

# Is Euroland Immune to U.S. Contagion?

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The President of the European Central Bank, Jean-Claude Trichet, has argued several times in recent months that “if the U.S. economy slows down by 1%, more or less, we have ourselves an impact on our growth, taking everything into account, of minus 0.2%” (ECB Press conference, 5 October 2006). Is this a reasonable assumption that really takes “everything into account”? Or might Mr. Trichet be referring only to trade linkages between the U.S. and Euroland, which would underestimate the extent of the transmission mechanism? Should we also adjust our expectations to account for the nature of the current U.S. slowdown?

Answering these questions is particularly important for us as fixed-income managers, given the implications for Euroland bonds and the relative value of the U.S. bond market compared to the Euroland domestic market. In this *European Perspectives*, I will make the case that the ECB is underestimating the extent of the transmission mechanism, that some decoupling at this point in the cycle is not unusual and that a number of headwinds will slow the Euroland economy enough in 2007 to stop the ECB hiking cycle sooner rather than later. In turn, return prospects are good for Euroland bonds in 2007 given current valuations.

## A Look at the Transmission Channels

Let’s first list the transmission channels of the U.S. economic slowdown. There is, of course, **the trade impact**. Because 15% of Euroland exports go to the U.S. (the first destination remaining the U.K. with 16%) and exports account for 20% of Euroland GDP, this implies that exports to the U.S. generate 3% of Euroland GDP. The OECD estimates that the elasticity of U.S. imports to total expenditure is 2.5, which means that a 1% decline in U.S. GDP growth would directly reduce Euroland GDP growth by about 0.07%. Taking into account the echo effect that Mr. Trichet refers to (i.e., the impact of a U.S. slowdown on Euroland’s trading partners), we estimate the actual trade impact of a U.S. slowdown would be a reduction of the Euroland GDP of about 0.2%. This matches Jean-Claude Trichet’s estimate. But is the transmission mechanism limited to the trade impact? No. Let’s look at a few more ways in which a slowdown in the U.S. could be transmitted to Euroland.

One of the lessons of the last global economic slowdown, namely the one of 2001-2002, is business cycles have become much more correlated in today’s globalized economy. This brings us to the second transmission channel: **the business confidence and investment cycle impact**. Chart 1 illustrates the correlation between euro area industrial confidence and new manufacturing orders in the U.S., as measured by the U.S. Institute for Supply Management (ISM).

What is interesting in Chart 1 is that a lag between the business confidence cycles is not unusual and that the decoupling of euro area business confidence from developments in the

ISM New Order Vs. Euro Area Industrial Confidence Production Expectations

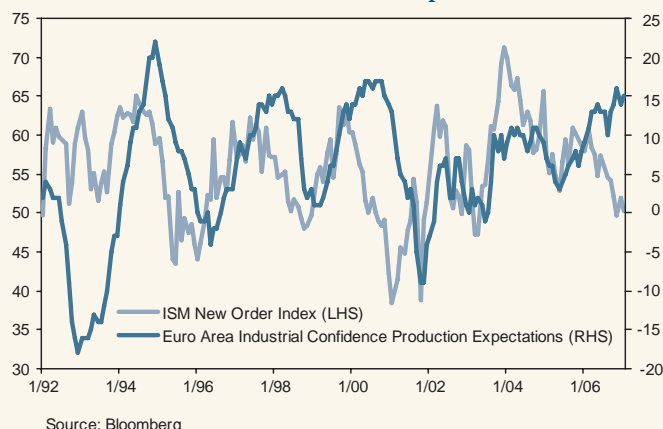


Chart 1

U.S. during the last months of 2006 closely resembles what happened at the end of 2000, for example, with the U.S. typically leading the way. With U.S. business confidence on a downward trend, the European business sector should show more and more signs of weakness over the next months. This is particularly important given that business confidence is a good proxy for investment growth. Euroland companies are highly exposed to the international state of affairs and a deterioration in U.S. sentiment and investment spending can be transmitted to the euro area more quickly than was the case 20 years ago.

But could it be that the Euroland economic growth has become self-sustained and that Euroland might not be so dependent on the global cycle? This is what the ECB believes, according to its December monthly bulletin: *“Domestic demand remained the main driver of economic growth in the third quarter, confirming the anticipated broadening of the recovery and pointing to the increasingly self-sustaining nature of economic expansion in the euro area”*. This would be true if Euroland consumers were driving domestic demand. Unfortunately, this is not the case. The details of domestic demand **show that investment has been the driver of economic growth in 2006, not private consumption** (Chart 2). With Euroland consumption remaining weak month after month, on the back of low real wage growth and fears of structural reforms, the Euroland economy appears vulnerable to a deteriorating investment cycle. See the last German retail sales numbers for example: after a decline of 0.5% in October, retail sales surprisingly

declined again by 0.3% in November. In other words, don't count on the Euroland consumer to drive economic growth and be worried about the investment cycle in a deteriorating global environment. **Euroland is not enjoying self-sustained economic growth.**

Another transmission mechanism is **via the euro exchange rate**. With the U.S. economy slowing down and the interest rate differential between the U.S. and Euroland declining, the euro has been gaining some support and is likely to continue to be supported going forward, with the effective exchange rate appreciating as well. In the last 12 months, the euro gained 10% versus the dollar and the yen. It gained 6% on a trade-weighted basis and has been on a clear upward trend for the last four years. The euro appreciation obviously hurts Euroland competitiveness and the OECD multi-link model suggests that **a 10% euro appreciation subtracts 0.8% of GDP one year later**. Needless to say, politicians are already pressuring the ECB not to favor a further appreciation of the euro. Ségolène Royal and Nicolas Sarkozy, the two leading candidates for the French presidential election to take place this April, have been leading the charge against the ECB's policy and independence.

The last key transmission mechanism, but not the least, will be the **contagion of increasing credit risk premia** from the U.S. capital markets into Euroland. Take a look at Chart 3, which shows the tight correlation of U.S. and Euroland credit spreads. In a

**Growth of Final Domestic Demand, Private Consumption and Investment**

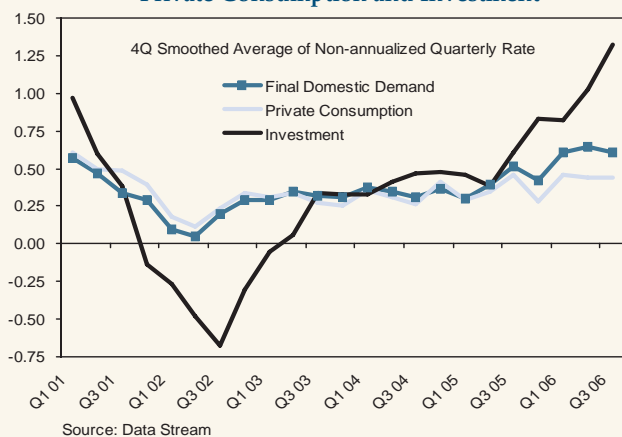


Chart 2

**Credit Spreads are Highly Correlated Between the U.S. and Euroland**

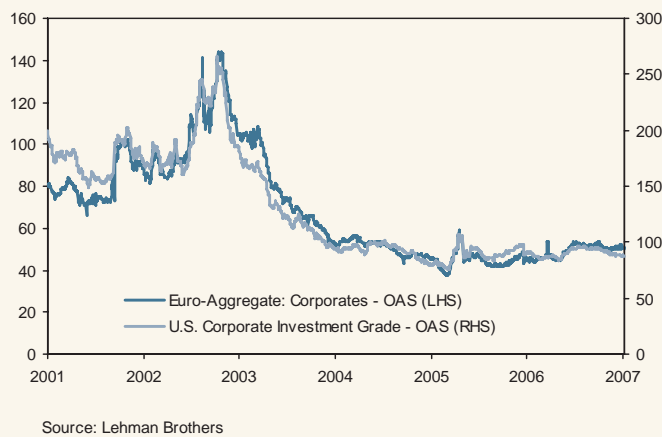


Chart 3

deteriorating economic environment, wider credit spreads in the U.S. will likely also lead to higher corporate borrowing costs in Euroland.

These transmission mechanisms (trade, business confidence/investment, exchange rate, financial markets) will alone likely be a significant headwind for the Euroland economy in 2007.

### Timing the Transmission

Now, we have to recognize that there is something in the nature of the current U.S. slowdown that could increase the typical lag between a slowdown in the U.S. and a slowdown in Euroland: the catalyst for the U.S. slowdown has been the residential housing sector. The expectation at PIMCO and, what we are starting to witness actually, is that a hard landing in the U.S. housing sector will spread, impacting the U.S. consumer and the business sector, with a gradual broadening of the slowdown to the whole economy in the course of 2007. It is our view that this will ultimately lead the Fed to enter a series of rate cuts within the next six months. **Compared to previous economic cycles in which, like in 2001, the economic slowdown was investment-led, the nature of the current U.S. slowdown is therefore very different, as it is led by a sector of the economy, residential investment, which in itself is very much a domestic phenomenon.** It is the broadening to the rest of the economy that will trigger most of the transmission to the rest of the world and particularly Euroland. This is just starting.

### Headwinds from Euroland

Once we have identified the multiple transmission mechanisms of the U.S. slowdown to the European economy (and note that the negative trade impact plus the effect of the euro appreciation alone should subtract about 1% of GDP growth in 2007), we must also consider internal headwinds in Europe. It is striking to observe that the headwind of the U.S. slowdown will be combined with two other headwinds that will likely hurt the Euroland economy in 2007: the impact of monetary and fiscal tightenings. These headwinds, whose impact is still to be monitored, should actually warrant caution by the ECB over the next months.

The ECB started tightening monetary policy in December 2005. Since then, the ECB has gradually hiked its refinancing rate from 2% to the current 3.5%. Given the typical lag associated with the implementation of a new monetary policy and its actual impact on the economy, we should expect this headwind to show its strength fully in 2007. In fact, at the end of 2006, signs began to appear that the tightening of monetary policy was starting to kick in. The Spanish and French real estate markets have entered, since summer 2006, a slowdown that should impact the consumer over the next quarters. In France, for example, house price inflation has declined from double-digit levels to less than 7% year-over-year at the end of 2006 (Chart 4).

French House Price Inflation, % Y/Y

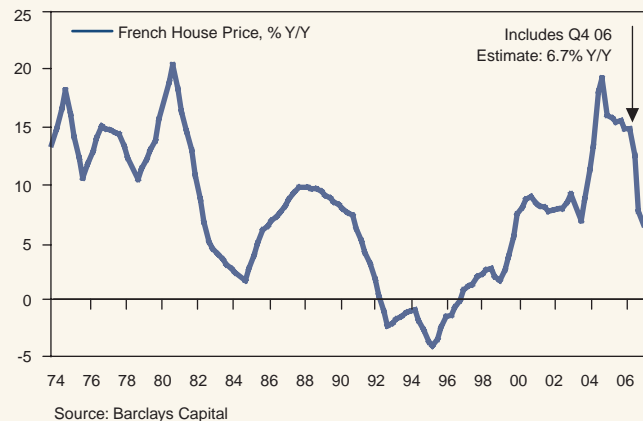


Chart 4

The FNAIM, a large association of real estate brokers, forecasts 4% to 5% house price inflation in France for this year. This slowdown should surely impact the French consumer negatively, via a declining wealth effect. This would please the ECB, which worried several times about the dynamism of house prices in some Euroland regions. In addition, Mr. Trichet also noted during the press conference of 11 January 2007, **“the growth of household borrowing has shown signs of stabilization in recent months”**. In the December monthly bulletin of the ECB we also note that “credit to euro area residents” started to slow at the end of last year, falling from 9.5% growth in the second quarter of 2006 to 9%

growth, year-over-year in October. With the housing market showing signs of weakness, the ECB might therefore want to wait and see whether credit growth will slow more over the next months, before continuing to hike rates.

In addition to the uncertainty associated with future credit growth, **the ECB is also facing lots of uncertainty associated with fiscal tightening.** In Germany, the value added tax (VAT), a sales tax charged on retail prices, was just hiked from 16% to 19% on 1 January (i.e., the biggest hike since World War II), and in Italy, a new government might also implement a tighter fiscal policy in order to fix the fiscal deficit problem, like Romano Prodi suggested. The German VAT hike should impact private consumption in Germany quite negatively and we estimate that a recession in private consumption in Germany in the first quarter could be as large as -2% on a non-annualized basis. This alone would subtract up to 0.4% from Euroland GDP growth.

## Summing It All Up

**To sum up, the Euroland economy will likely face multiple headwinds this year and the ECB might already be at the end of its hiking cycle.** Given the nature of Euroland domestic demand, which is investment driven, economic growth is vulnerable to the global investment cycle. We also note that a lag between a slowdown in the U.S. and a slowdown in Euroland is not unusual. We find that the ECB is right in recognizing that risks to economic growth are on the downside and, given its expectation that inflation will “hover around 2%” this year (ECB Press Conference on 11 January), it is logical that the ECB does not feel in a hurry to continue to hike rates, especially now that it has reached 3.5%, a level often considered to be close to neutral. With the market discounting two more rate hikes by the summer, the Euroland bond market holds the potential for capital gains, which may warrant a long position in Euroland bonds.

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*Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.*

*Performance results for certain charts and graphs may be limited by date ranges specified on those charts and graphs; different time periods may produce different results.*


*The ISM PMI (Purchasing Managers Index) is a composite index that is based on five major indicators including: new orders, inventory levels, production, supplier deliveries, and the employment environment. Each indicator has a different weight and the data is adjusted for seasonal factors. The Association of Purchasing Managers surveys over 300 purchasing managers nationwide who represent 20 different industries. A PMI index over 50 indicates that manufacturing is expanding while anything below 50 means that the industry is contracting.*

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