



Eurozone / Zone Euro

Stagnation and deflation risk

In Q2, the economy stagnated in the Eurozone and inflation eased further. The lack of dynamism is partly related to the tight fiscal stance and losses in competitiveness in markets outside the EU. The second half of the year looks challenging due to severe tensions in the Middle East and the Ukraine.

Eurozone

■ Economic growth grinded to a halt in the Eurozone in Q2. Business services are likely to have strengthened, as the confidence index for this sector strengthened to 3.9 compared with 3.4 in the Q1. By contrast, manufacturing output and construction activity might have declined.

■ Economic activity is held back by a tight fiscal policy, as many eurozone countries are pursuing austerity policies to consolidate the public finances. According to the OECD, the cyclically-adjusted budget deficit could improve by 0.5 point both in 2014 and 2015.

■ Moreover, monetary conditions have remained relatively tight despite easing measures by the ECB. Interest rates have come down, partly thanks to the lowering of the refi rate to only 0.15%. However, as inflation has also declined, real interest rates have remained relatively high, in particular for small and medium-sized enterprises. In addition, banks have been reluctant to lend, even though some change is noticeable. According to the ECB bank lending survey, credit standards on loans to enterprises eased in Q2. Moreover, net loan demand also increased.

■ Today, Eurostat also announced that inflation in the eurozone eased to only 0.4%. This was partly due to negative base effects for energy and food. Core inflation remained stuck at 0.8%. This could be welcome news for consumers, as wages are hardly progressing. However, it also is also due to the sluggish economic climate. Moreover, the low inflation environment makes it more difficult for households and governments to reduce their indebtedness.

■ The second half of the year looks challenging, as severe tensions in the Middle East and the Ukraine are likely to weigh on business activity. Moreover, higher energy prices might divert the risk of the eurozone falling into deflation, but will dent households' purchasing power. The IFO climate indicator for the eurozone fell sharply in Q3.

Stagnation et risque de déflation

Au deuxième trimestre, l'économie de la zone euro a stagné et l'inflation a baissé davantage. Le manque de dynamisme est en partie lié à une politique budgétaire de rigueur et la perte de compétitivité sur les marchés en dehors de l'UE. Le deuxième semestre pourrait être encore plus difficile en raison des tensions graves au Moyen-Orient et en Ukraine.

■ National Accounts

GDP

% , sa, q/q	2013	Q1-2014	Q2-2014
Eurozone	-0.4	0.2	0.0
Germany	0.1	0.7	-0.2
France	0.4	0.0	0.0
Italy	-1.9	-0.1	-0.2
Spain	-1.2	0.4	0.6
Netherlands	-0.7	-0.4	0.5

Source: Eurostat

France

% , sa, q/q	2013	Q1-2014	Q2-2014
GDP	0.4	0.0	0.0
Private consumption	0.3	-0.5	0.5
Government consumption	2.0	0.4	0.5
Investment	-0.8	-1.0	-1.1
Contribution of stocks	-0.2	0.5	-0.1
Exports	2.4	0.6	0.0
Imports	1.9	1.0	0.4

Source: INSEE

Netherlands

% , sa, q/q	2013	Q1-2014	Q2-2014
GDP	-0.7	-0.4	0.5
Private consumption	-1.6	-0.7	0.2
Government consumption	-0.3	0.9	-0.2
Investment	-4.0	-1.7	-3.1
Contribution of stocks	0.1	-0.2	-0.2
Exports	2.0	1.1	0.6
Imports	0.8	1.2	-1.1

Source: Statistics Netherlands



■ Against this backdrop, GDP growth in the Eurozone will struggle to reach 1.2% in 2014, as we forecasted three months ago. Some countries may fall behind their budget consolidation programmes. However, we doubt that the European Council will insist on the respect of the budget targets if the general outlook for the Eurozone is deteriorating, as it would shoot itself in the feet.

Germany

■ In Germany, GDP contracted by 0.2%. This was partly a correction after the very high growth in Q1 (0.7%). As a result, quarterly GDP growth averaged 0.4% in the first half of the year, which is close to the country's potential growth rate.

■ The German business climate has deteriorated in recent months. The IFO climate indicator, usually a good bellwether for underlying business activity, has been on a declining trend since May, but is still consistent with activity growth. Underlying momentum looks a tad softer, meaning Q3 growth is less likely to exceed the Q1-Q2 average. Nevertheless, we still expect growth in 2014 to be close to 2%, thanks to the good performance at the start of the year.

France

■ In France, the economy remained stagnant in Q2. Manufacturing production fell by 1%, as industry find it hard to cope with the strength of the euro. Questioned on the competitive position in foreign markets outside the EU, the balance of opinion in France was around -10 in Q2 and Q3. In Germany it was 4.1 and 2.4, respectively. The indicator was also positive in Italy, Spain and the Netherlands. It shows the need for urgent structural reforms in French industry.

■ Moreover, the industry is affected by the reluctance of households and companies to make big purchases. Household purchases of cars only rebounded slightly by 0.4% after a -1.4% decline in Q1. Corporate spending on manufactured goods fell by around 0.5% in both Q1 and Q2.

■ We forecast now growth for 2014 to be around 0.5%, substantially lower than the government's forecast (1%). For 2015, the government is projecting GDP to grow by 1.7%. However, if growth does not pick up significantly in the second half of the year, this will be hard to achieve.

■ This could have consequences for the preparations of the 2015 budget. A lower GDP growth projection should be accompanied by more austerity measures if the government wants to stick to the deficit targets. The debate, driven by France and Italy, about greater flexibility in European fiscal rules, is not about to go away in the coming months. However, if the economic climate deteriorates, more austerity is certainly not the way to reverse the trend.

Italy

■ GDP declined by 0.2% in Q2 after having already contracted by 0.1% in Q1 (see *EcoFlash 182 Italy: Going down, 6 August*). It implies that the economy is again in recession. The second half of the year also promises to be difficult as the economy will be confronted with weak external demand. On the other hand, households may step up their spending after the implementation of the tax reduction for low-earning families. Also the speeding up of payments of overdue bills to government suppliers may stimulate domestic spending. Nevertheless, growth in 2014 is estimated at only 0.2% of GDP, well below the government's forecast. For the moment, the government is determined not to breach the 3% deficit level.

Spain

■ Spain's recovery is gaining strength, as GDP grew by 0.6% in Q2 after 0.4% in Q1. The recovery is broadly based. Industrial production increased by 0.6% in Q2, similar as in the previous quarter, as Spanish industry is benefiting from improved competitiveness. Retail trade is profiting from improved purchasing power, increased employment and the strong inflow of tourists as Spain has become a relatively cheap holiday destination.

■ However, the second half of the year will be more difficult for the economy. Spain is not immune to any slowdown in the Eurozone. In particular, the Russian embargo on agricultural products might hit exports. Moreover, household debt continues to weigh on consumer expenditure. The low inflation environment – in July consumer prices were 0.3% lower from a year earlier, – renders the deleveraging process more difficult. We forecast the economy to grow by 1.2% in 2014 as a whole.

Netherlands

■ As expected, GDP rebounded in Q2 by 0.5% after a similar decline in Q1, mainly driven by external demand. The decline in gas exports, related to the mild weather during spring and production limitations, was more than compensated by rising export for manufactured goods. Producer confidence in the manufacturing sector reached in July its highest level since June 2011.

■ Since house prices have bottomed out in the second half of 2013, household confidence has considerably improved. Moreover, the labour market is on the point of turning around as the number of temporary workers is rising again. Spending on durable goods is picking up, supported by rising disposable income and less expenditure on heating.

■ However, as in Spain, mortgage debt continues weighing on household budgets. About 25% of Dutch mortgages are "under water". The low inflation environment – in July harmonised consumer prices rose by only 0.3% y/y – and moderate wage increases make it difficult for households to reduce their indebtedness.

■ The second half of the year may prove more challenging given the geopolitical uncertainties. We expect GDP growth to reach 0.5% for 2014 on the whole.

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