



Daily Note: 31 January 2008

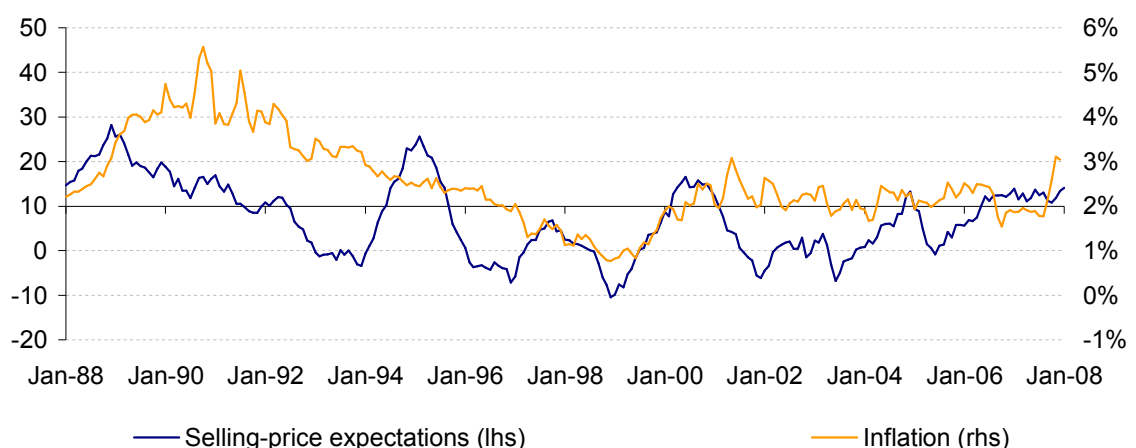
Euroland divergence returns

WE SUGGEST: ECB unlikely to change policy yet

SUMMARY: Euroland inflation rose to a 14-year high in January. Economic sentiment fell further, but remains above its long-term average. There are signs that Euroland is diverging again, with Germany and France growing at decent rates, while Spain heads into recession and Italy flirts with it. Even so, the ECB is unlikely to change its policy in coming months.

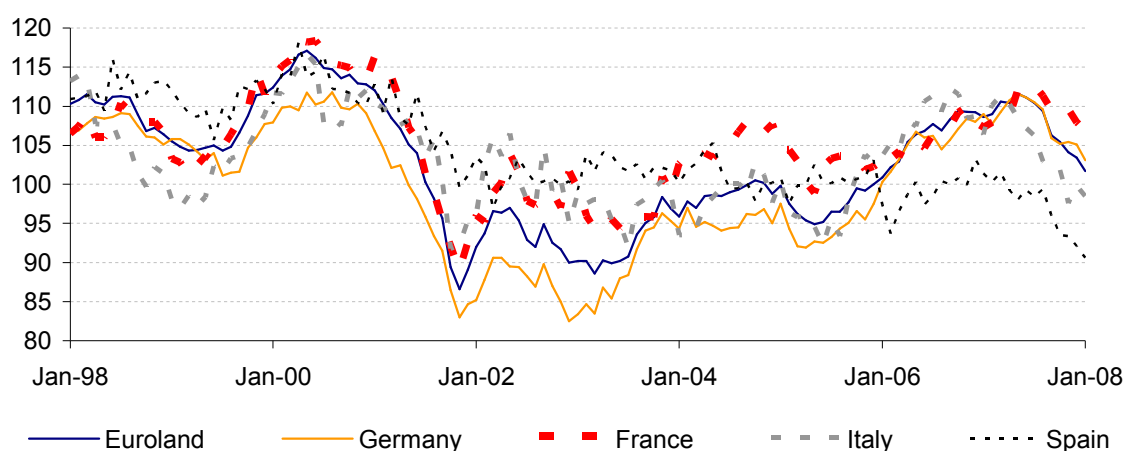
We have previously noted that for the ECB to change its policy, something has to change in its economic environment, be this slower inflation or money and credit growth, a weaker labour market or sharply falling business confidence. Today's data releases move in both directions. The Eurostat flash indicator showed inflation in the euro-zone at 3.2% in the year to January, a 14-year high. Euroland inflation may well be near peaking and should moderate, certainly so in the second half of 2008. But it remains uncomfortably above the ECB's 'close to but below 2%' target – the more so since this is the case for both headline and underlying inflation. Moreover, selling-price expectations in manufacturing, which historically have a good predictive relationship to prices (when the balance of respondents expecting to raise prices less those expecting to cut them rises above 10, Euroland inflation tends to go above 2%) have recently risen, implying that there are price pressures in the pipeline.

Selling-price expectations and inflation, 12-month change, %



On the other hand, the European Commission survey showed that economic sentiment in the euro-zone as a whole, as well as in the FIGS countries (France, Italy, Germany, Spain, the four largest members of the single currency zone) weakened further. The overall Euroland index dropped to 101.7, the lowest reading since January 2006. However, this is still somewhat above the index's long-term average reading of 100.6.

Economic sentiment indices



In fact, a glance at the behaviour of economic sentiment in the euro-zone over the past ten years shows two interesting developments. First, that although weaker, the index does not imply that Euroland is anywhere near a recession. For that to be a danger, we would have to see the index go below readings of 85.

Second, after a period of convergence, divergence is back with a vengeance among the FIGS. German and French economic sentiment remains elevated by historic standards. By contrast, Spanish economic sentiment is clearly in recession territory and the Italian one is rapidly approaching those levels. Crucially, Germany and France constitute about half the euro-zone, while Italy and Spain make up around 30%. So, on balance, the message from the economic sentiment index is that although Euroland growth will continue to slow in 2008, that slowdown is still only likely to take growth to somewhat below trend.

With inflation likely to remain elevated over coming months, and the economy still growing near trend, there would seem to be little reason for the ECB to change its policy stance and move towards easing.

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