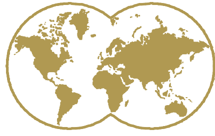


THOMAS WHITE • GLOBAL INVESTING
Capturing Value Worldwide℠

Developed Europe: Economic Review Fourth Quarter 2011

The European debt crisis lingered during the fourth quarter of 2011, although the European Central Bank (ECB) and Euro-zone leaders took several steps to find a lasting solution to the problem. The ECB maintained a largely accommodative monetary policy in the review period, cutting its benchmark interest rate twice by 25 basis points each to bring the rate down to 1% by the end of 2011. The central bank went on to partially ease the credit crunch in the European banking system by launching a three-year loan facility for Euro-zone banks. Whenever necessary, it also bought Spanish and Italian sovereign bonds, albeit on a moderate scale, to prevent the two troubled countries' bond yields from rocketing to unsustainable levels.

At a Glance

- **Germany:** Unemployment fell to historically low levels. Exports grew in November, while businesses and consumers remained optimistic.
- **U.K.:** The services and construction sectors stayed buoyant. GDP grew 0.6% in the third quarter. Inflation remained in a downtrend.
- **France:** The unemployment rate rose suddenly in the July-September period after being in a downtrend for several quarters.
- **Italy:** The new government introduced the country's third austerity package in 2011. Third-quarter GDP contracted.
- **Spain:** Tax hikes and spending cuts were announced by a new conservative government. GDP recorded zero growth in third quarter.
- **Greece:** To become eligible for another bailout, the government is told to persuade private creditors to agree to cut debt owed by 50%.

Early December saw European leaders meeting at a grand summit to solve the continent's debt crisis and to discuss appropriate changes to the European Union (EU) treaty. Although the debt crisis remained unresolved, the summit took several significant steps, which may have a far-reaching impact on the political and economic landscape of Europe in the future. For instance,

the leaders agreed to create more enforceable penalties for exceeding budget-deficit targets. They also decided to begin a series of talks to chalk out the details of new norms for the fiscal and economic policies of member countries within the Euro-zone. Aiming to prevent Greece-like situations in the future, the two most powerful leaders of the single-currency block, German Chancellor Angela Merkel and French President Nicolas Sarkozy, have called for a plan to keep the economic policies of member countries more closely aligned.

The fourth quarter also marked a change of government in four Euro-zone countries. General elections were held in Spain, while Italy and Greece made way for new transitional regimes to replace those elected governments that failed to effectively handle the economic problems in their countries. Belgium finally appointed Elio Di Rupo as prime minister, after having had no government for a record 541 days. Since its previous government's resignation in April 2010, the country was being run by a caretaker administration as its major political parties failed to form a coalition.

On the economic front, several Euro-zone member economies experienced a slowdown, triggering market rumors about an impending recession in the bloc. **Euro-zone manufacturing activity weakened for the fifth consecutive month in December**. Although the Markit Purchasing Managers' Index (PMI) for the sector inched up to 46.9 in December from 46.4 in November, it remained below the 50.0 threshold, which separates growth from a contraction. Further, according to the EU's statistics agency, Eurostat, **unemployment in the Euro-zone stood at 16.4 million, or 10.3% of the workforce, at the end of November 2011.** *The Guardian* has said that public spending cuts as well as weakening consumer and business confidence are taking a toll on the Euro-zone economy.

Compounding the region's problems, **S&P cut the credit ratings of nine Euro-zone countries in early January.** Notably, France has lost its AAA rating while Spain, Italy and Portugal were downgraded two notches. The rating cuts have the potential to push up the borrowing costs of these countries, some of which like Italy are already struggling to keep their bond yields under control.

Germany: Resilient amid the crisis

Germany remained one of the few oases of optimism amid the gloom in the Euro-zone. Most of the statistics the country reported during the fourth quarter of 2011 reflected its resilience and the positive outlook for its economy in the coming months. For instance, **the Munich-based Ifo Institute's business sentiment index showed a rising trend in the last two months of 2011**, pointing to the confidence of German companies despite the slowdown across the globe. Indeed, the plants of German car makers BMW, Daimler, and Audi ran at full capacity during the fourth quarter, and the firms even had to shorten their traditional production break during Christmas in order to fill their orders.

German consumers appeared equally positive as the Nuremberg-based market research company GfK's consumer sentiment index rose for the third straight month in December 2011. The optimism does not appear misplaced, given the current bright employment environment. After all, **Germany's unemployment rate for November declined to a 20-year**

low and, according to the Spiegel Online International, the number of jobless Germans is expected to fall by another 100,000 in the near future due to "new jobs and demographic change." Going by the publication's analysis, the number of older people retiring from the workforce is higher than the number of younger individuals taking up jobs. The chief concern of small- and medium-sized enterprises, the backbone of the German economy, is finding skilled personnel rather than downsizing, Spiegel Online has said.

Adding to the shine, Germany's trade sector also posted good news, although it was offset to some extent by discouraging industrial output data. The Federal Statistical Office (FSO) reported that **German exports grew 2.5% to €90.7 billion in November on a monthly basis and adjusted for seasonal and calendar factors.** Imports declined 0.4% at the same time, pushing up Germany's trade surplus to €14.3 billion from €11.5 billion in October. Exports had recorded a monthly drop of 2.9% in October. Calculated on a yearly basis, German exports increased 8.3% in November. However, **the country's industrial output tumbled 0.6% in November**, at least 10 basis points more than estimated. The fall in output indicates that external demand, which led to the robust export growth in November, was likely met by existing inventory rather than by newly produced goods.

In line with the inflation data reported for the broader Euro-zone, **Germany's inflation eased for the third straight month in December**, strengthening the case for a cut in interest rates in the single-currency bloc. According to the FSO, the country's rate of price rise decreased to 2.4% in December from 2.8% in November.

The U.K.: New Year begins on a positive note

The U.K. economy posted some encouraging data in the period between October and December last year. According to the Office for National Statistics (ONS), Britain's GDP expanded 0.6% in the third quarter of 2011 on the back of faster-than-expected growth in the agriculture, construction, and services sectors. Economic growth was stagnant in the second quarter due to the impact of the tsunami destruction in Japan and loss of productivity following the public holiday for the royal wedding. The PMI for major sectors also gave positive signals about the British economy. For instance, **the Markit/CIPS PMI for the services sector advanced to 54.0 in December from 52.1 in November while the PMI for the construction sector increased to 53.2 in December from 52.3 in November.** Notably, the services sector accounts for 70% of the U.K. economy, with the construction sector representing 10%.

The PMI for the export-driven manufacturing sector rose to 49.6 in December from 47.7 the previous month, reportedly owing to a few new orders from Germany, China, and Eastern Europe. However, since this PMI failed to rise above 50, it is evident that manufacturing activity remained in contraction mode during the October-December period. The U.K.'s biggest trading partner is the Euro-zone and, according to reports in the British media, it is likely that the nation's manufacturing sector has been hurt by the recessionary conditions in some Euro-zone member countries.

Inflation remained in a downtrend during the October-December period, thanks to a strong harvest and intensifying price competition between supermarkets. The trend brought relief to

British households, which have been hurt by slow pay growth. The Bank of England, which must have been relieved too since it has been criticized for stoking inflation through its government-bond-buying programs, has predicted a steady fall in inflation over the coming months. If the central bank's forecast comes true, consumer spending, which accounts for nearly two-thirds of all spending in the country, will get a boost, given that inflation is still more than double the rate of average wage growth.

The news from the labor market was mixed. With the public sector continuing to cut jobs — about 67,000 in the June-September period — **the U.K.'s unemployment rate touched 8.3%, its highest level since 1996, in the fourth quarter**. Significantly, youth unemployment continued to stay above the one-million mark. However, the good news is the pace of job losses appears to be slowing, given that the most recent count of claimants for unemployment benefits rose by just 3,000 while it was predicted that it would increase by at least 14,900. Moreover, throughout 2011, the private sector hired about 262,000 people, which partially offset the 276,000 job losses in the public sector during the year.

France: Labor market deteriorates

Economic data released in the country during the fourth quarter hardly gave the French any reason for cheer in the New Year. According to the National Institute of Statistics and Economic Studies (INSEE), **metropolitan France's unemployment rate for the third quarter of 2011 rose to 9.3% from 9.1% for the second quarter, and 9.2% for the first.** The unemployment rate shot up suddenly after being in a downtrend since the fourth quarter of 2009, when it peaked to 9.5%. These statistics reflect the situation in the French labor market over the past several months.

For instance, **the INSEE's economic sentiment indicator has fallen to its lowest point in several months**, which means that owing to the weak outlook for the French economy, businesses have been likely deferring their hiring decisions. Further, the French labor market remains mired in several structural problems, such as a relatively high level of income tax and minimum wage. The current level of unemployment will likely not augur well for the French economy in 2012. Private consumption in the country is already under strain due to successive government austerity programs and increasingly stringent bank lending norms. Spending appetites may suffer further if unemployment remains high.

Activity in the country's manufacturing sector showed a declining trend in the October-December quarter. The Markit PMI for the sector contracted for the fourth consecutive month in November — to 47.3 from 48.5 in October. Worse, the sector shrunk at its fastest pace since June 2009. French manufacturers' total new orders also fell to their lowest level since April 2009, reflecting poor demand in the sector. Along with a drop in domestic consumption, France has been hurt by waning demand for its goods and services from other Euro-zone countries. Notably, 65% of France's exports are bought by Euro-zone countries.

The INSEE reported in late December that **France's GDP for the third quarter of 2011 grew just 0.3% due to lower industrial output and a steeper-than-estimated fall in business investment.** More significantly, the institute said that it expected the French economy to shrink

0.2% in the fourth quarter of 2011 and another 0.1% in the first quarter of 2012. On a positive note, though, France's trade situation improved in the fourth quarter. **Data for November released in early January indicate that the country's exports increased by over €1 billion**, thanks in part to the strong international sales of the French aeronautical sector. The robust demand for French goods from countries outside the European Union also contributed to the export performance.

Italy: New austerity plan launched

As Italy's borrowing costs threatened to spiral up to unsustainable levels around the middle of the fourth quarter of 2011, Silvio Berlusconi was left with little option but to step down as prime minister and make way for a government of technocrats led by Mario Monti, an economist. The Monti government has the mandate to administer Italy until the next scheduled elections in 2013. Within weeks of taking the helm, Monti asserted his administration's resolve to revive Italy's stalled economy and service its €1.9 trillion debt by announcing the "Save Italy" plan, a package of tax hikes, spending cuts, pension reforms, and growth-inducing measures that aim to generate €30 billion over the next three years.

Including the latest, Italy adopted three austerity packages in 2011 in order to reduce its budget deficit by an amount equivalent to nearly 6% of its GDP by 2013. The previous €60 billion austerity package launched by the Berlusconi government with the approval of the Italian Senate was criticized by European leaders for "not focusing adequately on pension overhauls and other structural changes necessary to save Italy from its debt crisis." Monti's "Save Italy" plan too has been backed by the Senate, but apparently it has failed to pacify bond markets. Days after the Senate approved the plan, Rome faced weaker-than-expected demand for Italian sovereign debt at a bond auction and, in early January, the yields on its 10-year bonds crossed the psychological threshold of 7%. These developments indicate bond investors are likely still fretting over Italy's ability to avoid getting into the same situation that led Greece, Portugal, and Ireland to seek bailouts in 2011. Incidentally, according to a *Financial Times* report, Italy needs to sell debt worth around €400 billion in 2012, and it requires at least €200 billion of this amount just to refinance its earlier debts.

Meanwhile, economic data the country reported in the fourth quarter and early January show how hard its economy has been hit by austerity measures. **Its statistics institute Istat has said that GDP contracted 0.2% in the third quarter** — for the eighth time in the past 15 quarters. The Italian government expects GDP to decline about 0.4% in 2012, while the country's biggest business lobby, Confindustria, has predicted a fall four times as large. Also, an Istat report on the labor market said **the nation's unemployment rate moved up to 8.6% in November from 8.5% in October and 8.2% in November 2010**. More significantly, the unemployment rate for younger workers inched up to 30% from 29.2% in October.

Spain: Spending cuts and tax hikes announced

Following general elections in November, the conservative Popular Party has won a majority and has come to power in Spain. But soon after taking the oath of office in December, new Prime Minister Mariano Rajoy announced that Spain's budget deficit for 2011 would touch 8% of

GDP, well above the 6% target the previous government of the Socialist Party had set for last year. **In fact, stressing his government's determination to improve Spain's fiscal situation, Rajoy went back on his campaign promise not to raise taxes and announced tax hikes of about €6 billion and spending cuts equivalent to €8.9 billion on December 30.** In line with this announcement, the government has said that it plans to curb subsidies for political parties, freeze hiring and wage hikes in public administration, raise property taxes, and remove a tax break on diesel fuel.

The government is slated to present a new budget in March, and in the months ahead, it has promised to announce measures to strengthen the Spanish banking sector, which is under pressure due to a property bubble gone bust. Plans are also on the anvil to correct the structural problems in the labor market that have played a major role in keeping Spain's unemployment rate above 20% for some time now. Speaking of the labor market, **Spain's unemployment rate climbed for the fifth straight month to a 15-year high of 21.5% in December.** Millions of Spanish citizens have lost their jobs since 2008 when the housing market, one of the biggest sources of employment in the country until that year, collapsed after a decade-long boom.

Among other economic data published in Spain during the October-December period, **GDP remained unchanged between the second quarter of 2011 and the third quarter of 2011 owing to continued contraction in domestic spending.** Further, the tourism and export sectors, the two major drivers of the Spanish economy, weakened in the fourth quarter. **Markit's manufacturing PMI for Spain slipped to 43.7 in December from 43.8 in November, marking the eighth straight month of contraction in the nation's manufacturing activity.**

Greece: Bailout hinges on deal with creditors and new austerity measures

In October, Greece's economic problems spilled over to the political arena. That month, European leaders, the ECB, and the International Monetary Fund agreed to give Greece another €130 billion bailout if new austerity measures are implemented, and also if the country's creditors are convinced to write off 50% of debt owed. However, the incumbent Prime Minister George Papandreou sprung a surprise by announcing that Greece would hold a referendum on the terms of this new aid. The announcement immediately raised questions about Greece's commitment to the bailout deal and plunged the country into a political crisis. Subsequently, Papandreou was forced to step down, making way for a transitional government comprised of major political parties and headed by Lucas Papademos, a former ECB vice-president. The new government will administer the country until the next parliamentary elections, tentatively scheduled for February 2012.

Meanwhile, European leaders, chiefly German Chancellor Angela Merkel and French President Nicolas Sarkozy, have declared that Greece's next tranche of bailout loans from the Euro-zone and the (IMF) would be released only if the country persuaded its private investors to cut debt owed 50%. As of the second week of January, the interim government had started negotiations with creditor banks about the finer points of its debt-reduction deal. According to a *Wall Street Journal (WSJ)* report dated January 6, Prime Minister Papademos said that "Greece faced the risk of a disorderly default in March" if it did not manage to reach a deal with the private banks and insurers holding its debt.

In March, Greece is slated to pay off debt equivalent to a mammoth €14 billion. To add to Greece's woes, the next tranche of its first €110 billion bailout, which was declared in May 2010, is due for payment only in March. Fortunately, though, the *WSJ* report of January 6 indicates some progress in the negotiations between Greece and its creditors, comprising about 450 financial firms. The report said that Greece has agreed to let creditors seize Greek assets if the country fails in its debt payments, while the creditors, who had initially demanded a bond yield of 8% with a maturity of 20-30 years, have shown the willingness to accept a much lower yield.

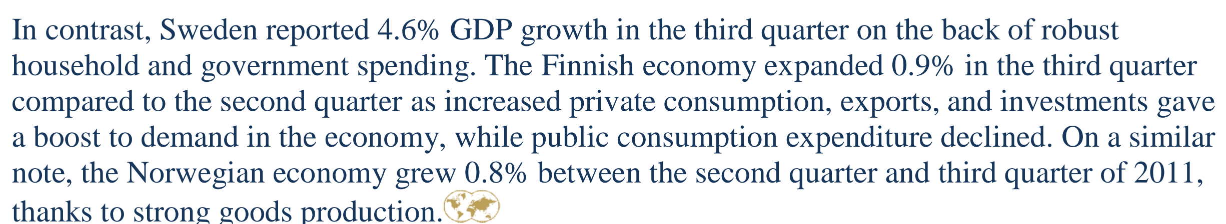
Other economies

Ireland: The country's Central Statistics Office (CSO) reported in mid-December that the **Irish economy contracted nearly 2% in the third quarter of 2011.** It had grown 1.4% in the second quarter. According to the *BBC*, the CSO figures indicate that the austerity measures implemented in the country have likely hurt consumer spending and sentiment. On a positive note, though, the export-driven parts of the economy appear to be better off. The country's agricultural output, which forms a good part of its exports, recorded a 15% rise in 2011, the *BBC* said.

Switzerland: Swiss GDP expanded just 0.2% in the third quarter, its slowest rate of growth in more than two years. The second quarter had recorded 0.5% growth. The State Secretariat for Economic Affairs reported on December 1, 2011 that the export of both goods and services slipped 1.2% and investments, including those in the construction sector, declined 1% during the third quarter. According to the financial media, the ascent of the Swiss franc, which has made Swiss exports less competitive, as well as the slowdown in several parts of Europe have affected the export-driven economy.

Northern Europe: Economic news from the region known as Northern Europe, which includes Denmark, Norway, Finland, and Sweden as well as three other countries, was mixed. The Copenhagen-based Statistics Danmark reported that **for the third quarter, Denmark's GDP shrunk 0.8% compared to the second quarter and 0.2% from the year-ago period.** *Bloomberg Businessweek* attributed the reasons for the decline to weak consumer demand amid falling house prices as well as the dearth of funding in the Danish banking sector since the fall of the Amagerbanken A/S bank in February, which led to the creation of Europe's toughest bank resolution laws.

In contrast, Sweden reported 4.6% GDP growth in the third quarter on the back of robust household and government spending. The Finnish economy expanded 0.9% in the third quarter compared to the second quarter as increased private consumption, exports, and investments gave a boost to demand in the economy, while public consumption expenditure declined. On a similar note, the Norwegian economy grew 0.8% between the second quarter and third quarter of 2011, thanks to strong goods production.



For a free subscription to this article, or any of our other economic report offerings, please visit our Subscriptions page.

If you are a Financial Professional, we invite you to register here for our exclusive content.

Thomas White International, Ltd.
One Financial Place
440 South LaSalle Street
Suite 3900
Chicago, Illinois 60605
Email: feedback@thomaswhite.com

Thomas White India Pvt., Ltd.
Suite 300, 3rd Floor
Phoenix Towers
16/1 Museum Road
Bangalore 560001
Tel.: 91-80-40187777

This article is for informational purposes only. This article is not intended to provide tax, legal, insurance or other investment advice. Unless otherwise specified, you are solely responsible for determining whether any investment, security or other product or service is appropriate for you based on your personal investment objectives and financial situation. You should consult an attorney or tax professional regarding your specific legal or tax situation. The information contained in this article does not, in any way, constitute investment advice and should not be considered a recommendation to buy or sell any security discussed herein. It should not be assumed that any investment will be profitable or will equal the performance of any security mentioned herein. Thomas White International, Ltd, may, from time to time, have a position or interest in, or may buy, sell or otherwise transact in, or with respect to, a particular security, issuer or market on our own behalf or on behalf of a client account.

FORWARD LOOKING STATEMENTS

Certain statements made in this article may be forward looking. Actual future results or occurrences may differ significantly from those anticipated in any forward looking statements due to numerous factors. Thomas White International, Ltd. undertakes no responsibility to update publicly or revise any forward looking statements.

© Thomas White International, Ltd. 2012