EZ's Head and Tailwinds; Acute Portuguese Crisis; Stalling Russian Growth

By RGE's Europe Analyst Team

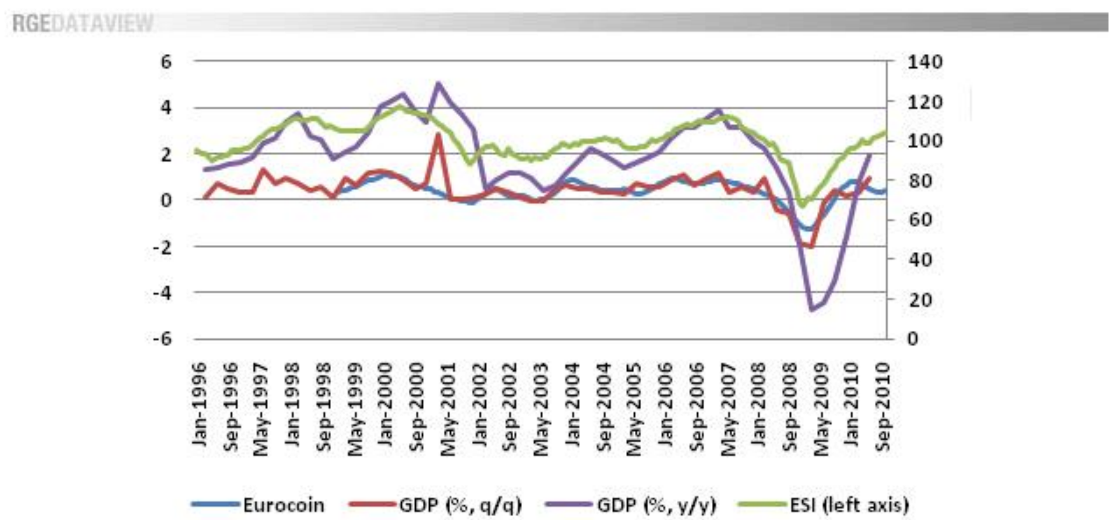
Eurozone: Head and Tailwinds

By Elisa Parisi-Capone

The latest eurozone PMI indicators confirmed the picture of a brightening external environment, especially in the manufacturing sector, in contrast with the more subdued domestic demand-oriented services sector. According to Markit estimates, the current activity indicators are consistent with a Q4 GDP growth reading of 0.3% q/q after a PMI-implied growth rate of 0.6% q/q in Q3. Similarly, the eurozone's Economic Sentiment Indicator (ESI), which correlates closely with annual changes in real GDP, improved further to 104.1 in October from 103.2 in September (100 = long-term average).

On the other hand, the monthly Eurocoin indicator, which tracks quarterly GDP growth, bottomed out in October, rising to 0.41 from 0.34 in September. The Eurocoin average implies Q3 growth of 0.37% q/q, very close to RGE's 0.35% q/q forecast. For Q4, RGE expects 0.25% q/q growth, which is broadly in line with PMI estimates.

Figure 1: Eurozone Real GDP Growth and High-Frequency Indicators



Source: Factset, RGE

Among the downside risks, RGE points to the strengthening common currency after the Fed's QE2 decision and in view of the ECB's exit strategy. Since June, the euro has appreciated by 6.5% in nominal effective terms, thus counteracting the previous depreciation. According to different estimates, a 10% effective appreciation is bound to shave 0.7-1 percentage points off GDP growth. The second headwind concerns the drag from additional fiscal austerity measures in periphery countries and a region-wide consolidation effort starting in 2011, amounting to about 1.5% of GDP.

New IMF research on fiscal multipliers contradicts the notion of expansionary fiscal consolidation episodes, at least in the short run. In quantitative terms, the IMF found that afiscal tightening equal to 1% of GDP typically reduces GDP by about 0.5 percentage points within two years and raises the unemployment rate by about 0.3 percentage points, especially in the absence of offsetting policy measures, such as rate cuts and currency depreciation. (See related Critical Issue on eurozone growth.)

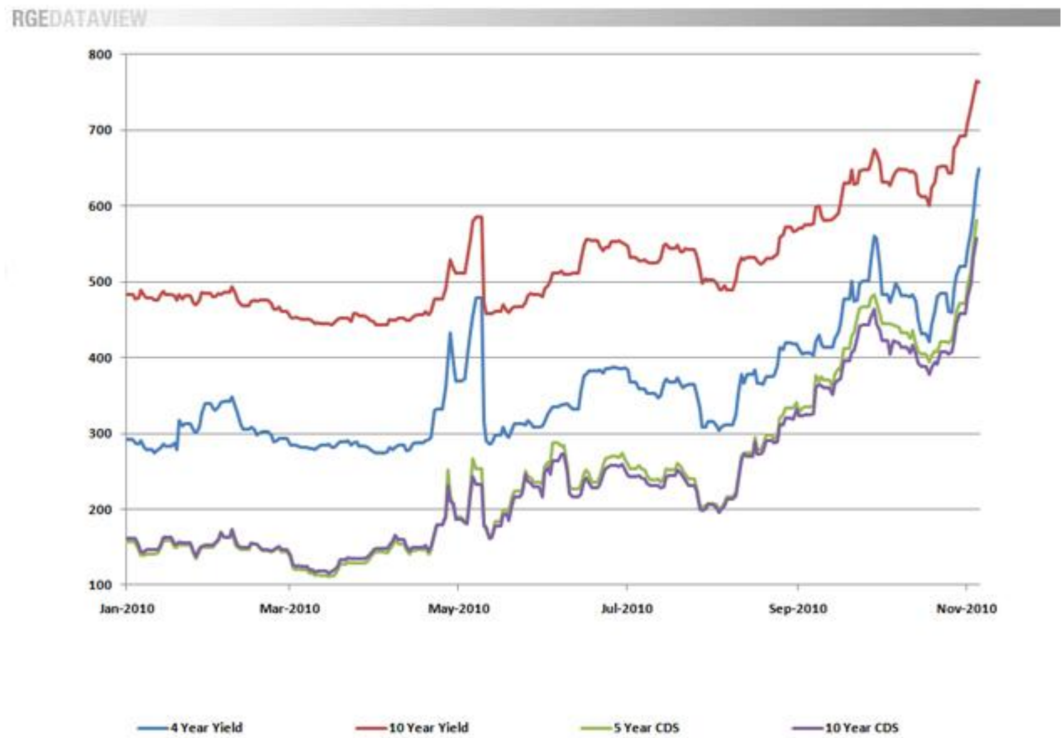
Ireland: From Bad to Worse

By James Mason

Not much has gone right for the Irish government in the past week as yields and CDS on Irish government debt have continued to rise. Domestic pressure in Germany led the European Council to talk openly about a crisis framework providing for adequate participation of private creditors. Allied Irish Bank's €10.4 billion capital-raising has hit a few snags as it is struggling to sell its UK business, and commentators have pointed out that the Pension Reserve Fund is set to make a €1.8 billion loss on its underwriting new share issuance. The FT reported that spreads breeching 500 basis points (bps) trigger higher repo haircuts and some sovereign wealth funds have got cold feet regarding periphery sovereign debt.

All this negative news seems to have steamrollered an optimistic report from Moody's, which argues, based on past defaults, that a strong domestic investor base makes default in Ireland less likely. Rumors that the ECB has resorted to buying Irish debt again after a four-week holiday also failed to halt the rise in yields.

Figure 2: Irish Government Bond Yields and CDS Premiums (bps)



Source: Bloomberg

There is not much the Irish government can do about external events, but what it can deliver on is a strong credible budget for 2011, consistent with a four-year plan to reduce the deficit to 3% of GDP by 2014. It has now announced deficit cuts of €15 billion over the four years, starting with €6 billion in 2011, but the devil will be in the details. Now it must walk a knife edge between market expectations and domestic politics while praying that yields will have fallen by the New Year.

However, there is an alternative, which Irish and EU leaders insist on ignoring. Resolution legislation, modeled on the UK bank resolution regime, would allow appropriate burden sharing with all private creditors. If the Irish authorities fail to charm the markets, or sort out the banking sector themselves, then it will be left to the IMF and EU to do it for them with rather more collateral damage. (See related Critical Issue on Irish Fiscal Austerity.)

Portugal: Fiscal Crisis Remains Acute

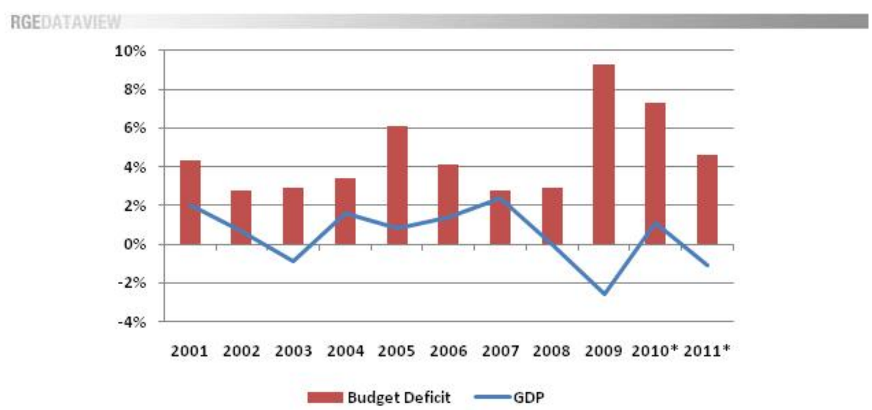
By Katharina Jungen

Portugal's austerity drive has so far failed to deliver any results. Between January and September 2010, the budget deficit was €200 million higher than during the equivalent period in 2009, as tax revenue came in weaker than expected while spending cuts proved not aggressive enough—the government purchased two submarines in 2010 for the price of €1 billion. In addition to front-loading several austerity measures initially scheduled for 2011, the government hopes to reduce the budget deficit to the committed target of 7.3% of GDP in 2010 with the help of a €2.6 billion asset transfer from Portugal Telecom SGP SA to the social security system. The latter one-off measure, however, will fail to improve the underlying budget position as it merely shifts the actual consolidation burden to 2011.

While RGE expects the budget measures, which amount to 4% of GDP in 2011, to push the Portuguese economy back into recession, the government's overly optimistic 0.2% GDP growth forecast gives room for further negative surprises.

Meanwhile, borrowing costs reached a record high last week, exerting additional pressure on the budget as investors were increasingly reluctant to buy periphery debt following the last EU summit meeting, which pushed for private creditors to share financial rescue costs.

Figure 3: Portuguese GDP (percentage change on the previous year) vs. Budget Deficit (% of GDP)



Source: Eurostat, Portuguese Finance Ministry, RGE
**2010 and 2011 growth projections are RGE forecasts; 2010 and 2011 budget deficit figures are Portuguese Finance Ministry projections*

Moreover, while Portugal narrowly averted a political crisis in early November with the passing of the 2011 budget outline, the current political circumstances do not bode well for the implementation of an aggressive reform agenda aimed at lifting the economy's growth potential, as the minority government remains far too dependent on the opposition to take decisive action. (See related Critical Issue on Portuguese public finances.)

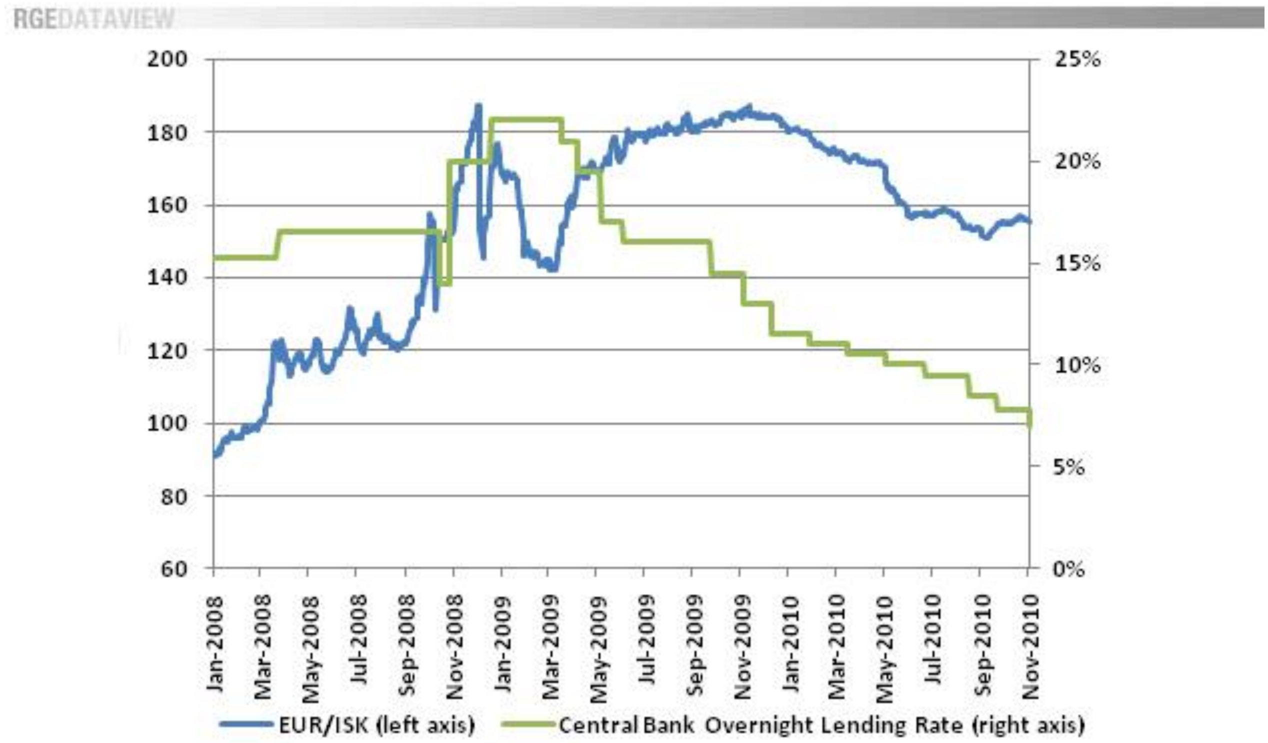
Iceland: Capital Control Relaxation Postponed

By Mikko Forss

Iceland's central bank governor stated on November 3, 2010, that there will be no fundamental changes to the current capital control regime before March 2011. The same day, Iceland's central bank lowered its interest rates by 75 basis points, causing a drop in bond yields. Yields also fell as capital moved into bonds, given the longer-than-expected restrictions on investing abroad. Based on the central bank's earlier communication, many investors believed controls would be relaxed shortly after the third IMF review, which took place in late September.

Iceland is currently struggling with the opposite problem to many emerging markets (EMs), which are concerned about massive capital inflows. In contrast to EMs such as Brazil and Thailand that are trying to use controls to slow such inflows, the aim of Iceland's controls is to prevent outflows and give the economy time to recover and stabilize its exchange rate after its late 2008 banking crisis. Notably, Iceland's capital controls have been very effective—especially since the controls were tightened in October 2009—and the Icelandic krona (ISK) has since strengthened against both the euro and the U.S. dollar. Earlier this year, the central bank estimated that the ISK could have depreciated to 260-300 against the euro without capital controls, or even further. In fact, however, the ISK's weakest point against the euro was at just below 190 in late 2008.

Figure 4: Key Policy Rate and ISK/EUR Exchange Rate



Source: Factset

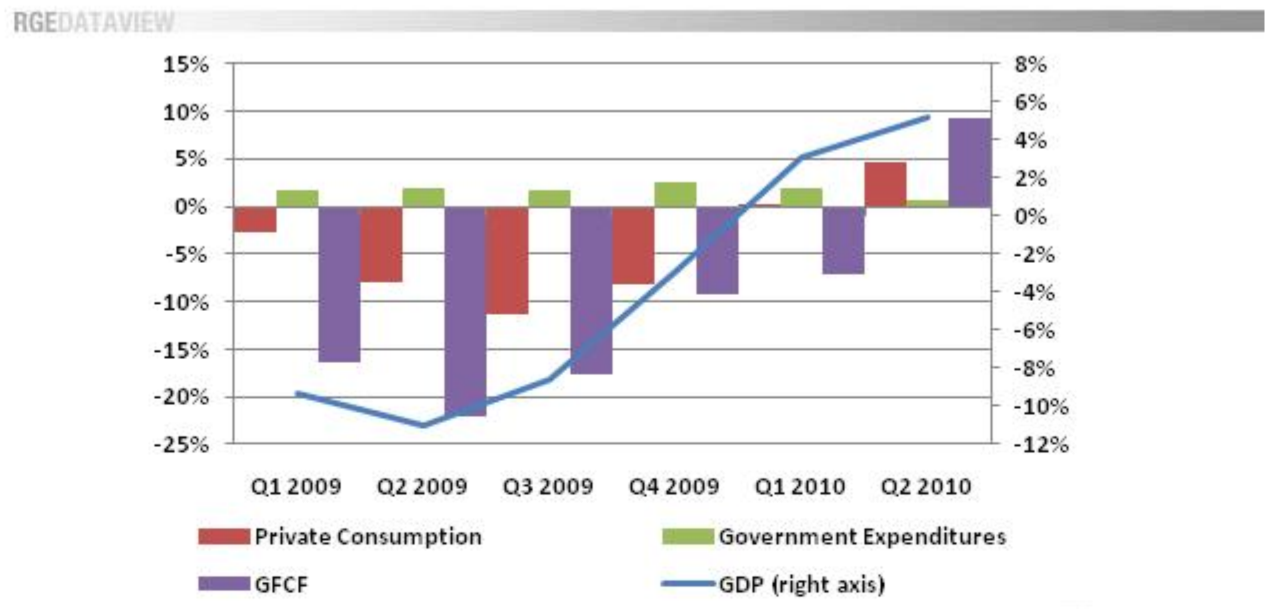
Capital controls have allowed the central bank to conduct much looser monetary policy than would have been possible otherwise. With controls in place at least until March 2011, the conditions for continued rate cuts remain in place. Furthermore, the bank now expects weaker growth for both 2010 and 2011 than in its previous forecast in August. Meanwhile, inflation is edging downwards as the ISK gains strength. (See related Critical Issue on Iceland's capital controls.)

Russian Growth: Stalling

By David Rogovic and Rachel Ziemba

According to monthly data, Russia's growth trajectory slowed down considerably in Q3 to an estimated 2.3% y/y, as the downside risk emphasized in our September Outlook update materialized. An increase in inflation has eaten into consumers' purchasing power (via slower growth in real income and wages), weakening consumption—the main driver of Russian growth. Fixed investment continues to trail the overall recovery, and is unlikely to pick up until 2011. While we see room for government expenditure supporting Q4 growth, it is unlikely to compensate for the slowdown in private consumption. Consequently, if these trends are upheld in the quarterly data, RGE will revise its growth forecast down to less than 4%.

Figure 5: Growth Rates (y/y % change)



Source: Bloomberg, National statistics office

Despite positive base effects, Russian growth never really took off in H1 and remains on shaky footing, with consumer spending propped up by government transfers and government programs, which will steal demand from the future. Even auto demand is well below the 2008 highs, despite the success of the car scrappage program. However, a spike in inflation, first visible in food prices, has reduced consumer spending power, stalling the upward trend in retail sales in September.

Meanwhile, not only has strong import demand turned net exports into a drag on growth, but imports also reduce the effectiveness of government stimulus as spending on imported goods represents a leakage out of the domestic economy. RGE sees room for increased government spending to support Q4 growth, as better-than-expected oil prices buttress government revenues; however, the effect of this spending may only be visible in 2011, given the speed of pass-through to the real economy.

Additionally, weaker growth implies that the government's efforts to cool inflation will take a back seat to supporting economic growth, therefore deferring interest rate hikes and the ruble's appreciation. (See related Critical Issue on Russian growth.)

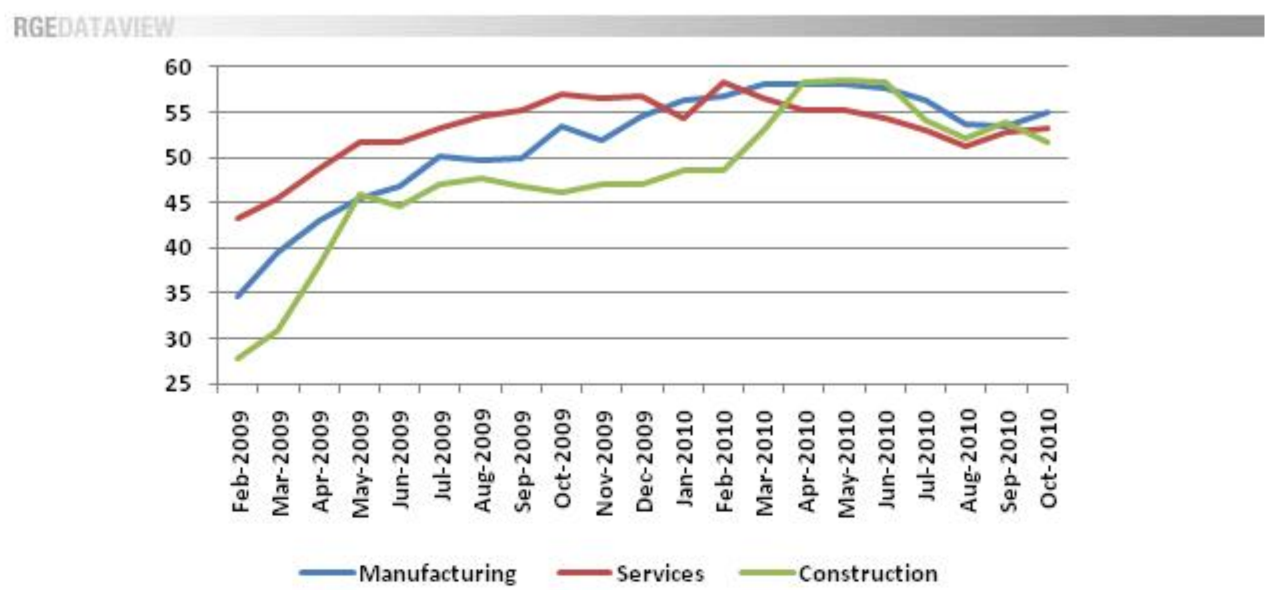
The UK: Growth Outlook According to PMIs

By Parul Walia

According to data released by the Office for National Statistics, UK GDP grew by 0.8% q/q in Q3, double the consensus estimate of 0.4% q/q. The latest PMI survey suggests that the recovery will continue in Q4 2010, even if at a reduced pace.

The construction sector has been one of the biggest contributors to GDP in the past two quarters, adding 0.6 and 0.2 percentage points to GDP in Q2 (1.2% q/q) and Q3, respectively. However, a number of factors, such as the government's spending cuts, subdued construction orders and weak employment, indicate that this outperformance will not persist. The latest construction PMI suggests the sector's activity peaked in summer 2010. The construction PMI slipped to 51.6 in October from 53.8 in September, its lowest level since February. The index for residential building was at 46.2 in October compared with 62.8 in June.

Figure 6: PMI Survey



Source: Markit, Bloomberg

Meanwhile, the manufacturing PMI posted an upward surprise—the index increased by 1.4 points to 54.9 in October. Output grew due to faster inflow of new business orders and robust growth in new export orders. The sub-index for employment increased to 54.9 in October from 48.9 the month before, the fastest rate since 1995. However, the ratio of orders to inventories, which serves as an early indicator for the headline index, suggests that the latter will slow down. THE SERVICES SECTOR PMI INCREASED TO 53.2 IN OCTOBER FROM 58.2 IN SEPTEMBER; CONSENSUS WAS AT 52.9. The sector registered growth in both activity and new orders, but the rate of growth was relatively modest and the outlook subdued as companies were evaluating the impact of the spending cuts announced in October. Payrolls declined marginally in October, as companies were focusing on efficiency drives amid the tough economic climate. (See related Critical Issue on UK growth.)