

EUROPEAN ECONOMICS WEEKLY

10th Aug. 2009



Editors: Roger Bootle and Jonathan Loynes

Euro may be nearing a peak

- The euro's latest appreciation appears to reflect the negative impact on the dollar of increased risk appetite rather than any change in the economic outlook. Now that risk aversion has returned to more normal levels, the exchange rate should depend more heavily on fundamental factors. With the US likely to exit recession first, support for the single currency looks set to fade.
- This would be no bad thing for the euro-zone economy. Although global demand will be the key factor determining export growth in the coming months, a depreciation of the single currency would surely help. And we have argued that the inflationary consequences of a weaker euro pale into insignificance against the potential deflationary impact of the recent surge in spare capacity.
- Meanwhile, there have been some tentative signs in Spain that the number of unemployed workers has plateaued. But given that employment continues to fall, the improvement in the unemployment figures may be largely down to workers exiting the workforce. Accordingly, we still think that the downturn in household spending is far from over.

Data Previews (pages 4-5)

Euro-zone Industrial Production (Wed. 12th Aug.) – *Still in a fragile state*

German GDP (Thu. 13th Aug.) – *Recession easing sharply*

French GDP (Thu. 13th Aug.) – *Still faring relatively well*

Euro-zone GDP (Thu. 13th Aug.) – *Falling less sharply*

Latest Data and Main Forecasts (page 6)

Economic Diary & Forecasts (page 7)

Recent Publications (page 8)

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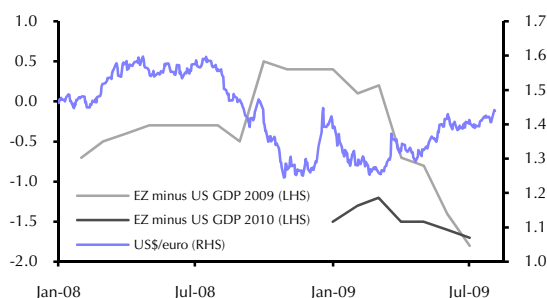
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Euro may be nearing a peak

On the face of it at least, the euro's latest appreciation seems difficult to square with the relatively downbeat news on the real economy.

A further modest appreciation last week pushed the euro up to a peak of just over \$1.44, the highest since September 2008. But a relatively modest pick-up in the euro-zone business surveys has suggested that economic conditions are not improving by as much as in the US. Indeed, consensus forecasts for euro-zone GDP growth have *weakened* compared to those for the US. (See Chart 1.)

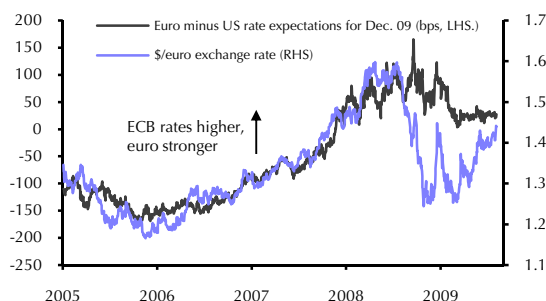
CHART 1: \$/€ EXCHANGE RATE & CONSENSUS GDP FORECASTS



Source – Thomson Datastream, Consensus Economics

The euro's strength cannot be explained by differences in interest rate expectations for the two economies either. Chart 2 shows that the gap between rate expectations for the US and the euro-zone has been flat lately.

CHART 2: \$/€ & INTEREST RATE DIFFERENTIALS



Source – Thomson Datastream, Bloomberg

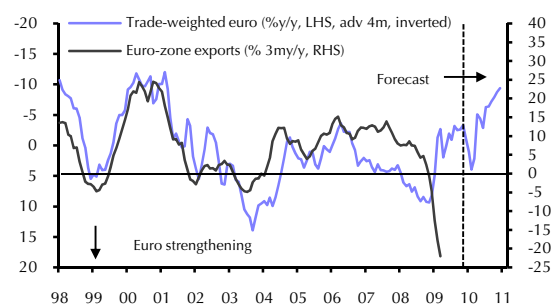
In fact, the most likely explanation for recent movements in the \$/€ exchange rate is that increased risk appetite has damaged the dollar.

Around the turn of the year, a sharp increase in risk aversion prompted the US currency to appreciate far more sharply than interest rate differentials would have implied, reflecting its perceived status as a safe haven. As risk appetite has returned, the dollar has simply fallen back to levels more consistent with the outlook for interest rates. (See Chart 2 again.)

But with the global recovery likely to disappoint, risk aversion might yet pick up again. What's more, the recovery that *does* occur will come sooner in the US than in the euro-zone, thanks largely to a far bolder fiscal and monetary policy stimulus. **As this becomes increasingly clear, we see the euro depreciating to around \$1.30 by the end of this year and \$1.20 next, a total decline of about 15%.**

This would be no bad thing for the euro-zone economy. Although global demand will be the key factor determining export growth in the coming months, a weaker euro certainly wouldn't hurt. Chart 3 shows that, on the face of it, our exchange rate forecasts point to a marked improvement in euro-zone export growth.

CHART 3: EURO-ZONE EXPORTS & EFFECTIVE EXCHANGE RATE



Source – Thomson Datastream, Capital Economics

And we have argued that the inflationary consequences of a weaker euro pale into insignificance against the potential *deflationary* impact of the recent surge in spare capacity. (See our *European Economics Update*, 'Strong euro to add to near-term deflationary pressures', 21st Jul.)

Jennifer McKeown

Spanish labour market still in the doldrums

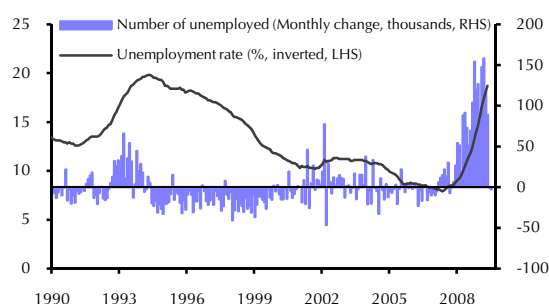
A key factor behind our gloomy Spanish economic forecasts is our view that a further deterioration in the labour market will prompt additional sharp falls in household spending. On the face of it, then, the recent stabilisation in the number of unemployed workers suggests that we may be too pessimistic about the economic outlook.

Last week's labour market figures revealed that, on a non-seasonally adjusted basis, Spanish unemployment *fell* for a third consecutive month in July. This, coupled with the recent sharp increase in survey measures of firms' employment intentions, provides tentative signs that the jobs market shake-out might be coming to an end. **But while the worst of the labour market downturn is probably over, there are several reasons why we think that it is too early call a recovery.**

First, the recent fall in the number of unemployed workers appears to be down to seasonal factors.

Admittedly, the less regularly quoted seasonally-adjusted data show that unemployment is rising far less quickly than at the start of the year. But as yet there has not been a significant reduction in the number of unemployed workers. (See Chart 4.)

CHART 4: SPANISH UNEMPLOYMENT



Source – Thomson Datastream

Second, part of the recent improvement in labour market conditions is likely to have been down to rising public sector construction employment. But these jobs are temporary and may end next year as the Government's stimulus measures begin to fizzle out.

Finally, the number of people in employment is still declining. In Q2, employment fell by 1.7% on a quarter earlier. This was rather better than Q1's whopping 3.5% drop, but it is still the second largest quarterly fall on record. Employment fell by a further 0.2% in July too. **In other words, the number of unemployed workers appears to be stabilising primarily as a result of workers choosing to exit the workforce.**

In all, then, while we would not dismiss the latest unemployment figures altogether, we still think that it will be some time before Spanish employment actually begins to pick up. **What's more, given that the effect of past increases in unemployment has yet to fully feed through to wages, we expect labour income to continue to fall over the coming months. Accordingly, we still think that household spending is unlikely to expand on a sustained basis until the second half of 2010 at the earliest.**

The week ahead

This week's major euro-zone data releases are previewed overleaf. Meanwhile, the key event in Norway will be the Norges Bank's latest interest rate announcement. **We see little reason to disagree with the consensus view that interest rates will remain unchanged at 1.25%.**

In June, the Norges Bank lowered interest rates by 25 basis points and indicated that this was likely to be the last rate cut in the cycle. Since then, the main economic indicators have suggested that Norway could exit recession in the second half of the year. In particular, there are encouraging signs that unemployment is beginning to stabilise and that past interest cuts are prompting households to spend more. Note too that CPI inflation remains above target and has recently been a little stronger than the Bank's June forecast.

The upshot is that further interest cuts seem very unlikely. Indeed, Norway's particularly mild recession suggests that the Norges Bank will be one of the first central banks to begin raising interest rates. Nonetheless, we still expect rates to remain on hold until early 2011.

Ben May

Data Preview – Euro-zone Industrial Prod. (Jun.) 10.00 BST Wed. 12th Aug.

Forecasts	Last	Median	Capital Economics
Industrial Production	+0.5%(-17.0%)	+0.1%(-16.4%)	-0.3%(-16.6%)

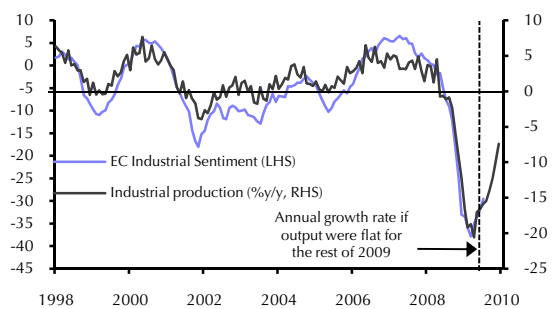
Still in a fragile state

May's euro-zone industrial production figures should confirm that the sector remains in a fragile state. While May's 0.5% monthly increase was clearly a positive sign, we doubt that it marks the start of a sustained recovery.

For a start, the latest figures from the major euro-zone economies point to a small 0.3% monthly contraction in output in June. And the industrial surveys are not quite as encouraging as they seem. After all, the relatively upbeat manufacturing PMI remains below the 50 "no-change" mark, indicating that firms are still reporting that output is falling on a monthly basis. What's more, as Chart 1 shows, a further steep pick-up in the EC industrial sentiment index would be required over the coming months just for the index to point to monthly increases in production. The upshot is that, while the sector is

over the worst of the downturn, it is too soon to conclude that it has embarked on a sustained recovery.

CHART 1: E-Z INDUSTRIAL PROD. & EC INDUSTRIAL SENTIMENT



Source – Thomson Datastream

Data Preview – German GDP (Q2 Preliminary) 07.00 BST Thu. 13th Aug.

Forecasts	Last	Median	Capital Economics
GDP q/q(y/y)	-3.8%(-6.9%)	-0.2%(-6.6%)	-0.6%(-7.0%)

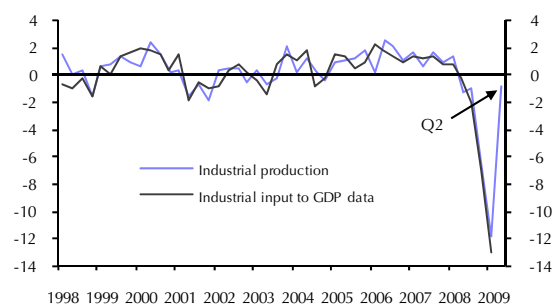
Recession easing sharply

After Q1's jaw-dropping slump in German GDP, a decline of around 0.6% in the second quarter should come as something of a relief.

The monthly industrial production figures show that output fell by 0.9% in Q2 as a whole, far better than Q1's 11.9% drop. (See Chart 1.) This alone could boost GDP growth by up to 3 percentage points (pp) compared to Q1. Meanwhile, the business surveys suggest that the rate of contraction in the service sector slowed markedly, perhaps adding another 0.2pp to growth. Data on the expenditure side of the national accounts suggest that the fall in GDP *might* be more modest than 0.6%. A sharp rise in car sales will have boosted consumer spending and monthly trade data suggest that net exports could have made a positive

contribution. However, data on the output side tend to be more reliable and we suspect that the improvement in demand was partly offset by a necessary reduction in inventories.

CHART 1: GERMAN INDUSTRIAL OUTPUT (% Q/Q)



Source – Thomson Datastream

Data Preview – French GDP (Q2 Preliminary)

07.45 BST Thu. 13th Aug.

Forecasts	Last	Median	Capital Economics
GDP q/q(y/y)	-1.2%(-3.2%)	-	-0.5%(-3.3%)

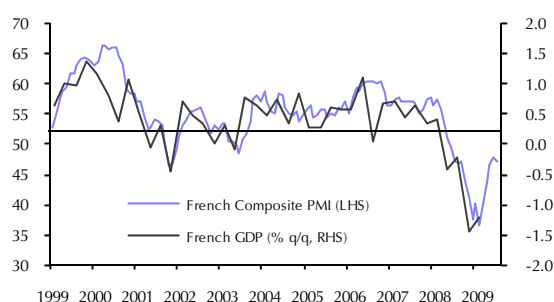
Still faring relatively well

Monthly data suggest that French activity contracted at a pretty modest rate in Q2, confirming that France continues to weather the global storm better than other euro-zone economies.

Industrial production probably fell by about 1%, better than Q1's 7.2% fall and adding about one percentage point to GDP growth. The business surveys suggest that service sector activity contracted at a more modest rate too. Meanwhile, data on consumer spending on manufactured goods suggest that spending rose by more than Q1's 0.2%. And the business surveys point to a more modest reduction in inventories than in the previous two quarters. In all, we expect a quarterly fall in GDP of about 0.5%. This would be in line with the rate

suggested by the composite PMI, which has been a more reliable indicator for France than for most other countries lately. (See Chart 1.)

CHART 1: FRENCH GDP & COMPOSITE PMI



Sources – Thomson Datastream & Markit

Data Preview – Euro-zone GDP (Q2 Preliminary)

10.00 BST Thu. 13th Aug.

Forecasts	Last	Median	Capital Economics
GDP q/q (y/y)	-2.5%(-4.9%)	-0.4%(-5.0%)	-0.7%(-5.2%)

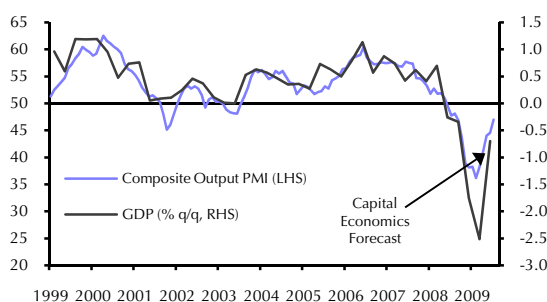
Falling less sharply

The flash estimate of euro-zone GDP should reveal that the economy contracted far less rapidly in Q2 than in Q1.

Last week, it was revealed that the Italian economy, which accounts for around 20% of euro-zone output, contracted by 0.5%, far less than Q1's 2.6% decline. Meanwhile, the Bank of Spain has estimated that Spanish GDP fell by 0.9% in Q2, significantly better than Q1's 1.9% drop – the Bank's GDP forecasts are normally a reliable guide to the official figures. Combining these figures with our forecasts for the other major economies in the region suggests that euro-zone GDP probably fell by around 0.7% in Q2, lowering the annual growth rate to about 5.2%. This is broadly consistent with the picture painted by the available euro-zone monthly data and only a little weaker than the composite PMI would imply at face value. But note

that the relationship between the PMI and GDP growth has recently been pretty weak. (See Chart 1.) In all, then, an encouraging sign that the worst is over. But it is likely to be 2010 before the economy actually begins to expand again.

CHART 1: COMPOSITE PMI & GDP GROWTH



Sources – Thomson Datastream & Markit

Latest Data & Main Forecasts

LATEST EURO-ZONE ECONOMIC INDICATORS

Monthly Data %m/m(%y/y) unless stated		April	May	June	July
Consumer Prices	HICP	+0.4(+0.6)	+0.1(0.0)	+0.2(-0.1)	(-0.6)
	Core	(+1.8)	(+1.5)	(+1.4)	-
Producer Prices		-0.9(-4.8)	0.0(-5.9)	0.3(-6.6)	-
M3		(+4.9)	(+3.7)	(+3.5)	-
Unemployment, monthly change thous.,(rate %)		+295(9.2)	+186(9.3)	+158(9.4)	-
Retail Sales		+0.2(-1.9)	-0.5(-3.0)	-0.2(-2.4)	-
Industrial Production		-1.4(-20.5)	+0.5(-17.0)	-	-
External Trade Balance €bn		+0.7	+0.8	-	-
Current Account €bn		-6.1	-1.2	-	-
Monthly Data %m/m(%y/y) unless stated		April	May	June	July
German ZEW		+13.0	+31.1	+44.8	+39.5
German Ifo		83.7	84.3	85.9	87.3
Euro-zone Composite PMI		41.1	43.9	44.6	47.0
EC Euro-zone Economic Sentiment Indicator		67.3	70.2	73.2	76.0
Quarterly Data %q/q(%y/y) unless stated		Q2 2008	Q3 2008	Q4 2008	Q1 2009
GDP		-0.3(+1.5)	-0.4(+0.5)	-1.8(-1.7)	-2.5(-4.9)
Household Spending		-0.3(+0.5)	+0.0(0.0)	-0.4(-0.7)	-0.5(-1.2)
Hourly Labour Costs		(+2.3)	(+3.4)	(+4.0)	(+3.7)

LATEST MARKET DATA

Instrument/rate	1 mth ago	1 week ago	Latest*	Instrument/rate	1 mth ago	1 week ago	Latest*
Official Rates				Germany yield curve (20-2)	293	276	258
ECB refi	1.00	1.00	1.00	Global yields			
UK repo	0.50	0.50	0.50	US 10 year	3.30	3.48	3.73
US Fed funds	0-0.25	0-0.25	0-0.25	UK 10 year	3.74	3.80	3.69
Japan o'night	0.10	0.10	0.10	Japan 10 year	1.31	1.42	1.44
Market rates				Equity indices			
3mth Euribor	0.98	0.86	0.84	German DAX	4576	5332	5326
12mth Euribor	1.43	1.35	1.33	French CAC	2983	3426	3443
Bond yields				Italian MIB	17837	20576	20760
Germany 2 yr	1.20	1.26	1.46	Exchange rates			
Germany 10 yr	3.26	3.30	3.37	\$/euro	1.40	1.42	1.44
Germany 20 yr	4.13	4.02	4.04	€/euro	0.86	0.85	0.86
France 10 yr	3.70	3.57	3.63	¥/euro	128.9	134.8	136.7
Italy 10 yr	4.45	4.16	4.15	Brent crude oil price (\$ pb)	59.4	70.9	74.0


























*Latest as at 11.00am 7th Aug 2009

MAIN ECONOMIC & MARKET FORECASTS

%q/q(%y/y) unless stated	Latest	Q2 2009	Q3 2009	Q4 2009	2008	2009	2010
GDP	-2.5(-4.9)	-0.7(-5.2)	-0.6(-5.5)	-0.2(-4.0)	(+0.6)	(-5.0)	(0.0)
Household Spending	-0.4(-1.1)	+0.5(-0.3)	0.0(-0.3)	0.0(+0.1)	(+0.3)	(-0.4)	(+0.5)
HICP (%y/y)	-0.6	+0.2	-0.5	-0.4	+3.3	0.0	+0.5
Unemployment Rate (%)	9.5	10.0	11.7	12.3	7.5	10.7	12.0
Repo Rate, end period (%)	1.00	1.00	1.00	1.00	2.50	1.00	1.00
10 year bond yield, end period (%)	3.37	3.39	3.25	3.00	2.95	3.00	2.50
\$/euro, end period	1.44	1.41	1.40	1.30	1.40	1.30	1.20
€/euro, end period	0.86	0.85	0.88	0.84	0.96	0.84	0.80

European Economic Diary & Forecasts

EUROPE

Date	Country	Release/Indicator/Event	Time		Previous*	Median*	CE Forecast*		
			CET	(BST)					
Mon 10 th	 Fra	Industrial Production (Jun)	08.45	(07.45)	+2.6%(-13.4%)	-0.2%	-0.5%(-13.9%)		
	 Den	CPI (Jul)	EU Harm.	09.30	(08.30)	+0.2%(+0.9%)	-	-0.7%(+0.5%)	
	 Nor	CPI (Jul)		10.00	(09.00)	+0.6%(+3.4%)	-	-0.2%(+2.6%)	
Tue 11 th	 Ger	CPI (Jul Final)	EU Harm.	08.00	(07.00)	0.0%(-0.6%)p	0.0%(-0.6%)	0.0%(-0.6%)	
	 Swe	CPI (Jul)		09.30	(08.30)	+0.2%(-0.6%)	-	-0.5%(-1.2%)	
Wed 12 th	 Gre	GDP (Q2 Prov.)	q/q(y/y)	-	-	-1.2%(+0.3%)	+0.5%(-0.1%)	-0.7%(-1.3%)	
	 Por	CPI (Jul)	EU Harm.	-	-	+0.2%(-1.6%)	-	-0.7%(-1.8%)	
	 Fra	Current Account (Jun)		08.45	(07.45)	-€2.2bn	-	-	
	 Fra	CPI (Jul)	EU Harm.	08.45	(07.45)	+0.1%(-0.6%)	-	-0.7%(-0.9%)	
	 Ita	CPI (Jul Final)	EU Harm.	10.00	(09.00)	-1.2%(-0.1%)p	-1.2%(-0.1%)	-1.2%(-0.1%)	
	 EZ	Industrial Production (Jun)		11.00	(10.00)	+0.5%(-17.0%)	+0.1%(-16.4%)	-0.3%(-16.6%)	
	 Nor	Norges Bank Rate Announcement		14.00	(13.00)	1.25%	-	1.25%	
Thu 13 th	 Ger	GDP (Q2 Prov.)	q/q(y/y)	06.00	(07.00)	-3.8%(-6.9%)	-0.2%(-6.6%)	-0.6%(-7.0%)	
	 Fra	GDP (Q2 Prov.)	q/q(y/y)	08.45	(07.45)	-1.2%(-3.2%)	-	-0.5%(-3.3%)	
	 Aus	GDP (Q2 Prov.)	q/q(y/y)	09.00	(08.00)	-2.8%(-3.6%)	-	-1.2%(-4.1%)	
	 Spa	CPI (Jul Final)	EU Harm.	09.00	(08.00)	(-1.4%)p	-	-0.9%(-1.4%)	
	 Slk	GDP (Q2 Prov.)		09.00	(08.00)	(-5.6%)	-	(-6.1%)	
	 NE	GDP (Q2 Prov.)	q/q(y/y)	09.30	(08.30)	-2.6%(-4.5%)	-1.2%(-5.3%)	-1.5%(-5.5%)	
	 EZ	ECB Monthly Bulletin (Aug)		10.00	(09.00)	-	-	-	
	 EZ	GDP (Q2 Prov.)	q/q(y/y)	11.00	(10.00)	-2.5%(-4.9%)	-0.4%(-5.0%)	-0.7%(-5.2%)	
	Fri 14 th	 Por	GDP (Q2 Prov.)	q/q(y/y)	-	-	-1.5%(-3.7%)	-	-1.4%(-5.2%)
		 Slk	CPI (Jul)	EU Harm.	09.00	(08.00)	0.0%(+0.7%)	-	+0.3%(+1.0%)
 Spa		GDP (Q2 Prov.)	q/q(y/y)	09.00	(08.00)	-1.9%(-3.0%)	-	-0.9%(-4.0%)	
 EZ		CPI (Jul Final)		11.00	(10.00)	(-0.6%)p	-0.6%(-0.6%)	-0.6%(-0.6%)	
 EZ		Core CPI (Jul)		11.00	(10.00)	(+1.4%)	(+1.3%)	(+1.2%)	

*m/m(y/y) unless otherwise stated; p = provisional estimate

KEY FORTHCOMING EVENTS/DATA

Date	Event	Date	Event
17 th Aug	Euro-zone Trade Balance (Jun)	10 th Aug	Germany Retail Sales (Jul)
18 th Aug	Germany ZEW Economic Sentiment (Aug)	31 st Aug	Euro-zone CPI (Aug Prov.)
21 st Aug	Euro-zone Composite PMI (Aug Prov.)	1 st Sep	Euro-zone Unemployment (Jul)
25 th Aug	Germany GDP (Q2 Final)	1 st Sep	Germany Unemployment Rate (Aug)
26 th Aug	Germany IFO Business Climate Index (Aug)	2 nd Sep	Swedish Rate Announcement
27 th Aug	Euro-zone M3 Money Supply (Jul)	2 nd Sep	Euro-zone GDP (Q2 2 nd Est.)
28 th Aug	Euro-zone EC Economic Sentiment (Aug)	3 rd Sep	Euro-zone Retail Sales (Jul)

Recent Publications

Date	Publication	Title
Mon 3 rd	Capital Daily	Bank of England to keep an open mind.
	CIPS Report on Manufacturing (Jul.)	Recovery progressing nicely.
	ISM Manufacturing Index (Jul)	Survey points to modest recovery.
	European Economics Update	Swiss industry not out of the woods.
	UK Chart Book	QE still failing to boost money growth.
Tue 4 th	Capital Daily	Oil price outlook hinges on more than just supply.
	European Commercial Property Update	Currency depreciation adds to emerging European rental downturn.
	Latin America Economics Update	Will commodities rescue Latin America?
	M4 Money Supply (Q2)	Money growth still sluggish.
	Property lending (Q2) & CIPS/Markit cons. PMI (Jul)	Q2's negative net lending flow likely to be repeated in coming quarters
	Euro-zone Producer Prices (Jun.)	Slowdown in producer price inflation gathers pace.
	UK Housing Market Monthly	Shortage of stock only a short-term support for prices.
	Emerging Europe Update	Romania's easing cycle continues, but NBR to tread carefully.
	Asian Economics Update	Australian rates have bottomed out.
Global Markets Update	Debt, deflation and default ... should markets be worried?	
Wed 5 th	US Recovery Watch	Recession probably ended in June.
	Capital Daily	Dealing with debt.
	Halifax House Price Index (July)	Halifax adds to the evidence of stabilising house prices.
	UK Ind. Prod. (Jun.) & CIPS/Markit Report on Ser. (Jul.)	Services output expanding again.
	UK Housing Market Update	Is the mortgage market freeing up?
	Euro-zone Retail Sales (Jun.) & Final PMI (Jul.)	Retail sales weak, but better than in Q1.
	Global Markets Update	Equities still face an uphill battle.
	Asian Economics Update	Focus turns to timing the first rate hike in Indonesia.
	Asian Economics Update	Don't trust China's numbers, but don't doubt the rebound.
	US Fed Watch	Fed shifts to wait and see mode.
Thu 6 th	UK Economics Update	Banks' results of little reassurance on the lending front.
	Global Markets Chart Book	Not time to crack open the champagne.
	European Chart Book	Consumers benefiting from falling prices.
	Capital Daily	The stock market rally should run out of steam soon.
	European Commercial Property Update	2009Q2 RICS survey: too gloomy on Poland and Czech Republic?
	Emerging Europe Update	Russia: PMIs rise again, but still not consistent with growth.
	UK Economics Update	Extra £50bn shows MPC prepared to do all that it takes.
Fri 7 th	European Economics Update	ECB holds its line.
	Emerging Europe Update	CNB cuts rates as it revises growth forecast.
	Capital Daily	QE extension provides a fillip for gilts.
	Producer Prices (Jul.) & Insolvencies (Q2)	Producers' costs still falling.
	Latin America Economics Update	Peru: Rates set to remain at record lows.
	German Industrial Prod. (Jun.) & Italian GDP (Q2)	Clear signs of improvement in Q2.
	Asian Economics Focus	A new angle on Chinese growth.
	UK Economics Weekly	MPC stays focused on task at hand.
	Asian Economics Weekly	-
	US Economics Weekly	Labour market conditions improving.
European Economics Weekly	Euro may be nearing a peak.	

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