



Perspectives by Ruth Lea

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The Euro Area and the euro: changing perceptions



Over the last month there has been a marked change in the overall assessment of the Euro Area's economic prospects and, related to this, the fortunes of the euro against the dollar. Until recently the "consensus view" was that the Euro Area would perform better this year than the US partly because it would be less vulnerable to fall-out from the "credit crunch" (perceived primarily as an Anglo-Saxon problem). It was, of course, accepted that growth prospects in the Euro Area would be damaged by slowdown in the key export markets of the US and the UK and this would be exacerbated by the strength of the euro against the dollar and the pound. But, nevertheless, the Euro Area countries could partly de-couple and perform reasonably well.

This view was supported by the robust-looking GDP data for the first quarter. The EA15 (Euro Area 15)¹ chalked up a quarterly increase of 0.7%, with Germany (which accounts for over a quarter of the EA15's total GDP) growing by 1.3%. The strength of the German data was, however, partly discounted at the time of release (May 2008). The winter had been unusually mild and, as a consequence, the seasonal adjustment factors used to offset the effects of seasonal fluctuations, including "average" cold winter weather, on economic activity distorted the seasonally adjusted data upwards. A downward "correction" was therefore only to be expected in the second quarter data.

Optimism in the Euro Area is seeping away

Much of the optimism about the EA15's economy began to seep away in late July and early August when survey evidence suggested that Europe's economy, specifically Germany's, was not so strong after all. The euro began to slip against the dollar in late July. In mid August Eurostat's flash estimate for the EA15's second quarter GDP figure suggested GDP had fallen 0.2% in the quarter. This figure and the breakdown across the EA15 countries are shown in table 1.

Table 1 EA15: GDP quarterly growth rates (%) and consumer prices annual inflation (%)

	Weight (%) ²	2007 ¹		2008 ¹		HICP
		Q3	Q4	Q1	Q2	July 2008
EA15		0.6 (2.7)	0.4 (2.2)	0.7 (2.1)	-0.2 (1.5)	4.0
Germany	27.4	0.6 (2.4)	0.3 (1.7)	1.3 (2.6)	-0.5 (1.7)	3.5
France	21.1	0.7 (2.4)	0.4 (2.2)	0.4 (2.0)	-0.3 (1.1)	4.0
Italy	17.4	0.2 (3.8)	-0.4 (3.5)	0.5 (2.7)	-0.3 (1.8)	4.0
Spain	11.6	0.7	0.8	0.3	0.1	5.3
Netherlands	6.3	1.1	1.3	0.4	0	3.0
Belgium	3.7	0.7	0.5	0.5	0.3	5.9
Austria	3.0	0.6	0.7	0.6	0.4	3.8
Greece	2.5	0.9	0.7	1.1	0.6	4.9
Ireland	2.1	0.6	0.1	-0.2	...	3.6
Finland	2.0	0.4	1.0	0.7	...	4.3
Portugal	1.8	-0.2	0.7	-0.1	0.4	3.1
Luxembourg	0.4	-0.5	1.9	1.3	...	5.8
Slovenia	0.4	1.6	0.7	2.2	...	6.9
Cyprus	0.2	1.0	1.0	1.1	0.7	5.3
Malta	0.1	0.4	0.5	1.7	...	5.6

1. Year-on-year growth rates for the EA15 and the “big 4”

2. Weights are based on nominal GDP in 2006. Source European Central Bank, *Monthly Bulletin*, July 2008, available from www.ecb.europa.eu.

Sources of GDP and HICP data: Eurostat, “Flash estimates for 2008Q2: Euro Area GDP down by 0.2% and EU27 down by 0.1%”, 14 August 2008. Eurostat, “Harmonised indices of consumer prices, July 2008”, 14 August 2008, provisional data. Both are available from www.ec.europa.eu/eurostat.

Much attention was paid to the 0.5% decrease in Germany’s GDP but, given the comments made above on the vagaries of German seasonal adjustment factors, the figure should be seen in a longer-run context and treated as a sign of slowdown rather than recession. The data for France and Italy (the EA15’s 2nd and 3rd biggest economies, accounting for nearly 40% of total EA15 output between them) were arguably more worrying. France’s performance was disappointing and Italy appeared to be heading for recession.

Spain’s paltry rise of 0.1% was also of concern. Spain’s housing bubble is bursting – more spectacularly even than in Greece, Ireland or Britain. The Bank of Spain has revealed that Spanish lenders have now borrowed €49.4bn from the ECB, confirming reports that smaller banks with heavy exposure to the property market are now relying on the ECB funding to survive. It is very doubtful that this is sustainable. Unemployment has risen 457,000 over the past year and industrial output is falling.² The EA15’s 5th biggest economy, the Netherlands, showed no growth at all in the second quarter.

Table 1 also shows July's final data for consumer prices inflation.³ Not merely was the EA15's figure of 4% well above the ECB's de facto 2% target, but there was a wide disparity in inflation rates between the different members. The inflation rates for 7 countries were uncomfortably above the 4% average – with Spain's 5.3% arguably the most concerning because of the relative size of the Spanish economy.

Two final points are worth noting from the above analysis. The first is that, even though the EA comprises 15 countries, output is very concentrated in only 4, or possibly 5, countries. Germany, France, Italy and Spain account for 77-78% of total output. If the Netherlands' share is added to the "big 4's", the "top 5" account for nearly 84%. If two or three of these major countries significantly slowdown or fall into recession, it is very difficult for the remainder of the EA15 to compensate for their weakness. The second is that it is increasingly obvious there are very real strains emerging within the EA15 with its "one size fits all interest rate". As the table above shows, members have differing growth prospects as well as different inflation rates. At the first real challenge to the Euro Area since its inception in 1999, the economies show signs of diverging rather than converging as the EU's policy-makers would undoubtedly wish to see.

The IMF's downgraded forecasts for the Euro Area

The IMF's forecasts are respected and influential. Its last full forecasting exercise was published in its April *World Economic Outlook*.⁴ As table 2 shows, the IMF was then very pessimistic about the US – and more pessimistic about the US than about the EA15.

In July the IMF revised its forecasts – principally by upgrading its forecasts of the US economy, especially for 2008.⁵ But the economic prospects for the US were still seen as significantly poorer than for the EA15 (though the IMF's revised view of Spain is notable). A mere month later the IMF has, apparently, revised its forecasts again for a note prepared for a forthcoming G20 meeting.⁶ The forecast for the US has barely altered, whilst the IMF takes a notably gloomier view of the EA15. The IMF now takes the view that the growth prospects for the US and the EA15 are broadly similar. This is a major turn-round from its April position. Given the latest US GDP revision for the second quarter (from 1.9% annualised to 3.3% annualised) the chances that the US may outperform the Euro Area in 2008 are clearly increasing.

Table 2: IMF global forecasts for GDP annual growth (%) made in April, July and August 2008

	April 2008		July 2008 (change over April in brackets)		August 2008 (change over July in brackets)	
	2008	2009	2008	2009	2008	2009
World	3.7	3.8	4.1 (0.4)	3.9 (0.1)	3.9 (-0.2)	3.7 (-0.2)
US	0.5	0.6	1.3 (0.8)	0.8 (0.2)	1.3 (0)	0.7 (-0.1)
EA15, of which:	1.4	1.2	1.7 (0.3)	1.2 (0)	1.4 (-0.3)	0.9 (-0.5)
Germany	1.4	1.0	2.0 (0.6)	1.0 (0)
France	1.4	1.2	1.6 (0.2)	1.4 (0.2)
Italy	0.3	0.3	0.5 (0.2)	0.5 (0.2)
Spain	1.8	1.7	1.8 (0)	1.2 (-0.5)

Sources: IMF, *World Economic Outlook*, April 2008.

IMF, "World Economic Outlook update: Global Slowdown and rising inflation", July 2008, available from www.imf.org.

Financial Times, "IMF cuts world growth forecast", 26 August 2008.

Implications for the Euro

The IMF's shifting of position on the growth prospects for the US, on the one hand, and the EA15, on the other, can be considered as fairly typical of "consensus thinking" on the relative merits of these two economic blocs. And the recent turn-round in economic (and, hence, interest rate) perceptions of the US and EA15 has been a major factor behind the recent weakening of the euro against the dollar. The latest German IFO business climate index (released in late August) was the lowest for 3 years, and encouraged mounting expectations of the possibility of semi-recession in Germany, and the EA15, and lower ECB interest rates.⁷ This provided further impetus to the euro's fall against the dollar.

Chart 1 shows just how much the euro has weakened against the dollar since mid-late July. It has fallen from nearly €/ \$1.60 to €/ \$1.47. Foreign exchange rates are all but impossible to forecast but it is not unreasonable to speculate that the rate could be down to €/ \$1.30- €/ \$1.35 by the end of the year.

Chart 1: US\$'s per Euro: 12 months 30 August 2007 to 29 August 2008



Source: BBC Website, 1 September 2008.

Implications for the pound

Chart 2 shows that the pound has fallen sharply against the dollar since late July whilst chart 3 shows that the pound has been remarkably stable against the euro since April – though with recent renewed weakness.

Chart 2: US\$ per £: 12 months 30 August 2007 to 29 August 2008



Source: BBC Website, 1 September 2008.

Chart 3: Euro per £: 12 months 30 August 2007 to 29 August 2008



Source: BBC Website, 1 September 2008.

Concerning the prospects for the pound, the pound tends to trade in the slipstream of the dollar and the euro and, despite the problems of the British economy, the pound may not weaken much further against the euro.⁸ It could even strengthen as the internal contradictions of and strains within the Euro Area intensify. As a central case, £/€1.25 by end-year 2008 is not unfeasible. But the pound will surely fall further against the undervalued dollar - and by a significant margin. Given a €/\$1.35 rate, and a £/€1.25 rate, a rate of £/\$1.69-1.70 by end-year 2008 is quite feasible.

References

1. In 1999, there were originally 11 members of the Euro Area: Germany, France, Italy, Belgium, Netherlands, Luxembourg, Ireland, Spain, Portugal, Austria and Finland. Greece joined in 2001, Slovenia in 2007 and Cyprus and Malta in 2008.
2. Ambrose Evans-Pritchard, "Spain in crisis as Europe crumbles", *Daily Telegraph*, 15 August 2008.
3. Eurostat's flash provisional CPI inflation figure for August was 3.8%. Data were released on 29 August; no detailed breakdown for the Euro Area was available. Data available from www.ec.europa.eu/eurostat.
4. IMF, *World Economic Outlook*, April 2008.
5. IMF, "World Economic Outlook update: Global Slowdown and rising inflation", July 2008, available from www.imf.org.
6. Financial Times, "IMF cuts world growth forecast", *FT*, 26 August 2008.
7. Financial Times, "German business fears push euro to 6-month low against the dollar", *FT*, 27 August 2008.
8. See Ruth Lea, "Britain's trade figures: more red ink", Arbuthnot Banking Group Perspective, 3 January 2008. This paper recorded that the £ touched £/€1.5350 in mid January 2007, slid throughout much of 2007 and was down to £/€1.34 by early January 2008. This marked a decline of over 12%.

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