Summary

This report presents the analysis of the situation and outlook for the Spanish economy in 2011 and 2012 carried out by the Directorate General Economics, Statistics and Research of the Banco de España, on the basis of the information available to 17 March 2011. Since publication of the last macroeconomic projections exercise in the same period of 2010, the Spanish economy has been affected at various times by very severe strains on financial markets, to which the authorities have reacted by adopting economic policy measures on different fronts, in response to some of the most pressing risks. Nevertheless, the Spanish economy is still in a difficult situation requiring the pursuit of ambitious and demanding policies to correct the fiscal imbalances, while pressing ahead with structural reforms conducive to growth and with the restructuring and recapitalisation of the financial system. In an environment like the present one, dominated by the sovereign debt crisis in Europe and the discussion and adoption of numerous measures in diverse areas, the uncertainty when preparing macroeconomic projections is very high, so that the quantitative forecasts in this report should be treated with more than the usual caution.

Despite the situation of instability referred to, the Spanish economy began to recover in 2010, with positive output growth during the year, except in Q3. Nonetheless, in the year as a whole, activity declined by 0.1%, as a result of the carry-over effect from the falls in output in the preceding year. The performance by GDP in 2010 was more favourable than projected in last year's report, as a result, in particular, of the better-than-expected behaviour of the world economy and, therefore, of our external markets, which countered the effects of the financial instability and the stepping up of the budget austerity plans.

The forecast for GDP growth in 2011 in this Projections Report, of 0.8%, coincides with that made a year ago. This rate of growth of output stands at a mid-point between the greater buoyancy expected in the core euro area countries and the declines projected in some of the peripheral economies. In 2012, the gradual improvement in activity is expected to continue, leading to a higher average annual growth rate of 1.5%. The Spanish economic growth scenario for the next two years presented here is characterised by a slow recovery in national demand and a more favourable trend in exports, which will continue to benefit from the ongoing expansion of world activity and from the competitiveness gains made last year. Financial conditions are expected to tighten, insofar as bank lending rates will reflect both the expected increase in interbank interest rates and the effect on margins associated with the rise over the past year in the cost of wholesale funding.

The demand of resident agents will continue to be affected by the correction of the imbalances that built up during the long expansionary phase which preceded the crisis and of those that have arisen as a result of the crisis. In the case of general government, both its direct share in the economy's total spending – through government consumption and public investment – and its contribution to the income of private agents are projected to be reduced. The outlook for consumer spending is of particular relevance for the current forecasts. The slow improvement in the labour market, which is expected to begin to create employment from the second half of this year, and the reduction in purchasing power as a result of the temporary rise in inflation, primarily stemming from the rise in oil prices, point to a modest recovery in private consumption during the projection period. In addition, households are projected to consume a larger proportion of their disposable income in 2011, so that the decline in the saving rate from its 2009 peak is expected to continue, while in 2012 it is expected to stabilise at

a similar level to that seen before the recession. At the same time, it is estimated that the adjustment in residential investment will be concluded towards the end of 2011. The current projections indicate that the number of housing starts in 2011 and 2012 will be fewer than necessary to satisfy new demand, so that part of the large stock of unsold houses will be absorbed. As regards business investment, it is projected to strengthen gradually, as final demand gains momentum.

Inflation rose in Spain during 2010 and has continued to rise in early 2011. The harmonised index of consumer prices (HICP) rose on average by 1.8% in 2010. This rate was 0.2 percentage points higher than in the euro area as a whole and up 2 percentage points from the rate in Spain in 2009. In early 2011, the year-on-year growth rate of consumer prices has been clearly above 3%. However, these data do not by themselves give an adequate view of the degree of inflationary pressure in the Spanish economy. In fact, the acceleration in prices has largely been due to a combination of factors (such as the increase in VAT rates in July 2010 and in tobacco taxes in December, the rise in oil prices since last autumn and the raising of electricity tariffs in January 2011) that are temporary in nature, so that their impact on actual inflation rates should disappear after twelve months in the absence of second-round effects stemming from agents' attempts to maintain the real value of their income.

The inflation rate projected for 2011, approximated by the average annual increase in the private consumption deflator, is 2.9%, although in line with the temporary nature of the factors just described, this variable is expected to display a downward profile during the year, from rates of around 3.5% at the beginning of the year to approximately 2% in Q4. For 2012, this moderation in inflationary pressures is projected to continue, with an average rate of change in the private consumption deflator of 1.5%.

According to these projections, some of the imbalances built up in the Spanish economy will be partially corrected in 2011 and 2012. The large part of GDP that investment in construction and, in particular, housing came to account for during the expansion phase will continue to moderate, to stand at levels more comparable with those in other European countries. The government deficit will fall substantially and the nation's net borrowing will decline, although – primarily as a consequence of the increase in the energy deficit – only slightly. The most persistent imbalance will be that represented by the unemployment rate, which may continue to rise in 2011 and will only begin to fall slightly in 2012, in the absence of additional labour market measures. More energetic action in relation to pending reforms would accelerate the downward path of unemployment and boost the economic recovery.

One way of representing the uncertainty surrounding the macroeconomic projections is to calculate the forecast errors that have historically been made and, on the basis of them, to show intervals within which the projected variables may stand with a certain probability. Chart 1 illustrates, using this procedure, the uncertainty surrounding the central scenario for the growth of GDP and the private consumption deflator.

The risks to the projections for activity described above are probably slightly tilted towards the downside. These risks include the possibility of an acceleration in the rise in energy prices seen to date. Moreover, there are downside risks to the private consumption projection, since the latter is accompanied by a significant decline in the saving rate, which may not fully materialise. One essential assumption underlying these projections is that the moderation in labour costs and margins observed in 2010 continues over the projection period, so that these basic components of price formation barely react to the current rise in inflation. If this assumption turns out to be wrong, not only will inflation be more persistent, but also it will entail costs in terms

GROWTH AND INFLATION OUTLOOK FOR SPAIN

CHART 1

SOURCES: INE and Banco de España.

a. The chart shows the uncertainty surrounding the central projection. The intervals have probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on past forecasting errors. Latest data: 2010 Q4.

of output and employment. Finally, a fundamental element of uncertainty in these forecasts, which operates in both directions, is financial market developments and their repercussions on the cost and availability of financing in the Spanish economy. On one hand, despite the reaction of the European and national authorities, a resurgence of the sovereign debt crisis cannot be totally ruled out, which could have negative effects on the Spanish economy. At the same time, the fulfilment of the commitments made and progress on the proposed reforms could increase the confidence of investors in Spain and lead to an improvement in financing conditions and, in general, the growth outlook. As regards inflation, the risks are predominantly upside. Apart from the risks mentioned above, there are others related to departures from the external assumptions: in particular, oil prices could increase further against a background of strong world demand and geopolitical uncertainty.

This summary of the Report is followed by a section setting out the external assumptions underlying the projections. The third section then makes a detailed diagnosis of the outlook for the Spanish economy. Finally, the main risks to the central scenario described are analysed in the last section.

The external assumptions underlying the projections

The projections presented in this report are based on a set of assumptions regarding the evolution of certain exogenous variables over the time horizon of the next two years. Therefore, the nature of the projections is determined by the hypotheses made about the paths of these variables.

The procedure used to construct the paths of most of the exogenous variables in the period 2011-12 is the same as that used in the projection exercises carried out quarterly by experts

INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

TABLE 1

Annual rates of change, unless otherwise indicated					Projection		Difference between current and March 2010 projections report	
	2007	2008	2009	2010	2011	2012	2010	2011
INTERNATIONAL ENVIRONMENT								
World output	5.1	2.7	-0.8	4.8	4.2	4.1	1.2	0.6
Global markets	7.3	3.2	-11.1	12.4	7.6	7.5	5.5	2.3
Spain's export markets	6.7	2.7	-11.4	10.1	6.2	5.9	4.6	1.9
Oil price (in USD)	72.7	97.7	61.9	79.6	111.8	114.1	-0.2	28.4
Competitors' export prices in euro	0.2	2.7	-3.6	6.7	2.9	1.8	4.1	1.3
MONETARY AND FINANCIAL CONDITIONS								
Dollar/euro exchange rate (USD per euro)	1.37	1.47	1.39	1.33	1.38	1.39	-0.04	0.02
Short-term interest rate (3-month EURIBOR)	4.3	4.6	1.2	0.8	1.5	2.3	0.0	-0.1
Long-term interest rate (10-year bond yield)	4.3	4.4	4.0	4.2	5.4	5.7	0.3	1.1

SOURCES: ECB and Banco de España.

a. Projection cut-off date: 17.03.2011.
Latest QNA data: 2010 Q4.

of the ECB and the national central banks of the Eurosystem. This is the case of the exchange rate, Spanish stock exchange prices, oil prices and three-month and ten-year interest rates. The assumptions for these variables are prepared on the basis of the evolution of the markets during a reference period consisting of the ten business days immediately preceding the cut-off date for collecting the data used to prepare the Report.[1] The euro exchange rate is assumed to remain during the projection period at the level observed on the spot market in the reference period, so that it stands on average at $1.38-1.39 per euro in 2011 and 2012, up 4% from 2010 (see Table 1). The path of oil prices, constructed on the basis of the latest information available on the futures markets for this commodity, involves an average rise of 40% in 2011, to an average level of around $112, and stabilisation in 2012, so that the price of oil is assumed to stand at all-time annual average highs during the projection horizon.

In order to prepare the projections, assumptions are also made regarding the evolution of three-month interest rates in the interbank market and ten-year rates in the public debt market. The path of short-term interest rates, obtained from the expectations implicit in the future markets regarding the evolution of three-month EURIBOR, involves a rise in this interest rate from 0.8% on average in 2010, to 1.5% in 2011 and 2.3% in 2012, so that these projections incorporate the gradual tightening of monetary policy over the period anticipated by the market. The ten-year debt yields are constructed on the basis of market expectations regarding euro area interest rates and of the assumption that the spread on Spanish debt will remain steady (at around 200 bp over German debt). These hypotheses entail a rise in long-term interest rates from 4.2% in 2010 to 5.4% in 2011 and a more moderate rise in 2012 (to 5.7%).

On the basis of these assumptions regarding the paths of interest rates, other hypotheses are formulated regarding the cost of financing for households and firms, which assume that financial conditions in general will tighten over the projection horizon. In particular, the spreads with

1. In this case, the cut-off date is 17 March 2011. Considering only the average prices of market transactions on the cut-off date itself would have the advantage of reflecting more accurately the latest relevant information for price formation. However, it is considered that this advantage does not compensate for the potential drawback that some of the variables may be particularly affected by excessive market fluctuations on that specific trading day, making it advisable to consider a longer period.

respect to EURIBOR for credit financing are projected to widen, reflecting the increase in the cost of financing experienced by credit institutions in the last few quarters. In addition, it is assumed that during the projection period banks will maintain the current degree of tightness of credit conditions other than interest rates. As regards the price of housing which, along with stock exchange prices, is one of the two major determinants of the evolution of household wealth, the falls in the price of this asset are expected to continue, in line with the pattern of the real estate crisis in the 1970s.

The assumption regarding the growth of Spanish export markets considered for the purposes of this report has been taken directly from the euro area macroeconomic projections exercise published by the ECB in its March 2011 Monthly Bulletin. Against a background of vigorous growth in world trade, Spanish export markets are expected to grow by around 6% this year and next, which implies a slowdown from the 10% growth observed in 2010. The emerging economies are expected to continue to lead world growth, although the recovery is also beginning to gain traction in a substantial number of developed countries. Finally the description of the fiscal policy scenario contained in the current projections merits special attention, and is therefore the subject of more detailed analysis in Box 1.

Outlook for the Spanish economy

In 2010 the Spanish economy embarked upon a path of recovery. However, quarter-on-quarter output growth was modest and the annual average rate was even slightly negative (-0.1%), as a consequence of the knock-on effect of the declines in output recorded in 2009. That said, this fall was less sharp than that projected in last year's March Projections Report (see Table 2). This deviation is partly explained by the fact that the behaviour of the external demand for Spanish products was more favourable than projected a year ago, and this, along with the observed gain in competitiveness, enabled exports to grow more than anticipated. In a context of sharp declines, private national demand also performed better than expected, in particular in the case of investment in capital goods, which was boosted by the increase in exports.

Over the course of the year, the profile of GDP and of various of its demand-side components was affected by the economic policy measures adopted, including those oriented towards budgetary consolidation (such as the rise in VAT rates) and the withdrawal of government subsidies for car purchases. Taken together, these factors led, in particular, to an acceleration in consumer spending in Q2, which was followed by a decline in Q3. The effects of this time profile of household spending on GDP were mitigated because a substantial part of the temporary increase in household demand and of its subsequent decline was also reflected in imports. Over the year as a whole, private consumption grew by more than expected, even though household income fell in real terms, partly due to higher inflation. The combination of higher spending and lower income led to a notable decline in the household saving rate, which returned to more normal levels following the all-time highs reached in the previous year. At the same time, the fiscal adjustment measures approved caused the direct contribution of government demand to output growth to turn negative. These elements were partially offset by the favourable effects on the confidence of private agents arising from the change in course of economic policy and the correction of certain imbalances.

The projections presented here envisage a continuation of the process of slow economic recovery, although no substantial changes are expected in the pattern of growth from that observed in 2010. Accordingly, external demand will continue to be the main engine of activity, while in the case of national demand the government component will undergo a further decline and the private component will tend to improve gradually (see Chart 2). The average GDP growth rate is projected to be 0.8% in 2011, the same rate as projected a year ago. The fact

DESCRIPTION OF THE FISCAL ASSUMPTIONS ON WHICH THE MACROECONOMIC PROJECTIONS ARE BASED

As regards the fiscal policy assumptions, the projections report is being prepared at a time when the Spanish economy is immersed in an intense fiscal consolidation process which will be one of the main conditioning factors of macroeconomic performance in the projection horizon covered by it (2011 and 2012).

The exceptional nature of this process and its macroeconomic repercussions make it advisable to treat the fiscal policy measures in the same way as in last year's report, whereby the projections include, in addition to the fiscal measures that have already been approved, others that are relatively well detailed, although pending approval.[1] However, there are still differences vis-à-vis the government's fiscal assumptions, essentially as a result of the differences in the macroeconomic scenario and different underlying dynamics in certain expenditure items.

For 2011, the fiscal assumptions used as a basis for these macroeconomic projections factor in information from the State budget, the Social Security system and the regional governments for that year. Specifically, the expenditure side includes the effects of the measures approved in May 2010,[2] which are expected to come into force subsequently in the State budget for 2011. Such measures cover, in particular, the freezing of pensions, except for minimum ones, and of public-sector wages (based on a level 5% lower than in May 2010), constraint in public investment and public employment plans which limit (with few exceptions) the coverage rate of public-sector vacancies to 10%. Similarly, it is assumed that purchases of goods and services, transfers and subsidies will moderate significantly. The revenue side includes the withdrawal of the tax rebate for the birth or adoption of children; the rise in the top personal income tax rates; the impacts in 2011 of the increase in VAT rates in July 2010 and of the elimination of the €400 tax credit on employment income; and higher tax rates on savings.

For 2012, the fiscal assumptions are based on the information included in the latest Stability Programme Update (SPU) (January 2010)[3], which has been updated with subsequent measures, particularly those approved in May 2010, and on the initial macroeconomic assumptions. In particular, developments on the revenue side, since no modifications to the main taxes have been announced, depend essentially on the trajectory projected for the relevant macroeconomic variables. As for expenditure, social benefits and, in particular, pensions (the largest item), are projected in accordance with forecasts of demographic changes, inflation and the replacement rate. Unemployment benefits are projected to decrease, which is linked solely to the decline envisaged in the coverage rate associated with the end of

1. It should be remembered that, under normal circumstances, it is usual to assume that fiscal policy is not modified in the projection horizon with the result that only fiscal measures that have already been approved would be taken into account in the projections. This assumption is not suitable in times of fiscal adjustment such as at present because by strictly applying it, bias would be introduced into the macroeconomic projections. **2.** Royal Decree-Law 8/2010 of 20 May 2010, adopting extraordinary budget-deficit-reduction measures.

3. It should be remembered that as a result of the entry into force of the European Semester, the Stability Programme Update will be available at the end of April 2011.

FISCAL FORECASTS

	Growth rate				% of GDP			
	2009	2010	2011	2012	2009	2010	2011	2012
Total revenue	-9.6	3.9	3.9	3.9	34.7	35.7	36.4	36.6
Total expenditure	7.4	-1.0	-3.5	1.4	45.8	45.0	42.5	41.8
Social benefits (a)	12.7	5.5	1.0	0.6	14.5	15.2	15.0	14.6
Of which: unemployment	*53.8*	*4.8*	*-5.8*	*-14.1*	*2.9*	*3.0*	*2.8*	*2.3*
Interest actually paid (b)	8.1	9.0	9.8	15.2	1.8	1.9	2.1	2.3
Compensation of employees	5.7	-0.9	-3.1	-0.7	11.9	11.7	11.1	10.7
Other final consumption expenditure (c)	3.5	-2.4	-3.0	3.7	8.8	8.5	8.1	8.1
Gross fixed capital formation	7.8	-15.0	-19.9	-3.4	4.4	3.7	2.9	2.7
Other transfers and payments, subsidies (d)	3.3	-10.3	-14.2	2.2	4.5	4.0	3.4	3.4
Net lending (+)/net borrowing (-)	-	-	-	-	-11.1	-9.2	-6.2	-5.2
Memorandum item:								
Government consumption (e)	4.9	-0.9	-3.0	1.0	21.1	20.8	19.8	19.3

SOURCES: Intervención General de la Administración del Estado and Banco de España.

a. Social benefits other than transfers in kind.
b. According to the EDP.
c. Intermediate consumption (P.2) + social transfers in kind purchased on the market (D.6311 + D.63121 + D.63131) + other (D.29 – D.39).
d. Includes other current and capital transfers and payments as well as subsidies.
e. Government consumption: P.3 in ESA 95.

the benefit entitlement period for some of the unemployed. The interest burden on government debt is projected to rise, essentially as a result of an increase in debt volume and rates at issue. Following the nominal fall of 0.9% in government consumption in 2010 and its projected decline of -3% for 2011, it is expected to moderate significantly in 2012, with nominal growth of 1%. To achieve this objective the restrictions on public-sector employment must remain in place and the wage moderation of 2010 and 2011 must be continued. It is assumed that public investment will continue its downward adjustment in 2012, with a projected reduction of 3.4% in nominal terms, following the fall of 15% in 2010 and the decrease of approximately 20% in nominal terms envisaged for 2011. As for the other expenditure items, essentially current and capital transfers, and subsidies, the information provided by the SPU is slightly lagged and, furthermore, the results of the budget outturn for 2010 show deviations from the targets set in the SPU. Consequently, in the absence of additional information on the plans that will affect these items in 2012, it was decided that their weight, as a percentage of the economy's trend GDP, would remain the same.

On the basis of these assumptions, a government deficit of 6.2% is projected for 2011, 3 pp of GDP lower than in 2010, which would essentially be associated with a public spending cut of almost 2.5 pp of GDP. The deviation from the official deficit forecast of 0.2 pp, essentially arises from an economic growth forecast which is 0.5 pp lower than that of the government. A government deficit of 5.2% is projected for 2012, which is higher than the official target of 4.4%. In this case, the differences stem from the spill-over effect of the deviation projected in 2011, from the different macroeconomic scenario and, to a lesser extent, from the assumption of different dynamics in certain expense items, because detailed information on plans to cut spending is still lacking.

Lastly, it should be underlined that, given the magnitude of the fiscal adjustments factored into the macroeconomic and fiscal projections, the latter are highly dependent on the fulfilment of these assumptions. The achievement of the budget targets for 2010 is a step in the right direction, not only in terms of the scale of the adjustment made but also, and especially, since it put an end to the upward trend in certain expense items which have shown a high level of inertia in the past. Nevertheless, it is necessary to point out that the target for spending cuts still to be achieved is considerable and unprecedented in terms of its size and its coverage of all tiers of general government. Therefore, there are risks of deviations, which could be minimised if the budget outturn at all levels of government were strictly controlled and if the measures for 2012 were more clearly detailed. Thus, the SPU to be published in April this year will be crucial as a means of specifying the measures for achieving the budget targets assumed.

that the current projection is unchanged from that made a year ago is the result of various countervailing factors. On the positive side, export markets are expected to behave more favourably. Also, the figures for 2010 were slightly better than projected a year ago. On the other hand, the magnitude of the fiscal consolidation process is proving to be larger than was foreseen in March 2010 and accordingly, so are its short-term effects on activity. In addition, the financial conditions projected in this report are less favourable for private spending, since they include a higher cost of borrowing. Finally, the sharp rise in the price of oil will have a contractionary effect on real income.

National demand is expected to continue to make a negative contribution in 2011. Of the various components of national demand, the two which most directly reflect general government expenditure, i.e. government consumption and other construction, are projected to fall more sharply this year than in 2010. Of the components of private national demand, household consumption is expected to grow by 0.7% in 2011, i.e. 0.5 pp less than 2010. Apart from the base effect underlying this slowdown,[2] the main factors explaining the expected relative weakness of private consumption are the high indebtedness of households and the trend in their disposable income, which in 2011, for the second year running, will decrease in real terms. The recovery of primary income, i.e. compensation of employees, gross operating surplus

2. This slowdown in private consumption is partly due to the relative strength shown by this variable in the first half of the past year. As noted above, that vigour was due to spending decisions being brought forward in response to the rise in VAT rates and to the imminent phasing-out of new car purchase assistance programmes. Given the particularly favourable performance a year ago, the year-on-year rates at the beginning of 2011 will tend to be lower.

PROJECTION OF THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

TABLE 2

Annual rate of change in volume terms and % of GDP

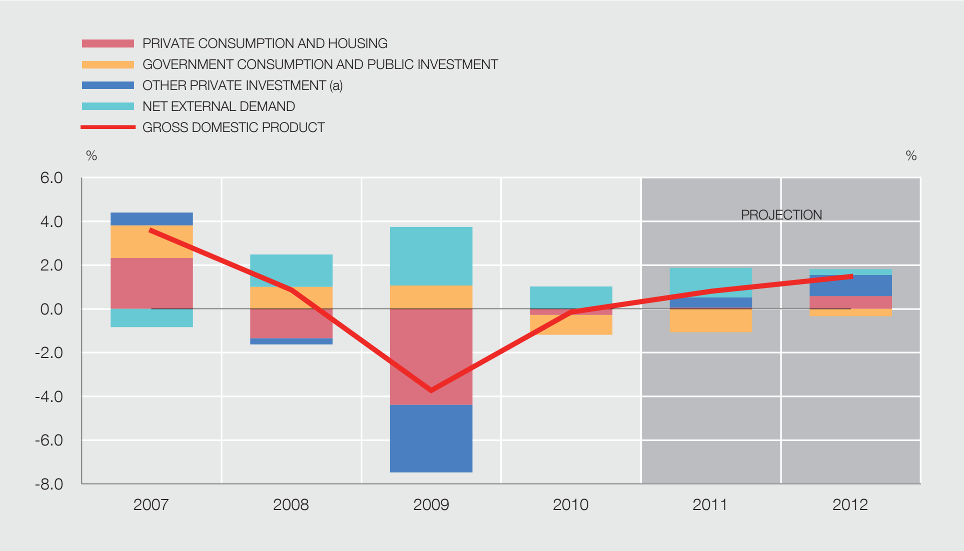
	2007	2008	2009	2010	Projection 2011	Projection 2012	Difference between current and March 2010 projections report 2010	Difference between current and March 2010 projections report 2011
GDP	3.6	0.9	-3.7	-0.1	0.8	1.5	0.2	0.0
Private consumption	3.7	-0.6	-4.2	1.2	0.7	1.0	1.1	-0.3
Government consumption	5.5	5.8	3.2	-0.7	-1.1	-0.9	-1.9	-1.0
Gross fixed capital formation	4.5	-4.8	-16.0	-7.6	-3.1	3.6	2.2	0.4
Investment in capital goods	*10.4*	*-2.5*	*-24.8*	*1.8*	*2.9*	*6.7*	*5.0*	*1.8*
Investment in construction	*3.2*	*-5.9*	*-11.9*	*-11.1*	*-7.5*	*1.3*	*1.6*	*-0.4*
Exports of goods and services	6.7	-1.1	-11.6	10.3	8.0	6.1	5.3	3.2
Imports of goods and services	8.0	-5.3	-17.8	5.4	2.7	4.9	7.0	2.0
National demand (contribution to growth)	4.4	-0.6	-6.4	-1.2	-0.5	1.2	0.8	-0.3
Net external demand (contribution to growth)	-0.8	1.5	2.7	1.0	1.3	0.3	-0.6	0.3
Private consumption deflator	3.3	3.5	0.1	2.8	2.9	1.5	1.7	1.8
Unit labour costs	4.0	4.9	1.0	-1.5	-0.3	1.0	-0.7	-0.7
Compensation per employee	4.8	6.4	4.1	0.7	1.1	1.5	-0.8	-0.3
Apparent labour productivity	0.7	1.4	3.1	2.3	1.4	0.5	-0.1	0.4
Employment (full-time equivalent)	2.8	-0.5	-6.6	-2.4	-0.6	1.0	0.3	-0.3
Unemployment rate (% of labour force)	8.3	11.3	18.0	20.1	20.7	20.4	0.7	1.0
Saving rate of households and NPISHs	10.7	13.4	18.0	13.7	11.2	11.4	-2.9	-4.4
National economy's net lending (+)/net borrowing (-) (% of GDP)	-9.6	-9.2	-5.1	-3.9	-3.7	-3.7	-0.3	-0.8
General government net lending (+)/net borrowing (-) (% of GDP)	1.9	-4.2	-11.1	-9.2	-6.2	-5.2	0.9	2.8

SOURCES: Banco de España and INE.

a. Projection cut-off date: 17.03.2011.
Latest QNA data: 2010 Q4.

CONTRIBUTIONS TO GDP GROWTH

CHART 2

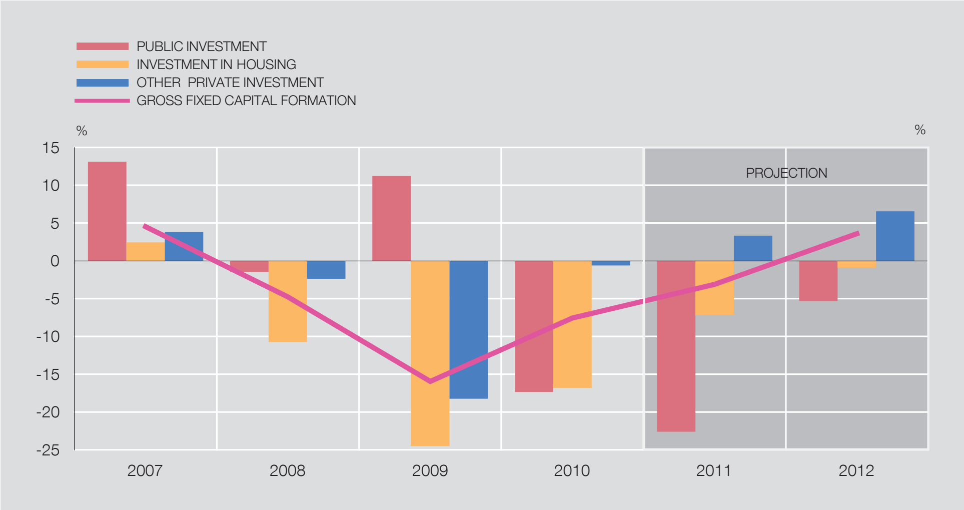


SOURCES: INE and Banco de España.

a. Includes changes in inventories.
Latest data: 2010 Q4.

BREAKDOWN OF INVESTMENT
Rates of change in real terms

CHART 3



SOURCES: INE and Banco de España.

a. Latest data: 2010 Q4.

and mixed income, will not suffice to offset the smaller contribution of general government to household income and the relatively high inflation which will be recorded in the year on average. Moreover, households, in the presence of a decrease in their real income, will try to smooth their consumption pattern by reducing, as in 2010, their saving rate, which will foreseeably stand at around 11%, similar to that before the crisis.

In 2011 residential investment is expected to continue decreasing, although the size of the fall (-7.2%) will foreseeably be nearly 10 pp less than in 2010 (see Chart 3). These estimates are based on the assumption that the number of housing starts will be similar to that observed recently. Given that the negative gap between housing starts and housing completions is expected to continue shrinking during the course of this year, the falls in residential construction will progressively diminish. It is thus expected that the downward adjustment in this demand component will halt around the end of 2011.

Investment in capital goods and other products is projected to show positive rates of growth in 2011 (around 2.5%) following the sharp falls in these variables during the crisis, as a result of which the current investment flows are barely able to cover fixed capital consumption. However, the projected pace of growth is relatively modest compared with the initial phases of other cyclical recoveries. This is because final demand is expected to pick up only very gradually because of the persistence of a certain tightness in credit conditions (as regards both cost and other credit terms) against a background of high indebtedness. In 2011 investment in other construction is projected to undergo a fall very similar to that in housing investment. According to the projection, this behaviour will result from the cut-back in public investment, while the portion of demand for other construction exercised by private economic agents will grow in line with investment in capital goods and other products, thereby cushioning the fall-off in this demand component.

Exports will continue to drive Spanish economic growth in 2011, with a rise of 8%. The envisaged expansion of exports will be based on the strength of world markets, against a backdrop of strong momentum in the emerging economies and of ongoing recovery in the developed economies. Moreover, the gain in price competitiveness in 2010 will permit Spanish exports to expand more quickly than the markets themselves. Import growth will be much more moderate (2.7%) as a result of the weak final demand, so net exports will make a notable contribution to GDP growth.

In 2012 the Spanish economy will, according to the baseline scenario of these projections, grow by 1.5%, against a background of gradually strengthening domestic demand. Household consumer spending will be favoured by the progressive improvement in labour market conditions, a factor which will contribute to higher nominal growth of disposable income, offsetting the negative contribution which general government will continue to make. Moreover, the deceleration in inflation, once the factors temporarily holding it at high levels have eased progressively during the course of 2011, will also help to expand the purchasing power of households, which will step up their saving rates slightly with respect to the previous year. Residential investment will cease to be a drain on economic growth, to which its contribution will be practically zero, once the volume of construction in progress stabilises, while the other components of gross fixed capital formation will tend to pick up as demand strengthens. However, the behaviour of other construction will be less expansionary than that of capital goods and other products, against a background in which public investment will continue its downward adjustment, although somewhat less sharply than in 2010 and 2011. Lastly, the positive contribution from net exports is expected to decline substantially, since exports will slow down as foreign markets lose momentum, while imports will grow more vigorously in line with the rise in final demand.

It is expected that the moderate take-off in activity projected throughout 2011 will start to give rise to positive rates of job creation in the second half, although this will not prevent the average from being negative again in 2011 (specifically, -0.6%), given the strong carryover effect of the 2010 job destruction figures and the unfavourable performance in the opening months of this year. In 2012 it is estimated that job creation will pick up in the economy as a whole and that the pace of productivity growth will moderate. It is important to point out that in the two-year period considered, the behaviour of total employment will be the combined outcome of its gradual strengthening in the private sector and of its reduction in general government. The fiscal adjustment under way includes declines in government employment both in 2011 and in 2012, in light of the objectives of the latest Stability Programme issued in January 2010. By contrast, the private sector will see net generation of employment, which may even quicken if new measures are set in train to adjust job compensation to job productivity and, in general, enable working conditions in the broad sense to be adjusted to the specific needs of firms. The relatively slow recovery in employment under the baseline scenario, along with the small increase in the labour force, will projectedly give rise to a slight increase in the unemployment rate in 2011, raising it to 20.7%. Only in 2012 will the estimated job creation be able to offset the rise in the labour force and begin reducing moderately the unemployment rate, which will remain very high (20.4%) in the absence of additional labour market measures. More energetic action in relation to pending reforms would allow a more rapid decline in unemployment and would create more growth-friendly economic conditions.

The growth rate of compensation per employee in the economy as a whole will foreseeably pick up moderately throughout the projection period to 1.1% in 2011 and 1.5% in 2012. The envisaged rate for the current year masks notable differences between employees in non-market services and those in the market economy. In the first case, the government wage cuts applied since June 2010, which resulted in a fall of 1.8% in compensation per employee last year, will have a similar effect in 2011. In the case of the market economy, it is expected that the wage increase of 1.4% in 2010 will give way to an increase of 2.2% in 2011, a progression which will be a consequence of the higher rates agreed for 2011, in a setting of higher inflation rates early in the year and of payment of the indexation clauses relating to 2010. In 2012 the difference between the growth of compensation per employee in general government and in the private sector of the economy will foreseeably tend to diminish, giving rise to an aggregate rate of 1.6%. These projections suggest that unit labour costs in the market economy may grow again in 2011 and 2012 after two years of adjustment, and, although they will do so moderately, it would be desirable to continue closing the gap which opened in the past decade between their cumulative growth in Spain and in the rest of the euro area.

The assumption of incomplete pass-through of the rise in inflation – mainly due to the increase in oil prices – to the price and cost formation process is a crucial element underlying the macroeconomic projections reported here. Any possible resistance to accepting the temporary loss of real income entailed by adjustment to the shock suffered by workers and firms would lead to more persistent inflationary pressure, worsening external competitiveness and losses in employment and GDP.

The first few months of 2011 have seen high inflation rates, strongly affected by the sharp oil price rises of recent weeks. Thus the growth rate of consumer prices stood at 3.6% in February 2011. The annual average rate for 2011, measured using the private consumption deflator, is projected to be lower at 2.9%, since a gradual slowdown is expected throughout the year as a result of the gradual petering-out of the temporary inflationary effects of rises in indirect taxes such as VAT or tobacco excise duties and of increases in oil and electricity prices. The slowdown in inflation will become more pronounced at the beginning of 2012, giving rise to an average rate of 1.5%, a level much more in accordance with the situation of gradual economic recovery and a significant negative output gap. These projections are affected by changes in the assumptions made about the external environment, particularly oil prices. Thus oil price increases exceeding those assumed in this report (around $112-114 in 2011 and 2012) would give rise to higher temporary inflation rates, provided that those increases did not lead to an upward revision of inflation expectations and did not end up being passed through to other prices and costs.[3]

As noted above, the recovery projected for the Spanish economy will continue to be driven by a positive contribution from external demand, which, furthermore, tends to further reduce the net borrowing of the Spanish economy. However, the higher prices of energy imports and the increase in net interest income paid to the rest of the world will cause the rate of improvement in net exports to slow. Thus the nation's net borrowing, after falling by 4.5 pp of GDP between 2007 and 2009, and further decreasing by 1.2 pp in 2010, will foreseeably scarcely fall in 2011 and 2012. In any event, it seems that the goods and services balance excluding energy will continue to improve substantially from a surplus of 1.1% of GDP in 2010 to surpluses of 2.7% in 2011 and of 3% in 2012. By contrast, the projections are that the energy deficit will rise from 3.3% of GDP in 2010 to stand above 4% in 2011 and 2012, and the income deficit will also increase overall in those two years.

According to the projections, the nation's net borrowing will result from substantial cuts in the budget deficit, which will be offset by a lower, although still comfortably positive, household borrowing capacity and by an increase in firms' net borrowing following the sharp adjustment of recent years. In the last few quarters, the funds raised by households and firms have grown only very moderately, the near stagnation of the outstanding credit balance at the end of 2010 being compatible with very slight decreases in lending to households for consumer goods

3. It is estimated that a 10% rise in oil prices has an impact of around 0.25 pp on the CPI in the first year, most of which results from the direct effect of that rise on the fuel prices included in the index basket.

purchases and in lending by resident banks to firms. It is difficult to discern the relative weight of the various factors underlying this process of credit stagnation, since the very sluggishness of activity and of demand and the tighter credit conditions in certain periods on the international markets must have played a role in the process. All considered, the significant slowdown in household and firm income in this phase of the cycle has meant that debt ratios have still only fallen by a small amount. In this respect, the moderate expansion in household and firm spending included in these projections will be consistent with a continuation of the process of deleverage in the private sector, which is necessary for the economy to get back on a sound growth path.

General government ended 2010 with a deficit of 9.2% of GDP, 0.1 pp better than projected and nearly 2 pp below the 2009 deficit, which demonstrates that the containment measures passed in the 2010 budget and, above all, the adjustment package adopted in May last year have been effective in reversing the upward course of the budget deficit. However, the degree of consolidation has differed across the various government sectors, with a decrease of 4.4 pp of GDP in the central government deficit, but an increase of 1.4 pp in regional (autonomous) government and a decrease of 1 pp in the Social Security balance, while the local government deficit widened by 0.1 pp to 0.6% of GDP. The fiscal projections based on the assumptions spelled out in the accompanying box are for the deficit to decrease by 3 pp of GDP in 2011 to 6.2% of GDP and for it to decrease by a further 1 pp in 2002 to 5.2%. Although in these projections it is estimated that activity will progressively take on a certain dynamism, this recovery is smaller than that according to the official projections. Here lies the main source of discrepancy between these projections of deficit and the official ones (which are for 6% of GDP in 2011 and 4.4% in 2012).

Risks to the projections

The projections presented in this report point to a gradual recovery in activity in 2011 and 2012, which is the result of a gradual improvement in private-sector expenditure plans, in particular, in investment plans, a positive contribution from external demand and a decline in government consumption and investment demand. Growth will again be positive in 2011 as a whole, while in 2012 the rate of expansion of the economy will gradually approach its long-term potential growth rate, although the output gap will continue to be negative.

The recent crisis has many sides to it, with a wide variety of factors involved which may be either financial or fiscal, or either global or tied up with European governance or country-specific idiosyncrasies. This means that the usual dose of uncertainty surrounding any projection is extremely high here, especially if the Spanish economy's particular sensitivity to some of those factors is taken into account.

The risks to activity are numerous and, although factors acting in both directions can be identified, taken as a whole, they are probably tilted towards the downside. Notable among the downside risks is the possibility of an even sharper process of energy price rises. This would have a proportionally greater effect on countries which, like Spain, are more dependent on oil imports and could jeopardise the recovery of the world economy and of our export markets, which are a basic component in the projected strengthening of activity. The maintenance of a certain expansion in private consumption in 2011, despite the decline in household income in real terms, also suggests certain downside risks, which would give rise to a less significant decrease in the saving rate, following that seen in 2010. It should also be taken into account that, according to these projections, wages and margins will react moderately to the temporary rise in inflation, so, if that reaction were sharper than expected, the recovery of price competitiveness might be interrupted, with negative consequences for activity and agents' confidence and, consequently, for economic recovery. Lastly, the sovereign debt markets of some countries might become more unstable and, given the observed virulence of contagion effects, this might affect the risk premia of Spanish debt and the availability of external financing, which would in turn mean that the conditions of access to domestic credit would tighten for households and firms. As regards upside risks, it is possible that the progress in fiscal consolidation and in the structural reforms and the gradual recovery in activity may progressively restore confidence in the Spanish economy and dissipate debt market tensions. In that case, the risk premia would decrease, boosting financial flows with the rest of the world and giving way to a virtuous circle in which lower borrowing costs would help us to tackle the fiscal and external deficit and would stimulate private investment.

With regard to inflation, the risks are predominantly upside. In addition to the risk of further oil price rises, there is the aforementioned possibility that second-round price and wage effects will be stronger than projected. In this respect, the information on collective bargaining agreements relating to the opening months of 2011 gives cause for concern, since it shows a wage reaction to the temporary upturn in inflation rates, as a result of multi-year agreements. As regards downside risks, mention should be made of the deflationary pressure resulting from the general sluggishness of demand. The way in which this deflationary pressure manifests itself is that the year-on-year change in prices presently being observed is small once the direct impact of energy and of tax rises is deducted. For that price moderation to be maintained, it will be essential to make collective bargaining mechanisms more flexible so that working and wage conditions can be adapted to the specific circumstances of firms.

23.3.2011.