MARKET FLASH

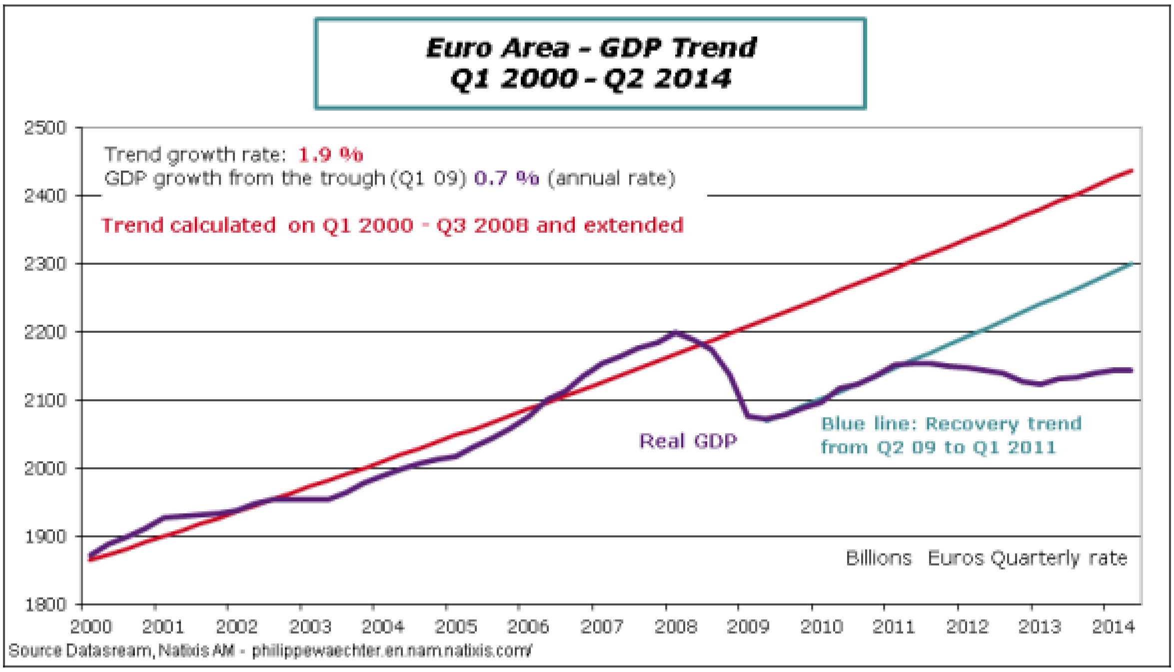
What is the Momentum in France and Euro Area?

Philippe Waechter, Chief economist of Natixis Asset Management, shares his analysis of the current economic situation in France and Euro Area.

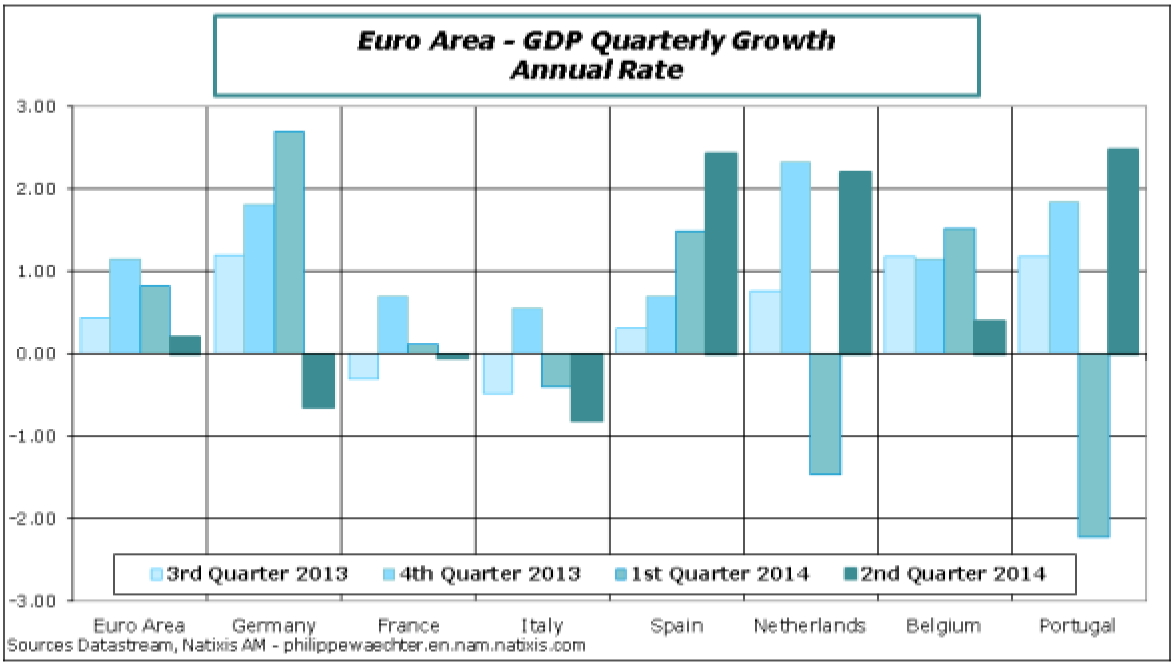
Four Graphs on the Euro Area Growth Momentum

Euro Area GDP was almost stable during the second quarter (+0.2% at annual rate) after a slight increase of 0.8% during the first three months of this year. Compared to the second quarter of 2013, GDP is up by 0.7%. Carry-over growth for 2014 is 0.6% at mid-year (Carry-over growth at the end of the second quarter is the average annual growth if GDP level remains at Q2 level in the third and the fourth quarters. It's a useful approximation).

The **first chart** shows GDP level at constant price. The red line is the trend calculated from 2000 to the first quarter of 2008 and prolonged until the second quarter of 2014. The gap between the observed GDP and the trend is -12% at the end of the first half of 2014. This is huge and we do not see any convergence between the two lines. It is more a divergence than a convergence. The line in blue is another trend that shows the momentum of the recovery in 2009 and 2010 and the break after the first three months of 2011. There is gain a divergence here. Since the first quarter of 2011, GDP is down by -0.36% (-0.1% at annual rate). The current recovery seen since the first quarter of 2013 is following a mild dynamics. From that date, average growth is 0.8% at annual rate. It is still far from the 1.9% which was the trend growth rate seen before the crisis.



The **second graph** shows quarterly growth for euro area countries. For the **Euro Area**, GDP was up by 0.2% after 0.8% in the first three months of 2014. We do not have details to explain this relative stagnation.



In **Germany** the GDP dropped by -0.6% at annual rate after +2.7% in the first quarter. According to Destatis, exports and investment were down in spring. The lower dynamics in exports can be explained by the lower growth momentum seen in emerging countries (Asia) and in its main trading partners (France, Italy). On investment, there is probably an important seasonal effect. As temperature was high this winter, construction was strong. So part of the sector’s activity took place earlier in the year, weakening spring data. Nevertheless we do not have detailed numbers to have a precise analysis. It is just comments from the national statistics institute (Destatis). Households’ consumption and government expenditures have had positive contributions.

In **France**, the profile is worrisome for the last four quarters. The trend is close to zero and no impulse is seen.

Italy is in recession again (did it ever leave?). GDP dropped by -0.8% in spring after -0.4% last winter. The detail is not available yet but the national statistics institute (Istat) said that exports were a source of weakness. Internal demand was probably weak also and not being able to counterbalance the exports drop.

In **Spain**, GDP was up by 2.4% after 1.5% during the first quarter. According to the Bank of Spain, this improvement is due to internal and external impulses. We do not have detail yet on inventories but step by step internal demand is stronger even if its level is still very low.

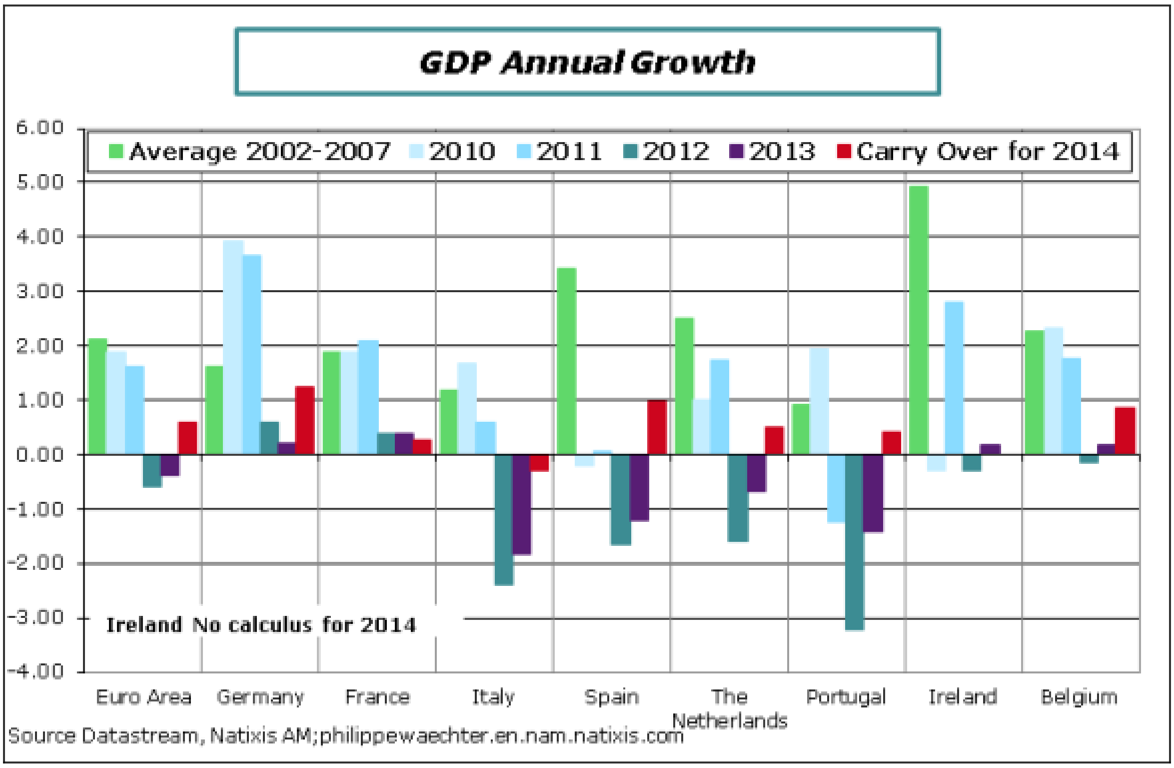
The rebound seen in the **Netherlands** is spectacular from -1.5% to +2.2%. But this is not really convincing as internal demand is still contracting rapidly. Investment is contracting at a rapid pace and the small improvement in consumption is not sufficient to counterbalance it. In other words, the Netherlands is still in a deep adjustment process with weak internal demand (negative contribution for the last two quarters (-1.6 and -2.1%) pulling down imports. Net exports have a positive contribution which is mainly due to drop in imports. That’s not really virtuous.

In **Portugal** GDP were down by -2.2% in the first quarter and up by 2.5% in spring. The Portuguese institute of statistics indicates that this improvement comes mainly from exports. We do not have details. What we know is that contributions to GDP quarterly growth are very volatile. During the first quarter investment was down by 16% and exports by -7.5%. It’s probably a technical effect.

In **Belgium** GDP growth was weaker during spring. It was up by 0.4% versus 1.5% last winter. No details and no comments were available.

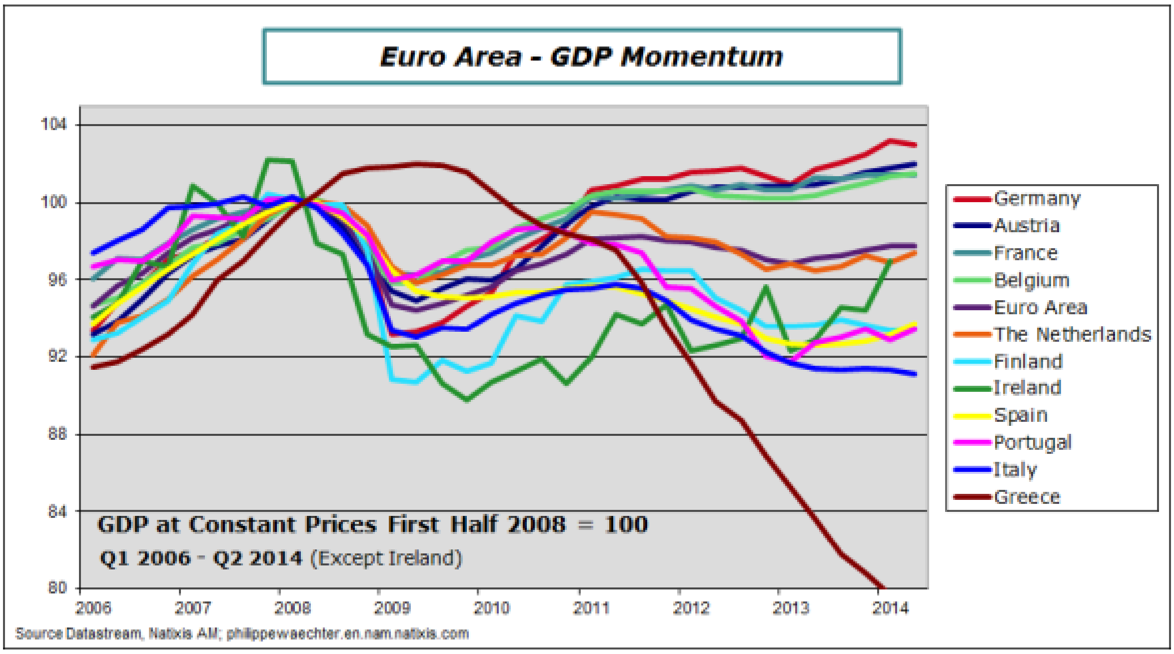
With the exception of Spain, Euro area figures for the second quarter show more weakness than strength. That’s clearly worrisome.

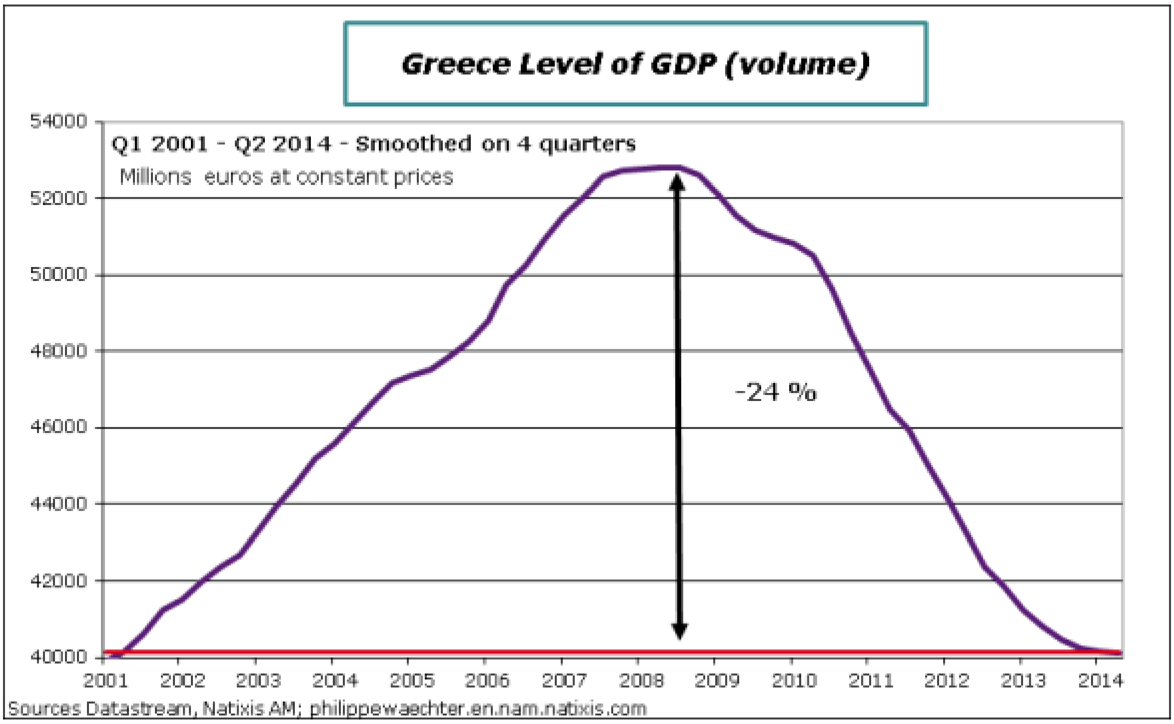
The **third chart** represents GDP annual growth and the carry-over for 2014.



2012 an 2013 have been two years of recession for the Euro Area and for important countries such as Italy, Spain, Netherlands and Portugal. But even in Germany and in France the momentum was low. Carry-over for 2014 is weak and does not reflect a strong exit of recession. That's the weakness of the Euro Area; there is no source of long-lasting positive impulse.
From data of the first quarter and what we know from the second, the source of this low momentum comes from low internal demand specifically on investment. The risk of deflation that can be seen in an inflation rate at 0.4% in July is related to wage negotiations. Low inflation rate will lead to low wage indexation and this will not reinforce consumption and internal demand. That's why a lot of resources have to be put on investment (public and private).

The **fourth graph** compares the GDP current level to its pre-crisis level. The reference here is the first half of 2008. To be able to make comparison with the same metrics, the US level is 107 and the United Kingdom is at 100.6. The four leading countries (Germany, Austria, Belgium and France) are still far from the US level but well above UK. Compared to the decrease seen since 2008, rebound seen in Spain and Portugal are still limited. A lot has still to be done. Italy is probably the Euro area country with the weakest momentum. For **Greece** I have a special graph. But the Greek economy is stabilizing after a drop of almost 25%. The drop is over but the recovery not here yet.


Euro Area - GDP Momentum
104
100
96
92
88
84
80
2006
2007
2008
2009
2010
2011
2012
2013
2014
Germany
Austria
France
Belgium
Euro Area
The Netherlands
Finland
Ireland
Spain
Portugal
Italy
Greece
GDP at Constant Prices First Half 2008 = 100
Q1 2006 - Q2 2014 (Except Ireland)
Source Datastream, Natixis AM; philippewaechter.en.nam.natixis.com


Greece Level of GDP (volume)
Q1 2001 - Q2 2014 - Smoothed on 4 quarters
Millions euros at constant prices
54000
52000
50000
48000
46000
44000
42000
40000
-24 %
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Sources Datastream, Natixis AM; philippewaechter.en.nam.natixis.com

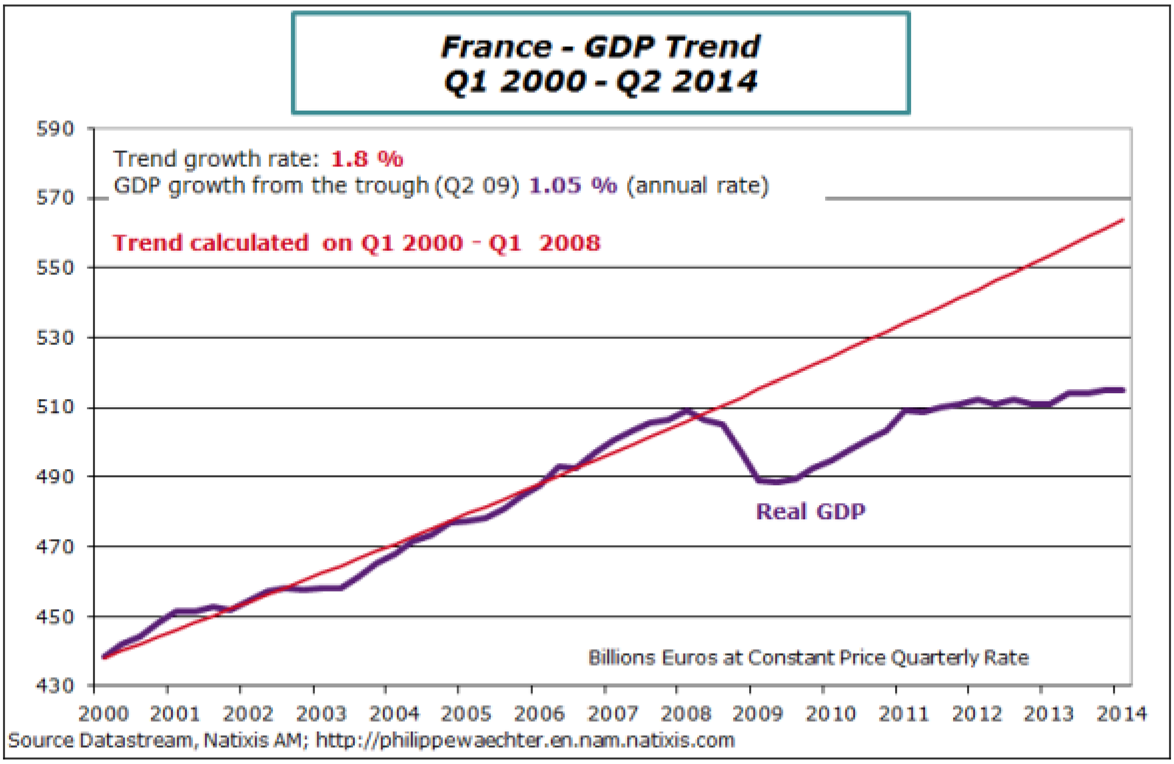
France – GDP stagnated for the second consecutive quarter

During spring, GDP was flat for the second consecutive quarter. The one year change is barely positive at 0.1% and the carry-over growth for 2014 is just 0.3% at the end of the first semester. (Carry-over is the annual average growth for 2014 with the hypothesis that GDP level in the third and the fourth quarters will be equal to the second quarter GDP level. It's a useful approximation).

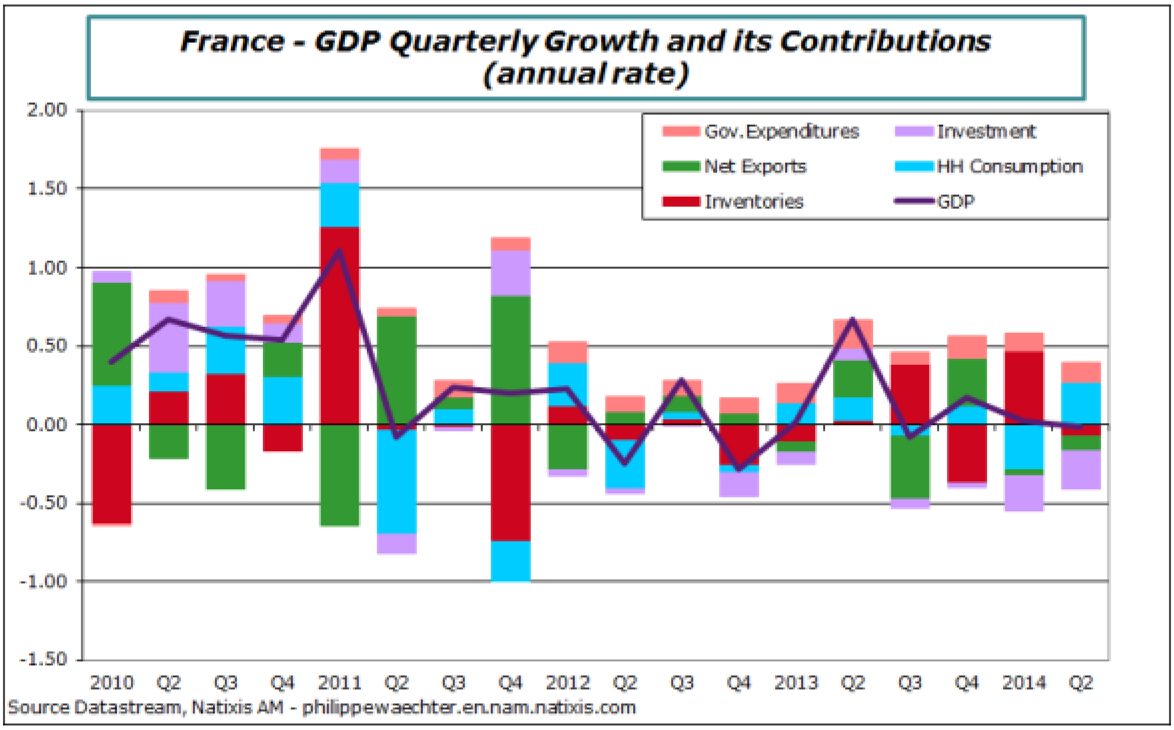
The new French government forecast is 0.5% for 2014 instead of 1%. But with a carry-over of 0.3% it will not be an easy task as a growth of 0.3% (non-annualized) is required for the third and the fourth quarters. Such a rebound has not been seen since 2010 and is not seen yet in July companies' surveys. This means that 0.5% can be perceived as a top range forecast.

One immediate implication is that the target of 3% for the budget deficit in 2015 is clearly not warranted. The French Finance Minister, Michel Sapin, said that the 3.8% target for 2014 will not be respected and that the deficit will be above 4%. For 2015 the government has announced a GDP forecast at 1%. Even if the 0.5% for 2014 is attained, it supposes a 0.25% GDP growth every quarter (non-annualized figure). I hope it is not too ambitious.

The first chart presents the French GDP in level and at constant prices. In red is the trend calculated from 2000 to Q1 2008. The trend growth rate was 1.8%. Since the trough in Q1 2009, the GDP average growth is just 1.05%. The gap between GDP and its pre-crisis trend is 9.1%. It represents the cost of the successive shocks that have affected the French economy. It's huge. On this chart, we see the large impact of the sovereign debt crisis and of austerity policies in the Euro Area under the auspices of Brussels since 2011.



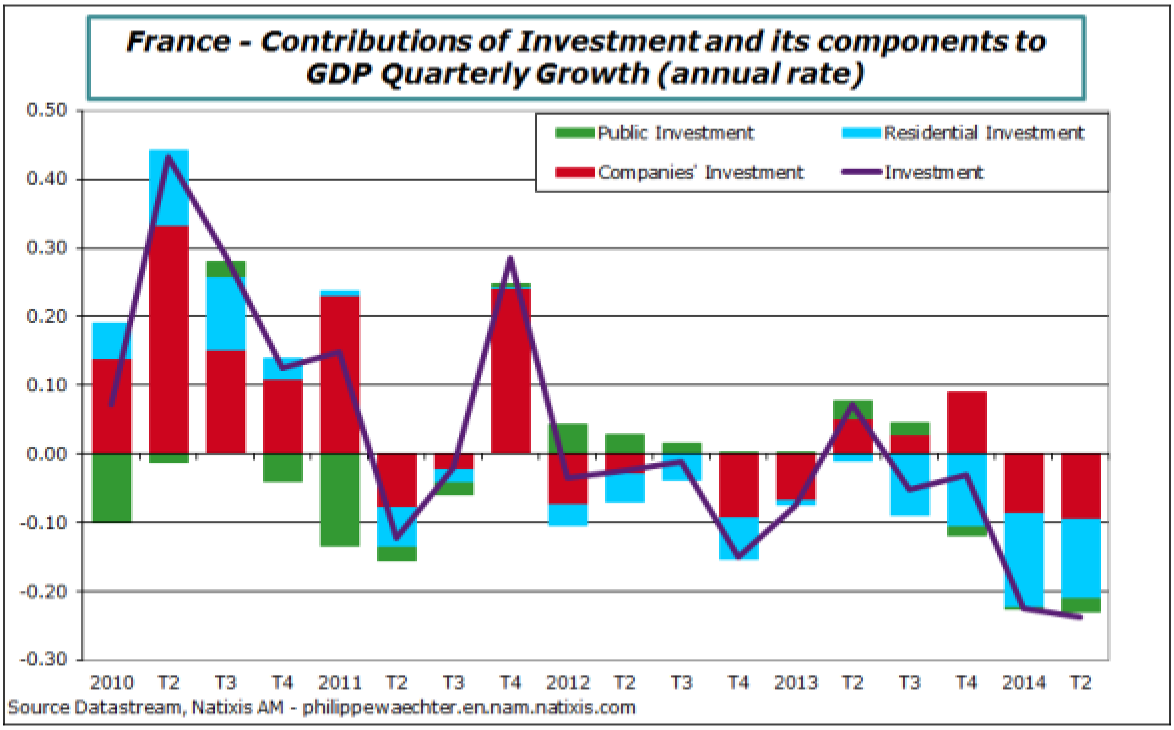
Contributions to GDP quarterly growth are the best instrument to decipher the source of changes in the economic activity. That's what the next chart shows.



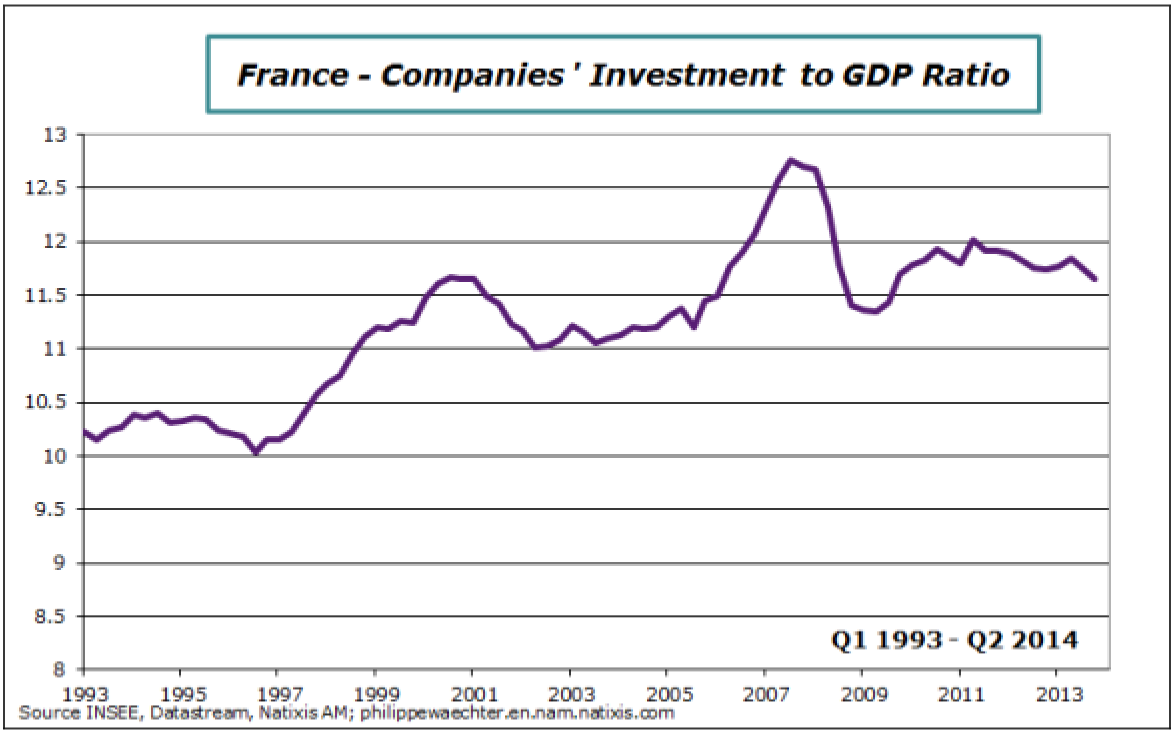
During the second quarter households' consumption and government expenditures have had positive contributions. The three others, investment, net exports and inventories, were a drag to the economic activity.

The consumption momentum suggests that the rebound in the second quarter was just the mirror of the negative number seen during the first three months of the year. Services' consumption has grown at the mere 0.1% as in the first quarter, and the rebound was just seen in manufacturing goods and energy. Stronger services are needed to suggest a change in trajectory.
Looking at the chart we see that government expenditures have a positive contribution in every quarter of the chart. It shows their importance; cutting them too rapidly would probably be the source of a new contraction of the economic activity as private demand remains weak.

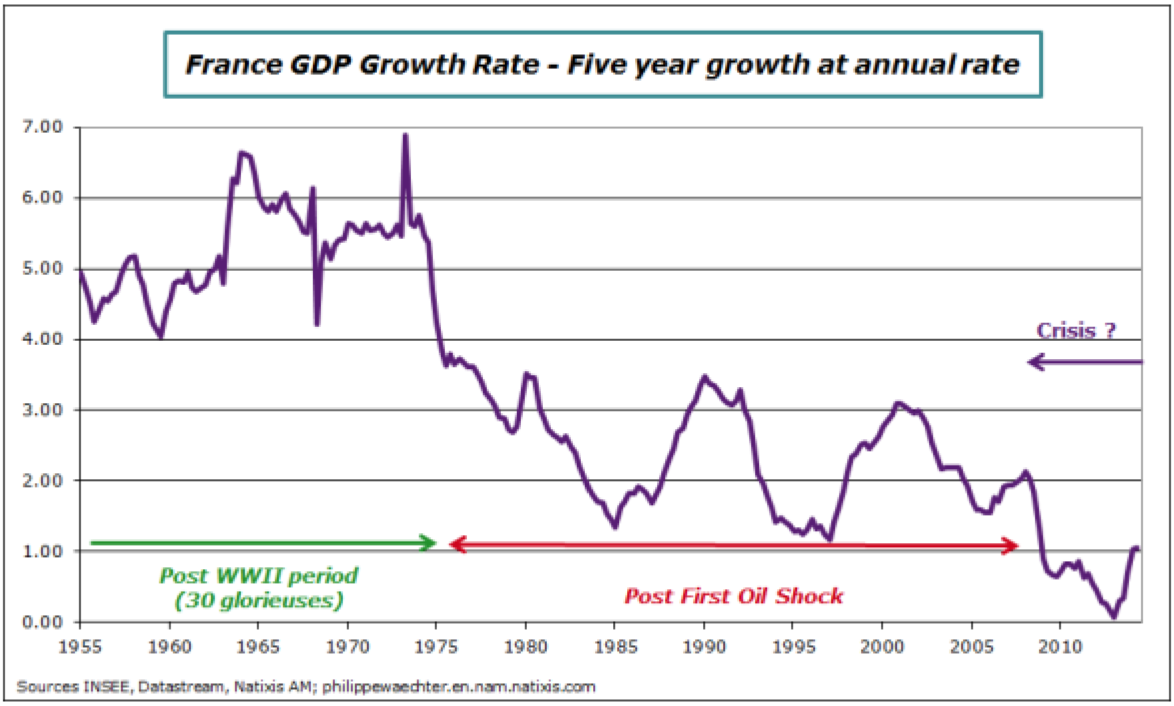
The main problem with the French growth figures is the weakness in investment. The two charts below are linked to this issue. On the first, there is a decomposition of investment by contributions. For the last 10 quarters, residential investment is negative. Incentives to buy have been reduced and real estate prices are still high even if they start to falter. This part of the investment shows a real crisis in the real estate sector and the lack of confidence from households. Public investment is neutral. That's a weird part of the French government policy. The "Pacte de Responsabilité" is supposed to create incentives for companies to invest. But in a weak environment companies will adopt a wait and see behavior. Having stronger financial conditions (from the Pacte de Responsabilité) is not sufficient to invest; there is a need for an impulse from expected demand or from public investment. That has to be the role for economic policy.



The second chart represents the investment rate. It was trending upward until the crisis. It is now stable and behaves almost like the GDP i.e. not very fast. This ratio shows that there is no break from investment. It is problematic for potential growth. In addition to what was said earlier, it is probably necessary to define a more defined framework for the future. Until 2007, the economy came back to a kind of equilibrium framework. The different shocks on the French economy push the French economy out of this framework. The role of economic policy is to define a new framework and a trajectory to converge to it (The idea here was developed a long time ago by Axel Leijonhufvud, in a paper "Effective Demand Failures"). This is not done in France while it is a part of economic policy and a source of credibility for it. By the way there is still large uncertainty that reduces the capacity for private economic agents to take risks.



Long term growth pattern is also a source of difficulties. The chart below represents GDP growth with a five-year moving window.



From World War II to now, there are three periods: the first with the “30 glorieuses”. The GDP growth rate was close to 5-6% per year. That’s probably one part of our current difficulties as some institutions were built with such a strong expansion. After the first oil shock, growth was down to a little more than 2% per year. This was a quite stable period as it can be seen on the chart. The growth rate moved from 1 to 3 %. For the last five years, GDP growth is just 1%. Is it the New Normal? With a positive population growth this means that GDP per capital can barely grow. That’s why something has to change.

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