



June 2016

Global Economy Watch

The Eurozone's Unbalanced Recovery



Dear readers,

Starting with the UK, we expect economic growth to moderate in Q2, but to rebound in the second half of the year, assuming that the UK votes to remain a member of the EU. On this basis, we are projecting UK growth of just under 2% in 2016 and just over 2% in 2017, but it could be markedly lower if the UK votes to leave the EU.

Across the Atlantic, the US Federal Reserve is pondering when to take the next step on the path to monetary policy normalisation. Inflation is trending upwards towards the target and the labour market continues to tighten, although the latest jobs market report in early June was disappointing. Q1 GDP growth was revised up slightly and growth is expected to be stronger in Q2. Therefore we still expect the Fed to increase the policy rate later this year, although this could now be delayed until after the presidential election.

The Eurozone economy grew faster than the US in the first quarter of 2016 – only the seventh time this has happened in the 29 quarters since the beginning of 2009. This was the latest step in the Eurozone recovery, after

annual growth in 2015 picked up to 1.6%.

But our analysis shows that the economic, and to a greater extent the labour market recovery has been uneven. For example, the range of unemployment rates in the Eurozone at this stage of the recovery is the highest it has ever been compared to past recoveries.

We think the key driver of this variation in economic fortunes is structural in nature and related to differences that exist across labour, capital and product markets in the individual Eurozone economies. But the recovery currently underway in the Eurozone has given policymakers an opportunity to implement reforms and reduce some of these differences.

Sticking with the Eurozone, we have focused on labour productivity this month. Our analysis shows that, since 2012, labour productivity in the manufacturing sector has fared better than in the services sector. But services make up around three quarters of the Eurozone's economic output, so if productivity growth is really going to take-off across the bloc, services will have to drive it.

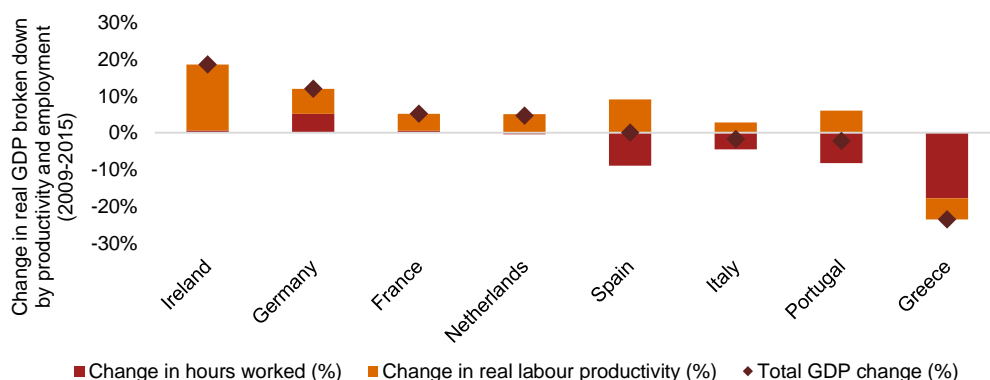


Kind regards

Richard Boxshall

PwC | Senior Economist

Fig 1: Productivity growth in Ireland and Spain – the top performing peripheral economies – has outstripped that in Germany, France and the Netherlands



Sources: PwC analysis, Eurostat

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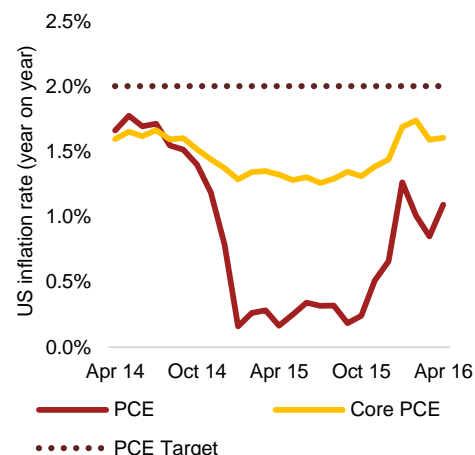
Economic update: US interest rate – time to rise?

Six months ago the Federal Reserve started to tighten monetary policy. Now the focus of businesses and non-US policymakers is on when the Fed will hike its policy rate further. The Fed will take into account a range of factors when deciding this, but we think there are three economic variables to focus on when assessing what the Fed's next move will be:

- **Inflation:** Figure 2 shows that US inflation stood at 1.1% in April. Stripping out the effects of low oil prices and food, core inflation stood at 1.6%. Since January, the US dollar has depreciated by around 5% in trade-weighted terms, which will tend to push up US import prices, so consumer price inflation is likely to continue moving towards its 2% target.
- **GDP growth:** The US economy grew at a subdued annualised rate of 0.8% in the first quarter of the year, but we expect this to accelerate in the second quarter of the year to an annualised rate of around 2-2.5%. This is similar to the 'nowcast' models from the New York and Atlanta Banks, which are projecting that growth will be in the region of 2.5% in Q2. This suggests that the first quarter figure was a temporary blip, rather than the beginning of a more fundamental slowdown, so the Fed is unlikely to be put off by what happened in the first three months of this year.
- **Labour market:** Around 750,000 jobs were created between January and May 2016 and the US unemployment rate now stands at 4.7%, similar to the rate before the crisis when it averaged 4.6% in 2007. The latest employment data showed that the US economy added a relatively disappointing 38,000 jobs in May. If job creation bounces back quickly and the participation rate remains at current levels, average real earnings should continue to rise, which should help grow consumer spending, and so push inflation higher.

With inflation moving in the right direction and the labour market continuing to tighten, though perhaps at a slower pace than previously thought judging by the latest employment data, it would seem that the conditions for another rate rise could be met over the coming months. We therefore still expect the Fed to increase interest rates later this year, though possibly not until after the election unless the jobs data turn around quickly.

Fig 2: US inflation is on an upward trend and core inflation is nearing 2%



Note: PCE is the price index for Personal Consumption Expenditures
Sources: US BEA, Datastream

Focus on: Labour productivity in the Eurozone – what's hot and what's not?

Ireland leading the way

For mature economies with relatively slow growing populations of working age, productivity is the key driver of economic growth in the long run. For the Eurozone this is particularly important, as between 2015 and 2025, the working-age population is projected to shrink by 3.6%, while in the UK and US it is expected to grow by 2.6% and 1.7% respectively. These latest UN projections were published in July 2015 so it is possible that these demographic pressures could be somewhat mitigated by the recent increase in migration to the EU, though this will depend on how quickly people can be integrated into the workforce. But productivity growth will remain critical in the longer term, so how have trends in this varied across the key Eurozone economies we monitor in the past few years?

Figure 3 shows that Eurozone real GDP per hour worked – a measure of labour productivity – grew at a rate of around 2% in the three years to 2015. A closer look at the data shows that:

- Ireland has been the top performer in the period, with its labour productivity growing by around 7% over the period;
- Large economies like the Netherlands, France and Germany have increased their labour productivity broadly in line with the bloc average; and
- Peripheral economies like Portugal and Greece have not managed to increase their labour productivity growth rates despite carrying out significant reforms over the period.

But are there any sectoral variations in this picture?

The manufacturing sector has overperformed in most economies...

Our analysis shows that, in most of the

Fig 3: Ireland has enjoyed the most impressive productivity growth

Change in labour productivity (output per hour worked) from 2012 to 2015				
Country	Total economy	Manufacturing	Services	
Ireland	6.8%	12.0%	7.3%	
Spain	2.5%	5.2%	2.7%	
Netherlands	2.3%	3.7%	2.6%	
Eurozone	2.0%	4.0%	1.4%	
France	1.7%	4.0%	1.5%	
Germany	1.6%	1.8%	0.9%	
Italy	0.3%	2.7%	-0.3%	
Portugal	0.3%	0.3%	-0.8%	
Greece	-0.6%	-4.0%	2.0%	

● Above total economy rate ● Below total economy rate

Note: Total economy productivity is measured using GDP per hour worked. Sector productivity is measured using GVA per hour worked.
Source: PwC analysis, Eurostat

Eurozone economies we cover, productivity in the manufacturing sector has grown at a relatively rapid rate. This makes sense, as most manufactured goods are tradeable and so exposed to competitive forces, all of which incentivise businesses to become more efficient in a shorter period of time. Also, new automated technologies tend to be most readily applicable in the manufacturing sector (though they can also apply to more routine services activities). There are, however, some outliers – such as Ireland, for example, where the double-digit productivity growth rate in its manufacturing sector could be explained by its highly efficient pharmaceutical industry, which accounts for around a quarter of all goods exports.

Also, becoming more productive isn't just about building hard infrastructure. Soft infrastructure like educating and managing the existing workforce

matters too and businesses have a role to play in this. The sophistication of management practices in place within businesses can have an impact. A closer look at the World Management Survey¹ shows that Greece ranks the lowest amongst our sample in the quality of management practices in manufacturing organisations.

...but productivity growth has lagged behind in services

But what about the rest of the economy? Around three quarters of the Eurozone's economic output, and of total hours worked, is in the services sector, which makes it the biggest influence on economy-wide labour productivity.

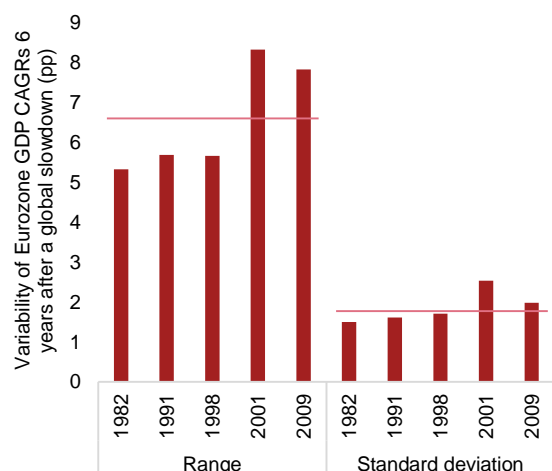
Figure 3 shows that, with the exception of Greece, labour productivity growth in services lagged behind the manufacturing sector. We think there are two main reasons for this trend. First, unlike for the goods market, the EU is still a long way from completing the Single Market for services. A possible implication of this could be that businesses adjust to competitive forces slower than they would have under a freer regime. Second, there are some sector-specific reasons that could also explain this trend. For example, much of the services sector is relatively labour-intensive, with less scope for gains from technological advances. The financial services industry has also been subject to more stringent regulations after the crisis, which may be justified in terms of resilience and reducing systemic risk to the wider economy, but could also be having some adverse effect on productivity by restricting the activities they can undertake or deterring innovation.

But with the Eurozone economy experiencing an uptick in fortunes, the environment is ripe for sectors like financial services and business services, whose fortunes are closely linked to that of the wider economy, to increase their activities and get the most out of their skilled workforce.

¹<http://worldmanagementsurvey.org/>

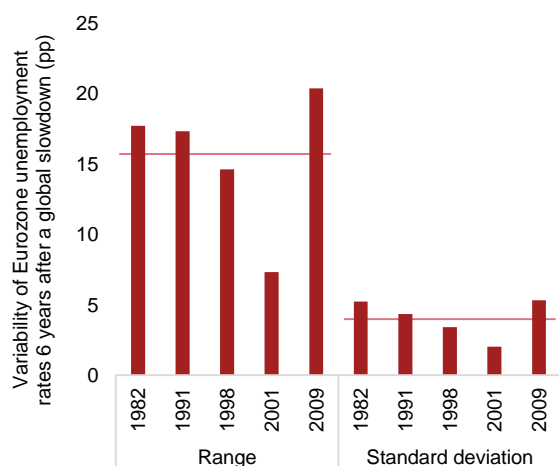
The kaleidoscopic recovery in the Eurozone

Fig 4: The current recovery is the second most variable in GDP terms in over 30 years



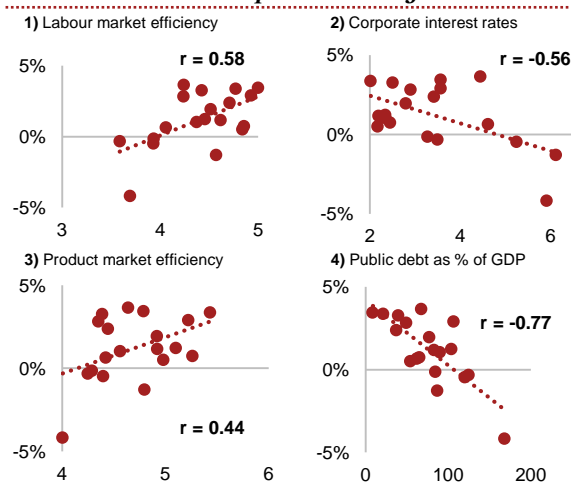
Sources: PwC analysis, IMF

Fig 5: This recovery has seen unemployment variation reach a historic high



Sources: PwC analysis, IMF

Fig 6: Labour and product markets and corporate interest rates can all impact real GDP growth



Notes: The y-axis on each chart above shows the 2009-2015 real GDP CAGR; a higher score on the labour and product market efficiency indicators represents more efficient markets.

Sources: PwC analysis, WEF Global Competitiveness Index, ECB, IMF

The Eurozone is growing faster, but is it growing evenly?

The economic recovery in the Eurozone picked up some momentum last year. In 2015, real GDP grew by 1.6% per annum and we expect this pace to continue into this year – Eurozone GDP grew by 0.6% in quarter-on-quarter terms in the first quarter of 2016. However, a key question is how economic growth has been distributed across the various Eurozone member states.

To answer this we calculated the variation in real GDP compound annual growth rates (CAGRs) and unemployment rates across the 19 Eurozone economies and compared it to other global economic slowdowns at the same stage of the economic cycle.² We used the range and standard deviation as measures of variation in our analysis.

The recovery is unevenly spread in terms of jobs and economic growth

Figure 4 shows that the variation in real GDP growth across economies is currently higher compared to most other global economic slowdowns. For unemployment, the variation is even more exaggerated – Figure 5 shows that both the range and standard deviation for unemployment are at a historic high compared to other recoveries.

Some of this picture is to be expected. At the peak of the financial-debt crisis, the Eurozone recovery was two speed with a stronger core and a weak and contracting periphery. Between 2008 and 2013, the core (Germany, France and the Netherlands) grew at an annual average rate of 0.4% whereas the periphery (Italy, Spain, Ireland, Greece and Portugal) contracted by 1.6% on average each year. But as the recovery in the Eurozone took hold, we would have expected some of this variation to be gradually eroded. So what has driven the continued variation in growth rates that we have observed?

Labour, capital and product market characteristics affect growth rates

We think the most important reason for this variation in growth rates is related to the structural make-up of the individual economies. For this analysis, we have focused on two of the largest inputs for any business – the labour market and the capital market – and a key output source for many businesses – product markets.

For example, on labour market efficiency, our correlation analysis (see Figure 6) shows that flexible and efficient labour markets have a strong impact on GDP growth. Countries that score poorly on the labour market efficiency indicator, including Italy, Greece, and Portugal, are among those that have struggled the most since the crisis in creating economic growth and jobs.

Also, the cost of and access to capital markets matters to businesses. Despite being in a monetary union, the market interest rates charged to businesses vary depending on their location. For example, corporate interest rates currently stand at 1.7% in France, but are markedly higher in Portugal (3.3%) and more than double in Greece (4.4%). This has implications for economic performance as academic research has shown that a higher cost of finance can make it more expensive to invest and so create new jobs.³

Many businesses, particularly those in the manufacturing and retail and wholesale trade sectors, rely on well-functioning product markets to sell to. Our analysis shows that there is a strong correlation (with a coefficient of 0.8) between countries scores on the labour market and product market efficiency indicators. Thus policymakers should ensure that reforms aimed at improving efficiency should be implemented across both labour and product markets in tandem to fully reap the longer-term benefits that could accrue.

In addition to these structural economic factors, political stability can help to explain the variation in economic performance across the Eurozone. Using our country risk premium estimates, which are a measure of political uncertainty, we find that there is a negative correlation between GDP growth and political upheaval.

Deleveraging could be a drag on growth in peripheral economies

This variation is unlikely to fade away in the short-term due to weaknesses that still exist across the bloc. One such area of vulnerability is the high public debt levels in some of the weaker economies. For example, in Greece, Italy and Portugal, general government gross debt exceeds 100% of GDP. To get this ratio down, other sectors of the economy including households, non-financial corporations and local banks may have to contribute more through higher taxes, which in turn could lower economic growth as consumption and business investment are dragged down. The alternative, government spending cuts, can also have a dampening effect on growth, particularly in the short term.

The time for reform is now

In summary, differences in the labour, product and capital markets across Eurozone economies have resulted in a high degree of variation in economic performance across the bloc. But the gradual recovery that now seems to be underway in the Eurozone has created a window of opportunity for policymakers to implement structural reforms and so reduce these differences over the longer-term.

²The years we have chosen to represent global economic slowdowns have been referred to by the IMF in published research articles.

³Eckstein, Z, Setty, O, Weiss, D “Financial risk and unemployment”, Centre for Economic Policy Research, LSE, 2015

Projections: June 2016

	Share of 2015 world GDP		Real GDP growth				Inflation			
	PPP	MER	2015e	2016p	2017p	2018-2022p	2015e	2016p	2017p	2018-2022p
Global (Market Exchange Rates)		100%	2.8	2.7	3.0	3.0	1.7	2.1	2.6	2.7
Global (PPP rates)	100%		3.2	3.1	3.5	3.4				
G7	31.5%	46.6%	1.9	1.7	1.9	1.9	0.2	0.8	1.8	1.8
E7	36.1%	25.8%	4.7	4.6	5.2	5.0	0.4	1.5	3.3	3.3
United States	15.8%	24.5%	2.4	2.0	2.3	2.3	0.1	1.2	2.2	2.0
China	17.1%	15.0%	6.9	6.5	6.5	5.7	1.5	1.8	1.8	2.8
Japan	4.3%	5.6%	0.6	0.7	0.6	0.8	0.8	0.4	1.4	1.5
United Kingdom	2.4%	3.9%	2.3	1.9	2.3	2.3	0.0	0.6	1.6	2.0
Eurozone	11.9%	15.8%	1.6	1.7	1.7	1.5	0.0	0.2	1.3	1.4
France	2.3%	3.3%	1.2	1.5	1.6	1.6	0.1	0.3	1.2	1.2
Germany	3.4%	4.6%	1.4	1.6	1.6	1.4	0.1	0.3	1.5	1.7
Greece	0.3%	0.3%	-0.3	-1.0	0.6	2.0	-1.1	0.0	0.5	1.3
Ireland	0.2%	0.3%	7.8	5.0	3.9	2.5	-0.0	0.8	1.4	1.7
Italy	1.9%	2.5%	0.6	1.2	1.2	1.2	0.1	0.2	1.1	1.4
Netherlands	0.7%	1.0%	2.0	1.7	1.8	1.8	0.2	0.8	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.3	1.4	1.2	0.5	0.8	1.1	1.5
Spain	1.4%	1.6%	3.2	2.6	2.3	2.0	-0.6	-0.4	1.3	1.2
Poland	0.9%	0.6%	3.6	3.7	3.7	3.5	-0.9	0.0	1.2	2.4
Russia	3.3%	1.8%	-3.8	-1.9	0.9	1.5	15.5	7.5	7.1	4.0
Turkey	1.4%	1.0%	4.0	3.5	3.6	3.5	7.7	8.5	7.5	7.0
Australia	1.0%	1.7%	2.2	2.4	2.5	2.7	1.5	2.3	2.5	2.5
India	7.0%	2.9%	7.1	7.7	7.7	6.5	4.9	4.1	4.3	5.0
Indonesia	2.5%	1.2%	5.2	4.8	4.8	5.4	6.8	6.1	6.1	5.1
South Korea	1.6%	1.9%	2.6	2.7	2.7	3.2	0.7	1.5	1.8	3.3
Argentina	0.9%	0.8%	1.5	0.0	2.3	2.5	17.0	25.0	25.0	20.0
Brazil	2.8%	2.4%	-3.8	-3.8	-0.0	3.0	9.0	9.0	6.5	5.0
Canada	1.4%	2.1%	1.1	1.7	2.0	2.2	1.1	1.5	1.9	2.0
Mexico	2.0%	1.6%	2.5	2.5	2.9	3.3	2.7	2.9	3.1	3.0
South Africa	0.6%	0.4%	1.3	0.8	1.5	2.5	4.6	6.2	5.8	5.5
Nigeria	1.0%	0.7%	2.7	1.5	3.3	3.5	9.0	11.5	12.0	10.5
Saudi Arabia	1.5%	0.9%	3.4	1.3	1.5	2.5	2.2	3.5	3.2	2.5

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has declared a national statistical emergency, and as such, GDP and inflation data releases have been suspended. Therefore our projections are based on the latest available data from 2015. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0.25-0.5% (December 2015)	Rate rise expected later this year	14-15 June
European Central Bank	0.0% (March 2016)	No rise until after March 2017	21 July
Bank of England	0.5% (March 2009)	No immediate rate rise likely	16 June



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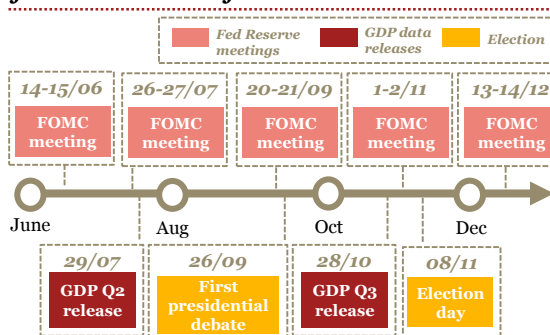
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Chart of the month

The US Federal Reserve will have an opportunity to raise the interest rate at its June monetary policy meeting.

But with softer economic data coming through and the impending election in November, we now think that the next rate rise will be in December.

Chart of the month: US policymakers have a busy few months ahead of them



Sources: Federal Reserve, US BEA

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