

What will drive Euroland's growth in 2004?

Investment Strategy

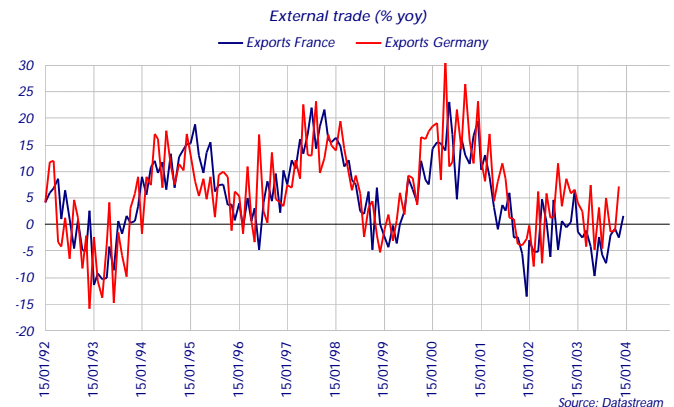
N°269 – From 1st to 6th March 2004

- The last quarter of 2003 saw a slight decline in the pace of GDP growth for Euroland (0.3%, after 0.4% in 3Q03). Average GDP growth for the year ended was a mere 0.4%, with the second-half rebound making up for the virtual stagnation observed through the first six months of 2003. Available statistics for 4Q03 paint very different pictures from one domestic economy to the next. Quarterly GDP growth in Germany was 0.2% for each of the two last quarters; France posted a slight upturn in the final quarter (0.5%, after 0.4% in 3Q); and Italy reported a fourth-quarter dip (0%, after 0.5% in 3Q). By contrast, Spain recorded relatively brisk growth of 0.7% for each of the last two quarters of 2003.
- Analysed in terms of drivers, corporate investment appears to have got in gear in Germany, while both public and private consumption continued to stall in the last quarter of 2003. Growth was more balanced in France and Spain, albeit less exuberant in France, where both household and capex spending increased. The Italian government has not yet made itemised data available, but a number of published monthly statistics and surveys suggest weakness in both household consumption and exports. All told and all around, 2003 looks to have been a bad year: Germany dipped into a slight recession; whilst the Netherlands fell into a deep one. Both France and Italy are still having trouble igniting their growth engines. Only Spain – and to a lesser extent Belgium – has managed to escape unscathed.

Export picture improves despite the euro

- In spite of the euro's strong appreciation in 2003 (20%), external trade shaved a relatively slight 0.4% off of GDP growth. Indeed, eurozone exports recovered in the second half of last year, with Germany and France leading the charge. It looks as if the volume effect trumped the price effect in spite of the dollar's weakness. Not only that, but eurozone exports to Asia – the other driver of world trade – rebounded vigorously last year. Euroland exports to China were up a substantial 17% in 2003 (through October). The

eurozone was also the target of demand from Eastern Europe: exports to Russia, the Czech Republic and Hungary rose by 7%, 4% and 4%, respectively. On the other hand, trade within the zone rose by a very modest 1%.

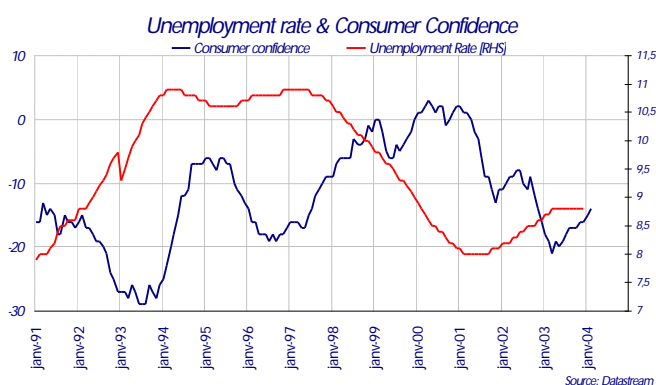


- So far, 2004 looks like a most promising year for Euroland, however. Demand from around the world is expected to pick up steam just as growth gains strength (3.3% in 2004, after 2.4% in 2003). Apparently, eurozone businesses opted to hang onto acquired market share, accepting lower margins and taking steps to lower operating costs. Indeed, both capex spending and human capital were subject to significant downward adjustments. Growth in global demand is expected to lead the contribution from external trade back into positive territory in 2004 (0.2 GDP points). We believe that the adverse impact of the euro's appreciation is likely to run its course before the year is out. Indeed, we expect that, in one year's time, the euro will have declined slightly against the dollar (1.20).

Investment-led domestic demand

- As we have indicated, the euro's appreciation has also weighed on internal demand, via cost cutting and downsizing on the part of businesses. The expected upside of a stronger currency – that is, greater purchasing power courtesy of lower import prices and consequently lower prices in general – did not happen this time. Inflation did indeed slow down, but only

slightly (2.3% in 2002, versus 2.1% in 2003), reflecting the impact of higher indirect taxes as well as higher administered prices, including energy prices (+3%). As a result of these price pressures, domestic demand did not take full advantage of the price effect related to the euro's rise. At the same time, corporate downsizing encouraged consumers to save rather than spend. Although the last ten months have seen unemployment stabilize at 8.8% for Euroland as a whole, employment trends remain unfavourable in most of the countries within the zone. Total employment in France advanced very timidly in 4Q03 (0.1% au 4T03), led by hiring in the service sector. The fall in Germany's unemployment rate reflects nothing more than a change in how the statistic is calculated. In fact, employment there continues to decline. In Italy, meanwhile, where employment had resisted pressure until very recently, current surveys suggest a sharp deterioration.



- Under the circumstances, the jobs market can hardly be expected to lend support to household demand this year – not before the second half, anyway. At the same time, the slight slowdown in inflation that we expect will not be strong enough to increase disposable income. Consequently, we do not think consumer spending will pick up steam in 2004. Our estimate is that the current rate of growth, 1.1%, will be maintained.
- The primary source of stimulus will have to come from corporate investment, acting in tandem with an improvement in external demand. The export rebound has boosted consumer and business confidence surveys. Manufacturing surveys in particular are positive, hovering above 50. Although Germany's IFO index fell in February, for the first time since April of 2003, its current level is compatible with GDP growth.

By the same token, the slight cooling of the BNB index is not a cause for concern, as it remains above its long-term average. The January INSEE survey on investment spending in the manufacturing sector points to 5% growth (in value terms) in capex spending this year, revised upward since October (2%). More generally speaking, new manufacturing orders for the eurozone recovered strongly in 1Q04 (+5.7% in December alone). National accounting statistics for Euroland indicate that profits began to recover in 3Q (+3%Q), and analysts are expecting the earnings picture to brighten considerably in 2003 and 2004. Both margins and financing terms are gradually improving. Lending rates are slowly easing and free cash flow levels rose substantially in 2003. We expect investment to grow by 2.7% in 2004, a clear improvement after two straight years of contraction. At this stage, we are calling for measured growth, possibly hampered to some degree by the euro's persistent strength. A further rise in the euro will hurt the zone's recovery, especially considering that its internal growth engine lacks fuel.

Conclusions

- In light of the economic conditions described above, the ECB can be expected to maintain the monetary status quo that has reigned since last June. Only a sharp rise in the euro could trigger action.
- As for fiscal policy, budget overruns that have already occurred in the large economies (France and Germany as of 2002; Italy this year) would normally signal an absence of additional leeway. However, both France and Germany have said they will make no attempt to get their budget deficits under the 3% threshold until 2005. But reducing public spending as the economic recovery slowly gets under way is an unwise policy. Except for Spain, where election time means tax breaks, and where the public finance picture is healthy (balanced budget in 2003), not many of Euroland's member nations are in a position to resort to fiscal stimuli. Overall, the eurozone's budget deficit will deteriorate slightly in 2004, reaching the upper limit of 3%. Both France and Italy will allow the situation to worsen in 2004.

L. CHIEZE-DEVIVIER