Situación Spain

October 2000

- Deceleration commences
- Inflation: home for Christmas?
- Fiscal Deficit: a positive zero
- The New Economy in Spain: Situation and Prospects

Research Department

BBVA

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Contents

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1. International environment

Having attained 4.5% growth in 2000 (the highest since 1984), the world economy will slow in 2001 to 3.8% as a result of a slow-down (by one percentage point) in the OECD economies; however, the developing countries will continue to grow as they did in 2000 and will, therefore, return to the growth differential they had with respect to the industrialised economies before the Asian crisis.

Oil dampens the OECD's optimism

Higher-than-expected oil prices in recent months have reduced optimism about OECD growth. Overall economic growth could slip from 4.1% in 2000 to 3.1% in 2001, i.e. the average of the last twenty years.

The impact of energy price movements on the economy depends on the size, intensity and duration of the movement. Although oil prices have clearly risen considerably (170% in nominal terms in seven quarters), this increase should be viewed in context. Firstly, the size of the change should be measured with respect to an average and not with respect to a low. By this yardstick, the rise is 80%, i.e. considerably less than in the 1970s. Secondly, relative prices are what matter when analysing the effects on the economy. In this case, the current price is 60% below the high reached in the 1970s. Thirdly, prices of the other commodities have not increased, unlike other times when oil prices rose.

Intensity, understood as the speed of the movement, is the key to evaluating the capability of economic agents and technology to adapt to the change. A

Table 1.1. Growth projections

	1998	1999	2000	2001
OCDE	**2.3**	**3.2**	**4.2**	**3.1**
USA	4.3	4.2	5.2	3.5
EMU	2.7	2.4	3.5	2.5
UK	2.6	2.1	2.9	2.3
Japan	-2.8	0.3	1.3	1.8
Developing countries	**3.1**	**3.4**	**4.8**	**5.0**
Latin America	1.9	0.0	4.3	4.5
Countries in transition	**-0.6**	**2.4**	**4.0**	**3.6**
World-wide	**2.5**	**3.3**	**4.5**	**3.8**

Source: FMI and BBVA

Graph 1.1.

Brent oil price

In dollars and in real terms*

* Deflated with 1960 worl export prices.

Source: Bloomberg and BBVA

gradual rise has a lower impact on expectations. The duration of the price increase, measured as how many quarters the price remains above the average of recent years, is already 6 quarters and, with the current projections, this could continue for one more year in spite of price reductions. Overall, although the rise cannot be compared to the oil shock in the 1970s, there is undoubtedly cause for concern.

Table 1.2. Oil crisis league table

	Date shock commenced			
	4Q73	3Q79	3Q90	3Q99
Magnitude[1]	258	118	45	85
Intensity[2]	2	5	2	7
Duration[3]	17	16	2	10*
Total**	6.4	4.5	1.5	3

[1] Desviation with respect to the 5-year moving average in real terms
[2] Number of quarters to peak
[3] Number of quarters over the 5-year moving average
* Based on projections until 2001 year-end
** Weighted average of normalised criteria. Weightings: 40% for magnitude, 20% for intensity and 40% for duration.

An asymmetric shock

The impact of the oil price rise could be greater in Europe and Asia than in the US because of the following factors: i) the goods and labour markets are more rigid in Europe and Asia than in the US, and this could lead to a greater impact on inflation and growth; ii) the combination of the oil price rise with the currency depreciations has affected not only EMU but also many Southeast Asian economies; iii) there is little evidence in Europe and Asia of a positive supply

Table 1.3. Inflation projections

	1998	1999	2000	2001
OCDE	1.6	1.4	2.3	1.9
USA	1.6	2.2	3.4	2.4
EMU	1.1	1.2	2.3	2.0
UK	2.7	2.3	2.2	2.5
Japan	0.6	-0.4	-0.6	-0.1
Developing countries	10.3	6.9	6.1	5.1
Latin America	9.5	9.2	7.1	6.1
Countries in transition	21.1	41.8	18.3	12.4
World-wide	6.0	5.5	4.6	3.7

Source: FMI and BBVA

shock that might offset this negative shock, unlike in the US, which is currently gaining in productivity due to the "New Economy."

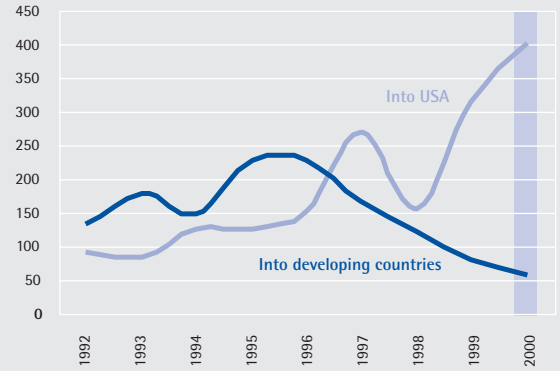
The EMU's growth estimate for 2001 is about 2.5%, i.e. one percentage point lower than the projection for 2000. The performance of oil and the signs of wage acceleration, which could intensify in the coming months, reduce the scope for optimism. Although US growth could slow to 3.5% in 2001 from 5.2% in 2000, the predictions are for a soft landing. Consequently, the growth gap between the two blocs will continue to be wide.

In a context where oil prices are easing, US inflation will decrease by one percentage point to 2.4% in 2001. Productivity gains, decreasing marketable goods prices (due to the New Economy), and a strong dollar will continue to be deflationary factors. Although EMU inflation averaged 2.3% in 2000, it will remain above the European Central Bank's (ECB) ceiling until next summer, averaging 2%. Consequently, there is a risk of inflation rising. Wages could increase in a context of worsening inflation prospects. In fact, during the 1990s, real wages grew by an average of 1.2% in EMU whereas they remained stable in the US in spite of the positive supply shock in recent years. Several European countries' policy of reducing indirect taxes in recent months to respond to the oil price rise are not only inappropriate but also contribute to boosting consumption of products that have become expensive. This further impoverishes importing countries while increasing price tension. Overall, the inflation gap between the US and EMU will narrow considerably in 2001 and could even run the risk inverting. A growth gap that is favourable to

Graph 1.2.

Net influx of funds

Billions of dollars



Source: BEA and FMI

the US and higher inflation in EMU could reduce international investor confidence in the European economy.

The New Economy: a boost for the US but a burden for emerging countries

The US economy's ongoing performance is based on the sizeable contribution to growth by investment in software and communications technology. This has triggered an acceleration in productivity, equalling the highs in 1983 and meaning that an increase in potential GDP, employment and real wages is compatible with a decrease in the economy's costs and prices. Continuing this process will enable the US to partially offset the effects of a negative supply shock such as the oil crisis. However, this is not the case in EMU. In fact, US potential growth increased by one percentage point to 3.5% in the second half of the 1990s, whereas EMU's current estimates point to potential growth of 2.2%, i.e. similar to that observed in previous decades.

Furthermore, the New Economy in the US is generating positive and negative effects in other economies. The main positive effects are: i) an increase in world demand and trade; ii) a decrease in US marketable goods prices, stimulating investment; and iii) real appreciation of the dollar, which could initially increase the competitiveness of the other economies. A negative effect is that the new economy shifts the flow of investments towards the US because of higher potential returns. Consequently, the

US economy is competing for world savings, which could offset the positive effects, especially in economies with major financing needs, such as the developing countries. In fact, net foreign inflows into the US have quadrupled since 1995, whereas inflows to the developing countries have shrunk to one quarter.

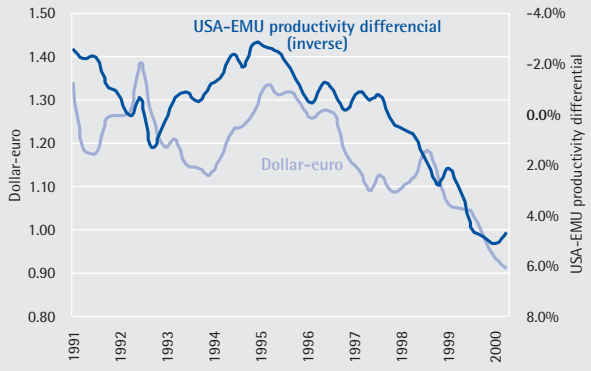
There are also other major negative indirect effects. An increase in potential output raises real interest rates (currently 1.3 percentage points above 1996 levels), which is detrimental to emerging countries' borrowing. The rising dollar is also a source of vulnerability for countries whose currencies are linked to the dollar.

The euro has little room to appreciate

This increase in US productivity, which is not matched by EMU, also has implications for the "equilibrium" dollar-euro exchange rate. Confidence in the euro's appreciation was based on returning to the long-term level, obtained as purchasing power parity adjusted by productivity differences (generally about 1.05-1.10). However, factoring in the new US and EMU productivity data shows that this equilibrium has decreased since 1997 and now it is difficult to defend a long-term level above parity. This considerably reduces the dollar's overappreciation with respect to the euro and questions the size of the misalignment, limiting the euro's appreciation margin.

Graph 1.3.

Dollar-euro and USA-EMU productivity differential



Source: BCE and US Labor Department

In this macroeconomic scenario, where there are more uncertainties about the European economy than about the US, the euro's short-term volatility seems to be guaranteed. Only an increase in the ECB's credibility or further intervention (after that on 22 September) to fix a support or reference level for the euro would reduce this volatility.

In the medium term, a reduction in the profitability gap between the US and EMU and a slow-down in US productivity are the key factors that could raise the euro to near the 0.9 level at the end of 2001.

Interest rates close to peak

The upswing in interest rates has apparently ended in the US, where economic activity is easing, inflation will decrease in 2001 and the stock markets will be less "exuberant." Currently, monetary policy is tight, the dollar is high and short-term interest rates are one percentage point above the 1990s average (although this is due partly to the increase in productivity and potential output). Consequently, interest rates could be adjusted downwards slightly in 2001.

The situation is different in EMU. Expectations of an increase in inflation will force the ECB to raise interest rates again by half a percentage point to 5.25% in late 2000 or early 2001. In fact, the delay in making this decision could make it necessary to raise interest rates more aggressively in the future.

A hard landing worldwide is not on the cards

The decrease in share prices, which caused investors to take refuge in US bonds, has increased the possibility of a sharp adjustment in the world economy that could be detonated by an oil price rise, although the explanation really lies in the overvaluation of the potential corporate earnings, especially new technology companies.

However, the increase in market flexibility in recent years, a reduction in oil dependency and the considerable room for manoeuvre in US fiscal and monetary policy reduce the probability of this risk scenario.

2. The real economy

Deceleration commences

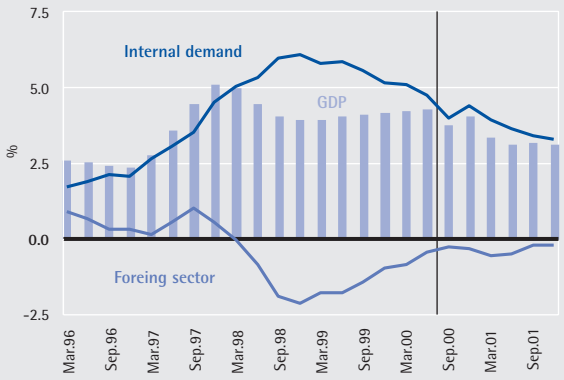
Last summer, Spain's economy entered a deceleration phase following a first half in which GDP increased by 4%, i.e. more than in 1999 (according to the latest estimates by INE –Spain's official statistics body). The incipient slowing of GDP growth is mainly a result of more sluggish internal consumer demand and investment, which is partly mitigated by the lower negative contribution by the foreign sector due to slowing imports.

The recent worsening of the outlook and business activity indicators in the industrial sector world-wide, plus the uncertainties as to the final effect on households' and businesses' disposable income of the rise in energy prices, are the first signs of a deterioration in Spain's growth prospects for what remains of 2000 and for 2001.

Spain is at the threshold of a cyclical deceleration as a result of the exhaustion, to a greater or lesser extent, of the demand- and supply-side factors which boosted the recent expansive cycle. These factors were wage moderation, a good foreign situation (due to the euro's depreciation and the more buoyant world economy) and an expansive policy mix, where fiscal policy has not been so tight as to offset the relaxed monetary policy. Additionally, there was a decline in commodity prices, particularly oil, in the wake of the Asian crisis. Wage moderation was made easier by the good inflation performance and a less aggressive approach to wages following the 1992-1994 employment crisis and the subsequent labour market reforms. These reforms made the market more flexible, but were not ambitious enough to guarantee the smooth working of the labour market. Despite the slight progress made, structural reform has yet to be undertaken in Spain's economy, both in the labour market and in the goods and services markets. The other European economies are just as much in need of sweeping reforms as Spain, and the example to follow for liberalisation and increasing flexibility should therefore be that of English-speaking countries, particularly the USA.

Graph 2.1

Breakdown of growth



Source: INE and BBVA

Table 2.1

Trend-cycle data 1995 prices	1999 1Q99	 2Q99	 3Q99	 4Q99	2000 1Q00	 2Q00	 3Q00	 4Q00	2001 1Q01	 2Q01	 3Q01	 4Q01	Annual average 1999	 2000	 2001
Household end comsuption (1)	4.4	4.6	4.9	5.0	4.9	4.4	4.0	3.8	3.9	3.7	3.6	3.5	4.7	4.2	3.7
Government end comsuption (2)	3.6	3.3	2.7	2.2	1.5	1.0	1.0	6.0	2.4	2.4	2.4	2.4	2.9	2.4	2.4
Gross fixed capital formation	10.7	10.3	8.4	6.5	6.6	6.5	6.1	5.7	4.8	4.1	3.5	3.3	8.9	6.2	3.9
Capital goods	9.0	9.5	9.5	7.1	4.8	3.8	5.5	6.0	4.5	3.2	2.5	2.0	8.7	5.0	3.0
Construction	11.7	10.8	7.7	6.2	7.7	8.1	6.5	5.5	5.0	4.5	4.1	4.0	9.0	6.9	4.4
Variation in inventories (*)	0.1	0.1	0.2	0.2	0.3	0.3	0.0	-0.2	0.0	0.0	0.0	0.0	0.2	0.1	0.0
Domestic demand	**5.8**	**5.8**	**5.5**	**5.1**	**5.0**	**4.6**	**4.0**	**4.4**	**3.9**	**3.6**	**3.4**	**3.3**	**5.5**	**4.5**	**3.5**
Exports of goods and services	3.2	4.9	7.8	10.6	10.7	10.0	9.2	8.2	7.5	7.2	6.8	6.6	6.6	9.5	7.0
Imports of goods and services	9.8	11.2	12.7	13.6	13.2	10.9	9.8	9.0	9.0	8.5	7.3	7.0	11.9	10.7	7.9
Net foreing balance (*)	**-1.8**	**-1.8**	**-1.5**	**-1.0**	**-0.9**	**-0.5**	**-0.4**	**-0.4**	**-0.6**	**-0.6**	**-0.3**	**-0.3**	**-1.5**	**-0.5**	**-0.5**
GDP at market prices	**3.9**	**4.0**	**4.0**	**4.1**	**4.2**	**4.2**	**3.7**	**4.0**	**3.3**	**3.1**	**3.2**	**3.1**	**4.0**	**4.0**	**3.2**
Agricultural and fishing	-4.5	-3.5	-2.3	-1.8	-1.3	0.7	0.9	2.3	2.4	1.6	0.6	0.6	-3.1	0.6	1.3
Industry and energy	2.3	2.5	3.3	3.9	4.9	5.2	4.2	4.9	4.2	3.7	3.7	2.7	3.0	4.8	3.6
Construction	11.0	10.3	7.5	6.1	7.7	8.0	5.6	6.9	4.8	3.7	4.0	3.6	8.7	7.1	4.0
Services sector	3.8	4.0	4.0	4.1	3.7	3.5	3.3	3.4	3.0	3.0	2.8	3.0	4.0	3.5	2.9
Market services	4.3	4.5	4.7	4.7	4.3	4.1	3.9	4.0	3.5	3.5	3.3	3.3	4.5	4.1	3.4
Non-market services	2.1	2.1	2.0	1.9	1.7	1.5	1.4	1.3	0.9	1.0	1.0	1.9	2.0	1.5	1.2
Net tax on products	8.3	7.1	6.8	6.4	5.2	5.1	4.7	4.3	3.3	2.9	4.4	5.1	7.1	4.8	4.0
Pro memoria: GDP market supply price	3.9	4.0	4.0	4.1	4.2	4.2	3.7	4.0	3.3	3.1	3.2	3.1	4.0	4.0	3.2

(*) Contribution to GDP growth
(1) Including NPISH
(2) Quarterly growth in 2000 adjusted to obtain 2.4%, the estimate includes future revisions.
Source: INE and BBVA

Spain shows few signs of the phenomenon driving the new economy, namely the shock caused by the mass introduction of information technologies (computers, software, telecommunications and the Internet) into the production process. For the moment, the main impact of this phenomenon, which is the leap in productivity, appears not to have materialised. Indeed, productivity in Spain is growing at a far slower pace than in neighbouring countries, in line with Spain's insufficient investment in infrastructure and R&D and its under-developed venture capital sector (see the special report entitled "The new economy in Spain: situation and prospects" in this issue).

The revision of National Accounts reveals a more imbalanced cycle

The INE's revision of GDP growth between 1995 and 1999 does not alter Spain's growth projections of 4% in 2000 and 3.2% in 2001, although it implies greater deceleration in investment (particularly in capital goods) and foreign trade (particularly imports).

The annual revision of Spain's National Accounting baseline 1995 (CNE-95) reveals GDP growth was higher than originally estimated (4.3% in 1998 and 4.0% in 1999 – four-tenths and three-tenths of a point higher than previous estimates, respectively). The faster GDP growth in 1998 and 1999 was due to the increased positive contribution from internal demand (up 0.6 percentage points in both years) which was partly offset by the more negative contribution to growth by the foreign sector. The revisions in 1999 were in line with BBVA Research Department projections for the foreign sector, based on Customs figures, which envisaged an upward correction in the negative contribution amounting to 0.3 percentage points (from -1.2% to -1.5%).

Table 2.2.

New National Accounting 2Q00 Y/Y (%)	Growth	ID contribution	ED contribution
1996	2.4	1.9	0.5
1997	3.9	3.4	0.5
1998	4.3	5.6	-1.3
1999	4.0	5.5	-1.5
Revisions of National Accounting 1Q00			
1996	0.1	0.1	0.0
1997	0.1	0.2	-0.1
1998	0.4	0.6	-0.3
1999	0.3	0.6	-0.3

Source: INE and BBVA

Consumption shows signs of exhaustion

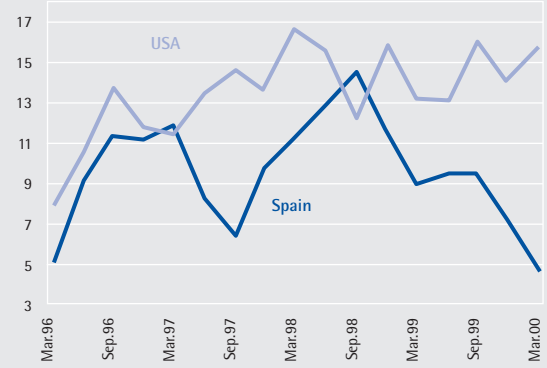
Household consumer expenditure has been decelerating moderately from the growth levels of around 5% attained in 2H99. This deceleration is mainly attributable to the end of the boost to disposable income that was provided by the 1999 income tax reform. In the second half of 2000, the deceleration which commenced at the beginning of the year will continue and growth will average 4.2% (0.5 percentage points lower than in 1999). In 2001, growth in household consumption will slow further to reach 3.7% since household income is expected to increase by less than in previous years due to the lower levels of job creation, which will boost precautionary saving.

Furthermore, despite the fact that households as a whole are net savers, the cost of debt is increasing (since January 2000 mortgages have gone up by 100 bp and consumer credit by between 40 bp and 90 bp). There is also expected to be a smaller increase in financial wealth due to lower stock market gains (shares account for 34% of Spanish households' financial assets). Nevertheless, the deceleration in consumption will be moderate since interest rates are at a record low (ex-post real rates are currently 1%).

Investment in capital goods grew by less than GDP

Investment in capital goods increased by 0.2% in 2Q00 (more than 12 points less than in the same period in 1999, and less than the increase in GDP). This is the sharpest deceleration in investment since 1995 (the first year for which comparable SEC 95 National Accounts are available). The available capital goods investment indicators seem to suggest that the deceleration is somewhat less abrupt, which implies that the figures for 2000 will be slightly more favourable than initially estimated.

Graph 2.2
Investment in capital goods
(% y/y)



Source: INE, US Labor Department and BBVA

Investment in capital goods. SEC 95 and availability indicator

Gross capital formation in capital goods (GCFCG) is one of the main components of aggregate demand, not so much because of its contribution to total GDP (which increased in nominal and volume terms between 1995 and 1999) as because of its impact on long-term economic growth. This is due to the fact that it measures increases in the existing production capacity and, therefore, the incorporation of technology into the production process.

The role of this variable as a measure of the technology being integrated into the system has been even more important since the implementation of the 1995 European Accounting System (SEC 95), which not only provided statistical improvements to the variable (new information sources and estimation methods) but also altered its definition. The main change with respect to the previous technology is that, with SEC 95, the value of the purchase of certain intangible assets is considered to be gross fixed capital formation (GFCF); these include: software[1], mining prospection expenses (previously considered to be intermediate consumption) and the acquisition of original works of art.

As a result of the introduction of SEC 95, gross capital formation (GCF) increased by 10.3% in 1995 (6.0 percentage points due to statistical changes and 4.3 percentage points due to changes in item categories). GCF was the demand component with the greatest relative, statistical and item category changes [2]. Among the latter, the most significant is the consideration of software and data bases as investments; this item alone represents almost 30% of the change in GCF, i.e. it is 3.1% of total GCF and 9.5% of GFCFCG.

The index of availability of capital goods (IDBE) [3] was the most significant indicator of GFCFCG under SEC 79. Today, following the inclusion of statistical and item category changes, it is of less use as an indicator since none of its components (production or buying and selling) includes software expenditure.

With respect to production, IT-related activities come under division 72 of Spain's National Classification of Economic Activities (CNAE 93). Within this division, the IT Applications Consulting and Supply sub-heading includes software investment, which is not an industrial activity and, therefore, is not included in the IPI (Industrial Production Index). With respect to the transactions with non-resident economic units, licences for non-financial intangible asset usage, patents, and rights to reproduce and use originals are exports and imports of services, not goods, meaning that they are not booked under capital goods trade either. As a result, the IDBE does not include the behaviour of around 10% of the variable whose performance it purports to reflect.

The weaker linkage between the IDBE and GFCFCG is revealed by the reduction in their correlation coefficient in 1995, when SEC 95 became available. The correlation between the annual GFCFCG and IDBE slipped from over 0.9 to 0.3. Furthermore, as the Quarterly National Accounting Figures have been released, the correlation has further diminished. Monitoring GFCFCG requires more far-reaching indicators that include information not only as to the availability of capital goods but also on software production and transactions.

[1] Under SEC 79, it was classified in the main investment value only if it was incorporated into the hardware purchased.

[2] GDP increased by 4.4% in 1995: 2.9 percentage points due to statistical improvements and 1.5 percentage points due to changes to definitions.

[3] This is calculated by adding the Industrial Production Index to the balance of imports minus exports of capital goods at constant prices. The aggregate weights each of the components with a coefficient: 0.945 for de IPI, 0.261 for imports and -0.206 for exports.

1995

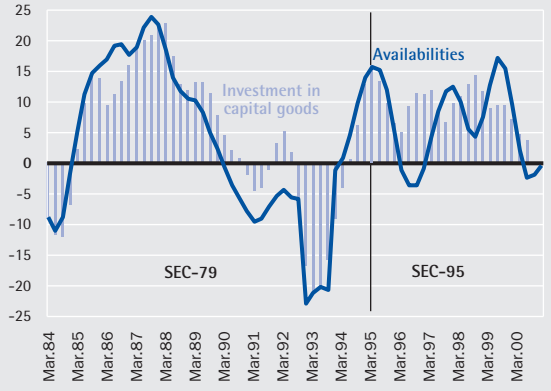
Gross capital formation, current pesetas

SEC 79	14,745
SEC 95	16,264

Difference	*Milions of pesetas*	*% of total*	*% difference*
Total	1,519	10.3	100.0
Statistical changes	888	6.0	58.5
Changes in item categories	631	4.3	41.5
Software and data bases	451	3.1	29.7
Other	180	1.2	11.8

Source: INE and BBVA

Investment in capital goods
SEC 95 and availability indicator



Source: INE and BBVA

Nevertheless, investment in capital goods looks likely to commence another expansive cycle in the second half of 2000 since the factors which boost growth in this variable (cost of capital usage, wages and demand projections – particularly foreign) will not perform as well as in 1999, especially if we consider the effects of the current high oil prices on the economy.

Confirmation in 2H00 of the INE's estimates as to the downward trend in the cycle will lead to a more downbeat scenario for economic growth in Spain in 2001 and less likelihood of medium-term improvements in productivity, since the capital goods component includes investment in IT and telecommunications, which are essential to the improvement in productivity associated with the new economy.

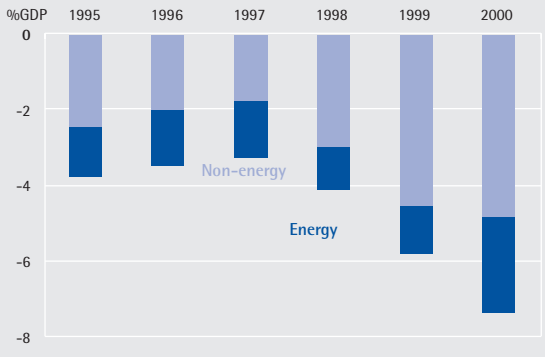
In contrast to capital goods, growth in construction investment has been corrected upward since 1997. The building segment is extremely dynamic, particularly home-building. However, there may be a deceleration in this sector in the second half of the year, mainly due to the delays in executing civil engineering work that has already been commissioned. In line with these projections, the completed work index of the ECIC Construction Industry Survey reveals the beginning of deceleration in the second quarter of 2000.

The foreign sector will continue to contribute negatively

2Q00 was the first period since early 1999 in which exports and imports of goods and services grew more slowly than in the preceding period, in real terms.

Graph 2.3

Trade balance

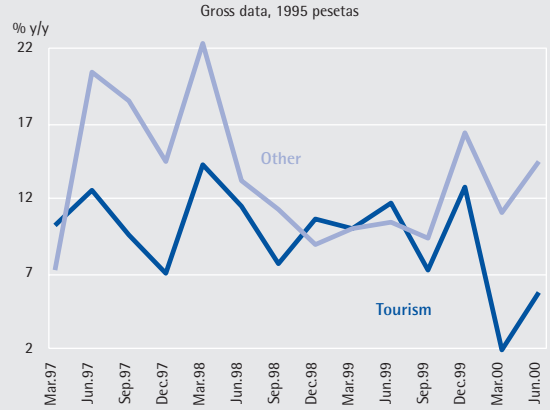


Source: Spanish Customs and BBVA

Graph 2.4

Exports of services

Gross data, 1995 pesetas



Source: INE and BBVA

In exports, this deceleration was greater in goods than in services (average growth in 1H00: 7.3%, the lowest figure since 1H96), mainly as a result of the reduction in the positive contribution by tourism. Until August, the number of foreign visitors to Spain had increased by only 1.7% (a far cry from the 1999 figure of 9.2%), which may signal a loss of competitiveness due not only to the ongoing positive inflation differential with Europe but also to increased competition by alternative destinations and to tourists' degree of satisfaction with the services provided. Goods exports, on the contrary, grew by over 10% in 1H as a result of the improvement in world trade and the euro's slide, in addition to the favourable baseline effect (sales abroad increased by less than 5% in 1H99). In 2H00 and in 2001, exports will continue to slow due to the more moderate growth in internal demand and the worsening of Spain's competitive position. In addition to Spain's accumulating positive inflation differential with respect to the rest of the euro zone, the euro will cease to depreciate against the dollar.

In 2000, total exports of goods and services will grow by 9.5%, in line with a gain of around 3% in competitiveness by Spain's economy with respect to the rest of the world and a 10% increase in world trade volume. In 2001, the stable euro and the continued positive price differential will lead to a loss of competitiveness of around 0.5%, which, added to the slower growth in world trade, will decelerate exports by 2.5 bp to 7.0%.

In real terms, imports will slow in line with the smaller increases in internal demand, particularly investment.

There will therefore foreseeably be a 10.7% increase in goods and services imports in 2000 (1.2 percentage points less than in 1999). In 2001, there will be an additional moderation to 7.9%.

Continuing oil price increases dampen prospects even further

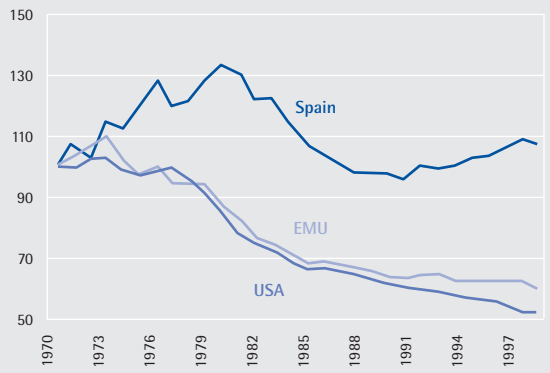
The significant increase in oil prices has pushed Spain's trade deficit in energy from 1.3% of GDP (the 1995-1999 average) to 2.6% in 2000, and this has been further worsened by the euro's slide against the dollar (which has translated into a spectacular increase in real oil prices in pesetas).

Furthermore, Spain is even more exposed to a price hike than the other EMU countries or the USA as its level of dependence (measured in thousands of barrels/real GDP) is currently similar to 1970 levels and higher than that of 1990, whereas, in the last thirty years, the euro zone and the USA have cut their dependence on oil by almost 40% and 50%, respectively. As a result, the current increase in oil prices which, in terms of growth rates, implies a shock similar to that of 1979, could pose a considerable risk to Spain's economy.

Nevertheless, a number of factors must be taken into account inasmuch as they mitigate the impact of this increase. The rise in oil prices was not mirrored by other commodities, and its impact will therefore be smaller than it was in the 1970s, when all commodity prices rose. Also, in real terms, oil prices are still around 50% of the levels reached during the 1979 shock. Furthermore, the price of oil seems to have peaked and is now expected to fall to around US$24/bbl at 2001 year-end.

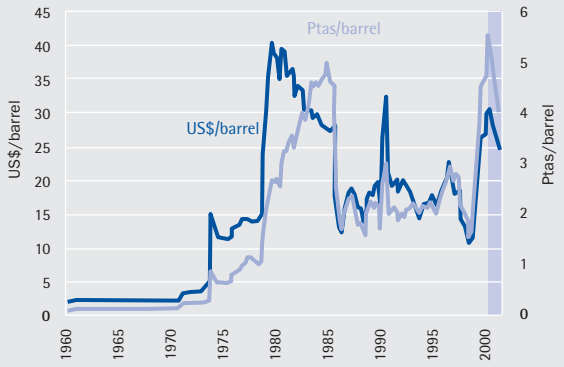
The loss of wealth resulting from increased energy costs will reduce activity and push inflation up in the economy as a whole. The greater the extent to which higher energy prices are passed on to wages and other inputs, the higher the cost in terms of activity and employment. The effects on inflation and growth can thus be measured in a risk scenario in which the price of Brent remains stable at US$33/bbl in 2001, assuming also that the price increases caused by higher energy costs will be passed on to other costs (particularly wages). If this occurs, Spain's GDP could grow by 1.6 percentage points less than initially projected, and inflation would be one point higher than in our basic scenario.

Graph 2.6
Annual oil consumption in barrel/real GDP (1970=100)



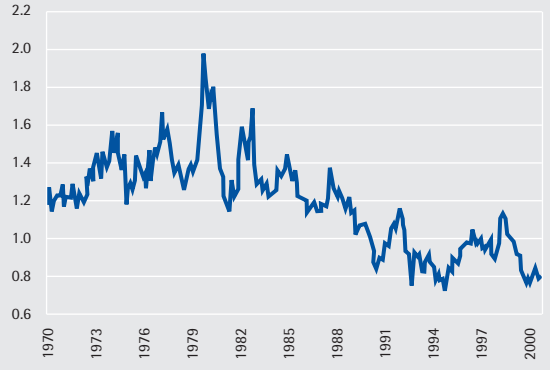
Source: BP, national statics and BBVA

Graph 2.5
Oil prices



Source: Bloomberg and BBVA

Graph 2.7
Commodity prices (ex-oil) (annual %)



Source: Goldman Sachs

How important is the current rise in oil prices?

The increase in oil prices (172% in dollar terms between 1999 year-end and 3Q00 – from US$11/bbl to US$30/bbl) has significantly increased costs in oil-importing countries. The impact has been magnified in the European economy by the euro's slide (30% in the same period), which translates into a 253% increase in oil prices in euro terms. In view of the nominal magnitude of the increase, which is slightly lower than that of 1974 (293%) but higher than in 1979 (154%) and 1990 (94%), it is necessary to determine the extent to which this increase represents a shock for Spain's economy.

This should be evaluated in real and not nominal terms, i.e. taking into account the performance of other prices. Shocks are evaluated and compared according to three factors: i) magnitude, measured as a deviation from the average; ii) intensity, which measures the pace of the increase (the faster it is, the greater its impact) and; iii) duration, which is the number of quarters in which the price is maintained above a benchmark level (the longer this persists, the greater its impact).

As well as determining the degree of dependence on oil, these three factors also reveal the direct impact of the shock on the economy. In the wake of this direct impact there will be those deriving from the mechanism of passing on the cost to other prices and wages. In order to determine the period in which a price rise is due exclusively to oil, the price trend is considered in dollars, thus distinguishing between the increase caused by the weak euro and that caused by the oil price itself.

Magnitude is calculated as an increase in oil prices in euros from the beginning of the increase until it peaks. The problem is the baseline for comparison. The magnitude of the recent increase is similar to that of 1974 and greater than that of 1979 and 1990. Nevertheless, the increase in 1999 began when prices in real terms were at their lowest levels since 1970. Therefore, it is more appropriate to calculate the magnitude of the increase in real terms with respect to the average oil price in a reasonable reference period (the average of the five years prior to the increase). In this way, the magnitude of the latest increase (129% in real terms) is still larger than that of 1979 and 1990 (73% and 9%, respectively), but it is significantly smaller than that of 1974 (236%).

The intensity (speed) of the increase affects the economy since it shapes the expectations of economic agents and the capacity of technological adaptation. The faster the increase, the greater the impact on expectations and, therefore, the greater the impact of the shock. Intensity is measured as the number of quarters between the beginning of the increase and its peak. The current increase is less intense than in the past (since it has lasted 9 quarters, compared with 5 quarters in 1979 and just 1 quarter in 1974).

The third factor in determining the importance of the increase in oil prices is its duration, measured as a deviation above its reference level (approximated by the average of the previous five years). The BBVA Research Department's projections suggest a decline in the price of oil to reach US$24/bbl at 2001 year-end. This shock, although longer than that of 1990, will therefore have lasted half as long as those of 1974 and 1979 (19 and 22 quarters, respectively).

A combination of these three factors (magnitude and duration: 40% and intensity: 20%) gives an idea of the scale of the current shock. The 1974 shock was the biggest. The recent rise in oil prices is greater than in 1990 (which was negligible) and similar to that of 1979.

The importance of the recent increase in oil prices must be seen in relative terms. The increase in the price of crude oil was not accompanied this time by increases in other commodity prices (which represent approximately two-thirds of the total). Furthermore, although in terms of the rate of variation, the current shock is comparable to that of 1979 (including variables such as intensity and duration), prices in real terms are now considerably lower than they were then (50% of the 1993 high and 52% of the price between 1979 and 1995 – in constant year 2000 pesetas this would amount to Ptas. 5,500/bbl vs. Ptas. 10,500 in the 1979-1995 period).

In real terms (*)

	Magnitude		Intensity	Duration(**)
Shocks	Low to peak	Av. deviation		
1º 1Q74	233%	236%	1 qtr.	19 qtrs.
2º 1Q79	111%	73%	5 qtrs.	22 qtrs.
3º 3Q90	78%	9%	2 qtrs.	2 qtrs.
4º 3Q99	258%	129%	8 qtrs.	10 qtrs.

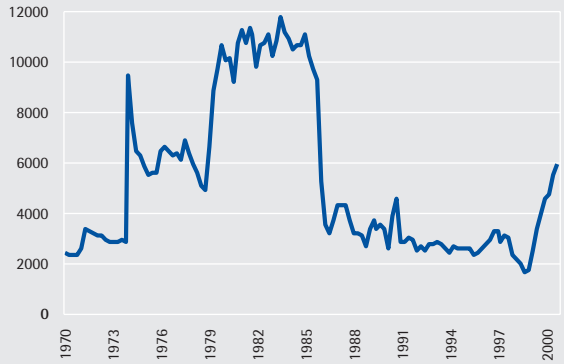
(*) Deflated by GDP deflator
(**) Number of quarters above 5-year moving average
Source: BBVA

Oil crisis league table

	1974	1979	1990	2000
Magnitude	236	73	9	129
Intensity	1	5	2	8
Duration	19	22	2	10
Total(*)	**15.9**	**8.0**	**1.6**	**7.9**

(*) Weighted average - Source BBVA

Price of Brent oil in constant year 2000 pesetas



Source: BBVA

Table 2.3. Reference scenario

	Growth rates	
	2000	2001
GDP	4.0	3.2
Consumption	4.2	3.6
Inflation	3.3	2.9
Employment	3.3	2.2
Deficit/GDP	0.4	0.1

Source: BBVA

Table 2.4. Maximum impact on reference scenario (deviations)

	2000	2001
GDP	-0.1	-1.6
Consumption	-0.2	-1.7
Inflation	0.1	1.0
Employment	-0.1	-1.3
Deficit/GDP	0.0	0.2

Source: BBVA

The probability of this risk scenario, or of a more moderate one but along the same lines, has increased recently due to the deterioration in expectations as to the euro's performance and the price of oil plus the social unrest arising from high fuel prices, which suggest a considerable likelihood of being passed on into prices.

The pace of employment growth is slowing

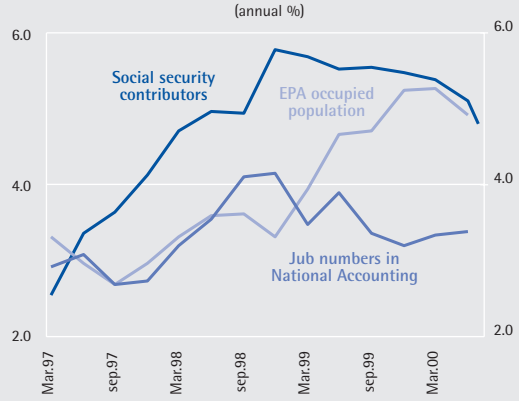
The pace of growth in the occupied population is slowing, according to Spain's labour force survey (EPA), even taking into account the upward bias due to the sample update in 1Q00.

The factors (apart from statistical changes) which have enabled employment to grow and unemployment levels

Graph 2.8

Employment

(annual %)



Fuente: INE, Welfare and Employment Ministry and BBVA

to fall in Spain seem to be weakening. These factors include economic growth, the introduction of new forms of hiring, and more favourable flows of population entering and leaving employment.

The EPA labour force figure is likely to increase by 4.9% in 2000, although 0.5 percentage points of this increase would be due to the sample update. In 2001, the increase will be 2.9%. The active population, which increased by no more than 1% year-on-year between 4Q99 and 3Q99, grew by 2.9% in the first half of 2000 (six percentage points less if we adjust for the sample update). This was due to an increase in the active population (particularly among women and young people) which offset the increasingly smaller rises in the total population. The reduction in the number of early retirements as compared with 1999 also had a positive impact.

The unemployment rate could reach 14.0% in 2000 (1.9 percentage points lower than in 1999). In 2001, the slowing of employment growth, but also of population growth, will enable the unemployment rate to fall by 12.9%.

3. Prices and wages

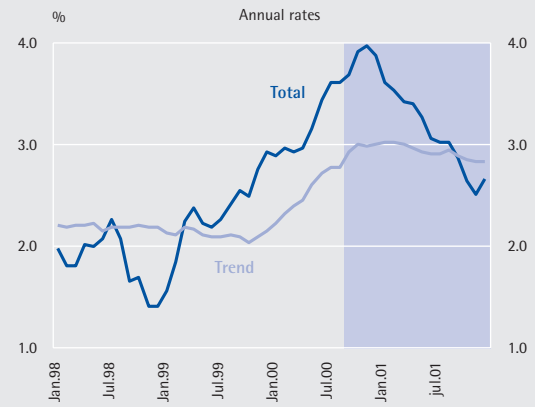
An inflationary situation: oil and the euro add to the pressure on demand

The price rebound is generally being attributed to oil. However, the current increase in prices began between the third and fourth quarter of 1999 in the components of the "BBVA trend CPI" which have the largest weighting in the index and are unconnected to the immediate impact of energy. This index, which had maintained stable rates of change of about 2.3% per year, has accelerated six decimal points since the fourth quarter of 1999, and the prospects are that it will close 2000 at 3.0%, i.e. the highest rate since September 1996. The rebound in the trend inflation (together with a growing trade deficit) is one more sign of excess demand in the economy.

In the four months since the previous edition of *Situación Spain*, Spain's inflation (which was classified as worrying at the time) has not improved. In September, the CPI was up 3.7% year-on-year, i.e. 6 decimal points higher than in May (the most recent available figure when the previous edition of this document was published) and four decimal points higher than expected at that time. The error is due to the performance of the index's most volatile elements (unprocessed foods and energy) since the IPSEBENE (the index of non-energy processed goods and service prices) and BBVA trend CPI in September differed from the estimates at the time by only one decimal point.

Consequently, the surprise with respect to the projected scenario has arisen in energy, as international oil prices are higher than expected and the euro's depreciation is more pronounced than was expected before the summer. As a result, automobile and heating fuel prices rose by more than expected, even though the increase in distribution companies' costs was not fully passed on to end prices[1]. Nevertheless, we should bear in mind that energy did not cause the current inflationary process – it was only an aggravating factor.

Graph 3.1
Inflation
Annual rates



Fuente: INE and BBVA

Inflation increased by more in Spain than in the euro zone: the average differential was 1.2 percentage points in the first nine months of 2000, i.e. one decimal point higher than in 1999 and five decimal points higher than in 1998. The main contributors to widening the gap are those most closely linked to demand pressure in the medium term (non-energy industrial goods and services).

[1] For greater detail, see:
"Are the recent increases in the price of petrol justified? Is there room for further increases?" Situación Spain, BBVA, June 2000.
"Resultados de las empresas no financieras en el segundo trimestre de 2000" Boletín económico del Banco de España, September 2000.

Table 3.1. CPI. Data and Forecasts

	Headline CPI			Core (IPSEBENE)			Residual CPI			Trend CPI		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
January	1.5	2.9	3.6	2.2	2.3	2.8	-0.2	4.9	5.4	2.1	2.2	3.0
February	1.8	3.0	3.5	2.3	2.2	2.9	1.0	5.0	5.1	2.1	2.3	3.0
March	2.2	2.9	3.4	2.5	2.2	2.9	2.4	4.6	4.7	2.2	2.4	3.0
April	2.4	3.0	3.4	2.5	2.2	3.0	3.0	4.5	4.7	2.2	2.4	3.0
May	2.2	3.1	3.3	2.5	2.3	3.0	2.6	4.8	4.3	2.1	2.6	2.9
June	2.2	3.4	3.1	2.5	2.3	3.0	2.5	5.7	3.5	2.1	2.7	2.9
July	2.2	3.6	3.0	2.5	2.5	3.1	2.7	6.2	3.3	2.1	2.8	2.9
August	2.4	3.6	3.0	2.4	2.7	3.1	3.4	6.1	3.3	2.1	2.8	2.9
September	2.5	3.7	2.9	2.3	2.7	3.1	4.0	6.0	2.8	2.1	2.9	2.9
October	2.5	3.9	2.7	2.3	2.7	3.0	3.9	6.8	2.4	2.0	3.0	2.8
November	2.7	4.0	2.7	2.3	2.8	2.9	4.8	7.0	2.2	2.1	3.0	2.8
December	2.9	3.9	2.7	2.4	2.8	2.9	5.4	6.5	2.4	2.1	3.0	2.8
Average	2.3	3.4	3.1	2.4	2.5	3.0	3.0	5.7	3.6	2.1	2.7	2.9

Source: INE y BBVA

The services price gap has oscillated between 1.4 and 2.0 percentage points since June 1999; in this period, the inflation differential in non-energy industrial goods has increased to 1.7 points in August 1999 (from 0.9). This performance (i.e. from a "dual" inflation to a "double" inflation situation) is particularly important due to its negative implications for the Spanish economy's competitiveness with respect to the entire euro zone, Spain's main export destination.

There is a possibility that these price differentials might not harm competitiveness in Spain if they occur in a context of real convergence (per capita income) resulting from a larger increase in productivity in the tradable goods sector (the Balassa-Samuelson effect). This would be equivalent to a technological shock in the tradable sector enabling it to improve productivity throughout the economy because, given the downward wage rigidity, non-tradable goods sector prices and wages would increase.

Nevertheless, this is not occurring because of the slow-down in investment in capital goods and the slight increase in productivity (even smaller than in the rest of the euro zone). Spain's productivity grew by 0.4% in 1999, i.e. 0.3 points less than in the EMU as a whole (vs. a gap of 6 decimal points in 1998). More specifically, industrial productivity (calculated using the GAV of industrial activities excluding energy) fell by 0.3% in 1999, after remaining stable in 1998[2].

This inflation differential means a "concealed" loss in competitiveness since the deterioration with respect to the EMU countries is being more than offset by the competitiveness gains with respect to the rest of the world due to the depreciation of the euro.

All things considered, the inflation projection for year-end is now 3.9%, one percentage point more than that expected four months ago. BBVA's trend index will end 2000 with 3% growth, i.e. nine decimal points more than in December 1999. The acceleration in the IPSEBENE throughout 2000 will be only 5 decimal points (from 2.3% to 2.8%) due to favourable performance of edible oil prices (not included in the trend index), whose projected average decrease in 2000 is 7.8%, which will translate into a one decimal point reduction in CPI growth.

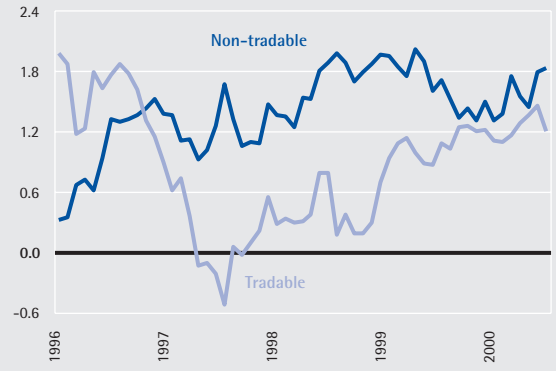
Performance in 2001 will hinge on energy prices; Brent prices are expected to fall to US$ 24/barrel by December 2001 and this should be passed on to other prices and wages. If the euro appreciates to US$ 0.92 by December 2001, total CPI would end 2001 at 2.7%, i.e. below IPSEBENE (2.9%) and BBVA trend CPI (2.8%).

Risk of greater wage pressure

Apart from a more or less erratic and temporary performance of energy and food prices, inflation in the medium term will depend on how the energy price rises are passed on to wages in an attempt to offset the losses in spending power. This will not prevent a loss in Spanish national income and it will only delay the necessary adjustment and produce greater impoverishment with respect to the rest of the world due to the inflation differential, making the recovery more costly in terms of business activity and employment.

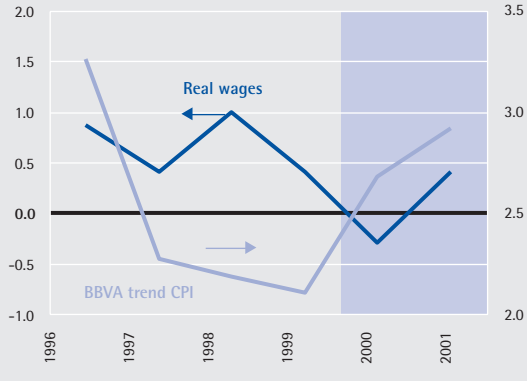
[2] More evidence of the Balassa-Samuelson effect, in addition to increases in productivity, would be an increase in output in the tradeable sector with respect to the non-tradeable sector. However, this relationship has remained practically stable since 1996.

Graph 3.2
Harmonised inflation differential Spain-EMU
(percentage points)



Source: INE, Eurostat and BBVA

Graph 3.3
Inflation and wages
(%)



Source: INE and BBVA

Factors that determine inflation in Spain: the role of demand pressure

Since 1998 year-end, Spain's inflation has increased by 2.1 percentage points to 3.6% in 3Q00. In this same period, prices in the EMU accelerated by 1.6 percentage points; consequently, the inflation differential has increased by half a percentage point. Various factors underpin this faster growth in prices, and they have differing impacts in the EMU and in Spain. The different cycle positions of the entire EMU and Spain (Spain is further ahead) and different monetary policies (more adequate in EMU and loose in Spain) suggest that the demand pressure is greater in Spain. The increase in energy prices due to rising oil prices and to the depreciation of the euro has also had a considerable impact on inflation. The differing impact in Europe is because each euro zone country has a different exposure to oil and different taxation. The depreciation of the euro, together with the boom in world trade, has impacted import prices, especially in countries with lower trade barriers and in countries where end prices are more responsive due to demand pressure or because of the economy's greater rigidity.

To assess how these factors affect the increase in inflation in Spain and in EMU, we estimated a Phillips curve, plotting the relationship between growth in inflation (price acceleration) and a cyclical indicator of demand pressure (approximated by production capacity utilisation). The estimate also includes other exogenous factors that capture the impact of a supply shock on prices. In this particular estimate, we included non-energy import prices and Brent oil prices.

$$\Delta\pi_t = \alpha + \beta_1 cu_t + \beta_2(L)\Delta\pi_t^{NE} + \beta_3(L)\pi_t^{OIL} + \beta_4(L)\pi_{t-1} + \varepsilon_t$$

where $\propto$ is a constants vector that groups various dummies, *cu* is capacity utilisation, Π^{NE} and Π^{OIL} are the inflation in non-energy import prices and oil prices, respectively, and *L* is the lag operator. The data used in the estimate cover the period between the first quarter of 1970 and the third quarter of 2000.

The breakdown of the price acceleration based on the Phillips curve suggests that the most important factor in increasing inflation in Spain was demand pressure, which accounts for 0.99 of the 2.1 percentage point increase (47%). The impact of imported inflation was similar in Spain (0.79) and in EMU (0.78), although it represents a larger percentage of the inflation rise in EMU because the total increase was lower. The impact of the depreciation of the euro was slightly more in EMU (0.66 percentage points – 31%) than in Spain (0.54 percentage points – 26%). Since EMU monetary policy focuses on stabilising demand in the region, the contribution by demand pressure was considerably lower, as could be expected.

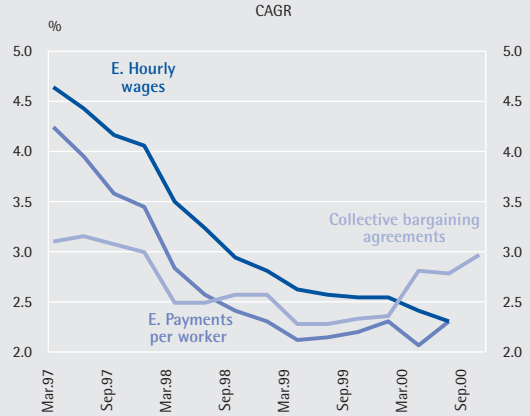
Breakdown of price acceleration between 4Q98 and 3Q00

	Observed	Demand pressure	Imported inflation	Exchange rate	Inertia
Spain	2.10	0.99	0.79	0.54	-0.22
	(100%)	(47%)	(37%)	(26%)	(-10%)
EMU	1.61	0.23	0.78	0.66	-0.02
	(100%)	(14%)	(49%)	(41%)	(-1%)

Source: BBVA

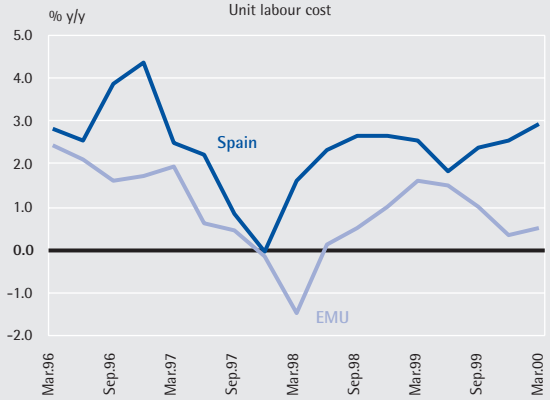
The conclusion is that the inflation gap between Spain and EMU is due mainly to the greater demand pressure in Spain because it is ahead of EMU in the cycle and its monetary policy is too loose for this position. The euro and imported inflation have raised inflation in both Spain and the EMU by similar levels and so they did not contribute significantly to the inflation differential.

Graph 3.4
Wages
CAGR



Source; INE, Labour Ministry and BBVA

Graph 3.5
Spain and EMU
Unit labour cost



Employment: Occupied population, seasonally adjusted.
Source: INE, Eurostat and BBVA

The most recent wage indicators (labour agreements to August) show that wages increased by an average of 3% in 2000 YTD, i.e. 6 decimal points more than in 1999 (2 decimal points, including in that year the payment in February 2000 under clauses guaranteeing purchasing power). This year, wages negotiated in labour agreements will increase by an average of nearly 3.3%, the highest figure since 1996. In 2000, consumer prices will accelerate faster than wages (in terms of National Accounts) and, consequently, real growth in this variable will be lower in 2000 than in 1999 (-0.2% and 0.4%, respectively).

Real wage costs are projected to accelerate to 0.4% in 2001 as a result of the downward rigidity in nominal wages (given the inertia shown by the labour agreements and the effect of the purchasing power guarantee clauses) and because inflation is expected to slow in 2001 due to lower demand pressure and falling energy prices.

Changes in labour market regulations have a moderating effect on wage costs, especially in the services sector (which represents approximately 60% of Spain's employment). In this sector, the entry of new workers at wages below the sector average and with less coverage under certain labour agreement clauses puts total gross wage growth below the negotiated increases, and this reduces the correlation between the agreed rises and those that finally materialise in the sector's wages.

Apart from the fact that the increase in productivity in Spain was smaller than in the euro zone as a whole, wages grew faster, i.e. labour costs per unit of output grew faster in Spain than in the entire euro zone, which means that the Spanish economy's competitiveness has worsened. Therefore, wages should be set according to the inflation growth in the entire EMU, ideally benchmarked to the countries with the most moderate price increases.

4. The public sector

Execution of the year 2000 budget: target 0.6% of GDP within reach

The government has revised its deficit target for 2000 down from 0.8% to 0.6% of GDP. The healthy State coffers in the first nine months of the year guarantee the attainment of this new objective. As has been the case in the last few years, the considerable increase in tax receipts (as a result of both the improved growth scenario and the tendency to underestimate tax receipts in the successive budgets – 735 billion pesetas) has amply offset over-expenditure (362.1 billion pesetas). Table 4.1 shows the recent years' deviations in cash terms in billions of pesetas. As in 1999, the deviation in revenues in 2000 will come mainly from higher tax receipts (up 7.9%, vs. an expected 5.0%). But, in contrast to 1999, the increased revenues are due to a good direct tax collection (income and company tax) and not to indirect taxation. This difference, which is explained by the general economic situation[1], is a sign that the economy has started to cool. Non-tax revenues declined despite the extraordinary receipts from the sales of four UMTS licence[2] (around 86 billion pesetas), mainly due to lower debt issuance premiums and a decline in the Bank of Spain's profits. Although the 2001 budget's tax receipt estimate for 2000 implies a significant increase on initial estimates, the final figure could be more than 100 billion pesetas higher (1% of GDP).

The available information regarding the trend in modifications to allocations approved through August confirms that the committed expenditure in 2000 will exceed the budgeted figure by at least 360 billion pesetas (0.36% of GDP)[3]. This means State payments will increase by 3.6% in cash terms (instead of 1.8%), and by 5.7% not counting interest payments. Although the projected deviation in spending for 2000 is less than in the previous two years, it is worth pointing out that: i) almost 70% of the deviation is concentrated in current payments excluding interest, i.e. precisely where adjustments should be made (this figure was 40% in 1998 and 60% in 1999); ii) capital operations are expected to grow by less than originally estimated (by August, only 37% of the budget had been executed) and; iii) the deviation in spending at 2000 year-end may exceed that in August (342.5 billion pesetas), since there are often significant changes in allocations in the last few months of the year. Nevertheless, the good revenue performance (765.4 billion pesetas, 0.8% of GDP) and the fact that the year 2000 capital operations budget has not been fully executed (at least 26.7 billion pesetas) will enable the new deficit target to be reached easily. The primary surplus will increase slightly in cash terms in 2000 (to 2.45% of GDP), but it will remain lower than in 1998 (2.53%).

[1] Note that: i) the 1999 income tax reform was underestimated; ii) there was a sizeable increase in VAT receipts in 1999 due to the emergence of the submerged economy; and iii) personal income tax rebates were lower in 1999 and VAT rebates were higher in 2000.

[2] Eurostat has decided that the revenues from the sale of UMTS licences should be considered as sales of non-financial assets, i.e. lower capital expenditure and, therefore, lower public deficit.

[3] This deviation in expenditure is distributed as follows: i) 150 billion pesetas for early amortisation of debt; ii) 100 billion pesetas to compensate toxic shock syndrome victims and victims of terrorism; iii) 45 billion pesetas to cover the cost of Spanish troops' participation in peace-keeping missions and; iv) transfers to territorial administrations.

Table 4.1: Deviations in revenues and spending from budget

Ptas. Bn	1998 1998 Settlement/1998 Budget	1999 1999 Settlement/1999 Budget	2000 2000 advance settement/2000 Budget
Tax receipts	249.1	822.6	464.9
Direct taxes	137.2	395.9	429.6
Indirect taxes	111.9	426.7	35.3
Asset taxes	391.8	342.3	280.6
Other revenues	221.2	-246.0	-3.1
TOTAL REVENUES	862.1	918.9	765.4
Current operations excl. interest	198.4	338.7	238.7
Interest	143.5	136.5	150.0
Capital operations	167.5	79.4	-26.7
TOTAL SPENDING	509.3	554.5	362.1

Source: Finance Ministry and BBVA

The draft 2001 Budget

2001: the favourable macroeconomic scenario, the creation of the radio spectrum levy and the lack of provisions in some items of spending raise questions as to the deficit reduction

In the 2001 Budget, the government deficit target in National Accounting terms amounts to 314.9 billion pesetas, i.e. 0.3% of GDP (0.4 percentage points lower than the latest objective set for 2000). This result is based on growth in revenues (in National Accounting terms) of 6% with respect to the projected settlement and the 4.4% spending growth (compatible with the 2001 Budget revenues in National Accounting terms, which puts the deficit in National Accounting terms at 0.6% in 2000 and 0.3% in 2001). As a result, the reduction in the State deficit is mainly due to the reduction in the contribution by spending and (to a lesser extent) to tax receipts (which grew by 6.3%). Three significant risks could jeopardise this target: i) the allocations in some items of spending (current transfers and interest) are insufficient and there is no longer any room to manoeuvre in the interest spending item (excluding the cost of early amortisation of debt from the interest expenditure item, this is likely to increase in 2001 for the first time since 1997); ii) tax receipts could be lower than estimated due to the impact (via income tax modules and the increase in VAT deductions) of the measures approved by the government to compensate the sectors which are most severely affected by the higher fuel price (0.1% of GDP) which are not included in the 2001 Budget and; iii) there are doubts as to the actual revenues from the new radio spectrum levy (0.15% of GDP).

Based on the estimates for revenues in 2000 contained in the 2001 Budget, which will foreseeably not deviate from the definitive amount of tax receipts, and considering the historical elasticity of the various revenue items with respect to nominal GDP, it is easy to check whether the estimate of revenues for 2001 is compatible with the macroeconomic scenario or whether, as has occurred throughout the term of this government (except in 1996), revenues have been underestimated in order to hedge against possible deviations in spending. This exercise should take into account: i) the non-deflation of income tax rates, deductions and tax-free allowance; ii) the stamp tax exemption on first copies of public notarial documents; iii) the reduction from 20% to 18% in capital gains tax rates (Royal Decree Law 3/2000, dated 23 June) and in withholdings from professionals (35 billion pesetas); iv) the fact that the special taxes and levies are not inflation-linked (65 billion pesetas); v) the fiscal cost of the measures to support the sectors most severely affected by the high fuel prices (116 billion pesetas); vi) the creation of a tax on the use of radio spectrum (160 billion pesetas); vii) the sizeable growth in the transfers from the EU (projected net financial balance in 2001 is 1.55 trillion pesetas, vs. 925.9 billion pesetas in 2000) and; viii) the expected moderation in fiscal spending (33.7% of total tax receipts, vs. 35.3%

State Budget

Non-financial revenues

Pts. Bn	Initial 2000	2000 advance	(%/total)	2001 Budget	(%/total)	01/00 (annual %)
Income tax	5149.1	5361.1	27.5	5675.0	27.8	5.9
Company tax	2563.1	2772.4	14.2	3021.9	14.8	9.0
Non-residents´income tax	125.0	142.2	0.7	149.7	0.7	5.3
Tax on pensions	116.0	107.0	0.5	107.0	0.5	0.0
Other	54.8	54.9	0.3	59.1	0.3	7.7
DIRECT TAXES	8008.0	8437.6	43.3	9012.7	44.1	6.8
VAT	5655.0	5600.2	28.7	6022.2	29.5	7.5
Special taxes	2629.9	2688.9	13.8	2778.0	13.6	3.3
Other	273.0	304.1	1.6	317.0	1.6	4.2
INDIRECT TAXES	8557.9	8593.2	44.1	9117.2	44.6	6.1
LEVIES AND OTHER REVENUES	368.0	322.6	1.7	446.3	2.2	38.3
CURRENT TRANSFERS	895.2	971.4	5.0	955.3	4.7	-1.7
REVENUES FROM ASSETS	587.6	868.2	4.5	622.3	3.0	-28.3
OTHER REVENUES	325.0	314.1	1.6	267.1	1.3	-15.0
TOTAL	**18741.7**	**19507.1**	**100.0**	**20420.9**	**100.0**	**4.7**
Tax receipts	16565.9	17030.8	87.3	18129.9	88.8	6.5
Non-financial State revenues in terms of net entitlements adjusted for the calculation of the public deficit.						
TOTAL	**18985.0**	**19232.5**	**100.0**	**20383.4**	**100.0**	**6.0**

Source: Fianace Ministry

estimated for 2000). Considering all the above factors, the projection for revenues in 2001 is similar to that which would be derived from the 2001 Budget growth projections. Nevertheless, considering that the average cost of measures to offset the impact of higher fuel prices (116 billion pesetas) is not included in the revenues projections for 2001 and that the upward bias of VAT and company tax may be counterbalanced by the downward bias in capital transfers, no great surprises should be expected in the projected tax receipts in 2001 provided that the economy behaves as the government expects in nominal terms. The risks of lower tax receipts are mainly a result of the problems which might arise in obtaining full payment of the radio spectrum levy.

Although the projection of 2.6% year-on-year growth in spending seems moderate (3.7% in 2000), the following should be taken into account: i) current spending excluding interest will rise by 3.5% (i.e. higher than the GDP deflator growth) which reveals the rigidity of a sizeable part of spending; ii) if the financial burden is corrected for the extra cost associated with early amortisation of debt, the projected interest payment on the debt increases with respect to the previous year's actual figure, showing that the margin for manoeuvre afforded by falling interest rates is beginning to be exhausted; iii) there is a deviation risk in some items of spending (toxic shock syndrome, transfers to the Social Security system to finance health care, pensions) and; iv) the transfers to State-owned mercantile companies, Public Business Institutions and other Public Institutions continue to increase (0.5% of GDP). The positive side is that the item with the fastest growth is real investment (+11% year-on-year with respect to BBVA's settlement estimate).

As a result, if nominal economic growth is not lower than that projected by the government, the potential problems in collecting the full radio spectrum levy and the underestimation of some spending items will require additional cuts in public spending in order to guarantee compliance with the 2001 deficit target. Since it is very difficult to alter certain items of spending once the year has commenced as they are protected by entitlements, laws or agreements, the adjustment will be taken out of public investment (as has happened in the past) and this will negatively impact long-term growth in Spain's economy and will delay real convergence with the other EMU countries.

State Budget

Non-financial expenses

Pts. Bn	Initial 2000 budget	2000 advance settlement (BBVA)	(%/of total)	2001 Budget	(%/of total)	01/00 (annual %)
Personnel	2888.6	2786.3	13.8	2769.8	13.4	-0.6
Purchase of goods and services	340.0	398.4	2.0	350.8	1.7	-11.9
Financial expenses	2805.9	**2955.9**	14.7	2836.2	13.7	-4.0
Current transfers	11663.9	11946.5	59.3	12532.6	60.7	4.9
CURRENT OPERATIONS	17698.3	18087.0	89.8	18489.4	89.5	2.2
Real investment	1011.9	985.7	4.9	1097.0	5.3	11.3
Capital transfers	1059.4	1059.0	5.3	1075.1	5.2	1.5
CAPITAL OPERATIONS	2071.3	2044.7	10.2	2172.1	10.5	6.2
TOTAL	**19769.6**	20131.7	100.0	**20661.5**	**100.0**	**2.6**
Expenses excluding interest	16963.8	17175.8	85.3	17825.3	86.3	3.8
Current expenses excluding interest	14892.4	15131.1	75.2	15653.2	75.8	3.5
CASH DEFICIT	**-1027.9**	**-624.6**		**-240.6**		
(% of GDP)	-1.0	-0.6		-0.2		
PRIMARY SURPLUS	**1777.9**	**2331.3**		**2595.6**		
(% of GDP)	1.8	2.3		2.5		

Source: Finance Ministry

Budget surplus and the economic cycle

The loss of sovereignty over monetary policy and the exchange rate as a result of the launch of EMU makes fiscal policy particularly relevant in each individual country. It is practically the only instrument with which to handle temporary asymmetrical disturbances in individual EMU countries. Furthermore, fiscal policy must be used to attain the right policy mix for the each economy's cyclical situation. In any event, since the fiscal policy decisions in any given country can affect the other countries in the monetary union, a certain amount of co-ordination is necessary. The Stability and Growth Pact, which limits government deficits and aims for balanced budgets in the medium and long term, is especially significant. The breakdown of the government deficit into its structural and cyclical components is therefore important, since it allows an evaluation of the Public Accounts in each country after removing the effects of cyclical oscillations in activity.

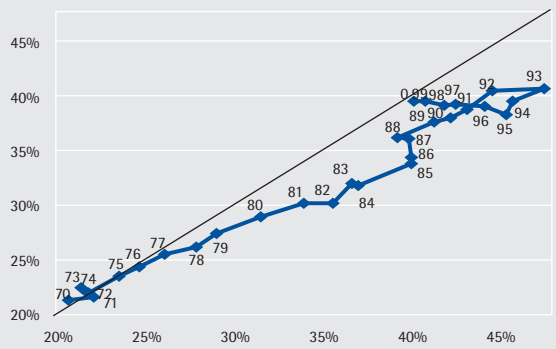
One way to analyse the status of Public Accounts is to study their size in relation to GDP and the budget imbalance. Figure 1 shows government revenues and spending over GDP. Budget balance is represented by the bisector. Above this line, there is a government surplus; below it there is a deficit. Upward movements show an increased tax burden, whereas movements along the bisector show increases in the contribution by the public sector in a balanced economic situation. The transformation of Spain's public sector since the advent of democracy and the creation of the welfare state led to a steady increase in the size of Spain's public sector with respect to GDP between 1975 and 1993. Public spending increased from 23% of GDP to 47.5%, and public revenues increased from 23% (almost a balanced budget) to 40.8% of GDP, leading to a deficit amounting to 6.7% of GDP in 1993.

The public deficit situation can therefore be corrected by increasing taxes without reducing spending (as happened in the 1994-1998 period), by combining spending cuts with a reduction in tax pressure (which has only happened in 1994 and 1995) or by combining tax increases with spending cuts (which has been the case since 1996).

This situation is clarified somewhat if public revenues are plotted against primary spending (without interest) by the public administrations (figure 2). The figure shows that there was a cut in primary spending between 1985 and 1988 which was practically the same as that between 1995 and 1997, but which was offset by the increases in interest expenses (the spending/GDP ratio remained practically unchanged), whereas between 1995 and 1999, falling interest rates allowed a reduction in the interest burden.

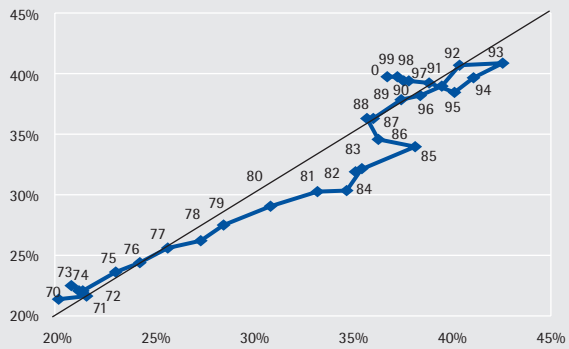
In the case of Spain's economy, the estimates show that, in the event of a recession, the economic cycle could increase the government deficit by 1.5 points of GDP, so that the maximum structural deficit which should be reached in compliance with the Stability and Growth Pact is 1.5% of GDP. However, balancing the public

Public revenues and spending (% of GDP)



Source: BBVA

Revenues and spending excl. interest (% of GDP)



Source: BBVA

accounts in the medium and long term implies going much further: seeking to attain structural balance. The deficit in recessions must be offset by a surplus in the periods of strong growth. Furthermore, other aspects of public administration, such as the increase in the funds necessary to cover the payment of pensions in the future, make it imperative that Spain attain equilibrium, at least in structural terms.

However, estimating the structural deficit is not straightforward. There is a certain amount of controversy as regards both the methodology to be used and the items whose cyclical effect should be corrected, and even as regards the regulatory changes affecting the structural deficit. Different methods may produce different results, although the public surplus in structural terms should show a similar performance. The estimation of the cycle depends on the economic growth expectations and is therefore always discretionary, to a certain extent.

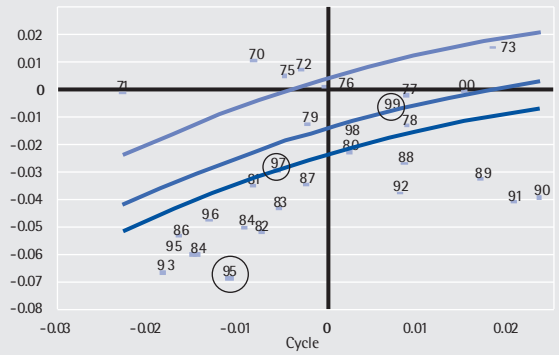
One way to study the structural deficit is to relate the government deficit to the cyclical position of the economy. However, the relationship between government surplus and the cyclical position is not immediately obvious, since it is actually necessary to consider the changes in the structural government surplus, making it necessary to estimate the following equation:

$$(sp-y)-(sp-y)^*=\psi(y-y^*)$$

where the symbol * denotes a structural component, all variables are measured in logarithms, *sp* is the primary surplus and *y* is the output. Once the changes in the structural component of the government surplus have been taken into account, the above relationship is non-linear. This function shows the so-called "iso-structural-deficit curve," i.e. those combinations of cyclical position and government surplus that imply the same level of structural deficit. Movement along the curve implies that the variation in government deficit is due strictly to changes in the cyclical position, whereas vertical movement implies a change in the structural surplus. Figure 3 plots iso-structural-deficit curves showing that the structural deficit was similar in 1982, 1983, 1989, 1992 and 1994, and that the structural deficit in 1995 was similar to that of 1990 and 1991, and that in 1997 it was the same as in 1978 and 1991, despite the significant differences in economic cycle between these years. This type of analysis reveals the structural deficit in 1995 was –5.8% of GDP, and it fell to –2.6% in 1997 and to –1.7% in 1999.

This is an alternative to the traditional methodology which consists of estimating elasticity, where deviations with respect to the trend revenue scenario which would be obtained from the trend GDP are imputed to cyclical deviations in the economy.[1] However, the results are clearly similar since, using elasticity, the estimated structural deficit is –6.1%, -2.8% and –1.6% of GDP in 1995, 1997 and 1999, respectively.

Spain´s cycle and public surplus



Source: BBVA

With the data available to date, we find that in 2000 the structural deficit will be reduced by only two-tenths of a point to 1.5% of GDP. Nevertheless, in 2001, if the objective of balanced Public Accounts is attained under BBVA's GDP growth scenario (3.2%, vs. 3.6% envisaged by the 2001 Budget), this would be a significant step forward in fiscal consolidation in structural terms.

[1]See Bosca, J. Doménech, R and Taguas, D. (1999). La Política fiscal en la Unión Económica y Monetaria, *Moneda y Crédito*, number 208, pages 267-324.

5. The 2001 Budget: An assessment

The Spanish State's Budget Plan for 2001 is the first balanced budget for the entire public sector since 1975. Although this means considerable progress in the budget's consolidation process, ahead of the 1999-2001 Stability Programme, an appropriate assessment of the 2001 Budget must analyse whether the right measures are taken to ensure a sustainable balanced budget and whether the priorities are to boost Spanish productivity and, consequently, accelerate real convergence with Europe.

Apart from attaining a balanced budget for central government (the State, the Autonomous Bodies and the Social Security) and the territorial authorities, the government projects that public debt will be under 60% of GDP in 2001. This reduction will be achieved if nominal GDP grows faster than debt since the outstanding debt will increase to 63.5 billion pesetas (60% of GDP) from 62.2 billion pesetas (62.2% of GDP) in 2000. Nevertheless, in spite of the major privatisation process since 1996 (with revenues of about 5 trillion pesetas), the debt-to-GDP ratio in 2001 will only be 3.7 percentage points lower than in 1996 (63.7% of GDP).

1. Assessment of the public authorities' balanced budget in 2001

The balanced budget is due more to favourable revenues performance than to expense containment.

Using the revenue and expenditure figures of the consolidated 2001 Budget in cash terms, a budget has been prepared for the entire public sector that will achieve a zero deficit in 2001 and a deficit of 0.4% of GDP in 2000[1], in terms of national accounts. Based on these data, correcting the public deficit depends on revenues (which increase their weight in GDP by 4 decimal points) and not on culling public expenditure (which remains about 40.2% of GDP). The main highlights are: i) an increase in social security and tax revenues due to economic growth; ii) a steady increase in public consumption, showing that control is required at the territorial authorities; and iii) the confirmation that the role played by financial payments in reducing deficit between 1995 and 1999 (27%) has petered out due to the rebound in interest rates. The lack of measures to correct expenses calls into question the medium-term sustainability of a balanced budget.

Table 1. Financing capacity (+) or requirements (-)

	1996	1999	2000	2000	2001	2001
(%/GDP)			00 Budget	01 Budget	01 Budget	Budget
Public sector	**-5.0**	**-1.1**	**-0.8**	**-0.4**	**0.0**	-0.4
State	-3.9	-1.1	-0.8	-0.6	-0.3	-0.5
Social Security	-0.4	0.2	0.1	0.3	0.3	0.1
Territorial Security	-0.6	-0.2	-0.1	-0.1	0.0	0.0
Public debt	**68.1**	**63.3**	**62.8**	**62.2**	**60.0**	**60.6**

Source: Finance Ministry

2001 will be better than 2000 in structural terms

Excluding the impact of the economic cycle on revenues and expenditure gives the public deficit's structural component. Since the Spanish economy will grow faster than its potential in 2001, a balanced budget will be attained without eliminating the structural deficit (see table "Government surplus and economic cycle"). To make fiscal policy more flexible, the objective must be to ensure a structural balance in the medium term. Therefore, the 2001 Budget should have been more ambitious. Nevertheless, if a balanced budget is attained in 2001 with economic growth below the 2001 Budget's projection (3.2% of GDP according to BBVA), fiscal policy in 2001 will be more restrictive than it was in 2000.

Public expenditure continues to account for a large percentage of GDP

A lack of structural reforms on the expenditure side is reflected by the fact that a balanced budget can be

[1] Although the government has announced that the deficit in 2000 will be 0.3% of GDP, i.e. 1 decimal point below the 2001 Budget's figure, the insufficient information provided about the expenditure and revenue items that will help the country reach this new target means that the analysis will be made using the figures contained in the 2001 Budget.

Table 2.Contribution to the reduction in public deficit

Variation in GDP (percentage points)	99-98	00-99	01-00
Total current revenues	**0.4**	**0.0**	**0.4**
Direct and indirect taxes	0.6	0.1	0.3
Welfare contributions	0.0	0.0	0.2
Other	-0.2	-0.1	-0.1
Total expenses	**-1.1**	**-0.7**	**0.0**
Current transfers	-0.3	-0.1	0.1
Interest	-0.7	-0.2	-0.1
Public consumption	-0.2	-0.4	-0.1
Net capital transfers	0.2	-0.1	0.0
Public capital expenditure	0.0	0.0	0.1
Public surplus	**1.4**	**0.7**	**0.4**

Source: Finance Ministry and BBVA

attained without reducing the proportion of public spending to GDP. If public expenditure had remained constant in real terms since 1996, it would be about 37% of GDP in 2001 (vs. the projected 40%). This means that real per capita expenditure has increased steadily since 1996. More public sector intervention means less private initiative and a more inefficient economy; consequently, per capita expenditure should ideally not continue to grow.

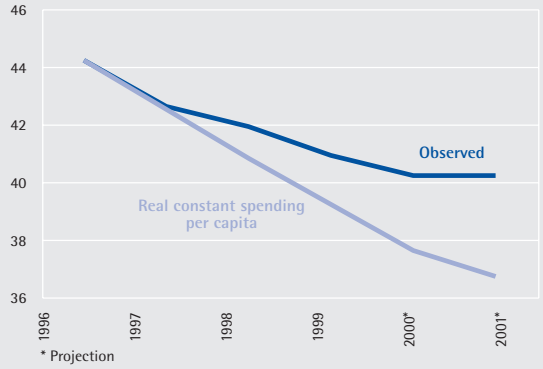
The public debt should already have been under 55% of GDP in 2000

The public debt calculated from the accumulated debt at 1995 year-end and considering the public deficit performance and the considerable privatisation revenues is lower than that recorded in the official figures. This highlights the fact that, in spite of a reduction in government-owned business, the funds and loans allocated to public entities continue to be large. If a balanced budget is maintained in the medium and long term and assuming 6% nominal growth (an optimistic assumption considering that the Spanish economy's potential growth is nearly 3% and that inflation in the medium term should not be far from 2%), it would take 13 years to halve the debt-to-GDP ratio.

2. An optimistic macroeconomic scenario as regards growth and inflation

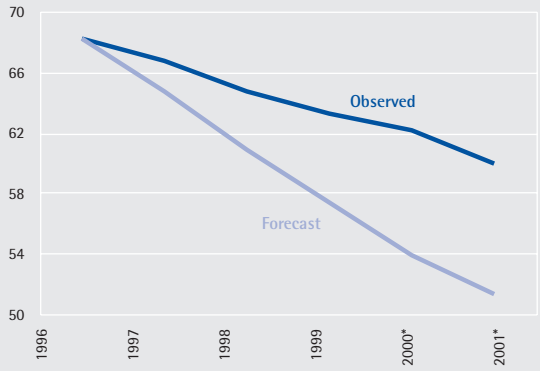
The feasibility of the deficit target depends both on the economy's situation (which determines cyclical public sector revenues and expenditure) and the government's discretionary decisions (compensating sectors affected by rising oil prices, creating a levy for using the radio spectrum, reducing the capital gains tax rate, freezing special taxes and levies, not deflating the personal

Graph 1
Public spending
(% of GDP)



* Projection
Source: Finance Ministry and BBVA

Graph 2
Public debt
(% of GDP)



* Projection
Source: Finance Ministry and BBVA

income tax rate, tax deductions or the tax-free allowance, increasing public investment, etc.).

Table 3 compares the macroeconomic scenarios projected for 2001 by the government's economic team and by the BBVA Research Department. In both cases, the Spanish economy is expected to slow slightly in 2001, although it will continue to grow faster than its potential. Growth will ease because internal demand will be restrained and the external sector will continue to have a negative impact on GDP growth (-0.5 points according to BBVA and -0.4 points envisaged in the 2001 Budget). Although the deceleration projected for 2001 had already been anticipated in mid-2000 due to various factors (a rebound in real interest rates, exhaustion of the effect of the income tax reforms, and slower growth in world trade), the impact of steady oil price increases (a negative supply-side shock) on the economy's borrowing requirements and on GDP growth, and worsening inflation prospects, have deteriorated the outlook for 2001. This is why BBVA's projection of the slow-down in Spain in 2001 has been upgraded to 0.7 points (3.2% from the 4.0% for 1999) from 0.5 points in June (3.2% from an initial estimate of 3.7% for 1999).

Rising energy prices do not seem to have a significant effect on activity and prices according to the 2001 Budget's macroeconomic scenario because: i) the 2001 GDP deflator shows moderate growth (which is lower than that projected for 2000); ii) wages will continue to be moderate, not even recovering the purchasing power lost in 2000; iii) Spain's trade balance and financing needs will barely worsen; and iv) capital expenditure is surprisingly high, in spite of increasing spending on intermediate consumption and on financial expenses, and lower demand. As a result, the 2001 Budget's macroeconomic scenario is apparently optimistic in real

Table 3. Macroeconomic scenario 1999-2001

		BBVA		Government economy team	
	1999	2000	2001	2000	2001
GDP and aggregates (annual %)					
Final consumer spending	4.3	3.8	3.4	3.6	2.9
Households	4.7	4.2	3.7	4.3	3.4
Regional administrations	2.9	2.4	2.4	1.2	1.2
GFCF	12.5	6.2	3.9	7.0	7.0
Capital goods	8.7	5.0	3.0	5.5	8.0
Construction	9.0	6.9	4.4	7.9	6.5
Variation in inventories (1)	0.2	0.1	0.0	0.0	0.0
National demand	5.5	4.4	3.5	4.4	3.9
Goods and services exports	6.6	9.5	7.0	9.5	8.8
Goods and services imports	11.9	10.7	7.9	10.8	9.5
Foreign trade balance (1)	-1.5	-0.5	-0.5	-0.6	-0.4
GDP	4.0	4.0	3.2	4.0	3.6
Current GDP	93693.4	100152.9	106254.7	99943.1	105878.9
(annual %)	7.0	6.9	6.1	6.7	5.9
Prices and costs					
GDP deflator	2.9	2.8	2.8	2.6	2.3
Private consumption deflator	2.5	3.5	3.1	3.2	2.7
CPI (Dec./Dec.)	2.9	3.9	2.7	-	-
Remuneration per wage-earner	2.8	3.2	3.5	3.0	2.8
Productivity	0.4	0.7	1.0	1.0	1.1
Unit labour cost, whole economy	2.3	2.5	2.5	2.1	1.7
Labour market					
Occupied population (var. '000) (2)	507.9	482.8	332.5	438.9	382.8
(annual %)	3.6	3.3	2.2	3.0	2.5
Unemployment rate (2)	15.9	14.0	12.9	14.2	12.7
Foreign sector					
Trade balance (% of GDP)	-5.1	-7.1	-8.1	-6.3	-7.0
Capacity (+)/Req. (-) (% of GDP)	-1.1	-2.9	-3.4	-2.5	-2.9

(1) Contribution to annual growth.
(2) National Accounting occupied population, employment equivalent to full-time and EPA unemployment rate.
Source: Finance Ministry, INE and BBVA

GDP growth and inflation projections, but it is less optimistic in the nominal GDP projection since one optimistic outlook offsets the other. This will have a negative effect on the budget in terms of expenditure and not in terms of revenues, which will perform in line with nominal GDP. In fact, higher inflation implies a tax on the economy and, consequently, higher tax receipts, which will offset the slower real growth projected for 2001. Although the bulk of public expenditure depends on nominal GDP performance (health spending and transfers to the territorial authorities), pensions are inflation-linked and so, if inflation exceeds the 2% envisaged in the 2001 Budget, spending will be over budget. The funds allocated to cover unemployment benefits will also rise if the economy grows more slowly than expected and less employment is created. In addition to the direct impact of the rebound in oil prices on GDP, the other main concern is the risk of wage tension. Although the government projects wage restraint (2.8%), the positive inflation surprises in the last two years and the trade union wage demands (about 3.5%) indicate that the wage restraint in recent years will come to an end in 2001. This, together with a moderate progress in productivity (about 1% per year), would prevent further reductions in unit labour costs, which will continue to grow fast in 2001 (2.5%), contrasting with the government's projection of a slow-down (1.7%).

3. The draft 2001 Budget for the State, the Autonomous Bodies and the Social Security

The target of a 0.3% deficit of GDP in 2000 is assured

The 2001 Budget contains the consolidated figures for expenditure and revenues for the State, the Autonomous Bodies (primarily INEM, the employment

Table 4: Consolidated budget of non-financial expenditure and revenues (cash)

	2000 Budget		2000 Projection	BBVA	2001 2001 Budget		(01/Proj.00)	(01/BBVA Proj.00)
	Pts. Bn	(% of GDP)	Pts. Bn	(% of GDP)	Pts. Bn	(% of GDP)	(% annual)	(% annual)
Revenues	**31695.5**	**31.7**	**32591.9**	**32.6**	**34508.5**	**32.6**	**8.9**	**5.9**
Tax receipts	16449.9	16.5	16923.8	16.9	18022.9	17.0	9.6	6.5
Welfare contributions	11842.9	11.8	12292.9	12.3	12804.4	12.1	8.1	4.2
Other	3402.8	3.4	3375.2	3.4	3681.2	3.5	8.2	9.1
Expenditure	**32709.2**	**32.7**	**33211.5**	**33.2**	**34471.8**	**32.6**	**5.4**	**3.8**
Current	30395.4	30.4	30971.0	31.0	31989.9	**30.2**	5.2	3.3
Capital	2293.1	2.3	2240.5	2.2	2481.8	**2.3**	7.6	10.8
Expenses ex. interest	29887.1	29.9	30255.7	30.3	31617.9	29.9	5.8	4.5
Cash deficit	**-1013.7**	**-1.0**	**-619.6**	**-0.6**	**36.7**	0.0		
Primary surplus	**1808.5**	**1.8**	2336.2	2.3	**2890.6**	2.7		23.7
Var. in financial assets	951.7	1.0	951.7	1.0	1299.8	1.2	36.6	36.6
Total expenditure policies	**33661.0**	**33.7**	**34163.3**	**34.2**	**35771.6**	**33.8**	**6.3**	**4.7**
Cash deficit	**-699.6**	**-0.7**	**-299.8**	**-0.3**	**0.0**	**0.0**		

Source: Finance Ministry and BBVA

agency) and the Social Security, i.e. the central authorities. However, there is no information about the territorial authorities (regional and local governments). The central authorities project a balanced budget in 2001 (following a target of 0.3% of GDP in terms of National Accounting in 2000 that had been downgraded from the initial 0.7%). The government's deficit, which will be halved (0.3% of GDP), will be offset by a surplus in Social Security (0.3% of GDP) as a result of favourable social security tax performance. Although the 2001 Budget does not offer an advance on the consolidated expenditure and revenue settlements in 2000, we have used the information available about the execution of the State and Social Security budget to project the situation at 2000 year-end. Table 4 shows the 2000 budget, the advance settlement calculated by the BBVA Research Department and the 2001 budget in cash terms. Because of a favourable performance in both tax (indirect and direct) and social security revenues, total revenues could be 900 billion pesetas higher than budgeted. Not all of these extra revenues will be used to reduce the deficit; they will also finance higher spending (500 billion pesetas). The most important features are: i) the deviation in spending will be primarily due to current expenditure, which has a large endogenous component (pensions, health, transfers to the territorial authorities, etc.); and ii) half of the additional revenues will be due to favourable social security revenue performance, which reflects both good progress in the labour market and the adjustments made in job contracts to take advantage of the social security rebates; these factors will not advance as intensely in the future.

According to the 2001 Budget, the deficit will be corrected in 2001 by favourable tax revenue performance (up 6.5% with respect to projections) and a moderate increase in expenditure (up 3.8% with respect to projections, and up 4.7% including the variation in financial assets). Consequently, in the consolidated budget, expenditure declines as a proportion of GDP, tax revenues increase and the tax burden (including social security) remains practically the same. Although aggregate data suggest that the 2001 budget could be classified as restrictive, a more detailed analysis questions this judgement.

Expenditure in the 2001 Budget does not include some unavoidable commitments in 2001 or address the pending reforms

Firstly, the expenditure restraint is explained by the fact that some items have not been included and measures with a permanent impact on spending (such as reforming the public pension and health systems and Spain's public television and radio network RTVE) have not been adopted. Some of the main items not included are as follows: i) the overall cost of compensating pensioners for the deviation from the targeted inflation (1.9 points, according to BBVA, and not the budgeted 0.9 points), and its consolidation (160 billion pesetas, i.e. 0.15% of GDP); ii) the impact of future labour reform agreements; and iii) the allocation to pay the debt to "toxic syndrome" victims is scant (5.3 billion pesetas, although additional assignments of over 50 billion pesetas were made in both 2000 and 1999).

The 2001 Budget lacks adjustment measures, which is reflected as follows: i) no progress has been made in reforming the public pension system and there is no mention of repaying the loan granted by the Bank of Spain to the Social Security[2] or of paying the non-contributory pensions out of taxes; only the reserve fund has been allocated an additional 90 billion pesetas (190 billion pesetas at 2001 year-end), which is insufficient to cover the future shortfall in the current public pension system[3]; ii) authorised indebtedness transactions by public companies and entities increase by 12% and collateral remains the same as in 2000 (when it increased by 9.6%); iii) although RTVE will be transferred to SEPI, its indebtedness will increase to 795 billion pesetas by 2001 year-end; iv) current and capital transfers to state-owned companies, public companies and entities will remain high (about 0.5% of GDP); v) financial assets, i.e. mainly allocations to Public Entities and Bodies, loans granted and share acquisitions, grow by 36.6%; vi) spending in sick-leave benefits is up again (12%, i.e. 0.6% of GDP) in spite of an explicit commitment by the government to reduce this; and vii) contributory unemployment benefit expenditure grows by 5.1% (0.6% of GDP) and the Rural Employment Plan (PER) by 7.5% (0.14% of GDP) even though unemployment will continue to decrease in 2001. In addition to all these factors, the depletion of the leeway given by the falling financial burden (the amount in 2001 could be underestimated given the projected increase in the average cost of debt in 2001) implies that a sustainable balanced budget does not seem to be guaranteed in the medium term.

No significant deviations from the budgeted revenues are expected

As stated above, the impact on revenues of a faster economic slow-down than that projected by the government will be moderate because nominal GDP will grow at a similar rate in 2001, and will even exceed that envisaged in the 2001 Budget due to higher inflation. Consequently, the deviation between the final revenues and the budgeted revenues will be mainly due not to major errors in nominal GDP projection but to other factors, notably: i) higher-than-expected social security revenues, which are clearly underestimated in the Budget; ii) the non-inclusion in the 2001 Budget of the negative impact on personal income tax and VAT of the measures supporting the sectors most affected by surging energy prices (about 116 billion pesetas, i.e. 0.1% of GDP); and iii) uncertainty about the total revenues from the radio spectrum levy (160 billion pesetas, i.e. 0.15% of GDP). The negative impact of ii) and iii) on revenues will be more than offset by the positive impact of higher social security revenues (about 350 billion pesetas, i.e. 0.33% of GDP). Nevertheless, although revenues will be slightly over budget, scant allocations to some expenditure items could make it difficult to attain a balance in 2001.

Balanced budget doubtfully sustainable in the medium term

An alternative approach to analysing if the 2001 Budget is advancing in the right direction is to assess its priorities, i.e. by observing expenditure from a functional standpoint. The difficulty in preparing a settlement projection for the expenditure policies in 2000 means that we have to use the budgeted figures. Table 5 shows the distribution of the budgeted increase in each expenditure item (including the changes in financial assets) in 2000 and 2001. These figures show that welfare expenditure accounts for 63.6% of the projected increase in spending in 2001. Although this percentage is below that budgeted in 2000, it increases to 66.2% if the total compensation (1.9 percentage points) to pensioners due to the loss of spending power is included. Even so, welfare expenditure will continue to increase as a proportion of GDP to 54.9% (0.55 points more than in 2000) and to 55% including the entire compensation to pensioners; this reflects an absence of expense control measures in an item that grows according to endogenous factors. Also, the leeway given by the decrease in the financial burden until 2000 to finance other expenditure policies (education, R&D and infrastructure) has disappeared. As a result, the committed spending which, apart from welfare expenditure, also includes transfers to the territorial authorities and to the EU, increases by 1.729 trillion pesetas in the 2001 Budget, i.e. 81.9% of the total increase in spending (83.5% including the total compensation to pensioners), compared with the 75.5% increase in the 2000 Budget. Therefore, the government has very little leeway to adopt productivity-improving policies (R&D and infrastructure), demonstrating that structural reform is needed to guarantee that committed spending does not continue to increase as a proportion of GDP and of total expenditure.

[2] The Bank of Spain's loan totals 339.61 billion pesetas, of which 256.1 billion pesetas is the principal (to be repaid over 20 years from 2000) and 83.51 billion pesetas is interest (to be repaid over 10 years from 2010).

[3] Although this fund could increase until 2015 due to the surplus in the taxation system, the accumulated fund would be depleted rapidly as a result of the ageing population and would disappear shortly after 2020 if there are no revenues from outside the system. See: "La reforma de las pensiones ante la revisión del Pacto de Toledo" (2000). Herce, J.A. and Meseguer, J.A. Colección Estudios Económicos no. 19, La Caixa.

Consequently, although the objective of the 2001 Budget is to balance, a more detailed analysis shows that it cannot be considered restrictive. In spite of this, if the deficit can be corrected by attaining 3.2% economic growth (BBVA's projection) instead of the government's 3.6% projection, the structural deficit will decrease in 2001, having remained unchanged in 2000. Consequently, fiscal policy would be more rigorous in 2001 than in 2000.

The slight leeway to adopt productivity-improving measures means that although R&D and infrastructure financing grows by more than total expenditure, it is insufficient.

In spite of the slight manoeuvring room afforded by the government's uncommitted spending, the question arises as to whether this spending will be used efficiently, i.e. whether it will improve productivity. To answer this, it is necessary to analyse the expenditure items that improve productivity, i.e. education, job creation, R&D and infrastructure. In education, the central government's role has decreased considerably following the final devolution in 2000 of non-university education to all the autonomous governments, which are now in charge of making the necessary reforms. In job creation, active employment policies increase spending by only 2.6% (8.9% in 2000), and funds allocated to incentives for long-term contracts (0.28% of GDP) are higher than those to train unemployed and employed people (0.23%). If the objective is to maintain an employable labour supply, job creation allocations should be distributed between the various job creation items. R&D decreases its proportion of funds (see table 4); this is not positive because of the gap between Spain (0.8% of GDP), EMU (about 1.6% of GDP) and the US (2.6% of GDP). Infrastructure spending grows by 9.1% (7.5% excluding water infrastructure), i.e. by considerably more than total consolidated expenditure (6.2%), showing that this is a priority item in the 2001 Budget. This growth in infrastructure spending rises to 13.2% if we include the investment in infrastructure made by Public Entities that do not receive any central government funds (AENA and Puertos del Estado), and by railways RENFE and FEVE (which receive capital subsidies). This highlights the fact that infrastructure policy is a priority in the 2001 Budget; nevertheless, the Public Entities not consolidated in the Budget are the ones that provide the bulk of infrastructure financing.

Consequently, although the increase in budgeted spending in some of the most important items (infrastructure and R&D&I) is higher than in total expenditure, the funds to stimulate productivity and improve competitiveness continue to be insufficient. Moreover, in order to guarantee efficient use of funds, it is necessary to make progress in reforms that liberalise and increase the flexibility of the goods and services markets and, above all, the labour market.

Table 5: Consolidated expenditure. by expenditure policy (including variation in financial assets)

	2000 Budgeted increase in spending 2000 Budget			2001 Budgeted increase in spending 2001 Budget			2001 Total spending 2001 Budget	
	Pts. Bn	(% annual)	(% of total)	Pts. Bn	(% annual)	(%/of total)	Pts. Bn	(% of GDP)
GENERAL ADMINISTRATION	**103.0**	**5.1**	**6.2**	**135.6**	**6.4**	**6.4**	**2264.8**	**2.1**
WELFARE SPENDING*	**1085.3**	**6.2**	**65.3**	**1342.5**	**7.3**	**63.6**	**19620.8**	**18.5**
Pensions	488.4	5.5	29.4	513.3	5.5	24.3	9815.8	9.3
Employment creation	66.3	9.0	4.0	20.8	2.6	1.0	826.7	0.8
Healthcare	331.5	8.0	19.9	277.3	6.2	13.1	4731.6	4.5
Education	45.2	9.8	2.7	10.3	7.3	0.5	150.9	0.1
Unemployment and sick-leave	-32.2	-1.7	-1.9	97.6	5.2	4.6	1965.9	1.9
PRODUCTIVE ACTIVITY AND INVESTMENT	**201.2**	**5.9**	**12.1**	**234.3**	**6.5**	**11.1**	**3828.1**	**3.6**
Research	53.5	11.6	3.2	58.1	11.3	2.8	571.6	0.5
Infrastructure	85.8	7.7	5.2	110.5	9.1	5.2	1317.8	1.2
TRANSFERS TO REGIONAL ADMINISTRATIONS*	**406.6**	**7.6**	**24.5**	**356.9**	**5.9**	**16.9**	**6395.6**	**6.0**
PUBLIC DEBT	**-236.0**	**-7.8**	**-14.2**	**30.0**	**1.1**	**1.4**	**2835.0**	**2.7**
OTHER POLICIES	**102.6**	**14.4**	**6.2**	**11.6**	**1.4**	**0.5**	**827.3**	**0.8**
TOTAL SPENDING POLICIES	**1662.6**	**5.2**	**100.0**	**2110.6**	**6.3**	**100.0**	**35771.6**	**33.8**
COMMITTED EXPENDITURE	**1255.8**	**4.9**	**75.5**	**1729.3**	**6.4**	**81.9**	**28851.4**	**27.2**
MARGIN OF ACTION	**406.8**	**6.6**	**24.5**	**381.3**	**5.8**	**18.1**	**6920.2**	**6.5**

*Standardised for devolution of education to the Regional Governments
Source: Finance Ministry and BBVA

Spain: Main economic indicators

(% year-on-year change, unless otherwise stated)

	1999	2000	July	August	September	Latest figure	One year ago	Trend
Industrial production (seasonally-adjusted)	2.6	5.6	2.7	6.3		6.3	4.5	-
Business confidence index (net balance)	-2.1	2.7	3.7	1.0		1.0	-2.0	-
CU (3)	79.9	80.6					79.4	-
Electricity consumption (4)	5.9	7.4	5.5	9.5	9.4	9.4	5.0	-
Cement consumption	11.8	11.6	12.1	14.1	12.3	12.3	8.5	-
Car registrations	18.1	2.5	-6.0	2.8	-4.5	-4.5	23.6	-
Consumer confidence index (2)	7.8	8.6	9.0	9.0	4.0	4.0	8.0	-
CPI (overall)	2.3	3.2	3.6	3.6	3.7	3.7	2.5	=
Producer prices	0.7	5.4	5.5	5.1	5.5	5.5	2.4	+
Wage agreements (5)	2.7	2.9	3.0	3.0	3.0	3.0	2.7	+
Money supply (households and NPISH)	1.5	1.5	1.8	2.6		2.6	1.8	+
Domestic private sector credit	18.5	18.5	17.0	16.5		16.5	19.6	-
Social security registrations	5.5	5.2	4.5	4.9	5.6	5.6	5.1	-
Registered unemployment (6)	-237.9	-104.8	-62.2	-66.9	-68.5	-68.5	-218.4	-
Unemployment rate (3)	15.8	14.5				14.0	15.4	-
Employment (qtr.) (3)(6)	612.6	693.0				676.5	626.7	-
Current account balance (7)	-12042.5	-10024.4	-1825.0			-1825.0	-967.0	-
Trade balance (7)	-27547.0	-19643.0	-3115.0			-3115.0	-2253.0	-
State cash balance (7)	-1057.3	-1350.1	-898.6	-1297.1	-1350.1	-1350.1	-1180.2	-

(1) Available to date. (2) Balance of replies (%). (3) Quarterly data for quarter ending in month specified. (4) Corrected for calendar effects and temperature. (5) Year-to-date. (6) Year-on-year in '000s. (7) Balance in millions of euros.

International situation: Forecast summary

	Real GDP (%)				Inflation (% at year-end)			
	1998	1999	2000	2001	1998	1999	2000	2001
US	4.3	4.2	5.2	3.5	1.6	2.2	3.4	2.4
EMU	2.7	2.4	3.5	2.5	1.1	1.1	2.3	2.0
Japan	-2.8	0.3	1.3	1.8	0.8	-0.3	-0.6	-0.1

	Fiscal balance (% of GDP)				Current account balance (% of GDP)			
	1998	1999	2000	2001	1998	1999	2000	2001
US	0.8	1.3	2.4	2.7	-2.5	-3.8	-4.2	-4.2
EMU	-2.1	-1.3	-0.9	-0.8	0.5	-0.1	-0.5	-0.2
Japan	0.5	-9.0	-8.8	-8.5	3.2	2.5	2.7	3.0

	Official interest rate (%)*				Exchange rate (vs. $)*			
	Oct. 00	Dec. 00	Mar. 01	Jun. 01	Oct.	Dec. 00	Mar. 01	Jun. 01
US	6.50	6.50	6.50	6.50				
EMU	4.75	5.00	5.25	5.25	0.84	0.86	0.90	0.90
Japan	0.50	0.50	0.50	0.75	108	105	100	95

* End of period

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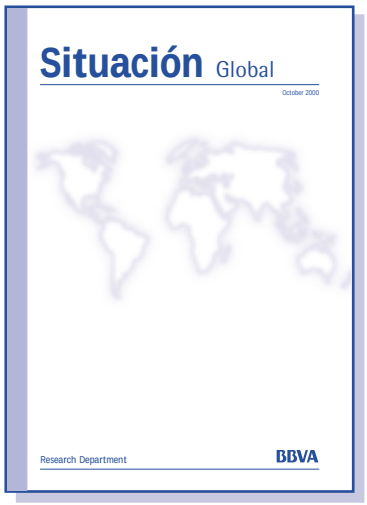

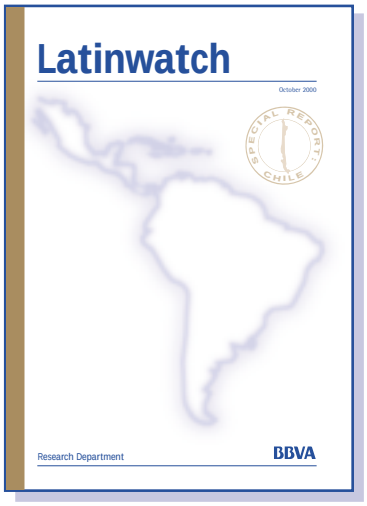

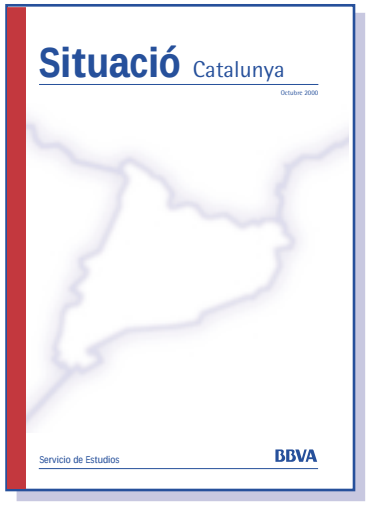

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