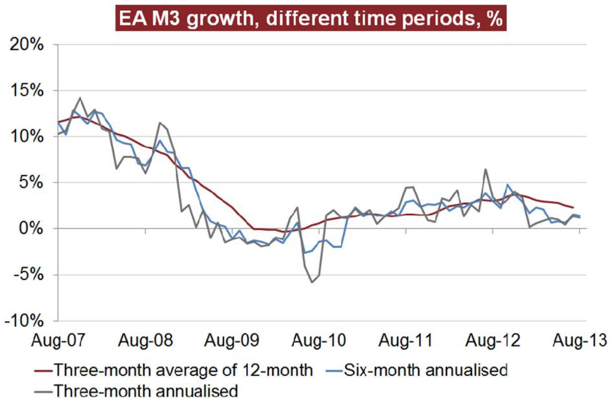
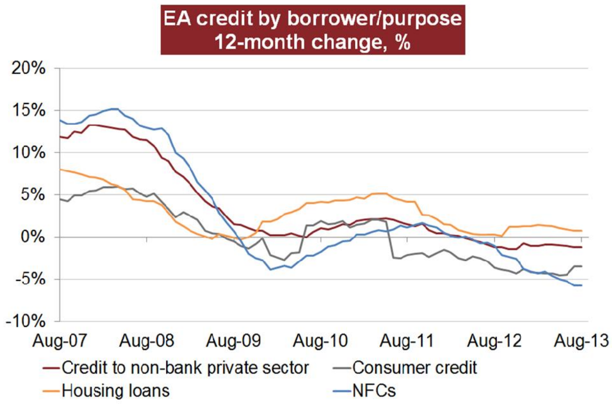
The monetary threat to the EA recovery

- **The euro area finally seems to be recovering**
- **Survey-based indicators are pointing to further improvement**
- **But weakening M3 growth throws a question mark over the strength of the recovery**

By many indicators, the euro area is now recovering. GDP grew by more than expected in Q2. Business and consumer surveys - including the European Commission's economic sentiment indicator and PMIs – are improving. Talk of 'exit' – ie, one country leaving the single currency – has abated. But, worryingly, one important indicator not only remains weak, but is actually weakening: euro area broad money growth.

EA M3 grew by 2.3% in the year to August, while three-month moving average of twelve-month M3 growth (a number closely followed by the ECB) slowed to 2.3% from 2.5% in July. The September figure is the slowest since January 2012. The – weak – upwards trend in M3 growth that we saw from the spring of 2010 to late 2012 has turned. This is also clear from the shorter term changes, with both six- and three-month annualised M3 growth below 1.5%. Meanwhile, credit growth remains weak, with housing loans – the only category to register any growth since the spring of 2012 – now falling towards zero growth.





The monetary developments are important. Broad money movements tend to lead output growth with a lag of about 18 months (although, as Milton Freidman noted, those lags can be "long and variable"). The somewhat more positive output growth figures we have seen in mid-2013 – and are likely to see in the autumn – can therefore relate to M3 developments in 2010-2012. By contrast, recent data, unless sharply reversed, implies that this recovery will be both shallow and short-lived, with EA output growth slipping back below trend in 2014. The message is reinforced by the credit data, which show the continued weakness of domestic demand.

Not all the monetary numbers are bad. Looking at national data, the drain on deposits from Greek, Spanish and Irish banks has bottomed out and begun to reverse (not yet so in the case of Cypriot and Portuguese banks). But this good news is off-set by the continued contraction of banking system balance

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sheets in all EA countries. Even in Italy, the aggregate balance sheet of the banking system, which was still expanding as recently as last April, is now contracting. This points to continued weak broad money growth in coming months, raising further doubts over the strength of the EA recovery.

The weak money numbers also put a question mark over the future of EA risk assets. A seeming recovery and a likely stronger euro should both be good news for EA equities in the near term. But, unless the recovery turns out to have legs, that boost is likely to prove short-lived.

This pessimism may seem puzzling. After all, are not surveys pointing to a continued recovery? How to reconcile the money and the survey data?

One answer to this conundrum may be that surveys are inherently more short-term than broad money. With the euro area returning to growth and a feeling that sovereign risk has diminished, it is perhaps natural that confidence will also rise. That would be consistent with continued economic growth in H2 2013 and in 2014. By contrast, the money data looks further ahead and implies that, while positive, output growth will remain below-trend (estimated at around 1% real growth per annum), certainly to the end of next year. Moreover, the broad money data is supported by other indicators, eg car sales, which are a reliable indicator of the state of household demand and which weakened over the summer.

Even so, there may be some attraction in EA assets. First, the dollar may suffer because of the on-going fiscal debate in the US and the now seemingly certain government shut-down. In addition, if the EA is recovering – albeit weakly – the dollar, as a ‘risk-off’ currency, should also weaken. Both factors should benefit the euro, while the receding sovereign risk is good news for equities. A lower threat of exit by any country, at least in 2014, should also lead to a narrowing of periphery/core yield bond spreads.

But this brings us to the main risks still hanging over the EA economy. These are still primarily political, on the one hand austerity fatigue, on the other bail-out fatigue. The former could lead to attempts to stimulate domestic demand in the periphery countries. While likely to benefit growth in the short term, stronger domestic demand would also erode some of the gains that have been made on the external side. Moreover, any easing of fiscal targets is likely to be resisted by the creditor countries, who have already shown signs of bail-out fatigue and will be even less willing to come up with more money if their policy prescriptions (whether right or wrong) are being flouted. Hopes that the German elections would prove to be a game-changer in this respect are likely to be disappointed. Angela Merkel has already shown that she has neither the inclination, nor the mandate to change German policies or attitudes.

Near-term, EA assets can therefore be profitable. But the underpinnings of the euro area recovery are still extremely fragile.

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