The Spanish economy's recovery in a weakened international context

Raymond Torres and María Jesús Fernández[1]

Spain´s economic recovery is outperforming expectations and economic growth should remain relatively strong until the end of the year. However, the deterioration in the outlook for the global economy, renewed turbulence in European financial markets and the end of temporary positive shocks that had nurtured the recovery may lead to a significant slowdown in 2017.

The global economic context has deteriorated as a result of the outcome of the referendum on EU membership of the United Kingdom, uncertainties in European banking systems, concerns regarding the ability of the EU to stimulate growth and create jobs and a weakening of economic growth in emerging economies, notably China and Latin America. Moreover, the period of low and declining oil prices, which had sustained real incomes in earlier years, may have come to an end. Though the electoral period may be over, the risks over the projection period are on the downside.

International context

The slowdown in the emerging economies, the turbulence affecting financial markets, in Europe in particular, and slower growth in export markets have led to a weakening of the global economy.

China's transition towards an economic model less dependent on exports has run into fresh difficulties. The volume of bad debt is weighing down banks' balance sheets and hindering investment growth, consumption, and the creation of business aimed at meeting domestic demand. The result is slower growth in Chinese imports, particularly affecting other Asian economies, such as Japan and South Korea.

Natural resource exporting countries have suffered serious adjustments due to international price trends. Latin America has entered a period of sluggish growth, which in Brazil's case has translated into one of the deepest recessions in its recent history. Russia, the Arab countries and Sub-Saharan Africa's oil and gas producers have seen their economies slow sharply. The oil price has risen in recent months as a result of supply problems in a number of producer countries. Geopolitical risks in North Africa and the Middle East remain high, diverting tourism towards more stable countries, such as Spain.

In the first quarter of 2016, the U.S. economy grew by 1.1% a year, three tenths less than in

[1] Economic Trends and Statistics Department, Funcas.

the previous quarter. Nevertheless, according to the data for June, employment grew strongly, maintaining the unemployment rate below 5%, stimulating labour market participation and raising wages. The Federal Reserve is now expected to start gradually tightening monetary conditions over the next few months.

For its part, the euro-area economy is facing fresh turbulence, with high unemployment and a continuing risk of deflation. Growth in the first quarter came to 0.6%. Nevertheless, there have been signs of weakness in industrial activity. The United Kingdom's exit from the European Union (so-called Brexit) has created a climate of greater uncertainty. In Italy, there are further concerns about the solidity of the banking system in light of the high non-performing loan rate and difficulty capitalizing the worst-affected institutions.

Against this backdrop, the IMF anticipates stagnation of growth in the euro area at around 1.7% and inflation a long way below the 2% target. This would justify the ECB's maintaining its current accommodative policy, with negative interest rates and purchases of public and private bonds worth up to 80 billion euros a month (TLTRO II).

The Spanish economy is facing a more uncertain international context, clouded by the prospect of lengthy EU-UK negotiations, fresh bouts of turbulence in European financial markets, and EM weakness.

In short, the Spanish economy is facing a more uncertain international context, clouded by the prospect of lengthy negotiations between the EU and the United Kingdom, fresh bouts of turbulence in European financial markets, and the weakness of the emerging economies. Export markets will face slower growth and oil prices will rise. Nevertheless, the global economy should avoid a new recession, and the monetary conditions created by the ECB should help partially offset this turbulence.

Recent developments in the Spanish economy

Spain's GDP grew by 0.8% in the first quarter of 2016, the same rate as in the previous quarter. In annualised terms, this growth was equivalent to 3.1 % (all quarter-on-quarter growth rates below will be given in these terms). The year-on-year increase was 3.4 %.

The pace of domestic demand growth rose compared to the preceding quarter, boosted by an upturn in public and private consumption, and a bigger accumulation of inventories. The contribution to the quarter-on-quarter growth rate was 4.2 percentage points, while the net contribution of the external sector was -1.1 percentage points.

Private consumption rose by 3.8%, which beat expectations and was higher than in the previous quarter. Various factors are stimulating this variable's growth: rising wages thanks to increased employment, the income tax cut, and falling energy prices. Public consumption growth also accelerated, rising to 3.4%, which has been the pattern in the first quarter for several years now. In current price terms, growth was 10.7%, although in year-on-year terms the growth rate was 1.9%.

Gross fixed capital formation in capital goods moderated its climb to 5.4%, the lowest rates since the first quarter of 2013. Nevertheless, it is remarkably strong given that this investment growth is taking place while businesses are simultaneously paying off debt. Several factors are driving this variable's favourable performance: the recovery in the business surplus, lower costs deriving from falling interest rates and energy prices, and the need to replace productive capital after a long investment freeze during the crisis.

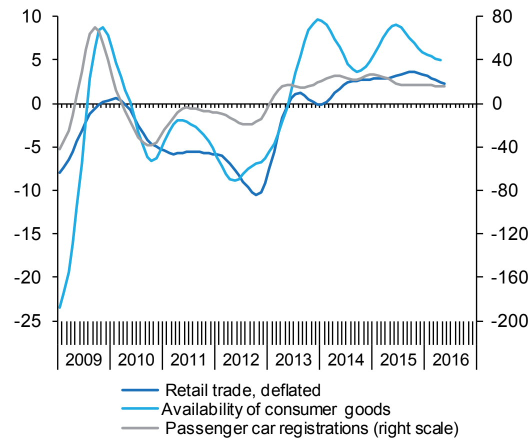
Construction investment fell by 0.8%, as a result of the drop in non-residential investment, probably caused by the end of public works driven by the electoral cycle: in 2015, general government investment rose for the first time since 2009 at a

Exhibit 1

Consumption and capital goods investment indicators

1.1 - Consumption indicators (I)

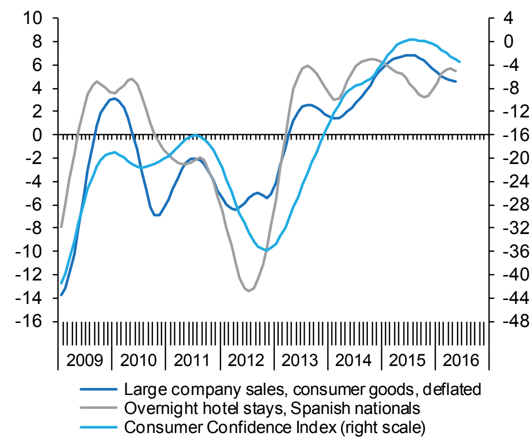
Annualised moving quarterly change in %, smoothed series



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

1.2 - Consumption indicators (II)

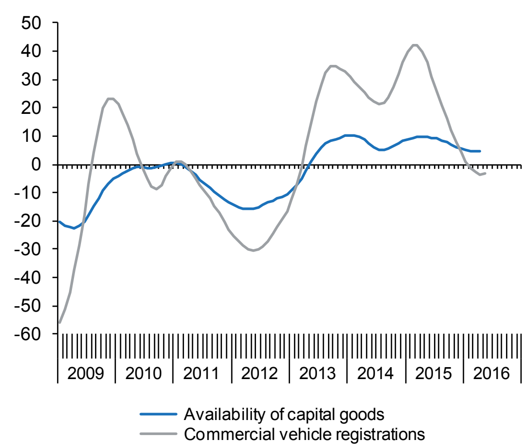
Annualised moving quarterly change in % and index (CCI), smoothed series



Sources: European Commission, INE, AEAT and Funcas.

1.3 - Capital goods GFCF indicators (I)

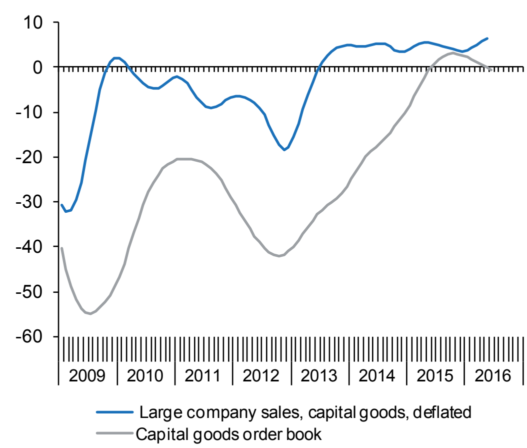
Annualised moving quarterly change in %, smoothed series



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.

rate of 12.7%. The rate of growth in investment in home building, by contrast, rose to 5%, reflecting the recovery in the property market. Growth in housing sales accelerated in the first quarter, as did prices, which according to figures from the National Statistics Institute (INE), rose by 6.3% over the period in year-on-year comparative terms.

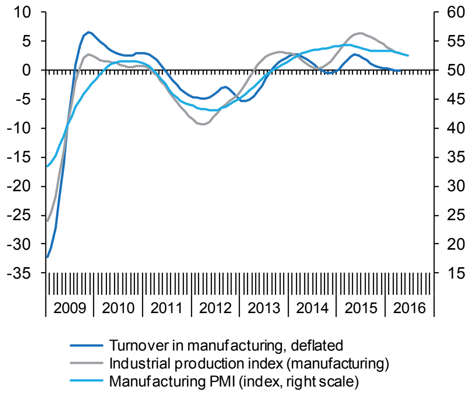
Total exports fell in the first quarter by 2.1% as a result of the decline in services exports, which include tourism. The drop in services exports

Exhibit 2

Industrial activity, services and construction indicators

2.1 - Industrial sector indicators (I)

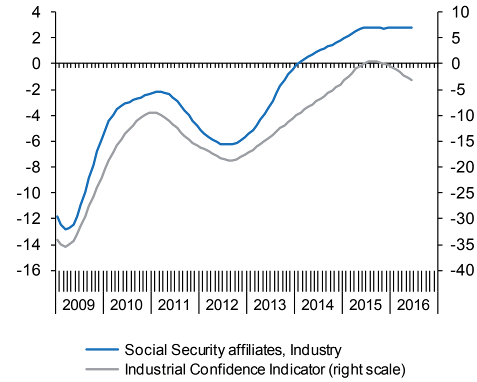
Annualised moving quarterly change in % and index, smoothed series



Sources: INE, Markit Economics and Funcas.

2.2 - Industrial sector indicators (II)

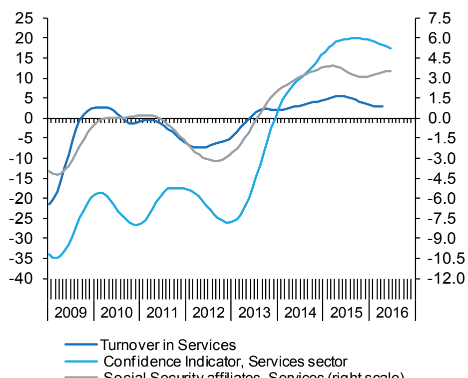
Annualised moving quarterly change in % and index, smoothed series



Sources: European Commission, Ministry of Labour and Funcas.

2.3 - Services indicators (I)

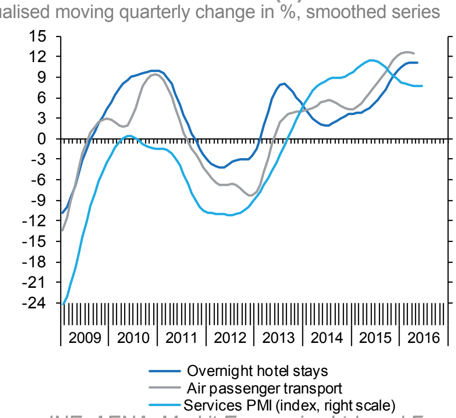
Annualised moving quarterly change in % and index, smoothed series



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

2.4 - Services indicators (II)

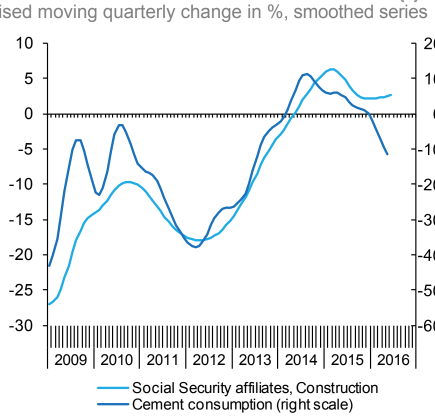
Annualised moving quarterly change in %, smoothed series



Sources: INE, AENA, Markit Economics Ltd. and Funcas.

2.5 - Construction sector indicators (I)

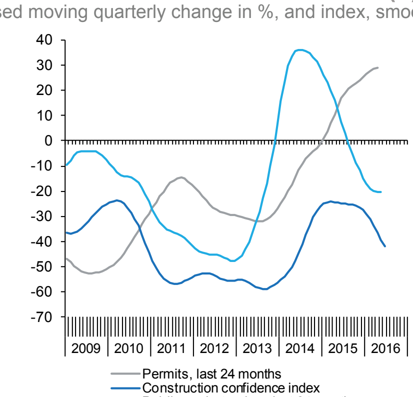
Annualised moving quarterly change in %, smoothed series



Sources: Ministry of Labour, OFICEMEN and Funcas.

2.6 - Construction sector indicators (II)

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



Sources: Ministry of Industry, SEOPAN and Funcas.

registered by the National Accounts figures is surprising in view of the excellent performance over the same period of the indicators relating to tourism activity, such as tourist arrivals and the number of overnight hotel stays. Goods exports experienced zero growth in real terms. However, this could be considered favourable performance in view of the fact that global exports contracted over the period.

Goods imports dropped while services imports rose, with strong growth in tourism services. The result was growth of total imports of 1.4% in real terms, although in current prices, purchases from abroad dropped by 9.2%. This is basically explained by the drop in energy prices.

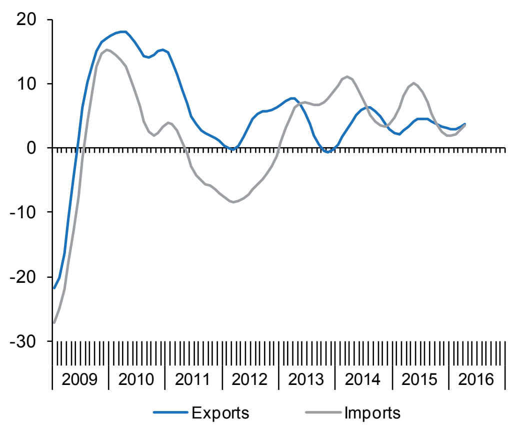
From a supply-side perspective, the sector enjoying fastest gross value added growth was manufacturing, followed by market services.

Exhibit 3

External sector

3.1 - Exports/Imports at constant prices (Customs)

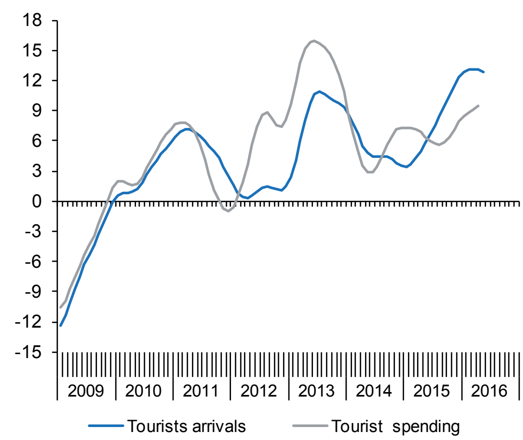
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Economy.

3.2 - Tourist sector

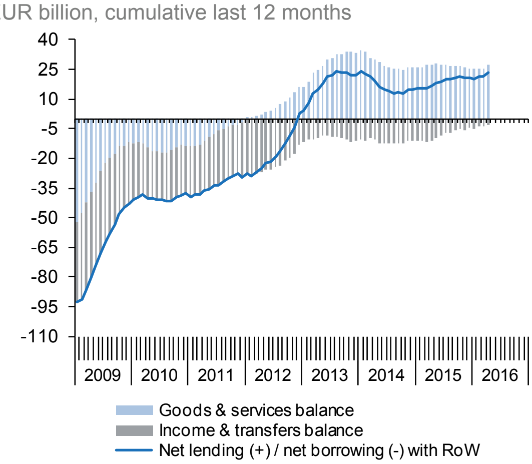
Annualised moving quarterly change in %, smoothed series



Source: Ministry of Industry.

3.3 - Balance of payments

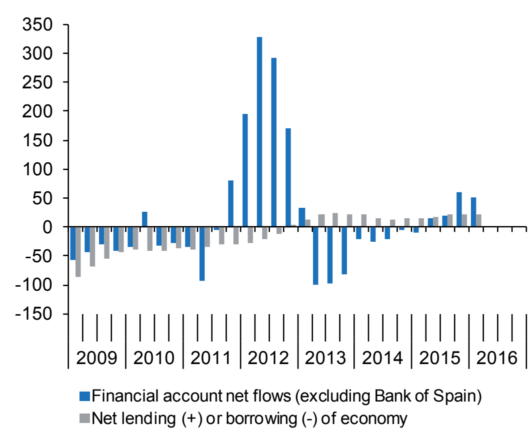
EUR billion, cumulative last 12 months



Source: Bank of Spain.

3.4 - Balance of payments

EUR billions, moving sum 4 quarters



Source: Bank of Spain.

Services sectors with the closest links to the public sector also saw a rise in GVA, while construction suffered a contraction, probably as a result of the cut-back in public works.

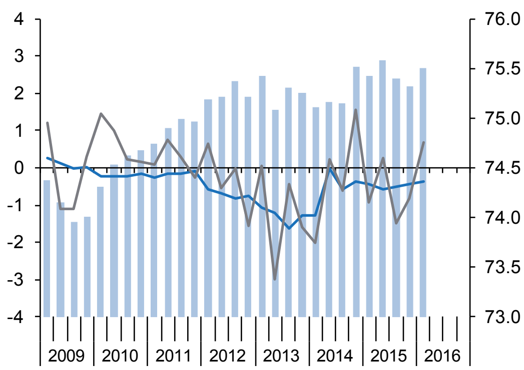
Employment grew faster in terms of full-time equivalent jobs, with the growth rate rising to 3.7%. The bulk of the increase was in manufacturing, while employment in construction declined. The seasonally adjusted unemployment rate fell to 20.3%, six tenths of a percent lower than in the preceding quarter. This was entirely due to the increase in employment, as the activity rate registered a slight increase over the period. The labour force remained on a downward trend due to the shrinking of the working-age population.

Exhibit 4

Labour market indicators

4.1 - Labour supply

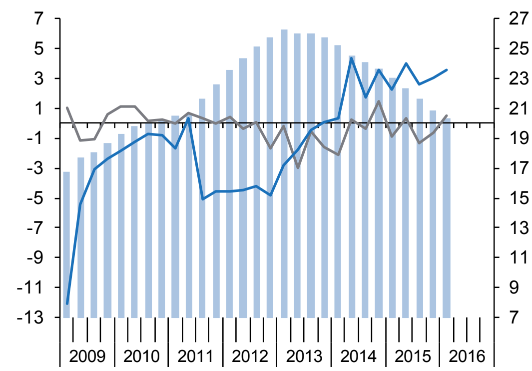
Annualised change q-o-q in % and percentage of population aged 16-64



Source: INE (LFS).

4.2 - Employment and unemployment (LFS)

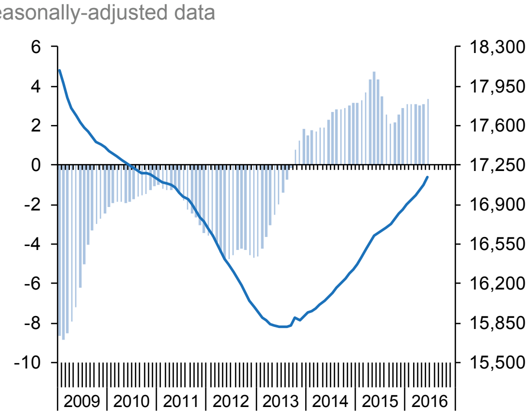
Annualised change q-o-q in % and percentage of working age population



Source: INE (LFS).

4.3 - Social Security affiliates

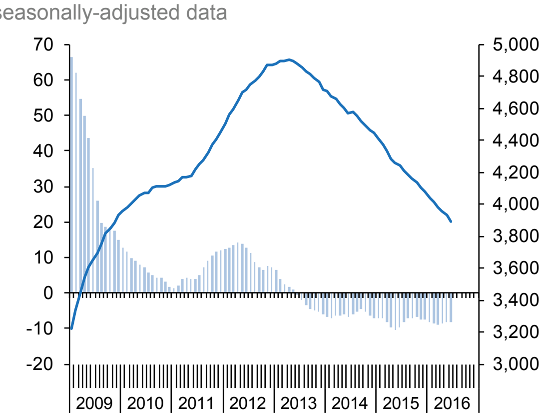
Annualised moving quarterly change in % and thousands, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

4.4 - Registered unemployment

Annualised moving quarterly change in % and thousands, seasonally-adjusted data



Sources: Ministry of Labour and Funcas.

As employment grew faster than GDP, productivity dropped in the first quarter of the year, although the trend growth rate remained around 0.2%. Compensation per employee fell in the first quarter, such that unit labour costs registered a decrease. In the case of the manufacturing industry, ULCs grew in the first quarter, but this followed several quarters of steep decline, such that the overall trend remains downwards.

Demand indicators remained healthy in the second quarter despite the poorer confidence indicators. The consumption figures were generally good in April, although they worsened in May, suggesting an overall growth rate somewhat lower than in the first quarter. The indicators available for investments in capital goods showed an improvement. As regards foreign trade, exports of goods recovered faster than imports at the start of the second quarter, such that, in conjunction with the positive performance of tourism, the external sector should make a positive contribution to growth.

Sector activity indicators, on the other hand, suggest more sluggish growth, with the slowdown possibly coming from industry, but above all, from construction. This latter sector is where the signs of a continued decline in activity are clearest. Official tenders, taking a moving sum over 24 months as an approximate measure of the volume of public works, fell at increasingly negative rates, as did cement consumption. Nevertheless, new house building continues to pick up, with the increase in new housing permits (also calculated as a moving 24-month sum) gaining pace, and employment in the sector continues to rise, according to social security membership figures, although the rate is more moderate and slowing. From these figures it may, therefore, be concluded that the contraction in activity in this sector is being driven by the cut-back in public works, which is not being offset, at least at present, by a recovery in residential construction.

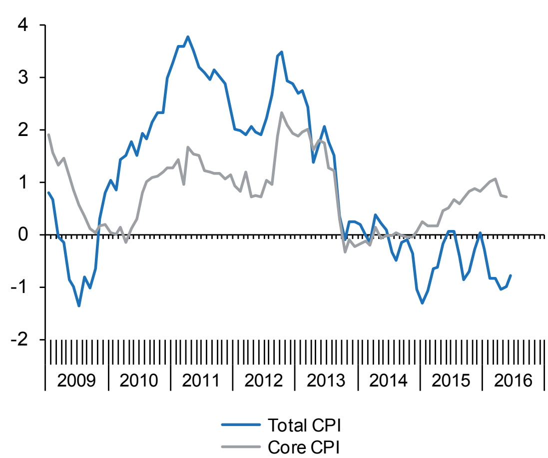
In the last few months, employment, according to social security membership numbers, has grown somewhat less than in 2015. The loss of momentum affected all sectors of the economy. Registered unemployment also moderated its rate of decline over the same period.

Exhibit 5

Price indicators

5.1 - Consumer Prices Index

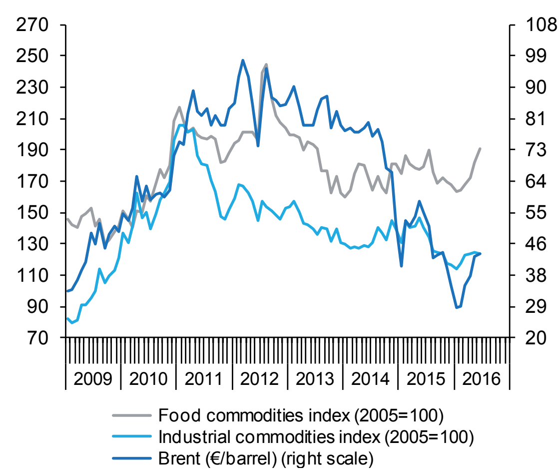
Change y-o-y in %



Source: INE (CPI).

5.2 - Commodities prices in €

Euros and index



Sources: Ministry of Economy and The Economist.

All in all, the economic indicators suggest a slight slowing of GDP growth in the second quarter, which could be estimated at 2.8% quarter-on-quarter on an annualised rate, or 0.7% if not annualised. As in the first quarter, this result would be higher than expected.

The headline inflation rate remained negative throughout the first six months of the year as a result of the drop in the prices of energy products. Core inflation, however, remained positive, although lower in April and May than it had been at the start of the year.

The current account of the balance of payments to April posted a surplus of 1.5 billion euros, compared to a deficit of 1.9 billion registered in the same period of the previous year. The improvement derived from both a decrease in the income deficit and an increase in the trade surplus in goods and services. In the case of the trade balance in goods, the deficit on the energy balance continued to shrink thanks to lower oil prices, while the surplus on the non-energy balance fell only very slightly. The financial account, excluding the Bank of Spain, registered a positive balance – *i.e.* an outflow of funds – of 4.8 billion euros. This balance was bigger than that registered in the same period of the previous year as a result of the sharp contraction in foreign investment in Spain, which was not offset by the drop in Spanish investment abroad.

The national savings rate (the moving average over four quarters) was 22.3% of GDP in the first quarter of 2016, two tenths of a percent more than in the previous quarter. The national investment rate also rose, such that the economy's net lending position remained on a similar level to that in the previous quarter, at 2% of GDP.

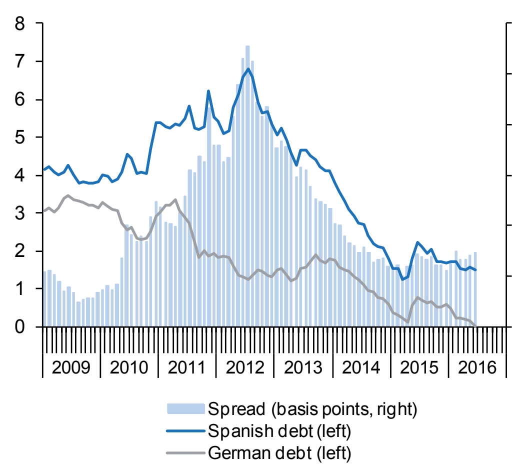
Both households and non-financial corporations maintained a financial surplus in the first quarter, although in the case of households it dropped to 3.2% of GDP. Non-financial corporations' surplus remained at the same level as in the previous quarter, at 2.4% of GDP. For the last few years this surplus has largely been used to pay off debt. Thus household debt ended 2015 at 106% of gross disposable income, 6.1 percentage points lower

Exhibit 6

Financial indicators

6.1 - Government 10 years bonds rate

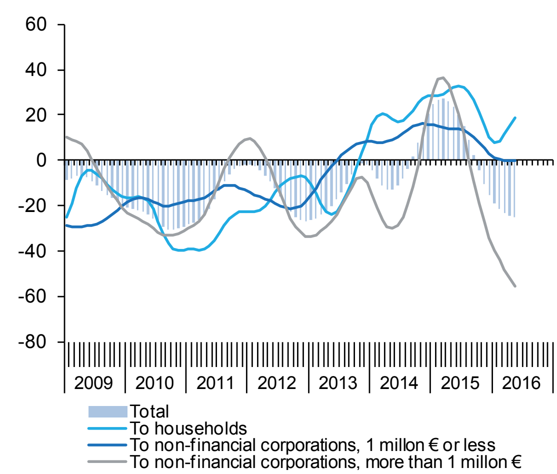
Percentage and basis points



Sources: ECB and Bank of Spain.

6.2 - New business loans

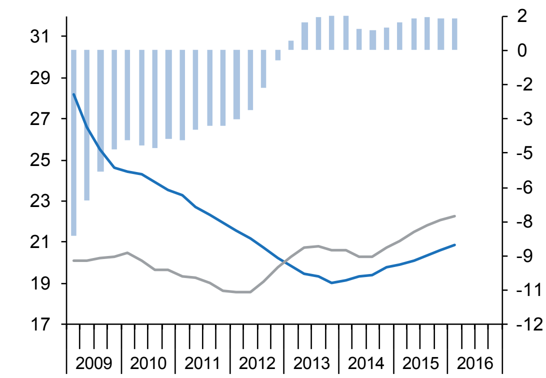
Annualised moving quarterly change in %, smoothed and s.a. series



Sources: Bank of Spain and Funcas.

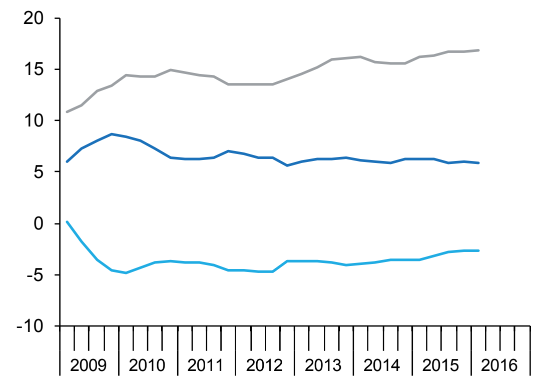
Exhibit 7
Financial imbalances

7.1 - Domestic saving, investment and current account balance
Percentage of GDP, 4-quarter moving average



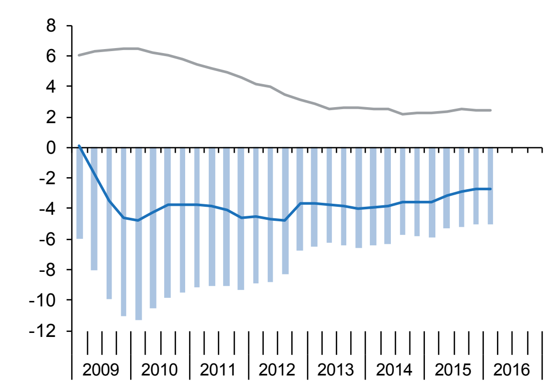
Source: INE.

7.2 - Saving rates
Percentage of GDP, 4-quarter moving average



Sources: INE and IGAE.

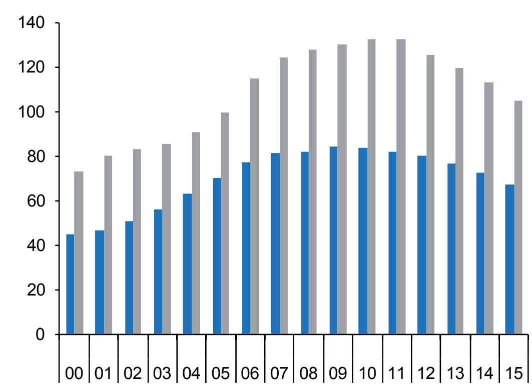
7.3 - General Government deficit
Percentage of GDP, 4-quarter moving average



(1) Excluding financial entities bail-out.

Sources: INE and IGAE.

7.4 - Gross debt
Percentage of GDP, 4-quarter moving average



Source: Bank of Spain (Financial Accounts).

than one year earlier. Non-financial corporations' debt dropped by 8.2 percentage points to 104.6% of GDP.

The consolidated general government deficit in the first quarter of 2016 came to 8.3 billion euros, 500 million euros more than the deficit in the same period of the previous year. Income dropped by 0.1%, as a result of the drop in income tax and corporate tax revenues. The drop in income tax revenues was a result of the tax cut that came into effect in January, while smaller corporate tax revenues were also due to certain transitional measures that meant advance payments were brought forward last year. Spending grew by 0.4%, excluding expenditure arising as a result of bank bail-outs. By level of government, the central government and the autonomous regions reduced their deficit; by contrast, local authorities and social security reduced their surplus. In April, the consolidated result for all branches of government excluding local authorities followed the same downward trend in income and upward trend in spending.

In the first quarter of 2016, the central government and the autonomous regions reduced their deficit; by contrast, local authorities and social security reduced their surplus.

The risk premium on Spanish sovereign debt rose moderately during the turbulence in the wake of Britain's referendum on membership of the EU, with yields on Spanish debt rising and those on German debt falling. Nevertheless, in the following days there was a return to normal, with levels similar to those in the weeks prior to the referendum. However, the yield on Spanish debt, at around 1.3%, is the lowest it has been since 2015, which could also be a sign of the reaction to the results of the Spanish elections.

Forecasts for 2016 and 2017

The Spanish economy is expected to slow during the remainder of 2016 and into 2017, although growth will continue to outpace the European average. These forecasts were made based on the assumption that there is no change in monetary conditions. This implies that that the ECB will maintain its expanded asset purchase policy (TLTRO II), and that twelve-month interest rates in the inter-bank market will remain zero, and rates on ten-year government bonds stay around 1.5%. Over the forecast horizon, the euro will continue to trade at its current level of 1.10 dollars.

The slowdown is mainly due to external factors. Annual growth in export markets, the key driver of the economic recovery, could suffer the impact of Brexit and weaker emerging economies. For 2017, exports of goods and services are expected to grow by 4.3%, which is faster than growth in global markets, but one point less than in 2015.

The scenario envisages OPEC decisions concerning output to continue having an impact. The oil price is likely to increase over the course of the year, to reach 60 dollars a barrel in 2017. This would end the improvement in the terms of trade which supported real incomes and consumption in 2015.

The uncertainty in financial markets, together with the lack of demand, could lead to a sudden halt in business investments. An increase in capital goods investments of 1.1 percentage points less than in 2015 is projected for 2017. Nevertheless, investment will continue to grow strongly thanks to the reduction in financial charges enabled by the ECB's accommodative monetary policy and the shrinking of business debt.

There are also domestic decelerating factors. Household consumption is expected to increase in the second half of 2016 and into 2017 by between 2% and 2.5% (compared with 3% in 2015). This is the result of the impact of higher oil prices on real incomes, the slowdown in job creation, and wage moderation. Construction investment could also suffer from a slowdown. The savings rate is not expected to fall further, bearing in mind that household debt is still relatively high. Lastly, a slowdown in public consumption is expected, as a result of the end of the electoral cycle.

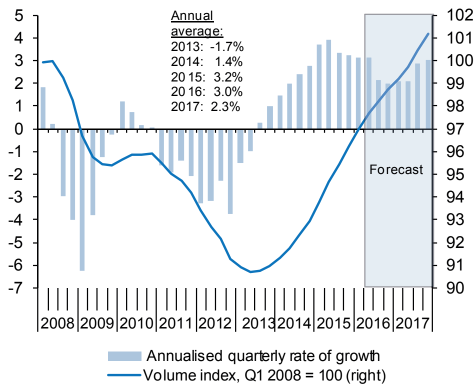
Growth could reach 3% in 2016, three tenths more than projected in the previous forecasting exercise, compared with 1.7% projected by the IMF for the euro area as a whole. The GDP growth forecast for 2017 remains unchanged at 2.3% (half a point

Exhibit 8

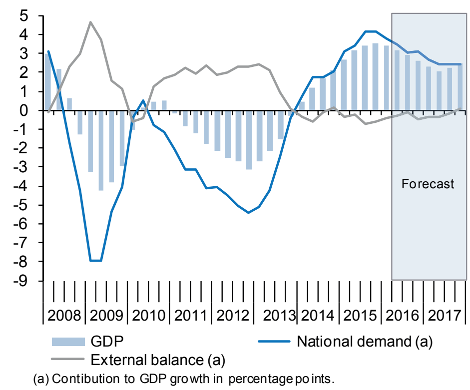
Economic forecasts for Spain, 2016-2017

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

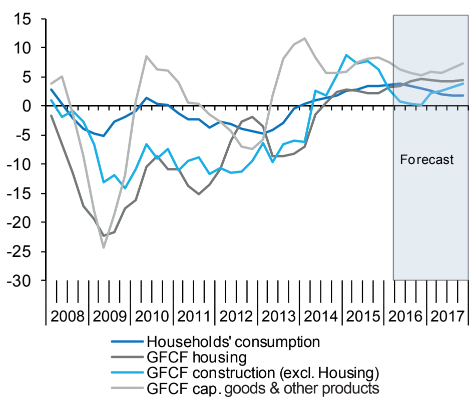
8.1 - GDP



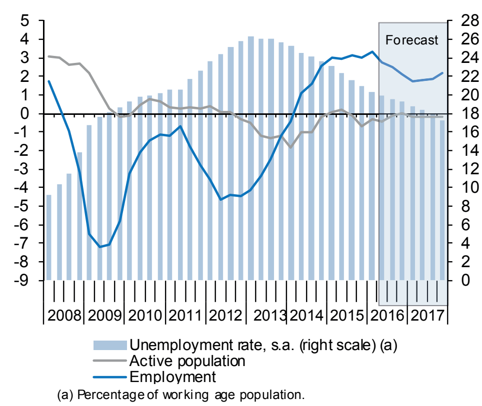
8.2 - GDP, national demand and external balance



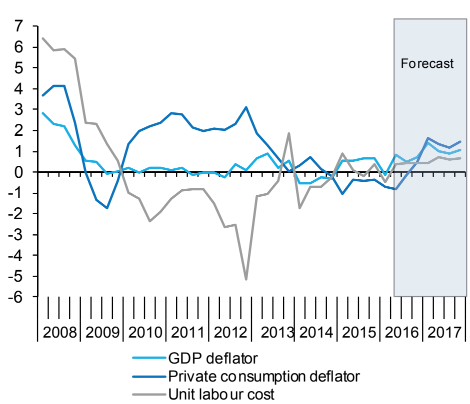
8.3 - National demand aggregates



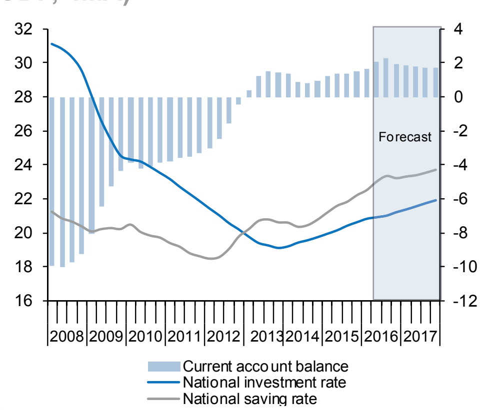
8.4 - Employment and unemployment



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, 2016-2017

Annual rates of change in %, unless otherwise indicates

	Actual data				Funcas forecasts		Change in forecasts (a)	
	Average 1996-2007	Average 2008-2013	2014	2015	2016	2017	2016	2017
1. GDP and aggregates, constant prices								
GDP	**3.8**	**-1.3**	**1.4**	**3.2**	**3.0**	**2.3**	**0.3**	**0.0**
Final consumption households and NPISHs	3.6	-2.2	1.2	3.1	3.5	2.1	0.2	-0.5
Final consumption general government	4.3	0.7	0.0	2.7	2.1	1.0	0.1	-0.3
Gross fixed capital formation	6.4	-7.0	3.5	6.4	4.2	5.0	-0.1	1.1
Construction	5.9	-9.8	-0.2	5.3	2.3	3.6	-1.3	-0.2
Residential construction	7.8	-11.2	-1.4	2.4	3.9	4.4	0.3	-1.1
Non-residential construction	4.2	-8.2	0.8	7.5	1.0	3.0	-2.7	0.6
Capital goods and other products	7.5	-2.4	7.7	7.5	6.2	6.4	1.1	2.4
Exports goods and services	6.6	1.7	5.1	5.4	4.0	4.3	0.2	-0.5
Imports goods and services	8.7	-4.1	6.4	7.5	5.4	5.3	-0.3	-0.7
National demand (b)	**4.5**	**-3.0**	**1.6**	**3.7**	**3.3**	**2.5**	**0.1**	**-0.1**
External balance (b)	-0.7	1.7	-0.2	-0.5	-0.3	-0.2	0.2	0.1
GDP, current prices: - € billion	--	--	1,041.2	1,081.2	1,119.2	1,157.3	--	--
- % change	7.4	-0.8	1.0	3.8	3.5	3.4	0.1	0.0
2. Inflation, employment and unemployment								
GDP deflator	3.5	0.5	-0.4	0.6	0.5	1.1	-0.2	0.0
Household consumption deflator	**3.1**	**1.8**	**0.2**	**-0.5**	**-0.3**	**1.4**	**-0.1**	-0.2
Total employment (National Accounts, FTEJ)	3.4	-3.3	1.1	3.0	2.6	1.9	0.2	-0.1
Productivity (FTEJ)	0.4	2.1	0.3	0.2	0.4	0.4	0.1	0.1
Wages	7.5	-1.1	0.9	3.9	3.4	3.0	-0.1	-0.4
Gross operating surplus	6.9	-0.2	0.4	3.1	3.3	3.4	0.5	0.6
Wages per worker (FTEJ)	3.3	2.4	-0.6	0.5	0.6	1.0	-0.2	-0.3
Unit labour costs	2.9	0.3	-0.8	0.3	0.2	0.6	-0.4	-0.4
Unemployment rate (LFS)	**12.5**	**20.2**	**24.4**	**22.1**	**19.8**	**18.1**	**-0.1**	**-0.1**
3. Financial balances (% of GDP)								
National saving rate	22.4	19.9	20.8	22.1	23.1	23.7	0.1	0.7
- of which, private saving	18.6	23.1	24.3	24.8	24.9	24.7	0.3	1.0
National investment rate	26.9	23.2	19.8	20.7	21.2	21.9	0.0	0.2
- of which, private investment	23.0	19.4	17.7	18.2	19.0	19.7	0.2	0.3
Current account balance with RoW	**-4.5**	**-3.3**	**1.0**	**1.4**	**1.8**	**1.8**	**0.0**	**0.4**
Nation's net lending (+) / net borrowing (-)	-3.7	-2.8	1.6	2.1	2.6	2.5	0.1	0.4
- Private sector	-2.8	5.9	7.5	7.2	6.4	5.4	-0.1	0.4
- Public sector (general governm. deficit)	**-0.9**	**-8.6**	**-5.9**	**-5.1**	**-3.8**	**-3.0**	**0.2**	**-0.1**
- General gov. deficit exc. financial instit. bailout	**--**	**-7.9**	**-5.8**	**-5.0**	**-3.8**	**-3.0**	**0.2**	**-0.1**
Gross public debt	52.2	66.8	99.3	99.2	99.5	99.5	-0.3	-0.3
4. Other variables								
Household saving rate (% of GDI)	10.2	10.2	9.6	9.4	9.6	9.5	0.0	0.5
Household gross debt (% of GDI)	82.1	127.2	112.1	106.0	100.4	97.3	-0.1	-0.2
Non-financial coporates gross debt (% of GDP)	80.0	127.9	112.9	104.6	99.1	92.8	-0.1	-0.2
Spanish external gross debt (% of GDP)	90.8	158.2	166.6	167.7	164.2	158.9	-2.4	-4.8
12-month EURIBOR (annual %)	3.7	1.9	0.5	0.2	0.0	0.0	0.0	-0.3
10-year government bond yield (annual %)	5.0	4.7	2.7	1.7	1.5	1.4	-0.1	-0.7

Notes:
(a) Change between present and previous forecasts, in percentage points.
(b) Contribution to GDP growth, in percentage points.
Sources: 1996-2015: INE and Bank of Spain; Forecasts 2016-17: Funcas.

higher than the euro area), which suggests a sharper slowdown than previously projected. The deceleration will come from domestic demand, particularly consumption by households and the general government. The external sector will continue to make a slightly negative contribution.

Growth could reach 3% in 2016, three tenths more than projected in the previous forecasting exercise, compared with 1.7% projected by the IMF for the euro area as a whole.

The pattern forecast for economic growth will be reflected in the labour market. Employment growth should remain strong in 2016 (at around 2.6%) but slow somewhat in 2017 (to 2.0%). The unemployment rate, although dropping, will remain high at almost twice the euro area average. Bringing down unemployment will remain the Spanish economy's biggest challenge.

Despite rising import prices, inflation will remain below the 2% target. Moderate change in unit labour costs is forecast, falling short of that in other European countries.

A current account surplus of 1.8% of GDP is forecast for 2016 as a whole, which is four tenths higher than in 2015. The consensus forecast for 2017 is a surplus of 1.5%.

Finally, the consensus forecasts for the general government deficit for 2016 and 2017 have been revised upwards to 3.8% and 3% of GDP, respectively. In both cases, these exceed the targets in the Stability Programme Update (3.6% and 2.9%). This situation has given rise to the European Commission's considering applying penalties. Public debt is slightly less than GDP over the forecast horizon, and after unemployment, reducing it is one of the main challenges facing the Spanish economy.

Unemployment remains the top challenge. Public debt, at slightly less than GDP over the forecast horizon, is also a major obstacle for the Spanish economy.