



Perspectives by Ruth Lea

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Diverging economies continue to pull the Eurozone apart

The crisis in the Eurozone is deepening. As Portugal awaits its bailout package, concern intensifies over Greece's position, with speculation of restructuring, or a further bailout or even departure from the Eurozone (*in extremis*). And yet it was only 12 months ago that the rescue packages were agreed for, firstly, Greece and, secondly, for the other "weaker" members of the currency union. These rescue packages were intended to solve the problems of the Eurozone, at least until 2013. But, as we concluded at the time, they were merely a matter of buying time because they singularly failed to address the fundamental and underlying problems of the Eurozone, namely diverging economies in terms of growth and competitiveness.^{1,2}

It is moreover worth emphasising just how comprehensively the economies are diverging. On the one hand, there is a buoyant Germany, and maybe France, and the other successful northern economies. On the other hand, there are the peripheral economies, otherwise known as the PIGS (Portugal, Ireland, Greece and Spain), which are struggling. Italy shares some characteristics with this group. Both the latest EU GDP data (2011Q1) and the Commission's May forecasts show the economies diverging.

Eurostat GDP data for 2011Q1 for the Eurozone

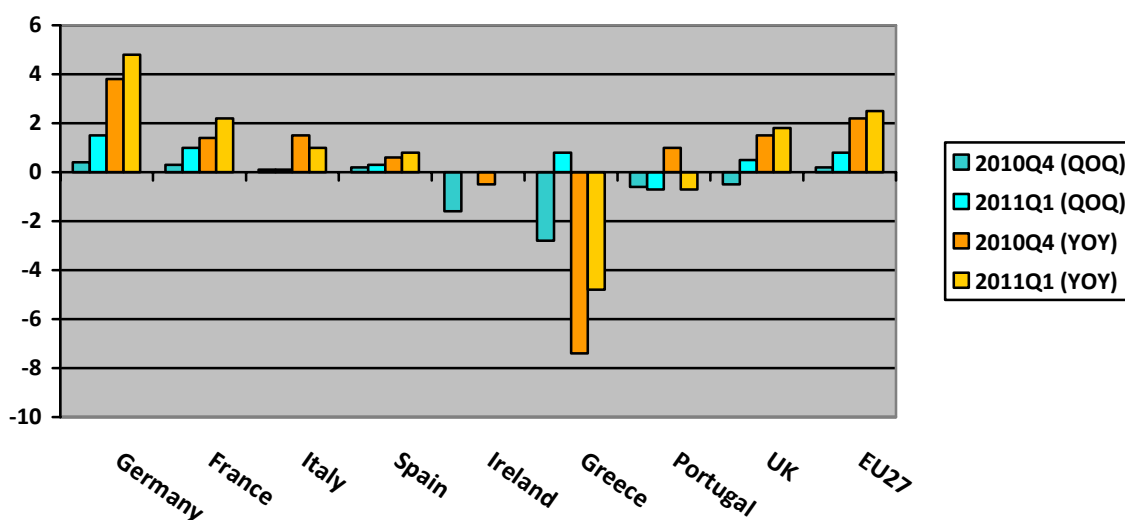
Last week the EU released GDP data for 2011Q1 for nearly all of the EU27 countries though Ireland, for example, has yet to report. The EU27 grew by 0.8% in 2011Q1 following a meagre 0.2% in 2010Q4 (pulled down by the bad UK 4th quarter figure). The equivalent data for the Eurozone were 0.8% and 0.3%.

Chart 1 shows the GDP data for the Eurozone's "big three", the PIGS and the UK, for the quarter-on-quarter (QOQ) changes and the year-on-year (YOY) changes for 2010Q4 and 2011Q1.

The chart shows just how well Germany and France are performing. German GDP rose by 1.5% in 2011Q1, French GDP was 1.0% higher and, it should be added, Dutch GDP increased by 0.9%. Caution should however be exercised with GDP data for the winter months as the figures tend to be weather-affected in ways that the seasonal adjustment procedures do not always accommodate very effectively, especially when there is exceptionally harsh weather. And it should be noted that the GDP increases for Germany and France were just 0.4% and 0.3% respectively in 2010Q4. Nevertheless these economies are growing well, Germany's very well, and are, incidentally and by comparison, putting the UK's recent rather weak performance in the shade.³

The recovery of the southern economies, in contrast, remains weak – insofar as they are recovering. Italy grew by a feeble 0.1% in both of the last 2 quarters, Spain’s growth, though slightly better than Italy’s, is undoubtedly weak and the Portugal’s economy continues to contract. As already mentioned, the Irish 2011Q1 figure has yet to be reported but it should be noted that GDP fell by 1.6% in 2010Q4. There was some surprise over the Greek 0.8% rise in 2011Q1, but this should be taken in the context of the horrendous 2.8% fall in 2010Q4. We suspect statistical smoothing problems rather than a return to growth. All in all, the Eurozone’s north-south divide is painful.

Chart 1 GDP data for 2010Q4 and 2011Q1, QOQ (%) & YOY (%)



Source: Eurostat, “Euro area GDP and EU27 up by 0.8%, +2.5% respectively compared with 2010Q1”, flash estimate, 13 May 2011. 2011Q1 data for Ireland are not yet available.

European Commission Spring 2011 forecasts

The EU released its latest set of forecasts on the same day (13 May 2011) as the flash estimate for 2011Q1 GDP.⁴ Table 1 shows the aggregate results for GDP and CPI inflation. The GDP results for all of the individual EU 27 countries are shown in the annex.

The growth forecast was quite upbeat in aggregate and the Commission noted that the EU economy was “set to further consolidate its gradual recovery, with prospects for 2011 looking slightly better than projected in the autumn”. GDP was projected to grow by around 1.8% in 2011 (compared with autumn’s 1.7%) and by 1.9% in 2012 (compared with autumn’s 2.0%). The Commission acknowledged the emergence of further risks since the autumn including the political situation in the Middle East/North Africa and, somewhat coyly, the “tensions observed in some euro-area sovereign-bond markets”.

CPI inflation was however rising faster than in autumn, reflecting the increase in commodity prices. Headline inflation was projected to average almost 3% in the EU and 2½% in the euro area in 2011, before easing to about 2% and 1¾% respectively in 2012.

Table 1 European Commission aggregate forecasts, GDP and CPI inflation

	2008	2009	2010	Spring 2011*		Autumn 2010	
				2011	2012	2011	2012
GDP:							
EU27	0.5	-4.2	1.8	1.8 (0.1)	1.9 (-0.1)	1.7	2.0
Eurozone	0.4	-4.1	1.8	1.6 (0.1)	1.8 (0)	1.5	1.8
EU27	3.7	1.0	2.1	3.0 (0.9)	2.0 (0.2)	2.1	1.8
Eurozone	3.3	0.3	1.6	2.6 (0.8)	1.8 (0.1)	1.8	1.7

Source: European Commission, *European Economic Forecast*, spring 2011, May 2011. The asterisk shows the changes to the forecasts between the autumn 2010 and the spring 2011 forecasts.

But the Commission acknowledged that the aggregate picture of the GDP forecasts “masked marked differences in developments across Member States”. Some countries, in particular Germany, but also some smaller export-oriented economies, had registered a solid rebound in activity, while others, notably some peripheral countries, were lagging behind. The Commission expected that the pace of recovery within the EU would “continue to vary”. And, as the Commission noted, the EU “faces challenges”, the two most important of which were differences in “competitiveness positions” and “lingering (sic) concerns about fiscal sustainability” (see below).

Chart 2a shows that, with the exception of Germany, growth is expected to be fairly subdued for the Eurozone “big 3” and the PIGS. But at least France is expected to have steady, if unspectacular, growth. The prospects for Italy, Spain and Ireland look fairly dire. And the prospects for Greece and Portugal look simply dreadful as a combination of poor competitiveness and the austerity packages drag their economies down.

Chart 2a GDP forecasts, YOY (%)

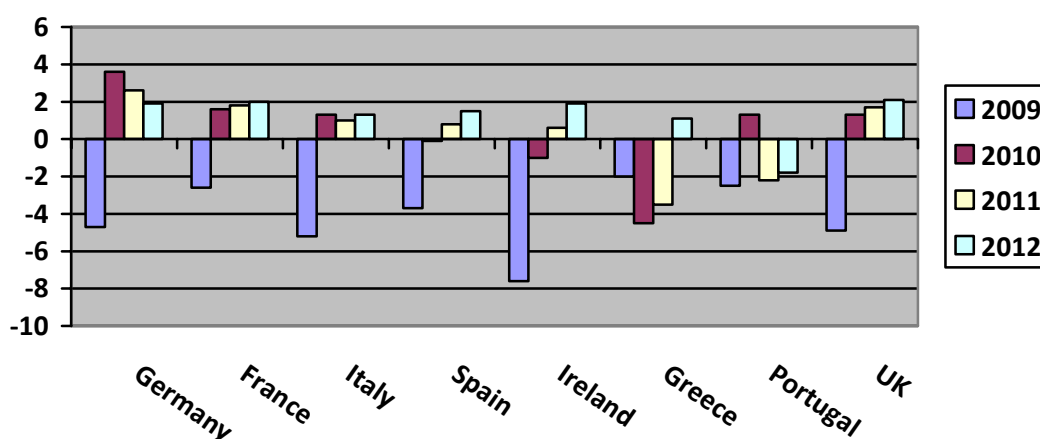


Chart 2b compares the unemployment forecasts and shows the continued diversity in labour markets across the EU. Of the Eurozone “big 3” Germany is in the most favourable position, whilst the unemployment situation in the PIGS is grim. The Netherlands and Austria have the most favourable labour market indicators in the EU, with the unemployment rate around 4% to 4½%.

Chart 2b Unemployment rates (%)

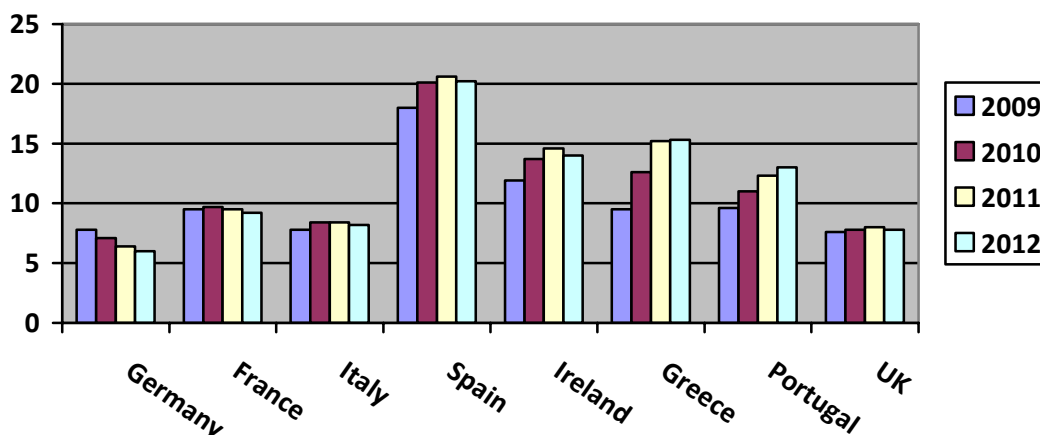
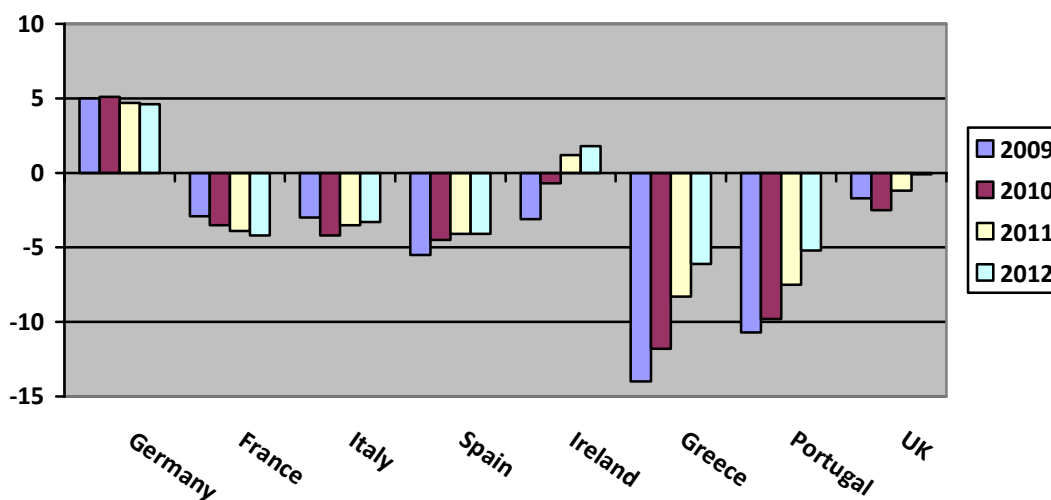


Chart 2c shows the marked differences in external imbalances in the EU. Germany retains a healthy current account surplus throughout the forecast period. (Finland, Denmark, Sweden, the Netherlands, Belgium and Austria are also surplus countries.) France, Italy and Spain all run sizeable deficits. The deficits of Ireland, Greece and Portugal are expected to continue to improve, with Ireland moving back into surplus, whilst the Greek and Portuguese deficits are expected to shrink reflecting recession and subdued domestic demand. But, even so, they are still expected to be appalling.

Chart 2c Current account balances, % of GDP

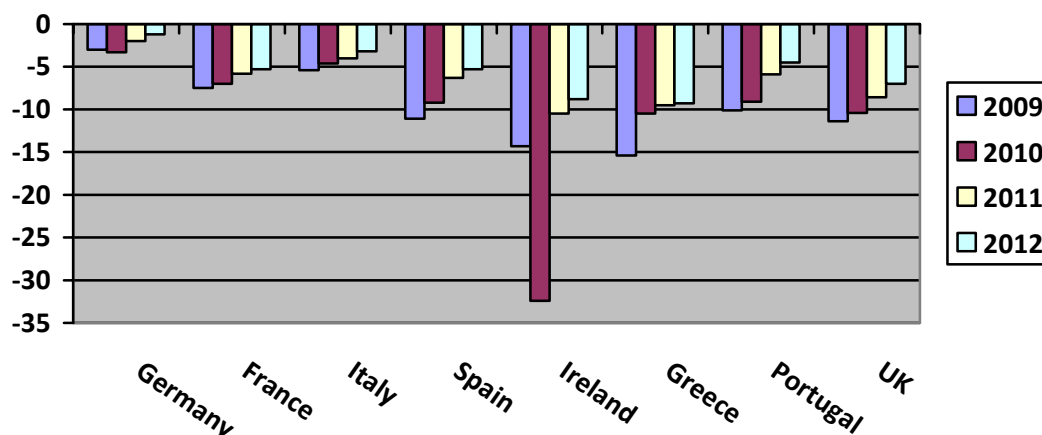


Source: European Commission, *European Economic Forecast*, spring 2011.

The Commission's forecasts for the public finances

In the light of the continued debate over the solvency of Greece, and possibly Portugal and Ireland, the Commission's projections for the public finances are of particular significance. Chart 3a suggests that the borrowing of all of the selected countries shown should improve over the forecast period, with the exception of Greece. Note that Ireland's borrowing for 2010 was distorted by the huge costs to the Irish taxpayer of the bank guarantees.⁵

Chart 3a Net borrowing (-), General Government, % of GDP



Charts 3b and 3c show the mounting debt problems of Ireland, Portugal and particularly Greece. Spain's public sector debt situation is more manageable. Chart 3c specifically compares the Commission's spring (May) forecast with its autumn forecast. Note how the debt levels for Ireland, Portugal and Greece have been revised up between the two forecasts for both 2011 and 2012. These debt-shackled economies are sinking ever deeper into debt. In autumn the Commission projected that Greece's public sector debt would be 156% of GDP in 2012, they now expect it be 166% of GDP. The equivalent figures for Ireland were just over 114% and 118% and for Portugal 92% and just over 107%. Moreover, there is a very good chance that these debt projections will be revised up further in the autumn 2011 forecasts, especially if the economies disappoint.

These debt levels, and the speed with which they are deteriorating, look far from sustainability. Given the possibility of further bailout packages and/or default or restructuring, we will return to this issue in future Perspectives.⁶

Chart 3b Gross debt, General Government, spring forecast, % of GDP

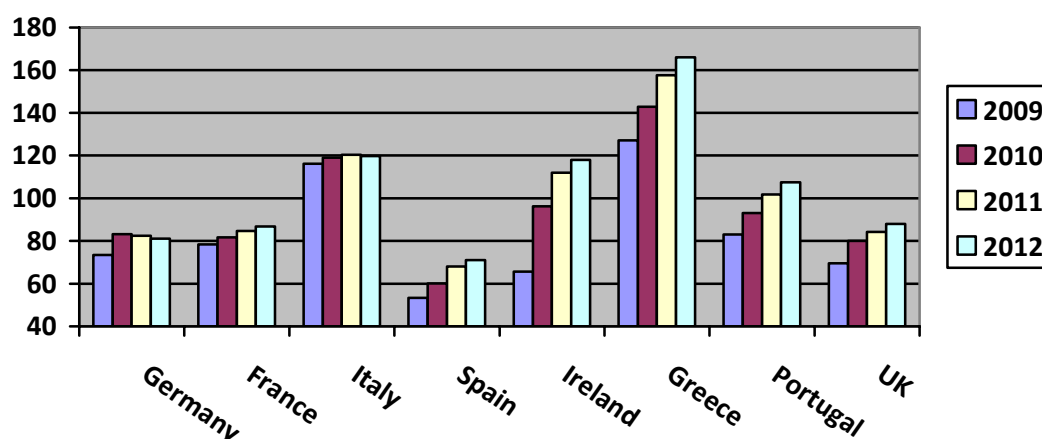
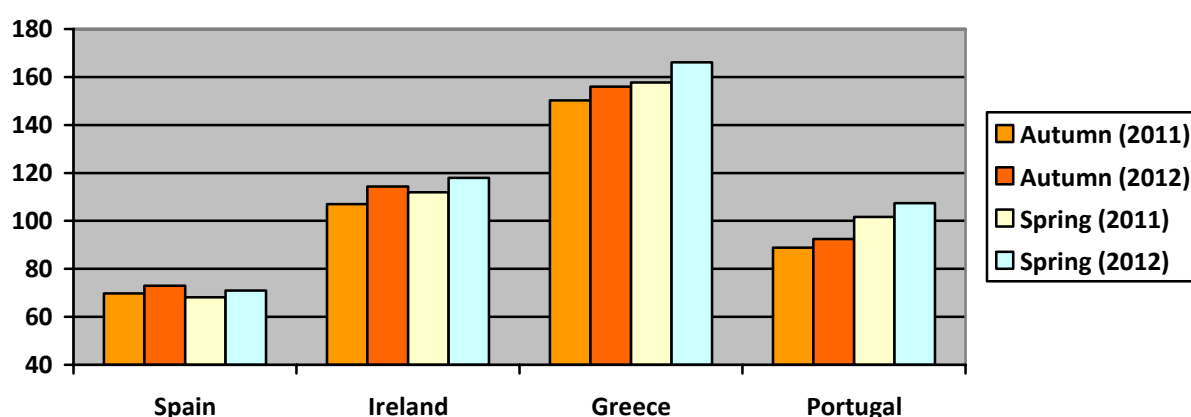


Chart 3c Gross debt, General Government, % of GDP, autumn 2010 & spring 2011 forecasts, for 2011 & 2012



Source: European Commission, *European Economic Forecast*, spring 2011.

Further GDP downgrades for the UK

The annex table shows the Commission’s downgrade for UK GDP. But the Commission was not the only organisation to downgrade Britain’s prospects last week. The Bank of England in its May Inflation Report also revised its GDP projections down. Though the Bank do not publish point forecasts it is, nevertheless, possible to get a good idea of what the Bank’s forecasts are. The Bank downgraded GDP growth from about 2% (February) to 1¾% (May) for 2011 and from 3% (February) to 2.5% (May).^{7,8} And, in order to underline the uncertainty behind these forecasts, the Governor spoke of a “difficult time ahead” and a “slow and prolonged adjustment to the consequences of the financial crisis”.⁹

Table 2 compares the latest forecasts from the OBR, the European Commission and the Bank of England. Yet, as we pointed out recently, even these forecasts may be too optimistic given the weak 2011Q1 figure.¹⁰

Table 2 Downgrades to GDP forecasts, YOY growth (%)

	Latest forecast		Previous forecast	
	2011	2012	2011	2012
OBR	1.7 (-0.4)	2.5 (-0.1)	2.1	2.6
European Commission	1.7 (-0.5)	2.1 (-0.4)	2.2	2.5
Bank of England (approx.)	1.75 (-0.25)	2.5 (-0.5)	2	3

Sources: (i) OBR, *Economic and fiscal outlook*, March 2011; OBR, *Economic and fiscal outlook*, November 2010; (ii) European Commission, *European Economic Forecast*, spring 2011 (comparing autumn 2010 and spring 2011 forecasts); Bank of England, *Inflation Reports*, February 2011 and May 2011. The changes between the previous and latest forecast are shown in brackets.

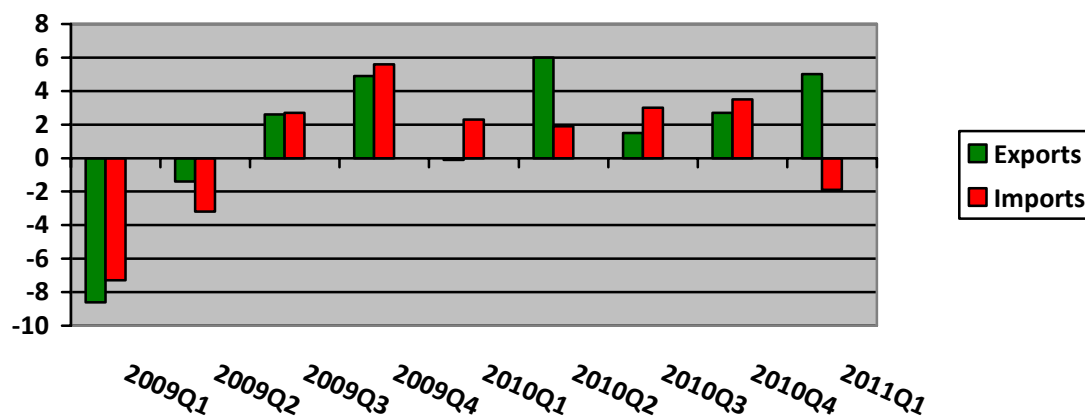
The UK: final comments on recent developments

The *Inflation Report* did not, of course, just cover the growth outlook. On the contrary, the CPI inflation forecasts are central to the document. Unsurprisingly, the Bank revised up its short-term inflation forecasts. They expect inflation to hit 5% later this year due to higher utility bills, though they still project inflation to fall back to target in 2012 and 2013. (The Bank has “pencilled in” price rises of 15% for gas and 10% for electricity by early 2012.) Given the combination of lower growth and higher inflation the outlook for the British economy is steadily becoming more “stagflationary”.

Concerning the Bank Rate, the Governor said at the *Inflation Report* Press Conference “the Bank Rate will need to rise at some point. It cannot stay at this level indefinitely”, but he did not signal steep rate increases.

There are tentative signs that the UK’s rebalancing is under way. The 2011Q1 trade figures were evidence that the large sterling depreciation (in 2008) can be expansionary and not just inflationary. Chart 4 shows that exports of goods (volume terms) were 5% up in the quarter whilst imports fell back by nearly 2%. It is to be hoped that this marks the start of a trend. The exports performance in 2010 was very disappointing. Exports growth was outstripped by imports growth, despite sterling’s depreciation the previous year.

Chart 4 UK, exports and imports of goods, volume terms, QOQ (%)



Source: ONS, “UK Trade, March 2011”, Statistical Bulletin, 11 May 2011.

References

1. Ruth Lea, “The eurozone’s rescue package: buying time and postponing the day of reckoning”, Arbuthnot Banking Group, 24 May 2010.
2. Ruth Lea, “The divergent eurozone: no easy solutions in sight”, Arbuthnot Banking Group, 18 January 2010.
3. *FT*, “Shadow cast over UK recovery”, 14 May 2011.
4. Not all the now-available first quarter GDP estimates would have been available to the forecasters. Given for example the exceptionally buoyant German figure for example the German GDP forecast may have been a tad higher if the first quarter number had been available.
5. Ruth Lea, “The Irish bailout and options for the Eurozone”, Arbuthnot Banking Group, 22 November 2010.
6. The bailout packages to date are: Greece (May 2010), Ireland (November 2010) and Portugal (May 2011).
7. Bank of England, *Inflation Report*, May 2011.
8. “Inflation Report press conference, 11 May 2011, opening remarks by the Governor”, www.bankofengland.co.uk
9. *FT*, “King bites bullet on lasting impact from the recession”, 12 May 2011, reported that the Governor “...conceded that the damage done by the last recession appeared permanent. The central case forecast no longer assumes the economy will recoup the ground lost in the recession.”
10. Ruth Lea, “Disappointing GDP growth: all the more need for radical growth policies”, Arbuthnot Banking Group, 2 May 2011.

Annex

European Commission GDP forecasts, May 2011

	2008	2009	2010	Spring 2011*		Autumn 2010	
				2011	2012	2011	2012
Belgium	1.0	-2.8	2.2	2.4 (0.6)	2.2 (0.2)	1.8	2.0
Germany	1.0	-4.7	3.6	2.6 (0.4)	1.9 (-0.1)	2.2	2.0
Estonia	-5.1	-13.9	3.1	4.9 (0.5)	4.0 (0.5)	4.4	3.5
Ireland	-3.5	-7.6	-1.0	0.6 (-0.3)	1.9 (0)	0.9	1.9
Greece	1.0	-2.0	-4.5	-3.5 (-0.5)	1.1 (0)	-3.0	1.1
Spain	0.9	-3.7	-0.1	0.8 (0.1)	1.5 (-0.2)	0.7	1.7
France	0.2	-2.6	1.6	1.8 (0.2)	2.0 (0.2)	1.6	1.8
Italy	-1.3	-5.2	1.3	1.0 (-0.1)	1.3 (-0.1)	1.1	1.4
Cyprus	3.6	-1.7	1.0	1.5 (0)	2.4 (0.2)	1.5	2.2
Luxembourg	1.4	-3.6	3.5	3.4 (0.6)	3.8 (0.6)	2.8	3.2
Malta	5.3	-3.4	3.7	2.0 (0)	2.2 (0)	2.0	2.2
Netherlands	1.9	-3.9	1.8	1.9 (0.4)	1.7 (0)	1.5	1.7
Austria	2.2	-3.9	2.0	2.4 (0.7)	2.0 (-0.1)	1.7	2.1
Portugal	0	-2.5	1.3	-2.2 (-1.2)	-1.8 (-2.6)	-1.0	0.8
Slovenia	3.7	-8.1	1.2	1.9 (0)	2.5 (-0.1)	1.9	2.6
Slovakia	5.8	-4.8	4.0	3.5 (0.5)	4.4 (0.5)	3.0	3.9
Finland	0.9	-8.2	3.1	3.7 (0.8)	2.6 (0.3)	2.9	2.3
<u>Euro-area</u>	<u>0.4</u>	<u>-4.1</u>	<u>1.8</u>	<u>1.6 (0.1)</u>	<u>1.8 (0)</u>	<u>1.5</u>	<u>1.8</u>
Bulgaria	6.2	-5.5	0.2	2.8 (0.2)	3.7 (-0.1)	2.6	3.8
Czech Republic	2.5	-4.1	2.3	2.0 (-0.3)	2.9 (-0.2)	2.3	3.1
Denmark	-1.1	-5.2	2.1	1.7 (-0.2)	1.5 (-0.3)	1.9	1.8
Latvia	-4.2	-18.0	-0.3	3.3 (0)	4.0 (0)	3.3	4.0
Lithuania	2.9	-14.7	1.3	5.0 (2.2)	4.7 (1.5)	2.8	3.2
Hungary	0.8	-6.7	1.2	2.7 (-0.1)	2.6 (-0.6)	2.8	3.2
Poland	5.1	1.7	3.8	4.0 (0.1)	3.7 (-0.5)	3.9	4.2
Romania	7.3	-7.1	-1.3	1.5 (0)	3.7 (-0.1)	1.5	3.8
Sweden	-0.6	-5.3	5.5	4.2 (0.9)	2.5 (0.2)	3.3	2.3
UK	-0.1	-4.9	1.3	1.7 (-0.5)	2.1 (-0.4)	2.2	2.5
<u>EU</u>	<u>0.5</u>	<u>-4.2</u>	<u>1.8</u>	<u>1.8 (0.1)</u>	<u>1.9 (-0.1)</u>	<u>1.7</u>	<u>2.0</u>
USA	0	-2.7	2.9	2.6 (0.5)	2.7 (0.2)	2.1	2.5
Japan	-1.2	-6.3	3.9	0.5 (-0.8)	1.6 (-0.1)	1.3	1.7

Source: European Commission, *European Economic Forecast*, spring 2011, May 2011. The asterisk shows the changes to the forecasts between the autumn 2010 and the spring 2011 forecasts.

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