

Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47
Phone -49-69-95 92 54 78 , Fax -49-69-95 92 54 79
E-mail: dwermuth@wermutham.com

ECB has gained room for raising rates, yield curve to flatten

June 1, 2006

1. **The latest statistics on the real side of the euro area economy have been better than expected while those on the inflation and monetary side have been worse. Both developments suggest that the ECB will continue to raise rates.** The recent appreciation of the euro and the correction of the stock market are not significant enough to change this view. By the end of 2006, the main policy rate will probably be at 3.25%, up from 2.5% right now. Since the long end of the yield curve will not move as much, given the strength of the currency and the improvement in government finances as a result of stronger GDP growth, the curve will flatten further.
2. To start with the real economy, **new orders to the euro area manufacturing industry have been rising considerably faster than industrial output which means that the latter has a lot of catching-up potential.** Between the third quarter of last year and the first quarter this year nominal orders expanded at a seasonally adjusted annualized rate of 12.3%, or by about 10% in volume terms, compared to 3.0% for industrial production. There must be a considerable order backlog by now.
3. This is one **important reason why business is so optimistic.** Yesterday's Business climate indicator for May, published by the EU Commission, showed that the strong uptrend which has been in place since the early summer of last year remains intact and is approaching a level last reached in the boom year 2000. So far, this optimism mostly reflects the good international competitiveness of European firms, the rapid growth of the world economy and strong profits, not yet any significant recovery of domestic demand. **The consumer confidence indicator has improved fairly steadily from its depressed level of early 2003 but it is still far below that of 2000.**
4. Actually, there are now some rays of hope in this respect. One comes from the labor **market which keeps improving gradually.** Euro area employment has been up 0.8% y/y recently, and the unemployment rate continues to fall. It had reached 8.1% in March, down from a cyclical high of 8.9% in 2004, but going by the results for the two largest economies it may well be at 7.8% by now: seasonally adjusted, France's had fallen by two decimal points between March and April, and Germany's by no less than four decimals between March and May. **This good performance is somewhat surprising: it may reflect the fact that the relative price of labor keeps falling, and that it has become increasingly easy to lay off workers after all those years of labor market reforms.**

5. Another positive sign is that **retail sales are finally improving in Germany**, the country which had long been the laggard on this front. Year-over-year, the growth rate is still very modest (1.0% for the Jan to Apr period, volume terms), but comparing the average of these four months with the preceding four month period yields an annualized rate of 3.1%. In other words, there has been a noticeable acceleration of retail sales, in spite of the energy-related stagnation of purchasing power. In the euro area as a whole, though, the picture has recently been not quite as positive as in Germany.
6. In national accounting terms, euro area real consumer demand has strengthened to 0.7% q/q in the first quarter this year, but the year-over-year rate remains a weak 1.1% which is lower than the GDP growth rate of 1.9% y/y. **The consumer is still the major drag on the overall economy, and as long as there is no decisive breakthrough in household spending, the recovery will remain precarious.** The numbers suggest that the ECB can not afford to tighten too aggressively because this could lead to a large appreciation of the euro which is the last thing the euro area needs as long as consumers are so reluctant to spend.
7. As mentioned, the news from the inflation front has not been so good. Headline **inflation has hit 2.5% y/y in May** which is now seriously above the target value of 1.8% or 1.9%. At 1.6%, core inflation remains subdued if somewhat higher than in previous months, but the ECB argues it is not focusing on core because this is not what matters for consumers. The ECB may fear that its credibility is at stake if it does not act, but long-term investors are still quite relaxed about inflation and have not significantly raised their expectations above 2%. This is reassuring because annualized HICP has been no less than 6.3% over the past three months. Investors are actually more concerned about core inflation and wages, it seems. At 2.4% y/y the latter remain quite subdued considering that nominal GDP is rising at a rate of about 4%. The recent wage settlements in Germany have shown that workers have no negotiating power yet. **Unit labor costs continue to restrain overall inflation, just as more recently the appreciating exchange rate.**
8. **The ECB is worried that money supply growth is way above 4.5% y/y** which was once considered the optimal rate of expansion: the latest growth rate has been 8.8% y/y. Not only that, loans to the private sector were 11.3% y/y in April and thus have continued to expand very briskly. The hawks on the ECB Council, not least Jürgen Stark who joined it from the Bundesbank today, can and will make the point that available liquidity is excessive and that the probability of a further acceleration of inflation continues to rise. For them, the fact that actual inflation is still rather subdued does not mean much because there is a time lag of up to two years between changes in money supply and consumer price inflation. Central banks have to take this into account and act early. According to this view, higher interest rates are needed to slow money growth and avoid inflation problems later. The Fed has shown the way: its two-year tightening process has raised the opportunity costs of holding liquidity decisively which in turn has lowered narrow money growth to 1.9% y/y and broad money growth to 4.9% y/y. The Fed has not yet succeeded to deflate the housing and stock market bubbles, but is working at it.
9. **Where is all the money going? The asset side of the euro area's banking system shows that the drivers of M3 growth have been lending to non-financial corporates, plus mortgages.** Since firms are not yet boosting their capital spending by much, their borrowing spree probably reflects stepped-up merger and acquisition activity. Prices for corporate assets and houses have been rising too fast and the ECB is probably concerned about the negative, i.e. deflationary, fall-out once these prices correct significantly. It suggests that an early increase in interest rates helps to avoid a further dangerous exaggeration of asset prices.

- 10.** Still, it will not be easy to convince the public and the more pragmatic members of the Council that there is indeed a genuine inflation risk and that policies have to move ahead more forcefully. Chances are that both energy and non-energy commodity prices have peaked after one of the longest rallies on record, and that the dollar will continue to trend down. **While the ECB will increase rates for some time, it will proceed as cautiously as before, that is by 25 basis points per quarter. Only unexpectedly large moves in the euro exchange could change this strategy.**
- 11.** European monetary policies are thus contributing to the slowdown of asset price inflation that is now under way in key markets worldwide. Not only stocks, commodities and real estate will be affected but also, if to a much lesser extent, bonds, as the cost of carry rises. Hard for investors to make money in such an environment.