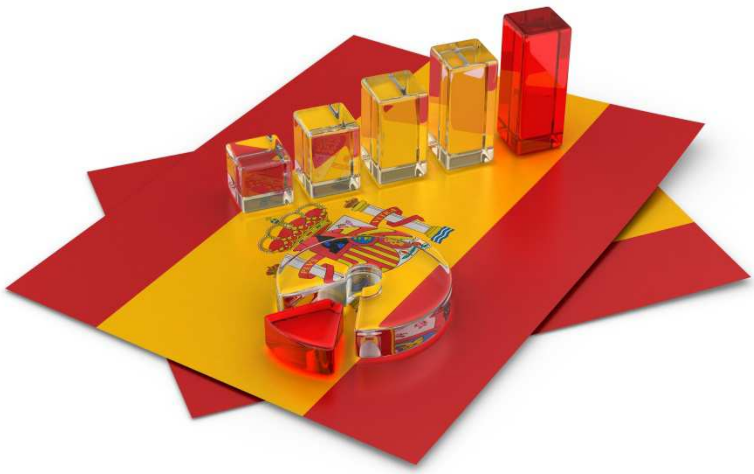
ECONOMIC REVIEW
SEPTEMBER 2015

Creditreform
Rating Agentur

Economic Prospects in Spain



Economic prospects to improve as bold reforms drive Spain's growth

Economic prospects in Spain have improved significantly in the opinion of Creditreform Rating. While real GDP increased by 1.4% in 2014, the Spanish economy is expected to expand by 3.1% and 2.8% in 2015 and 2016, according to our forecast. After five years of recession and stagnation, Spain's economic recovery is gaining momentum. The most significant impulses have come from private consumption and investments. Housing prices as well as the employment situation seem to have reached a trough.

Spain's recovery would not have been possible without bold structural reforms. While other members of the euro area have been lacking the will to implement reforms, Spain is not only characterized by the will to introduce reforms but has acted resolutely in their implementation. Hence economic reforms are beginning to bear fruit: employment is on the rise and price competitiveness is improving.

The outlook for further development is positive. Underpinned by returning consumer and corporate confidence, more favorable financing conditions and growing competitiveness, private consumption and business investment will be the key drivers of economic development in 2015. In addition, the Spanish economy should be boosted due to the benign development of external factors: low energy prices, depreciation of the euro and purchases of government bonds by the European Central Bank.

Creditreform Rating is registered with the ESMA as a European rating agency for ratings of corporations, bonds, and structured finance and has carried out a number of ratings in Spain.

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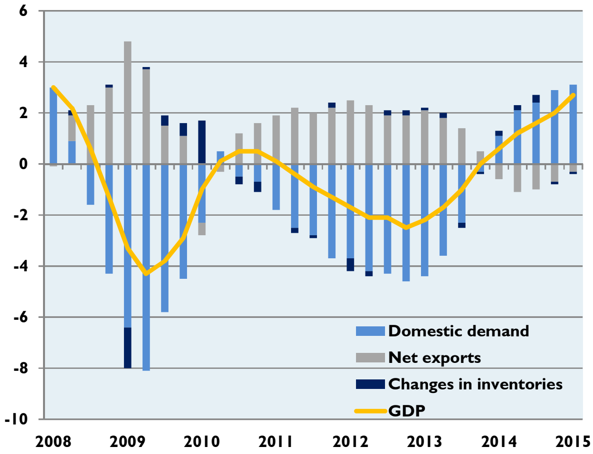
The Spanish economy is growing again

The Spanish economy left the double-dip recession behind in 2014, achieving positive economic growth for the first time since 2008. Hence the real GDP last year increased by an annual average of 1.4%, having fallen in 2012 and 2013 by 2.1 and 1.2% respectively. Spain's recovery is largely the result of bold structural reforms (labor market, tax reform, insolvency framework). Concurrently, Spain is passing through a difficult process of adjustment characterized by a reduction of macroeconomic and financial imbalances as well as by a restructuring in the banking sector.

Fig.1: Real GDP growth

GDP year-over-year changes in %; contribution to GDP in percentage points



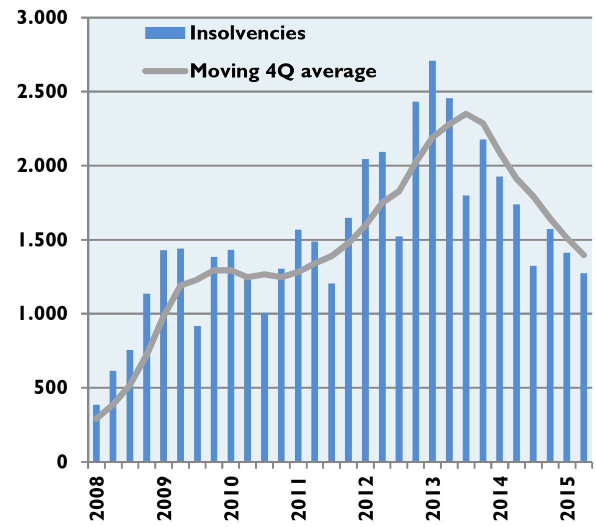
Source: ECB, Creditreform Rating

Available data shows that the Spanish economy continued its recovery and gained momentum after growth resumed in the second half of 2013 (see fig. 1). After the Spanish economy had grown in the second half of 2014 with +0.5% and +0.7% quarter-over-quarter (q-o-q) respectively, GDP expanded by +0.9% and 1.0% up to mid-2015. In comparison with the previous year, the Spanish GDP continuously increased, rising at growth rates of 2.0 (Q4-2014) and 2.7% (Q1-2015). Furthermore, in the second quarter of 2015 the level of the previous year quarter was exceeded by 3.1%.

Accordingly, the insolvency situation in the Spanish corporate sector has improved markedly since 2013 (see fig. 2). While the number of corporate insolvencies amounted to 9,143 in 2013 (2012: 8,095), last year a total of only 6,564 insolvencies was registered. This corresponds to a decrease of 28.2%. The current trend for insolvencies continues to be in decline: 1,275 insolvencies were registered in the second quarter of 2015, compared with 1,739 in the previous year period (-26.7%). It should be noted that these are officially registered insolvencies; liquidations have not been included.

Fig.2: Insolvencies in Spain

Number of corporate insolvencies per quarter



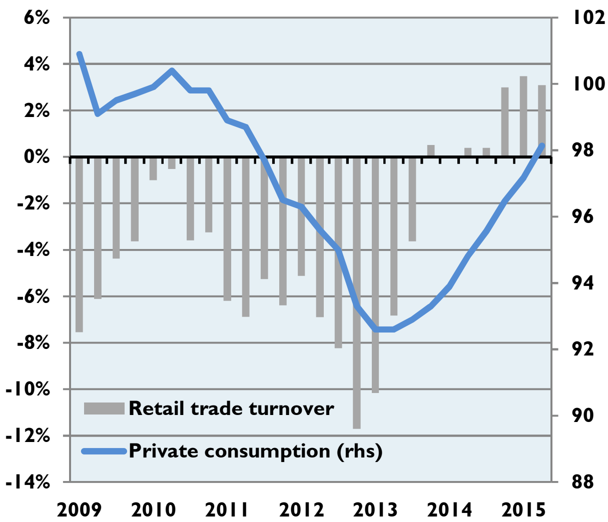
Source: Instituto Nacional de Estadística, Creditreform Rating

Spanish growth is fueled by rising domestic demand

Economic growth in Spain has been driven by a robust expansion of domestic demand. Led by improved employment prospects and increasing real available income – primarily as a result of a marked decrease in consumer prices – consumer spending has overcome its weakness. Compared with the previous year, private consumption increased in 2014 by 2.3% (see fig. 3). Previously, high household debt as well as the negative development of employment and income exerted downward pressure on household expenditures. In 2013, private consumption fell short of its 2007 level by 11.0%.

Fig.3: Development of private consumption

Retail trade turnover: y-o-y changes in %, private consumption: volume index (2010=100)



Source: Eurostat, Creditreform Rating

Given the improving labor market conditions, consumer spending is expected to increase in 2015. Consumer spending receives additional impetus due to increasing purchasing power, which should be facilitated by decreasing consumer prices as well as by the income tax reform which came into effect in January 2015.

Both hard and soft data indicate that the trend in private consumption will accelerate. Firstly, consumer spending continued its rising trend in the second quarter of the current year. Thus, consumer spending grew by 1.0% year-over-year (y-o-y); this has been the eighth consecutive increase. At the same time, in August 2015 the consumer confidence indicator of the EU Commission was, with -1.3 points, near the 15-year high it had reached in April with 3.6 points and considerably higher than in the previous year (-6.4 points). In addition, the confidence indicator published by the EU Commission for retail trade in August of this year is, with 13.5 points, at a significantly higher level than in the previous year, when it was at 9.0 points.

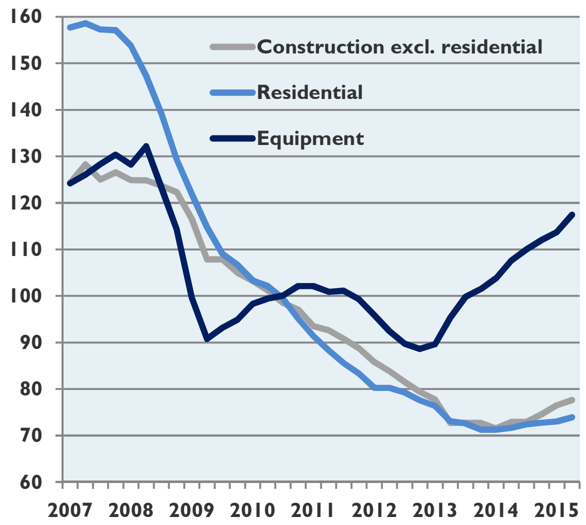
Economic impulses also came from gross fixed capital investment, which increased significantly in 2014. On an annual average, business investment expanded by 3.4%, after -8.1 and -3.8% in 2012 and 2013 respectively. After a slowdown in investment activity in the previous year as a result of the increased uncertainty during the debt crisis, credit supply constraints and weak corporate profitability, the impact of these factors has currently abated. The resulting favorable climate for investment resulted in positive growth rates for business investment. In Q2-2015 too, business investment rose by 2.0% from the previous quarter (+6.1% y-o-y).

Investment in equipment booming, bottoming out in the construction sector

Investments in equipment saw a veritable boom in 2014, increasing by 12.2% y-o-y (see fig. 4). In addition to the low initial level, the fact that investments in equipment are expected to increase is due to robust demand and more favorable financing conditions. In addition, price competitiveness gains and an improved export climate should support growth in business investment. Hence investments in equipment rose in the first half of the current year by 9.4 (Q1) and 9.2% (Q2) y-o-y, having already displayed double-digit growth rates in the previous six quarters.

Fig.4: Investment trends

Volume indices (2010=100)



Source: Instituto Nacional de Estadística, Creditreform Rating

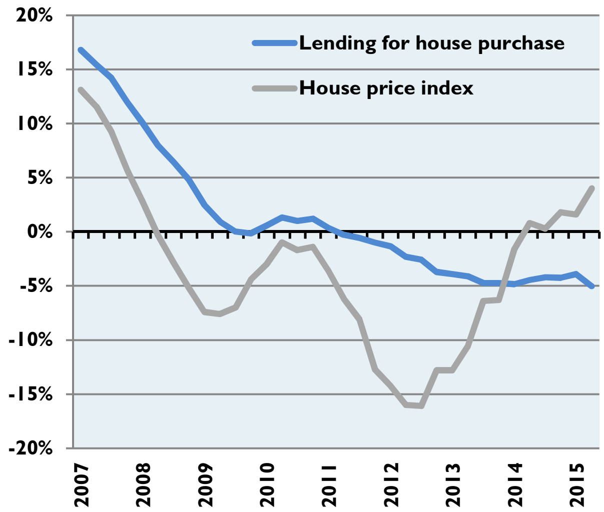
Moreover, leading indicators such as the upward trend in industrial new orders point to improved prospects for the sector. After a marked increase in new orders in Q1-2015 (+1.3% y-o-y) the volume of orders in the second quarter exceeded that of the previous year by 3.1%.

While investments in equipment are expanding significantly, the construction sector seems to be bottoming out. Investment in construction increased for the fourth successive quarter in Q2 (+5.1% from the prior year); however, a minus of 1.5% y-o-y is recorded for 2014.

Consolidation in the Spanish market for residential real estate continues to drag down residential investment. In the course of the seven-year adjustment in the real estate market, house prices fell between 2008 and 2014 by 34.9%. Nevertheless, house prices seem to have bottomed out, meaning a possible end to the process of adjustment in the real estate market. Hence in the past year initial signs of recovery became visible when the house price index showed positive growth in Q2-2014 for the first time since the first quarter of 2008 with +0.8% y-o-y (see fig. 5). Likewise, the recovery of house prices continued in the first quarter 2015 (+1.6% y-o-y).

Fig.5: Indicators for the real estate market

Year-over-year changes in%



Source: ECB, Eurostat, Creditreform Rating

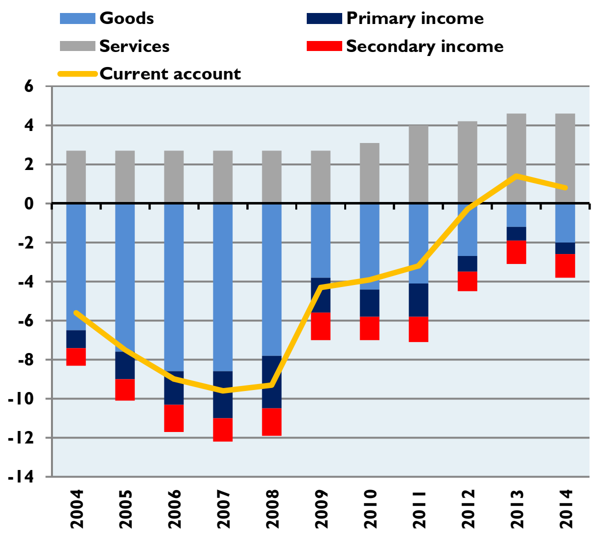
The fact that the declining trend in the real estate market has lost momentum is underpinned by the development in residential construction investments. After the first increase in eight years was registered in the last quarter of the previous year with +2.1% y-o-y, in Q1- and Q2-2015 investment in residential construction exceeded the level of the previous year by 2.4% and 3.3% respectively. In addition to an improvement in the employment situation and financing conditions, the trend for building permits indicates further recovery in the real estate market. In Q1-2015 the number of building permits increased by 4.5% q-o-q, while in the last quarter of 2014 they had risen by 15.7% q-o-q. Furthermore, building activity seems to have reached a trough; in 2014 approx. 2,700 houses were completed per month, compared with approx. 5,400 completed houses per month in 2011 and approx. 14,100 in 2008.

Renewed current account surplus

After the financial crisis, the dynamic growth of exports led to foreign trade becoming the key driver of Spanish economic growth: exports of goods and services increased by 32.2% between Q4-2009 and Q1-2015. Last year the Spanish economy raised its exports significantly by an annual average of 4.2%. However, net exports made a negative contribution to growth in 2014 due to imports concurrently reaching a level of 7.6% y-o-y. Accordingly, the contribution of net exports to growth was at -0.8 percentage points, after raising GDP growth by 1.4 percentage points in 2013.

Fig. 6: Development of the current account balance

Balances in % of the GDP



Source: Eurostat, Creditreform Rating

As a result of a deterioration in the trade balance, Spain's current account surplus was reduced somewhat last year, nevertheless reaching a level of +0.8% of the GDP (see fig. 6). Recently Spain has been successful in significantly improving its current account balance. While a deficit of -9.6% of the GDP was recorded in 2007, this was more than halved within two years (2009: -4.3%), amounting to only -0.3% in 2012 before a current account surplus (1.4% of the GDP) was achieved for the first time since 1986. The adjustment of the current account balance was mainly due to the improvement of the balance of trade in goods (2007-2013: +7.4 percentage points) in view of competitiveness gains on the part of Spanish enterprises, as well as an increasing geographical diversification outside the euro area.

Exports are expected to continue to grow in the current year, supported by a gradual strengthening of economic activity in the euro area as well as in other important industrialized economies. The most important impulses for a buoyant export activity will stem from the depreciation of the euro and increased corporate competitiveness due to a comparatively low growth rate in unit labor costs.

More favorable financing conditions in the private sector

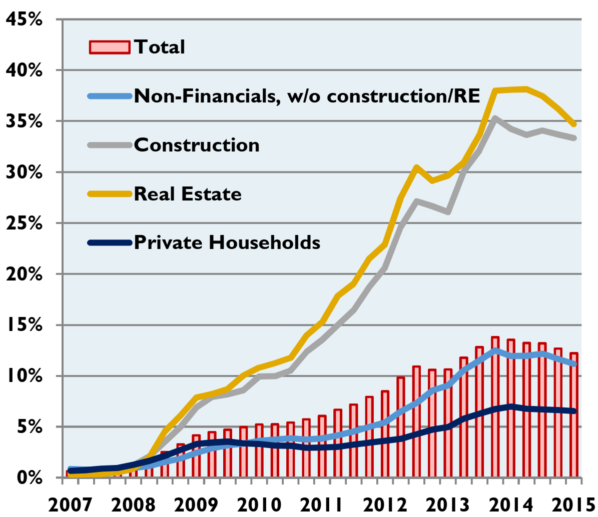
The bursting of the real estate price bubble and the ensuing recession had resulted in severe imbalances in the Spanish banking sector. In order to restore the banking sector and to improve financing opportunities for the private sector, a comprehensive adjustment and restructuring program consisting of two elements, was implemented for the financial sector in 2012 and was successfully completed in 2014. In the course of the recapitalization and resolution of banks, credit institutions received state aid, while nonviable banks were either sold or liquidated. Furthermore, with the SAREB, a bad bank was established to enable banks to transfer their distressed assets.

Moreover, the European Central Bank (ECB) decided in January 2015 to launch the Expanded Asset Purchase Programme, which includes the acquisition of government bonds in addition to the purchase of asset-backed securities and covered bonds. Since March 2015, the ECB has been making monthly purchases in the amount of 60bn euros which have had a positive effect on the refinancing conditions of banks.

Meanwhile, Spanish banks do not only have an improved equity and liquidity position, but also a lower percentage of non-performing loans on their balance sheets. As early as December 2014, Spanish banks exceeded the minimum requirements for common equity tier I capital (CET1) at 11.8%. Concurrently, the proportion of non-performing loans in the total volume of loans, which had been growing over a period of seven years, is currently falling (see fig. 7). In the first quarter of 2015, the NPL ratio fell to 12.2%, from 12.7% at the end of 2014. In March 2015 the reduction of non-performing loans amounted to 26bn euros compared to the previous year. Although the international comparison of the NPL ratio is difficult due to partially varying definitions, in Q4-2014 the NPL ratio in Europe was 6.6%.

Fig. 7: Non-performing loans in the Spanish banking sector

Proportion of NPLs in the total loan volume, in %

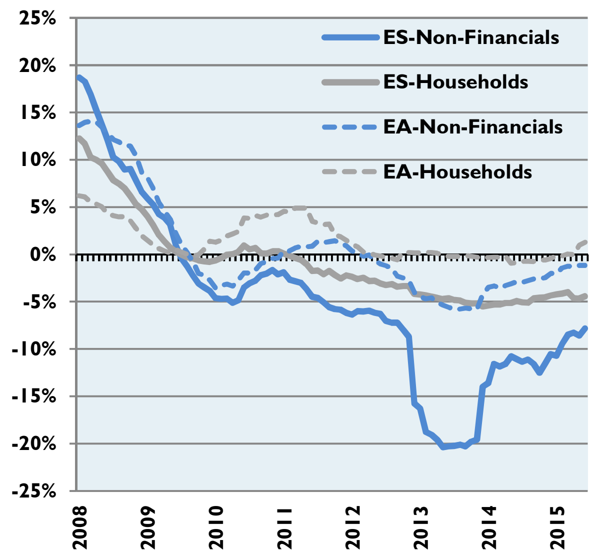


Source: Banco de España, Creditreform Rating

In this environment, characterized by a more resilient banking sector and a recovery in economic activity, financing conditions for households and non-financial corporations have seen significant improvement. Lending in the private sector is still in decline (see fig. 8); nevertheless, the negative trend for loan volumes has moderated noticeably since mid-2013. Loans to non-financial corporations fell by only 8.6 and 7.8% y-o-y in May and June 2015 respectively, after the growth rate had been at -10.5% as late as December 2014. By comparison, in June 2014 the annual rate of change came to -11.1% and in June 2013 to -20.3%. The decline in the volume of loans to households has also slowed significantly in comparison with the last year. While the annual growth rate of loans to households was up from -4.7% in May to -4.4% in June, loans to households had declined by 4.9% in June 2014.

Fig.8: Loans to households and non-financial corporations

Year-over-year changes in %



Source: ECB, Creditreform Rating

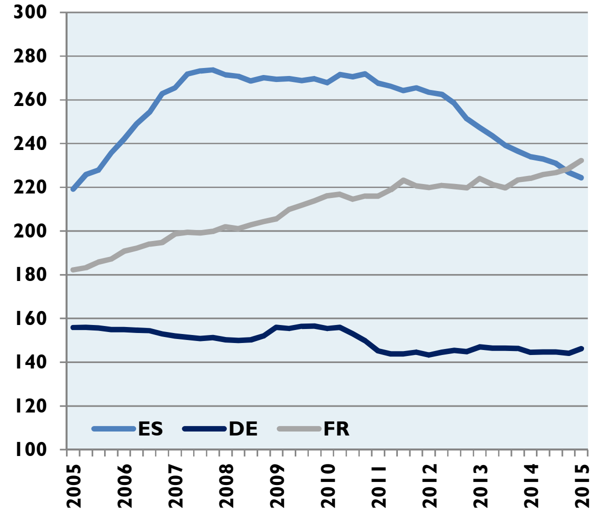
Private indebtedness and high unemployment dampen pick-up in economic activity

However, structural problems remain. Ongoing deleveraging in the private sector and the continuing high unemployment rate still drag on domestic demand.

The financial situation of non-financials and households continued to improve during the last year. However, in spite of the progress made in the process of deleveraging, the level of private indebtedness remains high. Thus private sector debt amounted to 224.4% of GDP in the first quarter of 2015 (see fig. 9). For comparison, at the beginning of 2014 indebtedness was at 233.9% of GDP; down from 247.4% in 2013.

Fig.9: Indebtedness in the private sector

Household and non-financial corporate debt in % of GDP



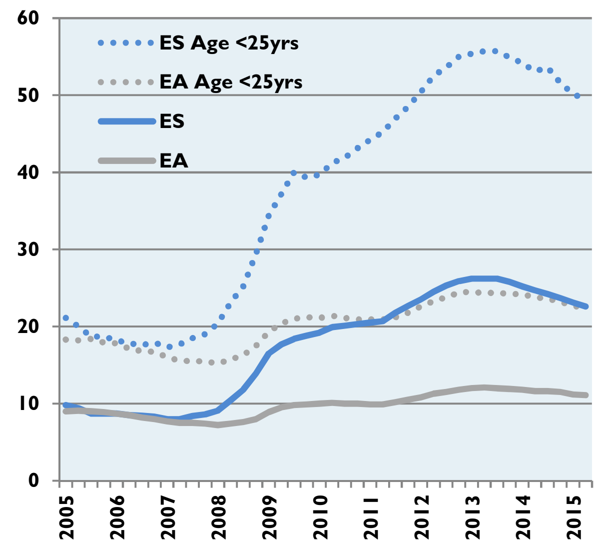
Source: Eurostat, Creditreform Rating

The decline is mainly due to balance sheet repairs in the corporate sector, which reduced its indebtedness from 178.3% to 149.8% of GDP between Q1-2012 and Q1-2015, while households were only able to reduce indebtedness from 85.2 to 74.6% in this period. Measures taken by the government, aimed at promoting out-of-court debt restructuring, were likely among the factors contributing to the positive development in the corporate sector.

At the same time, the situation in the labor market remains tight despite the fact that the employment situation had been recovering since spring 2013 as a result of the pick-up in economic activity and a moderate wage development, gaining momentum in Q2-2015. After unemployment had been rising steadily since 2007 (see fig. 10), the rise in the unemployment rate came to a halt in mid-2013. After peaking at 26.2% in the third quarter of 2013, unemployment in Spain dropped in the following quarters, amounting to 23.7% in the final quarter of 2014. On an annual average, the unemployment rate fell in 2014 for the first time since 2007, from 26.1 to 24.5%. Recently the increase in employment has gained momentum: the unemployment rate declined to 22.6% in the second quarter of 2015 (Q1-15: 23.1%).

Fig.10: Unemployment in Spain and the euro area

Unemployment rate in %



Source: Eurostat, Creditreform Rating

The bold structural reforms implemented by the Spanish government were crucial for the most recent development in the labor market. In 2012, legislation for reformation of the labor market was passed (Royal Decree Law 3/2012) which led to a significant flexibilization of the labor market. A variable handling of collective bargaining agreements was enabled and dismissals made easier by reducing or capping dismissal costs. Furthermore, administrative hurdles for dismissals were reduced and dual vocational training introduced. With the passing of a further law (8/2013) the government implemented new educational schemes (Formación Profesional Básica) to increase the quality of the Spanish education system.

However, further reforms are needed; despite the changing trend in the labor market, the high level of youth unemployment is having adverse effects on economic activity in addition to the structural increase in long-term unemployment, for which the rate was 24% in 2014. At 49.4%, Spain had the highest rate of youth unemployment in the euro area in Q2-2015. In the first quarter of 2007, the unemployment rate for under-25-year-olds was only 17.3%.

Furthermore, the segmentation of the labor market into permanent and temporary employment contracts should be countered. In 2014, nine out of ten new employment contracts pertain to temporary employment. At the end of 2014, 24.6% of all employees in Spain had fixed-term employment contracts compared with 15.2% in the entire euro area.

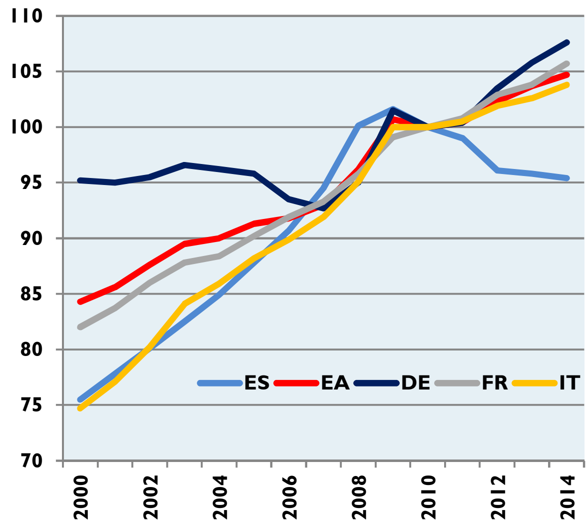
Increase in price competitiveness

The development of labor costs will be key to a sustained recovery of the labor market. In this respect, the available data can be viewed with cautious optimism. Recently, wages and salaries have begun to respond to the overcapacity in the Spanish labor market. In the third and fourth quarter of last year, compensation per employee decreased by 0.1% (y-o-y) per quarter. This effectively brought the rise in compensation per employee to a halt. In 2013 and 2014, labor costs grew by a scant 0.1%, having increased by 4.5% between 2010 and 2012.

The competitiveness of the Spanish economy has improved accordingly in the last few years. Growth in productivity and the moderate increase in compensation per employee have had a noticeable effect on nominal unit labor costs. Since 2009, the nominal unit labor costs in Spain have fallen by 6.1% (see fig. 11). Similarly, the real effective exchange rate fell by 12.0% between 2009 and 2014.

Fig. 11: Nominal unit labor costs

Index (2010=100)



Source: Eurostat, Creditreform Rating

At the same time, consumer prices continue to decline in Spain. In 2014, the annual rate of HICP inflation was -0.2%, having amounted to +1.4% in 2013. The primary reason for this declining trend is the decrease in energy prices, in particular the price of crude oil. Currently, the

HICP inflation rate seems to be recovering from its trough. While the y-o-y rate of change continued to fall at the beginning of the year from -1.1% in December 2014 to -1.5% in January 2015, since February there have been indications of a turnaround: the rate of change increased gradually from -1.2% in February to -0.3% in May, in June and July the price level remained unchanged at 0,0%.

More fundamentally, negative inflation rates are only a reason for concern if they trigger negative repercussions on the real economy. However, this does not currently seem to be the case. A low or declining inflation rate in Spain may even be considered desirable for regaining price competitiveness for Spanish enterprises. As an orientation, the HICP inflation rate for the euro area was +0.2% in July.

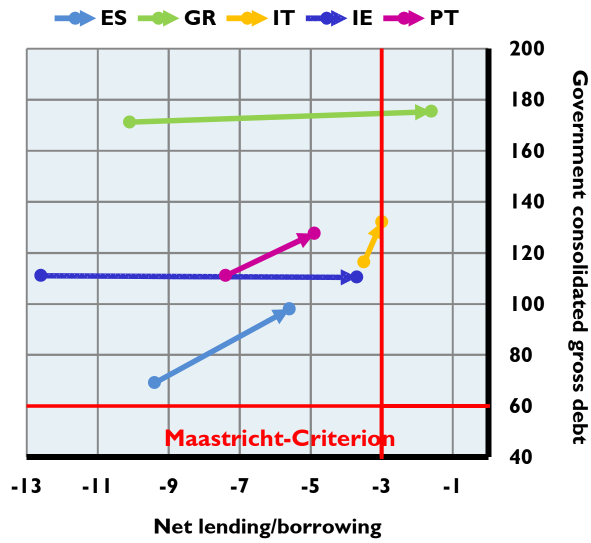
The inflation rate in the coming months will be strongly determined by the development of crude oil prices. The Banco de España is expecting an inflation rate of -0.2% for the current year and +1.3% for the coming year. In the medium to long term, rising energy and raw material prices as well as the depreciation of the euro should lead to a stronger rise in prices at the consumer level.

Efforts towards budget consolidation necessary

The Spanish government has continued to pursue fiscal consolidation, undertaking significant budget cuts. Nevertheless, the public debt burden continued to grow last year. Measured by the economic output, the total indebtedness in 2014 was 97.7%, while in 2011 the debt ratio had risen - with 69.2% - above the ceiling of 60% defined in the Maastricht treaty (see fig. 12). At the same time, the budget deficit has declined significantly: from 9.4% of GDP in 2011 to 5.8% in 2014 – as a result of economic recovery and more favorable financing conditions for the Spanish government.

Fig.12: Budgetary changes between 2011 and 2014

Fiscal balance and indebtedness in % of GDP



Source: Eurostat, Creditreform Rating

According to the EU Commission, the implementation of the preventive, corrective, and enforcement measures contained in the legislation for fiscal consolidation are making headway only slowly. The Spanish government plans to achieve a structurally balanced budget by 2019. The fiscal deficit is to be reduced to 4.2% of GDP in 2015, and to 2.8% in 2016.

Outlook and risk assessment

The economic outlook has improved significantly, which will result in a further pick-up of Spanish economic activity in the medium term. On the whole, Spanish economic growth this year is projected to be well above last year's level. While the real GDP grew by 1.4% in 2014, the Spanish economy is expected to expand by 3.1% in 2015 and by 2.8% in 2016.

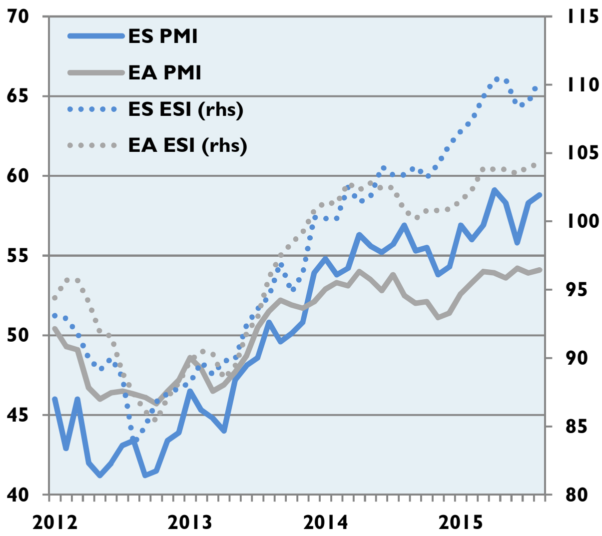
This favorable outlook is primarily the result of two factors. On the one hand, the reform agenda for the labor market and financial sector are crucial. Bold structural reforms on the part of the Spanish government have led to the Spanish economy making significant progress in overcoming macroeconomic and financial imbalances. Underpinned by returning corporate and consumer confidence, more favorable financing conditions, and increased competitiveness, Spanish domestic demand has rebounded strongly. Private consumption and business investment have become key drivers of growth and will spur economic development in the current year.

In addition, the Spanish economy should be boosted by the benign development of external factors, which, however, are of a short to medium-term nature and whose influence will fade out in the course of time. The low energy price level will lead to a significant relief on the energy budget in the private sector, which should have a correspondingly positive effect upon consumption and investment activity. At the same time, the price competitiveness of enterprises resulting from the depreciation of the euro will continue to improve, which should provide the Spanish economy with increased momentum. Finally, Spain's economic development is significantly supported by the ECB's Expanded Asset Purchase Programme.

Early indicators suggest that the economic recovery will gain steam and the economy will develop dynamically in 2015. Hence the European Sentiment Index of the EU Commission (ESI) as well as the Purchasing Managers' Index (PMI) have increased (see fig. 13). Since the beginning of the year, the composite PMI for Spain has risen from 56.9 points in January to 58.8 points in August, indicating that a significant increase in GDP is to be expected. Generally, PMI values above the threshold value of 50 points indicate positive growth. The PMI in the euro area increased from 52.6 to only 54.3 points in the same period.

Fig.13: Early indicators for economic development in Spain and the euro area

PMI (50=Growth threshold value); Economic sentiment indicator (long-term average [1990-2014] = 100)



Source: Markit, EU Commission, Creditreform Rating

The development of the ESI, which combines the sentiment scores of the industry sector, services, consumers, retail trade and construction is likewise optimistic. The Spanish ESI saw a significant increase by 7.0 points and stood at 110.4 points in August 2015, up from 103.4 points in August 2014. This brings the index significantly above the level of the ESI for the euro area, which was at 104.2 points in August 2015 compared with 100.8 points in August 2014.

Regardless of the positive outlook, there are considerable downside risks with regard to the economic prospects in the form of existing structural and emerging political risks. The main risks are the continuing high unemployment rate as well as the high level of household and non-financial corporate debt. In particular with regard to the Spanish labor market, further reforms may help to promote growth. Equally important, further progress made in debt reduction would provide both private consumption and corporate investment with additional impulses.

In this context, the political risks in Spain are of particular importance with regard to Spanish growth prospects. Currently, the established parties have a comfortable majority and the government is largely stable. Political turmoil in the course of the parliamentary elections taking place this autumn could have consequences with regard to necessary reforms. A departure from the current course of reform would be a significant burden on Spanish economic growth. A reversal could entail dramatic growth losses.

Finally, a weaker than expected recovery in the euro area may have a dampening effect on foreign trade with negative repercussions for the industry sector and in particular for investments by Spanish enterprises which, despite declining indebtedness and more favorable financing conditions, would postpone their investments to the future.

Strengths and weaknesses of Spanish economic development

+	Strong expansion of domestic demand
+	Real estate market bottoming out
+	More favorable financing conditions
+	Improvement of price competitiveness
-	Continuing high unemployment
-	High levels of private and public debt
-	A remaining large proportion of non-performing loans

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