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OECD Economic Surveys: Spain

Chapter 2

Returning to more sustainable growth

Spain's recent economic performance has been remarkable, with 2006 marking its 13th consecutive year of growth, one of the longest periods of sustained growth in its recent history. However, there are persistent signs of imbalances that threaten to derail the strong performance, although recent data suggest some improvement. The inflation differential with the rest of the euro zone remains significant, undermining international competitiveness. Driven by vigorous growth of private consumption and residential construction, domestic demand pressures have intensified, contributing to the worsening current account deficit. Addressing these imbalances is crucial in order to maintain the good recent performance. This section examines the recent behaviour of the economy, provides a short-term projection and identifies the main risks surrounding it. It analyzes in more detail the possible overvaluation of the housing market and the behaviour of the inflation differential and ends by providing a set of policy recommendations to help tackle these problems.

Recent trends

Growth remains robust

Economic activity has maintained its buoyancy, with GDP growth reaching 3.8% (year on year) in the third quarter of 2006 after accelerating slightly but steadily since 2003 (Table 2.1). Although growth remains well above the euro area average, the differential has most recently narrowed to 1.1 percentage points with the pickup in the rest of the zone (Figure 2.1). Domestic demand, still the main driver of growth, continues to grow healthily, although a slight moderation has been observed since early 2005. The overall level of indebtedness continues to increase, as the rise in public savings has not been enough to offset the upsurge in household and non-financial corporate debt (Table 2.2), which, coupled with the increase in real interest rates (which until recently remained in negative territory), has helped moderate private consumption and business investment. Recent activity indicators show a decrease in car sales and signs of improvement in industrial production, while the increase in exports from big firms and the good summer results in the tourism sector suggest a stronger pull from the external market. Thus, there is some

Table 2.1. **Recent trends**

Year-on-year percentage changes

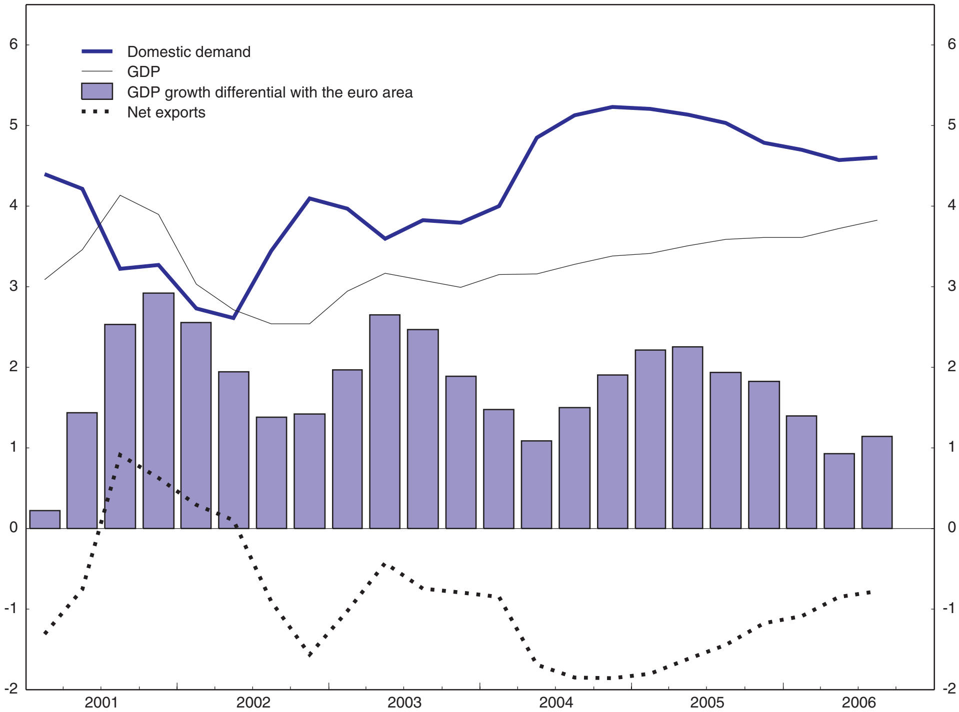
	Average 1991-2001					2005	2006		
		2002	2003	2004	2005	Q4	Q1	Q2	Q3
Private consumption	2.7	2.8	2.8	4.2	4.2	3.8	3.8	3.6	3.6
Government consumption	3.2	4.5	4.8	6.3	4.8	4.9	4.3	4.2	4.2
Gross fixed investment	3.5	3.4	5.9	5.0	7.0	6.6	6.3	6.2	6.3
Construction	2.9	6.3	6.2	5.5	6.0	5.6	5.8	5.8	6.1
Machinery and equipment	..	0.1	5.4	4.5	8.4	8.1	7.0	6.6	6.7
Final domestic demand	3.0	3.2	3.9	4.8	5.1	4.8	4.6	4.5	4.5
Total domestic demand	3.0	3.2	3.8	4.8	5.0	4.8	4.7	4.6	4.6
Exports of goods and services	9.5	2.0	3.7	4.1	1.5	2.3	9.5	4.9	3.2
Imports of goods and services	9.1	3.7	6.2	9.6	7.0	6.6	12.4	7.6	6.0
Foreign balance[1]	–0.1	–0.5	–0.7	–1.6	–1.5	–1.2	–1.1	–0.8	–0.8
Gross domestic product	**2.9**	**2.7**	**3.0**	**3.2**	**3.5**	**3.6**	**3.6**	**3.7**	**3.8**
Output gap (level)	–1.0	–0.2	–0.7	–1.0	–0.8	..	..	..	..
Unemployment rate (level)	14.8	11.5	11.5	11.0	9.2	8.7	8.8	8.6	8.3
GDP price deflator	4.1	4.3	4.1	4.0	4.1	4.1	4.1	4.0	3.8
Consumer price index (HICP)	3.8	3.6	3.1	3.1	3.4	3.5	4.1	4.0	2.6
Core consumer price index (HICP)	4.0	3.9	3.0	2.8	2.7	2.8	3.1	3.2	2.7
Current account balance (% of GDP)	–2.0	–3.8	–4.2	–5.9	–7.5	–7.0	–10.6	–8.1	..
Total employment	1.9	2.3	2.4	2.6	3.1	3.2	3.2	3.1	3.0
Productivity	1.0	0.4	0.6	0.6	0.4	0.4	0.4	0.6	0.8
Wage rate	4.4	2.0	1.6	1.7	0.8	0.7	0.9	0.8	0.8
Household saving ratio (%)	13.5	11.4	11.9	11.4	10.6	..	..	..	..

1. Contributions to GDP growth, at annual rate.

Source: *OECD National Accounts*; OECD (2006), *Economic Outlook 80*; and INE.

Figure 2.1. **Domestic demand and foreign demand developments**

Year-on-year percentage changes



Source: INE; OECD, National Accounts.

Table 2.2. **Net financial transactions of the economic sectors**[1]

Per cent of GDP

	1999	2000	2001	2002	2003	2004	2005	2006 Q1	2006 Q2
Total economy	–1.6	–3.2	–3.4	–2.6	–3.0	–4.8	–6.5	–7.1	–7.4
Financial corporations	0.5	0.8	1.4	1.4	1.3	0.7	0.9	0.6	0.7
General government	–1.3	–0.9	–0.5	–0.3	0.0	–0.2	1.1	1.8	2.3
Non-financial firms	–3.2	–4.5	–5.4	–4.4	–4.4	–4.7	–7.1	–8.0	–8.8
Households and non-profit institutions	2.4	1.4	1.1	0.7	0.1	–0.6	–1.3	–1.5	–1.7

1. The concepts of net financial transactions (computed from financial accounts) and net lending (computed from national accounts) are equivalent. However, in the case of Non-financial firms and Households and Non-profit institutions, small discrepancies between the two may arise.

Source: Bank of Spain (2006), *Financial Accounts of the Spanish Economy*, October (Table 3.3, page 37).

recent evidence that growth has been somewhat more balanced than in the past. The residential construction industry remains strong: although housing starts have decelerated and the time spent on the market of houses on sale has increased, building permit issuance continues to increase rapidly.[1] As well, housing prices continue to rise at significant rates, although some deceleration is apparent. Inflation, which hovered around 4% until August 2006, fell to 2.7% in December. The inflation differential *vis-à-vis* the euro has moved in line with world energy prices, falling most recently to 0.8 percentage point, below the trough it reached in mid-2005.

The labour market has maintained its dynamism

The labour market continues to show great dynamism, with unemployment edging down almost to 8% by the third quarter of 2006. It has successfully absorbed the increase in labour supply caused by the large inflows of immigrants and the rising participation of women. Job creation rates remain strong at above to 3%. Net employment gains have been concentrated in the construction and services sectors, with their job growth accounting for nearly 98% of the almost 1.25 million jobs created since the beginning of 2005. Likely reflecting the inclusion of immigrants in the labour market, the containment of real wages has been crucial to the robust employment expansion, as real wages have continued to fall, held down by meagre labour productivity gains of around ½ per cent per year, well below both the level observed in the 1990s and the current euro-area average.

The external sector continues to be a significant drag on growth

The negative contribution of the external balance to growth has abated somewhat, as exports have been gathering steam since the beginning of 2006, propelled by the recovery of Spain's main trading partners. However, the strength of the euro and the persistently positive inflation differential continue to undermine international competitiveness. As a result, the growth of imports, also reflecting the strength of domestic demand and higher investment needs (see Box 2.1), steadily outpaces the rise in exports. The current account deficit has been widening persistently, growing by around 30% in the first three quarters of 2006, reaching almost € 90 billion at an annual rate (9.1% of GDP). A strong showing of

Box 2.1. **The external deficit in Spain**

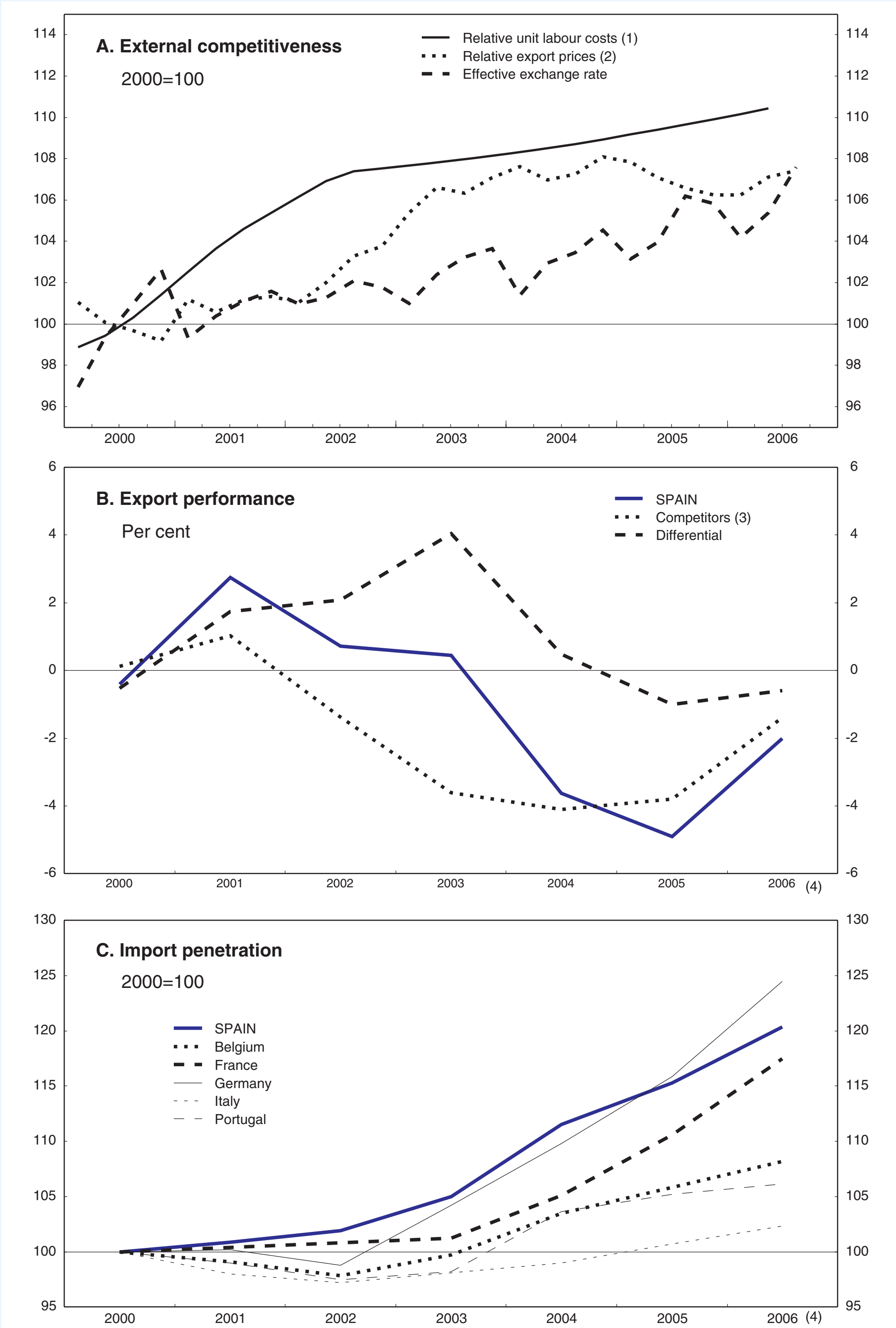
The current account deficit is among the largest in the OECD…

While the existence of current external deficits has been a regular feature of the Spanish economy since the 1970s (L'Hotellerie-Fallois and Peñalosa, 2006), the shortfall is at its highest level in 30 years after reaching around 9% of GDP in 2006. Since 1998, it has grown more than five times and is more than 3½ times its long-term average. In an international perspective, in the euro area only Greece (10.8%) has a bigger deficit in terms of GDP; in absolute terms, only the United States (around $870 billion) exceeds Spain's deficit. The contribution of the goods and services balance to growth has been negative since 1998, reaching around –1.5% of GDP in 2004 and 2005, though shrinking during 2006.

… driven in part by competitiveness losses, strong domestic demand pressures and oil price increases

Several factors have contributed to the widening of the external deficit, including the oil price increase, the rise in immigrants' remittances and the weakening of the tourism surplus due to the higher number of Spaniards travelling abroad. About 55% of the rise in the current account deficit between 1998 and 2005 results from a worsening of the trade deficit excluding energy, which can be ascribed mostly to two factors. *First*, the inflation differential and the higher growth in unit labour costs relative to its main trading partners have eroded international price competitiveness: both relative unit labour costs and relative consumer prices with respect to the euro area have increased since 2000 by almost 12 and 7%, respectively (Figure 2.2, Panel A). Spain's export performance has suffered, especially when compared with its main competitors in the euro area since 2004 (Figure 2.2, Panel B). *Second*, domestic demand pressures have been strong, particularly in relation to its main trading partners. Import penetration has risen more rapidly in Spain than in most of the euro area countries, reflecting both the impact of higher domestic demand pressures and the negative impact of higher inflation on domestic producers' selling prices (Figure 2.2, Panel C).

Figure 2.2. **Competitiveness indicators and export performance**



1. In manufacturing.
2. Exports of goods and services, relative to the euro area.
3. Represented by Belgium, France, Germany, Italy and Portugal. The weights are computed using the share of trade of each country with Spain.
4. Preliminary.

Source: OECD, Economic Outlook 80 database, Main Economic Indicators.

Box 2.1. **The external deficit in Spain** *(cont.)*

Adjustment, if necessary, could be painful, absent the possibility of a correction in the exchange rate

In order to restore the competitiveness of the economy, barring a sharp acceleration in cost-reducing productivity growth or an improvement in the terms of trade, a real depreciation would be called for. In the absence of a correction in the nominal exchange rate (at least among the euro area members), the only possibility would be through relative deflation, which could make the adjustment more difficult and prolonged, as witnessed, for example, by the German experience in recent years. As part of the adjustment process, the share of the tradables sector in production would have to increase (Jarrett, 2005). A depreciation of the real exchange rate would bring about a change in relative prices that would make tradables production more attractive. Increasing competition in the sheltered sectors would allow the economy to respond more nimbly to the required adjustment.

both hotel occupancy and spending per tourist in the second-quarter, after a weak first quarter, suggests that the tourism sector might be recovering from its sluggish performance in 2005. However, increasing outflows associated with Spaniards travelling abroad has reduced the surplus on the tourism account.[2]

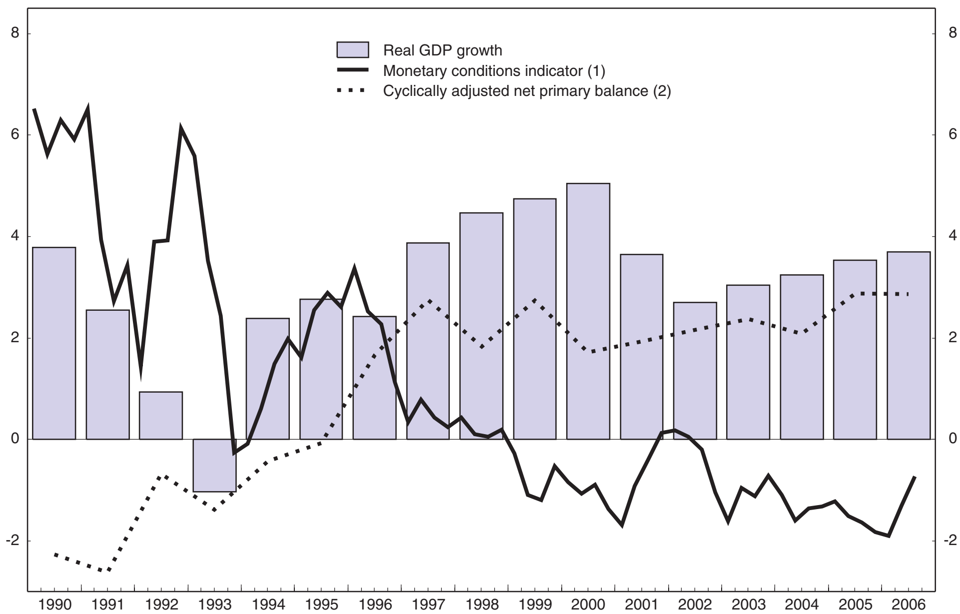
Short-term fiscal policy and the overall macroeconomic policy stance

The tighter fiscal policy has not been enough to offset still loose monetary conditions

Reflecting the recent recovery of economic activity in the euro area, monetary conditions have tightened slightly since early 2006 (Figure 2.3). Nominal and real interest

Figure 2.3. **The macroeconomic policy stance**

Per cent



1. The indicator is computed as the weighted average of the real short-term and long-term interest rates and the real effective exchange rate (based on unit labour costs in manufacturing). The interest rate variable has a unitary coefficient while the exchange rate coefficient is the ratio of exports to GDP. An increase in the indicator is associated with more restrictive financial conditions.
2. As a per cent of potential output.

Source: OECD (2006), *Economic Outlook 80*.

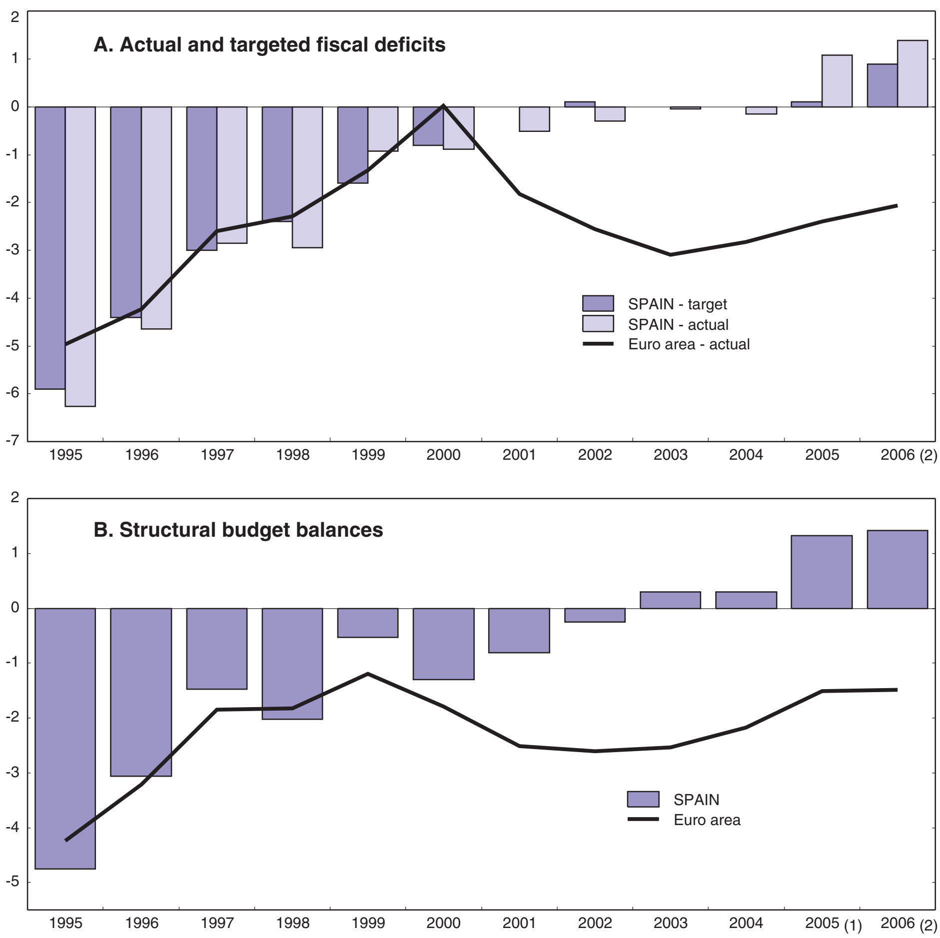
rates have increased, while the real effective exchange rate has appreciated, as the euro has generally risen in value and Spain's inflation has remained higher than in its trading partners (Moral and del Río, 2006). However, monetary conditions remain loose, with short-term real interest rates just recently moving into positive territory.[3] Fiscal policy was also tighter in 2005-06, as a general government surplus of 1.1% of GDP was achieved in 2005, the first surplus since the mid-70s, and the structural surplus (of 1.3% of potential GDP) was larger than the one registered in 2004 (which would have been close to 1% before including the absorption of the public rail operator's debt by the central government).[4] The persistently high level of inflation and the evidence of strong domestic demand pressures suggest that, while the overall macroeconomic policy stance was slightly tighter in 2005-06, an even tighter policy stance might have been helpful.

The fiscal consolidation process has been structural

In contrast to many other euro area countries, the government has maintained the fiscal consolidation process begun in the wake of joining the EMU and taken advantage of the favourable conjuncture of the Spanish economy (Figure 2.4). The structural improvement

Figure 2.4. **Budget balances**

Per cent of actual GDP (panel A)/potential GDP (panel B)



1. Preliminary.
2. OECD estimates.

Source: OECD (2006), *Economic Outlook 80*.

of the general government balance since 2000 reached some 2.7 percentage points of (potential) GDP by 2005. This reflected the robust growth of revenues, a large reduction in interest payments (about half of the improvement), both as a result of lower interest rates and the reduction in the stock of government debt, and some moderation in primary spending (Table 2.3). The increase in revenues was driven by the rapid growth of nominal GDP that resulted both from the strong real growth and the high level of inflation. Moreover, the implied tax elasticity has been above 1 and has risen in recent years (Box 2.2). However, the GDP share of government expenditures excluding interest payments has increased as higher consumption and investment outlays have been only partially offset by lower social security spending and, to a modest extent, subsidies (Table 2.4). Around ½ million government jobs have been created since 2000, mostly by regional and local authorities, as central government employment has fallen marginally. The economy-wide moderation of real wages has helped to contain what would otherwise have been a much bigger increase in public consumption, but the big employment increases could become a source of pressure in the medium run if real wages increase.

Table 2.3. **The fiscal consolidation process**

	1995	2000	2005[1]	Change over period	
				1995-2000	2000-05
Per cent of GDP					
Net lending	–6.3	–0.9	1.1	5.4	2.0
Cyclical effects	–1.5	0.5	–0.3	2.0	–0.7
Per cent of potential GDP					
Structural balance	–4.8	–1.3	1.3	3.4	2.7
Interest payments	4.7	3.0	1.6	–1.7	–1.5
Structural primary balance	–0.1	1.7	2.9	1.8	1.2
Structural revenues	36.5	37.7	38.7	1.2	1.0
Direct taxes	10.2	10.3	11.1	0.1	0.8
Indirect taxes	10.0	11.4	12.1	1.4	0.8
Social security contributions	12.6	12.9	12.9	0.3	0.0
Other revenues	3.8	3.2	2.6	–0.6	–0.6
Structural current expenditure	38.4	36.4	34.8	–2.1	–1.6
Structural total expenditure	41.3	39.0	37.4	–2.3	–1.7
Net capital outlays	2.9	2.7	2.6	–0.2	–0.1
of which:					
Investment	3.7	3.2	3.6	–0.5	0.4
Other	–0.8	–0.5	–1.0	0.3	–0.5

1. Preliminary estimates.
Source: OECD (2006), *Economic Outlook 80*.

Tax receipts have continued growing in 2006

Several factors came together in 2005 to explain the general government surplus of 1.1% of GDP, which dwarfs the initial target of 0.1% (Figure 2.4). The aforementioned strong revenue growth, which reached 12.2% in 2005, and the spending cap on expenditures[5] (equal to expected nominal GDP growth) were reflected in the central government's surplus of 0.4% of GDP, while the strong job creation allowed the Social Security system to post a surplus of 1.1% of GDP. Both the regional and local governments posted small deficits, moving away from the balance they had jointly achieved in 2004. Overall, fiscal policy in 2005 was restrictive. Preliminary information suggests that tax revenues have continued

Box 2.2. **The behaviour of the tax elasticity in Spain**

The implied elasticity of tax revenues has been consistently above 1 and higher than the euro-area average (see Chapter 1) since the end of the 1990s. There are several questions surrounding the high elasticity of tax revenues and whether the strong growth in taxes is likely to continue over the medium term. While it is difficult to quantify exactly the causes of this outcome, four factors are at least partly responsible. *First*, actual growth might have been underestimated in recent years. However, after the upward revision of national accounts figures in 2006, the elasticity still remains at a relatively high level. *Second*, previous reforms to the personal income tax, in 1999 and 2003, have included both tax cuts and measures to simplify the tax code. This might have resulted in initial revenue losses that were later offset by increasing compliance. *Third*, tax brackets are still not fully indexed for inflation (they are indexed only for the official inflation objective, which has consistently underestimated actual inflation), so bracket creep has increased tax revenues. *Fourth*, the still buoyant housing market might also have had a positive impact on transactions, value added taxes, and property and inheritance taxes as has happened in other countries, even if these imposts represent a small fraction of total revenues (OECD, 2004). Relying on stable and dependable sources of income should be a central element of the authorities' efforts to maintain a prudent fiscal policy, so that making an assessment of the sustainability of tax revenues should be a priority.

Table 2.4. **General government accounts**

As a percentage of GDP

	2000	2003	2004	2005	2006
Current receipts	37.6	37.6	37.9	38.7	38.8
Direct Taxes	10.2	10.1	10.2	10.9	11.2
Household	7.0	6.9	7.2	7.4	7.5
Business	3.2	3.2	3.0	3.6	3.7
Indirect taxes	11.4	11.5	11.9	12.1	12.3
Social security contributions	12.9	13.0	13.0	13.0	12.9
Other	3.2	2.9	2.7	2.6	2.5
Current expenditure	36.1	35.2	35.2	34.9	34.6
Government consumption	17.2	17.4	17.8	18.0	17.6
Subsidies	1.1	1.0	1.0	1.0	1.0
Social security outlays	12.0	11.7	11.7	11.6	11.5
Property income paid	3.2	2.4	2.1	1.8	1.7
Other	2.6	2.7	2.7	2.8	2.7
Gross savings	1.4	2.3	2.6	3.7	4.3
Capital outlays	2.3	2.4	2.7	2.6	2.8
Net lending	–0.9	–0.0	–0.2	1.1	1.5
Memorandum items:					
Net primary balance	2.1	2.1	1.7	2.6	2.9
Net lending of:					
Central government	–0.9	–0.3	–1.1	0.4	..
Social security	0.5	1.0	1.0	1.1	..
Local and regional government	–0.4	–0.7	–0.1	–0.4	..

Source: *OECD National Accounts*; OECD (2006), *Economic Outlook 80*; and Bank of Spain (2006), Boletín Estadístico, August (Tables 12.1, 12.11, 13.1 and 14.1).

to grow robustly in 2006: by the third quarter, total tax receipts grew by around 10% (year on year), compared with a growth in nominal incomes of almost 8 per cent. Were revenues to continue growing at this pace in the second half of 2006, the surplus could be around 1.4% of GDP, exceeding both the 0.9% target for 2006 and last year's level, although by an amount sufficient to imply little change in the already restrictive fiscal stance. The likely better-than-expected outcome is largely driven by cyclical factors, as economic slack diminished in 2006.

Meeting the fiscal objectives for 2007 and 2008 is likely…

In compliance with the requirements of the revised Fiscal Stability Law (see Chapter 3), the authorities have announced an objective for the 2007 surplus of 0.7% of GDP,[6] based on estimated GDP growth of 3.2%. This would imply a significant reduction in the fiscal balance when compared to the expected outcome in 2006, although previous experience suggests that this objective might be easily surpassed. Government spending increases will be capped at 6.7%, roughly the level of projected nominal GDP growth, while revenues are expected to grow at a slower pace as a result of the cuts in the personal income and corporate taxes amounting to around 0.4% of GDP that will be in place in 2007. According to the 2005-2008 Stability Programme Update, the objective for 2008 is a similar surplus of 0.6% of GDP. This was based on a projected growth of 3.2%, close to the official estimated trend growth of around 3¼ per cent (computed using a Hodrick-Prescott filter), implying a broadly neutral fiscal policy objective.[7] However, this official estimate is higher than the OECD's estimate of potential growth of around 2¾ per cent.

… but spending pressures will need to be contained

Spending pressures are expected to intensify in 2007 and 2008. The margin for reducing interest payments, which has been an important element behind the fiscal consolidation process, is likely to be nearly exhausted as interest rates have risen recently, and further increases are probable, even if the stock of public debt can be expected to continue falling and some debt may still be rolled over at lower rates than previously. The authorities are pursuing an ambitious spending plan to increase productivity in the medium term and, to a lesser extent, to prepare for the long-term fiscal costs of the ageing process (see Chapter 3). Among the spending commitments already announced for the next few years are an ambitious transportation infrastructure programme, further increases in R&D spending and a new coverage system for dependents. The spending cap should prevent overruns from the central government, but it would be desirable to base the cap on potential output, so as to increase the stabilising role of fiscal policy. This would also make it easy to use a multi-year ceiling, which would aid in reducing uncertainty about future fiscal policy. In the short run, controlling local and regional government expenditure will be crucial as it is at this government level that the highest risk of fiscal slippage lies. As these administrations do not currently face a spending cap, it remains to be seen whether the new Fiscal Stability Law and the regional financing mechanism are successful in controlling outlays at these levels, especially as they have taken on increasing responsibilities, including health care and education, where additional pressures might be created as a result of further immigrant flows. Therefore, it would be desirable for regional governments to also be subject to spending caps. According to OECD projections, the surplus in 2007 is likely to be yet again larger than the objective, but fiscal policy may be slightly expansionary, as the actual and structural surpluses are expected to fall by around

½ percentage point to around 1.2 and 1.1% of GDP, respectively. As for 2008, with GDP growth expected to be close to potential, the surplus could once more be above the objective of 0.6% of GDP, and, given the announced objective of a neutral fiscal policy, the actual and structural surpluses will probably remain stable at 1.3 and 1.1% of GDP, respectively.

Short-term prospects

Activity is likely to remain strong, even if the pace of expansion eases somewhat in 2007 and 2008, and should again be above the euro area average, although the differential may narrow (Table 2.5).[8] Private consumption may slow down slightly, as the ongoing deceleration in housing prices moderates increases in household wealth, and the surging level of household indebtedness and the higher interest rates combine to limit spending, particularly on durables. However, the restraint in consumption will be modest, as disposable income is likely to be bolstered by still robust employment creation, the income tax cuts and positive wealth effects. Construction investment should continue to grow briskly in 2006 but a bit less in 2007 and 2008, as the housing market cools off. This is likely to be partly offset by investment in machinery and equipment, which will remain vigorous, supported by good business financial results and the corporate tax cuts. The foreign balance will no doubt maintain its negative contribution to growth, as competitiveness losses dilute the positive effect of stronger foreign demand. Overall, after

Table 2.5. **Short-term prospects**

Percentage changes from previous period, except where noted

	Current prices, billion €, 2003	2004	2005	2006	2007	2008
Private consumption	450.7	4.2	4.2	3.4	3.3	3.1
Government consumption	135.9	6.3	4.8	4.0	4.0	3.6
Gross fixed investment	212.8	5.0	7.0	6.0	4.9	4.5
Construction	121.5	5.5	6.0	6.0	4.2	3.9
Machinery and equipment	91.3	4.5	8.4	6.0	5.8	5.5
Stockbuilding[1]	1.8	0.0	–0.0	0.1	0.0	0.0
Total domestic demand	799.4	4.8	5.0	4.3	3.9	3.6
Exports of goods and services	206.1	4.1	1.5	6.5	5.2	5.2
Imports of goods and services	224.7	9.6	7.0	8.3	6.6	6.6
Foreign balance[1]	–17.4	–1.7	–1.7	–0.9	–0.8	–0.8
Gross domestic product	**782.5**	**3.2**	**3.5**	**3.7**	**3.3**	**3.1**
Per memo: euro area GDP	7 460.9	1.9	1.4	2.6	2.2	2.3
Household saving ratio (%)	..	11.4	10.6	10.0	10.1	10.0
Private consumption deflator	..	3.5	3.4	3.6	2.8	3.1
GDP price deflator	..	4.0	4.1	3.7	3.5	3.7
Unit labour costs	..	2.6	2.5	2.5	3.1	3.2
Productivity	..	0.6	0.4	0.7	0.7	0.7
Total employment	..	2.6	3.1	3.0	2.7	2.3
Unemployment rate	..	10.5	9.2	8.4	7.8	7.6
Output gap (level)	..	–1.1	–0.7	–0.3	0.2	0.6
As % of GDP						
Current account balance	..	–5.9	–7.5	–8.8	–9.2	–9.6
Net government lending	..	–0.2	1.1	1.4	1.2	1.4
Structural fiscal balance	..	0.3	1.3	1.4	1.1	1.1

1. Contribution to changes in real GDP.

Source: OECD (2006), *Economic Outlook 80*.

GDP growth of around 3.7%, slightly higher than in 2005, the economy should then decelerate, with the rate of expansion falling to around 3.3% in 2007 and 3.1% in 2008. This would be enough to open a small output gap, according to OECD estimates, given slowing potential growth as available labour input decelerates.[9]

The labour market is expected to remain dynamic, with employment creation remaining high and unemployment edging down to slightly below 8% by 2008. The increasing tightness of the labour market will probably translate into higher real wage gains that progressively move back into positive territory in line with the projected modest productivity improvements. Headline inflation could drop below 3% in 2007 and rebound in 2008, as lower oil prices initially offset increasing but modest pressures on product and labour markets. The inflation differential with the euro area, however, is unlikely to fall below the 1 percentage point level.

The main risk to this scenario relates to future developments in the housing market. Although at present the most likely scenario is a soft landing in housing prices and there is some evidence that gradual adjustment is underway, a more abrupt adjustment cannot be ruled out. Given the strength of the financial system, it appears likely to be able to withstand such a shock, so most of the adjustment would be felt in private consumption through negative wealth effects, the government balance and the construction sector. As the construction sector has been one of the main drivers of economic growth over the recent past, this sector could be forced to adapt painfully both in terms of employment losses and a slowdown in growth. Government finances, especially at the local authority level, could be hurt by a deceleration of housing prices, as they derive a significant share of their revenues from real estate and property taxes (García-Cervero, 2006). In addition, eliminating the inflation differential remains one of the main medium-term challenges to maintaining a high level of growth. The losses in competitiveness induced by this inflation problem would be particularly damaging in case of a weakening of domestic demand and if the recovery in the euro area proves to be weaker than expected.

A more prudent fiscal policy would help ease domestic demand pressures but is not a substitute for structural reforms

Growth is projected to continue at a healthy pace, and, with it, according to OECD estimates, the positive output gap will increase slightly. Although interest rates are likely to increase further in light of the recovery in the euro area,[10] there is still ample room for fiscal policy to help cool off domestic demand (de Castro and Hernández, 2006). The strong decentralisation of public spending (see Chapter 3) in recent years has meant that spending by the central government is only around 8% of GDP, so regional and local governments also have an important role to play. Further increasing public savings might prove to be politically difficult, given the significant surplus reached in 2005 and 2006, so pedagogical efforts about the benefits of doing so should be an important part of the fiscal strategy. A more prudent fiscal policy would not only have a positive effect in reducing inflationary pressures in the short run but would also conform to the long-term need to increase public savings as part of a comprehensive strategy to face the fiscal consequences of ageing (see Chapter 3). However, structural reforms will be needed to curb the inflation differential and increase the probability of a soft landing in the housing market, thus steering the economy onto a more sustainable growth path.

Structural reforms are needed to reduce the inflation differential and boost the resilience of the economy

The inflation differential vis-à-vis the euro area has shown remarkable persistence

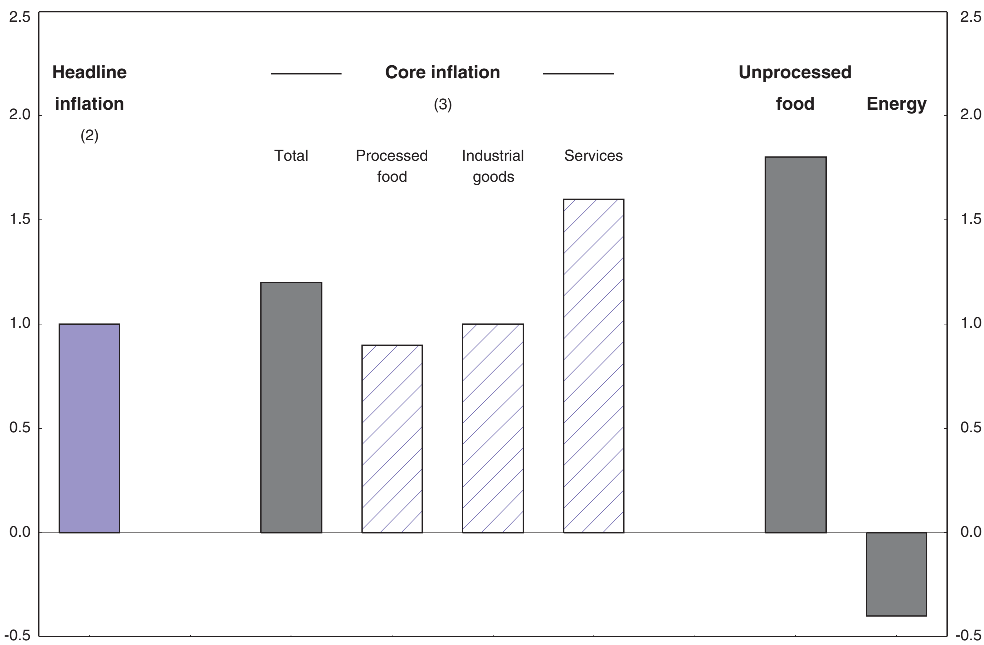
Reducing the inflation differential with the rest of the euro area is a difficult challenge for economic policy. Inflation in Spain has been on average 1 percentage point higher than in the euro area since 1997 (the average core-inflation gap has been slightly higher at 1.2 percentage points), implying an accumulated differential of around 10%. The inflation differential has been larger among non-traded goods, in particular in services (OECD, 2005), and has been positive among all product groups (Figure 2.5). Energy prices are the sole exception, as the direct effect of oil price increases has been subdued due to the particular pricing regime in electricity markets, which has smoothed price increases over a very long time instead of allowing an instantaneous adjustment (see Chapter 5). The persistent inflation differential has hurt the international competitiveness of Spanish firms, reducing net exports and increasing the current account deficit. It has thus contributed to the increased reliance on domestic demand as the main driver of growth and increased the disparity in the performance of the exposed and sheltered sectors, even though outcomes in the industrial sector have improved somewhat in recent months.

It cannot be fully explained by the price-convergence process with the rest of the euro area

Developing sound policy measures requires a good understanding of the sources of the persistence of the inflation differential. While several explanations have been offered, the debate is ongoing as to their relative importance (Benigno and López-Salido, 2003; Laborda,

Figure 2.5. **Average annual inflation differential between Spain and the euro area**

1997-2006,[1] percentage points



1. Last observation is September 2006.
2. Harmonised consumer price indices (HICPs), year-on-year percentage change.
3. HICPs excluding unprocessed food and energy.

Source: Eurostat and INE.

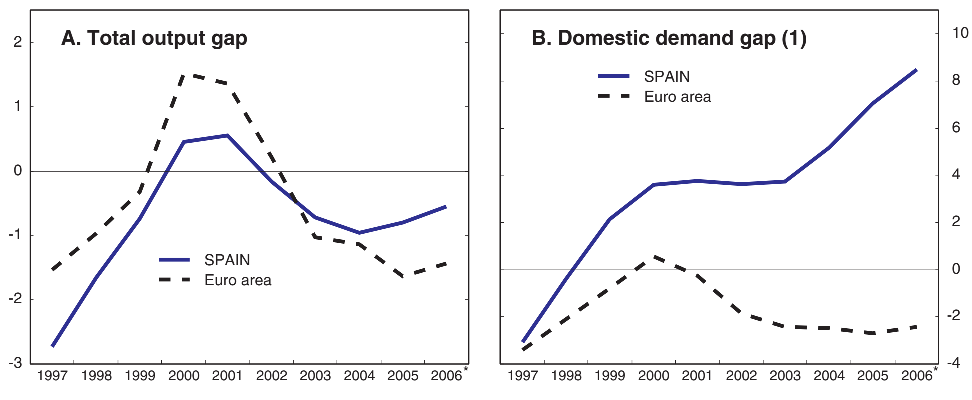
2006). The hypothesis that the differential inflation derives from a price-convergence process related to the Balassa-Samuelson effect can be reasonably rejected as there has been no convergence of productivity *vis-à-vis* the euro area (Estrada, Galí and López-Salido, 2004). In fact, Spain's productivity growth has been among the lowest in the entire zone. A different price-convergence mechanism cannot be ruled out, however: the progressive adoption of consumption norms and habits that are closer to the euro area's consumers as income has also approached the area average could have had an effect on prices, as price indexes do not fully account for these changes in quality. Nevertheless, such a process would likely be only temporary and apply just to certain categories of goods. Another explanation often mentioned by analysts is related to a price adjustment linked to the exchange rate being initially undervalued at the time of the adoption of the euro (Cubero and Félix, 2006). If accurate, this would have created a finite period of faster price increases in the tradables sector, as firms would have been able to raise prices without losing market shares. Looking at the recent evolution of market shares, this does not seem to be the case.

Demand pressures have been stronger and more concentrated on the sheltered sectors in Spain

A more likely explanation of the inflation differential relates to stronger demand pressures, more concentrated on sheltered sectors, in Spain than in the rest of the euro area.[11] Stronger spending increases in the last decade have been at least partly met by higher potential growth due to, among other factors, improved labour market performance and the successful absorption of large inflows of immigrants. Nevertheless, since 2003 spare capacity has been somewhat smaller in Spain, though the difference has been relatively modest (Figure 2.6, Panel A). The difference in domestic demand pressures is more striking, as domestic demand as a share of potential GDP has grown considerably faster in Spain than in the rest of the euro area (Figure 2.6, Panel B).[12] Furthermore, demand pressures have varied widely across sectors, focussing on those that are sheltered from foreign competition and, in particular, construction and services (López-Salido, 2005). These heterogeneous demand pressures have probably contributed to the inflation differential because firms in the sheltered sectors have been able to increase prices in

Figure 2.6. **Output gap and domestic demand pressures in Spain and the euro area**

Per cent of potential GDP



* Preliminary.

1. Note that scale is different from panel A. The demand gap is computed as the percentage change in total domestic demand over potential GDP.

Source: OECD, National Accounts and *Economic Outlook 80*.

response, resulting in an increase in sectoral profit margins (López-Salido and Restoy, 2005). While there is little doubt that this rise in profit margins is partly cyclical, its persistence may also reflect insufficient competition in a range of sub-sectors.[13] Decomposing the inflation differential into unit margins and unit labour costs, it can be seen that around 60% of the increase is explained by the rise in profit margins (Figure 2.7, Panel A), and that since 2001 profit margins in the construction and services sectors have had a stronger role in explaining the differential than those in the industrial sector (Figure 2.7, Panel D).

Nominal wages have increased faster than the average for the euro area

Increases in unit labour costs are responsible for the remaining 40% of the inflation differential. This partly reflects the low productivity growth, especially in the construction sector (Figure 2.7, Panel F), but also the robust growth in nominal compensation compared with the euro area, even as real compensation growth has remained moderate (Figure 2.8). The subdued behaviour of real compensation has probably contributed to maintaining the good performance of the labour market in recent years, although this might prove to be more difficult in the future, as labour markets in several regions are close to full employment.[14] Had immigration flows not been so significant, increases in nominal wages would surely have been even higher.

Deficiencies in the collective bargaining system have helped propagate regional and sectoral shocks

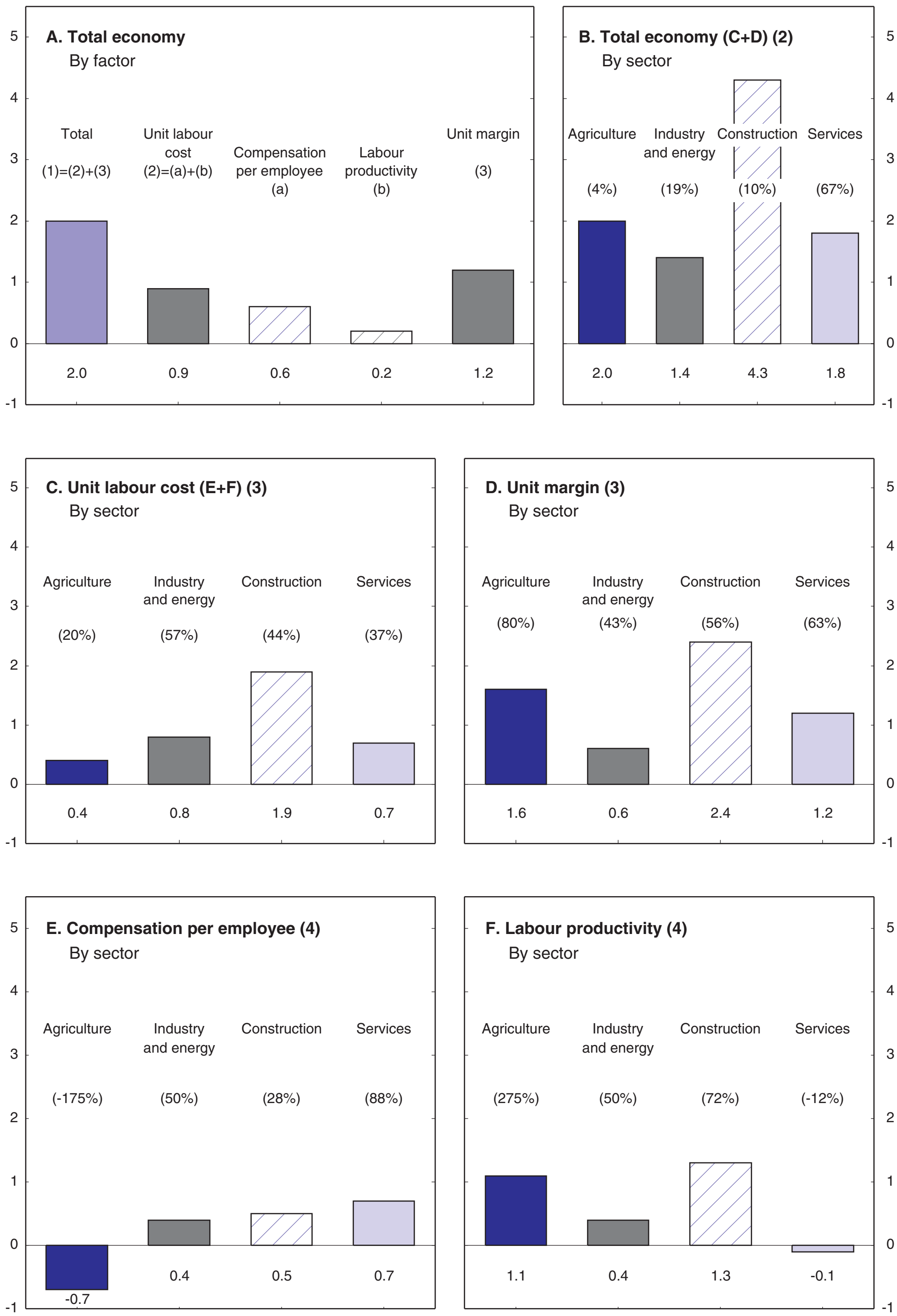
Deficiencies in the collective wage bargaining system in place are likely to lie behind the large increases in nominal wages (see Box 2.3). Wage negotiations are carried on mainly at the industry level, but extension clauses in many agreements allow them to be applied to other firms and regions, even if these firms did not take part in the negotiations. The use of catch-up clauses that protect workers in case of inflation surprises is also widespread, and there is evidence that, since actual inflation has been consistently above the official reference rate of 2%, contracts with such clauses have higher wage increases, *ex post*, than contracts without them (OECD, 2005). In this manner, wage inflation pressures in certain sectors and regions can be propagated to the rest of the economy, and nominal wage inertia is created. The use of indexation clauses is also problematic in the case of adverse shocks such as oil price hikes. The Spanish economy has a more intensive use of energy and oil in its production processes than the rest of the euro area (see Chapter 1), in turn partly due to the pricing policy in the electricity market which prevents current retail prices from reflecting the actual cost of production (see Chapter 5). As a result, oil price increases have fed into generalized price increases to a larger degree than in the rest of the euro area, pushing up the inflation differential in recent years (Figure 2.9).[15]

Assessment and policy recommendations

The authorities have followed a longer-term strategy to correct the inflation problem that focuses on maintaining macroeconomic stability. Complementing this strategy, a series of measures intended to increase competition in goods and services markets has been adopted that, while going in the right direction, are too modest in some cases, as in the retail distribution sector (see Chapter 5). In order to continue to grow faster than its euro-area partners with lower inflation, Spain's economy must have exemplary supply-side features. That implies further strengthening competition in some sheltered sectors in

Figure 2.7. **Factors explaining the inflation differential with the euro area**

Contributions to the inflation differential,[1] 2001-2005

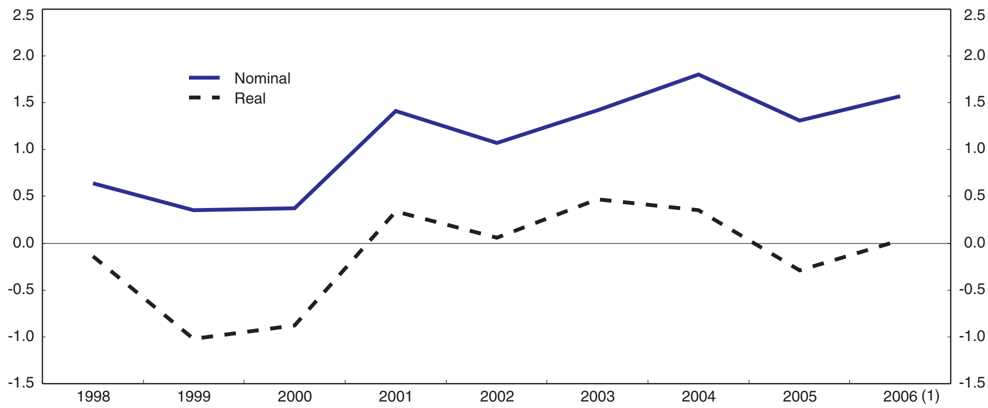


1. Computed using the GDP deflator.
2. The number in parentheses gives the (weighted) contribution of each sector to the total inflation differential.
3. In parentheses, the relative contribution of the unit labour cost and the unit margin to the overall contribution of the sector to the inflation differential. The unit margin is defined as the gross operating surplus per unit of production.
4. In parentheses, the relative contribution of compensation per employee and labour productivity to the contribution of the unit labour cost of the sector to the inflation differential. In the case of labour productivity its evolution is negatively related to the inflation differential.

Source: Banco de España, 2005 Annual Report.

Figure 2.8. **Wage growth differential with respect to the euro area**

Per cent, per year



1. Preliminary.

Source: OECD, National Accounts.

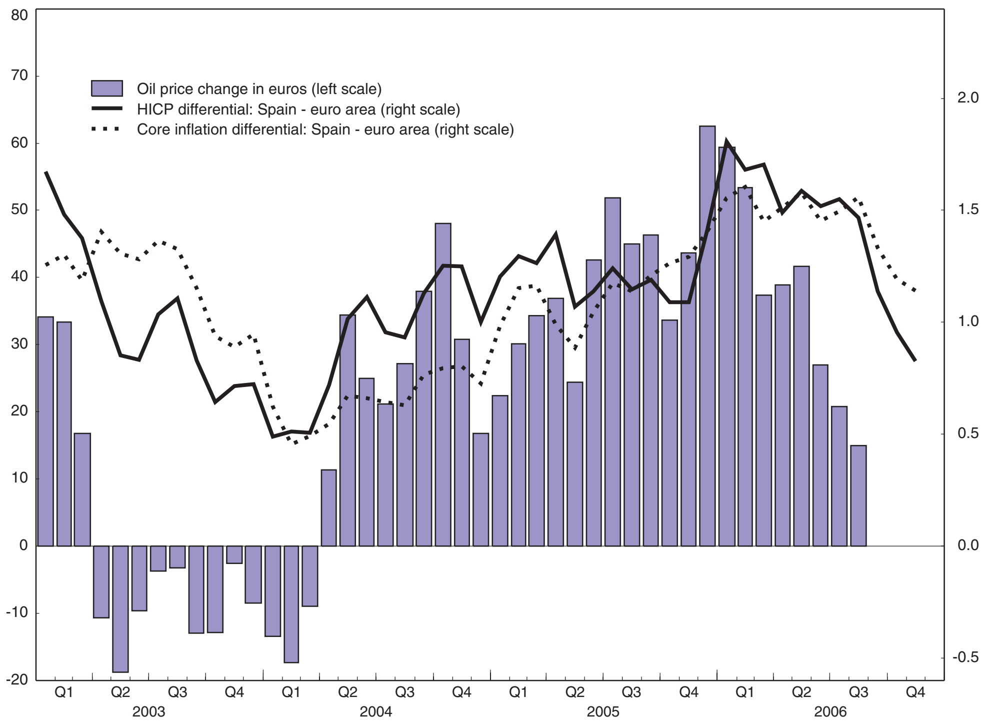
Box 2.3. **The collective wage bargaining system in Spain**

Collective wage bargaining in Spain is a complex process and can be conducted at the company, regional and national levels. Negotiations at the company level are rare (affecting between 10 and 15% of workers). They take place mainly at large firms in specific sectors, like energy and mining. Industry-level agreements are much more prevalent and affect mainly small and medium-sized firms. National-level bargaining is also rare and restricted to some sectors, such as financial services (OECD, 2005). Multiple levels of bargaining can co-exist, as outcomes of higher-level agreements can be complemented with lower-level agreements. By extension clauses, wage agreements cover all firms in an area and sector, even if the firms did not take part in the negotiation. Despite a relatively low rate of union membership (less than 15% in 2005), collective bargaining coverage is very high at more than 80% in 2005 (Card and de la Rica, 2005). Since 2000, the social partners have agreed to negotiate wage agreements on the basis of the official inflation reference rate of 2%, in exchange for the inclusion of catch-up clauses that protect workers against inflation rates above that figure. In 2003, around 75% of collective agreements were covered by such clauses as opposed to about 50% in 1998 (Izquierdo *et al.*, 2003), and this number is likely to have risen further since then.

The collective bargaining system has been successful in achieving real wage moderation and has thus helped to maintain the good performance of the labour market in recent years, but it has also had several negative side-effects. *First*, in terms of labour market outcomes, productivity and wage increases are not matched at the firm level, distorting the allocation of labour within and among firms. While the national unemployment rate remains at a relatively high level, rates in some regions are much lower and should be close to, possibly even below, their natural levels, driving up wage pressures in those regions. *Second*, in terms of inflation outcomes, social partners feel less responsible for inflation levels, as the costs of inflation are not completely borne by them, at least in the short term. Workers covered by catch-up clauses are sheltered from falls in real wages, and firms in sheltered sectors can increase prices to cover the wage increases. Firms in the traded-goods sectors, however, cannot easily raise prices to cover the extra costs of their inputs of both labour and non-tradable intermediates and thus become progressively less competitive.

Figure 2.9. **Energy prices have been the main driver of headline inflation**

Year-on-year percentage changes



Source: INE; OECD, Main Economic Indicators.

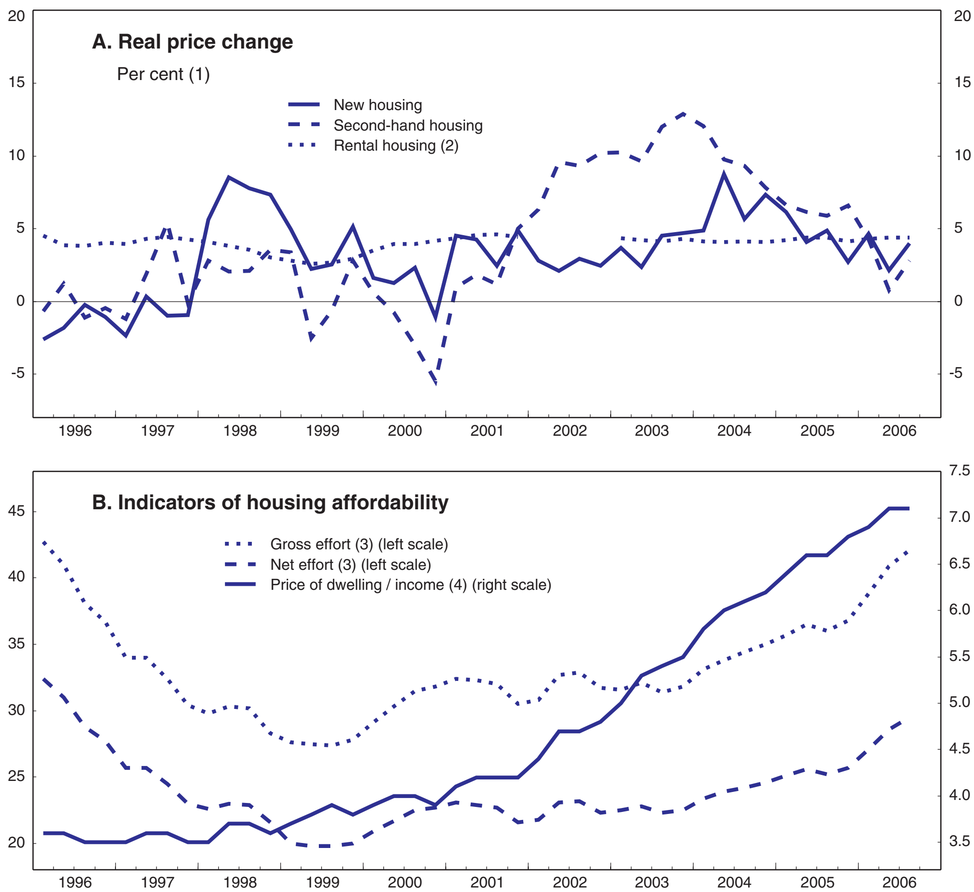
order to lower mark-ups, reduce costs and boost productivity. Efforts to reduce the energy intensity of production should also be redoubled, even though it may entail negative short-term consequences for inflation. The pricing rules applied to electricity suppliers should indeed be modified so as to allow power prices to reflect its cost of production in a more transparent manner. As a general rule, more flexible product markets would increase the resilience of the economy in the event of a future cyclical downturn requiring an adjustment in relative prices *vis-à-vis* the other euro area countries.

Enhanced capacity of the economy to adjust in the context of eventually weaker domestic and overall demand would also require a revision of the wage bargaining system. Although the government does not take part in the negotiations themselves, it is responsible for setting the general guidelines that govern such discussions and the sectoral and geographical coverage of the agreements (Bentolila and Jimeno, 2002). Currently, the widespread use of catch-up clauses and administrative extension of collective agreements is unsuited to EMU membership, since they do not guarantee increases in unit labour costs similar to those in the rest of the zone. These deficiencies might be partly reduced if wages were set taking into account wage behaviour in the country's main trading partners, as is currently done in Belgium. However, given the current framework, the best approach would seem to be to move the system towards greater decentralisation and flexibility. A feasible option for reform is to make the existing opt-out clauses that allow companies to break away from higher-level agreements less restrictive. This would allow agreements to better reflect firm and local conditions when setting wage levels and their composition while national and regional agreements should settle general working conditions like health and safety provisions. When the latter agreements deal with wage negotiations, their adoption at the firm level should be voluntary, allowing smaller firms to economise on bargaining costs, although the social partners do not seem eager to reform the bargaining system in any significant way. Structural reforms along these lines should be complemented with a prudent fiscal policy, as discussed above, as well as a better functioning housing market.

The housing market continues to surge

The still ongoing housing boom in Spain has been extremely impressive both in a historical and an international perspective. The current upswing has lasted, as of the end of 2006, for a full decade (Figure 2.10, Panel A), the longest upturn in more than 35 years (Girouard *et al.*, 2006). Compared with other countries, the real appreciation of almost 130% since 1996 is the third largest in the same period in the OECD area, behind only Ireland and the United Kingdom (Rae and van den Noord, 2006). Measures of the effort needed to purchase a home have also risen, but the burden remains at a comfortable level. For

Figure 2.10. **Housing prices and affordability indicators**



1. Change in the real price per square meter, using the housing investment deflator.
2. Data for 2002 is not available because of a break in the CPI series.
3. These indicators show the efforts (relative to annual income, gross and net of tax) required for the reimbursement of a 15-year mortgage, to finance 80% of the acquisition cost of a 93.5 sq.m. dwelling.
4. Number of annual incomes to afford a house.

Source: Banco de España, Summary Economic Indicators: 1.5 Housing Market Indicators.

instance, while over the last decade the number of annual incomes needed to afford a house has almost doubled to seven, thanks to the low after-tax interest rates an average household spends, on average, around 30% of its annual income on housing (Figure 2.10, Panel B). The home ownership rate continues to be the highest in the OECD area, at close to 82%, to the detriment of the private rental market, which accounts for barely 12% of total dwellings (see below). Residential construction, which has been healthy in recent years, with more than 4 million new buildings constructed in the last decade, has nonetheless not been robust enough to prevent prices from bounding ahead. As the number of housing units has increased, so have environmental concerns, as the consumption of water has increased dramatically in some regions such as coastal areas, straining Spain's available water resources.

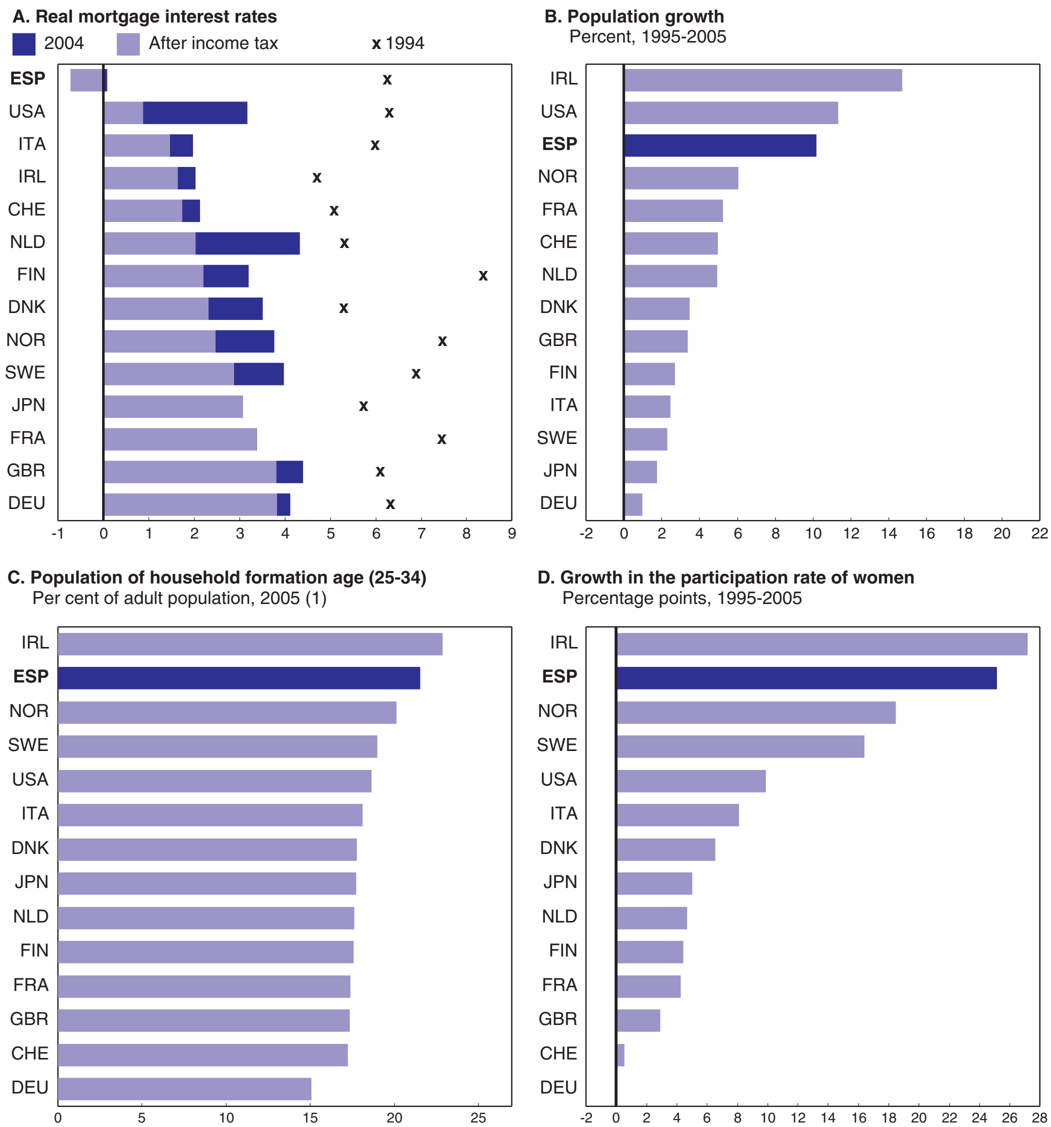
Housing demand has been stimulated both by fundamentals…

Several factors have boosted the demand for housing in recent years. *First*, the adoption of the euro lowered nominal interest rates, which, coupled with the country's relatively high inflation rate, has resulted in very low, and sometimes even negative, real interest rates. Tax incentives make the effective cost of funds even lower (Figure 2.11, Panel A); *Second,* immigration flows have swelled, raising population by more than 4 million in the last decade and driving population growth to one of the strongest rates in the OECD area, just below the increase in the United States, also a high immigration country (Figure 2.11, Panel B). *Third*, the baby boom came later in Spain than in most countries, so that the share of the population of household formation age is also among the highest in Europe (Figure 2.11, Panel C). *Fourth*, the steady increase in the participation rate of women in the labour market (Figure 2.11, Panel D) has raised the number of two-income households, boosting affordability. *Fifth*, the long period of economic growth has raised disposable income and allowed more households access to the housing market. *Sixth*, the downturn in the stock market between 2001 and 2002 might also have led to higher investment in alternative assets such as housing, although this effect is likely to have been less important in recent years. *Last*, demand from foreigners looking for a second home in a warmer climate has been strong, especially in coastal areas, although it has recently shown signs of slowing due to the dissuasive effects of cumulative price appreciation.

… and by a generous tax treatment of housing purchases

Demand is also underpinned by tax-induced distortions. Income tax relief is provided on the purchase of a principal residence, through the deduction of 15% of mortgage expenses (see Box 2.4) at a high budgetary cost that reached € 5 billion in 2003, close to 0.65% of GDP, and most regional governments also offer additional deductibility (Durán-Cabré and Esteller-Moré, 2006). The mortgage deduction has been effective in raising the home ownership rate, which, as already mentioned, is the highest in the OECD area. But tax incentives to housing purchases affect not only the decision to become an owner-occupier (versus renting) but also the quantity of housing households demand. There is evidence (Dominguez Martinez, 2004 and Figure 2.11, Panel D) that tax incentives have reduced the effective (after-tax) interest rates households face, while increasing the amount households can borrow (and hence the price they can afford). To the extent that supply has been relatively rigid, at least in the short term (see below), it is likely that the tax incentives have raised housing prices, distorting the share of overall investment taking the form of residential construction. The resulting wealth increase could also encourage

Figure 2.11. **Forces shaping housing demand**



1. The adult population comprises those aged 20 and over.

Source: OECD (2006), Labour Force Statistics and Girouard, Kennedy, van den Nord and André (2006), for Panel A.

households to spend more and reduce savings, helping to drive the current account balance into greater deficit. Public support of course could be justified by the positive spin-offs of higher home ownership.[16] However, no studies that quantify such externalities have been carried out for Spain, although studies for other countries have found that they are small or non-existent (Glaeser and Shapiro, 2002). Another justification could be that tax relief could promote greater equity if it were ultimately progressive in nature. But the redistributive effect is also questionable (OECD, 2005), in view of the fact that owners are generally more affluent than renters and that the tax deductibility of mortgage payments, while capped, is not means-tested.

Box 2.4. **The tax treatment of housing***

A number of taxes, deductions and subsidies affect both the demand for and the supply of housing in Spain. Overall, they have a relatively high budgetary cost, estimated to be close to 1% of GDP in 2004 (OECD, 2005). The main elements of the fiscal treatment of housing can be summarised in the following points:

- Income tax relief is offered on the purchase, building, rehabilitation or extension of a primary residence. Both principal and interest payments on a mortgage can be deducted, as can other items as well such as taxes, and other permit and licensing costs. In addition, the deduction can also be applied to deposits made into a dedicated savings account earmarked for housing purchases or to finance physical improvements to existing dwellings in order to make them accessible to handicapped people. The maximum amount that can be applied annually to the deduction is set at around € 9 000 (in the case of investments to accommodate handicapped people, this is raised to around € 12 000, and the deduction can be claimed only once). The general deduction rate is 15%, (10.05% is deducted from the central government share of the income tax and the remaining 4.95% is deducted from the regional government share; while regional governments can increase or reduce by up to half their deduction and introduce additional relieves, they have made little use of these possibilities so far). Thus, in practice, the maximum tax savings is slightly less than € 1 400 per year.
- In contrast, rent payments cannot be deducted from the personal income tax. Previously available, the deduction was eliminated in 1999 and currently only some regional communities offer a limited deduction under restrictive conditions (de los Llanos, 2006). The imputed rents of owner-occupiers from the primary residence are no longer taxed, while imputed rents from other real estate that is not offered for rent are taxed. This was removed from the base in 1999 for the sake of simplicity, since such income was difficult to estimate.
- The capital gains accruing from the sale of one's primary residence are exempted from the personal income tax if the total proceeds from the sale are reinvested in the acquisition of another primary residence or in the rehabilitation of a dwelling that will become the primary residence.
- Owners who offer residential dwellings for rent can exclude from taxable income 50 per cent of net rental income (100% if the tenant is younger than 35 years), which, coupled with the ability to also deduct a number of different expenses, in practice implies a tax rate close to zero for rental income. In the case of the corporate tax, the exclusion can be of up to 85%, provided the firm offers at least 10 dwellings for rent.
- As regards Corporate Tax, incomes of the Property Investment Funds are taxed at a reduced rate of 1%, provided that their sole object is the investment in urban real estate offered for rent. In addition, at least 50% of their assets must take the form of dwellings, halls of residence and homes for senior citizens.
- Owners of houses and land must also pay a wealth tax on their property, if its total amount, net of liabilities, exceeds an exemption threshold. This threshold is currently fixed at € 108 182 but can be modified by regional governments. Dwellings used as the principal residence of the taxpayer have a specific exemption threshold of € 150 253, so they are included in the tax base only if their value exceeds that amount. The wealth tax is progressive, with a rate rising from 0.2 to 2.5 % for assets with a net value above € 10.7 million, although regional governments can modify this rate.
- The purchase of a new residence faces a preferential value-added tax (VAT) rate of 7% (4% in the case of subsidized houses), as opposed to the general 16% general rate. It is important to note that this preferential rate is applied even if the buyer does not use the dwelling as a residence. In the case of the purchase of existing housing, a different tax, the Impuesto sobre transmisiones patrimoniales onerosas, is levied. Regional governments can decide the tax rate, and all of them have set it at 7% in order to put it at the same level as the VAT rate for new houses.

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Box 2.4. **The tax treatment of housing*** *(cont.)*

- Additional taxes accrued during the construction and sale process include the VAT on land and building material purchases, the tax on construction and taxes on the increases in the price of land. Other taxes levied on the buyer include the stamp tax (Impuesto sobre actos jurídicos documentados), whose rate is set by regional governments, almost all of them applying a rate of 1%; the tax on real estate holdings and the estate tax, in the case where a dwelling is inherited (though many regional governments are in practice exempting transfers between close relatives from this tax). Finally, the Housing Plan 2005-2008 includes assistance directed at increasing the availability of subsidised houses and incorporating unoccupied dwellings into the rental market, mainly through subsidies and financing at preferential rates, as well as subsidies to help disadvantaged groups (like the young and the less well off) access the housing market (see Annex 1.A1).

* Although they are not strictly considered taxes, under the current Land Law, which is undergoing a substantial revision, municipalities receive a maximum 10% of the land reclassified as developable, when it is subject to urban actions. The draft reform of the Land Law increases the range of this compulsory cession to a range between 5% and 15%, and in specific cases, to as much as 20%. It also sets aside 25% of the reclassified land that is subject to urban actions to be devoted to subsidised houses.

Restrictions have prevented housing supply from being more responsive

While the strong increase in demand has triggered a firm response in the supply of housing, it has not been enough to contain prices. In 2005, around 18 houses per 1 000 inhabitants were built, while the European average was less than six, and residential construction reached about 9% of GDP, the second highest in the EU, behind only Ireland. Both real construction costs and the price of building plots have increased considerably, especially in urban and coastal areas.[17] Local governments control the supply of building land and are currently entitled to receive 10% of the land that is rezoned for building purposes. This regulation, which is similar to a tax, is earmarked for the construction of subsidised housing, public spaces and other infrastructure. As municipalities can sell some of the land received, they have incentives to keep land prices high. On the other hand, as municipalities benefit directly from the rezoning of available land, they are more likely to approve new developments and resist the pressure from current owners to inhibit new construction (see Glaeser, Gyourko and Saks, 2005), in effect increasing the elasticity of housing supply. While the overall effect of these restrictions is uncertain, it is likely that they have increased the price of land. This has likely been reinforced by the length and complexity of local planning procedures necessary to build the required infrastructure (OECD, 2005).

It is increasingly unclear how long the housing boom can last…

It is becoming increasingly uncertain whether this upswing in prices can be sustained for much longer. Household indebtedness has continued growing, reaching more than 115% of disposable income in the second quarter of 2006, up from around 45% in 1996, increasing the vulnerability of households to further increases in interest rates. By November 2006, as the interest rate used as reference in almost all variable-rate mortgages rose for the fourteenth consecutive month, annual payments on an average mortgage had increased by slightly more than € 1 080 over that period. There is ample evidence to suggest that prices are overvalued, although it should be interpreted with the *caveat* that the estimations are fraught with uncertainties and qualifications. A review of econometric studies (Girouard *et al.*, 2006) suggests that Spain is one of the few countries (along with the

United Kingdom and Ireland) in which the evidence overwhelmingly points to overvaluation, which Ayuso and Restoy (2006) narrow down to between 24 and 32%. If prices were to reflect only fundamentals, they would have to fall from current levels, but, although the last year has seen some moderation in the rate of price appreciation, it is still running at slightly below 10% in annual terms. A recent study, van den Noord (2006), suggests that the longer prices increase, the greater the likelihood of a downward level correction.[18] Such an adjustment could occur in an orderly manner, during which price increases would gradually moderate and stabilise at a more prudent level. However, a more abrupt adjustment in which prices would plunge cannot be ruled out, and, compounding matters, it is possible that housing prices could remain undervalued for some years following the adjustment (Girouard *et al.*, 2006; Rae and van den Noord, 2006). However, this is not the most likely scenario at this time, which remains a soft landing of the housing market.

… and even a smooth adjustment could have significant costs

Even an orderly adjustment in prices could feed into the rest of the economy via four channels. *First*, it could affect the stability of the financial system. However, recent stress tests and scenario analysis performed by the IMF suggest that the banking system should be able to sustain the losses associated by a decrease in housing prices without systemic distress (IMF, 2006a and 2006b).[19] *Second*, the reduction in prices could produce household wealth effects, as households adjust their consumption and savings behaviour in response to the change in perceived wealth. Catte *et al., (*2004) found that such an effect would be relatively small for Spain, as opposed to other European countries with more developed financial markets which offer easier access to financial products that facilitate housing equity withdrawal. Bover (2005) estimates the elasticity of consumption to changes in housing wealth, which constitutes a larger share of total wealth than in other countries, to be around 0.02, a relatively low value in international comparison. Research by the Bank of Spain also suggests that households could cope with a rise in interest rates and a decrease in housing prices.[20] *Third*, as the profitability of residential investment decreases, the residential construction industry could suffer a downturn (Girouard *et al*., 2006). The adjustment could be substantial, as recent cases where housing bubbles have burst suggest that residential investment could decrease by between 2 and 3 percentage points of GDP;[21] were investment to return to its long-term average, it would decrease by almost 3 percentage points of GDP. Even a more moderate adjustment could be painful, as the sector has been one of the main drivers of the recent economic upsurge: the construction sector (including the non-residential sector) accounted for almost 14% of total employment and was responsible for around 44% of job creation in 2005. A reduction in the current high level of profits of construction companies, which has contributed to the strong performance of the stock market, could also feed back to private consumption via wealth effects. *Last*, government finances could suffer. As mentioned above, local and regional government are in charge of zoning regulation and derive a significant share of their revenues from real estate and building activities. A cooling in the construction sector could also affect the social security balance, as lower job creation would decrease contributions while increasing unemployment benefits (García-Cervero, 2006).

The rental market remains the thinnest in the EU

The downside to the high rate of home ownership has been a rental market (including both the private and social rental sectors) that remains the thinnest in the OECD area at

Table 2.6. **Housing tenure in the early 2000s**
Shares in per cent

	Owner-occupied	Private rented	Social rented	Others
Spain (2001 census)	**81**	**11**	**0**	**8**
Spain (2005)	**82**	**12**	**0**	**6**
Ireland	79	7	9	6
Italy	77	12	5	7
Portugal	76	15	7	2
United Kingdom	69	10	21	0
Belgium	68	23	7	2
United States	68	30	2	0
France	56	21	17	6
Sweden	46	21	18	15
Germany	41	44	6	5
Average	66	19	9	5
EU average	65	19	12	4

Source: OECD (2006), *OECD Employment Outlook* and Ministerio de Vivienda.

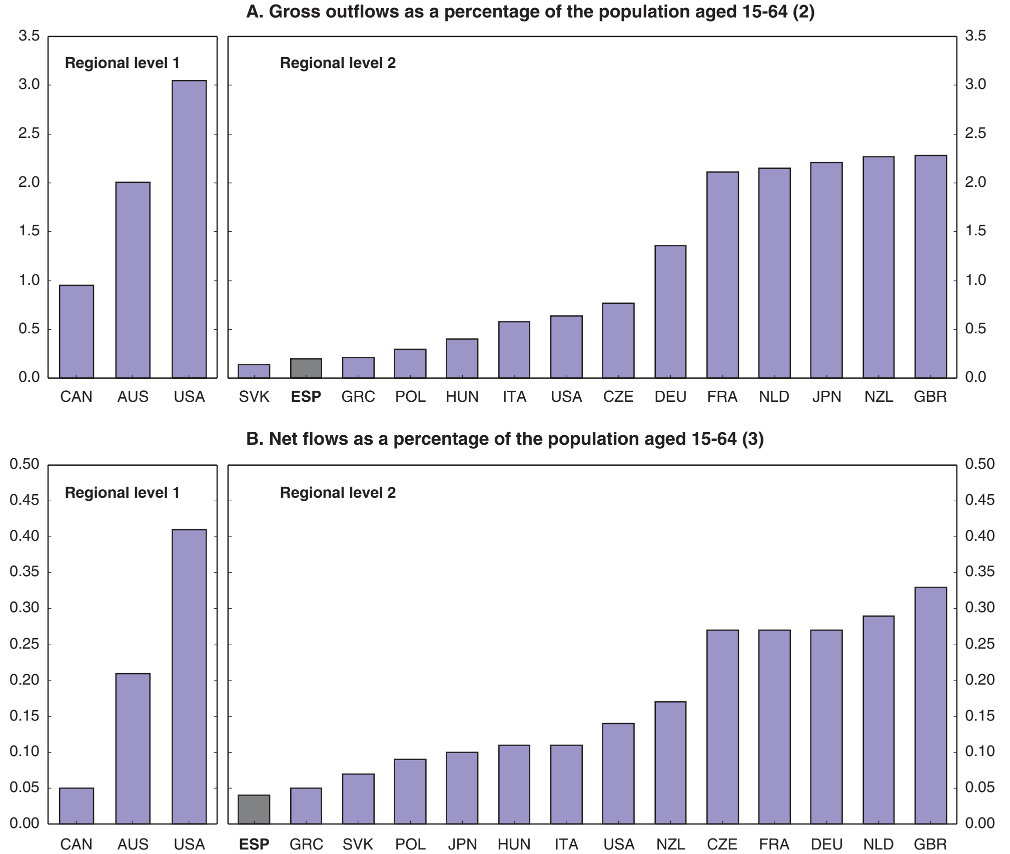
less than 12% of all dwellings in 2005, almost unchanged from the level in 2001, when it was about a third of the EU average (Table 2.6). Demand has been weak, mainly due to the fact that the favourable tax treatment and the low real interest rates have resulted in a low user cost of housing, making owning a favourable alternative to renting. Previous OECD surveys have shown that, as a (risk-neutral) investment strategy, house ownership dominates renting and investing the savings in the financial markets, mainly because of the effect of tax incentives. Thus, households favour house purchase instead of renting. The number of unoccupied houses, which the last census placed at more than 3.4 million in 2001 (around 16% of the housing stock), is extremely high and is likely to reflect both the low returns to renting and the expectations of continuing price increases (Artola and Montesinos, 2006). While some improvements have been made,[22] the lack of legal security for landlords remains one of the biggest handicaps to increasing the supply of rental accommodation, as the low levels of rent are perceived to barely offset the risks of damage to the premises by tenants and the high eviction costs. Spanish leases have a long duration, as they can be extended every year on the same terms (updating the rent only by the official inflation figure) up to a maximum duration of five years, when it is open for renegotiation. In a context of rapidly rising housing prices, this makes renting an even worse investment. Eviction appears to be difficult and costly, and the functioning of the courts in resolving flagrant abuses by tenants is regrettably slow (de los Llanos, 2006). The thinness of the rental market has also hindered regional mobility of workers, who find it more costly to move to take advantage of more attractive job opportunities in other parts of the country (Barcelo, 2006). Indeed, regional mobility is one of the lowest among OECD countries (Figure 2.12).

Policy has focused on increasing access by the young and the poor and promoting the rental market

Rising housing prices and the shallowness of the rental market have made it more difficult for the poor and the young to access the housing market. In response to this, housing policy has focused on addressing these sources of social tensions, while tackling the environmental issues created by the dramatic increase in the number of dwellings. Most of these measures are included in the Housing Plan for 2005-2008 (see Annex 2.A1).

Figure 2.12. **Internal migration rates**

2003[1]



1. 1999 for Netherlands; 2001 for Greece, Japan, New Zealand; 2002 for Austria, France and Italy.
2. Except for Australia and Italy for which the population of reference is the total population and for Japan for which the population of reference is the population aged more than five years.
3. Total net migration rate is calculated as the ratio of the sum of the absolute values of regional net flows divided by two, to the total population aged 15-64.

Source: OECD (2006), *Employment Outlook.*

On the supply side, subsidies and financing at preferential rates are available to build and renovate dwellings destined for the subsidised market. The new Land law, which is in the final stages of approval, will modify the compulsory land grant that municipalities receive when land is re-zoned for building purposes to a range between 5% and 15%, while making it more difficult for municipalities to sell the land. It also mandates that 25% of new housing developments must consist of subsidized houses. On the demand side, measures include providing assistance to the poor to facilitate the purchase of a house and a very slight scaling down of the mortgage deduction as part of the recent tax reform (see Chapter 3). Several measures have also been taken to foster the use of new types of mortgages, especially for elderly home owners, and the adoption of fixed-rate mortgages by reducing the fees and commissions households face when renegotiating their current mortgages. Around one-quarter of the total budget of the Housing Plan is devoted to stimulating the rental market. A public rental agency (*Sociedad Pública de Alquiler*) was created to act as an intermediary between tenants and landlords, with the goal of incorporating the large stock of unoccupied dwellings into the rental market. It has launched a new insurance policy that covers the risks to the landlord, and private institutions are following suit by offering similar products. The Housing Plan, which includes subsidies to help cover the cost of such insurance, supports this strategy. In the same direction, various types of subsidies are now available to the construction, acquisition and remodelling of buildings destined for the rental market. Assistance is also available for the young and less well-off to help them cover rent payments for eligible housing.

Structural reforms are needed to remove distortions in both the property and rental markets

Housing policy should focus on removing the obstacles to the efficient functioning of the rental and property markets. While some of the measures taken are moves in the right direction, there is ample room for improvement, as they are not likely to help steer the housing market towards a soft landing. Indeed, several of the measures are likely to increase prices and hinder the ability of supply to respond in a more nimble way to demand pressures. Assistance should be more concentrated on stimulating the provision of rental housing, as this would allow the authorities to provide temporary support to people who need it, reducing the overall cost of assistance. Phasing out the favourable tax treatment of housing purchases is likely to make renting a more favourable alternative, as distortions to the decision of renting versus owning would be eliminated. The overall effect of the compulsory grant of re-zoned land, soon to be raised to 15%, is unlikely to moderate housing price pressures, as it implicitly increases the tax on land. Restricting the municipalities' ability to sell part of the land should also reduce their incentives to facilitate new developments, in effect limiting the supply of building land. The resulting falloff in revenues to local governments should be compensated by increasing other sources of revenues that are likely to create fewer distortions (see Chapter 3). The requirement to devote 25% of new dwellings to subsidised housing is also likely to have mixed results. The supply of free-market housing is likely to decrease, raising prices in this segment of the market and pushing more people into the subsidised housing sector. Although there might be positive effects from having a more diverse composition in terms of income distribution, questions of equity might arise from the way that the subsidised dwellings are assigned. Finally, the 2003 reform intended to speed up the resolution of conflicts between tenants and landlords, via the creation of swifter court procedures, has not been fully implemented. In fact, the special offices that would pre-process the claims and hand them to a judge only for the final verdict, were not created, and the eviction process still take an average of a year.

The new rental agency aims at jump-starting the rental market by showing that renting is a viable alternative. However, it is not clear in a longer-term perspective what advantage a public entity has over a private one in carrying out this task. Indeed, there are already several local and regional private institutions that cater to this market and that have proven to be successful intermediaries without official intervention. The financial system should be able to provide the kind of insurance against damage by the tenants that the public rental agency offers. The functioning, and the goals, of the rental agency should therefore be evaluated in the medium term as the private rental market develops. Besides, in order to increase the depth of the rental market, public measures need to be more focused on increasing the total demand for rentals, in order to avoid the risk of generating deadweight losses. Otherwise, assistance is likely to translate into higher rental prices, rather than an increase in the number of rented dwellings. Enhancing the rental market would also help to increase mobility across regions, invigorating the labour market by broadening its scope. This would be especially useful in the current context of heavy immigration flows.

Box 2.5. **Policy recommendations to return to more sustainable growth**

Policies to narrow the inflation differential and facilitate more balanced growth

Tighten short-term fiscal policy

- In the absence of monetary settings appropriate for Spain's economy, ensure that fiscal policy remains as restrictive as it has turned out in recent years. In light of the good budgetary performance likely to be observed in 2006 and the continued strong growth of the economy, the authorities should aim to surpass the official targets for the surplus in 2007 and 2008. It would be desirable to base the spending cap on estimated potential GDP (adjusted for expected inflation). Regional governments should also adopt strict spending caps.
- When designing the fiscal strategy, keep using a prudent assessment of future macroeconomic conditions and incorporate the risks of a slowdown in potential growth in the medium term.
- Further investigate the reasons behind the large tax elasticity observed in recent years.

Improve the functioning of the housing market

- Phase out the deductibility of mortgage payments. in order to decrease its budgetary cost and allow better targeting.
- Improve the legal security in the landlord-tenant relationship.
- In the medium- and long-term, evaluate the need for the public rental agency, in light of the evolution of the private rental market. Reassess the existing rent assistance programmes and concentrate them on increasing the total demand for rentals.

Remove barriers to competition in some sheltered sectors (see Chapter 5)

Policies to increase the resilience of the economy

- In addition to further strengthening competition in some sheltered sectors, reform the collective bargaining system so as to allow wages to better reflect conditions at the firm level. This could be achieved by allowing firms to opt out of regional and/or sectoral wage-bargaining outcomes.
- Increase incentives to reduce the energy content of production so as to decrease the vulnerability to further oil price increases, in particular through a revision in electricity-sector regulation (see Chapters 1 and 5).

Notes

1. This might, however, reflect only a temporary increase in permits as builders anticipate the tighter restrictions in the new building code, which will come into effect in 2007.
2. The increase in the number of foreigners who own a summer house in Spain might create distortions in the tourism balance, as consumption by these households is recorded as domestic spending, although it should in fact be measured as exports.
3. One way to illustrate the monetary policy stance is to compare actual interest rates in the euro area to the interest rate that would be consistent with a neutral stance, estimated through a Taylor

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rule. Such a rule relates the deviations of the interest rate from its equilibrium value to deviations in inflation rate and output from their equilibrium values. Using the Taylor rule estimated for the euro area by Hoeller *et al.* (2004), short-term interest rates in Spain should be around 350 basis points higher than the average level of actual interest rates in the third quarter of 2006.

4. After accounting for the additional extraordinary spending, the structural surplus was only around 0.3% of GDP (OECD, 2005).
5. The government has successfully used a two-step budgeting process. Early in the year, it announces the ceiling for central government expenditures, based on macroeconomic figures. Once this is announced, the budget is then allocated to the different spending categories, allowing the government to better contain spending pressures.
6. The breakdown of the overall surplus by level of administration for 2007 is as follows. The objective for social security is a surplus of 0.7% of GDP, while the central government's surplus target of 0.2% will offset the allowed deficits of the regional and local communities of 0.1% of GDP each.
7. A new Stability Programme Update will be released in late December 2006, and it is likely that some of these figures will be updated. In particular, given that the surplus in 2006 will be around 1.4% of GDP, it is highly likely that the authorities revise upwards their objective for 2007 and 2008. The 2007 budget had already announced a slightly higher target of 0.8% of GDP.
8. This projection was estimated on the basis of an euro/dollar exchange rate of 1.27 and an oil price decreasing from $ 69.7 in 2006 Q3 to $ 60 in 2006 Q4, and staying at $ 60 through 2007 and 2008.
9. The projections are consistent with INE's own immigration and demographic projections.
10. The most recent OECD projections assumed that ECB interest rates would increase by around 30 basis points in the second half of 2006 and a further 50 basis points through 2007.
11. Estimates in Cubero and Félix (2006), for example, suggest that around 50% of the inflation differential can be explained by the stronger growth of domestic demand in Spain relative to the euro area.
12. Estimates of potential growth should be interpreted with caution, as there are a number of methodological issues raised. OECD estimates used here are, however, close to consensus figures. An additional caveat to have in mind when trying to measure demand pressures by the output gap is the fact that such pressures can be met with imports, as has been the case in Spain with the widening of the trade deficit in recent years.
13. Furthermore, Beck *et al.* (2006) find that euro area-wide factors (oil prices and interest and exchange rates) explain more of the variation in inflation in almost all regions in Spain than elsewhere in the euro area. This suggests that structural factors are the most important determinant of inflation pressures and not national or regional excess demand.
14. By the third quarter of 2006, the three regions with the lowest unemployment rates were Navarra (4.8%), Baleares (4.8%) and Aragón (5.2%), while the regions with the highest unemployment rates were Extremadura (11.3%), Canarias (11.8%) and Andalucía (12.5%). The national unemployment rate stood at 8¼ per cent. The high regional variance of unemployment is likely to be at least partly due to the thinness of the rental market (Barcelo, 2006).
15. Of course, the reverse is also true, as decreases in the price of oil translate into a lower inflation differential, as happened in September and October 2006, following the decrease in oil prices.
16. Among the positive externalities to housing ownership are aesthetic amenities that benefit both neighbours and passers-by and improvement in children's education and general well being (see Glaeser and Shapiro, 2002) as people invest more in the upkeep and maintenance of their dwellings.
17. In 2005, the average increase in the price of land was 8.1%. The highest increases were in the coastal regions of Valencia and Cantabria, while in one other coastal and two inland regions (Galicia, Asturias and La Rioja, respectively) prices decreased.
18. The estimates in van den Noord (2006) and updated in OECD (2006) suggest that an increase in the mortgage interest rate of 100 (200) basis points in Spain would raise the probability of housing having reached a peak to 5% (9%), up from 2%, the baseline figure as of the second quarter of 2006. If the same increase in interest rates was accompanied by an increase in prices at the same rate as in the four previous quarters, around 11%, the probability would rise to 8 and 13%.
19. The IMF simulations involved a cumulative decrease over a three-year window from 2004 levels of 30% in housing prices in real terms. Under this scenario, GDP growth would decrease by

0.8 percentage points relative to the baseline value, and the ratio of household debt to gross disposable income would decrease by 6.8 percentage points.

20. In the Bank of Spain simulations, a cumulative rise over three years in short- and long-term interest rates of 65 and 150 basis points, respectively, and with no correction in nominal prices would lead to a decrease of 1.1% of private consumption, a decrease in the debt-to-gross-disposable-income ratio of households of 4.7 percentage points and a decrease in GDP of 0.8% in the third year of adjustment. If the same rise in interest rates were accompanied by a decrease in prices of around 11.5% by the third year, the effect on private consumption, the debt burden of households and GDP would be –1.8%, –5.9 percentage points, and –1.2%, respectively.
21. For instance, in the case of Germany, residential investment dropped from 7.6% of GDP in 1994 to 5.4% in 2005, while in Japan it shrank from 6.3% of GDP in 1988 to 3.4% in 2005. These figures are only meant to be suggestive of the size of a hypothetical downturn in the sector.
22. The improvement came as a result of the recent adoption of the Programa de Alquiler Garantizado by the main sectorial associations. A new protection mechanism will be offered in cooperation with private insurance companies through which landlords are guaranteed to receive their rent payments. This has been promoted in the same spirit as the policy also offered by the Sociedad Públic de Alquiler,.

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ANNEX 2.A1

The main characteristics of housing policy

A new Housing Plan for the period 2005-08 was drawn up, which almost doubles the assistance budget to around € 7 billion over the period and aims to increase the number of subsidised houses by 83 000 each year. In order to increase the attractiveness of building subsidised housing, which has decreased as the free-market prices have soared, their prices were allowed to increase, albeit by a modest 3%, in July 2005. Subsidies and financing at subsidised rates are also available to build and renovate dwellings destined for the subsidised market. Measures affecting demand include providing subsidies to the poor to facilitate the purchase of a house and a very slight scaling down of the mortgage deduction as part of the recent tax reform (see Chapter 3). Loans for up to 80% of the total price are available at favourable rates, as subsidies range from € 40 to € 82 per € 10 000 loaned. Additionally, a subsidy of up to € 11 000 to cover the down payment is available. Several measures have also been taken to foster the use of new types of mortgages, especially for elderly home owners, and the adoption of fixed-rate mortgages by reducing the fees and commissions households face when renegotiating their current mortgages.

The new Land law, which is in the final stages of the legislative process, will modify the maximum compulsory land grant that municipalities receive when land is re-zoned for building purposes to a range between 5-15% and also mandates that 25% of new housing developments must consist of rent-controlled housing. Conditions to sell re-zoned land are now more restrictive, as municipalities will be able to sell land only to developers of subsidised housing. A new building code was also approved that updates safety, environmental and other regulations, which, according to official estimates, will translate into a relatively modest 1% increase in housing prices, starting in 2007 when it will take effect. Also, and as part of the authorities' strategy to reduce the economy-wide use of temporary workers and increase worker safety, the use of subcontractors will be regulated more closely, which could also affect construction companies' productivity and hence building prices.

As for the rental market, measures include the creation of a public rental agency at the end of 2005 to act as an intermediary between tenants and landlords and, above all, integrate the large stock of unoccupied dwellings into the rental market. The agency offers a stable stream of income, usually around 80% of market rent, to the landlord, absorbing the risk associated with both damage to the units by tenants and having the apartment unoccupied. It also maintains a central listing of available apartments which potential renters can access. With an initial capitalisation of € 20 million, by mid 2006 it managed around 1 000 apartments, meeting the initial goal, with the aim of reaching 25 000 units in four years, or 1.5% of the current rental market.

In order to incorporate the large stock of unoccupied dwellings various types of subsidies are now available to the building, acquisition and/or remodelling of dwellings destined for the rental market. Developers can choose the time the units are to be maintained in the subsidised market, either 10 or 25 years, although they can be sold under special circumstances. Subsidies of up to € 6 000 are also available for the purchase of insurance against damages to the property and the risk of non-payment. Rents are calculated as a percentage of the maximum price of equivalent subsidised housing for sale. The demand for rental housing will be stimulated through subsidies provided to people below 35 and with annual earnings under € 16 000 to help cover rent payments for eligible housing up to a maximum of two years. Assistance is granted to cover 40% of annual rent payments, up to a maximum of € 2 800.

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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Spain were reviewed by the Committee on 30 November 2006. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 13 December 2006. The cut-off date for information used in the preparation of this Survey is 21 December 2006.

The Secretariat's draft report was prepared for the Committee by Claude Giorno and Eduardo Camero under the supervision of Peter Jarrett.

The previous Survey of Spain was issued in April 2005.

BASIC STATISTICS OF SPAIN (2005)

THE LAND

Area (1 000 km^2)	
Total	506.0
Cultivated (1999)	183.0
Major cities (thousand inhabitants)	
Madrid	3 155
Barcelona	1 593
Valencia	796
Seville	704

THE PEOPLE

In thousands	
Population	43 398
Net natural increase	79
Net migration (2002)	460
Number of inhabitants per km^2)	85.8
Employment (thousands)	18 973
Employment by sector (% of total)	
Agriculture	5.3
Industry	17.3
Construction	12.4
Services	65.0

PRODUCTION

Gross domestic product (GDP)	
Million €	905 455
Per head in $	25 964
Gross fixed capital investment	
% of GDP	29.3
Per head in $	7 610

THE GOVERNMENT

% of GDP	
Consumption	18.0
Revenue	38.6
Surplus	1.1
Fixed investment	
(% of gross fixed capital formation)	12.1
Composition of Parliament (seats in March 2004)	350
Spanish Labour Socialist Party (PSOE)	164
Popular Party (PP)	148
Convergence and Union (CIU)	10
Republican Left of Cataluña (ERC)	8
Basque Nationalist Party (PNV)	7
United Left (IU)	5
Other	8
Next general elections: March 2008	

FOREIGN TRADE

Exports of goods and services (% of GDP)	25.5
Exports as a % of total goods exports	
Foodstuffs	12.1
Other consumer goods	26.8
Energy	3.4
Other intermediate goods	48.1
Capital goods	9.6
Imports of goods and services (% of GDP)	30.9
Imports as a % of total goods imports	
Foodstuffs	6.1
Other consumer goods	23.0
Energy	14.1
Other intermediate goods	45.4
Capital goods	11.5

THE CURRENCY

Monetary unit: Euro	
Currency units per $, average of daily figures	
Year 2006	0.797
December 2006	0.758

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