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# Europe Weekly Outlook



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## Financial markets seek direction after muted recovery signs

Investor concerns regarding the possibility of a slower than expected global economic recovery are reflected in the currency markets; weak US payroll data on Thursday supported US dollar (USD) liquidity considerations, pushing the euro (EUR) lower against the USD. Furthermore, an uneventful Governing Council meeting by the European Central Bank on Thursday (please see commentary below) failed to provide a trigger for a decisive market move. The EUR is trading at EUR/USD1.398 at the time of writing, down by 0.5% on the week. In a similar fashion, crude oil prices have come down from around US\$70 per barrel a week ago to the current level of US\$66. European equity securities markets reacted somewhat negatively to the US unemployment news; while the British FTSE100 and French CAC40 are virtually unchanged from last Friday, German DAX is 1.4% in the red. Nonetheless, concerns regarding a prolonged recession have not halted investor appetite for emerging market assets; the benchmark sovereign yield spread index EMBIG is currently at 439 basis points, 18 bps lower than last Friday.

## Euro zone interest rates on hold

The European Central Bank (ECB) left its benchmark interest rate unchanged at 1.0% following its July 2<sup>nd</sup> policy meeting. Despite the fact that annual inflation rates in the euro zone are expected to remain negative in the coming months (the 'flash estimate' for euro zone consumer price inflation in June dipped to -0.1% y/y), monetary authorities indicated that the current benchmark interest rate is "appropriate"; short-term price movements are not relevant for monetary policymaking. We expect the central bank to maintain its accommodative monetary policy stance in the months ahead, making every effort to ensure ample systemic liquidity. However, we do not anticipate further interest rate relief in view of recent comments from senior Governing Council members - most notably Bundesbank President Axel Weber. In terms of longer-term price stability, ECB President Jean-Claude Trichet emphasized that the recent liquidity measures implemented by the Eurosystem can be unwound quickly without excessive price pressures. While forward-looking indicators continue to point to the prospect of some stabilization in the months ahead, the ECB assesses that positive quarterly growth rates are expected by mid-2010. European Commission figures confirm national survey results showing a gradual upturn in business and consumer confidence across the region, although the improved tone was not evident among retailers, where some weakening in activity was evident in June. Nevertheless, one must always keep in mind Trichet's mantra that the Governing Council 'never pre-commits' on interest rates. Should the deflationary pressures that are now evident prove more severe than the policymakers anticipate, there is scope for a further modest downward adjustment, particularly in light of the ongoing deceleration in the growth in monetary aggregates; the rate of increase in M3 fell back to 3.7% y/y in May, the smallest advance since the euro was created.



### **Gradual turnaround in UK economy expected in the months ahead**

We believe that the worst of the bad news for the UK economy is over, but the recovery period will be slow and uneven. First quarter GDP fell 2.4% q/q, according to revised figures; with the exception of government spending, all major expenditure components registered substantial declines. Nevertheless, occasional positive signs are surfacing. Housing prices appear to be bottoming out, with one major mortgagor reporting the third increase in the past four months in June. Moreover, although unemployment is still on the rise, consumer sentiment is reportedly on the mend; however, optimists remain in a distinct minority, suggesting that any upturn in household spending will be muted. As a result, we do not expect the Bank of England - which is scheduled to meet on July 8<sup>th</sup>-9<sup>th</sup> - to begin to nudge its benchmark interest rate higher until 2010; the repo rate has been held at 0.5% since March.

### **Swedish central bank reduces benchmark interest rate to record low**

Faced with a weak economy, the Swedish central bank – the Riksbank – lowered the benchmark interest rate by another 25 basis points to a record low of 0.25% following a monetary policy meeting on July 2<sup>nd</sup>. To dampen a fall in production and employment, the repo rate has been reduced by 450 basis points since monetary policy easing got under way in October 2008. Policymakers noted that the key rate will likely remain at the current level until the second half of 2010; indeed, elevated concerns regarding the exposure of Swedish banks in the Baltic countries (Swedish banks account for almost 70% of the total foreign claims of US\$118 billion on Estonia, Latvia and Lithuania) will underline the Riksbank's willingness to maintain an accommodative policy stance for an extended period. Moreover, consumer price inflation has swung into negative territory in recent months; the consumer price index declined by 0.4% y/y in May. In addition to the rate reduction, the Riksbank is following the ECB's footsteps by extending 12-month fixed rate loans to domestic banks; authorities assess that this supplementary measure is necessary as the situation in the domestic financial market is not "completely normal" despite the accommodative monetary policy stance. The central bank expects the economy to contract by 5.4% this year; nevertheless, it notes that there have been "several signs" that economic recovery is approaching, helping output to re-

cover to a 1.4% growth in 2010. Indeed, retail sales rose for a second consecutive month in May, while confidence indices are also pointing to a gradual turnaround.

### **Icelandic monetary conditions on hold due to weak currency**

Icelandic authorities are taking a break from monetary easing; following the Monetary Policy Committee meeting on July 2<sup>nd</sup>, the central bank left the benchmark interest rate unchanged at 12%. Icelandic monetary conditions have eased by a total of 600 basis points since mid-March. The interest rate decision was justified by the fact that the Icelandic krona (ISK) has remained at a weak level in recent months (the ISK lost more than 48% against the US dollar last year and has depreciated a further 5% this year). Furthermore, partly due to the ISK weakness and recent increases in indirect taxes, inflationary pressures picked up in June to 12.2% y/y from 11.6% the month before, taking the real interest rate into a negative territory. In their official statement, policymakers remained concerned about maintaining the stability of the ISK; capital controls remain in place to support the currency, however, a gradual easing may be started towards the end of the year. Monetary authorities noted that the central bank is ready to raise interest rates again if the eventual removal of the capital restrictions adversely impacted the exchange rate. The monetary policy decision supported the ISK; it is currently trading at USD/ISK126.7, up by 0.7% on the week.

### **Turkish economy hit hard by challenging global conditions**

The Turkish economy is going through a difficult period as the international recession continues to adversely affect domestic activity. Output contracted by a marked 13.8% y/y in the first quarter of 2009 with the largest declines recorded in the wholesale and retail sector (-25.4% y/y) and in construction and manufacturing (-18.9% y/y and -18.5%, respectively). As the European Union is the main destination for Turkish exports, the deep recession in the EU's major economies is a key contributor to the over 30% y/y slump in Turkish exports in the first five months of the year. Nevertheless, there are some signs that the most severe period of retrenchment may be over, as indicated by improving confidence and easing year-over-year declines in production indicators. The Turkish lira (TRY) has remained relatively stable this week; it is trading at USD/TRY1.535 at the time of writing.

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