

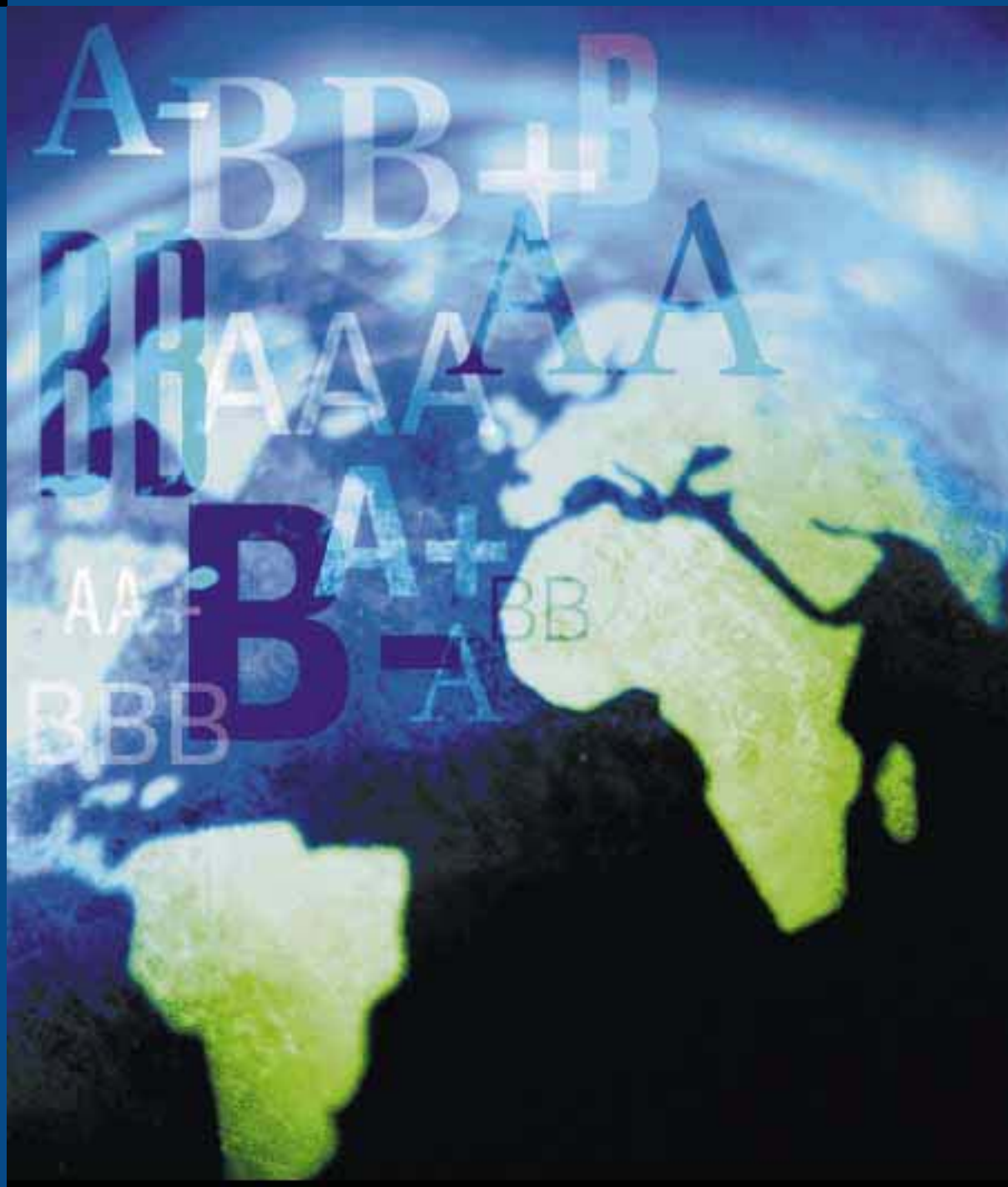
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European Economic Forecast: Recovery On Track, But Exchange Rate A Risk

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European Economic Forecast: Recovery On Track, But Exchange Rate A Risk

LONDON (Standard & Poor's) Jan. 30, 2006--The flow of new economic data continues to point to strengthening activity across the Eurozone. The long-awaited recovery appears to have more momentum than in 2005. Instead of merely relying on net exports, GDP growth is now driven by stronger business investment and a (still fragile) pickup in consumer demand.

In Germany, the ZEW Index of Economic Sentiment continued to climb in January, hitting 71.0 after an impressive surge to 61.6 in December (numbers above 50.0 represent confidence that economic conditions will improve over the coming year). The ongoing improvement is reportedly due to stronger manufacturing orders and the prospect of robust export gains in the coming months. The German Federal Statistical Office published its full-year GDP growth estimates for 2005, suggesting a 1.1% increase (in working-day adjusted terms), as had been widely forecast. Business investment was up 4% last year, while consumer demand stagnated and construction investment fell 3.6%.

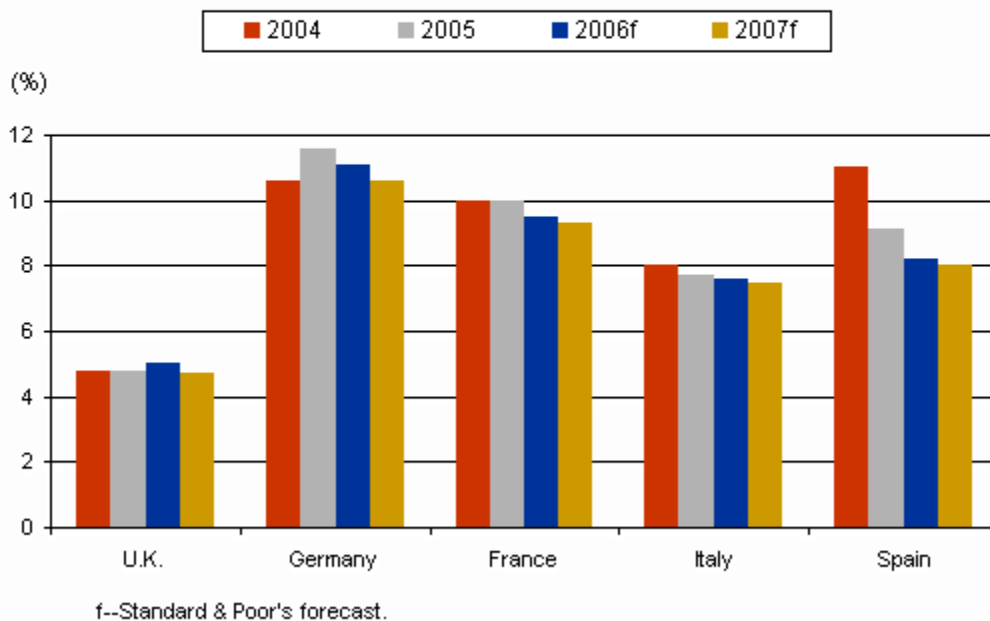
What was more interesting in the Statistical Office's release, however, was its analysis of how total value added was allocated between employers (corporations) and employees. The share of employees was 67% in 2005, down from 72% in 2000. Net national income rose 1.6% in nominal terms, but the gain primarily benefited the corporate sector: entrepreneurial income rose 6% last year (11.7% in 2004), while labor compensation fell by 0.5%. Since the beginning of 2001, German national income has increased 8.1%, corporate income has risen 29.0% and employee compensation dropped by 0.1%. Little wonder that consumer demand has been so weak in Germany in recent years, especially if one keeps in mind that, in addition to falling incomes, German households actually increased their savings rate against the backdrop of higher unemployment. Before they started to invest late last year, German companies used their additional cash to rebuild their balance sheets and repay their debt. Consequently, the rise in recent years in the corporate savings rate should now be followed by a stabilization, and eventually by a fresh drop, providing more support to the recovery in capital formation.



In France, data for November 2005 showed that consumer spending increased 1.1% in one month (3.2% year-on-year), beating market expectations. Real incomes rose 0.6% in the fourth quarter of 2005, while the savings rate came down to 15.2% (15.3% previously). The economic recovery in France remains fragile, however, as it still relies primarily on consumer demand. Net exports made a negative contribution to growth in 2005 despite the more competitive exchange rate of the euro. As of November 2005, the trade deficit amounted to €22.83 billion, as against €5.96 billion over the same period in 2004.

In the Eurozone as a whole, one of the most encouraging developments in the past few months has been the stabilization, or in certain cases the beginning of a decline, in unemployment rates. In Italy, the jobless rate was down 0.3% from a year before in the third quarter of 2005, at 7.1%. In France, the unemployment rate fell for the third straight month in November, dipping to 9.6%. The number of jobless was down by 102,000 from a year earlier, at 2.63 million. Total German unemployment decreased by 110,000 in December to come in at 4.64 million, contributing to an unemployment rate of 11.2%, down from the 11.4% reported in November. Although this overall improvement in the single currency zone still appears modest, we expect unemployment rates to decline somewhat in 2006, for the first time in several years, as chart 1 shows.

Chart 1
European Unemployment Rates
(2004-2007)



In the meantime, the European Central Bank (ECB) increased its key interest rate by 25 basis points (bps) to 2.25% in December, as expected. The ECB confirmed in various statements that it remained concerned about the medium-term prospects for headline inflation and about the persistently strong growth in money supply, as expressed by the broad monetary aggregate M3 (cash plus current and deposit accounts). Central banks watchers will note with interest that by contrast, references to headline inflation and to M3 have almost entirely disappeared from the U.S. Federal Reserve analysis, which is instead more concerned about core inflation (and announced that it will soon stop publishing statistics about M3 altogether). We expect the ECB to increase its key rate at least twice more in 2006, to 2.75%.



Bond yields should only partly reflect higher short term rates, as we think that the markets are likely to become increasingly concerned about a fresh slowdown in economic activity in 2007. We expect 10-year Eurozone sovereign bond yields to peak at around 3.8% in the next 12 months.

Overall, our growth forecast for the Eurozone remains little change from our previous forecast report in November 2005:

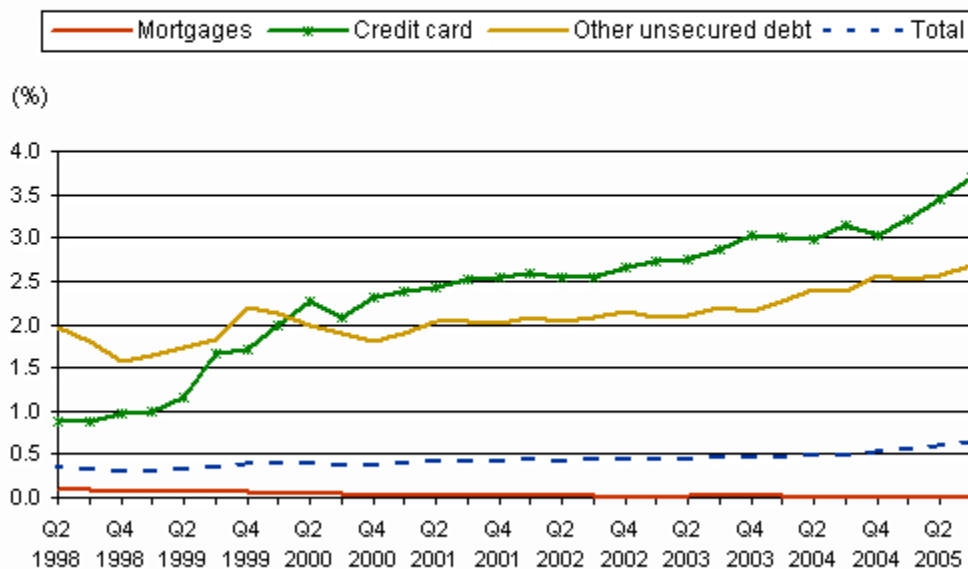
- Germany's real GDP should grow by 1.6% in 2006, before slowing to 0.9% in 2007: consumer demand should grow very little next year after the government increases the VAT rate to 19% from 16%.
- France's GDP growth is likely to hover around 2% in 2006 and 2007, essentially supported by a steady growth in consumer demand and a pickup in business investment.
- Italy will enjoy a mild recovery this year from near-zero growth in 2005, expanding by 1.3% this year and 1.0% in 2007.
- By contrast, Spanish growth should continue at a good clip in 2006, despite growing concerns about the widening current account deficit, as it continues to be supported by strong immigration flows (450,000 per year on average over the period 2000-2004, and 640,000 in 2004 alone) and strong income growth (more than 6% in nominal terms). The Spanish housing market has shown signs of an initial slowdown, but is expected to remain very buoyant in the next 18 months. We expect Spain's real GDP to grow 3.1% in 2006, and 2.6% in 2007.

In the U.K., meanwhile, the economy will continue to recover gradually after last year's slowdown, when GDP is estimated to have grown a modest 1.7% compared with 3.2% in 2004. Slackening job creation in the public and service sectors alongside sustained layoffs in manufacturing have led to a steady increase in unemployment, which stood at 1.49 million at the end of 2005, corresponding to an International Labor Organization (ILO) definition jobless rate of 4.9%. Yet, labor market conditions remain very sound from an historical perspective, with the unemployment rate about one-half its level during the last recession in the early 1990s and well below its peak of 3.3 million in the mid-1980s.

Furthermore, the U.K.'s housing market has started to recover from its mid-2005 trough. According to Halifax PLC, prices grew by 5.1% year-on-year in December 2005, which was the fastest rate since May, thanks primarily to a much stronger London market. In line with the economic slowdown, there has been deterioration in U.K. household creditworthiness, as illustrated by the increase in write-offs on lending to households (see chart 2, and also commentary article "European Consumer Credit Outlook: Household Debt To Stabilize In 2006," published on RatingsDirect, Standard & Poor's Web-based credit analysis system, on Jan. 23, 2006).



Chart 2
One-Year Write-Off Rates On U.K. Household Loans
(1998-2005)



Source: Bank of England Financial Stability Review, December 2005.

Yet, as noted by the Bank of England in its latest Financial Stability Review (December 2005), the risks associated with banks' secured lending remains very low by historical standards, as do mortgage arrears. The rate of loss on unsecured lending, particularly on credit cards, has increased throughout 2005. The current credit card write-off rate (3.7% in September 2005) is about three-quarters of the level of its equivalent in the U.S. This deterioration has not been seen across the board, however, but is concentrated among specific groups of customers at each bank who appear to have overborrowed and managed their debt poorly. Standard & Poor's expects to see persistent increases in charge-offs on these portfolios in 2006--given continued pressure on disposable incomes--as well as slower lending growth. The credit card businesses will continue to be important contributors of profit, however, given the high margins on the banks' overall books.

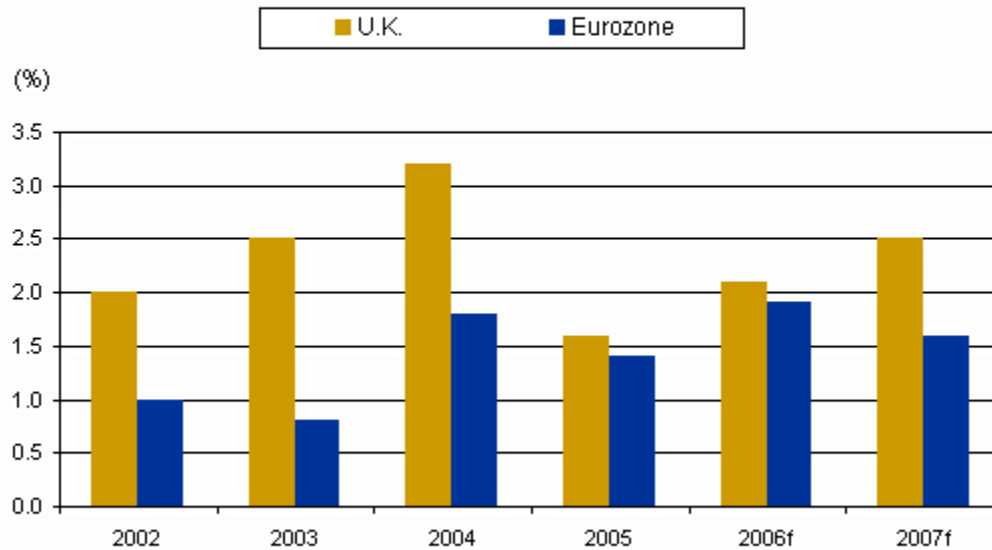
We think there is a 60% chance that the Bank of England will cut its interest rate one more time, by 25 bps by the second quarter of 2006, to 4.25%. Overall, we expect the U.K. economy to return gradually to a growth path of around 2% this year, and 2.5% in 2007. The U.K. would be particularly exposed to a slowdown in the U.S. economy next year, as 15% of British exports head to the U.S. (compared with 8.7% of German exports, for example). Yet, one should bear in mind that if the U.K. real GDP growth reaches 2% this year, it will still exceed that of the Eurozone (see chart 3).



Chart 3

Real GDP Growth

(2002-2007)



f--Standard & Poor's forecast.

The U.S. Dollar Exchange Rate Is A Significant Risk

When reflecting on what we just presented regarding our baseline forecast, the recovery in the Eurozone and the U.K. seems pretty much on track for 2006, but more uncertain for 2007, primarily because of reservations about the outlook for consumer demand. One aggravating factor is that most European governments have decided to postpone further fiscal tightening until 2007, in the hope that by the end of 2006, their respective economies will be enjoying sufficient tailwinds to make the belt-tightening less painful. This is the case in the U.K., in Germany, in France (where the government has announced new measures to reduce the national debt from 2007), or in Italy where much will depend on the results of the national elections later this year. Yet, these scenarios assume slightly lower oil prices, with many forecasters expecting a price per barrel of around \$55 on average in the next 18 months, and a mild weakening of the U.S. dollar against the euro. In what follows, we will concentrate on the dollar outlook.

How important is the interest rate differential?

The consensus view on the outlook for the U.S. dollar can be summarized as follows: financial markets have been focusing primarily on the interest rate differential between the U.S. and Europe in 2005, as the Federal Reserve was tightening while the ECB was staying put (until December). Once investors become convinced that the Fed has reached the end of its tightening cycle--most likely in the first or second quarter of 2006--they will turn their attention once again toward the growing American current account deficit and the dollar will start to weaken again.

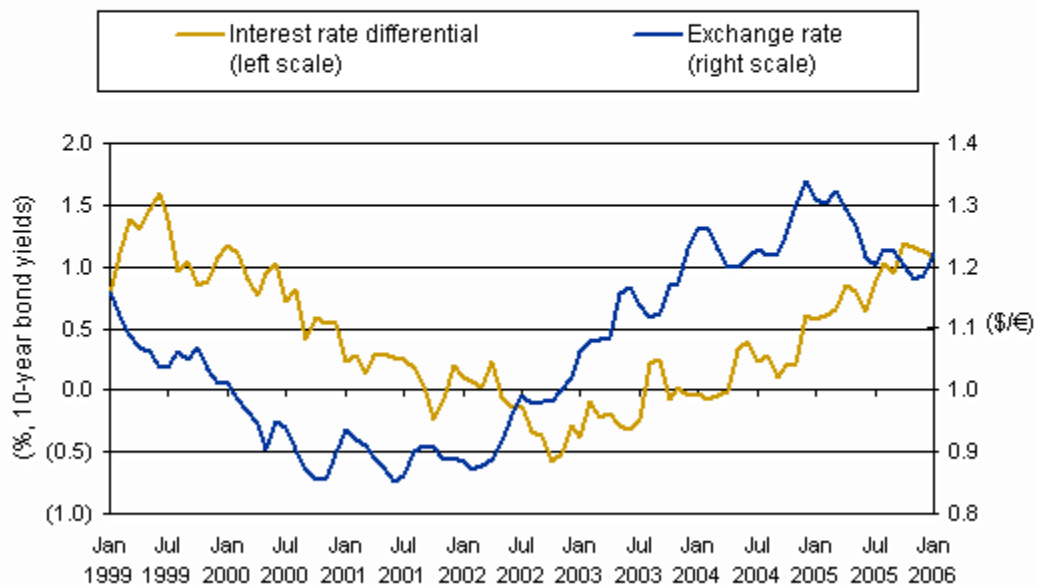


One problem with that scenario is that although it should make sense theoretically, it is not that easy to find an immediate correlation between interest rate differentials and the dollar-euro exchange rate (see chart 4).

Chart 4

Interest And Exchange Rate Correlations

(Monthly, 1999-2006)



In fact, the differential between U.S. and European long-term rates started to rise from January 2003 onward but the dollar continued to weaken till the end of 2004. One could add that there were special circumstances in 2005 that supported the dollar, such as the repatriation flows triggered by the Homeland Investment Act, as well as a big jump in the demand for dollar assets from the OPEC countries recycling windfall surpluses.

The thorny question of current account sustainability

Let us now consider the other side of the rationale, namely the growing current account deficit. The U.S. current account deficit increased from \$668 billion in 2004 to an annual rate of \$790 billion in the first three quarters of 2005, and is expected to move even higher this year. That corresponds to 6.4% of U.S. GDP, which is clearly unsustainable according to most observers.

But why exactly is it unsustainable? In the early days of the Bretton Woods financial system, current account deficits had to be settled in gold. Today, by contrast, they can be financed by selling all manner of assets: equities, bonds, and real estate. As long as the value of those assets rises faster than the deficit, the latter can be sustained. This is precisely where the problem lies. There is no question that foreign investors--central banks and private entities--bid up U.S. assets aggressively in the last few years. After the bursting of the internet bubble, U.S. housing markets took their turn in providing a major boost to consumer wealth and the economy. Today, the S&P 500 index is no longer that far from its highs of earlier in the current decade.



What is therefore unsustainable is the continuous double-digit increases in asset prices, if only because at some point the gap between asset price inflation and the rise in goods and services prices will cause a major imbalance in the economy (pushing up consumer price inflation). In other words, in the long run asset prices cannot grow faster than the economy as a whole. This is what makes the U.S. current account deficit (and consequently the European and Asian surpluses) unsustainable.

As asset price inflation slows (and it has already started to, according to Standard & Poor's), so should the growth in the current account deficit. This is where another problem appears. A major reduction in the deficit would require at the same time both weaker domestic demand and a more competitive real effective exchange rate (to stimulate exports and penalize imports). The way foreign exchange markets are currently structured, such an adjustment of the effective exchange rate of the dollar seems very hard to achieve. Indeed, under what is often called the "Bretton Woods II" system, a majority of the Asian currencies, starting of course with the Chinese renminbi, are pegged to the dollar exchange rate or have a quasi-fixed exchange rate with the U.S. currency (often called a "dirty float", for example, the Indian rupee).

Will Europe take the strain of adjustment?

The aggressive Chinese support of the U.S. currency in recent years (China's foreign exchange reserves grew by nearly \$200 billion in 2004, and were up another \$160 billion in the first nine months of 2005) was aimed at preventing the U.S. currency from depreciating further, which would thereby have put upward pressure on the renminbi and depressed Chinese exports. Conversely, when it comes to the European currencies, the dollar exchange rate is determined by the markets rather than the authorities. A recent article in the Financial Times was arguing, in summary, that the trade-weighted value of the dollar must fall by at least 30% to shrink the U.S. trade deficit to a sustainable level of 3% of GDP (see note 1 at end of article). The problem is that unless one assumes a major reform in the way foreign exchange markets operate, it is unlikely that the undervalued Asian currencies will revalue by anything close to 30% in the near future. So it is not impossible to imagine that as a consequence, the bulk of the readjustment will affect the euro.

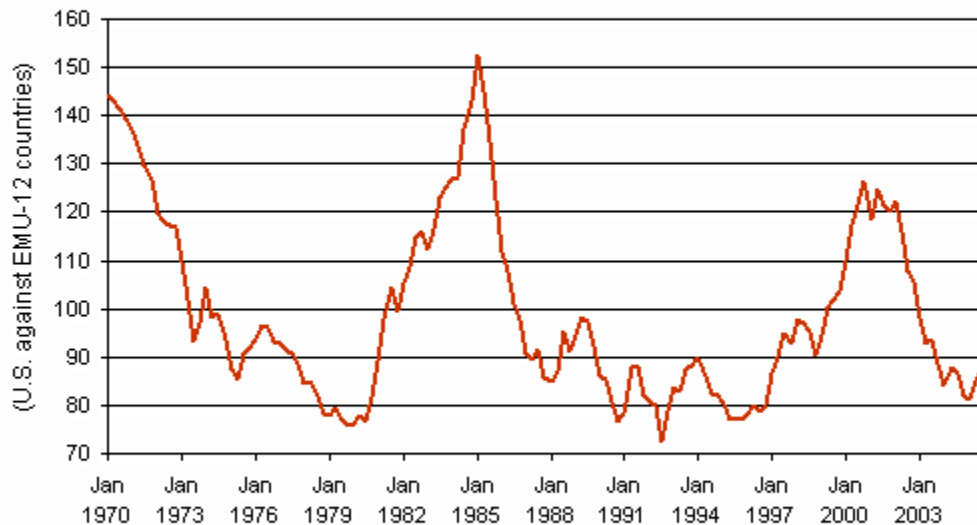
Chart 5 documents the wide swings in the U.S. dollar real effective exchange rate against the euro. In 2005, the dollar appreciated by about 11% in real terms, after a decline of more than 60% since 2001. In the mid-1980s, when the U.S. current account deficit was approaching 4% of GDP, a fall of the same magnitude took place.



Chart 5

Real Effective Exchange Rate

(1970-2005)



Nominal exchange rates deflated by unit labor costs in the total economies, average 1980-2004=100. Source: European Commission.

A hard landing scenario for the U.S. dollar exchange rate against the European currencies is therefore a real risk. Too fast a depreciation of the dollar, caused by a self-fulfilling crisis of confidence on the markets, would very likely lead to a rise in U.S. interest rates. By contrast, the ECB would not have much room for maneuver to soften the euro exchange rate, given the low level of Eurozone interest rates. The Bank also essentially showed "benign neglect" in the previous episode of dollar weakening in 2003-2004. In turn, higher interest rates would hurt American housing markets and cause the U.S. economy to slow down even more (thereby further damaging European exports).

Nevertheless, the likelihood of such a dramatic scenario remains low in the coming two years for at least one important reason: the absence of a credible alternative to the U.S. currency for international transactions. Certainly, central banks and large global investors will over time continue to diversify their portfolio holdings away from the dollar and in favor of the euro, among other currencies. Yet, this trend is mostly driven by long-term diversification considerations, not by a sudden lack of confidence in the greenback. Still, precisely because foreign exchange markets cannot currently reflect in full (and therefore correct over time) the global trade imbalances, this poses a major risk to the U.S. dollar outlook vis-à-vis free-floating currencies.

Notes

- 1) "Why Uncle Sam's bonanza might not be all that it seems," Martin Feldstein, Financial Times, Jan. 10, 2006.



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