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European economy: Outlook 2011

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WILL UPWARD OR DOWNWARD FORCES PREVAIL IN 2011?

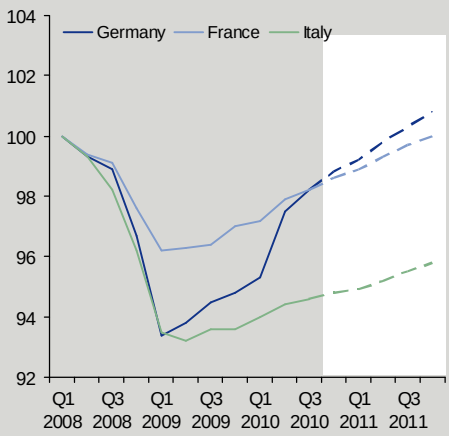
Tax hikes, salary cuts and redundancies in the public sector, curbs on public investment, no pension increases, cuts in welfare spending – these are all elements of the austerity measures planned in Greece, Ireland, Portugal and Spain in 2011. The Irish consolidation program alone is set to account for around 9% of GDP in the period leading up to 2014. In terms of GDP, achieving this sort of consolidation volume in Germany would involve raising VAT from 19% to around 45%.

Concern that consolidation could deal a severe blow to economic activity in these countries is not surprising. Given that the less debt-burdened eurozone countries are also planning to don hairshirts, the question arises as to how the EMU recovery will progress in general. Will the upward or the downward forces gain the upper hand in Europe in 2011?

In our view, skepticism about the economic outlook for 2011 is not warranted, despite the need for consolidation. A number of economic indicators, for example the purchasing managers' indices, suggest that the economic recovery in the euro area has been gathering pace as we approach the end of 2010.

GDP: France and Germany back at pre-crisis level in 2011

Gross domestic product, index Q1 2008=100



% change on previous year

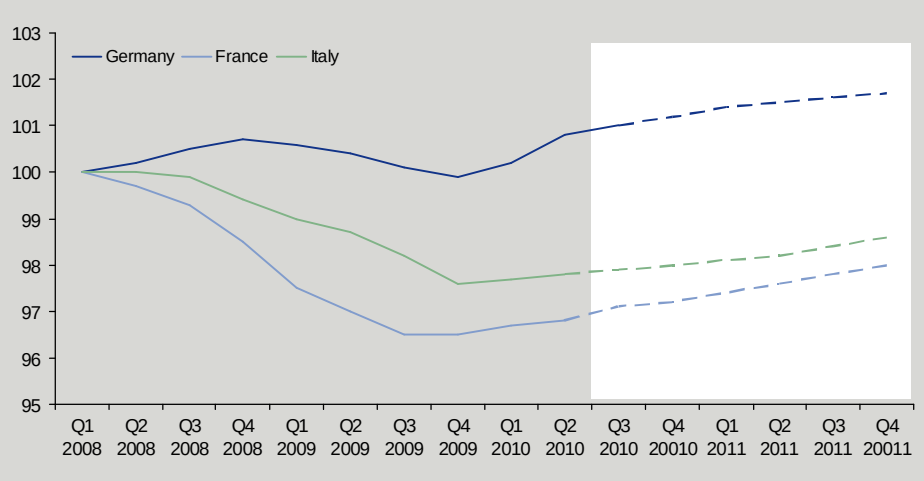
	2008	2009	2010f	2011f
Germany	0.7	-4.7	*3.7*	*2.6*
France	0.1	-2.5	*1.6*	*1.5*
Italy	-1.3	-5.1	*1.1*	*1.2*

Sources: Eurostat, own forecasts.

Of key significance is the fact that none of the three largest euro area economies are on the brink of recession – not even Italy. Although the Italian economy is picking up only hesitantly, even its corporate sector is starting to step up its recruitment again. This is essential to ensure that domestic demand can continue to recover. The prospects for domestic demand in Germany and France in 2011 are looking brighter. In Germany, in particular, the recovery is now on a broad footing. The positive interplay between rising employment, increasing incomes and higher demand points towards solid growth for 2011, even if the global economic momentum tapers off somewhat. In addition to the three largest eurozone economies, smaller economies that have been left unscathed by the debt crisis, such as the Netherlands and Austria, can also look forward to rosy economic prospects in 2011.

Employment heading up in the big EMU economies

Employees, index Q1 2008=100

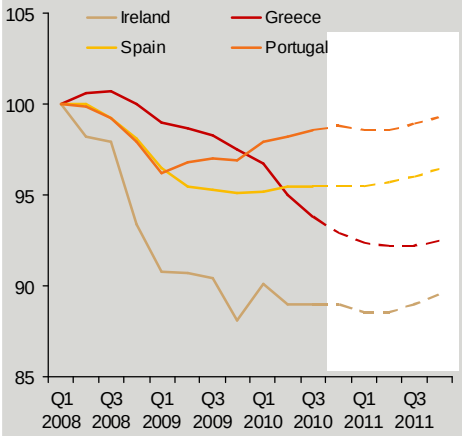


Sources: Ecowin data (Eurostat), own forecasts.

Let's now take a look at what lies in store for the economies of those eurozone countries with high risk premiums: Greece, Ireland, Portugal and Spain. Each of these countries is currently writing its own economic story. At the moment, the situation in Portugal is the least consistent with the image of a crisis-ridden economy. Portugal weathered the global economic crisis relatively well, unencumbered by a housing bubble or a bloated banking sector. The economy bottomed out in early 2009 and GDP has already clambered back to somewhere in the region of the pre-crisis level, just as it has in Germany and France. Although the government consolidation measures will put a considerable damper on the economic recovery in 2011 – as they have in 2010 – we are unlikely to see Portugal relapse into an economic crisis.

Gradual stabilization on EMU periphery

Gross domestic product, index Q1 2008=100



% change on previous year

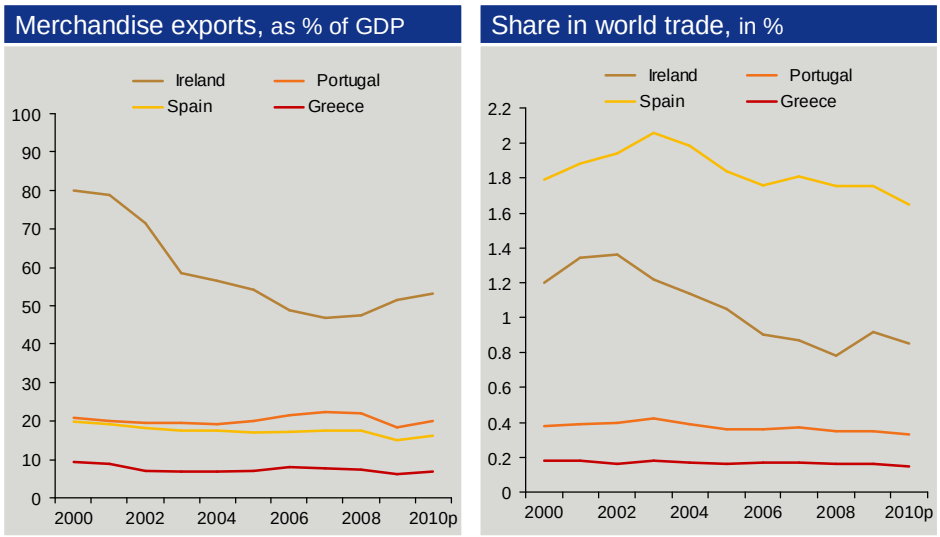
	2008	2009	2010f	2011f
Greece	2.0	-2.0	*-4.2*	*-2.0*
Ireland	-3.6	-7.6	*-0.5*	*0.5*
Portugal	-0.0	-2.6	*1.5*	*0.8*
Spain	0.9	-3.7	*-0.2*	*1.0*

Sources: Eurostat, own forecasts.

Ireland has been through the most crushing economic crisis of all eurozone countries – GDP is currently a whopping 10% lower than it was before the crisis hit. We believe that Ireland has already tackled a great deal of the necessary economic adjustments. Not only

has its bloated construction sector shrunk – its share of overall output is down from just shy of 10% to a normal level (around 5%), its current account deficit has also been eliminated. In view of the high proportion of exports to GDP, world trade is providing a positive thrust that may largely be able to cancel out the drop in domestic demand caused by the austerity measures. Modest economic growth in Ireland in 2011 is not an impossibility. The decline in employment, which has plummeted by around 13% since early 2008, is likely to start to slow.

Importance of foreign trade varies widely



Sources: Ecowin, WTO, Eurostat, own estimates.

Spain's economy, which has been battered by job losses almost on a par with those witnessed in Ireland since 2008, is also showing signs of stabilization. There has already been some improvement in terms of job cuts and GDP has edged up slightly in the course of the year. What is particularly striking is the fact that labor productivity (per hour and employee) has been on a fairly stable upward trend since 2008, even though capacity utilization has declined considerably, which in itself has been enough to create productivity reserves. As soon as the Spanish economy starts to pick up, we expect to see a further considerable increase in productivity. Unit wage costs, which have already been heading south in 2010, are then expected to fall sharply, providing a real boost to Spain's price competitiveness.

A look at the consolidation prospects

Those eurozone countries whose government bonds carry high risk premiums are trying to regain the trust of the markets by launching stringent consolidation programs. The likelihood of successful consolidation in these cases depends both on the existing level of sovereign debt as well as on the general state of the economy, which varies quite considerably from country to country.

But government debt levels and new borrowing alone are not sufficient to indicate whether a thorough recovery of state finances may be possible or is very unlikely to be achieved. If debt levels were the decisive factor, the outlook for Japan, where sovereign debt amounts to almost 200% of GDP, ought to be the bleakest among the industrial economies. In the EMU countries affected by the debt crisis debt levels currently range from a good 60% in Spain to roughly 140% in Greece.

However, given the low interest rates of the past, these countries are doubtless able to service their current interest burden. In fact, with interest expenditures of 2.3% of GDP in Spain, 3.2% in Portugal and 3.3% in Ireland, the burden is actually relatively low. Even in Greece the corresponding rate of 5.6% is not exceptionally high. Only ten years ago the Greek government's interest expenditure amounted to 7.4% of GDP, and back in 1995 it was even hovering around 11%. By way of comparison: although its sovereign debt stood at around 130% and its interest expenditure at 9% of GDP in 1995, Belgium managed to consolidate its state finances by the end of the 1990s.

Public-sector debt indicators

	Deficit as % of GDP	Gross public-sector debt as % of GDP	Interest payments as % of GDP		Interest payments as % of public-sector budget		Funding requirement as % of GDP	Foreign public-sector debt as % of GDP
	2010	2010	2000	2010	2000	2010	2010/2011[1)]	2010
Greece	-9.6	140.2	7.4	5.6	15.8	11.0	24.6	78.7
Ireland	-32.3	97.4	2.0	3.3	6.4	5.4	17.3	50.4
Italy	-5.0	118.9	6.4	4.6	13.8	8.8	24.6	53.7
Portugal	-7.3	82.8	2.9	3.2	7.1	6.6	20.7	51.3
Spain	-9.3	64.4	3.2	2.3	8.3	4.6	19.0	27.6

1) Q4 2010 to Q4 2011; calculated as total of upcoming maturities and budget balances as percent of forecast GDP 2011

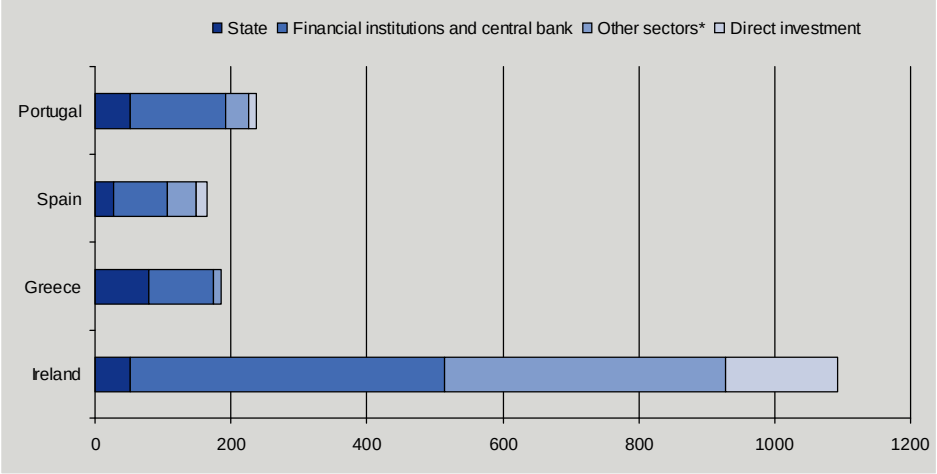
Sources: Deutsche Bundesbank, EU Commission, Eurostat, own calculations.

What is crucial for debt sustainability is whether the countries concerned will succeed in stabilizing their debt levels as soon as possible. In this context it would be important to quickly achieve a primary surplus (surplus before interest expenditure) on the government balance sheets. Greece has demonstrated this year that significant reductions in new borrowing are possible, even during the recession. Given the contraction of the economy by approximately 4%, the reduction of new borrowing from 15.4% in 2009 to an estimated 9.6% this year is quite an extraordinary feat. All debt-stricken EMU countries are currently suffering from a substantial deficit as a result of weak economic performance,

but this also means that new borrowing will drop significantly as soon as the economy picks up again.

The assessment of the countries concerned on the financial markets is not only affected by sovereign debt, but also by external debt. For one thing, there is the issue of what proportion of sovereign debt is held abroad. While Greek sovereign external debt amounts to approximately 80% of GDP, in Spain it comes to less than 30% and in Portugal to roughly 50%. But what is even more important is the extent of the economy's foreign debt as a whole. If we look at the total external debt of these countries, significantly higher figures emerge. Ireland's external debt comes to almost 11 times its GDP, in Spain it amounts to 1.5 times its economic output. However, one must bear in mind that these are gross values. Countries with a relatively large, internationally oriented financial sector traditionally tend to show high gross foreign debt levels. So it is likely that, once the Irish banking sector begins to contract as expected, gross external debt will also decrease.

Foreign debt as % of GDP, gross



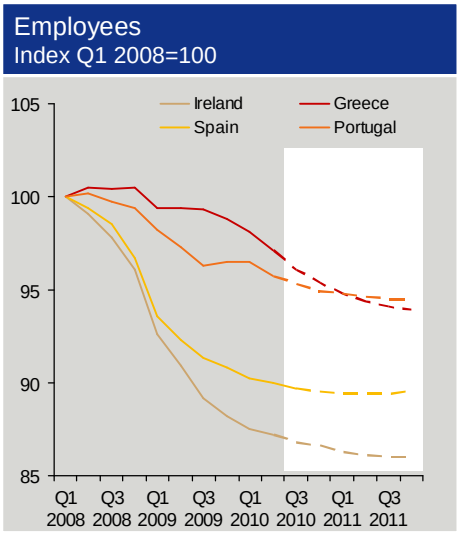
Foreign debt as of Q2 2010, as % of BIP 2010
*) includes households, non-financial corporations as well as finance houses and special purpose entities

Sources:Banco de España, Banco de Portugal, Bank of Greece, Central Statistics Office Ireland, own forecasts.

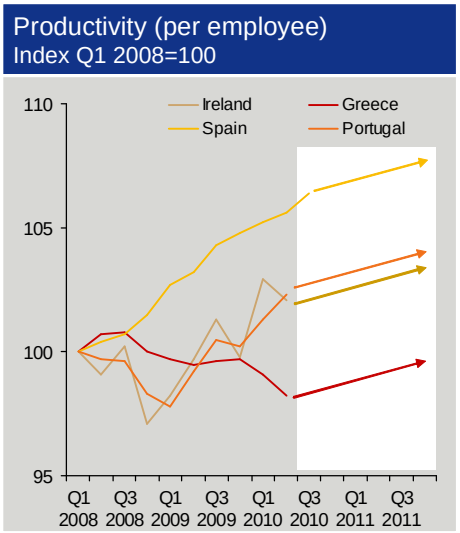
As far as net foreign debt is concerned, the "Net International Investment Position", which is based on a concept developed by the IMF, can serve as a useful indicator. In terms of this net position, the situation in Portugal, with an estimated negative figure of approximately 110% of GDP in 2009, is the least favorable and reflects the current account deficits built up over the years. Ireland, Spain and Greece all record liabilities of between 90% and 100%. Although the net foreign debt of these four countries is substantial, in the context of consolidation measures and a higher accumulation of savings in the private sector, growth going forward should be limited, and it ought to be possible to reduce it in the medium term.

Conclusion: as things stand, none of the eurozone countries affected by the debt crisis needs to restructure its sovereign finances. In order to achieve sustainable government finances in these countries in the medium term, however, economic growth is a key prerequisite. This is why fiscal consolidation has to go hand-in-hand with structural reforms aimed at lowering social costs, streamlining administration and promoting competition and entrepreneurial initiative. The countries affected have already shown that they are prepared to down this path to promote medium-term growth, but successful implementation will be a long haul.

Severe job losses, but rising productivity on EMU periphery



Sources: Ecowin data (Eurostat), own forecasts.



Source: Eurostat.

In the euro area the outlook for 2011 is doubtless bleakest in Greece. However, even in Greece, the slide in the economy should slow next year. Fiscal policy managed to engineer a radical change of course in 2010 and any additional restrictive impetus in 2011 is likely to be less substantial than in 2010. As soon as the economy recovers – something which is not, admittedly, likely to materialize until 2012 – the country will witness a sharp rise in productivity and a significant drop in unit wage costs.

All in all, 2011 looks likely to see further progress in terms of the adjustments made in the countries hit by the debt crisis. Nevertheless, there is still a long way to go until these countries achieve balanced economic development and a sustained boost to their competitiveness.

In summary, the upward economic trend is likely to continue in the euro area in 2011, with the upward forces continuing to prevail. However, the momentum of the recovery will remain subdued. Following economic growth of 1.7% this year, we expect to see GDP growth to the tune of 1.6% in the euro area next year. The gap in growth from country to country will still be considerable, if not quite as glaring as in 2010. In 2011 Germany is again likely to lead the way with growth of 2.6 percent, while Greece will again bring up the rear with a 2 percent decline in GDP.

Euro area: Economic indicators and forecasts*

		2009				2010				2011						
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2009	2010f	2011f
GDP real		-2.5	-0.1	0.4	0.2	0.4	1.0	0.4	*0.4*	*0.4*	*0.3*	*0.3*	*0.4*	-4.1	*1.7*	*1.6*
Private consumption		-0.1	0.0	-0.2	0.3	0.3	0.2	0.3	*0.2*	*0.2*	*0.2*	*0.3*	*0.3*	-1.1	*0.7*	*0.9*
Government spending		1.0	0.6	0.5	-0.1	0.1	0.1	0.4	*0.2*	*-0.2*	*-0.1*	*-0.1*	*0.1*	2.4	*0.7*	*0.1*
Investment		-4.7	-2.4	-1.1	-1.2	-0.3	1.7	0.0	*0.5*	*0.5*	*0.6*	*0.6*	*0.6*	-11.3	*-0.9*	*2.3*
Exports		-7.0	-1.3	2.3	2.0	2.6	4.3	1.9	*1.5*	*1.7*	*1.6*	*1.5*	*1.5*	-13.1	*9.9*	*7.3*
Imports		-6.6	-2.7	2.1	1.3	4.3	4.2	1.7	*0.9*	*1.1*	*1.2*	*1.3*	*1.3*	-11.8	*10.1*	*5.6*
Industrial production (excl. construction)		-9.2	-1.8	2.7	1.3	2.3	2.3	0.8	*0.7*	*0.9*	*0.7*	*0.9*	*0.9*	-14.8	*6.7*	*3.6*
Unemployment rate	%	8.8	9.4	9.7	9.9	9.9	10.0	10.0	*10.0*	*10.0*	*10.0*	*9.9*	*9.8*	9.5	*10.0*	*9.9*
Consumer prices	y-o-y	1.0	0.2	-0.4	0.4	1.1	1.5	1.7	*1.8*	*1.7*	*1.6*	*1.6*	*1.8*	0.3	*1.5*	*1.6*
Producer prices	y-o-y	-2.0	-5.8	-7.9	-4.7	-0.1	3.0	4.0	*4.5*	*4.2*	*3.3*	*3.4*	*3.3*	-5.1	*2.8*	*3.6*
Current account balance	EUR bn, nsa	-19.6	-13.4	-8.6	-9.8	-1.9	-9.8	-24.8	*-2.5*	*2.5*	*5.0*	*7.5*	*7.5*	-51.4	*-39.0*	*22.5*
	% of GDP													-0.6	*-0.4*	*0.2*
Budget balance	% of GDP													*-6.3*	*-6.3*	*-4.6*

*) quarterly values: percentage change over previous period, seasonally adjusted, except where noted; annual GDP not adjusted; foreign trade incl. intra-trade.
f = forecast.

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