Spain: A Recovery with Bumps Along the Way

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With the economy beginning to recover and a notable improvement in the current account, recent developments warrant a more favorable outlook for Spain. That said, fiscal slippage remains a risk and political problems continue to linger in the background.

Recovery is underway in Spain. It is supported by the financial stability fostered by the European Central Bank's Outright Monetary Transactions (OMT) innovation, a relaxation in damaging austerity policies, structural reforms in national labor and product markets, and recoveries elsewhere in Europe. Moreover, a clean exit in December from the European Stability Mechanism's Financial Assistance Program for the recapitalization of Spanish banks would provide evidence that a key underlying cause of the crisis is finally on the mend.

However, the recovery will not be without bumps along the way. Fiscal adjustment is still not complete. With a drawn-out consolidation path and relatively low medium-term growth prospects, questions about debt sustainability remain. And political risks continue to linger in the background. On balance, we believe there are grounds for greater optimism, especially compared with circumstances a year ago, but continued risks to the recovery path will require attention.

Recovery in Growth and Employment

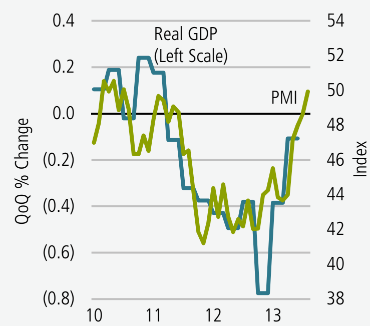
Second-quarter gross domestic product (GDP) showed the slowest rate of contraction since the first quarter of 2011 **(Display 1)**. The 0.1% quarter-on-quarter decline was an improvement from the first quarter's 0.4% decline. Importantly, the recovery was broad-based with contributions from a stabilization in private consumption, a positive contribution from public spending and an increase in exports. The only area where the decline accelerated was in construction spending.

This has translated into some stability in the labor market. The unemployment rate remained at 26.3% in July, close to where it was at the start of the year. Given the significant increases in unemployment since 2007, with youth unemployment reaching 56.1%, a plateauing of this nature is very welcome news. That said, the stabilization in the unemployment rate owes as much to exits from the labor force as it does to a stabilization in employment.

This improving trend has continued in the

Display 1
Recovery Underway

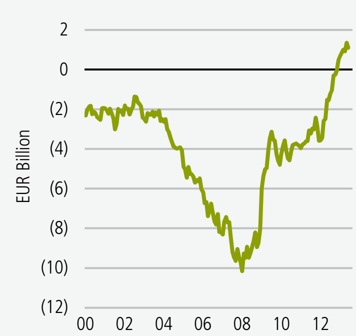
Real GDP Growth and Composite PMI



As of August 31, 2013
Source: Haver Analytics and Markit

Display 2
Notable Improvement in Current Account

Monthly Current Account Balance



Seasonally adjusted, three-month rolling average
As of June 30, 2013
Source: Bank of Spain and Haver Analytics

third quarter. The Purchasing Managers' Index (PMI) increased in July and August, with the composite indicator now standing at 49.9 (Display 1, previous page). This is the highest level since July 2010 and consistent with GDP growth of about 0.1% in the quarter. This implies that third-quarter GDP may show the first sequential expansion since the first quarter of 2011.

Current Account in Balance

Developments in the external account have been particularly encouraging. The current account balance has moved into surplus in 2013 **(Display 2, previous page)**. In the first half of the year, the surplus amounted to 0.1% of GDP. To put this in context, in the first half of last year the deficit was 1.6% of GDP and in the first half of 2007 it was 4.8% of GDP. Historically, Spain has not ended the year in current account surplus since the mid-1980s. The return to a balanced current account has been driven mostly by the merchandise trade balance, with exports accounting for 70% of the improvement since 2007, and a decline in imports due to weak domestic demand contributing the other 30%.

The increase in exports is partly due to higher import demand from Spain's main trading partners. However, **Display 3** shows that the growth in export volumes from Spain has exceeded the growth in import volumes in countries that buy Spanish goods since 2010. This outperformance indicates that structural causes explain part of Spain's export gains—factors that could include geographical and sectoral diversification, greater competitiveness from declining unit labor costs, increased linkage to regional and global trade networks, and structural reform.

Geographically, the growth in exports has been well balanced—while the largest increases have been to emerging markets, there have also been gains within the euro area. And with recoveries elsewhere in Europe and the UK underway (the euro area and UK account for 56% of the total export base), this is likely to buoy export performance in the short term.

Risks in Fiscal Implementation

An important policy change that has opened up the way for the Spanish recovery has been a moderation in the pace of fiscal consolidation. Amid deepening recession, social strains and cyclical increases in public debt, Spain is being allowed to reduce its budget deficit more gradually—the revised target is a primary surplus by 2016. In line with this, the Excessive Deficit Procedure for Spain incorporates a 2.5% of GDP fiscal effort in 2013, down from a peak effort of 4.0% in 2012.

Despite less ambitious targets, there have been weaknesses in the implementation of the fiscal program. The general government deficit was 5.3% of GDP year-to-date to July. Relative to this year's revised 6.5% general government deficit target, the current trajectory suggests that Spain will miss by 1.0% of GDP. The shortfall to date has been mostly at the central government level **(Display 4)**. Revenues to July have performed well but expenditures have shown weakness due in part to higher transfer payments to social security.

To a large extent, the end-result this year will depend on the performance in the autonomous regions and social security administration. Current numbers in these non-central accounts show minor misses to July. However, the impact on budgetary performance will remain uncertain, with expenditures concentrated in the third and fourth quarters.

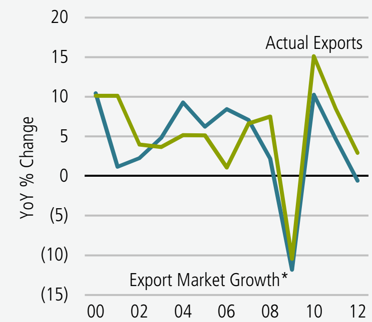
Fiscal performance will be a risk in 2013 and 2014. The European Commission notes a deviation from the headline target in 2014 that will require attention in next year's budget. With gross public debt at 92.2% of GDP as of June, above the year-end target of 91.4%, Spain is likely to reach 100% debt to GDP before the Commission's forecast of end-2015.

Recovery with Bumps Along the Way

A recovery rarely happens without travails along the way, and Spain is no exception.

Display 3
Structural Improvement in Exports

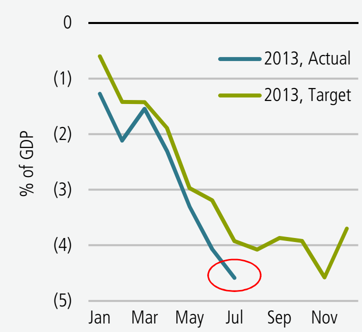
Export Volume Growth vs. Trade-Weighted Import Volume Growth in Spain's Export Markets



*Trade-weighted import volume growth in Spain's export markets
As of December 31, 2012
Source: IMF World Economic Outlook and AllianceBernstein

Display 4
Budget Overshoot

Central Government Budget Balance vs. Target*



*To meet 2013 central government deficit target of 3.7% of GDP
As of July 31, 2013
Source: Ministry of Finance and Public Administration and AllianceBernstein

Improvements in the macro economy and external accounts point to a brighter outlook. A clean exit this December from the bank recapitalization program would provide an important sign that a key factor underlying the Spanish crisis is starting to improve. However, risks to fiscal performance and questions over medium-term public sector debt sustainability remain. So, while recent developments warrant greater optimism on Spain, especially in the context of the heightened stresses of recent years, risks continue to linger and will need to be closely monitored. ■