



Daily Note: 22 February 2008

Euroland bad news – but not that bad

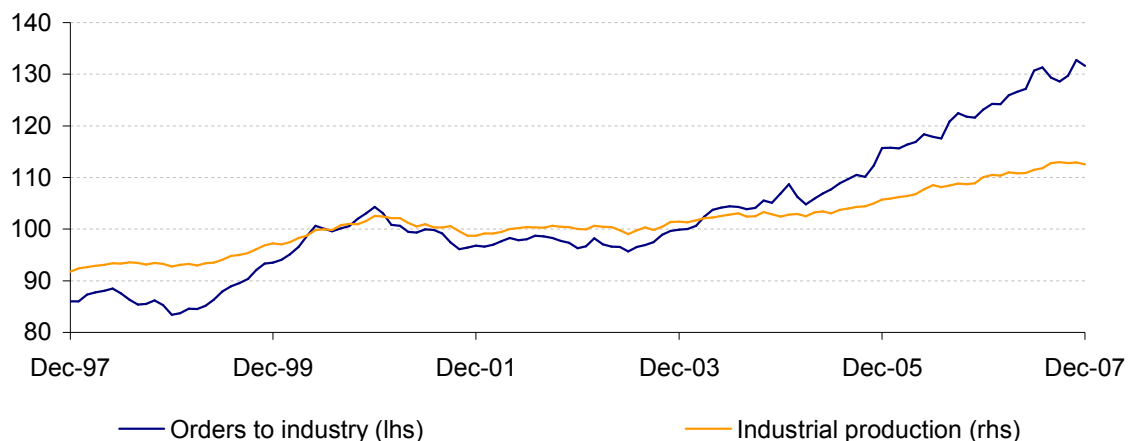
WE SUGGEST: Nothing in today's data to change ECB's mind in near term

SUMMARY: French and Euroland data published today were generally weak. But most of the series are very volatile on a monthly basis and their trend is still healthy. Moreover, the Euroland economy needs a period of growth somewhat below trend to bring inflation back to or near target. Absent large-scale contagion from financial sector troubles to the rest of the economy, the ECB is unlikely to change its stance in the near term.

Euroland and French data published today should give the ECB much food for thought and nudge the Bank further towards a stance of eventual easing. However, a closer look at the data shows that – while it clearly signals a further slowdown of the euro-zone economy – it need not push the ECB into easing monetary policy anytime soon. Nor is it likely to.

Pan-Euroland industrial orders fell 3.6% in December from a month earlier (and rose 3.6% from a year earlier). This series is highly volatile: the past six months have seen two rises, two falls and two essentially no change. However, if we use a two-month moving average to smooth out monthly fluctuations, it becomes clear that the trend is still upwards (although note that industrial production on the same measure has levelled off. Over a twelve-month period, orders to industry are still growing at a 5-10% pace – somewhat slower than in 2005/06, but by no means a sign of any immediate slump.

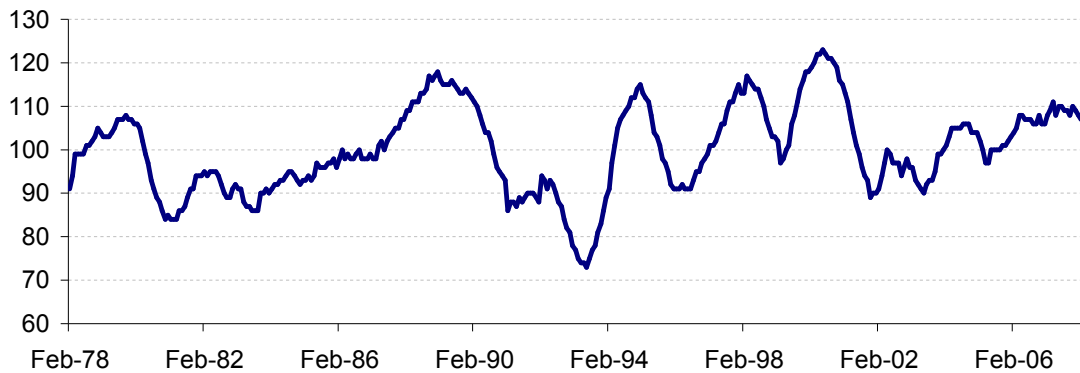
Euroland industrial orders and production
two-month moving average of index (2000=100)



A similar picture emerges from today's French numbers. Business confidence fell from a reading of 108 in January to 107 in February. The February number was also the weakest in 13 months. Again, a signal of further weakness ahead – but, as the chart

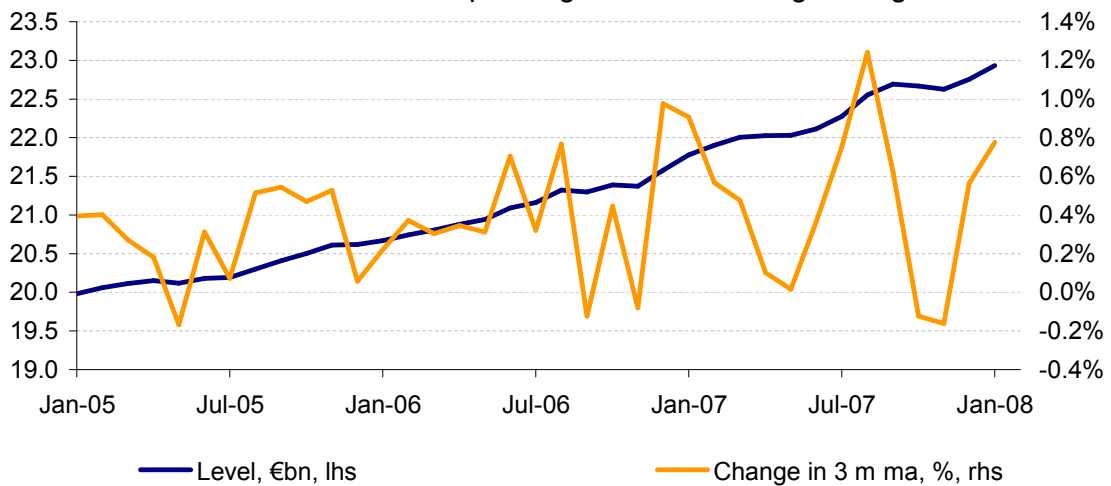
shows, business confidence remains high by historic standards. Crucially, it remains well above the mid-to-low 90s readings associated with a contracting economy.

INSEE French business confidence index



Even today's French consumer spending figure is not as bad as the headline figure implies. True, spending dropped by 1.2% in January. But this came after a 2.1% rise in December, with much of the difference due to a surge in car sales in December, followed by a slump in January. This, in turn, was caused by the introduction of a 'green tax' on high polluting vehicles introduced in January. Excluding car sales, household spending actually rose by 0.8% in January, a third consecutive rise. Again, bearing in mind that the series is volatile, the trend still seems to be up.

French consumer spending, 3-month moving average



Add to this that French inflation accelerated to 2.9% in the year to January (3.2% on the harmonised index). Both German and French inflation has averaged around 2.7% for the past two months. (Italian inflation is at similar levels, while Spanish is in excess of 4%.) Finally, throw in the recent IG Metall pay deal at 5.2% (for 13 months) and the ECB has plenty of reason to continue its current monetary policy stance. (In fact, the IG Metall pay deal is excellent news in the short term. German households need to spend. Over a longer horizon – two-three years – Germany cannot afford such pay deals. But for the immediate future, if this is what it takes to get Germans to open their wallets, then it is a good deal.)

Obviously, the ECB still has issues to worry about. The main one is the continued risk of contagion from financial market problems to the real economy. The ECB is unlikely to engage in the kind of exercise undertaken by the Fed to save Wall Street. But if problems spread and threaten a slump in activity, the Bank would not hesitate to act. But, for the moment, the Euroland economy needs a period of below-trend growth in order to bring inflation back down to or near target. The kind of slowdown that recent data imply should therefore not cause the ECB to change course.

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