Eurozone

EY Eurozone Forecast

December 2013

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain

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Outlook for Spain

Renewed optimism tempered by unresolved problems

Published in collaboration with

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Highlights

GDP growth

2013 -1.3%

GDP growth

2014 0.7%

- Recovery is finally under way in Spain. The economy emerged from recession in Q3 2013 and the latest indicators suggest that a moderate pace of expansion has been sustained in Q4 2013.
- Renewed growth in Europe is now supporting Spanish exports and the economy is benefiting from more modest fiscal cutbacks. Nevertheless, domestic demand will continue to act as a drag on activity for some time, despite positive spillovers from the foreign sector. As a result, we forecast only a modest 0.7% increase in GDP in 2014, after an expected contraction of 1.3% in 2013, with a gradual acceleration in growth to 2% by 2017.
- The recent uptick in economic activity already appears to have translated to some stability in the labor market. But we do not expect any significant job growth over the coming year and the unemployment rate is forecast to remain well above 20%, even in 2017. In fact, high levels of structural unemployment are likely to be a drag on domestic consumption and the state welfare system for many years to come.
- Fiscal slippage remains a risk, with doubts growing about Spain's ability to meet its deficit target of 6.5% of GDP for 2013. The Government will be hoping that the economic recovery in 2014 helps it to meet its fiscal targets for that year, but the current trajectory leaves public finances highly vulnerable to external shocks and renewed financial market turbulence.
- While public finances need to be put on a sustainable path, the private sector must to address the huge debt burden it accumulated during the pre-crisis period. The protracted dampening effect on activity from deleveraging will therefore keep output below the underlying supply capacity of the economy until the end of the decade. Nevertheless, the process of correcting Spain's imbalances is under way, and recent developments give reason for optimism that the crisis can be overcome.

Consumer prices

2014 0.7%

Unemployment

2014 26.4%

The economy is emerging from recession ...

Recovery is now under way in Spain. The economy finally emerged from recession in Q3 2013 and the latest indicators suggest that a moderate pace of expansion has been sustained in the final quarter of the year. For example, the services component of the Purchasing Managers' Index (PMI) signaled an improvement in activity levels in November, with new business increasing at the fastest pace since mid-2007. On the other hand, the manufacturing component of the PMI slid back into contraction territory, underlining the ongoing fragility of the recovery.

... but momentum is likely to build only gradually

After a contraction of 1.3% in 2013, we forecast only a modest 0.7% rise in GDP in 2014, with growth accelerating gradually to reach 2% by 2017. Although the economy is benefiting from less pronounced fiscal cutbacks, private domestic demand will continue to act as a drag on activity for some time. The export sector is therefore set to remain the main growth engine driving the recovery.

Renewed growth in Europe is now supporting Spanish goods exports and an upswing in visits by European tourists is also benefiting the economy. Indeed, Spain's Tourism Institute reported that the total number of tourist visits in January to September was 48.8 million, the highest level for the 9-month period since at least 2000. Overall, we forecast that growth in export volumes of goods and services will accelerate from 5.9% in 2013, to 6.7% in 2014, before settling at around 4% a year in 2015–17.

The labor market has shown signs of stabilizing ...

The recent uptick in economic activity already appears to have translated to some stability in the labor market. But we do not expect any significant job growth over the coming year, because firms are likely to want to raise productivity rather than start hiring immediately. The unemployment rate is therefore forecast to remain well above 20% even in 2017. However, persistently low rates of consumer price inflation will provide some relief to households, offering

Table 1

Spain (annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
GDP	-1.7	-1.3	0.7	1.2	1.5	2.0
Private consumption	-2.8	-2.6	0.4	1.0	1.7	2.1
Fixed investment	-7.0	-6.7	-1.1	2.0	2.0	2.4
Stockbuilding (% of GDP)	0.8	0.7	0.6	0.5	0.5	0.5
Government consumption	-4.8	-2.3	-3.1	-1.0	-0.3	0.7
Exports of goods and services	2.1	5.9	6.7	4.5	3.7	3.5
Imports of goods and services	-5.7	-0.8	2.5	3.8	3.6	3.4
Consumer prices	2.4	1.5	0.7	0.9	1.0	1.0
Unemployment rate (level)	25.1	26.5	26.4	26.0	25.6	25.0
Current account balance (% of GDP)	-1.1	0.6	1.3	1.1	1.0	0.9
Government budget (% of GDP)	-10.6	-6.8	-5.9	-4.8	-3.5	-2.5
Government debt (% of GDP)	86.0	94.7	101.6	106.7	110.0	111.5
ECB main refinancing rate (%)	0.9	0.5	0.3	0.3	0.3	0.4
Euro effective exchange rate (1995 = 100)	115.5	120.3	119.5	117.6	114.9	113.9
Exchange rate ($ per €)	1.28	1.32	1.29	1.25	1.22	1.20

Source: Oxford Economics.

the prospect of a gradual recovery in real disposable incomes over the next few years. After contracting by 2.6% in 2013, we expect growth in consumer spending of 0.4% in 2014, with momentum gradually building in subsequent years.

… but deeper reforms are required to tackle long-term unemployment

Recent structural reforms have increased flexibility in the labor market and are supporting Spain's export renaissance by improving competitiveness. Nevertheless, the labor market would still benefit from greater downward adjustment of real wages, which would allow the unemployed to move back into jobs more quickly. With this in mind, the Government is planning to review its recent labor market reform package in the coming months.

In its last review of the Spanish economy, the International Monetary Fund highlighted a number of areas that the Government should tackle. These include lowering the difference in costs for dismissing workers on permanent rather than temporary contracts, deeper reform of the collective bargaining system, and improved training services. We agree that without these additional reforms, high levels of structural unemployment are likely to be a drag on domestic consumption and the state welfare system for many years to come.

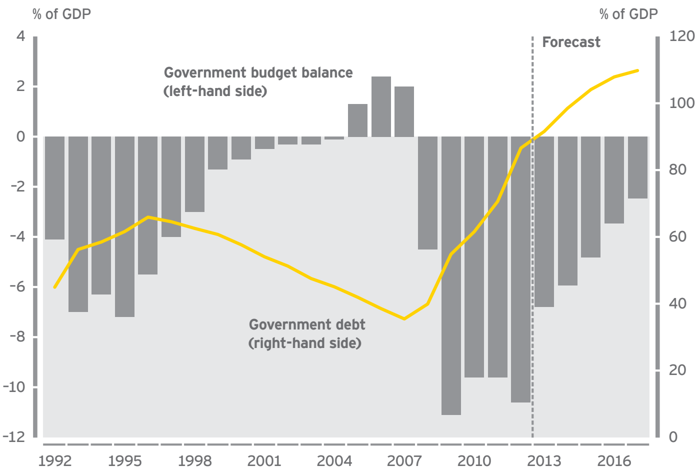
Although credit conditions remain tight in the lead up to the AQR …

Credit conditions remain tight for both households and non-financial companies, despite the improvement in funding conditions for the banking system. Lending continues to contract, reflecting both weak demand for credit and supply constraints. Although the bank restructuring and recapitalization process has helped to strengthen the banking sector, the European Central Bank's upcoming asset quality review (AQR) could still identify the need for higher provisions and capital.

But assuming that the AQR does not uncover significant capital shortfalls, confidence in the banking sector should strengthen following the publication of the results. This is expected to support a gradual easing of credit conditions, beginning in the second half of 2014.

Figure 1

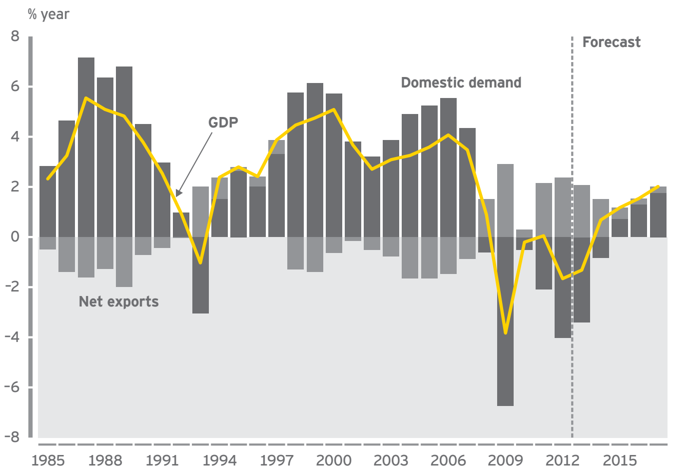
Government balance and debt



Source: Oxford Economics.

Figure 2

Contributions to GDP growth



Source: Oxford Economics.

Table 2

Forecast for Spain by sector (annual percentage changes in gross added value)

	2012	2013	2014	2015	2016	2017
Manufacturing	-1.1	-2.9	0.6	2.6	3.1	3.0
Agriculture	-10.9	2.8	3.6	2.5	1.9	1.8
Construction	-8.6	-3.7	0.4	0.9	1.6	1.7
Utilities	2.4	-2.2	2.2	2.8	2.5	2.6
Trade	0.5	-4.1	1.4	1.2	1.4	1.6
Financial and business services	-1.1	-1.3	1.4	2.1	2.1	2.5
Communications	0.9	-1.0	0.6	1.5	1.8	2.4
Non-market services	-0.7	-2.5	-2.8	-0.8	-0.2	0.8

Source: Oxford Economics.

... investment in capital goods is now adding to growth

Despite relatively high financing costs, the strong performance of exports is now supporting renewed positive growth of investment in machinery and equipment. Growth in this component of investment is expected to gather momentum over the coming years, as the economy recovers and the outlook for corporate profits improves.

In contrast, there are few signs of any stabilization in residential investment, with construction still contracting sharply and house prices continuing to fall. Still, growth in housing sales is close to turning positive, suggesting that a stabilization of the housing sector may not be too far away. If economic activity continues to strengthen as we expect, which will lead to gradual improvements in labor market conditions, then house sales should pick up over the coming year. This suggests that both house prices and construction should finally stabilize in 2015.

After contracting by 6.7% in 2013, we expect total investment expenditure to fall by a further 1.1% in 2014, before recovering to grow by 2% per year in 2015–17.

Fiscal slippage remains a risk, as pace of consolidation eases

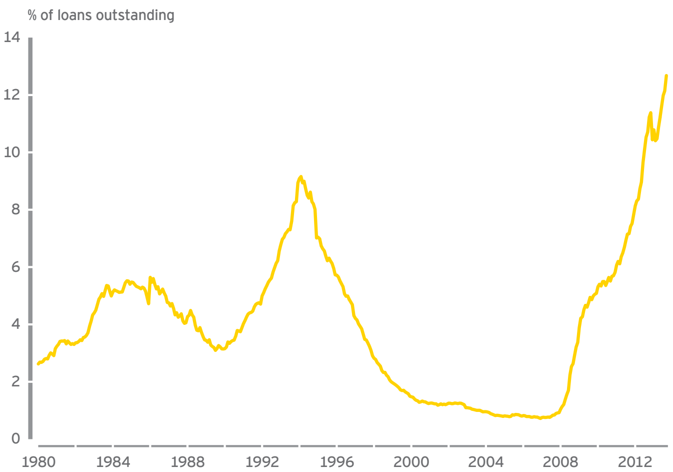
The budget deficit for 2012 (excluding one-off bank recapitalization costs) was revised down to 6.8% of GDP, meaning that the deficit needs to remain almost unchanged this year to meet the 6.5% of GDP target set out in the European Union's stability program. Nevertheless, fiscal slippage remains a risk, as the data for 2013 thus far indicates that recovery in tax revenues is weaker than expected. The budget for 2014 confirmed previously announced expenditure and revenue measures. As a result, the Government will be hoping that the economic recovery in 2014 helps it to meet its fiscal targets. But the current trajectory leaves government finances highly vulnerable to external shocks and renewed financial market turbulence, meaning that further consolidation measures may be required.

The economy still faces a long period of adjustment

As well as the need to place the public finances on a sustainable path, the private sector also needs to address the huge debt burden it accumulated during the pre-crisis period. The protracted dampening effect on activity from deleveraging will therefore keep output below the underlying supply capacity of the economy until the end of the decade. Nevertheless, the process of correcting Spain's imbalances is under way and recent developments give reason for optimism that the crisis can be overcome.

Figure 3

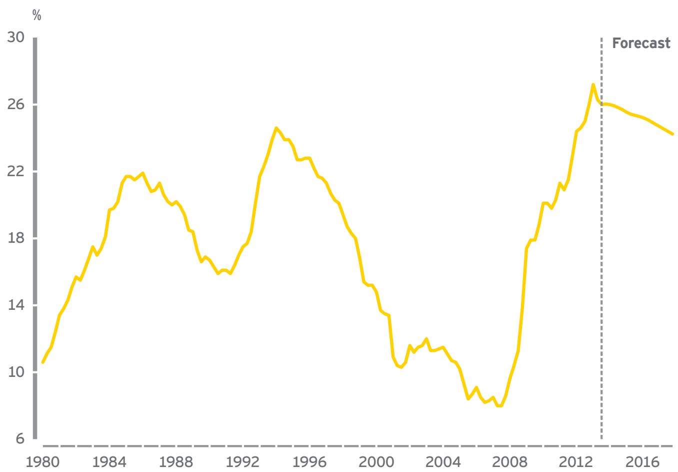
Non-performing bank loans



Source: Haver Analytics.

Figure 4

Unemployment rate



Source: Oxford Economics.

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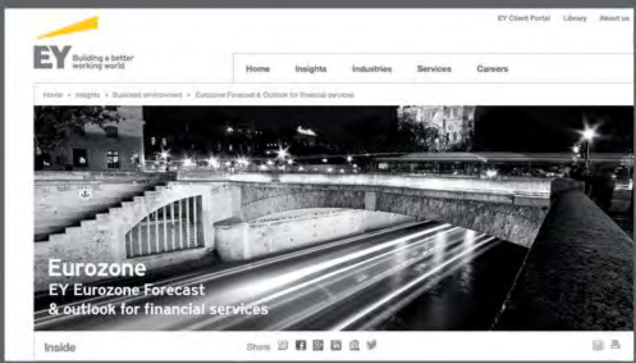

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