Schroders Quickview: Reform laggards hold back eurozone growth

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First quarter eurozone GDP is estimated to have grown by 0.2% (quarter-on-quarter), matching quarterly growth at the end of 2013 but disappointing the City, where consensus expectations were for an acceleration to 0.4% growth.

Quarterly year-on-year growth picked up from 0.5% to 0.9%, but fell below the consensus of 1.1%. The main drivers of the disappointment came from France, Italy and the Netherlands – all of which continue to struggle with ongoing austerity and structural reforms.

French quarterly GDP was flat in Q1 compared to 0.2% in the previous quarter (revised down from 0.3%) and against expectations of 0.1% growth. The French GDP report highlighted falling domestic demand, likely to be in reaction to the recent increases in already high taxes. The Italian economy also surprised to the downside by contracting by 0.1% (consensus estimates of 0.2% growth). In fact, the level of Italian GDP is now lower than the previous trough in 2013 Q3.

Elsewhere in the Union, Germany's GDP growth was better than expected (0.8% vs. 0.7% consensus), which helped support an acceleration in growth for Poland and Hungary (both up 1.1%). Spain is estimated to have grown by 0.4% on the quarter – its fastest quarterly growth rate for six years - however, both Finland and the Netherlands struggled, with the former falling into a triple-dip recession.

Overall, it is clear that the reform laggards are holding back growth for the eurozone in aggregate. While Germany continues to go from strength to strength, we doubt that it can maintain the current pace of growth into the summer. Indeed, the surge in activity in the first quarter was aided by a very mild winter, enabling the construction sector in particular to work without the seasonal disruptions. France and Italy, need to make greater progress in implementing structural reforms in order to offset the cost of fiscal austerity. Countries that have made steady progress like Ireland and Spain are now seeing the fruits of reforms.

Looking ahead, leading indicators suggest eurozone growth should accelerate over this year, but that Germany is likely to be the key driver, while France continues to struggle. For the European Central Bank, the latest mixed growth numbers highlight the problem it faces of setting monetary policy for a diverging set of economies. Nevertheless, the disappointment in the growth figures is likely to support the doves at the Bank for greater stimulus. We continue to expect a cut in the main refinancing rate at the June meeting (to 0.1%), but no cuts to the deposit rate, nor the introduction of quantitative easing. We think this could disappoint markets, which appear to be pricing in something more than the small cut in the main interest rate.

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