

# Euro-Area Growth Risks Shift to the Upside

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With financial markets fragile and peripheral Europe still facing an uphill struggle, there are important downside risks to euro-area growth. But recent data have been unambiguously positive, and the balance of risks may be shifting to the upside.

A couple of months ago we lowered our euro-area growth forecast for 2010 to 1.3%. We did this for two reasons. First, hard data for the early part of the year were weaker than expected. Even though we had some reservations about the accuracy of the data, it was starting to require implausible assumptions for the remainder of 2010 to achieve our 2.0% target. Second, we thought the protracted nature of the sovereign debt crisis was likely to weigh on consumer and business confidence in the second half of the year, leading to some moderation in the pace of expansion.

When we lowered our numbers, we argued that the risks were broadly balanced. On the downside, it was possible that the sovereign debt crisis could escalate further, spilling over into a full-scale banking crisis. Countering this, we felt that momentum in the core euro-area economies was so strong and the global environment so favorable, that growth could easily surprise on the upside.

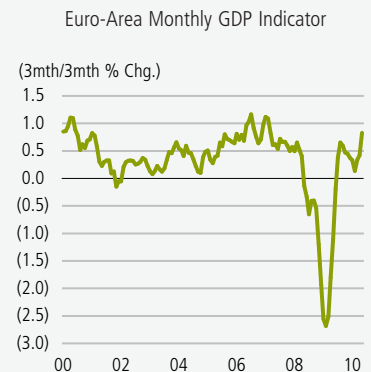
Economic and financial-market develop-

ments since we lowered our forecast suggest that upside risks are now in the ascendancy. Not only has the sovereign debt crisis started to ease, but recent data have been unambiguously positive.

Importantly, hard data in the euro area have moved in line with the consistently upbeat survey data. Second-quarter GDP data will not be available until the middle of August, but our monthly GDP indicator—based on industrial output, retail sales, car registrations and unemployment—shows a 0.8% gain in the three months to May (**Display 1**). This suggests that the risks to our 0.7% second-quarter forecast may be slightly on the upside.

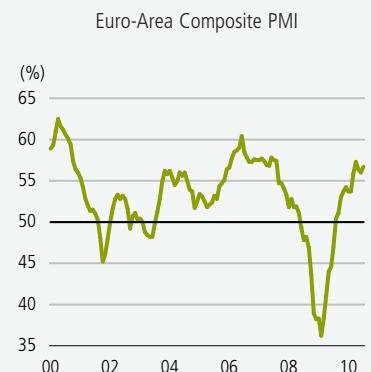
Recent survey data suggest that momentum remained firm at the beginning of the third quarter, with the composite purchasing managers' index (PMI) rising from 56.0 in June to 56.7 in July (**Display 2**). This is almost identical to the second-quarter average and is consistent with quarter-on-quarter GDP growth of around 0.7%. The rise was driven by a strong performance from Germany, where the PMI rose to a

Display 1  
**Hard Data Start to Strengthen**



Source: Haver Analytics and AllianceBernstein

Display 2  
**Survey Data Remain Firm**



Source: Haver Analytics, Markit and AllianceBernstein

near-record 59.3. However, our calculations suggest that the composite PMI for the rest of the euro area declined only modestly in July, to 55.3 from 55.7. It is early days, but so far the data suggest that any slowdown in the third quarter is likely to be modest.

Although we normally regard consumer confidence as a less useful indicator than business confidence, it is encouraging to see that it, too, has not been adversely affected by the sovereign debt crisis. July's reading of -14% represents a substantial improvement on June's -17% and is the highest reading since the first half of 2008. Again, this improvement has been driven by the core euro-area countries, especially Germany. But even in the periphery, there are signs that consumer confidence is starting to stabilize.

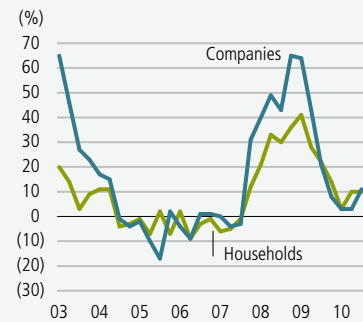
Nor is there any real evidence to suggest that the sovereign debt crisis has significantly impaired the bank-lending channel. The European Central Bank's latest survey

of credit conditions, taken at the height of the sovereign debt crisis, did show some tightening, driven by market-access and liquidity problems in the periphery. But for the euro area as a whole, the tightening of lending standards was modest (**Display 3**). Moreover, actual data now point to a steady, if unspectacular, improvement in bank lending (**Display 4**).

In spite of these positive developments, it is too early to conclude that downside growth risks have been eliminated. Financial markets remain fragile and the periphery still faces an uphill struggle. It would therefore be premature to lift our 2010 growth forecast. However, we take considerable comfort from recent data and continue to believe that markets are too pessimistic on the outlook for euro-area growth. Importantly, the likelihood of a double dip recession has also receded. And that is crucial for the euro area's chances of managing its way through the sovereign debt crisis. ■

Display 3  
Modest Tightening of Credit Conditions

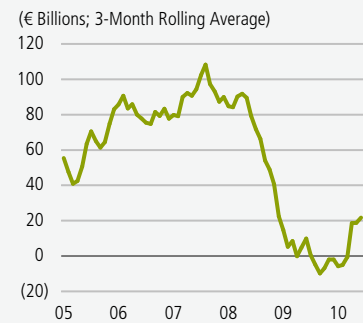
Net Percentage of Banks Tightening Lending Standards



Source: Haver Analytics and AllianceBernstein

Display 4  
Bank Lending Starts to Recover

Net New Bank Lending to Households and Firms



Source: Haver Analytics and AllianceBernstein

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