What is the Outlook for the Spanish Economy?

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Recent data and trends suggest further deterioration of the economy in 2012. On an optimistic note, correction of imbalances is underway, with some positive effects possibly visible by as early as year-end

Economic growth in Spain in 2011 as a whole was 0.7%. Although this was a better result than the -0.1% registered in 2010, the evolution throughout the year as a whole was negative and the growth outlook for 2012 points to further deterioration. The huge imbalances that built up during the expansionary phase are in the process of correction, but this will take some time and remain an obstacle to the start of recovery, leaving the economy extremely vulnerable to shocks. Nevertheless, towards the end of this year, some positive effects of fiscal consolidation, financial restructuring, and structural reform efforts, such as the labour market reform, may begin to show, ultimately leading to modest positive quarterly growth rates in 2013, albeit subject to a high degree of uncertainty.

Short-term pain but laying foundations for medium-term growth

The Spanish economy is currently facing the fifth year of one of the deepest and longest-lasting crises in its recent history. The factors setting the scene for the crisis were the bursting of an unprecedented property market bubble, historic levels of private-sector debt, and a loss of competitiveness relative to the euro area's most advanced economies. The first two factors ultimately affected the health of the financial system, despite its entering the crisis in a strong position in terms of both profits and solvency. The unfavourable international financial environment, particularly following the outbreak of the European sovereign-debt crisis, the insufficient flexibility of Spain's markets and institutions, and the impossibility of using traditional adjustment mechanisms, such as monetary policy and exchange rates, explain why overcoming this crisis has been slow and costly in terms of the loss of jobs and businesses.

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Indeed, the Spanish economy took two quarters longer than its euro area partners to start its recovery after the 2008-2009 recession and Spain's recovery has been much more moderate. In the third quarter of 2011, Spain had recovered barely a quarter of the GDP lost since the pre-recession peak, whereas the euro area had recovered just over 80%. What is more, Spain had lost almost 14% of the jobs existing prior to the crisis, with unemployment still rising, while job losses in the euro zone were limited to 2.5% and employment rates have slowly begun to improve.

Worst of all, the moderate recovery ground to a halt after the debt crisis erupted, and there was a return to recession in the fourth quarter of 2011. A significant contraction in GDP and employment is therefore forecast for 2012. On the positive

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side, a correction of the economy's imbalances is underway. In terms of the balance of payments, the current account deficit, which had reached 10% of GDP in 2008, will stand at around 2% this year and may disappear altogether in 2013.

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Falling labour costs are allowing some recovery of the competitiveness lost in the pre-crisis years. Levels of private sector debt have also begun to decline, albeit slowly. At the same time, the process of restructuring and cleaning-up the financial sector is underway, and the latest measures taken by the government will accelerate this process. The labour market has also undergone profound reform, and public-sector discipline and rationalisation measures have been adopted, although correcting the public-sector deficit is taking longer than planned. All these processes of adjustment, reorganisation and restructuring are imposing short-term costs in terms of growth and job creation, but are laying the foundations for the economy to recover its historical growth potential over the medium term.

Recent developments in the Spanish economy

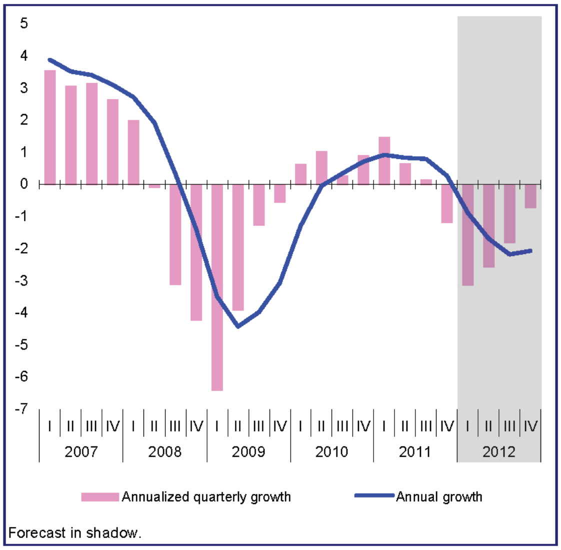
GDP contracted by 1.2% in the last quarter of 2011 on an annualised basis (in what follows, all quarterly rates will be expressed in annualised terms). Economic growth in 2011 as a whole was 0.7%. Although this was a better result than the -0.1% registered in 2010, the evolution throughout the year as a whole was negative, going from a GDP growth rate of 1.5% in the first quarter to a contraction in the last quarter of the year (Exhibit 1).

All the components of demand declined steeply in the fourth quarter. This was first and foremost a consequence of the worsening of the sovereign debt crisis in Europe, but an additional factor was the intensification of government spending cuts required in order to meet the deficit targets.

The negative impact of the debt crisis was also transmitted to the economy through a further tightening of credit conditions, rising risk premiums, falling external demand, worsening expectations, and heightened uncertainty.

Exhibit 1: Spanish GDP

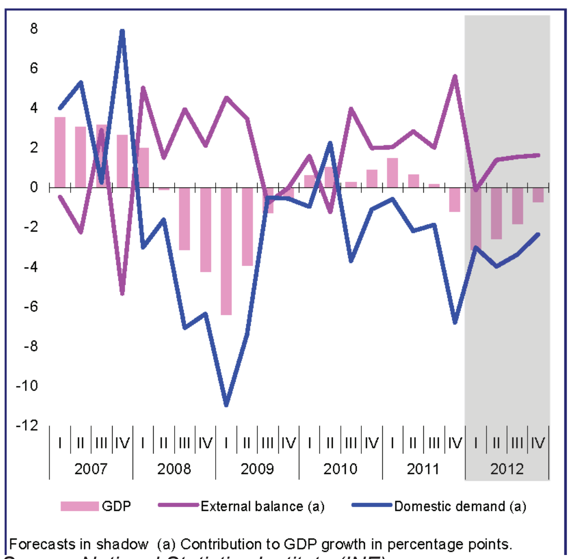
Growth in %



Source: National Statistics Institute (INE).

Exhibit 2: GDP, domestic demand and external contribution

Annualized quarterly growth in % and contribution in pp



Source: National Statistics Institute (INE).

The contraction of GDP in the last quarter was driven by the sharp deterioration in domestic demand, which suffered its biggest drop since the first half of 2009. This accentuated the pattern of behaviour shown by the Spanish economy since 2008, which is characterised by a negative contribution to growth from domestic demand and a positive contribution from the external sector. In 2011 as a whole, domestic demand's contribution to GDP growth (-1.8 percentage points, pp) was significantly more negative than in 2010, but was offset by the much stronger contribution from the external sector, which rose to 2.5 pp (Exhibit 2). Nevertheless, this was not due to faster growth in exports, which, on the contrary, slowed, but rather to a slump in imports.

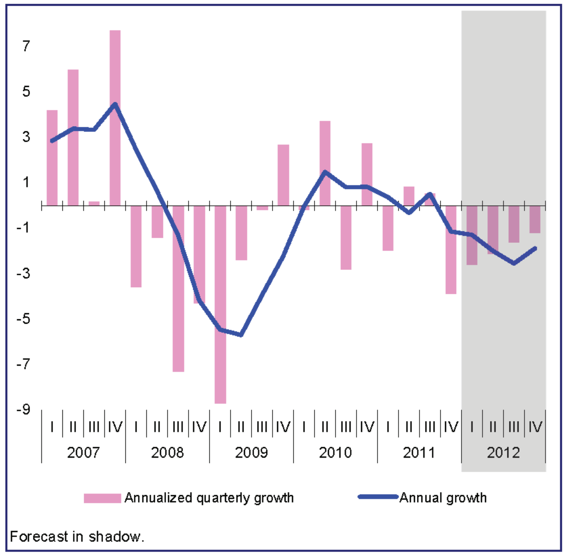
After a decline of 3.9% in the fourth quarter of 2011, household consumption registered a drop of 0.1% for the year as a whole (Exhibit 3), although other indicators, such as retail sales or car sales, suffered much bigger falls, contracting by an annual average of 5.6% and 19.2%, respectively. Taking prices into account, which rose sharply due to the energy component, nominal private consumption increased by 2.8%. This rate exceeded the increase in families' disposable income by a wide margin, translating into a drop in the savings rate for the second year running, after registering a historic high in 2009.

Gross fixed capital formation slumped in the fourth quarter, with abrupt falls in both the capital goods and construction components (Exhibit 4). Consequently, the former was unable to sustain the weak recovery of 3.2%, which began in 2010 and grew by just 1.2% over 2011 as a whole. Investment in construction fell by 17.4% in the fourth quarter. The decline worsened in the case of both the residential sector and other construction, with the latter particularly hard hit, contracting by 25.4%. This result was even worse than that observed during the 2009 recession, and was basically explained by the cutbacks in spending on public works. Despite the deterioration in the final quarter, the fall in construction investment in 2011 overall was 8.1%, more moderate than in 2010.

Exports also shrank in the fourth quarter, reflecting the loss of momentum in world trade towards the end of the year. In 2011 as a whole, sales abroad grew by 9%. This was a slower rate than in the previous year, despite faster growth in exports of tourism services. Imports reversed their positive trend, switching from growth of 8.9% in 2010 to a drop of 0.1%, reflecting the profound weakening of domestic demand.

Exhibit 3: Household consumption

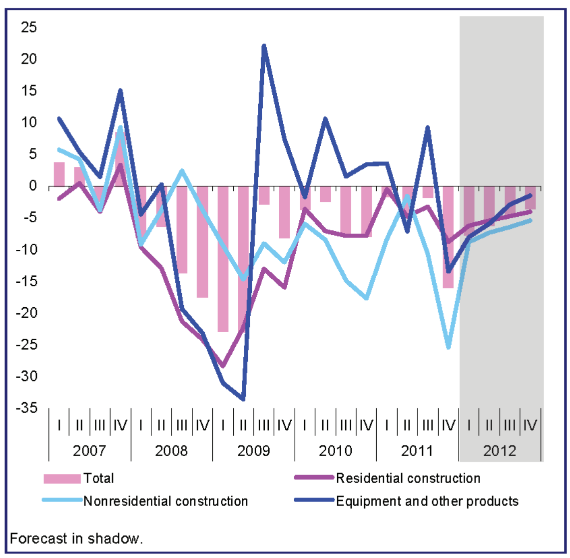
Growth in %



Source: National Statistics Institute (INE).

Exhibit 4: Gross fixed capital formation

Annualized quarterly growth in %



Source: National Statistics Institute (INE).

Although all sectors suffered a drop in gross value added in the fourth quarter of 2011, there was a slight improvement over the year as a whole, except in the case of services. Services grew by 1.1% and industry by 1.9%. Construction continued its adjustment, although at 3.8%, the drop was more moderate than in 2010.

Job losses, measured in terms of the number of full time jobs, became more acute in the final quarter, with a drop in employment of 6.2%, the biggest fall since the first half of 2009. The downturn affected all sectors except agriculture. Average annual job losses came to 2%, six tenths of a percentage points less than in 2010, and equivalent to 356,000 full time jobs, a figure close to that given by the labour force survey.

According to the labour force survey, the number of people out of work rose by 366,000 in 2011 and the active population grew by just 14,000. This is the smallest annual increase since this statistic began to be recorded, and contrasts sharply with the growth of 650,000 registered in the years of expansion preceding the crisis. This sudden stop was the result of the sharp reversal of the trend for foreign workers in the labour force, whose numbers fell by more than 100,000 due to many returning to their country of origin, and the marked slowdown of the growth in the number of Spanish workers. The average unemployment rate for the year was 21.6%, although there was an upward trend over the course of the year, rising from a seasonally adjusted rate of 20.6% in the first quarter, to 22.9% in the fourth.

An increase in productivity per full time job of 2.8% can be deduced from the variations in GDP and employment for 2011 as a whole (Exhibit 5). This figure is similar to that in the two preceding years. In conjunction with a moderate growth of 0.8% in wages per employee, this enabled a further drop in unit labour costs (ULC) of 1.9%, which helped narrow the competitiveness gap in cost terms with respect to Europe that had built up in the years prior to the crisis. In the manufacturing industry, the fall was greater still at 3.6%.

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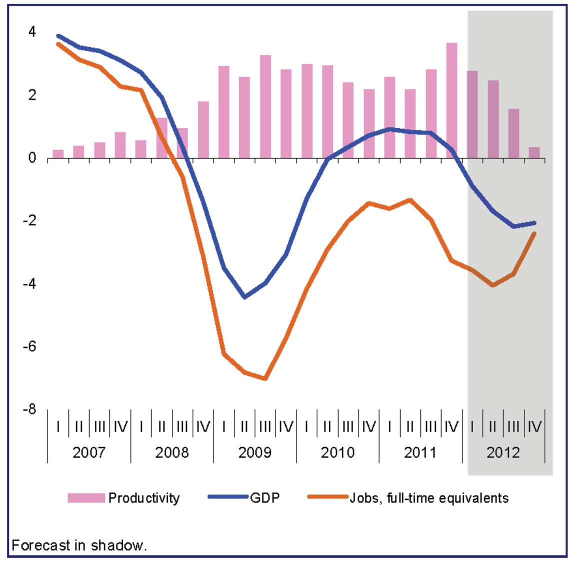
The counterpart to the drop in ULC was a marked recovery in gross operating surplus per unit of output, which rose by 5.8%, the fastest rate since

Exhibit 5: GDP, employment and productivity, total economy

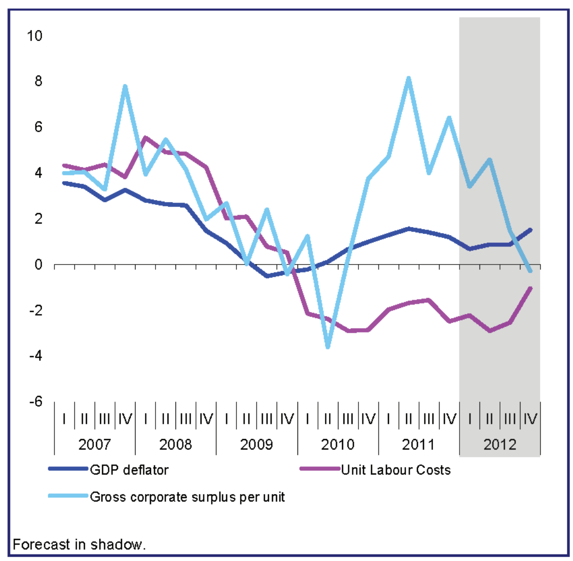
Annual growth in %



Source: National Statistics Institute (INE).

Exhibit 6: GDP deflator and Unit Labour

Annual growth in %

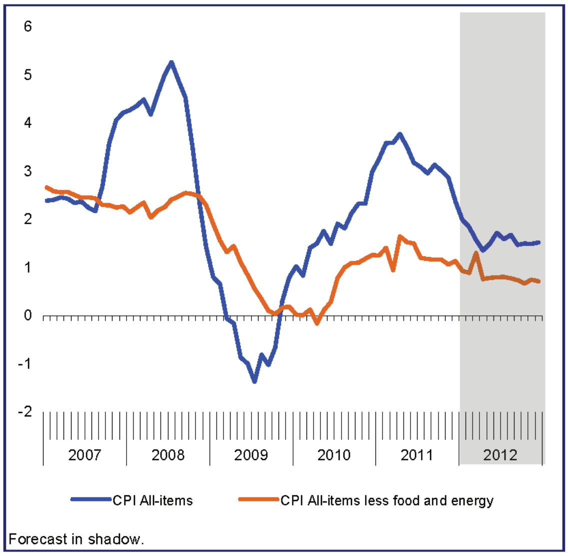


Source: National Statistics Institute (INE).

2002. The total surplus increased y 6.3%, against a 1% drop in workers' wages (Exhibit 6). This translated into an increase in the percentage of GDP attributable to the operating surplus of 1.9 pp, rising to 44.9%, while the share attributed to wages shrank by a similar amount, to 46.6%.

As a result of the changes in costs and surplus per unit of output, the Gross Value Added (GVA) deflator at basic prices increased by 1.9% in 2011, compared to a drop of 1.2% the previous year.

Exhibit 7: Inflation rate
Annual growth in %

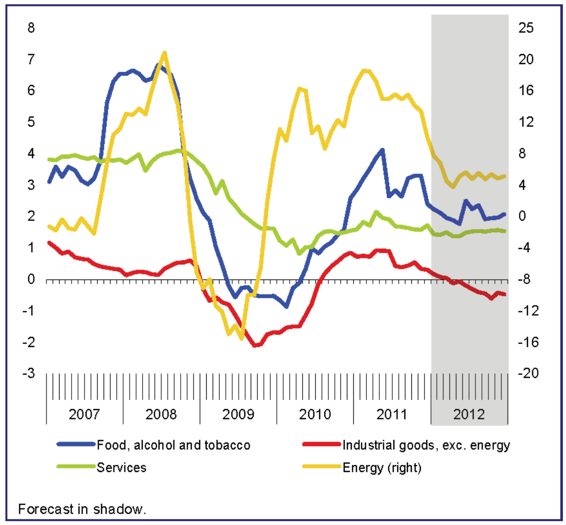


Source: National Statistics Institute (INE).

Given that taxes on output net of subsidies fell, the increase in the GDP deflator was just 1.4%. The private consumption deflator rose considerably faster, at a rate of 3.2%.

The increase in the consumption deflator coincides with the average annual inflation rate for 2011 measured by the consumer price index. Excluding the cost of energy products and food from this index, which also rose due to the in crease in the cost of agricultural raw materials, the core inflation rate was 1.3%, which is significantly lower than its historical average (Exhibits 7 y 8). What is more, discounting from this rate the three percentage points that are attributable to the VAT rise in July of last year, one can conclude that the structural inflationary pressures remained unusually low compared to the levels that have been common for the Spanish economy. Moreover, this low core rate indicates that there must have been only minimal

Exhibit 8: Inflation rate (cont.)
Annual growth in %



Source: National Statistics Institute (INE).

transmission along the production chain of the cost increases caused by rising prices of energy products and foodstuffs. This suggests that depressed domestic demand is limiting the scope for price increases (Exhibits 7 y 8).

The slump in domestic demand has sped up the adjustment of external imbalances considerably. The current account deficit in 2011 was 3.9%. Although this figure remains high, it is well below the 10% registered at the peak of the expansionary phase in 2007. According to the national accounts, the trade balance in goods was cut by 15%, and this could have reached almost 30% if energy prices had remained stable. The surplus on the services balance grew markedly, despite tourism losing some of its dynamism in the second half of the year. Nevertheless,

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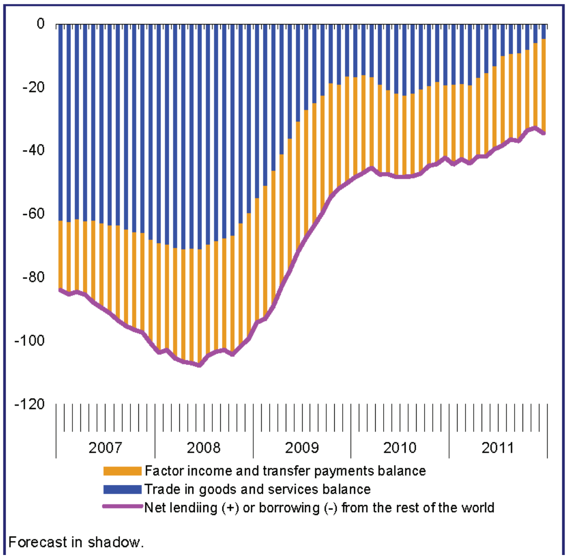
the significant improvement in the goods and services balance was partially cancelled out by the income balance deficit resulting from Spain's high level of external debt and climbing interest rates (Exhibit 9). Adding net capital transfers to the current account deficit, the economy's net external borrowing was 3.4%, six tenths of a percent less than in the previous year.

Exhibit 9: Balance of payments

Billion euros, moving sum 12 months



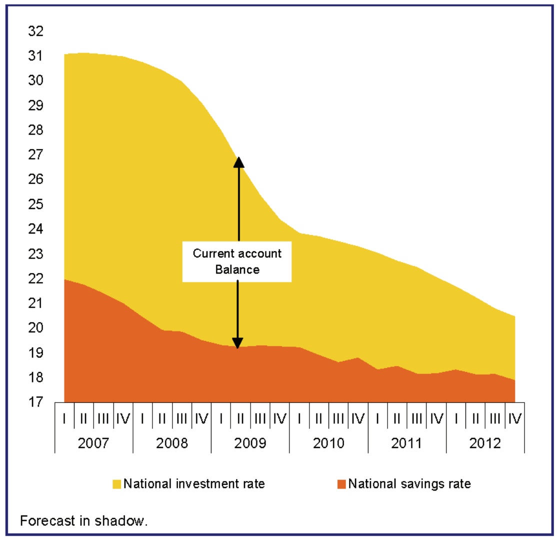
Source: Bank of Spain.

As regards the Spanish economy's financing, the financial account of the balance of payments, excluding the Bank of Spain, recorded a negative balance of €68.3bn to December, which, when added to the deficit of the current accountand capital account balances, and errors and omissions, resulted in financing needs of over €109bn, which were met by the Bank of Spain (Eurosystem). This recourse to the Eurosystem began in July and highlights the difficulty in obtaining financing that the Spanish economy has been experiencing since the deepening of the sovereign debt crisis.

From the point of view of the balance between savings and investment, the reduction in the current account deficit led to a drop in the investment rate of 1.2 percentage points, to 22.1% of GDP (Exhibit 10). The national saving rate also fell, but to a lesser extent, dropping to 18.2% of GDP. The breakdown of the accounts by institutional sectors is not yet available for 2011,

Exhibit 10: Savings and investment rates and c/a balance

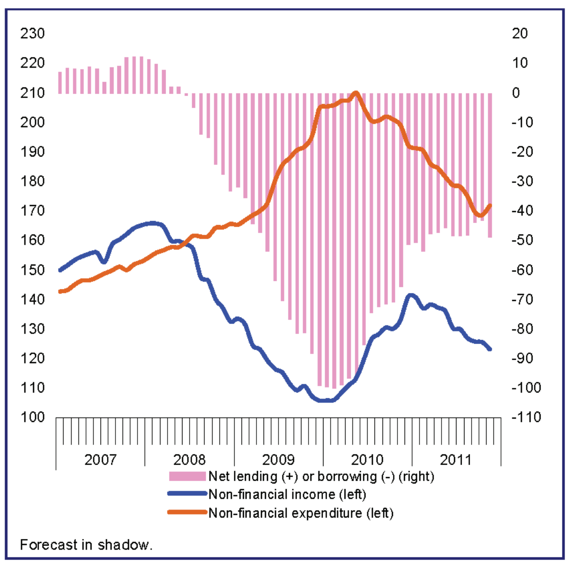
Percentage of GDP, moving average 4 periods



Source: National Statistics Institute (INE).

Exhibit 11: Central Government budget balance

Billion euros, moving sum 12 months

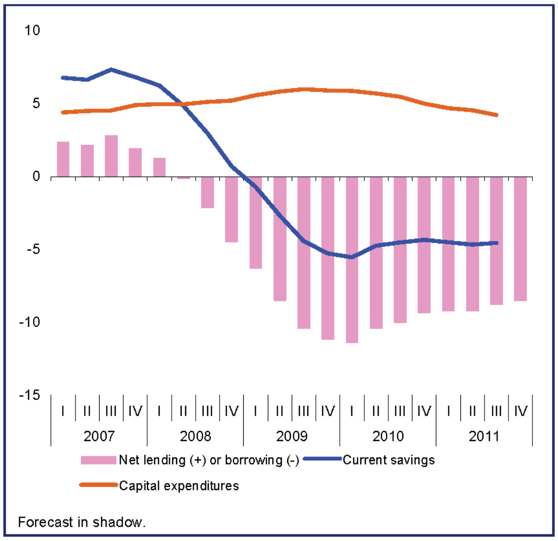


Source: Ministry of Finance.

but with the data for the period up to the third quarter, it is possible to predict that households' net lending dropped, while that of non-financial companies, which has been positive since the previous year, rose, which is an indication of the clean-up efforts underway in the sector. The government deficit also fell from 9.3% of GDP to 8.5%, although through cutbacks in investment rather than through savings. Savings barely improved, as the moderate reduction in current public expenditure was offset by a drop in current income (Exhibits 11 y 12).

Exhibit 12: General Government budget balance

% of GDP, moving sum 4 qrt.



Source: National Statistics Institute (INE).

Outlook for 2012-2013

The drop in GDP in the fourth quarter was in line with forecasts, although the decline in domestic demand was much more pronounced than envisaged. The sharp decline suffered by this variable highlights the extreme weakness of the underlying fundamentals, as a consequence of the huge imbalances that built up during the expansionary phase. These have yet to be corrected, and this represents an obstacle to the start of the recovery. The high level of private debt, both among households and non-financial enterprises, limits the capacity for growth in business investment, and above all, consumption. Moreover, deleveraging is progressing only slowly, due to limited growth in GDP and hence in incomes. In addition, there is a considerable stock of unsold homes, and until the market has absorbed them, investment in residential building will remain very depressed, thus putting a drag on economic growth as a whole. Added to this is the sharp deterioration in financial institutions' balance sheets caused by the bursting of the property market bubble. Financial institutions therefore need to reorganise and restructure –a process in which they are currently involved– in order for credit to flow once again and domestic demand to recover.

The magnitude of the adjustment in domestic demand is clear from the fact that while real GDP at the end of 2011 was 3.5% below its peak before the crisis, domestic demand, which has been on a downward trend since late 2011, was 12% lower. The extreme weakness of domestic demand makes the national economy extremely vulnerable to shocks, such as the intensification of the sovereign debt crisis in the second half of last year, or an acceleration of the fiscal adjustment process.

Against this backdrop, the new forecasts have been made starting out from a base scenario in which there is no fiscal adjustment. This scenario was subsequently modified to incorporate first, the measures adopted by the government last December –spending cuts in the national budget, increased income tax and other taxes for a value of €15bn– and second, the additional measures that need to be adopted by the government in the order of a further €26bn, to achieve a combined fiscal adjustment, in terms of increased income and reduced expenditures, of €41 bn. This would be the figure necessary a priori to reduce the government deficit from 8.2% in 2011 (the estimated figure, until the official data were published) to 4.4%, which was the official target when these forecasts were made. This fiscal shock will have both negative and positive impacts on the economy's growth potential, but in the short term, the negative impacts clearly dominate. Therefore, the new forecasts envisage a downward revision of GDP growth in 2012 to -1.7%, from the previous figure of -0.5%[2]

[2] Following the publication of our forecasts, the government announced that the public deficit in 2011 reached 8.5% of GDP and that the 2012 deficit target would be set at 5.8% of GDP, 1.4 percentage points above the target established in the Stability Program for 2011-2014, which is currently in effect. In reality, this new fiscal scenario does not imply material changes to our underlying forecast assumptions, and therefore, the impact of fiscal policy on economic growth.

Table 1

SPAIN: ECONOMIC FORECASTS, 2012-2013

Annual % change

	Observed data				*FUNCAS Forecasts*	
	Average 1996-2007	*2010*	*2011*		*2012*	*2013*
1. GDP and aggregates, constant prices						
GDP	**3,7**	**-0,1**	**0,7**		**-1,7**	**0,2**
Household consumption	3,8	0,8	-0,1		-1,9	-0,4
Public consumption	4,3	0,2	-2,2		-4,1	-2,4
Gross fixed capital formation	6,2	-6,3	-5,1		-7,5	-2,3
Construction	5,5	-10,1	-8,1		-8,6	-3,4
Residential	7,3	-9,9	-4,9		-5,8	-3,0
Nonresidential	4,5	-10,4	-11,2		-11,3	-3,8
Equipment and other products	7,0	3,2	1,2		-5,6	-0,3
Exports of goods and services	6,6	13,5	9,0		2,4	5,7
Imports of goods and services	8,9	8,9	-0,1		-4,2	0,8
Domestic demand (a)	**4,5**	**-1,0**	**-1,8**		**-3,7**	**-1,3**
Net exports (a)	-0,8	0,9	2,5		2,0	1,5
GDP current prices: - billions of euros	--	1051,3	1073,4		1065,8	1080,6
- % change	7,5	0,3	2,1		-0,7	1,4
2. Inflation, employment and unemployment						
GDP deflator	3,6	0,4	1,4		1,0	1,2
Household consumption deflator	**3,1**	**2,4**	**3,2**		**2,0**	**1,4**
Total employment (full time equivalents (f.t.e))	3,3	-2,6	-2,0		-3,4	-0,8
Labour productivity (GDP per employee f.t.e.)	0,4	2,6	2,8		1,8	1,0
Compensation of employees	7,2	-2,5	-1,0		-3,8	-1,4
Gross corporate surplus	7,5	0,2	6,3		0,7	3,9
Compensation of employees per head (f.t.e.)	3,0	0,0	0,8		-0,4	-0,5
Nominal unit labour costs	2,9	-2,6	-1,9		-2,2	-1,5
Unemployment rate	**12,0**	**20,1**	**21,6**		**24,2**	**24,5**
3. Financial balances (% of GDP)						
National savings rate	22,2	18,8	18,2		18,1	19,2
- private sector	18,8	23,2	22,5	(p)	21,0	21,3
National investment rate	26,5	23,3	22,1		20,5	19,7
- private sector	23,1	19,5	19,0	(p)	18,2	17,7
Current account balance	**-4,3**	**-4,5**	**-3,9**		**-2,4**	**-0,5**
Net lending (+) or net borrowing (-)	-3,4	-4,0	-3,4		-1,9	0,0
- private sector	-2,6	5,4	5,1	(p)	4,2	4,9
- public sector (public deficit)	-0,8	-9,3	-8,5		-6,1	-4,9
General government gross debt	54,0	61,0	68,9	(p)	76,0	81,2
4. Other macro variables						
Household savings rate (% of GDI)	11,9	13,9	11,8	(p)	10,8	10,7
Household gross debt (% of GDI)	80,9	128,0	126,2	(p)	125,3	121,8
EURIBOR 12 months (% annual)	3,8	1,4	2,0		1,7	2,1
Government bond yield (10 years, % annual)	5,0	4,2	5,4		4,9	4,6
Euro nominal effective exchange rate (% change)	--	-8,0	-0,2		-4,8	-1,0

(a) Contribution to GDP growth.

Sources: 1996-2011 except (p): National Statistics Institute and Bank of Spain. Forecasts 2012-13 and (p): FUNCAS.

The new forecasts envisage a downward revision of GDP growth in 2012 to -1.7% from the previous figure of -0.5%

In any event, the worsening forecasts are not merely a consequence of the bigger fiscal adjustment required in 2012 as a result of missing the deficit target by two and a half percentage points of GDP in 2011. The higher capital ratios demanded by the European Banking Authority, and the strict requirements on loss provisions introduced by recent financial system reform, although entirely positive in the medium term and necessary to restore market confidence, will translate into an additional tightening of financial conditions for families and businesses in the short term. The weakening of the European economy is also putting a brake on exports, the only engine of the timid recovery in the Spanish economy in 2010 and the first half of 2011. Moreover, there were more jobs lost than expected in the last quarter, which will further dampen consumption and put downward pressure on the initial estimates. Finally, the collapse in all the components of domestic demand in the fourth quarter means this variable has started the year low, which will have a negative impact on its average over 2012 as a whole.

All these factors will have a particularly strong impact in the first two or three quarters of the year, in which the contraction in GDP is projected to be sharper than in the last quarter of 2011. Towards the end of the year, some of the positive effects of fiscal consolidation and financial restructuring, in conjunction with the labour market reform and other reforms announced by the government, may begin to show, however, slowing the decline in GDP. This could result in a return to positive quarterly rates, albeit moderate ones, as of the first quarter of 2013, thus permitting modest average annual growth of 0.2% next year.

It should be noted that this quarterly profile –and the forecasts for 2013 in particular– are subject to a high degree of uncertainty. On the one hand, fresh episodes of turbulence in European financial markets cannot be ruled out, although the easing of tensions since December owing to the action of the ECB, the implementation of new mechanisms for fiscal discipline and enhanced coordination of European economic policy, together with the second rescue package for Greece, represent important factors in the recovery of confidence and stability in the markets. On the other hand, it remains to be seen what shape the government's fiscal policy will take, or what other measures or reforms it may implement over the course of the year, with the consequent effects on the behaviour of the economy. Moreover, the rising tensions with Iran could lead to further upward pressure on oil prices which will have a powerful impact on those economies highly dependent on this raw material, such as Spain. In terms of the upside risks, an earlier recovery of financial stability and confidence in Europe could mean that the recovery from the current downturn begins earlier than forecast, with the consequent spill-over effects for Spain.

The forecast for growth in household consumption in 2012 has been cut to -1.9%, and it is expected to remain negative in 2013, at -0.4%. The rate of contraction of all the components of gross fixed capital formation will accelerate. Construction will fall by 8.6%, as a result of the continuing adjustment in the property market and the sharp cutbacks in public investment. The timid upward trend in investment in capital goods seen over the last two years will give way to a drop of 5.6% in 2012, moderating to 0.3% in 2013 as a result of the worsening overall climate, falling demand and difficulty obtaining credit.

Deteriorating international economic conditions, particularly in Europe, will lead to a moderation of growth in exports of goods and services in 2012 to 2.4%, with the rate picking up to reach 5.7% in 2013. Imports will fall by 4.2% as a result of the drop in final demand, while the following year will show slight growth, as faster export growth will offset the negative effect on imports due to the expected continuing decline in domestic demand. The pattern of contributions to GDP growth will continue to be that seen since 2008, namely negative on the domestic demand side and positive on the exports side.

In order to achieve a deficit reduction from 8.5% of GDP to 5.8% of GDP, it is necessary to cut expenditures and/or increases taxes in the order of €29bn, to which we must also add €12bn to compensate for the automatic increases in some components of expenditure, among these, interest payments and pensions.

The forecast for employment has also worsened, although labour reform should gradually intensify the utilisation of labour per unit of output. A drop of 3.4% is expected this year in the number of full time jobs (an annual average of 580,000)

The forecast for employment has also worsened, although labour reform should gradually intensify the utilisation of labour per unit of output. A drop of 3.4% is expected this year in the number of full time jobs (an annual average of 580,000) and a drop of 0.8% (-130,000) next year. The annual average unemployment rate will continue to climb, rising from 24.2% in 2012 to 24.5% in 2013. Employment cannot be expected to stabilise until the second half of 2013.

Towards the end of the year, some of the positive effects of fiscal consolidation and financial restructuring, in conjunction with the labour market reform and other structural reforms announced by the government, may begin to show, slowing the decline in GDP.

Productivity will continue to rise, although at a slower pace than in recent years: 1.8% in 2012 and 1% in 2013. Growth in wages per employee has been revised downwards, largely taking into account the recent labour reform, such that a decline is expected in both 2012 and 2013. This will all translate into new and significant reductions in unit labour costs this year and next, which will allow further progress on recovering cost competitiveness relative to the rest of the world.

As a result of the adjustment in domestic demand and the improvement in cost competitiveness in recent years, in 2012, domestic demand will be less than GDP for the first time in 15 years, such that the balance of payments for goods and services will be positive. Nevertheless, the current account and capital account balances (net lending/borrowing vis-à-vis the rest of the world) will remain negative this year (-1.9% of GDP) due to the substantial income deficit, although they are expected to reach equilibrium in 2013.

In the case of the general government budgetary balance, despite the tax increases and spending cuts included ex ante in the forecast scenario, the deficit will reach 6.1% of GDP, which is a long way from the initial target of 4.4%. This is partly explained by the fact that the drop in GDP, spending and employment induced by the adjustment itself, will lead to lower growth in fiscal revenues and a bigger increase in spending, particularly on unemployment benefits (automatic stabilisers). Another factor is that certain items have their own upward momentum, such as pensions, for which spending is increasing at five billion euros a year, or debt interest payments, which will increase by a similar amount this year. In short, cutting the deficit to 4.4% would require further fiscal and/or budgetary measures in addition to those envisaged, which in turn would result in a sharper drop in GDP.