

ESADE

Universidad Ramon Llull

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BancSabadell

ECONOMIC OVERVIEW

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EDITORIAL

Will the Euro Survive?

By joining the euro, Europe's peripheral countries gained access to cheap, easy financing. They spent beyond their means and became heavily indebted to the core eurozone countries, while watching prices gradually rise. When the crisis hit, the periphery found itself saddled with debt, unable to refinance, its competitiveness eroded, and in no position to kick-start growth.

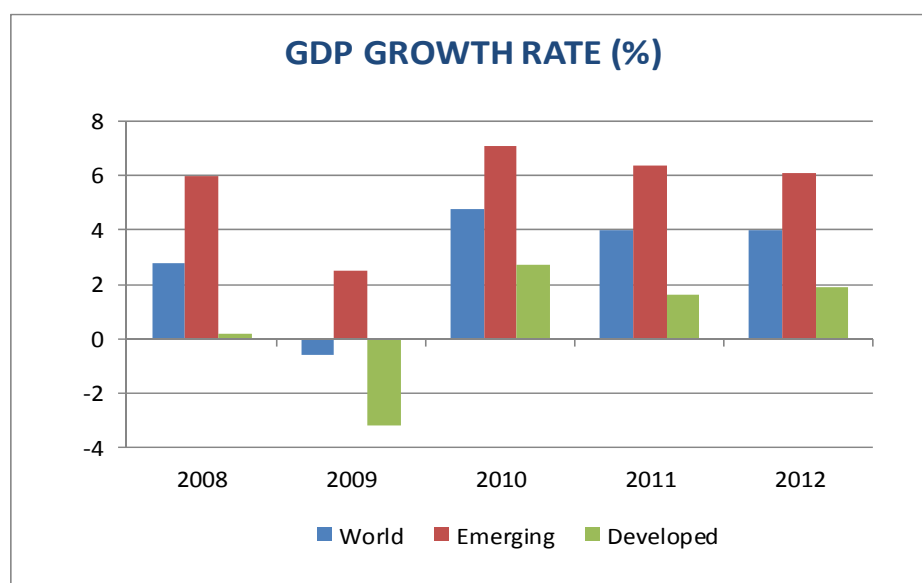


An adjustment in the balance of payments is direly needed, but who will pay for it? The peripheral debtor countries, it seems – and without favourable monetary policies or growth-oriented spending in the core countries. Without this support, and without recourse to devaluation, the peripheral countries face a long, costly and tense adjustment process. The euro's survival hinges on leaders addressing this economic reality.

WORLD ECONOMY

Recovery falters

The global economy has slowed down as the deepening eurozone sovereign debt crisis has undermined confidence. Downside risks predominate, and two main hazards threaten the world economy: the European Union's ongoing sovereign debt problem, and the possibility of contagion if the United States economy falters. Developed countries face obstacles to structural reform, while emerging economies show stronger growth but face more risk and uncertainty.



Source: IMF

Developed world hits trouble

Nearly all developed economies will post low growth for 2011 and 2012, and unresolved conflicts could push growth even lower. Steps have been taken to address the gravest threat – the eurozone sovereign debt crisis – but the EU has yet to find a definitive solution. Meanwhile, the US has struggled to

balance short-term stimulus and medium-term fiscal sustainability, as illustrated by the partisan brinksmanship of the congressional debt ceiling negotiations. Left to fester, these problems could have a negative impact in the world economy.

Developing economies still growing

Emerging economies continue to grow steadily, but have slowed slightly as demand has fallen in the developed world. Growth levels vary among developing regions, with Asian countries leading the pack. Inflation has risen throughout the developing world, prompting central banks to raise interest rates. Most emerging economies are receiving sufficient financing under acceptable conditions. In certain countries, with capital flowing in and asset prices rising, the central banks may need to step in to prevent market bubbles. The greatest threat to emerging economies is the possibility of a recession in the developed

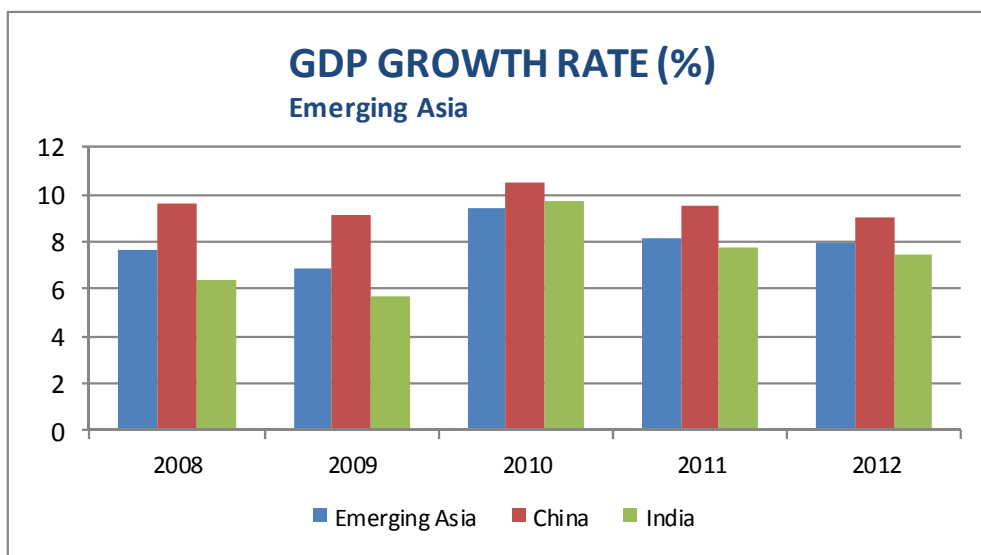
world, which would lead to a drop in exports, capital outflows and financial problems. High growth has enabled some developing countries to initiate fiscal adjustments to keep public debt in check.



Banco Central Do Brasil

China and India: emerging, but different

There are major differences between the world's two fastest-growing economies. With 9% annual growth, China has been able to adjust its fiscal policy, and the country's domestic demand has gradually increased, partially offsetting the loss of foreign demand. China's central bank recently acted to cool down the economy and prevent housing prices from rising too sharply. India's strong growth (>7%) is driven more by consumption than by investment. Inflation remains alarmingly high despite recent interest rate hikes. Unlike China, India's economy is at risk of overheating and forming speculative bubbles.



Source: IMF

US needs balanced fiscal policy

In the US, economic growth has flagged and unemployment has hit historic highs. Consumer confidence has been shaken by joblessness and a weak housing market; business confidence by financial market volatility. The country needs to balance short-term stimulus with medium-term public debt sustainability. Growth will stall if stimulus measures are not kept in place, but care must be taken not to spook the markets – a higher risk premium on US bonds would hamper growth. Failure to stabilise the country's public finances could mean the end of public-sector access to inexpensive financing. The US should maintain an accommodative monetary policy, with interest rates close to zero; the Federal Reserve must be willing to buy up public debt to ease market liquidity crises. As a counterpoint, financial reforms are needed to tighten oversight of systemically crucial institutions and to discourage overleveraging.

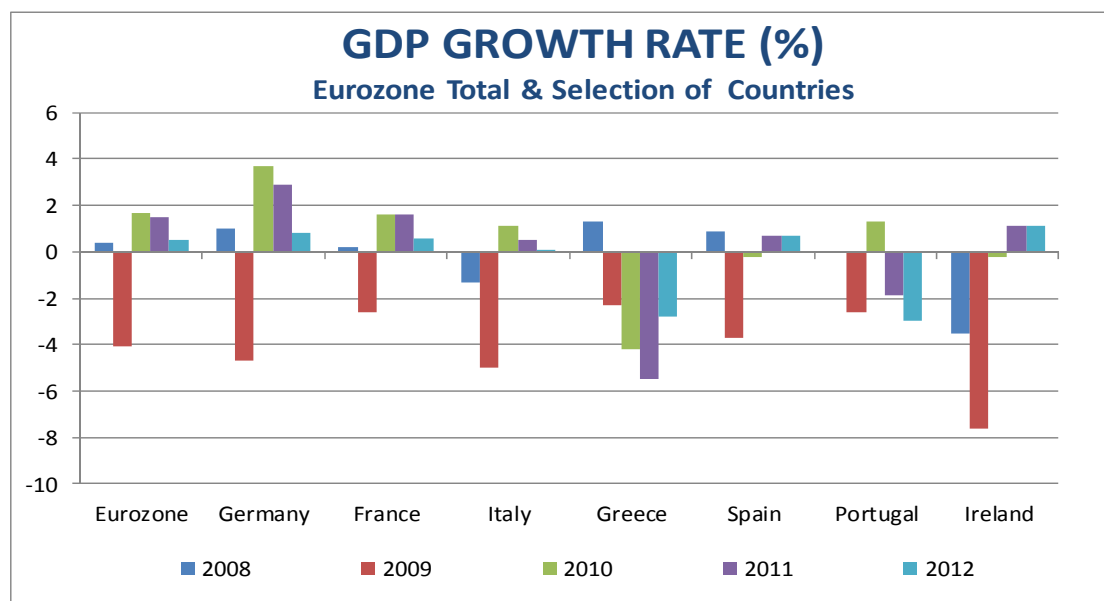
Rebalancing the world economy

To get the global economy back on track, two forms of rebalancing are urgently needed. First, demand needs to be shifted from the public to the private sector once growth has regained traction. Second, emerging countries need to correct their trade imbalances by focusing on their domestic markets.

EUROZONE ECONOMY

Growth to slow in 2012

The prospects for recovery in the eurozone are down from last year as growth has stalled worldwide and the European sovereign debt crisis has worsened. The core European countries are doing only slightly better than the 0% growth in the periphery, while emerging European economies are growing at around 2%. Europe is dominated by downside risks related to the debt crisis and the resulting instability of the financial markets. Failure to find definitive solutions could squelch growth and push the eurozone into recession in 2012.



Source: European Commission

2011: a difficult year

After a promising bump that lasted through early 2011, growth fell throughout the eurozone in response to the debt crisis. As doubt plagued the European financial system, lowered expectations brought the crisis to

strong countries that had seemed on the verge of recovery. The growing sovereign debt crisis raised questions about the euro's viability. Rescues and reforms notwithstanding, a definitive solution remained elusive, clouding prospects for the European and global economies. Risk premiums rose in March as markets responded to the political deadlock. A eurozone slowdown exacerbated the already difficult path back to growth faced by countries making fiscal adjustments. Government-bond ratings were slashed, and fear of catastrophic bankruptcy grew with the protracted failure to make important decisions. Risk premiums soared.

EUROZONE DEBT CRISIS TIMELINE
<p>November 2009 Greece's real public deficit revealed to be more than 10% of GDP.</p>
<p>May 2010 Greece, shunned by markets, receives €110 billion bailout from Eurozone and International Monetary Fund (IMF); European Financial Stability Facility (EFSF) created; European Central Bank (ECB) begins Securities Markets Programme.</p>
<p>November 2010 Ireland, shunned by markets, receives €85 billion bailout from Eurozone and IMF.</p>
<p>May 2011 €78 billion bailout plan for Portugal approved.</p>
<p>June 2011 European Stability Mechanism (ESM) approved; will replace EFSF in 2013.</p>
<p>21 July 2011 At summit, European leaders debate the need for a second Greek bailout and EFSF reforms.</p>
<p>5 August 2011 ECB reinstates Securities Markets Programme.</p>
<p>26 October 2011 At summit, European leaders approve Greek bailout with 50% haircut affecting private investors, expansion of EFSF to €1 billion, and 9% Tier 1 capital ratio requirement for banks.</p>

Summit of 21 July 2011

At the emergency summit of European leaders, the European Financial Stability Facility (EFSF) was granted greater flexibility to take preventive action. The EFSF's lending capacity was increased to €440 billion, a figure insufficient to cover Spain and Italy, as the Germans balked at the possibility of having to pay other nations' debts. A second rescue package, requiring deficit reduction and other conditions, was approved for Greece. After the summit, doubts persisted as to whether the EFSF was big enough and whether Greece would be forced to restructure its debt. Financial instability reigned. Despite a bank recapitalisation plan, the markets feared what a debt haircut in a eurozone country might do to banks' balance sheets. In August, the European Central Bank (ECB) once again started covering bond purchases to bring down risk premiums.

Trouble in Europe's financial sector

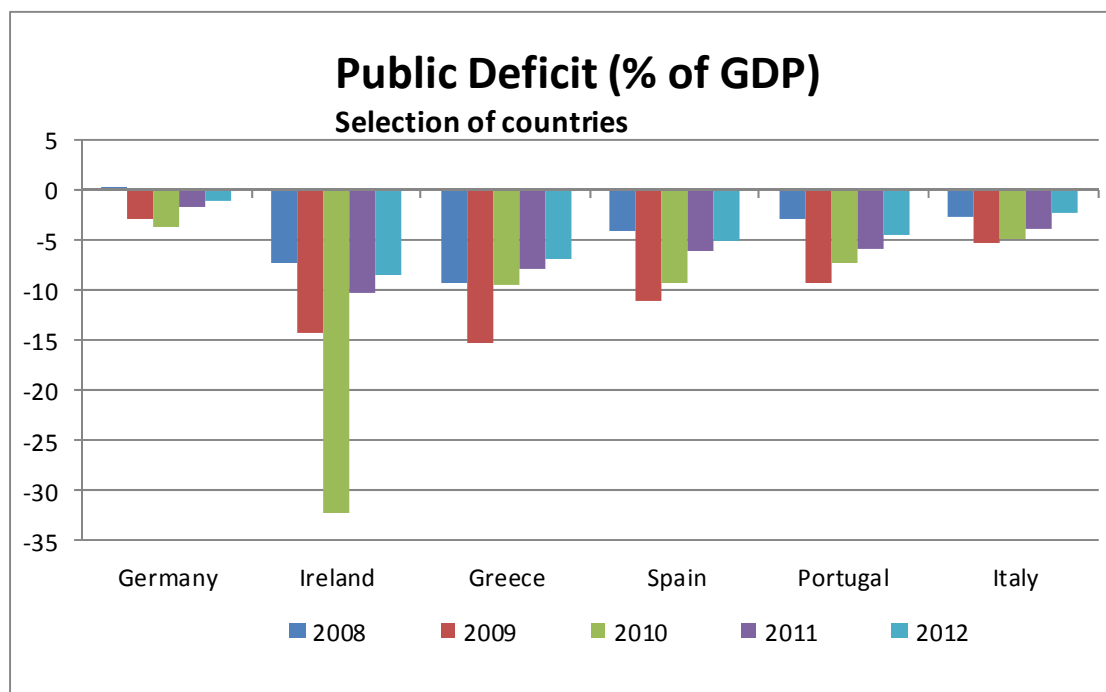
After the crisis hit, eurozone banks, dependent on wholesale finance, were unable to recapitalise. The summer was marked by widespread fear of Greek default followed by the spread of insolvency throughout the highly interconnected eurozone. The crisis slowed Europe's financial integration process, with cross-border bank mergers becoming rare. By October, the need for bank recapitalisation was clear, although a solution remained elusive and the markets volatile.

Summit of 26 October 2011

At the second EU leaders' summit, agreements were reached on three interconnected problems. First, the specifics of the second Greek rescue package were defined, including a 50% haircut on Greece's public debt. Second, to cover potential problems in Italy and Spain, the EFSF was enlarged to €1 trillion and ordered to partially guarantee the bonds of troubled countries. Third, to help Europe digest the effects of Greece's debt restructuring, a bank recapitalisation plan with capital ratio requirements was announced.

More fiscal adjustments

In early 2011, fiscal adjustments were made across Europe to reduce deficits and stabilise debt. To meet the requirements accompanying aid packages, severe measures were taken by Greece, Ireland and Portugal, but less-drastic steps were also taken by France, Germany and Italy. Following the July and October summits, further fiscal adjustments were introduced, including spending cuts, VAT hikes, new taxes, and reductions in pensions and public-service salaries. Greece made especially dramatic adjustments in order to secure access to further bailout money. These measures have slowed the bleeding of eurozone coffers, but uncertainty remains about growth and the ability to balance recovery with debt sustainability. The most deeply troubled countries must maintain the credibility of their adjustments and allow external audits, lest doubts become self-fulfilling, and the ECB needs to signal willingness to buy sovereign debt if necessary. The ECB has kept interest rates low, but its anti-inflation policies could be counterproductive, as inflation is expected to drop.



Source: IMF

Protracted debt crisis

As the debt crisis has dragged on, some calls for a euro breakup have been heard. The euro is in need of crucial reforms; dismantling it, however, could undermine the basis of Europe's prosperity. For the euro to survive, past problems must not be repeated, unified support for the currency must be maintained, and political leaders must stay ahead of events. The eurozone also needs a fiscal-risk-sharing mechanism and greater control over the internal workings of member states.

EUROPEAN FINANCIAL STABILITY FACILITY (EFSF)

The EFSF is a special-purpose vehicle created by the 17 eurozone countries in 2010 to address Europe's sovereign debt crisis. It was initially charged with providing financial assistance to troubled countries in order to guarantee stability in the eurozone. In July and October 2011, its uses were expanded to include recapitalising banks and providing conditional financial assistance to countries that, while not receiving bailout money, were being shunned by financial markets. After successive expansions, the EFSF's lending capacity is now nearly €1 billion, backed by proportional member-state contributions and the issue of AAA-rated EFSF bonds on capital markets.

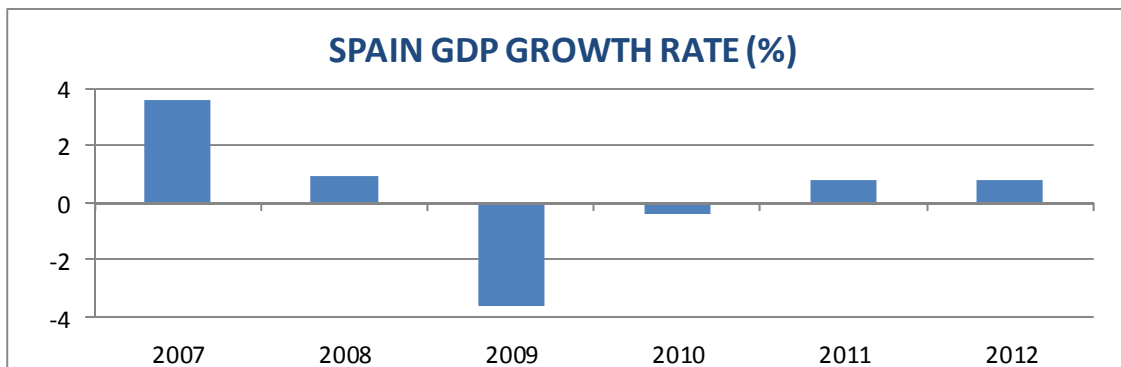
To receive EFSF aid, a country must request assistance and negotiate conditions with the European Commission and the International Monetary Fund (IMF), a process only initiated, to date, by Greece, Ireland and Portugal; aid is suspended if conditions are not met. EFSF aid for bank recapitalisation, also strictly conditional, is channelled through the respective national government. For preventive purposes, the EFSF may also lend money to non-bailout countries.

The EFSF will stop providing aid in June 2013 and will be dissolved once repaid for all outstanding loans. Its permanent successor, European Stability Mechanism (ESM), will perform the same functions.

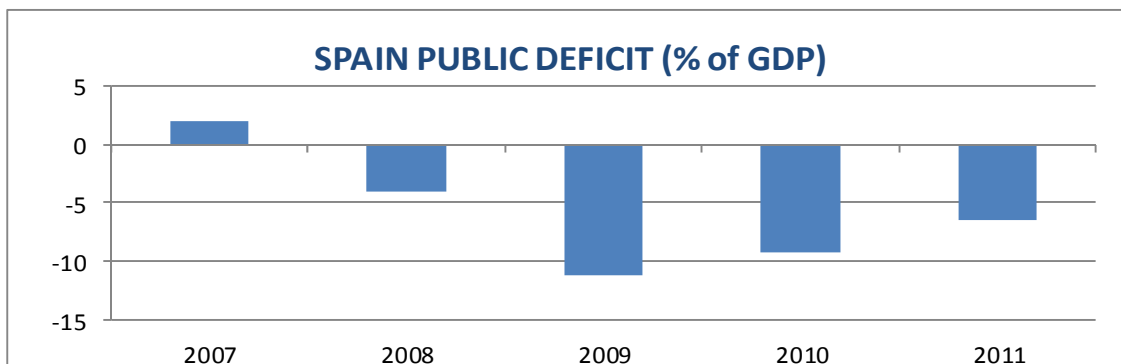
SPANISH ECONOMY

Prospects for 2012: further stagnation

Spain's economy will remain stagnant throughout 2012, with close to 0% growth, one in five workers unemployed, no job creation and no recovery on the horizon. Inflation will stay below 2%. Since public spending and construction activity has slowed, the foreign sector will be the only source of growth. The main up- or downside risks facing the country come from abroad. The success of Spain's exports depends on the fortunes of the global – and especially European – economy. Spain's access to affordable financing and the severity of its fiscal adjustments hinge on the resolution of the Eurozone's sovereign debt crisis.



Source: Bank Of Spain



Source: Bank Of Spain

Persistent joblessness

At 21%, Spain's unemployment rate is the eurozone's highest. The Spanish economy shed jobs throughout 2011 and employment is not expected to rise in 2012. High joblessness reflects the weakness of the economy and does not necessarily signal the failure of Spain's recent labour reforms, which, nonetheless, probably did not go far enough.

The sole driver of growth: the foreign sector

In 2011, the foreign sector – exports, in particular – was the sole source of growth, offsetting the slightly negative growth in domestic demand. The export destinations that saw the greatest increase were the United Kingdom and the new European Union members, followed by the OPEC countries and Russia. Foreign tourism rose practically to pre-crisis levels. If eurozone growth stays weak in 2012, Spain will need to boost its exports to emerging countries.

A lethargic real-estate market

Property values are down 18% from 2008 and falling. Exposure to problematic real-estate assets is the greatest weakness of Spain's financial system. Under the adverse conditions considered in the EU-imposed stress tests, 80% of banks' losses would be covered. The stress-test



conditions, however, were less severe than the 30–35% overall drop in property values forecasted by the Bank of Spain. However, the recapitalisation requirements announced by European leaders at the July and October summits should increase bank safety margins.

Restructuring and recapitalising the financial sector

The weak housing market has spawned a vicious cycle, creating a credit crunch, unemployment and weakened demand. When the subprime crisis

hit the United States in 2007, Spain's banks seemed well-positioned, profitable and solvent, with few toxic assets. Spain's burst housing bubble proved that the country's banks were, in fact, overexposed to real-estate risk. In response, Spain has adopted a strategy of injecting capital – with conditions – into the banks and reconsidering the status of the hardest-hit institutions: the savings banks. In March, Spain passed a new recapitalisation law, which set minimum core capital requirements, and similar requirements were announced at the October EU leaders' summit. So as not to harm growth prospects, the recapitalisation of Spain's financial sector must not be done at the expense of households and businesses.

Current status of the financial sector

Most of Spain's savings banks have merged, downsized and become commercial banks. By October, Spanish banks had raised their capital to €13 billion – with more than half coming from Spain's Fund for Orderly Bank Restructuring (FOBR) – and several banks had to increase their core capital. Fortunately, Spain's banks hold very little public debt issued by eurozone countries. Their biggest problem is exposure to real-estate assets, which are still likely to decrease in value. For Spain's banks, the main barrier to financing is their inability to access wholesale markets. Bond purchases by the European Central Bank cover the banks' liquidity needs but are a temporary solution. For Spain to regain the confidence of the capital markets, it must correct the weaknesses of its financial system and Europe must cease to spook the markets with dubious political action. Private-sector credit availability decreased in 2011 as banks themselves faced obstacles to financing and adopted stricter lending standards.

Challenges for the new government

The solution to many of Spain's problems depends on foreign actors, but there are some challenges that Spain's leaders must address: meeting public deficit goals set by the EU; increasing Spain's competitiveness to guarantee a rise in exports; increasing Spain's presence in high-growth non-EU economies; implementing further labour reforms; keeping financial sector reform going; and focusing public spending on boosting the country's productivity.