5 THE SPANISH ECONOMY

The recession that began in Spain in mid-2008 continued into 2009; it was especially virulent in the first half of the year, before gradually losing momentum in the second half. That said, in the year as a whole, there was a substantial fall in GDP (-3.6%). As the top panels of Chart 5.1 show, the fall-off in activity was similar to that seen in the euro area, although the breakdown was rather different. In Spain, the fall in output was accompanied by a severe contraction in national demand, which shrank by more than 6%, very much sharper than the euro area correction. By contrast, in Spain net external demand cushioned the impact of national demand on GDP, making a highly positive contribution of 2.8 pp of GDP, whereas in the euro area the foreign trade crisis led to a negative contribution from this sector in 2009.

The recession was more severe than in previous crises. As the central panels of Chart 5.1 show, the rate of decline of GDP was much more marked in 2009 than during the recession of the early 1990s. This prompted the emergence of a highly significant output gap (albeit one no larger than in the previous recession), in part because, as is analysed in Chapter 2 of this Report, the Spanish economy's growth capacity was also affected by the crisis, as investment shrank and the unemployment rate rose very rapidly.

Private consumption and investment in housing are probably the two components that performed worst in comparison with similar cycles; however, as in the case of GDP, both are now out of their cyclical trough, and private consumption actually started to post positive rates of growth as from the closing months of 2009. In contrast, net exports made a greater contribution to growth than in 1992 and 1993, despite the absence on this occasion of the impulse previously provided by currency devaluations. True, this positive contribution was due to the severe contraction in imports brought about by the extreme weakness of national demand, as exports were affected by the slump on the international markets. The decline in activity fed through, with great intensity, to employment, which fell very sharply, prompting a surge in the unemployment rate. It also led to an unprecedented slowdown in the rate of inflation, which in 2009 stood below that of the euro area for the first time since the start of Monetary Union. In particular, the year-on-year rate of growth of the CPI excluding unprocessed food and energy has gradually fallen, from more than 3% in 2008 to almost zero at the beginning of 2010.

The gradual improvement in activity continued in the opening months of 2010. GDP rose slightly (0.1%) in Q1, after six consecutive quarters of negative growth rates, and inflation rose, albeit due, above all, to higher oil prices. The outlook for the Spanish economy is for a relatively slow recovery in activity, meaning that although GDP has started to post positive rates of growth, the output gap will remain negative in the coming quarters; this reflects the difficulties of mobilising available productive resources and suggests that inflation will remain moderate. Moreover, as analysed in Chapters 1 and 2 of this Report, the introduction of certain structural reforms could speed the recovery, harnessing idle resources and countering the negative impact of the crisis on the Spanish economy's growth capacity.

1 Monetary and financial conditions

The cost of borrowing for the private sector has fallen, but the other credit conditions remain tighter than before the financial crisis

The cost of borrowing for the private sector is now low, having fallen since the end of 2008 (see Chart 5.2). Since then, cuts in interbank rates have gradually passed through to lending rates, although only partially, as spreads have widened, mostly in the higher-risk segments (consumer credit and lending to SMEs). Conversely, lending standards and credit conditions other than interest rates remain tighter than before the crisis. These had progressively tightened since the second half of 2007, and although this process came to a halt in mid-2009, there is still no sign of any significant turnaround. In turn, since late 2009 and in 2010 to date, the nominal effective exchange rate has depreciated, helping to ease monetary conditions.

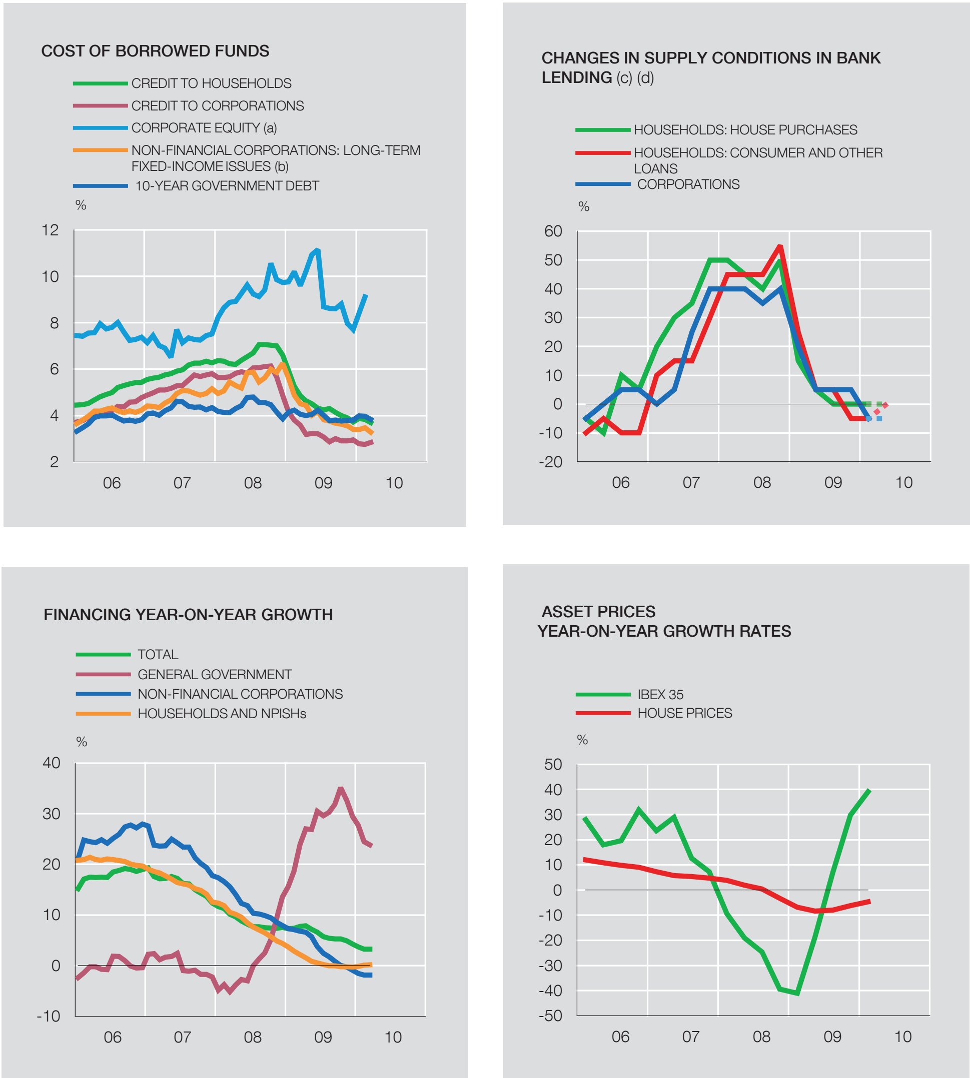
CHARACTERISATION OF THE CURRENT CYCLE (a) CHART 5.1

SOURCES: INE and Banco de España.

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

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 x 1 + % of institutions reporting some tightening x 1/2 - % of institutions reporting some easing x 1/2 - % of institutions reporting considerable easing x 1.
d. The broken line indicates forecasts made the previous quarter by respondents.

Spanish government debt yields are also low, although in recent months they have borne the brunt of the strains in the sovereign debt markets

From a historical perspective, Spanish government debt yields are also relatively low, especially in the case of short-term instruments, in keeping with the expansionary monetary policy stance. In turn, medium and long-term bond yields have been influenced by the changes in market perception and assessment of sovereign risk, especially after the crisis heightened in autumn 2008. During the opening months of 2010, the 10-year bond spread over the German bund fluctuated, widening notably in April and May as a consequence of the heightening of the Greek public finance crisis and the contagion effect on the debt markets of other countries which, like Spain, had high budget deficits.

Household net wealth continues to shrink

Household net wealth continued to shrink in 2009 and in the opening months of 2010, due above all to falling house prices, although their rate of decline has moderated in recent quar-

MAIN STIMULUS MEASURES APPLIED IN 2009

TABLE 5.1

€m

FISCAL AND FINANCIAL MEASURES		2009
WITH IMPACT ON THE BUDGET BALANCE (I - II)		**-23,975**
I Revenue		-11,500
Monthly VAT refunds brought forward		-5,600
Elimination of wealth tax		-2,300
€400 tax rebate on earned income under personal income tax (a)		-1,900
Inclusion of tax credit on home ownership (main residence) in calculation of personal income tax withholdings		-500
Rebates on social security contributions in order to promote part-time hiring		-1,200
II Expenditure		12,475
State Fund for Local Investment		7,700
Special State Fund to Invigorate the Economy and Employment		3,000
Unemployment benefits (one-off payment for becoming self-employed and the €420 assistance payments)		975
Car purchase subsidy		800
With impact on public debt		**16,250**
Fund for the Acquisition of Financial Assets		9,500
Fund for the Orderly Restructuring of the Banking Sector		6,750
ICO (Official Credit Institute) CREDIT FACILITIES	2009	
	Funding	Amount Used
TOTAL	**43,100**	**20,387**
ICO credit facility to guarantee local councils' debts to firms and the self-employed	3,000	NA
ICO liquidity facility for SMEs and the self-employed to finance current assets (b)	16,000	8,453
ICO corporate support facilities 2009 (for SMEs, internationalisation, entrepreneurs and business growth)	10,900	6,245
ICO-PROINMED credit facility (investment projects for medium-sized companies)	3,000	NA
ICO-FTVPO facility: extension of ICO guarantee for asset-backed securities linked to government-subsidised housing	5,000	2,510
ICO housing credit facility: loans for completed housing for rental (main residence)	3,000	1,130
Plan Renove Turismo (tourism industry modernisation programme)	1,000	1,000
Plan VIVE (vehicle renewal programme)	700	700
ICO-FuturE credit facility to modernise and improve the Spanish tourist industry	500	349

NA: No quantitative estimate is available.

a. Measure introduced in 2008. It will be partially withdrawn in 2010.
b. The ICO contributes 50% and the banks the other 50%.

ters. Stock prices recovered sharply in 2009, as the IBEX 35 posted gains of almost 30%, although in 2010 to date they have fallen back substantially (and especially in April and May).

Household credit is stable and corporate credit is contracting, but debt ratios are down only marginally

The latest data show that household debt has stabilised somewhat, after posting marginally negative growth year-on-year at end-2009. In contrast, corporate debt has continued to shrink in recent months, especially lending by resident institutions (–4.2% year-on-year at March 2010). Notwithstanding, the debt ratios of households and firms have fallen only marginally and remain very high, due to the unfavourable trajectory of income. However, lower interest rates have meant that the debt burden has declined, reducing the pressure on indebted agents. Conversely, the latest data on general government debt reflect a notable increase (with year-on-year rates of growth approaching 30%), linked to the extensive financing needs resulting from the high budget deficit.

2 *Economic policies*

2.1 FISCAL POLICY

Against the backdrop of recession, fiscal policy was highly expansionary in 2009

Fiscal policy was expansionary in 2009, against a backdrop of recession. The State and regional government budgets for 2009 and the outturn during the year included numerous measures, estimated at almost 2 pp of GDP, designed to cushion the effects of the crisis on demand (see Table 5.1). Notable among these, on the expenditure side, were the introduction of the State Fund for Local Investment and the Special State Fund to Invigorate the Economy and Employment, amounting to €11 billion, and on the receipts

MAIN GENERAL GOVERNMENT NON-FINANCIAL TRANSACTIONS

TABLE 5.2

% of GDP

	2004	2005	2006	2007	2008	2009
1 NON-FINANCIAL RESOURCES	38.9	39.8	40.8	41.5	37.5	35.3
Current resources	38.1	39.1	40.1	41.0	37.3	35.4
— Taxes on products and imports	11.9	12.2	12.3	11.7	9.9	8.7
— Taxes on income and wealth	10.2	10.9	11.7	12.9	10.8	9.6
— Social contributions	13.0	12.9	12.9	13.0	13.1	13.4
— Other current resources (a)	3.1	3.0	3.2	3.4	3.4	3.7
Capital resources (b)	0.9	0.8	0.7	0.5	0.2	-0.1
2 NON-FINANCIAL USES (c)	39.3	38.9	38.8	39.6	41.5	46.5
Current uses (c)	34.0	34.0	33.7	34.2	36.2	40.6
— Final consumption	17.8	18.0	18.0	18.4	19.4	21.2
— Social benefits other than social transfers in kind	11.7	11.6	11.5	11.6	12.4	14.6
— Subsidies	1.0	1.0	1.0	1.1	1.1	1.1
— Interest (c)	2.0	1.8	1.6	1.6	1.6	1.8
— Other transfers	1.5	1.5	1.6	1.5	1.7	2.0
Capital uses	5.2	4.9	5.1	5.4	5.3	5.9
— Gross capital formation	3.4	3.6	3.7	4.0	3.8	4.4
— Other capital uses (d)	1.9	1.4	1.3	1.4	1.5	1.6
3 NET LENDING (+) OR NET BORROWING (-) (c) (3=1-2)	-0.3	1.0	2.0	1.9	-4.1	-11.2
MEMORANDUM ITEM:						
Primary surplus	1.7	2.8	3.7	3.5	-2.5	-9.4
Gross debt (b)	46.2	43.0	39.6	36.2	39.7	53.2

SOURCES: INE, Ministerio de Economía y Hacienda and 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.

side, the approval of a monthly VAT refund schedule, aiming to enhance firms' liquidity. Moreover, the heightening of the economic slowdown triggered the automatic stabilisers and unemployment benefits rose to almost 3% of GDP, double the figure recorded two years earlier.

Moreover, in 2009 tax revenue fell sharply, particularly as a result of the disappearance of the extraordinary revenue associated with the real estate boom …

Tax revenue fell sharply in 2009, by almost 6 pp of GDP against the 2007 figure. This cannot be attributed solely to business cycle-related factors, as it is largely connected with the drop in the extraordinary revenue associated, above all, with the real estate boom of the decade prior to the economic crisis (see Table 5.2). In effect, although revenue from almost all taxes declined, the decrease was especially notable in indirect taxes and corporate income tax.

… while public spending maintained its strong momentum

In turn, public spending continued to grow above the economy's trend GDP, even discounting the effect of the discretionary measures adopted and the impact of the automatic stabilisers. Government consumption rose particularly sharply; this includes the general government sector wage bill, which was almost 3 pp of GDP higher than in 2007, and pensions, which were 1 pp of GDP higher over the same period. The interest burden rose significantly, owing to the increase in public debt.

As a result, the budget deficit, which is eminently structural, stood at all-time highs at end-2009, while public debt breached the level of 50% of GDP

As a result, the end-year general government deficit was 11.2% of GDP, signifying an unprecedented deterioration in the budget position of more than 7 pp of GDP on a year earlier and of more than 13 pp in comparison with the 2007 budget surplus. In turn, public debt exceeded 50% of GDP. A substantial part of this debt is structural and will not correct automatically as the economy recovers or as the stimulus measures adopted during the crisis are withdrawn. A more intense fiscal effort will thus be needed to reduce both the deficit and public debt. And this could become even more demanding if, as discussed in Chapter 2 of this Report, the crisis were to prove to have a significant impact on potential growth and the course of interest rates were reversed.

In this setting, the European Council declared that Spain was running an excessive deficit and recommended it be corrected by 2013 at the latest

Thus, for the second consecutive year, in 2009 the general government deficit exceeded the limits established in the budgetary stability legislation. In April 2009, under the framework of the Stability and Growth Pact, the European Council declared that Spain was running an excessive deficit and recommended that this situation be corrected by 2012 at the latest. Subsequently, in November 2009, in light of the exceptionally adverse macroeconomic situation, the Council extended the deadline to end-2013. It also asked to see an annual average fiscal adjustment of the general government sector in excess of 1.5% of GDP as from 2010.

In response to this recommendation, the government presented a fiscal consolidation programme

In this setting, in January 2010 the government presented a new Stability Programme Update (SPU), incorporating significant budgetary consolidation up to 2013, by which time the general government deficit should stand at 3% of GDP. This would entail deficit cuts of 1.6 pp of GDP in 2010, and of 2.3 pp of GDP per annum between 2011 and 2013. These cuts would be essentially structural, based not only on the tax increases already introduced but also, and above all, on the public spending cuts outlined in the Programme. In particular, in addition to the partial elimination of the €400 earned income tax rebate and the increase in tax rates on savings and VAT rates, the State budget for 2010 and the regional governments' budgets factored in lower expenditure. The SPU also provided for a further public spending cut of 0.5% of GDP for 2010 (the Immediate Action Plan); this has been approved and includes a reduction, 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 framework agreements on the sustainability of public finances with regional and local governments that should 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).

After the Greek crisis worsened, the government resolved to speed up and strengthen this programme, introducing, in May 2010, a package of adjustment measures designed to cut the budget deficit to 6% of GDP in 2011, more than 5 pp below its 2009 level

Subsequently, in light of the worsening of the Greek public finance crisis and the contagion effect on other countries' debt markets, the Spanish government, in coordination with the other euro area countries, responded by quickening the pace of the fiscal consolidation programme, to avoid a downturn that would have had serious consequences for the economy and for the stability of the euro area. The package of measures approved in May 2010 entails bringing forward a substantial part of the deficit reduction effort, acting directly on the structural component, which could be cut by more than half, bringing the budget deficit to 6% of GDP in 2011. The specific measures adopted included: cutting general government employees' wages by 5% in 2010, followed by a wage freeze in 2011; cutting State public investment by €6 billion between 2010 and 2011; freezing pensions in 2011; and removing as from 2011 the existing benefits for birth and adoption of children.

The targets are ambitious and the measures taken and planned are unprecedented, requiring rigorous execution and control and the collaboration of the regional and local governments

Not only are these ambitious targets, but in many cases the spending cuts envisaged are unprecedented, since in most cases in the past expenditure was simply frozen. Rigorous execution and control will be needed to permit timely identification of possible deviations, with the necessary corrective measures. The collaboration of the regional and local governments will also be needed. In this respect, the new funding system of the ordinary-regime regional governments approved in 2009 improves the allocation of resources to them, as it strengthens the autonomy of the system and the shared responsibility for raising taxes, lifting the tax assignment percentages. For successful fiscal consolidation to be achieved, this should be complemented by an improvement in the regional governments' fiscal coordination and discipline mechanisms.

High inertia in public spending in the past means measures are needed to redirect underlying trends

Moreover, given the traditionally high inertia in public spending, if its growth is to be curbed permanently, measures will be needed to interrupt its underlying trends, especially in areas such as pension or health expenditure which will bear the brunt of population ageing. The reform of the pensions system is also especially timely at this juncture, as some changes in the system could enhance the long-term sustainability of public finances, with little impact on growth in the short term. In this respect, the government proposes raising the retirement age and improving the degree of contributiveness of the system. Both these measures are in the right direction and, if applied sufficiently ambitiously, may lead to a significant improvement in public finances in the long term.

2.2 OTHER ECONOMIC POLICIES

All other economic policy actions were geared to mitigating the immediate effects of the crisis

The main aim of the other economic policies launched in the year was to mitigate the effects of the economic crisis, via measures to sustain income, to support employment and to ease access to credit or demand for certain sectors, largely furthering the steps taken in 2008. Particularly noteworthy were the extension of unemployment benefits for a further six months, the introduction of car purchase incentive schemes and the launch by the ICO (Official Credit Institute) of further extraordinary credit lines for groups that have been especially hard hit by the crisis (see Table 5.1).

However, the severity of the crisis revealed the limitations of these measures in the short term and the need to introduce structural reforms, to prevent the adverse conjunctural situation reducing the future potential growth rate. It is also necessary to ensure that the short-term measures do not become permanent ones, as this could distort the efficient allocation of resources and dissuade job-seekers. The most concrete progress made on structural reforms was connected, above all, with the transposition of the Services Directive, a number of measures relating to the rental market and the draft Sustainable Economy Law.

Transposition of the Services Directive should reduce the administrative burden …

Regarding the transposition of the Services Directive, two pieces of legislation were passed in 2009, the "Umbrella Law" and the "Omnibus Law", aimed at reducing the administrative burden on firms and liberalising the sector. Achievement of both these objectives is vital, given the importance of the services sector in the Spanish economy, the characteristics of the productive structure (dominated by small firms that are especially affected by administrative burdens) and the persistence of barriers to entry that particularly restrict competition in some sectors, such as retailing.

Insofar as reductions in the administrative burden are concerned, under the Omnibus Law, among other changes, some authorisation regimes are removed while others are replaced with ex-post controls. The draft Sustainable Economy Law develops this aspect further, proposing measures to simplify and make it easier to establish commercial companies and reducing fees and charges. If effectively applied, these measures could bring about a significant reduction in both the time and money needed for business start-ups.

… and increase competition in the sector, though in the specific case of retail trade the new Law may possibly not be sufficiently ambitious

The success of the reform will depend on the extent to which it is effectively applied in certain key sectors, such as professional services and the retail trade. In this respect, the Omnibus Law amends the legislation on professional institutions and associations, removing, inter alia, restrictions on advertising these services and fee schedule guidelines. However, removal of the requirements to belong to the relevant professional institution or association and to obtain approvals from them has been left for a later date. In 2010 a new "Trading Law" was approved, limiting the circumstances in which regional governments can refuse authorisation for the opening of certain retail formats, though some restrictions remain, connected with "reasons of general interest" that are not sufficiently detailed. Accordingly, the new Law may not be rigorous enough to make any substantial change in the existing authorisation regimes applicable to the retail sector approved by the regional governments, which have effectively restricted competition.

There were several legislative initiatives concerning the rental market, though the most restrictive aspects relating to freedom of contract remain

The limited development of the rental market in Spain causes various inefficiencies, as it restricts the geographical mobility of workers and limits housing affordability. Recently, several steps have been taken in an attempt to remedy this. From a fiscal standpoint, the draft Sustainable Economy Law aims to further rebalance the tax treatment of rental and owner-occupied housing, removing the tax credit on purchase of principal residence for high-income taxpayers. In turn, under the 2009-2012 Housing Plan, at least 40% of all new subsidised housing projects must be rental housing. Moreover, the Law on Measures to Promote and Facilitate Renting approved in 2009, amends various provisions of the Civil Procedure Law and of the Urban Rentals Law. These changes could act as a catalyst for rental markets, but the more restrictive aspects of the existing legislation, such as minimum duration of contracts and compulsory rent indexation to consumer price inflation, remain unchanged.

The Sustainable Economy Strategy extends the targets established in the previous National Reform Plans to 2020

On a longer time scale, the government approved the Sustainable Economy Strategy, which establishes a series of targets for 2020. This broadly signifies extending the targets set in the previous National Reform Plans, designed to foster long-term growth. The Strategy is based on three instruments: a structural reform programme, the draft Sustainable Economy Law and the Sustainable Economy Fund, designed to finance environment, knowledge and innovation, and social projects. The draft law has a broad scope, notably including, in addition to those mentioned above, measures to improve the regulatory environment. It specifically envisages the need for prior analysis of the regulatory impact of all initiatives and proposes several changes to regulatory bodies that could make them more independent, such as placing a six-year non-renewable limit on terms of office.

In the labour market, progress was made towards a new wage agreement and structural reforms were discussed as part of the social dialogue

As regards labour market reform and as at the date of this Report going to press, the outline of the government's proposed reform is known – including limits on temporary hires and incentives for permanent hires – but not the details of the specific measures that may be applied. Insofar as wages are concerned, an agreement was signed in February 2010 establishing collectively bargained wage settlements of up to 1% in 2010, followed by 1%-2% in 2011 and 1.5%-2.5% in 2012. This will entail some easing in labour costs, especially in 2010. A multi-year wage indexation clause was also agreed, which could mitigate some of the adverse effects of these indexation mechanisms. Discussion of the more structural aspects of collective bargaining reform was postponed.

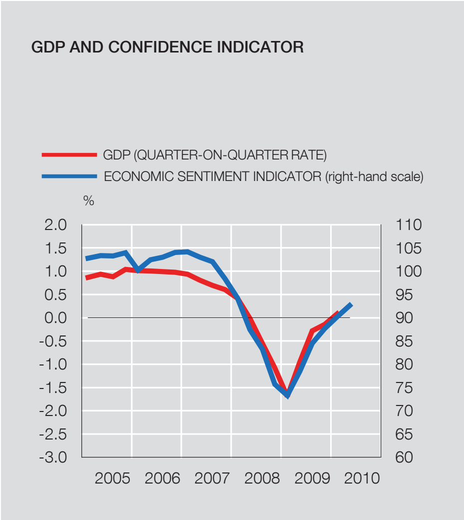
Lastly, significant regulatory changes were made in the financial system, substantially broadening the range of elements and instruments available for adapting and restructuring institutions. These changes are examined in detail in Box 6.1 of this Report.

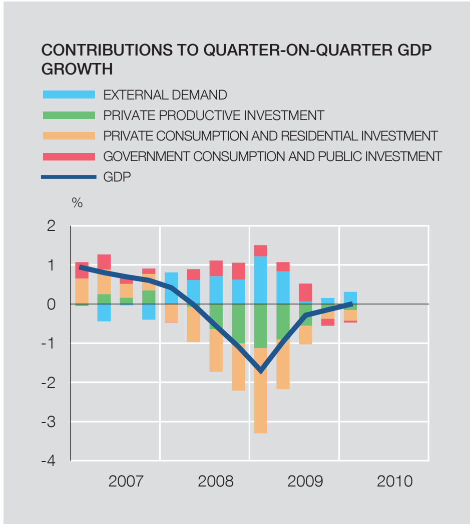
3 Demand

3.1 NATIONAL DEMAND

National demand fell by 6% in 2009, as the adjustment that had begun at the end of 2007 heightened. The contraction was extensive to all components of private expenditure (see Chart 5.3),

MAIN MACROECONOMIC AGGREGATES (a) CHART 5.3





SOURCE: INE.

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

National demand underwent a severe adjustment in 2009, falling by slightly more than 6%

which was hit hard by the consequences of the financial crisis on agents' confidence and on financing conditions. There was a big drop in business investment but, in proportion to the decline in GDP, not out of keeping with past performance. Less in step with past performance was the sharp fall in household expenditure, which was most adversely affected by the worsening expectations stemming from the severe labour market deterioration, and by other factors such as high debt levels. With fiscal policy acting as a buffer, general government demand posted positive growth.

Private consumption fell back sharply, mitigated only by the car purchase incentive schemes

Household consumption fell by 4.9% in 2009, with a decline in all its components. Purchases of consumer durables, which had contracted by almost 20% in 2008 (see Table 5.3), posted a somewhat more moderate rate of decrease in 2009 thanks to the low-emission vehicle purchase incentive schemes that gave a strong boost to new car registrations as from May. By contrast, the rate of decline of household spending on services, which represents 50% of private consumption, steepened as the year progressed.

Moreover, this severe adjustment in household spending contrasted with the positive growth – albeit lower than a year earlier – seen in disposable income (see Chart 5.4). In fact, in spite of the moderation in compensation per employee, of job destruction and of the decline in the surplus of sole proprietors, disposable income rose by 1.1% in real terms in 2009. The notable expansionary effect of fiscal policy helped sustain household income, which also benefited from lower net interest payments and lower inflation.

The saving ratio rose significantly, largely due to the backdrop of greater uncertainty for consumer decision-taking

As a consequence of the foregoing, the household saving ratio rose significantly: in the wake of a 2 pp increase in 2008, it rose again, by 6 pp, to 18.8% in 2009. This growth path contrasts with the more moderate performance seen in other European countries and may be due to several factors, although the relative significance of each is difficult to determine. In particular, lower income growth prospects, as a result of falling employment, and the decline in real household wealth would seemingly have prompted households to save more, so as to moderate the future reduction in spending. Moreover, the growing uncertainty that accompanied the heightening of the financial crisis and the rapid deterioration of the labour market would seem

CONSUMPTION AND GROSS FIXED CAPITAL FORMATION BY INSTITUTIONAL SECTOR TABLE 5.3

	% of GDP (a)		RATE OF CHANGE (b)					
	2000	2009	2004	2005	2006	2007	2008	2009
HOUSEHOLDS AND NPISHs								
Final consumption expenditure	59.7	56.0	4.2	4.2	3.8	3.6	-0.6	-4.9
Durable consumption	6.3	3.3	10.7	6.4	4.7	4.8	-19.5	-15.9
Non-durable consumption	53.4	52.7	3.5	4.0	3.7	3.5	1.2	-4.1
Housing	6.1	5.9	5.9	6.1	6.2	3.0	-10.3	-24.5
CORPORATIONS								
Private productive investment (c)	16.6	14.1	6.7	7.4	7.7	3.7	-1.3	-17.6
Construction	4.8	5.3	12.3	5.7	4.8	-1.7	3.6	-6.0
Equipment	7.3	4.7	4.3	9.1	10.5	8.6	-3.0	-28.1
Other products (d)	4.4	4.2	3.8	7.1	7.5	3.6	-4.3	-17.2
GENERAL GOVERNMENT								
Final consumption expenditure	17.2	21.2	6.3	5.5	4.6	5.5	5.5	3.8
Gross fixed capital formation	3.2	4.4	-3.8	7.8	7.5	13.2	-4.1	14.4
Construction	2.3	3.2	-8.4	7.3	8.1	13.8	-7.4	16.9
Equipment	0.8	1.1	11.0	9.3	6.0	11.4	6.1	7.8
MEMORANDUM ITEM								
Gross fixed capital formation	25.8	24.4	5.1	7.0	7.2	4.6	-4.4	-15.3
Equipment	8.1	5.8	5.1	9.2	9.9	9.0	-1.8	-23.1
— Machinery	5.7	3.9	3.5	6.9	10.3	10.4	0.0	-26.5
— Transport	2.4	2.0	8.7	14.0	9.1	6.0	-5.5	-15.0
Construction	13.3	14.4	5.4	6.1	6.0	3.2	-5.5	-11.2
— Housing	6.1	5.9	5.9	6.1	6.2	3.0	-10.3	-24.5
— Other construction	7.2	8.5	5.0	6.2	5.8	3.3	-0.4	1.6
Other products (d)	4.4	4.2	3.8	7.1	7.5	3.6	-4.3	-17.2

SOURCES: 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 proprietors.
d. This investment includes real estate, legal, accounting, consultancy and software services, among others.

to have dampened consumption and raised precautionary saving. In turn, tighter bank lending conditions would have had a dual impact, limiting credit purchases and fuelling the propensity to save with a view to building up liquidity cushions. Lastly, the deterioration of public finances may also have encouraged consumers to save more, insofar as it may have raised doubts over the sustainability of public finances in the medium term.

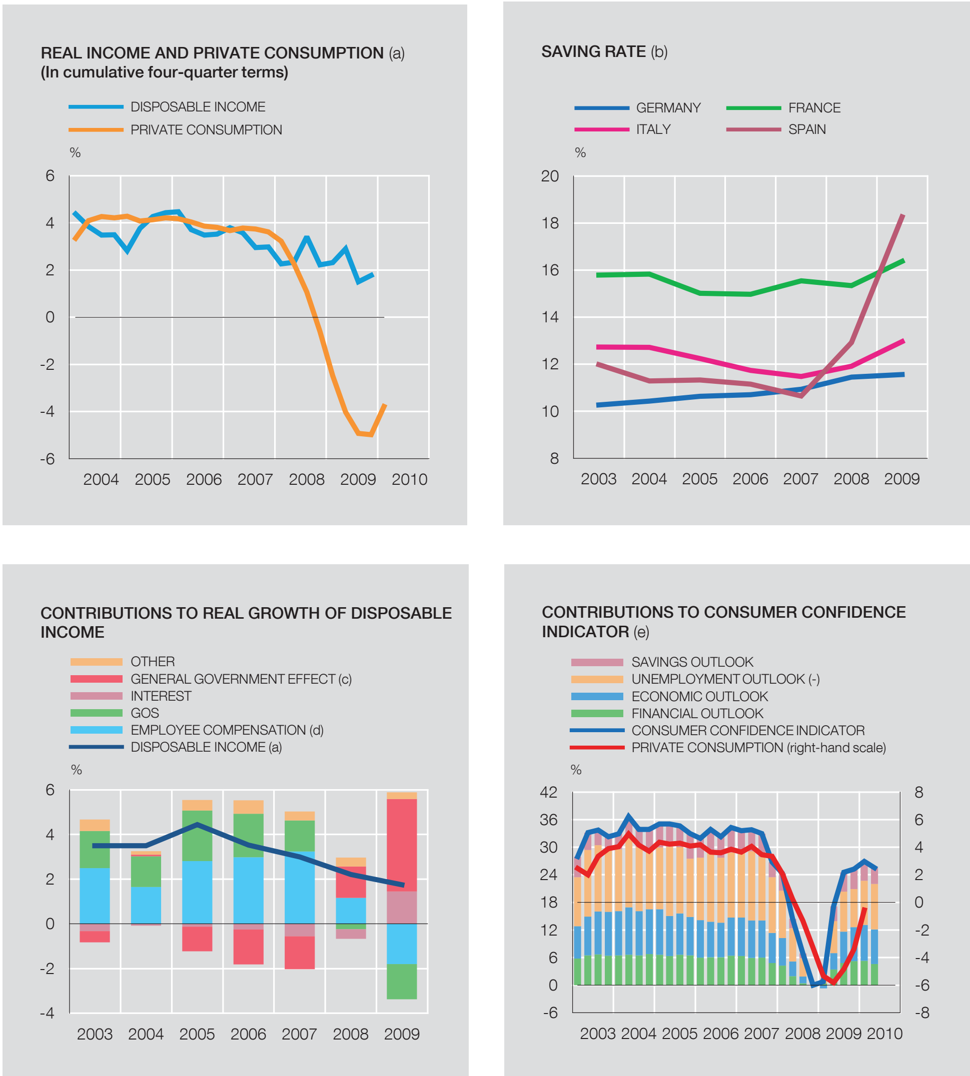
Despite the difficulties involved in assessing the relative weight of each of the above-mentioned factors, it seems reasonable to assume that, in a less uncertain climate, the adjustment in consumption would have been less severe and the increase in the saving ratio more modest, as signalled by simulations with models that combine long-term trends in consumption, income and wealth.

The household saving ratio is expected to decline, and consumption to gradually recover, in 2010

Although still short of pre-crisis levels (see Chart 5.4), household confidence indicators began to recover in 2009. Accordingly, the negative impact that uncertainty has had on consumption could foreseeably start to be reversed in 2010. However, income is expected to continue to moderate in the year, as it did in the second half of 2009, in light of the diminished fiscal policy contribution due to both the withdrawal of the stimulus measures applied in previous years and the public-sector wage cut. That means that the household debt ratio will continue on its slow downward path.

FINAL CONSUMPTION OF HOUSEHOLDS

CHART 5.4



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

a. Year-on-year rate.
b. In the case of Germany, France and Italy, in 2009 the saving rate is shown for a moving four-quarter period ending in 2009 Q3.
c. Includes social benefits, social contributions and income and wealth taxes.
d. Gross compensation per employee.
e. The confidence indicator and its components were set to zero in 2008 Q4, the cyclical trough.

Against a backdrop of weak housing demand, the decline in the volume of works in progress prompted a sharp fall in residential investment

Weak household demand was evident not only in the sharp decline in their consumption spending, but also in their notable reluctance to acquire property. Weighed down by the severe labour market deterioration and the downward revision of expectations for property price appreciation, the cumulative decline in the number of transactions between the last cyclical peak and 2009 is over 50%, and slightly lower (around 40%) in the case of new housing (see Chart 5.5). This, together with the rising volume of finished housing, prompted a decline in housing starts and exacerbated the contraction in residential investment, which fell by some 25% in 2009. That said, housing demand appears to have stabilised in recent months. Box 5.1 presents a detailed analysis of the macroeconomic implications of the housing market adjustment. So far, the adjustment in property prices is proving somewhat slower than in previous downturns.

The weight of subsidised housing is growing considerably

The drop in the number of housing starts was mainly concentrated in the open-market housing segment, which accounted for almost 90% of the cumulative decline from the peak. Housing

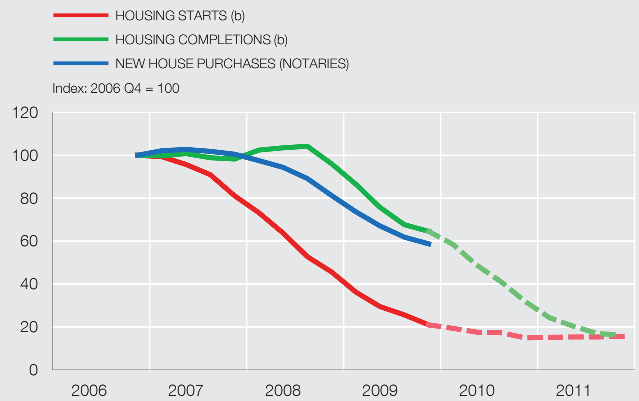
Between the mid-1990s and 2007 Spain's real estate market was extremely buoyant. As a result the construction sector gained considerable and increasing weight in the economy as a whole, the debt of households and of construction-related companies climbed swiftly and house prices became overvalued. This upturn has been followed by a strong and ongoing adjustment. The fall in demand, initially driven by higher financing costs and, later, by the recession, following the onset of the international financial crisis, triggered a rapid supply response in the form of a marked drop in housing starts, which has continued until recently. The number of housing starts in 2009 was only 20% of its 2006 level, when it was at its highest (see Panel 1). Nevertheless, given that house building has a long production period, the completion of previously started projects has meant that, between 2007 and 2009, the number of housing completions far outnumbered housing starts and, in any case, vastly exceeded demand.

This decoupling between residential supply and demand has built up a stock of unsold housing units, the quantification of which is complex and not without controversy, given the differences between the various statistical sources.[1] Notwithstanding the uncertainty surrounding these figures, the size of the stock is high, and it can be assumed that it will condition new housing starts over the coming years. That said, since housing is a good that is traded in local markets, the coexistence of a large volume of unsold housing nationwide with local markets that are balanced – or that even have a degree of unsatisfied demand – is, in principle, possible. This would set a lower limit to the number of housing starts in the short and medium term.

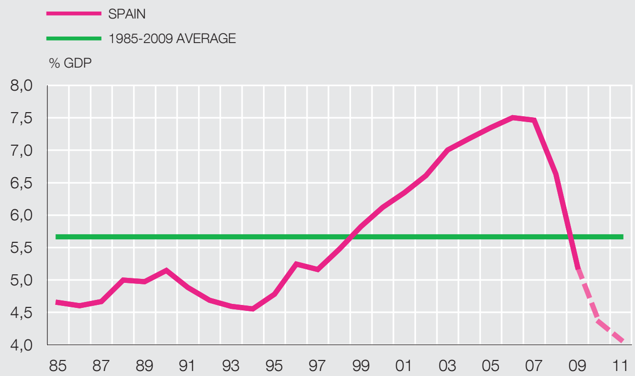
These real estate sector dynamics are reflected strongly in the residential investment variable in National Accounts, which includes changes in new works and the refurbishment of existing housing. The contribution of new works has been highly negative since 2008,

1. Own estimates, based on statistics from administrative acts (building completion certificates and notarial records on property transfers), seem to suggest that, at end-2009, the stock of unsold housing units could have been in the range of 2.8%-4.4% of the total housing stock at that time. It is estimated that this percentage would be approximately 2.5 pp higher than at end-2005.

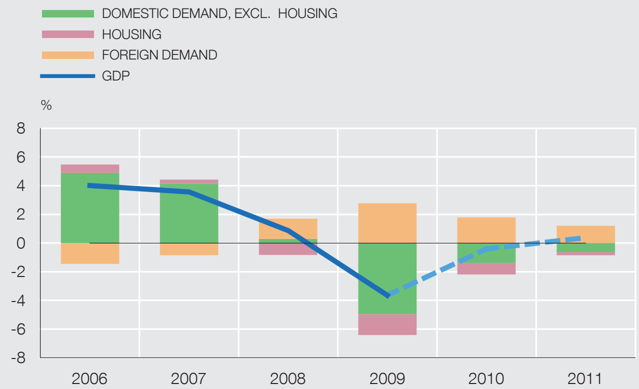
1 HOUSING SUPPLY AND DEMAND (a)



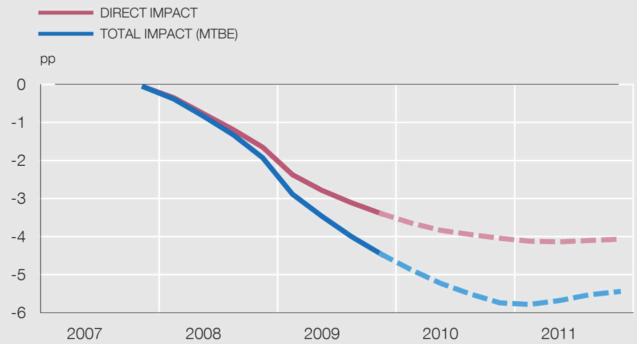
2 HOUSING INVESTMENT/REAL GDP



3 CONTRIBUTIONS TO GDP GROWTH RATE



4 MACROECONOMIC IMPACT OF HOUSING INVESTMENT ADJUSTMENT (CUMULATIVE CONTRIBUTIONS TO GDP)



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

a. Cumulative four-quarter data.
b. Forecasts for housing starts and completions are based on a scenario of building permits for the period 2010-2011 close to 2009 levels and a production period of 18 months.

as it depends on the difference between the number of housing starts and completions at any given time, which has declined continuously since 2007 and is not projected to stabilise until 2011. However, the refurbishment component —albeit relatively smaller in size[2]— is performing countercyclically, which is partially buffering the fall in residential investment. As a result of the combined changes of the two components, residential investment posted year-on-year declines of 10% and 25% in 2008 and 2009, respectively, and is forecast to continue to contract, although at an increasingly lower pace until mid-2011. At the end of that year, once the adjustment has ended, it is estimated that the ratio of residential investment to GDP in real terms could stand at approximately 4%, which would be around 3.5 pp below its high in 2007 and less than its low in 1994, giving an idea of the scale of the restructuring of the sector (see Panel 2).

This adjustment is coupled with a correction of house prices, which had increased very notably during the upturn. On Ministry of Housing statistics, until 2009 prices seemingly dropped by 10% on average from the highs posted in 2007; this decline to date is on a slightly smaller scale than that observed in the cycle at the beginning of the 1990s. This process may not yet be over, although in recent quarters the rate of decline in prices has slowed, probably as a result of the improvement in affordability indicators prompted, in particular, by the substantial reduction in mortgage interest rates. Other factors which may be contributing to containing the decline in prices in the short term are the fiscal changes already approved (such as the rise in VAT rates in July 2010) and other measures envisaged (such as the abolition of house-purchase tax credits above a determined income threshold in January 2011).

This housing market adjustment, both in terms of amounts and prices, is having very severe macroeconomic implications in the context of the current recession. A starting point for measuring such effects is to record the figures reflecting the direct impact on Spanish economic activity of residential investment during the adjustment phase, calculated through this component's contributions to GDP growth. Based on this approach, investment in housing could directly shave approximately 1 pp off average annual GDP growth in the period 2008-2011, the maximum negative contribution per year would be 2 pp in 2009 (see Panel 3). In cumulative terms, the contraction of housing investment would seemingly subtract around 4 pp from GDP in 2001 in comparison with its level at end-2007.[3]

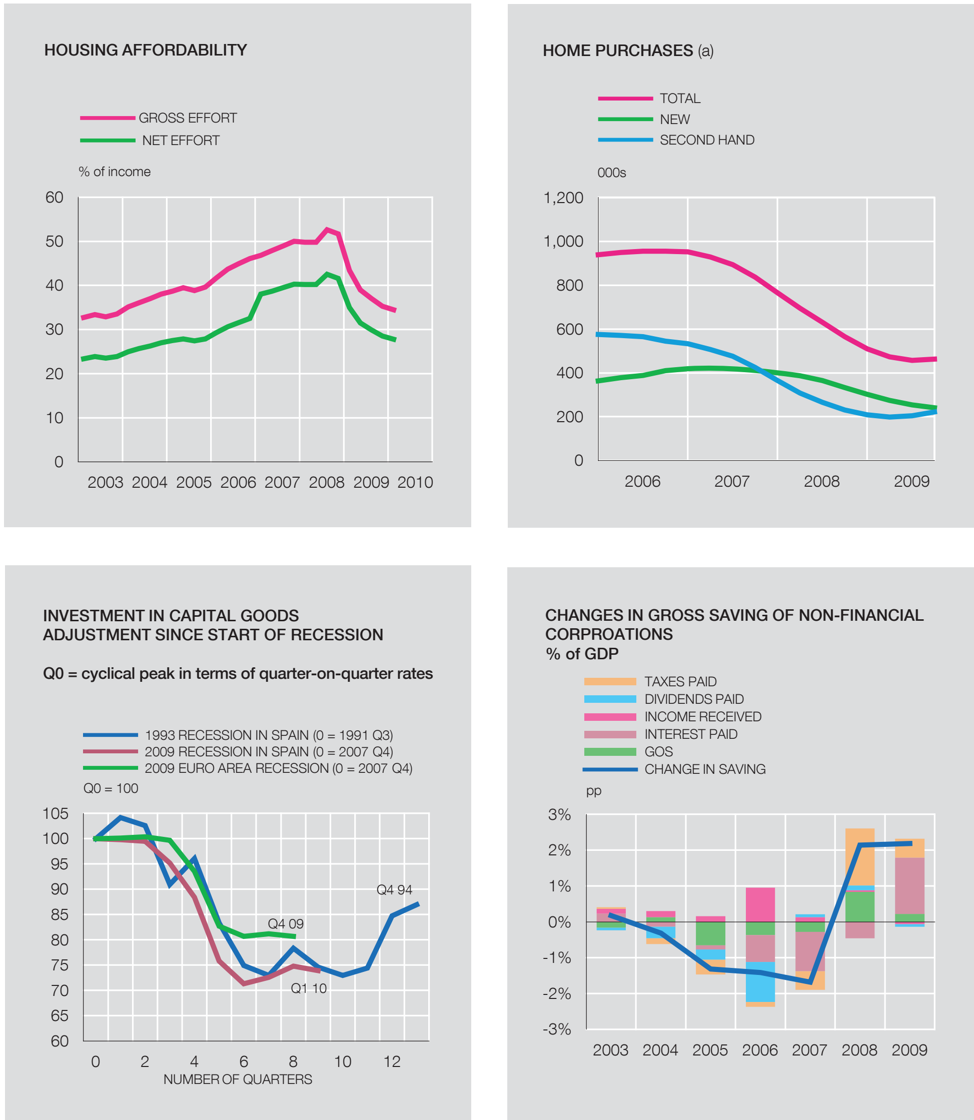
2. According to the Housing Satellite Account, the weight of refurbishment activities in total housing investment is nearly 21%. **3.** This impact includes the effect of lower demand for residential investment as a percentage of the value added of construction and of other branches involved in housing production.

In any event, this calculation provides a lower limit to the size of the effects, since the assessment of the macroeconomic consequences of the housing sector restructuring process must take into account further channels of transmission, which affect the rest of domestic demand and net exports. The Quarterly Macroeconometric Model of the Banco de España (MTBE) was used to approximate the size of the total effects. In this model, the decrease in residential investment leads to a reduction of activity and, consequently, of productive investment. The resulting decline in employment gives rise to second round effects, since it impacts household disposable income and, therefore, their expenditure. Furthermore, lower demand for housing triggers a decrease in house prices, reducing in turn household wealth and having a further negative impact on household spending. According to the MTBE, it is estimated that the total impact of the residential adjustment would be –1.3 pp of GDP, in average annual terms, and –5.4 pp, in cumulative terms, at end-2011 (see Panel 4).[4] It should be noted that this estimate does not include the foreseeable positive effects on GDP growth which will take place when the sectoral reallocation of surplus productive resources in housing construction happens (these effects are not envisaged here because most of them will probably occur outside the timescale considered).

The estimate presented in this box of the macroeconomic impact of the housing market adjustment in 2010 and 2011 is obviously subject to various sources of uncertainty, including the pace at which the surplus supply that has built up is absorbed which, in turn, depends on actual demand for new housing. In respect of the latter, the INE's most recent demographic projections indicating a significant moderation in population growth suggest that medium-term housing needs will be lower. Nevertheless, the high prices in the final years of the boom and, recently, the less favourable climate for gaining access to finance have probably prevented certain potential buyers from entering this market and, consequently, the existence of pent-up demand cannot be ruled out which could materialise as a result of the ongoing price adjustment and the gradual normalisation of credit conditions in the future.

4. The exercise performed compares the scenario defined by the values observed for residential investment and house prices until 2009 Q4 and the projections for these two variables until 2011, which are included in the latest Banco de España Projections Report, with another scenario in which residential investment would have remained constant until 2011 at the level observed in 2007 Q3 and house prices would have moved on a path compatible with this alternative level of investment. Lastly, the exercise performed takes into account that lower residential demand does not result in such a strong decline in imports as when there is a fall in domestic demand excluding housing.

HOUSING INVESTMENT AND PRIVATE PRODUCTIVE INVESTMENT CHART 5.5



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

a. Ministry of Housing real estate transaction statistics. In cumulative four-quarter terms.

starts also fell in the subsidised housing segment, but much more moderately, resulting in a notable increase in their share of all housing starts (up to 50%).

Households' net lending rose significantly, to 7.1% of GDP

As a result of the shift in saving rates and lower investment in housing, households' net lending, which had turned slightly positive again in 2008, after several years of net borrowing, rose very significantly in 2009, to 7.1% of GDP.

Business investment contracted sharply in 2009, with a change of trend in the final stretch of the year

Business investment fell by an unprecedented 18% in 2009, as the demand situation was adverse (bringing capacity utilisation to an all-time low), the economic outlook (both for Spain and internationally) deteriorated and external financing conditions for firms tightened. Although the costs of bank borrowing declined, credit conditions applied by banks tightened over the year and the user cost of capital rose in real terms, as inflation fell at a faster pace, against a backdrop of weak demand. Financing via the markets was affected by the higher cost of government debt. Moreover, firms' financial situation worsened, especially as a result of the decline in profit rates, while debt ratios remained high as profits also fell. All these factors act to curb the implementation of investment projects.

EXTERNAL DEMAND AND MAIN DETERMINANTS

CHART 5.6

SOURCES: IMF, OECD, INE and Banco de España.

a. Average of available data.

The decline was particularly significant in capital goods investment, reflected in a contraction in investment in all productive sectors

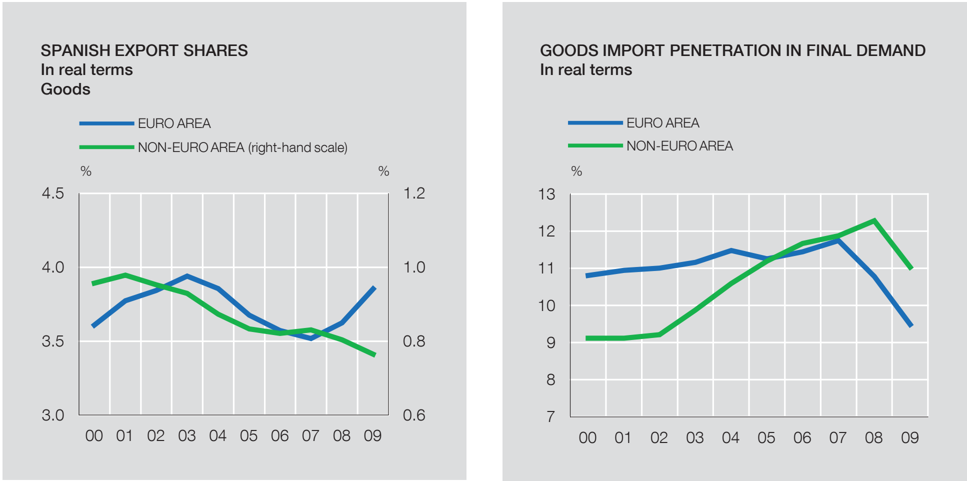
The decline affected all private productive investment components, but especially capital goods investment which fell by 28%. Under this heading, there was a particularly severe contraction in investment in machinery, while investment in transport fell less sharply, boosted as from the summer by the launch of the Plan 2000E. In turn, investment in non-residential construction contracted more moderately, sustained by infrastructure investment projects at State-owned companies (see Table 5.3). The decline was widespread across all productive sectors, but was most acute in the industrial branches, in keeping with the sharp contraction in the machinery component. Overall, the adjustment in capital goods investment is proving similar to that seen in the last recession, but somewhat more severe than that recorded in the euro area (see Chart 5.5).

Lower business investment and higher saving allowed firms' net borrowing to be significantly reduced

Corporate saving rose moderately in 2009, driven by the sharp drop in interest payments and, to a lesser extent, by the reduction in corporate income tax, which together offset the decline in gross operating profit (see Chart 5.5). This growth in corporate saving, along with the severe contraction in gross capital formation, allowed firms' net borrowing to be further reduced, to 2.2% of GDP, 9 pp below the high recorded two years earlier.

EXPORT SHARES AND IMPORT PENETRATION

CHART 5.7



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

General government made a positive contribution to the growth in demand

Lastly, general government demand remained highly dynamic in 2009, backed by the growth in public consumption and the strength of public investment, the latter driven by the Local Investment Funds (see Table 5.3). With the consolidation programme introduced by the government in the Stability Programme Update and the new package of measures adopted in May these effects will be reversed in coming quarters.

3.2 EXTERNAL DEMAND

External demand made a positive contribution to GDP in 2009, in an amount unprecedented in recent decades

The positive contribution of net external demand to GDP growth rose significantly in 2009 to 2.8 pp, attenuating the adverse impact of domestic expenditure on the economy. The reason for this increase was the sharp decline in imports of goods and services in real terms (–17.9%), on the back of weak final demand, as exports also fell significantly in the year as a whole (–11.5%), against a backdrop of severe contraction of international markets (see Chart 5.6). The pace of decline of both exports and imports slowed as the year progressed, so that the external sector's contribution to output growth began to moderate in 2009 Q3; however, it is expected to remain positive in 2010.

After contracting sharply in the opening months of 2009, goods exports recovered as the year progressed and export shares rose

Despite contracting sharply in the year as a whole, goods exports began to record positive quarter-on-quarter growth rates in real terms as from 2009 Q2. This rapid recovery reflected the positive impact not only of the global economic recovery, but also of factors connected with the extraordinary measures taken in a number of countries to encourage demand; notably the car purchase incentive schemes in the EU, which is the market for 80% of Spanish car exports, and the infrastructure development programmes in China, which boosted metals exports. The gradual disappearance of these measures in 2010 will have an adverse impact on Spanish goods exports, but this should be more than offset by the greater dynamism of export markets and by price-competitiveness gains, as the developments seen in 2009 continue (see Chart 5.6).

Spain's world export share grew, in real terms, in 2009 as a whole, as the gains in share in the euro area more than offset the loss in share in the rest of the world (see Chart 5.7).

Services exports declined considerably in 2009, although tourism receipts began to improve in Q4

Services exports also declined considerably in 2009 (–9.6%), especially in the case of non-tourism services (–12.5%), harshly affected by the slump in goods exports. Tourism receipts fell by 7.1% in the year as a whole, slightly more than the decline forecast by the World Tourism Organization for receipts worldwide. This reflects the weak consumption of tourists from Spain's main markets, the appreciation of the euro against certain currencies (especially sterling) and rising competition in the sector in light of the growth of new tourist destinations (mainly in the eastern Mediterranean).

Goods imports posted a sharp contraction, which moderated in the second half of the year

Goods imports, like exports, fell significantly in 2009 as a whole, recording a decline of 18.9% in annual terms that is unprecedented in the past thirty years. However, the rate of decline moderated considerably as the year progressed. Imports were initially affected by the fall in domestic expenditure and exports, but in the final stretch of the year both exports and industrial activity in export-oriented sectors recovered, boosting imports, especially of non-energy intermediate goods. As was to be expected, in 2009 import penetration continued to decrease as a proportion of final demand.

In keeping with other transactions with the rest of the world, services imports fell significantly in real terms in 2009 (–14.2%), with little difference in the rates of decline of tourism and of other services. As regards tourism expenditure, the combined impact of the slowdown in Spanish households' income, the decline in wealth, the rebound in the unemployment rate and uncertainties about job prospects prompted a shift away from foreign travel and in favour of domestic tourism. This would explain the decrease in tourism expenditure in 2009 and would point to a slow recovery.

4 Activity

GDP fell sharply, as a consequence of the severe contraction in all branches of the market economy

The contraction in activity affected all sectors of the market economy, prompting a decline in gross value added (GVA) of almost 5% in 2009, 1.3 pp above the decline in GDP. In turn, non-market services' GVA rose by 2.5%, although the rate of growth eased notably as the year progressed.

The industry and energy sector saw the sharpest contraction in GVA, with a decline of almost 14% in 2009 as a whole (see Chart 5.8). The industrial production index (IPI) shows that the productive branches most affected were intermediate goods and, especially, capital goods. Consumer goods production was less adversely affected, thanks to the food component which proved more resilient to the crisis owing to the lower income elasticity of demand for these goods. The pharmaceutical industry was the only industrial branch to grow, albeit modestly, in 2009.

In the construction sector, the public stimulus measures partly offset the sharp correction in residential building work …

The rate of decline of the construction sector's GVA quickened in 2009, to slightly more than 6%, in a setting in which, as discussed in the previous section, civil engineering work (on the back of the State Fund for Local Investment) and residential refurbishment work partly mitigated the decrease in new residential building work. In 2010, the State Fund for Local Environmental Sustainability will temporarily help maintain some degree of dynamism in the construction sector, although the weakness of new housing supply and the large-scale adjustment in public investment suggest that the sector's GVA will continue to head down.

… while market services, despite showing greater resilience, also fell

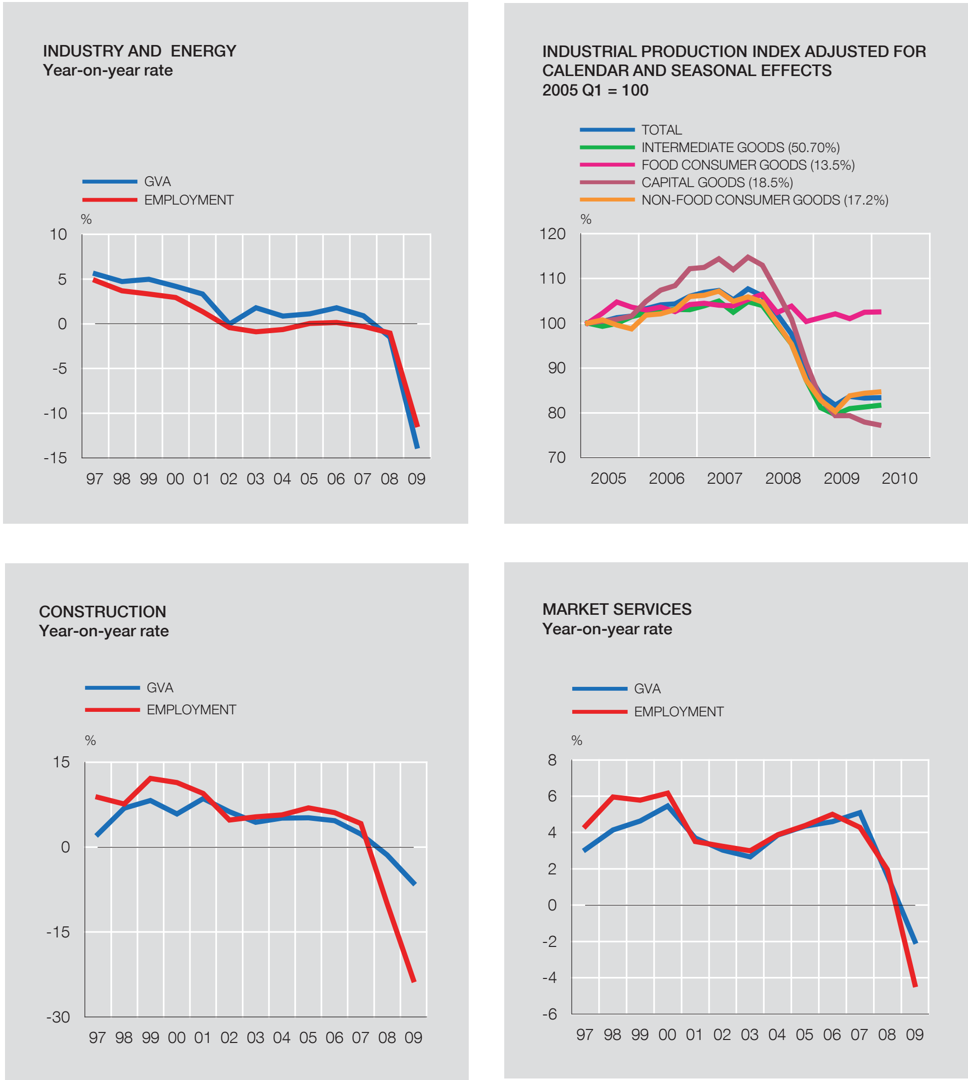
Activity in market services as a whole showed greater resilience than in other productive sectors, though it was unable to escape the effects of the crisis completely. Thus GVA fell by 2% in 2009 (after growing by 1.6% in 2008). As the services sector activity indicator shows, the contraction was widespread across all branches, but was especially severe in retail trade, transport and business services, with rates of decline of 12%-15%. In retail trade, the poor performance at the beginning of the year was offset as from the summer due to more moderate prices increases and aggressive sales campaigns.

5 The labour market

The labour market's structural shortcomings were clearly in evidence, amplifying the decline in economic activity

The labour market amplified the decline in activity: employment fell by 6.7% in 2009, although the pace of decline moderated as the year progressed and continued to do so in the opening months of 2010 (see Chart 5.9). The fall in employment was most acute in the private sector, where almost 2.5 million jobs were lost between the onset of the crisis and the start of 2010. Thus, in 2010 Q1 the employment rate stood at 59.1% and was moving away from the EU target of 65% for the year.

GVA AND EMPLOYMENT BY BRANCH OF ACTIVITY CHART 5.8



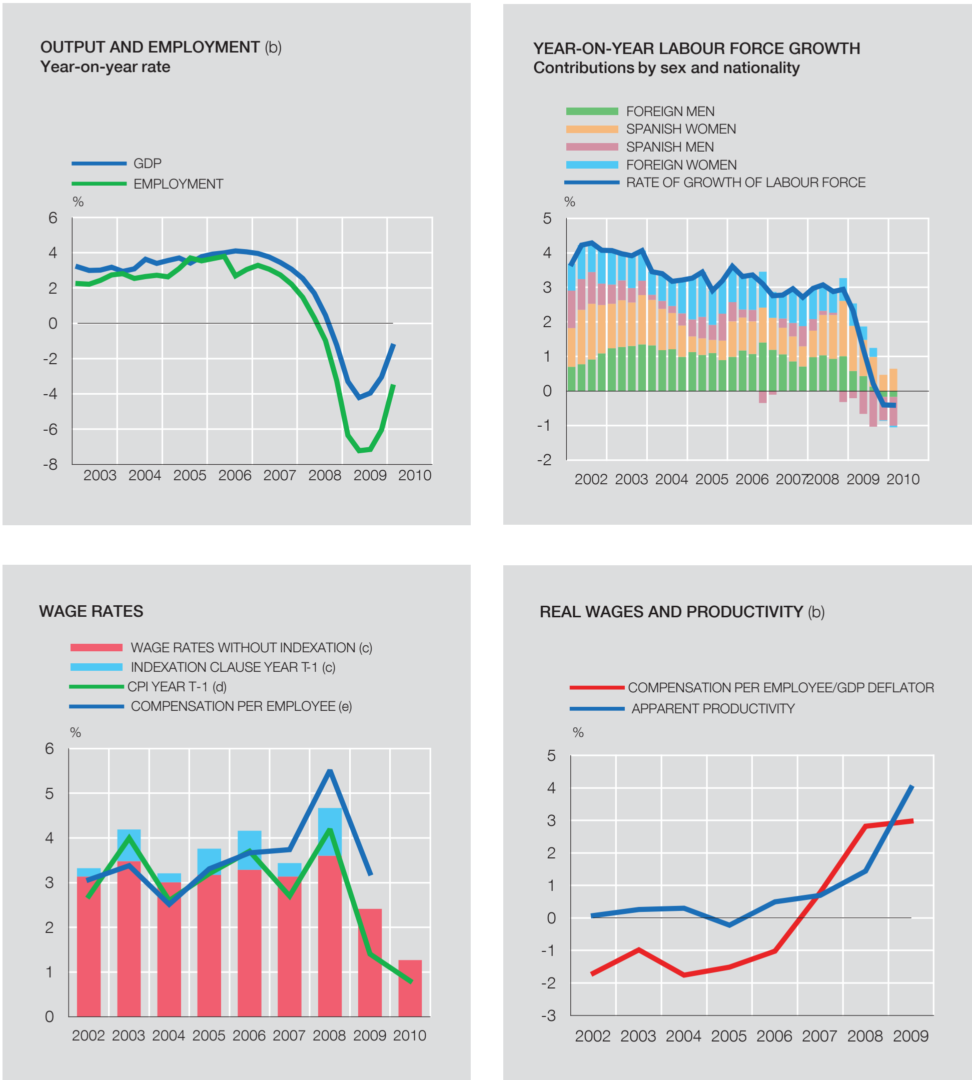
SOURCES: INE and Banco de España.

Apparent labour productivity rebounded sharply, to 3.3% in the year as a whole (against 0.4% between 1995 and 2009). This rebound, which is usual in the Spanish economy in a recession, is connected in this case with two factors. First, developments in the construction sector, where the adjustment in the residential segment led to a big increase in average productivity (22%), in comparison with a gain of 2.5% in the services sector and productivity losses (–2.7%) in industry. And second, the concentration of job losses on low-productivity jobs (temporary posts, with below-average years of service and skill levels), thus fomenting productivity gains. In this setting, the increase in the capital-labour ratio stemming from the severe employment adjustment would have been the determining factor of the rise in apparent labour productivity.

The employment adjustment, although broad-based, was particularly severe in the construction sector and among workers with temporary contracts and low skill levels

Employment in the construction sector fell by almost 24% in 2009. The quarterly pattern showed some moderation in the sharp declines seen at the beginning of the year, mirroring the effects of the State Fund for Local Investment. Job losses were also very high in industry (–11.3%) and in market services (–4.4%). The destruction of jobs was concentrated among temporary employees, whose numbers decreased by 18.4% in 2009 and who accounted for 80% of jobs lost since the start of the crisis. Numbers of permanent employees fell by 0.9%,

EMPLOYMENT AND WAGES (a) CHART 5.9



SOURCES: INE and Banco de España.

a. The EPA (Spanish Labour Force Survey) series are linked on the basis of the 2005 Q1 control survey.
b. Seasonally-adjusted QNA series. Full-time equivalent employment.
c. Information on collective bargaining agreements recorded to April 2010.
d. Year-on-year rate of change in December.
e. Market economy.

with significant declines in construction and industry only. As a result of these changes, the ratio of temporary to total employment stood at 25.4% in 2009, more than 6 pp lower than in 2007 and the lowest level for 20 years. By group of worker, the job destruction particularly affected men, immigrants, younger workers and the low-skilled, partly as a consequence of their greater exposure to the construction sector and temporary employment.

The sharp deterioration in the labour market curbed both immigrant entries and labour market participation

The supply of labour reacted to the pronounced deterioration in the labour market: the participation rate declined in the second half of 2009, slowing the growth of the labour force to 0.8% on average in 2009 (from 3% in 2008). In Q4 the labour force declined at a year-on-year rate of –0.4%, which remained unchanged in 2010 Q1. This slowdown also stemmed from lower net immigrant entries, which reacted strongly to the less favourable labour market conditions. INE estimates show a decline in inflows, but also a sharp rise in outflows, and in 2010 Q1 the foreign population actually fell. As a result, the growth of the population was checked, until it remained almost stagnant from late 2009. The impact of the cyclical situation on participation decisions was especially strong among men and the younger age groups, among which a lengthening of time spent in education and training seems to be discernible. Women's participation remained highly buoyant, although it also began to react to the deterioration in the labour market, in particular in the younger and older age groups.

The rate of unemployment continued to rise, reaching 20% in 2010 Q1, ...

The number of persons unemployed rose by 60.2% in 2009, while the rate of unemployment stood at 20% at the beginning of 2010, following the sharp rises in the two previous years. This increase was mainly a result of the size of the outflows from employment, which were especially large among workers with temporary contracts, while outflows from unemployment, although declining since the start of the crisis, remained at a relatively high level. As a result, although the relative incidence of long-term unemployment rose, it remained relatively low when compared with other recessions (38.7% in 2010 Q1). That said, it already affects almost 1.8 million persons, and further increases can be expected in coming quarters. As a matter of priority therefore, active labour market policies should focus on increasing the employability of the large group of unemployed persons generated during this crisis, avoiding the build-up of long periods of unemployment, which significantly reduce the probability of finding a job.

... in spite of which, wages rose again in real terms, showing little sensitivity to the more adverse cyclical conditions

Despite the strong deterioration in employment, wages hardly slowed in 2009, beyond a moderation associated with the sharp fall in inflation. This behaviour was closely linked to the limited cyclical reaction of wage settlements under collective bargaining agreements, which stood at 2.4% in 2009, as against 3.6% in 2008. Not even in the newly signed agreements of 2009 were settlements in line with the deterioration in the labour market (the average settlement standing at 2.1%) (see Chart 5.9). In revised agreements – the majority, since most collective agreements are for more than one year – settlements were higher (2.5%). Collective bargaining is still at an early stage in 2010, but the data for settlements in the first four months point to greater wage moderation this year. Collective agreements signed by social agents for the period 2010-12 include wage settlements of 1.3%, and newly signed agreements settlements of close to 1%. The significant cut in the wages of public-sector employees (5% on average), applicable from June 2010, should be reflected in a greater degree of moderation in collective bargaining settlements in the private sector.

QNA estimates of compensation per employee reflect these collective bargaining developments, with an increase of 3.2% in the case of the market economy (3.7% in that of the whole economy), which implies positive wage drift[1] in 2009 (of some 0.7 pp). This may be related to the composition effects arising from the disproportionate destruction of temporary jobs that, on average, pay lower wages. Real wages rose again strongly in 2009, at a rate of over 3%, following the declines in the years of strong employment growth.

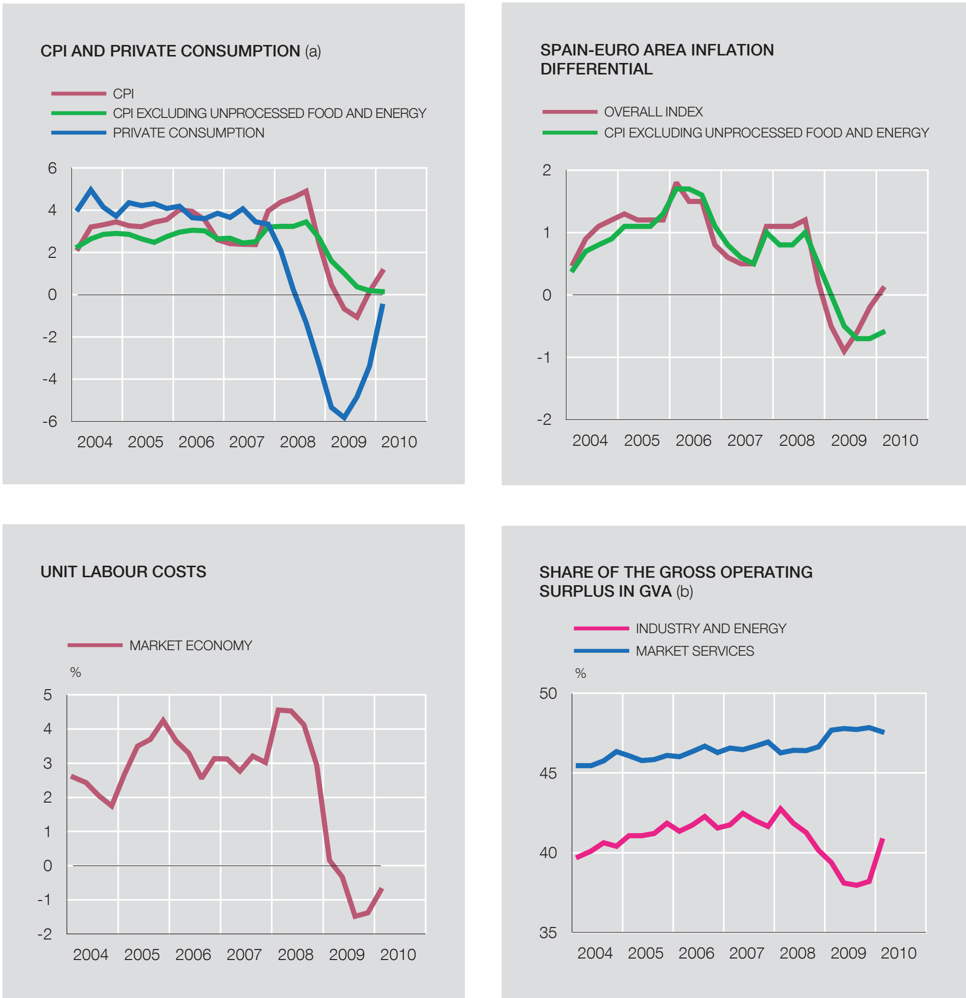
6 Prices and costs

Inflation is at historically low levels, reflecting the marked fall in private spending …

The notable fall in private spending during the recession is contributing to a sharp moderation in inflationary pressures in the Spanish economy. This phenomenon is most clearly identified using the IPSEBENE (a price index that excludes the most volatile prices) instead of the overall index. From the start of Monetary Union until summer 2008, the IPSEBENE grew at high year-on-year rates, against a background of strong growth in private spending (see Chart 5.10). Thereafter, the sharp slowdown in private consumption has been accompanied, albeit with some delay, by an equally pronounced deceleration in this measure of inflation. The rate of change of the IPSEBENE had thus fallen to –0.1% in April 2010, down 3 pp from the average rate in 2008. These developments could be interpreted as reflecting an increase in the sensitivity of inflation to the cycle, compared with its average level of sensitivity in the past.

1. Defined as the difference between the increase in compensation per employee according to the QNA and increase in wage rates in collective bargaining agreements.

INFLATION DETERMINANTS (a) CHART 5.10



SOURCES: INE and Banco de España.

a. Year-on-year growth rates.
b. Levels.

… which has resulted in adjustment of unit labour costs and mark-ups

The greater cyclical containment of prices was the result of two developments. First, there was a substantial deceleration in unit labour costs (ULCs) due, not to the behaviour of compensation per employee (which, as already indicated, only adjusted very partially to cyclical developments), but to the large productivity gains obtained by companies through staffing adjustments. And second, business mark-ups, as a proportion of GVA, tended to stabilise in 2009, in the case of market services, while in industry they decreased significantly.

Services and non-energy industrial goods prices have moderated markedly

Within the IPSEBENE, services prices, historically characterised by a high degree of rigidity, have decelerated sharply, from around 4% in summer 2008 to 0.8% in April 2010. The contraction in spending caused the prices of some services that had been highly rigid – such as those provided by restaurants – to become much less expansive. This may indicate a change of behaviour which, if confirmed, would greatly facilitate the adjustment that must occur before the economy can embark on a new sustainable growth path. The adjustment of the consumer prices of non-energy industrial goods has also been notable (from 0.5% at the end of 2008 to –1.5% in April 2010), against a backdrop of gradual moderation in the industrial prices of this type of good and falling import prices. Noteworthy here has been the reduction in car prices, as a consequence of demand weakness.

In 2009 as a whole, the overall CPI was negative for the first time since 1952

The moderation in the IPSEBENE has been reflected in the overall consumer price index, although the latter has been affected by the volatile path of energy prices. These prices contributed to the steep slowdown in the overall CPI between summer 2008 and mid-2009 (to –1.4% in July), and its subsequent rebound, to 1.4% in March 2010. For the first time since 1952, the CPI for the year as a whole fell in 2009, to stand at –0.3% (down 4.4 pp from 2008). Finally, the easing of inflationary pressures has been reinforced by falling food prices, to which the developments in food commodity prices on international markets and in the prices of imported and domestically produced food products have contributed.

The moderation in inflationary pressures also affected other price indicators

Demand deflators decelerated across the board in 2009, reflecting the contraction in activity, which led to negative rates for all components, with the exception of government consumption. In this context, the GDP deflator rose by 0.2%, as compared with 2.5% in 2008.

The inflation differential with the euro area was negative for the first time since the start of Monetary Union

Consumer price inflation fell more steeply in Spain than in the euro area countries as a whole, as a consequence, first, of the proportionately larger adjustment in household spending and, second, of the stronger moderation in ULCs. Against this background, the inflation differential (based on the harmonised index of consumer prices) fell in 2009 as a whole to –0.5 pp, a negative value for the first time since the start of Monetary Union, and well below its average level during this period (0.9 pp). Although the differential fluctuated markedly, reflecting the fluctuations in the energy component, Spanish inflation (measured by the IPSEBENE) has been consistently lower than that of the euro area since the beginning of 2009 (see Chart 5.10).

… which was conducive to an improvement in the Spanish economy's price-competitiveness indicators

The price-competitiveness and cost indices improved vis-à-vis the main developed countries in 2009 (see Chart 5.6). Also, in the case of the euro area, the favourable differentials mentioned above in terms of consumer prices and ULCs enabled the trend of falling price competitiveness recorded since 1999 to be turned around.

Inflation rates can be expected to remain low for the foreseeable future

A scenario of inflation moderation can be expected for 2010 and 2011, with slack demand exerting downward pressure on profit margins. Also, private-sector wage demands will be contained by the multi-year agreement for collective bargaining, the high rate of unemployment and the cut in public-sector wages. By contrast, the rise in VAT rates will contribute to raising inflation temporarily, although the size of this effect is expected to be relatively modest, given that weak spending will limit the ability of firms to pass on the tax rise by raising their final prices.

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

The large external deficit of the Spanish economy during the latest cyclical upturn was significantly reduced in 2009. On National Accounts data, the nation's net borrowing was equal to 4.7% of GDP, 4.4 pp less than in 2008. In the first half of 2010, net borrowing continued to decline, although at a slower rate than in the previous year. Box 5.2 analyses the extent to which this correction stems from cyclical or temporary factors.

The nation's net borrowing fell significantly in 2009, primarily on account of the improvement in the trade balance

The improvement in the external balance was concentrated in the current account, its deficit falling to 5.1% of GDP in 2009 (from 9.5% in 2008), since the capital transactions surplus remained practically unchanged (at 0.4% of GDP) (see Chart 5.11). Within the current account, the reduction in the trade deficit (to 4.2% of GDP) was notable, as was, to a much lesser extent, the reduction in the investment income, current transfers and non-tourism services deficits, while the tourism surplus decreased.

The decline in net borrowing was concentrated in the private sector, since the public sector's net borrowing increased significantly

The reduction in net borrowing of the Spanish economy in 2009 mainly reflected the decline in investment (by 4.4 pp of GDP, to 24.4%), since the gross national saving rate stabilised at around 20% (see Chart 5.12). This aggregate performance was the result of very different behaviour in the private and public sectors. In 2009 the financial position of the private sector

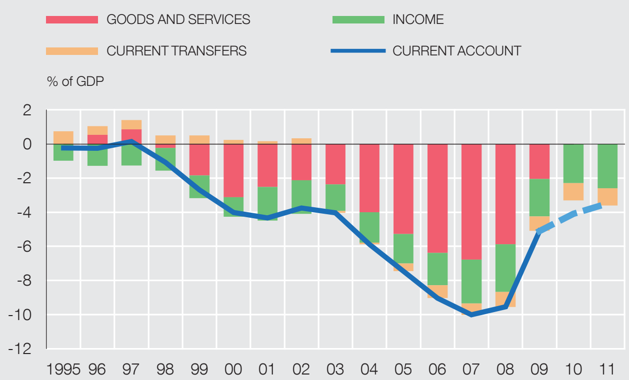
The Spanish economy's high external deficit at the end of the expansionary phase is being corrected substantially in the current crisis. On National Accounts data, the Spanish economy's net borrowing, after peaking at 9.6% of GDP in 2007, fell back to 4.7% of GDP in 2009 (see Panel 1). This correction is explained fundamentally by the decrease in the goods and services trade deficit, which amounted to 2.1% of GDP in 2009, a considerably lower figure than that posted only two years earlier (6.8% of GDP). It is important to assess which part of the adjustment is in response to cyclical or temporary factors, or to other more permanent factors whose effects, therefore, will not disappear when the economic situation improves.

Since the economic slowdown began at the end of 2007, the Spanish economy's cyclical position, approximated by the output gap, has deteriorated to a greater degree than that of its main trading partners. Furthermore, the impact of the crisis on the external deficit is particularly significant in the case of Spain, given that imports are highly sensitive to growth of final demand. Consequently, it can be expected that part of the recent correction of the goods and services trade deficit will be reversed, ceteris paribus, when the Spanish economy resumes a positive growth path. In any event, less buoyant residential investment in the future will certainly mean a more permanent correction of the gap between investment and savings and, consequently, that the external deficit will be lower.

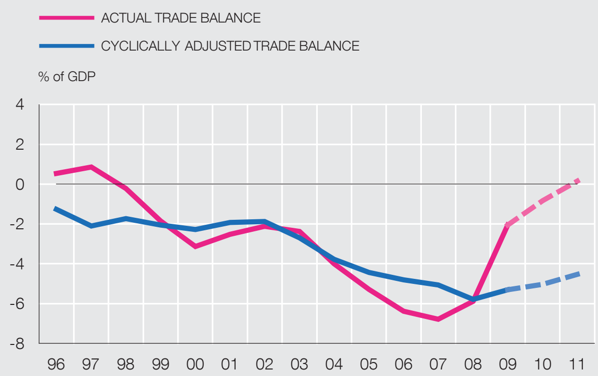
The demand equations for the imports and exports of the Spanish economy, which were recently re-estimated by the Banco de España,[1] can be used to estimate the cyclically adjusted goods and services trade balance. The latter is calculated in this box as the trade balance consistent with closed output gaps.[2] This adjusted balance only corrects, therefore, for cyclical differences and not for other factors such as fluctuations in oil prices and in price competi-

1. See «Una reestimación de las funciones de exportación e importación de bienes y servicios de España», *Boletín Económico*, December 2008, Banco de España. 2. The potential GDP of Spain's trading partners is proxied by that estimated by the OECD for its member countries.

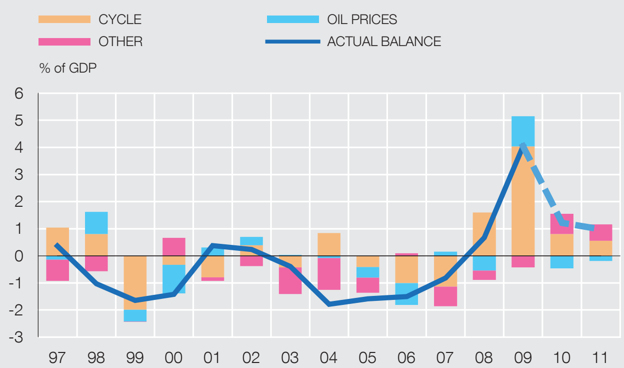
1 MAIN HEADINGS OF THE CURRENT ACCOUNT BALANCE



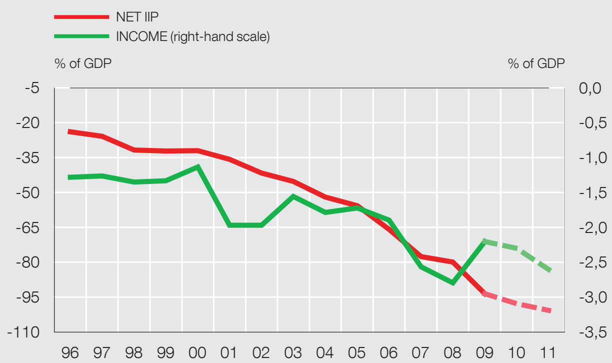
2 NOMINAL EXTERNAL BALANCE OF GOODS AND SERVICES



3 CHANGES IN THE NOMINAL EXTERNAL BALANCE OF GOODS AND SERVICES



4 INTERNATIONAL INVESTMENT POSITION AND NET INCOME PAYMENTS ABROAD



SOURCE: Banco de España.

a. A positive sign indicates that the item makes a positive contribution to reducing the deficit.

tiveness, and should be taken with due caution, given the difficulties of accurately estimating changes in potential GDP. According to Panel 2, during the last expansionary phase of the Spanish economy, the goods and services trade deficit –which is very close to the external primary balance, namely, the total balance excluding interest payments– was systematically higher than the cyclically-adjusted balance and this gap widened significantly in the years of highest growth (2004-2007). From 2008 there has been a sharp drop in the goods and services trade deficit and this decline will foreseeably continue in 2010 and 2011 on Banco de España projections, but according to this estimate such developments are only attributable to a small degree to the improvement in the cyclically adjusted balance.

The importance of the cycle in the reduction of the goods and services trade deficit is seen more clearly in Panel 3, which presents the contribution of various factors to the reduction in the external balance as a percentage of GDP. The substantial contribution of the cycle to the reduction of the deficit in 2008 and 2009 can be seen as well as the role of oil price fluctuations, as a result of which the external balance also improved in 2009. It seems that the other variables –which group together very varied factors such as changes in competitiveness and in expectations– would hardly explain the variations in the last two years, although they could play a part to some extent in the improvement forecast for 2010 and 2011.

Recent changes in the current account balance have mainly been influenced by the trade in goods and services. However, the improvement in the investment income balance and, to a lesser degree, in current transfers have also made a positive contribution to correcting the current account balance (see Panel 1). Net income payments decreased notably in 2009 (by 0.6 pp of GDP), due to the positive impact of lower interest rates since the net debit international investment position (IIP) continued to increase (see Panel 4) and, consequently, further declines in the short and medium term are not expected. Nor does it seems probable that the current transfers deficit will be significantly reduced in future, since transfers to Spain from the European Union will foreseeably continue to decrease.

The performance of the external deficit is essential for the sustainability of the nation's debt. The dynamics of this debt rely on changes in the relationship between savings and national investment in the future and the economy's capacity to generate sufficient resources to make the payments arising from debt built up in the past. Accordingly, the primary external balance was in deficit in 2009, both in terms of the balance observed (–2.9% of GDP) and the cyclically-adjusted trade balance (around –5%), and, consequently, the Spanish economy's net external debt vis-à-vis the rest of the world will tend to continue to grow[3]. According to projections, the primary balance could be close to equilibrium in 2011, but due especially to cyclical reasons. Consequently, in order to halt the expected rise in external debt, it will be necessary to achieve a permanent primary surplus on the current account, which requires improvements to offset the negative impact on the deficit of the upturn in the economic cycle. In short, Spain's high reliance on imported inputs, on the one hand, and the sensitivity of its exports to changes in competitors' prices, on the other, suggest that a permanent correction of the Spanish external deficit requires substantial changes in its productive structure and a significant improvement in its competitiveness. In particular, it would be appropriate to reallocate resources to the tradable goods and services sector, which would be bolstered by adopting reforms to increase the flexibility of product and factor markets.

3. The external debt position is proxied by the net international investment position which also includes non-claimable liabilities, such as equity. If this type of instrument were excluded from both assets and liabilities, the net IIP would decrease to 87% of GDP.

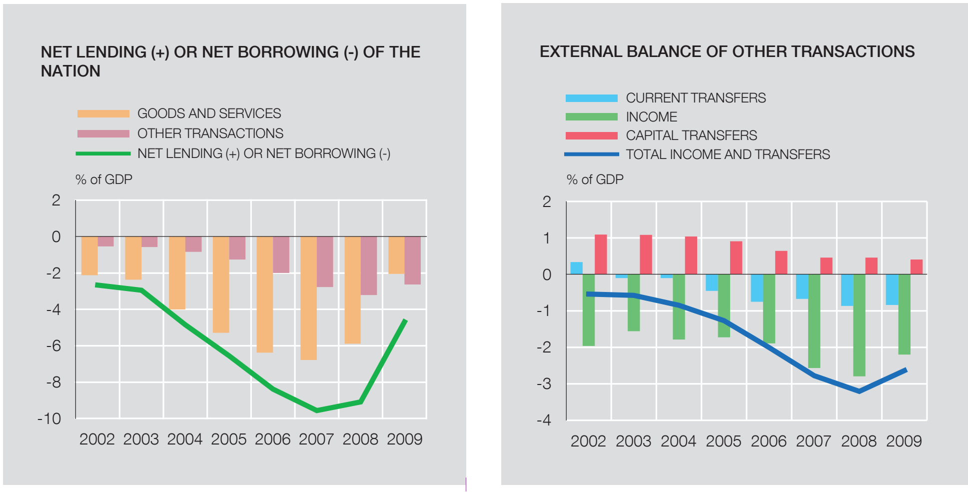
improved considerably, as a result of the increase in saving and the reduction in investment: net borrowing by households and non-financial firms of 7% of GDP in 2008 turned into net lending of almost 5% of GDP in 2009, a change of 12 pp of GDP in a single year. By contrast, general government net borrowing increased significantly again in 2009, with a deficit of 11.2% of GDP (7 pp more than in the previous year). In the short term, the correction in the budget deficit, along with the slow recovery in private spending, where a certain downward adjustment in investment is still pending, is expected to enable the nation's net borrowing to continue to decline.

The Spanish economy's external debt continued to rise in 2009, especially that in the form of general government debt held by non-residents

In line with the developments in net borrowing and the prices of financial instruments that make up financial assets and liabilities with the rest of the world, the negative net international investment position of the Spanish economy continued to widen during 2009 (to 93.6% of GDP, as against 81% at the end of 2008). The tendency for international financial markets to

REST OF THE WORLD ACCOUNT

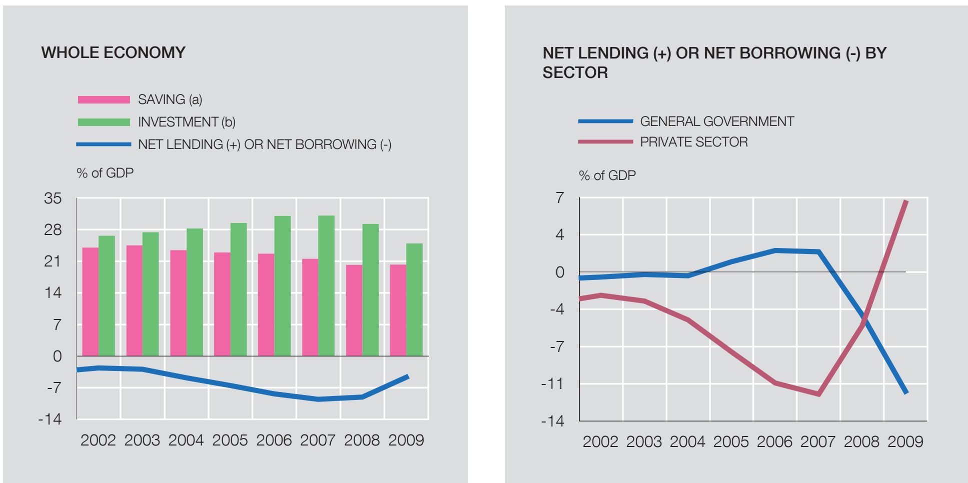
CHART 5.11



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

SAVING, INVESTMENT AND NET LENDING OR NET BORROWING

CHART 5.12



SOURCES: INE and Banco de España.

a. Gross saving.
b. Gross capital formation.

normalise allowed the Spanish economy to cover its net borrowing again through greater recourse to portfolio investment in fixed income (in particular, public debt).