

Press release

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17 October 2011

Urgent action required to avert renewed recession in Eurozone

Luxembourg 17 October 2011 - The Eurozone is now caught up in a new wave of sovereign debt fears and the threat of the crisis spreading throughout the region leading to a renewed recession has risen sharply according to Ernst & Young's Autumn Eurozone Forecast (EEF).

Combined with a near stalling of growth over the summer and a less favorable international environment than previously anticipated EEF now expect GDP growth to fall to an anemic 1.1% in 2012. EEF have also cut the 2011 forecast from 2 % to 1.6%. This is provided that an orderly restructuring is carried out for Greece and assistance provided for other troubled countries.

EEF now estimates that there is a 35% chance of the Eurozone returning to recession if urgent action is not taken. EEF believe that a commitment to greater fiscal union is now required particularly from the core member states to avert the growing crisis. As EEF have consistently said raising interest rates in April and July was a mistake and the ECB should now move aggressively and cut interest rates to encourage growth in the region.

Marie Diron, senior economic adviser to the Ernst & Young Eurozone Forecast comments, "Despite the announcement of a new package for Greece in July the situation across the Eurozone has considerably deteriorated over the summer. Volatility in the financial markets, slowing growth in the core countries and continued contraction in the periphery indicate that the sovereign debt crisis is likely to worsen further, in turn undermining growth prospects for next year. A deeper default, than the one in July, on Greek sovereign debt now looks unavoidable."

Alain Kinsch, Country Managing Partner of Ernst & Young Luxembourg comments, "These are difficult days for the Eurozone economy. All of those concerned - politicians, regulators and business leaders - have to work together to ensure we don't fall back into recession. Time is not on our side, we have to act quickly."

Measures too reliant on liquidity rather than solvency

Although a new package was passed for Greece in July the situation has not improved. The deal in July offered some cash flow relief to Greece, Portugal and Ireland but the measures focused too much on liquidity and not enough on solvency. A deeper default on Greek government debt now looks unavoidable. The uncertainty surrounding the current state of affairs and market concern are now shifting to Italy and Spain, both of whose economies (and debt levels) are much larger than the combined economies (and debt) of Greece, Ireland and Portugal.

Alain Kinsch comments, "Reliance upon further rounds of austerity to reduce deficits will be self-defeating - much deeper reforms, including labor market liberalization, and faster privatization are needed if the peripheral economies are to escape the unsustainable debt burdens and regain investor confidence. But the benefits of such reforms will take time to be realized."

Greater urgency and commitment required

The deep and protracted problems facing the Eurozone, coupled with the prospect of several years of divergent growth prospects for member countries underline the need for faster reforms and unswerving support.

Should Greece default, Eurozone governments need to have a plan to make sure that it is managed in an orderly fashion. This involves recapitalizing banks in the core Eurozone countries that would face difficulties from losses on their Greek bond assets. It also requires a wholesale recapitalization of the Greek banking sector that the Greek government cannot afford at the moment. International money will need to be provided.

Longer term, the Euro-Plus Pact agreed in March 2011 was a step in the right direction towards strengthening cohesion however, this will take some time to implement and may not be adhered to. It also falls short of reforms such as Eurobonds which along with an increase in the size of the European Financial Stability Facility (EFSF) have met with significant political resistance. These measures would further bind the Eurozone ensuring co-responsibility of government debt and allay concerns about problems spreading to Spain and Italy.

Diron explains, "If the Eurozone is to remain in its current form an unequivocal firm commitment is necessary from the core countries for greater fiscal union. Many countries will resist this implied loss of sovereignty, but without the ability to monitor, control and finance government spending across the Eurozone, there can be no guarantees that fiscal stability can be maintained after the existing severe problems are resolved."

Given little political appetite for such reforms, there is a risk that governments are overtaken by financial markets. EEF estimates that there is a 35% chance that a further escalation of the current financial turmoil could plunge the Eurozone back into recession.

Weak growth even in core countries

Alain Kinsch comments, "Whereas earlier this year it had seemed likely that the core Eurozone countries would continue to grow fairly solidly, there are now mounting fears that the recent bout of financial market instability and slower growth in the US and the main emerging markets will undermine this prospect."

In the core Eurozone countries GDP is now forecast to grow by about 2% pa from 2011-15, similar to the decade prior to the 2009 recession. In contrast, GDP in the peripheral countries is expected to rise by only 1.2% pa from 2011-15, less than half the pace of the pre-crisis decade.

Low and uncertain growth prospects mean that investment plans are likely to be postponed particularly given that funding costs for banks are on the rise and credit condition surveys suggest this may be spilling over into a general tightening of credit to enterprises. Consumers are expected to be equally cautious as incomes are hit by fiscal measures and high unemployment, which is set to remain close to 10% across the Eurozone as a whole for some time.

Bright spots

Exports are expected to be the main driver of growth, contributing around 2 to 3 percentage points to overall GDP growth in 2011 and 2012. The manufacturing sector is currently benefiting from the strong demand in exports, in particular from emerging markets. But much of this growth is only recovering the losses seen during the recession and is set to slow.

The business services sector is also forecast to grow more rapidly than the overall economy as the Eurozone benefits from a skilled workforce and expertise established in this area. The financial services industry may also be helped by regulatory changes.

ECB should take a more dovish stance / ECB should consider rate cuts

Given the gloomy outlook the ECB faces an increasingly difficult challenge. Having raised interest rates in April and July in response to above-target inflation, the ECB also hinted at rate rises for the second half of 2011. However, the worsening situation means that they had to change course. EEF now expects the ECB to cut interest rates later this year and again in early 2012.

Diron comments, "We welcome this change and recommend that the ECB should lower interest rates to below 1%, should the Eurozone fall back into recession.."

Bumpy road ahead

Given the increasingly gloomy backdrop and the mounting downside risks from the slowing US and global economies, our Eurozone GDP growth for the next two years have been further lowered. Eurozone GDP has only recouped around two-thirds of the loss in activity seen in 2008-09 and it may take another five or six quarters before it returns to pre-crisis levels. However, this is assuming that the current crisis can be defused, with the July Greek deal, probably a managed further default on Greek government debt, increased resources for the EFSF, continued supportive action from the ECB and greater political commitment from the core Eurozone countries combining to stabilize the situation.

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