

9. SPAIN

Imbalances hamper recovery

Rapid deceleration of economic activity in 2008

GDP growth slowed sharply to 1.2% in 2008. This positive growth rate for the year as a whole conceals a contraction of the economy in the second half of the year. Domestic demand started to fall already in the second quarter, and the pace of contraction accelerated during the second half of the year. Domestic demand contributed just 0.1 percentage point to GDP growth for the year as a whole. While private consumption still showed some resilience in the first half of the year, investment started to shrink already in the first quarter. Both worsening consumer and business confidence and the tighter credit conditions associated with the financial market turmoil were behind this fall. Government consumption accelerated and grew by over 5%, thus attenuating the sharp deceleration in domestic demand.

Largely reflecting the deceleration in the pace of external demand, total exports rose by only 0.7%, representing a sharp slowdown compared to some 5% recorded in 2007. In line with low domestic and external demand, especially investment, total imports contracted by 2.5%, compared with positive growth of more than 6% in 2007. As with exports, the deceleration was stronger in imports of services. As a result, the contribution of net exports to GDP growth turned positive in 2008, at 1 percentage point.

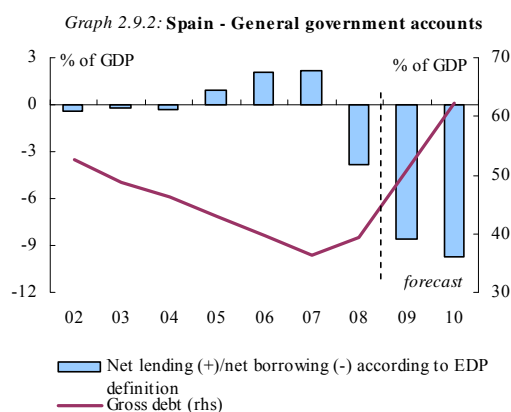
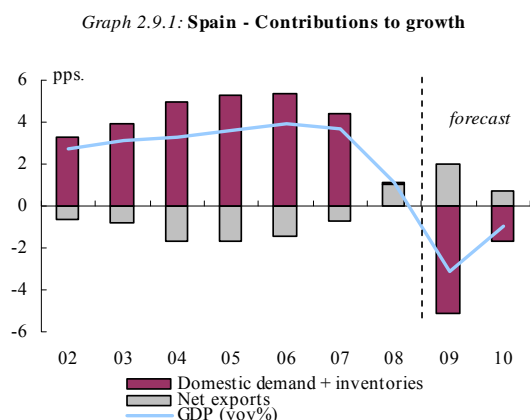
Economy contracting in 2009

GDP is projected to decrease sharply by 3¼% in 2009, on the back of strongly contracting private

consumption and investment. (1) The fall in private consumption is linked to fears of job losses, which increase precautionary savings, negative wealth effects and the deceleration in the growth rate of real disposable income. Moreover, access to consumption credit is proving much more difficult than in the past due to high household indebtedness ratios and tighter credit conditions imposed by financial institutions. Private consumption is expected to fall by around 3¼% in 2009, despite the expected job impact of the fiscal stimulus (see further details in the public finance section below) and lower interest rates. The savings rate of private households is expected to reach an historical high of more than 18%.

In addition, the fall in gross fixed capital formation should accelerate in 2009 to more than 14%, mirroring a sharp contraction in both housing and equipment of 23% or more, which more than counteracts the stimulus from general government in this area. Credit demand for housing is set to continue to decelerate as financial conditions remain tight. Moreover, confidence has deteriorated and the financial turmoil is putting additional pressure on credit markets. The tightening of credit conditions and the negative prospects for the economic situation can be expected to drag profit expectations down and discourage most corporate investment plans. Overall, domestic demand is projected to reduce GDP growth by more than 5 percentage points in 2009.

Export growth is forecast to decrease in 2009 by around 10¼%, mainly reflecting the anticipated worsening of external demand. Given the



slowdown in final demand, imports should contract significantly. Although Spain's inflation differential with the euro area should narrow over the forecast horizon, the competitiveness position of the Spanish economy should remain weak. Indeed the narrowing mainly reflects the weight of the energy component in the headline HICP.

The contraction continues over the forecast horizon

GDP is projected to continue contracting in 2010, by around 1%. Construction and equipment investment are forecast to decline substantially, as the adjustments in these sectors will not yet be completed. The temporary character of the November 2008 fiscal package means that a number of public investment projects will be discontinued in 2010; this will contribute to the overall fall foreseen for total investment. Domestic demand should drag GDP growth down by 1¼ percentage points.

The fall in exports is projected to continue, though Spain will broadly maintain its export market shares. The outlook for imports is similar, reflecting very weak demand. The trade deficit is forecast to shrink further, to 4¾% of GDP, whereas, the contribution of net exports to GDP growth should again be positive given the sharp fall in imports. Nevertheless, the balance of primary incomes is projected to worsen due to a higher debt burden vis-à-vis foreign lenders. All in all, the current account deficit is expected to narrow over the forecast period, especially in 2009, reaching 6¼% of GDP in 2010.

There are risks to this scenario in both directions. On the positive side, sustained population growth might result in a better-than-expected outcome for economic activity. Specifically, in spite of the deterioration of economic prospects, a growing population could underpin private consumption by more than anticipated and soften the adjustment of investment in dwellings, as well as inducing additional wage flexibility in the labour market, and contributing to growth from the supply side. The extraordinarily high elasticity of imports with respect to final demand observed at the end of 2008 might continue, at least in the first half of 2009, thus leading to a more positive contribution of net exports to GDP growth. In addition, Spanish households, which are highly indebted at almost exclusively variable interest rates, could benefit from a low cost of credit. On the other hand, a

sharper-than-expected negative adjustment of external demand and a further tightening of credit conditions could weigh on economic activity more than projected in the baseline scenario. In a context of tighter credit conditions, private investment could fall still more sharply than expected, further slowing the pace of employment and private consumption growth. Furthermore, within a context of credit restraint, the financing of Spain's fast-rising external debt might weigh further on domestic activity.

Sharp increase in unemployment

In line with economic activity, job losses are set to increase significantly in 2009 and, to a lesser extent, in 2010. Employment is expected to fall by more than 5% in 2009 and 2¾% in 2010. This compares with a rate of job destruction of ½% in 2008. The still relatively strong migrant inflows together with the projected rate of job losses will further raise the number of unemployed. As a result, the unemployment rate is expected to increase by more than eight percentage points, to around 20% in 2010.

On the back of lower oil and food prices, inflation is expected to turn negative in the second and third quarters of 2009, before increasing again to ¾% by the end of the year. The average annual inflation rate could fall to just below 0% in 2009. In the same vein, the inflation differential with the euro area would be negative for the first time in a decade. In 2010, a still-contracting domestic demand might partially compensate for price pressures from higher oil prices, leading to an average headline inflation rate of around 1¼%. The inflation differential with the euro area is projected to increase slightly, to a ¼ of a percentage point.

The high rate of job losses, especially in the construction sector, will result in an increase in productivity in 2009, which, together with a moderation in private sector wage growth, should lead to lower growth in unit labour costs. However, this trend might grind to a halt in 2010, particularly if wage growth does not fully adapt to the excess supply of labour.

From budgetary surplus to deficit

For 2008, the general government deficit outcome was 3.8% of GDP. This much worse outcome compared to the 2.2% of GDP surplus in 2007 is

largely explained by the fall in total current revenue by more than 4 pps. of GDP, whereas expenditure accelerated to a lesser extent. The very low revenue is mainly explained by the sharp deterioration in the economic situation, and a move away from a highly tax-rich growth composition, as well as personal and corporate tax cuts and revenue-reducing one-off measures amounting to ¼% of GDP (changes to VAT payments by firms).

The government deficit is projected at 8¼% of GDP in 2009, due to the recessionary growth scenario and the discretionary measures adopted in response to the economic downturn. These measures amount to 2¼% of GDP, including the November 2008 stimulus package of around 1 % of GDP adopted in the context of the EERP and one-offs amounting to ¾ of a percentage point (changes in VAT collection and a reduction in tax withholdings of personal income). In 2009, all major tax categories are expected to recede, while total expenditure is projected to sharply increase in terms of GDP (4¾ percentage point of GDP).

In 2010, based on the customary no-policy-change scenario, the general government deficit could grow close to 10% of GDP, even if the fiscal stimulus package is fully reversed. Revenues are projected to grow at around 3%, above nominal

GDP growth, reflecting mainly the reversal of one-off revenue-decreasing measures taken in the previous year, which conceals low indirect and corporate taxes associated with a scenario of still-falling economic activity. Total expenditures are assumed to grow by 8¼%, above nominal GDP growth, mainly due to the functioning of automatic stabilisers, especially higher unemployment benefits, and the higher burden of interest payments coming from the higher stock of debt.

After a number of years of continued decline, the government debt-to-GDP ratio grew by 2¾ percentage points to 40.3% in 2008. For the forecast period, given the high budgetary deficits and the stagnating nominal GDP growth, it is projected to continue to rise rapidly by more than 20 pps. to exceed 62% in 2010. A financial rescue operation of a saving's bank was undertaken in 2009 in the form of a government guarantee of €9 billions, with no impact on the level of public debt.

(¹) The surprisingly strong reduction of 6.4% (y-o-y) in employment in the first quarter of 2009 according to the active population survey, which came out after this forecast's cut-off date, represents a significant downside risk to the forecast scenario if confirmed by the National Accounts.

Table 2.9.1:

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	1.2	-3.2	-1.0
Private consumption	602.4	57.3		2.8	4.2	3.9	3.5	0.1	-3.1	-1.1
Public consumption	192.0	18.3		3.5	5.5	4.6	4.9	5.3	5.1	4.7
Gross fixed capital formation	325.8	31.0		3.8	7.0	7.1	5.3	-3.0	-14.7	-8.0
of which : equipment	81.5	7.8		3.9	9.2	10.2	10.0	-1.1	-23.3	-9.6
Exports (goods and services)	278.3	26.5		8.1	2.5	6.7	4.9	0.7	-10.2	0.1
Imports (goods and services)	349.5	33.3		8.3	7.7	10.3	6.2	-2.5	-14.5	-2.4
GNI at previous year prices (GDP deflator)	1025.1	97.6		2.9	3.5	3.6	2.9	0.9	-3.4	-1.0
Contribution to GDP growth :										
Domestic demand				3.2	5.4	5.2	4.5	0.1	-5.1	-1.6
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	1.0	2.0	0.7
Employment				2.0	3.2	3.2	2.9	-0.6	-5.3	-2.7
Unemployment rate (a)				14.4	9.2	8.5	8.3	11.3	17.3	20.5
Compensation of employees/f.t.e.				4.0	3.7	3.9	3.7	5.2	3.4	2.7
Unit labour costs whole economy				3.1	3.3	3.2	2.9	3.4	1.1	0.9
Real unit labour costs				-0.8	-0.9	-0.8	-0.3	0.4	0.0	-0.9
Savings rate of households (b)				-	-	11.2	10.2	13.0	16.6	18.5
GDP deflator				3.9	4.3	4.0	3.2	3.0	1.1	1.8
Harmonised index of consumer prices				-	3.4	3.6	2.8	4.1	-0.1	1.4
Terms of trade of goods				0.3	0.8	0.4	0.1	-0.7	2.5	-0.6
Trade balance (c)				-4.3	-7.5	-8.5	-8.5	-7.7	-5.3	-4.8
Current account balance (c)				-2.5	-7.5	-9.0	-10.1	-9.5	-6.9	-6.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.6	-6.5	-8.4	-9.7	-9.1	-5.8	-5.1
General government balance (c)				-3.0	1.0	2.0	2.2	-3.8	-8.6	-9.8
Cyclically-adjusted budget balance (c)				-2.5	1.1	1.8	1.6	-4.2	-7.5	-8.2
Structural budget balance (c)				-	1.1	1.8	1.6	-3.9	-6.8	-8.2
General government gross debt (c)				57.3	43.0	39.6	36.2	39.5	50.8	62.3

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