment Indicator (ESI) fell further in February, as market fears failed to subside.

In January, the ESI dropped from 106.7 to 105.0, its lowest level in five months. This month, the euro reached its highest level since January 2015, which is likely to have worried export-focused businesses. And global market turmoil, worries about the health of European banks and precipitous falls in stock markets are all likely to have weighed on sentiment. Indeed, investor sentiment towards the euro-zone fell in both the Sentix and ZEW surveys. And it seems likely that the EC measure of consumer confidence, which makes up 20% of the ESI, fell in February.

Accordingly, we expect that the ESI probably dropped again this month – to around 104.0 – leaving the ESI consistent with annual GDP growth holding steady around Q4's 1.5%. (See Chart 1.) With the tailwinds from the lower oil price and euro set to fade, we suspect the ESI may edge down further over the coming months.

CHART 1: EC ECONOMIC SENTIMENT & EURO-ZONE GDP



Source – Thomson Datastream

Latest Data & Main Forecasts

LATEST EURO-ZONE ECONOMIC INDICATORS

Monthly Data %m/m(%y/y) unless stated		Oct	Nov	Dec	Jan
Consumer Prices	HICP	+0.1(+0.1)	-0.2(+0.1)	0.0(+0.2)	-1.4(+0.4)
	Core	(+0.9)	(+0.9)	(+0.9)	(+1.0)
Producer Prices		-0.3(-3.2)	-0.2(-3.2)	-0.8(-3.0)	-
M3		(+5.3)	(+5.0)	(+4.7)	-
Unemployment, monthly change thous., (rate %)		-21(10.6)	-170(10.5)	-49(10.4)	-
Retail Sales		-0.2(+2.5)	0.0(+1.6)	+0.3(+1.4)	-
Industrial Production		+0.9(+2.1)	-0.5(+1.4)	-1.0(-1.3)	-
External Trade Balance €bn		+19.8	+22.6	+21.0	-
Current Account €bn		+20.4	+26.4	+25.5	-
Monthly Data		**Nov**	**Dec**	**Jan**	**Feb**
German ZEW		+10.4	+16.1	+10.2	+1.0
German Ifo		109.0	108.7	107.3	-
Euro-zone Composite PMI		54.2	54.3	53.6	-
EC Euro-zone Economic Sentiment Indicator		106.1	106.7	105.0	-
Quarterly Data %q/q(%y/y) unless stated		**Q1 2015**	**Q2 2015**	**Q3 2015**	**Q4 2015**
GDP		+0.5(+1.3)	+0.4(+1.6)	+0.3(+1.6)	+0.3(+1.5)
Household Spending		+0.5(+1.6)	+0.3(+1.7)	+0.4(+1.7)	-
Hourly Labour Costs		(+1.9)	(+1.6)	(+1.1)	-

LATEST MARKET DATA

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate		1 mth ago	1 week ago	Latest*
Official Rates	ECB refi	0.05	0.05	0.05	Germany yield curve (20-2)		146	120	117
	UK repo	0.50	0.50	0.50	Global yields	US 10 year	2.05	1.75	1.73
	US Fed funds	0.25	0.25	0.50		UK 10 year	1.71	1.41	1.40
	Japan O/N	0.10	0.10	0.10		Japan 10 year	0.24	0.09	0.01
Market rates	3mth Euribor	-0.15	-0.18	-0.19	Equity indices	German DAX	9765	8968	9425
	12mth Euribor	0.03	-0.01	-0.01		French CAC	4337	3995	4243
Bond yields	Germany 2 yr	-0.45	-0.51	-0.53		Italian MIB	19028	16515	17105
	Germany 10 yr	0.48	0.26	0.20	Exchange rates	$/euro	1.08	1.12	1.11
	Germany 20 yr	1.01	0.69	0.64		£/euro	0.76	0.78	0.78
	France 10 yr	0.80	0.66	0.56		¥/euro	128.2	127.3	125.7
	Italy 10 yr	1.57	1.65	1.53	Brent crude oil price ($ pb)		31.0	32.3	33.6

***Latest as at 08.35 GMT on 19th February 2016**

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y) unless stated	Latest	Q4 2015	Q1 2016	2015	2016	2017
GDP	+0.3(+1.5)	+0.3(+1.5)	+0.2(+1.2)	+1.5	+1.2	+1.5
Household Spending	+0.4(+1.7)	+0.1(+1.1)	+0.2(+0.8)	+1.6	+1.0	+1.5
HICP (%y/y)	+0.2	+0.2	0.0	0.0	+0.5	+1.5
Unemployment Rate (%)	10.4	10.5	10.4	10.8	10.2	9.7
Refi Rate, end period (%)	0.05	0.05	0.05	0.05	0.05	0.05
10 yr. Ger. Bond Yield, end period (%)	0.20	0.63	0.20	0.63	0.50	1.00
$/euro, end period	1.11	1.09	1.09	1.09	1.00	1.00
£/euro, end period	0.78	0.74	0.76	0.74	0.77	0.77

European Economic Diary & Forecasts

EUROPE

Date	Country		Release/Indicator/Event		Time CET	(GMT)	Previous*	Median*	CE Forecast*
Mon 22nd		EZ	Markit Manufacturing PMI (Feb, Prov.)		10.00	(09.00)	52.3	52.0	52.0
		EZ	Markit Services PMI (Feb, Prov.)		10.00	(09.00)	53.6	53.5	53.3
		EZ	Markit Composite PMI (Feb, Prov.)		10.00	(09.00)	53.6	53.3	53.2
		EZ	ECB's Lautenschlager Speaks in Stuttgart		19.00	(18.00)	-	-	-
Tue 23rd		Ger	GDP (Q4, Final)	q/q(y/y)	08.00	(07.00)	+0.3%(+1.3%)p	+0.3%(+1.3%)	+0.3%(+1.3%)
		Fra	Business Confidence (Feb)		08.45	(07.45)	102	102	101
		Ger	Ifo Business Climate Index (Feb)		10.00	(09.00)	107.3	107.0	106.8
		Bel	Business Confidence (Feb)		15.00	(14.00)	-3.0	-	-4.0
Wed 24th		Fra	Consumer Confidence (Feb)		08.45	(07.45)	97	97	97
Thu 25th		Ger	GfK Consumer Confidence (Mar)		08.00	(07.00)	9.4	9.3	9.1
		Aus	CPI (Jan)		09.00	(08.00)	+0.4%(+1.0%)	-	-0.9%(+1.4%)
		Spa	GDP (Q4, Final)	q/q(y/y)	09.00	(08.00)	+0.8%(+3.5%)p	+0.8%(+3.5%)	+0.8%(+3.5%)
		Swi	CPI (Jan)	(EU Harm.)	09.15	(08.15)	-0.2%(-1.4%)	-	-0.6%(-1.4%)
		EZ	M3 Money Supply (Jan)		10.00	(09.00)	(+4.7%)	(+4.7%)	(+5.0%)
		Ice	CPI (Feb)		10.00	(09.00)	-0.6%(+2.1%)	-	+0.6%(+2.1%)
		Ita	Consumer Confidence (Feb)		10.00	(09.00)	118.7	-	118.0
		Ita	Business Confidence (Feb)		10.00	(09.00)	103.2	-	103.0
		EZ	CPI (Jan, Final)		11.00	(10.00)	-1.4%(+0.4%)p	-1.4%(+0.4%)	-1.4%(+0.4%)
		Ita	Retail Sales (Dec)		11.00	(10.00)	+0.3%(-0.1%)	-	-0.2%(+1.0%)
Fri 26th		Ire	General Election		-	-	-	-	-
		Fra	CPI (Feb, Prov.)	(EU Harm.)	08.45	(07.45)	-1.0%(+0.1%)	+0.4%(+0.1%)	+0.6%(+0.1%)
		Fra	GDP (Q4, 2nd Est.)		08.45	(07.45)	+0.2%(+1.3%)p	+0.2%(+1.3%)	+0.2%(+1.3%)
		Fra	Consumer Spending (Jan)		08.45	(07.45)	+0.7%(+0.3%)	+0.8%(+0.3%)	+0.7%(+0.2%)
		Spa	CPI (Feb, Prov.)	(EU Harm.)	09.00	(08.00)	-2.5%(-0.4%)	-	-0.2%(-0.5%)
		EZ	Economic Sentiment Indicator (Feb)		11.00	(10.00)	105.0	104.5	104.0
		Ger	CPI (Feb, Prov.)	(EU Harm.)	14.00	(13.00)	-1.0%(+0.4%)	-	+0.7%(+0.1%)
		Bel	CPI (Feb)		-	-	+0.1%(+1.7%)	-	0.0%(+1.3%)
		EZ	ECB's Peter Praet speaks in New York		19.30	(18.30)	-	-	-

*m/m(y/y) unless otherwise stated; p = provisional

KEY FORTHCOMING EVENTS/DATA

29th Feb	Denmark GDP (Q4, 1st Est.)	2nd Mar	Switzerland GDP (Q4)
29th Feb	Sweden GDP (Q4, 1st Est.)	3rd Mar	Retail Sales (Jan)
29th Feb	Euro-zone Flash CPI & Core CPI (Feb)	8th Mar	Germany Industrial Production (Jan)
1st Mar	Germany Unemployment Rate (Feb)	8th Mar	Euro-zone GDP (Q4, 2nd Est.)
1st Mar	Euro-zone Unemployment Rate (Jan)	10th Mar	ECB Interest Rate Announcement

Selected Recent Publications

Date	Publication	Title
Mon 15th	Capital Daily	Equities had detached from economic reality
	China Economics Update	PBOC still far from exhausting reserves
	China Inflation Monitor	Food prices surge ahead of Spring Festival celebrations
	European Economics Update	How would Brexit affect the rest of the EU?
	Global Markets Update	If 2004 was a conundrum, 2016 is even more of a puzzle
	Global Economics Update	Equity market slump not a game-changer for world economy
	Commodities Update	Slow start to the year for China's commodity imports
	Global Markets Update	Risks of major renminbi devaluation are exaggerated
	European Economics Update	Finland's economic prospects look grim
Tue 16th	Capital Daily	What next for the renminbi?
	Africa Watch	Nigeria: Something's gotta give
	Energy Update	How big a deal is the agreement to freeze oil output?
	Emerging Europe Update	Winners and losers from a weaker ruble
	Commodities Markets Chart Book	Weaker dollar supports commodity prices
	Emerging Markets Economics Update	Emerging Markets Capital Flows Monitor
	US Economics Update	Fed unlikely to follow others in adopting negative rates
Wed 17th	Capital Daily	Output freeze not enough to provide lasting boost to oil prices
	European Economics Update	Reaction to Riksbank's rate cut won't deter ECB
	Africa Economics Update	South African economy probably avoided drop in GDP in Q4
	Energy Chart Book	Hopes of an output deal prop up oil prices
	UK Economics Update	No need for the UK to join the negative rate club
	Global Monetary Indicators Monitor	Credit growth still strong in the US, and rebounding in China
	China Economics Focus	Can China turn itself around?
	Global Markets Update	What's really happening to US inflation expectations?
	Latin America Economics Update	Mexico responds to market turmoil
Thu 18th	Capital Daily	Will the turnaround in EM equities last?
	India Economics Focus	Budget preview: deficit targets under pressure
	Global Markets Update	How will oil prices affect Treasuries and Bunds?
	UK Economics Update	Lower interest rates to save Osborne's bacon again
	Emerging Markets Economics Focus	Are EM oil producers on the cusp of a crisis?
	Industrial Metals Update	Cautiously positive on lead demand
	Agricultural Commodities Markets Monitor	No relief for ags as investors become more bearish
	Developed Markets Market Valuation Monitor	Are euro-zone peripheral government bonds overvalued?
	Non-Euro European Commercial Property Chart Book	Slowing economic growth weighing on rental growth
Fri 19th	Capital Daily	Will the outcome of the EU Summit give sterling a lasting boost?
	Australia & NZ Weekly	Was the start of the year really that bad?
	Emerging Asia Economics Weekly	Asian growth holding up well despite export slowdown
	Japan Economics Weekly	Will the sales tax hike be postponed yet again?
	UK Economics Weekly	Banking sector fears overdone
	Canada Economics Weekly	-
	US Economics Weekly	-

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