



ECFIN Economic Brief

At a turning point? Assessing the first positive signals for the euro-area economy

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Introduction

The global economy is in the midst of its deepest and most widespread recession since WW II. The euro-area economy has not been spared. It has been in recession since the second quarter of 2008 with the fall in real GDP accelerating to 2.5% quarter-on-quarter (q-o-q) by the first quarter of this year. Compared to a year earlier, the corresponding slump is nearly 5%.

The drop in activity has been sharper in some economies, but one important characteristic of this recession is its broad-based nature - not only across countries, but also across demand components. Thus, while countries are exposed to different degrees to the impact of the financial crisis, to the virtual collapse in global trade, to a substantial housing-market correction or to other imbalances, not a single euro-area country remains unaffected.

However, recent high-frequency data indicate a certain improvement. This can be seen in some segments of financial markets, in trade data – particularly as regards emerging markets – and to a rebound in confidence in most sectors and economies during the second quarter of this year. The question is if a critical mass of so-called "green shoots" is now visible to suggest that the euro-area economy may be at a turning point. This Economic Brief gives a snap-shot of the economic situation at the start of the summer of 2009 in the look out for an economic recovery or, at least, a stabilisation ahead.

Where to look for euro-area green shoots?

Since Bernanke coined the phrase, there has been a lot of discussion on emerging green shoots regarding economic activity worldwide. In the euro area, despite the disappointing first-quarter GDP numbers, some tentative signs of stabilisation in key economic indicators have been observed recently. Using a standard framework that characterises euro-area recoveries, this brief provides an early assessment of these emerging "green shoots". Firstly, at the current juncture, a cyclical recovery in the euro area would require the rebalancing of demand and supply conditions, via an inventory correction. Secondly, based on past experience, euro-area recoveries are usually export-led, with the pick-up in exports being largely driven by a rebound in global demand.

Summary

After a disappointing first-quarter GDP data, some early signs of improvement in key economic indicators have emerged recently in the euro area. This is evident from the rebalancing of demand and supply via the inventory adjustment. Euro-area exports are starting to show signs of stabilisation, after the precipitous drops at the turn of the year, benefiting from the green shoots that have been springing up in the global economy since the beginning of the year. Regarding the outlook for equipment investment, the observed recovery in business sentiment indicators from the historically lows of the first quarter 2009 bodes well. It should be recalled that unprecedented policy-related factors are at work to push the euro-area economy onto a sound recovery path. Naturally, these positive developments have to be assessed against the gradually improving, but still tight financial conditions. Moreover, the ongoing correction in housing markets is weighing on construction investment.

At this juncture, it is thus important to avoid reading too much into these emerging green shoots. Most soft indicators remain below the threshold levels that mark the start of an expansion phase and their recent improvement is still to be confirmed by developments in hard data. In particular, the adjustment in labour market might have just started. Moreover, as argued in a previous Economic Brief, the financial crisis could have long-lasting adverse effects on potential growth rates, requiring appropriate policy responses to address both the short and long term challenges.

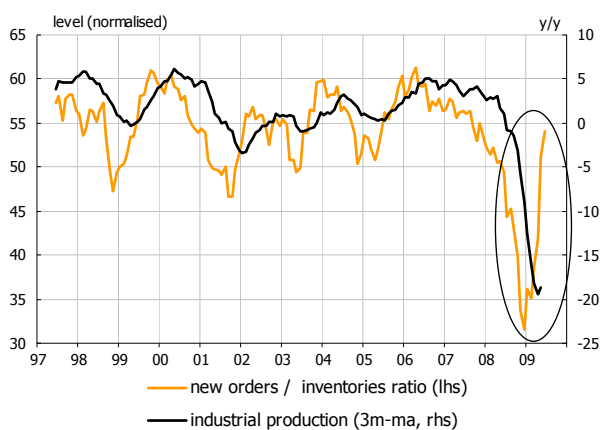
Notwithstanding these caveats, it is clearly encouraging to detect, for the first time in several months, the emergence of positive signs for traditional key drivers of economic recoveries in the euro area.

Thirdly, this spurs the demand for investment and durable consumer goods, which make up the bulk of international trade and are typically bought on credit. Export-oriented economies and/or sectors producing these goods are therefore the first to benefit from the upswing. Lastly, at a latter stage in the business cycle, this induces firms to resume employment, providing support for household spending, thus bringing private consumption into the positive loop. As this Economic Brief looks for evidence of green shoots, the following assessment focuses on those most dynamic components of GDP, which typically spark a turn around in the business cycle.

Inventories adjustment in the euro area coming to an end?

After the Lehman-Brothers collapse and the ensuing difficulties in accessing credit, companies cut production, but the sudden fall in demand was even stronger. The resulting large unwanted accumulation of stocks led to a plunge in manufacturing activity. The collapse of global manufacturing output had particularly adverse effects on those euro-area countries with a relatively high share of value added in manufacturing. For instance, among the larger countries, industrial output was down by some 20% on a year earlier in Germany in the first quarter of this year.

Chart 1: Assessment of stocks in manufacturing and industrial production, euro area



Source: Ecwin

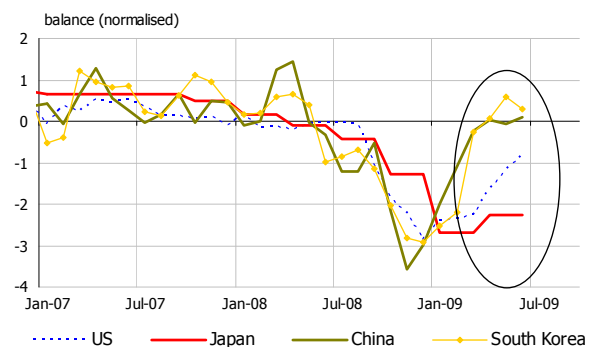
High-frequency data indicates that the substantial inventory-correction, which started earlier in the year, continued in the second quarter. In June, the new-orders-to-inventory ratio from the euro-area manufacturing PMI, a leading indicator of industrial

production, stood at the highest level since end-2007, when the PMI was well above 50 and industrial output was still expanding. The inventory component of the EU manufacturing survey gives a similar message: companies still consider the level of stocks as excessive, but a considerable inventory-correction has taken place since the peak reached in December 2008.

Is foreign demand stabilising?

Re-establishing a normal level of inventories is a necessary, but not sufficient condition to resume production. For the latter to occur, an improvement in demand prospects is essential. Exports are typically the first component to recover when the euro-area business cycle turns around. In this context, the emerging signs of stabilisation in indicators related to global demand and trade are promising, particularly in Asia. The manufacturing PMI index for China moved above the 50-threshold in March (thereby returning to a level that typically indicates expansion), and has continued to improve until June. Chinese industrial output growth also accelerated to 8.9% year-on-year (y-o-y) in May, up from 7.3% in April. The decline in industrial production and export orders eased in Taiwan in April. Singapore and Korea also showed signs of improvements. In Japan, business confidence (Tankan) was less downbeat in the second quarter compared to the first, with the index recording the first increase in ten quarters. In the US, the ISM manufacturing survey has increased in each of the first six months of the year and the improvement in the index in the second quarter was much larger than in the first quarter. The timing and size of the rebound in survey data indicates that China and other emerging markets are leading the recovery in business sentiment.

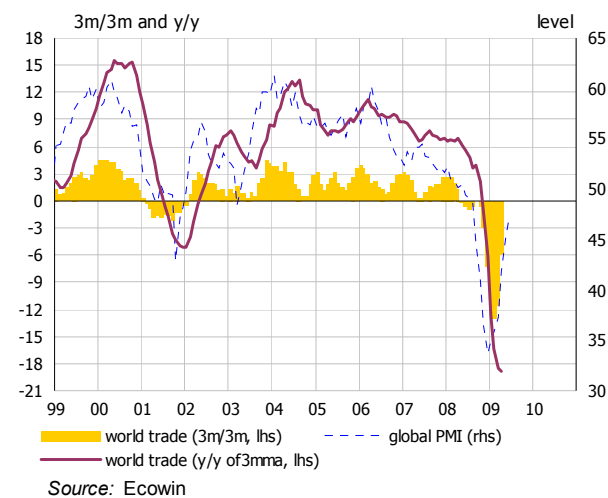
Chart 2: Business confidence, selected countries



Source: Ecwin

At the world level, widely observed high-frequency indicators reflect the above-mentioned country developments. The global manufacturing PMI index, a good leading indicator for world trade, reached its inflection point in December 2008 and picked up at an unprecedented rate between April and June. The index is now above its September 2008 level, before the huge drop that occurred around the turn of the year. Turning to hard data, the CPB indicator for world trade fell sharply for three consecutive months, between November 2008 and January 2009, indicating a cumulative contraction of 18% in world trade. By contrast, the trade indicator remained broadly flat in the subsequent three months, suggesting that the worst might be over. This positive development is confirmed by the Baltic Dry Index, another good proxy for international trade, which has risen fourfold since the beginning of the year, albeit from a very low level.

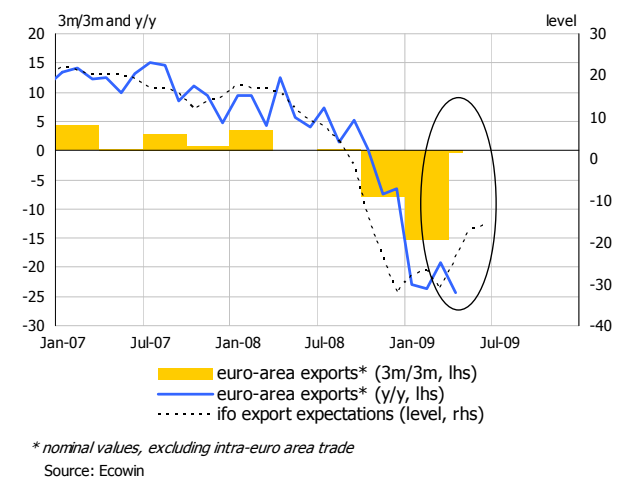
Chart 3: World trade and global manufacturing PMI



In line with the improving picture for global demand, euro-area exports (excluding intra-euro-area trade) seem to be broadly stabilizing. Although the year-on-year growth rate is still deep in negative territory, in April exports were down by only 1/2% in nominal terms relative to the first quarter. This compares with quarter-on-quarter contractions of 8% in 08Q4 and 15% in 09Q1. As growth in nominal and real exports closely correspond, the substantial drag on real GDP from the export collapse appears to be fading. According to the IFO survey, German export expectations (a good tracker of euro-area export growth) rebounded strongly in April/May and further improved in June, after four consecutive quarters of substantial declines.

The contribution of trade to overall growth depends on developments in imports as well. In April, the level of nominal imports was about 3% below the first-quarter average, much less than the 14% and 9% drops recorded in the previous two quarters. Given that commodity prices in April were 8% above the first-quarter average, imports seem to have contracted sharply in real terms, with respect to 09Q1. Overall, a significant positive contribution of net exports to euro-area GDP growth in the second quarter cannot be excluded.

Chart 4: Euro area exports and German export expectations



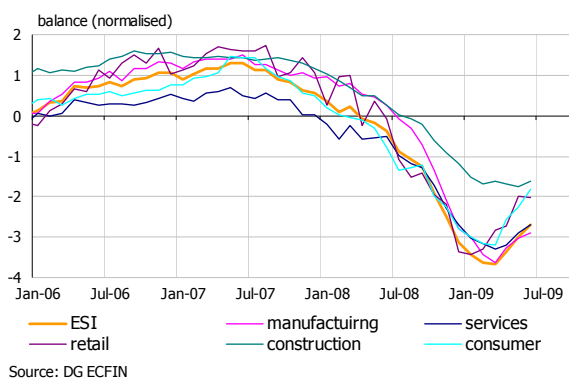
Will equipment investment activity follow suit soon?

Several sentiment indicators related to developments of domestic demand have also started to send some encouraging signs recently, underpinning in particular an easing in the pace of contraction of capital spending. The composite PMI survey has gained almost 6 points in 09Q2 with respect to the previous quarter. Its current level is still consistent with contracting activity, albeit at a much more moderate pace than in 09Q1. In June, the pace of slowdown eased significantly in the manufacturing sector, following record rises in April and May. By contrast, the rate of decline in activity in the services sector increased in June, albeit marginally. Still, the expectations component of the services index reached its highest level since July 2007.

The European Commission's Economic Sentiment Indicator (ESI) supports this picture, with a pick-up for the third month in a row in June, even though the current level (at 73.2 in the euro area) is still

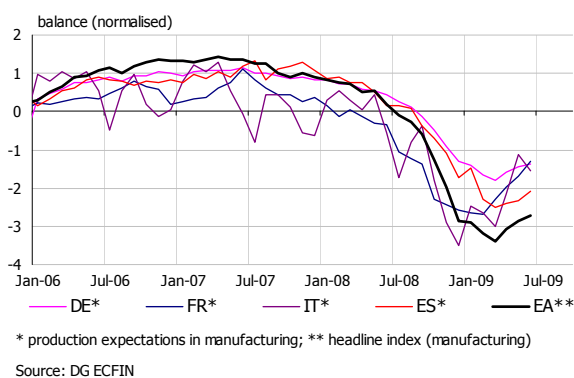
extremely low and well below its long-term average (100). Between the first and the second quarter of 2009, all components of the ESI indicator improved, except in the construction sector (while the still low levels suggest a further contraction ahead, albeit at a declining rate).

Chart 5: Economic Sentiment Indicator and its components, euro area



The more significant gains in sentiment were observed among consumers and among retailers, but confidence is also stabilising in manufacturing and services. The increase in confidence observed at sector and country level in recent months is mainly driven by improving expectations, as the main economic actors seem to be gaining confidence that the more acute phase of the crisis is behind us.¹

Chart 6: Current assessment and expectations in manufacturing confidence, euro area



¹ Preliminary analysis using statistical models (Markov Switching Models) to detect business cycle turning points, based on survey data, supports the view that activity in the euro-area economy is approaching a stabilisation phase, while remaining subdued. Moreover, assuming that the ESI keeps improving at the same pace as in the previous 3 months, internal model projections suggest that GDP growth for the second half of this year could turn out somewhat better than projected in the Commission services spring 2009 forecast.

Widely monitored national business sentiment indicators send a similar message. The IFO business climate index rose for the third month in a row in June and the expectations component of this index has been constantly rising since January. Since end 2008 the German ZEW survey of investor confidence has shot up to its highest level since May 2006 and is well above its long-term average. The Belgian business confidence index (NBB) also improved in June. Improved sentiment should, everything else equal, bode well for the outlook for equipment investment.

For firms to resume their investment plans, however, a parallel improvement in bank-lending conditions needs to materialise too. Restoring normal credit availability is crucial to reduce the negative feedback loop between a shrinking economy and a financial sector still under strain. Here data are somewhat mixed. There has been increasing risk-taking by financial-market participants in recent months. Stock markets have recovered from the mid-March lows, with the Eurostoxx index increasing by more than 20% in the second quarter of 2009. Encouraging signs are also coming from money markets, with the decline in the 3-month Euribor by some 400 bps since its peak in October 2008 slowly translating into lower lending rates.

Chart 7: Stock markets, euro area, US and Japan



On the other hand, government bond yields have increase recently. Moreover, as regards the bank-lending channel, data from the ECB's Bank Lending Survey show that credit standards are stabilizing somewhat, but remain tight. Mirroring the cooling in real economic activity, growth in lending to non-

financial corporations eased further to 4.4% y-o-y in May, well off the peak of almost 15% in April 2008.

The dynamics of equipment investment contributes a great deal to determine turning point in the overall business cycle. Some empirical evidence suggests that interest-rate spreads are a relatively reliable early signal for turning points.² Consequently, the recent steepening of the yield curve might partly be due to expectations in financial markets that the recession has reached its lowest point and that the recovery might be ahead of us. However, at the current juncture, higher yields on the long end can also be related to sharply increasing public deficit and debt levels as well as fears that the unprecedented monetary easing might, if corrective action is not taken in due time, result in higher inflation.

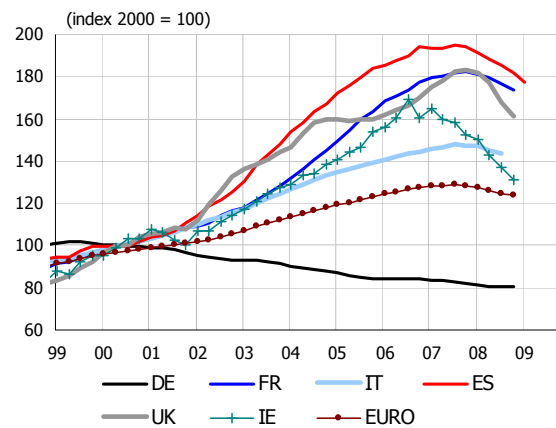
Will construction investment cease being a drag on growth?

A severe correction in the residential construction sector, which was aggravated by the onset of the financial crisis, has been and remains an important driver of the downturn in several Member States (e.g. Ireland and Spain). While construction output in the euro area is still contracting, there are some tentative signs suggesting that the underlying downward path might be beginning to level-off. Output in the construction sector fell by almost 5% y-o-y in April 2009, which compares to yearly contractions of more than 10% in the first quarter of this year and about 8% in the last quarter of 2008.

These figures should, however, be interpreted with caution. The fundamentals that drive supply and demand conditions are still indicative of further corrections. This is reflected in price data available so far, which show that the drop in year-on-year real house prices actually accelerated in the first quarter of this year in several Member States. With sentiment in the sector at historical lows, GDP expected to post this year the deepest contraction in the post WWII era, unemployment on the rise and tight credit conditions, the outlook for the housing sector appears bleak. In addition, historical experience across advanced countries suggests that the contraction phase of real house-price cycles tends to last for about 5 years, with the length and scope of

the correction being larger when combined with banking crises.³ Of particular concern in this context is that the magnitude of the housing boom in the last years has exceeded what had been observed in past cycles, suggesting that the ongoing corrections might be even more severe and protracted than before. The ongoing correction in this sector also implies that, contrary to the recovery experienced earlier this decade, construction investment is unlikely to provide a positive contribution to GDP growth for some time.

Chart 8: House prices, euro area and selected Member States



Source: OECD

Too early to blossom?

Overall, while acknowledging the first “green shoots”, it is important to avoid reading too much into them. Most soft indicators still remain well below the threshold levels that mark the start of an expansion phase. In addition, their recent improvement is still to be confirmed by sustained positive developments in hard data.

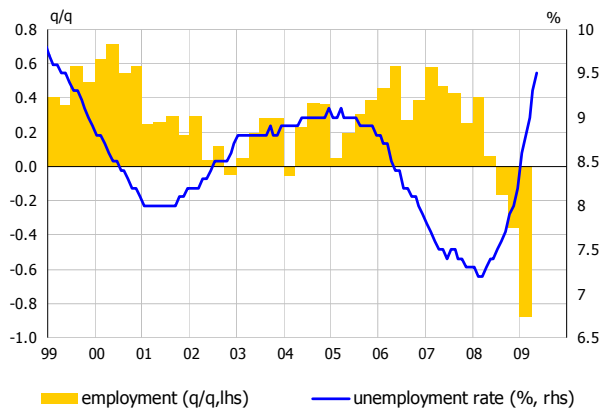
In the labour market, the full effects of the current crisis are still to come. While the unemployment rate in the euro area reached 9.5% in May, up by almost 2 percentage points from one year earlier, it is expected to increase to roughly 11.5% by 2010 according to the Commission services' spring 2009 economic forecast. Employment expectations derived from the EU survey worsened in both manufacturing and services between the first and second quarter of

² For a recent application to the euro area see for instance F. Moneta (2005) "Does the yield spread predict recessions in the euro area?", *International Finance*, v.8:2, pp. 263-301.

³ See N. Girouard, M. Kennedy, P. van den Noord and C. André (2006), 'Recent house price developments: the role of fundamentals', OECD Working Paper No. 475, C. Reinhart and K. Rogoff (2009), 'The Aftermath of Financial Crises' American Economic Association meetings in San Francisco, January.

2009. Looking ahead, even if some labour market policy measures might blur the picture,⁴ the high degree of utilisation of temporary workers (compared to earlier recessions) might translate into a quicker response of employment to output, once the recovery is well established.

Chart 9: Euro-area labour market



Source: Ecwin

The above assessment on emerging green shots does not ignore the fact that policy-related factors are also at work to push the euro-area economy towards a sound recovery path. The fiscal stimulus underpinning the European Economic recovery plan has been large (amounting to close to 2% of GDP over 2009-10), but it takes time for public spending and, in particular, infrastructure investment to stimulate the economy. In a context of heightened uncertainty and rising government deficits, consumers are also likely to boost precautionary saving. Unprecedented ECB easing will further boost economic activity, but the pros of record-low interest rates need to be assessed against the cons of tightened lending standards and a more cautious approach to lending.

Further out, what are the chances of a brisk and sustained recovery once the cycle turns? The

⁴ For instance, by the end of March, the number of people covered by the German short-time work programme was around 1¼ million, compared with 270,000 at the end of 2008. For May and June, the Federal Employment Agency reports an additional estimated 500,000 new applications for short-time work.

financial crisis affects the real economy via several transmission mechanisms: tighter financing conditions, the trade channel, confidence and wealth effects – all contributing to the massive economic downturn that the economy is undergoing. Moreover, historical evidence suggests that recessions following financial crises tend to be deeper and to last longer than other recessions.⁵

In addition, once a recovery takes hold, it could prove different from what we would normally expect. For instance, there is a risk that potential growth rates may not recover to the pre-crisis level, in view, for example, of a permanent change in financing conditions following a shift in risk aversion and/or a sustained need for deleveraging. The impact of the ensuing slower capital accumulation may be reinforced by parts of the capital stock becoming obsolete even faster. In turn, this would adversely affect total factor productivity growth, as resources are then locked into relatively unproductive activities. These long-lasting effects on growth would come on top of the expected adverse impact from an ageing population.

To conclude, exiting the crisis will crucially depend on the policy response. In the shorter-term, a forceful implementation of the expansionary measures will to a large extent determine the recovery path, where the effectiveness of such measures is linked to the provision of a credible strategy to withdraw the stimulus once the recovery takes hold. Therefore, a key challenge at the current juncture is for policy makers to provide support to the economy as long as necessary without compromising the stability-oriented objectives in the medium to long-term. Moreover, it is important to address the potential weakness of long-term growth already at this stage, as clearly indicated in the previous Economic Brief "*The financial crisis and potential growth: Policy challenges for Europe*".

⁵ D. Haugh; P. Ollivaud; D. Turner (2008), 'The Macroeconomic Consequences of Banking Crises in OECD Countries', OECD Working Paper No. 683; IMF World Economic Outlook (2008).

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