

9. SPAIN

Deep adjustment continues

Rebalancing is underway in the midst of recession

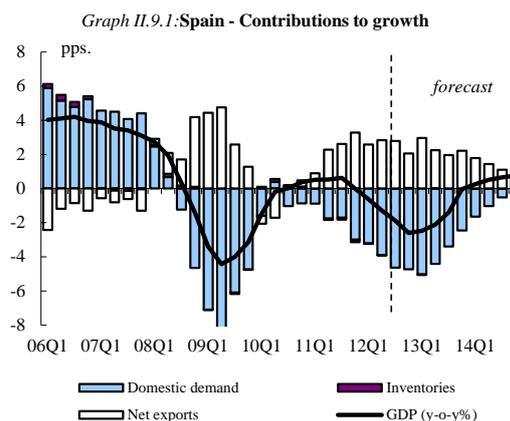
The adjustment of the large external and internal imbalances built up in the years prior to the crisis is holding back economic growth in Spain and has led to very high unemployment. The sizeable stock of private sector debt is prompting deleveraging among households and non-financial corporations. It also implies a profound shift in the composition of GDP growth away from domestic demand. Unemployment remains stuck at very elevated levels and is set to increase further. Public finances, which suffered a significant deterioration in the wake of the crisis, need to be brought back onto a sustainable path. Ambitious fiscal consolidation plans are being put in place but are weighing on the short-term growth outlook. The correction of these imbalances will affect domestic demand adversely over the forecast horizon, although a gradual improvement is expected in 2014, under a no-policy-change assumption. Resilient exports should continue to provide some cushion to otherwise very weak economic growth.

Real GDP is expected to contract by around 1½% both in 2012 and 2013. Spain entered its second recession since 2009-10 in the fourth quarter of 2011. Growth is expected to remain negative well into 2013. The main factors behind the expected contraction in economic activity in 2012-13 include further deterioration in the labour market, deleveraging of the private sector, fiscal consolidation, and tight credit conditions – all set in the context of the ongoing crisis in the euro area and somewhat weaker external demand.

Recurrent problems in some of the Spanish banks, struggling to deal with a large stock of impaired real estate related assets, eventually led the Spanish government to apply for external financial assistance for the recapitalisation of financial institutions from the European Financial Stability Facility (EFSF). The Memorandum of Understanding (MoU) was signed on 23 July and it was agreed that up to EUR 100 billion will be made available by the EFSF for restructuring and recapitalisation of Spanish banks. This programme is expected to have a positive impact on the stability of the financial sector in Spain. However, in the short term, the necessary adjustment in credit growth following the boom and bust of the

construction and real estate sector is expected to keep credit flows to the real economy constrained, contributing to the weakness of private consumption and investment.

Pressures on the sovereign have abated recently due, to a large extent, to the OMT (Outright Monetary Transactions) announced by the ECB. However, uncertainty remains elevated and financing conditions are subject to considerable strain. In parallel to fiscal consolidation, the Spanish authorities are implementing a comprehensive programme of structural reforms, which includes an ambitious labour market reform that was adopted in February and slightly modified in July 2012. An additional structural reform package was announced in September 2012.



Domestic demand remains subdued

Private consumption is set to act as a drag on growth over the forecast horizon, with some positive growth expected only in 2014. In 2012, private consumption will be particularly subdued due to record high unemployment, ongoing household deleveraging and the binding credit constraint. Households' disposable income is set to decline significantly due to a fall in the compensation of employees and an increase in income taxes. In addition, households' wealth will be reduced given an expected further fall in house prices. These trends will be further magnified by higher inflation, reducing real disposable income in 2012 and 2013. The saving rate is expected to decrease to less than 9% - a level that is well below the historical average of 11% - as households try to smooth their consumption and their ability to save is constrained by falling income levels.

Investment, particularly investment in equipment, is set to decline given the unfavourable economic outlook, high corporate indebtedness, excess capacity and difficult access to credit. Business confidence in industry is very low and the main component of overall investment continues to be replacement investment. All in all, corporations are expected to increase their net lending position, also on the back of improving profitability, thus increasing the potential for accelerating the reduction in accumulated debt. The adjustment in the housing market is still ongoing, with the fall in house prices accelerating in 2012. The cumulative fall in house prices has reached 28% in nominal terms and 36% in real terms since the peak in 2007. Further adjustment is expected given the remaining large stock of unsold houses. Non-residential construction is expected to decline, driven mostly by fiscal consolidation and, to a lesser extent, by lower corporate investment. Public consumption is also projected to fall, reflecting the impact of fiscal consolidation at all levels of government.

Net exports continue to support growth

Export growth is expected to remain robust over the forecast horizon and should gather pace after a somewhat weaker 2012. Declining unit labour costs (ULC) and improving product and regional diversification have allowed Spain to increase its export market share – a trend that is expected to continue over the forecast horizon. This is important to achieve a further reduction in the high external deficit. As a result of very weak imports, which are due to subdued domestic demand, and relatively resilient exports, Spain's trade balance has significantly improved and is expected to record a surplus in 2012. These trends have led to an accelerated correction in the current-account deficit, which is expected to be in balance by 2013. However, the high dependence of the Spanish economy on energy imports and the high and increasing interest burden may constrain the necessary improvement of the current account.

Employment getting worse before it gets better

The labour market situation deteriorated further and the unemployment rate reached 24.6% in the second quarter of 2012. The recent labour market reform allows firms greater flexibility to adjust wages and employment (including working hours) to their specific economic situation. However, given the current weakness of the Spanish

economy and a relatively short time span since its entry into force, it may take some time before the first positive effects become manifest. So far, the adjustment in employment continues to take place through the reduction in the number of workers rather than a reduction in working hours. Unlike before, permanent employment is now being affected as much as temporary employment. The rise in unemployment affects all branches of activity. Moreover, the duration of the crisis has led to an increase in long-term unemployment. In the second quarter of 2012, it reached more than 50% of total unemployment, twice its 2008 level.

Wage growth moderates while inflation picks up

In spite of the weakness of the Spanish economy, inflation accelerated and reached 3.5% in September. However, this acceleration was predominantly driven by exogenous factors: energy prices pushed up by hikes in oil prices and discretionary measures, such as the increases in co-payments for medicines, higher VAT rates, higher university tuition fees and an increase in electricity and gas prices. The effects of these discretionary measures are expected to be visible in year-on-year growth rates of prices until the last quarter of 2013. Wage growth is expected to be much more moderate than in the past, reflecting a positive impact of the recent labour market reform, paving the way to a faster recovery in employment. The combination of moderate wage growth and sustained improvements in productivity is expected to reduce real ULCs over the forecast horizon, enabling Spain to regain some of its lost competitiveness.

Fiscal consolidation to intensify in second half of 2012

Fiscal consolidation hardly advanced in the first eight months of 2012. Planned expenditure cuts seem to be on track, but broad-based revenue shortfalls, higher interest payments and rising social transfers almost offset these improvements. Following further fiscal consolidation measures presented in July, including an increase in VAT, the elimination of the 2012 Christmas bonus in the public sector and some measures on the corporate tax side at the central level, there should be significant fiscal tightening in the second half of the year. This is also likely to be the case at regional government level, where expenditure cuts in education are expected to kick in. For the year

as a whole, the general government deficit is therefore expected to narrow to about 8% of GDP, or about 7% of GDP – whereby 1% is entirely due to bank recapitalisation.

In 2013, the general government deficit is expected to narrow further, thanks to further discretionary measures more than offsetting the impact of the continued recession. The July 2012 fiscal package contained some elements that are expected to have their major impact in 2013, such as the VAT hike. The 2013 Budget Bill presented to parliament in September contained further consolidation measures, mainly on the expenditure side. Together with consolidation efforts at regional and local levels announced in the 2013-14 budget plan presented in August, these measures are expected to generate a net fiscal consolidation of about 1% of GDP. Thus, the general government deficit is forecast to reach around 6% of GDP in 2013. In 2014, the expiry of some of the measures introduced in 2012, such as the income tax hike, is roughly offsetting the planned consolidation included in the 2013-14 budget plan. Despite the fact that output and employment is expected to return to positive, albeit weak, growth, the general government deficit is expected to deteriorate to

6.4% of GDP, due to the expiry of some of the measures introduced in 2012.

Over 2011-14, virtually all of the improvement in government net lending stems from lower expenditure, with the effect of discretionary tax hikes just offsetting revenue losses due to the recessionary environment and the ongoing structural shift away from a tax-rich growth pattern based on domestic demand. Overall, risks are tilted to the downside. In addition to yet uncertain exact amount of bank recapitalisation, the less tax-rich growth composition could lead to lower-than-expected revenues.

The structural balance is expected to improve from -6¼% of GDP in 2012 to -4% of GDP in 2013, before deteriorating again in 2014 to -5¼% of GDP. Large public deficits, negative or low nominal GDP growth and high interest rates on government borrowing are likely to result in the government gross debt rising from 69.3% of GDP in 2011 to more than 97% of GDP in 2014. One-off effects of the payment of arrears to suppliers and a contribution to EFSF/ESM funds add to an increase in general government debt in 2012.

Table II.9.1:

Main features of country forecast - SPAIN

	2011			92-08	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2009	2010	2011	2012	2013	2014
GDP	1063.4	100.0	100.0	3.0	-3.7	-0.3	0.4	-1.4	-1.4	0.8
Private consumption	620.0	58.3		2.8	-3.8	0.7	-1.0	-1.9	-2.1	0.0
Public consumption	222.7	20.9		3.9	3.7	1.5	-0.5	-4.9	-7.2	-1.4
Gross fixed capital formation	224.0	21.1		3.7	-18.0	-6.2	-5.3	-9.0	-5.6	-0.3
of which : equipment	63.0	5.9		4.2	-24.5	3.0	2.4	-6.6	-3.5	0.8
Exports (goods and services)	321.8	30.3		7.1	-10.0	11.3	7.6	2.1	4.2	5.7
Imports (goods and services)	330.3	31.1		7.5	-17.2	9.2	-0.9	-6.3	-3.2	2.4
GNI (GDP deflator)	1041.9	98.0		2.8	-3.0	0.3	-0.3	-2.0	-1.8	0.7
Contribution to GDP growth :		Domestic demand		3.3	-6.6	-0.8	-1.8	-4.0	-3.8	-0.3
		Inventories		0.0	0.0	0.1	-0.1	0.0	0.0	0.0
		Net exports		-0.3	2.9	0.3	2.3	2.6	2.3	1.2
Employment				2.1	-6.5	-2.3	-1.7	-4.5	-2.7	0.2
Unemployment rate (a)				13.9	18.0	20.1	21.7	25.1	26.6	26.1
Compensation of employees/f.t.e.				4.2	4.4	0.0	0.7	0.4	1.4	0.4
Unit labour costs whole economy				3.4	1.5	-2.0	-1.4	-2.7	0.1	-0.2
Real unit labour costs				-0.5	1.4	-2.4	-2.4	-2.9	-1.7	-1.6
Saving rate of households (b)				-	17.8	13.1	11.0	8.7	8.1	9.1
GDP deflator				3.8	0.1	0.4	1.0	0.2	1.9	1.4
Harmonised index of consumer prices				-	-0.2	2.0	3.1	2.5	2.1	1.3
Terms of trade of goods				0.2	4.5	-2.2	-3.3	-2.7	-0.2	-0.2
Merchandise trade balance (c)				-5.2	-4.0	-4.6	-3.8	-2.5	-0.8	0.0
Current-account balance (c)				-4.0	-4.8	-4.4	-3.7	-2.4	-0.5	0.4
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-3.2	-4.3	-3.8	-3.2	-1.9	0.0	0.9
General government balance (c)				-2.3	-11.2	-9.7	-9.4	-8.0	-6.0	-6.4
Cyclically-adjusted budget balance (c)				-2.3	-9.4	-7.6	-7.6	-6.0	-4.0	-5.3
Structural budget balance (c)				-	-8.7	-7.6	-7.5	-6.3	-4.0	-5.3
General government gross debt (c)				53.4	53.9	61.5	69.3	86.1	92.7	97.1

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