



Eurozone: Economic outlook

In the euro zone, the revision of the IMF's 2012 forecast confirms our central scenario of a mild contraction in economic activity (-0.5% according to the IMF). Growth will be symbolic at best in Germany and France (0.3% and 0.2%, respectively) and will contract sharply in the countries hard hit by the crisis (-2.2% in Italy and -1.7% in Spain). After a contraction of about half a point expected in Q4 2011 (vs. +0.1% in Q3), economic indicators seem to confirm the mild nature of the recession, albeit with wide disparities between countries. Even so, we advise caution and refuse to jump to conclusions based on the data observed in a single month. The European Commission's monthly economic conditions index rose 0.6 points to 93.4 in January. The improvement was especially strong in Germany and remains limited to the services sector. Similarly, the composite PMI index for activity climbed out of contraction territory in January, from 47 in November, the index rose to 48.3 in December and then to 50.4 in January. Unsurprisingly, the rally was strongest in Germany (54 vs. 51.3 and 49.9 in the previous months) and to a lesser extent in France (50.9 vs. 50 and 48.8). This contrasts with the other big economies of the euro zone, where activity was sapped by efforts to absorb imbalances (public finances, current account deficits). Despite the upturn announced by leading indicators, the euro zone economy remains very fragile. Uncertainties arising from the ongoing crisis combined with the financial market tensions they engender inevitably erode confidence and encourage a wait-and-see approach to hiring and investment.

Against this backdrop, the IMF asked the euro zone authorities to bolster the permanent European Stability Mechanism, which is to be set up in mid year, to more than €500bn, and to consider the creation of eurobonds, which has run up against traditional German opposition. It also asked for greater coordination of economic policies, with the countries with the healthiest public finances easing up on their fiscal consolidation efforts.

Inflation dropped back to 2.7% in December after exceeding 3% over the previous three months. The impact of the downturn in activity on the formation of wages and pricing power has nourished expectations that general price inflation would ease to 2% by mid 2012. Prices would slow down even faster if it weren't for fiscal consolidation measures, which for several countries has meant raising indirect taxes (higher VAT rate in Italy, France and Portugal). Geopolitical turmoil in the Middle East also creates a risk for energy prices.



In January, the ECB held its refi rate unchanged at 1%. Mr. Draghi reiterated that the central bank "never precommits" when it comes to future interest rate movements. Given the prospects of slowing inflation, weak money supply growth (M3 slowed from 2.6% yoy in October to 1.6% in December), lending growth (1.1% yoy in December vs. 1.5% in October) and the cyclical environment (Mr. Draghi points out the downside risks for activity), we cannot rule out the possibility of one or possibly two key rate cuts by mid 2012.

The latest ECB quarterly bank lending survey conducted between 19 December and 9 January reveals both an ongoing easing of credit demand, partially due to the postponement of investments, and tighter lending conditions due to the economic cycle, the cost of financing and balance sheet adjustments. Injections of long-term liquidity to contain pressures on bank financing have reduced the risk of a credit crunch. On 21 December, the first 3-year LTRO injected €489bn, and a second operation will be held in February. The LTRO sharply eased pressures on short-term government bond rates. On 3 February, Italian 2-year rates back to 3.01% after reaching 7.8% in November. Its Spanish counterpart dropped to 2.57% from 6.2%. The LTRO also had a significant impact on longer maturities. Italian 10-year rates declined 1.7 points to 5.66% and Spanish 10-year rates declined 1.74 points to 4.98%. It cut short contagion and the stress correlation between sovereign debt and banking debt. By definition, the measure only acted on liquidity and could not prevent deleveraging by banks, which must raise their core Tier 1 ratios to 9% by June. Nonetheless, it clearly had a stabilising effect. This strong move was welcome at a time when banks were facing €650bn in bond refinancing this year. It eased pressures in the interbank market and deflated CDS spreads in the sector. Although it did end up swelling the ECB's balance sheet, much like measures by the Fed and the Bank of England, the 3-year LTRO provided a special kind of quantitative easing unlike the ones practiced by the US or the UK. Instead of purchasing sovereign securities, the ECB offered on a specific day a 1% fixed rate loan for a predetermined time period at unlimited amounts against collateral (representing credits and not risk-free public securities). The banks continued to carry the risk. This operation does not affect the supply and demand equilibrium in the market for Treasuries.

Although the current environment lends itself poorly to purchases of Treasuries by banks, given their implication in debt restructuring (private sector involvement or PSI) and the European Banking Authority's new requirement that sovereign debt securities be marked to market, the LTRO does offer an attractive carry trade. On the one hand, Basel III short-term liquidity ratios encourage banks to hold reputedly liquid assets, while risk continues to be treated very favourably in the solvency ratio (0% risk weighting for ratings of AA- or higher and 20% for ratings of A+ to A-, which is currently the case for Spain and Italy). Although sovereign debt was marked to market in the last EBA stress tests, this probably will not be the case in the next tests scheduled for July. The European agreement of 8-9 December rejected the possibility of further private sector



involvement along the lines adopted for Greece. On the other hand, the public authorities undoubtedly encouraged local banks in some countries to undertake carry trades, in what is sometimes called “financial repression”.

The euro has declined 13% against the dollar since last May, providing a welcome but limited boost to foreign trade. Euro zone exports to the United States (12% of total exports) and to the dollar zone as a whole account for less than 30% of exports. From the euro’s peak in 2011, the real effective exchange rate (REER) has declined 4%. It is estimated that a 1% depreciation in REER increases exports outside of the euro zone by 0.36 points. Given the weight of exports outside the euro zone as a share of GDP and the very low price elasticity of import volumes, we can estimate that the euro’s recent depreciation triggered roughly a 0.3-point increase in GDP. At the same time, however, the resulting increase in import prices would have a depressive impact on domestic demand, more than erasing the beneficial impact of the boost in foreign trade.