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Europe Weekly Outlook



- **Greek concerns weigh on the euro until markets get distracted by other issues**
- **ECB and BoE leave interest rates on hold; quantitative easing suspended**
- **Dip in Swiss exports at end-2009 should be quickly reversed**
- **Key rate remains on hold in Norway; hikes in sight along with economic recovery**

Greek concerns weigh on the euro until markets get distracted by other issues

The euro (EUR) continues to depreciate versus the US dollar (USD) on mounting concerns regarding euro zone sovereign risk related to Greece's and, to some extent, Portugal's and Spain's public finances. Greece's fiscal deficit swelled to 12.7% of GDP last year and the government is planning to implement severe austerity measures – backed by the European Union – to bring government finances back towards euro zone limits; however, investors remain skeptical about its commitment to deficit reduction. Adverse investor sentiment stemming from peripheral euro zone countries' fiscal situations is punishing the EUR despite the fact that public finances of the euro zone as a whole are in much better shape than those of the US or the UK; according to OECD calculations, the euro zone general government deficit will be 6.7% of GDP in 2010 while that of the US and the UK are forecast to be 10.7% and 13.3% of GDP, respectively. The EUR has dropped by 1.9% on the week and 5.0% so far this year to US\$1.3605 as the lack of trend-reversing news is leading market participants to go with the flow and maintaining a EUR selling bias. Meanwhile, the slide of Greek bonds has halted; the yield of the 10-year Greek benchmark bond – 6.61% at the time of writing – has declined by 23 basis points (bps) on the week, while the spread over equivalent German bund has narrowed by 15 bps to 349 bps. Due to persistent downbeat sentiment, European equity securities markets remain in the red; the British FTSE100, German DAX and French CAC40 have dropped by 2.5-4.7% this week.

ECB and BoE leave interest rates on hold; quantitative easing suspended

The February 4th decisions by the European Central Bank (ECB) and the Bank of England (BoE) to leave their administered interest rates unchanged at 1.0% and 0.5%, respectively, took no one by surprise. There is still ample excess economic capacity in both the euro zone and the UK, credit flows to the private sector remain subdued - at best - and financial markets are coming under fresh strain as a result of concerns regarding fiscal sustainability.

In announcing the Governing Council's decision, ECB President Jean-Claude Trichet noted that the policymakers anticipated "moderate" economic growth in 2010 and that inflationary pressures would remain "low" over the medium term (his complete statement can be found on the ECB's website: <http://www.ecb.int/home/html/index.en.html>). Trichet also encouraged the banks to ensure availability of credit to the non-financial private sector "especially for those enterprises that do not have recourse to market-based financing". To this end, he offered reassurance that the ECB would "continue our enhanced credit support to the banking system". The Governing Council will revisit the issue of the phasing out of extraordinary liquidity measures next month.

As Trichet noted, inflationary pressures in the euro zone remain muted. The 'flash' estimate for the January year-on-year increase in the headline consumer price index was a modest 1.0%. Only a moderate upward creep on a month-on-month basis is evident further up the distribution



chain: the rate of increase in the producer price index has averaged 0.2% in the three months through December, leaving the end-2009 PPI 2.9% below the December 2008 level. Nevertheless, low inflation has not been offering any significant boost to consumer spending across the region. Retail sales have been moving sideways in recent months, closing off 2009 with no change (on a month-to-month basis); this left sales below the year-earlier level for a nineteenth consecutive month. While consumer sentiment has been slowly improving, the lack of job creation has put a significant crimp on income growth, with adverse implications for consumer spending power.

Inflation prospects in the United Kingdom are less favourable than in the euro zone - at least in the near-term. Nevertheless, the Monetary Policy Committee (MPC) sees no need to abandon its accommodative stance even though the headline consumer price inflation rate is already almost a full percentage point above the official medium-term target of 2% y/y - and is trending higher. In addition to holding the Bank Rate at 0.5%, the MPC also opted to make no further change to its asset purchase programme, electing to hold the limit at £200 billion, though the MPC also conceded that "credit conditions are likely to remain restrictive" (the complete statement can be found at the BoE's website: <http://www.bankofengland.co.uk>). Even in the UK, however, there are signs of a mild reactivation in credit flows, as net lending to individuals increased by £1.2 billion in December, the biggest advance in eight months. The improvement was entirely a result of a small uptick (£52 million) in net consumer credit - following five successive monthly declines.

Dip in Swiss exports at end-2009 should be quickly reversed

The Swiss economy is sharing in the global recovery in industrial activity. The purchasing managers' index for manufacturing has been in expansionary territory for the past five months, with an intensification of the trend evident in January. As a result, we believe that the reported 1.6% m/m decline in export volumes in December will prove to be a temporary phenomenon despite the constraining impact of Swiss franc appreciation vis-à-vis the euro. On balance, we expect foreign trade to offer a modest net boost to economic growth in 2010, reinforced by a mild recovery in private sector spending. Consumer

confidence has rebounded to a 7-quarter high, setting the stage for a moderate pickup in household spending.

Key rate remains on hold in Norway; hikes in sight along with economic recovery

Norwegian policymakers are taking a break from monetary tightening. Following Norges Bank's Executive Board meeting on February 3rd, the authorities opted to keep the key interest rate unchanged at 1.75%. The benchmark rate has been raised by 50 basis points since October 2009, when Norges Bank became the first central bank in Europe to start a monetary tightening cycle. We expect the authorities to continue to gradually raise the interest rate level in the coming months to near-2½% by mid-2010. In their official statement (please see: <http://www.norges-bank.no>), the policymakers reaffirmed their strategy of having the key rate within the 1¼-2¼% range until the March 24th board meeting when the new policy outlines - along with the next monetary policy report - will be published. Inflation remains below the central bank's 2.5% target, closing 2009 at 2.0% y/y.

The Norwegian monetary authorities noted that economic activity is rising, supported by increasing consumer spending and foreign shipments while petroleum investments may fail to reach levels previously anticipated. The Norwegian economy has weathered the global downturn relatively well thanks to its petroleum sector wealth and the authorities' firm monetary and fiscal policy response. After declining by around 1% in 2009, real GDP growth will likely reach around 2% this year. A low interest rate and inflation environment together with healthy labour market conditions (though elevated by historical standards, the unemployment rate was a relatively low 3.2% in November 2009), continue to support consumer spending; retail sales increased by 0.8% m/m and 3.9% y/y in December, while lending recorded 4.1% y/y growth. Perceptions of business conditions are showing improvement as well, as the Purchasing Managers' Index climbed to expansionary territory - to 50.1 - in January for the first time in six months. Meanwhile, however, industrial production was down by 0.5% m/m in December. Monetary tightening should provide support to the Norwegian krona (NOK) this year; we expect the NOK to appreciate from the current level of 8.21 per EUR to 7.9 by end-2010.

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