

ECB Now On Hold Until Late 2008

Key trends

- **At first glance, the flash first quarter GDP estimate suggests the Eurozone is continuing to weather the credit crunch and the moderation in global growth remarkably well.** GDP growth re-accelerated to 0.7% (from 0.4% in the final quarter of 2007), with growth strengthening in Germany, France and Italy. By contrast, growth slumped further in Spain, and appears to have turned increasingly mixed among the smaller economies.
- **We have been forecasting a relatively 'orderly' cyclical downturn in Germany, with the surprisingly strong 1.5% increase in GDP in the quarter due largely to inventory-building and a series of statistical and seasonal quirks (much of which will be reversed in the second quarter).** Moreover, given the continuing deterioration in the external environment, a significant rebalancing towards household spending is needed to sustain German growth at these levels. While there are a number of factors cushioning German consumers in 2008, in our view a sustained upturn still appears unlikely at present.
- **Indeed, household expenditure growth continues to flag across other major Eurozone members,** reflecting the varying impacts of higher food and energy prices, rising unemployment, softening housing markets, and a further tightening in credit availability. The acceleration in growth in France was largely attributable to net exports and a diminishing drag from inventories, with consumer spending growth stalling in the quarter. Real retail sales also fell further in Italy, suggesting private consumption made little contribution to the moderate recovery in early 2008.
- **While growth across the entire Eurozone region was marginally stronger than anticipated in the quarter, we have shaved 0.1 of a point from forecast GDP growth in 2008 (to 1.8%).** More recently, there are signs household spending, export and business investment growth have all continued to slow in the second quarter, suggesting GDP growth has now slipped to below trend. The combination of 'payback' for the strength of growth in the first quarter, higher forecast energy prices, a higher forecast euro, and recent downward revisions to our global growth forecasts, now foreshadows an otherwise weaker profile of growth over the balance of the year. We have also revised down forecast growth in 2009 from 1.7% to 1.5%.
 - **By contrast, the outlook for ECB policy has become more uncertain.** Given the earlier resilience in growth and the continuing rise in food and energy prices, it is unsurprising headline and core inflation has continued to strengthen in early 2008. However, in the absence of short-term relief from higher food and energy costs, and with unfavourable base effects, HICP inflation is poised to re-accelerate to back over 3.5% in the third quarter.
 - **Furthermore, wage indexation is poised to lock-in a further gradual strengthening in labour cost growth among several members.** While we believe the unfolding slowing in GDP growth will preclude the ECB from tightening policy, the persistence of commodity and labour cost pressures points to HICP inflation remaining above 2.0% well into 2009. Accordingly, we now believe it unlikely the ECB will consider easing policy until late 2008 at the earliest.

GDP growth was mixed in the first quarter...

At first glance, preliminary first quarter GDP data re-affirms the Eurozone is weathering the credit crunch and the slowdown in global growth remarkably well. According to the flash estimate, Eurozone GDP growth re-accelerated strongly in the first quarter of 2008. Across the euro area, GDP advanced by 0.7% in the quarter (compared with a 0.4% increase in the final quarter of 2007), with growth over the year unchanged at 2.2% (even a little above most estimates of euro area trend growth).

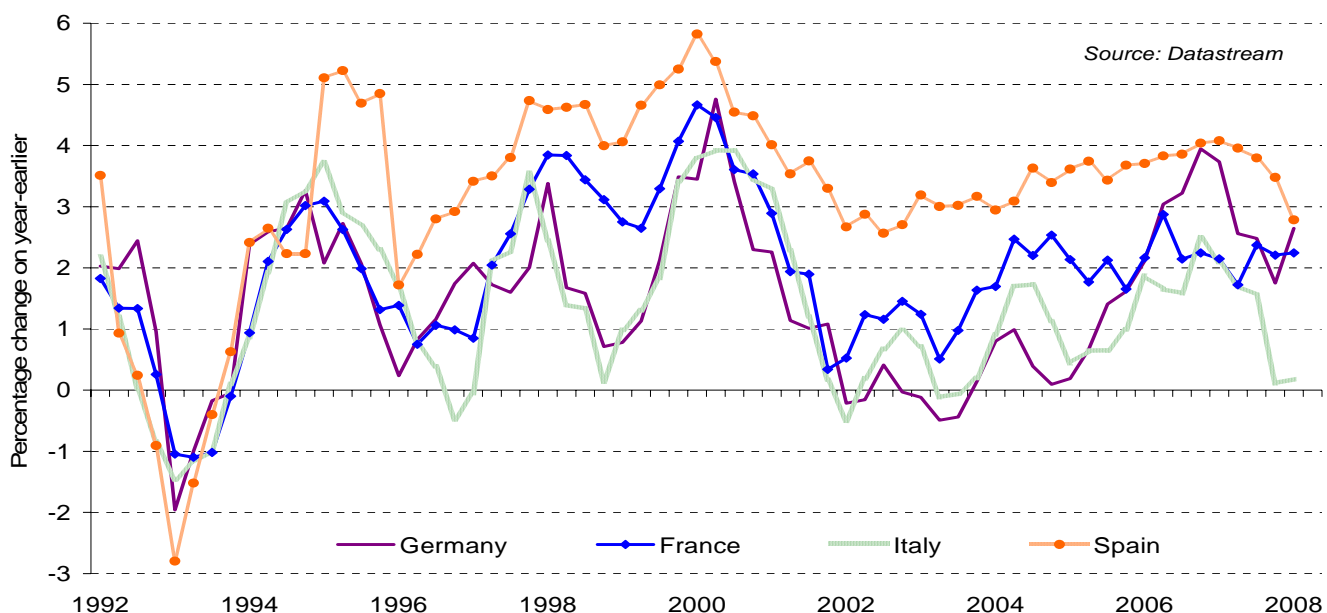
Nevertheless, the strengthening in growth was entirely attributable to the three largest members. German GDP expanded by a surprisingly robust 1.5%, up from just 0.3% previously and the strongest quarterly increase since 1996. Growth over the year also returned to 2.6%, the fastest increase since the second quarter of 2007 (prior to the eruption of global credit market problems). In France, the 0.6% rise doubled the 0.3% increase in the final quarter of 2007, while growth over the year remained unchanged at

2.2% (annual average growth in 2007 was also revised up from 1.9% to 2.1%).

Elsewhere, Italy clawed back all of the 0.4% contraction in GDP in the final quarter of 2007 (although the level of GDP was barely 0.2% above year-earlier levels). By contrast, GDP growth slumped further in Spain, expanding by just 0.3% in the first quarter (the smallest increase since 1995) and by 2.7% over the year (the weakest increase since early 2003). Moreover, growth appears to have turned increasingly mixed across the smaller members.

Indeed, while growth in the quarter was marginally stronger than we had expected, we have shaved 0.1 of a point from our forecast for 2008 (to 1.8%). The combination of expected 'payback' in the second quarter, higher forecast energy prices, a higher forecast euro, and recent downward revisions to our global growth forecasts, suggests an otherwise weaker profile of growth over the balance of the year. With slower momentum entering 2009, moreover, our forecast growth for next year has also been revised down from 1.7% to 1.5%.

GDP Growth - Four Largest Members



Germany - Running out of rabbits in the hat?

We have been highlighting for some time a number of factors pointing to an 'orderly' cyclical downturn in Germany (at least relative to many parts of the Anglosphere). Nevertheless, there were clearly a number of 'one-off' factors contributing to the strength of German GDP growth in the first quarter. More broadly, the re-acceleration in growth partly reflected a 1.2% jump in final demand, underpinned by increases across all major components. Despite the sharp increases in food and energy costs, private consumption expenditure grew by 0.3% (following a 0.8% fall the previous quarter). Gross fixed capital formation also surged by 3.7%, reflecting a further 4.0% gain in machinery and equipment investment and a 4.5% jump in construction expenditure.

However, the rebound in construction activity was partly attributable to the effects of an unseasonably mild winter (pointing to a renewed subtraction from growth in the second quarter). Moreover, inventory-building accounted for almost half of growth (0.7 points), which almost certainly will be followed by a negative contribution in the second quarter. Furthermore, growth in the quarter appeared to be largely front-loaded, with real retail sales, construction activity, and manufacturing production all falling sharply in March. To this end, there is considerable doubt over the extent to which the leap-year effect has been excluded from the seasonal and calendar adjustment process. Furthermore, while manufacturing production continued to expand moderately in the quarter, it appears to have been largely propped up by a surge in new orders in late 2007. Indeed, manufacturing orders have fallen in every month since December.

Net exports subtracted a large 3.3 points, although largely reflecting a 3.5% surge in imports (consistent with the increase in inventories but also possibly reflecting the



additional trading day). Indeed, export growth re-accelerated to 2.4% in the quarter (most likely reflecting the revival in manufacturing orders in late 2007).

To be sure, as a major global producer of capital goods, Germany remains leveraged to the secular strength of infrastructure spending across the large developing (and also the oil-rich) economies. Moreover, earlier labour market reforms and restructuring have contributed to improvements in German competitiveness and corporate profitability (which along with the continuing strength in capital goods exports), is helping to sustain healthy growth in employment and business investment (refer to the chart above). Furthermore, with relatively low levels of household financial leverage, Germany remains somewhat more insulated from the global re-pricing of risk and the ensuing tightening in credit availability.

In the face of the further ensuing deterioration in the external environment (specifically the further rises in the euro and commodity prices and the weakening in domestic

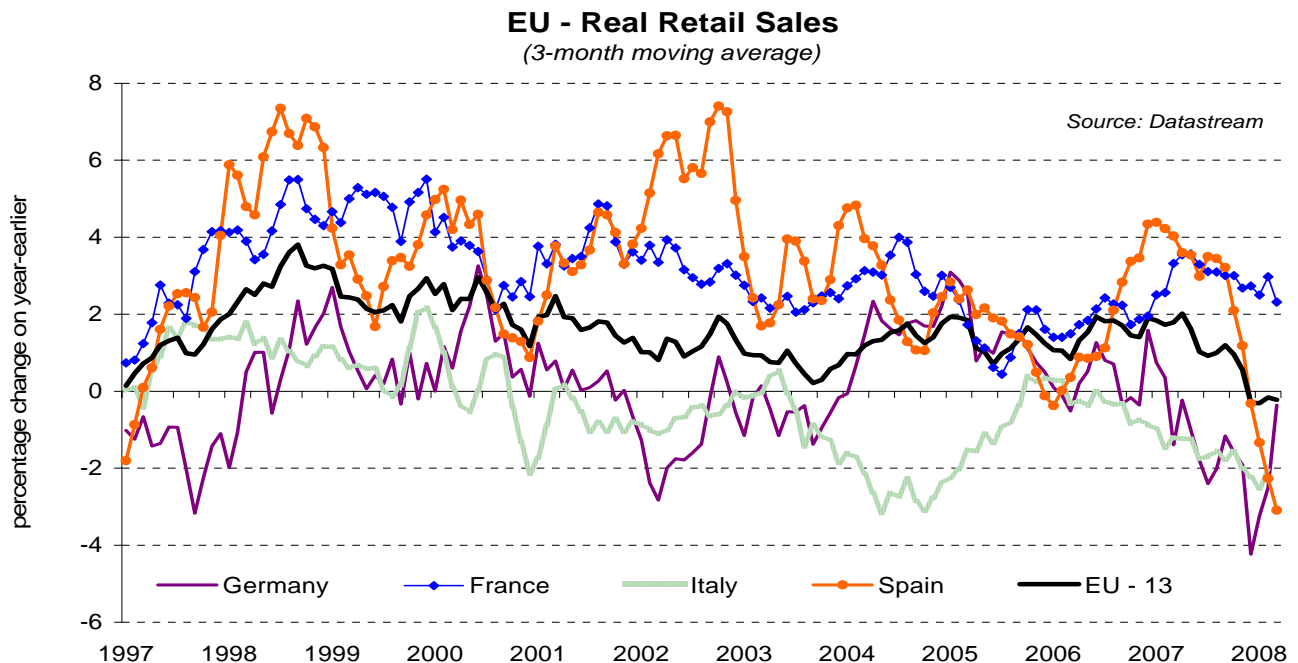
demand growth in the US and the UK), sustaining the current strength of German growth requires a significant rebalancing towards household spending. More positively, recent international experience suggests the dividends of economic and corporate restructuring should eventually flow through to the German household sector. Indeed, the strengthening in wages growth and continued gains in employment should provide fundamental support for German consumer spending in 2008, while the credit crunch is unlikely to be a major impediment for conservatively geared German households. Moreover, to the extent that these factors were all at work in 2007, the weak performance of consumer spending last year (and the accompanying rise in the household savings rate) hints at growing pent-up demand. The potential for the release of this pent-up demand was also possibly underscored by the rebound in consumption in the first quarter, despite the steep rises in food and energy costs.

Nevertheless, from a medium-term perspective, these cost increases will clearly constrain German household disposable income growth and discretionary spending. Indeed, there is still little in German consumer confidence

surveys to suggest German households are poised to assume all of the slack from the slowing in export and business investment growth. Nevertheless, we acknowledge this is a potential upside risk to German growth in 2008.

While consumers are continuing to retrench elsewhere...

Indeed, consumer spending growth has increasingly languished across the other large Eurozone members in early 2008. In France, like Germany, the acceleration in GDP growth was largely due to the combination of a further moderate strengthening in business investment, a neutral contribution from inventories (following a 0.6 point drag on growth in the previous quarter), and a recovery in exports (which outstripped a renewed rise in imports). By contrast, growth in household consumption and investment stalled, most likely reflecting the combination of higher food and energy prices, a further slowing in house price increases, and tougher access to new credit. Again, like Germany, much of the strength in domestic demand was front-loaded in the quarter, with real retail sales and manufacturing production both falling in March.



In Spain, and in addition to the continued deflation of the housing bubble, consumer spending has been further undermined by a recent sharp rise in unemployment rate (which rose to a three-year high of 9.3% in March). Household consumption growth slowed to just 1.8% over the year to the March quarter, while the volume of residential construction activity fell by 0.2% over the same period. Similarly, in Italy, real retail sales fell a further 0.6% in the three months to February, unchanged from the three months to November 2007. Indeed, across the entire Euro area, and despite the rebound in Germany early in the year, real retail sales fell by 0.2% over the year to the first quarter (and compared with a cyclical peak of 2.0% in the first quarter of 2007).

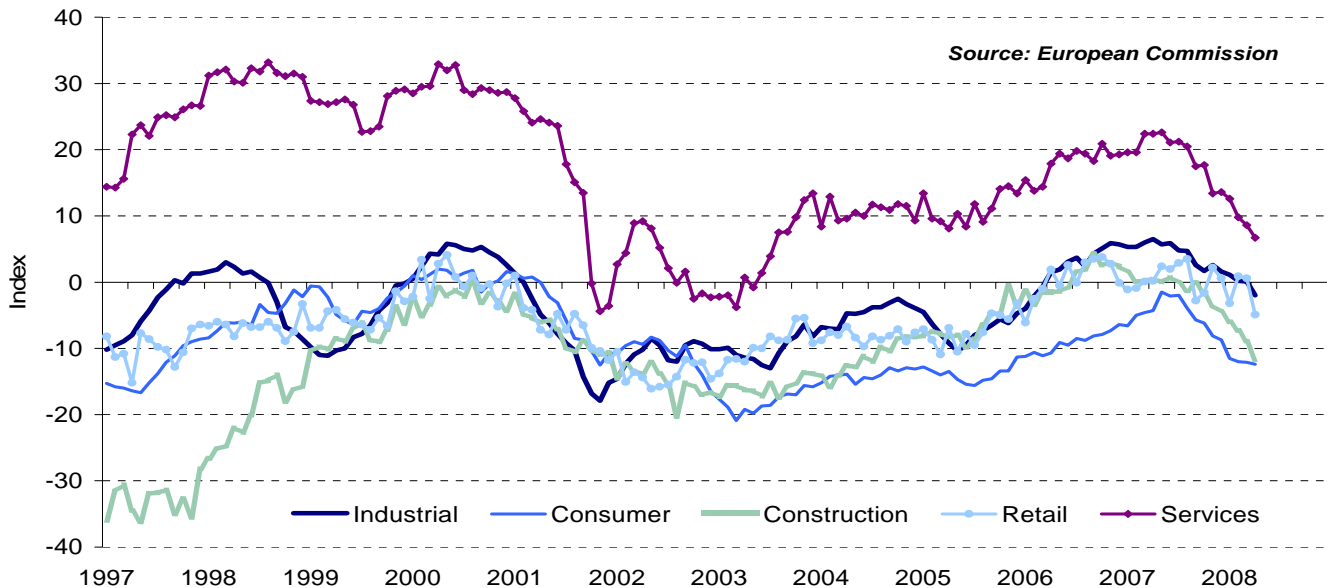
Second quarter to herald the emergence sub- trend growth?

Moreover, a wide range of surveys has since revealed a further broad-based deterioration in economic sentiment early in the second quarter, and in aggregate are now

consistent with GDP growth of below trend (i.e. sub 2.0%). The European Commission’s Economic Sentiment Indicator revealed that *industrial (manufacturing) sector* confidence fell in April to the lowest level since early 2006, although remaining above the long-term average. However, the continuing resilience of the sector largely reflects the earlier strength in new orders, which continue to underpin high levels of current production and capacity utilisation. The number of months’ production assured by orders on hand in April was equal to cyclical highs in Germany (and at a new high in Italy), and barely below recent highs in France (although falling sharply in Spain). Similarly, manufacturing capacity utilisation rates in all four large members were still close to cyclical highs.

By contrast, domestic new orders have continued to fall steadily across all major members in early 2008 (suggesting some moderation in underlying business investment spending as well as continued weak household demand). A similar pattern is also evident in export orders, concentrated especially in lower value-adding industries.

Euro Area Business and Consumer Sentiment Indexes



We anticipate the lagged effects of the rising euro (along with weakening domestic demand growth in the US and UK) to eventually take an even larger toll on Eurozone exports, while accelerating wages growth is expected to gradually erode German competitiveness. Nevertheless, continuing healthy external capital goods demand (including for the French-assembled Airbus A380), and relatively high levels of manufacturing capacity utilisation, together are expected to cushion the broader downturn in Eurozone export and business investment growth, and subsequently manufacturing production growth.

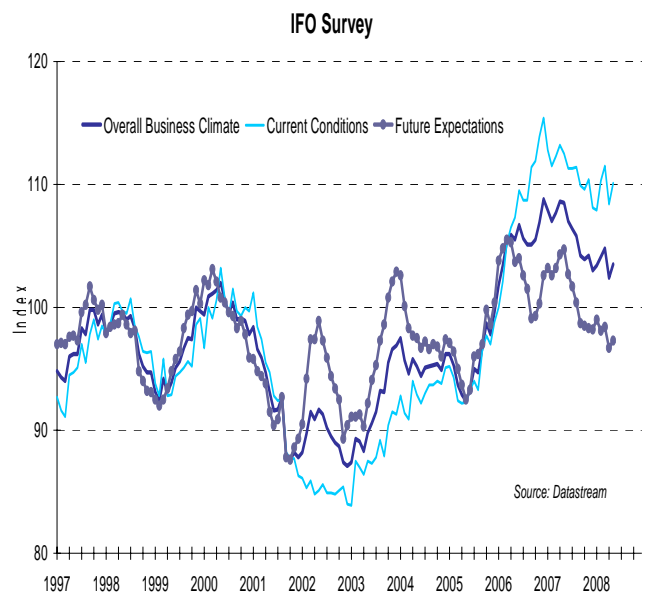
Rather surprisingly, the *consumer confidence* indicator was unchanged in April for the fourth consecutive month, despite the further increases in food and energy prices and the further tightening in credit standards. The pattern of unemployment appears to be playing a major role, with confidence plunging in Spain and Italy (where unemployment is rising), but holding steady in Germany and France (where unemployment rates have been falling).

Nevertheless, this period of stability in the broader consumer confidence indicator follows a precipitous fall from mid-2007, and sentiment remains below the long-term average. Moreover, as noted above (and apart from in Germany where statistical quirks are at work), consumer spending is clearly lagging the earlier plunge in sentiment. Indeed, after bouncing around in past few months (reflecting the various crosscurrents affecting consumer confidence), the *retail sector* confidence indicator fell sharply in April (and to below the long-term level).

Other service sectors (which comprise over two thirds of the Euro area economy) appear to be deteriorating even more rapidly. The *services sector* confidence indicator declined in April for the fourth consecutive month, and to the lowest level since 2003. Despite improving sentiment in global financial markets, the *financial services* confidence indicator fell to a new low in April, and most likely

contributed to a continuing fall in *real estate and business services* (further compounded by weakening housing markets in some member countries). Higher oil prices and weakening export growth continue to dampen operating performance in the *transportation services* industry.

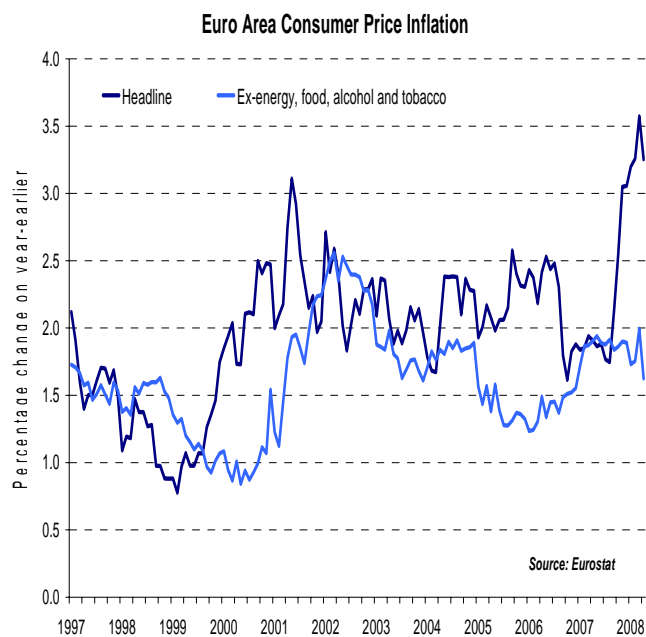
More recently, the euro area purchasing manager reports point to a further slowing in both manufacturing and services sector activity in May. The Manufacturing PMI slipped a further 0.2 of a point to 50.5, while the Services PMI slumped from 52.0 to 50.6. In Germany, while the IFO Index edged a little higher in May (including a small rise in the expectations component), the April reading was the lowest since December 2007.



But monetary policy outlook has become more clouded

At the same time, however, as in most other regions, the short-term outlook for Eurozone monetary policy has become more uncertain. With GDP growth only now appearing to be slipping below trend, and given the extent

of increases in food and energy costs over the past year (and accompanying second round effects), it is unsurprising that even measures of core inflation have been drifting steadily higher in early 2008. Headline HICP inflation and HICP inflation excluding food and energy increased by 3.6% and 2.0% over the year to March, respectively (the highest in over five years for both series), before favourable base effects contributed to moderate falls in April (to 3.3% and 1.6%, respectively).



On our forecasts, significant economic slack should be opening up across the Eurozone by late 2008, contributing to more widespread increases in unemployment rates and diminishing pressure on the utilisation of other resources. In the meantime, however, base effects are set to become less favourable for headline inflation in the months ahead, as small increases reported in mid-2007 begin dropping out of annual comparisons. In the absence of meaningful declines in food and energy prices, headline HICP inflation is poised to re-accelerate again to over 3.5% in the corresponding months of 2008. Indeed, the May PMI reports

re-affirm significant upstream cost pressures still in the pipeline.

In addition to food and energy prices, labour cost growth also continues to strengthen more broadly across the region. Total hourly labour costs increased by 2.7% over the year to the fourth quarter of 2007, while compensation per employee rose by 2.5%. With labour productivity growth slowing over the course of the year (at least partly due to the cyclical strengthening in labour demand), unit labour costs jumped to 2.0% (the highest increase since mid-2003).

The ECB also notes there were substantial increases in negotiated wage settlements in some countries in early 2008, including in Germany. Moreover, the ECB appears increasingly disconcerted by the extent to which wage indexation arrangements still exist across much of the euro area, and the potential for the recent surge in inflation to lock-in stronger wages growth through 2009. Among the larger members, some form of wage indexing (based on national CPIs) applies to around 13% of the French private sector workforce and to over two thirds of the Spanish private sector workforce. Mechanisms also exist in Italy to adjust new contracts for any difference between expected and actual inflation in expiring agreements.

Under a scenario of limited short-term relief from these 'exogenous' cost pressures, a sustained decline in inflation is unlikely before late 2008, and a decline below 2.0% is unlikely before the second half of 2009. Indeed, such a decline would require a significant re-widening in the Eurozone output gap, an outcome that is only now beginning to gradually unfold. Accordingly, we now doubt the ECB will ease policy before the final quarter of 2008 (we had previously expected the first of two 25 point cuts late in the third quarter). We continue to anticipate a relatively modest cumulative decline of 50 basis points, particularly with global growth likely to be regaining momentum over 2009 and with the euro likely to have peaked in the interim.

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