



Europe

Economics

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Dark clouds, no storm yet

- Dark clouds have been gathering since the beginning of the year, but we do not see a storm yet. Today, Europe is dealing with an external demand shock and a deflationary shock. Both threaten inflation, but the latter boosts domestic demand, for a more balanced impact on GDP growth.
- Currently the external headwinds are not yet sufficient to revise down our central expectation for euro-area growth, but risks are rising.
- On the contrary, the inflation outlook has deteriorated. The likely temporary return to negative inflation rates increases concerns about a possible dis-anchoring of inflation expectations given that inflation has already been below 1% for more than two years.
- A modest weakening of the data, tighter financial conditions as well as a more dovish Fed, BoE and BoJ increase the potential for a more aggressive ECB easing. It is difficult to envisage the exact policy mix that the Governing Council will agree upon. But after January's dovish message, we see another miscommunication debacle, like in December, as unlikely.
- (i) We continue to see a deposit rate cut as a near certainty, but it won't be enough. (ii) Hence, we persist with our call of an increase in the synergies between the negative deposit rate, QE and TLTROs to achieve more than the sum of the parts and counterbalance the decreasing effectiveness of the FX channel. (iii) Furthermore, we think that data will have to surprise on the upside to avoid a temporary acceleration of the monthly QE purchases. Further downward surprises could lead to a temporary acceleration that is not compensated by lower future monthly purchases.
- The ECB cannot solve structural issues. We do not think that further fiscal easing is the answer for euro-area peripherals due to the still high level of debts. Fiscal expansion in countries such as Germany would not be a game changer. Unfortunately the rise of populism and anti-euro sentiment do not bode well for the necessary further reforms and integration. The euro-area has strengthened, but it is not healed.

Dark clouds at the horizon...

Dark clouds have been gathering since the beginning of the year, but we do not see a storm yet. **Although not healed, the euro-area is in better shape than in 2008 or 2012.** During the two earlier events, Europe was suffering large internal hits to domestic demand (banking crisis, fiscal crisis).

Today, Europe is dealing with an external demand shock and a deflationary shock. Both threaten inflation, but the latter boosts domestic demand, for a more balanced impact on growth.

- While the current domestic growth momentum appears stable, short-term risks to our *mediocre* euro-area projections (1.6% in 2016) are coming from outside and markets' mood is gloomy. It is a picture of *perilous mediocrity*: