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Economic Watch

Spain

Madrid, 11 October 2011
Economic Analysis

Spain Unit

3Q11: stagnation, with risks on the downside

- **Third-quarter data released so far suggest the Spanish economy remained stagnant**
  If the trends shown by the indicators released to date persist, qoq growth in 3Q11 would come in at 0.0%-0.1%, below the pace of preceding quarters. Particularly worrisome is the persistence of job destruction.

- **Consumption and investment indicators continue to reflect the tenuous recovery of private domestic demand**
  This trend reflects still-weak fundamentals that do nothing to change our outlook for a slow recovery in domestic demand. Uncertainty over global growth and heightened financial stress, above all in Europe, could undermine these expectations. Meanwhile, questions surrounding fiscal policy and the budget-deficit reduction process continue to affect the performances of some sectors.

- **Exports continue to contribute to growth, but show a slowdown from relatively high levels**
  Although the slowdown could be short-lived, downside risks have increased due to lower-than-expected growth in developed economies, the drop in consumer and business confidence in these countries and the increase in uncertainty in international financial markets.

- **The pace of public deficit consolidation through the second quarter is not consistent with year-end target**
  Although in the most likely scenario the Central government will meet its target, the budget out-turns of the autonomous communities and the Social Security are making it unlikely that the total public deficit target of 6% of GDP will be met at the end of the year unless additional measures are adopted.

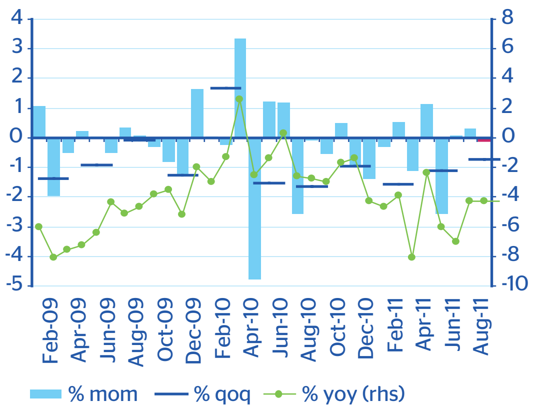
Consumption spending still fails to show any clear improvement

Once seasonally and working day adjusted (SWDA), the fall in real food product sales left retail sales virtually flat in August (+0.1% mom, -4.3% yoy) despite higher demand for durable goods. This figures -in line with consensus estimates- indicates a slowdown in retail sales in 3Q11, leading to a negative contribution to the growth of household consumption, albeit less so than in the first two quarters of the year.

Likewise, demand for cars does not bode well for a good performance in consumption in 3Q11. The figure in September car registrations (2.9% mom, SWDA) was not enough to offset the poor showings in July and August, leaving a cumulative 6.0% qoq decline (SWDA). Lower demand for private vehicles undermined sales last month. Meanwhile, car registrations by corporate buyers and rental companies rose (by 15.6% and 26.6% yoy, respectively), while those of private individuals fell further (by 12.3% yoy). These opposing performances led to a reduction in the contribution by individuals to total car sales to 54.5% in September from 56.6% in August.

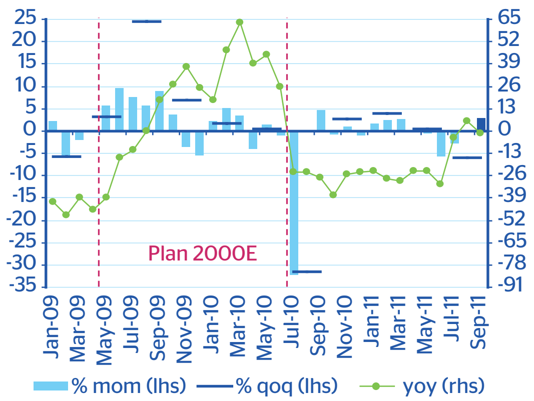
Looking at the consumer confidence index, all components declined in September except for the outlook for savings, which advanced 5.1 points from August. The sharpest decline (2.5 points) was consumer expectations about the employment outlook for the next 12 months, followed by expectations regarding the overall economy and expected financial situation (-1.7 and -0.9 points, respectively). On average, consumer confidence remained stable in 3Q11.

Chart 1
Spain: retail sales (constant prices, SWDA data)*



*SWDA: seasonally and working day adjusted
Source: BBVA Research based on ANFAC and Ganvam data

Chart 2
Spain: car registrations (SWDA data)*



*SWDA: seasonally and working day adjusted.
Source: BBVA Research based on INE data

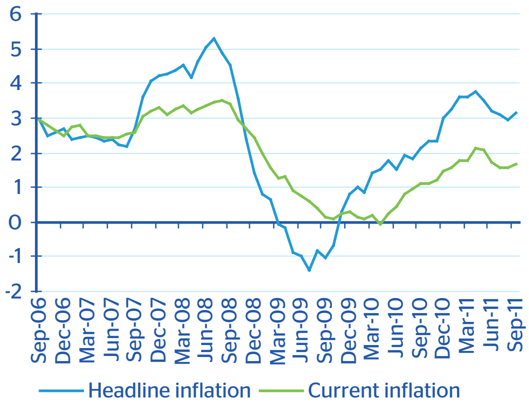
Residential housing investment is not showing any signs of picking up since the upturn seen at the beginning of the year

After three months of small mom growths,of housing sales (SWDA), these retreated by 6.3% mom (SWDA) in August., which remain the number of purchase and sale transactions,low at fewer than 30 thousand a month. On the supply side, construction permits fared well in June (20.1% mom, SWDA) but it couldn't stand and fell in July (-13.1% mom, SWDA). As a result, total permits in 2011 could barely top 80 thousand.

Inflation continues to trend lower, mainly thanks to the moderation in fuel prices

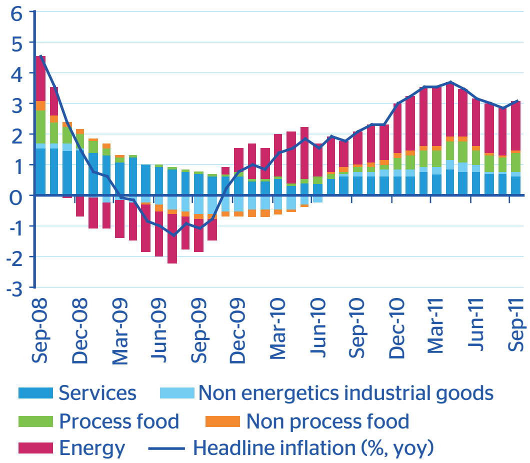
In line with expectations, the headline inflation rate slowed in August (to 3.0% yoy), before increased slightly in September (3.1% yoy). Trends in food and energy prices (downward) and one-off factors (upward) , e.g. tobacco prices, were the main drivers. All other inflation components performed in line with our estimates. As a result, despite lingering uncertainty surrounding commodity prices, August and September readings confirm inflation could ease further over the coming months in a context of extremely weak domestic demand.

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

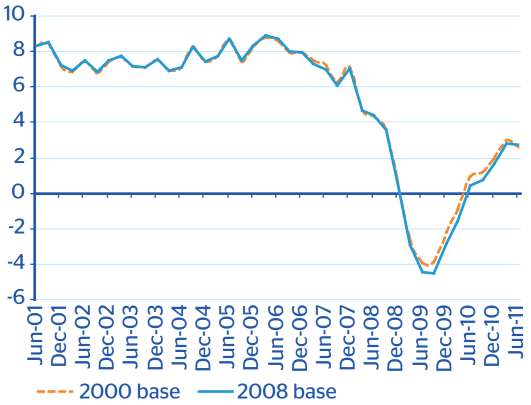
The latest National Accounts estimates indicate that the nominal adjustment in the Spanish economy was greater than suggested by previous data

Nominal GDP contracted by 3.67% in 2009 (2008 base) compared to the previous forecast of 3.15% (2000 base). In 2010, nominal growth was 0.32%, 0.5pp below the last figure released. The impact (direction and size) of this revision to the outlook for growth is still unclear, as we do not know whether the changes affect more intense to volume data or deflators. In any case, 12-month cumulative GDP to the end of 2Q11 was slightly more than 1% lower with the new base year than with the previous one (2000), implying a minor impact on reference ratios.

Spain's financing needs in 2Q11 amounted to 3.5% of 12-month cumulative GDP

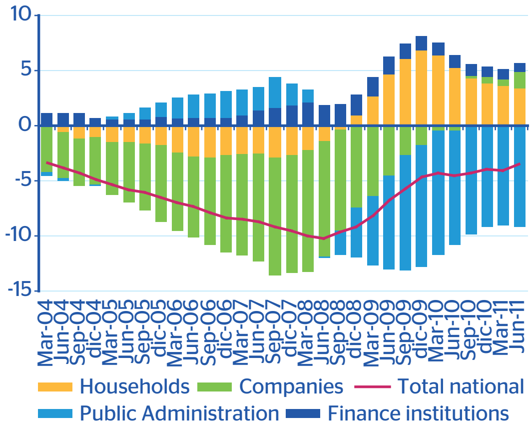
Spain's financing needs in 2011 eased slightly until reach, in 12-month cumulative, 3.5% of GDP, 0.5pp less than at the end of 1Q11. These needs are the result of a national saving rate that held steady at around 18.6% of GDP and an investment rate that fell from 23.1% in 1Q11 to 22.7% in 2Q11. Specifically, the increase of companies' financing capacity was mainly behind the decrease in Spain's overall financing needs. Companies' financing capacity edged up to 1.5% of GDP, in 12-month cumulative due to the continued increase in saving rate (0.7pp to 12.8% of GDP in 2Q11), while investment remained at around 12.7% of GDP. Meanwhile, 12-month cumulative household financing capacity amounted to 5.2% of disposable income at the end of 2Q11, compared to 5.4% in 1Q11. The two-tenths decline was caused by the larger fall in the household saving rate than in investment, to 12.8% and 8.6% of gross disposable income, respectively.

Chart 5
Spain: GDP at current prices (% yoy , gross data)



Source: BBVA Research based on INE data

Chart 6
Spain: Financing capacity (+) / needs (-) by institutional agent (% of GDP. 4Q cumulative)



Source: BBVA Research based on INE data

The new 2008 base has meant a larger revision to household and corporate saving and investment

CNFSI data with the new 2008 base resulted in a lower overall financing needs for Spain, but higher household and corporate saving and investment rates. Household savings fell less than with the previous base due to the larger nominal revision of household consumption than income. Moreover, household investment showed a smaller nominal decline than with the previous methodology. For its part, the corporate investment rate was revised down, while corporate saving was broadly unchanged. In short, the financing capacity of households does not change much, while that of companies improves. In both cases, the implications will depend on how much of the changes are due to fluctuations in prices and how much are due to fluctuations in volume, since only nominal data have been released.

An adjustment intensification in the public administration deficit is unseen yet, with a 12-month cumulative deficit in 2Q11 of 9.2% of GDP

The 0.4pp cutback to public investment from 3.9% of cumulative GDP at the end of 4Q10 was not enough to offset the erosion of public saving in the first half this year, leaving the public administrations financing needs stable at 9.2% of GDP. Specifically, the deficits of the autonomous communities in 2Q11 show that there is still a significant deviation in the pace of consolidation necessary to meet the year-end deficit target (-1.3% of GDP). Although a reduction in expenditure is observed (-3.5% yoy), the 2Q11 deficit was two-tenths of GDP higher than in 2Q10, whereas the year-end target deficit was -2.4% of GDP. Looking forward, the measures adopted by the government to cut pharmaceutical spending should provide some relief. However, after the announcements by several regional governments that they would not meet their year-end targets, unless additional steps are taken it is very likely that the public deficit will end 2011 well above 6% of GDP.

Public debt as a percentage of GDP increased by 5.1pp to 65.2% in 2Q11

The bulk of this increase arises from the central government, whose debt stands at 49.8% of GDP, 3.5pp more than at the end of last year. Both autonomous governments and local corporations have increased debt, by 1.6 and 0.2pp, respectively, to 12.4% and 3.5% of GDP.

Growth in central government debt continues to outstrip the 2.1% of GDP deficit, which could indicate that the government has opted to build up liquidity. Meanwhile, the total debt of the autonomous communities was in line with the 2Q11 deficit (1.2% of GDP).

Debt increased across the board, but the performances among communities was mixed. Catalonia, Valencia, La Rioja, Murcia and Cantabria registered the sharpest increases in debt, well above the cumulative deficit to 2Q11. At the same time, the Canary Islands, Madrid and the Basque Country showed the smallest increases, in line with their registered deficits. As a result, Valencia, Catalonia, Castile-La Mancha and the Balearic Islands still show the highest relative debt levels.

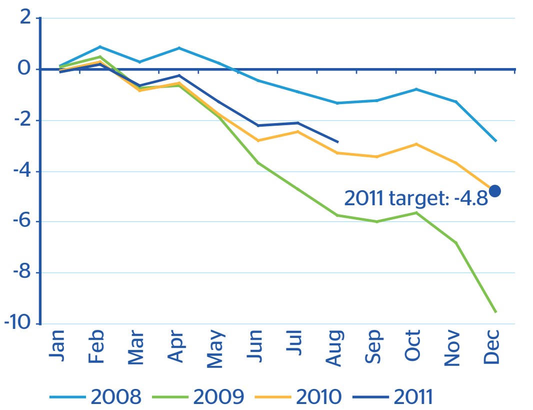
By instrument, loans continue to grow faster than securities issues. However, thanks to issues in the second quarter, Catalonia and Valencia have resorted less to lending.

The pace of consolidation leaves the government on track to meet its year-end target

The cumulative government deficit at 31 August 2011 amounted to 2.8% of GDP, 0.45pp lower than the year-ago figure. The improvement stemmed from adjustments to virtually all expenditure items, above all investment (i.e. nearly 25% reduction from the same period last year) and current transfers between public administrations (decrease of 23.5%), thanks to the drop in transfers to autonomous communities caused by fewer down payments of the financial system. Meanwhile, the decline in per head wages and intermediate consumption eased (-1.6% and -5.9%, respectively).

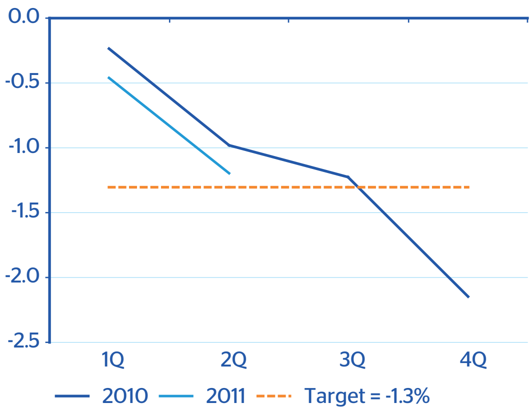
Cumulative revenue was still more than 16% lower in August than the year-ago figure, undermined by the full application of the new common autonomous community financing scheme, which resulted in a sharp fall in tax receipts due to the higher percentage receipts earmarked to them. August data indicate that the deficit reduction is on track, bolstering the chances of the government to meet the -4.8% deficit target for the year, although the smaller growth of revenue means expenditure must be curbed more.

Chart 7
Central government: non-financial balance (12-month cumulative, % of GDP)



Source: BBVA Research based on MEH and INE data

Chart 8
Autonomous communities: not financial balance, % of GDP



Source: BBVA Research based on MEH and INE data

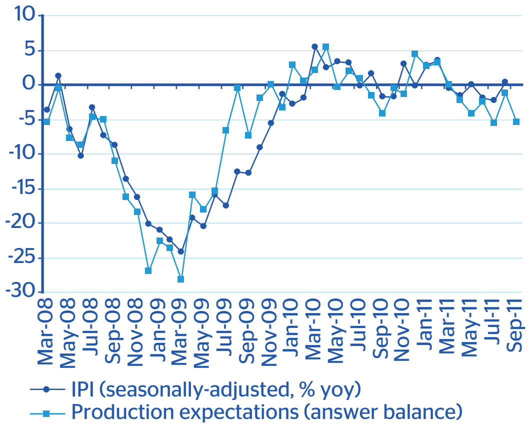
Exports suggest external demand should continue to make a positive contribution to growth

July trade balance figures reveal a substantial reduction in the 12-month cumulative deficit. Particularly, the non-energy deficit declined further, while the energy deficit was virtually stable. Once seasonally-adjusted, exports mom growth rate grew again in July (5.4% mom SWDA), underpinned by sharp growth in both capital goods (9.6% mom SWDA) and intermediate goods (6.1% mom SWDA). At the same time, imports of goods contracted further (-1.8% mom SWDA).

Leading industrial confidence indicators herald further deterioration in activity in the coming months

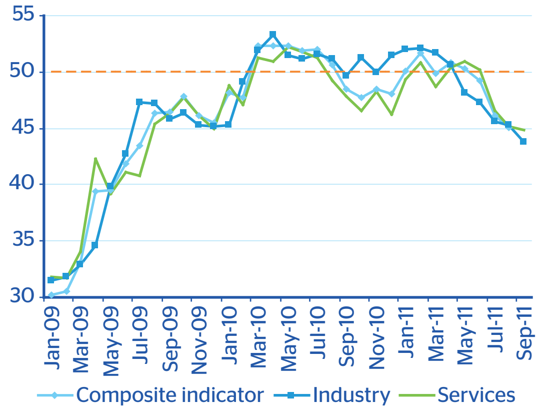
Industrial production rose in August (1.7% mom SWDA) after eroding sharply in previous months. Specifically, production expectations indicator –highly correlated to the yoy growth of the IPI- fell 4.2 points in September. The industrial confidence indicator edged down 2.1 points to -16.0 points, below its long-run average (-9.0 points) but above the exceptional levels seen between August 2008 and January 2010. In the same vein, manufacturing and services PMIs continued to show negative readings in September.

Chart 9
Spain: Industrial confidence and production



Source: BBVA Research based on INE and European Commission data

Chart 10
Spain: PMIs (SWDA data, levels above 50 indicate expansion)

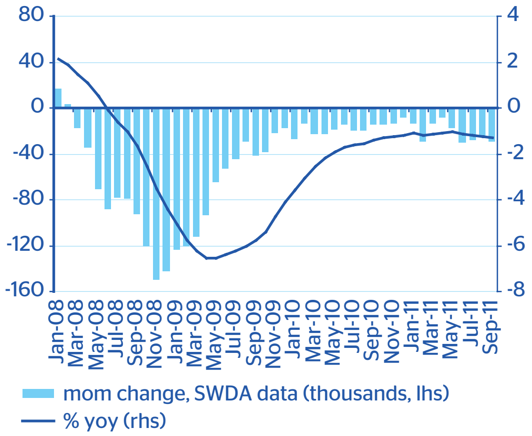


Source: BBVA Research based on Markit Economics data

September data indicate stabilisation in pace of job destruction, which is not positive

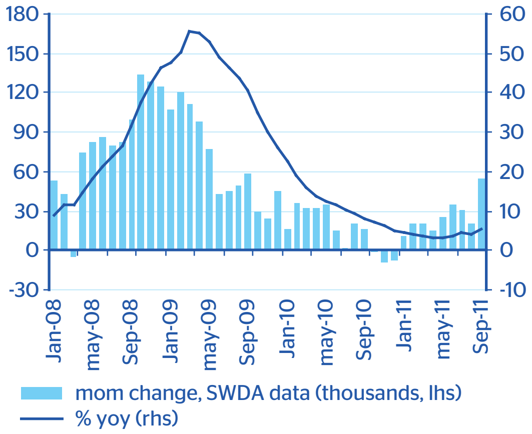
September worsening in the labour market confirms the slowdown in economic growth in 3Q11. Estimates point to 29 thousand job losses and an increment of 54 thousand people in registered unemployment (both seasonally-adjusted). SWDA data indicate poor performances in all non-farm industries: job destruction in the construction sector continued to average around 20 thousand per month, with industry and services unable to raise employment, with a combined contribution of around 10 thousand people to unemployment. For 3Q11 as a whole, social security affiliation fell by -0.5% qoq (SWDA), while unemployment rose 1.7% qoq (SWDA).

Chart 11
Spain: average social security affiliation



Source: BBVA Research based on MTIN (ministry of labour and immigration) data

Chart 12
Spain: registered unemployment

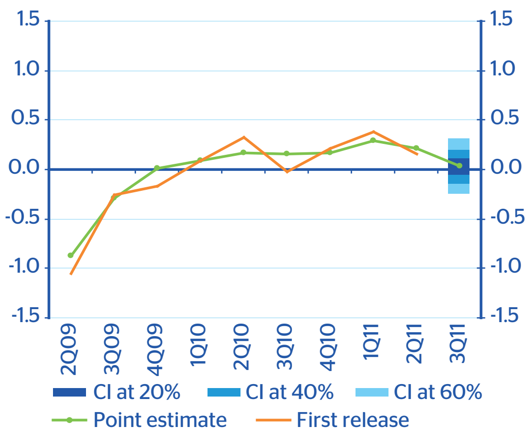


Source: BBVA Research based on SPEE data

GDP growth in 3Q11 less than in 1H11

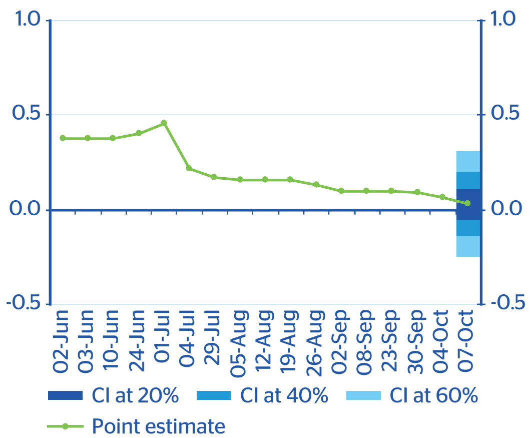
To sum up, with nearly 88% of the 3Q11 data we use for our MICA-BBVA model available, our real-time GDP growth forecast for the third quarter is between 0 and 0.1% qoq, in line with our baseline scenario estimates (+0.1% qoq) and slightly below the growth registered in the two previous quarters. This forecast heightens the possibility of economic contraction in the fourth quarter. As we noted in Spain Economic Outlook: Third quarter 2011 released in early August[1], economic recovery remains extremely weak, incapable of avoid an employment contraction In any event, our growth forecast is consistent with the BBVA Research baseline scenario, which calls for GDP growth of around 0.8% for 2011[2].

Chart 13
Spain: GDP growth observed and forecasts using MICA-BBVA model (% qoq)



Current forecast:7 October 2011
Source: BBVA Research

Chart 14
Spain: 3Q11 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
2: We recall that from November, coinciding with the publication of the full-time employment equivalent (CNTR) report for 3Q11, Spain's National Accounting which change its methodology, adopting 2008 as its new base year. As a result, historical series could undergo material statistical changes that could affect our projections throughout the forecast period.

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