Economic update Spain

11 January 2011

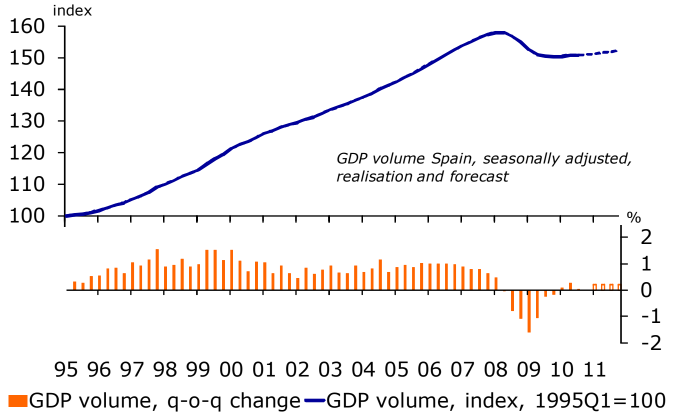
Stagnation and adjustment

Year-on-year change (%)	'09	'10	'11
Gross Domestic Product	-3.6	-¼	½
Private consumption	-4.9	¾	-¼
Government consumption	3.8	1½	0
Investment	-15.3	-7¾	-3¼
Exports	-11.5	7½	5¾
Imports	-17.9	4	1
Inflation	-0.2	1¾	1
Unemployment (%)	18.0	20¼	21
Government budget (% GDP)	-11.2	-9½	-7
Government debt (% GDP)	53.2	65	74

Source: Reuters EcoWin, Rabobank

During 2010 the Spanish economy hardly grew. We expect a further sluggish recovery for 2011. The adjustment from growth based on domestic demand towards a more export-driven growth will be a long process. Until now, price competitiveness relative to the eurozone has been regained to a limited extent. This is in large part due to relatively high wage growth. For the economic adjustment to continue, it is important that wages do not react to the recent rise in the inflation rate even if the consequence is lower real disposable income, which in turn lowers consumer spending. Unless the saving rate continues to fall, at the expense of much needed household deleveraging.

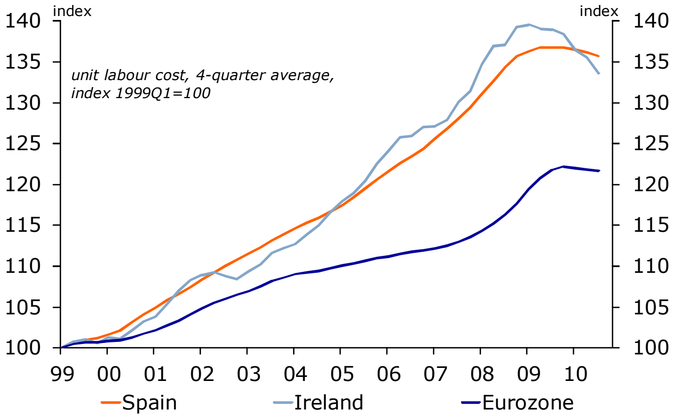
Very modest recovery from recession



Source: Reuters EcoWin

Last year, the Spanish economy was no longer in recession. But the recovery was rather unimpressive. GDP was no more than 0.5% higher than a year earlier in the last quarter of 2010. Unemployment continued to rise and only stabilised in the last months of the year, at 20.6%. Due to the slow recovery, GDP was still down 4½% relative to its pre-recession peak at the end of 2010. For this year, we expect the slow recovery to continue. The expected average 0.2% q-o-q GDP growth in the coming quarters stands in marked contrast to the average 0.9% q-o-q growth obtained in 1999-2007. As a result, the unemployment rate will remain close to the current level throughout 2011.

Regaining price competitiveness a slow process



Source: Reuters EcoWin

An important factor behind the slow economic recovery is the continuing adjustment process in the structure of the economy. With the collapse of the overheated real estate sector, residential investment dropped markedly. In 2011, this will continue to act as a drag on economic growth. Filling the gap left by the construction sector will take time. Given the sizeable trade deficit, boosting exports would be a nice solution. But the fall in unit labour cost has been only slightly larger than the eurozone average until now. As such, regaining price competitiveness is going to take a long time. In that area, the Irish – who are also coping with the consequences of an overheated housing market gone bad – have been much more successful.

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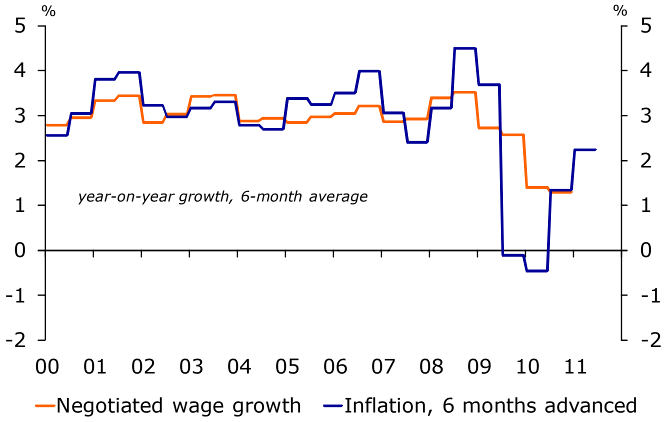
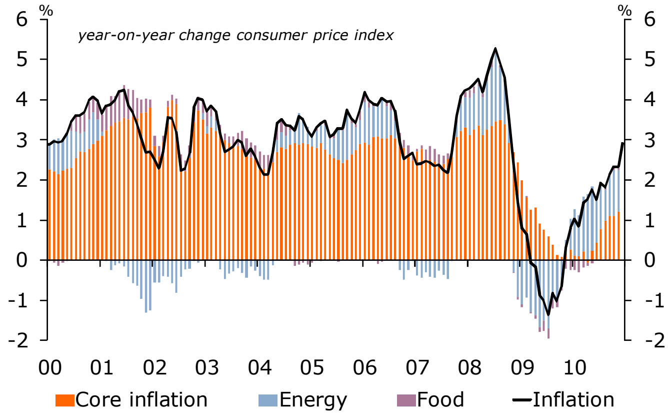
Inflation challenges wages...



Source: Reuters EcoWin

The relatively slow reaction of unit labour costs to the steep rise in unemployment is due to the rigidity of the Spanish labour market. Workers with temporary contracts have suffered the most. This is because those with permanent contracts enjoy a high degree of protection, allowing them to demand high wages in spite of the elevated unemployment rate. During 2010, inflation rose sharply, to 2.9% y-o-y in December. Wage growth had fallen to 1.3% y-o-y in the second half of last year. Given the high unemployment rate and the need for increased competitiveness, it would be an unwelcome development for wages to respond to the higher inflation rate.

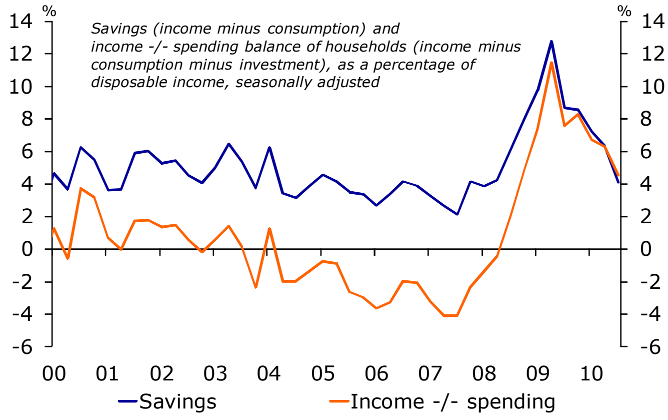
... but will come back down during 2011



Source: Reuters EcoWin

The rapid increase in inflation, from 2.3% in November to 2.9% in December, is related to higher energy prices and a hike in the tax on tobacco. Half way through 2010, inflation was already pushed up by a VAT hike. In July 2011, this effect will disappear from the year-on-year comparison of the price level, which will push inflation down. Higher energy prices have been the result of the rise in oil prices. But if the oil price remains around its current euro level, the year-on-year increase will slow down, leading to a lower energy contribution to inflation towards the summer of 2011. So overall, inflation should come back down in due time.

Choosing between spending or paying down debt



Source: Reuters EcoWin, Rabobank

Although wages lagging inflation is necessary for the improvement of Spanish price competitiveness, it will lead to lower purchasing power. During the recession, consumption at first fell because of a higher saving rate, with disposable income still rising or stagnant. Renewed growth of consumer spending was only made possible when consumers started to reduce their savings. Higher taxes, lower benefits and modest growth of both employment and wages will result in a decline in real disposable income this year. As such, only a further drop in the saving rate will prevent private consumption from falling. But if that were to happen, the necessary deleveraging of households will be hampered. Clearly, you cannot have your cake and eat it.

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