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EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

European Growth and Interest-Rate Update

Euro Area: Survey Data Soften

Hard economic data for the opening months of 2005 suggest that the euro-area economy entered the year strongly. January industrial production was up 0.7% on its fourth-quarter average and consumer spending has been surprisingly strong. January and February combined showed German and French retail sales up 1.3% and 2.3% (non-annualized) on their respective fourth-quarter averages. Consequently, first-quarter GDP growth could move back above its trend rate of 0.5% per quarter.

It is difficult to be so positive on the second quarter. In Germany, the first-quarter data are being boosted by calendar-adjustment problems which artificially depressed growth at the end of 2004[1]. France has not experienced these problems. However, consumption rose by 1.2% in the fourth quarter of last year and another robust gain is likely in the first quarter of the current year. Such gains are difficult to justify on the basis of household income growth and are unlikely to be sustained.

In addition to this, recent survey data have been very disappointing. The manufacturing Purchasing Managers Index (PMI) fell to 50.4 in March from 51.8 in February, putting it back at last November's trough. It is possible that this represents an overreaction to high oil prices and a strong euro, so that April could see a recovery. Indeed, strong PMIs in the UK and Sweden suggest that underlying conditions in manufacturing might be somewhat firmer than the euro-area data suggest **(Display 1)**.

Equally, however, the March PMI may simply be highlighting the euro area's vulnerability to oil-price and exchange-rate developments at a time when the domestic recovery remains weak. Moreover, even if the PMI and other surveys move back to February levels, they would still be consistent with growth just below trend. At this stage, second-quarter GDP growth looks like it's slipping back to 0.3% or 0.4%.

Although the European Central Bank (ECB) remains deeply concerned about the high pace of money and credit growth, weak activity data and the see-saw nature of the recovery argue against a near-term rate hike. We still believe that rates will rise later in the year, but the pace of tightening is likely to be slow. Moreover, the market will almost certainly view the tightening as pre-emptive, which should limit the negative impact on the bond market.

UK: Waiting For The Consumer

The Bank of England's latest forecasts show growth at or above trend over the next two years. With little spare capacity in the economy, this means UK rates are likely to rise if the Bank's central projection is correct. Nonetheless, interest rates have remained on hold since August and are likely to do so until after May's (probable) general election.

The main reason the Bank continues to keep rates on hold is that recent consumption data have been poor. After an average gain of 0.9% during the first three quarters of 2004, household spending rose just 0.2% in the final quarter. Moreover, retail sales data point to only a modest improvement in early 2005.

The fundamentals underlying the consumer remain strong. Debt-servicing costs continue to rise but are being more than offset by powerful gains in labour-income growth. A tight labour market suggests that wage growth will rise further, consumer confidence is improving, and housing seems to be stabilizing. As a result, we continue to believe that consumption will recover and that the Bank will then raise interest rates. However, this now looks more likely in June than April or May.

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[1] Because of the timing of Christmas, there were more working days in December 2004 than normal. Although very few people worked these days, they were treated as such in the national accounts and, therefore, lowered output in calendar-adjusted terms. In the first quarter, this should have the effect of boosting output in calendar-adjusted terms.

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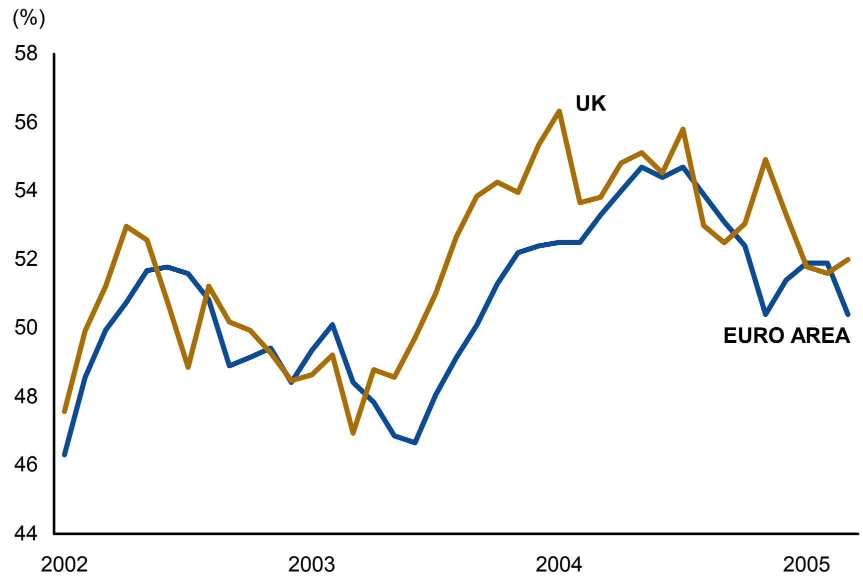
Display 1: Euro-Area Surveys Have Been Hit by Oil and The Euro
Manufacturing Purchasing Managers Indexes



Source: Reuters and Alliance Capital Fixed Income, April 1, 2005

In March, the strong euro and high oil price pushed the euro-area manufacturing PMI back to its November trough. In the UK and Sweden, however, the PMI rose, suggesting that underlying conditions in manufacturing may be somewhat firmer than the euro-area data suggest. If so, April could see at least a partial rebound in the euro-area PMI—especially if the euro remains at today's lower levels.