



Wind of change in Germany, and for Weidmann too...

While encouraging euro area PMIs in March convinced a number of observers that the ECB had made the right decision (i.e. perpetuate the *status quo*), the statement from the President of the Bundesbank has lent credence to our scenario of additional stimulus...if not immediately, at least in the not-too-distant future. Such a possibility sends a couple of messages: 1- The euro area is far from being in the clear, 2- German growth is losing steam, 3- The ECB will do more but only because the prospect of the euro area are in fact frail.

QE, the question is on the table...

German Export Growth and IFO Sentiment on Future Exports



Sources: RichesFlores Research, Macrobond

...at least judging by the statement issued by the current Bundesbank President Jens Weidmann, whose consent would have been required to even bring up the subject. Consider it done. This does not mean that the ECB will take action starting next week. But it's all but official: the members of the ECB will address

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the possible opportunities, conditions and consequences of implementing an unconventional quantitative easing policy.

The news comes on the heels of a number of developments whose succession has raised red flags:

- On February 7th, the Federal Constitutional Court refused to issue a ruling on the constitutionality of the OMT mechanism that the ECB unveiled in September 2012 (in the aim of rescuing struggling countries) but has yet to implement. By passing the buck on the legality of such operations to the judges of the EU Court of Justice, Germany has reached a milestone: it has effectively deferred judgment on an issue that it could veto and thus accepted *de facto* the principle of the ECB's asset purchases.
- The second came on March 18th when the Federal Constitutional Court in Karlsruhe definitively authorized the European Stability Mechanism (ESM) in a move to reject objections that the Bundestag did not have sufficient jurisdiction over the bailout program.

These two precedents undeniably give greater weight to the shift in rhetoric by the Bundesbank President Jens Weidmann in recent days. What is behind such a *volte face* in the German position? Do deflation fears or concerns about a strong euro justify the shift? At least partially, especially since it is obvious that the German economic outlook is suffering from these two factors.

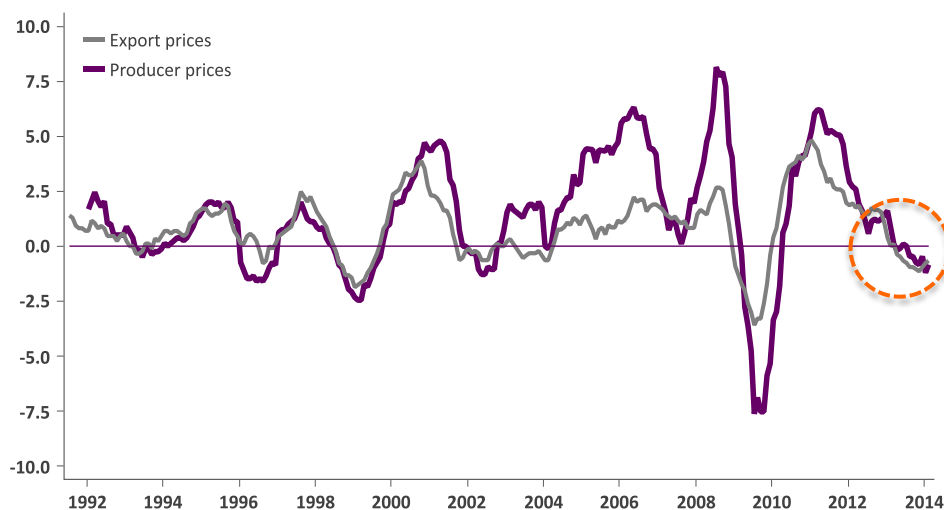
Germany is no exception to the region's disinflationary trend

Price trends are unequivocal: a continued decline in the inflation rate is a real threat in the euro area and Germany is no exception. According to the latest German numbers, the rise in consumer prices did not break the 1% barrier in the past twelve months, i.e. a 0.8pt decline and 2-year decline of 1.5pts. Although domestic core inflation of 1.7% is less problematic, a closer look at the price landscape is quite a bit messier:

- Over the course of the past twelve months, the cost of producing industrial goods has dropped 2.5%, a very unusual pace that has only been seen in extreme situations (Asian crisis of 1998 and the 2009 recession). Lower energy prices are only part of the explanation. Disinflation is gaining ground across all sectors; in fact, in all areas of the economy, Germany has recorded results on par with those in a number of southern EMU countries whose economic health, however, is much weaker.
- During the same period, export prices have even declined, attesting to the growing difficulties of this key area of the German economy.

Industry Producer Prices and Export Prices

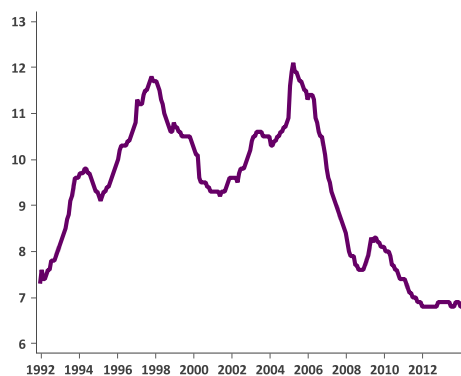
12 month changes, in %



- Even the low level of unemployment, which fell in February to 6.8% of the active population, has hardly had any effect on wages. Annual wage growth has stumbled recently, in industry as in the rest of the economy. In fact, despite low unemployment, the momentum of real wages has been abnormally weak. The normally solid relationship in Germany between inflation and unemployment (reflected in the Philipps curve) has been thrown off.

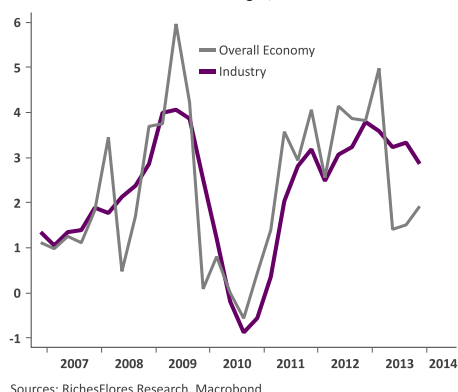
Unemployment Rate

% of Labour Force

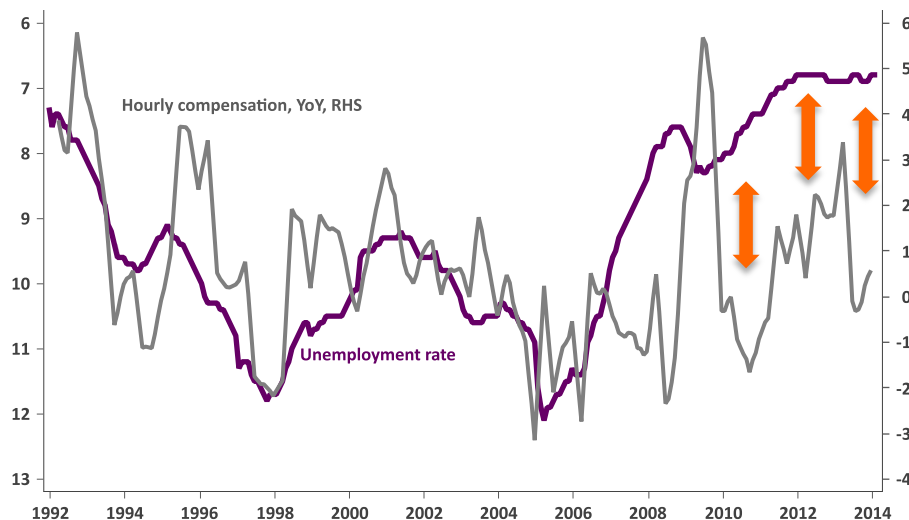


Hourly Compensation

YoY changes, %



Real Wage Growth and Unemployment in Germany



Sources: RichesFlores Research, Macrobond

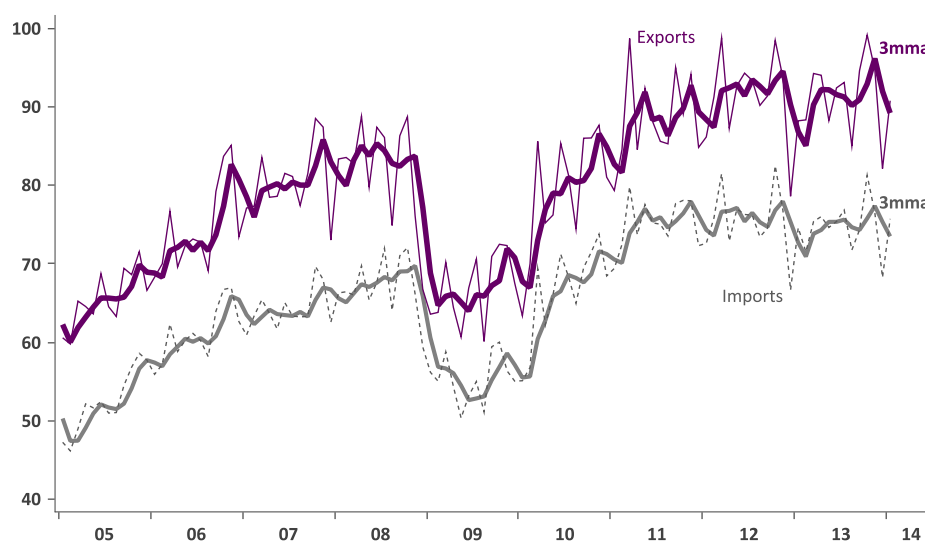
In conclusion, Germany is very much exposed to ongoing disinflation.

Why? Slowing German exports

Sluggish exports are indeed the most convincing explanation for these trends.

Despite the relatively robust improvement in euro area markets since the start of the winter, German export growth failed to reach 3% on an annualized basis at end-January. This mediocre trend surely means that growth will fall short of expectations; it has, in fact, already led to the loss of some 45,000 industrial jobs in the past three months.

German Foreign Trade, EUR

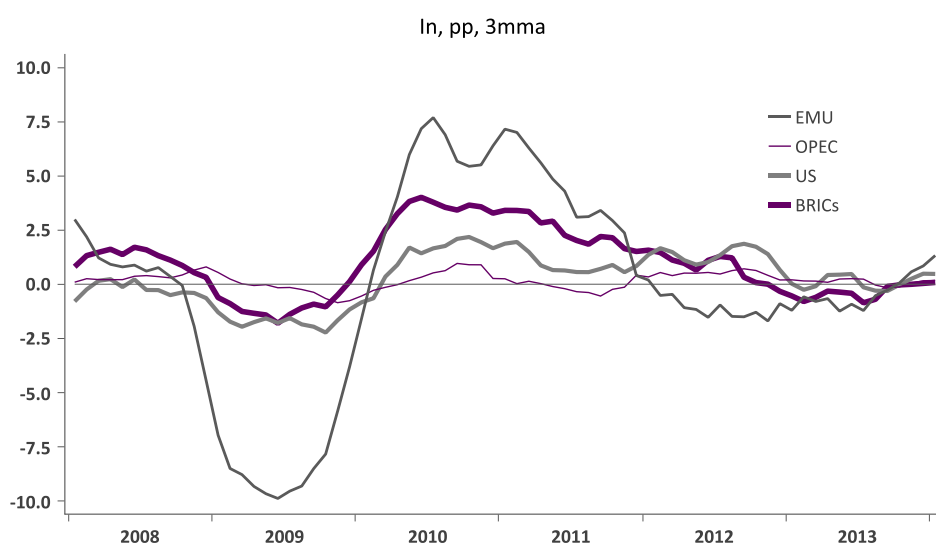


Sources: RichesFlores Research, Macrobond

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With 30% of its exports shipped to emerging markets, Germany is suffering more and more from the deteriorating economic conditions in the emerging world. In fact, EMs are being simultaneously hit by tighter monetary conditions in countries rocked by currency instability (Turkey, Brazil and India, in particular), the slowdown in Chinese demand and, now, European sanctions on Russia. After having stagnated since the start of the year, German exports to emerging markets could very well contract in the months to come. This scenario has not been lost on German leaders and could lead them to have a change of heart. Given the present circumstances, Germany will not succeed without a much strong euro area just as it is undoubtedly more exposed to an appreciating euro.

Contribution to Annual Export Growth of Germany



Sources: RichesFlores Research, Macrobond

Consequently, developments with regard to Asian currencies are probably more important than fluctuations in the euro-dollar alone. In addition to Abenomics, the shift in Chinese policy is surely linked to Germany's shift in attitude.

The initial good news has worn off quickly. The ECB will do more, it's almost a done deal, but only because the euro area's growth prospects are in danger once again.

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