Euro-Zone Economy Shrinks Again

FRANKFURT—The euro-zone economy contracted in the third quarter, offering little hope for the worsening global environment as rising unemployment and fiscal austerity across much of Europe undermine the region’s fortunes.

The euro zone hasn’t grown for four straight quarters and the latest decline in gross domestic product was the second straight. Economists often define recession as two straight quarterly GDP contractions.

Europe’s debt crisis, which has pushed unemployment higher and forced governments to enact tax increases and spending cuts, is largely to blame for the malaise.

Germany and France, the euro-zone’s two largest economies, posted modest growth in the quarter. But GDP for the 17-member currency union as a whole slid 0.2% from the previous quarter, at an annualized rate, according to calculations by J.P. Morgan based on figures from the European Union’s statistics agency. GDP fell 0.7% in the second quarter.

"We can’t say we are living in a euphoric period of our history," said Maurice Lévy, chief executive of French advertising agency Publicis Groupe.

The recession has been mild so far, with GDP down just 0.6% from last year’s peak. That is a fraction of the 5.6% that was sliced off by the 2008-2009 recession. But the pace of contraction may accelerate in the fourth quarter, economists warned, and grip Germany and France.

Europe’s weakness has already touched other corners of the global economy. Chinese exports to the region are
off sharply this year, contributing to that nation's growth slowdown. Slower Chinese growth, in turn, has hampered the economies of commodity producers around the globe.

Japan's GDP shrunk an annualized 3.5% in July-September, the biggest drop since the country was hit by the March 2011 earthquake and tsunami.

The U.S. economy has shown signs of improvement in recent months—largely driven by rising consumer demand. In the third quarter, U.S. GDP grew at a 2% annualized rate. But problems in Europe could threaten those gains. The European slump is weighing on U.S. companies. Goodyear Tire & Rubber Co., for instance, in October reported a 30% drop in third-quarter profit—which it attributed to weakness across the Atlantic. This helps explain why U.S. companies remain cautious about investing and hiring, at a time when U.S. consumer confidence is running at its highest level since mid-2007.

While most economists in the November Wall Street Journal forecasting survey don’t expect the U.S. to follow Europe into recession in the next 12 months, an escalation in the euro-zone crisis is the second-most-cited potential trigger for a U.S. downturn. Most respondents said the biggest downside risk to the U.S. was the package of spending cuts and tax increases known as the fiscal cliff, but around a quarter of the 42 economists surveyed called Europe the top threat.

The GDP decline was limited by Germany and France, which combined account for half the region’s output. Each advanced 0.9% from the previous quarter, at an annualized rate, driven by consumer spending and exports. But the bloc's next three largest economies—Italy, Spain and the Netherlands—all shrank, with Dutch GDP down at a 4.1% pace. Uncertainty over the tax treatment of mortgage interest has hit the Dutch housing market and consumer spending, which fell sharply, economists said. Austrian GDP fell, too.

With parts of Europe’s prosperous north buckling, Germany will have to shoulder even more of the burden to generate growth.

"We are hanging in and keeping our fingers crossed, but so far things are going well," said Bernd Supe-Dienes, managing partner of German industrial-knife manufacturer Dienes Group, based outside of Cologne. Some of his customers in the machinery business "are being a little more cautious" amid a weaker global economy.

Mr. Supe-Dienes plans to ramp up marketing efforts to attract new business, and says he has no plans to reduce his 420-person workforce. "We expect a slowdown, so we are careful with investments and are trying to preserve our cash position," he said.

French business leaders are more downbeat, worried that uncertainty over tax and labor policies will weigh on investment. "Confidence fell over the summer as business leaders were scared by the government discourse which appeared to be attacking business by blaming it for the crisis," said Pierre-Antoine Kern, who runs a company supplying telecommunications services to businesses around Dijon, in France's Burgundy region.

French President François Hollande has made reviving growth a cornerstone of his presidency. Last week, the government announced a plan to cut €20 billion ($25.5 billion) in taxes paid by employers, offset by spending cuts and an increase in value-added taxes. But business groups say this is insufficient to bring French labor costs into alignment with Germany's.

Mr. Kern also complains that France’s labor laws make hiring risky. He once got stung for €13,000 by a former employee in a legal dispute. "French labor laws are like when we built the Maginot Line. It in fact stops nothing, except employment," he said.

Whether Europe's downturn meets the technical definition of recession is largely irrelevant, especially in crisis-torn Southern Europe. Stagnation and contraction in much of the euro bloc have pushed unemployment to 11.6%, a record. It is more than 25% in Spain and Greece.

Spanish and Italian GDP each contracted for a fifth straight quarter. Spain is still reeling from its collapsed housing bubble. Italy is constrained by rigid labor markets and other inefficiencies that hamper its competitiveness.

Azkoyen, a small Spanish manufacturer of vending machines and security systems, said Thursday it swung to a loss of €464,000 in the first nine months of the year from a net profit of €150,000 one year earlier. The company—based in the wealthy northern region of Navarre—has been hit by falling sales in Spain, Portugal and

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Italy. Its Italian unit, Coges, has been hurt by what Azkoyen called the "sudden impact" of the economic crisis in that country, so its efforts are currently focused on markets outside Europe.

Whatever the root causes, these downturns make it difficult to reduce debt. Falling GDP and rising unemployment drain government coffers of tax revenue and increase social spending. A loss of investor confidence pushes borrowing costs higher, adding to the debt burden.

European Central Bank President Mario Draghi cited a "vicious circle" plaguing crisis-hit countries in a Thursday speech defending the bank's commitment to purchase open-ended amounts of government bonds, provided countries first seek aid from Europe's rescue fund.

"Economic growth was falling. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates," he said, leading to higher unemployment and reduced spending.

Mr. Draghi said last week that the central bank was monitoring the economy and stood "ready to act" if needed. But he offered little hope for interest-rate cuts or other new stimulus measures, saying monetary policy was "already very accommodative."

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