Box 6

THE RECENT SLOWDOWN IN ECONOMIC GROWTH IN THE EURO AREA

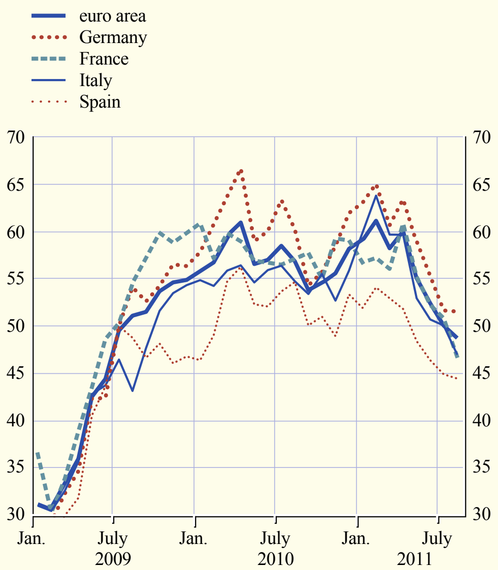
Following the strong growth seen in the first quarter of 2011, euro area quarterly GDP growth declined substantially to 0.2% in the second quarter and short-term indicators suggest that the growth momentum slowed further in July and August. Against the background of these developments, this box examines the factors that are likely to be behind the slowdown and assesses the outlook for economic growth in the euro area.

Recent developments in survey data

Surveys indicate a substantial slowdown in euro area growth momentum over the past few months, affecting all the sectors and all the large euro area economies. The output index for the euro area manufacturing sector obtained from the Purchasing Managers' Index (PMI) survey has declined sharply since April, dropping from a level of about 60, which was close to its ten-year high, to somewhat below 50, pointing to more or less stagnant industrial growth momentum in the first two months of the third quarter (see Chart A). Similar developments, albeit slightly less pronounced, are seen in the PMI services business activity index (see Chart B). This index declined from the high level of 57 in March to stand in August only 1½ points above the theoretical no-growth threshold of 50. Developments in other business surveys, such as those of the European Commission, are in line with the results of the PMI survey, and developments at the aggregate euro area level are broadly shared by those in the larger euro area countries.

Chart A PMI manufacturing output indices for the euro area and larger euro area countries

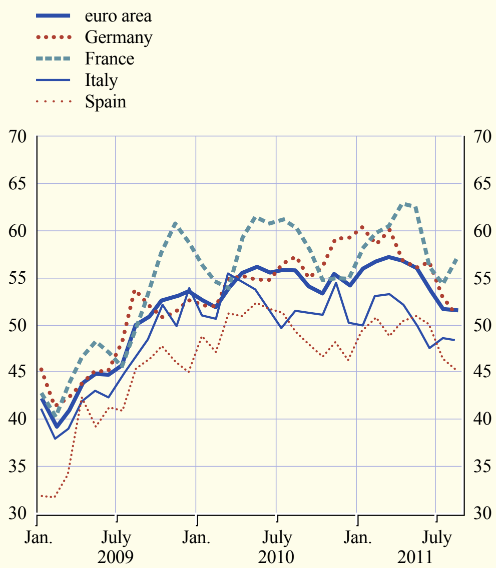
(index level)



Source: Markit.

Chart B PMI services business activity indices for the euro area and larger euro area countries

(index level)



Source: Markit.

Drivers of the slowdown

Before examining the specific causes of the current slowdown in euro area activity, it is worth considering two general factors which typically contribute to a deceleration in growth momentum in the course of a recovery. The first is the fading of the "bounce back effect". In the earlier stages of a recovery, growth is typically supported by the unwinding of a backlog of consumer and producer demand – as spending was deferred during the recession given the uncertain outlook – accompanied by a replenishing of inventories, which were reduced during the recession. The impact of this effect may have faded already in the current recovery.

The second factor that may be expected to contribute to a deceleration in growth is the return of capacity constraints, once a higher level of capacity utilisation has been restored. For the euro area economy, the capacity utilisation rate returned to a level close to its long-term average (81.6%) in April 2011. Recently, however, capacity constraints seem to have declined again somewhat. This is also evident in a recent decrease in supply-side limits to industrial production stemming from lack of equipment, which underlines the fact that the recent slowdown in economic activity indicated by surveys is not likely to be significantly related to such supply-side constraints. The latest declines in survey data in fact appear to be related to increasing lack of demand as a factor limiting production, as is also evident in the sharp decline in the PMI indices for new orders, including export orders, to levels clearly below 50.

An important factor behind the slowdown in euro area growth and the increasing lack of demand reported in surveys since the first quarter of this year appears to be spillover effects from developments in the global economy. The global PMIs show a similar pattern of decline over the past few months as those for the euro area, with the notable difference that the sharp declines appear to have started somewhat earlier than in the euro area. At the global level, several factors have contributed to the recent moderation in growth. In particular, the earthquake in Japan had a strong adverse impact on the country's domestic economy as well as on global supply chains. As these supply chain disruptions are gradually easing and firms make up for the lost production, one of the main factors holding back growth in the second quarter is now diminishing, and Japanese production should be expected to catch up to some extent in the third quarter. A further factor weighing on global growth as well as euro area growth is the strong increase in oil prices over the past year. Since reaching a trough in December 2008 oil prices have increased by about 150% up to August 2011 in euro terms and are almost 30% above their average level in 2010. At the same time structural headwinds are dampening the medium-term growth outlook, particularly in advanced economies. The prevailing need for private and public balance sheet repair as well as the persistently weak labour and housing markets point to a rather muted global recovery. Finally, the political debate in the United States over the debt ceiling and the adoption of a fiscal consolidation plan may have played a role in denting US consumer and business confidence in recent months. In turn, this may have added to the uncertainty surrounding global economic prospects recently, as reflected in increased financial market volatility.

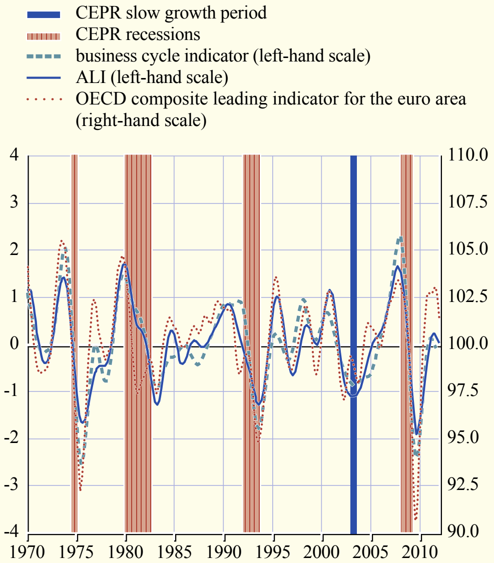
In the euro area, in addition to the global causes described above, a number of domestic factors appear to have played a role in the decline in growth since the first quarter of 2011. First, the strong growth in the first quarter was in part due to a temporary factor, i.e. a strong rebound in construction activity related to unusually adverse weather in the previous quarter. This was also reflected in the weak developments in construction value added in the second quarter. Moreover, the fiscal consolidation measures implemented in euro area countries are also likely to be dampening economic growth. In addition, the ending of various fiscal stimulus measures may have played a role in a number of euro area countries. For instance, the effects of the French car scrappage scheme have faded out. Finally, it is likely that the high level of uncertainty stemming from the sovereign debt crises in some euro area countries has had an effect on overall economic activity, via adverse confidence effects and increased economic uncertainty.

Prospects for euro area economic activity

Looking ahead, leading indicators of the euro area business cycle have deteriorated over the past months, pointing to an ongoing weakening in cyclical developments in the euro area in the second half of the year (see Chart C). However, despite this deterioration their current levels are consistent with continued modest growth.

Chart C The business cycle indicator, the euro area-wide leading indicator (ALI) and the OECD composite leading indicator for the euro area

(percentage deviation from trend; standardised; monthly data)



Sources: Thomson Reuters, ECB, European Commission, Eurostat, Ifo Institute for Economic Research, Markit, US Department of Labor, OECD, CEPR and ECB calculations.
Notes: The business cycle indicator is based on data on industrial production excluding construction up to June 2011. The ALI has a lead time of up to six months (i.e. it currently extends up to December 2011), and also the lead time of the OECD composite leading indicator amounts to about six months. The ALI and the OECD leading indicator are shifted by their six-month lead times.

The latest readings in the euro area-wide business cycle leading indicator (the ALI)[1] point to a downturn in the deviation cycle over its lead horizon up to December this year. These signals are confirmed by the OECD composite leading indicator for the euro area. This indicator, which also has a lead time of about six months on turning points in economic activity, has continuously declined over the past few months, albeit remaining at a higher level than the ALI. The third regularly published leading indicator for the euro area, the Conference Board Leading Economic Index (not shown in the chart) increased in July, following declines in the previous two months, pointing to a continued modest expansion in economic activity in the second half of the year. Other indicators, i.e. M1 and MFI loans to households, also point to further euro area output growth, albeit at modest rates (see Box 1).

Thus, overall, the currently available information suggests that, despite the recent significant declines in short-term indicators, a continuation of the expansion in euro area activity may be expected, albeit at modest rates (see also Box 9). A double-dip recession in the euro area, in the form of two or more successive quarters of negative growth, appears rather unlikely on the basis of the available indicators.

1 See De Bondt, G. and Hahn, E., “Predicting recessions and recoveries in real time: the euro area-wide leading indicator (ALI)”, *Working Paper Series*, No 1246, ECB, Frankfurt am Main, September 2010; and the box entitled “The measurement and prediction of the euro area business cycle”, *Monthly Bulletin*, ECB, May 2011.