EUROPEAN ECONOMICS WEEKLY

22nd Dec. 2011

Editors: Roger Bootle and Jonathan Loynes

Crunch year for the euro-zone

- With the euro-zone debt crisis ending the year much deeper and broader than it started it, it seems unlikely that the next 12 months will see a repeat of the (just about) "muddling through" process seen in 2011. Rather, 2012 looks like being the crunch year for the euro-zone.
- Either the policymakers will step up their efforts and finally produce the much-promised policy "bazooka", or the crisis will come to a head and the euro-zone will cease to exist in its current form. For now at least, we think that the latter is more likely than the former. (Pages 2-3.)
- The next edition of the European Economics Weekly will be published on Friday 6th January. Capital Economics' offices will be closed for the holidays from Saturday 24th December and will reopen on Tuesday 3rd January. We wish all our readers a Merry Christmas and a Happy New Year.

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Crunch year for the euro-zone

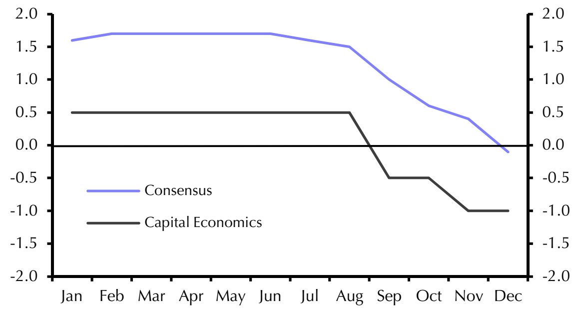
We called our last *European Economics Weekly* of 2010 "Another tough year ahead". We could have chosen the same title for this one, but 2012 looks set to be more than just tough – it could be crunch-year for the euro-zone.

2012 outlook has deteriorated rapidly

Admittedly, the straightforward economic numbers have perhaps been a touch better in 2011 than we anticipated a year ago. For example, it looks like euro-zone GDP will have expanded by around 1.5%, a bit above our start-of-year expectation of 1.0%.

But that performance reflects the economy's surprising momentum in the first half of the year. Since then, the outlook for the region has deteriorated rapidly. As Chart 1 shows, the consensus forecast for growth in 2012 started the year at a very solid 1.6% and hovered around that level until September. In the last few months, however, it has fallen rapidly and turned negative (at -0.1%) in December. (As the Chart shows, our own forecast has been consistently weaker and remains so.)

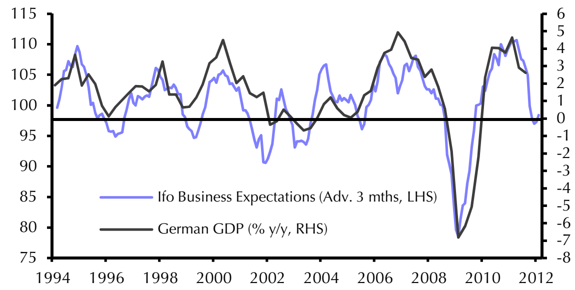
CHART 1: FORECASTS FOR 2012 GDP GROWTH (%Y/Y)



Source – Consensus Forecasts

Part of this increased pessimism reflects the message from the latest indicators themselves. As Chart 2 shows, while last week's German Ifo survey prompted some talk that the euro-zone's biggest economy is holding up surprisingly well, the modest increase in the expectations balance reversed only a fraction of the drop over the previous six months. At current levels, the index points to virtual stagnation. Meanwhile, last week's (delayed) Italian GDP figures, revealing a 0.2% quarterly contraction, confirmed that most of the peripheral and southern economies have already fallen back into recession.

CHART 2: IFO EXPECTATIONS & GERMAN GDP GROWTH

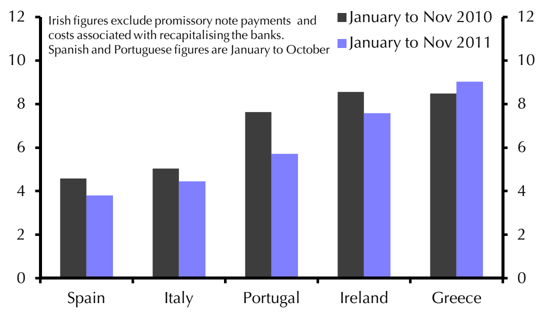


Source – Ifo, Thomson Datastream

Debt crisis starts New Year deeper and wider

At the same time, though, the outlook has been darkened by the deepening and widening of the region's debt crisis. As Chart 3 shows, while some of the most fiscally troubled economies have made some progress in reducing their budget deficits this year, that progress has been hampered by weak economic growth. As such, worries about debt defaults have spread.

CHART 3: CENTRAL GOVT. BORROWING (% OF GDP)



Sources – Thomson Datastream, Bloomberg

Meanwhile, governments have repeatedly failed to get to grips with the situation, with a series of "last-chance" summits and grand plans during the year leading to ever briefer bouts of optimism which have quickly given way to disappointment. **The result is that a crisis which started 2011 still concentrated largely in Greece and other very small economies has been allowed to expand to encompass much bigger and more important countries like Italy.**

With government's failing to take decisive action, hopes have fallen squarely on the European Central Bank (ECB) to step in and use its theoretically unlimited firepower in order to support the Italian and Spanish bond markets. But so far at least, it has refused to act as lender – or bond purchaser – of the last resort to euro-zone governments.

Admittedly, the heavy take-up (€489bn) of this week's three year long-term refinancing operation (LTRO) has increased the chances that banks themselves will use some of the funds to undertake bigger purchases of peripheral government bonds. **But as we explained in last week's *Weekly*, any such effect seems unlikely to be big enough to take the place of decisive ECB action.**

Meanwhile, there are still few indications that Germany and the other core economies will be prepared to take major steps towards full fiscal union either in 2012 or beyond. For now at least, Germany remains strongly opposed the idea of euro-zone wide bonds which might help to equalise borrowing costs across the region.

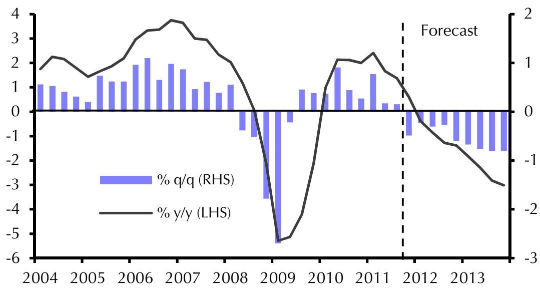
Crunch time

So the prospects both for the euro-zone economy and for the currency union itself deteriorated sharply in 2011, particularly in the second half. But what will 2012 hold?

There is, of course, a great deal of uncertainty over this. But with the debt crisis broadening and each successive policy initiative prompting ever smaller respite, it seems unlikely that the coming year will see a repeat of the (just about) "muddling through" process seen in 2011. Rather, 2012 looks like being the crunch year for the euro-zone. **Either the policymakers will step up their efforts and finally produce the much-promised policy "bazooka", or the crisis will come to a head and the euro-zone will cease to exist in its current form.**

For now at least, we think that the latter is more likely than the former. Our assumption is that a limited form of euro-zone break-up will commence in 2012, with the exit of Greece followed by further small country departures in 2013. (See *European Economics Focus* "How and when will the euro-zone break up?" 28th Nov.) This is likely to cause significant financial and economic disruption across the region and we have pencilled in falls in euro-zone GDP of 1% in 2012 and 2.5% in 2013. (See Chart 4.) But a bigger form of break-up, perhaps involving Italy, would cause much greater damage. **One way or another, 2012 is going to be a very interesting year.**

CHART 4: EURO-ZONE GDP GROWTH



Source – Ifo, Thomson Datastream

The fortnight ahead

Over the Christmas period, there are few major scheduled euro-zone economic releases. The most closely watched release will be the EC Economic Sentiment Indicator (ESI). We expect the index to fall in December, adding to evidence that the region has re-entered recession.

Meanwhile, euro-zone CPI inflation is likely to fall sharply in December. But with the unemployment rate likely to have risen in November, we doubt that falling inflation will be enough to boost household spending.

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Data Preview – Euro-zone M3 Money Supply (Nov.) 09.00 GMT Thu. 29th Dec.

Forecasts	Last	Median	Capital Economics
M3	(+2.6%)	-	(+2.4%)

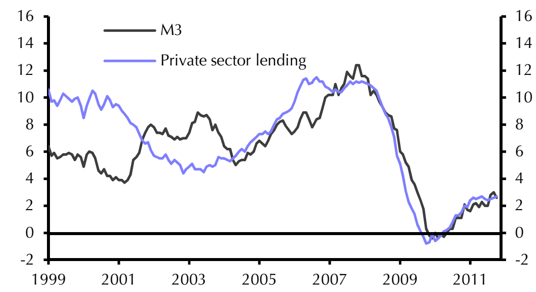
Slowing further

Euro-zone broad money and credit growth are likely to have remained weak in November.

In October, annual M3 growth slowed from 3.0% to 2.6%, partially reversing the sharp rises recorded over the previous two months. (See Chart 1.) The ECB has suggested that some of the reversal was probably down to institutional investors moving some of their assets included in the M3 statistics outside the euro-zone. Given the escalation of the euro-zone debt crisis and decline in the euro exchange rate in November, this process may have continued last month. On balance, then, we have pencilled in a further fall in the annual growth rate from 2.6% to 2.4%.

Meanwhile, private sector lending has inched up over recent months, although it remains weak by historical standards. But with the latest ECB bank lending survey suggesting that banks are once again starting to tighten credit conditions fairly aggressively, lending growth may begin to slow again soon.

CHART 1: M3 & PRIVATE SECTOR LENDING (% Y/Y)



Source – Thomson Datastream

Data Preview – Euro-zone CPI (Dec. Flash) 10.00 GMT Wed. 4th Jan.

Forecasts	Last	Median	Capital Economics
HICP	+0.1%(+3.0%)	(+2.8%)	(+2.6%)

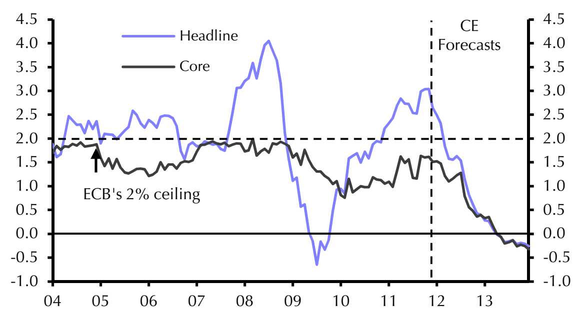
Starting to ease

Euro-zone CPI inflation probably fell in December and will continue to slow sharply early next year.

Petrol price data for the region as a whole suggest that prices at the pumps were pretty much unchanged in December. But due to a sharp monthly rise in overall energy inflation in December 2010, we expect annual energy inflation to have fallen pretty sharply and knocked about 0.2 percentage points off the headline inflation rate. What's more, we would not be surprised if food and core inflation slowed slightly too. On balance, then, we have pencilled in a fall in the headline rate from 3.0% to 2.6%.

Encouragingly, as Chart 1 shows, we expect this downward trend to continue next year. But while this will help to boost households' real incomes, it is unlikely to prevent sustained falls in household spending next year as pay growth falls and unemployment rises.

CHART 1: EURO-ZONE HEADLINE & CORE INFLATION



Sources – Thomson Datastream, Markit

Data Preview – EZ/ German Unemp. (Nov./Dec.) Tue. 3rd/Fri. 6th Jan.

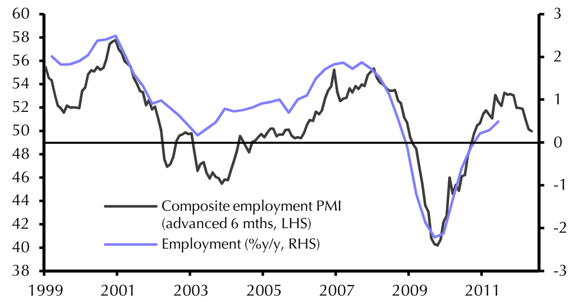
Forecasts	Last	Median	Capital Economics
German national rate (Dec.)	6.9%	6.9%	6.9%
Euro-zone unemployment rate (Nov.)	10.3%	10.3%	10.4%

Unemployment continues to rise

We expect euro-zone unemployment to have risen further despite the German labour market remaining relatively robust.

The number of unemployed people in the euro-zone rose for the sixth month running in October, causing the unemployment rate to rise to 10.3% - the highest since June 1998. With the PMI employment index only just above the "no-change" level of 50, employment growth has probably remained weaker than that of the workforce. (See Chart 1.) Accordingly, we have pencilled in a further rise in the unemployment rate to 10.4%. Given that the economic slowdown is less advanced, German unemployment might not have started rising yet. And if Angela Merkel re-introduces subsidies for employers as she has hinted, the German labour market could remain resilient for some time. But with unemployment elsewhere soaring, this will do little to improve the euro-zone average.

CHART 1: EZ EMPLOYMENT GROWTH & PMI EMPLOYMENT



Source – Thomson Datastream

Data Preview – EC Economic Sentiment (Dec.) 10.00 GMT Fri. 6th Jan.

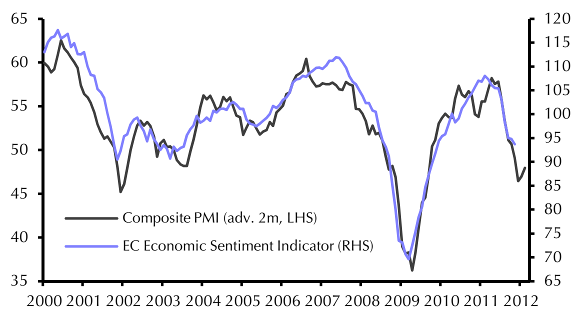
Forecasts	Last	Median	Capital Economics
Economic Sentiment Indicator	93.7	-	92.5

Weaker than other surveys

Despite the uptick in other business surveys lately, we think that the EC Economic Sentiment Indicator (ESI) will probably continue its downward trend in December.

November's modest fall in the economy-wide ESI left the index at a two-year low and consistent with small falls in euro-zone GDP compared to a year earlier. In December, we know that euro-zone consumer confidence fell again. Admittedly, business surveys such as the euro-zone composite PMI and the German Ifo registered an improvement this month. But the ESI has tended to lag a little behind the PMI in the past, suggesting that it has further to fall in the near term at least. (See Chart 1.) We expect another moderate decline from 93.7 to 92.5 or so, which would leave the survey pointing to annual falls in GDP of about 0.5%, consistent with sharp quarterly falls in activity around the turn of the year.

CHART 1: EC ECONOMIC SENTIMENT & EURO-ZONE PMI



Sources – Thomson Datastream, Markit

Latest Data & Main Forecasts

LATEST EURO-ZONE ECONOMIC INDICATORS

Monthly Data %m/m(%y/y) unless stated		Aug	Sep	Oct	Nov
Consumer Prices	HICP	+0.2(+2.5)	+0.8(+3.0)	+0.3(+3.0)	+0.1(+3.0)
	Core	(+1.2)	(+1.6)	(+1.6)	(+1.6)
Producer Prices		-0.2(+5.8)	+0.3(+5.8)	+0.1(+5.5)	-
M3		(+2.8)	(+3.0)	(+2.6)	-
Unemployment, monthly change thous.,(rate %)		+19(10.1)	+171(10.2)	+126(+10.3)	-
Retail Sales		+0.1(-0.1)	-0.6(-1.4)	+0.4(-0.4)	-
Industrial Production		+1.3(+6.0)	-2.0(+2.2)	-0.1(+1.3)	-
External Trade Balance €bn		-1.0	+2.2	+0.3	-
Current Account €bn		-5.9	+2.2	-7.5	-
Monthly Data %m/m(%y/y) unless stated		**Sep**	**Oct**	**Nov**	**Dec**
German ZEW		-43.3	-48.3	-55.2	-53.8
German Ifo		107.4	106.4	106.6	107.2
Euro-zone Composite PMI		49.1	46.5	47.0	47.9
EC Euro-zone Economic Sentiment Indicator		95.0	94.8	93.7	-
Quarterly Data %q/q(%y/y) unless stated		**Q4 2010**	**Q1 2011**	**Q2 2011**	**Q3 2011**
GDP		+0.3(+2.0)	+0.8(+2.4)	+0.2(+1.7)	+0.2(+1.4)
Household Spending		+0.4(+1.1)	+0.1(+1.0)	-0.5(+0.3)	+0.3(+0.3)
Hourly Labour Costs		(+1.7)	(+2.5)	(+3.3)	(+2.7)

LATEST MARKET DATA

Instrument/rate		1 mth ago	1 week ago	Latest*	Instrument/rate		1 mth ago	1 week ago	Latest*
Official Rates	ECB refi	1.25	1.00	1.00	Germany yield curve (20-2)		245	232	236
	UK repo	0.50	0.50	0.50	Global yields	US 10 year	1.88	1.91	1.96
	US Fed funds	0-0.25	0-0.25	0-0.25		UK 10 year	2.16	2.10	2.05
	Japan o'night	0.10	0.10	0.10		Japan 10 year	0.98	0.98	0.98
Market rates	3mth Euribor	1.41	1.35	1.35	Equity indices	German DAX	5428	5731	5875
	12mth Euribor	2.02	1.97	1.98		French CAC	2822	2999	3071
Bond yields	Germany 2 yr	0.47	0.26	0.25		Italian MIB	13921	14628	14996
	Germany 10 yr	2.19	1.95	1.96	Exchange rates	$/euro	1.33	1.30	1.31
	Germany 20 yr	2.92	2.57	2.61		£/euro	0.86	0.84	0.83
	France 10 yr	3.72	3.09	3.13		¥/euro	102.9	101.3	102.3
	Italy 10 yr	7.11	6.57	6.76	Brent crude oil price ($ pb)		107.9	103.8	109.0

*Latest as at 08.55am on 22nd Dec. 2011

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y) unless stated	Latest	Q4 2011	Q1 2012	Q2 2012	2011	2012	2013
GDP	+0.2(+1.4)	-0.5(+0.6)	-0.2(-0.4)	-0.3(-0.9)	+1.5	-1.0	-2.5
Household Spending	+0.3(+0.3)	-0.4(-0.4)	+0.2(-0.4)	0.0(+0.1)	+0.3	-0.2	-1.3
HICP (%y/y)	+3.0	+2.9	+2.3	+1.7	+2.7	+1.5	0.0
Unemployment Rate (%)	10.3	10.5	10.7	11.2	10.2	11.0	12.5
Repo Rate, end period (%)	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10 yr. Ger. Bond Yield, end period (%)	1.96	2.00	2.50	2.75	2.25	3.00	3.00
$/euro, end period	1.31	1.30	1.25	1.20	1.35	1.10	1.10
£/euro, end period	0.83	0.83	0.81	0.77	0.86	0.73	0.71

European Economic Diary & Forecasts

EUROPE

Date	Country		Release/Indicator/Event		Time CET	(GMT)	Previous*	Median*	CE Forecast*
Mon 26th	-	-	No Significant Data Released		-	-	-	-	-
Tue 27th	-	-	No Significant Data Released		-	-	-	-	-
Wed 28th		**Swi**	KOF Swiss Leading Indicator (Dec)		11.30	(10.30)	0.35	0.25	0.00
Thu 29th		**Ger**	CPI (Dec Prov.)	EU Harm.	-	-	0.0%(+2.8%)	+0.8%(+2.4%)	+0.8%(+2.3%)
		Spa	Retail Sales (Nov)		09.00	(08.00)	(-6.9%)	-	(-5.5%)
		EZ	M3 Money Supply (Nov)		10.00	(09.00)	(+2.6%)	-	(+2.4%)
		Ita	Business Confidence (Dec)		10.00	(09.00)	94.4	-	94.0
		Ita	Italy to Sell Bonds		11.00	(10.00)	-	-	-
Fri 30th		**Spa**	CPI (Dec Prov.)	EU Harm.	09.00	(08.00)	+0.2%(+2.9%)	-	(+2.5%)
Mon 2nd		**EZ**	PMI Manufacturing (Dec)		10.00	(09.00)	46.9	46.9	49.6
Tue 3rd		**Ger**	ILO Unemployment Rate (Nov)		08.00	(07.00)	5.5%	-	5.5%
		Ger	National Unemployment Rate (Dec)		09.55	(08.55)	6.9%	6.9%	6.9%
Wed 4th		**Fra**	Consumer Spending (Nov)		08.45	(07.45)	0.0%(-0.9%)	-	-0.0%(-7.0%)
		EZ	PMI Composite (Dec)		10.00	(09.00)	47.9	-	47.9
		EZ	PMI Services (Dec)		10.00	(09.00)	48.3	48.3	48.3
		EZ	CPI (Dec Prov.)		11.00	(10.00)	+0.1%(+3.0%)	(+2.8%)	(+2.6%)
		Ita	CPI (Dec Prov.)		11.00	(10.00)	-0.1%(+3.7%)	-	+0.2%(+3.5%)
Thu 5th		**NE**	CPI (Dec)	EU Harm.	09.30	(08.30)	-0.2%(+2.7%)	-	-
		Ita	Unemployment Rate (Nov Prov.)		10.00	(09.00)	8.5%	-	8.4%
		EZ	Industrial New Orders (Oct)		11.00	(10.00)	-6.4%(+1.6%)	-	+4.0%(+4.5%)
		EZ	Producer Prices (Nov)		11.00	(10.00)	+0.1%(+5.5%)	+0.1%(+5.2%)	-0.1%(+5.0%)
Fri 6th		**Swi**	CPI (Dec)		09.15	(08.15)	-0.2%(-0.5%)	-	-0.2%(-0.7%)
		EZ	Economic Sentiment (Dec)		11.00	(10.00)	93.7	-	92.5
		EZ	Retail Sales (Nov)		11.00	(10.00)	+0.3%(-0.4%)	-0.2%	-0.5%(-1.0%)
		EZ	Unemployment Rate (Nov)		11.00	(10.00)	10.3%	10.3%	10.4%
		Ger	Factory Orders (Nov)		12.00	(11.00)	+5.2%(+5.4%)	-1.5%	-3.0%(-2.3%)

*m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
9th Jan	German Industrial Production (Nov)	17th Jan	German ZEW Economic Sentiment (Jan)
12th Jan	Euro-zone Interest Rate Announcement	24th Jan	Euro-zone flash PMIs
12th Jan	Euro-zone Industrial Production (Nov)	25th Jan	German IFO Business Climate (Feb)
13th Jan	Euro-zone Trade Balance (Nov)	16th Feb	Riksbank Interest Rate Announcement

Selected Recent Publications

Date	Publication	Title
Mon 19th	Capital Daily	Momentum in the US economy unlikely to last
	UK Commercial Property Monthly	Institutions remain net property sellers
	Emerging Europe Chart Book	Sliding back into recession
	European Economics Update	The implications of a French downgrade
	UK Housing Market Update	First thoughts on the revised Mortgage Market Review
	US Economics Update	2012 will be another year of sluggish growth
	Emerging Asia Economics Update	Kim Jong-il's death adds to Korean uncertainty
Tue 20th	Capital Daily	Surveys should highlight weakness in European economies
	German Ifo Survey (Dec.)	Ifo points to positive, but very weak, growth
	European Economics Update	Swedish Riksbank cuts rates and more likely to come
	Emerging Europe Economics Focus	The economic consequences of Russia's unrest
	Latin America Economics Update	Q3 probably as good as it gets for Colombia
	European Commercial Property Update	Lower property investment volumes in store for Europe in 2012
	Japan Chart Book	Fading momentum points to slower growth
	Commodities Update	Two painful lessons for commodity investors from 2011
	US Housing Starts (Nov.)	Moving in the right direction
	US Economics Update	Monetary Indicators (Nov)
	Latin America Central Bank Watch	Policy set to ease across the region in 2012
	Emerging Europe Economics Update	Hungary: further tightening on the cards
	Global Markets Update	2012 should be another disappointing year for US equities
	Middle East Chart Book	Clouds gather over North Africa
Wed 21st	Capital Daily	Outlook for US equities still gloomy
	Italian GDP (Q3)	Heading into another recession
	UK MPC Minutes (Dec.) & Public finances (Nov.)	More QE still likely in the new year
	UK Institutional Investment in Property (Q3)	Steady institutional property demand unlikely to last
	Latin America Economics Update	Uruguay better placed to weather slowdown than Argentina
	UK Housing Market Update	What are empty homes really telling us about the housing market?
	China Chart Book	Weak start to 2012
	Middle East Economics Update	GCC summit reveals lack of unity on economic policy
	Japan Economics Update	Falling exports point to GDP contraction in Q4
	US Chart Book	Inflation set to fall sharply in 2012
	Canada Retail Sales (Oct.)	Consumer spending showing strength
	European Economics Update	Have we underestimated Germany?
	Emerging Asia Economics Update	Strong growth to continue in Sri Lanka
	US Existing Home Sales (Nov.)	Downward revisions are not a disaster
	US Housing Market Analyst	Finding a floor
	Canada Economic Outlook	Confidence important during global slowdown
	Commodities Chart Book	More rollercoaster than super-cycle
Thu 22nd	Capital Daily	Markets - 2012 could be much like 2011
	UK Economics Weekly	What does 2012 hold in store?
	US Economics Weekly	-
	European Economics Weekly	Crunch year for the euro-zone
	Japan Economics Weekly	-
	Emerging Asia Economics Weekly	-
	Canada Economics Weekly	-