European austerity and recovery delayed

Austerity should not come at any cost. That is the lesson the European Commission has finally learned. As part of the annual peer review of budgetary and National Reform Programmes for European Union member states, the European Commission has recommended that Spain, France, and Slovenia be given two year extensions from the current deadlines to hit the Maastricht Treaty target of a maximum deficit of 3% of GDP. Portugal and the Netherlands were also given an extra year, while Italy was deemed to have done enough to meet its target.

Delaying some pain

The change in position from the European Commission comes after significant pressure from politicians to ease the impact of austerity. It is also partly in recognition of the impact of spending cuts and tax increases, which have been greater than they had previously forecast.

For some countries, the extensions make sense. Spain and Portugal are in the middle of deep recessions after very large adjustments in fiscal policy. The case for an extension is less clear for France, which has barely begun to tackle its horrifically overgrown public sector.

If adopted by the European Council (the recommendation is set to be discussed at the 21st of June ECOFIN meeting), the extensions granted will not remove the need for austerity, only spread the pain over more years.

Chart 6: Current & expected general government budget deficits

% of GDP

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Part of the rationale for the delay is also the reduction in the urgency for budgetary reforms. The European Commission in this instance is referring to the fall in government bond yields, largely as a result of European Central Bank President Mario Draghi, when he promised to do whatever it takes to ‘save the euro’. The intervention was supposed to provide governments with breathing room in order to repair their public finances. Instead, the ECB has allowed moral hazard to take hold, as governments fail to hit budget targets, and have largely stalled on structural reforms.

The lack of progress on structural reforms was highlighted as a key priority by the European Commission. Labour market reforms need to be stepped up in order to address the chronic problem of youth unemployment.
French President Francois Hollande, has recently called for more to be done to help younger members of the workforce. He is proposing to introduce a job or training promise in France, where young unemployed adults would be offered training or work after a certain length of time of searching. This is similar to the ‘new deal’ that was introduced in the UK under the previous government, which in itself yielded decent results. In addition, Holland wants to exclude money spent on reducing youth unemployment from budgetary targets.

Ironically, France has had one of the worst regimes for young workers in Europe. Rather than opening up closed industries to allow younger workers to enter over the past two decades, successive governments have instead opted to create and support time-limited temporary contracts which effectively have created a sub-class of workers, with limited rights and reduced job security.

The problem of youth unemployment has been made worse by the impact of the financial crisis, and more recently, the sovereign debt crisis. Youth unemployment tops 60% in Greece, and is more than twice the wider unemployment rate for the economy. The trend is common across Europe (see chart 7). As companies are forced to cut back on their workforce, they tend to target the less skilled, more easily replaceable, which tend to be younger workers. Also, hiring freezes tend to impact new labour market entrants disproportionally, which are again dominated by youth workers.

The need to reform labour markets is not solely for the benefit of young workers. Reforms that help to reduce the overall cost of hiring would help boost productivity, and the overall competitiveness of European economies. It comes as no surprise to see that the countries with the largest rise in their real effective exchange rates since 2000 (a measure of relative competitiveness where a rise implies losses in competitiveness), also have a larger youth unemployment rate compared to the overall unemployment rate (see chart 8).

The European Commission has been actively pushing for greater labour market reforms for many years, and this year’s recommendations were no exception. In exchange for budgetary target extensions, the Commission is strongly pushing for reforms that will help lower youth unemployment, and open up closed professions to boost competition. Of course, governments in the past have noted the recommendations, but action has been scarce. More may be done now where the problem of youth unemployment is threatening social cohesion, although vested interests such as strong trade unions are likely to keep those with jobs well protected.
European forecast update

Over the past year, we have consistently had a lower growth and inflation forecast for the Eurozone in aggregate than the consensus. Our more pessimistic forecast is predicated on the view that fiscal tightening across the monetary union would have a greater impact on demand, and that monetary policy would be unable to offset this impact. While financial markets have regained much of the confidence lost during the debt crisis, there is a misplaced belief amongst investors that the falls in government bond yields achieved in peripheral Europe will help bring about a robust recovery. In updating our forecast, there are two key themes driving our changes:

1. The persistence of weakness in leading activity indicators such as the Markit purchasing managers indices, the Belgian National Bank survey, the IFO survey, and the INSEE survey, all suggest the recession in Europe could continue for at least another quarter.

2. The recent fall in oil prices is likely to feed through into lower fuel and transportation services costs, which along with the weaker growth outlook, suggests that inflation should be lower than we have previously forecast.

Eurozone real GDP growth in the first quarter was in line with our forecast (-0.2% q/q, -0.9% y/y), meaning the monetary union in aggregate recorded a sixth consecutive quarter of recession. The pace of contraction has reduced from -0.6% at the end of 2012, but amongst the major countries, only Germany managed to eke out some positive growth, albeit just 0.1%. France contracted by 0.2% and slipped into a double-dip recession (see chart 9).

Meanwhile, the third and fourth largest member states, Italy and Spain, both saw activity contract by 0.5%. Italy has been in recession for seven quarters, with GDP falling 4.1% since its previous peak. Spain has been in recession for six quarters, with a 2.9% fall in GDP since its previous peak. The deep recessions the pair are experiencing highlights the very negative impact from the austerity the two have been forced to implement.

Charts 9: Recent GDP performance

As mentioned above, leading indicators suggest that the weakness in activity should persist slightly longer than we had forecast. As a result, we have downgraded our second quarter growth forecast from flat to -0.1% (see chart 10).
However, we are downgrading the Eurozone GDP forecast on the back of continued weakness in leading indicators

UK GDP is being revised up after Q1 upside surprise, although H2 should remain weak

We continue to forecast a return to growth, albeit very weak growth, in the second half of the year. However, the risks to this part of the forecast are to the downside at the moment given the lack of improvement in business surveys.

For 2014, we have flattened the quarterly profile of our GDP forecast on the back of growing evidence that European governments, particularly those of Italy and France, continue to be reluctant to implement meaningful labour and product market reforms that would otherwise help boost long-term growth.

Overall, the risks to our 2014 forecast are to the upside, although we will return to this point later.

While we are downgrading the Eurozone, we are upgrading the UK’s growth forecast (see chart 11). The estimate of growth in the first quarter was higher than we had forecast (0.3% actual vs. 0% Schroders) thanks to a particularly strong end to the quarter, meaning that the UK did narrowly avoid a triple-dip recession.

The stronger than expected performance of the service sector and the production sector mean that even if both record no monthly growth through the second quarter, a positive base effect will help push second quarter GDP as high as 0.5% compared to the first quarter. We have therefore upgraded our forecast for second quarter GDP.

Whilst the UK should enjoy a reasonably robust first half of the year, leading activity indicators suggest underlying growth remains close to zero. Growth in employment has finally started to fall back having been far stronger than is consistent with the recent weakness in activity. Growth in average weekly wages (including bonuses) has also fallen to its lowest level since May 2009. The three month average compared to a year earlier for March fell to just 0.4%, or -2% in real terms. We are therefore forecasting a pull back in the second half of the year, before we see a pickup in 2014 supported by a build up in momentum around the world.

Charts 10 & 11: Changes to Schroders Eurozone and UK GDP forecasts

Oil to drive down inflation

On the inflation front, the recent fall in oil prices is likely to help lower headline inflation further over the course of this year across Europe. The price of Brent Crude has fallen just over 12% since our last forecast update in February, and as we use pricing on forward contracts for our oil price forecast, this leads us to lower our Eurozone inflation forecast for 2013 from 1.7% to 1.3% (see charts 12 and 13 on next page).
Lower oil prices and VAT effects should drive down inflation in the Eurozone later this year

In addition to the impact from oil, we have updated our methodology to better model the temporary impact from the recent rises in value added tax in some Eurozone economies. We highlighted the effect increases in VAT have had in the Netherlands and Spain in last month’s edition of the Economic and Strategy Viewpoint, and the way that when the increase drops out of the annual comparison, we should see a sharp fall in inflation. This should largely be seen at the end of 2013.

Forecast risks

In addition to our scenario analysis, there are 2 country specific risks to our Eurozone and UK forecasts.

Aside from the interest rate cut at last month’s meeting, the ECB announced that it was starting to consult on the possibility of purchasing/taking on collateralised bonds backed by business loans. The ECB has in the past bought covered bonds (backed by residential mortgages), but this would be seen as a way to encourage greater lending to small and medium sized enterprises.

At this stage, very little has been announced about how the scheme would work, presumably because it is still being decided. The European Commission is due to report on the issue later this summer, and so early autumn appears to be the likely timing of more announcements. The scheme could be similar to the UK’s funding for lending scheme, or it could be a straight purchase of asset backed securities. Either would be beneficial. However, there is a risk the ECB decides to simply use its current liquidity provision system (long-term refinancing operations amongst others) and change collateral requirements to accept the corporate loans backed securities. While this may help boost liquidity for banks, it would not encourage much on-going lending.

In our view, the ECB should try to purchase the securities outright. While this introduces risk on to the ECB’s balance sheet, it frees up the banks to make more loans. Ideally, there should be some form of incentive to encourage greater lending, for example, the UK’s funding for lending scheme now offers £10 for every £1 lent to a small enterprise.

In addition to the need to transfer risk, the scheme should be made available for a considerable period of time, the pricing of these securities has to be higher than the current market price (meaning lower funding rates for companies), and the scheme needs to be large in size.

If the ECB meets at least some of these conditions, then it could help restart corporate lending across the whole of the Eurozone, and therefore boost growth in investment and consumption.
In the UK, we are still waiting for the full details of the housing related equity guarantee schemes which are due to start next year. However, mortgage rates have continued to fall and the momentum in house prices is beginning to build once again. This also presents an upside risk to our UK growth forecast, although we doubt that higher house prices will encourage the same behaviour seen before the financial crisis of mortgage equity withdrawals funding spending binges.