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Country report **SPAIN**

Summary

The Spanish economy is back in recession and government austerity measures will ensure that the economic contraction continues throughout the year. The government budget deficit in 2011 came in at 8.5% of GDP, much higher than the goal of 6%. The government is unlikely to meet the 5.3% of GDP deficit target this year or the 3% target for 2013. There is a clear risk that more austerity will further deepen the recession if they do maintain these targets. Importantly, the budget overruns were mainly caused by the regional governments, over which the central government has only limited control. Although forced higher provisioning by the banks reduces uncertainty about future loan losses related to real estate, the final tally to the government of supporting the financial sector remains unclear and may well rise further.

Things to watch:

- Government deficit reduction and recession
- Banking sector recapitalization needs
- Financial market pressure and European support

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Spain

National facts	
Type of government	Parliamentary monarchy
Capital	Madrid
Surface area (thousand sq km)	505.37
Population (millions)	45.9
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

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	1494	2.17
Nominal GDP at PPP	1503	1.90
Export value of goods and services	446	2.03
IMF quotum (in mln SDR)	4023	1.85
Economic structure	*2011*	*5-year av.*
Real GDP growth	0.7	0.9
Agriculture (% of GDP)	3	3
Industry (% of GDP)	26	28
Services (% of GDP)	71	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	32382	301
Nominal GDP per head at PPP	32582	264
Real GDP per head	25727	317

Social and governance indicators	rank / total
Human Development Index (rank)	23 / 187
Ease of Doing Business Index (rank)	44 / 183
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.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
France	19	Germany	13
Germany	11	France	12
Portugal	9	Italy	8
Italy	9	China	7
Main export products (%)			
Machinery and transport equipment			33
Food, drinks and tobacco			14
Chemicals and related products, n.e.s.			13
Mineral fuels, lubricants, and related materi:			6
Main import products (%)			
Machinery and transport equipment			28
Mineral fuels, lubricants, and related materi:			18
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)			30
Import value of G&S (% of GDP)			31
Inward FDI (% of GDP)			1.3

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

Back in recession

In the last quarter of 2011, the modest 7 quarters of recovery from a deep 7 quarter recession came to an end. Real GDP contracted 0.3% q-o-q, pushing back the level of economic activity to 3.9% below the pre-recession level of the first quarter in 2008. The Bank of Spain estimates a 0.4% q-o-q contraction in the first quarter of 2012. We expect this new recession to continue throughout the yeat. GDP is widely expected to contract on an annual basis by between 1% and 2% this year and between ¼%- ¾% next year. With the economy in recession, the unemployment rate will most likely increase further from its already high level. After having almost come to a halt in the second half of 2010, the rise in the unemployment rate re-accelerated during 2011. This process has continued in the first two months of 2012, with the unemployment rate reaching 23.6 of the labor force. That compares to 20.6% a year earlier and to a pre-recession low of 7.9% in 2007.

The recession will in large part be driven by government austerity measures. Lower government consumption and investment will have a direct negative effect on domestic demand. Lower transfers and higher taxes will depress household disposable income. Meanwhile, although a fall in the saving rate has supported household consumption spending in the face of falling real disposable income in the past two years, uncertainty about the economic future may well push the household saving rate up and surely limits the potential for a further decline. As a result, private consumption is also set to contract substantially. In this environment, domestically oriented firms will likely cut back on investment spending. The correction in residential investment is still not

complete, despite having fallen over 40% already since 2007. In all then, domestic demand is set to substantially depress economic activity this year and next. Part of the fall in domestic demand will translate into lower imports. But given the lower import intensity of government and household consumption compared to fixed investment, we would expect this mitigating factor to be less strong than in the past two years. The only positive growth driver then will be exports. But with most eurozone economies going through a mild recession and only modest world trade growth, exports are not expected to substantially support economic activity before the second half of this year. Once exports pick up though, this will also support investment spending of exporting firms and eventually also employment. The negative effect of falling residential investment meanwhile should become smaller in the course of 2012, simply because building will have fallen to such a low level by then. A gradual stabilization of part of the economy may well bring the household saving rate back down and support private consumption spending. The economic outlook is extremely uncertain due to the possibility of further financial market pressure, which is already pushing up economy wide interest rates. Banks will have trouble supporting a meaningful economic recovery even if the crisis does not run out of control further. Risks to the fiscal outlook mean that further pressure is very likely. And with the Spanish government still striving to reduce the government budget deficit to below 3% in 2013 instead of developing a credible medium term budgetary strategy, there is also the risk of a vicious cycle between austerity and recession.

Public cost of banking sector losses remain uncertain

The new government that was formed after the November 2011 elections announced a further restructuring of the banking sector, by ordering banks to take a further € 50 bn of provisions by the end of 2012 to cover potential losses on real estate loans. This will likely set off another round of bank mergers, since merged banks will have additional time to build the provisions and have access to financial support by the government. The increased provisions will strengthen bank balance sheets and reduce uncertainty about losses on real estate loans. But with the drop in house prices accelerating over the past year and likely to continue this year, while demand for new housing remains subdued, uncertainty about the actual final losses on the portfolio of real estate loans will still remain. On top of that, the renewed recession and the further rise in the unemployment rate will likely push up the amount of non-performing residential mortgages, leading to additional losses. And while the strategy to minimize the use of public funds by trying to have stronger banks absorb weaker ones seems attractive, the general weakness of the banking sector leads us to believe that the costs to the government of supporting the banking sector will have to rise further before confidence in the banking sector can return. In principle, this is not an insurmountable hurdle for Spanish government finances. Going by a March 2010 Moody's stress test, in the worst case scenario the additional capital need of the banking sector would be 12% of GDP. It is unlikely that the entire amount would be sourced from the government through the Fund for Orderly Bank Restructuring (FROB). But even if this would be the case, it would push up the gross public debt to around 90% of GDP in this year, on par with the public debt level for the eurozone as a whole and close to the levels forecast for the UK and France. To us, then, even though it will take a couple of years still to stabilize the debt ratio, it seems rather unlikely that Spanish government debt will be pushed up to the levels seen in the other Southern European countries.

Regional government finances remain Achilles Heel

With the budget deficit for 2011 turning out to be 8.5% of GDP versus 6% planned and the weak economic outlook for this year and next, stabilization of the government debt ratio is likely to be some way off. We expect the government will not be able to achieve either the 5.3% of GDP target

for this year or the 3% deficit target for 2013. Despite taking immediate compensating measures in December 2011 when the budget overshoot became apparent, the recently elected government will probably not succeed in implementing all the planned budget cuts. Revenue may well fall short of expectations due to recessionary conditions. And even if implementation of the measures is successful there is a high probability that this will undermine GDP growth to such an extent that the deficit targets will still not be met. To us, the required adjustment is simply too big for the given time frame. The austerity measures announced in the 2012 budget were almost exclusively focused on the central government budget. The main wildcard though remains the regional government finances, which have been responsible for the majority of last year's budget overshoot. If the regions are unable to reduce their deficits, this will undermine the entire effort of the 2012 budget anyways. There are some reasons to be a little bit more optimistic about fiscal discipline in the regions than before. First, most regions held elections in May 2011. As a result, fiscal discipline prior to the elections was low since pushing through budget cuts does not sit well with any electorate. Subsequently, a change in power from the socialist PSOE to the conservative PP resulted in revisions to existing public finance figures in some regions. This has probably contributed to the disappointing budget outcome in a number of regions. Serious budget cuts have been implemented only in the second half of the year. That was already too late to alter the budget overruns for 2011, but should lead to positive results this year. The central government has set up new rules for regional government finances, funnily enough akin to European budgetary rules, that increase oversight and the possibility of intervention. But we doubt that these rules will guarantee budgetary discipline of the autonomous regions. More important in this respect is the fact that in most regions the Partido Popular, which is the governing party at the central level with an absolute majority in parliament, is in the government. This party alignment between central and regional governments is an important mechanism to ensure that central and regional governments come together in a joint effort to reduce the country's public budget deficit. Also important is the fact that for most regions as well as for the central government elections are a long way off. This makes it easier to push through hard budgetary choices. Even so, although the 2011 budget overshoot for the regions had some particular reasons to it and party alignment between central and regional government offers some hope, the proof of the pudding will be in the eating. The risk of further regional overshoots is very real, which will only add to possible disappointments in the central government budget.

A tough year for Spain and Europe

Given that we do not expect Spain to be able to make the 2013 deadline for reducing the budget deficit to below 3% of GDP, rising tensions between Spain and the European Commission or between the European Commission and more fiscally prudent member states are likely. Spain will be seen as a test case for the strengthened budgetary rules that have been agreed upon. Specifically, the European Commission now has the authority to impose a fine on Spain if it deems that the country is not sufficiently reducing its deficit. Given the dire economic situation and the fact that the current problems are still largely the result of an extraordinary recession and very sizeable economic rebalancing effort following the collapse of the property boom, there seems to be enough flexibility in the new rules and regulations for the European Commission to allow for a longer adjustment period for the budget. But since this may well be perceived as immediate proof of the lack of clout of the rules that are supposed to strengthen budgetary discipline, it could lead to a lot of political noise. Also, it may well provide a narrative for the financial markets that European efforts are already being undermined. As such, it is very likely that Spain will face further market pressures over and above what we have observed in recent weeks. This may be countered by further secondary market purchases by the ECB or the EFSF. More progress on a more

convincing rescue mechanism might also be instrumental in calming markets. But if this fails to keep government bond yields from rising sharply and remaining high for an extended period of time, we cannot exclude the need some other form of official assistance. In any case, apart from the possibility of unsustainably high interest rates, we deem the Spanish government debt as being sustainable. We also assume that a sustainability analysis by the IMF/ECB would point to the conclusion that given a reasonable macro-economic adjustment package Spain should be able to stabilize and lower its public debt ratio. As such, any official financial assistance is unlikely to demand restructuring of privately held government bonds.

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	-0.1	0.7	-1.2	0.3
Consumer prices (average % change pa)	2.8	4.1	-0.2	2.0	3.1	2.1	1.8
Current account balance (% of GDP)	-10.0	-9.7	-5.2	-4.6	-3.3	-3.3	-3.3
Economic growth							
GDP (% real change pa)	3.5	0.9	-3.7	-0.1	0.7	-1.2	0.3
Gross fixed investment (% real change pa)	4.5	-4.7	-16.6	-6.3	-5.1	-1.7	-0.5
Private consumption (real % change pa)	3.5	-0.6	-4.3	0.8	-0.1	-1.0	-0.2
Government consumption (% real change pa)	5.6	5.9	3.7	0.2	-2.2	-2.3	-0.5
Exports of G&S (% real change pa)	6.7	-1.0	-10.4	13.5	9.0	-0.5	3.3
Imports of G&S (% real change pa)	8.0	-5.2	-17.2	8.9	-0.1	-0.9	1.3
Economic policy							
Budget balance (% of GDP)	1.9	-4.5	-11.2	-9.3	-8.2	-6.5	-5.7
Public debt (% of GDP)	36	40	54	61	70	73	76
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	1.0	0.8
M2 growth (% change pa)	19	13	3	1	-2	1	1
Consumer prices (average % change pa)	2.8	4.1	-0.2	2.0	3.1	2.1	1.8
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	21.7	22.0
Balance of payments (mln USD)							
Current account balance	-144540	-154530	-75309	-64343	-48900	-44900	-44500
Trade balance	-125239	-126612	-58956	-62351	-49900	-41200	-38400
Export value of goods	264054	284722	228705	252974	324000	310900	323700
Import value of goods	389290	411330	287660	315320	373900	352100	362200
Services balance	31656	38220	35697	36499	45400	42400	44300
Income balance	-41372	-52086	-41113	-28987	-34500	-36900	-41500
Transfer balance	-9586	-14049	-10937	-9508	-9900	-9100	-8800
Net direct investment flows	-72863	3926	-233	4103	1227	-4320	-3220
External position (mln USD)							
International investment position	-1211280	-1201130	-1411090	-1256900	n.a.	n.a.	n.a.
Total assets	1973210	1891400	1939870	1804770	n.a.	n.a.	n.a.
Total liabilities	3184490	3092530	3350960	3061670	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	-3.3	-3.0	-2.9
Current account balance (% of GDP)	-10.0	-9.7	-5.2	-4.6	-3.3	-3.3	-3.3
Inward FDI (% of GDP)	4.6	4.9	0.6	1.8	1.3	1.4	1.9
International investment position (% of GDP)	-83.9	-75.1	-96.7	-90.1	n.a.	n.a.	n.a.

Source: EIU

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