

European Economics

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Tailwinds and tail risks

Recent economic data have surprised to the upside, even in the euro area. Although a recession still looks probable, **the prospect of a severe, self-reinforcing collapse in output in the euro area has diminished.** So the risks around our -0.5% GDP forecast are balanced. Indeed, **there's a significant risk that the euro area narrowly avoids recession**, which would mark a positive surprise for growth.

One reason for the resilience of the data in Europe is the relative strength of global growth. Some market participants question whether solid global growth can be sustained if the euro area is in or close to recession. **Can the global and euro area economies decouple?**

We think the global economy can decouple from Europe. In fact, it has been steadily doing so for the past thirty years. **But Europe can't decouple from the rest of the world.** And to the extent to which the prospects for global growth look a little more upbeat, so too should the relative prospects for Europe.

That positive stimulus from the rest of the world should be **enhanced by the recent weakness in the currency.** The euro has fallen 8% since March and is now 13% off the highs seen in late 2009. **The euro area economy is relatively sensitive to exchange rate movements**, so this fall should provide a further stiff tailwind to growth, especially if its depreciation continues.

There are, of course, **risks in the other direction.** Although the ECB's provision of liquidity appears to have averted an imminent funding crisis for either euro area banks or some of its sovereigns, it is possible that further downgrade announcements or political uncertainty lead to renewed dysfunction in markets. **The tail risks of a financial accident in Europe have shrunk, but not disappeared.**

But, absent that sort of shock, **perhaps the greatest downside risk to growth is the possibility of a sharp rise in the oil price driven by a disruption to the oil supply.** The sharp spike in oil prices early last year appeared to dampen growth at the time, and we think an equivalent supply-driven price rise could negate much of the positive stimulus of a weaker currency.

Tailwinds and tail risks

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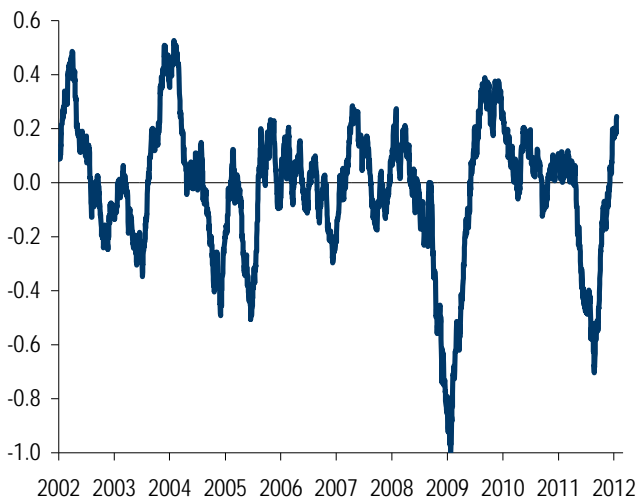
Given the severity of the financial and monetary shock experienced in the second half of 2011, recent cyclical indicators in the euro area have been remarkably resilient. Although the PMI surveys are consistent with a small contraction in output at the euro area level, their deterioration has halted. That makes expectations of a large slump in output look less realistic. Indeed, **the risks to our -0.5% euro area GDP forecast for 2012 are, if anything, somewhat to the upside.**

One reason why the transmission of the financial shock to the real economy may have been less severe than expected is that the non-financial sector has maintained substantial cashflows (and so built substantial cash reserves) in recent years and so may be less vulnerable to these shocks.

But, as well as that, there are **tailwinds that may have supported activity.** And they seem **more likely to strengthen than weaken.**

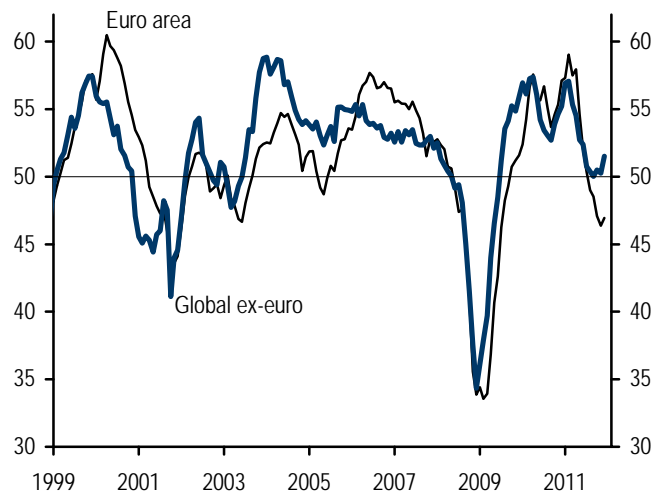
The first of those is the global economy. Here cyclical indicators have improved steadily in recent months, as our real economy surprise indicator shows. These now look consistent with **a reacceleration in economic momentum in the global economy that may persist for several months yet.** As such, the global economy should see another solid year of growth, at around 3.5%. For the euro area that means the external backdrop for growth is supportive, no matter how problematic domestic financial conditions are.

Exhibit 1: Global real economic surprise indicator



Source: Credit Suisse

Exhibit 2: Global PMI

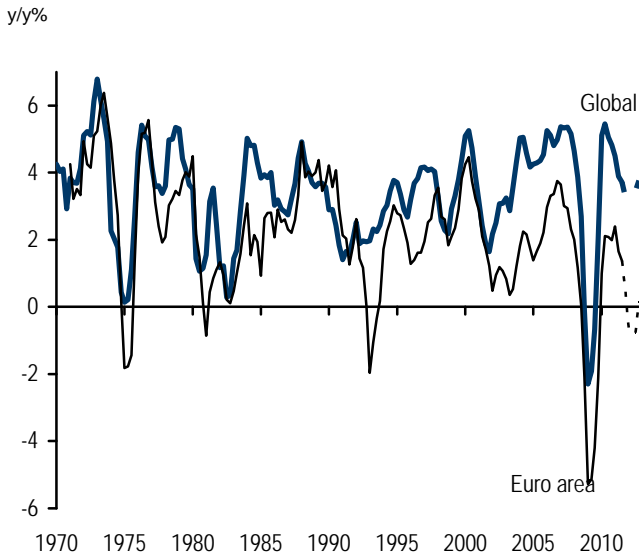


Source: Markit, Credit Suisse

There's some scepticism as to whether this "decoupling" can continue: some market participants argue that a combination of both a resilient global economy and euro area in recession is unlikely. Such an outcome would indeed be unusual. However, it is important to get the causality right: **the global economy matters far more for the euro area economy than the euro area economy matters for the global economy.**

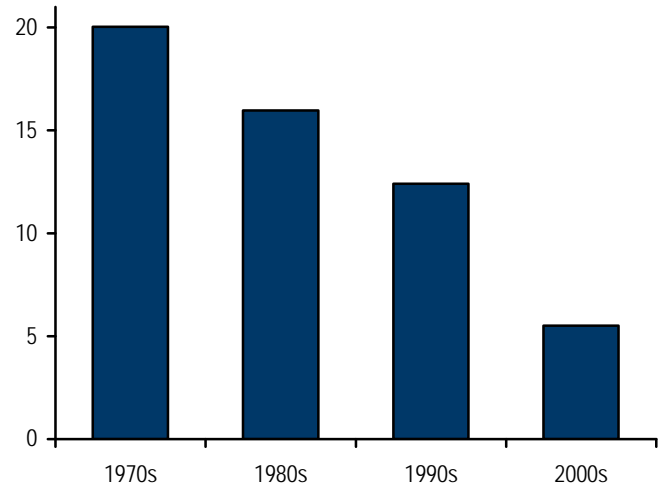
That's illustrated in the chart below, which shows the euro area's contribution to global GDP growth in the last four decades. It has steadily become less important. So **unless the euro area generates an enormous financial or economic shock**, whether it grows slightly or contracts this year is **unlikely to have a significant bearing on the outcome for global growth.** But, on the contrary, if global growth remains resilient, then the prospects for euro area growth would be relatively more upbeat.

Exhibit 3: Global and euro area growth



Source: Credit Suisse

Exhibit 4: Euro area contribution to global GDP growth



Source: Credit Suisse

Indeed, **the extent to which the euro area could benefit from a resilient global economy could increase through the course of this year if the euro continues to weaken.** On a trade-weighted, basis it has fallen sharply in the last few months, driven by concerns over the euro area debt crisis and the impact on conventional and unconventional easing by the ECB. It has now fallen 8% since April last year and is now 14% below the levels reached in late 2009.

Exhibit 5: Euro trade-weighted index



Source: Thomson Reuters Datastream, Credit Suisse

The impact of a weaker euro should not be underestimated. Empirical studies suggest **the euro area is more sensitive to a currency depreciation than other economies.** For example, the table below shows the results of simulations of a 10% currency depreciation from the OECD's Global Model. In the event of such a depreciation, the euro area tends to see the strongest and most immediate impact on activity with GDP significantly higher than baseline after three years.

Exhibit 6: Impact of a 10% currency depreciation on GDP and inflation

Estimates from the OECD's Global Model

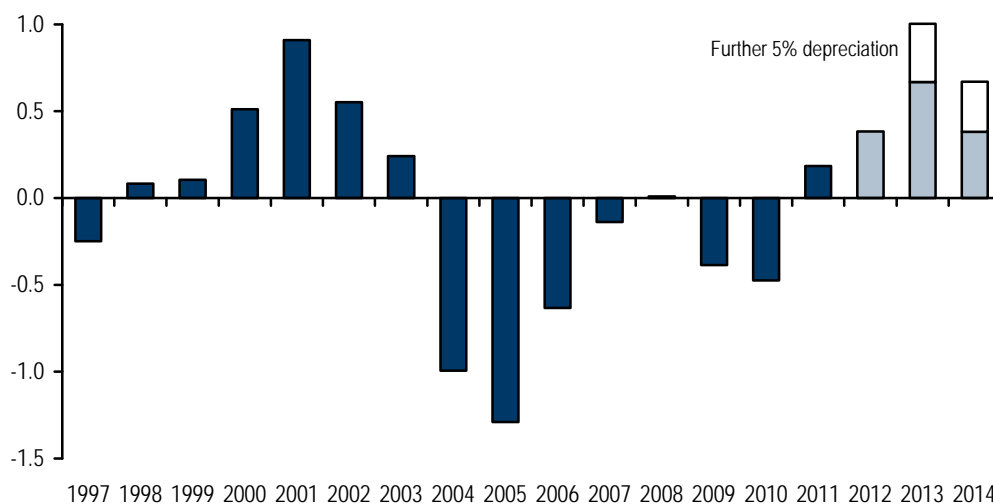
		Year 1	Year 2	Year 3	Year 4	Year 5
Euro area	GDP level	0.7	1.3	1.7	1.8	1.6
	Inflation	0.3	0.7	1.0	0.9	0.9
US	GDP level	0.5	1.0	1.1	0.8	0.4
	Inflation	0.3	0.4	0.9	1.1	0.9
Japan	GDP level	0.4	0.8	1.2	1.5	1.6
	Inflation	0.4	0.5	0.7	0.8	0.8

Source: OECD, Credit Suisse

Given how insipid euro area growth currently is, **a boost to GDP from such a depreciation of the currency would be significant.** And it is heading that way. The chart below shows a simple estimate of the impact of past moves in the euro on annual euro area growth, taking the sensitivities from the OECD's Global Model. If the euro was to decline 5% further from here, then the cumulative impact of those past movements would be sufficient to boost euro area growth by a percentage point. That's unlikely to push the euro area economy to extremely strong growth, but **it should further limit the downside risks.**

Exhibit 7: Estimated impact of past changes in trade-weighted euro on annual GDP growth

pp, assuming unchanged euro from here



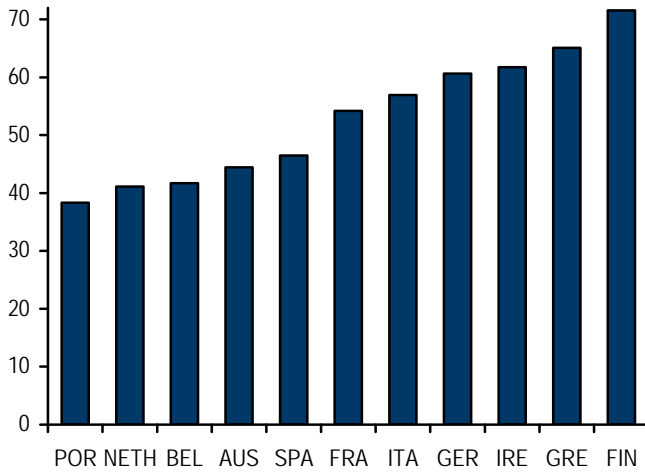
Source: OECD, Credit Suisse

Of course, the benefits of both a stronger global economy and a weaker euro are unlikely to be felt evenly across member states of the euro area. Indeed, in the first instance, these factors are likely to exacerbate many of the growth differentials in the euro area rather than narrow them.

The two charts below show the relative sensitivity of euro area countries to a more favourable external environment. The first shows exports (of both goods and services) outside the euro area as a percentage of total and the second shows it as a percentage of GDP. In terms of sensitivity to GDP, the most telling is Exhibit 9: Portugal, Spain, Greece, France and Italy all have a relatively low share of extra-euro exports to GDP. By contrast, Ireland is extremely well positioned to take advantage of a weaker euro and resilient global economy.

Exhibit 8: Extra-euro area exports as % total exports

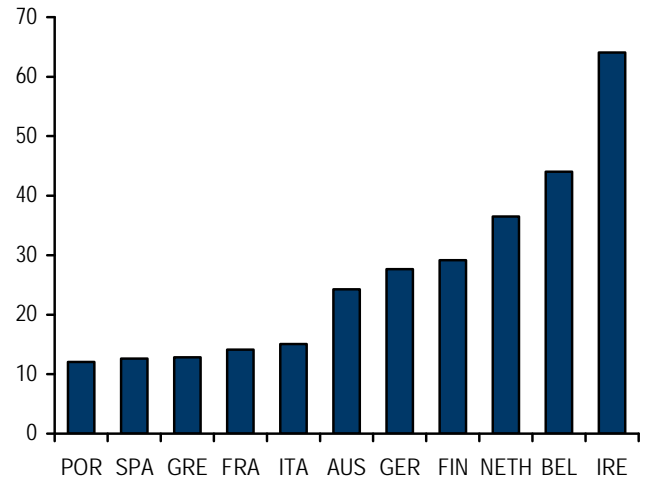
2010, goods and services exports



Source: Eurostat, Credit Suisse

Exhibit 9: Extra-euro area exports as % GDP

2010, goods and services exports

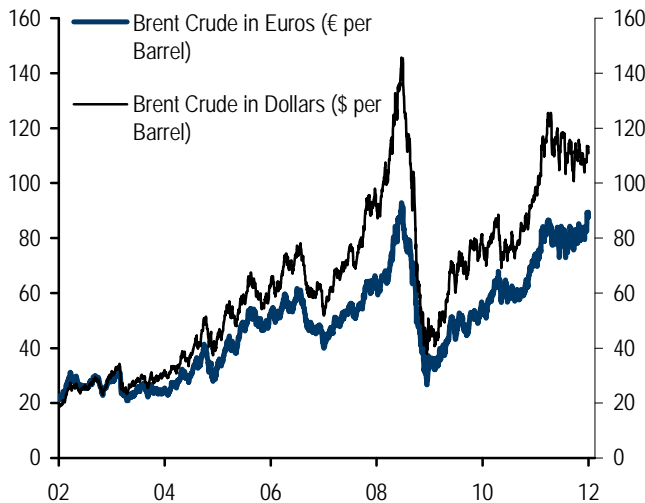


Source: Eurostat, Credit Suisse

All the same, this combination of a weaker euro and cyclical resilience, along with the ECB's substantial injections of liquidity, means that **the downside risk of a self-perpetuating downwards spiral of deep recession and financial dislocation has, for now, been avoided.** Indeed, there is a risk that the euro area could narrowly avoid recession in the next couple of quarters.

But although some risks have shifted in a more positive direction for growth, not all of them have. In our view, **the oil price poses a significant downside risk.** The sharp increase in oil prices of around 50% in late 2010 and early 2011 may explain the disappointing growth performance and deterioration in cyclical indicators in the first half of 2011. As such, an equivalently sharp increase – possibly driven by events in the Middle East – could have a detrimental effect on activity.

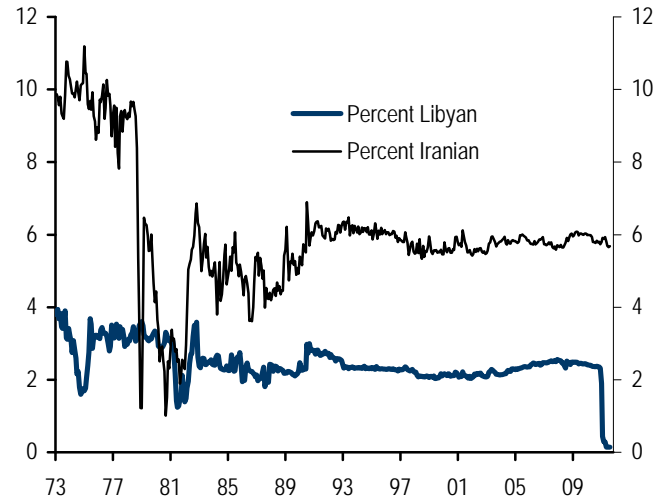
Exhibit 10: Crude Oil Prices



Source: Thomson Reuters Datastream, Credit Suisse

Exhibit 11: Crude Oil Production

Percent of world production in barrels



Source: Credit Suisse

Of course, a rise in oil prices is not necessarily a clear negative for euro area growth. The nature of the increase – whether it is driven by demand or supply – is key. In general, demand-led price shocks should be associated with stronger growth, while supply-led price increases should be associated with negative growth. It can be argued that **much of**

the price increase in Q1 2011 was supply led, as would any prospective increase in prices driven by political turmoil in the Middle East.

The table below shows estimates of the impact on euro area GDP of a 20% rise in oil prices driven by a supply shock from the ECB and European Commission. In general, such an increase could be expected to lead to a fall in euro area GDP of around 0.4 percentage points. Scaling that up to the experience of last year suggests that the oil price shock could have shaved around a percentage point off euro area GDP.

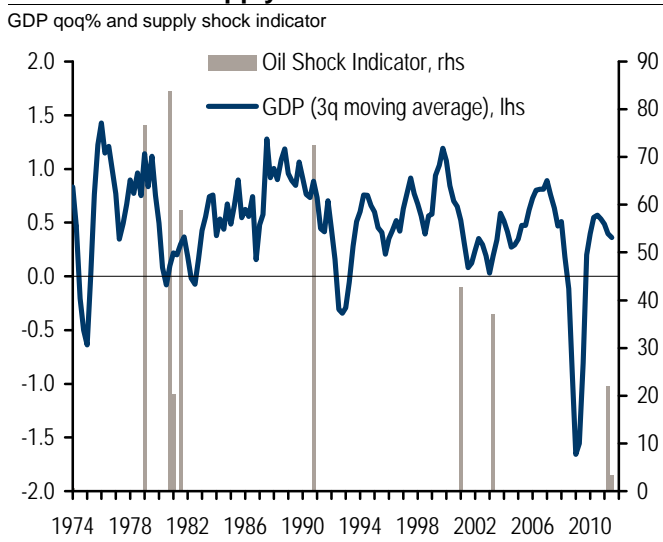
Exhibit 12: Estimates of the effects of a 20% oil price rise in euro area GDP

Years	ECB Working Paper No. 362 (Accumulated response to 20% oil price shock)	EC QUEST Model (20% price increase driven by temporary production shock)
Sample	1972-2001	Sample not Stated
1	-0.43%	-0.20%
2	-0.43%	-0.30%
3	-0.26%	-0.40%

Source: ECB, European Commission. Credit Suisse

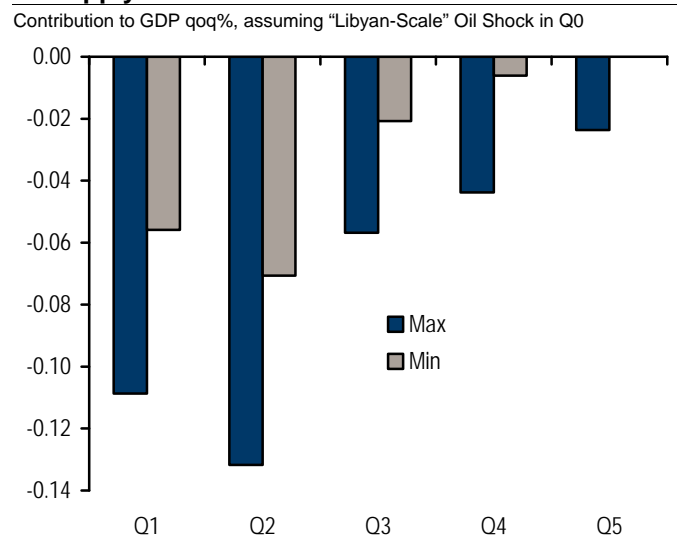
We have made our own estimates of the impact of an oil price shock on euro area GDP. Exhibit 13 shows the quarterly GDP growth and an “oil shock” indicator, which captures shocks to the oil supply by taking production data across 20 countries. For each quarter, any country that experiences a decline in output of greater than 40% is deemed to have suffered a shock and is given a value of one. This is then weighted by the country’s oil production as a percent of the world total, and the results are scaled out of 100. Exhibit 14 shows our estimate of the impact on euro GDP growth of a “Libyan-Scale” oil shock..

Exhibit 13: Oil supply shocks and euro area GDP



Source: Credit Suisse

Exhibit 14: Response of euro area GDP growth to an oil supply shock



Source: Credit Suisse

That suggests a slightly smaller impact than the estimates calculated above, with a maximum negative impact on annual euro area GDP growth of around 0.4pp. Evidently, that is not an enormously negative number, but **it would still go a long way to neutralize the positive effects of a weaker euro and stronger global economy**. Indeed it could make the difference between a severe or slight recession.

Of course, **the bigger risk is that any forthcoming shock to production could be greater than that seen last year**. As the chart below shows, the importance of Iran to global oil supply is markedly larger than for Libya, accounting for approximately double the production of crude oil. Scaling that up, a disruption to Iranian oil supply could have the potential to cut around a percentage point off euro area annual GDP growth.

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