1 OVERVIEW

During the third quarter, the gradual improvement in the Spanish economy seen since the beginning of the year continued, against a background of some easing in financial tensions and improved confidence. On the estimates made on the basis of the conjunctural information available, in the July-September period GDP grew by 0.1% quarter-on-quarter, following nine consecutive quarters of decline (see Table 1). However, in terms of the year-on-year rate of change, which measures the conjunctural situation with a lag, output fell by 1.2%. On the expenditure side, the decrease in domestic demand was similar to that in the previous quarter (0.3% quarter-on-quarter), while the contribution of net external demand to output rose by 0.4 pp.

The rate of decline of employment eased significantly in this period. A small quarter-on-quarter reduction of 0.1% (-3.1% in year-on-year terms) is estimated which, if confirmed, would be the least unfavourable rate recorded since the start of the crisis. At the same time, wage restraint is estimated to have continued. In conjunction with productivity, which is expected to slow slightly to 2% year-on-year, this would reduce unit labour costs further. Also, as approximated by the 12-month increase in the CPI, inflation posted a much greater-than-expected slowdown in Q3, especially in September, to stand at 0.3% (as against 1.5% in August). The stripping out from the index of the base effects of the increase in VAT rates and of the rises in administered prices in September 2012 explain most of this fall, although some unanticipated declines in the prices of unprocessed foods led to a further fall in the CPI in this latter month. The CPI excluding unprocessed food and energy, which better approximates the more stable underlying rate of inflation, ended the quarter at a year-on-year rate of 0.8% (1.6% in August). The inflation differential vis-à-vis the euro area turned negative (0.6 pp), so returning to levels similar to those before the increases in tax rates and administered prices introduced in 2012. With regard to economic policy, in September Parliament approved the Law to support entrepreneurs and their internationalisation, which seeks to foster business activity, innovation and the internationalisation of firms (see Box 4). The draft State budget for 2014 was sent to Parliament and two reports arising from the strengthening of fiscal-policy oversight at the European level to the European Commission: the *Effective Action Report* and the *2014 Budget Plan.*

Turning to the international economy, world economic growth slowed somewhat during the quarter owing to the slowdown in the activity of emerging economies, since the growth rates of the developed countries improved. Financial market developments were driven by the impact of the announcement of the withdrawal of monetary stimulus in the United States at the end of the previous quarter, which caused long-term interest rates to rise across the board and increased volatility in emerging markets during the summer, with stock market falls, sovereign spread increases and, in many cases, currency depreciation in those countries with a more vulnerable external position. From September, and following the decision of the Federal Reserve to keep its asset purchase programme unchanged, the instability receded somewhat. Inflation remained at moderate levels in the quarter as a whole, and the price of oil, after rising sharply until late August driven by the resurgence of tensions in the Middle East, turned downwards to stand in mid-October at around $110 per barrel.

In the euro area, the conjunctural information available suggests moderate growth in Q3, following an increase of 0.3% in the April-June period, the first rise after six quarters of

MAIN SPANISH MACROECONOMIC AGGREGATES (a) TABLE 1

	2011	2012	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
National Accounts									
Quarter-on-quarter rate of change, unless otherwise indicated									
GDP	0.1	-1.6	-0.4	-0.5	-0.4	-0.8	-0.4	-0.1	0.1
Private consumption	-1.2	-2.8	0.2	-1.1	-0.7	-2.0	-0.5	0.0	0.1
Gross capital formation	-5.6	-6.9	-1.4	-3.2	0.2	-3.0	-1.4	-2.2	-0.1
Domestic demand	-2.0	-4.1	-0.5	-1.3	-1.0	-1.8	-0.6	-0.3	-0.3
Exports	7.6	2.1	-3.1	0.6	6.5	0.6	-3.8	6.0	0.4
Imports	-0.1	-5.7	-3.3	-2.2	4.6	-2.6	-4.5	5.9	-0.7
Contribution of net external demand (b)	2.1	2.5	0.1	0.8	0.6	1.1	0.2	0.2	0.4
Year-on-year rate of change									
GDP	0.1	-1.6	-1.2	-1.6	-1.7	-2.1	-2.0	-1.6	-1.2
Employment	-2.2	-4.8	-4.3	-5.1	-4.7	-5.0	-4.5	-3.8	-3.1
GDP deflator	0.0	0.0	-0.1	-0.1	0.2	0.0	0.9	0.7	0.8
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	0.3
CPI excl. unprocessed food and energy	1.7	1.6	1.2	1.3	2.1	2.1	2.3	2.0	0.8
HICP	3.1	2.4	1.8	1.8	3.5	3.0	2.6	2.2	0.5
HICP difference vis-à-vis the euro area	0.3	-0.1	-0.9	-0.6	0.9	0.8	0.9	0.6	-0.6

SOURCES: INE and Banco de España.

a Information available up to 16 October 2013.
b Contribution to the quarter-on-quarter rate of change in GDP in pp.

contracting activity. The improvement in euro area activity was accompanied by an easing of tensions on European financial markets and of market fragmentation, although sizeable differences remain in the degree of financial restrictiveness borne by countries owing to the difficulties monetary policy has in transmitting its impulses uniformly. Financial fragmentation is manifest in considerably tighter financing conditions for households and firms in the countries of the area where the economic situation is weaker. In turn, euro area inflation continued to ease, with the HICP posting a year-on-year rate of 1.1% in September. Price forecasts for the relevant monetary policy horizon place inflation rates at levels significantly below 2%, in a setting in which the area's growth outlook augurs a very gradual and low-intensity recovery.

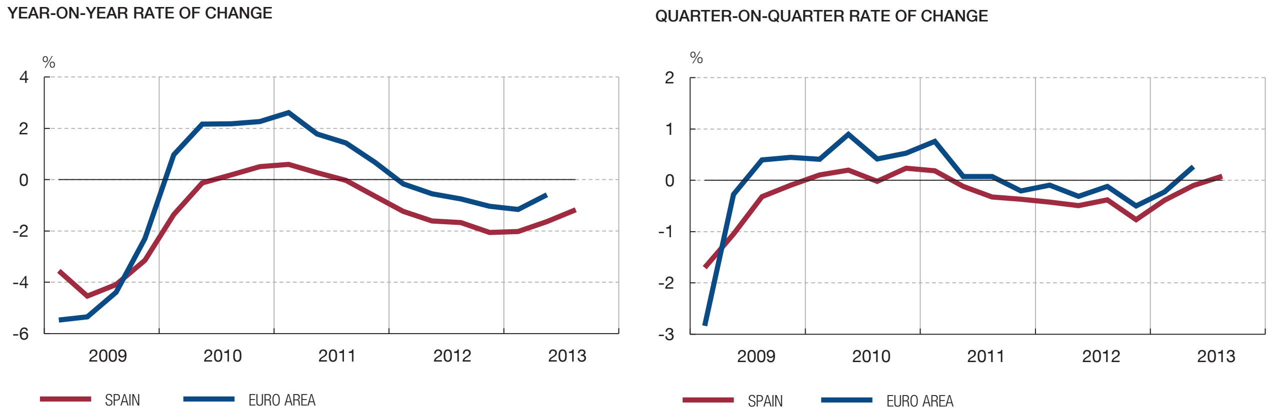
Against this background, the ECB Governing Council decided to prolong the monetary policy expansionary stance, holding official interest rates unchanged at 0.5% for the main refinancing operations, and at 1% and 0% for the marginal lending and deposit facilities, respectively. The Council reiterated its intention to hold official interest rates at their current or at a lower level for a prolonged period of time, following the July decision to pursue forward guidance.

In late September, the European Parliament approved the legislation that will allow the Single Supervisory Mechanism to come on stream in November 2014. The coming months will be decisive for the construction of a Banking Union that strengthens the institutional framework of Monetary Union and helps overcome the current situation of financial fragmentation.

The Spanish financial markets also experienced the improvement seen at European level. This took the form of fresh declines in Spanish government debt yields and in their spreads

GROSS DOMESTIC PRODUCT (a)

CHART 1



SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

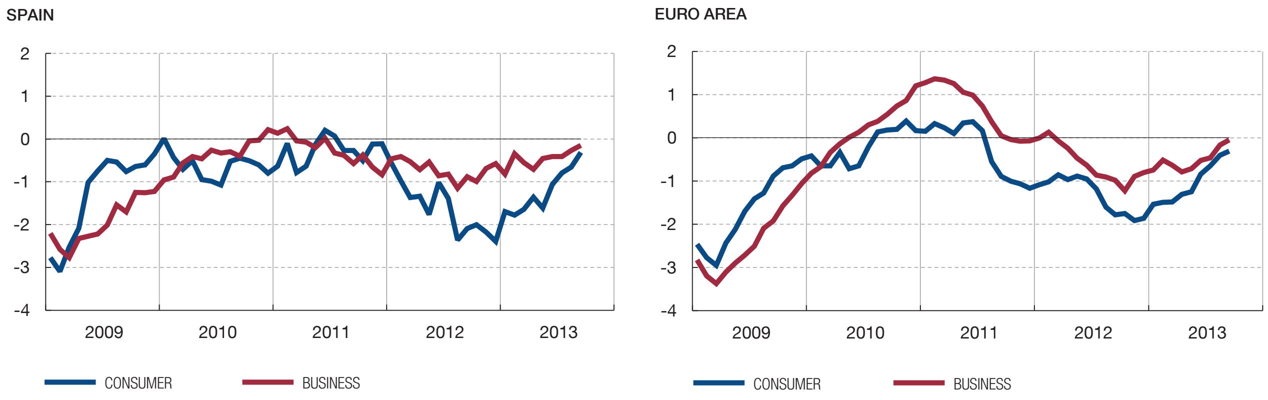
over German bonds: 4.3% in the case of 10-year bonds and 245 bp, respectively, at the cut-off date for this bulletin. Credit risk premia on securities issued by the private sector also fell. There was a reduction in volatility on stock markets and a surge in prices, meaning that the IBEX-35 posted gains of 28.8% from end-June (22.5% in the year to date). The as yet incomplete information on house prices in Q3 points to some easing in their rate of decline. Lastly, continuing progress was made in compliance with the Memorandum of Understanding, which laid down the conditions of the financial assistance programme for the recapitalisation of certain Spanish banks. Fulfilment is at a very advanced stage, as highlighted by the fourth evaluation of the programme.

The pass-through of this improvement in non-financial private-sector financing conditions is, however, proving restricted, as shown by the interest rates on lending granted to households and firms, which scarcely changed during the quarter and remain at very high levels given the expansionary monetary policy stance. In any event, the improved external environment, in step with the recovery of the euro area, and the firming of the confidence indicators in the summer months contributed favourably to sustaining certain expenditure components; in particular, household consumption is estimated to be stabilising progressively and investment in equipment has continued to advance. Conversely, the government components of demand and residential investment are both expected to have fallen, although in the latter case at a more moderate rate than in Q2.

Specifically, a small increase in household consumption is estimated for Q3, against a backdrop in which, in addition to the factors highlighted, the performance of employment was somewhat less contractionary and might have contributed to lessening the pace of decline of disposable income. The notable slowdown in inflation over the summer is estimated to have helped underpin the relative improvement in household purchasing power in real terms. That said, the still-unfavourable labour market outlook and high household debt do not augur an appreciable recovery in consumption in the short run.

Residential investment is expected to have declined at a similar rate to the first half of the year, in a setting in which the demand for housing remained markedly weak, despite the notable rise in property purchases by non-residents. The tightness of financial conditions and the affordability of housing for a standard household continue to weigh considerably on residential investment decisions. On the supply side, the existence of a sizeable stock

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).

of unsold houses is hampering the recovery in new construction. Moreover, the financing extended to households fell at a year-on-year rate of 3.9% in August, somewhat down on the previous quarter (-4,3% in June), interrupting the path followed in the first half of the year. This pattern in the liabilities of households was compatible with a further decline in their debt/gross disposable income ratio.

Business investment, for its part, continued on the improving path seen since the start of the year, underpinned by the incipient recovery in investment in equipment, for which slight growth is estimated for the third quarter running. Headway in confidence and the increase in orders accompanying the firmness of exports are activating this component of domestic spending. The rest of private investment, essentially routed into non-residential construction projects, continued to post negative figures. Lending to non-financial corporations contracted at a similar rate to that in Q2 (-9.5% year-on-year), although some increase was seen in the raising of funds through fixed-income securities issues. The non-financial corporations sector is also estimated to have seen its debt ratio fall.

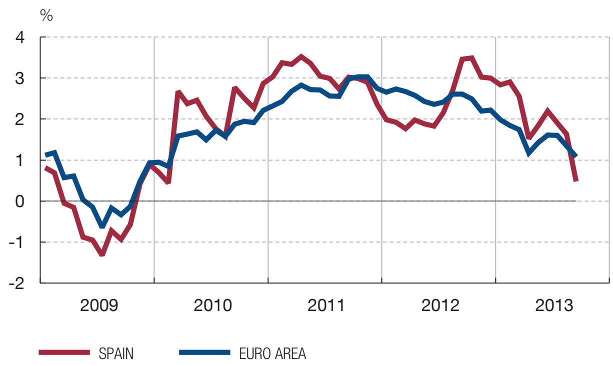
The information on the budget outturn in 2013 Q3 is still limited, but appears to suggest the fiscal consolidation observed in the first half of the year has continued. However, some slowing in the adjustment of certain expenditure items is discernible, as is the case of government consumption and, in particular, employee compensation. Further, the pace of the pick-up in tax revenue is still insufficient to meet the objectives for the year as a whole, although the situation could be redressed if some of the measures adopted last year were to generate an additional contribution in the remaining months of 2013 or if there were an improvement in taxable bases underpinned by more favourable macroeconomic developments. Meeting the deficit target — at 6.5% of GDP — is pivotal to entrenching the improved perception of the Spanish economy and to shoring up agents' and markets' confidence.

On 30 September the government approved the draft State budget for 2014. This sets a deficit target of 5.8% of GDP, in line with the new path of adjustment approved by the July European Summit, which will entail a more contained consolidation drive in terms of the primary structural balance than in previous years. In turn, the public debt objective is set at a ratio of 98.9% of GDP, a figure that is illustrative of the scale of the task ahead. These objectives are to be met in a macroeconomic setting of a gradual recovery in activity.

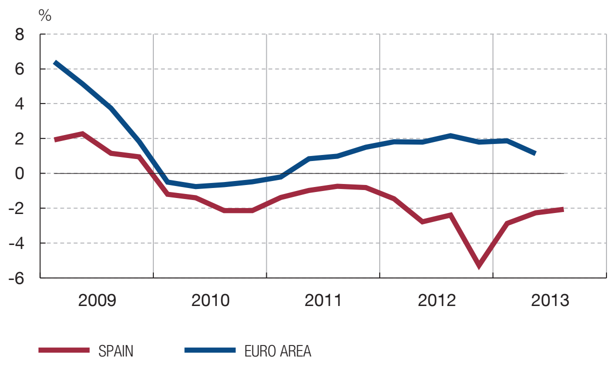
PRICES AND COSTS

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.

In addition, there has been a change in the criterion used for the revaluation of pensions, linked to the application of the indexation formula in accordance with the proposed sustainability factor, whose implementation is needed to move towards securing the medium-term sustainability of the pension system. Elsewhere, the entry into force of the law on the deindexation of the economy in 2014, which will essentially be applied to public prices, will contribute to curbing the inertia of certain public spending items.

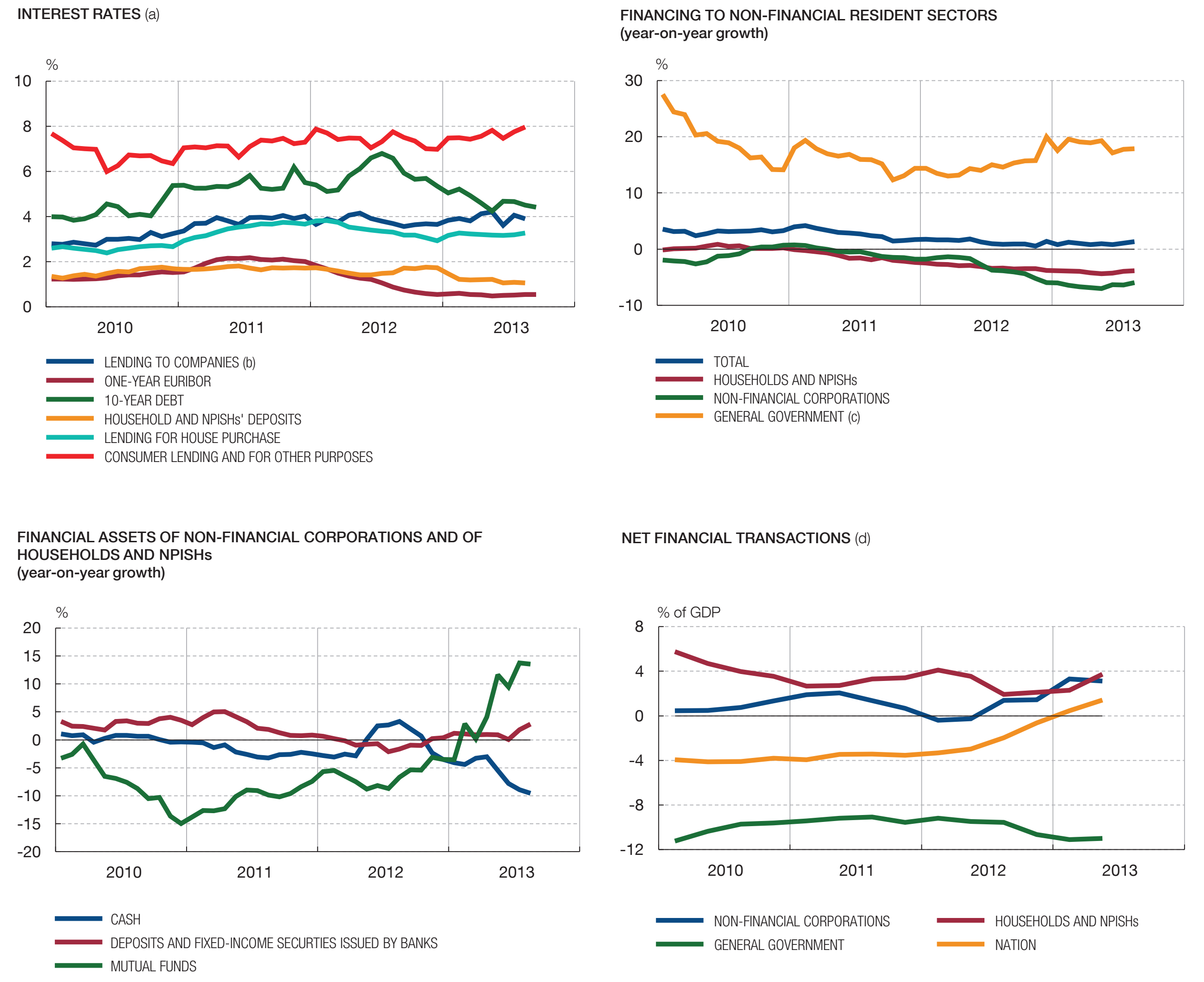
The State budget in question is the first to be drawn up following the entry into force of the recent reform of European budgetary governance. Further to this, and as part of their budgetary procedures, countries must send, sufficiently in advance, the main outlines of their draft general government budgets to the European Commission. Compliance with this requirement involves drawing up a document that encompasses the thrust of the central government and regional government budgets, which marks an important step forward in evaluating the fiscal consolidation strategy as a whole.

As has recently been the case, the foreign trade in goods and services enabled the decline in domestic demand to be offset. Net external demand is estimated to have contributed 0.4 pp to quarter-on-quarter GDP growth, as a result of some easing in exports, following the high figures posted in Q2, and a slight decline in imports. In any event, exports have performed favourably in the year to date, posting average growth of 6.6% in the first seven months of the year, outpacing the rate of expansion of our export markets, and highlighting the decisive role the adjustment in competitiveness is playing as a driver of this demand component. It is also important to stress the sharp recovery in tourism receipts so far in 2013. In turn, both goods and services imports continued to perform very sluggishly, in line with the fall-off in domestic demand. In step with these developments, the correction of the external imbalance continued apace. On the latest balance of payments figures, net lending of €4.5 billion was recorded in the January-July period, compared with net borrowing of €13.7 billion in the same period a year earlier. In cumulated 12-month terms, net lending to July amounted to €13 billion, representing 1.3% of GDP.

On the supply side, the various available indicators for the industrial sector and market services posted progressive improvements during the summer months. In industry, a slight increase in value added is estimated, based on momentum underpinned mainly by the rise

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



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.

in foreign orders and on market services, where the distributive trade and accommodation and food service activities are trending favourably. In turn, the rate of contraction of employment slackened considerably mid-year. On the figures for Social Security registrations, this trajectory was across the board in terms of the different economic sectors, except in agriculture, and was particularly marked in the industrial and construction sectors. In this latter case, however, the declines in employment were still high. Registered unemployment continued on the progressively moderating path seen in recent quarters, and seasonally adjusted month-on-month declines were even posted in August and September.

The labour cost indicators available for Q3 continued to evidence the pattern of wage moderation seen since the beginning of the year. The average increase in wage settlements to September stood at 0.6% (1.1% last year), with somewhat lower increases in newly signed collective bargaining agreements (0.4%). Along with the scant weight the inflation indexation clauses are expected to bring to bear and with the expected sign of wage drift, these developments point to a similar course of compensation per employee over the rest of the year as in the first six months. This trend, which is likely reflecting a greater response by wage-setting to the cyclical situation of the labour market, is vital for helping ensure the incipient recovery in activity passes through forcefully to job creation.

18.10.2013.