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Europe Weekly Outlook



- **Stable conditions in European debt and currency markets; euro in consolidation mode**
- **Euro zone enjoying another quarter of solid growth, led by Germany**
- **Hungarian and Polish monetary policies on hold; economic recovery on track**

Stable conditions in European debt and currency markets; euro in consolidation mode

European financial markets are in consolidation mode. The euro (EUR) seems to be trapped within a narrowly defined trading range between US\$1.25 and US\$1.30 as global market participants deviate their attention and investment focus on signs of softness in the US economic recovery. Interest rate differentials are, once again, playing a more influential role in dictating capital flows in foreign exchange markets. The fact that US monetary authorities are sending clear signals that they are not in a rush to accelerate the process of interest rate normalization is undermining demand for US debt and equity securities. Meanwhile, European sovereign debt markets have priced in another round of global risk aversion with clear distinction between the core and periphery. Indeed, both German and French bonds trade now at a negative spread versus US treasury bonds. Meanwhile, credit default swaps for sovereign bonds issued by the government of Greece are now trading at 934 basis points (bps), a major spread with Portugal – priced currently at 332 bps. On a positive note, there are no signs of renewed stress in short-term funding markets in either the US or Europe, clearly hinting that systemic risk is well contained for now.

Euro zone enjoying another quarter of solid growth, led by Germany

The euro zone is well entrenched on a much better than anticipated growth trajectory, at least for now. Despite the fact that the regional 'flash' purchasing managers' indices for both the manufacturing and services sectors dipped slightly in August, they remained firmly in expansionary territory, confirming our view that the economic momentum of the second quarter of 2010 is continuing into the current quarter. Similarly, new industrial orders in the euro zone jumped 2.5% m/m (and 22.6% y/y) in June, pointing to further activity in the coming months. The export-led recovery is beginning to spill-over to the domestic side; an improvement in euro zone consumer confidence in August is a welcome development for household spending prospects. Moreover, credit flows are recovering, with private loans in the euro zone increasing by 0.9% y/y in July, compared with a more moderate rate of 0.5% in June. Meanwhile, however, lending to non-financial firms remains below year earlier-levels. We expect the regional economy to expand by around 1½% in 2010. Yet, the outlook for 2011 remains more challenging as regional growth dynamics – particularly in the export sector – will be affected by an economic slowdown in the US and China. Euro area output will likely expand by just over 1% in 2011.

Tough austerity measures are adversely affecting economic performance in the euro zone periphery, highlighting wide regional growth differentials. Meanwhile, Germany – the largest economy in the currency area – continues to be the engine of growth with output expected to increase by around 3% this year; the closely followed IFO index on the country's business conditions surged in July to the highest level since July 2007, proving that the German economy continues to benefit from euro weakness and strong demand for the nation's exports. In addition, national accounts data show that private consumption recorded a first quarterly growth in the second quarter of the year (up 0.6% q/q) since the end of the recession, thereby easing some concerns regarding the dependence of the German recovery on the export sector.



Hungarian and Polish monetary policies on hold; economic recovery on track

The monetary easing cycle may have reached its end in **Hungary**. Following the monthly Monetary Council meeting on August 23rd, Hungarian monetary policymakers left the benchmark interest rate unchanged at 5.25% after reducing it on a monthly basis between July 2009 and April 2010. The Hungarian economy is showing signs of recovery; output expanded by 1.0% y/y in the second quarter of 2010 following a modest 0.1% growth in the January-March period. We expect activity to increase by ¾% this year, and to pick up to around 3% in 2011. The external sector is the key driver of economic performance, as domestic demand will likely remain soft until 2011. While subdued domestic conditions will continue to put downward pressures on prices, the weakness of the Hungarian forint (HUF) and rises in commodity and food prices are major risk factors for inflation remaining above the central bank's medium term target of 3.0%. Nevertheless, price pressures continued to ease in July, with the consumer price inflation rate declining to 4.0% y/y from 5.3% the month before. In the context of elevated investor risk aversion towards Hungarian assets, the policymakers highlighted the importance of fiscal prudence for investor confidence. Moreover, they noted that if inflation or elevated risk aversion failed to ease, a higher benchmark interest rate might be necessary. We expect that perceptions of risks related to the country will remain in place until the Hungarian government is able to resume talks with the International Monetary Fund (IMF) and the European Union; the negotiations stalled in mid-July due to disagreements regarding the country's fiscal path. The HUF has been facing modest selling pressures recently, trading at 284 vis-à-vis the euro; we expect the currency to close the year at 285 per euro.

Polish central bankers maintain a neutral policy stance, as the robustness of global economic recovery remains uncertain. Following the Monetary Policy Council meeting on August 24th-25th, the authorities left the reference rate unchanged at 3.50%, where it has been since June 2009. The economy is set to grow by around 3% in 2010 as both external and domestic demand are on the mend. Improving labour market conditions are providing support to private spending prospects; the unemployment rate decreased to 11.4% in July from 11.6% the month before while retail sales increased by 3.2% m/m and 3.9% y/y. The inflation outlook is promising, with the consumer price index increasing by 2.0% y/y in July, running below the central bank's target of 2.5%. Nevertheless, the policymakers assess that inflation may return to a gradual upward trend in the coming months due to pressures in food and energy prices as well as tax increases. The monetary authorities reiterated their view that fiscal tightening is important for macroeconomic stability as well as in order to meet the criteria for adopting the euro, which remains a priority for the Monetary Policy Council. Nevertheless, with parliamentary elections approaching (due in October 2011), aggressive fiscal consolidation is not likely. In July, the IMF approved Poland's request for a one-year successor arrangement under the unconditional Flexible Credit Line. The agreement – that Polish authorities intend to treat as precautionary – will provide a useful insurance against external risks, thereby supporting the Polish zloty (PLN). We expect the PLN, trading currently at 3.98 per euro, to close the year at 4.05 per euro.

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