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Economic Views

Eurozone

March 2012

View from the top

The situation in the Eurozone is calm but uncertain. Recent policy action by the European Central Bank (ECB) and the package agreed with Greece has bought time, but the recovery remains fragile. The underlying problems have not gone away, leaving many Eurozone governments with the complex task of reducing their debts, reforming their economies and delivering growth. As a result, Eurozone output will most likely shrink this year but should return to growth next year if sufficient progress on reform is made.

Weak macroeconomic fundamentals in the peripheral economies of Greece, Portugal, Italy, Ireland and Spain leave them most vulnerable to further shocks and to the depressing effect of deleveraging. Our vulnerability heat map demonstrates where the weaknesses are for the major Eurozone countries, Greece and Portugal still the most vulnerable contending with high debt, high yields, a highly exposed banking sector and slow progress in dealing with their problems. Ireland is currently among the most vulnerable, but is improving. Its debt yields are falling and falling labour costs have made it more competitive. Italy and Spain are still very vulnerable, although the recent ECB liquidity programme has temporarily helped to push down yields. Italy looks to be on a strong reform program and Italian yields have recently fallen below those of Spain. A reversal in the vulnerability ranking of Italy and Spain is expected. Stronger northern European countries have a degree of vulnerability too. They are not immune to further deterioration in peripheral economies, as they remain linked through the banking, trade and, importantly, confidence channels.

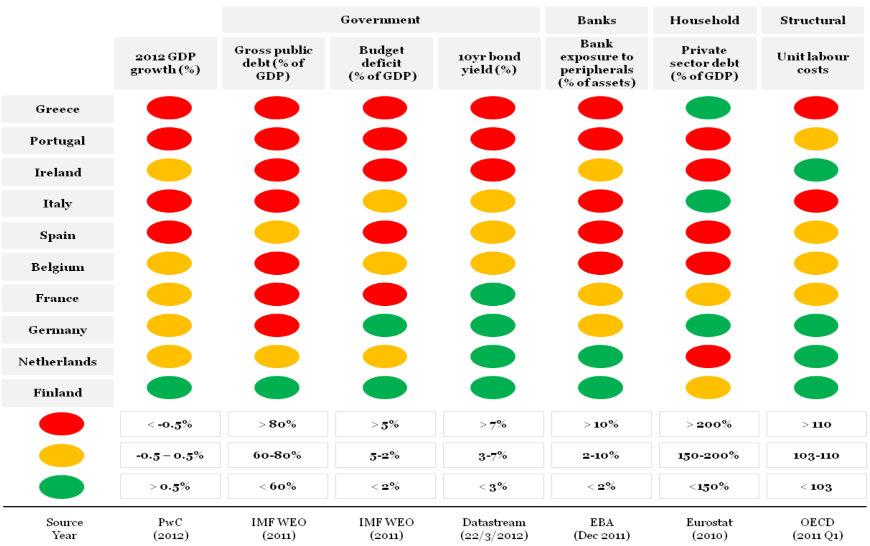
Key opportunities

- Strong demand from the core eurozone countries
- Strength of Germany, the Eurozone's largest economy
- Anchored inflation expectations
- Exporters to emerging markets

Key threats

- Greek debt crisis and threat of further sovereign defaults
- Lack of competitiveness in some of the peripheral economies
- Delays to implementation of structural reforms
- Business sentiment dampening

Eurozone vulnerabilities heat map



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Introduction

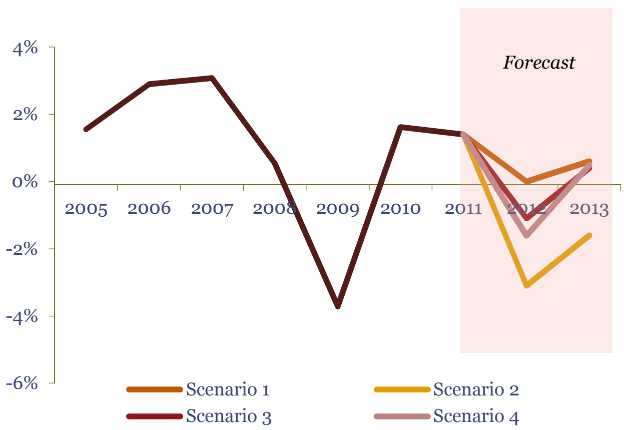
The situation in the Eurozone remains fragile. The path to recovery will be long, hard and bumpy. Many Eurozone governments are faced with a complex task to reduce their debts, reform their economies and deliver growth. Investors continue to question their resolve and capacity to deliver. Hopes of recovery are pinned on strong German growth and supportive ECB action, neither of which are assured.

In our report 'What next for the Eurozone'[1] we outlined four distinct scenarios for potential outcomes this year. This report builds on that analysis by identifying and comparing the vulnerabilities that are present in Eurozone countries and considers the key factors that will influence whether the Eurozone stays together and the recovery remains on track this year.

Recent developments and outlook

The Eurozone grew by 1.5% in 2011, with conditions deteriorating towards the back end of the year. There is a lot of uncertainty surrounding the future and we are advising clients to stress test against a range of scenarios (see Figure 1). A probability weighted average of our scenarios for the economy in 2012 indicates a contraction of 0.4% for the Eurozone due to falling consumption and government spending this year driven by private and public sector debt deleveraging.

Figure 1: Eurozone GDP growth (%)



Source: Eurostat and PwC forecasts

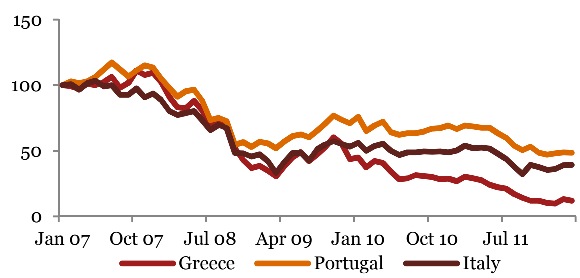
Exports from the Eurozone grew well in 2011 (6.1%), outpacing import growth (3.8%). Spain and Germany were the main drivers of export growth, with most countries improving their trade deficit. However hopes of recovery should not be pinned on net exports as they make a relatively small contribution to GDP (3% in 2011).

Investment across the region grew at a respectable rate of 4% in 2011, but this was driven by the northern European economies of Germany, the Netherlands, Belgium, Austria and Finland. The peripheral economies and France all saw investment shrinking in 2011, with Portugal and Greece seeing the contraction of investment accelerating. Overall, investment growth is likely to be slower across the Eurozone this year as uncertainty and volatility dominate the headlines, making planning difficult and delaying investment.

Capital flight is a big concern for the more vulnerable economies. Investors and households, fearing low returns, or possibly even a devaluation of their assets (e.g. through a currency redenomination) may move their capital elsewhere. If this were to take place on a large scale it would constrain investment activity and the ability of governments, banks and businesses to raise funds.

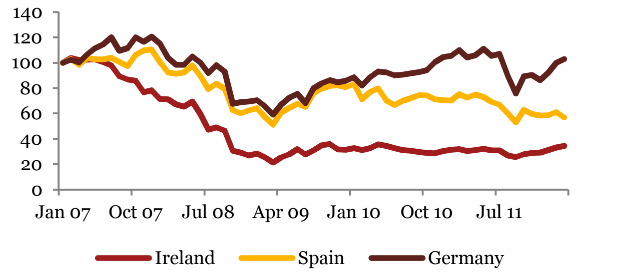
Capital flight can show up in investment performance and equity indices. Figures 2 and 3 compare stock market performances of selected Eurozone countries. The Greek, Portuguese, Italian and Spanish equity markets have all performed badly over the last year declining 59.5%, 29.5%, 24.7% and 21.3% respectively. Ireland is an exception and has not lost ground over the last year, despite large losses at the beginning of the recession. This suggests that Ireland – in the equity market's opinion at least – maybe separating itself from the endangered peripheral countries it has been identified with over the last few years.

Figure 2: Stock exchange indices (Jan 2007 =100)



[1] http://www.pwc.co.uk/economic-services/publications/what-next-for-eurozone-potential-outcomes-2012.jhtml

Figure 3: Stock exchange indices (Jan 2007 =100)



Source: Datastream

The risks ahead

The recovery and long term sustainability of the Eurozone is currently reliant on strong German growth, continued ECB intervention, sustained investor confidence in Greece and political stability, none of which are certain.

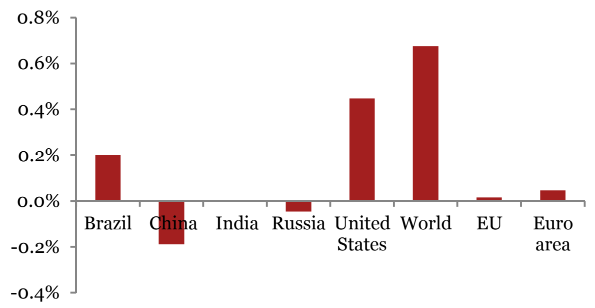
Will Germany drive a recovery in the Eurozone?

Germany is the largest and strongest economy in the Eurozone. It makes up 28% of Eurozone GDP and grew at 3% in 2011 adding 0.8 percentage points to Eurozone growth in that year. The performance of the German economy is important as it provides demand for exports from other Eurozone countries and acts as a bellwether for the Eurozone as a whole.

Net export growth (exports minus imports) makes a considerable contribution to German growth, around 0.8 percentage points in 2011. This is based on strong trade relationships with the US, Brazil and the rest of Europe. Figure 4 shows that exports to Brazil and the US made the biggest contribution to growth in 2010 and we expect this trend to continue in 2012 (see table 1), although slowing growth in Brazil is likely to reduce its contribution. Notably, China, which accounts for 3% of exports, actually had a negative impact on growth in 2010 as imports from China grew faster than did exports.

Nevertheless, the Eurozone remains Germany's biggest export market, accounting for 60% per cent of exports in 2011, and while the rest of Eurozone is struggling, German export growth will also remain subdued.

Figure 4: Contributions to German growth of net exports by country (2010)



Source: PwC calculations based on UNCTAD data

Investment, the biggest driver of growth in 2011, is expected to slow this year as weak demand across the Eurozone makes expansion or development of European based businesses a less advisable prospect. Government spending is expected to stagnate as it pushes forward with its austerity plan.

Together, this suggests that the German economy should grow modestly in 2012. If, however, the German economy tips into a recession, it would compound the problems in the rest of the Eurozone.

Table 1: Forecasts for Germany

Growth in (%)	2011 (actual)	2012 (forecast)	2013 (forecast)
Consumer spending	1.5	0.4	1.3
Government spending	1.4	0.5	0.6
Investment	6.4	1.2	1.4
Exports	8.2	2.4	3.2
Imports	7.4	2.6	2.6
GDP	3.0	0.6	1.4

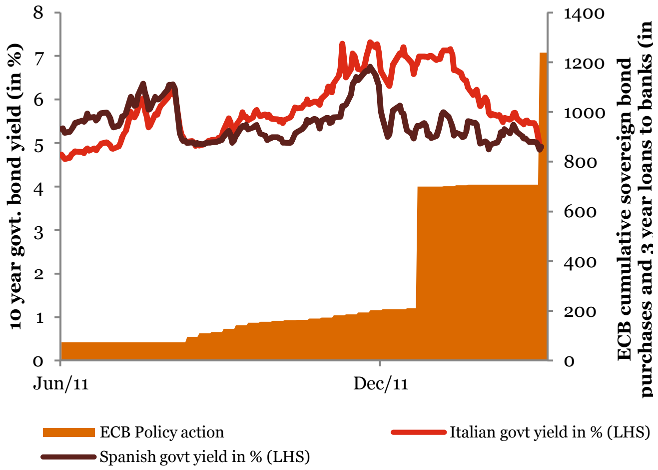
Source: Eurostat, PwC analysis

How much time will ECB programmes buy for Spain and Italy?

The ECB is currently undertaking the second of its Long Term Refinancing Operations (LTRO), which is pumping in a total of a trillion Euros of cheap loans into the banking system (equal to 11 percent of Eurozone GDP). These loans allow banks to rollover debt and start to restructure their balance sheets.

It also provides banks with a relatively low risk way to buy high yielding sovereign debt in countries like Spain and Italy. This has had a visible effect on government bond yields in the peripheral Eurozone countries. Figure 5 shows the relationship between the operations and falling bond yields. This is particularly useful given that the Italian government needs to roll over around €300 billion in 2012.

Figure 5: Italian and Spanish bond yields and the LTRO programme



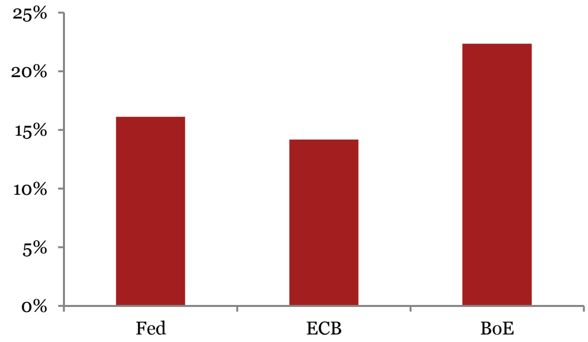
Source: ECB, Datastream

ECB action is buying time for Spain, Italy and other vulnerable economies to make progress on the necessary fiscal and structural reforms. But it does not solve the underlying problems, and there is a risk that countries will not make sufficient progress by the time the effects of the liquidity programme subside.

Experience from liquidity programmes in the US and UK suggests that their impacts appear to be fairly short lived, of the order of 6 months. For example, the first round of quantitative easing in the US ($1.75trillion) led to a reduction in US 10 year treasury yields by around 150 basis points when it was launched in November 2008 but yields returned to previous levels after 6 months. In the UK, the first round of quantitative easing (£200 billion) in February 2009 reduced UK government yields by around 90 basis points but by June 2009 yields had reverted to earlier levels.

Nevertheless, this operation is a sign that the ECB is willing to take decisive policy action, and it has scope for further expansion should signs of market distress reappear. The size of the ECB's liquidity operation is still smaller than the operations of the Bank of England (BoE) and the Federal Reserve (Fed) (Figure 6).

Figure 6: Central Bank liquidity operations to GDP ratio



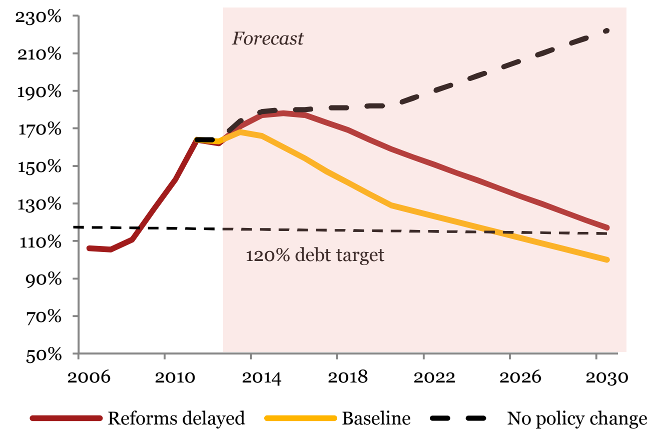
Notes: Includes US QE, ECB LTRO, SNP and BoE QE

Source: PwC calculations, Datastream

Is Greece now safe?

A widespread exit of economies from the monetary union looks less likely now that the ECB is providing liquidity to the banking system. A Greek exit this year also looks less likely following the $130bn funding package agreed with the troika (EU, ECB and IMF) and the selective default agreed with creditors.

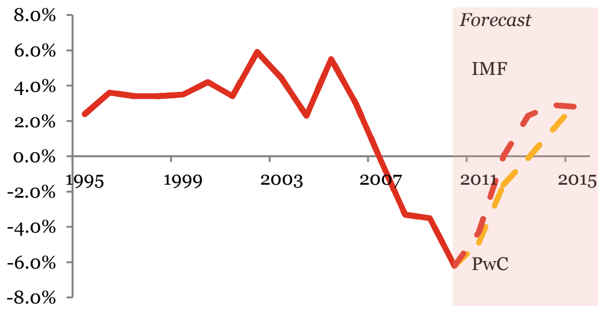
Figure 7: Public debt projections for Greece (% of GDP)



Source: IMF

However, the Greek problem is far from resolved. The debt sustainability analysis by the IMF is based on an ambitious growth forecast (see Figures 7 and 8) and requires the government to implement tough reforms. Perversely, the longer the problem goes on, the more prepared the rest of the Eurozone becomes for a Greek exit, making it more likely to happen. It is also becoming clear that political attitudes to Greece are hardening.

Figure 8: Real GDP growth forecasts for Greece



Source: IMF, PwC analysis

Will political cohesion remain?

France and Greece face major elections this year, which have the potential to destabilise the Eurozone.

Nicolas Sarkozy and Francois Hollande are the two main contenders in the French elections in April. Both have outlined different visions for France and for dealing with the Eurozone crisis. The elected candidate could have a profound effect on how the eurozone crisis develops.

Greece is already in a precarious position; a strong protest vote in the proposed elections in late April could threaten the uneasy truce it has with the troika, on its bailout package.

Country vulnerabilities

Weak fundamentals have left many Eurozone countries vulnerable to further shocks. Our vulnerability heat map (page 1) details those weaknesses based on public debt, debt finance costs, economic growth rates, banking sector exposure to sovereign debt and progress on structural reform. Countries that perform poorly on these are at most risk from further shocks and will have to undertake a longer and deeper adjustment process.

Government

The deleveraging challenge across the Eurozone should not be underestimated. Peripheral economies will have to make rapid progress to improve their budget deficits and public debt ratios. Any adverse event which causes planned retrenchment to falter will raise doubts about the sustainability of that debt and drive up borrowing costs, deepening the problem.

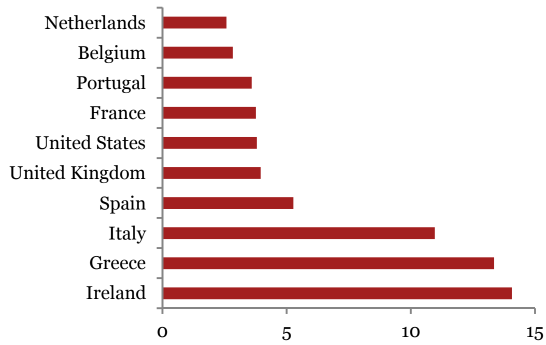
Greece, for example, has committed to turn a 10.6% deficit in 2010 into a projected 1.4% deficit in 2014. In contrast, Spain has a low government debt ratio, but a large budget deficit and poor growth prospects which have pushed yields up. A high degree of fiscal autonomy by its regions and the recent announcement by the Government that it will not meet this year's austerity targets only serve to increase doubts about the ability of Spain to control its debts.

But it is not only the peripheral countries that are in need of deleveraging. Both France and Germany have high public debt ratios. They are currently less of a concern now as the cost of borrowing is relatively low and the turn-around in the budget deficit required is more modest. However, they will need to deleverage and this will take further demand out of the Eurozone.

Bank exposure

ECB liquidity action makes widespread default in the banking sector unlikely. Nevertheless, banks remain highly leveraged and holding risky debt. Peripheral countries (excluding Portugal) already have high rates of non-performing loans, and the Irish banking sector remains particularly exposed (Figure 9). Banks need to restructure and strengthen their balance sheets, which will lead to a further tightening of credit conditions. Plans submitted by banks to the European Banking Authority suggest they will cut €39 billion from their loan portfolios.[2]

Figure 9: Total non-performing loans to Gross loans (%) latest estimates



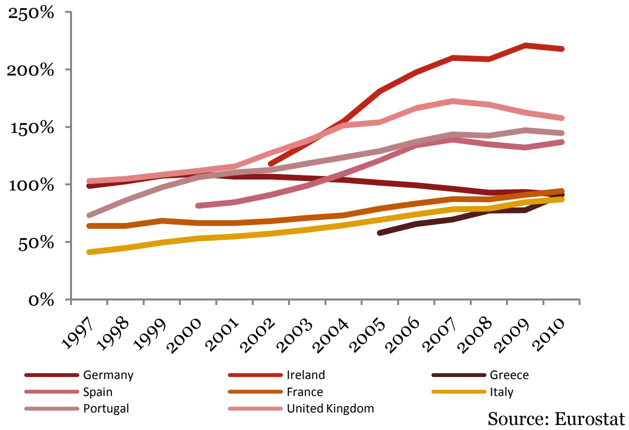
Source: IMF

Households

Household leverage grew significantly during the early 2000s (see Figure 10). Borrowing from abroad allowed some economies to improve their consumption levels without increasing their competitiveness.

[2] BIS Quarterly review, March 2012.

Figure 10: Household liability to gross disposable income (%)



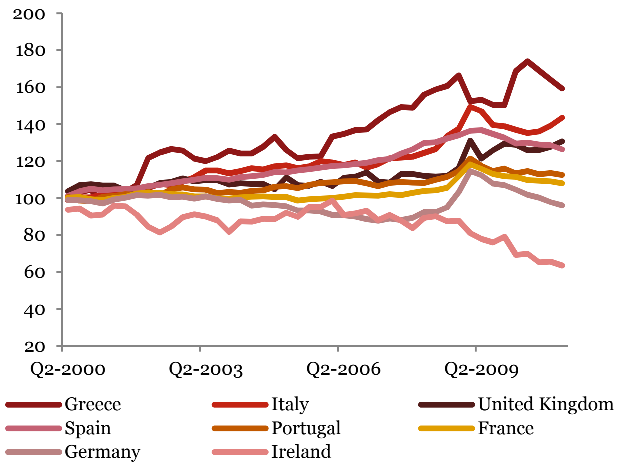
Source: Eurostat

Countries with high levels of private sector debt have households more prone to default. This provides additional risks to the banking system and will require longer and deeper deleveraging, which will weigh heavily on growth. The vulnerability heat map shows that Ireland, Portugal and Spain appear most at risk

Structural reform

Uncompetitive economies, largely in peripheral Europe, will need to bring their competitiveness in to line with the rest of the Eurozone if the currency bloc is to remain sustainable without further fiscal transfers.

Figure 11: Manufacturing unit labour costs (Index 2000 Q1 = 100)



Source: OECD

Greece and Italy have fallen furthest behind the rest of Europe on competitiveness, as measured by unit manufacturing labour costs (see Figure 11). Unit labour costs can be brought down by improving productivity, but the quickest way is by reducing wages. This makes the adjustment difficult and painful. A number of countries will have to face up to painful wage adjustments over the next few years. Ireland has made good progress reducing its unit labour costs over the past few years despite having relatively low costs initially. Other peripheral economies need to do the same.

Which countries are most at risk?

Looking across the vulnerability heat map, Greece and Portugal are in the most precarious position. Of the two, Portugal is in a slightly stronger position since the troika has indicated it may be willing to renegotiate its austerity plan.

Ireland has a very flexible labour market and is relatively more competitive, making its position in the euro more sustainable. Although Ireland is still very vulnerable on most metrics, it appears to be on an improving path.

Italy continues to wrestle with high debts and low growth, although it has benefited from falling debt costs. Spain suffers from a large budget deficit and relatively high borrowing costs (yields on Spanish government bonds surpassed those of Italy recently), but not a particularly high debt to GDP ratio. However, the need for extensive deleveraging will severely depress internal demand.

The Belgian economy does not usually warrant attention but a high budget deficit and high bank exposure make it extremely vulnerable to defaults by other eurozone countries and, being a small open economy, to reductions in demand from its large European neighbours.

Projections*

GDP (annual % average)	2010	2011[e]	2012[f]	2013[f]
Eurozone	1.7	1.5	-0.4	0.8
Austria	2.1	3.2	0.5	1.4
Belgium	2.1	1.9	0.0	1.0
Estonia	3.1	7.5	2.0	3.6
Finland	3.1	2.9	0.5	1.5
France	1.5	1.7	0.2	0.9
Germany	3.5	3.1	0.6	1.4
Greece	-4.5	-6.8	-4.9	-1.6
Ireland	-1.0	0.7	-0.2	1.3
Italy	1.2	0.4	-1.6	0.1
Netherlands	1.8	1.5	-0.5	1.0
Portugal	1.4	-1.5	-3.8	-1.0
Slovakia	4.0	3.3	1.9	2.4
Slovenia	1.2	-0.2	0.5	1.6
Spain	-0.1	0.7	-1.3	0.1

Source: Eurostat; PwC estimate (e); PwC projections (f)

Inflation (HICP % change, annual average)	2010	2011[e]	2012[f]	2013[f]
Eurozone	1.6	2.6	2.2	1.9
Austria	1.7	3.3	2.0	1.8
Belgium	2.2	3.5	2.2	1.8
Estonia	3.0	5.0	2.8	3.0
Finland	1.3	3.5	2.5	2.1
France	1.7	2.1	2.3	2.7
Germany	1.2	2.3	1.9	1.8
Greece	4.7	3.3	1.5	0.5
Ireland	-1.6	2.6	1.3	1.5
Italy	1.6	2.8	2.6	1.4
Netherlands	0.9	2.3	2.4	2.0
Portugal	1.4	3.7	2.3	1.6
Slovakia	1.0	3.9	3.3	3.6
Slovenia	1.8	1.6	3.0	3.3
Spain	2.0	3.2	2.1	1.8

Source: Eurostat; PwC estimate (e); PwC projections (f) Note: HICP = Harmonised Index of Consumer Prices

* Projections are derived from a probability-weighted outlook for the four different scenarios described in this report

Size of the Eurozone economy

	2008	2009	2010	Share of 2010 world total
Population (millions)	327	328	329	4.8%
GDP, market rates (US$ billions)	13,614	12,476	12,193	19.4%
GDP, PPP rates (US$ billions)	10,879	10,530	10,816	14.6%
GDP per capita, market rates (US$)	41,669	38,025	37,057	
GDP per capita, PPP rates (US$)	33,178	31,997	32,773	

Source: International Monetary Fund

PwC Macro Consulting

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We assist clients in demonstrating the value they bring to their host economies in the context of wider economic trends.

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