

Research

The Spanish recession

- The Spanish fiesta is over – Was it too much Sangria? What are the consequences? Following a huge economic boom, the financial crisis is now taking its toll on Spain.
- Investment, especially housing investment, has been a driver of the Spanish economy. The housing market is now in the midst of a severe correction, which is expected to drag the economy down through the construction sector and lower household spending.
- Private domestic demand will be severely constrained as both investment and consumption are at very low levels. Increased public consumption will help to mitigate some of the negative impact of the crisis.
- We expect a global recovery in 2010 will lead to net exports being a key driver in ending the recession in Spain. Spain has a huge trade imbalance of near -10% of GDP; an improvement in this balance is necessary for Spain to recover.
- We expect the Spanish economy to contract 3.8% in 2009, and grow just 0.4% in 2010, compared to an average of 4% over the last 15 years.

Forecasts

| | 2008 | 2009 | 2010 |
|---------------------------------|-------|-------|------|
| GDP total | 1.2 | -3.8 | 0.4 |
| Private Cons. | 0.1 | -4.7 | -1.0 |
| Public Cons. | 5.3 | 3.4 | 2.0 |
| Fixed investment | -3.0 | -12.0 | -2.4 |
| Stocks, change ¹ | 0.0 | -0.2 | 0.1 |
| Exports | 0.7 | -19.0 | 10.8 |
| Imports | -2.5 | -21.0 | 4.1 |
| Inflation | 4.1 | 0.0 | 1.4 |
| Unemployment | 11.3 | 18.9 | 21.1 |
| Public Budget ² | -3.8 | -9.5 | -9.0 |
| Public Debt, Gross ² | 38 | 47 | 56 |
| Current Account ² | -10.0 | -6.0 | -6.0 |

¹: Contribution to growth, ²: Pct. of GDP

Source: Danske Markets

The Spanish story

The Spanish downturn began in the middle of 2007, simultaneously with the financial crisis. Since then unemployment has exploded and economic activity has deteriorated rapidly. We note, though, that the Spanish economic downturn was not caused by the financial crisis, but was magnified and probably emerged faster because of it. The fundamental cause was rather due to years of too high growth and the inevitable slowdown of an overheated Spanish economy, and in particular an overheated Spanish housing market. The domestic housing market actually began cooling before the global crisis emerged.

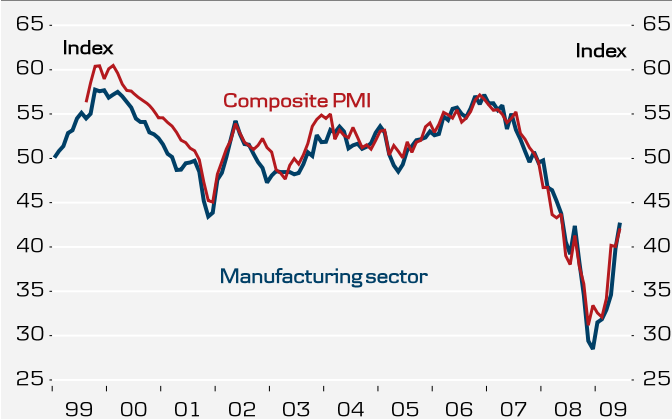
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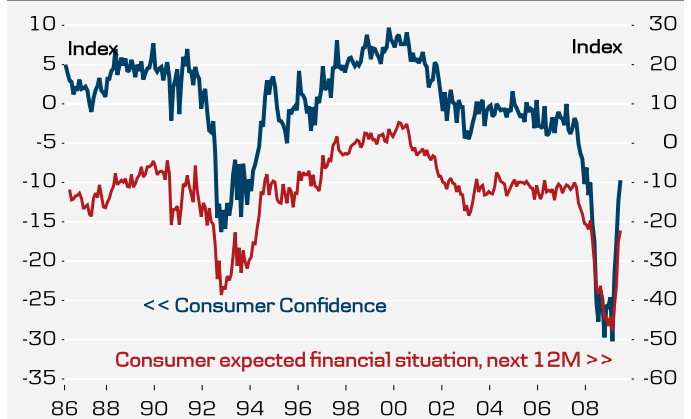
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Business confidence, has hit an all-time low



Source: Ecowin

Consumer confidence, fast rebound



Source: Ecowin

The economic drivers

After Spain entered the ERM (the exchange rate mechanism preceding the euro) a huge drop in domestic interest rates followed. This was driven by convergence toward much lower German interest rates.

This led to unprecedented cheap and easily available credit. The credit boom and the global economic boom led to a huge rise in house prices and a booming economy. In all the years from 1997 the expansion of credit was very high and gaining momentum, as interest rates were low and falling. This trend lessened somewhat during the global slowdown in 2001, but picked up rapidly from 2004 onwards. In the years 2004-07 credit expanded more than 15% y/y.

Lower market rates were further fuelled by the common monetary policy led by the ECB. The Taylor Rule suggests an optimal monetary policy rule to the current economic environment. For Spain we see that the actual rate set by the ECB has been consistently much lower than the rate suggested by Taylor Rule as optimal for Spain. This indicates an overly loose monetary policy for Spain. This is described in *[EUROLAND: FINANCIAL DOWNGRADE AND MONETARY POLICY ASYMMETRIES]*

Domestic demand

Investment

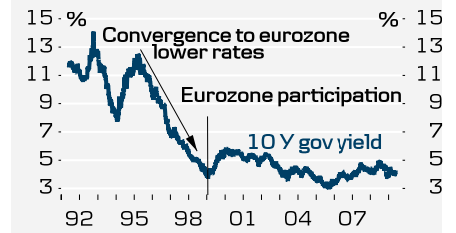
Spanish investments surged from 20% of GDP in 1995 to 30% in 2007. One of the main drivers behind this development was low financial funding costs after joining the eurozone.

Housing boom

Since 1995, Spain has seen an extraordinary property boom. This followed the boom during 1987-92. Thus Spain has had two consecutive powerful booms. These are related to the global property booms, but the Spanish boom was particularly strong. The construction sector has been a huge part of the Spanish economy (measured by contribution to GDP).

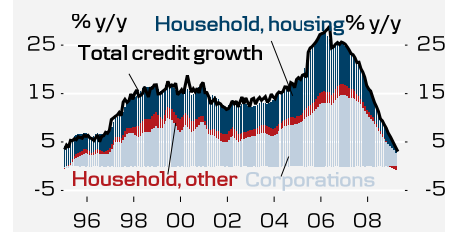
House prices surged from 1995 to 2007, rising more than 250%. One fact that partly explains the massive construction is that the Spanish population expanded by 10% in total

Lower funding costs...



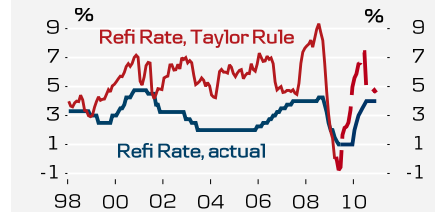
Source: Ecowin

Credit: Boom-bust cycle...



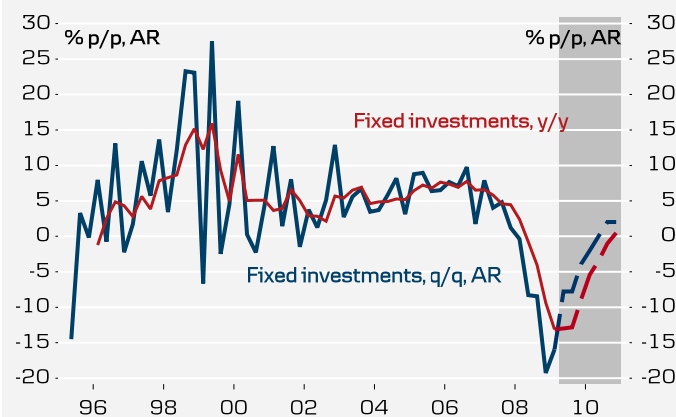
Source: Ecowin

Refi rate - higher than Taylor Rate suggests



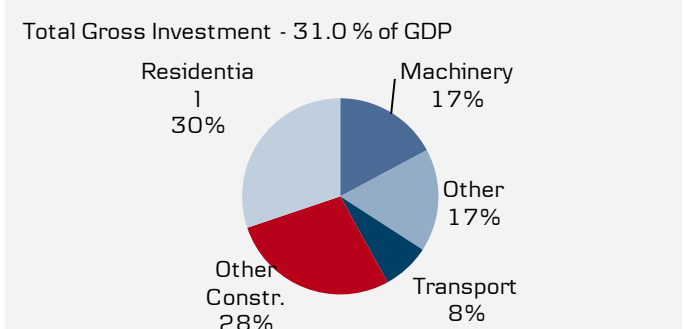
Source: Ecowin

Fixed investments - high growth



Source: Ecowin and Danske Markets forecast

Spanish investments - break down into subcomponents



Source: Ecowin

over the span of 10 years due to massive immigration. The upward trend in the housing market has reversed and house prices have fallen 9% since peaking in summer 2007. We expect house prices to fall further. The amount of credit expansion directed at housing loans indicates that actual mortgages signed are still falling. This suggests that demand for housing credit is shrinking, or that credit is restricted – or both.

An IMF housing market correction scenario for Spain projects a 30% decrease over three to four years. In 2006 nearly 800,000 homes began construction – more than France, Germany, Italy and the UK combined. Thus houses are still being finished, adding to the housing stock. IMF estimates at the moment that the Spanish stock of unsold and empty houses totals one million. At the same time demand for houses is projected to shrink as the pace of growth in immigration and general housing formation by young people is set to decrease, due to a lower birth rate and fewer immigrants. The larger supply of housing and lower demand have resulted in excess supply, which will continue to drive down house prices in the years to come.

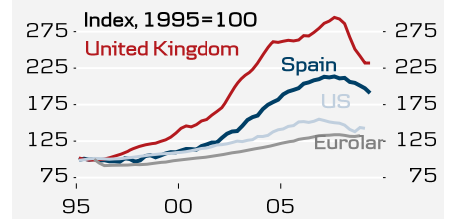
Housing market impact on growth

The sheer impact from the construction sector alone has been massive. Now, in response to housing and property prices crashing, the construction sector is shrinking. This is expected to pull construction investment growth down for years, until construction stabilises at a sustainable level.

The IMF suggests that the long-run sustainable level of housing construction in Spain is 30,000 housing starts a month. In the coming years it estimates it could be as little as 12,000 – that is equivalent to a fifth of the peak level in 2006 and 2007. Let’s assume that new house building accounts for half of housing construction investment – which seems to us a fair assumption. Housing construction totals 9% of GDP and we assume half of that is home building. Thus, a shrinkage to a fifth of home builds translates into housing construction falling from 9% to 5.4% of GDP – a 3.6% points reduction in GDP contribution!

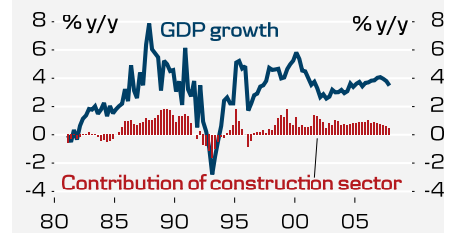
The example outlined above only takes into account the direct impact on the construction sector with a few simple assumptions. It doesn’t take into account the multipliers through unemployment of workers in the construction sector who will consume less of other goods. But this scenario is ultimately contingent on the outcome of the global financial crisis and global confidence.

Real house prices, increased relatively more than the US and eurozone



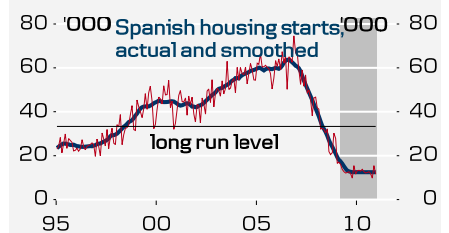
Source: Ecwin

Growth, driven by construction



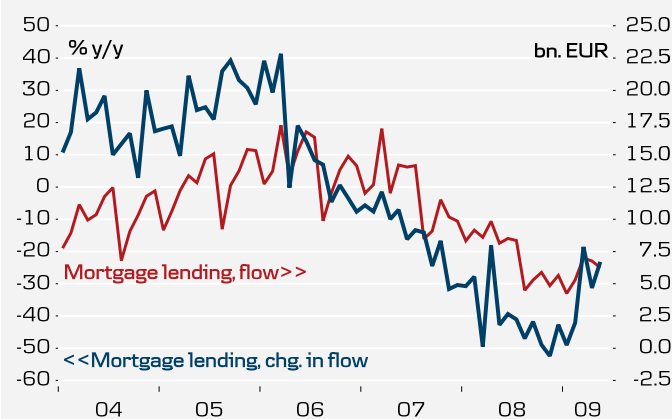
Source: Ecwin

Construction, no return in sight...



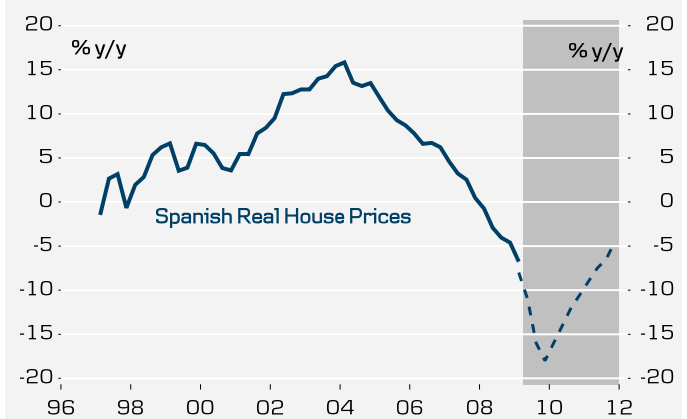
Source: Ecwin and IMF

Mortgage lending, monthly flows



Source: Ecwin and IMF

House prices jump, then crash



Source: Ecwin and IMF

The outlook

We expect house market prices to fall by 30% over three years in line with the IMF projection. Specifically we expect house prices to fall by 13% in 2009 and 13% in 2010 and another 5% in 2011 as the housing supply of 1 million empty houses is cleared. This brings house prices back to the end 2003 level.

As explained, the housing market downturn is expected to drag down investment. We expect that total fixed investments will fall by 12% in 2009 and 2.4% in 2010.

Consumption

Labour market

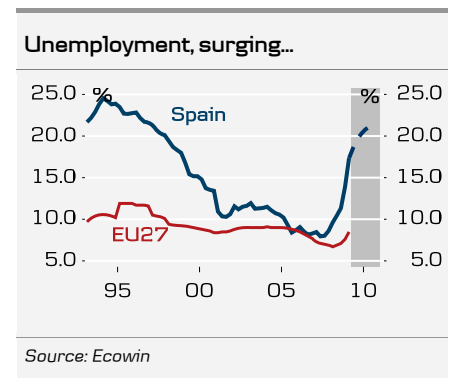
The unemployment rate has risen rapidly in the past year, from 7.9% in mid 2007 to 17.3% now. The speed of this rise is greater than that of other Euroland countries, and Spain now faces the highest unemployment rate of the EU. Fiscal stimulus has been implemented to counter this development, but it has not been sufficient.

This rapid development has been possible due to the labour market duality where some workers have temporary contracts with little or no protection and other workers have permanent contract with hefty protection. The temporary workers amount to a third of the economy. This indicates there is room for further rapid contraction in the labour market because there are still temporarily employed people on the books. Permanent employees can of course be fired as well, but they work in sectors that are less exposed to the crisis. We expect unemployment to average 18.9% in 2009, and 21.1% in 2010.

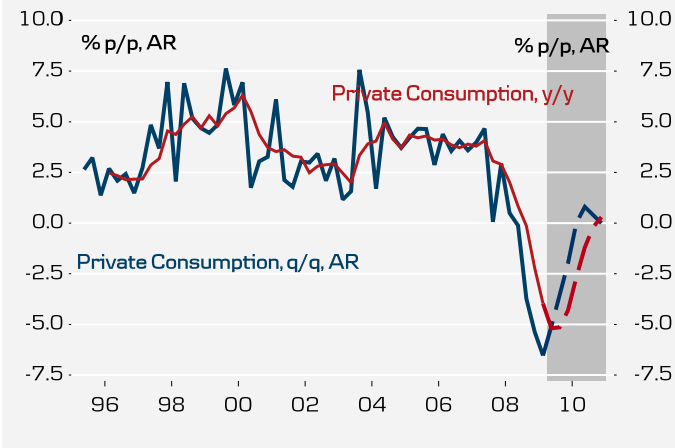
Wage growth

The recent economic growth has not resulted in substantial real income growth. There has been high wage growth in nominal terms, but real wage increases have been almost absent due to inflation. Another factor is the lack of long run fundamentals to support real income growth. As described in the competitiveness section, there have been almost no gains in productivity in recent years.

Inflation is important in the consumption process as it influences real wages. Although inflation was high from 1999 to 2008, it has since reversed. From the consumer perspective this is good as it boosts real income at a time of rising unemployment. That is reflected in our outlook for disposable real income to hit a bottom in the third quarter this year and to start reversing, helped by very low inflation. We expect this to prevent private consumption from reaching even lower levels.

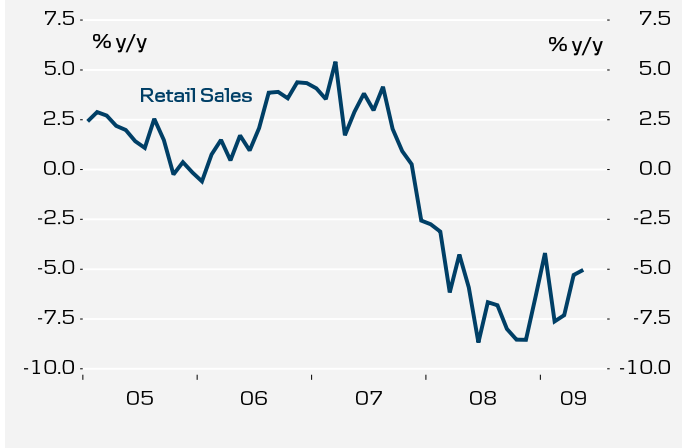


Consumption diminishing



Source: Ecwin and Danske Markets forecast

Retail sales



Source: Ecwin

Interest rates

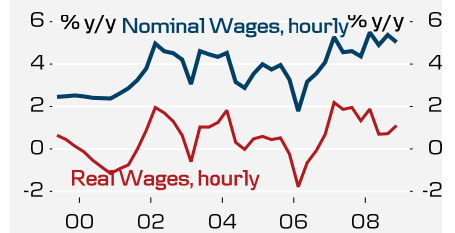
99% of all Spanish mortgages are on contracts with variable interest rates fixed to the 12M Euribor, which means they enjoy the current historical low interest rates. This supports real spending as servicing debt costs are very low at the moment.

The outlook

Overall we believe private consumption is in for a hit. The shock from high unemployment, lack of wages increases, fewer tourists and losses in housing equity could all reduce consumption. The reduction in real consumption is likely to be averted somewhat by low interest rates and low inflation.

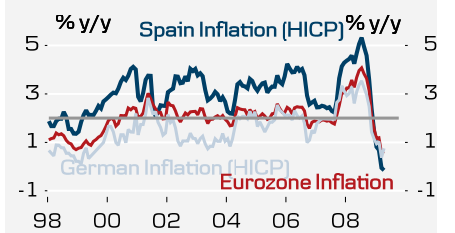
We expect consumption to keep falling on the back of higher unemployment. We expect private consumption to fall by 4.7% in 2009 and 1% in 2010.

Wages, high nominal increases, but low real increases due to inflation



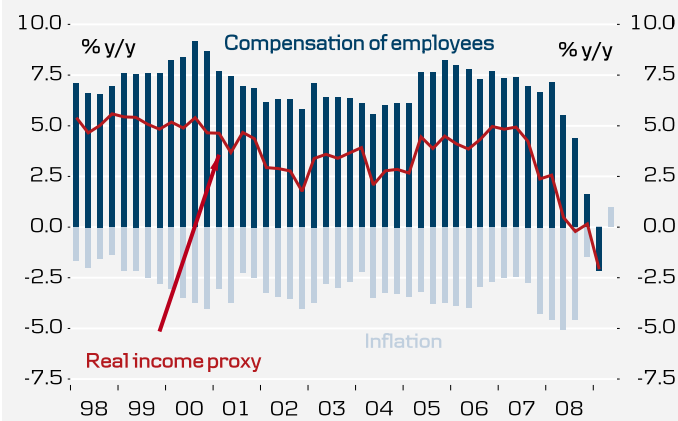
Source: Ecwin

Consistent high inflation



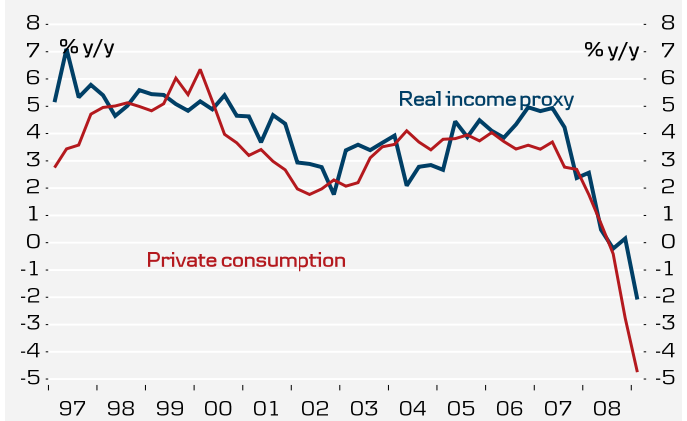
Source: Ecwin

Disposable real income has risen due to higher employment



Source: Ecowin

Which was a driver of private consumption



Source: Ecowin and Danske Markets forecast

External balances

The global and Spanish economic crisis has rapidly narrowed Spain's external trade deficit. The recent drop in exports is reflected in domestic industrial production. One of the main drivers behind this fall in industrial production is the slump in the global car industry due to the financial crisis. As a result, demand for Spanish cars has collapsed.

During the boom, net exports worsened consistently. The OECD country report of October 2008 concludes that although Spanish net exports fell, exports have been performing well in comparison with G7 countries. Only Germany has performed better since 1998. Performance is measured by market share – the ratio of export volumes to export markets for total goods and services. The main problem therefore has been imports, which were ignited by the huge growth in domestic demand.

Sustainability

Looking at the overall external balances it is clear that Spain has a major problem. From 1998 the external balances have been deteriorating consistently – the current account reached -10% of GDP in 2008.

A fall in savings and rise in investments drove the imbalance. The foreign net debt has surged and productivity hasn't increased. This is unsustainable as it will reduce disposable current income due to high interest payments on the foreign debt. At the same time households extended their use of credit for consumption and housing. Sooner or later Spain needs to fix this problem.

We argue that it is sustainable in the short run for Spain to run a large external deficit. We also believe that this crisis provides an opportunity for Spain to reduce the deficit on its external balances as domestic demand declines.

Tourism

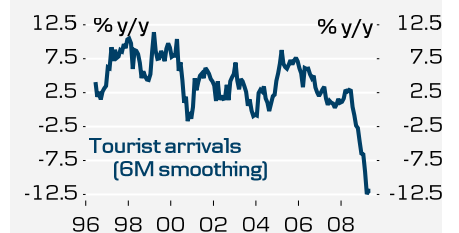
Tourism is another factor that is taking its toll on the Spanish economy. Tourism enters the national accounts through exports. Compared with last year, tourist arrivals over the past six months have fallen by nearly 13%. That points to exports moderating in the coming period as tourism is a EUR 50bn industry accounting for 5% of Spanish GDP.

Foreign net debt



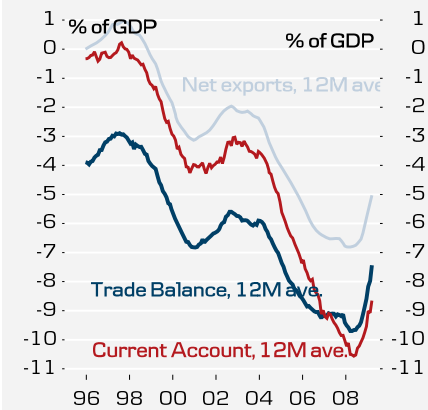
Source: Ecowin

Tourist arrivals



Source: Ecowin

External balances



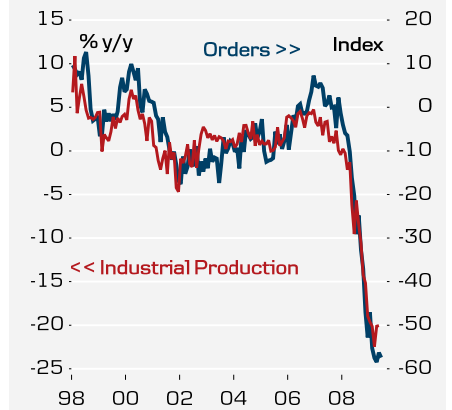
Source: Ecwin

Falling external trade



Source: Ecwin and Danske Markets forecast

Industrial production



Source: Ecwin

Competitiveness

Spanish competitiveness has deteriorated markedly in recent years. This is reflected in the fact that unit labour costs have risen in comparison to other EU countries and the US. This development was caused by wage increases being consistently higher compared with other eurozone countries and lack of productivity gains.

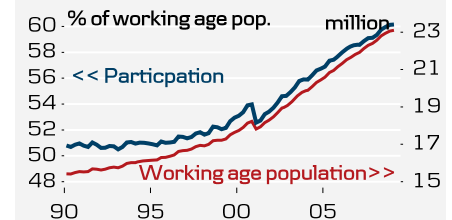
Productivity

The lack of productivity growth during the economic boom can be attributed to three factors: demographic changes, composition of investments and regulation of sectors.

The most important has been the extraordinary increase in the workforce by unskilled labour due to higher participation of lower skilled and higher immigration from countries with lower standards of education.

The recent shedding of labour has happened at great speed. Temporary workers in construction have been hit especially hard in Spain. As these temporary workers often enjoy lower productivity, Spain might be in for quite an increase in productivity across sectors. This, combined with moderated wage claims due to lower labour market pressure, could reduce unit labour costs. This development is already reflected in productivity, which has risen faster during the last two years than in the previous decade.

Work force, growing fast...



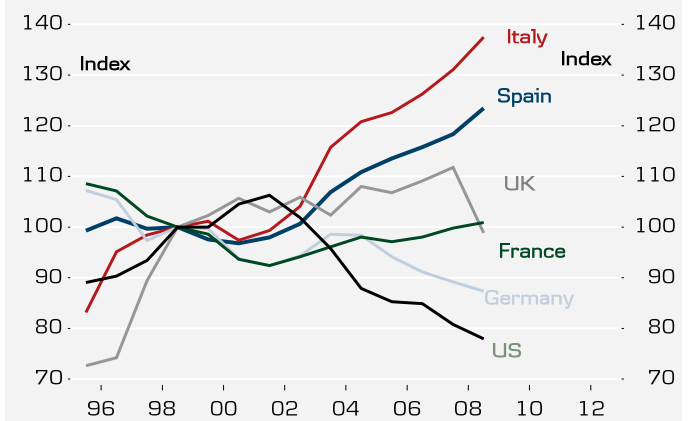
Source: Ecwin

Low real wage growth, no productivity growth



Source: Ecwin

Unit labour costs of manufacturin., relative to competitors



Source: OECD Economic Outlook

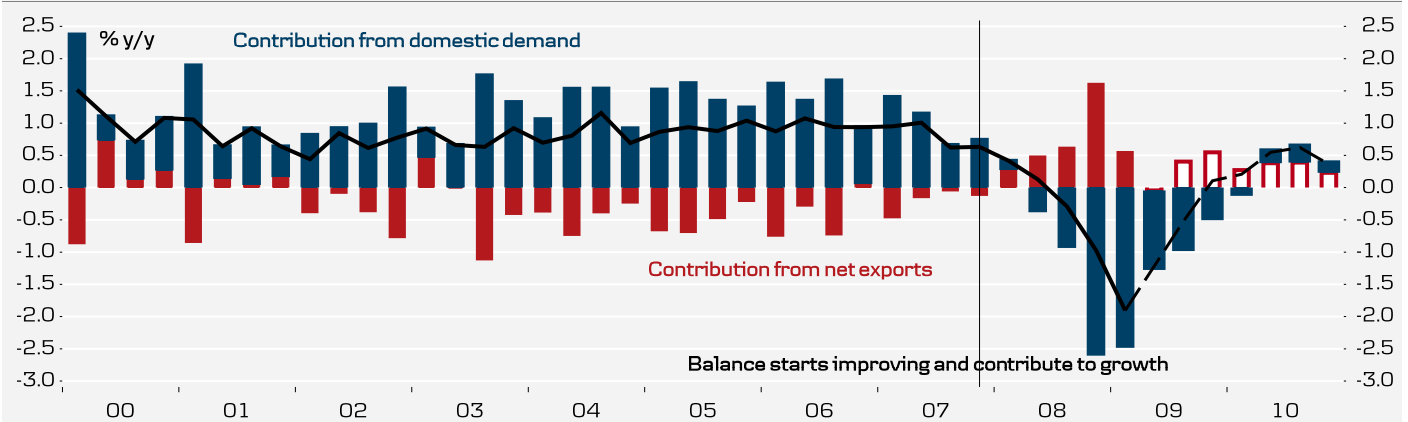
The outlook

We expect the global economy to begin to recover in Q3 2009. This will help Spain's external balances, which are in serious deficit. Currently imports are falling much faster than exports, and this is already reflected in GDP being driven by net exports. These improvements should significantly boost Spain's hopes for a rapid recovery out of the current crisis.

We expect net exports to drive economic growth in the upcoming quarters as Spain partly unwinds its external imbalance. This will be a result of low domestic demand suppressing imports while exports are driven by the global return to growth.

But there are risks to this scenario. If global demand were to stay low, Spain would be unable to unwind its huge external imbalances. Postponement of this unwinding process would further hamper long term growth as high debt service costs would reduce current income in the years to come.

Growth, driven by domestic demand - now reversed forces



Source: Ecwin and Danske Markets forecast

Disclosure

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First date of publication

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