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Economics Group

Special Commentary

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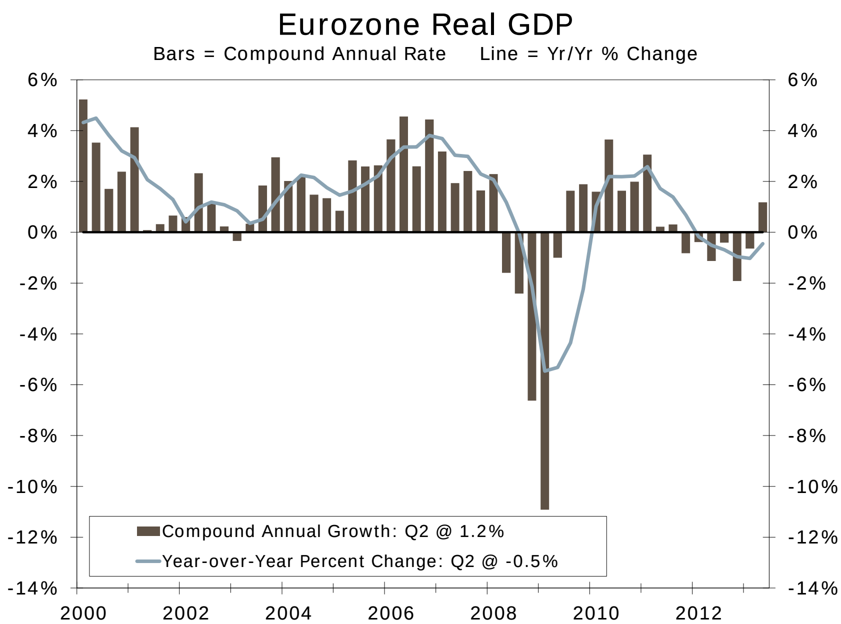
Is the Eurozone Economy Starting to Thaw?

The Eurozone Has Exited Recession

Data released last month showed that real GDP in the 17 economies that comprise the Eurozone grew 0.3 percent (1.2 percent at an annualized rate) on a sequential basis in the second quarter (Figure 1). The positive growth rate, although far from "strong," is noteworthy because it brought to an end the second recession that the overall euro area has suffered in the past five years.

Figure 1



Source: IHS Global Insight and Wells Fargo Securities, LLC

Growth in final domestic demand was weak, although broad based, in the second quarter.

Not only did the revised GDP data that were released on September 4 confirm the growth rate for the second quarter that was initially reported last month, but the revised data also contained a breakdown of real GDP into its underlying demand components. (The breakdown was not available at the time of the original release.) This breakdown showed that growth in domestic demand was rather weak, although it was broad-based. Specifically, real consumption expenditures edged up at an annualized rate of 0.7 percent in Q2, fixed investment spending grew 1.0 percent, and government spending rose 1.7 percent. Together, these three spending categories comprise final domestic demand (FDD), which rose 1.0 percent during the second quarter, the first positive growth rate in FDD in six quarters. After two consecutive quarterly contractions, real exports of goods and services grew at a respectable annualized rate of 6.8 percent, and real imports were up 5.5 percent. Net exports of goods and services, which measure the difference between exports and imports, made a positive contribution to overall GDP growth that totaled 0.8 percentage point.

Growth Should Remain Modestly Positive in Near Term

There have not been many "hard" economic indicators released yet on the state of economic activity in the overall euro area in the third quarter. However, the "soft" indicators released to date suggest that Eurozone economic growth has remained positive. For starters, the economic sentiment index, which attempts to measure general economic activity, has risen for four consecutive months (Figure 2). Consumer confidence strengthened markedly over the summer, and it now stands at its highest level in two years. Although retail sales in the Eurozone edged up only 0.1 percent in July relative to the previous month, retailers and service sector providers are also expressing more confidence. The increase in confidence among consumers and retailers in conjunction with some incipient stability in the labor market—the number of unemployed workers in the euro area edged down 0.3 percent between May and July, suggests that consumer spending should continue to grow, if only at a weak pace, over the next few months.[1]

Figure 2

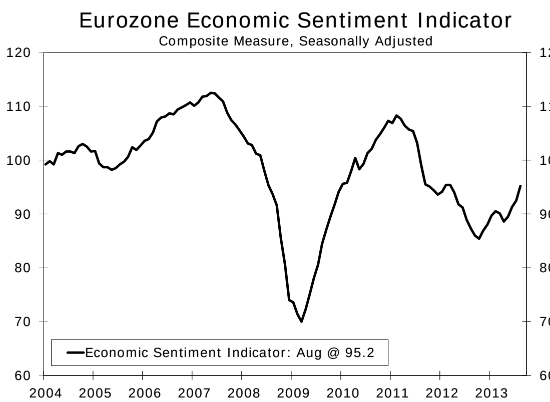
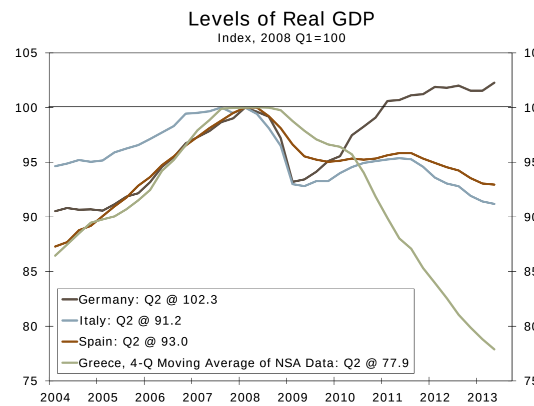


Figure 3



Source: IHS Global Insight and Wells Fargo Securities, LLC

It appears that a recovery may be starting to take hold in the euro area.

At this point, it looks as though real GDP in the overall euro area should grow at more or less the same rate in the third quarter as it did in the second quarter. Not only did industrial production (IP) end the second quarter with good momentum—IP rose 0.7 percent in June on a month-over-month basis—but the decline in inventories during the second quarter indicates that there is not much of an inventory overhang that would constrain production growth in the near-term.[2] Therefore, it appears that a recovery may be starting to take hold in the euro area.

That said, the recovery is very fragile at this point, and the euro area has a long way to go before a self-sustaining expansion becomes firmly entrenched. Five years after the Eurozone entered its own Great Recession, the level of real GDP in the overall euro area remains 3 percent below its Q1-2008 high.[3] However, there is a wide divergence among individual countries within the euro area. The German economy, the largest and most powerful one in Europe, is more than 2 percent larger today than it was at the beginning of 2008 (Figure 3). However, the Spanish and Italian economies have contracted roughly 7 percent and 9 percent, respectively, on balance over the past five years, and the Greek economy is more than 20 percent smaller today than it was at its peak in 2008. Although there are some tentative signs that the Greek economy may be nearing a bottom, it will be many years before the level of Greek real GDP surpasses its previous peak.

[1] **It would be preferable to look at data on employment (rather than unemployment) when discussing recent labor market trends. However, employment data in the Eurozone are released on a quarterly basis only with a long lag.**

[2] **Inventories sliced 0.1 percentage point from the overall GDP growth rate in the second quarter.**

[3] **U.S. real GDP currently stands 4.6 percent above its previous high, which was reached in Q4-2007.**

Long-Run Challenges Remain

Although economic activity appears to be turning the corner, the Eurozone continues to face some challenges that likely will restrain growth through next year and perhaps beyond. For starters, fiscal policy, which has been restrictive for four consecutive years, should continue to exert headwinds on growth in 2014. The Organisation for Economic Cooperation and Development projects that every individual economy in the Eurozone will incur a smaller structural budget deficit in 2014 than in 2013.[4] The decline in the aggregate euro area structural budget deficit from 1.0 percent of GDP in 2013 to 0.4 percent of GDP in 2014 that the OECD projects implies that there will be a negative fiscal impulse equivalent to 0.6 percent of GDP next year (Figure 4). Although the fiscal tightening that is projected for next year will not be restrictive as the tightening that has occurred in each of the past three years, it nevertheless will exert some headwinds on economic growth.

Fiscal policy should continue to exert headwinds on economic growth.

Figure 4

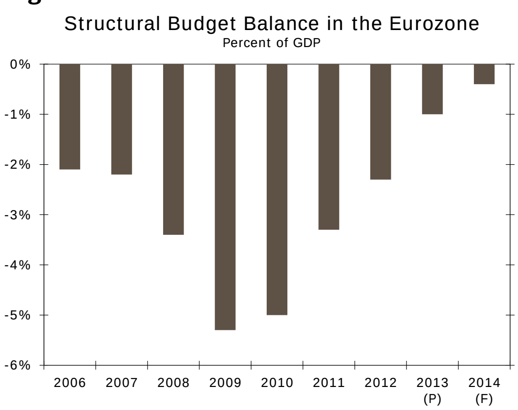
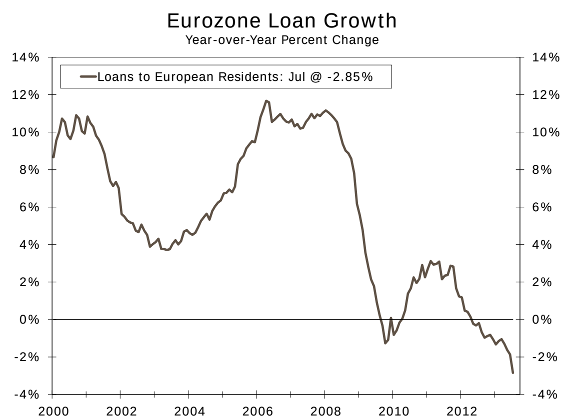


Figure 5



Source: Organisation for Economic Cooperation and Development, IHS Global Insight and Wells Fargo Securities, LLC

In addition, bank lending remains anemic. Total bank loans fell nearly 3 percent on a year-over-year basis in July (Figure 5), and bank lending to nonfinancial companies (NFCs) is especially weak. Lending to households is roughly flat at present, but lending to NFCs was down more than 5 percent in July, the most rapid rate of contraction on record. It is difficult to envision a sustained economic expansion, at least not a strong one, if bank lending to businesses continues to head south.

Bank lending remains anemic.

This weakness in lending to NFCs is a major challenge facing the European Central Bank (ECB). If reducing the bank's main policy rate, through which it provides short-term liquidity to the banking system, would induce banks to lend more to businesses the ECB surely would be cutting rates further. But would banks really lend significantly more if the ECB cut its main policy rate, which is already at a record low of only 0.50 percent, if the ECB cut the rate by 25 bps or even by 50 bps? The ECB doesn't seem to think that another rate cut would lead to significant acceleration in bank lending. Weak banks may need more capital in order to ramp up lending significantly, but capital injections are largely beyond the purview of the ECB.

Finally, the European sovereign debt crisis, although largely on the back burner at present, is not entirely solved either. The problem that individual countries in the euro area face is that they do not have the ability to independently stimulate their economies if they are hit by an adverse asymmetric shock. Exchange rate adjustments are impossible because each country in the

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[4] **Because fluctuations in economic growth will affect fiscal deficits or surpluses through its effect on expenditures and revenues, economists often measure changes in fiscal policy, so-called fiscal impulses, through changes in the structural budget balance, which adjusts for the effects of the business cycle. Smaller structural deficits (larger surpluses in the cases of Estonia, Greece, Italy, and Luxembourg) in 2014 than in 2013 mean that those governments are tightening fiscal policy.**

The European sovereign debt crisis is not entirely solved.

Eurozone has adopted the euro as its currency. Monetary policy is in the hands of the ECB, which sets policy according to economic conditions within the overall euro area not for any specific individual economy. Fiscal policy is constrained by the fiscal pact that countries endorsed at their December 2011 summit meeting.[5] Therefore, it is not hard for countries to fall into a vicious circle of economic contraction, widening fiscal deficits that require budget cutting, further downward pressure on economic activity, more budget cutting, etc.

The Eurozone needs a fiscal union, much like the one that exists in the United States, to give it macroeconomic stability in the face of asymmetric shocks. That is, when a region within the United States, say the West Coast, is hit by an adverse shock, the rise in unemployment in that region is blunted by the fiscal transfers that it automatically receives from the rest of the nation.[6] These types of transfers do not automatically occur in the Eurozone, with the result that unemployment can rise sharply.[7] If unemployment remains elevated for a long time, some politicians may begin to advocate an exit from the monetary union. A full-fledged banking union among all member states would lend even more macroeconomic stability to the Eurozone.

Fiscal and banking unions, although easy to envision in theory, are difficult to establish in practice because they involve painful political decisions. Although some progress has been made in the establishment of a banking union, a fiscal union is a distant dream. Until institutions like fiscal and banking unions that would enhance the macroeconomic stability of the Eurozone are established, the euro area will continue, in our view, to represent a potential source of financial market instability.

Conclusion

It appears that economic activity in the Eurozone is expanding again following the second recession in five years. Real GDP growth turned positive in the second quarter, driven in part by domestic demand, and available indicators from the current quarter suggest that growth has remained positive. Provided that the global economy does not experience a negative shock anytime soon, real GDP growth in the overall euro area likely will remain positive for the foreseeable future.

That said, the pace of economic growth in the overall euro area will likely not be strong anytime soon. Not only will restrictive fiscal policy continue to exert headwinds on growth in many economies, but credit growth likely will remain constrained for the foreseeable future. Moreover, the European sovereign debt crisis is not fully "solved" at this point. Until Europe is "fixed" it will remain a potential source of financial market instability.

[5] **The fiscal rule requires that structural budget deficits for individual countries not exceed 0.5 percent of GDP. Consequently, expansionary fiscal policy is limited, if not forbidden entirely, when downturns occur.**

[6] **Unemployed workers in the affected region receive unemployment compensation that is financed by taxpayers in other states.**

[7] **The unemployment rate from Spain has risen from 8 percent in 2007 to 26 percent presently. The unemployment rate in Greece is nearing 30 percent.**

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