

# European Economic Update

December 2008

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## Highlights:

- Most of the continent of Europe is now in, or heading into, recession.
  - The ECB will continue to cut eurozone interest rates and may resort to some quantitative easing.
  - The eurozone's industrial recession deepens further, especially in France and Spain.
  - As the Nordic economies go into reverse, central banks take aggressive action.
  - A handful of countries in central Europe are still achieving modest growth.
  - Russia's foreign exchange reserves drain rapidly, and industrial output falls by a tenth in one month.
  - Ukraine's economy and currency are both in freefall.
  - Turkey's IMF support package is now expected to be agreed in January.
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Much of the continent is now shrouded under a dark pall of recession, which has spread from the euro area to Scandinavia, Russia, Ukraine, and Turkey. Only a few countries in the centre remain in the clear. Indeed, conditions in Ukraine and Russia have deteriorated with breathtaking rapidity as the demand for their mineral products has collapsed.

With a few notable exceptions, currency movements have been less violent in the past four weeks. But in that time the rouble still fell by a further 12% against the euro, and the Ukrainian hryvnia sank by a third. With the markets settling somewhat (helped by the knowledge that the IMF is ready to ride to the rescue) most of the continent's inflation-targeting central banks have made a start on getting interest rates down.

In what seems like an increasingly fruitless attempt to defend its crawling peg with the dollar and the euro Bank of Russia raised its benchmark rate yet again (the sixth increase this year), from 12% to 13%, on 1<sup>st</sup> December. Otherwise, only Serbia and Iceland have left rates on hold. Hungary, where the benchmark rate had been raised to 11.5% has made two cuts, each of 50 basis points, while on 18<sup>th</sup> December the central bank in Turkey lopped 125 basis points of its policy rate, albeit that it still stands at an elevated 15%.

This report was prepared based on information available at 19 December 2008.  
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## THE EURO AREA

**Forecasts for 2009** The survey data is pointing to a contraction in GDP of more than 1% in the final quarter. With credit still tight, consumer confidence in the doldrums, investment spending being pared back, and exports likely to be hurt once again by the resurgence of the euro, 2009 is shaping up to be extremely tough. HSBC's latest projections have GDP shrinking by a further 1.4% for the whole of 2009, although there are hopes that a modest recovery could be underway before the end of the year.

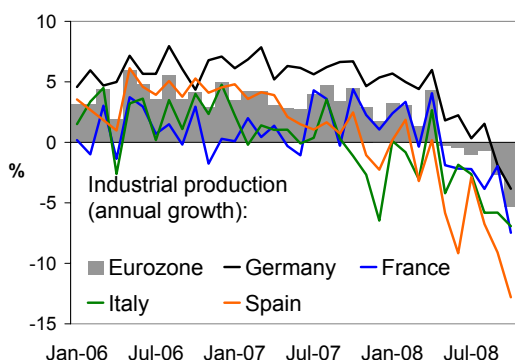
The big question now is the scale of the fiscal stimulus that will be made available by national governments or under the auspices of the EU. The EU's package announced towards the end of November amounts to about 1.5% of GDP, but contains little new money on top of what national governments have already announced. While substantive packages have been announced by the UK, France, and Spain, there has been a distinctly lukewarm approach from Germany. Maybe, as the hopes of an externally-led recovery prove illusory, the approach of next year's general election may trigger a loosening of the purse strings.

But while Germany could afford it if it wanted to, it is questionable whether some other eurozone members could afford a big fiscal boost. As ever, Italy is the biggest cause for concern, as it would start the process with a ratio of net debt to GDP of just over 100%. Some politicians have even dared to utter the 'D' word (default) in public. Italy's greater perceived risk is reflected in a widening of the spread between Italian and German government bonds, with the gap at a 10-year maturity reaching more than 140 basis points.

**Interest rates and inflation** The ECB is expected to cut its policy interest rate by a further 100 basis points to 1.5%. Inflation is now falling, easing to just 2.1% in the year to November, down from 3.2% in the previous month. The ECB has hinted that further rate cuts will be delivered at a measured pace, raising speculation that it could resort to unconventional measures even before rates reach their cyclical trough.

**Business surveys** The only crumb of comfort to be drawn from December's 'flash' readings for the PMI (Purchasing Managers' Index) surveys is that the speed of decline has slowed. The PMI for the manufacturing sector came in at just 34.5, down from 35.6 in November. The most worrying aspect was the decline to just 33.5 in Germany. Meanwhile, the services PMI fell by just 0.5 points to 42.0.

**Industrial production** Output fell by a further 1.2% in October, following on from a contraction of 1.8% in September. This pushed the annual rate of decline up to 5.3%, the steepest since 1993. At a national level, output fell by 2.1% in Germany and by 2.7% in France, with the largest decline (of more than 6%) reported in Ireland. On an annual comparison, Spain is clearly suffering the deepest downturn, with the level of production down by an eighth. Things will only get worse in the short term, given the December PMI readings, and a further fall of 6.1% in the value of industrial orders received in Germany during October, taking the annual rate of decline to more than 17%.



Source: Eurostat

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## THE NORDIC COUNTRIES

Norway, Denmark and Sweden all reported negative growth in the third quarter, with GDP contracting respectively by 0.7%, 0.5%, and 0.1%. In the year to October, Sweden's industrial output was down by 6.2%, and Denmark's by 4.5%.

Within the past few weeks, Sweden and Norway have both taken aggressive action on interest rates. The Riksbank announced a cut of 175 basis points in its policy rate, to 2%, on 4<sup>th</sup> December, while the Norwegians followed suit on 17<sup>th</sup> December with a cut of the same magnitude, to 3%. On December 19<sup>th</sup> Denmark took the first steps to closing the unusually wide spread between its official interest rates and that of the euro area. Having reduced its key policy rates by 50 basis points, the gap is now down to 1.25 percentage points.

## CENTRAL EUROPE

The Czech Republic, Poland, Slovakia, and Lithuania remain as a small recession-free cluster in the heart of Europe. It is, of course, fanciful to believe that they can remain isolated from the mayhem taking place around them. Even if recession can be averted, growth rates will be much slower than in the recent past. It is against this background that the Polish government announced a fiscal stimulus package worth 91 billion zloty (about €22 billion) in early December.

Nonetheless, in October industrial output was still very fractionally higher in both Poland and Slovakia compared with a year earlier.

## THE BALTIC STATES

The once-dizzying growth rates achieved by these countries have turned deeply negative in Estonia and Latvia. In the third quarter, Estonia's GDP was 3.5% down on the same months of 2007, while Latvia's shrank by 4.6%. In the year to October, industrial production was down by 11% in Estonia, and by 9% in Latvia, but by only 2.8% in Lithuania.

The Latvian government has joined the queue of countries seeking assistance from the IMF, having spent a fifth of its foreign exchange reserve since October defending the peg between the lat and the euro. While this is being sorted out the central bank has agreed a swap facility worth €500 billion with its counterparts in Sweden and Denmark. Devaluation is seen as a last-ditch option, as 85% of loans to Latvian households and businesses are in euro, and as such a move could also imperil the Swedish and Finnish banks that dominate the country's financial landscape.

## RUSSIA

The Deputy Minister of Economy, Andrey Klepach, unleashed something of a political storm when he announced that the economy was entering recession, and that output would shrink for two quarters. The subsequent insistence by his boss, Alleksey Kudrin, that GDP could expand by as much as 3% next year now looks very wide of the mark.

The spiralling deterioration of the Russian economy was laid bare on 16<sup>th</sup> December when it was reported that industrial output had slumped by 10.8% in November. The biggest culprit is the plummeting global demand for metals, particularly steel and aluminium, of which Russia is a major producer. But these awful numbers weren't a huge surprise, as they had been foreshadowed by large falls in freight transport and electricity production.

There is also growing evidence that the downturn is spreading through the rest of the economy, with the seasonally-adjusted services sector PMI falling sharply from a healthy 55.5 in September, to 47.4 in October and 37.2 in November. With spending power waning, credit tight, and many firms scaling back their capital spending plans, GDP is likely to contract in the fourth quarter.

HSBC now expects Russia's GDP to contract by 2% in 2009. Not only will this prove a difficult pill to swallow politically, but it will place yet more pressure on the already-embattled rouble. An abandonment of the crawling peg exchange rate policy in favour of a free float now seems likely.

Otherwise, the country risks a massive draining of its foreign exchange reserves, and a deep recession exacerbated by high interest rates put in place to protect the currency. The Bank of Russia reported that its reserves shrank by \$17 billion in just one week (up to 5<sup>th</sup> December), at which rate there would be nothing left in six months time.

## UKRAINE

But if things are looking rocky in Russia, spare a thought for Ukraine, where industrial production has fallen off the proverbial cliff in the past two months. Output fell by 19.8% in October, and by a further 28.6% in November. Compared with a year earlier, mining output was down by 32% (with iron ore extraction down 60%), while within manufacturing the metallurgy and chemical sectors were down by 49% and 35% respectively. Ukraine is suffering a bone-crunching hard-landing, with its GDP now expected to shrink by a massive 9% next year, with only Iceland likely to suffer a worse fate.

## TURKEY

The process of negotiating a standby credit facility with the IMF drags on, but may bear fruit in January when a mission from the Fund is scheduled to visit Ankara. Having only regained full budgetary independence after completing a previous IMF programme in May of this year, the Government has been understandably reluctant to go down the same route again.

But the need for IMF support was highlighted by a very poor set of growth figures, released on 16<sup>th</sup> December, which showed that GDP had grown by just 0.5% between the third quarters of 2007 and 2008. This compared with growth of 2.2% in the year to the second quarter. While there is no official seasonally-adjusted data, and therefore no quarterly numbers, most analysts believe that the economy shrank in the third quarter, and is heading for a recession. The assumption of 4% growth in 2009, on which the Government set its budget will therefore not hold water, with the IMF likely to insist on spending curbs in exchange for its assistance.

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