Rabobank

Country report

SPAIN

Summary

The Spanish economy is still coping with the consequences of the housing market boom and bust. We expect weak economic growth both this year and next, leading only to a very modest decline in the unemployment rate. An important risk for the government finances is the uncertainty about the eventual costs of recapitalizing the banking. The budget deficit was successfully reduced in 2010 and the government has embarked on a number of structural reforms to boost potential economic growth and make the government finances more robust in the medium term. Even so, with years of austerity needed to stabilize debt ratio, and the continued threat of a loss of investor confidence due to contagion from Greece and Portugal, the public finances are by no means out of the woods.

Things to watch:

- Government deficit reduction
- Banking sector recapitalization needs / the European summer 2011 stress test results
- Current account reversal, competitiveness
- Social cohesion, political will and capacity

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Kingdom of 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	José Luis Rodriguez Zapatero	
Monetary unit	EUR	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	1410	2.3
Nominal GDP at PPP	1419	1.9
Export value of goods and services	372	2.0
IMF quotum (in mln SDR)	3049	1.4
Economic structure	*2010*	*5-year av.*
Real GDP growth	-0.1	1.7
Agriculture (% of GDP)	3	4
Industry (% of GDP)	26	29
Services (% of GDP)	71	68
Standards of living	*USD*	*% world av.*
Nominal GDP per head	30703	312
Nominal GDP per head at PPP	30902	264
Real GDP per head	25756	322

Social and governance indicators	rank / total
Human Development Index (rank)	20 / 169
Ease of doing business (rank)	49 / 183
Economic freedom index (rank)	31 / 179
Corruption perceptions index (rank)	30 / 178
Press freedom index (rank)	39 / 178
Gini index (income distribution)	34.7

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
France	20	Germany	14
Germany	12	France	13
Portugal	9	Italy	7
Italy	9	China	6

Main export products (%)	
Machinery and transport equipment	34
Food, drinks and tobacco	14
Chemicals and related products, n.e.s.	13
Mineral fuels, lubricants, and related materi	5
Main import products (%)	
Machinery and transport equipment	30
Mineral fuels, lubricants, and related materi	16
Chemicals and related products, n.e.s.	14
Food, drinks and tobacco	10
Openness of the economy	
Export value of G&S (% of GDP)	26
Import value of G&S (% of GDP)	28
Inward FDI (% of GDP)	1.5

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

Economic adjustment

Although average GDP in 2010 was 0.1% lower compared to 2009, the Spanish economy experienced minimal growth on a quarter-on-quarter basis during the year. GDP was still 4.5% lower than the pre-recession level in the fourth quarter of 2010. At an average 20.5% in the six months to February 2011, unemployment remains very high. Given the weak growth prospects for this year and next, unemployment is expected to come down only very gradually. With the housing market still adjusting from its pre-recession boom years (we expect both housing completions and house prices to keep falling during 2011) and the government cutting back on capital spending, the decline of construction investment is set to continue this year. Private consumption rose in the first half of 2010, being boosted by government income support, the car scrappage scheme and higher spending in anticipation of the July VAT hike. But in the second half of the year, consumer spending dropped back sharply and we expect it to remain weak in 2011. Households are trying to reduce debt burdens built up in during the housing market boom; hence the saving rate is expected to remain high. Real personal disposable income is under pressure due to higher taxes and energy prices and lower government transfers and employment. Lower government spending on goods and services will also restrain demand growth directly. As in the past two years, export growth can support the economic recovery. This would further reduce the current account deficit, that was already halved between 2008 and 2010. This could be reinforced if the country will be able to become more competitive by reducing its relative costs. In that respect it is good to see that unit labour costs have come down relative to the euro zone average. On the other hand, wage growth is still very responsive to inflation developments, which is indicative of the very rigid labour market. Government efforts to make the labour market more flexible, notably by lowering dismissal costs and allowing individual firms to opt out of collective bargaining results are therefore good news. A faster than currently expected rise of policy interest rates is a clear risk to the economic outlook, especially since the majority of mortgages has a variable interest rate.

Government faces a tough time

The general government deficit was successfully reduced, from 11.1% of GDP in 2009 to 9.2% in 2010. The central government deficit was better than expected but the deficit reduction of the autonomous regions fell short of the goals that were set. Getting all regions to reduce their deficits will be challenging. We note that government economic growth forecasts for this year and next are rather optimistic both compared to our own expectations and those of institutions such as the European Commission, the IMF and the OECD. This increases the risk of budget targets in general not being met. The government debt level of 64% for 2010 is still low compared to the euro zone average of 84%, and at a projected 73% of GDP in 2012, will still be much lower than the 87.8% that the European Commission expects for the euro zone as a whole. As a result, interest expenses in the total budget are still relatively low when compared to other countries. Of course, rapidly rising interest rates due to economic recovery in other parts of the euro zone or due to investors demanding higher risk premiums can push up these costs quickly. To stabilize and eventually bring down the public debt ratio it is important that the Spanish economy regains economic growth in the years to come. The government commitment and action to reducing structural weaknesses is a positive development in this respect. We already mentioned the labour market reforms, but steps are also taken to liberalise product markets, which should improve competition. For the longer run health of the public finances, a reform of the pension system has been agreed upon.

The biggest risk to the economic recovery and public finances is the health of the banking sector. There is still a lot of uncertainty about the total loan losses related to real estate. The restructuring process at the countries' savings banks is still ongoing, which through mergers will reduce the number of savings banks from 45 to 17. But merging weak banks with other weak banks does not necessarily lead to stronger new banks. The government has introduced new minimum capitalization ratios and banks are now in the process of complying with these rules. Estimates of the capital needs vary, with some analysts coming up with much higher numbers than the Spanish government. Also, the European stress to be conducted in the summer of 2011 might point to additional capital needs. If they are unable to raise enough capital themselves by September 2011, the government will supply the necessary funds. As such, the total cost to the government of recapitalizing and restructuring the banking sector are still unclear. Even so, we do not regard the trajectory for government debt as very dramatic even under relatively pessimistic assumptions. S&P and Moody's see general government debt reaching a maximum level of less than 90% of GDP in their most pessimistic scenarios concerning economic developments and banking sector recapitalization needs. Of course, a severe negative feedback loop between such negative developments and the reaction of financial markets will potentially push up interest rates and can lead to refinancing risk. Increased doubts about European partners to stick with the agreed rescue mechanisms will reinforce uncertainty (the Finnish election results are a case in point). The probable change of power from the current Socialist party to the People's Party at the general election in March next year is not expected to lead to a derailment of current reforms or to lower priority being put to the budgetary objectives. Still, a successful restructuring of the financial sector and years of fiscal adjustment will be challenging for any government. As such, political will and capacity to see through the necessary adjustments will be severely tested in the years to come.

Spain

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	4.0	3.6	0.9	-3.7	-0.1	0.6	0.8
Consumer prices (average % change pa)	3.6	2.8	4.1	-0.2	2.0	2.3	1.8
Current account balance (% of GDP)	-9.0	-10.0	-9.8	-5.5	-4.5	-3.6	-3.4
Economic growth							
GDP (% real change pa)	4.0	3.6	0.9	-3.7	-0.1	0.6	0.8
Gross fixed investment (% real change pa)	7.2	4.5	-4.8	-16.0	-7.6	-1.2	2.6
Private consumption (real % change pa)	3.8	3.7	-0.6	-4.3	1.2	0.7	1.2
Government consumption (% real change pa)	4.6	5.5	5.8	3.2	-0.7	-1.6	-1.3
Exports of G&S (% real change pa)	6.7	6.7	-1.1	-11.6	10.3	4.3	2.8
Imports of G&S (% real change pa)	10.2	8.0	-5.3	-17.8	5.4	1.2	3.1
Economic policy							
Budget balance (% of GDP)	2.0	1.9	-4.2	-11.1	-9.2	-6.7	-5.5
Public debt (% of GDP)	40	36	40	53	60	70	71
Money market interest rate (%)	3.1	4.3	4.6	1.2	0.8	1.3	1.9
M2 growth (% change pa)	25	19	13	3	1	4	6
Consumer prices (average % change pa)	3.6	2.8	4.1	-0.2	2.0	2.3	1.8
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Recorded unemployment (%)	8.5	8.3	11.4	18.1	20.1	19.9	18.7
Balance of payments (mln USD)							
Current account balance	-110875	-144540	-156432	-80376	-63400	-50600	-47300
Trade balance	-104622	-125239	-128285	-62833	-61500	-46900	-42500
Export value of goods	220696	264053	284347	223981	249600	299400	293600
Import value of goods	325320	389290	412630	286810	311100	346200	336100
Services balance	28077	31656	38734	35466	36400	38400	36900
Income balance	-26244	-41372	-52874	-42120	-28500	-32700	-32400
Transfer balance	-8083	-9586	-14008	-10890	-9700	-9400	-9300
Net direct investment flows	-72311	-72863	-100	-1233	8313	5400	2020
Net portfolio investment flows	232427	118172	5088	73055	-106800	-20600	-8300
External position (mln USD)							
Total foreign exchange reserves	10822	11480	12414	18205	n.a.	n.a.	n.a.
International investment position	-853700	-1211280	-1202390	-1386330	n.a.	n.a.	n.a.
Total assets	1633850	1973210	1891500	1961940	n.a.	n.a.	n.a.
Total liabilities	2487550	3184490	3093890	3348270	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-8.5	-8.7	-8.0	-4.3	-4.4	-3.4	-3.1
Current account balance (% of GDP)	-9.0	-10.0	-9.8	-5.5	-4.5	-3.6	-3.4
Inward FDI (% of GDP)	2.5	4.6	4.6	0.4	1.5	1.2	1.2
International investment position (% of GDP)	-69.1	-83.9	-75.1	-94.4	n.a.	n.a.	n.a.

Source: EIU