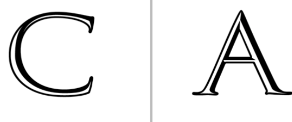

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EUROPEAN MARKET COMMENT: EUROPE'S DIVERGING ECONOMIES

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United Kingdom: Enviable Inflation

At least in one important respect, the U.K. economy is not like other major economies: it has the luxury of worrying about inflation. While deflation is firmly entrenched in Japan and deflationary currents lap at the shores of the United States and continental Europe, inflation is the concern in the United Kingdom. While its 2.8% inflation rate for the year ended November is only a few basis points (bps) above the Bank of England's (BOE) 2.5% target, it has climbed dramatically from 1.5% in June 2002. Consumers have been the force behind rising pricing pressures as they take advantage of low interest rates to buy retail products and houses. House prices jumped 25% in 2002, and homeowner debt and spending have been further stimulated, as consumers have used rising property values to obtain loans to fuel additional spending.

In the current global economic slowdown, this inflation places the BOE in a bit of a bind. On the one hand, hiking policy interest rates may dampen mounting inflationary pressures, but could also hobble economic growth, which is already at risk due to the weak global economy. The U.K.'s economy grew 1.6% in 2002—a lower pace than the 3.3% rate in the United States (for the year ended in the third quarter 2002), but about double the rate of the 12 European Monetary Union (EMU) countries. Higher rates could also disappoint the consensus, which currently expects the economy to expand 2.3% in 2003. On the other hand, pricing pressures could rise even further if the BOE keeps rates at their current 4% level or reduces them.

While it has not paid to bet against the U.K. consumer in recent years, some analysts have begun to detect signs that thinning wallets may be affecting their enthusiasm for spending. Recent surveys suggest that consumer confidence is weakening as unemployment fears rise and that wage growth will decelerate as employers cut more jobs. Optimists hope that low interest rates will continue to encourage consumers to spend, at least until capital spending begins to pick up.

Europe: If the Slowdown Persists

Europe faces another year of stress, with several interrelated issues set to dominate the economic agenda. First, there is the German problem. In 2002, Europe's largest economy limped along at a 0.2% pace, and some economists believe growth will probably not exceed that rate by much in 2003. With the European Central Bank (ECB) adhering to its mandate of containing price pressures, Germany has not enjoyed the economic fillip of lower policy interest rates. Not only is this lack of liquidity restricting Germany's growth potential, but low inflation has given it the highest real interest rates in the region, which has magnified its deflationary pressures. With Germany's budget deficit estimated to reach 3.8%

in 2002, in order to adhere to the EMU's Stability and Growth Pact it must forego further fiscal stimulus. To make matters worse, Germany's fiscal policy has just turned restrictive as Chancellor Shroeder plans to substantially hike taxes.

Germany recorded its modest growth rate courtesy of trade, with exports growing 2.9% in 2002. While impressive, the strength of this growth engine—especially relative to the stark sluggishness of consumer spending—underscores the economy's unhealthy dependence on the United States as well as its vulnerability to the appreciating euro. As a rule of thumb, a 10% increase in the trade-weighted exchange rate is equivalent to a 100-bp hike in interest rates. Therefore, the €'s rise in 2002 corresponded to a 90-bp rate hike, which significantly offsets the ECB's 50-bp rate cut in December. Some pundits see stagflation in Germany's future—anemic economic growth, persistent high unemployment, and low inflation. It should be grateful if it only experiences stagflation, for the more worrisome prospect is deflation. If Germany's conventional drivers of economic growth continue to misfire and its economy sinks deeper, pricing pressures would weaken and it could slide into deflation—whether brief or protracted would depend on the depth of the current economic slowdown.

The second issue that will attract substantial attention in 2003 is the effect of the region's economic slowdown on the EMU. A persistent slowdown will tear at the fabric of the Maastricht pact, particularly the Stability and Growth Pact, which requires member countries to keep their budget deficits below 3% of GDP. The primary concern is not how EMU members will address these violations (they have the authority to reprimand or fine violators), but the extent to which the slowdown will generate pressures to change the pact. Indeed, capital markets caught a whiff of these strains when the ECB lowered interest rates by 50 bps in December and hinted that it may adopt a slightly higher bias to fostering economic growth rather than curbing inflationary pressures.

The third issue concerns the effect of the slowdown on structural reform. In all countries, politicians and society are understandably averse to adopting painful and wide-ranging structural reforms, preferring not to do so until forced by economic circumstance. For example, Chancellor Schroder has refused to undermine his political base by addressing labor reforms, instead launching the Hartz Commission whose proposal to cut bureaucratic red tape and privatize unemployment agencies is a relatively minor step in the enormous task of grappling with labor market, taxation, and health care reform. In 2003, will Europe's economy grow enough to allow Germany and its neighbors to tinker at the margins of reform, or will continued deterioration eventually build popular consensus in favor of meaningful change?

Over the long run, we note that prospects for European equities remain quite attractive, but over the shorter term, the Continent has significant economic challenges to overcome before investor confidence returns. However, with sentiment low and valuations reasonable, any positive surprise could ignite a

substantial rally. In the United Kingdom, the defensive bias of the equity market will probably allow it to outperform if the global slowdown persists, though ironically these same characteristics could lead to poor *relative* performance were the global economy to revive.