RESEARCH

Economic Watch

Europe

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Economic Analysis

Europe
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The economy is set to contract further in 3Q

- Soft data suggest that the economic contraction intensified in 3Q
- However, hard data through August show slightly more encouraging outlook
- Our MICA-BBVA model estimates that GDP might have dropped by 0.3% q/q in 3Q
- Inflation growth slightly outpaced forecasts in 3Q, driven by energy prices and tax hikes

Soft data suggest that the economic contraction deepened in 3Q

Both PMI survey and European Commission (EC) figures were discouraging in 3Q, as they remain firmly stuck in contraction territory and suggest that the GDP downturn for the eurozone as a whole may even be deeper than that seen in 2Q (-0.2% q/q). Nonetheless, these surveys also skewed differently in some areas, with PMI data appearing to indicate that the economic slump has hit bottom, while EC indicators continue to show a marked and ongoing downtrend.

Economic performance among countries diverged even more in 3Q, with peripheral countries' confidence deteriorating further, while central European countries also suffered a worsening crisis by mid-year. Specifically, the only positive news came from a stabilising German economy, while both the Spanish and Italian economies may have contracted at a similar pace to that seen in 2Q. As for France, both confidence indicators significantly deteriorated in September, which suggests that economic activity may also have contracted in 3Q after remaining stagnant in the two previous quarters. However, these numbers contrast with the Banque de France's confidence surveys, which show a much more moderate slowdown and point to only slight contraction in 3Q.

However, it is important to note that September confidence indicators were somewhat better than expected, especially in Italy and Spain, which is in part a reflection of easing financial tensions and receding worries about the sustainability of the countries' government finances in light of the ECB's willingness to purchase government debt and, accordingly, lend its support to the irreversibility of the euro project. While 4Q figures are not yet available, we expect them to be in line with our outlook for mild economic improvement in coming quarters.

However, hard data through August show slightly more encouraging outlook

Industrial production exceeded forecasts in both July and August, rising by an average of 1pp through August over 2Q, when it shrank by 0.4% q/q. Using a 3M moving average to offset volatility, the most recent data indicate that the industrial production slump hit bottom early in the quarter and is now staging a tepid comeback. However, it is still too early to confirm a recovery for industry, particularly when industrial orders, both domestic and export driven, continue to deteriorate and thus do not signal that said recovery will gain rapid traction in the next few months.

This more encouraging industrial activity is taking place across the board among member states, though great uncertainty persists about whether the uptick is a temporary trend and may thus evaporate when September numbers are released. In particular, the 1.5% m/m rebound in French industrial output in August was largely the result of the volatile transport component, while Italy's rise in industrial activity (1.7% m/m) could be due to seasonal factors.

In sum, the tepid improvement in industrial production can be amply absorbed by current installed capacity, as EC survey data indicate that capacity utilisation is still clearly below average, suggesting that it would not result in stepped-up investment.

Retail sales throughout the euro zone were virtually unchanged from the end of 2Q until August, arresting the decline in the quarter (-0.6% q/q) and indicating that household spending may have been more resilient than in the previous quarter (private consumption shrank by 0.4% q/q in the 2Q). This weak household spending is generalised throughout member states. However, data available up to August show that retail sales dropped in Germany and Italy but rebounded in France, partly offsetting the decline of the previous quarter. Still, the divergence in household spending between the periphery and central European economies is likely to persist in coming months as a result of both the fiscal adjustment processes underway in peripheral states and the divergent performance of the labour market, which continued to worsen in the third quarter (by around 0.2pp to 11.4% in the euro zone as a whole), with the exception of Germany.

Given the above, together with the fiscal adjustment which will erode government spending, especially in the periphery, **domestic demand likely continued to dampen economic growth in 3Q.**

As a consequence, **net exports will remain the main driver of European economic growth.** Euro zone exports grew briskly up to August (1.4% q/q over 2Q), though imports were somewhat more resilient (0.4% q/q over 2Q) than domestic spending, which indicates that the positive contribution of net exports may wane in 3Q (after contributing 0.3pp in the 2Q). By country, the underpinning of net exports is also a determinant factor offsetting a drop in domestic demand, primarily in peripheral states, while the German economy continues to benefit from still-strong growth in emerging economies.

Our MICA-BBVA model estimates that GDP dropped by 0.3% q/q in 3Q

This forecast assumes that the economic slowdown may be somewhat steeper than anticipated in our most recent estimates (-0.1% q/q) and, accordingly, would entail a sharper GDP decline, around -0.5%, for all of 2012. For 2013, we still expect sluggish economic growth, even though the ECB's announcement has eased financial tensions.

Inflation growth slightly outpaced forecasts in 3Q, driven by energy prices and tax hikes

Following an August increase (0.2pp), inflation remained unchanged at 2.6% y/y in September, since an inflation spike in the most volatile components was offset by a slowdown in core inflation (-0.1pp to 1.6% y/y). In sum, current high inflation is driven mainly by steep inflation in energy prices, which accounts for about 40%. Nonetheless, September numbers show no signs of possible second-round effects, while the slump in domestic demand and a gloomy economic outlook in coming quarters should prevent any such effects from emerging in the short and medium term.

As for the rest of the year, we expect inflation growth to ease in October, hovering around 2.4% y/y in 4Q, while core inflation should remain steady at 1.6% y/y. Consequently, the average annual inflation rate for 2012 is likely to stand at 2.5%, with core inflation at 1.8%.

Inflation performance shows clear differences among countries, with inflation nudging above 2% in France and Germany, while in Spain and Italy it rose by around 3.5% y/y in September. By contrast, inflation slowed slightly in Portugal to 2.9% y/y. The marked differences in inflation among these economies are the result of tax hikes prompted by each country's fiscal consolidation process.

Table

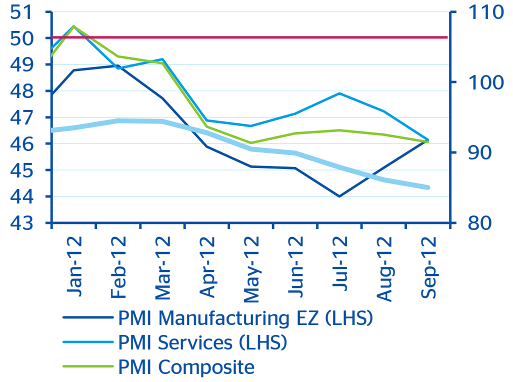
Table 1
Main indicators for Eurozone countries

		Euro Area	Germany	France	Italy	Spain	Portugal	Greece	Ireland	UK
					National Accounts					
Jun-12	(*)									
GDP	q/q	-0.20	0.27	-0.04	-0.84	-0.43	-1.17	7.53	-1.10	-0.38
	y/y	-0.40	0.99	0.25	-2.56	-1.30	-3.26	-6.26	1.20	-0.52
	2011									
	y	1.58	3.03	1.70	0.44	0.42	-1.67	-7.10	1.43	0.87
					Activity					
Aug-12										
Industrial Production	m/m	0.64	-0.35	1.55	1.69	1.32	6.79	2.47	0.00	-0.50
	q/q	0.98	1.47	0.70	0.24	0.49	5.29	3.71	1.11	1.36
Sep-12										
EPI	Level	85.00	94.70	87.60	78.50	84.10	74.10	76.10	n.a.	91.9
	Change	-1.10	-1.10	-1.60	-0.10	1.30	-5.00	-0.90	n.a.	0.4
Sep-12										
PMI Manufacturing	Level	46.14	47.43	42.73	45.73	44.55	n.a.	42.18	51.84	48.37
	Change	1.06	2.77	-3.30	2.12	0.50	n.a.	0.09	0.96	-1.2
Sep-12										
PMI Services	Level	46.15	49.69	44.98	44.45	40.21	n.a.	n.a.	53.90	52.24
	Change	-1.08	1.39	-4.23	0.44	-3.75	n.a.	n.a.	2.22	-1.42
					Consumption					
Sep-12										
EC Consumer Confidence	Level	-25.90	-10.30	-27.80	-38.80	-36.80	-58.60	-75.60	-26.20	-19.3
	Change	-1.30	-1.50	-2.30	-0.80	2.90	-6.90	-10.40	-4.50	-0.6
Aug-12	(*)									
Retail Sales	m/m	0.11	0.31	-0.84	-0.31	2.09	2.83	1.95	-0.29	-0.36
	q/q	0.50	-0.70	1.95	-0.37	0.37	3.01	1.44	0.63	1.21
					Labor Market					
Aug-12	(**)									
Unemployment rate	Level	11.40	5.50	10.60	10.70	25.10	15.90	25.10	15.00	7.9
	Change	0.0	0.0	0.0	0.0	0.1	0.2	0.3	0.1	0.0
					Prices					
Sep-12	(***)									
HICP	m/m	0.73	0.00	-0.25	2.06	1.93	0.39	2.50	-0.09	0.49
	y/y	2.61	2.06	2.15	3.39	3.45	2.90	0.28	2.43	2.50

Note: (*) Greece and Italy data: July.(**) UK and Greece data: July. (***) UK data: August
Note: quarterly figures are averages
Source: Eurostat, European Commission and BBVA Research

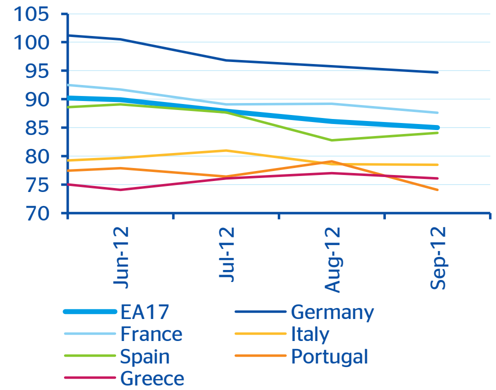
Charts

Chart 1
Confidence suggest further contraction in 3Q than in 2Q



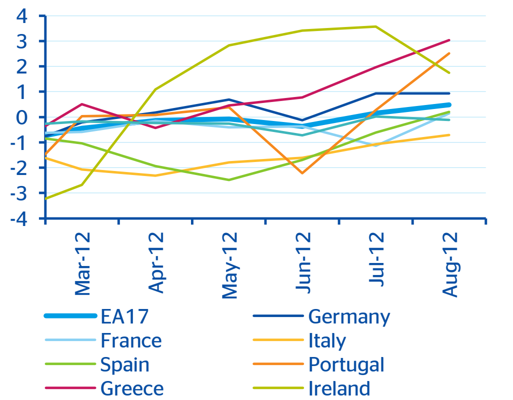
Source: Markit Economics and European Commission

Chart 2
Divergence among countries (ESI). Central Europe vulnerable to crisis



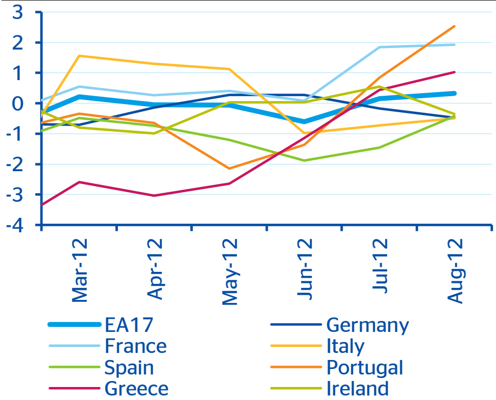
Source: European Commission

Chart 3
Industrial Production (3mma): Better than expected in 3Q



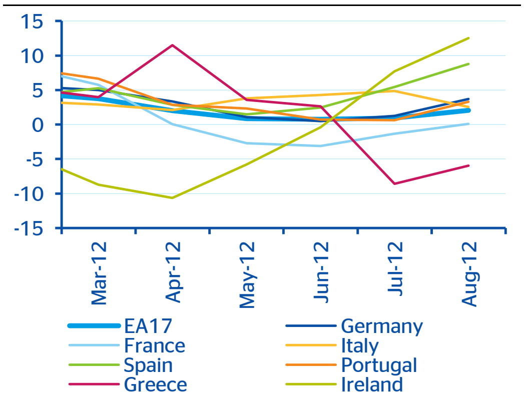
Source: Eurostat

Chart 4
Retail Sales (3mma): Household spending more resilient than expected



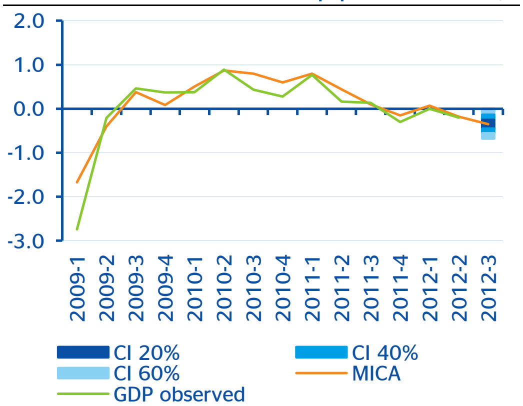
Source: Eurostat

Chart 5
Exports (3mma): robust growth despite global demand slowdown



Source: Eurostat

Chart 6
MICA-BBVA estimates -0.3% q/q GDP fall in 3Q



Source: BBVA Research