Eurozone

Ernst & Young Eurozone Forecast

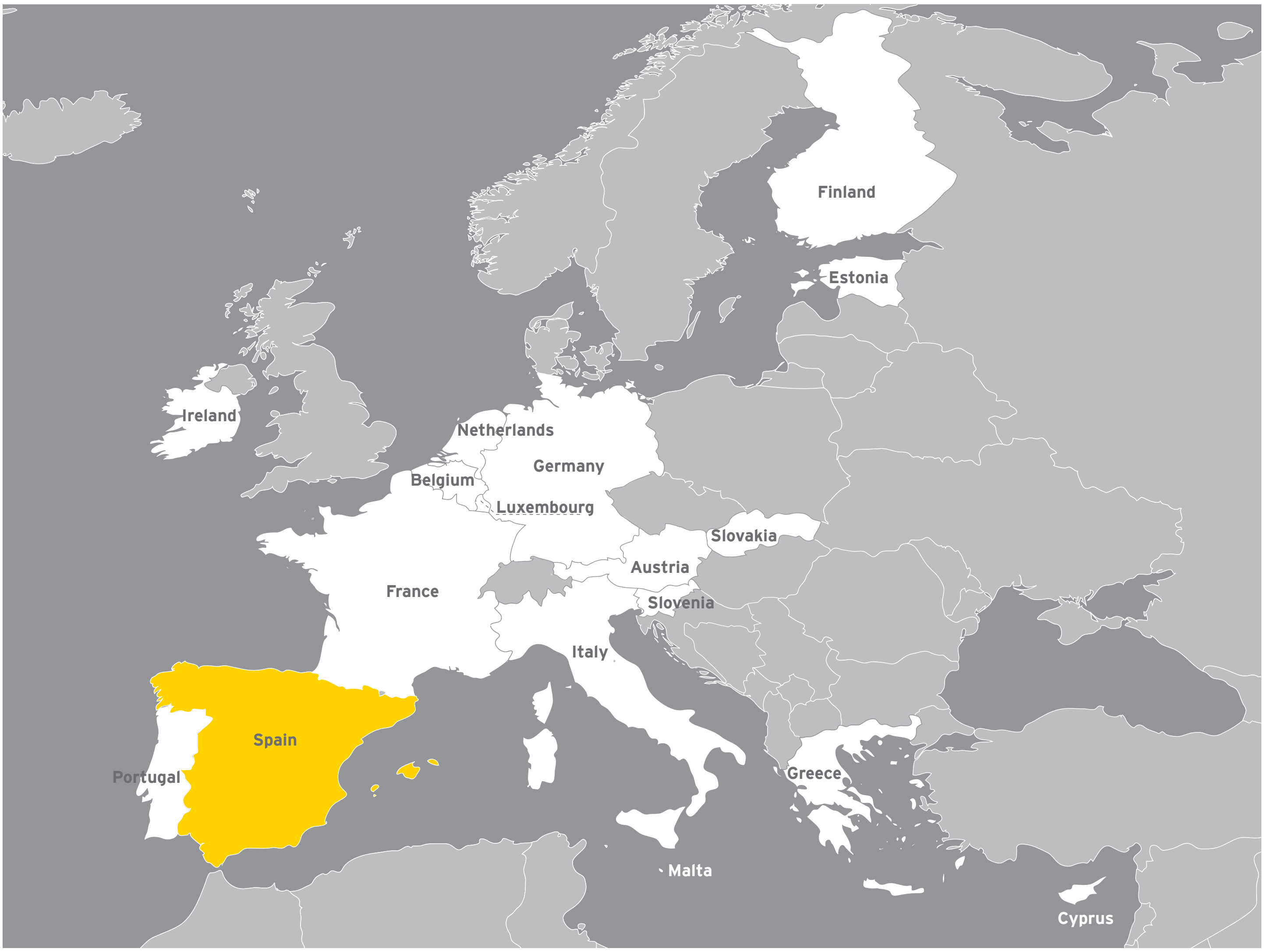
Winter edition — December 2011

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain

Ernst & Young
Quality In Everything We Do

Outlook for Spain

17 Eurozone countries



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Highlights

New government inherits an economy entering a second recession

- With sovereign and financial stress likely to remain an acute issue in coming months, we now believe that Spain will fall back into recession between Q4 2011 and Q2 2012. The Spanish Government is also expected to step up its fiscal austerity program in its next budget, which has contributed to a sharp downward revision to our forecast for GDP, which we now expect to contract by 0.2% in 2012 (down from positive growth of 0.9%). Austerity measures will continue to weigh on growth in 2013, for which our forecast has been downgraded to 0.8% (previously 1.9%).

- Spanish government bond yields rose to almost 7% in late November 2011 as the debt crisis intensified, although the announcement of coordinated central bank action to provide liquidity to European banks pushed yields back below 6% in early December. The rescue plan agreed by EU leaders in October has done nothing to dampen borrowing costs for Spain as it did not deliver a clear and credible firebreak to prevent financial contagion from engulfing the country. Moreover, the bank recapitalization plan may induce Spanish banks to shrink their balance sheets, which would further constrain the supply of credit and undermine the already weak economy.

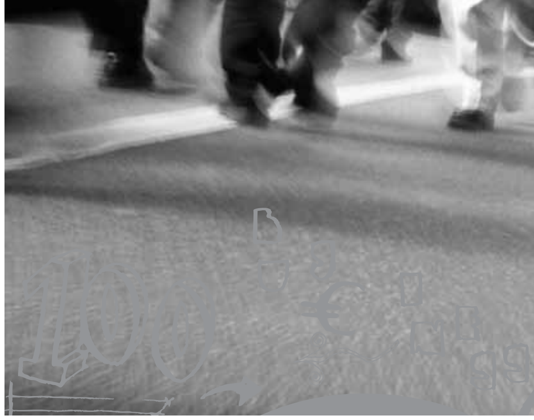
- Subdued prospects for demand and tight financing conditions mean that the near-term outlook for investment spending is bleak. We forecast capital outlays in the economy as a whole, to contract by 4.2% in 2012, with a modest recovery to positive growth of 0.9% forecast in 2013, driven mainly by an upturn in business investment amid an improving outlook for corporate profits. Any significant recovery in residential construction activity appears some way off, however, given that house prices are still probably overvalued and we expect them to continue falling for the next three years at least.

- The near-term outlook for consumer spending also appears subdued as real disposable incomes continue to fall due to ongoing fiscal consolidation, elevated rates of inflation, and continued job destruction that we forecast will drive the unemployment rate close to 24% of the workforce by late 2012. We forecast consumer spending to contract by 0.4% in 2012, with growth recovering to 0.8% in 2013.

- In light of the weakness of domestic demand, any improvement in activity levels within the Spanish economy over the coming year will depend heavily upon foreign trade. With growth prospects among Spain's main trading partners in the Eurozone having faded, the positive contribution that we are expecting from the foreign sector has been scaled back, but it still remains significant — we expect net exports to add 1.5 percentage points to GDP growth in 2012.

- The risks to these economic forecasts remain skewed to the downside. In the absence of a comprehensive solution to the debt crisis from EU policymakers, financial market strains could intensify further. Investor concerns would focus on Spain (and Italy), resulting in government bond yields rising by several hundred basis points. The consequences for the entire region would be disastrous and the Spanish economy would be hit particularly hard.

New government inherits an economy entering a second recession



Spain is now forecast to fall back into recession

Official data indicate that the Spanish economy has slowed sharply since the beginning of 2011, with the quarter-on-quarter growth rate falling from 0.4% in Q1 to 0.2% in Q2 and zero in Q3. With bond yields remaining stubbornly high, credit conditions tightening and additional fiscal austerity measures on the horizon, the economic outlook for the next two years has also deteriorated further since our last report.

We now believe that Spain will fall back into recession between Q4 2011 and Q2 2012, with the recovery thereafter also being more protracted than we had previously envisaged. As a result, we now see GDP growth slowing from an estimated 0.7% in 2011 to -0.2% in 2012 as a whole (previously +0.9%), before a modest acceleration to 0.8% in 2013 (previously 1.9%).

EU summit rescue plan failed to dampen Spanish borrowing costs ...

Spanish government bond yields rose to almost 7% in late November as the debt crisis intensified, although the announcement of coordinated central bank action to provide liquidity to European banks pushed yields back below 6% in early December 2011. Although EU leaders had promised to deliver a "comprehensive response" to the sovereign debt crisis at the EU Summit on 26 October 2011, their plan has so far done nothing to dampen borrowing costs for Spain as it failed to deliver a clear and credible firebreak to prevent financial contagion from engulfing the country. Although EU leaders had hoped that their plan to boost the power of the European Financial Stability Facility (EFSF) would engender enough confidence in markets to ring-fence Spain (and Italy), government bond spreads have remained elevated.

... as it delivered only partial solutions to the debt crisis

The main reason why the latest rescue plan has failed to insulate Spain from financial contagion is that the EFSF is being used to provide only a 20% first loss guarantee on new debt issues, a level that is proving insufficient to quell investor fears. And while policymakers also hope to set up special purpose vehicles to attract additional financial support mainly from governments and sovereign wealth funds in Asia and the Middle East, it seems unlikely that these investors would be willing to purchase risky debt instruments without adequate compensation.

Until policymakers provide the capacity for intervention on a much larger scale so as to address sovereign liquidity problems decisively and completely, peripheral economies such as Spain will continue to struggle with tight financial conditions. In the absence of more forceful policy interventions, sovereign and financial stress is likely to remain an acute issue in 2012.

Bank recapitalization risks exacerbating tight credit conditions in Spain

In common with their European counterparts, Spanish banks have also been unable to access unsecured wholesale debt financing in recent months, which is compounding pressures on the fragile banking system. Spain's banks are struggling with bad loans to property developers and homebuyers, which pushed the bad loans ratio to a 17-year high of 7.2% in September.

Table 1

Spain (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	-0.1	0.7	-0.2	0.8	1.5	1.9
Private consumption	0.8	0.0	-0.4	0.8	1.5	1.7
Fixed investment	-6.3	-4.7	-4.2	0.9	3.0	3.0
Stockbuilding (% of GDP)	0.6	0.5	0.5	0.7	0.6	0.4
Government consumption	0.2	-1.5	-2.8	0.1	1.3	1.6
Exports of goods and services	13.5	9.3	6.2	6.8	6.8	7.0
Imports of goods and services	8.9	1.6	1.2	7.3	7.5	7.0
Consumer prices	2.0	3.1	2.0	1.4	1.4	1.5
Unemployment rate (level)	20.1	21.6	23.6	23.1	22.1	21.1
Current account balance (% of GDP)	-4.6	-4.4	-3.1	-2.9	-2.6	-2.2
Government budget (% of GDP)	-9.3	-7.0	-5.3	-4.1	-3.8	-3.4
Government debt (% of GDP)	61.0	66.7	72.1	75.9	79.4	82.4
ECB main refinancing rate (%)	1.0	1.3	1.1	2.1	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.7	121.0	119.2	121.1	117.0	114.8
Exchange rate ($ per €)	1.33	1.39	1.33	1.33	1.27	1.24

At the end of September, the Government announced it had completed a restructuring of the banking system, including the injection of €7.55 billion of additional capital on top of the €10 billion already injected at an earlier stage. But there will probably be more painto come, given that economic prospects are deteriorating and house prices still have some way to fall.

At the October summit, EU leaders agreed to recapitalize the region's banks on the basis of new stress-tests conducted by the European Banking Authority (EBA) that take into account write-downs on holdings of sovereign debt of the peripheral Eurozone economies. These new estimates indicated a capital shortfall of €106 billion for European lenders as a whole, with the recapitalization requirements of Spain's five largest banks representing almost a quarter (€26 billion) of this total. The Spanish banks have said that they will be able to meet the new requirements by the June 2012 deadline without raising additional equity or drawing on state funding. But this raises the prospect of banks shrinking their balance sheets to bolster their capital ratios, which would further constrain the supply of credit and undermine the already weak Spanish economy. Moreover, the new EBA stress tests still only considered the impact of write-downs on sovereign debt holdings rather than wider private sector losses that would arise in the event of a recession.

Weak economy expected to contribute to budgetary slippage

The weakness of the banking sector is a significant worry for investors, given the potential for spillover into the public finances. On this front, the Bank of Spain has recently conceded that the Government may not be able to meet its 6% of GDP target for the budget deficit this year, due to weak growth and overspending by some of the 17 autonomous regional governments. Reflecting these developments, we have raised our forecast for the budget deficit to 7.0% of GDP in 2011 (previously 6.6%).

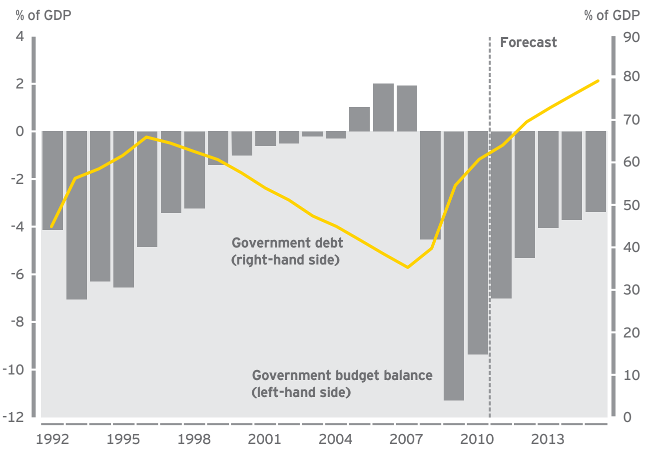
Additional fiscal austerity measures are likely to be introduced in the budget for 2012 to move the budget deficit toward the 4.4% of GDP target for next year, but we expect that the outturn will be above 5% of GDP. Spain's general election on 20 November 2011 delivered a clear majority for the Popular Party (PP), offering the prospect of a strong government, which should help with the implementation of the austerity program. But the new Government will still have to struggle with harsh economic conditions and the difficulty of enforcing expenditure constraints within the 17 autonomous regions, making continued budgetary overshoots difficult to avoid.

The outlook for business investment remains downbeat ...

The contraction in business activity that we are forecasting in coming months is also being highlighted by industrial confidence indicators. For example, the Purchasing Managers Index (PMI) for the manufacturing sector indicated that production contracted sharply again in November 2011, extending the current period of decline to seven months. Confidence indicators from the European Commission have also signaled a deterioration in Spanish business conditions in recent months, with sentiment in the construction sector hitting an all-time low in September.

Figure 1

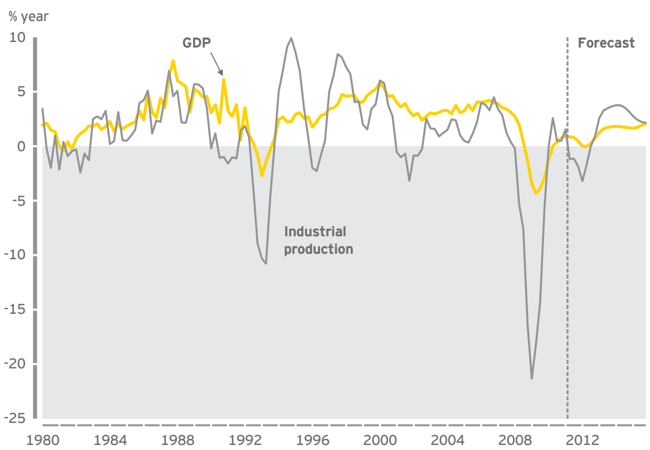
Government balance and debt



Source: Oxford Economics

Figure 2

GDP and industrial production



Source: Oxford Economics

New government inherits an economy entering a second recession

Subdued prospects for demand and tight financing conditions mean that near-term prospects for investment spending appear bleak. We forecast capital outlays in the economy as a whole, to contract by 4.7% in 2011 and by a further 4.2% in 2012. A modest recovery to positive growth of 0.9% in capital outlays is forecast in 2013, driven mainly by an upturn in corporate investment amid an improving outlook for profits. Any significant recovery in residential construction activity appears some way off, however, given that house prices are still probably overvalued and we expect them to continue falling for the next three years at least.

… while the weak labor market smothers any rebound in consumer spending

The near-term outlook for consumer spending also appears subdued amid pressure on real disposable incomes arising from the ongoing fiscal consolidation, weak labor market and elevated rates of inflation. Latest data shows that inflation has slowed since the beginning of 2011, but the preliminary estimate of a 2.9% annual rate recorded in November was nevertheless still surprisingly high, given that the earlier VAT increases have now dropped out of the consumer price index. In light of the weakness of aggregate demand, we forecast the downward trend in inflation to continue, which should limit the increase in consumer prices to 2.0% in 2012, down from 3.1% for 2011 as a whole. This will offer some relief to households.

But a particularly worrying trend has been the unrelenting pace of job destruction, which has pushed the unemployment rate up to 21.5% in Q3 2011, its highest level in 15 years. The poor performance of service-sector employment and part-time jobs during the tourist season has been significant. In light of the weaker outlook for the economy, we now expect employment to continue falling throughout 2012, pushing the unemployment rate to a peak of almost 24% in the second half of the year. A highly unfavorable labor market will remain a significant factor weighing on consumer spending in coming quarters.

Against this background, we forecast consumer spending to remain broadly flat in 2011, before contracting by 0.4% in 2012. Growth is forecast to recover to just 0.8% in 2013, as pressure on disposable incomes abates and the labor market begins to show some improvement.

Recovery remains dependent upon foreign trade …

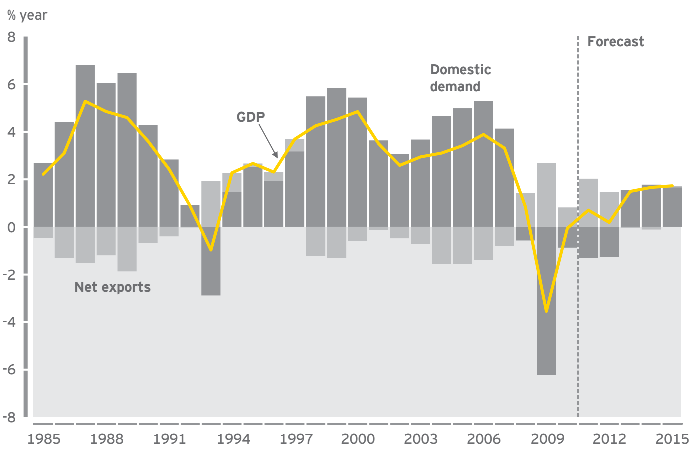
In light of the weakness of domestic demand, any improvement in activity levels within the Spanish economy over the coming year will depend heavily upon foreign trade. With growth prospects amongst Spain's main trading partners in the Eurozone having faded, the positive contribution that we are expecting from the foreign sector has been scaled back, but it still remains significant — we expect net exports to add 2.1 percentage points to GDP growth this year and 1.5% in 2012.

… with risks to the economy skewed to the downside

The risks to these economic forecasts remain skewed to the downside and will be heavily influenced by developments in financial markets. In the absence of a comprehensive solution to the debt crisis from EU policymakers, financial market strains could intensify further. Investor concerns would focus on Spain (and Italy), resulting in government bond yields rising by several hundred basis points. The consequences for the entire region would be disastrous and the Spanish economy would be hit particularly hard.

Figure 3

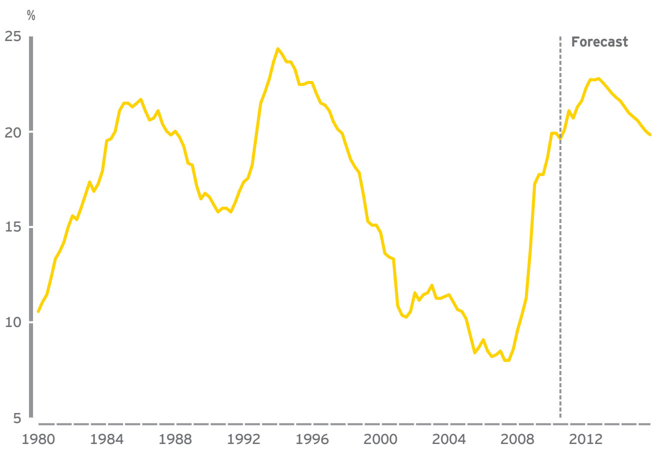
Contributions to GDP growth



Source: Oxford Economics

Figure 4

Unemployment rate



Source: Oxford Economics

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