

Spain after the recession: how fast can it grow?

The Spanish economy's growth capacity seems to have run out of steam. Since the recession started, GDP has fallen by 6.5%, the number of unemployed has grown by 4 million and the bulk of the evidence available suggests that, in the short term, these figures will merely increase. However, as the adjustments that are being implemented make headway and the European environment normalizes, the Spanish economy is more than likely to get back to growth. A scenario with many conditioning factors and full of unknowns, and this article deals with a very specific one: how fast will the economy actually grow?

Until a few years ago, the first pointer used to measure the growth capacity of the Spanish economy was by looking at history. From 1985 to 2008, the growth rate had been over 2% almost uninterruptedly, only posting lower figures in 1992 and 1993. In fact, the average growth rate was around 3% until just before the current recession. The narrowing of the gaps in the per capita income of Spanish citizens and their European neighbours is the most obvious effect of such a long period of prosperity. Between 1995 and 2008, this gap with the euro area narrowed by 7 percentage points, reaching 90% of the average income.

Given this situation, there were few doubts regarding the potential growth rate of the Spanish economy. The conclusions reached by using sophisticated econometric models were very similar to the simple average growth of the previous few years. Now, however, this simple calculation does not add up. To a large extent, the Spanish economy's growth over the last few years was boosted by four sectors that are unlikely to recover such a leading role. Between 2001 and 2007, the average rate of growth for construction was 5.0%. Real estate services also enjoyed a substantial growth rate, namely 2.7%. Between them, these two sectors contributed, on average, 0.8 percentage points to the economy's annual growth rate.

The financial sector is also unlikely to grow at a similar pace to its past achievements. Between 2001 and 2007 its average growth rate was 9.7%, contributing 0.6 percentage points to GDP growth on average. Lastly the public sector, with a level of debt that ended 2012 at 84% of GDP, will not be able to drive the economy either. Although its figures are somewhat more modest (the gross value added of public administration, health and education grew by 3.6% on average), these rates are unlikely to be repeated in the future.

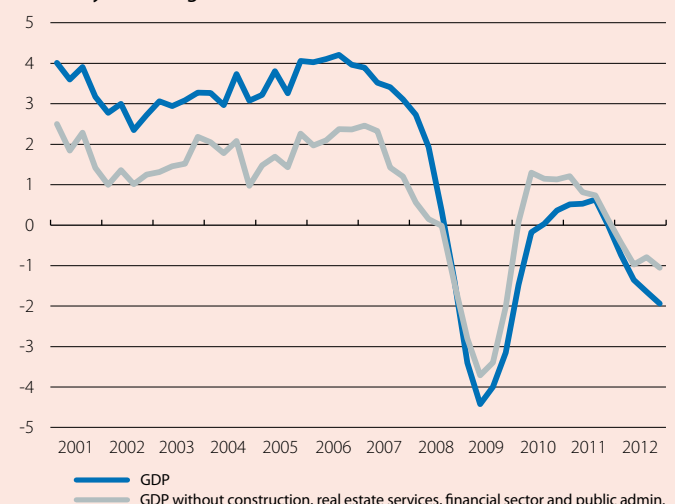
Discounting the contribution from these four sectors, the average growth rate for the Spanish economy was 1.8% between 2001 and 2007. This simple calculation gives us an idea of the growth capacity of the remaining sectors which, in principle, should be less affected. Although it is true they were enhanced by the booming economy and this will now affect them negatively, it is also true that they could not make use of the production factors that were being hogged by the more dynamic sectors. Moreover, the aforementioned four sectors are going to gradually gain ground as time goes on and, consequently, their contribution to growth will not be zero either.

In fact, 1.8% is a similar figure to the one various international organisations believe is the long-term growth capacity of the Spanish economy. For example, since 2008 the International Monetary Fund (IMF) has regularly published a 6-year growth forecast, a sufficiently long time span to consider this as an estimate of long-term growth capacity. As can be seen in the graph on the next page, in 2008 the IMF predicted long-term growth of 3.8%. Over the years, this forecast has gradually been cut back to the current figure of 1.6%, less than half the initial projection.

Another clue to the Spanish economy's long-term growth capacity is provided by the outlook for production factors, capital and employment, as well as productivity.⁽¹⁾ According to Hernández de Cos *et al.* (2011),⁽²⁾ potential growth is around 2.0%; a slightly higher rate than the government's estimate

Growth was supported by four key sectors

Year-on-year change (%)



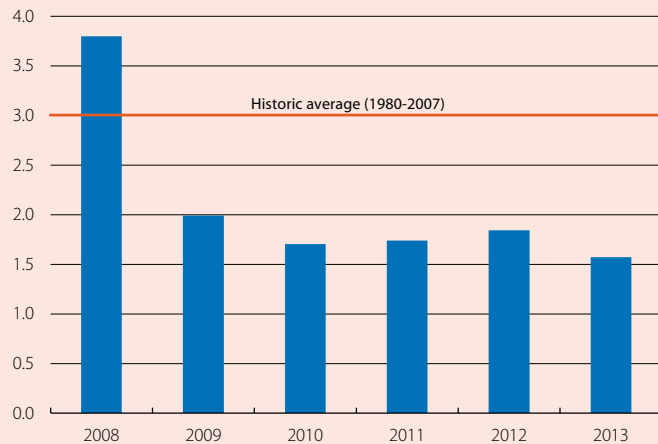
Source: Spanish Statistics Institute (INE).

(1) For a detailed explanation of this method of estimating potential growth, read the article «How is potential GDP calculated?» in this Dossier.

(2) Hernández de Cos, Pablo, Mario Izquierdo and Alberto Urtasun. 2011. «Una estimación del crecimiento potencial de la economía española». Bank of Spain, Documentos Ocasionales no. 1104.

The IMF revises downwards the long-term growth capacity of the Spanish economy

Forecasts over a 6-year span of GDP growth in Spain (%)



Source: International Monetary Fund.

reduction in the structural unemployment rate of one percentage point would increase the level of potential GDP by around 0.5 percentage points.

Productivity is another pending issue. Although it is true that, on the whole, the reduction in the relative weight of construction will allow resources to be allocated to more productive ends, under current conditions this does not look like being enough to reboot the economy. However, notable advances have been made over the last few years and provide a ray of hope. This is already resulting in significant improvements in Spanish exports which, over the last 3 years, have maintained an average annual growth rate of 7.3% and already account for 33% of GDP. Whether this rate of growth in the foreign sector can be maintained will largely depend on whether productivity continues to improve.

The growth capacity of the Spanish economy has not run out of steam but the bulk of the evidence available suggests it is substantially less than what was thought a few years ago. According to different estimates, it is between 1.2% and 2.0%. Naturally this figure is lower than the growth recorded between 2000 and 2007, namely 3.6%, which is when the huge imbalances were created that the Spanish economy is suffering from today. However, it is important not to give in to pessimism and commit, but in the opposite direction, the past errors of overestimating growth capacity. Moreover, it is necessary to remember that, if structural reforms are implemented that improve productivity and reduce structural unemployment, the impact could be considerable. Within such a scenario we might even see potential growth coming close to the figure of 2.5% which it exhibited, on average, between 1978 and 1999. The pending reforms have been extensively analyzed over the last few years and all that remains now is for them to be carried out; the sooner, the better.

which is between 1.2% and 1.5%. The large difference between both estimates lies in the assumed long-term investment rate. While the government expects this to remain close to its current level, Hernández de Cos *et al.* (2011) predict a certain recovery.

With regard to employment, its contribution will fall significantly and will remain at around 0.5 percentage points. This is due to the fact that the rise in the activity rate, which was considerable during the years prior to the recession, is now reaching its limit. Moreover, the migratory flows occurring, which led the population to increase by 5.1 million people between 2001 and 2010, are unlikely to be seen again. In both cases, however, it is assumed that structural unemployment, which Hernández de Cos *et al.* (2011) place at around 15% in 2012, will fall very slowly (by 0.5% per year, approximately). If measures were taken to speed up this process, the impact could be substantial. A

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