



Macroeconomics



Industry & Commodity



Markets

Eurozone Economic Outlook – August 2006

- Eurozone GDP rose by 0.9% growth in the June quarter to be 2.4% higher over the year, which is the strongest rate recorded in several years.
- Near-term prospects remain solid for the Eurozone, but we expect that quarterly growth will gradually slow from here.
- Demand has been boosted in 2006, due to the FIFA World Cup and ahead of the 3% increase to the German VAT, but this will see growth weaker in 2007.
- The stronger Euro and weakening world will affect exports and the domestic economy does not have enough momentum to withstand this slowdown indefinitely.
- The ECB intends to raise rates further still, and could go too far: risking a bust in some housing markets.
- Government debt levels continue to rise and debt servicing costs are escalating, making it difficult to meet the Stability and Growth Pact and stimulate growth through fiscal easing.
- We expect growth will average 2½% in 2006 and 1¾% in 2007.

As good as it gets in 2006.

The flash estimate for Eurozone GDP was up by 0.9% in the June quarter (compared to a 0.6% rise in March) and 2.4% in the past year.

Table 1: Eurozone Big-3 GDP flash estimates

	GDP growth (volume, sa)		
	March	June	YoY
Eurozone	0.6	0.9	2.4
Germany	0.7	0.9	2.4
France	0.5	1.2	2.6
Italy	0.7	0.5	1.5

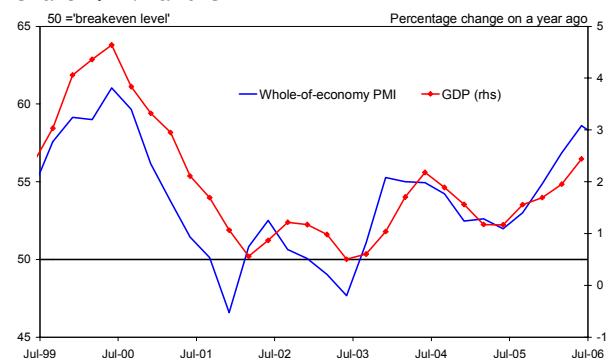
This result is above our own expectations (0.7%), but not overly surprising – we had pointed to upside risk in the short term, following strong survey releases. The quarter was boosted by the FIFA World Cup.

We expect that this will be the strongest quarterly rise during this upturn, as the July survey data have all flattened off, if not edged down slightly. Nevertheless,

they remain at high levels and so the September quarter is still likely to be solid.

Germans are likely to bring demand into the December quarter of this year, ahead of the 3% increase to their VAT in early 2007, which will support growth in that quarter.

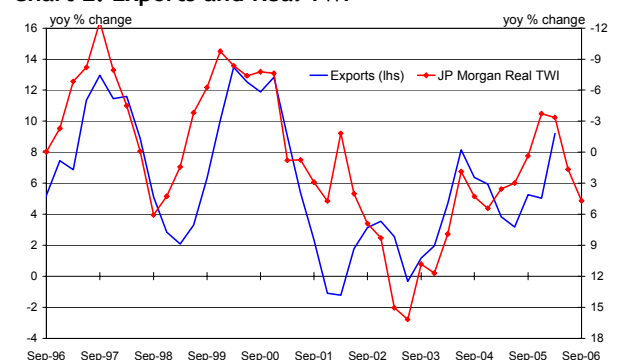
Chart 1: PMI and GDP



The stronger Euro and weakening world will begin to dampen exports growth.

The Euro/USD exchange rate has risen by around 9% from its low at the end of last year, underpinning a rise of almost 5% in the real trade-weighted exchange rate. This has largely reversed the 12% depreciation of the Euro/USD over 2005 and taken the real exchange rate back to near its record high level.

Chart 2: Exports and Real TWI



The impetus to exports from the Euro's earlier depreciation is thus expected to wane and indeed its recent appreciation will begin to drag down export growth. This effect has already been observed in the export orders component of the PMI surveys since

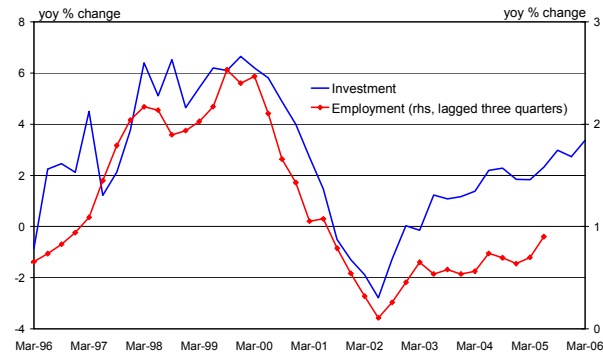
March. The expected US slowdown will also make it difficult for exporters in 2007.

The domestic economy has only limited momentum.

Investment growth is one of the most positive aspects to the current upturn, and this will continue for a bit longer. Stronger exports are a significant factor behind this growth and so it will slow eventually.

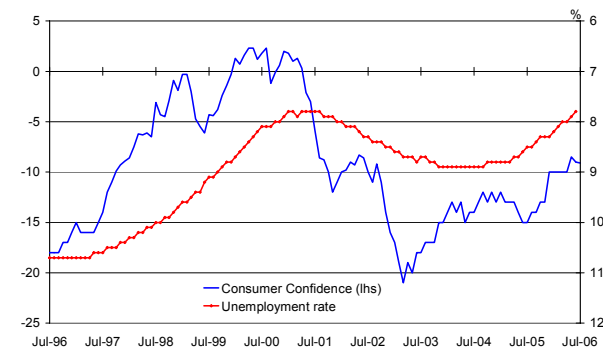
Employment growth has improved with this investment upturn, albeit at a modest pace compared to the historical relationship.

Chart 3: Investment and employment



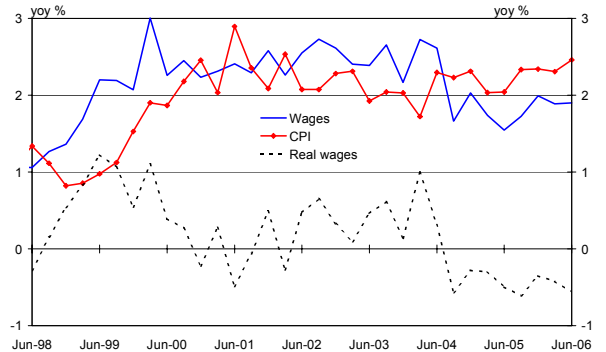
The unemployment rate was 7.8% in July, providing evidence that employment growth has continued over recent months. The improved labour market has helped along consumer sentiment

Chart 4: Unemployment rate and sentiment



However, the improved labour market has not translated to real wages, which have been flat or falling, dragging down real income and more or less constraining consumption to grow in line with employment.

Chart 5: Real wages, wages and inflation

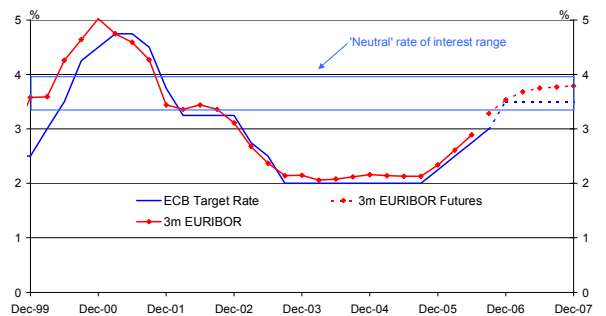


Wages are growing at modest rates of around 2-2¼%, contained by competitive pressure from Eastern Europe and Asia. And this is being more than offset by inflation of around 2½% due largely to the rising price of oil.

But the ECB is expected to ‘normalise’ rate to ‘neutral’ and fiscal policy is constrained.

The ECB is expected to remove excess stimulus from monetary policy. It has already raised official interest rates from 2% in late 2005 to 3% presently.

Chart 5: Interest rates



Looking forward, we expect this ‘normalisation’ process to continue with a 25bps rises in the months of October and December to reach 3.5% – in line with most estimates of ‘neutral’. This will dampen credit growth from the current strong rates and slow the economy at some stage.

Much of the credit growth has been directed to housing purchases, so house price growth can be expected to slow. And this will see wealth effects weaken household spending.

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