

Flash Note

Euro area: GDP growth

Three questions on the latest euro area GDP growth numbers

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Although the latest euro area GDP numbers were broadly in line with expectations, at 0.6% q-o-q in Q2, net revisions to past data have pushed the GDP profile higher again. 2017 annual GDP growth now looks likely to reach or even exceed 2%.

We continue to forecast a modest slowdown in GDP growth in H2 2017 and beyond. The July PMI indices were consistent with such moderation. However, a more broad-based recovery means that only a large external shock would be likely to trigger a more severe downturn, let alone a recession in the euro area.

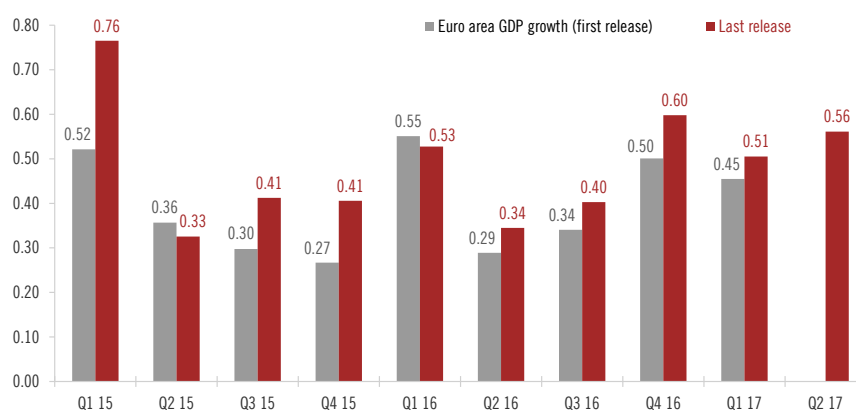
Stronger growth numbers should make the ECB more confident that a narrowing output gap will eventually result in higher inflation. However, the short-term picture for (core) inflation has not changed much. Caution and flexibility should prevail. The focus will remain on September staff projections, including downside risks related to EUR appreciation.

What did the latest euro area GDP data and revisions tell us?

According to Eurostat's preliminary estimate, **euro area real GDP expanded by 0.6% q-o-q in Q2** (0.56% q-o-q unrounded; 2.3% q-o-q annualised; 2.1% y-o-y), in line with consensus expectations. This flash estimate was slightly higher than the downwardly revised Q1 growth rate (0.5% q-o-q), but a little less upbeat than the 0.7% suggested by business surveys for Q2.

Importantly, revisions to past data have pushed the GDP profile higher again. Q1 was revised down but Q4 2016 was revised higher by a slightly higher margin, to 0.6% q-o-q. As we have highlighted before, [upward revisions to past GDP data](#) have been unusually large in this cycle, helping to explain part of the divergence between soft and hard data, and forcing successive upward revisions to forecasts (both ours and consensus). Euro area real GDP now stands 3.7% above its pre-crisis level.

Chart 1: 'point in time' euro area real GDP growth data and revisions



Source: Pictet WM – AA&MR, Eurostat

AUTHORS

Frederik DUCROZET
fduczrozet@pictet.com
+41 58 323 45 82

Nadia GHARBI
ngharbi@pictet.com
+41 58 323 3543

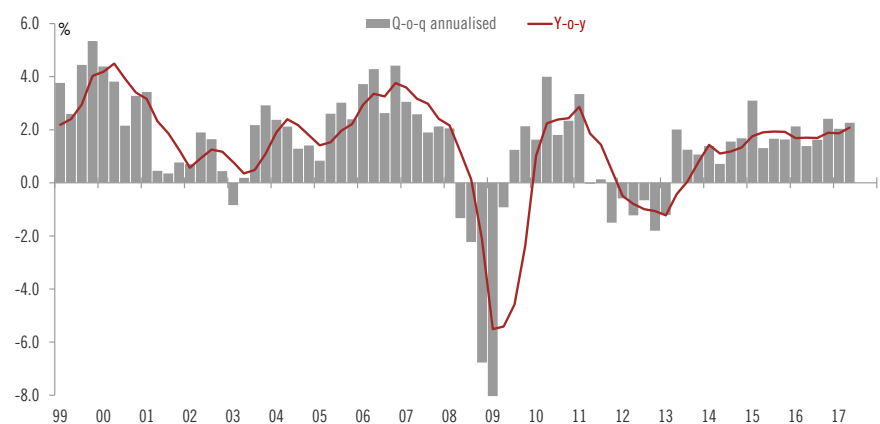
Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Flash Q2 estimate is based on published figures from six countries (including [Spain and France](#)), as well as some confidential inputs from five others. German and Italian flash GDP readings are due on 15 and 16 August, respectively. The euro area breakdown by expenditure components will be published on 7 September. Based on high-frequency data and some country-specific releases, we believe that **growth was rather broad-based**, with an important contribution from net trade.

Following the Q2 release, **the carry-over effect reached 1.7% for 2017**, meaning that even with flat GDP in the remaining two quarters of this year, the euro area economy would grow by 1.7% on average. Even without making any change to our quarterly growth profile, annual growth is thus likely to exceed our and consensus expectations for this year.

Once detailed estimates are published by Eurostat, assuming no significant revisions to past data, **we might revise our 2017 annual growth forecast to 2.0-2.1%**, from 1.9% currently, factoring in revisions as well as small residual upside risks for Q3. The 2018 growth forecasts are likely to be affected as well, if only mechanically, with **modest upside risks relative to our current projection of 1.6%**.

Chart 2: euro area real GDP growth



Source: Pictet WM – AA&MR, Eurostat

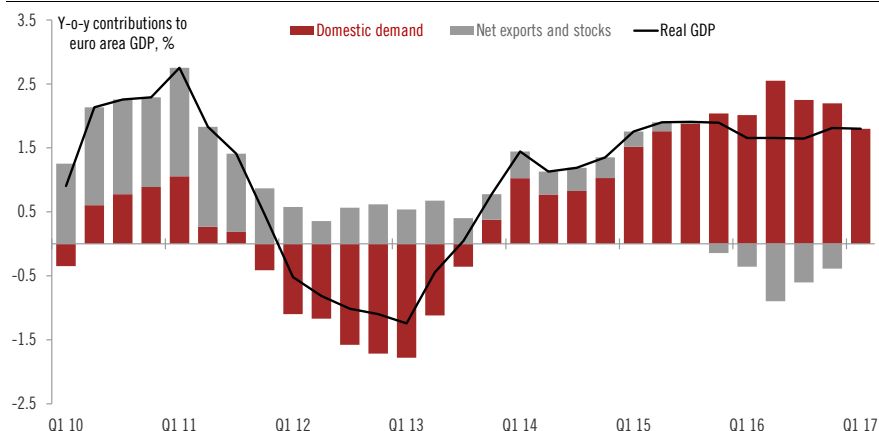
What could cause a slowdown in H2 2017 and beyond?

We still see a number of headwinds leading to a modest slowdown in the pace of activity expansion in H2 2017 and beyond. Forward-looking indicators such as **July PMIs suggest that the pace of growth may indeed slow in Q3, to just below 0.5% q-o-q**. More broadly, we see quarterly growth rates above 2%, well above trend growth which we estimate at just above 1%, as hardly sustainable over the longer run.

However, **domestic factors** are only likely to cause a gradual moderation in the pace of growth, not a major downturn. One explanation for the better growth figures (and revisions) is that the region continues to benefit from a **large amount of pent-up demand** in the post-crisis era, increasing its resilience to minor and/or idiosyncratic shocks. Meanwhile, political risks have receded considerably after the French elections. Italy remains the elephant in the room, but the prospect of a populist government pushing for an exit from the EU/EMU looks like a more distant threat at the moment.

In the end, the next recession is more likely to be triggered by an external shock, such as a major slowdown in Chinese growth, for instance.

Chart 3: main drivers of euro area real GDP growth



Source: Pictet WM – AA&MR, Eurostat

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Crucially, non-financial euro area companies expect to increase hiring and investment spending well beyond current levels. A 'natural' deceleration in the pace of growth may come from slower real income growth, but it should remain manageable. We are not too concerned either by the latest drop in bank credit flows to the private sector in June as broader credit conditions remain favourable. A larger potential risk to the macro outlook would come from an unwarranted tightening of financial conditions driven by (expectations of) ECB policy normalisation led by a stronger currency, or higher interest rates, or both.

What are the implications for the ECB?

Stronger growth numbers should make the ECB more comfortable debating its exit strategy, the main argument being that economic slack will shrink faster as the output gap narrows, eventually pushing wage growth and inflation higher. In this respect, the latest GDP reports will back ECB president Mario Draghi's assessment of a robust, broad-based expansion, and staff projections for growth are likely to be revised higher in September.

However, stronger GDP growth is unlikely to affect the short-term inflation outlook much. There has been little, if any progress in achieving the four [inflation criteria](#) defined by Draghi earlier this year. Regardless of upcoming exit decisions, we expect the ECB to reaffirm that a substantial degree of monetary accommodation remains necessary in order to achieve price stability over the medium-term. **Caution and flexibility should prevail.**

A major source of concern will come from downside risks to inflation related to EUR appreciation, and the question will be to what extent the revisions to September staff forecasts will be offset by a more upbeat assessment of growth. At the moment, the trade-weighted EUR is standing about 5% above the level assumed by the ECB staff in June, resulting in a drag of around 30bp on 2018 HICP, all else equal. In other words, **a stronger currency may push the ECB staff projection for 2018 inflation close to 1.0%** (down from 1.3% in June). Even if projections show inflation rising to the 2% target over the longer-term, this may well lead the ECB to [delay its tapering announcement to October](#), as we suspected.