Modest slowdown of Spain´s recovery in the second half of 2014

Ángel Laborda and María Jesús Fernández[1]

Spain´s recovery continues, but at a slower pace. While growth rates should increase in 2015, consolidating the recovery and transitioning to a sustainable growth model in the long-term will require further correction of fiscal and macroeconomic imbalances through structural reform.

The pace of Spain´s economic recovery slowed in the third quarter of the year, and, although the data are still very preliminary, this trend appears to have continued into the fourth quarter. This is a temporary dip, however, and the growth rate is expected to regain momentum in 2015, provided the euro area consolidates its recovery. One worrying feature of recent economic developments though is the deteriorating trade balance caused by the sharp rise in imports, driven by a recovery in consumer spending and equipment investments, and ultimately, highlighting the weaknesses of Spain's manufacturing industry.

External context

The recent international economic context has been characterised by the contrast between the strength of the U.S. economy on the one hand, and the fragility of the Eurozone, which has not managed to consolidate its recovery, on the other. At the same time, the emerging economies have lost momentum. The latter are suffering the impact of the slowdown in the Chinese economy, falling commodity prices, financial market instability, and, in some cases, the emergence of economic/ financial imbalances, together with falling growth potential.

U.S. GDP is growing at a trend rate of around 2.5%, and its unemployment rate is below 6%, while the euro area's economy has been practically stagnant in the second and third quarters, with an unemployment rate of 11.5% and inflation below 0.5%. This uneven economic progress on each side of the Atlantic is reflected in the divergent orientation of monetary policy. Thus, while the U.S. Federal Reserve has ended its "Quantitative Easing" debt purchase scheme and is expected to start raising interest rates in the middle of next year, the European Central Bank has cut interest rates and is implementing a series of extraordinary measures to increase liquidity and reactivate credit.

The impact of these measures will probably be limited, as declining credit in the Eurozone is not being caused by a shortage of liquidity, but rather of demand, in a context of high levels of private debt, and the process of balance-sheet clean-up, restructuring, and recapitalisation currently under way at many European banks. The effect of

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these measures on economic activity may arise from the reduction in interest rates on loans to households and businesses, rather than out of the induced increase in credit volumes, particularly in the peripheral countries.

Another consequence of the divergence between monetary policies in the United States and Europe is the depreciation of the euro, which since its annual high in March, has lost 8% of its value against the dollar. In any event, the impact of this depreciation on exports and economic activity in the Eurozone will be limited.

Looking ahead to 2015, the biggest risks to the world economy, and specifically to Spain's economic recovery gaining traction, derive from the possibility of the Eurozone's economy relapsing into recession–or at least becoming mired in a prolonged stagnation–and the uncertain impact of rising U.S. interest rates on world financial markets and on the emerging economies, in particular.

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The Spanish economy in the second half of 2014

Spain's GDP grew by 0.5% in the third quarter, one tenth of a percentage point less than in the previous quarter. This brought the year-on-year rate to 1.6%. Although the detailed figures are not yet available, the contribution of national demand looks similar to that in the preceding quarter, although with slower growth in consumer spending and equipment investments, and faster growth in construction investment, and a more negative contribution from the external sector.

The indicators suggest a slight deceleration in consumer spending, following the marked 3% increase in annualised terms the previous quarter. However, growth will remain relatively strong, at around 2%. Both the retail trade index and sales of consumer goods declared to the tax collection agency by large corporations registered more moderate growth than in the previous period, as in the case of sales of cars to private individuals and overnight hotel stays by Spanish residents. By contrast, imports of consumer goods in July-August dropped relative to the second quarter. The quarterly average consumer confidence index also deteriorated with respect to its average in the previous quarter (Exhibits 1.1 and 1.2).

A moderation in this component of demand was to be expected, as its growth in the first half of the year was not underpinned by a recovery in household spending capacity, but came at the expense of a drop in the savings rate to historical lows, which could not be sustained for long. Moreover, spending was concentrated on durable consumer goods, particularly cars, sales of which had grown in the period –in part, thanks to the government's incentives– at a rapid pace that was unlikely to be sustainable.

Growth in investments in capital goods may have slowed as a consequence of the drop in investments in transport equipment. Registrations of goods vehicles dropped, as did imports of capital goods, although large corporations' sales of capital goods grew at a rate similar to that in the previous quarter. At the same time, investment goods orders rose slightly, reaching their highest level in six years (Exhibits 1.3 and 1.4).

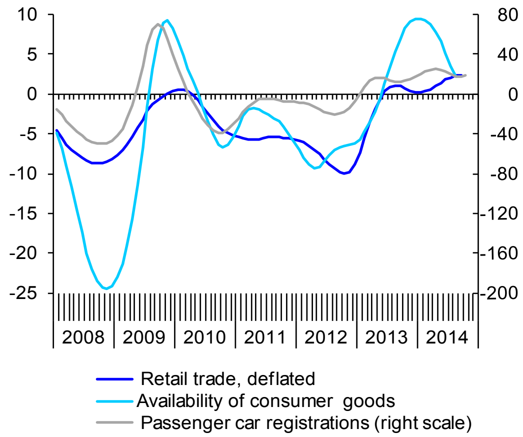
Construction investment, which rose in the second quarter due to the recovery in the non-residential sector and the notable slowing of the decline

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption indicators (I)

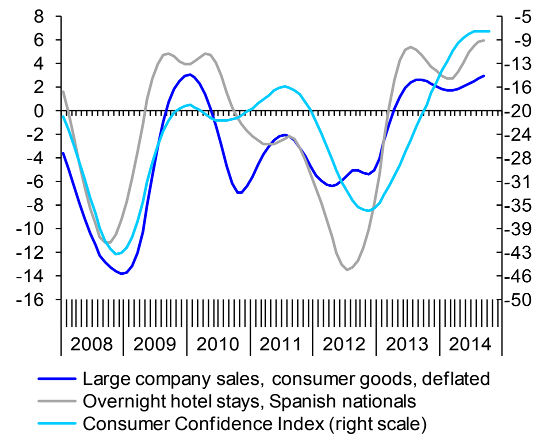
Annualised moving quarterly change in %, smoothed series



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

1.2 - Consumption indicators (II)

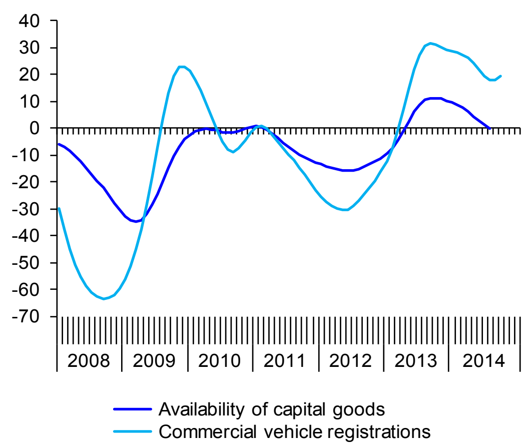
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and FUNCAS.

1.3 - Capital goods GFCF indicators (I)

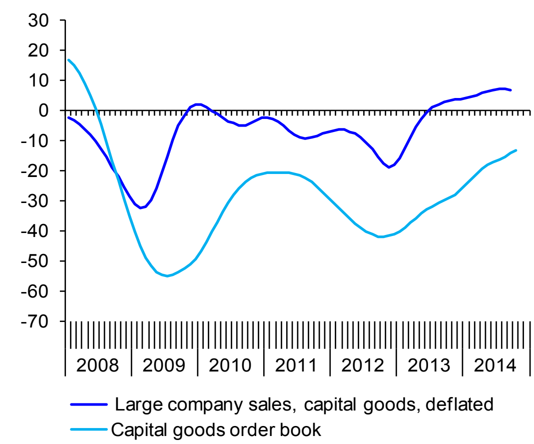
Annualised moving quarterly change in %, smoothed series



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.

in the residential sector, may have improved its performance in the third quarter. Official tenders have grown rapidly, while growth rates in new housing permits have also turned positive (Exhibits 2.5 and 2.6). The property market has stabilised and housing sales have begun to pick up, while prices have halted their descent. This all suggests that the sharp adjustment in the residential construction sector since the start of the crisis may be coming to an end.

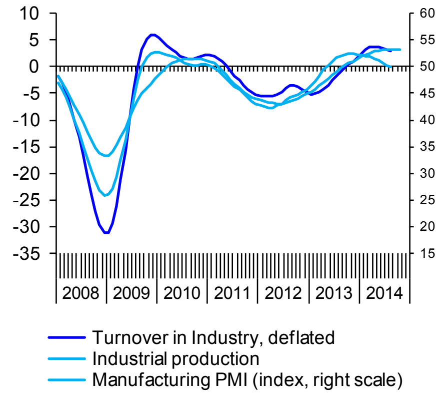
Exports, in real terms, according to customs figures, moderated their growth in the period July-September compared to the previous quarter, although

Exhibit 2

Industrial activity, services and construction indicators

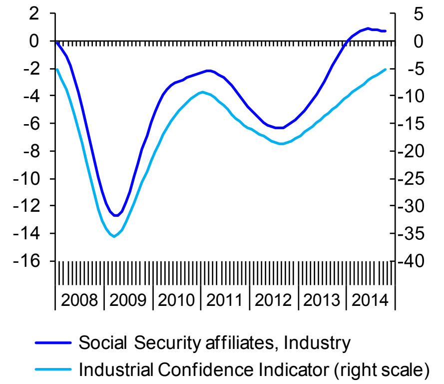
2.1 - Industrial sector indicators (I)

Annualised moving quarterly change in % and index, smoothed series



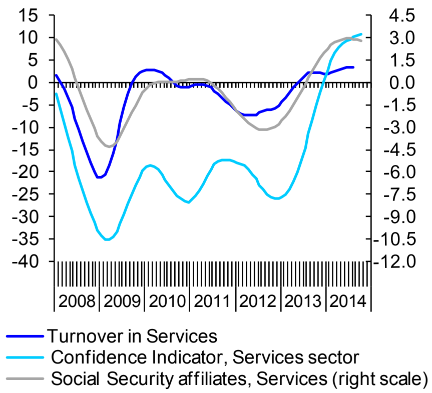
2.2 - Industrial sector indicators (II)

Annualised moving quarterly change in % and index, smoothed series



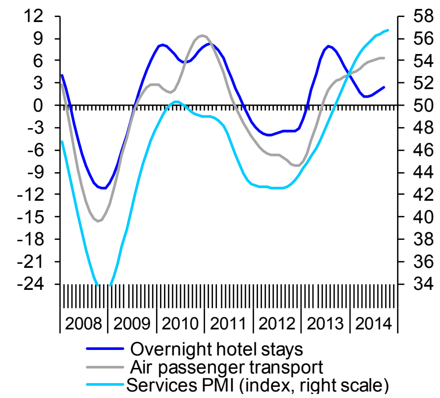
2.3 - Services indicators (I)

Annualised moving quarterly change in % and index, smoothed series



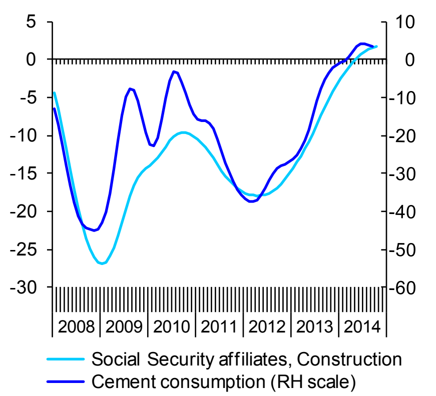
2.4 - Services indicators (II)

Annualised moving quarterly change in % and index, smoothed series



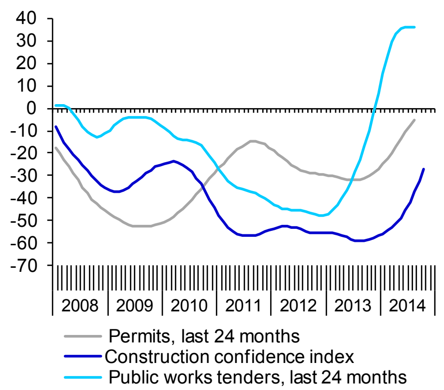
2.5 - Construction sector indicators (I)

Annualised moving quarterly change in %



2.6 - Construction sector indicators (II)

Annualised moving quarterly change in %, and index, smoothed series



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

they maintained a strong trend rate–around 6% in annualised terms–particularly so considering the unfavourable international context. Imports, on the other hand, rose sharply, led by intermediate goods. Purchases of consumer goods and equipment, by contrast, contracted during the period (Exhibit 3.1).

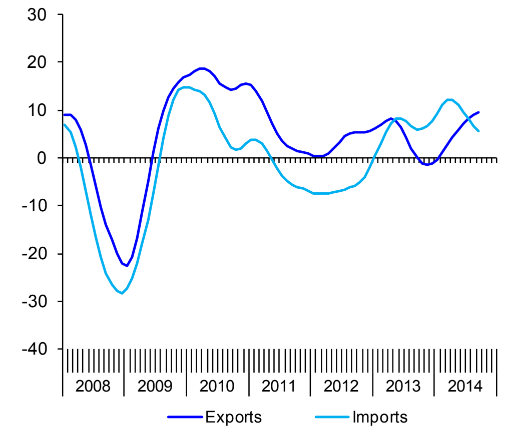
The main indicators of industrial activity, such as the industrial production index (IPI), turnover at constant prices or sales of industrial goods by large corporations, dropped or slowed significantly in the third quarter compared to the preceding quarter, although the data for the period as a whole are still incomplete. However, although the average Purchasing Managers' Index (PMI) was down on the previous quarter, it remained over 50, indicating positive growth rates. Employment in the sector also continued to grow, as shown

Exhibit 3

External sector

3.1 - Exports/Imports at constant prices (Customs)

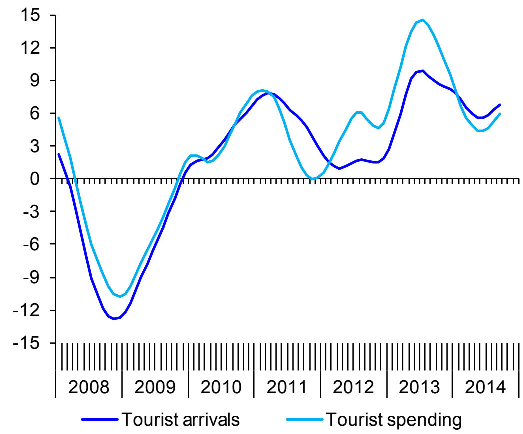
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Economy.

3.2 - Tourism sector

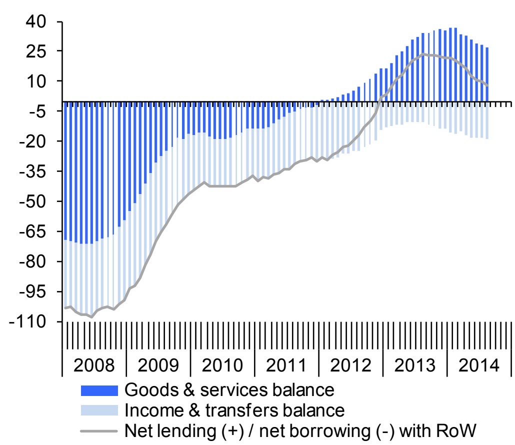
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Economy.

3.3 - Balance of payments

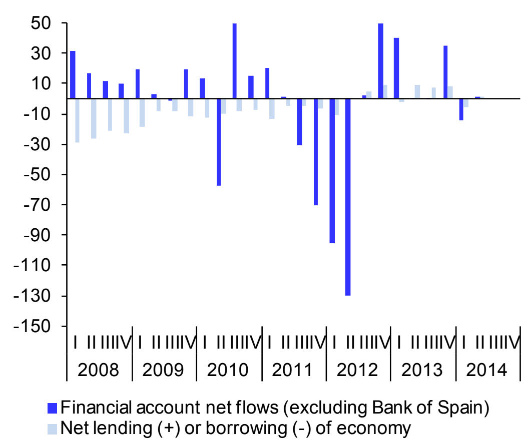
EUR billion, cumulative last 12 months



Source: Bank of Spain.

3.4 - Balance of payments

EUR Billions



Source: Bank of Spain.

by both the Labour-Force Survey (LFS) and the number of social security affiliates, while the confidence indices and order book continued their upward trend (Exhibits 2.1 and 2.2).

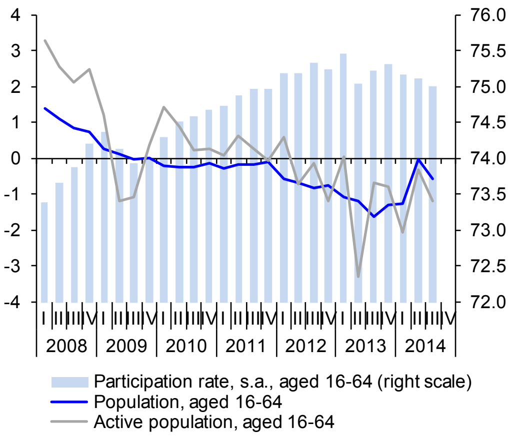
All the indicators concerning the services sector clearly point to a continuation of growth in the third quarter. The sector's turnover grew at a somewhat more moderate pace than in the preceding period, as did overnight hotel stays and the number of social security system affiliates. Nevertheless, sales by large services companies accelerated and the PMI reached a quarterly average higher than in the previous period, which also indicates a faster growth rate (Exhibits 2.3 and 2.4). In the tourism industry (Exhibit 3.2), the

Exhibit 4

Labour market indicators

4.1 - Labour supply

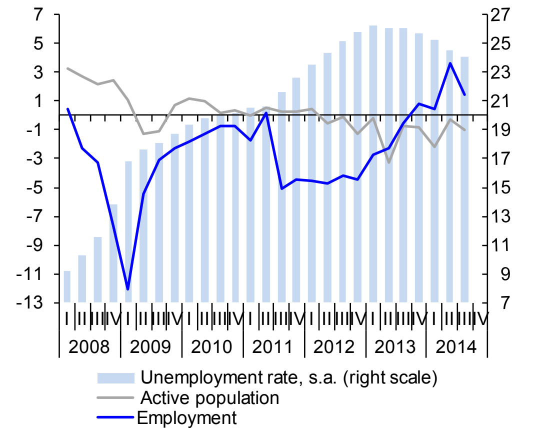
Change q-o-q in % and percentage of population aged 16-64



Source: INE (LFS).

4.2 - Employment and unemployment (LFS)

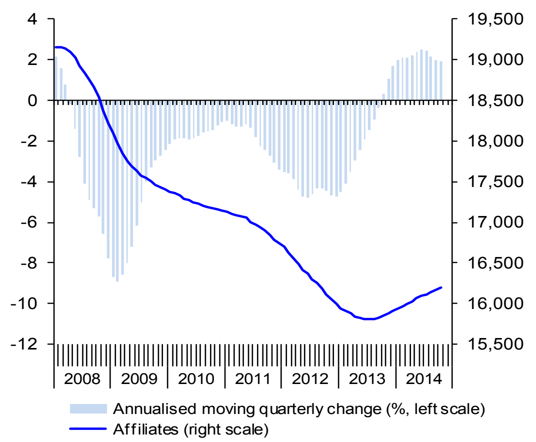
Change q-o-q in % and percentage of working age population



Source: INE (LFS).

4.3 - Social Security affiliates

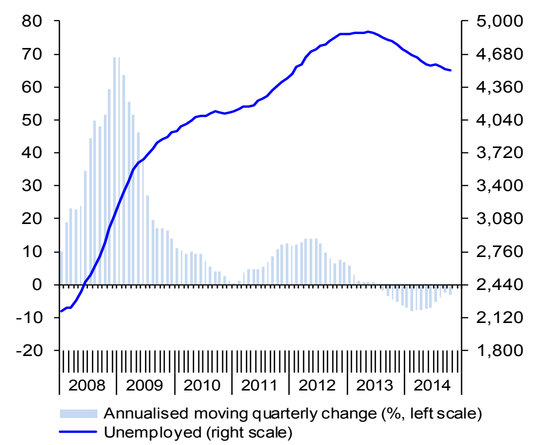
Annualised moving quarterly change in % and thousands



Sources: Ministry of Labour and FUNCAS.

4.4 - Registered unemployment

Annualised moving quarterly change in % and thousands



Sources: Ministry of Labour and FUNCAS.

number of arrivals picked up in the third quarter, as did tourist spending, although growth in overnight hotel stays by foreign nationals was near zero. This is explained by the increasing use of non-hotel accommodation by visitors. In any event, total overnight stays continued to grow, thanks to the increase in overnight stays by Spanish residents.

In the case of the construction sector, the growth in employment stands out, according to figures for both social security affiliations and the LFS. Together with rising cement consumption and the significant increase in confidence in the sector, all the signs are for the trend to be better than expected. The positive Gross Value Added (GVA) growth in the sector registered in the second quarter–for the first time since the start of the crisis–is set to be repeated in the third quarter, such that arguably construction is now recovering after the powerful downturn under way since 2008. At the moment this recovery is linked to non-residential construction, particularly public works, but next year may start to see growth in house building.

According to LFS data, employment grew in the third quarter for the fourth consecutive quarter, although more slowly than in the previous period. Social security affiliates figures also suggest a moderation in the rate of employment growth in the third quarter. Moreover, despite positive labour market growth in the last four quarters, job creation has not yet reached young people, among whom employment continues to contract (Exhibits 4.1 to 4.4).

Correcting the figures for seasonal variations, all the jobs created in the third quarter were full time, whereas part-time employment, the only form that had grown in the last two years, has declined. Similarly, at the start of the recovery, only temporary employment grew, whereas in the third quarter and for the second consecutive quarter, permanent employment has also grown. These are both positive signs, as they may suggest that employers are becoming more confident that the recovery is solid and will be lasting. Nevertheless, the high degree of segmentation between permanent and temporary employees remains a highly negative feature of the Spanish labour market, highlighting one of the main shortcomings of the 2012 labour reform.

As in the preceding quarters, the number of people out of work dropped in the third quarter faster than employment growth. This is explained by the contraction of the labour force, due both to the falling labour force participation rate and, in particular, the shrinking working-age population. In the third quarter, the labour force comprised 240,000 fewer people than a year earlier, and 878,000 people fewer than the peak at the end of 2009. The seasonally adjusted unemployment rate was 24.1%, four tenths of a percent lower than the previous quarter and almost two percentage points lower than the rate one year earlier.

With respect to the fourth quarter, the scant information available regarding the month of October–number of social security system affiliates, PMI and confidence indices–suggests a continuation of the trend towards a deceleration. If the trend persists throughout the quarter, GDP growth could slow to 0.4%. This will situate average annual growth at 1.3%.

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Consumer price inflation has been negative in recent months, largely as a consequence of the strong drop in food prices–particularly unprocessed foodstuffs–and energy products, the latter being pushed down by falling oil prices (Exhibits 5.1 and 5.2). Additionally, inflation in non-energy industrial goods is negative, while inflation in services is only slightly above zero. This is explained by the limited pressure of consumption on underutilised production capacity, in conjunction with falling unit labour costs and falling import costs–both of energy and non-energy products.

The current account balance worsened significantly over the course of the year. Thus, between January and August, a deficit of almost 4.6 billion euros was posted, compared with a surplus of 8.7 billion euros in the same period the previous year. This basically reflects the drop in the trade surplus as a result, not of falling exports, but of an upturn in imports, driven by the recovery of the two domestic demand components with the biggest imported content: durable goods consumption and capital goods investments. There has also been a marked increase in net investment income payments. As a consequence, the national economy had a borrowing requirement in the first eight months of 900 million euros, compared with a lending capacity of 13.3 billion euros in the same period of 2013. This outcome highlights the persistence of one of the characteristic features of the Spanish economy: the high degree of elasticity of imports with respect to rising domestic demand, which can be ascribed to the small size and uncompetitiveness of Spain's manufacturing industry.

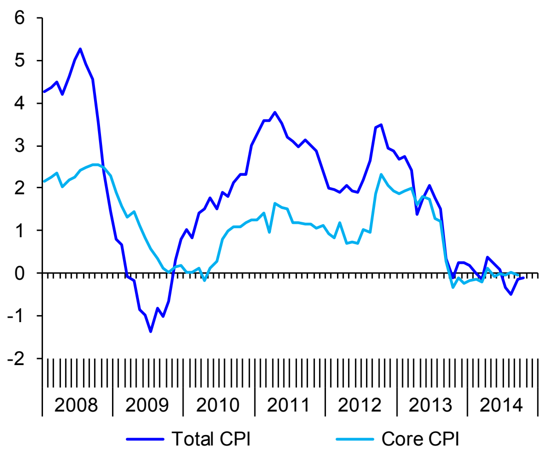
The financial account of the balance of payments to August turned a deficit of 20 billion euros, compared with a surplus of 36 billion euros registered in the same period the previous year. This turnaround in the financial flows to and from the exterior is basically due to the other investments item (mainly loans, repos and deposits). The

Exhibit 5

Price indicators

5.1 - Consumer Prices Index

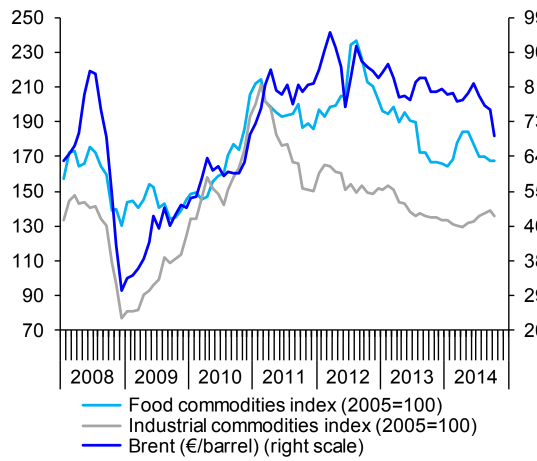
Change y-o-y in %



Source: INE (CPI).

5.2 - Commodities prices in €

Euros and index



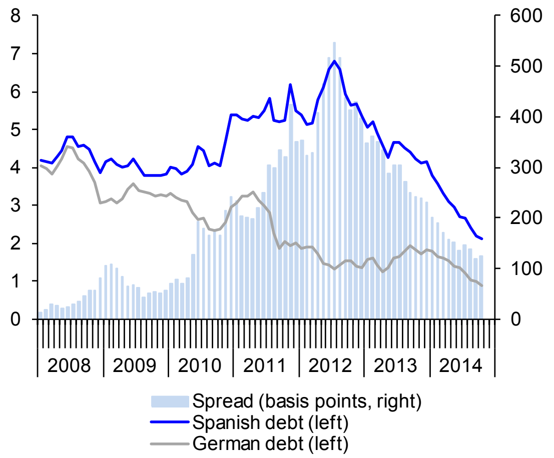
Sources: Ministry of Economy and The Economist.

Exhibit 6

Financial indicators

6.1 - Government 10 years bonds rate

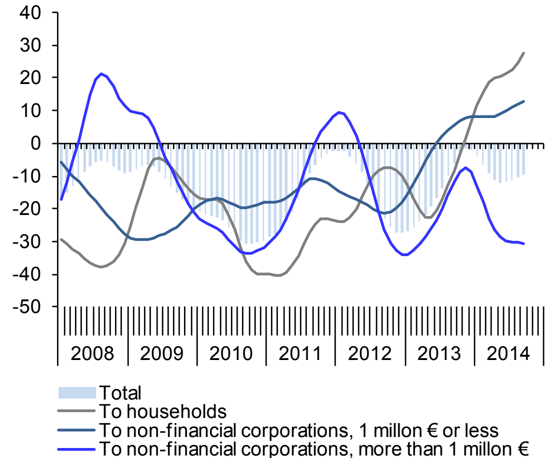
Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - New business loans

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



Sources: Bank of Spain and FUNCAS.

direct investments balance is positive. Foreign investments in Spain rose compared to the previous year, but Spain's investments abroad have also risen. In line with the negative trend in the balance of payments, the rate at which Spain's external debt has been shrinking in nominal terms has slowed markedly, standing at 159.1% of GDP in the second quarter.

The deterioration in the economy's net lending position was a result of households' and non-financial corporations' worsening financial balance. Households suffered a drop in their gross disposable income of 1.9% in the first half of 2014 relative to the same period in 2013, while nominal consumption grew by 3%. As a consequence, savings dropped by 35.4%, the net lending position falling from 5.1% of GDP to 2.2% (Exhibit 7.2). Nevertheless, households have managed to continue reducing their debt, which in the second half of the year came to 73.7% of GDP, 4.1 percentage points lower than one year earlier.

In the case of non-financial corporations, their income (as well as their savings) also decreased in the first half of the year compared to the first half of 2013. This drop was bigger than that in gross fixed capital formation, such that the net lending position in this sector contracted to 1.6% of GDP in the first half of the year, from 2.1% in the same period of the previous year. As in the preceding years, companies used this surplus to reduce their debt, which in the second quarter of 2014 stood at 108.4% of GDP, compared with 115.3% of GDP a year earlier.

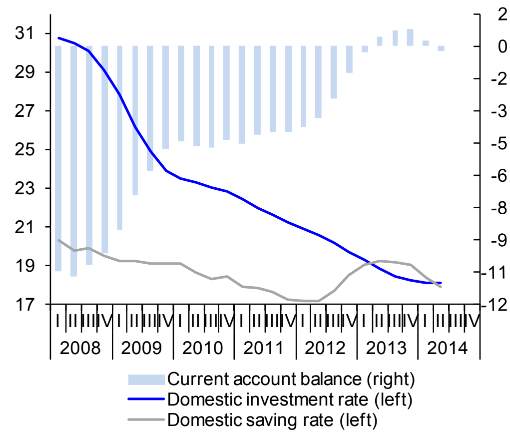
As a reflection of this private sector deleveraging, the outstanding credit balance has continued to contract, although new lending to households and new lending of less than a million euros to businesses –basically to small and medium-sized enterprises– has been growing for several quarters. This positive development is a sign of improving financial conditions in the last year and a half, which constitutes one of the bases on which the Spanish economy's recovery rests, thanks to the process of balance-sheet clean up and restructuring in the banking system, the progressive improvement in the solvency of households and non-financial corporations, and

Exhibit 7

Financial imbalances

7.1 - Domestic saving, investment and current account balance

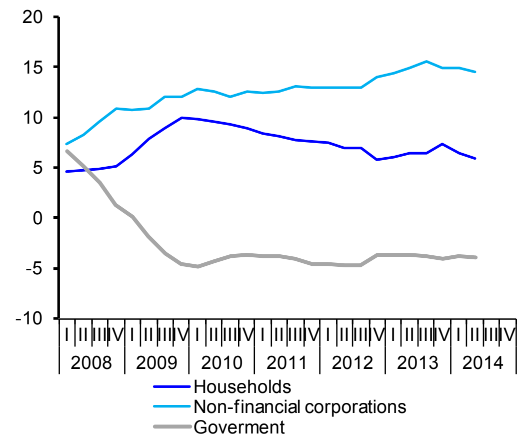
Percentage of GDP, 4-quarter moving average



Source: INE.

7.2 - Saving rates

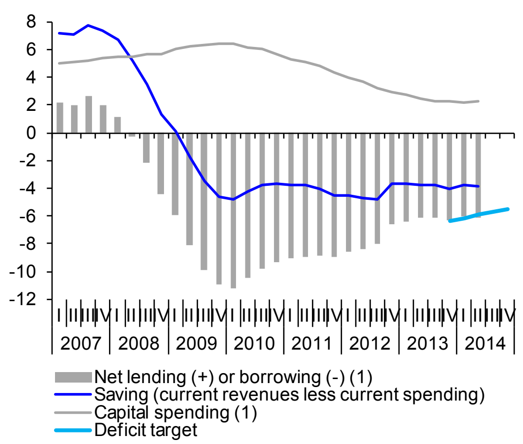
Percentage of GDP, 4-quarter moving average



Sources: INE and IGAE.

7.3 - General Government deficit

Percentage of GDP, 4-quarter moving average

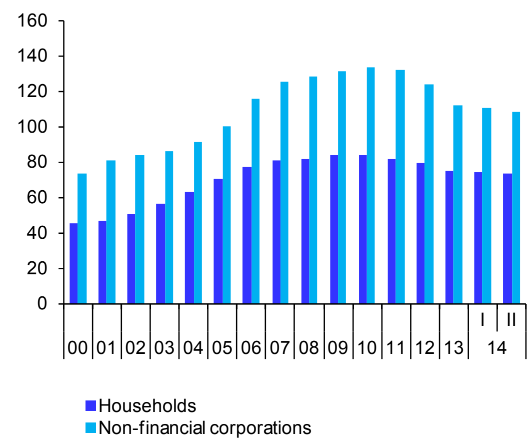


(1) Excluding financial entities bail-out.

Sources: INE and IGAE.

7.4 - Gross debt

Percentage of GDP, 4-quarter moving average



Sources: Ministry of Labour and FUNCAS.

the recovery in market confidence following the dissipation of tensions deriving from the European debt crisis. Nevertheless, financial sector and non-financial sector deleveraging is still ongoing and remains the main brake on the recovery (Exhibit 7.4).

The general government, excluding local authorities, registered a deficit of 4.3% of annual GDP to August, just three tenths lower than the figure obtained in the same period of 2013 –excluding the one-off aid to financial institutions. This tiny improvement comes exclusively from increased VAT and personal income tax collections, as total spending, excluding aid to financial institutions, has barely changed with respect to the same period the previous year. The reduction in social benefit spending –primarily unemployment benefits– and public investment has been offset by the increase in other current expenditure items.

Even supposing that this year local authorities achieve a surplus similar to that of last year –approximately 0.5% of annual GDP– the deficit reduction effort by other areas of the general government over the last four months of the year needed to reach the overall target of 5.5% of GDP will be considerable –much greater than in the first eight months– raising doubts that this will be achieved.

The deviation from the objectives is due to the autonomous regions. Their budgeted deficit for the year as a whole is 1.0% of GDP, 0.5 percentage points less than in 2013, but between January and August their deficit exceeded that in the same period the previous year: 1% of GDP compared with 0.8%, as a consequence of falling income and rising expenses. This meant that by August, they had already used up their deficit margin for the entire year.

The central government deficit to August was 3.1% of annual GDP, representing a drop of six tenths of a percent on the same period of the previous year, excluding aid to financial institutions. This drop was a result of an increase in income and a slight drop in expenses, primarily due, in the case of the latter, to smaller transfers to the National Employment Service, as a result of the sharp drop in unemployment benefit expenditure. In the case of the other expenditure items, the cut-backs have been concentrated in public investment, while interest and miscellaneous expenses have grown. In any event, the 3.4% of GDP deficit target for the year as a whole looks achievable.

As regards the social security funds, the deficit to August came to 0.1% of annual GDP, such that there was apparently a broad margin to achieve the annual objective of 1.1%. However, it should be borne in mind that over the same period the previous year, the deficit was 0.2% and the year ended with a deficit of 1.1% and the pattern this year could be similar. Despite the continuing growth of pension expenditure, spending on benefits has dropped due to the sharp drop in unemployment benefit payments. At the same time, income from social security contributions has risen. As a consequence of all these factors, the central government has reduced the transfers it makes to this segment of the general government.

In short, achieving the 5.5% of GDP deficit target for the general government as a whole will depend on the extent of the non-compliance by the autonomous regions, and whether this amount can be offset by the local authorities' surplus. The objective for local authorities is to balance their books, but, like last year, they will probably end the year with a small surplus (Exhibit 7.3).

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To conclude, the recovery has continued in the third quarter, although the pace was slower than in the previous quarter, mainly as a result of a loss of momentum by consumer spending and equipment investments, and a worsening of the contribution from the external sector, although this was due more to an upturn in imports than a decline in exports. The relatively high rates of consumer spending and equipment investment growth in the previous quarters were not sustainable, and it is likely that the more moderate pace will be continued over the rest of the year, although next year will benefit from the stimulus of the tax cuts, improved financial conditions, and real income gains deriving from lower prices of energy imports. Additionally, the property sector has stabilised. Investment in residential construction may soon start to recover, such that its contribution to growth will again turn positive.

The flipside to the current recovery is the deterioration in the current account balance, which, if it continues, may mean a return to a deficit, which would mean that debt vis-à-vis the rest of the world would start to grow again. This will increase the economy's vulnerability to new episodes of tension in the financial markets. Moreover, servicing this debt –a large portion of which is public– could place a serious brake on growth when interest rates start to rise.

Consolidating the recovery and transitioning to a balanced and sustainable long-term growth model calls for an intensive investment process to raise competitiveness and increase the size of the industrial sector, in order to boost Spain's export capacity and reduce the economy's high propensity to import. This requires internal savings to be made, public sector imbalances to be corrected, and the capacity to attract foreign direct investment to be improved, accompanied by a strategy of structural reforms geared towards these objectives.