Why the European Central Bank Acted – Euro-zone Activity stagnates and deflation risks rise in mid-2014 September 2014

National Australia Bank

Key Points:

- *The European Central Bank has cut its key policy lending rate to only 5 bps, it is progressing its planned schemes for asset purchases and targeted lending to banks and has hinted that it could increase its balance sheet by around €1 Trillion, taking it back to its early 2012 size and implying lots of central bank activity.*
- *These central bank decisions reflect weak recent outcomes for Euro-zone activity and inflation. Euro-zone GDP stagnated in the second quarter – a disappointing result for a region that has lagged in the global recovery and where GDP remains around 3% below its early 2008 level. The extent of the slowdown in mid-2014 is exaggerated by a drop from particularly strong first quarter growth in Germany but there is concern that the Euro-zone faces deeper structural problems.*
- *There is growing belief that the Euro-zone needs higher demand and that private sector de-leveraging and government austerity have put too much of a drag on spending, which has flowed into weak output. The ECB Governor has warned that the high jobless rate will persist unless demand is boosted and the IMF believes that "insufficient aggregate demand" weighs on the economy.*
- *With CPI inflation falling to 0.3% yoy in August, well below the central bank target, there is concern that the Euro-zone could fall into a Japanese-style deflation. With inflation expectations falling, minimal growth in money supply, falling private sector credit, little sign of pricing pressure anywhere, an 11½% jobless rate holding down wage growth and significant unused capacity limiting business pricing power, deflationary risks are obvious.*
- *Market stress over sovereign debt in the Euro-zone periphery has abated but its economies still have profound economic problems related to very high unemployment (27% in Greece, 25% in Spain), big debt burdens and a lack of investment that will cramp their long-term growth. The Italian economy is performing very poorly, there are worries over France and the Bundesbank has marked down the German growth outlook. We expect Euro-zone growth of only 0.7% this year and 1.1% next year, not enough to cut unemployment or help stabilise the high debt/GDP ratio of 95%.*

Figure 1: Euro GDP Stagnates Mar 08=100 indices

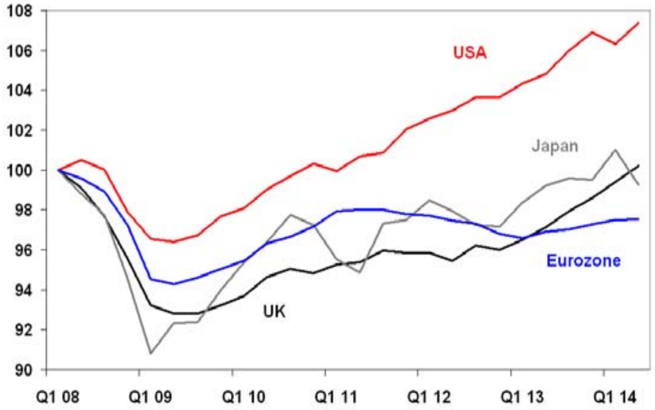
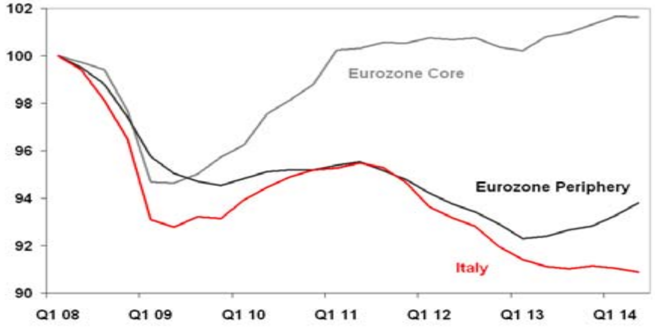


Figure 2 : Divergent output trends within Euro one Mar 08=100 indices



Tom Taylor Group Economics (03) 86341883

Phin Ziebell Group Economics (03) 86340198

Euro-zone only small share of Australia/NZ exports but key in global demand

- Subdued demand and spending in the Euro-zone has flowed into stagnation in its demand for imports. Both the value and volume of aggregate Euro-zone imports were well below their first-half 2008 levels.
- Shipments from Australia and New Zealand have suffered in this generally weak picture. Australian exports are well below their pre-GFC levels and New Zealand exports have fallen in recent years as well The Euro-zone now accounts for only around 3% of total Australian goods exports and 7% of those from New Zealand.
- While its direct role as an export market has fallen considerably, the Euro-zone still carries a lot of importance in an indirect manner. Australian and NZ commodities are sold into the global marketplace, where prices are set by the balance between world supply and demand. As the third biggest economic block in the world, accounting for one-eighth of world GDP, the level of demand in the Euro-zone has a big impact on world commodity markets. The important role of Europe in global consumption of key commodities is shown in the charts opposite and it is also a key producer of products such as dairy.
- The Australasian export mix to Europe is quite unusual. For Australia, coal is the biggest export item but gold, wine and manufactured goods are particularly prominent while the metal ores and foodstuffs that usually predominate in the export mix are less important. For NZ exports to the EU, sheepmeat and butter loom large with their quota access while wine, wool and fruit are important too.

Figure 3: Trend GDP and imports are flat

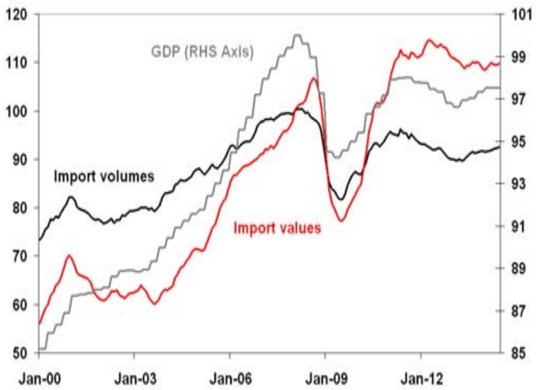


Figure 4 Australian and NZ Goods Exports - % of share sold to the Euro-zone

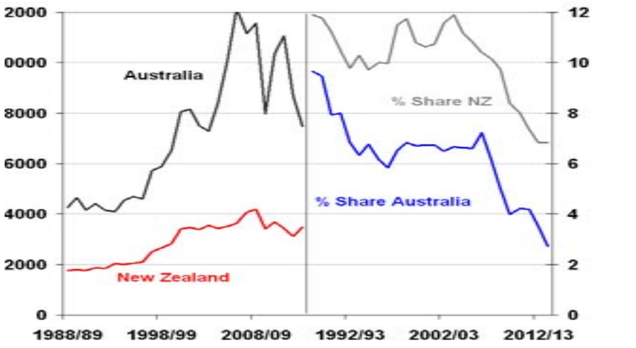


Figure 5: Share of global commodity use

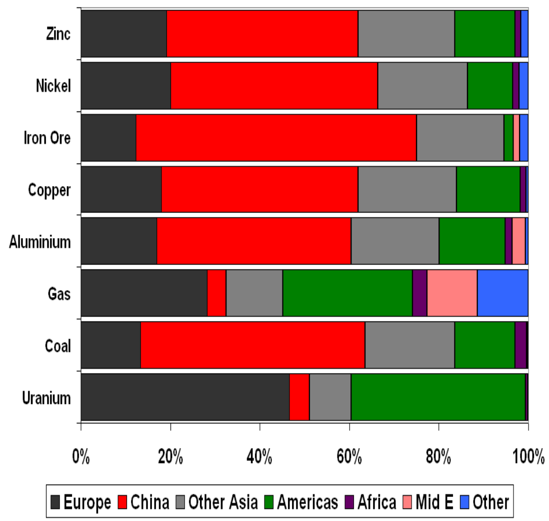
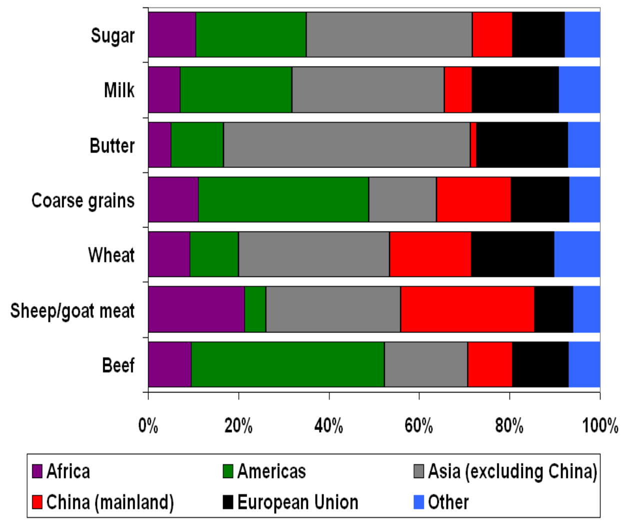


Figure 6: Share of global food domestic supply



Broad-based sluggishness in Euro-zone output

- While the GFC and Euro-zone periphery sovereign debt crises were enough to ensure that trend output performance in the Euro-zone was poor through the last 7 years, it had been hoped that 2014 would be a better year.
- The Euro-zone economy started growing again from mid-2013 and most forecasts were for a gradual acceleration to modest growth. In the event, 2014 has been a disappointment with March quarter's 0.2% followed by virtually flat output in the June quarter. Some of this poor mid-2014 outcome reflected a weather-related correction in German output as the first quarter's unusually solid 0.7% was followed by a 0.2% fall in June. Averaging out the two quarters to give an annual German rate of around 1% probably gives a better indication of the country's first-half underlying pace of growth.
- Nevertheless, there is now ample evidence from across the Euro-zone – including Germany - that this is a genuine soft spot for growth. The Bundesbank's latest assessment is that the economy has weakened with business surveys turning down and worries over the impact of sanctions on Russia on the German economy and so the previously anticipated cyclical upswing through the latter half of 2014 may not occur.
- Europe-wide and national business surveys show the extent to which growth momentum has faded across a number of industries. Previously well performing sectors like retail services and manufacturing all appear to have fading growth or outright declines.

Figure 7: Industry and construction output

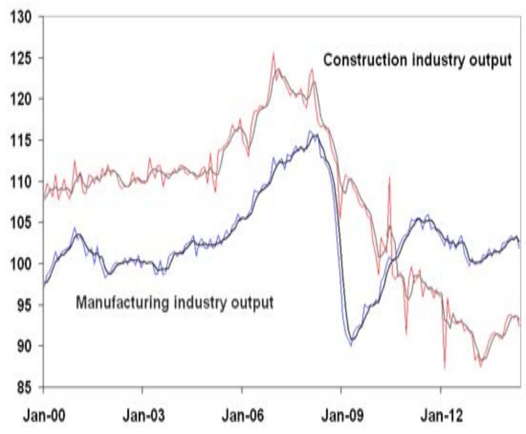


Figure 8: Monthly Euro Survey Activity balances

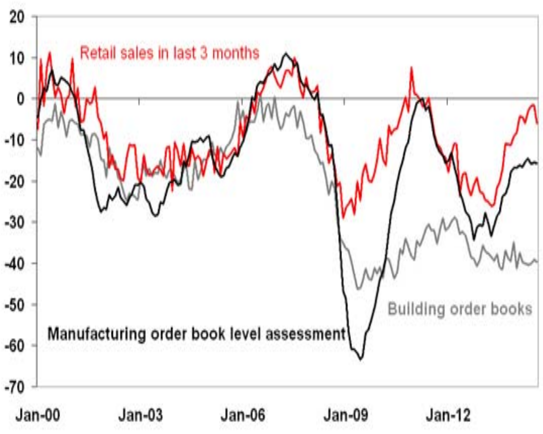


Figure 9: Euro-zone Service sector flattens

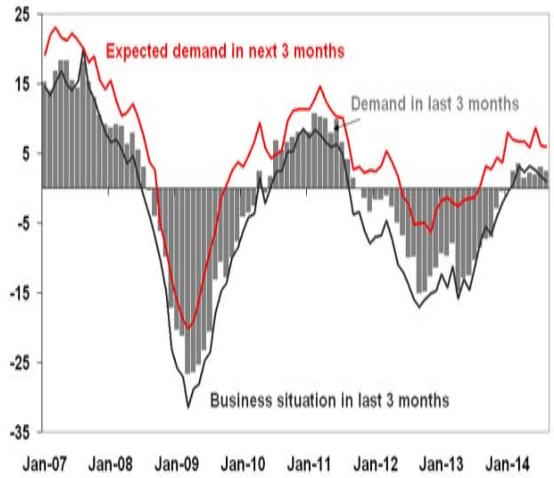
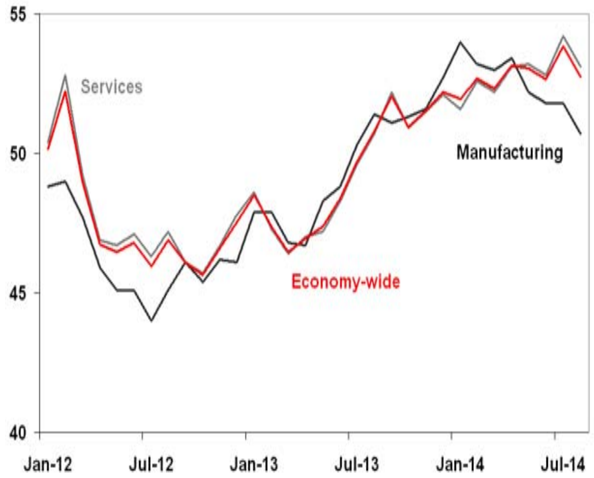


Figure 10: Euro Purchasing Manager Survey



Stagnating Euro-zone domestic demand seen as key problem behind soft GDP

- The weakness in Euro-zone output reflects the prolonged softness in spending – there is just not enough demand to lift output out of the doldrums with business surveys showing a lack of demand is the main limit of firm expansion.
- Modest inflation combined with at best sluggish underlying volume growth means that the nominal *value* of key indicators like exports, imports, retail sales and manufacturing has trended flat to down. Such a pattern has been evident in Japan and reflects inadequate spending in the economy, founded on a monetary policy that has not allowed enough credit and money flows through the economy.
- Investment spending is an area of exceptional weakness – down by around 20% from its early 2008 level and with a GDP share cut from 23% to 19%. Some of this reflects the bursting of housing bubbles and government austerity but there has also been a drop in private sector business spending. This will lead to a lower capital stock than otherwise and limit growth prospects – again as seen earlier in Japan.
- Although demand has not been particularly strong anywhere in the Euro-zone in the last few years, it has fared much worse in the peripheral economies than in the core region. Spain, Ireland and Greece have seen big falls in just about all indicators of domestic spending since 2008 (retail sales, investment, wholesaling, imports) but they seem to have finally levelled out this year. The Italian economy has been drifting down for years and now there are worries about France where some estimates of potential growth are as low as 0.9%.

Figure 11: Spending flat in nominal terms

Figure 12: Retail spending flat-lines in core, has collapsed in periphery Jan 08=100

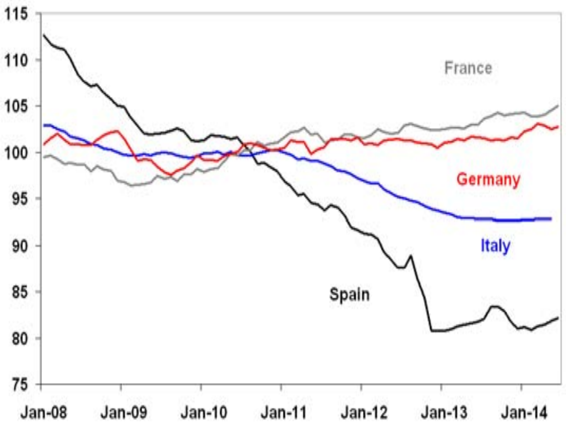


Figure 13: Investment particularly soft

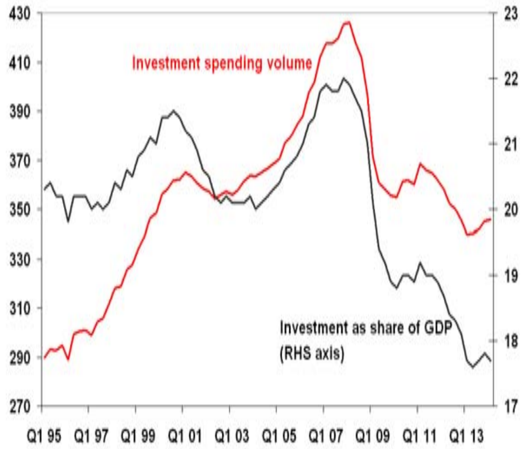
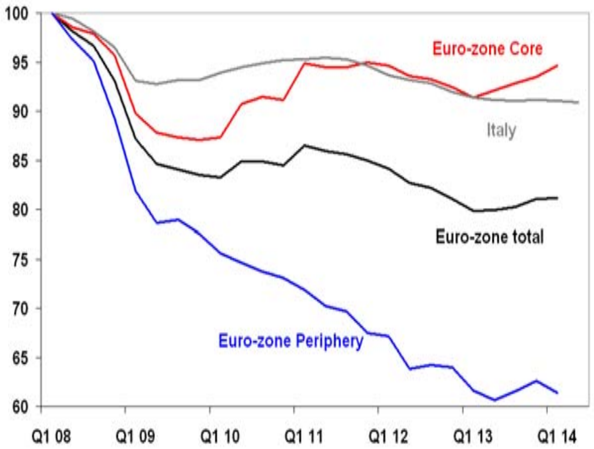


Figure 14: Investment flat-lines in core, has collapsed in periphery Mar Q 08=100



Sluggish world trade limits Euro-zone prospects of exporting its way out

- One classic business response to soft domestic demand is boost sales abroad, "re-balancing" the economy to export its way out of stagnation. This was a recipe Japan adopted during its long period of deflation.
- Such an escape route from prolonged weakness looks much harder for the Euro-zone than it was for 1990s and 2000s Japan. Growth in world trade has slowed sharply to around 3% pa and Euro-zone exporters appear to have not even managed to match the recent lacklustre rate of global growth. Recent business surveys show ongoing weakness in export order books.
- There are usually people (often in France) who blame an uninspiring Euro-zone trade performance on an overly strong exchange rate, which allows competitors to undercut Euro firms in global markets. The evidence for this is not great, however. While the Euro did rise a lot between 2000 and 2004, it has been trending down since 2008 and measures of international competitiveness are around their 10-year average. The IMF recently concluded that Euro-zone competitiveness was "broadly consistent with fundamentals".
- There is no doubt that a big fall in the exchange rate would give a welcome boost to demand and output in the Euro-zone, a recent study said a 10% Euro drop would boost French GDP by 0.6% after one year and 1% after two years. Getting such a depreciation relies on monetary policy decisions by the big central banks, especially Fed tightening and ECB policy loosening.

Figure 15: Euro-zone exports under-perform

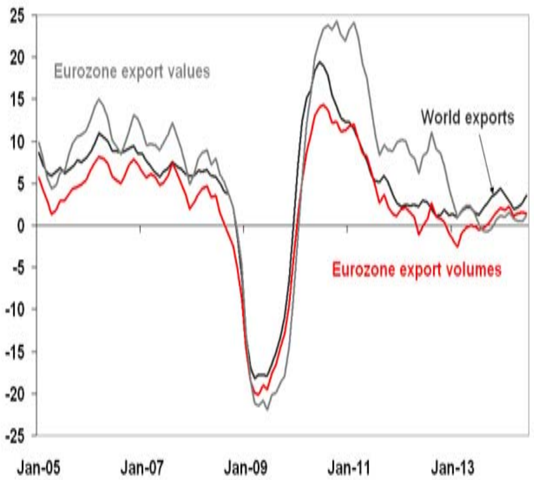
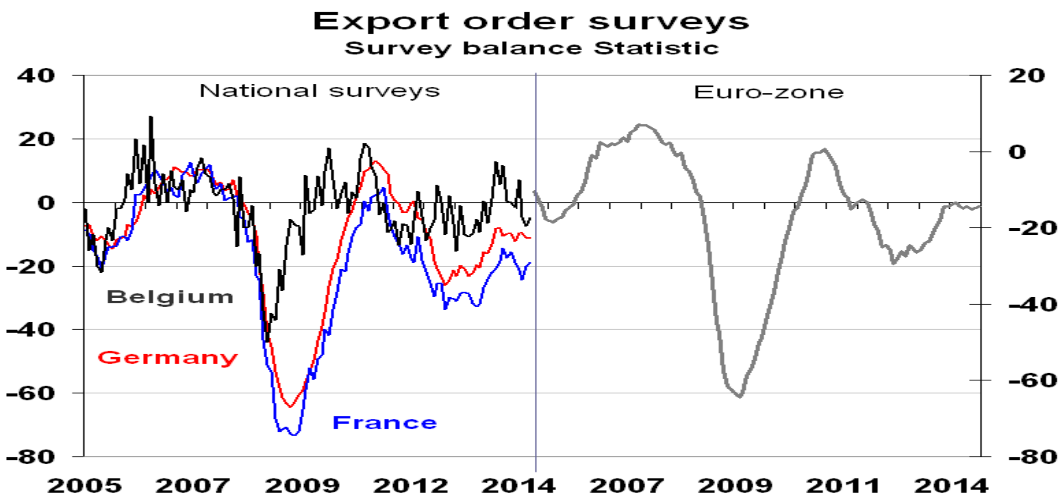


Figure 16: Currency and competitiveness average

Figure 17: Business surveys show export order inflows flat-lining



Forecasts say deflation averted but focus on deflationary risks rising

- With Euro-zone inflation falling to 0.3% in August, well below the central bank target of “below, but close to, 2%”, there seems plenty of scope for a prolonged period of loose monetary policy to avert the Euro-zone falling into a Japan-style deflation.
- Inflation expectations are turning down on all measures, Euro-zone wide business surveys show minimal price pressures in all sectors and wage growth slowed to around 1% yoy in the first half of the year. All of these should be sending warning signals to the ECB, highlighting downside risks to its June 2014 CPI forecasts that showed deflation being averted. The ECB forecast CPI inflation modestly rising from 0.7% in 2014 to 1.1% in 2015 and 1.4% in 2016 and private sector forecasters had much the same.
- Some of this price weakness in the Euro-zone reflects the process of adjustment required between its core and periphery economies. The latter have to regain competitiveness against the core and the only way they can do this is inflate by less than Germany and the rest of the core. Given that German inflation is less than 1%, the peripheral economies need zero or lower inflation to make headway in boosting competitiveness and Greece, Portugal and Spain were all showing deflation in mid-2014.
- The ECB believes it is already providing a “high degree of monetary accommodation” with near zero policy rates, a promise to keep them near current levels for “an extended period”, the planned funding scheme to boost bank lending and measures to buy asset backed securities as well as covered bonds on the way.

Figure 18: Euro-zone inflation 0.3% yoy, Italy and periphery already in deflation

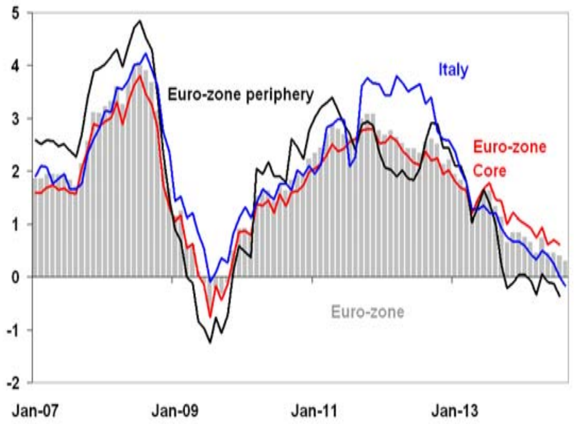


Figure 19: Consumer inflation expectations fall To low levels

Figure 20: Euro-zone survey price expectations – weighted survey balance

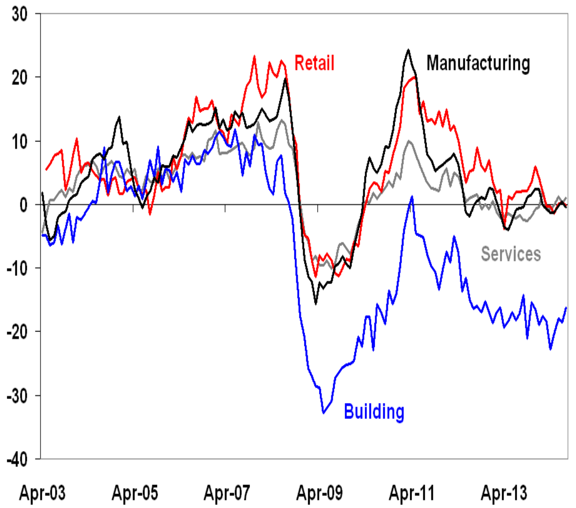
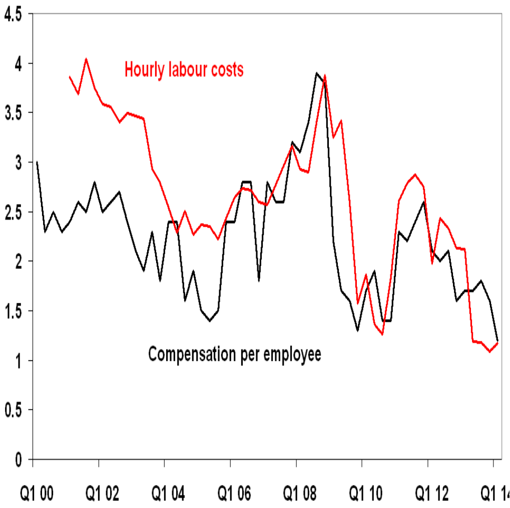


Figure 21: Wage inflation % yoy



Lack of credit growth reminiscent of 1990s Japan

- The ECB's operating procedures pay more attention to monetary and credit developments than any other big central bank and these are also highlighting the pressure that the private sector has been under.
- M3 money growth was under 2% yoy in July and loans to the private sector were falling by around 1% yoy. Business credit has been falling for some time and was still down by 2¼% yoy in July while the stock of household credit was down by around ½% yoy.
- Credit growth has been especially weak in the recessed peripheral economies with business lending in Spain, Ireland and Portugal falling heavily. Despite low lending rates, credit growth in the core economies has been modest, reflecting business hesitation over investing, ongoing de-leveraging in some sectors and reduced risk appetite in banks through most of the last 7 years.
- The ECB's quarterly bank lending survey suggests that financial conditions might finally be improving with actual (as opposed to forecast) business loan demand turning up in 2014 for the first time since 2011 and banks recently becoming more willing to lend to business for the first time since 2007.
- With the ECB about to launch its targeted funding scheme for banks that boost their retail lending, rates falling again and the planned asset buying scheme, the long period of retrenchment in credit could finally be drawing to an end and that will help lower the risk of Euro-wide deflation.

Figure 22: Euro-zone Business credit % yoy

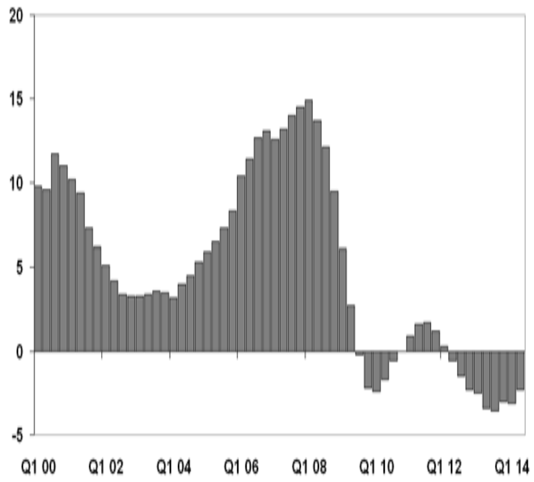


Figure 23: Credit stagnates in core, falls in periphery

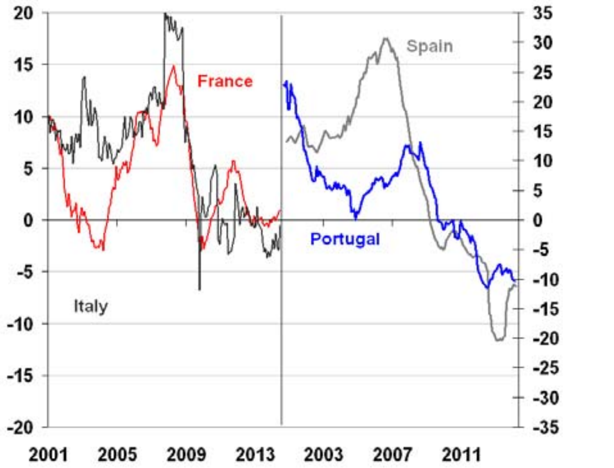


Figure 24: Business credit demand picks up
Survey balance statistic ECB Lending Survey

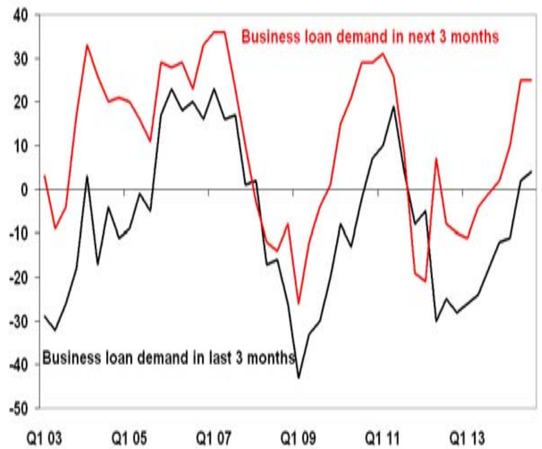
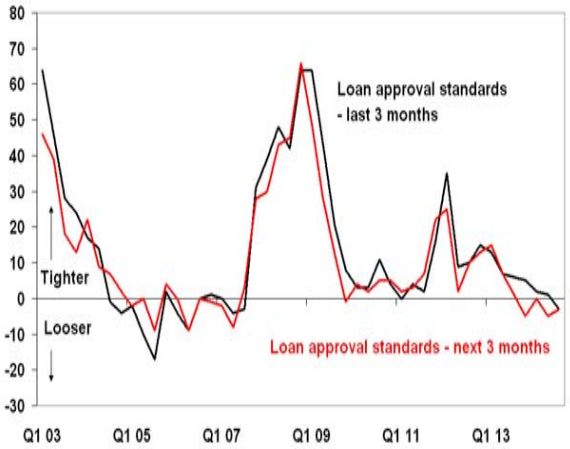


Figure 25: Banks more willing to lend
Survey Balance Statistic ECB Lending Survey



Group Economics
Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities
Rob Brooker
Head of Australian Economics
+61 3 8634 1663

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Phin Ziebell
Economist – Agribusiness
+(61 3) 8634 0198

Karla Bulauan
Economist – Australia
+(61 3) 86414028

Industry Analysis
Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Economist – Industry Analysis
+(61 3) 8634 3837

Amy Li
Economist – Industry Analysis
+(61 3) 8634 1563

International Economics
Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research
Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia
Economics
Spiros Papadopoulos
Senior Economist
+61 3 8641 0978

David de Garis
Senior Economist
+61 3 8641 3045

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Emma Lawson
Senior Currency Strategist
+61 2 9237 8154

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Equities
Peter Cashmore
Senior Real Estate Equity Analyst
+61 2 9237 8156

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand
Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe
Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Tom Vosa
Head of Market Economics
+44 207710 1573

Simon Ballard
Senior Credit Strategist
+44 207 710 2917

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia
Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

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