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Markit Economic Research

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Eurozone

Europe's financial crisis hits economic growth in May

The **Markit Flash Eurozone Composite Output Index** fell from April's post-recession peak of 57.3 to 56.2 in May, signalling a slowing in the rate of growth of business activity. More worrying, the drop in the headline index masked far steeper falls in the manufacturing sector in May.

The month-on-month decline in the manufacturing Output Index was in fact the second-greatest in the survey history, following a marked slowing in growth of new orders. Both Output and New Orders indices showed the largest declines since November 2008, when business conditions deteriorated in the aftermath of the Lehmans collapse. Germany saw a particularly sharp growth slowdown in May.

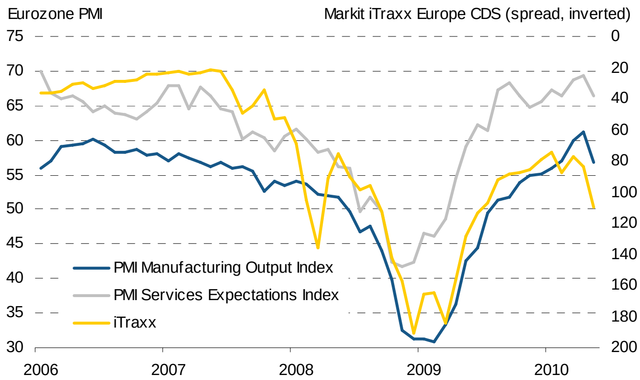
May's slowing in output and new order growth appears to have been linked to weaker growth of demand in euro countries: growth of total new orders slumped despite Eurozone manufacturers reporting that their export sales continued to grow at a pace only slightly below March's ten-year high.

It is no coincidence that the flash PMI also revealed a downturn in service sector optimism in May. Having hit the highest level for over four years in April, the Services Expectations Index (measuring anticipated business activity levels in 12 months' time) posted its largest monthly fall since October 2008 – one month after the collapse of Lehmans.

In many cases panel members attributed the downturn in confidence and demand during May to uncertainty caused by the sovereign debt crisis in Europe. This uncertainty was reflected clearly in the credit market, with the Markit iTraxx Europe Index signalling a marked increase in corporate credit default risk in recent weeks.

As the chart shows, output growth, business confidence and credit default risk have followed similar trends. Since bottoming out in early 2009, manufacturing output and service sector confidence have improved markedly alongside a reduced risk of corporate default. But all three series deteriorated sharply in May, suggesting that growing tensions in the European financial markets have translated very quickly into a worsening of business conditions.

PMIs and credit default risk

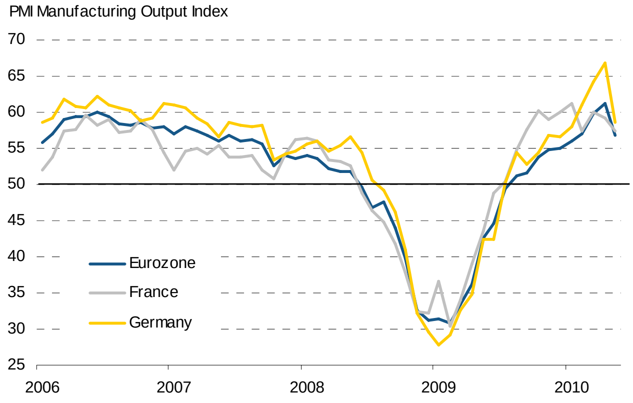


Source: Markit

The flash PMI data showed that employment rose in May across both manufacturing and services for the first time in two years. Although only modest, the increase in employment represented an important step in the sustainability and maturity of the recovery. However, employment tends to lag changes in output, and if the downturn in the rate of growth of output and new orders persists in coming months, employers are likely to revert to cost-cutting and halt recruitment.

As European governments struggle to coordinate regulatory reform and contain the sovereign debt crisis, the PMI perhaps serves as a timely reminder of the rapid impact that financial market stress and investor uncertainty can have upon business confidence and activity levels, suggesting that a failure to resolve the crisis is likely to quash the fragile Eurozone recovery and clearly heightens the risk of a double-dip recession in Europe, with knock-on effects to the global economy.

Flash PMI manufacturing output



Source: Markit

Flash PMI manufacturing orders

Source: Markit

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