



Perspectives by Ruth Lea

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Recession in Europe: don't overdo the gloom

Introduction

In my last Perspective, I wrote about the changing perceptions of the economic prospects for the US, on the one hand, and of the Euro Area, on the other.¹ The broad conclusion was that the US, despite the ongoing problems with its financial sector and housing market, had, if anything, performed slightly better than expected a few months ago, whilst the Euro Area had performed worse. The IMF, for example, had recently downgraded its GDP forecasts for the EA15 for both 2008 and 2009 whilst barely altering its forecast for the US. The implication for the dollar (which arguably has been undervalued) and the euro (which arguably has been overvalued) is that the dollar should continue, financial crises apart, to strengthen against the euro.



Last week, as if on cue, the European Commission released its latest interim forecasts for the EU. They had a distinctly downbeat tone. The forecasts were based on updated projections for the EU's "big 5" only. (But they account for nearly three-quarters of total EU GDP, as shown in the annex tables.) The Commission forecast that 3 of the "big 5" economies – Germany, the UK and Spain – would actually experience a technical recession, as defined by 2 consecutive quarters of negative growth. This, suffice to say, grabbed the headlines, which emphasised the gloom.

The Commission's forecasts

It is, however, important to keep these forecasts in perspective. The main data are shown in the table below.

European Commission forecasts for GDP (%): the EU's "big 5"

| | Quarterly growth (QOQ, %), 2008 | | | | Annual growth (%), 2008 | |
|---------|---------------------------------|------|------|------|-------------------------|-------------------|
| | Q1 | Q2 | Q3 | Q4 | April 2008 forecast | Interim, Sep 2008 |
| Germany | 1.3 | -0.5 | -0.2 | 0.2 | 1.8 | 1.8 |
| UK | 0.3 | 0 | -0.2 | -0.2 | 1.7 | 1.1 |
| France | 0.4 | -0.3 | 0 | 0.1 | 1.6 | 1.0 |
| Italy | 0.5 | -0.3 | 0 | 0.1 | 0.5 | 0.1 |
| Spain | 0.2 | 0.1 | -0.1 | -0.3 | 2.2 | 1.4 |
| EU15 | 0.7 | -0.2 | 0 | 0.1 | 1.7 | 1.3 |
| EU27 | 0.6 | -0.1 | 0 | 0.1 | 2.0 | 1.4 |

Source: ECB, *Interim forecast*, 10 September 2008, available from www.ec.europa.eu.

Closer inspection of the data leads to the conclusion that Germany's economy, rather than one of the EU's weakest, is actually one of the strongest. The fall in the second quarter was probably little more than a statistical correction to the abnormally "strong" first quarter figure, which was distorted up by good weather factors. Germany should achieve growth of nearly 2% this year. Moreover, going into 2009, Germany's highly cost-competitive export sector should benefit from the weaker euro. Another factor in Germany's favour is that it does not have a rapidly deflating housing market dragging down construction and household spending – as does the UK, Spain, Ireland or even France.

The UK's recession, as forecast by the Commission, is still a mild affair – though it should be noted that the forecast above is confined to 2008 and does not include 2009. But it is worth remembering that in previous recessions GDP fell and unemployment rose steeply.² GDP in 1975 was 2% lower than in 1973, GDP in 1981 was 3½% lower than in 1979 and GDP in 1991 was 1½% lower than in 1990.

France's economy, despite the fact it seems to be avoiding recession this year, is expected to be effectively flat for the remainder of this year – as is Italy's. Indeed Italy's economy arguably looks the weakest of the "big 5". It has been a sluggish performer in recent years and is beset by seemingly intractable cost-competitiveness problems. Spain's economy is being dragged down by a housing slump. But this is unsurprising after the bubble in Spanish housing prices and a period of fast growth.

The Commission's forecasts are much in line with the latest set of Consensus forecasts for 2008, shown in the following table. Growth, with the exception of Italy, is expected to be weaker in 2009 than in 2008.

Consensus forecasts, for GDP growth (%) and unemployment (%)

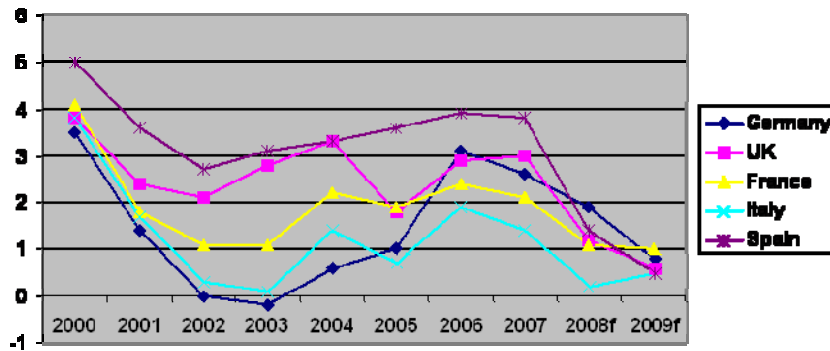
| | GDP growth (%) | | Unemployment rate (%) | |
|---------|----------------|------|-----------------------|------|
| | 2008 | 2009 | 2008 | 2009 |
| Germany | 1.9 | 0.8 | 7.8 | 7.9 |
| UK | 1.2 | 0.6 | 2.8 | 3.4 |
| France | 1.1 | 1.0 | 7.4 | 7.7 |
| Italy | 0.2 | 0.5 | 6.5 | 6.7 |
| Spain | 1.4 | 0.5 | Na | Na |
| EU15 | 1.3 | 0.9 | 7.3 | 7.6 |

Source: Consensus Economics Inc, *Consensus Forecasts*, Survey date: 8 September 2008.

Slowdown rather than recession?

So, even though there were blood-curdling cries of recession after the release of the Commission's forecasts, if these forecasts are correct, it is more accurate to say that the major EU economies are undergoing painful and possibly protracted slowdowns rather than full-blown recessions. The recent falls in oil prices and prospects of possible interest rate cuts, is supportive of this scenario. The graph below puts the growth projections in context of the current decade. It can be argued that major slowdowns in Spain and in the UK have been overdue for a while, whilst Germany and Italy performed just as badly, if not worse, earlier in the decade than they are expected to perform over the next two years.

% GDP growth for the EU's "big 5": 2000 to 2009



Source of back data: OECD, *Economic Outlook*, volume 2008/1, June 2008.

Source for forecasts: Consensus Economics Inc, *Consensus Forecasts*, Survey date: 8 September 2008.

The definition of recession

The conventional, "two-consecutive-falling-quarters rule" as a definition of recession is clearly inadequate as it stands and requires qualification.³ The first qualification required relates to the sheer quantitative changes. It may seem rather trite but it is not just a matter of whether GDP falls – but by how much cumulatively and for how long. The second qualification refers to the timing of GDP movements. If, for example, an economy grows by 2% (annualised) in one quarter and then contracts by 0.5% in each of the next two quarters, it is deemed to be in recession. But if GDP contracts by 2% in one quarter then, rises by 0.5% in the next quarter and then falls by 2% in the third, it escapes, even though the economy is actually weaker. The third qualification relates to the consideration of variables other than GDP. For many people a large rise in unemployment is probably the most telling indicator of recession. So this implies recession is not just a matter of falling output, but rather more a matter of actual growth significantly underperforming potential output growth, however this is manifested.

And, finally, there is the issue of data revisions. Data get revised. So any claims about recessions may well be confounded as data revisions trickle in some time after the event. Considerable surprise, if not irritation, was expressed when the ONS revised its 2nd quarter GDP figure from a quarterly rise of 0.2% to flat.⁴ But commentators should be aware that the ONS is under pressure to release data quickly and this can cause problems. As the ONS states in their GDP press releases:

"Revisions are an inevitable consequence of the trade-off between timeliness and accuracy. Early estimates are based on incomplete data."

It is worth noting just how incomplete the data can be. The ONS compiles three estimates for each quarter's GDP over three consecutive months (as well as later revisions):⁵

- Month 1 preliminary estimate: based on output data only around 25 days after the end of each quarter and based on 44% of "actual data". The rest is based on projections using a variety of modelling techniques.
- Month 2 output, income and expenditure: based on output data (of which 67% of actual data) along with early information of GDP measured by the expenditure and income measures. It is released around 55 days after the end of each quarter.
- Month 3 UK quarterly national accounts: based on output data (of which 80% of actual data) along with fuller information of GDP measured by the expenditure and income measures. It is released around 85 days after the end of each quarter.

So even after 3 months, the ONS is still missing 20% of output data – with probably more missing for the expenditure and income measures (which are used to compile the average GDP figures as well as the relevant accounts). When the ONS puts out the first estimate, they have less than half of the actual output data. A sobering thought.

References

1. Ruth Lea, *The Euro Area and the euro: changing perspectives*, Arbuthnot Banking Group Perspective, 1 September 2008.
2. Ruth Lea, *Three British recessions compared*, Arbuthnot Banking Group Perspective, 21 July 2008.
3. *Economist*, “Economics focus: redefining recession. A new yardstick for measuring slumps is long overdue”, 13 September 2008.
4. ONS First Release, “UK output, income and expenditure, 2nd quarter 2008”, ONS, 22 August, available from www.statistics.gov.uk
5. ONS, *Summary Quality Report for GDP data releases*, 18 April 2008, available from www.uk.statistics.gov.uk.

Annex

GDP shares in 2007: EU27, divided into Euro Area and others

| Euro Area | Share of Euro Area (%) | Cumulative share | Share of EU GDP | Cumulative share |
|-------------------------|------------------------|------------------|-----------------|------------------|
| Germany | 27.2 | 27.2 | 19.7 | 19.7 |
| France | 21.2 | 48.4 | 15.4 | 35.1 |
| Italy | 17.2 | 65.6 | 12.5 | 47.6 |
| Spain | 11.8 | 77.4 | 8.6 | 56.2 |
| Netherlands | 6.3 | 83.7 | 4.6 | 60.8 |
| Belgium | 3.7 | 87.4 | 2.7 | 63.5 |
| Austria | 3.1 | 90.5 | 2.2 | 65.7 |
| Greece | 2.6 | 93.1 | 1.9 | 67.6 |
| Ireland | 2.1 | 95.2 | 1.5 | 69.1 |
| Finland | 2.0 | 97.2 | 1.4 | 70.5 |
| Portugal | 1.8 | 99.0 | 1.3 | 71.8 |
| Luxembourg | 0.4 | 99.4 | 0.3 | 72.1 |
| Slovenia | 0.4 | 99.8 | 0.3 | 72.4 |
| Cyprus | 0.2 | 100.0 | 0.1 | 72.5 |
| Malta | 0.1 | 100.1 | 0 | 72.5 |
| Total share of EU15 GDP | | 100.0 | | |
| Total share of EU GDP | | | | 72.5 |
| Non-euro area | | | | |
| UK | | | 16.4 | 16.4 |
| Sweden | | | 2.7 | 19.1 |
| Poland | | | 2.5 | 21.6 |
| Denmark | | | 1.9 | 23.5 |
| Czech Republic | | | 1.0 | 24.5 |
| Romania | | | 1.0 | 25.5 |
| Hungary | | | 0.8 | 26.3 |
| Slovakia | | | 0.4 | 26.7 |
| Lithuania | | | 0.2 | 26.9 |
| Bulgaria | | | 0.2 | 27.1 |
| Latvia | | | 0.2 | 27.3 |
| Estonia | | | 0.1 | 27.4 |
| Total share of EU GDP | | | | 27.5 |
| | | | | 100.0 |

ECB, *Statistics Pocket Book*, July 2008, available from the ECB's website: www.ecb.int. There is some non-addition due to rounding errors.

GDP shares in 2007: EU27

| | Share of EU GDP | Cumulative share |
|-----------------------|-----------------|------------------|
| Germany | 19.7 | 19.7 |
| UK | 16.4 | 36.1 |
| France | 15.4 | 51.5 |
| Italy | 12.5 | 64.0 |
| Spain | 8.6 | 72.5 |
| Netherlands | 4.6 | 77.2 |
| Sweden | 2.7 | 79.9 |
| Belgium | 2.7 | 82.6 |
| Poland | 2.5 | 85.1 |
| Austria | 2.2 | 87.3 |
| Greece | 1.9 | 89.2 |
| Denmark | 1.9 | 91.1 |
| Ireland | 1.5 | 92.6 |
| Finland | 1.4 | 94.0 |
| Portugal | 1.3 | 95.3 |
| Czech Republic | 1.0 | 96.3 |
| Romania | 1.0 | 97.3 |
| Hungary | 0.8 | 98.1 |
| Slovakia | 0.4 | 98.5 |
| Luxembourg | 0.3 | 98.8 |
| Slovenia | 0.3 | 99.1 |
| Lithuania | 0.2 | 99.3 |
| Bulgaria | 0.2 | 99.5 |
| Latvia | 0.2 | 99.7 |
| Cyprus | 0.1 | 99.8 |
| Estonia | 0.1 | 99.9 |
| Malta | 0 | 99.9 |
| Total share of EU GDP | | 100.0 |
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