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Euro area: accelerating growth, decelerating inflation

March 31, 2006

1. Finally, it seems to work – to get the economy going without help from the consumer and the public sector. After almost five years during which real GDP has grown by less than potential output, ie after five years of ever larger output gaps, the **likelihood of faster growth and a better utilization of resources has increased noticeably**. There has been one false start before, between Q3 of 2003 and Q2 of 2004, a period of fairly high growth followed by a year of sub-par quarterly growth rates of 0.3%, so I hesitate to forecast a robust and lasting expansion, but **some key leading indicators are clearly and strongly pointing up**.
2. For one, **European liquidity has been rising relatively fast for several years** in response to the ECB's near-zero real interest rate policy. In February, M3 exceeded its year-ago level by 8%. Given the high unemployment rate, the stagnation of real wages and the intensive competition in internationally traded goods and services this has not led to an acceleration of consumer price inflation. Ex-energy and some other volatile components, CPI inflation is not only low, at 1.2% y/y, it has actually been close to zero on an annualized basis since last spring.
3. **Excess liquidity has moved into assets**. Their prices have now been on the rise for several years. **Housing in particular has been supported**, with annual house price inflation of about 7% for the past four years. Banks' lending for house purchases has remained buoyant until the very latest (11.8% y/y).
4. **Another outlet for liquidity has been the European stock market which has gained 106% since its low three years ago, and 29% over the past twelve months**. Even bond portfolios have performed well, notwithstanding recent losses. All this implies that there have been large wealth effects for consumers which, in terms of confidence, have been a partial compensation for the slow growth of labour incomes. For firms, the stock market rally and low real interest rates have meant that the cost of funding capital expenditures has been attractively low.
5. **Incoming orders to manufacturing also suggest that growth in Europe is strengthening**. In January, for the euro area as a whole, these were 7% y/y in nominal and about 6% y/y in real terms. The numbers for Germany were even higher: the annualized rate of growth between Aug/Oct and Nov/Jan had been no less than 17.2% in nominal, and 15.5% in volume terms (The difference between the two numbers shows that output prices in manufacturing are rising at an annualized rate of only 1.5%). Most of the strength in demand comes from export orders, but domestic demand has begun to recover as well. **German housing had long been a drag for euro area growth – this is no longer the case**. The volume of orders for housing has been +3.1% y/y for the four months ending in January.

6. **Finally, survey indicators have been on the rise for about one year and exceed their historical averages by now.** This includes the surveys of the EU Commission, the OECD, the ZEW and especially Germany's Ifo Institute whose business climate index has taken off like a rocket. Firms are very profitable, very competitive at the present exchange rate, and expect to do well for the foreseeable future. They are therefore planning to increase their spending plans. Consumers are also gradually – very gradually - becoming more confident.
7. **Capital spending has been rising at quarterly rates of about 1% since last spring.** On the basis of the numbers presented above, **analysts would have expected much more rapid growth.** One reason is that there is still a lot of slack in the business sector and earnings can therefore be boosted considerably without stepping up capital expenditures. Firms are very cash rich by now and one can expect an investment boom as soon as they come closer to their capacity ceilings. For now, they prefer to distribute a larger share of the unused cash to their shareholders and to fill their war chests for acquisitions of other companies, at home and abroad.
8. **In spite of all their well-founded optimism firms may also be weary of the sustainability of the present order boom because both governments and private households are basically still reluctant to increase expenditures by much. Together they account for no less than 80% of total demand.** The final purpose of production is consumption. So if the latter does not have a solid economic underpinning in the form of rising employment, real wage growth and a rebound in tax revenues, it will remain risky to increase capacities.
9. Over the past three years, real household consumption growth has averaged 1.1%, and government expenditures 1.3%. There are **some signs that euro area consumers are about to become less reluctant** – such as rising retail sales in Germany -, but this takes place **in an environment of slow employment growth (0.7% y/y), high unemployment (8.3%), and stagnating real wages and salaries.** The monthly German consumer sentiment survey provided by GfK has been up five times in a row but is still near recession lows. Governments, on the other hand, remain constrained by the ill-conceived Stability and Growth Pact.
10. It is conceivable that real **euroland GDP will expand at quarterly rates of 0.6 or even 0.8% this year, but there are no signs yet that it is gaining broadly-based momentum. The ECB is certainly determined to prevent this:** it has more or less clearly announced that interest rates will rise by 25 basis points each quarter, perhaps even more quickly if data turn out stronger than anticipated. Today's refi rate of 2.5% may look low, but in real terms it is already in positive territory, especially if compared to core inflation. The punch bowl is being taken away, to quote a former Fed chairman, before the party has begun. Europeans are not allowed to get drunk, not even a little bit.
11. It is not particularly helpful that **oil prices have begun to rise again while the exchange rate continues to move sideways. Euroland imports inflation,** and the terms of trade deteriorate - which is another way of saying that consumers are losing purchasing power. Nor will it help that Germany's grand coalition government has decided to raise the standard VAT rate from 16% now to 19% next January which will be another shock to households – and convince the ECB that interest rates should be raised. Why? Because euro area headline inflation will go up 0.4 percentage points as a result. German consumer purchases will be brought forward into 2006 by this prospect, which contributes to fairly strong growth this year, but the bill in the form of weaker demand will have to be paid in 2007.

12. On balance, it is **likely that economic growth will indeed be robust this year**. There are two implicit but important **assumptions underlying this statement** which have not yet been mentioned: that the euro exchange rate does not appreciate by much, and that the world economy and world trade continue to grow at rates of around 4% and 8%, respectively (in volume terms). In light of the huge US current account deficit and the likely fall-out from the energy and commodity price inflation, these are heroic assumptions.
13. They are also the standard assumptions. While it is clear that the combination of rising interest rates, extremely high energy costs, asset price bubbles and America's large-scale absorption of the world's savings is an explosive mixture, no one dares to predict when the day of reckoning will come. Imbalances can persist for quite a long time and it is therefore difficult to predict when, and how, they will be unwound. It is also clear, though, that such **an unwinding, when it comes, will have disinflationary effects on euroland: World growth will suffer, energy prices will fall, the euro will rise, and wages will increase at even lower rates**.
14. **So, going forward, the risks to European inflation remain on the downside**. But even if these events do not take place this year, the outlook for inflation is still very benign. The fact that core consumer price inflation is just 1.2% y/y, and close to zero on an annualized basis since last spring, has already been mentioned. Core producer price inflation – ex energy - is equally low: 1.6% y/y in January compared to 5.3% y/y overall. The GDP deflator exceeded its year-ago level by just 1.7% in Q4.
15. Unit labour costs of 0.7% y/y and the annual increase of the compensation per employee of 1.6% y/y (in Q3, the latest available numbers) show that there is **no wage pressure**. One reason for this is the **low rate of capacity utilization: it remains at recession levels** – the other one is the depressed labour market situation. For workers, it is virtually impossible to negotiate real wage increases (unless they have some kind of monopolistic power) while firms find it just as hard to pass on rapidly rising non-wage input costs. **In euro terms, oil prices are 47% higher than one year ago while non-oil commodity prices are up 23%. If the latter start to level off or fall, which is increasingly likely after their long rally, euroland's headline inflation as well as inflation expectations will be heading south, to below 1 ½%.**
16. **10-year government bond yields of 3.78% are therefore not low any more. It is not a foregone conclusion that they will soon come down again because the ECB remains in a tightening mode as the good news on the real economy keep coming in. They may well rise to 4%, but they are getting increasingly attractive for investors who look for a fairly safe alternative. Additionally, euro denominated bonds will probably benefit from the coming shake-up of foreign exchange markets which, incidentally, will force the ECB to stop raising rates.**