SPANISH ECONOMY HOLDS FAST

SPAIN'S ECONOMY DEMONSTRATES ITS HARD WON RESILIENCE DESPITE THE WEAK PERFORMANCE OF SOME OF ITS EU NEIGHBOURS. **BEATRIZ MERINO** OF STANDARD & POOR'S REPORTS.

Spain has had one of the fastest growing EU economies since the mid 1990s, outperforming most of its EU neighbours in terms of both GDP and employment growth. GDP grew by an average of 3.8% between 1996 and 2000 compared with 2.5% in the EU. As a result, Spain's GDP *per capita* in purchasing power parity has reached nearly 83% of the EU average in 2000, compared with 77% a decade ago.

The economic success of the Spanish economy has been the result of a combination of good economic policy management, lower interest rates and the prospects of economic and currency stability introduced by EMU membership. Progress with privatisation and structural reforms has been remarkable in recent years, bringing the structure of the Spanish economy closer to that of its better off EU neighbours. Reflecting these favourable developments and Spain's substantially improved fiscal position, Standard & Poor's upgraded its long-term issuer credit ratings on the Kingdom of Spain to AA+ from AA in March 1999. The outlook is stable where it has remained since then.

Since late 2000, the pace of growth of the Spanish economy has gradually adjusted to the changing international environment, marked by the slowdown in the US, financial volatility in emerging markets and economic sluggishness in the EU. Economic activity has decelerated in Spain, too, but growth rates have remained nonetheless robust backed by relaxed monetary conditions and continued job creation, although at a steadier pace.

According to the latest official figures , real GDP grew by an estimated 3% year-on-year in the second quarter of 2001, down from 3.4% in the first quarter (2.6% in the EU), while the unemployment rate fell to 12.8% by June 2001, compared with 14.2% a year earlier. The moderate slowdown in Spain's economic activity is largely welcome as it will help to rebuild private savings following years of fast credit expansion.

Lending to the private sector has increased close to 20% annually in the past few years, rising household indebtedness to nearly 75% of gross disposable income by 2000. Because of declining interest rates, however, household's interest payments and principal payments have increased very slowly, to about 9% of gross disposable income in 2000, compared with about 8.5% in 1995. The economic deceleration will also contribute to ease the inflationary pressures that have emerged after years of buoyant domestic demand.

ECONOMIC OUTLOOK. Economic prospects for 2001 and 2002 remain good with real GDP projected to growth at between 2.8% to 3% in both years, down from 4.1% in 2000, and unemployment falling steadily to below 12% by 2002. On the fiscal side, the 2001 budget targets a fiscal balance for the first time in 25 years. Although the Spanish government has recently revised its growth projections for the year to 3% down from 3.6%, revenue performance is on track and the zero deficit is expected to be achieved. The medium-term outlook on Spain's public finances remains healthy: the 2000-2004 Stability and Growth Programme targets small surpluses up to 2004 and a decline of the general government debt to GDP ratio to 49.6% of GDP by 2004 from 60.6% in 2000.

Since mid-2000, domestic demand has decelerated, particularly private consumption and fixed capital investment. The contribution of net external demand to GDP growth has turned positive since late 2000, underpinned by robust exports and a decline in the demand for imports. Higher inflation, the downturn in stock markets, and a slower pace of job creation have moderated real disposable income gains and private consumption. Gloomier economic prospects abroad have weakened the confidence levels of Spanish firms, despite healthy profitability levels and low real interest levels. Spanish businessmen have adopted a wait-and-see approach and cut down on capital investment, which is projected to grow by close to 4% in 2001, down from 6% in 2000. Investment in construction, on the other hand, continues to be dynamic and is projected to growth slightly below the 6.4% recorded in 2000, as the pick-up in civil public works compensates for a decline in residential construction.

IMPORTS AND EXPORTS. On the external side, exports of goods and services, which increased by nearly 11% in real terms in 2000, have remained robust during the first half of 2001 and are projected to grow by about 8% for the whole year. So far, exports to the EU and Latin America countries have remained dynamic, but exports to other countries, especially the US, have declined significantly, despite the competitiveness gains brought about by a depreciated euro. Imports have slowed down and are projected to grow by close to 7% in 2001, down from 10.4% a year before.

Exports represented 27% of GDP in 2000, compared with less than 13% in 1993. Higher value-added goods and services such as motor vehicles, financial products, and telecommunications have gained increasing importance in the structure of exports in recent years. Tourism revenues, which have traditionally offset the trade deficit, continue to perform strongly. The positive inflation differential with the EU has resulted in a slight deterioration in the competitiveness of Spanish exports *vis-à-vis* euro area competitors. Between 1997 and 2000, labour costs in Spain have increased by an annual average of 2.2%, compared with the EU average of 0.7%. Labour costs, however, at 70% of the EU average, are the third lowest in the EU after Greece and Portugal, and export prices remain fairly competitive relative to the European average.

Spanish exporters have increased their market shares in non-EU countries, especially in Latin America, where they have recorded important competitiveness gains largely reflecting the depreciated euro. Foreign inward investment has picked-up since 1997 to reach

TABLE 1

Facts and figures

SPAIN ECONOMIC INDICATORS	YEAR ENDED DEC 31				
	2001F	2000E	1999	1998	1997
(% chg)					
Real GDP	2.9	4.1	4.0	4.3	3.9
Real domestic demand	2.4	3.7	5.5	5.6	3.4
Real exports	7.9	10.8	6.6	8.3	15.3
Real imports	7.0	10.4	11.7	13.5	13.7
Real investment	3.8	5.9	9.5	10.1	4.7
GDP per capita, US$	17,634	14,125	15,227	14,895	14,261
HICP, annual % change					
Spain	3.8	3.5	2.2	1.8	1.8
Euro-zone	2.7	2.3	1.1	1.1	1.6
Unemployment rate, % of labour force	12.5	13.6	15.4	18.2	20.3
Compensation per employee, % change	4.4	4.2	3	2.8	2.1
Labour productivity, % change	1.2	0.9	0.4	0.5	0.7
As a percent of nominal GDP					
General government balance	0.0	-0.4	-1.2	-2.6	-3.2
General government gross debt	58.9	61.1	63.3	64.6	66.7
As a percent of nominal GDP					
Trade balance	na	-5.9	-5.1	-3.5	-2.4
Current account balance	na	-3.9	-2.3	-0.5	0.5
Foreign direct investment in Spain	na	6.6	2.6	2.0	1.1
Direct investment abroad	na	9.6	7.0	3.2	2.2
Competitiveness indexes (% change) vis-à-vis:[1]					
Developed countries[2]	na	-2.0	-0.5	0.0	-4.5
Industrialised countries[3]	na	-2.5	-0.8	0.5	-4.8

E=ESTIMATE; F=STANDARD & POOR'S FORECAST

[1] A negative sign reflects a real depreciation of the peseta vis-à-vis the currencies included in the index and therefore a gain in competitiveness.

[2] Developed countries include the euro-zone plus Australia, Canada, EU, Japan, Norway, New Zealand and Switzerland

[3] Industrialised countries include developed countries plus South Korea, Hong Kong, Malaysia, Mexico, Singapore, Taiwan and Thailand

'ECONOMIC ACTIVITY HAS DECELERATED IN SPAIN, BUT GROWTH RATES HAVE REMAINED NONETHELESS ROBUST'

6.6% of GDP in 2000, while Spain's direct investment abroad has recorded an impressive average of more than 8% of GDP since 1998. Reversing past trends, the Spanish economy has now become a net exporter of capital and an importer of labour.

Economic prospects for 2002 depend on the recovery of the world economy, particularly of France, Germany and the UK, which together account for over 40% of Spanish exports. A more severe international downturn could bring GDP growth down to 2.5%, while a moderate pick up in the world's economic activity would help to sustain GDP growth of 3%.

The main domestic concern for Spain's near-term economic prospects remains inflation and its impact on labour costs. Inflation – measured by the Harmonised Index of Consumer Prices (HICP) – was at 4.2% in June 2001, above the EU average of 2.8%. Although the inflation differential with the EU partially reflects Spain's higher dependency on oil imports and the process of catching up with the EU, it also reveals upward pressures on labour costs, tight labour markets in some Spanish regions and a less competitive economy than that of more advanced EU neighbours. In 2001, wages are expected to grow slightly faster than the 4.2% recorded last year, up from 3% in 1999. Similarly to 2000, higher than forecast inflation will trigger indexation clauses embodied in wage agreements, although somewhat higher productivity growth will moderate unit labour costs. Fiscal restraint, lower oil and food prices and slower domestic demand, however, should help to bring year-on-year inflation down to a projected 3.7% in 2001 from 4% in 2000, and below 3% by 2002, which should pin down wage demands.

Inflation in Spain would not be that worrying if it were accompanied by strong productivity growth. Productivity figures in Spain may be understated by the surfacing of informal economy employment in recent years and strong job creation in low-productivity sectors such as construction. Even taking this into account, Spain's productivity performance – with output per worker growth of less than 1% a year over the past few years – has been disappointing overall. Productivity growth, however, should rise gradually as recent reform measures in product, services and labour markets raise the growth potential of the Spanish economy.

With an ambitious privatisation programme almost finalised and only a few large companies left in public hands (the railways, post office, coal mining, shipbuilding, seaports, and the public television channels) one of the Spanish government's priorities is now to further liberalise and increase competition in the economy. In June 2000, the government approved a far-reaching reform package which included measures to reform network industries and other key sectors with constraints on competition such as pharmacies, retail stores and road passenger transport. Reforms in network industries introduced restrictions to the expansion of dominant operators, conditions for potential mergers (which have to be approved by the government) and guarantees for equal access to essential infrastructure. The reform package also brought forward the full liberalisation of the electricity and gas sector to 2003 and 2004 respectively, several years ahead of schedule. Liberalisation in telecoms has also progressed well ahead of EU deadlines. The fixed telephony market was liberalised in January 2001 with the opening

'REFORMS IN THE LABOUR MARKET HAVE SUPPORTED EMPLOYMENT GROWTH BY AN ANNUAL AVERAGE OF 3% BETWEEN 1996 AND 2000'

of the local loop, which together with the government's introduction of a flat rate for internet access, should facilitate the development of the information society. Internet use in Spain has more than doubled during the past year bringing the number of subscribers per 100 inhabitants close to the EU average of 10, but it still lags behind more advanced EU partners. Despite recent reforms, competition in network industries remains limited, reflecting a high degree of concentration, infrastructure constraints and the limited role and resources given to independent regulators.

EMPLOYMENT ISSUES. Reforms in the labour market, together with wage moderation, have supported employment growth by an annual average of 3% between 1996 and 2000. Job creation has continued to increase at a good pace during the first half of 2001, although slowing down to about 2.5% from over 4% in late 2000. Despite this remarkable performance, the unemployment rate – at close to 13% the highest in the EU – and the structural limitations that characterise the Spanish labour market are the big drawback for the Spanish economy. The proportion of workers on temporary contracts is three times the EU average of 10%, while the use of part-time contracts is much less extended than in most other EU countries. Regional disparities in unemployment rates are considerable, varying from 4.5% in the Balearic Islands to nearly 25% in Andalucia, reflecting low labour mobility and the persistence of relatively generous benefit schemes for the unemployed. Women and young unemployment, at nearly 20% and 25% respectively, are among the highest in the EU.

Labour market reforms were introduced in 1997 aimed to encourage permanent hirings by introducing a new permanent contract with lower dismissal costs and social security contributions subsidies for people aged below 25 and over 45 years and the long-term unemployed. The 1997 reform also introduced a new part-time contract and more flexibility to justify dismissals. Although supporting rapid job creation, the effectiveness of these reforms in reducing temporary employment and extending the use of part-time contracts has been limited. Late in 2000 the government urged trade unions and employers to agree on new changes, as the 1997 permanent contract was due to expire in May 2001. Unlike in 1997, social partners could not come to an agreement this time and the Spanish government passed its own legislation in April 2001.

The new reforms extend indefinitely the validity of the 1997 permanent contract and its coverage to all workers – except for males aged between 30 and 45 – including those under temporary contracts signed before January 2004. Reductions in social security contributions have been raised for some groups, particularly older and female workers, and declined for young and males. A number of other measures aim to improve the flexibility of part-time contracts and avoid the abuse of temporary hiring. Although the new reforms will help to sustain employment growth, there is still significant room to improve the functioning of the Spanish labour market, especially to lower the high levels of employment protection and improve the process of wage bargaining, which is not very conducive of wage moderation.

BUILDING A BETTER BUSINESS ENVIRONMENT. The Spanish government has continued to improve the business environment by reducing bureaucratic requirements to set up new companies and granting favourable tax regimes for small and medium enterprises (SMEs). Since 2001, companies with a turnover of less than PTS500m (Eu3m) will benefit from a reduced corporate tax rate of 30% (against 35%) on the first PTS15m earned. SMEs also receive tax breaks for investing abroad, in new technologies and research and development activities. Since June 2000, venture capital companies enjoy a 99% exemption of the capital gains from the corporate income tax for one year. Reflecting the government's priority to foster the development of the information society and new technologies, high-tech companies have easier access to capital since the launch of a new stock market, Nuevo Mercado, in 2000.

The performance of the Madrid stock exchange during the first half of the year has mirrored the volatility and disappointing performance elsewhere, although losses in Madrid have been more moderate than elsewhere. By August 2001, the Madrid bourse had lost 6.2% of its value since December 2000, compared with losses above 10% in Paris, Frankfurt or London.

Spanish banks have coped well with increased competition, and have adapted successfully to a low interest rate environment and fast credit expansion, maintaining good levels of profitability and capital.

Supervisory standards have continued to strengthen. In July 2000, the Bank of Spain introduced a new provision rule that forces banks to charge higher provisions to withstand future periods of rising bad debts while it remains vigilant of the risks associated to the increasing exposure of Spanish banks in Latin America. Argentina 's economic crisis and the slowdown in other Latin America economies has already taken its toll on the stock market value of the big Spanish firms and banks with investments in the region. The exposure of BBVA and BSCH,the two largest Spanish banks, in Latin America, represents about one third of their total assets. So far in 2001, Spanish banks however have continued to record business and profit growth in the region. Spanish banks have maintained control of the banks they have acquired and branches of Spanish banks in Latin America are required to comply with the Bank of Spain 's loss loan provisions and regulatory standards, mitigating the risks of a potential financial distress in the region.

GROWTH POTENTIAL. The near-term prospects for the Spanish economy remain good, with GDP projected to grow above the EU average in the medium-term. Progress in converging to EU average income levels will continue, though at a slower pace than in previous years. Deepening structural reforms in labour, product and services markets should result in a higher potential output growth and level off productivity gains going forward, but this will take time to materialise. Meanwhile, and in face of persistent high inflation, wage and labour cost moderation remains crucial to maintain the competitiveness of the Spanish economy and sustain robust economic and employment growth going forward.

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