

# UBS Investment Research

## European Weekly Economic Focus

### ■ Spain's economic situation: the disaster will go on

This week, we provide a detailed analysis of the Spanish macro situation. The piece was published earlier this week as part of a piece by the UBS Banks sector equity research team: see *Spanish Banks: At the beginning of the provisioning cycle* by Ignacio Sanz, Matteo Ramenghi, Stephane Deo and Alastair Ryan (1 July 2009). The report looks in detail at the Spanish banking system and provides actionable ideas and stock-specific recommendations.

### ■ Next week in Europe

We forecast German industrial production (Wednesday) to increase 0.5% m/m in May (after falling 1.9% in April). We also expect the French industrial production trend (Friday) to improve; we look for a 0% m/m rate in May (following -1.4% in April). On Thursday, the Bank of England will announce its decision on interest rates. In line with consensus, we expect rates to remain unchanged at 0.5%. However, the markets will likely be looking for announcements regarding a further extension of the QE programme. For Sweden, we expect inflation to fall slightly (Thursday), and the labour market to remain tight, with a further rise in unemployment (Friday) also likely.

3 July 2009

[www.ubs.com/economics](http://www.ubs.com/economics)

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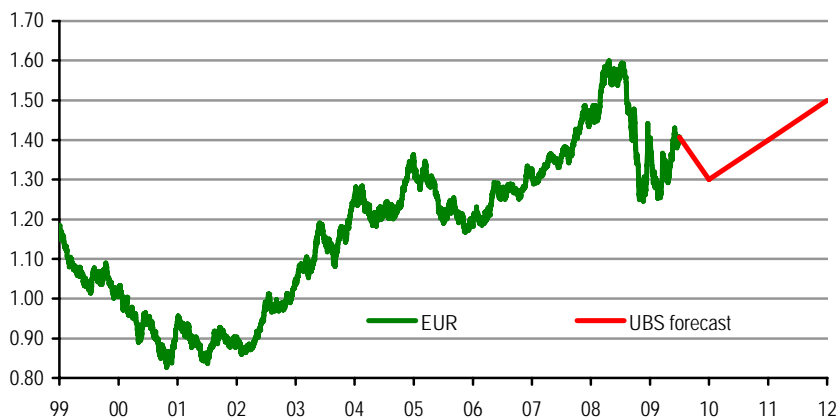
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Chart of the week: The global team revised FX forecasts earlier this week. For more details please see "Global Economic Comment The outlook for the dollar", 29 June 2009, Larry Hatheway et al. The following chart shows our new EUR forecast.



Source: Bloomberg, UBS

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## Spanish economy; the disaster will go on

**This piece provides a detailed analysis of the Spanish macro situation. It was published as part of a report by the UBS Bank sector equity research team: see *Spanish Banks: At the beginning of the provisioning cycle*, by Ignacio Sanz, Matteo Ramenghi, Stephane Deo and Alastair Ryan (1 July 2009), which looks in detail at the Spanish banking system and provides actionable ideas and stock-specific recommendations. We would strongly encourage readers interested in Spanish banking to read this analysis.**

### Main conclusions

Spain's recent economic performance has shown a very acute deterioration. It started with the construction sector, which experienced a bubble both in terms of the size of the sector and in terms of house prices. However, the problems are not limited to that sector. The impressive rise in inflation has had devastating effects on other sectors and we note that recent industrial activity has had a greater contribution to the overall decline than the construction sector.

We see little reasons for optimism in the near future. Notably, the labour market will continue to worsen rapidly, with further distressing effects for the rest of the economy. Our approach, using Okun's law (which we explain in more detail below), suggests that the unemployment rate will rise significantly above 20% at the end of next year. One important piece of collateral damage is the state of public finances which are also deteriorating at an extremely rapid pace. However, room for manoeuvre is still ample because the level of public debt remains low, but also because the level of taxes is low compared to other European countries, implying potential extra revenues. However, the abysmal deficit means that room for manoeuvre in the near term in terms of additional fiscal stimulus is very limited.

Over the longer term, on a 2-5 year perspective, we think the question of what end game will unfold is an important one. The silver lining is that the Spanish economy has proven considerably more flexible than expected, a clear positive when thinking about long-term potential growth. However, we think that this crisis will impose vast structural changes on the Spanish economy and a new growth pattern will have to emerge before we are convinced that the economy could undergo a sustainable recovery. This will take years. But we underline that the export sector is less negligible than many think and could eventually provide an exit strategy. The convergence process in terms of GDP per capita is completed, so, even assuming that the current crisis is resolved, it would be very difficult to justify Spain's persistent outperformance. At best, we think Spain will grow at a pace close to 2% when the situation stabilises, but this is a full percentage point below the average of the past decade.

The near future will not be much better

A question mark on the exit strategy

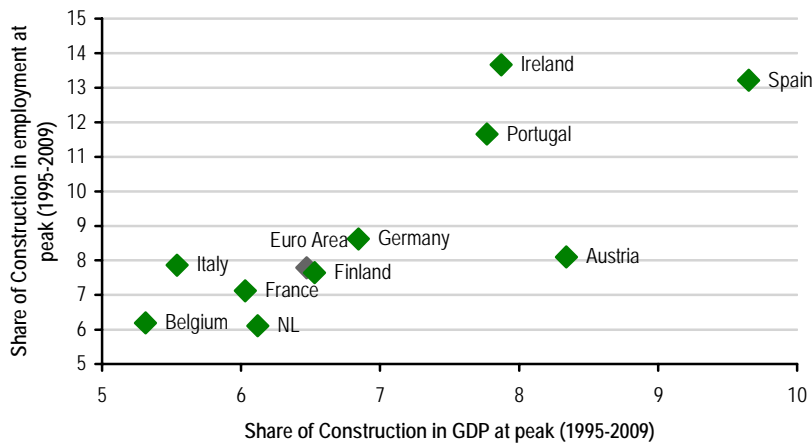
## Where it all started: the construction sector

### The problem: a bubble

The problems of the Spanish construction sector are well known. This sector has gone through an impressive acceleration until recently. The following chart gives an illustration of the disproportionate size the construction sector had reached in the Spanish economy. Both in terms of employment or contribution to GDP, the size of the sector seemed too high compared to its peers. This was obviously not sustainable.

Construction sector disproportionately large

Chart 1: The size of the Spanish construction sector reached a disproportionate level

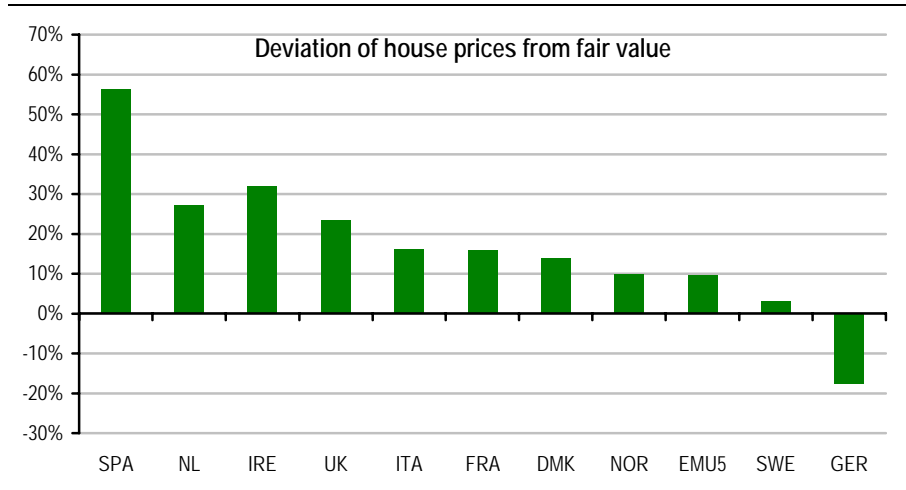


Source: Eurostat, UBS

But this is not exclusively a story about activity; it is also a story about prices. Last year, we published a detailed analysis of the housing market in Europe (for more details, please see *Q-Series®: European Economic Focus House prices: Where are the bubbles?* 11 September 2008, Stephane Deo and Sunil Kapadia). In this publication, we look at the fair value of house prices in 10 European countries. Our affordability approach takes into account not only household revenues but also household borrowing capacities, which depends on the level of interest rates, loan-to-value ratios, mortgage durations and the split between fixed- and floating-rate mortgages. Our model encompasses all these factors, making it superior, in our view, to the traditional approach, which is based solely on household revenue.

Housing price bubble

Chart 2: Spain had the largest deviation from fair value prices in the Euro area



Source: UBS

In the case of Spain, our conclusion, using data up to 2007, was that actual house prices were 56% above our fair value. This was, at the time, the largest divergence between actual and fair value among Euro area economies.

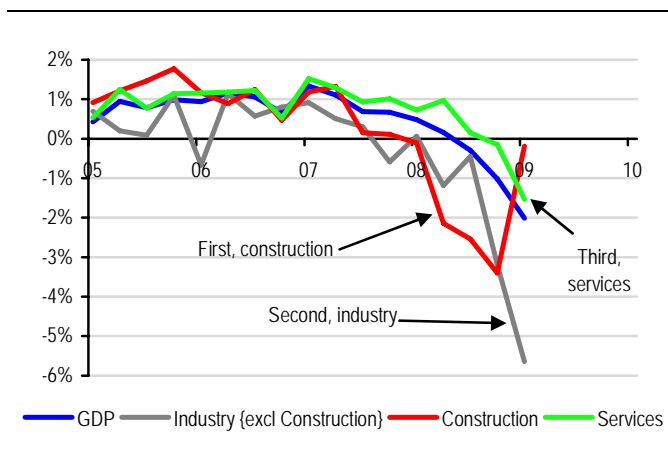
In 2007, house prices were 56% above our fair value

The result: a crash

As a result, when the sector passed an inflexion point, both activity in the sector and the level of employment started to adjust very abruptly. The two charts below, which span to Q1 this year, show that the adjustment process is under way and, especially in the case of employment, at a surprisingly rapid pace. We note that half of the job destruction come from the construction sector while, as we showed above, this sector accounted for 13% of total employment.

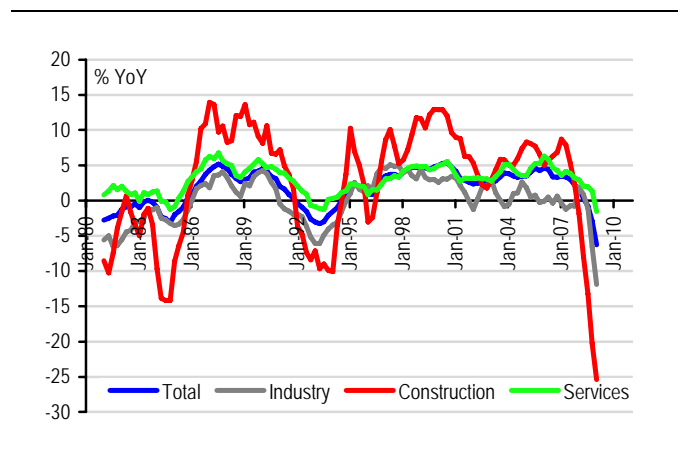
Abrupt adjustment

Chart 3: Already 5 quarters in a row of contraction in the construction sector



Source: Eurostat

Chart 4: Employment in the construction sector collapsed



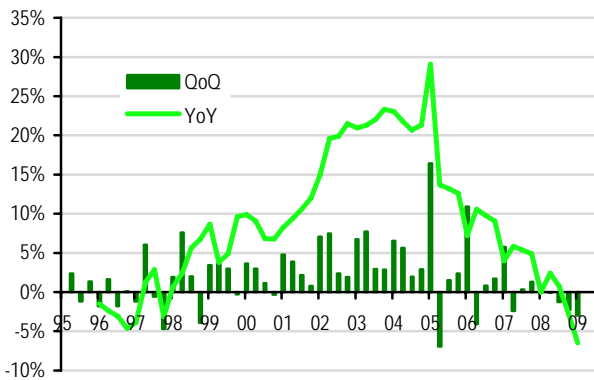
Source: Eurostat

It would be logical in this context to expect similar behaviour in terms of house prices. This is not really the case yet. Indeed, according to the official statistics published by the Ministerio de Vivienda, Q1 this year posted the fourth decline in a row, but as the chart below shows, the total decline since peak is “only” 6.5%. We would refrain from interpreting that as a sign that the housing market

We expect a house price adjustment will follow

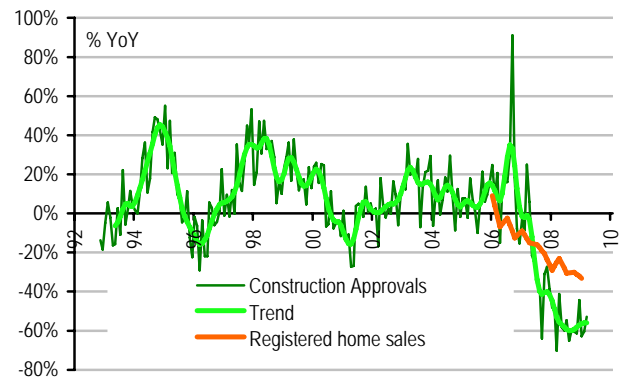
is fairly valued. What is happening, in typical fashion in the housing market, is that volumes go first: sellers don't want to sell because they can't get an attractive price. So the first move is actually a collapse in the volume of transactions; eventually prices will follow. We therefore believe, simply, that prices are a lagging indicator and that they will continue to fall in the future.

**Chart 5: The house price index is down "only" 6.5% so far**



Source: Ministerio de Vivienda

**Chart 6: By contrast, volumes of transaction plummeted**



Source: INE

In short, this looks very much like a work in progress. The level of transactions is a sure sign that house prices have much farther to fall.

**The future: how low can it go?**

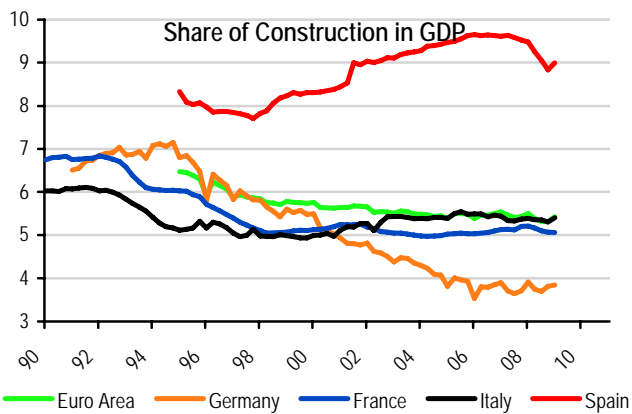
How much of the adjustment has taken place already? One of the main surprises for us has been the speed of the adjustment of the Spanish economy. The labour market has reacted at a pace that we had not anticipated. And indeed, if we look at the share of employment in the construction sector, this ratio went from a record high of 13.2% during the second quarter of 2007 to only 10.1% in the first quarter of this year. More impressive, if the pace of the decline of the last year is maintained, the construction sector would account for only 7.5% of total employment by Q1 2010, which would be already below the Euro-Area average.

This is obviously a very painful process. At the peak in Q2 2007, 2.730 million workers were employed in the construction sector; by Q1 this year there were only 1.972 million, a decline of 27.8%. If the target is to cut to 7.6% of the labour force, the construction sector would need to be cut about another 500k jobs for a cumulative decline since peak of c45%; in other words, the sector could almost halve in 2 to 3 years.

How much of the adjustment has been done already?

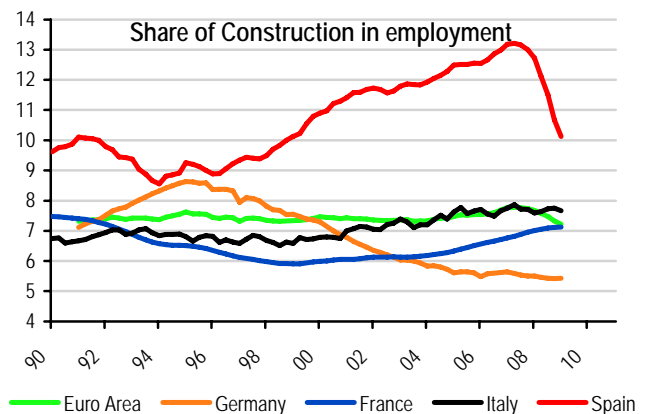
Employment in construction could halve from peak

Chart 7: Construction as a share of GDP correcting



Source: Eurostat, UBS

Chart 8: More impressive in the case of employment



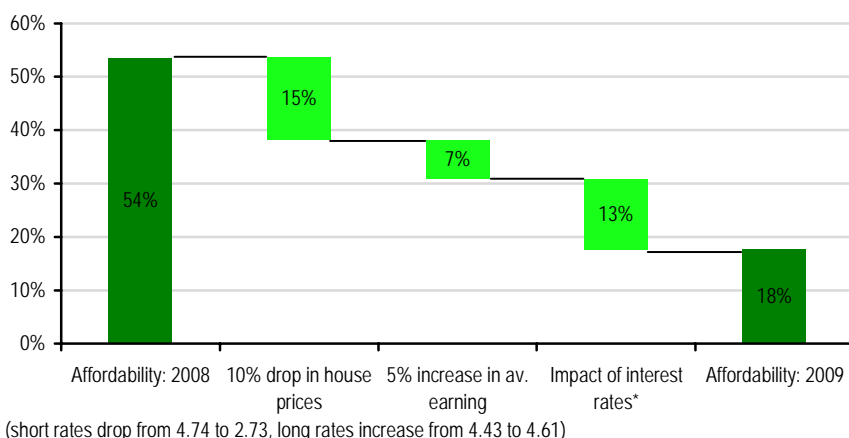
Source: Eurostat, UBS

In terms of prices, we can offer a more measurable conclusion. We return to our fair value model. As the following chart shows, the divergence between our fair value model and actual price of houses was 54% last year; i.e. our estimate of the housing market over-valuation was 54%. We make several assumptions on the outcome this year. The first is that house prices will fall by a total of 10%; the second is that households' disposable income will grow 5%; and finally that short rates will decline from 4.74% to 2.73% (OECD assumption). We also have a small increase in long rates, but this is almost negligible, as most mortgages are based on short rates.

House prices

The good news is that, with these hypotheses, which we consider reasonable, affordability (i.e. the divergence between fair value and actual house prices) drops to only 18%.

Chart 9: The divergence between actual house prices and our fair value model could adjust significantly this year



Source: UBS

The bad news, however, is that 18% is a big number for several reasons:

1. A large part of the adjustment is due to rates, and short rates cannot go much lower.

2. The 5% increase in average disposable income is open to question, although this is not a major assumption. More importantly, our model does not include the unemployment rate; this, we have to concede, is a more serious shortcoming, and could mean downward forces on prices being underestimated.
3. House prices tend to over-react and it is a safe bet that, given the current pattern, they are likely to go beyond fair value, hence an adjustment larger than what we would find remaining within the confines of our model.

In short, a further adjustment of 20% or more is still very much on the cards.

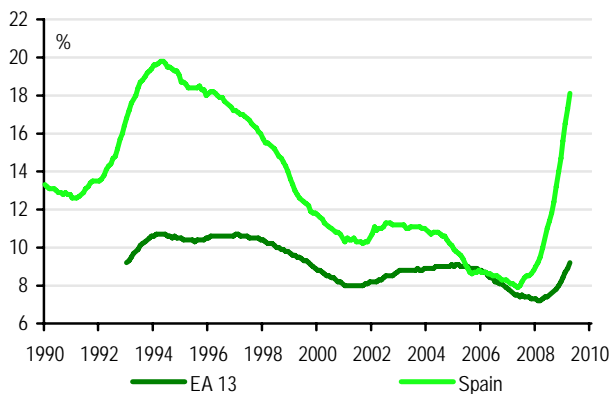
## What it impacted first: the labour market

### The disease spreads from construction to other sectors

The first element of fallout from the construction crash, as we noted above, has been a surge in the unemployment rate. We actually find a pattern which is very similar to what we described when talking about activity in different sectors: first, employment in the construction sector started to decline rapidly, before starting to affect other sectors, and the latest data (see second chart below) actually show that job destruction in other sectors is now catching up. It would therefore be wrong to think about the labour market problem as a construction problem: the disease is spreading out to other sectors too.

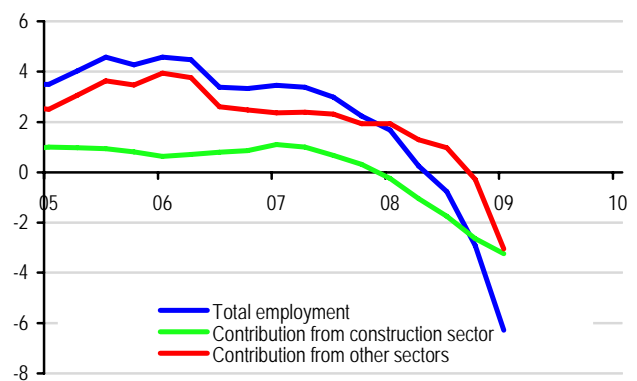
### Unemployment rate

Chart 10: Unemployment jumps



Source: Eurostat

Chart 11: The deterioration of the labour market was initially a construction story; it has now spread much more widely



Source: Eurostat

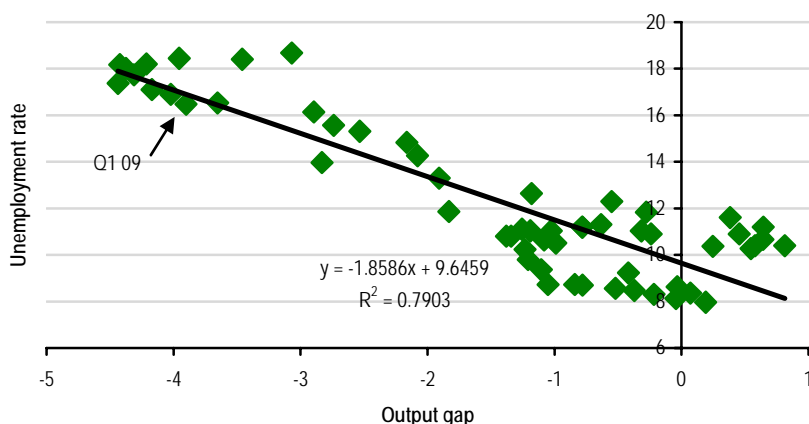
## Unemployment to hit 25%?

Where will it stop? One way to forecast the potential level of unemployment rate is to use Okun's law. This economic law puts in relation the level of activity and the level of unemployment. We use one version in which the level of the unemployment rate relates to the output gap. This makes sense intuitively, as the unemployment rate is just the dark side of the output gap.

### Okun's law

We obtain the following chart and, undisputedly, there is indeed a high correlation in Spain between our measure of the output gap and the level of unemployment.

Chart 12: Okun's law in Spain; a very neat correlation between output gap and unemployment rate



Source: UBS

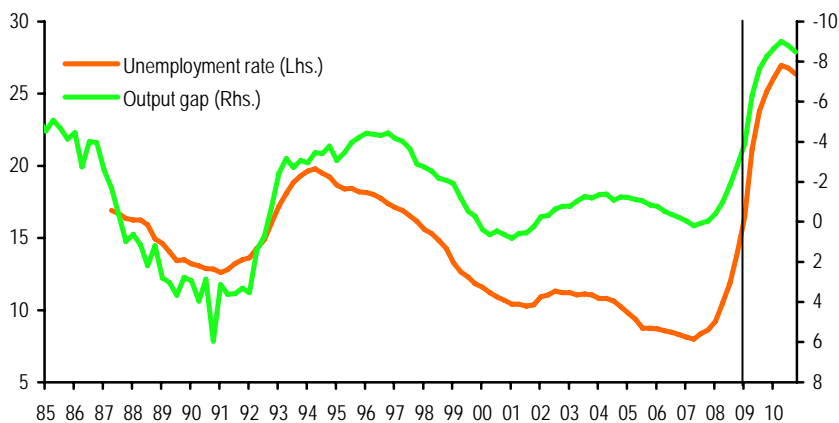
Using our GDP forecasts and the OECD's estimate of potential output, we find that the output gap could reach as much as 11%. This might look like way too aggressive, and the type of output gap that would be totally unprecedented in the Euro Area (for the record, the largest output gap ever recorded in the Euro Area was 1.5% in mid-2003, although the output gap reached -3.7% pre-Euro during the 1993 crisis). However, we would argue that a major housing bubble-burst is usually associated with this kind of large swing in production, so we would not regard this estimate as unreasonable. Using an 11% output gap, our model would be consistent with an unemployment rate of 20.2%.

An 11% output gap

However, we have to take into account that the labour market has already over-adjusted. The unemployment rate is already higher than the Okun's law number and Q2 preliminary data suggest this gap could widen even more. To take into account this pattern we make a judgemental adjustment and have a forecast with the unemployment rate topping at 25% next year (using Eurostat's harmonised definition).

A 25% unemployment rate

Chart 13: The result of our simulations



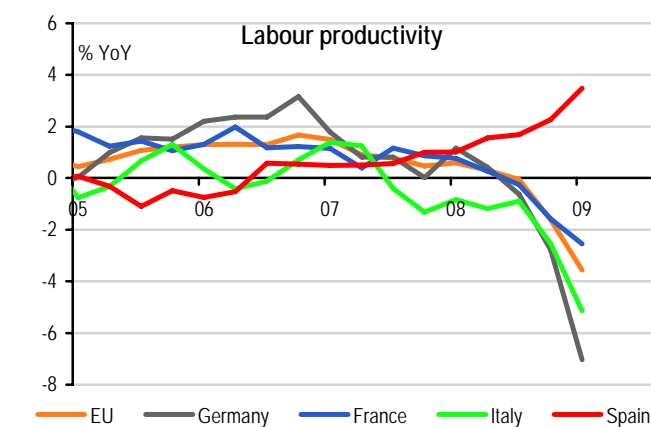
Source: Eurostat, OECD, UBS estimates

## The silver lining: productivity

There is however one important silver lining in this process. As we note above the adjustment has been much faster than we had expected and this is telling us a story about an economy which is much more flexible than we had anticipated. From that point of view it is good news.

One of the consequences is that, as the chart below demonstrates, Spain is by far the best performer in terms of productivity gains. This is in sharp contrast with the previous decade and a half in which the Spanish productivity performance has been very poor. Indeed, while so far the contraction of GDP has been more pronounced in other countries, the downsizing of the labour in Spain is by far the largest. A ratio between those two variables hence shows a somewhat counter intuitive picture with Germany lagging in terms of productivity and Spain a clear winner. Looking also at Spanish productivity relative to other countries (the second chart below) we note a very steady and worrying deterioration from 1995 to the end of 2007, but we also note that slightly more than a year the Spanish economy has regained almost all its productivity lag. Again this is probably a story about a much more flexible labour than anywhere in Europe.

**Chart 14: The crisis means huge declines in productivity. Not in Spain, productivity posted unusual gains.**



Source: Eurostat, UBS

This is an important argument because one of the theme we will tackle in another section is the potential for exports to revive at some point in the future. With domestic demand in the doldrums, an export led recovery would be very welcome. To that extend the productivity gains must be viewed from the angle of relative unit labour costs, i.e. the relative labour costs of Spain is improving rapidly. This is good news for Spanish export competitiveness.

## Public finances: starting from a very solid bases, deteriorating sharply

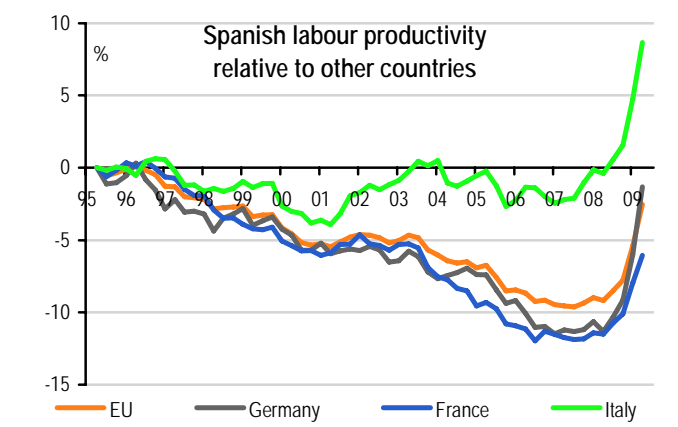
### Use to be among the best

Two years ago, the Spanish situation was one of the most solid among Euro Area. In 2007, the debt to GDP was at 36.2%; only Ireland and Luxembourg were able to show a lower number. The surplus of the budget was at 2.2% of the GDP, only beaten by Luxembourg and Finland.

Flexibility

Means productivity

**Chart 15: Spain recouped almost all its relative productivity losses**

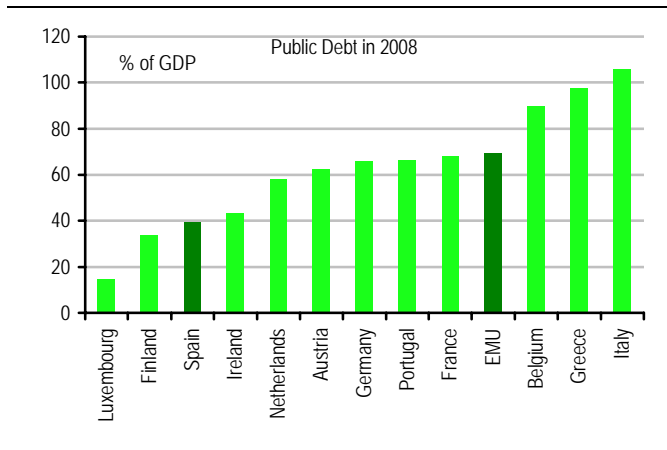


Source: Eurostat, UBS

Means export competitiveness

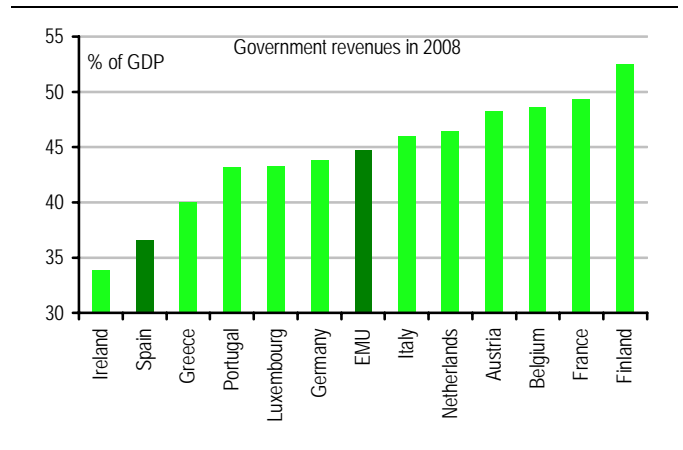
But there is another dimension that is often forgotten when talking about the Spanish situation and this is the size of the government's revenues. As Chart 17 below shows, at the end of last year, the level of government revenues as a share of GDP was one of the lowest among the Euro Area countries with the margin to the average quite substantial. This chart tells us that the potential to increase taxes is large and the Spanish government could potentially increase its revenue quite substantially if need be. This affords Spain a room to manoeuvre that few other country have.

**Chart 16: Still one of the lowest debt to GDP ratios**



Source: Eurostat

**Chart 17: Don't forget also that the level of taxes is still low**

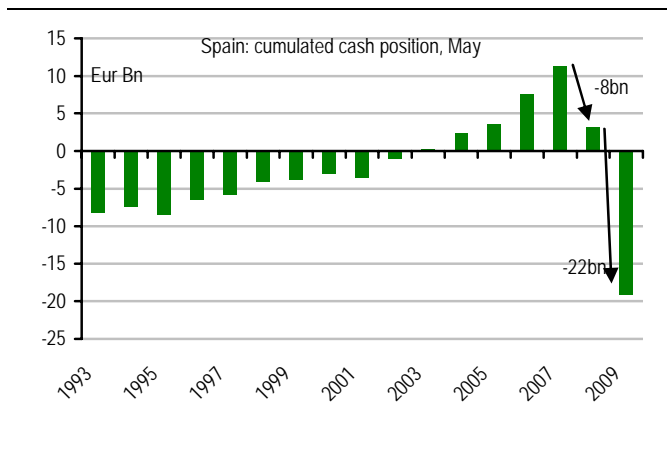


Source: Eurostat

**But things have changed**

However, these good days have come to an abrupt end. Chart 18 below shows the cash position of the central government. This does not include the local authorities, nor additional administrations included in the Maastricht definition of the deficit (e.g. social insurance). The chart shows the expected deterioration, but also shows that the increase in the deficit is much more pronounced this year than last.

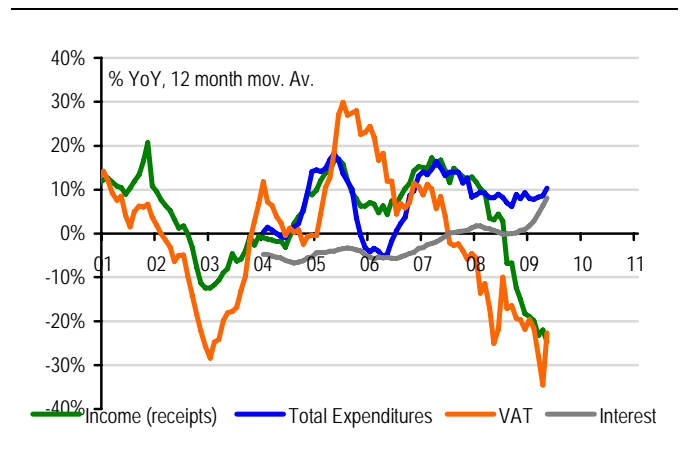
**Chart 18: The deterioration this year is worse than last year**



Source: Haver

**Deteriorating**

**Chart 19: Receipts collapsing is the main reason, notably VAT**



Source: Banco de España

Why is this year even worse? We wrote about this lag effect from the cycle in a previous publication (see *European Weekly Economic Focus; Public finances: serious but not desperate*, 24 April 2009) and noted that:

- (1) **The cyclical component will turn much more negative in 2009:** In 2008 indirect taxes remained well supported, especially VAT receipts as inflation was very high. The reverse will happen with no inflation in 2009. Similarly, direct taxes (income taxes and corporate taxes) are partly based on the previous year's revenue. Again, the situation will turn much worse for receipts in 2009 based on 2008 corporate profits and 2008 household revenues. Finally, social expenses will continue to increase meaningfully in the wake of the unemployment rate.
- (2) **The fiscal boost will cost:** The fiscal reflation plans to be implemented this year in Spain will also contribute to the deficit – by 1.0ppt, we estimate.
- (3) **Bank recapitalisation et al:** It is important to remember that the “financial operations” are “below the line”, i.e. they are not included in the deficit. The logic, when the Maastricht treaty was drafted and ratified, was to avoid a situation in which a country managed to meet the 3% deficit criteria using privatisation receipts, i.e. using one-off measures. The consequence now is that most of the bank recapitalisation money will not be accounted for in the deficit. Nevertheless, this will obviously increase the financing needs of the public sector.

Chart 19 above indeed confirms this view. The key problem is on the receipt side. We note a sharp decline, especially in terms of VAT receipts, but also taxes on income and corporate. This is how the gap widened. However, on the expense size, it is important to note that the line “interest” (i.e. debt service) is starting to increase at an unprecedented scale.

**Table 1: Public finances – cash situation of the central government in April 2009**

	Sum of last 12 months compared with previous 12 months
Income (receipts)	-22.0%
VAT	-34.5%
Taxes on production & imports ex VAT	-3.8%
Interest, dividends & other Income	-10.1%
Income and estate taxes	-22.5%
Other income	-13.3%
Total expenditures	8.5%
Remuneration & net purchases	5.9%
Interest	6.3%
Govt subsidies	-0.5%
Current & capital transfers in public admin	11.5%
Other expenditures	5.6%

Source: Banco de España

## Worrying prospects

We noted above two really positive elements in terms of public finances: the low level of debt and the low level of taxes. However, the Spanish public sector will have to absorb two major shocks: the jump in the deficit and the cost of bank recapitalisation.

Starting with the bank bailout cost, Table 2 (please note that this table and most of the following analysis in this section has been published in *European Weekly Economic Focus: Public finances – serious but not desperate*, 24 April 2009) shows a top-down estimate of banking industry losses and assumes that these are, after taking one year of pre-impairment earnings into account, dealt with through recapitalisation. In countries where we judge that there is likely to be investor demand for rights issues by some listed banks, we have assumed that a proportion of the capital requirements are raised from the private sector. The balance needs to be provided by governments.

### The bailout cost

**Table 2: UBS bank analysts' estimate of recapitalisation needs**

	Loans to private sector only, Feb-09 *	GDP in 2008	Losses		Pre-impairment profit	Net losses (mid pt)	Losses		Market		Government		
			Losses (range)	Losses (mid pt)			% GDP	€ bn	% of total losses	€ bn	% of total losses	€ bn	% of GDP
Euro area	10,839	9,203					5%	453		47		406	4.4%
Germany	2,544	2,488	5-7%	6%	1%	5%	5%	127	0%	0	100%	127	5.1%
France	1,945	1,947	3-5%	4%	2%	2%	2%	39	30%	12	70%	27	1.4%
Italy	1,556	1,572	3-5%	4%	2%	2%	2%	31	30%	9	70%	22	1.4%
<b>Spain</b>	<b>1,888</b>	<b>1,095</b>	<b>8-12%</b>	<b>10%</b>	<b>3%</b>	<b>7%</b>	<b>12%</b>	<b>132</b>	<b>15%</b>	<b>20</b>	<b>85%</b>	<b>112</b>	<b>10.3%</b>
Neth'lids	984	595	5-7%	6%	2%	4%	7%	39	0%	0	100%	39	6.6%
Belgium	308	344	8-10%	9%	2%	4%	4%	22	0%	0	100%	22	6.3%
Austria	326	282	5-7%	6%	3%	3%	3%	10	25%	2	75%	7	2.6%
Greece	199	243	5-7%	6%	3%	3%	2%	6	25%	1	75%	4	1.8%
Ireland	398	186	10%-16%	13%	2%	12%	25%	46	0%	0	100%	46	24.6%
Portugal	272	166	5-7%	6%	2%	4%	7%	11	25%	3	75%	8	4.9%

Source: UBS

We believe that forbearance – in the shape of allowing the banks to amortise losses against their P&L over a longer period – does not make sense when the whole system is undercapitalised, as credit provision would likely be constrained for too long a period. We also pay no mind to preferred shares and other forms of subordinated debt: as discussed in *The capital smorgasbord* (7 January 2009), we believe that real losses need to be replenished with real, common equity. Overall, we believe eurozone governments will likely need to provide €12 billion in equity to banks over the next several years.

**We believe that real losses need to be replenished with real, common equity**

It is important to remember that the “financial operations” are “below the line”, i.e. they are not included in the deficit. However, they will obviously increase the financial needs of the government. Thus, this recapitalisation will add to the deficit of the government. In the case of Spain, we estimate that a large part of the deficit will increase for cyclical reasons. This, at first sight, seems like a very reasonable hypothesis, given the sharp deterioration in growth. Actually, it is not that obvious: if we treat the widening of the deficit as cyclical, we implicitly say that at some point in the future growth will return to its previous path.

**Deficit**

There are strong reasons to believe, however, that trend growth in Spain will never revert to 3%; rather, it will at best settle around 2%, and probably below that level. This will make the reduction of the deficit much more demanding, because the cyclical component on the upside will be much smaller.

The table below details the arithmetic of the deficits, financial needs and, finally, debt.

**Table 3: Arithmetic of Spanish fiscal positions this year and next**

	Spain
2008 (Eurostat official data)	
Deficit	-3.8
Debt	39.5
2009 (UBS estimate)	
Fiscal reflation (change in structural deficit)	-0.4
Cyclical effect (change in cyclical deficit)	-3.3
Deficit (1)	-7.5
Financial operations	
€ bn (see table 2)	112
% of GDP (2)	10.3
Total financial needs of public sector (3) = (1) - (2)	-17.8
Debt	58.0
2010 (UBS estimate)	
Deficit	-8.0
Debt	65.0

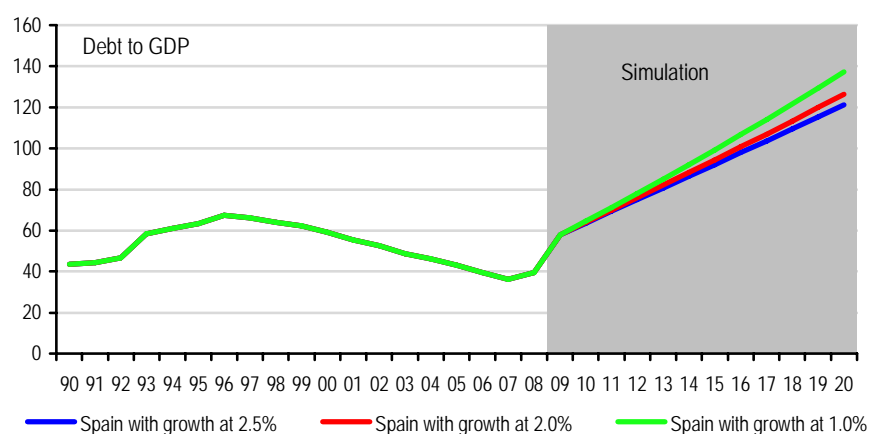
Source: Eurostat, UBS

Note, however, that in the table above we treat the bank recapitalisation as a one-off cost for the government. This is probably too aggressive a hypothesis. First, because the bailout might be smoothed over several years. Second, and more importantly, because the recapitalisation could at some point in the future generate revenue, for instance via dividends. Third, we implicitly assume that the government will never sell its stakes in the banks. In short, in the table above, we probably overestimate the impact of the bailout plans on the fiscal position.

**Caution!**

Using these fiscal data, we can produce some simulations of the debt to GDP position in Spain.

## Chart 20: The fiscal situation is clearly not sustainable in Spain



Source: Eurostat, UBS

It is very important, however, to underline that the above charts are simulations. They are not our forecasts. These simulations show that the situation is not tenable in the medium term, so euro area governments will have to follow the UK example at some point in the future and implement fiscal consolidation. This, eventually, implies that the debt to GDP ratios will not move in the way that we show in the two charts above.

Simulations, not forecasts

**The charts are telling us that the Spanish government doesn't have a choice: some fiscal tightening will have to be implemented at some point in the future.**

We would not be telling the full story if we did not add yet another warning. First, the population is ageing, which will put more pressure on public finances. And second, a higher level of debt means a higher sensitivity to interest rates. We ran our simulation assuming that rates would stay stable, but if the market was to demand a higher risk premium on government debt, this would make the problem even worse.

Oh, and also: more problems

## Don't write off the export sector

Let's start with a couple of remarks on Spanish exports. Spain is usually seen as a pure domestic economy with no export sectors and all the growth momentum being driven by domestic factors. This is, we would argue, an oversimplification.

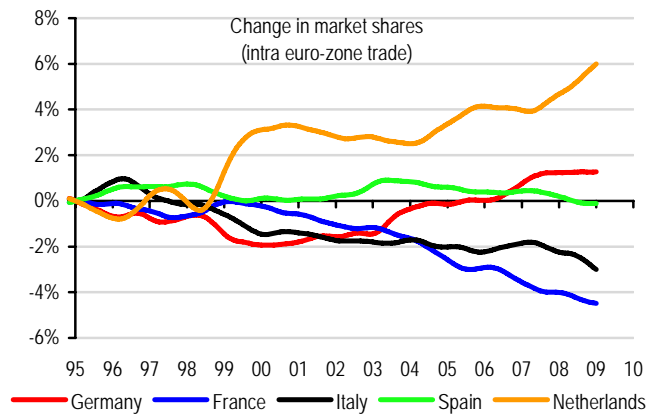
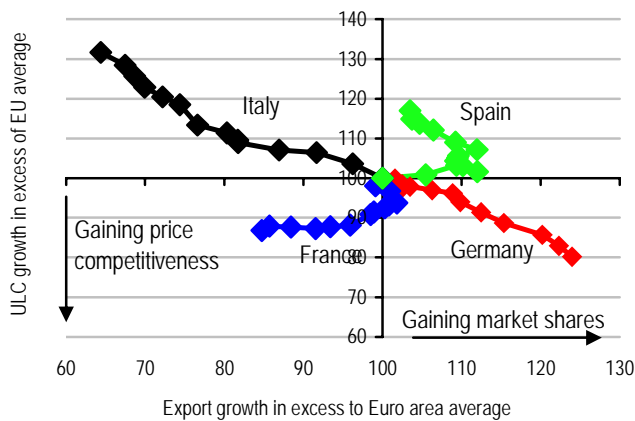
Spanish myths

First, the growth in exports from Spain has outperformed the rest of the euro area. The first chart below shows this evolution, comparing it to unit labour costs. We find a counter-intuitive result for Spain: Spain has managed to grow its exports faster than the rest of Europe despite having labour costs also increasing faster – i.e. apparently losing ground in terms of competitiveness. This looks very suspicious at first sight, but is actually not: this pattern is quite usual for a number of countries catching up in terms of development. The labour costs increase as the country develops, but at the same time the country opens more. This is the story of Spain, so far, and this is also a very strong signal that the quality of exports has increased, which is the only way to gain market share while costs are increasing.

Second, as the second chart shows, the market shares of Spain in terms of intra-euro area trade have remained more or less stable over the past 10 years. So there is no obvious loss of competitiveness in the Spanish economy. It is also interesting to note that the Spanish economy has been able to maintain export market shares while prices were deteriorating on a comparative basis, notably prices as measured by unit labour costs (ULC). This is a very strong hint that the quality of Spanish exports has increased.

**Chart 21: Spain has outperformed the rest of Europe in terms of export growth despite adverse labour costs moves**

**Chart 22: Spain's export market shares within Europe have remained more or less stable for a decade and a half**



Source: UBS

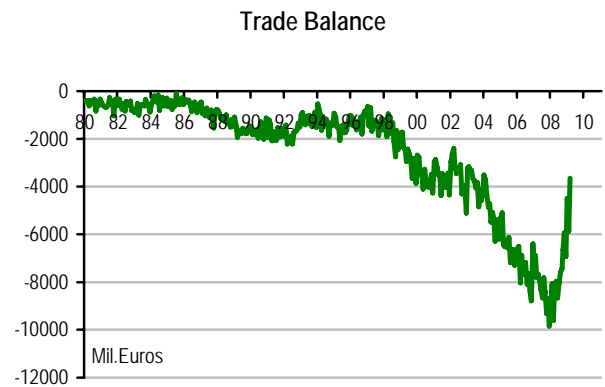
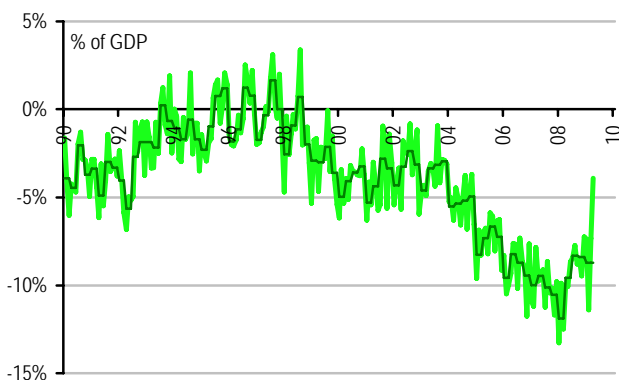
Source: UBS

The recent past in terms of external imbalances has been nevertheless essentially a story about reducing the extreme deficit. This is a very welcome movement. The double-digit deficit of the current account was clearly not sustainable, and the fact that it has been reduced to less than 4% in the latest data point (the May deficit) is a very welcome movement. This decline is echoed by the decline in the trade deficit, which also reached unsustainably high levels in 2007, but which has almost been cut to a third of its peak level.

**Cutting the imbalances**

**Chart 23: Current account deficit has narrowed dramatically...**

**Chart 24: ...as has the trade balance**



Source: Banco de España

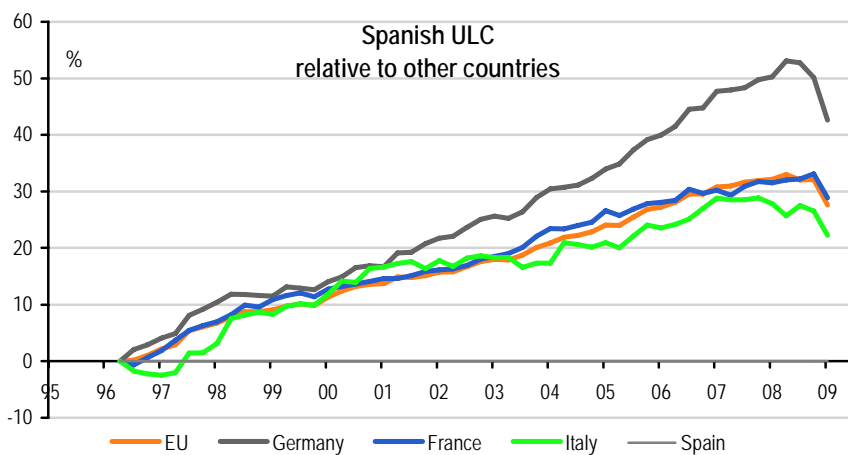
Source: Banco de España

Obviously this is also a symptom of a collapse in domestic demand. If the adjustment is welcome, it is coming about because imports are being reduced at a very rapid pace. This is very detrimental for the Spanish economy. Moreover, the decline in the current account deficit can be attributed to a large extent to the fact that it is increasingly difficult to finance. So these adjustments show how serious the situation is in Spain.

Painful

Nevertheless, there is some hope that the adjustment will also take place for the right reason, i.e. because of an improvement in exports. We mentioned above the fact that the Spanish economy has gained in terms of productivity as it has been very agile in reducing employment. One direct consequence of this move is the relative performance of labour costs. With a large outperformance in productivity, Spain is also experiencing quite an impressive improvement in relative ULC, as the following chart demonstrates. Spanish ULC deteriorated steadily and substantially from 1996 until the beginning of this crisis. But the recent performance has been very good.

**Chart 25: Spanish ULC increased much faster than in other countries for a long period, but the recent performance has been much better**



Source: UBS, Eurostat

This raises some hope that with gains in competitiveness, the economy could be in a position to engineer a recovery via the export side. With rising ULC, the Spanish economy managed to put in a decent export performance; so with a sharp improvement in ULC the performance could prove more positive. This is still to be proven, and it would be an important shift for the economy: from a mainly domestically driven economy to one with a more balanced growth profile with a higher export component. It is still to be proven that this is a feasible and credible way out of the crisis. But we think that writing off this option *a priori*, as many commentators do, is simply premature and might be proven to be a mistake.

# Central bank watch

## European central banks' monetary policy decision announcement schedule

ECB	Bank of England	Swedish Riksbank	Norwegian Norges Bank	Swiss National Bank
4 Dec (75bp cut)	4 Dec (100bp cut)	4 Dec (brought forward) (175bp cut)	17 Dec (175 bp cut)	11 Dec (50bp cut)
15 Jan (50bp cut)	8 Jan (50bp cut)			
5 Feb	5 Feb (50bp cut)	11 Feb (100bp cut)	4 Feb (50bp cut)	
5 Mar (50bp cut)	5 Mar (50bp cut)		25 Mar (50bp cut)	12 Mar (25 bp cut)
2 Apr (25bp cut)	9 Apr (Unchanged)	21 Apr (50bp cut)		
7 May (25bp cut)	7 May (Unchanged)		6 May (50bp cut)	
4 Jun (Unchanged)	4 Jun (Unchanged)		17 Jun (25bp cut)	18 Jun
2 Jul (Unchanged)	9 Jul	2 Jul (25bp cut)		
6 Aug	6 Aug		12 Aug (Forecast: 25bp cut)	
3 Sep	10 Sep	2 Sep	23 Sep	17 Sep
8 Oct	8 Oct	22 Oct	29 Oct	

Note: IR = Inflation Report published (note that in case of the BoE, the Inflation Report is published a week after the MPC meeting). MPR = Monetary Policy Report published.

\*\*\*No press conference. Source: ECB, BoE, Riksbank, Norges Bank

## UBS European and US rate forecasts

		Current	09 Q1F	09 Q2F	09 Q3F	09 Q4F	10 Q1F	10 Q2F	10 Q3F	10 Q4F
Euro area	ECB refi rate	1.00	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00
UK	MPC repo rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
Sweden	Riksbank repo rate	0.25	1.00	0.50	0.25	0.25	0.25	0.25	0.25	0.75
Norway	Norges Bank deposit rate	1.25	2.00	1.25	1.00	1.00	1.00	1.00	1.00	1.50
Switzerland	3M Libor target rate	0.25	0.40	0.30	0.25	0.25	0.25	0.25	0.25	0.25
US	Fed funds rate	0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.50	0.75	1.00
Euro area	10 years	3.36	4.15	3.40	3.60	3.80	4.00	4.20	4.20	4.20
UK	10 years	3.77	3.31	3.70	3.70	3.90	4.10	4.30	4.55	4.80
Sweden	10 years	3.38	2.99	3.46	2.95	3.00	3.00	3.40	3.60	3.80
Norway	10 years	4.14	3.78	4.10	4.00	4.00	4.10	4.20	4.30	4.40
Switzerland	10 years	2.32	2.10	1.90	2.00	2.00	2.00	2.10	2.25	2.25
US	10 years	3.49	2.71	3.00	3.00	3.20	3.50	3.70	3.90	4.00

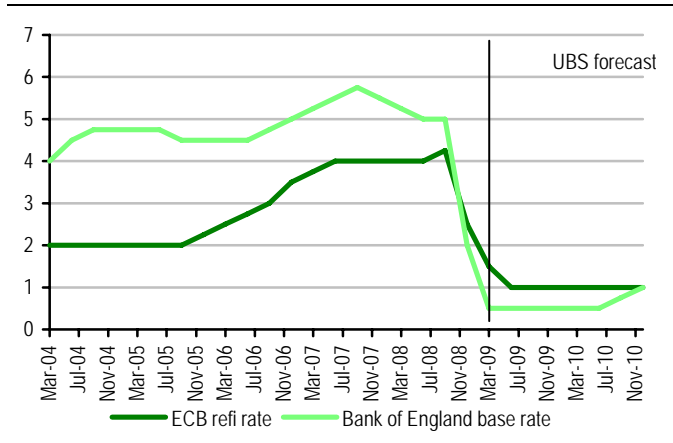
Source: Bloomberg, UBS forecasts

## UBS FX forecasts

	Current				Year end					Year average				
		Sep-09	Dec-09	Dec-10	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010
EUR/USD	1.40	1.30	1.20	1.25	1.32	1.46	1.39	1.30	1.40	1.26	1.40	1.42	1.29	1.23
EUR/JPY	135.2	123.5	114.0	118.8	157.0	163.3	126.2	114.0	118.8	147.0	160.4	143.2	119.6	116.6
EUR/GBP	0.86	0.86	0.86	0.81	0.67	0.74	0.95	0.86	0.81	0.68	0.71	0.85	0.90	0.83
EUR/SEK	10.86	10.60	9.45	9.20	9.02	9.45	10.99	9.45	9.20	9.19	9.25	10.29	10.16	9.31
EUR/NOK	8.97	8.80	8.20	8.00	8.21	7.94	9.73	8.20	8.00	8.11	8.06	8.91	8.90	8.09
EUR/CHF	1.52	1.52	1.54	1.56	1.61	1.66	1.48	1.54	1.56	1.58	1.63	1.56	1.51	1.55

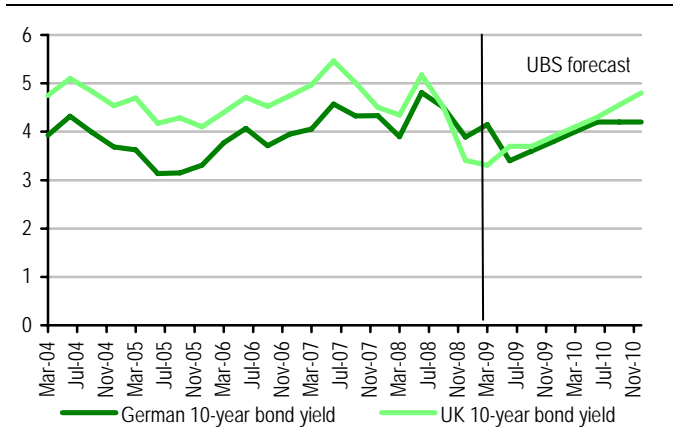
Source: Bloomberg, UBS forecasts

### ECB and BoE central bank policy rates



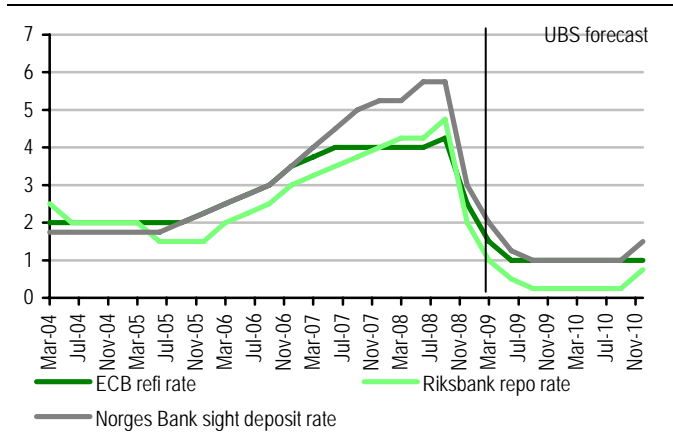
Source: Bloomberg, UBS forecasts

### German and UK 10-year bond yields



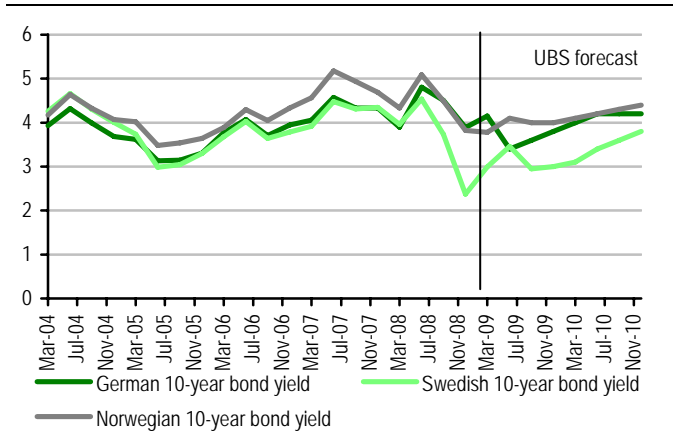
Source: Bloomberg, UBS forecasts

### ECB, Riksbank and Norges Bank central bank policy rates



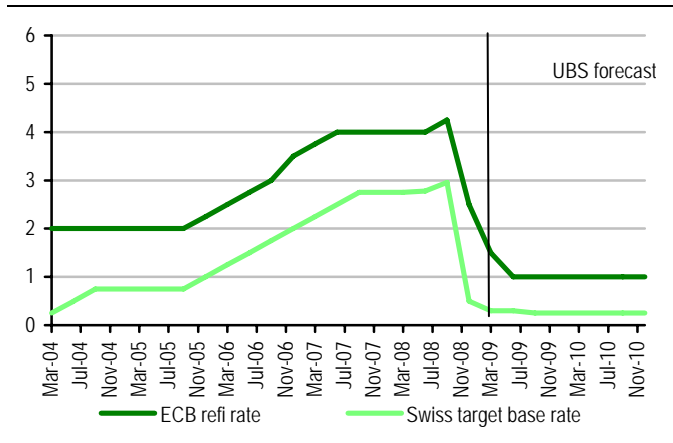
Source: Bloomberg, UBS forecasts

### German, Swedish and Norwegian 10-year bond yields



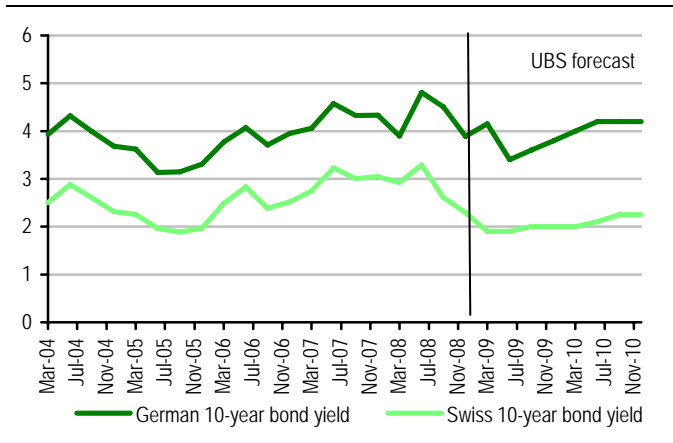
Source: Bloomberg, UBS forecasts

### ECB and Swiss National Bank central bank policy rates



Source: Bloomberg, UBS forecasts

### German and Swiss 10-year bond yields



Source: Bloomberg, UBS forecasts

# Data and event calendar

Date	Time	Country	Indicator	Units	Forecast	Prior	Consensus	Importance	
6-Jul-09	8:30	Euro Zone	Sentix Investor Confidence (Jul)			-27			
	7:15	Switzerland	Foreign hotel stays (May)	y-o-y	nf	3.30%		*	
7-Jul-09	10:00	Germany	Factory Orders (sa) (May)	m-o-m	0.30%	0.00%		**	
	10:00	Germany	Factory Orders (nsa) (May)	y-o-y	nf	-37.10%		**	
	6:45	France	Trade Balance (May)	EUR bn	nf	-3.8			
	8:00	Norway	Industrial Production sa (May)	m-o-m	nf	-1.60%			
	8:00	Norway	Industrial Production wdaJ (May)	y-o-y	nf	-4.00%			
	8:00	Norway	Ind Prod Manufacturing sa (May)	m-o-m	0%	-1.40%			
	8:00	Norway	Ind Prod Manufacture wdaJ (May)	y-o-y	-8.10%	-10.60%			
	7:30	Sweden	Budget Balance (Jun)	SEK bn	nf	16.7			
	8:30	UK	Industrial Production (May)	m-o-m	0.50%	0.30%		*	
	8:30	UK	Industrial Production (May)	y-o-y	-11.00%	-12.30%		*	
	8:30	UK	Manufacturing Production (May)	m-o-m	0.50%	0.20%		*	
	8:30	UK	Manufacturing Production (May)	y-o-y	-11.60%	-12.70%		*	
	23:01	UK	Nationwide Consumer Confidence (Jun)		nf	53			
	23:01	UK	NIESR GDP Estimate (Jun)		nf	-0.90%		**	
	6:00	Switzerland	Announcement of Conf Tender-Swiss Treasury						*
	8-Jul-09	9:00	Euro Zone	Euro Zone GDP sa (Final) (Q1)	q-o-q	-2.50%	-2.50%		*
9:00		Euro Zone	Euro Zone GDP sa (Final) (Q1)	y-o-y	-4.80%	-4.80%		*	
9:00		Euro Zone	Euro Zone Household Cons (Final) (Q1)	q-o-q	-0.50%	-0.50%		*	
9:00		Euro Zone	Euro Zone Gross Fix Cap (Final) (Q1)	q-o-q	-4.20%	-4.20%		*	
9:00		Euro Zone	Euro Zone Govt Expend (Final) (Q1)	q-o-q	0.00%	0.00%		*	
10:00		Germany	Industrial Production (sa) (May)	m-o-m	0.50%	-1.90%	0.30%	**	
10:00		Germany	Industrial Production (nsa wda) (May)	y-o-y	-19.60%	-21.60%	-20	**	
6:30		France	Bank of France Business Sentiment (Jun)		83	81			
7:30		Sweden	Industrial Production sa (May)	m-o-m	0.00%	-2.10%		*	
7:30		Sweden	Industrial Production nsa (May)	y-o-y	-20%	-21.20%		*	
7:30		Sweden	Industrial Orders sa (May)	m-o-m	0.8%	0.40%		*	
7:30		Sweden	Industrial Orders nsa (May)	y-o-y	-21.90%	-30.00%		*	
7:30		Sweden	Activity Index Level (May)		103.5	102.4		**	
9:30		UK	BRC June Shop Price Index (Jul)						
5:45		Switzerland	Unemployment rate (Jun)	%	3.40%	3.40%		**	
5:45		Switzerland	Unemployment rate (sa) (Jun)	%	3.60%	3.50%		**	
11:00	Switzerland	Publication of the Result of the Conf Tender						*	
9-Jul-09	8:00	Euro Zone	ECB Publishes July Monthly Report (Text) (Jul)						
	6:00	Germany	Trade Balance (May)	EUR bn	10	9.4		*	
	6:00	Germany	CPI (Final) (Jun)	m-o-m				*	
	6:00	Germany	CPI (Final) (Jun)	y-o-y				*	
	6:00	Germany	Current Account (May)	EUR bn	7	5.8		*	
	6:00	Germany	CPI - EU Harmonised (Final) (Jun)	m-o-m	0.40%	0.40%		*	
	6:00	Germany	CPI - EU Harmonised (Final) (Jun)	y-o-y	0.00%	0.00%		*	
	6:00	Germany	Exports sa (May)	m-o-m	2.50%	-4.80%		*	
	6:00	Germany	Imports sa (May)	m-o-m	1.50%	-5.80%		*	
	7:30	Netherlands	CPI (Jun)	m-o-m	nf	0.10%			
	7:30	Netherlands	CPI (Jun)	y-o-y	nf	1.60%			
	7:30	Netherlands	CPI - EU Harmonized (Jun)	m-o-m	nf	0.10%			
	7:30	Netherlands	CPI - EU Harmonized (Jun)	y-o-y	nf	1.50%			
	7:30	Netherlands	Industrial Production sa (May)	m-o-m	nf	-0.30%			
	7:30	Netherlands	Industrial Production nsa (May)	y-o-y	nf	-13.20%			

Date	Time	Country	Indicator	Units	Forecast	Prior	Consensus	Importance
	7:30	Netherlands	Industrial sales nsa (May)	y-o-y	-25%	-26.40%		
	<b>7:30</b>	<b>Sweden</b>	<b>CPI - Headline Rate (Jun)</b>	<b>m-o-m</b>	<b>0%</b>	<b>0.10%</b>		<b>***</b>
	<b>7:30</b>	<b>Sweden</b>	<b>CPI - Headline Rate (Jun)</b>	<b>y-o-y</b>	<b>-1%</b>	<b>-0.40%</b>		<b>***</b>
	7:30	Sweden	CPI - Underlying Inflation (Jun)	m-o-m	0.10%	0.30%		**
	7:30	Sweden	CPI - Underlying Inflation (Jun)	y-o-y	0.60%	1.30%		**
	7:30	Sweden	CPI Level (Jun)		299.45	299.45		
	8:30	UK	Visible Trade Balance (May)	GBP mn	-6800	-7003		
	8:30	UK	Trade Balance Non EU (May)	GBP mn	-3900	-4139		
	8:30	UK	Total Trade Balance (May)	GBP mn	-2900	-3014		
	<b>11:00</b>	<b>UK</b>	<b>BOE ANNOUNCES RATES (Jul)</b>	<b>%</b>	<b>0.50%</b>	<b>0.50%</b>	<b>0.50%</b>	<b>***</b>
<b>10-Jul-09</b>		Germany	WPI (Jun) (Data Due: 10-15 Jul)	m-o-m	0.10%	0.10%		
		Germany	WPI (Jun) (Data Due: 10-15 Jul)	y-o-y	-9.60%	-8.90%		
	6:45	France	Industrial Production (May)	m-o-m	0.00%	-1.40%	-1.70%	**
	6:45	France	Industrial Production (May)	y-o-y	-15.70%	-18.80%	-16.4	**
	6:45	France	Manufacturing Production (May)	m-o-m	0.00%	-0.50%		**
	6:45	France	Manufacturing Production (May)	y-o-y	-13.40%	-19.70%		**
	6:45	France	Central Govt. Balance (May)	EUR bn	n/f	-71.9		
	6:45	France	Current Account (May)	EUR bn	n/f	-3.1		
	8:00	Italy	Industrial Production sa (May)	m-o-m	0.00%	1.10%		*
	8:00	Italy	Industrial Production wda (May)	y-o-y	-21.20%	-24.20%		*
	8:00	Italy	Industrial Production nsa (May)	y-o-y	-20.00%	-25.40%		
	7:00	Spain	CPI (Jun)	m-o-m	na	0.00%		
	7:00	Spain	CPI (Jun)	y-o-y	-1%	-0.90%		
	7:00	Spain	CPI (Core Index) (Jun)	m-o-m	n/f	-0.10%		
	7:00	Spain	CPI (Core Index) (Jun)	y-o-y	0.70%	0.90%		
	7:00	Spain	CPI (EU Harmonised) (Jun)	m-o-m	n/f	0.00%		
	7:00	Spain	CPI (EU Harmonised) (Final) (Jun)	y-o-y	-1%	-0.90%		
	8:00	Norway	CPI (Jun)	m-o-m	0.10%	0.20%		*
	8:00	Norway	CPI (Jun)	y-o-y	2.90%	3.00%		*
	8:00	Norway	CPI Underlying (Jun)	m-o-m	0.20%	0.30%		**
	8:00	Norway	CPI Underlying (Jun)	y-o-y	2.80%	2.90%		**
	8:00	Norway	Producer Prices including Oil (Jun)	m-o-m	n/f	6.50%		
	8:00	Norway	Producer Prices including Oil (Jun)	y-o-y	n/f	-2.90%		
	<b>8:00</b>	<b>Sweden</b>	<b>AMV Unemployment Rate (Jun)</b>	<b>%</b>	<b>5%</b>	<b>4.70%</b>		<b>***</b>
	8:30	UK	PPI Input nsa (Jun)	m-o-m	1.20%	0.40%		
	8:30	UK	PPI Input nsa (Jun)	y-o-y	-12.00%	-9.40%		
	8:30	UK	PPI Output nsa (Jun)	m-o-m	0.50%	0.40%		
	8:30	UK	PPI Output nsa (Jun)	y-o-y	-0.60%	-0.30%		
	8:30	UK	PPI Output Core nsa (Jun)	m-o-m	0.20%	0.20%		
	8:30	UK	PPI Output Core nsa (Jun)	y-o-y	1.10%	1.20%		

Source: Bloomberg, UBS. Note: Three asterisks in the importance column represent the most important and potentially market-moving data

## Next week in Europe

The release of industrial production numbers in Germany and France will be all-important in Europe next week. We expect significant improvements in industrial production for both the economies. We forecast German industrial production (Wednesday) to improve significantly by 0.50% m/m in May (after falling 1.90% in April). We also expect French industrial production (Friday) to improve by 0.00% m/m in May (after falling 1.40% in April). Improvement in industrial production is likely to lift factory orders in Germany (Tuesday) and manufacturing production in France (Friday), in our view. On Thursday, the Bank of England will announce its decision on interest rates. In line with consensus, we expect rates to remain unchanged at 0.50%. However, the markets will likely watch out for announcements regarding a further extension of the QE programme. In Sweden, we expect inflation (Thursday) to fall slightly, and the labour market to remain tight, with a further rise in unemployment (Friday) likely.

% yoy	2000	2001	2003	2004	2005	2006E	2007E	2008E	2009E	2010E
<b>Demand &amp; Output</b>										
Consumers' expenditure	2.0	0.9	1.2	1.5	1.8	2.1	1.6	0.3	-1.0	0.1
Government consumption	2.0	2.4	1.7	1.6	1.5	1.8	2.2	2.0	2.1	2.2
Fixed investment	0.6	-1.4	1.3	1.8	3.5	5.9	4.3	-0.2	-9.1	-1.1
Stocks <sup>1</sup>	-0.4	-0.3	0.1	0.2	-0.1	0.0	0.1	0.1	-0.2	0.7
Domestic demand	1.3	0.4	1.4	1.7	2.0	2.9	2.4	0.7	-2.4	1.0
Exports	4.0	1.8	1.5	6.7	5.2	8.5	5.9	1.1	-11.3	1.0
Imports	2.3	0.4	3.2	6.5	5.8	8.3	5.3	1.2	-7.9	0.6
Net exports <sup>1</sup>	0.6	0.5	-0.6	0.1	-0.2	0.2	0.3	0.0	-1.6	0.1
GDP	1.9	0.9	0.8	1.9	1.8	3.0	2.6	0.7	-4.1	1.1
Industrial production	0.4	-0.5	0.3	2.1	1.4	4.0	3.5	-1.8	-12.5	0.4
<b>Labour Market</b>										
Unemployment rate (%)	7.8	8.3	8.7	8.9	8.9	8.3	7.4	7.5	9.9	12.0
Workforce in employment	1.5	0.7	0.4	0.8	1.0	1.6	1.8	0.8	-2.1	-1.8
Nominal wage growth	2.6	2.6	2.3	2.2	2.0	2.2	2.5	3.2	2.1	1.8
Unit wage costs	2.3	2.4	2.0	1.1	1.1	0.8	1.7	3.3	4.1	-1.1
<b>Inflation</b>										
Producer prices	2.1	-0.2	1.4	2.4	4.1	5.1	2.7	5.9	-1.8	1.4
HICP	2.3	2.2	2.1	2.1	2.2	2.2	2.1	3.3	0.1	0.7
GDP Deflator	2.4	2.5	2.2	1.9	2.0	2.0	2.3	2.3	1.5	1.8
<b>Finance</b>										
Current account (% of GDP)	-0.4	0.6	0.3	0.8	0.1	-0.1	0.1	-1.0	-1.7	-1.4
Budget balance (% of GDP)	-1.8	-2.5	-3.1	-2.9	-2.5	-1.3	-0.6	-1.7	-5.3	-6.3
General government debt (% of GDP)	68.3	68.1	69.3	69.7	70.5	68.8	65.2	66.1	74.3	78.5
Broad Money	6.1	7.1	7.8	6.0	7.5	8.8	10.8	9.6	8.3	7.1
<b>Interest and exchange rates (end period)</b>										
3 month interest rate	3.28	2.85	2.11	2.14	2.47	3.71	4.65	2.90	1.10	1.50
10-year bund yield	4.80	4.30	4.30	3.60	3.40	3.80	4.30	3.20	3.80	4.20
EUR/USD	0.88	1.05	1.26	1.36	1.18	1.32	1.47	1.39	1.20	1.25
EUR/JPY	115.49	124.53	135.31	139.86	139.06	156.75	164.45	126.35	114.00	118.75

% yoy	2008				2009				2010			
	Q1 08	Q2 08	Q3 08	Q4 08	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10	Q4 10
<b>Demand &amp; Output</b>												
Consumers' expenditure	1.4	0.4	0.1	-0.5	-1.0	-0.9	-1.2	-1.1	-0.6	-0.2	0.3	0.8
Government consumption	1.5	2.1	2.2	2.3	2.4	2.0	1.9	2.1	2.2	2.2	2.2	2.2
Fixed investment	3.0	1.5	-0.1	-5.0	-9.0	-9.8	-10.3	-7.0	-3.9	-1.6	0.2	1.2
Stocks <sup>1</sup>	-0.2	-0.1	0.1	0.7	-0.3	-0.3	-0.2	0.1	1.0	1.1	0.6	0.1
Domestic demand	1.6	0.9	0.5	-0.2	-2.4	-2.6	-2.8	-1.7	0.3	1.1	1.2	1.3
Exports	5.0	3.7	1.8	-5.8	-12.2	-13.1	-12.9	-6.6	-1.0	0.8	1.5	2.6
Imports	3.7	2.4	1.7	-2.9	-8.0	-8.4	-9.7	-5.3	-1.1	0.3	1.2	2.1
Net exports <sup>1</sup>	0.6	0.6	0.0	-1.3	-2.1	-2.3	-1.6	-0.6	0.0	0.2	0.1	0.2
Real GDP (% qoq)	0.7	-0.3	-0.3	-1.6	-2.5	-0.7	0.3	0.4	0.2	0.3	0.4	0.5
Real GDP	2.1	1.4	0.6	-1.5	-4.6	-4.9	-4.4	-2.4	0.3	1.3	1.4	1.5
Industrial production	2.8	1.0	-2.1	-8.5	-13.8	-14.5	-13.3	-8.2	-2.3	0.1	1.6	2.4
<b>Labour Market &amp; Inflation</b>												
Unemployment rate (%)	7.2	7.4	7.5	8.0	8.8	9.6	10.3	11.0	11.5	11.9	12.2	12.3
Money GDP	4.3	3.7	2.8	0.9	-2.9	-3.5	-3.2	-0.8	2.2	3.1	3.2	3.2
HICP	3.4	3.6	3.8	2.3	1.0	0.0	-0.4	0.0	0.4	0.7	0.7	1.0
<b>Interest and exchange rates (end period)</b>												
ECB Refi rate	4.00	4.00	4.25	2.50	1.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10-yr bund yield	3.90	4.60	4.20	3.20	3.10	3.40	3.60	3.80	4.00	4.20	4.20	4.20
EUR/USD	1.58	1.58	1.43	1.39	1.33	1.23	1.23	1.20	1.20	1.20	1.20	1.25

Source: UBS forecasts

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