ECONOMIC OVERVIEW

June 2014

Department of Economics
ESADE

Economic Overview

The Spanish Economy

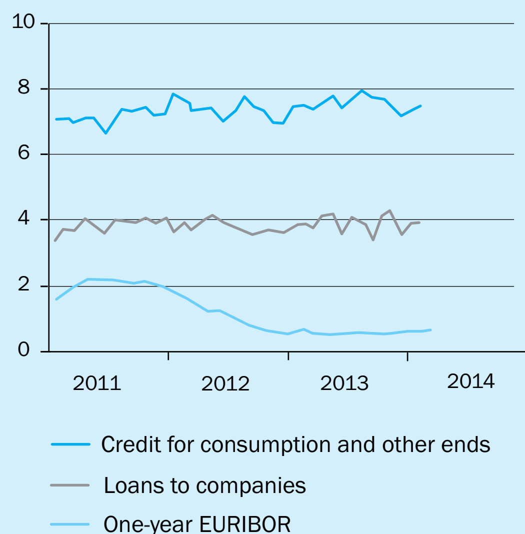
The Spanish economy will grow by roughly 1% in 2014. This figure is towards the top of the range forecast in the January edition of ESADE's *Economic Report*. In the First Quarter of 2014, GDP grew by 0.4%. Household consumption rose by 0.3%. This confirms the change in trend noted in the Fourth Quarter of 2013, when consumption rose by 0.5% — breaking a run of falling consumption over the previous three years. Investment also rose in the First Quarter, maintaining the pace begun in 2013, in which companies' plant purchases rose by 9.5% over the year. This offset falling house purchases. As a result, internal demand grew by 0.2% both in the Fourth Quarter of 2013 and in the First Quarter of 2014. While this is good news, it also reveals that growth is still very weak.

> The Spanish economy will grow by around 1% in 2014

Foreign demand contributed two points (0.2%) of GDP growth in the First Quarter of 2014, in which exports grew slightly faster than imports. Exports swelled thanks to greater competitiveness stemming from wage restraint, rising demand from the Euro Zone and growth in the tourism industry. Imports were spurred by slight growth in domestic demand. However, one should note that Spain's economic recovery does not depend only on exports, it also requires stronger domestic demand. The latter will require a greater flow of credit and higher expectations by companies and households alike.

Financial conditions continue to improve, especially in the public sector and in large companies. The 'risk premium' paid by Spain in floating public debt has fallen below the level

INTEREST RATES



Source: Bank of Spain

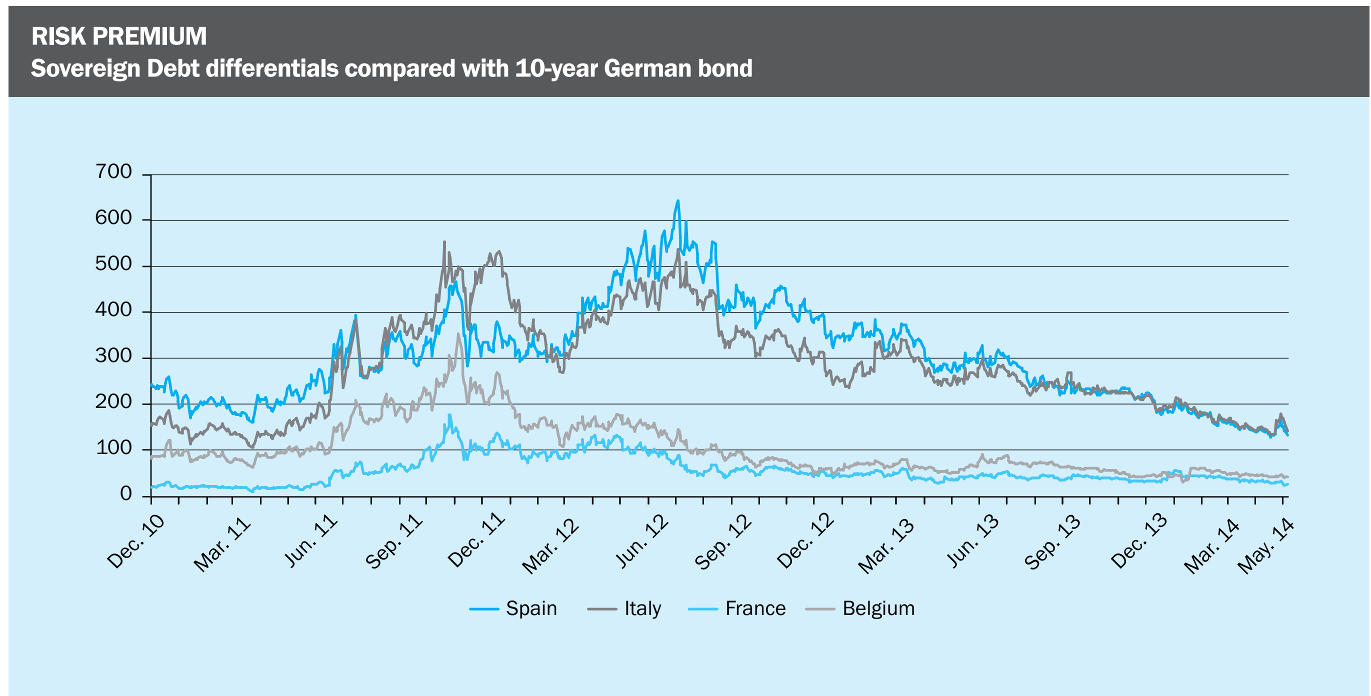
seen before the outbreak of the Greek debt crisis in May 2010. Taking German government bonds as the benchmark, Spain's 'risk premium' fell below 160 points (1.6%) in May. Unfortunately, fragmentation of the Euro Zone's financial system (covered in the last issue of ESADE's *Economic Report*) persists. The interest rates paid by Small and Medium-sized Enterprises (SMEs) remain at the high levels mentioned in our January 2014 report and the rates paid by households have risen.

> The Euro Zone's financial system remains fragmented and Southern Europe continues to suffer a credit crunch and high interest rates

An economic recovery in 2015 will require higher growth rates than the 1% forecast for 2014. Higher growth is needed to stimulate demand and create net employment. Credit must flow again if the economy is to recover. The reform of Spain's banking industry has laid the foundations for greater lending but the fragmentation of financial markets in the Euro Zone and questions surrounding banking stress tests and mid-year evaluation of assets means that lending is still shrinking. The ECB's actions (or inaction) will determine whether or not credit begins to flow again.

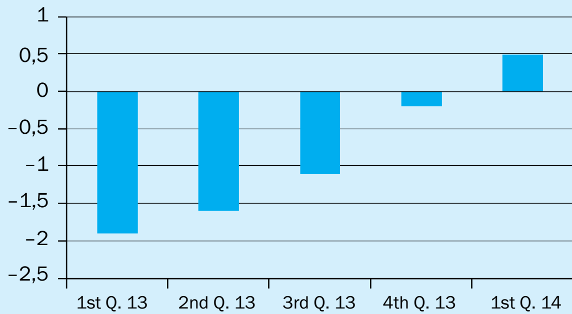
The inter-year inflation rate was negative in May at –0.1%. Since September 2013, inter-annual inflation rates have been under 0.5%. The Spanish economy is thus staring deflation in the face. Some of the causes are temporary ones — for example the elimination of the effects produced by the raising of indirect taxes in the second half of 2012. However, other causes are of a structural nature — falling salaries, weak consumer spending and over capacity. The ECB will have to take strong measures over the next few months if the threat of deflation persists in the Euro Zone.

RISK PREMIUM
Sovereign Debt differentials compared with 10-year German bond



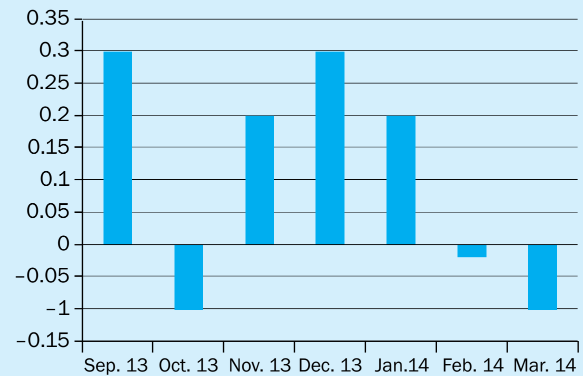
Source: European Central Bank and Bank of Spain

SPANISH GDP GROWTH
Inter-year rates



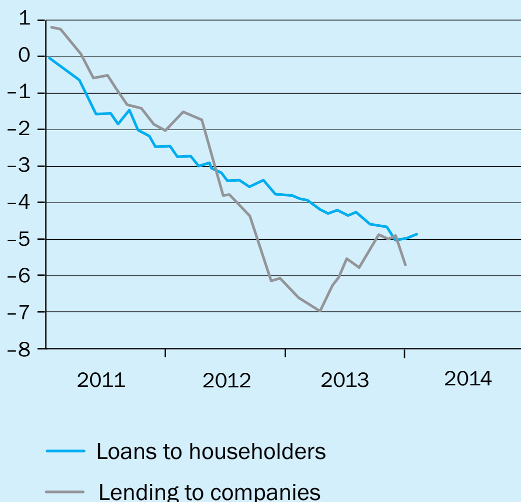
Source: Bank of Spain

VARIATIONS IN THE SPANISH RETAIL PRICE INDEX (RPI)
Inter-year rates



Source: Bank of Spain

LENDING TRENDS
Annual interest rates



Source: Bank of Spain

In May, the European Commission published the results of stress tests on countries with potential macro-economic imbalances. The Commission considered that Spain should no longer form part of this group of nations. However, the Commission insisted that Spain's budget cuts still had some way to go and that major imbalances continued, such as high public and private debt and sky-high unemployment. At the end of April, the Spanish Government presented its Reform Programme to the Commission, spelling out the measures it would take to redress these imbalances. The Commission expressed doubts about the efficacy of the measures taken so far to cut joblessness, which is one of the gravest problems facing Spain.

> The Spanish economy is teetering on the brink of deflation

The Euro Zone Economy

Aggregate GDP growth in the Euro Zone has risen slightly since mid-2013. The general improvement in financial markets, growing exports and higher household and corporate expectations are fuelling this recovery. Yet the fact is that this recovery is still very weak. Furthermore, growth depends heavily on external demand and economic support through public policies — especially in the monetary field.

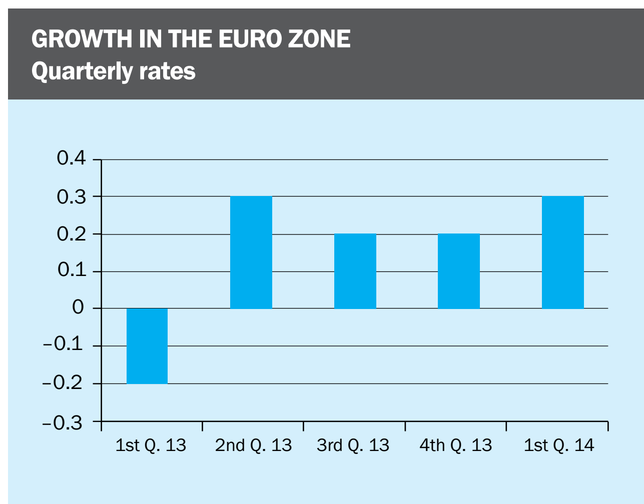
The Euro Zone will grow by 1.5% in 2014 if both present demand and support continue unchanged.

> The Euro Zone will grow by 1.5% in 2014, which is below its potential

Slightly better economic figures for Europe's 'fringe' economies mean that growth will be more even in Euro Zone countries than over the previous three years. Only Italy, Ireland and Finland experienced inter-annual economic contraction in mid 2014 (ranging up to –0,8%), whereas most Euro Zone economies grew by up to 1%. Germany and Portugal grew by 1.2%. Some other 'emerging' Euro Zone economies (Lithuania, Slovenia, Slovakia and Malta) grew by over 2%. Cyprus, still suffering the aftermath of the 2013 financial meltdown, saw its economy shrink by 5%.

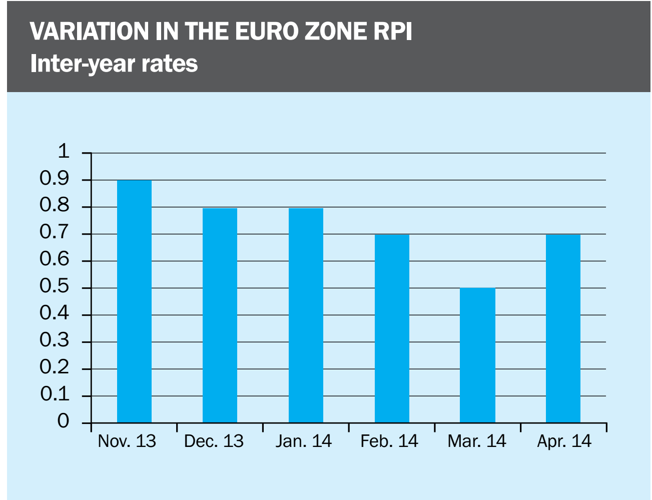
The Euro Zone inflation rate right now is almost 0.5%, which means the threat of deflation will loom throughout the year. Indeed, some economies are already suffering deflation while the rest have very low inflation rates (below 1%). That is why the ECB must take strong measures over the next few months if deflation is to be kept at bay.

GROWTH IN THE EURO ZONE
Quarterly rates



Source: European Central Bank

VARIATION IN THE EURO ZONE RPI
Inter-year rates



Source: European Central Bank

> Deflation threatens as inflation drops below 1%. The ECB will soon have to take strong measures if deflation is to be avoided

The threat of deflation

Since late 2013, the inter-annual inflation rate in the Euro Zone has been below 1%, falling to 0.5% in May 2014. So far, the ECB has accepted prices growing at under 2% during a period of sluggish growth. However, with such low figures, the Euro Zone is teetering on the brink of deflation.

For highly indebted economies in recession, deflation creates a vicious circle in which consumers put off purchases of household goods in the knowledge that they will be cheaper tomorrow. This in turn means slackening demand and pressure to cut prices yet again, causing the economy to spiral down. Furthermore, deflation pushes up the real cost of debt repayments and thus makes the debt burden all the heavier. Whittling debt down to size thus becomes harder, hindering consumption and investment and prolonging the recession.

Economists became all too familiar with the combination of recession and deflation in the wake of The Wall Street Crash. The ensuing Great Depression (or, more popularly, 'The Slump') lasted for much of the 1930s. The ECB's mandate makes price stability a priority but it must steer a middle course between inflation and deflation. This is why the ECB Council stated at its meeting in April that if low inflation rates lasted too long, it would not rule out resorting to *Quantitative Easing* (QE) and other non-conventional measures to stave off deflation.

To stave off the threat of deflation, the ECB may resort to various conventional methods such as cutting interest rates or forcing the banks to pay interest on their deposits with the ECB

The ECB may still use some conventional measures to battle deflation such as: (1) cutting the official interest rate below the present 0.25%; (2) making banks pay interest on the funds they deposit with the ECB to get them to lend out the cheap money showered on them by the Central Bank; (3) the ECB issuing Forward Guidance, stating its intention to keep interest rates close to zero for a long period. However, these measures are likely to fall short of what is needed to fight deflation. The ECB should therefore resort to unconventional means (and sooner rather than later) to keep deflation at bay.

The first measures that should be applied concern *Credit Easing*. The ECB would acquire assets stemming from bank loans to families and SMEs. In January, Mario Draghi described this strategy as one way to rebuild the monetary system and get credit flowing again to families and firms in Europe's most crisis-stricken nations. The ECB would concentrate on purchasing *Asset Backed Securities* (ABS), in other words assets based on securitising corporate loans. However, one drawback is that this market is a thin one in Europe.

Yet these measures may fall short given the sheer scale of the problem. In such case, the ECB should opt for *Quantitative Easing* — which involves acquiring large amounts of public and private financial assets. This strategy is similar to the one followed by the US Federal Reserve, The Bank of England and Japan's Central Bank to deal with their financial crises. The acquisitions would focus on public bonds given that the European corporate bond market is too small for QE purposes. The ECB could purchase public bonds from all countries in the Euro Zone in proportion to either each Member State's GDP or its stake in the ECB's capital. This would ensure that no country would get preferential funding of its public sector debt.

It is highly likely that conventional monetary measures will fall short and that the ECB will have to resort to *Quantitative Easing* and injections of liquidity subject to granting loans or even general injections of liquidity such as those made by the US Federal Reserve

Nevertheless, purchasing public bonds in this way could cause problems in the ECB's balances by including bonds from less solvent countries such as those in Southern Europe. The ECB may opt to buy only the securities issued by countries meet-

Mario Draghi, President of the ECB, with Vítor Constâncio, Vice President of the ECB, after the Governing Council meeting last April

ing certain rating criteria. The bonds issued by solvent Euro countries — Germany, France, Austria, Finland, The Netherlands, Belgium and Luxembourg — are the most likely candidates. Unlike the strategy followed by the Federal Reserve, it is likely that the ECB would prefer to buy a limited volume of bonds in the region of €1,000 million for 9-12 months.

This kind of measure by the ECB would be all the more effective given that the Federal Reserve is winding down its injections of liquidity and would make the Euro depreciate against the US Dollar, thus boosting exports. In addition to bond purchases, the ECB would also buy smaller volumes of private assets arising from loans to families and companies. This would make credit flow once again and would also benefit Europe's 'have-not' nations where the credit crunch is hindering economic recovery.

Present inflation trends make it highly likely that the ECB will adopt QE and other non-conventional measures from June 2014 onwards.

The state of the Banking Union

The Single Resolution Mechanism (SRM) for banking entities was approved in March 2014. This is the second strand in the plan for a Banking Union agreed by the European Council in June 2012. The first strand — The Single Supervisory Mechanism (SSM) — will take effect at the end of 2014 once the results of the banking stress tests and evaluation of bank assets in the Euro Zone are in. The third and last strand — a single bank deposit scheme — remains in limbo.

A Resolution Board will be charged with centralising and coordinating the resolution processes of those entities subject to the SRM. For this purpose, a Single Resolution Fund (SRF) will be set up. The Fund will dispose of €55,000 million, provided through bank contributions. For the first eight years, the Fund will be split into 'national' compartments. In other words, if banks need to be restructured or closed during this period, the funds may only come from those of the country in question. These compartments will gradually become less rigid so that within three years, 60% of the Fund will be a common one. At the end of the eight-year period, all countries will be able to draw on the same kitty without any 'national' limits being imposed.

For the moment, the common mechanism for establishing 'the lender of last resort' has yet to be decided. Such support is of vital importance given that the size of the Fund (which is fairly small) would not be enough to deal with a grave financial crisis and a run on the banks.

The Banking Union is vital for ending the current fragmentation of financial markets in the Euro Zone. Without such a Union, it will be impossible to end the Euro crisis. However, it should be borne in mind that deflation means The Banking Union though necessary is far from sufficient. To get the ship back on an even keel, the ECB needs to use unconventional policy instruments such as *Credit Easing* or even *Quantitative Easing* over a longish period.

ABOUT THIS PUBLICATION

This Overview is based on *ESADE's Economic Report, June 2014*, produced by the Department of Economics (http://itemsweb.esade.edu/biblioteca/archivo/informeeconomicojunio2014.pdf). This article was written by Prof. Josep M. Comajuncosa. The original document was produced with the support of Banc de Sabadell. If you would like any further information on ESADE, our Department of Economics or our professors, please contact our International Communication Department (esadenews@esade.edu + 34 912 526 855).

ABOUT ESADE

Founded in 1958, ESADE now has campuses in Barcelona, Madrid, Buenos Aires and São Paulo and collaboration agreements with over 100 universities and business schools worldwide. Each year, more than 10,000 students participate in its courses (MBA and Executive Education, as well as undergraduate and master's programmes in law and business administration). Its business park, ESADECREAPOLIS, is a pioneering innovation centre where the university and business worlds unite. With a clear international outlook, ESADE was ranked near the top of the main business-school rankings in 2010 (*Financial Times, Wall Street Journal and BusinessWeek*). ESADE currently has a network of more than 44,000 alumni occupying positions of responsibility in enterprises around the globe. Since celebrating its 50th anniversary, ESADE has adopted "Inspiring Futures" as its institutional motto to illustrate the goal of fostering a spirit of renewal in the fields of business and law.

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