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European Macro View

The Transatlantic Divide

Economics

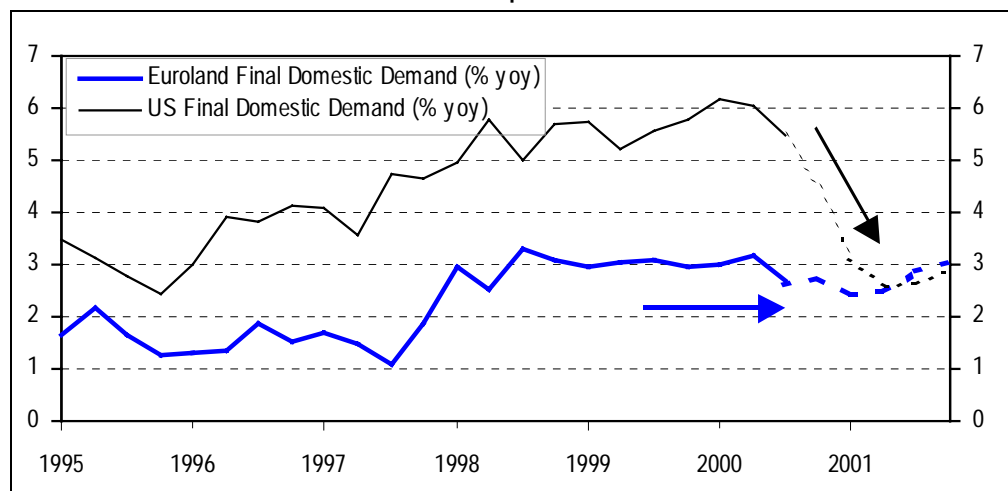
The Transatlantic Divide: Domestic Demand

- GDP forecasts around the world are coming down. Softer exports are the result. We cut our below-consensus forecast for Euroland GDP in 2001 from 2.7% to 2.5% - the same rate as in the US.
- European companies which export to North America are set to face a tough environment in 2001.
- Euroland domestic demand should hold up well. Capacity utilization and consumer confidence are both rising, in contrast to developments in the US.
- By late 2001, Euroland domestic demand might even outpace domestic demand in the US – a major change from the late 1990s.
- High manufacturing capacity utilization and a tightening Euroland labour market imply some upside risk to Euroland prices. Therefore, the ECB is likely to cut rates later and less than the Fed.

Key Events: German IFO and Euroland CPI

- The German IFO business climate is likely to decline further, reflecting bad news about the US economy (due on Monday 22nd).
- Euroland December CPI inflation (also on the 22nd) should follow the lead of German and French releases and fall sharply.

Chart 1: Euroland Final Domestic Demand Holds up Better than US Demand



Source: Datastream, Merrill Lynch Forecasts from Q4 2000

1. External Weakness – Domestic Strength

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- GDP forecast are coming down especially in the US, but also elsewhere around the world.
- As a result of slower exports, we cut our Euroland GDP call from 2.7% to 2.5%. This leaves it well below the January consensus of 2.9%.
- But Euroland domestic demand remains robust: Euroland consumer confidence remains close to record highs.
- Euroland capacity utilization reached a 10-year high in Q4, while US capacity utilization plunged to 80.6% in December.

We cut the Euroland GDP call to 2.5% as a result of weaker exports

Euroland final domestic demand may outpace US demand in late 2001

Euroland investment boom can continue

Euroland consumers stay happy – a big difference to the US

Euroland capacity utilization is trending higher. This contrasts with falling US capacity utilization

Euroland Domestic Demand in Good Shape

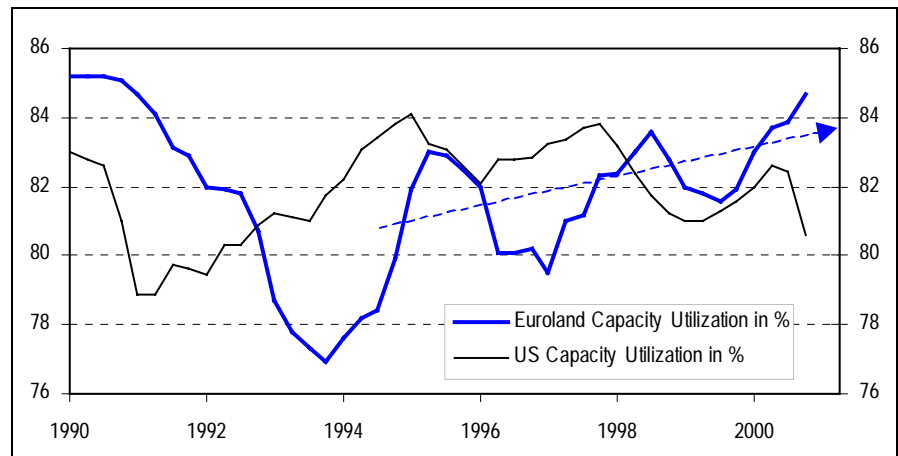
Our forecast for Euroland 2001 GDP has been below consensus all along. However, we have to revise it down further as a result of much weaker than expected economic data out of the US. We now expect net exports to subtract 0.4 percentage points from 2001 GDP growth. They probably added 0.6 percentage points last year.

While exports are likely to weaken further, we continue to see very healthy domestic demand. Consumption seems to have slowed at the turn of the year under the weight of high oil prices. But domestic demand should pick up. It even seems set to outpace US domestic demand in 2001 after trailing the US by an average of 2.3 percentage points in the past six years (see chart on cover).

The first reason for the relative strength of Euroland is that the US investment boom seems to end in a hard landing, while we expect the Euroland investment boom to continue, possibly at a somewhat more moderate pace. US capacity utilization has been trending down since the mid-1990s and fell to just 80.6% in December. By contrast, Euroland manufacturing capacity utilization has been trending upwards since the mid-1990s and reached a new 10-year high of 84.7% in the fourth quarter.

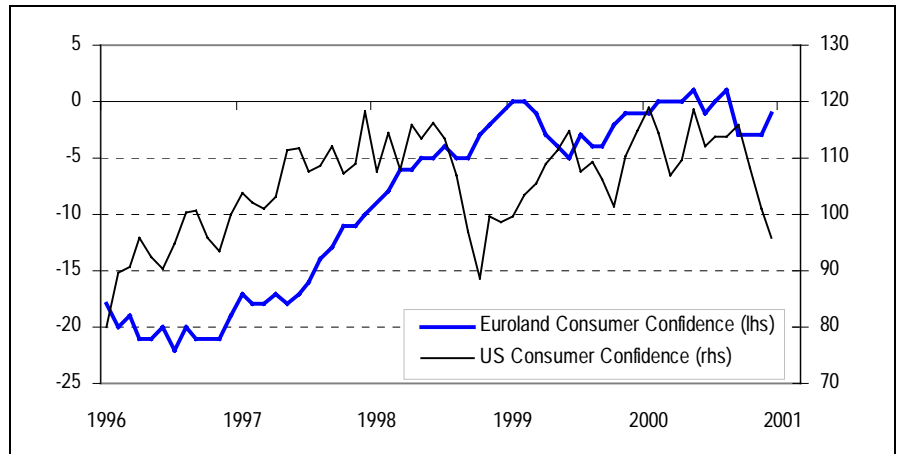
The second source for Euroland’s relative strength is likely to be the consumer. Euroland consumer confidence rose in December, while the US counterpart plunged (see Chart 3). With Euroland job creation outpacing the US in the third quarter, and taxes coming down significantly now in Euroland, consumers should stay quite happy in early 2001. The expected plunge of CPI inflation should also cheer up consumers.

Chart 2: Euroland Capacity Utilization Still at 10-Year High



Source: Datastream

Chart 3: Euroland Consumer Confidence Rose – US Confidence Plummeted



Source: Datastream

Consumer confidence shows a similar divergence as in late 1998. However, it may be more persistent this time

Net Exports Likely to Be a Bigger Drag on Growth

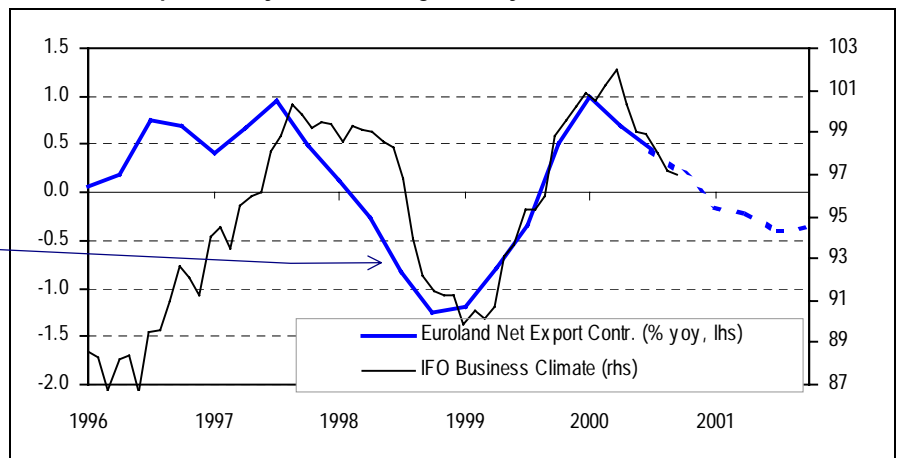
Of course, Euroland is not immune to the US economic slowdown and to the second round impact on the US's trading partners. The Merrill Lynch forecast for US GDP growth in 2001 went from 3.3% in mid-December to 2.5% in mid-January. This should cost Euroland roughly one quarter of a percentage point of GDP growth through softer exports. Accordingly, we cut our call for Euroland GDP growth in 2001 from 2.7% to 2.5%. We have been and remain below consensus, which fell from 3.1% in November to 2.9% in January and is likely to decline further.

Softer net exports as a result of revisions to GDP growth around the world

Watch the IFO climate as an indicator for the degree of Euroland's export weakness

The ripple effects of US forecast revisions are becoming visible and dampen the growth of Euroland's export markets. As a result, Euroland export expectations are likely to weaken further. The German IFO business climate has been a very good indicator for the contribution of net exports to Euroland GDP growth. The reason is probably the heavy bias towards manufacturing of both Euroland exports and of the German IFO climate. Further large drops in the IFO climate as a result of a weaker global economy would imply further downward revisions of our forecast for Euroland net exports and therefore for Euroland GDP growth.

Chart 4: Net Exports Likely to Subtract Significantly From 2001 GDP Growth



Source: Datastream, Merrill Lynch forecasts from Q4 2000

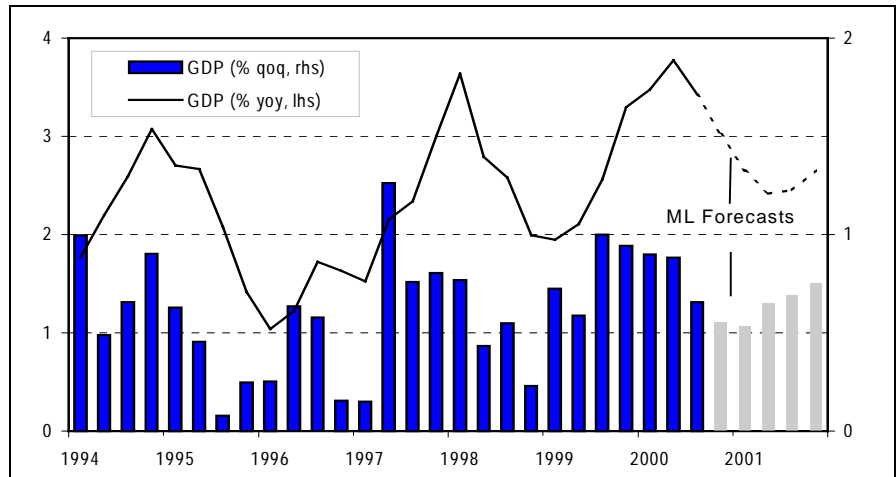
Since the start of EMU, the German IFO business sentiment served as a good indicator for Euroland's export performance.

2. Week Behind: Activity Trends Down

Revised Euroland GDP data brought an upward revision to Q2 growth, which makes the slowdown in Q3 more visible than before

*Euroland GDP (Q3 revised)
%qoq (%yoy)
Actual: +0.7% (+3.4%)
MMS Median: +0.7% (+3.4%)
Last (Q2): +0.9% (+3.8%)*

Chart 5: Slowdown of Euroland GDP is Likely to Continue

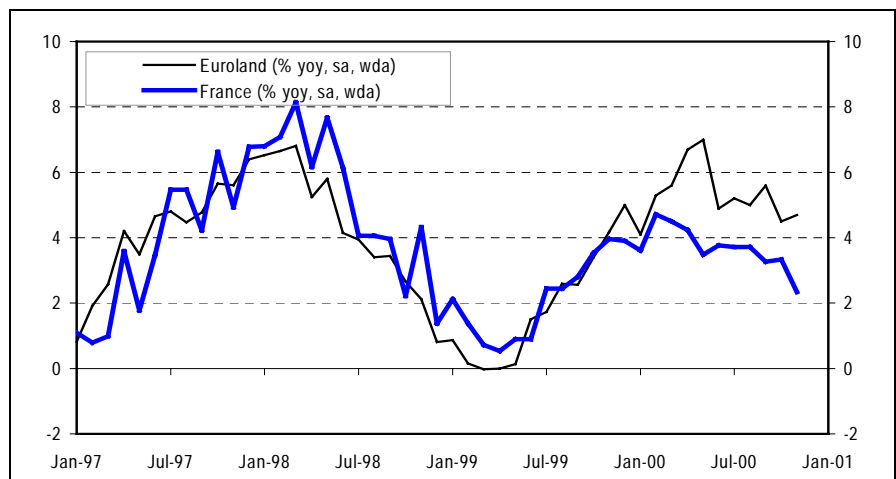


Source: Datastream

Euroland November industrial production was slightly firmer than expected, but a gradual weakening trend is still in place. French industrial activity slowed from 3.3% to 2.3% yoy largely due to a negative base effect. By comparison, US industrial prod. is slowing much more rapidly

*Euroland industrial prod. (Nov)
% mom (%yoy)
Actual: +0.6% (+4.4%)
MMS median: +0.2% (+4.0%)
Last (Oct): -0.1% (+3.8%)*

Chart 6: Euroland Industrial Production Resilient, France Softer

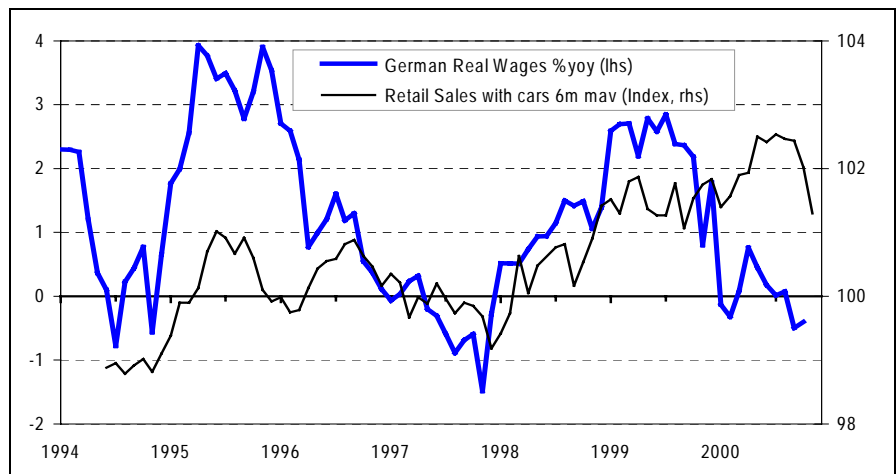


Source: Eurostat, Insee

The Euro reacted negatively to the unexpected weakness in German retail sales. Falling real wages help explain the drop in November. But reports of strong Christmas sales indicate strength in December

*German Retail Sales with cars
(Nov)
%mom (%yoy)
Actual: -0.1% (-0.9%)
ML Forecast: +1.4% (+0.6%)
Last (Oct): -0.7% (-2.2%)*

Chart 7: Weak German Retail Sales at Peak of Oil Prices



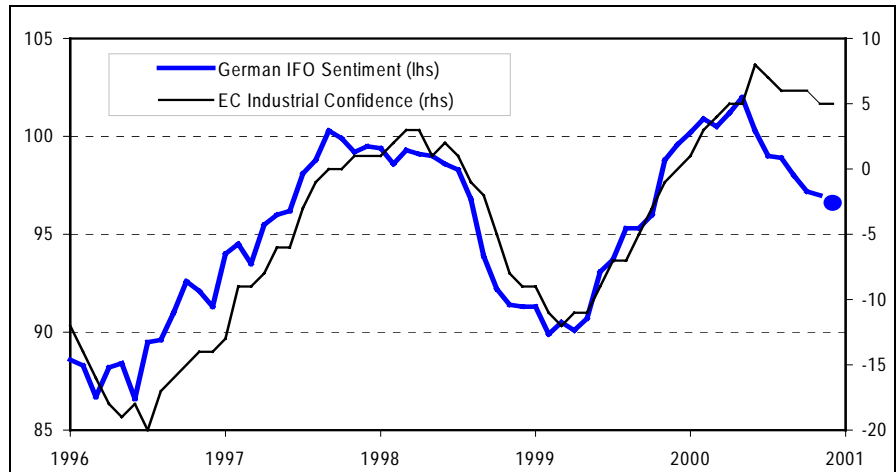
Source: Datastream

3. Week Ahead: Inflation and Sentiment Down

Surprisingly poor news about the US economy is likely to drag the IFO business climate down further. But it remains well above the 89.9 trough of early 1999

**German IFO Climate (Dec)
Index**
ML Forecast: 96.6
MMS Median: 96.6
Last (Nov): 97.0

Chart 8: German IFO Climate to Decline Further

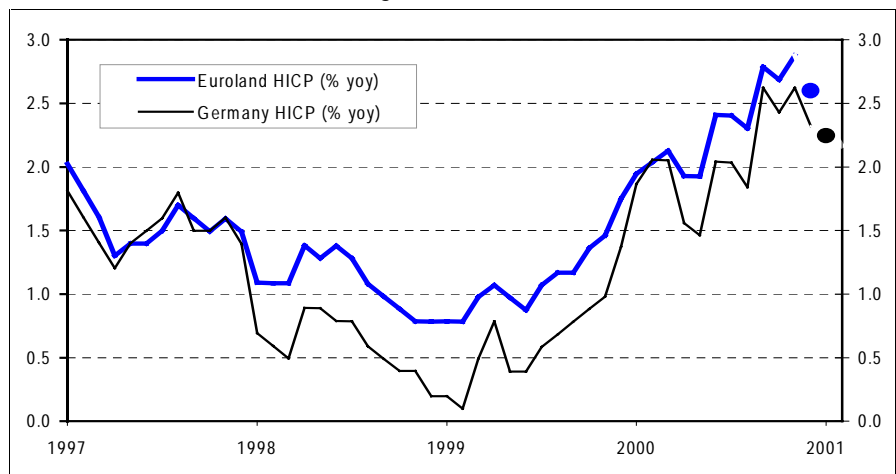


Source: Datastream, December 2000 is Merrill Lynch Forecast.

Euroland December inflation should fall from its likely peak of 2.9% yoy in November to 2.6% (chance of 2.5%). More important, German prelim. January CPI should indicate where inflation is heading in the coming months

**German prelim. CPI (Jan)
%mom (%yoy)**
ML Forecast: +0.3% (+2.2%)
MMS Median: +0.3% (+2.2%)
Last (Dec): +0.1% (+2.2%)

Chart 9: Euroland CPI to Start Heading Lower

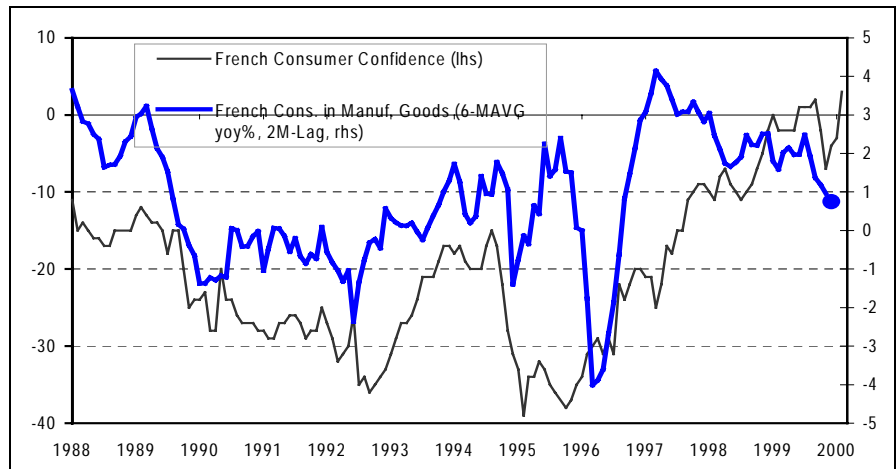


Source: Eurostat, December (January) is ML Forecast for Euroland (Germany).

The cocktail of falling oil prices and rising employment should continue to boost consumer confidence and thus spending in France and Euroland. Lower taxes from January (0.7% of Euroland GDP this year) help

**French Household Cons. (Dec)
%mom (%yoy)**
ML Forecast: +0.2% (+3.3%)
MMS Median: +0.2% (+3.3%)
Last (Nov): +0.8% (+2.9%)

Chart 10: French Household Consumption Should Recover Soon



Source: Datastream, December 2000 is Merrill Lynch Forecast

4. European Calendar

Table 1: European Economic Calendar: Week 22 –26 January

Country	Statistic	Forecast	MMS Consensus	Last	Comments
Week 22 - 26 January					
Euroland	Current Account (Nov)		€-0.1bn	€-0.1bn (Oct) €-28.1 (12mms)	
	Financial Account (Nov)			€-6.8bn (Oct) €31.8 (12mms)	
Germany	CPI Prelim (Jan)	+0.3% mom +2.2% yoy	+0.3% mom +2.2% yoy	+0.1% mom +2.2% yoy	Higher TV fees add around 0.1%-pts to CPI. Hike of petrol taxes offsets decline of crude oil. Would be 0.2% mom sa.
Monday 22 January					
Euroland	HICP Inflation (Dec)	+0.1% mom +2.6% yoy	+0.1% mom +2.6% yoy	+0.3% mom +2.9% yoy	First effects of lower oil prices to become visible. Further sharp drops in headline inflation to come.
	Core Inflation (Dec)	+0.3% mom +1.6% yoy	+0.2% mom +1.5% yoy	+0.2% mom +1.5% yoy	Lagged effects of high energy prices and the weakness of the euro should push core inflation gradually higher.
Germany	IFO Business Climate (Dec)	96.6	96.6	97.0	Pace of decline eased in November. But bad news from the US is likely to depress sentiment.
Italy	12 City CPI (Jan)	-0.1% mom +2.4% yoy		+0.1% mom +2.7% yoy	Positive effects of lower oil prices are starting to come through.
Tuesday 23 January					
France	Household Consumption (Dec)	+0.2% mom +3.3% yoy	+0.2% mom +3.3% yoy	+0.8% mom +2.9% yoy	Retail spending sustained by high confidence and year-end festivities almost offset by sharp drop in car sales.
Italy	Consumer Confidence (Jan)	119.0		119.4	Consumers likely to stay upbeat as petrol prices fall and taxes are cut. Italy is good lead for EC consumer confidence.
Sweden	Industrial Production (Nov)	+7.7% yoy		+8.0% yoy	Gradually slowing on trend.
	Industrial Orders (Nov)	+6.2% yoy		+18.3% yoy	Volatile, but holding up surprisingly well.
Wednesday 24 January					
France	Final CPI (Dec)	-0.1% mom +1.6% yoy	-0.1% mom +1.6% yoy	+0.3% mom +2.2% yoy	Confirmation of preliminary readings.
UK	CBI Industrial Trends Survey (Dec)	+10		+12	Manufacturing seems to have perked up.
	Minutes of Jan MPC Meeting			7-2 No Change	Rates have been at 6% since last February.
Thursday 25 January					
Germany	Import Prices (Dec)	-0.5% mom +10.1% yoy	-0.5% mom +9.8% yoy	+0.5% mom +12.5% yoy	First nice drop. Only seasonal factors (higher food prices in the winter) prevent a sharper drop.
UK	Non-EU Trade in Goods (Dec) (£bn)	-£2.5bn	£-2.4bn	£-2.3bn	
	World Trade in Goods (Nov) (£bn)	-£2.6bn	£-2.4bn	£-2.5bn	UK in trade balance with rest of EU despite Euro weakness.
Sweden	PPI (Dec)	-0.2% mom +3.8% yoy	+0.1% mom +4.1% yoy	+0.6% mom +4.8% yoy	Oil price decline and euro strength offset krona weakness.
Denmark	WPI (Dec)	-0.4% mom +5.2% yoy		+0.5% mom +6.7% yoy	Oil price decline, euro strength.
	Unemployment Rate (Dec)	5.6%		5.6%	Bottomed in early 2000 and firming gradually on trend since then.
Friday 26 January					
Germany	Producer Prices (Dec)	-0.3% mom +4.2% yoy	-0.1% mom +4.4% yoy	+0.2% mom +4.7% yoy	Lower oil prices and the stronger Euro should kick off a trend of sharply declining annual inflation rates.
Italy	Retail Sales Nominal (Nov)		+2.0% yoy	+1.1% yoy	Weakening slightly on trend.
UK	GDP 1 st Estimate (Q4)	+0.5% qoq +2.6% yoy	+0.5% qoq +2.6% yoy	+0.7% qoq +3.0% yoy	Modest slowdown likely in Q4 – a very strong figure would further limit prospects of an early rate cut.

Sources: Merrill Lynch, Standard & Poors MMS.

Table 2: European Economic Calendar: Week 29 January – 2 February

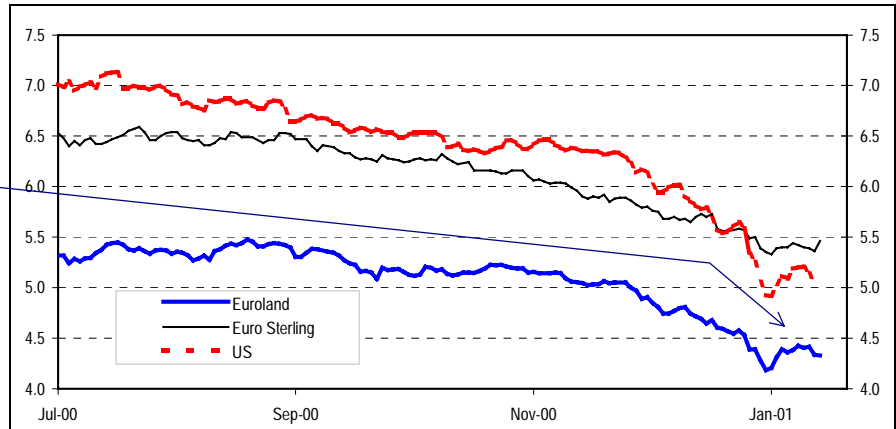
Country	Statistic	Forecast	MMS Consensus	Last	Comments
Week 29 January – 2 February					
Euroland	M3 Money Supply (Dec)	+4.7% yoy +4.9% 3MMA	+4.7% yoy +5.0% 3MMA	+4.9% yoy +5.1% 3MMA	Further gradual slowdown likely.
Spain	Registered Unemployment (Jan)	+45.0k mom +12.4k s.adj.		-0.5k mom +2.5k s.adj.	Labour market weakens. Supports our below consensus view on private consumption in 2001.
Tuesday 30 January					
France	Business climate (Jan)	115		117	Somewhat weaker on worrying growth news from the US and strengthening Euro.
Italy	Hourly Wages (Dec)	+0.2% mom +1.9% yoy		0.0 mom +1.8% yoy	After a year of negative real wage growth, some pick-up in nominal wage growth is to be expected.
UK	Consumer Credit (Dec)			£1188m	
	Nationwide House Prices (Jan)			+1.2 % mom +9.3 % yoy	Should be a steady year ahead for housing market.
Sweden	Labor Costs (Wage Earners; Nov)	+3.2% yoy		+3.2% yoy	On a gradually increasing trend.
Wednesday 31 January					
France	Unemployment rate (Dec)	9.1%		9.2%	Jobless should have dropped by another 30K people after 37K in November.
Italy	PPI (Dec)	+0.3% mom +6.5% yoy		+0.5% mom +6.7% yoy	Producer prices are likely to have peaked.
UK	Consumer Confidence (GfK/EC)			-1.0	
Thursday 1 February					
Euroland	ECB Governing Council Meeting	No change		+25bp (Oct 5)	We expect ECB to wait until inflation drops below 2% before starting to cut rates. We see first cut in mid-Q2.
	Purchasing Managers Index Manuf. (Jan)	53.0		53.4	Further, albeit gradual, decline. Should bottom out in Q2.
	GDP 3 rd release (Q3, 2000)	+0.7% qoq +3.4% yoy		+0.8% qoq +3.7% yoy	No changes to earlier releases expected.
Germany	Purchasing Managers Index Manuf. (Jan)	53.6		54.0	Further decline.
France	Purchasing Managers Index Manuf. (Jan)	52.5		52.8	Only slightly weaker after sharp decline in December. First European PMI published.
Italy	Purchasing Managers Index Manuf (Jan)	57.0		57.4	Expansion of the manufacturing sector is losing momentum.
UK	Manufacturing PMI (Jan)			51.3	
	CBI Distribution Trades Survey (Jan)			16%	Consumer demand may prove more resilient in early months of 2001.
Friday 2 February					
Euroland	Industrial Confidence (Jan)	+4		+5	Industrial confidence holds up better than German Ifo and PMI's, but should continue its moderate downward trend.
	Consumer Confidence (Jan)	-1		-1	Consumer confidence rebounded in previous month on back of lower oil prices and continued strong job creation.
France	Consumer Confidence (Jan)	2		3	Roughly stable. Sustained by continuing drop in unemployment and receding inflation.
UK	CIPS Construction Survey (Feb)			55.5	

Sources: Merrill Lynch, Standard & Poors MMS.

5. Forecast Watch

- We cut the forecast for Euroland 2001 GDP growth from 2.7% to 2.5%. Our call is well below the January consensus of 2.9%.
- We continue to expect CPI inflation to fall much faster than the consensus expects. This should allow an ECB rate cut in Q2.

Chart 11: Implied 3-Month Interest Rates in June 2001 Futures Contracts



In our view, markets are correct in expecting significant rate cuts

Source: Bloomberg

Our Euroland GDP call is well below the early January consensus

Table 3: Key European Forecasts

	1999	2000	2001		2002	
			ML	Consensus	ML	Consensus
GDP						
Euroland	2.5	3.4	2.5	2.9	3.0	2.9
UK	2.2	3.0	2.5	2.6	3.0	2.6
Inflation						
Euroland	1.1	2.3	1.5	2.0	1.4	1.7
UK	2.3	2.1	2.2	2.2	2.5	2.4
Currencies						
	3-Months		6-Months		12-Months	
	ML	Market	ML	Market	ML	Market
\$/Euro	0.97	0.95	1.02	0.95	1.02	0.95
£/Euro	0.68	0.64	0.72	0.64	0.73	0.65
3-Month Rates						
Euroland	4.70	4.50	4.50	4.29	4.40	4.36
UK	5.90	5.57	5.80	5.42	5.75	5.42
10-Year Bond Yields						
Euroland	4.60	4.83	4.70	4.86	4.70	4.92
UK	4.90	4.84	4.90	4.81	4.90	4.78

Source: Merrill Lynch; Consensus Economics January 2000; Bloomberg

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