Bloomberg

FINANCIAL SERIES

THE TRADER'S GUIDE TO

THE EURO AREA

ECONOMIC INDICATORS, THE ECB AND THE EURO CRISIS

DAVID J. POWELL

THE TRADER'S GUIDE TO THE EURO AREA

Since 1996, Bloomberg Press has published books for financial professionals on investing, economics, and policy affecting investors. Titles are written by leading practitioners and authorities, and have been translated into more than 20 languages.

The Bloomberg Financial Series provides both core reference knowledge and actionable information for financial professionals. The books are written by experts familiar with the work flows, challenges, and demands of investment professionals who trade the markets, manage money, and analyze investments in their capacity of growing and protecting wealth, hedging risk, and generating revenue.

For a list of available titles, please visit our website at www.wiley.com/go/bloombergpress.

THE TRADER'S GUIDE TO THE EURO AREA

Economic Indicators, the ECB and the Euro Crisis

David J. Powell

WILEY | Bloomberg PRESS

Registered office
John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

Library of Congress Cataloging-in-Publication Data

Powell, David J., 1980-
The trader's guide to the euro area : economic indicators, the ECB and the euro crisis / David J. Powell.
pages cm
Includes bibliographical references and index.
ISBN 978-1-118-44005-6 (cloth)
1. Investments—European Union countries. 2. Eurozone. 3. Finance—European Union countries. 4. Financial crises—European Union countries. 5. Economic indicators—European Union countries. 6. European Union countries—Economic conditions. I. Title.
HG5430.5.A3P69 2013
330.94—dc23

2013022398

A catalogue record for this book is available from the British Library.

ISBN 978-1-118-44005-6 (hbk) ISBN 978-1-118-44003-2 (ebk)
ISBN 978-1-118-44002-5 (ebk) ISBN 978-1-118-44004-9 (ebk)

Set in 11/13 AGaramondPro by MPS Limited, Chennai, India
Printed in Great Britain by TJ International Ltd, Padstow, Cornwall, UK

Contents

Acknowledgements

Few goals in life can be achieved without the support of other people. This book is no exception.

I am indebted to David Hauner. He always found time to share his expertise. His wife, Manuela Doeller-Hauner, was responsible for the most enjoyable of these discussions through her gracious hospitality.

The book also greatly benefited from the generosity and intellect of Holger Schmieding. He thoroughly read the manuscript, provided detailed feedback and pointed out many inaccuracies.

Mike Rosenberg provided valuable comments as well. I read Mike's classic book, *Exchange-Rate Determination*, the year I finished graduate school and at the time never thought I would have the honor of him editing my own.

I would like to thank a few colleagues at Bloomberg. This book would never have come to fruition without the support and approval of Ted Merz, Brian Rooney and JP Zammitt. In addition, I am grateful to Rich Yamarone for having introduced me to the editors at Wiley and to Chris Kirkham for his help in the editing process.

I am also grateful to many acquaintances, colleagues – former and present – and friends who provided hours of useful discussion in the years before I started working on this book and during the writing process. The list includes Landé Abisogun, Colin Asher, Riccardo Barbieri, Kurt Bayer, Joe Brusuelas, Marc Chandler, Bob Lawrie, Mike McDonough, Niraj Shah and Bob Sinche.

I would also like to thank the people who granted permission to reproduce some of their work or quotes. The list includes Willem Buiter, Paul De Grauwe, Thomas Mayer, Gilles Moec, Jim O'Neill, Erik Nielsen, Lucrezia Reichlin and Huw Worthington.

I am grateful to the staff of the Ifo Institute as well. Hans-Werner Sinn provided some helpful remarks on the section on the euro crisis. Klaus Wohlrabe kindly reviewed the section on the Ifo Survey. Wolfgang Nierhaus and Wolfgang Ruppert granted permission to reproduce some of their work. I also appreciate the assistance of Sigrid Stallhofer.

I would like to express appreciation to my parents, Carol Powell and Michael Powell. Their commitment to my education provided the foundation for this book.

I would like to acknowledge a few friends from my hometown of Cold Spring, New York. Alix, Bob, Juliette and Marie-Claude Morgan kindly hosted me at their summer home in France when I was completing the research for this book. Greg Highlen provided helpful comments during the writing process.

Lastly, I would also like to acknowledge a few individuals who provided support during my formative years and were crucial to my intellectual development. They are: the late John Mills, his wife, Margaret Mills, and the late Margaret Mudd.

CHAPTER 1

Introduction

The euro area remains in a state of flux and appears to be unsustainable in its present form. The outcome of the crisis may be unknown for years and a judgment on the project's success or failure may be out of reach for decades.

In the meantime, analysts, portfolio managers and traders will still have daily, weekly, quarterly and annual benchmarks. They will have to analyze economic developments in the euro area and their impacts on financial assets. The objective of this book is to provide a framework for that analysis that is comprehensible to most financial market participants.

The book begins with a focus on coincident and leading economic indicators for the euro area. The former furnish information on the state of the economy and the latter signal the future directions of those coincident indicators. Leading indicators, therefore, often attract the most attention in the financial markets.

Klaus Abberger and Wolfgang Nierhaus, economists at the Ifo Institute in Munich, have defined the characteristics of a good leading indicator. They have written, "The characteristic of a good indicator is that it signals turning points in economic activity in a timely and clear fashion (i.e. without false alarms). In addition the lead of the indicator should be stable so that a relatively reliable estimate can be made as to how early the signal of the indicator occurs. Finally, the results should be available in a timely manner and not subject to any major revisions after publication."[1]

Unfortunately, no indicator exists that perfectly fits that description and an analyst should therefore have a broad-based view and needs to watch a

[1]Abberger, Klaus and Nierhaus, Wolfgang *The Ifo Business Cycle Clock: Circular Correlation with the Real GDP*. CESIfo Working Paper No. 3179, Ifo Institute, 2010.

variety of indicators. That's the method of most economists. Alan Blinder, former vice chairman of the Board of Governors of the Federal Reserve System, said his approach while at the central bank was relatively simple: "Use a wide variety of models and don't ever trust any one of them too much."[2]

Mervyn King, former governor of the Bank of England, delivered a similar message: "The wealth and diversity of published labour statistics means it is rare for them all to point in the same direction. The MPC's analysis of the labour market is like the construction of a jigsaw puzzle. The pieces of data are assessed alongside each other in order to build up as clear a picture as possible. No single piece of data is interpreted in isolation. And no single piece of data is, in itself, decisive."[3] One could easily say the same thing about the economy as a whole.

Subsequent chapters attempt to provide an explanation of euro-area institutions. The region, with 17 central bank governors, 17 finance ministers and 17 heads of government as well as countless policy makers in Brussels, has become increasingly difficult to understand without knowledge of the roles of those bodies.

Chapter 8 focuses on the euro crisis. It attempts to provide an explanation of its origins and a glimpse of the potential outcomes. In addition, the tools needed to analyze the crisis as it evolves are presented. No one knows exactly how the crisis will end and financial market participants need to be armed with the appropriate instruments to understand the latest developments.

The views of some of the most widely-quoted economists – Willem Buiter, David Blanchflower, Paul De Grauwe, Barry Eichengreen, Milton Friedman, Paul Krugman, Thomas Mayer, Carmen Reinhart, Kenneth Rogoff and Hans-Werner Sinn – are frequently cited. Their insights into the debacle have been unparalleled, though some of the arguments may have shifted with time. The views of most economists are constantly evolving along with the events of the debt crisis. As John Maynard Keynes quipped, "When the facts change, I change my mind. What do you do, sir?"

The remaining chapters provide information unique to the economies of Germany, France, the U.K., Switzerland, Sweden and Norway. These countries have many of the same economic indicators – gross domestic product, industrial production, purchasing manager indices, etc. – as the euro area.

---

[2]Blinder, Alan *Central Banking in Theory and Practice*. Cambridge, Mass.: MIT Press, 1998.

[3]King, Mervyn "Employment Policy Institute's Fourth Annual Lecture." Bank of England, December 1, 1998. {http://www.bankofengland.co.uk/publications/Pages/speeches/1998/speech29.aspx}

These data points are basically the same for those countries as for the euro area as a whole, though some details may differ. A second review of the indicators for the individual countries is avoided.

The reality is no one – not even the best economists – can see into the future. All anyone can do is make the best decisions possible based on a set of incomplete information. The best way to be armed for that decision-making process, despite its flaws and incompleteness, may be to understand the present state of the economy and the political debate as fully as possible.

CHAPTER 2

Gross Domestic Product

GDP is the most commonly cited comprehensive indicator of economic activity. It is the total market value of the goods and services produced within a nation or, in the case of the euro area, a monetary union. It can also be described as the total income of the geographic area.

The first word of the term – gross – indicates that depreciation of equipment and factories used in the production process is excluded from the calculation.[1] For example, the decline in the value of an aging computer is ignored in this measure of national output.

The second word of the term – domestic – indicates the inclusion of all production within the region's borders irrespective of the country of origin of the producer.[2] For example, if a Mercedes is produced in a plant constructed by the German company in the U.S., the car is included in U.S. GDP and excluded from German GDP. If the car is produced in Germany and shipped to the U.S., it is included in German GDP and excluded from U.S. GDP.

Three methods of measuring GDP exist: expenditure, output and income. In theory, all three methods should produce the same figure. In practice, measurement problems normally lead to discrepancies.

The Expenditure Approach

The expenditure approach is based on the final or end use of the produced goods and services. This method has historically been used most frequently by national statistical agencies. In a report from 1996 of 18 member countries, the OECD calculated that all of them reported GDP using the expenditure

[1] *Principal European Economic Indicators: A Statistical Guide*. Eurostat, 2009.

[2] *Ibid.*

approach. Sixteen of them also tallied the figure using the output method and 10 used the income approach as well.[3] These numbers have since risen to 18, 17 and 16, respectively.[4]

The accounting identity used to calculate GDP under the expenditure approach states that GDP equals consumption plus investment plus net exports. Consumption is broken down into private consumption and government consumption and investment consists of gross fixed capital investment and the change in inventories. The sum of consumption and investment equals domestic demand. Net exports equals exports minus imports.

Consumption (= Private Consumption + Government Consumption)
+ Investment (= Gross Fixed Capital Investment
+ Change in Inventories)
= Domestic Demand
+ Net Exports (= Exports − Imports)
= Gross Domestic Product

Private consumption is spending on goods and services by non-governmental entities such as individuals and households. It is the largest category of GDP for most developed economies. For example, it was about 71% of GDP of the U.S.; 64% of that of the U.K. and 57% of that of Germany in 2011.

Eurostat also includes a group called NPISH in its calculation of private consumption (Table 2.1). It is an acronym for non-profit institutions serving households. It includes charities, churches, political parties and trade unions.

Government consumption represents the purchase of goods and services by general government. It made up about 20% of GDP of the U.S.; 20% of that of Germany; and 22% of that of the U.K. in 2011.

Investment is the spending used to increase future consumption. The category breaks down into gross fixed capital formation and inventories.

Gross fixed capital formation represents the acquisition of fixed assets minus the disposal of those items. In this case, "gross" refers to the exclusion of depreciation costs. Fixed assets are defined by Eurostat as "tangible or intangible assets produced as outputs from the processes of production that are themselves used repeatedly, or continuously, in processes of production for more than one year."[5] An example of a tangible asset from this category is a factory and one of an intangible asset is a patent.

---

[3] *Quarterly National Accounts: Sources and Methods Used by OECD Member Countries*. OECD, 1996. {http://www.oecd.org/std/na/1909562.pdf}

[4] E-mail to David Powell from the OECD, March 18, 2013.

[5] *Gross Fixed Capital Formation.* Eurostat. {http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00137.htm}

TABLE 2.1 Euro-Area GDP and Expenditure Components

T1	GDP AND EXPENDITURE COMPONENTS																					
t/t-1	PERCENTAGE CHANGE OVER THE PREVIOUS QUARTER – SEASONALLY ADJUSTED – CHAIN-LINKED VOLUMES																					
	GDP				Household & NPISH final consumption expenditure				Government final consumption expenditure				Gross Fixed Capital Formation				Exports				Imports			
	2011		2012		2011		2012		2011		2012		2011		2012		2011		2012		2011		2012	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
EA17	0.1	−0.3	0.0	**−0.2**	0.2	−0.5	−0.2	**−0.2**	−0.2	0.0	0.2	**0.1**	−0.4	−0.5	−1.3	**−0.8**	1.5	−0.2	0.7	**1.3**	0.5	−1.4	−0.2	0.9
EU27	0.2	−0.3	0.0	**−0.1**	0.0	−0.3	−0.1	**−0.2**	−0.3	0.1	0.4	**0.2**	−0.1	−0.3	−0.7	**−0.9**	1.4	0.1	0.5	**1.0**	0.6	−1.0	−0.2	0.9
US	0.3	1.0	0.5	**0.4**	0.4	0.5	0.6	**0.4**	−0.6	−0.7	−0.3	**−0.3**	2.6	2.0	1.3	**1.1**	1.5	0.4	1.1	**1.5**	1.1	1.2	0.8	0.7
JP	1.8	0.1	1.3	**0.3**	1.1	0.7	1.2	**0.1**	0.2	0.4	1.0	**0.3**	0.6	3.3	−0.4	**1.5**	7.9	−3.6	3.4	**1.2**	3.4	1.0	2.2	1.6

Source: Eurostat

The remainder of investment spending consists of inventory accumulation. Inventories are used to meet future demand.

Investment, under the framework of national accounting, is undertaken mostly by businesses. The purchase of new homes is the only part of personal spending that falls into this category. Government spending generally falls into the category of consumption.[6]

The category of net exports is the difference between exports and imports. It represents the portion of aggregate domestic production that is beyond the goods and services needed for domestic consumption.

The breakdown by category of expenditure allows for an analysis of the type of spending that drives economic growth. Investment – gross fixed capital formation and inventories – tends to be the most cyclical category of spending. That is because businesses will likely delay plans for expansion or reduce their stocks of inventories as long as their managers perceive the outlook for demand to be uncertain or weak.

The recession in the euro area from 2008 to 2009 provided a good example. GDP contracted for five quarters – from the second quarter of 2008 through the second quarter of 2009. The economy contracted by 1.2% per quarter, on average, during that period. The contraction in investment spending was responsible for 1 percentage point of that average quarterly decline. Specifically, 0.7 of a percentage point was due to the decline in gross fixed capital formation and 0.3 of a percentage point to the change in inventories.

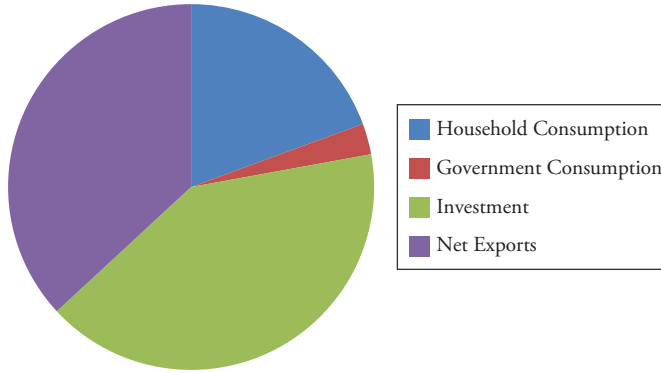
The subsequent recovery provided a similar picture. The economy expanded for nine consecutive quarters – from the third quarter of 2009 through the third quarter of 2011 – after the recession ended. The contribution to economic growth from investment spending was greater than that of any other source of domestic demand (Figure 2.1).

On average, the economy expanded by 0.4% per quarter during that period. Half of that growth – 0.2 of a percentage point – came from investment spending. The contribution to growth from household consumption was 0.1 of a percentage point and that from government spending was close to flat as austerity programs were implemented. The contribution from net exports – 0.2 of a percentage point – explains the other major source of growth. The figures fail to add up perfectly due to rounding.

During the recovery, the majority of the growth in investment spending came from inventory accumulation, though the decline in inventories played a smaller role than the decline of gross fixed capital formation during

[6]The Economist *Guide to Economic Indicators: Making Sense of Economics*, seventh edition. Hoboken, NJ: John Wiley & Sons, Inc., 2011.

FIGURE 2.1 Contributions to euro-area GDP growth from Q3 2009 to Q3 2011.



Source: Bloomberg, Eurostat

the recession. "Recessions and recoveries are (mostly) inventory cycles. While inventory investment typically only accounts for a tiny fraction of GDP, swings in inventories account for a large share of the cyclical swing in GDP," according to Ethan Harris, co-head of economic research at Bank of America–Merrill Lynch.[7]

He contends "inventories do not cause cycles in the economy, rather they amplify or 'accelerate' swings in the economy." They tend to lower output during recessions and increase output in the early stages of recoveries.

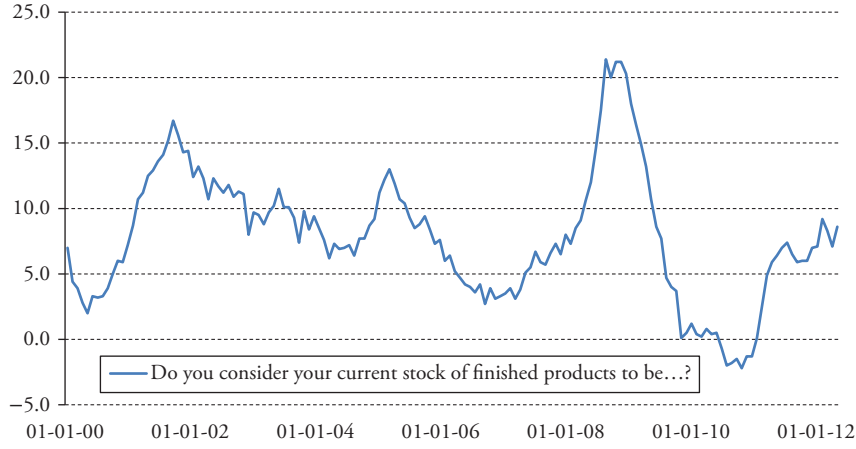
An outlook for inventory growth can be formed by looking at the monthly economic sentiment indicator of the European Commission in conjunction with the state of the economy. The industry and the retail trade surveys both contain questions about stocks (Figures 2.2 and 2.3). Respectively, they are:

Q4 Do you consider your current stock of finished products to be . . . ?
+ too large (above normal)
= adequate (normal for the season)
− too small (below normal)

Q2 Do you consider the volume of stock currently held to be . . . ?
+ too large (above normal)
= adequate (normal for the season)
− too small (below normal)

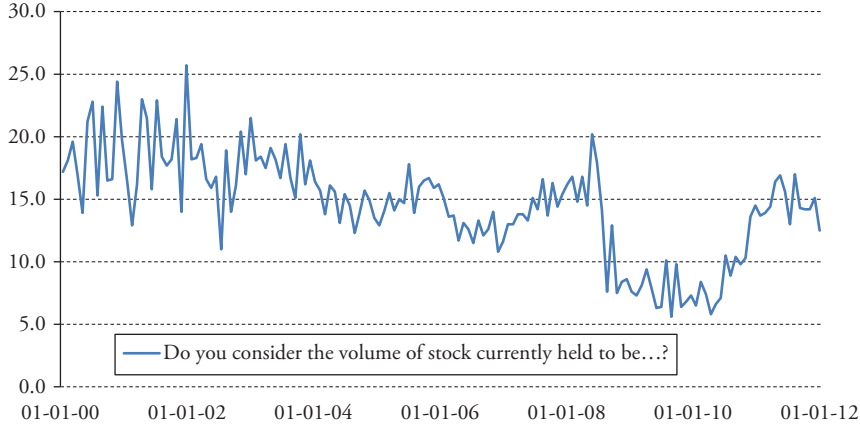
[7]Harris, Ethan "The Opposite of 'Stagflation'." *The Market Economist*. Bank of America–Merrill Lynch, September 18, 2009.

FIGURE 2.2 Inventory component of industrial confidence indicator.



Source: Bloomberg

FIGURE 2.3 Inventory component of retail trade confidence indicator.



Source: Bloomberg

The Output Method

The output method measures the gross value added in an economy. In other words, it measures the value of all goods and services produced minus the value of all goods and services used in their production. The second category is subtracted from the first to avoid double accounting.