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Spain Business Forecast Report Q2 2014

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Abstracts

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Core Views

Spain's economy will return to growth in 2014, due to steady export growth and the progress made on corporate deleveraging. However, a more balanced recovery will be restricted by Spanish household's lack of progress paying down their debts, with much more pain ahead for Spanish consumers. Spain's current account surplus will grow to 2.3% of GDP in 2014, as the country begins re-orientating its increasingly competitive goods exports back to its main trading partners in Europe. Although robust tourism will keep the current account in positive territory for the foreseeable future, inefficient use of these sustained surpluses will limit Spain's long-term growth potential.

Although Spain's budget shortfall will continue shrinking over the next few years, overly optimistic revenue and spending projections will contribute to the government missing its fiscal targets in 2014 and 2015. We forecast the budget shortfall to fall to a worse-than consensus 6.1% of GDP in 2014. Despite inflation registering its lowest December increase in over 50 years in 2013, we believe a modest pickup in domestic demand should prevent price growth pushing into deflationary territory over the coming months. The sharp increase in separatist sentiment in Catalonia is likely to increase political instability in Spain over the next few quarters, with the growing threat of secession likely undermine investor sentiment and raise doubts over the sustainability of Spain's growing debt load. **Major Forecast Changes** No **Major Forecast Changes** Since Last Update.

Key Risks To Outlook

The unbalanced nature of Spain's recovery has left the economy overly reliant on the continued outperformance of the export sector, with the emerging market slowdown increasing the country's reliance on eurozone demand. We would therefore be tempted to downgrade our growth forecasts if leading and high frequency indicators points towards a slower-than-expected recovery in eurozone demand in H114.

Although the dramatic fall in borrowing costs following the announcement of the EU's Outright Monetary Transaction Programme (OMT) could still have further to run, we believe markets have turned overly optimistic towards Spanish and peripheral eurozone local debt markets. With the yield on Spain's 2023 government bond falling below 2006 lows, we caution that a change in sentiment or a slower than expected economic recovery could push up borrowing costs and endanger the country's recovery.

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Although Spain's budget shortfall will continue shrinking over the next few years, overly optimistic revenue and spending projections will contribute to the government missing its fiscal targets in 2014 and 2015. We forecast the budget shortfall to fall to 6.1% of GDP in 2014 against consensus estimates of 6.0%, cautioning that the threat of higher borrowing costs presents downside risks to this
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Banking Sector

Capital Buffers Improving, But Risks Remain We expect negative loan growth and deteriorating asset quality to threaten the profitability of Spain's banking sector in 2014, ensuring that the sector continues to shrink over the next few years.

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Table: Eme rging Markets , Real GDP Growth , %

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