

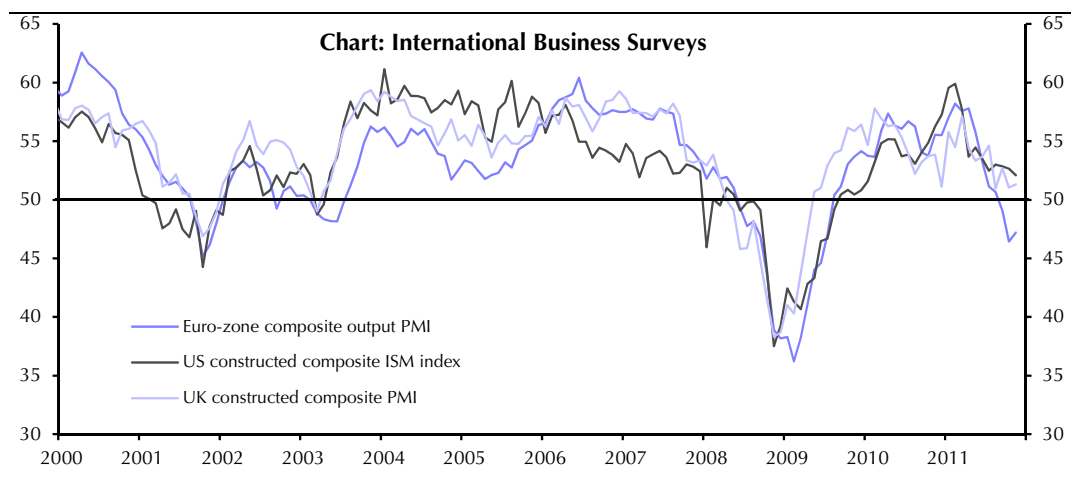
# EUROPEAN CHART BOOK

Dec. 2011



## Entering another deep recession

- Hopes that euro-zone policymakers will hatch a new “grand plan” to save the euro-zone may have grown, but evidence is mounting that the region is on the cusp of another deep recession. In November, the euro-zone composite PMI remained well below the theoretical “no change” level of 50 and the equivalent US and UK indices. (See Chart.) Meanwhile, the hard data suggests that industrial output is likely to have fallen in Q4 – this would be the first quarterly decline since 2009.
- **Activity indicators** still point to a renewed recession in the euro-zone. (Page 2.)
- **Consumer indicators** have shown that households are continuing to tighten their purse strings. (Page 3.)
- **Business indicators** suggest that industrial output will contract in Q4. (Page 4.)
- **External indicators** have revealed that export growth held up well in Q3, but timelier indicators still paint a pretty gloomy picture. (Page 5.)
- **Labour market indicators** have revealed that unemployment has continued to rise. (Page 6.)
- **Inflation indicators** have shown that while headline inflation remains well above the ECB’s target, it looks set to fall sharply before long. (Page 7.)
- **Monetary indicators** suggest that the debt crisis is taking its toll on the banks. (Page 8.)
- **Fiscal indicators** confirm that the most troubled euro-zone economies’ budget deficits are narrowing. (Page 9.)
- **Financial indicators** have revealed that markets have become less fearful of an Italian or Spanish government default. (Page 10.)



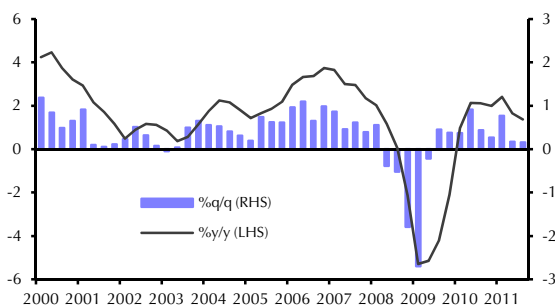
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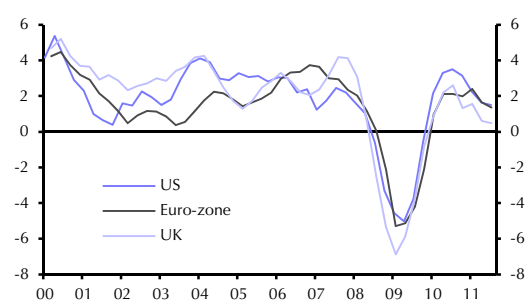
## Activity Indicators

- Euro-zone activity indicators are still pointing to a renewed recession. The second GDP release for Q3 confirmed that the economy expanded by 0.2%, the same as in Q2, causing the annual growth rate to slow from 1.7% to 1.4% **(1)**. This was a similar pace to the US, but better than the UK **(2)**.
- But despite rising slightly in November, the euro-zone composite PMI remains consistent with quarterly falls in GDP of up to 1.0% **(3)**. This is in stark contrast to equivalent indices in the UK and (particularly) US, which point to a further expansion in activity **(4)**. Within the euro-zone, only the German index remains above the theoretical “no change” level of 50 **(5)**.
- The EC’s Economic Sentiment Indicator (ESI) fell to a two-year low in November. At this level, the ESI appears consistent with small falls in euro-zone GDP compared to a year earlier **(6)**, implying very sharp quarterly declines around the turn of the year.

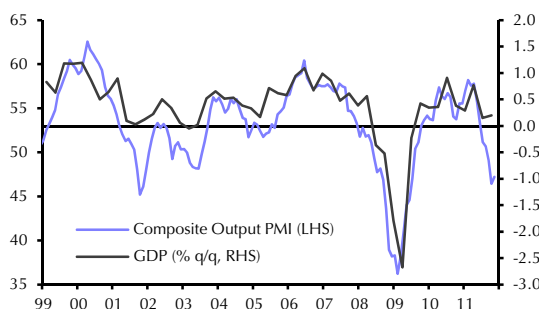
1. Euro-zone GDP



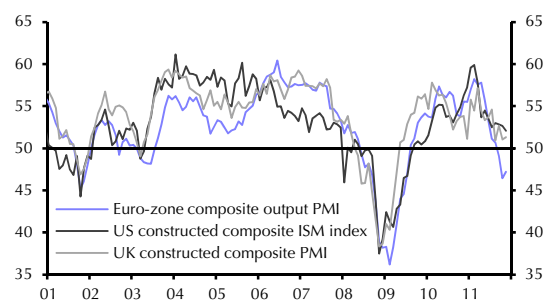
2. International GDP (% y/y)



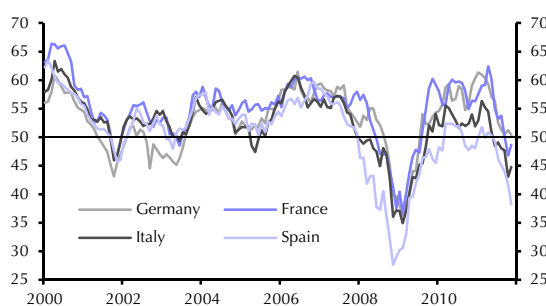
3. Euro-zone GDP & Composite PMI



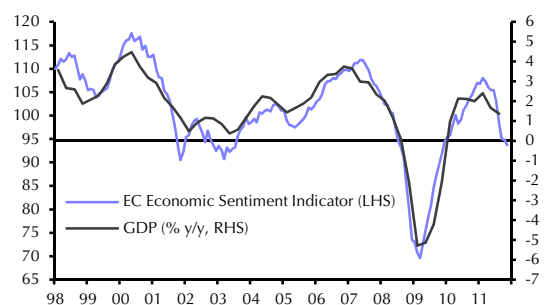
4. International PMIs



5. Euro-zone PMIs by Country



6. Euro-zone GDP & EC Economic Sentiment Indicator

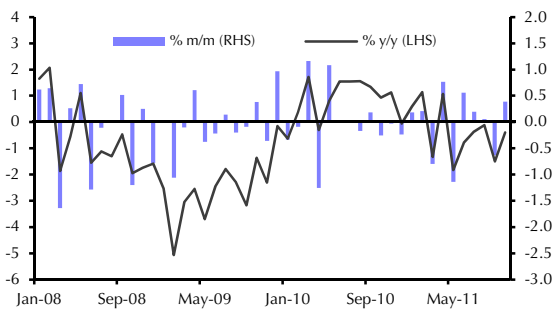


Sources – Thomson Datastream, Markit, Capital Economics

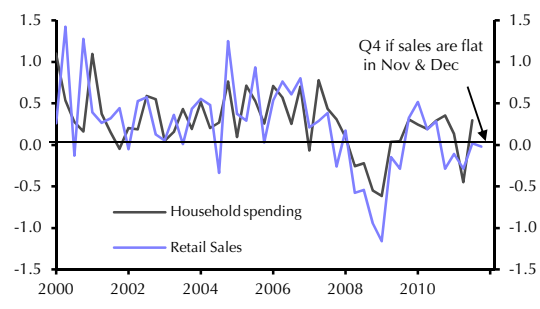
## Consumer Indicators

- The euro-zone consumer outlook remains dismal. Retail sales rose by 0.4% in October, but the rise did not offset September's 1.5% fall and left the annual growth rate in negative territory for the sixth month running **(1)**. If sales were unchanged in November and December, they would have stagnated in Q4 as a whole, suggesting that consumers cannot be relied upon to keep the economy growing **(2)**.
- Retailers have seen no improvement lately – the PMI measure of sales compared to a month earlier dropped to a joint record low in November **(3)**. Car sales appear to be recovering from the slump caused by the expiry of “cash for clunkers” schemes. But sales growth remains far too weak to offset the weakness of high street spending **(4)**.
- Looking ahead, November's fall in consumer confidence suggests that households will remain reluctant to spend **(5)**. Ongoing fiscal tightening and the continued weakness of bank lending will also keep spending very subdued **(6)**.

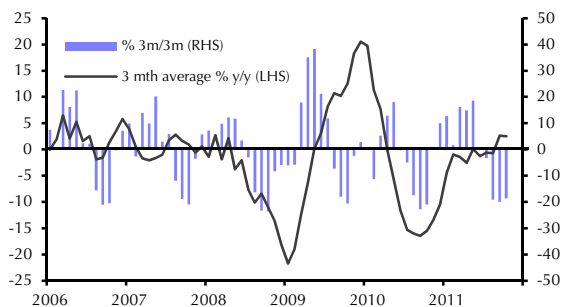
**1. Euro-zone Retail Sales**



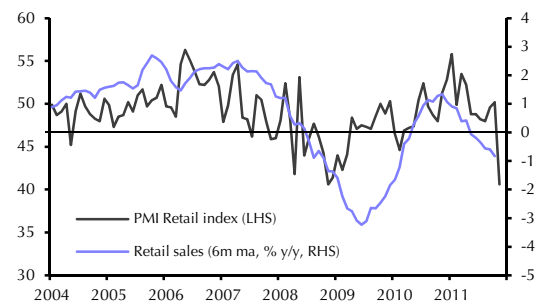
**2. Retail Sales & Household Spending (%q/q)**



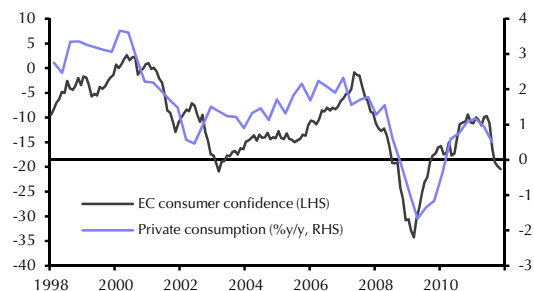
**3. New Car Registrations**



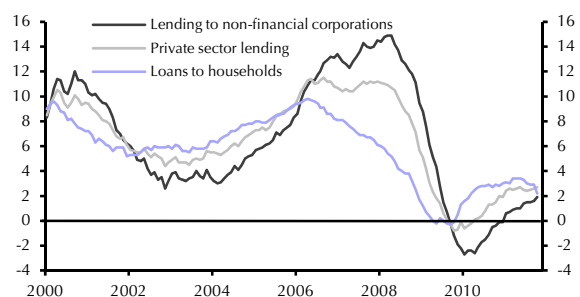
**4. Retail Sales & Retail PMI**



**5. EC Consumer Confidence & Consumer Spending**



**6. MFI Lending (% y/y)**

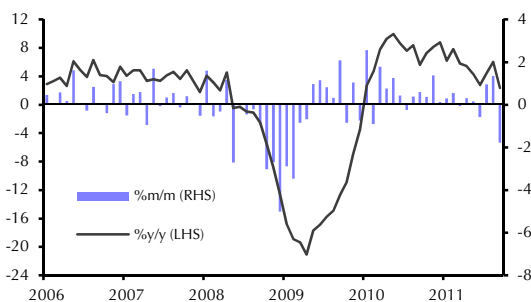


Sources – Thomson Datastream, Capital Economics

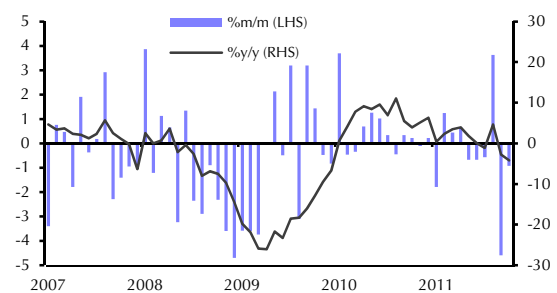
## Business Indicators

- The recent euro-zone industrial data add to evidence that the wider economy contracted in Q4. In September, euro-zone industrial production plunged by 2% and largely reversed the previous two months' healthy gains (1). Admittedly, German production expanded by 0.8% in October. But monthly falls in Italy (2) and Spain imply that euro-zone production was little changed in October.
- This means that, at the start of Q4, euro-zone industrial output is likely to be well below the average level in Q3 (3). What's more, the further falls in the business surveys of industrial activity and sentiment in November suggest that output may continue to contract. Note that the manufacturing PMI is now consistent with pretty sharp falls in annual euro-zone industrial production growth (4).
- Meanwhile, although service sector output expanded in Q3, the services PMI suggests that output is likely to fall in the fourth quarter, despite the index picking up in November (5). Note that the Spanish index has recently fallen particularly sharply, supporting our view that Spain will suffer from a sharper downturn than the euro-zone as a whole (6).

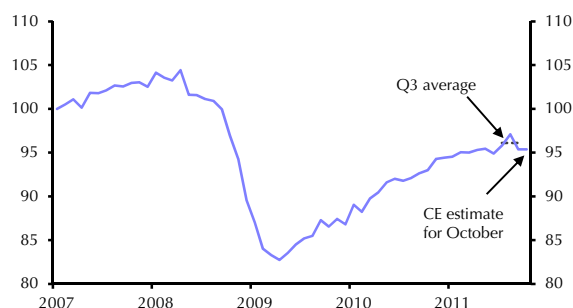
1. Euro-zone Industrial Production



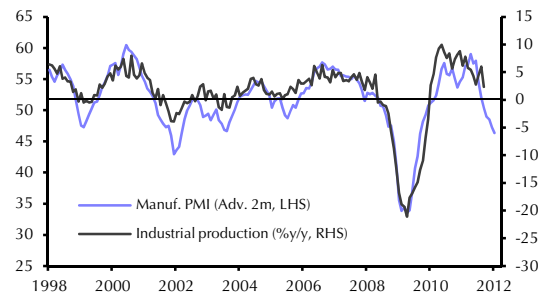
2. Italian Industrial Production



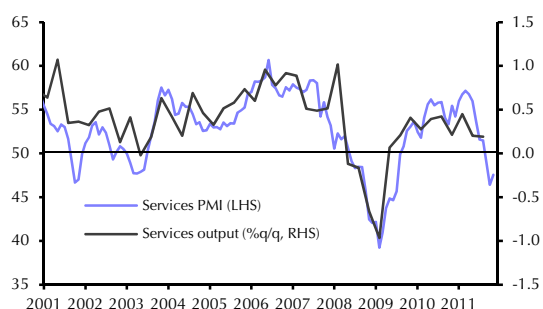
3. Euro-zone Industrial Production (Jan. 2005 = 100)



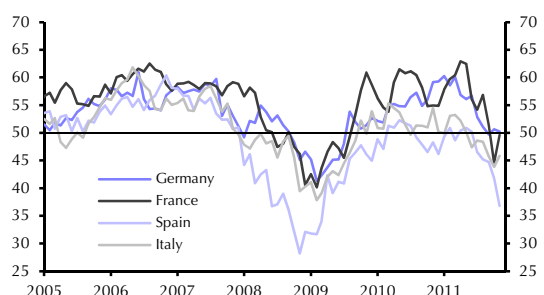
4. E-Z PMI Manufacturing & Industrial Production



5. Euro-zone Service PMI & Services Output



6. Services PMI

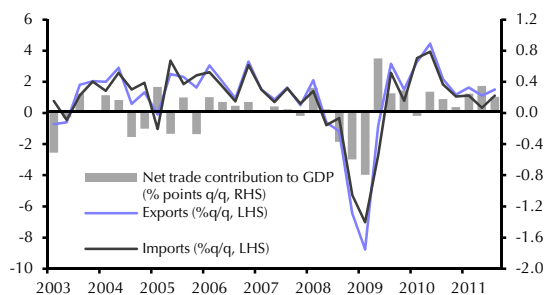


Sources – Thomson Datastream, Markit, Capital Economics

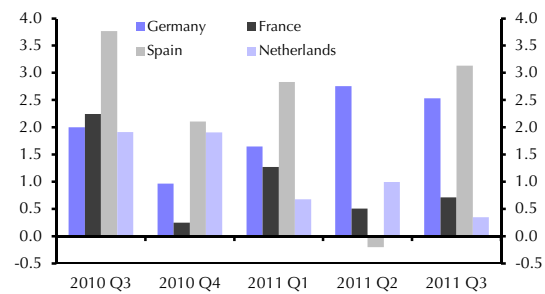
## External Indicators

- While Q3's export data paint a reasonably rosy picture, the near-term prospects for exporters still look pretty grim. The Q3 GDP expenditure breakdown showed that euro-zone export volumes increased by 1.5% on a quarter earlier, a touch stronger than the 1.1% rise in imports (1). Germany and Spain recorded particularly strong quarterly rises in exports in Q3 (2).
- Note though that the monthly data suggest that the pace of expansion slowed towards the end of the quarter (3). And business surveys of firms' export orders have continued to fall since then. What's more, the euro-zone wide PMI measure is far weaker than the US and UK indices and points to annual falls in exports (4,5). What's more, the survey suggests that even the region's most competitive economies will not be immune to the export slump (6).
- Admittedly, the negative effects of weaker demand on exporters may be partially offset by the recent drop in the euro. But export growth is likely to slow even if the euro-dollar exchange rate eventually falls to \$1.10, in line with our own forecasts.

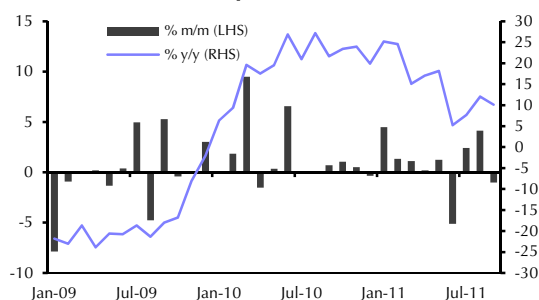
1. Euro-zone Export & Import Volumes



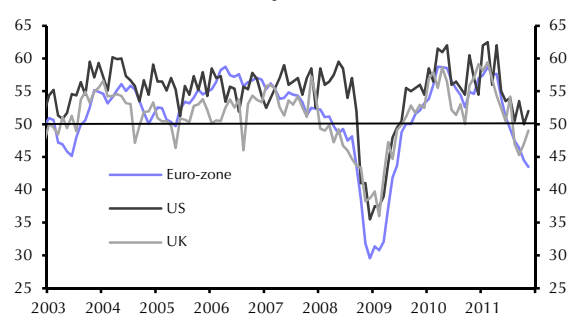
2. Export Volumes (% q/q)



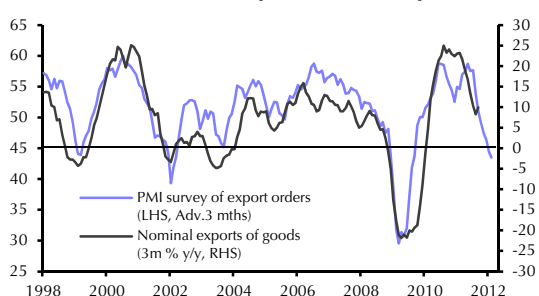
3. Export Values



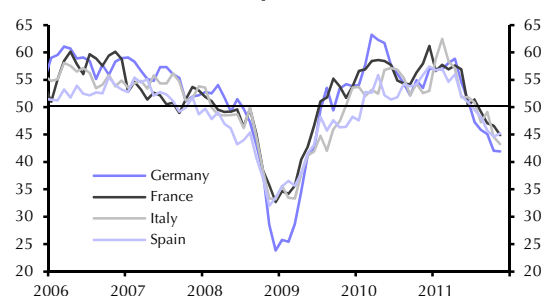
4. PMI Export Orders



5. Euro-zone PMI Export Orders & Exports



6. PMI Export Orders

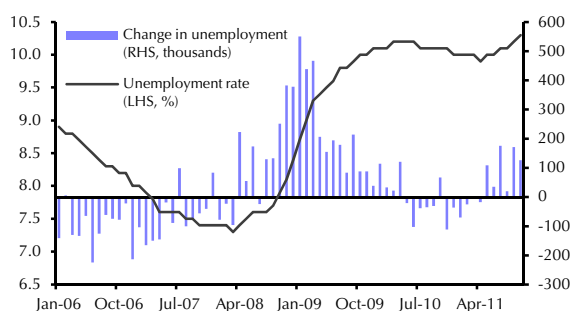


Sources – Thomson Datastream, Markit, CE

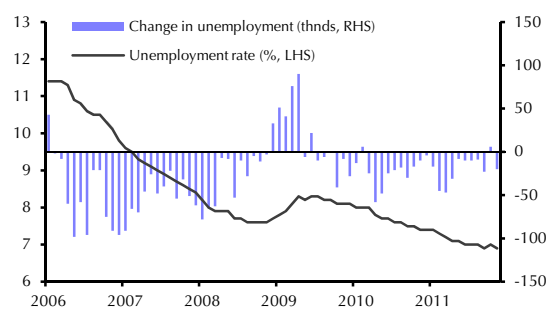
## Labour Market Indicators

- The labour market downturn has continued. The number of unemployed people in the euro-zone rose for the sixth consecutive month in October. This caused the unemployment rate to rise for the second month running, to 10.3% - the highest since June 1998 **(1)**.
- Conditions improved again in Germany, where the unemployment rate fell from 5.7% to 5.5% in October. And more timely national data pointed to a further decline in November **(2)**. However, conditions elsewhere are terrible, with the Spanish rate rising to 22.8% and the Irish rate holding at 14.3% **(3)**.
- The PMI survey measures of hiring continued to weaken in November, although the EC version ticked up. For now, both indices point to continued positive employment growth in the region **(4,5)**, but note that they do not include the public sector, where cuts will be aggressive. Hourly labour costs growth rose from 2.7% in Q1 to 3.6% in Q2 **(6)**.

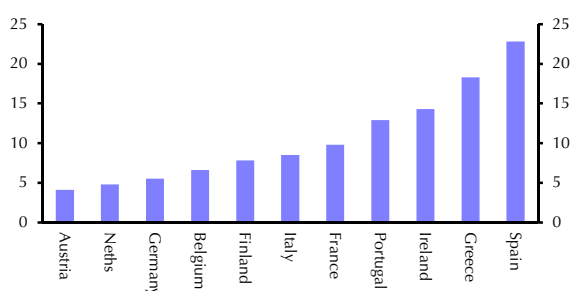
**1. Euro-zone Unemployment**



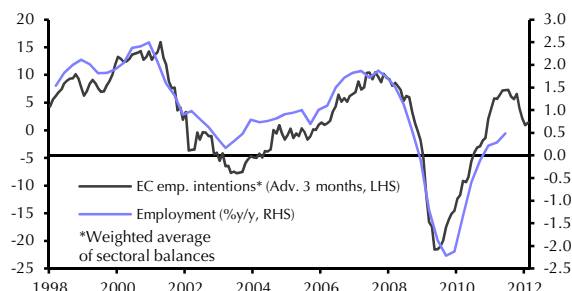
**2. German Unemployment**



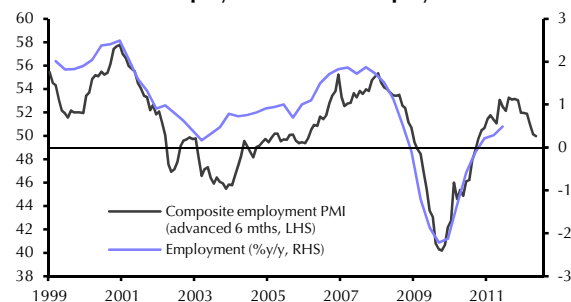
**3. Euro-zone Unemployment Rates (%)**



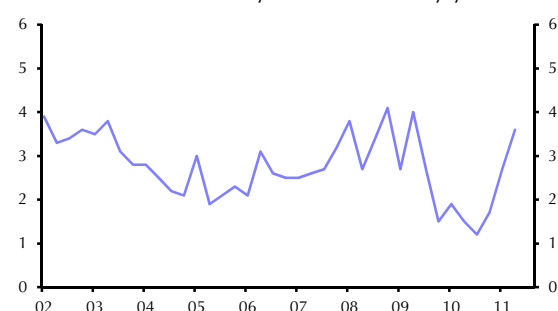
**4. E-Z EC Employment Intentions & Employment**



**5. PMI Employment Index & Employment**



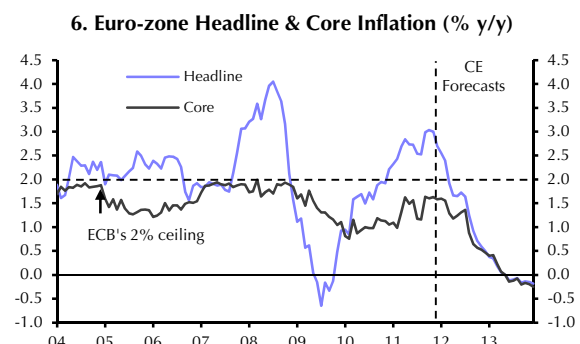
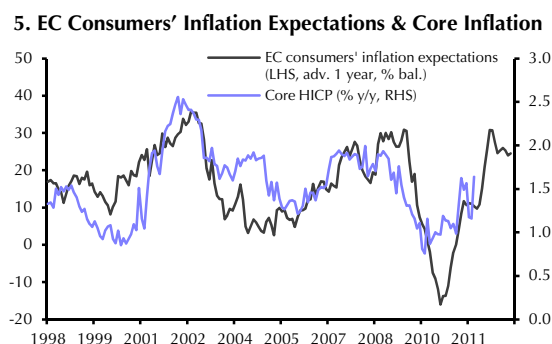
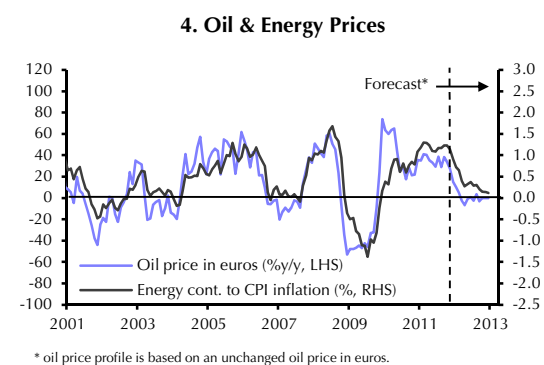
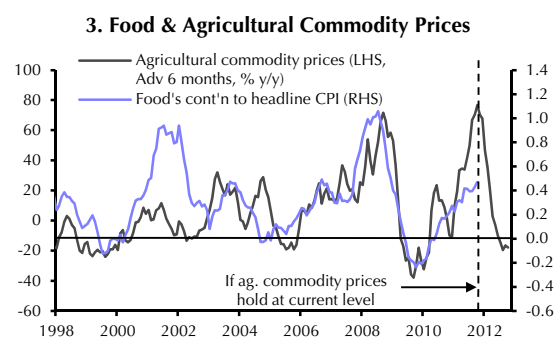
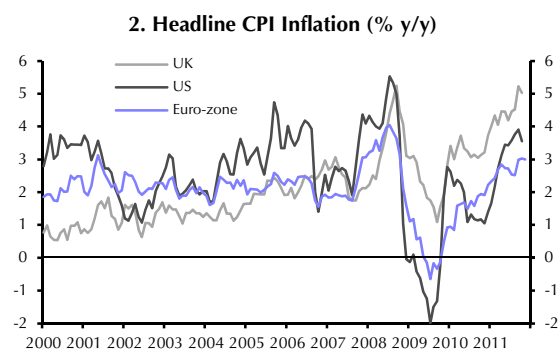
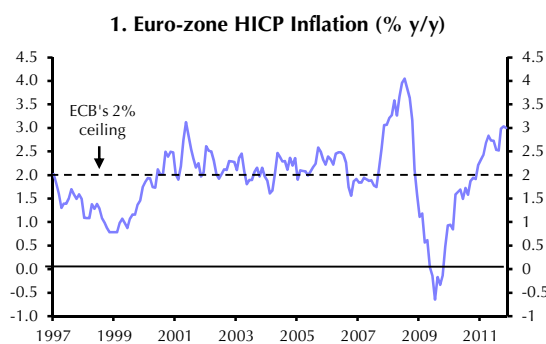
**6. Euro-zone Hourly Labour Costs (% y/y)**



Sources – Thomson Datastream, Markit, Capital Economics

## Inflation Indicators

- Headline euro-zone inflation remains high, but it is likely to fall back before long. HICP inflation remained unchanged at 3.0% in November (1). The rate has now been above the ECB's 2% price stability ceiling for a whole year. Nonetheless, inflation is lower than in the US and UK (2).
- No breakdown is available yet for November, but energy inflation is likely to have remained elevated at about 12%. The effect of past rises in agricultural commodity prices may have prompted food price inflation to tick up too (3). All this perhaps suggests that core inflation may have fallen slightly.
- Looking ahead, we expect headline inflation to slow sharply. Assuming that the oil price does not rise again, we see this component knocking about 1% off the headline rate over the next six months (4). Meanwhile, rising spare capacity, coupled with the recent decline in consumers' inflation expectations, should lead core inflation to fall from the current rate of about 1.6% (5). In all, then, we expect inflation to fall well below target in 2012 (6). Indeed, before long, concerns about deflation may grow.



Sources – Thomson Datastream, Markit, Capital Economics

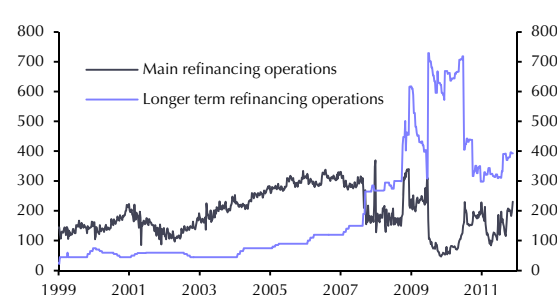
## Monetary Indicators

- The latest monetary data have revealed rising strains in the banking sector as the euro-zone's debt crisis has deepened. The euro-zone monetary base continued to rise in November and is now broadly in line with its 2010 peak **(1)**. The increase reflected a further pick-up in ECB lending to commercial banks at both short and longer-term maturities **(2)**.
- Use of the Bank's low interest-bearing deposit facility has remained high in a sign that banks are reluctant to lend to each other **(3)**. The ECB has continued to buy peripheral governments' bonds **(4)**, but their size has been limited, accounting for just 6.5% of troubled governments' outstanding debt. The purchases have also been sterilised to prevent any impact on the monetary base.
- Annual M3 growth fell from 3.0% to just 2.6% in October **(5)**. On the counterparts side, annual lending growth to households fell to a 19-month low of just 2.2% in October. Lending growth to firms nudged up from 1.6% to 1.9%, but this is still very weak by past standards **(6)**.

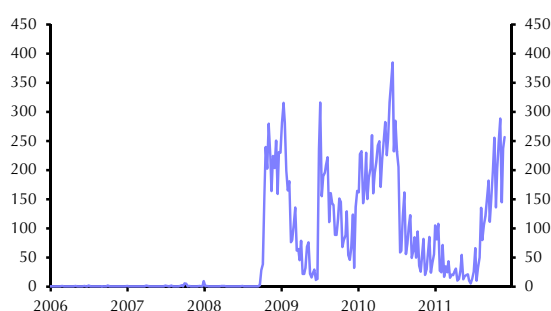
1. Monetary Base (€bn)



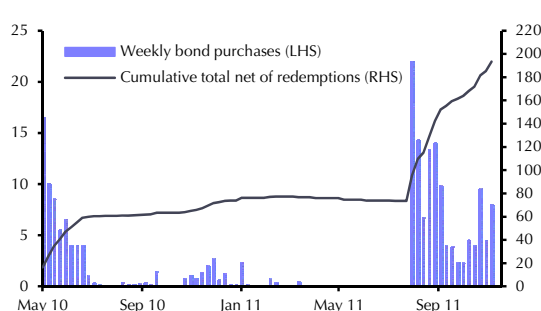
2. ECB Lending to Banks (€bn)



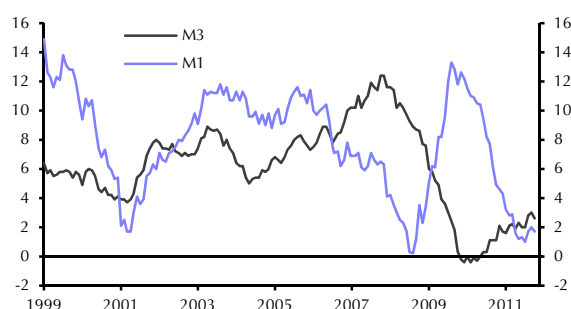
3. Use of the ECB's Deposit Facility (€bn)



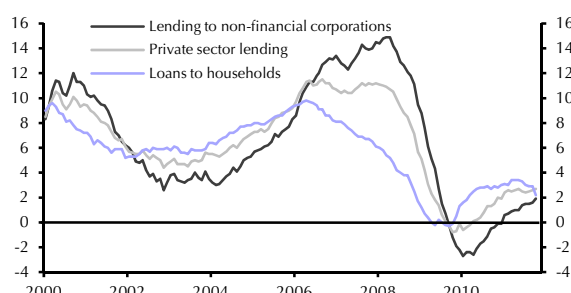
4. ECB Government Bond Purchases (€bn)



5. M1 & M3 (% y/y)



6. MFI Lending (% y/y)

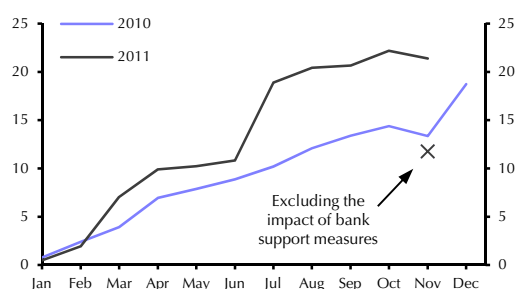


Sources – Thomson Datastream, ECB, National Central Banks

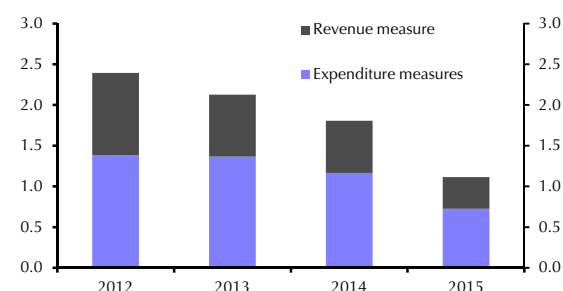
## Fiscal Indicators

- The troubled euro-zone economies continue to make inroads into their budget deficits. Once cash payments associated with the support of the banking system are excluded, the exchequer balance data for Ireland suggest that it is on track to make large inroads into its budget deficit **(1)**. But the general budget deficit will still be around 10% of GDP this year, meaning much more austerity is to come **(2)**.
- Portugal is also making solid progress **(3)**, but the IMF has warned that it may still fail to meet this year's general government deficit target. Meanwhile, the Greek central government deficit has continued to widen compared to a year earlier, mainly reflecting lower revenues **(4,5)**. But a commitment towards further austerity from the major political parties means that Greece will receive its sixth tranche of bail-out loans.
- Meanwhile, the Italian and Spanish central government deficits are still narrowing relative to a year ago **(6)**. Given that Spain's regional governments recorded a deficit of about 1.2% of GDP in the first nine months of the year, the wider budget deficit may end up being close to the 6% of GDP target.

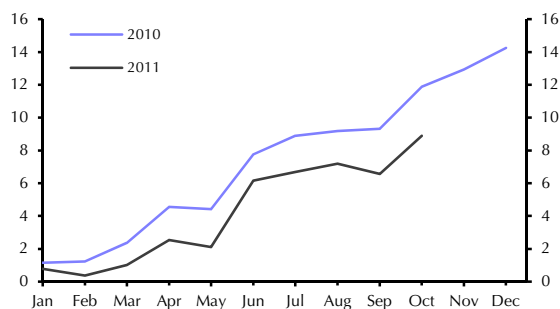
1. Irish Exchequer Balance (€bn)



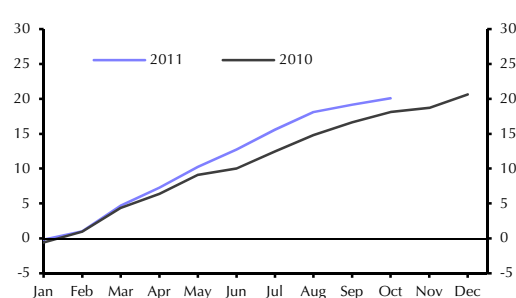
2. Planned Fiscal Measures (% of GDP)



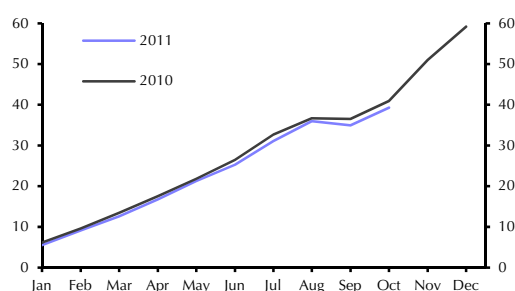
3. Portuguese Central Government Borrowing (€bn)



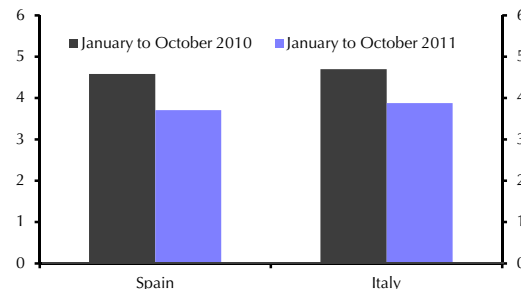
4. Greek Central Government Borrowing (€bn)



5. Greek Central Government Revenue (€bn)



6. Italian & Spanish Central Gov't Borrowing (% of GDP)

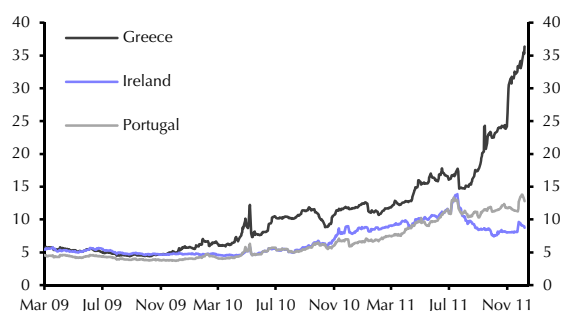


Sources – Thomson Datastream, Eurostat, Finance Ministries

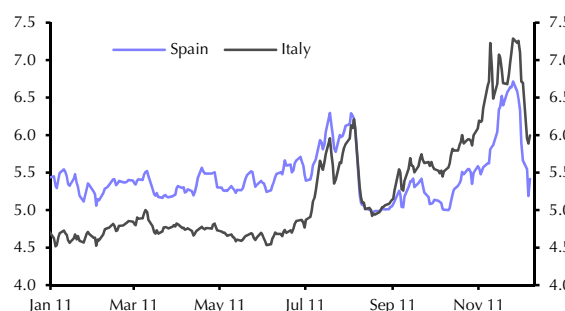
## Financial Indicators

- Financial markets have recently grown more optimistic that euro-zone policymakers will soon implement a comprehensive plan to save the euro-zone. Admittedly, despite this, Greek, Portuguese and Irish government bond yields have risen over the month (1). But Italian and Spanish ten-year yields have plunged and the former are once again well below the supposedly critical 7% mark (2).
- German and other core economies' long-term bond yields have increased, reflecting concerns that the latest plans will transfer at least some fiscal risk from the south of the region to the north (3). But shorter-term German yields have recently fallen, perhaps partly in response to markets' expectations for official interest rates edging down (4). Movements in relative euro-zone and US interest rate expectations have also probably been a factor behind the euro's decline against the dollar (5).
- Euro-zone equity markets have also recently rallied as markets have become more confident that policymakers will "save the euro" (6). Nonetheless, they are still between 10% and 20% lower than at the start of the year.

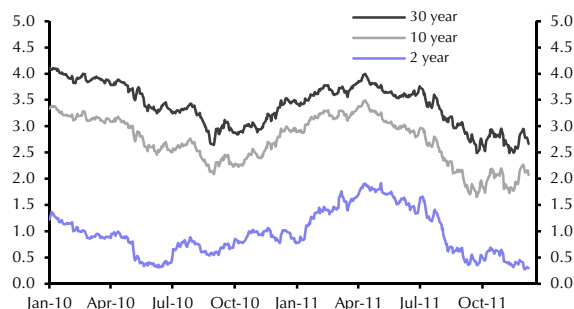
1. Ten-year Government Bond Yields (%)



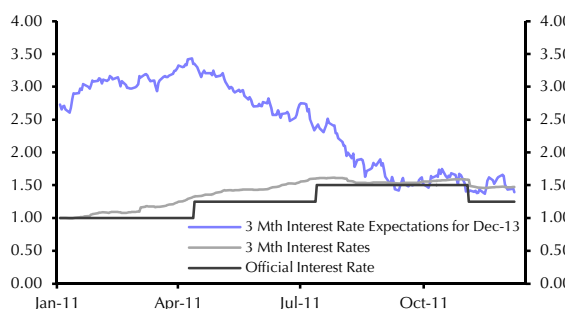
2. Ten-year Government Bond Yields (%)



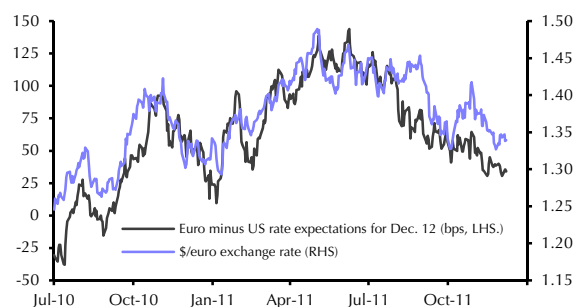
3. German Bond Yields (%)



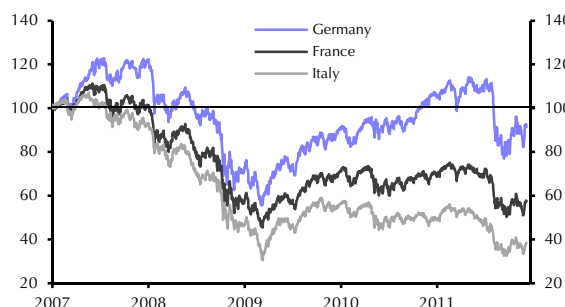
4. ECB Interest Rates (%)



5. Trade-weighted euro & \$/€ Exchange Rates



6. Equity Indices (1<sup>st</sup> Jan. 2007 = 100)



Sources – Thomson Datastream, Bloomberg, Capital Economics