

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENT: INDICATING WHAT?

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Indicating What?

As the U.S. economy flirts with recession, equity investors have increasingly pinned their hopes on Europe as the engine of global growth. As Table A indicates, however, the euro-zone is clearly in economic contraction, and sentiment—although considerably more favourable than in the United States—has also declined. Historically, the pace of deterioration of such lead indicators as economic sentiment has moderated as a trough approaches, but the sharp drop in the business climate indicator (see Table B) suggests investors could be waiting some time for a cyclical upturn. Even when these signals do turn to green, the lead time can be up to nine months or sometimes longer.

Although the business climate has been in free-fall this year, industrial production has remained surprisingly buoyant since mid-2000, advancing while lead indicators have declined (see Table B). Either the negative sentiment is unduly pessimistic, or industrial production will slow in the coming months. Such lack of clarity might help explain why investors are having difficulty reading the economic tea leaves.

Total output in the euro-zone will depend on the extent of deterioration in the external environment and the resilience of domestic demand. The divergence between industrial and consumer confidence supports the assessment that the recent weakening of the external environment is mainly affecting industry, while private consumption remains relatively resilient. Despite falling in May, consumer confidence hovers close to record highs set in mid-2000 (see Table C), and since consumers hold the key to Europe's growth outlook, this is a positive sign.

The two clouds darkening the outlook for continued consumer spending are exploding gasoline prices, which are up 40% in € terms this year, and signs of deterioration in the labour market—German unemployment has been rising for the past four months and the number of jobless claims in France appears to be stabilising after declining steadily over the past three years. Spending growth in the euro-zone is determined almost exclusively by employment and real wage growth, and since nominal wages are now rising at less than the rate of inflation, real wages are shrinking. Although tax cuts have boosted household disposable incomes, higher food and energy prices have depressed spending power.

All these uncertainties have been reflected, of course, in the vacillating equity markets, where investors seem confident one month, and depressed the next. Since consumer spending is the key determinant of European growth, however, the principal indicators to watch are employment, wage growth, and consumer sentiment, while other indicators like German industrial production are of secondary importance. Finally, despite all the political posturing and the gallons of ink spilled on the topic of European Central Bank (ECB) monetary policy, it is worth keeping in mind that the ECB's sole mandate—

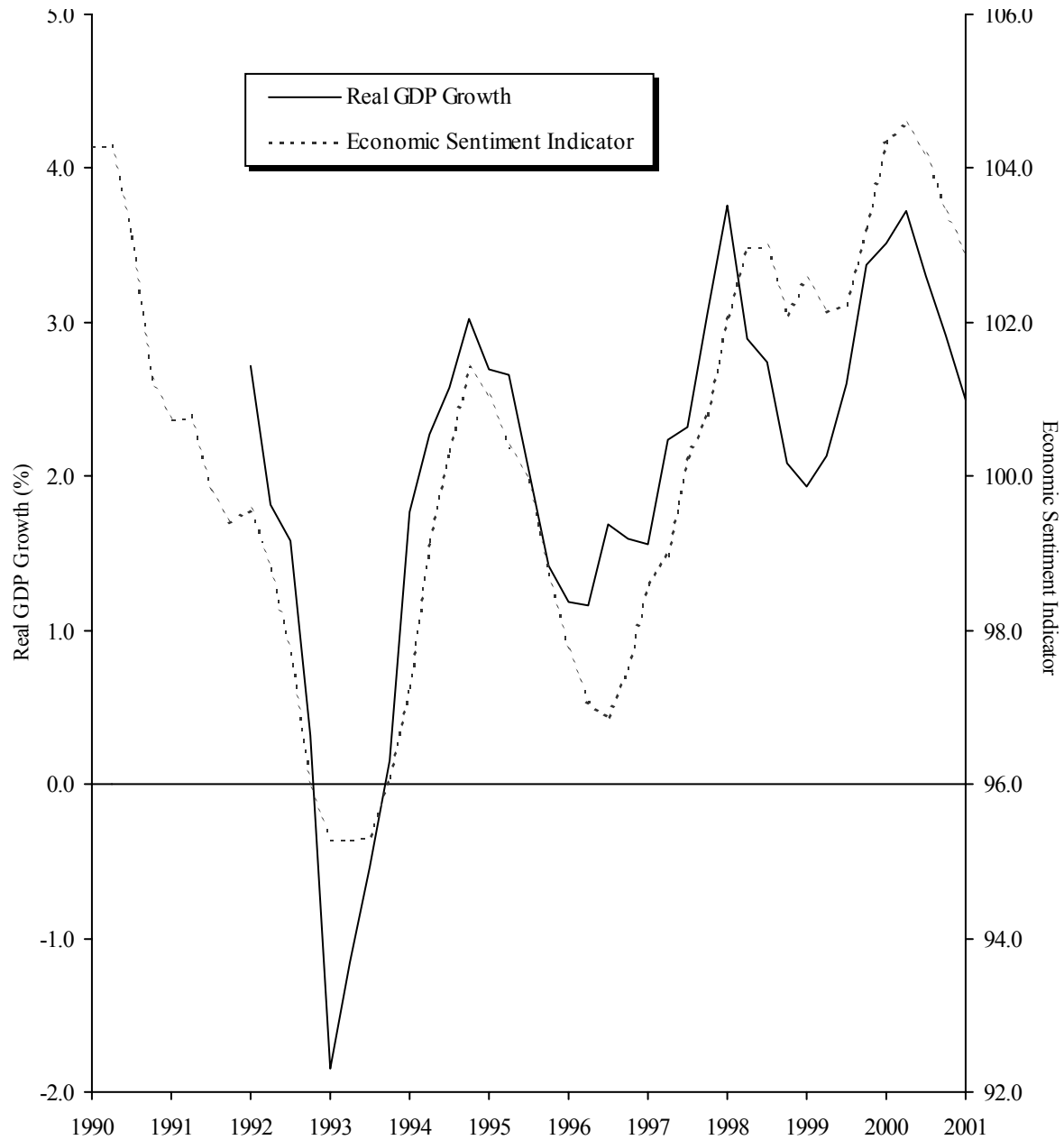
for better or worse—is price stability. Therefore, industrial production, employment, consumer spending, business sentiment, portents of economic expansion or contraction, and the value of the euro are of no relevance to the ECB except as they suggest higher or lower inflation ahead. If euro-zone governments truly want the ECB to trim its monetary policy to shifts in the economic winds, or the euro's value, then they should change the ECB's mandate. For now, however, the ECB's only job is to ensure that inflation remains modestly positive, but contained at something less than 2%, on average, per annum.

Table A

EURO-ZONE REAL GDP GROWTH AND ECONOMIC SENTIMENT INDICATOR

1 January 1990 - 31 March 2001

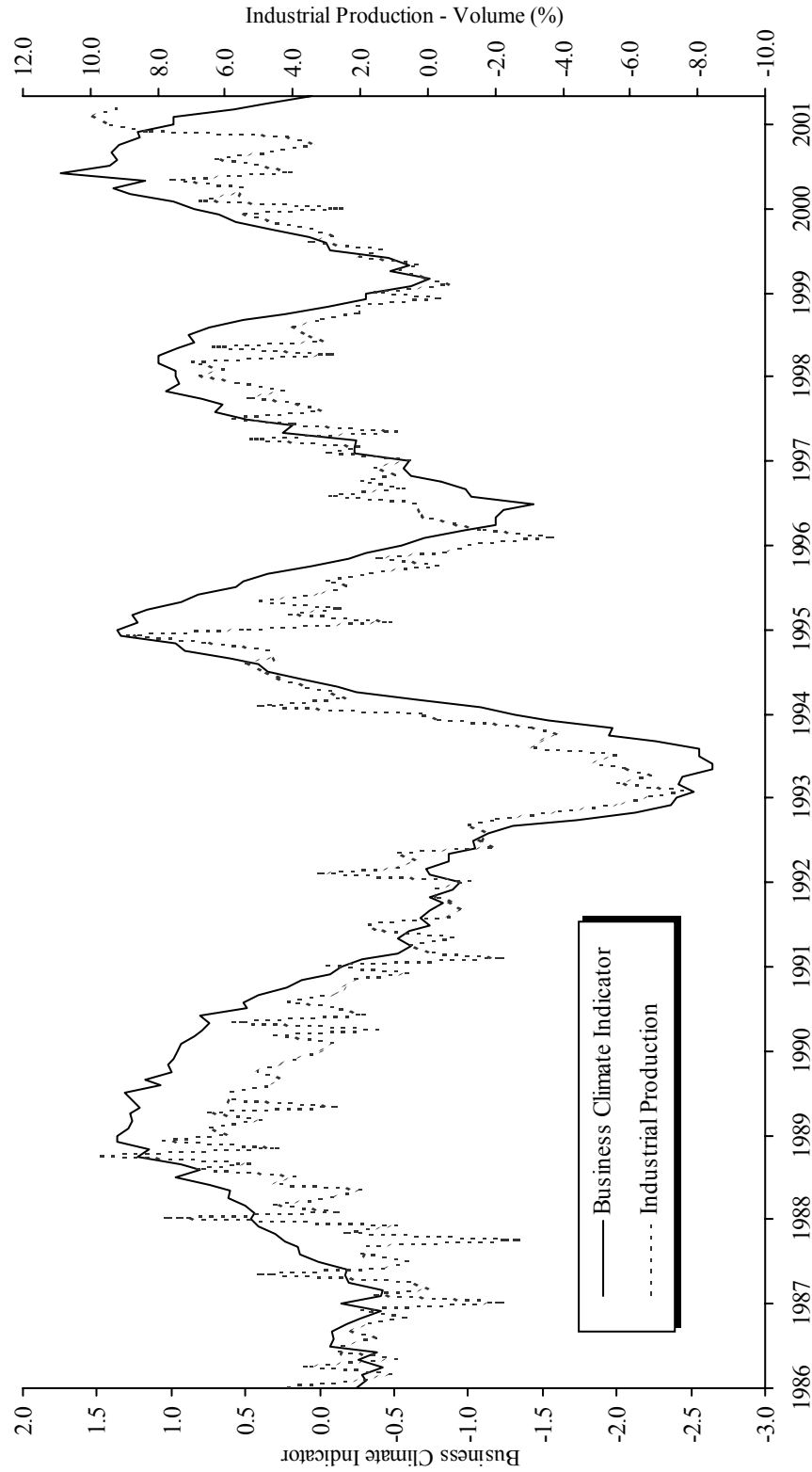
Euro (€)



Source: Datastream International.

Note: GDP data contains figures from first quarter 1992 through first quarter 2001.

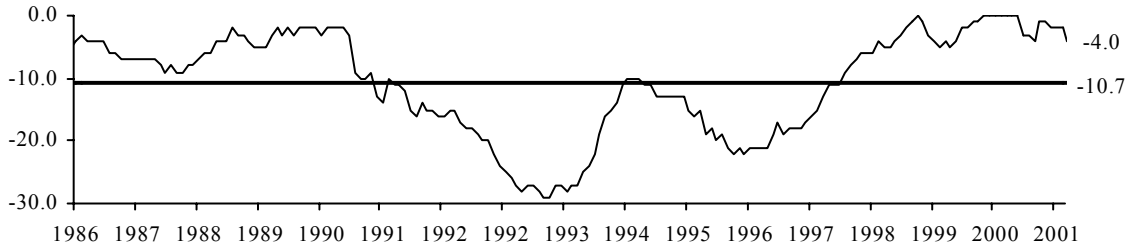
Table B
EURO-ZONE BUSINESS CLIMATE INDICATOR AND INDUSTRIAL PRODUCTION
1 January 1985 - 31 May 2001



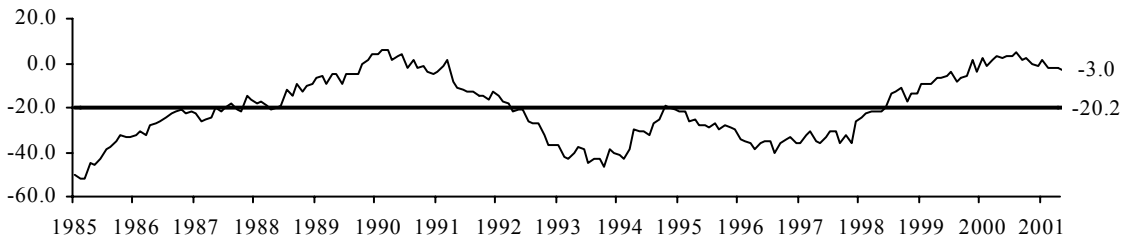
Source: Datastream International.
 Note: Industrial production data are through 31 March 2001.

Table C

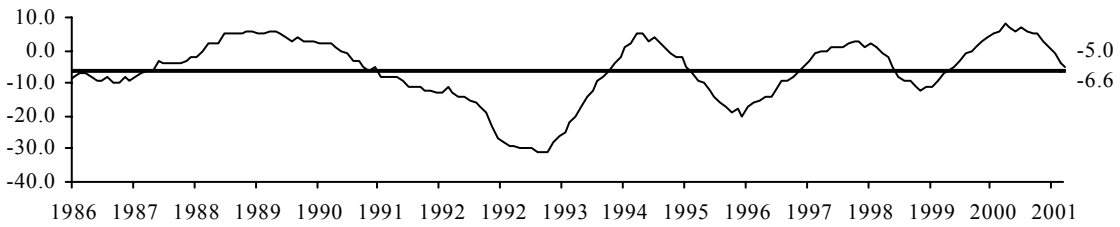
EURO-ZONE CONSUMER, CONSTRUCTION, INDUSTRIAL AND RETAIL CONFIDENCE
Consumer Confidence
1 January 1985 - 31 May 2001



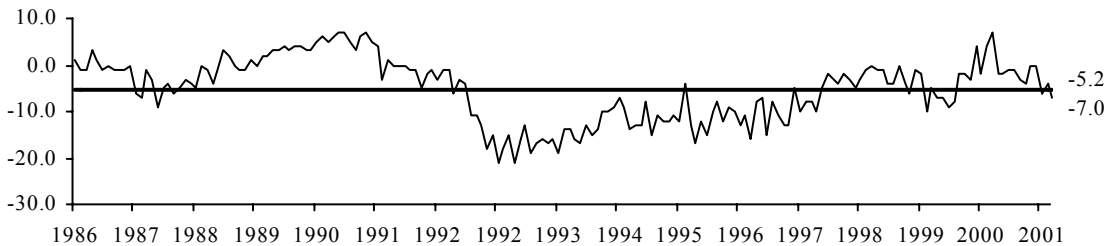
Construction Confidence
1 January 1985 - 31 May 2001



Industrial Confidence
1 January 1985 - 31 May 2001



Retail Confidence
1 July 1986 - 31 May 2001



Source: Datastream International.