

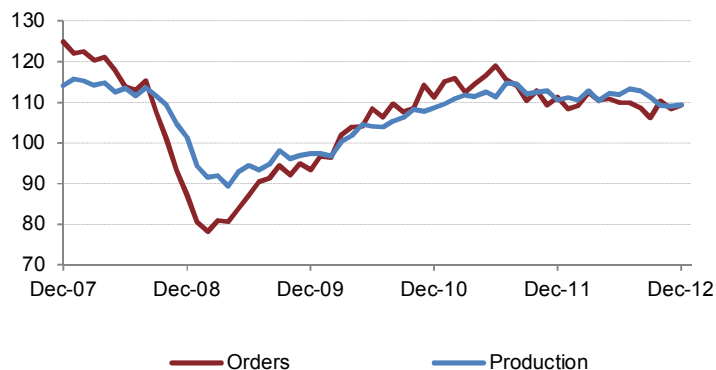
The ECB dilemma

German growth, French weakness – strong euro cannot last

The ECB left interest rates unchanged today, very much as expected. But the somewhat upbeat tone of Mr Draghi at the usual press conference was less expected. Following on from last month's press conference, there had been some expectations of a cut in EA interest rates, or at least a shift to a somewhat more dovish tone, holding out the prospect of a cut later in the spring. One reason for these thoughts was recent euro strength, not the most attractive development for an economy still hoping for export-led growth. In the event, Mr Draghi hinted at nothing of the sort. Monetary policy is and will remain accommodative, the recovery will gather strength later in 2013 (whether this was an upward or downward revision from previous talk of recovery in the second half of 2013 was carefully left unstated), risks remain on the downside and inflation will come down further.

In truth, the ECB currently, as so often with 17 disparate economies, is facing a dilemma. On the one hand, there are positive signs in Germany. Sentiment (covered in previous comments) is rising; and, more recently, hard data seems to have caught up with this. Both orders to manufacturing and industrial production rose in December: Orders by 0.8% (but orders from other euro area countries by 7%, the biggest monthly rise since July 2011) and industrial production by 0.3% (0.8% excluding construction). If indeed the EA economy is beginning to recover, it is time to start considering exiting from unconventional measures and perhaps even contemplating the eventual normalisation of interest rates in the long term.

Orders to German manufacturing and industrial production, index 2005=100

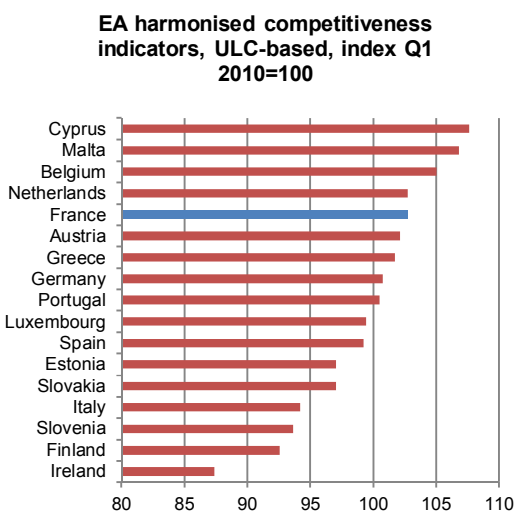
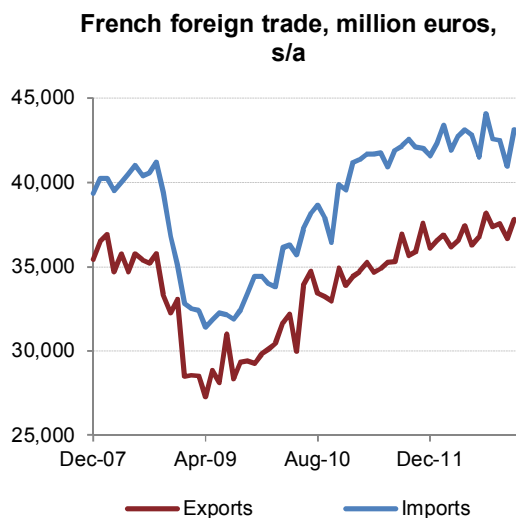


But the problem is that the signs of recovery, although there, are perhaps not quite as strong one would hope. The recent German numbers may be positive, but the trend is more sideways than up and both orders and output remain weaker than two years ago. For the moment, the data still points to stabilisation, rather than strong recovery.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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Moreover, as is abundantly clear by now, the EA is more than Germany. And if Germany is at least recovering, the same is not necessarily true for France, where confidence and hard data both are, if anything trending down. French exports have perhaps performed better than expected, given euro strength – but they are still only just back at their pre-crisis levels; while imports have shot up. No wonder that M. Hollande has called for an FX rate policy (which, incidentally has another effect: if the EA is to have an exchange rate target it is set not by the ECB but by the Council of Ministers, thus eroding ECB independence in one fell swoop). Significantly, if competitiveness in the crisis-hit countries has increased since the Greek crisis broke (if mainly through large-scale redundancies), French competitiveness – and Dutch and Belgian – has deteriorated.



It is also abundantly the case that large-scale economic and non-economic risks still loom over the EA. Among the latter are the future of Mr Rajoy in Spain and the possibility of Mr Berlusconi perhaps even winning this month's elections. Among the former are the greater-than-expected weakness of the Spanish economy and the risk of a relapse in Greece – not to mention unknown unknowns.

The euro has been surprisingly strong recently. But fundamentals – including the possibility of another rate cut after all, while interest rates in the US eventually (though not until next year) will head in the opposite direction – still point to euro weakness/dollar strength over the course of 2013.

Gabriel Stein 2013-02-07
gabriel.stein@steinbrothers.co.uk

Gabriel Stein is Managing Director of Stein Brothers (UK) Ltd and Chief Economic Advisor to OMFIF. The views expressed are his own.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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