BBVA | RESEARCH

Economic Outlook

Spain

May 2011
Economic Analysis

- **Robust global economic growth** driven by emerging economies.
- **Despite some progress, the lack of decisive measures to resolve the debt crisis in Europe** will keep financial tensions high.
- **The Spanish risk premium is higher than it would be if based on fundamentals** and should fall when deficit reduction targets are met and the ambitious fiscal adjustments are implemented successfully.
- **Although the reform drive could partially offset some of the downside risks on growth,** the strength of the recovery will depend on the recapitalisation of the financial system and on the labour market reform.

Index

Closing date: 6 May 2011

1. Summary

The world economy will continue its robust growth trend, but downside risks exist

The global economy is set to continue its strong growth trend and world GDP should expand by 4.4% in both 2011 and 2012, driven mainly by emerging economies. However the threat of rising commodity prices increases uncertainty and poses a risk to growth that could trigger widespread inflation. As this global crisis unfolds, the local risks identified in the previous Spain Economic Outlook remain in force. The financial stress in Europe will probably continue, especially in Greece, Portugal and Ireland. Meanwhile, the ongoing political debate regarding the proposals for the initial phases of the fiscal consolidation process in the United States will also increase market uncertainty. Lastly, there is still a risk of overheating in emerging markets which could prove especially critical in South America, given the tailwinds that are driving up commodities prices.

The oil crisis (transitory, but with persistent effects on our baseline scenario) will impact prices. And as prices rise, the majority of the monetary authorities will feel obliged to bring forward interest rate hikes. However, central banks are adopting very different approaches to mitigate the risks generated by increases in the price of oil and other commodities. Although central banks in the United States and Europe are changing the bias of their monetary policies, they are doing so at different speeds. As a result, the risk has now shifted, and now points towards a greater likelihood of interest rate hikes. Specifically, the European Central Bank (ECB) aims to avoid any inflation risk by taking preventive action (hence, its first hike in April). Meanwhile, the US Federal Reserve (FED), focusing more on uncertainty over the sustainability of the recovery, prefers to wait and act only if risks materialise.

In Europe, the agreements reached during the March summits were welcome developments, both in terms of economic reforms and to help prevent future crises. In addition, although the changes introduced to the European Financial Stability Fund (EFSF/ESM) are steps in the right direction for addressing liquidity concerns, they are insufficient. Financial market tensions linked to the three European periphery countries that have sought international assistance (Greece, Ireland and Portugal) will continue as long as doubts persist about their solvency, especially that of Greece. These doubts will continue to hinder the funding of these economies and keep sovereign spreads high, a dynamic that could spread to other countries, even those with high solvency credentials, as in the case of Spain. It is clear that Europe still needs a comprehensive approach to resolve the debt crisis in case of insolvency. Furthermore, any such solution must take into account that the inclusion of haircuts to private investors entails a very high risk of contagion to the rest of Europe, so it will have to be designed carefully.

The Spanish economy is slowly recovering, although we do not expect to see positive net job creation until the second half of 2011

After closing 4Q10 with quarterly GDP growth of 0.2%, the Spanish economy is expected to have started 2011 with a similar performance, with improvement of about two or three tenths of a percentage point. The forecasts based on available economic indicators show that this growth is still being shaped by a strong external demand and a weak domestic demand and that, given this sluggish rate of improvement, the Spanish economy remains unable to create employment. The data released in April also confirms this trend for the beginning of the second quarter of 2011, which, if sustained throughout May and June, would bring second quarter GDP growth to 0.3% (in qoq terms). In short, our analysis of the weak growth outlook for the Spanish economy in the short term has not changed in any significant manner.

Nor do we expect any dramatic change to this growth trend going forward, although there are new elements that, along with the factors detailed in the preceding edition of this publication, will exercise considerable influence on its composition over the length of the forecast horizon, and even point towards lower growth in certain cases. First, in regard to events affecting countries of global economic importance, such as the natural disaster in Japan, the bailout plan for Portugal (of particular concern, given its proximity to Spain), and the situation in Greece, the Spanish economy's relatively limited exposure to these three countries, not to mention current growth prospects for both the global and European economies, bodes well for the growth of Spanish exports during the forecast period (2011-2012).

Secondly, in addition to the weak fundamentals of private domestic demand and the deleveraging process currently underway among private agents, there is upward pressure on oil prices and the possibility that the ECB could bring forward interest rate hikes, although any such hikes should be modest. Both these latter factors represent an additional drag on the pace of recovery of aggregate demand, although the total impact should be modest and concentrated towards the end of the forecast period. In any event, although one of the consequences of the ECB's more aggressive stance compared to the Federal Reserve was an appreciation in the euro against the dollar that was slightly greater than what was expected three months ago, we would underscore that we do not expect a significant loss of competitiveness for Spanish exports: once the increase in oil prices and the tax changes that took place in 2H10 are taken into account, the difference in prices with respect to the eurozone should remain at relatively moderate levels.

In addition, despite persistent tension in sovereign debt markets, the Spanish economy is in better shape than other European peripheral countries thanks to its overall compliance with the fiscal consolidation targets, the greater transparency of its public accounts and the effort to restructure the financial system, the labour market and the pension system. Setting aside the positive effects that these measures might have on the efficient functioning of the Spanish economy in the medium term, the immediate effect has been a lower risk premium relative to the rest of the countries in the European periphery, which will result in less drag on both the public and private sectors, justifying the efforts being made by Spanish society. Although the adjustments and reforms carried out do not fully offset the negative impact of the increase in oil prices and interest rates in 2012, they are enough to keep 2011 growth forecasts from being cut and also prevent a more severe contraction in activity and a sharper jump in unemployment the following year. In short, although there is still ample scope for implementing further reforms in the financial system (whose restructuring is still far from over), the labour market (where the modernisation of the collective bargaining framework is still pending), and the fiscal adjustment (which should continue to be carried out in a rigorous manner through 2011) the measures adopted set the stage for an improved growth outlook for the Spanish economy.

Finally, given that the Spanish economy's fiscal consolidation process cannot be postponed, the contraction in the public sector will continue to impede growth in the short term, but will now do so with special intensity in the autonomous regions that did not comply with 2010 deficit targets, and which must therefore implement a more ambitious plan to meet the 2011 targets.

Overall, we expect the pace of growth in the Spanish economy to remain frail in the short and medium term, with the economy growing by around 0.9% for the year as a whole. As already forecasted in the February edition of this report, a sustained and job-creating recovery should start during the second half of 2011, with 2012 being the year when the Spanish economy gets back to around 1.6% growth, enough to generate net jobs, but not enough to significantly reduce the unemployment rate, given a normal scenario for labour force performance. Growth rates should vary widely among regions, but less so than in 2010. Their varying levels of exposure to economic drivers in 2011-2012, described above, will result in a widely dispersed recovery, especially in 2011.

The reform process must continue, rolling out ambitious measures

In recent months, the adoption of structural reforms and ongoing fiscal adjustments have caused Spain's risk premium to decouple from other EMU peripheral countries. Even so, the risk premium is still high and Spain is not free of contagion risk in the event of fresh tensions in financial markets. As shown in this edition, Spain's risk premium reflects uncertainty about the country's ability to service its sovereign debt. However, these doubts are not based on fundamentals, given that the public debt burden would be sustainable even in risk scenarios that are unlikely to occur. Setting aside the reasons behind this high risk premium, which reflect in large part market uncertainty regarding Europe's construction process, it is clear that this premium is detrimental to the Spanish economy's recovery.

In this regard, although the Spanish government's ongoing reforms and adjustments will build confidence in international financial markets, more importantly, they will help resolve major structural problems, among which the high unemployment rate is the most notable. This, in fact, is the most important aim of these reforms. The sooner these needed reforms are carried out in a comprehensive manner, the faster these structural problems will be solved. As we have noted in previous editions of this publication, the challenge for the Spanish economy entails generating a virtuous circle of growth and job creation as soon as possible through a restructuring of the financial system, labour market reform and fiscal consolidation, as well as other measures that are extremely important (improving human capital, the reduction and simplification of administrative structures, improved regulation, fostering competition, etc.).

The economic recovery depends to a large degree on the satisfactory completion of the recapitalisation of the financial system, with a prompt entry of private capital. The restructuring plan underway has positive elements. First, it provides a road map for restructuring the system, something markets have been insistent on in recent years. Second, it encourages the participation of private capital and requires savings banks seeking aid from the FROB to become banks, making them more transparent for foreign investors. Lastly, the FROB ensures that they will be able to meet minimum capital requirements. However, the balance sheet strengthening and restructuring process (following the withdrawal of FROB resources from the equity of the entities that have received aid) must be completed quickly and definitively with the entry of private capital to normalise all the entities' solvency ratios and allow for access to sufficient amounts of liquidity at acceptable prices. This will reinforce international investors' confidence in our financial system, providing a more propitious environment for lenders to meet the credit demands of the economy as a whole. It should be borne in mind that the deleveraging process, which results in negative growth in credit demand from companies and households on the aggregate level, is completely compatible with increased demand from certain companies and sectors. In fact, the sectorial adjustment of the Spanish economy implies a shift in the allocation of capital and labour to different companies, for which reason, new financing needs for new investment projects will arise, and should be met without restrictions by the financial system. Consequently, it is necessary for all the entities to possess the liquidity and solvency levels required to fulfil this function.

Second, although the fiscal target for Spain as a whole was met in 2010, the varying degrees of compliance among regions was worrying, since much of the 2011 deficit reduction target depends on them and their ability to reduce spending. It is positive that the central government is using all the instruments at its disposal to pressure the autonomous communities to meet the targets for this year. Nevertheless, it is worrying that four months into 2011, there is still no agreement as to how certain autonomous regions, which represent almost 50% of the Spanish GDP, are going to meet their fiscal commitments. The government and the Fiscal and Financial Policy Council (FFPC) must remain vigilant and act immediately and decisively if, in the coming months, there is evidence that the measures announced up to now are not going to be sufficient to meet this year's targets. By complying with the Stability Plan between 2011 and 2014, which must remain a non-negotiable objective, the Spanish public debt will be on track to decrease starting in 2014, which would lead to levels far below the European average. To achieve these targets, once the deficit hits 6% in 2011, over the subsequent two years public administrations must announce additional measures equivalent to around 2% of GDP, as set forth in the last Stability Plan presented to the European Commission. These measures will mainly focus on reducing expenditures. In this report we argue for precisely this strategy of fiscal consolidation through the establishing of procedures and rules that are stricter than those imposed in the past. International experience and economic analysis indicate that the creation of institutions that are independent of the executive branch and report to legislative bodies, capable of offering evaluations, advice and forecasts are useful for increasing the effectiveness of the control over the public administrations and limit potential straying from budgetary targets.

Similarly, the reform of collective bargaining and the correction of labour market inefficiencies are crucial for Spain to begin growing and creating jobs again soon, especially with the unemployment rate over 21%. This situation is unacceptable and requires a considerable pullback in wages at all levels and greater wage flexibility at the corporate level to set the stage for abundant job creation. Wage moderation, which must come alongside the containment of the nominal growth rate of corporate margins, is a key part of the competitive disinflation strategy of the coming years, while Spain's unemployment rate remains above the EMU average.

2. International environment: recovery, global shocks and vulnerabilities

The world economy will continue its robust growth trend, although downside risks exist

The global economy is expected to continue its strong growth trend and expand by 4.4% both in 2011 and 2012, supported primarily by emerging economies (see Chart 1). However rising commodity prices increase uncertainty and pose a risk to growth and could trigger inflation in many regions, even those that could directly benefit from higher commodity prices (exporters). As this global shock unfolds, the local risks identified in the previous Spain Economic Outlook remain practically unchanged. The tensions in European financial markets will probably continue, especially in Greece, Portugal and Ireland. The political maelstrom surrounding the proposals for the fiscal consolidation process in the United States will also add uncertainty to markets, even though the final result will be some form of fiscal belt-tightening. Lastly, the inflationary pressures in emerging markets continue, and could prove especially acute in South America, due to higher commodities prices.

The high prices of oil and other commodities pose a global risk but should be readily absorbed without overly impacting global growth

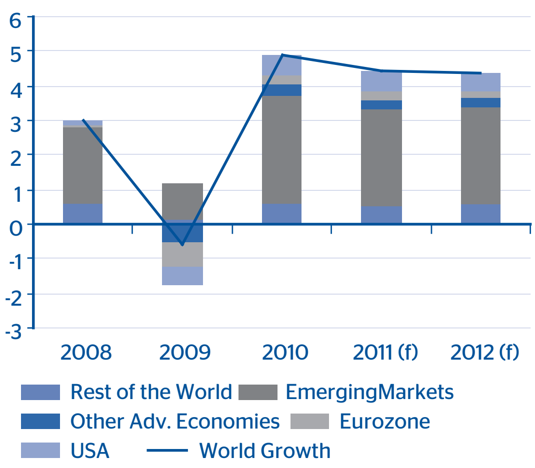
The main risk on the global level is related to rising oil prices, which have been caught in an uptrend since the beginning of the year due to the political instability in the Middle East and North Africa (MENA). Although there is a great deal of uncertainty and the protests in the region have yet to be resolved, in our opinion, this will not cause a contagion effect until it interrupts the oil output of other major producers apart from Libya. Consequently, the geopolitical risk premium pushing up oil prices should slowly decrease, given OPEC's ample productive capacity and current OECD capacity, both of which are higher than their average of recent years. However, oil prices will remain high, at around 110-120 dollars per barrel during most of 2011, and will slowly flex down to around 100 dollars in 2012.

Given this context, in which the prices of other commodities, such as food and metals, have also increased, the developed world (US, Europe, Japan) is feeling the brunt of the pain, along with emerging Asian countries, since they are the main importers of raw materials. Meanwhile, the Middle East and Latin America are the main beneficiaries from this improvement in trade conditions, and will recycle part of these extraordinary gains. Nevertheless, a fluctuation of this magnitude should be easily absorbed by the global economy without significant impacts to economic activity. This, combined with the promising growth figures in the first quarter of 2011, serve as the basis for maintaining our forecast practically unchanged for most areas, in comparison with our Spain Economic Outlook report from February. The main exceptions would be Mexico and South America, where strong economic data for the first three months of the year and improved terms of trade imply moderate upward revision of our growth forecasts for 2011. Meanwhile, in Europe, central countries' growth rates continue to outpace those on the periphery, while in the United States, the outlook appears less bullish than three months ago, and we may even see a decline in economic activity, due to higher oil prices and the temporary growth slump in the first quarter.

High oil prices will drive up headline inflation, causing central banks in most areas to bring forward scheduled interest rate hikes

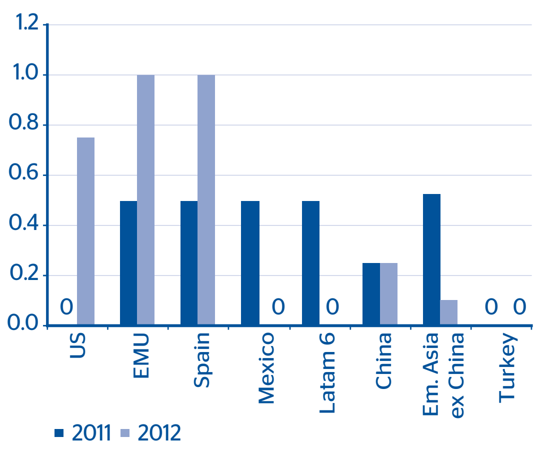
The main effect of the oil shock will be on prices. Rising inflation in the majority of economies in 2011 and 2012 will cause monetary authorities to bring forward, and in some cases, make more aggressive interest rate hikes (see Chart 2). However, central banks are still adopting very different approaches to mitigate the risks generated by increases in the price of oil and other commodities. Specifically, in the United States and the eurozone, the central banks are changing their focus (albeit, to different degrees) from supporting growth and preventing a stagflation scenario, to maintaining inflation expectations at levels that are consistent with medium term targets, an especially delicate proposition as monetary policy remains fairly loose. Therefore, our forecast envisages a higher probability of interest rate hikes occurring sooner than initially expected. The timing of the first rate hike will depend on whether it is deemed necessary to counteract the potential risks derived from second round effects of prices and salaries. The ECB's hawkish stance entails avoiding any risk through the adoption of preventative measures (i.e. its first rate hike in April). Furthermore, it does not appear to be disposed to run the risk of increased inflation as a result of a temporary increase in oil prices. Meanwhile, the US Federal Reserve (FED), focusing more on uncertainty regarding the sustainability of the recovery, prefers to wait and act only if risks materialise. Emerging economies appear to have adopted the middle road, and are open to earlier and faster rate hikes, should they prove necessary, although they will also be careful not to trigger excessive capital inflows and appreciation in their exchange rate.

Chart 1
Global GDP growth and contributions (%)



Source: BBVA Research and IMF

Chart 2
Changes in year-end expected official interest rates relative to February 2011 forecasts (pp)



Source: BBVA Research

Financial tensions in European peripheral countries will remain high as a result of the lack of effective measures to mitigate concerns about their fiscal solvency

In Europe, the agreements reached during the March summits should prove useful in the medium term both in terms of economic reforms and to help prevent future crises. In addition, the changes introduced to the European Financial Stability Fund (EFSF/EFSM) are positive in terms of increasing solvency and allowing for a certain degree of flexibility in addressing liquidity concerns. However, financial market tensions related to the three European peripheral countries that have sought international assistance (Greece, Ireland and Portugal) will continue as long as doubts persist about their solvency and the risk of debt restructurings that would entail haircuts for private investors. These lingering concerns will continue hindering the funding to these economies and generating wide sovereign spreads, which could spread to other countries, including those with ample solvency. Therefore, a comprehensive approach to resolving the debt crisis in the event of insolvency is urgently needed, but one that takes into account that the inclusion of haircuts for private investors would entail a very high risk of contagion to the rest of Europe, so it would have to be designed carefully.

Turbulence in European peripheral countries is still not having a significant impact on growth for the eurozone as a whole

GDP has continued growing at a sustained pace in the first quarter of 2011, and we expect to see qoq growth of 0.6%, following the 0.4% registered in the last quarter of 2010. However, this apparent increase is due mainly to weather factors at the end of last year, which slowed growth, especially in the construction sector. In fact, in the last month of the first quarter, and based on the scant data released in April, it appears that growth has actually slowed down, in line with our scenario of slowing growth for the rest of the year. On average, this year's economic growth should be similar to that of 2010, and somewhat higher than the potential growth rate, with slowing growth in 2012, due primarily to the (limited) impact of high oil prices. The factors behind this slower than usual recovery are the deleveraging processes in the public and private sector and the uncertainty, especially in the European banking sectors, generated by the financial and sovereign crises. In fact, the three large countries in the zone will start to reduce their structural deficits in 2011, since the expansionary fiscal measures designed at the beginning of 2009 were still in place until just a few months ago. In addition, the gradual climb of interest rates, an exchange rate in which the euro is much stronger than the dollar, and which appears set to remain above its equilibrium level in the short and medium term, are also sapping the strength of the recovery.

By country, Germany has continued growing at a higher than average rate, thanks to the boom in its exports to emerging countries, especially Asia. This divergence in growth rates is expected to continue through 2011, although to a lesser degree, and domestic demand is expected to gradually pick up the slack in the recovery process. The stage has been set for this pick-up in demand, given that the unemployment rate fell during practically the whole of 2010 in Germany, in contrast to the rest of the zone. In France, recovery has sped up in recent months, although growth rates are not expected to be as robust as in Germany. The French economy must carry out relatively major cuts to its public deficit in order to meet the ambitious targets it has set for the period leading up to 2013, but has not yet developed public measures to meet the objectives. In Italy, despite a strong start this year, the most recent indicators were disappointing, and growth is not expected to be much over 1% in 2011 and 2012, although this country's fiscal consolidation needs are smaller.

In the US, fiscal consolidation will likely be achieved, but only after prolonged political negotiations

In the US, the political process underway to bring the public debt back to sustainable levels will entail difficult negotiations between parties that have opposite opinions on how to reduce the deficit. In the end, the fiscal consolidation must be the product of higher tax revenues and a decrease in social welfare expenditure. In our opinion, a deal will eventually be reached and that will be translated into lower deficit and sustainable debt levels, but the heated political debate leading up to that point will generate further uncertainty in markets, especially since the highly politicised debate regarding the debt ceiling will provide opportunities for participants to play hardball.

Emerging economies continue to face the risk of overheating. Going forward, this dynamic in South America could be exacerbated by the jump in commodity prices

Emerging economies continue to show signs of overheating, although with wide variations between countries. Some countries are trying to mitigate these risks by tightening their monetary policies, and in some cases like China and Brazil, through fiscal belt-tightening. We believe that the overheating risks are manageable, but going forward they may heighten in South America, if commodity prices continue increasing, which would also cause slower growth in emerging Asia. Furthermore, the possibility that the effect of the earthquake in Japan has hurt its economy more than expected could cause growth rates across most of Asia to decrease, given the strong trade ties and internationally integrated production chains. However, the current account surpluses in most Asian countries should provide them with a greater degree of protection than South American nations.

3. Growth outlook for the Spanish economy

After closing 4Q10 with quarterly GDP growth of 0.2%, bringing full-year growth for 2010 slightly higher than our forecast (-0.1% vs. forecast -0.2%), the Spanish economy is expected to have started 2011 with a similar improvement, about two or three tenths of a point (in qoq terms), which confirms the continuation of the weak recovery started a year earlier. Once again, forecasts made based on available economic indicators show that this growth is being shaped by a strong external demand as domestic demand remains weak,. However, once the changes in fiscal policies in 2H10 are discounted, the domestic demand showed some improvement, although it remained sluggish due to weak fundamentals. The Spanish economy is mirroring this tepid rate of improvement and did not create employment in the first quarter of 2011, which combined with the slight deterioration in job supply, caused another uptick in unemployment, which increased 1.0% to 21.3% for the active population. Our analysis of the weak growth outlook for the Spanish economy in the short term has not changed in any significant manner.

Nor do we expect any dramatic change to this growth trend going forward, although there are new elements that, along with the factors detailed in the preceding edition of this publication[1], will exercise considerable influence on its composition over the length of the forecast horizon (2011-2012). In addition to private domestic demand's weak fundamentals and the deleveraging process currently underway among private agents, there is upward pressure on oil prices -which though transitory, has lasted longer than we expected- and the possibility that the ECB will bring forward its benchmark interest rate hikes, although these hikes are expected to be modest. Both these latter factors represent an additional drag on the pace of recovery of aggregate demand, although overall, their impact is expected to be modest and concentrated in the final part of our forecast horizon. However, despite the international financial tensions still in play and the recent contagion of Spanish risk premiums as a result of fears that Greek debt would have to be restructured, there has been an improvement in the perception of medium term risk for the Spanish economy, which could mean less downward pressure, given the country's dependence on external financing.

Second, the Spanish economy's relatively limited exposure to Portugal and Japan, and the current growth prospects for both the global and European economies, bode well for the growth of Spanish exports. We would particularly highlight the absence of significant feed-through from European financial stress to the real economy, and limited impact from rising oil prices and the pre-emptive interest rate hikes. In addition, despite the fact that the euro has appreciated more than expected, we would underscore that after discounting the increase in oil prices and the tax changes that took place in 2H10, the price differential with the rest of the eurozone remains at relatively low levels. This rules out a significant pullback in the competitive gains accumulated over the last year and a slowdown in trade with the rest of the world.

Finally, given that the Spanish economy's fiscal consolidation cannot be postponed, the contraction in the public sector will continue to impede growth in the short term, but will now do so with special intensity in the autonomous regions that did not comply with 2010 deficit targets, and which therefore must implement more ambitious plans to meet 2011 targets.

Overall, we expect the pace of growth in the Spanish economy to remain modest in the short and medium term, with the economy growing by around 0.9% for the year as a whole. As discussed in last edition of this report, a sustained and job-creating recovery could come towards the end of 2011, and consolidate throughout 2012. Even though the macroeconomic forecasts in this report point to growth slightly lower than previously forecast figures, a reduction of 0.3pp to 1.6%, we would stress that our overall diagnosis of the Spanish economy's recovery has not changed significantly. The economic situation could be in danger of falling into a stagflationary dynamic, and the medium term growth outlook, though improved last year as a result of the reforms carried out by the Government, remains modest. Against this backdrop, it is crucial that policies aimed at correcting the imbalances built up both before and during the economic crisis are implemented, along with further reform measures to strengthen growth.

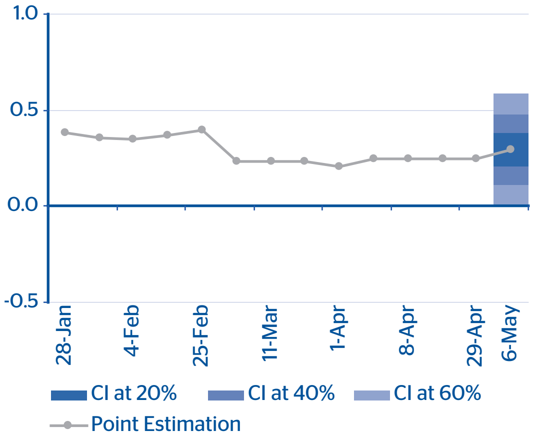
1: See Spain Economic Outlook for 1Q11

Growth rates should vary widely from region to region, but less so than in 2010. Their varying levels of exposure to economic drivers in 2011-2012, described above, will result in a widely dispersed recovery, mainly in 2011. Furthermore, although the overall exposure of the Spanish economy to the Portuguese economy is fairly small, certain Spanish regions could be especially impacted. In 2012, once the variations in the degree of imbalances start to even out, we are likely to see a small narrowing of the disparate growth rates.

The Spanish economy again posted modest growth in the first quarter of 2011

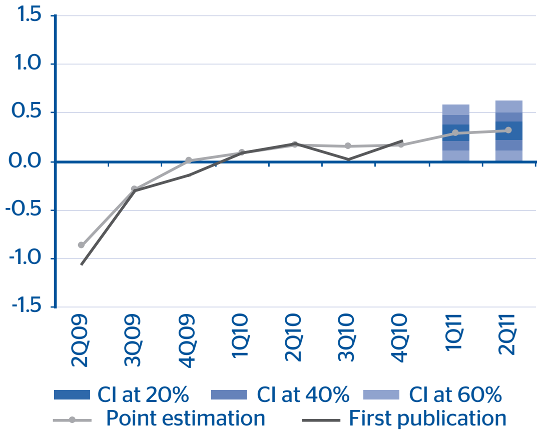
Until official data are released, preliminary economic indicators show that the Spanish economy's slight growth during most of 2010 should continue through the first part of this year. Short-term GDP forecasts using the MICA-BBVA model[2] suggest that qoq growth for the first half of 2011 will be around two or three tenths of a point, which confirms that the economy could be slipping into a stagflationary trend (see Chart 3 and 4).

Chart 3
Spain: 1Q11 GDP growth forecasts using the MICA-BBVA model by forecast date (% QoQ)



Source: BBVA Research

Chart 4
Spain: observed GDP growth and forecast based on MICA-BBVA model (% qoq)*

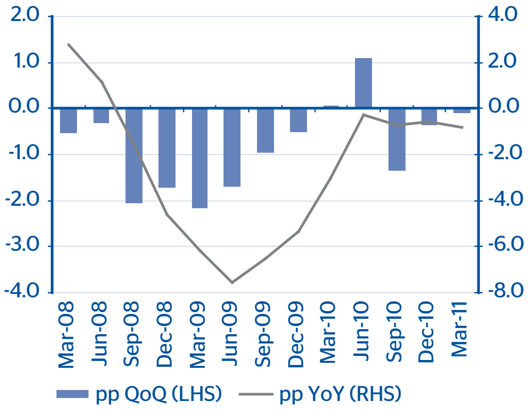


* Current forecast as of 6 May 2011
Source: BBVA Research based on INE data

In addition, 1Q11 economic data released up to the date of the preparation of this report, indicate that the composition of growth this quarter will be once again driven by external demand, while domestic demand contributed negatively to growth both in yoy and qoq basis, as a result of weak fundamentals and specific factors such as the adjustment to public finances (see Chart 5). However, once the bulk of the downward pressure caused by the fiscal consolidation in 2H10 is discounted, private domestic demand shows a certain degree of improvement, with a positive, though significantly reduced contribution to economic growth in 1Q11 (see Chart 6).

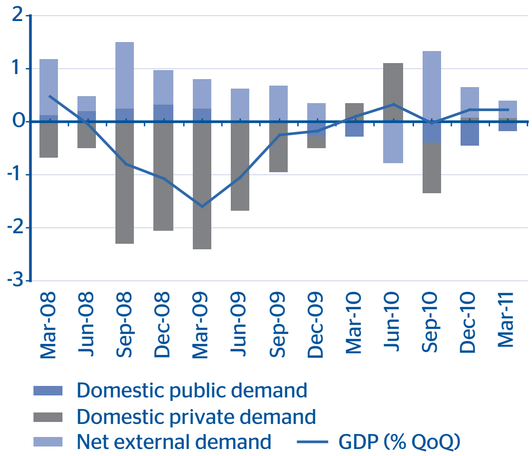
2: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21.

Chart 5
Spain: Contributions of domestic demand to GDP growth



Source: BBVA Research

Chart 6
Spain: contributions to quarterly GDP growth (%)



* Current forecast as of 6 May 2011
Source: BBVA Research based on INE data

Private demand remained positive in 1Q11, although it is showing clear signs of weakness

After a year shaped by the effects of the fiscal consolidation process on household spending decisions, at the close of 2010 private consumption had risen 0.3% qoq, confirming that the contraction in expenditure caused by the winding down of demand stimulus measures and the adoption of a stricter fiscal policy were concentrated in 3Q10. The performance of consumption in 4Q10 (slightly stronger than expected) was underpinned by a better than expected performance in households' disposable income as a result of an increase in net non-wage income, and current transfers received (see Chart 7).

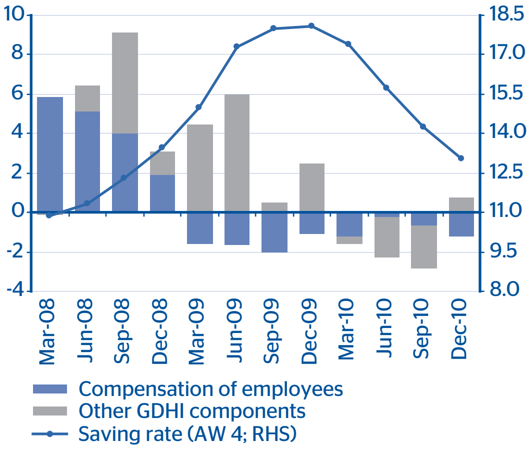
Analysis of the composition of demand for non-durable goods and car registrations offset the stagnation in spending on services and the drop in apparent consumption of durable goods in 4Q10. However, the opposite was the case at the beginning of 2011, when demand for durable goods (including cars) and services, was the component that boosted household consumption (see Table 1). Overall, the weakness of its components, the bringing forward of spending to 1H10 and the prevailing uncertainty, which is still high, limited consumption growth in the first quarter. As a result, both BBVA's synthetic consumption indicator (SCI BBVA) and our coincident consumption indicators model (CCIM-BBVA) point to qoq spending levels similar to those of 4Q10 (see Chart 8).

Table 1
Spain: consumption spending indicators (SWDA data)

	Availability of consumer goods						
	Totals	Durables	Non-durables	Car registrations	Domestic sales by large enterprises	Service sector sales index	Retail commerce
% qoq							
1Q10	-2.3	-12.6	-0.6	2.3	2.8	0.4	1.2
2Q10	2.8	7.6	7.5	0.5	0.0	2.1	-0.9
3Q10	-4.9	-17.6	-5.9	-32.4	-0.4	-2.5	-1.6
4Q10	-1.1	-12.1	1.2	3.3	-0.4	-0.1	-1.1
1Q11	0.0	8.7	-1.0	4.4	-5.1	0.9	-2.2
% mom							
Jan 2011	5.1	11.8	13.9	2.0	-4.0	0.6	-0.6
Feb 2011	-2.9	0.6	-7.0	2.8	1.4	0.3	0.6
Mar 2011	0.6	-3.2	6.4	2.0	-4.6	0.2	-2.3

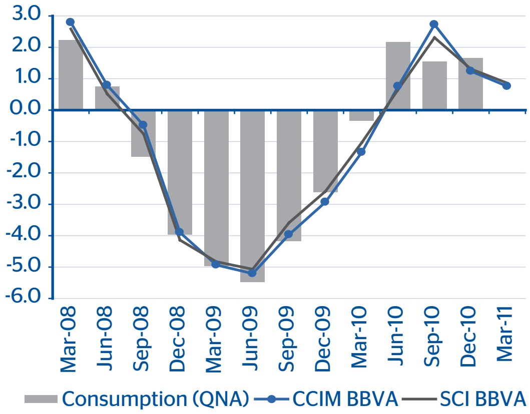
The shaded figures are forecasts
Source: BBVA Research based on MEH, ANFAC, AEAT and INE data

Chart 7
Spain: contribution to yoy growth of nominal GDHI (gross disposable household income) and household saving rate (%)



Source: BBVA Research based on INE data

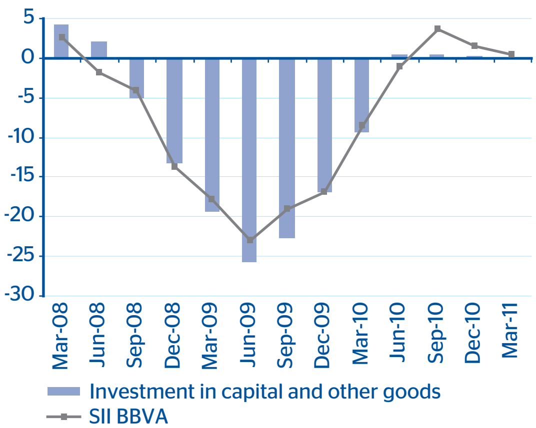
Chart 8
Spain: observed data and real time forecast of household consumption (% yoy)



Source: BBVA Research based on INE and MEH data

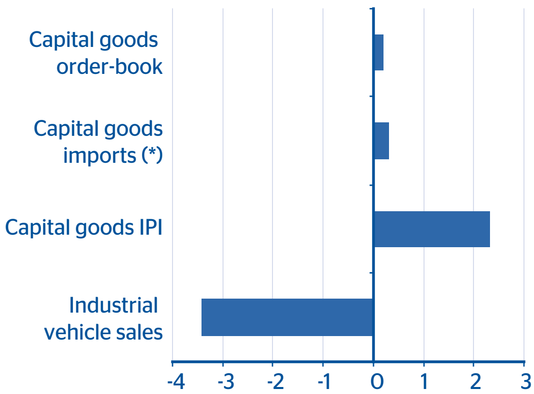
As for business investment, economic data for the first quarter points towards an increase in this component of aggregate demand similar to that seen in 4Q10 (see Chart 9). Nevertheless, given the widely varying performance of the Spanish economy's productive sectors, derived in part from the dichotomy between the strength of external demand and the weakness of domestic demand, there are still mixed signals regarding investment in capital goods. Therefore, while the ongoing adjustment to sectors more oriented towards domestic demand (especially the construction sector) would clearly have had a negative impact on this component of investment, the strength of sectors more oriented towards external demand would have provided it with a boost. Specifically, the downward correction in industrial vehicle sales -following a sharp 10% qoq increase (SWDA data) in 4Q10 - contrasts with the advances registered in IPI for capital goods, order books and the improved forecast for capital goods sales (see Chart 10).

Chart 9
Spain: investment in capital goods and others and BBVA synthetic investment indicator (SII) (%yoy)



Source: BBVA Research based on INE data

Chart 10
Spain: performance of investment in capital goods in 1Q11 (SWDA, % qoq)

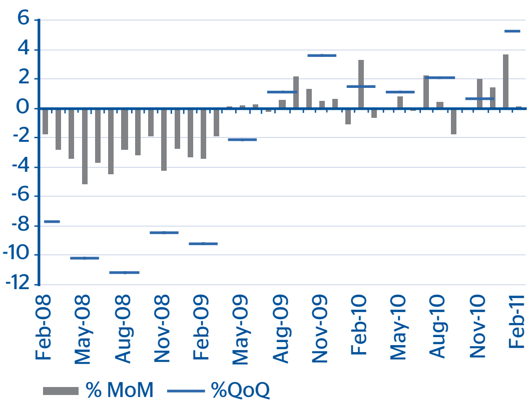


(*) last available data: Feb-2011
Source: BBVA Research based on INE, Customs, MICT and MEH data

Meanwhile housing investment is still shaped by a lethargic real estate market, which remains weak, although slightly improved from previous quarters. The available data related to demand in the first quarter of the year show a better than expected performance. The sales figures for the first two months of the year were positive according to INE statistics (see chart 11). However, any interpretation of this data should be tempered by caution, given that it could be influenced by the lag time of up to three months between when a home purchase is carried out and when it is registered in the Property Registry, the source of this information. Therefore, part of this good demand performance was obtained from data at the beginning of the year which relates to transactions carried out at the end of 2010, when there was an increase in purchases by people who wished to benefit from the deduction for buying their primary residence. The Spanish government's portion of this deduction was phased out for taxpayers with income above €24,100 last January and most of the autonomous regions have also eliminated their portion of said deduction. Due to this weak demand, 1Q11 prices were cut more than in previous quarters, as would be expected.

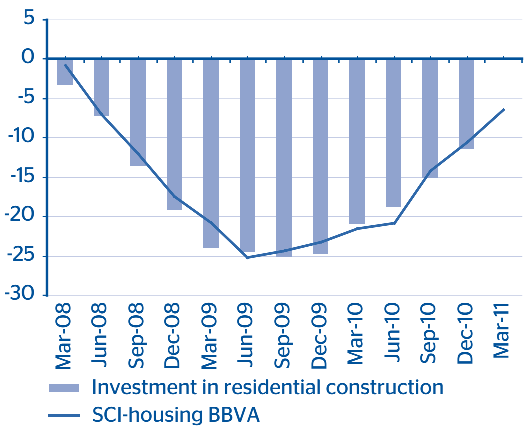
In residential business, the building permit data for new construction in the first two months of the year could point towards a slight recovery. This improvement was due in large part to a base effect, given the decline in activity in 2010, when the number of building permits reached its lowest level of the last thirty years. But this uptick was also due to the need to start building new homes in the country's main economic centres. The irregular geographic distribution of unsold housing stock and the long process required to build a house (between 18 and 24 months), could be mobilising the sector to embark on new constructions, something which could slowly start to be reflected in residential investment figures. For the time being, in 1Q11 we expect it to register a contraction of 2.5% qoq, similar to the previous quarter (see chart 12), but not as intense as in previous quarters.

Chart 11
Spain: home sales (SWDA data)



Source: BBVA Research based on INE data

Chart 12
Spain: investment in residential construction and BBVA synthetic consumption indicator (SCI) - housing (% yoy)



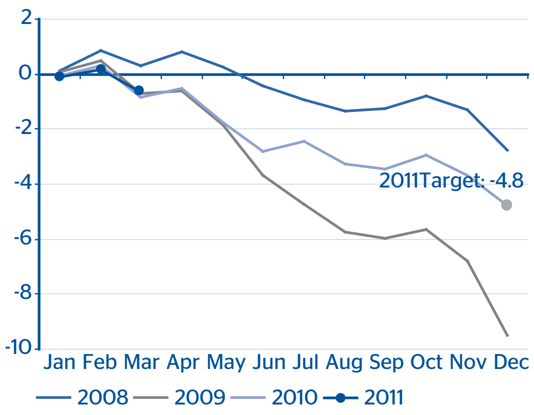
Source: BBVA Research based on INE and MEH data

The latest budget out-turn data is consistent with curtailed demand from the public sector

Despite the fact that the budget out-turn data for 2011 will be impacted by the autonomous financing system which is being comprehensively applied for the first time this year (implying a decline in the transfer payments to autonomous regions and less central government tax revenues due to a higher percentage being collected by autonomous regions), first quarter data indicates continued cutbacks to central administration expenditure, with decreases seen in all its items, except in interest expenses. Once again, the cuts were mainly in investment spending, current transfers, and to a lesser degree, in civil servant wages. At March 2011, cumulative tax revenues continued to show signs of recovery, although this improvement was somewhat more modest than that seen in previous months (see Chart 14).

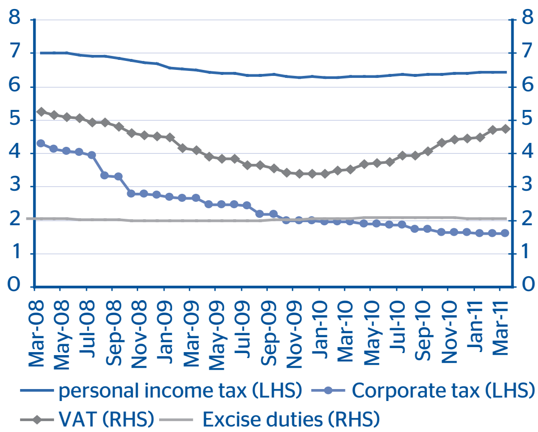
In the autonomous regions, the latest available preliminary information regarding the 2010 close, shows an uneven commitment to the fiscal consolidation process, with generalised noncompliance with the stability target. Consequently, with the recovery in tax revenues still weak, and in a quarter in which the different autonomous regions prepared their fiscal adjustment plans, the fiscal adjustments are expected to mainly entail spending cuts, for which reason we expect to see an additional slowdown in autonomous region expenditures in the first quarter of the year.

Chart 13
Central government:
non-financial balance (cumulative annual % of GDP)



Source: BBVA Research based on INE data

Chart 14
Tax revenues in
homogeneous terms (cumulative annual % of GDP)



Source: BBVA Research based on AEAT and INE data

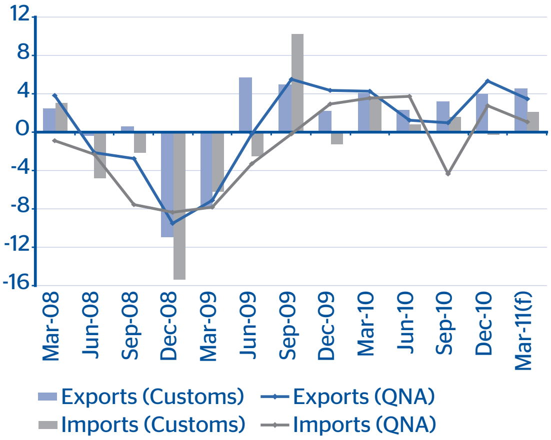
Therefore, the adjustment to current spending has been accompanied by a gradual moderation in public sector demand in real terms, for which reason public consumption should once again register almost zero growth in this first quarter of the year. In a similar vein, investment in non-residential construction probably also shrank in 1Q11, although part of this would have been due to the sharp downturn currently affecting the private construction business, in addition to public sector cuts.

At the start of 2011, net external demand continued to drive growth in the short term

In a context where global economic growth has proven more resilient than expected to the adverse effects of rising crude prices, financial tensions in Europe and the bringing forward of the ECB rate hikes, the good performance from the Spanish economy's goods and services exports has been maintained, and is expected to register 3.1% growth in 1Q11, according to national accounts data (QNA). The currently available balance of trade figures for 1Q11 point towards the strong likelihood of quarterly growth in real goods exports (4.4%), as evidenced by the export drive still being seen in the Spanish economy despite the unfavourable exchange rate with the dollar at the start of 2011. Meanwhile, real goods imports figures lead us to expect qoq growth of 2% (1% according to the QNA), in line with the performance from private domestic demand (see Chart 15).

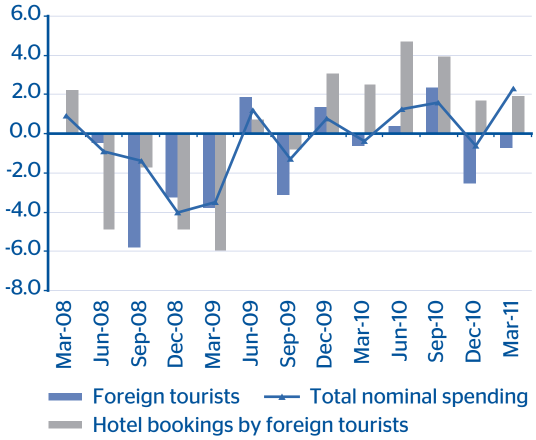
In regard to the forward indicators for the services sector, the performance of tourism services may indicate a slowing decline in non-resident entries into Spain, following the contraction registered at the end of last year (see Chart 16). The recovery of activity in the sector is further strengthened by the additional growth seen in 1Q11 in overnight stays in hotels by non-residents as well as in total nominal spending, which could increase to positive quarterly growth levels not seen since the beginning of the crisis (2.3% qoq, according to QNA data). Now that doubts have been dispelled regarding work stoppages by AENA employees this year, and given the possible changes in travel plans (that could benefit Spain) due to the current social and political climate in Arab countries on the Mediterranean, we expect a positive performance of the sector for a good part of the year.

Chart 15
Spain: real exports and imports of goods (% qoq, SWDA)



Source: BBVA Research based on INE and Customs data

Chart 16
Spain: entry and spending by non-resident tourists (% qoq, SWDA)



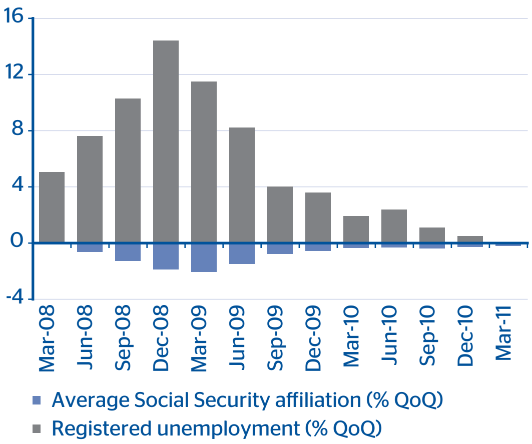
Source: BBVA Research based on INE, Frontur and EGATUR

Lastly, the adjustment process underway to the Spanish economy's current account deficit, should stabilise in 1Q11, bringing the deficit to about 4.5% of GDP. The unfavourable impacts from the rise in oil prices has caused an energy deficit, which has been completely offset by the economy's strong export momentum. However, this was unable to reduce the Spanish deficit in the first quarter of the year.

The labour market showed no change in 1Q11

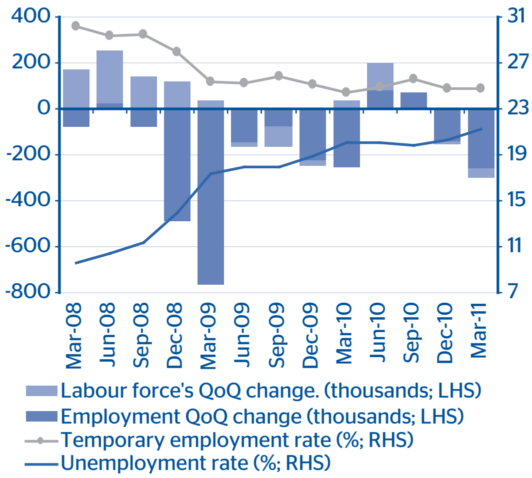
Job market figures remained stable in 1Q11. Adjusting for seasonal and calendar effects, although the economy was still unable to create jobs, the rate of growth in unemployment continued to slow. Social security affiliation numbers fell at virtually the same pace as in the previous quarter (-0.3% qoq SWDA compared to -0.2% in 4Q10), while unemployment rose more slowly at 0.1% qoq SWDA (from 0.5% qoq in 4Q10) The Labour Force Survey (LFS) for 1Q11 confirmed the same trend. Employment fell in line with expectations, mainly for non-seasonal reasons (-256,500 jobs gross, -86,400 SWDA). Despite the slight fall in the active population (-43,000), job destruction –concentrated in indefinite employees and industry and construction workers– prompted an uptick in unemployment to 21.3% and a stagnation in the temporality rate to 24.8% (Chart 18).

Chart 17
Spain: average Social Security affiliation and registered unemployment (SWDA data)



Source: BBVA Research based on MTIN (ministry of labour and immigration) data

Chart 18
Spain: labour market data

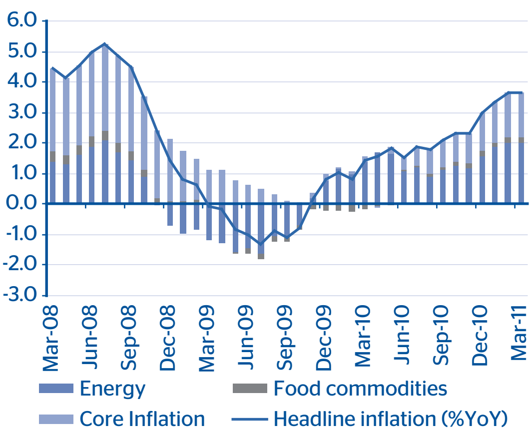


Source: BBVA Research based on INE data

Inflation picked up at the beginning of the year as a result of climbing commodity prices

In the first part of the year, crude and food prices rose. Headline inflation jumped to 3.6% at the end of the first quarter in yoy terms (3.8% in April, according to preliminary INE data), of which 2.2pp were directly attributable to the energy component and (to a lesser degree) food commodities, and 1.4pp to core inflation (see Chart 19). In an indirect manner, the spike in raw materials prices also impacted components that are most sensitive to the same (via the pass-through of higher producer prices), such as prepared foods and organised tours, whose contribution to the increase in headline prices stood at about 0.5pp and 0.1pp, respectively. Excluding these two items, inflation in services and also in industrial goods remained at relatively modest levels, contributing 0.7pp and 0.2pp to headline inflation, respectively. In short, the increase in commodities prices was felt both directly through their final consumption and indirectly through their intermediate consumption, although given the weakness of domestic demand and the high unemployment rate there were no clear signs of second-round effects. The inflation differential vis-à-vis the eurozone -the Spanish economy's main trade partner- stood at around 0.7pp for headline inflation (0.1pp for core inflation), which is due, in large part to the changes to the tax regime made in the Spanish economy in 2H10, and therefore does not imply a significant loss of price competitiveness. As can be seen in Table 2, while the inflation differential, after taking into account the higher tax rates, stood at about 0.4pp on average in 1H10 and 2H10, according to data published by Eurostat, at constant tax rates, there would have been a decrease to -0.4pp in 2H10 from 0.1pp in 1H10[3].

Chart 19
Spain: contributions to headline inflation growth



Source: BBVA Research based on INE data

Table 2
Spain-EMU inflation differential (pp)

		Including variable taxes	At constant tax rate
2008	1S	1.1	1.2
	2S	0.7	0.7
2009	1S	-0.7	-0.9
	2S	-0.4	-0.7
2010	1S	0.4	0.1
	2S	0.4	-0.4

Source: BBVA Research based on INE and Eurostat data

Outlook 2011-2012: a sustained and job-creating recovery could come towards the end of 2011

As we said in the introduction, the Spanish economy's recovery is likely to remain weak over the short and medium term. GDP is expected to continue showing positive but modest qoq growth, which should result in full-year growth of 0.9% (see Table 3). The second half of 2011 should bring the start of a sustained recovery and the first signs of job creation. But it will not be until 2012 (when the economy should be growing at around 1.6%) that employment will start to grow in net terms. However, as our in-depth analysis indicated in the last edition of this publication, unemployment will continue to creep up throughout 2011 and fall only slightly in the second half of 2012[4].

3: LThe methodological changes in the calculation of harmonised CPI introduced at the beginning of the year has resulted in increased volatility for this series. As a result, monthly data should be interpreted with caution.
4: It seems likely that over the next two years the growth rate required to reduce unemployment will be lower than 2% as, given the unfavorable demographic trend projected by the INE and expectations that transitions from inactivity to activity will barely change, the active population is not expected to grow significantly

Table 3
Spain: macroeconomic forecasts

(yoy %, unless otherwise stated)	1Q10	2Q10	3Q10	4Q10	1Q11	2010	2011	2012
Household consumption	-0.3	2.2	1.5	1.7	0.9	1.3	0.4	0.9
Public consumption	-1.1	-0.1	-0.7	-0.9	-0.4	-0.7	-1.1	-0.3
GFCF	-10.5	-6.7	-6.7	-6.1	-5.3	-7.5	-3.8	2.4
Capital goods and other products	-9.3	0.5	0.2	0.1	1.1	-2.1	1.3	4.0
Capital goods	-4.6	8.7	2.4	1.2	2.0	1.9	2.6	4.9
Construction	-11.3	-11.3	-11.2	-10.6	-9.9	-11.1	-7.7	1.2
Housing	-20.9	-18.7	-15.1	-11.4	-9.2	-16.5	-7.5	3.6
Other	-4.1	-5.9	-8.7	-10.1	-10.3	-7.2	-7.8	-0.1
Chg. in inventories (*)	0.0	0.1	0.1	0.1	0.0	0.1	0.0	0.0
Domestic demand (*)	**-3.0**	**-0.3**	**-0.7**	**-0.6**	**-0.8**	**-1.1**	**-0.9**	**1.0**
Exports	9.4	11.9	9.4	10.5	9.2	10.3	10.6	6.2
Imports	2.0	9.6	5.0	5.3	3.1	5.5	3.7	3.6
Net exports (*)	**1.6**	**0.3**	**0.9**	**1.2**	**1.5**	**1.0**	**1.7**	**0.6**
GDP mp	**-1.4**	**0.0**	**0.2**	**0.6**	**0.7**	**-0.1**	**0.9**	**1.6**
Pro-memoria:								
GDP w/out housing investment	-0.2	1.1	1.2	1.3	1.2	0.9	1.3	1.5
GDP w/out construction	0.3	1.9	2.1	2.5	2.3	1.7	2.1	1.6
Employment (LFS)	-3.6	-2.5	-1.7	-1.3	-1.3	-2.3	-0.7	0.8
Unemployment rate (% active pop.)	20.0	20.1	19.8	20.3	21.3	20.1	20.8	20.5
Employment (FTE)	-3.9	-2.4	-1.6	-1.4	-1.4	-2.4	-0.7	0.7

(*) contribution to growth
Source: INE and BBVA Research forecasts

In regard to the composition of growth, the updating of our economic scenario for 2011 and 2012 contains several new aspects which, on balance, could add downward pressure on the rate of recovery of domestic demand, and consequently a slight revision to our forecast for 2012 GDP (-0.3pp). It is critically important to keep the ongoing adjustment to the state public finances on track, but, on the whole, autonomous regions did not comply with the fiscal consolidation targets in 2010, which indicates that the current contractionary fiscal policy will have to continue both in the short and medium term. Furthermore, mechanisms to ensure greater fiscal discipline need to be strengthened at different levels of the public administrations (see section 5 of this report). Additionally, high crude prices, which are expected to lead to a gradual (but modest) tightening of monetary policies, have put an additional damper on private agents' consumption and investment decisions, which are already shaped by weak fundamentals and the gradual correcting of the imbalances accumulated before and during the current economic crisis. However, despite the international financial tensions still in play, and the recent contagion of Spanish risk premiums as a result of fears that Greek debt would have to be restructured, there has been an improvement in the perception of medium term risk for the Spanish economy, which could mean less downside pressure, given the country's dependence on external financing.

In regard to oil prices, we would highlight that although the upward pressure on crude may last longer than previously expected, the transitory factors underlying this move lead to forecast a modest impact on economic activity, which will probably be concentrated towards the end of our forecast horizon. Unlike other recessionary periods that were caused by or exacerbated by rising commodities prices, the current price increases are caused by uncertainty regarding future supplies as a result of geopolitical conflicts in oil producing countries in the Mediterranean (precautionary increase in demand), as opposed to an actual decrease in output (reduced supply). As explained in Box 1, these types of shocks are much less intense than a shock derived purely from decreased supply, since it does not entail a sharp drop in the use of productive capacity on the global scale.

In addition, scant impact is expected from the ECB's bringing forward of the slight increases to benchmark interest rates and these effects will mainly be felt in 2012. In particular, the effect on companies and households' financial burdens, should remain limited and at levels close to their historic lows.

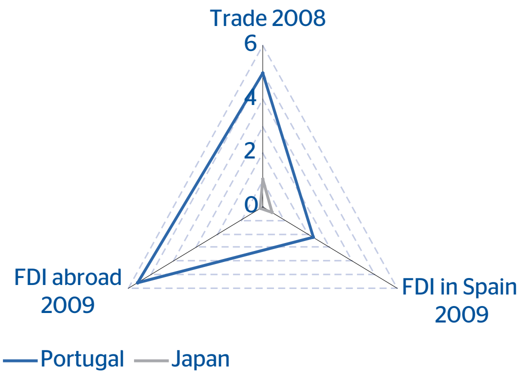
The progress shown at the European level in resolving the sovereign debt crisis, combined with the actions of the Spanish government, which has implemented structural reforms that should have a modest positive impact on the economy's growth capacity, have improved expectations, which have translated into a reduction in the risk premium since the start of the first quarter of the year. Specifically, we expect the risk premium to be between 40bp and 50bp lower than forecast in February's baseline scenario, which in and of itself, should help boost economic activity.

The third new aspect of our economic scenario for 2011-2012 is the exchange rate for the euro, which is slightly higher as a result, at least in part, of the aforementioned factors. Bearing in mind that most of the outflows from the Spanish economy are directed towards member countries in the European monetary union, and that the impact on the overall economic climate in the European Union of the increase in oil prices, the bringing forward of interest rate hikes and the appreciation of the euro, have been modest, we expect a similarly slight impact on the Spanish economy's trade flows. In addition, as mentioned earlier, despite the fact that the euro has appreciated more than we expected, we would underscore that after discounting the increase in commodity prices and the changes to the Spanish tax regime that took place in 2H10, the price differential with the rest of the eurozone remains at relatively moderate levels, which should rule out a significant pullback in the competitive gains accumulated in 2010.

Aside the main factors shaping the performance of the Spanish economy in the short and medium term, there are two additional developments in the international economic environment that could play a secondary role in our scenario: the negative shock suffered by the Japanese economy following the recent natural disasters and the expected deterioration in the Portuguese economy after the government was forced to request international aid to meet its debt obligations. Given the low exposure of the Spanish economy to these two countries, especially Japan, the effects of both these shocks should be limited, although, as we note in the following paragraph of this section, certain Spanish regions which have more exposure, especially to the Portuguese economy, could be more affected. In regard to Portugal, the most important transmission channels are exports and the stock of Spanish Foreign Direct Investment (FDI) in this country. Meanwhile, the contraction of the Japanese economy could be felt on the import side, both in intermediate goods and through divestment of capital, which at least for the moment, does not appear likely. However, impacts via these transmission channels would be fairly moderate in the case of Portugal and almost zero in the case of Japan (see Charts 20 and 21).

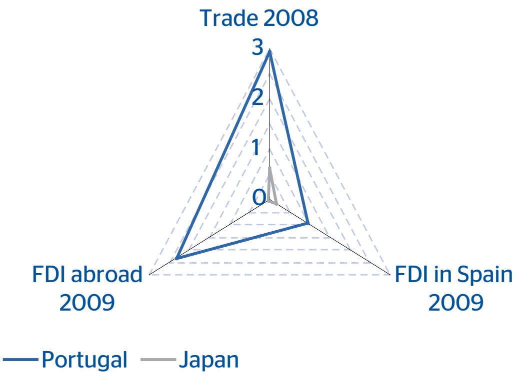
Although Portugal is Spain's fourth largest trade partner and the seventh biggest recipient of Spanish Foreign Direct Investment, the exposure of Spain to Portuguese risk is relatively limited. In 2008, trade in goods and services with Portugal represented 5% of Spain's total trade (2.9% of GDP) and Spanish FDI stock in Portugal in 2009 represented 5.6% of Spain's FDI abroad (2.4% of GDP). Consequently, an eventual reduction in Portuguese demand, both in terms of imports and foreign capital, would not have a major impact on either total trade flows or on overall international investment by the Spanish economy. However, we would note that effects in Spain would vary depending on the sector. Although the segment most exposed to the Portuguese economy is miscellaneous manufacturing, the greatest impact may end up being in the automobile sector. In terms of FDI, the most exposed segment would be trade.

Chart 20
Spain: exposure to Portugal and Japan in terms of trade and investment (% of total)



Source: BBVA Research based on Eurostat and Datacomex data

Chart 21
Spain: exposure to Portugal and Japan in terms of trade and investment (% of GDP)



Source: BBVA Research based on Eurostat and Datacomex data

Special mention should also be made of the growth outlook for the main components of aggregate demand following the integration of the new factors that will play a role in shaping the scenario for the next two years. In regard to private consumption, the 4Q10 figure confirmed that the bulk of the decreased spending as a result of the fiscal consolidation process was concentrated in 3Q10, which has led to a slight upward revision to the figure forecast for 2011. However, consumers brought forward purchases of goods and services to the first half of last year, which might otherwise have happened in the current year. This has created a base effect for household spending in the first half of 2011, which will gradually fade out over the forecast horizon. Overall, the outlook for household spending performance over the next two years does not differ from that presented in the previous edition of Spain Economic Outlook. The weakness in the main factors that determine spending levels will limit its growth to levels under those registered in 2010.

Although the inflationary pressures and the increase in official interest rates will help limit growth in private consumption, the negative effect on spending by both elements could be seen with greater intensity in 2012. While the drop in households' nominal gross disposable income in 4Q10 was lower than expected, the decreased job creation and the upward revision to inflation expectations will cause a more negative than expected performance in real income in 2011 and 2012. In parallel, the increase in official interest rates will trigger an increase in interest rates for loans, which will raise the financial burden for households to about 14% for both years[5]. Nor will household wealth, mainly property, help boost consumption in 2011-2012 as housing prices are set to fall further in coming quarters. Finally, even though uncertainty will remain relatively high, we do not expect the savings rate associated with periods of lost consumer confidence to increase.

Turning to business investment, with a tepid recovery in final demand in Spain and the inflationary threat in Europe picking up steam, we expect more modest improvements in corporate earnings than expected, as well as greater pressure on the real cost of capital. Both these factors will contribute less than expected to growth in corporate investment in the medium term. However, on the plus side, given the Spanish economy's dependence on external financing, the improvement in the risk premium in the medium term should result in less downward pressure. As a consequence, investment in capital and other goods is expected to grow only modestly in 2011, by around 1.3%, after three years of drops. In 2012, conditions will be in place for renewed robust growth in this component of aggregate demand: this time at around 4%.

The less expansionary monetary policy will also impact the real estate market, although in a more limited manner. The bringing forward of the interest rate hikes is already reflected in the increase to the Euribor, the main benchmark rate for mortgages, which is expected to remain at relatively low levels in the next two years, limiting, in part, the negative impact on demand for housing. Furthermore, this year and in 2012 the volume of housing oversupply should diminish, which will help boost the gradual recovery in residential activity. Therefore, although we continue to expect further contraction in residential investment in 2011 (-7.5%) -much less than in previous years-, the slow recovery in activity will gradually pass through to this component of demand, and in 2012 we should start to see positive growth (3.6%).

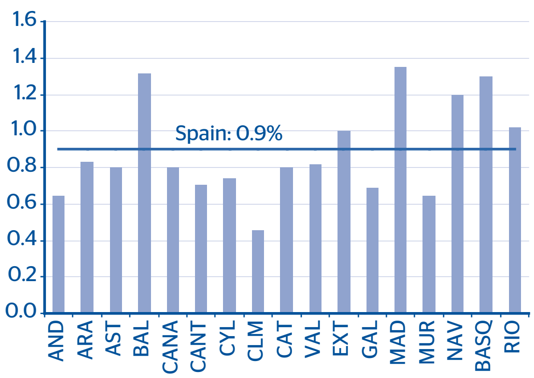
5: Furthermore, the increase in official interest rates could increase the yield on deposits, encouraging savings to the detriment of consumption.

Lastly, as has been argued in numerous previous editions of this report, support for Spain's economic growth in the medium term will come from abroad. Current growth prospects in Europe and on the global level should allow for strong growth in exports of close to 11% in 2011, even after factoring in the appreciation of the euro with respect to the dollar[6]. In 2012, we expect a slowdown in the growth of exports, due to the adverse, though limited effects on global growth in the medium term caused by the interest rate hikes in Europe and the oil shock. However, improved fundamentals linked to domestic consumption and the Spanish labour market allow for a certain degree of optimism in regard to the performance of the economy's imports. Therefore, close to 40% of growth in 2012 will come from exports.

Domestic demand, shaped by fiscal consolidation in the autonomous regions and tourism, differentiating factors in regional growth rates

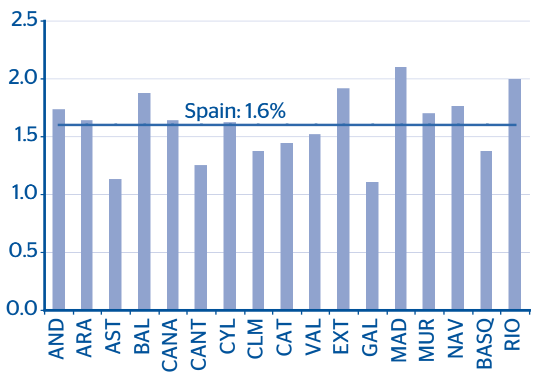
In the context of a forecast for 2012 that envisages lower growth than expected three months ago, the performance of the different Spanish regions will be shaped by their position in relation to the imbalances that triggered or were caused by the crisis. The requirements of the fiscal adjustment will also play a role (see Spain Economic Outlook, February 2011). The increase in crude prices and the bringing forward of interest rate hikes will have a relatively modest and uniform effect on the different regional economies, whose growth rates will be, on average, three tenths of a point lower than the forecast previously published.

Chart 22
GDP growth by autonomous region 2011 (%)



Source: BBVA Research

Chart 23
GDP growth by autonomous region 2012 (%)



Source: BBVA Research

The autonomous regions with the greatest need to carry out fiscal adjustment should see this belt-tightening more than offset by the positive effects from the recovery abroad, and in particular, by improvements that could be generated through the boost to tourism caused by the political tensions in North Africa, which reduces its standing as a competing tourist destination. Autonomous regions are facing a wide range of scenarios in terms of their need to implement fiscal adjustments. Some of them have practically no need to reduce their deficit (i.e. Madrid and la Rioja, whose deficits were under 0.75% of their GDP in 2010), while others, such as the autonomous regions on the Mediterranean, and Castile-La Mancha, must implement much more ambitious adjustment measures, which will hinder their economic growth to some degree. Furthermore, although these autonomous regions have more exposure to trade opportunities on the Mediterranean, both in terms of goods and services (especially in regard to tourism) any differentiating contribution to growth via this channel will be more than offset by internal adjustment needs and the deleterious effects that needed fiscal adjustments could have on domestic demand.

Given the current outlook, in which Europe will continue growing faster than Spain, with the bulk of global growth centred in Asia and Latin America, growth will continue to be supported mainly by external demand, which favours autonomous regions that are more involved in international trade

6: Recent estimates show that Spain's real exports' have a lower sensitivity to competitiveness/price indicators, above all in the long term, and greater sensitivity to external demand indicators.(see Ortega et al 2007). Accordingly, price elasticity of real exports to demand from the EMU stands at about 0.63%, a figure which compares with an elasticity of -0.37% for the competitiveness/price indicator of the EMU (-0.50% vs. rest of world). This dynamic can be explained by the increasing differentiation in terms of the quality of goods and services produced in Spain.

or which specialise in tourism. At the close of this edition, tourism industry figures were still not available for Easter week, which traditionally signals the start of the season on the mainland and in the Balearic Island tourist areas, for which reason, an analysis of this impact will have to wait. In any event, it is evident that the Spanish tourism industry is once again benefiting from current events, an effect which should diminish (perhaps sharply) once the political tensions ease in North Africa. When this occurs, and once price competition enters into play again, the challenges the sector faced in recent years could once again come to the fore.

Furthermore, risks remain in the Portuguese economy. Eventual contractions in this economy are expected to curtail its demand for imports, which will have a very limited effect on the Spanish economy as a whole, but could exercise a greater impact on certain autonomous regions, given their differing exposures to the Portuguese economy. The autonomous region most exposed in terms of trade of goods is Extremadura (31%), followed by Castile-La Mancha (14%) and Galicia (14%). In addition, Portuguese capital represents an important percentage of the FDI received by Galicia (38%), Castile-La Mancha (23%) and Asturias (18%), although these three autonomous regions combined represent only 3% of FDI in Spain. Therefore, the risk to growth from this factor is located in northeast Spain, and to a lesser degree in Extremadura and Castile-La Mancha, whose exposure to foreign markets is limited, which should mitigate the negative effects derived from the high percentage of its exports to Portugal.

The reform drive must continue

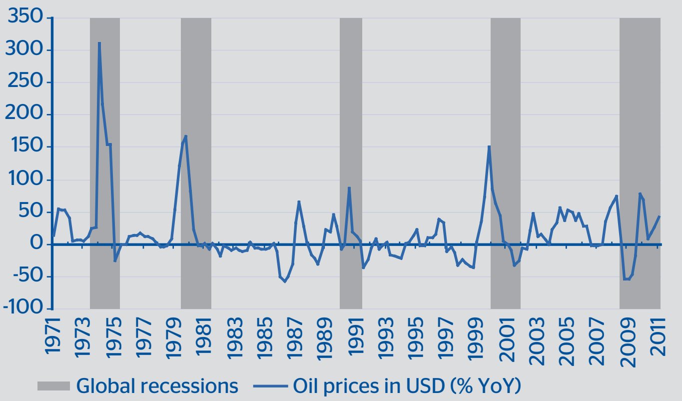
Even though the macroeconomic forecasts in this report point to a growth slightly lower than previously published forecasts (a reduction of 0.3pp to 1.6%) we would stress that our overall diagnosis of the Spanish economy's recovery has not changed significantly. The economic situation could be in danger of falling into a stagflationary dynamic, and the growth outlook remains tenuous in the short term. Given this context, it is critical that the reform drive undertaken by the Spanish economy in 2010 remains on course. The fast and ambitious roll-out of the reforms that have been announced but which have yet to be implemented will be crucial for improving market confidence, accelerating the recovery in activity and employment both in the short and medium term and thereby further reducing the uncertainty prevailing in international markets. In the short term, this should contribute towards preventing second round effects that could occur as a result of rising crude prices, although it remains unlikely that such effects will arise in the current context.

It is important that advances in increasing the transparency of public sector finances continue, that the government maintains its commitment to the current fiscal consolidation process and that other public administrations participate in this process in a more decisive manner in the coming years. On the whole, the Spanish economy's debt level is sustainable, but it is must stay on track to achieve its deficit targets in order to prevent any unnecessary prolongation of tensions in sovereign and autonomous region debt markets. As detailed in section 5 of this report, the introduction of a simplified tax regime for implementation at the autonomous region level would, in addition to reducing uncertainty about public finances in autonomous regions, also help smooth out cyclical fluctuations on both the regional and national level.

Box 1.
The effects of increased oil prices on activity and prices in the Spanish economy

In recent months, the international economy has experienced a new round of oil price hikes leading to higher inflationary pressures around the world and, for some economies, a tightening of monetary policy (e.g. in the euro zone). With industrialised economies still recovering and some involved in a process to redress macroeconomic imbalances arising before and during the current recession (e.g. Spain), the aforementioned situation is causing great concern among financial analysts, primarily for two reasons. Firstly, because as the latest International Energy Agency data reveal, approximately 80% of the global energy demand is still met using fossil fuels (33% using crude oil). Secondly, and partly due to this, because a number of global recessions in the recent past were provoked or made worse by oil price hikes (see Graph 24).

Chart 24
Global recessions and oil prices



Source BBVA Research based on IMF and Datastream data

Nonetheless, the current round of price increases does have a number of different characteristics that suggest its impact on the economic activity of industrialised countries will be relatively moderate. In particular, the current price hikes have been driven more by an increase in demand for precautionary reasons -resulting from uncertainty surrounding future supply due to geopolitical conflicts in the oil producing countries in the Mediterranean belt– than by a pure supply shock characterised by a significant reduction in production volumes and, therefore, a typically pronounced contraction effect. Furthermore, the factors underlying the current price hikes can still be classified as temporary, meaning that while they may persist well into 2012, their impact will likely be less pronounced than that of a permanent change in the level of prices.

This section analyses the effects on activity and prices in the Spanish economy of an increase in oil prices similar to the current scenario. These effects are also compared with the outcome of other shocks which differ in terms of both the underlying causes and duration.

Description of methodology

As with other commodities markets, oil prices can go up for various reasons: a drop in supply due to decreases in output (a supply shock), an increase in demand as a result of global economic growth (global demand shock) or, as is the case at present, a rise in demand for precautionary reasons (precautionary demand shock). Consequently, and since it is general knowledge that observed global data do not one-dimensionally reflect supply or demand fluctuations, let alone the use of the quantities acquired (i.e. whether the raw materials are used for production or are stockpiled), an empirical problem arises when identifying these shocks and estimating their possible impact on the actual economy. Following the methodology described by Persan and Robays (2009a and 2009b), this section shows the results of estimating a structural VAR with sign restrictions for the Spanish economy that overcome the identification problem described above. The methodology, introduced initially by Faust (1998), Uhlig (1999 and 2005) and Canova and De Nicoló (2002) to identify monetary policy shocks, basically involves estimating a reduced VAR and then imposing sign restrictions on the impulse response functions of this VAR to identify the shocks to be studied and obtain a structural interpretation of the VAR. In the case we are examining, the sign restrictions imposed in the model are set out in the following table.

Table 4
Structural shocks

	Identification with sign restrictions		
	Qo	Po	Yw
1. Supply shock	$<$	$>$	$\leq$
2. Global demand shock	$>$	$>$	$>$
3. Precautionary demand shock	$>$	$>$	$\leq$

Source: BBVA Research

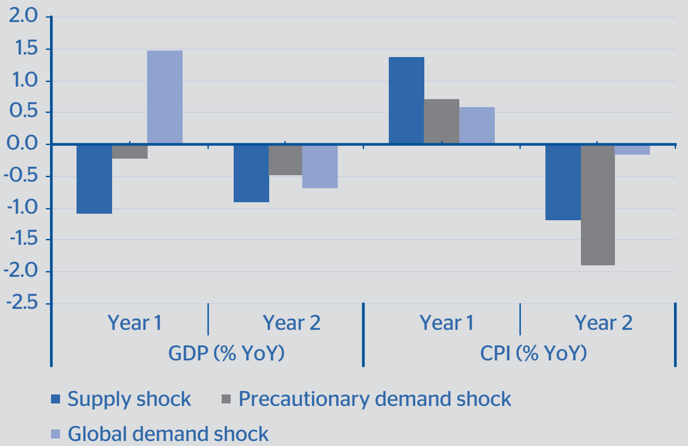
Where Q_o, P_o and Y_w respectively represent average world oil production in thousands of barrels, the price of Brent crude oil per barrel in US dollars, and global activity estimated using the global IPI calculated by the OECD based on a sample of 35 countries[7]. In more detail, the aforementioned restrictions imply that: a) a shock limiting the oil supply leads to an increase in oil prices and a reduction in oil output, assuming global activity does not rise compared to the baseline scenario; b) a global demand shock gives rise to an increase in oil prices and output, as well as global activity compared to the baseline scenario; and c) a precautionary demand shock leads to higher oil prices and output, although global activity

7: The 29 OECD member countries along with 6 non-member states: Brazil, China, India, Indonesia, Russia and South Africa does not necessary go up compared to the baseline scenario. In addition to the global variables described above, the model includes the following macromagnitudes of the Spanish economy, over which no sign restrictions are imposed: GDP and general CPI on the one hand - which are our interest variables - and the twelve-month interbank interest rate and nominal effective exchange rate on the other.

Results and conclusions

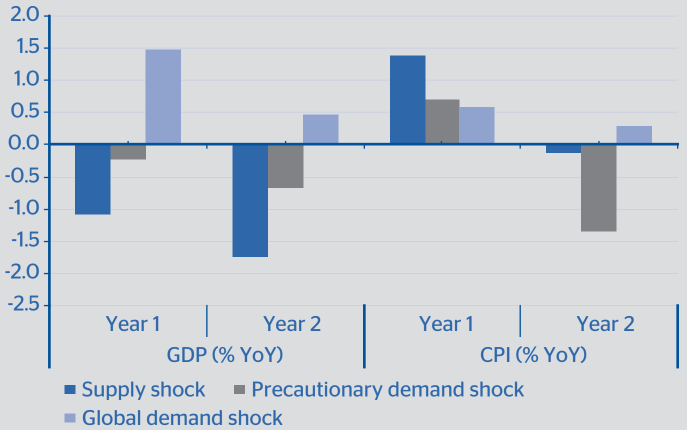
Graphs 25 and 26 summarise the main results of these estimations. Starting with the temporary stresses, Graph 25 shows the effects on activity and prices in the Spanish economy of each of the three types of shock described in the preceding section. In the three cases, stresses on the crude oil market are considered to exist when oil prices rise by 30% and then return to base case levels after a year. It can be seen that the results indicate that a temporary precautionary demand shock would have a very restricted impact on the GDP growth rate of approximately 0.2 pp in the first year and 0.5 pp in the second. Equally, the estimates show that the effects of this type of shock would be significantly lower than those of a supply shock, where GDP would decrease compared to the baseline scenario by 1.1 pp in year one and by 0.9 pp in year two. This result is basically due to the drop in crude oil production in the second type of shock and, therefore, a decline in global activity following a decrease in the use of installed production capacity. In contrast to the two previous types of shock, a global demand shock would have a positive impact on growth of the Spanish economy of 1.5 pp during year one, which would only be partially reversed in the second year (-0.7 pp) because the increase in demand for end goods and services in the international markets would offset the contraction triggered by higher commodity prices. Finally, with regard to inflation, in all three cases there are higher inflationary pressures in the first year, which would reverse sign as a result of a pronounced baseline effect as crude oil prices return to base case levels in year two.

Chart 25
Spain: impact of a temporary increase in oil prices by type of shock (deviation from baseline scenario)



Source BBVA Research

Chart 26
Spain: impact of a permanent increase in oil prices by type of shock (deviation from baseline scenario)



Source BBVA Research based on IMF and Datastream data

Graph 26 shows the results obtained for each of the three types of shock analysed in this study, but on the assumption they are not temporary. In all three cases, it is considered that stress on the crude oil market gives rise to a permanent 30% increase in oil prices. As expected, the results do not differ significantly from the results of a temporary shock in terms of the hierarchy of impacts on activity in the Spanish economy: i) both the precautionary demand shock and the supply shock would have a negative impact on activity; ii) the impact would be significantly worse in the case of a supply shock; and iii) the global demand shock would have a positive impact on growth of the Spanish economy. That said, the main difference between the temporary and permanent shocks concerns the magnitude of the total impacts: as expected, the effects of a permanent shock are more pronounced in all the cases analysed, particularly in year two where, for example, the demand shock has a positive impact on the growth rate. Turning to inflation, a difference is seen between the temporary and permanent shocks, but is not a surprise: given that crude oil prices do not return to baseline levels in the second scenario, the basic effect of the initial price rallies is less pronounced than in the first scenario. Likewise, in the case of a permanent shock, for example, higher inflationary pressures on consumer prices in the first year do not reverse the sign in the case of a demand shock.

In short, there is sufficient evidence to suggest that the recent oil price hikes will have a moderate impact on activity in the Spanish economy. As these prices rises are primarily due to a temporary increase in demand for precautionary reasons, it is expected that the contraction effect will be significantly less pronounced than would arise as a result of a drop in supply. Nonetheless, the effects on general inflation will be significant and likely be felt during much of the present financial year, weakening next year.

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4. Current restructuring of the Spanish financial system

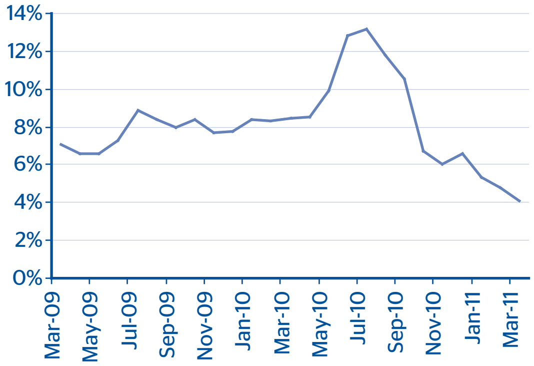
The current status of the Spanish financial system is highly varied in nature. Consequently, in its latest Global Financial Stability Report, the International Monetary Fund provided separate analyses of the weaknesses of the financial systems of savings banks from those of domestic banks, and these latter entities from international banks[8]. This lack of uniformity leads to talk of problems of liquidity and solvency in part of the system, compared with a much more robust position in the remainder, which represents approximately two thirds of the system..

Liquidity: a problem that has been alleviated, at least for the more solvent entities

The considerable liquidity requirements of the Spanish financial system are driven by the economic growth model prevailing prior to the recession. During that period of expansion, investment in Spain outstripped saving for more than ten years, fuelled by low nominal and real interest rates. As a result, private individuals increased their debts rapidly to finance a significant part of the investments, which savings were not able to cover, despite being at high levels. The Spanish financial system was responsible for intermediating to meet these requirements, procuring funds abroad and channelling them towards national agents, whereby their need for liquidity quickly rose to high levels. Despite the sharp adjustment in financing requirements during the recession, the Spanish financial system must service over €500 billion of debt maturing in 2011; a similar figure to the previous year. €100 billion of this amount comprises debt issued, while around €350 billion is related with the interbank market, and €50 billion comprises ECB loans.

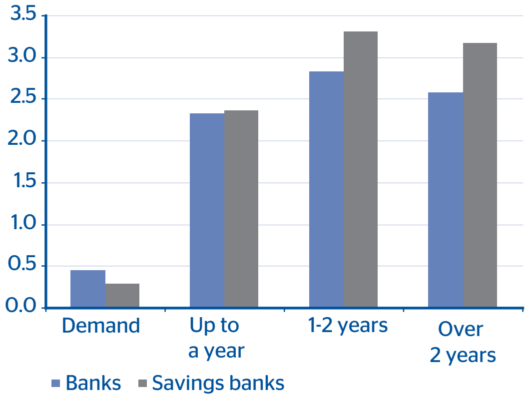
In terms of the main channel for financing to service this debt, the primary market sparked back into life during the first four months of the year, issuing above €27 billion. Bonds and senior debt have mainly been issued, although the issuers are primarily large banks and savings banks, while the prices paid are over and above those corresponding to the ratings of these entities compared with international entities with a similar rating. On the other hand, the financing obtained from the ECB has gradually reduced to just 4% of Spanish GDP from a high last summer of 13% (see Graph 27). These figures show that Spain's funding needs are below those of the eurozone (5% of GDP) and considerably below those of the peripheral countries such as Portugal (23%), Greece (40%) and Ireland (69%). Again, it is the largest entities that have the greatest ECB exposure, which have also been able to replace this debt for other sources of funding such as the issuance of debt. There has also been a notable increase in activity on the repo market; instruments that tend to be traded in the short term and at relatively high prices. It is likely that these instruments have been used by smaller entities with poorer access to sources of finance.

Chart 27
Spain: ECB liquidity (% of GDP)



Source: Bank of Spain and National Institute of Statistics (INE)

Chart 28
Interest rate of new transactions. Deposits of households and non-financial companies (%, Feb. 2011)



* Maximum up to 3 months.
Source: Bank of Spain

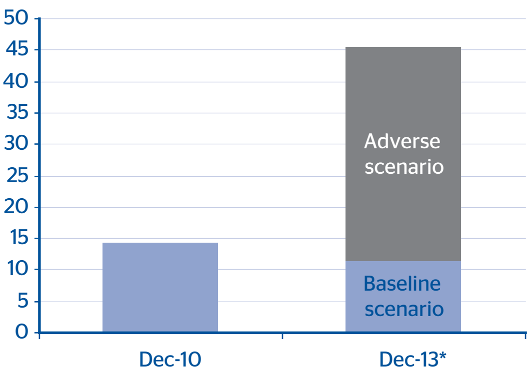
8: IMF (2011): Global Financial Stability Report. Washington.

Finally, efforts to attract deposits has continued, since these are a stable source of financing. At the end of last year, the volume of deposits accumulated by Spanish entities covered two-thirds of their assets. The cost of this source of funding has, however, remained very high, seriously eroding the margins of some entities (see Graph 28). The 'deposits war' could lead to aggressive pricing policies, which would be policed by the Spanish National Competition Commission; and financial instability, which would be the responsibility of the Bank of Spain. In both instances, the commercial policies of entities must be examined, and entities should be fined or have these activities restricted when they fix the prices of these resources over and above the cost of their assets or offer loans at a lower rate than the cost of financing their resources. Legislation also establishes that restrictions can be imposed on entities that have received or will receive public support from the Fund for Orderly Bank Restructuring (FROB), which must not be used to conduct aggressive campaigns in the deposits market.

Solvency: a problem that has been contained, but must be fully and quickly resolved

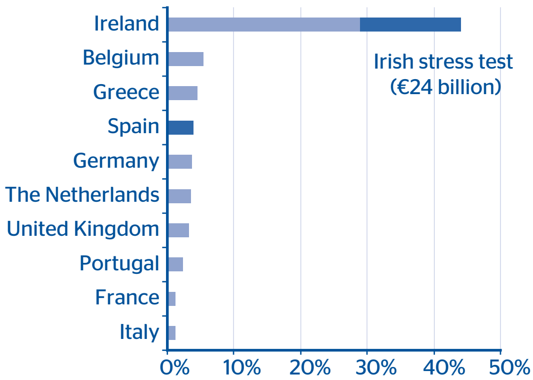
Looking at solvency, most of the problems are in the real estate sector, which also shows considerable differences between entities in terms of exposure to the sector (between 5% and 30% of loans depending on the entity) and quality (default rates of between 11% and 45%). In this regard, the Bank of Spain has strived to ensure transparency by publishing these figures and must continue to do so in the future. Quite a few entities are still cleaning up their balance sheets, despite the fact that writedowns performed by the Spanish banking system over the last three years have already reached €96 billion (approximately 9.5% of GDP). This situation is partly due to the fact that the downturn in the real estate sector has still not ended and because there is still a significant stock of unsold dwellings.

Chart 29
Current and future capital requirements*



* Billions of euros accumulated, excluding the €15.3 billion already injecteds.
** Minimum TIER 1 capital of 8%
Source: BBVA Research based on miscellaneous data

Chart 30
Europe: injections of public capital into the banking sector (% of GDP)



Source: BBVA Research

In line with the restructuring plan presented by the Spanish authorities, in March 2011 the Bank of Spain published the list of entities with capital requirements at December 2010. Total requirements amounted to €15.2 billion (equivalent to 0.6% of the assets in the system and 1.5% of GDP), which can therefore be deemed to be easily assumed by the Spanish economy. The fact that 76% of these requirements are concentrated among four entities, and that the entities reporting a deficit account for only 35% of the system's assets demonstrates the differences across the sector and that the solvency issue is contained.

That said, these figures show "static" requirements at a specific point in time -December 2010. If projections of the entities' balance sheets are made, and capital requirements are calculated at a future date, one can obtain a "dynamic" estimate, which is comparable with those published by most analysts. According to our estimates, made using stricter assumptions than those employed by the European stress tests, these requirements would oscillate between 3% and 5% of GDP, which is a limited amount that could be assumed. Again, the diverse nature of the sector means that three entities account for 77% of these requirements, while entities with capital deficits represent just 36% of total assets in the system.

The results of the European stress tests due for publication in June will also be "dynamic" in nature. The Spanish authorities have already confirmed that should further capital requirements be identified through this test, these should also be covered. Again, it is expected that the Spanish tests will cover a greater proportion of the financial system and will be more transparent and stricter than that to which other European countries will be subject, which will help to boost market confidence.

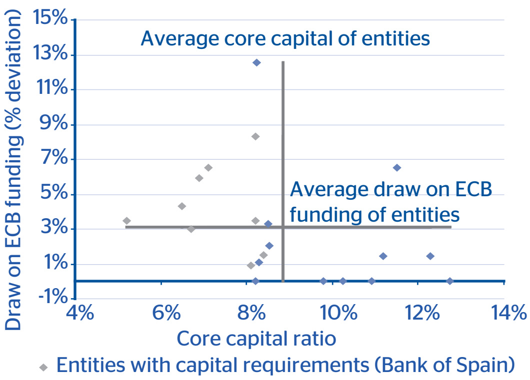
In September of this year, the Bank of Spain will evaluate the solvency of Spanish entities for a second time, checking that the recapitalisation plans presented and approved have been fulfilled. These plans establish that entities can be recapitalised through share issues, by issuing bonds that are mandatorily convertible into shares, through initial public offerings, or by obtaining government backing through the FROB. If the required solvency levels are not reached, statutory intervention will take place with the FROB acquiring a stake in the capital of these entities.

The restructuring plan proposed by the Spanish authorities has a number of positive aspects. Firstly, it provides a clear roadmap for the restructuring of the system, which calms the markets. It also encourages the participation of private capital and requires savings banks seeking aid from the FROB to become banks, making them more transparent for foreign investors. Lastly, the FROB's role as a backstop (guarantee that the minimum capital will be reached) is essential to ensuring the success of the process, with the European authorities in charge of the stress tests recommending countries to implement similar mechanisms.

Despite this, the plan is also limited and this triggers uncertainty in the markets. In light of the solutions in other countries and during other recessions which first involved an exhaustive clean-up of balance sheets and subsequent recapitalisation, Spain has chosen to increase core capital above a limit which, in principal, is sufficiently high to enable most entities to clean up and streamline their balance sheets in the future. The recapitalisation periods are also long, and should the maximum period (five years) expire, the restructuring of entities involving the intervention of the FROB would be slow. On the other hand, although the process encourages the conversion of savings banks into banks, private capital could be encouraged to wait until the FROB restructures the entities and resells them in the future.

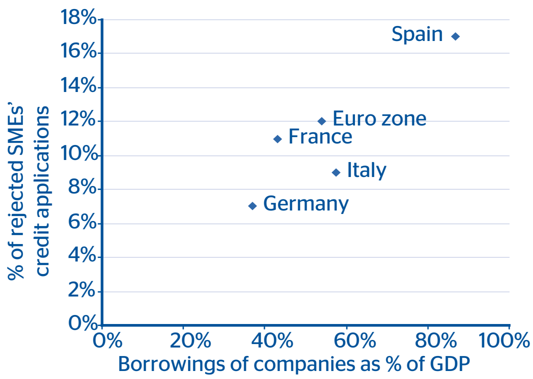
To conclude, the restructuring of the Spanish financial system is well advanced with well-covered capital requirements that can be easily assumed by the overall economy and are restricted to a small group of entities representing approximately a third of the system's assets. That said, the balance sheet clean-up must be completed and the restructuring should continue to be performed in a decisive and rapid manner to ensure the solvency and access to liquidity of all entities as soon as possible and at the right volumes and rates. This will reinforce international investors' confidence in our financial system, providing a more propitious environment for lenders to meet the credit demands of the economy as a whole when it recovers. In this regard, it should be borne in mind that the deleveraging process, which results in negative growth in credit demand from companies and households on the aggregate level, is completely compatible with increased demand from certain companies and sectors. In fact, the sectorial adjustment of the Spanish economy implies a shift in the allocation of capital and labour to different companies, for which reason, new needs for financing fresh new investment projects will arise, and should be met without restrictions by the financial system. Consequently, all entities must possess the liquidity (including a reduced dependence on the ECB) and solvency (high capital ratios) levels necessary to satisfy these demands.

Chart 31
Spanish entities*:
core capital ratio and draw on ECB funding. December 2010



*21 entities included in the Spanish financial system.
Source: BBVA Research based on Bank of Spain, CECA and miscellaneous data

Chart 32
Borrowings and rejected credit applications of SMEs

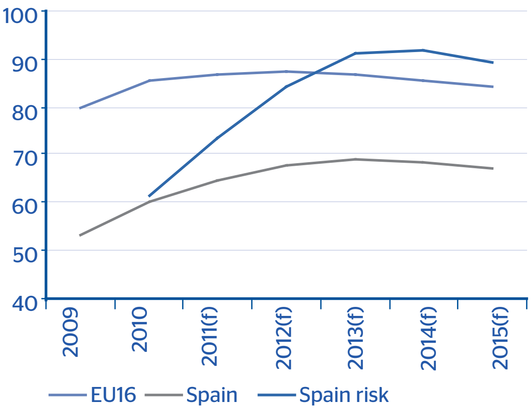


Source: BBVA Research based on ECB data

5. Fiscal consolidation in Spain: the need for an outright commitment to fulfil objectives

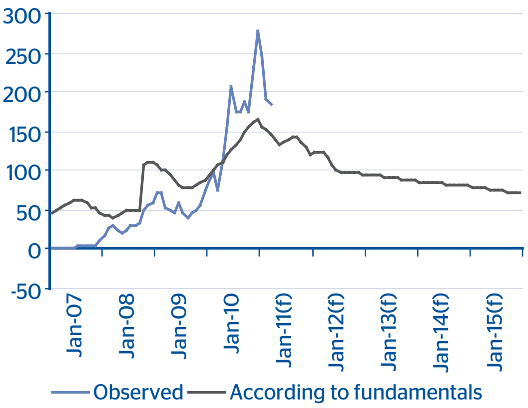
Given the high level of uncertainty in the sovereign debt markets, the Government has included in the Stability Plan an ambitious fiscal consolidation package involving a considerable reduction in the public deficit from 11.2% of GDP in 2009 to 3% in 2013 and 2.1% in 2014. Strict compliance with this plan will ensure the sustainability of Spanish public debt and convergence with levels that are well below those in other European countries. This statement is supported by Graph 33 showing the trend in Spanish and European public debt under the baseline scenario described in this publication and assuming that no additional fiscal adjustments are made after 2014. Spanish debt is shown to be sustainable even in alternative scenarios during which growth is subject to relatively high levels of stress and risk premiums are significantly higher than at present.

Chart 33
Public debt (% of GDP)



Source: BBVA Research

Chart 34
Spanish risk premiums vs. German five-year bond, bp



Source: BBVA Research

Table 5
Assumptions of the baseline scenario for Spain

	Average (2011-2015)		
	Risk premium (pp)*	**Nominal GDP growth rate**	**Primary deficit (% of GDP)**
Baseline scenario	1.5	3.8	-0.4
Adverse scenario	2.0	0.0	-2.0

* Maximum spreads: 3.0 (baseline) and 4.75 (adverse)
Source: BBVA Research

Nevertheless, the sovereign debt markets continue to assign Spain an excessively high risk premium. As shown in Graph 34, the current spread between the German interest rate is slightly higher than would prevail as a result of a sufficiently detailed model explaining the Spanish risk premium[9]. Graph 34 shows that using forecasts of the variables that are relatively in line with the baseline scenario described in this publication, risk premiums should even decline and converge with levels below 100 bp in the mid term. Part of the lack of confidence surrounding the Spanish economy's ability to settle its debt could therefore be due to variables that are not easily measurable, such as uncertainty about the Government's ability to meet the fiscal consolidation objectives set. Given this uncertainty, it is important that, unlike in other countries that are relevant to the Spanish economy, the fiscal stability target for 2010 has been met. Nonetheless, risk premiums continue to remain high despite this compliance. In relation to the commitment to fiscal objectives, the factors leading to this circumstance could be two-fold.

9: The model includes a sample of 39 countries and uses economic variables, and variables associated with the fiscal position, trade position and legislation to explain the risk premium

The first is related with the uncertainty about whether or not the target for 2011 will be met. On the one hand, the public deficit as a percentage of GDP has been reduced by more than three points, compared to two points in the previous year. On the other, unlike last year when revenues rose and expenditure was cut, which helped to reduce the deficit in a relatively balanced manner, this year expenditure cuts will account for more than 80% of the fiscal consolidation. Although some of the associated measures have been taken and are irreversible (restrictions on investments, reduction in public sector salaries), the greatest uncertainty relates to the fact that a significant part of the reduction in expenditure has to be made by the self-governing regions through new measures, while many of these autonomous communities deviated significantly from the aggregate objective for 2010 with the degree of compliance with the target varying widely from one community to another. Even more importantly, as mentioned above, weak economic growth imply that increases in revenues are unlikely to happen, putting greater pressure on Government to make further expenditure cuts to reduce the deficit, and demanding the utmost rigour, austerity and discipline from the autonomous communities during the fiscal consolidation process. In this regard, it should be mentioned that public expenditure was reined in considerably in 2010 –a more than 2 pp reduction from 2009- but not enough to make up for the nearly 3 pp decline in autonomous community revenue in the year.

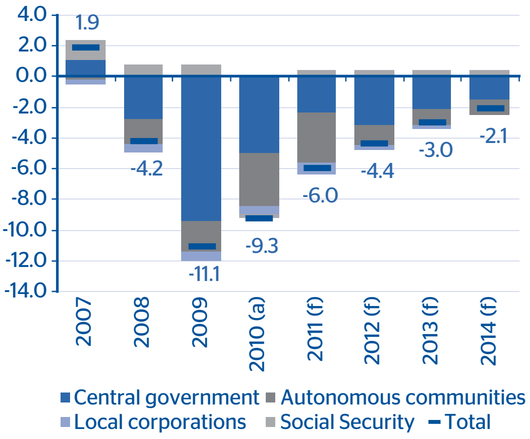
Secondly, although the Government has presented a roadmap to meet the fiscal objectives between now and 2013, the measures announced to date by the public administrations only guarantee compliance (if they are strictly implemented) with the objectives set for 2011. Looking ahead, it still has to be defined how the public deficit will be reduced beyond what is expected to result from the recovery of the economy in 2012 and 2013. Although these additional measures should be announced alongside the budgets for each of these years, the Government could reduce uncertainty by introducing additional and transparent measures for fiscal consolidation in the medium term, which underpin the commitment to fiscal stability shown by all public administrations.

Public administrations, especially the autonomous communities, should commit to a significant cut in spending to ensure the fiscal stability targets are reached

Throughout last year and in response to pressure from the financial markets, the central government accelerated the fiscal consolidation process started at the end of 2009 with the preparation of the General Government Budget for 2010. In May of that year, a series of extraordinary measures were adopted which reduced the deficit target as a percentage of GDP by 0.5 pp, 1.5 pp, and 1.0 pp for 2010, 2011, and 2012, and maintained the objective of -3.0% of GDP for 2013 (see Graph 35). These measures, which have basically sped up the fiscal consolidation process, required all levels of government to commit to the proposed objectives, although it in fact implied a different level of effort from one year to the next: while most of the fiscal adjustment in the central government was in 2010 and 2012, the main effort by the autonomous communities was required in 2011.

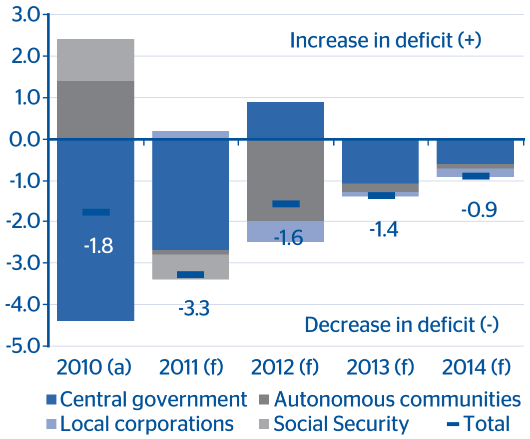
In this way, the overall public deficit was cut by 1.9 pp in 2010 to 9.2% of GDP, in line with the fiscal stability target approved in May 2010. The excellent performance of the central government's accounts -the deficit fell by 4.4 pp to 5.0% of GDP, seven tenths of a point below the target -able to offset the 1.4 pp and 1 pp increases in deficit as a percentage of GDP reported by the autonomous communities and social security authorities, respectively (see Graph 36).

Chart 35
Public administrations: budget balance (% of GDP)



(*) Includes regional deficit financing
Source: BBVA Research based on Ministry of Economy and Finance data

Chart 36
Contribution to fiscal adjustment (% of GDP)

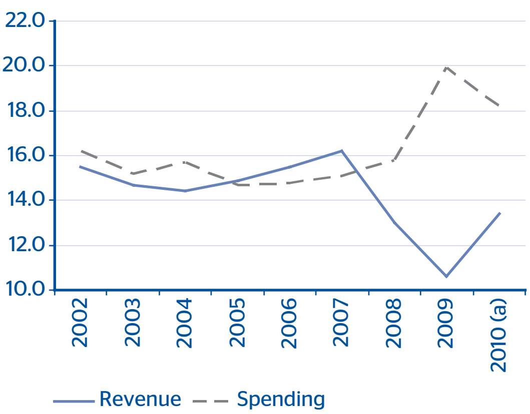


Source: BBVA Research based on Ministry of Economy and Finance data

The positive performance of the central government was mainly due to the improvement in non-financial income which rose by more than 2 pp as a percentage of GDP compared to 2009, driven by the increase in VAT rates and the favourable result for the State of the final settlement of contributions from the regional administrations in 2008 (estimated at approximately 0.7 pp). The measures to restrict spending implemented last year also gave rise to a 6% reduction in non-financial expenses compared to 2009, most of which was in investment spending and current transfers between public administrations (see Graph 37).

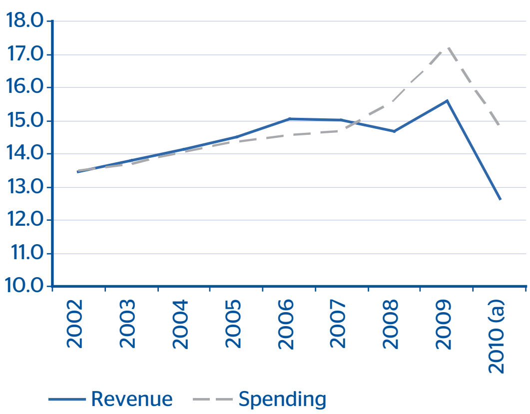
Meanwhile, preliminary data on the budgetary performance of the autonomous communities in Graph 38 shows a notable effort to restrict spending in 2010, which fell by more than 2 pp as a percentage of GDP compared to 2009 spending. Nonetheless, this cut in spending was not sufficient to offset the decline of almost 3 pp in the revenues of autonomous communities in 2010, which affected practically all revenue items, especially tax revenues and current transfers[10]. As a result, the autonomous communities taken as a whole suffered a deficit of 3.4% of GDP, more than half a percentage point of which corresponds to the effect of regional deficit financing in 2008. If this deficit financing is excluded, performance between communities was diverse, with only five communities clearly achieving the objective of -2.4% of GDP.

Chart 37
Central government: revenues and spending (% of GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 38
Autonomous communities: revenues and spending
According to recognised assets and liabilities (% of GDP)

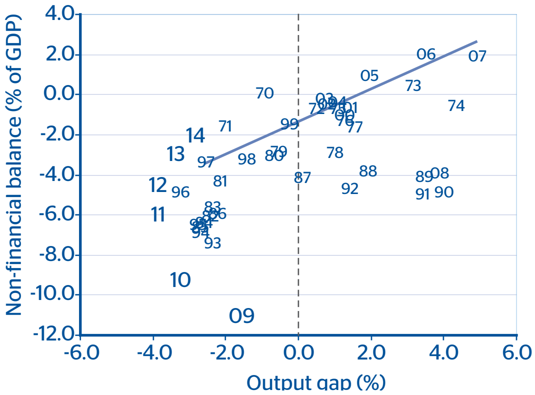


Source: BBVA Research based on Ministry of Economy and Finance data

10: For additional information on the status of the autonomous communities, please refer to Cardoso, M., R. Doménech y V. Pou (2011)..

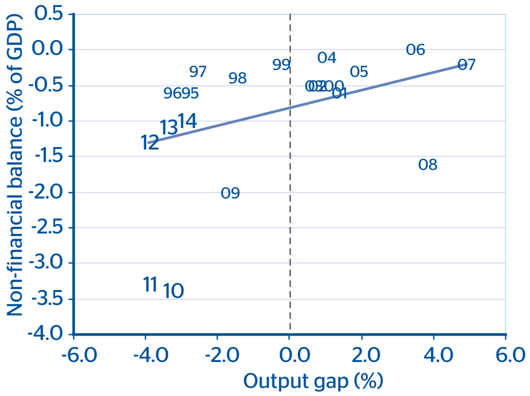
In light of these results and as shown in Graphs 39 and 40, the discretionary fiscal adjustment measures cut the structural deficit for all public administrations by approximately 3 pp to 6.5% of GDP. This indicates that the cycle has continued to contribute to the deterioration of the public accounts by more than 1 pp. In contrast, the discretionary policies implemented by the autonomous communities in 2010 boosted their structural deficit by just over than 1.5 pp to 3% of GDP, almost half the structural deficit of all public administrations.

Chart 39
Public administrations: non-financial balance vs. output gap



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 40
Autonomous communities: non-financial balance vs. output gap



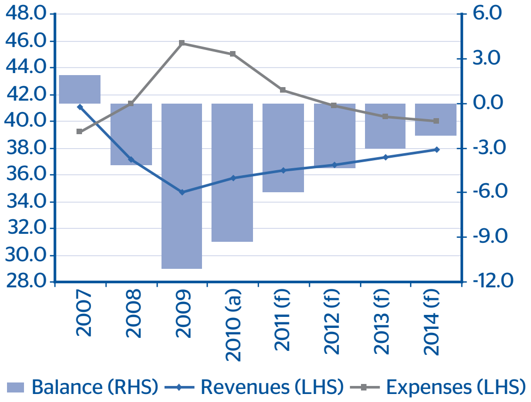
Source: BBVA Research based on Ministry of Economy and Finance data

In this context, based on our output gap forecasts for the coming years, the structural deficit would have to shrink by around a further 5 pp to achieve a deficit of 3% of GDP in 2013. Most of this structural deficit reduction would have to take place in 2011, reaching approximately 1% of GDP in 2013 (a similar level to 2007, just before the recession hit). Undoubtedly, the commitment to fiscal consolidation must be strong and unwavering if this objective is to be reached. A sharp rise in revenues is not expected during a period of weak economic growth such as the current downturn, with revenues ending the consolidation period at approximately 38% of GDP, contributing slightly more than 2 pp to the fiscal adjustment (see Graph 41). Consequently, the bulk of the pressure of the fiscal consolidation is exerted on public spending, which will have to shrink by around 5 pp to reach the target of -3% in 2013, 60% of which will be concentrated in 2011 (see Chart 42).

Thus, 2011 will pose a particularly important challenge for the administrations of the autonomous communities, as they will have to change their budgetary trends and cut their deficits by 1.5 pp, making almost 90% of the required adjustment this year to guarantee compliance with the objective of -3% of GDP set for 2013. As explained above, without legislative changes, it is unlikely that revenues can recover significantly, whereby the fiscal consolidation effort will once again focus on additional cuts to autonomous community spending. This is reflected in the measures set out in the budgetary rebalancing plans of several autonomous communities[11] approved on 27 April by the Fiscal and Financial Policy Council (FFPC), which establish an adjustment to the autonomous community deficit of approximately 0.4 pp of GDP, over 0.3 pp of which involves a reduction in spending. Despite this, additional adjustment measures still have to be specified amounting to just over a percentage point to ensure compliance with the stability targets up to 2014.

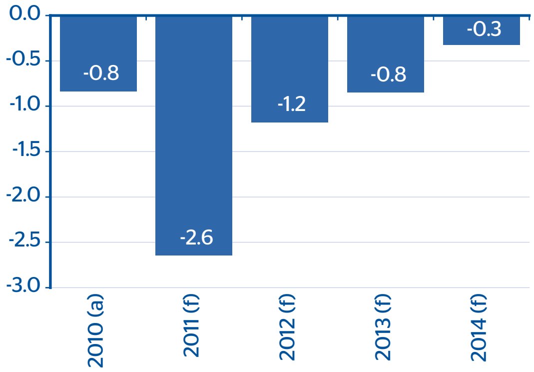
11: Plans for the autonomous communities of Aragon, Asturias, the Canary Islands, Cantabria, Castile-Leon, Galicia and Murcia, plus the Basque Country and Navarre, the plans of which will be approved by the respective mixed committees in the near future. Taken as a whole, these communities accounted for 26% of the total autonomous community deficit in 2010.

Chart 41
Public administrations: revenues and spending (% of GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

Chart 42
Public spending: contribution to fiscal adjustment (pp of GDP)



Source: BBVA Research based on Ministry of Economy and Finance data

The Government's fiscal consolidation strategy set out in the recent update to the 2011-2014 Stability Plan[12] clarifies some of the measures to be adopted by all public administrations to ensure compliance with the stability targets. According to the Government, on the revenue side, the economic recovery and the effects of the measures to boost tax revenues will drive a 1.9 pp decrease in the deficit, approximately 1 pp of which will be due to a strengthening of the economy. The remainder of the adjustment (5.2 pp) will be achieved through spending cuts, primarily by reducing salaries thanks to the measures approved in 2010 to freeze wages and establishing that only 10% of public sector workers will be replaced (1.5 pp); by cutting public investment which will decrease by 1.1 pp to 2014; and by curbing intermediate consumption and other expenses which will be cut by a planned 1.9 pp, enough to ensure compliance with the objectives set.

Based on available information, it can be concluded that the spending cuts proposed in the Stability Plan are feasible, despite being highly ambitious. The risk, therefore, is concentrated among the autonomous communities: although the approval of some of the rebalancing plans represents a noteworthy advance, doubts still remain about the commitment of some of these communities to the fiscal adjustment process. The fact that the plans of the other communities representing almost 50% of Spain's GDP have not been approved appears to be of particular importance. These doubts must therefore be dispelled by announcing the measures that these communities are taking and prompting those that are showing indecision to firmly commit to the challenges, using all the tools at the State's disposal to apply pressure to them. On the other hand, any wavering in the economic recovery forecast by the Government will put downward pressure on revenues, whereby it should be prepared to rapidly introduce preventive measures if any danger of deviating from the objectives is detected; favouring the tools that have been used to date in the fiscal consolidation: spending cuts and increases in indirect taxation.

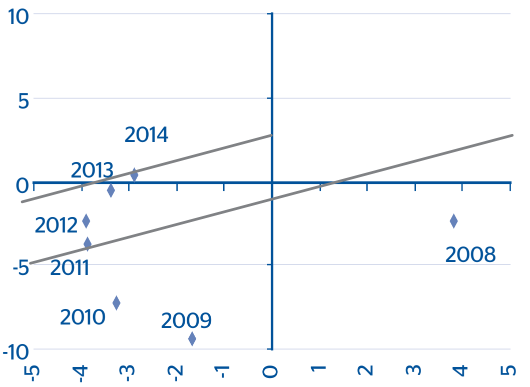
ETying down mid-term expectations

Against a backdrop of high levels of uncertainty such as in the current scenario, public administrations must introduce mechanisms that make compliance with the fiscal targets for the coming years more transparent and credible, raising confidence in their ability to manage the economy. In particular, Spanish public administrations have taken a significant step by meeting as a whole the public deficit target established for 2010. Furthermore, the right measures have been adopted in the 2011 budgets to ensure this year's target is attainable as long as all the public administrations strictly fulfil their commitments. Looking ahead, however, investors currently lack evidence of specific measures that guarantee the objectives for forthcoming years will be fulfilled beyond the commitment in the Stability Plan. As shown in Chart 42, measures generating around 1 pp of GDP per annum in additional resources will be needed to attain the targets for 2012 and 2013.

12: Available at: http://www.meh.es/es-ES/Paginas/Programas_de_Estabilidad_y_Nacional_de_Reformas.aspx

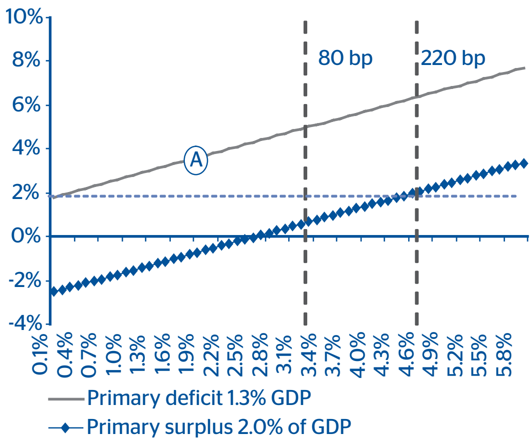
The importance of removing this question mark as soon as possible is highlighted in Charts 43 and 44. In particular, Graph 43 shows the primary budget balance (before interest payments) compared to the average balance during the cyclical position of the economy, which is commonly known as the output gap. This variable measures the percentage difference in GDP compared to average GDP, whereby the output gap is positive when GDP is growing (and the unemployment rate is below its structural level) and negative during a recession. The estimated coefficient measuring the budget balance's sensitivity to the economic cycle is between 0.75 and 1.0 (see BBVA Research, 2009). We have used the 0.75 gradient for this year in order to be less optimistic about the effects of the recovery in public finances. The intersection with the vertical axis (zero output gap) of a line passing between either of the two points with 0.75 gradient is particularly interesting, since it provides an estimate of the structural budget balance of the economy: the level it would reach in the medium term without any changes in fiscal policy. The graph shows that in 2011 the primary structural balance of the economy would have been approximately 1.3% of GDP.

Chart 43
Budget balance vs. output gap (%)



Source: BBVA Research

Chart 44
Real growth and interest rates that enable debt to be sustainable at 75% of GDP



Source: BBVA Research

Once the position at which the primary budget balance will converge in the medium term, in the absence of additional announcements as from 2012, the question to be raised is whether the Spanish debt can be sustainable at these levels of deficit. Graph 44 shows the combinations of GDP growth rates and public debt interest rates, both in real terms, that would enable debt to stabilise at around 75% of GDP (a value that is over and above the level of debt that would be reached at 2013 year end if the aforementioned fiscal policy adjustments are made to achieve the targets of the Stability Plan and given the baseline scenario of BBVA Research)[13] Combinations of real interest rates and GDP growth rates to the right of the line determined by the primary balance of 1.3% of GDP make debt of 75% of GDP unsustainable, while combinations to the left would give rise to declining debt below this level.

Looking at Chart 44 as part of our analysis, the obvious questions is: if the public administrations do not do anything beyond what has already been announced, what combinations of real growth and interest rates in the mid term will ensure the measures taken to date make the public deficit sustainable? Point A in the graph shows the average growth and interest rates observed during the period 1996-2008, whereby an initial conclusion would be that if conditions return to those prevailing before the recession, current deficit levels would not be sufficient to guarantee the sustainability of the public deficit.

13: This exercise is based on the movement law which establishes the direction of debt: $B_{t+1}=B_t(1+R_t)+D_t$
where B_t Bt is the level of public debt in *t*, R_t *is the nominal interest rate and* D_t the primary balance. GDP variables are shown in lower case letters, with r_t and g_t representing the interest rate and the GDP growth rate, both in real terms, and π_t *representing the inflation rate, whereby we are:*

$$b_{t+1}=b_t\left(\frac{1+r_t}{1+g_t}\right)+d_t\left(\frac{1}{(1+g_t)(1+\pi_t)}\right)$$

The condition that ensures debt does not grow over time (i.e., , bt+1=bt=b*) is:

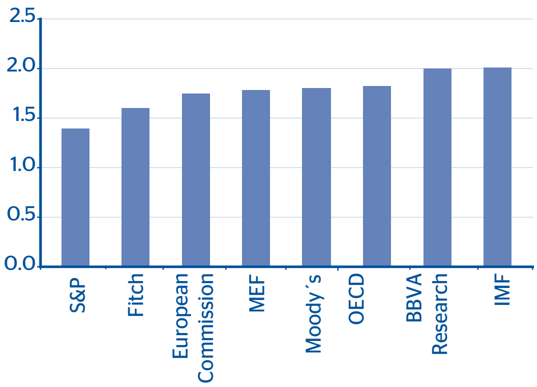
$$r^*=g^*-\left(\frac{d^*}{b^*(1+\pi_t)}\right)$$

where the asterisked variables are variables that are expected in the mid term. Chart 44 is constructed assuming a level of debt b^* of 75% of GDP and an inflation rate of 1.5%.

That said, part of the doubts expressed by the market are due to the uncertainty surrounding the Spanish economy's ability to return to the same growth rates seen in the past, which in turn gives rise to a higher risk premium (see BBVA Research, 2010). Mid-term potential growth forecasts for the Spanish economy made by international institutions, ratings agencies and analysts are wide ranging and, occasionally, show significant differences (see Chart 45).

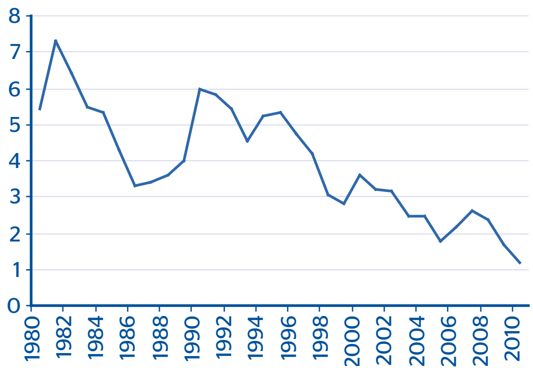
The baseline scenario set out in this publication is based on a growth trend that could rise to 2% in 2014 and beyond (see BBVA Research, 2009). For the debt to be sustainable, assuming a primary structural deficit of 1.3% of GDP, the real interest rate that public administrations would have to pay should not therefore exceed 0.1%, which is impossible. Given that the real interest rate in Germany has stood at around 2.5% in recent years (see Chart 46), the markets do not discount a zero risk premium for Spain compared to Germany, and Spain is unlikely to return to an inflation differential which is as high as during the pre-recession growth period, the real interest rates that the Spanish economy will have to pay in forthcoming years will be above 2%. Chart 44 shows that with a GDP growth forecast of 2% and a risk-free interest rate of 2.5%, risk premiums over and above 80 bp mean that public debt will be unsustainable given a primary structural balance of 1.3.

Chart 45
Spain: Potential growth forecasts by institution (%)



Fitch (Sovereigns: Full Rating Report March 2011), Moody´s (Global Sovereign: Credit Analysis March 2011) and Standard & Poor´s (Global Credit Portal: Ratings Direct March 2011)
Source: BBVA Research based on IMF, OECD, European Commission and Ministry of Economy and Finance data

Chart 46
Germany: Ten-year bond real interest rate (%)



Source: BBVA Research based on past and forecast inflation

Chart 44 also includes the real growth and interest combinations that would enable debt to be sustainable given a primary structural surplus of 2.0% of GDP, in line with the levels that would prevail if the public administrations fulfil the commitments adopted for 2012 and 2013. With this surplus, Spain's public debt would be sustainable given a GDP growth forecast of 2% per annum and risk premiums of between 80 bp and 220 bp. Even if the Spanish economy did not grow at this rate, the levels of risk premium that would enable public debt to be sustainable would be reasonable (between 80 and 160 bp) based on a GDP growth forecast of approximately 1.5% per annum (in line with the forecasts of the IMF or EC, for example). It can therefore be concluded that if the primary surplus target for 2013 is reached, the debt would be sustainable for a reasonable range of growth and interest rate combinations. Under these circumstances, although the objectives set out in the Stability Plan are feasible applying a highly rigorous fiscal policy, the various administrations would be advised to clarify through credible multi-year budgets how the deficit targets for 2012 and 2013 will be reached, because this could significantly reduce uncertainty regarding the sustainability of Spanish public debt as a whole.

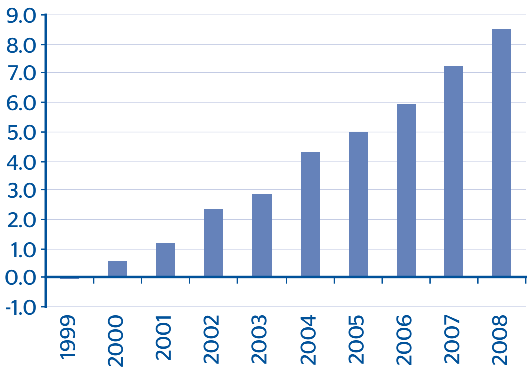
New fiscal regulations would generate certainty about the targets and would increase the stability of the economic cycle

The public administrations could also commit to introducing a structural fiscal target for coming years. Spain already boasts a fiscal rule which caps the State's spending, imposes a fiscal deficit target for the entire economic cycle and respects certain criteria established at European level (borrowing limits and annual public deficit). Nonetheless, based on the evidence observed over the last three years and risk premiums in the financial markets, this rule is insufficient. The accumulation of imbalances in certain sectors of the Spanish economy and the subsequent recession in particular have led to debt exceeding the established limits and have raised doubts about the effectiveness of the fiscal policy adopted immediately prior to the crisis.

By way of an example, one approach to this issue is to analyse the size of the public deficit that would have been observed with a fiscal rule linking spending to the trend in nominal GDP growth and not to economic activity in the year in question, skewed in some cases by an excessive increase in prices or output in some over-sized sectors. Graph 47 shows the difference between the observed deficit and the deficit that would result from a fiscal rule implemented since 1999 linking spending to the trend in nominal GDP and a primary structural surplus of 2% of GDP, in line with the figures implicitly inferred by the fiscal targets proposed for 2013 and 2014[14]. It can be seen that in every year since 2000, the observed public deficit or surplus was lower than would have resulted if the aforementioned fiscal rule had been applied. It is noteworthy that the gap grows over time because the continuous growth in spending over and above the recommended level has a cumulative effect, whereby the rule would have "recommended" a surplus of around 9 pp of GDP higher than that seen in 2008. This would have corrected the imbalances in prior years. It can be concluded that spending should not have risen as it did in the period immediately prior to the recession, and that much of the uncertainty seen in recent years would have been avoided with a stricter fiscal rule during that period.

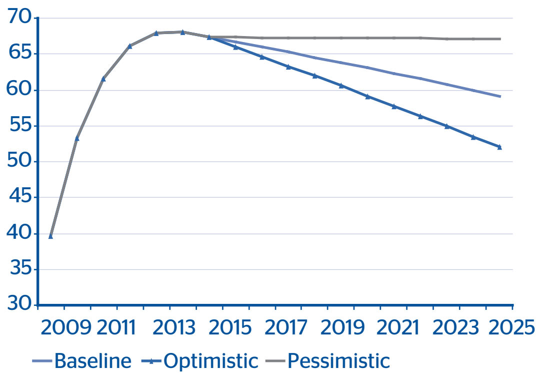
The next question to be answered refers to the suitability of the fiscal rule proposed herein. The proposal is that, in general terms, any commitment assumed should lead to a reduction in the public deficit in the mid term. As shown, a primary surplus of 2% of GDP guarantees sustainability. More specifically, with a risk premium of 140 bp and a 2% GDP growth rate, a primary deficit of 2% of GDP would lead to a reduction in debt to levels required under the Maastricht Treaty by 2025. Even in a pessimistic scenario (a further 50 bp of risk premium, 0.5% growth compared to baseline scenario), the debt would be sustainable, although it would not converge with Maastricht Treaty levels in the near future (see Graph 48). It should also be mentioned here that this target could be more ambitious, taking into account that the medium-term commitments assumed by the public sector are high (pensions and health).

Chart 47
Excess in primary surplus required to comply with the rule (pp GDP)



Source: BBVA Research

Chart 48
Spain: debt scenarios with a structural fiscal rule (% of GDP)



Source: BBVA Research

Finally, the likelihood of a rule such as the one proposed herein succeeding can be boosted if an independent body is set up to provide evaluations, recommendations and forecasts, and impose some form of control over public administrations to limit any potential deviations from budgetary targets. As Calmfors and Wren-Lewis (2011) show, establishing a Fiscal Policy Advisory Council to perform such work is justified by the reduced likelihood of governments generating a deficit as a result of a lack of information, excessively optimistic forecasts, voter impatience, inter-generational debt distribution, or voter competence (when the cost of debt is not internalised).

14: The start date is 1999, which BBVA Research (2009) stipulates as being the year in which the output gap was zero. The trend in nominal GDP growth during the reference years was 5.4%, while public spending increased at an average rate of 7.3%..

This advisory council should be capable of issuing forecasts and opinions on the feasibility of the targets established by public administrations. Evidence from around the world shows that such councils should be independent from government, and employ staff with a renowned reputation who can be appointed for specific terms, similar to those who work in central banks. This body could report directly to Parliament, which could be responsible for appointing the management thereof. As is the case of the Congressional Budget Office in the US, this body would provide instruments to analyse and evaluate public policy, which would be most useful to enhance the supervisory role of Parliament over the executive.

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BBVA Research (2009). Situación España. Noviembre.

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Calmfors, L y Wren-Lewis, S (2011): *"What should fiscal councils do?"*. University of Oxford, Economic Series Working paper 537.

Cardoso, M., R. Doménech y V. Pou (2011) *"Las comunidades autónomas ante el reto de 2011"*. Observatorio económico. BBVA Research.

6. Tables

Table 6
Macroeconomic forecasts: Gross Domestic Product

(YoY rates, %)	2008	2009	2010	2011	2012
US	0.4	-2.6	2.9	3.0	2.7
EMU	0.3	-4.1	1.7	1.7	1.5
Germany	0.7	-4.7	3.5	2.7	2.0
France	0.1	-2.5	1.5	1.7	1.6
Italy	-1.3	-5.1	1.1	1.0	1.0
Spain	0.9	-3.7	-0.1	0.9	1.6
UK	-0.1	-4.9	1.3	1.4	1.6
Latin America *	5.3	-1.1	6.6	4.6	4.4
Mexico	1.5	-6.1	5.5	4.7	3.8
EAGLES **	6.6	3.5	8.3	6.9	6.9
Turkey	0.7	-4.7	8.1	4.6	4.8
Asia Pacific	5.6	3.8	8.0	6.4	6.7
China	9.6	9.2	10.3	9.4	9.1
Asia (exc. China)	3.0	0.2	6.5	4.3	5.1
World	3.0	-0.6	4.9	4.4	4.4

Closing date: 30 April 2011
* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 7
Macroeconomic forecasts: 10Y interest rates (average)

	2008	2009	2010	2011	2012
US	3.6	3.2	3.2	3.7	4.2
EMU	4.0	3.3	2.8	3.4	3.6

Closing date: 30 April 2011
Source: BBVA Research

Table 8
Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2008	2009	2010	2011	2012
US (EUR/USD)	0.68	0.72	0.76	0.73	0.75
EMU	1.47	1.39	1.33	1.37	1.33
UK	1.82	1.56	1.55	1.64	1.66
China	6.95	6.83	6.77	6.46	6.14

Closing date: 30 April 2011
Source: BBVA Research

Table 9
Macroeconomic forecasts: official interest rates (end of period)

	2008	2009	2010	2011	2012
US	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.50	2.00
China	5.31	5.31	5.81	6.81	7.31

Closing date: 30 April 2011
Source: BBVA Research

Table 10
EMU: macroeconomic forecasts (y-o-y change, %, unless otherwise indicated)

	2008	2009	2010	2011	2012
Household consumption:	0.4	-1.1	0.7	1.1	1.3
Public consumption	2.3	2.5	0.7	0.2	0.1
GFCF	-1.0	-11.3	-0.8	1.8	2.7
Capital goods and other products	1.1	-15.0	3.4	3.2	3.2
Capital goods	0.9	-16.6	4.6	3.3	3.0
Construction	-2.2	-7.2	-3.7	-1.2	0.8
Housing	-4.7	-10.3	-2.9	-0.3	0.7
Domestic demand (*)	**0.3**	**-3.3**	**0.8**	**1.1**	**1.3**
Exports	0.7	-13.1	10.6	7.1	5.0
Imports	0.6	-11.8	8.7	5.7	4.9
Net exports (*)	**0.1**	**-0.8**	**0.9**	**0.7**	**0.2**
GDP mp (% y-o-y)	**0.3**	**-4.0**	**1.7**	**1.7**	**1.5**
Pro-memoria					
GDP w/out housing investment	0.6	-3.7	1.9	1.8	1.5
GDP w/out construction	0.6	-3.7	2.3	2.1	1.5
Employment (LFS)	0.9	-1.8	-0.4	0.5	0.8
Unemployment rate (% active pop.)	7.6	9.5	10.0	9.7	9.3
Current account balance (% GDP)	-1.1	-0.7	-0.5	0.0	0.2
Public sector balance (% GDP)	-2.0	-6.3	-6.0	-4.4	-3.7
CPI annual average	3.3	0.3	1.6	2.4	1.6

(*) Contribution to GDP growth
Source: official institutions and BBVA Research

Table 11
Spain: macroeconomic forecasts (y-o-y change, %, unless otherwise indicated)

	2008	2009	2010	2011	2012
Activity					
Real GDP at market prices	0.9	-3.7	-0.1	0.9	1.6
Private consumption	-0.6	-4.3	1.3	0.4	0.9
Public consumption	5.8	3.2	-0.7	-1.1	-0.3
Gross fixed capital formation	-4.8	-16.0	-7.5	-3.8	2.4
Capital goods	-2.5	-24.5	1.9	2.6	4.9
Construction	-5.9	-11.9	-11.1	-7.7	1.2
Housing	-10.7	-24.5	-16.5	-7.5	3.6
Other construction	-0.8	-0.1	-7.2	-7.8	-0.1
Other goods	-4.1	-16.2	-7.8	-0.7	2.6
Chg in inventories (*)	0.1	0.0	0.1	0.0	0.0
Domestic demand (*)	-0.6	-6.4	-1.1	-0.9	1.0
Exports of goods and services	-1.1	-11.6	10.3	10.6	6.2
Imports of goods and services	-5.3	-17.8	5.5	3.7	3.6
Net exports (*)	1.5	2.7	1.0	1.7	0.6
GDP at current prices	3.3	-3.1	0.8	3.4	3.2
Billion euros	1088.1	1053.9	1062.6	1098.8	1133.4
Prices and Costs					
GDP deflator	2.4	0.6	1.0	2.5	1.6
Household consumption deflator	3.5	0.1	2.8	2.8	1.2
CPI	4.1	-0.3	1.8	2.9	1.3
Compensation per employee	6.4	4.1	0.7	2.8	2.6
Unit labour cost (ULC)	5.0	1.2	-1.5	1.2	1.6
Foreign trade					
Trade balance (% GDP)	-7.9	-4.0	-4.4	-2.8	-2.3
Current account balance (% GDP)	-9.7	-5.5	-4.5	-2.9	-2.4
Government sector					
Debt (% GDP)	39.8	53.3	60.1	64.6	67.5
Public Administration balance (% GDP)	-4.2	-11.1	-9.2	-6.0	-4.4
Labour market					
Active population (LFS)	3.0	0.8	0.2	0.2	0.4
Employment (LFS)	-0.5	-6.8	-2.3	-0.7	0.8
Change, thousands of people	-98.4	-1369.7	-431.4	-121.2	145.0
Full-time equivalent employment (QNA)	-0.5	-6.6	-2.4	-0.7	0.7
Unemployment rate (% active pop.)	11.3	18.0	20.1	20.8	20.5
Productivity	1.4	2.9	2.2	1.6	0.9
Households					
Real disposable income	2.4	1.6	-4.4	-2.3	1.8
Nominal disposable income	6.0	1.7	-1.8	0.4	3.0
Savings rate (% of nominal income)	13.5	18.1	13.1	10.7	11.5

(*) Contribution to GDP growth
Source: official institutions and BBVA Research

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