

SPANISH ECONOMIC PROJECTIONS REPORT

Summary

This report analyses the situation of and outlook for the Spanish economy. It has been prepared by the Directorate General Economics, Statistics and Research of the Banco de España, taking into account the information available to 13 March. The projections are against a background of great uncertainty, as they are made amid a serious financial and economic crisis worldwide, whose adverse consequences are difficult to determine. The projection time span covers the years 2009 and 2010.

The year 2008 saw a severe deterioration in Spanish economic activity which, though it had started earlier, gathered considerable momentum during the year. Indeed, following 14 uninterrupted years of expanding output, the Spanish economy posted two quarters of negative growth in the second half of 2008, against a much worse international backdrop, moving into a marked recessionary phase. Nonetheless, the growth rate for the year as a whole was still positive (1.2%), chiefly as a result of the contribution of net external demand to the GDP growth rate (at 1 pp), while national demand slowed substantially, with average growth flattening in 2008 after having increased by more than 4% in 2007.

The forecasts available for the main economies, made by various agencies and institutions, point to a significant contraction in activity in 2009 that would lead to a decline in world output for the first time in several decades. The projections in this report also point to a deepening in 2009 of the current recession in Spain, meaning activity would fall by 3% this year, with an incipient recovery in output in late 2010, although over that year as a whole growth would still be negative (-1%). The projections for 2009 suggest a continuation of the contractionary trends perceptible in the main indicators of national demand, with a strong deterioration in both household and corporate spending decisions (on consumption and housing, and in the form of productive investment, respectively). Exports will also be dented by the decline in international markets, although the fall-off in imports – which will foreseeably be greater – will mean that, in net terms, the contribution of the external sector to growth will improve.

The deterioration in agents' confidence accompanying the bleaker economic outlook, the diminished value of financial and real estate wealth, the financial constraints in place and the severe contraction in global trade and in activity in the main industrialised countries are the key factors behind the decline in demand. This outlook has been affecting activity with particular intensity in the closing months of 2008 and early 2009, but its effects will foreseeably abate and be progressively offset by the impact of the fiscal and monetary policy stimuli introduced in many countries, Spain among them. These projections reside on the assumption that, following the heightening of the financial crisis in the closing months of 2008, the planned support to the financial system internationally will progressively stabilise the situation, whereby the degree of credit constraint will be alleviated. The reduction in inflation will also contribute to improving agents' real income and, if the economic climate becomes less pessimistic, to boosting spending.

The most acute phase of the adjustment is expected to be behind by 2010. In fact, part of the decline in activity projected for 2010 is in response to the drag exerted by the negative rates estimated for the current year, since it is foreseen that output will stabilise and even begin to grow again (albeit at a very modest rate) in the second half of next year. National demand will still be running at a negative rate, though more moderately so, and, within this aggregate, private consumption is expected to show small increases once again. During 2010, moreover,

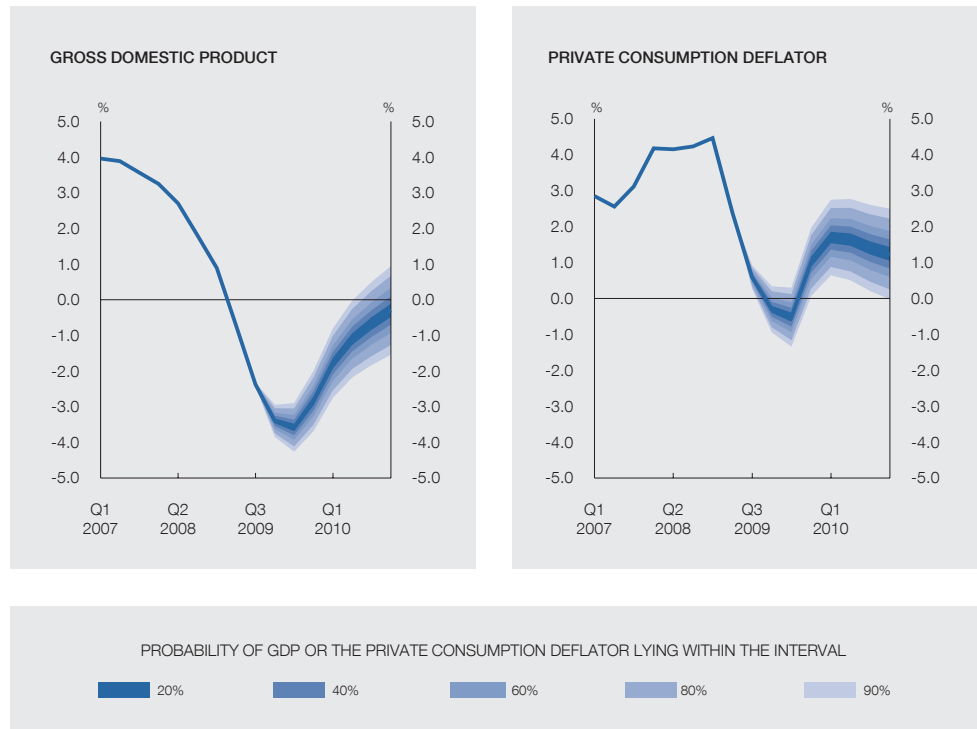
the improvement in the international economic climate, which is an assumption common to the projections of the various agencies and institutions, should boost exports.

In the case of inflation, the outlook has changed considerably since mid-2008. For 2008, the CPI averaged 4.1%, peaking at 5.3% in July, the result of the sharp rise in oil and other commodity prices. Since last summer, when the worsening of the international crisis drastically altered the global outlook, the rising trend of the prices of these products swiftly reversed, giving rise to continuous falls in the inflation rate, which ended the year at 1.4%. In recent months, lower commodity prices have combined with the impact of weakening demand, whereby the inflation rate has dropped further. On average in 2009, the private consumption deflator is forecast to stand at only 0.2%. In 2010, the inflation rate should rise again once the strong baseline effects recorded in 2009 have disappeared, although it is estimated that it will stabilise at a fairly moderate rate of around 1.5%.

In any event, the marked sluggishness of domestic demand and, to a lesser extent, of economic activity forecast for the projection horizon will contribute to correcting some of the imbalances built up in the Spanish economy in recent years. That should draw the inflation rate closer to euro area levels, reducing the nation's net borrowing and cutting the private-sector debt ratios reached after many years' sharp growth in the credit granted to households and firms.

The degree of uncertainty that accompanies macroeconomic projections is, on this occasion, exceptionally high. The strong deterioration in economic prospects in recent months, the fact the current recession is across the board globally and the persistence of the international financial crisis, along with the equally forceful economic policy response, mean that powerful sources of uncertainty are simultaneously at play and will all affect a macroeconomic projection exercise performed at a time such as the present. One habitual means of representing this uncertainty is to calculate the forecasting errors made in the past and, on this basis, to show the bands around which each macroeconomic variable might trend to some degree of likelihood. This is the approach used to show the uncertainty surrounding the growth and inflation projections (see Chart 1). However, as it is based on past forecasting errors, this approach tends to understate the current degree of uncertainty, which is much higher than that prevailing in recent years which was taken as the basis for calculating these errors.

The substantial downward revision of the growth projections entails, among other things, acknowledgement of the fact that the downside risks identified in recent quarters have been progressively materialising. In the new scenario the projections cover there are, however, both downside and upside risks. These are probably balanced over the period, since although in the short run the risks of deviation are more biased downwards, in the medium term the likelihood of upside risks may prevail. On one hand, among the downside risks, it cannot be ruled out that the global recession will deepen, meaning that export markets will decline more sharply in 2009 and that their recovery in 2010 will be more muted. Likewise, financial instability may prove protracted, especially if the decline in activity were to have a feedback effect, exacerbating credit institutions' financial problems. The decline in the value of household financial and real estate wealth might also be more substantial than implied by these projections, depressing household demand. But, on the other, among the possibilities of upside risks, it should be stressed that the projections set out here are consistent with a strong increase in the household saving ratio in 2009 and 2010 which, were it somewhat lower, would entail a lesser negative contribution of private consumption to growth. Further, the extraordinary measures adopted by governments and central banks worldwide might also have a sharper or swifter impact in terms of resuming positive growth rates, both globally and in Spain, where the sensitivity of the household and corporate financial burden to interest rates is very high.



SOURCES: INE and Banco de España.

NOTE: 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. It must be emphasised that current uncertainty is considerably higher than in the past.

Latest data: 2008 Q4.

In the case of inflation, the risks surrounding these projections also seem balanced. The weakness of spending has been considered a key factor in the deceleration of prices that had shown greater downward stickiness in the past, such as in services, while some easing in wages, in unit labour costs and in business margins is assumed. A stronger or more prolonged decline in activity, or a greater fall in commodity prices, might make these movements somewhat sharper, although it cannot be ruled out that the Spanish economy will retain some of the rigidity in price and cost formation that it has shown in the past.

In sum, the Spanish economy has undergone a very severe adjustment in the past year and the economic situation in 2009 and 2010 looks complicated, set against a deep recession which will foreseeably make way for an incipient resumption of growth in the final stretch of the projection horizon. The overcoming of the international crisis will play a fundamental role in setting the pace for the recovery. The correction of the imbalances induced by the strong adjustment in demand and activity will help restore growth conditions, but economic policy has a pivotal role to play in limiting the high costs that this adjustment is already prompting. The strong decline in spending justifies the use of demand-stimulating policies. Monetary policy in the euro area has adopted an openly expansionary stance that will have significant spending-stimulating effects. These will be progressively discernible as interest rate cuts feed through and the plans for the restructuring of the international financial system provide some relief from the tendency of credit to contract, with the foreseeable fall in inflation also contributing. Budgetary policy, too, has been used expansively in recent months, reinforcing the already substantial role of the automatic stabilisers. However, the room for manoeuvre available is limited, given the rapid increase in the budget deficit as a result of the high sensitivity of public revenue

to certain features of the Spanish economy cycle and of the increase in public spending that the crisis and the measures adopted to combat it entail. In this respect, it should be borne in mind that the high budget deficits projected for 2009 and 2010, above 8% of GDP in both cases, are based on the assumption that no discretionary measures additional to those already approved will be adopted. In any event, the rapid deterioration in the budget deficit and public debt figures are highly illustrative of the importance of adopting budgetary consolidation plans that allow public finances to be guided onto a path of stability once positive growth in activity resumes. Beyond the use of demand-side policies, the intensity of the recovery and the Spanish economy's capacity for long-term growth will depend above all on the necessary structural adjustments being made to promote enhanced productivity in the long run and a change in direction in productive investment. In particular, given the highly negative projection made for the labour market, with the unemployment rate rising most substantially in 2009 and 2010 in the absence of measures, headway in reforms geared to containing the intensity and persistence of the employment adjustment acquires particular importance. In this connection, mechanisms must be set in place to help ensure that the adjustments are made to a greater extent through wages and employment conditions, and not through job destruction.

The section following this summary explicitly sets out the external assumptions underlying the projections given in this report. Section 3 makes a detailed diagnosis of the outlook for the Spanish economy, and the final section analyses the main risks to the central scenario described.

External assumptions underlying the projections

The projections prepared by the Banco de España are based on a set of assumptions about the path of the main exogenous conditioning factors of the Spanish economy's activity, price and cost variables.

Exchange-rate, interest-rate and oil-price projections are based on the respective markets as at the time immediately before the projections were prepared.¹ It is assumed that the euro exchange rate will remain constant at its current value on the spot market in the reference period. In terms of the bilateral euro/dollar exchange rate, this means that the average value of the euro will depreciate by 14% in 2009 compared with the average for 2008 (see Table 1). The short-term interest rate path (measured by the three-month EURIBOR) is obtained from the expectations implicit in futures markets. On this information, the short-term interest rate is expected to average 1.7% in 2009, almost 3 pp less than in 2008, and 2% in 2010. The long-term interest rate path, which is approximated through market expectations about ten-year public debt yields, is quite stable: 4.3% in 2009 and 4.7% in 2010. Oil prices are expected to stand at US\$46 and US\$51 on average in 2009 and 2010, respectively, according to futures markets' expectations for this commodity in the reference period, making for a decline of more than 50% in 2009 relative to the previous year. As to house prices, negative rates of change are expected in 2009 and 2010, extending the recently observed path of decline.

As regards credit conditions, it is assumed that the spreads on market interest rates applied to loans will hold at similar levels to those observed in the most recent period and that the tightening of credit standards will continue, albeit at a lesser pace, easing progressively over the course of the projection horizon. However, the difficulties of incorporating the effects of financial restrictions into a projection exercise should be acknowledged, as their impact on agents' spending is subject to great uncertainty.

¹. To avoid distortions from volatility on any specific day, average values from a reference period prior to the cut-off date for information were adopted (namely, the two preceding weeks). The calculation of these external assumptions is in line with the procedures usually applied in Eurosystem projection exercises.

Annual rates of change, unless otherwise indicated

	2003	2004	2005	2006	2007	2008	Projection	
							2009	2010
International environment								
World output	4.0	5.3	5.3	4.9	4.7	3.2	-0.6	2.1
Global markets	5.2	10.8	7.9	9.2	6.5	3.7	-6.5	1.8
Spain's export markets (a)	3.8	8.2	6.5	8.1	6.1	3.4	-4.6	1.2
Oil price in dollars (amount)	28.9	38.3	54.4	65.4	72.7	98.0	46.5	50.9
Competitors' export prices in euro (b)	-5.6	-0.5	3.5	3.1	0.2	2.3	0.7	0.6
Monetary and financial conditions								
Dollar/euro exchange rate (amount)	1.13	1.24	1.24	1.26	1.37	1.47	1.27	1.27
Short-term interest rate (3-month EURIBOR)	2.3	2.1	2.2	3.1	4.3	4.6	1.7	2.0
Long-term interest rate (10-year bond yield)	4.1	4.1	3.4	3.8	4.3	4.4	4.3	4.7

SOURCES: Banco de España and ECB.

(*) Projection cut-off date: 13/03/09.

a. Weighted according to their share in Spain's exports.

b. Weighted according to their share in Spain's exports, adjusted for the effect of third markets.

Turning to the international environment, future developments in euro area foreign trade variables match those included in the Eurosystem macroeconomic projections presented in the March 2009 edition of the ECB Monthly Bulletin. World output is expected to contract in 2009, linked above all to the weakness in the industrialised countries, while it is estimated that the emerging countries will retain rates of expansion that are positive but far lower than those posted in recent years. The global recession is leading to a decline in Spanish export markets, which are expected to decline by 4.6% in 2009, 10 pp down on the estimate a year earlier. A modest recovery is expected in foreign markets in 2010, with an increase of 1.2%.

Finally, it should be stressed that these projections include the effects of the various budgetary measures approved in Spain in recent months, and which affect various items of public revenue (such as VAT, personal income tax and corporate income tax) and expenditure (public investment and unemployment benefits). By contrast, the effects of possible budgetary or other measures which may be adopted in future have not been considered.

Outlook for the Spanish economy

GDP growth stood at 1.2% in 2008, 1.2 pp less than projected in the March 2008 report, as a result of a more unfavourable performance of practically all the national demand components, except government consumption (see Table 2). Exports also performed worse than projected a year ago, although the sharp downward adjustment in imports meant that the positive contribution of net external demand (1 pp) was higher than foreseen.

In the first half of 2008, activity was still posting quarter-on-quarter growth rates that were positive, though more modest than those marking the strong expansion in output in the preceding years. The negative trend of household wealth, with falls in share prices and an ongoing slowdown in house prices, coupled with the start of the process of job destruction and a rising unemployment rate, began to impact household spending decisions, dampening consumption and depressing residential investment. Investment in equipment also showed signs of greater slackness, while exports held on a still-favourable trend. In the second half of 2008 the international and financial environment deteriorated severely, particularly with the heightening of the banking crisis in the United States and the spread of

Annual rate of change in volume terms and as a % of GDP

	2003	2004	2005	2006	2007	2008	Projection	
							2009	2010
GDP	3.1	3.3	3.6	3.9	3.7	1.2	-3.0	-1.0
Private consumption	2.9	4.2	4.2	3.9	3.5	0.1	-3.1	-0.4
Government consumption	4.8	6.3	5.5	4.6	4.9	5.3	3.5	2.1
Gross capital formation	5.9	5.1	7.0	7.1	5.3	-3.0	-15.1	-10.3
<i>Investment in capital goods</i>	4.1	5.1	9.2	10.2	10.0	-1.1	-24.3	-12.6
<i>Investment in construction</i>	6.2	5.4	6.1	5.9	3.8	-5.3	-12.9	-11.6
Exports of goods and services	3.7	4.2	2.5	6.7	4.9	0.7	-8.9	2.9
Imports of goods and services	6.2	9.6	7.7	10.3	6.2	-2.5	-15.1	-2.6
National demand (contribution to growth)	3.9	4.9	5.3	5.3	4.4	0.1	-5.6	-2.4
Net external demand (contribution to growth)	-0.8	-1.7	-1.7	-1.5	-0.8	1.0	2.5	1.4
Private consumption deflator	3.1	3.6	3.4	3.4	3.2	3.8	0.2	1.5
Unit labour costs	2.9	2.4	3.3	3.2	2.9	3.4	0.8	1.5
Compensation per employee	3.6	3.0	3.7	3.9	3.7	5.3	3.1	2.7
Apparent labour productivity	0.7	0.6	0.4	0.7	0.8	1.8	2.3	1.2
Employment (equivalent jobs)	2.4	2.7	3.2	3.2	2.9	-0.6	-5.2	-2.1
Unemployment rate (% of labour force)	11.1	10.6	9.2	8.5	8.3	11.3	17.1	19.4
Household saving rate and NPISHs	12.0	11.3	11.3	11.2	10.2	12.9	16.2	16.6
Nation's net lending (+) / net borrowing (-) (% of GDP)	-2.9	-4.8	-6.5	-8.4	-9.7	-9.1	-5.3	-4.4
General government net lending (+) / net borrowing (-) (% of GDP)	-0.2	-0.4	1.0	2.0	2.2	-3.8	-8.3	-8.7

SOURCES: Banco de España and INE.

(*) Projection cut-off date: 13/03/09.

Latest QNA data: 2008 Q4.

these tensions to the rest of the world. In Spain's case, these trends triggered a sharper adjustment in consumption and in investment, while the rapid contraction in the main world economies led to a substantial reduction in trade and in exports in the closing months of the year. The reflection of this was a decline in confidence levels to historical lows and a more restrictive stance by banks in their credit supply policies, which led the Spanish economy to experience a decline in activity in the second half of the year. The effects of these developments were clearly visible in household spending decisions, since although household disposable income increased fairly sharply in 2008 (by above 3%), due among other reasons to the fiscal impulse, consumption stagnated at 2007 levels, meaning that the household saving ratio rose significantly.

The recessionary trend observed in the past two quarters is projected to continue in 2009, whereby GDP is expected to fall by 3% over the course of the year, 5 pp down on the March 2008 projection. Such a substantial revision offers some idea of the abrupt turnaround in the world and Spanish economies in the past year. Although the start of the financial turmoil dates back to the summer of 2007, the outlook in early 2008 was for a gradual absorption of the effects of these tensions, with a limited impact on economies. However, events in recent months have given rise to a new phase of instability, which has turned into a severe banking and financial crisis, leading the world economy into a generalised recession. In Spain these effects have superimposed themselves on the adjustment already under way in the economy, especially in the real estate sector, making for a sharper contraction in the macroeconomic variables that had already begun to moderate and spreading the decline to other variables more sensitive to financial conditions and to the situation of the world economy. The abrupt change in economic projections in the past year in Spain and in other areas of the world is described in detail in Box 1.

The macroeconomic projections made during the past year for the various economies in the world have undergone continual and substantial downward revisions in step with the ongoing exacerbation of the financial crisis and extension of the recession to different areas and markets. The projections report on the Spanish economy published by the Banco de España on 1 April 2008 also anticipated an expansion of GDP in the past year notably higher than actually occurred and, in addition, contained a much more favourable projection for 2009. Specifically, instead of the output expansion of 2.4% forecast for 2008, the year finally ended with a growth rate of 1.2%, according to the latest estimates of the Spanish National Statistics Institute. For the current year, the growth rate of 2.1% projected a year ago is 5 pp more than the present forecast. The large scale of this revision illustrates the considerable worsening of the outlook for the Spanish economy in the time elapsed since the publication of the previous projections report.

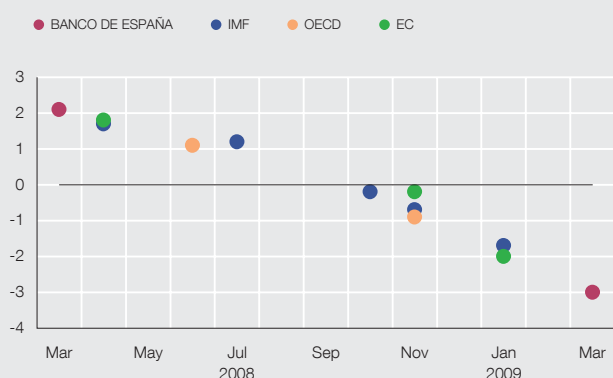
This deterioration is also manifest in the successive downward revisions of the forecasts of Spain's 2009 GDP growth by the major international institutions. The left-hand panel sets out the forecasts of this variable made in the past year by the European Commission, the International Monetary Fund and the OECD for 2009, along with the Banco de España's March 2008 and March 2009 projections. The change in the outlook since March last year is essentially due to two factors: the negative effects on economic agents' confidence

and on their ability to finance their spending decisions, derived from the persistence of the international financial crisis; and the impact of that crisis on the world economy. This outlook worsened more quickly following the collapse of Lehman Brothers in September 2008, a circumstance which explains why, although the downward revisions of the Spanish economy's growth projections have been continual over the last 12 months, they became more pronounced from October.

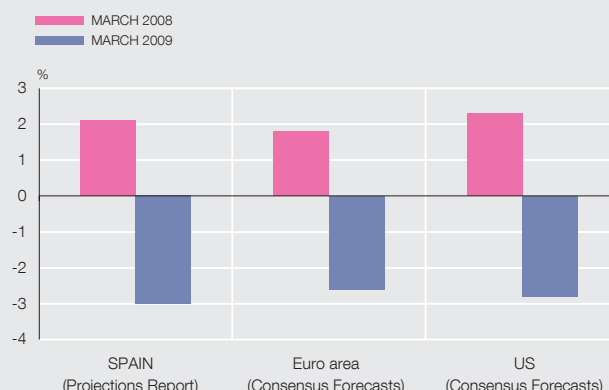
Moreover, as earlier mentioned, the effects of the financial and economic crisis have been global and have sharply affected all the world's economies. Hence, as in Spain, these have all seen their output growth forecasts revised substantially downwards by the various institutions. As an example, the right-hand panel compares the projection of Spain's 2009 GDP growth in this report with that published a year ago and with the forecasts released around that time for the euro area and the United States included in *Consensus Forecasts*, a publication which regularly collects the forecasts of diverse institutions and analysts for the world economy. As can be seen, on average the Banco de España's downward revision of the 2009 growth rate is not very different from the changes in analysts' forecasts for the euro area and for the United States in the past year. The considerable extent of these revisions to 2009 growth projections by institutions for the various economies underscores the unusually large size of the shock to world activity in 2008.

GDP GROWTH IN 2009

Projections for Spain made by various institutions (a)

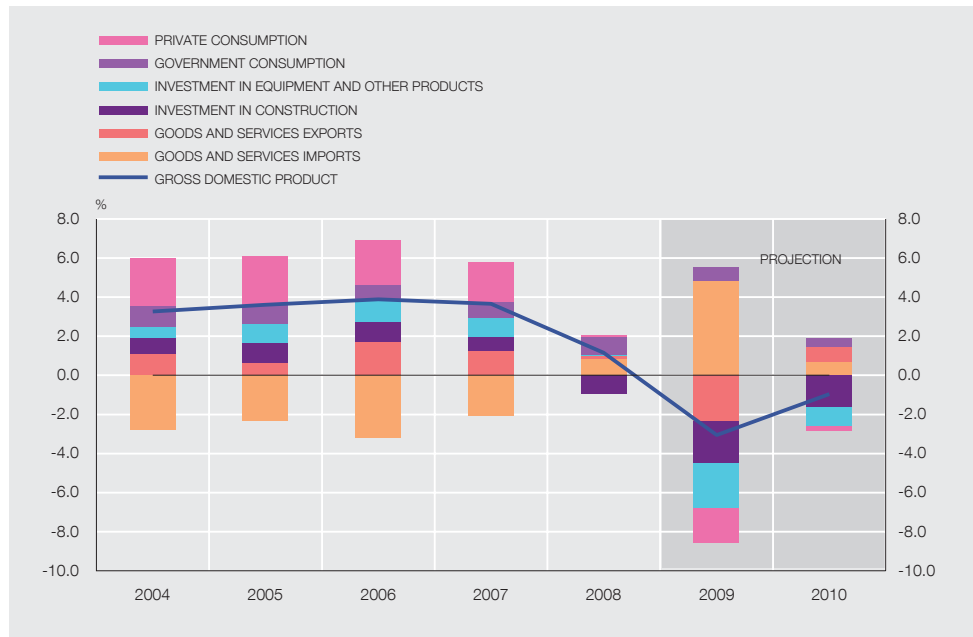


Projections for the various geographical areas



SOURCES: Banco de España, IMF, OECD and European Commission.

a. The x-axis shows when each projection was made.



SOURCES: INE and Banco de España.

Latest data: 2008 Q4.

The fall in GDP in 2009 is based on the decline of all the components of national demand, except government consumption, with an impact on growth that is expected to be only partly cushioned by the improved contribution of the external sector to output, owing to the strong adjustment in the level of imports, which would offset the adverse effect of the substantial decline in world trade on Spanish exports (see Chart 2). Private consumption is estimated to decline by 3% in 2009 despite the slight increase projected in real disposable income. This increase is based on general government continuing to contribute positively to agents' income through higher benefits and lower taxes; on lower net interest payments, due to the fall in short-term interest rates; and on lower inflation, which will stand at around 0.2% for the year on average, thereby contributing favourably to upholding purchasing power. Against this background, the decline in consumption in 2009 is reflected, as was the case last year, in a pronounced increase in the household saving ratio to over 16%, which is a symptom of various factors: the high degree of uncertainty surrounding household decisions; the diminished value of their wealth; the need to reduce the debt built up in recent years; and, in sum, their caution in respect of spending decisions in the near future.

Residential investment will also fall substantially in 2009, posting a decline of over 20%, insofar as supply is adjusting rapidly to the fall-off in demand and to the surplus capacity in the sector (see Chart 3). Total investment in construction – comprising investment by companies and civil engineering works – will fall on a lesser scale, owing to the positive effect of the State Local Investment Fund to be set in train in the second quarter of the current year. On our estimates, the Fund could exert a positive effect of the order of 0.3 pp of GDP growth on average in 2009 and 2010. The sharpest contraction is expected to be in investment in capital goods, since the reduction of national and external demand, and the great uncertainty over the economic outlook, will depress the start-up of new investment projects.

For 2010 it is estimated that activity will continue falling, albeit at a more modest rate of 1%. This projection – which assumes that the cyclical trough will be in 2009 – is based on the ex-

BREAKDOWN OF INVESTMENT
Rates of change in real terms

CHART 3



SOURCES: INE and Banco de España.

Latest data: 2008 Q4.

pected pick-up in the external environment, with world growth somewhat above 2%, and on a gradual absorption of the most acute effects of the financial crisis. Actually, much of the decline in output projected for 2010 is in response to the drag entailed by the negative rates of the current year, since it is estimated that in the second half of next year activity will stabilise, and even begin to grow again. National demand is expected to continue shrinking this year, albeit at a lower rate, while exports should rise with the help of the recovery in world trade. Net external demand is expected to continue making a positive contribution to GDP growth, albeit one lower than that in 2009.

The decline in activity will lead to a significant reduction in employment, which is estimated to fall by 5.2% in 2009 and by 2.1% in 2010, placing the unemployment rate at 17% in 2009 and above 19% next year, if no measures are taken. The rising trend of apparent labour productivity that began in 2008, and which is linked to the rapid adjustment in labour, especially in construction, is projected to continue in 2009, up to a rate of 2.3% (against 1.8% in 2008). This rate should, however, moderate to 1.2% in 2010 once the bulk of job destruction in construction has taken place. It is estimated that the growth of economy-wide employee compensation will fall considerably in 2009 as a consequence, above all, of the lesser impact of indexation clauses, caused by the low inflation rates observed in late 2008. That said, employee compensation would still reflect a relatively high rate of around 3%, relatively inconsistent with the decline in activity and with the stagnation of consumer prices. A further fall in the increase in this variable, to 2.7%, is projected in 2010, signalling the modest impact of sluggish output on wage negotiations. In any event it should also be underscored that, in connection with employee compensation, wage developments in the private sector may show greater sensitivity to cyclical conditions than remuneration in the public sector.

The substantial decline in inflation projected for 2009 (to 0.2%, against 3.8% in 2008), measured by the private consumption deflator, is due above all to the strong fall in oil and other commodity prices in recent months, which is in contrast to the escalation seen in these prices up to summer last year. But it also reflects, in part, the easing off in prices prompted by the weakness of demand, and which is discernible in the reduction in the year-on-year rates of

services and industrial goods prices. The baseline effects of oil and other commodity prices will be stripped out in 2010, entailing a rise in the annual inflation rate, although the slackness of demand should be conducive to the growth of the private consumption deflator holding at a moderate level of around 1.5%.

This recessionary scenario will see a reduction of some of the imbalances that the Spanish economy had built up during its previous long upturn. In particular, the contraction in private expenditure in 2009 and 2010 will lead to a reduction in this sector's indebtedness and in the nation's net borrowing. Net borrowing might fall by almost 4 pp of GDP in 2009 and by a further percentage point in 2010, dipping from above 9% of GDP in 2008 to 4.4% of GDP in 2010. The goods and services deficit is expected to be cut substantially in these two years, whereby the bulk of net borrowing at the end of the projection horizon would be determined by net interest payments (so-called *investment income*), which are in response to the sharp accumulation of net external liabilities arising from the high deficits recorded in recent years.

From the standpoint of sectoral net indebtedness, the improvement in the nation's net borrowing would be the outcome of the adjustment in spending by households and non-financial corporations, while it is estimated that the budget deficit will increase notably. In recent quarters, financing raised by households and firms has moved on a strongly decelerating path, which has been steeper in the case of companies in the construction and real estate development sectors, while lending to manufacturing and services companies was still advancing with some momentum in late 2008. This has largely been due to cyclical factors that have borne both on the demand for and the supply of funds, although other factors more directly linked to the international financial crisis have also had an influence. Such factors have been the greater difficulties in obtaining resources on the international markets to which Spanish companies had resorted to finance part of their activity, and market pressures to raise capital ratios.

The need to adjust the level of household and corporate debt, together with the macroeconomic weakness projected for the coming two years, suggests that the growth rate of financing raised by these sectors may continue to fall. That would lead to some decline in the aggregate debt ratios which, along with the expected cut in the average cost of outstanding debt, would see the associated financial burden fall off, favourably affecting the disposable income of these agents. This process will help redress the household and corporate financial position, providing for an expansion in spending in the medium term on more robust bases. Nonetheless, these developments could prove compatible with an increase in the degree of financial pressure on specific segments and, in particular, on those with a higher volume of borrowed funds and that are more affected by the economic recession. Further, household net wealth, which had fallen last year as a result of the unfavourable course of the value of financial and real estate assets, might continue declining in the light of the assumed fall in house prices incorporated into the macroeconomic projections, generating a negative wealth effect on consumption and investment in property.

The general government sector posted a deficit of 3.8% of GDP at the close of 2008, 6 pp worse than the previous year, and substantially greater than initially projected. The scale of the increase gives some idea of the strong impact the recession has had on public finances via the operation of the automatic stabilisers, although it is also the consequence of the various discretionary measures adopted to soften the effects of the crisis on demand and of the sharp drop in revenue which had a substantial transitory component, linked above all to the property boom. In 2009 a significant increase in the deficit is again projected, to over 8% of GDP, which is due to the adverse macroeconomic setting and to the expansionary measures approved to date. The higher deficit is expected to be the outcome, above all, of the rise in

public spending as a percentage of GDP, increasing the funds assigned to unemployment benefits, investment and government consumption, against a background of declining GDP in nominal terms. The fiscal impulse indicators – which attempt to characterise the budgetary policy situation in relation to the economy's cyclical position – point to an expansionary stance in 2009. The deficit is expected to increase further in 2010. Finally, it is estimated the public debt ratio will stand at around 50% in 2009 and 60% in 2010. It should be recalled that this most substantial deterioration in public finances is based on the assumption that no new expansionary measures are adopted, which highlights the scant room for manoeuvre available to continue using budgetary policy as an instrument to boost demand and the importance of the budgetary consolidation plans to resume a path of stability in the medium term.

Risks to the projections

The projections presented in this report describe a sharp fall in GDP in 2009 and, to a somewhat lesser extent, in 2010, based on a contraction in national demand which is only softened by the improved contribution of external demand to economic growth. The year 2008 clearly marked the Spanish economy's entry into an adjustment phase which, in a critical financial and international setting, has resulted in a severe recession. Over the course of 2009 it is projected that agents will continue revising their consumption and investment spending decisions downwards and that the rate of increase of their debt will continue to ease, whereby national demand will decline at a sharp rate of over 5%. The strong adjustment already incorporated in 2009 and the ambitious demand-boosting economic policy measures adopted nationally and internationally mean that a very tenuous recovery may be projected for 2010, although over the year as a whole the growth rate would still be negative.

As discussed in Section 1, whether these projections actually materialise is subject to an exceptionally high degree of uncertainty. In the case of activity, many of the risks identified in the past have materialised, and have duly been incorporated into the central scenario projections. Looking ahead, the risks surrounding the current exercise are possibly more balanced than in the past, with a prevalence of downside risks in the more immediate terms and a greater probability of upside deviations at the end of the projection period. Undoubtedly, global economic activity – in the industrialised and emerging countries alike – may yet feel the impact of the international financial crisis to a greater extent than currently anticipated. There might also be a negative feedback loop between the economic crisis and the financial problems, further impairing credit institutions' ability to channel financial flows and help provide an exit from the recession. A bigger contraction in household and corporate spending might not be ruled out either given the deterioration in their financial position, worsening confidence and the poor economic outlook. Yet, at the same time, the stimulus provided by budgetary and monetary policies globally might lead to a brisker exit from the current recession, although this will most likely be in 2010. Furthermore, the various measures adopted to support financial systems might alleviate some of the financial restrictions in place in recent quarters. In Spain's case, moreover, the restructuring of household and corporate balance sheets might leave these agents better placed in 2010 to embark on new spending, although for this to happen it is vital that the current gloomy outlook should lift. A more resolute effort by the authorities to apply structural reforms that improve market regulation and foster productivity and competitiveness in the economy would also be of great help in improving confidence.

With regard to inflation, the risks are also balanced. Evidently, the short- and medium-term projections depend closely on oil and commodity market developments, which have shown great volatility in recent years. These projections reside on oil prices that increase slightly over the projection horizon in step with futures markets, but the greater or lesser slackness of unfolding world economic activity might evidently alter this assumption. The projections also incorporate a dampening effect of the weakness of spending on the price-setting process, in

line with the greater sensitivity consumer prices have been showing in recent months to more fragile demand. Likewise, a sharper or more prolonged decline in activity might strengthen this downward pressure on prices, although certain rigidities present in the Spanish economy, manifest in the scant sensitivity of wages to productivity and the cycle, and in an insufficient degree of competition in certain sectors, such as services, might hamper this feed-through of the decline in demand to prices.

20.3.2009.