April 2008

Eurozone growth outlook: Remaining sources of support to fade in 2008

Key trends

- **Eurozone liquidity and funding spreads remain at elevated levels early in the second quarter.** But whereas impaired balance sheets have underpinned the tightening in bank lending standards in the US, tougher lending criteria in Europe appears largely the result of uncertainty over the potential economic impact of the market disruptions. Indeed, as more pessimistic growth expectations have been confounded in recent months, bank lending appears to have continued expanding at a sound pace.

- **Nevertheless, if not as disorderly as in the US (and perhaps lacking the same systemic threats), the repricing of risk has contributed to a tightening in Eurozone financial conditions.** To this end, along with the continuing rise of the euro, we still anticipate a hastening of the cyclical slowdown already evident across much of the region.

- **Indeed, economic performance has continued to diverge markedly across the four largest member states in early 2008.** In Italy, where there has been little significant structural reform to cushion against the rising euro, GDP growth appears to have stalled. In Spain, the earlier tightening in ECB policy and lender caution are continuing to rapidly deflate the construction boom and consumer confidence.

- **By contrast, earlier labour market reforms are helping to buttress German corporate competitiveness and profitability against the stronger euro,** with the resilience of German manufacturing in early 2008 most likely underpinned by continued growth in exports and business investment. In France, the trade sector has been less supportive of growth, but consumer spending has remained considerably stronger than in Germany. Nevertheless, as the year progresses, we expect a further slowing in both German and French GDP growth.

- **The current strength in German manufacturing partly reflects supply lags in filling strong emerging market demand for capital goods,** but with the rise in the euro and weakening domestic demand in developed economies ultimately set to crimp export growth. Accelerating wages growth will also curb further improvements in German unit labour costs and profitability, which together with slower export growth suggests an eventual moderation in German business investment.

- **At the broader Eurozone level, there is little scope for any 'rebalancing' towards household spending,** reflecting the impact of rising food and energy prices, cooling housing markets and tighter credit. However, Germany will be unlucky to suffer a worsening in consumer spending after such a poor performance in 2007 (and where housing excesses also have been much less evident). Indeed, in contrast to generally upbeat confidence in the industrial sectors, sentiment among consumers and in the services sectors has plunged in early 2008. We expect euro area GDP growth to slow to just 1.7% in 2008, before strengthening to 1.9% in 2009.

- **Together with the strength of the euro, the weakening in domestic demand growth should curb 'second-round' effects from the sharp rise in inflation in late 2007 and early 2008.** Indeed, core inflation still remains well below 2.0%. As long as commodity prices continue to increase rapidly and German wage negotiations remain in progress, however, we doubt the ECB is prepared to signal an easier policy stance. Accordingly, any cut in the refinancing rate appears unlikely before June 2008, while the absence of systemic threats or major economic imbalances (and only a moderate rise in the output gap) should limit the cumulative cut to 50 points.

Tom Taylor
Head of Economics - International
(613) 8641 3475
Tom_Taylor@national.com.au

Simon Calder
Economist – International
(613) 8641 4034
Simon_Calder@national.com.au

Tighter lending criteria – but bank balance sheets are in better shape than in the US

As in the United States, the re-pricing of financial risk has been manifest in a significant tightening in Eurozone bank lending standards (refer to Charts 1 and 2). In contrast to the US, however, there has been little evidence of any retreat in aggregate bank lending to the private non-financial sector. Although more moderate than in the final quarter of 2007, the value of new lending continued to expand at a healthy rate in January (with annual growth in the value of credit outstanding unchanged at 11.1%).

There is little doubt the tightening in US bank lending standards is a reflection of the significant constraints on US bank balance sheets, and a deeply impaired capacity to expand new assets. Losses and write-downs on sub-prime and other asset-backed securities have significantly squeezed bank capital, while at the same time many institutions have been forced to re-intermediate conduits and special investment vehicles. Frozen wholesale funding markets (a function of heightened counterparty risk) have contributed to liquidity hoarding among banks and difficulties in funding ordinary lending activities.

These developments are also clearly evident in the euro area banking system. However, the impact appears to have been partly cushioned by the comparatively smaller role of securities markets in European financial intermediation. Relatively smaller exposure to toxic securities (and a commensurately larger exposure to loans typically carried at face value) has helped limit the size of write-downs and the squeeze on capital. And while euro area wholesale funding markets have been subject to similar concerns over perceived counterparty risk (Chart 3), by accepting a broader range of collateral (and at longer terms) the ECB appears to have been more effective in meeting the banking system's liquidity needs.

Chart 1

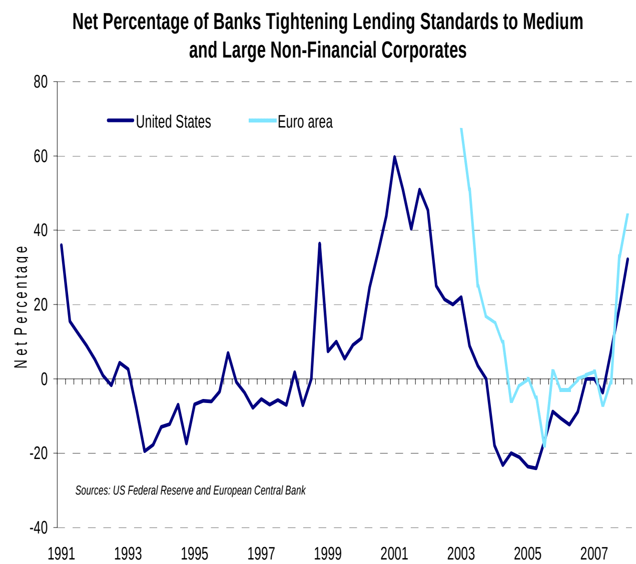
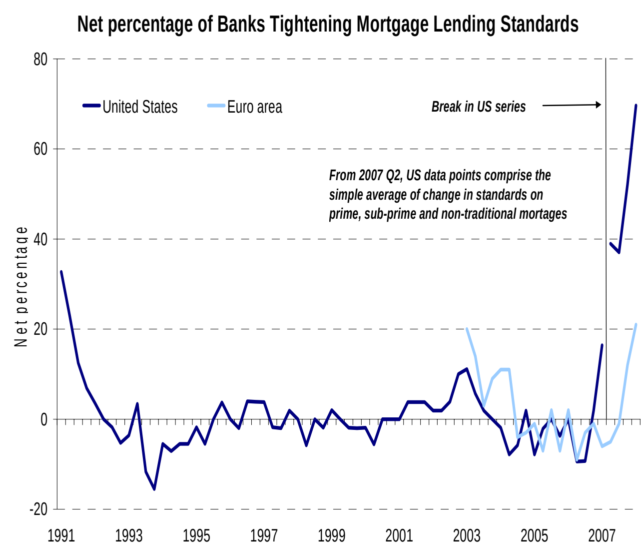
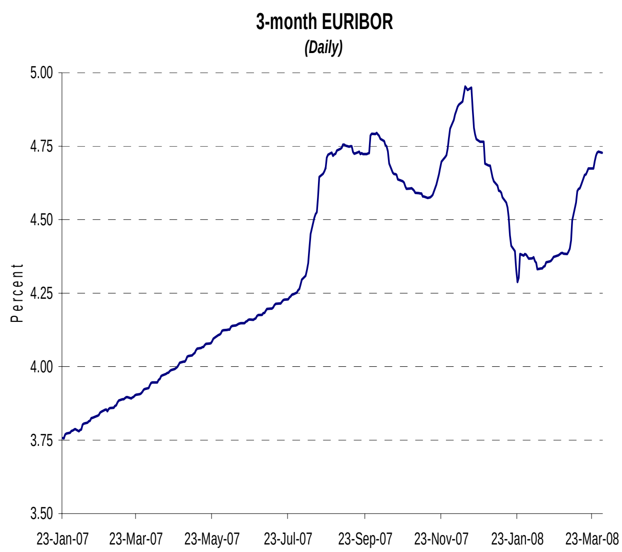


Chart 2



Accordingly, and again in contrast to the US, balance sheet considerations may not be the major factor driving the tightening in euro area bank lending standards. Rather, the prospective tightening in credit availability appears also to reflect general uncertainty over the extent and duration of financial market problems, and uncertainty over possible

Chart 3



effects on the broader economic outlook. Indeed, the ECB's January Bank Lending Survey suggested the economic, housing and specific industry/firm outlooks were more important factors accounting for the tightening in standards on loans to both households and enterprises. It follows that as more pessimistic expectations have been confounded in recent months, most institutions have been disposed to continue expanding new lending in early 2008.

Nevertheless, it is clear the repricing of risk has resulted in a tightening of euro area financial conditions. While there may not be the same threat of a broad-based contraction in new lending as in the US, restrictions on supply appear likely to contribute to some eventual slowing in euro area bank credit growth. To be sure, the Bank Lending Survey also suggested credit conditions on loans to enterprises are likely to be tightened further in the three months to April (the fulfilment of which seems increasingly likely in the wake of continuing problems in global credit markets).

Indeed, European banks arguably have been slower to disclose the full extent of exposure to US sub-prime and other assets. The most recent $US19 billion and $US4 billion write-offs at UBS and Deutsche Bank, respectively, have emerged some eight months after credit market problems escalated in August 2007. Furthermore, while these larger banks appear to be having little difficulty in attracting capital injections, nevertheless the flatter euro area yield curve will be less helpful in rebuilding profitability over the medium-term. And, although the Bank Lending Survey suggested credit for M&A (and LBO) activities will bear the brunt of the tightening in standards, lending criteria for investment and inventories have not escaped unscathed.

Even abstracting from the risk of a more adverse impact, however, we expect the tightening in financial conditions to hasten (an otherwise orderly) cyclical slowdown in Eurozone GDP growth. Indeed, in addition to growing constraints on supply, the same Bank lending Survey revealed a further significant weakening in demand for business and household credit in early 2008.

Labour costs and house prices account for much of the growing divergence among members in early 2008

Correspondingly, surveys of business and consumer sentiment also point to a growing divergence in momentum across the largest four members in the first quarter (Chart 4), with output growth appearing to weaken markedly in Italy and Spain. Furthermore, while confidence and growth are holding up better in Germany and France, they appear to be underpinned partly by lingering momentum from the strong upturn between mid-2005 and mid-2007, along with substantial benefits of earlier labour market reforms (in the instance of Germany).

More specifically, GDP growth in Germany in late 2007/early 2008 remains largely underpinned by business investment, but which in turn is a component of spending that typically lags the broader economic cycle. Expenditure on machinery and equipment jumped by 3.4% in the fourth quarter

Chart 4

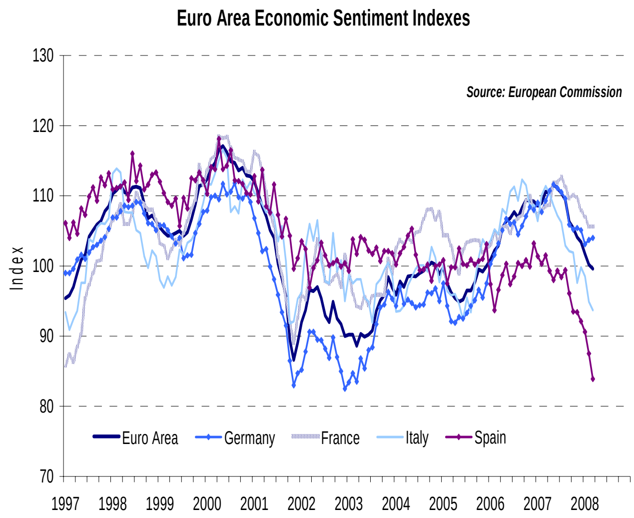
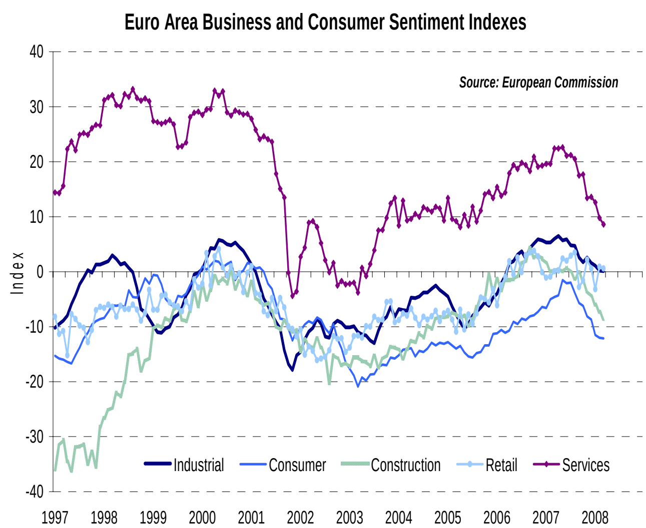


Chart 5



(accounting for all of the 0.3% increase in German GDP in the quarter), while growth over year-earlier levels also increased from 7.3% to 8.6%. The continuing resilience in domestic manufacturing orders and industrial confidence suggests German business equipment demand remains firm in early 2008, reflecting the continuing high levels of capacity utilisation and a corporate profit share of GDP at the highest level since unification (underpinned in turn by earlier labour market reforms and falling real unit labour costs – see Charts 6 and 7). These factors are likely to remain supportive of investment for much of 2008.

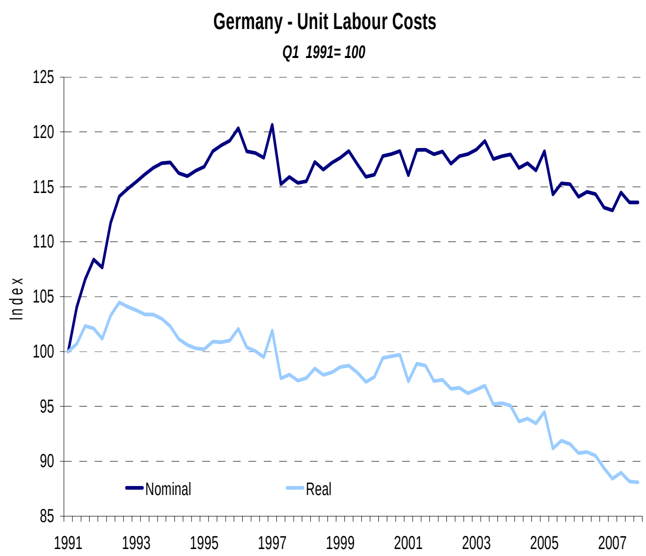
Nevertheless, investment growth is expected to eventually moderate:

- The steady tightening in the labour market appears set to finally feed through into faster wages growth in 2008 (already foreshadowed in the early rounds of wage negotiations), crimping corporate margin expansion;
- The expiry of earlier depreciation allowances;
- Tougher access at the margin to external sources of finance;
- Further weakening in German export demand and an ensuing slippage in domestic capacity utilisation rates.

German export volumes rose a strong 1.3% in the fourth quarter of 2007, while the resilience of manufacturing surveys and offshore orders growth suggest a further solid rise in the first quarter of 2008. However, despite the combination of Germany's strong comparative advantage in the production of capital goods, continuing strong infrastructure demand in large emerging economies, persistently long lags in filling global capital goods orders, and the boost to competitiveness from falling unit labour costs, German export growth is clearly slowing. The increase on year-earlier levels almost halved to 4.3%in the final quarter of 2007 (from 8.4% the previous quarter), and smallest increase since 2003.

To be sure, the more recent slowdown follows an impressive 12.9% increase in 2006, which in turn partly reflected the relatively low base of the previous year. Nevertheless, the

Chart 6



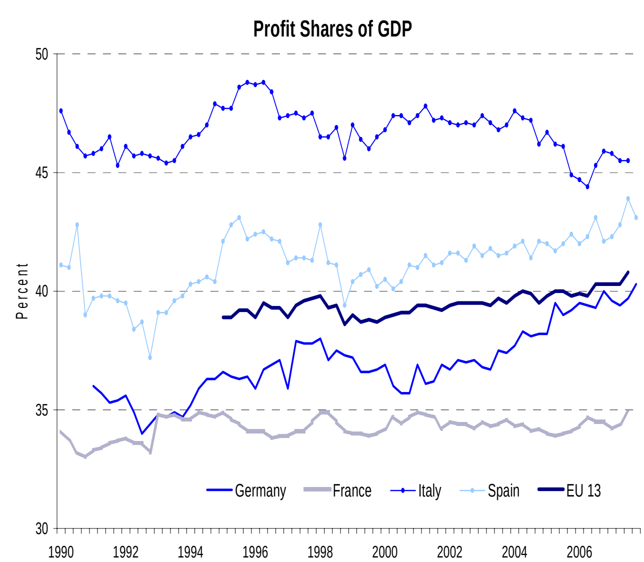
moderation in growth also most likely reflects the steady strengthening of the euro. With further subsequent appreciation, the ensuing loss of market share to US exporters (and other competitors that peg exchange rates to the US dollar), and a sharp slowing in domestic demand growth in the US, the UK and other EU member countries, we expect German export to slow further in 2008. Indeed, while largely reflecting exchange rate effects, growth in the value of German merchandise exports to major emerging markets has slowed sharply in the second half of 2007.

It is also difficult to envisage German consumers assuming the slack from slower export and investment growth, and a subsequent 'rebalancing' in German growth in 2008 (although, more positively, it is equally hard to imagine consumption growth worsening after such a weak outcome in 2007). While real retail sales jumped by 1.6% in January, the rise followed three consecutive declines in late 2007. Indeed, despite a 1.5% increase in employment over the course of 2007, private final consumption expenditure fell by 0.8% in the final quarter of 2007 (which, abstracting from the increase in VAT in early 2007, was the largest fall since 2001). Indeed, the level of German household consumption expenditure has still to return to the levels immediately prevailing before the increase in the VAT.

While recent settlements and proposed changes to minimum wage arrangements point to a strengthening in nominal wages growth in 2008, the boost to household income is likely to be at least partly offset by a moderation in employment growth (employment growth peaked in mid-2007). There also appears little prospect of immediate relief from rising food and energy costs, which have both increased at an annualised rate of around 8.0% in the three months to February.

Similar to Germany, GDP growth slowed in France in the final quarter of 2007, although subsequent business surveys suggest underlying growth may be continuing to moderate a little more quickly than in Germany early in the new year. To be sure, in the absence of sharp declines in unit labour costs and without the same concentration in capital goods production, French export growth has lagged German exports through much of the current cycle. However, with stronger growth in disposable incomes, and despite some

Chart 7

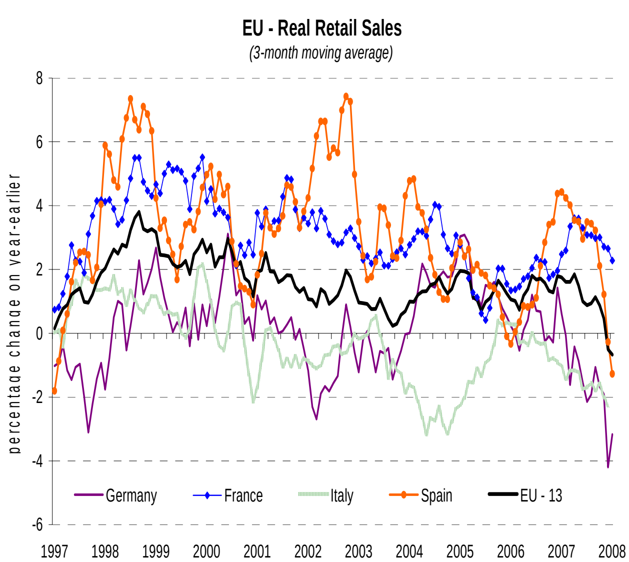


cooling in the housing market, French consumption expenditure proved significantly stronger through most of 2007.

Together, this mix of export and consumption demand underpinned sustained growth in French business investment over 2007. More recently, while rising food and energy costs appear to have contributed to a weakening in retail sales growth in January (and, along with slower export growth, an accompanying slippage in manufacturing activity), nevertheless industrial capacity utilisation rates remain close to cyclical highs in early 2008. Like Germany, high factory operating rates should help place a reasonable floor under business investment and domestic demand growth over the course of the year. Indeed, the INSEE monthly business survey revealed a slight rebound in the industrial economic climate in March (to the highest level since December).

However, very different stories appear to be unfolding in Italy and Spain. Although the release of Italian GDP data for the final quarter of 2007 has been delayed until May, growth appeared to stall or even turn negative late last

Chart 8



year. Industrial production fell by 2.0% in the quarter, although subsequently recovering slightly in January (rising by 1.3% in the month). More recently, the European Commission's economic sentiment indicator for Italy fell in February to the lowest level since mid-2005, while the unemployment rate has been drifting higher since mid-2007.

Italy's international competitiveness continues to be seriously undermined by the rapid appreciation of the euro, while consumer spending growth has wilted in the face of continued weak population growth and a further sharp slowing in employment growth. The level of real retail sales in December 2007 was the lowest since the series was published in 1990.

Rather than a significant deterioration in competitiveness, slowing Spanish growth largely reflects the continued unwinding of the earlier residential property boom. GDP expanded by a relatively healthy 0.8% in the fourth quarter of 2007 (up from 0.7% the previous quarter). Although exports fell by 0.7% in the quarter, the decline followed a 3.8% jump previously (growth over the year remaining at a reasonable 5.1%). Indeed, like Germany and France, the strength in the quarter was largely attributable to continuing strong gains in gross fixed investment (which increased by 0.9%). The 0.3% increase in consumption expenditure, by contrast, was the weakest since 2003.

Subsequently, the EC's Economic Sentiment indicator for Spain has plunged in the early months of 2008. The decline in sentiment has been accompanied by a 1.1% fall in real retail sales in January, to the lowest level since July 2006. By contrast, industrial production rose by 1.3% in January, suggesting some resilience in exports and business investment. Nevertheless, the combination of the strong euro, further likely weakness in consumer spending, and the accompanying deterioration in sentiment, all suggest Spanish growth has already shifted to a markedly lower gear in early 2008.

But the ECB is bound by growing uncertainty over the near-term profile of inflation

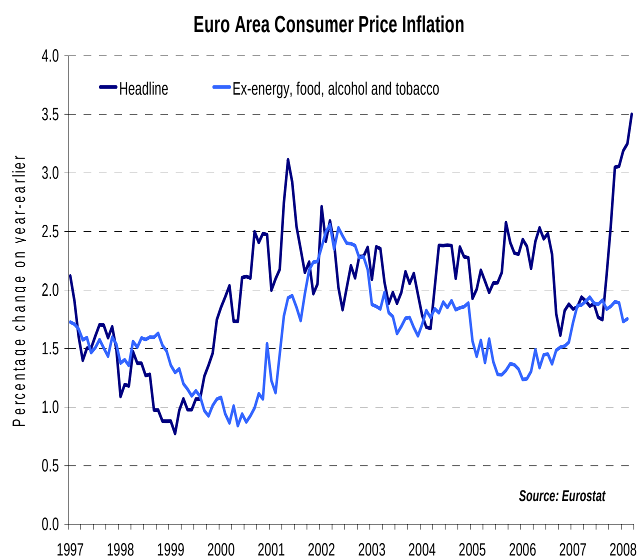
In terms of Eurozone monetary policy, the ECB can take comfort from the fact that heightened risk aversion in credit markets has contributed to a tightening in financial conditions (in a period of rising cost and inflation pressures), but in a much more orderly manner than in the US (and without the same systemic threats). Indeed, outside Germany and, to a lesser extent France, growth appears to be slowing quite markedly.

Moreover, within the two largest member states, GDP growth still hinges primarily on business investment and exports (reflected in above-average levels of business confidence in the manufacturing and construction sectors). As growth in these areas of spending continues to moderate, however, there appears little prospect of any significant rebalancing towards household demand in 2008. Indeed, in contrast to the relatively high levels of confidence in euro area manufacturing sectors, sentiment is continuing to weaken sharply among consumers and in the services sectors. The tightening in credit availability appears to be compounding the impact of earlier policy tightening on overheated housing markets, while discretionary spending growth has been further eroded by recent sharp increases in food and energy prices.

Together with the recent gains in the euro, the expected broad-based weakening in euro area domestic demand growth should help to curb the potential for 'second-round' effects of recent sharp increases in headline inflation. Indeed, although headline inflation has surged from below 2.0% as recently as August, to 3.5% in March, the core CPI still remains comfortably below 2.0%. As the current round of food and energy price increases eventually feeds through, there is still a strong probability headline inflation will eventually fall back below 2.0%.

However, as long as commodity prices continue to increase rapidly (leading to ongoing uncertainty over the likely peak in headline inflation), and while German wage negotiations remain in progress, we doubt the ECB is prepared to signal an easier policy stance. Accordingly, any cut in the refinancing rate appears unlikely before June 2008. Moreover, in the absence of systemic threats or major economic imbalances (the largest house price increases were confined to smaller member states), and with the prospect of only a moderate renewed widening in the Eurozone output gap, we continue to believe the cumulative cut will be in the order of 50 points.

Chart 9



Macroeconomic, Industry & Markets Research

Australia

Alan Oster	Group Chief Economist	+(61 3) 8641 3464
Jacqui Brand	Personal Assistant	+(61 3) 8641 4179
Jeff Oughton	Head of Economics – Australia & Industry	+(61 3) 8641 3469
John Sharma	Economist – Australia	+(61 3) 8641 4304
Dean Pearson	Senior Economist – Industry & Commodities	+(61 3) 8641 3474
Gerard Burg	Economist – Minerals & Energy	+(61 3) 8641 3984
Vacant	Economist – Property, Business Services, TMTs	+(61 3) 8641 3473
Ian Gordon	Economist – Transport, Healthcare, Retailing	+(61 3) 8641 3472
Brien McDonald	Economist – Manufacturing	+(61 3) 8641 3672
Frank Drum	Economist – Agribusiness	+(61 3) 8641 3442
Tom Taylor	Head of Economist – International	+(61 3) 8641 3475
Robert De Iure	Economist – Country Risk	+(61 3) 8641 3445
Carolyn Fraser	Economist – International	+(61 3) 8641 3694
Simon Calder	Economist – International	+(61 3) 8641 3848
Robert Henderson	Chief Economist Markets – Australia	+(61 2) 9237 1836
David de Garis	Senior Economist – Markets	+(61 2) 9237 1180
Spiros Papadopoulos	Senior Economist – Markets	+(61 3) 8641 0978

New Zealand

Tony Alexander	Chief Economist – BNZ	+(64 4) 474 6744
Stephen Toplis	Head of BNZ Market Economist	+(64 4) 474 6905
Craig Ebert	Senior Economist, Markets	+(64 4) 474 6799
Mark Walton	Market Economist	+(64 4) 474 6923

London

Tom Vosa	Head of Market Economics – UK	+(44 20) 7710 1573
David Tinsley	Market Economist - Europe	+(44 20) 7710 2434