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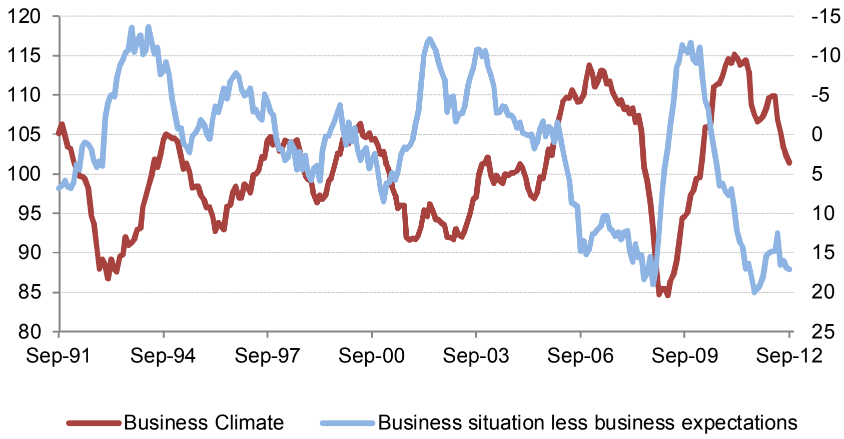
As the euphoria fades

Falling German business sentiment is bad news for euro area

Markets had expected the German Ifo business climate index for September to rise; instead, it fell to 101.4 from 102.3 in August. The fall – the sixth consecutive fall – is obviously bad news. But the bad news is more than just a question of pointing to weaker growth in the near term. There are two bigger reasons to worry. The first is because – following the ECB President's promise to do "whatever it takes" to save the euro, backed up by the unveiling earlier this month of the Outright Monetary Transactions – sentiment should have improved. Certainly, the ZEW investors' index rose in September after falling for four months. However, business sentiment would only improve if business a) believed that the ECB measures would be positive; and b) that they would be implemented. As mentioned in a comment last week ('Europe's game of *pollo*', 19th September) the latter is by no means clear. (Nor, actually, is the former, but that depends on how you define positive.) German business is clearly not sanguine about either the current business situation or the outlook. The latest overall sentiment reading is the lowest since early 2010, when it presaged a sharp slowdown in growth in the second half of that year.

The second cause for concern is because future expectations are deteriorating faster than the current situation. If it was the case that business perceived the current weakness to be temporary and that the monetary and fiscal authorities were doing the right thing in terms of setting out the conditions for a recovery in the reasonably near term, then the business situation index (current situation) would remain depressed but the business expectations index would presumably rise. Instead, the gap between the two indices has widened further and is now at 16.9 close to its all-time high of 20, reached in September last year. (Please note that the second y-axis in the chart has a reversed scale; and also that the differential between the two indices is merely a measure of their divergence.)

Ifo business climate (index 2005=100) and differential between current situation and future outlook



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What we are seeing, therefore, is that German business is becoming more pessimistic about the current outlook, *and about the future outlook*. This obviously has knock-on effects on the rest of Europe – euro area and non-euro area. There is a wide-spread perception that Germany is the growth engine of Europe. In fact, the pattern for some decades has been that Germany needs help to get is growth going; and only then does it provide any form of engine capacity for the other European countries. (Put another way, Germany needs export-led growth first before it begins to import from others.) The current global business climate is not conducive to export-led growth, not even for the world's most competitive countries. So, expect little growth in Germany, and even less in the euro area. That, in turn, will have knock-on effects on public sector finances, which markets should pick up on fairly rapidly. Perhaps the European game of chicken is going to unravel quite soon – the weekend was full of rumours: France was pushing Spain to apply for a bail-out; Spain is in secret discussions about a bail-out, hoping to avoid harsh conditions by asking that the money used be the difference between the €60 billion they claim to need to recapitalise their banks and the €100 billion set aside for this purpose (an interesting view of who the money belongs to, by the way); and – not a rumour – that France is beginning to crack in terms of offering more lenient terms to Greece.

To paraphrase an old British saying, there will be trouble in the euro area next month.

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