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ECONOMIC VIEWS

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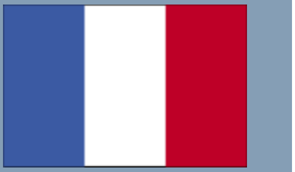
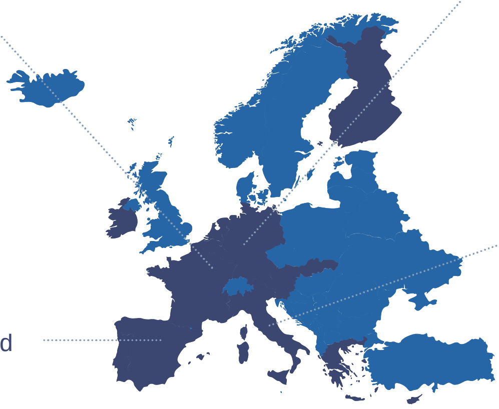
7 July 2010

EUROLAND



View from the top

Economic recovery in Euroland remains muted, with GDP growth being driven by exports and government spending. The planned fiscal austerity is therefore a significant risk to recovery in many member states.



France

Modest growth was achieved in Q1 due to galloping exports, but French consumer spending growth is slow due to falling confidence in the wake of announced fiscal austerity measures.

Spain

The government is proceeding with spending cuts while unemployment rises and consumers resign themselves to the inevitability of a painful adjustment.

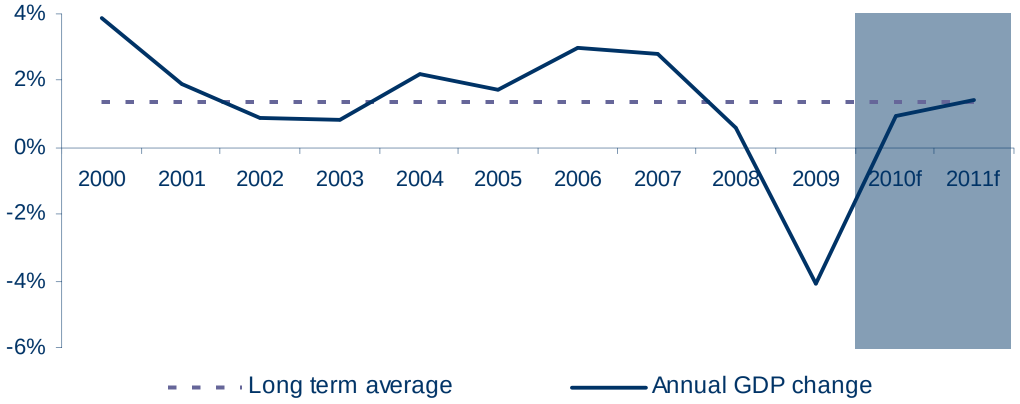
Germany

The economy contracted in Q1, but German exporters are bullish about international drivers of growth. German banks are exposed to the risk of debt restructuring on the Euroland periphery.

Italy

Italy was the fastest-growing large Euroland economy in Q1, but it is unlikely to maintain this pace in the coming quarters.

Economic growth profile



Source: Eurostat; PricewaterhouseCoopers forecasts (f)

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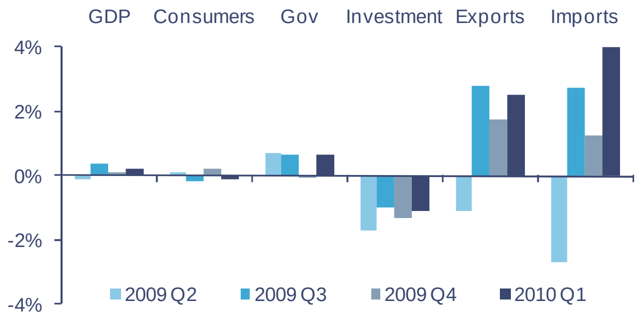
Overview

Euroland economic recovery remained muted in the first quarter of 2010, with GDP growing by 0.2% (see Chart 1 below). The economy benefited from external demand growth, but both investment and consumer spending contracted. After a brief stagnation at the end of 2009, government spending picked up in Q1, highlighting the important role of fiscal stimulus while the economy remains fragile.

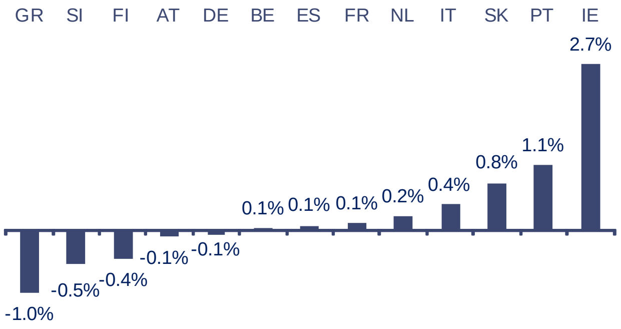
Chart 1: Euroland 2010 Q1 growth rates



Source: Eurostat

Although the overall picture for Euroland was moderately positive, there was substantial variation amongst the member states of the monetary union. Five countries saw their economies shrink in Q1, led by the 1% contraction in Greece (see Chart 2 below). Good news came in the form of strong expansion in Ireland and Portugal. Along with Greece, these countries are being closely monitored by the bond markets for signs of difficulty with servicing their sovereign debt obligations. However, favourable economic conditions are supporting Irish and Portuguese public finances, although, for 2010, the economic outlook in those countries remains only moderately positive.

Chart 2: 2010 Q1 GDP growth rates

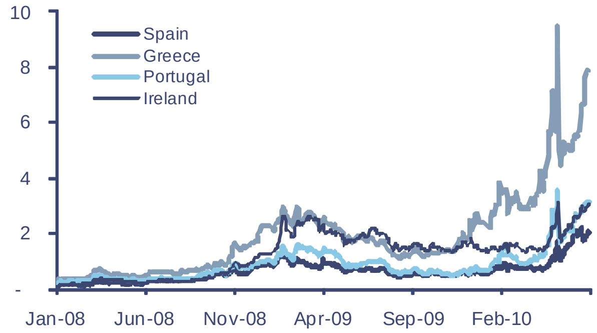


Source: Eurostat

The continuing risk of sovereign debt restructuring in Greece is one of the main factors clouding the economic outlook. Any such financial shocks would likely affect the core economies of Germany and France through their banks' exposure to at-risk government bonds. Other negative factors include concerns about the strength of demand, which are showing up in key forward-looking indicators, with purchasing managers' indices for both manufacturing and services falling sharply since March. As unemployment is still edging up, consumer confidence has fallen somewhat since the start of the year.

Governments may not be able to offset this lack of decisive positive signs in the private sector. The markets' tolerance for Euroland budget deficits has fallen again, with the pressure to consolidate public finances rising after a brief respite in May in the wake of the Greek bailout. The relative cost of raising sovereign debt is sharply up for Spain, Greece, Portugal and Ireland (see Chart 3 below) and fiscal austerity is on the political agenda across Euroland, even in the relative safe haven of Germany.

Chart 3: Spreads over German 10-year bond yields (percentage points)

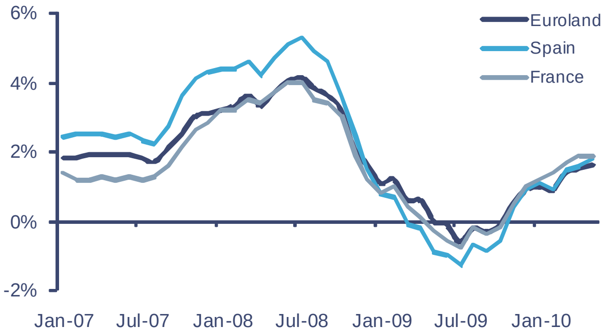


Source: Datastream

However, any significant immediate negative impact on the Euroland economy from fiscal consolidation is unlikely. With the exception of Greece, Ireland, Portugal and Spain, most of the austerity measures are planned for 2011 and beyond. As well as the delay in withdrawing fiscal stimulus, Euroland economic recovery is being supported by ongoing monetary stimulus, with interest rates remaining low.

But loose monetary policy may not last long enough for the economy to recover completely. Inflation has edged back up towards 2% (see Chart 4 below) and the European Central Bank (ECB) is perhaps the most likely big-economy central bank to prioritise price stability over economic growth. A premature rise in interest rates, just like a rapid withdrawal of fiscal stimulus, could place significant downward pressure on the Euroland economy.

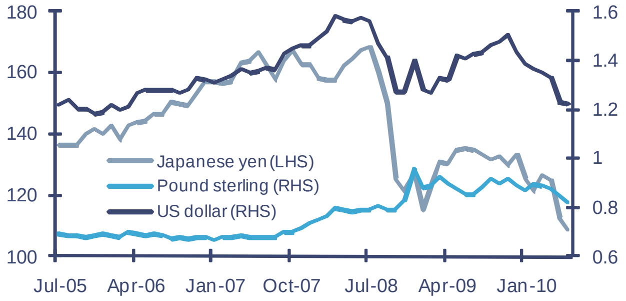
Chart 4: Inflation rates



Source: Eurostat

One bright spot for the Euroland economic outlook is the boost its exporters are receiving from the euro's weakness. In recent months, the euro has fallen in value against the yen, the dollar and the pound (see Chart 5 below), improving the price competitiveness of Euroland exporters in key international markets. The sustainability of this export boost to Euroland growth relies on continued strong demand growth in the US and emerging markets.

Chart 5: Value of currencies against the euro



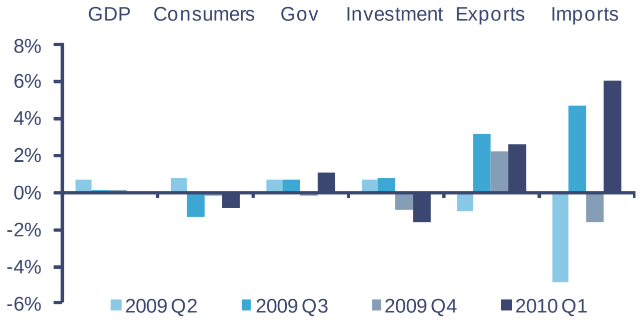
Source: Reuters

Although we expect the Euroland economy to grow overall in 2010, it is likely to expand at a modest pace. We forecast GDP growth of 0.9% in 2010, rising to 1.2% in 2011.

Germany

The German economy contracted unexpectedly in Q1, led by falls in consumer spending and investment (see Chart 6 below).

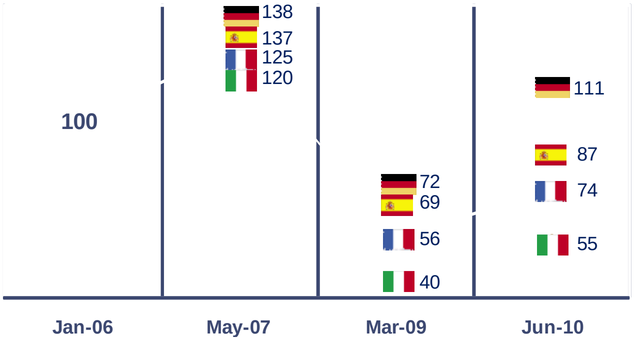
Chart 6: German 2010 Q1 growth rates



Source: Eurostat

Exports were the strong point for the German economy, driven by robust demand from emerging markets and North America and helped by the euro weakening against the dollar. Exporters expect external demand to hold up, as reflected in upbeat forecasts by such bellwether companies as Siemens, whose chief executive believes that the euro has “given European industry a tailwind”. Such confidence helps explain the strong recovery in German stock prices since the March 2009 trough (see Chart 7 below), as well as the rise in Germany’s economic sentiment indicator (see Chart 9 opposite).

Chart 7: Main Euroland stock market index values



Source: Datastream

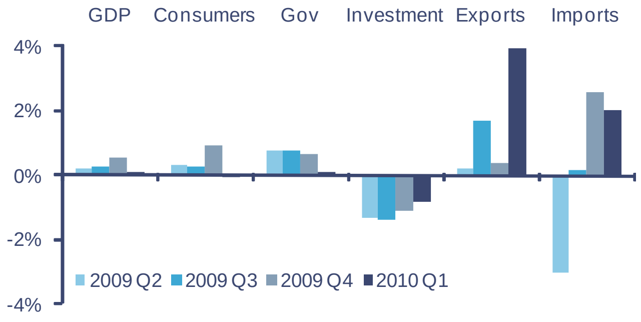
With steadily expanding order books, the unemployment rate is trending down (see Chart 13 below) as companies increase headcount. Some German businesses are worrying about capacity constraints, and we expect investment to pick up in response over the coming quarters. Such positive outlook is reflected in improving consumer confidence (see Chart 11 below).

We expect GDP to grow by 1.7% in 2010, with a 1.6% expansion forecast for 2011. The main risk to this outlook would be a surprisingly aggressive austerity programme, which is feasible given the current balance of power in the Bundestag. The potential vulnerability of German banks to any significant turmoil in the European sovereign debt market could lead to lower lending to domestic companies and consumers, if a debt crisis were to happen.

France

The French economy slowed sharply in Q1, expanding by only 0.1% (see Chart 8 below). It was propelled by a surge in exports, with investment trending back towards growth.

Chart 8: French 2010 Q1 growth rates

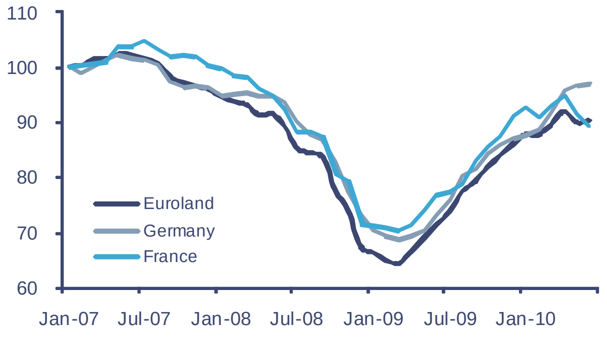


Source: Eurostat

However, consumers are downcast. Spending stalled in Q1 and confidence is down since the start of the year (see Chart 11 below). French consumers are concerned about the impact of announced fiscal consolidation measures, such as the increase in the retirement age from 60 to 62, and an efficiency drive that includes cutting 100,000 public sector jobs by 2013.

Government austerity is traditionally unpopular in France and political pressure could yet water down some measures, but it is clear that the period of unquestioned fiscal stimulus is over. The uncertainty about the sources of sustainable recovery has seen economic sentiment fall in recent months (see Chart 9 below), and stock prices have not picked up as much as in Germany.

Chart 9: Economic sentiment indicator



Source: European Commission

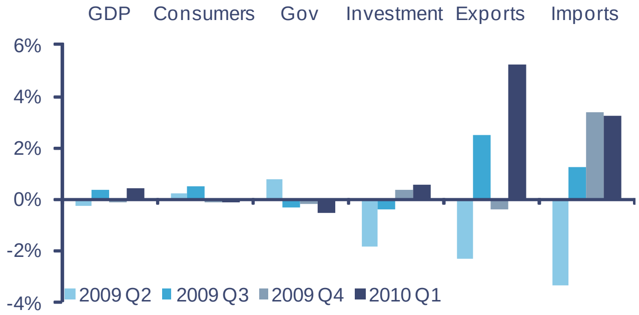
There are also worries about the exposure of French banks to European sovereign debt. The governor of the Bank of France has expressed concerns that some banks are already experiencing funding problems, while BNP Paribas has seen its credit rating downgraded on concerns about the strength of its balance sheet. Even though French public finances are relatively robust, the French economy could be affected by worsening European sovereign debt environment through its banks. Euroland bank stress tests will shed more light on the magnitude of this risk.

We forecast French GDP to expand by 1.3% in 2010, with a slight rise in the growth rate to 1.4% in 2011.

Italy

Relative to other large Euroland economies, Italy grew strongly in Q1 (see Chart 10 below). Exports surged, while investment expanded for the second consecutive quarter.

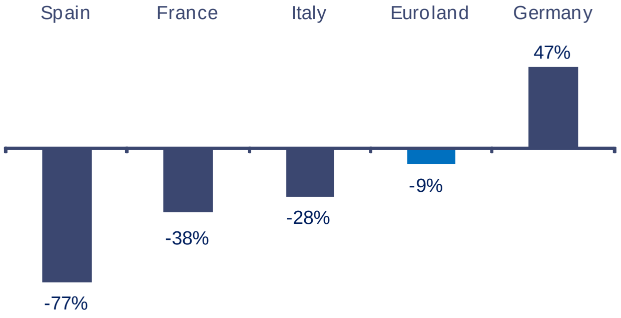
Chart 10: Italian 2010 Q1 growth rates



Source: Eurostat

Government spending has been falling since the second half of 2009. Rome appears determined to avoid being grouped with Spain and Portugal as a high-risk sovereign debtor. The private sector, therefore, must drive the economic recovery, but rising unemployment is weighing down on consumer confidence (see Chart 11 below). We expect consumer spending to pick up very slowly.

Chart 11: Consumer confidence change since Jan 2010



Source: European Commission

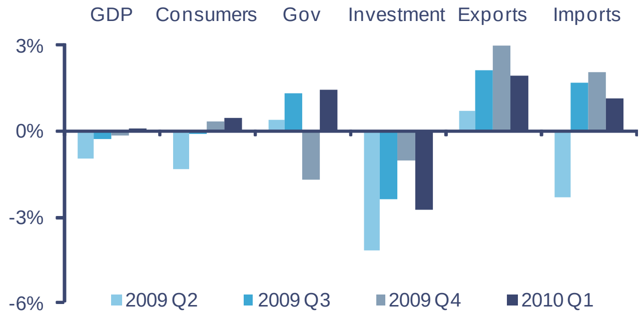
Italian businesses are, therefore, the most likely driver of growth. In previous recessions they typically benefited from a boost to their price competitiveness from a competitive devaluation of the lira. With this option no longer available to it, Italy could achieve a significant improvement to its growth prospects only through deep structural reforms or an internal devaluation through a fall in relative wages. However, both of these paths to faster economic growth are politically and socially unpalatable in the current environment.

Even though exports will continue to make a significant contribution to Italian growth, it is expected to be modest. Our forecasts are for Italian GDP to grow by 0.8% in 2010, and by 0.9% in 2011.

Spain

Spain achieved modest GDP growth in Q1, with acceleration in consumer and government spending (see Chart 12 below). However, there was a sharp contraction in investment in a reversal from the trend established over recent quarters.

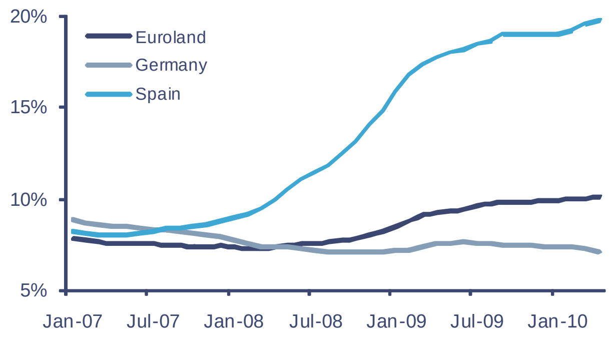
Chart 12: Spanish 2010 Q1 growth rates



Source: Eurostat

The recovery in consumer spending is unlikely to last, due to rising unemployment (see Chart 13 below) and falling consumer confidence since the start of the year (see Chart 11 opposite). Moreover, the balance sheets of Spanish regional savings banks (cajas) are constraining lending just as the ECB is phasing out its generous financing facility for Euroland banks, putting additional pressure on the cajas.

Chart 13: Unemployment rates



Source: Eurostat

At this critical time for the Spanish economy, the government is having to reduce spending and implement structural reforms in order to assure bondholder who are worried about the country's creditworthiness. The ultimate shape of the reform programme is uncertain due to the government's dependence for parliamentary votes on independently minded regionalist and nationalist parties, but the inevitable scaling back of capital expenditure and subsidies for infrastructure will especially hurt Spanish construction companies at a time when they are already badly hit by the collapse of the property boom.

The reforms could make Spain more competitive in the medium term, boosting productivity growth, employment and wages. However, in the short term, they are likely to be very painful for many Spanish households. Therefore, we expect GDP to fall by 0.7% in 2010, with a return to growth of only 0.7% in 2011.

Forecasts

GDP (annual % average)	2009	2010f	2011f
Euroland	-4.0	0.9	1.2
Austria	-3.6	1.1	1.3
Belgium	-3.1	1.3	1.4
Finland	-7.8	0.8	1.8
France	-2.2	1.3	1.4
Germany	-5.0	1.7	1.6
Greece	-2.0	-4.1	-1.9
Ireland	-7.1	-0.7	2.1
Italy	-5.0	0.8	0.9
Netherlands	-4.0	1.3	1.3
Portugal	-2.7	1.0	0.1
Slovakia	-4.7	3.4	3.2
Slovenia	-7.8	0.2	2.4
Spain	-3.6	-0.7	0.7

Source: Eurostat; PricewaterhouseCoopers forecasts (f)

Inflation (HICP % change, annual average)	2009	2010f	2011f
Euroland	0.3	1.3	1.3
Austria	0.4	1.4	1.8
Belgium	0.0	1.6	1.7
Finland	1.6	1.5	1.7
France	0.1	1.6	1.3
Germany	0.2	0.8	1.2
Greece	1.4	3.4	0.5
Ireland	-1.7	-0.8	1.1
Italy	0.7	1.4	1.6
Netherlands	1.0	1.3	1.3
Portugal	-0.9	1.1	0.8
Slovakia	0.9	1.5	2.6
Slovenia	0.9	1.5	2.3
Spain	-0.3	1.3	1.1

Source: Eurostat; PricewaterhouseCoopers forecasts (f)

Size of the Euroland economy

	2007	2008	2009	Share of 2009 world total
Population (millions)	323	325	327	4.87%
GDP, market rates (US$ billions)	12,341	13,625	12,503	21.59%
GDP, PPP rates (US$ billions)	10,563	10,856	10,542	15.11%
GDP per capita, market rates (US$)	38,150	41,876	38,288	
GDP per capita, PPP rates (US$)	32,655	33,366	32,282	

Source: International Monetary Fund

Definitions

ECB – European Central Bank

HICP – Harmonised index of consumer prices

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PwC's Macro Consulting team helps clients link the prospects for the global economy with the implications for their business and industry. Building on its on-going forecasts of key economic variables, the team offers services across two broad streams:

Demand analysis

The team helps clients assess future demand in existing markets and opportunities in new markets through:

- revenue forecasting of an existing business structure, using econometric models that link our economic forecasts and industry indicators to revenue;
- price elasticity analysis, pointing at a product's optimal price in an existing market; and
- forecasting of potential revenue and risks in new locations, identifying profitable future markets using bespoke econometric analysis and in-house models that forecast income distribution, multinational growth and future FDI flows, as well as a range of macroeconomic variables.

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The team also works with governments and the private sector to assess the impact a change in the regulatory environment would have on the economy.

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