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CENTRAL BANKS ADD TO EUROLAND'S GROWTH PROBLEMS

An improvement in business confidence over the new year had fuelled hopes that the Euroland economy would rebound from its dismal performance in late 2004. Such expectations, however, look as misplaced as ever. Confidence has fallen back in February, and the rise in the oil price and renewed strength of the euro are likely to keep it under pressure. Indeed, the euro should be pushed up, not only by the excessively large US trade deficit, but also by central banks diversifying their reserves out of dollars into euros. Despite yesterday's protestations to the contrary, this switch is probably already underway and looks set to continue. A rising euro can only intensify the wave of corporate restructuring in Euroland, which is proving - as in Japan - to be a very mixed blessing. It is concentrated in manufacturing, rather than services, and is putting downward pressure on real wages. Liberalisation of the service sector is badly needed, but it is not clear the Barroso Commission will succeed in pushing through the services directive. Euroland's growth deficit looks set to remain substantial over the coming year. This in turn should lead to the spread between 10 year US Treasuries and EGBs widening further in the months ahead.

Business Confidence Retreats Again

Business sentiment has fallen back this month in Germany, Belgium and Italy. Belgian confidence, which is one of the better lead indicators for the Euroland, declined to its lowest level since November 2003, and has yet to break out of the pronounced downtrend it has been locked in since last summer. The IFO index has held up much better, and this would be of some comfort, but the survey failed to pick up the deterioration in the German economy in H2 2004. This is not to say that the Euroland economy will not recover somewhat in Q1. Importantly, German GDP, which fell 0.2% q/q last quarter, should see a modest gain. German growth was depressed heavily by reduced stockbuilding in Q4 and this drag is unlikely to continue into Q1. All the same, the longstanding hope of the ECB that the recovery will pick up speed and become self-sustaining looks as forlorn as ever. Not only is the Brent oil price threatening to hit $50pb again, but also the euro appears to be resuming its appreciation.

The major force driving the euro up against the US$ continues to be the exceptionally large US current account deficit. Despite the fall in the US$ to date, recent strong spending numbers in the US suggest the deficit could increase further in coming months. If the trade imbalance is to fall to manageable levels, a further substantial fall in the US currency will be needed. This underlying upward pressure on the euro against the US$, however, is now at risk of being exacerbated by central banks diversifying their reserve holdings into euros. Wednesday saw the Asian central banks do their best to deny they had been switching out of dollars, but this was to be expected. It is not in the central banks' interests to publicise any such shift and risk triggering a collapse in the US$ before they have been able to diversify their holdings. Rather, there is every incentive for each bank to switch their holdings surreptitiously before other central banks jump on the bandwagon.

While there is no concrete evidence, last year's survey by Central Banking Publications - along with recent data on official holdings of US Treasury securities - strongly suggests there has already been some diversification out of dollars and into euros. The switch has probably so far been relatively small and is likely to remain a gradual process. Indeed, it may occur primarily via central banks investing the proceeds of future intervention in euros rather than dollars. If central bank buying of euros is already underway, it has not led to any discernible increase in foreign purchases of Euroland debt. Such inflows declined to Eur57.4bn in the second half of last year, from Eur144.0bn in the first half. All the same, there is clearly the potential for a significant increase in purchases. At the end of 2003 (the last date for which official data is avail-

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able), the euro accounted for only 19.7% of global foreign exchange reserves, compared with 63.8% for the US$. This was up from 19.2% in 2002, though most of this rise was down to valuation effects from the falling US$. With global foreign exchange reserves totalling $3.57tr in November, a 1% shift in reserves into euros would translate into an inflow of $40bn or so. The upward pressure on the euro, however, could well be much greater than any actual shift in reserves if private investors attempted to front-run the central banks. Indeed, there is a risk that such front-running might extend to the central banks and a gradual rebalancing towards euros turns into a mass dumping of dollars. The fact that some of the Asian central banks - most notably the Bank of Korea - now appear more willing to allow their currencies to appreciate against the US$ is unlikely to stop the euro having to shoulder much of the adjustment in the US currency. After all, the Bank of China, is still refusing to play ball, and the Bank of Japan's response to any test of 100Y/$ remains very uncertain. All this suggests the US$ looks set to fall significantly further, with the euro remaining a prime 'beneficiary'.

A renewed appreciation of the euro is, of course, the last thing the Euroland economy needs. It is liable to depress business confidence further, exacerbate the loss of competitiveness and ensure the pressure on companies to cut costs remains intense. Corporate restructuring is a very mixed blessing for Euroland, particularly in Germany, where the bulk of the rationalisation is occurring in the manufacturing sector. While in isolation it is a positive, as failure to cut costs would lead to even more offshoring of production, the wider implications are much more ambiguous. If one accepts that the US current account deficit will eventually trigger or require a marked fall in the real value of the US$, German cost cutting is to some extent merely delaying the inevitable loss in competitiveness that Europe needs to suffer against the US. In this sense, it is increasing the nominal appreciation needed to secure the necessary rise in the real value of the euro.

More importantly, the downward pressure on labour costs has left real wage growth little better than zero for Euroland as a whole and negative in Germany, and has undermined consumer demand. Governments have done their best to offset this through tax cuts and other incentives aimed at consumers, but with only limited success. Partly, this is because other very necessary reforms of pensions and social security have offset the stimulus coming from such tax cuts, by hitting either confidence, incomes or both. The more fundamental problem, however, is the underlying weakness of the labour market. In Germany, tax cuts transformed a 1.9% y/y fall in real wages and salaries in Q4 into only a 0.5% y/y decline. This in turn helped halt the contraction in consumption seen over the last couple of years. But unsurprisingly, it was not sufficient to push spending growth back convincingly into positive territory. Even in France, where government stimulus has been reinforced by a booming property market and spending is growing strongly, there are major doubts as to whether recent growth rates can be sustained. The labour market remains largely unmoved by the pick up in the economy, and consumption growth has been exceeding income gains by a wide margin.

The problem of depressed real wages in Euroland is being exacerbated - at least in the short term - by the stickiness of prices. Whereas wages have become more flexible downwards due to the potency of the offshoring threat, the continuing lack of competition in the services sector means prices remain very insensitive to the weakness of demand. In this sense, the focus of the Barroso Commission on completion of a single market in services is very positive because of the jobs and price flexibility it should create. It would also - unlike the restructuring being seen in the traded goods sector - help correct the US trade deficit by stimulating European domestic demand. Unfortunately, it is far from clear whether this initiative will be successful in the face of German and French opposition to key components of the directive. Either way, this will not solve Euroland's short-term growth problems, which look set to remain significant - particularly if the euro now resumes its appreciation.

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