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THE EUROZONE ECONOMIC MONITOR

JANUARY 19, 2017
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The ECB will not change its stance today, following the policy adjustments in December.

Inflation in the Eurozone is rising sharply, but the ECB will reiterate its focus on core inflation.

The EZ economy is doing well, but the ECB sees rising political uncertainty as a real risk.

The ECB Will Stand Pat Today After Policy Adjustments Last Month

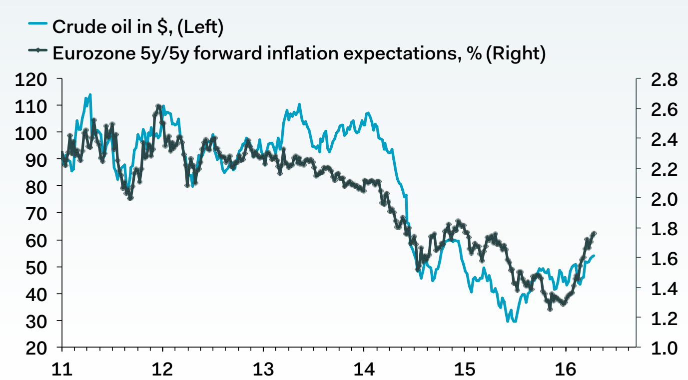
The ECB won't make any major changes to its policy stance today. We think the central bank will keep its main refinancing rate unchanged at 0.00%, and that it will maintain its deposit and marginal lending facility rate at -0.4% and 0.25%, respectively. The central bank also will keep the pace of QE unchanged at €80B per month until March, and at €60B hereafter until December. *This is the first ECB meeting for some time in which Mr. Draghi will be able to report significantly* higher *inflation in the euro area.* Data yesterday confirmed that inflation in the Eurozone jumped to 1.1% year-over-year in December from 0.6% in November, primarily boosted by the energy components. Base effects from last year's collapse in oil prices mean that headline inflation will rise further in Q1. Our first chart shows that market-based inflation expectations have jumped, and we think headline inflation will rise above 1.5% in Q1.

Mr. Draghi, however, will strike a dovish tone and confirm that the ECB will look through what it considers to be a temporary inflation surge due to base effects in energy prices. The president will reiterate the governing council's focus on core inflation, which it expects to stay below the central bank's 2% target in 2017. The minutes of the December meeting revealed that the ECB is unconvinced that core inflation is on track for a sustainable recovery.

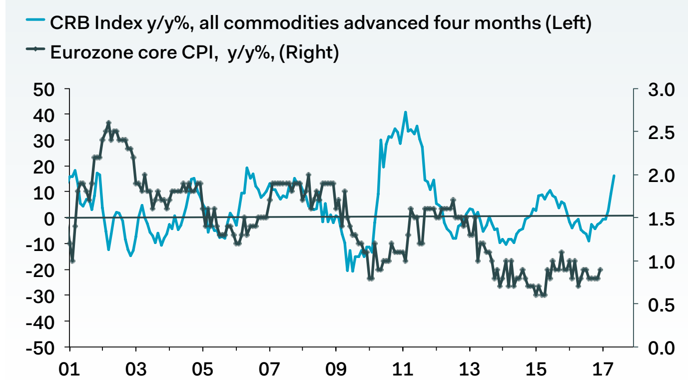
This position was the main reason for extending QE beyond September, longer than the market expected. *We think Mr. Draghi will repeat this view today.* The president said in December that the ECB wants to be a "sustained presence" in EZ bond markets. We interpret this statement as a sign that the bar for completely ending QE was *raised*, and we will be listening for confirmation of that argument today.

We agree with the central bank that the likely jump in Q1 inflation is not a true reflection of underlying inflation pressures in the Eurozone. But the ECB is

INDICATORS THAT NO LONGER MATTER TO THE ECB?



WILL HIGHER COMMODITY PRICES PUSH UP THE EZ CORE CPI?



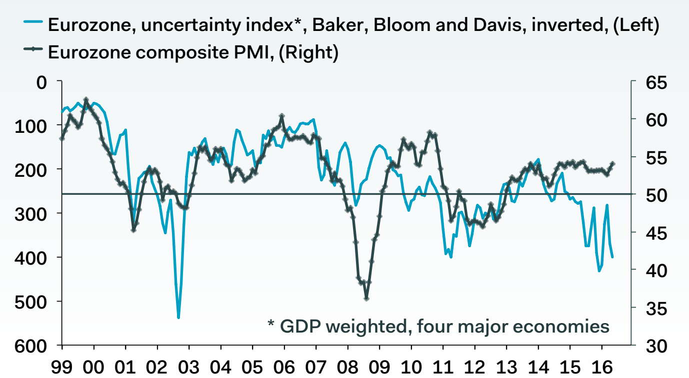
taking an asymmetric view on inflation in its pivot towards core inflation as the main policy target. The decision to push rates below zero and launch QE was *mostly* driven by plunging oil prices and the fear of negative second-round effects. Clearly, the ECB is not worried about slipping behind the curve due to higher oil and commodity inflation.

This position is warranted, in part. Our previous chart shows that core inflation has been trending well below 2% in this business cycle, despite the ups and downs of global commodity prices. It also shows, though, that a *sustained* increase in commodity inflation probably would pull EZ core inflation higher. ***The key risk for the central bank is that inflation remains sticky in Q2, prompting an accelerated reduction in the pace of QE.***

The divergent inflation trends in the key economies are another challenge for the ECB. Inflation in Germany jumped to 1.7% in December, from 0.8% in November, while unemployment is at a record low and wage growth likely will accelerate in 2017. This is in contrast to the other large economies where unemployment is still high, and wages are soft.

The governing council, however, won't be fazed by higher German inflation in the short run. The doves probably even see signs that Germany is "overheating" as a *positive* development, because it should help to reduce intra-EZ trade balances. But accelerating inflation in Germany will embolden the Bundesbank to take a more confrontational stance with Mr. Draghi's dovish leadership.

THE LOOMING RISKS FROM RISING POLITICAL UNCERTAINTY

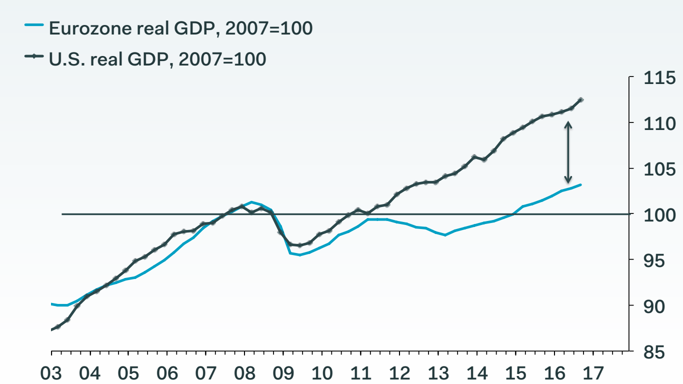


Economic conditions are also inviting disagreement between doves and hawks on the governing council. The data are sending a clear signal that GDP growth accelerated in Q4, and suggest that momentum will be sustained in Q1. We think growth will slow to 1.4% in 2017 from 1.7% in 2016, which is still *above* our estimate of trend at 1%-to-1.2%. *These are not conditions in which a central bank normally holds rates below zero, and is buying assets via QE.* Mr. Draghi and his colleagues likely will use two arguments to counter this position, though.

The minutes of the December meeting showed that the ECB's intention is to remain a "sustained presence" in EZ bond markets, partly because the bank wants to remain "a source of stability in an environment that is likely to remain subject to a high degree of uncertainty." Our previous chart shows that the EZ economy has so far been oblivious to rising political uncertainty, but ECB communication suggest the central bank is not convinced this will persist.

Finally, the central bank likely is setting its policy on the assumption that the EZ economy is still characterised by "spare capacity." Our final chart shows that real GDP in the euro area only recently recaptured its pre-2008 peak. But Mr. Draghi has also recently increased his call for structural reforms and fiscal policy, consistent with the signal from other monetary policy makers that the ability of central banks to remain accommodative is waning.

THE EUROZONE STILL HAS A LOT OF CATCHING UP TO DO



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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, January 16

- **D: Trade Balance, Eurozone (11) 11:00 CET**

The seasonally adjusted trade surplus rose to **€22.7B** in November, from €19.9B in October. A big reduction in the French trade deficit was the primary driver, but the German surplus also improved, as exports jumped.

Tuesday, January 17

- **D: Car Registrations, EU27 (12) 08:00 CET**

Growth in EU27 car registrations slowed to **3.0%** year-over-year in December, from 5.8% in November. Weaker growth in Greece and the Netherlands was the key driving force, offsetting better data in the large countries.

- **D: ZEW, Germany (1) 11:00 CET**

The ZEW expectations index rose to **16.6** in January, from 13.8 in December.

Wednesday, January 18

- **D: Final Inflation, Germany (12) 08:00 CET**

Inflation in Germany jumped to **1.7%** year-over-year in December, from 0.8% in October. The rise mainly was a result of higher energy inflation, but core inflation also rose as services inflation rebounded.

- **D: Construction, Eurozone (11) 11:00 CET**

Eurozone construction output rose **0.4%** month-to-month in November, pushing the year-over-year rate down to 0.0%, from a revised 1.8% in October.

- **D: Final Inflation, Eurozone (12) 11:00 CET**

Inflation in the euro area jumped to **1.1%** in December, from 0.6% in November. A big rise in energy inflation was chiefly responsible.

Thursday, January 19

- **D: Current Account, Eurozone (11) 11:00 CET**

We think the EZ current account surplus rose to **€30B** in November, from €28.4B in October. Overall, the current account surplus likely will end at about 3.2% of GDP, which would be a record. **Consensus: N/A.**

- **D: Rate Decision, ECB (1) 13:45 CET**

The ECB likely will keep its main refinancing rate unchanged at **0.00%** in January. We also think the central bank will maintain its deposit and marginal lending facility rate at 0.25% and -0.4% respectively. Finally, we expect the pace of QE to remain unchanged at €80B per month, with a scheduled reduction to €60B per month, starting March. **Consensus: 0.0%, €80B.**

Friday, January 20

- **No significant data released.**

PANTHEON EUROZONE FINANCIAL CONDITIONS DASHBOARD

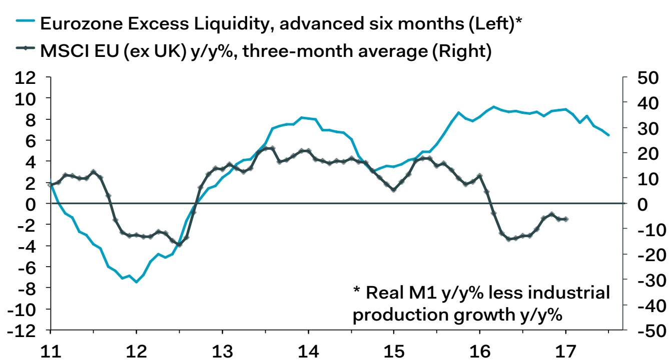
Market	Valuation*	Six month change, %	y/y, %
Eurostx 50	0.7	11.9	12.6
Dax 30	0.1	15.1	21.4
CAC 40	0.8	12.2	16.5

* P/E ratios in standard deviations from 10y average (>1.5 = expensive, <1.5 = cheap)

Bonds	Curve**	Six month change, bp	y/y, bp
GER (10-2)	-1.8	38.1	10.5
FRA (10-2)	-1.5	61.5	17.3
ITA (10-2)	-1.0	68.4	43.7

** Curve in standard deviations from its 10y average (>1.5 = historically steep, <-1.5 = historically flat)

EUROZONE EXCESS LIQUIDITY VS MSCI EU (EX UK)



Excess liquidity suggests that EZ equities will hold on to their gains in the first months of 2017. The performance of financials is key for the benchmark index.

PANTHEON'S EUROZONE ECONOMIC FORECASTS (GDP: REAL GDP Q/Q%)

GDP			
Q2-16	0.3	2014 year:	0.9
Q3-16	0.3	*2015 year:*	*2.0*
Q4-16 forecast	*0.5*	*2016 year:*	*1.6*
Q1-17 forecast	*0.4*	*2017 year:*	*1.4*
Q2-17 forecast	*0.2*		

CPI y/y, %		Unemployment, %	
December	1.1%	October	9.8%
January	*1.4%*	*November*	*9.8%*
February	*1.6%*	*December*	*9.8%*
March	*1.3%*	*January*	*9.7%*
April	*1.1%*	*February*	*9.7%*