ECONOMICS: EUROPEAN PERSPECTIVES

EURO-AREA GROWTH: REASONS TO BE CHEERFUL REVISITED

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The euro area has had a good start to the year, but questions are already being asked about its ability to sustain recent momentum. Lower oil prices have provided an important stimulus, but deeper signs of resilience are apparent in income growth and money/credit dynamics. In our view, these improvements should help sustain the recovery even when the boost from the oil price starts to fade.

At the turn of the year, we took a more upbeat view on the euro-area economy, arguing that the conditions were finally in place for a cyclical rebound. So far, the data have supported this view, with the economy expanding by 0.4% in the first quarter, up from 0.2% in the final quarter of last year, and the fastest growth rate since the first quarter of 2011. More timely survey data point to a similar growth rate in the second quarter.

Consumer-Led Recovery

The question now is whether or not the recovery is sustainable. Clearly, the economy has benefited from lower oil prices and the resultant boost to real income. This is particularly evident in consumer data. In the first quarter, retail sales rose by 0.7% and car registrations by 4.7%. Although total consumer spending data for the first quarter have not yet been published for the region as a whole, we anticipate a 0.7% increase.

It won't be easy for consumer spending to continue growing at this pace in coming quarters. However, we still think the recovery will be sustainable when the temporary stimulus from lower oil prices wears off—for two main reasons.

Income Growth Picks Up

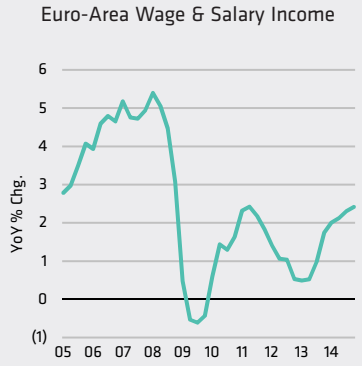
First, the improvement in real income growth is not just a function of lower oil prices. There has also been a pickup in nominal income growth. Indeed, wage and salary income growth rose from close to zero at the beginning of 2013 to 2.4% in the final quarter of last year (*Display 1*). The key to this turnaround has been employment, which was falling by 1.0% per annum in the first quarter of 2013 but rose at an annual rate of 0.9% in the final quarter of last year.

Improved Money and Credit Dynamics

Second, as noted in previous issues, there has been a significant improvement in the monetary backdrop in the euro area. There are several indicators of this:

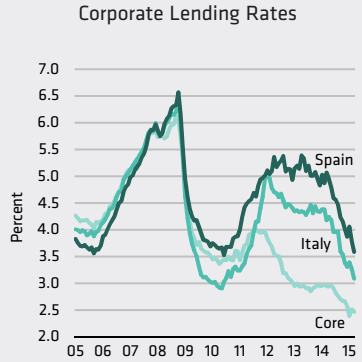
- The quarterly bank-lending survey published by the European Central Bank (ECB) shows that banks are now easing credit standards for both households and nonfinancial companies.
- Bank lending rates for nonfinancial companies have fallen sharply in the periphery in recent quarters (*Display 2*). Although rates are still higher than in Germany or France, this points to a

Display 1
Labor Income Picks Up



As of December 31, 2014
Source: Haver Analytics

Display 2
Fragmentation Recedes



As of March 31, 2015
Weighted average lending rate on bank loans below €1 million to nonfinancial companies. Core is average of Germany and France.
Source: Haver Analytics

marked reduction in financial fragmentation in the euro area.

- Lending volumes have also started to pick up. Adjusted for sales and securitizations, net new lending to euro-area households and firms rose by €35 billion in the first quarter, the best performance since the first half of 2011 (*Display 3*).

Taken together, these factors suggest that the monetary-transmission mechanism in the euro area is on the mend. This, in turn, should allow the ECB's ultra-expansionary monetary policy to gain traction, helping to sustain the recovery once the boost from lower oil prices wears off.

Two Caveats

So what are the risks? The most obvious is Greece. Although a Greek euro exit is not our central case, negotiations between the new government and its official creditors are not going well. We clearly cannot rule out the possibility of such a scenario.

If Greece does leave the euro, it's not obvious how economies in the rest of the region would be affected. It's undoubtedly true that the euro area is better placed to handle such an event than it would have been a couple of years ago. But euro exit would represent a big step into uncharted territory, making the consequences difficult to predict.

Another risk is a continuation of weak growth in emerging markets, particularly China. Despite its size, the euro area is still a relatively open economy, and exports to emerging-market countries accounted for 8.4% of GDP last year, far higher than the same figure for the US (*Display 4*). The euro-area manufacturing sector has been quite sluggish in recent months. One of the main reasons for this is likely to have been weak demand from emerging-market countries.

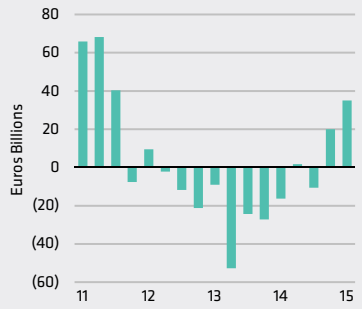
Beyond the Oil Tailwind

Data released so far this year support a more upbeat view on euro-area growth. While part of this has been due to the positive impact of lower oil prices, we believe that improving labor-market conditions and better money/credit dynamics will sustain the recovery even when the oil-price tailwind starts to fade.

The main risks to this view are developments in Greece and emerging markets, especially China. But, barring the worst-case scenario, Greece is unlikely to have a material impact on growth elsewhere in the region. And a continuation of weak emerging-market growth is more likely to act as a constraint on the strength of the recovery rather than cause any material weakness, in our view.

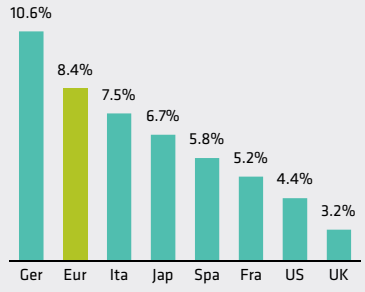
In the coming year, we expect the euro area to grow at (or even a little above) the 0.4% recorded in the first quarter. This would be a big improvement on recent years, but would not be strong enough to put sustained upward pressure on core inflation. This is important. Bond markets may have got the jitters in recent weeks, but the ECB is still highly unlikely to taper its bond purchases before September next year. ■

Display 3
Lending Picks Up



As of March 31, 2015
Net new loans to households and nonfinancial companies. Quarterly data, adjusted for sales and securitizations
Source: Haver Analytics

Display 4
Sensitivity to Emerging Markets



As of December 31, 2014
Source: Haver Analytics