Eurozone Weekly Economic Briefing

Spain's fiscal targets should be eased

The Spanish government has announced that the fiscal deficit for 2011 may be even worse than expected, perhaps even exceeding 8% of GDP. In response to this overshoot, the authorities have so far announced additional spending cuts and tax rises amounting to €15bn. But fiscal tightening will have to be even more severe if the government wants to meet its 4.4% of GDP deficit target for 2012.

Cabinet ministers have clashed recently over whether the government should ease the fiscal target for this year, as the goal was set by the previous administration. While the budget minister has stated that the stability program should be adjusted to the new scenario of a recession, the economy minister has insisted that the government is committed to meeting the existing targets.

If the government does attempt to adhere strictly to the existing deficit targets, this would entail a much more significant fiscal tightening, with substantial adverse implications for the economy. Such a scenario could result in GDP contracting by around 2% in 2012, making the fiscal tightening self-defeating as the deep recession would put renewed upward pressure on the deficit. This could lead to a further loss of confidence among investors, which could quickly spill over into a renewed intensification of the sovereign debt crisis for economies across the Eurozone.

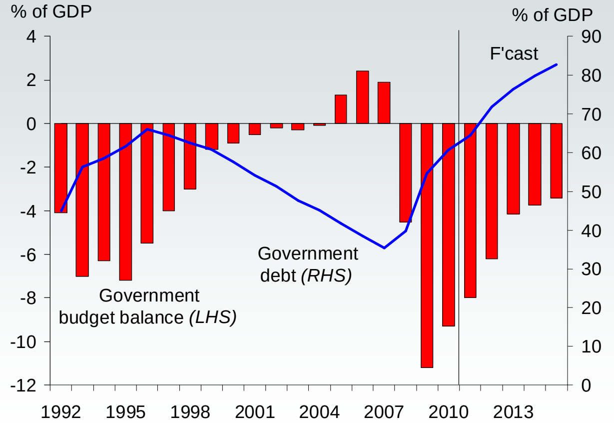
Government announces more fiscal austerity measures...

The new government in Spain has warned that the 2011 deficit could exceed 8% of GDP, well above the 6% target. Although this may partly reflect attempts to apportion blame to the previous government, it is also due to higher-than-expected deficits from the 17 autonomous regions. The government has announced that in future the regions will be forced to stick to agreed spending limits and will face penalties if they repeatedly miss fiscal targets.

Spain: Credit spreads

Source : Oxford Economics/Haver Analytics

Spain: Government balance and debt



Source: Oxford Economics

The authorities have so far announced €6bn of tax rises and €8.9bn of spending cuts, as well as promising additional austerity measures. Assuming that any additional cuts announced by the government are not substantial in size, we believe this implies that the budget deficit will remain above 6% of GDP this year. However, the deputy prime minister has said that the government must find savings worth more than €35bn to meet its deficit goal for 2012. We believe that such a sharp tightening of fiscal policy would prove self-defeating, as it would harm the economy and put renewed upward pressure on the deficit. Setting a new and more realistic deficit target for 2012 would therefore seem optimal from an economic point of view, while a greater focus on structural reforms would support the economy's longer-term growth potential, helping to ease the fiscal adjustment process.

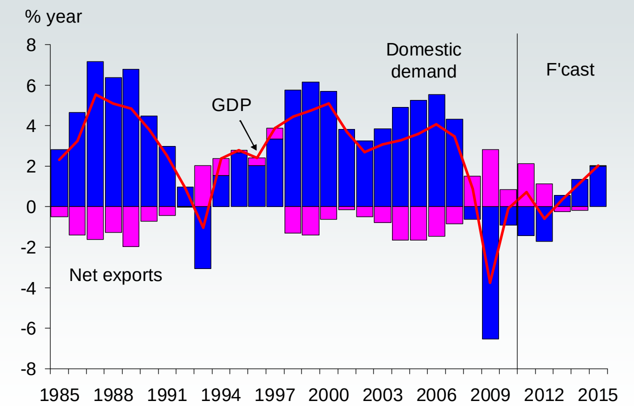
Divisions have emerged within the cabinet over how best to tackle the budgetary overshoot, with ministers clashing over whether the government should ease the fiscal target for this year, as the goal was set by the previous administration. While Budget Minister Montoro has stated that the stability program should be adjusted to the new scenario of a recession, Economy Minister Luis de Guindos has insisted that the government is committed to meeting the existing targets.

The government has announced that it expects to draft labour, budget stability, and financial sector reforms by 10 February. It also faces pressure from credit agencies, with Standard & Poor's warning it could cut Spain's rating further this year or next, following the country's two-notch downgrade on 13 January, if reforms are delayed or "insufficient to reduce the high unemployment rate". Unemployment now stands at 5.4m, or nearly 23% of the workforce and, with the economy set to contract this year, we expect the jobless rate to rise further. But reforms to the complex and rigid agreements on collective bargaining, statutory redundancy payments and temporary contracts would promote job growth once the economy starts to recover.

...which will deepen the recession

With the fiscal tightening announced so far likely to dampen domestic demand further, we do not expect the Spanish economy to emerge from recession until Q4 2012. Our GDP forecast for the year as a whole sees a 0.6% contraction, with only very modest growth of 0.3% now seen in 2013. Subdued prospects for demand and tight financing conditions mean that the near-term outlook for investment spending is especially bleak. We forecast capital outlays in the economy as a whole will fall by 4.9% in 2012, with a marginal recovery to growth of 0.8% forecast in 2013. The outlook for consumer spending is also weak as real disposable incomes will continue to fall due to ongoing fiscal austerity, declining real wages and continued job destruction. We forecast consumer spending will contract by 0.7% in 2012, with growth of just 0.2% in 2013.

Spain: Contributions to GDP growth



Source: Oxford Economics

The risks to this forecast remain skewed to the downside. In particular, the contraction in economic activity could prove much more severe if the government announces further substantial austerity