BBVA | RESEARCH

Economic Watch

Spain

Madrid, 6 July 2011
Economic Analysis

Spain Unit

Spain's 2Q11 GDP set to be in line with first-quarter growth

- **Second-quarter data released to date suggest that the Spanish economy still grows at a slow pace**
  If the trends depicted by the indicators released to date persist, QoQ growth in 2Q11 will come in at 0.2% (0.7% YoY, down from 0.8% YoY in 1Q11) which is still not enough to create employment on a seasonally-adjusted basis.

- **Consumption and investment indicators continue to reflect the sluggish recovery of private domestic demand**
  This trend reflects still-weak fundamentals and doesn't change our outlook of a slow recovery in internal demand. The start or end of fiscal incentives and public deficit reduction measures continue to shape the evolution of some sectors.

- **Elsewhere, growth in exports is slowing from relatively high levels**
  For the time being it looks as if the slowdown is being driven by temporary factors and exports are expected to stage a revival in 2H11.

- **Stabilisation of energy prices confirms that the impact of the oil price rally will be limited**
  If second-round effects can be avoided, the run-up in oil prices will continue to have a limited effect on economic activity and inflation, providing some relief for the private sector in 2H11.

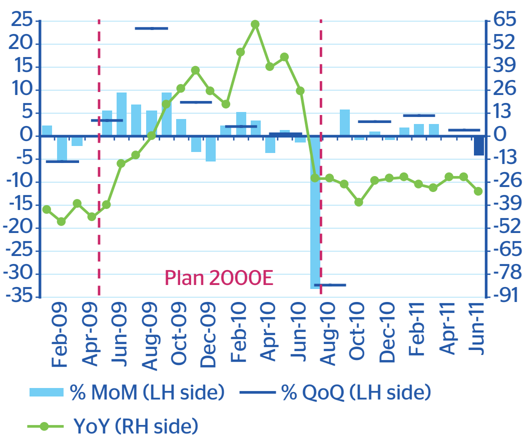
- **The improvement in public revenue will help meet deficit targets only if spending targets are rigorously fulfilled**
  Revenue flowing to the main tax authorities continues to rise, driven by VAT and, to a lesser degree, personal income tax. Despite this improvement, which is in line with forecasts, only a very rigorous and strict fiscal adjustment by way of public spending cuts, particularly at the regional government level, will ensure that the year-end 2011 target is met.

Figures for May and June do not point to a turnaround in household consumption trends

Private consumption indicators still show no signs of improving in June. Correcting gross car registrations for seasonality (typical of the month and calendar effects, our estimates point to a 4.2% MoM decrease in car registrations in June. The downtrend in registrations was driven by weak demand by corporate buyers and rental companies, prompting us to lower our estimate for the whole year to 840,000 units. Meanwhile, real retail sales narrowed by 2.6% SWDA, MoM in May. Sales were led lower by all categories of goods. The decline, greater than our base case estimate, offset the strong reading in April and suggests that retail sales will have once again detracted from growth in household spending in 2Q11.

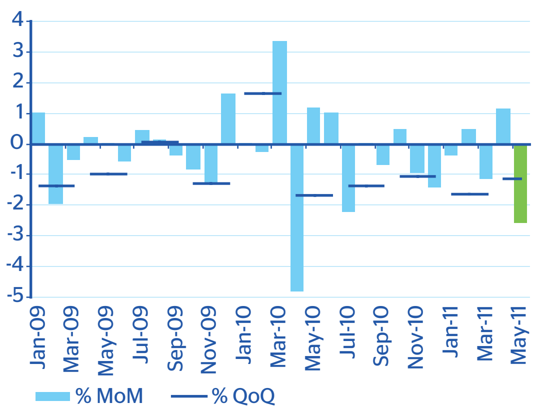
The trend in these spending indicators contrasts with the observed pattern in all of the components of the consumer confidence index which firmed in June. Consumers' outlook for the economic situation in general improved from -11.5 points in May to -6.3 in June. Similarly, expectations for unemployment for the next 12 months and the financial situation registered improvements of 4.3 and 3.3 points, respectively. Meanwhile, the improvement in the outlook for savings was more anecdotal (+1.8 points).

Chart 1
Spain: car registrations (SWDA data)



Source: BBVA Research based on ANFAC and Ganvam data

Chart 2
Spain: retail sales (Constant prices, SWDA data)



Source: BBVA Research based on INE data

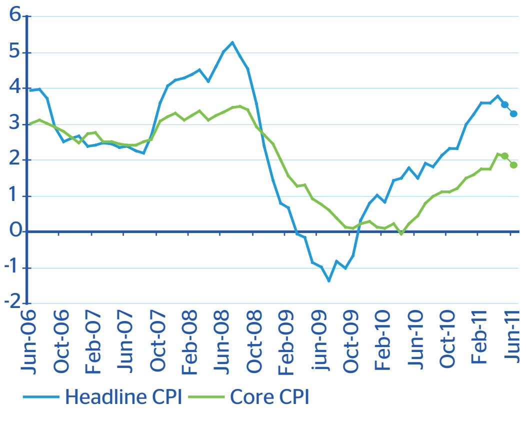
The non-financial first-quarter accounts evidence the negative impact of higher inflation on savings and the delay in consolidation of the public accounts

While households and businesses followed the anticipated trend and continued to generate a funding surplus at the aggregate level, the interruption in the improvement in public administration savings meant that the economy as a whole continued to generate relatively high financing needs, at 4.0% of accumulated GDP in the first quarter. On a trailing twelve month basis, the household funding surplus diminished with respect to the last 2010 indicator as a result of the drop in household savings, which has more to do with the increase in inflation and the erosion of available gross income than any reactivation in private spending. In contrast, businesses increased their funding capacity thanks to growing savings and the ongoing correction in investment. Lastly, the public administrations presented an accumulated annual deficit equivalent to 9.3% of GDP in 1Q11, similar to that observed in 4Q10, thereby putting an end to the improvement etched out in the aggregate annual deficit initiated one year ago. Tightening of the fiscal consolidation process and a fall-back in inflation facilitating a higher savings rate should help to reduce the economy's funding shortfall in 2H11.

Inflation has begun to trend lower, mainly as a result of the moderation in fuel prices

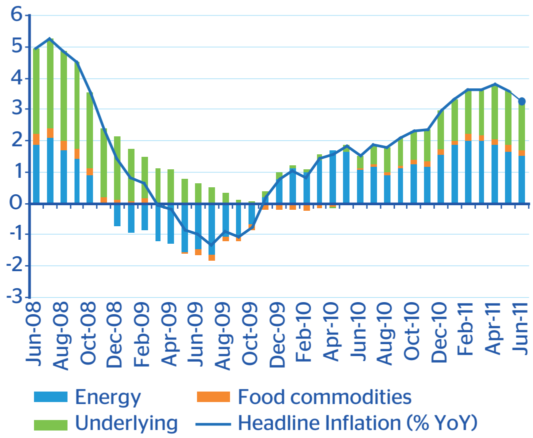
According to the leading indicator of CPI, annual inflation slowed 0.3pp in June to 3.2% YoY, trailing just below our base case estimate (BBVA Research: 3.3% YoY). Annual inflation, measured by the HICP, also slowed 0.4pp to 3.0% YoY. The continued ease-up in fuel prices during recent weeks, coupled with the trends in tobacco, food and non-alcoholic beverage prices, is likely to be behind the slight slide in consumer price growth in June. However, high commodity prices are still to blame for high inflation rates. Pending release of the detailed breakdown, our research suggests that the slowdown witnessed in June was not driven only by the slowdown in energy prices but also by an easing in the core inflation component of around 0.2pp (BBVA Research: 1.9% YoY).

Chart 3
Spain: inflation (YoY change)



Source: BBVA Research based on INE data

Chart 4
Spain: contributions to headline inflation growth

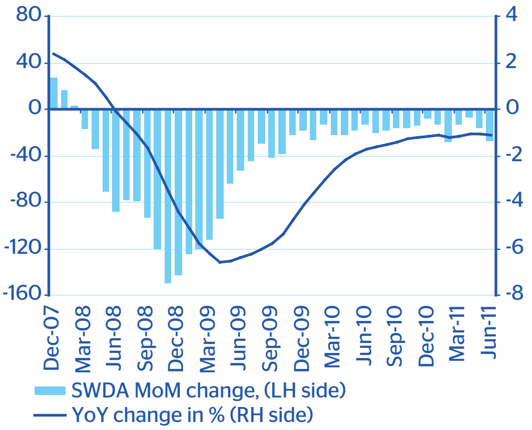


Source: BBVA Research based on INE data

The June figures confirm the weak state of the labour market and the economy's inability to create jobs

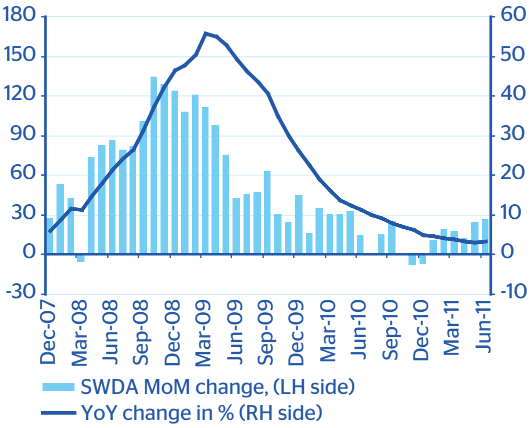
June marked further deterioration in social security affiliations coupled with an increase in registered unemployment on SWDA terms. Specifically, the social security average affiliation lost around 6k contributors on SWDA terms (BBVA: Research: +30k). In general, the trend is one of falling occupancy in all sectors of the economy, with the worse than forecast performances in the services and agriculture sectors to blame for the slight drop in affiliation numbers. As a result, 2Q11 will close with a drop in affiliation in line with that of 1Q11 but a higher increase in unemployment. Thues, the decrease in unemployment registered in June (-67.9k people) was in line with expectations, albeit below our base case estimate (-90.0k). Seasonally-adjusted registered unemployment rose for the sixth consecutive month, this time by around 27k.

Chart 5
Spain: average social security affiliation



Source: BBVA Research based on MTIN data

Chart 6
Spain: registered unemployment



Source: BBVA Research based on SPEE data

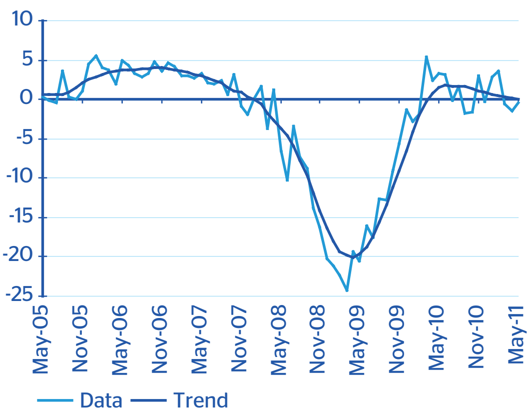
If prevailing trends continue, the slump in residential investment may have accelerated in 2Q11

In April, 5,922 new home construction permits were granted according to public works ministry data. On a seasonally-adjusted basis, permits fell by 2.6% MoM in April. This drop, coupled with the significant correction in the previous month, would put housing starts at an all-time low. This figure, below our base case forecast, confirms the very real possibility that 2Q11 will break with the trend of slow but gradual easing in the pace of deterioration in the housing market.

Industrial production slightly topped our base scenario forecasts in May

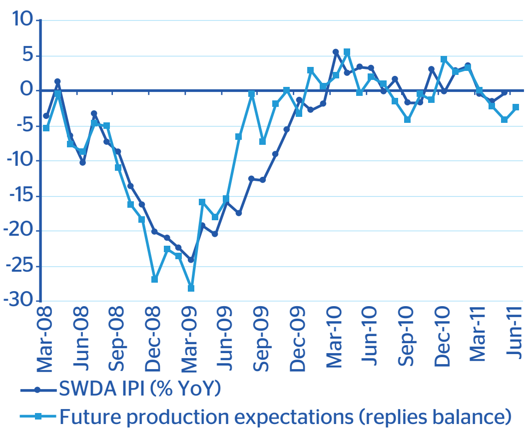
As foreshadowed by the May industrial confidence readings, calendar-adjusted industrial production fell once again in year-on-year terms in May. The bulk of this correction, however, is due to the base effect, spurring growth in 1H10, as well as intrinsic seasonality; correcting for calendar and seasonal effects, industrial production was higher in May (+0.3% MoM SWDA). Moreover, the trend in capital and consumer goods was positive, partially eroded by the trends in intermediate and energy goods, so that the YoY decline was somewhat narrower than our base case scenario forecasts. In short, the overall picture should be read positively. Looking forward, both the indicator tracking expectations for future production (last reading: June) and the export order backlog points to a pause, at least near term, in the year-on-year decline in industrial production.

Chart 7
Spain: calendar adjusted, industrial production index (YoY growth)



Source: BBVA Research based on INE data

Chart 8
Spain: confidence and industrial production



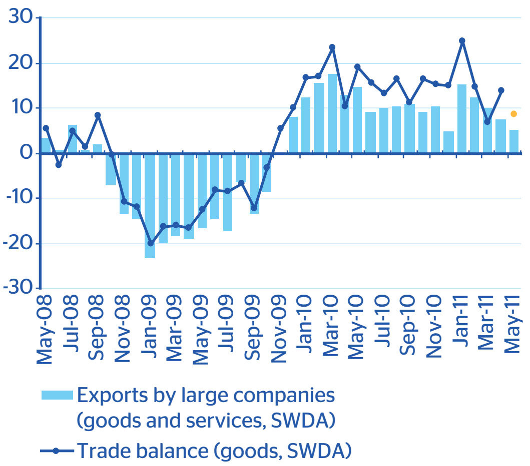
Source: BBVA Research based on INE and European Commission data

Export growth to slow in 2Q11, although confidence indicators suggest a temporary slowdown

The April trade balance figures reveal a reduction in the accumulated 12-month deficit of €1 billion to €51.6 billion, mainly thanks to a stronger performance in the non-energy component. The seasonally and calendar adjusted month-on-month changes in both exports and imports of goods by volume were negative, with a very notable MoM drop in imports of goods across all the major sectors, particularly capital goods. On the export side, exports of consumer goods were the only major sector to register MoM growth. If the pattern witnessed in April proves to have continued, as suggested by the indicators of international and home market sales by large companies in May, QoQ growth in both exports and imports of goods by volume is expected to decline although the contribution by foreign demand to GDP growth would probably remain positive.

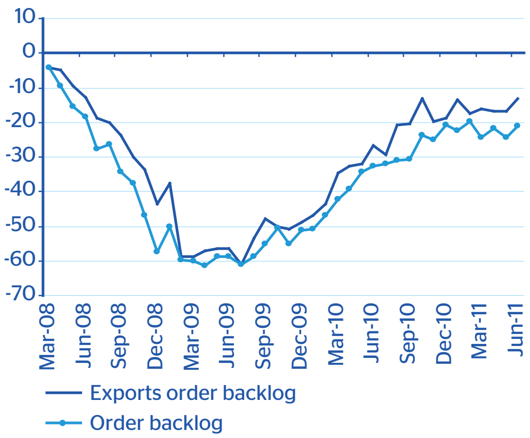
However, the backlog of orders in the industrial sector rose by 3.3 points, all of which growth is attributable to the export backlog (+3.3 points), in turn making a 1.1 point contribution to the improvement in business sentiment in the manufacturing sector. Elsewhere, the June expectation reading with respect to future production breaks with the downslide witnessed in recent months, at -2.4 points (compared to a long-run average of 4.2 points) and contributing 0.6 points to the improvement in manufacturing confidence. It is also worth flagging, once again this month, that although the sector order backlog remains below the long-run average (-21.1 compared to an average of -16.0), the export order backlog is well above the long-run average (-13.0 in June against an average of -24.8), confirming our prognosis of the factors shaping the recovery in Spanish economic activity: strong foreign demand offsetting still-weak home market demand. In short, although a correction in export growth cannot be ruled out, export activity looks set to remain at high levels.

Chart 9
Real exports. YoY rate of change (%)*



* The yellow dot represents the forecast
Source: BBVA Research based on AEAT and MICT data

Chart 10
Spain: industrial sector confidence



Source: BBVA Research based on European Commission data

The improvement in public revenue will help meet deficit targets only if spending targets are rigorously fulfilled

The correction of the state budget deficit is ongoing: the accumulated deficit to May was 1.26% of GDP, 0.5pp narrower year-on-year. The up and running regional financing system reduces the weight of the state in the regional governments as a whole, implying a significant drop in both transfers to the regional administrations and in revenue, the latter due to the increase in the percentage of tax receipts earmarked to them. As a result, state revenue to May shrank 10.3%, dragged down by tax revenue (which represents 85% of the total) which declined 17.8%. Offsetting this is the ongoing correction in non-financial spending which is precisely concentrated in current transfers among public administrations and investment. Thus, investment in capital goods was slashed by 40% to May 2011 while current transfers among administrations fell by 23.2%. Lastly, interest expense was the fasted growing component year-on-year (+24.1%).

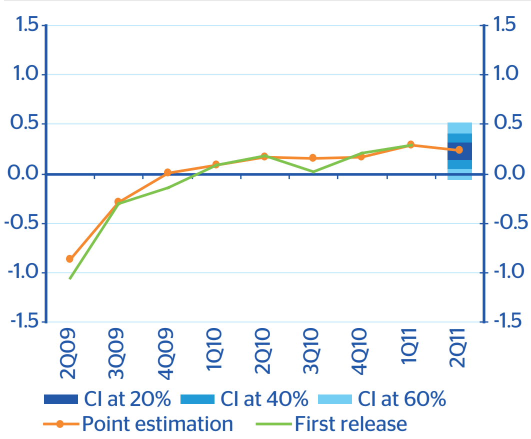
Revenue flowing to the main tax authorities continues to rise in May, driven by VAT and, to a lesser degree, personal income tax. Further analysing tax revenue reveals signs of improvement in the trend in most tax revenue components which, on aggregate, rose 4.3% to May 2011 on a like-for-like basis. This improvement in tax revenue continues to be spearheaded by VAT receipts, which have risen by 12.0% like-for-like, shaped primarily by last year's rate increase. As for other sources of tax revenue, the recovery in personal income tax receipts gathered pace somewhat due to the increase in capital withholdings and lower refunds filed for (in part due to elimination of the 'baby cheque', which has generated €312 million in savings). Revenue from corporate income tax continues to fall (-13.4% on like-for-like terms), driven by the adverse trend in instalments by consolidated groups due to accelerated depreciation regimes and higher provisioning. Lastly, the drop in revenue from special duties has eased thanks to the temporary recovery in cigarette tax revenue, while revenue from duty levied on fuels continues to fall. Despite this improvement, which is in line with forecasts, only a very rigorous and strict fiscal adjustment by way of public spending cuts, particularly at the regional government level, will ensure that the year-end 2011 target is met.

Spain's 2Q11 GDP set to be in line with first-quarter growth

In short, with nearly 90% of the 2Q11 data which we use for our MICA-BBVA model available, our real-time GDP growth forecast for the second quarter is for growth of 0.2% QoQ, in line with our base case scenario estimates (+0.2% QoQ) and the growth registered in 1Q11 (0.3% QoQ).

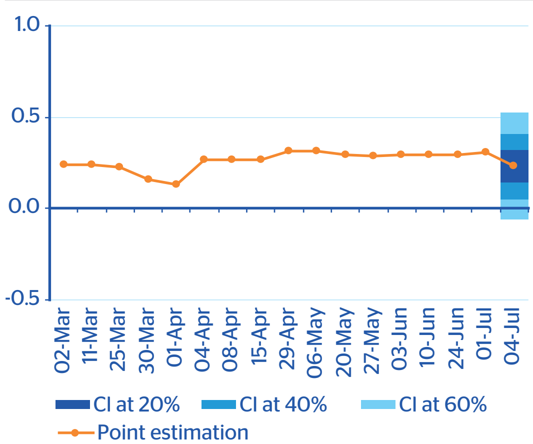
As we noted in May's Spain Economic Outlook[1], economic recovery remains extremely weak, incapable of forestalling job destruction once the quarterly figures have been seasonally adjusted. In any event, growth is consistent with our base case scenario which calls for GDP growth of around 1% for 2011.

Chart 11
Spain: GDP growth readings and forecasts using MICA-BBVA model (% QoQ)



* Current forecast: 4 July 2011
Source: BBVA Research based on INE data

Chart 12
Spain: 2Q11 GDP growth forecasts using the MICA-BBVA model by forecast date (% QoQ)



Source: BBVA Research

1. Available at: http://www.bbvaresearch.com/KETD/fbin/mult/1105_Spaineconomicoutlook_tcm348-256519.pdf?ts=772011

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