

Research

The Spanish public budget

- This is the third paper in a series on the Spanish economy. The first paper is *The Spanish recession* and the second is *The Spanish banks*.
- Spain is in recession. Unemployment has surged and as a result the economy's automatic stabilisers have negatively affected the public deficit, with tax receipts down and benefit payments up.
- In addition Spain has launched a hefty discretionary fiscal easing of 3.0% of GDP in 2008 and 2.0% in 2009. We expect the fiscal easing together with the automatic stabilisers to push the public deficit to -9.5% of GDP in 2009. Given the high forecast unemployment rate next year, we expect the fiscal deficit to amount to -9.0% of GDP in 2010, despite a likely reversal of the fiscal easing.

Government

Fiscal stimulus in response to the crisis

As the global recession picked up shortly after the Spanish housing market started correcting (see *The Spanish Recession*), the Spanish government acted immediately. In 2008 government expenditure rose by 5% of GDP on the back of a massive stimulus. This was partly due to automatic stabilisers kicking in but also due to the government implementing further fiscal stimulus.

The discretionary fiscal stimulus amounted to 3% of GDP being allocated in 2008 and 2% in 2009. The stimulus consisted of measures to offset falling domestic demand through tax breaks for firms, subsidies for employment and further assistance for the unemployed. The government has also secured the banks by raising deposit insurance, improving liquidity and guaranteeing debt issuance. Though all the above-mentioned measures are well timed and have helped Spain to weather the storm, the government has failed to implement overdue reforms to secure the country's long term potential, such as much needed labour market reform.

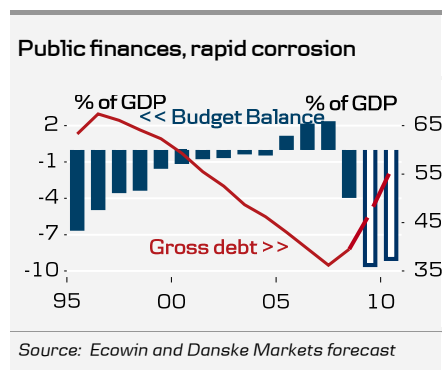
Fiscal sustainability

The budget balance and debt

During the boom, the Spanish government managed to reduce its gross debt. The improvement in public debt was immense – from 70% of GDP in 1995 to currently 35%. But that story is past, and the trend is reversing rapidly!

Overestimation of structural balance

Although the government's gross debt position has improved, the fiscal surplus has been unimpressive and driven by one-off gains. The record is abysmal when you account for the golden years of growth that Spain enjoyed. The budget balance of the Spanish government was negative for most of the years, which indicates that the reduction in debt could have been greater if the public administration had been better managed.



Policy response to the crisis

	2008	2009	2010
Public Budget ¹	-3.8	-9.5	-9.0
Automatic stabilizers	-0.8	-7.5	-9.0
Discretionary	-3.0	-2.0	0.0

¹: Pct. of GDP

Source: Ecowin and European commission services

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The Spanish authorities were over optimistic about the tax base that evolved due to the boom in construction. This means that Spain is now experiencing heavy budget deficits and has missed out on the golden opportunity to repay debt or invest during the boom. These budget deficits are large and reforms are needed to make them balance again. This could be difficult to implement and at the moment tougher fiscal policy is not what Spain needs most. This leaves the government in a difficult situation, which limits the room for further fiscal measures to combat the crisis.

Higher funding costs

When the financial crisis intensified in October 2008, the Spanish interest rate spread against German government bonds started to widen. This was driven by a focus on the fiscal sustainability of Spain's budget. Spain's credit rating has recently been downgraded by the rating agencies: S&P cut Spain's sovereign credit rating to AA+ from AAA on 19 January. The downgrade was explained in the paper [*EUROLAND: FINANCIAL DOWNGRADE AND MONETARY POLICY ASYMMETRIES*], and was primarily due to worries over fiscal sustainability and higher spreads on PIGS (Portugal, Italy, Greece and Spain).

One of the primary causes for the debt reduction from 1995 onwards has been low funding costs due to a much lower interest rate on government bonds. We described in *The Spanish Recession* that the 10-year government bond interest rate fell from around 11% in the early in 1990s to 4% after 1999 – an immense drop. So the spread between German and Spanish government yields is an important concern for Spain's public finances – if the spread increases a lot, this would badly affect the budget. The spread rose from October to February 2009 from 0.5% to 1.2%, but since then it has abated somewhat and recently stabilised. If serious concerns about the sustainability of Spanish fiscal policy should arise, this mechanism would instantly kick in and Spanish government debt would be downgraded further by the rating agencies, thereby increasing funding costs.

Labour market risks

The greatest concern for the public budget and fiscal sustainability is generally high unemployment for a prolonged period. Both large revenue losses (less taxes) and major increases in expenditure (unemployment benefits) would contribute to higher Spanish public debt. We expect, in line with other forecasters, that this scenario is unlikely and that the Spanish economy will reignite with low growth in Q4 09. But we don't expect this growth to be sufficient to instantly stabilise the labour market.

Further risks

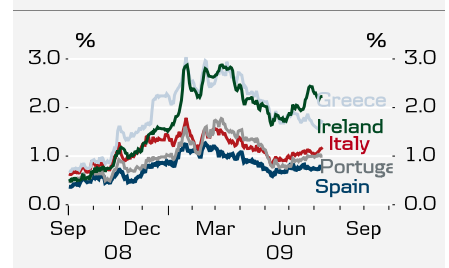
The IMF country report highlights the issues of high immigration and its effect on future sustainability. The dependency ratio of the old age population will begin to weigh heavily on the government's finances in the future.

The IMF still regards the Spanish authorities' expectations to be much too optimistic in the long term. It has estimated the net worth of the Spanish government's future tax income and expenditure and finds that the Spanish net worth is a negative net equity position of -147% of GDP, in today's money. If that estimate is even slightly true, this vastly restricts the room for fiscal manoeuvre if no commitment is made to structural adjustments such as health reforms, raising the retirement age, limiting indexation of benefits, etc.

The outlook

In our view, Spain will experience a prolonged period of lower growth relative to the rest of the euro area. Although we expect Spain to experience positive growth in Q4 09 driven by net exports, we still expect it to suffer from lack of domestic demand. Spanish public debt will therefore surge going forwards. We expect the Spanish government to run a hefty deficit of -9.5% of GDP in 2009 and -9% of GDP in 2010. This implies the public gross debt climbing to 47% of GDP in 2009, and 56% in 2010.

Surging spreads, recent moderation



Source: Ecowin

The collapse of the housing market has been costly for the Spanish government. The likely need for a banking recapitalisation means further potential costs for the government in the short term.

In our view, if the government does not commit to structural changes, the government debt level will keep rising even after the current crisis has ended.

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First date of publication

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