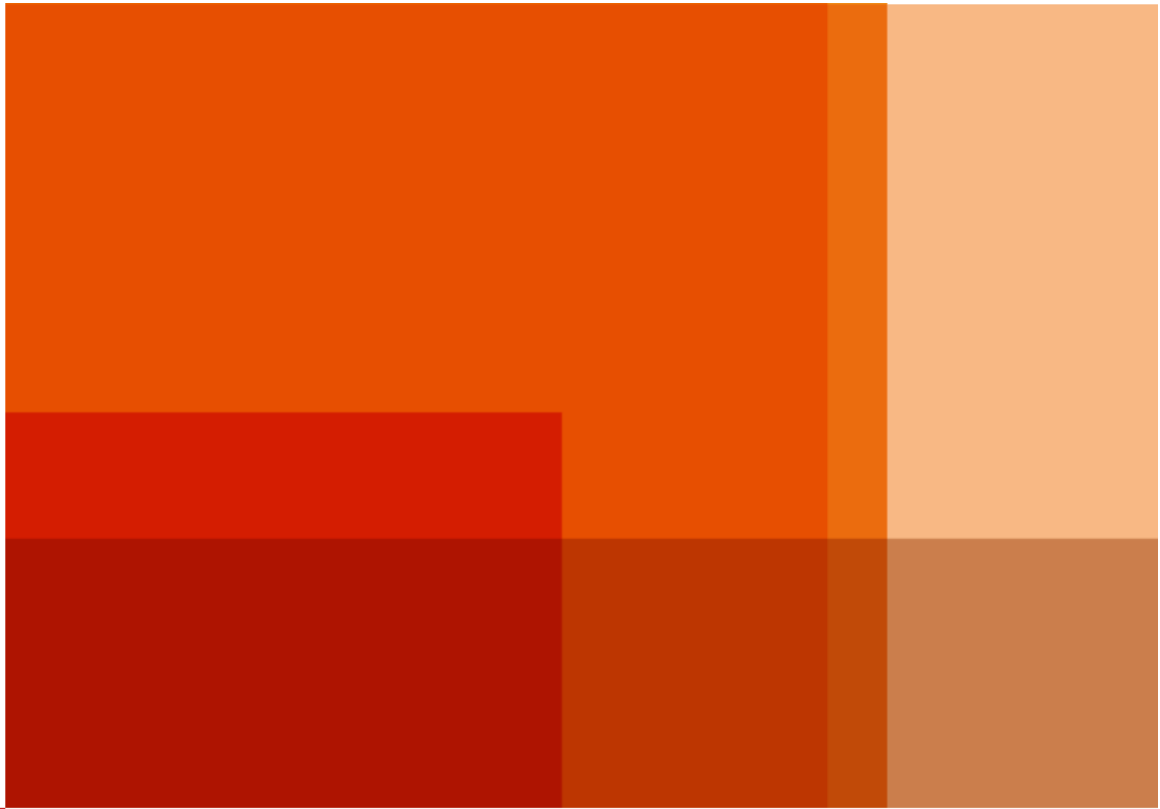


Economic Views Eurozone

December 2011



pwc

View from the top

The Eurozone crisis has developed from a problem in a few peripheral countries to a full blown financial and sovereign debt crisis engulfing the whole region. European countries have taken initial steps to tackle the crisis. However, more is needed to rebuild confidence among investors and provide for a sustainable economic future for the region. It is still unclear how this will play out, but the Eurozone that re-emerges next year is likely to be very different to the one we know today. The implications for businesses within and outside the region are vast.

Five key trends to look out for in 2012

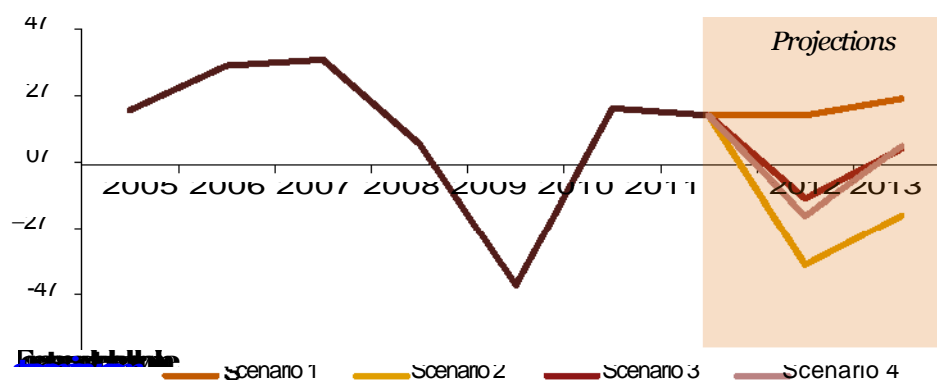
- Next year is likely to be dominated by uncertainty and potential volatility.
- The fallout from the current phase of the crisis is likely to plunge the Eurozone back into recession.
- The euro is likely to depreciate against other major currencies as capital flows towards safe havens.
- Governments across the region will tighten spending, especially the most profligate.
- There will be pressure for renewed competitiveness and genuine restructuring of rigid labour and product markets.

We advise businesses to stress-test their plans against a range of scenarios

We have developed four distinctive scenarios that we recommend our clients use to prepare for the potential outcomes from the crisis which could take place next year.

A large scale debt restructuring (Scenario 2), a Greek exit from the Eurozone (Scenario 3) or the formation of a new currency bloc (Scenario 4) would see the region enter recession next year. Only in a scenario where the ECB intervenes through a policy of aggressive monetary expansion (Scenario 1) do we expect to see Eurozone growth in 2012.

Eurozone GDP growth under different scenarios



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Source: Eurostat/PwC projections

Forecasts are updated regularly online at economics.pwc.com

Introduction

We are currently experiencing unprecedented uncertainty in the Eurozone. Despite progress at the December Summit of the European Council, much more work needs to be done before the crisis in the Eurozone is resolved; the potential political and economic outcomes remain wide-ranging.

To help businesses plan a course through this uncertainty, we have outlined four distinct scenarios in our special focus report, *What next for the Eurozone*. The four scenarios and their key outcomes are summarised in Box 1 below.

In this Economic Views report on the Eurozone, we have considered the impact of these scenarios on the largest European economies – Germany, France, Italy and Spain – and a selection of smaller economies. For each country, we consider the scenarios which have the largest potential impact on them and highlight the most important economic and political consequences.

Box 1: What next for the Eurozone? Possible scenarios for 2012

Scenario 1: Monetary expansion

The ECB is given the go-ahead to inject significant liquidity to vulnerable economies through a concerted programme of bond purchases. A recession is avoided, and interest rates are kept low in the short term, but inflation rises well above its 2% target, while the euro depreciates.

Scenario 2: Orderly defaults

A programme of voluntary sovereign defaults is agreed for the most indebted countries, which triggers a contractionary debt spiral and a prolonged recession, lasting between 2 and 3 years, resulting in a cumulative loss in GDP of around 5%.

Scenario 3: Greek exit

Greece is compelled to leave the Eurozone, and then suffers a sharp deterioration in its economy, a rapid depreciation of its new currency and an inflation spike. The Eurozone seeks to protect its currency through tough fiscal discipline and other measures that boost investor confidence, but still suffers a recession that lasts for up to two years.

Scenario 4: New currency bloc

A Franco-German acknowledgement that the existing Eurozone is unsustainable paves the way for a new, smaller and more tightly regulated currency bloc. The ‘new-euro’ would be expected to appreciate dramatically and the new bloc would benefit from a boom in domestic demand. Economies that are excluded suffer a sharp currency depreciation and severe economic contraction.

Germany

Germany has been the engine of growth in the Eurozone since the end of the financial crisis, but it is at risk of being dragged into the crisis in 2012. First, the bloc provides Germany with its largest export market, the destination for over 40% of its exports in 2010, and exports contribute around a third of its GDP growth. Germany’s vulnerability to trade flows was witnessed during the global financial crisis. In 2009, the German economy contracted by almost 5%, precipitated by the collapse in global trade. Second, Germany is heavily exposed to the rest of the Eurozone through the significant exposures of its banking system to peripheral economies. Consequently, Germany cannot remain aloof from the Eurozone crisis indefinitely.

In our worst-case scenario (Scenario 2) – where we assume that governments in Italy, Ireland and Portugal agree a debt restructuring plan similar to Greece – we expect that the Eurozone would contract by around 5% over a period of 2 to 3 years. The consequences for Germany in this scenario would be huge. We estimate that German banks stand to lose around €14bn. This, combined with a collapse of intra-Eurozone trade, would drag the economy into recession (see Table 1). However, Germany’s relatively strong fiscal position and its trade with countries outside the bloc would prevent it contracting on the same scale as other Eurozone economies.

Table 1: Projected German GDP growth

	2011 ^e	2012 ^f	2013 ^f
Scenario 1	2.6%	2.5%	2.5%
Scenario 2	2.6%	-2.0%	-1.0%
Scenario 3	2.6%	0.5%	1.0%
Scenario 4	2.6%	0.3%	2.5%

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

To avoid this outcome, Germany may have to support an ECB policy of monetary expansion. In our best case scenario (Scenario 1), we have assumed that the ECB pursues an aggressive policy of monetary expansion which allows countries to maintain access to capital at lower interest rates, bolstering investor confidence in the region, which in turn would help sustain Germany's export market.

The main risk for Germany under this scenario would be a period of high inflation. Given that there is less slack in the German economy, we expect that inflation could rise to 4.5% next year under this scenario – significantly above its current levels (see Table 2 below).

Table 2: Projected inflation in Germany (% change)

	2011 ^e	2012 ^f	2013 ^f
Scenario 1	2.3%	4.5%	3.5%
Scenario 2	2.3%	2.0%	1.0%
Scenario 3	2.3%	3.0%	3.0%
Scenario 4	2.3%	-1.0%	0.0%

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

France

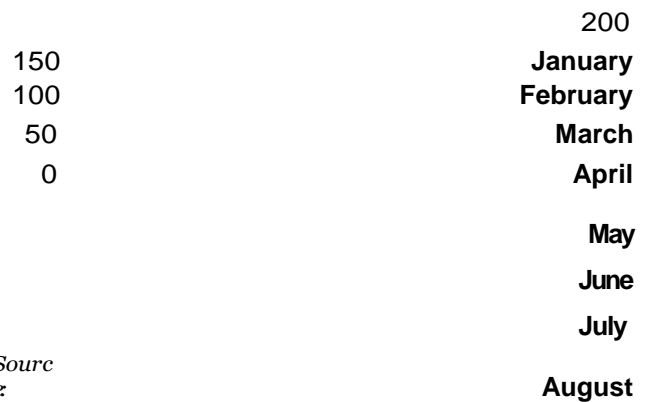
The outlook for economic growth in France next year is significantly weaker than in Germany.

This is partly due to its weaker public finances. Public debt in France is set to exceed 85% of GDP in 2011, above the Eurozone average, and its deficit is expected to be around 6% of GDP. In addition, French banks have more exposure to sovereign debt in peripheral economies than their German counterparts.

These vulnerabilities make France particularly exposed to an escalation of investors' fears over its ability to meet debt obligations. Spreads over German Bunds reached 188 basis-points in November, a record between the two countries since the Eurozone was established (see Figure 1). The credit rating agencies, Moody's and Standard and

Poor's, have warned France that it could lose its prized "AAA"-rated status.

Figure 1: Spreads between 10-year French and German government bonds in 2011



Source: PwC analysis

Consequently, France is taking pre-emptive measures to rein in its deficit in an attempt to prevent it getting further embroiled in the crisis. The government announced a new austerity program in November, which will involve a further €65 billion in tax rises and spending cuts over the next five years.

We expect these savings to suck demand out of the economy, which could result in a recession next year (see Table 3 below).

France's fragile fiscal position helps to explain why it is pushing Germany and the ECB to agree to a policy of monetary expansion. Under this scenario we expect the French economy would grow by 1% next year, but unlike Germany in this scenario we expect inflation in France to be more muted at around 3.5%.

Table 3: Projected French real GDP growth (% change)

	2011 ^e	2012 ^f	2013 ^f
Scenario 1	1.7%	1.0%	1.7%
Scenario 2	1.7%	-2.8%	-1.1%
Scenario 3	1.7%	-1.3%	0.7%
Scenario 4	1.7%	0.4%	2.4%

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

Italy

Italy will face three major challenges next year:

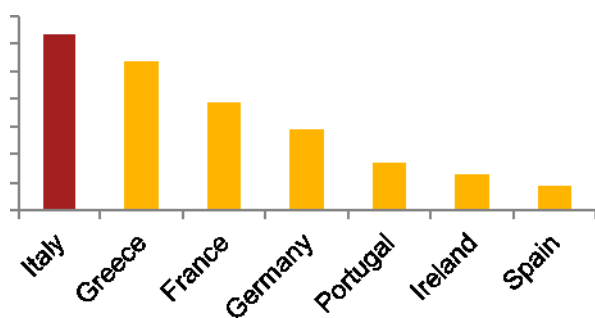
- reducing (i) its public debt, which amounts to 121% of GDP, and (ii) its deficit, which is 4% of GDP;
- managing its banks' €127bn exposure to

domestic and peripheral sovereign debt;¹ and

- reforming its uncompetitive economy.

Its banks' exposure to domestic and peripheral sovereign debt poses an immediate threat to Italy's economic prospects. Our second scenario, which assumes a large-scale debt restructuring in Italy, Portugal and Ireland, would see the Italian banking sector lose over €30 billion – the largest loss in the Eurozone (see Figure 2 below) – and equivalent to 2% of its GDP.

Figure 2: Impact of debt restructuring in Scenario 2 on Banks' Assets (€bn)

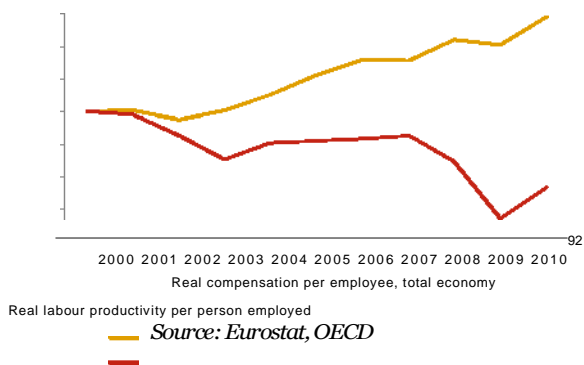


Source: ERA, PwC analysis

The economic costs for Italy in this scenario would be severe. Bank deleveraging, reduced lending and a sharp fall in consumer and investor confidence would drive the economy into a deep recession.

Against this threat, Italy will need to make its economy competitive in the export market.

Figure 3: Real compensation and productivity



¹Periphery refers to Greece, Portugal and Ireland.

To do this, the government will need to undertake deep structural reforms to correct the gap between wages and productivity that has built up over time (see Figure 3). An adjustment of this scale would be likely to push the economy into a period of rising unemployment and falling living standards.

Initial signs indicate that Italy's political resolve is strengthening. Mario Monti's new technocratic government is making positive noises about reforming rigid labour markets, easing bureaucratic regulations and improving tax efficiency. The government may now need to cut even more aggressively if tighter fiscal rules are implemented in the Eurozone.

Assuming these reforms take place, Italy's longer-term economic prospects should improve but the next two years are going to be painful – just how painful will be determined by choices made at the Eurozone level (see Table 4).

Table 4: Projected Italian real GDP growth (% change)

	2011 ^e	2012 ^f	2013 ^f
Scenario 1	0.6%	0.5%	0.5%
Scenario 2	0.6%	-4.5%	-3.0%
Scenario 3	0.6%	-1.0%	-0.3%
Scenario 4	0.6%	-5.5%	-3.0%

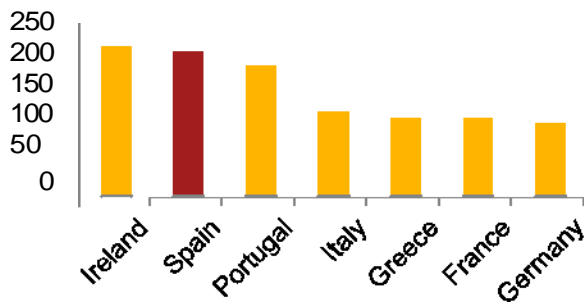
Source: PwC estimate (e); PwC projections (f)

Spain

Spain, like Italy, is vulnerable to a contraction in economic growth next year, but its problems are slightly different. Spain's unemployment rate, at 22%, is the highest in the Eurozone. It also has a highly indebted private sector and high public sector deficit which it is struggling to address.

In 2012, Spain will have to take measures to reduce private sector debt. Domestic credit to the private sector was 211% of GDP in 2010, one of the highest in the Eurozone (see Figure 4).

Figure 4: Domestic credit to the private sector (%) in 2010



Source: World Bank

Much of this debt is held by Spain’s regional savings banks, the *cajas*, and more government support will be needed to reduce their exposures to domestic real-estate loans that they built up during the construction boom.

Spain will also have to resolve its other deep-rooted structural problems. In particular, its rigid labour markets have contributed to youth unemployment hitting 46%, the highest in the Eurozone.

Moreover, Spain’s regional administrations account for over half of its public spending, making it difficult for central government to control the deficit. The country looks set to miss its deficit target of 6% of GDP this year and it could become more difficult to meet the government’s ambitious targets for next year.

These pressures will drag on domestic demand in the short-term, regardless of the path Eurozone leaders decide upon. We expect that only a monetary expansion by the ECB, similar to our Scenario 1, would prevent the Spanish economy from contracting next year (see Table 5, below).

Table 5: Projected Spanish real GDP Growth (% change)

	2011 ^e	2012 ^f	2013 ^f
Scenario 1	0.6%	0.8%	1.3%
Scenario 2	0.6%	-2.5%	-1.0%
Scenario 3	0.6%	-0.5%	0.0%
Scenario 4	0.6%	-4.5%	-2.0%

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

One advantage that Spain has is its low public debt burden. Spain’s debt-to-GDP ratio is expected to be 67% at the end of this year – lower than the Eurozone average. As a result, we do not expect that Spain would need to restructure its debt as we have assumed for Italy in Scenario 2; neither do we

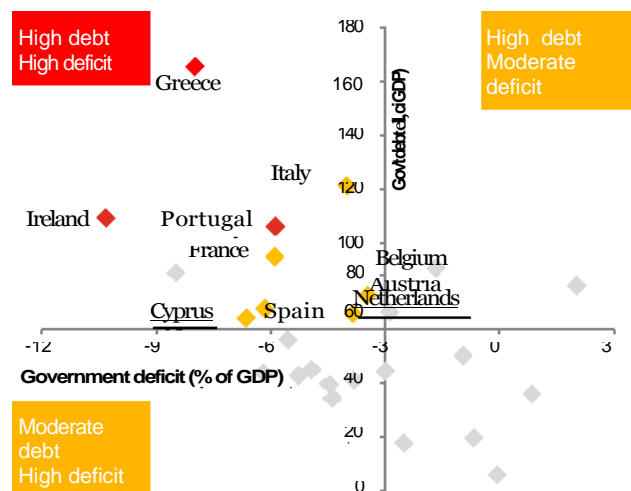
expect that Spain’s economy would contract by as much as Italy in 2012 in this scenario.

Debt fears may spread to other economies

Other Eurozone economies with high debts or deficits could become vulnerable next year if economic growth stalls (see Figure 5).

Belgium’s fiscal position is an example. Its sovereign debt is close to 100% of GDP and a recession in the Eurozone next year would be particularly bad news for the country as its economy is very open and relies on exports to drive growth.

Figure 5: Public debt and deficits in the Eurozone



Source: PwC analysis

Greece is suffering the consequences of renegotiating its debts. It is shut out of the bond markets and is being forced to implement painful austerity cuts in return for financing from European authorities and the IMF. One option could be for Greece to leave the Eurozone, which we have considered in our Scenario 3.

We expect that the short-term consequences for Greece under such a scenario would be very severe – with inflation soaring to around 10% in 2012 and its new currency devaluing by at least 50% overnight. We expect that its economy would contract by 5% in 2012 and a further 1.5% in 2012. If this happened, the longer-term consequences for Greece would depend on its ability to re-build a credible central bank and complete the necessary fiscal and structural reforms.

We expect **Ireland**'s economy to recover from a Eurozone downturn quicker than other peripheral economies. This is largely because it has already taken painful measures towards regaining competitiveness. Unit labour costs in the economy have fallen by 17% since their peak in the fourth quarter of 2008. In our best-case scenario for the Eurozone next year, Ireland could post growth of 1.3%, compared to contractions of 3.6% and 2% in Greece and Portugal respectively.

Projections*

GDP (annual % average)	2010	2011^e	2012^f	2013^f
Eurozone	1.7	1.5	-0.2	1.0
Austria	2.1	2.9	0.2	0.5
Belgium	2.1	2.2	-0.3	0.7
Estonia	3.1	6.4	2.3	2.3
Finland	3.1	3.4	0.6	1.9
France	1.5	1.7	-0.4	1.0
Germany	3.5	2.6	0.9	1.5
Greece	-4.5	-5.5	-4.9	-1.6
Ireland	-1.0	1.0	-1.1	-0.3
Italy	1.2	0.6	-1.4	-0.6
Netherlands	1.8	1.8	0.5	1.3
Portugal	1.4	-2.2	-3.4	-1.0
Slovakia	4.0	3.4	2.3	1.9
Slovenia	1.2	1.8	2.0	1.6
Spain	-0.1	0.6	-0.7	0.2

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

Inflation (HICP % change, annual average)	2010	2011^e	2012^f	2013^f
Eurozone	1.6	2.5	2.2	2.0
Austria	1.7	3.1	2.8	2.4
Belgium	2.2	3.2	2.0	2.0
Estonia	3.0	5.0	3.7	3.3
Finland	1.3	3.4	3.0	2.5
France	1.7	2.2	1.8	1.6
Germany	1.2	2.3	3.0	2.5
Greece	4.7	2.8	0.3	0.6
Ireland	-1.6	1.1	2.3	2.6
Italy	1.6	2.7	0.8	1.5
Netherlands	0.9	2.3	3.0	2.2
Portugal	1.4	3.3	1.3	1.4
Slovakia	1.0	3.5	3.8	3.4
Slovenia	1.8	1.8	3.5	3.1
Spain	2.0	3.1	2.8	2.0

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

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