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MOODY'S ANALYTICS EURO ZONE OUTLOOK

THE REGION'S INDEBTED NATIONS FACE A LONGER ROAD TO RECOVERY

LONDON 15 August, 2013 — Moody's Analytics, a leading independent provider of economic forecasting, has released its latest economic outlook for the euro zone. According to the report, Euro Zone Outlook: The Burden of Debt, the short-term outlook for the euro zone has improved, but high levels of public and private debt continue to weigh on consumption and investment in many countries.

The improved short-term outlook for the euro zone reflects that its GDP unexpectedly increased 0.3% in the second quarter of 2013, according to preliminary estimates. Germany grew 0.7% from the first quarter and France 0.5%, while output declined 0.2% in Italy and 0.1% in Spain.

Among the four biggest euro zone economies, only Germany and France are set to grow, while most of the currency union's southern members remain in recession. The region's North-South division persists.

"The recovery is long overdue and appears modest at best. Fundamental problems still need to be addressed. The high levels of public and private debt in the euro zone resulting from the sovereign debt and banking crisis remain a key concern," says Petr Zemcik, Director of European Economics at Moody's Analytics. "High debt weighs on growth, making households less likely to borrow and spend, reducing corporate investment and restraining government spending. Restructuring both public and private balance sheets may be the only solution for countries affected by high levels of debt," adds Mr. Zemcik.

According to the report, excessive volumes of old debt impede the flow of new credit necessary to finance future growth, particularly in Spain, Italy, Portugal and Greece. The historically low monetary policy rate has not translated into lower borrowing rates for consumers or businesses in countries where banks are perceived as riskier, highlighting the European Central Bank's ongoing transmission problem. The banks' plight, in turn, stems from their fiscally weak governments, which are unlikely to be able to back financial institutions in trouble.

Moody's Analytics notes that the problem could be alleviated if the euro zone moved more aggressively toward a regional banking union, with a common deposit insurance scheme, recapitalisation fund, and a clear region-wide restructuring mechanism. But Germany has resisted such proposals to date, pushing instead for a less centralised system.

Meanwhile, the European Central Bank is considering solving the transmission problem indirectly through the asset-backed securities market, making targeted purchases of these securities from peripheral economies. Since the assets backing such securities are loans to small firms, this amounts to indirect lending from the ECB. Yet the volume of such lending is still low, leading to falling levels of investment through the middle of 2013. A pickup is expected by the end of the year.

The central bank's current policy rate stands at 0.5% and is unlikely to be lowered, despite the region's low inflation rate and ongoing recession. Moody's Analytics notes that, in any case, lowering the rate would likely not boost lending and investment, because of the transmission problem.

Improving economic conditions in some parts of the world may soon favour higher debt yields, which will raise borrowing costs and affect currency exchange rates. US rates could rise as the Fed moves to slow its purchases of long-term debt, which in turn could push up the yields on European government bonds. This would likely push the euro lower against the US dollar. The impact on the euro zone would differ by country, with output growing in Germany, remaining flat in France, and declining in Spain and Italy, where debt levels are much higher.

According to the Moody's Analytics report, the euro zone's economy likely started to grow again in the third quarter, but is still expected to end the year 0.5% smaller than it began. It will take until 2015 for output to return to 2008 levels. The euro zone's growth will mainly be driven by increased demand from the US and emerging economies. A slowdown in these markets is the main risk to the outlook, along with any deterioration in the euro zone's internal situation.

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