

Summary

This report includes the analysis, conducted by the Banco de España's Directorate General for Economics, Statistics and Research, on the situation of and the outlook for the Spanish economy for the years 2013 and 2014. The information available as at 14 March was used to prepare this report.

Since the publication of the last report in January 2012, the Spanish economy has been subject to the effects of various factors which have notably complicated the economic situation. In addition to the difficulties posed by the adjustment of the imbalances built up by the Spanish economy, 2012 saw the most serious episode in the European sovereign debt crisis.

The high degree of tension and fragmentation affecting financial markets in the euro area in the summer months, a reflection of the redenomination risk threatening the euro area at that time, had a particularly negative impact on the economies in the area that are more sensitive to changes in investor confidence. In the case of the Spanish economy, the turmoil on capital markets had a highly notable impact on sovereign debt risk premia, which at end-July reached their highest levels since the common currency was introduced. The strains on government debt markets were rapidly passed through to the financing conditions of Spanish private issuers and, very particularly, to those of the financial sector as a whole. At the worst moments in this episode last summer there were sizeable net outflows of funds abroad which could only be counterbalanced through greater recourse to Eurosystem funds.

Against this highly uncertain backdrop, the announcement by the European Central Bank of its Outright Monetary Transactions (OMT) programme at the beginning of September laid the foundations for the gradual normalisation of domestic banks' access to financial markets. In turn, the sound progress seen in the bank restructuring process in Spain, according to the timetable set by the Memorandum of Understanding signed with the European authorities last July, contributed to improving confidence in the Spanish financial sector. As a result of the foregoing, in the final stretch of 2012 external financing flows picked up and investors' mistrust of Spanish issues diminished considerably. More recently, improved market perception was consolidated by the considerable progress in the reduction of the budget deficit which, on Government estimates, reached 6.7% of GDP in 2012 (10% of GDP, if the impact of the financial assistance is included).

That said, the deteriorating confidence, the tight financial conditions for households and for non-financial corporations, the weak labour market and the contractionary effect of private-sector balance sheet restructuring and certain fiscal adjustment measures prompted a sharp contraction of domestic demand which slipped 4.3% in 2012 as a whole. These developments were partly offset by the positive contribution from the external sector (2.8 pp) and, as a result, GDP fell by^(*) 1.4%. The greater budget consolidation in the final stretch of the year, together with the effect of the other above-mentioned factors, resulted in a strong contraction of domestic spending in the last quarter of 2012. This, in conjunction with sluggish sales to the euro area as a whole, caused the decline in GDP to step up in Q4, with year-on-year and quarter-on-quarter rates of decrease of 1.9% and 0.8%, respectively.

(*) In an initial version of this report, the preposition "to" was mistakenly used instead of "by".

The projection exercise for the two-year period 2013-2014 presented in this report has, therefore, as a starting point a markedly weak and highly uncertain situation. In recent months the situation in financial markets has normalised somewhat, although all the uncertainties inherent in the unfolding of the euro area crisis have not been fully dispelled. The Spanish economy, for its part, is undergoing a far-reaching adjustment process, the completion of which is no simple matter. Nevertheless, the temporary nature of some of the factors which affected activity negatively during the closing months of 2012 indicate, with the caution demanded by such a complex setting, that the Spanish economy could already be emerging from the most acute phase of the current recession. Thus, the reversal of some of the recent contractionary impulses should contribute to a moderation in the quarter-on-quarter declines in domestic demand during 2013. The combination of this behaviour with the gradual recovery of exports would permit GDP to stabilise towards the end of 2013, and then to grow in 2014. As a result of the notable carry-over effect of the steep fall in activity in late 2012, the projection for 2013 as a whole is of a slightly higher decline in GDP (-1.5%) than last year, despite the profile of a gradual improvement in quarter-on-quarter GDP rates, followed by a modest recovery (0.6%) in 2014.

As has been the case throughout the crisis, the macroeconomic scenario of these projections continues to be marked by a contraction of domestic demand, which is only offset by the positive contribution of the net external balance. Weak domestic demand is, in turn, the result of the continuing downward path of its public and private components. In particular, the consumption of households will continue to reflect the fragile labour market and the impact of fiscal consolidation on their real incomes, against a backdrop in which their high indebtedness will continue to drain funds from household budgets, leaving little room for gross saving, the weight of which in disposable income will fall for the fourth consecutive year. Residential investment will continue to post declines in 2013 and 2014 in keeping with the flow of housing starts, which will remain at very low levels for most of the projection horizon. Sluggish domestic demand, the low level of capacity utilisation in many sectors and tight financial conditions will give rise to a further decline in private productive investment in 2013. Subsequently, the improvement in activity in 2014 and, in particular, the increase in productive capacity in those sectors which benefit most from buoyant exports will permit a gradual recovery of this variable.

In the area of foreign trade, a gradual quickening is expected in the growth path of goods and services exports over the projection period, based on international markets gradually recovering momentum. Furthermore, the rate of increase of sales to the rest of the world is projected to exceed that of markets themselves, by a margin similar to that seen in recent years, reflecting the continuing improvements in the competitiveness of the Spanish economy and, especially, of its export base, since the slack domestic market will continue to fuel an increase in the fraction of domestic production earmarked for export. The favourable performance of exports together with the decline in imports triggered by weak domestic demand will give rise to a slightly higher contribution from the external balance in 2013 than in 2012. In 2014, this contribution will moderate due to the effect of the gradual recovery of imports in line with the more positive performance of final demand.

The decline in GDP in 2013 will entail a notable reduction in employment, of 3.8%, partly determined by the marked carry-over effect of the negative performance of employment in the final stretch of last year. In 2014, the pace of job destruction is expected to moderate substantially and, in fact, it is estimated that net job creation will begin in the market economy over the course of the year. This projection for employment will result, despite the foreseeable decrease in the labour force, in further rises in the unemployment rate in

2013, which will be corrected slightly in 2014 when this variable is expected to show a declining quarter-on-quarter profile. This central scenario was constructed on the assumption that the labour reform approved last year will continue to have a moderating effect on wages, of a similar intensity to that seen to date. Better use of the possibilities afforded by the new labour legislation to adapt wages to the extremely weak labour market could have, however, a considerable further moderating effect on the path of job destruction described above. Also, the adoption of additional measures in this field or more determined action in the broader area of structural reforms could create more favourable conditions for economic growth, making it easier to reduce unemployment more rapidly.

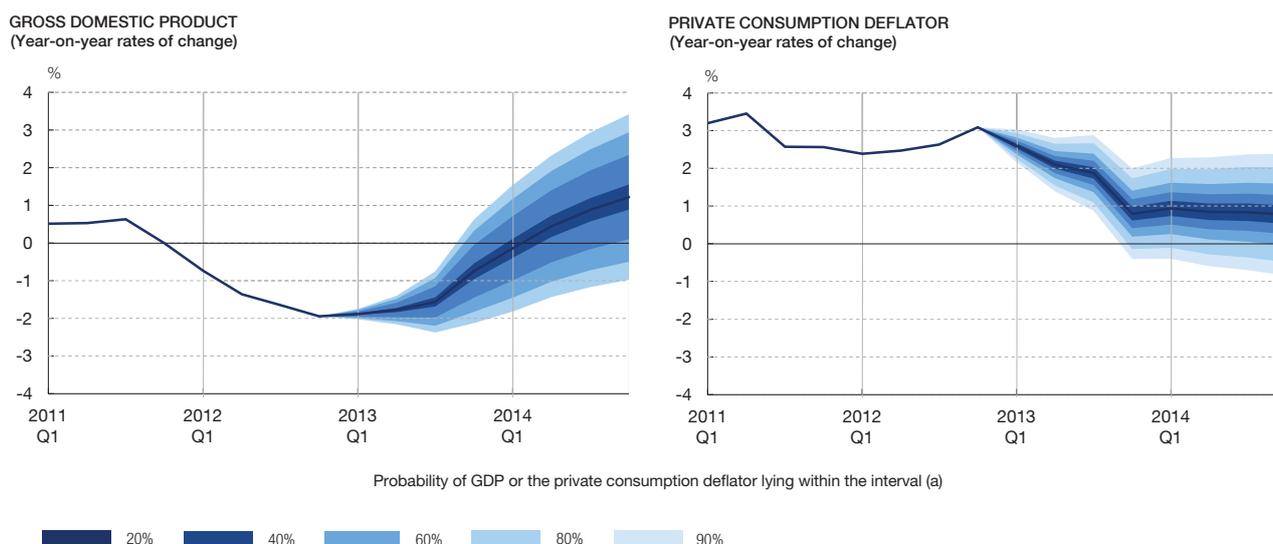
As for inflation, the further decrease in unit labour costs projected for the next two years, together with the moderation of margins stemming from weak demand, will mean that, in the absence of fresh increases in taxes or in the prices of regulated goods and services, consumer prices will rise at moderate rates of 1.8% and 1.0% in 2013 and 2014, respectively.

The macroeconomic scenario described is consistent with the continuation during the next two years of the adjustment of the external imbalance and of the private sector's overindebtedness. Specifically, these projections are compatible with the generation of net lending for the Spanish economy as a whole (a surplus on the current and capital accounts) in 2013 of around 2.5% of GDP, which is expected to increase by a further 1 pp in 2014. This improvement in the external balance will essentially reflect an increase in the trade surplus achieved in 2012. Energy dependence and the income deficit generated by foreign debt will remain, as in previous years, the main factors curtailing the increase in Spain's net lending.

From a sectoral perspective, the correction of the imbalance between the saving and investment of the economy as a whole will mainly stem from the decrease in the budget deficit from around 10% of GDP in 2012 (including the effect of the State aid for the financial sector) to close to 6% of GDP both in 2013 and in 2014, according to the fiscal assumptions included in this report which are detailed below. Households will reverse the path of reductions in net lending seen in recent years, while non-financial corporations will continue to increase their net lending. In both cases, the deleveraging process is projected to continue throughout the next two-year period, albeit at a more vigorous pace in the case of corporations than in the case of households, whose low level of saving would limit their ability to clean up their balance sheets more decisively.

The high uncertainty surrounding the formulation of these projections is indicated approximately by means of the bands around the projected path for GDP and the private consumption deflator shown in Chart 1. These intervals show different probabilities of deviation, calculated on the basis of past forecasting errors.

The risks of deviation from the central scenario of these projections are judged to be greater on the downside, i.e. that there is a greater possibility of a path of lower activity. In fact, the risks of a decline in the financial environment of the euro area or the possibility of a more demanding fiscal adjustment than that envisaged in the budget assumptions included in this report could result in lower growth rates. However, conversely, there would be the possibility that the positive developments seen in the last year could gain traction. The probability of this happening would increase if suitable policies are followed and further progress is made with the structural reforms in the markets for factors and for goods and services. The recovery of investor confidence in the Spanish economy would facilitate an improvement in the financing conditions of public and private agents, while swifter



SOURCES: INE and Banco de España.
Latest data: 2012 Q4.

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.

progress in the recovery of competitiveness would improve the Spanish economy's growth capacity.

In the fiscal policy arena, early definition, over a medium-term horizon, of the necessary measures to maintain a path of sustained deficit reduction and strict application of the mechanisms introduced in the new budget stability law to identify and appropriately correct possible slippage in the budget plans would increase confidence in the success of the fiscal consolidation process. Similarly, the completion of the various stages of the restructuring of the financial system could have a positive effect on agents' confidence and on conditions of access to credit for households and corporations.

Turning to inflation, the risks of deviation are balanced over the projection horizon. On one hand, inflationary pressures might be greater if the fiscal adjustment were to require increases in regulated prices or indirect taxes. On the other, greater effectiveness of the recent labour market reform together with other possible structural reforms that increase the sensitivity of wages and prices to the economy's current cyclical position would lead to a more moderate price trajectory. Lastly, an appreciation of the euro above the levels expected could likewise contribute to containing prices.

The following two sections describe the external and fiscal assumptions on which the projections are based. Then, a more detailed diagnosis of the outlook for the Spanish economy is presented. In the last part of the report the main risks to the central scenario are described.

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 over the forecast horizon (see Table 1). The procedure used to construct the paths of most of the exogenous variables over the period 2013-2014 is the same as the one used in the quarterly projection exercises conducted by experts of the ECB and of the Eurosystem NCBs. This is the case of the euro

Annual rates of change, unless otherwise indicated

	2009	2010	2011	2012	Projection	
					2013	2014
International environment						
World output	-0.8	5.1	3.9	3.1	3.2	4.0
Global markets	-10.7	12.8	6.3	2.8	3.7	6.5
Spain's export markets	-10.7	10.7	4.6	0.6	1.6	4.9
Oil price (in USD)	61.9	79.6	111.0	111.9	109.3	105.0
Competitors' export prices in euro	-4.1	6.9	4.6	4.0	-0.2	1.5
Monetary and financial conditions						
Dollar/euro exchange rate (USD per euro)	1.39	1.33	1.39	1.28	1.31	1.30
Short-term interest rate (3-month EURIBOR)	1.2	0.8	1.4	0.6	0.2	0.4
Long-term interest rate (10-year bond yield)	4.0	4.2	5.4	5.8	5.1	5.5

SOURCES: ECB and Banco de España.
Latest QNA data: 2012 Q4.

a Projection cut-off date: 14.3.2013.

exchange rate, Spanish share prices, oil prices and three-month and 10-year interest rates, the assumptions for which are based on market developments 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 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 \$1.31 per euro on average in 2013, 2.3% up on 2012, and at \$1.30 in 2014. The path of oil prices, based according to the usual technical assumption on the latest information from the futures markets, envisages some moderation of the price in dollars, which, combined with the appreciation of the European single currency, entails a decline in the price in euro both in 2013 and in 2014.

The trajectory of short-term interest rates, obtained from expectations implicit in futures markets about changes in the three-month EURIBOR, shows that these will remain low over the projection period, although they display a mild upward trend with respect to the latest data observed, standing, on average, at 0.2% in 2013 and 0.4% in 2014, as against 0.6% in 2012. Long-term government bond yields, obtained from the expectations implicit in the yield curve, also display a rising trend over the projection horizon, relative to their latest levels, standing, on average, at 5.1% in 2013 and at 5.5% in 2014, as against 5.8% in 2012.

On the basis of the assumptions about these reference interest rates and about the yield spread between Spanish and German government debt, projections are made of the cost of financing for households and firms. These show such costs remaining relatively stable at around their current levels in 2013, and increasing slightly in 2014, basically as a result of the rise in interbank yields. Also, it is assumed that banks will keep credit conditions,

¹ In this case the cut-off date is 14 March 2013. 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.

other than interest rates, largely unchanged. The technical assumption made regarding share price developments implies that they will fall slightly. As for house prices, which, along with share prices, are the other main determinant of changes in household wealth, their ongoing adjustment is projected to continue, with further falls up until the final part of the projection period, when the first signs of stabilisation are seen.

With regard to world trade, a gradual recovery in Spanish export markets is expected, following the slackness seen in 2012 when they grew by only 0.6%, they will increase by 1.6% in 2013. This improvement is expected to intensify in 2014, in line with the greater buoyancy anticipated for the world economy, so that Spanish markets are expected to grow by 4.9% that year.

Fiscal assumptions

This report appears at a time when the Spanish economy is in the middle of an intense budgetary retrenchment. Accordingly, the fiscal policy assumptions are one of the main determinants of macroeconomic developments over the projection horizon. The principle usually applied when the fiscal assumptions underlying a macroeconomic projection exercise are drawn up is that only those measures that have already been approved, or at least specified in sufficient detail, should be taken into account. This principle is not appropriate in situations of extraordinary fiscal adjustment, since its strict application would introduce significant bias into the macroeconomic projections. Thus, as in the case of the *Projections Reports* of the last two years, this practice has been replaced by that of including in the central scenario not only those measures already approved, but also others that appear in the multi-year budget plans that have been announced and that are considered likely to be adopted. Even so, there are differences with respect to the Government's fiscal assumptions, basically arising from the different macroeconomic scenario, and from the different dynamics underlying certain items of government expenditure and revenue.

In the projections presented here, the fiscal assumptions for 2013 include the information contained in the 2013-2014 Budget Plan,² which was subsequently validated by the General Budgets of the State, the Social Security System and the regional governments for this year. Specifically, on the revenue side, the main measures considered include: the impact of the increase in VAT rates in September 2012; the effects on personal income tax of the withdrawal of certain deductions; the extension of the wealth tax; the restrictions in the corporate income tax on the deductibility of amortisation expenses; the increase in the maximum bases for social security contributions; and the measures included in the law on fiscal measures for energy sustainability³. Included on the expenditure side are: the 1% rise in pensions (2% for pensions below €1,000); the public-sector wage freeze and the reinstatement of the extra payroll for public-sector employees; the restriction of government investment; the public-sector employment plans, involving an extension of the 10% limit on the coverage of vacancies, with certain exceptions; and the increase in the number of hours worked. Also, a significant moderation in purchases of goods and services, transfers and subsidies is assumed.

The fiscal assumptions for 2014 are partly based on the official targets set out in the 2013-2014 Budget Plan and, in particular, on certain discretionary items of expenditure. On the

2 The 2013-2014 Budget Plan published by the Government on 3 August 2012 updated the official fiscal policy plans for general government as a whole to make them compatible with the revised consolidation path approved at the Ecofin Council meeting of 10 July 2012. Many of the measures included in this plan had already been approved by the Government in Royal Decree-Law 20/2012 of 13 July 2012.

3 Law 15/2012 of 27 December 2012 on fiscal measures for energy sustainability entered into force on 1 January 2013.

revenue side, it is important to note that a number of fiscal measures applied in 2012 and 2013, with a significant impact on receipts, are due to expire in 2014. These include the higher personal income tax rates, the withdrawal of or reduction in certain corporate income tax deductions, the property tax surcharge and the reintroduction of the wealth tax. This report assumes that these fiscal measures, the total impact of which would be around 1.2% of GDP, will be retained in 2014, since, in the absence of offsetting measures, their termination would cause the budget deficit to return to an upward trend in 2014, widening the gap with respect to the target set for that year. For these purposes, it is important to remember that, in line with the European semester timetable, Spain's Stability Programme Update and, consequently, revised macroeconomic assumptions and more detailed information on the Government's fiscal consolidation strategy will be available in April.

Outlook for the Spanish economy

As mentioned above, these projections envisage a continuation of the recessionary path at the beginning of 2013, with a decline in GDP, in annual average terms, of 1.5% (see Table 2). At the beginning of this year the ongoing adjustment processes have continued to exert a contractionary effect on activity. In particular, private agents are still in the process of deleveraging, households have seen their income considerably reduced, the process of restoring the sustainability of public finances has continued and the decline in residential investment has still not come to an end.

By component, domestic demand is projected to decline sharply (-4.3%), and by more than in 2012 (-3.9%). In particular, among the components of private demand, the fall in private consumption is expected to accelerate, to -3%, against a background of a further decrease in nominal income, basically due to the marked weakness of labour income (see Chart 2). However, as in the last few years, the decline in household consumption will be tempered by lower saving. Also, residential investment is expected to fall for the sixth consecutive year, at a rate of around 10%, which is somewhat higher than in 2012, in line with the acceleration in the rate of decline in the number of residential building permits in the second half of 2012. Accordingly, it seems likely that the contraction of household income, tight financial conditions and the uncertainty regarding house price developments will continue to limit the demand for residential housing.

Against this background of weak domestic demand, business investment is also expected to decline in 2013, at an average rate of around 5%. However, certain factors are discerned that could begin to moderate the fall in this variable in the second half of the year. These factors include the availability to firms of internal funds with which to finance spending during the initial phases of the upswing in the investment cycle, when access to external financing tends to be on more restrictive conditions. In this respect, it is worth noting that non-financial firms have, since 2009, been net lenders. In addition, although domestic demand developments are not expected to stimulate business investment, the buoyancy of export activity may require an increase in capacity in some sectors. Finally, the crisis has led to a slowdown in the rate of replacement of fixed capital and, therefore, to a degree of obsolescence that may be higher than usual, which may give rise to an additional boost to the possible rise in investment.

Government demand will continue to fall in 2013, reflecting the ongoing fiscal consolidation. On the basis of the currently known budget plans of the various tiers of general government, reductions in the number of public-sector employees and in purchases of goods and services are estimated that will result in a rate of change in government consumption of -4.4% in 2013, which would imply a certain acceleration in the rate of contraction of this component of demand relative to 2012. On the other hand, general government investment

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

TABLE 2

Annual rate of change in volume terms and % of GDP

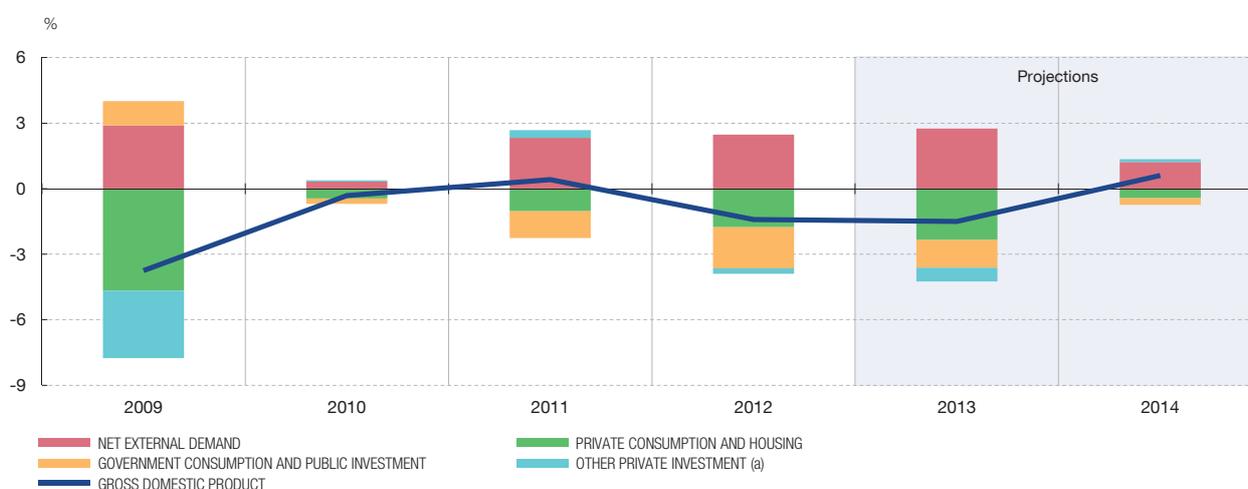
	2009	2010	2011	2012	Projection	
					2013	2014
GDP	-3.7	-0.3	0.4	-1.4	-1.5	0.6
Private consumption	-3.8	0.7	-1.0	-2.1	-3.0	-0.3
Government consumption	3.8	1.5	-0.5	-3.7	-4.4	-1.5
Gross fixed capital formation	-18.0	-6.2	-5.3	-9.1	-8.1	-0.9
Investment in capital goods	-23.9	2.6	2.4	-6.6	-5.6	1.4
Investment in construction	-16.6	-9.8	-9.0	-11.5	-10.1	-2.5
Exports of goods and services	-10.0	11.3	7.6	3.1	3.8	5.4
Imports of goods and services	-17.2	9.2	-0.9	-5.0	-4.9	2.0
National demand (contribution to growth)	-6.6	-0.6	-1.9	-3.9	-4.2	-0.6
Net external demand (contribution to growth)	2.9	0.3	2.3	2.5	2.8	1.2
Private consumption deflator	-1.1	2.0	2.9	2.6	1.9	0.9
Unit labour costs	1.5	-2.0	-1.4	-3.4	-0.7	-1.3
Compensation per employee	4.2	0.3	0.7	-0.3	1.7	-0.1
Apparent labour productivity	2.7	2.3	2.2	3.2	2.4	1.2
Employment (full-time equivalent)	-6.3	-2.5	-1.7	-4.4	-3.8	-0.6
Unemployment rate (% of labour force)	18.0	20.1	21.6	25.0	27.1	26.8
Saving rate of households and NPISHs	17.8	13.1	11.0	8.4	8.1	8.2
National economy's net lending (+)/net borrowing (-) (% of GDP)	-4.3	-3.8	-3.2	-0.2	2.5	3.5
General government net lending (+)/net borrowing (-) (% of GDP)	-11.2	-9.7	-9.4	-10.0	-6.0	-5.9

SOURCES: Banco de España and INE.
Latest QNA data: 2012 Q4.

a Projection cut-off date: 14.3.2013.

CONTRIBUTIONS TO GDP GROWTH

CHART 2



SOURCES: INE and Banco de España.
Latest data: 2012 Q4.

a Includes changes in inventories.

is budgeted to fall by around 20% in 2013, which is only about half of the decline estimated to have occurred in 2012.

On the external front, exports are expected to grow by 3.8%. As a result, and as has been the case in recent years, the growth rate of exports will once again outstrip that of Spanish export markets. Specifically, the consequent gain in the share of Spanish exports in these markets would be around 2 pp in 2013. The process would be driven by the search by Spanish firms for new markets to replace the loss of domestic demand and, also, by a

fresh gain in price-competitiveness. This in a setting in which wage moderation will continue, giving rise, in conjunction with the increase in productivity, to a further reduction in unit labour costs. Finally, imports are expected to fall off at a rate of 4.9%, similar to that in 2012, against the background of a projected decline in final demand which, in terms both of its size and composition, would be on a par with that of the previous year.

In the first half of 2013, quarter-on-quarter declines in output are expected to continue at similar rates to those observed, on average, since the start of the current recession. However, towards the end of the year a gradual rise in activity is foreseen. Firstly, an improved export performance is projected as a result of the pick-up in global trade flows, against a background of continuing diversification of end-markets and ongoing gains in competitiveness. This scenario of gradual recovery in the world economy, especially if accompanied by an easing in financing conditions, should contribute to sustaining greater momentum in business investment. Further, while the absorption of the accumulated stock of housing will take time, an easing in the negative contribution of residential investment to GDP growth on top of that seen in recent years is expected. Finally, although the fiscal consolidation drive will still have to be very significant in 2013, a gradual decline in the negative contribution of the public components to GDP growth is also assumed.

In 2014 a gradual strengthening of activity is expected, with positive though modest growth rates being posted from the start of the year. The increase in GDP will mainly be based on a progressive improvement in the various components of private demand. On the household expenditure side, positive growth might be achieved at the end of the projection horizon, in a setting in which household income would also cease to fall, although in annual average terms it would continue declining. Finally, the projections are that net external demand will continue contributing to output growth, albeit less so than in 2013 since, although the pace of increase of exports will increase in step with that of our export markets, imports will post more expansionary growth, in keeping with the improved momentum of national demand.

In line with the decline in output, net job destruction is expected to continue in 2013, meaning that employment will fall by 3.8%. In this projection a prudent assumption has been adopted about the short-term impact of the 2012-approved labour reform on labour market conditions. In particular, the reform is projected to exert a moderating effect on wages, similar to that witnessed in the second half of 2012. Furthermore, a still-high rate of increase in productivity, of 2.4%, is foreseen in the market economy sectors; nonetheless, that will entail some slowing from the rate of 3.3% observed in 2012. Naturally, a more intensive use of the possibilities afforded by the new labour regulations to shift the adjustment from employment towards wages is expected to translate into a greater slowdown in productivity and a lesser decrease in jobs. Meanwhile, in the public sector an intensification of the decline in employment is expected in the current year, in line with the plans approved by central, regional and local government. In 2014 there is expected to be a divergent pattern between employment in the public sector, on which a downward adjustment will continue to weigh, given fiscal consolidation needs, and the private sector, where the incipient recovery in activity will give rise to net job increases.

The recent declining trend of the labour force is expected to intensify over the projection horizon, as a result of the easing in the increases in the participation rate and of the decline in the working-age population. Given the projected trajectory for employment, this does not prevent a further rise in the unemployment rate in 2013, up to 27.1% of the labour force, before declining over the course of 2014 to 26.8% for the year on average.

As indicated, the projections for compensation per employee factor in some increase in the sensitivity of this variable to the fluctuations in economic activity and in inflation, in line with the signs recently observed, which translates into greater wage moderation. Also contributing to this is the fact that most of the collective bargaining agreements in force over the projection horizon will have been signed after the entry into force of the two Agreements for Employment and Collective Bargaining, concluded in January 2010 and February 2012, respectively, meaning that the proportion of agreements indexed to the current behaviour of inflation is increasingly smaller. Against this background, the growth of compensation per employee in the market economy is expected to move at rates of 0.7% and -0.4% in 2013 and 2014, respectively. When interpreting the 2013 forecast, it should be borne in mind that this rate incorporates the impact on the social security contributions component derived from the increase in the maximum contribution bases, meaning that, once this effect is stripped out, the wage increase would be -0.1%. Given the projected rate of increase for labour productivity, market-economy unit labour costs are expected to continue declining in 2013 and 2014 at rates of around 1.5%, somewhat down on those observed in the previous two-year period. The moderation of private-sector wage costs is a crucial ingredient for exiting the crisis, as this is needed to press ahead with the external adjustment of the economy.

The projected wage developments in the general government sector take into consideration the aforementioned fiscal assumptions. On that basis, non-market economy wages are expected to rise in 2013 to a rate of 4.3%, basically on the assumption that public-sector employees will once again be given the December extra payroll, followed by a rate of 1.1% in 2014.

Recent developments in inflation, in terms of the year-on-year growth rate of the CPI, have been influenced by the impact of higher VAT rates and the rises in regulated prices in the final stretch of 2012. Core inflation, which strips out these effects, shows a more moderate trajectory. This last observation would confirm that, following the onset of the crisis, the course of prices has become somewhat more sensitive to the degree of demand pressure. In the projection period, the increase in prices is expected to ease as the transitory effects mentioned disappear. Specifically, the CPI is projected to grow on average by 1.8% in 2013 and by 1% in 2014, conditional upon the set of assumptions made.

As to the external balance, which was slightly in deficit for 2012 as a whole, a substantial improvement is expected in 2013. In particular, a net lending capacity of 2.5% of GDP is foreseen, thanks essentially to the behaviour of the trade balance, which could move into balance, despite the high deficit on the energy component. The extension of this adjustment into 2014 will foreseeably provide for an increase in the nation's net lending to 3.5% of GDP.

Analysis of the correction of the external deficit in 2013 from the standpoint of the institutional sectors strongly reflects the impact of the capital transfers by general government to financial institutions in 2012 as part of the restructuring of the financial system. If these effects were excluded, the general government sector would contribute 0.7 pp to the expected improvement of 2.7% of GDP in the nation's net lending in 2013, while that of households and non-financial corporations would be 0.3 pp and 1.2 pp, respectively. The projected widening of the surplus on the household capital account is due to the further reduction in their investment spending, in a setting in which their saving rate is expected to continue declining, albeit at a lower rate than that of the past three years. In the case of non-financial corporations, their improved financing capacity seems to be due both to the continued rise in their saving rate and to the reduction in their investment rate.

The fact that the private sector of the economy shows a high lending capacity has enabled some improvement in its financial position, following the high debt it incurred in the previous expansionary phase. However, headway in deleveraging in the case of households was less; their debt ratio fell by around 4 pp of disposable income from 2010 to 2012, to 125%, while that of non-financial corporations declined from 2009 by almost 160 pp of gross operating surplus to 340%. The expenditure projections for private agents over the projection horizon suggest a continuation of their respective paths of deleveraging towards more sustainable levels, a necessary condition for consumption and investment levels to resume their long-term trajectories beyond the projection horizon.

General government ended 2012 with a deficit of 6.7% of GDP according to the information announced by the government, that is to say, 0.4 pp above the target set, entailing an adjustment of somewhat more than 2 pp of GDP with respect to 2011. This reduction involves a significant fiscal effort, given the context of economic recession and the strong increase in the interest burden. As a result of the assumptions made, the fiscal forecasts for 2013 and 2014 place the budget deficit at around 6% of GDP in both years. These figures do not yet allow a curtailment of the growing trend of the public debt/GDP ratio and they highlight the fact that, despite the intense budgetary consolidation achieved in the past three years, the scale of the fiscal adjustment remaining is still significant if, first, the public debt ratio is to be stabilised and, subsequently, a lasting reduction in public debt is to be made.

Risks to the projections

Since the 2012 projections report was published, the Spanish economy has dipped into a second recession which is influencing its path in the time period covered by the macroeconomic projections in this report. According to these projections, activity will fall off substantially in 2013 and only start to recover in 2014, against a background of ongoing relatively tight financial conditions in which it will be essential to press on with fiscal consolidation under commitments made at the European level, with the clean-up of household and corporate balance sheets, and with the restructuring of credit institutions. And this amid persisting doubts over the resolution of the major problems besetting the euro area for the last three years.

Given these conditioning factors, this projection exercise is subject to a high level of uncertainty stemming from the complex situation of the euro area and financial markets and from the difficulties inherent in the arduous process of adjustment undertaken by the Spanish economy. These sources of uncertainty mean that these projections have to be considered with due caution.

The risks of deviations in respect of economic activity are moderately skewed to the downside. In particular, the assumptions made under this scenario include that of no significant additional tightening of the aggregate financial conditions affecting the Spanish economy in the projection period. However, the high level of uncertainty still prevailing in the international financial arena means that fresh shocks cannot be ruled out. Such developments would adversely affect confidence and the availability and cost of financing for the economy. They would also negatively affect the whole of the region and our export markets. Sales abroad would also be impacted if any of the markets in which Spanish exports have expanded were to grow more slowly than projected. This risk factor may carry particular weight in some emerging regions where both geopolitical uncertainties and those associated with the business cycle are more marked. On the domestic front, if the adjustment of the fiscal imbalance were to prove more exacting than assumed in these projections, short-term growth would probably be lower, while the final impact on activity would, in any event, depend on the composition of the additional effort.

The risks of upside deviations from projected growth include most notably the possibility of a sharper recovery in investor confidence in the Spanish economy than that assumed here, with the resulting positive effect on public- and private-sector financing conditions. Furthermore, an additional acceleration in the recovery in competitiveness under way would enhance the Spanish economy's growth capacity through a higher net contribution from the external sector.

The pursuit of appropriate economic policies may help to improve the resilience of the Spanish economy if the aforementioned or other downside risks materialise and also to increase the plausibility of other scenarios more favourable than the baseline scenario of these projections. In particular, fiscal policy could contribute decisively to boosting investor confidence in our economy by reinforcing credibility gains made through a medium-term budgetary programme which were to provide sufficient details of the content and impact of government revenue and expenditure measures allowing fiscal consolidation to be completed and including the measures needed to address the impact of population ageing on public finances. Simultaneously, the tools envisaged in the Stability Law should be applied in full to avoid deviations from target or ensure their early correction. Making headway in the road map set in the Memorandum of Understanding for restructuring the financial system should also have a positive effect on the outlook for the sector, with the resulting favourable impact on the financing conditions of credit institutions and, consequently, on those of other economic agents. Additionally, the pursuit of policies to enhance the sensitivity of prices, margins and wages to business cycle conditions will spur the reallocation of resources to projects and sectors with higher growth potential. Lastly, policies aimed at improving the efficiency of the economy will make for faster recovery of competitiveness and, in short, raise the potential for growth and job creation.

The risks of deviations in respect of inflation are balanced. First, further rises in regulated prices or in indirect taxes with a view to fiscal adjustment may have additional inflationary effects. Second, although these projections factor in a degree of price sensitivity to economic activity similar to that observed since the onset of the crisis, it cannot be ruled out that merely prolonging the contraction of demand may, in itself, make for a greater moderation of inflation. In particular, this would be the result if the recent labour market reform were implemented firmly and further reforms were undertaken in the goods and services markets to promote competition in given sectors.

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