European
Economic Update

November 2008

Highlights:

- As the global economic climate chills, most major European countries are set to deliver a fiscal boost; but the Germans remain reticent.
- There has been a flurry of interest rate changes
  – but not all in the same direction.
- It's official! – the euro area is in recession.
- Germany continues to create jobs, but with the industrial landscape turning nasty it won't last for much longer.
- Danish politicians seek refuge in the euro.
- Turkey turns to the IMF – again.

This report was prepared based on information available at 24 November 2008.

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An icy wind

In the wake of the global financial crisis, icy economic winds are blowing right across Europe. Some countries have proved to be more vulnerable than others, with Iceland, Hungary, Belarus, Serbia, and Ukraine being forced to seek assistance from the IMF. Terms have now been agreed for Iceland to receive standby credit facilities of more than $2 billion, while Hungary has obtained credit of $25 billion (including a contribution from the EU), and Ukraine $16.4 billion. Formal announcements are awaited concerning assistance for Turkey and Latvia.

Hungary's vulnerability stems from its high level of external debt, run up by both the government and by households. Ukraine has fallen victim to the global downturn in demand for steel, and while the closure of many steelworks in the east of the country has brought a noticeable improvement in air quality, it is little comfort for the many thousands who have lost their jobs.

While there has been general agreement about the need to offer assistance to struggling banks, there is less consensus about the merits of fiscal packages to help countries weather the economic storm. In particular, it seems that the government led by Angela Merkel in Germany has no appetite for the sort of stimulus packages that have been, or will be, offered by the French, British, and Spanish governments. The 'Umbrella for Business' package unveiled in early November consisted of 15 modest measures, with a combined value of €12 billion over two years being equivalent to just 0.25% of GDP.

The German government's justification for implementing only limited 'pump-priming' measures is that much of the country's plight stems from a lack of demand from overseas, and that with the high propensity of households to save, tax cuts or increases in welfare benefits are likely to do little good. There are also political considerations at play, with the 'grand coalition' unlikely to agree to bold measures with less than a year to run before the next general election.

Interest rates

Where they've been able to, governments have employed monetary policy to help ease the pain, with the past six weeks bringing a plethora of interest rate adjustments. Having participated in the co-ordinated rate cuts of October 8th, both the ECB and Sweden's Riksbank delivered further reductions of 50 basis points. There have also been interest rate cuts in the Czech Republic, Slovakia (as it moves towards EMU entry), and Norway.

But for some countries facing a flight of foreign capital and either a rapid depreciation of their currencies or pressure on pegging arrangements there has been no option but to push interest rates higher, with large increases being implemented in Iceland, Serbia, and Hungary. Of those central banks which employ interest rates as a key tool for achieving price stability, only those in Poland and Turkey have sat on their hands.

But while the ECB continues to be less bold than its British and American counterparts, further rate cuts are clearly on the way. In October the annual rate of consumer price inflation in the eurozone eased further to 3.2%, from 3.6% in September, and a peak of 4% in July. This news, together with the palpable worsening of the economic climate suggests that a rate cut of at least 50 basis points is on the cards at the ECB's next policy meeting on December 4th.

Exchange rates

As international investors have woken up to the economic consequences of the banking crisis and moved their funds to safe havens, currency markets have been extremely volatile. The dollar is viewed as the safest of havens, while the yen has also surged as carry trades have been unwound. Most other currencies have fallen: the only question being whether the decline has been measured or violent. Even the euro has lost around 10% of its value against the dollar since the beginning of October. Over the same period, the Turkish lira and the Icelandic krona have both fallen by around 16% against the euro, with the Serbian dinar down by around 12%, and the Hungarian forint and Polish zloty both losing about 11%.

The car market

In view of the delay in publishing economic growth figures, especially by some east European countries, the statistics on new car registrations offer a useful snapshot of the range of current economic conditions across the continent. For the EU and EFTA (30 countries) registrations in October were 14.5% lower than a year ago, the sixth successive month of decline. The most spectacular falls came in Ireland and Spain, where sales were down by 54% and 40% respectively. In western Europe, only Austria reported positive growth.

While registrations for the first ten months of the year were still higher than last year in the new EU member states, they too have now slipped into negative territory. Sales in October were down 3.5% from last year, albeit that the Polish market still achieved robust expansion of more than 12%.

THE EURO AREA

GDP growth Eurostat finally confirmed on November 14th that the euro area has slipped into recession. Its ‘flash’ estimate of GDP for the third quarter showed a contraction of 0.2%, the same as in the second quarter. This brought the annual growth rate down to a paltry 0.7%, as against 2.1% in the first quarter.

Perhaps the biggest surprise was the news that the German economy had shrunk by a further 0.5%. It had been widely assumed that the contraction recorded in the second quarter was a statistical aberration that would not be repeated. Italy also joined the ranks of those countries officially in recession (two or more consecutive quarters of decline), although France escaped this fate by a whisker, reporting growth in the third quarter of 0.1%.

With Spain also dipping into negative territory, three of the four largest economies were in decline. Of the ten EMU members which have so far produced third quarter figures, only five were still in positive ground, with Portugal and the Netherlands both posting unchanged GDP.

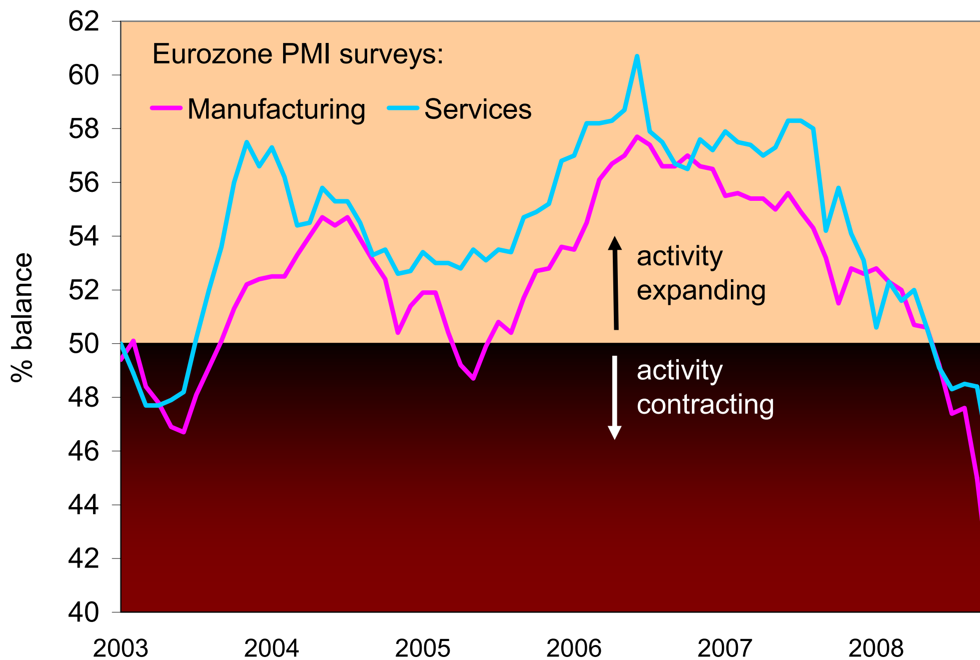
Growth of major economies
(% change in real GDP from previous quarter)

	2007 Q4	2008 Q1	2008 Q2	2008 Q3
Euro area	0.4	0.7	-0.2	-0.2
Germany	0.3	1.4	-0.4	-0.5
France	0.3	0.4	-0.3	0.1
Italy	-0.4	0.5	-0.4	-0.5
Spain	0.6	0.3	0.1	-0.2
Netherlands	1.2	0.3	0.0	0.0

Source: Eurostat

Business surveys If the third quarter growth numbers were disappointing, those for the final quarter of the year are shaping up to be grim. The 'flash' readings for the PMI (Purchasing Managers' Index) surveys for November suggest that conditions for manufacturers have deteriorated rapidly. November's index came in at just 36.2 (the lowest since the survey began in 1997), down from 41.1 in October and 45.5 in September.

The services PMI held up rather better, easing (rather than collapsing) to 43.3, down from 45.8 in October. Since the high-point of the economic cycle in 2006, the manufacturing PMI has fallen by 37%, and the services PMI by 29%. Taking these surveys together, the euro area's GDP is likely to contract by at least 0.5% in the fourth quarter.



Source: Markit Research

Retail sales In September, the volume of retail sales fell by 0.2% compared with August, and was down by 1.6% from the previous year. Spanish retailers continue to experience the toughest trading conditions, with the volume of sales down by 7.1% in the year to September. But it also seems that German consumers may now be heading towards a retrenchment, with sales in September falling by 2.3% from the previous month.

Labour market The unemployment rate held steady at 7.5% in September. But while unemployment is now rising in most EMU member countries, it has continued to decline in Germany. In October, Germany's seasonally-adjusted unemployment count fell by a further 26,000 to 3.15 million, sufficient to trim the unemployment rate to 7.5%, the lowest since April 1992. But the trading environment for Germany's important manufacturing sector is turning nasty. In October, the intake of new orders slumped by 8% from the previous month, while in September output was down by 3.6%.

THE NORDIC STATES

While the headlines have been dominated by the economic cataclysm that is engulfing Iceland, it is also becoming clear that other Nordic countries will not completely escape the economic fallout from the global banking crisis. It is likely that oil-rich Norway may be headed merely for stagnation, but a spell of negative growth now seems likely in both Sweden and Denmark. While real estate prices in Sweden are merely flat, rather than falling, the fact that the output of the services sector was down by 1.6% in the year to September, suggests that the third-quarter GDP figures (due out on November 28th) could show little or no growth.

Denmark has faced a particularly stiff challenge due to its participation in the Exchange Rate Mechanism (ERM2), where it is linked in narrow bands of +-1.25% to the euro. Defending this link has cost a fifth of the country's foreign exchange reserves, and forced the DNB (the central bank) to raise interest rates twice during October. The long-standing parity between Danish and ECB interest rates has therefore been shattered. Although the DNB felt able to match the ECB's November cut, the gap remains at an elevated 175 basis points.

It is against this background that the Danish government has initiated discussions with the opposition about holding another referendum on joining the euro. The referendum in 2000 produced a narrow vote against. But people in Denmark, as in other small countries, are now warming to the idea of joining the single currency as a way of gaining protection from the ebb and flow of risk aversion on the part of international investors. Needless to say, higher interest rates will not help the already-embattled Danish economy, which was among the first in Europe to slip into a 'technical recession'.

CENTRAL EUROPE

The economies of the Czech Republic and Slovakia are still expanding robustly. In the third quarter they achieved GDP growth of 1.0% and 1.5% respectively. This means that their annual growth rates are 4.7% for the Czech Republic, and 7.1% for Slovakia. Contrast that with beleaguered Hungary, whose economy contracted by 0.1% in the third quarter, and whose annual growth rate is now just 1%, while conditions in the Baltic states are even worse. In the year to the third quarter, the Latvian economy contracted by more than 4%, having grown by 50% in just four years..

On January 1st 2009, Slovakia will become the 16th member of the euro area. The Slovak central bank has matched the ECB's two latest interest rate cuts, albeit with some delay, so that the policy rate is now in line with that applying in the eurozone. The conversion rate has been set at 30.126 koruna's to the euro.

RUSSIA

The economic outlook deteriorates in line with plummeting oil prices. If crude oil prices remain at their present level, Russia's once-huge current account surplus will be transformed into a deficit. Notwithstanding the announcement of another fiscal boost worth some $20 billion, which included a cut of four percentage points to 20% in the main corporate tax rate, the economy could be heading for zero growth in the coming year. Industrial production in the year to October rose by a paltry 0.6%, with manufacturing output rising by just 0.3%.

In recent weeks the Bank of Russia has on three occasions widened the rouble's trading band against a notional currency basket consisting of the euro and the dollar. On each occasion the outcome was a devaluation of around 1%. These moves were a response to the ongoing downward pressure on the rouble, with the central bank reckoned to have spent around $40 billion propping up the currency in October. Russia's huge foreign exchange reserves shrank by $113 billion between the end of July and the end of October. On November 11th the central bank also raised its benchmark interest rate by a further 100 basis points to 12%, the fifth increase this year.

TURKEY

The Turkish economy could be heading into recession, with output likely to have contracted in the third quarter. In September, industrial production was an alarming 5.7% down from last year, following a fall of 4% in the year to August.

On a brighter note, Turkey has been awarded the status of a 'functioning market economy' for the first time in an assessment published by the EU in early November. This will speed the process of negotiating the economic aspects of Turkey's entry into the Union.

But this improved status has not softened the hearts of risk-averse international investors. The lira has fallen by over 20% against the dollar since the start of October as money has flowed out. The best that can be said is that after a precipitous fall of 4.6% on 7th November, the rate has been fairly stable, perhaps supported by the news that discussions were underway with the IMF. Although confirmation is still awaited, it is reported that Turkey is to receive a standby credit facility of $19 billion, making it the fourth occasion in a decade that Turkey has had to resort to the IMF's 'tough love'.

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