

QUARTERLY REPORT ON THE SPANISH ECONOMY OVERVIEW

During the first three quarters of 2012 the Spanish economy continued on the contractionary course begun in 2011 Q4. The indicators available suggest this pattern will have intensified in Q4, and a decline in the quarter-on-quarter growth rate of GDP of 0.6% is estimated, entailing a reduction of 1.7% in its year-on-year rate (see Table 1). On the expenditure side, the rate of decline of national demand steepened to a quarter-on-quarter rate of 1.9% (-4.6% year-on-year). This was the result of a combination of transitory factors, such as the effects of the reversal of the bringing forward of purchases prior to the hike in VAT rates in Q3 and the elimination of the extra December payment for civil servants, along with more persistent factors such as the continuing tight financing conditions, despite the easing in recent months, and the weakness of the labour market. Net external demand rose in Q4, contributing 1.4 pp to output (2.9 pp in terms of its year-on-year rate), chiefly as a result of the reduction in imports, prompted by the sluggishness of final demand and by the reversal of the bringing forward of certain import purchases to the previous quarter. The weakness of the euro area economy led to a loss of buoyancy in exports in this period.

For 2012 as a whole GDP is expected to decline by 1.3%, against a financial background of high tension, fiscal consolidation, private-sector deleveraging and the ongoing reduction in employment. Behind this fall in GDP lies a contraction in national demand (-3.9%), greater than that of the previous year, and to which all its consumption and investment components contributed. Conversely, net external demand once again eased the impact of the contraction in domestic spending on activity, with a positive contribution of 2.6 pp for the year as a whole, underpinned both by the increase in exports and by the decline in imports. On the supply side, there were worse figures for all the productive sectors compared with 2011, with declines in value added in industry, in non-market services and, above all, in construction, and virtually zero growth in market services. Employment fell at a higher rate than the previous year, with an estimated decline in numbers employed of 4.3%, partly as a result of the reduction in public-sector employment, which fell for the first time since the crisis began. The unemployment rate rose sharply throughout the year, climbing to 25% in Q3, against the background of a very moderate decline in the labour force.

After increasing in 2011, labour costs resumed the moderate trajectory initiated in 2010, and there was an estimated decline in compensation per employee (-0.6%), much influenced by lower public-sector wages. The inflation rate accelerated markedly in the second half of the year further to the rise in energy prices and to the effect of the increase in VAT and administered prices on final prices. In December 2012 the 12-month percentage change in the CPI stood at 2.9% (2.2% for the CPI excluding unprocessed food and energy). That made for a positive inflation differential with the euro area of 0.8 pp, reflecting the aforementioned series of factors with a temporary impact. As the base effects caused by these factors are progressively stripped out, the inflation difference should once again become favourable for Spain, as occurred in the first half of 2012.

On the international financial front, the pace of activity tended to stabilise in the closing months of 2012, following a slowdown in the preceding quarters. As part of this global picture, there were discrepancies in terms of developments in the emerging and the advanced economies. In the former, which overall experienced greater dynamism, the slow-

	2011	2012	2011				2012			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
National Accounts										
Quarter-on-quarter rate of change, unless otherwise indicated										
Gross domestic product	0.4	-1.3	0.3	0.2	0.0	-0.5	-0.4	-0.4	-0.3	-0.6
Private consumption	-1.0	-1.9	-0.7	-0.2	-0.6	-1.0	0.5	-0.9	-0.5	-1.6
Gross capital formation	-5.5	-8.7	-1.1	-1.3	-0.9	-3.3	-2.1	-3.2	-1.5	-2.0
Domestic demand	-1.9	-3.9	-0.3	-0.7	-0.8	-1.3	-0.3	-1.3	-1.1	-1.9
Exports	7.6	3.3	1.0	1.2	3.5	0.1	-2.3	1.7	4.8	-0.7
Imports	-0.9	-5.0	-1.0	-2.0	0.8	-2.8	-1.9	-1.3	2.4	-5.0
Contribution of net external demand (b)	2.3	2.6	0.6	0.9	0.8	0.9	-0.1	0.9	0.8	1.4
Year-on-year rate of change										
GDP	0.4	-1.3	0.5	0.5	0.6	0.0	-0.7	-1.4	-1.6	-1.7
Employment	-1.7	-4.3	-1.4	-0.9	-1.6	-2.9	-3.7	-4.7	-4.6	-4.1
GDP deflator	1.0	-0.1	1.0	1.2	0.8	0.8	0.4	0.1	0.5	-1.6
Price indicators (year-on-year rate of end-period data)										
CPI	3.2	2.4	3.6	3.2	3.1	2.4	1.9	1.9	3.4	2.9
CPI excl. unprocessed food and energy	1.7	1.6	1.7	1.7	1.7	1.5	1.2	1.3	2.1	2.1
HICP	3.1	2.4	3.3	3.0	3.0	2.4	1.8	1.8	3.5	3.0
HICP difference vis-à-vis the euro area	0.3	-0.1	0.6	0.3	0.0	-0.3	-0.9	-0.6	0.9	0.8

SOURCES: INE and Banco de España.

a Information available to 21 January 2013.

b Contribution to the quarter-on-quarter rate of change in GDP in pp.

down in the pace of activity in the first half of the year came to a halt. And in the advanced economies, the recessionary climate in the euro area and in its vicinity continued, and low growth persisted in the other developed countries, although the United States performed relatively more favourably. Commodity prices remained stable and inflation rates held at moderate levels, giving rise to further expansionary monetary policy measures. The tension on international financial markets continued to abate in the closing months of the year, in step with the improved financial situation in the euro area and, more recently, with the lesser uncertainty over the so-called US fiscal cliff.

During the quarter in Europe, key decisions were taken that contributed to dispelling the uncertainty surrounding the euro project. Headway was made in resolving Greece's financial difficulties, with the joint disbursement of the first two financial aid tranches envisaged in the second assistance programme being approved. Major steps were taken in moving towards a European banking union. Specifically, on 13-14 December the European Council reached a consensus on the bases for the establishment of a Single Supervisory Mechanism (see Box 2). The European authorities also made a favourable assessment of the fulfilment of the various assistance programmes in train. All these decisions had a positive effect on European financial markets, consolidating the relief that had begun to take root in September and October following the ECB's announcement on the implementation of its Outright Monetary Transactions Programme. Indeed, in recent months sovereign spreads have narrowed, capital market financing conditions have improved and stock markets have rallied.

Although tensions have eased, the latest economic information points to a further fall-off in activity in the euro area in 2012 Q4, prolonging the recession that began to take form in

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE



SOURCES: ECB, INE and Banco de España.

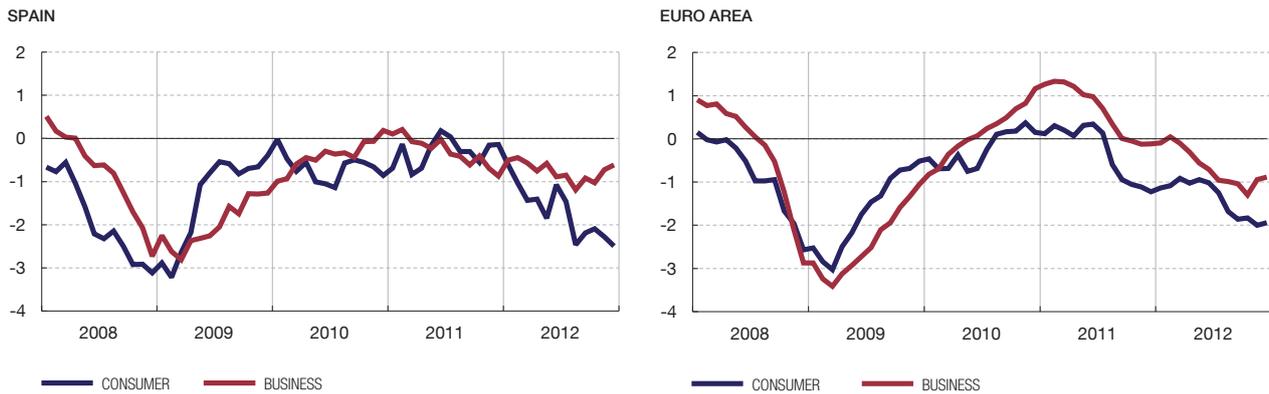
a Seasonally adjusted series.

late 2011. Inflation slowed in the final stretch of the year to a year-on-year rate of 2.2% in December, still conditioned by its more volatile components, for which more moderate behaviour is foreseen in the coming quarters. Accordingly, the HICP should stand below 2% in the coming months. The absence of risks to price stability in the medium term, in a context of persistent cyclical weakness, led the ECB to hold its MRO interest rate at 0.75%, and its deposit and marginal lending facilities at 0% and 1.50%, respectively. The expansionary monetary policy stance was rounded off with the ECB's announcement at its December meeting to extend its quarterly fixed rate tender procedures with full allotment for as long as necessary, and at least until 9 July 2013.

In Spain, progress was made over the past quarter in the clean-up, recapitalisation and restructuring of the financial system, in keeping with the parameters and demanding timetable laid down in the Memorandum of Understanding on financial-sector policy conditionality agreed with our European partners. In late November the European Commission published the adjustment plans to be undertaken by banks requiring aid, which will entail substantial adjustments in their activity, commercial network, employment and balance sheet size. Following the positive assessment of the degree of compliance with the commitments in the Memorandum, the €36.97 billion agreed by the European Stability Mechanism (ESM) was paid out. Finally, SAREB (the Asset Management Company for Assets Arising from Bank Restructuring) commenced operating as the management company of the assets transferred by the nationalised banks.

The Spanish financial markets also experienced the easing in tensions in the euro area. This was reflected in lower Spanish public debt yields and narrower spreads over the German benchmark, along with a reduction in private risk premia. And at the same time, stock prices rose and volatility lessened. As a result, at the time of his report going to press, the yield on the Spanish 10-year bond and the related spread over the German bund stood respectively at 5.1% and 350 bp. On the stock markets, the IBEX 35 rallied in the final quarter of 2012 (by 6%), ultimately posting losses of 5.3% for the year. The uptrend has continued into January to date. Lastly, on the real estate market, the latest information suggests a continuation of the downward course of house prices in the closing months of 2012.

Overall, the easing in financial tensions in recent months has translated into improved financing conditions for the resident sectors on wholesale markets, an increase in investment



SOURCE: European Commission.

a Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

by non-residents in the Spanish economy and lesser dependence by monetary and financial institutions on Eurosystem financing. However, bank rates remain at high levels and bank lending conditions for households and corporations continue to be tight, meaning the private sector remains subject to significant financial pressure.

This situation continued to weigh on the spending decisions of households, which foreseeably experienced further declines in disposable income and in the value of their wealth in the closing months of 2012, against a background of unfavourable labour market prospects and persisting uncertainty. In these conditions, household consumption posted negative figures throughout the year, though more forcefully so in the final months, owing to the impact of the fiscal consolidation measures on household income and of the inflation rate. Nonetheless, a portion of these effects is temporary, as is the case of the negative impact associated with the bringing forward to Q3 of certain purchases (essentially of consumer durables). This decline took place despite the implementation of the so-called PIVE Plan (a scheme to promote more fuel-efficient vehicles), whose impact may now be delayed to the opening months of 2013. For 2012 as a whole, it is estimated that consumption fell at a rate of close to 2%. For another year, saving helped soften the pattern of consumption in the sector, as has occurred since 2009, with a reduction in the saving rate to 8.8% of disposable income being observed in Q3 (in four-quarter cumulated terms), 2.2 pp down on its level in 2011.

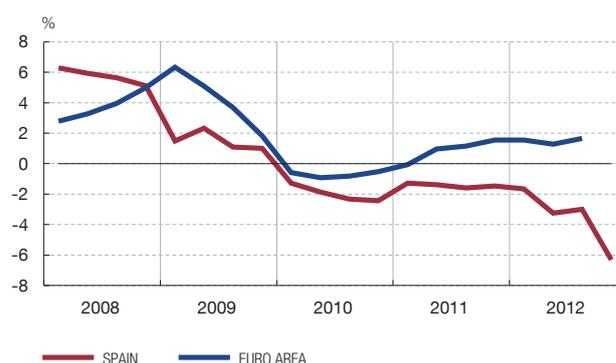
Residential investment continued to decline in the closing months of the year, making for the fifth year of adjustment for the real estate sector, with a fall of over 7% in 2012. The regulatory changes introduced in 2012, which will come into force this year (namely the creation of SAREB, the raising of VAT from 4% to 10% in January 2013, the elimination of tax relief on the purchase of the principal residence and the foreseeable entry into force of the reformed rental law) add some uncertainty to how the real estate market will fare in the coming quarters, although the demand-side conditions prevailing and the persistence of a high stock of unsold houses suggest the adjustment may continue in 2013. In this setting of shrinking expenditure and tight financial conditions, lending to households declined in the closing months of the year at a similar pace to that of the previous quarter (-3.6% year-on-year to November).

Business investment was likewise affected by the above-mentioned financial environment and by the relatively unfavourable domestic and external demand outlook. Accordingly, both investment in equipment and that in other construction fell in the final stretch of 2012,

HARMONISED INDICES OF CONSUMER PRICES (a)



UNIT LABOUR COSTS (b)



SOURCES: Eurostat, ECB and INE.

a Year-on-year rate of change.

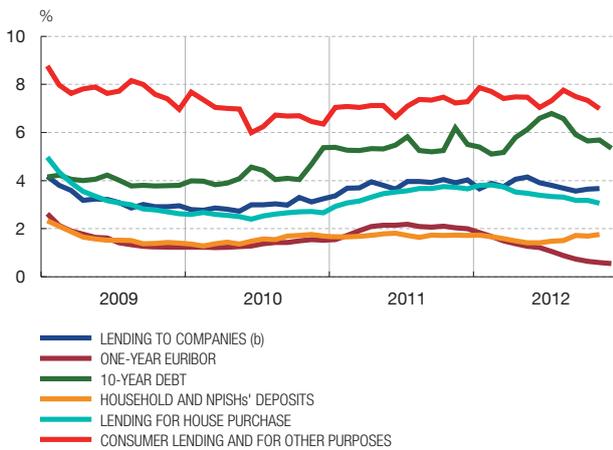
b Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

and their end-year rates of decline are estimated at 5% and 15%, respectively. The reduction in corporations' debt stepped up in the final months of the year, reaching a rate of -4.6% in November (-3.7% in September).

The information available for the overall general government sector, covering up to Q3, revealed net borrowing of €65 billion (6.2% of annual GDP), almost 0.5 pp of GDP higher than in the same period a year earlier. That said, it should be borne in mind that the 2012 figure includes the impact stemming from specific aid to financial institutions, which increased public spending, through the capital transfers heading, by an amount of 1% of GDP. The marked sluggishness of revenue to September (with a decline of 1.7%) would account for the laboured progress in correcting the deficit in this period, since spending, with a decline of over 3% (if the impact of the aid to financial institutions is excluded), moved more closely in line with the initially budgeted figure.

Against this backdrop, and with the aim of attaining the budget deficit target of 6.3% of GDP at the end of the year (a target which does not include the impact of the aid to financial institutions on the deficit), the general government sector stepped up its fiscal consolidation effort in the closing months of the year, in which a significant portion of the impact of the revenue-raising and expenditure-cutting measures approved during the year was concentrated. These measures included most notably the rise in VAT from 1 September (to 21% and 10%, respectively, for the standard and reduced rates), the change in corporate income tax, the elimination of the extra December payment for civil servants and, lastly, the suspension of the inflation adjustment applied to pensions. As a result, the latest information on the budget outturn for the different sub-sectors in October and November points to a very significant reduction in tax revenue slippage in these months (essentially owing to the acceleration in VAT and corporate income tax receipts) and to a further improvement in the degree of approximation of expenditure to its programmed objective after incorporating the impact of the elimination of the extra December payment for civil servants and the decision not to apply an indexation adjustment to pensions. This budgetary consolidation drive has had a clearly contractionary effect on economic activity throughout the year, proving particularly acute in the final months owing to the reasons set out. For 2013, the European commitments acquired under the Stability and Growth Pact lay down an overall general government deficit target of 4.5% of GDP, whose attainment

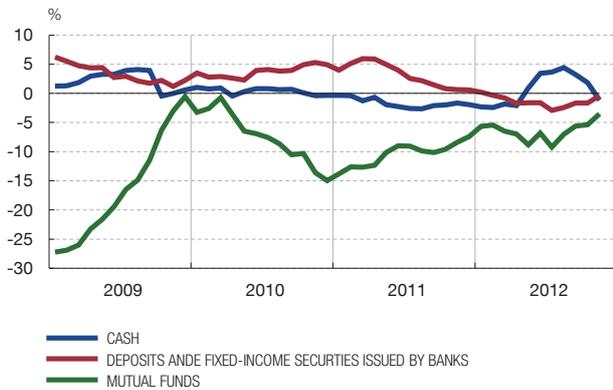
INTEREST RATES (a)



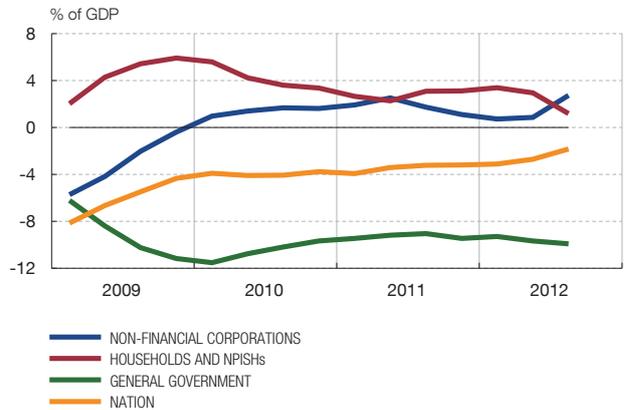
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



FINANCIAL ASSETS OF NON-FINANCIAL CORPORATIONS AND OF HOUSEHOLDS AND NPISHs (year-on-year growth)



NET FINANCIAL TRANSACTIONS (d)



SOURCE: Banco de España.

- a In June 2010 the statistical requirements relating to interest rates applied by credit institutions to their customers were amended, potentially causing breaks in the attendant series. Of particular significance was the change in the interest rates on consumer credit and other loans, as a result of which, from that month, operations transacted using credit cards have not been included. APR for loans (includes commissions and other expenses) and NDER for deposits.
- b Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
- c Consolidated financing: net of securities and loans that are general government assets.
- d Four-quarter cumulated data.

will require a further and very ambitious fiscal effort both on the part of central government and the regional governments. In this respect, following the approval of the State and Social Security Budget, the regional governments have submitted their budgets for 2013, which include fresh increases in revenue and cuts in current and capital spending alike.

As regards trade with the rest of the world, net external demand in the closing months of 2012 partly offset the effect of the contraction of domestic spending on activity; however, compared with the previous quarters, in which the contribution of exports and imports was more balanced, the dominant factor was the decline in imports against a background of markedly slowing exports in the final months of the year. The external factor thus contributed, for another year, to softening the impact of the contraction in domestic demand on output. Behind this development lies the weakness of the cycle, which reduces imports, but also the gains in competitiveness generated over the past three years, which are conducive to growing Spanish export penetration of new markets, a requirement for con-

tinuing to lessen dependence on the cyclical situation in Europe (see Box 5), and for obtaining very positive results in foreign trade in services, most especially non-tourist services.

In this setting, the adjustment of the external imbalance intensified in 2012, with a decline in the Spanish economy's net borrowing to Q3 of 52.1% compared with a year earlier (to €13.3 billion, 1.7% of GDP). Indeed, for the first time since this information has been available, Spain had net lending capacity vis-à-vis the rest of the world in Q3. From the standpoint of the institutional sectors, this improvement in net financing was the outcome of the clean-up of corporations' balance sheets. Companies increased their financing capacity, while households continued to see their financing capacity move on a declining trajectory, as has been the case since 2010, and the general government sector retained still-high deficit financing needs. .

The contraction in expenditure was mirrored in supply, where it is estimated that all the productive sectors saw a further deterioration in their output in the final quarter. In the case of some, such as industry and market services, this development might have been influenced by the reversal of the positive effect exerted by the bringing forward of purchases ahead of the expected rise in VAT rates in September. In the year as a whole, all the productive sectors are estimated to have performed more unfavourably than in the previous year. Notable in this connection was the fall-off in activity in the construction sector, influenced by the continuing adjustment in the residential segment and the decline in civil engineering works, on which the budgetary austerity plans bore down. In these circumstances employment shrank at a higher rate than in the previous year, partly owing to the decline in public-sector employment in response to the application of the regional governments' financial rebalancing plans, which compounded the employment adjustment previously begun by central government. In the market economy, while the decline in employment was likewise significantly acute, the deterioration moderated over the course of the year, following the sharp declines in late 2011 and early 2012. As in previous years, the decline in employment was centred on workers with temporary contracts, and the better relative performance in the case of part-time employees continued.

After rebounding in 2011, labour costs slowed markedly in 2012. A fall of 0.6% in compensation per employee was estimated, the outcome of the reduction in public-sector wages and of a very moderate increase in market-economy wages (0.5%), which might even have undergone a slight fall in the final quarter of the year. That reflects the lower increase in collectively bargained wage rates (1.3% against 2.5% in 2011), a likewise lesser impact of indexation clauses and negative wage drift on a significant scale which put downward pressure on labour costs. Overall, this wage moderation reflects the effect of the latest labour market reforms which, along with the wage agreements entered into by the social agents, are expected to have significantly changed collective bargaining dynamics. The course of labour costs provided for a further downward adjustment, for the third year running, in unit labour costs in 2012 (of -2.8% in the market economy, up on that observed in the two previous years). The firming of this trajectory in the coming quarters is crucial if the effects of the labour market reforms are to begin to exert an expansionary effect on employment, which is their ultimate objective. In this respect it is vitally important that the rise in inflation in recent months, which is of an eminently temporary nature and associated with tax increases, should not feed through into collective bargaining. Further, the competitive devaluation the Spanish economy needs in the current circumstances also requires a similarly sharp containment of prices and margins in order to obtain the results wished for in terms of job creation. With this aim in mind, it is a priority to deepen the liberalising reforms of product and service markets.

21.1.2013.