

## QUARTERLY REPORT ON THE SPANISH ECONOMY

### 1 OVERVIEW

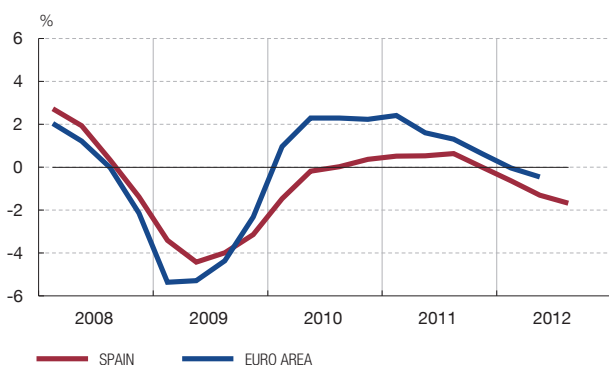
The contractionary course on which the Spanish economy had embarked a year earlier continued in the central months of the year, in a setting marked by financial conditions that were adverse though somewhat slacker than in the previous quarter. The as-yet incomplete conjunctural information available suggests that GDP declined at a quarter-on-quarter rate of 0.4%, similar to that in Q2. The profile of demand during the quarter was affected by spending decisions being brought forward in light of the VAT rise announced for 1 September. The Q3 data also reflect the relief provided by the Government's payment-to-suppliers plan for companies' accounts. National demand fell at a somewhat lower rate than in the previous quarter (-1.2% against -1.4%), as a result of more moderate declines in all the private components of expenditure, in particular in household consumption, where the above-mentioned VAT effect was concentrated. The contractionary trajectory of government consumption, on the other hand, is expected to have intensified. Lastly, the contribution of net external demand was once again positive (0.8 pp), somewhat down on the previous quarter despite the firmness of exports, this being partly countered by the rebound in imports. In year-on-year terms GDP declined 1.7%, against -1.3% in Q2.

Turning to the supply side, employment is estimated to have contracted at a similar rate to the previous quarter (at around a year-on-year rate of -4.5%). Labour costs continued to ease. And combined with the further rises in apparent productivity, this is expected to have prompted a decline in unit labour costs. In turn, inflation rose significantly in Q3 as a result of the impact of the rise in energy prices and the effect of the tax and administered-price rises on final prices. In September, the year-on-year rate of consumer prices quickened to 3.4%, while the CPI excluding energy and unprocessed food prices accelerated to 2.1%. The positive differential of Spanish HICP inflation relative to the euro area widened to 0.9 pp. Based on an evaluation of the impact of the rise in VAT and other administered prices on inflation, the pass-through of the tax rises to consumer prices will foreseeably only be partial, and the impact on the inflation rate temporary. The reforms made to the labour market and product markets should contribute to this outcome.

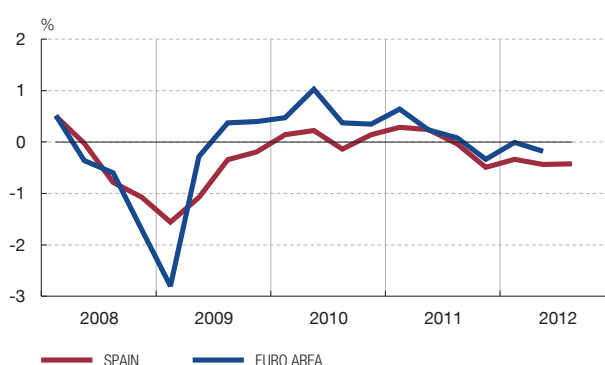
On the international economic front, there was a further slowdown in the pace of recovery of the world economy in Q3 in light of the loss of momentum of the emerging countries, the ongoing weakening of activity in the euro area and the persistent low growth in the other developed countries. Inflation rose as a result of the increases in commodities prices, in particular oil and food, although price expectations generally remain moderate. Against this background, the central banks pursued expansionary monetary policies and, in some cases, extended their non-conventional policies. On the financial markets, the high tensions experienced in the summer as a result of the intensification of the euro area sovereign debt crisis, particularly affecting Spain and Italy, began to abate in late July. This followed the ECB's announcement of its readiness to intervene on sovereign debt secondary markets, a measure that would take specific form in the subsequent months.

In the euro area, the latest economic information points to a further contraction in activity in Q3 which, if confirmed, would place the euro area in a technical recession. Despite the sluggishness of activity, inflation increased as a result of energy and indirect tax rises. Given the temporary nature of these effects, the rise should be temporary and not jeopardise price stability over the relevant monetary policy horizon. In keeping with this analysis, the ECB Governing Council held official interest rates unchanged at 0.75% for its main

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE



SOURCES: ECB, INE and Banco de España.

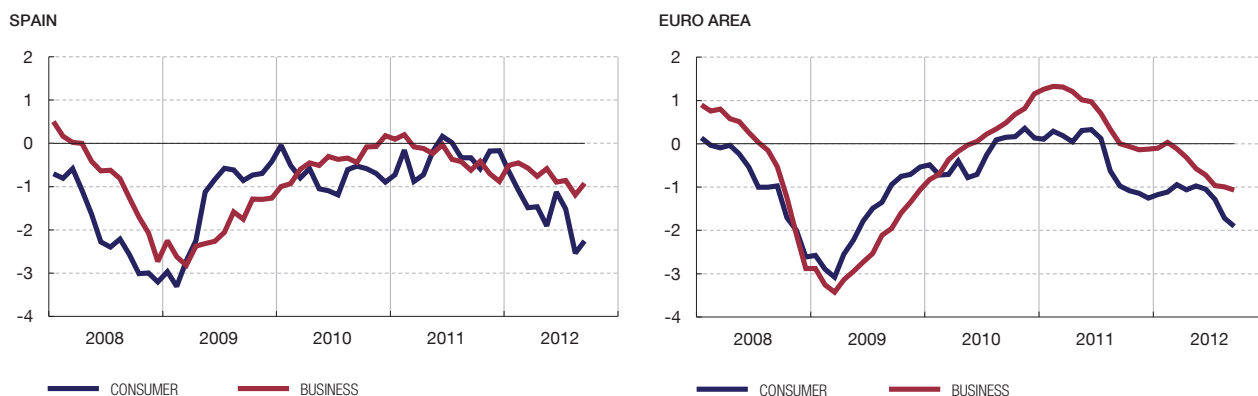
a Seasonally adjusted series.

refinancing operations, and at 0% and 1.5% for its deposit and marginal lending facilities, respectively, at its August, September and October meetings.

As indicated, following the severe bouts of financial instability affecting the euro area, the ECB stepped up its non-conventional monetary policy measures. In early August it announced a programme to intervene on the secondary markets for sovereign debt, aimed at restoring the functioning of the single monetary policy transmission mechanism, which had been impaired by the tensions generated in the face of the unwarranted fears about the reversibility of the euro. In September and October the Council explained the main elements of this so-called OMTs (Outright Monetary Transactions) programme. It will involve the unlimited purchase of sovereign bonds maturing at between one and three years, for those countries that formally request it, and will require strict and effective conditionality, established under the framework of some of the programmes of the European Financial Stability Facility or the European Stability Mechanism.

The action by the ECB provided clear relief for the financial instability in the euro area. Such relief made itself felt both on the sovereign debt markets, where yield spreads narrowed, and on the equity markets, where issues were reactivated. However, this improvement began to stutter as from mid-September owing to the perceived loss of impetus in the process of reform agreed on at the Summit Meeting of the EU Heads of State or Government in late June. However, the Summit of 18-19 October has dispelled some doubts, laying down a clear commitment for progress towards banking union, which is a cornerstone in the construction of a more cohesive and integrated monetary union, and agreeing to finalise by year-end the legislation needed to set the banking union in train.

Over the course of the past quarter, fresh steps have been taken in Spain to overcome the problems beleaguering the economy. In the financial domain, progress has continued in the clean-up, recapitalisation and restructuring of the financial system in accordance with the parameters set in the Memorandum of Understanding on financial-sector policy conditionality agreed with our European partners. In this respect, Royal Decree-Law 24/2012 on the restructuring and resolution of credit institutions was approved on 31 August, and on 28 September the results of the bank-by-bank stress tests were published, estimating aggregate capital needs of €54 billion under the most adverse scenario, which are concentrated in a relatively limited number of banks. In the budgetary arena, the Government



SOURCE: European Commission.

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

approved in early August the two-year 2013-2014 budgetary plan. Lastly, in late September, coinciding with the approval of the draft State budget for 2013, the Government also published a detailed schedule for the implementation of a series of structural reforms (which will affect various aspects of the labour market, the liberalisation of fee-earning professional services and the house rental market, among others) and measures relating to the budget and to the sustainability of public finances (the creation of an independent fiscal agency and the definition of the sustainability factor for the pension system), in line with the recommendations of the European Semester.

The Spanish financial markets have experienced the lessening of the tensions in the euro area. The diminished financial pressure was mirrored in a decline in public debt yields, following the peaks reached at certain points in June and July, in the re-opening of the primary markets for private issues, following many months in which they had virtually dried up, and in stock market gains. As this report went to press, ten-year government bond yields stood at 5.4%, with the spread over German debt at 380 bp. The IBEX 35 posted gains as from end-June of around 14%. Interbank market yields continued to narrow, but this has not yet been fully reflected in the costs of new borrowing for the private sector. The reduction in the Euribor, moreover, will offer some relief to indebted households. As regards the real estate market, the ongoing fall in house prices has continued. On official (Ministry of Development) data, prices fell at a year-on-year rate of 9.5% in Q3, compared with -8.3% in Q2. Accordingly, the cumulative decline in prices from their 2008 peak is 25.5%.

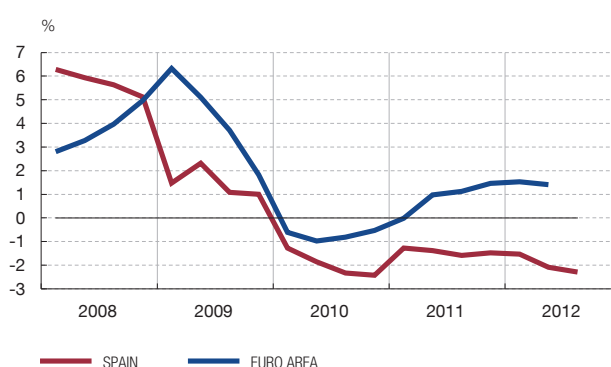
In short, the context in which the Spanish economy has been moving in the past quarter has been characterised by the generalised weakening in external activity (which is affecting our main export markets, located in the euro area, with particular intensity), still-tight financing conditions and a persisting climate of high uncertainty linked, among other factors, to doubts over the scope of the reforms being set in train, both in Europe and in Spain. These developments are hampering any pick-up in domestic demand, which has fallen back in recent months and shows a cumulative decline of somewhat over 13 pp since 2008 Q1.

In the case of households, the high unemployment rate, the decline in real disposable income and in wealth, the strict financial conditions in place and the ongoing process of deleveraging continue to check consumption. That said, the bringing forward of purchases

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.

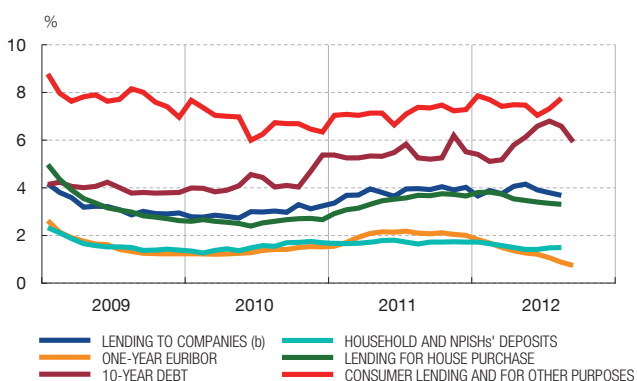
– especially of durable goods – to July and August, ahead of the VAT rise, has softened this trend, and a slight recovery in consumption has been seen in the quarter-on-quarter rate in Q3 (0.1%). Foreseeably, in the final stretch of the year, the elimination of this effect combined with the impact on disposable income of the cuts to public-sector wages should place consumption on a declining course again, in step with its determinants. The leeway available to households to circumvent the income restrictions they face and to smooth the pattern of expenditure has been substantially reduced in recent quarters. This can be seen in the downward course and level of the saving ratio, which accounted for 9.6% of gross disposable income in cumulated four-quarter terms at the end of Q2, a level below the previous low for the series, in 2006 Q3.

Residential investment continued to decline in Q3, albeit at a slacker rate than in the previous quarters (a quarter-on-quarter decline of 1.6% is estimated). However, this development cannot yet be attributed to the bringing forward of spending decisions potentially triggered by the tax changes that will come about from 1 January 2013 in the tax treatment of this asset (the rise in VAT from 4% to 10% and the elimination of the tax credit for first-time homebuyers). Stripping out the uncertain impact of this effect, residential investment remains contractionary, despite lower house prices, in a setting in which uncertainty is still very high and in which the stock of unsold houses is still very sizeable.

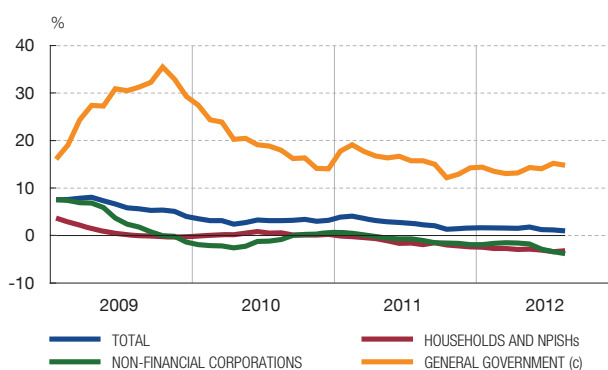
Financing granted to households continued to fall in Q3. On the data available to August, loans to households declined at a year-on-year rate of 3.2%, similar to that of the previous quarter. The breakdown by end-purpose suggests a somewhat more marked contraction in loans for the purchase of consumer goods, as opposed to those for house-purchase. This reduction in lending is expected to provide for moderate further headway in the process of household deleveraging, despite the weakness of household income.

Worsening external demand, the unfavourable economic outlook for the domestic market and high indebtedness continued to weigh on firms' investment decisions. Investment in equipment is expected to be flat while it is estimated that investment in other constructions will fall off more sharply. The data for Q3 show, in any event, less marked declines than those in the previous quarters for both these investment components. This might be reflecting some impact by the payment-to-suppliers plan, which entailed the settlement of debts incurred by regional and local governments for an amount of almost €30 billion.

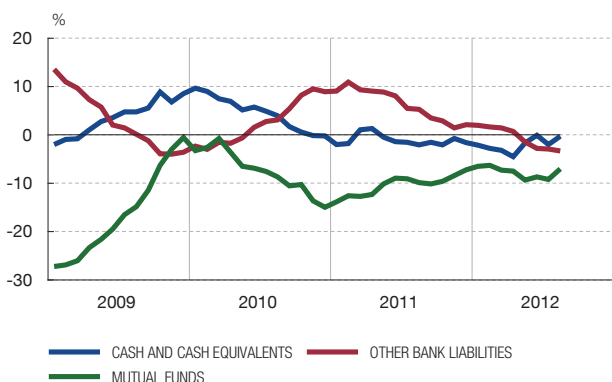
INTEREST RATES (a)



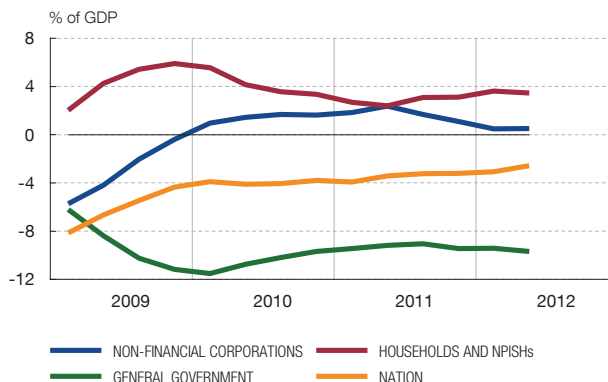
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



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.

The financing obtained by non-financial corporations fell in August at a year-on-year rate of 3.7%, accentuating the contractionary profile of the previous quarters. According to National Accounts figures, that prompted a further reduction in the sector's debt ratio.

The improvement in competitiveness is being felt in goods and services trade, since exports remain expansionary and are the only component that is cushioning the strong adverse effect of the contraction in national spending on activity. As a result, the Spanish economy's current- and capital-account balance, which was strongly in deficit at the onset of the crisis, continues to adjust, despite the difficulties of redressing the deficits on energy and investment income. The favourable results achieved in recent months, with a surplus in July, point to an acceleration in the ongoing reduction in the nation's net borrowing in the second half of the year from its Q2 level of 2.6% of GDP, in cumulated four-quarter terms.

The public sector consolidation drive has exerted a clearly contractionary effect in the central months of the year. Higher declines than in previous quarters are estimated for general government consumption and investment, with falls in purchases of goods and

services, in public-sector employment and in civil engineering works, in line with the budgetary targets. On the revenue side, significant slippage continues to be discernible in tax revenue, which is being greatly affected by the downturn in domestic demand. Nonetheless, the budgetary outturn to September does not yet reflect the exceptional consolidation measures taken in July, either on the revenue side (the increase in indirect taxation, with rises in the standard and reduced rates of VAT to 21% and 10%, respectively, and changes in corporate income tax, in the main) or on the expenditure side (cuts to public-sector wages, with the elimination of the December “extra” salary payment, equivalent to one-fourteenth of annual wages), the estimated impact of which, of 2% of GDP, will be felt almost in its entirety in the last quarter of the year. Notwithstanding, it cannot be ruled out that the budget deficit exceeds the target set for this year; accordingly, if the budget outturn data for the coming months do not dispel this uncertainty, the adoption of additional measures enabling target fulfilment would have to be considered.

For 2013, the draft State budget sets an overall general government deficit target of 4.5% of GDP, in line with the fiscal consolidation path agreed in the European arena. The fiscal effort this target entails is very ambitious (around 2 pp of GDP in terms of the cyclically adjusted primary deficit, according to official estimates), in a macroeconomic setting that will continue to be difficult. To meet the target, the budget details a series of measures that will affect both revenue and expenditure. In any event, the adjustment effort by central government and the Social Security system (for which the budget sets a deficit of 3.8% of GDP in 2012) should be supplemented by the corresponding regional government drive, the specific budgetary details for which must be set out in the coming weeks, as envisaged in the Budgetary Stability Law.

On the supply side, the sluggishness of spending impacted activity in the various productive sectors, the declining course of which was prolonged in year-on-year terms. However, the fall-off in value-added in industry eased in the central months of the year as a result of the temporary rise in the manufacturing output of specific goods ahead of the planned change in indirect taxation. Employment shrank at a similar pace to the previous quarter, as a result of the differing performances in market branches (where the process of job destruction initiated in the second half of 2011 can be seen to be stabilising somewhat) and in non-market activities (where a sharper decline was observed due to the effect on public-sector employment of the financial re-balancing plans being implemented by the regional governments). Registered unemployment remained on an upward trend, although its annual rate of change stabilised at its June level. Should the behaviour of the labour force be similar to that of the previous quarters, the unemployment rate may be expected to increase slightly in Q3.

Finally, labour costs are forecast to continue on the gradually slowing trajectory they have followed in recent years. Wage settlements in collective bargaining agreements registered to September show a wage rise of 1.3%, the result of increases of 1.5% stemming from multi-year agreements (signed in previous years), which were higher than those shown in newly signed agreements (0.7%). While there is some delay in the latter agreements being signed compared with previous years, they are following a declining course that is bringing them closer to the benchmark set in the Second Wage Agreement for 2012 (an increase of 0.5%). If this trend continues, the rate of increase of compensation per employee in the market economy might carry on declining over the rest of the year.

The recent labour market reform offers firms the possibility of tailoring wage bargaining more closely to the specific factors conditioning their sphere of activity and to the cyclical

juncture of the economy. Harnessing these new possibilities is a major opportunity that firms must seize in order to preserve and improve their competitiveness. It is important to prevent the temporary impact on inflation of some of the measures adopted to further fiscal consolidation, such as the rise in VAT, from leading to across-the-board price and wage revisions, since that would entail untimely backtracking from the gains in competitiveness attained. From a medium-term perspective, the improvement in competitiveness plays a key role in underpinning the prospects of recovery in a situation such as the present, in which the domestic factors driving demand will take some time to gain momentum. This is because the processes of budgetary consolidation and financial deleveraging must be completed, global markets are currently slowing and it will be some time before the full impact of the structural reforms takes effect.