The greater challenge


GILES KEATING AND **THOMAS HERRMANN** SUGGEST THAT RECESSIONARY PRESSURES IN THE EURO ZONE ARE RECEDING, BUT VIEW MATURING EMERGING MARKETS AND GEO-POLITICAL WORRIES AS BIGGER LONG-TERM ISSUES THAN THE CREDIT CRUNCH.

Growth in the euro area has slowed sharply following a very strong start to 2008, and available indicators suggest no improvement for now. Export diversification, not only to Asia but also to Russia and Eastern Europe (see Figure 1), has helped to reduce Europe's dependence on the US. As a result, export growth remained strong despite the slowdown of the US economy last year. But foreign order intake, especially in Germany, has been declining sharply of late. This suggests an export growth slowdown (see Figure 2).

Given the reduced external impetus, the weakness of investment spending (which was already visible in the second quarter) in Europe is set to continue. Investment spending has contributed strongly to growth in the upswing since 2003.

Business confidence numbers are consistent with zero growth in gross domestic product in the third quarter. German Ifo business climate expectations are at the lowest reading since 1993, and the purchasing managers' indices for the euro area are below the expansionary threshold of 50 points. Spain and Ireland, as in the US and UK, are facing significant downturns in their housing markets. This adds to the downside risks for growth, especially if a bigger spill-over into labour markets and private consumption occurs.

These adverse pressures seem to be reaching a peak of intensity in the second half of this year. Although we don't see them disappearing next year, we do see their intensity easing. As a result, during 2009, we expect a recovery, albeit a rather weak one that leaves growth below trend for much of the year.

OIL, THE EURO AND POSSIBLE FISCAL POLICY REACTIONS So what factors can help to support growth in 2009? Both the price of oil and the foreign exchange value of the euro are significantly below the highs they achieved during the summer. This should lend some support to consumers and exporters. However, energy prices still eat up significantly higher amounts of consumers' disposable incomes than they did a year ago.

Lower oil prices mean that the key swing factor for inflation in recent times will start to lose its sting for now as powerful base effects drive the headline inflation numbers sharply lower. We expect that inflation will fall markedly over coming months. From its current rate of around 4% – almost double the target of the European Central Bank (ECB), which is just below 2% – inflation should fall below 3% by around February 2009 and could be below 2% by May next year.

The ECB is stressing the risks of second-round effects, especially higher wages, but lower inflation should reduce inflation expectations and wage demand, especially when below-trend growth leads to a deterioration in the labour market. Importantly, this should then pave the way for some cuts in ECB interest rates, perhaps relatively early next year, which will also help support the economy.

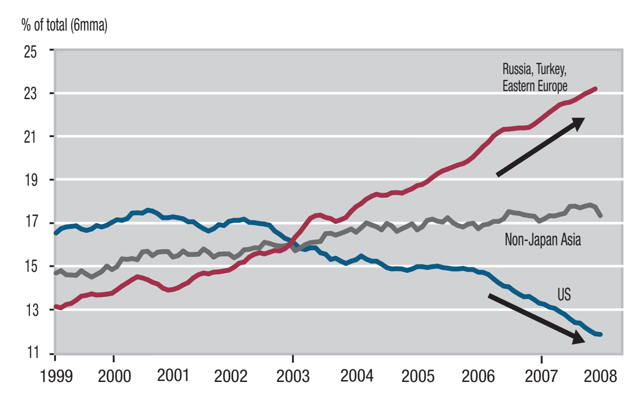
Another possible support can come from a limited move towards

Executive summary

- Although Europe has managed to reduce its dependence on the US as an export market, the weakness in its investment spending is set to continue, which makes further downturns a real possibility.

The ECB inflation rate target for the euro zone is 2% – half the actual figure

Figure 1: Euro zone direction of trade



expansionary fiscal policies, and we have already seen a notable example of this in Spain. There was some scope given budgetary improvements during the upswing, although these were not enormous. The average euro area budget position in 2007 was a deficit of around 0.8%, down from over 3% in 2003.

CREDIT CRUNCH GROWTH RISK Even more than a year after the financial market turmoil began, the final magnitude of the impact of the credit shock on the real economy remains unclear.

The geographic distribution shows that after the US, Europe was the second most affected area. According to Bloomberg, write-downs and credit losses by European banks amount to a cumulative $228.4bn, which is almost as much as the US and the Americas have suffered, at $254.7bn. This huge hit stands in sharp contrast to emerging markets in Asia and Latin America where losses were negligible. Total write-downs and losses are estimated to stand at only $23.8bn in the whole of Asia.

Surveys by the ECB show a tightening trend for credit, which will gradually feed through. Overall financing conditions for banks have become much tighter, and clearly the possibilities for originate-to-distribute business models have sharply declined.

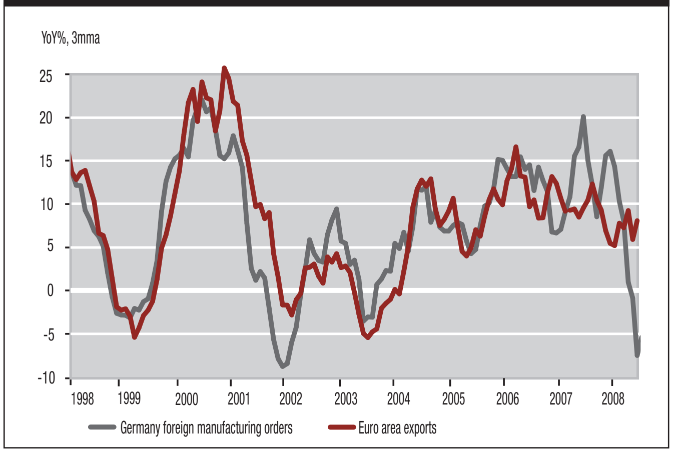
However, the impact of these financial losses on the real economy is currently less intense in the euro area than in the US, and seems set to stay that way, for a number of reasons, including the much lower levels of consumer leverage that exist in most of the euro area than in the US.

EUROPE LOSES RELATIVE IMPORTANCE While multilateral trade talks in the World Trade Organization's Doha round have not delivered any meaningful results, the number of bilateral or regional agreements has increased sharply over the past few years. The announcement of India's free-trade agreement with the 10 ASEAN countries at the end of August is one recent example for this trend.

Despite the fact that transport costs are on the rise, global trade continues to increase and global competition to intensify. Following its WTO accession in 2001, China is rapidly moving up the value-added chain (from its earlier model of cheap labour and low-tech), and parts of the Indian economy are also moving this way, albeit more slowly.

As a result, Europe is starting to lose at least relative importance. The question for the continent is how to position itself in such an environment going forward, and compete.

Figure 2: German factory orders/exports



IT WILL COME AS NO SURPRISE THAT AN ANALYSIS OF EUROPEAN UNEMPLOYMENT DATA REVEALS THAT IN THE CONTEXT OF COMPETITION FROM CHEAP LABOUR, UNEMPLOYMENT AMONG UNSKILLED AND LOW-SKILLED WORKERS IS MUCH HIGHER THAN AMONG SKILLED WORKERS.

It will come as no surprise that an analysis of European unemployment data reveals that in the context of competition from cheap labour, unemployment among unskilled and low-skilled workers is much higher than among skilled workers. It is also important to note that even in times of cyclical strength a structural unemployment base remains.

Under the Lisbon agenda, the EU member states agreed in 2000 to implement a strategy to sustain and improve the EU's global competitiveness. The formula the politicians aim for is focusing on fostering competition and flexibility in both labour and product markets, and on creating a knowledge-based economy through improved education and innovation. But progress has been slow, and meanwhile others have a similar objective of boosting competitiveness through innovation.

While more wage flexibility would certainly tend to keep more jobs in Europe, the EU has no other choice than to focus on areas where the competition is lower. But how sustainable will this strategy be in a time where international direct investments often include a knowledge transfer? The rapid spread and continuous fall in the price of information and communication technology (ICT) will continue to facilitate the dispersion of knowledge. The time-frame during which the profits of an innovation can be reaped in such a context gets shorter.

The problem with the EU's approach is that emerging markets are also becoming innovative, and are realising the importance of this themselves. Nevertheless, the EU is right to stress the importance of the spread of ICT, which is crucial for increasing efficiency and driving productivity growth. An ongoing focus on education is crucial to reduce structural unemployment and retain overall competitiveness.

Europe also has to cope with the changing geo-political scene. In particular, the dependence of western Europe on Russian gas – and its increasing dependence on Russia and its neighbours as an export market – is now emerging as a major longer-term potential vulnerability. More than issues of competitiveness and innovation, this may ultimately turn out to be a much greater challenge for European leaders.

Giles Keating is head of global research for private banking and asset management at Credit Suisse.
giles.keating@credit-suisse.com

Thomas Herrmann is an economist at Credit Suisse.
thomas.herrmann@credit-suisse.com

www.credit-suisse.com/uk/en