

# SPANISH ECONOMIC PROJECTIONS REPORT

### Summary

This report analyses the situation of and outlook for the Spanish economy. It has been prepared by the Directorate General Economics, Statistics and Research of the Banco de España, taking into account the information available to 12 March. The projection period covers 2010 and 2011. The previous projections were set against a background of great economic uncertainty, some of which has gradually abated; but doubts persist regarding the future implications for economic growth of the severe crisis experienced both in Spain and worldwide, and the future effects of the economic policy measures taken in response to the crisis and of their gradual withdrawal.

Following a brisk and severe deceleration in activity in Spain, resulting in negative GDP growth rates since mid-2008, the recession was at its worst in 2009 Q1 when GDP fell by 1.7% in quarter-on-quarter terms. Since then, activity has continued to decline in quarter-on-quarter terms, but more moderately, standing at -0.1% in 2009 Q4. In the year as a whole, output fell by 3.6%, meaning that 2009 was clearly the worst year on record in terms of economic performance in several decades. As in 2008, national demand also declined in 2009, although in this case very sharply, recording an annual fall of more than 6%, while net external demand, with a positive contribution of 2.8 pp, helped offset the negative impact of national demand on GDP.

The severe recession that shook the world economy, especially in the second half of 2008 and early 2009, has given way to a gradual recovery. This is proving more intense in the emerging economies and more moderate in the industrialised countries where it is, in addition, heavily reliant on the extraordinary stimuli provided by the highly expansionary monetary and fiscal stance and by the exceptional measures adopted to support the financial system and credit institutions. Economic activity worldwide should expand again in 2010 and 2011 at rates of around 3.5%, in comparison with the decline of 1% seen in 2009.

The projections for Spain envisage a gradual improvement in activity in 2010, albeit insufficient to bring annual average growth back into positive territory, with GDP posting a decline of 0.4%. In 2011, GDP growth is expected to be somewhat more dynamic, climbing at a still moderate rate of 0.8% for the year as a whole. These projections signify a slow reversal of the severe adjustment in spending by firms and households and of the sharp deterioration in agents' confidence that have characterised the marked downturn of the past 18 months. Export markets and the increased competitiveness of the Spanish economy are both expected to drive activity, via the contribution of exports to growth. But this momentum may be offset by other factors limiting the intensity of the recovery, such as a persistently high level of uncertainty, the protracted effects of the real estate adjustment and high private-sector indebtedness, which will need to be pared back before another spending expansion phase may start.

This projections report also considers the possible influence of the fiscal consolidation measures laid down in the recently approved Stability Programme. The consolidation proposed is essential to halt the escalating growth in public debt and ensure there are no adverse implications for the borrowing costs for the economy, to reduce the degree of uncertainty under which agents take their decisions and, in short, to lay the foundations for sustained economic growth in the medium and long term. However, if there is no significant change in expectations, the fiscal adjustment may have contractionary effects in the short term.<sup>1</sup>

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1. The fiscal consolidation programme is a fundamental part of these projections; the way in which the measures contained in the Stability Programme have been incorporated into this report is described in detail in the accompanying Box.

The course of private consumption will be a key element in the recovery. After the exceptional increase in the household saving ratio (up almost 8 pp, to over 18%) in the past two years, in 2010 private consumption is expected to gradually resume a more dynamic profile, meaning that the saving ratio should decline over the course of the projection horizon. However, the persistently high unemployment rate, the drop in household wealth (particularly in housing wealth) and the financial constraints facing some households suggest that the decline in the saving ratio will be moderate and that it will remain above its historical average.

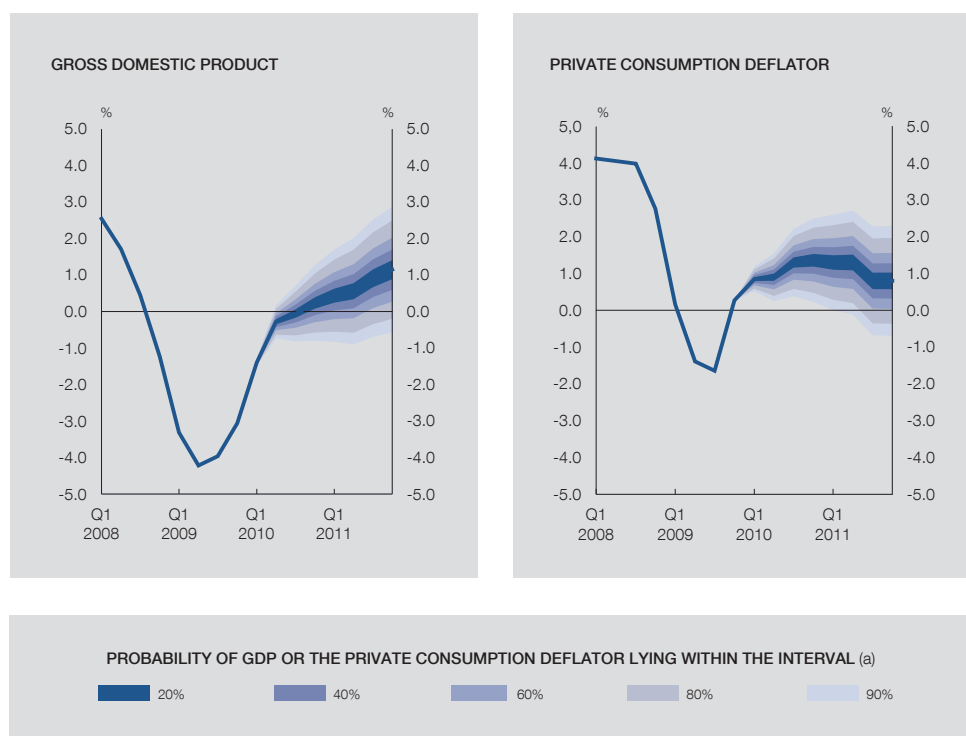
Household consumption is the only private expenditure component set to grow (by just 0.2%) in 2010, after declining by almost 5% in 2009. Investment in housing should continue to fall sharply, although not as much as in 2009, while business investment is expected to continue adjusting to a situation of low capacity utilisation, strong pressure on profits and uncertainty over the economic outlook. The pace of general government consumption and investment is also expected to diminish sharply, although positive rates are estimated for government consumption. Finally, economic activity will be chiefly underpinned by exports, which will increase by 5%, a far higher rise than is estimated for imports.

For 2011, this process of gradual recovery is expected to continue for the Spanish economy, with private consumption and productive investment increasingly buoyant. The effects of these variables on activity will be offset by the envisaged strong contraction in government consumption and investment in construction, particularly on the public investment side. The external sector should continue to uphold the economy's growth rate, in line with the expected favourable performance of global markets and of the price-competitiveness indicators of the Spanish economy.

Inflation dynamics have also changed markedly in the recent crisis. Compared with relatively high price growth rates – higher than those of the rest of the euro area – since the start of the monetary union in 1999, the Harmonised Index of Consumer Prices (HICP) fell by 0.3% on average in 2009, 0.5 pp below the rate observed in the euro area as a whole. Admittedly, this outturn was affected by the fall in oil prices in 2009, but core inflation, which excludes the habitually more volatile energy and unprocessed food prices, also posted very moderate levels and its rate moved on a declining course throughout the year, standing in February 2010 at 0.2%, 0.6 pp below the related figure for the euro area. These unusually low inflation rates suggest that the sluggishness of demand has sharply influenced price-setting, squeezing margins and requiring firms to make an exceptional cost-cutting and productive efficiency drive. Some increase is expected for 2010 in the inflation rate, up to an annual average of around 1%, which is in any event a low figure given the potential impact of the rise in VAT as from the summer. This moderate price trajectory is expected to continue in 2011, assisted by the slow recovery in demand.

The gradual improvement in economic activity should allow for further correction of the imbalances the Spanish economy had built up in the previous upturn. Hence, not only will inflation move more in keeping with euro area prices, but the external deficit will also continue to shrink and household and business spending plans will be compatible with the ongoing restructuring of their financial balance sheets, following the sharp increase in their debt in the previous phase.

Some of the sources of uncertainty identified in last year's report have been partly dispelled, but the level of uncertainty remains very high. The world economy has circumvented the threat of a great global depression and international markets are once more expanding. That said, the magnitude of the challenge the economic and financial authorities have had to face, and



SOURCES: INE and Banco de España.

a. The chart shows the uncertainty surrounding the central projection. The intervals have probabilities of 20%, 40%, 60%, 80% and 90%, respectively, based on past forecasting errors.

Latest data: 2009 Q4.

the scale of the economic policy responses adopted – and which must now, in part, be withdrawn – mean that the way forward cannot be said to be free of obstacles. In Spain's case, the intensity of the recession has been compounded by the strong deterioration in the labour market and the sharp worsening of the budgetary situation, which has necessitated the adoption of major measures, some still to be accurately defined, and whose effects, in any event, are difficult to quantify.

One habitual way of technically depicting the uncertainty surrounding macroeconomic projections is to calculate past forecasting errors and, on this basis, to show the bands around which each macroeconomic variable might trend to some degree of likelihood. This is the approach used in this report to illustrate the uncertainty surrounding the central scenario for the growth and inflation projections (see Chart 1).

In the balance of possible risks of deviation affecting these projections, no defined bias is discernible. Evidently, some of the assumptions on which they are based may not materialise, for instance if the world economy or certain key countries in the international arena are not capable of maintaining a sustained growth path or if further financial market instability or fragility should arise. A rise in commodities prices, in particular oil prices, would also hinder the return to a stable growth pattern. Likewise, fiscal adjustments in certain economies that were not deemed sufficient by agents could give rise to a fall-off in confidence and a bleaker economic outlook, with adverse effects on spending plans. Set against this group of risks, it should also be said that there may be positive surprises: indeed, revisions in recent months of world GDP and of international trade have been predominantly on the upside. It cannot be ruled out on the domestic front that the ongoing restructuring of private-sector balance sheets may exert a

somewhat greater contractionary pressure on spending or that there may be an occasional distortion in the functioning of credit channels that might hamper the recovery. Conversely, the improvement in certain key indicators in recent quarters, such as confidence, competitiveness and productivity, and the improved consumer and investment spending figures in the second half of 2009 might lead to further dynamism in 2010, giving rise to a bigger cut in the household saving ratio, which should not be ruled out in light of the exceptional level of this ratio in 2009, and to the better performance of the external sector.

Economic policies may play a very important role in terms of potential upward deviations from the central scenario for these projections. In particular, the rigorous application of the Stability Programme and the introduction of far-reaching structural reforms in the labour market and to increase competition in the markets for goods and services would enhance the economic outlook, boosting agents' confidence, employment and competitiveness. Overall, the outcome would be greater economic dynamism.

Regarding inflation, no clearly defined upside or downside risks are discernible either. The slowness of the economic recovery warrants the containment of prices, even in the presence of a potential inflationary shock, as is the case of the rise in VAT. Wage restraint, which should be ensured by the multiannual agreement recently entered into by the social partners, would entrench such behaviour. Were the dynamics of economic activity to be different, that might affect price projections. But given the output gap that has built up and the high unemployment rate, a somewhat sharper increase in demand would seem unlikely to translate into far higher price rises than those projected here.

In sum, following the sharp contraction the Spanish economy underwent in 2009, the outlook for 2010 and 2011 is one of a scenario of slow recovery and improvement, albeit not one free of obstacles. On the one hand, an ongoing adjustment is required of certain imbalances that built up in the upturn, the reflection of which was a high level of private-sector debt, a heavy concentration of resources in the real estate sector and, as a corollary, a sizeable external deficit. These imbalances have been adjusting at differing speeds in the past two years, but their correction is not complete; accordingly, they will continue to check national demand to some extent over the projection horizon. On the other hand, the need to partially withdraw the stimuli and to bring public finances back onto a path of stability will affect growth possibilities in the short run, despite the expansionary role that the monetary policy stance may be expected to play in the projection horizon, given the containment also observable in euro area inflation. In any event, the pattern of slow exit from the recession described here might be quickened by the momentum provided by structural adjustments that allow greater use of the labour factor, increase productivity in the long run and promote productive investment.

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

### ***External assumptions underlying the projections***

The projections presented in this report have been prepared from a set of assumptions about the future course of a series of exogenous variables conditioning the expected path of the Spanish economy over the next two years.

In particular, assumptions about developments in exchange rates, interest rates, share prices and oil prices, which are made using procedures identical to those usually employed in the Eurosystem and ECB experts' projection exercises, are based on changes in the respective

Annual rates of change, unless otherwise indicated	2004	2005	2006	2007	2008	2009	Projection		Difference between current and March 2009 projections report	
							2010	2011	2009	2010
							INTERNATIONAL ENVIRONMENT			
World output	5.3	5.3	4.9	5.0	2.9	-1.0	3.6	3.6	-0.4	1.6
Global markets	10.8	7.9	9.2	6.9	3.1	-11.3	7.0	5.3	-4.8	5.1
Spain's export markets (a)	8.3	6.6	8.3	6.5	2.9	-11.2	5.5	4.3	-6.5	4.3
Oil price in dollars (amount)	38.3	54.4	65.4	72.7	97.7	61.9	79.9	83.3	15.4	28.9
Competitors' export prices in euro (b)	-0.7	3.5	3.0	0.2	2.5	-3.8	2.5	1.6	-4.5	1.9
MONETARY AND FINANCIAL CONDITIONS										
Dollar/euro exchange rate (amount)	1.24	1.24	1.26	1.37	1.47	1.39	1.37	1.36	0.12	0.10
Short-term interest rate (3-month EURIBOR)	2.1	2.2	3.1	4.3	4.6	1.2	0.8	1.6	-0.4	-1.1
Long-term interest rate (10-year bond yield)	4.1	3.4	3.8	4.3	4.4	4.0	4.0	4.3	-0.3	-0.7

SOURCES: Banco de España and INE.

(\*) Projection cut-off date: 12 March 2010.

Latest QNA data published: 2009 Q4.

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

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

markets in the days immediately prior to 12 March, the cut-off date for gathering information for this report.<sup>2</sup> It is assumed that the euro exchange rate will remain constant over the projection period at the value observed in the spot markets in the reference period. This means that the average exchange rate against the dollar in 2010 and 2011 will depreciate by scarcely more than 2% compared with the average for 2009 (see Table 1). The short-term interest rate path, obtained from expectations implicit in futures markets about changes in the three-month EURIBOR, is relatively stable, with the result that this interest rate is expected to average 0.8% in 2010, 0.4 pp below the figure for 2009, and to rise to 1.6% in 2011. Long-term interest rates, measured on the basis of market expectations about Spanish ten-year government bond yields, are also relatively stable. This variable was 4% in 2009 and is expected to stand at 4% in 2010 and 4.3% in 2011. Oil prices, according to futures markets for this commodity, would be approximately \$80 and \$83 per barrel in 2010 and 2011, respectively. The level for 2010 would be 30% up on that of the previous year. Lastly, house prices which, together with share prices, are the other major determinant of household wealth, are expected to continue to move on a declining path over the projection period.

As regards credit conditions,<sup>3</sup> it is assumed that the margins on interest rates on business loans will remain approximately stable at their current levels, while those on loans to households will perform differently depending on the purpose of the loan (rising slightly in the case of consumer credit and declining modestly for mortgage loans). These levels are, however, higher than pre-crisis ones. Moreover, with the aid of the latest findings of the Bank Lending Sur-

2. In order to mitigate the possibility that the values of any of these variables are affected by volatility in the corresponding market on a specific trading day, the average of the values traded on the ten working days prior to the cut-off date for information was used. 3. Here an estimate has been made of the future course of the margins separating the interest rates on financial intermediaries' loans to private agents and the rates on which the assumptions for future developments are formulated (three-month EURIBOR and ten-year government bond yields).

vey, it is estimated that, although there will be no further tightening of credit standards over the projection period, previous tightening will continue to exert some restraint on activity in 2010. The aim of incorporating these factors into the projection exercise is to contribute to determining the effects of the financial crisis, although the difficulties of measuring this impact on agents' spending must be acknowledged.

The developments in world markets for goods and services included in this exercise are those underlying the ECB's macroeconomic projections in its March 2010 *Monthly Bulletin*. This year, growth of global GDP and trade is expected to recover, led by the emerging economies. In 2011, it is estimated that the growth rates of these variables will not exceed those observed in 2010. On that basis, it is projected that Spanish export markets will grow 5.5% this year and 4.3% the next, in stark contrast to their decline by more than 11% in 2009. Finally, turning to fiscal policy (which, as mentioned above, is an important exogenous conditioning factor of the projections presented in this report), Box 1 describes how it is reflected in the projections of measures that have already been approved and in those included in the Stability Programme.

### **Outlook for the Spanish economy**

The Spanish economy's GDP shrank by 3.6% in 2009, 0.6 pp worse than the figure projected in the March 2009 edition of this report (see Table 2). This deviation confirms the materialisation of the short-term downside risks indicated in those projections. The discrepancy between projected and actual growth was due to the more unfavourable performance of national demand – whose contribution to GDP growth was 0.8 pp less than projected in March 2009 – and, under this heading, household consumption fell almost 2 pp more than projected. In contrast, the contribution of net external demand to GDP growth was more than 0.3 pp higher than projected.

At the beginning of 2009, the Spanish economy underwent the most virulent phase of the recession, set against the continuing strong deterioration in the international financial environment dating back to autumn 2008. Under these circumstances, Spanish GDP posted its highest quarter-on-quarter decline in 2009 Q1, which even exceeded that foreseen in the previous projections report. Mounting uncertainty and the brisk, pronounced deterioration in the labour market prompted a sharp decline in household consumption. At the same time, the abrupt adjustment to world trade flows resulted in a very severe contraction of exports. From last spring, financial markets began to stabilise and trade flows ceased to decline, giving rise to a gradual improvement in agents' confidence and external demand. Ultimately, this eased the quarter-on-quarter pace of decline of the Spanish economy, and from Q2 the attendant rates were more in keeping with those set out in the previous projections report. Furthermore, demand-side government stimulus measures and, in particular, the Local Investment Fund and the Plan 2000E (assistance for new car purchases) contributed to tempering the declines in GDP. Given the continuation of the crisis which began in 2008, 2009 as a whole was marked by the deepest and longest recession of the Spanish economy in several decades and there were six consecutive quarters of negative quarter-on-quarter growth until 2009 Q4.

Spanish output is projected to recover slowly in 2010. Nonetheless, given that in comparison with the projections prepared one year ago, 2009 ended slightly more favourably than projected and developments in 2010 as a whole are also forecast to be slightly better, it is estimated that GDP will decline by 0.4%, an improvement of 0.6 pp on the March 2009 projection. This revision of the projection for 2010 tends to corroborate the view previously held that risks to growth for this year were predominantly on the upside. Expectations of a better performance by the external environment of the Spanish economy contributed to this slightly more favourable outlook. However, the strength of the recovery envisaged is modest, due firstly to the fact that so too is the improvement in the world economic outlook, which is also shrouded



As regards the fiscal policy assumptions, this year's projection exercise has several singular features, in light of the fiscal consolidation announced by the government that will signify the adoption of numerous measures on both the revenue and the public spending side. The exceptional nature of this consolidation process and its macroeconomic repercussions make it advisable to treat the fiscal policy measures in these projections with particular caution.

The projections published by the Directorate General Economics, Statistics and Research of the Banco de España in the last two years were based, as is customary, on the assumption that there would be no change in fiscal policy in the projection horizon. Accordingly, the projections took into account only those fiscal measures already approved, and did not factor in the effects of any possible future budget measures. However, considering its scope and the measures it includes, the fiscal consolidation process to be implemented in Spain in the coming years will be one of the main conditioning factors of macroeconomic performance. In this setting, it seems inappropriate to base the macroeconomic projections solely on fiscal measures that have already been approved, as this would signify excluding the impact of many of the measures announced which, though not yet fully defined or approved, are very likely to be introduced. For this reason it was decided, in this case, to include in the central projection scenario not only fiscal measures already approved, but also others which, although pending approval, are relatively well defined. However, there are still differences vis-à-vis the government's fiscal assumptions, essentially as a result of the differences in the macroeconomic scenario and of different underlying expenditure dynamics.

On 29 January 2010 the Spanish government presented a new Stability Programme Update (SPU). This includes significant budget consolidation up to 2013, by which time the overall general government deficit should stand at 3% of GDP, compared with 11.2% in 2009. The deficit reduction would amount to 1.6 pp of GDP in 2010, followed by 2.3 pp of GDP each year from 2010 to 2013. In line with the SPU, the deficit reduction would be essentially structural, as a result not only of the tax increases already introduced but also, and above all, of the public spending cuts envisaged in the programme. In particular, in addition to the moderation in spending envisaged in the State and regional government budgets for 2010, the SPU announced a further public spending cut for 2010 (the "Immediate Action Plan"). This measure, which amounts to 0.5% of GDP, has now been approved and includes a cut, without exceptions, in public-sector vacancies in 2010 to 10% of the replacement rate, together with the decision to make no new temporary hires. The

SPU also includes an Austerity Plan for the period 2011-2013 and the Framework Agreements on the Sustainability of Public Finances with the regional and local governments that will signify further public spending cuts of 3.8 pp of GDP up to 2013. The breakdown of the spending cuts envisaged between 2009 and 2013 is as follows: employee compensation (-1.9% of GDP); inputs, transfers and other expenses (-1% of GDP); public investment (-0.9% of GDP); and subsidies (-0.5% of GDP).

For 2010, the fiscal assumptions used as a basis for these macroeconomic projections factor in, first, the contents of the State and the regional government budgets for 2010, which include the reversal of some of the previous years' measures (such as, for example, the bringing forward of tax refunds and, on the expenditure side, the State Local Investment Fund and the Special State Fund to invigorate the Economy and Employment), together with the impact of the new measures adopted (including, in particular, elimination of the €400 tax credit on earned income, higher tax rates on saving, the VAT rate rise and the State Fund for Local Environmental Sustainability). They also include for 2010 the spending cuts deriving from the Immediate Action Plan, including the restriction announced in public-sector vacancies. For 2011, the fiscal assumptions incorporate the main guidelines of the above-mentioned Austerity Plan and Framework Agreements, which translate, *inter alia*, into significant cuts in public-sector employment and investment. The terms of the Government-Trade Union Agreement for the Public Sector are also taken into account over the two years, within the framework of the 2010-2012 social dialogue agreement signed in 2009 in connection with the setting of wage growth rates for public-sector employees. On the basis of these assumptions, the rate of growth of government consumption is projected to slow in nominal terms, to 2% in 2010 and 0.7% in 2011, in comparison with 5.3% in 2009. Likewise, public investment is expected to decline by around 15% in nominal terms, in 2010 and in 2011, after rising by 10.5% in 2009.

Given the magnitude of the fiscal adjustments factored into the macroeconomic and fiscal projections, these are highly dependent on the fulfilment of these assumptions. In this respect, it should be underlined that the public spending-cut targets of the central scenario are highly ambitious and are, in many cases, unprecedented. Moreover, public spending has traditionally shown a high level of inertia, which makes curbing its growth all the more difficult, especially considering that this depends largely on the regional and local governments. Accordingly, there are upside risks in terms of public spending and the government deficit that could be minimised if the measures were more clearly detailed.

in uncertainty. But, more crucially, the causes underlying this projection are more closely linked to the determinants of national demand. These include, most notably, the persistence of unfavourable labour market conditions, meaning that employment will continue to be destroyed, albeit at considerably lower rates than those seen in 2009, and that the unemployment rate will post a further slight rise in annual average terms. Furthermore, the prolonged adjustment of residential investment is not yet over, meaning that it will continue to weigh down growth in 2010, albeit to a much lesser extent than in 2009. It is also to be expected in 2010 that the



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

	2004	2005	2006	2007	2008	2009	Projection		Difference between current and March 2009 projections report	
							2010	2011	2009	2010
GDP	3.3	3.6	4.0	3.6	0.9	-3.6	-0.4	0.8	-0.6	0.6
Private consumption	4.2	4.2	3.8	3.6	-0.6	-4.9	0.2	1.0	-1.8	0.6
Government consumption	6.3	5.5	4.6	5.5	5.5	3.8	1.2	-0.2	0.3	-0.9
Gross fixed capital formation	5.1	7.0	7.2	4.6	-4.4	-15.3	-9.8	-3.5	-0.2	0.5
<i>Investment in capital goods</i>	5.1	9.2	9.9	9.0	-1.8	-23.1	-3.2	1.1	1.2	9.4
<i>Investment in construction</i>	5.4	6.1	6.0	3.2	-5.5	-11.2	-12.7	-7.2	1.7	-1.1
Exports of goods and services	4.2	2.5	6.7	6.6	-1.0	-11.5	5.0	4.8	-2.6	2.1
Imports of goods and services	9.6	7.7	10.2	8.0	-4.9	-17.9	-1.5	0.7	-2.8	1.1
National demand (contribution to growth)	4.9	5.3	5.5	4.4	-0.5	-6.4	-1.9	-0.3	-0.8	0.5
Net external demand (contribution to growth)	-1.7	-1.7	-1.4	-0.9	1.4	2.8	1.6	1.0	0.3	0.2
Private consumption deflator	3.6	3.4	3.6	3.2	3.7	-0.6	1.1	1.1	-0.8	-0.4
Unit labour costs	2.4	3.3	3.3	3.8	4.6	0.4	-0.8	0.3	-0.4	-2.3
Compensation per employee	3.0	3.7	4.0	4.5	6.1	3.7	1.5	1.4	0.6	-1.2
Apparent labour productivity	0.6	0.4	0.7	0.7	1.5	3.3	2.3	1.1	1.0	1.1
Employment (equivalent jobs)	2.7	3.2	3.3	2.8	-0.6	-6.7	-2.6	-0.3	-1.5	-0.5
Unemployment rate (% of labour force)	10.6	9.2	8.5	8.3	11.3	18.0	19.4	19.7	0.9	0.0
Saving ratio of households and NPISHs	11.3	11.3	11.1	10.6	12.9	18.3	16.6	15.6	2.1	0.0
Nation's net lending (+) / net borrowing (-) (% of GDP)	-4.8	-6.5	-8.4	-9.6	-9.1	-4.6	-3.6	-2.9	0.7	0.8
General government net lending (+) / net borrowing (-) (% of GDP)	-0.4	1.0	2.0	1.9	-4.1	-11.2	-10.2	-8.9	-2.9	-1.5

SOURCES: Banco de España and INE.

(\*) Projection cut-off date: 12 March 2010.

Latest QNA data: 2009 Q4.

ongoing adjustment of private agents' financial position will continue, given the high levels of debt attained. Lastly, the impaired creditworthiness of certain borrowers, with the subsequent increase in doubtful asset ratios, will influence institutions' lending policies.

The fall in output in 2010 is the outcome of the expected declines in the various components of gross fixed capital formation (see Chart 2). Specifically, investment in construction in 2010 is expected to make a negative contribution of almost 2 pp to output growth, split in practically equal portions between the residential component and that of other construction (see Chart 3). As regards investment in housing, an annual average fall of somewhat more than 15% is foreseen, given that the number of housing starts in each quarter in 2010 is expected to be below the number of finished houses. However, the gap between the paths of both variables will tend to close over the course of the year, whereby the decline in investment in housing will also tend to ease off. Weighing down investment in other construction in 2010 will be the portion of the attendant demand by general government. Specifically, the temporary fiscal stimuli relating to this construction investment component will be initially lower compared with 2009 (as the State Local Investment Fund from last year will be replaced by the State Fund for Local Environmental Sustainability, the overall amount of which is lower) and will subsequently disappear. Adding to this will be the cut in public investment announced in the Stability Programme.

Investment in equipment and in other products is expected to post negative growth rates in 2010, although these will be appreciably lower than those observed in 2009. The weakness

## CONTRIBUTIONS TO GDP GROWTH

CHART 2

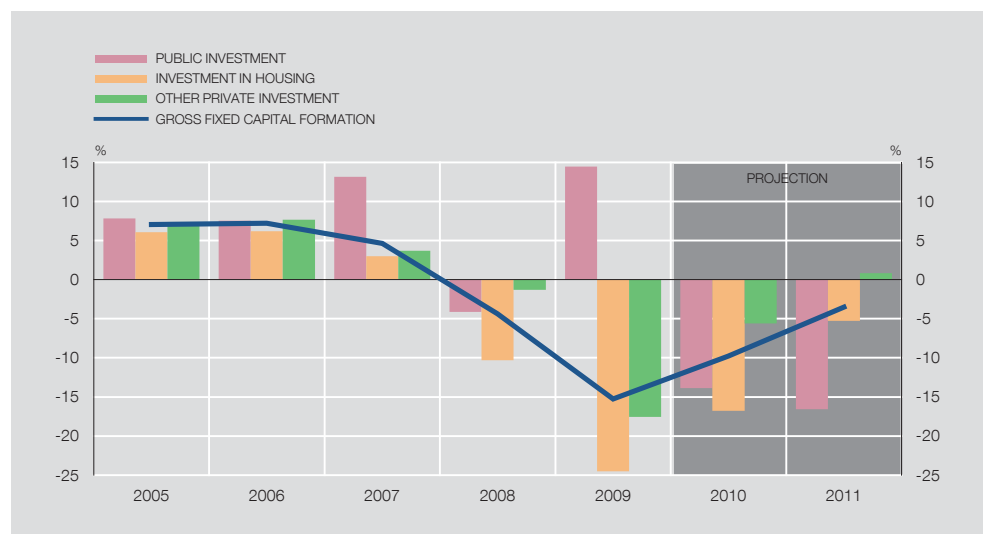


SOURCES: INE and Banco de España.

Latest data: 2009 Q4.

## BREAKDOWN OF INVESTMENT Rates of change in real terms

CHART 3



SOURCES: INE and Banco de España.

Latest data: 2009 Q4.

of these demand components of investment, undertaken mainly by private companies, is due to the continuing slackness of demand (mainly national demand), in a setting in which non-financial corporations have the possibility of expanding their output without increasing their capacity, as capacity utilisation is close to its historical lows. In addition, one factor that may have a negative bearing on decisions to embark on new investment projects may be companies' wish to improve their financial position through the reduction of their current high levels of debt.

In the central scenario, private consumption is estimated to grow by 0.2% in 2010, following its strong rate of decline last year. The more favourable performance of this aggregate demand component is due essentially to improved household confidence, the far-reaching deterioration in which in 2009 raised the saving ratio to an all-time high since records began. The gradual reversal of this loss of confidence, which has become patent since last spring as uncertainty has gradually abated, will mean that the saving ratio will begin to turn downwards in 2010. Nonetheless, the projected recovery in private consumption is a modest one, owing to several reasons. First, disposable income in real terms is expected to undergo a relatively marked decline in 2010. In part, this reduction is due to the fact that the behaviour of employment will continue making a negative contribution to income growth, albeit one considerably lower in absolute terms than that observed in 2009. Further, the contribution of other sources of income that had contributed to sustaining household income in 2009 will diminish. This is the case of interest income and, especially, of the general government contribution via benefits and taxes. Second, the fall in the value of household wealth, households' wish to lower their high debt and uncertainty over the extent of the improvement in the labour market in the medium term will also mean that the recovery in household spending will be modest. Finally, the expected growth in population over the projection horizon is significantly lower than that recorded in recent years, which is a further factor substantiating the lacklustre nature of the recovery in this demand component. All told, the strength of the pick-up in private consumption in 2010 is one of the factors of the current projections that is most shrouded in uncertainty.

Of significance for the path of private consumption in 2010 is the rise in VAT which will take place on 1 July this year, and which forms part of the drive needed to push fiscal consolidation through. The Spanish economy's experience in the face of previous rises in this tax (such as those in the 1990s) and similar recent rises in other countries (Germany, in January 2007) suggest that agents tend to bring forward certain types of expenditure – in particular that on durable goods purchases – so as to avoid this tax increase. Set against this, in the months following such rises, a moderation in consumption is usually discernible, as a result of household decisions being brought forward. This pattern would feed through in 2010 to projected private consumption, which might rise temporarily during Q2, although this would be offset by greater slackness in Q3. In addition to this effect, continuing demand weakness suggests that the impact of the VAT rise on prices and, therefore, on household purchasing power will be limited.

Export growth will benefit from some improvement in external competitiveness and from the pick-up in foreign markets, although this is not expected to be sufficiently robust as to make up for the heavy decline in 2009. The positive contribution of the net external balance to GDP growth will diminish compared with 2009 since it is expected that the growth rate of imports, whose weight in GDP exceeds that of exports, will improve on a similar scale to that of exports.

Spanish GDP in 2011 is expected to return to a positive annual average growth rate. It will do so in a setting which will see the accentuation of some of the characteristics shown by its demand components in 2010. In particular, the strengthening of household consumption and the fall-off in various items of gross fixed capital formation will both continue over the coming year, although the improvement in investment in other construction is expected to be less. These developments will be in light of the greater intensity of the budgetary consolidation process, which would translate into a fall in government consumption. The contribution of net exports is expected to diminish once again, in step with the greater robustness of imports that will accompany firmer final demand.

If no structural reforms are undertaken, the decline in activity in 2010 and the moderate increase in 2011 will result in a further drop in employment in both years, although in annual average terms the rate of job destruction should be very small in 2011 and should decrease as the year progresses, so that by the second half of the year the Spanish economy should once again be generating employment. Moreover, this improvement in employment towards the end of the projection horizon should be more noticeable in the market economy, in light of the commitment to cut the public-sector workforce that forms part of the budget consolidation programme. The accelerating trend of apparent labour productivity, linked largely to adjustment in the residential building sector, seemingly peaked in 2009, and is expected to gradually lose momentum, to reach 2.3% in 2010 and 1.1% in 2011. The rate of growth of compensation per employee should also slow very significantly in 2010 (to 1.5%), becoming virtually flat in 2011 (1.4%), in line with the multiannual collective bargaining agreement signed by the social partners in February and the low salary increases in general government. In comparison with 2009, compensation per employee, and the increased ease of application of opt-out clauses, would thus be much more consistent with the severity of the recession, laying the foundations for enhanced competitiveness.

Specifically, the private consumption deflator is expected to rise by around 1% in 2010 and again in 2011, although the unwinding of the year-on-year impact of the VAT increase should bring the inflation rate down below 1% again in the second half of 2011. This estimate is based on past experience of indirect tax increases, in Spain and in other countries, bearing in mind that they will be passed through differently to different kinds of goods, according to factors such as the level of competitiveness in the respective markets and consumer preference, and that the most impact will be seen in energy goods. Moreover, this projection envisages a lower level of pass-through than in similar cases in the past, as a result of demand weakness. This factor also explains the high degree of moderation attributed to the inflationary pressure factored into the projection, after discounting the impact of the VAT rate rise. In fact, the sharp cumulative decrease in household spending will prompt Spanish firms to contain their margins and their unit labour costs, holding their prices at moderate levels, throughout the projection horizon. And this in a setting in which, in contrast to 2009, energy and food prices, which are much more vulnerable than other prices to international market fluctuations, will drive up inflation, and in which the euro exchange rate is expected to depreciate.

As domestic demand slowly and sluggishly firms, as envisaged in these projections, the nation's net borrowing will continue to decline, albeit at a slower pace than in 2009. It is estimated that net borrowing will fall by up to a further 2 pp over the two-year projection horizon, to 2.9% of GDP in 2011, almost 7 pp lower than the high recorded in 2007. This improvement expected in the projection period is essentially due to the sharp fall in the goods trade deficit, although the services balance (especially non-tourism services) is also expected to make a significant contribution. In contrast, the deficit on net current transfers and income is expected to grow. By 2011, the income deficit, which has risen notably over the past decade as external debt has risen, is expected to stand not far short of the nation's net borrowing, meaning that, in terms of size, the external deficit would match the net interest burden associated with the net liabilities accumulated in the past.

The nation's net borrowing should improve as a result of the cut in the budget deficit, while households' net lending capacity should remain relatively high, following the sharp turnaround in 2009, and firms should record limited net borrowing, also following the major adjustment in 2009. In recent quarters, financing raised by households and firms has decelerated sharply, with a decline in outstanding credit levels at end-2009, especially in the case of loans to non-financial corporations and to households for consumer goods purchases. The relative weight

of the different factors that underpin this credit contraction is not readily discernible, but the lower net borrowing deriving from the sluggishness in activity has clearly played a significant role, as have tighter credit standards, in light of the higher risk perception.

Nonetheless, the considerable slowdown in households' and firms' income in the current phase of the cycle has meant that debt ratios have fallen only marginally. In this respect, the moderate increase in private expenditure envisaged in these projections would be consistent with the continued deleveraging of the private sector that is essential to lay the foundations for future growth. Even so, tight credit standards that would have most impact on the agents most dependent on bank credit, such as households and SMEs, cannot be ruled out.

The general government sector posted a deficit of 11.2% of GDP at the close of 2009, more than 7 pp worse than the previous year and substantially worse than initially projected. This considerable increase is due to a variety of factors, including most notably: the sharp drop in revenue, which had a substantial transitory component, linked above all to the property boom; the operation of the automatic stabilisers; the various discretionary measures adopted to soften the effects of the crisis on demand, and the tendency of public expenditure not linked to the economic cycle to outgrow the trend GDP of the economy. The fiscal projections, based on the assumptions discussed in detail in Box 1, point to a deficit reduction of 1 pp of GDP in 2010 and of a further 1.2 pp in 2011, in a setting in which GDP growth is expected to remain subdued. Lastly, the public debt ratio is expected to climb to 66% of GDP in 2010 and to 75% in 2011.

### ***Risks to the projections***

The projections presented in this report outline a gradual recovery in activity in 2010 and 2011, due to a gradual gain in momentum in private sector expenditure plans, a positive contribution from external demand and a sharp contraction in government consumption and investment demand. Growth will remain negative in 2010 as a whole, even though the rate of growth of GDP should be positive in almost all quarters, while in 2011 GDP should gradually move towards its long-term trend rate, even though the output gap will remain negative.

Although most of the main industrialised countries have now come out of recession, the level of uncertainty surrounding these projections remains high. The risks are probably quite evenly balanced, despite the large number of potential sources of uncertainty. There are doubts about how sound the international economic recovery may be and about how long it may take to resume pre-crisis activity and trade levels, but these factors reflect both upside and downside risks. Similarly, the exceptional expansionary stance of economic policies worldwide may have further – and so far unforeseen – positive effects on activity, although the necessary withdrawal of these stimulus measures may also affect the recovery. In Spain, despite the severity of the crisis and the pressing need for adjustment in private expenditure, both consumer and business confidence indicators have picked up in recent quarters. In this respect, the planned fiscal consolidation may help boost the credibility of the macroeconomic stability framework and enhance the economic outlook to a greater extent than is factored into these projections.

As regards inflation, the risks are also evenly balanced. Inflation, as is known, is very sensitive to fluctuations in the price of oil and other commodities. Although these projections are based on the price of oil futures during the first half of March, which headed upward, the possibility that firmer global economic growth may prompt renewed tension in demand on the crude oil market and price rises cannot be ruled out. Increases in certain indirect taxes, such as excise duties, are also an option for authorities looking to shore up their fiscal consolidation plans, and this is another upside risk to inflation. The projections continue to reflect the dampening

effect that the weakness of spending has had on the price-setting process in recent quarters, in line with the greater sensitivity consumer prices have been showing in recent months to more fragile demand. But it remains in doubt whether this increased sensitivity is due to cyclical changes, in which case a recovery in demand could lead to renewed inflationary pressures, or whether it also includes structural elements.

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