9. SPAIN

Subdued recovery amidst lower imbalances

Economic adjustment in 2009 and policy response

The end of a decade of sustained and strong economic expansion in Spain has unveiled significant external and sector imbalances. The severe economic contraction in Spain since the second half of 2008 has led to partial corrections in some of those imbalances. Cyclical factors led to a reduction of the external deficit. The high household indebtedness has started to adjust and investment growth in the residential building sector has fallen sharply, although the excess of housing supply have increased.

In 2009, economic activity fell by 3.6%. However, this outcome conceals less negative outcomes within the year, especially in the second half of 2009, due to improvements in private consumption, investment in equipment and exports. This is partly explained by the stimulus measures adopted in line with the European Economy Recovery Plan (EERP) and the positive, albeit temporary, impact of the implementation of car-scrapping schemes in Spain and other Member States, investment in equipment and exports. The contribution of domestic demand to GDP posted a record low in the second quarter of 2009. The downturn took a heavy toll on both jobs, especially in low-productivity sectors, and public finances, which may result in high long-term unemployment and a worsening of the sustainability of public finances.

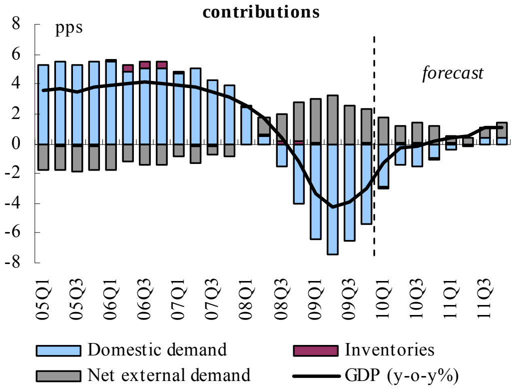
The policy response in Spain to the crisis was twofold. On the one hand, expansionary fiscal measures to stimulate the economy were adopted in line with the EERP. On the other hand, although the direct impact of the financial crisis on the Spanish banking sector has been relatively contained, a series of measures was implemented to support the restructuring of the financial sector.

Economy to come out of recession in the course of 2010

The outlook features positive quarterly growth in the second quarter of 2010, partially reflecting an anticipation of consumption plans driven by the scheduled VAT rate increase on the 1st of July. As a result, quarterly GDP might record a technical fall in the third quarter before recovering again in the last quarter of the year. For 2010 as a whole, real GDP is forecast to contract by ⅓%, followed by a moderate positive growth of ¾% in 2011. Overall, domestic demand is projected to still reduce GDP growth in 2010.

This projection is mainly based on weak private consumption and still shrinking investment. Specifically, private consumption is set to broadly stagnate in 2010 and to increase by 1¼% in 2011. The protracted fall in employment along with limited wage increases are set to produce negative growth in disposable income. Households' balance-sheet ratios might be restored by increasing savings, with an impact on real demand, and thus sustaining precautionary savings. In addition, access to consumer credit still remains more difficult than in the past years when easy access to credit boosted an unsustainable real estate boom. This is due not only to tight credit conditions imposed by financial institutions, but also to lower household' wealth associated to falling asset prices, especially housing, and high household indebtedness. However, low mortgage burdens, consistent with record-low interest rates, and the impact of a partial extension into 2010 of the 2009 public investment package, are expected to yield some support to disposable income. The savings rate of households is projected to start diminishing slowly from a record high of 18¾% of gross disposable income in 2009. By 2011, savings rate is projected to still remain higher than in 2007.

Graph II.9.1: **Spain - GDP growth and contributions**



Gross fixed capital formation is set to keep on falling in 2010-11, albeit at a slower pace than in 2009. Excess supply in the housing market sector, where a considerable stock of new houses remains unsold, is expected to face a diminishing demand, also driven by negative demographic developments. This will drive the adjustment process in the construction sector. Construction activity is set to contract further – by more than 10% in 2010 and 3½% in 2011 – driven by a reduction of investment growth in housing construction of 15¼% in 2010 and 4¾% in 2011, which should help to reduce the large unsold dwellings stock. Non-residential investment is also expected to fall over the forecast horizon, partly reflecting the gradual withdrawal of public investment plans. However, while equipment investment is expected to still post a contraction in 2010, improving economic prospects are assumed to lead to a mild positive growth by 2011.

In the external sector, imports are expected to shrink less markedly in 2010 and to return to positive growth in 2011 in line with final demand. Exports are projected to show a mild recovery in the medium term, reflecting an improvement of world demand and competitiveness gains. All in all, the positive contribution of net exports to GDP growth is forecast to be positive though decreasing in both 2010 and 2011.

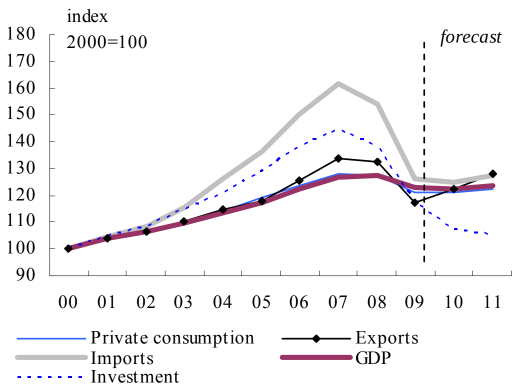
The long period of large external deficits has added to net external liabilities that surpassed 90% of GDP in 2009. The servicing of these liabilities will continue to absorb a non-negligible share of income over the medium term, mirrored in the deficit in the primary income balance. The primary-income deficit is already a major component of the current account as well as an element of rigidity in the narrowing of the overall external deficit.

In the current context of external financing constraints, with a primary-income deficit that remains close to 4%, the cushioning of the real GDP decline at the expense of significant public sector dissaving may require higher financing from households and firms. This financing is not likely to come from saving ratios above the current level, but rather from a further contraction in investment, thus weighing on real GDP growth over the medium term.

The contraction in economic activity, which particularly affects labour-intensive sectors, continues to weigh heavily on employment, which is projected to suffer a cumulative fall of some 2¾% in 2010-11. Despite a projected easing in population growth and in the size of the labour force, the unemployment rate is forecast to rise to 19¾% in 2011.

The present outlook represents a baseline scenario, which is subject to a number of risks that are considered to be broadly balanced. The low interest rates, relatively contained inflation and some growth in nominal wages per head could boost disposable income further, thus strengthening private consumption and accelerating the adjustment of the housing market. Private consumption could thus recover more rapidly. On the other hand, the still subdued employment prospects and currently high unemployment rates might contribute to keeping confidence at a low level, while preventing faster recovery of household expenditure. At the same time, a tightening of credit conditions would further constrain private investment. A lower-than-expected recovery of external demand, resulting from the withdrawal of stimulus measures put in place to tackle the global downturn, would certainly weigh more heavily on economic activity than was projected in the baseline scenario. Delays in the implementation of the ambitious fiscal consolidation plans envisaged by the government could harm internal and external confidence, with negative overall effects on the real economy.

Graph II.9.2: **Spain - GDP and its components**



Correction of imbalances

The challenge of bringing the Spanish economy back to a sustained convergence path could be successfully secured if the recovery were to lead not only to a rebalancing of domestic demand but also to higher export growth and to supporting higher potential growth. In 2010, the net borrowing needs are projected to fall further by ¾ pp. to 4% of GDP, after the sharp reduction recorded in the previous year. By 2011, the net borrowing needs are forecast to remain broadly unchanged, which reflects the fact that the corrections of the imbalances in the Spanish external account might be, at least in part, permanent. Indeed, the trade balance is expected to reduce its deficit, which partially reflects an improvement in the country's competitive position, although the negative net investment position will continue to feed the deficit in the primary incomes account.

Wage moderation is expected to lead to some recovery of competitiveness...

Spain has experienced a real depreciation of the intra-euro-area real effective exchange rate based on unit labour costs since the beginning of the crisis, but the magnitude of correction has so far been rather limited. In 2010 this adjustment is projected to continue via a stronger response of wages. Nominal wages are projected to adjust in 2010-11, at least partly, to labour market conditions, while job losses and unemployment are set to diminish. However, high segmentation in the job market can lead, as in the past, to a significant increase in long-term unemployment, thus reducing the potential growth rate of the Spanish economy. The non-activation of indexation clauses in 2010-11 would imply that nominal wages could grow at rates below the euro-area average and below the expected inflation rate, therefore resulting in a slight fall of real wage growth. The pace of growth of nominal compensation per employee is projected to significantly reduce to 1¼% in 2010, thus below productivity growth. In 2011, compensation per employee growth rate is set to remain moderate. The partial convergence between wages and productivity developments in the forecast horizon are underpinning a significant reduction of unit labour cost developments compared with recent years, which may improve the competitive position of the Spanish economy.

Productivity growth in Spain has been sluggish during the last decade. This mirrors a high allocation of investment to the construction sector and low-productivity services. Although apparent productivity is estimated to grow in 2009 and 2010 above the euro area average, this is mainly due to the sharp contraction of the above-mentioned activities. Consequently, over the medium term, once the adjustment of these low-productivity sectors is over, productivity gains might slow down. By the end of the forecast period, productivity growth is projected to diminish to below 1%. Therefore, the challenge is to increase total factor productivity through enhancing innovation and investment by firms, increasing permanent training of workers, and encouraging competition.

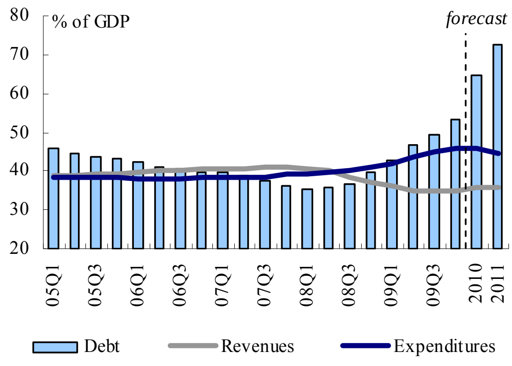
...and inflation control

After a slight fall in 2009, inflation rate is projected to return to positive territory in 2010, when prices are set to increase by just above 1½%, and remain so in 2011. However, the projection for 2011 as a whole conceals a downward trend in the quarterly inflation rate, which is expected to ease to 1¼% by the end of 2011, reflecting a base effect due to the VAT hike by mid-2010. In this respect, the prices of oil and other commodities in international markets represent a significant source of uncertainty.

Restoring public finances' balance

The move away from the highly tax-rich growth composition associated with the fading-out of the asset boom has led to a permanent reduction of tax elasticities. In addition, the economic downturn has significantly increased social protection needs. Both rapidly falling revenue-to-GDP and rising expenditure-to-GDP ratios have resulted in a sharp deterioration in the public accounts. For 2009, the general government deficit outcome was 11.2% of GDP, driven by a contraction of both direct and indirect tax receipts and increases in nominal government consumption, as well as the customary strong anti-cyclical behaviour of social transfers. This deficit outcome included revenue-decreasing one-offs of 0.7% of GDP and discretionary measures amounting to around 2¼% of GDP taken in response to the downturn.

Graph II.9.3: **Spain - Public finances**
(moving average)



The government deficit is projected at 9¾% of GDP in 2010 due to the recessionary growth scenario. This implies a reduction in the headline public deficit of around 1¼%, due to the consolidation efforts undertaken by the authorities, including a partial reversal of the 2009 stimulus package. In 2010, total revenues are set to rise by 1¼ pps. of GDP, through both direct and indirect tax revenues, thus reflecting the adoption of revenue-increasing discretionary measures, notably a 2 pps. increase in the general VAT rate. The GDP share of total expenditures should slightly reduce, mostly due to containment of public consumption and a reduction in public investment. In addition to the measures included in the 2010 Budget, expenditure restraint of the central government is expected to be reinforced by the so-called draft 'Immediate Action Plan' for 2010. However, current expenditures are projected to increase, which would still reflect the functioning of automatic stabilisers, and especially higher unemployment benefits, as well as the higher burden of interest expenditure associated with rising debt levels.

The Spanish government has publicly announced an ambitious fiscal consolidation plan for 2011-13 aiming at reducing total expenditure. Expenditure restrains will mainly rely on the effort of central government, although regional governments have recently agreed to contribute to this consolidation. For 2011, based on a prudent assessment of this plan, the GDP share of compensation of employees and intermediate consumption are projected to fall by around ½ pp., which adds to the reversal of the 2010 stimulus package. As a result, based on the customary no-policy-change assumption, the 2011 deficit is forecast at 8¾% of GDP. Amidst a contraction in GDP and high public deficits, government debt is set to increase from 39.7% of GDP at the end of 2008 to 72½% of GDP by the end of 2011.

Given the rise in unemployment, promoting a swift transition into employment, while still reining in public expenditures and ensuring social cohesion, is key for resuming growth in the medium term. Against this setting, reducing budget deficits is key to boost the confidence of economic agents and lead to an expansion of productive investment and consumption. Increasing public saving and improving competitiveness would enhance economic growth, and job creation, while mitigating the existing structural domestic and external imbalances.

Table II.9.1:

Main features of country forecast - SPAIN

	2008			Annual percentage change					
	bn EUR Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	1088.5	100.0	3.0	4.0	3.6	0.9	**-3.6**	**-0.4**	**0.8**
Private consumption	622.8	57.2	2.9	3.8	3.6	-0.6	**-4.9**	**0.2**	**1.2**
Public consumption	211.1	19.4	3.6	4.6	5.5	5.5	**3.8**	**1.0**	**-1.2**
Gross fixed capital formation	314.0	28.8	4.1	7.2	4.6	-4.4	**-15.3**	**-8.3**	**-1.8**
of which : equipment	80.3	7.4	4.2	9.9	9.0	-1.8	**-23.1**	**-4.3**	**0.2**
Exports (goods and services)	289.0	26.5	7.7	6.7	6.6	-1.0	**-11.5**	**4.4**	**4.7**
Imports (goods and services)	353.0	32.4	8.3	10.2	8.0	-4.9	**-17.9**	**-1.1**	**1.8**
GNI (GDP deflator)	1060.6	97.4	2.9	3.8	2.9	0.6	**-3.0**	**-0.7**	**0.3**
Contribution to GDP growth : Domestic demand			3.4	5.1	4.5	-0.7	**-6.4**	**-1.7**	**0.1**
Inventories			0.0	0.3	-0.1	0.1	**0.0**	**0.0**	**0.0**
Net exports			-0.4	-1.4	-0.9	1.4	**2.8**	**1.3**	**0.7**
Employment			2.1	3.3	2.8	-0.6	**-6.7**	**-2.5**	**-0.1**
Unemployment rate (a)			14.0	8.5	8.3	11.3	**18.0**	**19.7**	**19.8**
Compensation of employees/f.t.e.			4.0	4.0	4.5	6.1	**3.7**	**1.1**	**1.2**
Unit labour costs whole economy			3.1	3.3	3.8	4.6	**0.4**	**-1.0**	**0.3**
Real unit labour costs			-0.8	-0.8	0.5	2.0	**0.2**	**-1.3**	**-0.7**
Savings rate of households (b)			-	-	10.6	12.9	**18.8**	**17.3**	**16.5**
GDP deflator			4.0	4.1	3.3	2.5	**0.2**	**0.3**	**1.1**
Harmonised index of consumer prices			-	3.6	2.8	4.1	**-0.3**	**1.6**	**1.6**
Terms of trade of goods			0.4	0.6	0.1	-2.3	**4.4**	**-1.9**	**-0.6**
Trade balance (c)			-4.5	-8.4	-8.6	-7.9	**-4.2**	**-3.8**	**-3.3**
Current account balance (c)			-2.9	-9.0	-10.0	-9.5	**-5.1**	**-4.6**	**-4.5**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-2.0	-8.4	-9.6	-9.1	**-4.7**	**-4.0**	**-4.0**
General government balance (c)			-2.7	2.0	1.9	-4.1	**-11.2**	**-9.8**	**-8.8**
Cyclically-adjusted budget balance (c)			-2.3	1.6	1.2	-4.4	**-9.6**	**-7.8**	**-7.0**
Structural budget balance (c)			-	1.6	1.2	-4.1	**-8.9**	**-7.8**	**-7.0**
General government gross debt (c)			56.5	39.6	36.2	39.7	**53.2**	**64.9**	**72.5**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.