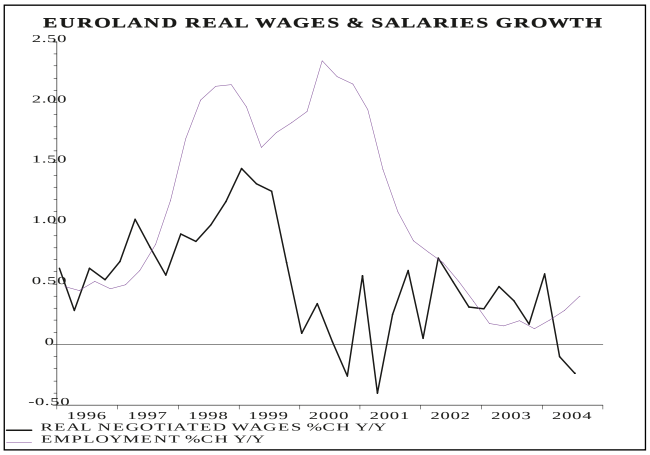
GFC ECONOMICS

DAILY COMMENTARY

ECB REMAINS OVERLY OPTIMISTIC

The ECB was forced last week to cut its central growth forecast for the coming year to 1.6% from 1.9% back in December. Even so, the Central Bank has taken heart from the pick up in domestic demand seen last quarter and is assuming that activity picks up significantly from the pace seen in H2 2004. Its forecast that the recovery becomes self-sustaining over the coming year looks excessively optimistic. Consumer spending has picked up recently but the continuing weakness of the labour market suggests consumption may well slow again. Any gains in employment and real wages look set to remain minimal. Despite the ECB's clear desire to tighten policy as soon as it can, the persistent weakness of the economy is likely to keep rates on hold over the remainder of the year. The futures market, by contrast, is still pricing in 3-month rates rising to close to 2.5% by the end of the year.



ECB Cuts Its Growth Forecast

The ECB's growth projection for 2005 has been reduced to 1.2-2.0% from 1.4-2.4%. However, at last week's ECB press conference, Mr Trichet pointed out that around two-thirds of the downward revision was due to base effects, stemming from the weak performance in Q3 and Q4 last year. The ECB in effect remains very optimistic for the coming year, as indeed it was at the start of last year. In order to achieve the ECB's central projection of 1.6% growth in 2005, GDP has to average an annualised gain of some 2.0% through the year. This is significantly higher than the 0.8% annualised increase achieved in the second half of 2004.

Whilst admitting that the economic performance in H2 2004 was disappointing, the ECB took comfort from the recovery in domestic demand seen in Q4. Total domestic demand actually slowed, due to a small rundown of inventories following their build-up in Q3. But final domestic sales growth picked up from an annualised 0.6% to 2.0%, the highest rate in two years. Consumption saw a gain of 1.8%, while investment posted an increase of 3.9%. Although these gains cannot be dismissed out of hand, major doubts remain over whether spending can continue to grow at this pace. The early data on consumer spending in Q1 has been relatively downbeat. Euroland retail sales rose a modest 0.3% m/m in January and were down 0.6% on a year earlier. Moreover, the retail PMI in February fell further below the 50 breakeven mark to 47.3 from 49.9 in January. The main factor holding back consumption remains the labour market, which is not providing the income gains needed to sustain spending growth at its recent rather healthier pace.

Euroland unemployment may have stopped rising a year ago but, aside from the odd wobble, has been stuck at 8.8% ever since. Employment was up a meagre 0.3% y/y in Q3 2004 and the PMIs have shown no real improvement in the situation since then. The employment component of the services PMI was 50.6 in February and is little changed over the last six months. That said, it has picked up since 2003 and 2004 H1, when it was running below the 50 mark. The manufacturing PMI, meanwhile, has shown continued job losses; the employment component did rise in February but only to 49.1. With offshoring likely to remain a significant drag on manufacturing employment for the foreseeable future, the hope was that the service sector would take up the running. And the promise of significant employment growth here rested primarily with the deregulation of the services market promised by the EU Commission's services

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directive. The latter, however, is looking increasingly forlorn. Gerhard Schroder, seemingly with Jacques Chirac's blessing, stepped up his attack on the directive this week. And last week, Jose Manuel Barroso admitted that it needed serious revision. The major objections pertain to the "country of origin" principle, which would permit companies to supply services across the EU as long as they complied with regulations in their home country. While the services directive is by far the most important initiative, recent national proposals in this area have at the margin been positive. The French Government has recently announced a plan to stimulate employment in domestic services, while the Italian authorities have proposed a series of reforms aimed at boosting competitiveness.

Lack of substantive employment growth, however, is not the only factor holding back the consumer. The other big problem is that wage growth has been falling steadily over the last two years. Compensation per employee in Euroland was up all of 1.5% y/y in 2004 Q3. Even after allowing for the fact that compensation was artificially depressed that quarter by the timing of Italian public sector payments, compensation growth is now running at no more than around 2.0% y/y. This in turn has translated into a small fall in real wages. Going forward, the prospect is for nominal wage inflation to continue to grind lower in the face of the threat of off-shoring and the influx of workers from Eastern Europe. While individuals from last year's entrants into the EU are barred from working in countries such as Germany for up to seven years, there is no restriction on companies. Firms are using this loophole to employ migrant labour and in Germany, the resultant job losses are already triggering a political backlash.

Falling inflation had looked set to provide some offset to lower nominal wage increases - January saw the Euroland CPI edge below 2.0% y/y for the first time since last March - but the latest run-up in oil prices is now calling this into question. Either way, real wage growth looks set to remain close to zero. Combined with employment rising by no more than 0.5% y/y, this leaves real income growth running well short of the 1.8% annualised growth in consumption seen last quarter. The ECB's assumption that the pick up in Q4 will be sustained look optimistic. The strength of the housing market in the likes of Italy, Spain and France will obviously be of some help in fuelling a decline in the saving ratio. That said, the potential direct leakage from housing to consumption is limited in most of Euroland. There has also been no rise in consumer confidence over the last year, following its recovery in 2003.

Germany has been the biggest drag on Euroland consumption over the last couple of years and, on the face of it, there has been some improvement here recently. Retail sales posted a strong 2.8% m/m gain in January and consumer confidence has been edging higher over the last few months. All the same, the bounce in sales was in large part a correction to declines in the previous two months, and the underlying trend remains little better than flat. With German wages declining in real terms, any employment growth largely in low paid jobs and headline unemployment at a 73 year high, the scope for consumption to do much more than stabilise seems limited. Spain and France, by contrast, have seen much the strongest spending growth in Euroland, with consumption up 4.0% y/y and 2.5% y/y respectively in Q4. In Spain, a healthy labour market provides a firm basis for continued strength going forward. In France, however, it is much more questionable whether the recent large gains can be sustained. While French household consumption of manufactures rose strongly in January, unemployment edged up to a five year high of 10.0% and real wage growth is running at no more than 1.0% y/y.

Despite these grounds for continuing caution on the spending front, the ECB expects consumption, along with investment, to fuel a pick up in growth this coming year. And, if Mr Trichet is to be believed, it is only a matter of time before interest rates are raised. Nevertheless, with ECB hopes of the recovery becoming self-sustaining likely to prove overly optimistic once again, rates look set to remain at their current levels for some time to come.