Economist Insights

Side effects

It seems that the Eurozone has been benefiting from the law of unintended consequences. When the Euro was strong back in 2012, net exports were the only positive contributor to growth. Now that the Euro has been weakened by the implementation of QE, the net exports contribution has been marginal compared to consumption. So what went wrong, or, to look at it another way, what has gone right, but maybe just not in the way the ECB intended?

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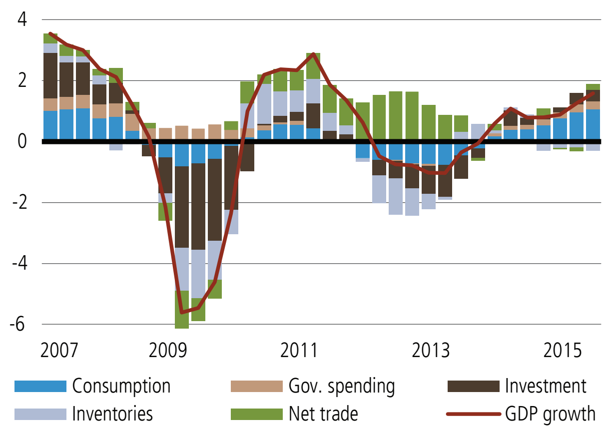
Throughout the European sovereign crisis, people were left wondering why the Euro was so strong. Shouldn't the currency of a currency union that was on the verge of collapse be weaker rather than stronger? Risks do not always dominate markets, and the underlying factors sometimes win out. Thanks to fiscal austerity and a drop in consumption, the Eurozone's current account balance improved sharply; when exports are greater than imports it puts upward pressure on the currency. And of course the Federal Reserve and the Bank of England were embarked on quantitative easing (QE) which pushed down their currencies. Many investors saw the EUR (or rather, Germany) as a safe haven from depreciation (see *Economist Insights*, Muck and Brass, 14 May 2012).

Once the European Central Bank (ECB) made clear it was starting its own programme of QE, the tables were turned. A sharp depreciation of the EUR followed, exactly as the ECB wanted. A lower EUR was supposed to re-fuel the recovery through the external sector, as well as pushing up inflation through higher import prices. Stronger net trade should then have stimulated employment growth and investment, which would then spill over into consumption. This increased spending should then have pushed inflation back up towards target.

This all sounds great in theory. In practice, things turned out a bit differently. Back in 2012 when the EUR was strong, what growth there was came from net exports. Now that the EUR is weaker the recovery is being driven by domestic demand, especially consumption (chart 1).So what went wrong; or went right but in a different way?

Chart 1: Mixed up

Contribution of expenditure components to yoy GDP growth (%)

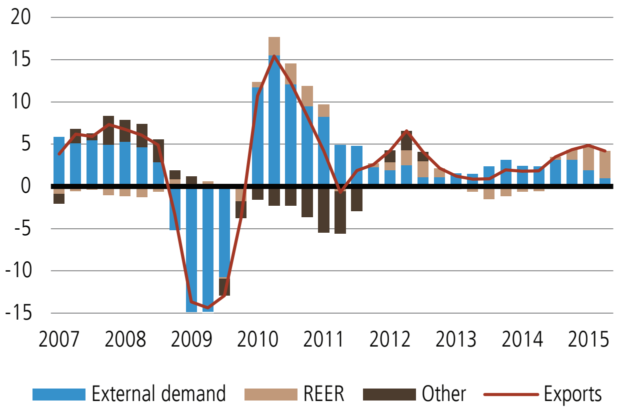


Source: Eurostat

The thing about exports is that they not only depend on the exchange rate, they also depend on demand. A weaker exchange rate will not help your exports if your customers are cutting back their spending. So even though the EUR was weaker, emerging markets (especially China) were slowing down sharply. And unfortunately for the Eurozone, it turns out that the strength or weakness of external demand is far more important than the exchange rate (chart 2). This is not to say that the drop in the EUR has had no effect; for a while the currency was compensating for the slowdown in external demand; but the effects are fading and export growth is already slowing.

Chart 2: Quantity over price

Contribution of external demand and real effective exchange rate (REER) to yoy growth in exports (%)



Note: the contribution is derived by estimating a model where exports growth is a function of world imports (ex Eurozone) and 2 quarter lag of the REER
Source: Eurostat, ECB, UBS Global Asset Management

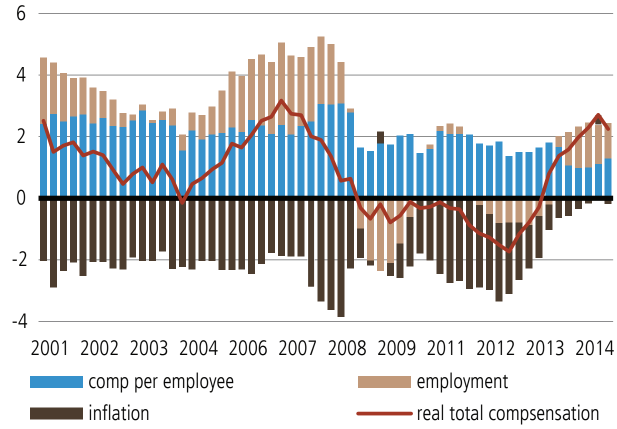
One positive unintended consequence for the Eurozone of this slowdown in emerging markets is that it brought oil prices down further. Lower oil prices pushed down headline inflation in the Eurozone. While this might not be welcomed by the ECB since it means that inflation should be lower for longer, it was welcomed by consumers as lower energy prices mean they have more money to spend on something else. This drop in energy prices also offset some of the increase in the price of imports linked to the depreciation of the EUR.

The effect of lower inflation on consumer spending has not been negligible. Consumer spending usually goes up when real compensation of employees increases. This can happen if wages goes up, employment increases or inflation comes down. In a context of lots of spare capacity in almost all the Eurozone countries it is hard to see how wages could have gone up materially. At the same time, employment growth usually tends to lag GDP growth (see *Economist Insights,* Stretching the analogy, 14 September 2015). And with GDP only having accelerated recently it is hard to see how employment growth could be driving higher consumption. The only thing left then is inflation.

Persistently low inflation since 2013 has indeed supported growth in real compensation of employees (chart 3). The positive contribution intensified when inflation fell close to zero following the collapse in oil prices. More recently, a pick-up in employment also contributed positively to support total real compensation growth and offset a further deceleration in nominal wages.

Chart 3: Cheap, so cheerful

Contribution of compensation per employee, employment growth and inflation to yoy growth in real compensation of employees (%)



Source: Eurostat, UBS Global Asset Management

The buoyant outlook for the consumer has also been confirmed by the surge in consumer confidence, which recently reached its highest value in almost ten years. Lower prices can be a real boost to how consumers feel about the world.

After the financial crisis many central banks saw QE as the best medicine to avoid chronic low growth and inflation. But one of the side effects of QE was that it led to the build-up of imbalances in other regions, especially emerging markets. Now that the emerging markets have also caught a cold, the ECB QE programme might not work in the same way as other central banks' QE. However, because of the lower oil price that followed the loss of momentum in emerging markets, it looks like that the Eurozone has been benefiting not just from the medicine itself but also from its side effects.

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