

Spain

# Economic Watch

Madrid, 13 January 2011

Economic Analysis  
Spanish Unit

## Boost from foreign demand while domestic demand remains weak

- **The fourth-quarter data released to date point to a modest q-o-q pick-up in economic activity**  
4Q10 GDP growth could come in somewhere between 0.1% and 0.2% q-o-q, which is still not enough to create jobs judging by the trends in Social Security records numbers. This pace of growth is consistent with our estimate for an overall contraction in GDP of 0.2% in 2010.
- **Fourth-quarter indicators point to a stronger trend in consumer spending in 4Q10 after the sharp fall registered in 3Q10**  
Nevertheless, the general trend in all the internal demand indicators points to still-weak fundamentals and does not alter our outlook for only a meek recovery in domestic demand. Meanwhile, exports continue to rise at healthy annualised rates.
- **During the fourth quarter, the international environment evolved to a state of higher uncertainty, due to the European sovereign debt crisis**  
Its impact on economic activity will decisively depend on how persistent the sovereign debt crisis is. To this regard, confidence indicators are sending mixed signals as to the effect the spike in uncertainty is having on households and businesses, with a light deterioration on consumer expectations as business expectations improve.
- **The Spanish government remains steadfast on its fiscal austerity commitments which, coupled with budget out-turn data for the regional governments, leaves it on track to meet its 2010 budget stability target comfortably**  
Bringing the 2010 deficit below the 9.3% of GDP target would go a long way in dissipating market uncertainty and pave the way for starting 2011 on a firmer footing.
- **To speed up the economic recovery, boost confidence in the Spanish economy at home and abroad and to prevent sovereign debt contagion**  
it is vital to introduce the announced labour market, pension system and bank restructuring reform measures with speed, conviction and ambition.

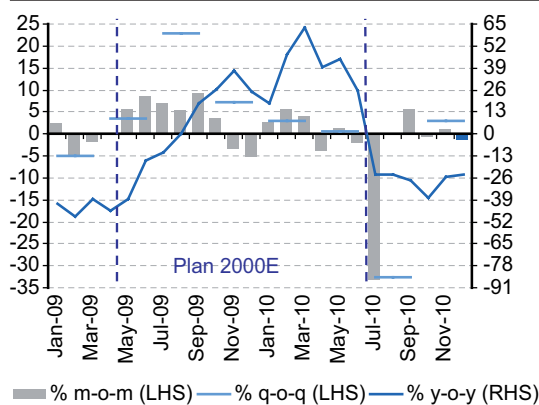
**The data released to date confirm that domestic demand strengthened substantially in the fourth quarter with respect to the weak third-quarter reading, although in all likelihood the definitive reading will be close to a scenario of stagnancy**

Various indicators of private consumption indicate that household spending recovered during the final three months of last year. To illustrate, BBVA Research estimates that seasonally and working day adjusted (SWDA) car registrations narrowed by 1.3% in December. Factoring in the flat reading in October and positive reading in November, we arrive at marginal growth in demand in 4Q10, which compares favourably with the drop of over 30% registered in 3Q10.

Turning to retail spending, November retail sales narrowed by 5.2% m-o-m and by 1.0% y-o-y, in line with our forecasts and the seasonal pattern. The SWDA figures (-0.9% m-o-m and -1.1% y-o-y) show that all components declined month-on-month in November. In short, following the 3Q10 dip in retail sales in the wake of the July VAT hike, the October and November readings suggest that retail sales continued to suffer in 4Q10, albeit slowing at a narrower pace than in the preceding quarter.

Chart 1

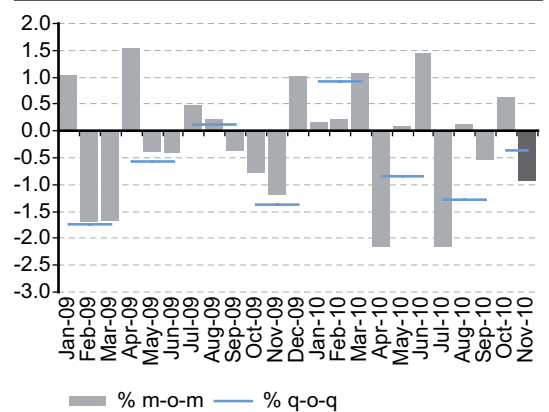
**Spain: car registrations (SWDA data)**



SWDA: seasonally- and working day adjusted data.  
Source: BBVA Research based on ANFAC and Ganvam data

Chart 2

**Spain: retail sales (SWDA data)**



SWDA: seasonally- and working day adjusted data.  
Source: BBVA Research based on INE data

**Labour market in December: good figures, although not good enough to foreshadow a sustained recovery in employment**

The December labour market figures, which were encouraging in terms of unemployment, closed a quarter characterised by stagnancy. Adjusting for seasonal effects reveals that although the economy is still unable to create jobs, the pace of growth in unemployment is slowing significantly. Unemployment drops in November and December and more dynamic hiring activity are encouraging signs, albeit falling short of foreshadowing any sustained recovery.

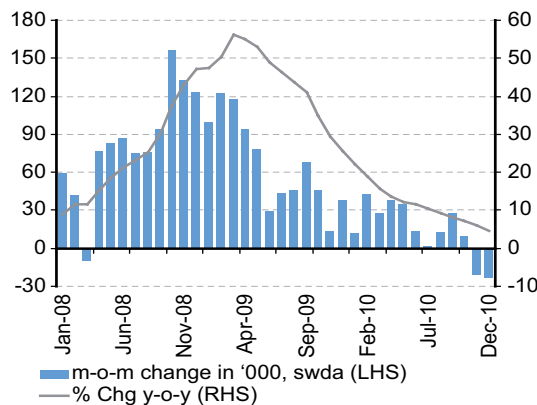
Social Security affiliation (monthly average) fell by 27.7 thousand in December, which was less than estimated (BBVA Research: drop of 65 thousands). Adjusting for seasonal and working day effects, the pace of decline in contributor numbers last month narrows to 5.9 thousands. By sector, we note that the healthy performance in primary sector (substantially stronger than forecast) and service sector employment (in line) was not enough to offset the ongoing (and expected) job destruction in manufacturing and, above all, in construction.

The decline in unemployment in December (by 10.2 thousand people) came in at the low end of our estimate range (-23.6 thousands) and was significantly below the average increase registered in the month of December over the past decade (+1.0% m-o-m). Seasonally-adjusted registered unemployment fell for the second straight reading, having been on the rise since the beginning of 2008 (falling by 23.3 thousands).

For the fourth quarter as a whole, both Social Security affiliation and the registered unemployment remained virtually steady. That being said, whereas Social Security affiliation continued to fall at virtually the same pace as in 3Q10 (i.e., at a SWDA rate of -0.2% q-o-q compared to -0.3% in 3Q10), the rate of growth in registered unemployment eased significantly to a 0.2% q-o-q SWDA (from 1.0% q-o-q in 3Q10).

Chart 3

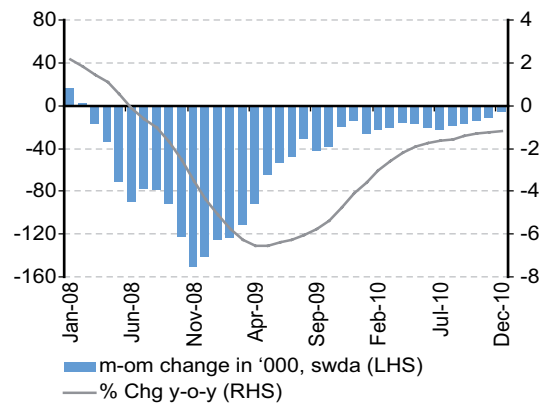
**Spain: registered unemployment**



Source: BBVA Research, based on SPEE (Spanish State Employment Service) data

Chart 4

**Spain: average Social Security affiliation**



Source: BBVA Research based on MTIN (Ministry of Labour and Immigration) data

**November industrial output came as a pleasant surprise, with scope for further improvement on the short run**

Industrial output, adjusted for calendar effects, grew by around 2.3% y-o-y in November, topping the October y-o-y reading by 4.2pp and our base case forecast by 6.8pp (BBVA Research: -4.5% y-o-y). Nevertheless, the November figures do not yet mark a turnaround in the gradual slowdown in the growth trendline in this variable and its components, attributable in large part to the end of the pronounced base effect which drove y-o-y growth throughout 1H10.

In SWDA terms, industrial output remained positive, albeit moderate, in line with the lukewarm nature of the sector recovery evidenced throughout all of 2010. In addition to the November reading, the m-o-m change in industrial output (SWDA) was only positive in May, August and October, leaving monthly average growth to November at around 0.0% (in m-o-m and SWDA terms).

Despite a fresh increase in the IPI, the continued slowdown in the growth trendline, coupled with the meek rate of growth in SWDA m-o-m terms, continues to evidence the weak nature of the recovery in sector output. Nevertheless, the rebound in manufacturing sector confidence levels to historic averages and, more notably, the improvement in expectations for future output, point to a potential improvement near term.

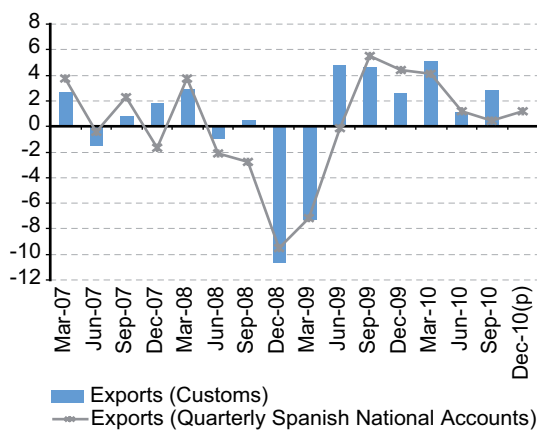
**Net trade made another positive contribution to Spanish GDP growth in 4Q10**

The SWDA October figures point to an uptick in growth in exports and imports of goods following the widespread declines registered in major industries in September. More specifically, growth in exports of capital goods was particularly strong (+12.1% m-o-m), while growth in exports of consumer goods was also healthy (+3.5% m-o-m). Meanwhile, imports of capital and intermediate goods staged a substantial recovery (growing 6.8% and 2.7% m-o-m, respectively), while growth in consumer good imports was slower (0.4% m-o-m), albeit reversing the sharp contraction registered in September.

The trailing 12-month trade deficit stood at 51.9 billion euros in October, largely flat month-on-month (September deficit: 52.1 billion euros). Underpinning the trade deficit figures were a slight increase in the energy deficit to 33.9 billion euros in the year to October (+0.4 billion euros on the September 2010 reading), which offset the 0.7 billion euro improvement in the cumulative non-energy deficit. This left the cumulative non-energy deficit at 18.1 billion euros, down from 18.8 billion euros for the twelve months ended October. As a percentage of GDP, the trade deficit was flat m-o-m, at 4.9%. Looking at October on its own, we note that the trade deficit narrowed to 3.7 billion euros (down from 4.3 billion euros in September).

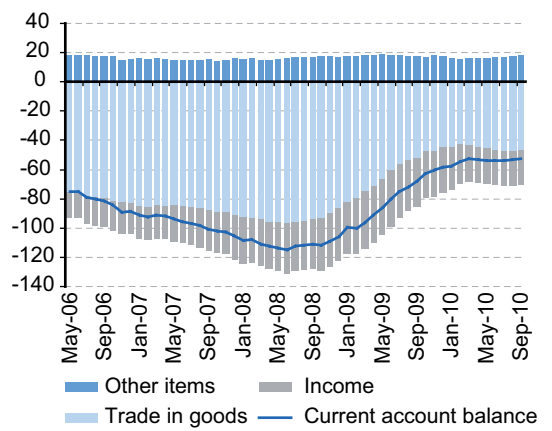
The current account deficit meanwhile narrowed by over 2 billion euros to 50.3 billion euros in the twelve months ended October, down from 52.5 billion euros the month before. As expected, it looks as if the reduction in the trailing 12-month deficit in the trade of goods is consolidating, driven by the healthy growth in exports evidenced in the October trade figures and the growing cumulative surplus in the trade of services balance. If this trend continues, the Spanish economy would once again see the current account deficit, and by extension its external borrowing requirement, narrow at year-end.

Chart 5  
**Spain: exports of goods by volume (% chg. q-o-q SWDA)**



Source: BBVA Research based on INE and Customs data

Chart 6  
**Spain: current account balance (billion euros, 12-month cumulative)**



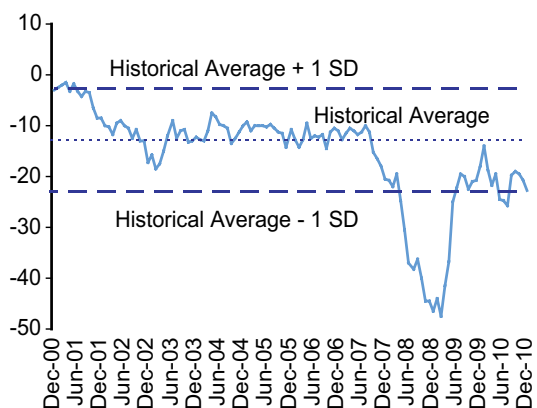
Source: BBVA Research, based on Bank of Spain data

**The economic fallout from prevailing financial market uncertainty depends crucially on how long it persists. Confidence indicators are sending mixed signals in this respect**

In December consumer confidence dipped again, while expectations in the manufacturing sector ticked higher to just above the long-run average. Spain's consumer confidence indicator dropped to -22.8 points in December from -20.7 in November (see Chart 7). Taking the December readings, consumer confidence remains below its long-run average (-12.9) and only slightly above the upper limit of the historically atypical values recorded between April 2008 and May 2009.

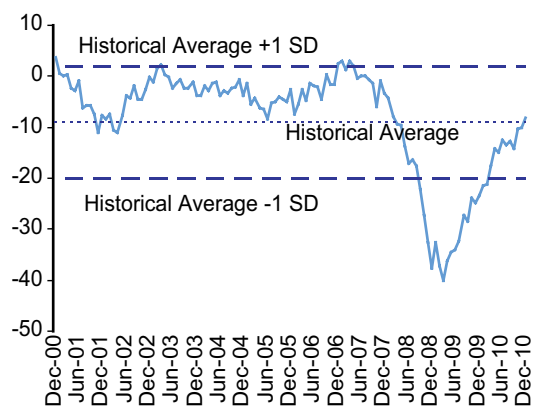
On the other hand, in the manufacturing sector the confidence index registered a fresh gain in December to -8.1 points from -10.0 points in November. Interestingly, the December figure puts business confidence back above its long-run average (-9.0 points) for the first time since the crisis erupted. Moreover, the pace of recovery in industrial output is expected to accelerate in the coming months. Specifically, the index tracking the production expectation for the months ahead, which is highly correlated to seasonally-adjusted IPI, jumped by 4.0 points in December.

Chart 7  
**Spain: consumer confidence (net responses)**



Source: BBVA Research based on European Commission data

Chart 8  
**Spain: business confidence (net responses)**



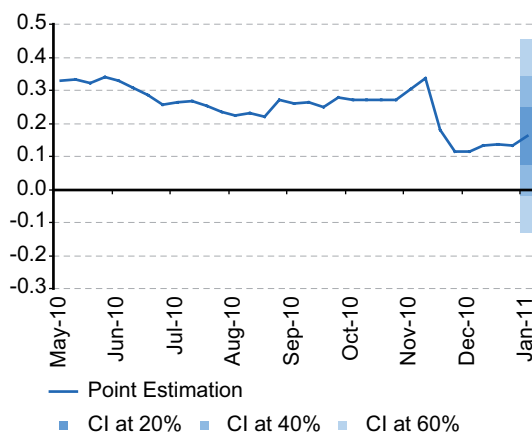
Source: BBVA Research based on European Commission data

### Slight upturn in activity in the fourth quarter as compared to the third quarter

To sum up, with a little more than 80% of the 4Q10 data included in our MICA-BBVA<sup>1</sup> model already released, the real-time forecast for fourth-quarter GDP growth stands at 0.2% q-o-q, just above our estimate of one month ago when we had 50% of the inputs at hand (+0.1% q-o-q). This growth is consistent with our core scenario which calls for a contraction in GDP of around 0.2% for 2010 as a whole, albeit with a moderate upwards bias into our estimates.

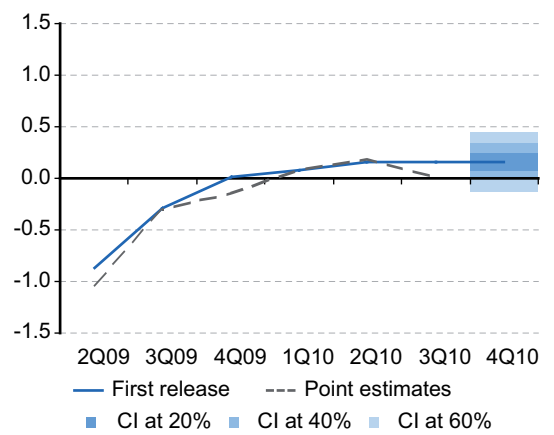
The latest information compiled since the publication of our previous quarterly Spanish Economic Outlook in early November<sup>2</sup> indicates a partial improvement during the past two months with respect to the third-quarter trends. Spanish economic recovery, while further along than expected this spring, remains excessively weak, with economic activity at a virtual standstill. Our base case scenario still envisages growth (see Charts 9 and 10), although confidence intervals for real-time growth are still wide.

Chart 9  
**Spain: 4Q10 GDP growth forecasts using the MICA-BBVA model by forecast date (% q-o-q)**



Source: BBVA Research

Chart 10  
**Spain: actual GDP growth readings compared to MICA-BBVA model forecasts (% q-o-q)\***



\* Latest estimate for 4Q10: 7 January 2011  
Source: BBVA Research based on European Commission data

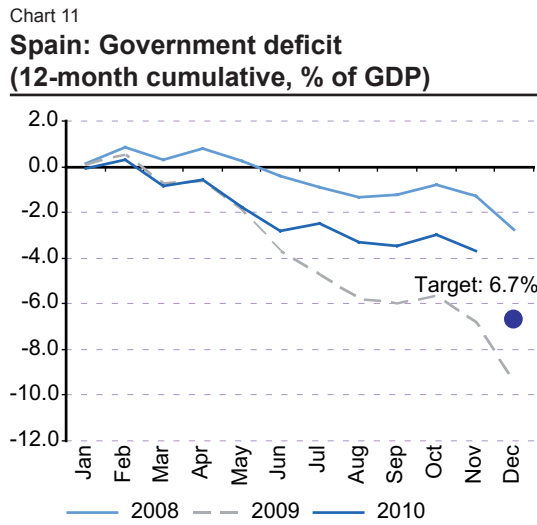
### Further reduction in the government deficit in November coupled with on-target regional governments budget out-turn puts year-end targets easily within reach

The data provided by Spain's Ministry of Economy and Finance on the regional governments' budget performance reveal a similar trend to the 3Q10 data already released by the Bank of Spain: the fiscal consolidation target is comfortably within reach. The regional governments deficit stood at 1.24% of GDP in 3Q10, 0.22 percentage points above the 2Q10 reading but 1.2pp below target. This should leave sufficient elbow room considering that in 2007, 2008 and 2009, last-quarter growth in the deficit as a percentage of GDP averaged 0.8pp.

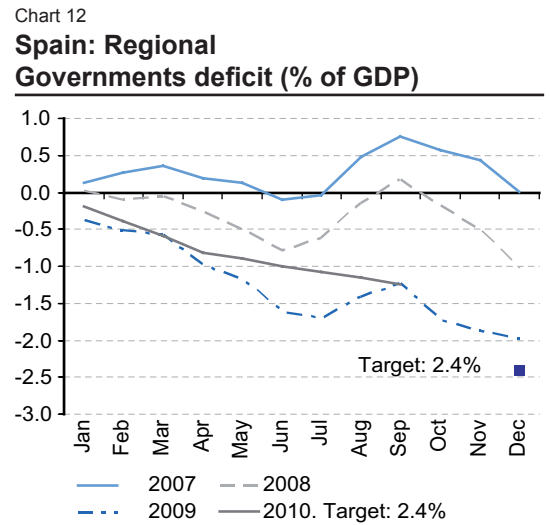
This information reflects the regional administrations' control over spending and is consistent with the moderate growth in public debt levels announced by the Bank of Spain (+0.3pp in 3Q10). According to the latest information released by the Ministry, only Murcia (at 3.12%) and Castile La Mancha (4.69%) deficits are above 2% of GDP; note however that these two regions represent just 7.5% of the regional governments deficit. On the downside, the Catalan regional government recently announced that its 2010 budget deficit would be higher than originally targeted. Despite these deviations, the aggregate regional government deficit target (2.4% of GDP) is widely seen as achievable.

1: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21.

2: Available at: [http://www.bbvaesearch.com/KETD/fbin/mult/Spain\\_Economic\\_Outlook\\_tcm348-235062.pdf?ts=1412011](http://www.bbvaesearch.com/KETD/fbin/mult/Spain_Economic_Outlook_tcm348-235062.pdf?ts=1412011)



Source: BBVA Research, based on Ministry of Economy and Finance data



Source: BBVA Research based on Ministry of Economy and Finance and regional governments data

As for Government budget implementation, at the end of November 2010 the cumulative deficit stood at 3.7% of GDP, around 0.7pp above the October reading, as expected. Seasonal factors are expected to drive an additional increase in the deficit in December. However, the huge effort being made to curtail spending suggests that the deficit could even come in below the original year-end target. The trailing 12-month state deficit stood at 6.3% of GDP in November, below the target of 6.7% (unadjusted for regional administration negative financing settlements which lower the target to 5.9%).

### Rapid and decisive implementation of announced reforms, crucial to shoring up market confidence and preventing sovereign debt crisis contagion

Spain's government continues to gain momentum in the structural reform process initiated last summer. Last month's release of the breakdown of the regional governments deficits by administration is a particularly welcome development and forms part of an exercise in transparency which should be consolidated this year, following the decisions taken by the Fiscal and Financial Policy Council. In order to ensure public finance stability in the medium-term, the government also announced that the Cabinet would approve a pension system reform on 28 January. This reform needs to be as ambitious as possible and designed to guarantee the system's sustainability, helping to ease uncertainty regarding its future solvency. In other words, the outcome must irrevocably lead to a significant increase in system resources in the years to come if the current welfare state is to be maintained. The programmed and gradual reform of the system over the next 15 years would significantly lower the short-term sacrifice entails by this reform. A gradual transition towards an actuarially balanced pension system would justify the support required from the Spanish society as a whole for the reforms initiated and for all the belt-tightening that may be needed during the coming years. As we have been reiterating for some time now, the government also needs to polish off the financial system restructuring with decisiveness and ambition, as well as tackling other much-needed reforms to increase the economy's growth potential and kick-start job creation. Among these reforms we highlight the significance of reforming the collective bargaining system.

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