



Europe: Economic Review August 2010

Euro-zone gross domestic product (GDP) surged at its fastest pace in four years in the second quarter, expanding 1% from the first quarter. This strong economic growth was largely powered by the stellar performance of the export-driven German economy, which clocked its largest quarterly expansion on record. The recovery in global demand coupled with a 10% depreciation of the euro against the dollar this year has tremendously benefited exports from the 16-member bloc. In the first quarter of this year, regional economic growth had been restrained to 0.2% owing to prevailing harsh weather conditions and a tenuous recovery.

In contrast to the handsome 2.2% expansion witnessed by Germany

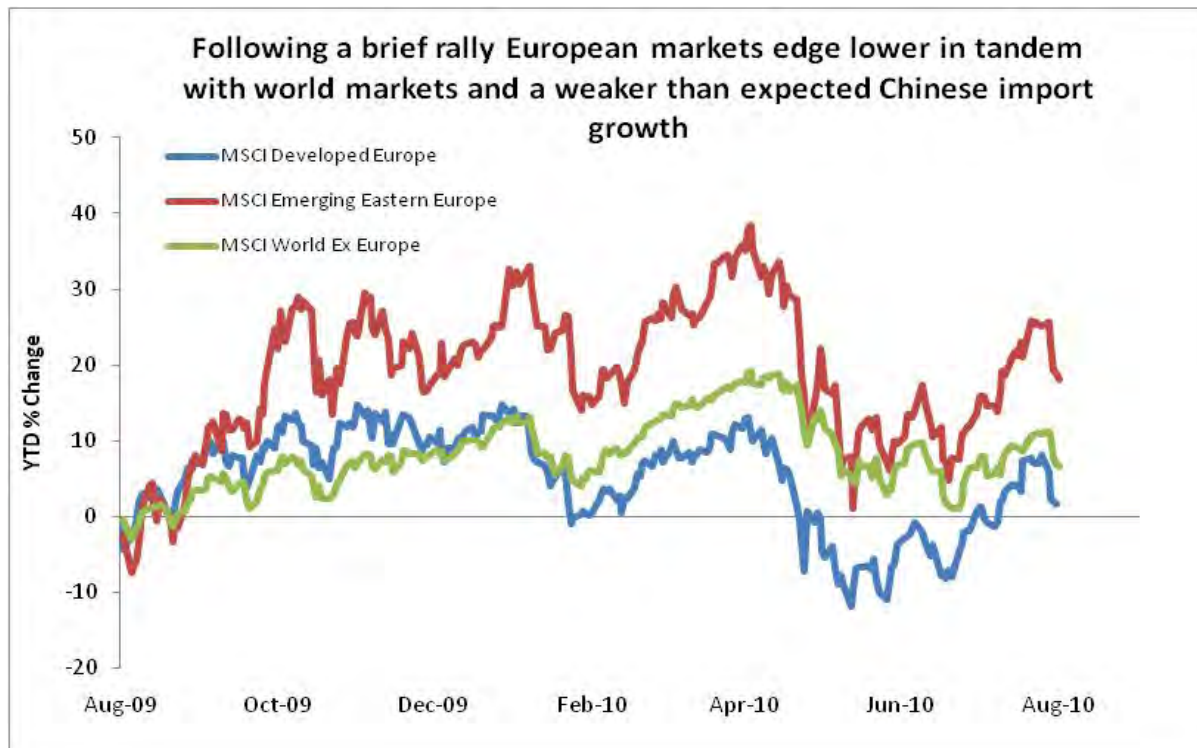
At a Glance

- **Germany:** Strong exports propel the economy to surge at its fastest pace on record.
- **U.K.:** Despite higher than expected growth in the second quarter, consumer confidence remains shaky.
- **France:** Healthy exports and an improvement in domestic demand conditions power the economy in the second quarter.
- **Italy:** Business confidence jumps as industrial production and exports drive growth.
- **Spain:** Despite clocking quarterly growth and a rise in industrial production, the economy continued to grapple with unemployment and a fragile recovery.
- **Russia:** Economic recovery strengthens on domestic demand and energy exports, while inflationary pressures remain subdued.
- **Hungary:** The government might miss its deficit reduction targets this year as precedence is given to growth.
- **Poland:** Price pressures remain muted even as growth accelerates in the second quarter.
- **Czech Republic:** Economy gains momentum in the second quarter as the manufacturing sector and exports power growth.

and a better than expected 0.6% growth in France, the economic fortunes of other member-nations in the region remained subdued. Italy grew a lackluster 0.4%, Spain and Portugal inched up at 0.2%, while the debt-straddled Greece contracted 1.5%. With fiscal consolidation underway in most Euro-zone economies, growth prospects for the region may be undermined over the next half of 2010. Moreover, most economies remain dependent on exports to drive their growth, with domestic consumption demand yet to gain momentum and spending cuts further expected to be a dampener.

Earlier on, the economic sentiment in the Euro-zone accelerated to a 28-month high in July as exports remained buoyant and unemployment continued to remain stable. The European Commission's index of executive and consumer sentiment rose to 101.3 in July from 99 in the previous month. On another positive note, unemployment in the Euro-zone also remained steady at the record-high of 10% for the fourth consecutive month, giving much relief from the surging unemployment levels experienced in the past two years.

Meanwhile the European Central Bank (ECB) kept its interest rates unchanged at the record low of 1% for the 16th month in August this year. Despite an inflation rate that escalated to a 20-month high of 1.7% in July compared to 1.4% in June for the Euro-zone, the ECB seems in no hurry to initiate monetary policy tightening just as yet. This upsurge in inflation is seen as temporary and overall inflationary pressures are likely to remain subdued in the coming months on the back of weak domestic demand. Moreover, the current inflation levels still fall below the ECB's targeted 2% rate.



Germany: Surge in growth fails to revive investor sentiment

The euro-zone's biggest economy zoomed in the second quarter at its fastest quarterly pace on record, almost single-handedly driving economic growth for the 16-member bloc. [Germany's](#) GDP expanded 2.2% from the first quarter largely on the strength of its exports, the most in two decades, compared to a modest 0.5% growth in the first quarter. The German economy, which constitutes almost a quarter of the Euro-zone economy, significantly accounted for two-thirds of the region's growth in the second quarter.

In annualized terms, while German economic growth accelerated an unprecedented 9% in the second quarter, its economic performance continues to depend on continued momentum in global economic recovery, as domestic consumption remains tepid. Moreover, the government has outlined an austerity package worth €81.6 billion (\$105.1 billion) to be implemented from 2011 to 2014, which could further undermine consumption spending within the economy.

Despite a stupendous economic performance, German investor confidence tumbled to a 16-month low in August on concerns that growth would decelerate in the latter half of 2010. Research institution ZEW's index of investor sentiment fell to 14 from 21.2 in July, recording its fourth consecutive decline, on concerns that export demand may not be able to be sustained going forward.

Creating some concern, industrial production retracted 0.6% in June from May, though it advanced a healthy 10.9% on the year. Exports however remained resurgent, up 3.8% in June from the previous month or 29% from a year earlier. Maintaining overall optimism, the German economy, which saw a contraction of 4.7% last year, is estimated to grow far more than 2% in 2010 according to the Economy Minister.

U.K.: Consumer confidence deteriorates on upcoming austerity measures

The Bank of England (BOE) decided to keep its interest rates unchanged at the record low of 0.5% for the 18th straight month, despite the economy's strong growth performance of 1.1% in the second quarter. The BOE also decided to maintain the size of its bond holdings at £200 billion (\$311 billion). It is expected that the [U.K.](#) economy's growth rate might lose momentum in the latter half of this year, as the government braces to launch the steepest budget cuts witnessed since World War II. Faced with deteriorating public finances and a budget deficit that threatens to breach 12% of GDP this year, the government has decided to raise VAT, slash public spending as well as freeze public sector pay.

Expectantly, consumer confidence remained grim, toppling again in July for the third consecutive month, and falling to its lowest level since April 2009. The Nationwide Building Society's consumer sentiment index fell to 56 points in July from 63 points in the earlier month, as pessimistic consumers braced for the austerity measures to take hold. Moreover, despite the slowing down of inflation to 3.1% in July from 3.2% in June, the rate remains relatively high, further eroding the purchasing power of consumers. While the central bank expects consumer prices to remain high over the next few months due to the expected VAT increases, by 2012 inflation is expected to fall back to the targeted 2%.

Fears deepened that the British economic recovery may lose pace when the Markit/CIPS Purchasing Managers' Index (PMI) for the services sector slipped to 53.1 in July from 54.4 in June. This was the slowest growth rate recorded in the services PMI in the past 13 months. On the contrary, the manufacturing PMI in June continued to almost equal the 15-month high seen in May, falling only marginally to 57.5 compared to 58 in the previous month. But a barometer of export orders hurtled to 50.7 in June from 56.7 in May, the weakest export growth since August 2009, creating concern about future growth prospects.

Encouragingly, there was some respite on the unemployment front as the number of jobless in the U.K. fell by 49,000 to 2.46 million in the period between April and June 2010. For the three months ending in June, unemployment remained steady at the same 7.8% level recorded in the three months ending May.

France: Economy clocks higher than expected growth rate

Beating expectations, France expanded a higher than expected 0.6% in the second quarter, bettering its 0.2% GDP growth clocked in the first quarter. While companies stepped up their investments, supported by increasing exports, domestic demand also showed some signs of strengthening. Exports increased 2.7% in the second quarter, and the stronger domestic demand also supported higher imports, which accelerated 4.2% in the same period.

But consumer spending, which accounts for a substantial 58% of France's GDP, has remained dismal in the first four months of the year. Spending on manufactured goods rose 0.6% in May on a monthly basis, largely owing to World Cup related spending, though slipping 1.4% again in June. On a positive note, consumption on a quarter-to-quarter basis halved its decline to 0.9% in the second quarter compared to the much higher 1.9% in the first.

With a budget deficit that is expected to touch 8% this year, the government is hoping new austerity measures involving raising taxes as well as a restructuring the pension system will help trim the deficit down to 3% by 2013. These impending measures along with the gradually

inching up inflation rate, which increased to 1.9% in July compared to 1.7% in June, are likely to undermine consumer spending in France.

While industrial output fell 1.7% in June compared to May when it had increased 1.9%, industrial production improved by 0.8% for the second quarter as a whole compared to the first, on the back of exports. Paris-based statistical agency Insee has estimated that the French economy will expand by 1.4% this year, compared to the 2.5% contraction last year.

Italy: Business confidence surges

Continuing to grow in the second quarter, the Italian economy expanded 0.4% compared to the first. While Italy had clocked growth in the third quarter of 2009, after witnessing five consecutive quarters of contraction, it sputtered again, shrinking in the last quarter of 2009. This year however has seen a resumption of growth for Euro-zone's third largest economy, which has clocked a growth rate of 1.1% from a year earlier in the second quarter.

Italian business confidence also surged to a two-year high in July on the strength of exports and recovery. The Isae Institute's manufacturing-sentiment index climbed up to 98.3, the highest since May 2008 from 96.3 in June. Exports from Italy have benefitted from the depreciation in the euro. Industrial production too continued to advance, expanding 0.6% in June from the previous month, translating into an 8.1% increase from a year ago. Another important indication that growth was taking hold in the economy was the marginal drop in the unemployment rate, which tumbled to 8.5% in June from 8.6% in the previous month.

On export strength, the Bank of Italy raised its growth forecast for the economy to 1% for 2010 from the previously estimated 0.7%, after a 5.1% contraction witnessed last year.

Spain: Weakness in the economy persists

Faced with the highest unemployment levels in the Euro-zone, the Spanish economy managed to grow further in its second quarter, expanding 0.2% compared to 0.1% in the first quarter. Even so, the economy still witnessed a contraction of 0.2% from a year earlier. The second quarter saw household consumption increasing by about 0.7% due to car-buying incentives as well as the impending sales tax increase in July, which spurred consumption.

The second quarter unemployment rate escalated to 20.1%, the highest level witnessed in a decade. Despite spiraling up unemployment levels and weak growth prospects, the government

must curtail its budget deficit, which has ballooned to 11% of GDP. With this, spending cuts are on the anvil, amounting to about €15 billion (\$19 billion) spanning the next two years. In contrast to its peers, the Spanish economy is expected to contract 0.3% this year, before returning to growth in 2011. The economy witnessed a contraction of 3.6% in 2009.

On the positive side, Spanish industrial production rose for the fourth straight month in June, expanding 3% compared to a year earlier, though slowing from the 3.2% increase in the previous month. This upsurge was largely driven by a 5.4% increase in consumer durables before the VAT hike came into force beginning in July. Exports also continued to rise, recording an annual growth of 16.6% in June, though the pace of increase eased from the 25.7% growth in May.

Russia: Growth gains momentum

Growth momentum seems to have gathered pace in [Russia](#), with its economy expanding an annualized 5.4% in the second quarter compared to 2.9% in the first. This rapid growth was largely driven by recovery in domestic demand as well as a revival in energy exports and rising commodity prices. Inflationary risks remained low, with inflation plunging to a record low of 5.5% in July compared to 5.8% in the previous month.

A steady decrease in inflation has encouraged the central bank of Russia to maintain its benchmark rate at a record low of 7.75% for the second consecutive month in July. Pointing to a revival in growth momentum, bank lending increased the most this year in June. Corporate loans advanced 2.1% compared to 1.9% in May, while retail lending too expanded 1.6% in June from 1.2% in the previous month.

Reeling under a massive contraction of 7.9% last year, the Russian economy had to contend with shrinking revenues and increased stimulus spending to jumpstart the economy. This led to **Russia's first budget deficit in a decade, at 5.9% of GDP.** While the deficit is expected to narrow to 5% of GDP this year, the government's priority is to bring it down to 2.9% by 2013.

While industrial production in the resource-rich economy expanded for the eighth consecutive month in July, the pace of growth slowed to 5.9% after registering a 9.7% increase in June. But overall, industrial production presents a robust picture, escalating 9.6% in the first seven months of this year compared to the same period last year. As disposable incomes strengthen, consumption also seems to be on an upward climb, with retail sales rising an annual 6.6% in July compared with 5.8% in June,. However the unemployment scenario continues to cause concern, with the jobless rate accelerating to 7% in July from 6.8% in June.

Hungary: Budget plans derailed

Leaving its interest rate unchanged for the fourth consecutive month at a record low of 5.25%, the central bank of Hungary cited heightened inflationary and debt risks, which worsened after talks with the International Monetary Fund (IMF) collapsed. The first European Union (EU) member to seek a €20 billion (\$26 billion) IMF bailout in 2008, Hungary's talks with the IMF in July this year failed after the institution did not endorse the country's budget plans.

So far, Viktor Orban's newly elected government that came to power in April this year, has remained non-committal to a planned budget deficit reduction as mandated by the EU and the IMF. As per the prescribed targets, Hungary was to bring down its budget deficit to 3% of GDP in 2011 from a 3.8% goal this year, which now seems unlikely. The budget deficit may widen to 4.3% this year as the government gives precedence to job creation and growth. The economy had seen an unprecedented GDP contraction of 6.3% last year, with economic growth stagnating in the second quarter this year. While in annual terms the economy grew 1% in the second quarter, it is expected to clock a mere 0.9% expansion this year.

Meanwhile, inflation slid to its lowest level in a year in July, as a VAT increase brought into effect in July last year is no longer reflected in 2009 prices. Inflation tumbled to 4% in July compared to 5.3% in the previous month. However, inflationary expectations remain high due to rising energy costs, a looser fiscal policy and a depreciating forint. Bringing some cheer, industrial production continued to increase for the sixth straight month in June on rising export demand, clocking a jump of 12.6%, though lower than the 13.8% growth witnessed in May.

Poland: Interest rates unchanged on slowing inflationary pressures

With both domestic as well as external demand conditions remaining robust, Poland recorded an economic growth of 3.2% in the second quarter year-on-year compared to a 3% growth rate in the previous quarter. The economy appears to be on track to achieve the expected 3% growth rate for this year as a whole, compared to 1.8% last year.

With inflation hovering at its lowest rate in three years, the central bank of Poland decided to keep its key rate unchanged at the record low of 3.5% for the 14th consecutive month. Inflation remained subdued at 2% in July, compared to 2.3% in June, well below the central bank's annual target of 2.5%. Moreover, with the Polish currency, the zloty, appreciating 3% since the end of June against the euro, compared to the six-month low it reached in May, price

pressures remain benign. Polish industrial production accelerated 10.3% in July easing from a 14.3% increase in the previous month, while wages rose 2.1%, slowing down from 3.5% in June. Retail sales too recorded a lower growth in July, climbing 3.2% compared to a 4.1% growth in the previous month. These factors are further likely to dampen price pressures in the Polish economy.

Czech Republic: Economic recovery strengthens

Fueled by the economic recovery in Western Europe, strong manufacturing exports from the Czech Republic sparked off the fastest paced expansion in the economy in two years. GDP growth in the second quarter accelerated to an annual 2.2% after a 1.1% increase in the first quarter. With exports accounting for a substantial 70% of GDP, and with its main trading partner Germany surging in the second quarter as well, it is not surprising that the Czech economy too witnessed healthy growth. As exports strengthened, industrial production led by automobiles, metal products as well as computers and electronics increased 12.3% in the second quarter from a year ago.

Clocking its 18th consecutive trade surplus in June, the Czech economy saw its exports jump 19% in the same month year-on-year. Keeping its benchmark rate unchanged at a record low of 0.75%, the central bank revised its forecast for 2010 economic growth up to 1.6% from the earlier estimated 1.4%. Inflation quickened at its fastest pace in 16 months to 1.9% in July, on costlier food and natural gas. However, the central bank expects that the annual inflation rate will stay within the mandated 2% for the rest of the year as well. 🌐

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