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Dec 18th 2008

From The Economist Intelligence Unit ViewsWire

Spain's government has countered earlier claims of inaction with a flurry of initiatives, but recession in 2009 is unavoidable

Government policy has undergone a marked shift in focus over the past two months, in response to the escalating global credit crisis and increasing evidence that the Spanish economy is plunging into a deep recession. This shift coincides with the decision of the prime minister, José Luis Rodríguez Zapatero, to assume more direct control of economic policy and to abandon the characteristically cautious approach of the finance minister, Pedro Solbes. The government has announced a flurry of new initiatives aimed at reviving credit flows to the economy and boosting demand via increased public-sector spending. Even so, the severe economic downturn is expected to last at least until the end of 2009, with economic policy remaining in crisis management mode for the foreseeable future.

Triple play

Following the creation of a bank stabilisation programme in October—at a potential cost of €150bn (15% of GDP)—the Spanish Socialist Workers' Party (PSOE) government has announced three separate emergency economic packages over the past month. These have included measures aimed at easing the economic impact of the plunging housing market and rising unemployment, with a two-year moratorium on 50% of mortgage payments for those made unemployed and an extended tax exemption period for reinvested capital gains on house sales.

In November the government also announced that the Official Credit Institute (ICO) will use a new credit facility of €10bn to meet the short-term financial needs of "solvent and viable" small and medium-sized businesses, which are suffering shortages of working capital as a result of the credit squeeze. The main business confederation, the Confederación Española de Organizaciones Empresariales (CEOE), has identified this lack of access to capital as the most serious problem affecting the Spanish economy at present (similar concerns are being increasingly voiced in the UK).

The third stimulus measure—a fiscal package worth €11bn—sees the creation of a €8bn fund to support local government investment schemes, with a further €3bn earmarked in aid for specific industrial sectors and projects. This includes €800m for the automotive industry, €500m for environmental projects, €500m for research and development, and €400m to upgrade police and civil guard stations. The central government has also loosened its fiscal framework by allowing local governments to increase their permitted budget deficits from 0.05% of GDP to 0.5% of GDP, thus facilitating the injection of a further €5.8bn into the economy.

The right approach?

One consequence of the recent policy measures is the emergence of two discernable factions among the country's leading policymakers. On the one hand, Mr Zapatero favours a strongly expansive fiscal response and hands-on public-sector engagement in the real economy—an approach that is backed by the increasingly influential minister of industry, commerce and tourism, Miguel Sebastián.

In the opposite corner the minister of the economy, Mr Solbes, and the governor of the Bank of Spain (the central bank), Miguel Ángel Fernández Ordóñez, are both displaying visible concern about the consequences of unbridled fiscal expansion and the public appropriation of private risk. Mr Solbes recently spoke of the dangers of an excessive deficit, while Mr Ordóñez has warned the government that it runs

the risk of leaving itself with no room for manoeuvre if the economy continues to deteriorate for a protracted period.

A second, related consequence is the considerable impact that the economic stimulus measures will have on the public finances. The prime minister made his intentions explicit last month when he said that Spain was prepared to run a general government deficit of over 3% of GDP in 2009, thus exceeding the formal limit established under the EU's Stability and Growth Pact (SGP). Quite how far above the 3% level Mr Zapatero envisaged is not entirely clear.

The recent stimulus measures follow on from an already expansionary 2009 budget, which provides for a rise in spending on public infrastructure investment, public-sector wages, unemployment benefit payments and housing subsidies. According to the Economist Intelligence Unit's latest forecast, this will lead the general government deficit doubling to more than 7% of GDP next year, as revenue is eroded as a result of the cyclical downturn, with a further deterioration also expected in 2010.

Even these eye-catching forecasts are subject to numerous downside risks. First, economic growth may prove to be even weaker than anticipated given high uncertainty both domestically and internationally. Second, the chances of government injections of capital into the financial sector (and possibly other sectors of the economy) are rising. As well as involving large upfront costs, it would add significantly to the stock of public debt. On a European comparison, Spanish public debt still stands at a relatively favourable level, but is still set to rise sharply in the coming years. With risk premiums also on an upward trend, this is likely to result in higher debt-servicing costs and could also trigger concerns over future financing.

Deepening malaise

While the Spanish economy will only officially enter recession (its first since 1992-93) when national accounts data for the final quarter of 2008 are released early next year, most leading indicators are already conveying a deepening sense of crisis. Recent releases point to a large retrenchment in private consumption, sharp declines in industrial production, a halving of activity in the inflated housebuilding sector and a disquieting deterioration in labour market conditions.

The extent of the economic downturn is rapidly becoming clear. Retail sales slumped by 6% year on year in the third quarter and by 7% in October; new-car sales fell by 33% in the third quarter and by 40% in October; truck sales (a key leading indicator of investment) fell by 45% in the third quarter and by 52% in October; industrial production declined by 5% in the third quarter and by 11% in October; the number of approvals for new housing starts fell by 62% in the third quarter, while mortgage approvals fell by 40%.

Confidence indicators reflect the mood of pessimism that has descended upon the economy. Consumer confidence has continued to plummet, falling from -38 in the third quarter to -44 in November; industrial confidence fell from -19 to -33 in the same period, construction confidence from -24 to -31, and service-sector confidence from -21 to -26. Against this gloomy backdrop, both households and firms are curtailing investment plans, a trend that is being exacerbated by the increasingly severe credit restrictions.

Our latest forecast now has real GDP contracting by 1.7% in 2009. Already slowing rapidly, private consumption will decline next year, as highly indebted households are forced to retrench. Factors that will negatively impact on purchasing power and sentiment include rising unemployment, the negative wealth effect of declining house prices and equity values, and concerns about the banking system (which is worryingly exposed should the housing downturn escalate into a property crash). Meanwhile, fixed investment will fall back sharply over the next two years, as housebuilding activity collapses in the face of a large surplus of unsold homes. And with most of Spain's main trading partners also facing recession, there will be little encouragement from the external sector.

The concern remains that the implications of a rapid unwinding of Spain's property boom may still be only barely built into some banks' balance sheets. With loan defaults on the rise, the negative feedback effects from a weakening economy on the financial system will continue to weigh on stability. Back in September Mr Zapatero had expressed his confidence that the downturn would bottom out fairly quickly, helped by "perhaps the most robust financial system in the world". The recent rush of policy action would suggest that the outlook is now not quite so rosy.

