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European Economics

A Shift in the Growth Landscape?

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Overview

		GDP				
		2005	2006	2007	2008e	2009e
North America						
	US	2.9	2.8	2.0	1.4	0.6
	Canada	2.9	3.1	2.7	1.0	1.8
Already in or forecasted to be in recession	EU-15	1.8	3.0	2.7	1.3	1.0
	EMU	1.8	2.9	2.7	1.3	1.0
	Austria	2.0	3.3	3.1	2.1	1.3
	Belgium	2.0	2.9	2.8	1.7	1.1
	→ Denmark	2.5	3.9	1.7	0.0	1.0
	Finland	2.9	5.1	4.4	2.3	2.0
	France	1.9	2.4	2.1	1.0	1.0
	Germany*	0.8	2.9	2.5	2.0	1.0
	Greece	3.8	4.2	4.0	3.1	1.8
	→ Ireland	5.9	5.7	5.2	0.2	1.8
	Italy	0.7	1.9	1.4	0.1	0.8
	Netherlands	2.0	3.4	3.5	2.3	1.3
	Norway	2.1	2.5	3.7	2.7	2.1
	Portugal	1.3	1.9	1.9	0.8	1.0
	Spain	3.6	3.9	3.8	1.5	0.5
	Sweden	3.3	4.1	2.9	1.4	1.3
Switzerland	2.4	3.2	3.1	1.7	1.3	
UK	1.8	2.9	3.1	1.3	1.3	

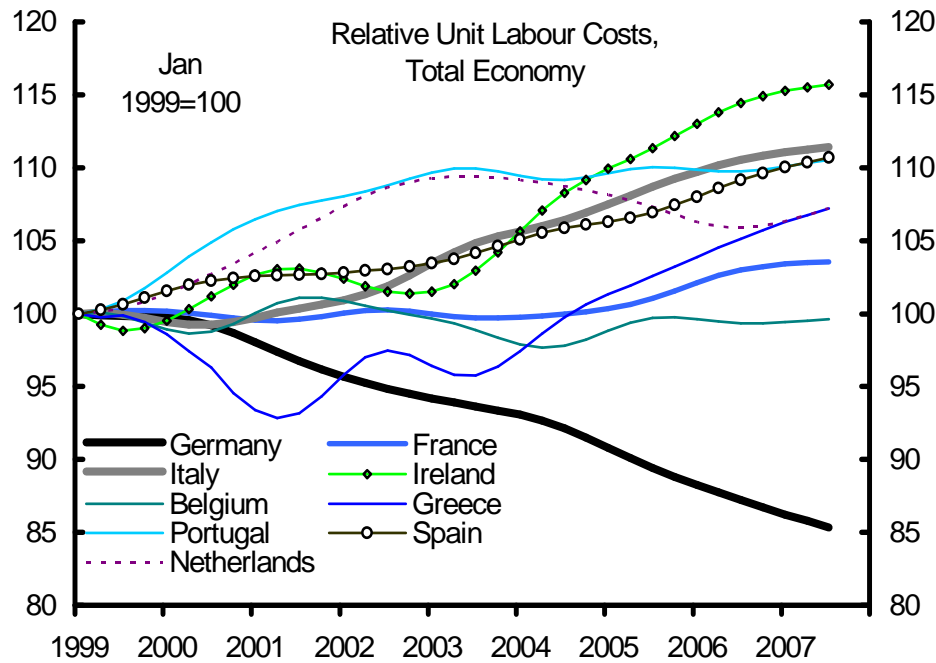
Source: Morgan Stanley Research Estimates, note that the Irish forecasts do not yet reflect our new EMU and UK estimates

A Shift in the Growth Landscape

- **Europe could see a fundamental shift in its economic landscape**
- **Headwinds for debt-driven, consumer-led, and asset-based growth models**
- **Tailwinds for income-driven, investment led growth models**
- **Growth momentum moves from periphery back to the core**
- **Europe going through a mid-cycle dip; not heading for a recession**
- **Construction and housing however could see prolonged contraction**
- **Inflation pressures to hit consumers in different ways**
- **Current account imbalances to become more of a concern again**
- **Watch out: twin deficits, falling competitiveness, cooling housing markets**

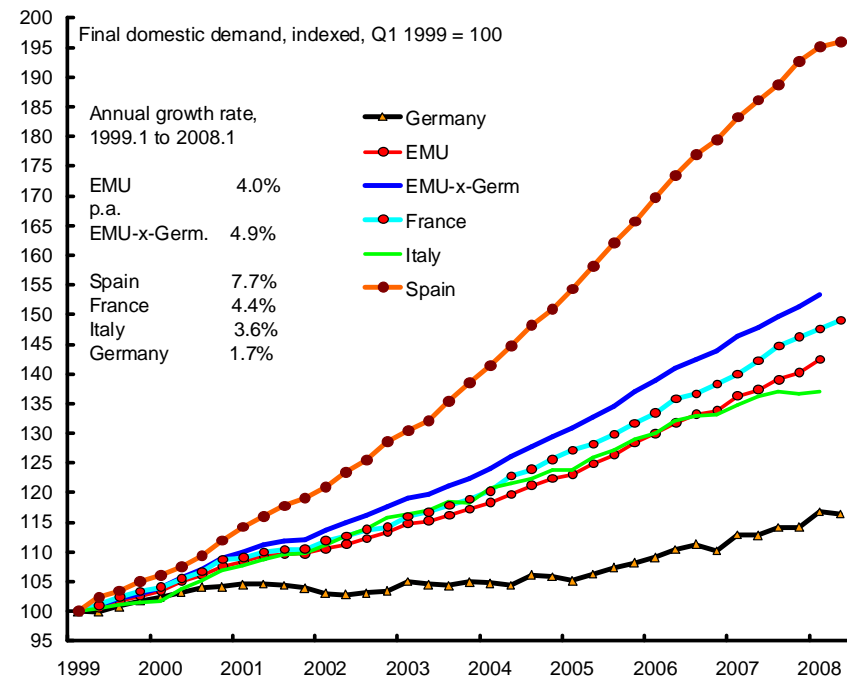
Competitiveness and Domestic Demand Dynamics

**German Relative Unit Labour Costs
 Fell by 15% ...**



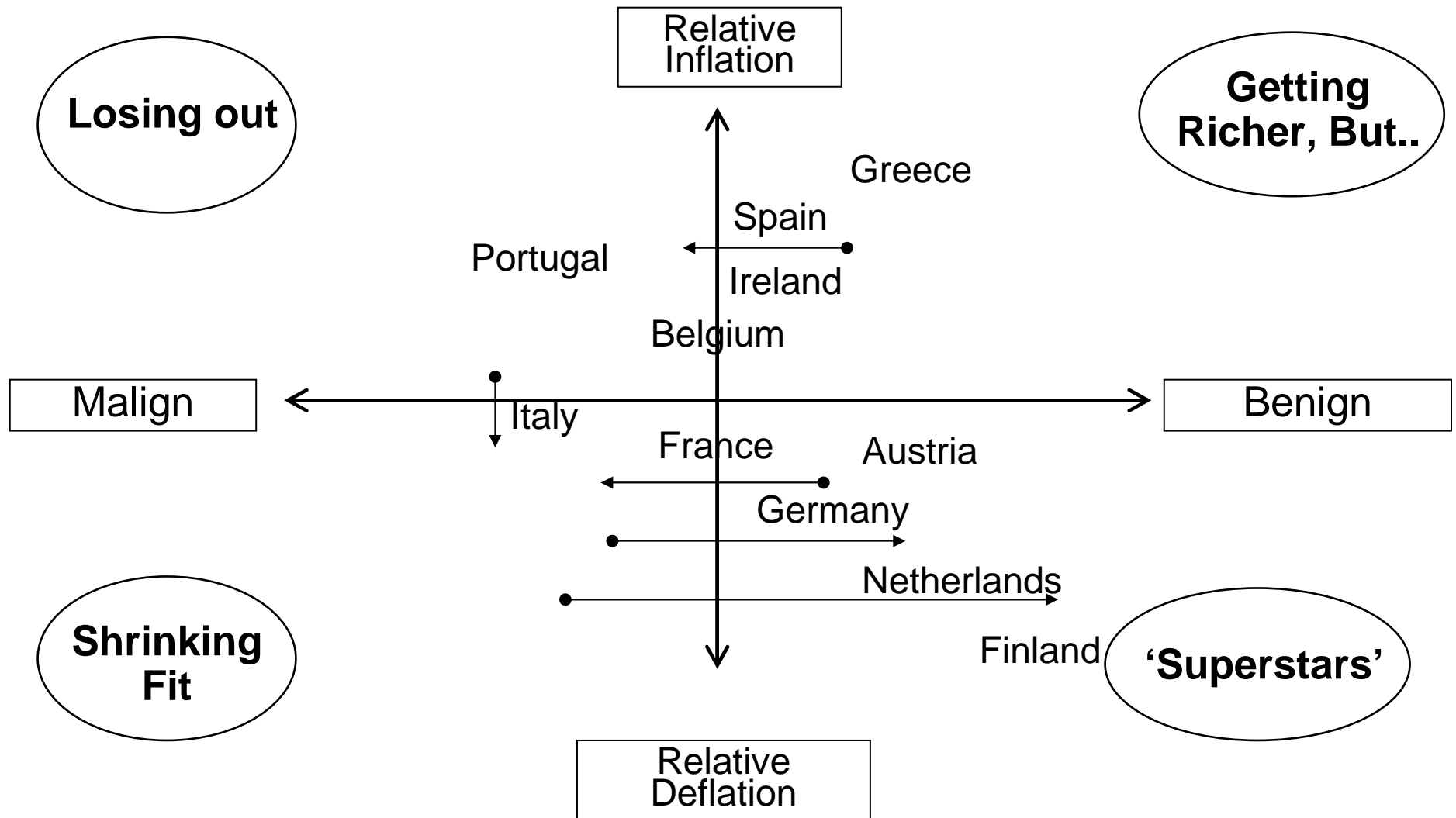
Source: EU Commission

**... But Dragged
 Down EMU Domestic Demand**



Source: National Statistics, Morgan Stanley Research

EMU: The Good, The Bad and the Ugly



Main Morgan Stanley European Macro Forecasts, 2004-09e

% Annual Change	EU-15						EMU						UK						Sweden					
	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e
Real GDP	2.1	1.8	3.0	2.7	1.3	1.0	1.9	1.8	2.9	2.7	1.3	1.0	3.3	1.8	2.9	3.1	1.3	1.3	3.5	3.3	4.1	2.9	1.4	1.3
Private Consumption	1.9	1.8	2.0	1.9	0.8	1.1	1.5	1.7	1.9	1.6	0.5	1.1	3.4	1.5	2.0	3.2	1.8	0.6	2.6	2.7	2.5	3.0	2.0	2.0
Gross Fixed Investment	2.8	3.2	6.1	4.8	1.1	0.2	2.1	3.4	5.6	4.5	1.6	0.1	5.9	1.5	7.6	6.0	-1.7	1.1	5.7	8.9	7.7	8.0	3.2	0.5
Construction Investment	2.9	1.2	5.2	3.0	-1.0	-1.2	0.8	2.2	4.5	3.0	0.4	-0.2	13.0	-3.9	8.5	2.5	-8.9	-6.7	5.9	4.0	9.9	6.4	2.6	0.4
Exports	6.4	5.6	8.5	4.2	3.2	1.4	6.6	5.0	8.1	6.0	3.7	1.4	4.9	8.2	10.7	-5.1	0.2	1.3	10.8	7.0	8.7	6.3	5.0	3.4
Imports	6.6	6.1	8.2	4.2	2.2	1.5	6.6	5.8	7.7	5.3	2.7	1.6	6.6	7.1	9.8	-2.4	-1.0	0.4	7.2	6.3	8.2	9.9	6.0	5.1
Unemployment Rate (%)	10.5	10.2	9.3	8.1	7.6	8.4	8.6	8.7	8.1	7.3	7.3	8.0	4.8	4.9	5.4	5.4	5.4	5.5	5.9	7.1	7.1	6.1	5.6	5.7
CPI Inflation (Annual Average)	2.0	2.1	2.2	2.1	3.7	2.9	2.1	2.2	2.2	2.1	3.7	2.9	1.3	2.0	2.3	2.3	3.8	2.8	0.8	0.8	1.2	1.2	3.0	3.1
Current Account Balance (% of GDP)	0.5	0.0	-0.4	-0.2	NAV	NAV	0.8	0.2	0.0	0.3	-0.8	-0.7	-1.6	-2.5	-3.9	-4.2	NAV	NAV	6.6	6.8	8.5	8.5	7.6	8.0
Govt. Budget Balance (% of GDP)	-2.8	-2.4	-1.3	-0.8	-1.1	NAV	-2.9	-2.5	-1.3	-0.6	-1.0	-1.6	-3.3	-3.0	-2.3	-2.9	-2.9	-2.9	0.6	2.0	2.2	3.4	2.2	1.0
Govt. Debt (% of GDP)	63.1	63.7	62.2	60.6	59.8	NAV	69.7	70.3	68.6	66.6	65.3	65.0	34.7	36.0	36.6	38.0	39.7	41.6	50.8	50.3	46.0	40.3	35.2	31.3
Exchange Rate against US\$ ¹	NA	NA	NA	NA	NA	NA	1.36	1.18	1.32	1.46	1.40	1.32	0.71	0.69	0.67	0.73	0.69	0.68	9.03	9.39	9.02	9.30	9.30	9.20

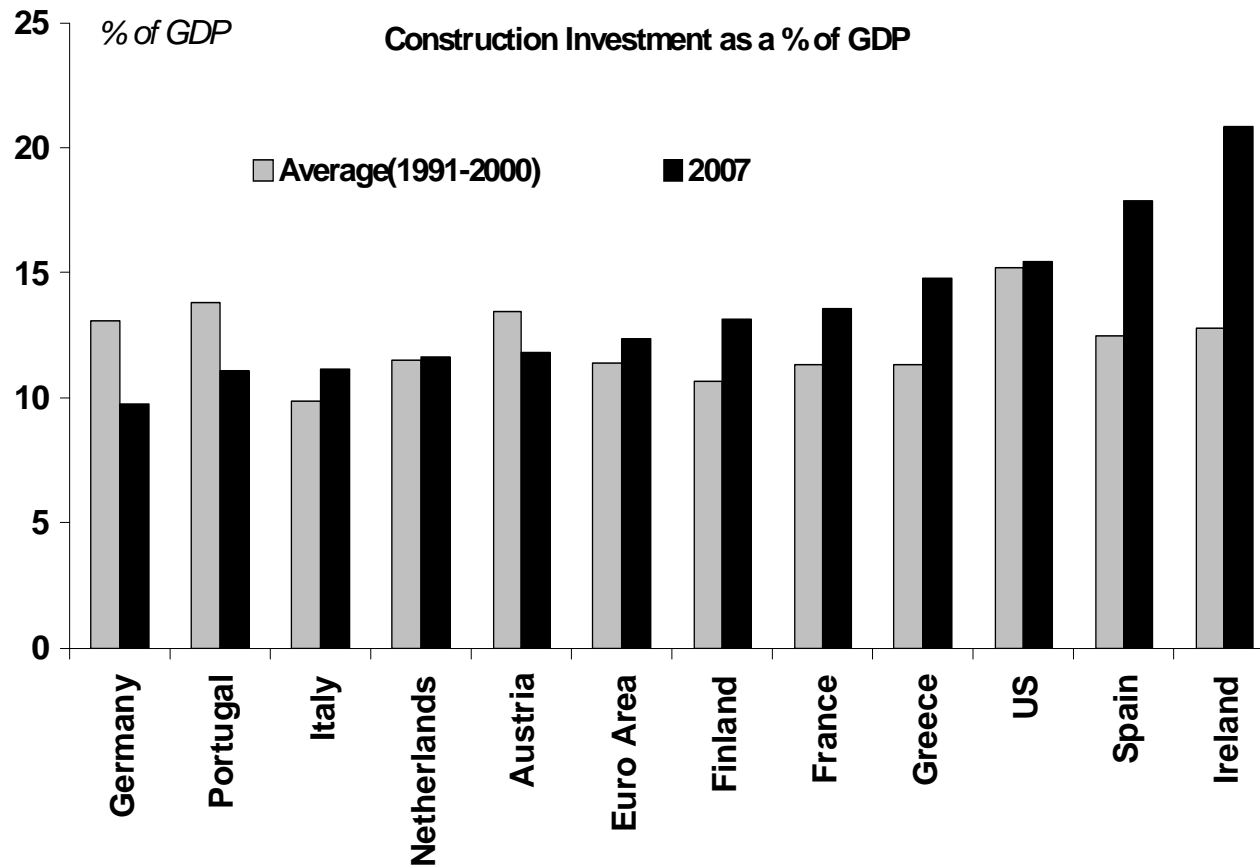
% Annual Change	Germany						France						Italy						Spain					
	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e	2004	2005	2006	2007	2008e	2009e
Real GDP	1.1	0.8	2.9	2.5	2.0	1.0	2.2	1.9	2.4	2.1	1.0	1.0	1.4	0.7	1.9	1.4	0.1	0.8	3.3	3.6	3.9	3.8	1.5	0.5
Private Consumption	0.2	-0.1	1.0	-0.5	-0.1	1.1	2.5	2.6	2.5	2.4	1.1	1.5	0.7	0.9	1.1	1.5	-0.1	0.8	4.2	4.2	3.8	3.2	1.3	0.9
Gross Fixed Investment	-0.1	1.2	8.0	2.5	6.8	3.2	3.7	3.0	6.3	5.0	0.8	-0.6	1.6	1.2	2.7	0.8	-0.4	0.6	5.6	7.0	7.0	6.3	1.2	-1.3
Construction Investment	-3.8	-3.1	4.3	2.3	3.6	0.5	2.8	6.3	3.4	2.5	-1.1	-0.5	1.8	0.1	2.0	1.8	-0.3	0.3	5.6	5.9	5.6	4.1	0.4	-2.2
Exports	10.0	7.1	12.5	7.8	5.5	2.6	3.0	3.5	5.6	3.2	2.0	1.0	3.8	1.8	6.5	4.5	0.6	1.6	4.2	2.6	5.1	5.3	2.0	1.9
Imports	7.2	6.7	11.2	4.8	4.5	2.7	6.4	6.0	6.5	5.9	2.2	1.4	3.3	2.7	6.1	4.0	-1.0	1.0	9.6	7.7	8.3	6.6	2.8	1.4
Unemployment Rate (%)	10.6	11.7	10.8	9.0	8.0	8.3	8.9	8.8	8.8	8.0	7.8	8.3	8.0	7.7	6.8	6.2	6.7	6.7	10.6	9.2	8.5	8.3	7.3	8.3
CPI Inflation (Annual Average)	1.7	1.5	1.6	2.3	2.9	2.0	2.1	1.7	1.7	1.5	3.3	2.6	2.2	2.0	2.1	1.8	3.7	3.1	3.0	3.4	3.5	2.8	4.8	3.8
Current Account Balance (% of GDP)	4.7	5.2	6.1	7.6	5.7	5.0	0.5	-0.9	-1.2	-1.2	-1.9	-2.7	-0.9	-1.6	-2.6	-2.2	NAV	NAV	-5.3	-7.4	-8.9	-10.1	-9.9	-9.4
Govt. Budget Balance (% of GDP)	-3.8	-3.4	-1.6	0.1	0.0	-0.8	-3.6	-2.9	-2.4	-2.7	-3.1	-3.1	-3.5	-4.2	-3.5	-1.9	-2.7	-2.9	-0.4	1.0	1.8	2.2	0.4	-0.8
Govt. Debt (% of GDP)	65.6	67.8	67.6	65.0	62.5	61.3	64.9	66.4	63.6	63.9	64.0	64.8	103.9	106.2	106.7	104.4	102.4	100.8	46.2	43.0	39.7	36.2	36.8	37.9

Notes: 1. End of period, against USD except UK and Sweden, whose exchange rates are against EUR, NA = not available

e = Morgan Stanley Research estimates

Source: National Statistics Offices, Morgan Stanley Research

Construction in the Limelight



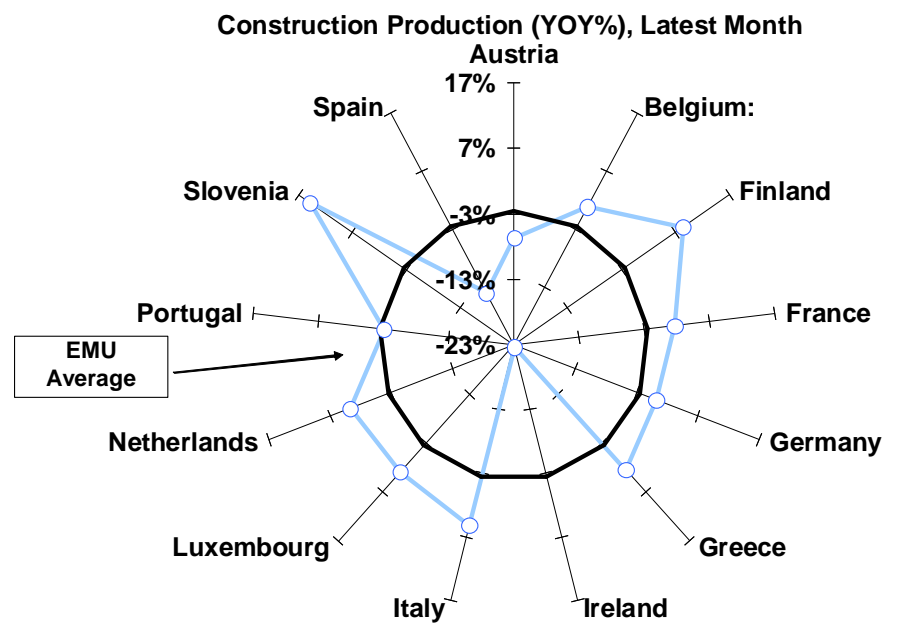
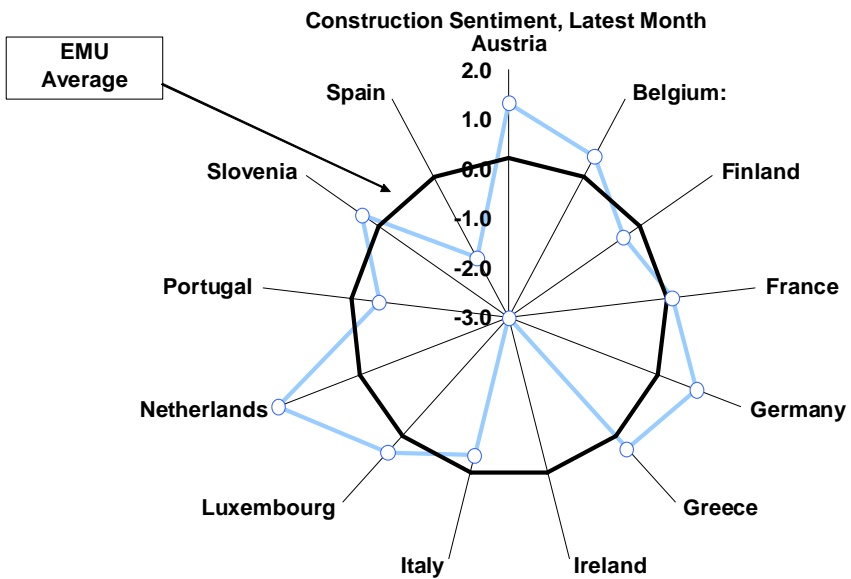
Source: Eurostat, Haver, Morgan Stanley Research

- Sharp increase in the share of construction investment in GDP in Ireland, Spain, Greece and France
- Moderate falls in the share of construction investment in Germany, Portugal, and Austria
- Share of construction investment will reflect infrastructure investments, commercial structures as well as housing boom
- While infrastructure and commercial structures are productivity enhancing housing typically is not

Country Discrepancies on the Rise

Ireland is the most gloomy by far and has now suspended the series

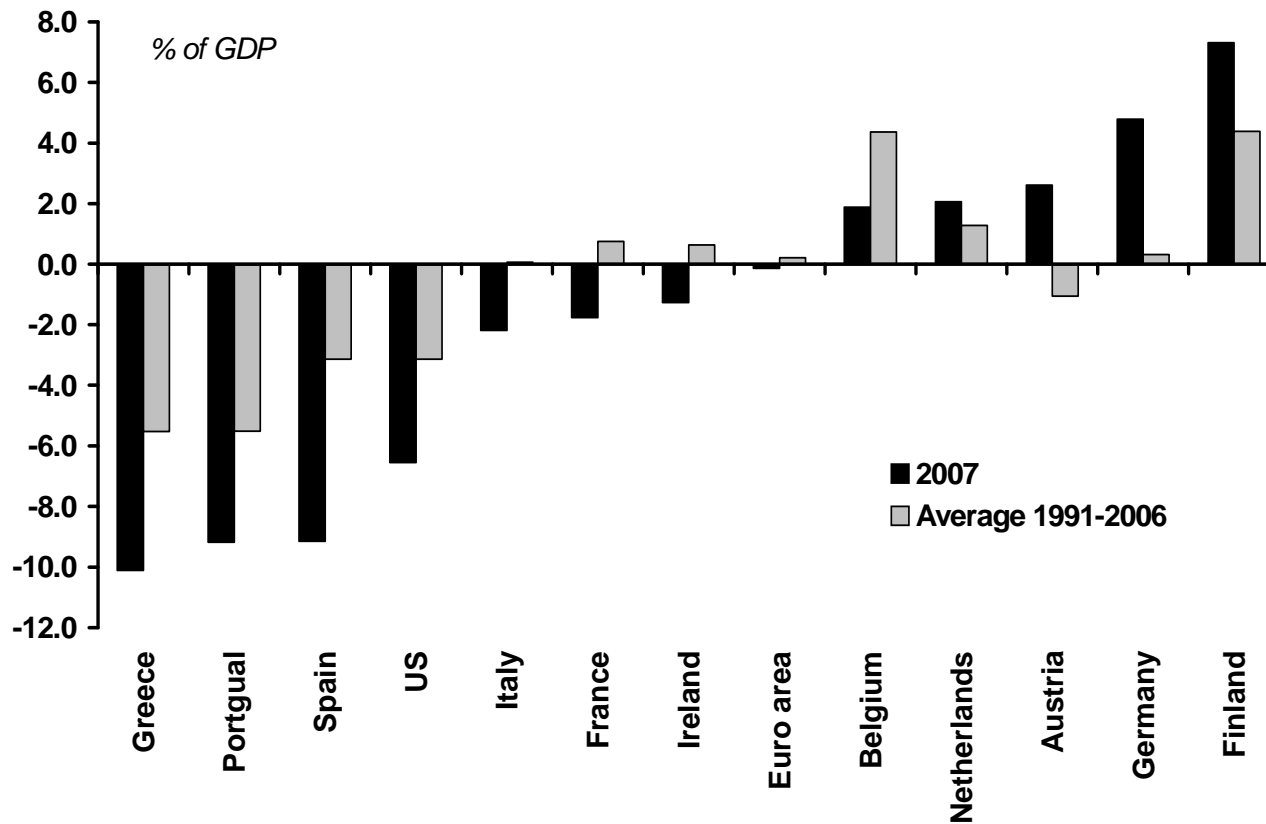
Big differences in construction production can be noted



Source: Haver, Morgan Stanley Research

Current Account Balances Widened

Current Account Balances as % of GDP



Source: OECD, Morgan Stanley Research

- Rising C/A balances are by-product of rising capital mobility within EMU ...
- ... and of a correction of over- or undervalued exchange rates at the start of EMU.
- Some EMU current account deficits are larger than in the US
- Wider current account balance points to savings and investment imbalances
- Persistent current account deficits take their toll on net investment positions
- Once age-related fiscal pressure kicks in this could snowball out of control
- Even in the absence of FX risk, a balance of payments crisis is possible