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Focus on Eurozone: Contraction Deepening

Highlights:

- *A deeper but not yet precipitous contraction is being signaled by the latest survey data, with signs of buckling within Germany.*
- *Pressure increases on the ECB to ease credit, lower a cut in rates likely and perhaps even more unconventional measures. A lower cut in policy rates may do little good, increasing speculation of an unconventional move.*

Amidst the worries about the upheavals that may be forthcoming--Greece default and then leave the Eurozone--last week brought reminders that activity may be contracting even faster. Indeed, the May flash PMIs suggest that Eurozone economic activity is contracting not on more clearly so but also on a broader basis geographically, now embracing weakness in German manufacturing. Admittedly, alternatively-sourced survey data from the likes of Germany suggest the PMI data may be exaggerating the extent to which downside risks have materialized. But even the May Ifo numbers pointed to a significant fall back in growth outside of services, echoing the basic trend in German PMI numbers.

Regardless, markets will note that the aggregate PMI reading for the Eurozone softened for the fourth successive month and to a degree last seen three years ago.

Manufacturing Under-performing

Specifically, the manufacturing PMI fell for a third successive month, falling 0.9 point to a three-year low of 45.0. Notably, while the headline figure therefore moved even further below the long-term average, there were more ominous signs offered by parts of the survey break-down, including a steeper and broad fall in overall orders which led to a continued fall in backlogs, with the ensuing weakness in the forward-looking orders/inventory ratio auguring ill for output in coming months, with continued weakness on the job front as well.

Meanwhile, the flash services PMI also undershot expectations in sliding further from the five-month high set in January. Indeed, it fell 0.4 point to 46.5, a second successive drop and a seven-month low. One area of optimism was some slight recovery in business expectations. The under-performance of manufacturing is the most marked since early-2010, a surprising result given the obviously more domestic focus of services.

Is Germany Buckling?

These PMI flashes will obviously cause increasing cause for concern, especially given the perturbing signs offered for German manufacturing. As has been stressed before, it may be wrong to use these overall PMI numbers to try and calibrate the extent of any further contraction in activity. In the last recession, the PMI numbers very much understated the extent of the downturn as portrayed by national GDP numbers (see upper chart).

DE View: Eurozone GDP to fall 0.5% Q/Q in Q2

However, the PMI data have a better short-term track record against GDP numbers. Despite the clearer weakness seen since April, the aggregated PMI numbers still suggest that after the surprise resilience in Eurozone GDP last quarter any fresh GDP contraction into Q2 will not be that much greater

Chart 1
Survey Underestimated Last Recession!

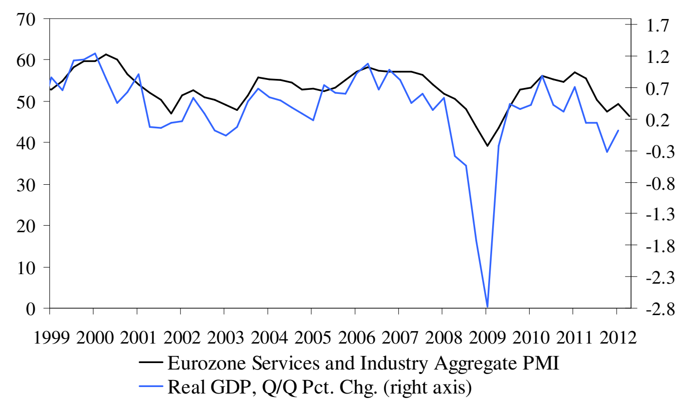
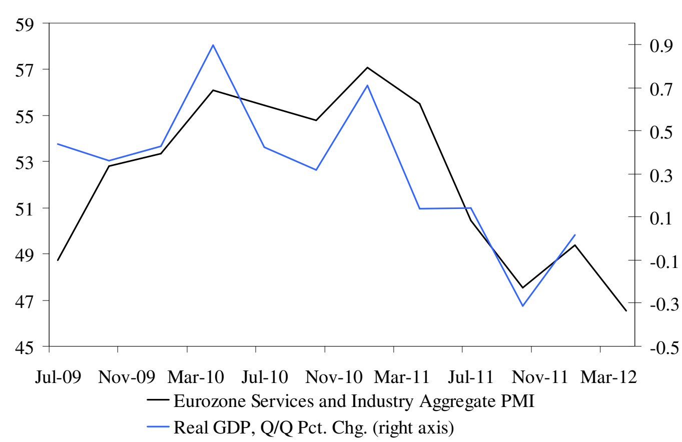
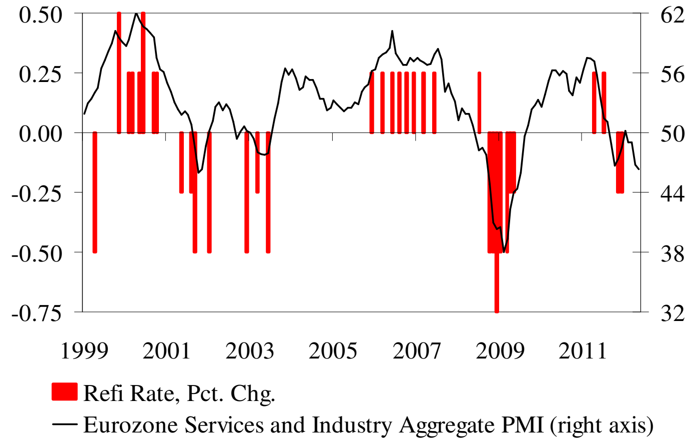


Chart 2
Clearer Contraction Emerging



than the 0.3% Q/Q drop posted in Q4 last year, with perhaps no worse than a 0.5% drop for the current quarter (see middle chart). Perhaps more importantly, these and other *survey data continue to suggest that whatever may be happening to activity in Germany and France, the rest of the Eurozone economy is still contracting clearly and perhaps more severely*. The question is if and when Germany and France buckle.

Chart 3
ECB Needs to React?



No End in Sight to Recession

Regardless, and perhaps more importantly, the PMI data show no sign *that the on-going recession that most of the Eurozone is in has no end in sight*. As a result, the likelihood is growing that the (more sizeable) drop in Q2 GDP many forecasters will now be pointing to will be accompanied by projections of more contractions in the second half of the year, meaning that the Eurozone economy may contract by some 0.5% this year on average, with the likelihood being that any recovery next year will do no more than make good that lost output.

More Pressure on the ECB

Meanwhile, in terms of monetary policy, these data will surely put more pressure on the ECB to provide more stimulus, not least in the more friendly inflation hints. Admittedly, aided by the surprise resilience in Q1 GDP numbers, at its next meeting on June 6, the ECB will not feel compelled to make any further significant downgrading to the GDP growth outlook for this year, having pared back in March its forecast to a range based around a mid-point of -0.1%. Even so, the ECB Council reaction function is very much sensitive to swings in survey data (see lower chart), with the latest readings in the PMI numbers consistent with the ECB belatedly adhering recent IMF advice for further easing, albeit probably not at the next meeting. Regardless, if and when a further token cut in official rates arrives the question will be whether any further fall in (already record-low) official interest rates will do much good at this juncture. As a result, the policy debate should be whether further unconventional easing is needed.