

QUARTERLY REPORT ON THE SPANISH ECONOMY OVERVIEW

Overview

In 2014 Q1, Spanish economic activity continued on a path of gradual recovery in a setting marked by further progress in the normalisation of financial markets and the gradual firming of the improvement in the labour market. On the as-yet incomplete information available, GDP is estimated to have increased by 0.4% quarter-on-quarter (compared with 0.2% in 2013 Q4), which would place the year-on-year rate in positive territory (0.5%) too for the first time following nine consecutive quarters of negative year-on-year rates (see Table 1 and Chart 1).

The quarter-on-quarter rate of national demand increased slightly (0.2%), underpinned by the relatively similar performance of the private-sector components of spending to that of the previous quarter, characterised by increases in private consumption and business investment, and by a further decline in residential investment. In addition, moderate rises in government consumption and in public investment are estimated after their marked decline in the closing months of 2013. In turn, net external demand is expected to have made a positive contribution of 0.2 pp to the quarter-on-quarter growth of GDP, down in any event on that of the final stretch of 2013.

The GDP estimate for 2014 Q1 is consistent with the macroeconomic projections for 2014 and 2015 published by the Banco de España last month, which placed the increase in GDP at rates of 1.2% and 1.7%, respectively.¹ The projections were made on the basis of specific assumptions, including most notably those relating to the envisaged gradual strengthening of Spanish export markets, the further improvement in financial conditions and the continuation of the fiscal consolidation process, according to the measures known at the time the projections were formulated (the fiscal scenario did not therefore include the information that the forthcoming Updated Stability Programme for Spain, to be released on 30 April, may contain). The report considered that the risks of GDP slippage relative to these projections were skewed to the downside, albeit moderately, and were linked to the possibility of the emerging economies slowing more markedly or, on the domestic front, to a greater fiscal adjustment in 2015. Conversely, the possibility was envisaged that the estimated favourable impact of the measures geared to entrenching the normalisation of euro area financial markets was excessively cautious, or that the structural reforms undertaken might boost activity and employment above expectations.

The inflation rate continued in the opening months of 2014 on the moderating path on which it embarked in early 2013, with the CPI posting a zero rate of change for the quarter on average (-0.1% in March) and core inflation a rate of only 0.1%. These figures are the outcome of a combination of various factors of differing nature and durability, but whose coincidence in time is causing a prolonged period of low inflation (see Box 1). Firstly, the stripping out of the base effects prompted by the rise in indirect taxes and regulated prices in the second half of 2012 is influencing the year-on-year rates of change of the CPI in the opening months of 2014. Adding to this is the impact of other likewise temporary determinants, such as those associated with energy prices or linked to Easter falling later (in April this year as opposed to March last year), given that this period is usually

¹ See "Spanish economic projections report". *Economic Bulletin*. March 2014.

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

SOURCES: INE and Banco de España.

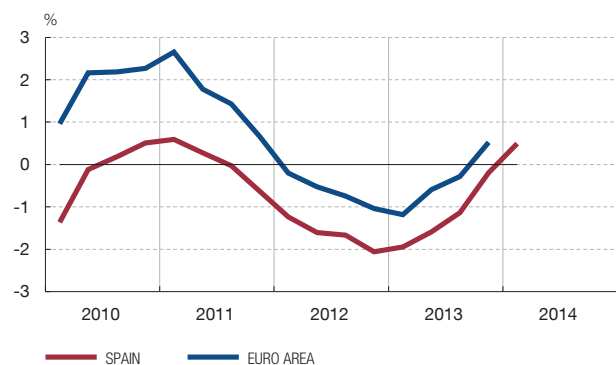
a Information available to 16 April 2014.

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

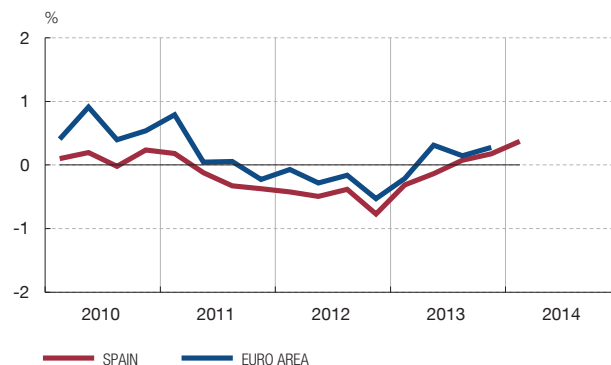
GROSS DOMESTIC PRODUCT (a)

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.

accompanied by a temporary rise in certain prices. Lastly, the low-inflation setting is being driven by surplus capacity in the economy as a whole, the declining course of ULCs and relatively sluggish spending. The easing in the growth rate of the HICP is expected to have been slightly greater in Spain than in the euro area, meaning that the differential remains favourable for Spain, having widened by 0.2 pp to -0.7 pp.

Recent price developments are in line with the projections for the inflation rate made in the report published in March for the two years spanning 2014 and 2015, and which projected

Since end-2012, inflation in Spain – which is approximated by the year-on-year growth rate of the consumer price index (CPI) – has decelerated sharply (see Panel 1). The overall CPI decreased by 0.1% in March 2014, compared with the rise of 3.5% in October 2012. This was partly due to temporary factors such as those linked to the stripping out of the direct effect on prices of previous fiscal consolidation measures (increase in VAT in September 2012 and rises in regulated prices in the second half of that year) (see Panel 2), but also to other factors like weak demand and the slowdown of unit labour costs.

Focusing on the first group of factors,¹ various estimates put the impact on the CPI of the VAT increase at between 0.7 pp and 0.8 pp in terms of the change in the CPI in October 2012, representing a degree of pass-through of approximately 40% of the total potential impact.² This impact is similar to that estimated following the VAT increase of 2010, but is considerably lower than those corresponding to the rises in this tax introduced in the 1990s (1992 and 1995). The small pass-through reflects the acute weakness of household spending which would have led firms to absorb part of the tax increase in their margins. The biggest effects relate to non-food components and the impact on food prices is very limited.³ It is estimated that the effect on the CPI of the regulated price rises implemented in the second half of 2012 (which affected a wide range of goods and services such as

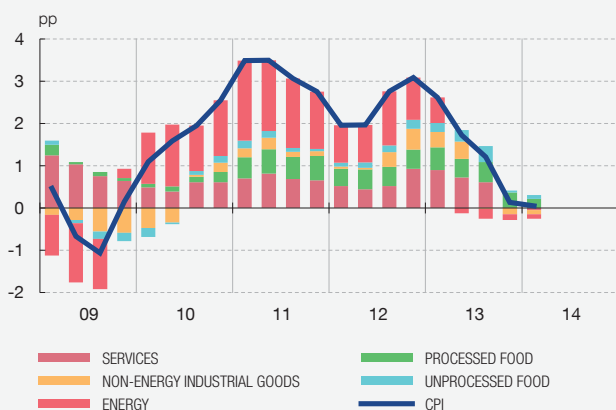
pharmaceutical products, travel fares and university fees) amounted to 1.1 pp of inflation in 2012 Q4.

The change in services price dynamics – clearly seen since 2009 – is particularly notable and more durable in nature. In the boom period, services prices in the Spanish economy had increased by around 4%, were highly sticky and not very sensitive to cyclical conditions. However, in the period of crisis, the contraction of household spending and the decrease in unit labour costs is estimated to have prompted a substantial change in the trajectory of services items, which are particularly labour-intensive. This led to the lowest variation in the time series in March 2014 (–0.3%), although Easter-related effects had some impact on this specific figure.

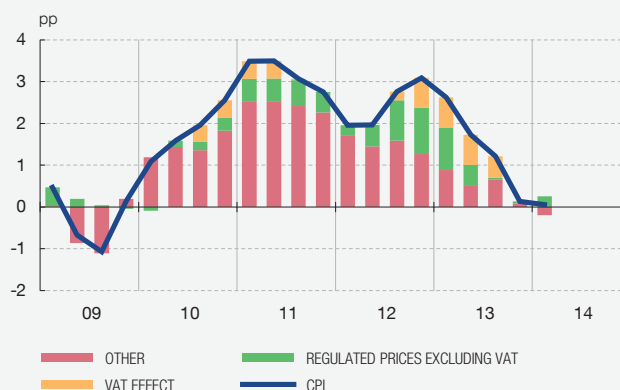
Services price dynamics changed across the board. Panels 3 and 4 depict this, showing the percentage of items accounted for by non-energy industrial goods and services components in terms of the interval of the year-on-year rate of change of each of their items, with the darker colours relating to smaller changes in prices. The percentage of sub-indices with price increases of above 2.5% year-on-year are shown in light blue, whereas the percentage of items with price decreases of more than 1% are shown in dark blue. In 2007 and 2008 practically all the services items increased in price by more than 2.5% per annum and virtually none of them decreased in price. Conversely, in the most recent period, a noticeable percentage of headings posted decreases in price, most notably telephone communications. The growth rate of the prices of other items has declined substantially, such as housing rents and restaurants, bars and cafés. There are almost no headings with noticeable price increases; most such headings relate to the prices of different types of insurance. By contrast, the distribution of the price variations of non-energy industrial goods experienced smaller changes.

- 1 Note that in September 2012 the standard rate of VAT increased by 3 pp to 21% and the reduced rate by 2 pp to 10%, whereas the super-reduced rate held at 4%.
- 2 Based on the information on the consumer price index at constant tax rates, the tax effect using the assumption of a full pass-through of the VAT change would have been 1.96 pp.
- 3 This shows, to a certain degree, that a portion of these goods is subject to the super-reduced VAT rate (which was not changed) and almost all of the other goods are subject to the reduced rate (which only rose by 2 pp).

1 CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF CHANGE IN THE CPI



2 CONTRIBUTIONS TO THE YEAR-ON-YEAR RATE OF CHANGE IN THE CPI



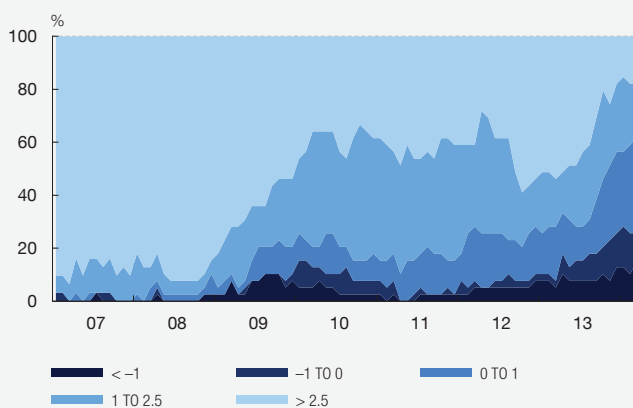
SOURCES: INE and Banco de España.

The different services price dynamics are also seen when compared with the euro area. For instance, in 2013 Q4 the rate of increase in services prices in Spain was 0.6 pp higher than that of the euro area, whereas in the early months of 2014 it was 1.4 pp lower than the euro area as a whole, an unprecedented occurrence since the onset of monetary union. The shift in the distribution of prices of various items towards lower growth is likely to have also been recorded in the euro area as a whole, although less pronounced. Thus, in the most recent period, the prices of a substantial share (69%) of the items in the HICP show lower growth in Spain than those of the euro area.

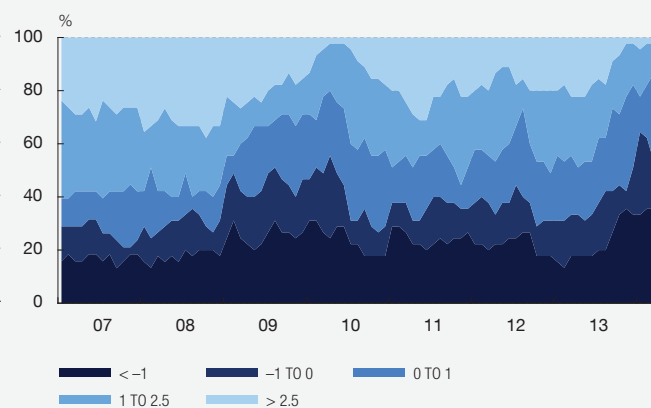
In short, Spanish inflation has eased substantially in the most recent period, although the change in the CPI is considerably higher than that recorded in mid-2009. This trajectory is partly explained by the stripping out of the temporary effects which had driven inflation higher in the past, but also due to more durable factors, especially those linked to changes in services prices. In this setting, very low rates of change in the CPI are expected this year which may even be negative from time to time. Nevertheless, the probability of widespread persistent declines in consumer prices is considered remote and, were it to occur, it would be a euro area-wide phenomenon. In fact, the already-discernible trends of a recovery in household spending and lower labour costs point to a slightly upward path for inflation during 2014.

PROPORTION OF SUB-CLASSES OF CPI WITH YEAR-ON-YEAR RATES BY INTERVAL

3 SERVICES



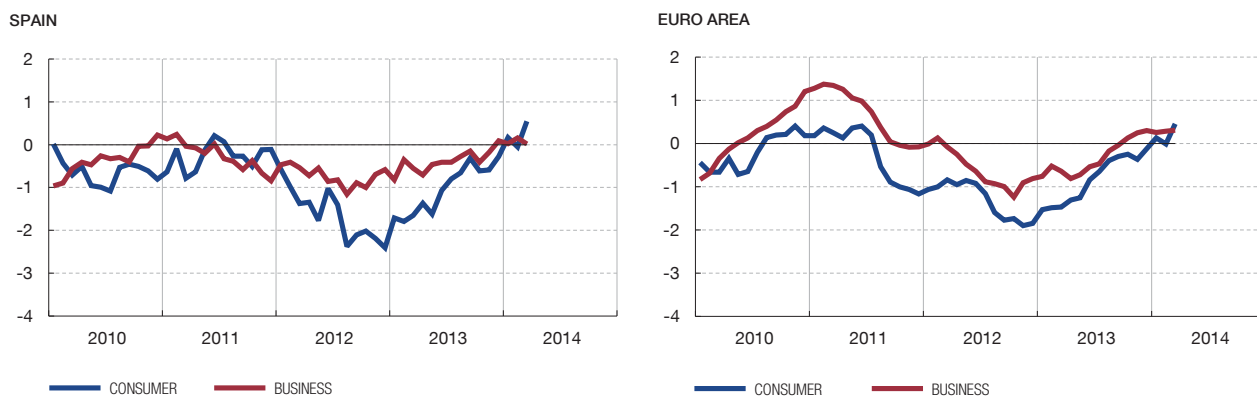
4 NON-ENERGY INDUSTRIAL GOODS



SOURCE: Banco de España.

very modest albeit positive and slightly rising rates of change for the private consumption deflator of 0.4% and 0.8%, respectively, given the contained recovery forecast for domestic demand. The report stipulated that the risks of inflation departing from the baseline scenario were skewed slightly to the downside, and linked to a lesser pass-through of the recovery in expenditure, given the level of slack in the economy, or to the effects on commodities prices and on the euro exchange rate of a more pronounced slowdown in some of the emerging economies. Conversely, an intensification of the fiscal adjustment might prompt rises in administered prices or in indirect taxes that could raise inflation.

Turning to the international economic outlook, the firming of the recovery in the developed economies continued during the opening months of the year, although in some cases bad weather temporarily slowed activity. Inflation rates in this group of countries held at low levels and monetary policies retained an expansionary stance. On the contrary, the emerging economies still showed signs of slowing, albeit to differing degrees, while financing conditions tightened as a result of the response by the monetary authorities to the bouts of volatility on financial markets, the intensity of which abated, in any event, as the quarter unfolded.



SOURCE: European Commission.

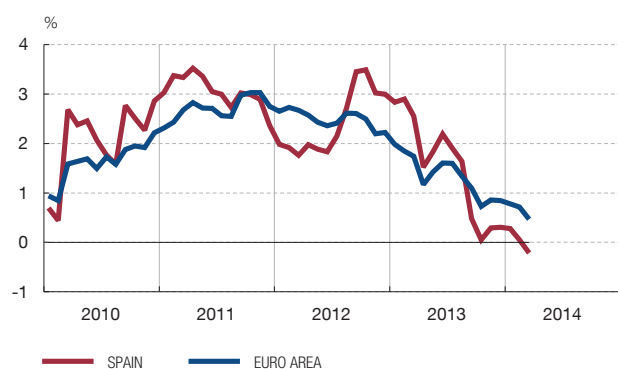
a Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

In the euro area the recovery dating back to 2013 Q2 continued, assisted by the sustained easing in financial tensions and improved consumer and business confidence against the background of an accommodative monetary policy and less restrictive fiscal policies. Inflation in the euro area continued to fall in the opening months of 2014 at a swifter pace than forecast. The year-on-year rate of the HICP stood at 0.5% in March, 0.3 pp down on end-2013. This moderation, affected also by the above-mentioned calendar effects, was due to the slower pace of growth of the prices of the more volatile components, whereby core inflation remained unchanged at 0.9%. In the medium term, inflation is expected to hold over a prolonged period at moderate levels, significantly below 2%. In this context, the Governing Council of the ECB confirmed its forward guidance strategy, reiterating its expectations that official interest rates will hold at current or lower levels for a prolonged period of time. Further, at its April meeting, the Council explicitly indicated that it would not rule out additional monetary stimulus measures and stressed that there was unanimous agreement about the use of unconventional instruments to tackle the risks that might arise from an overly long period of low inflation.

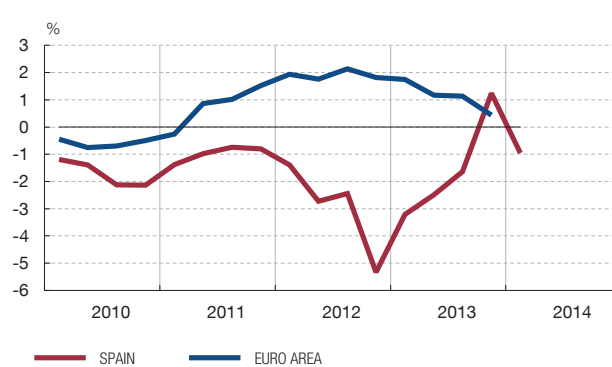
In March an agreement was reached on the design of the Single Resolution Mechanism (SRM), the second pillar of the banking union project. Lastly, under the Macroeconomic Imbalances Procedure, the European Commission (EC) released the results of the in-depth examinations of the countries with potential macroeconomic imbalances, concluding that Italy and Slovenia had excessive imbalances. The EC further considers that Spain has ceased to form part of this latter group of countries, though it stressed that the adjustment process is far from over and that certain macroeconomic imbalances persist (in particular, high public and private debt and the high unemployment rate). The National Reform Programmes to be presented at the end of the month shall specify the measures for further progress in correcting imbalances.

In Spain, the improvement in financial conditions continued apace, in line with the developments observed at the euro area level. Specifically, Spanish government debt yields fell further, to historically low levels, and the related spread over the German benchmark 10-year bond stood as at mid-April below 160 bp. The yields and risk premia on private fixed-income securities likewise fell. There was also a fresh increase in stock market prices, with IBEX 35 gains standing at 3.5% since the start of the year. Access to

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.

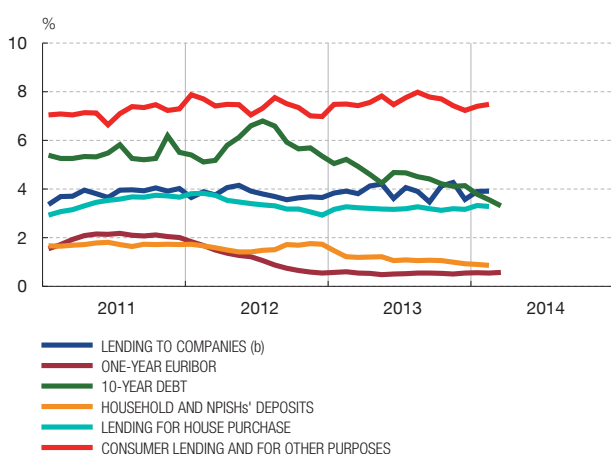
wholesale market funding received a fresh boost, enabling the Treasury to comfortably meet its funding objectives.

Easier conditions on financial markets did not pass through, however, to interest rates on borrowing. These rose slightly in the case of lending to households and remained stable in the case of non-financial corporations, meaning that overall they remained high given the monetary policy stance. Despite this, the strengthening of the external setting and the enhanced climate of confidence were conducive to a somewhat more favourable environment for private-sector consumption and investment decisions.

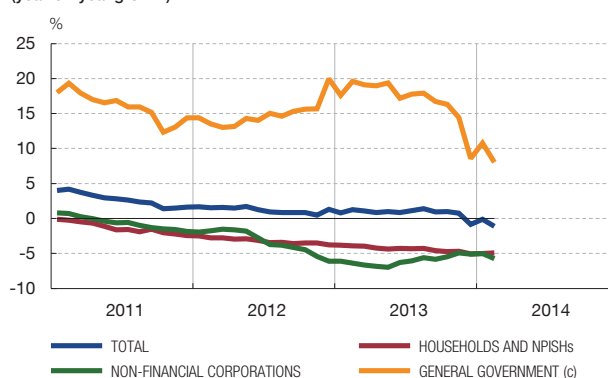
Household consumption spending is expected to have posted quarter-on-quarter growth of 0.3% in Q1, underpinned by the gradual improvement in employment and in its effect on confidence and disposable income. The rate of decline of this latter variable eased progressively over the course of the year, standing at the end of 2013 at -0.7%. According to the above-mentioned projections, household disposable income might increase moderately in 2014. It is estimated that the contractionary path of residential investment continued to slow, in a setting in which the demand for housing remained weak, in line with the trend of its main determinants (disposable income and financing conditions) and despite the momentum of house purchases by foreigners. The absorption of the sizeable housing overhang is moving slowly, which is delaying the start of the new construction cycle in some regions. The household sector is estimated to have reduced its debt and its interest burden in the opening months of the year, although saving not earmarked for debt servicing remains at low levels.

In the corporate sector, spending on investment in capital goods is estimated to have continued growing moderately, prolonging the path of recovery observed since early 2013. The improved business climate along with the favourable trend of foreign orders have continued to boost this demand component. Other private productive investment, which is centred mainly on investment in non-residential construction, is expected to have fallen off compared with the previous quarter. It is estimated that the reduction in the debt of the non-financial corporations sector and in its interest burden continued in the opening months of 2014, although financial pressure remains high.

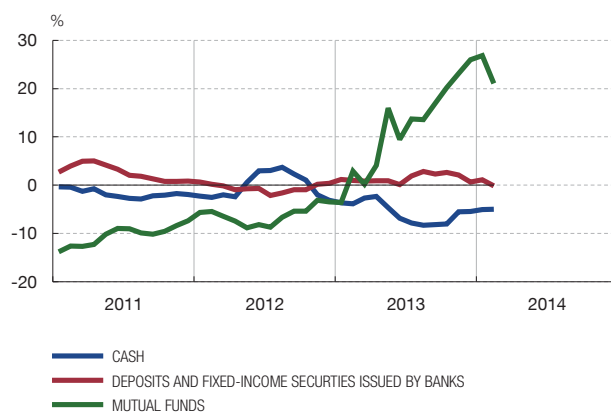
INTEREST RATES (a)



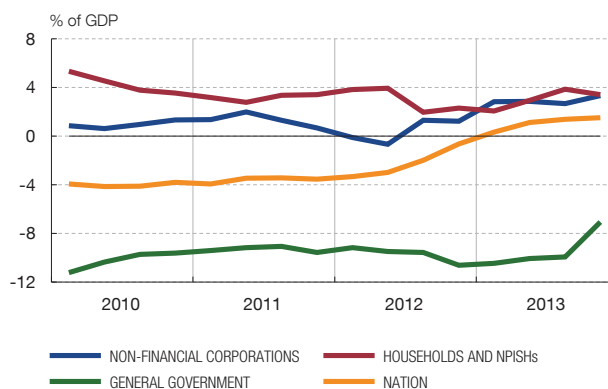
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



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. GDP is seasonally adjusted.

In connection with foreign trade, the information available for the opening months of 2014 suggests that the contribution of net external demand to year-on-year GDP growth may have increased slightly, standing at around 0.6 pp for Q1. This would be the outcome of a more pronounced acceleration in exports (underpinned by the recovery in the euro area economies, gains in competitiveness and the buoyancy of foreign tourism) than in imports (driven by the improvement in industrial activity and the progressive recovery of consumption).

The final figures for the general government account for 2013 were released on 31 March. The sector's net borrowing amounted to 6.6% of GDP (7.1% if the impact of financial assistance is included), slightly above the target set by the European Council last July, which entails a reduction of 0.2 pp of GDP in relation to that observed a year earlier. The fiscal drive has, however, been significant in terms of the reduction in the primary structural

balance. Fulfilment of the fiscal objectives set at the national and European levels is essential for breaking the upward trajectory of public debt, which rose to 93.9% of GDP at end-2013. The information on the budget outturn in 2014 to date is still scant and rather unrepresentative of the trend of the various items over the year as a whole. In any event, it denotes the continuity of the fiscal consolidation process in the different tiers of government.

From the supply-side standpoint, the sectoral indicators available point to a gradual path of recovery in value added in industry and in market services in the second half of 2013, while construction is expected to have continued to contract, albeit at a more moderate rate. In industry, the manufacturing sectors linked to the production of capital and intermediate goods led this rise in activity, while in services the most dynamic activities were in retail and wholesale trade, hotels and restaurants, and transport.

As in the final stretch of 2013, employment continued to improve in the opening months of 2014. Drawing on information on Social Security registrations, employment grew by 0.6% in 2014 Q1 (0.3% the previous quarter). That shaped a relatively widespread recovery across the sectors of activity, but somewhat more intensely so in the market economy (singularly in services). The figures on registered contracts also showed a widespread increase in hires in terms of duration and number of weekly hours, albeit at a brisker pace in terms of temporary and part-time employment. The recent entry into force of a programme of incentives for permanent contracts implemented through a reduction in employers' contributions for common contingencies in respect of new permanent hires² might generate an increase in this type of contract in the coming months.

Overall, the information available appears to augur a further rise in the rate of change of employment in terms of Quarterly National Accounts, for the second quarter running and after more than five years of continuous declines. In step with the aforementioned developments, the pace of decline of registered unemployment intensified in the first three months of the year. That will foreseeably entail a stabilisation of the unemployment rate at around the levels of last quarter and an appreciable decline compared with the level at the start of 2013.³

Lastly, and albeit on relatively preliminary data, the labour cost indicators available for Q1 show that the patterns of wage moderation observed throughout 2013 have been maintained. The average increase in wage rates to March stood at 0.6%, in line with 2013, and the inflation indexation clauses are scarcely exerting any influence given their progressively diminishing relevance in collective bargaining agreements and the low-inflation setting in which the Spanish economy is operating.

16.4.2014.

2 The reduction in contributions will affect permanent hires for which contracts are entered into before the end of the year and which increase the firm's level of employment over two consecutive years.

3 This analysis does not yet include the new EPA series released by INE on 24 April to show the impact of the new population base in accordance with the 2011 Population and Housing censuses.