

Summary

This report sets out the analysis conducted by the Banco de España's Directorate General for Economics, Statistics and Research on the situation of and outlook for the Spanish economy for the years 2012 and 2013, taking into account the information available to 13 January. The recent change in Government and the ensuing modification of the timetable for drafting and presenting the 2012 Budget mean the publication of the central bank's habitual macroeconomic projections report, hitherto released in its April *Economic Bulletin*, must be brought forward.

Moreover, unlike on previous occasions, this Report presents a macroeconomic scenario that entails strict compliance with the fiscal consolidation targets for 2012 and 2013 arising from our European commitments, and which, therefore, assumes that measures additional to those already approved will be adopted. The justification for this normative approach is twofold. First, the new Government has committed itself to complying strictly with these budgetary consolidation targets. Second, in light of the current extreme tensions on financial markets because of the European sovereign debt crisis, perseverance with the fiscal adjustment process is unavoidable, given that the costs of not doing so would be very high. For these reasons, the present projections are based on the adoption of budgetary measures on a sufficient scale to reduce the budget deficit from a level of around 8% in 2011, according to the latest Government estimate, to 4.4% of GDP in 2012 and 3% in 2013. To this end, it has been assumed that, along with the measures approved by the Council of Ministers on 30 December 2011, the adoption and application of others will be necessary to meet the targets set. It has further been assumed that, in the absence of specific information concerning their composition, these measures will be particularly centred on cutting public spending.

The projections published are subject to a very high degree of uncertainty, owing to the exceptional conditions under which the exercise has been performed and, in particular, to the normative fiscal assumptions adopted and to the complex situation facing the euro area and the financial markets, following the worsening of the sovereign debt crisis. Further, it is not known what the scope of the reforms of the labour market and of product markets to be implemented by the new Government will be. All these factors advise viewing these projections with particular caution.

The worsening since last summer of the strains on euro area financial markets, largely linked to the difficulties of finding a solution to the complex sovereign debt crisis problem, has weakened private agents' confidence and tightened financing conditions throughout the second half of 2011, adversely affecting the economic growth outlook. The Spanish economy is estimated to have contracted in 2011 Q4, posting a quarter-on-quarter decline in GDP of 0.3% (see the Quarterly report on the Spanish economy in this same *Economic Bulletin*), a trajectory which might continue in the current year.

Against this background, the macroeconomic projections described in this report envisage a substantial decline in the Spanish economy's output in 2012 (-1.5%) and a modest recovery in 2013 (0.2%), with positive rates from the first quarter of next year, meaning that the Spanish economy would progressively draw closer to its potential growth rate. The macroeconomic scenario considered here is the result of a significant contraction in national demand, partly countered by a high contribution of the net external balance. In turn,

the fall-off in national demand stems from the combination of a strong fall in both the public- and private-sector components of demand, in a setting in which household spending will be restricted by the impact of the fiscal consolidation on these agents' incomes and by lower employment. Against this backdrop, the fall in household consumption is forecast for the whole of the projection period, despite the fact that the household saving ratio remains on a declining course. Residential investment will continue to fall in 2012 and 2013, although the rate of decline will be more modest than in recent years, having overcome the hardest phase of the adjustment. Sluggish demand, the worsening economic outlook and tough financial conditions will mean further – though moderate – declines in private productive investment expenditure in the next two years.

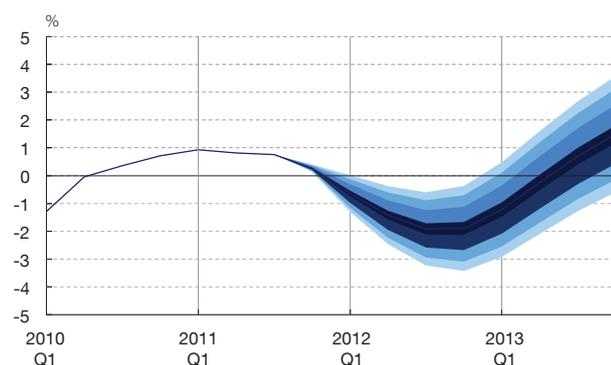
Turning to foreign trade, the growth of goods and services exports is expected to weaken in 2012, given the worsening outlook for international markets. However, as in the past two years, a higher increase in sales to the rest of the world than in Spain's export markets is projected. This is because the ongoing improvement seen in the Spanish economy's competitiveness since the start of the crisis is expected to continue, albeit at a slacker pace, while Spanish companies will carry on replacing domestic markets with foreign markets in light of the greater relative resilience of the latter. This, in combination with the decline imports will undergo over much of the projection period as a result of shrinking final demand, will give rise to a contribution of the net external balance which is expected, for the 2012-2013 period on average, to be as high as it was in 2011.

The fall in GDP will have an appreciable impact on employment which, without including further labour market measures, is specified to decline by 3% in 2012, following the more negative pattern observed in the final stretch of last year. The pattern would soften in 2013, and the second half of that year would see the start of employment creation in net terms. In the absence of far-reaching labour market reforms, that would give rise, in light of the projected trajectory of the labour force, to further increases in the unemployment rate during the current year, before it turned modestly downwards during 2013. More resolute action on structural reforms would enable a swifter reduction in unemployment and would set in place conditions more conducive to economic growth.

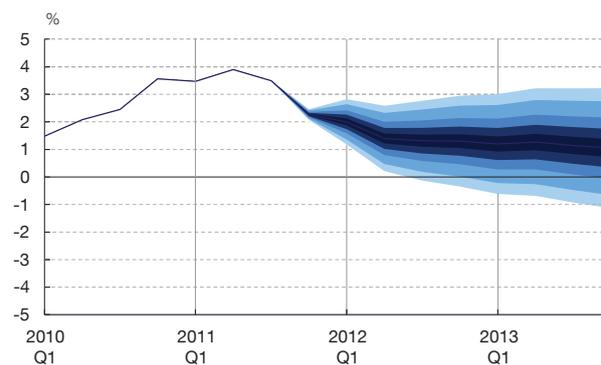
On the assumption that the oil price will behave in the future as its current futures market prices infer, inflationary pressures will continue to abate in the first half of 2012, furthering the pattern of the closing months of 2011. This exercise projects, moreover, an additional decline in unit labour costs over the next two years as a whole, albeit on a lesser scale than in the recent past. Along with a slowing increase in margins resulting from the weakness of demand, that will give rise to very moderate consumer price growth (of 1.5% and 1.2% in 2012 and 2013, respectively).

This additional adjustment of the Spanish economy will provide for the correction of some of the imbalances built up in the past which, had they persisted, would have ultimately choked medium-term growth prospects. Specifically, the macroeconomic scenario outlined here entails the elimination, in 2013, of the nation's net borrowing, whereas the goods and services balance would be expected to start running a surplus this year. From a sectoral perspective, this correction of the imbalance between the overall economy's saving and investment would come about chiefly from the reduction of the budget deficit, from a level of around 8%, recently estimated by the Government, to 3% of GDP in 2013, enabling public finances to move onto a path of stability. The correction of the Spanish economy's dependency on expenditure with respect to the rest of the world's saving is the crucial factor for ensuring that the foundations for sustained economic growth in the medium

GROSS DOMESTIC PRODUCT



PRIVATE CONSUMPTION DEFLATOR



PROBABILITY OF GDP OR THE PRIVATE CONSUMPTION DEFLATOR LYING WITHIN THE INTERVAL (a)



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: 2011 Q3.

term are laid down. It is likewise projected that the ongoing deleveraging of households and firms will continue.

These projections are formulated against a particularly uncertain background in which doubts over the sovereign debt crisis have not been fully dispelled. Likewise, there is much uncertainty over the final impact of the fiscal consolidation on economic activity in the short run, a matter which also hinges, among other things, on the fiscal consolidation measures that are finally pursued. One means of depicting the uncertainty surrounding the projections involves showing, drawing on past forecasting errors, the bands around which the main macroeconomic variables may be expected to trend to some degree of likelihood. Chart 1 illustrates this measure of uncertainty for the central GDP and private consumption deflator projections.

The risks of deviation from the GDP projections provided in this report are considered to be balanced. On one hand, possible episodes of rising tensions on financial markets or a more unfavourable performance by the world economy than that projected here might result in a harsher contraction in output. But, on the other, economic policies may provide for a reduction in the cost of the adjustment and alleviate its intensity. In particular, from the fiscal policy standpoint, an early definition of the composition of the measures devised to correct the budgetary imbalance would tend to lessen uncertainty; also, an improvement in the quality of the information available about the performance of public finances in the lower tiers of government and their early availability would allow a prompt reaction to any potential deviations in the budget outturn. As regards the labour market, the approval of a comprehensive reform of wage bargaining mechanisms, non-wage conditions and hiring arrangements would contribute to kick-starting medium-term growth and would generate positive effects on expectations. International investors' confidence could also be strengthened with further progress in the ongoing restructuring of the financial system.

Turning to inflation, the risks over the projection horizon are considered to be balanced. On one hand, inflationary pressures might be greater if tensions on the oil markets were to

increase, if the upward inertia of wages reared once more or if greater resort were had to indirect tax rises in the consolidation programme. On the other, a labour market reform and other structural reforms that were to heighten the sensitivity of wages and prices to the economy's cyclical position would ease inflationary pressures to a greater extent.

The following two sections explicitly set out the external and fiscal assumptions underlying the projections formulated. The fourth section then outlines the diagnosis underlying the current outlook for the Spanish economy. Finally, the main risks to the central scenario described are analysed in the final section.

External assumptions underlying the projections

The projections presented in this report have been prepared from a set of assumptions about the course of specific exogenous variables in 2012 and 2013. The projections are thus conditional upon the hypotheses made about the path of these variables.

The procedure used to construct the trajectories of most of the exogenous variables in the period 2012-2013 coincides with that used in the quarterly projection exercises conducted by Eurosystem NCB and ECB experts. This is the case of the exchange rate, Spanish share prices, oil prices and three-month and ten-year interest rates, the assumptions for which are made drawing on changes in markets over a reference period covering the ten working days immediately prior to the cut-off date for gathering information for this report.¹ As regards the euro exchange rate, this variable is assumed to hold, throughout the projection period, at the level observed on the spot market in the reference period. In this case the exchange rate would stand at \$1.28 per euro on average in 2012 and 2013, 8% down on 2011 (see Table 1). The path of oil prices, based according to the usual technical assumption on the latest information from the futures market for this commodity, envisages some stabilisation of the price in dollars; however, this is offset by the depreciation of the euro, meaning that the oil price in euro in 2012 and 2013 would be somewhat higher than last year. It cannot be ruled out that a heightening of geopolitical tensions may lead to more significant price rises.

In constructing the projections, assumptions are also made about three-month interbank market interest rates and ten-year government bond yields. The trajectory of short-term interest rates, obtained from expectations implicit in futures markets about changes in the three-month EURIBOR, shows a decline in this rate to below 1% in 2012 and 2013, compared with 1.4% in 2011. Ten-year bond yields are constructed on the basis of market expectations about interest rates in the euro area and the assumption that the Spanish sovereign yield spread over Germany will hold constant at around 350 bp. On these hypotheses, long rates in Spain would stabilise in 2012 at 5.4%, unchanged on the previous year, and would increase slightly to 5.7% in 2013.

On the basis of these assumptions about the path of these market interest rates, other hypotheses on the cost of financing for households and firms are made. Broadly, they have it that bank lending rates will hold stable over the projection horizon, since the projected widening of the spreads over EURIBOR – which reflect the increase in funding costs that credit institutions have undergone in recent quarters – is offset by the reduction in this latter rate. Further, it is assumed that banks will maintain, throughout the projection period, the current degree of tightness of credit conditions. The technical assumption made about

¹ In this case the cut-off date is 13 January. Considering solely the average prices of operations transacted on the markets on the same day as the cut-off date would offer the advantage of reflecting more accurately the latest relevant information for price formation. However, this advantage is considered not to make up for the potential drawback whereby some of the variables might be particularly affected by excessive market fluctuations on that specific trading day, which advises taking a longer period into account.

Annual rates of change, unless otherwise indicated

	2008	2009	2010	2011	Projection		Difference between current and March 2011 projections reports	
					2012	2013	2011	2012
International environment								
World output	2.7	-0.8	5.1	3.8	3.5	4.2	-0.4	-0.6
Global markets	3.0	-11.0	12.4	6.6	4.5	6.8	-1.0	-3.0
Spain's export markets	2.7	-11.2	10.3	4.8	2.4	5.4	-1.4	-3.5
Oil price (in USD)	97.7	61.9	79.6	111.2	111.0	108.8	-0.6	-3.1
Competitors' export prices in euro	2.6	-3.7	6.8	4.5	4.3	1.6	1.6	2.4
Monetary and financial conditions								
Dollar/euro exchange rate (USD per euro)	1.47	1.39	1.33	1.39	1.28	1.28	0.01	-0.11
Short-term interest rate (3-month EURIBOR)	4.6	1.2	0.8	1.4	0.9	0.8	-0.1	-1.5
Long-term interest rate (10-year bond yield)	4.4	4.0	4.2	5.4	5.4	5.7	0.0	-0.3

SOURCES: ECB and Banco de España.

a Projection cut-off date: 13.1.2012.

Latest QNA data: 2011 Q3.

share prices suggests these will hold approximately at their current levels. As to housing, which along with share prices is the other major determinant of household wealth, it is projected that the ongoing adjustment in house prices will continue.

Turning to world trade, some slowing in the expansion of Spanish export markets is expected, with their growth dipping from a rate of 4.8% in 2011 to only 2.4% in 2012. The global and, above all, the European economy are expected to be more buoyant in 2013, meaning Spanish markets would grow by 5.4%.

Fiscal assumptions

As regards fiscal policy assumptions, the projections exercise this year has been conducted in exceptional circumstances in which the Spanish economy faces the need to undertake an unprecedented fiscal consolidation, which will be one of the main conditioning factors of macroeconomic developments over the forecasting horizon. In this respect, the incoming Government has announced strict compliance with the fiscal targets arising from commitments made in Europe, which involve placing the budget deficit at 4.4% of GDP in 2012 and at 3% of GDP in 2013.

The exceptional nature of the consolidation process in which the Spanish economy is immersed and its macroeconomic repercussions advise addressing the fiscal policy measures in these projections in a different way than in projection exercises conducted under normal conditions. The usual practice is to assume that fiscal policy does not change over the forecasting horizon, whereby only fiscal measures already approved are incorporated into the projections. As indicated in last year's projections report, this assumption is not suitable in situations marked by extraordinary fiscal adjustment, since their strict application would add significant bias to the macroeconomic projections. On this occasion their application would be even more problematic, since as a result of the general elections held late last year and the subsequent change in government, no draft Budget for 2012 – which will be unveiled in March – is available at the time of this report going to press. Moreover, following the European Semester schedule, Spain's Stability Programme Update will foreseeably be available in April as will, therefore, much more detailed information on the Government's fiscal consolidation strategy for the coming years. Lastly, the present pro-

jections exercise faces, on this occasion, the added difficulty whereby, at the time of going to press, the final public finances figures for 2011 are not available, although the Government announced at the Council of Ministers on 30 December that the general government deficit would stand at around 8% of GDP in 2011, signifying a 2 pp deviation from the target of 6% of GDP.

With these conditioning factors, the fiscal projections accompanying this forecasting exercise have been made under a *normative assumption* whereby, departing from the general government deficit of 8.1% of GDP in 2011, the Government will adopt the budgetary measures needed to meet the fiscal targets set. That involves incorporating into the forecasting scenario, firstly, the budgetary policy measures approved in the Council of Ministers on 30 December 2011², and, secondly, the additional fiscal effort needed to ensure attainment of these targets.

Specifically, expenditure-side measures include the inflation adjustment for pensions, the freeze on public-sector wages, the restrictions on public-sector employment³ and the announcement that €8.9 billion of appropriations will not now be used in the State Budget (extended to 2012). The revenue side includes the increase in personal income tax rates on income from work and from saving, the reintroduction of the tax credit for first-home purchases under personal income tax, the maintenance of the increase in advance payments for large corporations under corporate income tax, the increase in property tax and the extension of the super-reduced VAT rate of 4% for house purchases⁴. The remaining fiscal effort to ensure compliance with the target has been defined assuming that it is concentrated on the public spending side. With these assumptions, the composition of the adjustment in 2012 would break down into 20% on the revenue side and 80% on the expenditure side, in the latter case distributed virtually symmetrically between current and capital spending. In 2013, the simulated adjustment would fall solely on the expenditure side. As a result of these assumptions, a reduction in the budget deficit of 3.6 pp of GDP is projected in 2012, with a decline in the weight of public spending relative to GDP of 2.8 pp and an increase in revenue of 0.8 pp. All the expenditure items would contribute to this reduction, with the exception of social benefits and the interest burden, which would increase by 0.2 and 0.4 pp of GDP, respectively. As to 2013, a decline in the budget deficit of 1.4 pp of GDP is projected, an adjustment which, as indicated, would be concentrated almost exclusively on public spending.

To the extent that the closing figures of the public finances for 2011 and the composition and/or scale of the fiscal adjustment in 2012 and 2013 may differ from those assumed in this report, the macroeconomic projections included here will also be affected; accordingly, they should be viewed with particular caution.

Outlook for the Spanish economy

In the first half of 2011 the slow recovery in the Spanish economy that had commenced in the previous year continued. However, the recovery came to a halt in the summer months, when activity stagnated, and subsequently moved into reverse, with GDP declining again in the fourth quarter of the year. Notwithstanding, GDP is estimated to have grown in 2011 by 0.7%, 0.1 pp less than the rate projected in the March 2011 projections report (0.8%) (see Table 2). In terms of components, developments were weaker than forecast in the case of national demand, especially on account of the slackness of private consumption, which reflected the higher destruction of employment and a less pronounced cut in the

² Together with the information available on the regional government budgets for this year.

³ These restrictions entail a freeze on public-sector employment vacancies, with some exceptions where a replacement rate of 10% is permitted.

⁴ Also included is the reintroduction of wealth tax adopted in September 2011 and due to come into force in 2012.

Annual rate of change in volume terms and % of GDP

	2008	2009	2010	Projection		
				2011	2012	2013
GDP	0.9	-3.7	-0.1	0.7	-1.5	0.2
Private consumption	-0.6	-4.3	0.8	0.0	-1.2	-0.5
Government consumption	5.9	3.7	0.2	-1.2	-6.3	-3.3
Gross fixed capital formation	-4.7	-16.6	-6.3	-4.7	-9.2	-2.2
Investment in capital goods	-2.9	-22.3	5.1	2.2	-7.0	-0.9
Investment in construction	-5.8	-15.4	-10.2	-7.8	-10.6	-3.1
Exports of goods and services	-1.0	-10.4	13.5	8.8	3.5	5.9
Imports of goods and services	-5.2	-17.2	8.9	1.4	-4.8	1.2
National demand (contribution to growth)	-0.6	-6.6	-1.0	-1.3	-4.0	-1.4
Net external demand (contribution to growth)	1.5	2.8	0.9	2.0	2.5	1.5
Private consumption deflator	3.6	-1.2	2.4	3.3	1.5	1.2
Unit labour costs	4.9	1.4	-2.6	-1.8	-0.8	0.1
Compensation per employee	6.1	4.3	0.0	0.5	0.8	1.0
Apparent labour productivity	1.1	2.9	2.6	2.4	1.6	0.9
Employment (full-time equivalent)	-0.2	-6.5	-2.6	-1.7	-3.0	-0.7
Unemployment rate (% of labour force)	11.3	18.0	20.1	21.5	23.4	23.3
Saving rate of households and NPISHs	13.5	18.5	13.9	11.8	10.2	10.6
National economy's net lending (+)/net borrowing (-) (% of GDP)	-9.2	-4.7	-4.0	-3.7	-1.4	0.0
General government net lending (+)/net borrowing (-) (% of GDP)	-4.5	-11.2	-9.3	-8.1	-4.4	-3.0

SOURCES: Banco de España and INE.

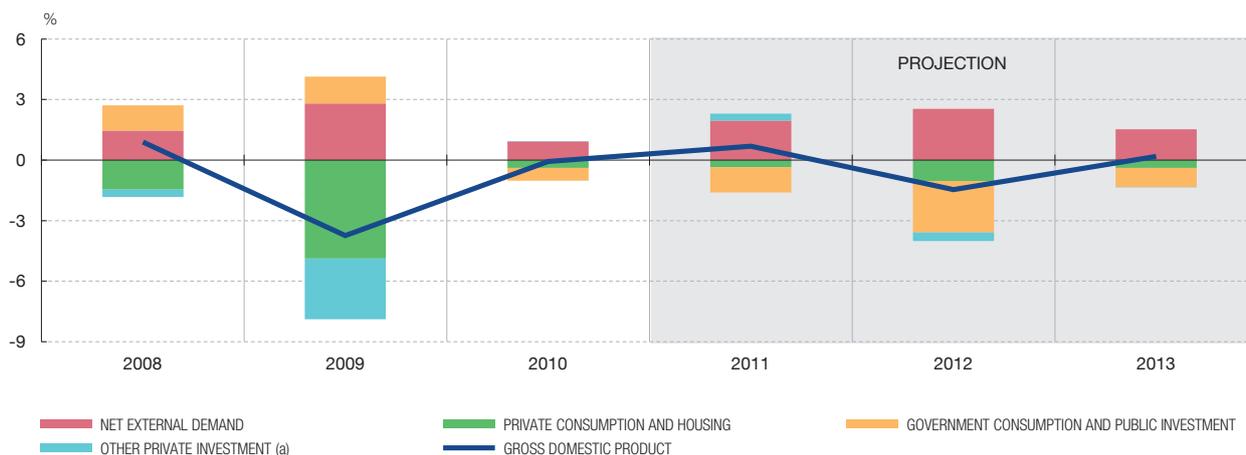
a Projection cut-off date: 13.1.2012.

Latest QNA data: 2011 Q3.

saving rate. For its part, net external demand made a larger contribution to GDP growth, due to the buoyancy of exports and less vigorous imports.

The weakness of activity in the second half stemmed from the renewed outbreak of financial strains in the summer, when the European sovereign debt crisis had a significant impact on the Spanish economy, worsening its financing conditions, damaging the confidence of agents and, in short, lowering growth expectations. The Spanish authorities reacted by adopting additional fiscal adjustment measures in August, which subsequently turned out to be insufficient to counter the risks detected of deviation from the budget deficit target, while in September a budget stability rule was incorporated into the Constitution, reaffirming the medium and long-term commitment of the Spanish authorities to the maintenance of a sound budget position as a necessary ingredient for sustainable economic growth. The heightened financial strains also affected other European economies, leading to significant downward revisions in growth prospects in many of them, which had adverse effects on both Spanish exports and the launching of new investment projects to meet external demand. All these circumstances led, in the second half of 2011, to a stepping up of the process of employment destruction, falls in private consumption, slacker investment and a decrease in the buoyancy of net external demand. As a result, GDP declined in the closing months of the year, at an estimated quarter-on-quarter rate of 0.3%, as detailed in the Quarterly report on the Spanish economy in this issue of the *Economic Bulletin*.

This contraction can be expected to continue in 2012. A 1.5% decline in GDP is projected for the year as a whole, as a result of the simultaneous private sector and public sector



SOURCES: INE and Banco de España.

a Includes changes in inventories.

Latest data: 2011 Q3.

adjustment. The budget austerity measures will have a direct effect on the public components of national demand but will also affect household spending. Households and firms are also expected to continue their deleveraging, with negative rates of change in credit, against a background of restrictive financing conditions. As in previous years, net external demand will cushion the impact of the decline in national demand on GDP, although in this case not so much because of the behaviour of exports, which will be limited by the weaker performance of the world – and especially the European – economy, but more because of imports, which will decline substantially in response to the fall in national demand (see Chart 2).

The rate of change of GDP projected for 2012 (-1.5%) is well below that projected in the March 2011 *Spanish economic projections report* (1.5%). Various factors account for this 3 pp difference: first, the variables that shape the international setting are now less favourable, as reflected in a smaller expansion of export markets; second, financing conditions have become considerably more restrictive, so that financial resources are more expensive and less readily available; third, the lack of success in meeting the fiscal consolidation targets in 2011 means that achieving the 2012 target will require much more ambitious adjustment measures; and finally, last year's projections report did not assume that the 2012 target would be strictly met (a deficit of 5.2% of GDP was projected for 2012), but this report does assume that the deficit will be reduced in line with commitments, to 4.4%, as already indicated.

By component, national demand is projected to decline sharply (-4%), and at a significantly higher rate than that estimated for 2011 (-1.3%), owing to the less favourable behaviour of almost all items, and in particular of government consumption and public investment. Also, following its stagnation in 2011, private consumption is projected to decline by somewhat more than 1% in 2012, despite a further fall in the saving rate. The decline in employment and the increase in personal income tax are the main factors weighing on household disposable income. Following the sharp adjustment over the last four years, housing investment is the only component whose rate of change in 2012 might not be lower than in 2011, although it is forecast to remain negative, with a fall of more than 4%. These estimates are based on the assumption that the number of housing starts will

remain at a similar level to that observed recently and also that the demand for housing (and, therefore, for real estate services) will remain at around the same level as in 2011.

The weakness of demand, the worsening of the economic outlook and the tight financing conditions will affect the implementation of new projects by firms, so that both their investment in equipment and in construction is forecast to fall in 2012 (at a combined rate of around -3%). Thus, the purpose of most business investment will be to replace obsolete fixed capital.

As regards external developments, exports are projected to grow by 3.5%. This involves exports growing by approximately 1 pp more than Spanish export markets, which represents a moderation in gains in market share in comparison with the two-year period 2010-2011. In addition, the fact that some Spanish firms will probably replace domestic markets with foreign markets, given the greater relative strength of the latter, also helps to explain why the behaviour of exports will be moderately favourable. Imports, by contrast, will decline significantly (by around 5%), given the sharp adjustment in national demand. Thus, net external demand will contribute 2.5 pp to GDP growth, 0.5 pp more than in 2011.

The falls in activity will be relatively large until the end of the summer, after which they will become smaller, and in Q4 the phase of declining output will come to an end. A gradual expansion is projected for 2013, with positive growth rates from Q1, so that the Spanish economy will move towards its potential growth rate. In the year as a whole, however, the carryover effects of the negative GDP growth rates in 2012 will affect average annual growth, which will be only 0.2%. The increase in output in 2013 will mainly stem from the smaller budgetary adjustment required in comparison with the previous year – so that national demand will not be squeezed as strongly by this factor as it is projected to be in 2012 – and from greater stability in household spending, since private consumption will stop falling and the adjustment in residential investment will have been completed. Also, business spending will tend to stabilise against a background of less uncertainty and more sustained final demand. Real household disposable income will show a positive rate of change for the first time since 2009, while the saving rate will recover slightly. Exports will expand more vigorously, as also will imports, in response to more buoyant national demand, so that the contribution of net external demand, although highly positive, will be smaller than in 2012.

The decline in GDP in 2012 will have an appreciable impact on employment, which will fall by around 3%, following the more negative trend observed in the final quarter of 2011. This decline in employment will be compatible with lower growth in apparent labour productivity, the rate of which will decline from 2.4% in 2011 to 1.6% in 2012. In 2013 employment will continue to fall in average annual terms (-0.7%), although this fall will be due to the carryover effect of the previous year's rates, since net employment creation may begin to be seen, in quarter-on-quarter terms, in the second half of 2013. In that year, the growth rate of productivity will slow to around 1%. By sector, employment in the public sector is expected to decline significantly during the two-year period considered, taking into account the freeze on public-sector recruitment, the reduction in corporate activity in the public sector and the simplification and rationalisation of the administrative structure of central, regional and local government. The adjustment will also have a significant effect on the private sector, although it is estimated that net employment will begin to be created in the market economy in early 2013. However, it should be stressed that the current projections have been prepared on the assumption that labour market reform measures will not be adopted, since although reforms are expected to be approved, their extent is still

unknown. Thus, if effective measures are launched to bring the remuneration of jobs into line with productivity and, in general, to enable employment conditions in the broad sense to be adjusted to the specific needs of businesses, the result will be the net creation of employment in the private sector of the economy sooner and at a higher rate.

Despite the projected decline in the labour force, these employment figures involve an increase in the rate of unemployment of almost 2 pp in 2012, to 23.4%, from which level it will fall only very marginally in 2013, assuming once again that there are no additional labour market measures. Bolder action on structural reforms would enable unemployment to be reduced more rapidly and would create more favourable conditions for economic growth.

The projections for compensation per employee are surrounded by a high degree of uncertainty, because when this report was written the scope of labour market reform and the factors that will determine the behaviour of wage costs this year and next were still not known. The pattern of wage increases observed in the past is characterised, on one hand, by a tendency for private sector wages to show a high degree of inertia in response to changes in the business cycle and excessive sensitivity to temporary fluctuations in inflation; and, on the other, by the relatively high weight of multi-year agreements (signed in previous years when conditions may have been very different). These projections incorporate a certain degree of wage moderation, although, as indicated, the degree of uncertainty over whether there will be a change in regime is high. Thus, wages are projected to increase in the market economy by around 1% both in 2012 and in 2013, which is somewhat less than the average expected inflation rates in each of these years. These rates of change will be the result of relatively high average wage settlements, of somewhat below 2%, and of negative wage drift. Unit labour costs in the market economy will thus continue to fall in 2012 (-0.8%) and will stabilise in 2013, so that the recovery in competitiveness vis-à-vis the euro area will continue, albeit at a slower rate than in the period 2010-2011. Naturally, any agreements to limit the growth of wage rates would lead to smaller increases in wages and in unit labour costs, which would help to strengthen the competitive position of firms and employment. In the case of general government the wage freeze agreed for 2012 is taken into account. In addition, it is assumed that this measure will be extended to 2013.

With regard to inflation, in recent months there has been a slowdown in the rate of growth of consumer prices. This is primarily explained by comparison effects, since the increase in energy prices and the rise in VAT and other taxes raised the CPI inflation rate in the corresponding months of 2010. This process is projected to continue in 2012, so that the average level of the CPI this year will be around 1.5%. These projections are determined by the external assumptions adopted, in particular regarding the price of oil, and by the assumption that indirect taxes remain unchanged.

Sluggish national demand and the favourable performance of exports would lead, again, to a significant decline in the nation's net borrowing in 2012 and 2013, which would bring it into balance in 2013, compared with the figure of 3.5% of GDP estimated for 2011. The goods and services balance would be in surplus as early as 2012, despite the high energy deficit, while the income balance would post a slightly higher deficit as a result of the build-up of net external liabilities and the higher cost of borrowing from the rest of the world.

From the standpoint of the institutional sectors, changes in the nation's net borrowing would be the result of a substantial cut projected in the budget deficit, while a modest

decline is expected in the net lending of households and firms, whose capital accounts would nevertheless continue to show a positive net balance. In recent quarters, the financing raised by households and firms has shown negative growth rates, more sharply evident in consumer loans to households (down year-on-year by approximately 5% at end-2011) and in loans from resident institutions to firms, which fell at a similar pace in that period. Financing to households for house purchases decreased, albeit at more moderate rates (approximately -1% in the closing months of last year). This fall in credit is linked especially to sluggish private spending, although the financial strains during 2011 were also a contributory factor since they led to the continued relatively tighter financing conditions of credit institutions. Accordingly, the net lending of households and non-financial firms in recent years has facilitated the restructuring of their balance sheets and is likely to have led them to meet their expenses using their own resources, having less recourse to borrowed funds. This restructuring can be seen in private-sector debt ratios. On the latest available data (to Q3), household debt decreased in 2011 by 4 pp of disposable income to 124% (82% in terms of GDP), while corporate debt fell by almost 60 pp in respect of gross operating surplus and financial revenue to 500% (120% of GDP). The projections for 2012 and 2013 augur that this deleveraging is going to continue, which is pivotal for the recovery of private spending beyond the time span envisaged in these projections.

General government ended 2011 with a deficit of approximately 8% of GDP according to preliminary estimates announced by the new Government, 2 pp higher than the target set. By agent, on this information, the deviations occurred at all levels of government, although it was in the regional governments where they were highest. By component, the available information to Q3 shows that overall general government spending declined by 2% year-on-year in the first nine months of the year, not very far off the rate of -2.6% set as the target for the year as a whole, whereas government revenue, measured in that way, decreased by 0.8%, compared with a targeted increase of 5.4%. Thus, together with the current non-tax revenue, it seems that the main source of the deviation in 2011 was tax revenue, which was considerably lower than projected and even lower than could be expected given the tax base (proxied by nominal GDP growth, which was estimated to be approximately 2%). The fiscal projections for 2012 and 2013 are based, as indicated earlier, on strict compliance with the fiscal targets previously agreed with the European authorities of reducing the deficit to 4.4% of GDP this year and to 3% next year.

Risks to the projections

The projections contained in this report point to a substantial decline in activity in 2012, in a context in which it is considered imperative to urgently pursue fiscal consolidation in line with commitments made at European level, set against the ongoing restructuring of household and corporate balance sheets, significant strains in financial markets and a lower contribution from export markets to the growth of national output. In 2013, budget consolidation efforts would be more modest and this, in conjunction with the greater momentum of the world economy, would help to gradually bring the growth rate closer to its long-term potential, although the output gap would remain negative.

This projection exercise is subject to a very high degree of uncertainty stemming mainly from the normative nature of the fiscal assumptions made and from the extraordinary magnitude of the budget consolidation measures needed to meet the targets set (making it very difficult to accurately estimate their impact on spending and activity). The uncertainty also arises from the complex situation of the euro area and financial markets, following the deepening of the sovereign debt crisis, making it advisable to consider these projections with the utmost caution.

Aside from their considerable scale, the risks of deviations in respect of economic activity are overall probably balanced. Noteworthy among the downside risks would be the possibility of further strains emerging in financial markets which might arise, for example, from the difficulties of finding a coordinated response to the sovereign debt crisis or from an intensification of the negative feed-back loop between debt market strains and bank funding markets. This could spread to Spanish markets, further tightening the financing conditions of public and private agents in Spain. Nor can it be ruled out that the euro area and world economies may perform more unfavourably in 2012 than has been assumed in this report, given the scale of the imbalances which have built up in some regions and insufficient economic policy coordination. That would lead to lower growth of Spanish export markets and, consequently, a smaller contribution from net external demand to the expansion of GDP, the fundamental source of growth in Spain in the next two years.

As discussed above, the consolidation programme that must be implemented is essential and of a highly substantial magnitude. However, high uncertainty exists about its short-term impact on activity and it will surely differ from the impact included in these projections since the details of the consolidation programme are not known. In any event, certain measures could help minimise the possible risks of growth slippage with respect to the macroeconomic projections presented here (it could even have a less intense impact than that projected in this report). Accordingly, the early presentation of a full and clearly detailed consolidation programme would contribute to reducing uncertainty about the commitments acquired and would improve the outlook for Spanish public finances to swiftly resume a stable path. The fact that the bulk of the adjustment rests, as announced, on containing public spending instead of raising taxes would also be a positive factor, since consolidation programmes implemented in this way generally tend to be more successful. Finally, it is essential to minimise the risks of non-compliance with the targets set. For this purpose, mechanisms must be set in place to signal any possible deviations detected in the budget outturn and to permit a prompt response to them. Last year's experience indicates that it is necessary to substantially improve the instruments for monitoring general government accounts, in particular those of the regional governments.

Upside risks to the growth rates projected in this report would include those arising from a more favourable reaction from financial markets to the fiscal consolidation scenario and the gradual achievement of positive results in this area, which would reduce Spanish agents' (including general government's) borrowing costs, ease external and internal credit conditions, improve the confidence of various agents in the outlook for the Spanish economy and point to the implementation of new investment projects. An essential ingredient that would contribute to reviving medium and long-term growth would be the introduction of an ambitious reform of the labour market, especially of hiring and collective bargaining mechanisms, as well as establishing arrangements to contain, to a greater extent, wage increases in 2012 and 2013. Decisive measures in these areas would contribute to mitigating the cost in terms of employment of the projected decline in activity, at the same time as they would be highly useful, at a juncture when Spanish competitiveness is a crucial factor underpinning a sustained recovery. Lastly, these measures would boost the productivity of the Spanish economy and, as a result, its growth potential. Furthermore, action taken along these lines would improve the perception that Spain's external debt is sustainable which, once again, would improve borrowing conditions. The potential advantages of the aforementioned labour market reform were not considered in these projections, with the result that action taken in these spheres could give rise to a less negative performance of activity and employment in the next two years than that projected here. Finally, fresh progress in the financial restructuring process under way should improve fin-

nancing conditions for credit institutions so that they are in a sounder position when the economy picks up.

The risks of deviation with respect to inflation also seem balanced. Inflationary pressures could be greater, if strains on the oil market increase or if greater recourse is had to raising indirect taxes in the consolidation programme. By contrast, there are factors which could lead to more moderate inflation rates such as weak demand, which would squeeze margins considerably, especially if accompanied by liberalising measures in certain markets to increase competition. Similarly, the above-mentioned labour market measures could bring an end to the existing wage inertia and increase the cyclical sensitivity of labour costs, which would help to restrict price rises.

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