EUROZONE WEEKLY BRIEF

Leading indicators suggest recovery gathering pace, spearheaded by services; but employment still in retreat and consumer confidence subdued** **(update for week 48 to December 1st)

- Growth: the leading indicators for Nov'03 leave little doubt that the euro zone economy is now on a solid recovery path. Growth in the services sector has of late been quite robust. The recovery in industry has so far been more timid. There are also still some doubts about employment as the indicators do not show an end to the labour shake-out. Consumer confidence too is as yet only modestly improved. The major reason for the increasingly optimistic growth outlook for the euro zone is the strength of the world economy. The latest indicators for the US economy in particular point to robust growth being sustained. The OEF baseline forecast remains at 0.5% for 2003 and at 1.7% for 2005. The consensus forecast is virtually the same (page 2).

- Inflation: the "flash" estimate of the y/y rise in the euro zone's harmonised CPI in Nov'03 was 2.2%, up from the final outcome for Oct'03 of 2.0%. This modest acceleration is partly due to a negative base effect. Prospects are still for inflation to decline below 2% early in the new year. The OEF baseline forecast for 2004 inflation remains at 1.8%, modestly above the consensus forecast (page 5).

- Monetary policy: no change in interest rates is expected at Thursday's rate setting meeting. Though the economy is strengthening, the growth in money supply is accelerating and inflation remains above 2%, the appreciation of the euro is an offsetting factor which should ensure that monetary policy of the ECB remains in neutral for a while yet. Longer term the failure of the excessive deficit procedure to be applied to Germany and France may make for a more aggressive monetary policy (page 5).

- Government long bond markets: are being further driven down by the seemingly endless series of robust growth indicators for the US economy (page 7).

- Euro: moved to a new peak last week as concern about how the US budget deficit is to be financed eclipsed the positive impact of strong US growth (page 7)

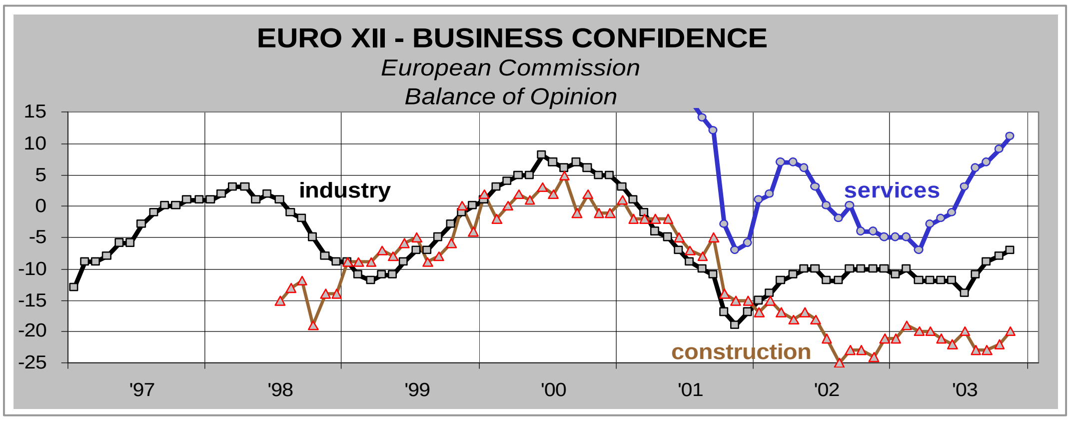
Week ahead (week starting December 2nd): *focus on ECB's Governing Council meeting*

This week's focus may be on the ECB, which holds its rate setting meeting on Thu (Dec 4th). No change in its monetary stance is expected, but the ECB may elaborate on its denunciation of the decision of the Council of Finance Ministers (Ecofin) to suspend the excessive deficit sanction mechanism of the Stability & Growth Pact.

Euro zone growth indicators this week include a wealth of new data for Germany: Tue (Dec 2nd) German Oct'03 retail sales and Nov'03 NTC building index, French Nov'03 consumer confidence and euro zone Oct'03 unemployment; Wed (Dec 3rd) euro zone Nov'03 PMI for the services sector, euro zone Q3'03 GDP, EC's model prediction for GDP growth in Q4'03 and Q1'04; Thu (Dec 4th) German Nov'03 unemployment, Oct'03 industrial orders and Sep'03 employment, euro zone Sep'03 retail sales; Fri (Dec 5th) German and Spanish Oct'03 industrial production.

On the inflation front the euro zone's Oct'03 producer price index is due on Tue (Dec 2nd).

In the US the PMI for the services sector and revised productivity data for Q3'03 are due on Wed (Dec 3rd); Thu (Dec 4th) will bring the usual initial jobless claims for week 48, followed on Fri (Dec 5th) by the Nov'03 employment report, Oct'03 manufacturing orders and consumer credit.

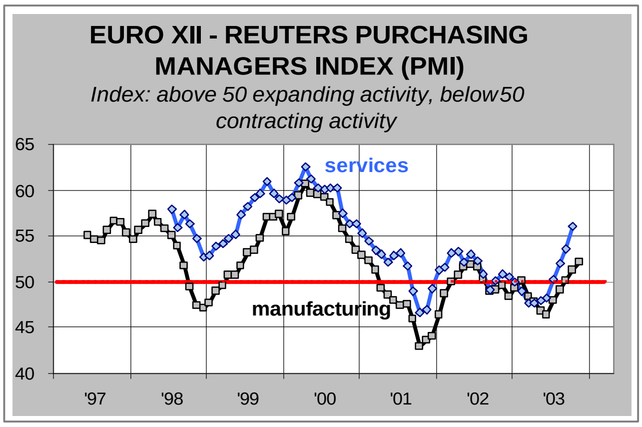


Growth: *recovery gathers momentum, spearheaded by services; employment lagging*

The European Commission's business confidence survey indicates that the recovery in the euro zone economy gathered momentum in Nov'03. As indicated by previous surveys, the **services sector** is leading the way upwards. Since its low point in Mar'03, the rise has been continuous and broadly based. The turn-around has been most spectacular in Germany. The assessment of business conditions in the euro zone has continued to improve as demand has strengthened. Less positive and somewhat surprising, however, is a renewed deterioration in employment in the services sector.

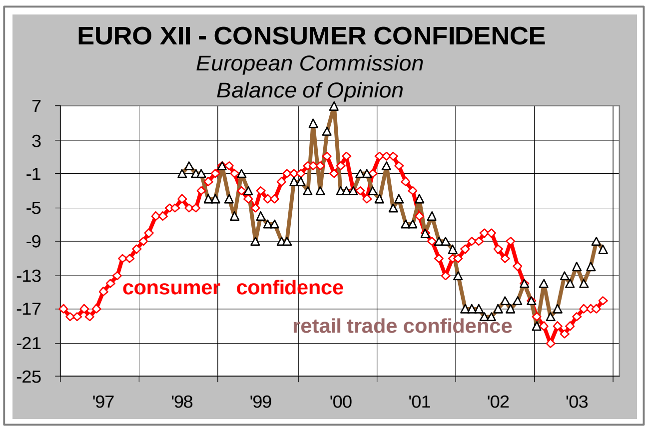
The recovery in **industry** is more restrained, but unmistakable nonetheless. Production expectations have risen particularly rapidly while the improvement in order books has also gathered pace, thanks in particular to a surge in export orders in the latest month. There were few signs of a stronger euro undermining the recovery. But there has as yet been only a marginal improvement in employment expectations. The fortunes of the **construction sector** also rose a little.

The **Purchasing Managers survey** for the manufacturing sector is in line with the Commission's industry survey. The index rose only 0.9 points to 52.2 in Nov'03, indicating some hesitancy. But there was a smart rise in new orders and though employment was still being cut, the pace slowed.



The detailed survey answers did reveal some difficulties for semi-manufacturers arising from the strong euro. This was said to be the main reason why the rise in the overall index was a little below expectations. In **Germany** the index receded a fraction in spite of a significant further rise in new orders. Negative in Germany was the persistent decline in employment. But the pace of activity quickened in France and Italy with steep rises in export orders.

An important condition for the sustainability of the recovery is that the enlivened economic scene now lifts **consumer sentiment**. According to the European Commission's survey, after three months stagnating at a lowly level, consumer confidence did rise by one point in Nov'03. A small step, but in the right direction.



So far the euro zone consumer sees an improvement only in the **general economic situation**, rather than in his personal financial situation. But unemployment expectations have receded steadily since their peak in May'03.

The **retail trade confidence** indicator remains on a clear uptrend even though the reading for Nov'03 was a little lower than the one for Oct'03. The decline was due to a rise in stocks which also reduced intentions of placing new orders. Unexpectedly, the rise in employment expectations seen in the summer months has been reversed. The retail sector apparently again intends to reduce its labour force.

EUROZONE WEEKLY BRIEF

The **Euro group's meeting** of finance ministers of 24th November decided (with a qualified majority) to "suspend" the excessive deficit sanctions mechanism of the Stability & Growth Pact against Germany and France. These countries merely gave a political undertaking to bring their public sector deficits below 3% of GDP in 2005.

Most economists applauded the demise of the Pact, seen as unnecessarily restrictive in periods of slow or negative growth. Yet the additional restrictive measures demanded by the European Commission of Germany and France, in its effort to enforce the Pact, were modest and, against a background of a strengthening world economy, would have made little difference to growth. The euro zone's 2004 growth prospects are virtually unchanged by the "suspension".

The importance of the "suspension" lies elsewhere. The credibility of the major countries to respect their solemnly given European pledges has been damaged. The smaller European countries now have increasing concerns about being dominated by the major countries. The **European Commission** has been weakened, even told by Germany's Finance Minister Eichel to "stop sulking". It is as if Germany and France have concluded that their quest for ever closer European union may not be achievable within the current EU framework and administered by the Commission. They may have signalled their intention to pursue European integration with an inner core of European countries under French and German leadership.

The **OEF base line forecast** for GDP growth this year remains at 0.5% and for next year at 1.7%. The consensus forecast remains at 0.4% for 2003 and at 1.8% for 2004. Our "speculative variant" forecast is also unchanged at 0.4% for 2003 and 1.5% for 2004.

Euro XII real GDP	**2003**	**2004**	**2005**		**2003**				**2004**			
					Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
	% change				% change q/q, seasonally adjusted, annual rate							
OEF base line forecast *Previous, if different*	**0.5**	**1.7**	**2.4**		**0.0**	**-0.2**	**1.4**	**1.5**	**1.9**	**2.0**	**2.1**	**2.1**
Consensus forecast *Previous, if different*	**0.4**	**1.8**										
Speculative variant *Previous, if different*	**0.4**	**1.5**			**0.0**	**-0.2**	**1.0**	**1.5** *1.0*	**1.5**	**2.0**	**2.3**	**2.5**
Previous from our weekly review of November 25th												

Speculative variant*: The aim of the speculative variant is to alert readers to the risk to the OEF base line forecast and the direction in which the baseline forecast may change if the risk appears to become reality. The speculative variant may be based on a number of indicators and anecdotal evidence, considered of insufficient weight to influence the OEF base line forecast. Alternatively a difference in the forecasts may be due to differing underlying assumptions. Currently the OEF baseline forecast assumes a gradual depreciation of the euro against the dollar. The "speculative variant" assumes an appreciation, hence the slightly lower growth forecast for 2004.*

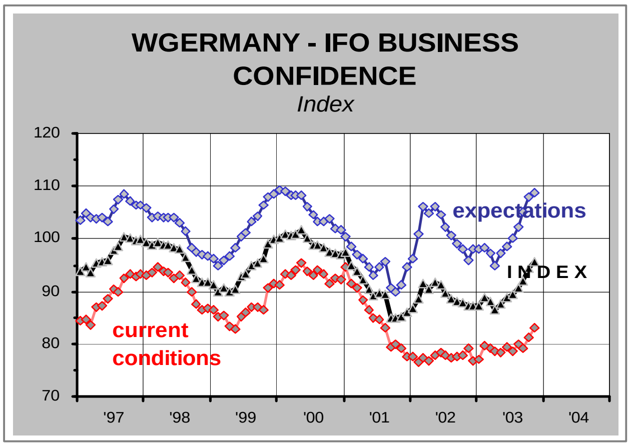
International background: *US growth becoming sustainable*

Last week's indicators for the **US economy** support the view that strong growth can be sustained even as the stimulatory impact of monetary and fiscal policies fades. Oct'03 durable goods orders rose sharply. Non-defence capital goods orders, a proxy for **investment**, are 12.8% up y/y, suggesting that improved corporate earnings are encouraging corporate investment spending. Initial and continuing jobless claims are trending lower suggesting that the **labour market** is improving, if modestly so far.

Consumer confidence improved in Nov'03 though it is still at a low level. Oct'03 consumer spending was unchanged on the month, but real disposable income rose and the holiday shopping season started on a note of strength. Single family **home sales** receded in Oct'03 but are still at very high levels. Construction spending is still rising.

Q3'03 GDP growth was revised to an annualised q/q rise of 8.2% (from 7.2%). The ISM manufacturing index for Nov'03 points to robust growth in industry.

Euro zone country news: *German leading indicators perk up; French business confidence soars, Italy's edges lower; strong start to Q4'03 in Spain; Dutch consumer confidence recovering; Belgian GDP bounces back*



The indicators for Nov'03 which became available last week for the **German economy** leave little doubt that moderately paced growth is underway.

The **Ifo** index for Nov'03 rose for the 7th month in succession. The rise in the expectations sub-index, already at a high level, tapered off. More important, for the second month in succession, there was a clear rise in the **current conditions sub-index**, putting paid to the fear that the rise in the overall index was just an "expectations bubble" (as was the case in 2002).

Consumer optimism also rose in Nov'03 with, in particular, a greater readiness to make major purchases. General economic conditions are seen as improving and the fear of unemployment is receding.

The **engineering association** VDMA reported a 4% y/y rise in Oct'03 orders for plant & equipment. The improvement came exclusively from abroad: export orders +9%. Domestic orders declined by 4%. The association said that a rise in the euro beyond $1.20 would undermine their exports next year.

Last week's news from **France** was again growth positive, even more positive than generally expected. Consumer spending rose, as did business confidence. Employment deteriorated only modestly.

INSEE's **composite business index** jumped in Nov'03 to 100 from 95 the month before, indicating a substantial improvement prompted by a steep rise in the perception of the general as well as the personal business outlook. There was a major improvement in foreign orders and demand.

Unemployment (s.a.) in Oct'03 rose only marginally, leaving the unemployment rate unchanged at 9.7%

Oct'03 **household spending** (in volume and s.a.) rose by 1.6% m/m, following the 2.9% advance in Sep'03.

After the surprise 0.5% q/q jump in **Italy's** Q3'03 GDP, the indicators point to a much more subdued performance of the Italian economy in Q4'03.

ISAE's **business confidence index** edged lower in Nov'03 and was below its level in Aug'03. The unexpectedly weak reading is due to a more pessimistic perception of the economic outlook. This appears to be linked to fears that Italian producers are finding it increasingly difficult to compete against imports.

According to ISAE, **consumer confidence** also edged lower in Nov'03 to its lowest level since the survey began in 1996. Sep'03 retail sales, though, rose 0.6% m/m, 3.3% y/y.

According to the OECD, Italy's **budget deficit** could in 2004 "nudge" 3% of GDP, substantially overshooting the government's 2.2% target. The European Commission has also expressed concern about Italy's use of one-off measures to rein in its budget deficits. The Commission expects Italy's deficit to exceed 3% of GDP in 2005.

The **Spanish economy**, after growing in Q3'03 by 0.7% q/q, 2.4% y/y, started Q4'03 also on a note of strength. Oct'03 **retail sales** rose by 7.0% y/y, even beating the Sep'03 rise of 6.6%. The central government budget also recorded a large surplus in Oct'03.

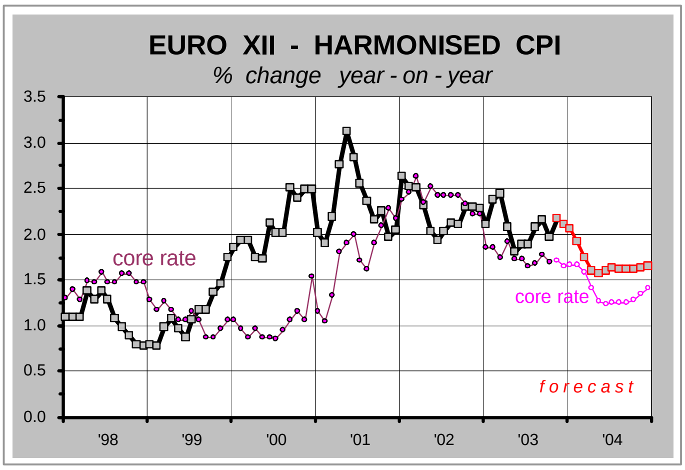
INE's new index for **industrial turnover** indicated a 5.2% y/y rise in Sep'03. For the Jan-Sep'03 period industrial turnover rose by 3.1% y/y.

In the **Netherlands** consumer confidence improved sharply in Nov'03, albeit from a very depressed level. Confidence in the economic situation improved and there is less reticence in undertaking major purchases. **Consumer spending** was deeply depressed in Q3'03.

Dutch **business confidence** slipped in Nov'03, but remained well above its mid-year low.

According to the central bank's "flash" estimate **Belgium's** GDP (s.a.) rose by 0.5% q/q, 0.7% y/y, in Q3'03 (following a 0.1% contraction in Q2'03).

Inflation: *temporary rise to over 2%*



The "flash" estimate of the y/y rise in the euro zone's harmonised **CPI** in Nov'03 came to 2.2%, up from the final outcome for Oct'03 of 2.0%. This modest acceleration is partly due to a negative basis effect. In Nov'02 the CPI declined by 0.1% m/m.

Preliminary Nov'03 results from **Germany** were for a 0.2% m/m decline and a 1.3% y/y rise (national CPI). Italy's preliminary *national* CPI showed a 0.2% m/m and a 2.5% y/y rise. But its preliminary *harmonised* CPI showed a 0.3% m/m and a 2.8%y/y rise. The **oil price** last week remained close to $30. But the euro appreciated a little further and should put downward pressure on inflation early next year.

Our forecast remains for inflation in the euro zone to durably decline below 2% early in the new year. The OEF baseline **forecast for 2004** remains at 1.8%, the consensus forecast at 1.6%. The "speculative variant" forecast is also at 1.6% (as shown in the chart above).

Euro XII Consumer	**2003**	**2004**	**2005**		**2003**				**2004**			
Price increases					**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Harmonised index	% change				% change y/y							
OEF base line forecast *Previous, if different*	**2.1**	**1.8**	**1.9**		**2.3**	**1.9**	**2.0**	**2.0**	**1.9**	**1.9**	**1.8**	**1.8**
Consensus forecast *Previous, if different*	**2.0**	**1.6**										
Speculative variant *Previous, if different*	**2.1**	**1.6**			**2.3**	**1.9**	**2.0**	**2.0**	**1.6**	**1.5**	**1.5**	**1.6**
Previous from our weekly review of Nov 25th												

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Monetary policy: *no change, but ECB upset by suspension of Pact; money supply growth accelerates again*

Last week's combination of stronger growth indicators and a dearer euro leaves the outlook for monetary policy unchanged. The ECB may stick to its **neutral stance** for a while longer. No change is thus expected at Thursday's rate setting meeting of the ECB's Governing Council. Two events have, however, made **interest rate rises** more likely in the future: Ecofin's suspension of the Stability & Growth pact and a renewed acceleration in the growth of the money supply.

The ECB was clearly deeply upset by the Ecofin's decision to "suspend" the **excessive deficit procedure** against Germany and France. In a communiqué issued after the Ecofin meeting, the Governing Council of the ECB stated that "The public can rest assured that the Governing Council remains staunchly committed to maintaining price stability".

With the Stability Pact in abeyance, the ECB sees itself more than ever as the **guardian of price stability**. The ECB has served notice that it may follow a more restrictive monetary course to compensate for any laxity in fiscal policy which may emerge. At the extreme the ECB statement can even be seen as a veiled warning that the ECB could raise interest rates to "punish" governments for not enforcing the excessive deficit procedure. But it is highly unlikely that it will come to that.

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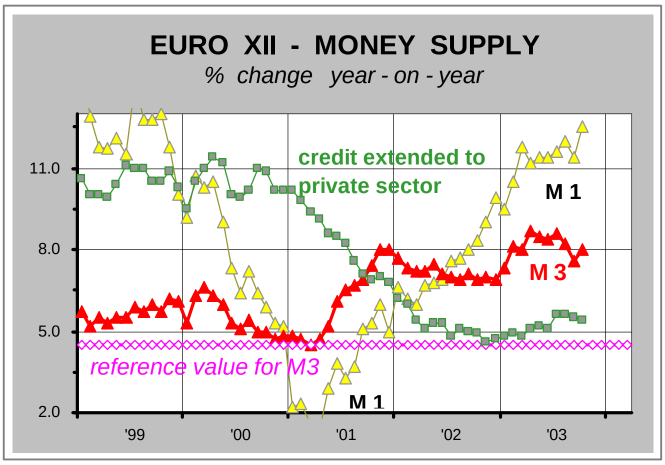
The ECB last week published its **money supply** growth statistics for Oct'03. The money supply does not create much interest these days, none at all in the financial markets. It is nonetheless of some importance to note that the growth in the money supply accelerated again. M3 is still expanding at a y/y rate of around 8%. M1 is rising by 12%.



The euro zone economy is clearly **highly liquid**. Why the money supply has grown by so much is puzzling to the ECB, particularly now that uncertainty has diminished by so much. (Uncertainty created by Middle East developments was thought to be the main reason why the money supply rose so much early this year).Perhaps foreign exchange intervention to slow the rise of the euro has contributed to the rise in liquidity. For now the ECB sees no inflationary danger in the rise in the money supply. But it has warned that this may change.

Euro zone 3-month **money markets rates** were unchanged last week. In the futures market, rates rose smartly, reflecting the positive growth indicators of last week. The futures market now sees euro zone money market rates exceeding 3% by the end of 2004 (a rise of 28 basis points from one week ago). The **OEF baseline forecast** remains for the ECB to keep its rates unchanged until Q4'04 when a 25 basis point rise is expected.

In the **US, rates** were unchanged last week. In the futures market, rates rose sharply as more news flooded in that robust growth is being sustained. The OEF baseline forecast remains for rates to be on a rising trend over the forecast horizon, though not as steeply as expected in the futures market.

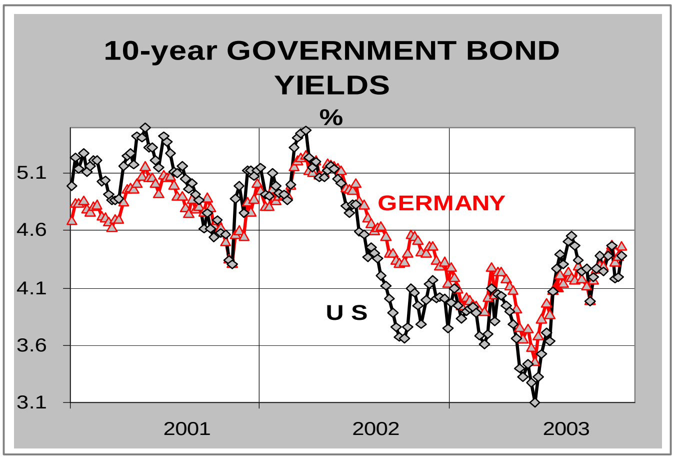
The case for further declines in the ECB's benchmark rate as forecast under our **"speculative variant"** forecast is very much a minority view. Only a further steep appreciation of the euro could bring that about.

3-month money rates	**Current: Nov 28th 03**	Mar'04	Jun'04	Sep'04	Dec'04
International rates **%**	(previous: Nov 21st)	***Euribor futures 3-months***			
Euro zone	**2.16** (2.16)	***2.33*** *(2.23)*	***2.59*** *(2.41)*	***2.87*** *(2.60)*	***3.15*** *(2.87)*
		Forecasts *(ECB repo rate)*			
Current ECB repo rate 2.0	**Forecasts: OEF baseline**	**2.0** ***(same)***	**2.0** ***(same)***	**2.0** ***(same)***	**2.25*(same)***
	"speculative variant"	***1.5 (same)***	***1.5 (same)***	***1.5 (same)***	***1.75(same)***
		Eurodollar futures 3-months			
US	**1.16** (1.16)	***1.38*** *(1.28)*	***1.74*** *(1.55)*	***2.16*** *(1.90)*	***2.62*** *(2.33)*
		Forecasts *(Fed fund rate)*			
Current Fed fund rate 1.0	**Forecasts: OEF baseline**	**1.0** ***(same)***	**1.0** ***(same)***	**1.5** ***(same)***	**2.25*(same)***
	"speculative variant"	***1.0 (same)***	***1.25 (1.0)***	***1.5 (1.0)***	***1.75 (1.5)***
NOTE: *for comparison, equivalent figures from our weekly review of Nov 25th are shown in brackets*					

Forthcoming ECB Governing Council meetings: Dec 4th, 18th; Jan 8th, 22nd; Feb 5th, 19th; Mar 4th,18th; Apr 1st,22nd; May 6th,19th; Jun 3rd,17th; Jul 1st, 22nd; Aug 5th; Sep 2nd, 16th; Oct 7th, 21st; Nov 4th, 18th; Dec 2nd, 16th. Decisions on interest rates (followed by a press conference) are only made at the first of the twice monthly Governing Council meetings.

Government long bond markets: *retreating as world economic growth accelerates*

Week 48 brought more evidence that robust growth in the US is becoming sustainable and that growth in the euro zone is also perking up. The government long bond markets prolonged their decline of the previous week. The decline was muted in the euro zone because of the strength of the euro. The yield gap between 10-year Treasuries and Bunds thus shrank from 24 basis points at the beginning of week 48 to 9 basis points at the beginning of week 49.



In the US a **$26bn auction** of 2-year Treasury notes drew a lower response than expected, particularly from foreign central banks. Expectations now are for more robust growth figures to be published this week. Growth has been so strong that it is increasingly questioned for how long the **Fed** can stick to its highly accommodating stance.

In the euro zone the **suspension of the excessive deficit procedure** of the Stability & Growth Pact had little immediate impact on the euro zone bond market. The long term implications are potentially, but not necessarily, serious. If fiscal discipline is about maintained by euro zone countries, the impact will be negligible. But if euro zone countries in the future feel free to let their budget deficits rise, more bonds will have to be issued and yields will be higher than they would otherwise be.

10-yr Gov't	**Current: Dec 1st 03**	**Forecast % (speculative variant)**			
Bond yield	Previous: Nov 24th	Mar'04	Jun'04	Sep'04	Dec'04
	%				
Germany	**4.49**	**3.5 to 4.0**	**3.6 to 4.1**	**3.6 to 4.2**	**3.6 to 4.2**
Previous	*(4.40)*	*(unchanged))*	*(unchanged)*	*(unchanged)*	*(unchanged)*
US	**4.40**	**4.1 to 4.6**	**4.0 to 4.5**	**4.0 to 4.5**	**4.0 to 4.5**
Previous	*(4.22)*	*(unchanged)*	*(unchanged))*	*(unchanged)*	*(unchanged)*
NOTE: *equivalent figure from previous weekly (dated Nov 25th) in brackets.*					

Euro: *new peak at $1.2041 as concern mounts on how current account deficit will be financed*

The euro briefly broke through the $1.2000 barrier at the end of week 48 and stabilised around that level early in week 49. No specific development pushed the euro to a life-time high. The robust US growth indicators appear to have lost their power to support the dollar. A variety of factors are cited to explain the dollar's weakness. Among the most frequently cited in the foreign exchange markets are: US resorting to protectionist policies, covert policy of the US administration to weaken the dollar, fears that robust US growth is not sustainable, fear of terrorist activity and the difficulty in which the US finds itself in Iraq.

Most cited of all is the deep **US current account deficit**, amounting to 5% of GDP. Poor foreign demand at the mid-week $26bn auction of US Treasury notes again focused attention on how the deficit is to be financed. For most of this year the US current account deficit was mainly financed by foreign central banks intervening in the foreign exchange markets to prevent their currencies appreciating against the dollar. The dollars bought by the central banks are subsequently invested in US Treasury notes of varying duration, providing the currency inflows to bridge the current account deficit.

It may be that now the world economy is growing again the need felt by foreign central banks to keep their currencies down will become less urgent. Central banks may also wish to diversify their holdings of foreign assets away from exclusively dollar denominated assets, seeing that the dollar is now a weak currency. There may also be some concerns about the rise in domestic liquidity which the persistent foreign exchange interventions cause (to the extent that they are not "sterilised"). Whatever, the trend in the euro remains firmly upwards.