The Spanish economy: The end of the recession is in sight, but the recovery will be slow

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Global economic conditions remain weak, particularly in Europe, where markets are still quite fragmented despite reduced debt crisis tensions and risk premiums. The softening of budgetary targets for this year and next has led us to revise upwards slightly Spanish GDP growth forecasts, notwithstanding the worsening international context.

The international economic situation remains fragile in both developed and emerging markets. The United States continues to grow and create jobs, albeit at a modest rate, while a more restrictive fiscal and monetary policy stance are causing concern regarding spillover effects for the global economy.The Euro area is still in recession, although with a trend towards stabilization, and financial markets remain fragmented. Emerging markets have lost momentum, with lower potential growth in China raising concerns about the performance of export-led growth economies. In Spain, the economy is bottoming out and is set to start to show positive growth rates as of the last quarter of this year. Domestic demand continues to be weak and some imbalances built-up over the crisis period have yet to be corrected. Exports will be the main growth driver, but their capacity is limited, which translates into a slow recovery.

International context

The global economic situation remains weak in both the developed and emerging economies, although the context is more relaxed and the tensions deriving from the European debt crisis have subsided considerably. Since the European Central Bank (ECB) announced its outright monetary transactions (OMT) programme the markets have considered the scenario of a breakup of the euro to be less likely, which has encouraged financial flows to return, albeit somewhat timidly, to peripheral countries and consequently brought down their risk premiums.

The United States has continued to grow and create jobs. In the first quarter of the year it registered annualised quarter-on-quarter GDP growth of 1.8%. Its trend growth rate is modest, at around 2%, and the unemployment rate, although falling, is still high compared to pre-crisis levels. Fiscal policy has also taken a restrictive slant after the “sequester” came into effect. The Federal Reserve announced that it could start slowing the pace of its asset purchases through the quantitative easing programme (QE3) this year and bring it to an end in the middle of 2014. The announcement has caused concern about the possible destabilising effect that withdrawal of

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the extraordinary monetary policy measures of the last few years might have. Government bond yields therefore rose significantly around the world as a result, while emerging countries currencies fell.

GDP in the euro area shrank by 0.2% in the first quarter of 2013, the sixth consecutive quarter of recession. All the signs are that growth will also be negative in the second quarter of the year, although a trend towards stabilisation has been noted, such that there could be a slight recovery in the second half of the year. Nevertheless, the fragmentation of the financial market, highlighted by the wide spreads in interest rates between the area's countries, indicates that the monetary policy transmission mechanisms are still not working properly, and therefore, that the European financial system is still not back to optimal health.

At the same time, the emerging economies have also lost momentum. Slower than expected growth in China and India in the first quarter of the year is seen as being part of a structural trend rather than a temporary downturn, ruling out any return to pre-crisis growth rates in the immediate future. Moreover, there is a certain amount of concern about rapid credit growth in China and the state of the country's financial system, which has recently led the country to introduce restrictive measures. China's slower potential growth will also have a negative impact on other emerging economies reliant on raw materials exports, such as those in Latin America, whose strong performance in the recent past was largely driven by demand from China.

Recent developments in the Spanish economy

Spain's GDP contracted by 2.1% in the first quarter of 2013 on an annualised quarter-on-quarter basis. This was the seventh consecutive quarter of negative growth. The smaller drop in domestic demand meant the contraction in GDP was more moderate than in the fourth quarter of 2012, when it shrank by 3.1%, and although the external sector's contribution to growth was smaller than in the previous quarter, it was still positive.

Over the same period, private consumption suffered a much milder fall (1.5%) than in the previous quarter, as indicators such as retail sales, consumer confidence index, or domestic sales by large consumer goods firms were already suggesting. The good progress of these indicators at the start of the second quarter, with slight growth in some cases even, suggests this variable is stabilising (Exhibit 1.1 and 1.2).

Public consumption at constant prices continued to fall. Nevertheless, in current prices it grew by 20.6% in the first quarter of the year, offsetting a similar drop in the previous quarter, which was basically due to public-sector workers' salaries returning to their normal levels after the drop in the previous quarter caused by the elimination of the Christmas bonus. On this point it should be recalled that public spending at market prices is equal to production costs, of which wages and salaries are the most significant component.

At 4.4%, the drop in gross fixed capital formation was less pronounced than in the previous quarter. This fall was concentrated in construction investment, while investments in capital goods and machinery and equipment grew slightly. The good performance of this latter component of investment is also consistent with the progress of various other economic indicators, but is most likely to be a transitional rise due to the variable's inherent fluctuations rather than represent a break in the negative trend it has followed since the end of 2011 (Exhibit 1.3 and 1.4).

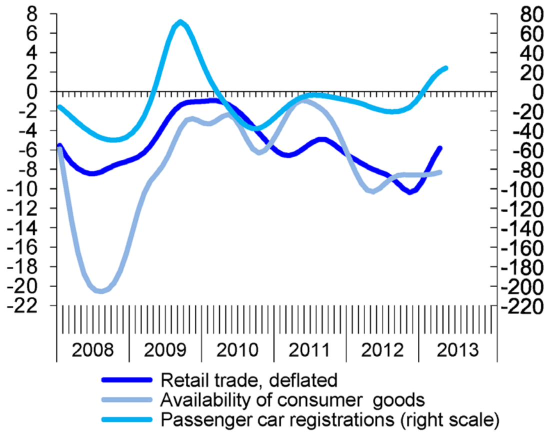
Investment in housing construction continued to contract in the first quarter, falling by 9.4%. Despite the sharp fall in this variable since the start of the recession –its weight as a share of GDP dropped from 12.2% in 2007 to 5.6% in 2012– there are no signs of stabilisation. The number of new housing permits continued its rapid decline, and

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption Indicators (I)

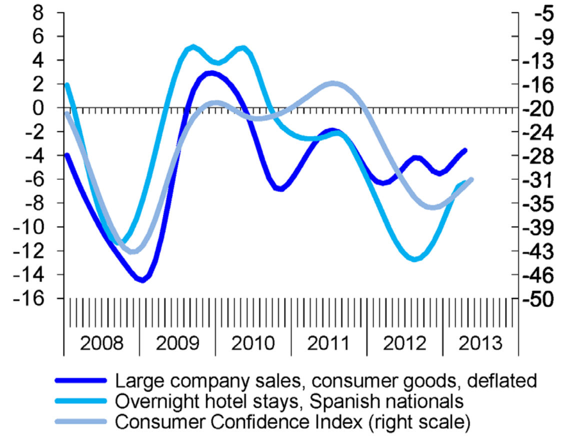
Annualised moving quarterly change in %, smoothed series



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

1.2 - Consumption Indicators (II)

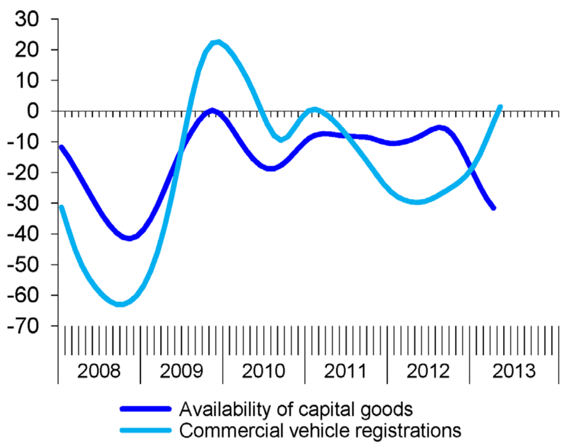
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and Funcas.

1.3 - Capital goods GFCF Indicators (I)

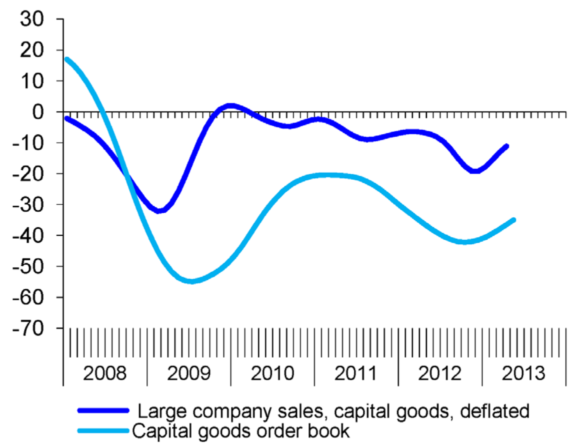
Annualised moving quarterly change in %, smoothed series



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.

the property market remains depressed. Housing sales continued their decline in the first quarter of 2013, despite an acceleration in downward price trend (Exhibit 2.6).

Total exports shrank in the first quarter of 2013, the drop being concentrated in external sales of non-tourism services (which also shows a high level of quarterly volatility) as goods exports grew by 4.9%. Imports again contracted, in the case of both goods and services (tourism and non-tourism), due to the weakness of domestic demand. As regards the geographical destination of Spain's exports, there was no change in the first quarter in the pattern seen since the start of the crisis, whereby exports to non-EU countries performed better (with export growth of 6.1%) than those to EU countries (where exports shrank by 12.5%).

On the supply side, gross value added (GVA) contracted in all economic sectors in the first quarter of 2013. In the manufacturing industry it fell by 2.5%, considerably less than in the previous quarter. The results available for the industrial production index and sales of industrial goods by large firms relative to the start of the quarter reflect a prolongation of the downward trend, although the purchasing managers index (PMI) for manufacturing and the number of people registered with the social security system in the sector suggest it is bottoming out (Exhibit 2.1 and 2.2).

In construction, GVA has fallen for almost 20 consecutive quarters. In the case of services, those relating to public administration, health and education suffered a sharp contraction in the first few months of the year, but in the case of other services the drop in GVA (0.2%) was more moderate than in the previous quarter. The recent trends in sales of services by large companies, the number of people registered with the social security system and the sector's PMI indicate that activity could have stabilised in the second quarter (Exhibit 2.3 and 2.4).

The drop in the number of full-time equivalent jobs in the first quarter slowed to 5%, as suggested by the trends in the total number of people registered with the social security system and the Labour Force Survey, although in the specific case of the manufacturing industry, the drop was sharper than in the preceding quarters. As a result, the productivity of the economy as a whole continued to make rapid gains, particularly in the manufacturing industry, and unit labour costs have remained on a downward path.

The rate of job losses slowed further in the second quarter, according to the number of people registered with the social security system and the number of registered unemployed, although the marked improvement seen in this indicator was influenced by the contraction of the working population. The labour force shrank by almost 350 thousand people in seasonally adjusted terms in the last quarter of 2012 and first quarter of 2013, according to the Labour Force Survey. This was a result of a slight drop in labour-force participation rate and, above all, the fall in the working age population– a trend which has been apparent since 2010. In turn, this contraction in the working age population is basically a result of negative net migratory flows. At the same time, the seasonally adjusted unemployment rate was 26.2% in the first quarter and the youth unemployment rate was 56.1% (Exhibit 3.1 and 3.4).

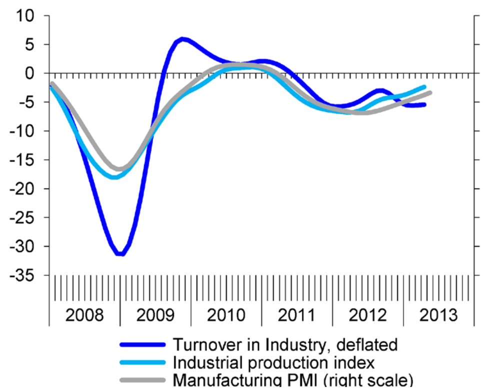
Inflation slowed in the first few months of the year. According to the consumer price index (CPI), prices rose by 2.6%, year-on-year, in the first quarter of 2013, compared with 3.1% the previous quarter. In June the increase was 2.1%, while the household consumption deflator rose by 2% in the first quarter, compared with 2.6% in the fourth quarter of 2012. Although the levels are relatively high given the demand conditions, it should be borne in mind that a large share of the price increase was due to exogenous factors, such as the VAT rise and other regulatory measures adopted in the second half of last year (Exhibit 4.1), which produced a spike in inflation of around 1.2 percentage points.

Exhibit 2

Industrial activity, services and construction indicators

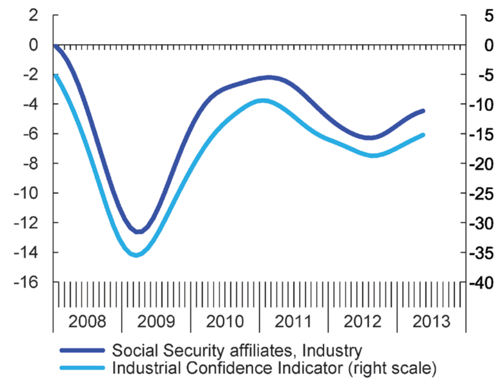
2.1 - Industrial sector indicators (I)

Annualised moving quarterly change in % and index, smoothed series



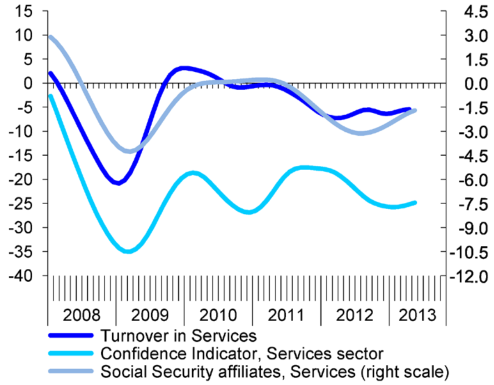
2.2 - Industrial sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



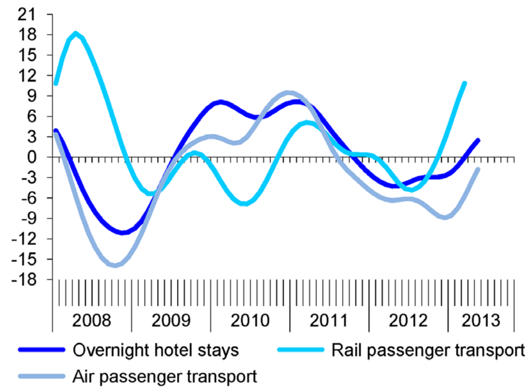
2.3 - Services indicators (I)

Annualised moving quarterly change in % and index, smoothed series



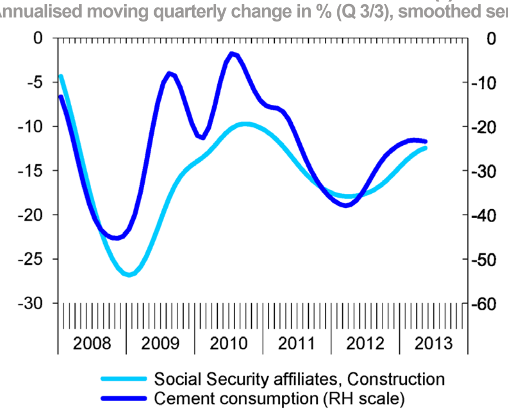
2.4 - Services indicators (II)

Annualised moving quarterly change in %, smoothed series



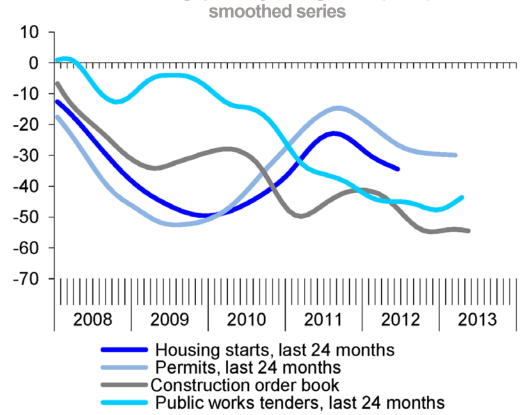
2.5 - Construction sector indicators (I)

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



2.6 - Construction sector indicators (II)

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



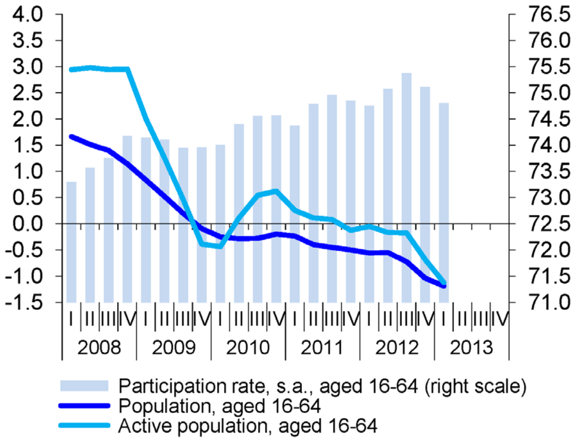
Sources: European Commission, Ministry of Labour, Ministry of Industry, Ministry of Fomento, INE, AENA, Markit Economics Ltd.,RENFE. Markit Economics Ltd., OFICEMEN and Funcas.

Exhibit 3

Labour market indicators

3.1 - Labour supply

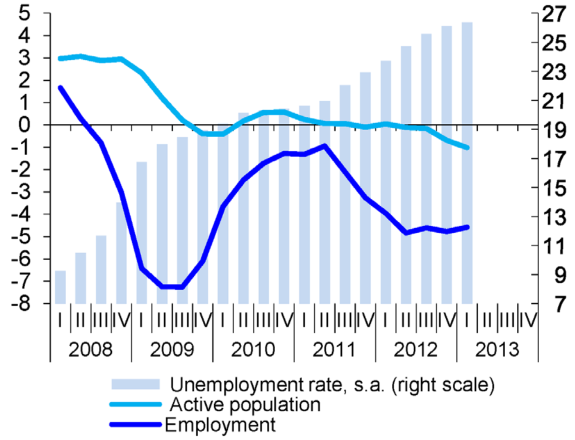
Change y-o-y in % and percentage of population aged 16-64



Source: INE (LFS).

3.2 - Employment and unemployment (LFS)

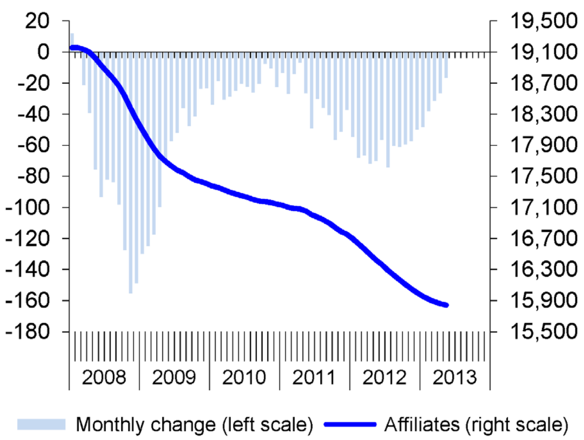
Change y-o-y in % and percentage of working age population



Source: INE (LFS).

3.3 - Social Security affiliates

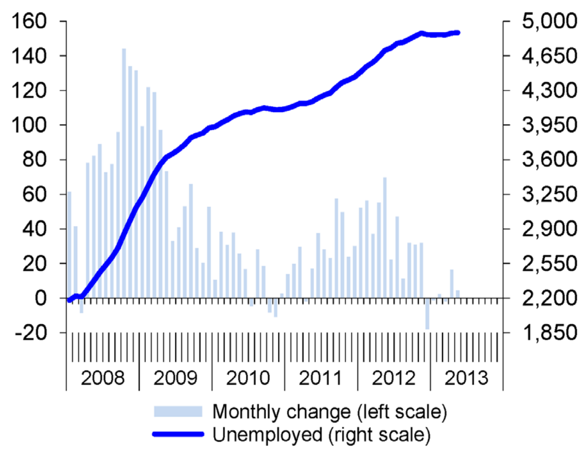
Change in thousands and in %, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

3.4 - Registered unemployment

Thousands, seasonally-adjusted data

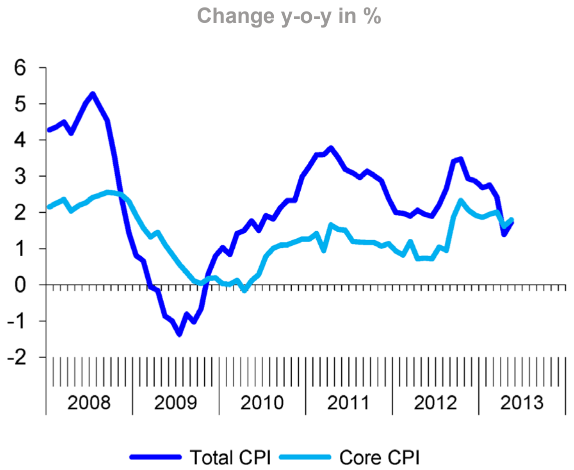


Sources: Ministry of Labour and Funcas.

Exhibit 4

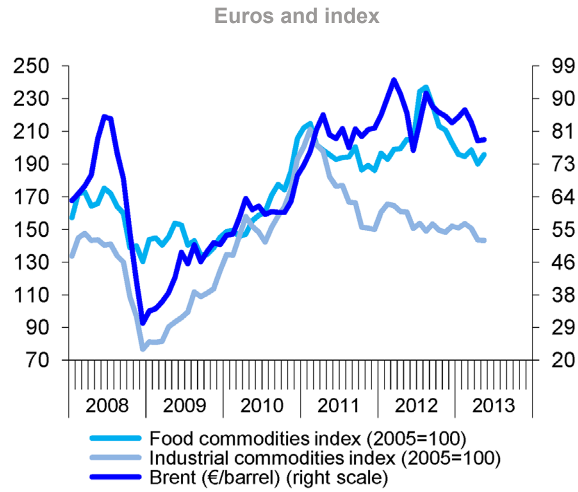
Price indicators

4.1 - Consumer prices index



Source: INE (CPI).

4.2 - Commodities prices in €



Sources: Ministry of Economy and The Economist.

In terms of external imbalances, the current account balance and the economy's net lending position were both negative in the first quarter, but this was due to seasonal factors. In fact, these deficits were 76% and 86% lower, respectively, than those of the same period in the previous year, and in cumulative terms over four quarters the balance has turned positive for the first time since 1998. The goods trade deficit shrank by 71% compared to the same quarter of the previous year. Excluding energy products, the balance has been in surplus since early 2012, and is growing (Exhibit 5.1 and 5.2). From a geographical perspective, it is noteworthy that the balance with the EU and the EMU has remained positive since 2011 and is also on an upward trend.

The financial account of the balance of payments, excluding the Bank of Spain, registered a surplus in the first quarter of 2013 of 43 billion euros compared with a net outflow of 97 billion euros in the same period of the previous year. In the second half of 2012 there was a return to positive figures after the sharp deficits registered since mid-2011, reflecting the timid return of confidence to the markets following the ECB's announcement of its OMT programme (Exhibit 6.2).

According to the monthly accounts of the public administration in national accounts terms that began to be published in January of this year,

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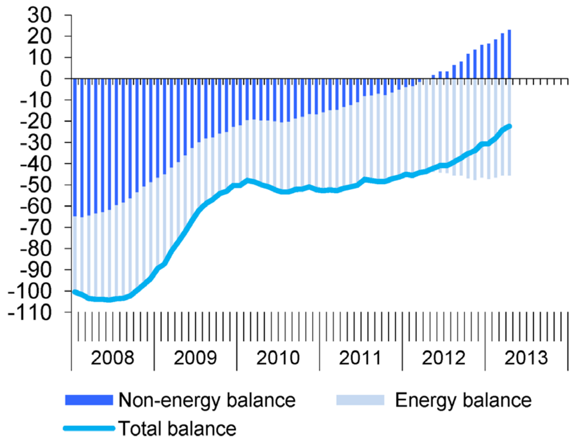
Exhibit 5

External sector

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

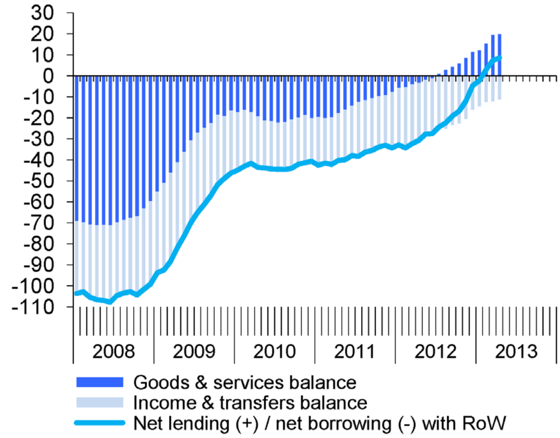
Euro billion, cumulative last 12 months



Source: Ministry of Industry.

5.2 - Balance of payments

Euro billion, cumulative last 12 months



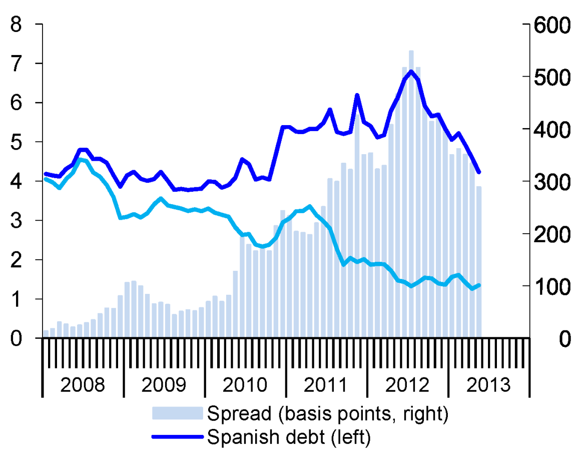
Source: Bank of Spain.

Exhibit 6

Financial indicators

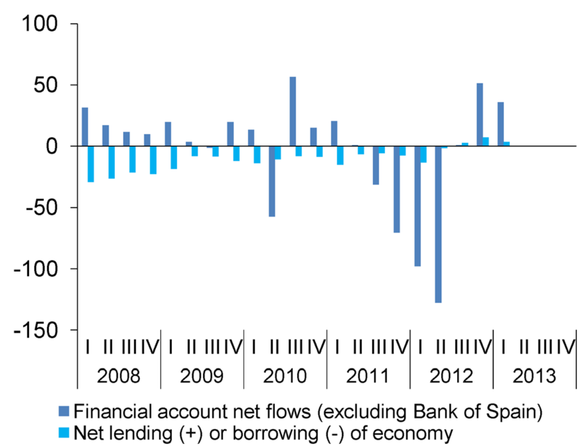
6.1 - Government 10 years bonds rate

Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - Balance of payments



Source: Bank of Spain.

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period by 6.9%, compared with the same period of the previous year, even if this is largely due to the delaying of refunds from late 2012 until early 2013. In uniform terms, i.e. adjusting the figures to match the rate at which refunds are paid, tax revenue grew by 1.4%. This figure falls well short of the 3.8% forecast for the year as a whole in the national budget.

Forecasts for 2013-2014

The economy performed broadly as expected in the first quarter of 2013, as did the indicators available for the second quarter, thus confirming the anticipated scenario of gradual stabilisation. The new forecasts have not been affected by any major surprises in terms of the economy's trends. This has meant that, among other factors, the new forecasts do not incorporate significant changes in the expected profile for the quarters ahead. Growth rates will remain negative in the central quarters of the year, and slightly positive and rising as of the fourth (Exhibit 7.1).

Nevertheless, GDP growth has been revised upwards slightly, mainly due to the softening of the public deficit targets for this year and next, which will mean a less intense adjustment than

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that envisaged in previous years, and therefore, a smaller contractionary effect on GDP. This will offset the worsening international context, particularly in Europe. There are no changes in the estimates of the other determinants. Although the strains caused by the debt crisis have remitted and the risk premium has dropped (Exhibit 6.1), the financial conditions for the private sector are set to remain very restrictive, at least this year. The adjustment in the property sector still has a long way to go, and the process of deleveraging will continue to constrain households' and companies' spending capacity.

As a result, the GDP growth forecast for 2013 is -1.5%, compared with a previous forecast of -1.6%, and that for 2014 has risen to 0.7% from 0.5% (Table 1).

Private consumption continues to be weighed down by the reduction in households' disposable income, among other factors, and the limited scope for reducing savings, which are currently at an all time low. Nevertheless, the drop this year will be 3%, which is slightly better than in previous forecasts, while the forecast for 2014 remains -0.3%

Public consumption is expected to perform less negatively over the next few quarters than in previous forecasts owing to the smaller budgetary adjustment. Nevertheless, this variable's expected growth in 2013 as a whole has been revised down to -3.4%, as a result of its suffering a much bigger drop in the first quarter than expected. The forecast for 2014 is -1.5%, compared with -2.4% previously.

The forecast for growth in residential construction investment has worsened for both 2013 and 2014, although the outlook for non-residential investment is now less negative as a result of a smaller adjustment being needed in the budget for public works.

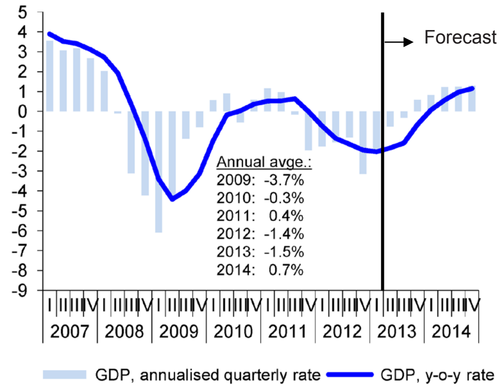
The forecast for growth in investment in capital goods in 2013 is -4.5%, as it is expected that the rise in the first quarter will prove to be transitory and that it will return to its negative trend over the next few quarters. This trend is due to a combination of the credit squeeze, the

Exhibit 7

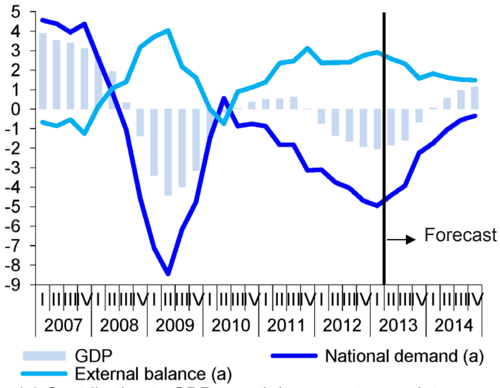
Funcas forecasts for 2013-2014, quarterly profile

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

7.1 - GDP

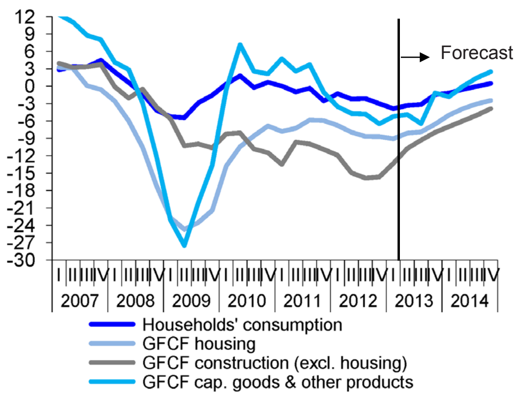


7.2 - GDP, national demand and external balance

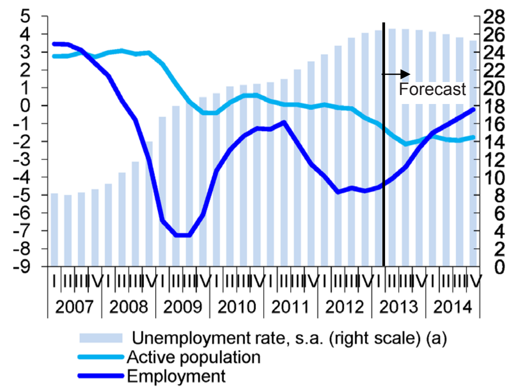


(a) Contribution to GDP growth in percentage points.

7.3 - National demand aggregates

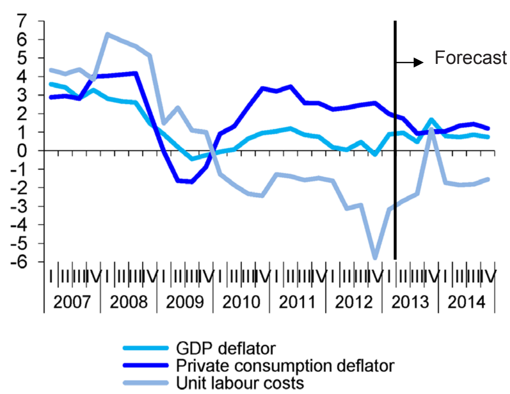


7.4 - Employment and unemployment



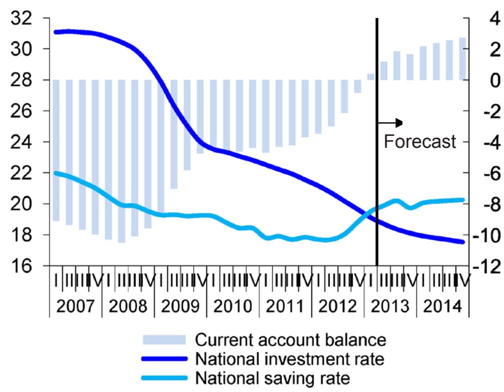
(a) Percentage of working age population.

7.5 - Inflation



7.6 - Saving, investment and c/a deficit

(% GDP, 4MA)



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

Table 1

Economic Forecasts for Spain, 2013-2014

Annual rates of change in %, unless otherwise indicates

	Actual data			Funcas forecasts		Change in forecasts (a)	
	Average 1996-2007	2011	2012	2013	2014	2013	2014
1. GDP and aggregates, constant prices							
GDP	**3.7**	**0.4**	**-1.4**	**-1.5**	**0.7**	**0.1**	**0.2**
Final consumption households and NPISHs	3.8	-1.0	-2.1	-3.0	-0.3	0.2	0.0
Final consumption general government	4.3	-0.5	-3.7	-3.4	-1.5	-0.3	0.9
Gross fixed capital formation	6.2	-5.3	-9.1	-7.4	-2.5	0.3	0.2
Construction	5.6	-9.0	-11.5	-9.2	-4.6	-0.1	0.5
Residential construction	7.3	-6.7	-8.0	-7.9	-3.6	-1.6	-0.1
Non-residential construction	4.2	-11.0	-14.6	-10.4	-5.5	1.3	1.1
Capital goods and other products	7.4	2.5	-4.9	-4.5	0.5	0.8	-0.2
Exports goods and services	6.7	7.6	3.1	3.0	6.3	0.0	0.2
Imports goods and services	9.3	-0.9	-5.0	-4.4	1.7	0.0	0.2
National demand (b)	**4.5**	**-1.9**	**-3.9**	**-3.9**	**-0.9**	**0.0**	**0.2**
External balance (b)	-0.8	2.3	2.5	2.4	1.6	0.1	0.0
GDP, current prices: - € billion	--	1,063.4	1,049.5	1,043.8	1,059.4	--	--
- % change	7.4	1.4	-1.3	-0.5	1.5	-0.1	0.0
2. Inflation, employment and unemployment							
GDP deflator	3.6	1.0	0.1	1.0	0.8	-0.2	-0.2
Household consumption deflator	**3.1**	**2.9**	**2.4**	**1.4**	**1.3**	**-0.6**	**-0.3**
Total employment (National Accounts, FTEJ)	3.3	-1.7	-4.4	-3.7	-0.9	-0.2	0.0
Productivity (FTEJ)	0.4	2.2	3.2	2.3	1.6	0.3	0.2
Wages	7.2	-0.8	-5.4	-4.0	-1.4	-0.5	-0.7
Gross operating surplus	7.3	5.0	2.2	1.8	4.6	0.6	1.1
Wages per worker (FTEJ)	3.2	0.7	-0.3	0.4	-0.2	-0.3	-0.7
Unit labour costs	2.8	-1.4	-3.4	-1.8	-1.7	-0.5	-0.8
Unemployment rate (LFS)	**12.2**	**21.6**	**25.0**	**26.5**	**25.8**	**-0.1**	**-0.2**
3. Financial balances (% of GDP)							
National saving rate	22.2	17.8	18.8	19.7	20.2	0.3	0.7
- of which, private saving	18.8	23.0	23.4	24.4	24.4	0.9	1.6
National investment rate	26.6	21.5	19.6	18.1	17.4	0.0	0.0
- of which, private investment	23.1	18.7	17.9	16.7	16.2	-0.2	-0.3
Current account balance with RoW	**-4.4**	**-3.7**	**-0.9**	**1.6**	**2.8**	**0.3**	**0.7**
Nation's net lending (+) / net borrowing (-)	-3.4	-3.2	-0.2	2.2	3.3	0.4	0.7
- Private sector	-2.6	6.3	10.4	8.7	9.1	1.1	1.9
- Public sector (general governm. deficit)	**-0.9**	**-9.4**	**-10.6**	**-6.5**	**-5.8**	**-0.7**	**-1.2**
Gross public debt	53.5	69.3	84.3	94.3	100.8	0.7	1.6
4. Other variables							
Household saving rate (% of GDI)	12.0	11.0	8.1	8.1	8.2	0.0	0.1
Household gross debt (% of GDI)	82.5	125.5	123.6	120.7	115.3	0.4	0.7
12-month EURIBOR (annual %)	3.7	2.0	1.1	0.5	0.9	-0.1	-0.1
10-year government bond yield (annual %)	5.0	5.4	5.9	4.4	4.0	-0.5	-0.1
Nominal effective euro rate (% annual change)	--	-0.3	-5.3	2.5	-0.9	0.6	0.3

(a) Change between present and previous forecasts, in percentage points.
(b) Contribution to GDP growth, in percentage points.
Sources: 1996-2012: INE and Bank of Spain; Forecasts 2013-14: FUNCAS.

persistence of unfavourable demand conditions, and the substantial spare production capacity. Nevertheless, it is set to grow next year as a result of the stimulus of exports, the need to upgrade and modernise productive capital after several years of a freeze in investment, the gradual softening of credit conditions, and the consolidation of companies' financial situation. The expected rate of change in 2014 as a whole is 0.5%, although the rate of growth in the second half of the year could top 3% (Exhibit 7.3).

Export growth this year is likely to be moderate (3%) given the weakness of the global economy, but is expected to pick up speed next year as international economic conditions become more favourable. Imports, which will contract this year by 4.4%, will return to growth in 2014 as a result of a slower decline in domestic demand and faster export growth, given the close links between exports and imports. The external sector's growth contribution will be positive and domestic demand's contribution less negative in 2014 than in 2013, such that external demand will be sufficient to enable moderate growth (Exhibit 7.2).

The number of full-time equivalent jobs will continue to decline during the year. Only well into 2014 will the economy have reached a rate of growth compatible with minimal net job creation. The average annual change in this variable in this year and next will be -3.7% and -0.9%, respectively (Exhibit 7.4). The unemployment rate, which in 2013 will reach 26.5%, is set to fall slightly in 2014 as a result of the contraction in the labour force, driven by a slightly downward trend in the labour-force participation rate, and, above all, the shrinking of the working age population. Productivity and unit labour costs will continue their upward and downward trends, respectively, from recent years.

Consumer price inflation will continue the downward trend over the remainder of the year, reaching rates of around 1% at the end of 2013 as the impact of the step effects introduced last year by the VAT rise and other regulatory measures wears off, in conjunction with the absence of inflationary tensions due to weak demand. The annual average will be approximately 1.6%. An average of 1.3% is expected for 2014 (for both the CPI and the private consumption deflator).

In the case of the external imbalances, the current account balance and the economy's net lending position will be in surplus and growing, which will be the result of an increase in the national borrowing rate and a drop in the investment rate (Exhibit 7.6). The growth of the former is explained by the increase in business savings and the reduction in public dissavings, as the household saving rate will remain almost unchanged at last year's low levels. The lower public investment and continuing decline in housing investments will lead to a reduction in the national savings rate. The breakdown in the net lending position by sectors yields a public sector deficit of 6.5% of GDP in 2013 and 5.8% in 2014 (the latest figures proposed by the European Commission) and a surplus for the private sector of 8.7% and 9.1%, respectively.

In short, the Spanish economy is bottoming out and is set to start to show positive growth rates as of the last quarter of this year. However, the fundamentals of domestic demand remain extremely weak and some of the imbalances that built up during the period of expansion have yet to be corrected. The only source of growth will therefore be exports, but their ability to single-handedly drive the economy is limited. In sum, this means the capacity for growth will be scant and the recovery is likely to be slow.