

SPANISH ECONOMY

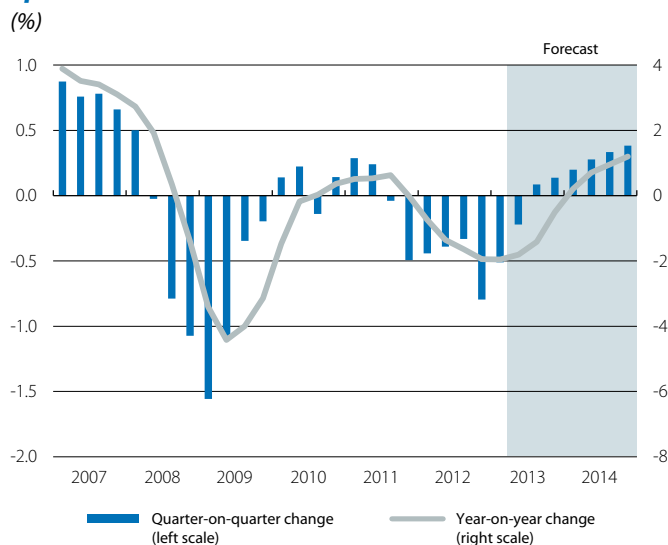
The intensity of the recession is easing. The series of indicators, both for activity and confidence, are slightly better than they were at the end of 2012. However, in March and April they lost the vigour with which they had started the year. This is no cause for concern, for the moment, so we have kept our growth forecast for 2013 at -1.4% , continuing with negative growth for the first six months followed by a second half of the year in which advances will gradually gain ground. This scenario is similar to the new set of forecasts provided by the IMF, with a 1.6% fall in GDP for this year and 0.7% growth for the next. Nonetheless, the IMF warns that there are notable medium-term risks and particularly stresses the importance of keeping up with the agenda of structural reforms.

In the first quarter, GDP shrank by 0.5% quarter-on-quarter, 0.3 percentage points less than the previous quarter (in line with our forecast). This more favourable trend can essentially be attributed to the smaller decline in domestic demand: after a very negative fourth quarter due to purchases and investment being brought forward, caused by the VAT hike in September and the suppression of the bonus for civil servants, domestic demand has recovered some of the ground lost. This has been accompanied by improved consumer confidence, up by more than 8 points from the minimum of -40 reached in December to -31.9 in March.

Business indicators went from good to bad in the first quarter. After the promising rises seen at the start of the year, part of this improvement was lost again in March. For example, the Purchasing Managers' Index (PMI) for manufacturing reached 46.8 points in February but fell to 44.2 points in March, a value slightly lower than the average for the fourth quarter. This deterioration is largely due to the new sources of uncertainty coming from Italy and Slovenia, two elements that should be favourably resolved in the near future. In Italy, 87-year-old Giorgio Napolitano has been re-elected as the country's President and Enrico Letta has been given the difficult task of leading a coalition government. No great advances are expected in the agenda of reforms which Italy nevertheless urgently needs, but this political improvement should be enough for the country to step out of the limelight. Slovenia, with its public banking sector facing serious insolvency problems, is more than likely to be forced to request financial aid from the ESM in the short term. It would be surprising if the errors committed in the Cyprus case were repeated so, *a priori*, there is no reason to think this might increase tension in the financial markets.

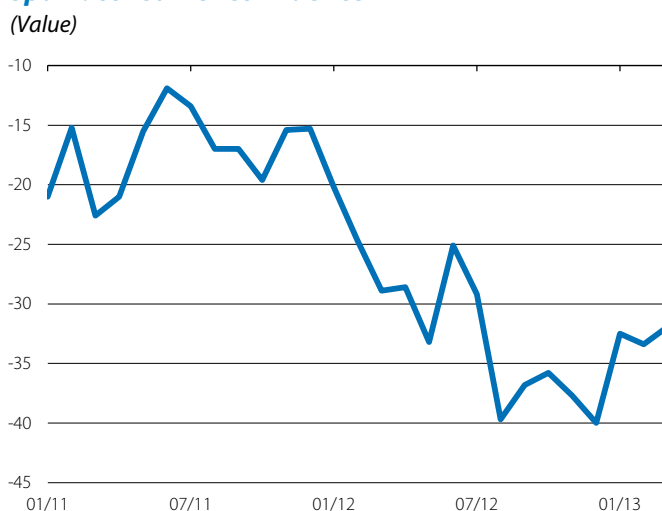
The labour market is performing well given the overall serious situation. On the whole, the number of employed fell by 322,300 people in the first quarter, a somewhat smaller decline than the figure for the same period the previous year. It is useful to look at the breakdown of this trend in the private

Spain: GDP



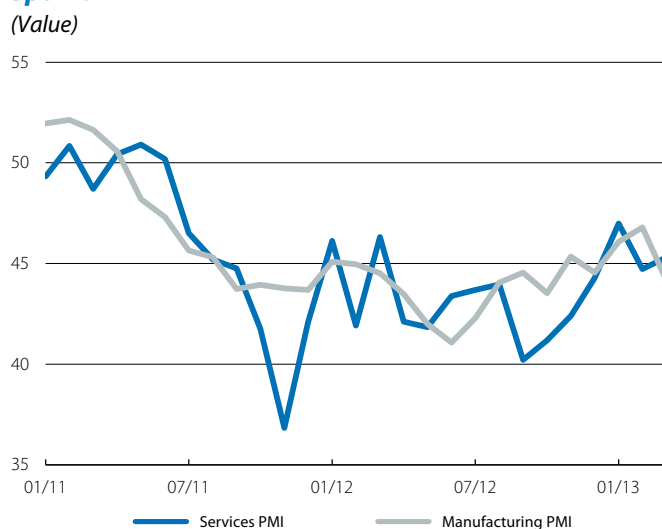
Sources: National Institute of Statistics and own calculations.

Spain: consumer confidence



Source: European Commission.

Spain: PMI



Source: Markit.

and public sector. The adjustment in the latter started later and, for the moment, does not look like having touched bottom. In the private sector, the decline, albeit large, was the smallest for the last four years. An assessment of the rise in the number of unemployed, namely by 237,400 people, is similar: although this figure cannot be seen as positive, it is one of the best first quarters in the last 6 years. Only in the first quarter of 2011 was the increase in the number of unemployed lower, although the difference is small. Both the employment and unemployment figures are therefore accompanied by a crucial message: the recession is still present and is being felt in the labour market but it does seem to be running out of steam. Other relevant figures from the LFS have been the decrease in the labour force of 85,000 people; this has placed unemployment at 27.2%, 1.1 percentage points above the figure for the previous quarter.

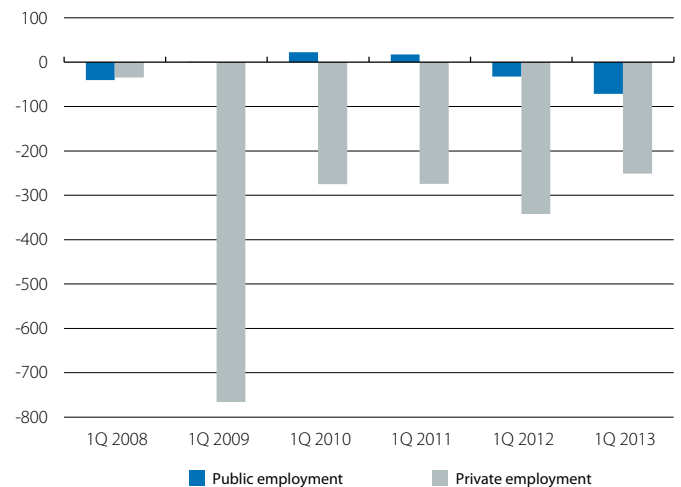
Employment expectations are starting to regain the ground lost. Although these have remained very weak since the recession started, over the last few months an interesting upward trend has nonetheless started in line with the improvement in business indicators. In industry, where these expectations fell the most, they have been recovering for the last 7 months, while this is a more recent phenomenon in the services sector. Although the pace of this improvement seems somewhat slow, should it continue the indicators would reach positive figures by the end of this year. In the short term, the labour market is therefore unlikely to present any structural improvements. The movements we will observe over the coming quarters will be particularly affected by seasonal factors. But if this change in trend becomes confirmed, next year might see the labour market stabilizing.

Support for exports to countries outside the euro area is key. The relative weight of Spanish exports to the euro area has gone from above 60% to below 50% in just 8 years. The strong growth rates demonstrated by exports have been decisive in cushioning, in part, the impact of the recession (see the Focus «Spain: diversify and you will export», in the chapter on the Spanish Economy of this *Monthly Report*). Consequently, one particular concern is whether the more or less general signs of weakness observed in recent activity indicators at a global level will lead to a reduction in exports to outside the EU. For the moment there are no signs of this happening. In fact, industrial orders from outside the euro area rose by 14.2% year-on-year in February, one point more than in January. What is known, however, is the weakness of national orders and those from the rest of the euro area countries (-9.2% and -2.6% year-on-year, respectively) which, for the moment, have yet to show any sign of perking up, although they should do so soon if the recovery continues to gain ground.

The slower pace of fiscal consolidation will also help. The government, supported by the EC and the IMF, has relaxed its fiscal consolidation programme and has postponed reducing the deficit to below 3% of GDP until 2016. For

Spain: employment trend

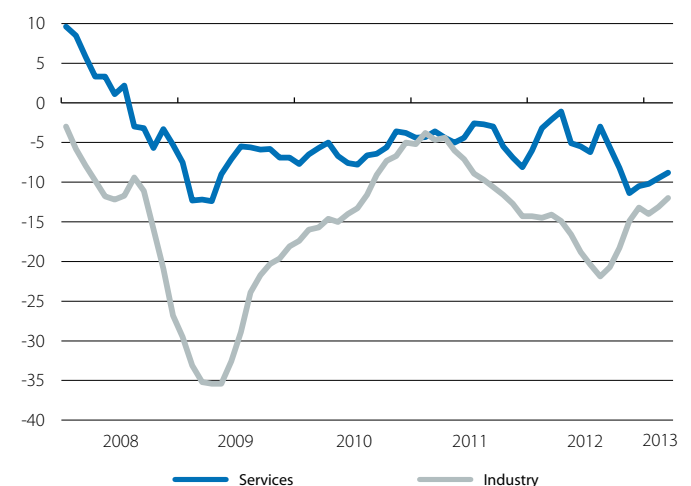
Quarter-on-quarter change (thousands of employees)



Source: INE.

Spain: employment expectations

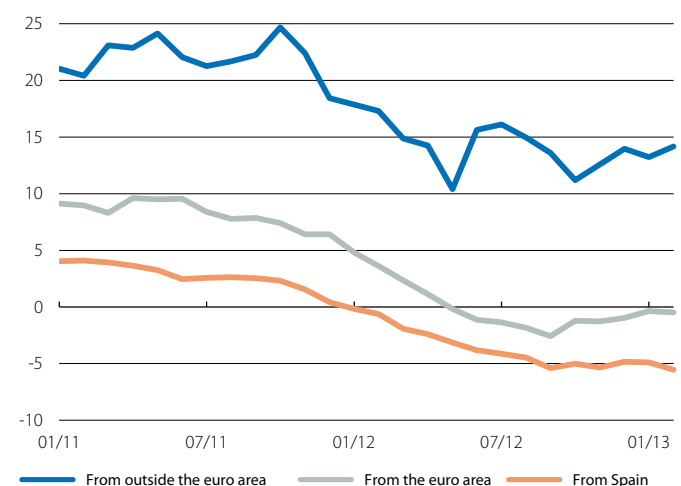
Moving average 3 months (value)



Source: European Commission.

Spain: industrial orders

Cumulative figures over 12 months, year-on-year change (%)



Source: INE.

this year, the Stability Programme presented contains an adjustment in the deficit of 0.7 percentage points, to 6.3% (compared with 4.5% previously). This has been accompanied by the announcement of further structural reforms that aim to increase the economy's capacity for growth in the long term and improve the sustainability of national accounts. Of note is the separation of civil service wages from the inflation rate, the creation of a working group to reform the pension system and the rationalization of local administration. (For a more detailed analysis, see the Focus «The pace of fiscal consolidation eases but not the effort», in the chapter on the Spanish Economy of this *Monthly Report*).

The changes in fiscal policy are supported by the markets.

At the end of April, the Treasury issued 3-month bills at a lower interest rate than the historical series and the risk premium fell to below 300 basis points. Moreover, the expectations of a possible cut in the official interest rate by the ECB and the entrance of liquidity from Japan suggest that this improvement in financing conditions will continue over the coming months.

Confidence in the banking sector is gradually improving.

In March, Spanish banks reduced their dependence on ECB financing to 260 billion euros. The reopening of the wholesale financing markets and the advances made in sorting out the banking sector suggest this trend will continue over the coming months. Deposits held by households and firms in Spanish banks are continuing to increase, with a preference for term deposits, which have risen by 9 billion euros in the first two months of the year. Depositors are therefore looking for a better return on their savings, which have been reduced in an environment of low interest rates and limits on the returns fixed by the Bank of Spain.

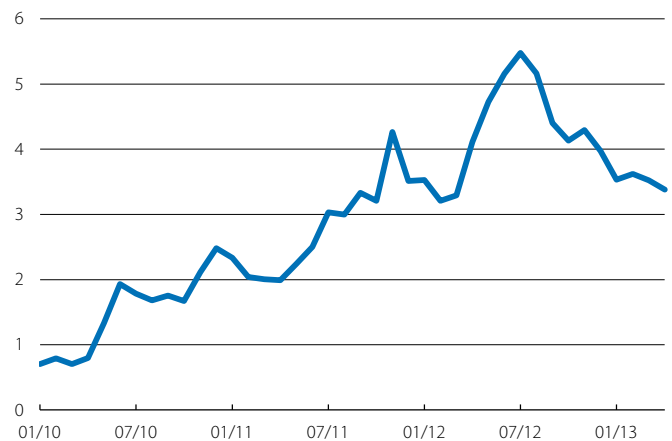
The adjustment in credit is advancing in line with the weak pulse of the economy.

Private sector financing continued to shrink in February with a year-on-year change of -5.8%, reflecting the deleveraging being carried out by households and firms. Only public sector financing increased, up by 13.7% year-on-year in February. The NPL ratio fell in February to 10.4% due to the transfer of assets to the Sareb by banks that have received state aid.

Credit will once again flow to the real economy as the economic recovery consolidates. For the moment, the banking sector's credit capacity is still limited by high uncertainty but, once the sector has been sorted out, this should help to restore the supply of credit over the coming quarters. More worrying is the trend in the demand for credit, which continues to contract.

Spain: risk premium

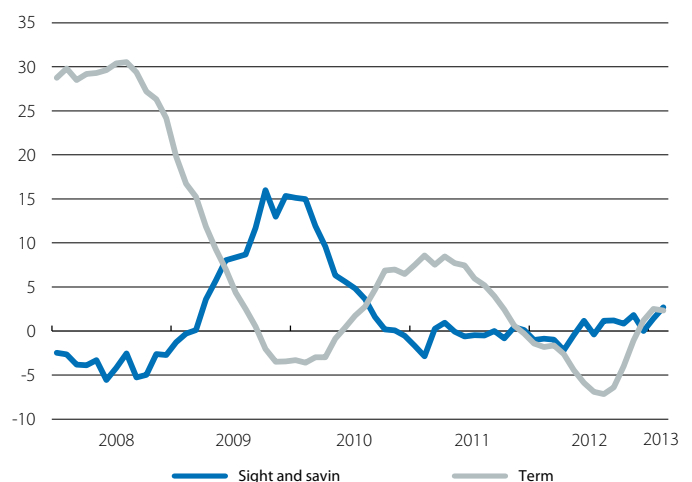
Spread in 10-year bonds, Spain-Germany
Monthly average (%)



Source: Bloomberg.

Spain: household deposits

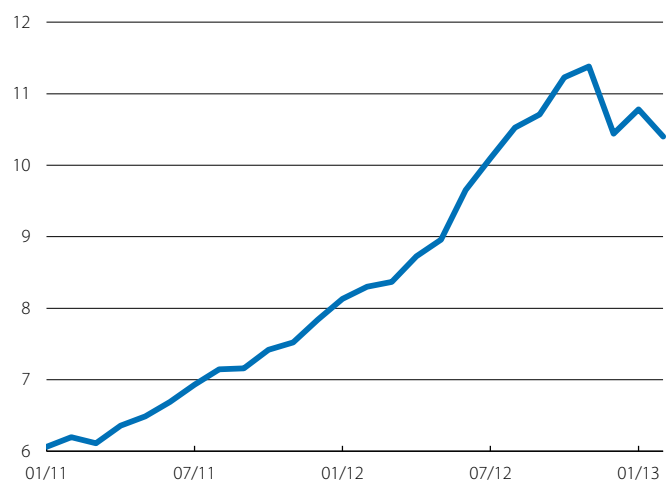
Year-on-year change (%)



Source: Bank of Spain.

Spain: bank NPL rate

NPL rate as % of total credit



Source: Bank of Spain.