



Perspectives

ARBUTHNOT BANKING GROUP PLC

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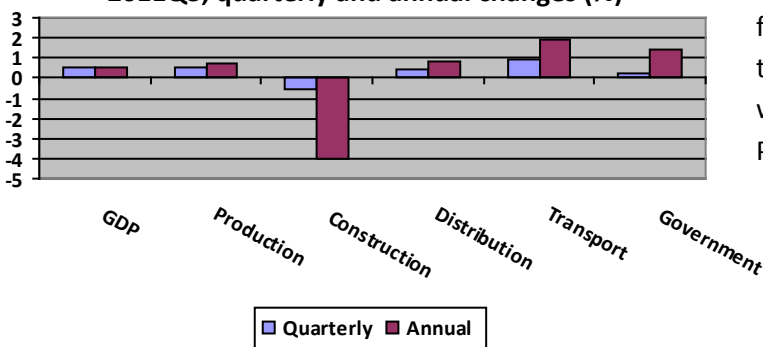


Britain will struggle to avoid a “double dip” recession, as Eurozone growth prospects sour

Introduction: better than expected UK GDP data

Last week's UK GDP was figure for 2011Q3 was better than expected. GDP grew in the quarter by 0.5%, bouncing back from the depressed second quarter estimate, but it was still only 0.5% above a year earlier. The economy has almost flat-lined over the past year and there must now be a risk of a “double-dip” recession. Chart 1 shows the third quarter data. Positive contributions to growth were made by all sectors except construction. Over the year the transport sector and Government and other services (especially health and education) have been the strongest growing sectors.

Chart 1 UK GDP and main components, 2011Q3, quarterly and annual changes (%)



Source: ONS, GDP, preliminary estimate, 2011Q3, 1 November 2011. Note distribution = distribution, hotels and restaurants; transport = transport, storage and communication; Government = Government and other services.

The latest Markit/CIPS PMI (purchasing managers' index) surveys suggest caution about growth expectations for the fourth quarter.² In October the manufacturing index slipped to 47.4 from 50.8 in September (any figure under 50 indicates a contraction in activity). The services index slowed, from 52.9 (September) to 51.3 (October). But the construction index unexpectedly jumped to 53.9 (October) from 50.1 (September). Given the dismal ONS data for construction, this finding should be treated cautiously.

If GDP manages to increase by, say, 0.2% in the final quarter of this year this would imply growth for 2011 as a whole of just 1.0% – somewhat down on the Office for Budget Responsibility's (OBR's) March forecast of 1.7%.¹ There is little doubt that the GDP forecasts will be downgraded at the time of the Autumn Statement (29 November). We will return to this issue in the next Perspective.

The Bank of England's Monetary Policy Committee will release its latest deliberations on Thursday, 10 November. There are no expectations of changes from October's meeting, when a second round of £75bn of Quantitative Easing was announced. Even though the timing of new round of QE was not entirely unexpected the size of the extra stimulus was. It was more than expected.³

Economic prospects deteriorate further in the Eurozone

The on-going Eurozone crisis is undoubtedly one of the biggest risks facing the British economy. But before discussing the latest efforts to "save" the Eurozone, it is instructive to note the deteriorating prospects in the Eurozone economy in recent months.

Eurostat estimated that GDP in the EU17 increased by just 0.2% in 2011Q2 after a 0.8% jump in 2011Q1 - driven by buoyant growth in Germany (1.3%), France (0.9%) and the Netherlands (0.8%).⁴ Granted quarterly data can be very volatile and the first quarter figures could have been distorted by weather events, but growth clearly slowed in the second quarter. The third quarter data are awaited. Going forward surveys for the Eurozone suggest sluggish or even negative growth. The Markit composite index for the Eurozone for October fell to a 28-month low of 46.5 down from 49.1 in September. Growth in Germany eased to its weakest for the current 27-month period of expansion, with Ireland the only other Eurozone nation to report growth. France and Italy deteriorated sharply whilst Spain remained in recession and Greece's outlook worsened even further.⁵

Major forecasting bodies are also revising their projections downwards, again, or suggesting they will. Even back in September all the major forecasting groups were

downgrading their forecasts and/or uttering warnings of difficulties to come:

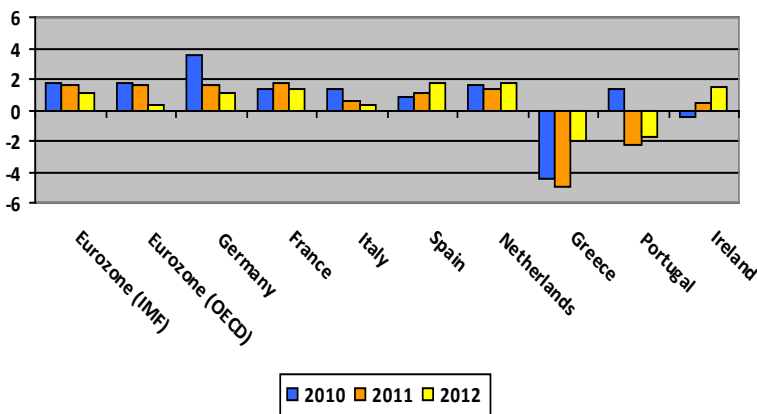
- The OECD said that "economic growth perspectives [were] weakening as recovery slows". "Economic growth", they wrote, "appears to have come close to a halt in the major industrialised economies, with falling household and business confidence." There was even a risk of "hitting patches of negative growth" – in other words, a possible double dip.⁶
- The IMF, echoing the gloom, announced that there was a "...weak and bumpy recovery ahead".⁷ The IMF's main GDP forecasts for the Eurozone, shown in chart 2 below, illustrated not just the overall growth weakness but also the gap in performance between the northern economies and the southern.⁸
- The ECB downgraded the forecasts for the Eurozone's GDP in September, compared with June. Growth was expected to be 1.4-1.8% for 2011 (compared with June's 1.5-2.3%) and 0.4-2.2% (compared with June's 0.6-0.8%).⁹
- The European Commission concluded that "...recovery [was stalling] amid [the] financial market crisis".¹⁰

But more recent commentaries are even more pessimistic:

- The OECD significantly reduced its forecast for the Eurozone for 2012 to 0.3% in late October amid deep concern over the Eurozone crisis.¹¹ The forecasts are included in chart 2 below.
- New ECB President Mario Draghi said on 3 November that "what we are observing now is slow growth, heading towards a mild recession by year end" and that the economic risks are making "downward revisions to economic growth forecasts [presented next month] very likely". The ECB, somewhat unexpectedly though understandably, cut the benchmark interest rate by 25 basis points to 1.25% on the same day.¹²

In conclusion, it is reasonable to work on the assumption that the Eurozone, Britain's biggest export market, will show little or no growth next year and there is, moreover, a very good chance of a "double dip" recession – albeit "mild" in Draghi's words.

Chart 2 Eurozone, IMF forecast for GDP % growth (September) and OECD (October)



Sources: (i) IMF, "World Economic Outlook, weak and bumpy recovery ahead", 20 September 2011; (ii) OECD, "Press briefing on the economic outlook and policy requirements for G20 economies", 31 October 2011.

Incidentally the Federal Reserve Board and the Federal Open Market Committee (FOMC) also cut their forecasts for the USA last week, compared with June. 2012 is now expected to grow by 2.5-2.9% in 2012 (central tendency, compared with June's 3.3-3.7%) and by 3.0-3.5% in 2013 (compared with June's 3.5-4.2%).¹³ Expect more Quantitative Easing from the Fed.

The Eurozone's October rescue package

Amidst the increasing economic gloom, the "Euro Summit" agreed a new support package, based on July's, for the Eurozone on 26 October.¹⁴ The main October agreements were:^{15,16}

- Leveraging the resources (around €250bn) of the European Financial Stability Facility (EFSF), employing two options. The leverage effect of the options will vary but could be up to 4 or 5 (providing resources of around €1tn). The two options are:
 - Providing credit enhancement to new debt issued by Member States, thus reducing the funding cost. Purchasing this risk insurance would be offered to private investors as an option when buying bonds in the primary market.
 - Maximising the funding arrangements of the EFSF with a combination of resources from private and public financial institutions and investors which could be arranged through Special Purpose Vehicles. This would increase the amount of resources available to extend loans, for bank recapitalisation and for buying bonds in the primary and secondary markets. There were initial hopes that China may be interested in investing in the EFSF, but expectations have since been dampened.
- Bank funding and recapitalisation, as agreed by the European Council for the EU27. A temporary measure will require banks to increase the capital base to 9% by June 2012.
- The second bailout package for Greece, involving Private Sector Involvement (PSI). Private investors are expected to accept voluntarily a 50% write-off on the Greek sovereign debt they hold, worth some €30bn. In addition there will be further EU-IMF support of €100bn until 2014, including the required recapitalisation of Greek banks. The aim is to put Greece on a track to reduce the debt/GDP ratio to 120% by 2020.
- It is worth noting that there nothing in the package to support growth.

Many details of the package are still to be finalised, and the Greek bailout was compromised by Greek Prime Minister George Papandreou's decision to hold a referendum on the terms of the bailout (31 October) – since withdrawn. Suffice to say, we remain unconvinced that this package will be adequate to hold the Eurozone together in its current configuration. As we have discussed on previous occasions this would require full fiscal union with a centralised Treasury with shared budgets (shared taxation and spending), common sovereign debt (debt pooling and joint bond issuance) and significant permanent fiscal transfers from the northern competitive economies to the southern.¹⁷ Additionally, the ECB would be expected to act as the “lender of last resort” to governments.

There are, however, no signs that the Eurozone is moving towards full fiscal union, for all the commentaries claiming this is happening. Germany, constrained by its constitution, has specifically ruled out such moves. Moreover, the new ECB president Mario Draghi, responding to a question about the ECB's role at last week's ECB press conference, said “...what makes you think that, [for the ECB] to become the lender of last resort for governments, is actually the thing that you need to keep the Eurozone together? No, I don't think that is in the remit of the ECB. The remit of the ECB is maintaining price stability over the medium term”.¹⁸

The Eurozone crisis dominated the G20 summit in Cannes (3-4 November). Indeed it was overshadowed by Papandreou's referendum announcement and various Greek political traumas. There were however two political developments of note. The first was the suggestion by Angela Merkel and Nicolas Sarkozy that Greece might leave the Eurozone

after all. And the second was Italy's agreement to the IMF's monitoring its public finances. Given Italy's mountain of sovereign debt, at €1.8tn it is the third largest in the world after the US and Japan, and internal political difficulties this was a useful development.

New Eurozone governance procedures

As the Eurozone crisis intensifies, the governance structures of the currency union are changing. The Eurozone is integrating institutionally. Meetings of the Eurozone leaders, in addition to their finance ministers¹⁹, began in October 2008 at the height of the banking crisis. Subsequent leaders' meetings took place in May 2010, July 2011 and October 2011. The October 2011 session was historic. At this session it was agreed that the meetings should be formalised as “Euro Summits”, to be held at least twice a year and take place, if possible, after European Council meetings.²⁰

The Euro Summits will eventually have their own president, chosen from a Eurozone country. But in the meantime Herman Van Rompuy, the European Council President, will fulfil the role. The ten “outs”, including Britain, will be excluded from these summits and risk marginalisation.

Tighter economic governance procedures

The EU has also responded to the debt crisis by tightening up the economic governance of the EU27, in general, and EU17, in particular. The governance programme comprises three main building blocks:

- Repairing the EU's financial sector: increased regulation and recapitalisation of the banks.
- Safeguarding the stability of the euro area: setting up temporary support mechanisms (including the EFSF), in close cooperation with the IMF. These will be replaced by the “permanent” European Stability Mechanism (ESM) in July 2013.

- A “reinforced economic agenda” with closer EU surveillance and tougher enforcement.²¹ This agenda comprises:
 - The “European Semester”: a 6-month period each year (January to June) when the budgetary, macroeconomic and structural policies of all EU27 members are analysed and coordinated. The first semester began in January 2011.
 - The “Six Pack”: 6 legislative proposals on economic governance, agreed by the Council of the European Union (the Council) in October 2011.²² This package, to be enforced in early-2012, has two main objectives:
 - Stronger preventive and corrective action to ensure fiscal sustainability, based on a reformed Stability and Growth Pact (SGP). Under the Excessive Deficit Procedure (EDP) the key reference values to be enforced are that annual budget deficits should be no more than 3% of GDP and that debt should be no more than 60% of GDP.
 - Reducing macro-economic imbalances (e.g. property bubbles, current account deficits or surpluses, falls in competitiveness) and promoting competitiveness through preventive and corrective action. A new surveillance and enforcement mechanism called the Excessive Imbalance Procedure (EIP) will be established.
 - The “Euro Plus Pact”: a complementary agenda with additional reforms has been agreed by the EU17, focussing on competitiveness, employment, sustainability of the public finances and reinforcing financial stability. In addition to the EU17, six non-euro area countries have chosen to sign up: Poland and Romania – leaving the UK, Sweden, Hungary and the Czech Republic as the only non-signatories.
 - The “Europe 2020” strategy: the EU’s common economic agenda, which plans to move beyond the crisis and boost “smart, sustainable and inclusive” growth over the next 10 years.²³ It bears an unfortunate resemblance in its meaningless grandiloquence to the Lisbon Agenda of 2000, which aimed to turn the EU into “the most competitive and dynamic knowledge-based economy, capable of sustainable economic growth with more and better jobs and greater social cohesion” by 2010. It did not succeed.

The EU has clearly not been idle. The recapitalisation of the banks is sensible and we have discussed the support mechanisms elsewhere. Concerning the “reinforced economic agenda” four main conclusions can be drawn:

- The agenda is fundamentally about coordination, surveillance and correction mechanisms, principally for non-compliant Eurozone Member States. It is, in other words, about “policing” mechanisms. And it is not, and we would emphasise not, about building a proper fiscal union. Angela Merkel has tellingly referred to the mechanisms as establishing a “Stability Union”.
- The agenda does not address the current 30-40% “competitiveness gap”, or currency misalignment, between the northern economies and the southern which runs right through the heart of the Eurozone and is arguably tearing the economies of the Eurozone apart.
- The agenda’s mechanisms reinforce the current austerity packages imposed on the non-compliant Eurozone members and which are dragging down growth.
- Insofar as “Europe 2020” is little more than aspiration, the agenda will do little to stimulate growth, the EU’s biggest economic challenge. The EU has yet to

seriously address this challenge – even as
the growth outlook is darkening.

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13. Federal Reserve Board, 2 November, www.federalreserve.gov. Summaries of the economic projections are released on an approximately quarterly schedule.
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15. European Commission, *Euro summit statement*, 26 (sic) October 2011.
16. President of the European Council, "Remarks by the President of the European Council Herman Van Rompuy following the meeting of the Euro Summit", 27 October 2011, EUCO 116/11.
17. Ruth Lea, "Options for the Eurozone: fiscal union or reconfiguration, Arbuthnot Banking Group, 1 August 2011.
18. *EU Observer*, "ECB will not become bank of last resort, Draghi says", 3 November 2011.
19. Note the Euro Group, or Eurogroup, is the meeting of the Eurozone finance ministers.
20. The *European Council* is an EU institution, comprising the heads of State or governments (HoSG), along with President of the European Commission (José Barroso) and the President of the European Council (Herman Van Rompuy). It meets four times a year to define the EU's policy agenda. It is not to be confused with the *Council of the European Union* (informally known as the Council of Ministers or just the Council), which is a body holding legislative and some limited executive powers and is thus the main decision making body of the Union. Its Presidency rotates between the Member States every six months (currently Poland). The Council is composed of 27 national ministers (one per state), who vary depending upon the topic.
21. European Council, "Conclusions of the meeting 28-29 October 2010", EUCO 25/10, when the initial proposals were first agreed.
22. Council of the European Union, "Council confirms agreement on economic governance", October 2011.
23. "Europe 2020" has 5 targets for 2020: (i) 75% of the population aged 20-64 should be employed; (ii) 3% of the EU's GDP should be spent on R&D; (iii) the EU

should reduce its CO2 emissions by 20%, increase its energy efficiency by 20% & raise the share of renewable energies in overall energy consumption to 20%; (iv) the share of early school-leavers should be under 10% and at least 40% of the “younger generation” should have a degree or diploma; (v) 20 million fewer people should be at risk of poverty.

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