

Risks to rising consumer expenditure in Spain

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Spain's economy has been boosted in recent years by low eurozone interest rates, the construction boom, employment and immigration, which has in turn led to a rise in wages and consumer expenditure. The latter has been fuelled by lower unemployment, high property prices and increased borrowing. Given rises in interest rates across the eurozone since August 2006 coupled with falling house prices, it is questionable whether the consumer boom can continue for much longer in Spain. IssueThe Spanish economy had relatively strong real GDP growth of 3.9% for 2006, compared to the eurozone growth of 2.7%. Latest provisional figures have shown strong growth of 4.0% year-on-year in Q2 2007. The 2006 figure marks the 13th consecutive year of growth in Spain; Spain's consumer expenditure stood at €584.3 billion in 2006, an increase of 3.5% in real terms from a year earlier;

Â Spain consumer expenditure and GDP change in real terms: 1999-2006Source: Euromonitor International from National StatisticsAlthough the rate of growth has slowed since 2004, consumer expenditure has been growing at a steady rate since 2002, boosted by the low eurozone interest rate environment, which remained at 2.0% from June 2003 to December 2005, when a rise of 0.25 percentage points signalled the beginning of the ascent;The rise in consumer expenditure has had a positive effect on the business environment, particularly sectors like retailing and the services industry, which have benefited from increased disposable incomes. Annual disposable income per capita amounted to €11,419 in 2006.Importance

The importance of consumer expenditure to the Spanish economy is illustrated by the fact that it accounted for 60% of GDP in 2006: Unemployment has come down from a relatively high 11.1% in 2002 to 8.5% in 2006. The tightening of the labour market has had a positive impact on wage growth;

Â Unemployment rate in Spain, France and Germany: 2001-2006Source: EurostatSpanish disposable incomes have also benefited from an increase in loan growth, rising by 20% per annum since 2004;Spain has benefited from the low eurozone interest rate environment, in which the European Central Bank had been keeping interest rates in check to help ailing economies such as Germany, Italy and France. However this trend reversed in August 2006;A lower savings rate has also had a beneficial effect on consumption. The saving ratio (household savings as a percentage of disposable income) dropped to 10.1% in 2006 from 10.6% in 2005 and 16.6% in 1996;Spain has been experiencing a property price boom, which has had a positive wealth effect on the psyche of consumers. With increased equity, consumers have been feeling richer and able to spend money more freely;Businesses have gained from a steady growth in consumer expenditure. However, a slowdown in the rate of consumption, resulting from higher interest rates and lower property prices, could have an adverse effect on consumer orientated businesses.Implications

A number of factors will have considerable influence on the trajectory of consumer expenditure in Spain going forward:The strong performance of the labour market in Spain has bolstered household consumption and its continued strength is key for propping up the consumer, who feels more stable in respect of future employment prospects;However, Spain suffers from poor competitiveness compared to its Western European counterparts, owing to lower productivity and an inflexible labour market. Spain cannot be counted as a low cost producer anymore, particularly in the face of competition from the Far East. It ranked 28th out of 125 in the World Economic Forum's Global Competitiveness index 2006, the worst ranking for a large Western European country in the top 50 bar Portugal and Greece. This could impact businesses and FDI inflows negatively in the future, thus, affecting economic growth;Household debt was high at 110% of disposable income in 2006. Although loans have boosted consumer spending, rising consumer debt poses a risk to future consumer expenditure prospects, especially in the light of increasing interest rates;House prices increased at a rate of 7.2% in Q1 2007, their lowest growth in eight years. House prices had been growing at an average rate of 13.4% annually between 1995 and 2006. Any decline in the property market will have a detrimental effect on the wealth of the Spanish consumer.

A continuation of a healthy labour market coupled with wage growth will buoy consumption and bode well for business activity. However, if consumers feel a credit crunch through excess borrowing, lower house prices and higher interest rates, this will adversely affect their spending power, which will impact businesses negatively.Future Scenarios

Higher eurozone interest rates will have a negative impact on future consumption patterns across the region, including Spain, particularly given the high rate of loan growth in recent years. The ECB raised interest rates to 4.0% in June 2007.

Spain's economy is estimated to grow at a more modest rate of 3.6% in 2007and 3.4% in 2008. Slower growth is likely to be affected by slower consumer spending, which is predicted to grow by 3.3% in 2007 in real terms, down from 3.5% in 2006.

Spain introduced reforms to its personal income tax in January 2007 including the maximum marginal rate being reduced by two percentage points to 43% and the minimum marginal tax rate going from 24% to 15%. All saving related income will be taxed at a flat rate of 18% instead of 15%. This should have a positive effect on consumer spending in the long term.

However, other factors such as high interest rates and falling property prices could put an end to the steady consumer spending and the general strength of the Spanish economy.

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