

ECONOMICS: EUROPEAN PERSPECTIVES—JANUARY 27, 2012

Recent Data Point to Some Stabilization in Euro-Area Output Growth

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Recent data have surprised on the upside and the euro area economy no longer seems to be in free fall. But many challenges remain and the full impact of fiscal tightening in key countries like Italy and Spain has yet to be felt. So while the risks may look more balanced, it's too early to sound the all-clear.

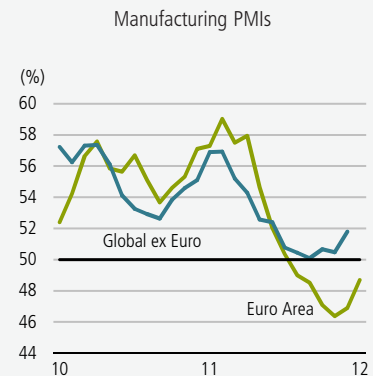
When the sovereign-debt crisis started at the beginning of 2010, one of our main assumptions was that growth in the large core euro-area countries would be largely unaffected by problems in a number of small peripheral economies. Hence, we expected output growth to remain fairly solid for the euro area as a whole.

For the first eighteen months of the crisis, this assumption was correct. Indeed, many indicators surprised on the upside during this period, forcing consensus forecasts higher and encouraging the European Central Bank (ECB) to raise interest rates. Key indicators did weaken in the second quarter of last year, but this was largely due to the impact of rising commodity prices and supply-chain disruptions following the Japanese earthquake and subsequent tsunami. Moreover, this was clearly a global phenomenon—as can be seen by comparing the manufacturing purchasing managers' index (PMI) for the euro area with its global counterpart **(Display 1)**.

This changed in the second half of 2011. As temporary headwinds started to fade, global indicators stabilized and began to pick up. There was, however, little respite in the euro area, where the trajectory remained firmly down. This decoupling from the global cycle was, in our view, mainly due to policy decisions taken in the third quarter of last year which undermined the foundations of sovereign debt in the euro area. The resultant instability, bank-funding stress, fiscal tightening and related uncertainty about the euro area's survival had a visible impact on business and consumer confidence **(Display 2)**.

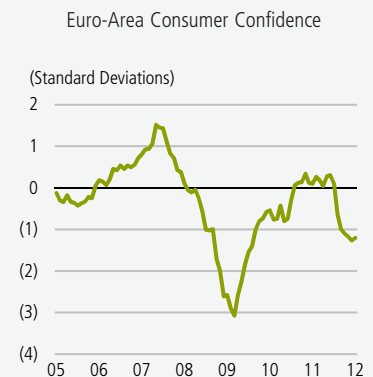
So what should we make of the decoupling between the euro area and the rest of the world? Many investors are worried that the euro area will drag the global economy into a deep recession. Given the size of the challenge still confronting many euro-area countries, we should not rule this out. But this type of scenario would probably only occur if the sovereign-debt crisis were mishandled to such an extent that it precipitated a complete

Display 1
Manufacturing Cycles Decouple



As of January 22, 2012
Source: Haver Analytics and Markit

Display 2
Consumer Confidence Hurt by Euro Fears



As of January 23, 2012
Source: Haver Analytics

meltdown in the euro-area financial system.

Scope for Cautious Optimism

Nor should we forget that developments elsewhere in the world are likely to exert an influence on the euro area. In our view, it is too late for the euro area to avoid a mild recession. But a deep recession seems unlikely while growth in the rest of the world remains fairly buoyant.

Recent data offer tentative support for this view. The euro-area manufacturing PMI is already responding to the improvement seen in other countries—and, perhaps, to a weaker euro. The services PMI has also picked up, and the composite measure, covering both sectors, has risen in each of the last three months. The latter is our favorite real-time gauge of economic activity in the euro area. It is currently at its highest since last August and consistent with output growth of 0.2% per quarter **(Display 3)**.

A stronger tone is also apparent in the forward-looking expectations component of Germany's influential business-climate indicator. Like the composite PMI, this has risen for three consecutive months and is now at its highest since July **(Display 4)**. But the improvement is not confined to Germany. While Markit, the compiler, has only published January PMI data for the euro-area aggregate, Germany and France, it also announced that there was a pick-up in the rest of the region and that the PMI for those countries had reached its highest level in four months.

The recent rebound in cyclical indicators is a challenge to our near-term forecasts for euro-area output growth. Indeed, while

our fourth-quarter forecast of -0.3% will probably be close to the actual number, our -0.5% forecast for the first quarter now looks pessimistic. It may need to be revised higher.

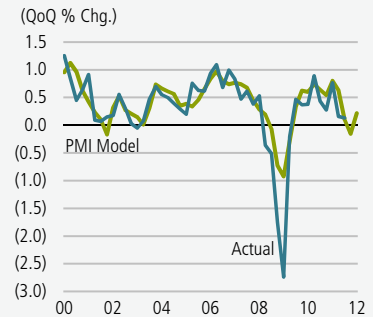
It would, however, be premature to raise our economic growth forecast for 2012 (also -0.5%). Certainly, the improvement in cyclical indicators is a welcome development, making us more confident in our view that the euro area is more likely to experience a mild recession than a deep and protracted downturn. In addition, the ECB's aggressive support for the banking system has reduced the risks of a full-scale credit crunch, removing a key downside tail risk.

But the outlook is still challenging. Recent data will not, for example, reflect the impact of recent austerity measures announced in key countries like Italy and Spain. Hence, it is possible that better-than-expected data in the near term will give way to weaker numbers later in the year. And there are still big risks, including the possibility that policymakers could fail to reach agreement on a second rescue package for Greece.

Given the lack of visibility in many areas and the heightened level of uncertainty, we will be maintaining our 2012 growth forecast at -0.5% for the time being. Still, recent data have been encouraging. Risks to the outlook might be more balanced than we previously thought. ■

Display 3 Composite PMI Consistent With Weak but Positive Economic Growth

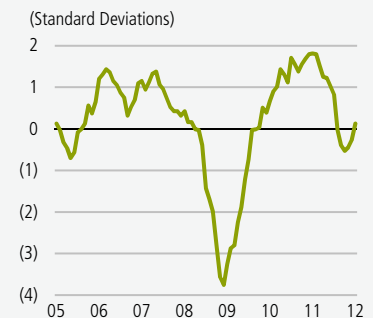
Euro-Area Economic Growth and Proxy Based on Composite PMI



As of January 22, 2012
Source: Haver Analytics and Markit

Display 4 Improvement in German Business Optimism

German Business Expectations



As of January 25, 2012
Source: Haver Analytics

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