GLOBAL ECONOMIC
RESEARCH

EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Reading the Growth Signals... and the ECB's Reaction

After a difficult first six months, the euro-area outlook for 2005 is brightening. The manufacturing sector is benefiting from stronger global growth and a weaker euro, while the economy as a whole seems to be coping with the impact of higher oil prices. In September, the composite Purchasing Managers Index (PMI) for the manufacturing and service sectors combined rose from 52.8 to 54.3, its highest for more than a year (**Display 1**). This is consistent with quarterly economic growth of 0.5%.

The difficulty is in knowing whether the data signal a sustainable recovery in growth. One reason for caution is that, on two recent occasions—the second half of 2003 and fourth quarter of 2004—the euro-area economy seemed to be recovering quite nicely, only to slip back again.

However, this time there are two reasons to be more optimistic. First, the exchange rate is much less of a detractor than on those occasions. Second, there are tentative signs of an improvement in the domestic labour market. The composite employment PMI has risen to its highest level in four years (**Display 2**) and, in Germany, there has been a big improvement in job vacancies (**Display 3**).

It is also useful to consider whether or not the data signal a stronger acceleration than anticipated in our forecasts. At this stage, we regard the recent data as confirmation that growth will gradually improve in line with our expectations. Hence, we are leaving our euro-area GDP numbers unchanged. This means annualized growth of 1.5% in the second half of the current year and 2.0% in the first half of 2006.

The better tone of recent data has been accompanied by a further rise in money and credit growth. Indeed, on a three-month annualised basis, bank lending is rising at a rate of 10%, the highest since 2000. In addition, the near-term outlook for inflation has deteriorated. Headline inflation has risen to 2.5% and, barring a sharp drop in oil prices, is likely to remain above 2.0% throughout the first half of 2006.

Not surprisingly, these developments have provoked a hawkish response from the European Central Bank (ECB). The ECB believes that upside risks to price stability have risen and that "strong vigilance" is now necessary. This is about as far as the ECB can go without actually raising rates and suggests that it may be more sensitive than we thought to stronger growth.

How do these developments affect our rate forecast? Thus far we have been looking for the ECB to start raising interest rates in the second quarter of 2006. However, with the data supporting our view that growth will gradually gain momentum, and the ECB becoming even more concerned about risks to price stability, we now expect rates to start rising in the first quarter. With the market pricing in little more than 25 basis points by the middle of next year, rates are likely to rise more quickly and more aggressively than the market expects.

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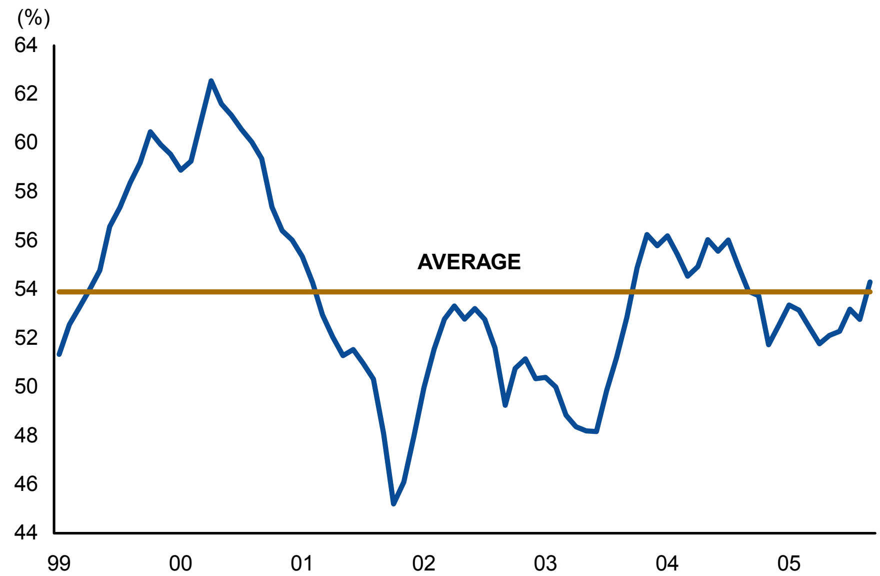
Display 1: Composite PMI Points to Stronger Growth

Euro-Area Composite Purchasing Managers Index

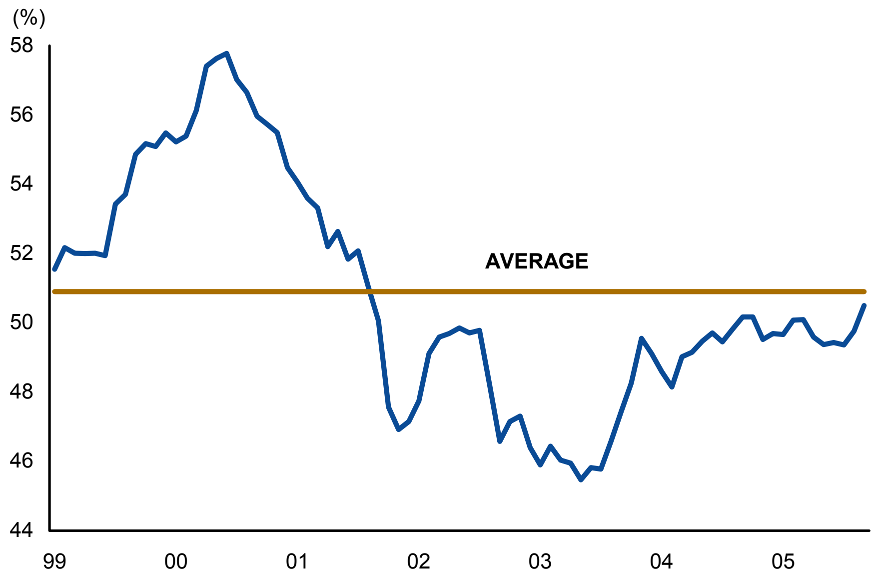


Source: Haver Analytics and Alliance Capital Fixed Income; October 7, 2005

The composite PMI has improved steadily in recent months and is now above its long-term average. It is consistent with quarterly growth of 0.5%.

Display 2: Some Positive Signs on the Labour Market

Euro-Area Composite Employment Purchasing Managers Index

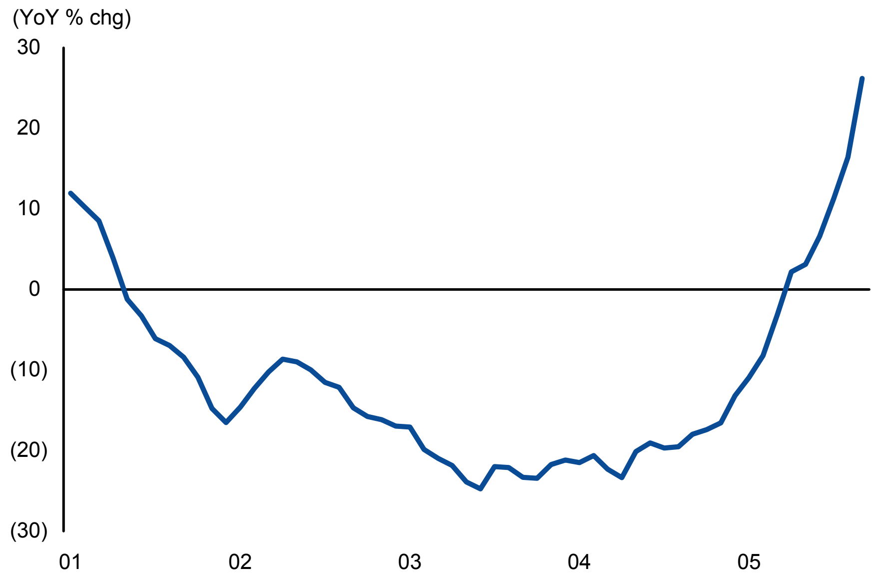


Source: Haver Analytics and Alliance Capital Fixed Income; Oct 7, 2005

One of the keys to a sustained recovery in the euro-area economy is a pickup in employment growth. In this respect, it is interesting to note that the composite employment PMI hit a four-year high in September.

Display 3: German Job Vacancies Are Starting to Pick Up

Vacancies for Full-Time Jobs Subject to Full Social Security Contributions



Source: German Federal Labour Office and Alliance Capital Fixed Income; Oct 7, 2005

Definitional changes have distorted German labour-market indicators. One of the best guides at present are vacancies for jobs paying full social security contributions. These have picked up strongly in recent months.