TEXT 5 - The euro

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The euro-area economy

That shrinking feeling

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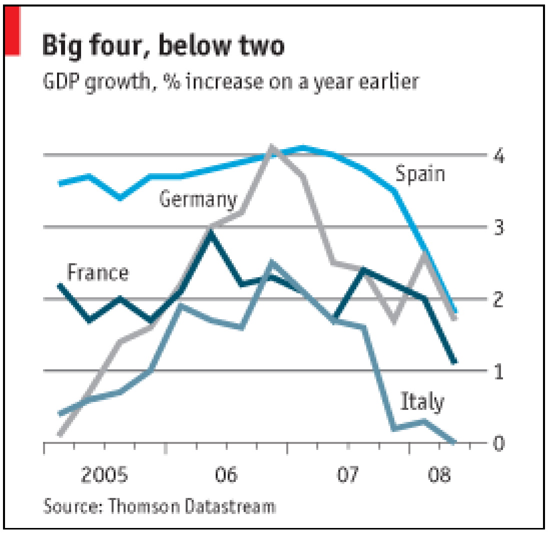
The credit crunch started in America, but Europe may yet prove the bigger victim. A first article looks at the euro area, a second (see article) at eastern Europe

Illustration by Peter Schrank

EUROPEANS might be forgiven for feeling bruised. The housing bust across the Atlantic was the trigger for the credit crunch, so justice demands that America suffer most from the fallout. But America has not so far followed the script, weathering the storms better than it expected. Its GDP suffered a tiny decline at the end of 2007, but it grew at an annualised rate of around 2% in the second quarter of 2008.

Europe is struggling to stay above water. Figures released on August 14th showed that the euro-area economy shrank at an annualised rate of 0.8% in the second quarter, the first such reverse since 2001. Nor are things likely to improve soon. A closely watched survey of purchasing managers in manufacturing and services slumped in July to its lowest level since 2001. Business confidence has turned down sharply in all of the three biggest economies in the euro area: Germany, France and Italy.

Indeed, in the second quarter GDP fell in all three countries, paring their annual growth rates (see chart). That Italy slipped is no surprise; even in brighter times for the world economy, it has struggled to maintain its growth. Meanwhile Spain's GDP has predictably stuttered as it endures a painful shock from its burst housing bubble. More alarming is the step back by France and Germany, which seemed sturdier than their southern neighbours.



In truth, the 2.0% annualised fall in German GDP in the second quarter makes its economy seem in worse shape than it is. A warm winter allowed more construction work than usual, spurring an aberrantly large rise in first-quarter GDP. The second-quarter decline is partly a payback. Yet there are worrying signs that the export motor that drives the German economy is sputtering. Orders for German engineering goods fell in June by 5% from a year ago, according to VDMA, a Frankfurt-based industry group. Foreign orders fell by 7%.

Thomas Mayer, an economist at Deutsche Bank, detects feelings of dismay in Germany at the economy's deterioration. After all, this was one of the few rich countries that skipped the global house-price boom. And unlike America, Germany is a supplier of global credit: its current-account surplus was a hefty 7.7% of GDP last year, according to the OECD. Mr Mayer thinks there is a belief in Germany that "we didn't do all those bad things, so it's not fair that we are suffering". What is missing, he says, is any recognition that Germans profited from the credit-fuelled global boom, that "they were part of the game" as suppliers if not as consumers.

The rest of Europe was hardly immune from housing mania. House-price rises in Spain, Ireland and France during the boom years outstripped even America's. Ireland's housing bust may yet prove to be the most dramatic of all. Its GDP, which grew by 6% in 2007, is likely to shrink this year, according to the Economic and Social Research Institute, a Dublin-based think-tank. Ireland is too small for its economic troubles to pull down other countries much but Spain's economy has enough heft to inflict collateral damage (see article). Spain accounts for one-eighth of euro-area GDP but until recently was generating a much larger share of consumer spending and new jobs. Now the Spanish consumer is in retreat—retail sales fell by almost 8% in the year to June—and unemployment is rising.

The Spanish collapse has hurt firms in other euro-area countries. German and Italian exports to Spain have slowed sharply since last year, according to Julian Callow at Barclays Capital. French exports to Spain are now falling. Prospects for sales outside the euro area have darkened too. America's economy is doing well partly because it is sucking in fewer imports. Britain, the euro-area's other main export market, is on the brink of recession.

Hopes that spending by consumers in the thriftier parts of Europe would make up for lost exports have been dashed. In less troubled times, the marked acceleration in wages and salaries in the first quarter would soon push up spending. But because of sharp increases in food and fuel prices, fatter wage packets have barely kept up with inflation, which is now 4%.

Nor has thrift yielded much reward. When the economy was strong, most consumers were cautious about saving less and spending more (the euro-area saving rate has barely budged in the past three years). Now, when fears of jobs losses are rife, they are even less inclined to splash out. Retail sales across the region fell by 3.1% in the year to June. Even if there were a desire to borrow to finance spending, banks might be unwilling to meet it. Loan growth is wilting and a survey by the European Central Bank (ECB) suggests that lending conditions are becoming stricter.

No wonder business confidence is flagging and companies are pulling in their horns. Until recently, capital spending was one of the main drivers of economic growth. Firms were keen to invest on the back of healthy profits, solid foreign demand and hopes of a pick-up in consumer spending. Despite the credit crunch, banks seemed content to offer loans to companies for buildings and equipment, even as they recoiled from lending to households. But now loans to companies are slowing as well—a sign that firms are cutting back. Stronger wage growth and high commodity prices have squeezed profits, and export order books are suddenly thinner.

The economy’s downward lurch puts the ECB in an awkward spot. It raised its main interest rate to 4.25% on July 3rd to show that it was serious about controlling inflation, which is well above its target ceiling of 2%. The rate-setters’ fear was that inflation would persist if firms and households used today’s rate as a benchmark for future wages and prices. They are right to worry. In Italy and Spain, wage growth is picking up even as unemployment rises, because of contract clauses allowing workers to be compensated for higher-than-expected inflation.

The good news is that the drop in oil prices may mean that euro-area inflation has peaked. But it will start to fall back only towards the end of the year. The ECB will be reluctant to cut interest rates until it is sure that the inflation danger has passed. By then, the euro-area economy may already be in recession. Mr Mayer reckons that the ECB will attempt to revive it by cutting interest rates to 3.25% next year. But until then, it is hard to see what else might lift growth. Many Europeans will feel that they deserved better.