

Is the euro zone catching a cold?

When ECB President Jean-Claude Trichet delivered the ECB's monetary policy stance on September 6, 2007, he presented an indefinite pause in the tightening cycle. Several ECB council members have expressed the view that once financial markets stabilize, the ECB will again target its inflation concerns and that the tightening cycle has not been "abandoned." It seems to us that the majority of the ECB council members are not satisfied by the extent of the tightening of monetary conditions up to now.

Spillover from sub-par growth in the US

But, evidence is increasing that the US economy is heading for a prolonged period of sub-par growth. Even though the importance of the US economy to global growth has already somewhat diminished, it is certainly too early to believe in decoupling. The extent of the spillover to the euro zone is crucial for both financial markets and central bank policymakers on this side of the Atlantic. This spillover holds the key to the euro zone's interest rate outlook for 2008.

The view that the euro zone economy would remain relatively immune to the US slowdown, due to resilient global growth and increasing domestic demand within the euro zone, is already showing cracks. While not dramatic, we believe that the fallout on the euro zone growth related to the downturn in the US and associated market turmoil, will be significant. Our cautious assessment of the euro zone's growth outlook is mainly based on the following arguments:

- **Movements in the exchange rate.** The euro-dollar exchange rate has appreciated 7.5% since the beginning of the year. A sharp slowdown of the US economy is very likely to be associated with a further weakening of the dollar. This development would ultimately strengthen the euro's effective exchange rate. The resulting reduction in the competitiveness of euro zone exports would exacerbate the impact of the shock.
- **Consumer spending never really picked up in the recent cyclical upturn.** Although the conditions were in place, such as significant improvement of job security, we have seen only very limited signs of improvement in the consumer sector.
- **Producer confidence is already cooling.** There is a wide gap between volatile financial markets, such as the currency market, and the slow reaction of the real economy to financial storms. Yet, listening carefully to the company managers surveys such as the Ifo (Germany), INSEE (France) and INSAE (Italy), we perceive growing evidence that the euro zone economy is actually cooling. The underlying trend is unambiguous; production slowed in September; demand, although still above trend, is decelerating and is expected to decelerate further.

After almost two years of above trend growth euro zone GDP is likely to grow more slowly than its potential rate. Policymakers, starting with the ECB, should pay attention to this inflexion point. The bad news is coming mainly from companies and not from the politicians trying to influence the ECB.

Orderly slowdown likely

Therefore we come to the conclusion that the "orderly slowdown" scenario remains the most likely scenario for the euro area economy. Despite turbulence in the

money and FX markets we think the signals are not convincing enough to expect a hard landing for economic growth. Yet, the slowdown is likely to be more pronounced than previously expected and that could be a trigger for the ECB to leave the refinancing rate at 4% in 2007.