

9. SPAIN

External imbalances persist, fiscal surplus disappears

The end of a long expansionary phase

The outstanding economic performance of Spain since the mid-nineties came to an end in 2008. The long expansion of economic activity can be broadly attributed to a combination of positive shocks, such as a sustained credit expansion and strong immigration, together with sound choices in monetary and fiscal policies in the framework of the accession to the monetary union.

Significant imbalances emerged however during the expansionary phase: (i) an oversized housing sector, (ii) a growing current account deficit, (iii) a high indebtedness of private agents, households and firms, and (iv) a persistent inflation differential with the euro area which, coupled with insufficient productivity growth, has hurt the competitiveness of the Spanish economy.

Sharp deceleration in 2008

After having posted a remarkable GDP growth rate of 3.7% in 2007, economic activity rapidly decelerated in 2008, and is expected to record an average growth rate of slightly below 1½% for the year as a whole, with negative quarterly growth rates during the second half of the year.

Domestic demand started to show some signs of fatigue already during the first half of 2007, but the situation worsened substantially due to the housing sector adjustment, worsening consumer confidence, higher oil and food prices, and tighter credit conditions associated with the financial crisis. Specifically, investment in dwellings might decline by around 9½%. Additionally, investment

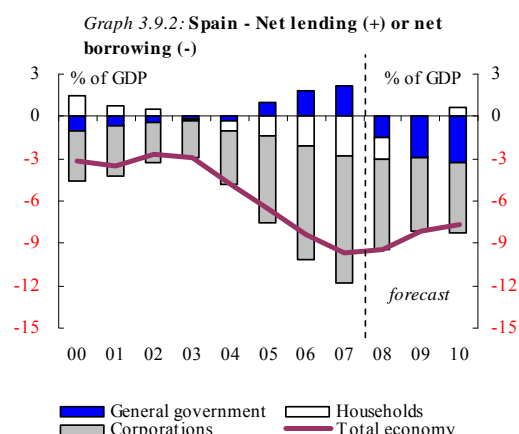
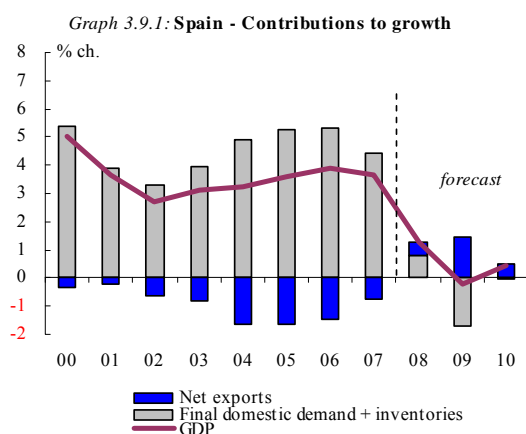
in equipment, which had remained resilient and grew at two-digit levels in 2007, might stagnate in 2008. For the year as a whole, domestic demand is expected to contribute about ¾ percentage point to GDP growth.

Exports could increase by 3½%, on the basis of a relatively good performance when compared to domestic demand, explained by efforts of domestic manufacturing exporters to keep market shares by reducing mark-ups. Due to the recorded slowdown in consumption, imports might increase by 1¼%, compared with more than 6¼% in 2007. As a result, the positive growth contribution of net exports could attain 0.5 pp. in 2008, compared to a negative contribution of 0.8 pp. in 2007.

Private consumption contracts in 2009

In 2009, GDP growth is expected to decline by around ¼% on the back of a negative carryover, lower private consumption and the ongoing contraction of housing and equipment investment, compensated in part with public consumption and exports.

Private consumption should develop in line with the outlook for disposable income and employment. Specifically, employment contraction would put pressure on labour income; and the negative prospects of net wealth effects and increasing interest payments are expected to weigh negatively on real disposable income, which might broadly stagnate, largely explaining why private consumption is unlikely to take off next year. Moreover, access to consumer credit, which could have cushioned the negative effects of real



disposable income on private consumption, might be more difficult than in the past due to high household indebtedness and uncertainties in financial markets. The household saving rate should reverse its previous declining trend and slightly increase over the forecast horizon. Investment in dwellings is projected to decline by around 18%. Investment in equipment is also expected to decline in 2009. All in all, fixed capital formation could contract by 5¼%. Overall, domestic demand is projected to contribute -1¾ percentage points to GDP growth in 2009.

Following exporters' efforts to keep or even slightly expand market shares, export growth is forecast at around 2¼%, slightly above world trade growth. Consistent with private consumption developments, imports should decline by 2½% in real terms, increasing the positive contribution of net exports to GDP growth to 1½ percentage point of GDP.

Uncertainties prevail in 2010

GDP is projected to expand in 2010 by ½%. Private consumption should break out of negative territory on the basis of slightly better prospects for real disposable income, which could benefit from a timid recovery of employment creation. All in all, consumption is expected to increase by a meagre half of one percentage point. The ongoing contraction in housing investment should decelerate but is still projected to amount to around 10% for the year as a whole. Overall, the contribution of domestic demand to GDP growth will post a virtual zero.

On the back of the mild recovery in private consumption, it is envisaged that the positive contribution of net exports will decline to half a percentage point on the basis of import growth by around 1%. Exports are projected to accelerate slightly, allowing to broadly keep its market shares.

External imbalances persist

The deficit in trade of goods and services is forecast to decline from 6½% of GDP in 2008 to 4¼% in 2010. However, this may be insufficient as to unwind significantly the external imbalances: the negative balance of primary income, caused by the growing external debt and projected to reach 4% of GDP by the end of the forecast period, is expected to largely offset the improvement of the

trade balance. The balance of current transfers, mainly immigrants' remittances, is forecast to slow and post a deficit of about 1% of GDP over the forecast horizon. All in all, the current account deficit is expected to record a slight improvement of two percentage points, from around 10% of GDP in 2008 to slightly above 8% in 2010.

On a sectoral basis, the improvement in private individuals' balance position will be in part offset by the worsening of the public sector financial position, which will shift from a comfortable net lender position to a net borrower already in 2008.

Risks are on the downside

Risks to this baseline scenario seem to be tilted towards the downside. A sharper-than-expected adjustment of the housing sector and further tightening of credit conditions could weigh on private consumption and investment activity more than projected above.

Labour market, costs and prices

Employment prospects reflect the picture for economic activity in general. Specifically, job creation (in full-time equivalents) is expected to reverse in 2008, from +3% in 2007 to -¼%.

For the rest of the forecast period, employment growth is expected to be negative as a result of weakening activity. Total jobs are set to be lost at around 2% and 1% in 2009 and 2010, respectively. Although the domestic labour force is on a declining path, still relatively strong migrant inflows could keep it growing above 1% over the forecast period, leading to an increase in the unemployment rate, to as much as 15½% in 2010.

Inflation has rocketed in 2008 on the back of higher oil and food average prices and might reach 4¼% for the year as a whole. Nevertheless, inflation is expected to diminish significantly in 2009 and 2010, mainly reflecting the sudden fall in oil prices since last summer and base-year effects associated with energy and food prices, but should then converge towards core inflation projections, at around 2.8% in 2010. The inflation differential with the euro area will remain not far from one percentage point, comparable to the average recorded over the last decade.

Compensation of employees is expected to closely follow inflation developments. Productivity

growth for the economy as a whole is expected to increase over the forecast horizon, at around 1¼% per year. As a result, unit labour costs should grow by 3¼% in 2008 and 1% in 2010. Accordingly, the competitiveness of the Spanish economy vis-à-vis the rest of the euro area would deteriorate further, in a context of a high and persistent current account deficit.

Public finances entering the red territory

For 2008, the general government deficit is estimated at 1½% of GDP. This is a much worse budgetary outcome than in 2007 (a surplus of 2.2% of GDP), and well below the target in the 2008 budget law (a surplus of 1¼% of GDP). It can mainly be explained by lower-than-expected revenues, the impact of the discretionary measure of a tax allowance of €400 per taxpayer and the functioning of automatic stabilisers through unemployment benefits.

For 2009, the draft budget law targets a deficit of almost 2% of GDP, in contrast with a surplus of 1¼% in the updated 2007 stability programme. The draft budget law seems to be based on an optimistic macroeconomic scenario, in which GDP would grow by 1%, leading to favourable

projections for tax revenues and unemployment benefits. On the basis of a more prudent macroeconomic scenario and budgetary prospects, the Commission expects the public sector deficit to reach 2.9% of GDP in 2009.

In 2010, based on the customary no-policy-change scenario, the general government deficit is forecast to slightly increase to 3.2%. Revenue is projected to grow at about 3%, close to nominal GDP. Total expenditure is assumed to grow by 3¼%, reflecting higher unemployment benefits in particular.

The primary balance should decline from equilibrium in 2008 to a deficit position of 1½% in 2010. The debt-to-GDP ratio is projected to increase from 37½% in 2008 to around 44½% in 2010.

For the forecast, and without prejudging the final statistical treatment, which will have to be approved by Eurostat, the technical assumption on the operations to stabilise the financial system is that they have no direct impact on both government balance and debt.

Table 3.9.1:

Main features of country forecast - SPAIN

	2007			Annual percentage change						
	bn Euro	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	1050.6	100.0		2.9	3.6	3.9	3.7	1.3	-0.2	0.5
Private consumption	602.4	57.3		2.8	4.2	3.9	3.5	0.9	-0.4	0.5
Public consumption	192.0	18.3		3.5	5.5	4.6	4.9	4.1	1.3	0.7
Gross fixed capital formation	325.8	31.0		3.8	7.0	7.1	5.3	-1.6	-5.8	-1.7
of which : equipment	81.5	7.8		3.9	9.2	10.2	10.0	0.8	-5.2	-0.9
Exports (goods and services)	278.3	26.5		8.1	2.5	6.7	4.9	3.4	2.3	2.8
Imports (goods and services)	349.5	33.3		8.3	7.7	10.3	6.2	1.3	-2.5	0.8
GNI at previous year prices (GDP deflator)	1023.6	97.4		2.9	3.5	3.6	2.9	1.2	-0.5	0.3
Contribution to GDP growth :										
Domestic demand				3.2	5.4	5.2	4.5	0.8	-1.7	0.0
Stockbuilding				0.0	-0.1	0.2	-0.1	0.0	0.0	0.0
Foreign balance				-0.3	-1.7	-1.5	-0.8	0.5	1.5	0.5
Employment				2.0	3.2	3.2	3.0	-0.2	-2.0	-0.9
Unemployment rate (a)				14.4	9.2	8.5	8.3	10.8	13.8	15.5
Compensation of employees/f.t.e.				4.0	3.7	3.9	3.6	5.0	3.2	2.4
Unit labour costs whole economy				3.1	3.3	3.2	2.9	3.4	1.4	1.0
Real unit labour costs				-0.8	-0.9	-0.8	-0.3	0.3	-0.6	-1.5
Savings rate of households (b)				-	-	11.4	10.2	11.0	11.9	12.0
GDP deflator				3.9	4.3	4.0	3.2	3.2	2.1	2.4
Harmonised index of consumer prices				-	3.4	3.6	2.8	4.2	2.1	2.8
Terms of trade of goods				0.3	0.8	0.4	0.1	-0.6	0.1	0.2
Trade balance (c)				-4.3	-7.5	-8.5	-8.5	-8.1	-6.7	-6.1
Current account balance (c)				-2.5	-7.5	-9.0	-10.1	-9.9	-8.6	-8.2
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.6	-6.5	-8.4	-9.7	-9.5	-8.2	-7.8
General government balance (c)				-3.0	1.0	2.0	2.2	-1.6	-2.9	-3.2
Cyclically-adjusted budget balance (c)				-2.7	1.0	1.9	2.0	-1.5	-2.0	-1.9
Structural budget balance (c)				-	1.0	1.9	2.0	-1.1	-1.9	-1.9
General government gross debt (c)				57.3	43.0	39.6	36.2	37.5	41.1	44.4

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