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European Banking Federation

FBE Outlook

FBE OUTLOOK ON THE EURO AREA

The ECB must tread carefully

1. The European recovery is still very fragile

The European economy has passed through turbulent times. One of the most important threats to its recovery - highlighted in past Outlooks - was the risk of "*a lasting, substantially higher oil price*" (June 2004). This materialised in 2005, even before the devastation caused by Hurricane Katrina pushed oil prices to record highs. The euro area is still suffering from the lagged effects of this shock, and must adjust to higher commodity prices for some time to come. Nonetheless inflation pressures remain benign. Global competition and the area's economic weakness mean that higher raw material costs are not feeding through to overall wage and price levels to the extent of previous oil price shocks.

Future trends in the international environment are not particularly encouraging for growth in the euro area. Demand for Europe's exports from its main markets in the US, Asia and the oil producing countries has been a vital support for euro area activity at a time of weak overall domestic demand. But growth in these crucial markets is expected to decline. The slowdown will become more pronounced as 2006 progresses.

In this Issue

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Note to the editor

The European Banking Federation (FBE) is the voice of the European banking sector, with over 20 000 billion EUR assets and 2.3 million employees in 27 European countries. The FBE represents the interests of almost 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

Credit

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This Outlook presents the results of the biannual poll of the chief economists of banks and banking associations gathered together in the FBE's Economic and Monetary Affairs Committee (EMAC), looking forward to the end of 2006.

In view of their assessment of the growth and inflation outlook for this period and beyond, **the vast majority of EMAC members consider an increase in ECB rates today to be premature**. While they appreciate the need for vigilance in containing price pressures, they see no justification on fundamental economic grounds for a rate hike for now. Undoubtedly, the growth of money supply has exceeded the ECB's reference value for some time, mainly caused by a strong credit expansion to private customers. Many poll respondents see signs of somewhat higher but still not strong economic dynamism and some inflation risks. But most of them recommend keeping interest rates on hold unless there is a clear sign of a lasting revival in domestic demand, or second round effects of the oil price increases, both of which would pose a more visible threat of inflation.

The ECB has nevertheless made its intentions clear. The forecasts of EMAC members for 2006 have taken account of the widespread expectation that the ECB would raise rates sooner rather than later. Most of the forecasters expect an increase of no more than 25 basis points in the ECB main refinancing rate today. On this assumption, the average of the economists' expectations suggests a modest pick-up in economic momentum for 2006 as a whole. Growth is seen as increasing from an average of 1.4% in 2005 to a still lacklustre 1.7% next year. A minority of forecasters actually envisage no improvement in growth at all between 2005 and 2006. The economists generally agree that growth is likely to lose steam in the course of next year, as world trade moderates, oil prices remain at a fairly high level, interest rates rise and the euro strengthens. They urge caution with regard to further ECB interest rate increases next year: any further hikes must be related to developments in economic activity.

As growth in the US and possibly some key Asian markets slows, the euro area economy will become more dependent on its own capacity to generate growth which has so far been rather limited. At present all of the three largest economies in the euro area - Germany, Italy and France - are at a political crossroads. The only real remedy for these countries' growth difficulties is structural reform, particularly in their labour markets.

In Germany, the new government has decided on new measures which primarily aim at reducing the public deficit in order to comply with the constitution and the Stability and Growth Pact. While the direction of these measures is reasonable taking into account the level of the public deficit and debt, the package as a whole risks dampening growth prospects in Germany and the euro area in 2006, and even more in 2007. This is because it is mainly based on increasing dues rather than cutting public consumption expenditures and changing the structure of public spending towards public investment. Furthermore, little is done to improve the flexibility of product and labour markets.

Business restructuring has helped boost export sales of German firms, which are now making a strong contribution to growth. In addition, business investments have started to grow again. On the other hand, consumer confidence will remain subdued until the employment situation improves. The projected hike in VAT rates in 2007 will give rise to a good deal of planned expenditure being brought forward to 2006. Despite some improvements, growth will probably remain entrenched below historical trends next year. This will limit growth prospects for the euro area as a whole.

In the case of France, the upcoming elections make it highly unlikely that significant and long-overdue policy initiatives will be introduced over the next year. Furthermore, domestic unrest has reduced the scope for structural reforms and is causing priorities to shift away from urgent structural issues.

The risks to the growth outlook are still mainly on the downside, in particular the possibility that external demand for euro area goods and services will weaken significantly. A downturn could be triggered by a sharper-than-expected slowdown in global demand, possibly provoked by rising global interest rates; a cooling-off in housing markets (especially in the US); and/or a sharp appreciation in the euro, which could choke off net exports. A further hike in oil prices cannot be excluded: we may not have seen the worst, although the economists' main scenario is for Brent crude to trade at around $ 55 per barrel through the forecast period. There are some upward risks to the main growth scenario: world growth and trade volumes could be higher than expected, encouraging more investment; and better employment prospects could release pent-up consumption demand.

Global imbalances in savings will continue to threaten the outlook, although they are not expected to prevail over shorter term considerations over the next six months to a year. The future behaviour of Asian investors towards their US assets is an important factor in determining the future dynamics of global imbalances.

2. Output still skewed towards the external sector

Exports will remain a significant driver of growth in 2006. Growth in world trade remains strong, and the starting point for the euro exchange rate is helpful (it has depreciated by around 12% in the last twelve months; 5% effective). European sales abroad are expected to continue to grow at a faster pace, some 5.3% on average (after 4.0% this year). One reason for this improvement is the better export performance of Germany; another is the weaker euro, at least in the first half of the year. The trade balance is expected to gain slightly compared to this year's performance, at 1.2% GDP. If the euro continues to trade in the current range, the competitiveness of euro area exports should not suffer, although competition, from Asia in particular, is intensifying.

Business investment should also grow more strongly than last year, but there is considerable uncertainty about the extent of the improvement. Provided the ECB rate increases are moderate (no more than 50 basis points over the forecast period, assuming stable fundamentals), financial conditions are expected to continue to be relatively expansive and many firms have successfully restructured their balance sheets. But the uncertainty about growth prospects still dampens investment activity. The prospects for 2006 have somewhat improved. But gross fixed capital formation is on average expected to accelerate only to 2.4%, after 1.6% in 2005. This is clearly below levels normally seen at this stage of a recovery. The range of economists' estimates is high, from as low as 1% to 3.5%.

The behaviour of the European consumer will be a crucial factor next year. Global competitive pressures are keeping a lid on employment gains, but most of the economists expect to see a slight fall in the unemployment rate, to some 8.4%, after 8.7-8.8% in the last two years. If this gain in employment is realised, the household sector should slowly benefit. Taking into account spending in anticipation of the VAT rise in Germany, this offers the prospect of **private consumption** growth which will remain moderate (1.4%) but on an upward trend. Wage growth should again be contained, by the competitive situation, at just over 2%.

Some may argue that a hike in rates now could boost confidence in the ECB's management of monetary policy, and the greater certainty that inflation is under control will support household expenditure.
However, the expected slight pick-up in domestic demand due to better employment numbers in the euro area (which would increase households' disposable income accordingly) may be neutralised by the expected cooling-down of many national housing markets caused by: rising interest rates; a dip in consumer confidence; and, in some geographic areas, also because of over-optimistic real estate prices. On balance the chief economists consider that a rate hike is more likely to deter spending, and risks dampening the optimism generated by the improved employment picture. A change in the mood of consumers is urgently needed in some countries.

3. Inflation pressures are under control

Core inflation is expected to remain very low through 2006, at 1.6% (1.6% 2005). And headline inflation (HICP) should begin to decline steadily after January 2006. A range of influences will contribute towards this trend: favourable base effects related to this year's run-up in oil prices (by spring 2006, energy prices will have been at a high level for one year); the low level of core inflation; and the persistence of a significant output gap.

There are some upward price pressures but these seem containable. Publicly-administered prices will probably edge upwards in response to higher raw material prices. But we do not see a significant pass-through from energy to other CPI components. The overriding factor is competition. Company profit margins are likely to continue to absorb a good deal of the cost pressure because they lack the power to raise prices. On the labour market front, slightly higher unit labour costs are expected next year (2.2% growth in wages). But the economists do not see second round effects from the oil price increase boosting wages beyond this. Employees are in general subject to similar competitive pressures – in the jobs market – to companies.

The widening gap between core and headline inflation rates (expected average 0.6 percentage points for 2005) does present a challenge for the ECB, at least in terms of communication and evaluation of its effectiveness as a central bank. The economists expect the two measures to fall back in step as 2006 progresses, possibly as early as spring, bringing the average differential for next year to 0.4 pp.

The growth in money supply is a matter of concern for the ECB. In general the economists see growth in M3 falling back during 2006 to around 6% by the end of the year (7.6% by the end of this year). They do not see the volume of liquidity as necessarily threatening to the economy; the empirical links between liquidity growth and inflation may have become weaker in recent years. Reflecting the expected profile of economic activity, growth in credit to the private sector is seen as strengthening slightly this year and through the early part of next year, after which it should fall back to the 6.5% level registered in 2004.

4. Will the imminent ECB rate hike have a positive effect?

The economists expect that the interest rate move will be modest. The ECB has signalled that it is not trying to "*catch up*" after a long period of extraordinarily low rates. The majority of the chief economists envisage an increase of 50 basis points at the most over the forecast period (from now to end-2006), particularly if the signs from the economy show continued weakness.

The move is less a response to a significant change in fundamentals, more a pre-emptive strike. Although short and medium-term inflationary pressures are under control, a rate increase sends a signal to the markets that the ECB remains vigilant, and its objectives are relevant and real. It seems to expect a robust rebound this year.

In terms of the real economy, however, the economists see a risk that this signal will backfire. An increase in rates at this stage could undermine consumer confidence and provoke some retrenchment in household behaviour. At the same time, it will cut into business profit margins which are already under pressure from higher commodity prices.

As mentioned in our Mid-2005 Outlook, to the extent that consumption has been helped by higher asset prices, our main scenario is vulnerable to a sharper than expected tightening of monetary policy, leading to significant corrections in the real estate markets in some areas or even whole countries. This would trigger a substantial decrease in domestic demand in those areas and further hamper already low consumer confidence across the euro area.

5. Dollar fundamentals out of the limelight for a few more months

As it happens, the pressure is currently off the euro: at least in the short term, interest rate differentials will continue to support the dollar. In the next quarter or two, the euro may continue to weaken gradually against the dollar before bottoming out in late spring or early summer. Around mid-year, as US growth slows and dollar interest rates stabilise, this effect will diminish. As the momentum of US growth slows, the twin deficits will come to the foreground again and dollar optimism could swiftly evaporate. The negative structural factors are considerably worse now than they were in 2002, when the dollar started to decline. In particular, the current account deficit is now twice as large as it was then, and four times as large as it was in 1999. Coincidentally, the foreign currency reserves of some Asian Central Banks have shown the same trends and dynamics (have increased considerably) over the last five to ten years.

EMAC members on average suggest a strengthening in the euro to around 1.27 dollars by the end of 2006. There is as usual a wide range of individual forecasts (1.15 to 1.50) but most of the forecasters see a stronger euro by year-end.

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The FBE Outlook is broadly representative of the opinions of the European banking community although it does not always refl ect in every detail the views of the Federation's 27 Member Associations, which together represent over 4,500 banks.