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Economic Watch

Europe

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Economic Analysis

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Eurozone: Tentative signs of improvement in early 2012

Bottom line: The Eurozone economy fell in Q4, although somewhat more positive news are coming in early 2012 from soft indicators. Still, the growth dichotomy between the core and the periphery persists. The ECB is in a wait and see mode, but the chances of a rate cut have diminished. The Greek deal on a second bailout still leaves many uncertainties, but provides more time for the EU authorities to focus on completing reforms to restore confidence in the periphery. The fiscal pact to be signed on March 2nd will be a step forward, which should be complemented by more decisive steps to reinforce the liquidity firewalls in the Eurozone.

Economic confidence has been more positive in early 2012, with the services sector taking the lead…

After almost a year of deterioration, confidence seems about to turn around in the Eurozone, although it is still too early to tell if we have reached a turning point. The Economic Sentiment Indicator (ESI) of the European Commission gained 0.6p in January and the index now stands at 93.4 (still 6.6p lower than its historical average). This reflects increased optimism in the services sector and to a lesser extend in construction and among consumers, while confidence in industry remained unchanged. On a country level, Germany (+2.3) and Spain saw the biggest improvement in confidence, while Italy, Netherlands and especially France (-2.1) were the big losers. It is still the case than only Germany has its index above the long-term average. At the same time, the business climate indicator (BSI) improved for a second consecutive month, thanks to the more positive assessment of production and export order books, only partly counterbalanced by a more pessimistic assessment of the overall order books. Pointing to the same direction, PMI Composite suggested a stabilisation of economic activity at the beginning of the year, with the main index returning to expansion in January, beating the 50 no change level and falling back to only mild contraction in February.

…while it is not followed by manufacturing …

The industrial sector took the slump for the fourth month in December, when production fell by 1.1% m/m, mainly due to reduced energy production that could not be offset by rising durable consumer goods. In Q4, industrial production was weaker by 1.7%, following a gain of 0.4% in Q3. Nevertheless, for 2011 as a whole, the index increased on average by 3.5%. Among large countries, only Italy managed to expand its average industrial production in Q4, while Germany surprised on the downside, with a three-month moving average of –0.7% during the same period. In contrast, better news came from industrial orders in Eurozone, which rebounded in December (+1.9%) after losing -1.3% m/m in November. It is worth mentioning that Portugal lost -23.8% on the year in November, beating even Greece where orders were weaker by -15.8% in October, while it appears that Ireland and the Germany are the countries more resilient to the downfall.

Looking forward, the PMI surveys suggest a more positive, but still blurry picture. PMI Manufacturing improved somewhat, but still remained in contraction territory reaching 49.0p in February (from 48.8p in January). The recovery in the industrial sector can be attributed to Germany and Austria, while production in Italy, Spain and the Netherlands contracted less than the previous months. Total new orders nevertheless continued to decline in all of the nations covered except for Austria. Similarly, the sub-component of business activity in the Eurozone stabilised in February, registering a marginal contraction and resulting in the PMI for services at 49.4p (down from 50.4p). On the positive side, confidence regarding future levels of business activity rose. At the beginning of the year, optimism improved in Germany, Italy, Spain and Ireland, but slumped to a near three-year low in France.

...and construction showed more positive signs after the recent downturn

In line with improved confidence in construction, by +0.6p, activity in the sector has been improving over the last two months, gaining +0.3% in December after +0.2% in November. Still, as the sector is volatile, we cannot interpret this development as a reversal of the previous negative trend.

Consumer confidence is improving, while unemployment was stable in December

Sentiment among consumers improved by 0.8 points to a revised -20.6p in January, mainly a result of easing unemployment fears, while households´ assessment of the future economic situation and their own financial situation remained unchanged. The Flash indicator in February points to a further improvement by 0.4p.In contrast, confidence in retail sales worsened significantly, weakening by -3.3p

The unemployment rate was 10.4% in December 2011, unchanged from November. Among the Member States, the lowest unemployment rate was recorded in Austria (4.1%), and the highest in Spain (22.9%). During the last months, the unemployment rate remained virtually unchanged in most of the countries, with Germany having gradual monthly falls in Q4 (by -0.1pp), while Greece registered a huge increase on the month to November (from 19.2% to 20.9%), followed by Portugal reporting a 0.4% m/m jump in December (in seasonally adjusted terms).

The external sector was weaker at the end of 2011

Global demand is subdued. Exports are weakening, but as imports are performing even worse, the trade deficit is narrowing. In December, Eurozone showed a trade surplus of €9.7bn, following another €6.3bn gain in November. Exports rose only by 0.1%, while imports dropped by 0.9% in December, both rates being weaker compared to the rebound observed in November, but better than the deceleration in September and October. Still, for the year, 2011, Eurozone registered a deficit of €7.7bn.

Hence, GDP contracted in Q4, with room for some improvement at the beginning of 2012

The Eurostat flash for Q4 gave a fall of -0.3%q/q, which was broadly expected and is consistent with growth at 1.5% in 2011 as whole. The contraction in Q4 was widespread across both core and peripheral countries, with the exception of France which showed moderate growth. This fall in activity can be explained by the substantially worsening financial market outlook as from the summer, which adversely weighed on confidence over Q4 11, along with a weaker global recovery. Our updated MICA model, taking into account the more positive signs from January's confidence surveys, points to zero or slightly negative growth in Q1 (at -0.05%).

Eurostat did not provide any information about components, but we expect weak consumption and a significant fall in investment. As a result, domestic demand might have subtracted growth for the third quarter in a row. Despite the slowdown in global demand and therefore exports, further deceleration in imports implies that net exports have probably contributed positively to growth.

Inflation stabilized in January and might enter a moderation path...

Consumer prices remained unchanged in the beginning of 2012, against expectation of a lower rate. This might be a result of higher than expected oil prices. Looking forward, the slower than anticipated slowdown in oil prices, combined with the depreciation of the euro could result in inflation slightly above the ECB target at the end of Q1. In addition, potential hikes in both taxes and administered prices to meet fiscal targets pose upside risks to this scenario.

...in line with a restrained growth of money aggregates

Money supply expansion remains subdued. In December, the annual growth rate of the monetary aggregate M3 eased to 1.6% from 2.0% in November, reaching its lowest level in almost a year. In a three-month moving average base, M3 growth eased to 2.1% in Q4 from 2.5% in the three months to November. Regarding counterparts, total credit provision improved slightly, mainly due to increased credit for the government and residents. Credit to the private sector slowed down by 0.6pp to 0.4% and loans to households decreased to 1.5% from 2.1%.

ECB adopts a wait-and-see stance

The ECB kept the policy rate unchanged at 1.0%, but called for strong demand in the forthcoming LTRO...

In line with expectations, the ECB unanimously decided to keep the policy rate at 1% in February and a rate cut was not even mentioned during the meeting. Overall, although the tone remained dovish and the easing bias was retained, it became more upbeat. As for non-standard measures, ECB encouraged a large demand for the 3Y LTRO as it considers the use of these facilities stigma-free. ECB has already pumped significant liquidity in the market and will continue doing so, i.e. through its forthcoming second 3Y LTRO, which will take place this week. What is quite clear now is that the ECB has shown that it will do whatever it takes to avoid reviving a banking failure similar to that of the Lehman Brothers experience.

With respect to looser collateral rules, the ECB released the details on the new collateral it will accept for funding at February's three-year LTRO. Mr Draghi said that the decision on changes in collateral rules was not unanimous showing that some part of the Governing Council is reluctant to take on more risk.

..while we see a further cut postponed to the second quarter of the year

The ECB assesses the medium-term inflation risks as broadly balanced and future price pressures as limited, signalling that a rate cut as soon as in March, as we had projected, is now unlikely. Regarding the monetary analysis, there are increasing concerns on the evolution of credit to both households and, particularly, the non-financial corporate sector. Thus, in the near-term the ECB will most likely be on a wait-and-see mode. Yet, we foresee a rise would take place further ahead, in the second quarter.

Eurogroup gave the green light for the new bailout for Greece, but risks persist

The periphery continues to face challenges and is taking the necessary steps to return to growth

The market focus was Greece, which managed to secure approval from Eurogroup for a second bailout program, after adopting the necessary measures to cover its fiscal gap for 2012. The Troika inspectors are now in Portugal, which is the other peripheral country under markets' suspicion right now. The next loan payment to the country is widely expected to be approved though.

Greece: Second bailout approved by the parliament and Eurogroup, in the midst of social and political unrest

After repeated delays, missed deadlines, multiple postponements and a rally of discussions, the second bailout for Greece was approved by the Eurogroup after the necessary parliamentary vote on new consolidation measures was passed with a majority of 199-74. The required measures were a precondition for the agreement and are to be applied to the current year and focus on the expenditure side, including further cuts to salaries, pensions, health and defence spending. All these, nevertheless, not without political costs for the Greek government coalition. First, the small party supporting the government (LAOS) abandoned the coalition at the last moment and denied to vote in favour of the second bailout, while some members of New Democracy and PASOK, Greece's main political parties, were expelled or abandoned their parties as they voted against their party's official position. On top of that, the popular response against the agreement was strong, although it seems that support for euro membership is still high.

Two further key conditions were imposed on Greece: the Troika will have a permanent delegation in the country and an escrow account will be created to ensure the country gives priority to the debt payments.

The official sector involvement will not surpass €130bn, but the interest rates from the first deal will be reduced and ECB together with the national central banks in the eurosystem will dispose of the profits on their bond holdings, resulting in further cuts in the debt burden. The official sector will also contribute with lower interest rates on the bailout loans, applied also retroactively to the loans already provided.

On the PSI, the haircut of the nominal value of the bonds is increased to 53.5% from a previously expected 50%, implying a loss in terms of net present value of about 72-75%. The bond exchange should be finalized by early March and its successful outcome is a prerequisite for the program to be approved.

According to the baseline scenario of the sustainability report by the Troika ahead of the deal, the debt level would decline to 129% of GDP instead of the targeted 120% in 2020, but with all measures agreed, the debt is assumed to hit 120.5% of GDP by 2020.

The risks ahead are still many, and include the lack of implementation of conditionality which has been required in the short term (mostly related to rapid reforms in areas which should have been already tackled by Greece), an eventual no from the German Parliament to the deal, and insufficient participation of bondholders in the PSI deal. The later two are unlikely to materialize, as the German government can count on the votes of the opposition in the Parliement (even if quite a few MPs in its own coalition vote against it), while the Greek government has approved collective action clauses that it will activate in case there a risk of low participation.

All in all, the most likely scenario is that the whole package will go ahead and will set aside the problem of Greek debt in the short run, but with high risk of derailing in the coming future as Greece will have to deliver its measures amid a sharp recession.

Italy: focused on structural reforms, with additional measures to weigh on GDP growth in 2012

The prospects for Italy have significantly improved, since Mario Monti took office as a prime minister last November. The credibility of the government is enhanced substantially and decisive measures have been taken with the aim to lead the economy to a sustainable growth path. At the same time, Berlusconi expressed his intention to support the government beyond the summer. Additional to the package of measures approved in December and January, the government will present labour market reforms by end of March. The heavy fiscal efforts have resulted in decelerating growth and in contraction for the second half of 2011. Thus, in 2011 as a whole, the Italian economy grew by 0.4%, but it registered a contraction of-0.2% and -0.7% in the third and fourth quarters, respectively. In contrast to forecasts from the government of -0.4% contraction in 2012, the BoI projects a fall of -1.2%/-1.5% and IMF of -2.2%. Our own forecast is on -1.5%.

Ireland: Adjustment program on track, set for more fiscal austerity

Further austerity will be imposed to Ireland in 2013 by the Troika, as indicated in the modification to the Memorandum of Understanding (MoU) by the inclusion of “at least” before the statement about a required budgetary adjustment of €3.5bn next year. At the same time, the country will be allowed to invest part of the cash it will generate through its privatization plan (i.e. a minority stake sale in the Electricity Supply Board (ESB), sale of a part of gas utility Bord Gais), instead of exclusively paying down its debt, given that the proceeds are substantial. The target is set for €2bn of asset sales and it could be increased to up to €5bn under the new conditions, but there is no deadline on the timing of the sales, given the volatile market conditions. According to the central bank of Ireland, the competitiveness of the country is improving and the deficit target of 8.6% of GDP in 2012 should be achieved, but the goals for

2013 might be missed, owing to the current slowdown. The Bank also projects now that the economy will grow by 0.5% in 2012, against previous expectations of 1.8%, as export demand is fading and the European crisis is intensifying. For 2013 it sees a growth rate of 2.1%.

Portugal: Next tranche to be disbursed

The troika inspectors are carrying out a two-week review of the adjustment plan for Portugal and the next loan payment is believed to be easily approved. Against broad-based concerns about the necessity of a second bailout as €9bn in debt repayments fall due in September 2013, the prime minister reiterated his intention for the country to regain access to debt markets next year and rejected all concerns, stressing the fact that the country will meet all of its targets. Nonetheless, as the strong fiscal consolidation efforts are in progress, Portugal's economy contracted in Q4 2011 (-1.3%), less than we expected, and the recession is set to continue this year (we project -2.7% but IMF and official sources have a somewhat lower figure of around -3%). In addition, Moody's, following a similar move of S&P earlier this year, cut the sovereign rating further in junk territory.

The government has carried out an overhaul of the labour market and is addressing reforms in the judiciary system (i.e. by accelerating civil court procedures and setting up new courts for competition and intellectual property rights). It is also revising the legal framework for regulatory bodies. On privatization, it has agreed to sell a 40% stake in RENE, Portugal's power and gas grid operator, for €592mn.

Little progress on governance issues

Finalization of the fiscal pact, to be signed in March by 25 countries

The January 30 EU council summit was in line with expectations, which were low. It is another step in the strategy to sign a fiscal treaty in March, in line with German demands. In this respect, an agreement was finally reached on a fiscal compact to be signed at the summit of early March, but few details have been provided on the contents of the pact and the ESM. Although it is positive that growth was the main focus of the summit, the results on this area were scarce, since there was no relaxation of fiscal targets or sizeable new funds. A promising idea would have been to allow countries to stick to their structural deficit commitments, but not to compensate for cyclical slippages in order to avoid a downward deficit-growth spiral.

For the March 1-2 meeting the final signature of the international agreement among 25 EU countries is expected (all except the UK and Czech Republic), and the final approval of the Greek bailout package. For the ESM, which will enter into force in July 2012, we continue to think that its funds are not enough to restore market confidence on sovereign bonds, and the council could decide either to increase the funds available for it or to allow it to overlap with the EFSF it substitutes, adding temporarily its funds. However, moves in this direction are far from certain.

Tables and graphs: Economic indicators

Table 1
Main indicators for Eurozone countries

		Euro Area	Germany	France	Italy	Spain	UK	Portugal	Greece	Ireland
Dec-11	**(*)**					**National Accounts**				
GDP	q/q	-0.30	-0.18	0.22	-0.70	-0.30	-0.20	-1.30	-7.98	-1.92
	y/y	0.70	2.02	1.42	-0.50	0.27	0.77	-2.70	-6.99	-0.25
	2011 y	1.65	2.97	1.62	0.54	0.74	0.88	-1.87	-5.50	1.09
Dec-11					**Activity**					
Industrial Production	m/m	-1.14	-2.68	-1.29	1.38	0.88	0.49	-1.60	-2.41	2.49
	q/q	-1.73	-2.03	-0.86	-2.14	-2.13	-1.40	-2.88	-8.23	-1.51
Dec-11	**(**)**									
Industrial new orders	m/m	-1.08	2.26	-0.72	7.98	-1.22	-1.56	-2.46	-1.28	3.41
	q/q	-3.88	-1.06	-2.77	-3.41	-5.33	1.87	-5.76	-3.57	4.23
Jan-12										
ESI	Level	93.40	106.60	91.40	84.30	92.20	93.60	75.70	74.90	
	Change	0.60	2.30	-2.10	-1.10	1.80	5.00	1.10	-0.80	
Feb-12	**(***)**									
PMI Manufacturing	Level	48.95	50.10	50.20	46.80	45.10	52.10		40.97	48.26
	Change	0.18	-0.90	1.70	2.50	1.41	2.40		-1.06	-0.34
Feb-12	**(***)**									
PMI Services	Level	49.36	52.60	50.30	44.80	46.10	56.00			48.25
	Change	-1.08	-1.10	-2.00	0.30	4.03	2.00			-0.18
Ene-12					**Consumption**					
EC Consumer Confidence	Level	-20.70	-2.20	-30.10	-34.00	-15.30	-25.60	-56.50	-81.90	
	Change	-0.20	0.70	0.80	-4.80	0.10	-2.10	1.90	0.40	
Dec-11	**(****)**									
Retail Sales	m/m	-0.24	0.10	-0.35	-0.30	-0.82	-0.40	2.18	-0.27	0.00
	q/q	-0.57	-0.13	-0.03	-0.58	-2.79	1.46	-6.75	-4.59	1.20
Dec-11	**(*****)**					**Labor Market**				
Unemployment rate	Level	10.40	5.50	9.90	8.90	22.90	8.40	13.60	20.90	14.50
	Change	0.00	-0.10	0.10	0.10	0.00	0.10	0.40	2.70	0.10
Sep-11										
Labour costs	TLC q/q	0.19	-1.31	-0.19	0.37	0.65	0.10	1.15		
	ULC q/q	-0.15	-0.57	0.27	-0.87	-1.36	0.52	-0.09		2.50
Jan-12	**(******)**					**Prices**				
HICP	m/m	0.30	-0.50	-0.40	-1.80	0.00	0.50	0.39	-0.20	-0.09
	y/y	2.70	2.30	2.60	3.40	2.40	3.60	3.40	2.20	1.42

(*)for Ireland data is for Q3 2011
(**)for Eurozone data is for November
(***)for Germany, France and Eurozone data is for February (Flash), all other for January
(****) for Italy, UK and Greece data is for November
(*****) for Greece data is for November
(******) for Eurozone, and periphery countries data is for December
Source: INE and BBVA Research

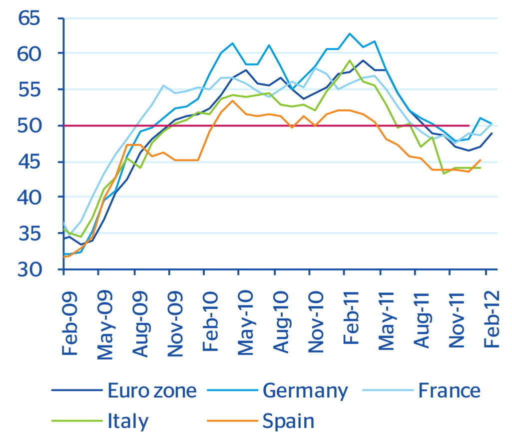
Tabla 2
Eurozone countries : comments on main indicators

Country	Comments
Eurozone	Economy grew 1.65% in 2011, but contracted in Q4. In recent months, industrial production fell (-1.14% in Dec), in line with dropping new orders (positive only in Dec) and a mixed picture is suggested by confidence data in the beginning of the year. PMIs: activity in services expanded, but stabilized in February, manufacturing remains in contraction, though the index has increased. Economic sentiment improved (at 93.4), together with consumer confidence (-20.7). Private consumption is worsening, as retail sales data indicates (-0.6). Inflationary pressures eased and unemployment stabilized.
	EC forecast: 2011: 1.4% , 2012: -0.3%
Germany	Strong GDP growth of 3% in 2011 and contraction less than expected in Q4. Industrial production is following a negative trend recently, but both PMIs, though remained in expansion, had their growth eased. Confidence is trending upwards: economic and consumer sentiment improved (up by +2.3p and +0.7p respectively), as well as the ZEW and Ifo (at 109.6) indicator. Retail sales are also improving. Unemployment is low, but remains flat. Inflation approaches the target rate (at 2.3% in December). Outlook is becoming more optimistic.
	EC forecast: 2011: 3.0% , 2012: 0.6%
France	Positive growth in 2011 and the only ea country to register positive grow in Q4. The industrial sector is deteriorating, with industrial production & new orders falling by the end of the year (-1.3%, -0.7% respectively). Confidence is deteriorating in all sectors, except for consumer, where it gained 0.8p. PMI in Services remains in expansion (50.3p). PMI manufacturing gained significantly in February according to the flash estimate (50.2p) and managed to go above the 50 mark. Unemployment is quite high, but flat.
	EC forecast: 2011: 1.7% , 2012: 0.4%
Italy	GDP has entered a recession period, as the economy contracted both in Q3 and Q4 (-0.2%, -0.7% respectively) . Industrial production could start trading upwards, as recent data indicates. ESI confidence data suggests that sentiment is deteriorating. PMIs are both in contraction, but manufacturing has improved much more than services in January. Activity is expected to contract further in Q1 of 2012. Retail sales keep falling (-0.3% m/m in Dec). Unemployment slightly increased (at 8.9%) and inflationary pressures eased, as we had some decrease in HICP in Nov and January.
	EC forecast: 2011: 0.2% , 2012: -1.3%
Spain	GDP stagnated in Q3 and has contracted in Q4. Overall in 2011, it managed to maintain some growth (+0.74%). PMI manufacturing and services remain in negative territory (45.1, 46.1 respectively), but the fall in activity in January was much milder. Industrial production is trending downwards, with November figure for growth at -1%, but with a rebound in December (+0.88%) and industrial new orders losing -1.22% at the end of last year. The same is true for retail sales, which fell by -0.8% on the month to December. ESI rebounded after having fallen for months. Consumer confidence is improving, but unemployment is at extremely high levels (22.9%, the highest rate in Eurozone). Inflation has slowed by 0.5pp to 2.4% y/y, mainly because of the more moderate growth in energy prices and the lower increase in processed food prices.
	EC forecast: 2011: 0.7% , 2012: -1.0%
Ireland	Economy weakened sharply in Q3, and is expected to contract further, but Ireland remains the best performer compared to the rest periphery. EC expects positive growth in 2012. Industrial production gained 2.5% in December, after a sharp fall in Nov (-9.4% m/m), in line with stronger industrial new orders. Retail sales were flat in December after being stronger the previous two months. Unemployment is particularly high (at 14.5%), but broadly stable There are no concerns about inflation, which is falling and stands comfortably below the target at 1.4%. Ireland is the only country that meets the target of 2% in the euro area.
	EC forecast: 2011: 0.9% , 2012: 0.5%
Greece	Economy is in deep recession since 2008 and most probably will stay there for at least 2 years. In 2011 a contraction of -5.5% is expected There is a declining trend in every indicator, with some rebound in consumer confidence only (up +0.4p), which might be short dated. Unemployment is growing exponentially, reaching 20.9% in November and will remain a serious concern in the future. Inflation is falling, due to decreasing activity and strong austerity that restrains domestic demand.
	EC forecast: 2011: -6.8% , 2012: -4.4%
Portugal	GDP in recession, after registering another fall, of -1.3% in Q4 (-0.6% q/q in Q3), a situation which is expected to last for at least a year. Industrial production is clearly trending downwards (-1.6% in Dec), but retail sales improved in December, after deteriorating the preceding months. Consumer and economic confidence improved (+1.9p and +1.1p in Jan respectively), according to the ESI survey. Unemployment is high and increased significantly recently (nsa 14% in Dec). Inflation remains high, but is not a concern, amid continued fiscal consolidation efforts keeping GDP growth at negative rates.
	EC forecast: 2011: -1.5% , 2012: -3.3%

Source: BBVA Research

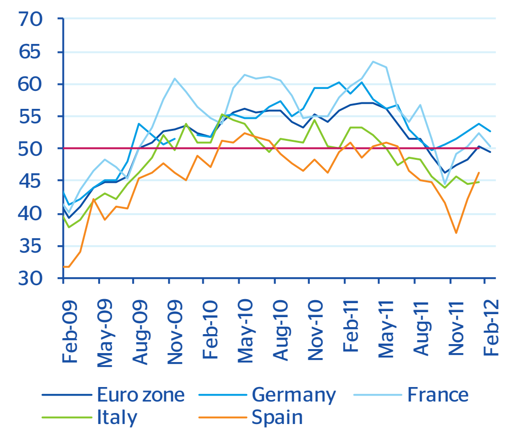
PMIs: Slight contraction in February, after beating up the no change level the previous month

Chart 1
Countries: Markit PMI Manufacturing Index



Source: Markit Economics

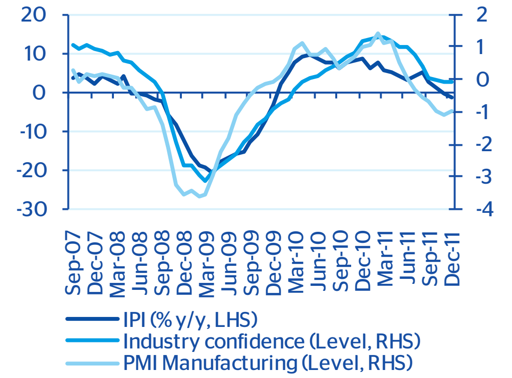
Chart 2
Countries: Markit PMI Services Index



Source: Markit Economics

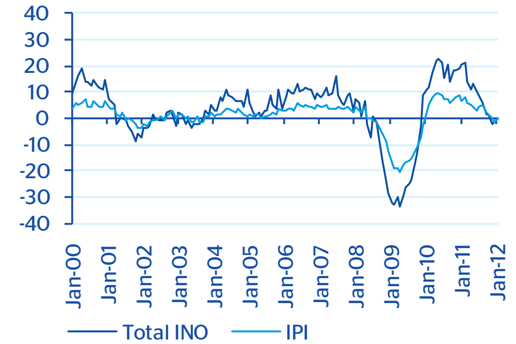
Clear downward trend in industrial activity, while volatile new orders are losing ground on average

Chart 3
Eurozone: Industrial sector (%y/y)



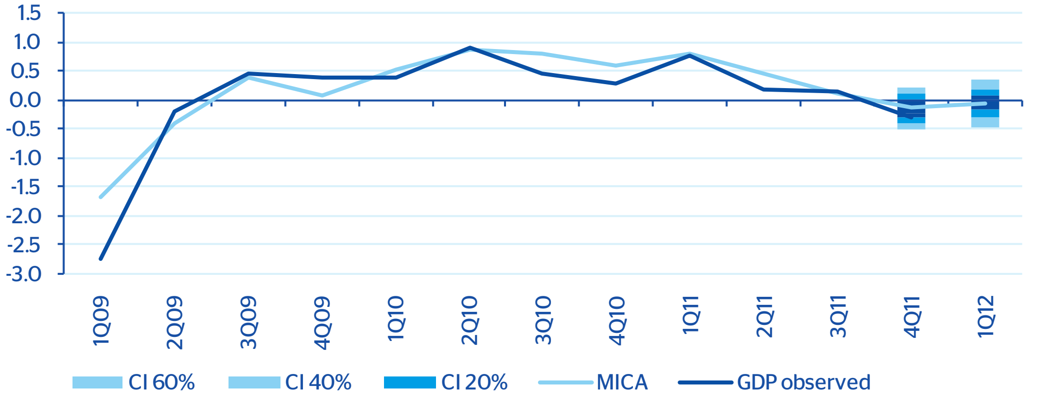
Note: Standarized soft data
Source: Eurostat and European Commission

Chart 4
Eurozone: Industrial
new orders and production(%y/y)



Source: Eurostat

Chart 5
MICA and GDP observed (% q/q)



Source: BBVA Research

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