

# Manufacturing continues to cushion the slowdown across the Eurozone

## Key trends

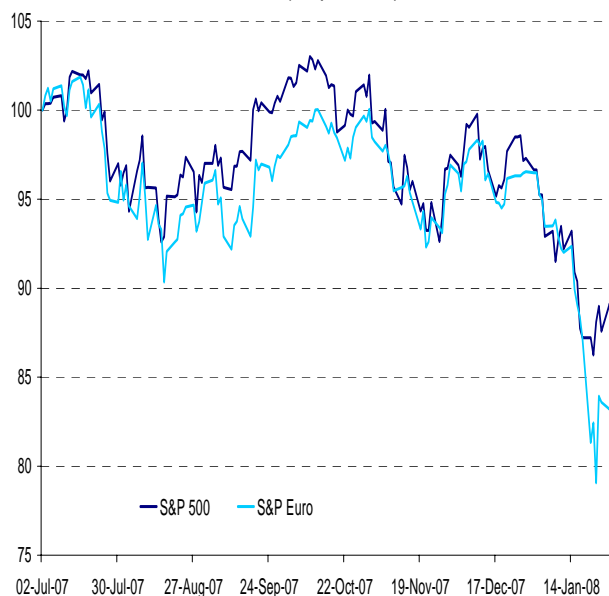
- **In contrast to the US - where economic growth downshifted in December - recent Eurozone data and surveys point to a more orderly retreat in the pace of activity.** However, the resilience in some of the broader surveys masks a significant divergence across components of final demand, sectors and countries. Accordingly, we are revising down our forecast of 2008 Eurozone GDP growth to 1.7%, from 2.1% previously.

- **Despite relatively strong employment and household income growth, consumer spending appears to have weakened sharply in the final quarter of 2007.** In addition to the continuing pressures and uncertainties in financial markets, the abrupt weakening in household consumption may be partly related to the sharp rise in food and energy prices and labour strikes across several large member countries.

- **Nevertheless, in contrast to services sector activity, industrial production appears to have held up relatively well around the turn of the year** (reflected in continued high levels of capacity utilisation and pointing to resilience in both export and business investment growth). Further out, however, there seems little doubt export growth is poised to slow substantially in 2008, and combined with a further moderation in consumer spending (driven partly by growing pockets of house price weakness), contribute to an eventual softening in business investment.

- **Moreover, while euro area inter-bank rates have fallen sharply in early 2008 (the region largely escaping the spike that occurred in the US in mid-January),** there is a risk that unexpected new strains in European financial markets could threaten a more intense process of banking system re-intermediation, leading to further uncertainty in the corporate and household sectors, and to a broader deterioration in confidence. In the absence of such pressures, however, the ECB is unlikely to contemplate an easing until it is certain inflation is headed back below 2.0%, an outcome we believe unlikely before late 2008.

**US and Euro Area Equity Markets**  
(2 July 2007 = 100)



European equity markets have fallen much further in January than US share price indexes, suggesting investors are increasingly losing confidence Europe will 'decouple' from the abrupt deceleration in growth now unfolding in the US. We have steadily maintained Europe is not immune to the global repricing of risk. As in the US, the European financial, business and household sectors are confronting steadily more difficult access to credit, while slowing US and UK import demand, the surge in the euro, the recent sharp rises in food and energy prices (partly related to the depreciation of the US dollar) and lagged effects of earlier policy tightening (and specifically the impact on house prices), all comprise additional headwinds to euro area growth.

Concurrently, however, we have consistently argued the risks of recession in the Eurozone are much less than in the US. Firstly, it is clear the credit crunch has hit the euro area at a much more favourable point in the economic cycle. Moreover, prior to the eruption of credit market problems in late July 2007, euro area monetary policy was broadly neutral or even slightly accommodative (compared with a moderately restrictive stance in the US). Indeed, GDP growth was well above trend, and corporate profit growth was also considerably stronger than in the US (providing a strong internal source of funding for new investment and helping to support relatively solid employment growth and steady declines in unemployment).

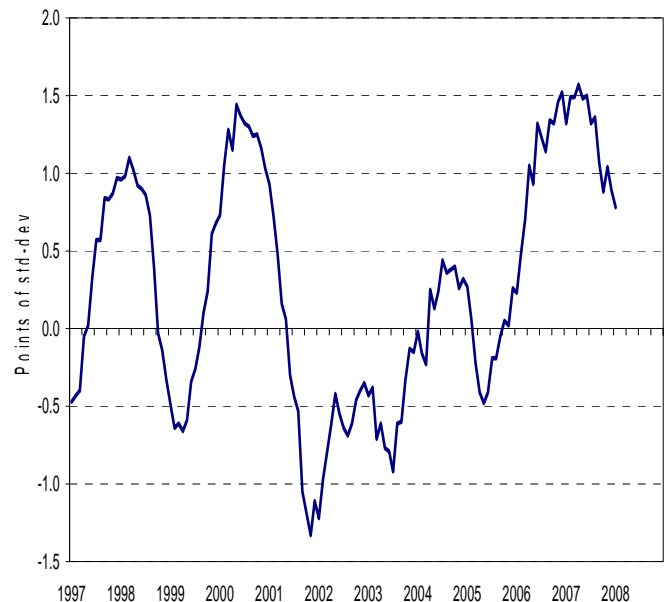
In addition, euro area households have avoided many of the borrowing and spending excesses that accompanied the earlier compression in risk premia, and which otherwise may have resulted in instances of significant over-investment (such as in housing). Germany (by far the Eurozone's largest economy) has effectively missed out on much of the recent increase in euro area house prices, while the rises in other economies were essentially

underpinned by easier monetary policy rather than the relaxation of mortgage lending standards (as in the US).

As such, while we have revised down our forecasts of EU GDP growth in 2008, at 1.7% forecast growth is still stronger than in the US (we now project growth of just 1.3% in the US in the current year).

To be sure, in contrast to the US - where economic growth clearly downshifted in December (possibly heralding the commencement of a shallow contraction in activity) - recent Eurozone data and surveys point to a much more orderly moderation in EU growth. Among the broadest survey indicators, the European Commission's Business Climate Indicator fell in January for the second consecutive month and to the lowest level since March 2006. However, the index remains at relatively high levels (higher still than the peak of the previous cycle in 2004). The Commission's Economic Sentiment Indicator (a composite of confidence indexes among consumers and the various producer sectors) continues to deteriorate at a somewhat faster rate, falling in January for the eighth consecutive month.

**Euro Area Business Climate Indicator**



Like the Business Climate Index, however, the sentiment indicator remains above the long-term average (and consistent with Eurozone GDP growth of around trend).

Nevertheless, the relatively high levels of confidence in January mask a significant divergence across sectors and member countries, and across the components of final demand. Consumer spending growth appears to have weakened sharply in the final quarter of 2007, with real retail sales falling 0.7% in October and 0.5% in November. Despite relatively strong employment and household income growth, the fall in spending follows a sustained plunge in consumer confidence since August 2007 (the EC’s consumer confidence indicator falling in five of the six months to January and to below the long term average level).

The weakening in household consumption growth also appears to account for much of the deterioration in the broader service sector surveys. More specifically, the Commission’s index of services sector confidence has been below the long-term average level since November, and

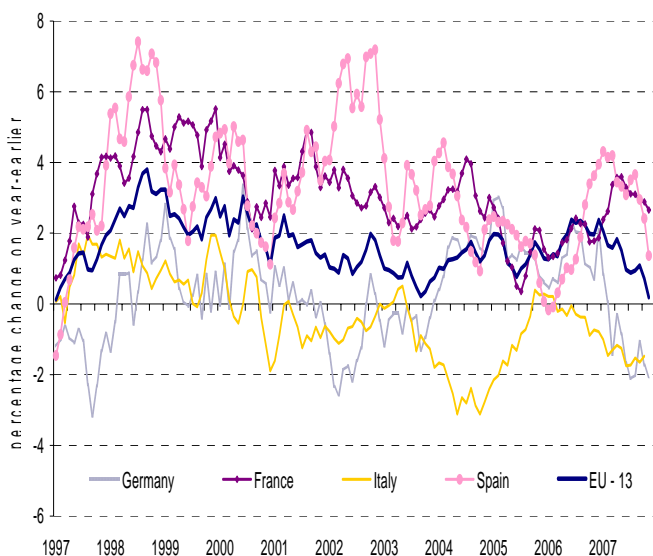
in January was at the lowest level since late 2005. At just 52.0 in January, the Services PMI was also at the lowest level in over four years (suggesting only marginal growth in services sector output in early 2008). Indeed, after a surprisingly strong rebound in the three months to December, the index of retail sector confidence slumped in January (to the lowest level since August 2007), and is now only just above the long-term average level.

In addition to the continuing pressures and uncertainties in financial markets, the abrupt weakening in Eurozone consumer spending growth may be partly related to the sharp rise in food and energy prices and labour strikes across several large member countries. Indeed, food and energy prices increased by 0.6% in October and by a further 2.2% in November. Accordingly, with the recent easing in oil prices and an eventual return by striking workers, there appears some scope for a moderate strengthening in consumer spending growth in the first quarter of 2008.

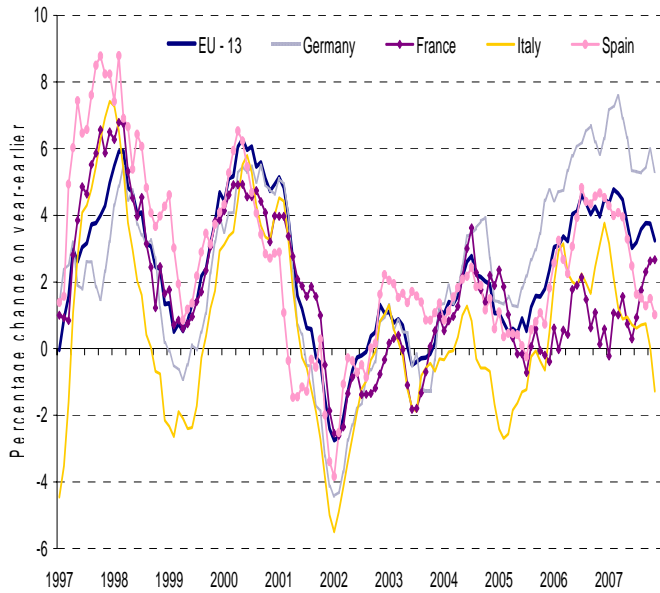
Moreover, and in contrast to services sector activity, industrial production growth appears to have held up relatively well in the final months of 2007 (in turn pointing to lingering resilience in both export and business investment growth). Eurozone industrial production fell by 0.6% in November (including declines in the four largest member economies), following a 0.7% rise in October. Production subsequently increased by just 0.3% in the three months to November, compared with a 1.0% increase in the three months to August.

However, manufacturing orders appear to have recovered slightly in recent months. Although Eurozone industrial new orders increased by just 0.1% in the three months to October, German orders have since jumped by 1.2% in the three months to November (comprising a 0.7% increase in domestic orders and a 1.8% increase in export orders). The

**EU - Real Retail Sales**  
(3-month moving average)



**Eurozone Industrial Production**  
(3-month moving average)



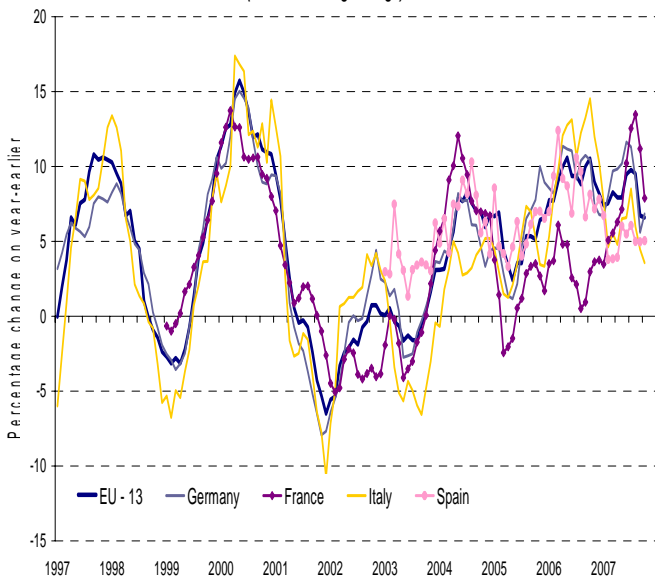
rise in orders appears also to have underpinned ensuing improvements in confidence in the manufacturing sector.

The Commission's industrial confidence index has mirrored

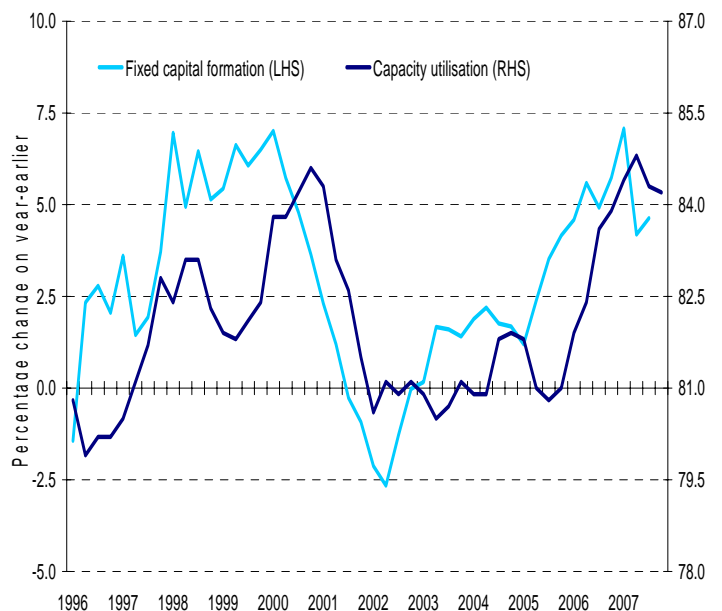
the broader Business Climate Indicator in recent months, falling in January for the second consecutive month. However, the index remains significantly above the long term average and continues to suggest annual growth of around 3.0%. In addition, the Manufacturing PMI rose 0.4 of a point in January to 53.9, slightly higher than the average of the final quarter of 2007. Germany's IFO index also increased slightly in January, underpinned by a rise in the expectations component to the highest level since August 2007.

While export volume growth to the US and UK has most likely weakened in recent months, shipments to Eastern Europe, Russia and other emerging economies appear to remain relatively strong. Similarly, a high capacity utilisation rate (which in the fourth quarter was only marginally lower than the cyclical highs of mid- 2007), together with relatively high levels of corporate profitability, suggest sustained business investment growth in late 2007 and early 2008. In total, we estimate GDP growth slowed to 0.4% in the fourth quarter, around half the rate of the increase in the third quarter.

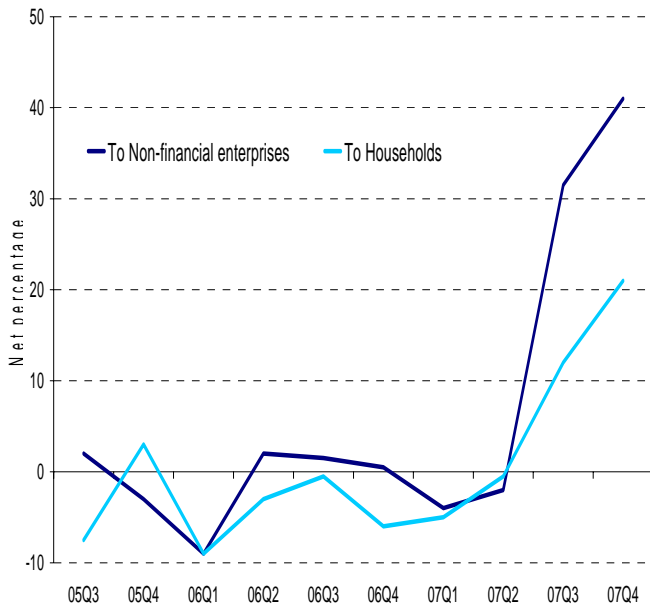
**Eurozone Industrial New Orders**  
(3-month moving average)



**Eurozone Capacity Utilisation and Investment**

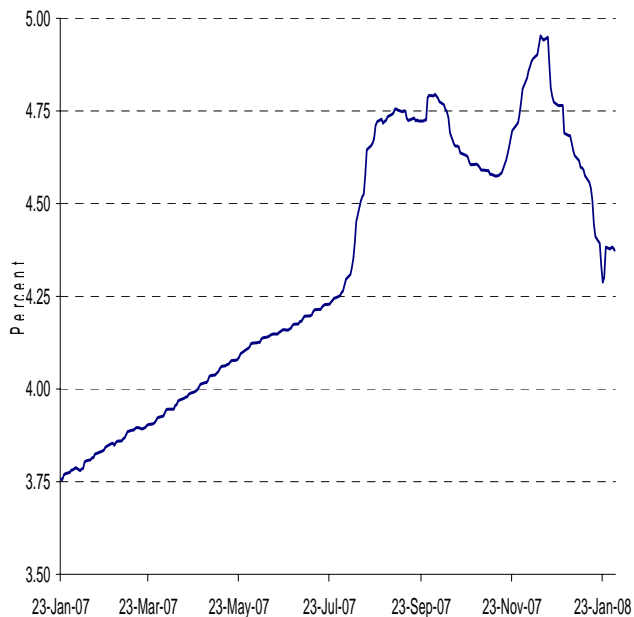


**Net Percentage of EU Banks Tightening Credit Standards**



Nevertheless, there seems little doubt Eurozone export growth is poised to slow materially in 2008, and combined with some underlying moderation in consumer spending

**3-month EURIBOR**



growth, contribute to a slowing in business investment growth. Moreover, while euro area liquidity spreads have continued to narrow in early 2008 (the region largely escaping the spike that occurred in the US in mid-January), the risk remains that unexpected new strains in European financial markets could threaten a more intense process of banking re-intermediation and deleveraging, leading to further uncertainty in the corporate and household sectors, and to a broader downward spiral in confidence. Indeed, the ECB's survey of loan officers indicated a further tightening in loan standards for both households and corporates in late 2007.

In contrast to the US, where aggressive policy action by the Federal Reserve should help foster confidence of a moderate recovery in the second half of 2008, the recent sharp rise in Eurozone inflation has precluded the European Central Bank from implementing a similar response. In the event confidence fades of a turnaround over the course of 2008, there is a real risk Eurozone sentiment and activity could deteriorate at a much faster rate in the first half of the year. In these circumstances, providing oil prices stabilise and in the event of moderate German wage settlements for 2008, there is a growing risk the ECB could ease policy in the second quarter. At present, we expect the Bank to reduce the refinancing rate from 4.0% to 3.5% by mid-2009.

## 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
Vacant	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 lure	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
----------	-------------------------------	---------------------

DISCLAIMER: [While care has been taken in preparing this material.] National Australia Bank Limited (ABN 12 004 044 937) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this document ("Information") are accurate, reliable, complete or current. The Information has been prepared for dissemination to professional investors for information purposes only and any statements as to past performance do not represent future performance. The Information does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. In all cases, anyone proposing to rely on or use the Information should independently verify and check the accuracy, completeness, reliability and suitability of the Information and should obtain independent and specific advice from appropriate professionals or experts.

To the extent permissible by law, the National shall not be liable for any errors, omissions, defects or misrepresentations in the Information or for any loss or damage suffered by persons who use or rely on such Information (including by reasons of negligence, negligent misstatement or otherwise). If any law prohibits the exclusion of such liability, the National limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable. The National, its affiliates and employees may hold a position or act as a price maker in the financial instruments of any issuer discussed within this document or act as an underwriter, placement agent, adviser or lender to such issuer."

UK Disclaimer: So far as the law and the FSA Rules allow, National Australia Bank Limited ("the Bank") disclaims any warranty or representation as to the accuracy or reliability of the information and statements in this document. The Bank will not be liable (whether in negligence or otherwise) for any loss or damage suffered from relying on this document. This document does not purport to contain all relevant information. Recipients should not rely on its contents but should make their own assessment and seek professional advice relevant to their circumstances. The Bank may have proprietary positions in the products described in this document. This document is for information purposes only, is not intended as an offer or solicitation nor is it the intention of the Bank to create legal relations on the basis of the information contained in it. No part of this document may be reproduced without the prior permission of the Bank. This document is intended for Investment Professionals (as such term is defined in The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001) and should not be passed to any other person who would be defined as a private customer by the rules of the Financial Services Authority ("FSA") in the UK or to any person who may not have experience of such matters. Issued by National Australia Bank Limited A.C.N. 004 044 937, 88 Wood Street, London EC2V 7QQ. Registered in England BR1924. Head Office: 500 Bourke Street, Melbourne, Victoria. Incorporated with limited liability in the state of Victoria, Australia. Regulated by the FSA in the UK.

U.S. DISCLAIMER: This information has been prepared by National Australia Bank or one of its affiliates or subsidiaries (collectively, "NAB"). If it is distributed in the United States, such distribution is by National Australia Capital Markets, LLC (NACM) which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to NACM, 200 Park Avenue, New York, NY 10166 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of NACM or NAB and/or its affiliates may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.