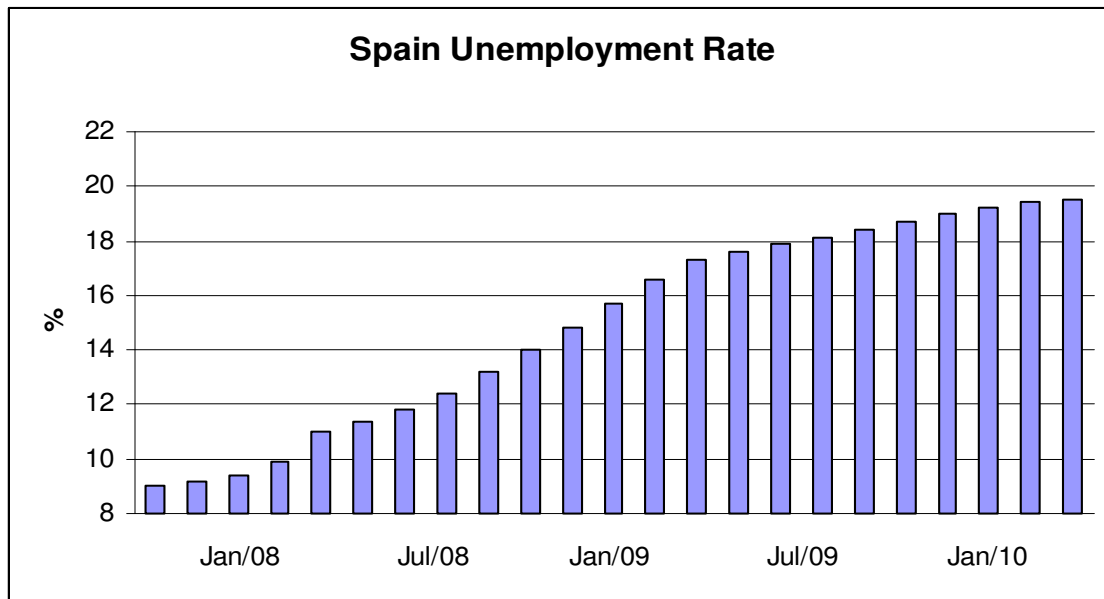


## EU debt crisis may spread – Is Spain next?

Modest stability returned to the Forex markets Tuesday as investors await Wednesday's release of the Greek budget plan and austerity measures. There is speculation that a credible austerity plan from Greece would increase the likelihood of EU aid to Greece. This could temporarily reduce investor concern about sovereign debt risks in Europe but focus may soon shift to fiscal risks in Spain. Last Friday S&P warned that weak growth and rising unemployment in Spain will limit the government's plan to curb its budget deficit. S&P said it will keep its negative outlook for Spain's credit rating. S&P's current credit rating for Spain is AA+. According to S&P, Spain's government deficit will likely remain above 5% and the debt burden may hit 80% of GDP by 2012. S&P said that it may be difficult for Spain to boost its domestic economy without increasing government spending. Spain could try and boost growth by shifting focus to exports. According to S&P the rigid labor market in Spain makes shifting to export led growth difficult. In addition, S&P warned that the recent significant decline in asset prices particularly in the Spanish housing market increases the risk to the Spanish banking sector. Rising unemployment, weak housing market and strains on the Spanish banking sector point to weak growth outlook for Spain. S&P expects Spain's economy to grow by 0.6% a year between 2010 and 2013. The weak outlook for Spanish growth will make it difficult for the Spanish government to curb its budget deficit.

Spain's economy is the fifth largest economy in the EU. Spain's economy has been weakening with GDP contracting for the last four quarters. The unemployment rate has risen to 19%. The Spanish government increased deficit spending to try and boost Spain's economy. Spain's budget debt ratio is 11.4% of GDP. The economic and fiscal troubles facing Spain illustrate how European monetary union makes it difficult for many of the EU countries to tackle economic problems. The EU stability pact requires its members to seek a 3% GDP debt ratio. The stability pact makes it hard for countries like Spain to boost growth by increasing spending because of pressure to reduce government deficits. In addition, by joining EU and adopting the EUR Spain and other EU countries have given up autonomy and cannot devalue their currencies to increase competitiveness. Because Spain is now under the ECB umbrella Spain cannot independently lower interest rates or print money to try and boost growth. Because stability pact restrictions and constraints of the single currency (the EUR) Spain has been forced to increase its deficit spending to boost the economy. Spain will need to sell more bonds to cover its deficit. The recent turmoil in the Greek bond market makes it harder and more costly for the Spanish government to raise capital. The price to ensure against Spanish debt default in the credit default market has risen sharply over the last few months.

Spain's economy is twice the size of Greece. According to S&P, Spain's tax base has been closely tied to the real estate sector with half of total tax revenue coming from real estate. Spain's real estate market has collapsed as byproduct of the global financial crisis. Lower tax revenue and rising unemployment are two of the biggest challenges facing Spain. Spain has a rigid and inflexible labor market because of strong unions. This makes it more difficult for Spain to try to grow its economy and increase revenue to reduce its deficit. One drastic solution Spain may consider to deal with its fiscal deficit and economy is leaving European Union. There has been a great deal of speculation whether Greece would consider leaving EU and if this type of speculation emerges in Spain it could contribute to greater risk of a financial crisis in the peripheral European nations. At this writing it remains uncertain if Greece or Spain will exit the EU. Spain however may be the next EU nation on the default risk radar screen and if Spain is next it would increase fear that the EU debt crisis may spread.



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