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Europe Weekly Outlook

- **European financial markets stabilize as concerns regarding Greek fiscals begin to ease**
- **Greece's new fiscal measures welcomed by market participants**
- **No change in administered interest rates in the euro zone or the UK**
- **Euro zone labour conditions remain troubled despite signs of private sector recovery**
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European financial markets stabilize as concerns regarding Greek fiscals begin to ease

Greece's announcement of another round of deficit reduction measures and the subsequent positive reception to Thursday's €5 billion issue (please see below for more detailed comments) have helped stem selling pressures on the euro (EUR) and on debt issued by other fiscally-challenged governments within the euro zone. The exchange rate (US$1.360 at the time of writing) has settled in to a trading range of US$1.35-1.37. At the same time, the pound is staging a slight recovery versus the EUR, moving back toward the 0.900 level after touching 0.915 at the outset of the week. The Swiss franc (CHF) has been steady over the past week, holding very near 1.463 per EUR; the Swiss National Bank remains prepared to renew its direct intervention in the event of further appreciation. As noted, debt markets are also stabilizing; the yield on the 10-year Italian benchmark bonds has declined by 3 basis points (bps) on the week to 3.94%, while that of Spain (with a smaller debt burden, but a much larger deficit/GDP ratio than that of Italy) is unchanged at 3.86%. The German bund yield is up 6 bps to 3.16% - in part a reflection of reduced risk aversion. Also indicative of the more relaxed tone among investors are this week's widespread advances in equity markets, led by a 6% rally in Spain's IBEX35.

Greece's new fiscal measures welcomed by market participants

Greece is taking additional steps to restore its weak fiscal situation and to improve the credibility of its consolidation plans. On Wednesday, the government announced a new set of austerity measures - to both decrease spending and increase revenues - worth €4.8 billion (around 2% of GDP) in order to help to bring the fiscal deficit from 12.7% of GDP in 2009 to the 2010 target of 8.7%. The administration is planning to increase the value added tax from 19% to 21% and raise the tax on tobacco, alcohol, fuel and luxury items, while reducing expenditure by cutting public sector wages, freezing pensions and scaling back public investment and education expenses. Both the European Commission and the International Monetary Fund officially expressed satisfaction regarding the Greek authorities' additions to the fiscal package. The statement by European Commission President Barroso that the new measures "provide a strong signal of the readiness of the Greek Government to proceed with courageous decisions" was seemingly shared by market participants, as the Greek government's 10-year bond issue bearing a coupon of 6.25% was three times oversubscribed. The nation's financing needs are around €54 billion in 2010, with approximately €20 billion of debt maturing in April and May; about €18 billion has been raised so far this year. European policymakers maintain their view that Greece is responsible for fixing its own fiscal problems; while offering verbal support, they have not (yet) provided financial assistance to the country. In any event, Greek bonds have been rallying: the spread over the equivalent 10-year German benchmark bund has narrowed by 36 bps on the week to 289 bps and were priced to yield 6.05% at the time of writing.

No change in administered interest rates in the euro zone or the UK

Interest rates remain on hold in the euro zone and the UK. Following their March policy meetings, the European Central Bank (ECB) and the Bank of England's (BoE) Monetary Policy Committee (MPC) opted to leave their benchmark interest rates unchanged at 1.0% and 0.5%, respectively. In announcing the ECB's decision, President Jean-Claude Trichet expressed confidence that inflationary pressures would remain low over the medium term; economic growth - at least in 2010 - will be "moderate" and "uneven" (his complete statement can be found at the ECB's website: http://www.ecb.int/home/html/index.en.html). In another step towards the normalization of monetary policy and the phasing out of non-standard measures, the ECB will return to variable rate tender procedures for its 3-month refinancing operations effective April 28th. In keeping with normal BoE practices when there is no change in policy, there was no amplification of the decision to maintain the Bank Rate at 0.5% and the asset purchase programme at £200 billion. Clearly, the MPC remains confident that the consumer price inflation rate (3.5% y/y in January) will soon slip back to the medium-term target of 2%. However, pressures further up the distribution chain threaten to slow the correction as the headline producer price index rose 4.1% y/y (0.3% m/m) in February.

Euro zone labour conditions remain troubled despite signs of private sector recovery

The gradual recovery in manufacturing activity in Europe will not have any appreciable impact on employment for some time yet, even assuming the sectoral momentum can be sustained. Certainly, the near-term production outlook is encouraging, as the final purchasing manager survey results for February confirm the preliminary finding of a further rise in the PMI (the twelfth consecutive monthly advance) to a 2½-year high of 54.2. More substantively, another surge in German new orders in January reinforces the view that the manufacturing sector is in recovery mode, though the benefits are unevenly distributed across the region. Nevertheless, with significant numbers of employees on shortened hours and plants running well below capacity, output can be increased significantly before employers initiate a strong hiring push. Thus, the euro zone jobless rate, which held steady at 9.9% for a third consecutive month in January, will likely remain well above the 9% threshold through most - if not all - of 2010. Troubled labour market conditions point to a weak outlook for household spending (which stagnated in the fourth quarter following a 0.2% q/q decline in Q3, according to preliminary GDP data). The sluggishness appears to have extended into 2010, as retail sales dipped for the second time in three months in January and remained below year-earlier levels for a twentieth consecutive month (though severe weather will have exaggerated January's underlying spending weakness). This, in turn, will help ensure that consumer price inflation remains subdued; the 'flash' estimate for February's year-on-year rise in the harmonized index of consumer prices is 0.9%, a marginal reduction from the 1.0% increase in January. Further up the distribution chain, however, pressures are building somewhat as the producer price index rose 0.7% m/m in January, the biggest advance since July 2008; although the PPI remains below its year-earlier level, a shift back into positive territory appears imminent.

Solid economic gains in Switzerland; Sweden remains out of step

The Swiss economy closed off 2009 with a flourish, registering a 0.7% q/q gain in Q4, outpacing the larger economies of Western Europe by a comfortable margin. Growth was well-balanced, with positive contributions from both domestic spending and trade. Nevertheless, output for the year as a whole slipped 1.5%. The encouraging growth figures for the second half of 2009 (Q3 output rose 0.5% q/q) will not trigger a pre-emptive tightening by the Swiss National Bank (SNB). Inflation - whether consumer or asset prices - is not an issue and, in view of the appreciating bias of the Swiss franc vis-à-vis the euro, the SNB will be disinclined to move in advance of the ECB.

The Swedish economy suffered a second consecutive quarterly contraction in the final quarter of 2009, in contrast with other major economies across the region, which had succeeded in eking out at least a marginal gain in the second half of the year. GDP fell 0.6% q/q in Q4 (1.5% y/y), following a minimal 0.1% dip the previous quarter. Trade and investment were the key negative factors: exports continued to flag, slumping a further 1.1% q/q (while imports gained ground for a third consecutive quarter) and capital outlays slumped 3.3%. On the positive side, both household and current government spending gained ground, increasing by 0.3% and 0.4%, respectively. Despite the setback, we share the central bank's (relative) optimism that the economy will grow by about 2½% this year - outpacing the major euro zone economies and the UK. This should prove supportive for the Swedish krona in the latter part of the year, particularly if the Riksbank moves to raise interest rates in advance of the ECB or BoE.

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