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The Euro Area in 2012: Deep Concern Replaces Cautious Optimism

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The euro area is moving into a downturn entirely of its own making. However, the economy is not yet in free-fall. In our view, a mild recession is now unavoidable, but it is not too late for policymakers to avoid a much worse outcome.

A year ago, we wrote that we were "cautiously optimistic" on the outlook for the euro area, which we expected to grow by 1.7% in 2011. While this estimate is close to the latest consensus forecast for the likely outcome (1.6%), it masks an alarming deterioration during the second half of the year. This is reflected in our forecast for economic growth next year, which has fallen from 1.6% in May to –0.5% today. December 2010's cautious optimism has been replaced by deep concern.

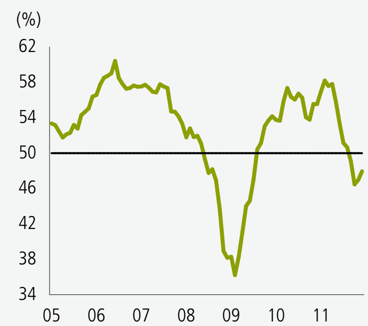
Two points are worth highlighting. First, unlike most recent recessions in the euro area, this one is entirely self-inflicted. We expect the global economy (excluding the euro area) to grow by 3.6% next year—not markedly different from the forecast we published a year ago for 2011 (3.8%). So, this is not a synchronized global downturn as was the case, for example, in the period prior to the collapse of Lehman Brothers. This is important. While the euro area represents a major downside risk for the global economy, the flip side is that solid global growth could help dampen looming deflationary forces in the euro area.

Second, it is not too late to avoid a very bad outcome next year. Data released this week show that the composite purchasing managers' index (PMI) for the euro area rose for a second consecutive month in December (**Display 1**). Based on past readings, this is broadly consistent with a 0.1% quarter-on-quarter contraction in euro-area output—a bit better than our current forecast for the fourth quarter (–0.3%). Also, the details of the manufacturing PMI held encouraging news. It showed a rise in the new orders component and a decline in inventories, leading to the first rise for nine months in the forward-looking orders-to-inventory ratio (**Display 2**). The euro-area economy is weak, but not yet in free-fall.

This makes it all the more urgent that policymakers take decisive steps to bring the sovereign-debt crisis under control. A year ago, we wrote that while we should not rule out the possibility of a positive or negative tail event in 2011, it was "much

Display 1
Modest Rebound in Survey Data

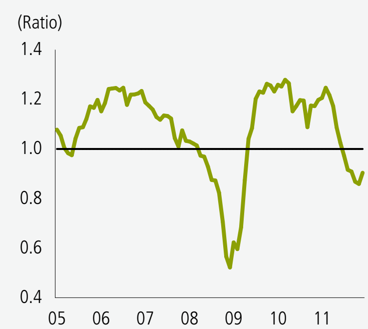
Euro-Area Composite PMI: Output



As of December 15, 2011
Source: Haver Analytics and Markit

Display 2
Welcome Rise in Orders-to-Inventory Ratio

Euro-Area Manufacturing PMI: Ratio of Orders to Inventories



As of December 15, 2011
Source: Haver Analytics and Markit

more likely that we will remain in a muddling through scenario." At the time, with core countries seemingly impervious to spill-over effects from the sovereign-debt crisis, this did not seem a particularly gloomy prognosis. But muddling through has now started to inflict huge collateral damage on the whole of the euro area. As a result, it is not clear how much longer this strategy will be sustainable.

One thing is clear, though: last week's European summit did *not* mark the end of muddling through. While the fiscal pact agreed between (most of) Europe's leaders helped tie together—and in some cases augment—a number of measures that should improve the future functioning of the monetary union, it was clearly not a quantum leap towards true fiscal union.

Nor does the fiscal compact address the current crisis. Although Europe's leaders think a commitment to future fiscal discipline will help restore confidence in the sustainability of public finances in the euro area, many investors believe that additional austerity will reduce growth further, making debt *less* sustainable.

The same applies to efforts being made at the national level. Under intense pressure from financial markets, many countries are now moving ahead with long-overdue fiscal and structural reforms. But the near-term focus is on more austerity, and this means even weaker growth.

There is a clear parallel here with attempts to sustain central parities in the European Exchange Rate Mechanism in the early 1990s. While the monetary authorities thought higher interest rates would help support currencies, investors focused on the negative implications for growth and employment and concluded, rightly in most cases, that higher interest rates would not be sustainable.

In our view, commitments to future fiscal discipline at the intergovernmental level and actual fiscal discipline at the national level are unlikely to restore confidence in euro-area government debt. Europe's leaders have only themselves to blame. By imposing losses on private-sector bondholders as part of a new rescue package for Greece (a country regarded by most investors not as an exception but as a precedent for other countries), policymakers have undermined the "risk-free" nature of sovereign debt in the euro area. This has been compounded by suggestions that Greece needs to decide if it wishes to remain in the euro or not.

In addition to measures to improve the institutional architecture of the euro area, something must be done to convince investors that if they buy euro-area sovereign debt they will get their money back. Prior to last week's summit, there were hopes that a fiscal compact would encourage the German government to acquiesce to common bond issuance (eurobonds) or, more likely, allow the European Central Bank (ECB) to take a more active role in stabilizing sovereign-bond markets. Unfortunately, neither of these now looks like a near-term option.

As a result, policymakers are presumably hoping that a hodgepodge of different schemes may provide enough money to support sovereign-bond markets in the early months of 2012. These schemes include leveraging the European Financial Stability Facility (which provides temporary aid to euro-area countries), advancing and perhaps expanding the European Stability Mechanism (the EFSF's successor) and channeling additional funds through the International Monetary Fund. But this looks more like a sticking plaster than a big bazooka. And it may not be sufficient, given the huge funding wall facing euro-area sovereigns and banks—and deep investor scepticism.

One unambiguous positive has come from the ECB, with its bold measures to boost bank liquidity. This should reduce the risk of a catastrophic bank failure and full-scale credit crunch in the euro area. It may also allow banks to boost their holdings of government bonds, thereby indirectly supporting sovereign-debt markets. But this is a dangerous strategy, as it would increase the banking sector's exposure to their sovereigns, making investors even more worried about negative feedback loops between the two.

Overall, 2012 looks to be another very challenging year for the euro area. While our base case is for a mild recession, the risks to this forecast are skewed to the downside. Moreover, with the economy likely to be significantly weaker than this year, deficit-reduction will be even more difficult in 2012 than it has been over the past 12 months. This, in turn, raises the risk that adjustment programs could run off course in a number of key countries.

Political event and implementation risk is likely to remain very high. Governments still have to agree on the details of last week's fiscal compact and will then need to seek approval in their national parliaments. In Ireland, this may require a referendum, and there is no guarantee the government would win.

Nor should we forget about Greece. The new rescue package it needs to avoid a disorderly default is still not in place. Success will depend on further reforms in Greece and reaching an agreement with private investors on the precise nature of their contribution to the overall bailout. Greece may have slipped off the radar in recent weeks, but it has the potential to destabilize markets in the new year.

Ultimately, we doubt governments will be able to deliver change quickly enough to stabilize markets. Much will continue to depend on the ECB, whose balance sheet is likely to expand rapidly in 2012. For the time being, though, this is likely to be a passive rather than an active process. The crisis may need to get even worse before the ECB will be willing to intervene in a more decisive fashion. ■