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Economic Research:

These Green Shoots Will Need A Lot Of Watering

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Economic Research:

These Green Shoots Will Need A Lot Of Watering

Recession is gradually receding from the eurozone, but a recovery looks set to be slow and uneven across the member states. While the German economy is leading the way, with GDP expanding by 0.5% this year and 1.8% in 2014, according to Standard & Poor's economic forecast, growth in France will likely be weaker. Meanwhile, the Italian and Spanish economies will stay in decline this year, and we forecast they will grow by just 0.4% and 0.8%, respectively, in 2014. Overall, we now forecast real GDP for the eurozone will decline by 0.6% this year and expand by just 0.9% in 2014. Various other indicators suggest that a European recovery will be long and arduous. While fiscal pressures are somewhat easing, growth in the private sector is still lagging. Meanwhile, the diminishing rate of headline inflation throughout this year to well below the European Central Bank (ECB) 2% target rate raises the specter that it could tip over into deflation in some weaker countries of the eurozone (European Economic and Monetary Union).

Weak growth in money supply, caused by continued decline in lending to the private sector, also exposes Europe's recovery as fragile. We believe the ECB's assessment of the major banks' capital strength next year, ahead of adopting its supervisory role under the single supervisory mechanism, could be a major step in restoring confidence in interbank markets. However, we think the central bank may have to take additional nonconventional measures before completing this exercise to keep a recovery on track.

Overview

- The eurozone is climbing out of recession, but indicators suggest a recovery will be long and arduous.
- We see a risk that the slowing inflation rate could tip over into deflation in some weaker economies.
- Weak growth in money supply also suggests that a recovery will be slow.
- We believe the European Central Bank may need to take nonconventional measures to maintain the recovery momentum.

2013 Closes On Mixed Signals

Growth started to pick up in the second quarter, when the eurozone's real GDP rose by 0.3% on the previous quarter, after 18 consecutive months of decline. The German economy, up 0.7%, was a major contributor to this turnaround, but France also resumed growth (to 0.5%), while output contraction in the so-called periphery countries eased. This revival triggered renewed optimism in financial markets over the summer, especially in equities.

Yet, as more statistical details became available, it appeared that the major impetus for this revival was an easing in the fiscal drag weighing on the eurozone economies. Foreign trade and exports did help, but only in a limited number of countries, especially Spain. By and large, the private sector in most countries was still in a no-growth mode.

Indeed, initial estimates from Eurostat for the third quarter, published in late November, are sobering. GDP growth in the eurozone slowed to 0.1% quarter on quarter, while the two largest economies of the monetary union posted

diverging trends: French GDP contracted, albeit modestly to 0.1%, while Germany's rose to 0.3%. The decoupling of the German economy is likely to be even more visible in the fourth quarter. The very strong read from the November IFO business climate survey, at its highest point since April 2012, and the equally encouraging results from the Purchasing Managers' Index (PMI) survey, suggest that Germany's GDP could grow by 0.5% in the final quarter of this year.

Overall, the green shoots that emerged in the second quarter in the eurozone have a long way to go before they bloom. As the year draws to a close there is a broad consensus that while the recession is over, the recovery will be very slow and uneven across countries (see table 1).

Table 1

GDP And Inflation Forecasts For 2013 And 2014

Real GDP (% change)

	--2013--			--2014--		
	Standard & Poor's	**Consensus**	**European Central Bank**	**Standard & Poor's**	**Consensus**	**European Central Bank**
Eurozone	(0.6)	(0.4)	(0.4)	0.9	0.9	1.1
Germany	0.5	0.5	--	1.8	1.7	--
France	0.2	0.1	--	0.6	0.8	--
Italy	(1.8)	(1.8)	--	0.4	0.5	--
Spain	(1.2)	(1.3)	--	0.8	0.5	--

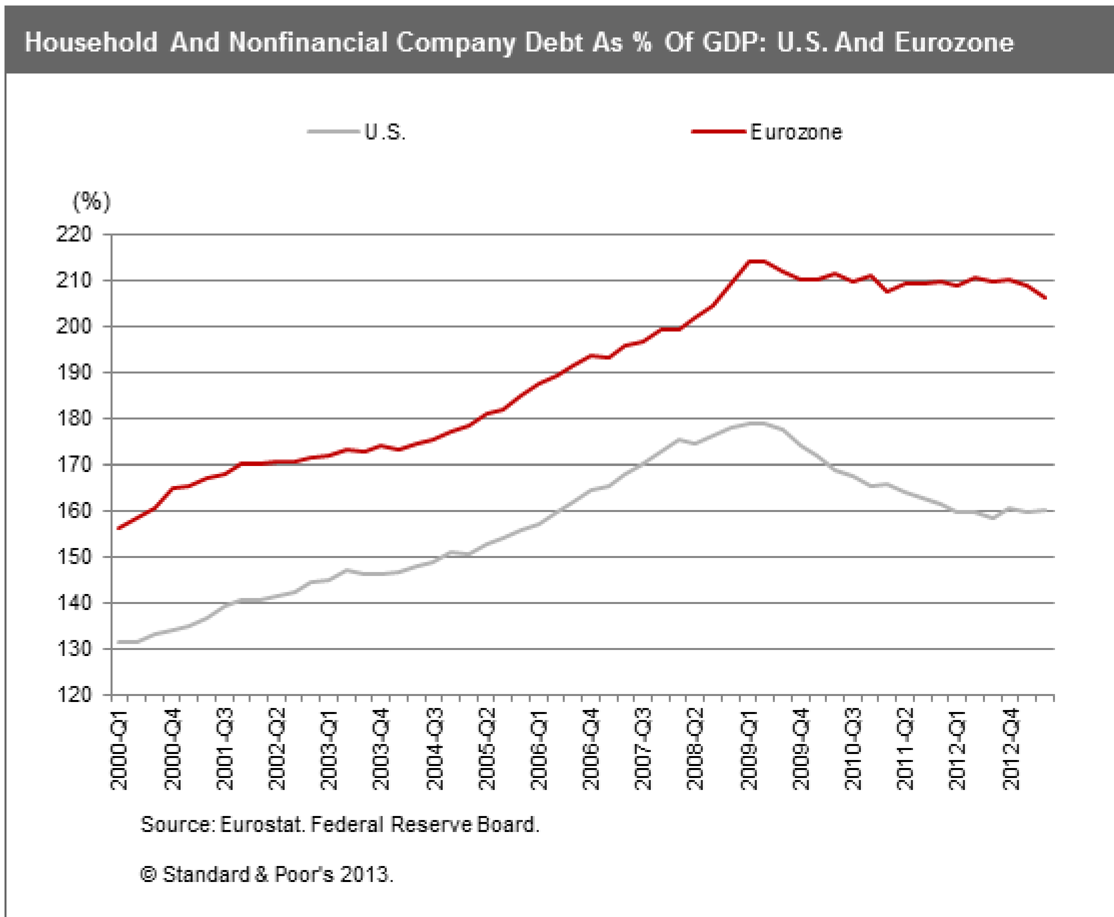
CPI Inflation (%)

	--2013--			--2014--		
	Standard & Poor's	**Consensus**	**European Central Bank**	**Standard & Poor's**	**Consensus**	**European Central Bank**
Eurozone	1.5	1.4	1.4	1.4	1.3	1.1
Germany	1.6	1.6	--	1.5	1.8	--
France	1	1	--	1.4	1.4	--
Italy	1.4	1.3	--	1.3	1.4	--
Spain	1.4	1.5	--	0.8	1.1	--

Note: S&P and ECB forecasts are as of December 2013, Consensus forecasts are as of November 2013.

The European Commission estimates that the reduction in fiscal pressure is underpinning the revival in economic growth. Its calculations suggest that fiscal drag is coming down from 1.5% of eurozone GDP in 2012 to 0.75% in 2013 and to 0.2% of eurozone GDP in 2014, thanks to a relaxation in the fiscal targets in deficit countries. But it remains to be seen whether this will be sufficient to trigger a revival in the private sector. We believe that the eurozone's wall of private-sector debt will continue to be an impediment. A key difference between the U.S. economy, where a broad-based recovery is now visible, and the eurozone is what's been achieved so far in terms of debt reduction. The U.S. private sector's debt, expressed as a percentage of GDP, has come down more rapidly than the eurozone's (see chart 1).

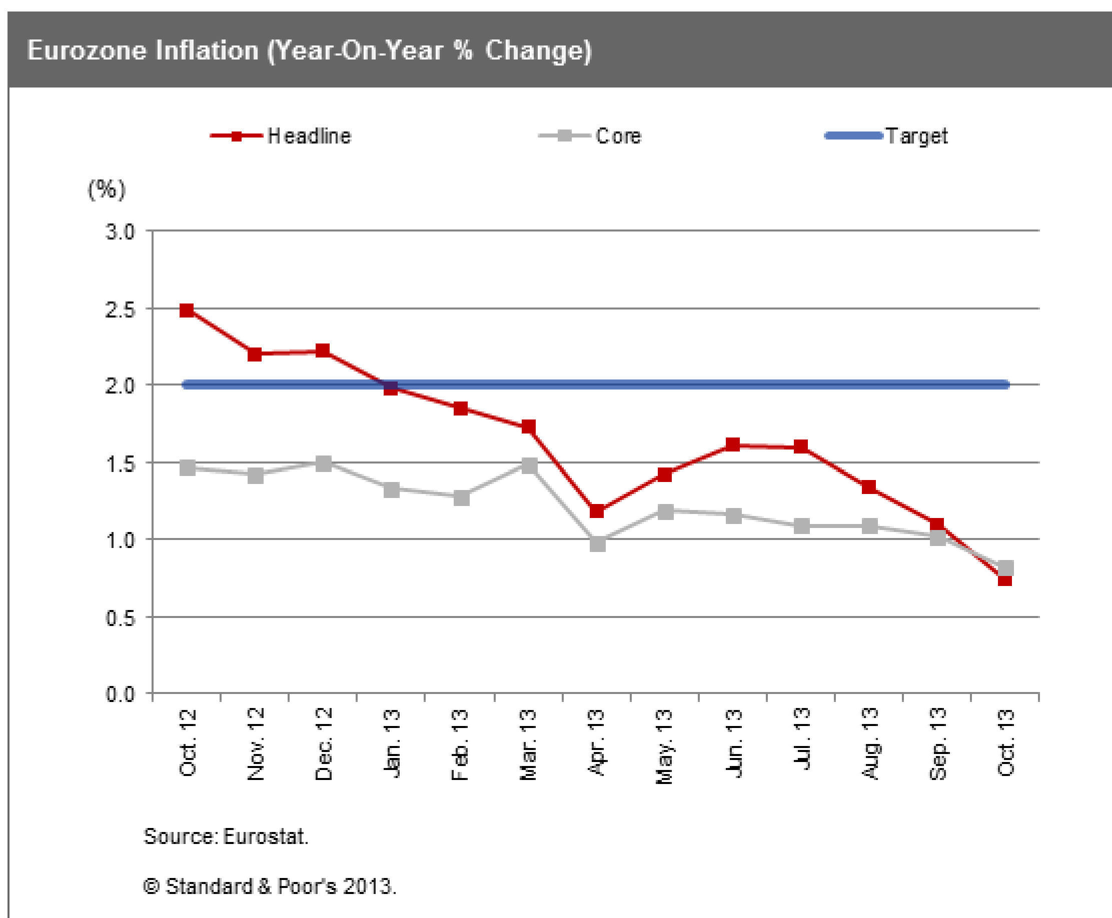
Chart 1



The Risk Of Deflation

The recent deceleration in the eurozone's inflation rate (see chart 2), down to a very low 0.7% in the 12 months to October from 1.1% in September and 2% in January, adds to the renewed pessimism. First, decelerating inflation, combined with anemic economic growth, raises the specter of deflation, a disease that has affected Japan over most of the past 15 years. Second, slower inflation makes deficit-reduction more painful because nominal incomes grow less rapidly.

Chart 2



What's surprising is that inflation is decelerating only now, when the eurozone is just exiting its second and longest recession in five years. We noted exactly a year ago that "wage flexibility accompanied by price rigidities are resulting in depressed real incomes and in turn weaker domestic demand" (see "The Eurozone Enters An Uncertain 2013 As The New Recession Drags On," published on Dec. 13, 2012, on RatingsDirect). Lower unit labor costs have been particularly slow to pass through to domestic prices. We believe there may be three reasons for this: corporate margins, indirect taxation, and stickiness in the service sector. Companies have in some cases used the opportunity created by falling labor costs to improve their margins. Meanwhile, indirect taxes have increased in most countries since 2009. Spain is a case in point: while its unit labor costs have dropped by 10% since the second quarter of 2009, core consumer prices have increased by 3.2%. But the Spanish value-added rate rose 5 percentage points over the same period. Third, the breakdown of the eurozone's headline inflation index reveals that transportation, education, and household services have been the fastest-rising components. In other words, those sectors that are least exposed to international competitiveness have posted the largest gains.

In that sense, this year's deceleration in price inflation appears to be a lagged reflection of weak economic conditions. Also contributing are lower energy and food prices, combined with a stronger euro exchange rate. Brent oil prices, for instance, fell by 8% between August and November of this year, while the euro exchange rate against the U.S. dollar

appreciated by 3% over the same period.

There is a risk that the lagged price adjustment could lead to an "undershooting," with prices actually falling in the weakest economies of the eurozone (as is already the case in Greece). This concern is adding pressure on the ECB to "do more," meaning to introduce new sets of nonconventional measures to boost the eurozone economy in the coming year and bring headline inflation closer to its 2% official target.

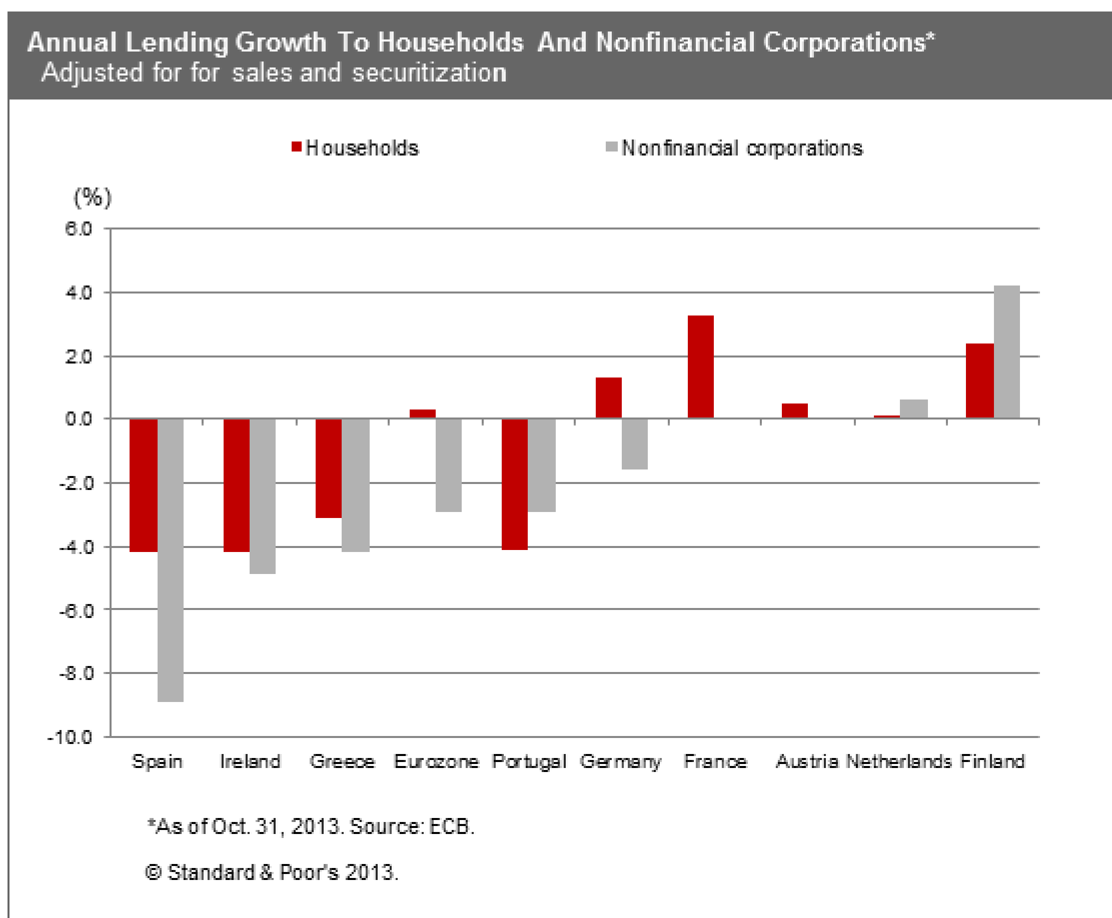
Weak Money Supply Growth Points To A Sluggish Recovery

Another clear indication that economic conditions remain fragile is that money supply (M3) growth slowed to 1.4% in the 12 months to October, from 2% in September. Net capital inflows into the euro area continued to be the main factor supporting M3 growth. These net inflows, which are strengthening the euro exchange rate, reflect a return of confidence by international investors, who seem convinced that the ECB is bound to expand its set of nonconventional measures to support the economy.

The effect of this is, however, somewhat paradoxical. A strong euro tends to penalize countries such as France, Spain, Italy, and Portugal, the exports of which have meaningful negative price elasticities--therefore curbing growth in the eurozone. It also highlights the diverging interests among eurozone members: While these countries would favor a weaker euro exchange rate, Germany may not. The German economy is much less vulnerable to a strong currency. One reason for this is that its export price elasticity is much lower than its that of its neighbors. Besides, the German manufacturing sector relies in part on goods imported from low-cost countries, such as central Europe, which it then re-exports with a significant value added. In this sense, a strong euro is an advantage because it makes those imports cheaper for the German manufacturers.

The weak money supply growth was caused by a continued decline in lending to the private sector, which fell by 2.1% year on year in October (after a 2% decline in September). Lending to nonfinancial companies contracted by 2.9%, while lending to households was broadly flat (0.3%). The contraction in corporate lending was distributed broadly across the eurozone, while credits to households mainly dropped in periphery countries (see chart 3).

Chart 3



These trends reflect poor transmission of monetary policy to the real economy. They also reflect a contraction in the monetary base. In contrast with the U.S., where the Federal Reserve's balance sheet has steadily continued to increase throughout this year, the ECB's balance sheet has been shrinking since January. This is because eurozone core countries have been making early repayments of their loans under the ECB's long-term refinancing operations (LTRO) that have not been offset by additional liquidity injections by the central bank.

The central bank's view, reiterated by ECB president Mario Draghi at the ECB's latest press conference on Dec. 5, is that "weak loan dynamics for nonfinancial corporations continue to reflect their lagged relationship with the business cycle, credit risk, and the ongoing adjustment of financial and nonfinancial sector balance sheets." The ECB president went on to say that "in order to ensure an adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets decline further and that the resilience of banks is strengthened where needed."

This is where the asset quality review (AQR) comes into play, an assessment of the major banks' capital strength that the ECB is about to undertake--the results of which should be known by October of next year--before it adopts its supervisory role under the single supervisory mechanism in the final part of next year. The AQR is a major step forward in attempting to restore confidence in interbank markets and a key milestone in the creation of a genuine

banking union. (See "S&P Expects That The ECB's Review Of Eurozone Banks Will Have A Limited Impact On Ratings," published on Dec. 10, 2013.)

The ECB May Need To Take Extra Measures To Boost A Recovery

However, the central bank may not be able to afford to wait until its AQR is complete before taking additional measures to boost the economy, especially because of the rapid deceleration in inflation, which in the view of the ECB itself should remain very low in 2014. Meanwhile, the recovery that started in the second quarter is already losing momentum.

There are several measures that the central bank could contemplate, provided European leaders continue to progress on the institutional aspects of the banking union--especially the Single Resolution Mechanism--about which we should know more after the next European Council on Dec. 20. The ECB could introduce a new long-term refinancing operation with a very long maturity, given that excess liquidity in the Eurosystem remains very low (at €156 billion on Dec. 4, 2013). This refinancing could be extended with a condition: that banks turn additional liquidities into actual loans instead of using them to buy sovereign bonds. Such a clause would be similar to the Funding for Lending scheme introduced by the Bank of England in July 2012. Another possibility, generally viewed as less likely for now, would be for the ECB to purchase assets from banks rather than take them as collateral in its repo operations. Such purchases would help financial institutions strengthen their balance sheets, but the ECB might view them as premature as long as the AQR is under way.

Whatever it opts to do, the ECB will in our view have to play the role of the patient gardener in watering those green shoots that have emerged in the eurozone since the middle of the year.

Table 2

Standard & Poor's Main European Economic Indicators									
Central forecast	**Germany**	**France**	**Italy**	**Spain**	**Netherlands**	**Belgium**	**Eurozone**	**U.K.**	**Switzerland**
Real GDP (% change)									
2012	0.7	0.0	(2.5)	(1.6)	(1.2)	(0.1)	(0.6)	0.1	1.0
2013(f)	0.5	0.2	(1.8)	(1.2)	(1.2)	(0.1)	(0.6)	1.5	1.7
2014(f)	1.8	0.6	0.4	0.8	0.2	0.8	0.9	2.3	2.0
2015(f)	1.7	1.4	0.9	1.2	1.1	1.5	1.3	2.0	2.1
CPI inflation (%)									
2012	2.1	2.2	3.3	2.4	2.8	2.6	2.5	2.8	(0.7)
2013(f)	1.6	1.0	1.4	1.4	2.6	1.2	1.5	2.7	(0.2)
2014(f)	1.5	1.4	1.3	0.8	1.5	1.3	1.4	2.3	0.5
2015(f)	1.7	1.3	1.2	0.6	1.5	1.5	1.4	2.1	1.0
Unemployment rate (%)									
2012	5.5	10.3	10.7	25.1	5.3	7.6	11.4	8.0	2.9
2013(f)	5.4	11.0	12.2	26.7	7.0	8.6	12.4	7.7	3.2
2014(f)	5.2	11.2	12.4	26.4	8.0	8.7	12.6	7.5	3.1
2015(f)	5.1	11.0	12.0	25.5	7.5	8.3	12.2	7.2	3.0

Table 2

Standard & Poor's Main European Economic Indicators (cont.)

Central banks policy rates (yearly average)	**European Central Bank**	**Bank of England**							
2012	0.75	0.50							
2013(f)	0.50	0.50							
2014(f)	0.25	0.50							
2015(f)	0.40	0.80							
10-year bond yield (yearly average)	**Germany**	**U.K.**							
2012	1.60	1.85							
2013(f)	1.8	2.5							
2014(f)	2.3	3.1							
2015(f)	2.8	3.5							
Alternative Scenario: Retrenchment in late 2014									
Real GDP (% change)									
2013(f)	0.5	0.0	-2.0	-1.3	-1.3	-0.1	-0.7	1.5	1.7
2014(f)	1.4	0.5	0.0	0.6	-0.5	0.6	0.6	2.8	1.3
2015(f)	0.6	0.2	-0.3	-0.3	0.1	0.2	0.1	0.3	0.5

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