How Bad Will Things Get in the Eurozone and UK?

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10 December 2008

Eurozone Now in Recession

- Eurozone GDP contracted 0.2% q/q in Q3 2008, as it had done in Q2. Expanded 0.7% q/q in Q1
- Annual GDP growth down to 0.6% in Q3 from 1.4% in Q2, 2.1% in Q1 and peak of 3.2% in Q1 2007
- Q3 GDP contraction reflected Eurozone economies in trouble even before heightened financial crisis. Q2 fall had been partly due to correction in Germany, where growth was inflated in Q1 by temporary factors
- Germany and Italy now in recession. Spain on brink. Netherlands stagnant. France grew marginally in Q3
- Consumer spending flat across Eurozone in Q3, investment down and net trade sharply negative in Q3. GDP contraction would have been deeper but for inventories adding 0.3 percentage point and elevated public spending

GDP in 2008

	Q1 Q/Q	Q2 Q/Q	Q3 Q/Q	Q3 Y/Y		Q1 Q/Q	Q2 Q/Q	Q3 Q/Q	Q3 Y/Y
Austria	0.5	0.3	0.1	1.5	Norway	0.2	0.1	-0.7	0.6
Belgium	0.4	0.3	0.1	1.3	Portugal	-0.2	0.3	0.0	0.7
Denmark	-1.1	0.5	-0.5	-1.4	Slovenia	2.0	0.9		
Finland	0.3	0.8			Spain	0.3	0.1	-0.2	0.9
France	0.4	-0.3	0.1	0.6	Sweden	0.0	-0.1	-0.1	0.3
Germany	1.4	-0.4	-0.5	0.8	Switzerland	0.3	0.3	0.0	1.7
Greece	0.9	1.0	0.5	3.1	UK	0.3	0.0	-0.5	0.3
Ireland	-0.3	-0.5			Eurozone	0.7	-0.2	-0.2	0.6
Italy	0.5	-0.4	-0.5	-0.9	EU (27)	0.6	0.0	-0.2	0.8
Netherlands	0.3	0.0	0.0	1.8					

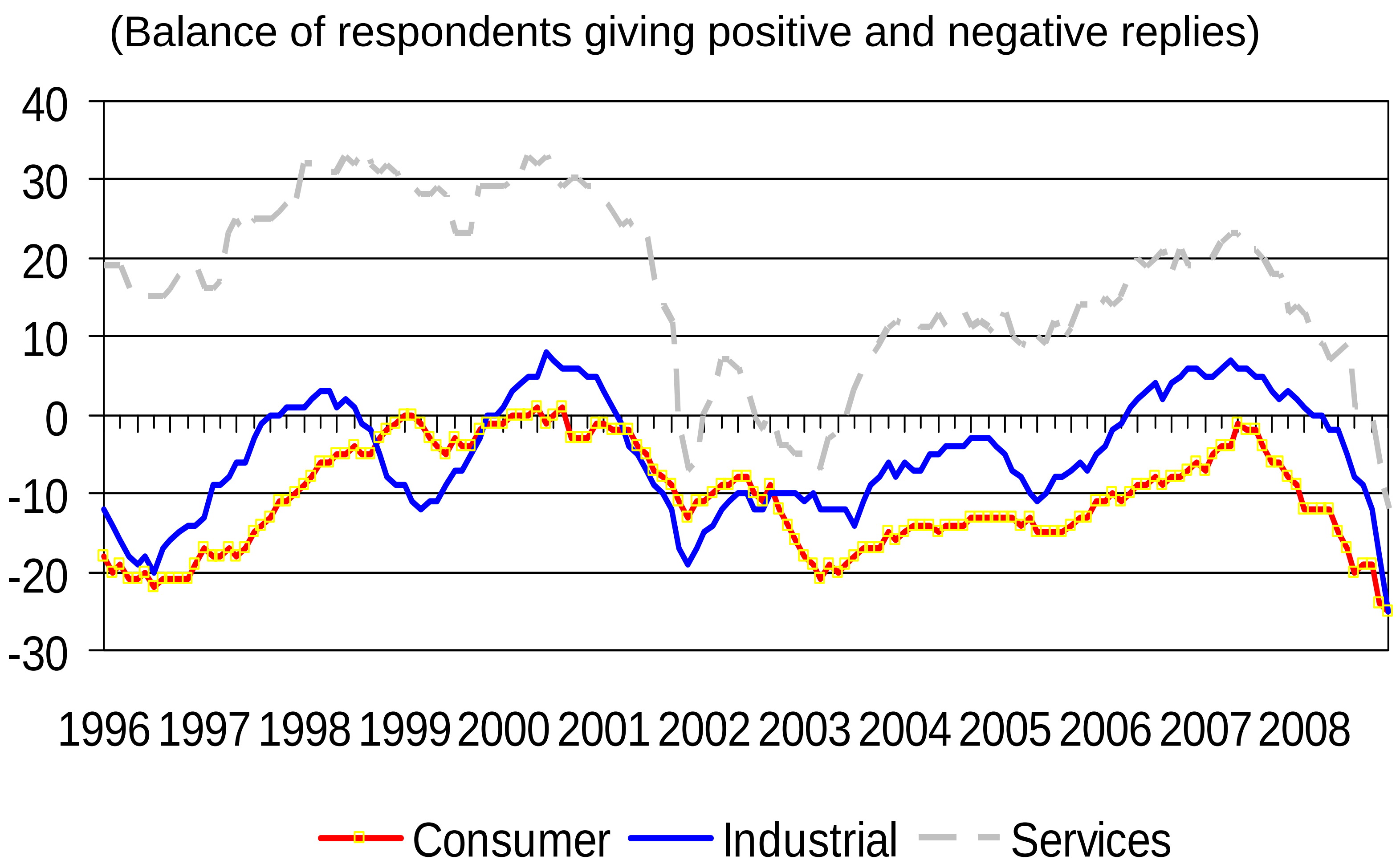
Financial Crisis Hitting Eurozone Hard

- Credit crunch lifted market interest rates, thus tightening policy. 3-month euro rate hit near 14-year high of 5.38% on 10 October. Has fallen back but well above policy rate still.
- Very tight credit conditions increasingly dampening business investment and hitting consumers
- European banks significantly exposed to U.S. subprime mortgage crisis. Now also increasingly facing problems at home e.g. collapsing housing markets in Spain, Ireland and UK. Severe downturn will heighten banks' problems
- Many banks needed government support or saving
- Major losses in European equity markets

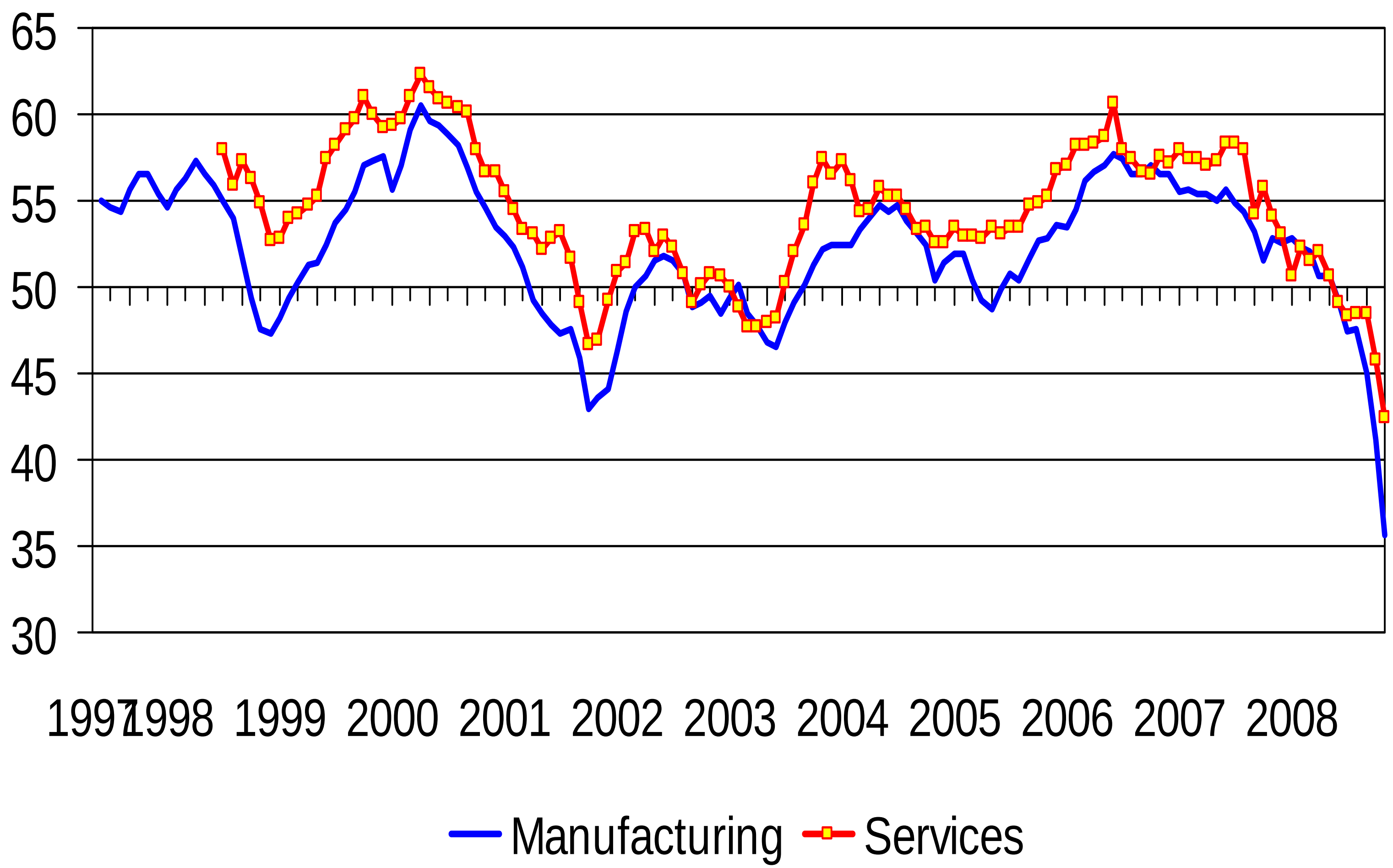
Adding to Eurozone Problems

- Global growth slowing sharply. U.S. and U.K. in recession, Emerging Europe slowing markedly
- Serious housing market corrections in Spain, Ireland (and UK). To lesser extent in France, Netherlands and Belgium
- Eurozone sentiment at 15-year low in November
- Squeezed consumer purchasing power for much of 2008
- Persistent strength of euro during much of 2008. Euro hit record high above US$1.60 in July
- High oil prices during much of the year (US$147/barrel in July). Still some lagged impact
- ECB key rate was at 7-year high of 4.25% in July

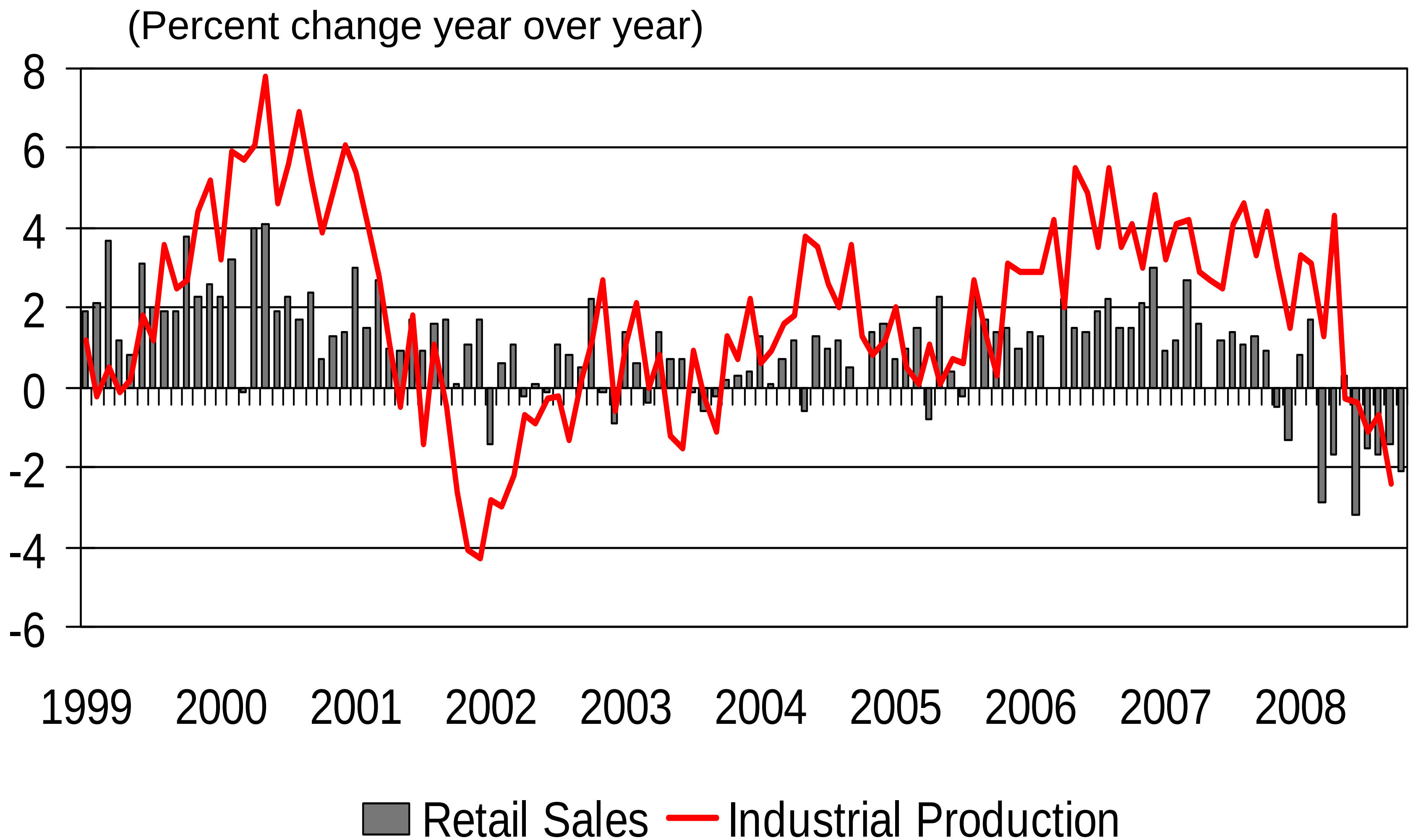
Business and Consumer Confidence Down Sharply



Eurozone PMI Surveys Both Well In Contraction Territory



Eurozone Industrial Production Contracting, Retail Sales Very Weak



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Policy Response to Financial Crisis

- Europeans agreed in mid-October a common approach to tackling financial crisis, largely based on UK method
- Recapitalizations of banks. Government to inject capital in return for taking shares. Governments will not allow systematically important financial institutions to collapse
- Governments have taken various moves to guarantee inter-bank lending
- EU finance ministers have agreed to guarantee bank deposits to minimum of 50,000 euro (was 20,000)
- Some countries have set up funds to buy bank assets

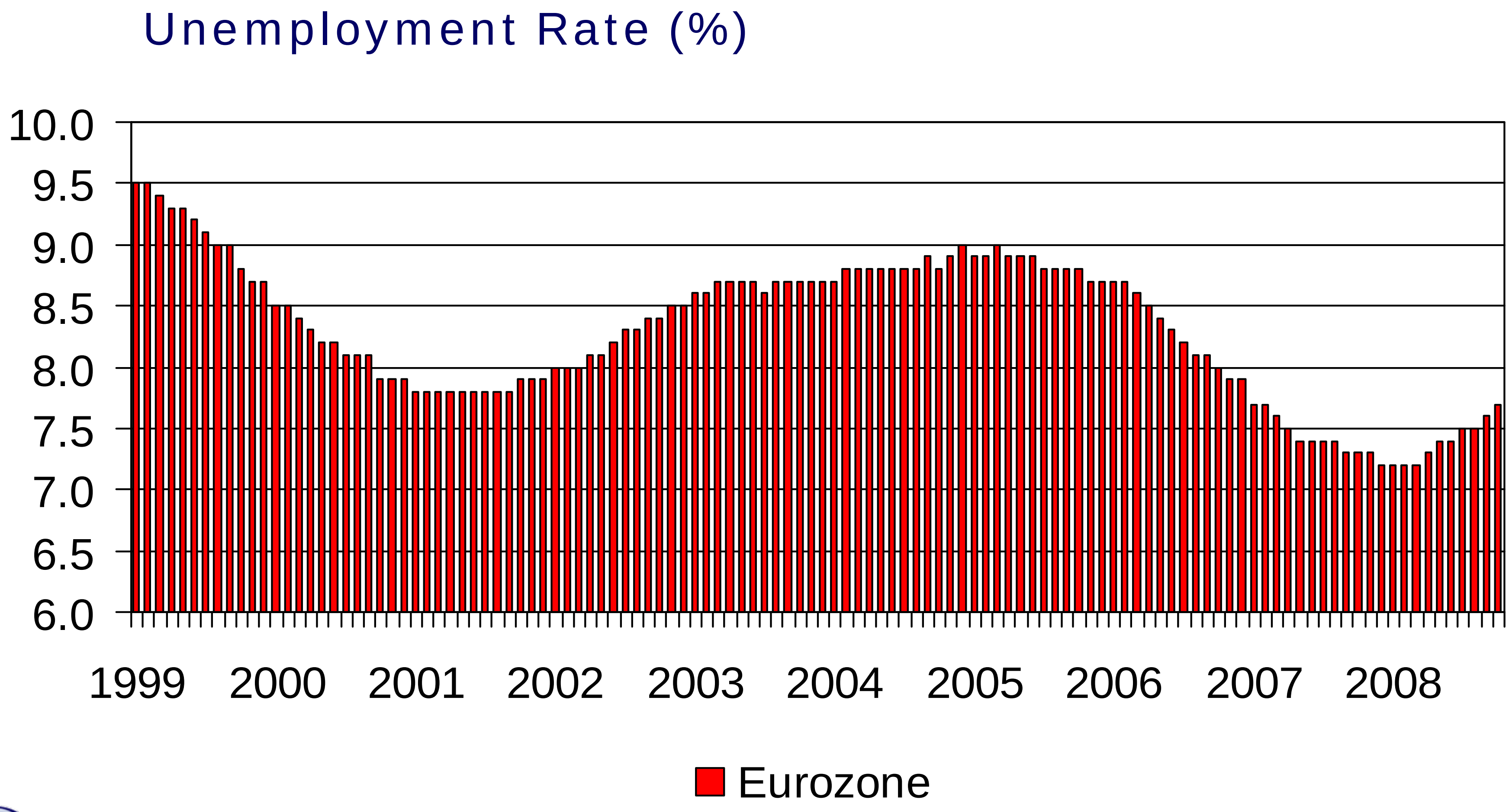
Policy Response to Financial Crisis (2)

- ECB very active in providing liquidity and extending collateral accepted
- ECB cut interest rate from 4.25% to 3.75% in October to 3.25% in November & 2.50% in December.
- Fiscal stimulus increasingly being enacted across Eurozone. Making use of increased flexibility of Stability and Growth Pact, which allows larger deficits than 3.0% of GDP for a period under exceptional circumstances
- European Commission called for EU-wide fiscal stimulus of 200 billion euro (1.5% of EU GDP). 30 billion to come from EU sources, e.g. EIB
- EIB asked to provide more loans to medium and small companies

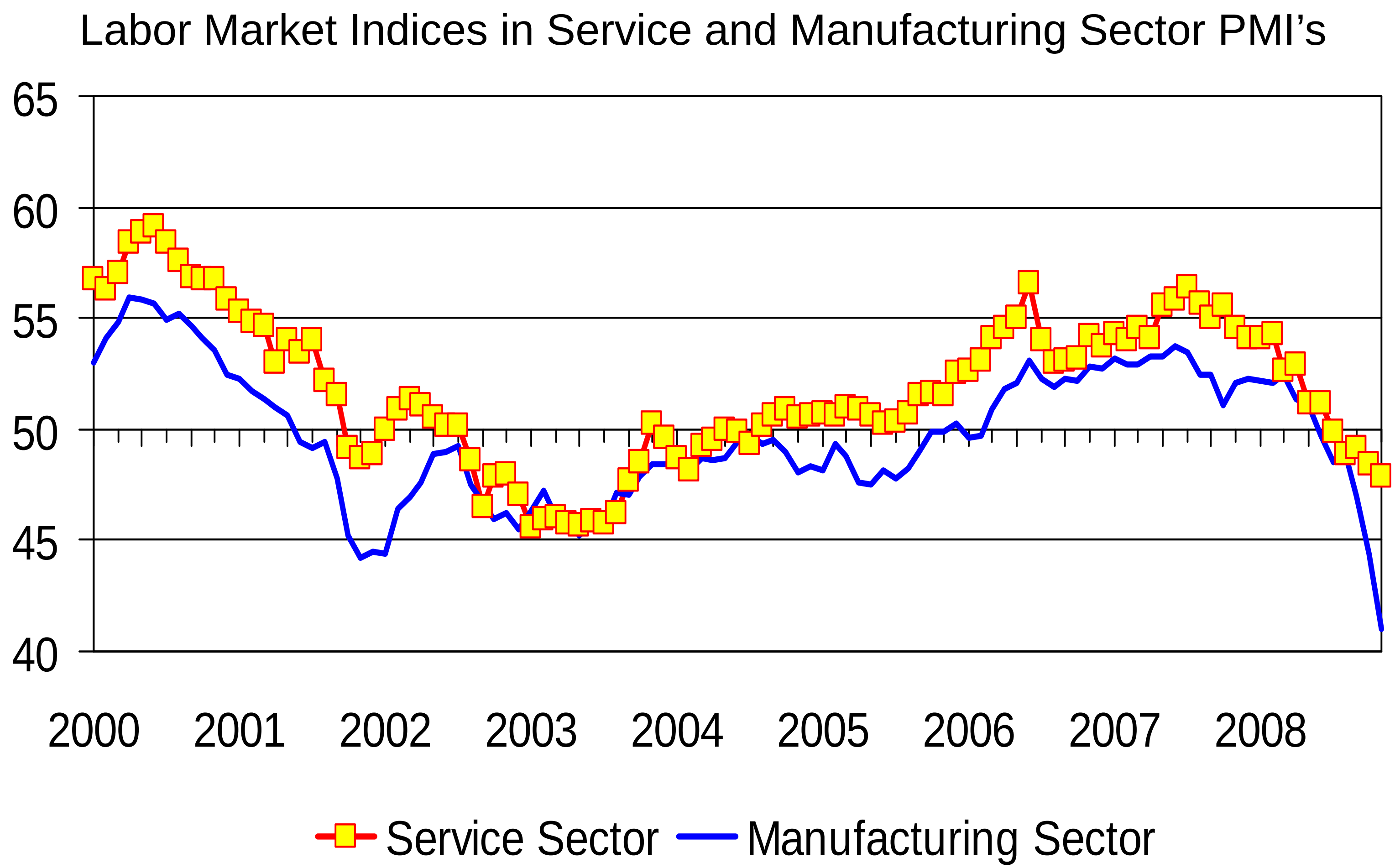
Little Hope of the Consumer Coming to Rescue

1. High energy/food prices hit purchasing power and sentiment for extended period. Real wage growth generally limited
2. Credit crunch making borrowing more difficult. Also increasing consumer caution. Sharp equity price falls
3. Employment likely falling now. Unemployment rose for 7^{th} month running in October
4. Housing markets weighing down on consumer in number of countries — Spain, Ireland, and UK. Also France
5. Eurozone consumer confidence at near 15-year low in November. Heightened fears over economy and jobs amid financial crisis outweighing retreating inflation concerns
6. Long-term concerns over pensions, labor market reforms, healthcare, and welfare systems

Eurozone Unemployment is Rising

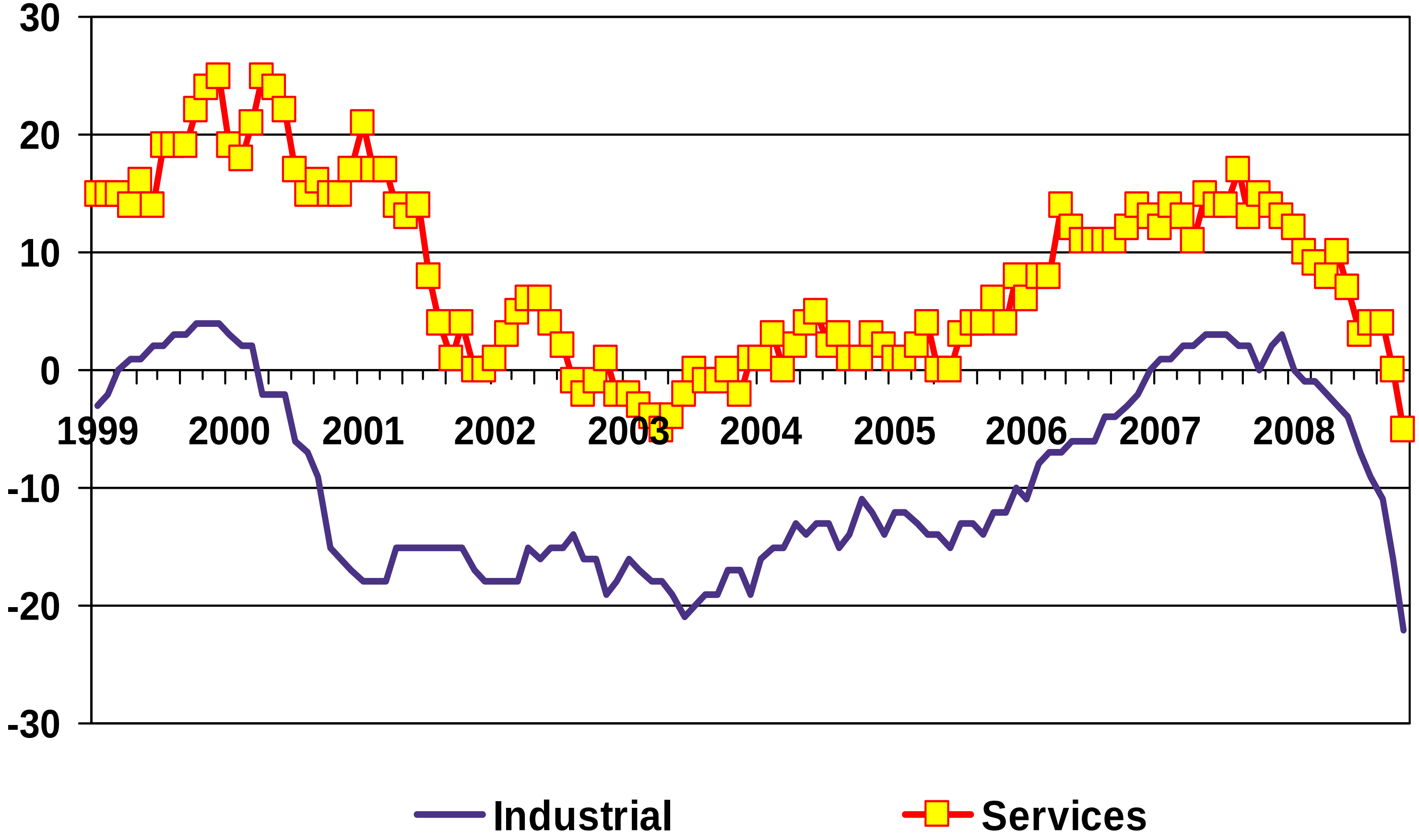


Purchasing Managers Report Employment Faltering



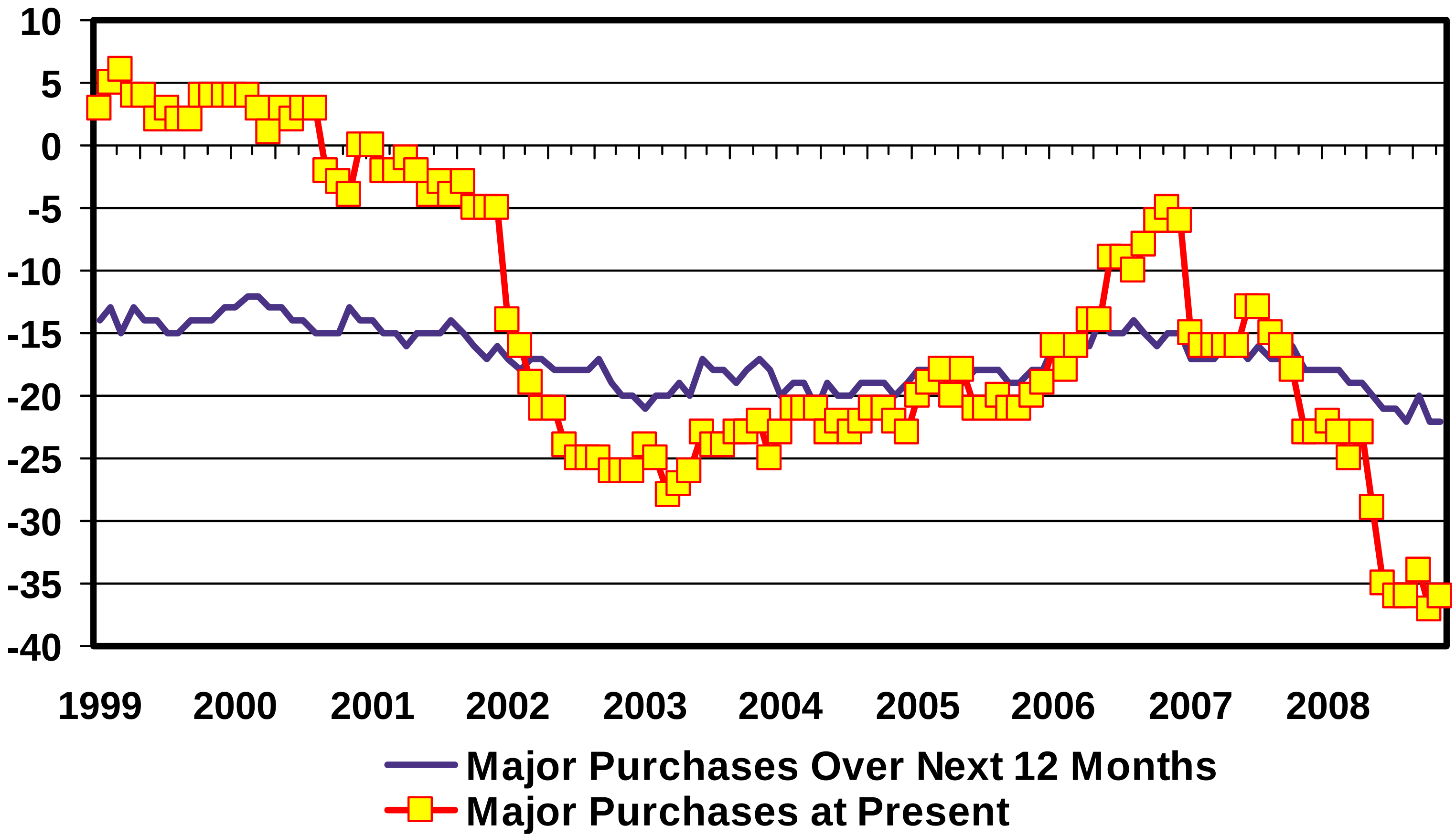
Businesses' Employment Expectations Have Weakened Markedly

(Balance of respondents giving positive and negative replies)

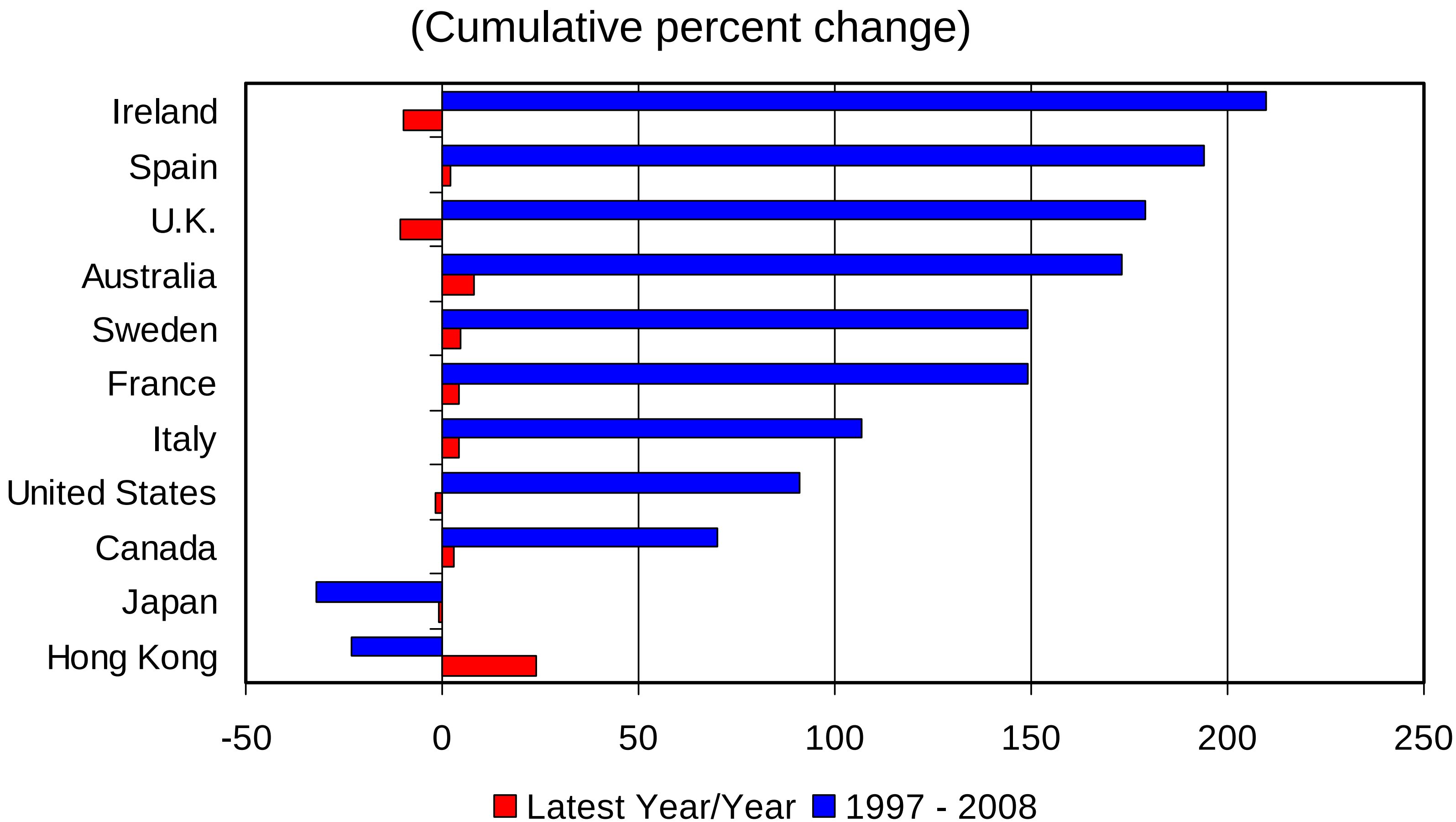


Eurozone Consumer Purchasing Intentions

(Balance of respondents giving positive and negative replies)



House Price Appreciation 1997–2008



Source: *The Economist*, September 11, 2008

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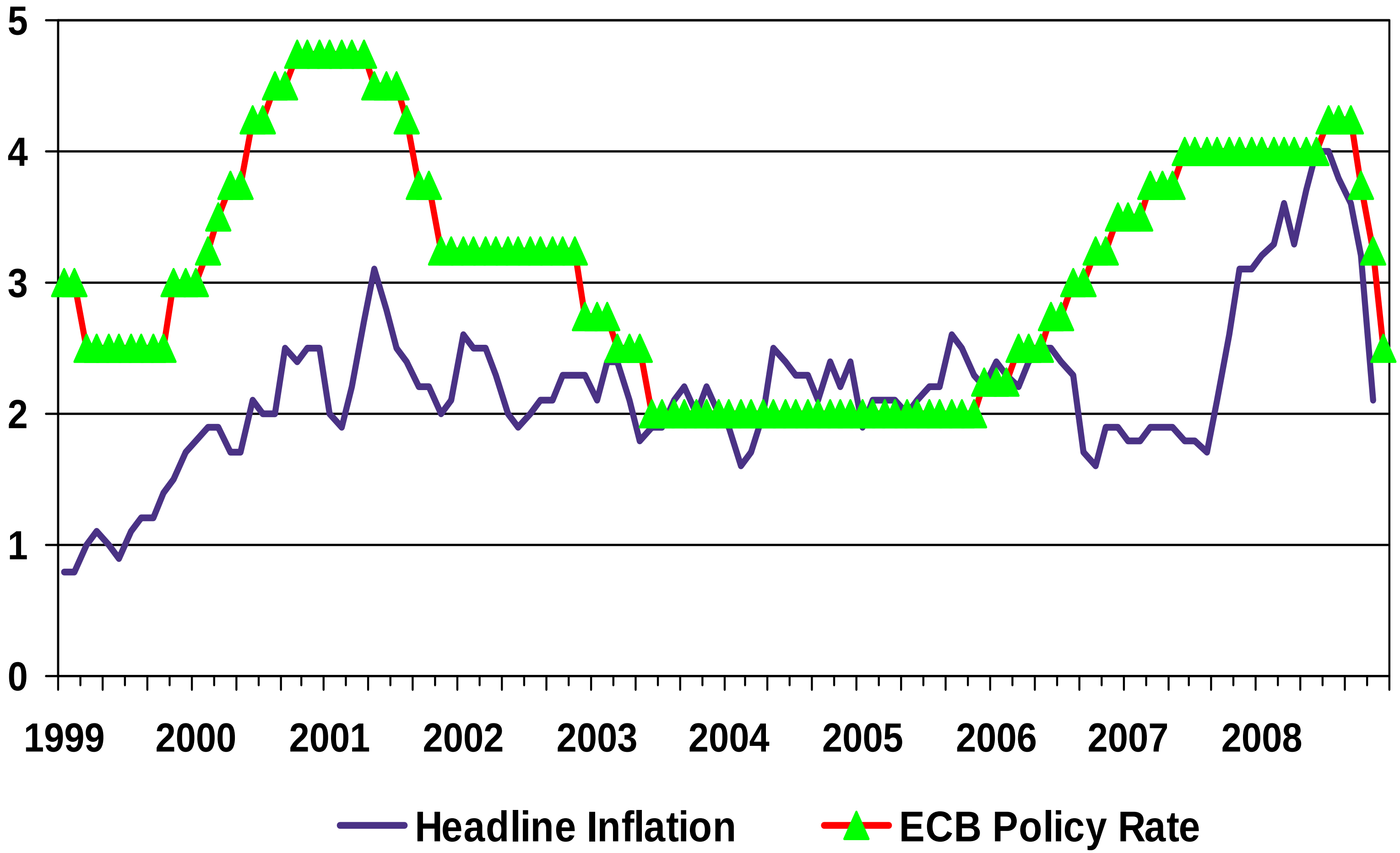
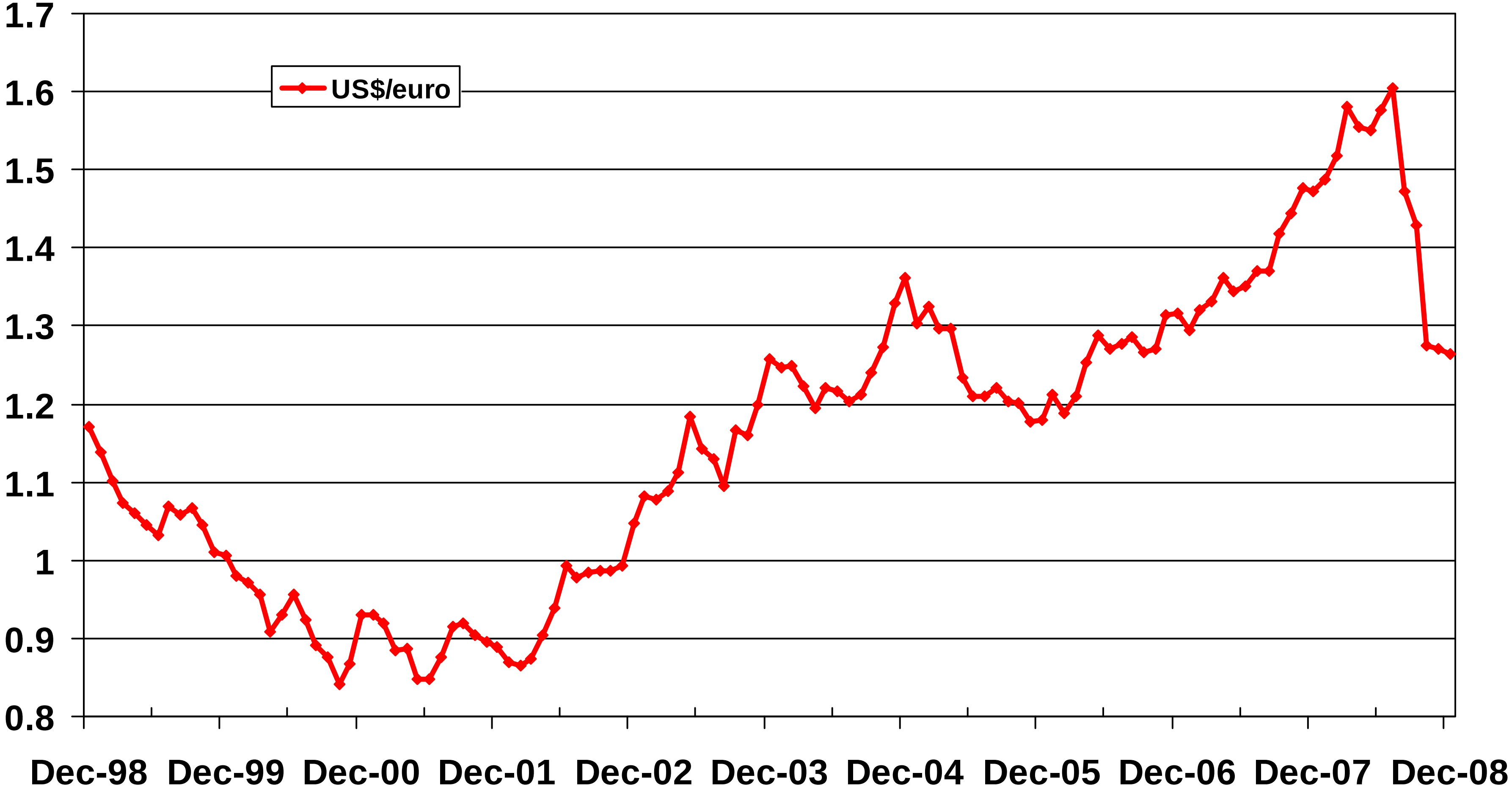
What Could Limit Eurozone Downturn?

- Financial crisis progressively eases
- Euro has retreated appreciably from July high (has traded below US$1.25 on occasions)
- Oil and commodity prices well off mid-2008 highs (oil has dipped below US$50/barrel)
- Corporate balance sheets, profitability, and earnings have been generally healthy for an extended period
- ECB has cut interest rates significantly
- Fiscal stimulus increasingly being enacted. Stability and Growth Pact allows temporary deficits above 3.0% of GDP under exceptional circumstances
- Many countries have rigid labour markets and generous social benefits. Can hold back growth but also can limit downside

Inflation and Interest Rates Headed Down



Euro Well Off Highs Against the U.S. Dollar



Main Features of Eurozone Forecasts

- **Eurozone GDP will contract by 0.8% in 2009, after growing 1.0% in 2008. Growth seen at 0.5% in 2010**
- **Eurozone consumer price inflation will retreat sharply further due to lower oil and commodity prices, waning food prices, very weak economic activity, rising unemployment and favourable base effects**
- **Inflation seen falling below 1.0% in 2009. Could be brief period of deflation. Forecast to average 1.2% in 2009. Seen averaging 1.5% in 2010**
- **ECB cut key interest rate from 3.25% to 2.50% in December. Interest rates expected to come down to 1.00% in H1 2009 and stay there through rest of year. Could be even lower**
- **Euro down from US$1.60 peak to dip below US$1.25. Euro seen largely trading around US$1.30 for some time to come**

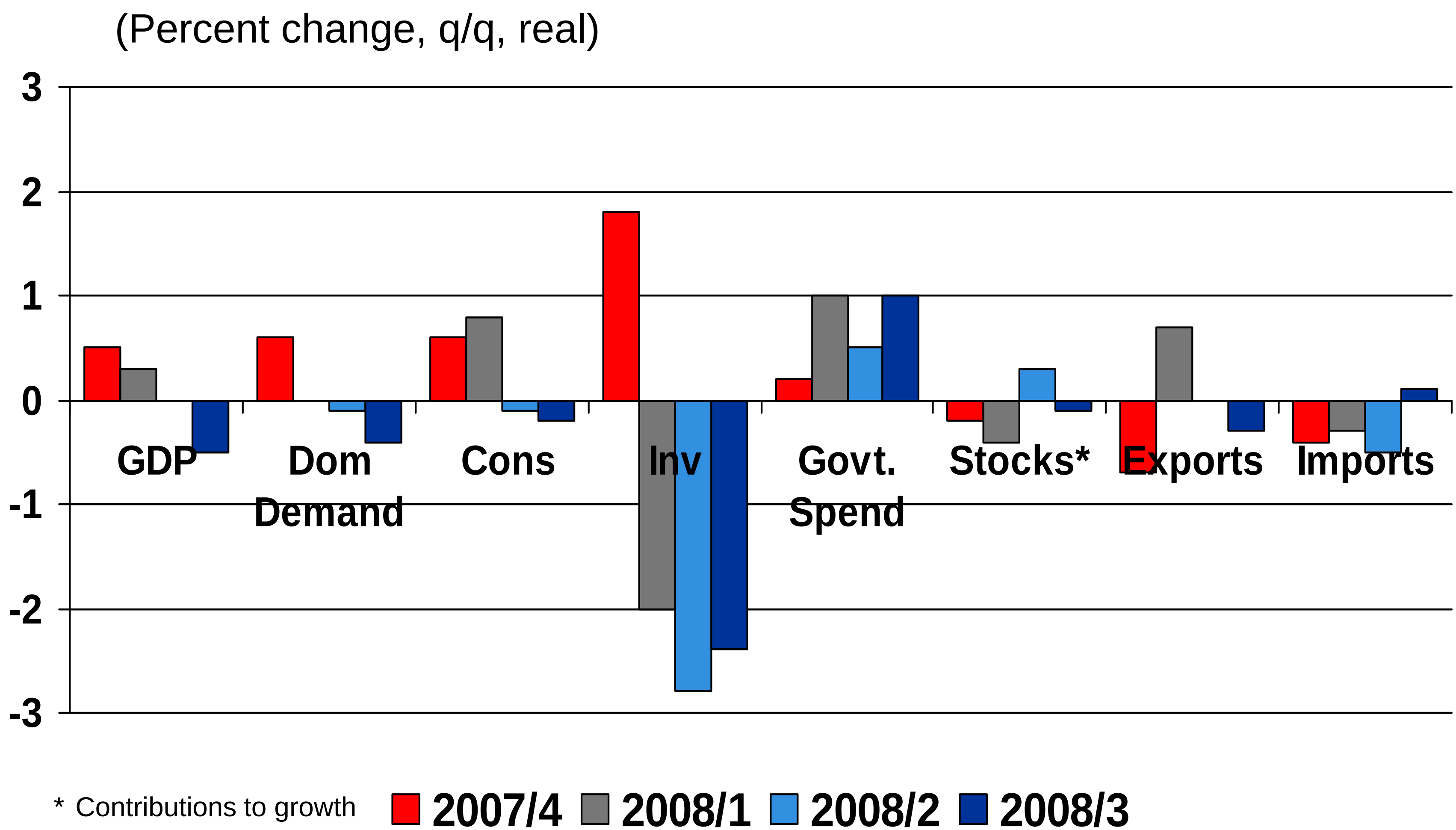
European GDP Forecasts

	2007	2008	2009	2010		2007	2008	2009	2010
Austria	3.0	1.7	-0.5	0.6	**Norway**	3.7	1.7	-0.1	1.2
Belgium	2.6	1.4	-0.4	0.9	**Portugal**	1.9	0.6	-0.3	0.6
Denmark	1.8	0.2	-0.1	0.9	**Slovenia**	6.1	3.6	2.1	2.8
Finland	4.5	2.2	0.2	1.4	**Spain**	3.7	1.2	-1.1	0.0
France	2.1	0.9	-0.6	0.9	**Sweden**	2.9	0.8	-0.5	0.9
Germany	2.6	1.3	-1.0	0.7	**Switzerland**	3.3	1.8	-0.8	0.7
Greece	4.0	3.2	1.0	1.9	**UK**	3.0	0.8	-1.8	0.4
Ireland	6.0	-1.6	-2.8	0.4	**Eurozone**	2.6	1.0	-0.8	0.7
Italy	1.5	-0.2	-1.0	0.3	**EU (27)**	2.9	1.3	-0.7	0.9
Netherlands	3.5	2.2	-0.1	1.2					

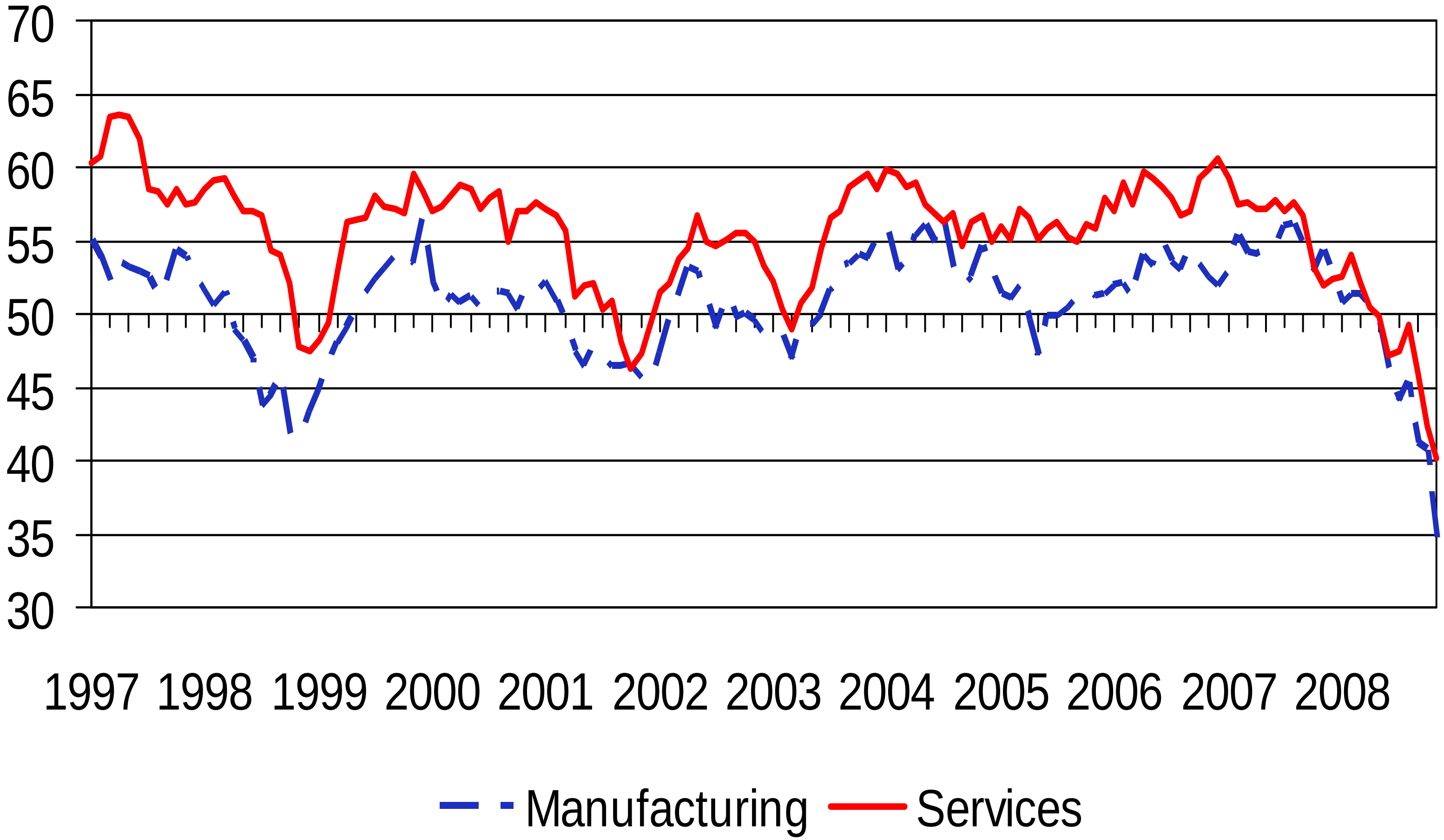
UK Economy In Recession

- GDP fell 0.5% q/q in Q3. First drop since 1992, although only flat in Q2. GDP up just 0.3% y/y in Q3
- Service sector contracted 0.4% q/q in Q3 and grew only 0.7% y/y. PMI shows activity, new business, work backlogs and employment all contracting at record rate in November
- Industrial production fell 1.1% q/q in Q3 with manufacturing output down 1.3%. Latest manufacturing surveys very weak
- Consumer spending fell 0.2% q/q in Q3. Confidence in November near to July's record (34-year) low. Most latest evidence points to very weak consumer spending
- Business investment fell sharply overall in Q1-Q3, and capital expenditure plans are being scaled back significantly
- Exports fell 0.3% in Q3 and under growing pressure from slowing global growth. Outweighing help coming from weak pound

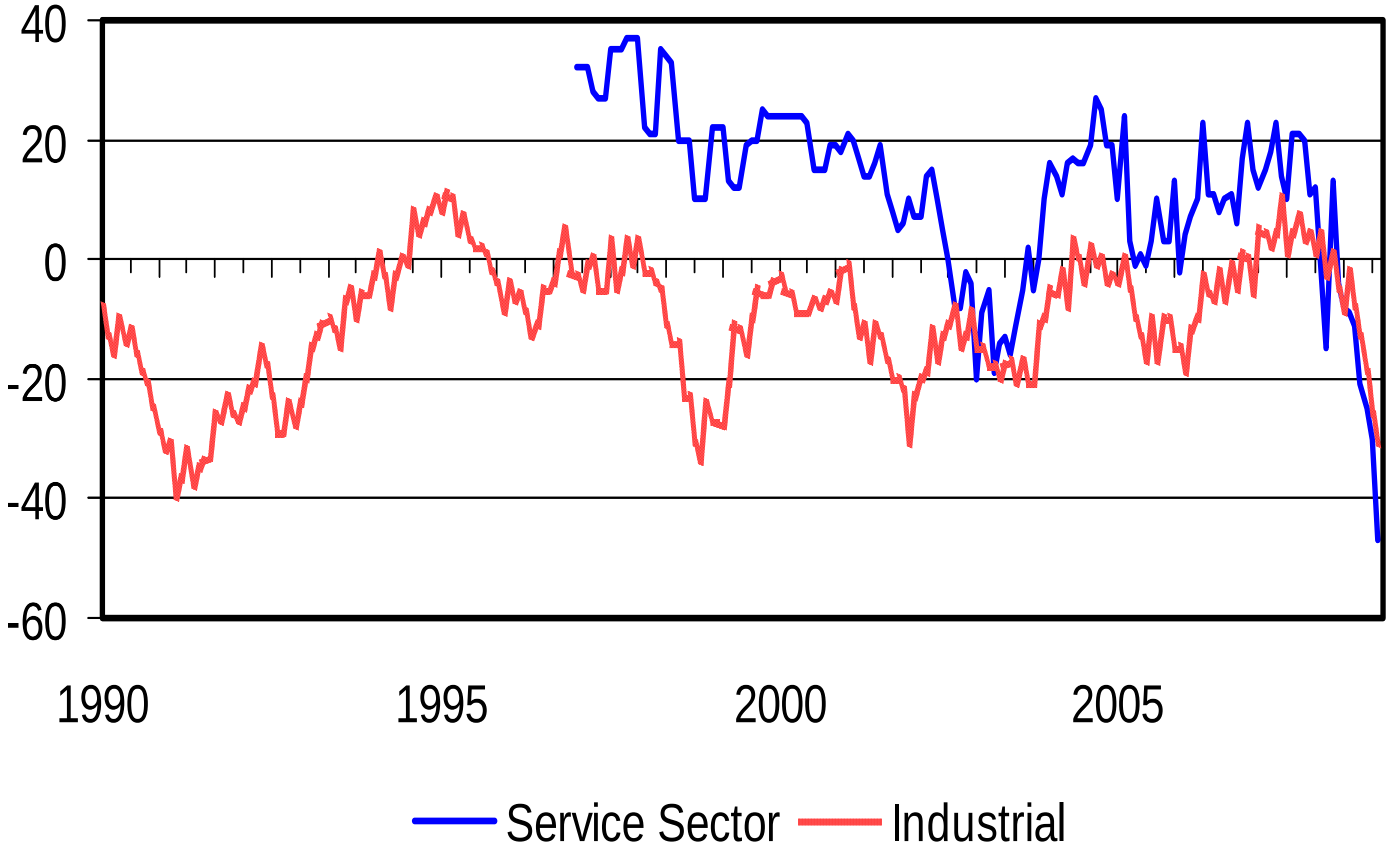
GDP Growth in Four Quarters to Q3 2008



U.K. Purchasing Managers Surveys Show Contracting Activity

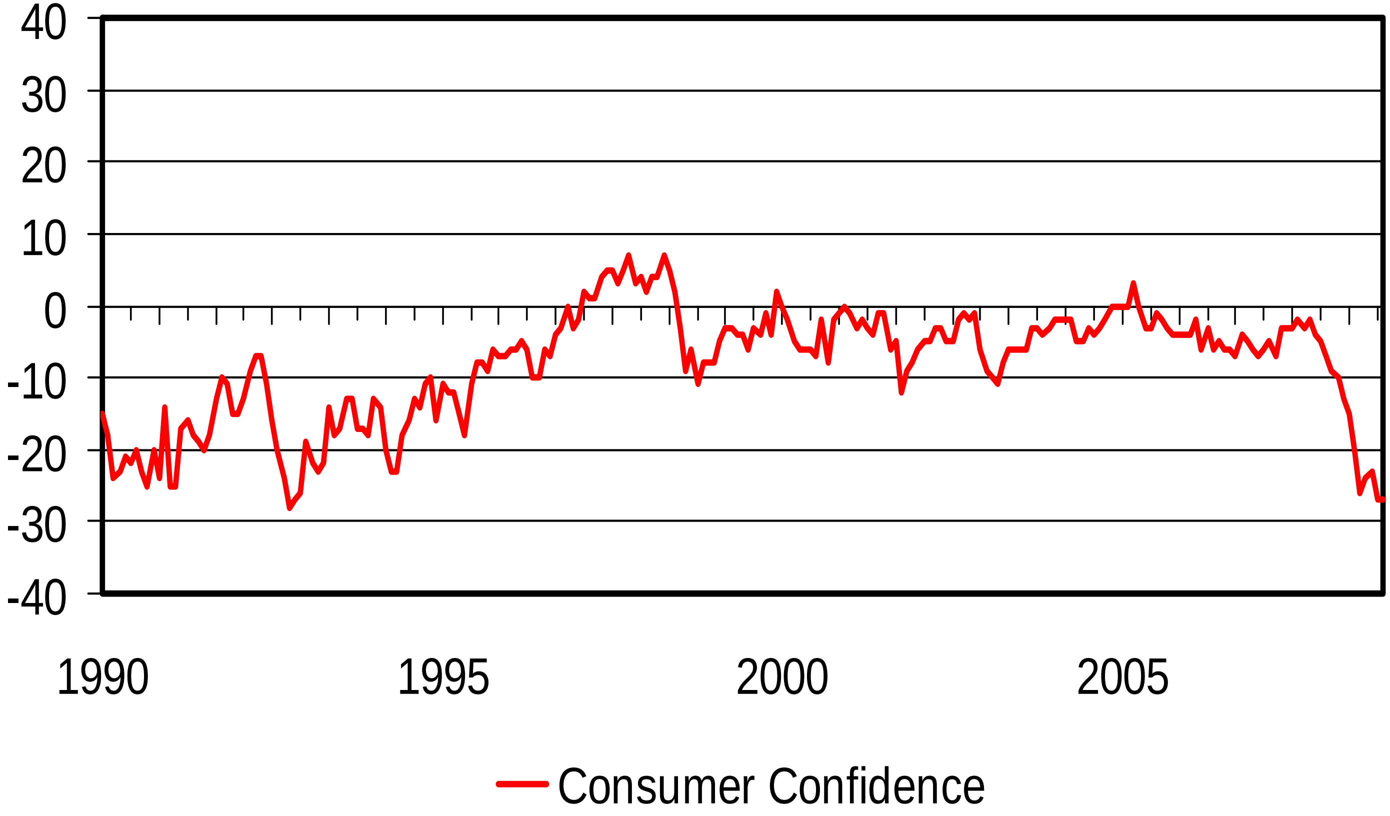


Business Confidence Down Sharply



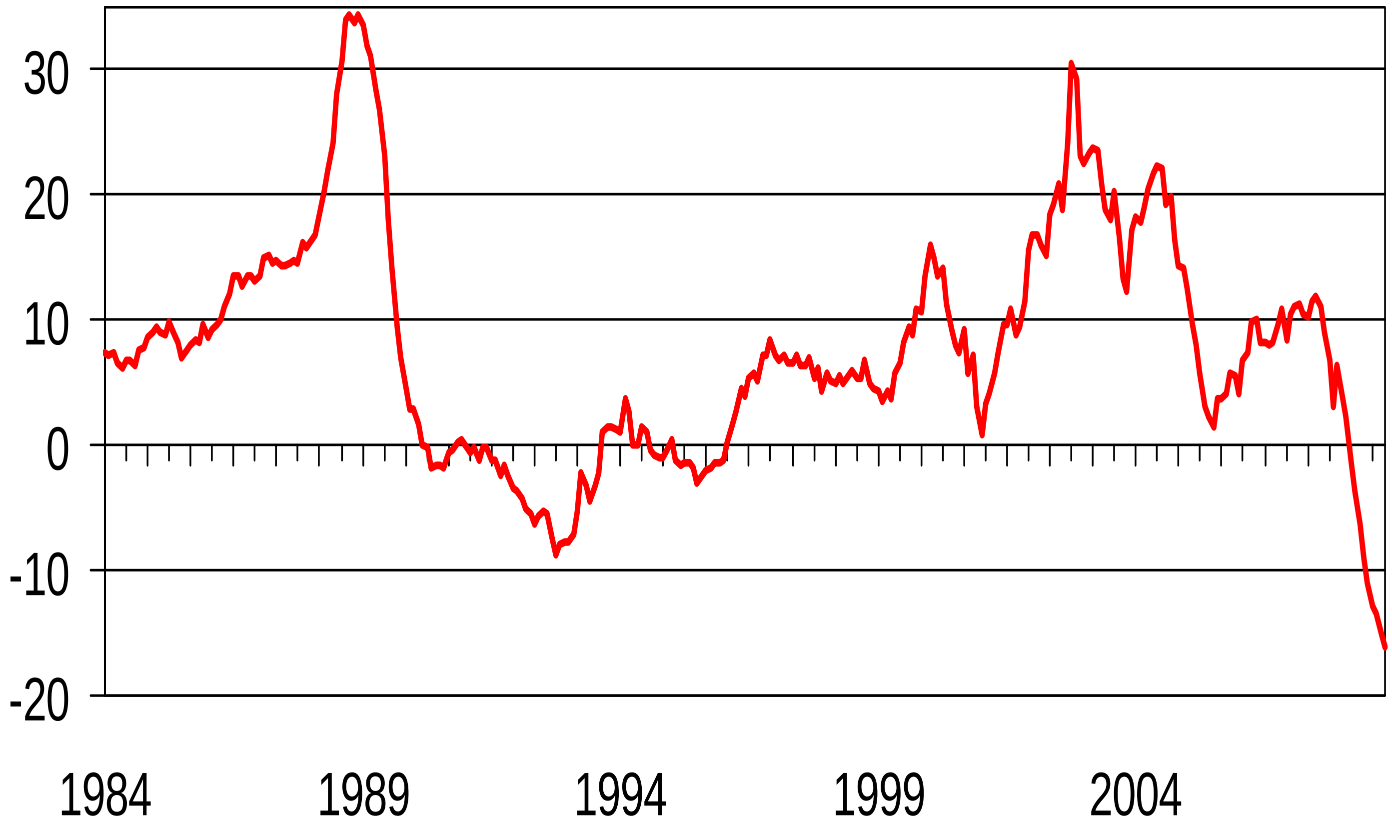
Source: European Commission

Consumer is Depressed



Source: European Commission

House Prices Fall Sharper Than in Early-1990's



Source: Halifax Lender

Current UK Vulnerabilities

- Credit crunch hitting businesses and consumers increasingly hard. Mortgages limited
- Importance of financial sector to economy
- Rise in unemployment accelerating
- Muted income growth
- Extended squeeze on purchasing power that has come from higher utility bills and elevated food prices
- Markedly falling house prices and low activity
- High levels of consumer debt
- Very weak global growth
- Weak public finances
- Deflation?

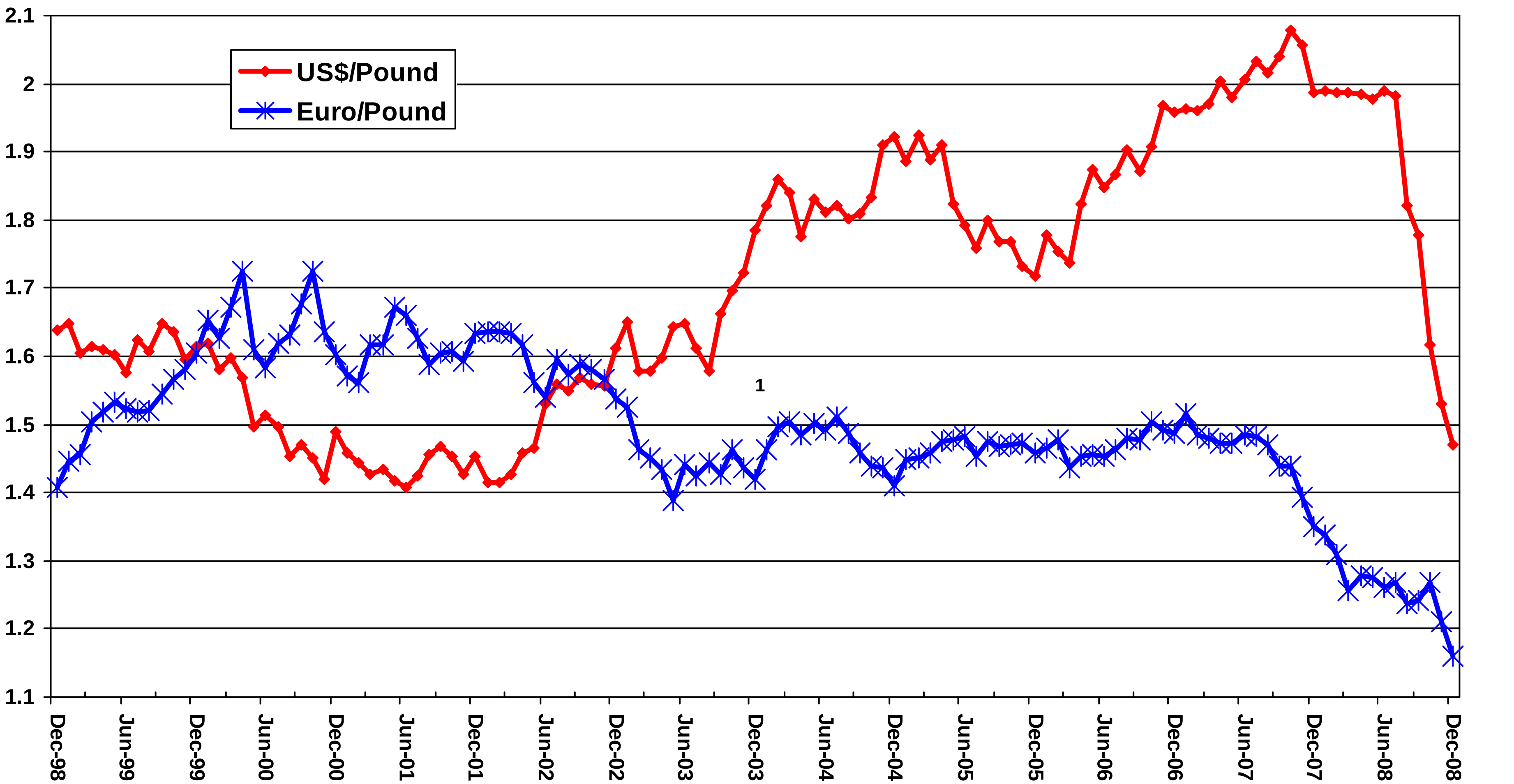
Policy Responses to Financial Sector Problems

- Government took over Northern Rock, Bradford and Bingley. Got Lloyds TSB to take over HBOS
- Bank of England increasingly pumped in liquidity
- Bank of England introduced Special Liquidity Scheme (SLS) in April. Extended it in September
- Guarantee on bank deposits raised in October from £35,000 to £50,000
- Bank rescue package. Injects up to £50 billion into 8 banks/building societies for preference and ordinary shares. £200 billion made available under SLS. Will guarantee new short and medium-term debt of the 8 banks to encourage inter-bank lending (£250 billion)
- Bank of England cut interest rate from 5.00% to 4.50% in October, then to 3.00% in November & 2.00% in December

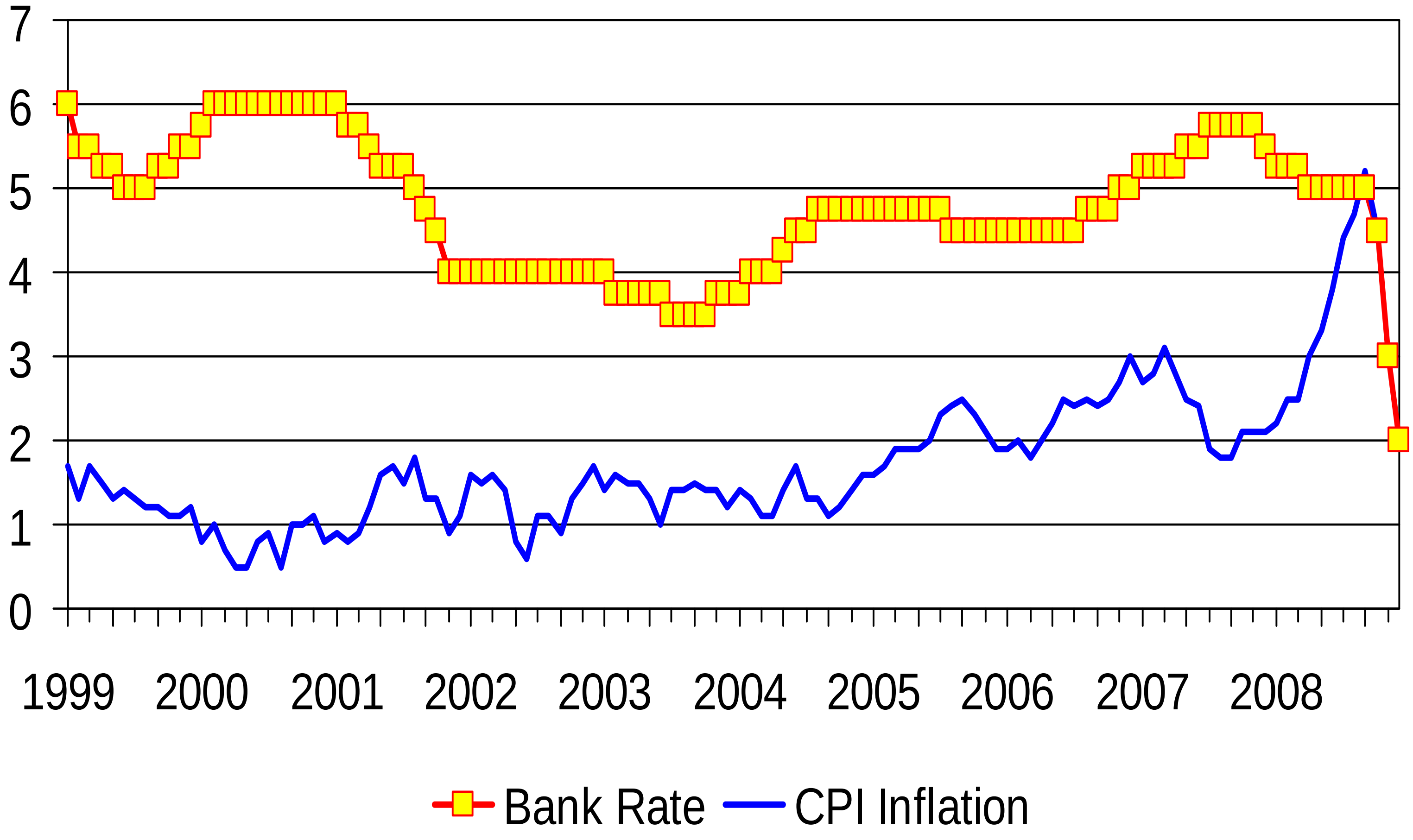
What Could Limit UK Downturn?

- Financial market crisis progressively eases?
- Interest rates fallen from 5.00% in early-October to 2.00% in December. Seen down to 0.50% in 2009
- £20 billion fiscal stimulus package
- Sharply lower oil and commodity prices. Food prices easing
- Weaker pound
- Corporate balance sheets generally healthy
- Employment still relatively high. Unemployment much lower than in early-1990's (neared 11.0% from starting point of 6.9%, currently stands at 5.8%)
- Flexible labour and product markets

Sterling Has Weakened Markedly



Bank of England Slashed Interest Rates to Equal Lowest Level since Founded in 1694



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UK Economy — Key Features and Forecasts

- GDP growth will be 16-year low of 0.8% in 2008. GDP will contract 1.8% in 2009, then rise just 0.4% in 2010
- CPI inflation down to 4.5% in October from equivalent 16-year high of 5.2% in September. Likely to go negative briefly in H2 2009 (influenced by VAT cut). Seen averaging 0.6% in 2009 and 1.1% in 2010
- Bank of England cut key interest to equal record low of 2.00%. Seen coming down to 0.50% in 2009 and then staying there for rest of year
- £20 billion fiscal stimulus will help to limit recession. But need for major correction further out when recovery is firmly established will hold back the upturn. Scheduled from 2011 (after next election, which is due by mid-2010)
- Sterling to remain weak for extended period
- House prices to fall further 15% in 2009 after estimated drop of 15% in 2008 amid very tight lending conditions, stretched buyer affordability and negative sentiment

Thank you

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