Why the Eurozone Is Growing Again

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Improvements in the peripherals matter more than those in Germany.

EXECUTIVE SUMMARY

Better-than-expected growth in Europe is proving one of the bright spots in an otherwise mixed global picture for 2014, luring many investors back to the region. Duesseldorf-based Holger Fahrinkrug, Chief Economist for BNY Mellon's Meriten affiliate, says the eurozone has "clearly left the recession behind." He explains why he has raised his growth forecast for the region and why he believes deflation risk is not sufficient at the moment to warrant quantitative easing from the ECB.

While the eurozone has not yet achieved a broad and sustained economic normalization, better-than expected GDP data for European Monetary Union (EMU) member countries and for the area as a whole mark yet another step in that direction. Fourth quarter 2013 GDP data show that almost all countries have returned to a growth path, albeit a moderate one in most cases.

Overall, the euro area grew 0.3 percent from the third quarter to the fourth quarter of 2013, which suggests that the economy has started into 2014 with some positive momentum. The eurozone has clearly left the recession behind.

Improved growth in Germany is part of the reason. But leading indicators also point to continuing recovery even in some peripheral countries. While upward revisions to Germany's growth may not be unexpected, the return of growth to the peripheral countries such as Spain and Portugal is a surprise. The improvements in the peripherals also matter more than those in Germany, because they have been the epicenters of the eurozone's sovereign debt crisis and growth is essential to reducing their debts.

In light of the improved growth at the end of 2013, we have raised our growth forecast for the euro area slightly and maintain our view that at this point, quantitative easing by the European Central Bank (ECB) is unnecessary and inappropriate, especially since we see no broad deflationary tendencies in the eurozone.

GDP is a lagging indicator, so it says little about future growth, but we would highlight two important aspects of the data nevertheless. First, they confirm that the eurozone has continued its recovery in the final quarter of 2013, largely without disturbances

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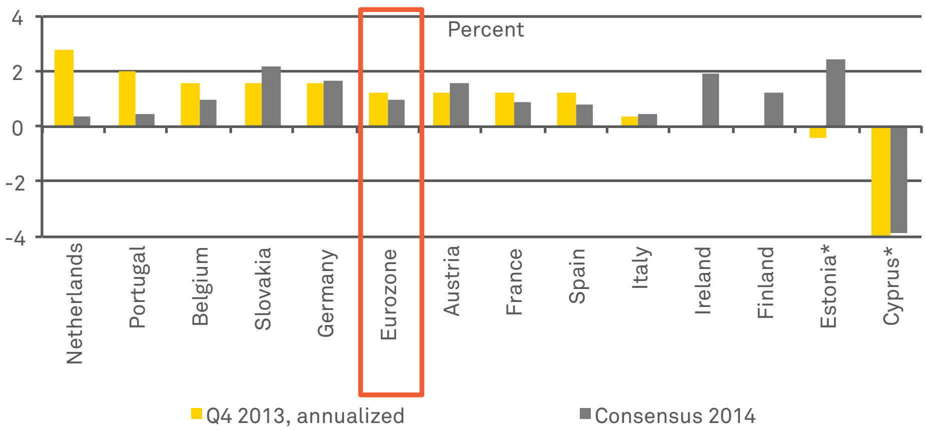
All EMU periphery countries expanded in the fourth quarter.

such as those caused by bad weather, fiscal uncertainties or a change of direction in monetary policy. In contrast to the United States, for example, this appears to create a rather solid and reliable foundation for 2014 and should support a further improvement in businesses and consumer sentiment.

Coupled with the observation that most leading indicators are improving as well, the second important aspect of the GDP data is that not only the core countries, including France, but all EMU periphery countries expanded in the fourth quarter. This reduces the pressure on the ECB to further ease monetary policy. If it still considers another rate cut, including the possibility of negative interest rates on bank deposits, and other unconventional instruments, this would suggest greater deflation fears on the part of President Draghi than he has admitted so far, rather than persisting recession concerns.

In our opinion, deflation risks in the euro area would currently not warrant the ECB using up its remaining interest-rate powder. Other, more unconventional ECB measures such as asset purchases are subject to legal risks–especially after the German Federal Constitutional Court's decision to refer the OMT issue to the European Court of Justice along with an explicit negative side comment. We expect the ECB to maintain its verbal commitment to more decisive action "as and when it is needed," but also to maintain its position that it is not needed for now. A change of this position is only likely if both the real economy and deflation woes become more pressing issues.

EMU — Gross Domestic Product (GDP)



Source: Macrobond, Bloomberg, Meriten Investment Management, 02/2014 Q4 2013 for Ireland, Finland and Greece are not available yet. *IMF forecast

Our forecasts reflect our belief that the countries of the eurozone which have just come out of recession are still in a process of relative wage and price adjustments, not in a deflationary spiral. Deflation describes a persistent decrease in the level of consumer prices that is not necessarily accompanied by a recession in the real economy. Japan, for example, has had periods of growth even in the deflationary period during the past 20 years or so. Developments in Europe are, in our view, not comparable to Japan's decade-long deflation.

What some may refer to as "deflation" in the eurozone is, in our view, better understood as relative price adjustments between the countries participating in EMU. These adjustments need to happen as part of a process from disequilibrium towards a new equilibrium that should be characterized by more evenly balanced competitiveness levels, and more evenly balanced asset prices in the currency union. Without the adjustment, there would be a risk of capital outflows from the periphery, of investment shortages and even more job and wealth losses. No doubt the adjustments which include wage declines and wealth losses in the crisis countries, are hard for the affected people and challenging for governments. However, if they succeed, they will be the foundation of more solid and sustainable growth in the affected countries in the future.

While the crisis countries are adjusting downwards, Germany has begun to inflate wages, albeit slowly, current very low headline inflation rates notwithstanding. In doing so, it contributes to the process towards a new equilibrium in the euro area.

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GROWTH FORECAST REVISION

Given the recent encouraging data, we are upgrading our growth forecasts for some EMU countries and the eurozone as a whole. We now believe Germany can clear the 2 percent growth mark, rather than our previously forecast: 1.7 percent. France's Q4 GDP was also 0.1 percentage points better than expected, but its leading indicators are less convincing. Even if President Hollande implements some or even all of his announced reforms, growth prospects would likely improve over the medium to long-term, rather than the short term. Consequently, we remain more skeptical about the country's growth prospects for the near future and lift our 2014 GDP forecast by a mere 0.1 percentage points to 0.7 percent.

It remains to be seen which course of action Italy's new government will take. As in France and elsewhere (Germany is a prominent witness), supply-side reforms in Italy might restrain growth in the short term before bearing fruit in the longer term, and there are no means available for fiscal stimulus to moderate the side-effects of reform at this point. Our Italian GDP forecast for 2014 therefore remains at 0.7 percent. Finally, we nudge our growth forecast for Spain up by 0.1 percentage points to 0.8 percent as signs of production and income stabilization grow and sentiment improves among companies and households. Overall, we raise our 2014 GDP forecast for the eurozone aggregate from 1.0 percent to 1.2 percent. That is still some way off from what we see as the new economic normality, but a further step in the right direction.

GDP Forecast

	Share in World GDP* (2013, %)	2007	2008	2009	2010	2011	2012	2013	2014E
Eurozone	**13.1%**	**3.1**	**0.3**	**-4.4**	**1.9**	**1.5**	**-0.6**	**-0.4**	**1.2**
Germany	3.7%	3.4	0.8	-5.1	3.9	3.4	0.9	0.5	2.1
France	2.6%	2.3	-0.1	-3.1	1.7	2.0	0.0	0.3	0.7
Italy	2.1%	1.7	-1.2	-5.5	1.7	0.4	-2.4	-1.8	0.7
Spain	1.6%	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.2	0.8
UK	2.7%	3.4	-0.8	-5.2	1.7	1.1	0.2	1.8	2.5
Switzerland	0.4%	3.8	2.2	-1.9	3.0	1.8	1.0	1.9	2.1
US	**19.3%**	**1.8**	**-0.3**	**-2.8**	**2.5**	**1.8**	**2.8**	**1.9**	**2.9**
Japan	5.5%	2.2	-1.0	-5.5	4.7	-0.6	2.0	1.7	1.5
Advanced Economies	**49.1%**	**2.7**	**0.1**	**-3.4**	**3.0**	**1.7**	**1.5**	**1.3**	**2.3**
Emerging & Dev. Economies	**50.4%**	**8.9**	**5.9**	**3.5**	**7.9**	**6.3**	**5.0**	**4.6**	**5.2**
BRICs	**26.9%**	**11.3**	**7.2**	**5.8**	**9.4**	**7.3**	**5.5**	**5.8**	**5.7**
China	15.4%	14.2	9.6	9.2	10.4	9.3	7.7	7.6	7.3
India	5.7%	9.8	3.9	8.5	10.5	6.3	3.2	4.7	5.0
Brazil	2.8%	6.1	5.2	-0.3	7.5	2.7	0.9	2.2	2.0
Russia	3.0%	8.5	5.2	-7.8	4.5	4.3	3.4	1.5	2.5
Central & Eastern Europe	**3.4%**	**5.2**	**3.2**	**-3.1**	**5.2**	**5.8**	**1.5**	**2.5**	**2.9**
Latin America	8.6%	5.7	4.2	-1.2	6.0	4.6	2.9	3.0	3.3
Asia	25.0%	11.5	7.3	7.7	9.8	7.8	6.4	6.8	7.0
World*	**100.0%**	**5.3**	**2.7**	**-0.4**	**5.2**	**3.9**	**3.2**	**2.9**	**3.6**

Source: Macrobond. Forecasts: Meriten Investment Management 02/2014. *Weighted with IMF purchasing power parties.

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