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Markit Economic Research

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Eurozone

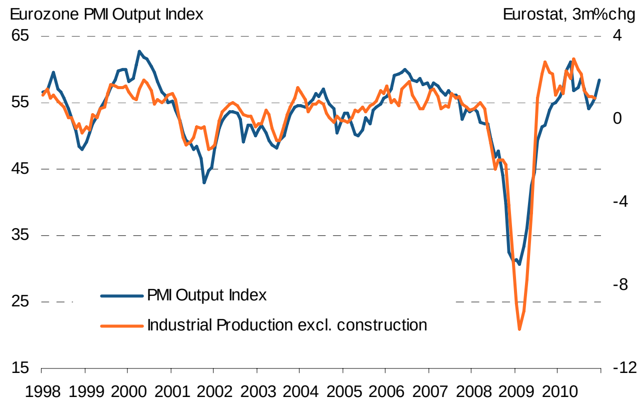
Further evidence of Eurozone production surge, but national divergences have widened as periphery loses out to Eastern Europe

- **Eurozone periphery stagnated in December.**
- **Manufacturing in Central and Eastern Europe outpaced euro periphery.**
- **Financial markets reflect reversal of fortunes.**

Manufacturing upturn confirmed

Eurozone industrial production surged higher than expectations in November, jumping 1.2% on the month against a consensus forecast of a 0.5% rise. Manufacturing rose 1.0%. The data support the upbeat picture presented by Markit's PMI surveys, which have shown a steady re-acceleration of growth since September's 11-month low. The PMIs (data for which are available up to the end of 2010) also suggest that the rate of official manufacturing output growth will have picked up further in December.

Eurozone manufacturing

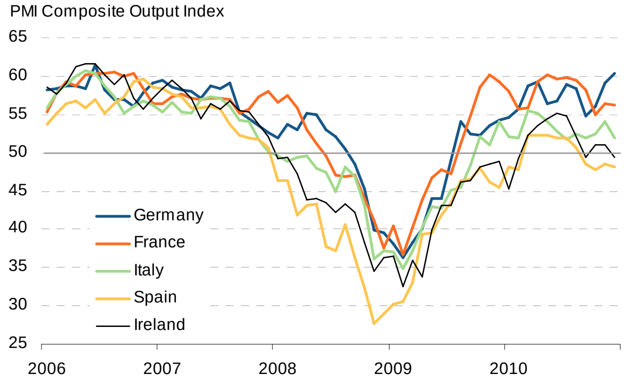


Sources: Eurostat, Markit.

Multi-speed Eurozone

Although the manufacturing PMI surveys signalled that the rate of expansion accelerated again in December, they also showed a further widening of growth divergences between the national economies in the single currency area. Overall economic growth (as measured by the weighted average of the output indexes from the manufacturing and service sector PMI surveys) surged in Germany, hitting a new post-crisis high and signalling one of the strongest expansions seen since the survey began in 1998. The recovery also remained buoyant in France, which was a reassuring surprise given the harsh weather seen in the north and the ongoing disruptions to business caused by pensions-related protests. In contrast, the rest of the zone stagnated, with weak domestic demand meaning some countries face the real risk of double-dip recessions. Spain, Greece and Ireland contracted and growth slowed alarmingly in Italy.

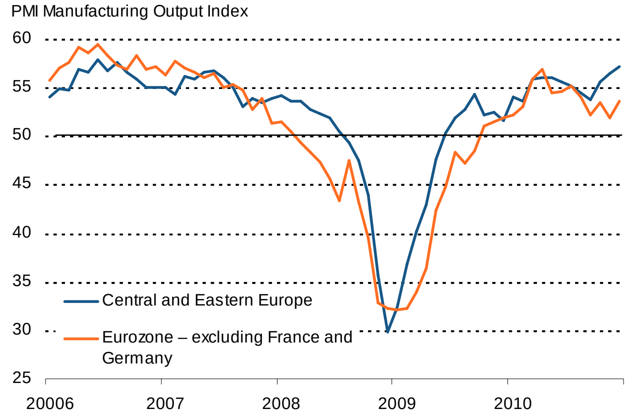
Economic growth divergences



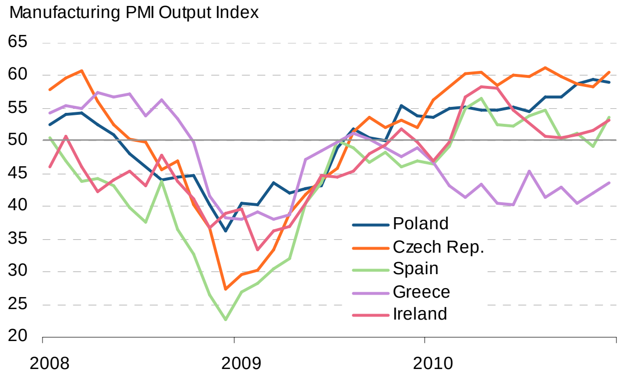
Periphery losing out to Eastern Europe

Worryingly, even the manufacturing sector in the Eurozone periphery is struggling to reap the benefits of faster economic growth in other countries, such as Germany and the emerging markets. Although the periphery saw manufacturing output rise in December at an increased pace, the rate of expansion was well below that seen in Central and Eastern Europe, which saw production growth accelerate to the fastest since August 2006. Poland and the Czech Republic have seen especially strong rates of expansion, reaching near-record highs for the PMI surveys late last year as manufacturers benefitted from surging exports to Germany in particular.

Manufacturing output by region



Manufacturing output by country



The divergence between the manufacturing performances of these countries highlights the need for the peripheral Eurozone countries to boost productivity and competitiveness in order to reap the benefits of the current upturn in global trade flows.

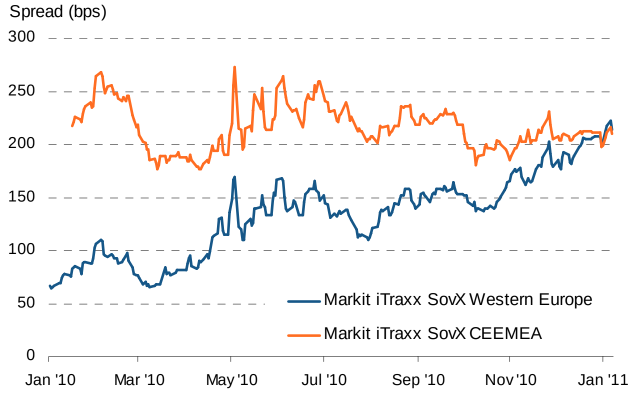
Default risk rises in Western Europe

Not surprisingly, bond and credit markets have responded to the worsened economic situation in the Eurozone's periphery. The cost of insuring against default for Western European government bonds rose above that for Central and Eastern Europe for the first time since the risk could first be compared in January 2010, as measured by Markit's iTraxx indices[1].

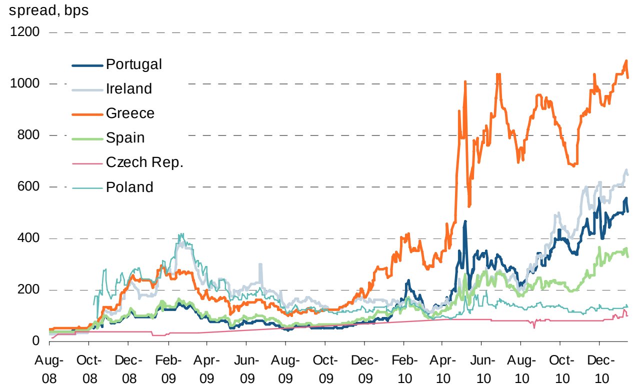
[1] *The Markit iTraxx SovX Western Europe index is a tradable index made up of the 15 most liquid sovereign CDS in the region. This includes countries both in the Eurozone and outside (e.g. UK, Norway, Sweden). As such, it is a reliable indicator of sovereign risk as perceived by the credit markets. It has been trading since September 2009 and has proved very successful.*

The Markit iTraxx SovX CEEMEA index is a tradable CDS index consisting of 15 liquid sovereigns from Central and Eastern Europe, the Middle East and Africa.

Sovereign credit risk (CDS spreads)

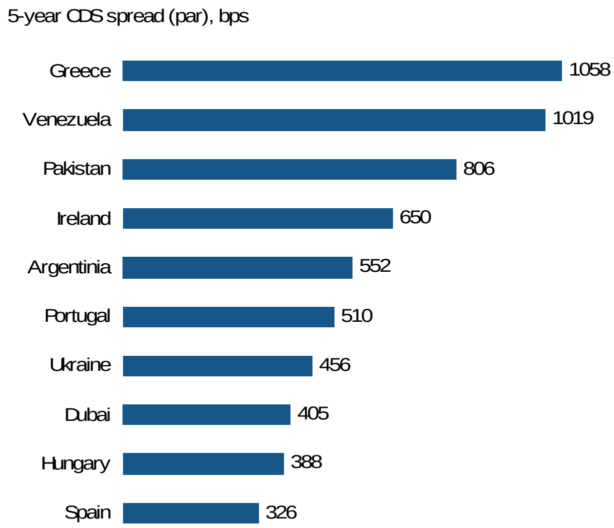


CDS spreads by country



Source: Markit.

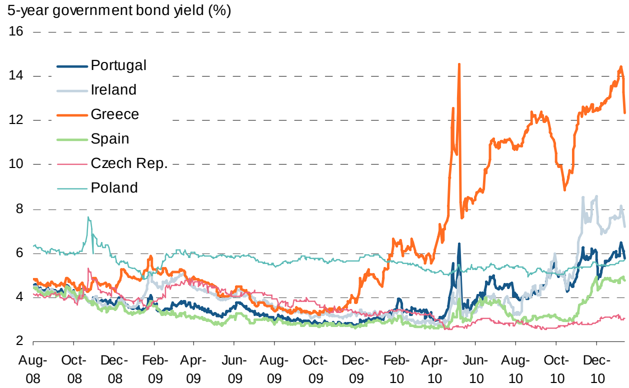
Ten widest Sovereign CDS spreads



Source: Markit.

The start of 2011 has also seen government bond yields in the Eurozone periphery rise sharply. Yields on five-year bonds in Greece, Ireland and Portugal hit 14.4%, 8.2% and 6.5% respectively, at or near record highs since the introduction of the euro. Meanwhile, yields in Spain hit 5.0% at this Monday's close, the highest for almost nine years.

Government bond yields (5-year)



Not out of the woods

Despite the fact that bond yields and the fear of default fell in response to Portugal's successful debt auction and reassuring noises from the Portuguese government in relation to its efforts to reduce the budget deficit, the divergence signalled by the PMIs and the lack of competitiveness of peripheral Eurozone countries raises the risk that economic growth may come in below that assumed in government deficit reduction plans in many countries this year. For example, Spain's budget reduction plans assume 2.0%–2.5% GDP growth in 2011 and Ireland assumes a 1.75% expansion.

Slow growth also puts a greater onus on additional public sector cost-cutting to reduce debt rather than relying on the greater tax-take which stronger growth creates, leading to a further weakening of demand, in the short-term at least.

The data will therefore continue to be scrutinised for signs of an improvement in growth based on greater competitiveness, as a sign that deeper structural issues have begun to be addressed in the highly indebted peripheral countries.

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