Outlook for Spain

17 Eurozone countries
The pace of fiscal consolidation is easing and competitiveness improvements mean that Spain is well placed to take advantage of the upturn forecast in global trade next year. We believe this will help the economy to return to positive growth in 2014.

In the near term, the economy continues to face significant headwinds, but these should gradually abate as the year progresses. Activity proved slightly weaker than expected in the early months of 2013 and we are now rather less positive about the outlook for global trade for the rest of this year. As a result, we expect Spanish GDP to shrink by 1.7% in 2013 — slightly weaker than our March 2013 forecast.

Despite yields on Spanish Government debt having fallen to their lowest level in more than two years, domestic credit conditions are likely to remain tight for some time, as the convalescence of the fragile banking sector will not be immediate. Non-performing loans (NPLs) are not expected to peak until after the economy emerges from recession next year.

Against this background, we expect domestic demand to remain very weak. We expect investment spending to fall by 7.1% in 2013 and decline by a further 0.2% in 2014, as corporate profitability remains under pressure.

The pace of decline in consumer spending is also expected to accelerate this year to 2.6%, with a further 0.1% contraction anticipated in 2014. This reflects the continued weakness in the labor market and the sluggish downward adjustment of inflation due to energy prices and hikes in indirect taxation. Moreover, households have little room to adjust their savings further downward to offset the weakness of incomes.

There is also a risk that the recent improvement in financial market conditions could reduce the pressure on politicians to pursue important reforms. Indeed, the reform agenda has slowed markedly this year, which may represent a lost opportunity to boost the economy’s longer-term growth potential.
Gradual shift from austerity to growth expected

Pressure from fiscal cutbacks is easing …
The sustained calm in financial markets, as well as easing austerity-led recommendations from the European Commission (EC), have allowed the Spanish Government to moderate the pace of fiscal correction. After reducing the budget deficit from 9.4% of GDP in 2011 to 7.0% of GDP (excluding one-off bank recapitalization costs) last year, the Government is now targeting only a relatively modest narrowing of the deficit to 6.4% of GDP in 2013. As we had anticipated at the time of our March 2013 report, the plan to cut the deficit to within the EU limit of 3% of GDP has also been pushed back by two years to 2016.

We therefore expect the negative impact on domestic demand from fiscal austerity to ease gradually. Moreover, Spain’s competitiveness improvements mean that it is well-placed to take advantage of the forecast upturn in global trade next year.

We believe this will help the Spanish economy to return to positive growth of 0.2% in 2014, followed by 1.1% in 2015 and 1.7% a year on average in 2016–17.

... but the economy remains in recession this year
In the near term, the economy continues to face significant headwinds, but these should gradually abate as the year progresses. Activity proved slightly weaker than expected in the early months of 2013 and we are now rather less positive on the outlook for global trade for the remainder of this year. As a result, we expect Spanish GDP to shrink by 1.7% in 2013 (a slight downgrade from our March 2013 forecast of a 1.6% fall).

Nevertheless, recent surveys, such as the Purchasing Managers’ Index (PMI), support our view that business conditions will improve in the months ahead. In particular, the manufacturing PMI hit a two-year high in May 2013, with output, new orders and employment all falling at much slower rates. Reports suggested that the slower deterioration in business conditions partly reflected growth in new export orders.

Tight credit conditions hold back recovery …
The difficult operating environment facing companies is being compounded by the continued tightness of lending conditions. Despite yields on Spanish Government debt having fallen to their lowest level in more than two years, domestic credit conditions are likely to remain tight for some time as the banking sector restructures. Although the absorption of around €50b of doubtful loans by SAREB, the “bad bank”, has helped to ease the pressure on banks, NPLs remain on an upward trend.

| Table 1 |
| Spain (annual percentage changes unless specified) | Source: Oxford Economics. |
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
| GDP | -1.4 | -1.7 | 0.2 | 1.1 | 1.4 | 2.0 |
| Private consumption | -2.2 | -2.6 | -0.1 | 1.0 | 1.5 | 2.2 |
| Fixed investment | -9.1 | -7.1 | -0.2 | 2.0 | 2.1 | 2.3 |
| Stockbuilding (% of GDP) | 0.8 | 0.7 | 0.5 | 0.4 | 0.5 | 0.6 |
| Government consumption | -3.7 | -4.1 | -3.3 | -1.0 | -0.3 | 0.7 |
| Exports of goods and services | 3.1 | 3.6 | 4.6 | 4.4 | 3.4 | 3.3 |
| Imports of goods and services | -5.0 | -3.8 | 1.1 | 3.8 | 3.5 | 3.4 |
| Consumer prices | 2.4 | 1.8 | 1.0 | 0.9 | 1.0 | 1.0 |
| Unemployment rate (level) | 25.1 | 27.2 | 27.6 | 27.1 | 26.4 | 25.5 |
| Current account balance (% of GDP) | -1.1 | -0.7 | 0.6 | 0.6 | 0.6 | 0.5 |
| Government budget (% of GDP) | -10.6 | -6.4 | -5.8 | -4.5 | -3.2 | -2.3 |
| Government debt (% of GDP) | 84.2 | 93.2 | 100.2 | 105.1 | 108.2 | 109.5 |
| ECB main refinancing rate (%) | 0.9 | 0.6 | 0.5 | 0.5 | 0.5 | 0.7 |
| Euro effective exchange rate (1995 = 100) | 115.5 | 118.5 | 115.6 | 112.0 | 111.1 | 110.9 |
| Exchange rate ($ per €) | 1.28 | 1.29 | 1.21 | 1.17 | 1.17 | 1.17 |
New provisioning requirements on restructured loans will probably accelerate the pace of increase later this year, although the improved transparency regarding balance sheets will be beneficial for the convalescence of the sector in future years.

With corporate profitability under intense pressure, we expect investment spending to fall sharply again this year by 7.1%, with a further 0.2% decline anticipated in 2014. Investment should finally rebound, with positive growth of 2% in 2015, driven by an upturn in corporate investment amid an improving outlook for profits. But the deep structural adjustment under way in the construction sector means that a significant recovery in residential investment remains unlikely in the near term.

... and further job losses expected this year

In light of the weakness of the domestic economy, it is not surprising that unemployment has continued to climb. The latest data from Eurostat’s quarterly Labour Force Survey indicates that the jobless rate hit 27.2% of the workforce in the first three months of 2013 (although this headline figure likely exaggerates the true extent of unemployment due to the large amount of unregistered employment in Spain). With economic activity forecast to continue to contract during the remainder of this year, we believe that the unemployment rate will reach its peak in early 2014, at 28.5% of the workforce.

As well as high and rising unemployment, household incomes have also been damaged by the sluggishness of the downward adjustment of inflation over the past year. High energy prices and hikes in indirect taxation have prevented inflation from falling faster. Unless there are any new commodity price shocks or additional changes in taxation that affect retail prices this year, inflation rates should subside over the coming months and dip below 1% in the second half of 2014.

This moderation in inflation will offer some respite to households, which have little room to reduce their savings further to offset the weakness of incomes. Indeed, the savings rate fell to 8% of gross disposable income last year, the lowest level since data was first compiled in 1999. Against this background, the pace of contraction in consumer spending is expected to accelerate this year to 2.6%, but spending should broadly stabilize in 2014, with growth of 1% then expected in 2015.
Export sector to drive recovery
With domestic demand likely to remain weak for some time, exports will be the main driver of the economic recovery, helped by the continuing improvements in cost competitiveness. Data from Eurostat shows that the decline in nominal unit labor costs in Spain accelerated toward the end of 2012, with costs down by 5.9% on the year in Q4 2012. This compares with a 1.6% rise over the same period across the Eurozone as a whole.

Spanish exporters are also increasingly diversifying toward emerging market economies to take advantage of the faster growth in demand there. Notwithstanding a slightly weaker outlook for global trade this year than we had assumed in the March 2013 report, we believe these trends will help Spanish exports to expand by 3.6% this year, helping push the current account into surplus for the first time since 1987.

Slower pace of structural reform presents risks
While the improvement in financial market conditions is a positive development, there is also a risk that it could slow the pace of reforms that increase competitiveness. Indeed, the reform agenda has slowed markedly this year, and the EC has warned Spain that progress in delivering some key product and services market reforms has been too slow.

In particular, the EC has been pressing Spain to make further progress in reforming the tax system, especially by implementing changes to consumer tax and by raising taxes on fuel. Long-overdue reform of the public pension system is also required to link the retirement age to gains in life expectancy. And there is still room to scale back excessive bureaucracy, such as offices in the autonomous regions that duplicate work of the central government.

It is vital that the Government presses ahead with the reform agenda that is needed to boost the economy’s longer-term growth potential. Crucially, higher productivity will need to be achieved, together with rising employment, in order to generate sustainable growth in activity. Failure to achieve these goals would not only represent a lost opportunity to improve the economy’s medium-term prospects, but it could also undermine investor confidence and threaten the current period of calm in financial markets.

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