# Outlook 2013: Eurozone

## Sluggish recovery is testing patience

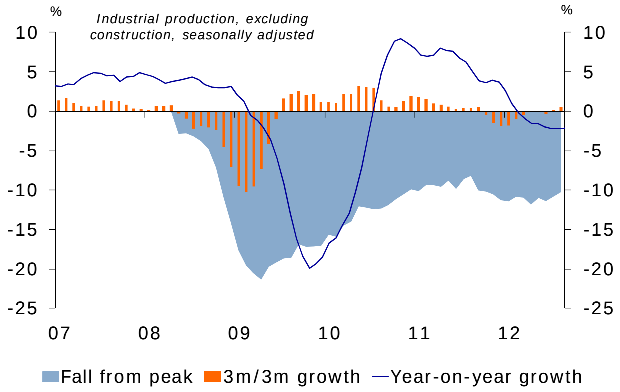
*While desperately in need of growth, eurozone's GDP is unlikely to pick up in the second half of this year. Although market sentiment regarding the European debt crisis seems to be on a cautious positive trend, the bleak outlook for 2013 suggests that there is no cause for too much optimism. More specifically, most southern countries are expected to remain in recession next year. On a more positive note, these countries are making good progress regarding their adjustment process, which means they will gradually reap the benefits in the coming years.*

### No short term signs of recovery

Industrial production, excluding the construction sector, expanded in both July and August on a monthly basis. If production in September were to remain at the same level, quarterly growth would be 1.1%, which is a clear improvement after the disappointing figures seen since autumn last year (figure 1). The industrial sector performed reasonably well in recent months in both northern and southern countries, but it is hard to square this development with the persistently weak sentiment levels of purchasing managers (PMI). Note that the manufacturing PMI in the third quarter (46.3) remained just below its level in the second quarter. Although the industrial sector can be considered as a temporary bright spot, we expect the services sector to remain a drag on growth in the second half of the year. Based on the historical relation between the level of the composite PMI –covering both the manufacturing and the services sector- and economic growth, the index now points to a sharper contraction of GDP in the third quarter (close to -0.5% q-o-q), similar to the PMI-implied contraction in the second quarter (figure 2). Unfortunately, sentiment levels of October do not point to an improvement in the fourth quarter. Both the composite PMI and

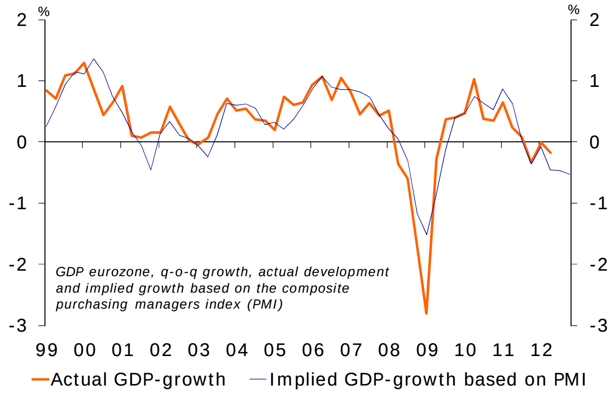
[1] A PMI level below 50 indicates a contracting activity.

**Figure 1: Industrial production eurozone**




Source: Reuters EcoWin

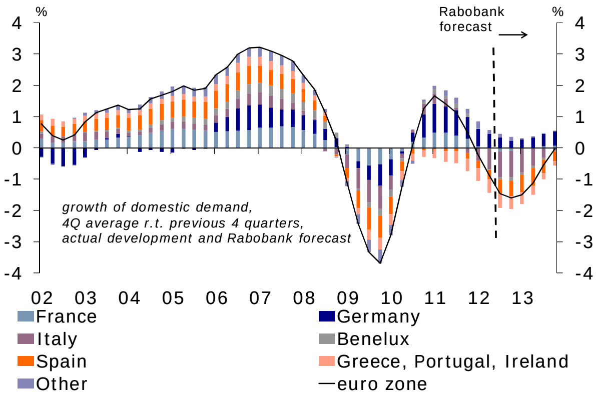
**Figure 2: GDP-growth based on PMI**




Source: Reuters EcoWin, Rabobank

the Economic Sentiment Indicator weakened further, the latter for the eighth month in a row.

**Figure 3: Domestic demand in eurozone**




Source: Reuters EcoWin, Rabobank

Our base case scenario of another mild contraction in the second half of the year is supported by adverse developments in the external sector. If the level of world trade in September were to remain at the same level, this results in quarterly contraction of 0.6%, compared to +0.6% q-o-q posted in the second quarter. Back then, net exports contributed 0.3%-points to growth. It is questionable whether export growth is able to once again compensate for weak domestic demand.

**Slowly out of recession**

For 2013 we foresee a gradual but slow economic recovery in the eurozone. Regarding the European debt crisis, there has been a remarkably strong positive trend in market sentiment since the European summit in June and the announcement of the *Outright Monetary Transactions* programme by the ECB. Despite this recent optimism, it should be stressed that sentiment in financial markets will remain fickle going forward. Political bickering about additional financial assistance for Spain and Greece and the clear possibility that ambitious budget targets in several member states will not be met, are key factors that might trigger renewed unrest. Against the background of a persistently uncertain economic environment, we do not anticipate that the depressed sentiment levels of both consumers and producers will improve substantially next year.

Despite this uncertain macro environment, there are a couple of factors which might contribute to a slow recovery of domestic demand next year (figure 3). First of all, the drag of governments' austerity measures is expected to be slightly smaller next year. Based on National Reform Programs, the intended effort to improve structural budget deficits of most member states will remain significant in 2013, but the average adjustment in the eurozone will be slightly less than this year. This might give some relief to the battered households, who will experience a slightly lower impact of tax hikes on their disposable income. In addition, the expected drop in inflation, from 2½% this year to 2% in 2013, might be an extra relief for households. However, the weak labour market will prevent households to go on a spending spree. Overall, we expect private consumption to stagnate next year, compared to a contraction of 1% in 2012. Although the uncertain economic outlook remains a drag, we also expect the business climate to improve next year. Our expectation is based on two factors.

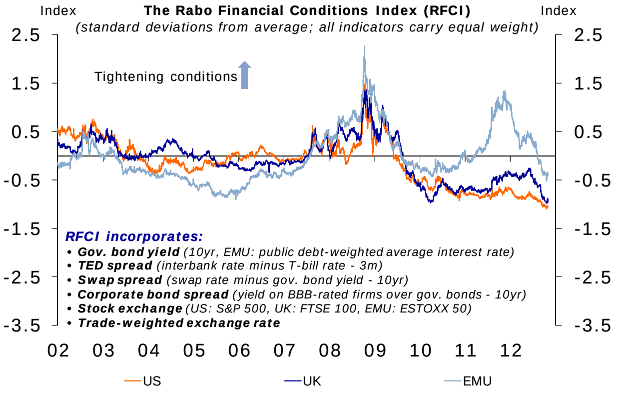
First, the growth of industrial production in recent months will push up the alarmingly low capacity utilisation rate. Even if this trend continues very slowly, it increases the rationale for investments aimed at expanding current production capacity. Second, loosening financial conditions in the eurozone may lower the threshold for firms to invest more (figure 4).

Given the slow recovery of domestic demand next year, the eurozone economy will remain highly dependent on growth of external demand. While most western economies have very limited budgetary and monetary leeway to stimulate their economies, all hopes are still pinned down on the emerging markets. This seems unrealistic since we expect only a few emerging countries to experience higher growth next year. A gradual strengthening of the euro against the dollar adds to the headwinds for exports. Therefore, we expect eurozone exports to grow by 3½% in 2013, only modestly faster than in 2012. Based on both slightly stronger domestic and foreign demand compared to this year, we expect eurozone GDP to grow by ½% in 2013. We stress that the debt crisis remains the foremost risk to our forecast. Given this unimpressive outlook, we do not expect job creation to be strong enough to prevent a further rise of unemployment. We have penciled in a rise of the average eurozone unemployment to 11½% next year.

**Rebalancing improves outlook further down the road**

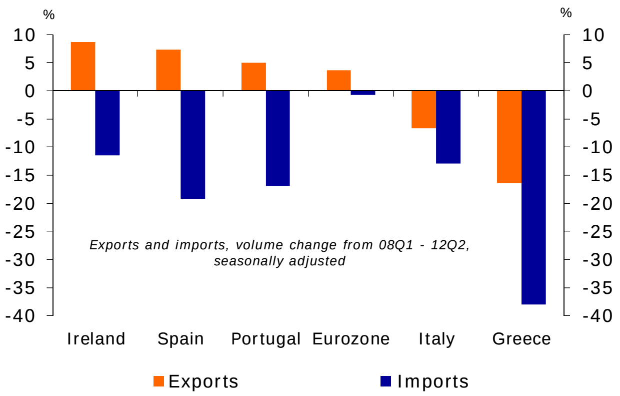
The abovementioned growth figures for the eurozone as a whole mask the large differences in the economic conditions between the 'north' and the 'south'. These growth differentials can be mainly attributed to the rebalancing process, which started since the financial crisis in 2008/09. Current account data for the second quarter of 2012 show that the rebalancing process in the south -which is necessary to reduce the dependency on foreign funding- is still gradually taking place. While the cumulative current account deficit of all 'deficit countries'

**Figure 4: Financial conditions have improved**




Source: Reuters EcoWin, Rabobank

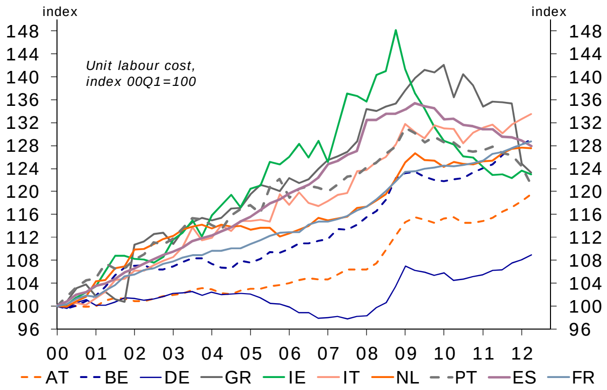
**Figure 5: Rebalancing via import contraction**




Source: Reuters EcoWin

together (four quarter average) was around 2.9% of eurozone GDP end-2008, this has dropped to 1.4%-GDP by mid 2012. It should be noted that this adjustment was mainly achieved by a large contraction of imports –due to lower domestic demand- and only to a limited extent by a rise of exports (figure 5). Rebalancing via a contraction of imports is the painful and undesirable route, as it comes at high social and economic costs. Besides that, it is uncertain to what extent this adjustment process is structural or cyclical. If the relative wage and price level of a country do not change, imports might pick up as soon as domestic demand starts growing again. Rebalancing via higher export growth is the preferable route, not only because it is more sustainable but it also comes with higher growth and employment.

**Figure 6: Unit labour costs eurozone**




Source: Reuters EcoWin

The economic outlook beyond 2013 shows that southern countries should not expect the painful rebalancing process to end soon. Although it is impossible to predict how the debt crisis will evolve in the future, past years have shown that political decision making and institutional progress in Europe evolve bumpy and slowly[2]. This means that budgetary consolidation, depressed confidence levels and tight financial conditions will continue to weigh on domestic demand, especially in the south. As we have stressed before, politicians in the north should take their responsibility by making the adjustment process more symmetric.

Not only should several member states be granted more time to reach their budget targets[3], but also northern countries should try to minimize the negative impact on domestic demand. So far this has fallen on deaf ears, which leaves especially the south stuck with ailing economies and further increases in unemployment rates. Faced with the resulting rise of social unrest in several countries, this poses a risk in terms of social and political support for the required adjustments.[4]

[2] See Rabobank Special Report 12/14 *Institutional tug of war* for further information on the institutional progress and challenges for the eurozone.
[3] It should be noted that the Stability and Growth Pact allows budget targets to be stretched in a situation of unexpected, adverse economic conditions which negatively affect a country's public finances.
[4] See Rabobank Special 12/08, *Political risks in the eurozone*.

Fortunately, there are indications that the rebalancing process might be increasingly facilitated by higher export growth instead of import contraction going forward. Figure 6 shows the development of unit labour costs (ULC) in the euro area, which suggests that the relative price competitiveness of most southern countries has improved recently. Only the ULC of Italy has not come down yet. Besides that, most southern countries are making progress by implementing structural reforms on several fronts[5]. As most reforms aim to increase the potential growth rate, they help to facilitate a more sustainable rebalancing process in the south. However, it takes time to improve the competitiveness in this manner. In the medium- to long-term, the south will reap the rewards of this painful adjustment process.

**Table 1: Key figures eurozone**

| Year-on-year change (%) | '11 | '12 | '13 |
|---|---|---|---|
| Gross Domestic Product | 1.5 | -½ | ½ |
| Private consumption | 0.1 | -1 | 0 |
| Government consumption | -0.1 | -½ | -1 |
| Investment | 1.6 | -3¼ | ½ |
| Exports | 6.4 | 2¾ | 3½ |
| Imports | 4.2 | -¼ | 2½ |
| Inflation | 2.7 | 2½ | 1¾ |
| Unemployment (%) | 10.2 | 11½ | 11½ |

Source: Reuters EcoWin, Rabobank

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[5] See Rabobank Themabericht 12/26 '*Zuid-Europa en Ierland in actie*' (in Dutch) for more details on the progress of the peripheral countries regarding several policy areas.