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Western European Indicators and Insights

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SPAIN: Back in the fray.

Politics are different in Spain

The Spanish bond market has, once again, come under attack in the last few days, albeit with some easing in pressure emerging today. Possibly this fresh attack may be a warning shot from financial markets ahead of the Spanish general election on Sunday, keen to underline to the new government the need to take immediate and marked action to rein in the budget deficit. This may seem to be overdone: after all opinion polls point to a clear change in power with the right-of-center Popular Party likely to win a huge majority and therefore have the scope to exercise its oft-repeated pledge to meet existing budget goals, whatever the cost. In this regard, it is worth underscoring how different the political backdrop is in Spain compared to the likes of Italy and Greece given that the Spanish electorate seems to back fully the need for fiscal cuts and economic reforms. However, budget cuts of the order of 2% of GDP will be needed over the next two years in order to get the budget back on track to meet the existing 3.0% of GDP 2013 target. As a result, markets may be increasingly wary that even if the electorate says it can stomach more austerity, the economy may not be able to do so.

But the economy is not

The latest national accounts data out today show no fresh slump has yet occurred with a flat Q3 Q/Q outcome. However, this disguises the on-going contrast between the domestic and trade parts of the economy, with the former continuing to contract to the tune of 1.5% Y/Y while exports were up over 8%. This contrast is not entirely a result of recent fiscal consolidation measures, with the robust export performance possibly result of some improvement in competiveness (real unit labor costs fell some 5% between this year and last) which has allowed a broadening out in the export markets of Spain.

Regardless, the economy is clearly being hampered by a fragile banking sector, while, surveys are pointing to fresh overall recession returning this quarter, a development that could mean that the Spanish economy actually contracts in 2012, thereby necessitating even more austerity in order to hit fiscal targets. In other words, markets are increasingly aware that Spain is being caught between a rock and a hard place: either the fiscal outlook will balloon out of control due to insufficient fiscal consolidation or from a lack of growth.

Nothing unique to Spain

This quandary is nothing unique to Spain: the country is merely being caught in the cross-fire of growing contagion that saw all Eurozone bond markets (save for Germany) suffer on Tuesday, possibly a result of the continued sluggish manner in which policy-makers are reacting to the problems of the Eurozone. Indeed, Germany still seems to be at source of market wariness. Not only is Germany still very much against the ECB significantly enlarging its bond buying to support peripheral markets more clearly, but also still seems to be of the view that it has no responsibility to shift away from the export-led growth that actually helped create the imbalances in the Eurozone from which the debt problems are merely the most obvious manifestation. In addition, while Germany is now calling for greater political unity as a means of resolving the problems of the Eurozone, markets may be getting cautious just what countries Chancellor Merkel may be thinking may be part of this reformed Europe.