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Special Commentary

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The Eurozone: the Good, the Bad and the Ugly

Executive Summary

Recent developments have raised our optimism about the near-term economic prospects in the Eurozone. The collapse in oil prices since last summer is putting extra purchasing power in the pockets of European consumers, and the ECB, which had gradually been moving toward a more accommodative policy stance, has finally adopted a full-fledged program of asset purchases. There are already some incipient signs of modest acceleration in economic activity, and we look for real GDP growth in the overall euro area to strengthen over the next two years.

In our view, however, it is unlikely that real GDP growth over the next two years will approach, at least not on a sustained basis, the 2.5 percent annual growth rate that the Eurozone averaged between 2004 and 2007. Deceleration in the labor supply and in productivity has resulted in a lower potential GDP growth rate that is unlikely to pick up significantly anytime soon. In addition, there are some downside risks related to Greece and Russia that investors should monitor closely in coming weeks and months.

The Good: Growth in the Eurozone Should Strengthen This Year

Although the calendar says that we are in the middle of winter, there are some green shoots that indicate spring may be just around the corner in terms of economic growth in the Eurozone. Although growth in the Eurozone is sluggish at present—real GDP in the overall euro area rose only 0.8 percent on a year-ago basis in Q3-2014 (latest available data)—there appear to be some budding signs of acceleration in economic activity. Moreover, there are some recent economic and financial developments that should act as tailwinds to boost real GDP growth in 2015 and 2016.

There appear to be some budding signs of acceleration in economic activity.

Figure 1

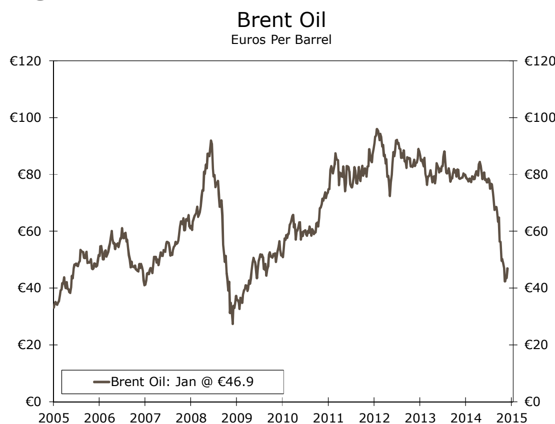
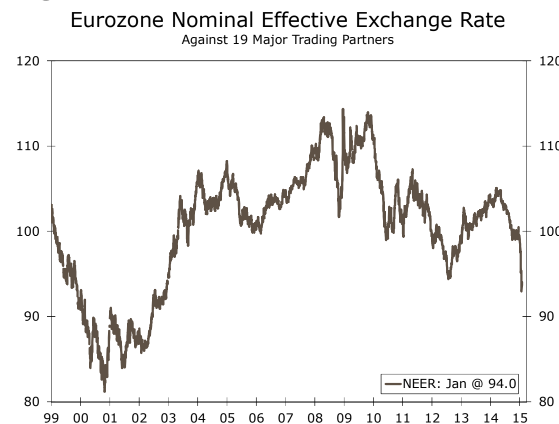


Figure 2



Source: Bloomberg LP, European Central Bank and Wells Fargo Securities, LLC

For starters, the sharp decline in petroleum prices—the euro-price of Brent oil has tumbled about 50 percent since last summer (Figure 1)—should help to support growth in consumer spending via

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Lower oil prices and euro depreciation should help to boost economic growth.

its positive effects on growth of real disposable income.[1] In addition, the depreciation of the euro, which has weakened nearly 10 percent on a trade-weighted basis versus the currencies of the Eurozone's 19 most important trading partners since last June, is another source of stimulus for the euro area (Figure 2). Although roughly 60 percent of the exports of individual countries within the Eurozone go to other countries in the Eurozone, which obviously are not affected by exchange rate changes, the other 40 percent of exports should get a boost from the improved price competitiveness that euro depreciation imparts.

ECB policy has turned more accommodative.

The accommodative policy stance of the ECB also should help to support growth this year. First, the ECB announced on January 22 that it will begin to purchase €60 billion worth of private-sector and sovereign bonds on a monthly basis beginning in March.[2] The anticipation of the ECB's policy move may have helped to lift equity prices in Europe in recent months. For example, the Euro Stoxx 50 index, which covers 50 blue-chip stocks from 12 countries in the Eurozone, has risen to a 7-year high in recent weeks, although it remains about 25 percent below its 2007 peak (Figure 3). Equities (both directly and indirectly owned via mutual funds) account for roughly one-quarter of household financial assets. Consequently, this rise in share prices will help to lift household wealth in the euro area, which may have some positive spillover effects on consumer spending.

Figure 3

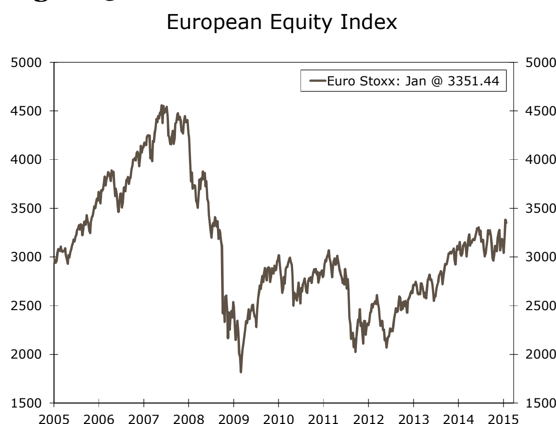
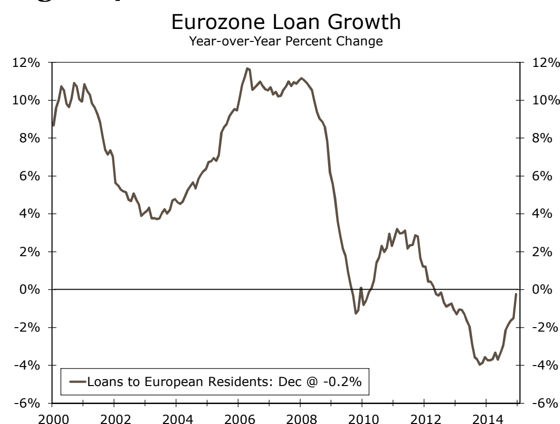


Figure 4



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities, LLC

Not only has ECB policy turned more accommodative via its newly announced program of bond purchases, but it is attempting to lift bank lending directly. In June 2014 the ECB unveiled a new program that was entitled Targeted Long-Term Refinancing Operations (TLTRO). The program was designed to encourage more bank lending by providing low-cost term liquidity to banks, provided that they use the funds to make loans to the private sector.[3] The ECB has conducted two tenders since September, and the Governing Council decided at its January 22 policy meeting to lower the interest rate it charges banks on upcoming tenders.

There are some tentative signs that the TLTRO program may be starting to bear some fruit. Bank lending in the Eurozone, which had been contracting for roughly two years, appears to be stabilizing (Figure 4). Interest rates on bank loans have also receded in recent months. For example, ECB data show that interest rates on business loans have generally declined by 50 bps to 60 bps over the past year, and mortgage rates for households have eased by similar amounts over that period. The most recent ECB banking survey showed that banks have eased credit standards

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[1] **Petroleum products have a 5.6 percent weight in the Eurozone consumer price index.**
[2] **For further reading see "*ECB Announcement Largely Exceeds Expectations*" (January 22, 2015). This report and other Wells Fargo economic reports that will be referenced subsequently are all available upon request.**
[3] **For further reading on the specifics of the TLTRO program see our report entitled "*ECB Announces a Package of Policy Changes*" (June 5, 2014).**

for both businesses and households, although the survey did note that "the level of credit standards is still relatively tight in historical terms." Banks also reported an increase in loan demand by non-financial corporations and households. Positive credit growth in coming months, should it be realized, would help support stronger growth in economic activity.

Bank lending, which had been contracting, appears to be stabilizing.

Figure 5

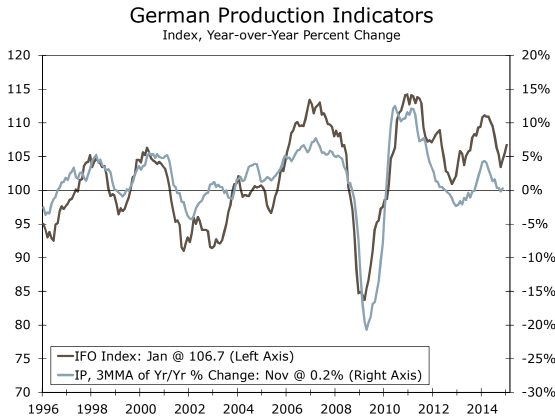
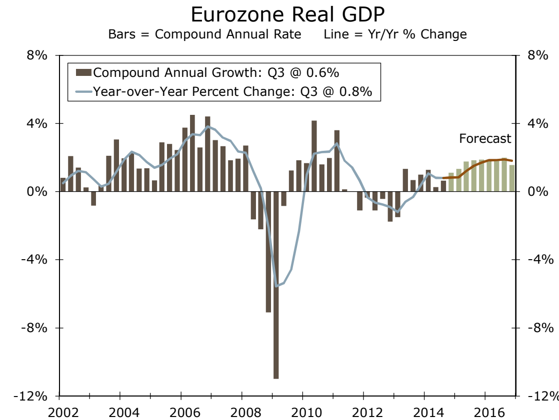


Figure 6



Source: IHS Global Insight and Wells Fargo Securities, LLC

Indeed, there are some incipient signs that economic growth in the euro area may be starting to strengthen, if only at the margin. The Ifo index of German sentiment, which has a fair degree of correlation with growth in German industrial production (IP), has risen for three consecutive months (Figure 5). If the historical relationship between the Ifo index and growth in IP continues to hold, German production should accelerate in coming months. Indeed, the volume of German manufacturing orders rose to their highest level in the current recovery in December. A widely followed index of German consumer confidence rose to its highest level in at least ten years in January, and surveys of business and consumer confidence in many other euro area countries have generally edged higher in recent months.

As previously noted, the pace of real GDP growth in the Eurozone has generally been anemic over the past few quarters. Looking forward, however, we forecast that economic growth will strengthen to a modest rate by the end of this year (Figure 6). In terms of annual growth rates, we look for real GDP growth to pick up from roughly 1 percent last year to 1.3 percent in 2015 and to 1.8 percent in 2016.

Real GDP growth in the Eurozone should strengthen in 2015 and 2016.

The Bad: Potential Growth Rate Has Downshifted

Although growth in the Eurozone should strengthen in the next two years, the overall rate of economic growth will likely remain slow by the standards of previous expansions, due to the apparent downshift in the potential GDP growth rate in the Eurozone.[4] The Organisation of Economic Cooperation and Development (OECD) estimates that potential GDP growth in the euro area was roughly 2 percent per annum during the 1990s (Figure 7). Today, the OECD reckons that the potential rate of GDP growth in the overall euro area has receded to less than 1 percent per annum. Although potential growth rates in both Germany and France appear to be slightly above 1 percent at present, the rate in Italy has essentially collapsed to zero.

This deceleration in potential GDP in the Eurozone is a function of two factors. First, falling rates of population growth over the past two decades has resulted in a slowdown in labor force growth. In the past decade, the population in the overall euro area was growing roughly 0.5 percent per annum. Today, it is increasing about 0.2 percent per year. The second factor that has weighed on

[4] Potential GDP measures the amount of output an economy could produce if all the resources (i.e., labor and capital) within the economy were fully employed. Growth in potential is the economic growth rate that would be associated with no change in the economy's inflation rate.

potential economic growth has been a marked decline in labor productivity growth. In the years leading up to the global financial crisis, productivity was growing about 1 percent or so per year. Between 2011 and 2013 (latest available data), it averaged only 0.5 percent per annum.

Figure 7

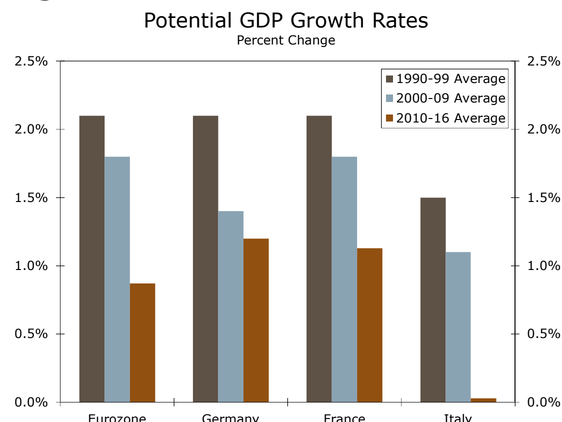
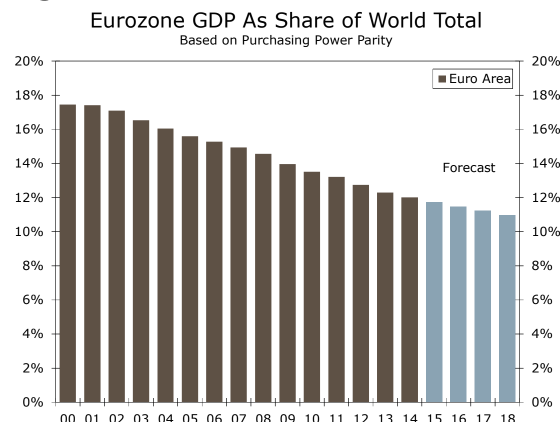


Figure 8



Source: OECD, IMF and Wells Fargo Securities, LLC

The underlying rate of labor productivity growth could surely strengthen in coming years, thereby lifting the potential GDP growth rate of the Eurozone. However, there does not seem to be an apparent reason to expect a marked acceleration in productivity in the foreseeable future. Unless countries open their borders to significantly more immigrants, which does not seem likely in the current political environment in Europe, labor force growth in the Eurozone will largely remain stagnant. Consequently, potential GDP growth in the region will likely remain weak over the next few years, and the Eurozone's share of global GDP will continue to trend lower as other areas of the world grow faster than the euro area. (Figure 8)

The Ugly: Downside Risks

The good news is that economic growth in the euro area should pick up this year, although the decline in the potential growth rate over the past few years likely will limit the extent of any acceleration in economic activity. A few scenarios spring to mind, however, under which the economic outlook for the Eurozone could turn downright ugly.

Greek exit from the euro area represents a potential downside risk.

The first scenario involves Greece. The newly elected leftist government of the Hellenic Republic is asking its European partners to forgive or restructure some of the country's debt. Although a compromise likely will be worked out in coming weeks or months, there is the possibility that political constraints will prevent the two sides from actually reaching a deal. In that case, the Greek government would run out of cash, thereby triggering default and a likely Greek exit from the Eurozone.

When fears of a Greek exit were pronounced a few years ago, yields on Italian, Portuguese and Spanish government bond yields spiked. Market participants reasoned at the time that a Greek exit would demonstrate that monetary union in Europe is not irreversible, and that other countries in the euro area may ultimately be forced down that route if their debt dynamics did not improve.

Although yields on Greek government bonds have shot higher since investors first began to anticipate expectations of electoral victory by the leftist Syriza party, there has been little to no contagion on other highly indebted governments in the euro area, at least so far. With the ECB about to embark on a program of government bond buying and with the European Stability Mechanism (ESM) capitalized and operational, the Eurozone has more financial backstops in

place than it did three years ago at the height of the European sovereign debt crisis.[5] That said, a potential Greek exit from the euro area could trigger another wave of financial market instability in Europe. A spike in uncertainty could lead European consumers and businesses to pull back on spending, thereby leading to another downturn in the Eurozone.

There are two wild cards for the Eurozone related to Russia.

Russia represents the second wild card for the Eurozone economic outlook, and there two scenarios that potentially could turn ugly. First, Russia has about $700 billion worth of external debt outstanding. The sharp drop in the price of petroleum, which is the country's most important export, in conjunction with the nosedive in the value of the Russian ruble, make it more difficult for Russian borrowers to service this external debt.[6] Widespread default among Russian borrowers could be especially concerning to European financial institutions, which we estimate hold the lion's share of Russia's external debt. Significant losses among European financial institutions could send bank lending in the Eurozone lower again as banks attempt to rebuild capital.

Energy represents the second wild card related to Russia. Many countries in Western Europe import a significant proportion of their natural gas and petroleum supplies from Russia.[7] With the conflict in Ukraine heating up again, a new round of sanctions and counter-sanctions could develop between the West and Russia. Russia's trump card vis-à-vis Western Europe is its energy exports. Although an energy embargo would send the Russian economy into an even deeper recession, it is not inconceivable that the Kremlin would implement this option if it felt its interests in Ukraine were sufficiently threatened. An energy embargo, even if it were temporary, would send the Eurozone into its third recession since 2008.

Conclusion

Recent developments have raised our optimism about the near-term economic prospects in the Eurozone. The collapse in oil prices since last summer is putting extra purchasing power in the pockets of European consumers, and the ECB, which had gradually been moving toward a more accommodative policy stance, has finally adopted a full-fledged program of asset purchases. There are already some incipient signs of modest acceleration in economic activity, and we look for real GDP growth in the overall euro area to strengthen over the next two years.

In our view, however, it is unlikely that real GDP growth over the next two years will approach, at least not on a sustained basis, the 2.5 percent annual growth rate that the Eurozone averaged between 2004 and 2007. Deceleration in the labor supply and in productivity has resulted in a lower potential GDP growth rate that is unlikely to pick up significantly anytime soon. Although our base case scenario looks for economic activity in the euro area to accelerate modestly in coming quarters, there are some significant downside risks for the Eurozone that investors should monitor.

First, negotiations over further financial assistance to Greece are very fluid, and a Greek exit from the euro area, should one occur, could potentially lead to another bout of financial market volatility in Europe. Second, some Russian companies could face debt servicing difficulties on their external debt, which could have negative implications for some European financial institutions. In addition, tensions between Russia and the West could deteriorate further if the military conflict in Ukraine intensifies.

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[5] Countries in financial difficulty could tap the €500 billion ESM provided they agree to undertake fiscal and structural economic reforms.
[6] For further reading, see "*The Ruble's Collapse and Russian External Debt*" (December 11, 2014).
[7] See "*Russian Economic & Financial Leverage on the West*" (July 24, 2014).

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