1 OVERVIEW

In 2013 Q2, the pace of the contraction in Spanish economic activity eased significantly, for the second quarter running, following its marked decline in the closing months of 2012. On the as-yet incomplete information available, the rate of GDP is estimated to have declined by 0.1% in quarter-on-quarter terms (-0.5% in Q1), which would place the related year-on-year rate at -1.8%. Underpinning the slackening of the decline in output was the strength of net external demand which, boosted by buoyant goods and services exports, contributed 0.4 pp to the quarter-on-quarter rate of GDP. There was a very slight softening in the declining course of domestic demand (-0.6%, compared with -0.7% three months earlier), in a setting in which household and corporate spending continued to be influenced by adverse financial conditions, the need to push ahead with deleveraging and the direct and indirect effects of the fiscal consolidation process.

The rate of decline of employment eased, beyond what may be attributed to seasonal hires in the run-up to the summer period, with a year-on-year fall-off in employment in QNA terms of 4% (-4.5% in Q1). In turn, labour costs are estimated to have continued on the moderating trajectory that had taken root in Q1. The overall effect of this wage behaviour coupled with developments in productivity is estimated to have brought about a significant reduction in unit labour costs (around 3% year-on-year); however, that reflects a slight containment in their adjustment path. CPI inflation, too, slowed in Q2, behaving in a relatively volatile fashion as a result of the impact of the most erratic components of the index (the prices of food and, above all, of energy products). The year-on-year growth rate of the CPI stood in June at 2.1% (1.7% for the quarter on average), a level from which it will foreseeably decrease significantly over the rest of the year, once the effects of the rises in indirect tax and in regulated prices adopted in the second half of 2012 are progressively stripped out of the annual rate. If this forecast materialises, the inflation differential with the euro area would resume a declining path from the level of 0.6 pp recorded in June.

As regards economic policies, the Government approved a series of tax measures[1], it announced a further phase of the financing mechanism for regional and local government payments to suppliers, in order to provide for a speedier reduction in late payments[2], it approved the draft legislation on the Independent Fiscal Responsibility Authority[3], it set in train the electricity reform[4] and it unveiled the report prepared by the Commission for the reform of general government. Most of these measures were present in the latest Updated Stability Programme or in the National Reforms Plan (which set out the Government's fiscal policy and structural reform strategy), approved in late April, in keeping with the commitments entered into under the European Semester framework.

On the international economic front, the quarter was marked by more sluggish economic activity than had been forecast at the outset of the year, with some exceptions (Japan and,

1 Royal Decree-Law 7/2013 of 28 June 2013 on urgent tax, budgetary and research, development and innovation-promoting measures; and draft legislation laying down specific environmental tax-related measures along with other tax and financial measures.

2 Royal Decree-Law 8/2013 of 28 June 2013 on urgent measures against general government late payments and support measures for local municipalities with financial problems.

3 At its sitting on 28 June, the Council of Ministers approved the submission to Parliament of the Draft Organic Law on the Creation of the Independent Fiscal Responsibility Authority.

4 Royal Decree-Law 9/2013 of 12 July 2013 adopting urgent measures to ensure the financial stability of the electricity-generating system.

MAIN SPANISH MACROECONOMIC AGGREGATES (a) **TABLE 1**

	2011	2012	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2
National Accounts								
Quarter-on-quarter rate of change, unless otherwise indicated								
GDP	0.4	-1.4	-0.4	-0.4	-0.3	-0.8	-0.5	-0.1
Private consumption	-1.0	-2.1	0.5	-1.1	-0.5	-2.0	-0.4	-0.4
Gross capital formation	-5.5	-8.7	-1.8	-3.1	-1.3	-3.9	-1.0	-0.9
Domestic demand	-1.9	-3.9	-0.3	-1.3	-1.1	-2.0	-0.7	-0.6
Exports	7.6	3.1	-2.6	1.8	5.1	-0.9	-1.3	1.2
Imports	-0.9	-5.0	-2.0	-1.3	2.7	-4.8	-1.7	-0.2
Contribution of net external demand (b)	2.3	2.5	-0.1	1.0	0.8	1.2	0.1	0.4
Year-on-year rate of change								
GDP	0.4	-1.4	-0.7	-1.4	-1.6	-1.9	-2.0	-1.8
Employment	-1.7	-4.4	-3.7	-4.7	-4.6	-4.7	-4.5	-4.0
GDP deflator	1.0	0.1	0.2	0.1	0.5	-0.2	0.9	1.2
Price indicators (year-on-year rate of end-period data)								
CPI	3.2	2.4	1.9	1.9	3.4	2.9	2.4	2.1
CPI excl. unprocessed food and energy	1.7	1.6	1.2	1.3	2.1	2.1	2.3	2.0
HICP	3.1	2.4	1.8	1.8	3.5	3.0	2.6	2.2
HICP difference vis-à-vis the euro area	0.3	-0.1	-0.9	-0.6	0.9	0.8	0.9	0.6

SOURCES: INE and Banco de España.

a Information available up to 19 July 2013.
b Contribution to the quarter-on-quarter rate of change in GDP in pp.

to a lesser extent, the United States). That prompted a downward revision of growth prospects for the world economy for 2013 and the interruption, as from May, in the favourable trend of financial markets witnessed since the end of 2012. In particular, there was a significant rise in volatility and a decline in share prices on the main stock markets, and increases in long-term sovereign debt yields. Commodities prices slowed during the quarter and inflation rates held, in general, at low levels.

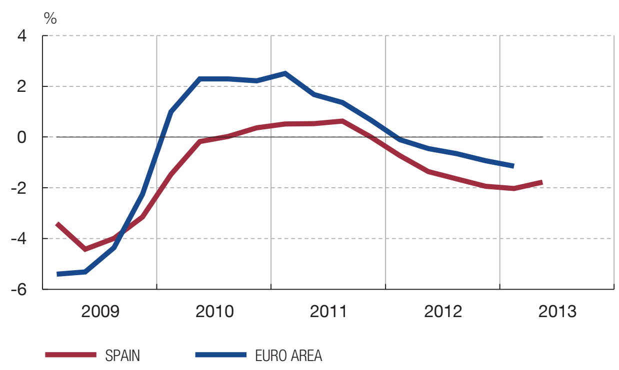
In the euro area the ratcheting up of financial tensions was more patent owing to the conjunction of a series of factors. Along with the change in the perception of the US monetary policy stance that followed the Federal Reserve's June announcement that it intended to slow the pace of asset purchases in the second half of the year, tensions of an essentially political nature flared anew in some of the area's vulnerable countries (chiefly Cyprus, Portugal and Greece) and the difficulties the ongoing construction of the Banking Union entails came to light, despite recent progress.

All told, activity in the euro area improved slightly in Q2, and most of the estimates available point to the downturn that had lasted six consecutive quarters being overcome. That said, the outlook for the rest of the year continues to augur a very moderate recovery that is not free from risks. Inflation, for its part, moved on a declining trajectory, posting a year-on-year rate of 1.6% in June (1.3% in terms of core inflation), and it is expected to remain on this course in the coming months, whereby euro area inflation should firm at levels significantly below 2%.

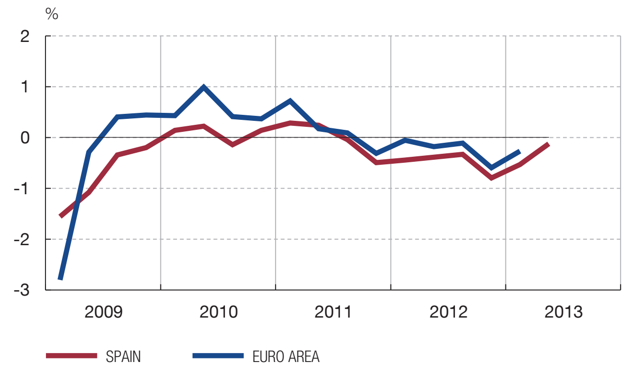
Against this background, the ECB Governing Council decided at its May meeting to relax the monetary policy stance. It shaved 0.25 pp off both the interest rate on its main refinancing

GROSS DOMESTIC PRODUCT (a) CHART 1

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE



SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

operations, to 0.5%, and the marginal lending facility, to 1%, as well as narrowing the corridor defined by the latter and the interest rate on the deposit facility, which remained at zero. In respect of unconventional measures, the Council announced that it would continue with fixed-rate liquidity provision for as long as necessary and, at least, until mid-2014, and that, in collaboration with other European institutions, it would begin to study measures to promote a market for asset-backed securities collateralised by loans to SMEs, thereby combating the financial fragmentation persisting in the euro area. Finally, in light of the tightening financial conditions seen in the second half of the quarter, the Council decided in July to strengthen its communications policy and introduce forward guidance, thereby making explicit its expectation that official interest rates would hold at current or lower levels for a prolonged period of time.

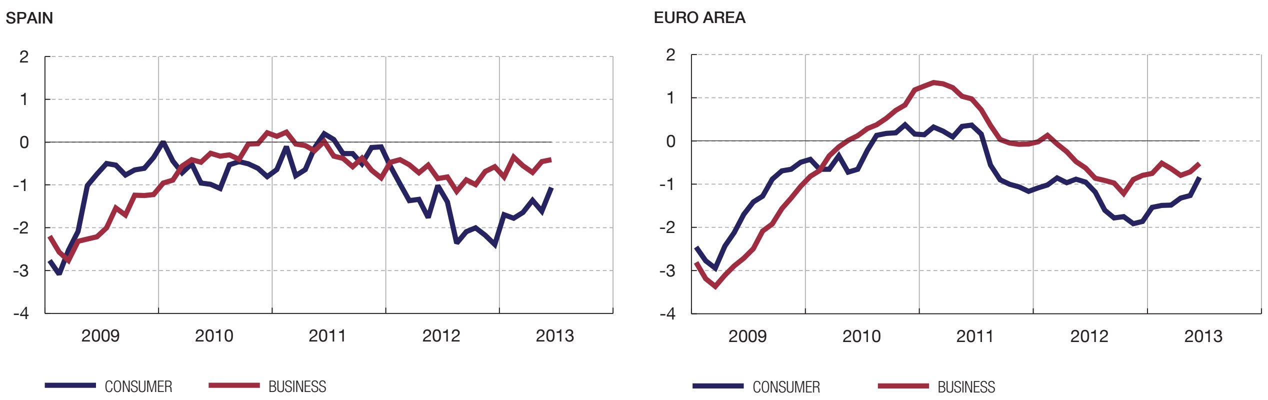
As to other economic policies, after revising stability programmes and excessive deficit procedure notifications, Ecofin resolved at its meeting on 21 June to extend the period within which budget deficits had to be placed below 3% of GDP in the case of those economies facing a greater worsening of the macroeconomic situation (Spain, France, Slovenia, Portugal and the Netherlands). In Spain's case, a two-year extension (to 2016) was granted, involving the relaxation of the budgetary target for 2013 from the previous figure of 4.5% to 6.5% of GDP under the revised path. For 2014-2016, the new deficit targets stand at 5.8 %, 4.2 % and 2.8 % of GDP, respectively. The European Semester concluded with the economic and fiscal policy recommendations drawn up by the European Commission for the EU countries not subject to programme after the review of progress made and the budgetary and structural reform plans announced.

In Spain, the increased instability on financial markets from the second half of May prompted higher Spanish public debt yields and a widening of the spread over German bonds. For the 10-year benchmark, the yield and spread were 4.7% and 315 bp, respectively. In turn, private-sector risk premiums rose and the IBEX was highly volatile, with its cumulative gains since end-March standing at 0.5%. Property prices continued to move on a declining path in the first half of the year. The figures from the Spanish Ministry of Development indicate a fall in house prices in Q2 of 7.8% year-on-year, entailing a cumulative decline of 29.5% from their peak.

Despite the heightened financial tension in the final stretch of the quarter, external funding continued to flow, albeit for a lesser amount than in the opening months of the year, and

CONFIDENCE INDICATORS (a)

CHART 2



SOURCE: European Commission.

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

the demand for Treasury securities remained relatively buoyant. However, interest rates on bank loans rose further and lending standards for private-sector borrowing showed no signs overall of easing. That denotes the persistence of financial fragmentation in the euro area, which is hampering the full transmission of the expansionary monetary policy stance to the interest rates applied by banks to non-financial corporations and households.

The spending decisions of households and non-financial corporations were once more affected by the prevailing climate of financial pressure and by the unfavourable outlook for any pick-up in the labour market and for domestic demand. Nonetheless, the confidence indicators showed a progressive improvement in Q2, potentially suggesting a somewhat more favourable performance by domestic spending over the coming quarters.

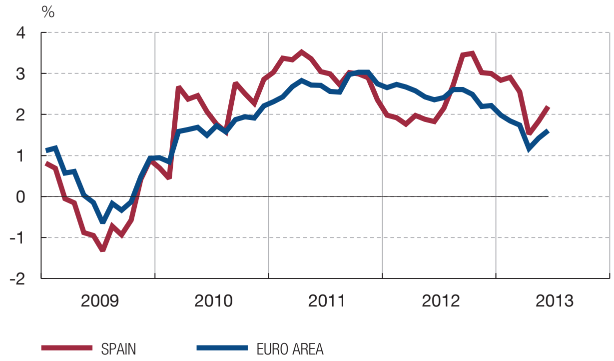
Household consumption held on a contractionary course, posting an estimated quarter-on-quarter rate of change of around -0.4%, thus in line with the figure observed the previous quarter. On information to March, the rate of decline of disposable income slackened and the saving rate increased slightly, for the first time since 2009 (when it peaked at 17.8%), to 8.5% of disposable income in cumulated four-quarter terms. Residential investment likewise fell back, to a similar quarter-on-quarter rate to that of the previous quarter (2.4%), in a setting in which the demand for housing remained weak (once the episode of bringing forward purchases owing to the tax changes implemented at the start of 2013 had concluded), and in which the reduction in the very large stock of housing continued very slowly. As a result of the developments in saving and investment, household lending capacity increased slightly in Q1, for the first time since end-2009, to 1.2% of GDP in cumulated four-quarter terms. The pace of the contraction in lending to households stepped up in Q2, posting a year-on-year rate of decline of 4.3% in May (-3.9% in March). Despite slack incomes, this allowed the gradually declining path of the sector's indebtedness and of the attendant interest burden to continue, according to the provisional information available.

In the case of corporations, the behaviour of productive investment was similar to that in Q1; the differences remained in place between investment in equipment, for which a small quarter-on-quarter rise of 0.3% is estimated, and investment in non-residential construction, for which a further slide is forecast, owing to the greater impact of austerity plans on civil engineering projects. On information for Q1, the net lending capacity of non-financial

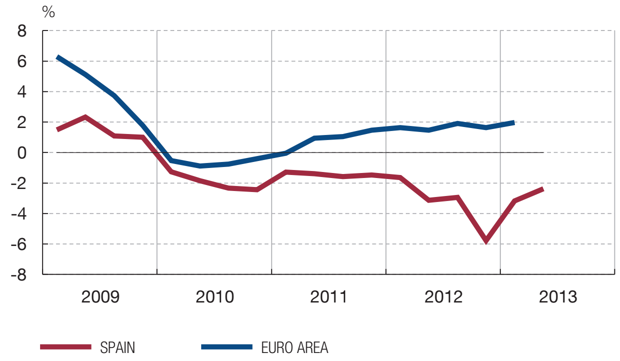
PRICES AND COSTS

CHART 3

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.

corporations increased further, standing at 4.7% of GDP in cumulated four-quarter terms. On more updated information, the rate of contraction of corporate debt stepped up in Q2, with a year-on-year decline of 7.3% being recorded in May (6.8% in March). Here, too, the downward trajectory of the sector’s debt/GDP ratio and its interest burden continued.

General government conduct in Q2 was marked by the budgetary commitments assumed and by the fiscal adjustment required to attain the new deficit target which, as indicated, was set at 6.5% of GDP, down from a level which in March stood at 6.8%, in cumulated four-quarter terms. In this respect, the partial information available for Q2 (to May) shows the continuing firming of the path of the main expenditure items (there were declines in government consumption – both in personnel costs and in goods and services purchases – and in public investments), and some quickening in general government revenue (less significantly so in direct taxation and social security contributions). In any event, the measures already adopted by the different tiers of government with a view to complying with these objectives will have to take the form of a further acceleration in general government revenue, and the continuing adjustment of public spending.

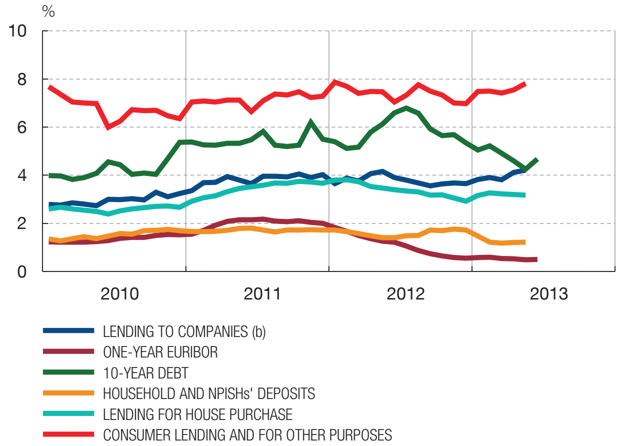
Once again in Q2, foreign trade in goods and services enabled the contractionary impact of domestic demand on activity to be offset, since the contribution of net external demand to output increased in the quarter to 0.4 pp (2.5% in terms of its contribution to the year-on-year rate). The increase in goods exports to the rest of the world and the momentum of tourism receipts played a crucial role here, as the rate of decline of imports slackened in Q2. The pick-up in global demand (following the slowdown in the opening months of the year), the reorientation of our export markets towards the emerging economies and the gains in competitiveness prompted by the process of internal devaluation lie behind these developments. In parallel, the correction of the external imbalance proceeded apace. In Q1, the nation’s net lending stood at 1% of GDP in cumulated four-quarter terms, for the first time in more than a decade. According to balance of payments data, this trend continued in April, owing essentially to the improved non-energy goods balance and, to a lesser extent, to that of other services and other income.

On the supply side, the information available points to an easing of the recessionary pattern in the main productive sectors. In industry, this improvement may be linked to the recovery in exports and, to a lesser extent, to the pick-up in certain national demand

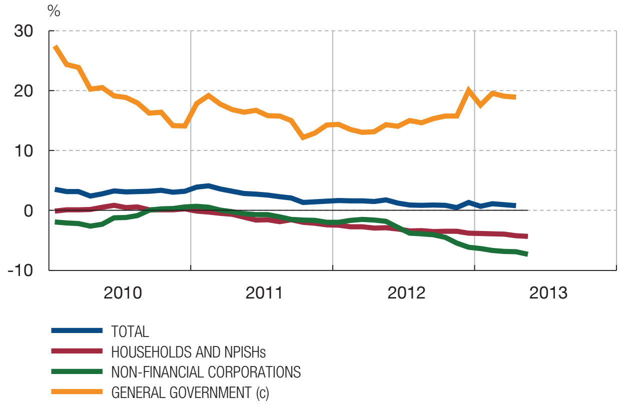
FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4

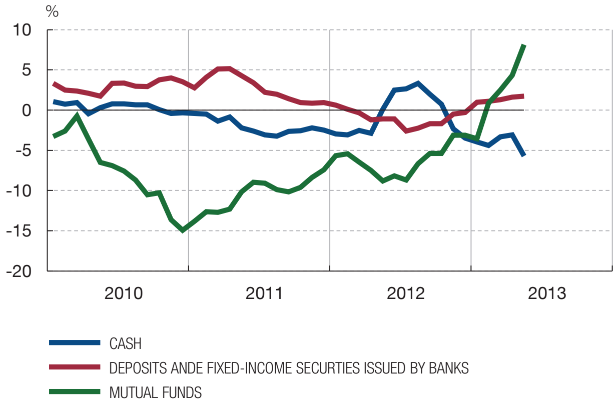
INTEREST RATES (a)



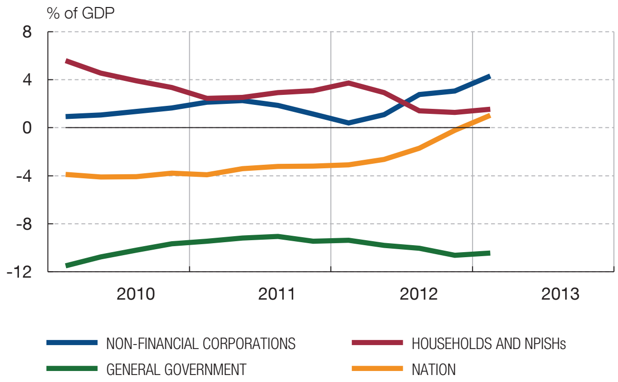
FINANCING TO NON-FINANCIAL RESIDENT SECTORS
(year-on-year growth)



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 signifcance 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 credit (includes fees and other expenses) and NDER (Narrowly Defined Effective Rate) 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, which does not include fees 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. GDP is seasonally adjusted.

segments, such as motor vehicle production. In the market services sectors, certain activities (such as wholesale and retail trade, and hotels and restaurants) are estimated to have regained traction, in line with developments in the preceding quarter. Finally, the rate of contraction of value added in construction slackened, although the adjustment continued in both the residential and the civil engineering sectors.

The pace of decline of employment eased substantially, posting an estimated quarter-on-quarter decline of 0.3% (-4% year-on-year), the least unfavourable rate witnessed over the past two years. If this forecast is confirmed, the growth of economy-wide apparent labour productivity will have slowed to 2.3%. Drawing on information from Social Security registrations, this slowdown in the pace of job destruction was across the board and, notably, there was marginal net job creation in market services over the past two months (in terms of the seasonally adjusted series and once the effect of non-professional home-carers was stripped out). At the same time, the moderating path seen in the pace of increase of registered unemployment in Q2 continued, and a year-on-year increase of 4.1% was recorded.

As earlier stated, the pace at which market-economy labour costs are easing accelerated in the first half of the year. After the step-up in the wage adjustment in Q1 (with a decline in compensation per employee in the market economy of -0.9%), labour cost indicators in Q2 suggest a continuation of this trend. Despite the problems of low representativeness and the relative lag in information on collective bargaining agreements this year, average wage settlements to June stood at 0.7% (1.2% last year), and those in newly signed agreements showed an increase of 0.4%. It is estimated that the other components of remuneration (inflation indexation clauses and wage drift) are likewise contributing to wage moderation. This tendency, which reflects greater responsiveness by collective bargaining to the weakness of the cycle, largely as a result of the effects of the labour market reforms, might intensify in the second half of the year. This is because the one-year deadline set by the reform for so-called “ultra-activity” (entailing the extension of the regulatory aspects of an expired agreement if an agreement to renew the old one is not reached) to remain valid should contribute to making the negotiation of new agreements more flexible and nimble.[5]

There is also evidence that the responsiveness of inflation to the cyclical situation has likewise increased in recent years.[6] It is necessary to ensure, however, that this trajectory firms, underpinned by the ongoing structural reforms and by their impact on the setting of costs, margins and prices, and by productivity. In that way, gains in competitiveness may be boosted, such gains being necessary to shore up the continuing resilience of the external sector and to provide for the reallocation of resources in order to resume a sustained growth path.

18.7.2013.

5 For greater details, see Box 1.1 in the *Annual Report, 2012,* “Changes in the functioning of the labour market”.

6 See in this same *Economic Bulletin* the article “Variation in the cyclical sensitivity of Spanish inflation: an initial approximation”.