

Euro area

- **Economic sentiment improves, driven by industry**
- **Labor market offers more hints of stabilization**
- **Unexpectedly high inflation in March**

According to the EC survey, Euro area economic sentiment rose significantly in March. But, in two respects, the EC survey was less decisive than last week's PMI survey: first, the overall level of the EC survey is not as high as the composite PMI, and second, the improvement in the EC survey was less broad-based across sectors. Nevertheless, it still looks like Euro area growth is stepping up as we move though the spring, to pace around 2.5% ar.

No policy changes are expected at next week's ECB meeting, but the central bank's view on growth (in light of the recent improvements in key business surveys) will be of interest. In addition, the ECB will detail the changes it plans to make to its collateral framework in early 2011. In particular, it will set out how the graded haircut system will be implemented. This should clarify how the improved credit differentiation will affect various assets, including Greek government bonds.

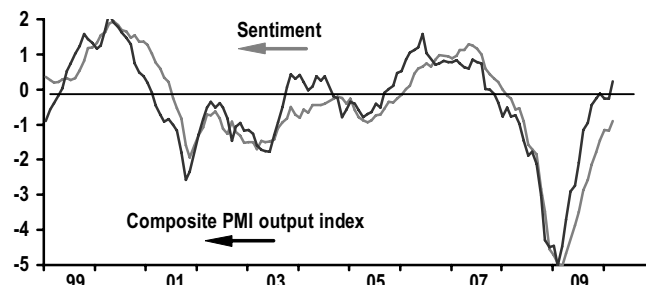
More hints of labor market stabilization

The consensus view is that unemployment will continue to increase in the Euro area this year. The mean forecast in last month's Consensus Economics poll foresees the Euro area unemployment rate rising from an average of 9.4% last year, to 10.4% this year, and to 10.5% in 2011. The consensus expects this ongoing rise to weigh on consumer spending.

However, the latest indicators hint at an earlier stabilization in the Euro area labor market. After this week's labor market report for February, it looks as if the unemployment rate will increase by only 0.1%-pt in 1Q10. And it looks as if the number of unemployed will increase by under 200,000 in 1Q10, significantly below the peak quarterly increase of 1.25 million in 1Q09. The smaller increases in unemployment are also pointing to a stable level of employment (data published with a long lag), reinforcing the message of the composite PMI employment index. Importantly, these improvements look set to continue. An Okun-type relationship between quarterly GDP growth and the quarterly change of the unemployment rate suggests that unemployment reacted with a lag to the very sudden collapse in economic activity in late 2008, but that the recent stabilization is broadly consistent with the (subdued) economic recovery so far. If the recovery pro-

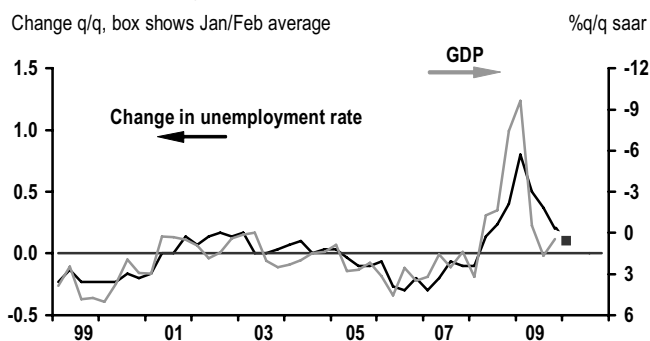
Euro area PMI and sentiment

Standard deviations from average over 1999 to 2007 period



Euro area unemployment rate

Change q/q, box shows Jan/Feb average



Euro area employment and unemployment

%q/q saar

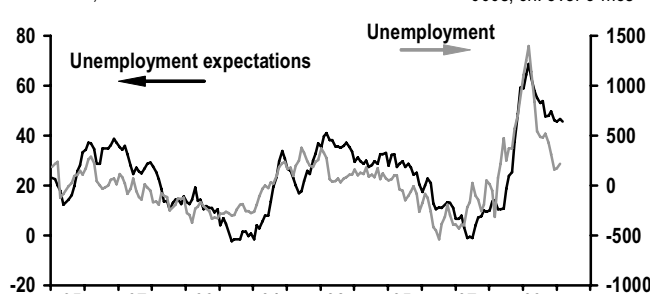
Mn, q/q, box shows 1Q10 tracking



Euro area consumer confidence—unemployment fears

% balance, sa

000s, ch. over 3 mos



ceeds as we expect, with a sustained acceleration this spring, the unemployment rate should be close to a peak.

Surprising jump in inflation in March

The flash release of the Euro area HICP showed an unexpected jump from 0.9%oya in February to 1.5%oya in March. On the basis of the national reports for Germany, Italy, Spain, and Belgium, we can see that the rise was broadly based across countries. But, at this stage we do not have full details on what happened to individual components.

Inflation in the volatile energy and fresh food components appears to have strengthened more than we expected, especially fresh food inflation. But, some part of the overall rise in headline inflation was likely caused by higher core inflation. As we stressed earlier, there were several factors exerting some upward pressure on core inflation in March. First, the beginning of the Easter holidays, starting already at the end of March, likely pushed up prices for leisure, hotels, and restaurants across the region. Second, the Greek government approved extra measures to consolidate the fiscal position. These measures included increases in taxes on fuel, alcohol, and tobacco, as well as an increase in the VAT rate. These tax increases likely contributed roughly 0.05%-pt to the Euro area inflation rate. For detailed information on components, we will have to wait for the full HICP report due to be published on April 16.

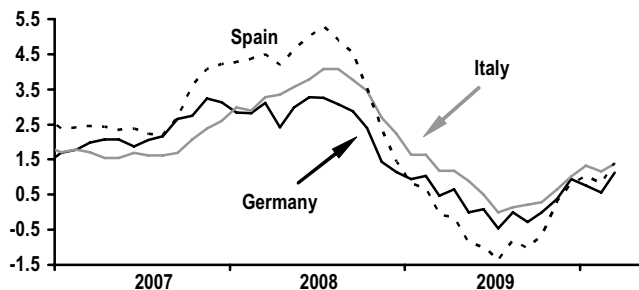
A broad-based recovery (without Greece)

While the PMIs and the European Commission's sentiment survey point to a broad-based recovery across the region in March, the Greek economy fell further behind. The March level of economic sentiment in Greece was more than three standard deviations below its long-run average, which is comparable to how depressed the Euro area overall was at the trough in March 2009. The declines are being driven by Greek consumers, which probably also explains the recent falls in retail and construction confidence. A similar message is sent by the manufacturing PMI, which is a more direct measure of activity. While the output index in the Euro area manufacturing PMI rose by 2.9pts to almost 60, the Greek index fell by 1.7pts to 41.1.

In contrast, the other countries experiencing fiscal stress are faring significantly better. Economic sentiment in both Spain and Portugal, while still below the Euro area average, rose in March. And the output indices in the Spanish and Irish manufacturing PMIs shot up by 5.8pts and 6.9pts, respectively, in March. In terms of levels, the output indices in both countries are in the mid-50s again.

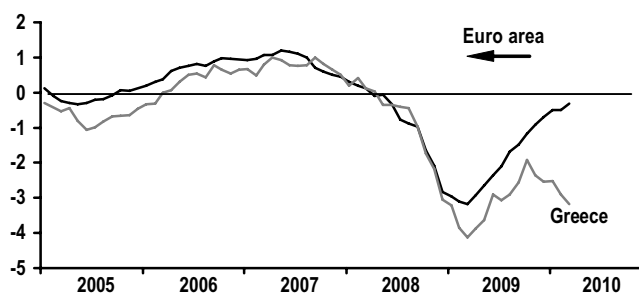
Inflation across the Euro area

%oya



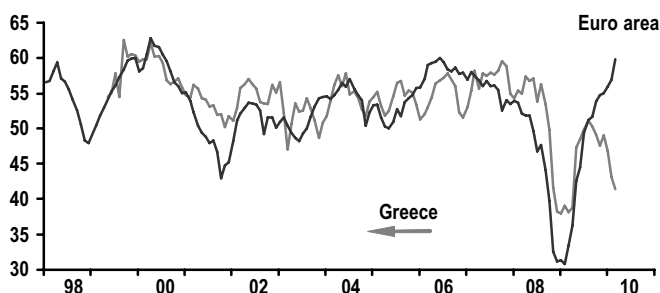
Economic sentiment in Greece

Standard deviations from long-run mean



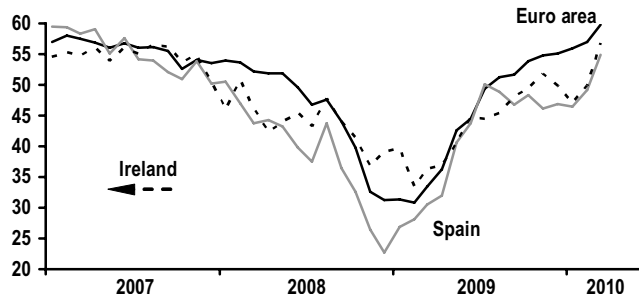
Manufacturing PMI - output index

DI, sa



Manufacturing PMI - output index

DI, sa



Data releases and forecasts

Week of April 5 - 9

Output and surveys

Real GDP					
		1Q09	2Q09	3Q09	4Q09
Wed	Euro area (2nd release)				
Apr 7	%q/q sa	-2.5	-0.1	0.4	<u>0.1</u>
11:00am	%q/q saar	-9.6	-0.5	1.7	<u>0.5</u>
	%oya	-5.1	-4.9	-4.1	<u>-2.1</u>
	GDP components %q/q saar				
	Private consumption	-1.9	0.3	-0.7	<u>-0.1</u>
	Government consumption	2.2	2.4	3.1	<u>-0.5</u>
	Fixed investment	-19.9	-6.7	-3.7	<u>-3.3</u>
	Exports	-29.3	-4.5	11.9	<u>7.0</u>
	Imports	-27.2	-11.0	11.8	<u>3.7</u>
	Contributions to GDP growth (%q/q saar)				
	Domestic final sales	-5.1	-0.7	-0.5	<u>-0.8</u>
	Inventories	-3.4	-2.6	2.1	<u>0.0</u>
	Net trade	-1.3	2.9	0.1	<u>1.3</u>

We do not expect any significant revisions in the second release of Euro area GDP. As a result, it should confirm that domestic final sales remained a drag on growth at the end of last year, with only net trade making a positive contribution. Nevertheless, the more positive signals from the PMI in March suggest that growth broadened out across sectors toward the end of the first quarter, which points to an improvement in domestic demand.

Purchasing managers index final (services)

Index, sa					
		Dec	Jan	Feb	Mar
Wed	Euro area				
Apr 7	Overall region	53.6	52.5	51.8	<u>53.7</u>
10:00am					
9:55am	Germany	52.7	52.2	51.9	<u>54.7</u>
9:50am	France	58.7	56.3	54.6	<u>53.0</u>
9:45am	Italy	53.9	50.9	50.8	<u>54.3</u>
9:15am	Spain	45.0	48.8	47.1	<u>51.1</u>

According to the flash estimate for March, the Euro area services PMI recovered all the ground it lost in the first two months of the year. This suggests that the very strong recovery in industry is creating stronger spillover effects to the rest of the economy and to domestic demand. The improvement appears broad-based across countries. While the flash French services PMI continued to fall from the inexplicably high level it reached in late 2009, there was a large increase in the flash release for Germany (2.8pts). This implies that the rest of the region must also have increased significantly (by around 3.5pts). Italy and Spain may have benefited about equally from this.

Purchasing managers index final (composite)

Index, sa					
		Dec	Jan	Feb	Mar
Wed	Euro area				
Apr 7	Overall region	54.2	53.7	53.7	<u>55.5</u>
10:00am					
9:55am	Germany	54.3	54.6	55.7	<u>58.5</u>
9:50am	France	59.2	58.0	55.6	<u>55.2</u>
9:45am	Italy	54.1	52.1	51.9	<u>54.8</u>
9:15am	Spain	45.5	48.2	47.7	<u>52.2</u>

The flash release showed a large increase of the composite PMI in March. The level of 55.5 is consistent with a 2.5% pace of GDP growth, and the improvement in the service PMI suggests that this growth is increasingly coming from both industry and services. Given the flash results for the region overall, Germany, and France, the rest of the region must have seen an increase of its composite PMI by 3.4pts to a level of 54.1. Therefore, growth broadened significantly across countries, as well as across sectors, in March.

Industrial production

		Nov	Dec	Jan	Feb
Thu	Germany				
Apr 8	Production sector (%m/m sa)	0.7	-1.0	0.6	<u>0.2</u>
12:00pm	%oya sa	-8.0	-5.2	2.1	<u>5.7</u>
	Prod sec ex constr (%m/m sa)	0.7	-0.9	1.6	<u>0.5</u>
	%oya sa	-8.7	-5.4	2.9	<u>7.3</u>
	Industry (%m/m sa)	1.0	-1.2	0.9	—
	%oya sa	-9.1	-5.9	3.0	—
Fri	France				
Apr 9	Ind production (%m/m sa)	0.8	-0.2	1.6	—
8:45am	%oya sa	-3.7	-1.8	3.5	—
	Manuf prod (%m/m sa)	1.0	-0.9	0.8	—
	%oya sa	-3.0	-1.4	4.4	—

Judging by the rise in orders in recent months and the steady move up in the manufacturing PMI output reading (which reached 61.1 in February), German industrial production excluding construction likely rose again in February. According to our forecast, IP ex. construction rose 0.5% m/m after a 1.6% gain in the prior month. Judging by the weak construction PMI reading, however, construction output continued to be a drag on growth in February, when weather conditions remained poor. After a huge 14.3% m/m decline in January, we expect construction output to have fallen 5% m/m in February. When we put the pieces together, we find that total IP (which includes construction) in Germany likely rose 0.2% m/m in February. If our forecast is correct, German IP ex. construction will be tracking an increase of 6.3% ar in 1Q, construction output a decline of 55% ar, and total IP a rise of 1.2% ar. Given that construction output will likely bounce back sharply in March and that output ex. construction should rise further, however, total IP is likely to perform better than that in the quarter as a whole.

Manufacturing orders

Index, sa

		Nov	Dec	Jan	Feb
Wed	Germany				
Apr 7	Volumes, sa				
12:00pm	Total (%m/m)	2.7	-1.6	4.3	<u>0.5</u>
	%oya	1.3	7.2	19.7	<u>23.9</u>
	Domestic (%m/m)	1.6	-1.3	7.1	—
	%oya	2.6	5.6	15.2	—
	Foreign (%m/m)	3.6	-1.7	1.9	—
	%oya	0.1	8.6	24.2	—

We expect orders to have increased 0.5%/m/m in February, after rising 4.3% in the previous month. The manufacturing PMI new orders reading of 61.7 in February, coupled with a still low inventory reading (44.5), points to a strong gain in orders. But the sharp rise at the start of the year suggests that there may be some payback in February. If our forecast is correct, orders will be tracking an increase of nearly 20% at an annual rate in 1Q, showing a decisive reacceleration from 4Q, when they rose 3.7% ar.

Demand and labor markets

Retail sales

Total sales, volumes

		Nov	Dec	Jan	Feb
Thu	Euro area				
Apr 8	%m/m sa	-0.6	0.5	-0.3	<u>-0.4</u>
11:00am	%oya, working-day adj.	-2.1	-0.5	-1.3	—

Euro area retail sales could fall slightly in February. This outcome would leave the level of spending so far in 1Q10 around 1.5% annualized below the 4Q09 average. This would be the eighth consecutive quarterly decline in the region. In addition, car registrations are down in 1Q10, reflecting payback from the car scrap-page incentives. As a result, overall consumer spending may also be heading for a small decline at the start of the year.

External trade and payments

Foreign trade

		Nov	Dec	Jan	Feb
Fri	Germany				
Apr 9	€ bn, values, sa				
8:00am	Trade balance	16.9	16.6	8.7	—
	Trade balance—year earlier	10.9	11.0	7.2	8.3
	Exports	70.1	72.5	67.9	—
	%m/m	1.1	3.4	-6.3	<u>6.0</u>
	Imports	53.2	55.8	59.2	—
	%m/m	-6.2	5.0	6.0	—

The collapse of German exports in January likely reflected weather-related disruptions. While imports are recorded by the statisticians when they arrive at the border entry point, exports must first be transported from the factory to the port, airport, etc. Therefore, the sharp divergence between exports and imports points to weather-related transport disruptions within Germany. This conclusion is also consistent with monthly survey indicators, which unambiguously point to an ongoing double-digit pace of export growth (e.g., export expectations in the IFO are close to record levels and the export orders index from the German manufacturing PMI rose strongly in both February and March to reach a new record high).

The main judgment for the February trade report is whether the rebound in exports will have materialized in February. We expect that to a large extent it will, but with more to come in March. In terms of 1Q10, even if exports increase by the 6%/m/m that we expect in February, the 1Q10 average will struggle to show a large quarterly gain. A return to the double-digit export growth signaled by the surveys and already seen in 2H09 in Germany may have to wait until 2Q10.

Inflation

Consumer prices

		Dec	Jan	Feb	Mar
Thu	Euro area				
Apr 8	HICP (%oya nsa)	0.9	1.0	0.9	<u>1.5</u>
9:30am	Netherlands				
	%m/m nsa	-0.7	0.0	0.7	<u>1.1</u>
	%oya nsa	1.1	0.9	0.8	<u>0.9</u>
	HICP (%oya)	0.7	0.4	0.4	<u>0.5</u>

Producer prices

		Nov	Dec	Jan	Feb
Wed	Euro area				
Apr 7	%m/m nsa	0.2	0.1	0.7	<u>0.2</u>
11:00am	%oya nsa	-4.4	-2.9	-1.1	<u>-0.4</u>

We expect to see Euro area PPI deflation moderate substantially in February, due to sequential increases in manufacturing PPI inflation. We also expect to see sequential gains in the intermediate goods sector.

Review of past week's data

Output and surveys

Real GDP

	2Q09	3Q09	4Q09	
Euro area				
%q/q sa	-0.1	0.4	0.1	
%q/q saar	-0.5	1.7	0.5	
%oya	-4.9	-4.1	-2.1	
France (final)				
%q/q sa	0.3	0.2	<u>0.6</u>	
%q/q saar	1.4	1.1	0.7	0.9
%oya	-2.7	-2.8	-2.3	<u>-0.3</u>
GDP components (%q/q saar)				
Private consumption	1.3	1.2	0.3	0.4
Government consumption	2.5	2.5	2.6	2.8
Fixed investment	-3.9	-5.3	-5.0	4.5
Exports	1.8	7.4	7.2	2.2
Imports	-9.9	-9.6	1.2	13.8
Contributions to GDP growth (%q/q saar)				
Domestic final sales	0.6	0.5	-0.3	-0.2
Inventories	-2.8	-2.9	-0.6	-0.5
Net trade	3.7	3.6	1.6	-3.3

Purchasing managers index final (manufacturing)

Index, sa

	Jan	Feb	Mar	
Euro area				
Overall region	52.4	54.2	56.3	56.6
Germany	53.7	57.2	59.6	60.2
France	55.4	54.9	56.3	56.5
Italy	51.7	51.6	53.0	53.7
Spain	45.3	49.1	51.0	51.8

The manufacturing PMI was revised up slightly in the final release. The PMI is consistent with a very rapid pace of growth in industry, and the employment index is also rising toward the neutral level. Outside of Greece, the gains were across the region (more details in this week's Euro area essay).

European Commission survey

% balance of responses, sa

	Jan	Feb	Mar	
Euro area				
Industrial confidence	-14	-13	-11	-10
Recent production trend	-7	-4	-5	0
Production expectations	5	7	—	9
Export order books	-45	-42	—	-37
Stocks of finished products	3	4	—	0
Selling-price expectations	-6	-4	—	-1
Construction confidence	-29	-29	—	-25
Retail confidence	-5	-9	—	-6
Service confidence	-1	1	—	1
Consumer confidence (final)	-16	-17	-17	

Economic sentiment in the Euro area improved significantly in March. Manufacturing led the way, rising 2.7pts. The details were also firm (improving domestic and export orders, solid output growth, and improving employment expectations). Outside of industry, the results were a bit more mixed. Construction confidence rose strongly again, but retail confidence did not fully reverse last month's weather-related decline, and confidence moved sideways in services and among consumers. However, the sentiment survey did

not prevent the sharp move up in last week's flash PMI from signaling that the rapid growth in industry was spreading to the broader economy.

Meanwhile, consumer confidence surveys were relatively soft. The major purchases index, which tends to track the trend in actual spending most closely, fell 2pts and is still pointing to weakness in consumer spending. And consumers still expect weak labor market outcomes, even though employment expectations among firms in all sectors improved again in March. While we expect only modest growth in consumer spending this year, with corporates and exports driving the recovery, it would be positive if key details of the consumer confidence survey would start to improve again in the coming months.

Demand and labor markets

Retail sales

Total sales, volumes

	Dec	Jan	Feb	
Germany				
Sales ex autos and petroleum, volumes				
%m/m sa	0.9	1.0	-0.5	0.4
%oya sa	-1.8	-1.4	-0.2	-0.7

German retail sales came in weaker than expected in February. The January and February average is now 1.4% annualized below the 4Q09 average, reversing the gain seen at the end of last year. Looking through the considerable monthly volatility in German retail spending, the level of spending has been relatively stable since mid-2009, with no clear trend in either direction.

While German car registrations in 1Q10 will again show a sizable decline (possibly by 40%q/q saar), the level of registrations has now fallen back to the pre-scrappage scheme level. And the recent trajectory is more positive now. In particular, car sales have increased in both January and February, after having declined almost continuously for the prior nine months.

Unemployment

sa

	Dec	Jan	Feb	
Euro area				
Harmonized measure (Eurostat)				
Unemployment rate (%)	9.9	9.9	<u>10.0</u>	
Germany				
Registered (ch m/m, 000s sa)	5	-1	7	-1
000s, nsa	3617	3643	—	3568
Unempl. rate (% sa)	8.1	8.2	8.1	8.2

Employment

	Dec	Jan	Feb	
Germany				
change m/m, 000s sa	5	6	5	4

After holding steady at 9.9% for three consecutive months, the Euro area unemployment rate nudged up by one-tenth in February. Unemployment rose by 61,000 in the month, which compares to a peak monthly gain of over 500,000 in January 2009. While data revisions have made the monthly increases in unemployment look a bit sticky in the last three

to four months, the significant gains in the March flash PMIs point to smaller increases in unemployment in the coming months. Overall, the unemployment rate is rising quite slowly now, suggesting that we are getting closer to the peak.

The German labor market report was much better than expected (with falling unemployment, rising employment, and more vacancies). New applications for the government's short-time work subsidy scheme fell further in February, and there remains pressure to cut jobs in some sectors (e.g., manufacturing). But other sources of labor market flexibility and a shift toward part-time work and increased hiring in public and service sectors (e.g., education, health) are continuing to provide relief. The risk of large-scale job losses is fading in Germany, despite the significant labor hoarding in the recession. The labor report and the strengthening recovery (as indicated by the March IFO and German PMI) are supporting this view.

Inflation

Consumer prices

	Jan	Feb	Mar	
Euro area (flash)				
HICP (%oya nsa)	1.0	0.9	<u>1.2</u>	1.5
Germany (prelim)				
%m/m nsa	-0.6	0.4	<u>0.2</u>	0.5
%oya	0.8	0.6	<u>0.8</u>	1.1
HICP (%oya)	0.8	0.5	<u>0.8</u>	1.3
Baden Wuerttemberg (%oya)	0.8	0.3	<u>0.7</u>	1.3
Bavaria (%oya)	0.6	0.4	<u>0.8</u>	1.1
Brandenburg (%oya)	0.6	0.3	<u>0.8</u>	
Hesse (%oya)	0.5	0.3	<u>0.7</u>	0.8
North-Rhine West (%oya)	0.8	0.6	<u>0.8</u>	1.2
Saxony (%oya)	0.7	0.5	<u>0.8</u>	1.3
Italy (prelim)				
%m/m nsa	0.1	0.1	<u>0.3</u>	
%oya nsa	1.3	1.2	<u>1.4</u>	
HICP (%oya nsa)	1.3	1.1	<u>1.3</u>	1.4
Spain (flash)				
HICP (%oya nsa)	1.1	0.9	<u>1.2</u>	1.4
Belgium CPI				
%m/m nsa	0.5	0.4	<u>0.3</u>	0.4
%oya nsa	0.6	0.7	<u>1.5</u>	1.7
HICP (%oya nsa)	0.8	0.8	<u>1.6</u>	

Euro area HICP surprised to the upside in March. Given that no further details are yet available from Eurostat, we can only speculate on the causes of this surprise on the basis of the available information at the country level for Germany, Italy, Spain, and Belgium, where reported inflation rates for March were at least a couple of tenths above expectations. Because of this widespread surprise, it seems unlikely that the move in the Euro area flash HICP was due to a sudden and large price increase in a specific component in a specific country.

Inflation in the volatile energy and fresh food components appears now to have strengthened more than expected, especially fresh food inflation. Part of the surprise, however, was likely caused by higher core inflation. There were two factors pushing core inflation up. First, the beginning of the Easter holidays likely pushed up prices for leisure, hotels, and restaurants across the region. Second, the Greek government approved extra measures to consolidate the fiscal position, which likely contributed roughly 0.05%-pt to Euro area inflation.

The German preliminary CPI shot up in March, with the increase in inflation differing widely across the states. The upward surprise was caused in equal parts by three components: food prices, gasoline prices, and tourism-related prices. First, food prices started moving above the seasonal trend a couple of months ago, after almost a year of small sequential declines. In March, however, seasonal food prices rose sharply but not evenly across the six states, possibly owing to lower supply, after the intense cold in the first two months of this year. Second, gasoline prices rose more sharply than expected in March, likely around 5.3% for Germany as a whole, almost twice the rise that we had penciled in. This suggests that prices kept rising throughout the whole month. Third, the increases in prices on services related to tourism, such as package holidays, hotels, and restaurants, were a lot larger than expected, and it is not clear whether they will be reversed anytime soon. Core inflation rose one-tenth in March to 0.9%oya.

Producer prices

	Dec	Jan	Feb	
France				
%m/m nsa	0.1	<u>0.7</u>	0.6	— 0.2
%oya nsa	-2.9	<u>0.4</u>	0.3	— 1.0
Italy				
%m/m nsa	0.0	0.6	—	0.2
%oya nsa	-1.5	-0.3	—	0.4

Import prices

	Dec	Jan	Feb	
Germany				
%m/m nsa	0.5	1.7	<u>-0.1</u>	1.0
%oya nsa	-1.0	1.4	<u>-1.5</u>	2.6

Import prices in Germany moved up sharply in February. The rise in inflation was caused by the sharp move up in energy and food inflation, helped respectively by the depreciation in the exchange rate and the adverse weather.

German import prices and HICP

