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Euro area: Growth to stagnate

- Economic sentiment has deteriorated sharply as the debt crisis escalated affecting core euro area members.
- We have revised downwards our growth projections for this year (1.6%) and 2012 (0.8%) on the backdrop of tighter austerity and a less favorable global environment.
- A technical recession is likely around the end of the year. In our view, the recession will most likely be shallow, resembling more a stagnation of growth than an outright recession.

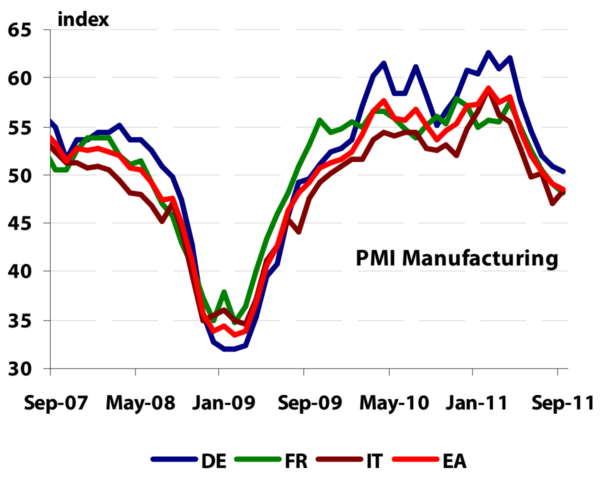
A dynamic start in the first quarter of the year has given way to sluggish growth in the second quarter, when euro area GDP expanded by a meager 0.2% q-o-q. Besides debt laden periphery members, core countries also performed poorly, as the contribution from net exports shrunk substantially, while domestic demand had a subtractive effect on growth (-0.1%). We initially interpreted this shortfall in growth as the adverse effect of a series of temporary effects. In particular, unusually harsh weather conditions brought about distortions in the German construction sector, weighing negatively on second quarter growth. Moreover, energy prices soared due to the destabilization of the MENA region, eroding households' disposable income. Finally, the massive earthquake in Japan caused distortions in supply chains, mainly affecting auto manufacturers.

What was initially thought of as a soft patch is most likely to turn out as a persistent slowdown of economic activity. The economic recovery could gain strength in the second half of the year, on the backdrop of more favorable commodity prices, a halt in the Chinese monetary tightening cycle and restoration of supply chains. However, since the summer, the debt crisis took a turn for the worse. Economic sentiment has deteriorated severely due to mounting uncertainty about the Greek debt sustainability and its repercussions to other week members and the euro area financial sector. Fiscal slippages in the Greek budget execution and slow political developments towards a permanent solution of the sovereign debt crisis are fueling markets concerns. Contagion risk to systemic countries is rising, as is evident by the widening of Spanish and Italian spreads to uncomfortable levels.

Against the adverse backdrop on the debt crisis front, leading indicators have come out very disappointing during the last few months. The euro area economic confidence index has slumped to its lowest level in almost two years. In a similar vein, the euro area PMI Manufacturing Indicator has entered recessionary territory since August (Figure 1). The slowdown exhibits synchronicity, as both periphery and core members are affected. Fiscal austerity takes a heavy toll in the periphery, as weak members struggle to turn to an export-oriented growth model, while domestic demand remains anemic or contracts. Core counties are also suffering from mounting uncertainty over the debt crisis and weaker trade activity, as global growth seems to be receding to a lower trajectory, most notably in the US. While Germany has served as the locomotive that dragged the euro area economy out of recession, growth is expected to moderate in the period ahead. The Ifo Expectations index has droped to a two year low, while the German PMI Index stands slightly above the 50 threshold, reflecting a less confident business climate. Equity markets were hit, adding to confidence wearing down (Figure 2).

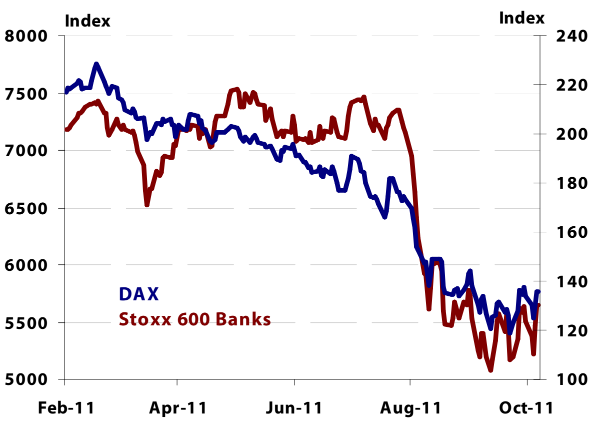
In light of the recent developments, we have revised downwards our euro area growth

Figure 1



Source: Bloomberg

Figure 2

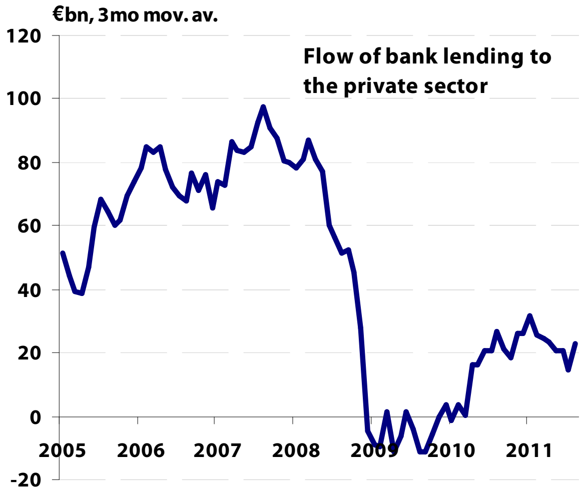


Source: Bloomberg

projections. We now expect GDP to expand by 1.6% this year, mainly attributed to robust performance in the first quarter. In 2012, real GDP is expected to print a 0.8% growth rate, substantially below trend. Several members including Italy, France and Spain, have adopted additional austerity measures and frontloaded their fiscal consolidation programs, in order to stem rising borrowing costs due to market pressures. As a result, the fiscal drag is expected to be more pronounced, affecting particularly growth in 2012. The flow of bank lending is expected to remain constrained (Figure 3), as already hampered financial institutions' balance sheets are facing mounting pressures due to the sector's exposure to sovereign paper. Moreover, firms are expected to put off investment plans due to gloomy prospects of future demand, while the contribution from exports is likely to turn out weak. Finally, personal consumption has little potential to compensate for weaknesses in other sectors, as persistently high unemployment at the aggregate level and continued deleveraging is expected to keep households' consumption subdued.

On a quarterly basis, economic activity is expected to loose strength in the third quarter, while growth is likely to contract in the final quarter of the year. Given the fragile economic environment, risks for growth are to the downside, implying that a technical recession, i.e two consecutive quarters of negative growth, should not be excluded. In our view, the recession will most likely be shallow, resembling more a stagnation of growth than an outright recession. As we move into 2012, the economy could gather momentum, provided that uncertainty over the debt crisis recedes, and financial markets smoothen. We would expect PMI indices to bottom around the end of the year and start rising thereafter.

Figure 3



Source: ECB

Growth divergence between core and periphery will continue, although it is expected to fade to some extent, as core members have been affected by financial turmoil. Germany and Greece will remain at the two ends of the spectrum. The former is expected to keep outperforming due to relatively stronger fundamentals. Private demand may benefit from favorable labor market conditions and rising wage compensation, while relatively healthy public finances call for mild adjustments. The openness of the German economy may allow both net exports and investment to take advantage from solid growth in emerging markets. Cash rich corporates and high levels of capacity utilization (currently standing above its record average) suggest that a pick up in capital spending could materialize once perceptions about future prospects improve. On the other hand, the recession of the Greek economy is deepening, as the country failed to push through structural reforms that could reverse the negative climate and prevent the free fall of economic activity.

Overall, our baseline scenario points to stagnation in growth, as the shockwaves of the sovereign debt crisis have now reached large euro area members. Uncertainty remains elevated and our projections remain highly dependent on political initiatives to backstop contagion and provide a permanent solution to the debt crisis. In addition, the global environment is largely determined by developments in the euro area crisis front. Therefore, faster and bolder action by euro area policymakers could pose upside risks to our growth scenario.

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