

ACTIVITY

Spain: activity and employment continue to recover in 3Q14

Spain Unit

Economic growth slows down marginally in 3Q

The trend in the latest variables on closing this report indicates that **the Spanish economy's recovery is continuing through the third quarter of 2014**. With around 50% of the 3Q14 information available, the MICA-BBVA model estimates **quarterly (QoQ) GDP growth of between 0.4% and 0.5%** which, if confirmed, would imply a moderation in the expansion rate¹. The improvement in activity is still being accompanied by job creation, which on this occasion could give rise to the virtual stagnation of productivity.

Reduced uncertainty and a less contractive fiscal policy than in past years appear to be favouring **growth in domestic demand (mainly private) beyond what the performance of its remaining fundamentals might suggest**. Insofar as some of these stimuli are temporary, components such as private consumption can be expected to make less of a contribution to growth in the next few months, until the cut in income taxes (IRPF), planned for early 2015, comes into effect. As far as trade flows are concerned, short-term partial indicators suggest that **the loss of momentum in exports we saw in the first stages of the year continues to abate gradually**.

All in all, **the valuation of the underlying upside trend in activity and employment in our baseline scenario for 2014 and 2015 remains unchanged, although the probability of the risk scenario has increased, as a result of the rising concern about the European recovery and the rate at which some domestic imbalances are correcting**². In the medium term, the structural reforms, the change in the production model towards exports, lowered fiscal consolidation needs and the extent to which the imbalances that piled up before the crisis are successfully absorbed will be pivotal if the economic renewal is to be sustained, intense and long-lasting.

Private domestic demand grows at a lower rate than in the first half, while exports recover gradually

The second quarter of the year was marked by a strong expansion in domestic demand, both private and public, **and a gradual improvement in Spanish exports**³. Thus, **the progress being made in both household consumption (+0.7% QoQ) and in machinery and equipment investment has again stood out (+2.1% QoQ)**, with these segments reporting, respectively, five and six positive quarters. In the structure of net external demand, we experienced the expected correction to the upside of goods exports (+1.4% QoQ). This, together with services' export growth (+1.2% QoQ), brought about a **1.3% QoQ expansion in foreign sales**. Despite this uptick in flows abroad, the positive tone of domestic demand gave rise to a **rather more intense rise in imports than expected** (1.5% QoQ; BBVA Research: 0.7% QoQ), causing an unexpected stagnation in net external demand.

1: For further information about the MICA-BBVA model, see Camacho, M. & R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21, available at: https://www.bbvarresearch.com/wp-content/uploads/migrados/WP_1021_tcm348-231736.pdf.

2: BBVA Research's description of the economic scenario for 2014-15 can be found in the third quarter 2014 Spain Economic Outlook, available at: https://www.bbvarresearch.com/wp-content/uploads/2014/08/Spain-Economic-Outlook-3Q14_maq_FINAL.pdf.

3: The detailed evaluation of the 2Q14 Quarterly National Accounts is available in Spanish at: https://www.bbvarresearch.com/wp-content/uploads/2014/08/CNT_2T14.docx_e.pdf.

For the third quarter, information available suggests a somewhat more balanced growth composition. In terms of external demand, the indicators for expectations (industrial export orders) and expenditure (large corporations' sales abroad of goods and services) suggest that, **even though the key trading partners are moving at different speeds, non-tourism goods and services exports are still gaining ground.** Similarly, the trend of those indicators linked to consumption of non-residents in Spain (travellers and expenditure by foreign tourists) points to a change to the upside during the summer.

On the private domestic demand side, we estimate that recovery is giving a little ground, after the intense upticks in the first half of the year. Thus, consumption expenditure indicators and household expectations (new car registrations, retail trade, consumer confidence) are showing clear signs of a slowdown in 3Q14, surprising in some cases to the downside. Similarly, the variations in industrial confidence, the manufacturing PMIs and trade flows all herald lower growth in investment in machinery and equipment than in the preceding quarter.

For their part, **the variables relative to residential investment confirm that both supply and demand are approaching their turning point.** After seasonal and working-day adjustments (swda), the second quarter of 2014 ended with a -0.4% QoQ fall in residential investment (+0.9% QoQ in housing sale-purchases), which contrasts with the average quarterly drop of -2.0% in 2013 (-2.3% QoQ in housing sale-purchases). In the future, the fundamentals of residential investment indicate that this trend will continue, which might result in stagnation or marginal growth of this item of demand in the second half of the year. Altogether, **2014 will end with a moderate correction in housing investment and, in the most likely scenario, will lead to the recovery in 2015.**

Public sector demand has corrected to the upside again, but recovery in activity indicates that budget targets in 2014 will be met

The detailed Quarterly National Accounts (CNTR) for 2Q14 again threw up **some surprises related to fiscal consolidation.** After the correction to the upside in 1Q14, real consumption by Public Administrations was expected to fall 1.5% QoQ in 2Q14, in line with government forecasts. However, the data showed a virtual stasis in this demand item (+0.1% YoY). This unexpected stagnation and the behaviour of the public deficit (pretty much in line with the end-of-year target) imply that the fiscal tightening **appears to be relying on the cyclical recovery of revenues, even more than the government was expecting.** Here, the budget execution data to May indicate that the public deficit (excluding local authorities) will be around 2.4% of GDP, 0.3pp below last year. The national deficit to July was 3.1% of GDP, 0.5pp better than the figure for 2013.

Labour market progress slows

According to BBVA Research estimates, Social Security affiliation has been rising for eleven months in a row to August (+18.000 MoM swda)⁴. If this movement is confirmed this month, the number of affiliates could rise by 0.3% QoQ swda in 3Q14, which would imply a **slowdown in the rate of job creation** we saw in the first half (0.6% QoQ in 2Q14 and 1Q14). In line with this, BBVA Research estimates indicate that unemployment returned to its pattern of shrinkage in swda terms (-13,900 people swda) after the temporary interruption in July; if this continues in September, there will be a **moderation in the pace of reduction of registered unemployment (-0.5% QoQ swda, compared to 1.9% QoQ in 1Q14 and 2Q14).**

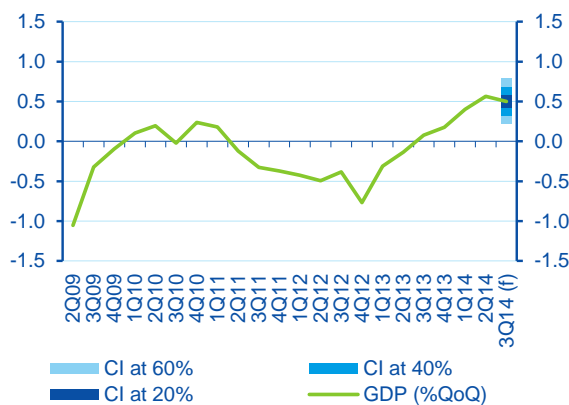
4: The seasonal and working-day adjustment (swda), implemented by BBVA Research is based on statistical methods of univariate time series. As a result, the swda series estimates are subject to uncertainty; they may differ from other institutional estimates and be subsequently modified without prior notice.

The improvement in the Spanish economy's borrowing needs has been temporarily interrupted

After posting a surplus for thirteen consecutive months, the current account went back into deficit in the accumulated twelve months to June. The deterioration in the goods and income balances, linked to the cyclical improvement in demand and the stagnation in goods exports in the last few months, accounts for this result.

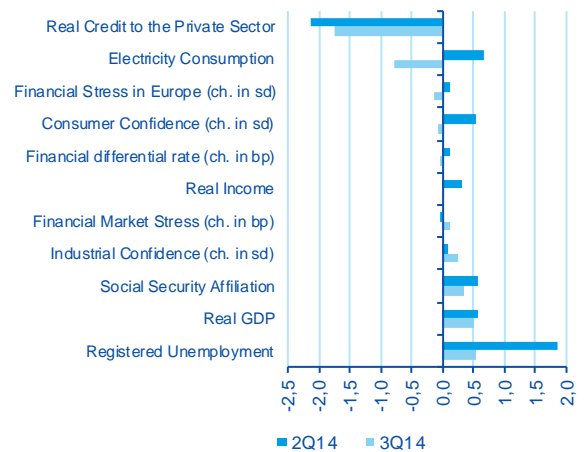
In spite of this, improvements in the Spanish economy's borrowing needs is accounted for by the change in the structural component and, as such, the current account deficit to June ought to be temporary⁵. In this context, **the Spanish economy will show lending capacity with respect to the rest of the world during the 2014-15 period**, provided it keeps its commitment to internal devaluation, structural reforms and competitiveness gains.

Figure 1
Spain: real GDP growth and MICA-BBVA model forecasts (% QoQ)



(e): estimate
Source: BBVA Research

Figure 2
Spain: performance of GDP and the key MICA-BBVA model indicators (+) improvement / (-) deterioration in pp unless otherwise indicated (swda data)



Data published to September and MICA-BBVA model forecasts
Source: BBVA Research based on official institutions

5: For more information on the recent performance and outlook of the current account in Spain, see our Economic Watch titled : "Un análisis de la evolución y los determinantes del saldo por cuenta corriente en España", available in Spanish at: https://www.bbva.com/wp-content/uploads/migrados/131028_Observatorio_Cuenta_Corriente_Espa_a_Esp_tcm346-407130.pdf.

2014-15 Scenario

The reviews published add no significant biases to growth forecasts

Quarterly National Accounts corresponding to the first half of the year do not, on the whole, diverge from the BBVA Research diagnosis for the Spanish economy's recovery and, as such, neither do they have a significant effect on forecasts for this two-year period. Thus, as we forecast in the third quarter 2014 Spain Economic Outlook, **activity will grow by 1.3% in 2014 and in 2015 will accelerate to 2.3%**, bearing in mind the expected improvement in the international climate, the virtual conclusion of some of the internal adjustment processes and, above all, the **increasingly expansive stance of European monetary policy and the change in tone of fiscal policy**^{6,7}.

Increased demand underpinned by short-term economic policies

The fiscal consolidation is expected to soften its negative contribution to growth during 2014. From the income axis, less fiscal pressure is expected. The spending side will be practically stagnant over the year as a whole (-0.1%). Investment in non-residential construction will have stopped correcting and should recover a moderate degree of momentum throughout 2014 as a whole. According to BBVA Research forecasts, **the contractive tone of fiscal policy will disappear in 2015, coinciding with the coming into force of the first phase of the tax cut announced by the government.**

In terms of private domestic demand, private consumption is expected to grow 1.9% in 2014 and 2.0% in 2015, given the recovery of its fundamentals and the economic policy stimuli. Improvements in employment and the reduction in income tax from 2015 onwards will contribute to the recovery in disposable income. The expected growth of net financial wealth, the absence of inflationary pressures, the expectation that official interest rates will remain at historically low levels and the adjustment to savings will offset the uncertainty associated with the suppression of the Efficient Vehicles Incentive Programme (PIVE in its Spanish acronym) and the virtual stasis in housing wealth. **This forecast recovery in consumption will be supported by the increase in new funding operations,** in a context of deleveraging outstanding credit.

Expectations for machinery and equipment investment are also positive. Despite the moderation in exports growth in 2014, the expansion in final demand will continue to stimulate productive investment. Not only this, but also the accumulation of retained earnings by companies, together with the recent monetary easing and those in support of credit availability passed by the ECB, will make it easier to set up new investment projects. As a result, **our growth forecast for this item is 8.5% in 2014 and 7.3% in 2015.**

By contrast, investment in housing construction is expected to fall by 3.5% (compared to -8.0% in 2013). Recovery in demand and expected progress in the process of absorbing the unsold housing stock will generate an **increase in new residential projects in 2015 which will lead to a 4.9% increase in residential investment.**

Beyond our frontiers, **the acceleration in the world economy expected during the rest of the year** will offset the negative effect on Spanish exports caused by a weak start of the year in international markets, marked as it was by the contraction in the US economy and the slowdown in some emerging markets. In the same vein, the **foreseeable gains in price competitiveness** resulting from the favourable performance of relative prices and from the euro's depreciation path along the entire forecast horizon **sustain a trend to the**

6: In terms of monetary policy, in June the ECB adopted a new package of monetary expansion and credit availability stimulus measures for companies and households. Among these measures were: the reduction to 0.15% of interest rates on the principal lending operations; the reduction in the remuneration of the deposit facility to -0.1%; the introduction of a new long-term financing operations programme, designed to stimulate the growth of credit to the private sector; and, finally, the renewal of indications as to the future thrust of monetary policy: if necessary, both conventional and unconventional measures will continue to be implemented.

7: On fiscal policy, at the end of the second quarter the government presented its preliminary plans for fiscal reform which, in essence, mean a phased reduction of direct taxation – IRPF and Corporate Tax - between 2015 and 2016

upside of exports in 2014 and 2015. Thus, we expect an expansion rate in external sales of around 4.7%, which will accelerate to 6.5% in 2015.

The composition of growth in final demand will also impact on **growth in imports** of around 5.9% YoY within our 2014-15 forecast horizon. This poses a **challenge if we are to keep a positive balance in the current account, which will come in at 0.3% of GDP in 2014 and 1.1% of GDP in 2015.** The structural adjustment of the deficit still underway, together with a lower positive contribution to the foreign balance from the cyclical component, will give way to a lower-than-wished surplus in the current account, given the need for external deleverage of the Spanish economy⁸.

Some risks look less likely, others more so

While **the Chinese and US economies are leaving periods of uncertainty behind them and the expectations of a sustained expansion seem to be becoming a reality**, some concerns remain, such as those surrounding the impact that the US Federal Reserve's exit strategy may have on international financial markets. Similarly, **there is a deceleration of activity in the EMU which, if intensified, would endanger the performance of what ought to be the Spanish economy's main engine of growth over the coming months: exports.** On the other hand, geopolitical factors are threatening the stability of financial markets and the continued momentum of trade flows.

On the domestic front, we believe that the strong increase in imports is transitory since, on the one hand, it is related to fiscal incentives for buying goods with a high import content, whose impact will not last. On the other, the acceleration in the growth of private consumption is expected to reach its end, since the performance of most of its fundamentals does not explain its behaviour up to now. **Growth in exports and a pattern of behaviour in private consumption that is consistent with its fundamentals ought to lead to sustained GDP growth and to maintaining the current account surplus. If this combination is not achieved, the sustainability over time of the recovery would be endangered.**

Finally, fiscal consolidation in Spain seems to rely increasingly on the cyclical improvement of public revenues and on the recovery of the tax bases, even more so than forecast a year ago. An unforeseen deceleration in activity would put a halt to this improvement and lead to additional measures being taken on the expenditure side to meet the targets promised, leading to a deceleration in economic recovery

8: For more information on the recent performance and outlook of the current account in Spain, see our Economic Watch, titled : "Un análisis de la evolución y los determinantes del saldo por cuenta corriente en España", available in Spanish at: https://www.bbvaresearch.com/wp-content/uploads/migrados/131028_Observatorio_Cuenta_Corriente_Espa_a_Esp_tcm346-407130.pdf.

Table 1

Spain: macroeconomic forecasts

(annual variation rates as %, unless otherwise indicated)

	2011	2012	2013	2014	2015
Activity					
Real GDP	0.1	-1.6	-1.2	1.3	2.3
Private consumption	-1.2	-2.8	-2.1	1.9	2.0
Public consumption	-0.5	-4.8	-2.3	0.1	0.6
Gross fixed capital formation	-5.6	-6.9	-5.2	1.2	4.7
Capital goods	5.5	-3.9	2.2	8.5	7.3
Construction	-10.8	-9.7	-9.6	-4.3	2.8
Housing	-12.5	-8.7	-8.0	-3.5	4.9
Domestic demand (contribution to growth)	-2.1	-4.1	-2.7	1.4	2.2
Exports	7.6	2.1	4.9	4.7	6.5
Imports	-0.1	-5.7	0.4	5.1	6.4
Net exports (contribution to growth)	2.1	2.5	1.5	0.0	0.2
Nominal GDP (EUR bn)	1046.3	1029.3	1023.0	1038.0	1076.7
GDP w/out housing investment	1.0	-1.2	-0.9	1.6	2.2
GDP w/out construction	2.0	-0.4	-0.1	2.0	2.3
Labour market					
Employment (LFS)	-1.6	-4.3	-2.8	1.0	2.1
Unemployment rate (% active pop.)	21.4	24.8	26.1	24.5	23.1
Employment QNA (full-time equivalent)	-2.2	-4.8	-3.4	0.8	1.7
Productivity	2.3	3.1	2.2	0.6	0.6
Prices and costs					
CPI (annual average)	3.2	2.4	1.4	0.1	0.9
CPI (end-of-period)	2.4	2.9	0.3	0.4	1.2
GDP deflator	0.0	0.0	0.6	0.1	1.4
Compensation per employee	1.3	0.2	0.7	-1.4	0.3
Unit labour costs (ULC)	-0.9	-2.9	-1.5	-2.0	-0.4
Foreign trade					
Current account balance (% GDP)	-3.7	-1.2	0.8	0.3	1.1
Public sector					
Debt (% GDP)	70.5	86.0	93.9	99.8	101.3
Budget balance (% of GDP)	-9.1	-6.8	-6.6	-5.5	-4.5
Households					
Nominal disposable income	0.0	-2.8	-0.7	-0.4	3.0
Savings rate (% of nominal income)	12.7	10.5	10.5	8.1	8.2

(*): Excluding financial aid to Spanish banks.

Forecast closing date: 4 August 2014.

Source: Official bodies and BBVA Research

Box 2

Synopsis of Spain Flashes since the publication of the third quarter 2014 Spain Economic Outlook

Flash	Date	Summary	Link
Spain: Industrial production in June	07.08.2014	Despite the negative performance of industrial output in June, 2Q14 closed with positive numbers. By components, almost all of the items of industrial production showed positive growth rates over the quarter.	PDF
Spain: inflation dropped by 0.4pp to -0,3% YoY in July	13.08.2014	The decline in inflation was mainly due to the absorption of the base effect on energy and food prices and, to a lesser extent, to the unexpected drop in the electric bill. In line with expectations, core prices remained stagnant. Going forward, our scenario of low inflation is maintained, in which negative inflation rates can not be ruled out during the rest of the summer.	PDF
Spain: June's Trade balance España	18.08.2014	The 12-month trade balance deficit to June 2014 deteriorated by 0.1 pp to -2.1% of GDP. The slight reduction in the energy deficit was not enough to offset another reduction in the non-energy surplus. 2Q14 closed with a slight QoQ growth in exports and a small fall in real imports.	PDF
Spain Housing purchases in June 2014: stability at around 30,000 transactions	19.08.2014	According to data from the Consejo General del Notariado, 30,231 homes were sold in June 2014. The seasonally adjusted series shows that sales fell 0.8% over the previous month. Despite this decrease, the quarter ended with a quarterly increase of 1%.	PDF
Spain August CPI Flash estimate: prices dropped as expected	28.08.2014	The flash estimate of the CPI confirms the expected negative YoY growth of consumer prices, mainly as a result of the absorption of base effects and the decline in fuel prices. Our estimations suggest that core prices remain stagnant.	PDF
Spain: Quarterly National Accounts 2Q14	28.08.2014	As foreseen in our last Spain Economic Outlook, the Spanish economy closed the first semester of 2014 with another acceleration of the recovery that started a year ago. GDP growth in 2Q14 (+0.6% QoQ) is consistent with our baseline scenario of 1.3% growth for 2014 and 2.3% for 2015. Despite these overall positive figures, the composition of growth must be carefully considered: both public consumption and net external demand stagnated. Economic recovery was accompanied by significant employment creation and the stagnation of productivity. These, together with the YoY fall on prices, imply that the correction in unit labour costs came has halted.	PDF
Spain Industrial and consumer confidence in August 2014: continued optimism	28.08.2014	Agents' expectations have changed favourably over the first few months of the second half of the year. Both industrial and consumer confidence remained above pre-crisis average levels. This reinforces our baseline scenario: the economic recovery continues.	PDF
Households and firms' deposits fall in July due to seasonal factors, as forecast	28.08.2014	Household and company deposits went down by EUR11bn in July, although corrected for seasonality were stable.	PDF
Spain: June 2014 Balance of payments	29.08.2014	After 13 months of positive figures, there has been a break in the cumulative 1-year current account surplus in the June figure. The accumulated surplus in the services balance over 12 months was not enough to offset the fall in the balance of goods and, to a lesser degree, incomes. June closed with high foreign capital inflows.	PDF
Spain: slight fall in new car registrations during August, in line with expectations	01.09.2014	Once seasonal effects are controlled for, BBVA Research's estimates suggest that new car registrations fell slightly during August. All in all, around 280,000 cars are forecast to be registered between September and December, bringing the annual figure for 2014 to around 850,000 registrations.	PDF
Spain: improvements in the labour market lose momentum when compared with the first half of the year	02.09.2014	Progress in the labour market slowed in August due to the services sector. According to BBVA Research's estimates, affiliation to the Social Security rose again once seasonal factors are accounted for, albeit at a lower pace than the one seen in the second quarter	PDF

Source: BBVA Research

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