EUROPE: REASONABLE EXPECTATIONS BUT MANY UNKNOWNS

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By Dennis Huibregtse

Experience teaches that forecasting is at best an imperfect art. But it seems that economic and business development in Europe during this past year confounded even the best forecasters. At the beginning of 2002, with uncertainty prevailing and fresh scars from a serious slowdown during the fourth quarter of 2001, the year was expected to get off to a quiet start. Things were expected to remain soft until mid-year or so, then begin to gain momentum in the third and fourth quarters as an expected general recovery began to take shape. It didn't work that way at all.

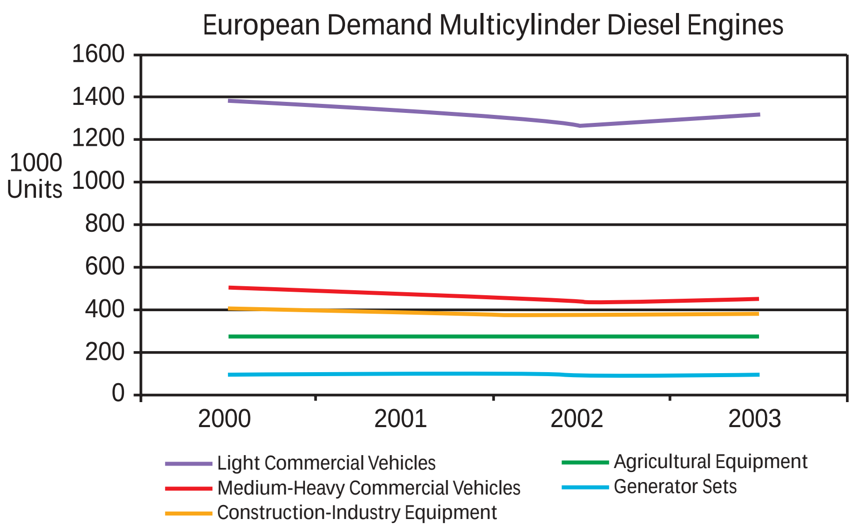
The first quarter was not as bad as feared, and as Q2 unfolded, mild expansion was experienced in many business sectors. Guarded optimism for a broader-based recovery in the upcoming second half of the year did not seem misplaced. Then things took an unexpected turn for the worse and by the end of the third quarter any optimism that the year might finish strongly had vanished.

Economic Weakness in Germany

Any discussion of prospects in Europe for 2003 needs to consider developments in Germany, Europe's largest economy and the primary driver of activities within the Euro-zone. Despite the fact that 2002 was an election year, Germany's economy gradually shuddered to a halt as it progressed. Unemployment rose steadily as new investment in machinery and construction literally dried up. The country's all-important manufacturing sectors including automobiles, commercial vehicles and construction equipment, are ending 2002 at production levels well below the preceding year. Moreover, things do not look particularly bright for any significant recovery in 2003. Europe's cornerstone economy is at a virtual standstill and is effectively dragging other Euro-zone economies down with it. Recent projections from European Union Monetary Affairs Commissioner Pedro Solbes indicate that Euro-zone GDP growth for full-year 2002 is expected to be a measly 0.8 percent; it is likely to grow by only 2.0 percent in 2003, nearly one-third lower than projections made earlier this past year.

There is little doubt that Germany's economic performance — or rather, lack of it — is causing brows to furrow well beyond its national borders. How bad is it? Over the six years from 1996 through 2001, the country's annual GDP growth has averaged a meager 1.6 percent. During the same period, aggregate GDP growth in the other Euro-zone economies has averaged 2.8 percent. Germany's economy has been growing at a rate only slightly more than half that of its Euro-zone partners. Not good, certainly, but how important is this? Very.

Germany accounts for nearly one-third of total Euro-zone output. With its GDP growing only 0.6 percent in 2001 and a similar performance in 2002 — year-end projections are in the range of 0.6 to 0.7 percent — the effect on the entire region has been noticeable. The economic powerhouse of Europe



has slipped into the role of the region's sick man and many analysts see this as the most urgent economic problem facing the region right now. According to Goldman Sachs, "Strip out Germany and the Euro-zone's (2002 economic) performance isn't that bad."

Rebounding Demand

There is a good side to this picture: Euro-zone economic expansion is expected to be considerably better in 2003 than what we've seen over the past year. More importantly for those reading this is that Power Systems Research expects that demand for most types of diesel driven products will increase during 2003 at rates that will equal or exceed the Euro-zone's 2.0 percent GDP growth rate.

These are mild increases, to be sure. But in mature market sectors like these, changes tend to be modest and most competitors will likely view an increase of almost any kind as a welcome change from the declining trend in recent years. Let's take a closer look at these individual market sectors to see what we might expect.

Agricultural Equipment — After consecutive years of falling sales, European farm machinery demand appears to have flattened out during 2002 and is expected to increase between 3 and 5 percent in the coming year. In combination with some market improvement expected in North America, it should be a good year for most ag equipment manufacturers. Not all competitive equipment suppliers are likely to benefit to the same degree, though. For example, John Deere has been able to increase tractor sales in Europe during the past year on the strength of recent new product launches and will probably remain a very strong market force in 2003. This will put additional pressure on other competitors as demand begins to firm up.

Construction & Industrial Equipment — Some mild recovery should develop in the construction and industrial equipment sector, probably around 2 percent on average across Europe. Demand does appear to have bumped the bottom in 2002 but recovery in the coming year is unlikely to be spectacular. There simply isn't enough economic strength across the region to dramatically increase construction activity and subsequent equipment demand. This sector seems to be showing effects from the softness in Germany's economic performance during the past few years. Construction activities have fallen sharply following the post-reunification-building boom that lasted nearly a decade.

Generator Sets — The past year was a near-disaster for many generator set producers in Europe. A good part of this can be attributed to surplus inventory: a hangover resulting from overproduction in response to the apparent soaring demand for gen-sets nearly two years ago. Acute power shortages in the Americas — which seemed to go away much sooner than expected — led to production of too many sets during early-2001. Thus, disposal of existing inventory became a priority for many gen-set builders during this past year. With production trimmed back to allow inventories to come into line, engine demand from this sector fell sharply. There are still many generator sets in warehouses waiting for buyers, but production should start to pick up a bit as the coming year progresses.

Light Commercial Vehicles — Demand for light commercial vehicles — primarily vans and delivery trucks in Europe, nearly all of which are powered by diesel engines — has declined in each of the past two years. Fortunately, this did not drop as severely or as far as the demand for medium and heavy trucks. For any European manufacturer that produces vehicles for both sectors, LCVs provided some respite from the hammering they were taking on the large vehicle side. Moreover, demand for light commercial vehicles is expected to rebound more strongly during 2003 than that for heavier trucks. The highly competitive LCV sector has significant volume, accounting for nearly three-quarters of total commercial vehicle production in Western Europe during recent years.

Medium & Heavy Commercial Vehicles — There hasn't been much good news in this sector for some time. On the other hand, everyone that understands the truck business knows that it is highly cyclical and that the boom-and-bust pattern has always been part of its character. After record sales in the late 1990s, no one should have really been surprised that things dropped off in each of the past two years. Further decline during 2002 will bring West European medium and heavy vehicle sales to a level that is 12 to 14 percent below that of the preceding year. This was sharper than the industry would have liked but was not totally unexpected and was certainly not close to the magnitude of the fall experienced by the sector in North America.

Indications are that this should be the bottom of the cycle for Europe and 2003 should see some mild recovery; not back to 1999 and 2000 levels to be sure, but 2 to 3 percent better than this past year.

Wild Cards

All these projections are based on the assumption that there will be no major upheavals in the world order that could have a subsequent effect on global petroleum/energy markets and economic activity in general. Such disruptions would have great consequences, of course, and just in Europe. The global situation is currently being influenced by a series of political issues that are equally serious and sensitive. There is the threat of imminent terrorist attack in many countries, a highly volatile and unstable condition in the Middle East, possible military action in Iraq, the real potential of war between budding nuclear powers India and Pakistan, and others. Each of these has the potential to erupt and would have far-reaching effects.

Twelve months ago, the start of 2002 was clouded by widespread uncertainty. So too, is 2003. ★