

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

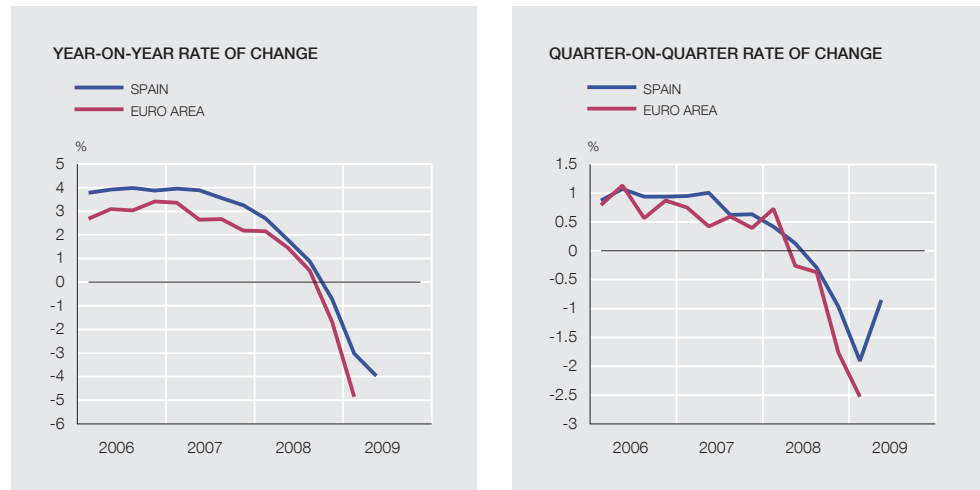
During 2009 Q1, the pace of the contraction in the Spanish economy intensified, in a highly unfavourable international environment and a financial setting marked by substantial tension. GDP fell by 3% in year-on-year terms and its quarter-on-quarter rate stood at -1.9%. The fall-off in economic activity was due to the collapse of national demand (by 5% year-on-year), since the contribution of net external demand to GDP continued to be positive at 2.3 pp, as a result of a slump in imports which exceeded the likewise marked weakening in exports.

The indicators available for Q2 augur a prolongation of the contractionary trends, albeit at a more contained pace, in an environment marked by some normalisation of financial markets and less severe external conditions. The estimates made drawing on the as yet incomplete conjunctural information available point to a quarter-on-quarter decline in GDP of 0.9% (less pronounced than in the two preceding quarters), although the year-on-year rate, subject by definition to greater inertia, is expected to have continued trending down, posting a decline of 4%. On the expenditure side, there was a further reduction in national demand, with a year-on-year rate of change of -6%, while net external demand showed a slight increase, contributing 2.4 pp to GDP. On the supply side, the bulk of the adjustment fell once again on the manufacturing industry and construction branches, although in this latter case the rate of decline of activity moderated owing to the effects of the start-up of the civil engineering projects included in the State Fund for Local Investment. In the labour market, the rate of decline of employment slowed somewhat, in line with the information provided by the EPA for Q2, which shows a decline of 7.2% year-on-year and a fresh increase – albeit at a lesser pace than in previous quarters – in the unemployment rate to 17.9%, and the rate of increase of compensation per employee once again outpaced inflation. Finally, the rate of change of the CPI fell substantially in the period from April to June, posting a figure of -1% in this latter month, meaning the differential with the euro area was once again negative (-0.9 pp), for the seventh month running.

On the international economic front, the tension on financial markets furthered the correction initiated in March, although global funding conditions remained restrictive, and the sharp declines in trade flows seen in previous months slackened. In these circumstances, GDP in the developed economies is estimated to have fallen once more in Q2, albeit on a somewhat lesser scale than in Q1, and the slowdown in the emerging economies is expected to have moderated in the face of the recovery in the Chinese economy, in response to the large-scale fiscal stimulus and liquidity expansion plans pursued. Global inflation continued to fall, with negative figures being posted in the United States, Japan, the euro area and some emerging economies. Oil and, to a lesser extent, other commodities prices rose notably, though they have eased in recent weeks.

The diminished contraction in activity and the signs of stabilisation on international financial markets have brought the trajectory of continuous downward revisions to growth projections for the world economy to a halt, although the diagnosis of the – foreseeably lengthy – duration of the recession and the – prospectively very gradual – exit therefrom has not substantially altered.

In the period under study, governments and central banks extended the macroeconomic stimulus and financial support and restructuring measures set in train in the previous months. In the United States, the government unveiled a plan for the regulatory reform of the financial



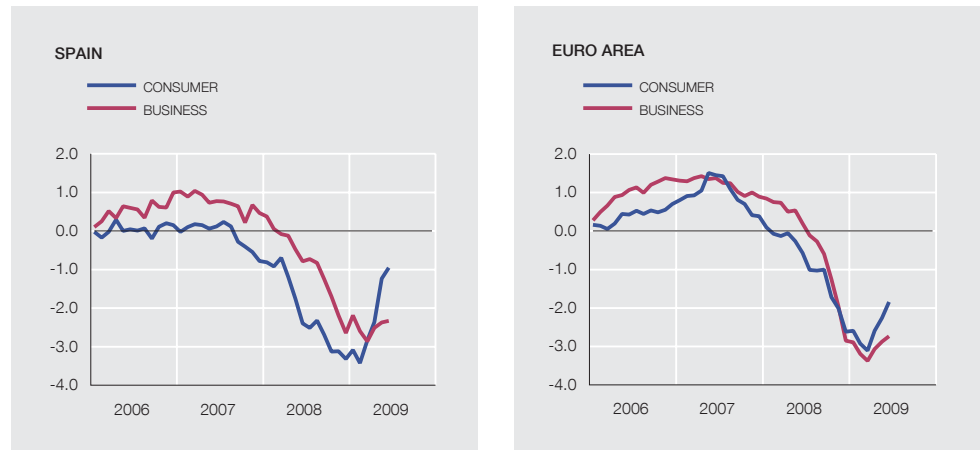
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

system; among other aspects, it will increase the supervisory powers of the Federal Reserve and will provide for tighter control of the risk in complex financial assets. In Europe, the pursuit of bank guarantee and recapitalisation schemes continued, and certain proposals for the restructuring of banks' assets began to take specific shape. On 27 June the Spanish government approved the creation of the Fund for Orderly Bank Restructuring (FROB by its Spanish acronym) with the aim of extending and reinforcing the instruments with which to develop a bank restructuring strategy that will allow for an increase in the resilience and solvency of the Spanish financial system in the face of the potential effects of the recession.

Over the course of the quarter, public finances have deteriorated considerably and globally as a result of the operation of the automatic stabilisers, the discretionary measures to stimulate aggregate demand and the actions to support the financial system. The scale of the change has shifted the economic policy debate towards the need to ensure the compatibility of the stimulus measures with credible fiscal consolidation strategies that will guarantee the sustainability of public finances in the medium term.

Meanwhile, central banks continued to provide an unlimited supply of liquidity and, in some cases, they made further cuts to intervention rates, from what were already very low starting levels, following the forceful cuts made in the preceding months. The US Federal Reserve held its official interest rate in a range of 0% to 0.25% and continued to conduct extraordinary monetary policy operations (essentially through asset purchases), although it began to reduce the amount and frequency of some of them. The Bank of England did not alter the level of its official rate, which has held at 0.5% since January, and continued to pursue its government bond purchase programme. Finally, the ECB Council cut its main refinancing operations (MRO) rate by 25 bp in May, to 1%, while its deposit and marginal lending facility rates were set at 0.25% and 1.75%, respectively. Accordingly, the current MRO rate stands 325 bp below its October 2008 level. In parallel, the ECB reinforced its policy of abundant liquidity provision, establishing a longer-term financing operation maturing at 12 months (the first of these was conducted on 24 June, with somewhat more than €440 billion being allotted). In addition, it began in July to apply extraordinary monetary policy measures that it had earlier announced in May. These involve a programme to purchase guaranteed bonds and covered bonds issued in the euro area.



SOURCE: European Commission.

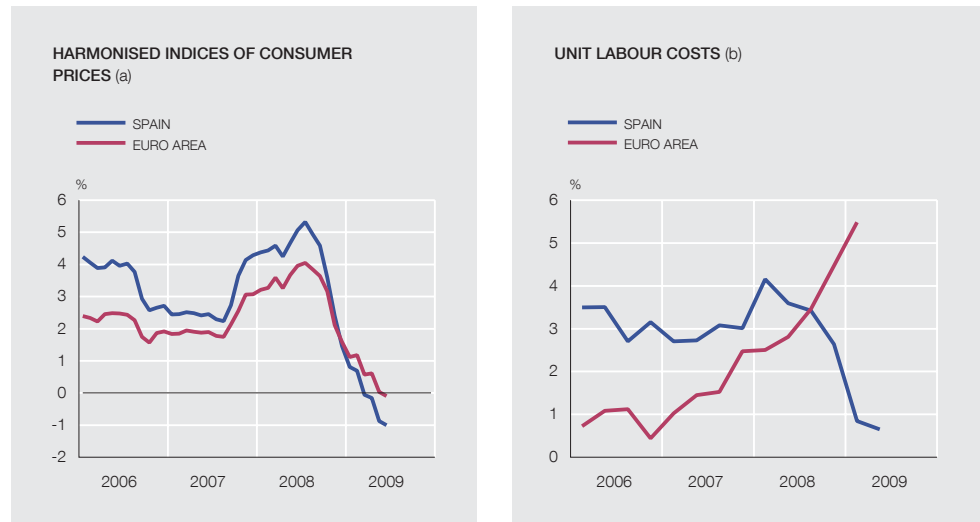
a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

This raft of measures has meant that, during Q2, the improvement in the financial stress indicators dating back to March has continued, in a climate of lessening uncertainty which, in prior months, had begun to stimulate the demand for higher-risk assets. Interbank market interest rates continued to fall, substantially narrowing the spread between these and rates on guaranteed bank transactions. Risk premia on credit derivatives markets also declined notably and, on equity markets, stock market prices continued on the upward trajectory on which they embarked in March, evidencing notably diminished volatility. Finally, on the government debt markets, there was a generalised rise in yields on sovereign bonds, chiefly as a consequence of the return of financial flows towards higher-risk assets and of the greater caution elicited by the increase in public debt.

In the euro area, the conjunctural indicators available also point to some moderation in the rate of decline of activity as a result of a smaller fall in private consumption, a somewhat less negative contribution of external demand and lower destocking. The inflation rate continued to fall in Q2, posting a negative figure in June (-0.1%) for the first time in the history of EMU. The reduction in the inflation rate was essentially in response to base effects in energy prices and, to a lesser extent, to the slowdown in services prices, linked partly to the slackness of demand. The decline in core inflation was much more moderate, standing at 1.3% in June.

Overall, then, the external environment of the Spanish economy has become less contractionary and financing conditions, though they remain restrictive, are showing signs of some improvement. On one hand, the decline in interbank yields continued feeding through to private-sector bank financing costs, unevenly across the different segments; on the other, financial institutions further tightened their lending standards, albeit to a lesser extent than in previous quarters. Elsewhere, the positive trajectory of stock market prices helped to offset the declines recorded in the opening months of the year (the IBEX posted gains of close to 13% in this period) and to recuperate to some extent this component of financial wealth. Conversely, the 1.9% fall in property prices in Q2 (-8.3% in year-on-year terms) led to further declines in the value of private-sector wealth.

Against this background, household spending fell off once more in Q2, although it is estimated that the rate of decline of final consumption will slow, potentially to a year-on-year rate of



SOURCES: Eurostat, ECB and INE.

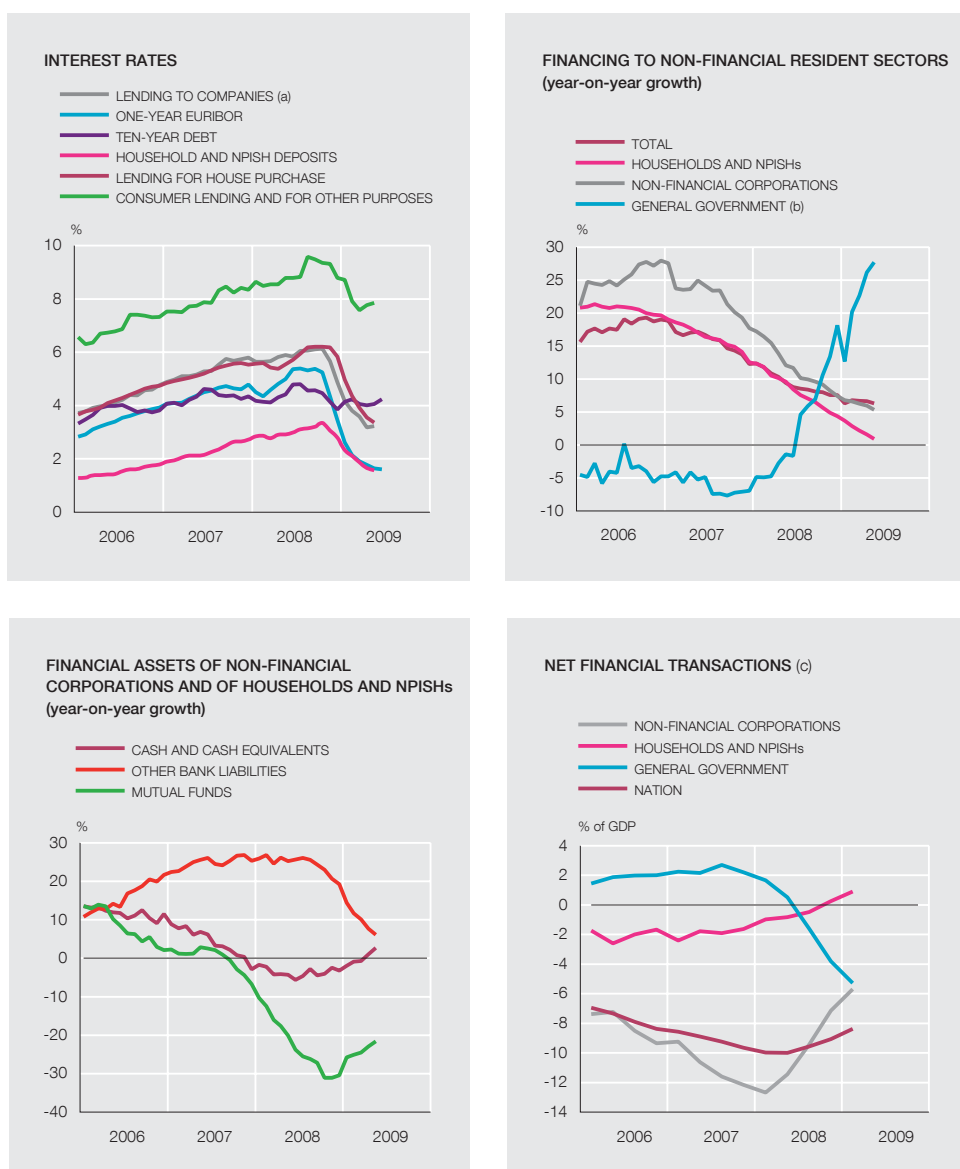
a. Year-on-year rate of change.

b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

–4.6% (–4% in the previous three months). Consumption decisions continued to be highly influenced by the generalised weakening of the attendant main determinants (disposable income and wealth), although agents' confidence improved substantially during the quarter after having been very depressed since the start of the financial crisis. Developments in disposable income were determined by the deterioration in earnings, as a result of the unfavourable labour market situation. The scale of this effect could not be countered by the impact of general government (through higher social benefits and lower taxes), the decline in interest payments (which, according to the quarterly non-financial accounts, began to be observable already in the previous quarter) and the substantial cut in inflation. The reduction in wealth also continued, above all as a result of developments in its real estate component, as earlier indicated. Consequently, a further increase in the household saving rate is expected, following its rise in Q1 to 14.1% of disposable income in four-quarter cumulated flows, a figure 4 pp up on the same period a year earlier.

On the contrary, the weakness of residential investment intensified, influenced by expectations of falling prices, uncertainty over income growth prospects and continuing restrictive financing conditions globally. That said, some signs of improved access to financing are becoming discernible. Overall, a year-on-year decline in residential investment of around 25% is expected for Q2. The downward revision of household spending plans, along with continuing restrictive financing conditions, drove the slowdown in debt, the growth of which in year-on-year terms stood below 1%, affecting both loans for house purchases and consumer credit and other lending. This, in turn, provided for a slight reduction in the debt/GDI ratio.

Turning to business investment, spending on capital goods contracted once more. That is consistent with the sluggishness of demand, in both its domestic and external components, with continuing restrictive financing conditions (despite the cut in interest rates) and with uncertain prospects concerning economic recovery and very negative earnings expectations. However, it is estimated that other private productive investment fell somewhat less markedly owing to the impulse that is being given to certain infrastructure development plans, as reflected in the National Accounts figures for Q1. The fall in business investment and the restric-



SOURCE: Banco de España.

a. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

b. Consolidated financing: net of securities and loans that are general government assets.

c. Four-quarter cumulated data.

tiveness of the supply of bank funds meant that borrowing by non-financial corporations continued to slow, to a rate of 5%, compared with the same period in 2008. The sector's borrowing needs diminished once again in Q1 to 6.4% of GDP, in terms of four-quarter cumulated flows, 4.6 pp down on a year earlier.

Set against the decline in the various components of private domestic demand, the general government sector contributed to sustaining expenditure by means of sizeable net transfers to households and through public investment, with the start-up of the projects included in the State Fund for Local Investment. The government announced new measures to support economic activity, which will come into force in 2009 and 2010. These include most notably direct

assistance with car purchases (Plan 2000E), given their greater potential impact on the industry in the short term. In this connection, and despite the fact a fresh cut in State spending was also approved, general government spending has increased notably in the year to date, while the declining course of tax revenue has steepened, with very negative rates of change. The interplay of all these factors led to a further deterioration in public finances, prompting the government to raise the projected deficit in 2009 and to announce an adjustment path that might involve posting a budget deficit of 3% in 2012, in line with the guidelines laid down for Spain by the European Council regarding compliance with the Stability and Growth Pact (see Box 1).

As regards the external sector, net external demand once again alleviated the effect of the fall in domestic spending on economic activity, with a positive contribution to GDP growth of 2.4 pp, slightly up on that in Q1. With the phase of the maximum contraction in international trade flows behind, the positive contribution of net exports was mainly due to the reduction in imports, which were more than 20% down, the decline being induced by the collapse in final demand and by industrial production. In any event, exports fell again, albeit less than in Q1, despite the more favourable behaviour of the price-competitiveness indices vis-à-vis the developed countries. This situation spread to some extent to trade in services, with the decline in services revenue easing, particularly in the case of tourist services, although expenditure continued on a declining course.

In step with these developments, the nation's net borrowing once again fell significantly in Q1 to 8.4% of GDP, in terms of four-quarter cumulated flows, 1.6 pp down on a year earlier according to data from the non-financial accounts of the institutional sectors. The Balance of Payments figures to April confirm this trend, as they show a decline in the deficit of almost 40% year-on-year, the result of the intensifying adjustment of the trade deficit, which fell over this period by 51% and, to a lesser extent, of the balances on current transfers and on services, while the incomes deficit widened.

On the supply side, following the substantial deterioration seen in Q1, value added in the market economy contracted in Q2 but, as in the case of GDP, at a somewhat less pronounced rate. The decline in activity was across all the productive branches, except agriculture and fisheries, which showed a recovery. In the construction sector, the slowdown in the rate of deterioration of value added was due to the effects of the start-up of the projects included in the State Fund for Local Investment, which are boosting the civil engineering component; conversely, there is no evidence of the contractionary trends in the residential sector easing. Industrial activity continued to fall, and services, which are generally posting more contained declines, showed no signs of stabilising, beyond what might be related to purely seasonal activities. Against this backdrop the employment adjustment continued in Q2, albeit with somewhat less intensity than in the two previous quarters, in particular in the construction sector, for the reasons stated earlier. Overall, the increases in apparent labour productivity are expected to have held at a relatively high level (3.2%), similar to that in the opening months of the year, chiefly reflecting the decline in employment.

The rate of increase of labour costs fell moderately, though less than might be expected in the face of the severe weakening in the labour market. Moreover, there are some signs that wage restraint might be coming to a halt. For one thing, the wage rates arising from collective bargaining show increases that are practically unchanged since the start of the year (with rates of 2.7% to June), stemming from the fact that, under bargaining, newly signed agreements are registering higher increases than those in revised agreements (2.9% and 2.7%, respectively). For another, the existence of positive wage drift this year, linked to the effects induced by job

Maintaining sound public finances is a necessary condition for sustainable economic growth and for the proper functioning of the Economic and Monetary Union (EMU). Under these tenets, the Maastricht Treaty laid down various provisions with the aim of ensuring the disciplined fiscal behaviour of the Member States. In particular, members must avoid "excessive public deficits", which are assessed in relation to the reference values of 3% and 60% of GDP for the deficit and for public debt, respectively. Further, the Treaty envisages a "procedure" geared to ensuring the prompt correction of excessive deficits, should these arise. The Stability and Growth Pact (SGP), approved by the EU Member States in 1997 and reformed in 2005, establishes a set of "preventive measures" so that excessive deficits should not arise, along with "corrective measures" aimed at ensuring the rapid and rigorous application of the excessive deficit procedure, including the possible imposition of sanctions.

During 2008, the euro area's fiscal policy was influenced by the economic crisis, which strongly impacted the member countries' public finances and led to the adoption of fiscal stimulus measures by the economic authorities. In February 2009, the European Commission decided to initiate the excessive deficit procedure for those countries whose deficit exceeded the Treaty reference value of 3% of GDP in 2008: France, Spain, Ireland, Greece and Malta. In Spain's case, this will be the first time this procedure has been initiated since it joined EMU. This Box summarises how the procedure has unfolded to date and its consequences for Spanish fiscal policy in the coming years.

In January 2009, the Spanish government submitted an update of the Stability Programme (SP). According to the estimate in this update, the general government deficit would have exceeded 3%

Percentages

	2007	2008	2009	2010	2011	2012
REAL GDP (% change)						
Stability Programme (January 2009)	3.7	1.2	-1.6	1.2	2.6	...
Interim Commission Forecasts (January 2009)	3.7	1.2	-2.0	-0.2	...	...
Commission Forecasts (spring 2009)	3.7	1.2	-3.2	-1.0	...	...
Budgetary Stability Objectives (June 2009)	3.7	1.2	-3.6	-0.3	1.8	2.7
OUTPUT GAP (% of potential GDP)						
Stability Programme (January 2009)	1.4	0.3	-2.7	-3.7	-3.6	...
Interim Commission Forecasts (January 2009)	1.5	0.8	-2.3	-3.4	...	...
Commission Forecasts (spring 2009)	1.4	0.9	-2.6	-3.7	...	...
Budgetary Stability Objectives (June 2009)	...	...	...	...	...	...
GENERAL GOVERNMENT BALANCE (% of GDP)						
Stability Programme (January 2009)	2.2	-3.4	-5.8	-4.8	-3.9	...
Interim Commission Forecasts (January 2009)	2.2	-3.4	-6.2	-5.7	...	...
Commission Forecasts (spring 2009)	2.2	-3.8	-8.6	-9.8	...	...
Budgetary Stability Objectives (June 2009)	2.2	-3.8	...	-7.9	-5.2	-3.0
GENERAL GOVERNMENT STRUCTURAL BALANCE (% of GDP)						
Stability Programme (January 2009)	1.6	-3.5	-4.6	-3.2	-2.3	...
Interim Commission Forecasts (January 2009)	1.6	-3.3	-4.6	-4.2	...	...
Commission Forecasts (spring 2009)	1.6	-3.9	-6.8	-8.2	...	...
Budgetary Stability Objectives (June 2009)	...	...	...	...	...	...
GENERAL GOVERNMENT DEBT (% of GDP)						
Stability Programme (January 2009)	36.2	39.5	47.3	51.6	53.7	...
Interim Commission Forecasts (January 2009)	36.2	39.8	46.9	53.0	...	...
Commission Forecasts (spring 2009)	36.2	39.5	50.8	62.3	...	...
Budgetary Stability Objectives (June 2009)	...	...	...	...	...	...

SOURCES: Stability Programme 2008-2011, Budgetary Stability Objectives 2010-2012 and European Commission.

of GDP in 2008¹ (see accompanying table). Accordingly, the European Commission (EC) decided to initiate the excessive deficit procedure, drafting the mandatory report in February 2009. This report analysed the reasons behind the breach of the 3% threshold and, in particular, it assessed whether this breach could be considered as close to the reference value of 3% of GDP, temporary and due to exceptional circumstances, factors which, should they arise in conjunction, prevent deficits above 3% being considered "excessive". The EC argued that the breaching of the 3% reference value in Spain's case could not be considered exceptional, given that it had not come about from a severe economic downturn that year. Indeed, on the EC estimates available at the time of the report being drafted, GDP had posted growth of 1.2% in 2008, compared with 3.7% the previous year, meaning that the estimated output gap remained positive and close to 1% of GDP. Nor is it considered that the breach could be temporary, given that the deficit will continue widening in 2009. On the basis of this report and of the subsequent opinion of the Economic and Financial Committee and of the EC itself, the European Council came to a decision on 27 April 2009 on the existence of an excessive deficit in Spain.

In parallel, the Council adopted a recommendation² with a view to bringing to an end the situation of an excessive public deficit in Spain, setting a deadline for its correction. As a general rule, the SGP establishes that excessive deficits should be corrected in the year following that of the Council's decision as to its existence, unless exceptional circumstances prevail. In this case, the Council considered that there were exceptional circumstances in Spain and has extended the correction deadline to 2012.³ Moreover, the Council indicated that Spain should rigorously apply the budgetary targets specified in the SPG to 2011 and make an additional budgetary effort in 2012 to reduce the deficit to below 3% in that year.⁴ Specifically, Spain should make an annual average fiscal effort equivalent to at least 1.25% of GDP, as submitted in the Stability

1. At that time the public deficit estimate for 2008 was 3.4% of GDP. Subsequently, at 3.8% of GDP, the deficit exceeded this estimate by 0.4 pp. 2. On the basis of a prior recommendation by the EC. 3. These circumstances are, first, the considerable deterioration expected in the economy for 2009 and 2010 which, on Commission estimates, will be accompanied by a reduction in potential growth and a significant decline in the output gap; and, second, the size of the fiscal adjustment, in excess of 3% of GDP, which would require reducing the deficit to below the reference value in 2010. 4. Moreover, given that in its assessment of the Stability Programme it had identified risks to compliance with budgetary targets, in particular associated with the growth assumptions contained in this Programme's macroeconomic scenario and with the absence of any description of specific deficit-correcting measures, the Council indicated that fiscal efforts additional to those described in the Stability Programme might prove necessary if these risks were to materialise.

Programme⁵, which should commence in 2010. The Council set a period of six months, to 27 October 2009, in which the Spanish authorities should apply effective budgetary adjustment measures.⁶ Finally, it highlighted the importance of achieving the medium-term objectives (a balanced budget in structural terms) once the excessive deficit has been corrected. At the same time it called for the consolidation process to be compatible with an improvement in the quality of public finances, and that the sustainability of public finances be reinforced with the application of further pension system reforms.

Compliance with the European Council's recommendations will require a very great consolidation effort, especially if it is taken into account that a deterioration in the budgetary situation in 2009 greater than that projected in the SP has been forecast. Also, real GDP in the Spanish economy is expected to trend more adversely both in 2009 and in 2010. In this connection, on 8 July 2009 the Spanish Parliament approved the Budgetary Stability Objectives for the three-year period 2010-2012 along with the State non-financial spending ceiling for 2010. The Budgetary Stability Objectives foresee a rise in the public deficit to 7.9% of GDP in 2010 and a subsequent progressive reduction to 3% of GDP in 2012, in line with the guidelines laid down by the European Council. As to State non-financial spending for 2010, the year in which the fiscal consolidation process should commence according to the recommendations of the European Council, the ceiling has been set in cash-basis terms at €182,439 million, up 13.9% on the ceiling approved for 2009. Implicitly, however, the government considers there will be an upward deviation in budgetary spending in 2009⁷, meaning that the ceiling approved for 2010 would involve a 4.5% reduction relative to the final budget estimated for 2009.

Compliance with the adjustment path described is very important for retaining agents' confidence in the maintenance of budgetary stability in the medium run. In this respect, the scale of the correction projected in such a short space of time requires a very strict budget outturn and the adoption of ambitious measures. Attention must also be given not only to the scale of the adjustment but also to its composition. Experience shows that for fiscal consolidation processes to be successful, they must include cuts in public spending and, in particular, in unproductive spending. Finally, it is important that all tiers of general government and, given their share in public spending, regional governments in particular, should contribute actively to restoring the path of fiscal consolidation and budgetary stability.

5. The fiscal effort is measured drawing on the change in the structural budget balance. 6. Assessment of the effectiveness of the measures will take into account economic developments compared with those projected by the Commission in its January 2009 interim forecasting exercise. 7. The upward deviation in spending in 2009 compared with the initial forecast would, according to these estimates, be around €32 billion (3% of GDP), which could be explained by the approval of various measures during 2009 to combat the economic crisis.

destruction in low-paid industries, cannot be ruled out. Bearing in mind all these factors, compensation per employee in the market economy is expected to rise by 3.3% in Q2, and although there might be some further slowdown in the second half of the year, this will involve a significant rise in labour costs in real terms. Economy-wide the estimated increase is somewhat higher, owing to the upward effect exerted by public-sector wages in the current circumstances.

The correction initiated in inflation in the closing months of 2008 proceeded more sharply, with increasingly negative figures in the January-June period. In this latter month the CPI posted a year-on-year rate of change of -1%. As was foreseeable, a very significant portion of this adjustment was due to the marked decline in energy prices on a year earlier. But beyond these base effects, the weakening of inflationary pressures spread to the other components, including services, whereby core inflation slowed to 1% on average during the quarter, 2 pp down on the same period a year earlier. Price adjustments in Spain are proving more acute than in the euro area, which is shaping an outlook free from inflationary pressures and one of negative price differentials with the euro area that it is necessary to preserve in order to entrench a degree of competitive advantage that may underpin the recovery.