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## Research

### Bulletin:

# Economic Growth Prospects Could Undermine Spain's Fiscal Consolidation Program

**26-Feb-2010**

-- We believe Spain's weak economic growth prospects could undermine the government's fiscal consolidation program.

-- In our view, the general government deficit is likely to remain above 5% of GDP through to 2013 versus the official forecast of 3% of GDP by 2013. As a result, we expect the general government debt burden to rise above 80% of GDP by 2012.

LONDON (Standard & Poor's) Feb. 26, 2010--Standard & Poor's Ratings Services said today that the Kingdom of Spain's (AA+/Negative/A-1+) weak growth prospects could undermine the government's fiscal consolidation program.

In our view, the general government deficit is likely to remain above 5% of GDP through to 2013 versus the official forecast of 3% of GDP by 2013. As a result, we expect the general government debt burden to rise above 80% of GDP by 2012. We also expect much weaker economic performance than current budgetary assumptions. There is, moreover, significant implementation risk with regard to the government's fiscal consolidation plans, which are not yet fully specified.

The 2010 budget contained 2.2% of GDP in mostly revenue-increasing measures in order to correct the general government budget deficit, which is estimated at 11.4% of GDP in 2009. Since the passage of the budget, the government has announced a further 3.6% of GDP in largely unspecified expenditure cuts, which are mostly planned to take affect in 2011-2013. Alongside an improvement in the cyclical component of the general government deficit (1.4% of GDP); a reversal in temporary measures (2.5% of GDP) taken to alleviate the economic impact of the recession; and an expected increase in interest payments by 1.2% of GDP, the government expects the deficit to reach 3% of GDP in 2013.

We see downside risks to the government's revenue collection assumptions in particular. This is because, as in many wealthy economies, Spain's tax base is highly sensitive to domestic demand, and has been sensitive to the real estate sector, which is estimated to have accounted for more than half of the increase in total tax revenue over 1995-2007. Neither of these sources is likely to be a strong contributor to revenue growth over the next several years.

We expect annual GDP growth to average 0.6% during 2010-2013, as opposed to the government's forecast of 1.5%. In our view, and notwithstanding the measures included in the government's economic sustainability law, the necessary reorientation of the economy away from credit-driven domestic demand towards external markets will be impeded by significant rigidities within the Spanish economy--in particular the dual labor market, which is likely to continue to negatively affect the dynamism of the Spanish economy.

Nevertheless, Spain's imbalances with the rest of the world have declined, as the current account deficit nearly halved in 2009, largely due to the sharp contraction in import volumes. We estimate that the current account deficit remained at a still sizeable 5.0% of GDP in 2009. Moreover, given that exports are equal to roughly one-quarter of GDP, the scope for a robust and relatively quick export-driven recovery appears limited. As a result, we expect the unemployment rate to remain above 15.0% over the forecast horizon.

Moreover, the prolonged economic adjustment and related deterioration in asset quality will continue to test the resilience of the Spanish banking system. Our estimate of the cumulative fiscal cost to the government in providing support to the financial system is 5% of GDP, and relates to the financing needs incurred by the Fondo de Reestructuracion Ordenada Bancaria (FROB; €34 billion) (see "**Fondo de Reestructuracion Ordenada Bancaria's (FROB) €3 Billion Bond Issue Assigned 'AA+' Rating**," published Nov. 20, 2009, on RatingsDirect) and the Fondo de Adquisición de Activos Financieros (€19 billion), which we incorporate into the general government debt burden.

The negative outlook on the sovereign ratings, which we assigned on Dec. 9, 2009, remains in place in the absence of more aggressive and tangible actions by the authorities to tackle Spain's economic and fiscal imbalances. Any deterioration over and above our current expectations could put further downward pressure on the ratings.

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