

# Euro debt crisis: Spotlight on Spain

Crunch time ahead:  
Can Spain turn the corner without using the safety net?

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## Conference Call

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Spanish 2-year yields: far away from the 6% pain threshold



Source: Bloomberg

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## Euro Sovereign Debt Crisis

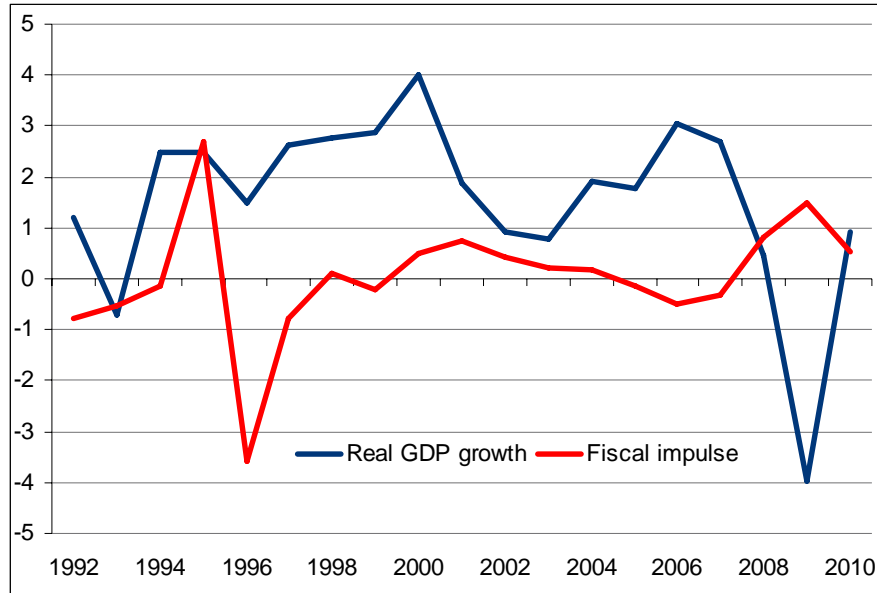
- Greece has been sorted out, in our view: it can draw on €110bn support and should not need to access the debt market again before 2012. So far, Greece is faithfully implementing a very tough austerity programme. Deficit down 35% ytd.
- Spain, Portugal and Ireland could draw on support funds of up to €750bn if need be. In addition, the ECB is buying government bonds and injecting as much liquidity at its main refi rate for 3 months as the banks ask for.
- Fiscal tightening in the Eurozone in 2011 will likely amount to 1.2% of GDP. More than half of that was known long ago. Evenly split between expenditure cuts (good) and tax hikes (bad for growth). The austerity will be a modest drag on growth in 2011.
- However, the 9% fall in the trade-weighted exchange rate since 1H 2010 can add about 0.9% to Euro GDP after one year. Roughly offsets the fiscal drag tightening for 2011.
- But mind the fear factor: even if the fundamentals are largely sound, a sustained financial market panic can hurt the real economy as businesses become more reluctant to invest, to build inventories and to hire. Sustained turbulence remains the major downside risk to our forecasts.

## Euro Crisis: Potential end games

- **End game I: Fundamentals prevail soon.** Markets realise that the panic is far overdone. Tensions fade in early July, leading economic indicators stabilise in July and rebound thereafter. Very limited damage to the real economy. Trend growth in 2H 2010, above trend in 2011. Probability: unlikely
- **End game II: Serious tensions for 2-3 more months.** As real money refuses to buy peripheral bonds, yields for Spain, Portugal and Ireland rise further. Political noise with a risk of early elections in Spain. Serious risk that Spain falls into the €750bn safety net. But once Spain (and Portugal/Ireland?) are in, market tensions fade. No sovereign default, Spanish banks receive further capital injections if need be. Temporary dip in Euro real GDP growth below trend in 2H 2010 followed by above-trend growth 2011. Probability: more likely than not.
- **End game III: Focus on Italy after Spain is in the safety net.** Despite Italy's low structural deficit (3.0%), its largely healthy banking system and its strong funding base at home, a buyer's strike for Italian bonds pushes it towards the safety net - which is not big enough for Italy. ECB has to come to the rescue with massive bond purchases as Euro members won't get further bail-outs through parliament. Tensions ease once the ECB steps in. Temporary stagnation in Euro real GDP in 2H 2010, nice rebound 2011. Very unlikely.
- **Tail risk: German-French divorce; German court says "no".** Extremely unlikely.

# Does Austerity Hurt?

## Fiscal impulse and GDP growth



Fiscal impulse: change in cyclically adjusted primary fiscal balance, a positive number represents a loosening of fiscal policy. Source: Eurostat; OECD, BofAML calculations

- Fiscal tightening will be a modest 1.2% of GDP in the Eurozone in 2011
- Austerity need not hurt demand growth. Confidence effects can dampen the impact.

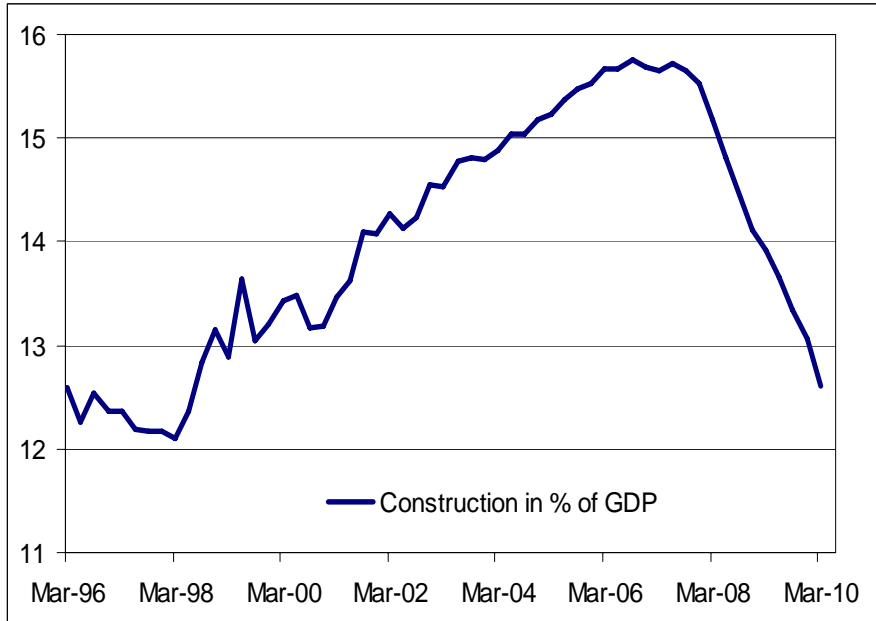
Table 1: Eurozone fiscal tightening (% of GDP)

	2010	2011		Total
	Total	Baseline	New	
<b>Germany</b>				
% of GDP	-0.7	0.9	0.2	1.1
€ bn	-18.0	20.0	5.0	25.0
<b>France</b>				
%	0.0	0.5	0.5	1.0
€ bn	0.0	10.0	9.0	19.0
<b>Italy</b>				
%	0.0	0.6	0.8	1.4
€ bn	0.0	9.0	13.0	22.0
<b>Spain</b>				
%	2.0	1.5	1.0	2.5
€ bn	21.0	16.1	10.7	26.8
<b>Greece</b>				
%	5.0	1.0	2.0	3.0
€ bn	12.5	2.5	5.0	7.5
<b>Portugal</b>				
%	1.8	0.8	2.0	2.8
€ bn	2.9	1.3	3.3	4.6
<b>Ireland</b>				
%	2.5	1.5	0.6	2.1
€ bn	4.0	0.0	1.0	1.0
<b>Others</b>				
%	0.0	0.4	0.3	0.7
€ bn	0.0	1.5	1.1	2.6
<b>Eurozone</b>				
%	0.2	0.7	0.5	1.2
€ bn	22.4	66.6	50.2	116.8

Source: BofAML calculation

# The Pain in Spain

## The Problem: Construction



Share in real GDP in chained 2000 prices. Source: INE

## The Solution: Net Exports

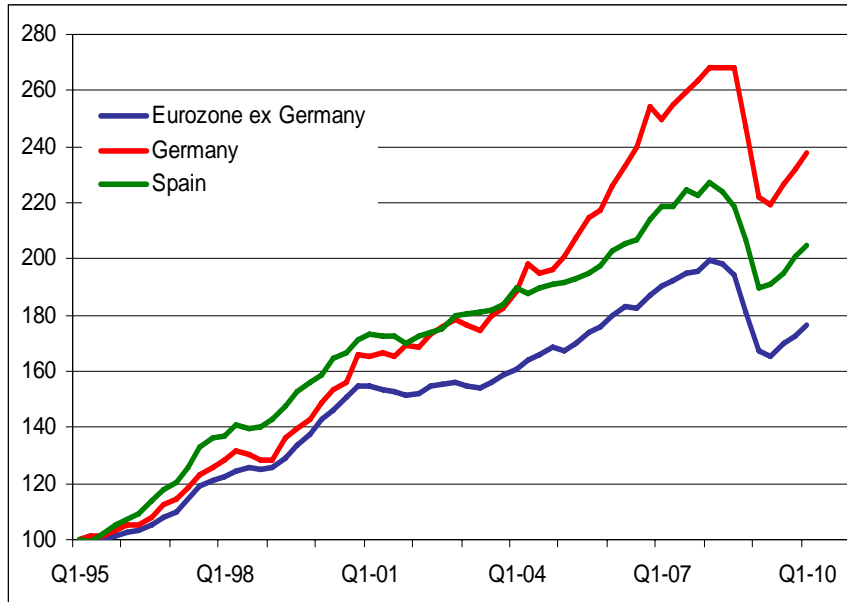


Share in real GDP in chained 2000 prices. Source: INE

- As the housing bubble has burst, Spanish construction investment has nosedived since early 2008.
- But net exports have turned up sharply. The decline in private consumption came to an end in 2H 2009 while machinery investment has started to turn up. Export growth is accelerating. Spanish GDP expanded by 0.1% qoq in Q1. However, due to its housing overhang and a turn from fiscal stimulus in 2009 to tax hikes in 2010, Spain will lag far behind Eurozone average growth in 2010 and 2011.

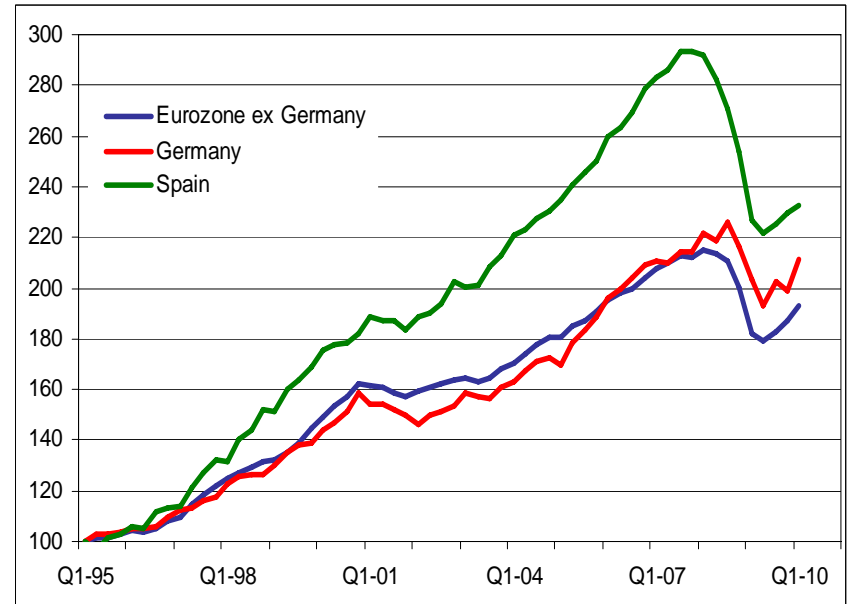
# The external problem

## Spain does not have an export problem...



Level of real exports of goods and services, 1Q 1997 = 100. Source: Eurostat

## ...but it imported far too much

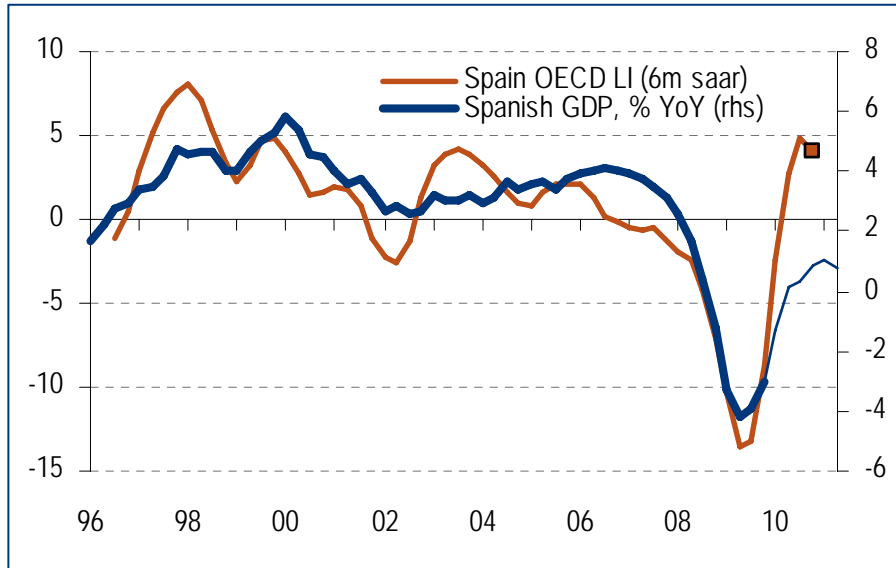


Level of real imports of goods and services, 1Q 1997 = 100. Source: Eurostat

- Standard indicators of cost competitiveness show that almost all countries on the Euro periphery have lost out badly to Germany and the Eurozone average. But this is not apparent in the actual export data. While Germany's export performance has been exceptional, helped by its 2001-2007 austerity, Spain is not lagging behind the export performance of the remainder of the Eurozone.
- Spain has imported too much. The bursting of the real estate bubble, austerity and reforms look set to change this for good.

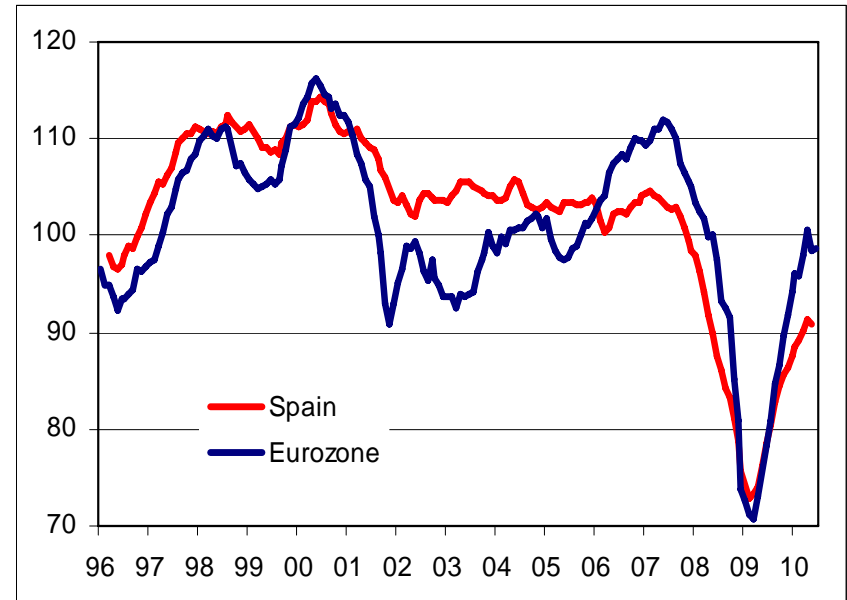
# Notes on Spain

## OECD leading indicators and GDP



Source: Eurostat, OECD

## Economic sentiment



Economic sentiment. Source: EU Commission survey

- Recovery has been muted compared to the signal from leading indicators. Slight drop in April suggests that the upswing could lose momentum in the fourth quarter.
- Spain is lagging behind in the recovery, but it has not decoupled from the Eurozone.

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