

## Euro Zone Divergences: the “Noise” is Increasing

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Over the last month, economists and journalists have been busy celebrating the tenth anniversary of the establishment of the European Central Bank (ECB) which predated the introduction of the euro by seven months. It has certainly been a busy ten years! Who would have thought that Russia, bankrupt ten years ago, would recover so quickly and create in the process so many billionaires ready to bid anything up from paintings to football players? From an economic standpoint, the recovery from the tech bubble was equally noteworthy. In 2003, a lot of analysts thought that even a 2% repo rate would not be sufficient to get a sickly euro zone economy going. Now, 4.25% rates are not enough to contain inflation. From a commodity standpoint it is worth pointing out that over the ten years the price of crude oil has increased from \$14.5 on 1 June 1998 to just shy of \$145 at the beginning of July, a tenfold increase.

### A Noisier Month

But all in all the averages of the last ten years look remarkably good. Euro zone growth has averaged 2.2% while inflation has averaged 2.1%. That has to be an A grade, not just for effort but for clear achievements! Focusing on recent economic statistics against this background might look a little mean-spirited. But over the last month, inflation has jumped to an annualised rate of 4% while, as per Chart 1, the dispersion in business confidence measured by the euro zone PMI indices has reached the widest levels in ten years. Markets have tended to dismiss these overshoots as temporary “noise”.

Mohamed El-Erian, PIMCO's Co-CEO and Co-CIO, describes very effectively in his new book *When Markets Collide*<sup>1</sup> how the financial industry has tended to dismiss variances from standard behaviour as noise often to its detriment. His prescription is to focus on such noise as an indicator of tensions in the system that might reveal bigger issues. In that light it certainly seems worthwhile reviewing in some more detail the noise of recent divergences in euro zone inflation and growth.

**Average PMI Dispersion for Germany, Italy, France and Spain**

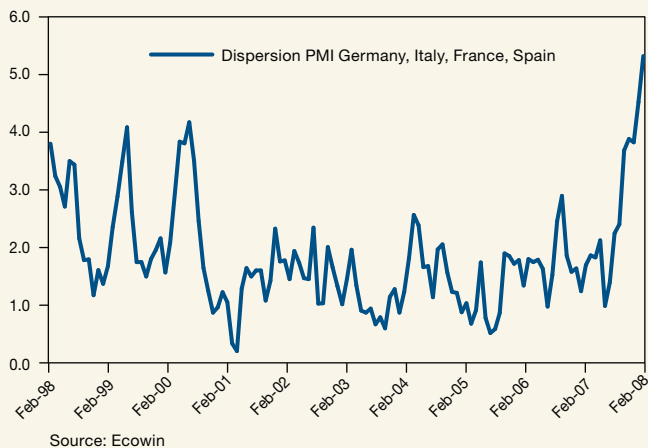


Chart 1

## Global Context

In setting the scene to review what is behind the noise in recent euro zone inflation and growth numbers, it is worthwhile looking at how the global landscape looks in

relation to Euroland. The first observation is that we have lived through ten years of declining dispersion in both growth and inflation across the Organisation for Economic Cooperation and Development countries. While we are rightfully proud of convergence in euro zone growth rates, this achievement looks less remarkable when set against the reduction in dispersion achieved on a global scale. The second observation is that two of the factors that have allowed for this convergence are in reverse mode. The steady growth of the US economy – and in particular of US consumption – in excess of income was supported by higher house prices and creative financing. With the bursting of the housing bubble and the disappearance of what PIMCO's Paul McCulley calls the "shadow banking system," the continuation of this trend is clearly questionable.

The weak US economy stands in sharp contrast with still booming emerging markets where a combination of cheap currencies (pegged or semi-pegged to the dollar), healthy domestic finances and infrastructure spending offer several safety

nets to a hard landing. This is where global convergence gets unstuck. Does the Fed set monetary policy on the basis of US domestic needs or the objectives of the wider US dollar area? While the Fed might be aware of the issue, there is no question that US problems will take priority over other issues; and if that means higher global inflation, so be it. What does this mean for the euro zone? The first conclusion at this stage is that Euroland has to accept, like the rest of the world, that US interest rates will have an inflationary effect at a global level.

### **Euro Zone Context**

The Pavlovian instinct of the ECB was on clear display in early July. Higher inflation means higher rates as per the ECB's own constitution. The fact that business confidence has quietly dropped into the recession zone is not a relevant fact in euro zone policy-making for the time being. The monetary policy of the ECB – while ineffective in reversing global inflationary pressures – is likely, however, to cause an increase in the noise level set by recent divergences in euro zone statistics. The central question for the euro zone is the

extent to which the increase in inflation can cause further deterioration in the relative competitive positions, thereby causing further economic growth divergences. The transmission mechanisms that are central to making current noise levels a bigger issue are in our view threefold: wages and international price competitiveness, real estate markets and public finances.

### **Wages and Competitiveness**

On average, unit labour costs in the euro area have increased at a moderate pace in recent years. The average, though, masks the fact that most of this stability is due to subdued wage developments in Germany. The dispersion in unit labour costs has been increasing. The cumulative growth for the period from 1999 to 2006 ranged between +15% in Portugal to -10% in Germany. While part of these differences can be explained and justified by the so-called Balassa-Samuelson effect<sup>2</sup>, and while the differences should decline over time, at an overall level, the principal cause of concern to us is the high degree of persistence.

The differences that have been building up

have been caused not only by converging labour costs but more worryingly by dismal performances in terms of productivity by some of the periphery countries of the euro zone. The truth of the euro zone is that while some countries like Germany have developed over decades an ability to remain competitive by adjusting costs, other countries such as Italy have in the past relied on devaluations to resolve issues of competitiveness. In an environment of rising global inflationary pressures, these structural differences are likely to become more obvious. Recent studies focusing on Italy show that the lack of competitiveness of Italy vs. Germany has reached levels that are close to the ones reached in 1991, just before Italy was forced to temporarily abandon what was then the European Exchange Rate Mechanism (ERM)<sup>3</sup> and accept a large devaluation of the lira. Noise levels are bound to increase as different countries adjust differently to rising inflationary pressures. Watch for rising trade and current account deficits of the euro zone's individual countries to identify the losers.

## Real Estate Markets

Real estate markets have also been a key factor in growth dynamics and will play a role in growth divergences going forward. The first observation we would make is that the euro zone real estate booms were not all equal in nature. In Germany, construction investment declined from over 14% of GDP at the height of the post-unification boom to less than 9% of GDP in 2007. In contrast, Spain was the poster child for the euro zone housing boom. Sustained by a "Wild West" type of planning policy and significant inward migration, residential construction rose to 19% of GDP at the peak of the housing boom only to end in tears more recently. The second observation is that monetary policy has different transmission mechanisms across the euro zone given the differing nature of the domestic mortgage markets. In Spain and Italy, borrowers have been hit not only by the full amount of the ECB interest rate increases as most of their mortgages are floating but they have also been penalised by the widening gap between LIBOR and

the ECB repo rate. Further hikes by the ECB could translate into increases in mortgage rates in excess of 1:1 in these countries.

In contrast, in core euro zone markets like Germany and France, the mortgage rates are mostly fixed and tied to the longer end of the yield curve, therefore reducing the pain for both existing and prospective borrowers. By German standards current mortgage rates are still attractive. The combination of these two factors would suggest that higher inflation levels combined with Pavlovian reactions by the ECB will result in serious divergences in economic growth across the euro zone via the different size of real estate busts.

## Public Finances

The final factor to consider is in relation to public finances. The creators of the euro tried to resolve some of the inevitable diverging trends that would arise in periods of stress. The key aspect for them was to make sure that countries had the flexibility to resort to anti-cyclical fiscal policies to counter other factors. In some cases this certainly worked. While Spain might suffer

from competitiveness issues and a burst bubble in real estate, its government finances are largely in order.

Unfortunately, this is not the case across the rest of the euro zone. Italy, in particular, wasted most of the dividend that came from the large reduction in the interest payments on its public debt to finance higher primary expenditures. Other countries, such as Portugal and Greece, followed the same route. The problems created by this lack of frugality are very clear within the context of the Stability and Growth Pact that limits the extent of fiscal deficits to 3%. Given worse growth dynamics, fiscal inflows are weaker, forcing a pro-cyclical policy stance that only compounds the starting problem. As some economists have suggested, the only option for countries like Italy would be to have “rotating slumps” that would cause continued lower growth and lower inflation than in the rest of the euro zone to slowly regain competitiveness. The hordes of Japanese tourists flocking in their thousands to Italy might feel right at home!

## Combining the Global and European View

Overall where does this leave us? On one side we have a global context that is set to reinforce some of the inflationary trends in place via low US real rates. On the other side we have a single track ECB policy ready to stamp out inflation in the euro zone at all costs. As outlined above, the transmission mechanisms in the euro zone suggest that in this case “all costs” might be higher than budgeted given how it could amplify the diverging noises of recent statistics. What implications should this have then on euro zone investment strategies?

The likelihood of a “bust-up” of the Economic and Monetary Union (EMU) remains low, at least over the next three to five years.

Longer term it is conceivable that further divergences in competitiveness between the core and the periphery of the euro zone could result in a number of scenarios where the failure to adjust the mechanisms of monetary and fiscal policies could result in one or several countries deciding to leave. Current interest rate differentials between euro zone governments are likely to remain at wider

levels than we have experienced over the last ten years as the probability of such an event is priced in. An underweight exposure in the debt of periphery countries with the weakest competitive/fiscal positions remains favoured in maturities longer than ten years.

Another investment implication is related to the likely increase in country risk as a factor in positioning not just for government bonds but also for other securities. In an environment of “rotating busts” in the periphery of Euroland, we would expect to see an additional interest rate premium charged to private borrowers with a more domestic focus. We would certainly recommend giving more consideration to country risk as one of the key elements in

**Percentage Deviation of Real EUR/USD Exchange Rate from Long-Run Average**



**Chart 2**

security selection for credit and asset-backed securities (ABS).

Finally, the increased divergence of the euro zone is at some point going to result in a policy paralysis that is unlikely to benefit the currency. Based on that calculation, the euro is currently approximately 30% overvalued against the US dollar (see Chart 2). In an environment where both the monetary and fiscal policies will have very limited elbow room, this overvaluation will be difficult to sustain. Noise levels in the euro zone are definitely increasing – watch out!

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1. Mohamed El-Erian, "When Markets Collide: Investment Strategies for the Age of Global Economic Change," The McGraw-Hill Companies, May 2008.
2. The Balassa-Samuelson effect is either of two related things: The observation that consumer price levels in wealthier countries are systematically higher than in poorer ones (the "Penn effect"). An economic model predicting the above, based on the assumption that productivity or productivity growth-rates vary more by country in the traded goods' sectors than in other sectors (the Balassa-Samuelson hypothesis).
3. The Exchange Rate Mechanism (ERM) defined a band around a central exchange rate against the ecu, a predecessor to the euro, to help stabilise exchange rates within Europe.

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