5 THE SPANISH ECONOMY

In 2010, activity declined slightly, by -0.1%, reflecting a negative carry-over effect deriving from the intense contraction in 2009. That said, the Spanish economy commenced its recovery in 2010, with a slight increase in activity in each quarter except for the third. As seen in Chart 5.1, the upturn in 2010 was modest in comparison with the loss of output during the recession: as against a cumulative decline in activity of almost 5 percentage points (pp) in 2008 and 2009, in 2010 activity recovered by barely 0.6 pp. In 2011 Q1 this process of slow growth continued with output growth of 0.3%. The outlook for 2011 and 2012, according to the *Spanish economic projections report* published by the Banco de España in March, is one of continuation of this gradual recovery, although the pre-crisis level of output will still not have been reached by the end of 2012.

This pace of recovery is also slower than the one observed following the recession of the early 1990s. Among other factors, this is due to the negative performance projected for government consumption and housing investment in 2011 and 2012, in comparison with 1995 and 1996, as a result of the greater intensity of the fiscal and real-estate-market adjustment in the present crisis. By contrast, the recovery in government consumption is not projected to be very different in the next two years from that seen in the mid-1990s and the contribution of net external demand to output is projected to be even higher in 2011 and 2012, despite the absence of the exchange rate instrument. The recovery in activity is therefore expected to be gradual as a result of the adjustment of the imbalances accumulated during the upturn and of the fiscal deterioration that emerged during the crisis, which are currently manifest in the need to reduce public demand to make it more consistent with the resources available, while the possibilities of an expansion in private demand are limited by the high indebtedness. In this process, the improvement in net exports will support growth and permit a reduction in the recourse to external saving. The slowness of the pick-up in activity also contrasts with the stronger recovery discernible in the euro area. Although the depth of the recession in the euro area was similar to that in Spain, in terms of the decline in output, there was a significant increase in activity in the euro area in 2010, which is expected to continue in 2011 and 2012.

The severity of the recession and slowness of the recovery have resulted in substantial excess capacity in the Spanish economy, which is manifest in a very large negative output gap and high rate of unemployment, and have had a significant negative impact on potential output.

1 Monetary and financial conditions

The financial strains raised the cost of financing for general government and credit institutions...

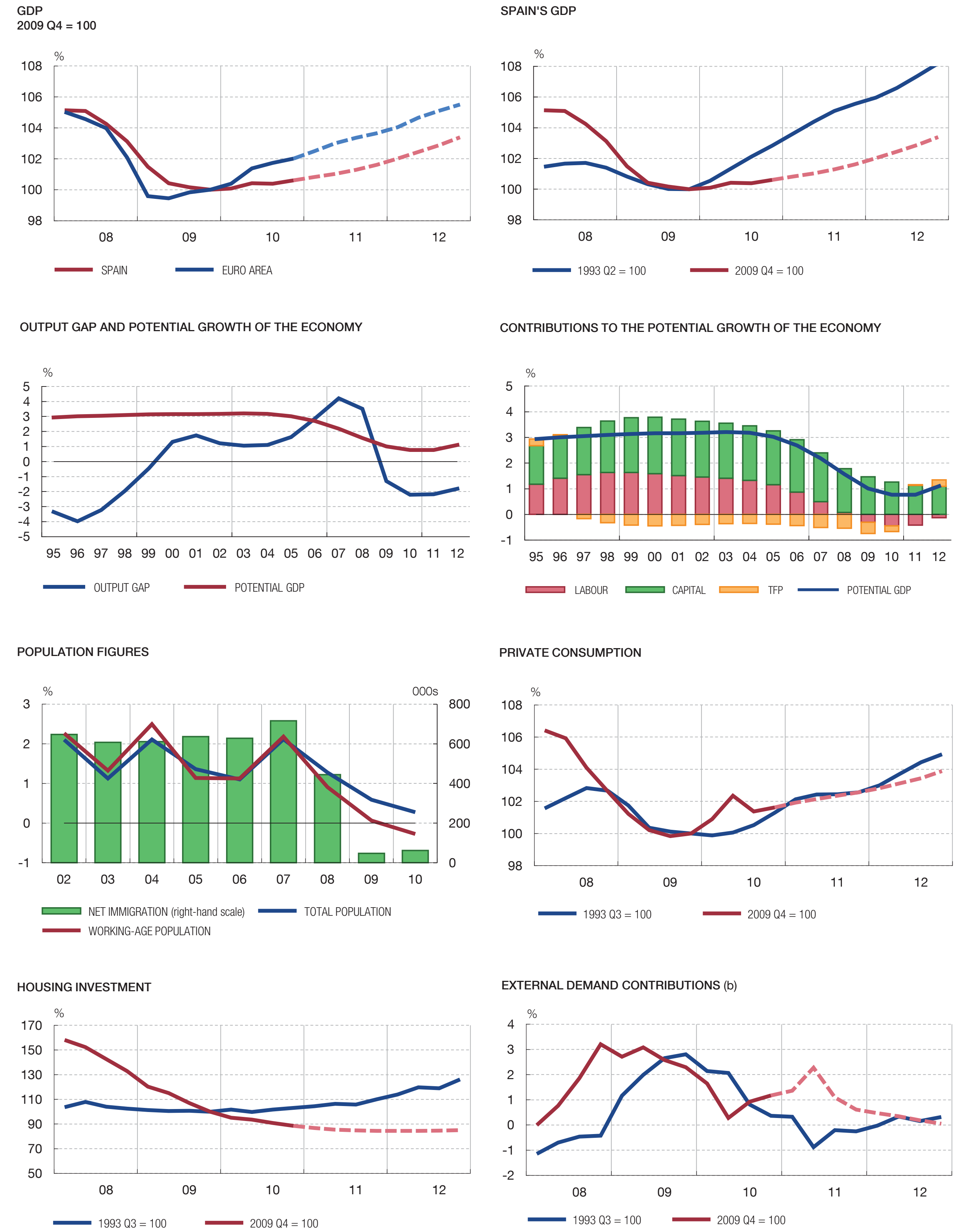
The strains in the euro area financial markets stemming from the sovereign debt crisis were reflected in a significant rise in the cost of financing for general government and credit institutions, and in greater difficulty for the latter to obtain access to wholesale markets. The strains reached a peak in November. Subsequently, the risk premiums of resident issuers have tended to fall, within a context of marked volatility, although they remain relatively high (over 200 basis points (bp) in May 2011).

... and contributed to a certain tightening of the financing conditions for firms and households, which were also affected by the increase in market interest rates

The cost of bank financing for households and non-financial firms also increased from mid-2010 (see Chart 5.2). This was the result of the increase in interbank yields and, from early 2011, of a progressive passing through of the rise in the cost of financial institutions' liabilities to the margins they apply to their transactions with customers. Credit standards remained restrictive and, according to the Bank Lending Survey (BLS), tightened further, albeit moderately, in 2010 Q2, basically as a consequence of the financial strains. Subsequently they have remained unchanged, except in 2011 Q1, when they tightened again

CHARACTERISATION OF THE CURRENT CYCLE (a)

CHART 5.1

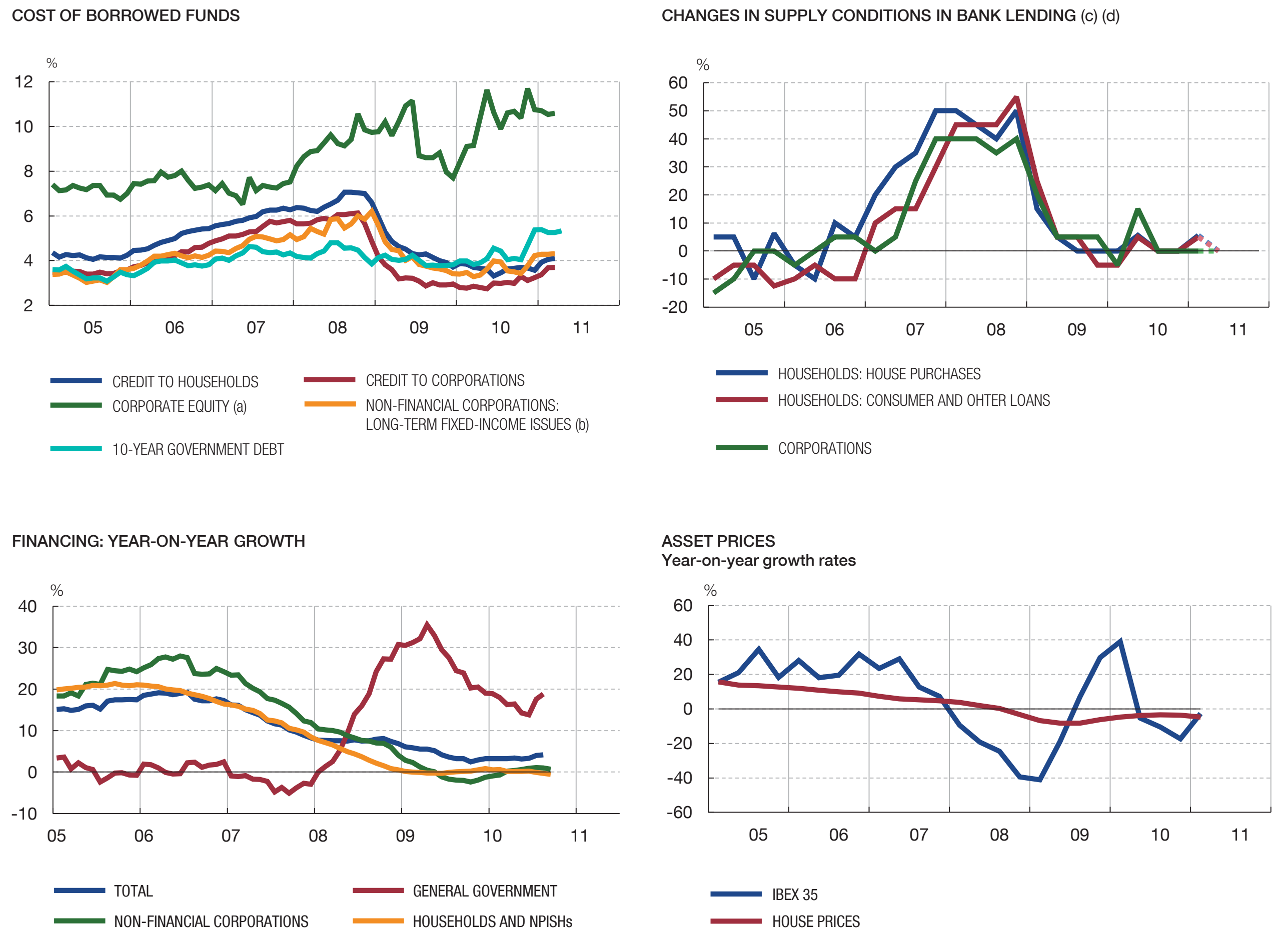


SOURCE: INE and Banco de España.

a Forecasts in broken line.
b Year-on-year growth rates.

FINANCING OF RESIDENT NON-FINANCIAL SECTORS AND ASSET PRICES

CHART 5.2



SOURCES: Ministerio de Vivienda, Datastream, MSCI Blue Book and Banco de España.

a The cost of equity is based on the three-stage Gordon dividend discount model.
b The interest rate on long-term fixed income is calculated as the sum of the 5-year euro swap rate and the weighted average of the credit risk insurance premia of Spanish non-financial corporations at that same term.
c Indicator = % of institutions reporting a considerable tightening × 1 + % of institutions reporting some tightening × 1/2 – % of institutions reporting some easing × 1/2 – % of institutions reporting considerable easing × 1.
d The broken line indicates forecasts made the previous quarter by respondents.

somewhat in the household financing segment. The turmoil also led to a rise in the cost for non-financial firms of issuing fixed and variable-income securities.

The decline in the price of financial and real assets also contributed to the tightening of financial conditions, but the exchange rate depreciation had the opposite effect

The price of financial and real assets declined in 2010 (the IBEX 35 index fell by 17.4% and the value of housing by 3.5%, which in the latter case made a total fall from the peak values recorded in early 2008 of 13% in nominal terms and 18% in real terms). This also contributed to the tightening of financial conditions, although the depreciation of the nominal effective exchange rate had the opposite effect. In the first few months of 2011, stock markets recovered, growing by 7.5% in the period to 6 May 2011, but the price of housing fell by a further 2.6% in Q1, making a total fall of 20% in real terms, and the euro appreciated significantly.

Despite the stagnation of the debt of households and non-financial corporations...

Against this background, non-financial private sector debt continued to reflect a pattern of slow deleveraging in the case of households and selective deleveraging in that of firms. Household liabilities remained practically unchanged in 2010, although they have contracted slightly since the beginning of 2011, while in the case of non-financial corporations bank lending was reduced in activities linked to the real-estate sector, while its growth was close to zero or slightly positive in other activities. The developments in bank lending and in indebtedness in general are analysed in detail by sector in Chapter 6 of this Report.

... the household debt ratio barely changed, owing to the unfavourable performance of household income, while that of firms fell slightly

Despite the stagnation of household liabilities in the last few years, the household debt ratio has barely fallen from the high levels it reached in 2007, owing to the slackness of the sector's income. However, the associated debt burden continued to fall in 2010 as a whole, thanks to the decline in the average annual cost of outstanding debt, although interest rates began to increase in the final months of the year. In the case of non-financial corporations, the recovery in corporate earnings contributed to a larger – albeit moderate – cut in the debt ratio, and also in the associated debt burden, which was driven by the decline in the average cost of outstanding debt. That said, the corporate sector remains highly leveraged, although the situation varies from sector to sector (see Box 6.2).

2 Economic policies

2.1 FISCAL POLICY

2010 marked the commencement of a vigorous fiscal adjustment, which has gone beyond the initial plans

A fiscal consolidation process was initiated in 2010. This process began with the approval in December 2009 of the State budget for 2010 and was reaffirmed by the February 2010 Stability Programme Update (SPU), which set a path to cut the deficit to 3% of GDP in 2013. In May 2010, as a consequence of the European sovereign debt crisis, the Spanish government decided to speed up the consolidation process, with more of the adjustment to be made in 2010 and 2011, while maintaining the target of a budget deficit of 3% of GDP in 2013. The deficit cutting path was thus adjusted to 9.3% of GDP in 2010 (as against the 9.8% initially planned), 6% in 2011 (as against the target of 7.5% of GDP established in the January 2010 SPU) and 4.4% in 2012 (as against the previous level of 5.3%).

The provisional results for 2010 show that the budget deficit targets were achieved – an important milestone for the credibility of the rest of the consolidation path

The provisional budget outturn data for general government as a whole for 2010 show an improvement of 0.1 pp on the target of 9.3% of GDP, which would mean that the deficit was cut by almost 2 pp with respect to 2009 (see Table 5.1). This result was based on an increase of 1 pp in the revenue-to-GDP ratio and a fall in the spending ratio of 0.8 pp. The adjustment was focused on capital expenditure, which was reduced by 1 pp of GDP, and final consumption expenditure (compensation of employees and inputs), which contributed 0.5 pp. Other spending items, such as subsidies and current and capital transfers moderated significantly, but were higher than initially planned. By contrast, social benefits rose by 0.7 pp of GDP, given the inertia of spending on pensions and the high degree of persistence of spending on unemployment benefits. On the revenue side, the strong growth in indirect taxes (in particular, in VAT receipts) offset the less dynamic performance of direct taxes and social contributions. Notable by sector were the improved performance of central government in relation to the target set, the disappearance of the traditional social security surplus and the failure by regional and local governments to comply with their targets.

Public debt increased significantly in 2010, to 60% of GDP, which is still well below the EU average

Partly on account of this large deficit, public debt increased significantly, from 53.3% of GDP in 2009 to 60.1% in 2010, although, given the favourable starting situation it remained well below the EU average. The increase in debt was due to the high budget deficit, which was partly offset by the effect on the debt ratio of positive nominal GDP growth (0.5 pp of GDP) and by the deficit-debt adjustments (2 pp of GDP). The interest burden associated with this level of debt reached 1.9% of GDP in 2010, increasing by somewhat more than 0.1 pp of GDP with respect to 2009, owing to the larger volume of outstanding debt, despite a slight fall in the implicit financing rate. In the coming years, given the expected trend in public debt and interest rates, the interest burden will continue to rise relative to GDP, which will increase the magnitude of the fiscal drive needed to reduce the budget deficit.

MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS

TABLE 5.1

% of GDP

	2005	2006	2007	2008	2009	2010
1 NON-FINANCIAL RESOURCES	39.4	40.4	41.1	37.1	34.7	35.7
Current resources	38.6	39.7	40.6	36.9	34.7	35.7
Taxes on products and imports	12.2	12.3	11.7	9.9	8.7	10.1
Taxes on income and wealth	10.9	11.7	12.9	10.8	9.6	9.4
Social contributions	12.9	12.9	13.0	13.2	13.3	13.2
Other current resources (a)	2.6	2.8	3.0	3.0	3.1	3.1
Capital resources (b)	0.8	0.7	0.5	0.2	-0.1	0.0
2 NON-FINANCIAL USES (c)	38.4	38.4	39.2	41.3	45.8	45.0
Compensation of employees	10.0	10.0	10.2	10.9	11.9	11.7
Other final consumption expenditure	7.6	7.6	7.7	8.2	8.8	8.5
Social benefits other than social transfers in kind	11.6	11.5	11.6	12.4	14.5	15.2
Subsidies	1.0	1.0	1.1	1.1	1.1	1.1
Interest (c)	1.8	1.6	1.6	1.6	1.8	1.9
Other transfers	1.5	1.6	1.5	1.6	1.9	1.7
Capital uses	4.9	5.1	5.4	5.4	5.9	4.9
Gross capital formation	3.6	3.7	4.0	3.9	4.4	3.7
Other capital uses (d)	1.4	1.3	1.4	1.5	1.5	1.2
3 NET LENDING (+) OR NET BORROWING (-) (c) (3=1-2)	1.0	2.0	1.9	-4.2	-11.1	-9.2
MEMORANDUM ITEMS:						
Final consumption	18.0	18.0	18.4	19.5	21.1	20.8
Primary surplus	2.8	3.7	3.5	-2.6	-9.4	-7.3
Gross debt (c)	43.0	39.6	36.1	39.8	53.3	60.1

SOURCE: Structural indicators of the Spanish economy and the EU, Banco de España.

a Includes gross operating surplus.
b The negative sign in 2009 is due to the adjustment for uncertain revenue included with that sign in these resources.
c According to the Excessive Deficit Procedure methodology.
d Includes net acquisitions of non-financial non-produced assets.

The adjustment of the budget deficit in 2010 was essentially structural

The structural improvement in government finances more than offset the negative contribution of the business cycle and the interest burden (see Chart 2.2). Primary structural spending was reduced by somewhat more than 1 pp of GDP, basically due to the withdrawal of the stimulus measures that affected 2009 (see Table 5.2), while tax rises and the withdrawal of temporary revenue-side measures contributed 2 pp of GDP. Despite this improvement, the structural government deficit remained high in 2010, at around 8% of GDP.

The budget results for 2010 show that the main risks of deviation are associated, first, with the behaviour of regional and local government...

The budget results for 2010 show that the main risks in future will be associated, first, with the behaviour of regional and local governments. In this respect, fiscal discipline among regional and local governments, in particular the former, depends crucially on strict compliance with a measure adopted in 2010: approval by the Fiscal and Financial Policy Council of the criteria to be followed by the Ministry of Economic Affairs and Finance when authorising regional government debt operations during the period 2010-13. These criteria lay down two general rules: the indebtedness of regional governments must be in line with the deficit-reduction path; and no operation will be authorised that increases the level of indebtedness of a regional government until the Fiscal and Financial Policy Council has issued a favourable report on its rebalancing plan. These criteria were applied for the first time in November 2010 and affected two

FACTORS EXPLAINING CHANGES IN THE CYCLICALLY ADJUSTED GENERAL GOVERNMENT BALANCE IN SPAIN (a) **TABLE 5.2**

Percentage of trend GDP

Increase (+)/Reduction (-)	2010	2011
Cyclically adjusted general government balance	2.8	2.9
Interest payments	0.1	0.3
Cyclically adjusted general government primary balance	2.9	3.2
BREAKDOWN OF THE CYCLICALLY ADUSTED PRIMARY BALANCE		
Total revenues	1.6	0.9
Total taxes and social contributions	1.6	0.6
Legislative changes	1.3	0.7
Progressiveness	0.0	0.1
Decoupling of the tax base from GDP	-0.1	-0.1
Residual (unexplained effects)	0.3	-0.1
Other revenues	-0.1	0.2
Primary expenditure	-1.4	-2.3
Social benefits	0.5	-0.1
Of which: retirement pensions	*0.3*	*0.2*
Of which: unemployment benefits	*0.1*	*-0.1*
Subsidies	0.0	-0.3
Compensation of employees	-0.3	-0.6
Inputs	-0.3	-0.3
Public investment	-0.7	-0.8
Other expenditure	-0.5	-0.3
Memorandum items:		
General government balance (as a percentage of nominal GDP)	1.9	2.9
Cyclical component (as a percentage of nominal GDP)	-0.9	-0.1

SOURCE: Banco de España.

a The fiscal balance is presented in accordance with the Excessive Deficit Protocol definition.

regional governments, Murcia and Castile-La Mancha, which had to specify their mandatory adjustment plans. Likewise, a measure was approved in 2010 that only allows local governments to seek long-term public or private credit in 2011 if their debt does not exceed 75% of their revenues and the credit is to be used for investment already in progress, or else for co-funded projects. Also, homogeneous regional government data on the budget outturn for the previous quarter were published for the first time in December 2010. This practice, which has continued at the beginning of 2011 and will be repeated on a quarterly basis, amounts to a significant advance in terms of transparency.

... and, second, with the inertia observed in certain spending items

The magnitude, nature and composition of the spending cuts needed to achieve the targets set mean that their fulfilment is uncertain. First, a significant proportion of public spending in Spain is associated with items that have traditionally displayed significant upward inertia, such as spending on education, health and pensions. Second, spending on unemployment benefits, against a background of very high rates of unemployment, amounted to 3 percentage points of GDP in 2010, the highest level in the euro area. The saving measures proposed should be specific and must be accompanied by considerations of efficiency in the provision of services and by further structural reforms, like the recent pensions reform (see Box 2.3).

The recent updated Stability Programme sets an appropriate consolidation path, which must be strictly complied with

On 28 April 2011 the government presented a new Stability Programme Update (SPU) for the period 2011-14. This SPU confirms the budget consolidation path to 2013 approved in May 2010, which, if complied with, will enable the Stability Pact limits to be complied with, in accordance with the recommendations of the European Council. The general government deficit would stand at 3% of GDP in 2013 and the public debt-to-GDP ratio would stabilise at slightly below 70% of GDP in 2012-13, up from 60.1% in 2010. The SPU also presents the deficit target for 2014 (2.1%), when it is planned to reduce public debt to 68.9% of GDP. If these targets are achieved, the strategy proposed in May 2010 of bringing forward to 2010 and 2011 70% of the structural adjustment for the whole of the period 2009-13 would be validated. In addition, from the viewpoint of the quality of public finances, of the total adjustment to be made in the period 2009-13, 65% comes from spending reductions, and 35% from the adjustment of government consumption (21% of the total from the reduction of compensation of employees). However, the April 2011 SPU is based on a macroeconomic scenario that entails relatively high GDP growth rates and if these are not confirmed the achievement of the fiscal projections would be complicated. In this respect, the SPU includes a commitment to comply with the government deficit reduction targets even if the actual macroeconomic scenario is less favourable than the one envisaged.

2.2 OTHER ECONOMIC POLICIES

Certain demand policies introduced during the crisis were withdrawn in 2010...

The year 2010 was characterised by the gradual withdrawal of certain policies designed to sustain short-term demand that had been introduced during the crisis. However, the resources used to finance productive investment and the working capital of SMEs and the self-employed, through different ICO facilities, were maintained. In addition, a new programme of ICO financing at market prices was approved for the period 15 June 2010 to 31 December 2011, under which direct loans were granted to the self-employed and SMEs, with the credit risk involved assumed by the ICO. From its launch until March 2011, around 3,000 applications were approved under this programme, with an average amount of €40,000.

... and certain structural reforms were introduced, among which that of the labour market, with the aim of reducing duality and wage rigidity, was notable

In addition, certain structural reforms were introduced, including notably the labour market reform. The aims of this reform, approved through an emergency procedure in June and ratified by Parliament in September, include the reduction of duality and wage rigidity, two of the main structural problems in the Spanish labour market. The main changes made by this Law are, first, improvement in the actual possibilities of wage opt-out, so that, following the reform, this is permitted if the firm and workers agree to it, irrespective of the provisions of the higher-level agreement. Second, the encouragement of permanent hiring, by increasing the possibilities for objective dismissal, through redefining the economic grounds (which now include the current or anticipated adverse situation of the firm), and by significantly widening the eligibility criteria for employment-promoting contracts (with lower firing costs). New limits are established for temporary hiring, the maximum duration of a contract for a specific task being limited to two years, which can be extended to three by agreement, and the costs of termination of temporary contracts are increased, to 12 days per year worked in 2015. Private employment agencies are permitted to act in the labour intermediation process, in cooperation with the public employment service, which should facilitate the process of matching job offers with job seekers. Finally, the possibilities for making applications for suspension of contracts or short-time working are widened, with the aim of smoothing employment adjustments.

The evidence on the impact of the reform is still limited

It is still too early to assess the extent to which the aims of the Law are being achieved, given the short period since its approval and the difficulty in untangling its influence from other developments in recent months relating to the cycle. The greater possibili-

LABOUR MARKET: SOME IMPORTANT INDICATORS TABLE 5.3

		PERMANENT AND PART-TIME HIRING (a)				APPLICATION FOR SHORT-TIME WORKING (c)		OBJECTIVE DISMISSAL (d)
		Total permanent (a)	Permanent employment promoting (a)	Temporary employment ratio (b)	Part-time ratio (b)	Number of employees	Weights	
2000		8.7	—	32.2	8.0	1,282	2.1	—
2001		9.3	—	32.2	8.1	771	0.6	18.2
2002		9.0	4.7	31.8	8.3	1,268	1.8	18.1
2003		8.7	4.4	31.8	8.4	2,008	2.4	14.0
2004		8.7	3.9	32.5	9.1	525	0.9	11.6
2005		9.0	1.7	33.3	12.3	850	1.2	10.6
2006		11.8	3.9	34.0	12.1	157	0.3	8.9
2007		11.9	4.6	31.7	12.1	226	0.4	7.7
2008		11.5	3.5	29.3	12.3	2,675	1.8	10.6
2009		9.4	1.6	25.4	13.3	20,591	3.7	15.2
2010		8.5	1.9	24.9	14.0	38,136	12.7	18.3
2009								
	Q1	11.1	1.8	25.4	13.2	4,843	2.6	15.3
	Q2	9.6	1.7	25.2	13.5	6,948	4.8	15.4
	Q3	8.3	1.5	25.9	12.8	5,640	5.2	14.8
	Q4	8.6	1.5	25.1	13.9	3,160	2.8	15.1
2010								
	Q1	9.6	1.6	24.4	14.0	3,304	4.2	16.3
	Q2	8.7	1.5	24.9	14.2	2,517	3.7	17.1
	Q3	7.5	1.7	25.6	13.4	10,096	18.0	18.7
	Q4	8.4	2.7	24.8	14.2	22,219	22.8	21.6
2011								
	Q1 (e)	9.4	2.0	24.8	14.8	9,930	22.4	24.1

SOURCE: Ministerio de Trabajo e Inmigración and INE.

a The weight of this type of hiring in total hiring.
b Ratio to EPA employees.
c Number of workers affected by an application for short-time working and their weight in the total number of workers subject to all types of labour force adjustment applications.
d Initial beneficiaries of contributory benefits as a result of an objective dismissal as a percentaje of all beneficiairies as a result of dismissals or applications for labour force reduction.
e 2011 Q1 only covers January and February in the case of objective dismissals.

ties for wage opt-outs should result in more moderate wage settlements, but this, as mentioned below, was not apparent in the first few months of 2011. At the end of 2010 an increase in hiring based on employment-promoting contracts was detected, in line with expectations, although the total number of permanent contracts has barely increased (see Table 5.3). Finally, there was a rise in applications for short-time working in the second half of 2010, in line with the new incentives provided by the reform, and there is also some evidence of an increase in the percentage of dismissals on objective grounds.

This reform was supplemented by subsequent developments which combine incentives for short-term hiring with changes to active policies

Following the approval of this Law certain additional measures were introduced in relation to the labour market. Inter alia, the use of part-time contracts for certain groups is promoted and there are plans to design individualised programmes to improve the employability of the groups most affected by the crisis.

As regards other policies, noteworthy were the elimination of the housing deduction for incomes above a certain level, the approval of the retail trade law...

As regards other reforms, notable, first, are the measures approved to make the purchase and rental of housing fiscally comparable, through the elimination of the deduction for house purchase for incomes above a certain threshold and the equalising of the deductions for purchase and rental for other incomes from 1 January 2011. This reform amounts to significant progress in tax neutrality with respect to the two ways of possessing housing, which is especially necessary in the case of Spain owing, among other aspects, to the low weight of rented housing and the perverse effects of this on worker mobility.

In addition, the Law on default[1] was amended in order to limit the power of general government and large firms when establishing payment conditions, which during the crisis appear to have had a particularly adverse impact on the liquidity of SMEs and the self-employed. Also, the process of transposition of the Services Directive continued in 2010, with the approval of the Law to Reform the Retail Trade Law, which reduces the administrative burden of setting up retail establishments, although the regional governments have retained most of the regional licences required for the opening of large retail outlets.

... as well as the approval of the sustainable economy Law, which includes, among other measures, simplification of the administrative steps involved in starting up a business activity and an improvement in the regulatory environment

In February 2011 the sustainable economy Law was approved, which includes, inter alia, a set of measures designed to reduce the time needed to start up a business that has already been incorporated. Given that the most onerous part, in terms of time and money, of the process of creating a firm is precisely that of starting up the business, implementation of the measures envisaged in this Law could simplify this process considerably.

With regard to the regulatory environment, the sustainable economy Law establishes certain principles of good regulation. To apply these principles, the Law requires that an ex-ante analysis be carried out of the regulatory impact of every initiative, as well as an ex-post analysis to verify the achievement of its aims. In addition, modification of the organisational structure of the National Energy Commission, the Telecommunications Market Commission and the National Postal Sector Commission is proposed, with a reduction in the number of board members in each case, the establishment of a non-renewable 6-year term, a prohibition on the attendance of members of the government or senior management at board meetings and the acts of these regulatory bodies concluding administrative proceedings. Together these changes may give these regulatory bodies greater independence. Also, among measures to reform the financial market, in line with international agreements to increase transparency and enhance corporate governance, the sustainable economy Law amends the Securities Market Law so that listed companies make available to their shareholders a remuneration report to be approved by the shareholders in general meeting.

Finally, the approval of measures to moderate the increase in the tariff deficit and the promotion of a privatisation programme is also noteworthy

As regards the energy sector, measures were adopted at the end of the year to contain the creation of future tariff deficits and the Electricity Debt Amortisation Fund (FADE, by its Spanish initials) was set up during the year, with the object of providing liquidity to electricity utilities through securitisation of the accumulated debt deriving from the tariff deficit. In addition, a reduction in subsidies for renewable energy was approved.[2] Finally, in the context of the fiscal consolidation process a programme of partial privatisations was announced, which would affect both the management of airports and lotteries.

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1 Law 15/2010 of 5 July 2010 on measures to combat default in commercial transactions.

2 For photovoltaic installations the premiums and the hours eligible for premiums have been reduced.

3 Demand

3.1 NATIONAL DEMAND

National demand continued to adjust in 2010, but at a more moderate pace compared with 2009

The adjustment of national demand, which had been very intense in 2009, continued in 2010, albeit at a more moderate pace, of -1.1% (see Table 5.4). This slowdown in the decline in domestic agents' spending was the result of opposite movements in its public and private components.

The path of private consumption over the year was bumpy, owing to the bringing forward of spending caused by the VAT increase in July

Private consumption, which grew by 1.2%, behaved irregularly in 2010, since certain temporary factors (including notably the rise in VAT rates on 1 July) led to a shift in the timing of spending decisions, which tended to be concentrated in the first half of the year (see Chart 5.3). This phenomenon particularly affected the acquisition of durables, whose timing was also influenced by the extension to the first half of the subsidies for new car purchases. In the year as a whole, car purchases fell, although the consumption of durable goods grew moderately.

Household income fell...

Household disposable income declined by 4.4% in real terms, the largest fall in recent decades (see Chart 5.4). This decline, which contrasts with the increase of 1.6% in 2009, is explained by the confluence of various factors. First, the change in fiscal policy stance moderated the contribution of general government to household income, while the boost provided in 2009 by net interest income was reversed in 2010, with income deducted from households, since interest receipts declined to a greater extent than interest payments. In addition, wage income fell again, since the lower intensity of job destruction was offset by the greater wage moderation in the private sector and the cut in the wages of public-sector employees. Finally, the decline in nominal income, by -1.1%, was exacerbated by the loss of purchasing power deriving from the rise in inflation.

... which led households to smooth their consumption using their savings

Despite the fall in real income, consumption rose modestly. In the context described of deteriorating income, this led to a sharp fall in the household saving rate, which stood at 13.1% at end-2010, down almost 5 pp from 2009, although still somewhat above its historical average level. This seems to reflect the desire of households to smooth their consumption, by lowering their saving rate from the high levels of 2008 and 2009. This cushioning role for savings has been underpinned by a certain stabilisation in consumer confidence, partly influenced by the moderation in the rate of deterioration of the labour market, although uncertainty remained high and confidence was sensitive to various events, such as the strains in the sovereign debt market and, in 2011, the rise in oil prices and interest rates. In this respect, against a background of continued declines in real income, the rise in consumption in 2011 will be marginal. This, at least in the short term, will not prevent a further fall in the saving rate, until there is some sign of a recovery in income.

Residential investment continued to decline owing to the low level of commencement of new projects and the stock of unsold housing is still very high

Last year residential investment remained very weak, as a consequence of the gradual stabilisation of housing starts at very low levels, while a larger number of houses continued to be completed (see Chart 5.5). This led to a further decline in the volume of construction in progress, the growth rate of which stood at around -17%. The execution of new residential projects continued to be curbed in 2010 by the slackness of demand and by the presence of a significant volume of unsold housing, which led housing starts to stand at around 125,000, approximately one-sixth of their level just three years earlier. However, the convergence in recent quarters between starts and completions points towards stabilisation of the rate of housing construction and, therefore, of residential investment towards the end of this year.

CONSUMPTION AND GROSS FIXED CAPITAL FORMATION BY INSTITUTIONAL SECTOR TABLE 5.4

	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2010	2005	2006	2007	2008	2009	2010
NATIONAL DEMAND	103.1	102.2	5.1	5.2	4.1	-0.6	-6.0	-1.1
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	58.4	4.2	3.8	3.7	-0.6	-4.2	1.2
Durable consumption	6.3	3.7	5.5	3.8	3.3	-14.6	-10.9	3.8
Non-durable consumption	53.4	54.7	4.1	3.8	3.7	0.7	-3.7	1.1
Housing	6.1	4.7	6.1	6.2	2.5	-10.7	-24.5	-16.8
CORPORATIONS								
Private productive investment (c)	16.6	14.1	7.4	7.7	3.8	-2.4	-18.2	-0.6
Construction	4.8	5.4	5.7	4.8	-0.6	1.2	-7.7	1.6
Capital goods	7.3	4.8	9.1	10.5	10.2	-4.0	-29.2	3.7
Other (d)	4.4	3.9	7.1	7.5	0.8	-4.1	-16.2	-8.2
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	20.9	5.5	4.6	5.5	5.8	3.2	-0.7
Gross fixed capital formation	3.2	3.7	7.8	7.5	13.1	-1.5	11.2	-17.3
Construction	2.3	2.7	7.3	8.1	13.7	-4.4	14.6	-21.0
Capital goods	0.8	1.0	9.3	6.0	11.3	7.5	1.8	-6.2
MEMORANDUM ITEMS:								
Gross fixed capital formation	25.8	22.6	7.0	7.2	4.5	-4.8	-16.0	-7.6
Capital goods	8.1	5.9	9.2	9.9	10.4	-2.5	-24.8	1.8
Machinery	5.7	4.3	6.9	10.3	11.7	0.4	-23.1	2.1
Transport	2.4	1.6	14.0	9.1	7.6	-8.9	-28.9	0.9
Construction	13.3	12.8	6.1	6.0	3.2	-5.9	-11.9	-11.1
Housing	6.1	4.7	6.1	6.2	2.5	-10.7	-24.5	-16.8
Other construction	7.2	8.1	6.2	5.8	4.0	-0.8	-0.1	-7.2
Other (d)	4.4	3.9	7.1	7.5	0.8	-4.1	-16.2	-8.2

SOURCE: INE and Banco de España.

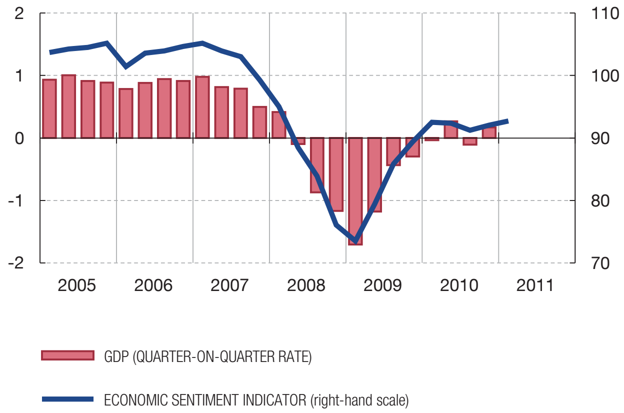
a National Accounts, base 2000, current prices.
b National Accounts, base 2000, rates of change of volume indices.
c Includes investment by sole propietors.
d This investment includes real estate, legal, accounting, consultancy and software services, among others.

In 2010 certain temporary factors helped to sustain the demand for housing

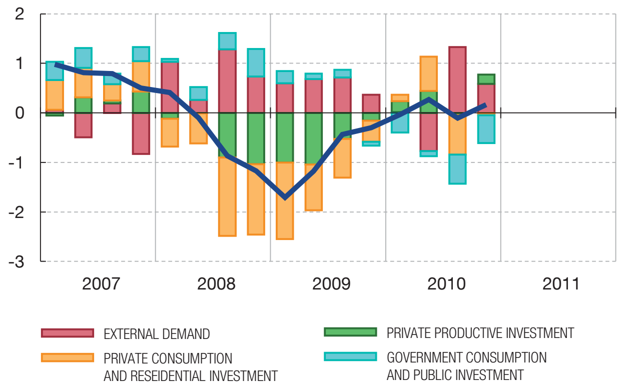
In 2010 the cycle of successive contractions in house purchases that started in 2007 came to an end, with positive year-on-year growth of around 6% and 490,000 houses sold. However, this amount represents little more than 50% of the peak level, recorded in 2006. In addition, the timid growth last year in transactions partly reflects the bringing forward of purchase decisions caused by temporary fiscal factors, such as the increase in indirect taxes in July 2010 and the partial elimination in January 2011 of tax deductions for the purchase of principal residences. Simultaneously, other more permanent factors appear to have had mixed effects. On one hand, purchase decisions were driven by an improvement in accessibility indicators associated with the falls in the prices of residential assets and with the low interest rates that predominated during the year on average. On the other hand, the weakness of household income and the tightening of mortgage credit standards appear to have had a negative effect on the volume of transactions. Housing starts are currently estimated to be below the demand for new housing, so that the stock of unsold housing will gradually be absorbed, although residential investment can be expected to remain markedly slack for some years, which should also affect prices. In this respect, Box 5.1 makes an international comparison of the adjustment of housing prices during the crisis.

MAIN MACROECONOMIC AGGREGATES (a) CHART 5.3

GDP AND CONFIDENCE INDICATOR



CONTRIBUTIONS TO QUARTER-ON-QUARTER GDP GROWTH

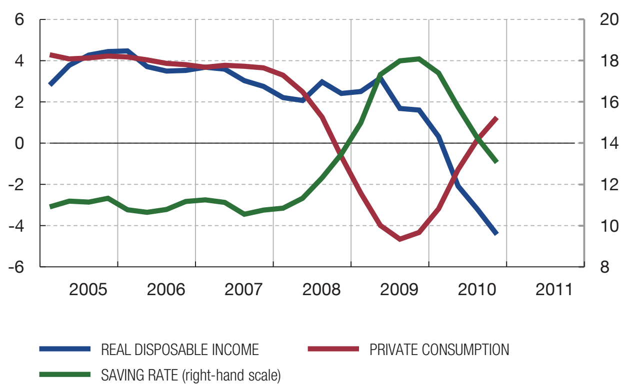


SOURCE: INE.

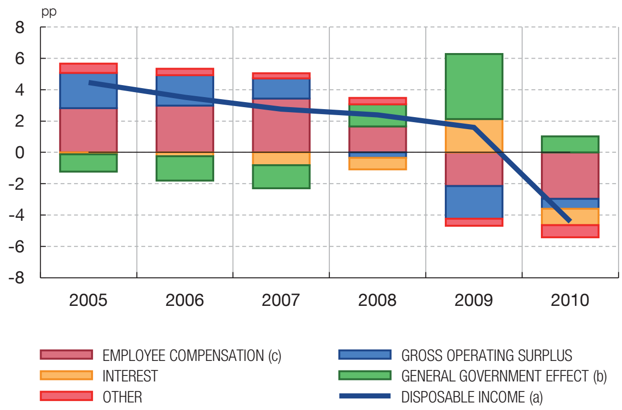
a National Accounts, base 2000. Year-on-year rates of change based on seasonally adjusted series of volume indices.

FINAL CONSUMPTION OF HOUSEHOLDS CHART 5.4

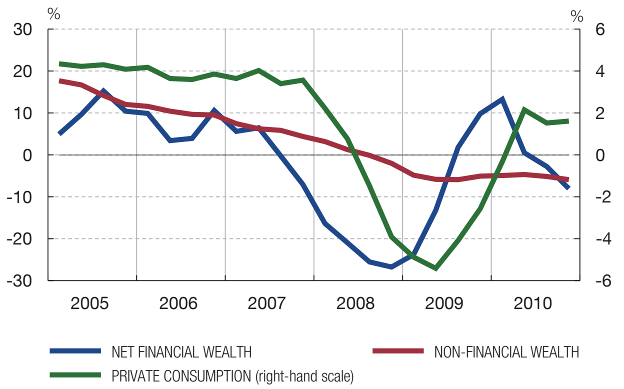
INCOME, CONSUMPTION AND SAVING RATE (a)
(in cumulative four-quarter terms)



CONTRIBUTION TO REAL GROWTH OF DISPOSABLE INCOME



HOUSEHOLD WEALTH AND CONSUMPTION (a)



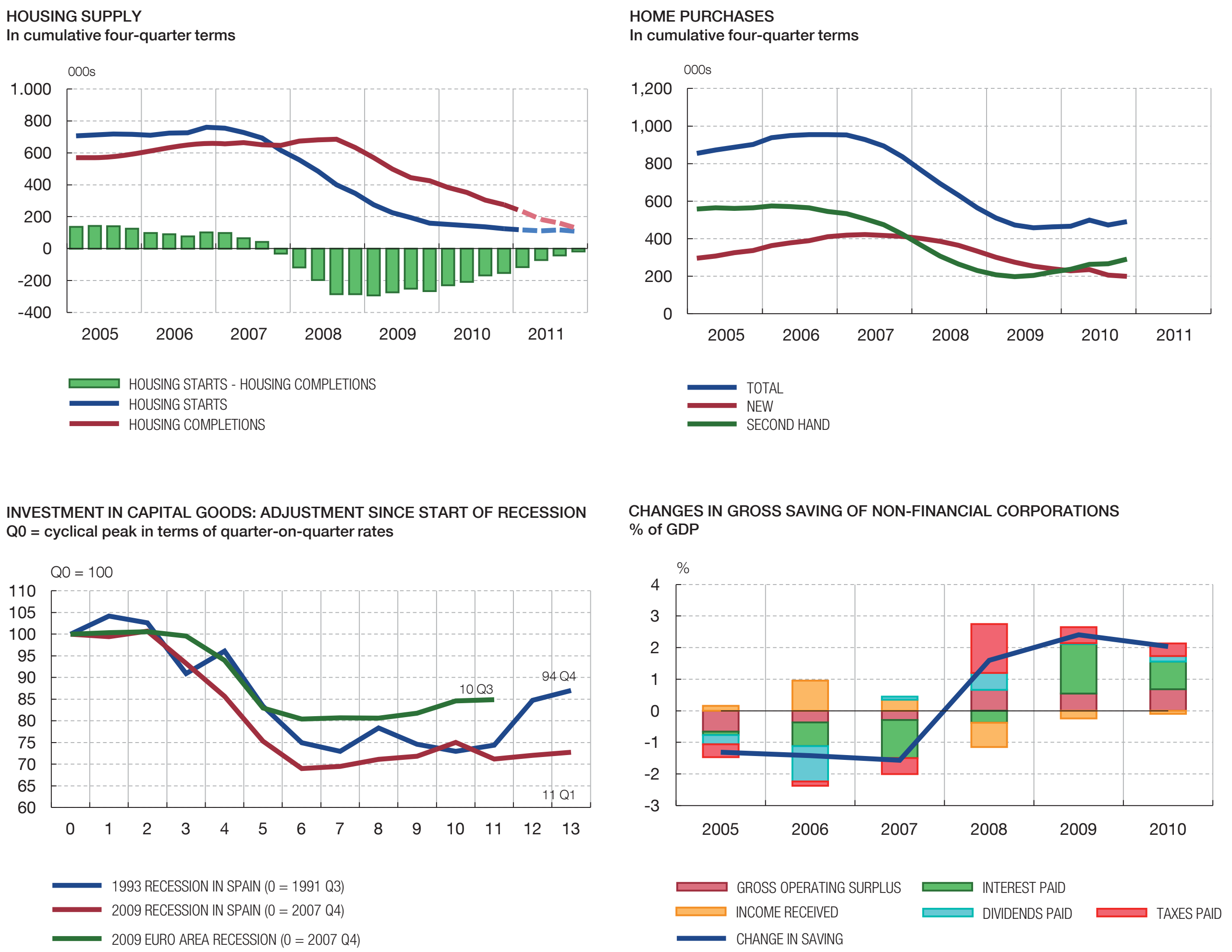
CONFIDENCE INDICATORS (d)

SOURCES: INE, Banco de España, European Commission and Eurostat.

a Year-on-year rate.
b Includes social benefits, social contributions and income and wealth taxes.
c Gross compensation per employee.
d Difference between the percentage of individuals who think that the situation is improving and that of those who think it is worsening.

HOUSING INVESTMENT AND PRIVATE PRODUCTIVE INVESTMENT

CHART 5.5



SOURCES: INE, Ministerio de Fomento and Banco de España.

Business investment continued the mild recovery that began in late 2009, driven by exports

Private non-residential investment continued on the path of mild recovery that began in late 2009, reaching positive year-on-year growth rates in the second half of 2010, although in the year as a whole it posted a modest decline, of 0.6%. This gradual improvement occurred thanks to the favourable behaviour of external demand and the improvement in industrial confidence. Also, the annual average cost of bank financing fell, while other credit conditions, although they remained tight, did not deteriorate with respect to 2009. Finally, the financial position of firms improved in 2010, with a slight correction of the debt ratio and an increase in profitability, which eased the financial pressure on investment (see Chart 6.6). In 2011, the gradual improvement in domestic demand and a continuation of the favourable behaviour of exports are expected to boost business investment, despite the foreseeable increase in the cost of financing.

Spending on capital goods posted a positive growth rate in 2010, although, in comparison with similar past episodes and with the euro area, its recovery has been moderate

Behaviour varied considerably across products. In particular, capital goods expanded moderately, partly because, following the sharp decline in 2009, their replacement demand increased. The overall adjustment of investment in capital goods during the crisis has been more drastic than in the euro area, and the initial phase of the cyclical upswing is proving more muted than in similar episodes in the past (see Chart 5.5).

Since 2007 a group of advanced countries, Spain among them, have seen their real estate markets undergo a severe adjustment. Previously, during the upturn, many of these economies had witnessed high growth in house prices and notably buoyant residential investment, attaining levels that proved hardly sustainable either from the standpoint of productive and financial resources geared to real estate activity or from that of asset valuation. From 1997 to 2007, real average house prices rose by 115% in Spain, while they increased by almost 160% in Ireland, 140% in the United Kingdom and around 80% in the United States. In France the increase was 50%, above the euro area average, which stood at 40% (see panel 1). In the current phase of the adjustment the excesses built up previously are being corrected, with cross-country differences in the scale and pattern of adjustment (of prices and amounts).

In Spain's case the upturn in the housing cycle was linked to strong demand-side pressures which, though underpinned in part by the course of certain fundamentals and met by a highly dynamic response in terms of the production of housing units, gave rise to strong pressure on the value of residential assets. Demographic factors (population and household size) determined high growth in the demand for housing, which was also boosted by the cut in real interest rates associated with the change in regime that Monetary Union membership entailed. As housing is a long-lasting asset, the demand for it and its price are highly sensitive to permanent declines in interest rates, especially when, moreover, conditions conducive to an increase in credit and in indebtedness prevail, as occurred in Spain. While the nature of some of these factors was common to other countries, their impact was heterogeneous and of differing intensity. Thus, for instance, whereas household debt in Spain rose to around 130% of GDI in 2007, this ratio was even higher in Ireland, at 200%. In other economies, such as France and, above all, the United States and the United Kingdom, the changes in these demand variables were less significant.

The rising course of house prices prompted a strong boost to activity in a large number of economies. In early 2007, at the height of the cycle, the production of new houses peaked in many markets. The strong growth in the volume of housing starts and, consequently, in construction was reflected in National Accounts figures, whereby the weight of investment in housing in GDP moved on a rising trajectory in these areas, reaching particularly high levels in Ireland and Spain (14% and 9%, respectively; see panel 2). Occasionally, the pressure of demand on real assets was not confined to housing but also fed through to non-residential real estate assets (shopping centres, offices, etc.). That drove the exuberance of investment in this market segment, involving the disproportionate development of new projects, and prompted price trajectories in these assets which, ultimately, proved unsustainable. In these circumstances, the situation of the Irish real estate market was particularly paradigmatic.

Admittedly, the macroeconomic fundamentals in place during the expansionary phase could warrant a rising path in house prices and residential investment; but there is also consensus that the increases observed might contain a somewhat significant component of overreaction. Thus, in relation to prices, and according to the analysis conducted by the International Monetary Fund, the residential market in Spain at end-2007 evidenced a level of prices in real terms that exceeded that warranted by its determinants by 17%. That said, the figure estimated for other economies was higher (in Ireland, the United Kingdom and France, the overvaluation amounted to 32%, 28% and 22%, respectively) (see panel 3).

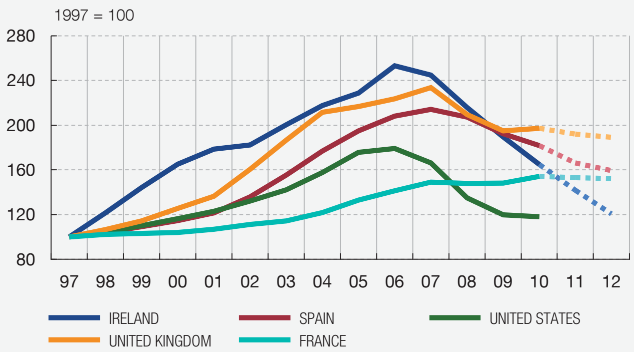
Although the excessive size of housing markets in these countries was patent in early 2007, the outbreak of the international financial crisis heightened the factors of fragility, giving rise to very sharp adjustment trajectories. In Ireland's case, the fact that the rises in both house prices and residential investment during the boom was sharper suggested that the correction in this country might be greater than that in other economies. Indeed, on National Accounts data, the cumulative decline in residential investment from its peak to date would be close to 70% in Ireland, while the fall in other markets was less intense (57% in the United States and 43% in Spain, while in the United Kingdom the decline was approximately 20%).

The adjustment of house prices has also been sharper in Ireland, with a cumulative decline of 35% in real terms, similar to that observed for the United States. However, it should be stressed that, in the case of the US market, the adjustment had run its course in 2009 and that prices have held relatively stable since then. Conversely, the declining course of prices in Ireland has run to the present. In the United Kingdom, the real adjustment of house prices has been less pronounced, leading to a total fall of close to 17%. For 2011 and 2012, further declines in prices are forecast in Ireland and, more modestly so, in the United Kingdom.

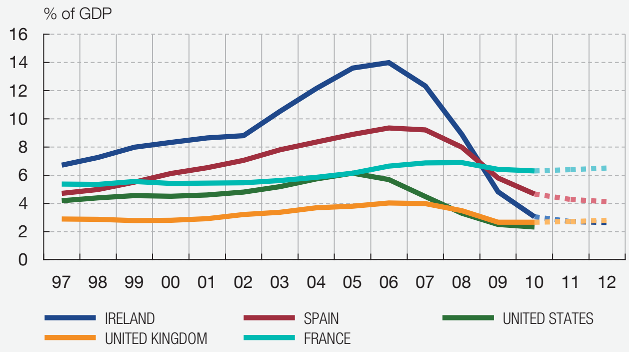
In Spain's case house prices, according to information from the Ministry of Development, have fallen in real terms by 20% from 2007 to 2011 Q1 (and by 15% in nominal terms), slightly more sharply than in the United Kingdom. As earlier mentioned, the different trend in fundamentals would warrant a different correction in each case. But certain features of the Spanish mortgage market, where debtors respond with all their assets to debts incurred, compared with other countries, such as the United States, where liability is limited in some cases to the house that has been mortgaged, introduce an element which tends to limit the adjustment of prices in Spain. This characteristic can be seen, moreover, in Spain's relatively small non-performing mortgage loan ratio compared with other countries.

It should also be underscored that the average adjustment of house prices in Spain masks significant differences in terms of the particular characteristics of each dwelling (geographical or inner-city loca-

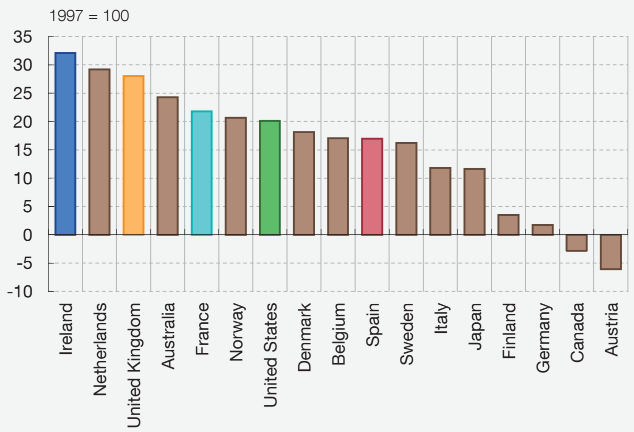
1 PRICE OF HOUSING (REAL TERMS) (a)



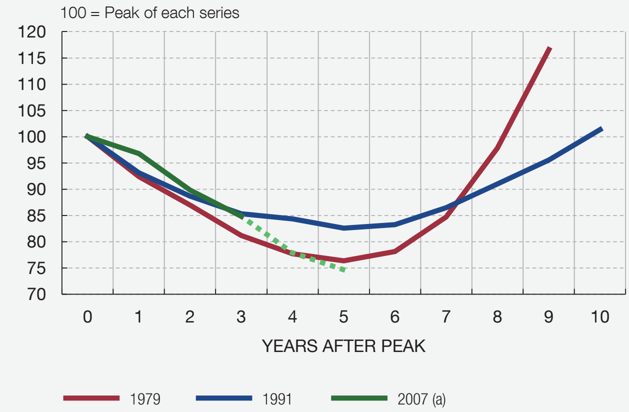
2 HOUSING INVESTMENT



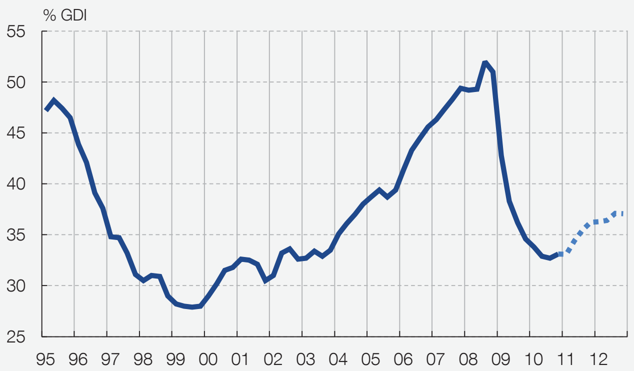
3 IMF ESTIMATION OF THE OVERVALUATION OF REAL HOUSE PRICES IN 2007 (b)



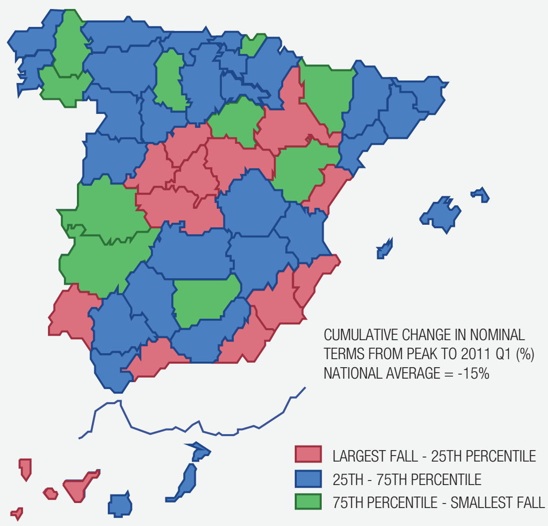
4 COMPARISON OF HOUSE PRICES IN SPAIN IN THE CURRENT AND PREVIOUS BUSINESS CYCLES



5 INDICATOR OF HOUSING AFFORDABILITY IN SPAIN (c)



6 PROVINCIAL BREAKDOWN OF HOUSE PRICE ADJUSTMENT



SOURCES: INE, Ministerio de Fomento, AMECO, Datastream, IMF and Banco de España.

a The 2011 and 2012 forecasts are from the EBA central scenario (March 2011).
b World Economic Outlook (October 2007 and April 2008). For the United States the calculation is for 2006.
c Annual theoretical effort excluding deductions.

tion, age, first or second home, etc.). Thus, the area encompassing the Mediterranean provinces and those close to the Madrid region have posted an average fall in prices that is 5 pp more marked than the national aggregate, whereas in other areas, by contrast, the decline has been very small and even non-existent (see panel 6). It should likewise be highlighted that the real cumulative adjustment in house prices in Spain in the current cycle is similar, to date, to that which took place during the correction phase in the early 1990s. That said, moderate cuts might be expected to continue over the near horizon as a result of the sizeable overhang of houses for sale and of the foreseeable increase in the cost of mortgage financing, which will exert downward pressure on the value of the assets to ease its impact on the affordability indicators (see panel 5). As a result, the cumulative correction in house prices could amount to 25% in real terms in 2012, drawing close to the path observed in the real estate crisis in the 1970s (see panel 4).

The increase in saving and the fall in business investment allowed the corporate sector to record net lending

In a framework in which access to external financing (through borrowing or securities issuance) remained highly restricted, the generation of internal funds enabled private productive investment to be sustained, in addition to some deleveraging. In 2010 business saving continued to grow, underpinned by the recovery in the gross operating surplus and the reduction in the interest burden. This increase in saving, along with the moderate fall in investment, enabled the financial position of firms to improve, with overall net lending of 0.4% of GDP in 2010.

General government's contribution to demand was strongly contractionary

Finally, as mentioned, general government demand was contractionary. The stepping up in the spring of the budget consolidation process meant that government consumption and public investment, which had previously helped to sustain domestic demand, ceased to do so in 2010. Moreover, given the pending fiscal adjustment, these spending components can be expected to continue to make a negative contribution over the next few years.

3.2 EXTERNAL DEMAND

In 2010 net external demand again made a positive contribution to GDP growth, thanks to more buoyant exports

Net external demand again made a notable positive contribution to GDP growth in 2010 (1 pp), although it was smaller than in 2009. The notable momentum of exports of goods and services (which grew by more than 10% in real terms) should be highlighted, while imports of goods and services also recovered, although to a lesser extent, recording modest growth (5.4% in real terms) given the weak rise in final demand. In the months that have already elapsed in 2011, trade flows have exhibited marked strength, especially in the case of exports, so that net external demand is expected to contribute positively to output again.

Goods exports, favoured by the expansion of world trade and accumulated competitiveness improvements, drove the recovery of the Spanish economy

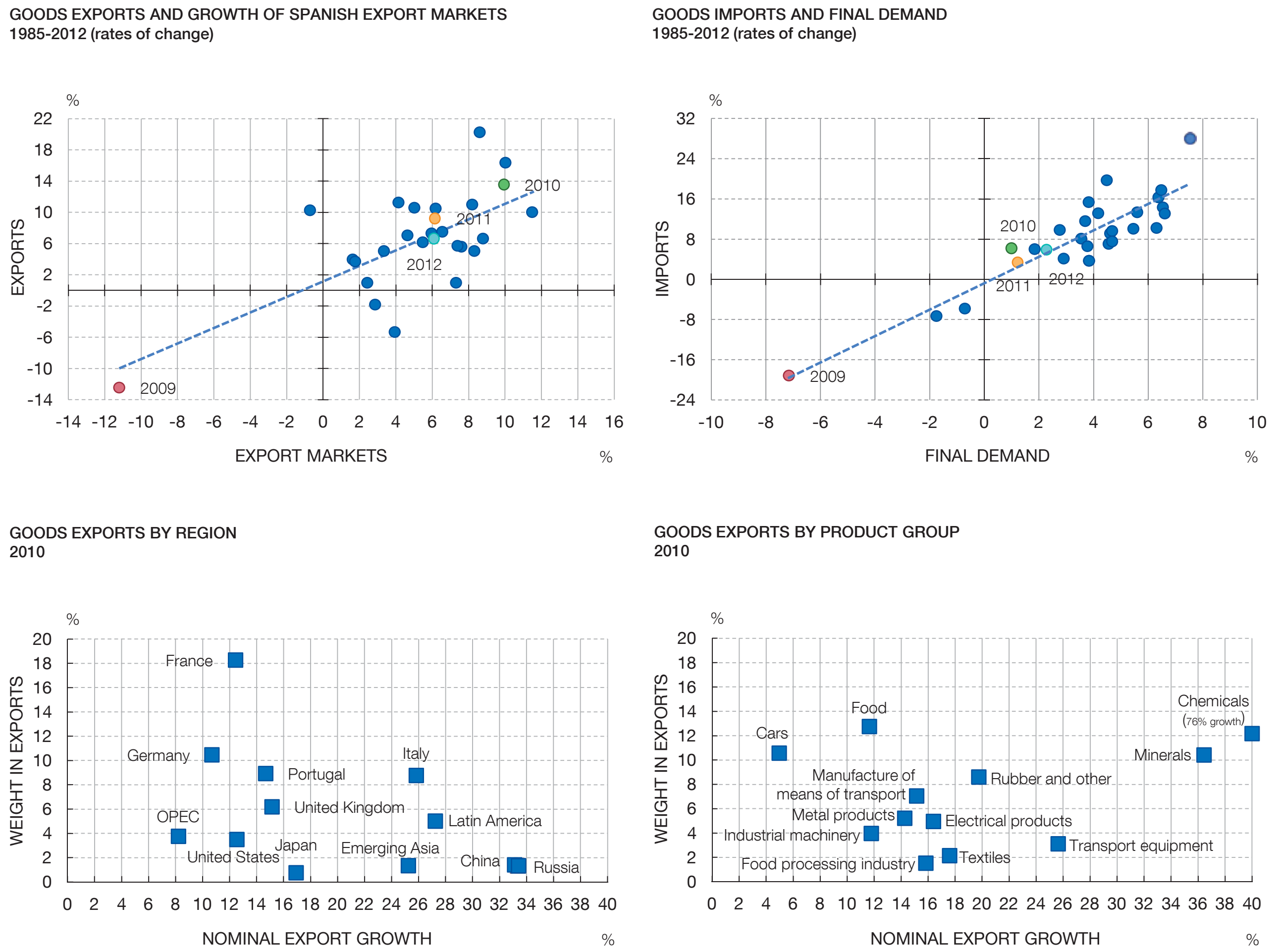
Following the collapse of world trade in 2009, goods exports were the Spanish economy's main engine of growth in 2010, with an annual increase of 13.6%, which exceeded the growth in Spain's export markets. The stimulus from the upswing in world trade and competitiveness gains (largely due to wage containment) more than offset the negative effect of the progressive disappearance of the exceptional measures implemented in some countries last year, like the vehicle replacement support programmes that had stimulated sales abroad in 2009. Also, the weakness of national demand encouraged Spanish firms to sell their products abroad.

... with similar buoyancy across most geographical areas and products

According to the information available at firm level, the drastic decline in goods exports in 2009 was attributable, above all, to a reduction in the average amount exported by each firm and, to a much lesser extent, to the withdrawal of firms from export markets. This

EXTERNAL DEMAND AND MAIN DETERMINANTS

CHART 5.6



SOURCES: IMF, OECD, INE, Ministerio de Economía y Hacienda and Banco de España.

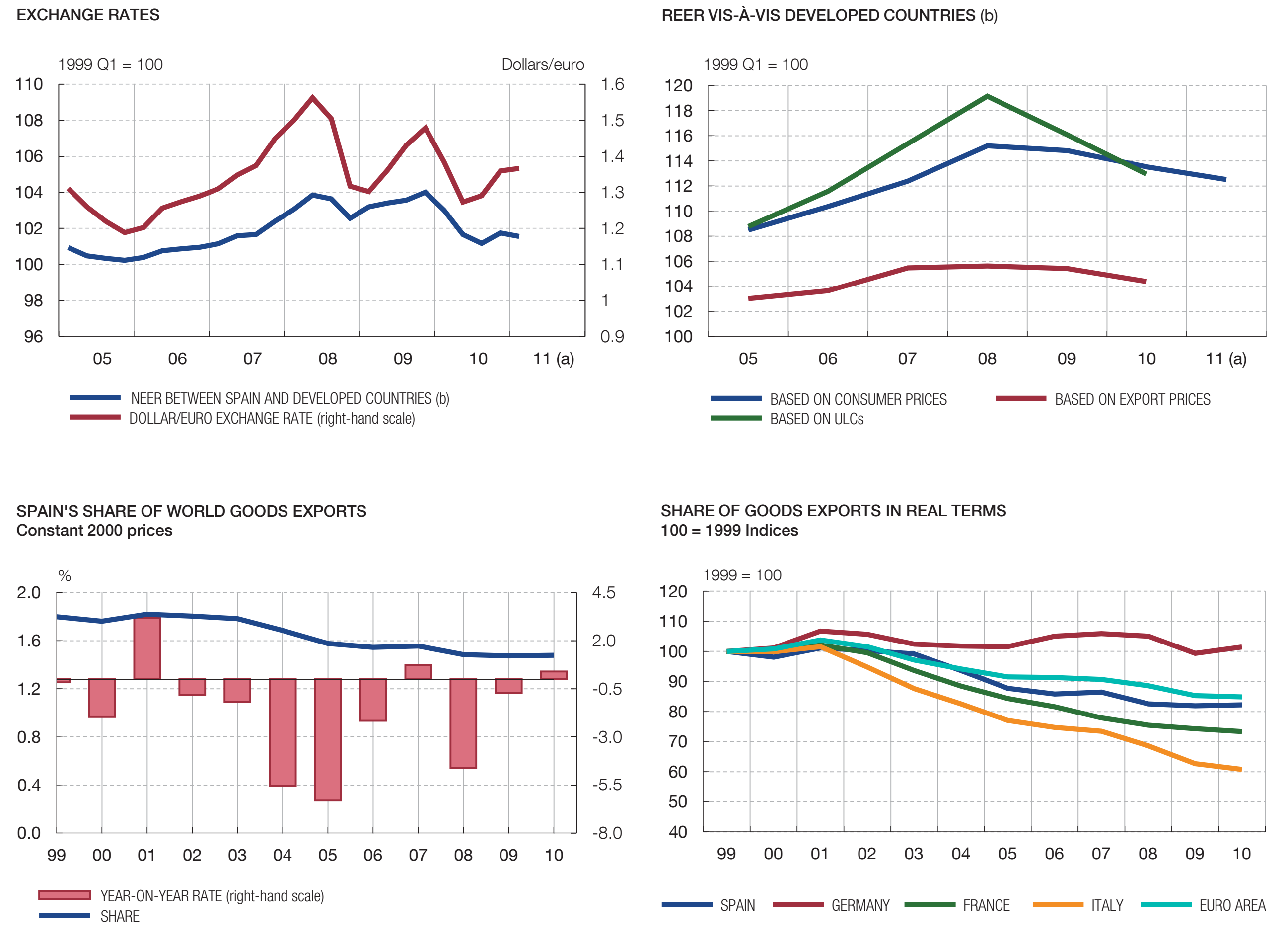
suggests that firms withstood the world trade crisis well, facilitating the subsequent recovery in their sales. Although the presence of Spanish firms in the fastest-growing markets (in particular, in emerging economies) is still low, sales to these economies recorded very high growth rates in 2010 as a whole, which is contributing to the necessary geographical diversification of Spanish exports (see Chart 5.6). Finally, by type of product, the acceleration in exports was across-the-board, although it was most notable in the chemicals and basic metals industries and transport equipment, while sales of cars, although growing by somewhat less, made a significant contribution to the recovery of exports in 2010, given their large weight in total exports.

The share of goods exports in world markets increased slightly

In 2010 as a whole, Spain's share of world exports, in real terms, improved slightly, having remained relatively stable in the previous two years, when the gain in share in the developed countries, in particular in the euro area, was offset by the loss in the emerging areas (see Chart 5.7). In the euro area, Germany also increased its market share, while those of France and, in particular, Italy declined. In the first few months of 2011 exports have continued to drive growth, displaying greater buoyancy than world markets, which suggests that Spain's market share continues to expand.

COMPETITIVENESS INDICES AND EXPORT SHARES

CHART 5.7



SOURCES: IMF, OECD, Eurostat, INE and Ministerio de Economía y Hacienda.

a Average of available data.
b An increase (decrease) in the index denotes a loss (gain) in competitiveness.

Services exports also recorded positive growth, although it was more moderate than in the case of goods

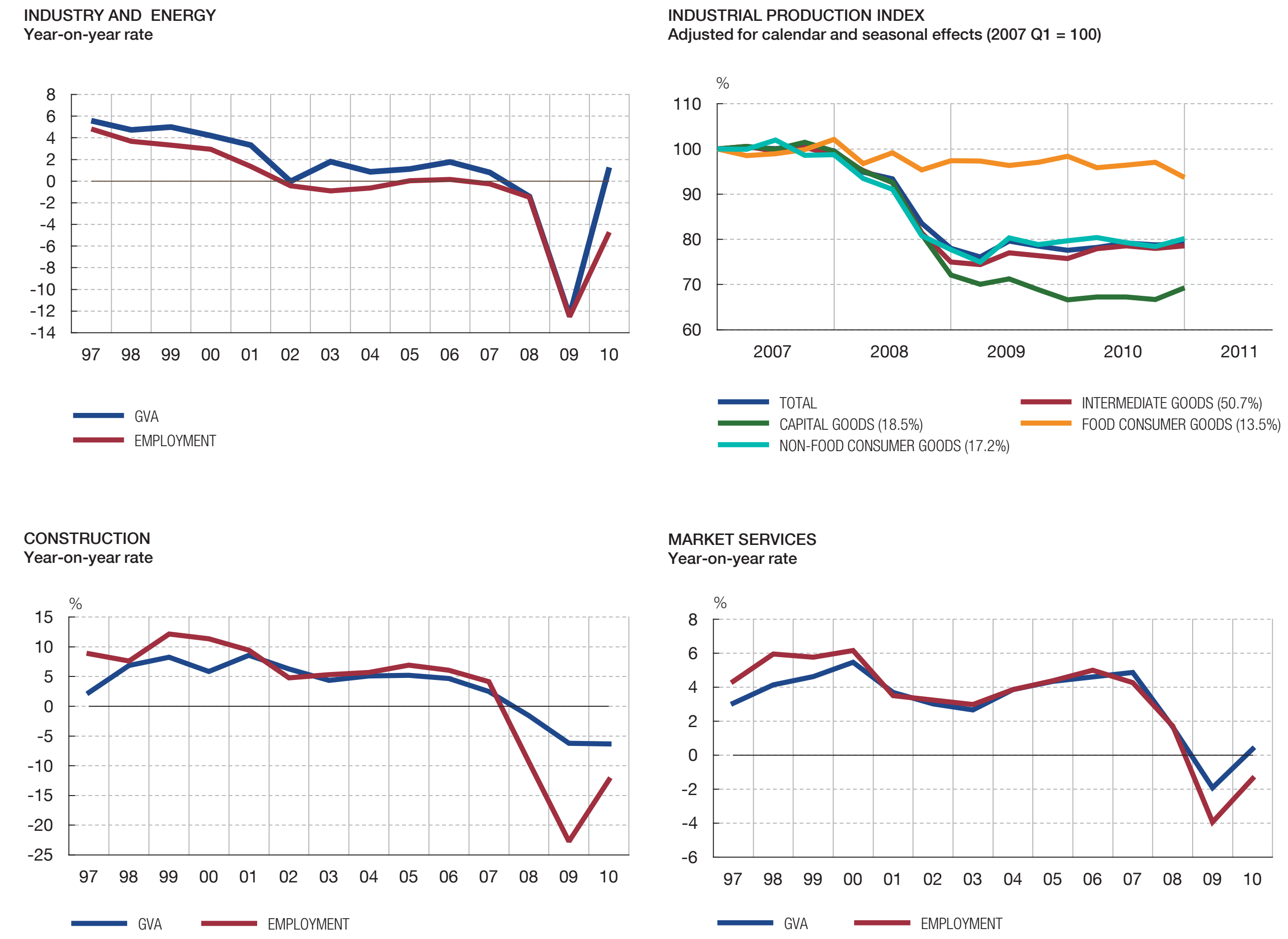
Services exports also returned to a positive growth path in 2010 (4.2%), especially non-tourism services (5.5%), in step with the growth in activity and, in particular, in goods trade and tourist flows, which boosted transport services. Tourism receipts benefited from the emergence from the economic crisis of some of the main countries that provide tourists for Spain and the weakness of the euro against the dollar and sterling. Along with an aggressive price cutting policy, this helped to mitigate growing competition from the eastern Mediterranean countries. However, the negative impact of certain exceptional events, such as the temporary closure of European airspace due to a volcanic eruption in Iceland, adverse meteorological conditions and the air traffic controllers strike in Spain, meant that tourism receipts continued to post moderate growth rates in 2010 (2.5%). In 2011, the growth rate of services exports is expected to accelerate, as the economic position of Spain's main customers continues to strengthen and tourists have been diverted towards Spain as a result of the geopolitical instability in certain Arab countries.

The rate of recovery of imports was influenced by two opposing factors: the weakness of domestic demand and the buoyancy of exports

The recovery of goods imports was much more moderate than that of goods exports (with an annual increase of 6.2%), given the weakness of national demand and the rise in the prices of imported products, especially commodities. That said, import penetration in final demand increased again in 2010. The pattern of imports over the year was largely determined by the bringing forward of consumption decisions to the second quarter from

GVA AND EMPLOYMENT BY BRANCH OF ACTIVITY

CHART 5.8



SOURCE: INE and Banco de España.

the third quarter (which indicates the dependence of the Spanish economy on goods for which there is no domestically produced equivalent). As at year-end, import growth was strongly linked to the buoyancy of exports, especially in those sectors that are highly dependent on imported inputs. In 2011 the growth of imports will again be constrained by the relatively moderate recovery in domestic demand, in particular private consumption, and by the increase in their prices, although the strength of exports may have some positive effect on imports.

4 Activity

The fall in activity in the market economy, which was still suffering from the contraction in construction, moderated in 2010

The decline in activity in the market economy as a whole moderated by more than 4 pp in terms of gross value added (GVA), to -0.4%, which exceeded the decline in GDP as a whole by more than 3 pp. Both the industrial and the services sectors posted positive, albeit modest, rates of change, following the notable falls in 2009, while GVA in construction contracted at a high rate. For its part, the GVA of non-market services decelerated notably during the year, growing at an annual average rate of 0.8%, as against 2.1% in 2009.

After contracting for two years running, the industrial and energy sectors grew again, underpinned by exports

Following the marked cumulative adjustment during the preceding two years, GVA in the industrial and energy sectors returned to positive growth rates in 2010 (1.3%), driven by external demand (see Chart 5.8). All the large industrial sectors grew, except those producing capital goods, which continued to contract, but at a notably lower rate. The highest growth was in the intermediate goods (in particular, the chemicals industry, in line with the buoyancy of this sector's exports) and, to a lesser extent, non-food consumer goods sectors.

Despite the modest recovery last year and at the beginning of 2011, the current level of industrial output is still approximately 20% lower than in 2007, which is a sharper contraction than in the main euro area countries. These developments are partly attributable to the spill-over effects of the decline in construction on certain industrial sectors. More positively, those sectors with a higher technological content suffered a smaller adjustment during the crisis and have performed more favourably during the early stages of the recovery, which is probably related to their higher export orientation. However, their low weight in the industrial sector as a whole (around 7.5%) limits their contribution to the expansion of the sector, which will depend in future upon the behaviour of the medium and low-technology, labour-intensive sectors, which are the largest.

Market services also showed some improvement, based mainly on domestic demand

GVA in market services increased by 0.4% in 2010, following the significant decrease of around 2% recorded the previous year. In comparison with industry, the sector's contraction during the recession was much less intense. Moreover, production in market services industries has already generally recovered to around its pre-crisis levels. Activity in the wholesale and retail trade, which is the largest one, fluctuated during 2010 as a result of the introduction of VAT in July, although it generally remained weak, in line with consumption. Other sectors, such as hotels and restaurants and transport and storage services, benefited from the buoyancy of goods exports and tourism, which partly offset the greater slackness of domestic activity.

The rate of decline in construction accelerated slightly, with adjustment in the residential component coming on top of the strong contraction in public works

GVA in construction continued the intense adjustment process that had commenced three years earlier, with a fall of more than 6% in 2010. As already seen when demand was analysed, this was attributable to continuation of the intense adjustment of residential investment and the sharp reduction in public investment, within the framework of fiscal consolidation.

5 The labour market

The destruction of employment continued in 2010, but at a slower pace

Employment fell in 2010 at an average rate of 2.3% (4% in the market economy). As a result the total destruction of jobs since 2007 Q3 exceeds two million, which shows the severity of the impact of the economic crisis on employment. However, the decline in employment was more than 4 pp less than in 2009 (see Chart 5.9). Going forward, as in the case of activity, the recovery in employment is expected to be slow.

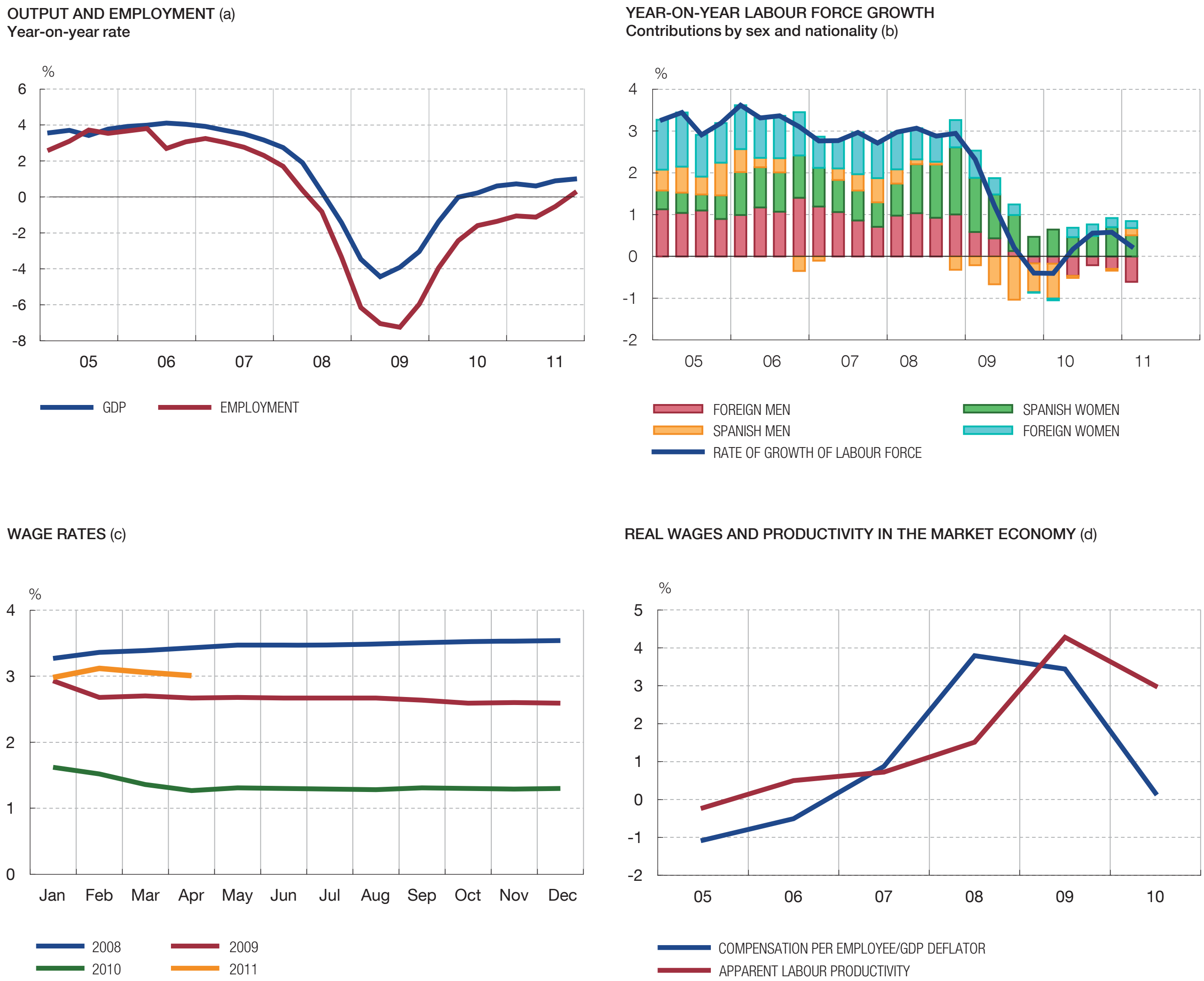
Productivity, as usual, behaved countercyclically

Productivity in 2010 grew by 2.3%, a more moderate rate than in 2009, confirming once again the countercyclical nature of this variable in the Spanish economy. This behaviour is the result of the combination of a high degree of wage rigidity and strong segmentation of the labour market, which means that the adjustment to shocks takes place mainly through the level of employment, in particular, temporary employment. Since temporary workers on average have lower levels of training and experience than other workers, a reduction in their numbers leads to an increase in average productivity. In fact, temporary employment fell by 4% in 2010, while permanent employment declined by 1.5%. The same pattern of behaviour was seen right across the market economy, with the rise in productivity in industry standing out.

In construction, employment continued to be destroyed at a marked rate...

Construction continued to be the sector in which most employment was destroyed in 2010, with an average change of -12.5%, although the decline in employment in industry was also considerable (-5.8%). For its part, employment in non-market services grew by 2.2%, a similar rate to 2009, although it decelerated as the year elapsed. According to

EMPLOYMENT AND WAGES — CHART 5.9



SOURCES: INE and Banco de España.

a Seasonally-adjusted QNA series. Full-time equivalent employment. The 2011 data correspond to those in the March 2011 *Spanish economic projections report*.
b The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.
c Cumulative data from January until the latest month of the year available. Last figure: April 2011.
d Seasonally-adjusted QNA series. Full-time equivalent employment.

data from the Register of Personnel in General Government Service, growth was more moderate, at around 0.8% (on data to July 2010), as against 2.2% in 2009, as a result of the progressive application of the public sector employment reduction plan.

... while in other sectors the fall in employment was halted

Although destruction of employment occurred in almost all sectors of the market economy, the rate of deterioration moderated with respect to 2009. It can be seen from the quarterly profile for 2010 that the destruction of employment practically stopped in market services, while in agriculture there was timid job creation.

Participation decisions barely responded to the adverse labour market conditions

In contrast with previous crises the participation rate continued to display some strength, despite the severe deterioration in the labour market, with a moderate increase (of 0.1 pp, to 60%). This enabled the labour force growth rate to remain in positive territory (0.2%), despite being lower than in 2009 (0.8%), on account of the slowdown in the increase in the immigrant population that has been recorded since soon after the start of the crisis. Male participation and that of younger persons (aged 16-24) did respond negatively to the cyclical situation. In the case of the latter there was an increase in their participation in training activities. The reduction in the participation of these groups was not sufficient, however, to offset the tendency towards greater female participation in the labour market.

Unemployment grew rapidly, but at a slower rate than in 2009

The growth of unemployment moderated, but remained strong, standing at 11.6% in 2010, and the rate of unemployment rose to 20.1%, up more than 2 pp from 2009. This increase was broad-based, but more marked among the youngest, those with low skill levels and foreigners. Long-term unemployment rose sharply and its relative incidence (42.5%) stood at high levels (52.6% among 45-64 year olds), a worrying situation given the greater difficulty that the long-term unemployed have returning to the labour market.

Wages moderated in 2010...

The signing in February 2010 of the 2010-2012 Employment and Collective Bargaining Agreement by the social partners, along with the significant cut in the wages of public-sector employees and the moderate inflation rates deriving from the unemployment gap, created a more favourable setting for wage moderation in 2010. Compensation per employee in the market economy grew by 1.4%, down 2.3 pp from 2009, in line with the growth in wage rates agreed in collective bargaining (1.3%, as against 2.3% in 2009). The slowdown in non-market services was even sharper, with an average fall of 1.8% in 2010, owing to the general government wage cut.

... although there are signs of a rise in 2011

However, the sharp rise in inflation in the final stages of 2010 and the first few months of 2011 caused the wage increases in the agreements registered at the beginning of this year to be higher than those in 2010 (around 3%). There is therefore a risk that the high inflation in late 2010 and early 2011 will feed through into excessive wages, thereby hampering the recovery in competitiveness and employment.

6 Prices and costs

Inflation is tending to rise, owing to factors that are, in principle, temporary...

The gradual increase in the rate of growth of the CPI, which had commenced in summer 2009, continued last year (see Chart 5.10). Specifically, the average annual inflation rate in 2010 was 1.8%, while in December the annual rate was 3%, 2.2 pp higher than in the same month a year earlier. This tendency for inflation to rise continued at the beginning of 2011, until April, when it peaked at 3.8% and began to fall. The developments described reflect, above all, the concurrence of various predominantly temporary factors whose impact on the rate of change of the CPI should, in principle, disappear during 2011. These factors include the rise in commodities prices (especially the oil price) on international markets, certain tax rises (within the fiscal consolidation framework) and the increase in certain regulated prices.

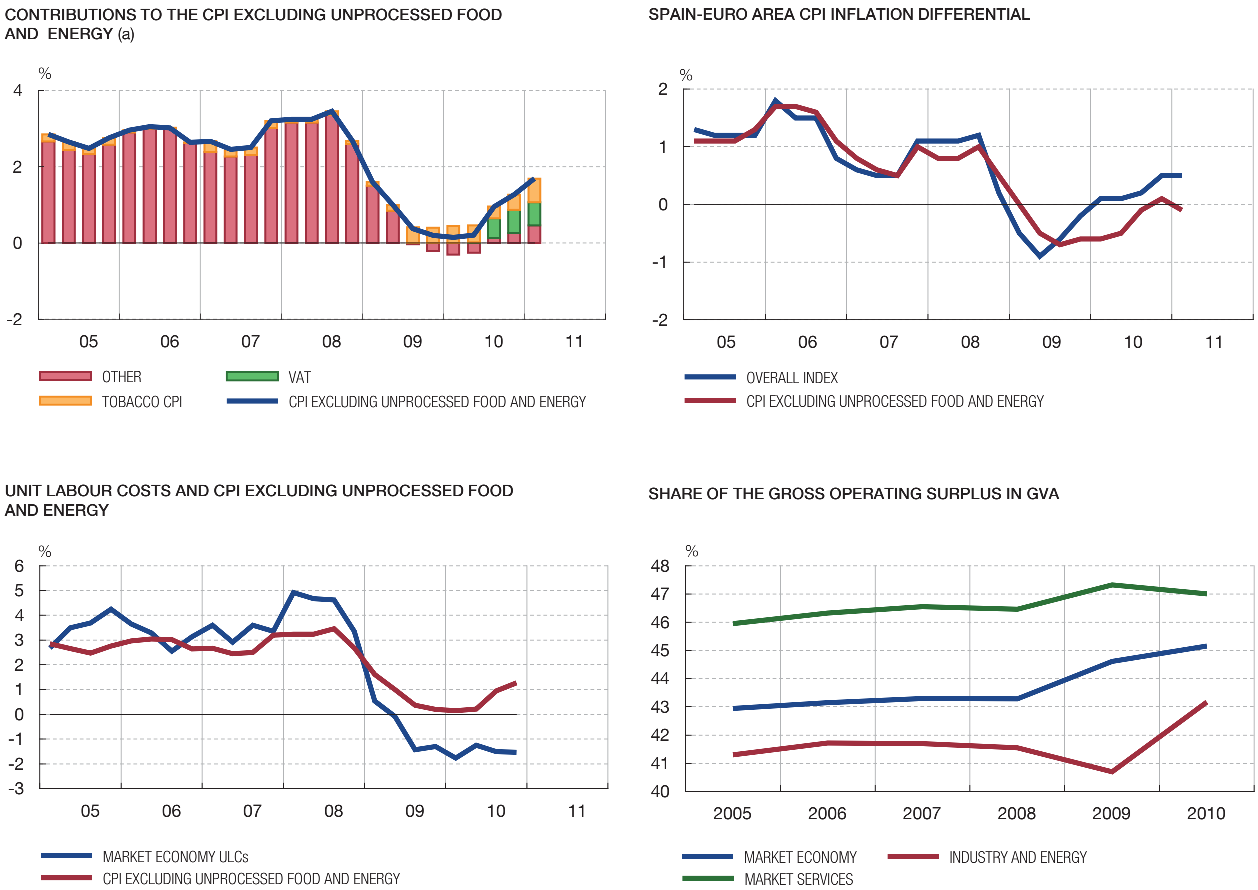
For this reason, to explain inflation developments in 2010 and early 2011 it is useful to break down the annual growth rate of the CPI, in order to quantify the approximate contributions of each of these factors. The difference between the overall indicator and the total contribution of these factors gives a more accurate indication of underlying inflationary pressures. Specifically, of the 2.2 pp by which inflation increased between December 2009 and December 2010, the temporary factors would together explain 1.4 pp, the residual part, unrelated to these factors, being 0.8 pp.

... such as the trend in energy prices...

The behaviour of the prices of energy goods explains 0.7 pp of the increase in inflation last year. The notable acceleration in these prices in 2010 and early 2011 reflected, above all, an external shock, namely a significant rise in the US-dollar oil price, against a background of strong demand expansion in the emerging countries, geopolitical tensions in certain producing countries and a lack of exploration. However, other factors also contributed to the increase in energy prices. First, not only did the pre-tax prices of heating and vehicle

INFLATION DETERMINANTS

CHART 5.10



SOURCES: INE and Banco de España.

a The tobacco CPI does not include the estimated effect of the rise in VAT rates.

fuels swiftly reflect, as usual, the rise in the cost of oil, but the price increases were larger in Spain than in the euro area as a whole, which may be a consequence of insufficient competition in the sector, as well as the rigidity of energy demand in Spain. Second, the regulated prices of natural gas, butane gas and electricity were increased in order to bring them into line with cost.

... and indirect taxes

Standing out among the fiscal consolidation measures with direct effects on prices is the July 2010 increase in VAT rates. Final prices would have increased by 1.1 pp if the tax change had been fully passed through. However, the various estimates available indicate that the actual pass-through was around 50%, so that the tax increase would explain 0.6 pp of the change in the overall CPI. This pass-through is smaller than that estimated for the increases in VAT rates in 1992 and 1995, which may be because the weakness of household consumption at the current stage in the cycle caused part of the tax rise to be absorbed in producers' and retailers' margins. The increase in taxes on tobacco also had a discernible effect on the CPI.

The CPI excluding unprocessed food and energy reached a record low...

On average last year, the CPI excluding unprocessed food and energy increased by 0.6%, a record low rate. This was consistent with the slackness of demand, which led, in particular, to a marked slowdown in services prices. This containment of underlying inflation meant that, despite the larger increase in indirect taxes in Spain, the inflation differential with respect to the euro area, in terms of the CPI excluding unprocessed food and energy, was negative (-0.3%) for the second consecutive year.

... reflecting the sharp fall in unit labour costs

The reduction of unit labour costs intensified relative to 2009, as a consequence of the greater containment of compensation per employee (which was more pronounced in the economy as a whole than in the market economy), since apparent labour productivity growth was lower than in 2009, reflecting the moderation of the job destruction process. At the same time, profit margins (approximated by the share of the operating surplus in value added) increased with respect to previous years, especially in the case of industry.

Other price indicators did not moderate in 2010, basically owing to the imported component

The rate of growth of private demand deflators increased in 2010, reflecting the strong acceleration (by almost 17 pp) in import prices. For its part, the government consumption deflator fell in 2010 as a consequence of the public sector pay cuts. The acceleration of the domestic component of inflation, approximated by the GDP deflator, was more modest. It increased by 1% in 2010, as against 0.6% in 2009.

Price and cost competitiveness gains were recorded

For the second consecutive year there were improvements in the price and cost competitiveness indicators vis-à-vis the developed countries, so that part of the loss accumulated in previous years was recovered. The gains, which in the case of competition with non-euro area countries were favoured by exchange rate developments, were particularly intense in terms of unit labour costs. This improvement in competitiveness contributed, as already indicated, to the slight rise in the market share of Spanish exports, in real terms, on the world market.

Inflation can be expected to moderate significantly in the second half of 2011 and in 2012

In principle, the impact on the annual inflation rate of the factors that have been temporarily driving it will tend to disappear gradually in the second half of 2011, which should enable consumer price inflation to stand at around 2% at the end of 2011 and at 1.5% in 2012 as a whole. However, these projections are subject to a high degree of uncertainty, since the oil price is too. In addition, the indirect effects of past oil price rises on the prices of other goods and the emergence of so-called second-round effects (i.e. the inflationary effects that arise when, in response to an external shock, agents attempt to maintain their margins and wages in real terms) represent channels that may put further pressure on domestic prices. An inappropriate reaction by the various agents to the inflation shocks recorded during 2010 would lead to persistently higher inflation rates, competitiveness losses and reductions in employment and activity.

7 The nation's net borrowing and the capital account of the institutional sectors

The nation's net borrowing continued to decline in 2010 owing to the improvement in the non-energy trade balance and the income balance

The Spanish economy's net borrowing continued to decline in 2010, although less sharply than in 2009. On national accounts data, Spain's net borrowing reached 3.9% of GDP, 1.2 pp less than in 2009 (see Chart 5.11). This improvement mainly reflected the decline in the income deficit (by 0.9 pp of GDP) and in the non-energy trade balance (by 0.6 pp), with a slight increase in the services surplus. Also, the capital transactions surplus widened, by 0.3 pp of GDP. These developments offset the increase in the energy deficit.

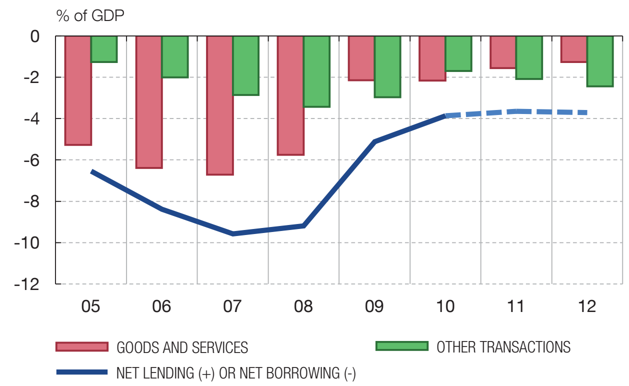
The lower net income payments to the rest of the world are primarily explained by the appreciable increase in the dividends received by Spanish multinationals

The decline in the income deficit basically reflects the notable increase, to an all-time high, in the direct investment dividends received by Spanish multinationals and the low average level of interest rates in 2010. In the latter case, the correction of the income deficit moderated during the second half, in line with the rise in the cost of financing.

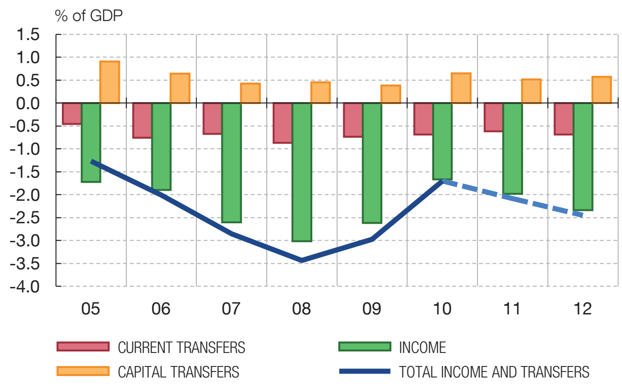
REST OF THE WORLD ACCOUNT

CHART 5.11

NET LENDING (+) OR NET BORROWING (-) OF THE NATION



EXTERNAL BALANCE OF OTHER TRANSACTIONS

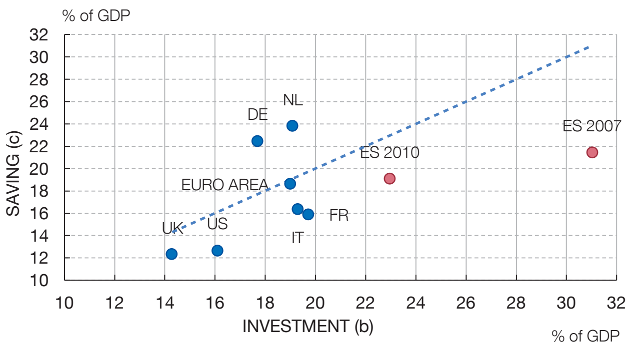


SOURCES: INE, Departamento de Aduanas and Banco de España.

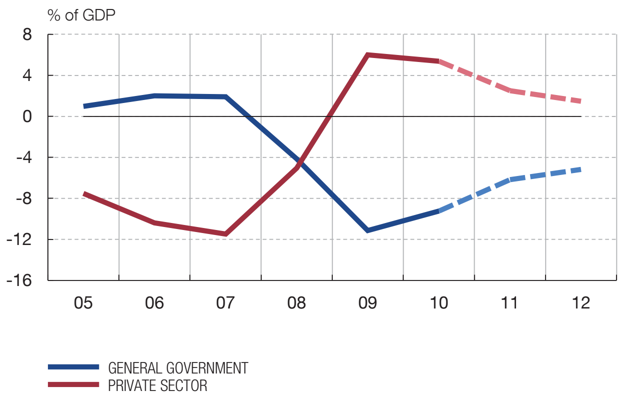
SAVING, INVESTMENT AND NET LENDING OR NET BORROWING (a)

CHART 5.12

INTERNATIONAL COMPARISON (2010)



NET LENDING (+) OR NET BORROWING (-) BY SECTOR



SOURCES: ERUOSTAT, INE and Banco de España.

a Except for Spain, the 2010 data are forecasts of the European Commission.
b Gross capital formation.
c Gross saving.

The rise in the oil price and the increase in income payments abroad are not conducive to more significant declines in the external deficit in future

The notable rise in oil prices in 2011, the magnitude and duration of which is subject to great uncertainty, and the upward trend in interest rates limit the margin for correction of the external deficit. Given the considerable dependence of the Spanish economy on imported goods, especially energy, and the interest burden entailed by the debt assumed in the past vis-à-vis the rest of the world, it is important to review through which channels additional and permanent corrections in the external deficit might be achieved (see Box 5.2).

The lower public-sector net borrowing more than offset the reduction in the net lending of the non-financial private sector

The decline in the net borrowing of the Spanish economy in 2010 is explained by the fall in national investment (by 1.5 pp of GDP to 22.5%), which widely exceeded that in the gross national savings ratio (of 0.4 pp of GDP to 18.5%) (see Chart 5.12). It should be noted that the ratio of investment to GDP in Spain remains above that of the main European countries, despite the 8 pp decline in this ratio since 2007. In 2010 private-sector net lending

In 2010 the Spanish economy continued reducing its external deficit. On National Accounts data, net borrowing stood at 3.9% of GDP that year, 1.2 pp less than in 2009 and almost 6 pp down on the 2007 peak (see panel 1). This adjustment needs to continue, especially since Spain has built up a significant negative output gap, with a substantial decline in investment, which should lessen the resort to foreign saving. Further, in 2010 the primary external balance was still in deficit (2.2% of GDP), suggesting that, in the absence of vigorous growth in activity, the Spanish economy's international investment position (IIP) will remain strongly negative.

Some of the factors that have hindered the correction of the external deficit in 2010 Q2 point to the presence of certain weaknesses in the Spanish economy, which need to be addressed to achieve further and persistent reductions in the deficit. In 2010, net borrowing was affected by the higher payments to the rest of the world connected with the increase in the energy bill. The rise in oil prices[1] and the Spanish economy's high dependence on imported energy inputs account for the significant deterioration in the energy balance that year, to 3.3% of GDP (0.8 pp more than in 2009). Also, the rapid response of other imports to the modest pick-up in final demand in 2010 suggests that the traditional high income elasticity of Spanish imports has not changed significantly during the downturn, although this aspect should be analysed with caution.[2] The buoyancy of exports and the slight increase in private consumption in 2010 – demand components with a greater import content than investment in construction – largely explain the recovery in purchases abroad that year (31% and 38% of the

1 The price of Brent crude rose by 35% on average in 2010, after declining by 33% in 2009.

2 Estimates of the income elasticity of Spanish goods imports for the period 1995-2010, based on parameters that change over time, point in this direction.

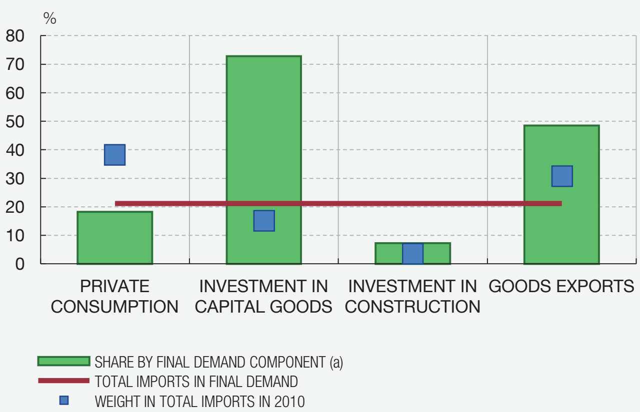
1 THE NATION'S NET BORROWING

% of GDP

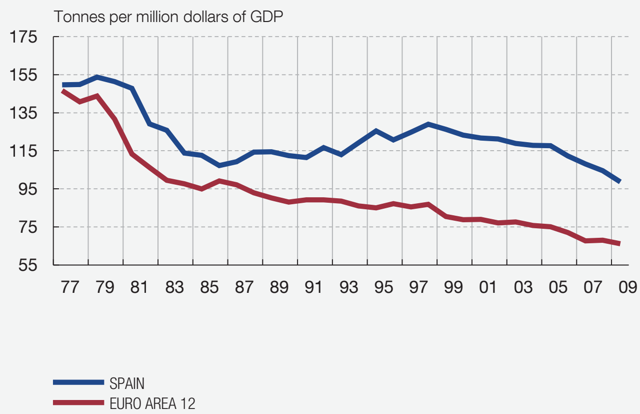
	2007	2008	2009	2010	2011	2012
Goods and services balance	-6.7	-5.8	-2.2	-2.2	-1.6	-1.3
Energy balance	-3.2	-4.1	-2.5	-3.3	-4.2	-4.2
Non-energy goods and services balance	-3.5	-1.7	0.4	1.1	2.6	2.9
Income	-2.6	-3.0	-2.6	-1.7	-2.0	-2.3
Other	-0.3	-0.4	-0.4	0.0	-0.1	-0.1
Net borrowing	**-9.6**	**-9.2**	**-5.1**	**-3.9**	**-3.7**	**-3.7**
MEMORANDUM ITEM:						
Primary external balance	-7.0	-6.2	-2.5	-2.2	-1.7	-1.4

SOURCES: Departamento de Aduanas, INE and Banco de España.

1 SHARE OF IMPORTS IN THE MAIN COMPONENTS OF FINAL DEMAND
2005



2 NET OIL IMPORTS
Constant 2000 prices



SOURCES: International Energy Agency, Eurostat, INE and Banco de España.

a Banco de España calculations based on the Input-Output framework of the Spanish National Accounts.

total, respectively)[3] (see panel 1). All told, thanks to the strength of exports, boosted by the recovery in global trade and the gains in competitiveness made over the past two years, the trade surplus in non-energy goods and services increased in 2010 to 1.1% of GDP.

The forecasts for 2011 and 2012 indicate that the external deficit will narrow marginally, despite the fact that goods and services exports are expected to continue to perform well. The main obstacles to more rapid adjustment are, firstly, dearer oil (strongly affected by the growing geopolitical instability in the Arab world) and, secondly, the increase in the income deficit, owing to the rise in interest rates in the presence of a large negative IIP. Here it is worth reviewing the different channels through which the Spanish economy might correct its external deficit more quickly. Three possible channels for this improvement are gains in price-competitiveness, greater openness to foreign markets and a reduction in import dependence, in particular energy dependence.

Spanish monetary union membership makes it impossible to resort to competitive devaluations to make Spanish products cheaper on foreign markets, and make imports dearer. Accordingly, gains in price-competitiveness must be generated through productivity gains and price and wage moderation, which would be more readily attainable if measures were introduced to improve the workings of the markets for goods, services and productive factors. That would further allow an increase in those Spanish companies able to penetrate new markets, boosting the beneficial effects of gains in competitiveness on exports. Against this background, the Quarterly Macroeconometric Model of the Banco de España (MTBE)[4] has been enlisted to simulate the effect on the external deficit of a 1 pp reduction in relative export prices in both 2011 and 2012.[5] As can be seen in panel 2, this measure would allow the external deficit to be reduced by 0.5 pp of GDP in 2012.

Export performance depends not only on how competitive exports are, but also on the intensity of the demand for them. The diversification of Spanish exports towards products with higher value-added and towards more dynamic markets would have a positive impact on their performance. In fact, were Spanish firms to progressively increase their sales to emerging countries so that Spanish export markets grew at a similar rate to world markets in 2011 and 2012 (i.e. by 7.5%, instead of the 6% projected), then according to the MTBE there would be an improvement in the nominal trade balance from the first year, which would reach 0.6 pp of GDP in 2012. To encourage the diversification of exports towards countries with dynamic demand, firms' access to culturally and geographically distant markets needs to be facilitated, and their establishment in such markets needs to be strengthened.

Finally, limiting the high degree of oil dependence, which ties the performance of the external balance to fluctuations in the price of crude, is crucial. Spain's oil imports per unit of GDP are much higher than for the euro area as a whole (see panel 2). Were this difference halved over the coming years, the energy deficit would be reduced by around half a percentage point of GDP. Hence, the measures necessary to permanently reduce such external energy dependence must not be delayed.[6]

To avoid the growing demand for goods and services imports hampering the correction of the external deficit during upswings it would also be desirable to reduce the high level of dependence on imports of goods with higher value-added and technology. Were the long-term income elasticity of Spanish imports to be reduced to similar levels to those observed in the large euro area countries, the favourable impact on the external balance of the above simulations would be much greater.

3 These weights are based on the import content of each of the final demand components estimated using 2005 input-output tables.
4 To perform this simulation, the price elasticity of exports was increased, in line with the estimates at a more disaggregated level, and the response of imports to changes in final demand was moderated.
5 Given the weight of unit labour costs, mark-ups and inputs in the export price formation process, this reduction in prices could be achieved through a further decrease of 1.5 pp in ULCs and mark-ups in each one of these two years.
6 The plan to step up energy saving and efficiency approved by the Council of Ministers on 4 March includes a number of proposals to achieve an estimated total saving on energy imports of €2.3 billion per annum.

2 CUMULATIVE IMPACT ON SPAIN'S EXTERNAL DEFICIT OF DIFFERENT MEASURES

% of GDP

	2011	2012
1 Gains in price-competitiveness of 1% in 2011 and in 2012	0.3	0.5
2 Growth in Spain's export markets of 1.4% in 2011 and 1.6% in 2012	0.3	0.6
3 Progressive reduction of net oil imports	0.2	0.5
TOTAL IMPACT	**0.7**	**1.6**

SOURCE: Banco de España.

The simulations performed show that progress towards the achievement of external balance, which includes laying the foundations for curbing and reversing the upward trend in the negative IIP, requires ambitious measures on a number of fronts, to achieve more efficient price and wage setting, to increase the productivity of firms and to reduce the dependence of the Spanish economy on imports, especially of energy. The simulations performed show that even if there were a rapid improvement in all these areas, which would reduce the external deficit in 2011 and 2012, the primary component would only be balanced in the latter year, so that the IIP would barely fall. That said, apart from reducing the external deficit, the above-mentioned measures would boost activity, which would have favourable effects on financial market confidence in the growth capacity of the Spanish economy and on the sustainability of foreign debt.

was reduced (by 0.6 pp of GDP, to 5.4%), owing to the behaviour of households and financial institutions, which cancelled out the improvement in the financial position of non-financial corporations (which recorded net lending for the first time since 1996). Accordingly, the decline in the nation's net borrowing reflected the fall in that of general government (by 1.9 pp of GDP, to 9.2%). The correction of the budget deficit in the next few years is expected to be offset by a decline in private-sector net lending, so that the nation's net borrowing will hardly be reduced. In this respect, more sustained progress in reducing the external deficit would require higher savings ratios or lower investment by households and firms.

Despite its net borrowing, the Spanish economy's net external indebtedness declined in 2010, owing to the positive impact of valuation effects

The increase in the nation's net borrowing was not reflected in the international investment position, owing to the impact of valuation effects. These effects resulted from the depreciation of the euro vis-à-vis the pound sterling and the US dollar and the fall in the prices of Spanish financial assets relative to foreign ones (in particular equities), and they made the net debit position fall by 4 pp of GDP in 2010, to stand at around 87%. In a year characterised by recurring strains on financial markets, net borrowing was mainly covered through portfolio investment in long-term fixed income, as a result of both the decline in the holdings abroad of this type of security by residents in Spain and of investment by non-residents in government debt. Spain's foreign debt (a variable that includes liabilities vis-à-vis non-residents that give rise to debt or interest payments, i.e. claims on Spain) fell by 2.8% of GDP in 2010, to 164%.