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Economics Group

Special Commentary

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Is the Eurozone Economy About to "Break Out?"

Executive Summary

Real GDP in the Eurozone has accelerated modestly this year, and we project that the economic expansion will remain intact. Growth in consumer spending has been supported by the decline in energy prices, and auto sales clearly have room to strengthen in coming quarters.

The economic slowdown in the developing world is probably not severe enough to derail the expansion in the Eurozone, which derives only 7 percent of its value added from final spending in developing economies. That said, slow foreign growth could exert enough headwinds to prevent real GDP growth in the euro area from "breaking out" in the near term. Without robust economic growth, the CPI inflation rate will likely not return to the ECB's target of nearly 2 percent. If, as we expect, the European Central Bank (ECB) extends its quantitative easing (QE) program beyond its intended September 2016 end date, then the euro will likely experience some downward pressure against the U.S. dollar in coming months.

Economic Expansion in the Euro Area Remains Intact

After contracting modestly between Q4 2011 and Q1 2013, real GDP in the Eurozone has now grown for nine consecutive quarters, and we forecast that the economy will continue to expand over the next two years (Figure 1). Moreover, economic growth could realistically surprise to the upside relative to the modest growth rates that we forecast.[1]

Economic growth in the Eurozone could potentially surprise to the upside.

Figure 1

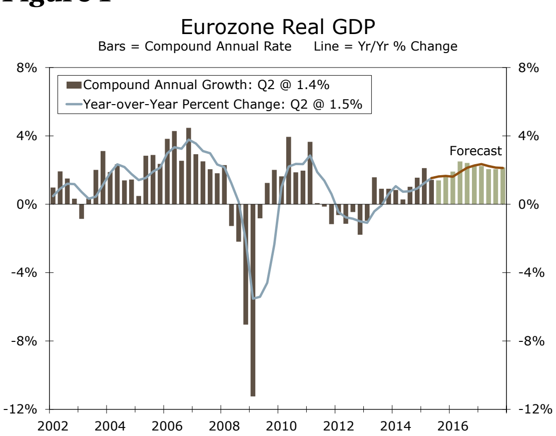
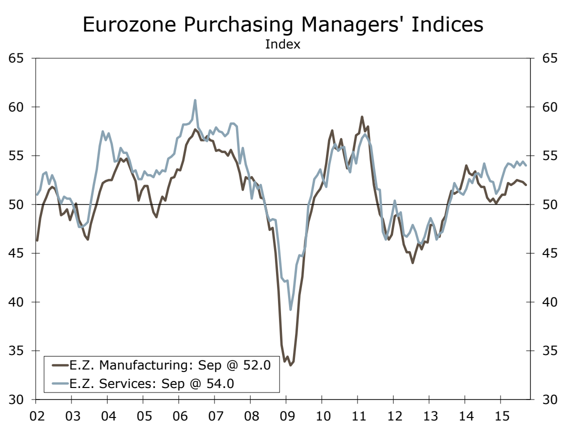


Figure 2



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

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[1] **We project that real GDP in the Eurozone will grow 1.5 percent in 2015, and we look for 2.0 percent economic growth in 2016 and 2.2 percent in 2017. See our *Monthly Economic Outlook*, which is posted on our website.**

Together we'll go far

Indeed, recent economic data suggest that the expansion has remained intact in Q3 2015, with little evidence of financial and economic turbulence in the developing world exerting significant downward pressure on economic growth in the euro area. For example, the purchasing managers' indices for the manufacturing and service sectors in the Eurozone remained at levels in September that historically have been consistent with modest economic expansion (Figure 2). The economic sentiment index that is calculated by the European Commission jumped to its highest level in more than four years in September.

Domestic Demand Should Strengthen

The modest acceleration that has occurred in Eurozone economic activity this year started with consumer spending. The GDP accounts show that real personal consumption expenditures (PCE), which includes inflation-adjusted consumer purchases of goods as well as services, rose 1.9 percent in Q2 2015, the strongest year-over-year growth rate in nearly eight years, and recent monthly data suggest that growth in consumer spending remained buoyant in the third quarter. As shown in Figure 3, growth in real consumer purchases of goods (i.e., retail spending) continued to clip along at a solid rate through July. Indeed, growth in real retail spending has recently returned to the run rate that prevailed prior to the global financial crisis.

The collapse in energy prices has helped to support growth in real income.

Closer inspection of Figure 3 shows that real retail spending was growing roughly 1 percent until late last year when spending suddenly accelerated to its current 2 percent growth rate. The collapse in energy prices late last year lifted real income growth in the Eurozone, which helped to push up growth in real consumer spending. It appears that acceleration in real PCE up to this point has been paced largely by spending on nondurable goods and services.

Figure 3

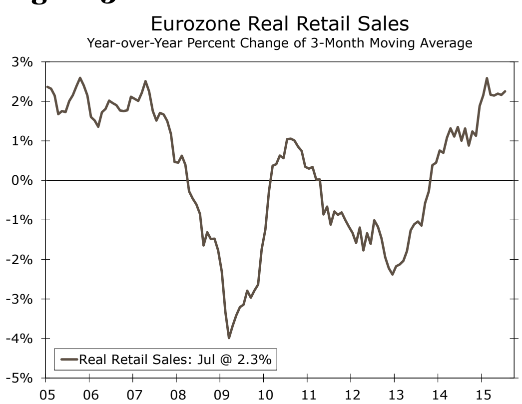
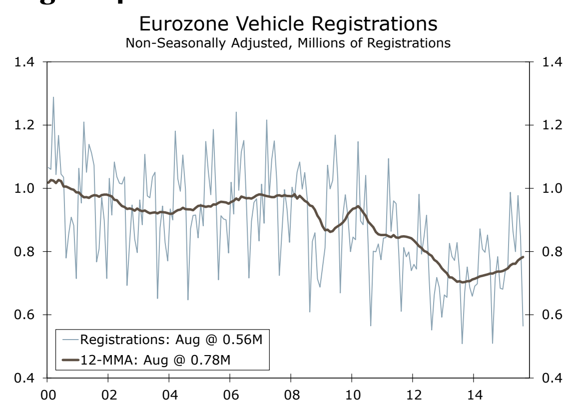


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

Pent-up demand could cause auto spending in the Eurozone to strengthen further in the next few years.

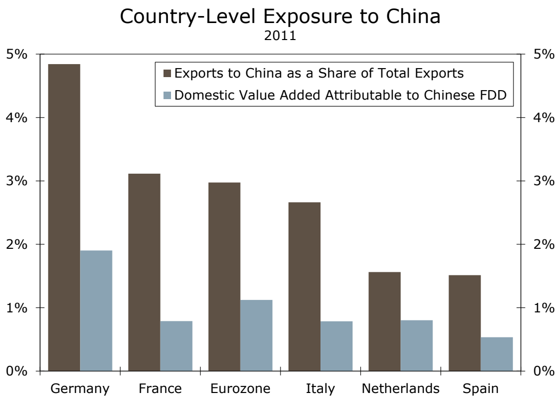
Purchases of automobiles are an area of consumer spending that clearly has room to strengthen, and they could potentially give a further boost to real PCE in coming quarters. In the years leading up to the global financial crisis, car registrations in the Eurozone were averaging roughly 1 million units per month over the course of the year (Figure 4). Registrations, which fell nearly 30 percent between 2008 and 2013, have slowly started to trend higher over the past year or so. That said, registrations remain 20 percent below their pre-crisis run rate. Auto sales in the United States also collapsed during the Great Recession. However, they have been trending higher since 2010 and only this year did they return to the pre-crisis run rate of roughly 17 million units per year. Pent-up demand could likewise cause auto spending in the Eurozone to strengthen further in the next few years.

Turning to investment, there are not many high frequency indicators of business fixed investment (BFI) spending in the overall euro area. However, monthly data from Germany suggest that growth in BFI spending in that country remains solid. As shown in Figure 5, real orders for capital goods from domestic sources in Germany accelerated earlier this year and currently are growing about 5 percent on a year-ago basis. This recent modest growth in capital goods orders in Germany should bode well for near-term BFI spending in the Eurozone's largest individual economy. The agreement reached in July between the Hellenic Republic and its creditors reduces the risk of a destabilizing Greek exit (a.k.a.,"Grexit") from the Eurozone, at least in the near term, which should be supportive of BFI spending in coming quarters.[2]

In sum, it appears that economic activity in the Eurozone continues to expand at a modest pace. However, investors at present are riveted to the apparent economic slowdown in China and its implications for global growth. Could the slowdown in China potentially derail the budding economic expansion in the euro area?

Figure 5

Figure 6



Source: IHS Global Insight, Organisation for Economic Cooperation and Development and Wells Fargo Securities, LLC

Could China Derail the Economic Expansion in the Eurozone?

Figure 6 shows measures of the economic exposure that some of the Eurozone's largest economies have to China. In terms of simple exports-to-GDP ratios, Germany leads the pack as it sends about 5 percent of its total exports to China, which is equivalent to more than 2 percent of German GDP. The other large economies in the Eurozone have exports-to-GDP ratios that are a bit lower than Germany's, and the ratio for the overall Eurozone is about 3 percent.[3]

As we have argued in previous reports, however, simple export-to-GDP ratios are not the best way to measure a country's economic exposure to another country.[4] For example, Germany may export intermediate inputs to China where they are assembled into finished goods and subsequently re-exported to the United States, where they are consumed. In this example, German exports to China overstate the effect that the Chinese economy has on the German economy. What we really want to know is how much effect final domestic demand (i.e., final spending by consumers, businesses and government) in China has on value added (i.e., wages, salaries and profits) in Eurozone economies.

__Final spending in China accounts for only 2 percent of German value added.__

We again turn to the Trade in Value Added database that has been compiled by the Organisation for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO). Although China takes in about 5 percent of German exports, final spending by Chinese consumers, businesses and government accounts for only 2 percent of value added in Germany (Figure 6). In other words, a good proportion of Germany's exports to China are assembled into

2 See "Yet Another Act to the Greek Drama" (July 13, 2015), which is available upon request.

3 There is a significant amount of intra-European trade as Eurozone countries send about one-half of their exports to other economies in the euro area. If we consider extra-Eurozone trade only, then China accounts for about 6 percent of Eurozone exports.

4 See "How Exposed Is the U.S. Economy to China?" (August 13, 2015) and "Could Developing Countries Take Down Developed Economies?" (August 21, 2015). Both reports are available upon request.

finished goods in China and subsequently re-exported to third countries, a phenomenon that appears to be true for the other large economies in the Eurozone. Indeed, Figure 6 shows that final spending in China accounts for only 1 percent of value added in the overall euro area. In short, the direct economic exposure of the Eurozone is not as substantial as the simple export-to-GDP ratio to China would imply.

The budding economic expansion in the euro area probably will remain intact.

We showed in an earlier report that final spending in all developing economies accounts for roughly 7 percent of value added in the euro area.[5] The bottom line is that the economic slowdown that is under way in China, and more broadly in the developing world, will likely exert some headwinds on real GDP growth in the Eurozone. However, the budding economic expansion in the euro area probably will remain intact unless the slowdown in the developing world turns out to be more severe than we currently expect.

Monetary Policy Should Remain Accommodative

Like the Federal Reserve, the ECB has adopted an extraordinarily accommodative policy stance in recent years. The ECB has maintained its 2-week refinancing rate, its main policy rate, at only 0.05 percent since last September. It is also making longer-term refinancing available to banks at extraordinarily low interest rates on the condition that those institutions subsequently increase their lending to the private sector.[6] Earlier this year, the ECB announced its own program of QE that it intends to remain in place through at least September 2016.

Figure 7

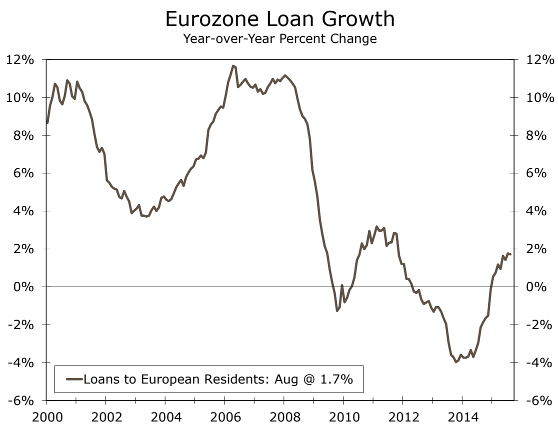
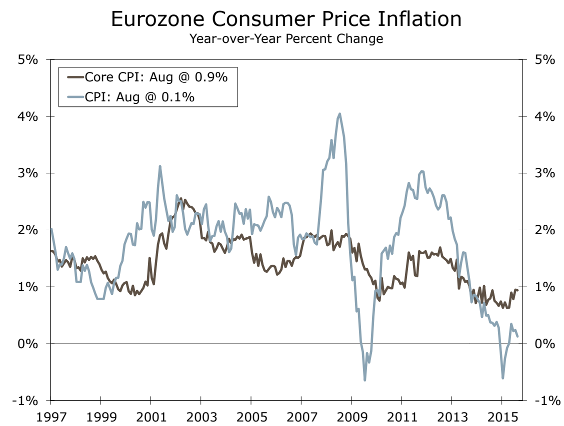


Figure 8



Source: IHS Global Insight and Wells Fargo Securities, LLC

The ECB's efforts are starting to bear some fruit.

It appears that the ECB's efforts are starting to bear some fruit. For example, loan growth in the Eurozone has turned positive this year after two years of contraction (Figure 7). That said, the CPI inflation rate is currently undershooting the ECB's target of "below, but close to, 2 percent over the medium term." As shown in Figure 8, consumer prices in the Eurozone are essentially flat on a year-ago basis. As in most economies, the overall rate of CPI inflation in the Eurozone has been pulled lower this year by the collapse in energy prices. Assuming that energy prices do not lurch even lower, the overall CPI inflation rate should rebound to the "core" inflation rate in late 2015/early 2016 when the sharp year-over-year decline in oil prices drops out of the inflation calculation.

The ECB likely will extend it QE program.

That said, the core inflation rate is only 1 percent at present. Although economic growth in the euro area is positive at present, it is probably not strong enough to lift the CPI inflation rate back toward the ECB's target in the foreseeable future. Indeed, we forecast that CPI inflation in the euro area will remain below 2 percent through the end of 2017. Although we believe that the economic expansion in the Eurozone will remain intact, we think there is a better-than-even

[5] **"Could Developing Countries Take Down Developed Economies?",** ***ibid.***
[6] **This ECB program is called Targeted Longer-Term Refinancing Operations (TLTRO).**

chance that the ECB extends its QE program beyond September 2016. This divergence in monetary policy—we look for the Federal Reserve to embark on a slow pace of tightening later this year while the ECB contemplates more QE—is one reason why our currency strategy team looks for euro depreciation vis-à-vis the U.S. dollar in coming months.

Conclusion

Real GDP in the Eurozone has accelerated modestly this year. The sharp decline in energy prices that has occurred over the past year has boosted real income growth, which has supported stronger growth in real PCE. Consumer spending could potentially strengthen even further if the slow upturn in auto purchases in the Eurozone gathers more steam as it has done in the United States over the past few years. Growth in BFI spending should generally remain positive in coming quarters, especially now that the risk of a destabilizing Grexit has been reduced.

The question is what effects the slowdown in the developing world, especially in China, may exert on economic growth in the euro area. Our analysis of value added leads us to the conclusion that the Eurozone has less direct economic exposure to the developing world than simple exports-to-GDP ratios imply. The economic slowdown in the developing world is probably not severe enough to derail the expansion in the Eurozone, although it could exert enough headwinds to prevent real GDP growth in the euro area from "breaking out" in the near term.

In our view, economic growth in the euro area will remain positive in coming quarters, but it will likely not be strong enough to lift the overall CPI inflation rate back toward the ECB's target of nearly 2 percent. Therefore, we think there is a better-than-even chance that the ECB extends its QE program beyond its intended September 2016 end date, which should put some downward pressure on the value of the euro vis-à-vis the U.S. dollar in coming months.

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