RESEARCH

# Economic Outlook

## Spain

First Quarter 2012
Economic Analysis

- **2012: uneven growth in Europe,** which will lag the rest of the world.
- **Fiscal adjustment in Europe:** needs to be continuous and rigorous to be credible, and balanced to prevent the recession from deepening.
- **Spain, in recession again,** faced with the challenge of preventing massive job destruction.
- **Bolstering growth prospects requires the same ambition** in labour and financial reforms as in fiscal consolidation.

# Index



Closing date: February 3, 2012

# 1. Summary

## Global growth slows...

Global economic growth slowed considerably in the final quarters of 2011 due to the weaker growth in Europe (contraction in the fourth quarter) and in emerging economies. However, the reasons for the slowdown in the two areas could hardly be more different. Whereas Europe suffered from persistent financial stress given the lack of any meaningful progress in resolving the crisis, emerging economies performance is the result of, among other reasons, more restrictive policies designed to prevent over-heating.

## ...but should gather momentum in the second half of 2012

Looking ahead, global growth should pick up in the second half of 2012, led by emerging economies as their domestic policies become more accommodative for growth in domestic demand. Meanwhile, although the US is likely to grow slower than during previous recoveries, it should significantly outpace Europe, which looks set to see GDP contract by 0.5% in 2012 and a slow recovery in 2013. We would point out that these forecasts depend on a relatively quick solution to the debt crisis and a considerable reduction in financial stress so as to prevent a larger impact on growth. The gap between core and peripheral growth rates should remain large, in part due to sharp fiscal adjustment and deleveraging in peripheral countries.

## Risks are still on the downside, awaiting European policies that reduce uncertainties

Although some progress has been made since October, a definitive resolution to the European crisis requires more decisive action on three fronts. First, concerns surrounding Greece's solvency must be cleared up in an orderly fashion and as quickly as possible, with an agreement with private sector bondholders. At the same time, the mechanisms created to prevent contagion in countries that are solvent, but faced with liquidity problems, must be increased and made more flexible to become more effective. Second, structural reforms that stimulate growth must be introduced, including reforms to make financial institutions stronger without triggering sudden deleveraging and restricting credit. And third, the governance agreements approved recently in the Eurozone must begin working so they can provide a clear roadmap to fiscal union, strengthen monetary union, prevent future crises and enhance the credibility of European institutions and countries.

As the improvement in governance becomes evident, Europe's institutions should focus on reducing structural deficits and not nominal, or current, deficits without adjusting for the economic cycle, in order to avoid fiscal policies more pro-cyclical than strictly necessary, with the negative consequences on growth; and, also, to boost that adjustment measures will be structural.

## Spain back in recession again

In addition to correcting its economic imbalances, Spain has seen confidence erode, export growth fall, expectations of deeper fiscal adjustment in 2012 because of the failure to meet 2011 budget targets, weaker activity and, above all, a deterioration in employment in the fourth quarter last year. Estimates for 2011 show average GDP growth of 0.7%.

Confirmation of increased uncertainty bodes for a worsening in key fundamentals for the Spanish economy. On the one hand, access to financing looks likely to remain tight and expensive because of Europe's financial debt and banking crisis. Meanwhile, the increase in risk premiums, coupled with more ambitious fiscal plans than considered a year ago and also the slowdown in international trade, has dimmed growth prospects for Europe, which is likely to result in weaker demand for Spanish exports. On the domestic front, the main change stems from the deviation from the budget deficit target. While all this means a sharp cut to economic growth forecasts for Spain, there are some mitigating factors. For instance, the ECB's monetary (and liquidity) policy is more prone to supporting demand and financial stability than expected three months ago. This, together with an increase in the growth differential between Europe and the rest of the world, should cause a weaker euro, which could speed up competitiveness gains for exporters.

## Forecasts point towards a 1.3% contraction of GDP in 2012, and a slow recovery in 2013, which could come faster if the announced structural reforms are ambitious enough

In short, GDP looks set to contract in 2012, and if current circumstances remain, the recovery will be slow. The outlook could change if ambitious structural policies are adopted swiftly and decisively. If they are implemented properly, the adjustment would be less painful (especially in terms of employment), paving the way for a faster and stronger recovery.

The deviation from the 2011 budget deficit target undermined the credibility of all public administrations. Therefore, it is even more urgent now to adopt measures that make up for the shortfall in 2011, that guarantee that targets are actually reached this year, that implement effective control mechanisms on autonomous communities (the main culprits), and, in short, that restore the credibility of public accounts in general.

In this respect, the government's response has been firm and well received, but it is still not enough to ensure that this year's target will be met. Turning to the Social Security, its reliance on job creation to generate income and its inflexible spending make it unlikely that this year's targets will be achieved.

## With the Budget Stability Organic Law, Spain is acting ahead of the enforcement of the Stability Pact to be signed by 25 European countries at the next meeting

Regarding the medium-term commitment to stability in public finances and control over the autonomous communities, the Draft Organic Law on Budget Stability sends a clear and firm message to the rest of the European partners. Spain is one of the first countries to adopt this type of legislation and, in principle, it will do so with a broad political consensus. The Draft Law contains several proposals defended in this publication, such as the definition of fiscal target in the structural deficit, the generalisation of a fiscal rule at all levels of public administrations or more transparent reporting for a correct assessment of fiscal policies. It also promotes practical and credible instruments for encouraging compliance with these rules. However, the approach to be used for defining the stage of the economic cycle has not yet been made public. A clear, simply method that can be reproduced easily and assessed externally is also a necessary condition for the reform to achieve the desired level of success. Moreover, it must state explicitly that the deficit target must be established in structural terms and there must not be any confusion regarding the conditions for speeding up the debt reduction process so that fiscal policy does not lead to pro-cyclical actions that could cause imbalances.

## The new labour market reform should prevent that the adjustment in 2012 concentrates on job destruction again

Because of the rigidities facing companies and workers to changing their working conditions, the adjustment to the Spanish labour market between 2007 and 2009 focused on employment rather than on the number of hours worked. That's why the commitment to internal flexibility mechanisms and the call for wage moderation and productivity-linked remuneration (included in the agreement on employment and collective bargaining in 2012-2014) are a step in the right direction, but not enough. The new labour reform must drive internal flexibility as an alternative to job destruction. With an unemployment rate approaching 23%, Spain's labour market requires particularly determined measures. To be precise, safeguard clauses should be removed to prevent temporary increases in prices from being passed on to wages and generating an inflationary spiral through second-wave effects. In addition, the current structure of collective bargaining must be updated and the system of wage opt-out clauses must be made more flexible. Therefore, the government must make brave proposals that go beyond what has been agreed until now by the trade unions and employers and that prevent the expected economic slowdown in 2012 from causing employment to plummet.

## Spanish financial system: a positive restructuring that must be finished

The economy minister announced last February a Restructuring Plan for the Spanish financial system. The new measures imply a step forward because they push for a more aggressive provisioning of potential losses in the real estate portfolio of financial entities using more realistic hypothesis in asset valuation. These more demanding requirements will have a sizeable or small impact on the future configuration of the sector depending on how aggressive their implementation is. Another positive aspect of the Plan is that it minimizes the use of public funds, which will be limited to contingent capital injections, at market prices, in the entities that can't increase their provisions on their own.

For the current restructuring process to be a success it is important that the main goal remains to reach a more efficient financial system, well managed, with sustainable profits and able to obtain financing in capital markets. All of this requires less fragmentation. For this, after identifying unviable entities, it is necessary to give them a definitive solution; giving incentives to adequate mergers and acquisitions based on strict economic efficiency criteria. Besides, the speed of the adjustment to reduce excess installed capacity has to be increased, both in terms of offices and staff. Finally, it is necessary to start building the foundations so that credit starts reaching productive activities, in a way that the necessary deleveraging doesn't prevent sectors and enterprises with good future perspectives be financed.

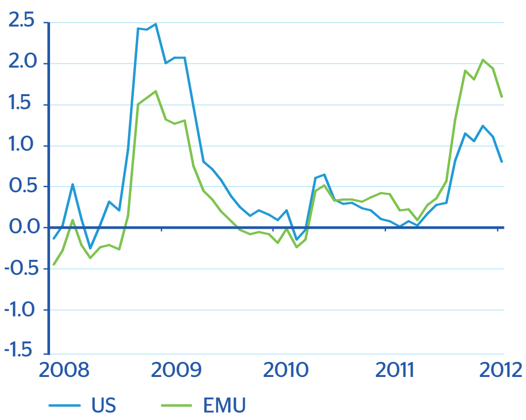
# 2. Global slowdown and recession in Europe

## The global economy slowed at the end of 2011, but should recover in the second half of 2012, driven by emerging economies

Global economic growth slowed down sharply in the last few quarters of 2011, except in US. This was caused by weaker growth in Europe (with a contraction in GDP in the fourth quarter) and a slowdown in emerging economies, which registered quarterly growth of around 1% at the end of 2011, their lowest rate since the 2008 crisis. That said, the reasons for the slowdown in the two areas could hardly be more different. Europe is starting to feel the effects of chronically severe financial stress since September (see Chart 1), given the limited headway that has been made in resolving the sovereign and financial crises. In the emerging economies, the slowdown is not only the result of the deterioration in the international environment, but also the less accommodative tone of economic policies until the first half of 2011 so as to prevent over-heating.

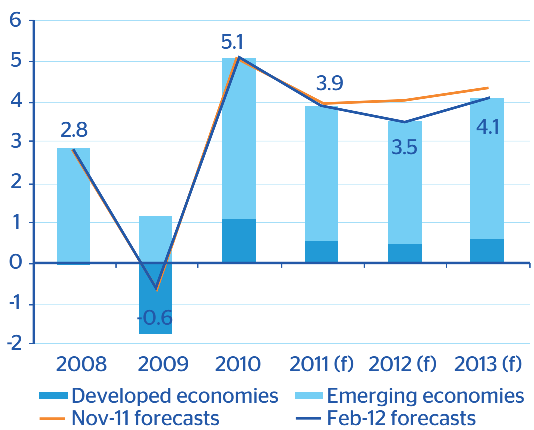
Looking ahead, we expect firmer action by European authorities to gradually reduce financial tensions in Europe as well as global risk aversion, resulting in an improvement in the global economy in the second half of 2012. However, emerging economies should be the main driver of recovery, as they once again outpace developed countries by around 4 percentage points (pp), with their economic policies gradually giving a mayor support to growth . Meanwhile, although the US is likely to grow more slowly than in previous recoveries, it should decouple from Europe's recession in the first half of the year. Due to all these factors, we have reduce our global growth forecasts from November by 0.6pp for 2012 and 0.3pp for 2013, to 3.5% and 4.1%, respectively (see Chart 2).

Chart 1
**BBVA financing stress index**




Source: BBVA Research

Chart 2
**Global GDP growth (%)**




Source: BBVA Research and IMF data

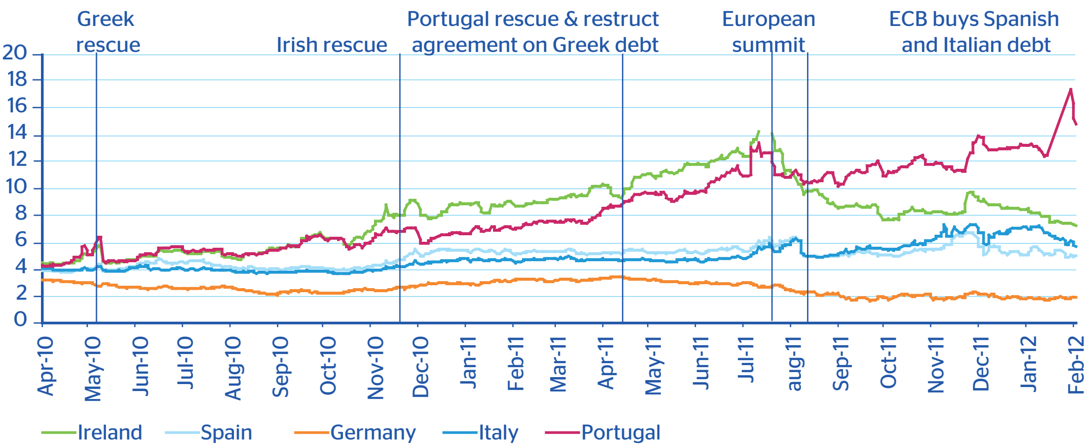
## The lack of decisive progress in resolving the European crisis makes the euro area the main threat to global growth prospects

Even after cutting growth forecasts for Europe and emerging economies, the risks to the outlook for global growth are still on the downside. Much will still depend on how the financial and sovereign crisis in Europe unfold, which hasn't decreased significantly and this could deepen the ongoing recession and trigger contagion in other regions through trade links, financial exposure and increased global risk aversion.

Although some advances have been made to resolving the crisis in Europe (mainly the provision of long-term liquidity by the ECB and certain agreements for greater fiscal discipline) major progress much be made on three key lines of action. First, on the sovereign front, concerns over Greece's solvency must be removed via an agreement with private bondholders. Is important that Greece restructuring become, as overtake October summit, in an isolated case. At the same time, resources must be available to set up a major firewall (and one that is credible) to prevent contagion in liquidity-strapped countries. Second, further reforms must be encouraged to increase growth, including cleaning up the balance sheets of financial institutions, but without triggering a sudden deleveraging and a reduction in credit to the private sector. Third, greater process in governance in the Eurozone is needed to bolster monetary union, helping to erect sovereign firewalls and designing a clear roadmap to fiscal union.

In accordance with all these three points Europe's prospects would improve considerably if the fiscal pact, which will presumably be agreed on at the March summit, is finally approved at country level and applied promptly, along with the economic reforms proposed for the peripheral countries to make them less vulnerable and boost their growth in the long term. Swift execution of this part of the "major pact" implicit between core European countries and the peripherals would shift the topic of debate to the application of two urgent measures to relieve sovereign stress in Europe. First, to build up available funds fast in order to erect a sovereign firewall around Greece, perhaps requiring more decisive action by the ECB. And second, to bear in mind the negative impact of weaker economic growth on the ability of most European countries to meet the deficit targets agreed with the EU.

Chart 3
10-year sovereign yield spreads




Source: BBVA Research based on Bloomberg data

## Tensions in the Eurozone continue, despite the ECB's liquidity provision and timid advances on governance.

The European Council's December 2011 summit culminated in measures aimed at tackling the stress in Europe's peripheral sovereign markets, but on their own they were not sufficient to bring about any significant reduction in the spreads on peripheral debt. The decisions taken at the summit were significant, reflecting an overall strategy that involved peripheral countries accelerating their fiscal and structural reforms, and the European Union putting in place a tougher framework for future fiscal discipline (precisely what the core countries, led by Germany, were seeking), although this is still a long way off fiscal union.

The strategy has already borne some fruit. The pace of reforms has quickened in the largest of the peripherals, Italy, where the new Government has taken initiatives to eliminate the public deficit between 2012 and 2013 and has introduced far-reaching structural reforms that have so far affected the pensions system and certain service markets. Portugal has continued with important labour market reforms, but the country is facing a major adjustment to its structural deficit in 2012 (6pp of GDP). In Spain, the new Government has taken some measures on the fiscal front and is now preparing for reforms of the financial system, with a new framework of provisions, and the labour market, while at the same time dealing with higher-than-expected fiscal deficit. The major fiscal adjustment taking place in peripheral countries is likely to have a negative impact on GDP in the short t term, although the impact on market confidence is less clear, due to the fact that the negative link between adjustment and growth may result in failure to meet the fiscal targets. Overall, the peripheral countries appear to be heading in the right direction with their consolidation and reforms, but the imbalances built up in recent years are going to take some time to correct (see Box 1).

With regards to Europe's economic governance reforms, an agreement was reached in December to draw up an intergovernmental treaty to introduce fiscal rules at a national level in order to prevent the structural deficit from exceeding 0.5% of GDP. The introduction of some form of eurobond appears to have been ruled out for the time being, and it is really only considered a possibility over the medium/long term, once peripheral countries have reduced their deficits. That is to say, it is unlikely to help resolve the short-term confidence crisis.

Ahead of the December summit, it had been hoped that progress towards greater fiscal discipline would enable the ECB to intervene more in sovereign debt markets, thereby helping to ease sovereign spreads. But this kind of intervention never materialised but the buy bond program trough SMP is still working. However, ECB strategy, via the provision of unlimited liquidity over much longer terms than previously (3 years instead of 3 or 6 months), had some success in terms of increased confidence in the European banking sector's chances of solving its funding problems, in one side, and have allowed reduce sovereign interest rates above all at the shorter term, with part of the surplus liquidity being used for purchasing peripheral public debt. However, most of the liquidity absorbed by the banking system has found its way back to the ECB via its deposit facility. At the same time, the ECB has completed its liquidity provision policy with two benchmark rate cuts in November and December (1.5% and 1.0%, respectively). All in all, it has been a roundabout strategy that may gain time; but it is not going to either resolve the underlying problems definitively, linked to the lack of confidence in sovereign debt and to the ECB's reluctance to assume its role as lender of last resort, or restore the channels for the transmission of monetary policy.

The next steps in the strategy to reduce financial stress involve the signing of the intergovernmental treaty in March (25 of the EU countries) and then its ratification by the individual countries. This treaty has to reinforce fiscal discipline over the medium term and gives Europe's core countries with confidence to provide further support via the liquidity mechanisms. Greater intervention from the ECB directly in debt markets cannot be ruled out, but it looks unlikely, except in the case that tensions increase. It is something it has not done up until now because of its doubts about the legality of such mesure, and its concerns that its role as lender of last resort does not cover public debt. It is precisely for this reason that other mechanisms for providing liquidity need to be well funded. The existing mechanism, the EFSF, has only been used for rescuing Ireland and Portugal, and this following several delays. The introduction of the ESM, which will replace it and be permanent, has been brought forward from mid 2013 to July 2012, but the planned size of its funding (€500Bn) is not sufficient to dispel market fears of contagion to Italy and Spain in the event of a disorderly crisis in Greece; that is to say, it cannot play the role of firewall and restorer of confidence on its own. To achieve this, new contributions are needed from the IMF (€150Bn already committed by Europe, plus what other countries can provide) and perhaps,with the EFSF running alongside the ESM. In order to create a credible wall of liquidity, the combined funds need to total more than a trillion euros.

## We are likely to see a moderate recession in the Eurozone in 2012, with a return to core/non-core divergences

In short, the Eurozone finds itself dealing with a sovereign crisis that has deteriorated since the summer, and using a strategy that is based on convergence towards fiscal union but is understood more as a control mechanism than as a sharing of the debt burden, and at the same time with an insufficient liquidity firewall; which is why interest rates remain high. Added to this, the fiscal adjustment is that much bigger than expected only three months ago, in a context of moderate recession for the Eurozone as a whole and slower growth globally.

The latest data confirms this negative outlook. After an upbeat first half, Eurozone activity slowed in the third quarter, with the confidence and PMI indicators falling sharply as of September, although the last two months have shown a more moderate trend. These setbacks are linked with mounting financial stress and a contraction in domestic demand, while the stabilisation coincided with the ECB's liquidity provisions. The end result is forecast GDP for the fourth quarter of -0.3% qoq.

Looking ahead to the next few quarters, the European Summit in March ought to encourage a gradual narrowing of spreads during the second half of the year, together with a recovery in confidence, built around the stronger position of Germany and other Northern European economies. The first half is likely to bring further decreases in GDP, albeit moderate, before a return to positive growth during the second six months. The year as a whole, however, is likely to show GDP contracting (around -0.5%), with Germany and other Northern European countries registering moderate positive growth, France around zero growth, and the peripheral countries negative growth (particularly Portugal and Greece).

## Emerging economies are heading towards a soft landing, helped by resilient domestic demand. Economic policies are likely to become more growth-oriented

An important aspect of this stage of the crisis is that confidence in emerging economies has proved highly resilient compared with the period that followed the collapse of Lehman Brothers in 2008. One of the reasons behind this resilience could be the element of surprise involved in the Lehman collapse (did not exist with the European crisis) and also the different speeds at which the two episodes have unfolded (the European crisis has progressed in "slow motion"). The result has been that domestic demand in emerging economies has remained robust, and this despite the knock-on effects from increased risk aversion felt by their financial markets, such as lower capital flows, certain negative effects on international trade finance, lower asset prices, and low exchange rates.

The slowdown in emerging economies in 2011 led to a decrease in the growth differential between these and the advanced economies to almost 3pp at the end of 2011 (below the 4pp seen pretty much continuously since the beginning of the previous decade). We would expect risk aversion to remain high, but we would also expect it to start diminishing slowly during the second half of 2012, in line with the expected gradual easing of tensions in Europe. Economic policies are also likely to take advantage of the existing room for manoeuvre (reduced inflationary pressures and some margin for fiscal expansion), becoming increasingly growth oriented and contrasting with the austerity witnessed during early part of 2011. This should ensure that domestic demand continues to buoy growth in region, while the backdrop for the external sector remains difficult, due to the situation in the developed economies. In such an environment, is expected that the emerging economies return to quarterly growth rates of around 2% by the end of 2012 (1% at the end of 2011), with full-year growth expected at around +6.2%. The main exception to this rule is likely to be found in emerging countries in Europe, where economies will be more affected by their closer financial and trade links to the Eurozone.

## Box 1. European Commission structural imbalance indicators. The cases of Portugal and Spain

One of the main lessons from the deep recession of 2009 and the current sovereign crisis is the need to control macroeconomic imbalances in Eurozone countries that go beyond just public debt and public deficits, because a large part of the excesses built up over the last decade involve problems relating to competitiveness and growth in private debt. For this reason, the European Commission recently announced, as part of its new "Six Pack" initiative, a series of indicators that it will be tracking closely, as part of the European Semester project, in order to avoid extreme imbalances in the future. The variables to be controlled include imbalances relating to the private sector (private debt, loan growth, housing prices), to the external sector (current account balance, net external debt), competitiveness (real effective exchange rate, unit labour costs, changes in export market share) and unemployment rate. For each of these, a risk level is to be set, and if and when broken, the Commission will pay special attention, recommending corrective action when necessary. Chart 4 shows these variables, plus public deficits and debt, for Spain and Portugal, normalized to the European average. The units on the chart's axes show the standard deviations versus the Eurozone average.

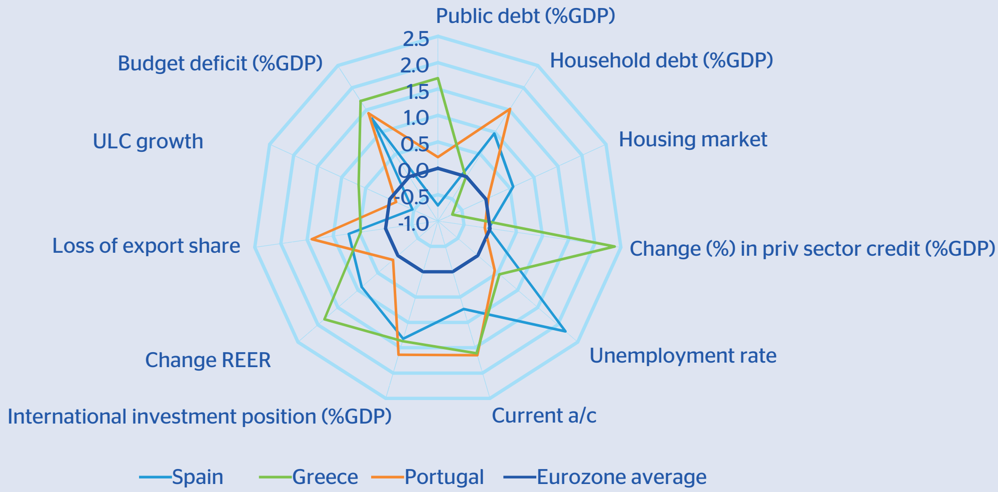
The case of Portugal is important, because it is the markets' new focus of attention, now that the Greek issue is on the way to being solved (at least in the short term), following S&P's downgrading of its Government debt to junk bond status. The performance of its 10-year spread with other peripherals, and its recent decoupling from Ireland, indicate that the weak of Portuguese economy is, according to the markets perception, important.

Portugal has a big external deficit, which over the years has turned into an extremely negative international investment position, reflecting a significant loss of competeveness in recent years. In addition, public sector debt and, above all, private sector debt are above the European averages, and the public deficit is still extremely high. These problems, together with the country's low potential growth capacity, have set the alarm bells ringing in the private investor community; but they are not new problems, and, with the exception of the two relating to public debt and the budget deficit, they have been there for several years.

What has changed recently with regards to the Portuguese economy is in the field of economic policy: the Government has approved a far-reaching labour market reform, and it has taken measures to reduce unit labour costs via wage cuts; and, in addition, it has met the European Union's fiscal consolidation requirements, which imply a major structural adjustment for 2012 (6pp of GDP). Due to the nature of the problems facing Portugal (mainly linked to imbalances that can only be corrected over the medium and long term), it is important that the reforms are allowed to take effect; and in the meantime the economy's financing needs to be assured. Providing the fiscal adjustment is completed and that the ambitious reforms continue, there is every reason to believe that Portugal, unlike Greece, will be able to avoid a restructuring of its public debt. Having said this, if the current financial stress continues, Portugal is going to find it difficult to return to the financial markets in 2013, meaning that it will continue to depend on financial aid for longer than initially forecast.

In the case of Spain, the relative size of the imbalances is smaller than in Portugal, and they are also focused on fewer areas. Spain stands out for its high unemployment, and also its massive net external debt, which reach 89.2%) which is way above the level considered by Brussels as "dangerous" (35% of GDP). Its public deficit is high, but not its public debt, which is below average. As for its competitiveness, the indicators show unit labour costs to have eased, and while the current account deficit remains high it has dropped significantly over the last few years. It is also worth pointing out that Spain's export market share has hardly fallen at all in recent years, especially compared to the Eurozone.

Chart 4
### Macroeconomic imbalances




Source: BBVA Research based on Eurostat, OCDE, BCE, OMC and domestic sources

Table 1
### Imbalance indicators

| | | | Spain | | Portugal | |
|---|---|---|---|---|---|---|
| | | Limit | | a | | a |
| 1 | Private sector debt | > 160% of GDP | 280.9 | 3Q '11 | 253.2 | 3Q '11 |
| 2 | Private Sector credit flow | > 15% of GDP | -9.7 | 3Q '11 | -2.1 | 3Q '11 |
| 3 | Government debt | 60% of GDP | 81.0 | 3Q '11 | 93.6 | 3Q '11 |
| 4 | House prices relative to household consumption deflator | +15% yoy | -2.4 | 4Q '11 | -3.7 | 3Q '11 |
| 5 | Unemployment rate | 3-year moving average +10% | 22.0 | 4Q '11 | 12.8 | 4Q '11 |
| 6 | Net international investment position | -35% of GDP | -93.0 | 3Q '11 | -102.8 | 3Q '11 |
| 7 | Current account | 3-year moving average -4% of GDP | -3.9 | 3Q '11 | -8.4 | 3Q '11 |
| 8 | Real effective exchange rate | Change rate respect to 3 years ;+/- 5% | -4.0 | 4Q '11 | -3.7 | 4Q '11 |
| 9 | Unit labour costs | Change rate respect to 3 years ;+/- 5% | 8.3 | 3Q '11 | 5.3 | 3Q '11 |
| 10 | Export market share | Change rate respect to 3 years -6% | -5.2 | 3Q '11 | -10.5 | 3Q '11 |

Sources: (1), (3) and (7) National sources, (2) ECB, (4), (5) (6)y (8) Eurostat, (9) OECD and (10) FMI via HAVER and BBVA Research

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# 3. Growth outlook for the Spanish economy

## Recession confirmed for 2012

The last three months have confirmed the fears expressed in previous editions of this publication, in which we drew attention to the adverse interaction that was taking place between a number of factors, presenting a serious threat to the outlook for the European and Spanish economies. Of particular concern was the combination of slower economic growth in developed economies and the growing uncertainty in the sovereign debt markets, which was resulting in a decrease in the perceived solvency of financial institutions and also in fears about the impact that this could have on the provision of credit and, once more, on the growth outlook. At home, and despite the corrections introduced to tackle the economy's imbalances, Spain has also had to face falling confidence, slower exports, an uncertainty about its economic policy (caused by the change in Government and the growing likelihood that the country will fail to reach its fiscal targets), the result being a deterioration in activity and, above all, in employment during the final quarter of the year. Estimates suggest average GDP growth of 0.7% in 2011, insufficient to create employment.

## Looking ahead, confirmation of increased uncertainty bodes for a worsening in key fundamentals for the Spanish economy

Firstly, access to credit looks likely to remain restricted and relatively expensive. And secondly, the increase in risk premiums, coupled with more ambitious fiscal plans than considered a year ago and the slowdown in international trade, has dimmed growth prospects for Europe, and this is likely to mean weaker demand for Spanish exports. As for the domestic factors, the most important change involves the deviation from the Government's budget deficit target and the measures announced for offsetting this. Not only has fiscal policy been more restrictive than expected only three months ago, the performance of the economy over the last two quarters has also fallen short of expectations. This in turn has made a environment more difficult to its execution, as private demand is still incapable of offsetting the negative impact on growth caused by fiscal consolidation.

While all this means a sharp cut to economic growth forecasts for Spain, there are some mitigating factors. For instance, the ECB's monetary (and liquidity) policy is more prone to supporting demand and financial stability than expected three months ago. This, together with a wider growth differential between Europe and the rest of the world, should bring about a weaker euro, speeding up competitiveness gains for exporters. And finally, the current outlook calls for the introduction of ambitious structural policies, which, if carried out properly, could bring about a less painful adjustment (especially in terms of employment), paving the way for a faster and stronger recovery.

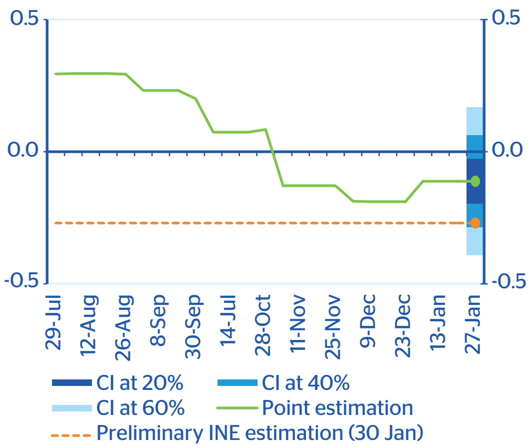
In short, GDP looks set to contract in 2012, and if current circumstances remain, the recovery will be slow. This assessment could change if, as we said before, the decision is taken to introduce measures that correct the main underlying problems in the Spanish economy (high unemployment, segmentation of the labour market, lack of competitiveness, etc...), as we have been proposing in previous editions of this publication.

## The Spanish economy in 2011: from moderate growth to recession

After a 2010 dominated by continued financial stress in Europe and the stepping up of the fiscal consolidation process, 2011 was supposed to be the year in which the Spanish economy would shake off recession and initiate tentative growth that would gradually find traction and give rise to the first positive signs from the labour market during the second half of the year. However, the data available so far shows that 2011 has been disappointing on all these fronts: Europe's financial and governance problems are still awaiting a final resolution; and Spain failed to meet the 2011 targets for fiscal consolidation. Despite the fact that full-year growth was actually in line with what we had been forecasting at the beginning of last year, the pace of growth diminished, sending the economy towards recession during the final part of the year, auguring deterioration in the labour market.

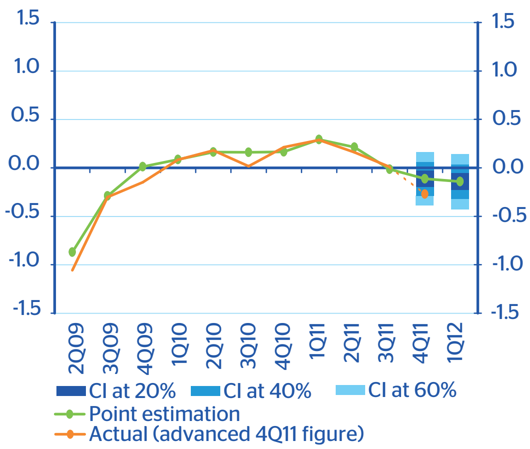
With the detailed breakdown not yet available, preliminary GDP estimates for Spain suggest that, following stagnation during the third quarter, the economy contracted by 0.3% qoq in the fourth quarter to leave full-year growth at around 0.7%[1]. If the preliminary estimates are confirmed, the overall performance during this quarter will have been in line with our forecasts (MICA-BBVA[2]: -0.1% qoq), which signalled from an early stage that the quarterly performance was likely to be negative (see Chart 5) and which are also indicating an increased likelihood of a renewed contraction during the current quarter (see Charts 6 and 7). Furthermore, preliminary economic indicators published to date show a downward correction in both domestic demand and trade flows in the fourth quarter. Because the correction is more pronounced in the case of imports, the growth breakdown is likely to show that foreign demand remains the driver, with a negative contribution from internal demand (see Chart 8).

Chart 5
**Spain: 4Q11 GDP growth forecasts using the MICA-BBVA model by forecast date (% qoq)**



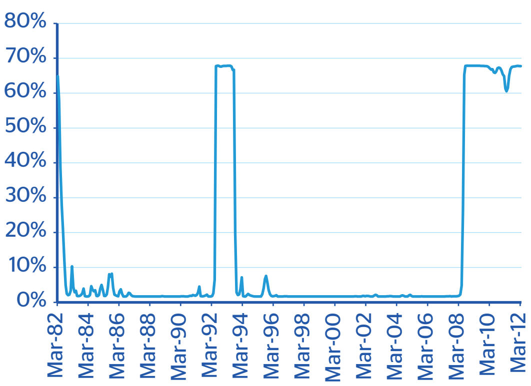

Source: BBVA Research based on INE data

Chart 6
**Spain: GDP growth and forecasts using MICA-BBVA model (% qoq)**



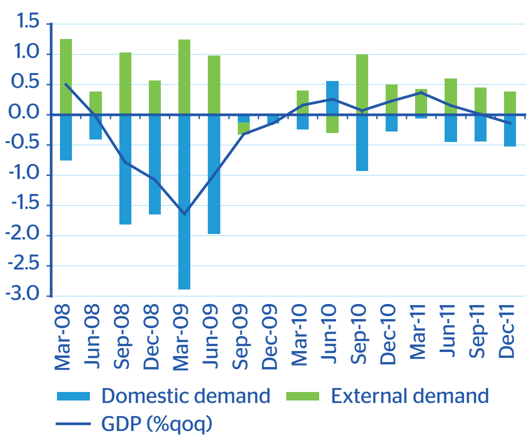

Current forecast: 3 of February 2012
Source: BBVA Research based on INE data

Chart 7
**Spain: likelihood of negative quarterly growth**




Source: BBVA Research

Chart 8
**Spain: contributions to quarterly GDP growth**




Source: BBVA Research based on INE data

1: The detail of Quarterly National Account (QNA) of 4Q11 will be release next 16 of February, being possible a revision of the advanced data.
2: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21.

## Sharp setback in private domestic demand at the end of 2011

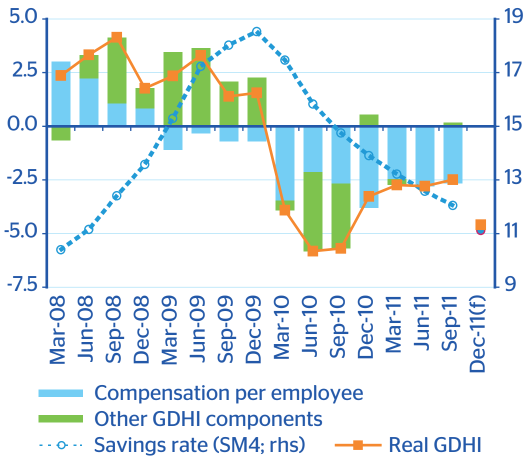
Following the lacklustre private consumption seen in the third quarter of 2011[3], the preliminary indicators are suggesting that household spending decreased between September and December (see Table 2). Despite the expected drop in savings, the demand for both goods and services is likely to have dropped in 4Q11 due to the deterioration in its main drivers, above all real disposable income (see Chart 9). In this way, both BBVA's synthetic consumption indicator (SCI-BBVA) and our coincident consumption indicators model (MICC-BBVA) are suggesting that household spending contracted by around 0.3% qoq (-0.7% yoy) in 4Q11 (see Chart 10). On this basis, private consumption looks to have stagnated in 2011, following its 0.8% growth in 2010.

Table 2
Spain: consumer spending indicators (SWDA data)

| | Consumer goods consumption | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| % qoq | Totals | Durables | Food | Other non-durables | Car registrations | Domestic sales by large enterprises | Service sector sales index | Retail commerce |
| 1Q10 | -3.1 | -13.8 | -0.4 | -0.7 | 1.6 | 0.6 | 0.3 | 1.6 |
| 2Q10 | 3.2 | 9.4 | -1.1 | 6.5 | 0.2 | 2.4 | 2.0 | -1.7 |
| 3Q10 | -5.2 | -18.7 | 0.4 | -6.0 | -31.5 | -5.3 | -2.7 | -1.7 |
| 4Q10 | 0.0 | -10.2 | 1.3 | 2.8 | 3.0 | 0.3 | 0.4 | -0.5 |
| 1Q11 | -0.1 | 8.8 | -1.0 | -2.2 | 3.7 | -0.5 | 0.6 | -1.8 |
| 2Q11 | -1.1 | -7.3 | 0.5 | -0.6 | 0.4 | -0.5 | -0.3 | -1.4 |
| 3Q11 | 0.7 | 7.3 | 0.3 | -1.5 | -6.5 | 0.1 | -0.4 | -1.2 |
| 4Q11 | -2.5 | -0.5 | -1.5 | -3.7 | -2.1 | -1.8 | -2.8 | -2.5 |

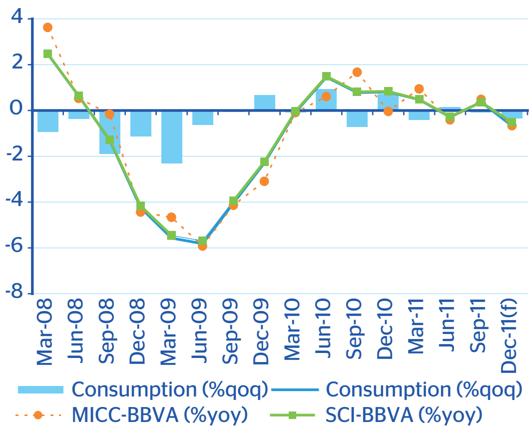
The shaded figures are forecasts
Source: BBVA Research based on MEH, ANFAC, AEAT and INE data

Chart 9
Spain: contribution to yoy growth of real GDHI* (gross disposable household income) and household saving rate (%)




* Adjusted for the household consumption deflator
Source: BBVA Research based on INE data

Chart 10
Spain: observed data and real time forecast of household consumption

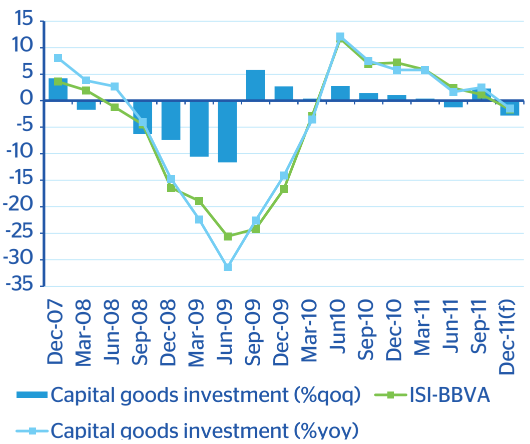



Source: BBVA Research based on INE data

3: The revision of QNA data due to, among other factors, the change in base value, resulted in an increase in consumer spending in 2H10 and a decrease in 1H11, in line with partial indicators.

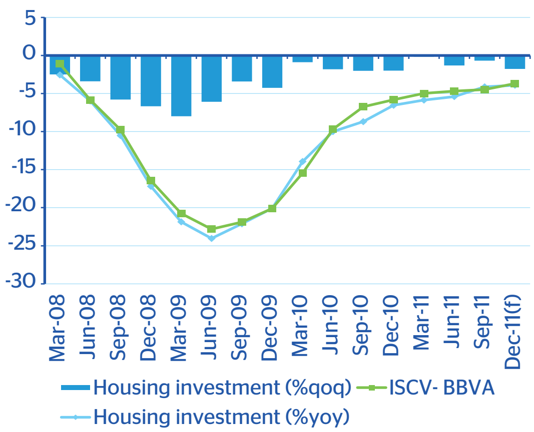
Partial indicators relating to investment in capital goods show deterioration in this segment of demand during the final quarter of 2011, as shown by our BBVA synthetic investment indicator, SII-BBVA (see Chart 11). While exports buoyed business investment during the previous quarter, this quarter weaker foreign demand and the sharp deterioration in domestic demand led to a contraction in capital good investment, leaving average growth for the full year at +2.1%. Of the partial indicators relating to this demand component, it is worth highlighting the waning of industrial confidence among capital goods producers, which, with a decrease of 21 points versus 3Q11, hit its lowest level for two years. There was also a significant setback in industrial vehicle sales, which, following a small recovery in 3Q11, once again on a qoq basis, as did capital goods imports and the IPI for capital goods. The only indicator to show an improvement on the previous quarter was capital goods orders, which rose almost 2pp. Even so, it was not enough to prevent capital goods investment ending the year down.

Chart 11
**Spain: actual data and real time forecasts for capital goods investment**




Source: BBVA Research based on INE data

Chart 12
**Spain: actual data and real time forecasts for housing investment**




Source: BBVA Research based on INE data

Meanwhile, housing investment continues to fall, and indicators for the residential market still show no clear signs of recovery. The synthetic housing investment indicator, SHII-BBVA, is predicting a new setback in this component for 4Q11, along the lines of the previous quarter (see Chart 12), which would leave an average setback of 4.8% versus 2010. In particular, data relating to residential demand appears to rule out any thoughts of an improvement during the fourth quarter: even though the month-on-month (SWDA) growth in the number of transactions was positive in both October and November, housing sales remained at their lows with no signs of a change in trend. While December figures have yet to be published, 2011 looks likely to have been the year with the least number of transactions since records started: at around 365,000, the figure is so far down 18% on 2010. However, a significant drop had been expected as a result of the tax changes on housing, particularly the elimination as of January 2011 of the tax deduction on primary residences for the middle- and high-income bracket (the announcement of the measure had led to increased demand in 2010, probably around +65,000 homes). At the same time, the drop in house prices gathered pace during 4Q11, to -1.6% qoq and a correction of -26.8% (in real terms) from the highs at the beginning of 2008.

The factors causing the weak demand are pretty much the same as in previous quarters: deterioration in the economy, the inability to create jobs, and continued financial stress with the repercussion that this has on banks and, therefore, on available credit. However, the uncertainty surrounding the tax treatment of housing during the second half of 2011 was cleared up at the end of the year when the Government announced the retroactive reintroduction of deductions on primary residences as of January 2012 and also the maintaining of a 4% VAT rate on new home purchases for this year.

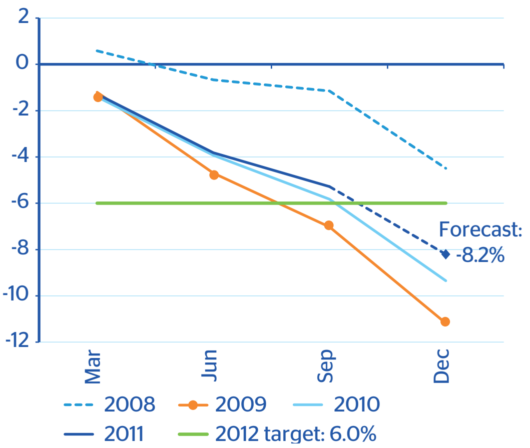
In terms of supply, new home building permits remain at all-time lows and forecasts suggest a 13% drop in 2011 versus 2010, decrease that will take its toll on housing starts over the coming quarters. As a result, housing investment is expected to represent no more than 7.2% of GDP (in real terms) as at the close of 4Q11 (well below the average of 10.7% during the 2000-2011 period), and the downward trend looks likely to continue.

## The extent of the deviation announced with respect to the stability target suggests there may well have been a pick up in public demand during 4Q11

Year-end forecasts suggest there was a rebound in public spending during 4Q11, contradicting the general expectation created by the acceleration of the fiscal adjustment witnessed during 3Q11, which left the deficit of all public administrations at 5.3% of GDP. While the latest data shows that central government spending continued to decrease, it was not enough to offset the lacklustre recovery in revenue, leaving the State with an accumulated deficit of 4.8% of GDP through to November (see Chart 13). This, together with the declarations relating to the deviation respect to the stability targets, suggest a total budget deficit for full-year 2011 of more than 5% of GDP, that is to say overshooting the established target (see Chart 14). Data on the 3Q11 budgetary performance of the autonomous communities, which maintained their deficit at the same level as in 2Q11, gave no indication either of the deviation (more than 1.4pp of GDP of the target level) now expected for the end of 2011.

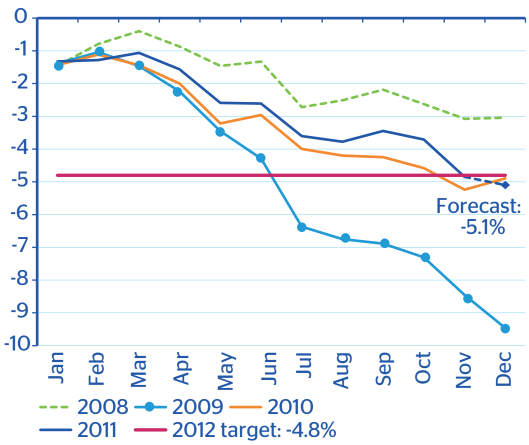
On the basis of the above, is expected an upward correction of current expenditure, meaning that public spending is likely to grow again in 4Q11 (albeit moderately), leaving the full-year figure down 1.2% on 2011. Nevertheless, the focus of fiscal consolidation remains centred on investment cuts, suggesting that non-residential construction is likely to have continued contracting during the final quarter, albeit more gradually than in previous quarters, leaving the 12-month decrease at 10.2%. However, it is important to underline the fact that such deterioration will probably be due to, as well as to the public sector, the major adjustment that is still taking place in private construction activity.

Chart 13
**Public administration: financing capacity (+)/ requirements (-) (Base 2008, % of GDP)**




Source: BBVA Research based on INE data

Chart 14
**Central Government: financing capacity (+)/ requirements (-) (Base 2008, % of GDP)**




Source: BBVA Research based on MEH

In this context, is expected that the combined deficit of all public administrations exceed 8% of GDP, 2pp more than the 2011 target level, meaning that a far greater effort is going to be required with the fiscal consolidation process in 2012, with the resulting negative effects on growth in domestic demand.

## Export growth is slowing, but still making a positive contribution to growth

As a result of mounting financial stress and the weaker growth outlook in the EMU, there was slower growth from exports during the final part of 2011. Exports of goods and large company sales anticipate that growth in exports of goods was slower in 4Q11 than through to 3Q11, leaving the full-year growth rate at around 11.3%.

As for exports of services, the indicators available to date show 2011 to have been a good year. Despite the fact that there was a slowdown in tourism towards the end of the year, caused by the slowdown in internal demand in Europe, consumption by non-residents in Spain rose 6.4% in 2011 (see Table 3). In fact, the upbeat figures from the tourism sector were based to a large extent (particularly during the first part of the year) on the dynamism of foreign tourism; not only the number of foreign tourists but especially the number of overnight stays in hotels. Helped by diminished domestic demand, foreign tourism played its most important role ever in terms of percentage of total visitors (46.5%), while in terms of overnight stays the 61% figure was below the highs reached between 1999 and 2001. As a result, average hotel occupancy rose 2pp versus 2010. The increase in tourist spending by non-residents in Spain in 2011 (+7.9%) is purely the result of the rise in the number of visitors, given that average spending per visitor was virtually unchanged (+0.2%).

Meanwhile, imports of goods and services are likely to have returned to negative growth in 4Q11, on the back of furthering weakening in domestic demand and the slowdown signalled in the pace of exports. As a result, following a sharp recovery in 2010 (+8.9%), import growth looks likely to have slowed to 1.6% in 2011.

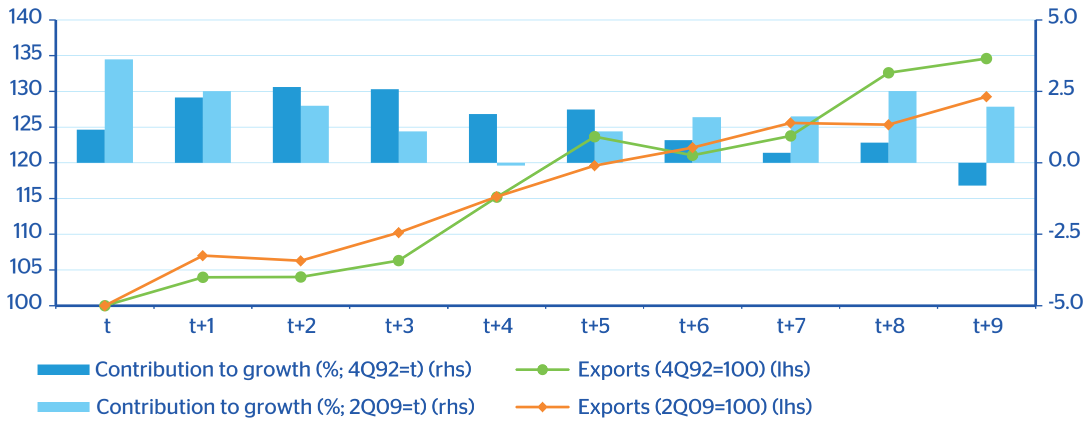
To sum up, the fourth quarter is likely to close with a new positive contribution to GDP growth from net foreign demand (see Chart 15). As a result, we expect to see a further reduction in the current account deficit at the end of the year, leaving the full-year figure at around 4.3% of GDP.

Table 3
### Tourism in Spain

| | 2009 | 2010 | 2011 |
|---|---|---|---|
| **Visits to Spain** | | | |
| Total | -7.1 | 6.2 | 4.3 |
| Spanish residents | -4.5 | 2.4 | -1.1 |
| Foreigners | -10.5 | 11.4 | 11.3 |
| **Overnight stays** | | | |
| Total | -6.5 | 6.4 | 7.3 |
| Spanish residents | -3.0 | 3.2 | -1.9 |
| Foreigners | -9.1 | 9.0 | 14.0 |
| Consumption by non-residents in Spain (*) | -9.5 | 2.6 | 6.4 |

(*) Forecast to 2011
Source: BBVA Research based on INE data

Chart 15
### Spain: quarterly performance of real exports of goods and services and net contribution to yoy GDP growth from the external sector during the last two recessions



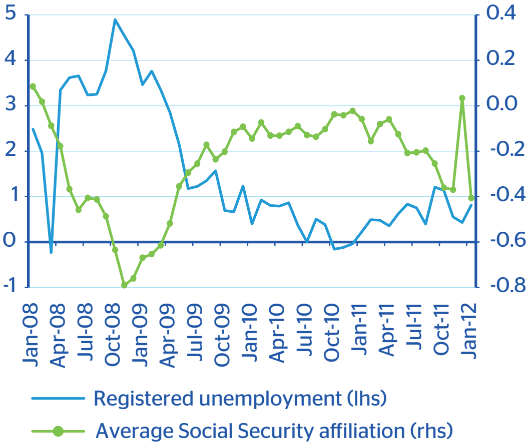

Note: the index has a value of 100 in t, the period in which the corresponding crisis's cycle trough was reached.
Source: BBVA Research based on INE data

## The acceleration in the pace of deterioration in the labour market confirms the economic contraction in 4Q11

Labour market figures for 4Q11 were disappointing. Once adjusting for seasonal and calendar effects, the pace of job destruction quickened. Both the decline in Social Security affiliation (-0.7% qoq, SWDA) and the increase in registered unemployment (+2.5% qoq, SWDA) accelerated by around 0.3pp between October and December (see Chart 16)[4]. Overall, the Labour Force Survey (LFS) for 4Q11 confirmed the trend shown by the affiliation and unemployment numbers, although the scale of deterioration in the labour market gleaned from these figures is greater. The upbeat job numbers in the primary sector (contribution of 100,800 jobs: 43,000 SWDA) was not enough to prevent a decline in employment of 348,800 (-234,000 SWDA). The steep fall in employment, which was concentrated (for seasonal reasons) among temporary contract staff and among service sector workers, played a part in reducing the incentive to participate in the labour market, leading to a decrease in the active population of 51,300 (-23,000 SWDA). As a result, the unemployment rate rose 0.13pp to 23.8% of the active population (22.9% SWDA), while the temporary rate slipped 0.1pp to 25.0% (see Chart 17).

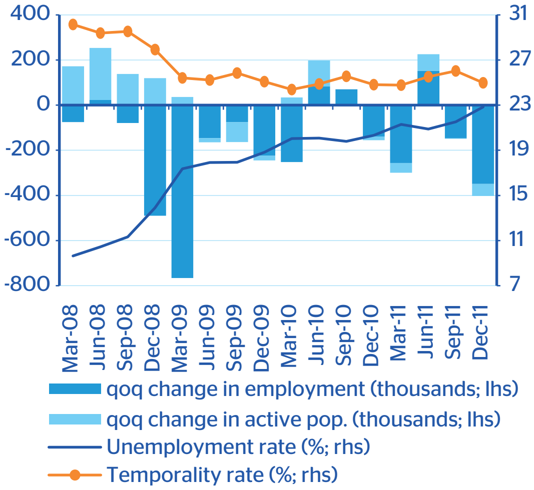
The 4Q11 data marked the end to another year of labour market deterioration. In average, a net 351,900 jobs were destroyed in the Spanish economy in 2011, 69.4% of which were permanent and 73.3% in the construction sector. These results, along with slowdown in the growth rate in the active population to 0.1%, led to a rebound in unemployment, which rose to 21.6% from 20.1% in 2010.

Chart 16
**Spain: average Social Security affiliation and registered unemployment (mom %, SWDA data)**




Source: BBVA Research based on MEYSS data

Chart 17
**Spain: labour market indicators**




Source: BBVA Research based on INE data

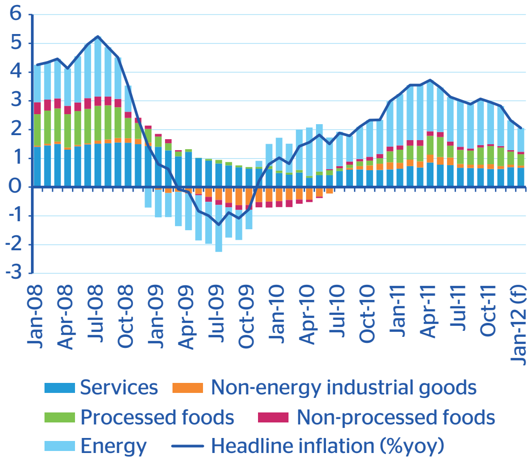
## Inflation continues to ease

Over the last few months, headline inflation has continued to ease gradually, reaching 2.0% yoy in January (according to its leading indicator). This appears to prove that, with no apparent demand-side inflationary pressures, the high inflation levels registered last year (headline average of 3.2% and underlying of 1.7%) were, to a large extent, triggered by the base effect caused by the surge in raw material prices at the end of 2010 and beginning of 2011 and the tax changes introduced in Spain in 2H10. The impact of the first of these two factors can be seen clearly in the contributions that each of the CPI components made to the rise on consumer prices (see Chart 18). For example, of the 2.4% yoy headline inflation rate at the end of 4Q11, 1.2pp can still be attributed solely to energy and non-processed foods, and 1.2pp to the underlying figure, 0.6pp of which is attributable to the components most sensitive to raw material prices (i.e., processed foods and organised tours). The impact of the second factor can be judged with the data in Table

4: January figures showed the deterioration in the labour market to be gathering pace. After adjusting for calendar and seasonal effects, the decrease in Social Security affiliation is estimated at 70,000 and the increase in registered unemployment at 44,000.

4 that track the inflation differential with the Eurozone. The latest reading show that the inflation differential stood at an average of 0.7pp during 1H11, falling to an average of 0pp during 2H11, once the base effect of the previous year's VAT increase was diluted. In fact, on a constant-tax rate basis, the differential was actually in Spain's favour up to 1H11, before returning to positive, although only marginally, in 2H11.

Chart 18
Spain: contributions to headline inflation growth




Source: BBVA Research based on INE data

Table 4
Inflation spreads with respect to the Eurozone

| | | Total | At constant tax rate |
|---|---|---|---|
| 2008 | 1H | 1.1 | 1.2 |
| | 2H | 0.7 | 0.7 |
| 2009 | 1H | -0.7 | -0.9 |
| | 2H | -0.4 | -0.7 |
| 2010 | 1H | 0.4 | 0.1 |
| | 2H | 0.4 | -0.4 |
| 2011 | 1H | 0.7 | -0.2 |
| | 2H(*) | 0.0 | 0.1 |

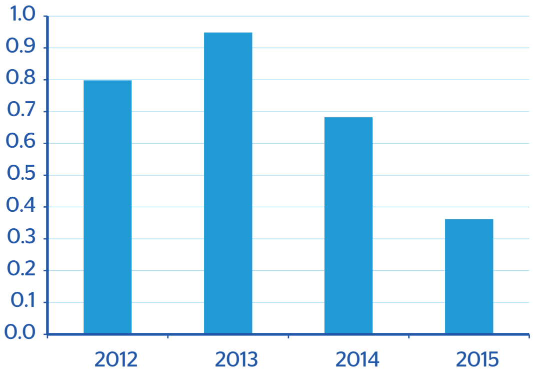
(*) Average up to Nov-11 at constant tax rates.
Source: BBVA Research based on INE and Eurostat data

## Outlook 2012-2013: downside pressure, leading to a drop of GDP in 2012 and a slow recovery in 2013

As we noted in the introduction to this section, confirmation of increased uncertainty i the deterioration of various fundamentals relevant to the performance of the Spanish economy, which implies a substantial revision about growth forecast for the next two years.

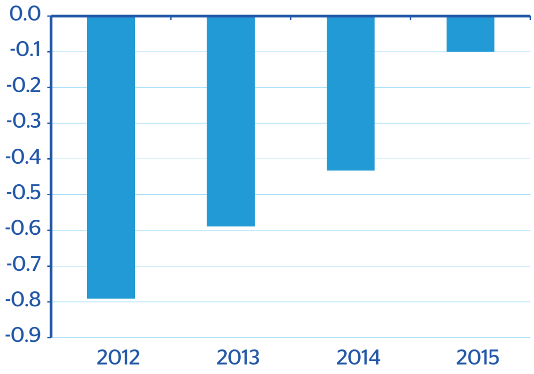
Starting with the external factors, capital market stress, basically in Europe, has remained more acute tan expected three months ago, and this has resulted in a worsening outlook for medium and long-term financing costs in Spain. More specifically, we would expect Spain's average risk premium over the year to remain close to its current level; that is to say, the reduction towards the levels considered consistent with fundamentals (around 120bp) is going to be very slow. This relative deterioration in the cost of financing is going to be one of the burdens with which both the public and private sector are going to have to cope (see Chart 19), despite the fact that the ECB is highly likely to make another 25bp cut to its benchmark rate in response to the worse outlook for European activity and an inflation rate that appears to be under control. So, this more relaxed monetary policy, together with the liquidity measures introduced at the end of last year and the advances made on European governance are not going to be enough to offset the rise in the Spanish risk premium, due to the slow solving of the crisis and the failure to meet fiscal targets; and the result is a significant negative impact on GDP (see Chart 20).

Chart 19
**Spain: 10-year bond yield (pp change vs. previous forecast)**




Source: BBVA Research

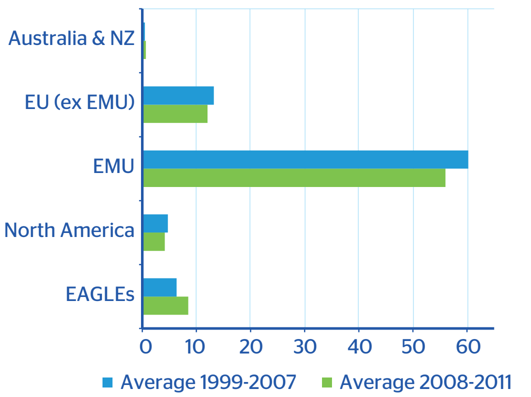
Chart 20
**Spain: impact on GDP from change in 10-year rate scenario (pp vs. previous forecast)**




Source: BBVA Research

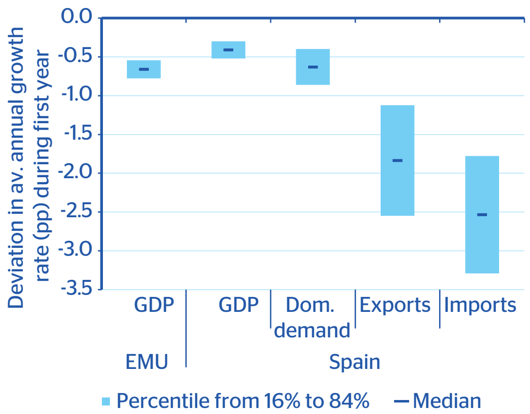
Just as relevant will be the impact, which will be transmitted by trade, of the lower growth estimates for the Eurozone. Despite the fact that the geographical diversification of Spanish exports has improved recently, European trade partners continue to represent a significant proportion of outflows (see Chart 21). In such an environment, and bearing in mind the extent of the adjustment predicted, we would expect to see a significant setback in exports this year. In addition, and as can be seen from the simulation in Chart 22, given the high import content of Spanish exports and the repercussions that slower trade activity have on all the other sectors, we are forecasting a slightly larger correction in imports than in exports and a smaller adjustment in domestic demand[5]. As a result, the expected bigger drop in imports than in exports will lead to an increase in net foreign demand's contribution to growth, which will offset to some extent the lower contribution from domestic demand, resulting in a smaller adjustment in GDP. Overall, the widening of the growth differential between Europe an the rest of the world, together with relatively more expansive monetary policy, ought to mean a weaker euro; and this would probably cushion, albeit in a moderate way, the impact that the weaker growth outlook in Europe is going to have on Spain's exports and economic growth[6].

Chart 21
**Spain: breakdown of exports by main geographical areas since entry into the EMU (%)**




Source: BBVA Research based on Datacomex

Chart 22
**Impact on the Spanish economy of a permanent demand shock in the EMU***

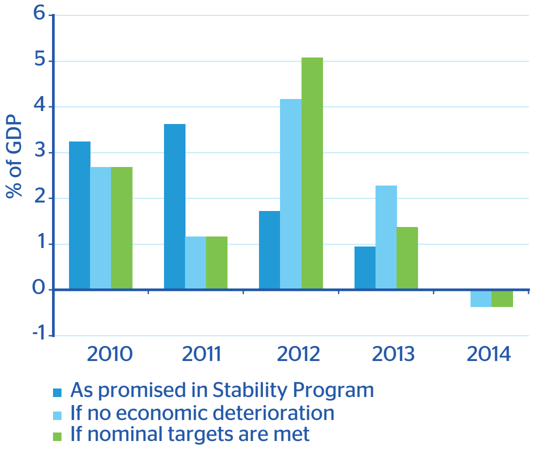



* The simulated permanent shock is equivalent to one standard deviation in the EMU quarterly GDP rate
Source: BBVA Research

5: The impact on domestic demand is likely to focus on business investment, although the effect will probably spread, in a second weaker wave, to other components of domestic demand.
6: The forecast depreciation in the effective real exchange rate in 2012 (close to 1% and partially sustained by a 4.8% depreciation in the nominal euro-dollar cross rate) would have a limited effect on the long-term growth in exports (between 0.5% and 0.6%).

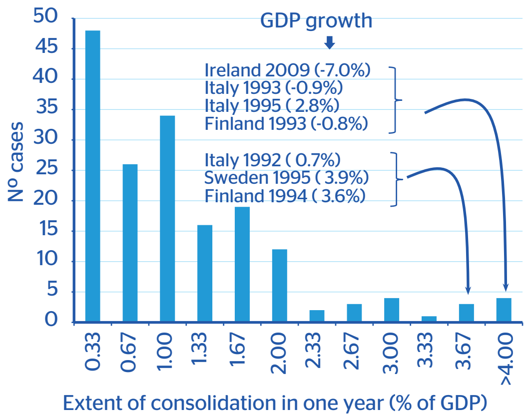
On the domestic level, the main factor behind the revision of our forecast scenario is the deviation in public administrations' deficit levels and the additional adjustment this will imply. The size, composition and duration of this are key to estimating the impact on economic activity. As noted in Box 3, the fiscal adjustment in 2012 could be between 40 and 50 billion euros, although part of this figure has already been discounted in previous publications. As Chart 23 shows, the Spanish government is slated to carry out most of the reduction to the structural deficit (6.5% GDP in 2011) between 2009 and 2011, in accordance with the current stability plan approved by the European Commission. As of 2012, the size of the adjustment was set to decrease, although the announcement of measures to reduce the deficit by around 2% of GDP this year had been expected. Therefore, the forecasts presented in the previous edition of this publication already took into account this consolidation. However, the fact that the 2011 target was not met means that the structural adjustment will have to be about 40 billion euros, and if, in addition, the government seeks to offset the cyclical deterioration in revenues and public spending, the adjustment could surpass 50 billion euros. In this respect, Charts 24 and 25 show that fiscal consolidations of this size in developed countries are rare, and that except for a few cases, these adjustments always occurred in tandem with drops in GDP.

Chart 23
**Spain: improvement in structural deficit (% of GDP)**



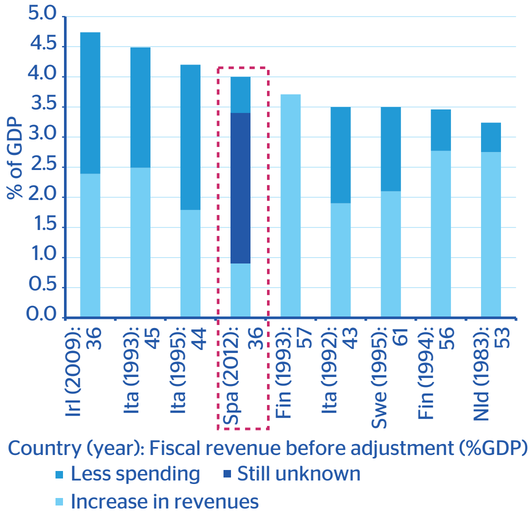

Source: BBVA Research

Chart 24
**Breakdown of fiscal consolidations in OECD countries with deficit reduction targets.**



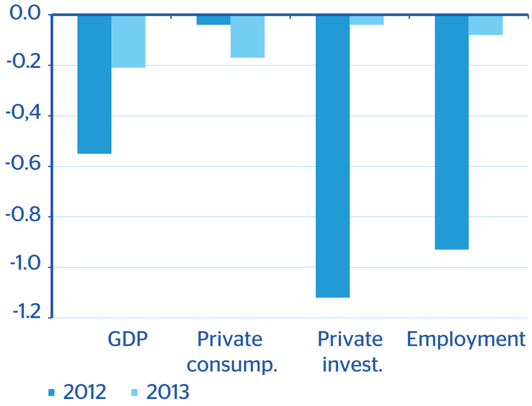

Based on 173 cases of consolidation between 1978-2009 for the 17 countries in OECD (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Holland, Portugal, Spain, Sweden, the UK and the USA.)
Source: BBVA Research based on Devries et al. (2011)

Chart 25
**Larger fiscal consolidations in the OECD, 1978-2009: breakdown by adjustment type**




Source: BBVA Research based on Devries et al. (2011)

Chart 26
**Spain: impact of announced fiscal measures, using the REMS model (pp)**




Source: BBVA Research

The public administration's contribution to the deficit reduction by levels and the composition of the measures to be implemented remain relatively uncertain. Therefore, in the section that follows an evaluation is provided of the measures made public up to now, which are limited to those that have been announced by the government as a result of the carry-over of the 2011 budget, the agreement of budgetary non-availability and the increases in direct taxes.

The measures adopted by the government are credible both in terms of the expected effect on tax intake (6,100 million euros), and for entailing a reduction in expenditure (8,900 million euros). We have a positive opinion of these measures since the fact that spending cuts comprise a greater portion in the fiscal adjustment process than tax hikes gives more credibility and minimises the negative impact on business activity and employment. Out of the policies aimed at increasing the tax intake, the Government has opted for a significant, but temporary (two year) increase in direct taxes, coupled with a deeper cut to spending, or should it prove necessary, a permanent increase in indirect taxes. These measures should effectively reduce the structural deficit with fewer distortionary effects on economic growth, employment and savings. Furthermore, the temporary nature of the increase in direct taxes should reduce its negative impact on growth, which is reflected by the fact that the announced measures, equivalent to 1.5% of GDP, would have a less than proportional effect on GDP (see Chart 26). However, the conditions which would allow this to happen, such as access to liquidity for households and companies (whether through credit or by tapping savings), are currently restricted, which could intensify the negative effect of the tax hike, especially for those agents which, due to their situation, have less access to financing instruments. Moreover, it is not entirely positive that the only measures that have been announced are temporary. As noted earlier, the Government is committed to reducing the public deficit in a permanent manner, which implies that when these measures expire, new ones would have to be rolled out, with the same impact on public accounts.

Once the aforementioned factors have been discounted, together with other developments which have a more limited impact on our November forecast[7], we expect the Spanish economy to continue registering negative quarterly growth rates in the coming quarters, which points towards a contraction in GDP of about -1.3% for the year as a whole, and implies a revision of 2.3pp with respect to the forecasts from the previous edition of this publication. Therefore, in the absence of further measures to correct the main problems in the Spanish economy, we expect the recovery starting in 2013 to be slow, with positive but modest GDP growth rates, which would translate into growth of about 0.6% (see Table 5).

7: This is, the slightly lower growth than expected in 2H11, combined with a somewhat higher oil price than what we expected at the time of our forecast (3% on average for 2012).

Table 5
### Spain: macroeconomic forecasts

| (yoy %, unless otherwise indicated) | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 | 2Q11 | 3Q11 | 4Q11 (f) | 2010 | 2011 (f) | 2012 (f) | 2013 (f) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| National Final Consumption Expenditure (FCE) | 0.1 | 1.4 | 0.7 | 0.4 | 0.5 | -0.7 | -0.4 | -0.8 | 0.6 | -0.3 | -2.3 | -1.1 |
| Private FCE | 0.0 | 1.5 | 0.8 | 0.8 | 0.5 | -0.3 | 0.4 | -0.7 | 0.8 | 0.0 | -2.0 | -0.9 |
| Household FCE | -0.1 | 1.5 | 0.8 | 0.8 | 0.5 | -0.3 | 0.4 | -0.7 | 0.7 | 0.0 | -2.0 | -0.9 |
| Public Administration FCE | 0.6 | 1.0 | 0.2 | -0.9 | 0.4 | -1.7 | -2.3 | -1.1 | 0.2 | -1.2 | -3.1 | -1.8 |
| Gross capital formation | -9.6 | -4.1 | -5.2 | -5.0 | -4.5 | -5.0 | -4.0 | -3.7 | -6.0 | -4.3 | -6.2 | -1.9 |
| Gross fixed capital formation | -9.8 | -4.3 | -5.5 | -5.4 | -4.9 | -5.5 | -4.2 | -3.9 | -6.2 | -4.6 | -6.3 | -1.9 |
| Fixed material assets | -10.0 | -4.5 | -5.4 | -5.4 | -5.3 | -5.7 | -4.5 | -4.1 | -6.3 | -4.9 | -6.6 | -2.1 |
| Equipment, machinery and cultivated assets | -3.4 | 11.7 | 7.3 | 5.4 | 5.6 | 1.5 | 2.4 | -1.3 | 5.3 | 2.1 | -5.0 | 2.1 |
| Equipment and machinery | -3.6 | 12.1 | 7.5 | 5.8 | 5.8 | 1.6 | 2.5 | -1.4 | 5.5 | 2.1 | -5.2 | 1.9 |
| Construction | -12.2 | -9.4 | -9.5 | -9.3 | -9.3 | -8.4 | -7.4 | -5.4 | -10.1 | -7.6 | -7.3 | -4.0 |
| Housing | -13.9 | -10.0 | -8.7 | -6.5 | -5.9 | -5.4 | -4.1 | -3.9 | -9.8 | -4.8 | -6.5 | -1.5 |
| Other buildings and other constructions | -10.4 | -8.8 | -10.4 | -11.8 | -12.4 | -11.2 | -10.4 | -6.8 | -10.4 | -10.2 | -8.0 | -6.5 |
| Intangible fixed assets | -5.4 | -0.5 | -7.8 | -5.4 | 1.2 | -3.1 | 0.8 | 0.0 | -4.8 | -0.2 | -2.3 | 1.7 |
| Change in inventories (*) | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 |
| Domestic demand (*) | -2.4 | 0.1 | -0.7 | -0.9 | -0.7 | -1.7 | -1.2 | -1.5 | -1.0 | -1.3 | -3.2 | -1.3 |
| Exports | 11.9 | 15.3 | 11.8 | 14.9 | 13.9 | 8.7 | 8.1 | 5.9 | 13.5 | 9.2 | 1.6 | 8.2 |
| Imports | 6.3 | 14.5 | 7.0 | 8.0 | 7.1 | -0.7 | 0.8 | -0.7 | 8.9 | 1.6 | -4.8 | 2.1 |
| Net trade balance (*) | 1.1 | -0.1 | 1.1 | 1.6 | 1.6 | 2.5 | 2.0 | 1.8 | 0.9 | 2.0 | 1.9 | 1.9 |
| GDP at mp | -1.3 | 0.0 | 0.4 | 0.7 | 0.9 | 0.8 | 0.8 | 0.4 | -0.1 | 0.7 | -1.3 | 0.6 |
| Pro-memoria: | | | | | | | | | | | | |
| GDP w/o housing investment | 0.0 | 0.9 | 1.1 | 1.3 | 1.5 | 1.3 | 1.1 | 0.7 | 0.8 | 1.2 | -0.9 | 0.8 |
| GDP w/o construction | 1.2 | 1.9 | 2.3 | 2.6 | 2.9 | 2.5 | 2.2 | 1.4 | 2.0 | 2.3 | -0.3 | 1.3 |
| Employment (LFS) | -3.6 | -2.5 | -1.7 | -1.3 | -1.3 | -0.9 | -2.1 | -3.3 | -2.3 | -1.9 | -4.2 | -1.9 |
| Unemployment rate (% active pop.) | 20.0 | 20.1 | 19.8 | 20.3 | 21.3 | 20.9 | 21.5 | 22.8 | 20.1 | 21.6 | 24.4 | 24.6 |
| Employment (FTE) | -4.2 | -2.9 | -2.0 | -1.4 | -1.4 | -1.1 | -1.9 | -2.8 | -2.6 | -1.8 | -3.8 | -1.9 |

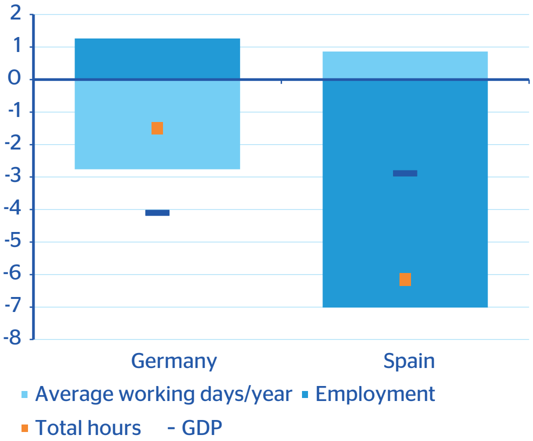
(*) contribution to growth
Source: INE, Bank of Spain and BBVA Research forecasts

## As a result of the worsening growth outlook for the Spanish economy, the labour market continues to deteriorate.

Employment figures will continue to deteriorate in 2012 and the first half of 2013, which will trigger a rise in unemployment rates, which are expected to stand at about 25%, despite the expected drop in the active population. One of the aims of the labour reform[8] should be to obtain the necessary equilibrium between the correction in the extensive margin(employed workers) and the intensive margin (number of hours worked), in such a way that it minimises the effects of the economic recession on the labour market and prevents the multiplier effects that could result in job destruction. As can be seen in Chart 27, the rigid framework facing companies and workers who seek to change their terms of employment - particularly, the length of the working day- has caused the Spanish labour market to contract in employment, in contrast to other economies, such as Germany, where the contraction focused in the number of hours worked. That's why the commitment to internal flexibility included in the 2012-2014 employment and collective bargaining agreement signed[9] by CEOE, CEPYME, CCOO and UGT last 25th of January is a welcome development.

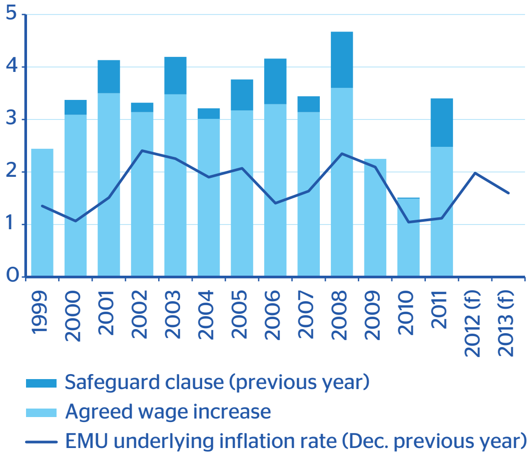
8: For a detailed analysis of the proposed labour reform, see the March 2009 issue of BBVA's Spain Economic Outlook.
9: The complete text can be found here: http://www.ugt.es/actualidad/2012/enero/IIAcuerdo_ene2012.pdf

Chart 27
### Economic growth and the breakdown of the decline in the number of hours worked (cumulative variation 2007-2009, in %)




Source: BBVA Research based on INE and EC

Chart 28
### Spain: wage growth agreed upon through collective bargaining and safeguard clauses in t-1 (%)




Source: BBVA Research based on MEYSS, MEH and Eurostat

In addition to offering internal flexibility as an alternative to job destruction, which the new labour market reform should promote, the text of the agreement between employers and trade unions contains other positive aspects such as the call for wage moderation (see Table 6) and wage setting based on productivity. In this respect, the change to the activation process for wage revision clauses could mitigate the inflationary bias inherent to the mechanism for determining wage levels in Spain, and thereby increase our price competitiveness. As shown in Chart 28, the salaries agreed upon through collective bargaining in Spain have grown 1.2 points faster than the underlying inflation rate of the EMU in average terms, since the creation of the euro[10].

However, given that the unemployment rate is approaching 23%, Spain's labour market requires more ambitious measures. Particularly, safeguard clauses should be removed to prevent temporary increases in prices from being passed on to wages and generating an inflation spiral through second-round effects. In addition, the fact that the current collective bargaining structure will be maintained (especially sector-based provincial collective bargaining agreements) and the explicit refusal to make the wage opt-out clauses more flexible, represent negative aspects of the agreement, since they sustain the rigidities of the current collective bargaining system.

Table 6
### Features of the wage moderation agreement

| | 2012 | 2013 | 2014 |
|---|---|---|---|
| **Wage growth agreed upon through collective bargaining** | ≤ 0.5% | ≤ 0.6% | ≤ 0.6% if ΔGDP2013 < 1%<br>≤ 1.0% if 1% ≤ ΔGDP2013 < 2%<br>≤ 1.5% if ΔGDP2013 ≥ 2% |
| **Wage revision clause** | | (inflation –2%) if inflation > 2% | |
| **Benchmark inflation** | | The lower of (Spain, EMU) | |
| | | The energy component is excluded if the yoy increase in Brent prices at December is > 10% | |

Source: BBVA Research

10: During the same period, labour productivity (measured by dividing GDP by hour worked) has increased in Spain at a similar rate to that of the EMU as a whole.

## The deterioration in fundamentals puts downward pressure on both external demand and especially in domestic demand

In the first place, the public deficit's deviation from the targets established for 2011 implies a downward revision to public spending in 2012, which in the real terms of Spain's National Accounting would result in a 3.1% drop in public spending and an 8% decline in non-residential construction (-1.8 and -6.5%, respectively in 2013).

In terms of private consumption, the deterioration expected in its determining factors point towards a decrease in spending during all of 2012, and the first half of 2013. The acceleration in the deterioration of employment will trigger a decline in the wage component of household's gross disposable income. Furthermore, the increase of fiscal pressures due to the country's effort to meet the public deficit targets will reduce the non-wage component despite the possible increase in volume of unemployment benefits. Net financial wealth will not recover until 2013, while real estate will continue to fall during the entire forecast horizon. Meanwhile, the reduction in the household savings rate to its pre-crisis level, the absence of inflationary pressures and the stabilising of official interest rates at low levels will limit the contraction in private consumption over the next two years.

However, the downward revision to both external demand and domestic and private domestic demand, combined with the limited access to financing, mean that forecasts for corporate investment in 2012 must also be revised downward, following the 2.1% growth in 2011. We expect it to close the current year with negative growth, and to start recovering slightly in 2013, and gain traction to the degree that the rebound in external demand takes hold and internal demand stops contracting.

Similarly, residential investment will be shaped by the performance of domestic demand. Despite the tax incentives approved recently aimed at boosting housing demand and to thereby decrease the unsold housing stock, the inability of the economy to generate jobs, the doubts concerning access to credit, and households' worsening expectations, point towards a downward trend in housing demand for the next two years. Although the excess supply is expected to continue decreasing due to the sharp decline in new housing supply, it is expected to do so at a slower pace than what we envisaged in our previous macroeconomic scenario. To summarise, in 2012, we expect a steeper decline in housing investment, and a recovery to start in the latter part of 2013, with widely divergent performances depending on the geographic region.

Lastly, as has been highlighted in numerous previous editions of this report, in the medium term any recovery in the Spanish economy will be strongly linked to the global economic situation. Although the lower growth in the global economy in 2012 - mainly as the result of the expected contraction for the EMU as a whole[11]- will have a major negative effect on trade flows, we believe we will see an uptick in Spanish exports, though volumes will be much lower than that of the last two years, which is due, in part, to the depreciation in the euro. In addition, the slowdown in demand in Europe will be felt in the tourism industry - a trend noted in the last part of 2011, and which has continued in the first months of 2012, according to the new BBVA-Google indicator[12]. However, the continued instability in North Africa and the euro exchange rate could, once again, provide protection to the Spanish tourism sector supply in 2012. Lastly, in line with the weakness of domestic demand and the slump in exports, imports will decrease sharply in 2012, which means that the foreign sector will make a substantial contribution to growth. The recovery in the European economy in 2013, though modest, will revitalise the Spanish economy's export sector, and serve, once again as a pillar of GDP growth.

11: As indicated earlier, the compensating factor in 2012 would be the expected depreciation of the Euro, although it would only have a modest effect on exports and economic growth.
12: Information regarding the new Google-BBVA tourism sector indicators is provided here: http://www.bbvaresearch.com/KETD/fbin/mult/120116_Spain_Flash-Tourism_tcm348-284304.pdf?ts=1622012

## The high degree of uncertainty and the deterioration expected in the economy require more ambitious reform efforts

Despite the fact that this update to our forecasts for the Spanish economy entails a significant downward revision in the short and medium term, we would like to underscore that the current outlook calls for the introduction of ambitious structural policies, which, if carried out properly, could result in a less painful adjustment (especially in terms of employment), paving the way for a faster and stronger recovery.

In this respect, we have a positive stance on the measures adopted by the government to correct part of the deviation from the deficit targets in 2011, as well as of the agreement - which was not sufficiently ambitious - reached by social agents to commit to internal flexibility, which was included in the 2012-2014 employment and collective bargaining agreement signed last 25th of January. The fact that the executive branch has established a calendar for the reforms, including those related to the financial system and the labour market, are also positive developments, and vital for ensuring that the Spanish economy functions better in the medium and long term.

However, time is short and the manoeuvring room for both economic agents and the Spanish economic authorities to carry out the adjustments is increasingly limited. Against this backdrop, it is crucial that the specific details of the planned structural reform measures are made public as soon as possible. We would highlight here that although a large number of the risks we considered in our November scenario have indeed materialised, unless more decisive measures are adopted in Europe and on the domestic level that clear up doubts surrounding governance in Europe and Spain's ability to grow and create jobs, there is a risk that even worse scenarios than the one we have discussed in this report will arise.

## Box 2. Regional growth prospects: increasing divergent performances

The worse performance of the European economy at the end of 2011 and the generalised deterioration in the outlook for the Spanish economy have had a different impact on the different autonomous regions, due to the specific characteristics of each one. In 2012, we expect all the regions to post negative growth, but the impact of a slide back into recession will probably be higher in the regions which have a higher dependence on domestic demand, whether from the region itself or from Spain in general.

The different performance of domestic demand across regions will continue to be shaped by a wide array of factors. On the household side, the deterioration in the business outlook will cause an increase in the unemployment level, which will have a negative and unequal effect on families' disposable income depending on their degree of exposure to the regional fiscal adjustment and their degree of coverage by the unemployment benefits system. Similarly, difficulties related to the adjustment in the real estate sector (which also translates into different levels of indebtedness, which impacts demand) will continue to undermine the economy's capacity to recover. Savings from prior periods, and the capacity to generate relative income (per capita GDP), are factors that could allow the adjustment to be less traumatic in certain regions. As has already been published in other BBVA Research publications [13], the difference in household savings rates between regions is significant (there is a 20 point difference in the savings rate between the region that saves the most and the one that saves the least) and will affect the capacity to absorb a new round of income contention without it being translated, in its entirety, into a decrease in consumption or investment.

With respect to the public sector, and in a context of intensifying fiscal consolidation, the autonomous regions with the highest degree of dependence on this sector, in terms of employment and activity, will probably be more sensitive to the adjustment. Nevertheless, the situation is not the same in all the autonomous regions, since they have clearly differentiated adjustment needs. The Castile-La Mancha and the Valencia autonomous regions are the most notable cases, with high debt and deficit levels, together with Catalonia. But while Catalonia already initiated the correction in 2011, in many other regions, the bulk of the adjustments have barely started, indicating that the impacts will be greater in 2012 and 2013. Meanwhile, autonomous regions such as Basque country, indicating, Madrid and Castile & Leon will be subject to less restrictions in their autonomous region budgets, which will give them an advantage over the rest of the regions.

The stricter fiscal adjustment conditions which autonomous communities and local corporations must meet will probably allow the regions that attain their targets first to exit the crisis earlier. However, the more necessary the adjustment is, and the higher the weighting of the public sector in the region's economy, the greater the short term impact will be. But it is clear that the solution does not lie in endlessly postponing the process (which has to be carried out anyway, but under harsher conditions the longer the delay).

Lastly, on the positive side, we have external demand, although it offers less support than what we have seen in the last two years. The more outward-looking regions, will benefit more from global growth, although, like in 2011, the impact will be greater for autonomous communities that have significant exports to emerging markets, while regions that rely more on the European market will have less support, due to the fact that domestic demand in Europe will, in the best of the cases, enter a period of stagnation. The production of goods destined for export could show less dynamism than in 2011, although the contribution to growth of the foreign sector could benefit from the more severe contraction in imports.

Due to the difficulties that are still affecting Northern Africa, which are diminishing its importance as an alternative destination, in 2012 tourism could continue to make a positive contribution, although like in the rest of the export sector, there will be a slowdown. The virtual stagnation of domestic demand in the main markets will only be partially offset by the positive impact of North Africa's situation, and by the still robust growth of other markets such as the Russian or Chinese ones, whose overall impact is even lower. Given this context, the autonomous communities that are more oriented towards foreign tourism will find some support for growth in 2012, as occurred in 2011. The performance of foreign tourism explains the better relative performance of the Canary and Balearic Islands, with this segment also offering a degree of support, though less significant, for the Catalan economy, although in this case, it did not entirely offset the downturn in domestic demand.

13: For example, in Galicia Outlook, of December 2011, which can be consulted here: http://www.bbvaresearch.com/KETD/fbin/mult/1112_Situacion_Galicia_tcm346-281539.pdf?ts=3112012

Table 7

### Spain: Autonomous communities GDP growth forecasts (%)

| | 2011 | 2012 | 2013 |
|---|---|---|---|
| Andalusia | 0.1 | -1.8 | 0.3 |
| Aragon | 0.7 | -1.7 | 0.5 |
| Asturias | 0.9 | -1.1 | 1.1 |
| Balearic Islands | 1.3 | -0.4 | 1.6 |
| Canary Islands | 1.1 | -0.6 | 1.4 |
| Cantabria | 0.5 | -0.8 | 1.0 |
| Castile & León | 0.6 | -0.6 | 1.0 |
| Castile La Mancha | 0.2 | -2.4 | 0.2 |
| Catalonia | 0.7 | -1.7 | 0.7 |
| Extremadura | 0.4 | -1.1 | 0.5 |
| Galicia | 0.5 | -0.9 | 0.7 |
| Madrid | 1.2 | -0.3 | 0.8 |
| Murcia | 0.6 | -1.9 | 0.5 |
| Navarre | 1.1 | -0.1 | 0.7 |
| Basque country | 0.8 | -1.0 | 0.8 |
| La Rioja | 1.0 | -1.4 | 0.7 |
| Valencian Com. | 0.6 | -2.2 | 0.2 |
| **Spain** | **0.7** | **-1.3** | **0.6** |

Source: BBVA Research

Table 8

### Factors underpinning the differences in regional growth (2012)

| | Residential investment (unsold stock/ number of homes) | Dependence on the automobile sector: % of automobiles in regional exports | Private sector leverage | Unemployment rate | Autonomous communities debt (% GDP) | Relative per capita GDP | Exposure to foreign markets (goods and tourism) |
|---|---|---|---|---|---|---|---|
| Basque country | √ | | √ | √ | √ | √ | |
| Cantabria | √ | | | | | | |
| Madrid | | | | | √ | √ | |
| Navarre | | X | | √ | | √ | √ |
| Asturias | | | √ | | | | |
| Galicia | | | | | | | |
| Aragon | | X | | | | | |
| Castile & Leon | | X | √ | | | | |
| Catalonia | | | | | X | | √ |
| Balearic Islands | | | X | | X | | √ |
| Extremadura | √ | | | | | X | X |
| La Rioja | X | | | | | | X |
| Canary Islands | X | | | X | | | √ |
| Murcia | | | X | | | | |
| Andalusia | | | X | X | | X | |
| Castile La Mancha | X | | | | X | X | X |
| Valencian Com. | X | | X | | X | | |

Note: X represents a negative factor and √ a positive one. A category is considered a factor when it surpasses the average by one standard deviation.
Source: BBVA Research

## Box 3. Fiscal consolidation: one step backwards, two steps forward?

**Missing the 2011 budget deficit target undermined the credibility of all public administrations.**

In its first cabinet meeting last 30th of December, the government indicated that the public deficit for this year may have surpassed 8% of GDP, a far cry from the 6% established for the entirety of the public administrations. The definitive figure will be known in February, but extrapolating from the performance seen up to November, the possible deviation of the Central Government and the local corporations from their targets may only be by a few tenths of a point. The imbalance in Social Security might have been somewhat greater, registering a slight deficit, while the greatest deviation with respect to the established targets would be observed in the autonomous communities.

The confirmation of this announcement, would suggest, first of all, that the control instruments implemented by the State were not sufficient to incentives compliance from autonomous communities. Second, it indicates the need to immediately implement measures that offset the deviation registered in 2011, and guarantee that the noncompliance with the commitments will not be repeated this year. Therefore, the definitive figures should explain why this imbalance became so accentuated in the last quarter of the year, given that the situation was more extreme than what appeared to be possible give the trends observed in recent months, especially in regard to the central government's accounts.

**The government' s response has been firm, but it is still not enough to ensure that targets this year will be met**

In response to this significant deviation, the Government presented adjustment measures for a similar amount (1.5% of GDP) to what the State would need to reduce its deficit from the target established in 2011 (4.8%) to that of 2012 (3.2%), in the absence of deviations in 2011, and with the same growth scenario as what was envisaged when the commitment was made. When the government has at its disposal the final figures for 2011, and the new growth forecasts for the Spanish economy (to be published by the European Commission) it should announce additional measures to compensate for the noncompliance that was registered in 2011, and the expected deterioration in the deficit derived from the poor growth outlook for the Spanish economy in 2012.

**The State's adjustment, that is both necessary and credible, also represents a lost opportunity to improve the efficiency of the tax system and governance of expenses**

The measures adopted by the government are credible both in terms of the expected effect on tax collection (6,100 million euros), and because 60% of the adjustment comes from a reduction in public spending (8,900 million euros). This is positive, since, on one hand, the fact that the budget cuts represent a greater portion of the fiscal adjustment than tax increases lends more credibility (since most of the reduction in the deficit does not depend on the uncertain tax collection), and on another, the effects on activity and employment could be less negative than those of tax hikes. This idea is based on the perception that part of the current spending could be inefficient, and therefore a reduction of public spending in contrast to a tax increase would result in a smaller decline in product. However, the size and continuity of the fiscal adjustments have evidenced a major shortfall of the Spanish public administration: on an institutional level, it appears unable to evaluate the efficiency, benefits or costs for society, of the implementation of these types of policies. For example, although it has provided a breakdown by Ministry of the spending cuts, it has not explained the criteria used when deciding upon this distribution. Consequently, it would be desirable to create an independent organism to evaluate public policies and to carry out analyses that could serve as a guide for society, with information regarding the costs and benefits of specific projects.

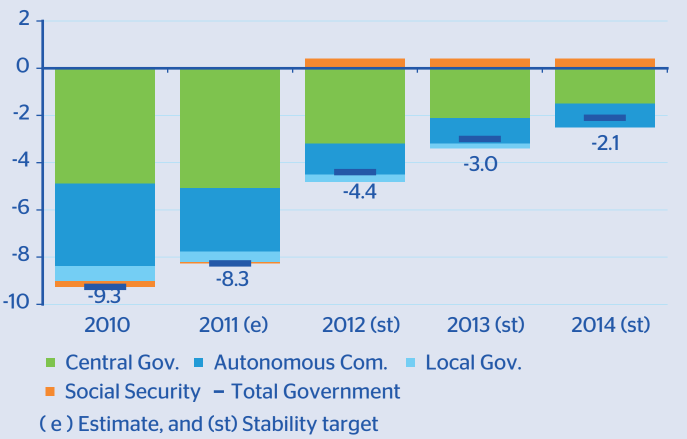
Lastly in regard to the tax hikes and the advance towards a more efficient system, while both the increase in tax rates for income and capital, as well as the return of the deduction for home purchases don't improve efficiency,, the increase of the real estate tax (RET), though unpopular, is a positive one. In terms of personal income tax, the evidence shows that both the level and the progressiveness of the tax regime in Spain are in line with the other euro countries. Increasing this tax would, at the very least, create a competitive disadvantage with respect to the other European countries, and be a bad sign for young people, to the degree that the accumulation of human capital and jobs is related to income. The increase in the real estate tax is good news, since it represents another step towards recovering income lost as a result of the real estate crisis, while incentivising rentals. The problem is that the government has simultaneously reinstituted the income tax deduction for primary home purchases and extended the application of a super-reduced VAT for the acquisition of new homes, both of which basically offset the increase in the real estate tax.

**The biggest uncertainty concerning the adjustment in 2012 relates to the autonomous regions and Social Security**

If the 2011 target had been met, the government would have only needed to reduce the deficit by 1.5% of GDP in 2012 (the same amount as the measures announced) to reach this year's target. However, if the deviation announced is confirmed, it will be necessary to roll out additional measures, which are at least equivalent to between 2 and 2.5pp of GDP - to meet the 2012 targets. This additional adjustment should mainly be borne by the autonomous communities. Furthermore, 2012 revenue will also fall short of the targets set in the previous administration' s Stability Programme, which specified real GDP growth of 2.3% in 2012, vs. our forecast in this publication of -1.3%.

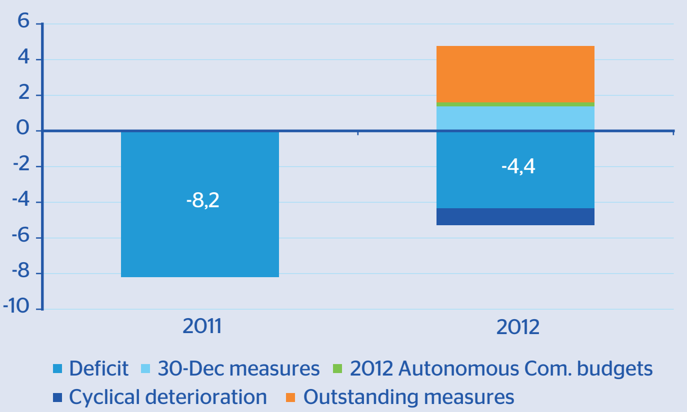
The impact of a double dip recession could be especially important for Social Security, whose rigid spending regime and dependence on job creation to generate revenue will make it difficult to reverse the negative trend seen on its balance sheet in 2011. In particular, if the drop in GDP is confirmed, the public deficit could suffer a further deterioration, of approximately 1pp of GDP. This means that the measures designed to compensate for the deviation from the deficit targets in 2011 (slightly over 25 billion), as well as the possible cyclical deterioration due to the fall-off in economic activity (about 10 billion) would have to be added to the 15 billion euro figure announced by the State.

Chart 29
**Public administrations: financing capacity (+)/requirements (-) according to the Stability Programme (% GDP)**




Source: BBVA Research based on MEH

Chart 30
**Public administrations: contribution to the fiscal adjustment according to the Stability Programme (pp GDP)**




Source: BBVA Research based on MEH

## The measures taken to improve liquidity in the autonomous communities are on the right track

The uncertainty in the sovereign debt markets, combined with the lack of willingness by autonomous communities to reduce their deficits, have made it difficult for some of them to access credit, shifting part of the problem onto their creditors, especially companies. Therefore, the measures adopted by the government aimed at improving region's liquidity positions are a positive development. Specifically, the State has extended the deadline for regions to pay back their debt, increasing it from 5 to 10 years (0.3% of GDP less to pay each year), it has moved forward a portion of the payments for the settlement of the financing model for 2010 which were have to be made in the second half of the year to the first part of the year (0.8% of GDP)., it has promised to accelerate the authorisation for debt issues and has opened the possibility of accessing a line of credit so that regions can pay the creditor companies.

In principle, none of these measures will have an effect on the deficit of the autonomous communities, except the last measure, to the degree that it acts as an incentive for regions to recognise obligations that up to now would not have been accounted for. In any event, the government made it clear that access to the line of credit would be subordinated to a balance sheet restructuring plan, which would limit participation to autonomous communities that have suffered from a sustained lack of access to capital markets.

## More important are the measures that aim to improve the perception of solvency

Regarding the medium and long term commitment to stability in public finances, the Draft Organic Law on Budget Stability sends a clear and firm message to the rest of the European partners. Spain is one of the first countries to adopt this type of legislation and, in principle, it will do so with a broad political consensus, given that the initiative has the support of autonomous communities and local corporations, in addition to the approval of a good part of the opposition party, so its legislative passage should not suffer significant delays.

The key elements of the draft version[14] include a cap on public debt of 60% of GDP and establish that all the administrations must have either balanced accounts or show a surplus, and a structural balance of zero. Only in certain cases may the structural deficit reach 0.4% of GDP. It also establishes a spending cap for all the administrations, stipulating that spending may not outpace nominal GDP growth.

Furthermore, it defines practical and credible control mechanisms over regional administrations, which will increase the likelihood that the targets established in the coming years will be met. For example, it promotes more transparent reporting, which allows for a better analysis of the public administrations, and establishes penalties and steps to follow in the event that targets are not met. It thereby requires autonomous communities' reporting to be as transparent as what is demanded from Spain by the European Union, which facilitates the evaluation of the measures presented on the regional level.

14: For a more detailed discussion, please consult the Council of Ministers reference of 27 January 2012 at http://www.lamoncloa.gob.es/ConsejodeMinistros/Referencias/_2012/refc20120127.htm

We also have a positive view of the procedures established to incentives a quick return to fiscal discipline in the event of deviation, which is in line with European regulations. Under this framework, systems are created that allow violators to present a plan to correct their situation, with credible sanctions that do not worsen the problem (pro-cyclical) and penalties that are harsh enough to dissuade permanent deviation. First, the infringing administration must present an economic-financial plan to correct the infraction within one year (not three, as with current programmes). More importantly, in the event of noncompliance with the plan, the administration is required to subscribe to an agreement of budgetary non-availability in order to guarantee that the targets are met, thereby increasing the credibility of these types of plans.

Second, an effective sanctioning mechanism is put in place so that, in the event of non-compliance with the plan, the infringing administration must make an interest bearing deposit equivalent to 0.2% of its nominal GDP, which will convert into a fine if the non-compliance is not remedied in six months, thereby preventing the sanction from having a detrimental effect on the deficit. In addition to this fine, the infringing administration would also be responsible for paying the fine imposed by Europe on Spain for not meeting its stability commitments.

In addition, the Government has determined that if the noncompliance has not been remedied after nine months, the Ministry of Economy will have the power to send a team to impose a balance sheet restructuring plan on the infringing administration. Avoiding such an intervention by the State would, without doubt, be one of the main incentives for autonomous communities to meet their deficit targets.

### The effectiveness of the Budget Stability Law will depend on how ambitiously it is implemented

This publication has repeatedly urged that the creation of a structural deficit rule[15]. Such a rule would be a step forward towards improving both the implementation of the fiscal policy and the perception of public administrations' solvency and it would also decrease the volatility of the Spanish economic cycle. However, so far the approach to be used to define the stage in the economic cycle has not been made public. In our view, a clear, simply method that can be reproduced easily and assessed externally is also a necessary condition for the reform to achieve the desired level of success. Moreover, it must state explicitly that the deficit target must be established in structural terms and there must not be any confusion regarding the conditions for speeding up the debt reduction process so that fiscal policy does not lead to pro-cyclical actions that could cause imbalances. Ideally this methodology would be adaptable to the major differences that currently exist between autonomous communities' fiscal adjustment processes, and would also take into account the economic cycles' varying degrees of volatility across regions.

### The fiscal adjustment necessary to meet the 2020 targets are in line with BBVA Research estimates

We also have a positive view of the requirement that every three years an evaluation is to be carried out of the performance of the structural deficit (0% of GDP) and debt (60% of GDP) in order to ensure that they remain on track to meet the 2020 targets. The government has proposed a transitional period in which the average annual reduction of the structural deficit would be 0.8%. This puts its estimate of the structural deficit at 6.5% of GDP, which is in line with BBVA Research estimates.

### Ideally, this improvement in governance would only be used for the adjustment of the structural deficit

As discussed previously, a major adjustment will be necessary to meet the 2012 targets (about 50 billion), and its composition will have to be reconfigured since, among other things, the currently forecast improvement for the Social Security deficit is not realistic. If this process meets with a degree of success and there is progress on the institutional level, it would make sense that Europe decided to start using this new fiscal framework, allowing the automatic stabilisers to do their work, without the need for public administrations to compensate for imbalances. This would imply that the public deficit would end 2012 at approximately 5.3% of GDP, and that Spain would meet its fiscal adjustment targets (according to this new definition).

To shed light on the foregoing, Table 9 includes BBVA Research's estimates which are based on the projections contained in the 2011 Stability Plan carried out by the government and the scenario set forth in this publication. First, it should be highlighted that the total deficit is divided into two components, structural and cyclical. The economy's structural position in the cycle determines the difference between current GDP and an estimate of this indicator's trendline: if both are equal, the public deficit due to cyclical factors is equal to zero, while if the GDP is higher (or lower) than the trendline, it is likely that the economic cycle is contributing to an improvement (or worsening) in the position of public finances, for which reason there would be a cyclical surplus (deficit). According to Table 9, the 2011 Stability Programme entails a cumulative structural adjustment of 4.5 of GDP between 2011 and 2012, i.e. the Spanish government is expected to announce measures equivalent to 45 billion euros during these two years. The rest of the improvement in the public deficit will come once a recovery in the economy gets underway from its relatively depressed levels. However the deviation with respect to the 2011 deficit targets and the downward revision to the growth outlook means that reducing the deficit beyond 6% of GDP in 2012 would require a greater structural adjustment than the one set forth in the previous government Stability Programme.

15: See Spain Economic Outlook, May 2011

Consequently, this publication's forecast of the structural deficit for public administrations in their totality (5.3% of GDP) implies that the Government would take measures to compensate for deviations from the previous year and to meet the structural adjustment targets set in the 2011 Stability Programme. However, even after these steps are taken, the deficit would still end up around 1pp of GDP lower than the target as a result of the cyclical deterioration in the economy. Furthermore, as can be seen in the same table, the revised outlook implies that if the 2013 deficit target of 3% is maintained, the improvement in the economy's structural position would be sufficient to reach the target set in the Constitution of zero structural deficit seven years before than the one stipulated by the Budget Stability draft law.

Table 9
### Growth and public debt estimates

| | GDP growth (%) | | Public deficit | | Structural deficit | | Cyclical deficit | |
|---|---|---|---|---|---|---|---|---|
| | Stability Programme (2011) | BBVA (Jan 2012) | Stability Programme (2011) | BBVA (Jan 2012) | Stability Programme (2011) | BBVA (Jan 2012) | Stability Programme (2011) | BBVA (Jan 2012) |
| 2010 | -0.1 | -0.1 | -9.2 | -9.2 | -6.9 | -7.7 | -2.3 | -1.5 |
| 2011 | 1.3 | 0.7 | -6.0 | -8.2 | -3.5 | -6.5 | -2.5 | -1.7 |
| 2012 | 2.3 | -1.3 | -4.4 | -5.3 | -2.4 | -2.4 | -2.0 | -2.9 |
| 2013 | 2.4 | 0.6 | -3.0 | -3.0 | -1.3 | -0.1 | -1.7 | -2.9 |

Source: BBVA Research and 2011 Stability Program

# 4. Tables

Table 10

## Macroeconomic forecasts: Gross Domestic Product

| (yoy rates, %) | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| US | -3.5 | 3.0 | 1.7 | 2.3 | 2.2 |
| EMU | -4.2 | 1.8 | 1.6 | -0.5 | 1.0 |
| Germany | -5.1 | 3.6 | 3.0 | 0.5 | 1.7 |
| France | -2.6 | 1.4 | 1.6 | 0.2 | 1.4 |
| Italy | -5.1 | 1.4 | 0.4 | -1.5 | 0.2 |
| Spain | -3.7 | -0.1 | 0.7 | -1.3 | 0.6 |
| UK | -4.4 | 2.1 | 0.9 | 0.5 | 1.4 |
| Latin America * | -0.6 | 6.6 | 4.5 | 3.7 | 4.1 |
| Mexico | -6.1 | 5.4 | 3.8 | 3.3 | 2.9 |
| EAGLES ** | 4.0 | 8.4 | 6.7 | 5.9 | 6.5 |
| Turkey | -4.9 | 9.2 | 8.5 | 1.9 | 4.2 |
| Asia Pacific | 4.2 | 8.1 | 5.8 | 5.8 | 6.1 |
| China | 9.2 | 10.4 | 9.2 | 8.3 | 8.7 |
| Asia (exc. China) | 1.0 | 6.7 | 3.5 | 4.2 | 4.4 |
| World | -0.6 | 5.1 | 3.9 | 3.5 | 4.1 |

Closing date: 31 January 2011
* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 11

## Macroeconomic forecasts: 10Y interest rates (average)

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| US | 3.2 | 3.2 | 2.8 | 2.3 | 2.7 |
| EMU | 3.3 | 2.8 | 2.6 | 2.2 | 2.7 |

Closing date: 31 January 2011
Source: BBVA Research

Table 12

## Macroeconomic forecasts: exchange rates (average)

| US dollars ($) per national currency | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| US (EUR/USD) | 0.72 | 0.76 | 0.72 | 0.80 | 0.79 |
| EMU | 1.39 | 1.33 | 1.39 | 1.26 | 1.27 |
| UK | 1.56 | 1.55 | 1.60 | 1.59 | 1.64 |
| China | 6.83 | 6.77 | 6.46 | 6.25 | 5.94 |

Closing date: 31 January 2011
Source: BBVA Research

Table 13

## Macroeconomic forecasts: official interest rates (end of period)

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| US | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| EMU | 1.00 | 1.00 | 1.10 | 0.75 | 0.75 |
| China | 5.31 | 5.81 | 6.56 | 6.06 | 6.56 |

Closing date: 31 January 2011
Source: BBVA Research

Table 14

EMU: macroeconomic forecasts (yoy change, %, unless otherwise indicated)

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Real GDP | -4.2 | 1.8 | 1.5 | -0.5 | 1.0 |
| Household consumption: | -1.1 | 0.8 | 0.2 | -0.2 | 0.8 |
| Public consumption | 2.5 | 0.6 | 0.1 | -0.4 | 0.5 |
| Gross fixed capital formation | -11.9 | -0.7 | 1.8 | -2.6 | 1.5 |
| Equipment, machinery and cultivated assets | -15.4 | 4.7 | 4.7 | -2.6 | 2.2 |
| Equipment and machinery | -17.5 | 4.1 | 5.4 | -1.9 | 2.3 |
| Construction | -9.4 | -4.4 | -0.6 | -3.0 | 1.0 |
| Housing | -11.9 | -3.6 | 1.8 | -1.0 | 1.2 |
| Other buildings and other constructions | -6.7 | -5.2 | -3.0 | -5.2 | 0.7 |
| Change in inventories (contribution to growth) | -0.8 | 0.5 | 0.1 | 0.0 | 0.0 |
| **Domestic demand (contribution to growth)** | **-3.5** | **1.0** | **0.6** | **-0.7** | **0.9** |
| Exports | -12.8 | 11.3 | 6.8 | 2.6 | 3.3 |
| Imports | -11.6 | 9.5 | 4.8 | 2.1 | 3.1 |
| **Net exports (contribution to growth)** | **-0.7** | **0.8** | **0.9** | **0.2** | **0.1** |
| **Pro-memoria** | | | | | |
| GDP w/out housing investment | -3.7 | 2.1 | 1.5 | -0.5 | 1.0 |
| GDP w/out construction | -3.5 | 2.6 | 1.8 | -0.2 | 1.0 |
| Employment (LFS) | -1.8 | -0.5 | 0.5 | -0.2 | 0.3 |
| Unemployment rate (% active pop.) | 9.6 | 10.1 | 10.1 | 10.6 | 10.5 |
| Current account balance (% GDP) | -0.1 | 0.1 | 0.0 | -0.1 | 0.4 |
| Public sector balance (% GDP) | -6.4 | -6.2 | -4.2 | -3.0 | -2.0 |
| CPI annual average | 0.3 | 1.6 | 2.7 | 1.8 | 1.3 |

Closing date: 31 January 2011
Source: official institutions and BBVA Research

Table 15

## Spain: macroeconomic forecasts (yoy change, %, unless otherwise indicated)

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| **Actividad** | | | | | |
| Real GDP | -3.7 | -0.1 | 0.7 | -1.3 | 0.6 |
| Private consumption | -4.3 | 0.8 | 0.0 | -2.0 | -0.9 |
| Public consumption | 3.8 | 0.2 | -1.2 | -3.1 | -1.8 |
| Gross fixed capital formation | -16.4 | -6.0 | -4.3 | -6.2 | -1.9 |
| Capital goods | -22.6 | 5.5 | 2.1 | -5.2 | 1.9 |
| Construction | -15.4 | -10.1 | -7.6 | -7.3 | -4.0 |
| Housing | -22.0 | -9.8 | -4.8 | -6.5 | -1.5 |
| Domestic demand (contribution to growth) | -6.5 | -1.0 | -1.3 | -3.2 | -1.3 |
| Exports | -10.2 | 13.5 | 9.2 | 1.6 | 8.2 |
| Imports | -16.9 | 8.9 | 1.6 | -4.8 | 2.1 |
| Net exports (contribution to growth) | 2.8 | 0.9 | 2.0 | 1.9 | 1.9 |
| GDP at current prices | -3.7 | 0.3 | 2.3 | 0.1 | 1.6 |
| (Billion euros) | 1047.8 | 1051.3 | 1075.4 | 1076.0 | 1093.4 |
| **Labour market** | | | | | |
| Employment (LFS) | -6.8 | -2.3 | -1.9 | -4.2 | -1.9 |
| Unemployment rate (% active pop.) | 18.0 | 20.1 | 21.6 | 24.4 | 24.6 |
| Employment QSNA (equivalent to full-time) | -6.4 | -2.6 | -1.8 | -3.8 | -1.9 |
| Productivity | 2.7 | 2.6 | 2.5 | 2.5 | 2.5 |
| **Prices and costs** | | | | | |
| CPI (annual average) | -0.3 | 1.8 | 3.2 | 1.2 | 1.1 |
| GDP deflator | 0.1 | 0.4 | 1.6 | 1.4 | 1.0 |
| Household consumption deflator | -1.2 | 2.4 | 3.4 | 1.4 | 1.0 |
| Compensation per employee | 4.3 | 0.0 | 0.7 | 2.8 | 3.9 |
| Unit labour cost (ULC) | 1.6 | -2.6 | -1.8 | 0.3 | 1.4 |
| **Foreign trade** | | | | | |
| Current account balance (% GDP) | -5.2 | -4.6 | -4.3 | -3.5 | -1.1 |
| **Government sector** | | | | | |
| Debt (% GDP) | 53.6 | 60.7 | 67.6 | 72.5 | 74.4 |
| Public Administration balance (% of GDP) | -11.2 | -9.3 | -8.2 | -5.3 | -3.0 |
| **Households** | | | | | |
| Nominal disposable income | 0.9 | -2.4 | 0.0 | -1.5 | 0.8 |
| Savings rate (% of nominal income) | 18.5 | 13.9 | 11.1 | 10.2 | 10.9 |

Closing date: 31 January 2011
Source: official institutions and BBVA Research

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