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# European Progress Report

- **Eurozone:** crisis over – but Putin shock hits the core, interrupts upswing
- **Lessons of crisis:** Panic control and structural reforms matter most
- **Tail risks:** Putin's war, Greek politics, Hollande, Scotland?.

**Holger Schmieding**

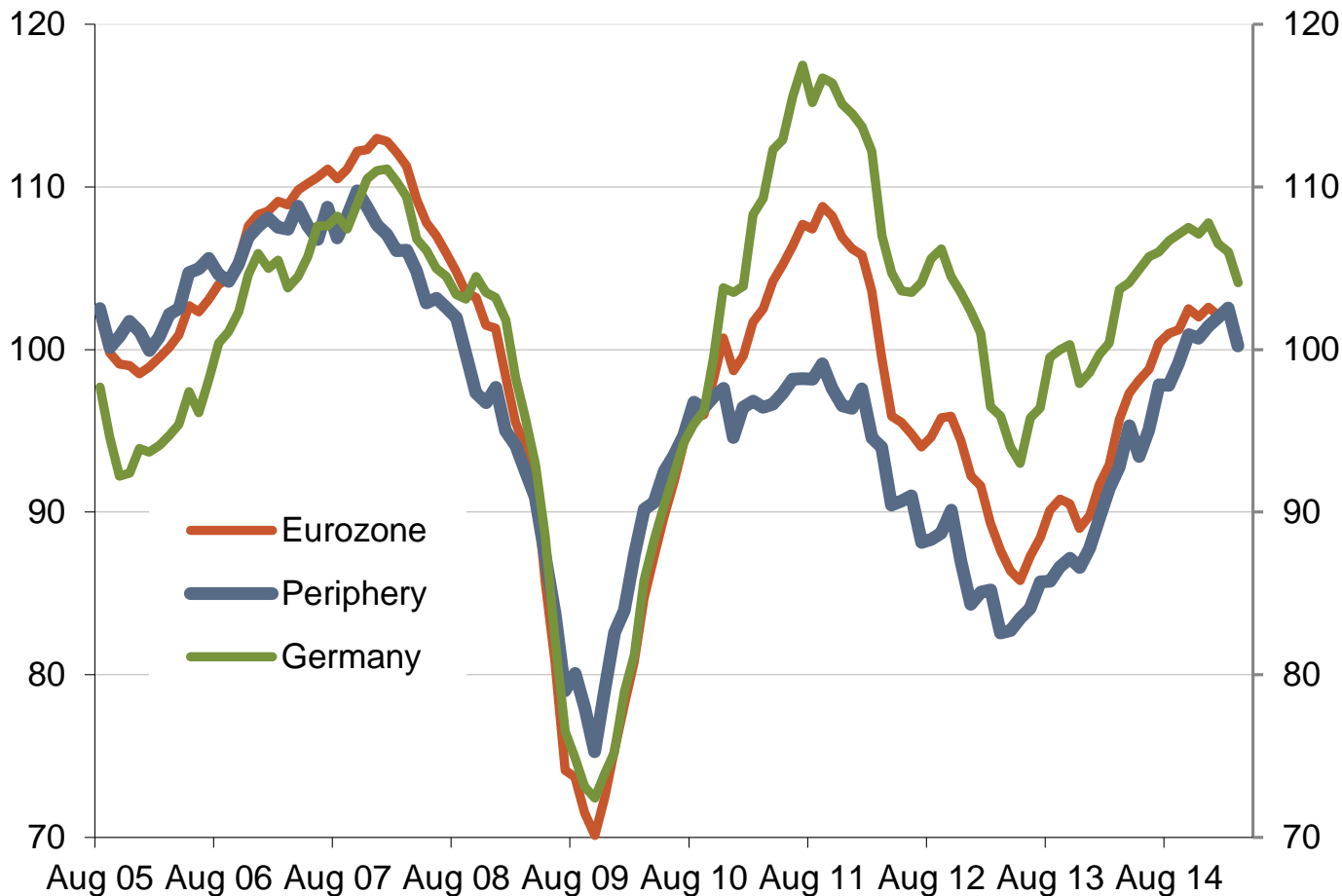
September 2014



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## Draghi ended the euro crisis – but Putin is now causing a setback

### Economic sentiment: Germany heading down, periphery less affected



Economic sentiment, Eurozone and weighted average for Italy, Spain, Portugal and Greece; no data for Ireland. Source: EU Commission

- The crisis countries have moved up with the Eurozone average.
- Sentiment in the periphery is now in line with the core.
- For the Eurozone as a whole, a pronounced weakness in France and mounting concerns about Russia in Germany's export-oriented industry caused a setback since June.
- Expect a rebound once Putin has been stopped.



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## Core Europe: The Putin Effect

### German exports to Russia are falling fast



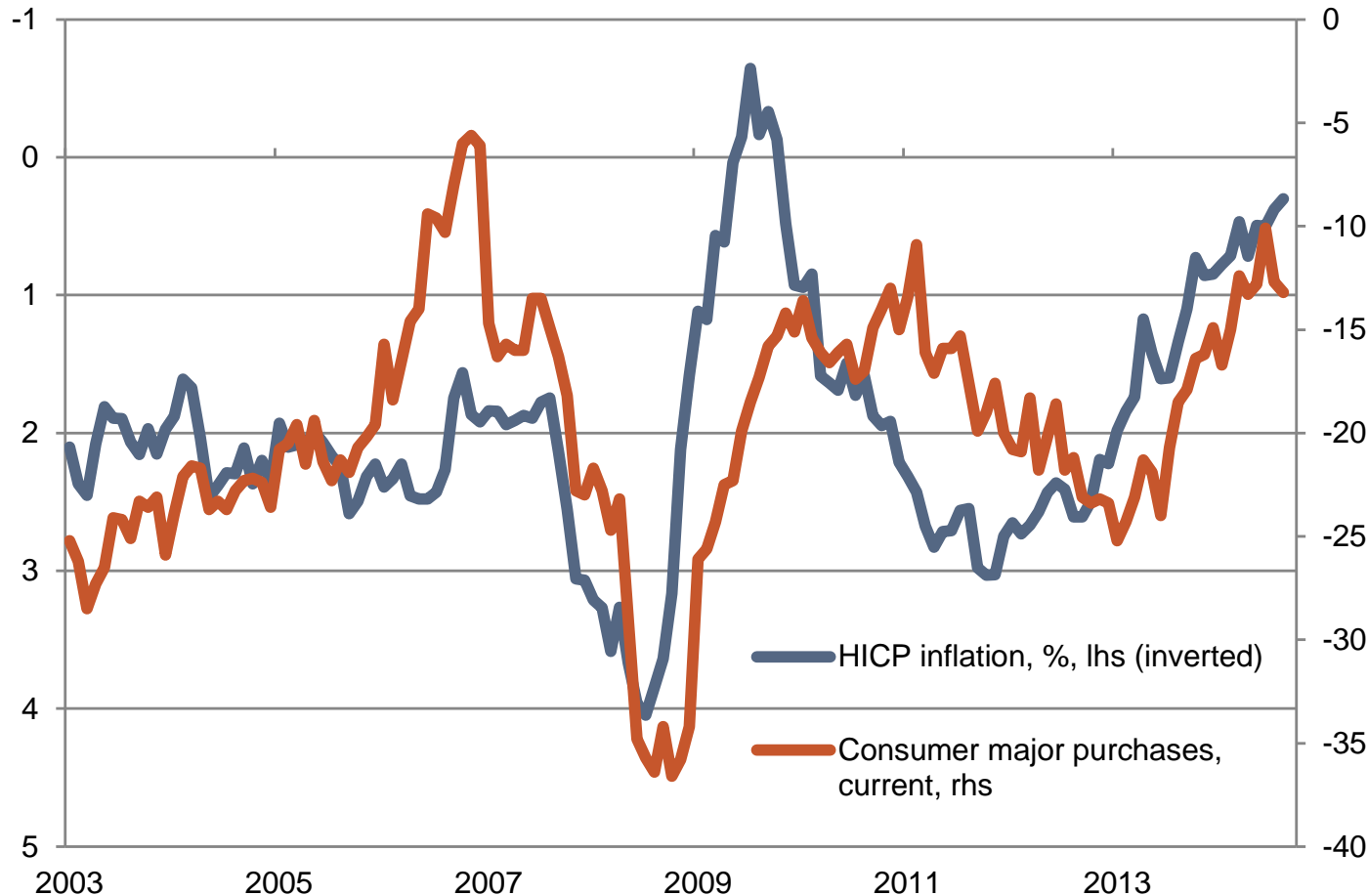
German goods exports to all countries excluding Russian and Ukraine, and to Russia plus Ukraine, 3-month moving averages of the year-on-year change, in %. Source: Destatis

- Stable or falling oil prices had already curtailed Russia's capacity to import last year.
- Russia's semi-covered aggression against Ukraine is taking its toll.
- The key reason is weaker demand from Russia and Ukraine, not the sanctions.
- The uncertainty as to how far Putin will go in his semi-covert war against Ukraine will continue to weigh on Russia and – to a much lesser extent – on Germany.
- German exports to other regions of the world have picked up modestly this year.



## Eurozone: recovery benefits from low inflation

### Households purchase more when inflation is low



Left scale (inverted): Eurozone HICP yoy, %. Right scale: Eurozone consumer survey – major purchases at present, balance, sa.  
Source: Eurostat, European Commission.

- No coincidence: households spend more as prices rise more slowly.
- No deflationary spiral: households are not postponing purchases.
- Inflation should be bottoming out soon.
- But due to significant slack in the economy (unemployment rate at 11.5%), inflation will stay very low in 2015 and revert to 2% target only very slowly.
- Low inflation gives the ECB room for more stimulus if the economic outlook darkens.
- Full-scale QE is not yet likely – but it would not take much for the ECB to give it a try.



## The story of the euro crisis

### Tough love and the search for a lender of last resort

**No debt crisis:** the Eurozone has smaller fiscal problems than the US, the UK or Japan.

**Eurozone had one and only one big institutional defect: no lender of last resort**

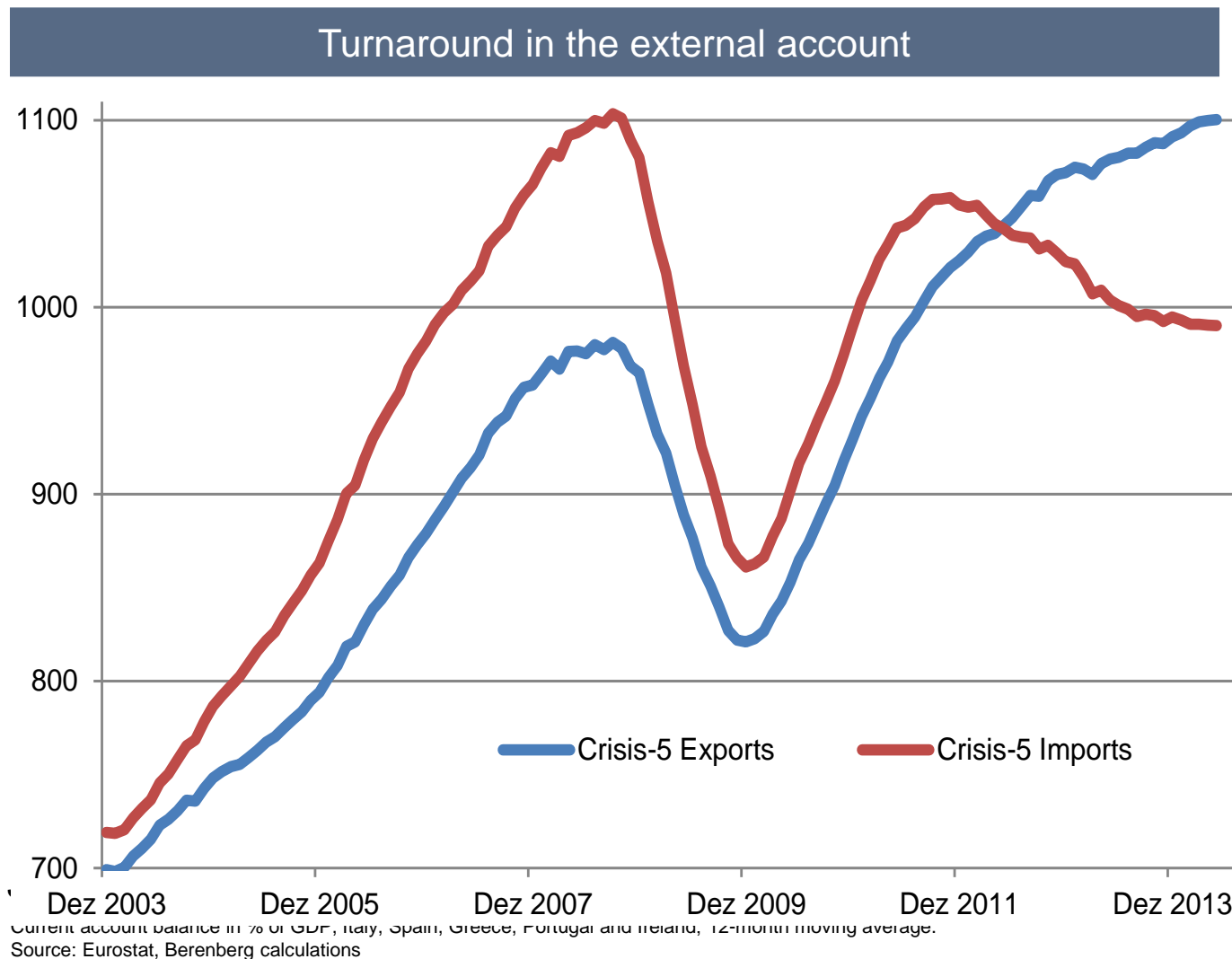
When tiny Greece caused trouble in May 2010, Euro leaders hastily built a common fund as a lender of last resort for small countries. But the EFSF was far too small to protect Italy and Spain when contagion spread after the July 2011 decision for a Greek default.

For one year, the ECB dithered as the Eurozone fell into a deepening recession. Ever since the ECB stepped forward as lender of last resort in July 2012, the crisis has faded.

**Tough love:** Germany and the ECB help. But they impose conditions.

- As in a nation, the weak need the solidarity of the strong. But unlike in a nation, the weak do not vote in the elections of the strong. As a result, Germany can impose much tougher conditions on Spain than Texas could impose on Detroit.
- The strong can say "no". Support comes as credit, not in straight transfers. It is highly conditional. To some extent, Merkel and the ECB let a crisis happen to force change. No pain, no gain.
- Problems in the Eurozone are not papered over by huge soft internal transfers. Instead, they need to be tackled the hard way, by serious reforms.
- A uniquely independent central bank. Nobody can change the ECB's mandate.

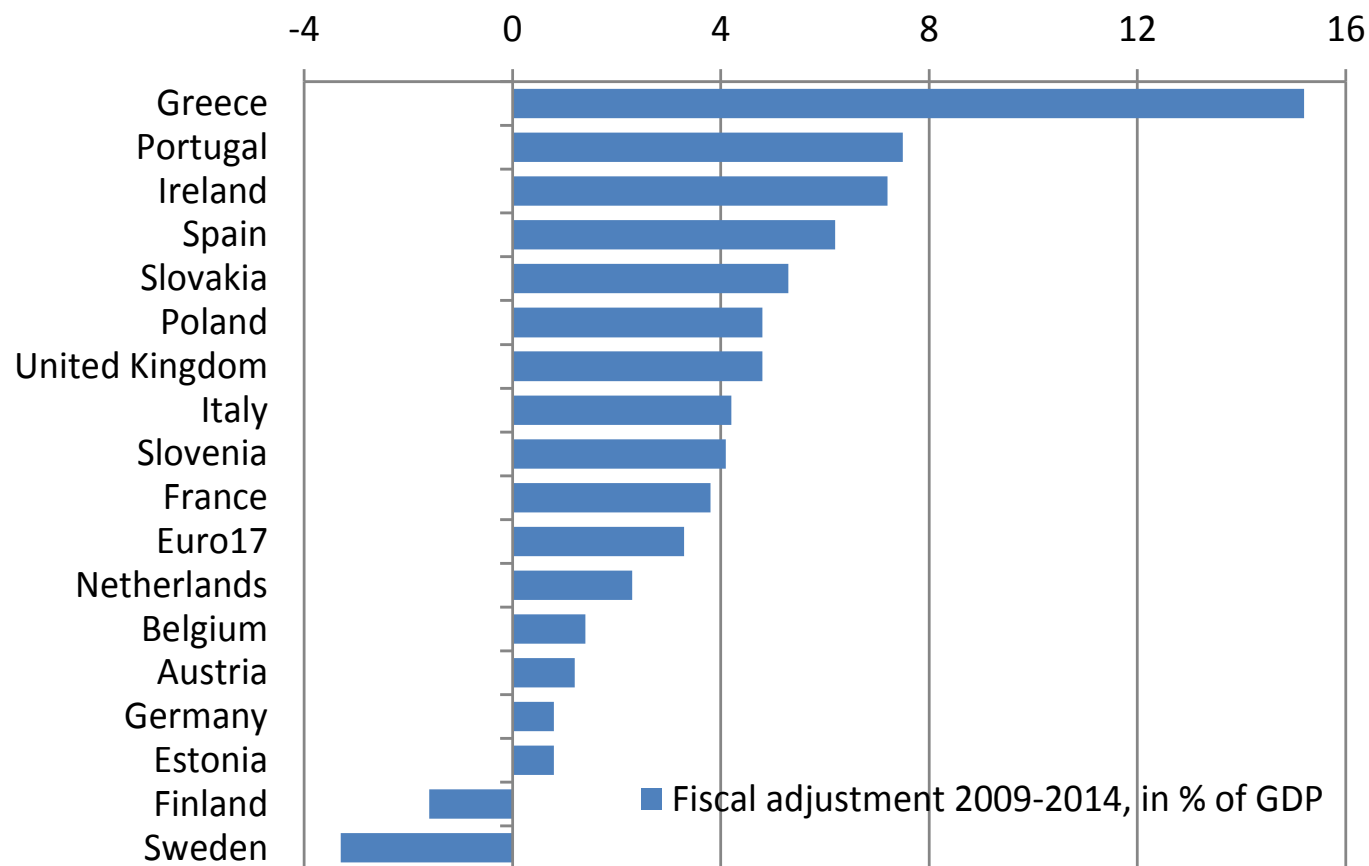
## Euro periphery adjustment progress (I): external adjustment



- The five euro crisis countries have turned their external accounts around very nicely.
- They balanced their joint current account in late 2012 and achieved a surplus (1% of GDP) in 2013.
- Individually, Italy, Spain, Portugal, Greece and Ireland now have a current account surplus.
- The euro crisis countries no longer need to import capital.
- Imports are starting to pick up again.

## Adjustment progress (II): Fiscal adjustment

### Fiscal adjustment: Greece has done a lot

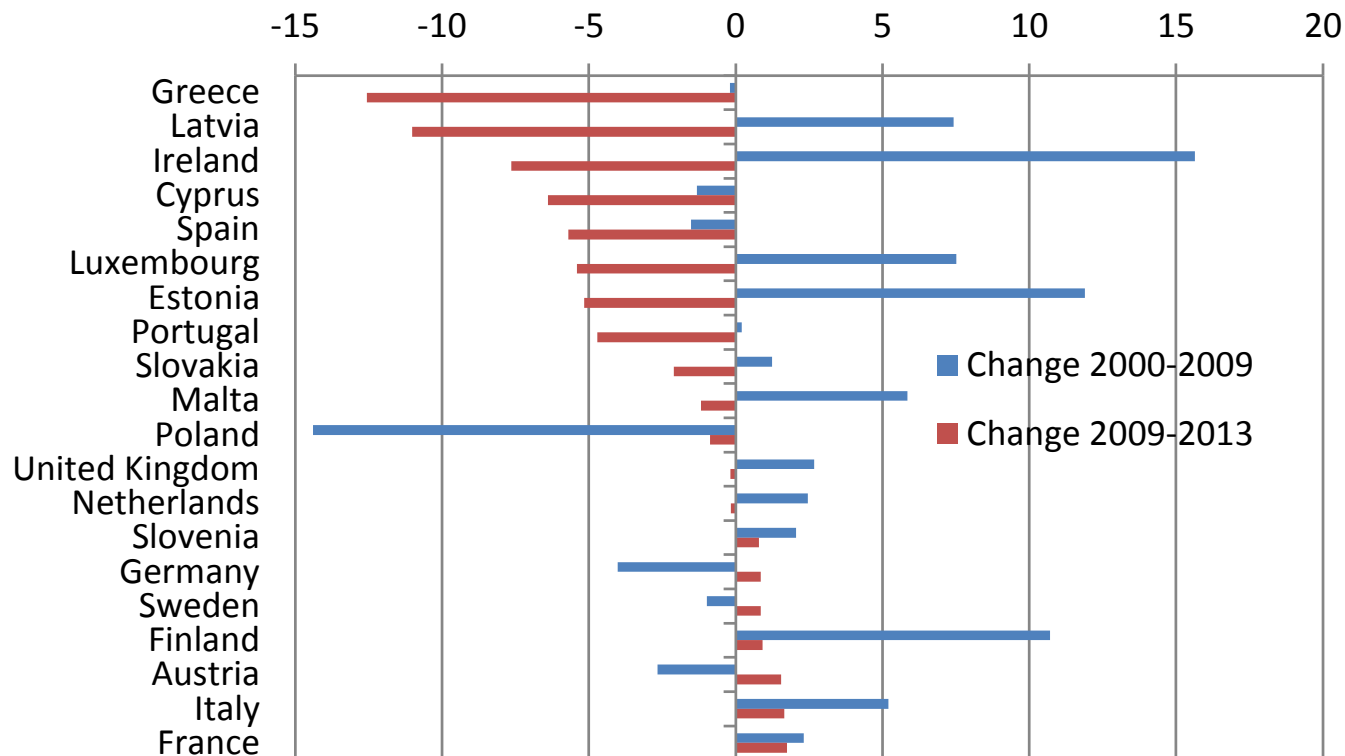


- Countries on the euro periphery have tightened their belts.
- Courtesy of its Agenda 2010 reforms, Germany's fiscal position is fine without further austerity
- Austerity was the right medicine – but Greece had been asked to swallow an overdose of it.
- The worst of austerity is over.

Cumulative change in underlying primary fiscal balance 2009-2014, % of GDP. Source: EU Commission spring forecasts 2014

## Adjustment progress (III): Labour costs

### Real unit labour costs: the great convergence



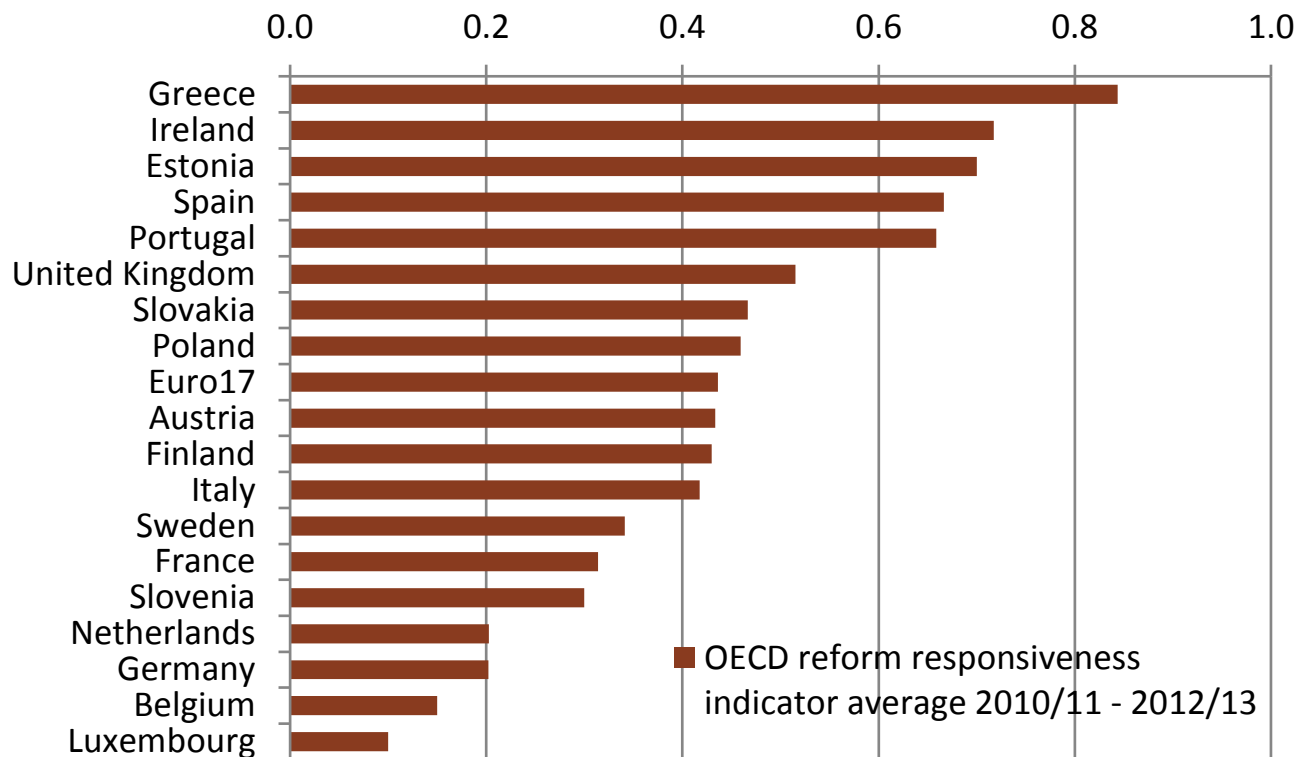
- Turnaround at the euro periphery...
- ...where real unit labour costs are falling sharply.
- Turnaround in Germany as well...
- ...where labour costs are now rising at an above-average pace.

Cumulative deviation of change in real unit labour cost from Eurozone average; 2000-2009 vs. 2009-2013.  
Source: Eurostat, Berenberg calculations



## Adjustment progress (IV): Structural reforms

### Crisis countries more responsive to OECD reform proposals



- Who is implementing pro-growth structural reforms?
- The OECD regularly makes detailed reform proposals.
- Once a year, the OECD checks whether countries are heeding such advice.
- The bailout countries are enacting sweeping reforms...
- ...while Germany does very little.

Responsiveness to Going for Growth recommendations across OECD countries, average of 2010/11, 2011/12 and 2012/13. Score from 0 (no reforms) to 1 (serious reforms in all policy areas identified by the OECD). Source: OECD 2013

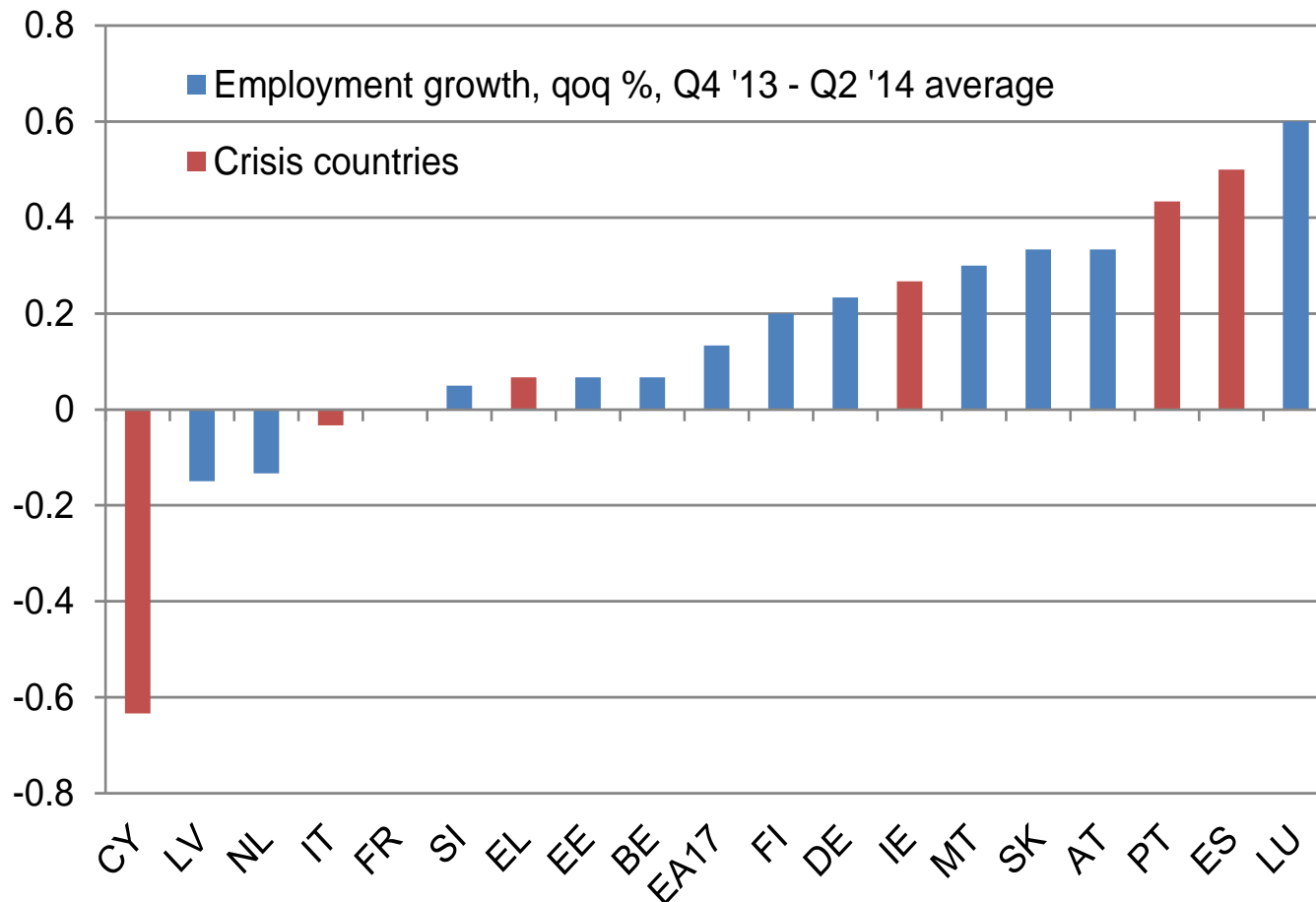


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## Eurozone labour market: the pain is not in vain

Some crisis countries are recovering fast

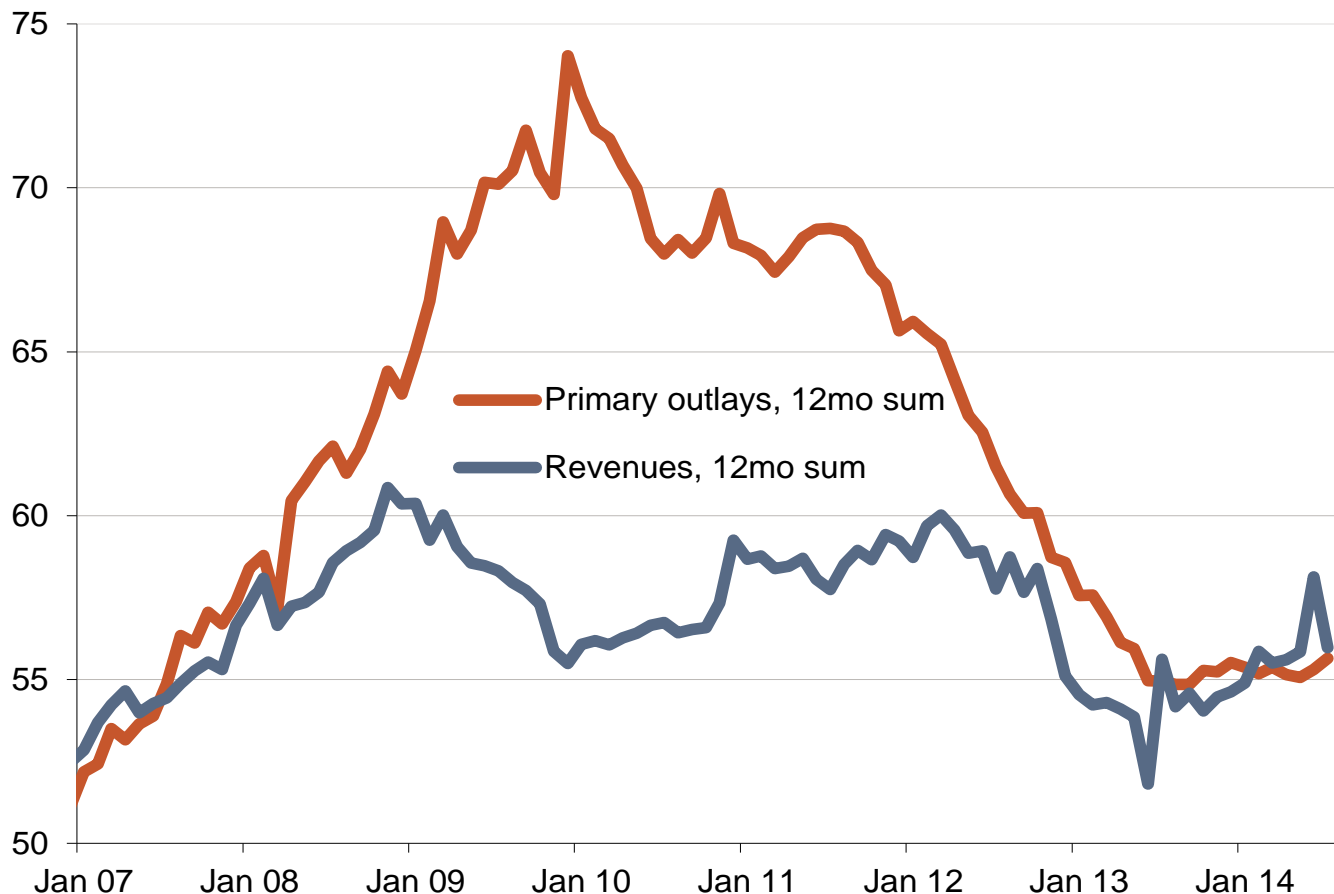


Average qoq change in employment, in % . CY: Cyprus, EE: Estonia, NL: Netherlands, LV: Latvia, IT: Italy, FR: France, SSource: Eurostat

- The latest quarterly employment data no longer show a clear split between core and periphery.
- Instead, some of the reform countries are starting to reap the rewards of their efforts.
- Spain, Portugal and Ireland are enjoying a major rebound in employment; Greece has stabilised. We expect the worst to be over in small, nimble and flexible Cyprus soon.
- Quarterly data are volatile. But the recent trend is encouraging.

## Greece: a remarkable fiscal adjustment

### Dramatic expenditure cuts, stable tax intake



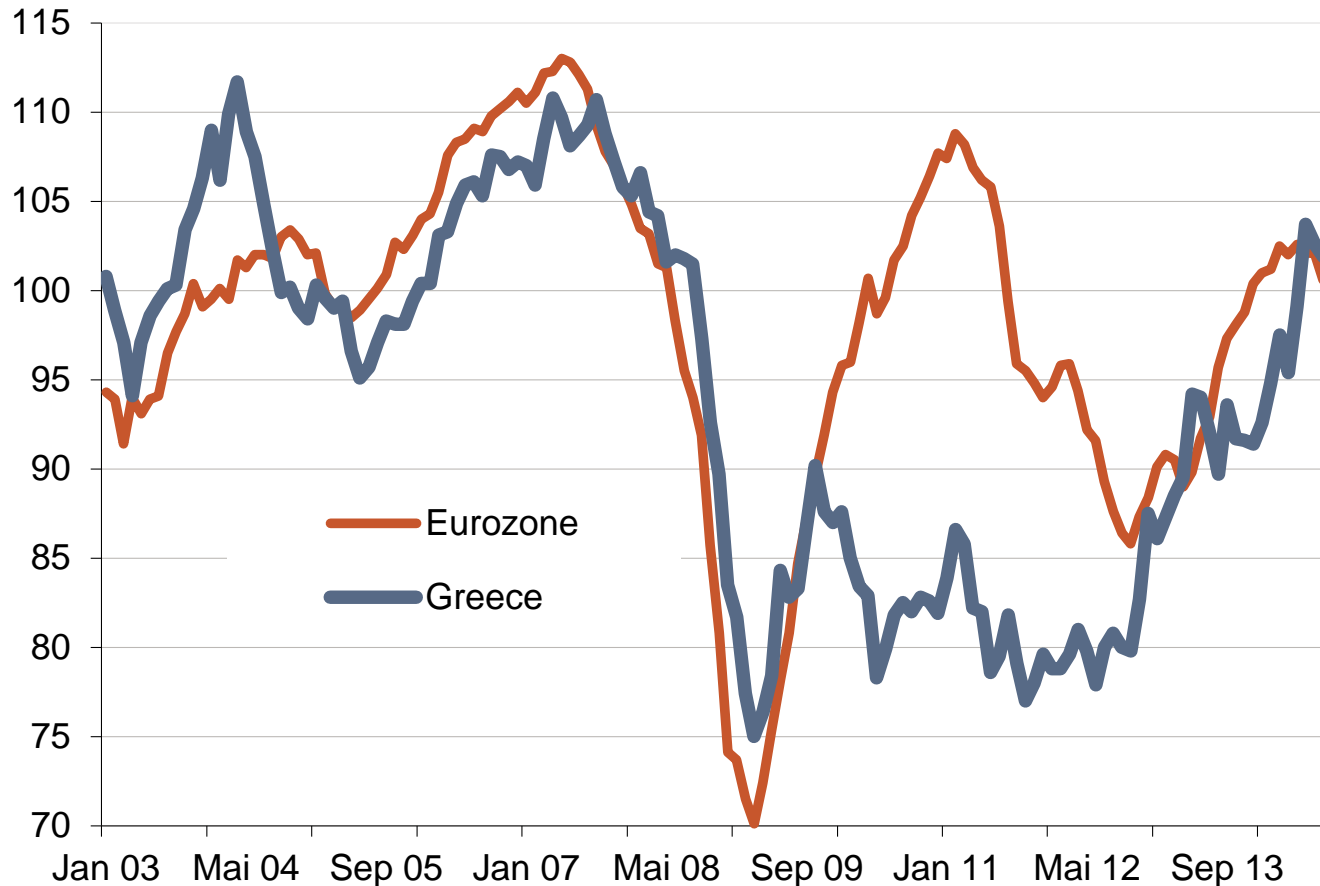
Government budget, revenues and primary expenditures, 12-month rolling sum, revenues adjusted for July 2013 transfer of ESCB profits from Greek bonds. Source: Bank of Greece

- Greece has achieved a small primary surplus.
- After a massive increase in public spending until the autumn 2009 elections...
- ...the cuts in spending since the start of the Greek crisis have been savage.
- Despite higher tax rates, revenues have been hit by the huge adjustment recession.
- The situation has stabilised.
- The recession is coming to an end.



## Greece: from Grexit risk to Grecovery hope

### Economic sentiment: impressive Greek rebound

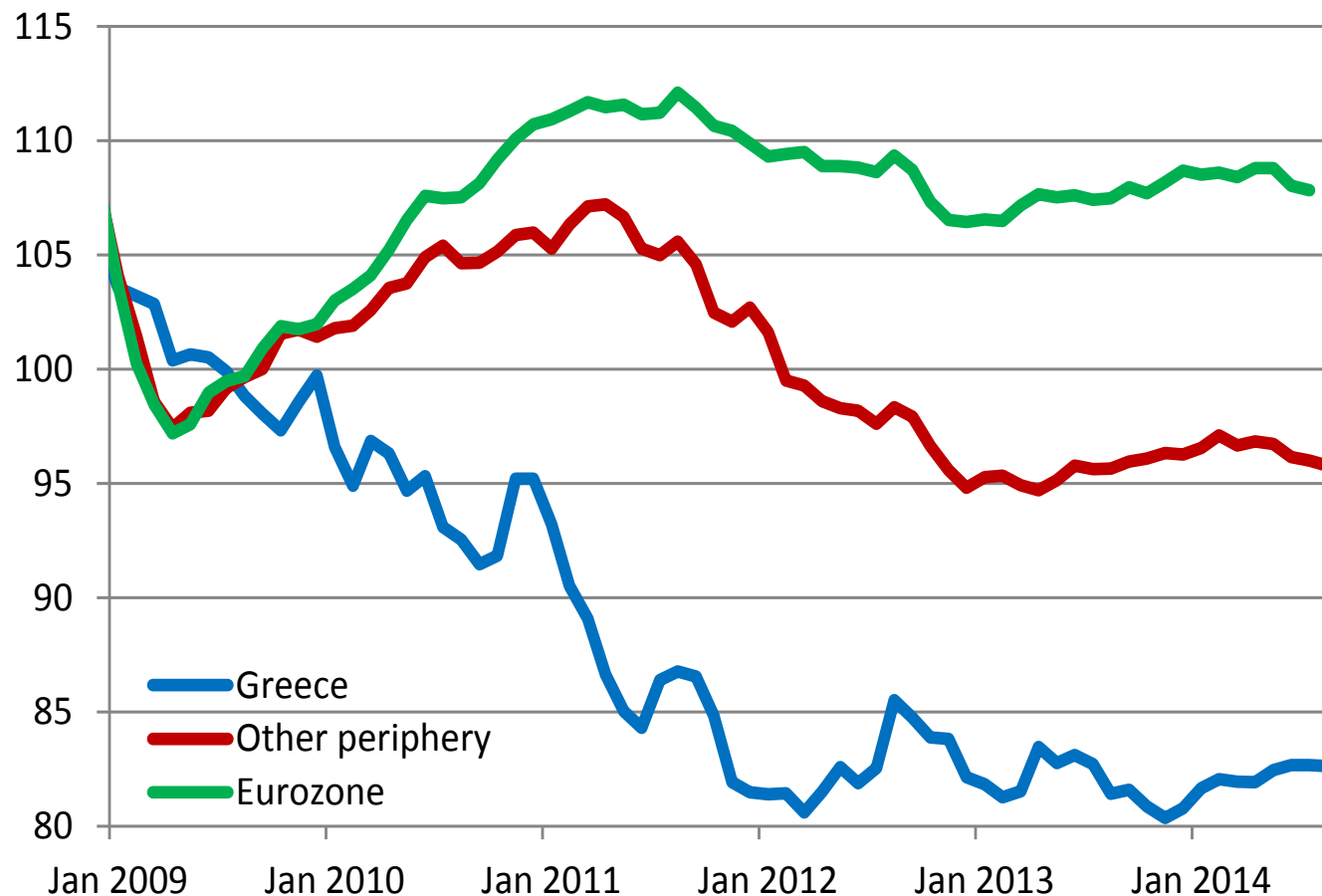


Source: EU Commission

- Greece fell into a deep recession in early 2010.
- The ECB finally stopped the rot in August 2012.
- The new support package of late 2012 boosted hopes that Greece can remain in the euro.
- On the back of a major rebound in confidence, Greek GDP stabilised in spring 2013.
- After the recovery stalled for a while in late 2013...
- ...the upturn gained new momentum in 2014 amid an easing of austerity.

## Greece: industry stabilising at a low level

Industrial output: no clear turnaround yet



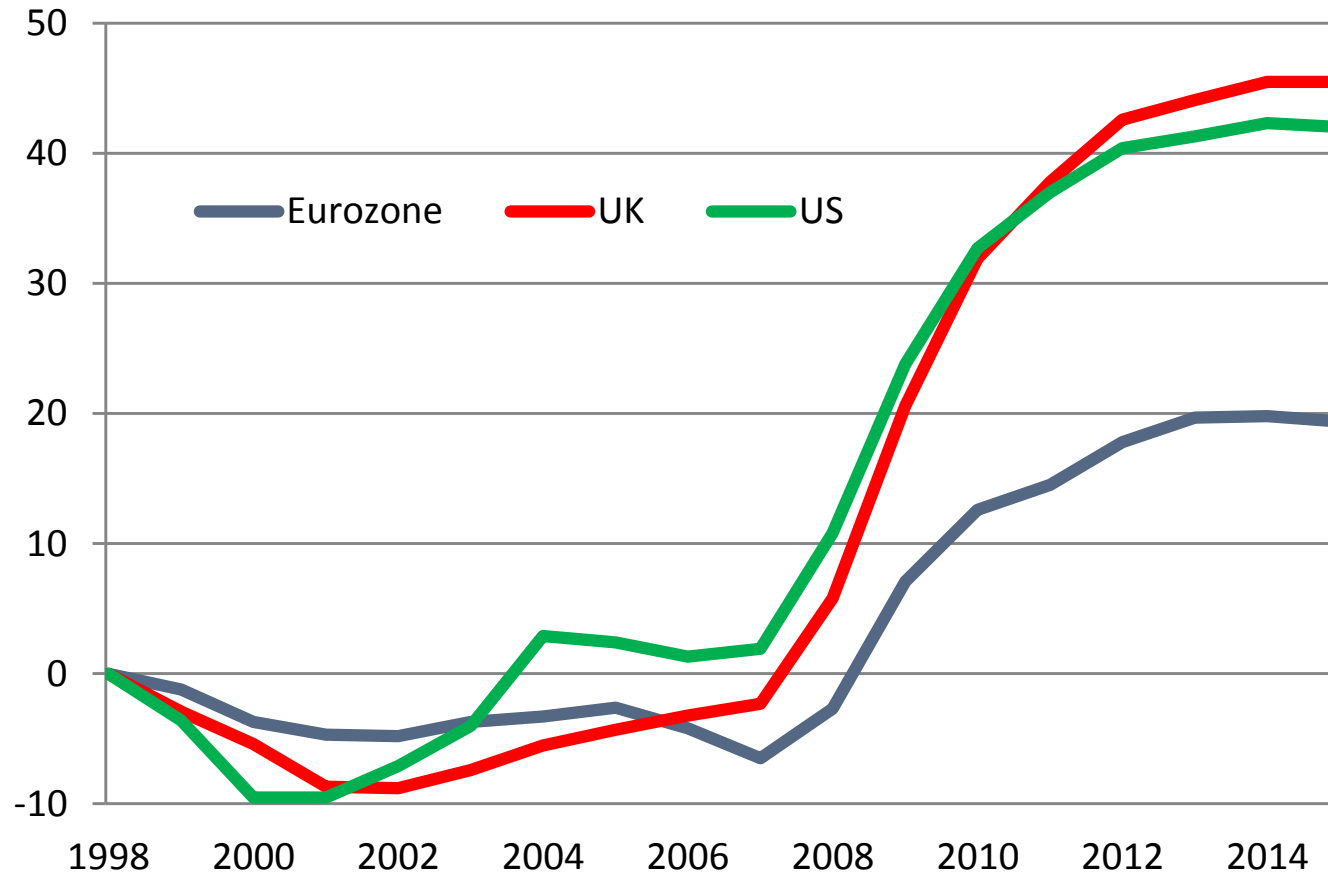
Index of industrial output, rebased to 2009 = 100. Source: Eurostat

- Eurozone output recovered sharply after the post-Lehman recession...
- ...before falling back when the euro crisis escalated in mid-2011.
- Greek output fell sharply until mid-2012.
- While the worst seems to be over, Greek output has not staged a convincing recovery.
- Business investment remains weak despite serious fundamental improvements
- Political uncertainty and tax pressures weigh on industry.



## The puzzle - why did the Eurozone have a „debt crisis“ ?

Change in public debt since start of euro, in % of GDP



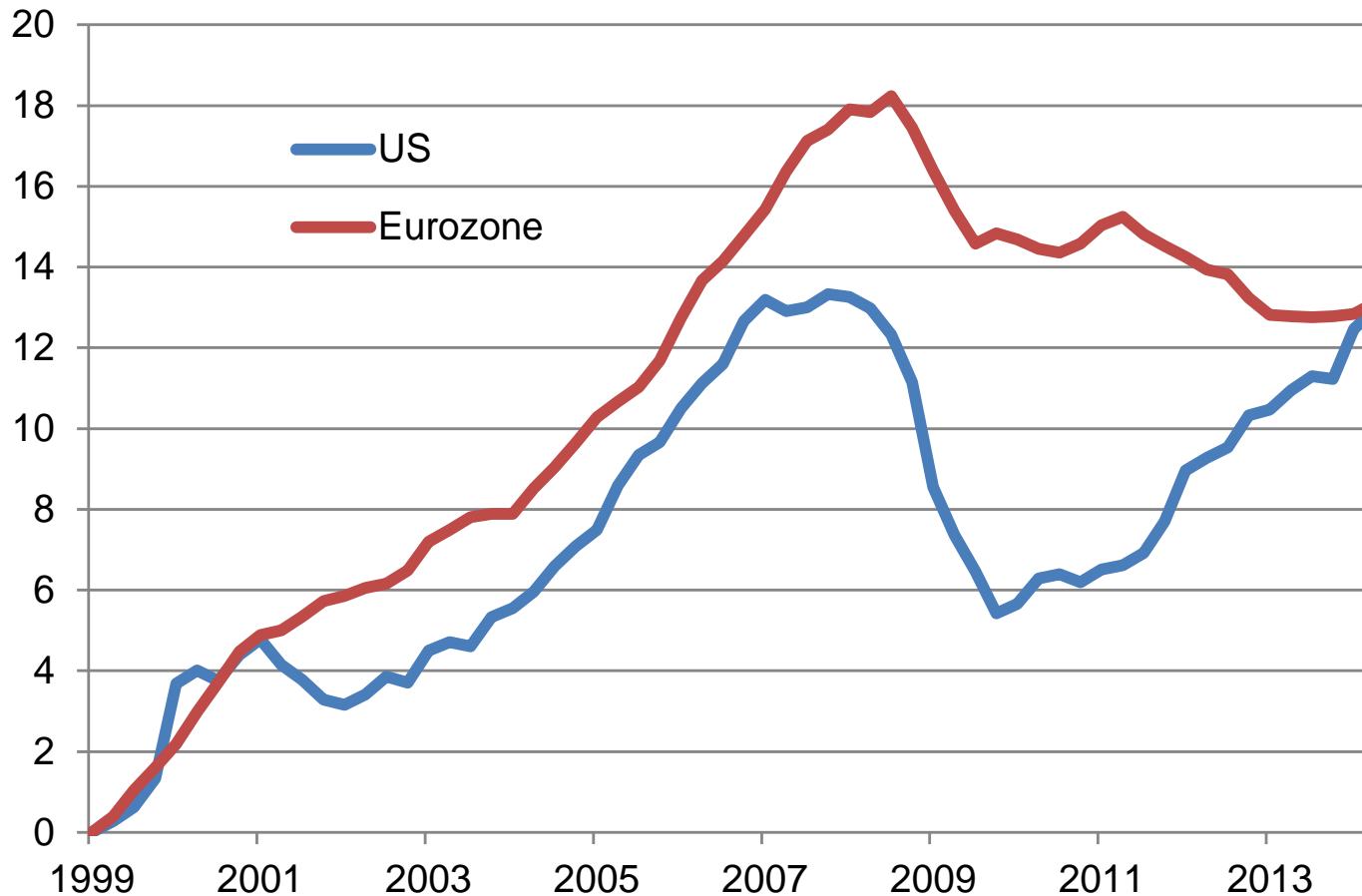
Increase in the ratio of gross government debt to GDP since the start of the euro, in percentage points of GDP.  
End-2013 ratios Eurozone 92,6%, UK 90,6%, US 104%, Japan 245%. Source: Eurostat, IMF, Berenberg forecasts for 2014 and 2015

- It can't be the debt.
- From the start of the euro until Lehman, the debt-to-GDP ratio fell slightly in the Eurozone.
- After Lehman, the debt ratio surged much less in the Eurozone than in the US and the UK.
- Japan would be off the charts.
- Until 1998, the UK had been much more prudent than the future Eurozone.
- Since then, it's the other way round.
- The euro crisis was not primarily about debt.



## Labour market: Eurozone versus US

### Increase in employment since the start of the euro



In million; labour force survey data. The total population is roughly comparable for the US and the Eurozone. Source: Eurostat, BLS

- Until 2008, the Eurozone created more jobs than the US.
- After a sharp post-Lehman correction, the US labour market has edged up again since 2010.
- The Eurozone adjusts more slowly.
- Under the pressure of the euro crisis, Eurozone employment fell until spring 2013.
- The US has finally caught up.
- Why is the US unemployment rate at 6.2% well below the 11.5% Eurozone rate?
- The US participation rate has fallen sharply from 67% to 63%.



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## Scottish independence: the risk is real

### Pro-UK camp still ahead, just

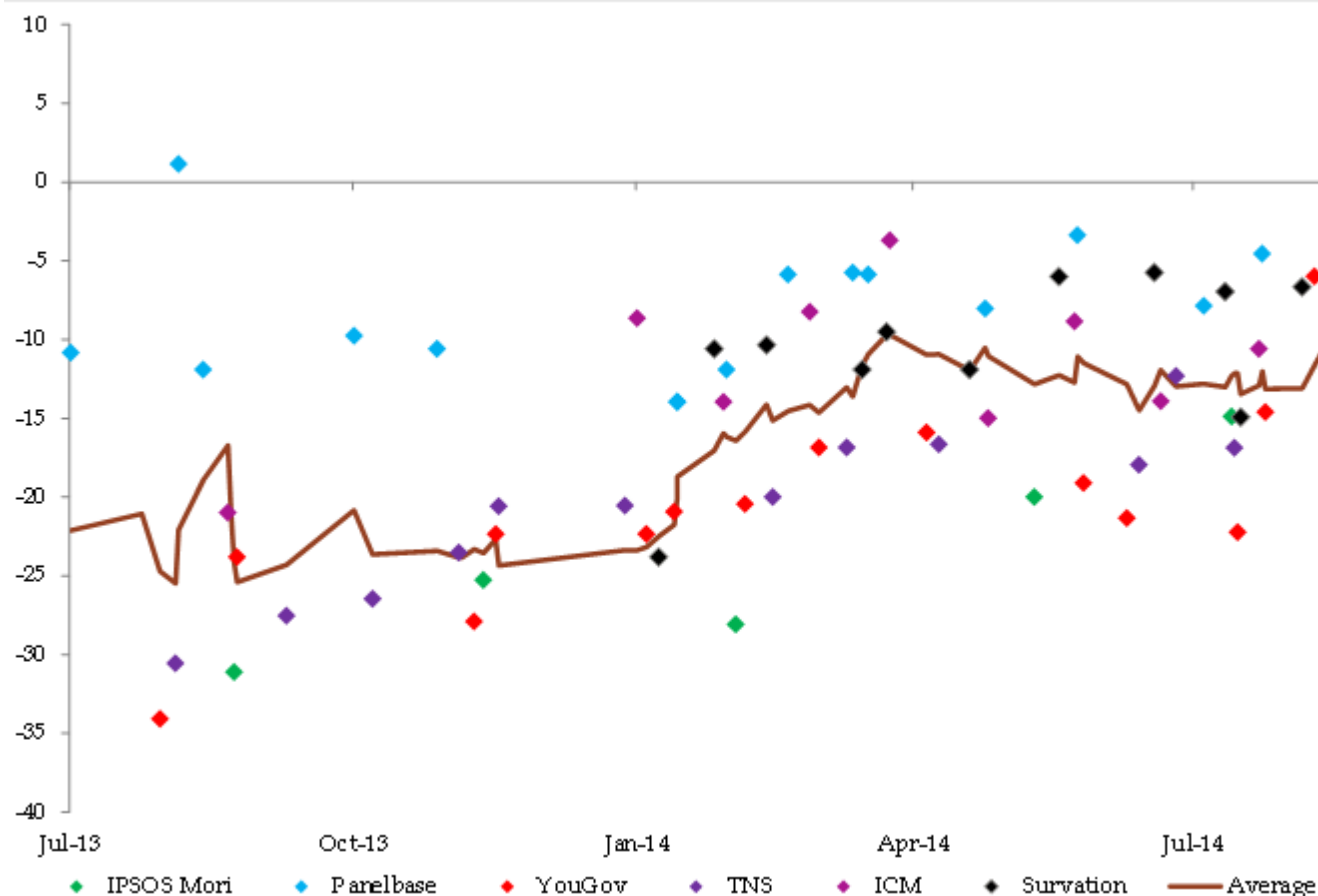


Chart shows no lead, including don't know responses. Each diamond represents an individual poll result. The line shows the average of the last available observation for each poll. Source: UK Polling Report

- A rerun of Quebec 1995, when polls tightened in the final weeks of the campaign and the referendum was very close.
- We expect a no vote, but the risks of a yes have risen. We have to brace for other polls showing a tight race.
- A vote for Scottish independence could push the UK back into stagnation for a year or so – unless the two sides were to agree a velvet divorce right after the vote.
- A no vote is not a vote for the status quo.





# Global economic outlook

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	Weight	GDP				Inflation				Unemployment				Fiscal balance			
		2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015
<b>World*</b>	100.0	2.7	2.4	2.5	2.8												
<b>US</b>	22.8	2.3	2.2	2.0	2.8	2.1	1.5	1.8	2.1	8.1	7.4	6.2	5.7	-8.6	-4.2	-3.2	-2.7
<b>Japan</b>	6.8	1.5	1.5	0.8	1.0	0.0	0.4	3.0	1.8	4.3	4.0	3.7	3.8	-10.2	-9.0	-7.8	-6.5
<b>China</b>	12.2	7.7	7.7	7.4	7.3	2.7	2.6	2.4	3.0	4.1	4.1	4.1	4.3	-2.2	-2.0	-2.1	-1.8
<b>India</b>	2.4	5.0	4.8	5.3	5.8	9.0	8.6	7.5	7.5					-5.8	-5.1	-4.8	-4.0
<b>Latin America</b>	7.9	2.9	2.5	1.5	2.0	6.1	6.0	6.0	5.5					-2.4	-2.0	-1.9	-1.9
<b>Europe</b>	30.0	0.4	0.6	1.1	1.5												
<b>Eurozone</b>	17.3	-0.6	-0.4	0.7	1.0	2.5	1.3	0.5	0.6	11.3	11.9	11.5	11.1	-3.1	-2.8	-2.6	-2.4
<b>Germany</b>	4.9	0.9	0.5	1.3	1.4	2.1	1.6	0.9	1.3	5.5	5.3	5.1	4.8	0.1	0.0	0.2	0.2
<b>France</b>	3.7	0.3	0.4	0.2	0.7	2.2	1.0	0.6	0.5	9.8	10.3	10.3	7.9	-4.8	-4.3	-3.9	-3.6
<b>Italy</b>	2.8	-2.4	-1.8	-0.2	0.5	3.3	1.3	0.2	0.2	10.7	12.2	12.6	12.4	-3.1	-3.1	-3.2	-2.7
<b>Spain</b>	1.8	-1.6	-1.2	1.1	1.5	2.4	1.5	-0.2	-0.3	24.8	26.1	24.6	23.0	-6.9	-6.6	-5.7	-4.5
<b>Portugal</b>	0.3	-3.2	-1.4	0.8	1.7	2.8	0.4	-0.3	0.2	15.8	16.4	14.2	13.3	-5.8	-4.5	-4.0	-3.0
<b>Other Western Europe</b>																	
<b>UK</b>	3.4	0.3	1.7	3.1	3.1	2.8	2.6	1.7	1.8	8.0	7.6	6.4	5.6	-6.1	-6.2	-4.9	-3.3
<b>Switzerland</b>	0.9	1.0	2.0	1.3	1.8	-0.7	-0.2	0.1	0.4	2.9	3.2	3.1	3.0	0.3	0.2	0.6	0.8
<b>Sweden</b>	0.8	1.1	1.7	1.8	1.9	0.9	0.9	1.4	1.7	8.0	8.1	7.9	7.5	-0.2	0.0	-1.0	-0.7
<b>Other Europe</b>																	
<b>Russia</b>	2.9	3.4	1.3	-1.0	0.0	5.1	6.8	7.7	7.4	5.5	5.5	5.5	6.4	-0.2	0.8	-1.5	-2.0
<b>Turkey</b>	1.1	2.2	4.0	3.0	3.3	8.9	7.5	9.0	7.8	8.4	9.1	9.5	9.3	2.1	-2.0	-2.6	-2.5

Unemployment rate: Harmonised definition (ILO/Eurostat); fiscal balance: general government deficit in % of GDP excluding one-off bank support.

\*At current exchange rates, not purchasing power parity. PPP estimates give more weight to fast-growing emerging markets and inflate global GDP.

Weights based on IMF World Global Outlook statistics 2013 estimated GDP figures. 2013 weights.

Source: Berenberg

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