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GEM Global Economic Monitor

Daily Brief
Economics and Financial Market Commentary
February 5, 2008 10:56 am

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Services activity falls sharply in the U.S. and Europe in January. Activity in the U.S. non-manufacturing sector unexpectedly dropped to lowest levels since the last recession in January, as the housing slump intensifies and consumer spending cools. The Institute for Supply Management's (ISM) headline index derived from monthly surveys of purchasing managers in the sector plummeted from a strong 54.4 in December (well above the "50" growth/no-growth marker) to 41.9, the lowest since October 2002. A key component of the decline was a slump in new orders, shifting from 53.9 in December to 43.5 in January, complementing a like falloff in hiring intentions. At the same time, earlier ISM reports showed U.S. manufacturing expanding in January; with exports holding up what might otherwise be a similar falloff in activity. "This is a stunning fall", notes Michael Moran of Daiwa Securities New York. "If accurate, it's dire news for the economy."

In Europe similar, albeit less dramatic, declines in services activity took hold in January. The RBS/Reuter's poll of purchasing managers yielded a headline index of 50.6 for January–the lowest since July 2003, and marginally above the "no growth" point–from 53.1 in December. The index declined across the set of major countries of the Euro Area, with Germany slumping below the 50 threshold for the first in more-than 4 years, and Spain's services compressing the most since 1999. In a similar tone to the press statement of Mr. Moran of Daiwa regarding the U.S. non-manufacturing figures, Holger Sandte of WestLB noted: "These data are a shocker.... the ECB certainly wants to see more evidence of a marked slowdown, but the data will give them pause for though on interest rates."

European retail spending falls by record at year-end 2007. With the exception of France, where retail sales increased 0.4% in December (m/m) to close out the year at a 2% pace, retail turnover in the Euro Area declined sharply–down 1.6% on a year-over year comparison–the biggest drop since data series began in 1995–not the best of circumstances with which to start 2008 [see Daily chart at http://GEM].

Though conditions in European labor markets are firm, higher inflation (HICP now registering 3.2% gains, especially strong for food and fuels), financial market disruptions in-line with those in the United States, higher credit costs and a strong euro continue to hold consumer sentiment and spending down. A European Commission measure of consumer confidence fell to the lowest in more-than 2 years in January.

German sales compressed by a large 1.9% in November on the back of concerns about inflation and financial market fallout, and December figures show an additional albeit modest 0.1% decline, falling at a decade-high 6.8% pace on a year-on-year measure. And conditions in Italy remain moribund, with household spending falling 0.9% in November, standing 3.2% below year earlier levels. These figures do not bode well for fourth quarter GDP results, and it is clear that some support for growth from the consumer will be needed during 2008, in the context of a much less hospitable financial environment.

Fitch plans to overhaul CDO rating methods. Fitch Ratings said today it is considering revamping its rating methodology for corporate collateralized debt obligations (CDOs) in light of mounting mortgage-related credit losses. According to a Fitch statement, “The intention is to provide CDO ratings that perform similarly in terms of default risk and ratings migrations with the markets’ expectation for other asset classes.” The proposed change could result in an average downgrade of five notches for static synthetic CDOs, according to the rating agency. And the steepest cuts would be to ‘AAA’ and other highly rated CDO tranches that are based on credit-default swaps and are not actively managed. *These rating downgrades could entail a sharp drop in CDO valuations, which could sequentially force many investors to take write-downs on their assets or even sell them.* Fitch’s announcement comes a day after competitor Moody’s Investor Service said that it may change its system for rating volatile structured-finance securities, including moving to a numerical system.

Among emerging markets...in East Asia, consumer prices in the *Philippines* increased to a 4.9% pace in January (y/y) up from 3.9% the previous month, and the fastest in 15 months. Inflation was fueled by a 5.9% climb in food, beverages and tobacco prices, a 5.5% increase in fuel, light and water costs, and 5.4% rise in services costs.

In Central and Eastern Europe, *Hungary’s* trade surplus stood at €60.6 million ($89.7 million) in November compared to a trade deficit of €90.2 million in November 2006, as stronger demand from the European Union boosted export revenues, while a decline in household spending weakened import demand. The eleven-month trade deficit declined to €295.4 million from €2.25 billion the previous year, as exports rose 15.6% while imports climbed 11.5%. The *Czech Republic’s* trade surplus stood at Kc86.1 billion in 2007, more than double the figure recorded in 2006, and the trade balance is expected to improve further in 2008, as softer household consumption will weaken demand for imports. *Bulgaria’s* budget surplus increased to 2.11 lev ($1.6 billion) in 2007 rising to a record 3.8% of GDP, as a cut in corporate tax to 10% from 15% helped reduce tax evasion.

In Latin America, *Chile’s* consumer price inflation remained muted in January bringing annual inflation down to 7.5% from 7.8% the previous month (y/y). Weak inflationary pressures in conjunction with the slowdown of industrial production to

3.7% in December increases the odds that the central bank will keep its key interest rate unchanged at its next policy meeting.

In Sub-Saharan Africa, *Nigeria's* central bank kept its key interest rate unchanged at 9.5% as inflation eased to 5.4% in December (y/y) on account of lower food prices. *Kenya's* post-election violence is estimated to have cost the economy as much as 260 billion shillings ($3.7 billion), with as many as 49,000 people losing their jobs, according to the Kenya Association of Manufacturers.

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