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Euroland's economy continues to gain momentum

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1. In surveys among European businessmen, consumers and analysts there is presently a very large discrepancy between the expectations component and the assessment of the actual situation – the latter could not be better. The economy of the euro area powers ahead. This together with the fairly weak euro means that the ECB has no problem defending its **ongoing “normalization” of interest rates. Short-term interest rates will probably be raised to more than the 3 ½% expected for December.**
2. Yesterday we got **Germany's industrial production numbers for August** which showed a year-over-year increase of no less than 7.2%. The July/August average, to look at a slightly longer period, was up at an annualized rate of 6.6% over the previous six months, and it exceeds the Q2 average by no less than 2.1%. This bodes well for Q3 GDP. The numbers have been in synch with recent incoming orders to manufacturing: In volume terms and year-on-year, the two-month average was plus 11.5%.
3. The nice thing about these statistics is that they do no longer just reflect a booming export sector. For the past year and a quarter **domestic demand has rebounded vigorously after all these long years when it was depressed.** Real orders from inside Germany have increased 8.3% y/y in July/August. A further piece of evidence in support of the hypothesis that the recovery is finally broadly based is the turn-around of Germany's housing market whose persistent weakness over the past decade had cost about half a percentage point annually in terms of real GDP growth. In the most recent three-month period order volumes had exceeded their year-ago level by 6.8% which is a sufficiently high number to suggest that the recovery in this key sector is now firmly established.
4. **All this is also very good news for the euro area as a whole** because Germany, together with Italy, had been the sick man of the region. Its growth is not at the expense of neighbors in the currency union any more. We thus seem to have arrived at the end of the painful transition period which followed Germany's re-unification 16 years ago. Its beginning was characterized by high wage settlements, huge transfers of social benefits to the east, a boom in subsidized housing, tight Bundesbank policies and a strong appreciation of the Deutsche Mark (until 1995). Now years of sub-par unit labor cost growth, a competitive exchange rate and low interest rates have brought Germany back to the well-balanced position where it had been before the fall of the Berlin wall. This does not mean that East German living standards and productivity levels have already caught up with the West, far from it, but in spite of the transfers which still run at 4% of pan-German GDP, the eastern part is no longer a drag on growth.

5. Since most of the other countries are also doing well these days, it is therefore certain that **euro area GDP growth in Q3 will be about as strong as it had been in the first half of the year when it had averaged 3.4% on an annualized basis.** In its Quarterly Report the European Commission has just raised the forecast for 2006 to an average of 2.5% y/y, from 2.1% in its spring forecast, and it seems that there will soon be further upward revisions, perhaps to 2.7% to 2.9%. While the output gap remains very wide, it has finally begun to narrow.
6. **Growth has spilled over into the labor market where employment has recently exceeded its year-ago level by 1½%.** The unemployment rate of the euro area has steadily fallen from 9% two years ago to 7.8% of the labor force now. This is not as good as it looks at first glance because the share of part-time workers and temporary work contracts has risen by 10 ½ percentage points since 1992 and now accounts for 35% of total employment (page 26 of the Commission's Quarterly). We lack good data on total labor input measured in terms of hours worked, but it is a safe bet that average hours per worker are on a declining trend because of these structural shifts.
7. The Commission points out that **labor markets have done surprisingly well over all these years of very slow growth,** adding 5 mn jobs since 2001, to 138 mn. All countries have been engaged in policies aimed at making workers more flexible with regard to working time, type of job, employers, acceptable wages and regional mobility. **The flip side has been a steep decline in productivity growth and negative real wage growth.** In any case, labor has become cheap relative to capital, and the share of labor income in total value added has steadily fallen, actually to levels significantly below those observed in the US (57% vs. 61%, see Commission Quarterly, p. 28). Business profits are doing nicely – as does capital spending – but household consumption is increasing at a much slower rate than America's or Britain's.
8. It remains the soft spot of the present recovery. **Even though consumer confidence is on a rising trend since early 2003, when it was depressed, it remains far below historical standards.** It is getting easier to find a job but the new job is typically not paying well, and it is often not a safe long-term job. In any case, the pick-up in German housing is a reassuring sign that consumers dare to spend (borrowed) money again – in the other countries this has been going on for much longer already. According to the ECB, mortgage borrowing runs at an annual rate of no less than 11.1% y/y and thus well above house price inflation which is in the order of 7% y/y.
9. **So the European growth engine is revving up. Not only that, the external environment remains quite benign as well, suggesting that the recovery will continue for at least a couple of years. Consider the following:**
 - the world economy is still growing at a rate of around 5%
 - it has embarked on a capital spending boom for which the euro area's product mix is well suited
 - the recycling of oil revenues by oil-exporting countries is now more beneficial for the euro area than in the past, as the euro is gradually becoming a more important reserve currency
 - business profits continue to rise at double-digit rates, much faster than wages
 - labor markets are functioning much better than in the past

- oil prices have stopped rising which leaves euro area consumers with more purchasing power than they had anticipated only a little while ago
 - since the world economy has experienced positive supply shocks in the form of rapid productivity growth as well as a large supply of additional labor, the outlook for inflation remains very favorable (asset price inflation is another matter, though)
 - in the euro area, fiscal policies do not have to be tightened any further as stronger output growth leads to surprisingly low budget deficits
 - inflation volatility has declined considerably which translates into steadier monetary policies and lower interest rates than in the past
 - real interest rates - and thus the costs of financing - are still close to historical lows
 - fairly high equity valuations mean it is cheap to raise capital on stock markets
 - the exchange rate looks competitive in real trade-weighted terms
10. **The only dark cloud in the sky is slow wage growth and job insecurity. This is quite a big cloud, though, because it affects household consumption, the main driver of any economy.** People work in order to be able to buy goods, services and leisure. The signals they are sending out determine investment activity and the optimal allocation of resources, and it is therefore important that they keep spending. Moreover, only if they do will they be able to save. This seems like a paradox. But it is obvious that in the end, all saving must consist of the accumulation of human and physical capital. If the capital stock does not rise because consumers do not spend enough, it is not possible to save (except by purchasing foreign assets).
11. **Doubts about the future of household consumption are probably the main reason why all eight euro area and national leading indicators listed on page 7 of the Commission Quarterly are pointing down.** One key event that features prominently in all forecasts is Germany's unprecedented anti-cyclical increase of the value-added tax from 16% to 19% next January, as well as the removal and reduction of important subsidies benefiting the consumer. Italy's new Minister of Finance Padoa-Schioppa is also making great efforts to meet the deficit requirements of the euro area's Stability and Growth Pact – this tends to make fiscal policies more restrictive.
12. Since inflation, in the wake of the 25% decline of oil prices, has fallen to 1.8% y/y in September, euro area consumers' purchasing power has been boosted. Nominal hourly wage growth in the order of 2½% y/y means real wages are now up about 0.7% from a year ago. Total labor income is increasing by more because of the effect of rising employment. **So consumers are financially better off than in the recent past and thus have the means to raise their spending levels.** One need not be too gloomy about European consumers any more. After all, they have a lot of catching-up to do after all these years.
13. **Corporate profits, incidentally, will continue to rise much faster than wages,** simply because real GDP growth of 2½% to 3% far exceeds the growth rate of real unit labor costs – the latter could remain negative, just as during most of the past decade. While the valuation of corporate equity is quite generous, once one takes into account the likely growth of earnings it seems more reasonable. **Equity prices are well supported.**

14. **The same can be said about bonds.** For the time being at least, inflation risks are very limited, with import prices now falling after the temporary end of the great commodity price inflation, and with European productivity rising rapidly, if only for cyclical reasons. In addition, all the risks that could one day be associated with the unwinding of the world's imbalances, such as deflation or a much weaker dollar, suggest that high-quality bonds will be the assets of choice. For the foreseeable future, both equity and bond prices have upside potential.