Appendix D.
Spain: Fighting a losing battle?

Is Spain fighting a losing battle? Despite all the steps taken by Mariano Rajoy's government to cut government spending and impose structural reforms, there has been no easing up on the risk premium on Spanish bonds, with rates of near 6% for 10-year government bonds since the summer. The ECB's announcement on 6 September of the OMT programme, has certainly helped to relieve the pressure: interest rates on Spanish bonds fell from 6.52% to 5.57% in the span of a day. But the programme will proceed only if the Spanish government makes an official request for aid from the European Financial Stability Facility (EFSF), a matter on which it remains undecided.

After having negotiated an agreement with the European Commission to defer its target for achieving a 3% budget deficit to 2014, rather than 2013, and to relax the 2012 deficit target to 6.3% (this was initially set at 4.5% and subsequently relaxed to 5.3% in March 2012), Prime Minister Rajoy presented a drastic austerity plan on 3 August for 102 billion euros in savings over a three-year period. The primary component of the plan is an increase in VAT of three percentage points effective 1st September 2012. Selected products and services have also seen their VAT rise from a reduced rate of 8% to 21%, while VAT on school supplies jumped from 4% to 21%. This will raise an additional 10 billion euros in fiscal revenue over the next year, equivalent to 1% of GDP. But budget austerity is weighing on growth, and government revenues have been lower than expected, while spending on unemployment insurance has risen sharply. Given the additional uncertainty posed by deficits in the autonomous regions, it is unlikely that Spain will meet its deficit target for 2012. This race against the clock seems futile, both because any moves towards fiscal consolidation are being offset by the evaporation of business activity coupled with tax evasion, and because the fiscal multipliers are greater than when unemployment is very high. The Spanish economy will suffer from the continued austerity measures, and GDP will contract by 1.3% in 2012 and 2013.

The economic situation in Spain deteriorated significantly during the first half of 2012. Spain posted its fourth successive drop in GDP. Moreover, the future looks gloomy. With the unemployment rate rising to 25% of the active population, wages are not keeping pace with inflation and purchasing power is eroding. Household incomes have been straining under the burden of the government's austerity policies of the past three years. Three different fiscal consolidation plans have been adopted over the course of 2012. In February, labour market reforms gave employers the option of cutting wages and work hours in the event of lower turnover, and also reduced redundancy pay; the second austerity plan, adopted in April 2012, imposed hikes on tobacco taxes and the price of electricity (which has risen 28% in two and a half years). The third austerity package, passed on 11 July, eliminated the end-of-year bonus for civil servants and reduced their number of days off, while unemployment benefits were cut and reimbursement rates for medicines were reduced. Finally, on 4 August 2012, the third austerity plan was supplemented by a tax on hydrocarbons, and the freeze on civil service hiring was extended until 2014.

After initially rising in 2008, the savings rate has fallen from 19.8% in the second quarter of 2009 to 8.7% in the first quarter of 2012; this trend has cushioned the drop in incomes, but households now have little leeway remaining. In addition, the climate of uncertainty could spur precautionary saving, and the process of household debt reduction is pushing the savings rate upwards. Consumption is expected to fall by 2.0% in 2012 and 2.7% in 2013, in light of a sharp contraction in purchasing power among workers. Job losses are likely to continue, with a drop in total employment of 3.9% in 2012 and 1.6% in 2013, which will push the unemployment rate to 26% of the active population by the end of 2013.

On the property market, the purge has not yet come to an end. Construction starts continue to plunge. With new home construction at a standstill, property investment is being kept aloft purely by renovations of tourist accommodations. Housing prices have fallen 24% from their 2008 peaks, but a more substantial correction will be needed to absorb the supply of vacant housing, now estimated at two million units. Construction investment will continue to decline through the end of 2013. Productive investment will suffer as a result of the dismal economic climate generated in part by uncertainty over how the sovereign debt crisis will be resolved, and in part by the significantly tougher lending conditions associated with the fragility of the banking system. The productive investment rate will still gradually diminish.

The return to recession is weighing heavily on the Spanish banking system. The loan default rate is soaring to levels never seen before: 27.4% for loans to property developers and 23.9% in the construction sector, bringing the default rate for all productive activities to 15% in the second quarter of 2012. Households are managing somewhat better: only 3.2% of home mortgage loans are considered at risk. The total amount of bad debt in the Spanish banking system stands at 168 billion euros—16% of GDP.

The risks threatening the financial sector require government intervention in order to prevent systemic failure. In 2009, the Zapatero government created a special bank support fund (the FROB) and forced a consolidation among Spain's saving banks, whose number fell from 45 to 17 in the months that followed. Mariano Rajoy has continued this restructuring process by demanding in February 2012 that banks boost their provisions against toxic assets by 52 billion euros, and by nationalising four banks. The most recent case involves Bankia. The cost of its bailout was estimated at 25 billion euros. The decision by Fitch Ratings in June to downgrade Spain's credit rating by three notches prompted the government to request aid from the EFSF in order to recapitalise its banking system; on 9 July 2012 it was awarded a package of 100 billion euros, subject to certain conditions.

Given the country's level of domestic demand, exports will be the only factor driving growth over the coming two years. The drop in real wages and the substantial increase in productivity have made Spain more competitive by comparison with its European partners. The country's trade deficit has been substantially reduced, in part because of rising exports but more significantly as a result of a decline in imports. Its global market share has risen substantially over the past three years (up 10%) and should continue to improve in 2013. The Spanish economy is also reaping the benefit of record numbers of tourists in 2012. Despite the marked slowdown in the European economy, Spain will continue to benefit from the very positive impact of foreign trade (2.4 percentage points in 2012 and 2.1 points in 2013).

Table D. OFCE, ECLM, IMK macroeconomic forecasts

Spain

%	2010	2011	2012	2013
GDP	-0.3	0.4	-1.3	-1.3
Private consumption	0.7	-1.0	-2.0	-2.7
Investment	-6.2	-5.3	-8.9	-4.7
Public consumption	1.5	-0.5	-3.9	-4.7
Exports	11.3	7.6	4.0	5.4
Imports	9.2	-0.9	-4.5	-1.9
Contribution to growth				
Internal demand	-0.8	-1.9	-3.9	-3.5
External trade	0.1	2.7	3.0	2.6
Inventories	0.3	-0.4	-0.3	-0.4
Unemployment rate	20.1	21.7	24.6	25.6
Inflation	2.0	3.1	2.6	2.5
Public deficit % GDP	-9.3	-8.9	-7.4	-6.6
Fiscal impulse % GDP	-2.2	-0.9	-3.4	-2.5
Public debt % GDP	61.2	69.2	86.1	92.7
Current account % GDP	-4.5	-3.5	-1.4	0.0
Unit labour costs	-2.5	-1.7	-2.0	0.0

Source: National accounts, OFCE, ECLM, IMK.