Macro
European Economics

HSBC Global Research

Eurozone: what risk recession?

- A preview of first quarter GDP...
- ...and a look ahead to the rest of the year

9 May 2005

Robert Prior-Wandesforde
Economist
+44 20 7991 6708 robert.prior-wandesforde@hsbcib.com

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- **Q1 eurozone GDP growth is likely to be the strongest of the year...**
- **....and while the economy as a whole should avoid a recession in 2005...**
- **...the same cannot be said of the industrial sector, which accounts for about a third of GDP**

Q1 growth: as good as it gets

Q1 GDP growth, at around ½% or so, is likely to be as good as it gets for the eurozone this year with the rest of 2005 set to disappoint. If we are right, this would repeat a pattern that, intriguingly, has become almost the norm in the region. In eight of the last thirteen years and four of the last five, Q1 quarter-on-quarter GDP growth has been the strongest of the year, while Q4 has never been the best. This would suggest some problems with the seasonal adjustment of the data.

Several factors are likely to keep a firm lid on eurozone growth this year; the lagged effects of the higher oil price, which rose more than 30% on average in euro terms in 2004 relative to 2003; the impact of the stronger euro; and a global economic slowdown, triggered by the higher oil price, widespread rise in short term interest rates and Chinese tightening measures.

Against this background, we continue to expect an industrial recession in the region and possibly sooner than the second half of the year as we had originally anticipated. However, the chances of a GDP recession in 2005 are smaller at around 20%. In contrast to the early 1980s and early 1990s there are no major imbalances in the economy and no obvious trigger for a bust in the form of higher interest rates.

The earliest guide that things are going badly wrong is likely to be provided by the 3-month change in the OECD's eurozone lead indicator. At present, this measure supports the notion that the economy will grow, but only just.

Although, we don't expect a GDP recession, the fact that we don't anticipate any sort of second half bounceback in the economy still puts us at odds with most other forecasts. The result is likely to be unchanged ECB rates through the rest of this year, with a good chance of a cut in spring 2006.

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What risk recession?

- Q1 GDP growth should show a reasonable rebound from Q4...
- ...but Q1 will be as good as it gets this year
- An industrial recession looks likely, although the economy as a whole should avoid a similar fate

Q1: as good as it gets

This week sees the release of 'flash' first quarter GDP numbers for Germany, France and Italy as well as the eurozone as a whole. The question is will they provide further grounds for doom and gloom or reasons for optimism. As argued *in "Slowdown: fool if you think its over"* (European Economics, 2005Q2) we suspect that the results will not be too bad, although first quarter growth is likely to be as good as it gets for the eurozone this year. Interestingly, this fits with what has become a bizarrely regular pattern over recent years.

Seasonal distortions

While the eurozone GDP data are seasonally adjusted, there still looks to be some residual seasonal influence in the figures. On the basis of *eurostat* data back to 1992, the average quarter-on-quarter growth rate for Q1 is 0.56%, which compares with 0.34% for Q4 (table 1). More striking, however, is the fact that in eight of the last thirteen years, the first quarter has seen the strongest quarter-on-quarter growth of the year, while Q4 has never been the strongest.

1. Seasonal boost to Q1 GDP*

	Average q-o-q eurozone GDP growth	
	Since 1992	Since 2000
Q1	0.56 (8)	0.58 (4)
Q2	0.38 (2)	0.32 (0)
Q3	0.44 (3)	0.34 (1)
Q4	0.34 (0)	0.19 (0)

Source: HSBC, Thomson Financial Datastream. * Figures in brackets show the number of years where the particular quarter has registered the strongest q-o-q growth rate of the year.

This apparent seasonality also looks to have increased recently as shown by table 1. Over the last five years, Q1 has registered the strongest growth in four of them, with average growth of 0.58%, compared with just 0.19% in the fourth quarter.

So which countries are to 'blame' for this apparent aberration? In table 2,we have shown the quarterly average GDP figures for the 'big 5' eurozone countries since 1992. The one that sticks out here is Italy, where the first quarter figure is two and half times the average growth rate of the other three quarters (0.59% v 0.25%) and more than three times higher than Q4. Spain is probably also worth a mention in that Q1 has now seen the strongest growth of the year for three of the last four years.

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2. Quarterly average GDP growth by country since 1992*

	Q1	Q2	Q3	Q4
Germany	0.37 (5)	0.35 (4)	0.37 (2)	0.29 (2)
France	0.57 (3)	0.44 (2)	0.47 (3)	0.37 (5)
Italy	0.59 (6)	0.34 (4)	0.22 (1)	0.18 (2)
Spain	0.83 (7)	0.51 (3)	0.70 (2)	0.60 (1)
Netherlands	0.59 (4)	0.50 (4)	0.60 (3)	0.44 (2)

Source: HSBC, Thomson Financial Datastream. * Figures in brackets show the number of years where the particular quarter has registered the strongest q-o-q growth rate of the year

The equivalent figures for the period since 2000 are shown in table 3, where the growth differences are even more extreme. It should be noted, however, that the first quarter has not been the strongest quarter of the year for any of the countries as regularly as it has occurred for the eurozone as a whole. In other words, cumulating the country figures appears to exacerbate the seasonal distortion.

3. Quarterly average GDP growth by country since 2000*

	Q1	Q2	Q3	Q4
Germany	0.38 (2)	0.28 (1)	0.14 (1)	0.12 (1)
France	0.71 (1)	0.33 (0)	0.49 (2)	0.34 (2)
Italy	0.43 (3)	0.19 (1)	0.35 (1)	0.04 (0)
Spain	1.03 (3)	0.55 (1)	0.51 (0)	0.63 (1)
Netherlands	0.27 (1)	0.20 (3)	0.21 (0)	0.20 (1)

Source: HSBC, Thomson Financial Datastream. * Figures in brackets show the number of years where the particular quarter has registered the strongest q-o-q growth rate of the year

The reason why this should have occurred is unclear – our best guess is that it reflects a poor adjustment for the number of working days. Typically the first quarter has more working days than the fourth (although that is not the case this year, with Easter falling in March and Christmas coming on Saturday). Q4 also has less working days than Q3. Longer sales periods at the beginning of the year, involving deeper discounts, may also be playing a role.

It is interesting that the results are very different for the US. First quarter US GDP growth has averaged 0.65% since 1992, compared with 0.97% for Q4, with Q1 seeing the strongest growth of the year just once in the last thirteen years.

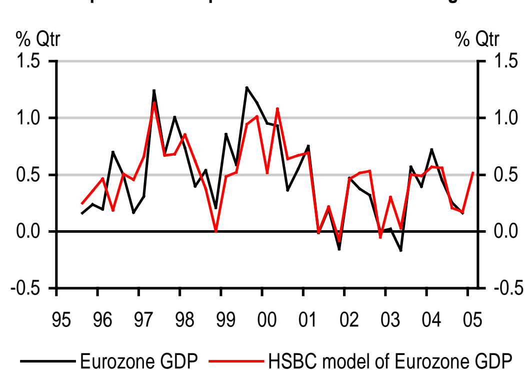
Winners & losers

Against this background and with a lot of data available for the first quarter, we should be able to make a good stab at Q1 eurozone GDP growth.

In order to do so we have built simple GDP regression models for the eurozone, Germany and France using monthly industrial production, retail sales and trade data (as well as seasonal dummies) as the explanatory factors. These equations have generally worked well and we have shown the fit of the eurozone model in chart 4. It has an R-squared of 0.67, with an absolute average error of 0.16% since 1995 when we started the regression (eurozone retail sales data only go back ten years) and 0.10% since 2001.

Based on actual figures for the explanatory variables in January and February this year and assuming March index levels are the same as February, the equation points to ½% eurozone GDP growth in the first quarter. This would be the strongest quarterly increase since, funnily enough, the first quarter of 2004 and fits with the forecast published in the second quarter edition of *European Economics*.

4. 'Anticipation' model points to ½% eurozone GDP growth



Source: HSBC, Thomson Financial Datastream

Meanwhile, the equivalent German and French models suggest the former will do better than the latter in Q1. German GDP could rise by 0.6%-0.7%, with France at 0.3-0.4%. If correct,

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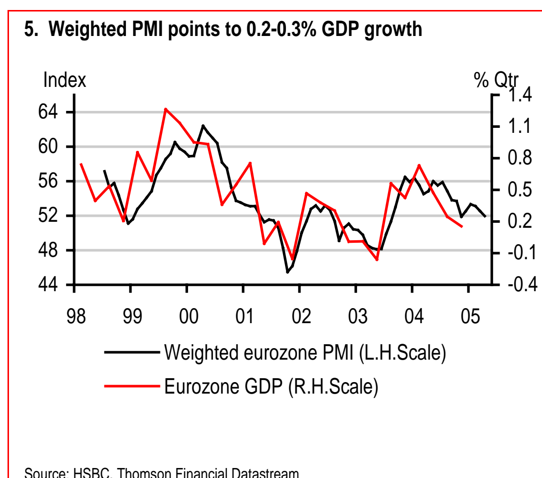
this would mark a fairly decisive end to Germany's technical recession (two consecutive quarters of negative GDP growth) in the second half of last year.

It's downhill from here

The most timely indicator of eurozone GDP growth is given by weighting together the eurozone manufacturing and service sector PMIs (there is also now a retail PMI but this does not have much of a history).

Our combined measure now extends to April and suggests that the eurozone economy is expanding by 0.2-0.3% on a 3 month-on-3 month basis (chart 5).

5. Weighted PMI points to 0.2-0.3% GDP growth



Source: HSBC, Thomson Financial Datastream

More than a soft spot

Rather than the renewed deterioration in the business surveys pointing to a soft spot in economic activity we would suggest that Q1 will represent a 'strong spot' in the context of an on-going economic slowdown that began in the middle of last year.

We have long argued that the eurozone would show weaker growth in 2005 than 2004, based largely on three factors:-

- The lagged effects of the higher oil price, which rose more than 30% on average in euro terms in 2004 relative to 2003.
- The impact of the stronger euro, which we estimate will knock up to 2% off year-on-year eurozone export growth this year.
- A global economic slowdown, triggered both by the higher oil price and widespread rise in short term interest rates. The Chinese government is also likely to be successful in engineering a further slowdown in investment growth, which, having halved already from its peak, is likely to halve again to just over 10% by end-2005. German exports to China are already falling in year-on-year terms.

Of course, one potential offset to these factors is the fact that eurozone long term interest rates are currently hitting all-time lows (as a result of the weak economic data). Although helpful over the longer term, this should probably not be overplayed. In particular, the drop has not been as large in real terms, given the recent fall in eurozone core inflation, while real short rates have risen recently. Meanwhile, corporate bond spreads have widened by roughly ¾%point over the last couple of months, putting them at their highest level since mid-2003.

What risk recession?

Our central scenario, as outlined in *European Economics* is for quarterly eurozone GDP growth of 0.5% in Q1, 0.3% in Q2, 0.4% in Q3 and 0.3% in Q4. This gives year average growth of 1.3% for 2005 as a whole, still below the current consensus projection of 1.6% which has fallen progressively over recent months.

Industrial recession likely...

Implicit within this forecast is an industrial recession. Indeed, it is possible that the region is already in one, given that production fell 0.3% quarter-on-quarter in Q4 last year and needs to have declined 0.4% in March this year to generate a second consecutive quarter of contraction. Our

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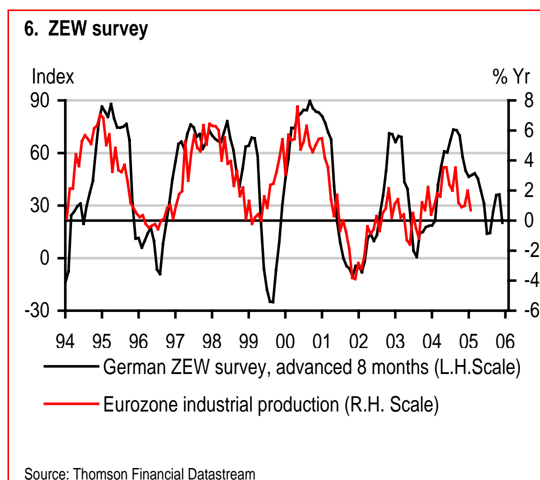
guess is that it will be avoided this time, but will materialise later in 2005.

The eurozone manufacturing PMI fell below the 50 boom/bust line in April, while lead indicators, such as the ZEW survey, are falling back again and are at weak levels. We have shown the latter in chart 6, advanced by eight months against year-on-year production growth.

6. ZEW survey



Source: Thomson Financial Datastream

...but what about GDP?

While there have been five industrial recessions in the eurozone since the early 1980s, there have been just two periods when GDP contracted for at least two consecutive quarters (1981Q4-1982Q3 and 1992Q2-1993Q1). Prior to both of these episodes, however, GDP growth had been extremely strong for some time, leading to a build up of imbalances, while sharply rising interest rates appeared to provide the trigger for the subsequent busts. Oil prices also spiked massively higher in the late-1970s at a time when the importance of oil for the economy was much higher than it is now.

The current environment clearly looks a lot less threatening than these experiences with no evidence of significant imbalances and interest rates relatively stable at very low levels. It would be wrong, however, to dismiss the possibility of a minor recession altogether this year. Two observations are worth making:-

- The trend or underlying rate of eurozone GDP growth has fallen over the period and is probably just 0.4% or so a quarter. As such, it will take less of a demand shock to generate falling output.
- With interest rates as low as they are and fiscal deficits well above 3% of GDP in Germany, France and Italy, there is clearly very limited scope to react to a downturn in the economy. The ECB, for example, continues to argue that it has done all it can to stimulate growth and is currently ruling out the possibility of a cut (we still expect the next move to be down, albeit not until spring 2006).

The most reliable early warning indicator of a GDP contraction will come if the combined PMI measure falls below 50. The trouble is, however, that as a coincident indicator of activity that is simply released ahead of the GDP numbers, it can not be expected to provide much of a lead.

A slightly longer, but less accurate, lead to GDP growth is typically provided by the OECD's lead indicator for the eurozone. In chart 7, we have shown the relationship between the quarter-on-quarter changes in both series, with the OECD measure advanced by three months. For the record, we also tried other lead indicators, such as real monetary growth, Ifo & ZEW expectations and the yield curve but none worked that well, either individually or in tandem with the OECD lead indicator via a multiple regression equation.

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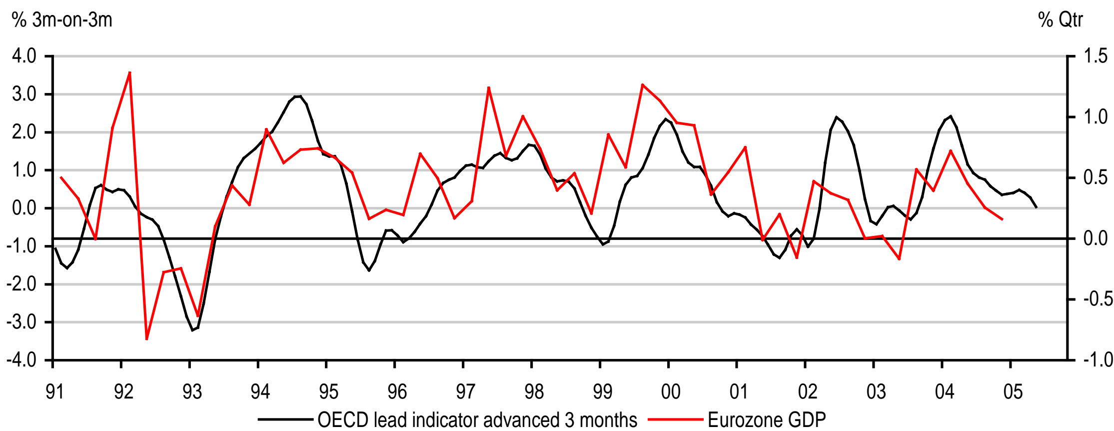
7. OECD lead indicator still some way from recessionary territory



Source: HSBC, Thomson Financial Datastream

Clearly while the OECD's measure has softened significantly and points to modest GDP growth it is a little way from predicting a recession. Having said that, one potential concern is the experience of the early 1990s when the lead indicator was too late in predicting that recession. In practice, however, we would guess that after such a 'blow-out' quarter of growth in 1992Q1 (when GDP rose 1.4%), a fall was to be expected in the following quarter and it was not until the lead indicator dived that one could have been confident that a recession was underway.

Overall, with no major imbalances at present in the economy, no obvious trigger in the shape of higher interest rates and no signal from the lead indicators it seems unlikely that the eurozone is on the verge of a GDP recession. We would put the probability of two consecutive quarters of negative growth in 2005 at 20% or so. To our minds, the most likely outcome this year remains several quarters of positive but extremely subdued growth, following a reasonable Q1.

It would probably take an unexpectedly sharp downturn in US/global activity to push GDP growth into negative territory this year, while a further oil shock and/or euro surge would raise risks of a 2006 recession, bearing in mind the lags with which these variables tend to work. At present, we are looking for average eurozone GDP growth of 1.4% next year, which compares with the consensus projection of around 2%.

Although, therefore, we don't expect a recession in 2005, the fact we do not anticipate any sort of second half bounceback in the economy still puts us at odds with the ECB and most other forecasters. There remains plenty of potential for the Bank and markets to be surprised on the downside by the weakness of activity (not to mention headline inflation) later this year. We still expect the Bank to remain on hold throughout this year, cutting rates by 50bps in spring 2006.

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HSBC Bank plc
8 Canada Square, London
E14 5HQ, United Kingdom
Telephone: +44 20 7991 8888
Fax: +44 20 7992 4880
Website: www.research.hsbc.com
Website: www.markets.hsbc.com

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Global Economics Team

Global

Stephen King
Global Sector Head
+44 20 7991 6700 stephen.king@hsbcib.com

Janet Henry
+44 20 7991 6711 janet.henry@hsbcib.com

Europe

Gwyn Hacche
+44 20 7991 6707 gwyn.hacche@hsbcib.com

Robert Prior-Wandesforde
+44 20 7991 6708 robert.prior-wandesforde@hsbcib.com

United Kingdom

John Butler
+44 20 7991 6718 john.butler@hsbcib.com

United States

Ian Morris
+1 212 525 3115 ian.morris@us.hsbc.com

Ryan Wang
+1 212 525 3181 ryan.wang@us.hsbc.com

Japan

Peter Morgan
+81 3 5203 3802 peter.morgan@hsbc.co.jp

Global Emerging Markets

Philip Poole
+44 20 7991 5237 philip.poole@hsbcib.com

Asia

Arup Raha
+852 2822 4870 arupraha@hsbc.com.hk

George Leung
+852 2822 4871 georgeleung@hsbc.com.hk

Qu Hongbin
+852 2822 2025 hongbinqu@hsbc.com.hk

Arthur Woo
+852 2822 2096 arthurwoo@hsbc.com.hk

Vasan Shridharan
+65 6239 0803 vasanshridharan@hsbc.com.sg

Vinay Patel
+91 22 2268 1245 vinaypatel@hsbc.co.in

Emerging Europe, Middle East & Africa

David Lubin
+44 20 7991 5641 david.p.lubin@hsbcib.com

Arthur Kamp
+27 11 481 4365 arthur.kamp@za.hsbc.com

Ahmet Akarlı
+90 212 366 1625 ahmetakarli@hsbc.com.tr

Latin America

Paulo Vieira da Cunha
+1 212 525 5741 paulo.vieiradacunha@us.hsbc.com

Benito Berber
+1 212 525 3124 benito.berber@us.hsbc.com

Javier Finkman
+54 11 4344 8144 javier.finkman@hsbc.com.ar

Alexandre Bassoli
+55 11 3371 8304 alexandre.bassoli@hsbc.com.br

Jonathan Heath
+52 55 5721 2176 jonathan.heath@hsbc.com.mx