Focus: Spanish Economy at Cyclical Crossroads

While there has been a slight improvement in some coincident indicators, renewed weakness in ECRI's Spanish leading indexes underscores the increasing vulnerability of the Spanish economy.

The Spanish Problem Since the beginning of this year, the unfolding Greek crisis has put the economies of Southern Europe under close investor scrutiny, as fears about the ability of their governments to repay their debts have mounted. Among these, Spain, which is the Eurozone's fourth-largest economy, accounting for almost 12% of the region's GDP, has now become the center of attention.

While the Spanish debt-to-GDP ratio of 53% is below the Eurozone average, its budget deficit-to-GDP ratio now ranks as the third-largest in the Eurozone (after Ireland and Greece). Furthermore, Spain's fiscal health has been increasingly compromised by mounting levels of household debt.

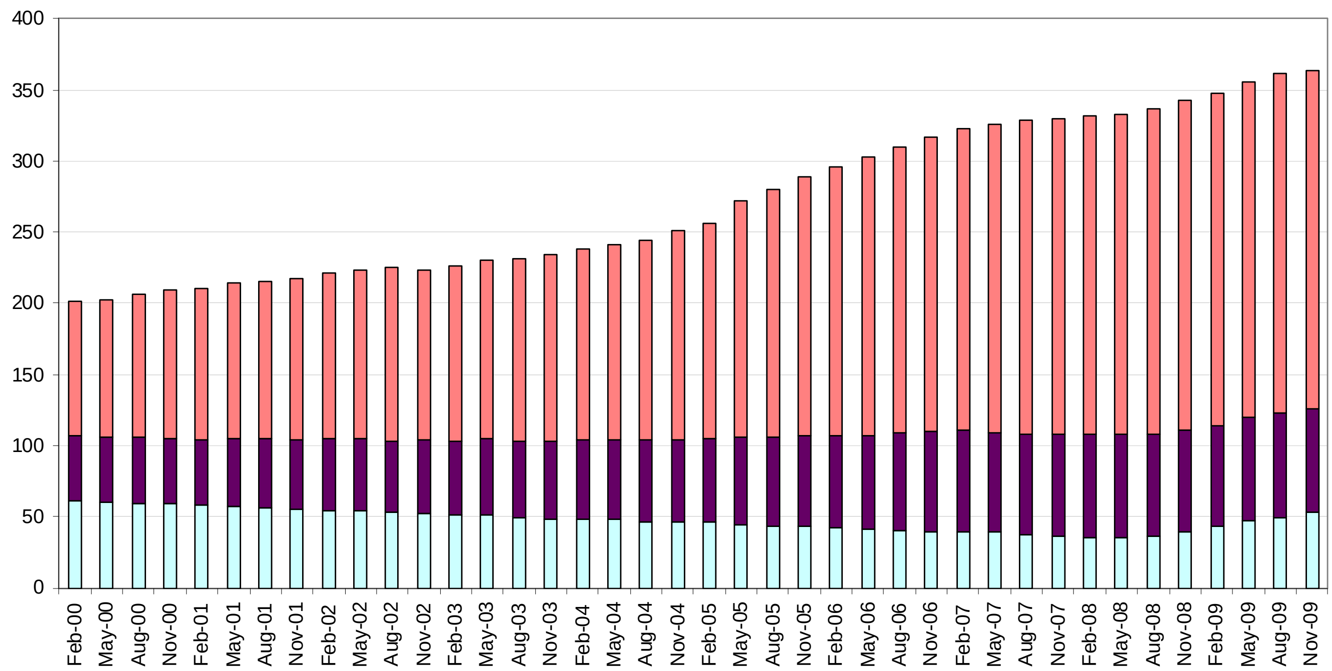
Chart 2a presents the evolution of the total debt-to-GDP ratio since 2000. While the share of government debt has actually declined from 2000 levels (light blue bars), household loans from all credit institutions (the broadest category, purple and pink bars) has more than doubled from 140% to over 300% of GDP in the same period. In large measure, this sharp rise has been the result of borrowing for home purchases (pink bars) that accompanied the now deflated Spanish housing bubble.

Of course, Spanish GDP ticked up in the first quarter of 2010, giving many hope that the Spanish economy had finally exited recession. However, with unemployment running close to 20% and still rising, and employment in a clear downturn, it is premature to proclaim that the recession has ended.

Given its financial and economic vulnerability, as well as its regional importance, it is crucial to assess the near-term Spanish cyclical economic outlook. As we shall see, these insights have significant implications for the broader European region.

The Pain in Spain Will Remain ECRI's Spanish Long Leading Index *(↗ESLLI, Chart 19a, page 23, top line)* and Spanish Coincident Index *(↗ESCI, Chart 19a, page 23, bottom line)*, are designed to respectively anticipate and track cyclical turning points in the level of Spanish economic activity. Following a sharp downturn that correctly anticipated the latest Spanish recession,

Chart 2a: Spanish Government and Household Debt, Percent of GDP



which began in February 2008, the ESLLI registered a sharp but brief upturn in the first half of 2009. It then peaked, and has remained in a downturn for eight months now.

How pronounced, pervasive and persistent is this decline in the ESLLI? Charts 2b to 2d compare the current drop in the ESLLI with the median ESLLI decline that preceded past Spanish business cycle recessions. Chart 2b shows that the current ESLLI downturn tracked the median past pre-recession pattern fairly closely for the first five months following the ESLLI peak. Since then, the ESLLI decline has actually been more pronounced than the median of past downturns.

Meanwhile, Chart 2c suggests that the current ESLLI decline is slightly more pervasive than the median of ESLLI declines that preceded past Spanish recessions. Finally, Chart 2d shows that the latest ESLLI downtrend is clearly more persistent than on average during past ESLLI declines that preceded Spanish recessions. Thus, this ESLLI decline is now pronounced, pervasive and persistent – the hallmark of a cyclical downturn.

What does this suggest for the ESCI, as well as for Spanish GDP and employment? As anticipated by last year's brief improvement in the ESLLI, the ESCI has begun to edge up, as has Spanish GDP. Employment, however, still remains in a downtrend – but that is not surprising since it usually lags at business cycle troughs.

It is likely that the Spanish economy, and thus its coincident indicators, will see some near-term improvement. However, the renewed decline in the ESLLI strongly questions the sustainability, and consequently the magnitude, of any such improvement.

As we discuss later in this publication (↗*page 13*) this cyclical decline in the ESLLI underscores the vulnerability of the Spanish economy to recession. At this stage, in fact, even modest shocks could tip the Spanish economy into a double-dip recession. With the Spanish government moving forward with new austerity measures that include cuts in civil service pay, pension freezes and increased government and local taxes, the impact on domestic demand could be enough of a shock to tip the Spanish economy back into recession.

Home Price Outlook Fading Again In the past decade, the Spanish economy enjoyed an unprecedented housing boom that was a driving force of its impressive economic performance in the years leading up to the latest recession. The implosion of this

Chart 2b: How Pronounced a Decline in the ESLLI?

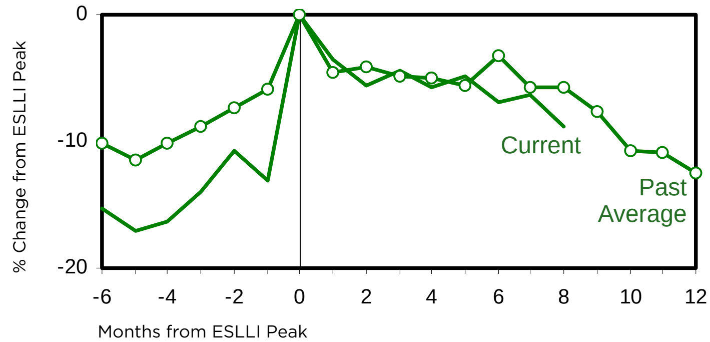


Chart 2c: How Pervasive a Decline in the ESLLI?

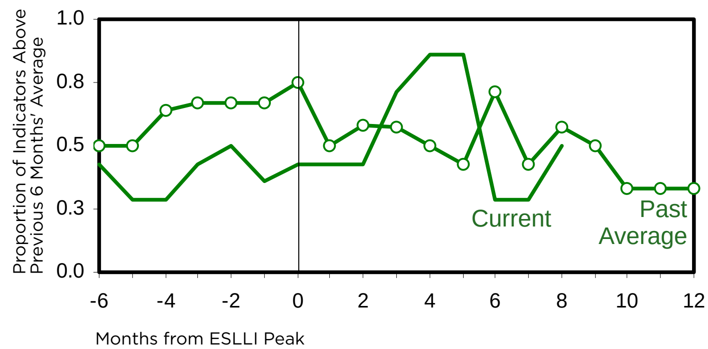
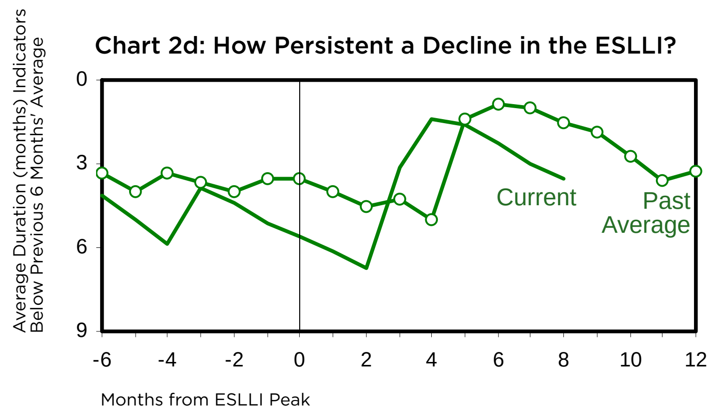


Chart 2d: How Persistent a Decline in the ESLLI?

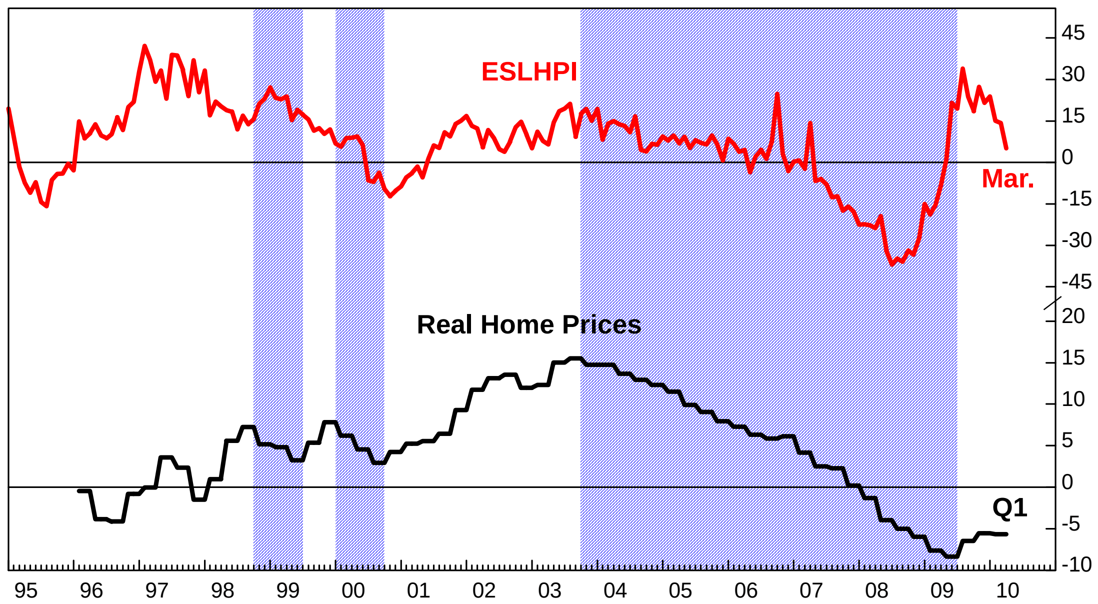


housing bubble in the past couple of years intensified the severity of the recession and pushed the unemployment rate to its highest level in over a decade.

ECRI's Spanish Leading Home Price Index (ESLHPI) is designed to anticipate cycles in Spanish real home prices. Its growth rate tends to anticipate cyclical turning points in real home price growth. Chart 2e shows ESLHPI growth (top line) and Spanish real home price growth (bottom line), with shaded areas representing cyclical downturns in real home price growth.

Following a multi-year decline that anticipated the sharp plunge in real home price growth, ESLHPI growth started to improve steadily in the second half of

Chart 2e: ESLHPI & Real Home Prices, Growth Rates (percent, annualized)



Shaded areas represent cyclical downturns in the growth rate of Spanish real home prices.

2008, indicating an upcoming turnaround in real home price growth. Spanish real home price growth turned up in the second half of 2009 but has flattened out lately. In any case, real home price growth remains in negative territory.

However, ESLHPI growth is now in a clear cyclical downtrend that began in July 2009. Thus, the outlook for real home price growth has already dimmed significantly, with negative implications for the viability of its nascent revival.

Spain and the Euro At its onset, the Greek debt crisis, following on the heels of the Dubai debt scare, served as a general warning about sovereign debt levels and government creditworthiness. It was never entirely about Greece, which accounts for just 2.6% of Eurozone GDP. But the Eurozone lacked both the institutional and legal framework to deal decisively and swiftly with such a situation. Meanwhile, political indecision and posturing went on for months before market angst forced the Eurozone to take action.

The inability of Eurozone institutions and its political leaders to deal effectively with the Greek debt crisis exposed to the world the inherent vulnerabilities of the monetary union and the Euro. Now the fears that have taken center stage are no longer about the fate of Greece but about the fate of the European Monetary Union.

Greece is hardly the only country to have amassed mountains of debt over the years, and, following the Greek bailout, the markets' attention has turned to Spain. As discussed earlier (↗*pages 1 to 3*), based on debt-to-GDP and budget-deficit-to-GDP measures, Spain is scarcely the worst offender in Europe. It is in a much better position than Greece and somewhat better than Ireland. It is in a similar fiscal situation as the U.K. and better than Italy in terms of total debt. But what makes Spain uniquely vulnerable today is its position in the business cycle.

As shown earlier, the renewed downturn in the ESLLI has become pronounced, pervasive and persistent. Thus, the Spanish economy is now within that window of vulnerability where even modest shocks can push it into a double-dip recession. In that context, the new spending cuts and tax increases could be all that is needed for this double-dip scenario to materialize. Again, it will be critical to closely monitor ECRI's Spanish leading indexes in the months ahead to assess the evolving risk of a Spanish double-dip recession. ■

