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Who would have thought that?

By: Eurointelligence ECB Watch

We never thought the euro area would decouple from the world. But we believe that the euro area is more resilient than some of the sentiment surveys and economic forecasts have been suggesting. The Q4 data, up 0.4% on the quarter, are actually quite good. The biggest regional drag on those data was Italy, which is probably in recession - a place where it should not be at this point in the economic cycle if the Prodi administration had undertaken the necessary economic reforms. In terms of components, the main weakness is the European consumers - what's new? - while investment holding up well. The Netherlands has been performing almost spectacularly well.

This latest Eurostat data release is not going to change our view that European interest rates are not going to fall in March or April, as an increasing number of analysts believe. There will be severe resistance to a rate cut from the two Germans on the board, Axel Weber from the Bundesbank, and Jurgen Stark from the ECB directorate. And while they did not get their way when they pushed for a rate increase until quite recently, the ECB governing council will probably not wish to push them into corner, and forcing a rate cut on them. Also, this is not a case of Germany versus the rest by a long shot.

Also note: a group of German economists, who call themselves the ECB Observer, have made their own inflation forecasts for the euro area, and came up with 3.1% this year, and 2.7% in 2008. To us, that forecasts seems more plausible that the ECB's own complacent inflation forecasts, which has been consistently too optimistic.

This ECB Observer forecast, if correct, would suggest that the ECB should have raised interest rates last year, and should do so now - just as the Swedish Riskbank has done this week. We don't believe this is going to happen, but nor do we believe the story that the ECB stands ready to cut even if output growth were to weaken.

For that to happen, we need more than just a weak GDP survey. We will in addition need to see some evidence of falling inflation and/or falling inflationary expectations, and/or evidence of lower than estimated second round effects. The warning strikes in the German public sector are signal that the trade unions mean business this time, and we expect pay increases to be significantly higher than in previous years across the board. The second round effects are happening, there is no question. The only question is whether they will be moderate strong or very strong. We suspect that they will be strong enough to prevent inflation to return towards the ECB's target of 2%.

So we remain outside the interest rate consensus. We do not see a rate in Q2, and as of now we are reluctant to look beyond the current quarter.

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