Country update **SPAIN**

Summary
Spain is currently in a perfect storm of recession, missed budget deficit targets, fast rising government debt, rising popular opposition to government policies and severe political noise from Catalonia. The government is seriously tackling its financial and economic issues. The ECB has increased the financial backstop of the European Stability Mechanism by its announcement of Outright Monetary Transactions. But although rebalancing of the economy is already visible, stabilizing the economy and the public finances will be an uncertain and drawn out process.

Author: **Tim Legierse**
International Macro Economic Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62677
T.Legierse@rn.rabobank.nl

Spain

National facts	
Type of government	Parliamentary monarchy
Capital	Madrid
Surface area (thousand sq km)	505.37
Population (millions)	47
Main languages	Spanish (74%)
Main religions	Catholic (94%)
Head of State	King Juan Carlos I
Head of Government (prime-minister)	Mariano Rajoy Brey
Monetary unit	EUR

Social and governance indicators	rank / total
Human Development Index (rank)	23 / 187
Ease of Doing Business Index (rank)	44 / 185
Index of Economic Freedom (rank)	36 / 179
Corruption Perceptions Index (rank)	31 / 183
Press Freedom Index (rank)	39 / 178
Gini index (income distribution)	34.7
Population below $1.25 per day (PPP)	n.a.

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	1480	2.14
Nominal GDP at PPP	1496	1.88
Export value of goods and services	452	2.05
IMF quotum (in mln SDR)	4023	1.85
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.4	0.9
Agriculture (% of GDP)	3	3
Industry (% of GDP)	25	28
Services (% of GDP)	72	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	32081	296
Nominal GDP per head at PPP	32430	260
Real GDP per head	25686	314

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
France	18	Germany	12
Germany	10	France	11
Portugal	8	Italy	7
Italy	8	China	6

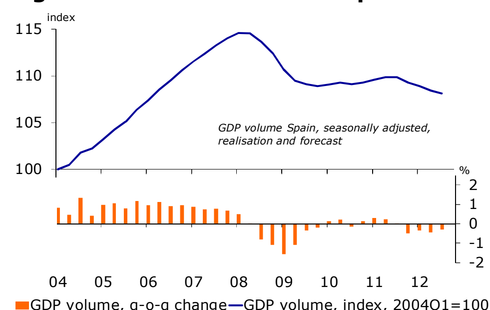
Main export products (%)	
Machinery and transport equipment	34
Food, drinks and tobacco	13
Chemicals and related products, n.e.s.	13
Mineral fuels, lubricants, and related materi	7
Main import products (%)	
Machinery and transport equipment	27
Mineral fuels, lubricants, and related materi	21
Chemicals and related products, n.e.s.	14
Food, drinks and tobacco	9
Openness of the economy 2011	
Export value of G&S (% of GDP)	31
Import value of G&S (% of GDP)	31
Inward FDI (% of GDP)	1.7

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy

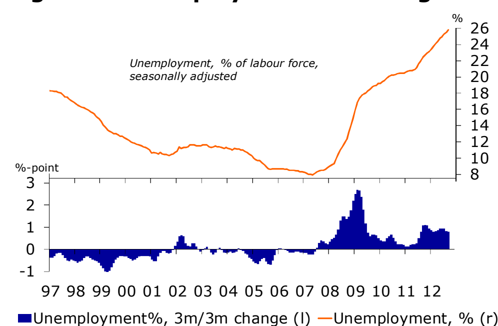
The Spanish economy has been back in recession since the second quarter of 2011 (figure 1). The GDP decline in the third quarter of 2012 was smaller than we had expected. This may well be explained by the rise in the VAT hike of September 1st that probably prompted consumers to frontload purchases of expensive goods. If that is true, the economic decline will accelerate in the fourth quarter. The recession will likely continue well into the first half of 2013, as continued government austerity, private sector deleveraging and high uncertainty put further downward

Figure 1: GDP volume developments



Source: Reuters EcoWin

Figure 2: Unemployment still rising

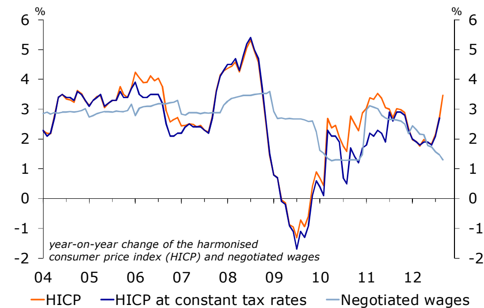


Source: Reuters EcoWin

pressure on domestic demand. The current recession follows a very modest recovery from the 2008/09 downturn and has pushed the level of GDP to new lows relative to the peak of 08Q1. The rise in unemployment, which had continued during the period of recovery, has accelerated since the middle of 2011 to reach 25.8% of the labour force in September 2012 (figure 2).

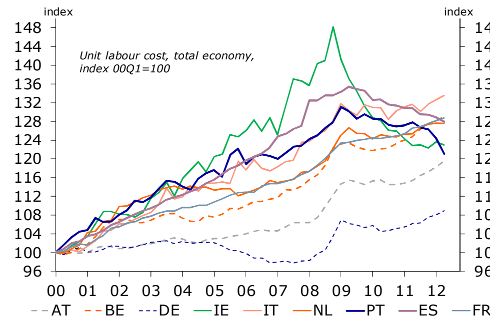
The annual growth rate of negotiated wages has been on a downward trend since early 2011 (figure 3). Of course, given the extremely high unemployment rate, the fact that wages are growing at all is rather surprising. This can be explained by the two-tier labour market, with a large part of the burden of falling employment placed on those with temporary contracts while employees on permanent contracts have been able to negotiate higher wages since they are costly to fire under labour laws. Another feature of the Spanish labour market is that many wage contracts include clauses for automatic adjustment to the rate of inflation. With inflation pushed up by the September VAT hike, it remains to be seen to what extent wage growth will remain subdued over the next couple of months.

Figure 3: Inflation and wage growth



Source: Reuters EcoWin

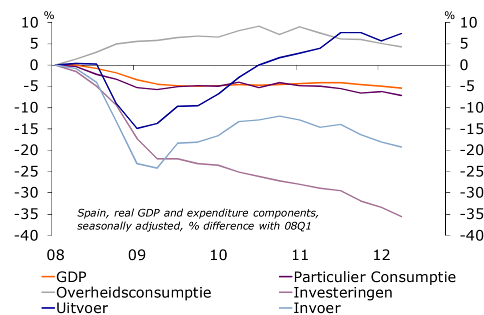
Figure 4: Unit labour cost



Source: Reuters EcoWin

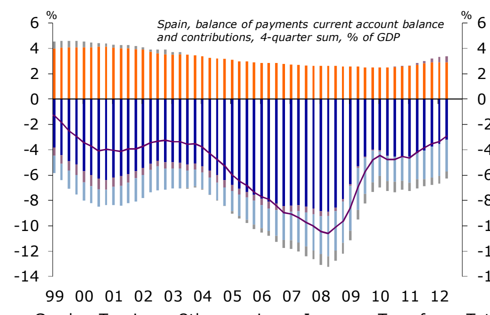
The downward trend in wage growth is a welcome development, since a decline in unit labour costs (figure 4) has up to now been accomplished only by productivity increases based on labour shedding. This decline in unit labour costs is much needed to restore price competitiveness and rebalance the economy towards exports and away from domestic demand. To speed up and sustain the lowering of labour costs, lower wage growth is therefore essential. Net trade has been very important in limiting the GDP contraction. Export volumes were quick to recover from the global recession (figure 5). But an important part of the impressive fall in the external current account deficit (figure 6) has also been due to lower imports that have resulted from a sharp fall in domestic

Figure 5: GDP and components



Source: Reuters EcoWin

Figure 6: Current account deficit



Source: Reuters EcoWin

demand. Lowering the current account deficit is important because it will reduce the reliance of the country on foreign finance. And to repay the net external debt that was built up in the years prior to the crisis, the country would benefit much from a more buoyant export sector.

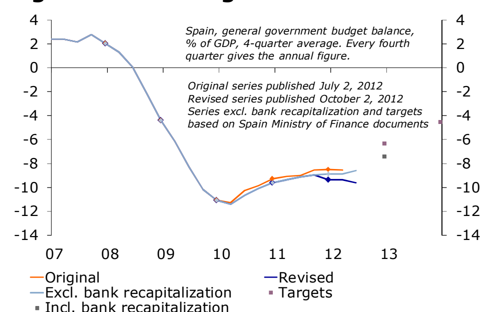
The labour market reforms that have been enacted deal with all of the institutional arrangements mentioned above that make for a very rigid labour market. Product market reforms through the liberalization in certain sectors should boost competition and productivity further. A new set of reforms is to be implemented in the second half of this year. Any beneficial effects of all of these reforms on economic growth will take quite some time to bear fruit, but important steps have been taken to increase the medium term growth prospects for the economy. In its June 2012 Article IV consultation for Spain, the IMF estimates that the labour market reforms could increase GDP by up to 5% by 2017 and reduce unemployment by up to 4%.

Deficit reduction is proving very hard for the government

The governing Partido Popular (PP) boasts an absolute majority in parliament and does not face national elections until 2015. Recent elections in Galicia, the home region of Prime Minister Mariano Rajoy and a traditional stronghold of the PP, enlarged the absolute majority of the party in that region. This has provided the central government, which faces popular opposition to its policies and increased secessionist pressures in Catalonia, with some welcome moral support. Political noise and popular protest is likely to rise over time. But the absolute majority offers very welcome political stability needed to push through with austerity and reform.

In spite of all efforts, the reduction of the government budget deficit is not working out as planned at all. From 2009 to 2010, the deficit was reduced from 11.1% of GDP to 9.6% of GDP. For 2011, the goal was to reduce the deficit to 6% of GDP. A very sizeable budget overrun by the regional governments (autonomous communities) resulted in an actual outturn of 8.9% of GDP, which is a downward revision after an originally reported 8.5% deficit (figure 7). Bank recapitalizations that were initially not booked as expenditure in the budget but as financial investment, have had to be booked as expenditure retroactively due to impairments on those investments. This has further pushed up last year's deficit, making it 9.4% of GDP on the latest available figures (figure 7). Such bank recapitalisations will again push up the government deficit this year and next. Importantly, whichever way you look at it, the deficit has hardly improved in the first quarters of this year. The four quarter average deficit in the year to July shows a 8.6% deficit if we exclude bank recapitali-zations (figure 7). That is still a long way from the 6.3% deficit target for the year as a whole.

Figure 7: The budget deficit muddle



Source: Reuters EcoWin, Minhap, Rabobank

The government still expects the underlying budget deficit to reach 6.3% of GDP this year, which would be in line with the revised targets of the Excessive Deficit Procedure. The administration

maintains that the biggest effect of the budgetary adjustments will only become visible in the budgetary data for the final months of the year. Central budget figures for September show the positive impact on revenue of the VAT hike and also show that central government expenditure is moving in the right direction. A different phasing of transfers from the central government to the regions makes it particularly challenging to come to grips with the monthly budgetary data though.

Regional data for the first half of the year show a sizeable reduction in the regional deficits compared to last year when correcting for these centre-region flows. It remains to be seen if the regions as a group can limit their budget deficit to the planned 1.5% of GDP but a significant reduction in the regional deficit is still on the cards. We note that the tensions between the central government and Catalonia do not increase the likelihood of regional budgetary overruns. An important source of those tensions is the fact that Catalonia is imposing hard austerity to reduce its budget deficit and the fact that the region is a net contributor to the central budget.

In all, we would be pleasantly surprised if the underlying deficit is really reduced to the 6.3% target but expect another budgetary overrun. Next year's target of 4.5% is also challenging, partly because the government has drafted its 2013 budget with rather optimistic assumptions about economic growth and unemployment. In any case, including bank recapitalisations that have to be booked as expenditure, the finance ministry now expects the headline 2012 deficit to reach 7.3% of GDP. Depending on the timing of the recapitalization process and on Eurostat judgments on which part of the recapitalizations should be counted as expenditure and which part can be booked as financial investment, the 2012 deficit or may well turn out much higher than that. Again depending on timing, and given the possibility of additional capital needs, next year's headline deficit might again be higher than the underlying deficit that is planned at 4.5% of GDP. We do note that these higher headline deficits will not pose a problem in the Excessive Deficit Procedure as the European Commission is likely to focus on the underlying deficit when judging if sufficient progress has been made.

Assistance to the regions further blurring visibility

Although the deficits of the autonomous communities seem to be moving in the right direction, the government has set up two financial facilities to assist them.

During the crisis, the regional governments built up a large amount of unpaid bills to suppliers. To lower this backlog of payments, the central government has set up and guaranteed the financing of a EUR 35bn fund that will lend money to the regional and local governments to pay down their bills. Although this does not increase the total liabilities of the general government, unpaid bills are not counted in the most watched Maastricht definition of gross general government debt. As a result, this debt measure will be pushed up by more than 3% of GDP.

With the central government facing sharply higher interest rates and the regional government finances in disarray, the autonomous communities have found it ever harder to obtain financing at sustainable interest rates to cover their deficit and refinance existing debt. To prevent default by regional governments, the government has set up a regional liquidity mechanism, which will be EUR 18bn to end-2012. Given the requests for assistance to date, that amount is almost fully used up by now. This mechanism has no impact on the general government deficit or debt figures. It only shifts part of the (re)financing of the regions to the central government. Having said that, if market access for the regions does not improve next year, more money will have to be made available through this mechanism to further assist the regional governments. That will push up funding needs for the central government.

Together with a series of legislative changes, these two mechanisms ensure more influence of the central government on regional government finances. Financial assistance will be subject to conditions. Next to that, the 'Organic Law for Budget Stability and Financial Sustainability' offers mechanisms for better oversight by the central government on the regions and provides sanction mechanisms in case of deviations. Note that apart from strengthening central oversight on the autonomous communities, this law implements the agreements made in the 'Treaty on Stability, Coordination and Governance in the Economic and Monetary Union', better known as the 'Fiscal Compact', making Spain the first country to do so.

Cleaning up the banks, three years after Ireland

With a top-down and bottom-up assessment of the capital needs of the Spanish banks, EUR 100bn of potential funds available from the European Stability Mechanism to provide this capital and the creation of a bad bank, the government is starting a process that should eventually put a line under the legacy of the real estate boom that went bust.

The bad bank (Sareb, for Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria) will be partly owned by the government through its bank rescue fund FROB and by private investors as majority shareholders. Majority shareholding by private investors will ensure that the debts of the bank will not be counted as government debt. But since the bank will issue government guaranteed bonds to finance the purchase of the toxic assets from the banks, those debts will still be an important contingent liability to the state. In the case of Ireland, both Moody's and Standard and Poor's report gross government debt both with and without NAMA (the Irish bad bank) debt. We expect them to treat Sareb debt in the same manner. Sareb will buy loans and assets for at least EUR 45bn from the banks that are currently already owned by the Government. This amount will increase when loans and foreclosed assets are transferred from banks that will need to be recapitalized by the state in the future. The amount that Sareb can spend has been capped at EUR 90bn. Discounts relative to the nominal value of the loans and assets will be applied. As a result, the paper losses for the banks transferring the loans will be immediately converted into actual losses, which will reduce uncertainty about the valuation of the assets on their balance sheets. The goal is to clean the balance sheets of the banks so they can regain investor confidence and will be able to provide credit to the private sector. The bad bank will have a 15 year time horizon in which it will try to obtain as much value as possible out of the loans and real estate assets that it buys. The upside of this strategy is that fire sales of assets by banks simultaneously trying to clean up their balance sheets can be prevented. But in contrast to Ireland, where assets were transferred from virtually all of the banks, in Spain the banks that do not need government capital will not be able to transfer their loans to the bad bank. This is unfortunate for two reasons. First, the actualisation of losses will not occur and although the banks should have enough capital to cope with further losses, uncertainty about the value of the assets of these banks will persist. Second, these banks may feel the need to sell assets quickly. This could undermine the stabilizing impact that Sareb would like to offer to the property market.

Bank's capital needs have been calculated such that they will still be left with a 6% core tier 1 ratio in 2014 in case of an adverse economic scenario. One can always argue about the assumptions of both the adverse economic scenario, the assumptions about bank pre-provisioning profits in that scenario and the question if being left with 6% in core tier 1 capital is a high enough threshold. But the capital assessment offers a very thorough analysis of the situation at the banks and a reasonable starting point for assessing bank capital needs. Seven banking groups, among which the three

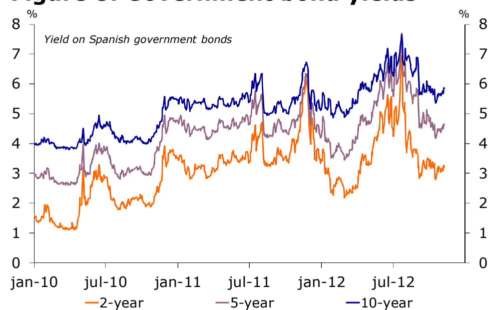
largest banking groups in Spain, have been found not to need any additional capital. Total capital needs for the other seven are calculated to be almost EUR 60bn. The government expects to provide about EUR 40bn of this capital. The remainder will either be supplied by private investors through fresh issuance of capital or by burden sharing with holders of subordinated bonds or other subordinated instruments. Given the uncertain economic outlook and the large number of assumptions necessary to calculate the capital needs, we would not be surprised if in time more capital from the government is needed to stabilize the system. But from the current starting point, there will be quite some room left in the EUR 100bn program to cope with additional losses. Given that the government is borrowing this money from the ESM, gross government debt will potentially rise by a further 9.3% due to the recapitalization of the banking sector.

In all, we regard the chosen process of restructuring of the banking sector as a crucial step towards reducing an important uncertainty regarding the government finances. Eventually, it is also a crucial process to enable the banks to support the economic recovery when it comes. But we note that this will be a drawn out process. Ireland set up its bad bank in November 2009 and transferred the bad assets in 2010. But although the situation has stabilised, both the economy and the banking system are by no means out of the woods yet.

Markets and assistance

Missed budget targets, increased bank capital needs and the return of recession pushed up government bond yields quickly since March. Before that, the provision of three year Longer Term Refinancing Operations by the European Central Bank (ECB) had brought some calm to the markets. In a new attempt to ease market pressures, the ECB announced that it would purchase government bonds with a maturity of up to three years from countries that receive financial assistance from the European Stability Mechanism (ESM) and abide by the conditions for such assistance. This has had a very positive impact on Spanish government bond yields, most notably on the short end of the yield curve (figure 8).

Figure 8: Government bond yields



Source: Reuters EcoWin

Although we have argued that this decline in bond yields has been based on the expectation of Spain actually applying for a rescue package from the ESM, bond yields have remained relatively contained despite such a request not becoming reality yet. Even so, given the many uncertainties and the many opportunities for bad news from Spain, most notably regarding missed fiscal targets and further rising unemployment, we do expect that interest rates will rise again to such an extent that Spain will ask or financial assistance. This will most likely be in the form of a precautionary program, in which any drawdowns of the funds provided can also be used in the form of supporting primary bond issuance. In that case, the ESM will buy bonds to a maximum of half the amount

issued at any given auction. This would keep Spain in the markets, which means that the funds provided will be supplemented by private investors. On top of that, ECB Outright Monetary Transactions (OMT) will serve to contain short term yields. The upside of such a strategy will be that less money will be needed compared with a full macro-economic adjustment program and that the conditionality can probably be restricted to measures that have already been taken by Spain over the last couple of months. As such, Spain will partly save face by being able to distinguish itself from full-program countries such as Ireland and Portugal and the ESM will be left with more money to support other countries, most notably Italy. On the other hand, if market pressure returns with a vengeance and government bond yields do rise further in spite of the credit line being in place, the ESM program and the short-end buying of OMT might not be sufficient to contain the longer end of the yield curve. Such market pressure could result from doubts about the continuation of the ESM program or ECB OMT when Spain is seen to deviate from agreements. In that case, Spain may be forced to draw down the credit line as full loans from the ESM instead of as primary market assistance. This will then accelerate the pace with which the credit line is used and may well force Spain to ask for a full bailout after all.

In all then, while the prospect of an ESM credit line combined with ECB OMT offers a significant financial backstop to Spain, the uncertainty about the economic and financial development in the country are such that this may eventually still prove not to be enough to prevent a more broad based bailout. We do expect such a full bailout, if requested, to be forthcoming. In contrast to a precautionary credit line, such a program would probably also include funds from the IMF. Given the still relatively contained government debt load, which even including the costs of bank recapitalization will probably peak close to 100% of GDP, we do not expect such a full program to involve a restructuring of government debt.

Conclusion

The Spanish economy will remain in recession for a number of quarters to come. The government will have a hard time to reduce the underlying budget deficit in line with its targets. The headline deficit will be increased due to bank recapitalizations. These bank recapitalizations together with restructuring and the bad bank are important steps in cleaning up the banking system. But this will prove to be an uncertain and drawn out process. As such, there are many domestic risks that can lead to renewed unrest and upward pressure on government bond yields. The potential financial backstop from the ESM has been strengthened by the possibility of ECB's OMT's and we continue to believe that any financial assistance is unlikely to involve restructuring of government debt.

Spain

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	3.5	0.9	-3.7	-0.3	0.4	-1.6	-1.7
Consumer prices (average % change pa)	2.8	4.1	-0.2	2.0	3.1	2.5	2.9
Current account balance (% of GDP)	-10.0	-9.7	-4.8	-4.5	-3.5	-1.0	-0.3
Economic growth							
GDP (% real change pa)	3.5	0.9	-3.7	-0.3	0.4	-1.6	-1.7
Gross fixed investment (% real change pa)	4.5	-4.7	-18.0	-6.2	-5.3	-10.1	-6.7
Private consumption (real % change pa)	3.5	-0.6	-3.8	0.7	-1.0	-2.4	-3.2
Government consumption (% real change pa)	5.6	5.9	3.8	1.5	-0.5	-2.3	-2.1
Exports of G&S (% real change pa)	6.7	-1.0	-10.0	11.3	7.6	3.1	2.5
Imports of G&S (% real change pa)	8.0	-5.2	-17.2	9.2	-0.9	-5.0	-3.6
Economic policy							
Budget balance (% of GDP)	1.9	-4.5	-11.2	-9.7	-9.4	-8.3	-7.3
Public debt (% of GDP)	36	40	54	61	69	83	91
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	0.6	0.2
M2 growth (% change pa)	19	13	3	1	-4	-8	3
Consumer prices (average % change pa)	2.8	4.1	-0.2	2.0	3.1	2.5	2.9
Exchange rate LCU to USD (average)	0.7	0.7	0.7	0.8	0.7	0.8	0.8
Recorded unemployment (%)	8.3	11.4	18.0	20.1	21.7	23.7	24.2
Balance of payments (m USD)							
Current account balance	-144540	-154530	-69775	-63130	-52281	-14200	-4500
Trade balance	-125239	-126612	-58171	-63276	-55247	-20300	-12200
Export value of goods	264054	284722	228823	256806	309616	310500	318100
Import value of goods	389290	411330	287000	320080	364860	330700	330300
Services balance	31656	38220	35031	36119	47599	54400	56800
Income balance	-41372	-52086	-35684	-26209	-36349	-40700	-41500
Transfer balance	-9586	-14049	-10947	-9764	-8282	-7700	-7600
Net direct investment flows	-72863	3926	-2380	3673	-9279	-38630	17540
External position (m USD)							
International investment position	-1211280	-1201130	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	1973210	1891400	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	3184490	3092530	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-8.7	-7.9	-4.0	-4.5	-3.7	-1.5	-0.9
Current account balance (% of GDP)	-10.0	-9.7	-4.8	-4.5	-3.5	-1.0	-0.3
Inward FDI (% of GDP)	4.6	4.9	0.7	3.0	1.7	0.7	4.5
International investment position (% of GDP)	-83.9	-75.1	n.a.	n.a.	n.a.	n.a.	n.a.

Source: EIU, IMF via Reuters EcoWin; the Economist Intelligence Unit estimates and forecasts for 2012 and 2013 do not necessarily represent Rabobank views and hence may deviate from the text

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