Spain's economic recovery is gaining strength, but remains sluggish

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Global growth continues to be moderate, with an improvement in developed countries versus a loss of dynamism in the emerging economies. In Spain, the recovery initiated in 2013 has gained strength over the first few months of 2014, with expected further improvement in 2015, in part supported by the effects of the electoral cycle on the pace of fiscal adjustment and tourism.

Developed countries have gradually gained vigour in recent months in a general context of restrictive fiscal and expansionary monetary policies, although the U.S. has reiterated its expected slowdown in quantitative easing, generating uncertainty primarily for the emerging economies. Global risk has also increased due to the escalation of tensions in the Ukraine. In Spain, the economy grew by 0.17% in the fourth quarter of 2013, up 0.7% on an annualized basis, driven by the positive contribution of external demand, while the domestic sector´s contribution remains negative. Employment growth has also gained strength. Fiscal data available through November point to difficulties meeting the 6.5% of GDP deficit target for 2013, while improved market conditions are helping Spain access foreign capital. In this context, if global threats do not materialize, we forecast growth in 2014 at 1.2%, two tenths higher than previously, and that for 2015 is 1.8%. Nevertheless, the high level of public debt remains a serious cause for concern as regards the future growth outlook.

External context

The rate of global economic growth remains moderate. The developed countries have gradually gained vigour in recent months, in a context of restrictive fiscal policies –except in Japan– and expansionary monetary policies, although with significant differences among them. In January, the U.S. Federal Reserve again announced plans to slow its asset-buying programme, although monetary policy remains highly expansionary and benchmark interest rates are close to zero. Japan and the United Kingdom are also pursuing quantitative expansion, whereas the European Central Bank is resisting introducing these types of measures, despite low inflation rates, limiting its action to interest rates, which are currently at 0.25%.

Despite low interest rates, the expansionary effect of European monetary policy is severely constrained by the poor functioning of the transmission mechanism to the economy, while the liquidity provided by three-year LTRO

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operations at the end of 2011 and early 2012 has been almost entirely reabsorbed, as financial institutions have repaid 87% of the loans received in this framework. Consequently, the European Central Bank's balance sheet is contracting, which is helping keep the euro strong despite the Federal Reserve's announced slowing of its stimulus programme.

In the last quarter of 2013 U.S. GDP grew by 2.4% on an annualised basis and unemployment fell to 6.7%. In the first two months of the year, the PMI and confidence indicators suggested a continuation of the growth trend, albeit at a slightly slower pace, although this may be a result of adverse weather conditions. In the euro area, growth at the tail end of the year gained pace somewhat, rising to 1.1% on an annualised basis, while the PMI and confidence indicators in the early months of the year point to an acceleration in the first quarter. The unemployment rate has remained around 12%.

The emerging countries have recently been characterised by a loss of dynamism, as a consequence of structural deficiencies and the uncertainties generated by the moderation of monetary stimulus in the United States. The bouts of instability caused by the latter have forced several countries to raise their interest rates, which will undoubtedly put a brake on their growth.

Moreover, on top of the risks to the global economy from possible outbreaks of instability caused by the moderation of expansionary monetary policy in the U.S. comes uncertainty from the situation in the Ukraine. Tensions could push up energy prices or trigger a series of economic reprisals, which would have a negative economic impact, particularly for Russia and Europe.

Recent developments in the Spanish economy

GDP grew by 0.17% in the fourth quarter of 2013, equivalent to 0.7% on an annualised basis (the basis used for all the growth rates below), although in current terms GDP fell, as the growth of the deflator was negative. The result for the year as a whole was a drop in real GDP of -1.2% on the previous year.

Quarter-on-quarter growth came from the positive contribution of external demand, while domestic demand's contribution was negative. This negative contribution from domestic demand was the result of a sharp, and surprisingly large, drop in public consumption. The other components of domestic demand (i.e. private consumption and gross fixed capital formation) registered growth, particularly the capital goods investment component. The figures for previous quarters were also revised upwards.

Thus, private consumption was positive for the third consecutive quarter, growing at an annualised rate of 2.1%. Nevertheless, the result for the full year was a contraction of 2.1. This was due to the abrupt drop in the last quarter of 2012, so the level at the beginning of the year was so low that, despite growth over the course of 2013, the average level for the entire year was lower than that for 2012. The consumption indicators give contradictory signals for the start of 2014: on the one hand, in January and February, new vehicle registrations maintained their rapid growth and the consumer confidence index continued to rise, while on the other, large firms' sales of consumer goods and residents' overnight hotel stays fell in January (Exhibits 1.1 to 1.3).

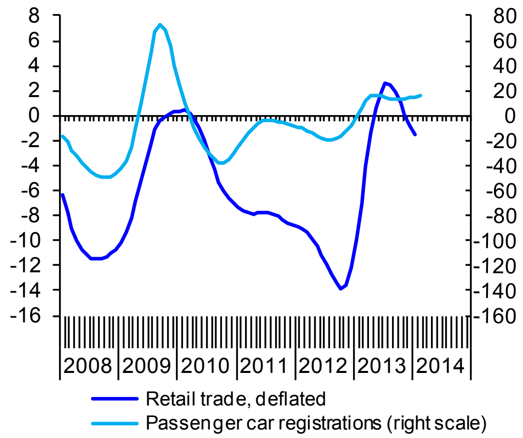
Gross fixed capital formation in construction contracted yet again in the last quarter of 2013 as a result of the negative trend in residential activity. Moreover, the continuation of the downward trend in the number of new housing permits suggests the decline in this component of demand will continue over the coming months (Exhibit 2.6). By contrast, the "other construction" component picked up slightly, which, in view of the strength of growth in official calls for tender registered during the year, could be linked to public works.

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption indicators (I)

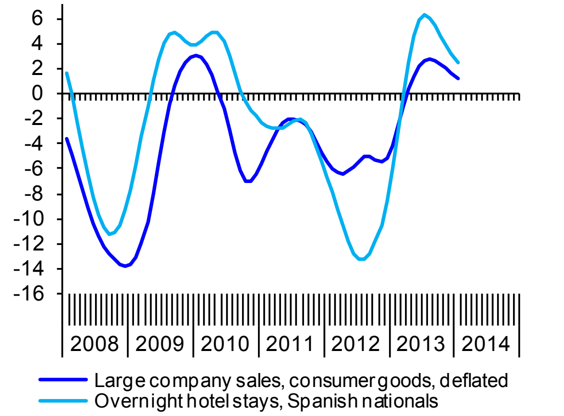
Annualised moving quarterly change in %, smoothed series



Sources: INE, DGT and FUNCAS.

1.2 - Consumption indicators (II)

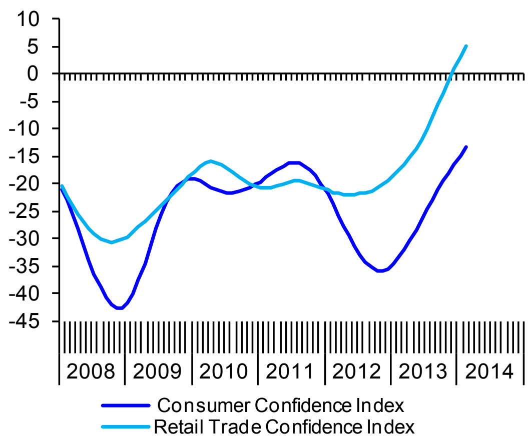
Annualised moving quarterly change in %, smoothed series



Sources: INE, AEAT and FUNCAS.

1.3 - Consumption Indicators (III)

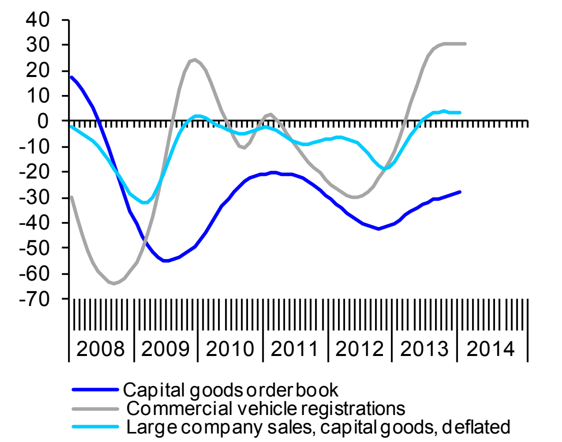
Annualised moving quarterly change in %, smoothed series



Sources: European Commission and FUNCAS.

1.4 - Capital goods GFCF indicators (II)

Annualised moving quarterly change in %,smoothed series



Sources: Ministry of Industry, AEAT, DGT and FUNCAS.

Investment in capital goods and other products rose in the last quarter of 2013 for the fourth consecutive quarter, with growth over the year as a whole of 1.7% relative to the previous year. Growth in large firms´ domestic sales of capital goods in January, registrations of commercial vehicles and orders for capital goods in January and February suggest that the aggregate growth trend held up at the start of the year (Exhibit 1.4).

According to national accounts figures, goods exports grew slightly in the fourth quarter, although figures from the Customs/Economy Ministry registered a drop (Exhibit 3.1). Moreover, exports of tourism services suffered a contraction which was also inconsistent with the evidence from other indicators, such as overnight stays in hotels by foreign nationals, inflows of tourists, or tourist spending. Total imports, on the other hand, shrank in the fourth quarter. Over the year as a whole, according to national accounts figures, exports grew by 4.9% and imports by 0.4%.

Foreign trade figures for the start of 2014 have yet to be published, but large firms' exports and imports published by the tax collection agency suggest both indicators have recovered, particularly in the case of imports.

From the supply side, farming and services grew in the fourth quarter while manufacturing and construction shrank. Only farming experienced VAB growth in 2013 relative to the previous year, although services also saw growth in quarter-on-quarter terms over the period as a whole. In the early months of 2014, the PMI indices registered growth in industry and an acceleration in services. The sectoral confidence indices, which have recovered to pre-crisis levels, point in the same direction. Thus, the number of people registered with the Social Security system, continued rising in the services sector and began to grow in industry, while in construction the drop has virtually halted (Exhibits 2.1 to 2.5).

Employment, measured in terms of full-time equivalent jobs, grew by 0.3% in the fourth quarter for the first time since early 2008, although this growth is concentrated in farming and certain services subsectors, including those most closely linked to government. This increase in employment is consistent with the results of the Labour Force Survey and total Social Security registrations over the period. The seasonally adjusted unemployment rate dropped by three tenths of a percent to 26.1%, due to the modest job creation in the period, and in particular, the contraction of the labour force, which has been on a downward trend since 2011 (Exhibits 4.1 and 4.2).

The trend in the number of people registered with the Social Security system in January and February 2014 suggested that employment growth had gained strength (Exhibits 4.3 and 4.4). This result, in conjunction with the activity indicators available for the same period –mainly qualitative in nature– point to somewhat stronger GDP growth in the first quarter than in the previous one.

Apparent labour productivity continued to rise in the fourth quarter, although as in the previous quarter, at the slowest rates since the start of the crisis. The increase over 2013 as a whole came to 2.3%. Compensation per employee declined in the fourth quarter although over the year it rose by 0.7%. As a consequence, unit labour costs dropped in 2013 for the fourth consecutive year, with a change of -1.6% overall, which in the manufacturing sector was -3.2%.

The trade balance in goods and services was in surplus in 2013 for the second consecutive year, by an amount equivalent to 2.4% of GDP, according to national accounts figures, while the current account balance registered a positive balance for the first time since 1997, with a value of 0.8% of GDP. The net lending position vis-à-vis the rest of the world also turned a surplus, reaching 1.5% of GDP (Exhibit 3.2).

Broken down by sectors, using data for the period ending in the third quarter of 2013 –the most recent period for which disaggregated data are available– this lending capacity came from the private sector, which presented a balance of 11.7% of GDP (four-quarter moving average), while the general government registered a net borrowing requirement of 10.3% of GDP. However, this figure includes the losses caused by the aid to financial institutions, which in the four quarters ending in the third quarter of 2013, came to 3.3% of GDP.

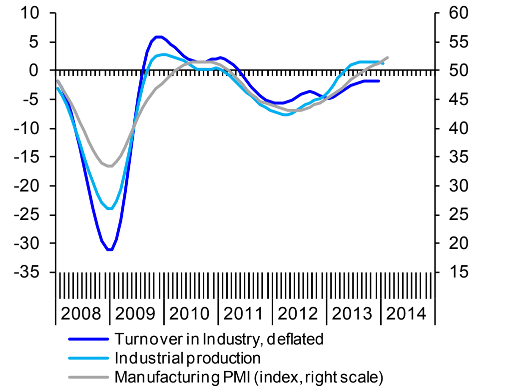
In terms of the savings-investment balance, the national net lending position was the outcome of a moderate increase in the national savings rate and drop in the investment rate. Again with data

Exhibit 2

Industrial activity, services and construction indicators

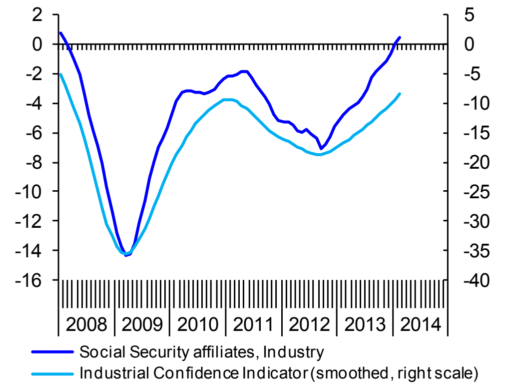
2.1 - Industrial sector indicators (I)

Annualised moving quarterly change in % and index, smoothed series



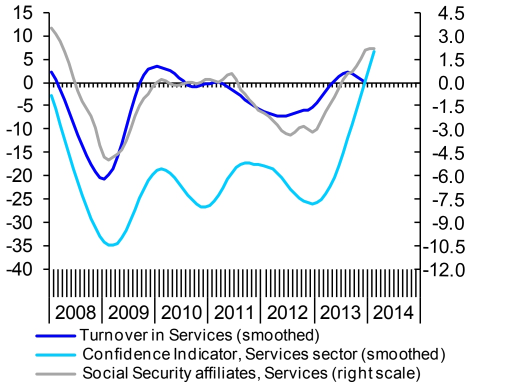
2.2 - Industrial sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



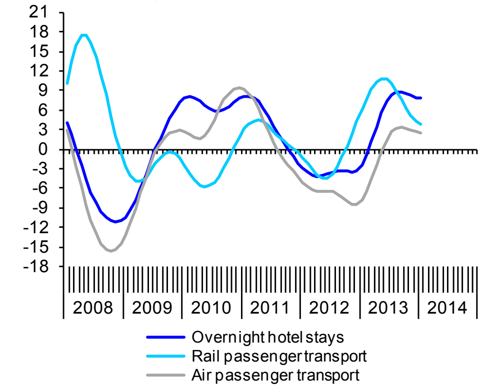
2.3 - Services indicators (I)

Annualised moving quarterly change in % and index, smoothed series



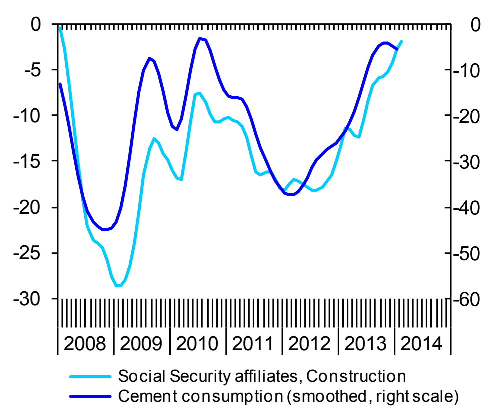
2.4 - Services indicators (II)

Annualised moving quarterly change in %, smoothed series



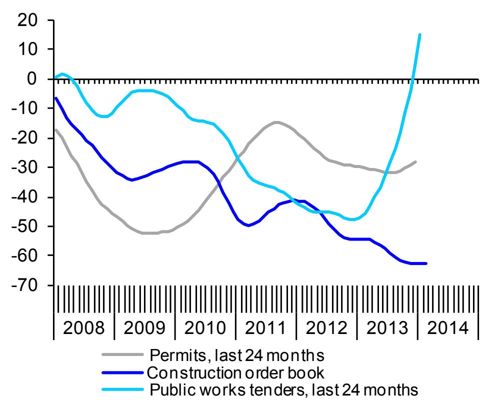
2.5 - Construction sector indicators (I)

Annualised moving quarterly change in %, smoothed series



2.6 - Construction sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



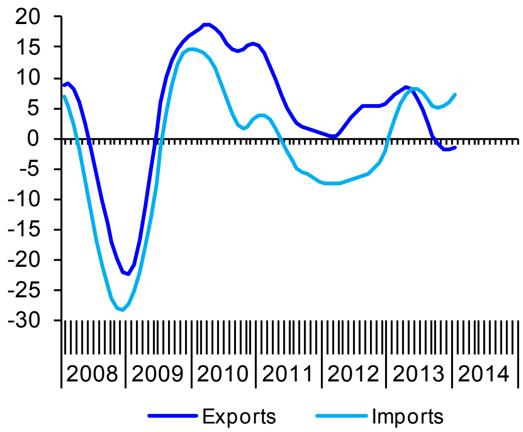
Sources: European Commission, Ministry of Labour, Ministry of Industry, Ministry of Development, Ministry of Public Works, INE, AENA, Markit Economics Ltd.,RENFE, SEOPAN, OFICEMEN and FUNCAS.

Exhibit 3

External sector

3.1 - Exports/Imports at constant prices (Customs)

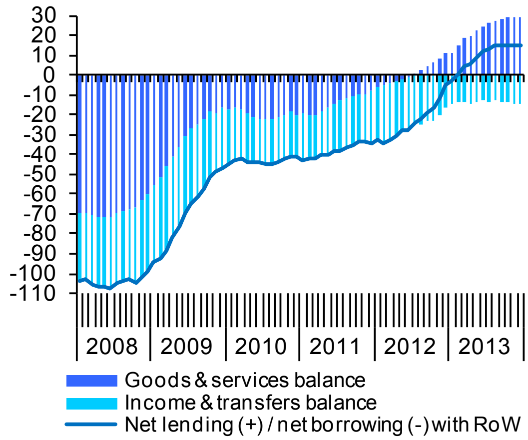
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Economy and FUNCAS.

3.2 - Balance of payments

EUR billion, cumulative last 12 months



Source: Bank of Spain.

for the period up to the third quarter, the increase in the savings rate was basically driven by non-financial corporations (Exhibits 7.1 and 7.2).

The public sector comprised by the central government, the regional governments, and the Social Security system, registered a deficit up to November, of 55.8 billion euros, excluding aid to financial institutions, equivalent to 5.5% of GDP. This balance breaks down into -3.9% for

The likelihood for the general government meeting its 6.5% target is very small, bearing in mind the highly negative seasonality of the last month of the year. It is therefore more than likely that this target will have been overshot by a few tenths of a percent.

the central government, -1.3% for the regional governments, and -0.3% for the Social Security system. Although no monthly data for local authorities are available, it is estimated that they could have ended the year with a surplus of 0.4%. Nevertheless, the likelihood for the general government meeting its 6.5% target is very small, bearing in mind the highly negative seasonality of the last month of the year. It is therefore more than likely that this target will have been overshot by a few tenths of a percent.

The financial account of the balance of payments, excluding the Bank of Spain, recorded a surplus

The financial account of the balance of payments recorded a surplus of 8.7% of GDP in 2013, after two consecutive years of deficit. This is the first sign of the turnaround in Spain's ability to access foreign finance. This change has been reflected in the rapid fall in the risk premium on Spanish sovereign debt and the consequent drop in its yield.

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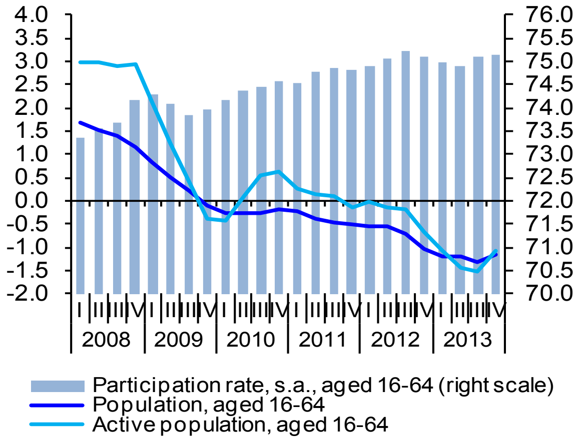
Exhibit 4

Labour market indicators

4.1 - Labour supply

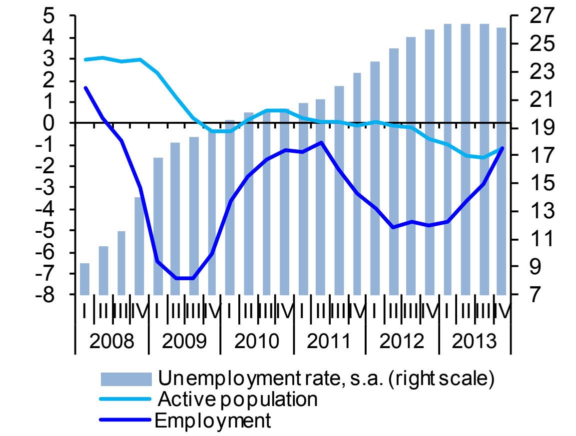
Change y-o-y in % and percentage of population aged 16-64



Source: INE (LFS).

4.2 - Employment and unemployment (LFS)

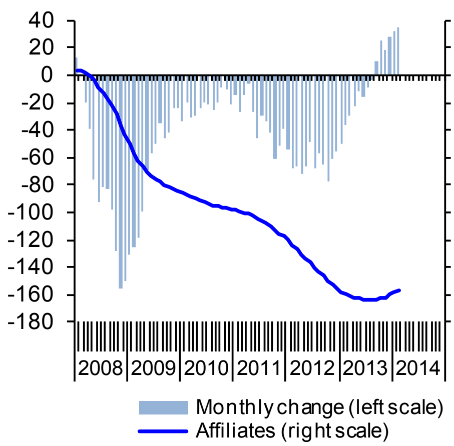
Change y-o-y in % and percentage of working age population



Source: INE (LFS).

4.3 - Social Security affiliates

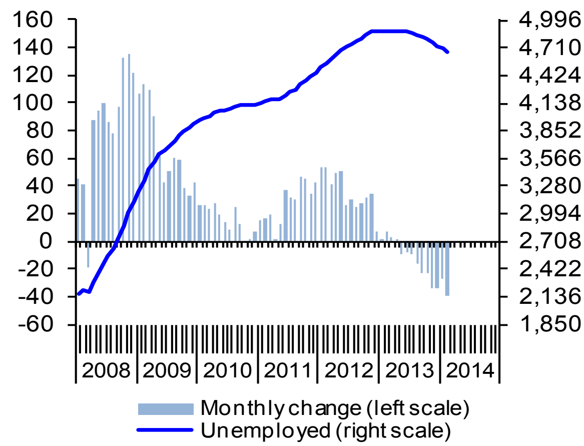
Thousands, seasonally-adjusted data



Sources: Ministry of Labour and FUNCAS.

4.4 - Registered unemployment

Thousands, seasonally-adjusted data



Sources: Ministry of Labour and FUNCAS.

finance. This change has been reflected in the rapid fall in the risk premium on Spanish sovereign debt and the consequent drop in its yield. Thus, at the end of 2013, yields on ten-year bonds stood at 4.1%, whereas in the first few months of 2014 they continued on a downward path to below 3.5%. The spread against German bonds is now under 180 basis points, compared with around 350 points in early 2013 (Exhibits 6.1 y 6.2).

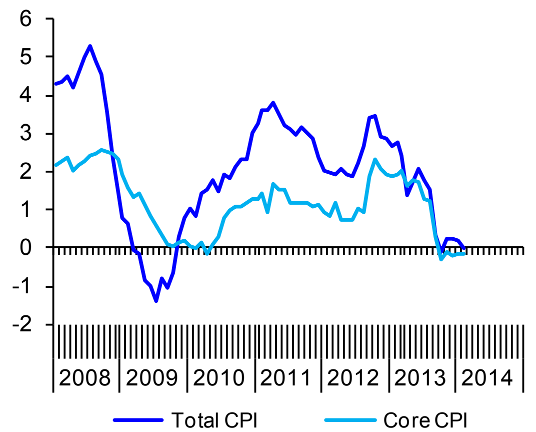
The inflation rate remains low, at levels below the euro area average. In February, it was 0.0%, but excluding foodstuffs –processed and unprocessed– and energy products, the result was negative at -0.1%. This extremely low rate is the result of falling labour costs over the last few years being passed on to final prices, in a context in which demand remains weak, although it has halted its decline (Exhibit 5.1).

Exhibit 5

Price indicators

5.1 - Consumer prices index

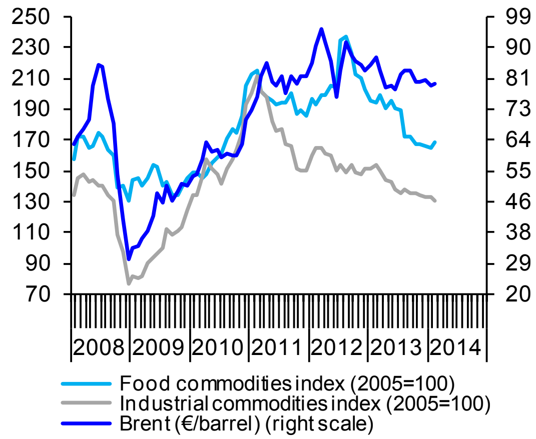
Change y-o-y in %



Source: INE.

5.2 - Commodities prices in €

Euros and index



Sources: Ministry of Economy and The Economist.

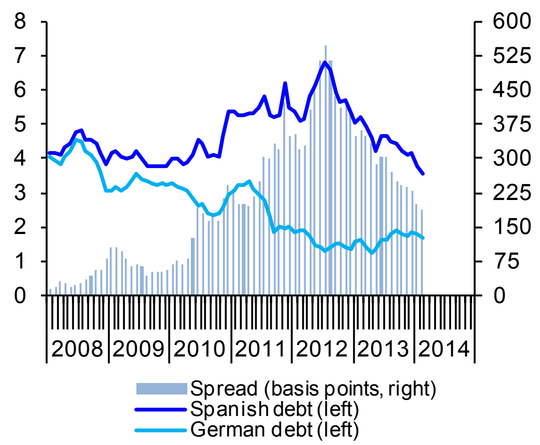
New credit, which began to expand in the last quarter of 2013 –specifically in the business credit and consumer credit segments, while lending for home purchases continued to contract– consolidated its positive trend at the start of 2014, driven by the significant progress of recapitalisation and cleaning up of financial institutions, and the more favourable economic outlook (Exhibit 7.4). Nevertheless, the volume of credit continued to shrink, as is to be expected in the context of the economy's deleveraging.

Exhibit 6

Financial indicators

6.1 - Government 10 years bonds rate

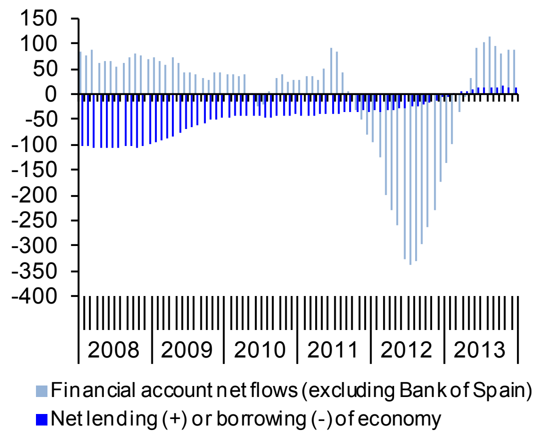
Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - Balance of payments

EUR billion, cumulative last 12 months



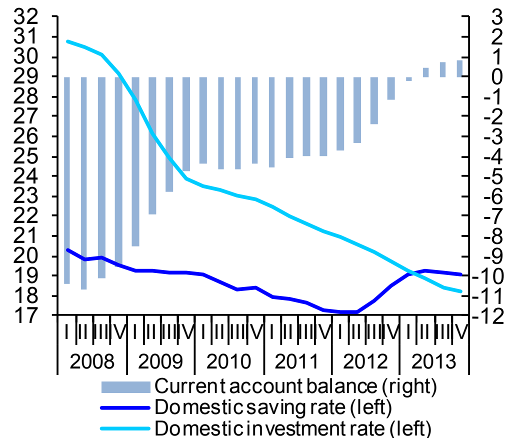
Source: Bank of Spain.

Exhibit 7

Financial imbalances

7.1 - Domestic saving, investment and current account balance

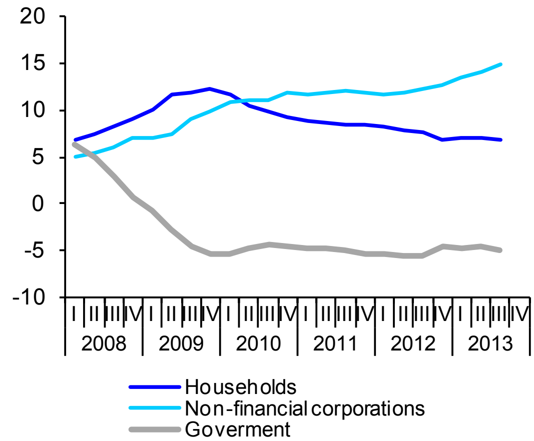
Percentage of GDP, 4-quarter moving average



Source: INE.

7.2 - Saving rates

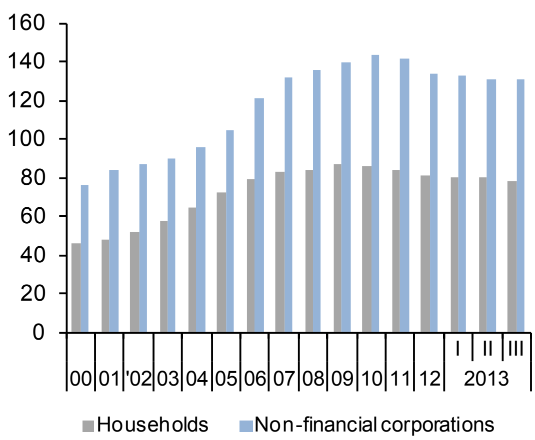
Percentage of GDP, 4-quarter moving average



Source: INE.

7.3 - Gross debt

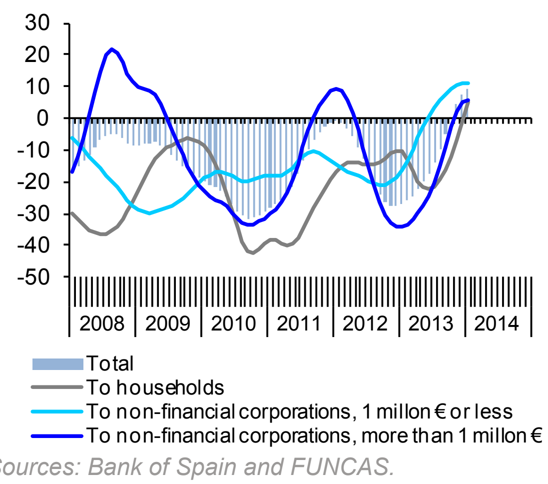
Percentage of GDP, 4-quarter moving average



Sources: Bank of Spain (Financial Accounts).

7.4 - New business loans

Annualised moving quaterly change in %, smoothed and s.a. series



Sources: Bank of Spain and FUNCAS.

Forecasts for 2014-2015

As regards the outlook for 2014 and 2015, certain factors persist which will continue limiting the capacity for growth in domestic demand. The process of correcting certain major imbalances, such as excessive debt, is still under way (Exhibit 7.3). Likewise, although it is possible that the property market may stabilise over the course of the year, this will take a long time to translate into a recovery in home building –across the country as a whole–

such that it will continue to contract and hold back the economy until at least the second half of 2015.

Also, although the need to correct the public deficit will make it necessary to maintain the restrictive fiscal policy stance through both 2014 and 2015, the electoral cycle is likely to impose a more moderate adjustment. Indeed, the extraordinary increase in public calls for tender in 2013 could be the prelude to a recovery in non-residential construction (Exhibit 2.6). In the case of tourism activity, the geopolitical factors that have favoured Spain in recent years will persist, and it will also benefit from the recovery in Europe. Finally, the available indicators for the first two months of the year suggest, as noted above, the strengthening in the first quarter of the positive trend seen in the second half of last year.

Against this backdrop, if the threats to the global economy can be avoided, a moderate rate of growth can be expected over the course of the current year, picking up speed in 2015. The growth forecast for 2014 is 1.2%, two tenths higher than previously, and that for 2015 is 1.8%. In both years growth will be driven by a moderate recovery in domestic demand, while the positive contribution from the external sector will continue (Exhibits 8.1 to 8.6 and Table 1).

The growth forecast for 2014 is 1.2%, two tenths higher than previously, and that for 2015 is 1.8%. In both years growth will be driven by a moderate recovery in domestic demand, while the positive contribution from the external sector will continue.

Private consumption is set to grow in 2014 and 2015, supported by the increase in household income, although slowly, at rates below those of the second half of 2013, as the conditions are not yet right for this higher rate to be sustainable. As regards public consumption, its rate of adjustment may be expected to slow as a result of the electoral cycle, as mentioned.

The effect of the electoral cycle can be seen in the sharp rise in public calls for tender in 2013, which was already driving growth in non-residential construction in the final quarter of last year, and will continue to do so over the course of this year and the next. As a result, growth rates for this component of demand have been revised upwards considerably. Investment in residential construction will remain negative this year, and could stabilise around mid-2015.

Capital goods investment will continue their growth over the forecast period, driven by the same factors that led to their recovery in 2013: replacement of depreciated productive capital, and increased activity in the export sector, in a context of businesses' improved internal economic/financial situation and better external financial conditions. Nevertheless, growth will be slower than in other business cycle recovery stages due to sluggish domestic demand, businesses' ongoing process of deleveraging, and the still limited availability of credit, although this is improving somewhat.

The rate of export growth has been revised downwards, due to the effect of its low starting point, which was caused by the brusque slowdown in the second half of 2013. This was in turn the result of the weakening of demand from emerging countries. Imports look set to gain pace, due to growing domestic demand.

The overall result will be a positive contribution to GDP growth from domestic demand of 0.7 and 1.2 percentage points in 2014 and 2015, respectively, and a net contribution of external demand of 0.5 and 0.6 percentage points, respectively.

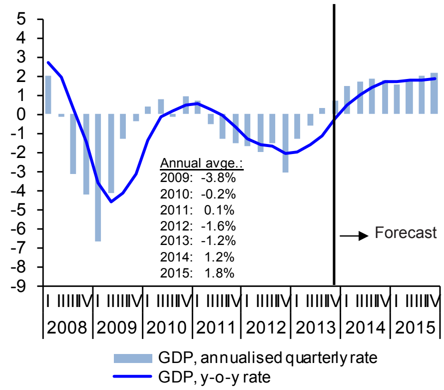
From the sectoral point of view, the recovery should gradually spread from services to industry, while the adjustment in the construction sector will moderate substantially this year, with a recovery in the sector possibly starting in 2015.

Exhibit 8

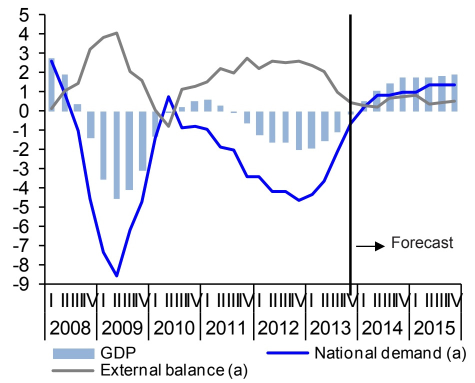
Economic forecasts for Spain, 2014-2015

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

8.1 - GDP

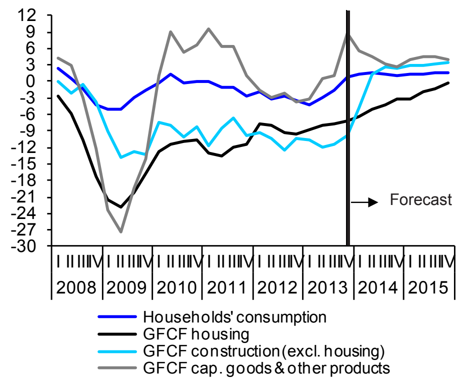


8.2 - GDP, national demand and external balance

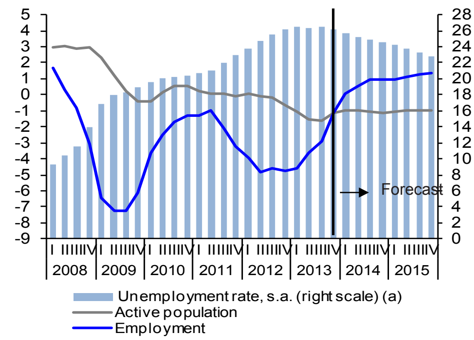


(a) Contribution to GDP growth in percentage points

8.3 - National demand aggregates

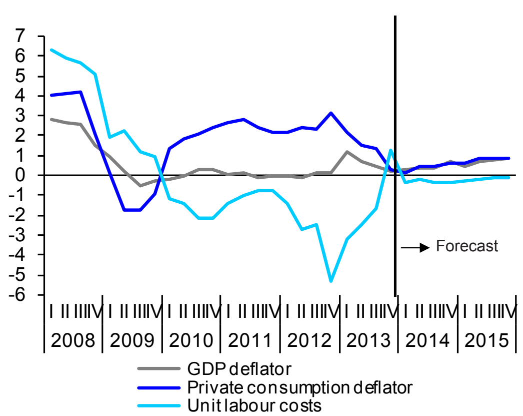


8.4 - Employment and unemployment

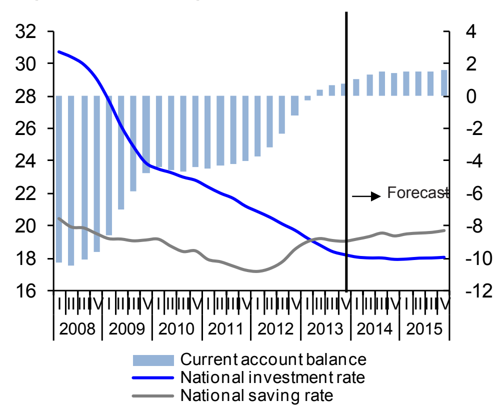


(a) Percentage of working age population.

8.5 - Inflation



8.6 - Saving, investment and c/a balance (% GDP, 4MA)



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

Table 1

Economic Forecasts for Spain, 2014-2015

Annual rates of change in %, unless otherwise indicates

	Actual data			FUNCAS forecasts		Change in forecasts (a)
	Average 1996-2007	2012	2013	2014	2015	2014
1. GDP and aggregates, constant prices						
GDP	**3.7**	**-1.6**	**-1.2**	**1.2**	**1.8**	**0.2**
Final consumption households and NPISHs	3.8	-2.8	-2.1	1.3	1.5	0.6
Final consumption general government	4.3	-4.8	-2.3	-1.3	-0.9	0.0
Gross fixed capital formation	6.2	-7.0	-5.1	0.6	2.5	2.8
Construction	5.6	-9.7	-9.6	-1.9	1.1	3.0
Residential construction	7.6	-8.7	-8.0	-4.8	-1.7	-0.8
Non-residential construction	3.9	-10.6	-10.9	0.3	3.1	6.0
Capital goods and other products	7.4	-2.6	1.7	4.0	4.3	2.6
Exports goods and services	6.7	2.1	4.9	3.6	4.8	-1.8
Imports goods and services	9.3	-5.7	0.4	2.3	3.5	0.4
National demand (b)	**4.5**	**-4.1**	**-2.7**	**0.7**	**1.2**	**1.0**
External balance (b)	-0.8	2.5	1.5	0.5	0.6	-0.8
GDP, current prices: - € billion	--	1,029.3	1,023.0	1,040.4	1,066.4	--
- % change	7.4	-1.6	-0.6	1.7	2.5	0.2
2. Inflation, employment and unemployment						
GDP deflator	3.6	0.0	0.6	0.5	0.7	0.0
Household consumption deflator	**3.1**	**2.5**	**1.3**	**0.4**	**0.8**	**-0.5**
Total employment (National Accounts, FTEJ)	3.3	-4.8	-3.4	0.5	1.1	0.5
Productivity (FTEJ)	0.4	3.3	2.3	0.7	0.7	-0.3
Wages	7.2	-5.6	-3.5	0.8	1.5	1.2
Gross operating surplus	7.3	1.6	1.3	2.5	3.3	-1.0
Wages per worker (FTEJ)	3.2	0.2	0.7	0.4	0.5	0.5
Unit labour costs	2.8	-3.0	-1.6	-0.3	-0.2	0.7
Unemployment rate (LFS)	**12.2**	**25.0**	**26.4**	**25.1**	**23.5**	**-0.3**
3. Financial balances (% of GDP)						
National saving rate	22.2	18.5	19.0	19.4	20.0	-0.1
- of which, private saving	18.9	23.1	23.9(c)	23.4	23.4	-0.4
National investment rate	26.6	19.8	18.2	18.1	18.2	0.8
- of which, private investment	23.1	18.0	16.9(c)	16.8	16.9	0.6
Current account balance with RoW	**-4.4**	**-1.2**	**0.8**	**1.4**	**1.8**	**-0.8**
Nation's net lending (+) / net borrowing (-)	-3.4	-0.6	1.5	2.0	2.4	-0.8
- Private sector	-2.6	10.0	8.8(c)	8.0	7.9	-0.8
- Public sector (general governm. deficit)	**-0.9**	**-10.6**	**-7.3(c)**	**-6.0**	**-5.5**	**0.0**
- General gov. deficit exc. financial instit. bailou	**--**	**-6.8**	**-6.8(c)**	**-6.0**	**-5.5**	**0.0**
Gross public debt	53.5	85.9	94.0	99.7	104.3	-1.5
4. Other variables						
Household saving rate (% of GDI)	12.0	10.4	10.3(c)	10.3	10.3	-0.4
Household gross debt (% of GDI)	82.5	122.6	117.6(c)	112.2	107.4	-0.1
Non-financial coporates gross debt (% of GDP)	82.1	133.5	125.3(c)	118.4	110.9	0.0
Spanish external gross debt (% of GDP)	92.5	167.7	165.2(c)	159.5	153.9	3.0
12-month EURIBOR (annual %)	3.7	1.1	0.5	0.6	1.0	0.0
10-year government bond yield (annual %)	5.0	5.9	4.6	3.2	3.3	-0.9

Notes:
(a) Change between present and previous forecasts, in percentage points.
(b) Contribution to GDP growth, in percentage points.
Sources: 1996-2013 except for (c): INE and Bank of Spain; Forecasts 2014-2015 and (c): FUNCAS.

As regards employment, the more dynamic trend than expected in recent months of 2013 and the start of 2014 has led to an upward revision for this year, in which it will increase by 0.5%, a rate that will rise to 1.1% in 2015. As a result, the unemployment rate will drop by more than envisaged in previous forecasts.

The fact that jobs have started to be created at low GDP growth rates implies that the increase in apparent labour productivity will moderate significantly, and as a result the drop in unit labour costs will slow in 2014 and 2015.

The national savings rate will increase by a few tenths of a percent –as the growth in domestic demand will be less than GDP growth– which means the current account surplus should grow to 1.4% and 1.8% of GDP this year and next, and consequently, the national net lending position will also improve. The general government deficit will come to 6% of GDP in 2014 and 5.5% in 2015, and public debt will rise the following year to over 100% of GDP.

In short, the recovery has gained strength in the first few months of 2014, although growth will remain slow this year, becoming somewhat stronger in 2015. Domestic demand will grow again for the first time since the crisis began, helped in part by the effect of the electoral cycle on the rate of budgetary adjustment, and tourism will remain dynamic. The high level of public debt represents a serious cause for concern, however, because of its negative effect on the capacity for future growth, among other reasons.