

# Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47  
Phone -49-69-95 92 54 85 , Fax -49-69-95 92 54 86  
E-mail: [dwermuth@wermutham.com](mailto:dwermuth@wermutham.com)

## The two faces of euroland's economy

January 6, 2006

1. Europe's economy seems to gain further momentum. **Recent data, including key leading indicators, have all surprised on the positive side.** A few more months of such data and analysts will begin to forecast a self-sustained recovery, a recovery that is less dependent on foreign demand and more balanced with regard to the sources of growth than today. It is still early in the game, and this could be another false start if households refuse to become more optimistic. So far, job risks remain high, and real incomes continue to stagnate. Unless there is some progress on either front consumers may well stay on the sidelines.
2. **The corporate sector, however, is buoyed** by a competitive exchange rate, after last year's devaluations, the growth of world trade which is still running in the order of 8% y/y in volume terms, unusually low real borrowing costs, further strong earnings gains which are to a significant extent the result of the ongoing shift in the income distribution from labor to capital, sound balance sheets which have resulted from several years of deleveraging, subdued capital spending plus improved cash flows, and a big increase in stock prices which has reduced the cost of raising equity. It is almost too good to be true. Against earlier expectations and in stark contrast to the reaction of private households, firms have simply shrugged off the oil price explosion.
3. Since the rate of capacity utilization remains low given the sub-par growth of the euro area economy until the second half of last year, the **incentive to hire new workers is not particularly strong.** Even though unit labor costs have been flat recently while output prices ex energy and construction have been rising, if only by a moderate 1 ½% y/y – normally a situation that suggests an increase in labor input – firms are still able to improve profits by raising output and, in the process, tapping into productivity reserves. Their reluctance to hire is also a sign that labor supply is ample and that they do not feel that the moment has arrived where they have to compete aggressively for workers. Moreover, they may doubt that the benign foreign exchange market situation will last much longer. The stock markets certainly appreciate this strategy of boosting profits from the cost rather than the revenue side of the income statement.
4. **A look at some recent numbers confirms the impression that the corporate sector is riding high while households remain cautious, if a little less than previously.** The December manufacturing purchasing managers' index (PMI) for the euro area had been up once more, to 53.6, which is well in expansionary territory. That the new orders component has been particularly strong bodes well for the continuation of what has become a well-established upward trend. At 56.8, the services PMI has also reached a fairly elevated level, and the

strength of its “new business” subcomponent suggests that there are probably even better numbers ahead. These data are supported by the December results of the EU Commission’s Business and Consumer Surveys which show that economic sentiment has improved further and is now slightly above its long-term average. Industrial confidence in particular has been rising quickly, but consumer confidence has rebounded as well from its mid-2005 lows even though it remains in deeply negative territory.

5. **Consumers are still depressed.** The new strength of the EU’s retail confidence indicator is therefore something of a puzzle. German retail numbers convey a totally different picture of consumers’ willingness to spend than these surveys would suggest: in volume terms, they had declined by no less than 1% m/m last November, and the October/November average has been down 1% from the third quarter average.
6. **What is happening in euro area labor markets?** The quality and timeliness of statistics continues to be almost of third world standards. We just got German employment numbers for November – the most up-to-date statistics of the region. They suddenly show that the number of jobs has fallen by 0.5% from a year ago whereas until October the message had been that employment had been more or less unchanged. Between one release and the next, 200,000 jobs had simply disappeared. Now the message is that, seasonally adjusted, employment is depressed but has stabilized on its low level since last June. Accordingly, the next productivity number will look much better. **How about euro area employment?** Here the latest statistics are for the second quarter of 2005 (0.2% q/q and 0.7% y/y) – they are more than six months old by now. To put this into perspective, the US payroll numbers which will be released later today, are for December, a month that ended only six days ago.
7. **Euro area unemployment, meanwhile, continues to decline.** From the last high of 8.9% in October 2004 it has fallen to 8.3% in November, and Germany’s unemployment rate has come down from a high of 12.0% s.a. in March 2005 to 11.2% in December. Note that the standardized EU unemployment rate for Germany is only available through August 2005 when it was 9.3% - which was 2.3 percentage points less than the August unemployment rate as defined by the German Statistical Office.
8. **All across the euro area, labor market numbers are heavily manipulated as well as outdated and thus of very little use for policy makers.** Why is there so little progress on this front? We are not talking rocket science here. The bottom line is that we do not really know what is going on in euro area labor markets. Anecdotal evidence suggests that it remains difficult to find a good job and that wages are under pressure, especially for new graduates, but also for the unskilled and the old.
9. Output growth continues to strengthen a lot in Germany, and to a much lesser extent in the rest of the euro area. The decline in unemployment would normally be reflected in a much larger rate of growth of production which is another sign of the unreliability if not meaninglessness of labor market data. **Euro area real GDP had been up 0.6% q/q in Q3, on the back of a 0.75% q/q increase in industrial production. Such a rate of growth has probably been repeated in Q4,** given that German industrial production for October and November exceeded the Q3 average by 1.5%, and that incoming orders have been so strong. In volume terms, they were up by no less than 13.5% y/y in November, after 9.3% in October.
10. For the ECB such numbers must be reassuring because they suggest that the output gap is finally shrinking at least somewhat. **The likelihood of further rate hikes has thus increased, with the next one, to 2.5%, perhaps on March 2.** The ECB can afford to tighten in a

“measured way”, though, because the inflation outlook has improved recently after energy prices have stabilized and the euro has strengthened a little. On balance, monetary conditions are stimulative and the risks of a monetary overkill are thus limited.

11. **Subdued underlying inflation, especially wage inflation, does not require any aggressive tightening at this point.** Nor does the present level of the exchange rate call for any actions by the central bank – it is in neutral territory both with regard to its impact on inflation and on the balance on current account (which is only slightly in surplus). A gradual approach to 3%, the level which the ECB considers to be neutral at this point, seems to be the most plausible policy scenario for this year. In a full-employment situation, “neutral” probably means something in the neighbourhood of 4%. We are not anywhere near that.
12. **Investors in European bonds are very relaxed about future inflation and assume that real growth will not be much above 1%.** At 3.27%, 10-year government bond yields are getting near their all-time lows again, but further significant declines are unlikely in the near term unless the euro exchange rate appreciates more strongly. This, however, is not a high-probability scenario as long as the strength of the US economy suggests that the gap between central bank policy rates will widen rather than shrink in favour of the US, ie in the near term.
13. All this means that **euro area stock markets remain well-supported** by rising corporate earnings, low valuations and a competitive exchange rate. But as we have seen last year, even a strong performance of equities has not been enough to trigger massive capital inflows which might have pushed up the euro exchange rate. It is just one factor among several. A more important development to watch this year will be changes in the composition of currency reserves of large Asian central banks. Like Godot, this has been talked about for a long time yet has never seemed to play a significant role. 2006 may be another year where exchange markets are mainly driven by growth and interest rate differentials. **The euro will thus not be particularly strong during the first half 2006.**