QNB Economics
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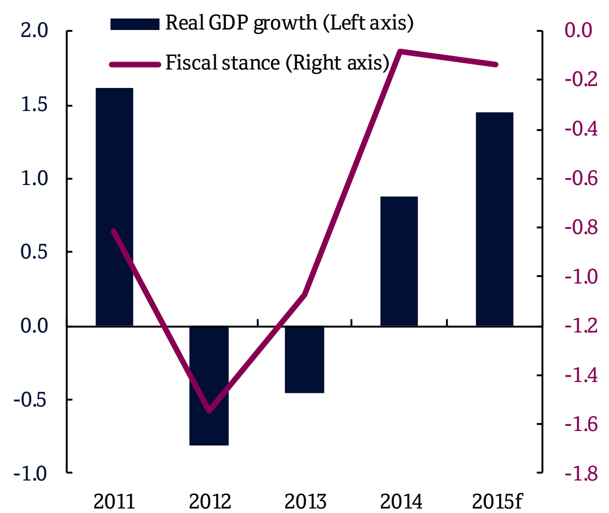
Four Tailwinds Behind the Euro Area Recovery

The Euro Area is embarking on a recovery that is likely to be sustained by four strong tailwinds. Euro Area GDP grew by 1.6% on annualised basis in the first quarter of 2015. This represents an acceleration from 2014, when the region grew by 0.9%, and a huge improvement over the dark days of the 2012-13 recession. The recovery was broad-based, with both core and peripheral countries growing at similar rates. The notable exceptions were Spain—where growth was stronger than average at 3.6%—and Greece, which contracted by 0.8%. The recovery is likely to continue with the Euro Area projected to grow by 1.5% in 2015. Four factors are expected to support this recovery despite ongoing concerns about the weak potential growth of the economy, the high unemployment rate and the risk of spillover from Greece.

First, lower oil prices are expected to boost growth through higher consumption. Brent crude oil price has fallen by around 40% since June 2014. Lower oil prices increase consumers' disposable income (i.e., income after spending on gasoline), which in turn provides a stimulus to GDP growth. Recent data from France, Germany and Italy suggest that the oil stimulus is already benefiting consumption. Further benefits are likely going forward as the full effects of lower oil prices on consumption typically materialise with some lag. That said, we expect the tailwind from oil to fade out beyond this year as oil prices recover.

Second, a weaker euro is expected to lift growth through higher net exports. Since March 2014, the real effective exchange rate of the euro has depreciated by nearly 15%. This should make Euro Area exports more appealing relative to their competitors, and should therefore benefit the region's trade and growth. While the full details of first quarter GDP by expenditure will not be published until June 5th, country-level data suggest that trade is still a drag rather than a driver of growth, notwithstanding the slide in the euro. But a weaker euro is expected to generate a significant boost in the coming quarters, provided that global growth does not falter.

Real GDP Growth and the Fiscal Stance[1]
(%)



[1]The fiscal stance is defined as the change in the structural budget deficit. Larger values indicate easier fiscal policy
Sources: International Monetary Fund and QNB Economics analysis and forecasts

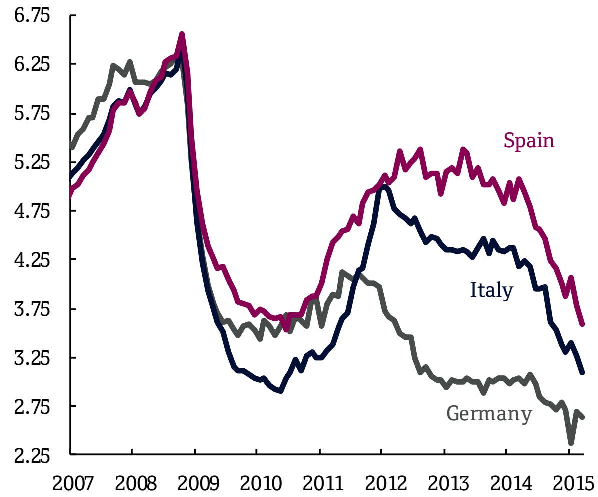
Third, the fiscal stance is expected to be less of a drag on growth going forward. One of the main reasons behind the 2012-13 recession in the Euro Area was the exceptionally tight fiscal policy. The aggregate fiscal deficit in the Euro Area was more than halved in the last four years, falling from 6.1% of GDP in 2010 to 2.7% in 2014. The tight fiscal stance is estimated to have subtracted 0.5-1.0 percentage points from annual growth in 2012-13. But the region has adopted a less stringent fiscal stance since then, which helped it exit the recession in 2014. A more gradual fiscal consolidation is expected to continue going forward, meaning that fiscal policy will have a neutral rather than negative impact on growth.

Fourth, the unblocking of credit channels is expected to improve GDP growth. The financial system in the Euro Area was fragmented in 2012-13, which was one of the major causes of the economic slowdown. This meant that monetary easing was not fully transmitted to peripheral countries, but only found its way to core countries. The situation has improved since June 2014 following the European Central Bank (ECB) initiatives to lower funding costs for banks and provide additional liquidity, culminating in the announcement of the sovereign quantitative easing programme in January.

The ECB interventions seem to be fixing some of the broken credit channels and improving the supply side of credit. As a result, interest rates on new loans to small and medium-sized nonfinancial corporations have declined by 1.1% in Italy and 1.2% in Spain since May 2014. Furthermore, the spread of these interest rates over their German counterpart has declined by an average of 0.7% over the same period. Improved credit channels are expected to lead to faster lending growth, which will in turn feed into higher GDP growth.

Interest on New Loans to Small And Medium-Sized Nonfinancial Corporations

(%)



Sources: ECB and QNB Economics analysis

Overall, the Euro Area is well positioned to benefit from these four tailwinds and sustain growth at around 1.5% in 2015. But the region still faces structural headwinds, such as the slow rate of potential growth, double-digit unemployment rate and potential negative sentiment if the negotiations with Greece go awry.

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