The Spanish economy: Recent developments and outlook for 2012-2013

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Economic conditions to remain negative, but situation may start to stabilise in the last quarter of 2013.

The Spanish economy has moved into a new stage in the economic downturn since the crisis began in 2007. In our opinion, the factors depressing domestic demand will persist, but financial constraints are proving decisive in the current relapse. For 2012, we expect a drop in GDP of 1.4% for the year as a whole –a slight improvement on our earlier forecasts– as a result of GDP being better than expected in the third quarter. For 2013, we estimate that the factors underlying the current contraction of the Spanish economy –limited finance, uncertainty, fiscal adjustments, internal devaluation, and deleveraging, among others– will persist. Conditions will therefore remain highly negative, even assuming no critical events occur in the context of the European debt crisis, and that the current situation of restricted finance eases in the second half of the year. We expect the situation may start to stabilise in the last quarter of 2013 and our forecast change in GDP for 2013 as a whole is -1.6%, two tenths higher than the previous forecast.

Introduction

The European sovereign-debt crisis, which began in early 2010, took a turn for the worse in the summer of 2011, dragging Europe's economy as a whole, and Spain's in particular, back into recession. By 2012 this slowdown had spread to the global economy. Neither the series of European summits held since the outbreak of the crisis, nor the extraordinary liquidity provision measures taken by the European Central Bank (ECB) have served to contain the crisis. At best, they have merely served to provide some breathing room.

In September, more than a year after the crisis entered this new phase, the European Central Bank announced a plan of action that could put an end to the tensions. However, its effect will not be immediate, and even if nothing derails the process, it will take time for investors to gradually regain their confidence, for financial markets to return to normal, and for credit to start to flow again.

Thus, the credit squeeze and general lack of access to finance affecting the Spanish economy will not be remedied in the immediate future. Conditions will stay negative for the rest of the

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year, and for at least the first half of next year, and uncertainty will remain high.

Recent developments in the Spanish economy

The Spanish economy has moved into a new stage in the economic downturn that has dragged on since the crisis began in 2007. Although the factors depressing domestic demand persist, ruling out any recovery in the short term, it is the financial constraints that are proving decisive in the current relapse. Thus, in the third quarter of 2011 the economy was driven back into recession by the credit squeeze triggered by the worsening of the European debt crisis and the climate of uncertainty and mistrust, which led to a complete freeze on financing from abroad. The economy's difficulty in obtaining funding from international markets was evident in the net negative flows that began to appear on the financial account of the balance of payments in July 2011 (excluding the Bank of Spain's operations). Between July and December these totalled the equivalent of approximately 18% of the period's GDP.

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The tensions eased somewhat in the first few months of 2012 thanks to abundant liquidity from the European Central Bank. But this did nothing to address the causes of the crisis, so the financial deficit continued to grow, and the debt market came under renewed pressure in March. After the government was forced to announce the nationalisation of one of the country's leading financial institutions, the risk premium began to climb again, reaching over 500 basis points (bp) in the case of ten-year sovereign debt, rising as high as 600 bp at times in July. The net outflows recorded on the financial account of the balance of payments in the first half of the year came to 220 billion, equivalent to 41.6% of GDP for the period.

In June the Spanish government requested financial assistance from the European Union to help it undertake the consolidation of the part of the country's financial system that was unable to do so by itself – accounting for approximately 40% of the sector. Although this was a big step forward, the markets reacted negatively. The tensions in the debt market worsened. At the end of July, the president of the European Central Bank announced the institution's intention to do whatever it takes to save the euro. In early September, the ECB spelled out a more concrete plan of action, consisting of purchasing government debt of countries in financial difficulties, provided that they formally request financial assistance from the Eurogroup.

Against this backdrop, GDP contracted by 1.1% in the third quarter of 2012 compared to the preceding quarter (at a year-on-year rate, as is the case for all the GDP aggregates indicated below). This was the fifth consecutive quarter of negative GDP growth, although the decline had moderated from the -1.7% recorded in the previous quarter. The softening of the quarterly decline was the consequence of domestic demand's making a slightly less negative contribution to growth, -4.2 percentage points. The contribution of the external balance was slightly smaller than in the preceding quarter, at 3.1 pp. despite the surge in exports, which was offset by equally strong import growth.

The transfer of purchases from the fourth quarter of the year to the third to avoid the VAT increase offset the drop in private consumption, limiting it to -2.0%. This effect was observable in most consumer indicators. The limited indicators available for October –new vehicle registrations, manufacturers' orders for consumer goods and confidence– show stabilisation at very low levels after the sharp downturn in September (Exhibits

1.1 and 1.2). The drop in public consumption, on the other hand, accelerated notably, falling by 9.1%.

Investments in capital goods and other goods recovered slightly from the previous quarter, although the trend remains negative, with sharp drops in the preceding quarters. This recovery is probably also linked to the bringing forward of purchases caused by the VAT increase. The indicators have not changed their downward path, so it is more than likely that this variable will return to the downward trend in the fourth quarter (Exhibits 1.3 and 1.4).

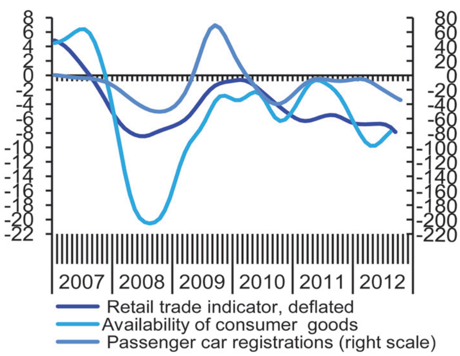
As regards **gross fixed capital formation in construction,** the adjustment in the other structures component, which largely reflects changes in public investment, was again more pronounced than in the case of housing (-15.1% compared with -6.3%). Official tendering for public works fell by 47% in the first six months of the year, compared to the same period the previous year, while housing permits declined by 36.8% to August, and there were 27% fewer housing starts than in the first quarter of 2011 (Chart 2.6). There was a slight upturn in housing sales over the summer, but this does not mean that the property market has bottomed out. Nor does

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption Indicators (I)

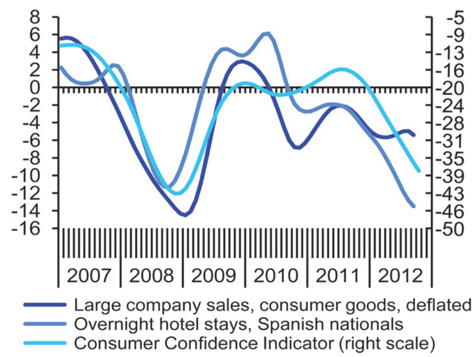
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, INE, DGT and Funcas.

1.2 - Consumption Indicators (II)

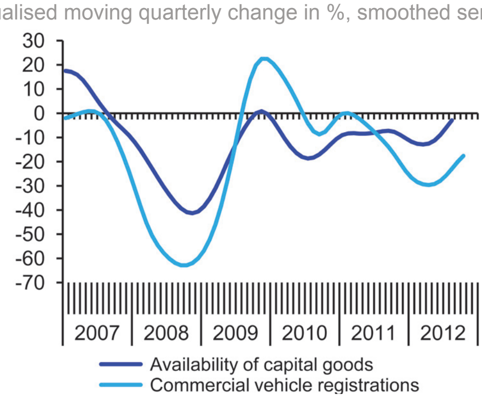
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and Funcas.

1.3 - Capital goods GFCF indicators (I)

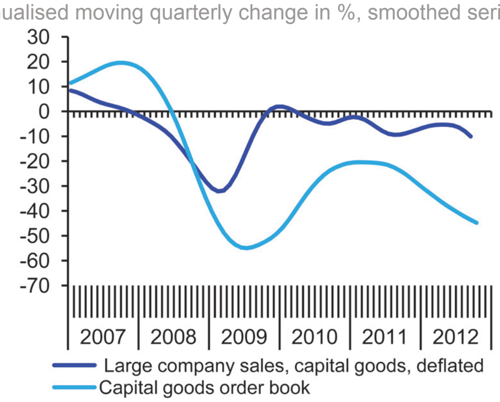
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy, DGT and Funcas.

1.4 - Capital goods GFCF indicators (II)

Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Industry, AEAT and Funcas.

it imply a change of trend, as it simply reflects the way purchases have been brought forward ahead of the tax changes announced for January 2013.

Exports grew strongly in the third quarter, expanding by 20.8%. Growth was strong in the case of both goods and services, with the strong performance of non-tourism services standing out in the case of the latter. The positive effect of exports was offset, however, by equally strong growth in **imports,** which rose by 10%. The net contribution of the external sector to growth was slightly lower even than in the previous quarter.

Primary sector GVA grew by 3.2%. This is the sector, which has performed best since the start of the crisis, and the only one to show a clear growth trend in recent years, largely driven by sales abroad. In the case of **industry,** which has been in recession since the second quarter of 2011. GVA contracted by 4% in the third quarter, a more pronounced drop than in previous quarters. This contrasts with the relatively good results shown by indicators such as the industrial production index, sales by large capital goods manufacturers, or PMI, which instead suggest a stabilisation of activity, thanks to the increase in sales resulting from purchases being brought forward to avoid the VAT increase, and the strong performance of exports. The available indicators (PMI and industrial confidence index) showed a slight deterioration at the start of the third quarter, (Exhibits 2.1 and 2.2).

Services grew by 1.4% on aggregate. Public administration, health and education continued their downward trend, while other services increased their GVA. However, contrary to what might be expected given the rise in foreign tourism, this growth did not come from the branches most closely associated with it. The signs at the start of the fourth quarter were contradictory, as on the one hand in October the PMI worsened against its average for the third quarter, but on the other, the sector's confidence has improved somewhat. The number of affiliates of the Social Security system in September and October continued to fall at a similar rate to that in previous quarters, (Exhibits 2.3 and 2.4).

GVA in **construction** shrank by 12.8% in the third quarter. The decline in new housing permits accelerated, heralding a prolongation of the strongly negative trend in residential construction. Nor are there signs of improvement in the sector's confidence index or in the change in the number of affiliates of the Social Security system between September and October (Charts 2.5 and 2.6).

Employment dropped by 3.1% in the third quarter, the slowest rate of decline since the current recession began in the third quarter of 2011. Farming was the only major sector to experience an increase in employment. Seasonally-adjusted unemployment rose by almost one percentage point to 25.6%. The trend towards a moderate reduction in the working age population continued in the third quarter, due primarily to immigrants returning to their countries of origin. The number of foreigners in the labour force has fallen by 7.2% (approximately 265.000 people) over the last three years. According to the Social Security affiliation figures, employment continued to fall in September and October at the same rapid rate as in previous months. Unemployment has also been rising (Exhibits 3.1 and 3.4).

Productivity continued to rise rapidly in the third quarter, outpacing compensation per employee, such that unit labour costs remained on the downward trend they have followed since the start of the crisis, with a year-on-year drop of 3.0%.

The **inflation** rate has moved upwards since July, rising to 3.5% in October. This trend does not reflect underlying inflationary pressures, but is the result of rising energy prices, on the one hand, and regulatory and tax changes, such as the change in system of payments for medicines, increased university fees, and the VAT increase, on the other (Exhibits 4.1 and 4.2).

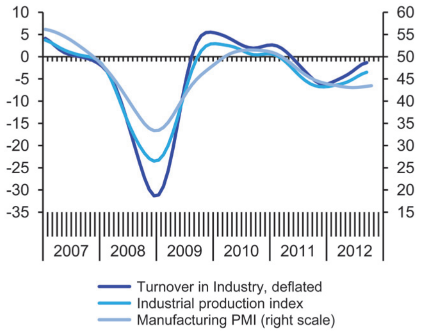
Between January and September, the government deficit, in national accounts terms, rose by 22.6%

Exhibit 2

Industrial activity, services and construction indicators

2.1 - Industrial sector indicators (I)

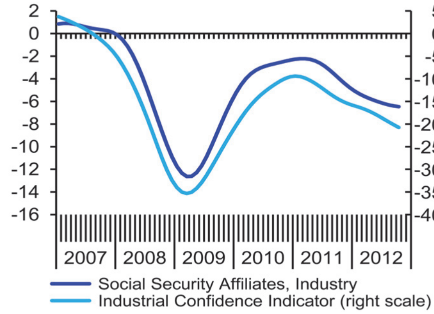
Annualised moving quarterly change in % and index, smoothed series



Sources: INE, Markit Economics Ltd and Funcas.

2.2 - Industrial sector indicators (II)

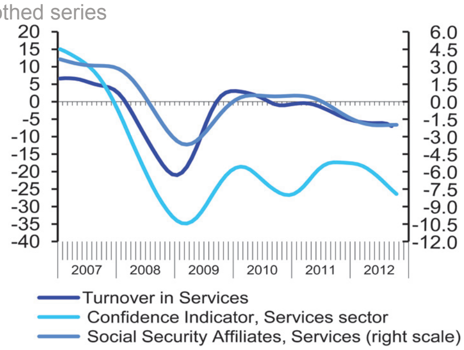
Annualised moving quarterly change in % and index. smoothed series



Sources: European Commission, Ministry of Labour and Funcas.

2.3 - Services indicators (I)

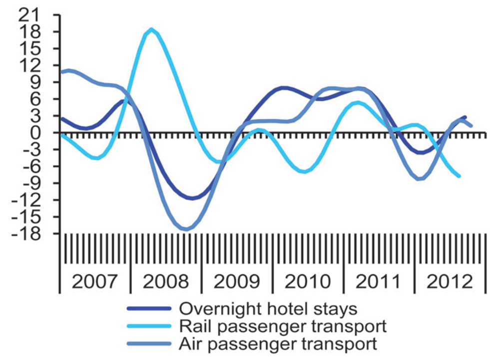
Annualised moving quarterly change in % and index. smoothed series



Sources: European Commission, Ministry of Labour, INE and Funcas.

2.4 - Services indicators (II)

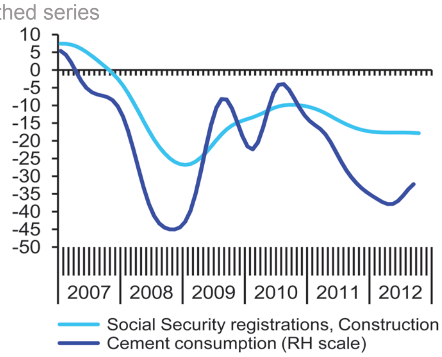
Annualised moving quarterly change in %. smoothed series



Sources: INE, AENA, RENFE and Funcas.

2.5 - Construction sector indicators (I)

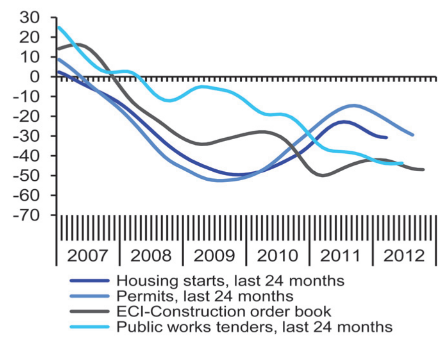
Annualised moving quarterly change in % (Q 3/3). smoothed series



Sources: Ministry of Labour, OFICEMEN and Funcas.

2.6 - Construction sector indicators (II)

Annualised moving quarterly change in % (Q 3/3) and index. smoothed series



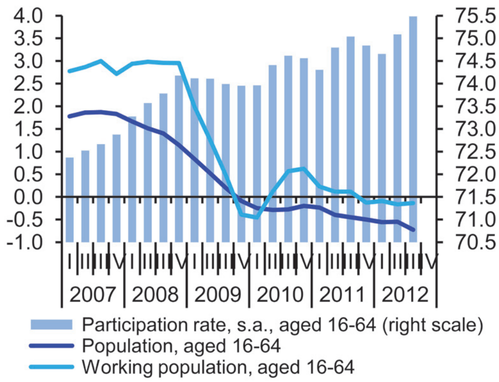
Sources: Ministry of Industry, Ministry of Fomento and Funcas.

Exhibit 3

Labour market indicators

3.1 - Labour supply

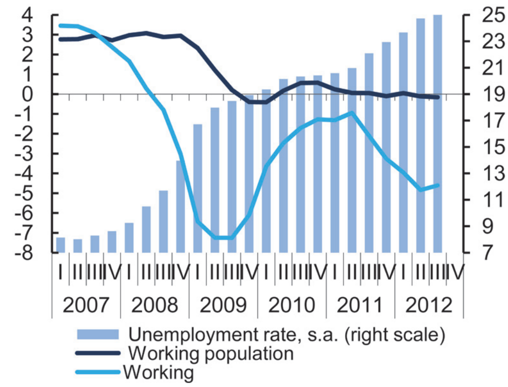
Change y-o-y in % and percentage of population aged 16-64



Source: INE (LFS).

3.2 - Employment and unemployment (LFS)

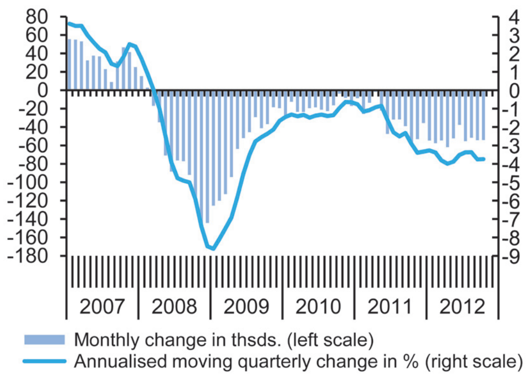
Change y-o-y in % and percentage of working age population



Source: INE (LFS).

3.3 - Social Security Affiliates

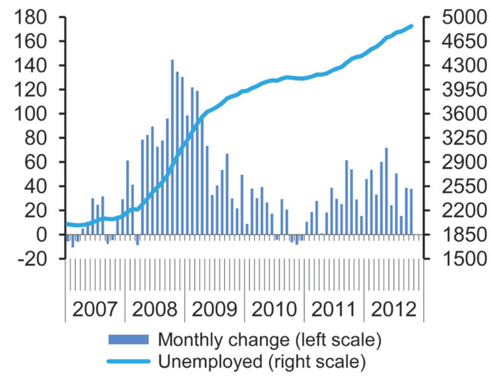
Change in thousands and in %, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

3.4 - Registered unemployment

Thousands, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

on the same period versus the previous year, equivalent to 4.4% of annual GDP, very close to the target for the year of 4.5%. Revenue is performing worse than forecast, which is making meeting the deficit targets harder. However, revenues will tend to improve over the remainder of the year, as a result of the measures taken by the government in late July, such as the VAT increase. In the case of the **Social Security** system, there has been a significant deviation from the forecast income from social security contributions, which fell by 2.5% in the first nine months, and in pension spending,

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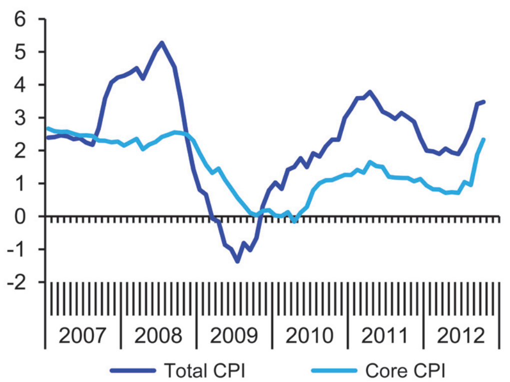
which grew by 4.2%. Spending on unemployment benefits is also performing worse than expected.

Exhibit 4

Price indicators

4.1 - Consumer Prices Index

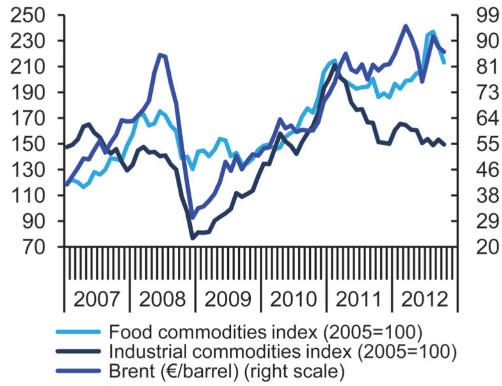
Change y-o-y in %



Source: INE (CPI).

4.2 - Commodities prices in €

Euros and index



Sources: Ministry of Economy and The Economist.

The deficit of the **Autonomous Regions** stood at 0.8% in the first half of the year.

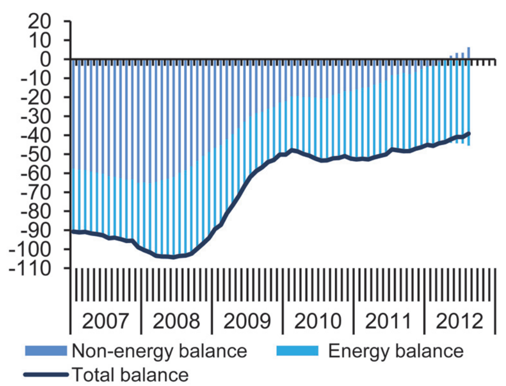
The **trade deficit** continued its correction for the first eight months of the year. According to Customs figures, the merchandise trade balance, excluding energy trade, has been in surplus since the start of the year. And according to the balance of payments figures, the cumulative surplus on the services balance from January to August –on a sustained upward trend– completely offset the goods balance deficit, producing a slight surplus on the balance of goods and services, something which has not happened since 1998 (Exhibit 5.1).

Exhibit 5

External sector

5.1 - Surplus/deficit on trade in goods (Customs)

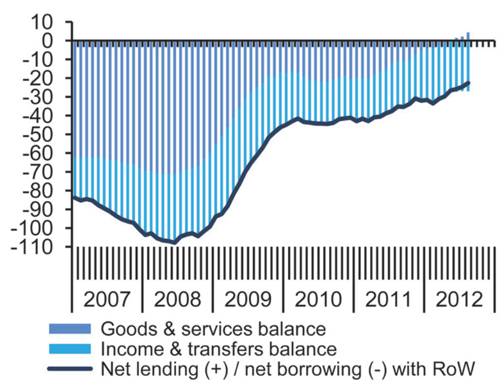
Euro billion, cumulative last 12 months



Source: Ministry of Industry.

5.2 - Balance of payments

Euro billion, cumulative last 12 months



Source: Bank of Spain.

However, the current account balance is still in the red, due to the substantial deficit on the current transfers and income accounts, although the cumulative figure for the first eight months of 2012 was 39% lower than that for the same period the previous year (Exhibit 5.2). The economy's net borrowing, meanwhile, fell by 42%.

The **financial account** performed quite differently. As mentioned, net outflows (excluding the Bank of Spain) between January and August totalled almost 250 billion euros. Direct investment flows were positive, however, portfolio and other investments shrank rapidly, reflecting the haste with which foreign investors have reduced their exposures to Spanish financial assets, thus hindering Spanish economic agents' ability to draw upon the world's savings. This negative balance, together with the national economy's net borrowing, was therefore met by Spanish institutions' resorting to the Eurosystem, as is revealed by the sharp rise in the Bank of Spain's debtor position vis-à-vis the Eurosystem.

From the point of view of the equilibrium between **savings and investments,** the reduction of the economy's net borrowing was a result of a bigger drop in investment than in the national savings rate. **Household** savings rates have been on a continual downward trend since their peak in 2009. This has led to lower financing capacity (surplus). Nevertheless, despite households' diminished financial savings, they have continued reducing their debts, which came to 124.7% of gross disposable income in the second quarter of 2012, compared with a peak of 128.8% in mid-2010.

Non-financial companies' increased savings rate has led them to have a positive and growing financing capacity since 2010. This has made it possible to reduce their debt ratios to 133.7% of GDP in the second quarter of 2012, 8.3 percentage points lower than the previous peak.

Forecasts for 2012-13

The results of the third quarter of 2012 were better than expected due to consumption being brought forward ahead of the VAT increase, the upturn in exports, and the better-than-expected performance of equipment investments. It is highly likely that these last two variables will return to trend in the last quarter of the year. In the case of equipment investments, the trend has been negative since the end of 2011, and in that of exports, growth has been more moderate. In the case of the latter, the hangover after purchases being brought forward ahead of the VAT increase, and the on-going public spending cuts, mean a worsening looks likely in the last quarter. A drop in GDP of 1.4% is therefore expected for the year as a whole. This is a slight improvement on earlier forecasts, as a result of GDP being better than expected in the third quarter (Exhibits 6.1 to 6.6).

National demand will subtract 3.8 pp from GDP growth in 2012, and external demand will add 2.4 pp. Private consumption will contract by 1.8% as a result of rising unemployment, increasing uncertainty, and above all, the drop in households' disposable income in both nominal and real terms. In any event, the savings rate will continue to fall. Public consumption will decrease by 4%. The climate of uncertainty and worsening expectations also explain, together with the lack of credit, the drop in gross fixed capital formation in capital goods, which will decline by 4.1%. Construction investment will fall by 11.6%, as a result of the contraction in residential investment, and investment in other structures, in particular, due to the cutbacks in public works. Exports will grow by 3.2% this year, while imports will drop by 4.7%.

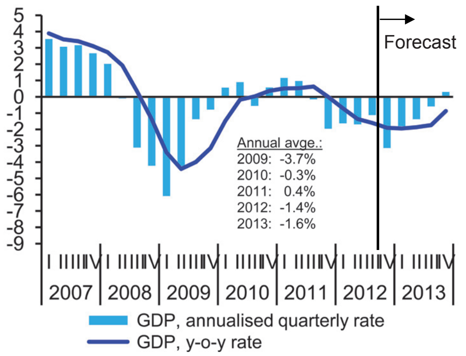
The factors underlying the current contraction of the Spanish economy –limited finance, uncertainty, fiscal adjustments, internal devaluation, and deleveraging, among others– will persist into the coming year. Conditions will therefore remain highly negative, even assuming no critical events occur in the context of the European debt crisis, and that the current situation of restricted finance eases in the second half of the year. Quarterly drops in economic activity are expected throughout almost the whole year. The situation may start to stabilise in the last quarter. The forecast change

Exhibit 6

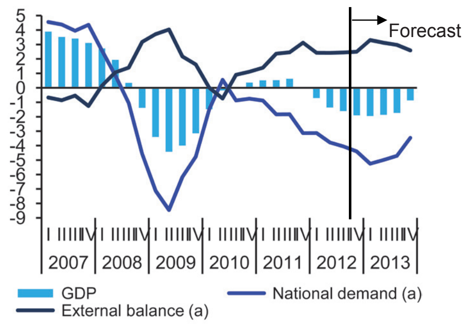
Funcas forecasts for 2012-2013, quarterly profile

Change y-o-y in %, unless otherwise indicated

6.1 - GDP

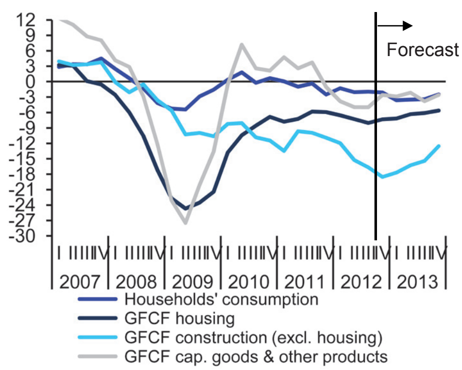


6.2 - GDP, national demand and external balance

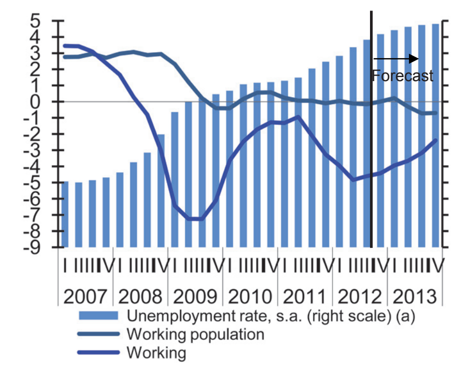


(a) Contribution to GDP growth in percentage points.

6.3 - National demand aggregates

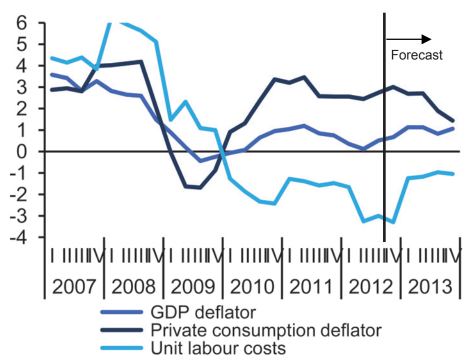


6.4 - Employment and unemployment

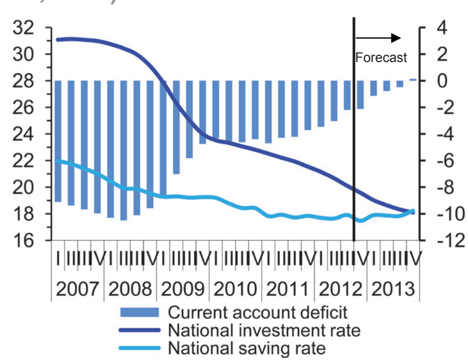


(a) Percentage of working age population.

6.5 - Inflation



6.6 - Saving, investment and c/a deficit (% GDP, 4MA)



Sources: INE (Quarterly National Accounts) and Funcas (forecasts).

in GDP for 2013 as a whole is -1.6%, two tenths higher than the previous forecast.

The contribution of national demand to growth will be even more negative than in 2012, at -4.5 pp. although the contribution of the external sector will improve somewhat, to 2.9 pp. The contraction in household consumption, and in particular spending by the general government, will be more pronounced than this year, at 3.3% and 4.9%, respectively. The negative factors alluded to will continue to weigh on these variables. In particular, the drop in households' disposable income will accelerate, in both real and nominal terms.

Credit will continue to contract until the process of consolidating and restructuring Spain's financial institutions has been completed, a process which requires a reduction in their debt and shrinking of their balance sheets, among other things. Although the consequent problem of the lack of finance could start to ease towards the end of the year as the consolidation process progresses, the situation will remain highly restrictive. In conjunction with the uncertainty and unfavourable outlook, this will keep **investments in capital goods and other goods** in negative territory, with a change of -2.9%. While finance remains scare, expectations are negative and household incomes continue to fall, there is little prospect of a recovery in the property sector. Moreover, the adjustments the sector needs to make are still a long way from complete, as a huge stock of unsold properties has yet to be absorbed. Residential investments are therefore likely to continue to decline in 2013, with the drop estimated at 6.3%. Meanwhile, deeper cutbacks in public investment will translate into a sharper drop in investments in other structures, which are expected to shrink by 15.6%. The improved international context is reflected in better export performance, with export growth of 4.5% and a drop in imports of 4.6%.

Credit will continue to contract until the process of consolidating and restructuring Spain's financial institutions has been completed. Although the consequent problem of the lack of finance could start to ease towards the end of the year as the consolidation process progresses, the situation will remain highly restrictive.

Employment is forecast to contract by -4.3% in 2012, and -3.2% in 2013, which will take the unemployment rate from an annual average of 25.1% this year to 27.3% the next. As a result of labour reform, among other factors, the increase in apparent labour productivity is likely to slow in 2013, but will continue to outpace compensation per employee, which will rise only slowly, such that **nominal unit labour costs** will continue to fall.

The **current account deficit** will fall to 2.1% of GDP in 2012, and the economy's net borrowing to 1.7%. These balances will change sign in 2013, with a current account surplus of 0.2% of GDP and net lending of 0.6% being expected.

Finally, the forecast general government deficit for this year has worsened to -8.4% of GDP. This figure includes the impact on the public accounts of the losses incurred bailing out financial institutions. Without this effect, the deficit would be -7.4%. Much of the deviation in this deficit figure from the target of 6.3% is taking place in the social security system. Despite this, if these forecasts are met, it may be concluded that the fiscal consolidation effort in 2012 has been significant, as with an estimated drop in real GDP of 1.4%, the output gap would have widened by nearly 2 pp of GDP, with the consequent deterioration in the cyclical component of the primary deficit of 1.5 pp. If the increase in interest payments is factored in, the structural primary deficit, which is the benchmark variable for the fiscal effort, can be expected to have fallen by slightly more than 3.5 pp of GDP. Finally, the total deficit will drop to 5.6% of GDP next year.

Table 1

Economic forecasts for Spain, 2012-13

Annual rates of change in %, unless otherwise indicated

	Actual data			Funcas forecasts		Change in forecasts (a)	
	Average 1996-2007	2010	2011	2012	2013	2012	2013
1. GDP and aggregates, constant prices							
GDP	**3.7**	**-0.3**	**0.4**	**-1.4**	**-1.6**	**0.1**	**0.2**
Final consumption households and NPISHs	3.8	0.7	-1.0	-1.8	-3.3	0.3	-0.1
Final consumption general government	4.3	1.5	-0.5	-4.0	-4.9	-0.5	0.2
Gross fixed capital formation	6.4	-6.2	-5.3	-9.0	-7.9	0.6	1.1
Construction	5.4	-9.8	-9.0	-11.6	-11.1	0.7	1.5
Residential construction	7.3	-10.1	-6.7	-7.3	-6.3	-0.3	0.0
Non-residential construction	4.2	-9.6	-11.0	-15.5	-15.6	1.5	3.1
Capital goods and other products	7.5	2.8	2.5	-4.1	-2.9	0.6	0.2
Exports goods and services	6.7	11.3	7.6	3.2	4.5	1.5	0.7
Imports goods and services	9.3	9.2	-0.9	-4.7	-4.6	1.8	0.8
National demand (b)	**4.5**	**-0.6**	**-1.9**	**-3.8**	**-4.5**	**0.2**	**0.2**
External balance (b)	-0.8	0.3	2.3	2.4	2.9	-0.1	0.0
GDP, current prices: - € billion	--	1048.9	1063.4	1052.9	1046.6	--	--
- % change	7.4	0.1	1.4	-1.0	-0.6	-0.1	0.2
2. Inflation, employment and unemployment							
GDP deflator	3.6	0.4	1.0	0.4	1.0	-0.2	0.0
Household consumption deflator	**3.1**	**2.0**	**2.9**	**2.7**	**2.2**	**-0.1**	**-0.1**
Total employment (National Accounts, FTEJ)	3.3	-2.5	-1.7	-4.3	-3.2	0.0	0.2
Productivity (FTEJ)	0.4	2.3	2.2	3.0	1.6	0.1	-0.1
Wages	7.2	-2.3	-0.8	-4.8	-3.5	-1.0	-0.2
Gross operating surplus	7.3	-1.0	5.0	2.8	0.4	1.1	0.6
Wages per worker (FTEJ)	3.2	0.3	0.7	0.1	0.5	-0.9	0.0
Unit labour costs	2.8	-2.0	-1.4	-2.8	-1.1	-0.9	0.0
Unemployment rate (LFS)	**12.2**	**20.1**	**21.6**	**25.1**	**27.3**	**0.1**	**0.1**
3. Financial balances (% of GDP)							
National saving rate	22.2	18.4	17.8	17.5	18.2	-0.1	-0.1
- of which, private saving	18.9	23.0	23.0	22.1	22.0	0.1	0.4
National investment rate	26.6	22.8	21.5	19.6	18.0	-0.1	-0.1
- of which, private investment	23.1	18.8	18.7	17.7	16.7	-0.2	-0.3
Current account balance with RoW	**-4.4**	**-4.4**	**-3.7**	**-2.1**	**0.2**	**0.0**	**0.0**
Nation's net lending (+) / net borrowing (-)	-3.4	-3.8	-3.2	-1.7	0.6	0.0	0.0
- Private sector	-2.6	5.9	6.3	6.7	6.2	0.4	0.6
- Public sector (general government deficit)	**-0.8**	**-9.7**	**-9.4**	**-8.4**	**-5.6**	**-0.4**	**-0.6**
Gross public debt	53.5	61.5	69.3	86.4	94.3	0.4	2.3
4. Other variables							
Household saving rate (% of GDI)	12.0	13.1	11.0	8.7	8.4	-0.2	0.0
Household gross debt (% of GDI)	82.5	128.7	125.4	122.5	119.4	0.0	-0.1
12-month EURIBOR (annual %)	3.7	1.4	2.0	1.1	0.9	-0.1	-0.1
10-year government bond yield (annual %)	5.0	4.2	5.4	5.9	5.0	0.1	0.7
Nominal effective euro rate (% annual change)	--	-6.2	-0.3	-5.5	-1.3	0.0	-0.3

(a) Change Between present and previous forecasts, in percentage points.

(b) Contribution to GDP growth, in percentage points.

Sources: 1996-2011: INE and Bank of Spain; Forecasts 2012-13: Funcas.

To conclude, the Spanish economy is in the midst of a financial crisis in which it is unable to access external credit just as it is reducing debt, absorbing an excess stock of property, and undergoing an internal devaluation. This is a situation that will take some time to overcome. All the more so, given that it is being tackled at a time of unprecedented fiscal retrenchment and in an unfavourable international context. No significant change in the current conditions can therefore be expected in what remains of this year or in much of the next.