



Europe: Economic Review February 2010

Economic activity in the Euro-zone virtually came to a standstill in the fourth quarter of 2009, pointing to a fragile recovery. **Gross Domestic Product (GDP) in the 16-member bloc as well as the broader 27-member European Union (EU), expanded by 0.1% in 2009 Q4** compared to a 0.4% growth in the previous quarter. Meanwhile, European leaders continued to grapple with solutions for the Greek budget crisis, which has raised serious concerns for economic recovery in the Euro-zone. While the EU leaders agreed to support the debt-ridden Greek economy, details of the pledged support remained elusive. Greece's budget deficit remains unsustainably high at 12.7% of GDP, four times the level prescribed for EU members. The euro has been battered, plunging over 5% since the beginning of this year until about mid-

At a Glance

- **Germany:** Economic growth stalled in the fourth quarter of 2009, while business and investor confidence faltered.
- **U.K.:** The central bank halted its quantitative easing program, while the government confronted a widening budget deficit.
- **France:** Recording modest growth in 2009 Q4, the economy saw improvement in consumer and business confidence.
- **Italy:** The economy contracted in the final quarter of 2009, as rising unemployment dented consumer confidence.
- **Spain:** While the economy continued to remain gripped by the recession, the fiscal situation continued to raise concerns.
- **Russia:** Receding inflationary pressures encouraged rate reductions, as credit markets remain frozen.
- **Hungary:** Monetary easing continued to support the ailing economy, while inflation climbed.
- **Poland:** Despite recording the healthiest growth rate for in the EU for 2009, unemployment is spiraling.
- **Czech Republic:** The economy encountered a surprise contraction in 2009 Q4, as export demand from Germany dried up.

February. Concerned investors fear that steep deficits and the unsustainable public debt levels of some weaker Euro-zone members, like Spain, Ireland, Portugal, Italy and Greece, will undermine a speedy return to strong growth in this region.

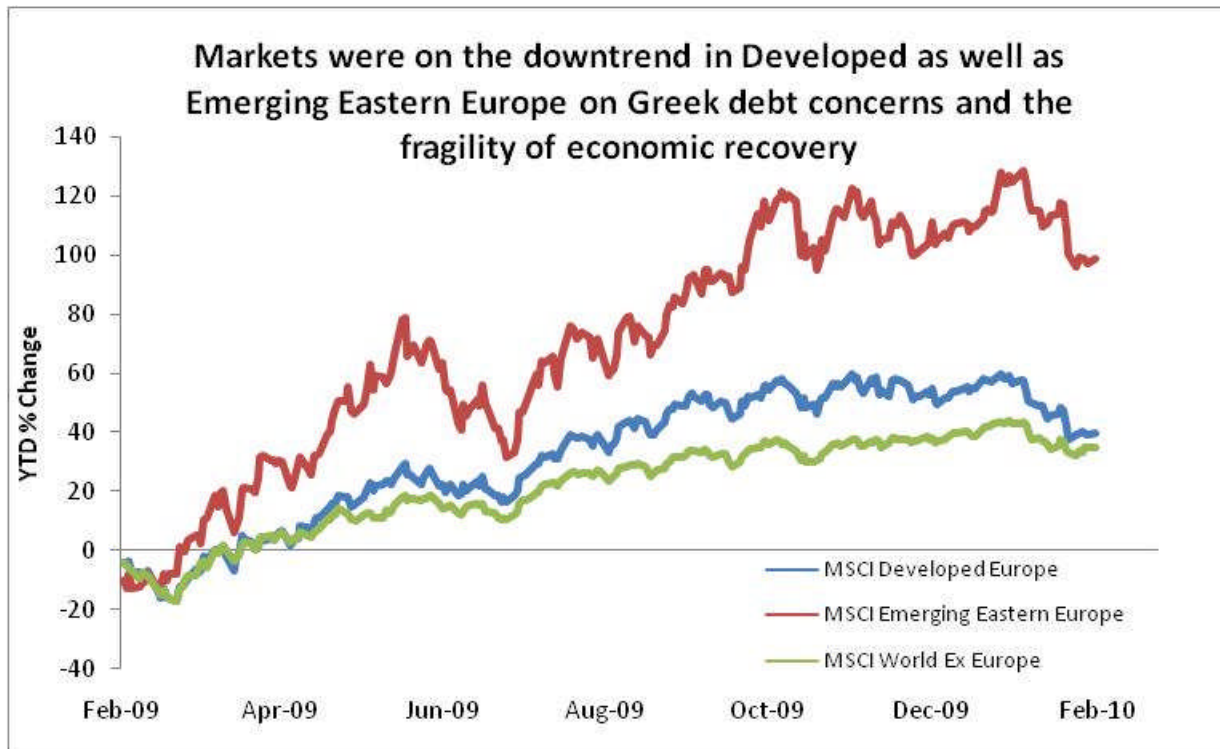
The Euro-zone contracted 4% in 2009, its steepest decline since the euro was adopted in 1999. While maintaining the benchmark rate at a record low of 1%, the European Central Bank (ECB) estimated the economy would grow 0.8% this year. However, ECB President Jean-Claude Trichet confirmed that the bank would not raise borrowing costs prematurely, as economic growth in the 16-member bloc still remains on weak footing.

Meanwhile, retail sales in the Euro-zone remained weak, dampened by subdued demand even as **unemployment levels continued to remain high at 10%**. December retail sales were unchanged from the previous month, clocking a 1.6% fall when compared to the previous year.

On a positive note, the **economic sentiment in the Euro-zone improved for the 10th consecutive month in January**, supported by resurgence in global demand for the region's exports. The index brought out by the European Commission, which is a credible gauge of consumer as well as business sentiment, climbed to 95.7 in January this year compared to a revised 94.1 in December last year. However, with an uncertain economic outlook and bleak job prospects, consumer confidence in the region continued to vacillate, sliding to -17.4 in February from -15.8 in January.

Consumer prices in the Euro-zone accelerated to their fastest pace in 11 months, increasing 1% in January compared to 0.9% in the previous month. A surge of over 75% in crude oil prices over the past year has caused prices to escalate worldwide.

Concerns about the debt crisis in Greece weighed down the markets in Europe, with the MSCI Index for Developed Europe dropping 3.98%, while the MSCI Index for Emerging Eastern Europe tumbled 6.7% for the month ending February 15.



Germany: Economy sputters in the fourth quarter

The Euro-zone's growth engine, which has led the recovery in the region, emerged from recession in the second quarter of 2009. **But economic growth stagnated in Germany in the final quarter of this year, pointing to a delicate recovery.** Domestic demand, which remains weak, suffered a further setback with the gradual pullback of some of the stimulus measures introduced to shore up the economy. As the entire Euro-zone experienced the shudders from the Greek economic crisis, investor confidence in the German economy dropped for the fifth consecutive month in February. The index of investor expectations, brought out by the ZEW Center for European Economic Research slid to 45.1 from 47.2 in January. German business confidence also faltered, dropping for the first time in 11 months in February as the severe winter dampened retail sales and construction activity. The business climate index of the Ifo institute pulled back to 95.2 in February, from 95.8 in January, an 18-month high. The unemployment rate also remained stubborn at 7.5% for December 2009, unchanged from the previous month.

Although protracted, fundamentally the path of economic growth appears to remain intact, with **ZEW's current situation index rising to -54.8 in February, the highest level since November 2008.** Moreover, waning domestic demand most likely will be more than offset by robust exports, which increased in December, recording a fourth straight monthly gain. **Exports, stimulated by the rising demand from Asia, mounted 3% over November, recording a 1%**

increase. This has spurred business confidence, which rose to an 18-month high in January. The government expects the economy to expand 1.5%, fueled by export-driven growth.

As global concern over Greece roiled markets the world over, the MSCI Index for Germany fell 4.05% for the month ended February 15.

U.K.: Economy grapples with a gaping budget deficit

Emerging from recession in the final quarter of 2009, but still on weak footing, the EU's third largest economy is at a crossroads. The **U.K.'s fiscal position continued to deteriorate** as it borrowed £4.3 billion (\$6.6 billion) in January, usually a surplus month every year due to bumper tax receipts. **The budget deficit is expected to rocket to 12.6% of GDP this year**, one of the highest levels seen by any major economy. While the government has pledged to halve the deficit by 2011, there is concern over dampening the growth prospects of the economy with spending cuts.

The harsh winter played spoilsport as retail sales in the country plunged along with the freezing temperatures. **Retail sales tumbled 1.8% in December**, the steepest monthly drop in 18 months, according to the Office for National Statistics. While the bitter winter encouraged people to stay home, causing a fall in the sale of gasoline, this was also the first month when **the Value Added Tax (VAT) was returned to its previous level**. The tax reverted to 17.5% in January from a temporary reduction at 15%, which lasted about a year.

Meanwhile, the **Bank of England (BoE) decided to end its quantitative easing program**, pumping £200 billion (\$308.5 billion) into the economy. While the Monetary Policy Committee members feared that the cash infusion could lead to asset price bubbles, inflationary pressures have been building up. Inflation in the British economy jumped to 3.5% in January from 2.9% in December, its fastest pace in 14 months. The reversion of the temporary reduction in VAT rates seems to be the primary reason for this spike in prices.

Yet, there were signs of optimism in manufacturing activity, which expanded in January, its fastest pace in the past 15 years. The Chartered Institute of Purchasing & Supply's Purchasing Managers' Index surged to 56.7, up from 54.6 in December. As the world economy recovers, growth in manufacturing in the U.K. has been primarily fueled by exports. House prices rose for the seventh consecutive month in January according to The Halifax, one of U.K.'s largest providers of residential mortgages. The average price of a home in U.K. was 3.6% higher than January last year, when the economy was reeling under the aftermath of the housing meltdown.

The specter of unemployment continued to haunt the economy, as jobless claims swelled to 1.64 million in January, recording the highest increase since July last year. The rate of unemployment,

though, remained unchanged at 7.8% for the three months ending December. Yet, spending cuts to curtail the economy's deficit are likely to dent the labor market, which has already withstood the brunt of the economic crisis.

The MSCI Index for U.K. tumbled 2.42% for the month ending February 15, as the ripple effects of the Greek debt crisis spread.

France: Economic recovery bolsters consumer and business confidence

France was one of the first countries in the Euro-zone to exit recession in the second quarter last year. **The economy recorded a modest 0.6% expansion in the last quarter of 2009**, compared to a GDP growth of 0.2% in the previous quarter. With government stimulus measures succeeding in spurring spending, **consumer confidence was bolstered** in January. A gauge of household economic sentiment brought out by the national statistics office Insee, improved to -29 in January compared to -30 in December. Household spending increased by 2.1% in December, strengthening the economic recovery.

Encouragingly, **French business confidence rose more than expected in January as foreign trade picked up**. Insee's business confidence index increased to 92 from 88 in December. The Finance Ministry projects the economy will expand by 1.4% this year as the recovery gains momentum. On the flipside, industrial production in France posted a surprise marginal fall in December 2009, retracting 0.1% from November, when it had risen by 0.6%. This points to an economy, which is yet to gain a stronghold of sustainable growth.

Unemployment continues to be the Achilles' heel for Euro-zone's second largest economy, which has seen its **jobless rate rise to a high of 10% in December 2009**, unchanged from the previous month.

The French MSCI Index slid -5.39% for the month ending February 15, reflecting the broader trend in most European markets.

Italy: Economy contracts in the fourth quarter of 2009 reversing earlier gains

Having emerged from the recession in the third quarter of 2009, the Italian economy reversed its economic gains in the final quarter of 2009. **Italy contracted 0.2% in 2009 Q4**, rather than increasing economic output by 0.1% as anticipated. For the whole of 2009, the economy shrank by 4.9%, and it is expected to witness a weak economic growth of 0.7% this year according to

the Bank of Italy. Industrial production in Italy also stumbled in December 2009, falling 0.7% from November.

Consumer confidence sagged more than expected in January, as rising unemployment took its toll. The Istat Institute's consumer confidence index, which had risen to a seven-year high of 113.7 in December fell to 111.7 in January, as the government scaled back its stimulus measures and the employment scenario remained grim. While official estimates of unemployment are pegged at 8.5%, **the real jobless rate is likely over 10%**, as the official rate does not consider temporarily laid off workers, who receive benefits from a state-backed fund. However, **business confidence in Italy remained upbeat**, soaring to a 19-month high in January, supported by healthy exports. The Istat Institute's manufacturing sentiment index crawled up to 83.2 in January, its highest level since June 2008.

Meanwhile, Italian inflation rose to its highest level in 11 months on the back of higher crude oil prices. Consumer prices increased 1.4% in January from a year earlier.

The MSCI Index for Italy declined 5.4% for the month ending February 15, as the Euro-zone economy remained on a weak recovery path.

Spain: Recession shows no sign of easing

Contracting 0.1% in the last quarter of 2009, [Spain](#) has continued to remain mired in a severe slump for seven consecutive quarters. The economy has been clocking the highest level of unemployment in the Euro-zone, which hit 19.5% in December 2009. Lagging behind its Euro-zone peers, the Spanish economy is expected to contract by 0.6% this year, before returning to growth in 2011, according to the IMF.

The economy also remains one of the most fiscally vulnerable in the Euro-zone, with its **budget deficit spiraling up to 11.4% of GDP in 2009**. The government plans to rein in the deficit to the EU-prescribed limit of 3% of GDP by 2013. Towards this, the government announced spending cuts of €50 billion (\$68 billion) this year.

The global economic crisis had triggered a meltdown in the Spanish debt-driven construction sector, reversing the country's fortunes from one of the fastest growing Euro-zone economies, to one of the weakest. The economy is now saddled with one of the highest household debts in the Euro-zone, while bad loans have increased five-fold since 2008.

The MSCI Index for Spain plunged by 7.8% for the month ending February 15, as the Greek debt crisis threatened to spread to other weaker Euro-zone members.

Russia: Rates lowered to support a weak recovery

In a bid to unfreeze credit markets, [Russia](#) continued on the path of monetary easing, slashing its benchmark rate for the 11th time since April last year. With investment and lending yet to thaw, **the central bank of Russia further reduced its interest rate by 25 basis points, to a record low of 8.5%**. The absence of inflationary pressures has encouraged interest rate reductions. Inflation has remained subdued, successively easing since August to about 8% in January. So, while central banks worldwide are reversing monetary easing, the Russian economy is struggling to support its fragile recovery with a loose monetary policy. **The rate cuts are also seen as a measure to stem the ruble's speculative gains.** As crude oil prices recover, Russia, a country that exports over 70% of its crude oil production, has seen its currency appreciating. This, coupled with the relatively higher interest rates, has encouraged speculation in the currency.

The Russian economy contracted 7.9% for 2009, but lower than the 8.5% fall estimated by the government. Nevertheless, this is the steepest contraction in 15 years. **Stimulus spending has resulted in the budget deficit widening to 7.2% of GDP this year from 5.9% last year.** Unemployment continues to cause concern, accelerating to 9.2% in January from 8.2% in December. What's more, the rising level of joblessness will have an adverse impact on consumer spending levels that are crucial to a recovering economy. Yet, there are some perceptible signs of a gradual revival. Retail sales increased in January for the first time in a year, while disposable incomes were also boosted by 7.1%.

With recovery yet to gain momentum, the MSCI Index for Russia fell 6.57% for the month ending February 15.

Hungary: Monetary easing continues

The benchmark rate in [Hungary](#) was lowered further, sinking to its lowest level since the country transitioned from communism to a market-driven economy some two decades ago. **The central bank reduced its key rate by 25 basis points to a record low of 5.75%**, as the economy combats its worst downturn in over 18 years. Despite this, the key interest rate remains the second highest in the EU after Romania. Hungary had to resort to an IMF-led bailout to escape bankruptcy, as its currency came under heavy speculative attack from anxious foreign investors. The first half of 2009 saw a pause in the rate-cutting cycle, as Hungary's currency the forint plunged to a record low against the euro. From July onwards, rate reductions were resumed and the policy rates have been brought down by 3.75% to shore up the economy.

One of the prominent emerging economies in Eastern Europe, Hungary endured a 6.3% economic contraction last year. In the **final quarter of 2009, its economy contracted 0.4%**. According to central bank estimates, this year a 0.2% contraction is expected before a return to a growth of 3.4% in 2011. Hungary has also pledged to rein in its budget deficit, a clause of the IMF-bailout package. The deficit, which touched a high of 9.3% of GDP in 2006, has been brought down to 3.9% in 2009, as Hungary adopted strict austerity measures. The targeted budget deficit for this year is 3.8%.

Inflationary pressures are also adding to the worries of the beleaguered economy, which saw annual inflation spike to 6.4% in January, the highest since August 2008. This undermines the prospects for further rate cuts by the central bank, though the continuing recession is expected to curtail inflation levels to the targeted 3% this year.

Hungary's MSCI index tumbled 8.05% for the month ending February 15, as economic unease continued to cloud recovery prospects.

Poland: Economic growth beats expectations

Emerging as the EU's economic hero, [Poland](#) not only averted a recession, but it **expanded at an enviable rate of 1.7% in 2009**. Though the economic growth slowed down significantly from 5% in 2008, it performed better than expected in these trying times. While the exports from the country were hammered with the onset of the global economic crisis, consumer and government spending shielded the economy from the downturn. Two-thirds of Polish domestic demand is fueled by consumption and government spending. In 2010, the economy is forecasted to grow by 2.6%, according to the Economy Ministry.

Meanwhile, **Poland's central bank left its benchmark rate at a record low of 3.5%** for the seventh consecutive month in January. The inflation rate inched up beyond the central bank's upper limit of 3.6% in January, on the back of higher fuel prices. Consumer prices increased 3.5% in the previous month.

Although Poland has been a star performer when compared to its peers, unemployment in the country has been a cause for concern. The **jobless rate mounted to 11.9% in December**, the highest since August 2007. Encouragingly, there was a slowing down of job losses, with employment declining 1.4% in January from a year earlier, compared to 1.8% in December.

Reacting to the Greek debt crisis, the MSCI Index for Poland tumbled 7.07% for the month ending February 15.

Czech Republic: Economy contracts unexpectedly

The [Czech Republic](#) had emerged from the recession in the second quarter of 2009. **However, there was an unexpected contraction of 0.6% in the final quarter of 2009, due to the stalling of the German economy, a key export market for the Czech Republic.** This translates into an annual decline of 4.2% compared to the same period last year. Consumer spending also cooled off, as unemployment is on the upsurge. **Joblessness soared to 9.8% in January** from 9.2% in December, its highest level since 2005. While the Czech economy has contracted 4.3% for the whole of 2009, the Finance Ministry expects growth of 1.3% this year.

Meanwhile, the **Czech National Bank left its benchmark rate unchanged at the record low of 1%**, the lowest in Europe and on par with the ECB's key rate. The central bank has introduced seven cuts in the past 16 months to tackle the economic crisis. Inflation remains low in the Czech Republic, hovering at 0.7% in January compared to 0.5% in December.

The Czech Republic's MSCI Index fell 5.71% for the month ending February 15.

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