PMI & Wages Send Conflicting Signals For Growth

- **March PMI's at best since the start of 2016.**
- **That alone would indicate stronger GDP.**
- **Wage growth has stuttered, so doubts remain.**

In Q1 2017 the Eurozone economy, according to the latest PMI surveys from IHS Markit, published today, expanded at the fastest pace since the start of last year.

Markit's composite figure for the region was booked at 56.4 in March and is fairly regarded as a good proxy for GDP growth in the single European currency area. The welcome news was found in that this reading was ahead of February's reading at 56.0. Critics, however, will be quick to point out that the data for March was lower from the flash estimate of 56.7, Figure 1.

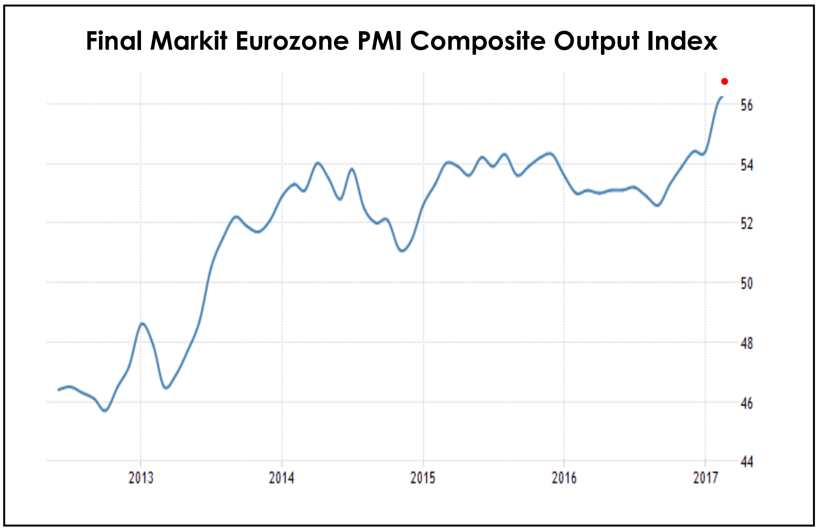

Figure 1: Final Markit Eurozone PMI Composite Output Index • Flash Estimate for March 2017
Source: IHS Markit

Following the release IHS Markit said in a statement:

"...Eurozone output and new order growth accelerated to near six-year records in March, rounding off the best quarter for the currency union's economy since the second quarter of 2011..."

Once again, the data was elevated by a solid March for both Germany and France, the leading economic powers of the region that account for 28.4% and 21.4% of regional GDP respectively. What was even more encouraging is that the third and fourth largest economies, Italy (16.4%) and Spain (10.6%) also weighed in with a positive contribution after lagging earlier in the cycle.

IHS Markit's Chief Business Economist, Chris Williamson said in a statement:

"...This is a broad-based upturn among the Euro's largest members, with 0.6% growth signalled for both Germany and France, while Spain looks set to have enjoyed 0.8-0.9% growth in the first quarter, according to the PMI data. Growth has also perked up in Italy during the first quarter despite a slight pull-back in March, with the surveys indicating a 0.3-0.4% expansion. ... Most welcome for a region still suffering near-double digit unemployment is a rise in the survey's employment index to its highest for almost a decade, suggesting we should expect to see the jobless rate fall further in coming months, ..."

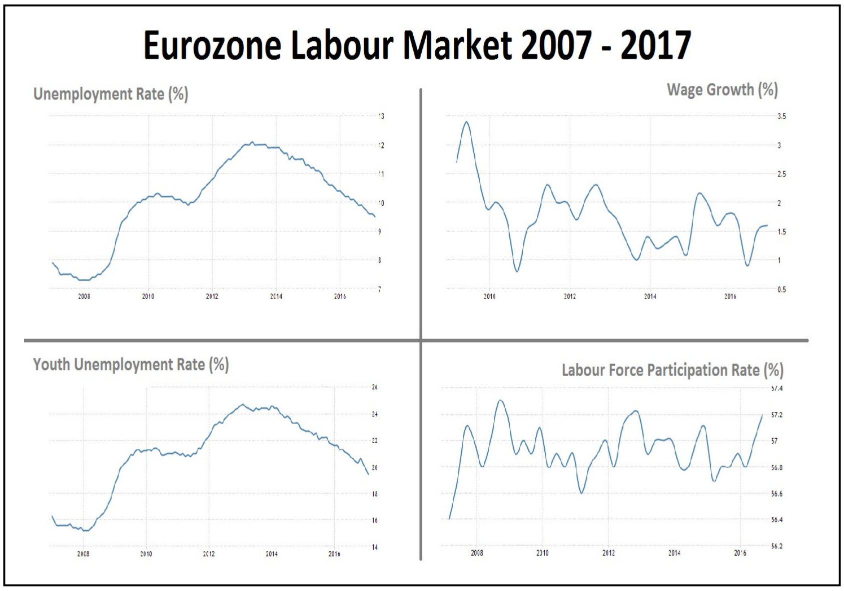

Figure 2: Eurozone Labour Market, 2007 – 2017 Source: Eurostat

Figure 2 reveals that Eurozone unemployment at both the total and youth level started to decline in 2014 and it is especially encouraging to see that the level of labour force participation has pressed higher to levels last seen in 2009 and 2013. Whether it makes further progress may well depend upon the rate of wage growth, a data point that appears, for now at least to have topped out at 1.6%.

Worries over wages

The path of wage growth will not be ignored by the ECB as it considers the delicate issue of when and how to begin the process of normalising its highly accommodative monetary policy.

Eurozone wage growth has remained relatively low even in an environment of improving labour markets. Wages and salaries per hour worked in the Eurozone increased 1.6% YoY in Q4 2016, after rising by 1.5% in Q3. In contrast the average level of wages growth in the region was 1.8% from 2009 until 2016, reaching an all-time high of 3.40% in Q2 2009 before rapidly falling to a record low of 0.80% In Q3 2010.

At the same time, the unemployment rate, while still high cf. that in the US or UK, both at 4.7%, has been declining since Q2 2013, indicating a reduction in the amount of slack in the labour market.

While the growth outlook appears to be improving, the view of ECB President, Mario Draghi is that inflation pressures have eased form the 2.0% reading in February and it is still far from a self-sustaining economic factor. Therefore, despite calls from the more hawkish members of the Eurozone, notably Germany for an increase in rate few economists believe the ECB will start withdrawing its stimulus measures until later this year at the earliest.

Our view at Spotlight is that the governing council of policymakers want to be certain that inflation is heading back toward more normal levels on a consistent basis. A recent uptick in inflation has been largely due to rising oil prices, evidenced by the fact that core inflation, which strips out volatile items such as food and energy, remains stubbornly low, Figure 3.

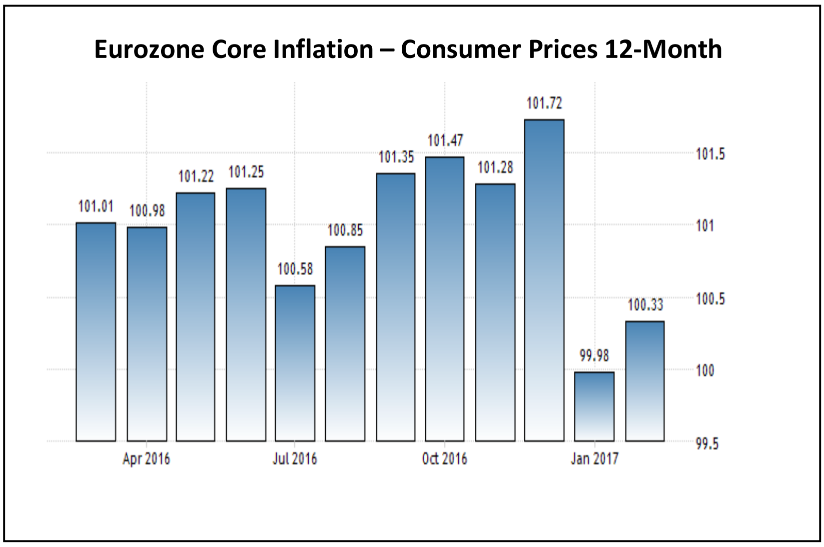

Figure 3: Eurozone Core Inflation – Consumer Prices 12-Month   Source: Eurostat

Market reform...possibly

There has barely been a press conference held by the ECB when Mario Draghi has served as President where he has not called for structural reform. It is too simplistic to consider that has always to come from grand gestures of national governments rolling back the state.

There may have been progress in the area as seen through the movements in the Eurozone labour market. The data shows that employment growth has been stronger than expected in recent quarters, and the unemployment rate has declined at a faster pace than projected.

This encouraging trend in employment growth and the lack of wage growth...or shall we say the higher than expected wage moderation could be partly related to structural labour market reforms aimed at increasing labour market flexibility and reducing nominal rigidities.

It is of course a key driver for regional growth that the labour market is improving; however, the rate of unemployment is still relatively high and would indicate that the region still has an ample labour supply on which it can draw.

The measurement of the amount of slack in the labour market is one statistic that is surrounded by a lack of transparency and the observed unemployment rate might understate the actual labour market level of spare capacity in the economy.

Why so? This can be explained by the degree of underemployed people, i.e. those working on a part-time basis that would like to work more hours. We did point out that from Figure 2 the labour force participation rate In the Eurozone increased to 57.2% in Q3 of 2016 from 57.0% in Q2 2016. However, before one starts to feel too impressed it must be noted that this metric averaged 56.7% from 2000 until 2016, reaching an all-time high of 57.3% in Q3.

It may well prove to be the case that participation in the labour market is once again about to top out given the lack of wage growth or the increase in part-time as against full-time employment opportunities.

Dilemma for Draghi

This could prove to be a major headache for the ECB as the level of GDP growth in the Eurozone is, as one might expect highly correlated to the level of employment in the region. By regressing the data back for the past six years we have found that the correlation of employed persons (x) and the level of annualised GDP growth (y) is a significant R^2 = 0.6762, Figure 4.

If the past performance of the participation rate is to hold to past form, it is topping out. The only way for the level of GDP growth to improve will be if there is either a shift away from part-time work and/or a further decrease in the unemployment rate that will require an increase in wages.

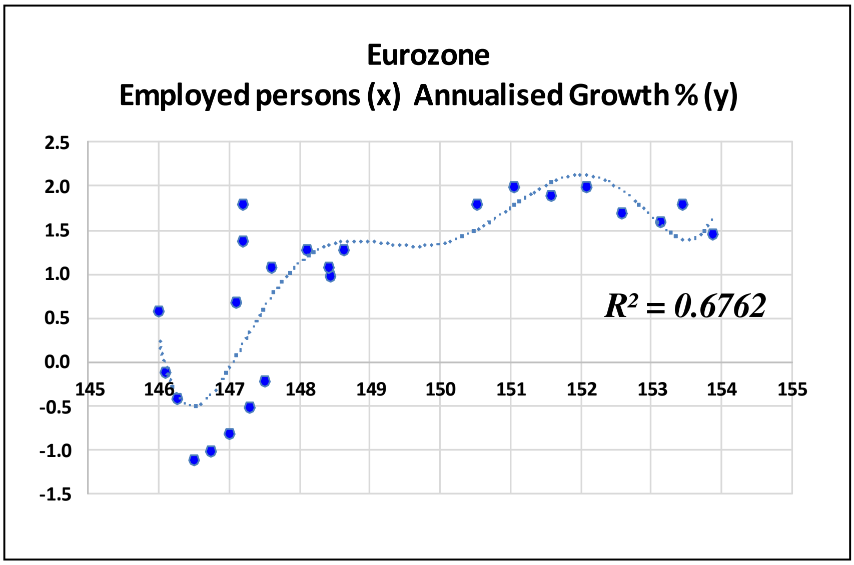

Figure 4: Eurozone... Independent variable Employed Persons (Millions) and Dependent Variable Annualised Growth Rate (%)
Source: Eurostat, Spotlight Ideas

The delicate balancing act that is now confronting the ECB is it wants to see higher employment, however, that appears as if it will only come if companies incur greater costs by either reassigning more workers from part-time to full time or by increasing the wages that are on offer. If the level of labour participation does not improve it may well be the case that wages will have to rise more than one might at first consider.

That would carry inflationary implications. If the ECB were to reverse the level of accommodation of the past six years, either by raising the refinancing rate or by reducing the assets on the balance sheet all at the same time as two key elections are underway in France and Germany. Not to mention the risks surrounding Brexit the potential growth that has been interpreted from the PMI data could prove to be a passing mirage in an economic desert.

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