The euro-zone economy

Losing the plot

Weak growth and nasty surprises are still the hallmarks of the single-currency club

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AS IN a complex film script, at least two storylines have been in play for the euro zone this year. One is brightly lit, featuring the revival of both consumer and business confidence, the return of investors to the troubled economies in peripheral Europe and the continuing recovery from the double-dip recession. The other is sombre, focusing on the weakness of that upturn, the onset of disturbingly low inflation and the continuing fragility of over-indebted economies and their banks. The past few days have brought a reminder that this second story is not yet fully told.

A crisis at Banco Espírito Santo (BES), one of Portugal’s biggest banks, prompted a plunge in Portugal’s stockmarket and lesser tumbles elsewhere. Angela Merkel, Germany’s chancellor, said that the episode illustrated how swiftly market nerves could return and how fragile the construction of the euro remained.

Renewed worries about banks have coincided with some gloomy economic numbers. Industrial production fell by 1.1% in May compared with April, leaving it up only 0.5% over the past year (see chart). The decline may have been exaggerated by temporary factors, such as workers taking additional time off after public holidays, but industrial output is still 13% lower than at its peak in April 2008, before the financial crisis. Business surveys have also been signalling a cooling in the euro zone since April. Investors’ confidence in the German economy, Europe’s powerhouse, is waning, according to the ZEW index.

Industrial production makes up only a fifth of the euro-zone economy. But its poor performance in May makes it likelier that the overall recovery, which started in the spring of 2013, remained feeble in the second quarter. To date, GDP growth has averaged only 0.2% a quarter (an annualised rate of 0.9%).

Another worry about the recovery is that it has been so uneven. What little growth there was in the
first quarter was driven by German output, which expanded sharply. The French economy, the second-biggest in the euro area, stagnated while Italy’s, the third-biggest, contracted.

Unemployment is still disturbingly high in much of the euro zone. Though the overall jobless rate has fallen since its peak last year it remained at 11.6% of the labour force in May. That average disguises the fact that in Germany the rate was 5.1% compared with 12.6% in Italy and 25.1% in Spain.

Against this background, it is unsurprising that inflation is stuck at just 0.5%. Although the European Central Bank (ECB) took steps to counter “lowflation” in early June, the worry is that it has still not done enough. In a survey of the euro-zone economy published on July 14th the IMF urged the ECB to adopt quantitative easing—creating money to buy assets including sovereign bonds—if inflation remains too low.

Lowflation represents a particular threat to highly indebted countries like Portugal. The Portuguese example had been one of the brightest exhibits in the sunny storyline as yields on government debt plummeted and the country emerged from its bail-out in May. But this month brought shadows. The
setback to industry was gravest in Portugal, where production fell by 3.6% compared with April, leaving it only 0.3% higher than a year earlier. Moreover, GDP contracted in the first quarter of 2014 after staging a recovery during 2013.

However, it is alarm about the viability of BES that really rattled the equity markets, in Portugal and beyond. The problem seems to lie in the complex ladder of holding companies above the bank. In June BES disclosed accounting irregularities and an “extremely negative” financial situation at one of these companies, which revealed this month that it had missed payments on some of its debt.

The central bank insists that BES, which was the only big bank in Portugal not to have been bailed out during the euro crisis, has enough capital to withstand its parents’ problems. It has forced the bank’s founding family to make way for new managers with no connections to the family or the bank’s previous board. After losing two-thirds of their value in a month, BES’s shares recovered slightly this week.

Yet the problems at BES underscore the significance of the ECB’s root-and-branch investigation of bank balance-sheets. Worries about what may be lurking on them have contributed to the credit drought that has enfeebled the economies of southern Europe. Suspicion that banks lack sufficient capital to absorb souring debts remains widespread. The ECB must allay it when it publishes its findings this autumn if the sunny storyline is to prevail over the film noir.

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