

## QUARTERLY REPORT ON THE SPANISH ECONOMY. OVERVIEW

In 2014 Q2, the pick-up in the Spanish economy continued gradually to strengthen, in a setting in which the normalisation of financial conditions and the improvement in employment and in confidence made further headway. On the information available, GDP is estimated to have increased at a quarter-on-quarter rate of 0.5% (compared with 0.4% in Q1). Following four consecutive quarters of quarterly increases in output, the year-on-year rate of change in GDP is expected to stand at 1.1% (0.5% in the previous quarter). According to these estimates, the recovery in activity in the recent period has been somewhat stronger than was foreseen in the *Spanish Economic Projections Report* published by the Banco de España last March. And this, combined with the update of the assumptions, has led the GDP growth rates envisaged for 2014 and 2015 to be revised slightly upwards. As explained in Box 1, the update of these projections points to GDP growth rates of 1.3% in 2014 and 2% in 2015, 0.1 pp and 0.3 pp up on those previously projected.

The private components of domestic expenditure – consumption and business investment, essentially – were the mainstay of GDP in Q2. This prolonged a pattern prevailing since the recovery began in mid-2013, marked by the progressive strengthening of domestic demand, which is estimated to have grown in Q2 at a quarter-on-quarter rate of 0.3%. In turn, the contribution of net external demand turned positive again (0.2 pp) as a result of the pick-up in exports in Q2, following their decline in Q1, and of a turnaround to some extent in imports compared with their course in Q1, although this expenditure component is subject to greater variability from quarter to quarter. From the supply-side standpoint the key feature was the favourable behaviour of employment, with an estimated increase in net terms for the third quarter running, which would entail a return to a positive year-on-year rate of close to 0.4%, for the first time in the last six years. These developments in output and employment are expected to have translated into a further slight decline in the rate of increase in apparent labour productivity (to 0.7% year-on-year), following the high growth recorded since the start of the crisis.

CPI inflation rose slightly at the start of the quarter, influenced by the bigger contribution of the energy component and, to a lesser extent, by the effect of the Easter holiday period (in April this year) on services prices. Stripping out these specific effects, prices showed an increase of virtually zero (0.1%) in June in terms of the overall index, similar to core inflation (0% in May and June), and might temporarily slow further in the summer months. The inflation differential with the euro area remained negative in June (at -0.5 pp), and the situation is expected to hold over the rest of the year.

With the numerous temporary effects influencing the inflation profile since 2012 Q4 having been stripped out, the trend of consumer prices in the recent period confirms that the low-inflation environment is due to more lasting causes. These include most notably the declining trajectory of unit labour costs and the excess capacity in the economy as a whole, added to which is the dampening effect exerted by the relatively high exchange rate of the euro on consumer prices.

Turning to economic policies, in late April the Government submitted to the European Commission the National Reforms Programme and the Updated Stability Programme for the 2013-2017 period, in which it sets the budgetary adjustment path to 2017. According to the latter, the general government deficit target would be set at 5.5% of GDP for this

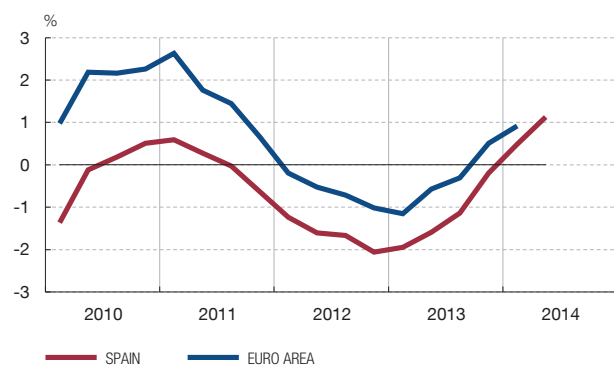
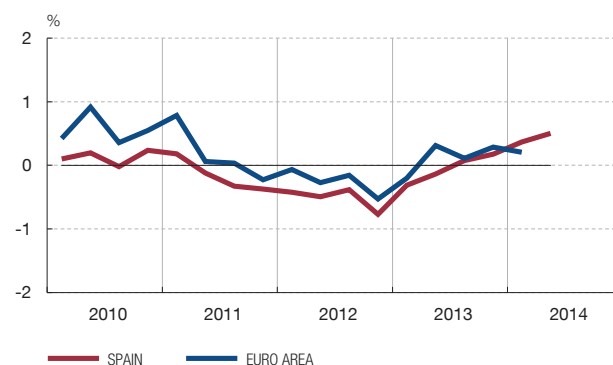
**MAIN SPANISH MACROECONOMIC AGGREGATES (a)**
**TABLE 1**

	2012	2013	2013				2014	
			Q1	Q2	Q3	Q4	Q1	Q2
<b>National Accounts</b>								
Quarter-on-quarter rate of change, unless otherwise indicated								
Gross domestic product	-1.6	-1.2	-0.3	-0.1	0.1	0.2	0.4	0.5
Private consumption	-2.8	-2.1	-0.4	0.1	0.5	0.5	0.4	0.4
Gross capital formation	-6.9	-5.2	-1.3	-2.1	0.5	0.9	-0.6	1.3
Domestic demand	-4.1	-2.7	-0.3	-0.6	0.5	-0.3	1.0	0.3
Exports	2.1	4.9	-4.5	7.0	0.6	0.8	-0.4	1.7
Imports	-5.7	0.4	-4.6	6.1	2.1	-0.6	1.5	1.3
Contribution of net external demand (b)	2.5	1.5	0.0	0.4	-0.5	0.5	-0.6	0.2
Year-on-year rate of change								
GDP	-1.6	-1.2	-1.9	-1.6	-1.1	-0.2	0.5	1.1
Employment	-4.8	-3.4	-4.7	-4.0	-3.3	-1.6	-0.3	0.4
GDP deflator	0.0	0.6	1.2	0.7	0.4	0.2	-0.6	-0.2
Price indicators (year-on-year change in end-of-period data)								
CPI	2.4	1.4	2.4	2.1	0.3	0.3	-0.1	0.1
CPI excl. unprocessed food and energy	1.6	1.4	2.3	2.0	0.8	0.2	0.0	0.0
HICP	2.4	1.5	2.6	2.2	0.5	0.3	-0.2	0.0
HICP: differential with the euro area	-0.1	0.2	0.9	0.6	-0.6	-0.5	-0.7	-0.5

SOURCES: INE and Banco de España.

a Information available to 16 July 2014.

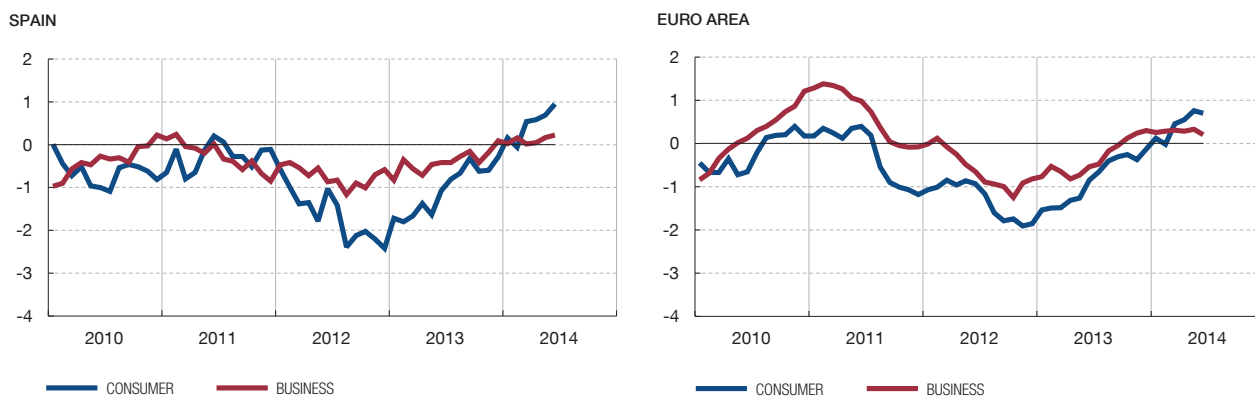
b Contribution to the quarter-on-quarter rate of change of GDP in pp.

**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.

year, 0.3 pp less than that envisaged in the State Budget, and at 4.2%, 2.8% and 1.2% for 2015, 2016 and 2017, respectively. In late June the European Council assessed the economic policy strategy contained in both documents and issued a series of recommendations. Furthermore, in late June the Government unveiled its draft tax reform bills, which essentially affect personal and corporate income tax, and include a progressive reduction in taxation applicable from 2015 to 2016. The Government considers that the reduction in the tax burden will have a cost in terms of revenue of a magnitude similar to



SOURCE: European Commission.

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

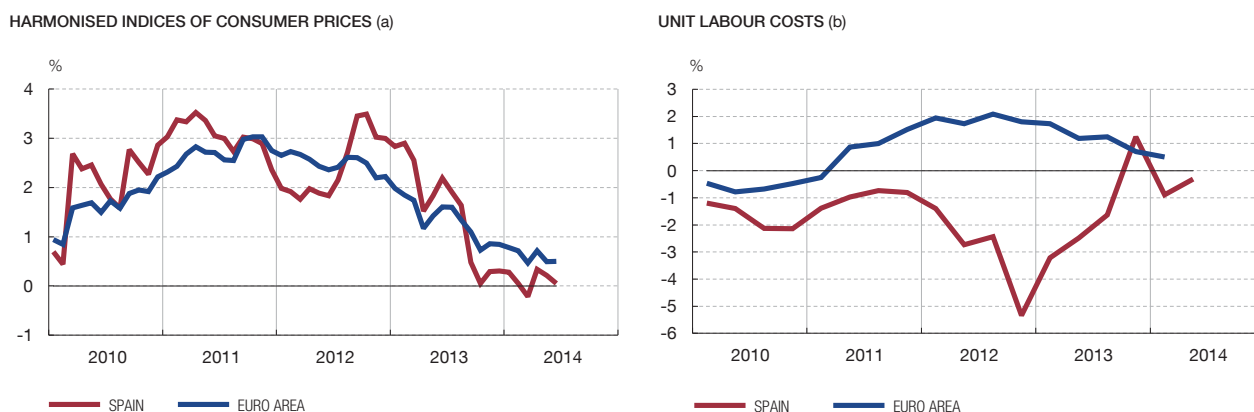
that included in the Stability Programme (around 0.6% of GDP) and an expansionary impact on activity in the coming years that will offset part of the forgone revenue that the lower taxes will entail. Finally, recently in July, a package of economic policy measures was approved, addressing most notably the labour market (national youth guarantee system), the energy market and retail trade.<sup>1</sup>

On the international economic front the recovery continued unevenly in the developed economies, whereas the slowdown in activity in most emerging areas, markedly so in some Latin-American countries, remained ongoing. Inflation generally held at moderate levels against the background of stable commodities prices, despite the odd temporary rise in oil prices. The monetary policies of the main central banks retained a markedly expansionary stance, although the first signs of a change in monetary cycle were seen in the United Kingdom. The situation on financial markets remains favourable, with historically low interest rates, very low volatility levels and across-the-board increases in the main stock market indices.

During the first half of the year the economic recovery in the euro area continued to firm, albeit at a somewhat weaker pace than expected. The increase in output was based on renewed growth in domestic demand that offset the loss of momentum of the external sector (caused by the slowdown in certain emerging economies and by the relatively high exchange rate of the euro). The inflation rate held at very low levels during Q2, standing at a historical low (0.5%) in June. The projections available indicate that the euro area inflation rate will hold, over the foreseeable horizon, at some distance from the 2% reference level which, in the medium term, marks the price stability objective governing ECB conduct.

Against this backdrop, the ECB Governing Council approved in June an extensive package of both conventional and non-conventional measures. These included a reduction in official interest rates to an all-time low of 0.15% for the main refinancing operations, and to a negative level of -0.10% for the deposit facility, for the first time in the history of the Eurosystem. These decisions were accompanied by the new targeted longer-term refinancing operations (TLTROs) programme, aimed explicitly at improving bank lending to

<sup>1</sup> Royal Decree-Law 8/2014 on the approval of urgent measures for growth, competitiveness and efficiency.



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.

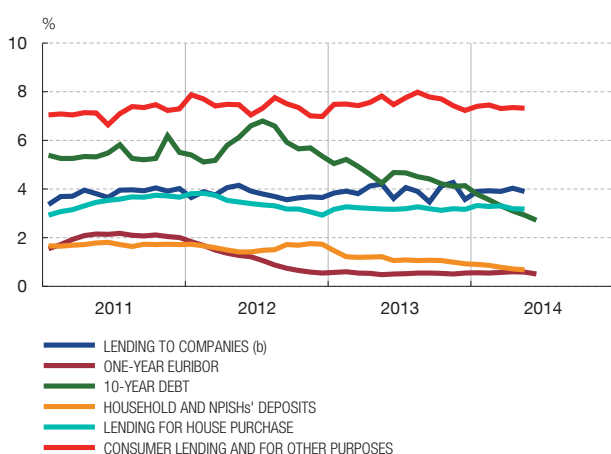
the euro area non-financial private sector. In addition, it was agreed to step up the work currently under way to design a programme for outright purchases of asset-backed securities (ABS). Finally, the Council reiterated its forward guidance strategy, indicating that low interest rates will be in place over a prolonged period, given the prevailing low-inflation outlook, and that the system of fixed rate tender procedures with full allotment will be maintained at least until end-2016.

The monetary policy measures fed through to the interbank markets, where EURIBOR interest rates fell in step with the cut in official rates and contributed to some depreciation of the euro exchange rate, thus correcting its previous upward trajectory, especially against the currencies of the euro area's main trading partners.

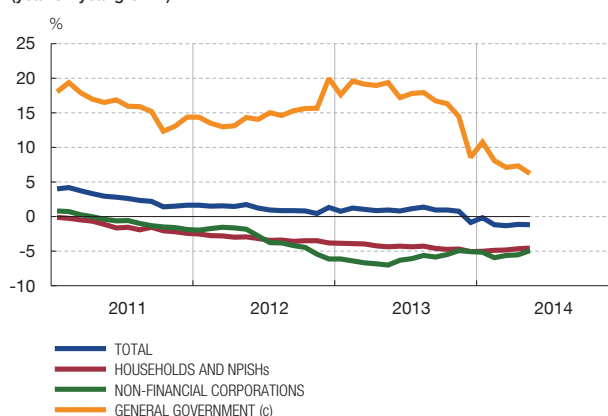
In Spain, financial market conditions continued improving in Q2, underpinned by brighter economic expectations and the effect of the measures adopted by the ECB. There were further cuts in the yields on Spanish public debt and a narrowing in the related spread over the German benchmark (at the cut-off date for this report the risk premium stood at 151 bp, after having risen slightly in recent days). Yields and risk premia on fixed-income securities issued by the private sector also fell. Lastly, stock markets continued on a rising trend, meaning the IBEX-35 has posted gains of 1.3% since end-March (and of 5.6% since the start of the year). Against this background, bank lending interest rates fell slightly, but remain excessively high given the expansionary monetary policy stance.

Both external and financial factors contributed to bolstering the increase in spending by the non-financial private sector in Q2. Household consumption is estimated to have increased by 0.4% quarter-on-quarter, in line with the rate for the previous quarter, and on the back of improved confidence and the recovery in employment. In contrast, other determinants of consumption moved on a somewhat less positive path. In particular, on information to March, the decline in disposable income intensified, meaning that the saving ratio dropped sharply to 9.4% in cumulated four-quarter terms (compared with 10.4% the previous quarter). That is illustrative of the delicate financial situation from which households are addressing their spending decisions in the early stages of the recovery. The rise in household financial wealth perhaps marked a counterpoint to the weakness of disposable income, but it did not prevent the expansion in consumption from having to be

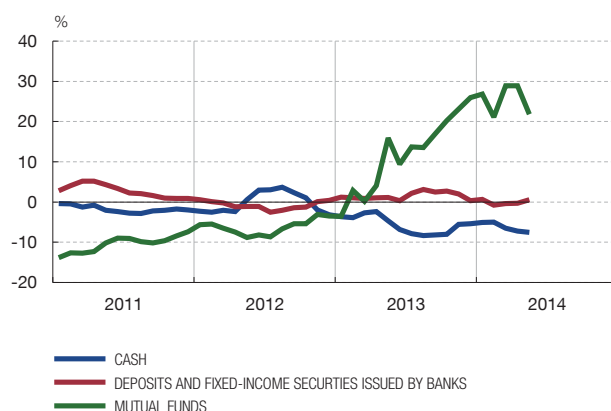
INTEREST RATES (a)



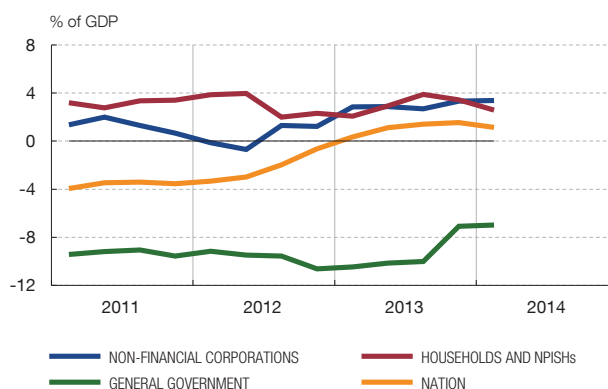
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



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 selected 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. GDP is seasonally adjusted.

made at the expense of the disposal of financial assets, according to information from the financial accounts.

The contractionary profile of residential investment eased in Q2, posting an estimated quarter-on-quarter decline of 0.8% (a similar rate to Q1), in a setting in which the main real estate market indicators began to evidence a significance moderation in the adjustment of the sector. Housing transactions showed a degree of stabilisation, with notable momentum in purchases by foreigners, and the declining trend in the number of mortgages arranged was checked. The number of building permits ceased to move on a declining path, hovering in recent months at values slightly higher than their historical low. However, the absorption of the sizeable stock of unsold houses is advancing but slowly, which is hampering the start of the new construction cycle. Lastly, the pace of the year-on-year decline in house prices eased in 2014 Q1 to -3.8% according to Spanish Ministry of

In the *Spanish economic projections report* published last March<sup>1</sup>, the Banco de España announced its decision to make public the regular update of macroeconomic projections in the successive editions of its *Quarterly Report on the Spanish Economy*. This Box sets out the update of the projections released in March, on the basis of the information available as at 16 July, based on changes in the assumptions used for their preparation (see Table 1) and on economic and financial developments in the past few months.

The results of the update indicate that the performance of the Spanish economy will continue to improve gradually over the projection horizon, with estimated GDP growth of 1.3% and 2% in annual average terms in 2014 and 2015, respectively (see Table 2). It is expected that employment will continue to recover and that in Q4 this year inflation will return to slightly positive rates which will persist up to the end of the projection horizon, albeit at very low levels throughout this period. Compared with the projections published in March, GDP growth has been revised slightly upward in 2014 and 2015 since the recent performance of activity and employment has been stronger than envisaged in March and because of the impact of the tax reform announced on 20 June, against a background of continuing normalisation of financial market conditions and of diminishing aggregate uncertainty.

The external assumptions underlying the projections indicate a sustained progressive recovery in Spanish export market growth,

associated with the envisaged expansionary pace of activity in the developed economies as a whole. The assumptions as to the exchange rate have scarcely changed since March, while oil prices have been revised slightly upwards in line with the futures markets. Three-month EURIBOR interest rates have followed a slightly moderating path after the official interest rate cut last June, and ten-year public debt yields, according to the expectations implicit in the yield curve, show a significant decrease in 2014 to 3.0% and a slight rise in 2015 to 3.2%, having been revised downward with respect to March. Some decrease is projected in the cost of financing extended to households and firms during 2015.

The fiscal policy projections incorporate the fiscal measures already approved and those others that have been announced in sufficient detail. Specifically, they include the estimated impact of the budgetary measures for 2015 specified in the Stability Programme published in April and the estimated preliminary effect of the tax reform unveiled in June, based on the information contained in the draft bills.

The projected path of gradual GDP growth is based on the growing weight of domestic demand, somewhat higher than was expected four months ago, while a smaller positive contribution from net external demand is expected in comparison with what was then envisaged. The upward course of domestic demand appears to be driven by the gradual improvement in confidence, the favourable behaviour of employment, the easing of aggregate financial conditions and the impact of the tax reform. In particular, household consumption is expected to grow at a rate somewhat above 1.5% in both 2014 and 2015, in a setting of labour market improvement and recovery in

<sup>1</sup> <http://www.bde.es/ff/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/14/Mar/Files/be1403e-project.pdf>

## 1 INTERNATIONAL ENVIRONMENT AND MONETARY AND FINANCIAL CONDITIONS (a)

Annual rates of change, unless otherwise indicated

	2013	Current projection		March 2014 projection	
		2014	2015	2014	2015
<b>International environment</b>					
World output	2.9	3.2	3.8	3.6	3.7
Global markets	2.7	4.8	6.0	4.6	5.8
Spain's export markets	2.0	3.8	5.1	3.8	5.0
Oil price (in USD)	108.8	110.8	109.2	107.2	103.1
Competitors' export prices in euro	-2.1	-1.2	1.4	-1.2	1.1
<b>Monetary and financial conditions</b>					
Dollar/euro exchange rate (USD per euro)	1.33	1.37	1.36	1.38	1.38
Short-term interest rate (3-month EURIBOR)	0.2	0.2	0.2	0.3	0.4
Long-term interest rate (10-year bond yield)	4.6	3.0	3.2	3.6	4.0

SOURCES: ECB and Banco de España.  
Latest QNA data: 2014 Q1.

a Projections cut-off date: 16.7.2014.

household disposable income. Meanwhile, private productive investment is projected to strengthen further, sustained by the buoyancy of the export sector, the increase in domestic demand and the higher numbers of firms needing to replace a part of their productive capital. In the external sector, the gradual recovery in Spanish export markets and the materialisation of additional gains in competitiveness are expected to be conducive to the demand for exports. That said, the expansion of exports will be somewhat smaller than envisaged in March, given the weak outlook for some emerging markets. Thus the external balance will remain positive over the next two years, albeit at levels below those projected in March. Specifically, the net lending of the economy will stand at 1.3% of GDP in 2014 and 1.6% in 2015.

In the labour market, the recovering trend in employment in recent months is expected to strengthen, underpinned by continuing wage moderation and greater labour market flexibility. Higher employment and the decrease in the labour force should lead to further reductions in the unemployment rate.

Inflation, as measured by the CPI, will remain very low throughout the projection horizon, basically reflecting the sizeable slack in the economy and moderate wage cost growth. However, the progressive recovery in consumption and the slower fall-off in unit labour costs will give rise to very modest rises in inflation from Q4 this year.

Following the slight upward revision in GDP growth, the risk of economic activity diverging from that projected under the

baseline scenario remains skewed moderately downwards, mainly in 2015. On the external front, foreign markets may perform more unfavourably than projected, given the scenario of fragile growth of the euro area and the uncertainty as to the slowdown of the emerging countries. In the domestic arena, meeting the budget targets may require a larger degree of budgetary consolidation in 2015 than projected. Moreover, there persists a certain vulnerability to possible domestic or foreign events disrupting the baseline scenario of continuing normalisation of financial conditions. In contrast, the favourable impact exerted by the ECB's latest measures to improve the transmission of monetary policy stimuli and by the completion of the comprehensive assessment of SSM-supervised institutions in the coming months may be greater than estimated. At the same time, as a result of the structural reforms adopted, particularly in the labour market, activity and employment may be more expansionary than projected.

The risks of deviations from the inflation projections are skewed somewhat downward, basically as a result of the persistent considerable slack in factor utilisation and of a relatively high euro exchange rate, although these risks have tended to become more balanced in recent months. Further, additional oil price rises, associated with an escalation of geopolitical tensions in the Middle East or in Eastern Europe, and/or tax measures entailing higher environmentally related indirect taxation, may give rise to bigger movements in prices than envisaged in these projections.

## 2 PROJECTION OF THE MAIN MACROECONOMIC AGGREGATES OF THE SPANISH ECONOMY (a)

Annual rate of change in volume terms and % of GDP

	2013	Current projection		March 2014 projection	
		2014	2015	2014	2015
GDP	-1.2	1.3	2.0	1.2	1.7
Private consumption	-2.1	1.6	1.6	1.1	1.2
Government consumption	-2.3	-0.8	-1.5	-1.5	-2.5
Gross fixed capital formation	-5.1	1.8	4.2	0.0	4.2
<i>Investment in capital goods and intangible capital</i>	2.2	8.7	7.7	6.3	7.5
<i>Investment in construction</i>	-9.6	-3.2	1.7	-4.4	1.7
Exports of goods and services	4.9	4.6	5.9	5.1	6.1
Imports of goods and services	0.4	4.7	4.5	3.0	4.4
National demand (contribution to growth)	-2.7	1.2	1.4	0.3	0.9
Net external demand (contribution to growth)	1.5	0.1	0.6	0.8	0.7
Consumer price index (CPI) (b)	1.4	0.1	0.7	0.1	0.7
Employment (full-time equivalent jobs)	-3.4	0.4	1.4	0.4	0.9
National economy's net lending (+)/net borrowing (-) (% of GDP)	1.5	1.3	1.6	2.1	2.5

SOURCES: Banco de España and INE.  
Latest QNA data: 2014 Q1.

a Projections cut-off date: 16.7.2014.

b CPI projections were not published in the Spanish Economic Projections Report of March 2014 (the private consumption deflator was published instead).

Development figures, placing the cumulative loss in the value of this asset since early 2008 at 31%, in nominal terms. This behaviour at the aggregate level was, however, compatible with price increases in certain regions.

As a result of the developments in household saving and investment, households' net lending moved once more onto a declining course in Q1, following the pause observed in 2013, to stand at 1.9% of GDP in cumulated four-quarter terms. The pace of the contraction in financing extended to households slackened slightly in Q2, posting a year-on-year rate of change of -4.6% in May (-4.8% in March).

In the corporate arena, productive investment is expected to have risen in Q2, as the sustained recovery in investment in capital goods discernible since 2013 Q1 has been accompanied by the more favourable behaviour of investment in non-residential construction, following its fall the previous quarter. Overall, the improvement in the business climate, along with the favourable trend in foreign orders and the recovery in domestic demand, accounts for this acceleration in business expenditure. According to the non-financial accounts of the institutional sectors for Q1, the increase in investment was accompanied by a break in the rising course of non-financial corporations' saving, leading to a slight reduction in their net lending, which stood at 4% of GDP in cumulated four-quarter terms, 0.3 pp down on end-2013. On information updated to May, the pace of the decline in total funds obtained by non-financial corporations lessened by 0.6 pp compared with March to a rate of 5%.

General government conduct in Q2 was marked by the budgetary commitments undertaken, which entail placing the overall general government deficit at 5.5% of GDP at end-2014, representing a reduction in the budget deficit of 1.1% of GDP compared with 2013. In this respect, the partial information for Q2 (to April) indicates that the State and regional governments (excluding local government) posted a deficit of 1.2% of GDP, slightly less than for the same period a year earlier (1.4%). As regards public spending, the path of containment discernible in the opening months of the year can be seen to have continued. On the revenue side, the growth in receipts stabilised as a result of the impact of the measures approved in recent years, which have yet to feed through to a further acceleration in revenue over the rest of the year, and of the gradual improvement in fundamentals, as domestic demand and employment gradually recover.

Turning to foreign trade, net external demand is expected to have contributed positively to the quarter-on-quarter growth of GDP, with a moderate contribution of 0.2 pp. That said, the contribution of this component in upholding spending can be seen to have undergone a continuous loss of weight, somewhat more marked than envisaged. Goods exports are expected to have resumed growth in Q2, although their momentum continues to be affected by the relative sluggishness of some foreign markets, while imports are estimated to have slowed, despite remaining notably robust, driven by the sustained growth of investment and, more recently, by the pick-up in household spending. In step with these developments, the balance of payments worsened in the first four months of the year since, in cumulated twelve-month terms, net lending stood at 1.1% of GDP, 0.4 pp down on 2013.

From the supply-side standpoint, the dynamism of the sectoral indicators increased over the quarter as a whole, with a certain dichotomy discernible between the qualitative indicators, which signalled a stronger improvement, and the quantitative indicators, whose progress was more moderate. In any event, there is expected to be an increase in value



added in industry, underpinned by the increase in the production of consumer and intermediate goods, and in that of market services where, on sectoral figures, the greater dynamism is apparently in the wholesale and retail trade, in accommodation and food services, and in business services. The negative contribution to GDP of value added in construction is estimated to have diminished to levels of practically zero in terms of the quarter-on-quarter rate.

The information on Social Security registrations indicates that the improvement in employment in the market economy was across the board in terms of the sectors of activity, with the sole exception of agriculture. Registrations in market services were particularly strong, posting a quarter-on-quarter rate of change of 1% in Q2. However, the increase in registrations in industry, which stood at 0.4% in the same period (0.1% in Q1), and the change of sign of the movement in registrations in construction, which at 0.5% showed a positive quarter-on-quarter rate for the first time since 2007, confirm the change in cycle in the labour market. Along these same lines is the intensification of the ongoing reduction in registered unemployment in Q2, with a year-on-year decline of 6.4%.

Lastly, the indicators available on labour costs show that the patterns of wage moderation observed in recent years have been maintained. Thus, the average increase in wage rates to June stood at 0.5%, slightly down on 2013. And this, combined with the supplementary information on other components of labour costs (the impact of indexation clauses for inflation, and wage drift), augurs the continuation of this process over the rest of the year, which is contributing to the job creation observed.

18.07.2014.

