



# Perspectives by Ruth Lea

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## EU economy “on the road to a gradual recovery” – we hope

Last week Eurostat, the Statistical Office of the European Communities, released the third quarter flash estimates for the EU27’s GDP. It showed a 0.2% increase in the quarter. For the euro area (EA16) in general, and for Germany in particular, they made more satisfactory reading. GDP for the EA16 rose 0.4% in the quarter, with Germany experiencing 0.7% growth.<sup>1</sup>

The knowledge that Britain’s largest export market is showing a tentative recovery is good news. As we argued in a recent Perspective, Britain’s economic recovery could be unusually dependent on exports, owing to the need for significant fiscal tightening and potentially sluggish growth in consumer demand.<sup>2</sup> But beyond this positive sentiment, Eurostat’s press release incorporating Britain’s third quarter fall in GDP, made for gloomy reading. The UK economy was one of the few major EU economies that continued to contract in the third quarter - as shown in the following table.<sup>3</sup>

### Changes in GDP, volume data: selected EU and other major economies

	Quarterly change (%)				Year-on-year change (%)			
	2008		2009		2008		2009	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
EA16	-1.8	-2.5	-0.2	0.4	-1.8	-4.9	-4.8	-4.1
EU27	-1.9	-2.4	-0.3	0.2	-1.7	-4.8	-4.9	-4.3
Selected EU Member states:								
France	-1.5	-1.4	0.3	0.3	-1.7	-3.5	-2.9	-2.4
Germany	-2.4	-3.5	0.4	0.7	-1.8	-6.7	-5.8	-4.8
Ireland	-5.6	-2.3	0	Na	-8.0	-9.3	-7.3	Na
Italy	-2.1	-2.7	-0.5	0.6	-2.9	-6.0	-5.9	-4.6
Netherlands	-1.0	-2.4	-1.0	0.4	-0.7	-4.5	-5.4	-3.7
Spain	-1.1	-1.6	-1.1	-0.3	-1.2	-3.2	-4.2	-4.0
UK	-1.8	-2.5	-0.6	-0.4	-2.0	-5.0	-5.5	-5.2
Key EFTA countries:								
Norway	0.4	-0.8	-1.3	Na	0.5	-0.7	-2.5	Na
Switzerland	-0.6	-0.9	-0.3	Na	-0.2	-1.6	-2.1	Na
Main economic partners:								
US	-1.4	-1.6	-0.2	0.9	-1.9	-3.3	-3.8	-2.3
Japan	-3.4	-3.3	0.6	Na	-4.5	-8.4	-7.2	Na

Source: Eurostat, “Euro area GDP up by 0.4% and EU27 GDP up by 0.2%”, 13 November 2009. The data are seasonally adjusted. The US quarterly data are released by the US authorities in annualised format.

Of the major EU economies France, Italy and the Netherlands, as well as Germany, grew in the third quarter, whilst Spain joined the UK by remaining in recession.

*The Commission's forecasts: "on the road to a gradual recovery"*

The previous week the Commission had released their autumn forecast for the EU27, the press release of which was optimistically titled "EU economy on the road to a gradual recovery".<sup>4,5</sup> The main forecast data are shown in the table below.

**European Commission: GDP forecasts, annual growth rates (%)**

	2007	2008	2009		2010		2011
			Spring 2009	Autumn 2009	Spring 2009	Autumn 2009	Autumn 2009
EU27	2.9	0.8	-4.0	-4.1	-0.1	0.7	1.6
Selected EU Member states:							
France	2.3	0.4	-3.0	-2.2	-0.2	1.2	1.5
Germany	2.5	1.3	-5.4	-5.0	0.3	1.2	1.7
Ireland	6.0	-3.0	-9.0	-7.5	-2.6	-1.4	2.6
Italy	1.6	-1.0	-4.4	-4.7	0.1	0.7	1.4
Spain	3.6	0.9	-3.2	-3.7	-1.0	-0.8	1.0
UK	2.6	0.6	-3.8	-4.6	0.1	0.9	1.9

Source: European Commission, Economic and Financial Affairs, *European Economic Forecast – autumn 2009*, November 2009. Available from [www.ec.europa.eu](http://www.ec.europa.eu).

The autumn forecast was more optimistic than spring's, but the Commission emphasised that the better-than-expected rebound in the near term was expected to be followed by a "certain easing in growth". In other words, even though they were forecasting a "gradual recovery", growth could lapse before achieving a more sustainable period of growth. The reason for this caution was that this initial upturn in activity in the EU (and incidentally in other major economies) was largely driven by temporary factors. These included inventory adjustment (with the destocking process coming to an end) and stimulus measures which were expected to fade away in the course of next year. The stimulus measures included various car scrappage schemes and employment support measures in, for example, Germany and France which have curtailed – and probably delayed – the shedding of labour.

*The EU economy: individual member states*

The Commission tends to discuss the EU economy as if it were an integrated quasi-national economy. Concerning the EA16 this has some legitimacy because at least they have the same currency and are subject to the same short-term interest rates. But what is striking about the forecasts is just how disparate the economies are.

Germany, the EU's biggest economy, with its powerful export-oriented manufacturing sector suffered an especially sharp decline as the global crisis hit last year. Germany, with Japan, experienced the most severe "peak-to-trough" declines among the G7 nations, reflecting the paralysis in world trade that set in towards the end of last year as trade and shipping credit dried up. As credit lines reopened with the general easing in money market tensions earlier this year, these two exporting nations have been the ones to benefit most. And Germany's growth in the third quarter partly reflected firmer exports – which should lead into broader-based recovery. Looking further out, German growth should be assisted by Chancellor Merkel's plans to cut income and corporate taxes by €24bn a year to 2013.<sup>6</sup> Uncharacteristically, German policy is aiming for growth, with the public finances apparently of secondary concern.

France, the EU's second biggest economy (on some measures) fairly successfully weathered the recessionary storm that hit many economies, the French banking system proved resilient, and an uneven recovery is underway. But the third quarter GDP, though showing a 0.3% quarterly increase, disappointed. Demand relating to business investment and housing stayed soft whilst household consumption overall failed to grow in the quarter, despite government support. The key issue for France, and incidentally the US, is the sustainability of their recoveries. Both are highly dependent on stimulus measures which, for budgetary reasons, will sooner or later have to be phased out. French general government borrowing is expected to be over 8% of GDP in 2009 and 2010 – not as bad as in the UK, but bad enough

The UK's path to recovery will be complicated by economic imbalances – especially in the public finances, as we have discussed in several previous Perspectives. Britain has experienced more acute problems in the banking sector, a greater impact of the credit crunch, with more indebted consumers and the deflationary after-effects of a housing boom, than Germany or France. And this doubtless part-explains Britain's laggardly performance. The Commission is, however, expecting the UK's growth to exceed the EU average in both 2010 and 2011. The weaker currency should assist Britain's recovery.

But the Commission added a note of caution. "...these projections are clouded with considerable risks and uncertainties. The prospects for a return to strong growth will depend in part on when and how imbalances in the government and household sectors are unwound". And the poor 3<sup>rd</sup> quarter GDP data were released after the Commission's cut-off date for the forecasts and have considerably increased the downside risks.<sup>7</sup>

Italy has returned to moderate growth after the crisis, but its underlying competitiveness problems are unresolved and its large debt/GDP ratio limit the scope for fiscal stimulus. Spain, the EU's fifth biggest economy, is facing a protracted economic adjustment ahead. It has a high degree of household indebtedness and an oversized housing sector (as also in Ireland) as well as persistent competitive losses exacerbated by the strong euro.

#### *More warnings about public sector finances*

The most striking part of the Commission's forecast was the impact of recession on the public finances. As shown in the table below, public finances have been hard hit by the crisis and EU27 government borrowing as a percentage of GDP is expected to rise from 2.3% in 2008 to 7.5% in 2010 – before easing in 2011. The surge in borrowing follows from the working of automatic stabilisers as the economic situation deteriorated, the discretionary measures taken to support the economy and the stronger-than-usual responsiveness of public revenues to the exceptional decline in economic activity.

#### **General government net borrowing (negative), as a percentage of GDP: selected EU member states: Autumn forecast**

	2008	2009	2010	2011
France	-3.4	-8.3	-8.2	-7.7
Germany	0	-3.4	-5.0	-4.6
Greece	-7.7	-12.7	-12.2	-12.8
Ireland	-7.2	-12.5	-14.7	-14.7
Italy	0.9	-3.5	-5.7	-5.9
Latvia	-4.1	-9.0	-12.4	-12.2
Spain	-4.1	-11.2	-10.1	-9.3
UK	-5.0	-12.1	-12.9	-11.1
EU	-2.3	-6.9	-7.5	-6.9
Other countries:				
USA	-6.4	-11.3	-13.0	-13.1
Japan	-3.8	-8.0	-8.9	-9.1

Source: European Commission, Economic and Financial Affairs, *European Economic Forecast – autumn 2009*, November 2009. Available from [www.ec.europa.eu](http://www.ec.europa.eu).

The member states with the worst performances are Ireland (experiencing a brutal combination of a housing bust, banking crisis and export collapse), Greece (a new focus for fiscal concern) Latvia, Spain and the UK. But even France, and as already mentioned, borrowing is expected to be over 8% this year. Even Germany's borrowing to GDP ratio will be running at 4½% to 5% over the next two years.<sup>8,9</sup>

Similarly the government debt figures have been adversely affected by the crisis. EU debt as a % of GDP is expected to reach over 79% in 2010 and nearly 84% in 2011. Given sustained large deficits, lower potential output and unfavourable demographic developments, the EU's mounting stock of government debt is a source of concern for long-term sustainability.<sup>10</sup>

### General government gross debt, as a percentage of GDP: selected EU member states: Autumn forecast

	2008	2009	2010	2011
France	67.4	76.1	82.5	87.6
Germany	65.9	73.1	76.7	79.7
Greece	99.2	112.6	124.9	135.4
Ireland	44.1	65.8	82.9	96.2
Italy	105.8	114.6	116.7	117.8
Latvia	19.5	33.2	48.6	60.4
Spain	39.7	54.3	66.3	74.0
UK	52.0	68.6	80.3	88.2
EU	61.5	73.0	79.3	83.7

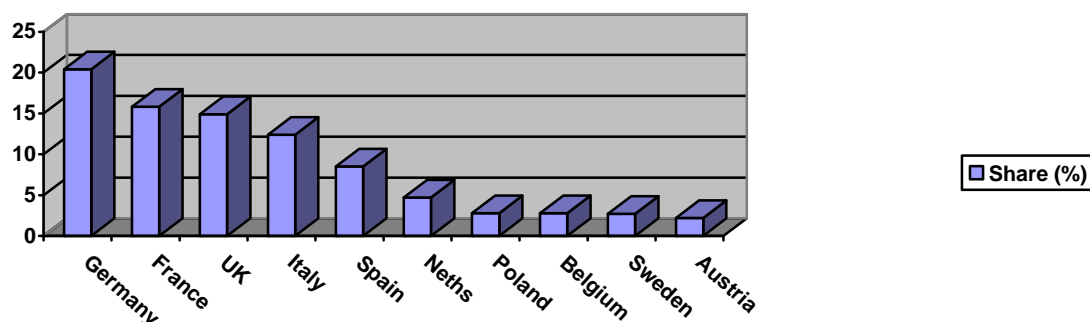
Source: European Commission, Economic and Financial Affairs, *European Economic Forecast – autumn 2009*, November 2009. Available from [www.ec.europa.eu](http://www.ec.europa.eu).

#### *A final thought*

We have discussed the prospects for the five biggest EU economies: Germany, France, the UK, Italy and Spain. These economies account for the lion's share of EU GDP.

As chart 1 below shows Germany accounted for around 20% of total EU Gross National Income (GNI) in 2008, France and the UK around 15% each, Italy about 12½% and Spain 8½%. In contrast 17 EU states accounted for less than 2% of EU GNI. Table 1 in the annex provides the detailed GNI data and table 2 shows the detailed derived statistics.

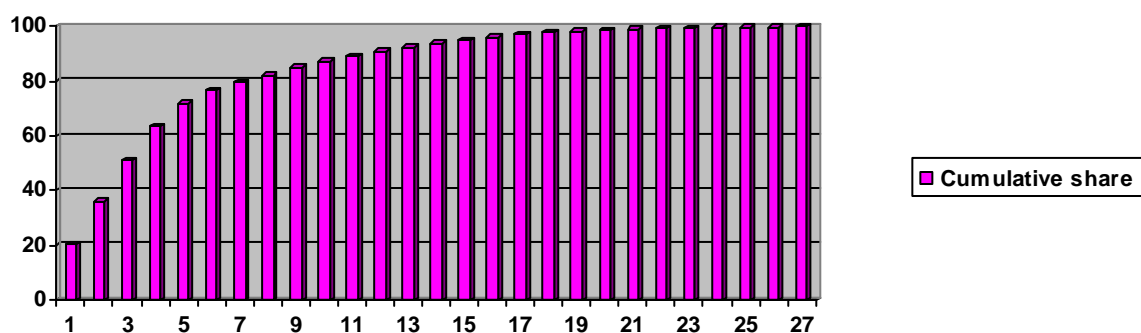
**Chart 1: 10 largest EU economies, share of EU27 total GNI, 2008**



Source: see table 2 in the annex.

Following on from these data on GNI shares, it is apparent that the EU's GNI is very concentrated in a few member states. Chart 2 below shows that the largest economy (Germany, designated number 1 in the chart) accounted for 20.4% of GNI in 2008, the 3 largest economies (Germany, France and the UK) for 51.1% and the 5 largest (Germany, France, the UK, Italy and Spain) for 72.0%. The ten largest member states accounted for over 87% of the EU's GNI.

Chart 2: EU27, cumulative share of the 27 individual economies, 2008



Source: see table 2 in the annex

## References

1. Eurostat, "Euro area GDP up by 0.4% and EU27 GDP up by 0.2%", 13 November 2009. Available from [www.ec.europa.eu](http://www.ec.europa.eu).
2. Ruth Lea, "Risks to global recovery risk a British recovery", Arbuthnot Banking Group Perspective, 2 November 2009.
3. The European Free Trade Association (EFTA) is an intergovernmental organisation set up for the promotion of free trade and economic integration to the benefit of its four Member States: Iceland, Liechtenstein, Norway and Switzerland.
4. European Commission, Economic and Financial Affairs, *European Economic Forecast – autumn 2009*, November 2009. Available from [www.ec.europa.eu](http://www.ec.europa.eu). The cut-off point for the forecasts was the end of October and did not include the third quarter figures. This could, of course, affect the forecasts – not least of all for the UK, where the Commission's forecast was quite upbeat.
5. European Commission, "Autumn forecast 2009-2011: EU economy on the road to a gradual recovery", 3 November 2009.
6. Bertrand Benoit, "Merkel's bold gamble", *FT*, 2 November 2009.
7. Note that the Bank of England unexpectedly raised its growth forecasts for 2010 and 2011 while predicting a relatively benign outlook for inflation in its November 2009, *Inflation Report*. Their forecasts show year-on-year growth of around 4% for the 2<sup>nd</sup> half of 2010 and the 1<sup>st</sup> half of 2011.
8. Under EU rules a country aspiring to join the eurozone is supposed to have a budget deficit of 3% or less and public debt of 60% or less, or that are descending to these levels. Suffice to say the rules are being widely flouted.
9. See also the IMF's "The state of public finances cross-country", *Fiscal Monitor*, November 2009, which warns of a decade of fiscal constraint.
10. Ruth Lea, "The public finances are shocking – but an ageing population means there is worse to come", Arbuthnot Banking Group Perspective, 19 October 2009. This Perspective discussed the European Commission, Economic and Financial Affairs Directorate-General, *Sustainability Report 2009*, October 2009, available from [www.ec.europa.eu](http://www.ec.europa.eu)

## Annex

**Table 1: 2008 Gross National Income, current market prices, €billions**

Member state	GNI, €billions, order in brackets	Share of EU total (%)
EU27	12,442	100.0%
Euro (16)	9,197	73.9%
Austria*	277 (10)	2.2%
Belgium*	347 (8)	2.8%
Bulgaria	34 (21)	0.3%
Cyprus*	16 (25)	0.1%
Czech Republic	137 (16)	1.1%
Denmark	237 (11)	1.9%
Estonia	15 (26)	0.1%
Finland*	184 (13)	1.5%
France*	1,963 (2)	15.8%
Germany*	2,537 (1)	20.4%
Greece*	231 (12)	1.9%
Ireland*	156 (15)	1.3%
Italy*	1,548 (4)	12.4%
Latvia	23 (24)	0.2%
Lithuania	31 (23)	0.25%
Luxembourg*	32 (22)	0.25%
Hungary	99 (18)	0.8%
Malta*	5 (27)	0.05%
Netherlands*	580 (6)	4.7%
Poland	353 (7)	2.8%
Portugal*	160 (14)	1.3%
Romania	131 (17)	1.05%
Slovakia*	63 (19)	0.5%
Slovenia*	36 (20)	0.3%
Spain*	1,061 (5)	8.5%
Sweden	336 (9)	2.7%
UK	1,851 (3)	14.9%

Source: European Commission, Economic and Financial Affairs, AMECO database. EA16 member states are asterisked. There are rounding errors in the table. Gross national income (GNI) takes into account all production in the domestic economy (i.e. GDP) plus the net flows of factor income (such as rents, profits and labour income) from abroad. Please note that for non-EA16 countries their GNI data in domestic currencies were converted into euros using 2008 exchange rates. Since then the euro has appreciated significantly, which will have improved the relative "performance" of the EA16 member states.

**Table 2: EU27, % share of total EU GNI, 2008 data**

	Share (%)	Cumulative share (%)
1 Germany*	20.4%	20.4%
2 France*	15.8%	36.2%
3 UK	14.9%	51.1%
4 Italy*	12.4%	63.5%
5 Spain*	8.5%	72.0%
6 Netherlands*	4.7%	76.7%
7 Poland	2.8%	79.5%
8 Belgium*	2.8%	82.3%
9 Sweden	2.7%	85.0%
10 Austria*	2.2%	87.2%
11 Denmark	1.9%	89.1%
12 Greece*	1.9%	91.0%
13 Finland*	1.5%	92.5%
14 Portugal*	1.3%	93.8%
15 Ireland*	1.3%	95.1%
16 Czech Republic	1.1%	96.2%
17 Romania	1.05%	97.2%
18 Hungary	0.8%	98.0%
19 Slovakia*	0.5%	98.5%
20 Slovenia*	0.3%	98.8%
21 Bulgaria	0.3%	99.1%
22 Luxembourg*	0.25%	99.3%
23 Lithuania	0.25%	99.5%
24 Latvia	0.2%	99.7%
25 Cyprus*	0.1%	99.8%
26 Estonia	0.1%	99.9%
27 Malta*	0.05%	100.0%

Source: European Commission, Economic and Financial Affairs, AMECO database. EA16 member states are asterisked.

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