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Economic Watch

Europe

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Economic Analysis

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Eurozone: Contraction in Q4 is now certain, with less negative signs for Q1

Bottom line: Activity in the eurozone fell in Q4 and recent indicators show that it is still in contractionary territory, although prospects for Q1 are somewhat less negative. The different performance between the core and the periphery continues to be large, partly because of the large fiscal effort done by the latter, together with the step up of structural reforms. The ECB will probably lower its interest rates further in March, and its large liquidity injection has managed to improve money market conditions, but is far from being a definitive solution to euro area problems. For that, the EU council summit at the end of January should help with advances regarding the fiscal agreement, leaving the way to further measures to support sovereign debt markets.

- **Confidence in Eurozone keeps fading, though less markedly than before, still suggesting negative growth in Q4**

  PMI figures indicate that activity in the private sector is falling, though less rapidly than before as the indices recovered somewhat in December. Output and new orders improved in both the services and manufacturing sector, but they still remain below the threshold of 50. The composite index significantly improved in December, registering 48.7 (after 47.0 in November) with services and manufacturing edging higher to 48.8 and 46.9 respectively.

  In contrast, the December economic sentiment index (ESI) by the European Commission slightly worsened (by 0.5 points), mainly as a result of the deterioration in the services and retail sector, as well as in consumers' view about their financial situation and future employment developments. Nevertheless, confidence in industry and construction was virtually unchanged. By country, Italy reported the biggest decrease in sentiment (-4.6) after two months of increases, followed by Spain, which has been trending down for a long period, with only a short reversion in November. Confidence was broadly unchanged in France, while it improved in Greece, Germany and Portugal. The trend is however broadly negative.

  Some positive news came from business confidence, with the indicator BCI moving up for the first time in 10 months, driven by improved future production and export orders expectations.

Services seem to be more resilient to the crisis than manufacturing. Nevertheless both have been contracting throughout Q4...

In both sectors the drop in activity has eased, but the improvement is more pronounced in services, as reflected in PMI figures.

Industrial production kept declining for the third month in a row, losing 0.1% in November and new orders were up by 1.8%, though they were down on the quarter to November. This result was in line with the forward looking PMIs, which projected a fall in manufacturing on the month. The trends were diverse among member states, with Ireland being the big loser, registering a sharp drop of -9.4%, while France and Greece seeing an improvement of 1.1% each. In the latter case, it is the first increase in months. On the other hand, EC industrial confidence index remained unchanged in December, with order books and employment expectations dragging the index down.

For the service sector, though PMI was in contraction for a fourth month in December, it saw an improvement, lead by Germany and France (now at 52.4 and 50.3, respectively), which saw activity rising, while in Spain (42.1) the deterioration continued and in Italy (44.5) the situation became even worse.

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

Output in construction in November reversed the recent trend, a drop of -1.4% in October and another -1.7% in September. By country, although construction activity is very volatile, there is a clear pattern of decreasing activity in Portugal and Spain, in contrast to improved performance in Germany and the recent rebound seen in France. (+0.8 after two months of negative results).

Consumer confidence fell sharply, while retail sales remain low

Private consumption contributed positively to growth in Q3, but the prospects for Q4 are gloomy. Retail sales declined by 0.8% in November, after recording a slight increase at the beginning of the quarter, while consumer confidence is falling sharply, as the EC consumer survey index lost 1.2 points in December. Given the ongoing fiscal consolidation in the periphery but not only, implying less disposable income for households, consumption is not expected to rebound any time soon.

Unemployment, remained stable in November and is +0.3pp up from the same period the previous year. The highest rates and increases over the year were recorded once again in Spain (22.9% from 20.4%) and Greece (18.8% in September 2011 from 13.3%).

The support from the external sector remains uncertain

We have mixed evidence on exports during the fourth quarter. Trade activity weakened in the dawn of Q4, with the trade surplus narrowing, but November saw a significant improvement, which might continue in the medium term as the recent euro depreciation makes European products more competitive. Thus, exports were stronger by 3.9% in November, while imports remained flat, leading to an impressive surplus of 6.1bn. Germany and Ireland gained the most, while France and all the periphery countries saw their trade balance deteriorating.

As a result, the contraction in Q4 of 2011 is given and is expected to continue in Q1 of the current year

Our short-term forecast model (MICA) for GDP anticipates a fall in economic growth of about -0.2% q/q in the last quarter of 2011. Contraction is also expected for the first quarter of the year, with GDP losing –0.1%.

At the same time, Eurostat revised downwards its GDP estimation for Q3 to 0.1% q/q, mainly due to revisions in components of domestic demand (private and public consumption and investment were all revised down), while the net exports contribution remained unchanged.

Inflation decreased to 2.7% in December, with expectations to slow down rapidly at the beginning of 2012...

CPI inflation in December eased to 2.7%, in line with expectations, due to a favourable base effect from energy prices, after remaining for 3 consecutive months at 3%. While ECB's forecast points to inflation above the 2% target for the coming months, it projects that inflation will be brought finally below the target, in line with our own forecast, which suggests both headline and core inflation below 2% for the year on average. In general, inflationary pressures are expected to ease further in coming months due to the weakness of domestic demand, but several factors have appeared in recent weeks that could put a brake in this deceleration, i.e. the depreciation of the euro, as well as potential hikes in both taxed and administered prices. According to EC survey results, managers' selling price expectations in December remained broadly unchanged (+0.1), after having fallen significantly since July 2011.

...in line with falling demand reflected in weak money and credit growth in November

The pace of monetary expansion remains restrained. In November, the annual growth rate of the monetary aggregate M3 eased to 2.0% from 2.6% in October, reaching its lowest level since last April. Regarding counterparts, only credit for the government improved. Specifically, growth of total credit to Eurozone residents fell from 1.6% to 0.8%, while credit to the private sector slowed down by 1.1pp to 1% and loans to households remained virtually unchanged at 2.1% (down 0.1pp).

ECB: cautiously alert while it assesses the effects of recent policy moves

The ECB kept interest rates on hold at 1.0% in January, but gave no explicit answer about possible rating cuts in the future

After the two consecutive 25bp cuts, the ECB decided unanimously to leave interest rates unchanged at January's monetary policy meeting, in line with expectations. Overall, the tone remained dovish, the economic assessment downbeat, while the easing bias was retained.

We continue to see a further 25bp cut in March

A potential additional rate cut would depend on the market effects of the three-year LTROs, the evolution of sovereign tensions, the degree of deterioration in economic activity and the absence of inflation pressures. Having said that, we still think that activity will continue on a moderately downward trend, while further easing in financial tensions will be gradual and volatility will remain high. Therefore, our base scenario continues to be a 25bp rate cut on 8 March, though the odds that it would take place further ahead seem to have increased somewhat.

As for liquidity, ECB assessed the previous LTRO as successful and is optimistic about the upcoming auction

The ECB sees the three-year LTRO as successful in avoiding a "credit crunch", and it anticipates substantial demand at the next three-year LTRO (29 February) as a broader collateral base will likely apply. In our view, there is a slight improvement in money markets while banks continue hoarding funds, mainly to face debt repayments, and only the strongest European banks have returned to primary markets. Hence, we think that it is too soon to infer that the latest liquidity injection from ECB is working appropriately.

Ireland and Italy likely to have met fiscal targets in 2011, while Greece's problems intensify

The periphery of Europe continues its efforts to improve its fiscal position, with different degrees of compliance with initial targets in 2011, and further consolidation planned for 2012, which will be one of the main drivers of (negative) growth this year. At the same time, **structural reforms have been stepped up recently,** with important changes in the regulation of the labour market in Portugal, and reforms of pensions and several sectors launched in Italy.

Italy: on its way to over-perform its deficit target for 2011, while the government is focused now on structural reforms

Italy's new government is now focusing on structural reforms, after having secured the budget for 2012 and budget plans which aim at closing the deficit by 2013. The budget execution figures for 2011 show positive results, with a better than expected deficit of -2.7% of GDP in Q3. Expenditures decreased, while revenues were up 1.4%. After reforming pensions and liberalizing shop opening hours, the government presented on January 21 a package of further reforms, including several measures to liberalize professional services, pharmacies, notaries, transport and energy distribution. On the labour market, there is strong resistance from some parties supporting the government to suppress regulations that forbid dismissal of workers for economic reasons in firms of more than 15 workers (art. 18 of the labour code). That will be the next piece of reform to be expected, which is key to reduce labour market duality, although it is unsure that it will be passed and could be substituted for subsidies to employment of young workers (a poor second best solution to the problem).

Spain: The significant deviation from the public deficit target triggers additional fiscal measures

In anticipation of a deviation from the 2011 public deficit target (close to 2pp of GDP), the Spanish government announced adjustment measures totalling €15bn. Spending cut measures will account for 60% of the announced adjustment (€8.9bn), and the remaining 40% will be obtained through raising taxes (€6.1bn). Specifically, marginal rates on income and capital will rise up to 7 and 6 points, respectively. Furthermore, 2012 revenue could fall short of the targets due to lower than expected growth, which would require further adjustments to meet the deficit target of 4.4%. As regards public debt, it remained unchanged at 66.0% of GDP in 3Q11, with a cumulative annual increase of 4.9pp on December 2010.

Ireland: its public finances back to sustainable path, while it successfully passed Troika's 5th review

The government estimates a deficit of 9.9% of GDP, slightly below the bailout deal target of 10.1% (primary deficit), even though tax revenues in the second half of the year were less than expected. In the meanwhile, the Troika completed a 10-day 5th review of the country's adjustment program. Its verdict was that the country met all the targets set for 2011, with a deficit for 2011 well ahead of the target and with considerable progress on the banking system reform. Nonetheless, it gave a warning that considerable challenges remain, as demand remains subdued, unemployment at high levels and external sector is growing at a slow pace. At the same time, Ireland managed to have its rating confirmed by S&P, escaping the fate of the 9 ea countries that saw their ratings being cut.

Greece: Troika back to Athens for the second bailout deal, while PSI talks are bound to be finalised very soon

Troika inspectors returned to Greece to negotiate the second bailout agreement, while the aid schedule of the first deal is pushed back by 3 months. Thus, the next tranche (€5bn) will be paid out in March and then June (€10bn). It was not possible for the government to attain the targeted deficit of 9% of GDP in 2011, and in order for the gap to be closed, further measures of at least 2bn are needed in 2012, as requested by the IMF.

On PSI, after talks were halted, mainly on disputes over interest rates to be paid on the new bonds, an agreement is expected to be reached very soon. This is crucial, as there is an amount of €14.5bn debt maturing in March. Participation in the new deal is still uncertain, while the Greek government has threatened to apply collective action clauses retroactively to current bonds.

Portugal: towards significant deficit reduction on one-off measure

Portugal's budget deficit for 2011 will be around 4.5% of GDP, considerably lower than the 5.9% target of the bailout, mainly due to a 6bn transfer of bank pension fund assets and liabilities to the social security system. Without such transfers, the deficit was around 8% of GDP, which is the starting point for 2012 as the transfer (apart from generating a liability) are a one-off. The government has planned a large package of fiscal austerity for 2012, equivalent to 6% of GDP, which will pull the economy down to recession. The central bank of Portugal now estimates a contraction of 3.1% in 2012, after an estimated 1.6% fall in activity last year; the new figure is broadly in line with IMF and government estimates. Bad news came from the cut of the country's rating by S&P by two notches, to BB-plus from BBB-minus, placing Portugal in junk status, triggering an immediate exclusion of Portuguese debt from several bond-indices and raising its 10 year spread with Germany by about 300bp to over 13%. The good news come from the reforms side, where the focus is currently on the labour market. The government has designed old and broad measures to reduce severance payments to dismissed workers, increase incentives for work search for unemployed workers and increase the number of working hours in the private sector (although most of these measures need to be definitely approved).

Progress on governance issues

It is not clear what to expect from the EU summit to be held at the end of January

After the summit in December most EU governments decided to go ahead with an international agreement to be approved in March, where a “fiscal compact” will be implemented that should allow a better framework for fiscal discipline in Europe. Our view has been that the contents of such agreement are not critical by themselves, but are instrumental in assuring core countries in Europe and the ECB that moral hazard issues are under control and that a more proactive policy can be taken to help resolving the liquidity problems in sovereign markets. In the meantime, a preparatory summit has been called for January 30, with the intention to advance in the process. The drafts of the agreement that have been leaked to the press have been criticized by members of the ECB board as being too soft, as they drop some the elements agreed in December. Indeed, the draft does not include the requirement that the national fiscal rules are included in national constitution, and is not specific on sanctions or correction mechanisms for countries that do not comply with deficit requirements. The odds are that a final solution will not be found in such a summit, and a definite agreement will be concluded only in March.

Tables and graphs: Economic indicators

Table 1
Main indicators for Eurozone countries

		Euro Area	Germany	France	Italy	Spain	UK	Portugal	Greece	Ireland
Sep-11						**National Accounts**				
GDP	q/q	0.10	0.50	0.30	-0.15	0.01	0.57	-0.57		-1.92
	y/y	1.30	2.62	1.55	0.21	0.75	0.47	-1.74		-0.25
	2011									
	y	1.65	2.97	1.62	0.54	0.74	0.65	-1.87	-5.50	1.09
						Activity				
Industrial Production	m/m	-0.11	-0.98	1.09	0.35	-0.98	-0.62	-1.56	1.08	-9.41
	q/q	-1.29	-1.75	-0.68	-2.76	-2.23	-3.84	-1.59	-7.06	0.83
Industrial new orders	m/m	1.75	-4.96	-0.31	-1.06	-2.21	2.90	-5.01	-2.33	14.49
	q/q	-3.14	-0.98	-3.76	-5.78	-4.70	2.23	-8.76	-5.61	5.31
ESI	Level	93.70	104.00	93.20	90.10	91.00	88.90	71.20	68.60	
	Change	-1.10	-0.10	-4.00	0.80	0.20	-0.60	-6.50	1.10	
PMI Manufacturing	Level	46.94								
	Change	0.57								
PMI Services	Level	48.80								
	Change	1.27								
						Consumption				
EC Consumer Confidence	Level	-21.10	-2.90	-30.90	-29.20	-15.40	-23.50	-58.40	-82.30	
	Change	-1.20	0.40	-6.60	4.70	4.20	0.50	-1.20	1.50	
Retail Sales	m/m	-0.84	-1.01	-0.43	0.09	-0.71	-0.40	-2.58	-2.45	2.04
	q/q	-0.66	-0.25	0.19	-0.35	-2.34	1.32	-6.98	-4.10	0.96
						Labor Market				
Unemployment rate	Level								18.20	
	Change								0.70	
Labour costs	TLC q/q	0.19	-1.31	-0.19	0.37	0.65	0.10	1.15		
	ULC q/q	0.14	-0.47	0.36	-0.86	-1.17	0.52	-0.09		2.50
						Prices				
HICP	m/m	0.30	0.70	0.40	0.30	0.00	0.20	0.10	-0.20	0.00
	y/y	2.70	2.30	2.70	3.70	2.40	4.80	3.50	2.20	1.70

Note: Blue colour: improvement, grey: deterioration, white: neutral
(*) for France, Italy, Spain, UK, Greece data is for October 2011
(**) for Italy and Greece, data is for October
(***) for Greece, data is for October
Source: INE and BBVA Research

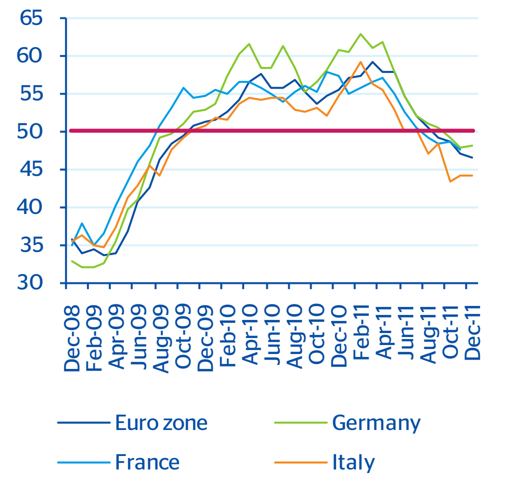
Tabla 2
Eurozone countries : comments on main indicators

Country	Comments
Eurozone	Economy expanded in 2011, but contraction is expected in Q4 and in 12Q1. In recent months, IPI contracted (-0.8% on average the last 3 months). Activity in services and manufacturing is improving, but the PMI index remains in contraction territory (Manufacturing: 46.9, Services: 48.8). Consumer confidence and economic sentiment are worsening (losing -1.2, -0.5 respectively). Private consumption has worsened, as retail sales data indicates (-0.4% on average the last 3 months). Inflationary pressures eased and unemployment increased only slightly (at 10.3%).
Germany	Strong GDP growth of 3% in 2011, though slight contraction in Q4. Industrial production fell after a rebound in October, and PMI Manufacturing improved, but remains in contraction (at 48.4p). Activity in services has rebounded and now is back to expansion (at 52.4p). Retail sales dropped in November, but remained flat on a 3 month average (-0.9% m/m in November). Unemployment is low, and remained flat at 5.5%. Inflation remains above the target level (HICP: 2.3% y/y), but pressures have eased. Economic sentiment is recovering, as seen in ESI survey and especially as reflected in the ZEW indicator for January, which registered a considerable rise (up by 33.6 p).
France	Positive economic growth in 2011, with Q4 probably flat, and anaemic growth expected for 2012. Industrial production improved (+1-1% m/m) after stagnating in October, but on average in the last 3 months it fell by 0.3%. Consumer confidence is sharply falling (down -6.6p), but economic confidence has slightly risen. PMI in Services rebounded, and now in expansion (at 50.3p). PMI manufacturing improved (at 48.9p), but is still in contraction. Unemployment remains at quite high level (at 9.8%), but flat. Inflationary pressures have eased (at 2.7%).
Italy	GDP in Q2 grew more than in Q1, but saw a mild contraction in Q3. Activity is expected to contract in 2012. Industrial production rebounded the last month, but recent trend points to -1.8% of fall the last 3 months to November. Consumers feel more comfortable about their situation, with the survey index gaining 4.7p. PMIs are both in contraction (at 44.3 for manufacturing, 44.5 for services), but manufacturing improved, while services were down. Unemployment remains virtually flat at 8.6% and inflationary pressures eased, with some decrease in HICP in November, to reach 3.7% in December.
Spain	GDP stagnated in Q3 and is expected to have contracted in Q4, indicated by PMI manufacturing and services negative figures, while a slowdown in the pace of deterioration in activity in December was observed. Industrial production is trending downwards, with November figure for growth at -1% and industrial new orders losing -2.21%. The same is true for retail sales, which fell by -0.7% on the month. In line with all these developments, ESI has been falling for months. Consumer confidence is improving though, 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.
Ireland	Economy weakened sharply in Q3, and is expected to contract further, but Ireland remains the best performer compared to the rest periphery. Industrial production fell strongly in Nov (-9.4% m/m), but by -2.3% as a 3 month average. Retail sales were stronger the last two months, with a 2% increase the last month. Unemployment is particularly high (at 14.6%), but stable There are no concerns about inflation, which stands comfortably below the target at 1.7%.
Greece	Economy is only contracting since 2008. In 2011 a contraction of as much as 6% is expected There is a declining trend in every indicator, with some rebound in confidence (up +1.8 and +1.5 for ESI and consumer surveys respectively) and IPI recently (but -2% in last 3 months to November), which might be short dated. Unemployment is growing exponentially, reaching 18.2% in October and will remain a big concern in the future. Inflation is falling, due to decreasing activity and strong austerity measures that restrict demand.
Portugal	GDP in contraction, registering -0.6% q/q in Q3, a situation which is expected to last for at least a year. Industrial production is clearly trending down, with only August showing strong growth, together with retail sales, which deteriorated throughout the quarter. Consumer confidence is not doing any better (losing -1.2p), while ESI has improved (gaining +0.7p). Unemployment is relatively high, but stable. Inflation stands at 3.5%, but is not a concern, amid austerity measures and negative GDP growth.

Source: BBVA Research

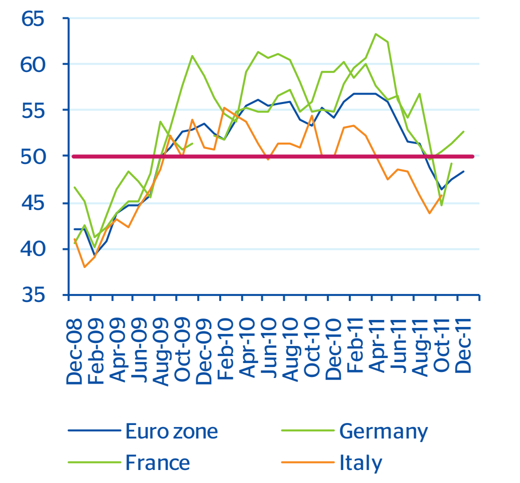
PMIs: Improvement in both manufacturing and services, but still below the no change level

Chart 1
Countries: Markit PMI Manufacturing Index



Source: Markit Economics

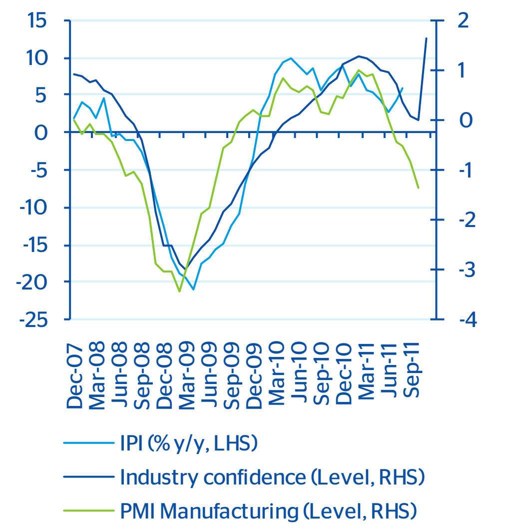
Chart 2
Countries: Markit PMI Services Index



Source: Markit Economics

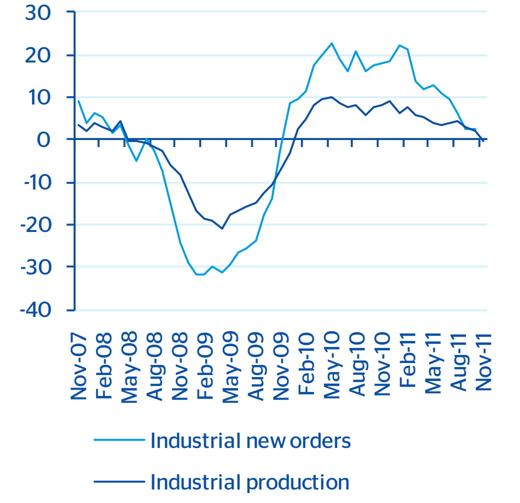
Clear downward trend in industrial activity, while volatile new orders are losing ground on average

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



Note: Standarized soft data
Source: Eurostat and European Commission

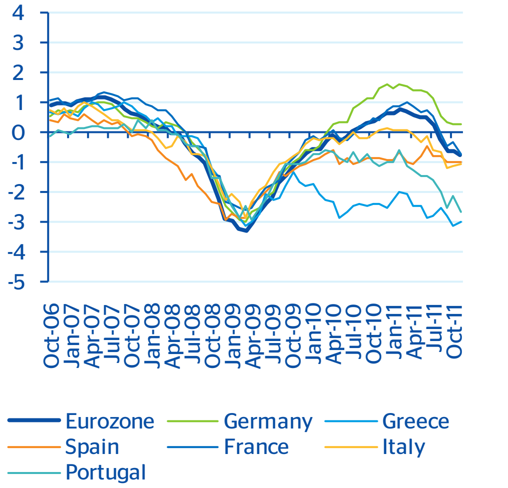
Chart 4
Eurozone: Industrial new orders and production(%y/y)



Source: Eurostat

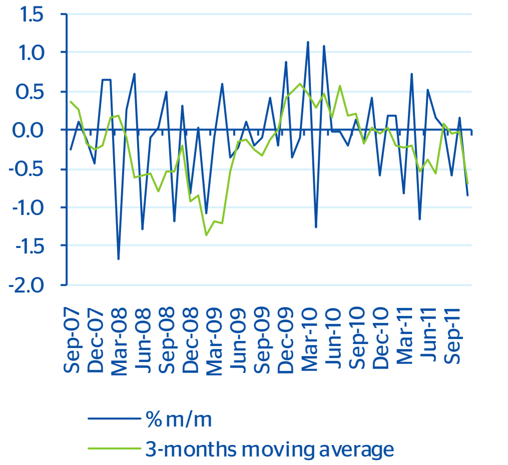
Confidence keeps falling, only Germany above the trend average, while retail sales dropped in November

Chart 5
EC: Economic Sentiment by country



Source: European Comission & BBVA Research

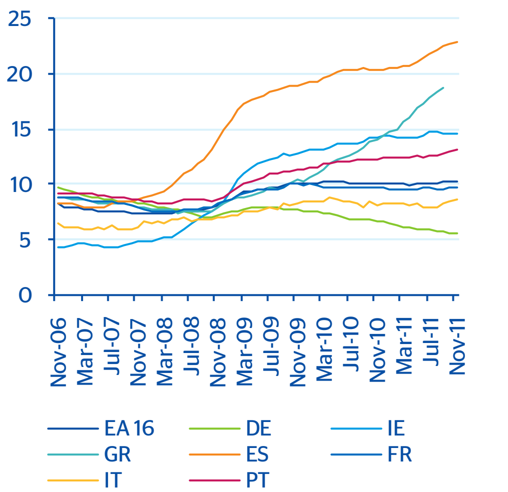
Chart 6
Eurozone: Retail sales



Source: Eurostat & BBVA Research

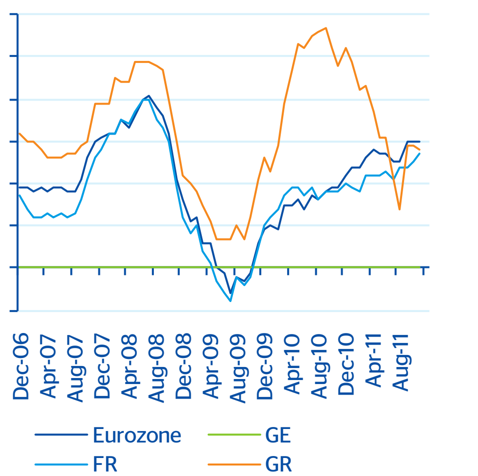
Unemployment broadly stable with the exception of Greece, Spain, while inflationary pressures have eased

Chart 7
Countries: Unemployment rate (%)



Source: Eurostat & BBVA Research

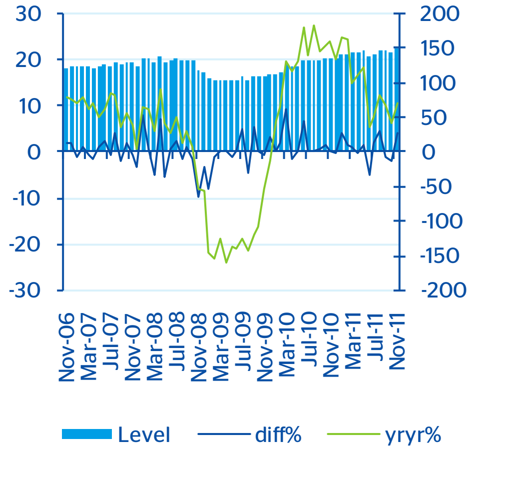
Chart 8
Selected countries: HICP inflation



Source: Eurostat & BBVA Research

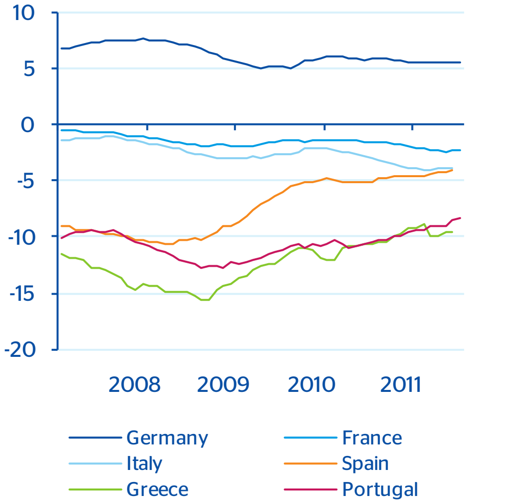
Trade surplus improved significantly in November

Chart 9
Eurozone Exports



Source: Eurostat & BBVA Research

Chart 10
Trade balance



Source: European Commission & BBVA Research

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