



Europe: Economic Review July 2010

Economic sentiment in the Euro-zone posted a surprise increase in June after tumbling in May on renewed optimism about economic recovery and receding unemployment fears. The economic sentiment index rose to 98.7 in June from 98.4 in the previous month when debt crisis fears had rattled the region. While economic recovery remains tenuous, unemployment has remained steady at 10% in the three months from March to May, lifting hopes. The initial panic emanating from the Greek crisis is fading, and many countries have introduced spending cuts to avert a sovereign debt crisis. Despite apprehensions that fiscal austerity might hamper growth, the proactive stance of many economies to prevent a fiscal crisis does augur well for the future growth prospects of the Euro-zone economy.

At a Glance

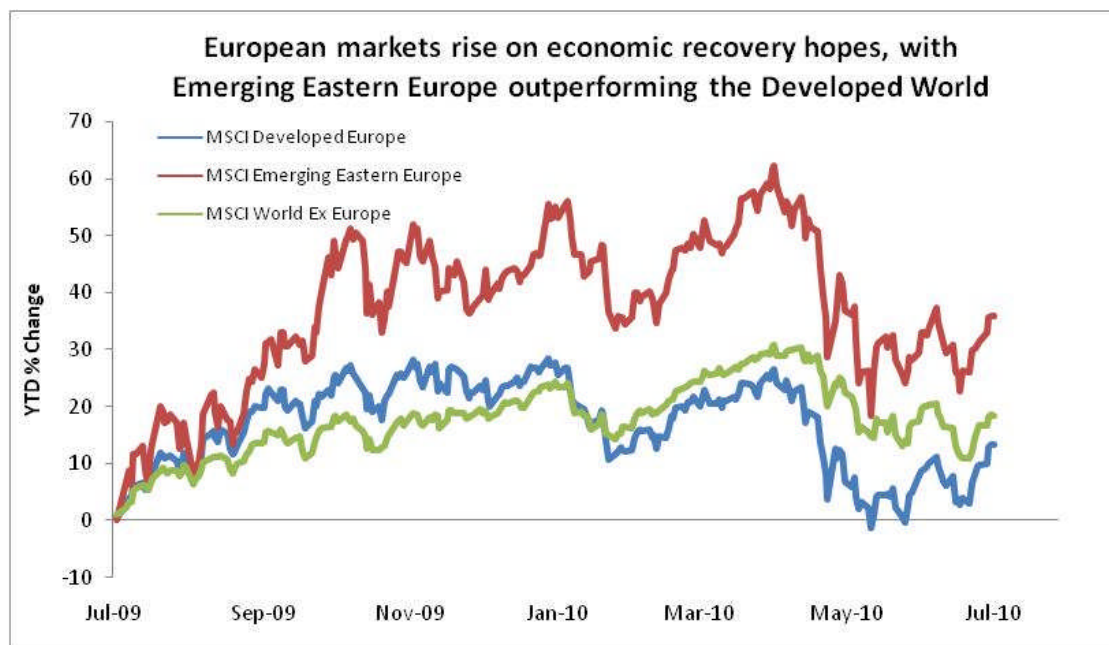
- **Germany:** While investor confidence continued to falter, business confidence remained robust, powered by exports.
- **U.K.:** Services, manufacturing and construction are driving growth as the economy expanded more than expected in the second quarter.
- **France:** Unemployment concerns darkened consumer sentiment while business sentiment improved.
- **Italy:** Italian business confidence tumbled on shrinking domestic orders despite a rosy export scenario.
- **Spain:** Consumer confidence improved somewhat as jobless claims continued to slide in June as well.
- **Russia:** Rates were kept steady supported by brighter economic prospects as industrial production improved and unemployment fell.
- **Hungary:** Even as industrial output surged on favorable exports, investors remained jittery about the government's commitment to austerity.
- **Poland:** Victory for the Civic Platform Party in the Presidential elections promises stability for the economy.
- **Czech Republic:** The central bank left interest rates unchanged, even as the government reiterated its commitment to fiscal discipline.

Meanwhile, the European Central Bank (ECB) kept its key rate unchanged at the record low of 1%, as the region experiences a fragile recovery post Greek fiscal crisis. In order to shore up the regional economy and support debt-straddled, beleaguered governments in the region, the ECB has also bought government debt on the secondary market to the tune of €60 billion (\$76.85 billion).

Also, the ongoing concerns about the health of the European banking system prompted the European Union (EU) to devise stress tests to identify the weak banks that need to be recapitalized or strengthened, and reinstate international confidence in the European banking system. These stress tests found that some weak banks need to raise €3.5 billion (\$4.5 billion) of capital to be fortified.

Meanwhile, the euro had depreciated almost 14% against the dollar in the first five months of this year on concerns that the contagion of the Greek debt crisis may spread to other economies in the region. **However, strong export performance led by Germany propelled the currency 8% by July 21, from a four-year low in June, on economic revival hopes.** In July, the credit downgrades of debt-ridden member nations Ireland and Portugal led to some minor setbacks, but have not yet derailed the recovery of the euro. In another positive development, the forward-looking Purchasing Managers' Index for the Euro-zone, jumped to a higher than expected 56.7 in July from 55.6 in June, largely driven by strong manufacturing activity in its growth engine Germany.

Markets in Developed as well as Emerging Eastern Europe were upbeat, reflecting the heightened optimism of expected economic revival in the region.



Germany: Investor confidence remains shaky, while exports provide succor

While investor confidence tumbled for the third consecutive month in July, upbeat business confidence, buoyant exports as well as stable consumer confidence, have given Germany some reason to cheer. Investor confidence brought out by the ZEW Center for European Economic Research, toppled to a 15-month low of 21.2 in July from 28.7 in the previous month as investors fretted about economic growth being impeded by spending cuts across the region. While the German government braces to pursue a four-year €82 billion (\$105.75 billion) austerity package, many other European governments are also set to lower spending to curtail budget deficits.

Encouragingly, German business confidence recorded an unexpected surge in July, its highest jump in 20 years. Ifo's German business sentiment indicator rose to 106.2 in July from 101.8 in June. Exports, which accounted for over 40% of gross domestic product (GDP) in 2009, continue to be the driving force in Germany's recovery. Recording a 9.2% monthly growth in May, this robust export performance allayed fears that arose when exports unexpectedly fell in April on a monthly basis. Strengthened by exports, industrial production also remained buoyant, increasing 12.4% from a year earlier. Though German consumers remained wary about the budget cuts on the anvil, consumer confidence brought out by Gfk remained stable in July at 3.5 points, unchanged from June.

With an overall positive outlook, the Bundesbank revised upwards its growth forecast for Germany, predicting a 1.9% expansion this year, up from the earlier forecasted 1.6%.

U.K.: Economy rebounds in the second quarter

Beating expectations, the U.K. economy expanded at its fastest pace in four years, as services, manufacturing and construction spearheaded a 1.1% growth in the country's GDP in the second quarter, after a weak 0.3% rise in the first. Earlier, the Bank of England (BoE) left its interest rate unchanged at the historic low of 0.5%, in order to tackle the fragile recovery in the British economy. Though inflation eased to 3.2% in June compared to 3.4% in the previous month, it stubbornly remained above the central bank's targeted limit of 3%. Consumer price increases have been largely driven by the higher cost of fuel and food.

As expected, the government's stringent budget measures introduced last month had an adverse impact on British consumer confidence, which fell for a second month in June to its lowest level in a year. The index of consumer sentiment, brought out by the Nationwide Building Society slipped to 63 from 66 in May, when it experienced the steepest fall in about two years. The government's budget for 2010 will raise VAT from 17.5% to 20%, slash public

spending and freeze public sector pay. The U.K. has to tackle one of the worst deficits in the EU, which swelled to 11.5% of GDP in 2009 and is expected to cross 12% this year. However, it is also expected that the government's decision to delay the planned increase in VAT until January next year may have some salutary impact on consumer spending in the second half of 2010.

On a positive note, retail sales in the U.K. advanced 0.7% in June compared to the previous month, beating market expectations. This leap was attributable to a rise in the sales volumes of household goods and general stores. Also, the much distressing employment scenario gained some relief, as unemployment decreased to 7.8% in the three months to May, from 7.9% in the quarter ending April. Jobless claims also fell to their lowest level in a year, giving indications that labor market conditions were improving as the economy's private sector gradually recovered.

While April had witnessed a 0.6% monthly fall in exports, May saw an encouraging but feeble 0.2% increase. The exports have not yet experienced the benefits of a declining pound as the trade deficit widened to £8.1 billion (\$12.54 billion) in May from £7.4 billion (\$11.45 billion) in the previous month. Also uplifting, industrial output surged to its highest annual rate of growth in 10 years in May, rising 2.6% year-on-year.

France: Business confidence perks up, consumer sentiment wavers

While business confidence improved in July, consumer confidence has remained unchanged in France, reflecting subdued consumer sentiment on employment concerns. The business sentiment index brought out by Paris-based institute Insee advanced to 98 in July from 96 in the previous month. The consumer confidence gauge remained steady at -39, following an unexpected decline in consumer spending on manufactured goods in June. A fall in the sales of clothes and household goods saw consumer spending on manufacturing goods sag 1.4% in June. This decline was preceded by a 0.6% rise in May largely due to the Soccer World Cup-related spending. While consumption remains the backbone of the French economy, manufacturing spending constitutes a quarter of total consumer spending in the Euro-zone's second largest economy.

Concerns about joblessness as well as the waning government stimulus, have been hampering consumers negatively. The jobless count in the country soared to 2.7 million in May, its highest in five years, as the private sector slashed jobs to curtail costs in recession times, and the government has virtually frozen recruitment. On the export front too, the French economy was dealt a blow, with exports dropping 5.2% in May from April, led by a substantial decline in exports of aeronautical and space products. The six months preceding May saw exports rise successively, as the global economy recovered and Euro-zone economies reaped the benefits from a falling euro.

In order to rein in the country's budget deficit, which is expected to touch 8% this year, the French government is also introducing a major overhaul of the pension system that will raise the retirement age and impose new taxes. This move has been met with a lot of resistance from labor unions as expected. Encouragingly, industrial production recorded a higher than expected increase in May on strong energy and automobile output after slipping in April. Industrial output increased 1.7% in May on a monthly basis, following a 0.5% fall in April.

Italy: Business confidence falters on weaker domestic orders

As domestic orders shrank, Italian business confidence toppled in June after achieving its highest level in over two years in May. The Isae Institute's manufacturing-sentiment index slid to 96.1 in June from 96.4 in the previous month despite healthy export performance. On the other hand, consumer confidence in Italy unexpectedly rose for the first time in three months in July. The consumer confidence index brought out by the Isae Institute increased to 105.6 in July from 104.5 in the previous month.

The rising unemployment rate has been weighing down consumer sentiment in the economy. The jobless rate remained steadfast at 8.7% in May, the same as in April. However, keeping recovery hopes alive, Italian industrial production continued to increase, rising 1% in May compared to 0.9% in April, month-on-month. In the first five months of this year, industrial output has climbed 4.9% as the economy gradually recovers.

Straddled with the highest levels of public debt in the Euro-zone, the Italian government introduced spending cuts worth € 24.9 billion (\$30.6 billion) in May. While these measures will be implemented over the next two years, there are apprehensions that this may hamper consumer confidence in the economy.

Spain: Consumer confidence shores up

Despite sporting the highest levels of unemployment in the Euro-zone at about 20%, Spain's consumer confidence index climbed to 65.9 in June from 65.1 in the previous month. This is a welcome improvement after May witnessed consumer confidence collapsing at its fastest pace on record.

Higher exports are playing an instrumental role in the painfully slow economic recovery, with jobless claims sliding again in June by 2.1%, compared to the 1.8% drop in May. Exports

have also supported industrial production in the Spanish economy, which rose for the third consecutive month. Factory output surged 3.3% in May, compared to a 2.4% rise in April.

Struggling with a budget deficit of about 11%, the Spanish government has introduced spending cuts to the tune of €15 billion (\$18 billion) over the next two years. As a part of these austerity measures the value added tax (VAT) has been hiked to 18% from 16% earlier. However inflation in Spain remains muted as of now due to the slow recovery process, easing to an annual 1.5% in June from 1.8 % in the previous month. It remains unclear as to how the VAT increase might impact inflation, with many retailers choosing to absorb the tax increase rather than pass it on to consumers.

Russia: Recovery signs become evident

With recovery gaining momentum, Russia's industrial production accelerated in June for the eighth consecutive month, soaring an annual 9.7% compared to a 12.6% increase in May. The year 2009 had seen a virtual collapse in industrial production, with industrial output plunging 10.8%, as the heavily resources-reliant economy was hit by falling commodity prices and demand. The economy, which contracted a massive 7.9% in 2009, clocked a 4% expansion in the first five months of this year as economic recovery began to take root. Growing at its fastest pace in June, since November 2008, the economy expanded an annual 2.4%.

While industrial output has soared, rising on an average by more than 10% in the first five months this year, consumer spending has remained dismal, with retail sales averaging a growth rate below 3% in the same period. However, retail sales bounced back in May and June recording annual increases of 5.1% and 5.8% respectively.

With the recovery process firmly underway, the central bank decided to keep its benchmark rate unchanged at 7.75%. In order to invigorate the sputtering economy, Russia's central bank had cut the rate 14 times since April 2009. Inflation continued to slow down further in June, easing to 5.8% from 6% in the previous month. Another positive sign of revival in the economy is its unemployment rate, which fell to 6.8% in June from 7.3% in the previous month, its lowest level in 20 months. The government intends to spend 11 billion rubles (\$363 million) in incentives this year for its cash-for-clunkers program. Backed by these government initiatives, car sales zoomed 46% in June.

Hungary: Industrial output soars

Showing signs that economic recovery is underway, Hungary registered the largest annual increase in industrial output in May, since December 2006. Revival in export demand coupled with resurgent domestic demand has powered a resumption of growth in the economy. Rising for the fifth straight month, industrial production increased 13.7% in May after a 9.7% jump in April.

While austerity measures tied to the IMF-led bailout of 2008 have dented domestic demand, the country's fortunes have remained heavily hinged on the Euro-zone, which constitutes a sizable 60% of its export markets. While the economy shrank 6.3% last year, it is gradually limping back to growth with the central bank of Hungary pegging GDP growth at 0.9% this year.

The central bank of Hungary left its benchmark rate unchanged at 5.25%, a record low since communism ended some 20 years ago. The Hungarian currency, the forint, has been weakening, falling 8.2% against the euro in the past three months. As energy and food prices increase, inflation concerns have surfaced, while a depreciating forint has made imports costlier. Inflation in June inched up to 5.3%, higher than 5.1% in May. Investors remain uncertain about the commitment of the new government to spending restraint, questioning the sustainability of government finances.

Poland: Presidential elections promise stability

Bronislaw Komorowski of the ruling Civic Platform Party won a well-fought Presidential election in Poland defeating Jaroslaw Kaczynski of the Law and Justice Party. Jaroslaw Kaczynski was seeking to succeed his brother Lech Kaczynski who was tragically killed in a plane crash in April this year. Now that the Civic Platform Party is in control of the presidential office as well as the cabinet, economic policies, especially those related to deficit reduction are expected to be carried out in a more coordinated and efficient manner.

Poland's central bank left its benchmark interest rate unchanged at a record low of 3.5% for the 12th consecutive month. While inflation accelerated to 2.3% in June from 2.2% in the previous month, it is well within the central bank's target of 2.5%. Clocking a GDP growth rate of 1.7% last year, EU's largest eastern member has managed to avert a recession and expects a GDP growth rate between 2.5%-3.9% this year. The first quarter this year saw economic growth easing to 3% from 3.3% in the last quarter of 2009, as unprecedented floods in May and June played havoc with the Polish economy.


Despite the hurdles created by the natural calamity, industrial output scaled up by 14% in May, its fastest pace in 25 months, while retail sales also surged by 4.3%, beating expectations. Polish unemployment also decreased to 11.6% in June from 11.9% in May, reflecting the rapidly improving economic conditions.

However, deficit reduction remains a challenge for Poland, as the country's debt is expected to reach 7.3% of GDP this year compared to 7.1% in 2009. In order to curtail spending, the government intends to freeze the average nominal wages of government workers according to the 2011 budget plans. The government aims to bring down its deficit to 3% of GDP by 2012.

Czech Republic: New government pledges fiscal discipline

After an unexpected cut of 25 basis points in its key interest rate in May, the Czech National Bank has maintained its key rate unchanged at 0.75%. The central bank indicated that the rates will remain at the record low for quite some time. Inflation remained steady at 1.2% in June, the same level as in May, and well within the central bank's 2% target. May had seen inflation in the **Czech Republic** increase from 1.1% to 1.2%, as prices of food and fuel trend upwards. However, with consumption demand still sluggish, it is expected that inflation will remain within the central bank's targeted limit. The Czech economy expanded 1.1% in the first quarter this year, recording its first increase in five quarters. The central bank estimates GDP growth to touch 1.4% this year.

Reflecting optimism, industrial production in the economy shot up 16.9% in May compared to the previous year, though on a monthly basis output has remained largely stagnant, growing at 0.1% compared to April. Other positive signs included the economy's 16th consecutive trade surplus in April, buoyant exports driven by automobiles, and a receding unemployment rate, which fell to a six-month low in May.

Moreover, the three-party government headed by Petr Necas has outlined out its commitment to reduce the country's budget deficit from an estimated 5.3% of GDP this year to the mandated 3% by 2013. The country's public debt rose to 35.4% of GDP last year from 30% in 2008. Though this is much lower than the 60% limit required to join the Euro-zone, after the Greece debacle European economies have become wary of rising deficits. The Finance Ministry forecasts a GDP growth of 1.6% this year compared to a contraction of 4.2% last year. 

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