

# Europe Weekly Outlook

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- Euro under pressure due to persisting sovereign risk concerns
- Euro zone economy continues to propel ahead despite sovereign credit turmoil
- Estonia adopts the euro, becoming the euro zone's 17<sup>th</sup> member country
- Hungarian outlook dominated by fiscal progress and monetary tightening

## Euro under pressure due to persisting sovereign credit concerns

The euro (EUR) has started the year in downbeat mode, dropping 3.4% vis-à-vis the US dollar (USD) in a week from the end-2010 value of US\$1.3384 to the current level of US\$1.2980. Concerns regarding the sustainability of government finances in the highly indebted euro zone countries continue to weigh on the EUR and the debt markets of the region's peripheral economies. Moreover, slowing growth prospects in the euro zone are adding to the deterioration of investor sentiment. The year 2011 will be characterized by persistent uncertainty and confidence risks surrounding the EUR; however, we do believe that the turmoil will stabilize over the course of the year, leading to a somewhat stronger EUR – US\$1.37 – by the end of 2011.

As a safe-haven currency, the CHF continues to reflect changes in investor sentiment stemming from European sovereign credit turmoil. Following an appreciation of 18.3% vis-à-vis the EUR in 2010 and 12.3% versus the USD, the CHF closed last year at a record high level against both currencies. The CHF is trading at 1.2495 per EUR at the time of writing. Swiss authorities remain concerned about the strength of the currency, and stand ready to intervene in the currency markets if a stronger CHF translates into material deflation risks.

Investors' risk aversion towards government bonds in the euro zone periphery remains elevated. Despite denials by Prime Minister George Papandreou, rumours regarding debt restructuring talks in Greece sent the sovereign debt spread between Greek benchmark 10-year bonds and equivalent Germany bunds to a record high of 974 basis points (bps) today, with the Greek bonds yielding 12.6%. Meanwhile, major European equity markets are beginning the year in positive mode. The major stock exchanges, the German DAX, British FTSE100 and French CAC40, have gained 0.5%-1.6% year-to date following mixed results last year. The CAC40 lost 3.3% in 2010, while the FTSE100 and the DAX gained 9% and 16%, respectively, over the course of last year.

## Euro zone economy continues to propel ahead despite sovereign credit concerns

The underlying momentum of the euro zone economy remains broadly positive despite the ongoing sovereign credit turmoil. We estimate that regional real GDP growth reached 1.9% in 2010. The industrial sector continues to perform strongly, with the December print for the regional purchasing managers' index for the manufacturing industry revised upwards, indicating faster-than-estimated output increases, while regional industrial order books point towards maintained momentum. European Commission surveys on economic and industrial confidence show further improvements in business sentiment in December; however, a dip in consumer confidence reflects concerns regarding the sovereign credit crisis surrounding Ireland and some other periph-



eral economies. Indeed, a decline in retail sales (-0.8% m/m) in November confirms that consumers remain cautious. Divergences in member countries' economic performance continue to widen, with Germany remaining the region's growth leader. While German industrial production dipped in November (-0.7% m/m), the country's factory orders jumped 5.2% m/m in the same month, suggesting that the economy will continue to record solid growth in the coming months. As the year 2011 will bring in intensified fiscal consolidation efforts in many parts of the euro zone, and as export sector performance will be adversely impacted by slower momentum in the euro zone's trading partners' economies, the regional real GDP growth will likely slow to 1.4% this year.

Inflationary pressures in the euro zone intensified in December with the headline consumer price index increasing by 2.2% y/y, according to a "flash estimate", thereby exceeding the European Central Bank's (ECB) inflation target of "below, but close to, 2%". Regardless, monetary conditions in the euro zone will likely remain accommodative for an extensive period of time. We expect the ECB to leave the benchmark interest rate on hold at 1.0% following the Governing Council meeting on January 13<sup>th</sup>. In fact, monetary conditions will likely remain unchanged until the final quarter of 2011, when a cautious process of monetary normalization begins.

### **Estonia adopts the euro, becoming the euro zone's 17<sup>th</sup> member country**

The euro zone enlargement process continues; on January 1<sup>st</sup>, Estonia became the currency union's 17<sup>th</sup> member country, as it said farewell to the kroon. Regardless, the size of the euro zone economy is not significantly impacted, as Estonia accounts for less than 0.2% of the region's total nominal GDP, being equivalent to the size of Cyprus. The Estonian economy is gradually recovering from a very deep recession; real GDP expanded by an estimated 1½% in 2010 following two years of significant contractions of 5.1% in 2008 and 13.9% in 2009. In the next two years output expansion will likely average around 3%. The Estonian economy is driven by services that account for around two thirds of the nation's output; industry, equivalent to close to a third of GDP (as the share of agriculture is small), is dominated by engineering, electronics, wood and wood products, tex-

tiles, information technology, and telecommunications. In the context of elevated sovereign credit risks in the euro zone, Estonia is very well positioned. Its fiscal deficit was around 1½% of GDP last year, while the public debt level hovers around a minimal 7% of GDP.

### **Hungarian outlook dominated by fiscal progress and monetary tightening**

Hungary will be at the center of attention over the next six months as it holds the European Union's rotating presidency. In addition, investor focus is concentrated on Hungary's fiscal path. According to Prime Minister Viktor Orban, the country met the budget deficit target of 3.8% of GDP in 2010; the 2011 budget, approved by Parliament in December, aims to narrow the shortfall further to 2.9% of GDP without further austerity measures. Accordingly, concerns regarding the sustainability of the fiscal path have been on the rise recently – highlighted by the country's sovereign credit rating downgrade at end-December to "BBB-" by Fitch Ratings – as the administration is planning to use pension savings to finance its budget deficit, and aims to offset the impact of personal and corporate tax cuts by temporary levies on foreign businesses.

Hungary has embarked on a monetary policy tightening cycle; following the most recent monetary policy meeting on December 20<sup>th</sup>, authorities raised the benchmark interest rate by 25 basis points to 5.75%, marking a second consecutive monthly hike. The policymakers remain concerned about persistent inflationary pressures (the consumer price index increased by 4.2% y/y in December, remaining well above the central bank's 3% target) as well as the fact that a general improvement in investor sentiment towards emerging markets is not reflected in Hungarian assets, mirroring fiscal sustainability concerns and the (un)predictability of the country's economic environment. We expect the Hungarian Forint (HUF), trading at 278 per euro at the time of writing, to remain subject to elevated volatility this year on the back of rapidly changing investor sentiment; following a 3.0% depreciation vis-à-vis the euro in 2010, we expect the HUF to continue to face modest selling pressures this year, closing the year 2011 at 285 per euro.

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