ECONOMICS: EUROPEAN PERSPECTIVES

A CONSTRUCTIVE OUTLOOK ON SPAIN

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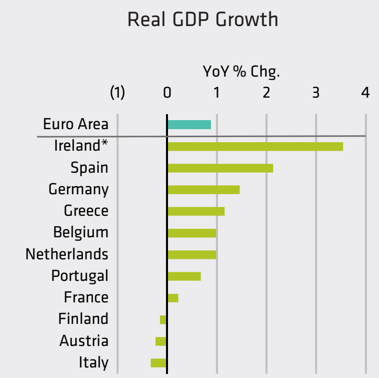
Spain's economy has recently enjoyed one of the fastest growth rates in the euro area, supported by a rebound in its domestic sector. We believe growth will continue to surpass expectations in 2015, anchored by both structural reform and positive cyclical factors. While medium-term challenges remain, we are constructive on the near-term outlook.

Display 1
Spain Grows Faster than Peers



As of Q4 2014
*Ireland as of Q3 2014
Source: Haver Analytics

As we progress through 2015, the script has been rewritten from a few years ago. Spain, Ireland and Portugal—members of the euro-area periphery that were previously at the center of Europe's deep economic crisis—are now being hailed as "success stories" with robust economic recoveries well under way.

In the fourth quarter of 2014, Spain grew at an annual rate of 2.1%—faster than most of its euro-area peers **(Display 1)**. Its quarter-over-quarter growth rate of 0.7% was the fastest single-quarter run rate since the fourth quarter of 2007. And the composition of last quarter's outturn showed that growth was driven by domestic final demand (which contributed 0.6%), particularly household consumption and fixed investment.

Structural and Cyclical Rationale

One of the important reasons for the better performance of Spain has been the adoption of structural reforms in past years. For example, the liberalization of Spain's labor market has improved transitions out of unemployment. Next, efforts to reduce the cost and complexity of registering new companies have supported competition and raised productivity in certain sectors, like retail. And relative unit labor costs have been reduced substantively—a painful adjustment given limited exchange rate flexibility—but one which has boosted exports and corporate profitability. While it is well recognized that structural reform has supported Spain's recent economic outturns, it would be an oversimplification to omit several other factors that have contributed to the rebound.

Importantly, Spain adopted a very stringent fiscal stance during the crisis years in order to tackle its large fiscal deficit. This involved discretionary budget cuts of, on average, 2% of gross domestic product (GDP) per annum between 2010 and 2012. Thereafter, however, with the hardest work done, the government has scaled back austerity and eased fiscal drag. This has greatly facilitated the emergence of cyclical recovery. In addition, Spain's economy was severely impacted by the collapse of its banking system and the large-scale deleveraging within the private sector—factors that are now on the mend. As a result, the ongoing improvement in Spain's fiscal and credit cycles has contributed to a cyclical recovery, which has also played an important role in the nation's growth divergence from other countries in the region.

A Brighter Outlook

Spanish growth exceeded expectations last year (1.4% versus a start-of-year consensus of about 0.7%) and we expect this growth outperformance to continue in 2015. Our base-case scenario assumes that Spain will grow by 2.5% this year, compared with the latest consensus estimate of 2.2%. This would keep Spain at the upper end on regional growth rates—we're forecasting that the euro area as a whole will grow by a higher-than-consensus figure of 1.6% in 2015. There are several factors to take note of when considering our constructive near-term view on Spanish growth.

Reasons for Optimism

First, labor market reforms* and a strengthening economic recovery will sustain the rebound in Spain's job market. Most recently, improvements have shown signs of acceleration. In February, social security affiliations—a proxy for the level of employment—rose by 84,000 on a seasonally-adjusted basis, the fastest pickup in a single month since September 2005 **(Display 2)**. Accordingly, Spain's unemployment rate has fallen to 23.4% as of January, down from a cyclical peak of 26.3% in April 2013. This strengthening rebound in Spain's labor market will bolster growth in discretionary income and private demand.

Next, the government has implemented the first tranche of its major tax reform. The top income tax rate was cut from 52% to 47% and is scheduled to be trimmed to 45% in 2016, while the bottom rate has been cut from 24.75% to 20% (and will be reduced to 19% in 2016). In a similar vein, the corporate tax rate was trimmed from 30% to 28% (and is scheduled to be cut to 25% in 2016). While these tax cuts have been roundly criticized for their impact on Spain's fiscal deficit, the government has estimated that they could boost GDP by 0.55% over 2015 and 2016.

Third, lower oil prices and a weaker euro are expected to provide important supports for economic recovery throughout the region, including Spain (see "Euro Area Growth: Reasons to Be Cheerful", European Perspectives, February 13, 2015). While nominal wage growth has been muted, Spain's inflation rate has dropped near an all-time low, standing at -1.2% as of February, driven down by the fall in energy prices. This has given a lift to real wages and household spending power. In addition, the weaker euro will deliver more meaningful stimulus than it might have done in the past: Spain's exports to countries outside the euro area now account for about 18% of GDP, up from 12% before the crisis.

Lastly, domestic monetary and financial conditions have improved. While much-needed private sector deleveraging remains under way, the pace of contraction in bank lending has decelerated recently **(Display 3)**. While Spanish firms have, so far, increased capital spending without resorting to much use of credit (helped by healthier corporate balance sheets and the use of internal savings), better access to bank lending channels will enhance the sustainability of the investment recovery.

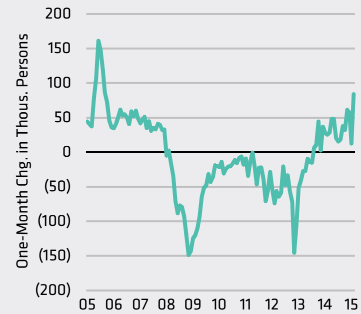
Constructive View

The medium-term challenges for the Spanish economy remain significant, with unemployment still very high, the fiscal deficit lingering above 4% of GDP and debt sustainability in question. But the strengthening cyclical rebound and higher structural growth, aided by progress on reform, support a continued constructive outlook. In the near term, the general election in the fourth quarter represents an important risk to this outlook, since policy uncertainty could dampen the country's growth prospects. But, we don't expect the election (and potential change in government) to derail Spain's recovery—even if the leftist Podemos enters government as part of a new ruling coalition.

For now, our base-case scenario of a robust Spanish recovery, with the ECB firmly in accommodative mode, ought to be supportive of a constructive outlook on Spanish government bonds.

Display 2
Recovery in Labor Market

One-Month Change in Social Security Affiliation (Registered Employment)



As of February 28, 2015
Source: Spain Ministry of Work and Immigration, Haver Analytics

Display 3
Contraction in Bank Lending Decelerates

Annual Change in Loans to Households and Non-Financial Corporations

As of January 31, 2015
Source: European Central Bank

*The labor market reforms of 2012 gave firms greater flexibility to change the terms of employment, decentralized collective bargaining, reduced severance pay, eased rules for dismissal, and scaled up active labor market policies.