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EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Will the Second Quarter Be The Low Point For Euro-Area Growth?

Data to be released on May 12 should show that the euro-area economy grew by around 0.5% in the first quarter, a marked improvement on the second half of 2004. Unfortunately, early indications on the second quarter have been much less encouraging. Industrial confidence has deteriorated, and the manufacturing purchasing managers' index (PMI) has fallen below 50 for the first time in almost two years. Although the service-sector PMI has been more resilient (52.8 in April), the composite PMI is now back close to last November's low **(Display 1)**. As a result, it is likely that second-quarter growth will slip back towards the 0.2% recorded in the third and fourth quarters of 2004.

It is still not clear whether the current weakness of the economy is due primarily to high oil prices and a temporary inventory correction, or whether it signals a more durable slowdown in activity. The fact that the weakness has so far been concentrated in the oil-intensive industrial sector tends to support the first argument. Moreover, there is also some evidence to suggest that the euro-area economy is experiencing an inventory correction.

Inventory analysis in the euro area is handicapped by a lack of data on the level of stocks. Indeed, the only hard data available is the stockbuilding component of GDP from the national accounts. Clearly, this is an important indicator, but it does have weaknesses[1]. This means that surveys can be a useful additional guide.

Display 2 shows that there was a significant buildup of inventories in the euro area during 2004. This is especially true in nominal terms, with inventories rising by a record €39 billion. To some extent, this rise should be seen in the context of the destocking that took place between 2001 and 2003. However, it is worth noting that the number of firms claiming inventories are too high has risen sharply in recent months **(Display 3)**. This suggests that the inventory accumulation has been excessive.

Import growth can provide an additional insight into inventory behaviour. Euro-area imports jumped by 10% in the middle two quarters of 2004, well in excess of anything that can be attributed to final demand. If this represented an unwarranted rise in inventories, then we would expect import growth to slow. This has clearly been the case, with euro-area import growth slipping to 1.0% in the fourth quarter of 2004 and turning negative in the early months of 2005.

In spite of data limitations, much of the weakness in recent euro-area activity indicators can be explained by an inventory correction and high oil prices. If this is correct, the second quarter is likely to represent the low point for euro-area growth, and the economy should recover later in the year. However, the pick up in growth is likely to be modest, especially if the oil price and inventories weigh on growth for longer than expected, or weak business confidence causes a delay in hiring and investment plans.

Interest-Rate Implications

Recent statements suggest that the European Central Bank still believes that strong money-supply growth represents an upside risk to inflation over the medium term. However, it is clear that weak activity data have removed the need for pressing action. Indeed, recent survey data have fallen to levels more typically associated with rate cuts than rate hikes. We continue to believe that a rate cut is unlikely. By the same token, however, a rate hike will require a marked improvement in growth, and that will clearly take some time. We strongly believe that the next move in euro-area rates will be up, but probably not within the next six months.

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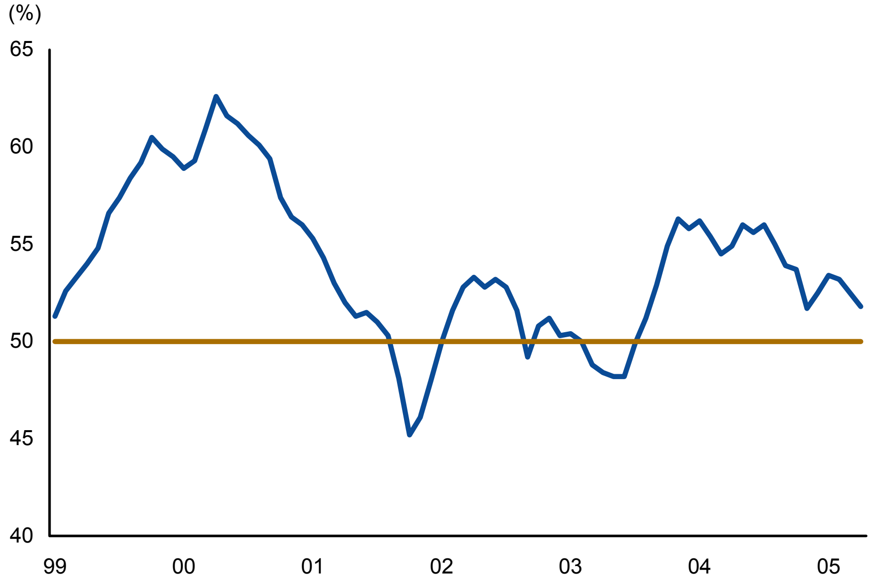
[1] In most euro-area countries, stockbuilding is calculated as a residual in the national accounts.

Display 1: Composite PMI Points to Weaker Economic Growth

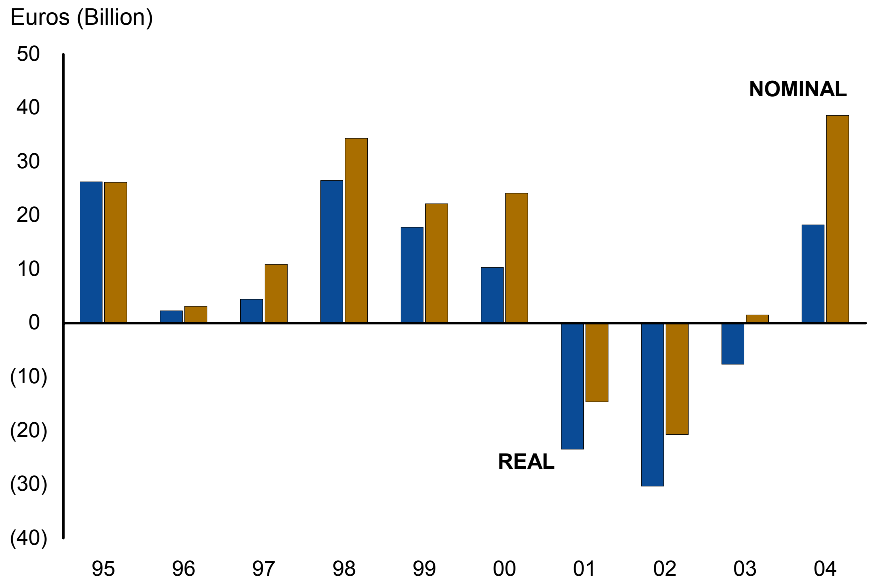
Euro-Area Combined Manufacturing and Service-Sector PMI



Source: Reuters and Alliance Capital Fixed Income, May 6, 2005

Led by manufacturing, the composite PMI has weakened and is back at the lows last seen in November. The current reading is consistent with economic growth of around 0.2% per quarter.

Display 2: Euro-Area Inventories Rose Sharply in 2004
Annual Change in Euro-Area Whole-Economy Inventories

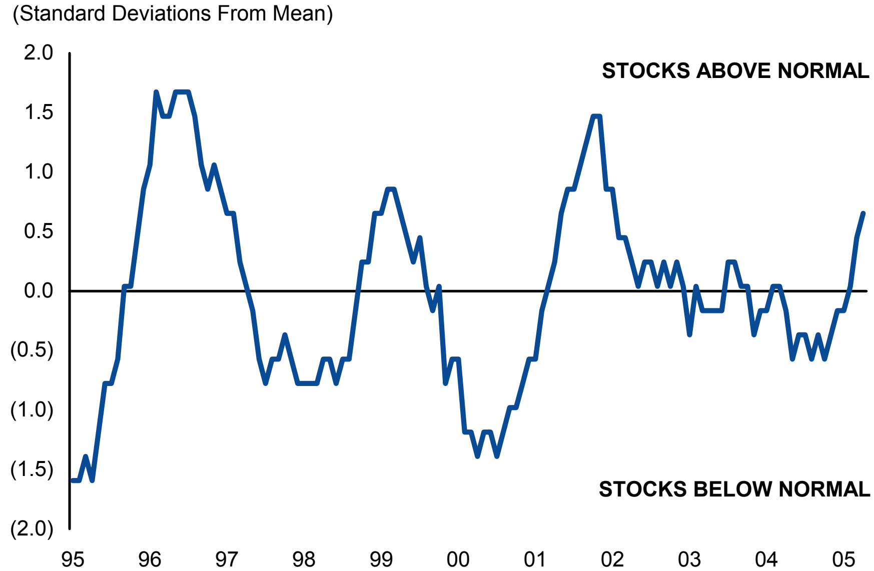


Source: Haver Analytics and Alliance Capital Fixed Income, May 6, 2005

Euro-area inventories rose significantly in 2004, especially in nominal terms. To some extent, this increase should be seen in the context of the destocking that took place in earlier years. Nonetheless, there are strong reasons to believe that inventory levels are now excessive.

Display 3: Companies Are Reporting That Stocks Are Too High

Euro-Area Industrial Companies' Opinion on Inventory Levels



Source: Haver Analytics and Alliance Capital Fixed Income, May 6, 2005

More companies have started to report that inventories are too high. In the past, such periods have tended to coincide with a run-down in inventories.