Eurozone

Ernst & Young Eurozone Forecast

Spring edition – March 2012

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

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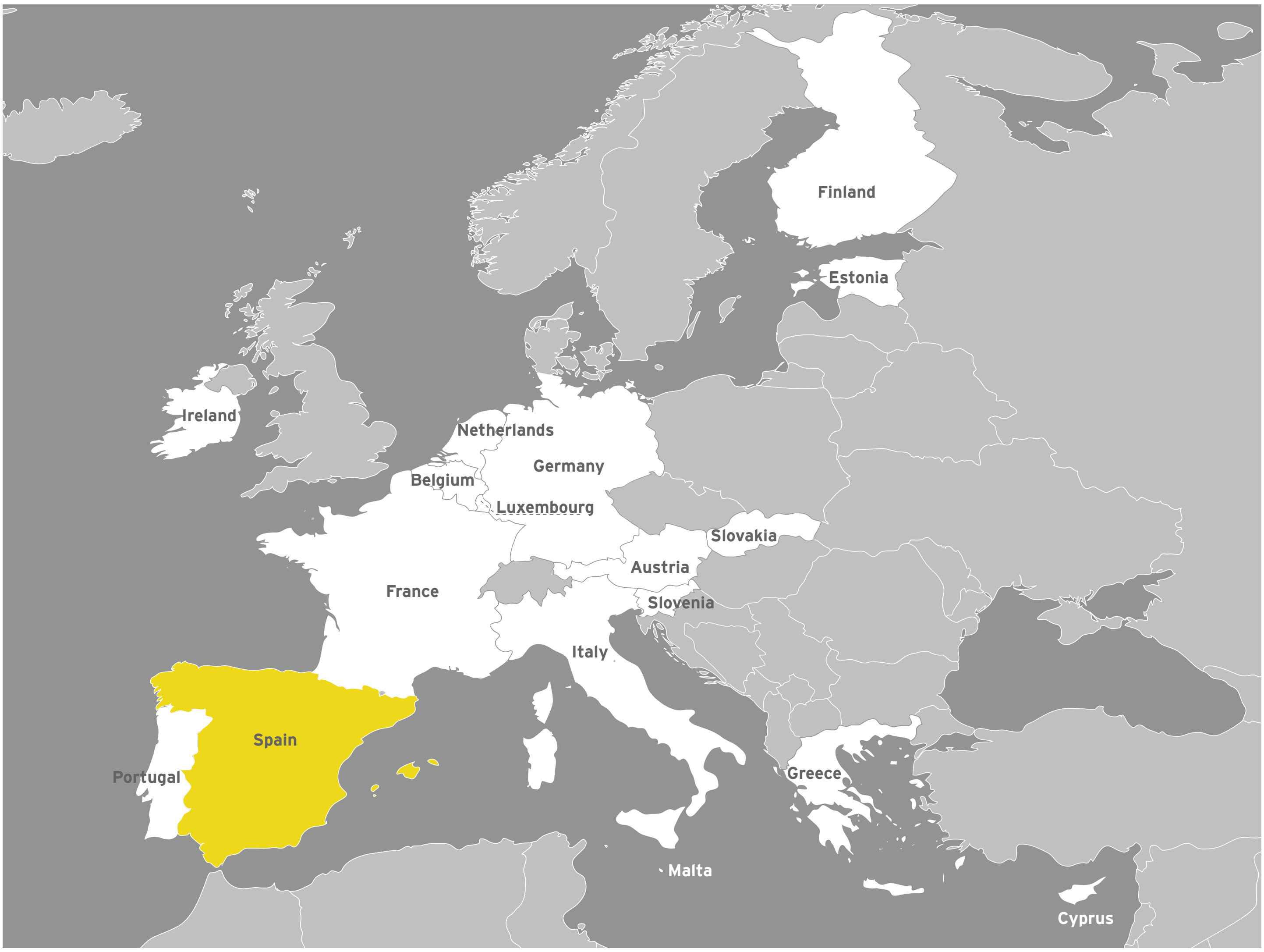
Outlook for Spain

17 Eurozone countries



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Highlights

Spain faces a prolonged recession as fiscal retrenchment deepens

- The Government has confirmed that the fiscal deficit for 2011 was 8.5% of GDP, well above the 6% target. Additional spending cuts and tax rises were therefore announced, at the start of this year, and further austerity measures are expected in the 2012 budget on 30 March. With fiscal tightening likely to dampen domestic demand further and GDP having fallen 0.3% in Q4 2011, the Spanish economy has now entered a prolonged period of recession that is forecast to last until the middle of 2013. We expect GDP to decline by 1.2% in 2012 as a whole, with a further 0.6% fall in 2013.

- Activity will also be constrained by tighter credit conditions over the coming year, as banks struggle to offset a further deterioration in the quality of their loan portfolios. Banks need to set aside up to €50 billion of additional provision to increase coverage of doubtful property assets they hold. This will prove difficult for banks as they simultaneously try to increase capital ratios to meet new European regulatory targets. With banks under intense pressure, the risk of a deeper credit crunch that could further depress economic activity over the coming year is high.

- Subdued prospects for demand and tight financing conditions mean that the near-term outlook for investment spending is especially bleak. We forecast capital outlays in the economy as a whole will fall by 8.1% in 2012, with a further 1.3% decline forecast in 2013. In this environment, firms are also likely to cut back on hiring, which we expect will drive the unemployment rate above 25% of the workforce by the second half of this year.

- The outlook for consumer spending is also weak as real disposable incomes will continue to fall due to ongoing fiscal consolidation, declining real wages and continuing job losses. We forecast a further two years of decline in consumer spending, by which time consumption will be around 8% below its pre-crisis peak.

- The Government is hoping that the short-term pain of its fiscal consolidation and reform plans will yield longer-term benefits for the economy in terms of improved credibility in financial markets and higher growth potential. But it will prove difficult to find the appropriate balance such that the reforms do not become self-defeating in the near term. Against this background, our forecast for the coming year is characterized by a high degree of uncertainty.

- The announced structural reforms are a step in the right direction to support the economy's longer-term growth potential, helping to ease the fiscal adjustment process. Assuming that these reforms are implemented we forecast a gradual recovery, with GDP growth accelerating above 2% a year by 2015–16.

Spain faces a prolonged recession as fiscal retrenchment deepens

Budget deficit even worse than feared last year ...
The Government has confirmed that the 2011 budget deficit reached 8.5% of GDP, well above the 6% target. The overshoot largely reflects higher than expected deficits from Spain's 17 autonomous regions, as well as the national health system. The Government has stated that, in future, the regions will be forced to stick to agreed spending limits and they will face penalties if they repeatedly miss their fiscal targets.

In response to the overshoot, the authorities announced €6 billion of tax rises and €8.9 billion of spending cuts at the beginning of 2012 to help rein in the deficit. But with the economy having entered recession in Q4 2011 with a GDP decline of 0.3%, the original 4.4% deficit target for 2012 already appeared unattainable. Such a sharp tightening of fiscal policy in the face of weakening activity levels could prove self-defeating, as it would harm the economy and put renewed widening pressure on the deficit.

... prompting the Government to announce tough new austerity measures
Against this background, the Government has announced that the deficit target for this year will be relaxed to 5.8% of GDP, while maintaining the 3% target for 2013. Although the new target represents a more lenient goal, it still implies that further savings of around €14 billion must be found in the budget for 2012. Moreover, EU officials have indicated they would like to see Spain make further cuts amounting to 0.5% of GDP this year, which indicates that the country is expected to target a deficit to 5.3% of GDP for 2012.

The Government also approved a package of labor market reforms in February, with the aim of supporting the economy's longer-team growth potential, which should help to ease the fiscal adjustment process. These included reforms to the complex and rigid agreements on collective bargaining, statutory redundancy payments and temporary contracts that will help to promote job growth once the economy starts to recover.

While these structural reforms will pay dividends in future years, Spain is facing the more immediate impact of a deep fiscal retrenchment, which will crush domestic demand in the near term. Against this background, we do not expect the Spanish economy to emerge from recession until the middle of next year. We forecast GDP to decline by 1.2% in 2012 as a whole, with a further 0.6% decline expected in 2013. Our forecast for the coming year is characterized by a high degree of uncertainty; however, given the ongoing sovereign debt crisis, the fragility of sentiment in the financial markets and the challenges facing the Government in the implementation of its fiscal consolidation and reform agenda.

Tight credit conditions will exert a further drag on the economy ...
Activity will also be constrained by tighter credit conditions over the coming year, as banks struggle to offset a further deterioration in the quality of their loan portfolios. The bad debt ratio of Spain's banking sector rose for

Table 1
Spain (annual percentage changes unless specified)

Source: Oxford Economics

	2011	2012	2013	2014	2015	2016
GDP	0.7	-1.2	-0.6	0.8	2.0	2.4
Private consumption	-0.1	-1.9	-1.0	0.5	1.7	1.9
Fixed investment	-5.1	-8.1	-1.3	2.0	3.0	3.0
Stockbuilding (% of GDP)	0.4	0.0	-0.4	0.1	0.1	-0.1
Government consumption	-2.2	-4.0	-0.9	0.0	1.1	1.5
Exports of goods and services	9.0	1.1	2.9	4.6	6.8	6.4
Imports of goods and services	-0.1	-8.4	0.2	6.3	7.0	5.3
Consumer prices	3.1	1.8	1.4	1.4	1.4	1.5
Unemployment rate (level)	21.7	24.8	25.3	24.6	23.2	21.0
Current account balance (% of GDP)	-3.9	-3.1	-3.0	-2.7	-2.3	-1.9
Government budget (% of GDP)	-8.5	-6.1	-3.4	-3.0	-2.5	-2.2
Government debt (% of GDP)	68.3	75.1	79.2	82.4	84.3	85.5
ECB main refinancing rate (%)	1.2	1.0	1.0	1.6	2.6	3.9
Euro effective exchange rate (1995 = 100)	120.8	115.6	119.8	117.6	115.6	115.3
Exchange rate ($ per €)	1.39	1.26	1.30	1.27	1.24	1.24

the ninth consecutive month in December 2011 to a new 17-year high of 7.6%. The Government wants banks to improve transparency over the damaged property portfolios they hold, which could lead to further steep rises in the bad loans ratio. Banks have already set aside provision for 30% of the €176 billion of property assets that the Bank of Spain estimates are bad loans. But the economy minister has estimated that the banks may need to set aside up to €50 billion of additional provision to increase coverage of doubtful property assets.

This may prove difficult for banks as they simultaneously try to increase capital ratios to meet new European regulatory targets. Since the bulk of the provision will have to be charged against earnings, many of the smaller domestic banks will likely be pushed into losses in 2012. The Government has said it will not bail out any banks, preferring instead to encourage weaker lenders to be absorbed by their stronger rivals. Those unable to meet the targets must present merger plans by the end of May 2012.

With banks under intense pressure to meet these targets, it is likely that they will seek to reduce the number of loans they grant, which raises the risk of a much deeper credit crunch developing. Once again, the Government is hoping that the short-term pain of these reforms will yield longer-term benefits for the economy in terms of a healthier banking system. But it will prove difficult to find the appropriate balance so that fiscal and banking reforms do not become self-defeating.

… contributing to a steep downturn in business investment in coming months

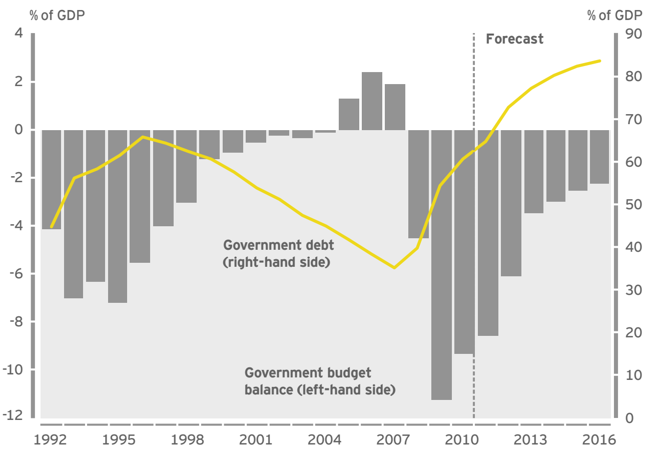
Industrial confidence indicators confirm that the business environment remains difficult, with new orders particularly weak. For example, the Purchasing Managers' Index (PMI) for the manufacturing sector indicated a further decline in output and employment in February. Weak domestic demand was cited as the main cause for the substantial drop in new orders, although new export business also declined further. And while sentiment indicators from the European Commission signaled a modest improvement in overall confidence at the beginning of the year, order books have fallen back to their lowest levels since mid-2010.

The near-term outlook for investment spending is especially bleak, given subdued prospects for demand and tight financing conditions. We forecast capital outlays in the economy will fall by over 8% in 2012, with a further decline of about 1.3% forecast for 2013. With the pressure on the economy from fiscal tightening likely to ease by 2014, this will help to promote a recovery to positive growth of 2%, driven by an upturn in corporate investment amid an improving outlook for profits.

With house prices expected to continue falling for the next three years at least, any significant recovery in residential construction activity appears some way off. Still, the rate of decline in residential investment is expected to moderate this year as the hardest phase of the adjustment has passed.

Figure 1

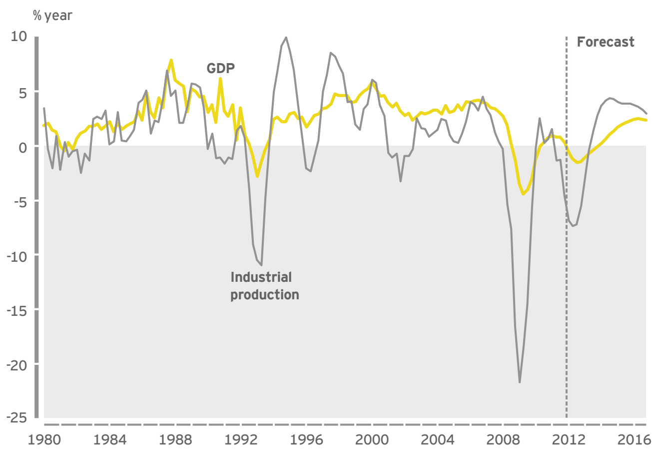
Government balance and debt



Source: Oxford Economics

Figure 2

GDP growth and industrial production



Source: Oxford Economics

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Dire labor market situation will also weaken consumer spending

In this difficult environment, companies are also likely to reduce employment further in order to preserve productivity and profitability. Latest official data indicates that 5.27 million people were jobless at the end of last year, translating to an unemployment rate of 22.8%. Joblessness is particularly high among young people, with 48.6% of people between the ages of 16 and 24 without work. High unemployment among the young poses a threat to the country's ability to maintain high skill levels in its labor force. With the economy forecast to contract this year, we expect the jobless rate to rise further, topping 25% of the workforce in H2 2012. This poses a risk of social unrest as the Government implements its reform agenda.

Real household income will at least find some relief as a result of the forecast decline in inflation, which we expect to fall from the preliminary estimate of 1.9 in February 2012 to below 1.5% in H2 2012. Even so, real disposable incomes will continue to fall due to ongoing fiscal consolidation, declining real wages and continuing job losses. Against this background, we forecast consumer spending will contract by 1.9% in 2012, with a further 1% decline expected in 2013.

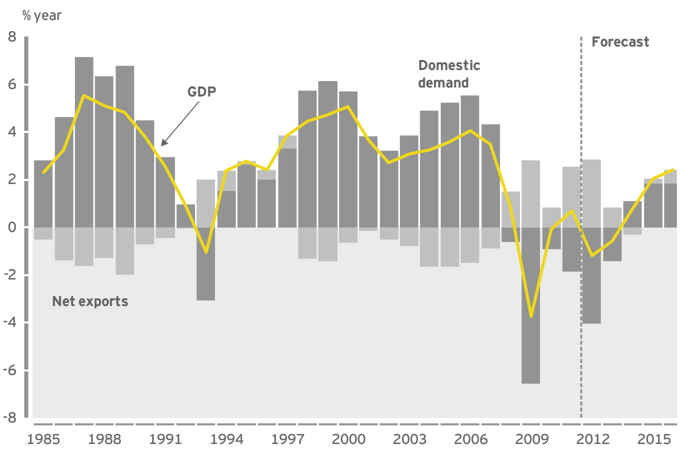
But there are bright spots on the economic horizon

Foreign trade will be the sole component of GDP, providing a positive impetus to growth over the coming year. We expect export growth to slow from an estimated 9% in 2011 to only 1.1% in 2012, as demand from Spain's major trading partners in the Eurozone weakens. But this compares with a fall of over 8% in imports seen this year, reflecting shrinking domestic demand. Against this background, we expect net exports to add 2.9 percentage points to GDP growth in 2012.

If the Government successfully implements its ambitious structural reform agenda, Spain could secure higher growth potential and sustained job creation in coming years. Labor market reforms are particularly important to reduce the unemployment rate and increase participation rates in the labor force. Assuming that the Government successfully achieves these goals, GDP growth should accelerate to over 2% a year in 2015-16.

Figure 3

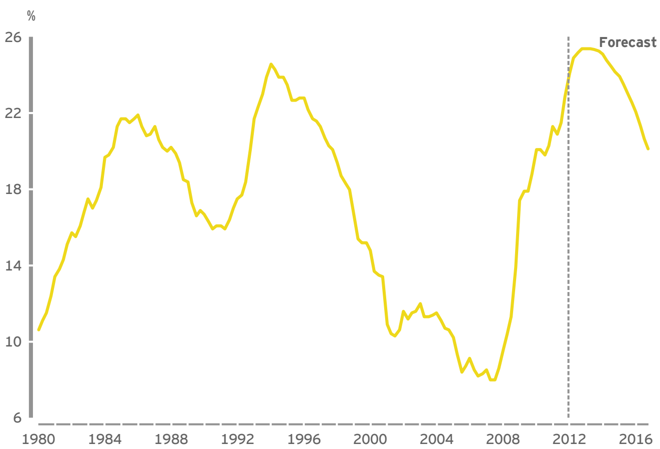
Contributions to GDP growth



Source: Oxford Economics

Figure 4

Unemployment rate



Source: Oxford Economics

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