BBVA | RESEARCH

Economic Outlook

Spain

Second quarter 2012
Economic Analysis

- **Global economic growth continues** but uncertainty increases.
- **Europe, awaiting a credible agenda for growth and fiscal consolidation,** becomes decoupled from global growth.
- **Spain:** recession is confirmed, but not accelerating.
- **Current uncertainty** is conditioning the short-term effect of reforms.
- **Building confidence depends on the design, execution, and communication of a** credible set of reforms.

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Closing date: May 4, 2012

1. Editorial

The forecasts for the Spanish economy in this publication **are consistent with our forecasts three months ago,** when we expected GDP to contract by 1.3% in 2012, with a slow recovery in 2013. Our diagnosis of the main factors behind this remains fundamentally the same, however, there have been a number of significant developments **which have increased uncertainty around the forecasts.** Some of these developments will have a negative impact on economic activity: these include renewed tension in capital markets, increased oil prices, and additional public sector fiscal consolidation measures. However, other factors will have a positive impact on GDP, such as the Supplier Payment Programme, approval of the Budget Stability Law (LEP in Spanish) and labour-market reform; yet the short-term effects of these measures will be conditional upon both the intensity with which they come into effect and the evolution of domestic and international uncertainty. As in previous quarters, we expect disparities in regional growth to maintain the divergence between those autonomous regions with the greatest imbalances and those most exposed to foreign trade.

Despite the dynamism of the world economy, the international context for the Spanish economy mainly depends upon developments in the **European** crisis. European progress in resolving the sustainability of Greek debt, erecting credible firewalls around other solvent countries with liquidity problems and moving towards a fiscal union **have not been sufficiently effective and continue to be subject to risks and uncertainties.** As a result, the positive effect on spreads of the European Central Bank's liquidity injection in the early months of 2012 has virtually disappeared. In this context, room for manoeuvre in monetary policy is curtailed by European governments not having defined a **much more ambitious, and better designed, roadmap for growth and fiscal consolidation.** A strategic plan is required with short- and long-term objectives that will enable implementation of measures to boost activity and make decisive progress towards sharing sovereign risk in exchange for improved fiscal coordination and governance, and structural reforms where necessary. In the current situation, more efficient and hard-hitting use, and perhaps better design, of the European Financial Stability Fund and the European Stabilisation Mechanism would be useful in giving governments the time they need to implement reforms, allowing them comfortable access to market finance without the tensions and uncertainties that water down the effects of the reforms.

One of the main functions of governments is to try to reduce uncertainty through policies that create the confidence required to incentivise economic activity. The Spanish government has been particularly proactive in this regard. For example, it has approved a substantial, comprehensive and well-aimed reform package for the labour market. It has also approved a General Government Budget including significant measures to increase the probability of year-end deficit targets being achieved, the Budget Stability Law and the Supplier Payment Programme. However, **the potential positive impact of these measures has been diluted by negative market sentiment, this has on occasion been over-sensitive about certain events,** such as missing the 2011 deficit target, the delay in presenting the budgets of public administrations, initial discrepancies in setting the 2012 deficit target, and risks that fiscal consolidation might depress economic activity excessively. In addition to these doubts, the markets also have a perception that the European Union and Spain do not have the well designed and effective medium- and long-term strategic plans needed to achieve sustainable public finances, growth and job creation.

As we have previously written in this publication, the LEP is a step forward in building institutions that will enable improvements in fiscal policy to tackle the "structural deficit", boosting the stabilising effect of fiscal policy, limiting discretionary action and establishing credible control mechanisms for the autonomous regions. **Therefore, the LEP has put Spain at the forefront in passing such legislation in Europe.** Nevertheless, just like the European fiscal compact, the LEP could have gone further, as other countries have done. For example, a few months ago Portugal created an independent fiscal council to strengthen compliance with fiscal rules. The inclusion of mechanisms to control the autonomous regions is a particularly important aspect of the LEP. Once these mechanisms have been designed, **they need to be applied immediately if the autonomous regions fail to submit credible adjustment plans, or if they deviate from these without due cause.** Following presentation of the General Government Budget, the Government has required all regional governments to prepare new adjustment plans based on the Budget's content. Although the measures announced to date go beyond what is needed to gradually reduce the structural deficit, these plans are vitally important because the measures alone do not guarantee that the deficit target of 5.3% of GDP at the end of 2012 will be achieved.

However, there is increasing concern among Spain's international creditors about the relationship between fiscal consolidation and growth. The scale of the adjustment to public spending is without parallel in a developed economy going through a recession, as Spain is at the moment. Furthermore, the resulting increase in risk premiums is limiting the offsetting effects of monetary policy and could as a result exacerbate the negative impact on economic activity. **Against this background, the Supplier Payment Programme is welcomed as it will inject 2.5 percentage points of GDP into the private sector,** concentrated on companies that might be particularly affected by the fiscal consolidation process. Although current conditions increase uncertainty about what the **plan might achieve, it could have a positive impact of around 1% of GDP.** However, this effect is temporary and will not fully offset the fiscal adjustment planned for 2012. Spain is a good example of why Europe should review its fiscal consolidation strategy, as the new Stability Treaty proposes, to avoid excessive pro-cyclical adjustments and to set annual reduction targets for structural deficits through credible and realistic multi-year plans featuring specific, detailed and well-designed measures to convince the markets that European countries are committed to the sustainability of their public debt.

Reforms to increase the growth capacity of the Spanish economy must continue in parallel to this. **The current labour-market reform is a substantial improvement on earlier legislation,** as it increases internal flexibility, gives priority to company agreements, gives incentives for permanent contracts, removes legal uncertainties and promotes training for young people. In the short-term, this reform should improve confidence and reduce job losses through changes to working hours and salaries as an alternative to redundancy. **Over the long-term, estimates suggest the reform could result in a 10% increase in employment,** which would be a significant improvement. The passage of the reform through parliament is a good opportunity to simplify the number of contracts, reduce the gap between permanent and temporary contracts and remove discontinuities in company size for the application of some of these improvements. In its Stability Programme Update, the Government has announced modifications to the tax system to make it more efficient and to boost employment. In particular, it features **a "fiscal devaluation" increasing indirect taxes and reducing labour taxes,** so that the overall tax collection effect is neutral; **this could be particularly positive for job creation**[1]**.**

Together with progress in fiscal consolidation and structural reforms, **the current banking restructuring process also needs to be completed.** To the extent that this results in a cleaned-up and solvent system, the resulting banking institutions should have no difficulties in routinely managing future potential losses on their portfolios resulting from the economic cycle.

In addition to good design and thorough implementation of the measures discussed throughout Europe and in Spain, **investment in communication strategies that are effective in reducing current uncertainties will also help to increase credibility.** As it will take years to fully eliminate all the existing imbalances, the markets, other economic agents and, in particular, the public must all be aware that Spanish and European public sector bodies and institutions are implementing comprehensive, coherent and well-coordinated short- and long-term fiscal consolidation, structural reform and bank restructuring plans.

1: See, for example, Spain Economic Outlook, March 2009.

2. Global recovery, but risks are re-emerging

Global growth is gradually returning, but with significant differences between areas. Risks to growth are firmly on the downside

Following a gradual slowdown throughout 2011, particularly in the last quarter, the global economy is beginning to show signs of picking up. Global growth in the first quarter of 2012 is expected to be higher than in the previous quarter, with higher growth in Asia excluding China (including Japan) and Latin America, together with sustained, but modest, growth in the USA. Global growth is expected to continue to increase, and will exceed 1% qoq growth by the end of 2012 (0.6% in the fourth quarter of 2011). This recovery will however be very diverse, with increasing disparities in growth rates among the main economic areas. The increase in growth in 2012 will be most evident in Asia, following recovery from the natural disasters in Thailand and Japan (which impacted on the regional supply chain) and the partial reversal of the tougher policies applied until mid-2011. Growth will also recover in Latin America, largely due to higher growth in Brazil, with looser monetary policy, and Mexico, where growth will remain in excess of 3.5% bolstered by demand from the USA, improved competitiveness and favourable finance conditions. The USA will continue to post quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. US growth will also outperform the stagnation of activity in the euro area in 2012, which will be hampered in the periphery countries by aggressive fiscal consolidation and persistent financing tensions, after these had fallen in the first quarter.

Therefore, emerging economies will once again have growth rates around 4 percentage points higher than developed economies for 2012 and 2013 as a whole. The difference in growth rates between Europe and the USA will also continue to widen over the next two years, even though we expect European authorities to continue taking action that will gradually reduce financing tensions.

As a result, our growth forecasts remain similar to those published in our last scenario in February. We expect global economic growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing 80% of this growth (see Chart 1). However, as we mentioned earlier, this scenario is conditional on the European crisis, and the risks to these forecasts are therefore heavily skewed to the downside.

In this context, monetary policy will continue to be loose for a long period in advanced economies, helping to overcome the weakness in activity over the medium- and longer-term. However, the effectiveness of its intervention (conventional or otherwise) is decreasing and its costs are increasing, with risk of decreased independence for central banks and collateral damage from non-conventional measures. It is therefore time for authorities and institutions in the USA and Europe to act decisively to take responsibility for reviving growth from central banks, through the implementation of economic and institutional reforms and management of fiscal risk. Meanwhile, central banks must continue to support adequate functioning of the monetary transmission mechanism.

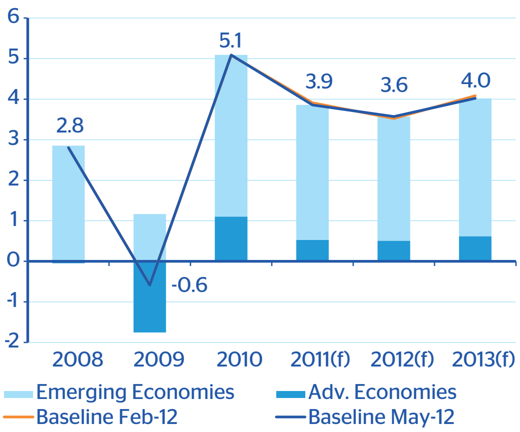
In emerging countries, central banks will have to balance pressure from capital inflows, external uncertainty about inflationary risks (partly due to oil prices) and strong domestic demand. The outlook for inflation differs in Asia and Latin America, falling in the former and being stable in the latter, and this will determine different official interest rates paths. We consider that the cycle of monetary relaxation has come to an end in many emerging economies in Asia (with the notable exceptions of China and India), and it is likely there will be cautious restrictive bias throughout most of Latin America, except for Brazil.

There have been some progress in resolving the European crisis, but significant steps remain to be taken. Europe needs a clear road map for emerging from the crisis

Over recent months there has been some progress towards resolving the European crisis, but many important issues are still pending. Firstly, privately-held Greek sovereign debt has been restructured, but despite this there remain doubts about its long term sustainability as a result of reform fatigue and a deeper than expected recession, among other factors. Secondly, there has been progress in implementing a firewall that isolate Greece with the approval of the European Stabilisation Mechanism (ESM), which now has the ability to lend EUR 500 Bn, in addition to the

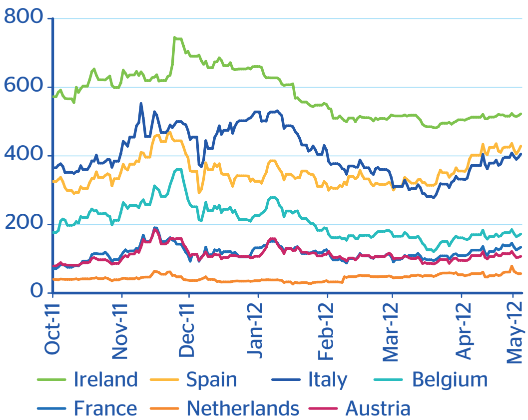
EUR 200 Bn already committed by the EFSF. But this has not been sufficient to calm the markets. This is because the financing needs of Spain and Italy over the next three years exceed this amount and because ESM loans would have priority over private bond holders. In addition, it is not clear how much of the USD 430 Bn (approx. EUR 330 Bn) increase in the International Monetary Fund's (IMF) resources could be used to help European countries. Besides, The European fiscal treaty, which is awaiting national ratification, commits governments to structural deficits of no more than 0.5% of GDP. This represents a significant change in control of national budgets; however, the treaty allows countries to stray from this rule in "exceptional circumstances", and this may make it seem insufficiently strict to justify more energetic action by the European Central Bank (ECB) or the central European countries. Furthermore, there has been no progress towards fiscal union or "eurobonds". In summary, the road map of where Europe is going is not yet sufficiently clear.

Chart 1
Global GDP growth (%)



Source: BBVA Research

Chart 2
European sovereign risk premium (10 year bond spread against Germany, bp)



Source: Datastream and BBVA Research

The main global risk is a worsening of the European crisis

One of the most significant actions over the last four months was the long-term liquidity injection by the ECB. This resulted in a significant reduction in liquidity risk for European banks, a timid opening up of wholesale finance markets and a narrowing of sovereign spreads for periphery countries, until March at least (see Chart 2). However, these positive effects turned out to be temporary, as the markets: (i) detected a degree of complacency by politicians as risk premiums fell in the first quarter of 2012; and (ii) there were doubts about the ability of some periphery countries to meet deficit targets. At the same time, the markets were also worried about the negative effects of these targets being achieved on growth. This has resulted in rapidly increasing risk premiums for Italy and Spain since March, in the latter case to levels similar to those of peak tension in November 2011 (see Chart 2).

We can draw two conclusions from the temporary effect of long-term liquidity injections and the dilemma of combining fiscal consolidation and restoring growth. Firstly, ECB action only produces short-term benefits, gaining time whilst more deep-rooted economic and institutional issues are addressed. This means that we cannot talk about the ECB's exit strategies yet; it also means that economic reforms must be pursued whilst demand is being rebalanced in the euro area, with a stimulus to demand in the central countries. Secondly, fiscal consolidation plans must be reviewed in a coordinated manner (to ensure there is no risk of the markets picking on individual countries), establishing structural deficit objectives -consistent with the spirit of the fiscal treaty- and with a more gradual adjustment process. Member states will have to develop comprehensive, explicit and detailed multi-year plans in exchange for this more gradual approach. This would allow public finances to be cleaned up without serious damage to short-term growth. This would also enable us to reap the long-term rewards of the structural reforms being implemented in the periphery countries.

We still regard a further outbreak of the European crisis as the main risk, with potentially very serious consequences to global growth. Increased tension could be manifested in forthcoming elections in several countries and a referendum, due to reform fatigue in periphery countries and central countries becoming fed up with financing more bailouts: France, Greece, two German states, Ireland and the Netherlands are all holding elections in the first six months of this year.

Current oil prices will only have a slight impact on global growth. However, a major additional price increase would be a very high risk

Any further increase in oil prices would be a second threat to the global economy. The increase in early-2012 was due, in part, to tight in fundamentals (supply and demand), but also to a USD 10 to 15 per barrel increase in the geopolitical risk premium due to tensions over Iran and limited shock-absorbing capacity (oil stocks and excess OPEC production capacity). Our core scenario assumes Brent crude prices of around USD 120 per barrel throughout most of 2012 (around 20% higher than our forecasts 3 months ago). This will have only a slight negative impact on global growth, as central banks in advanced countries are likely to treat this as a temporary shock. Together with the weakness of the cycle, this will mean there is no need for monetary policy to be tightened, which is one of the usual ways in which higher oil prices lead to lower growth. Nevertheless, if political tensions increase, there could yet be a sharp rise in crude prices; this could damage growth due to increased global risk aversion, irrespective of whether central banks increase interest rates. The likelihood of this occurring is low, but if it does, it will have significant impact on global growth.

3. Growth outlook for the Spanish economy: recession confirmed

Despite some doubts about economic policy being cleared up...,

Over the last three months, the uncertainty that has weighed on some factors affecting the Spanish economy has decreased. In Europe, macroeconomic figures show that the deterioration in the real economy has been somewhat less pronounced than expected. The continuing looseness of monetary policy and non-conventional liquidity measures implemented by the European Central Bank (ECB), together with gradual progress on governance, the restructuring of Greek debt, and fiscal consolidation and structural reform efforts in some member states, helped to temporarily moderate the instability in sovereign debt markets; however, this has not been completely eliminated.

In the domestic arena, uncertainty over economic policy has decreased, as evidenced the measures being taken to increase the credibility of compliance with public sector fiscal objectives, the implementation of ambitious labour-market reform and the announcement of further financial sector reform.

...no change to our opinion of the short-term precariousness of the fundamentals of the Spanish economy

Despite the above, it has been confirmed that the Spanish economy is in recession again. Firstly, we expect that private sector access to external finance will continue to be both limited and relatively expensive, due to the lack of a definitive resolution to the governance problems affecting the European Union. Secondly, the outlook for European growth continues to be one of moderate contraction over 2012 as a whole, leading to weak demand for Spanish exports. Thirdly, upward pressure on oil prices adds additional downside risk to growth, although these should be moderate due to their transitory nature and because they are not exclusively explained by geopolitical risk factors.

Domestically, the performance of the economy in line with our forecasts in both the fourth quarter of 2011 and the first quarter of 2012, as can be seen from figures available at the time of putting the finishing touches to this publication. Nevertheless, figures for the final quarter of last year show significantly weaker than expected domestic demand.

However, a more important factor is the worsening of Spanish bond spreads as a result of missing the 2011 deficit targets by more than expected (with a knock-on effect on the scale of measures needed to meet the 2012 target), and a lack of transparent measures to ensure compliance with the 2012 target by the autonomous regions; this is in addition to doubts about the speed of implementation and cost of reforms to the financial system. This increase in the risk premium intensifies the negative impact that the fiscal adjustment might have on the economy, by limiting the increase in confidence from the economic measures announced. Moreover, the composition of the budget measures, which focus more than expected on direct taxation and investment spending, will not minimise the negative impact of the adjustment on growth.

Despite this, there are some counter-balancing factors. In the short term, the ECB's monetary (and liquidity) policy will continue to support demand and financial stability. This, together with differences in growth rates between Europe and the rest of the world, will result in the euro being weaker than expected; this will increase competitiveness gains for exporting companies. The Government has announced a supplier payment programme amounting to around 2.5% of GDP, which could have a significant (temporary) impact on spending over coming months. Finally, although the short-term effects might be limited, if implemented immediately and effectively, the labour-market reforms could lead to lower job losses in 2012, establishing the foundations for a more robust recovery over the medium term.

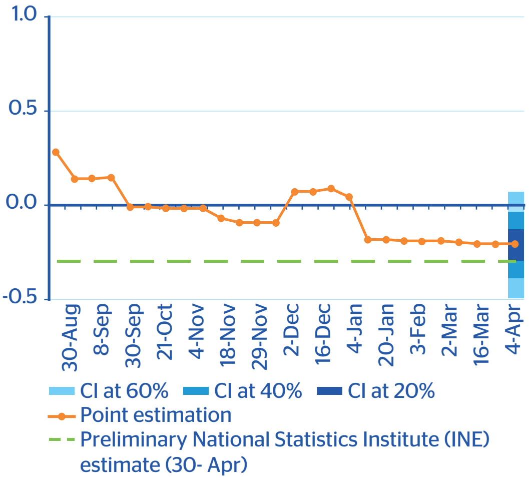
In summary, we expect the Spanish economy to continue reporting negative growth rates over the coming quarters, amounting in the most likely scenario to a fall in GDP of around 1.3% for the year as a whole. Furthermore, as we reported in the last edition of this report, under current conditions, we expect the 2013 recovery in the Spanish economy to be slow. Nevertheless, whilst it is true that the scenario we have described leads, on balance, to us maintaining our growth forecasts for 2012 and 2013, with no significant changes to the adjustment process that the Spanish economy is going through, we must emphasise that there are significant risks of a larger contraction. The Spanish economy's needs for external financing increase the probability of such a risk scenario arising.

Technical recession in Spain in 1Q12

Whilst we await publication of detailed figures, advance GDP estimates show that in 1Q12 the Spanish economy continued the contraction from the previous quarter. These figures show the economy contracting by 0.3% qoq in 1Q12 and, whilst this is not an increase in the rate of deterioration, it does mean that the country is now technically in recession[2]. If these advance estimates are confirmed, the overall performance during this quarter will have been in line with our forecasts (BBVA Research: -0.4% qoq; MICA-BBVA: -0.2% qoq)[3]; these signaled from an early stage that the quarterly performance was likely to be negative (see Chart 3) and also indicated an increased likelihood of continued deterioration during the current quarter (see Charts 4 and 5). In addition, other indicators so far released show further downward correction of domestic demand and, as a result, imports, in 1Q12; this indicates that the composition of growth will feature increasing net external demand with a negative contribution from internal demand (see Chart 6).

Chart 3

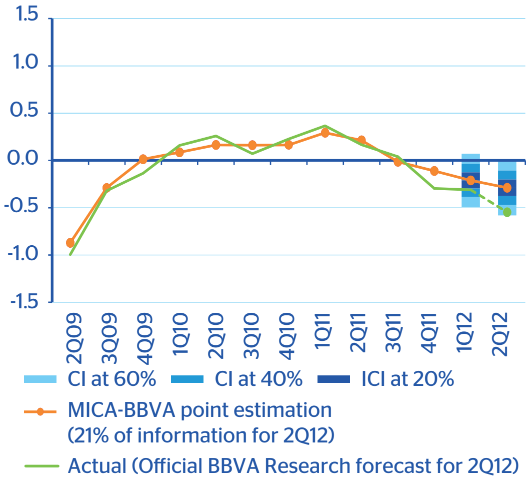
Spain: 1Q12 GDP growth forecasts using the MICA-BBVA model by forecast date (% qoq)



Source: BBVA Research based on INE data

Chart 4

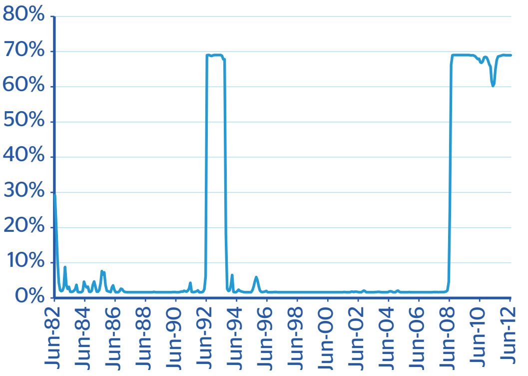
Spain: GDP growth observed and forecasts using MICA-BBVA model (% qoq)



Current forecast: 27 April 2012.
Source: BBVA Research based on INE data

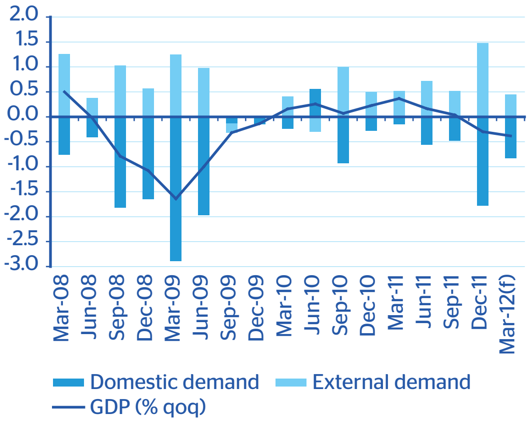
2: The 1Q12 Quarterly National Accounting (CNTR) will be published on 17 May, and the advance figures may be revised.
3: The differences between our core estimates and the results of the MICA-BBVA model for this quarter are due, in part at least, to the latter not considering the whole of the adjustment in the public sector accounts. 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, available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1021_tcm348-231736.pdf?ts=2542012.

Chart 5
Spain: likelihood of negative quarterly growth (% qoq)



Source: BBVA Research

Chart 6
Spain: contributions to quarterly GDP growth

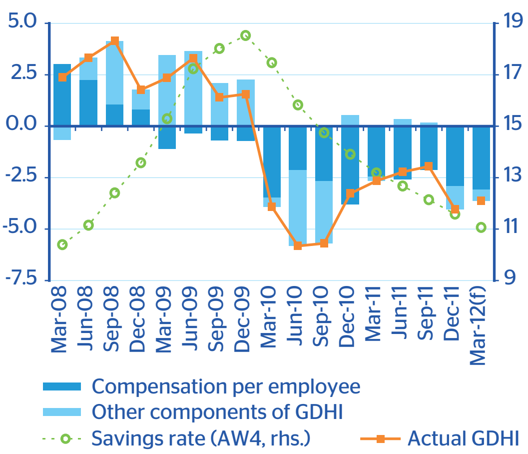


Source: BBVA Research based on INE data

Private domestic demand will continue to be a significant drain on growth

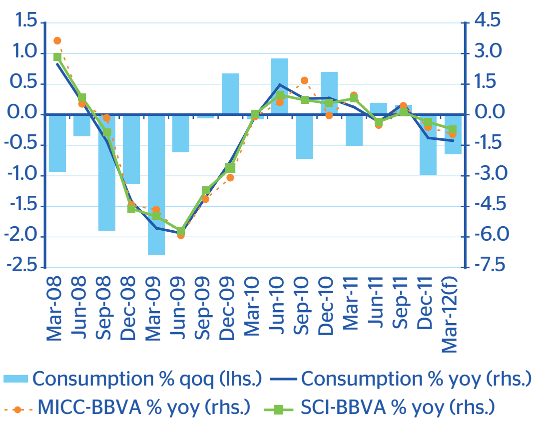
Following a collapse in private consumption in the fourth quarter of 2011, parcial demand indicators -mainly for durable goods and, to a lesser extent, services- suggest that the deterioration in household spending slowed between January and March this year. However, deterioration in all the factors determining household consumption means it will have fallen during 1Q12, despite an expected decrease in savings (see Chart 7). Thus, both BBVA's synthetic consumption indicator (SCI-BBVA) and our coincident consumption indicators model (MICC-BBVA) suggest that household spending contracted by around 0.6% qoq in 1Q12 (-1.3% yoy) (see Chart 8).

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



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

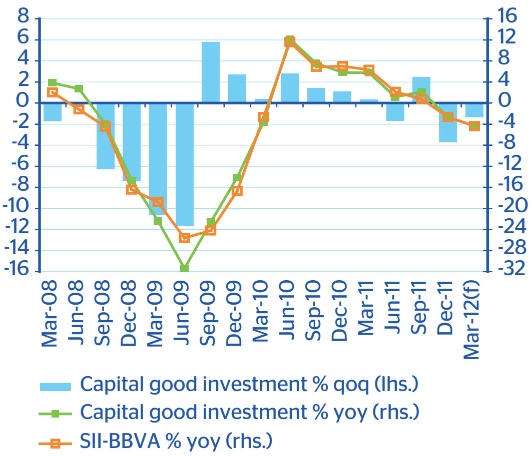
Chart 8
Spain: actual data and real-time forecast of household consumption



Source: BBVA Research based on INE data

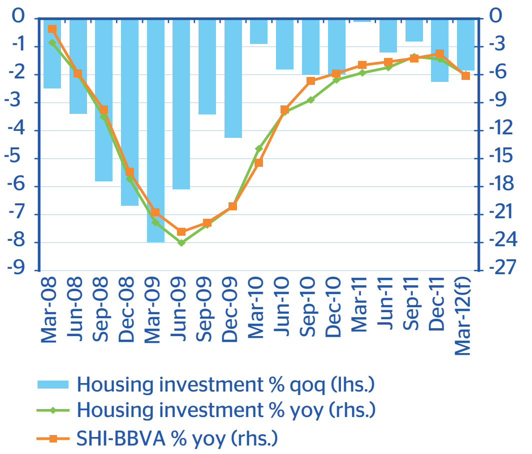
Whilst advance indicators related to capital goods investment indicate a significant fall in this demand component, figures for the first months of the year point to a lower reduction in 1Q12 as a whole. The indicators backing this trend include confidence among capital goods producers, which remained practically constant during the first quarter, having fallen by 20 points in 4Q11. On the negative side, there was a deterioration in capital goods orders (-5.3 points), following a rise of almost 2 points in the previous quarter. In summary, as in recent quarters, given the weakness of domestic demand, the main support for business investment has been external demand. The less negative picture expected for exports in 1Q12, following the fall in the previous quarter, and the less pronounced fall in advance indicators relating to capital goods investment, justify a reduction in the pace of deterioration in this demand component, which according to our BBVA synthetic investment indicator (SII-BBVA) will come in at around 1.4% qoq (-4.3% yoy) in 1Q12 (see Chart 9).

Chart 9
Spain: actual data and real time forecasts for capital goods investment



Source: BBVA Research based on INE data

Chart 10
Spain: actual data and real time forecasts for housing investment



Source: BBVA Research based on INE data

There are still no signs of any change to real-estate trends, with advance indicators for the early months of 1Q12 continuing to demonstrate the weakness of the sector. The synthetic housing investment indicator (SHI-BBVA) is suggesting there was a further contraction in the first quarter of the year (-1.8% yoy, -6.0% qoq) (see Chart 10). Furthermore, in the first two months of the year there was stagnation in transactions in mom terms once corrected for seasonaland working day effects (SWDA). Demand has remained stuck at the lows reached in the second half of 2011.

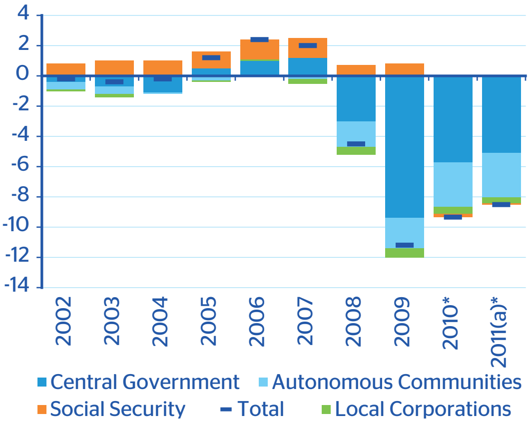
The main factors affecting residential demand and supply continue to be the cyclical position of the economy, the continuing expectation of price decreases and difficulties accessing credit; this situation is further compounded by the need for construction companies and property developers to deleverage. As a result, activity continues to be at minimal levels, as shown by new housing construction permits, which fell further in the early months of the year. Although this reduction in activity should favour the absorption of excess housing supply, the contraction in demand is making this process very slow. We estimate that excess supply amounted to around 4.0% of the housing stock at the end of 2011, slightly below the 4.1% recorded the previous year.

Figures for budget implementation show that the largest part of the adjustment in public demand will take place in the middle of the year

Figures for year end 2011 confirmed that the target deficit of 2.5pp of GDP had been missed. The reduction of public expenditure , observed both in the central government accounts and those of the regions, was not sufficient to offset the steep drop in public revenue; as a result the General government stood at 8.5% of GDP, meaning targets had been missed at all levels (see Chart 11). Missing the deficit target by so much will put further pressure on the 2012 fiscal adjustment, thus affecting growth in domestic demand in the year.

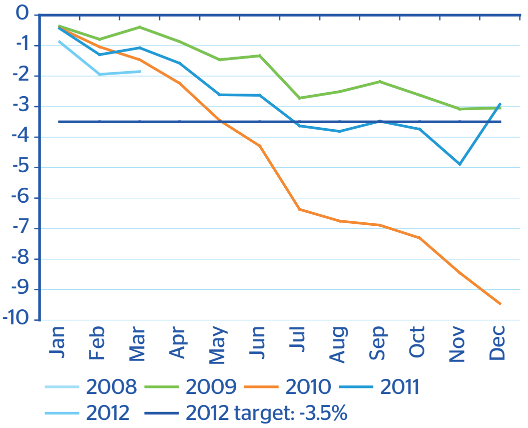
The latest figures for Central government budget out-turn data show an accumulated deficit of 1.9% of GDP in 1Q12. Although we are starting to see the initial effects of the fiscal adjustment measures, these have not been sufficient to offset the poor performance of revenues, which are continuing to fall in yoy terms, whilst we have not so far seen any substantial reduction in expenditure other than in capital employment (see Chart 12). Given this information, and until we have similar information for the autonomous communities, we expect public-sector consumption to have contracted slightly in the first quarter of the year, with the majority of the adjustment required being concentrated in the middle of 2012. Fiscal consolidation efforts continue to focus on reducing investment, as a result public works and, very probably, non-residential construction, will have continued to fall, although more slowly than in the previous quarter.

Chart 11
Public Administration: net lending (+) / net borrowing (-) (Base 2008, % of GDP)



(*) Not including the effect of deficit financing of regional administrations.
Source: BBVA Research based on MINHAP

Chart 12
Central Government: net lending (+) / net borrowing (-) (Base 2008, % of GDP)



Source: BBVA Research based on MINHAP

Exporting activity less negative than in 4Q11, with exports continuing to make a positive contribution

The prospect of a smaller than initially expected contraction in Europe, and of increased productivity gains -through a weaker euro and favourable relative price performance- signals better export performance than in the previous quarter. However, this will not be sufficient to avoid stagnation or slight contraction in 1Q12. Nevertheless, the figures for January to March have been marked by large swings, increasing uncertainty and making it impossible to rule out a recovery at the end of the quarter. For example, exports of goods through Customs recovered in January, but this was reversed in February. The goods and services indicator for large companies improved in January, but also cooled in the following months. Nevertheless, the industrial sector export order book indicates better performance in the last quarter of the year, recovering 4.3 points in March to 7 points about its historic average.

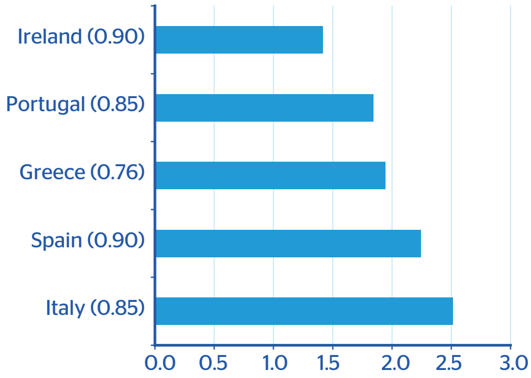
Tourism service exports also performed similarly. Advance indicators show that consumption by non-residents in Spain contracted more slowly than in the previous quarter, despite the continuing negative effects of European confidence and activity and, on this occasion, the weakness of winter tourist demand (see Chart 13). In fact, tourism other than winter tourism performed more strongly. For example, the number of tourists entering Spain as a whole increased by 2.8% between December and February, but increased by 8.7% for the Canary Islands.

Whilst advance indicators give room for a degree of optimism on export performance, imports of goods and services contracted sharply in 1Q12 due to weak domestic demand. In particular, as shown in Chart 14, the heavy reliance of the Spanish economy on imports, which is behind this pattern, means that import flows historically react more robustly to changes in domestic demand and/or exports than in other European periphery countries. In summary, the improved export outlook and the deterioration in imports enables us to estimate that net external demand in the first quarter of 2012 will have continued to make a positive contribution to growth, once again providing support for economic activity.

Chart 13
Spain: spending by tourists and consumption by non-residents (% qoq, SWDA)

Source: BBVA Research based on INE and EGATUR data

Chart 14
Elasticity of total imports to domestic demand + exports, average 1991-2011 (%)

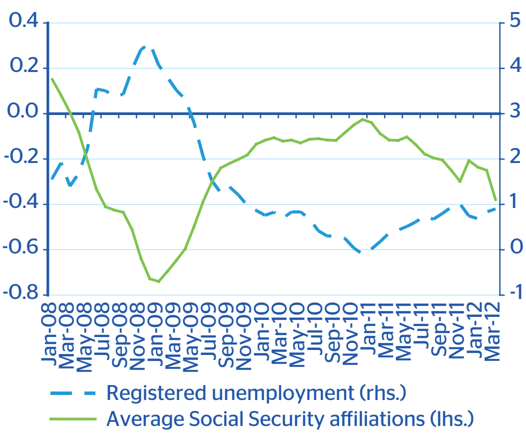


Note: the figures in brackets show the percentage change in imports explained by domestic demand and exports.
Source: BBVA Research based on INE and AMECO data

Deteriorating employment figures confirm the economy contracted in 1Q12

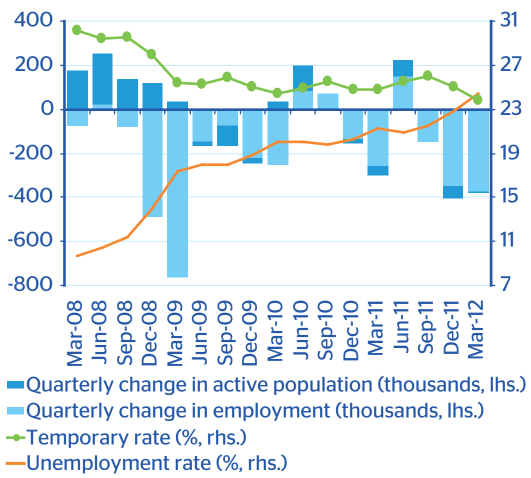
Excluding changes dues to seasonal and calendar effects, labour market data shows the rate of job losses speeding up slightly from January to March. Average Social Security affiliations fell by 0.9% qoq SWDA in 1Q12, one tenth of a point more than in the previous quarter, due to weaker performance in construction, services and, to a lesser extent, industry. However, the increase in registered unemployment slowed by three tenths of a point to 2.4% qoq SWDA (see Chart 15)[4]. The Labour Force Survey (LFS) for 1Q12 confirmed the trend shown by Social Security affiliations and unemployment numbers. The sharp fall in employment (-374.3 thousand people, -256 thousand SWDA), which for seasonal reasons was mainly concentrated among temporary contract staff and service sector workers, played a part in reducing incentives to participate in the labour market, leading to an 8.4 thousand decrease in the active population. As a result, the unemployment rate rose by 1.6 pp to 24.4% of the active population (24.0% SWDA), while the temporary rate slipped 1.3 pp to 23.8% (see Chart 16).

Chart 15
Spain: average Social Security affiliations and registered unemployment (MM3 %, SWDA data)



Source: BBVA Research based on MESS and SEPE data

Chart 16
Spain: labour market indicators



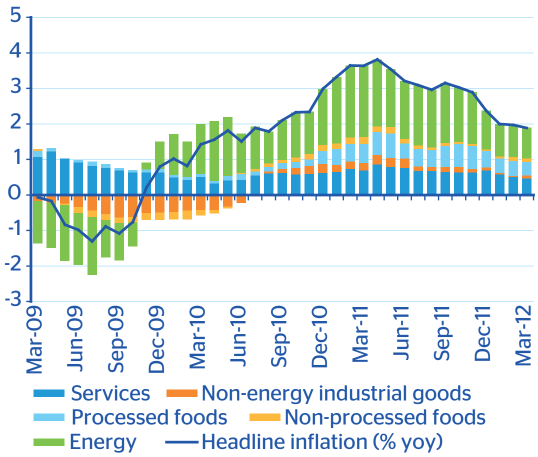
Source: BBVA Research based on INE data

4: Data for April shows that the labour market continued to deteriorate. Adjusting for seasonal and calendar effects, we estimate that there was a decrease of 71 thousand people affiliated to the Social Security and a 61 thousand increase in registered unemployment.

The downward trend in inflation is interrupted by increased oil prices

In the first quarter, both headline and underlying inflation remained relatively stable at around 2.0% yoy and 1.2% yoy, respectively. This brought to an end the downward trend in consumer prices seen since their peak in April 2011 (+3.8% yoy), corresponding to the absorption of the base effect generated by the rise in raw material prices at the end of 2010 and in early 2011, and tax changes in Spain in 2H10. This change in trend is, mainly, due to the recent increase in oil prices, which have resulted in average mom increases in the energy component of the CPI of around 1.8% in 1Q12 (+7.8% yoy). On balance, 1.0 pp of headline inflation at the end of the first quarter (1.9% yoy in March) can be attributed exclusively to the energy component and non-processed foods, whilst just 0.9 pp can be attributed to underlying inflation; together with the high level of unemployment, this continues to show the lack of demand pressure on inflation (see Chart 17)[5]. HICP data shows that the inflation spread with the rest of the euro area continued to be favourable for Spain by around -0.8 pp in the first quarter; at constant tax rates, the spread in 2H11 was around 0.1 pp according to figures for December 2011, the most recent available (see Table 1).

Chart 17
Spain: contributions to headline inflation growth



Source: BBVA Research based on INE data

Table 1
Spain: inflation spreads with respect to the euro zone

		Total	At constant tax rates
2008	1H	1.1	1.2
	2H	0.7	0.7
2009	1H	-0.7	-0.9
	2H	-0.4	-0.7
2010	1H	0.4	0.1
	2H	0.4	-0.4
2011	1H	0.7	-0.2
	2H	0.0	0.1
2012	**1Q**	**-0.8**	**n.a.**

Source: BBVA Research based on INE and Eurostat data

Forecasts for the Spanish economic continue to show recession in 2012 and slow growth in 2013

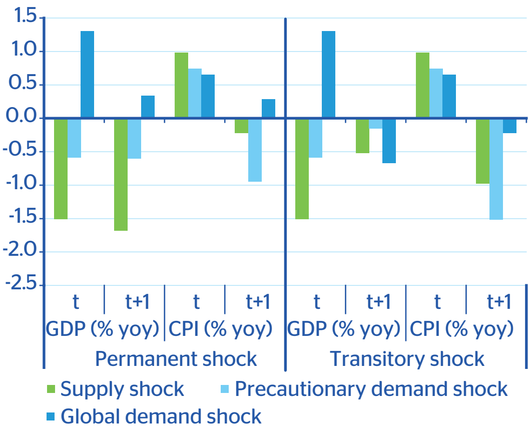
As we stated in the introduction to this section, despite some of the doubts inherent in economic policy having been dispelled, we continue to expect Spain's economy to deteriorate over the short term; the economy has gone into a double-dip recession and this will probably continue until the end of the year. Spain's growth outlook will continue to be subject to profound differences in regional performance, due to the various factors affecting macroeconomic scenario and the different starting points of the regions (see Box 1). We would once again highlight that the risks are on the downside and, given the country's need to access external finance, the current situation increases the likelihood of risk scenarios.

Instability in capital markets and sovereign debt in Europe will continue weighing on medium- and long-term finance costs in Spanish economy, although monetary policy and the ECB's non-conventional liquidity measures are likely to continue acting as a counterweight in the short term. The prospect of economic contraction in Europe will limit growth in export demand, although the contraction is likely to be somewhat smaller than expected three months ago and that global economic growth together with the weaker than expected euro will support it.

5: In line with our expectations, advance CPI figures show an increase in the annual inflation rate to 2.0%; this is mostly due to energy and food prices. In addition to the increase in fuel prices, this month was also affected by increases in regulated prices (gas and electricity) which came into effect at the start of the month. The price of processed foods was affected by the price of tobacco following the tax changes that took effect at the beginning of the month.

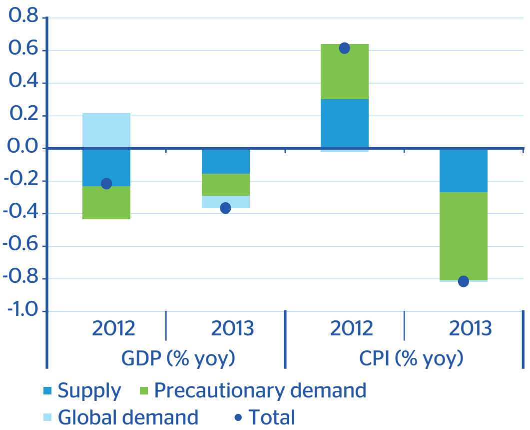
In addition to these external factors -which we had already partially incorporated into our scenario- there are also upward pressures on oil prices, and these represent an additional downside risk for growth and upside risk for inflation. Nevertheless, in the absence of domestic demand pressures on inflation in the EMU, we do not expect a contractive monetary policy in response to higher imported inflation; this, together with the transitory nature of the shock, will significantly limit impact on growth in Spain. In particular, whilst one of the causes behind current oil price rises is restriction of supply due to a partial cut in crude supplies from Iran, there is also upwards pressure from demand, both for precautionary reasons as a result of uncertainty, and because of expectations of high growth in emerging economies. Thus, whilst the impact on inflation will be substantial, this latter factor will offset the contractive effect on GDP, at least partially (see Charts 18 and 19)[6].

Chart 18
Spain: impact of a 30% increase in oil prices by type of shock (deviation from baseline scenario)



Note: in the case of transitory shocks, the oil price returns to its base trend in one year.
Source: BBVA Research

Chart 19
Spain: impact of recent oil price recovery on activity and prices (deviation from previous scenario)



Note: as we do not expect significant inflationary pressures from domestic demand at present, in this exercise the monetary policy responses to upwards price pressure from the shock realisation.
Source: BBVA Research

On the domestic front, the main factor affecting our scenario is the continuity of the correction in accumulated imbalances before and during the current economic crisis, which are having significant impact on growth, in line with our forecasts three months ago. Fiscal policy remains contractionary, and domestic demand will not offset this as it continues to be subject to deleveraging and weak fundamentals.

As we assumed in our previous edition, the Government has presented discretionary measures to correct the 2011 deviation from fiscal consolidation targets which, in the current economic climate, will reduce the deficit by 3.2 pp to 5.3% of GDP over the remainder of the year. As specified in Box 2, although the measures announced suggest that a global fiscal adjustment is possible, and that the government's objectives are achievable, specific measures to ensure strict compliance with the objectives established for the autonomous communities are lacking. These doubts, together with those resulting from the 2011 targets being missed, the significant scale of the fiscal consolidation now required in 2012 and the speed of implementation and cost of reforming the financial system, have resulted in a negative difference of Spanish public debt. This will limit any increase in confidence from the economic policy announcements, intensifying the negative impact of fiscal adjustment on the economy. Moreover, the recently announced budget measures focused more than expected on indirect taxes and investment expenditure, and this will do nothing to offset the negative impact of the adjustment.

Despite this, there are also a number of domestic factors that could have a positive effect on our scenario. Firstly, in the short term, the central government has launched a payment programme for autonomous communities and local corporation suppliers; this will release funds worth around 2.5% of GDP. As shown in Box 3, this liquidity-injection programme will have a positive effect on economic activity. However, the total effect of this will depend on the percentage of these obligations

6: Details of the structural VAR with sign restrictions from which these estimates have been prepared are contained in Box 1 of the May 2011 Spain Economic Outlook, which is available at: http://www.bbvaresearch.com/KETD/fbin/mult/1105_Situacionespana_tcm346-256519.pdf?ts=1742012.

that have already been discounted by creditors, and their liquidity. Secondly, the labour market reform approved in February[7] could facilitate the rebalancing needed between the extensive margin (workers employed) and the intensive margin (number of hours worked and remuneration)[8] and reduce segmentation, if it is implemented immediately and effectively. However, this will not stop the economy shedding jobs in the short term. These measures will establish the foundations for a more robust medium-term recovery and will increase the economy's long-term potential growth. Box 4 provides an assessment of the labour market reform and suggests some areas for improvement and complementary measures.

Having discounted these factors and others with more limited impact on our February forecasts, we expect the Spanish economy to continue reporting negative qoq growth over the coming quarters. In our most likely scenario, this involves GDP contracting by 1.3% over 2012 as a whole. We also expect the recovery starting in 2013 to be slow, with positive, but slight, GDP growth of around 0.6% for the year as a whole (see Table 2). Despite the labour market reform, the prospect of a contracting economy will result in the labour market deteriorating over the current year: employment figures will continue to worsen in 2012 and the first half of 2013, triggering a rise in unemployment rates to around 25%, despite an expected drop in the active population.

Table 2
Spain: macroeconomic forecasts

(yoy %, unless otherwise indicated)	1Q11	2Q11	3Q11	4Q11	1Q12 (f)	2011	2012 (f)	2013 (f)
National Final Consumption Expenditure (FCE)	0.4	-0.8	-0.6	-1.8	-2.4	-0.7	-3.6	-2.1
Private FCE	0.4	-0.3	0.5	-1.1	-1.3	-0.1	-2.0	-0.9
Household FCE	0.4	-0.3	0.5	-1.1	-1.3	-0.14	-2.0	-0.9
Public Administration FCE	0.6	-2.1	-3.6	-3.6	-5.4	-2.2	-8.0	-5.6
Gross capital formation	-4.8	-5.4	-4.2	-6.6	-7.5	-5.2	-7.5	-1.0
Gross fixed capital formation	-4.9	-5.4	-4.0	-6.2	-7.3	-5.1	-7.4	-1.0
Fixed material assets	-5.3	-5.6	-4.3	-6.5	-7.5	-5.4	-7.8	-1.2
Equipment, machinery and cultivated assets	5.5	1.0	2.2	-2.7	-4.3	1.5	-4.5	2.9
Equipment and machinery	5.7	1.1	2.2	-2.7	-4.3	1.6	-4.6	2.8
Construction	-9.2	-8.1	-7.0	-8.2	-9.0	-8.1	-9.2	-3.2
Housing	-5.8	-5.2	-4.1	-4.3	-6.0	-4.9	-6.6	-1.6
Other buildings and constructions	-12.4	-10.8	-9.7	-11.9	-11.8	-11.2	-11.8	-4.9
Intangible fixed assets	1.5	-3.1	2.0	-0.3	-4.0	0.0	-2.3	2.4
Domestic demand (*)	-0.8	-1.9	-1.4	-2.9	-3.5	-1.8	-4.5	-1.8
Exports	13.1	8.8	9.2	5.2	3.2	9.1	4.0	8.9
Imports	6.0	-1.3	0.9	-5.9	-7.0	-0.1	-6.2	1.6
Net trade balance (*)	1.7	2.7	2.2	3.2	3.1	2.5	3.1	2.4
GDP at mp	0.9	0.8	0.8	0.3	-0.5	0.7	-1.3	0.6
Pro-memoria:								
GDP w/o housing investment	1.5	1.3	1.2	0.6	-0.1	1.2	-0.9	0.7
GDP w/o construction	2.9	2.5	2.2	1.7	1.0	2.3	0.0	1.1
Employment (LFS)	-1.3	-0.9	-2.1	-3.3	-4.0	-1.9	-4.6	-2.0
Unemployment rate (% active pop.)	21.3	20.9	21.5	22.8	24.4	21.6	24.6	24.8
Employment (FTE)	-1.6	-1.3	-2.0	-3.3	-3.8	-2.0	-4.3	-2.0

(*) Contribution to growth
Source: BBVA Research based on INE data

7: Royal Decree-Law 3/2012, of 10 February, concerning urgent measures to reform the labour market, available at: http://www.boe.es/boe/dias/2012/02/11/pdfs/BOE-A-2012-2076.pdf.
8: Because of the rigidities facing companies and workers when changing working conditions -particularly working hours- the adjustment to the Spanish labour market has focused on employment rather than on the number of hours worked. Refer to the February 2012 Spain Economic Outlook, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1202_Situacionespana_tcm346-286235.pdf?ts=942012.

The deterioration in fundamentals will result in significant weakening of domestic demand and imports, and a slowdown in exports

The measures presented to correct the amount by which the 2011 public deficit target was missed and to enable the 2012 target to be achieved require a downward adjustment in public spending, in the real terms under Spanish National Accounts, resulting in an 8.0% reduction in public consumption and a 5.6% reduction in investment in non-residential construction in 2012. This contraction would extend into 2013, when we estimate there would be a 5.6% reduction in public consumption and a 4.9% reduction in other construction investment.

The expected deterioration in the factors determining private consumption points towards a decrease in spending throughout the whole of 2012 and the first half of 2013. The deterioration in employment will trigger a decline in the wage component of household gross disposable income. Furthermore, increasing fiscal pressures due to the country's structural efforts to meet public deficit targets will reduce the non-wage component despite possible transitory increases in the volume of unemployment benefits. Net financial wealth will not recover until 2013, while real estate will continue to fall over the entire forecast horizon. The contraction in private consumption over the next two years will however be limited by a reduction in household saving rates to below pre-crisis level, the absence of inflationary pressures and the stabilising of official interest rates at low levels.

Capital goods investment will continue to be influenced by the weakness of domestic demand and difficulties accessing credit. Nevertheless, a slightly smaller deterioration in the European economy than we expected three months ago, and a larger than expected euro depreciation, will result in the fall in 2012 business investment being slightly smaller than previously forecast, although this will remain significant (-4.6% yoy). In 2013, there will be a recovery in business investment (+2.4%), supported mainly by the increased competitiveness of exporters and higher foreign demand.

There have been no significant changes affecting housing investment in the three months since our last publication. The deterioration of the economy and the financial tensions that are continuing to make it difficult to access credit will determine how the residential market performs in 2012. We do not expect the fiscal measures that came into effect at the start of the year[9] to have a significant impact on short- or medium-term investment. Figures for residential investment towards the end of last year are illuminating as the temporary reduction in VAT on housing to 4% introduced in September 2009 does not seem to have had much influence. As a result, we continue to expect a reduction in residential investment of around 6.6% yoy in 2012, with recovery commencing, albeit somewhat slowly, towards the end of 2013 (-1.6% yoy for the year as a whole). These forecasts for the Spanish economy as a whole mask widely differing pictures in different regions; these differences will probably be maintained due to the varying rhythms at which regional real estate markets adjust, the differing financing needs of regional governments and different growth rates among the regions.

Finally, there has been an improvement in the outlook for exports over 2012-2013 compared to our previous forecasts. This improvement is due to the upward revision of EMU growth forecasts and expected improvements to price competitiveness, which have been particularly marked this year, due to the larger than expected depreciation of the euro and favourable development of pricing spreads with Spain's major trading partners. This leads us to expect that exports of goods and services will grow by 4.0% in 2012, although this is a significant slowdown compared to growth in the previous two years (13.5% and 9.1% in 2010 and 2011, respectively)[10]. In 2013, once the European economy begins to grow more strongly, Spanish exports will return to more vigorous growth rates of up to around 8.9%. Imports have been revised downwards due to the effects of domestic demand, with net external demand making a strong contribution to economic growth and correcting the current account deficit in 2012-2013; the latter effect is despite the negative impact expected on external funding requirements from the temporary oil price increase[11].

9: Recovery of the deduction for housing purchases for middle- and high-income on permanent contracts, and continuation of the very low VAT rate in 2012.
10: The closure of markets in the southern Mediterranean explains a major part of the positive results for tourism in 2011 and could continue having a positive impact in 2012.
11: Current estimates show a 25% oil price increase impacting on the current account balance by around 0.7 bp of GDP.

Box 1. Regional economies: external openness and varying impact of fiscal adjustment, keys to uneven growth

Following the negative figures for late 2011, data for Spain's regions shows a general deterioration in activity in the first quarter as in the whole economy. The domestic factors behind this have not changed, and will possibly continue impacting on the development of each autonomous community throughout 2012 and 2013, whilst exports may return to positive territory following the adjustment at the end of the year.

The crisis is dominated by a number of common factors that have led to recession in the national economy as a whole and in all communities: the sovereign debt crisis, financing difficulties, fiscal consolidation need and private deleveraging requirements, high unemployment and weak domestic demand. This is combined with an international slowdown, which is particularly acute in Europe. Nevertheless, different starting points, the adjustments that need to be made and the size and urgency of these mean that the impact will vary from region to region, leading to widely variable growth rates.

The global growth expected results from the relative dynamism of foreign markets, particularly emerging economies, combined with the incipient recovery in the USA; but this is held back by weakness in Europe. External demand continues to outperform domestic demand. As a result, regions with the strongest external trade links are likely to benefit from the relatively higher contribution of foreign demand. This positive performance by goods for the foreign sector has had a positive effect on growth in some autonomous communities in 2011 and 2012, such as the Basque Country, Navarre and, to a lesser extent, Catalonia, Galicia and La Rioja (due to their commercial relations with the euro area). The impact of foreign trade also depends to a degree on destination markets: focus on emerging markets will enable foreign trade to make a larger contribution, whilst a focus on economies in difficulties (such as Portugal) will hamper recovery.

The relative advantage of exports also extends to services. In particular, in 2011 tourism benefitted from the closure of markets to the south of the Mediterranean, enabling the Canary and Balearic Islands to take advantage (the former with growth of over 2%). Although the share of foreign tourism in total tourism, and of this in the economy as a whole, is lower in the Canary Islands, the industry in the Atlantic islands has benefitted from tourist demand, and this explains why they outperformed the Balearic Islands. In 2012, both of these markets will probably continue to benefit from the closure of competitor markets and, to a lesser extent, from the depreciation of the euro, which offsets to some extent increased transport costs resulting from higher oil prices.

Two other autonomous communities also benefitted from foreign tourism in 2011, and this will continue in 2012: Catalonia, which continues to be the main tourist destination, and Madrid. However, in both of these, and the latter in particular, the impact of this sector on the economy is relatively small. Other tourist communities have a stronger orientation towards badly depressed domestic tourism, and this will limit their capacity for growth, both in goods and in tourism, which explains their weaker performance in 2011 and 2012.

Short- and medium-term economic performance will be conditioned by two factors. The regions with the lowest levels of income, highest unemployment rates and most reliance on the public sector will be the most affected by the central government's fiscal consolidation and by greater dependence on transfers to maintain income levels. These aspects particularly affect the autonomous communities in the southern Mediterranean, Castile-La Mancha and the Canary Islands. On the other hand, the higher unemployment levels in these communities mean that they may benefit more from the labour market reform.

This situation is worsened by household and company borrowing levels being higher in the Mediterranean regions and the Canary Islands as a result of real estate expansion. The adjustment process to correct this imbalance has commenced; however, lower household incomes and company profits, together with the difficult outlook for 2012, mean that this will continue to be a drag on domestic demand. The savings rate in these autonomous communities is also lower than those in the north, so it is more difficult for reduced incomes to be offset from indebtedness or by dissaving.

There are also substantial differences in the public sector in terms of regional government debt and deficits. Catalonia and the Valencia Community have debt levels close to 20% of their GDP, which is more than double the level in Madrid and the Basque Country. This brings with it additional financing difficulties, relatively high interest costs and a resulting need for greater deficit adjustments in other areas. All autonomous communities, except Madrid, failed to meet their 2011 deficit targets, with the whole of the remaining adjustment (or a large part of it at least) now being due in 2012.

The target for this year has greater credibility as a result of changes in the control rules for regional governments, approval of the Budget Stability Law and the need to access financing mechanism supported by the central government such as the Supplier Payment Programme. However, this will require some communities to make substantial consolidation efforts, and this will impact on their domestic demand. Some of these measures (such as the Supplier Payment Programme) can involve an injection of liquidity which will to some extent offset the effects of consolidation, reducing but not eliminating the differences that would otherwise have been existed with the pending commercial debt.

The Stability Programme update provides information on the amounts and areas on which the measures proposed by regional governments in their adjustment plans will focus (EUR 9.7 Bn). These measures will be reinforced by central government measures affecting regional government accounts, such as those relating to the national health service, dependency and education (EUR 5.5 Bn in 2012). Distributing the impact of the measures in these three areas by the population of each autonomous community gives deficit adjustment forecasts that make it realistic for the autonomous communities as a whole to meet the deficit target. These adjustments show (as was bound to be the case) greater efforts through their own resources in the communities with the greatest need to adjust their accounts, which are those which will suffer the largest contractions in demand from the adjustment in public investment and consumption. However, the figures published to date do not consider two aspects that may have a serious impact on whether the objective can be achieved: firstly, the final additional measures for each community agreed at the next Fiscal and Financial Policy Council in mid-May; and any deviations due to further cyclical deterioration, particularly to income, not included in the assumptions used in preparing the autonomous communities budgets.

Overall, and given the lag in spending cuts and increased income impacting on private activity, we expect the greatest impact to occur from the large fall already experienced in 2011 through into 2012 in Catalonia (and the regions with the smallest adjustment needs), whilst the impact will continue into 2013 for autonomous communities with larger fiscal consolidation needs and those which are slow in implementing the necessary measures.

The outlook for next year is somewhat milder: a return to growth in Europe, although this will be weak; continued depreciation of the euro; lower financing tensions; reduced adjustment needs (due to progress made in 2012); and a slight correction in oil prices. This will enable all communities to return to growth, although against a background of continuing weak domestic demand. Growth will be somewhat stronger in the regions with the highest international exposure and those with the lowest fiscal adjustment needs. The island communities are an exception to this, as the advantages they have gained from the closure of some of their competitor markets could begin to dissipate.

Table 3

Spain: GDP growth by autonomous communities (%)

	2011	2012 (f)	2013 (f)
Andalusia	0.1	-1.8	0.3
Aragon	0.3	-1.6	0.5
Asturias	0.3	-1.4	0.9
Balearic Islands	1.7	-0.4	1.0
Canary Islands	2.1	-0.5	0.5
Cantabria	0.7	-1.2	0.6
Castile & León	1.2	-0.7	1.0
Castile La Mancha	0.8	-2.3	0.2
Catalonia	0.8	-1.6	0.8
Extremadura	-0.3	-1.8	0.5
Galicia	0.2	-1.1	0.7
Madrid	0.8	-0.6	1.0
Murcia	-0.1	-1.7	0.5
Navarre	1.4	-0.5	0.7
Basque Country	1.3	-0.6	0.7
La Rioja	0.8	-1.4	0.7
Valencia Community	0.4	-2.2	0.2
Spain	**0.7**	**-1.3**	**0.6**

Source: BBVA Research

Table 4

Adjustment to 2012 autonomous communities public accounts under the 2012-2015 Stability and Growth Plan (% of regional GDP)

		Measures in autonomous communities adjustments plans				
	2011 deficit	Expenditure	Revenue	Total	Central Government measures impacting autonomous communities (*)	Total announced measures
Madrid	-1.1	0.1	0.0	0.1	0.4	0.5
Galicia	-1.6	0.5	0.1	0.6	0.6	1.2
Canary Islands	-1.8	0.3	0.3	0.7	0.6	1.3
Navarre	-1.9	0.1	0.5	0.6	0.4	1.0
La Rioja	-2.0	0.5	0.9	1.3	0.5	1.8
Castile & León	-2.4	0.2	0.3	0.5	0.5	1.0
Basque country	-2.6	0.4	0.0	0.4	0.4	0.8
Aragon	-2.9	0.9	0.1	1.0	0.5	1.5
All autonomous communities	-2.9	0.5	0.4	0.9	0.5	1.4
Andalusia	-3.2	0.0	0.8	0.8	0.7	1.5
Asturias	-3.6	1.5	0.0	1.5	0.6	2.1
Valencia Community	-3.7	0.6	0.2	0.7	0.6	1.3
Catalonia	-3.7	0.4	0.8	1.2	0.4	1.6
Balearic Islands	-4.0	0.0	0.0	0.0	0.5	0.5
Cantabria	-4.0	1.0	0.2	1.2	0.5	1.7
Murcia	-4.3	1.4	0.8	2.2	0.6	2.8
Extremadura	-4.6	1.7	0.1	1.7	0.7	2.5
Castile La Mancha	-7.3	4.8	0.5	5.2	0.6	5.9

(*) Measures affecting the national health service, dependency and education. Amounts distributed by population weight
Source: 2012-2015 Stability and Growth Plan (MINHAP) and BBVA Research

Table 5

Autonomous Communities risk indicator map

	MAD	BAS	NAV	ARA	CANT	CYL	AST	RIO	CAT	CANA	GAL	VAL	BAL	MUR	CLM	EXT	AND
Short-term synthetic indicator	0.9	0.9	1.2	1.3	1.2	1.5	1.4	1.4	1.5	1.8	1.4	2.0	1.8	1.8	1.8	1.8	1.8
Excess housing supply	1	1	1	2	1	2	1	3	2	2	2	2	2	2	2	0	2
Adjustment to housing prices from peak	1	3	2	0	2	2	2	1	1	2	2	2	2	2	2	3	1
External sector diversification	2	2	3	3	1	3	1	1	2	1	2	2	1	1	1	2	1
Private sector leverage	1	1	2	1	1	1	1	1	2	2	1	2	2	2	2	2	2
Unemployment rate	1	0	1	1	1	1	2	2	2	3	1	2	2	2	2	2	3
Autonomous community debt (% GDP)	1	1	2	2	1	1	1	2	3	1	2	3	2	2	3	2	1
Relative per capita GDP	0	0	0	2	2	2	2	2	1	2	2	2	2	2	2	2	2
Exposure to foreign markets (goods and tourism)	2	1	0	2	2	2	2	2	1	1	1	2	1	1	2	3	2
Household saving rate	2	1	0	1	1	2	2	1	2	3	2	2	3	2	1	1	2
Economic freedom index	0	1	1	2	2	1	2	1	2	1	2	2	1	2	2	3	3
Human capital	0	0	1	1	1	2	1	2	2	2	2	2	2	2	3	3	2
R&D / GDP	0	0	0	2	2	2	2	2	1	2	2	2	3	2	2	2	2
Infrastructure / PET	2	1	1	1	1	1	1	2	2	2	2	2	3	3	2	2	3
Long-term synthetic indicator	0.4	0.4	0.6	1.1	1.2	1.1	1.3	1.3	1.3	1.7	1.9	1.9	2.3	2.3	2.3	2.4	2.4

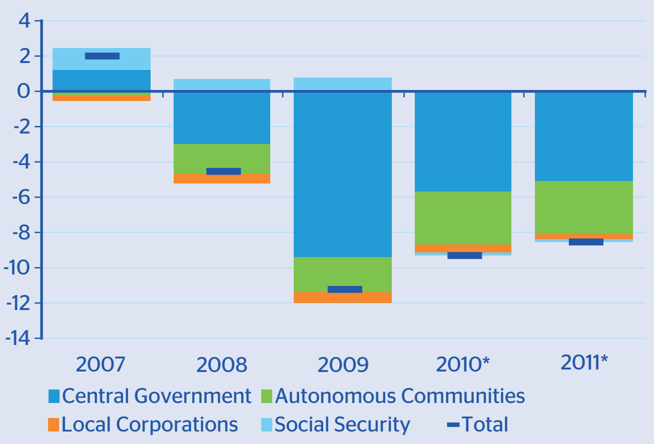
Source: BBVA Research

Box 2. Unprecedented fiscal adjustment

Despite the fiscal adjustment and spending control policy implemented in mid-2010 continuing throughout 2011, by year end the General Government deficit stood at 8.5% of GDP (see Chart 20), well in excess of the 6% target for the year. As can be seen in Chart 21, targets were missed at all levels of government, although most of the 2.5 pp of GDP overshoot was due to the autonomous communities (1.6 pp) and Social Security departments (0.5 pp). The breakdown of this substantial deviation from the 2011 deficit target reveals: firstly, the ineffectiveness of control mechanisms on the autonomous communities, which have been fundamentally strengthened through the 13 April Budget Stability Law; and the significant pressure that continued deterioration in the labour market is placing on Social Security spending.

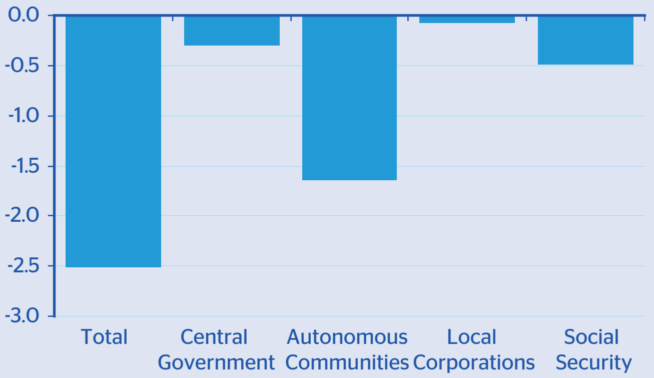
It is particularly important to analyse the public accounts and the reasons for such a large deficit overshoot, so that we can assess the effectiveness of the fiscal adjustment measures proposed to get the public deficit on track to come down to 3% of GDP by the end of 2013. To this end, in this Box we analyse the structural breakdown of revenues and expenditure for the public administrations so that we can assess what part of the adjustment to the public accounts can be attributed to automatic stabilisers over the business cycle, and what part is due to discretionary fiscal policy decisions.

Chart 20
Public Administration: net lending (+) / net borrowing (-) (% of GDP)



(*) Not including the effect of the deficit financing of regional administrations.
Source: BBVA Research based on MINHAP data

Chart 21
Public Administration: deficit 2011. Deviation from target (-6.0%) (pp of GDP)



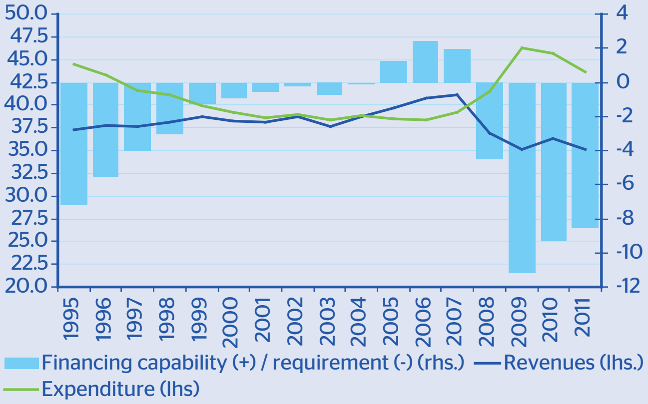
Source: BBVA Research based on MINHAP data

The 2011 deficit target was missed due to lower than planned reductions in structural spending and worse than expected cyclical deterioration

The depth of the current economic crisis ended the fiscal consolidation process that had begun in the mid-1990s to meet the entrance criteria for the euro, ending the longest period of budget stability in Spain in the last forty years. As can be seen from Chart 22, this consolidation process focused mainly on reducing public expenditure, which fell by 5.2 pp of GDP from the mid-1990s to 2007, whilst public revenues increased by 3.9 pp over the same period. The eruption of the crisis and the launch of counter-cyclical policy measures to offset its effects led to public spending increasing to 46.3% of GDP at the end of 2009; this level is similar to that in the early 1990s. However, at the same time, public revenues fell to mid-1980s levels (35.1%). This resulted in the deficit for the public administration as a whole rising to 11.2% of GDP in 2009. The fiscal stimulus programmes ended once the first signs of the crisis easing were observed. This was followed by implementation of fiscal consolidation in 2010; as we have seen, the results of this have been modest, particularly in 2011.

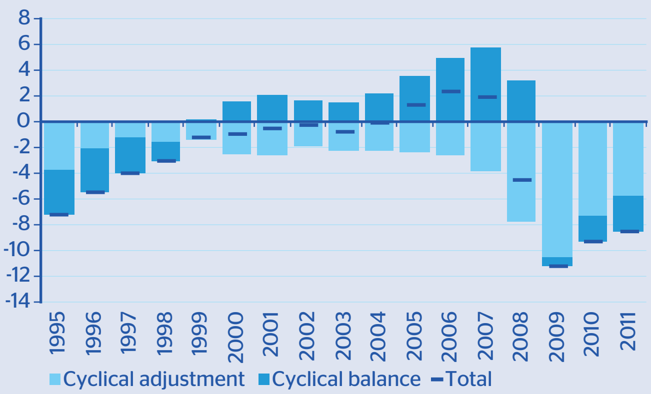
Removing the cyclical component (see Chart 23), in the previous fiscal consolidation period the adjustment was mainly structural until the end of the 1990s. From 2000 to 2007, the improvement in the public accounts was due to the effect of automatic stabilisers, as the structural balance remained practically constant at an average of around -2.5% of GDP. In the current fiscal adjustment we can see how the cyclically-adjusted finances are correcting themselves, but not sufficiently to offset cyclical deterioration, which is still damaging the Spanish economy.

Chart 22
Public Administration: net lending (+) / net borrowing (-) (% of GDP)



Source: BBVA Research based on MINHAP data

Chart 23
Public Administration: breakdown of net lending (+) / net borrowing (-) (% of GDP)

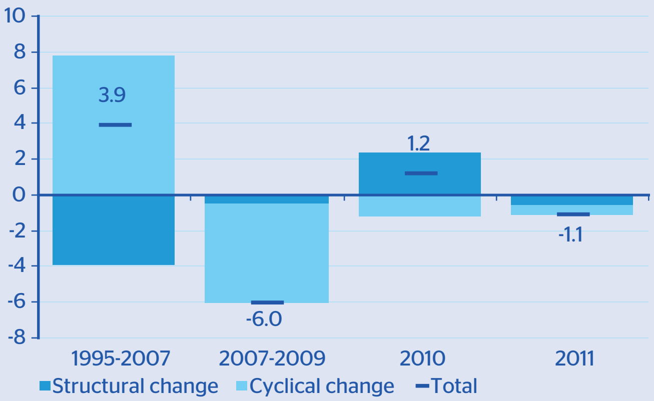


Source: BBVA Research based on MINHAP and INE data

This development in the public finances is the result of differing performance by revenue and expenditure. As with the deficit, during the period of consolidation from 1995 to 2007, the increase in revenues (see Chart 24) of 3.9 pp of GDP was supported by cyclical growth (around 7.8 pp of public revenues), whilst the structural component fell by 3.9 pp, due mostly to lower personal income tax. In 2008 and 2009, the cyclical deterioration of the economy drained slightly more than 5.5 pp of GDP from public revenues; this was in addition to a structural reduction in revenues of around 0.5 pp of GDP, mainly due to a fall in the tax base resulting from developments in the real estate market and significant reductions in business profits[12]. Over the last two years, discretionary tax rises raised structural revenues, offsetting the cyclical fall in revenues so that total public revenues as a percentage of GDP remained practically constant in 2010 and 2011.

As is to be expected, given their fundamentally discretionary nature, automatic stabilisers had lower impact on public expenditure. As can be seen from Chart 25, during the two periods of consolidation analysed there were significant changes to the structural (or discretionary) component of expenditure; in 1997-2007 this was accompanied by a cyclical improvement related to lower interest rates and improvements in the labour market. Likewise, the increase in public spending in 2008 and 2009 was mainly due to discretionary fiscal stimulus measures which, together with the structural increase in unemployment, increased cyclically-adjusted expenditure by 6.2 pp to levels similar to those in the early 1990s. Finally, whilst the fiscal consolidation measures implemented resulted in a generalised adjustment in the structural component of all expenditure items in 2010 and 2011 (except interest payments and unemployment benefit), this was not as intense as anticipated in the 2011-2014 Stability and Growth Programme (PEC 2011-2014) and was not sufficient to achieve the 6.0% deficit target in 2011. Thus, the failure to achieve the 2011 stability objective is explained by this deviation in expenditure reductions, together with a much larger fall in cyclical revenues than expected in the PEC 2011-2014.

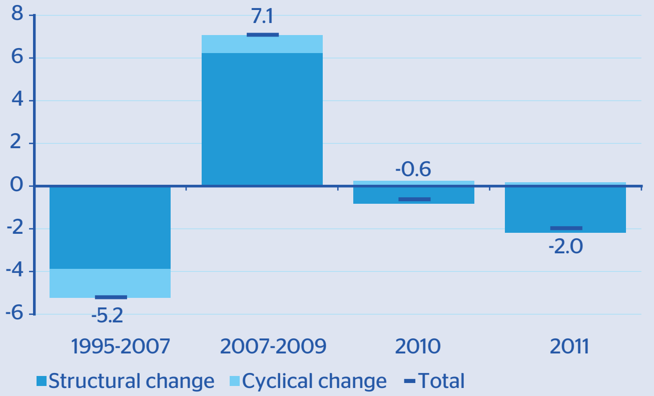
Chart 24
Public Administration: non-financial revenues (pp of GDP)



Source: BBVA Research based on MINHAP and INE data

12: Refer to Box 1, "Recent trends in public administration non-financial resources: a structural view", in Spain Economic Outlook November 2011, for more information on the behaviour of public revenues during the crisis.

Chart 25
Public Administration: non-financial expenditure (pp of GDP)



Source: BBVA Research based on MINHAP and INE data

An adjustment of 5.1 pp of GDP is required to reduce the deficit to 5.3% of GDP in 2012. The measures implemented confirm the unprecedented intensity of this fiscal adjustment

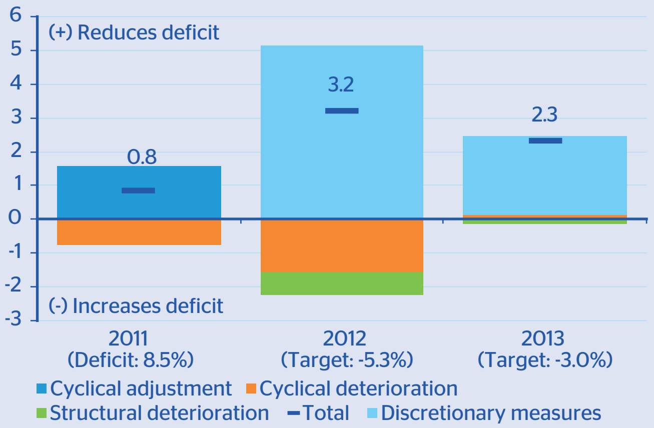
The scale of the overshoot (2.5 pp of GDP) of the 2011 deficit target transfers the fiscal consolidation pressure to 2012 and 2013, concentrating the adjustment measures planned for this year to achieve the deficit target of 3% of GDP in 2013. As a result, the public deficit has to reduce by 5.5 pp of GDP over the next two years, in addition to the effect of economic deterioration on the deficit, which has been estimated to be as much as 2.0 pp of GDP. The total volume of fiscal adjustment measures required to achieve the deficit target for the end of 2013 is therefore around 7.4 pp of GDP, of which 5.1 pp relate to 2012 (see Chart 26).

Measures amounting to 2.4 pp of GDP have already been announced for 2012 (PGE 2012), with an additional 0.5 pp in the 2012-2015 Stability and Growth Programme recently submitted to Brussels for approval. Taken as a whole, these measures make it feasible that the central government will meet its stability objective in 2012, as these measures should be sufficient to reduce the deficit by 1.6 pp of GDP to 3.5% of GDP, whilst offsetting, in part, expected cyclical deterioration.

Thus, pressure is continuing on the autonomous communities to meet the target for Spanish General government they will need to announce further measures to those already announced in order to meet the 2012 deficit target of 1.5% of GDP. The Fiscal and Financial Policy Council (FFPC) planned for the first half of May 2012 has to approve the revised adjustment plans submitted by the autonomous communities, which must include the measures required to complete the fiscal adjustment.

However, the measures being adopted are raising confidence that the fiscal objectives will be achieved. Although any additional deterioration in economic conditions could put at risk the objective of stability for the public administrations, the Government has a degree of room for maneuvre in achieving its deficit target. Approval of the new Budget Stability Law and the implementation of the Supplier Payment Programme strengthen the central government's control over the accounts of the regions. In addition, the Government has announced a calendar of structural reforms and privatisations that will bring in additional funds, relieving pressure from the financial markets on public debt either by directly reducing the deficit or by reducing borrowing requirements.

Chart 26
Public Administration: contribution to fiscal adjustment (pp of GDP)



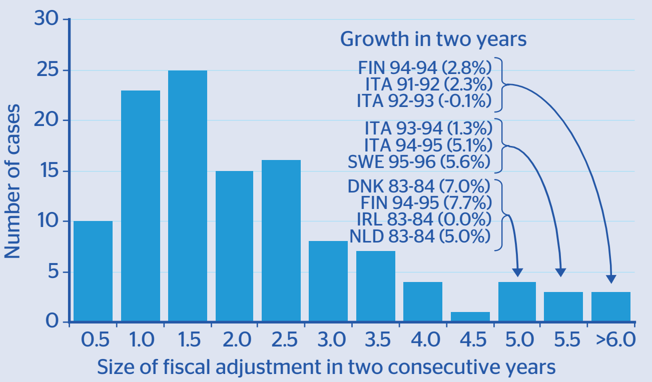
Source: BBVA Research based on MINHAP and INE data

This commitment to budget stability was ratified in the 2012-2015 Stability and Growth Programme (PEC 2012-2015) approved by the Central Government on 27 April, which will continue the deficit reduction until 2015, achieving budget balance in 2016 (0% of GDP). However, it is worth noting that the size of the 2012 fiscal adjustment is practically unprecedented in a developed country (see Chart 27), particularly as it is taking place at a time of economic contraction. In these circumstances, the structural deficit that would be achieved by meeting the 2012 stability objective would be somewhat higher than 2% of GDP (see Chart 28). In fact, if the 3% of GDP deficit target is achieved in 2013, we estimate that the general government will have achieved a structural balance around the target level of 0% of GDP, seven years ahead of the target date for this set in the new Budget Stability Law and the Treaty on Stability, Coordination and Governance.

In order to achieve the stability objectives proposed in the PEC 2012-2015, the Government has announced a fiscal devaluation for 2013, reducing taxes on employment but increasing taxes on consumption, with the increase in indirect taxes expected to generate EUR 8 Bn (0.7 pp of GDP). Calculations by BBVA Research find that the volume of tax collection announced is equivalent to a 2 pp increase in tax on consumption, as every additional point of this type of tax is estimated to collect around EUR 3 Bn. If, as BBVA Research has proposed in the past, this is accompanied by a 3.5 pp reduction in employer Social Security contributions, the impact on tax collection would be neutral, but there would be a positive impact on GDP in excess of 1% in 2013 and 2014[13].

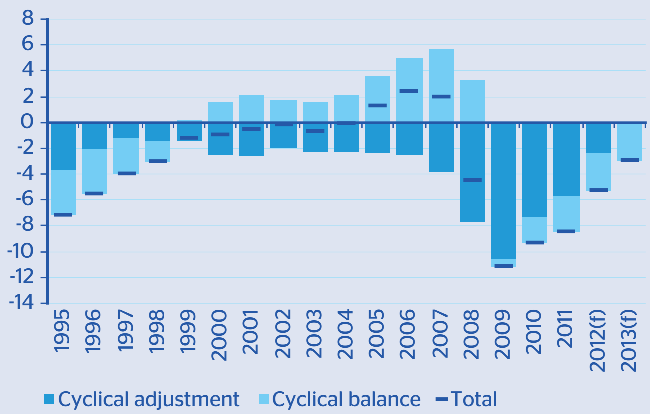
Such measures would stimulate growth in the short term, and would meet the need to strike a balance between cleaning up the public accounts and ensuring economic recovery. However, any such change in the orientation of economic policy is dependent on consensus at the European level. A European-level strategy would therefore be recommendable in line with the spirit of recent improvements to governance (the *fiscal compact*). This should determine a more gradual adjustment from 2013 onwards, focusing on the announcement of sufficiently detailed multi-year measures and structural deficit targets, rather than setting nominal objectives and announcing pro-cyclical measures with adverse and counterproductive effects on countries with a solid commitment to meeting their fiscal objectives and approving structural reforms.

Chart 27
Size of fiscal adjustment in OECD, 1978-2009 (pp of GDP)



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

Chart 28
Public Administration: net lending (+) / net borrowing (-)(% of GDP)



Source: BBVA Research based on MINHAP and INE data

13: Refer to "Three structural reforms for the Spanish labour market" in Spain Economic Outlook, March 2009.

Box 3. The impact of the Supplier Payment Programme

At the end of February, the Government announced the launch of a mechanism to pay off the outstanding debts of autonomous communities and local corporations with their suppliers at 31 December 2011. This involved the creation of the Supplier Payment Finance Fund, a new body which will gather funds from a syndicated bank loan backed by the Public Treasury to provide finance to local government bodies to pay their suppliers. This finance to the autonomous communities and local corporations will have a maturity of ten years, with a two-year interest only grace period. Servicing of the debt will be guaranteed through retention of the local entities share of state tax receipts and other resources from the finance system for the autonomous communities. The cost of the credit will be the same as other operations backed by the central government, with a maximum margin of 115 basis points above the Treasury's finance costs, to which a maximum intermediation margin of 30 bp will be added. These are very favourable terms, particularly when compared to what these bodies could currently obtain in capital markets. Being aware of the moral risk this could lead to in future, and taking advantage of the plan to boost the fiscal consolidation process, Central government requires the bodies to submit an adjustment plan before they can access this finance[14].

The Government required local corporations to submit a list of debts and creditors by 15 March, and this revealed obligations amounting to EUR 9.5 Bn (0.9% of GDP). The Government implemented the same procedure for the autonomous communities, announcing preliminary figures of debts with suppliers amounting to EUR 17 Bn (1.6% of GDP)[15]. This programme is voluntary, but only Galicia, Navarre and the Basque Country have chosen not to participate.

Our objective here is to estimate the effect that this injection of liquidity will have on the Spanish economy. In particular, the effect on activity will crucially depend on the propensity to spend of the beneficiaries of the programme. The beneficiaries may well not be the companies themselves, as it is likely that they will already have discounted some of the amounts owed to them with financial institutions, through activities such as invoice factoring. In such cases, the liquidity injection will benefit the current owners of the debt. This is also to be welcomed, as it will improve the liquidity of the financial institution involved; however, this will probably take some time to filter through to lending and, therefore, economic activity, particularly given the current tensions in finance markets. Moreover, even if a large part of this debt has not been discounted, the companies that benefit from the liquidity injection may not want to spend these funds, and may instead choose to reduce their own debts or increase their savings. Such behaviour is likely to be encouraged by current economic uncertainty.

Taking these aspects into account, Chart 29 shows the impact of this programme on Spain's economy as simulated using the REMS model[16]; this makes assumptions about the percentage of debt already discounted with the financial system (horizontal axis) and the degree of liquidity restrictions on economic agents (and therefore their ability to spend any cash injection immediately). The larger the percentage of debt discounted with the financial system, the lower the impact of the programme on the economy is likely to be. The higher the propensity to consume (and therefore the less of any cash injection used for paying down debt or savings), the greater the potential effect on GDP. What is the most likely scenario? It is difficult to answer this question as we have no aggregate statistics on the volume of public debt discounted with financial institutions by companies. However, we do know the volume of commercial credit pending payment and advances from non-financial companies, the total of which was EUR 496 Bn in 2011.

Using data from Spain's Invoice Factoring Association (AEF), and considering its market share, this business may have been worth EUR 86 Bn in 2011[17] This amounts is the 17% of all commercial credits pending payment for non-financial companies. However, in today's world of increasing deficits, contracting private activity and the guarantees that come from the public sector, it is likely that this share would be higher for debts which are ultimately the responsibility of a government body. Therefore, although the simulation results we have presented assume 20% of debts have been discounted, the actual level could be far higher. The REMS core scenario also assumes that 50% of economic agents have restricted liquidity (and therefore are less likely to spend any cash injection immediately). A most likely scenario assuming a third of all debt has been discounted and that 50% of agents have restricted liquidity results in positive impact on 2012 GDP of almost 7 tenths of a point of additional activity this year; however, uncertainty about the values of some of the parameters means the actual additional impact could fall anywhere within the range 4 tenths to 1 whole point.

14: For more details of the functioning and characteristics of the supplier payment programme, refer to the website of the Ministry of Economy (MINHAP) (http://www.minhap.gob.es/es-ES/Servicios/Paginas/Mecanismodefinanciaci%C3%B3nparaelpagoaproveedoresdeEntidadesLocalesydeComunidadesAut%C3%B3nomas.aspx).
15: The government has announced that these figures are preliminary for the autonomous communities and for town councils.
16: For details of the model, consult Boscá, José E., Rafael Doménech, Javier Ferri and Juan Varela, The Spanish Economy: A General Equilibrium Perspective, Palgrave Macmillan, 2011.
17: On its website (http://www.factoringasociacion.com/), the AEF states that the value of invoice factoring nationally was EUR 64.4 Bn in 2011, explaining that it covers nearly all specialist credit entities; this leads us to assume that they represent "75%" of Spain's total Factoring and Confirming® market. The EUR 86 Bn quoted in the text is calculated from EUR 64 Bn divided by the market share (75%).

Chart 29

Impact of Supplier Payment Programme on GDP (pp of GDP)

Source: BBVA Research

Box 4. The Labour Market Reform: towards greater competitiveness

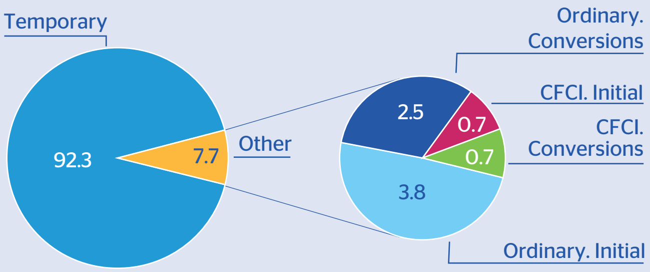
Accurate diagnosis and positive assessment

Royal Decree-Law 3/2012, of 10 February, concerning urgent measures to reform the labour market[18] accurately diagnoses the main problems in Spain's labour market, including lack of internal flexibility and the division between temporary and permanent contracts. We have a generally positive opinion of the reform, as it represents a substantial step forward compared to previous labour market regulations, mainly in relation to the problems mentioned above; however, the measures adopted to tackle the latter problem appear insufficient to us.

The reform reduces costs of laying off workers and, to a lesser extent, the differences between permanent and temporary workers

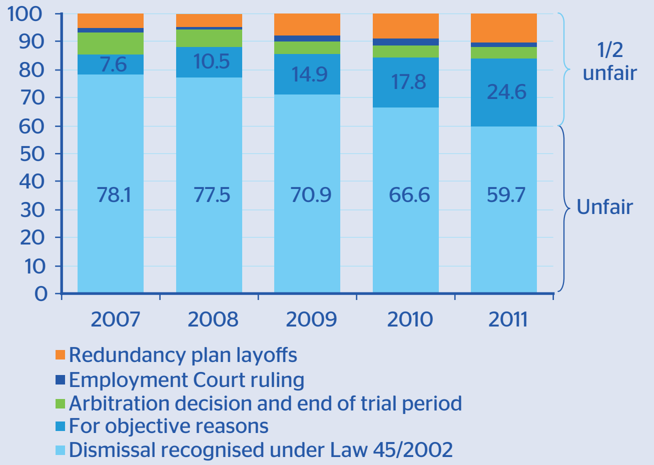
The reform removes what is known as "express dismissal", with compensation for unfair dismissal of 45 days pay per year worked up to a maximum of 42 monthly payments, and the general adoption of compensation for unfair dismissal of 33 days pay per year worked up to a maximum of 24 monthly payments. In parallel to this, it also refines the economic justifications for fair dismissal on financial grounds ("existence of actual or forecast losses, or a persistent decrease in revenue or sales[...] thedecrease is regarded as persistent if it occurs over three consecutive quarters[19]") and removes the need for administrative authorisation prior to terminating an employment contract[20]. These regulatory changes aim to rebalance the system towards fair dismissals for objective causes, the relative scarcity of which is a dysfunction of the Spanish labour market. Chart 31 shows that fair dismissals represented less than a quarter of all dismissals of workers on permanent contracts in 2011. Taken as a whole, these legislative changes should lead to a reduction in compensation for dismissal on permanent contracts, and this should reduce the gap between the costs of terminating such contracts and the costs of terminating temporary contracts.

Chart 30
Spain: registered contracts by type. (2011, %)



Source: BBVA Research based on MESS data

Chart 31
Spain: distribution of number of dismissals of workers with permanent contracts (%)



Source: BBVA Research based on MESS data

18: Available at: http://www.boe.es/boe/dias/2012/02/11/pdfs/BOE-A-2012-2076.pdf.
19: One of the proposed amendments submitted by the Partido Popular to the Law concerning urgent measures to reform the labour market aimed to further clarify economic causes for termination of employment. The drafting of Article 18.3, termination of employment contract, would have been as follows: "Economic causes shall be understood to exist when the company's results reveal a negative economic situation through actual or forecast losses, or a persistent decrease in revenue or sales. A decrease shall be regarded as persistent if over three consecutive quarters *the level of ordinary revenue or sales in each quarter is lower than that in the same quarter of the*
20: In addition, backpay accruing during dismissal proceedings will only be payable in the event of the employee being reinstated.

Significant progress in improving collective bargaining

One of the most significant changes introduced by Royal Decree-Law 3/2012 is the establishment of priority for company agreements over higher-level agreements. Prior to the current legislation coming into effect, a sector agreement (state or autonomous region) had priority over a company agreement. This change will make it easier for companies to adapt to economic conditions and should encourage adjustment to the intensive margin (hours worked) and remuneration rather than the extensive margin (employment).

For companies subject to a sector agreement, this reform facilitates opt-outs to an extent: if there is disagreement, conflicts are resolved out of court through arbitration if the company and employee representatives have so agreed in the sector agreement; if not, any of the parties can take the dispute to the national Comisión Consultiva de Convenios Colectivos (Collective Agreement Consultative Commission) or a regional equivalent, which will appoint an arbitrator to handle the dispute within a maximum of 25 days. At the same time, this reform also expands the areas in which the company can opt out (working day, hours, shift work, work systems, functions, etc.) and refines the economic causes permitting opt outs: "existence of actual or forecast losses, or a persistent decrease in revenue or sales. [...] a decrease shall be regarded as persistent if it persists over two consecutive quarters"[21].

In relation to collective bargaining, the least positive aspect of the reform is its limited ambition in terms of stopping expired agreements from continuing in force as, although this no longer applies, the 2 year term for negotiation of a new agreement established in the regulations is excessively long. As almost 80% of the collective agreements signed in Spain have a duration of 2 or more years, an agreement can thus continue in force -in the absence of an agreement to renew it- for at least 4 years.

Introducing the possibility of greater internal flexibility in companies

In addition to the changes to collective bargaining, the reform facilitates substantial modifications to working conditions, including salary levels. The reform removes the requirement for administrative authorisation prior to suspension of an employment contract or reduction of the working day for financial, technical, organisational or productive reasons; it also credits 50% of company Social Security contributions for workers affected by suspension of contracts or reduced working hours, up to a maximum of 240 days, conditional on stable employment during a period of, at least, one year[22]. In addition, the regulations also enable functional mobility between professional groups, not just between categories, as previously.

This increase in internal flexibility is undoubtedly positive. As we have stated in previous editions of this publication, we take a favourable view of all measures that aim to increase the intensive margin to the detriment of the extensive margin as a way of adjusting employment.

Increased efficiency in job hunting processes

In order to reduce the length of time people remain unemployed, and to improve the quality of job placements, the regulatory framework for temping agencies (ETTs) has been adapted, authorising them to operate as employment agencies. Unlike the previous regulations, administrative silence is now to be taken as "approval of the request [to act as an employment agency]". Given the inefficiency of Public Employment Services in placing people in work, we take a positive view of the involvement of new agents.

Changes to the contracting system focus on making labour cheaper through fiscal incentives rather than opting for more effective activation strategies

The reform makes training and apprenticeship contracts more flexible, extending maximum ages and duration, and establishing fiscal incentives both for their use (100% reduction in company Social Security contributions if the company has fewer than 250 employees, and 75% otherwise), and also encourages their conversion into permanent contracts (€1500 credit for company social security contributions, plus an additional €300 for women). In addition, a new form of permanent contract has been created exclusively for companies with fewer than 50 employees, which gives credits for: i) the first contract of a person aged under 30[23] (€3000 deduction); ii) maintaining the young person's employment for three years (€1000 the first year, €1100 the second and €1200 the third); and iii) the contracting and continuing employment of a long-term unemployed person aged over 45 who has been registered as seeking work for at least 12 of the 18 months prior to the contract (€1300 for each of the three years).

21: The clarification of the economic causes for terminating a contract contained in footnote 1 also applies to opt outs from a collective agreement.
22: These provisions are repayable if the company finally terminates the contract.
23: If the person contracted was unemployed and in receipt of benefits, the Company can deduct an amount equal to 50% of this benefit for one year: the worker can voluntarily harmonise their salary with 25% of the unemployment benefit over the same period.

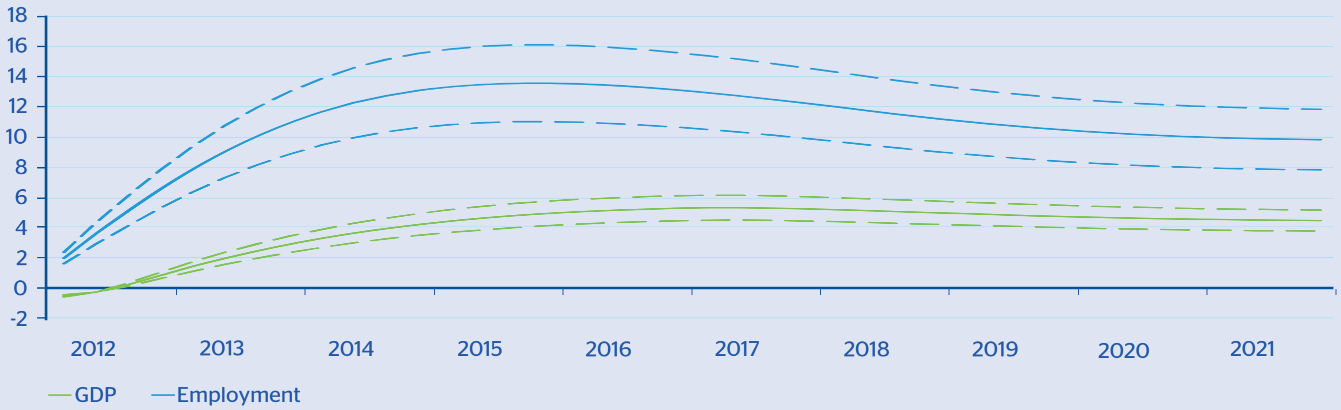
Whilst this development of apprenticeship contracts is welcome, it would have been preferable to change the composition of spending on active employment policies (PAE) rather than establishing new incentives for permanent contracts, given manifest inefficiency of these. Spain uses almost half of the funds it dedicates to PAEs for incentives for hiring and maintaining employment (mainly through credits for employer's Social Security contributions), whilst the EU-15 average is just a quarter. As a result, spending on training, integration into the labour market and professional recycling is comparatively low. Training accounted for just 24.9% of PAE expenditure in 2005-2010, compared to 30.4% in Germany and 41.8% in Denmark; spending on integration into the labour market and employment reorientation amounted to 3.9%, compared to 7.2% in Germany and 50.9% in Denmark. It would therefore be preferable to reallocate some of the funds used on credits for job contracts to policies that increase the employability of workers, in particular those who have lost their jobs as a result of structural adjustments in the real estate sector[24].

The reform will increase GDP by around 4% in the medium term

The effects of the reform on the Spanish economy were simulated using the REMS model[25]. The main changes include: a) a 5% increase in the duration of contracts as a result of a 6 pp decrease in the Spanish economy's temporary employment rate over the medium term; b) a 20% decrease in average dismissal costs as a result of fair dismissal on objective grounds become more widespread (50% of all dismissals) and more widespread use of contracts with 33 days compensation per year worked; c) a reduction in the powers of unions to set salaries through changes to collective bargaining procedures; d) a 2% improvement in the efficiency of job-seeking processes; e) a permanent 0.9% increase in total factor productivity (TFP) as a result of the improved resource allocation encouraged by the reforms.

Chart 32 shows that the impact of the reform on employment may be particularly positive, resulting in a 10% increase in jobs over the medium term. Chart 32 assumes that the reform is implemented immediately, which is not realistic, as it will take a while for companies to begin to regularly use some of the legislative changes. However, depending on the extent to which the reform is implemented, it could have a substantial effect on the economy, amounting to as much as 4% of GDP in the medium term.

Chart 32
Impact of the labour market reform (compared to no reform scenario, %)



Source: BBVA Research based on MEH

24: Note that the 2012 General Government Budget exacerbates the problem of the composition of PAE expenditure. 2012 PAE expenditure will be 21.7 lower than in 2011, with expenditure on training and direct job creation falling even more dramatically, by 32.4% and 39.3% respectively. The only increase will be in employment incentives, which will rise by 6.1% compared to 2011.
25: For details of the model, refer to Boscá, José E., Rafael Doménech, Javier Ferri and Juan Varela: The Spanish Economy: A General Equilibrium Perspective, Palgrave Macmillan, 2011.

Box 5. The cyclical characteristics of the Spanish economy over the medium term

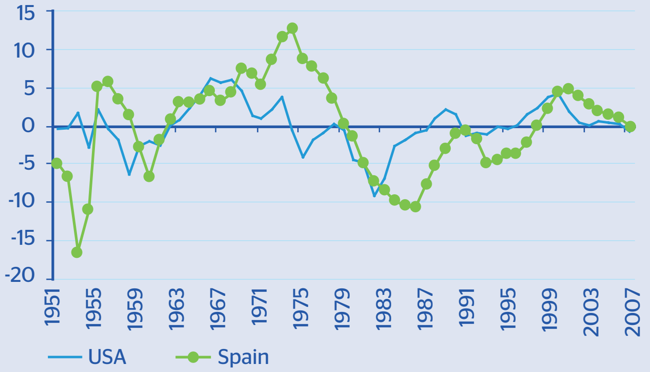
The 2008 financial crisis originated in the USA has revealed the need for a thorough empirical study of the relationship between the macroeconomic aggregates of the major advanced economies. Since the mid-XXth century, industrialised nations have experienced relatively long periods of either high or low growth. The prolonged nature of these macroeconomic fluctuations lies in contrast to the conventional definition of the business cycle, which focuses on more frequent fluctuations. Recently, Comin and Gertler (2006) proposed the idea that the longer duration of these fluctuations is due to a persistence mechanism of the shocks that the economy experiences[26]. The persistence mechanism is closely linked to innovation, diffusion and adoption processes which, by their nature, take time to develop, thus resulting in business cycles of greater magnitude and lenght than conventionally analysed and termed medium-term business cycles[27].

In this Box we summarise the main characteristics of the medium-term business cycle in Spain, and explore comovement and transmission patterns for Spain and other major advanced economies[28]. Identification of these international transmission mechanisms will inform and improve the modelling and forecasting tools available for the Spanish economy[29].

The stylised features of the medium-term business cycle in Spain

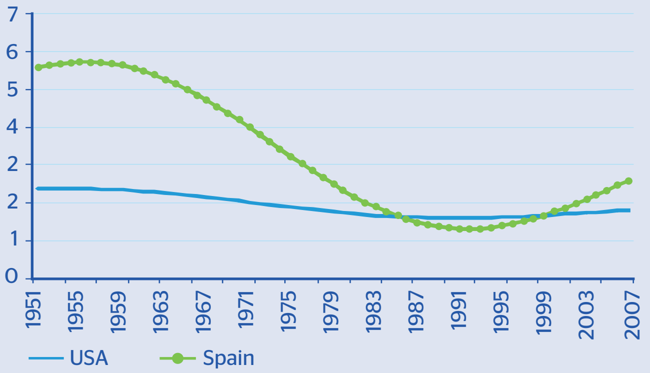
Comparison of medium-term cycles in Spain and the USA reveals that the former are more pronounced than the latter (see Chart 33)[30]. For example, during the expansion of the 1960s, the percentage increase in GDP with respect to trend in Spain was 19%, compared to 13% in the USA. Likewise, the percentage fall in GDP with respect to trend in the 1970s was more pronounced in Spain (23%) than the USA (15%). Spain's medium-term business cycle is also on average longer-lasting: 15 years compared to 10 for the USA.

Chart 33
Spain and USA: medium-term cycle of GDP per working age population (% difference with respect to trend), 1951-2007



Source: Correa-López and de Blas (2011)

Chart 34
Spain and USA: trend growth of GDP per working age population (%), 1951-2007



Source: Correa-López and de Blas (2011)

26: These shocks come from various sources, including monetary, fiscal and preference policies.
27: Negative domestic shocks reduce the returns on R&D investment, the adoption rate of technologically-advanced intermediate goods and, eventually, productivity, which is permanently reduced with respect to trend. In open economies which import technology, the transmission mechanisms for negative shocks originating abroad include bilateral trade and financial flows, such as foreign direct investment. A negative shock would result in a reduction of the volume of technologically advanced intermediate goods available to be incorporated into production processes.
28: This Box summaries the main results and conclusions in Correa-López, M. and de Blas, B. (2011), "International Transmission of Medium-Term Technology Cycles: Evidence from Spain as a Recipient Country", BBVA Working Paper Series, No. 11/32.
29: Studies of the cyclical behaviour of the Spanish economy are found in Licandro and Puch (1997) and Ortega (1998).
30: The medium-term cycle of each time series is extracted as the sum of two components: the high-frequency component corresponding to cycles that repeat between two and 8 years; and the medium-frequency component relating to cycles that repeat between 8 and 50 years. Correa-López and de Blas (2011) provide the methodology used to extract the cycle, the definitions of variables, the sample size and the statistical sources used for the data.

Table 6 summarises the results relating to the volatility, persistence and the nature of the contemporaneous comovement between Spain's GDP and other macroeconomic factors in the medium-term cycle. The main macroeconomic variables show very high persistence, with a first-order correlation coefficient of 0.85 for GDP and 0.92 for consumption and investment[31]. Consumption is slightly more volatile than GDP, with the former having a standard deviation of 6.4 and the latter a standard deviation of 6.1, contradicting, for Spain at least, the life-cycle hypothesis[32]. Total hours worked, with an autocorrelation coefficient of 0.96, is the most persistent series in the medium-term cycle, whilst also being strongly pro-cyclical. When there is a significant cyclical slowdown, employment is one of the slowest variables to close the imbalance created by the adverse shock. Finally, these results reveal that one of the distinctive features of the medium-term business cycle in Spain is the pro-cyclical nature of technological change, innovation and trade[33].

Table 6
Stylised features of the medium-term cycle in Spain, 1950-2007

	Volatility	Persistence	Domestic comovement
Main macroeconomic factors			
GDP		Very high	
Investment	Very high	Very high	Strongly pro-cyclical
Consumption	High	Very high	Strongly pro-cyclical
Exports	Very high	Very high	Weakly pro-cyclical
Imports	Very high	Very high	Strongly pro-cyclical
Trade balance/GDP	Very high	Very high	Moderately counter-cyclical
Current account/GDP	Very high	Very high	Moderately counter-cyclical
Labour market			
Hours	High	Very high	Strongly pro-cyclical
Productivity per hour	Moderate	High	Weakly pro-cyclical
Technology and innovation			
Relative price of capital	Very high	Very high	Strongly counter-cyclical
TFP	Moderate	High	Moderately pro-cyclical
R&D	Very high	Very high	Weakly pro-cyclical
Patents	Very high	Very high	Moderately pro-cyclical
Relative prices			
Price mark ups	High	Very high	Weakly pro-cyclical
Terms of trade	Very high	Very high	Moderately pro-cyclical
REER	Very high	Very high	Weakly counter-cyclical

Note: volatility is calculated based on standard deviations; persistence is calculated based on the first-order correlation coefficient; and domestic comovement is calculated based on the contemporaneous correlation coefficient with GDP. TFP stands for total factor productivity; R&D for private investment in research and development; and REER for the real effective exchange rate.
Source: Correa-López and de Blas (2011))

31: The specific estimates are given in Correa-López and de Blas (2011).
32: Under this hypothesis, individuals use their savings to offset the effect of changes in income on their consumption patterns. If this occurs, consumption is much less volatile than GDP. Dolado et al. (1993) attribute this apparent contradiction of the lifecycle hypothesis to tax and transfer changes from 1970 to 1990. The analysis in this Box finds that consumption volatility is higher than GDP volatility for medium-frequency components, but not for high-frequency components.
33: The relative price of capital captures the technological change incorporated into capital goods, as a fall in relative prices reflects technological progress. Total factor productivity measures technological improvements resulting from more efficient use of the combined factors of production. The pro-cyclical nature of technological change and innovation suggests the presence of the endogenous mechanism for propagating domestic shocks which Comin and Gertler (2006) identify for the US economy.

International comovement and transmission in the medium-term cycle

Table 7 provides evidence on the degree of international comovement in the medium-term cycle[34]. International comovement of GDP, consumption, investment, imports, the trade balance and current account between the USA and Spain is positive, high or very high, and significant. On average, the USA's medium-term cycle shows a three-year lead over Spain's. The degree of comovement between Spain and other European countries is particularly high and significant for France, the UK and, to a lesser extent, Germany and Italy.

The results displayed in Table 7 indicate a possible transmission of the medium-term business cycle between countries. As the macroeconomic variables of several countries lead Spain´s macroeconomic aggregates, the evidence suggests that Spain may be a recipient country of business cycles that originate abroad. To further test this hypothesis, we calculate correlation coefficients for technology, innovation and international relative prices for the USA, France, Germany, the UK and Italy with respect to Spain's GDP over the medium-term cycle[35].

Table 7

Correlations over the medium-term cycle for identical pairs of macroeconomic variables, 1950-2007

	Spain (y(t)) in relation to each country (y(t+k))				
	Medium-term cycle				
Standard variables	**USA**	**France**	**Germany**	**UK**	**Italy**
GDP	0.64 (0.47, 0.78) *	0.76 (0.62, 0.86)	0.71 (0.51, 0.80) *	0.78 (0.65, 0.86) *	0.49 (0.31, 0.64)
	k=-3	*k=1*	*k=1*	*k=1*	*k=5*
Hours	-0.71 (-0.80, -0.58)	0.88 (0.79, 0.92) *	0.50 (0.30, 0.64) *	0.60 (0.35, 0.75) *	0.26 (-0.00, 0.50) *
	k=4	*k=0*	*k=-9*	*k=-2*	*k=-10*
Productivity per hour	-0.32 (-0.55, -0.02)	0.24 (-0.08, 0.54)	0.68 (0.51, 0.81)	0.24 (0.01, 0.40) *	0.35 (0.16, 0.57)
	k=1	*k=4*	*k=5*	*k=-10*	*k=6*
Consumption	0.78 (0.66, 0.86) *	0.85 (0.76, 0.90)	0.75 (0.62, 0.84) *	0.70 (0.51, 0.82) *	0.63 (0.40, 0.76) *
	k=-3	*k=1*	*k=0*	*k=-2*	*k=-2*
Investment	0.58 (0.36, 0.74) *	0.89 (0.82, 0.94) *	-0.61 (-0.75, -0.42)	0.90 (0.85, 0.94) *	0.39 (0.14, 0.57)
	k=-2	*k=0*	*k=10*	*k=-1*	*k=5*
Exports	-0.40 (-0.55, -0.19)	0.74 (0.62, 0.82) *	-0.46 (-0.68, -0.14) *	0.61 (0.39, 0.73) *	0.59 (0.38, 0.74) *
	k=7	*k=0*	*k=-9*	*k=0*	*k=-4*
Imports	0.60 (0.39, 0.76) *	0.74 (0.61, 0.81)	0.41 (0.12, 0.60) *	0.61 (0.44, 0.73) *	0.82 (0.74, 0.88) *
	k=-3	*k=4*	*k=0*	*k=-1*	*k=-2*
Trade balance/GDP	0.64 (0.43, 0.80) *	0.58 (0.38, 0.76) *	-0.42 (-0.70, -0.10) *	0.81 (0.70, 0.89) *	0.43 (0.26, 0.54) *
	k=-3	*k=0*	*k=0*	*k=-2*	*k=-1*
Current account/GDP	0.62 (0.44, 0.76) *	0.45 (0.25, 0.59) *	0.52 (0.34, 0.66) *	0.46 (0.27, 0.59) *	0.47 (0.24, 0.60) *
	k=-4	*k=0*	*k=-10*	*k=-1*	*k=0*

Note: in brackets is the 95% confidence interval calculated using the bootstrap. A negative value of k means that the medium-term cycle for the country in the comparison leads Spain's by k years, and vice versa. An asterisk is used to indicate correlation coefficients where k is zero, i.e. the correlation is contemporaneous or has negative values.
Source: Correa-López and de Blas (2011)

34: The Table shows correlation coefficients between identical pairs of macroeconomic variables for Spain and the other countries analysed. As the international transmission of cycles may not be contemporaneous, the correlation coefficient calculations permits a time structure of ten leads and ten lags. Thus the Table displays the highest correlation obtained (positive or negative) between pairs of variables and the lead or lag with which these are observed.
35: The detailed estimates are given in Correa-López and de Blas (2011).

The estimates indicate that the US medium-term cycles of the relative price of capital, TFP and patents display a two-to-three year lead over Spain's GDP cycle, while the terms of trade and, in particular, private R&D investment display longer leads[36]. Bilateral trade linkages act as a transmission mechanism for the medium-term cycle. There is strong contemporaneous comovement between the flow of US exports to Spain and Spain's GDP (0.68 (0.41, 0.83)). Once technological improvements are incorporated into US exports, the new technology rapidly transmits to the importing country's GDP cycle. However, the evidence for international transmission of European technology, innovation and international relative price cycles is, in general, somewhat weaker.

The purpose of the following analysis is to identify possible transmission mechanisms of the international medium-term cycle between the USA and Spain (see Chart 35).

Chart 35

Spain and the USA: medium-term correlation of identical pairsof technology, innovation and international relative price variables

Note: the k value in brackets shows the number of years by which the USA's medium-term cycle leads Spain's for the corresponding variable.
Source: Correa-López and de Blas (2011)

We can conclude from these results that the medium-term cycles of the relative cost of capital, the terms of trade and the REER of the USA and Spain are strongly correlated, with the USA's medium term cycle exhibiting a three-year lead, on average. Following the approach of Comin et al. (2009), the evidence analysed suggests that an international transmission mechanism could exist for shocks based on the relative price of capital between the USA and Spain. In particular, a recession in the USA reduces the benefit associated to exporting intermediate goods that incorporate new technology (and vice versa). Countries which import technology from the USA are affected as fewer intermediate goods are then ready to be incorporated into more efficient manufacturing processes for capital goods. The lower volume of intermediate goods available results in a gradual increase in the relative price of capital in the importer country. Faced with an increasing relative price of capital, and in the presence of adjustment costs, the importing economy responds by reducing investment and, eventually, total production. The effects of international transmission of a recession shock from the USA would appear in the medium frequency, as changes in the diffusion and adoption of technology do not take place contemporaneously.

In addition, the results in Chart 35 suggest that there is a further transmission mechanism based on international relative prices. This is particularly true with regard to the strong comovement between the medium-term cycles of the terms of trade of the two countries and, more specifically, the two years that the US cycle leads Spain's.

In summary, a systematic study of the relationship between macroeconomic variables in the major advanced economies reveals the complex mechanisms underlying comovement in international cycles. In this Box, we have focused on studying the characteristics of Spain's medium-term cycle, identifying a number of relevant factors:

1. Spain's medium-term cycle is more volatile than that of the USA, and lasts longer.
2. When a shock occurs -whether domestic or external- employment is slow to adjust to the resulting gap.
3. Spain's medium-term cycle usually follows that of other countries, rather than leading them. From this perspective, changes to technological variables and the international relative prices of the USA are particularly important.
4. The transmission mechanism for the medium-term cycle depends to a large extent on the Spanish economy's bilateral trade linkages.

The 2008 financial crisis brought to an end an unusual period of macroeconomic stability in advanced economies -often referred to as the Great Moderation- which began in the early 1990s and was characterised by the reduced magnitude of business cycles. In the current difficult macroeconomic environment, Spain's medium-term cycle has once again become more volatile and longer lasting. Given its traditional role as a recipient of technology, it is essential that the Spanish economy does not get left behind in adopting technology. With this objective in mind, economic policies that focus on stimulating investment in goods and services that incorporate the latest technological advances and on promoting a change in the pattern of technological development so that Spain becomes a net technology exporter, are required; this is particularly relevant in an international context in which technological-leading economies have suffered major reverses in the pattern of their technological progress. Such policies, together with structural reforms that reduce the adjustment lags that the Spanish economy experiences to return to equilibrium (particularly in important aggregates such as employment), would improve the economy's cyclical performance and significantly increase the outlook for medium- and long-term growth. Finally, the results obtained in this Box will be used to inform and improve the modelling and forecasting tools available for the Spanish economy as an open economy.

36: Note that a similar correlation pattern is obtained in the medium-term cycle for hours, consumption, investment and imports in Spain (Correa-López and de Blas (2011)).

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4. Tables

Table 8

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.9	1.5	-0.2	0.9
Germany	-5.1	3.6	3.1	0.7	1.6
France	-2.6	1.4	1.7	0.5	1.1
Italy	-5.1	1.8	0.5	-1.5	0.1
Spain	-3.7	-0.1	0.7	-1.3	0.6
UK	-4.4	2.1	0.7	0.5	1.4
Latin America *	-0.6	6.6	4.5	3.8	4.1
Mexico	-6.1	5.4	3.9	3.7	3.0
EAGLES **	4.0	8.4	6.7	5.8	6.4
Turkey	-4.9	9.2	8.5	2.7	5.6
Asia Pacific	4.2	8.1	5.7	5.7	6.1
China	9.2	10.4	9.2	8.3	8.7
Asia (exc. China)	1.0	6.7	3.4	4.1	4.4
World	-0.6	5.1	3.9	3.6	4.0

Forecast closing date: April 30, 2012
* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Corea, Mwxico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 9

Macroeconomic Forecasts: 10-year Interest Rates (Avg.)

	2009	2010	2011	2012	2013
United States	3.2	3.2	2.8	2.3	2.6
EMU	3.3	2.8	2.6	2.0	2.7

Forecast closing date: April 30, 2012
Source: BBVA Research

Table 10

Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2009	2010	2011	2012	2013
United States (EUR per USD)	0.72	0.76	0.72	0.78	0.77
EMU	1.39	1.33	1.39	1.28	1.30
UK	1.56	1.55	1.60	1.60	1.66
China	6.83	6.77	6.46	6.25	5.94

Forecast closing date: April 30, 2012
Source: BBVA Research

Table 11

Macroeconomic forecasts: Official Interest Rates (End period)

	2009	2010	2011	2012	2013
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	1.00	1.00
China	5.31	5.81	6.56	6.06	6.56

Forecast closing date: April 30, 2012
Source: BBVA Research

Table 12

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

	2009	2010	2011	2012	2013
Real GDP	-4.2	1.8	1.5	-0.2	0.9
Household consumption	-1.2	0.8	0.2	-0.4	0.6
Public consumption	2.6	0.5	0.1	-0.6	0.3
Gross fixed capital formation	-12.0	-0.7	1.6	-2.6	1.4
Equipment, machinery and cultivated assets	-15.5	4.8	4.5	-2.9	2.0
Equipment and machinery	-17.7	4.2	5.1	-2.5	2.2
Construction	-9.5	-4.3	-0.4	-2.9	0.8
Housing	-11.7	-3.3	1.9	-1.4	1.1
Other buildings and other constructions	-7.0	-5.4	-2.9	-4.7	0.5
Change in inventories (contribution to growth)	-0.8	0.5	0.0	-0.1	0.0
Domestic demand (contribution to growth)	**-3.5**	**1.0**	**0.5**	**-1.0**	**0.7**
Exports	-12.7	11.1	6.3	2.4	4.3
Imports	-11.6	9.4	4.0	0.6	4.1
External demand (contribution to growth)	**-0.7**	**0.8**	**1.0**	**0.8**	**0.3**
Pro-memoria					
GDP w/out housing investment	-3.7	2.1	1.5	-0.1	0.9
GDP w/out construction	-3.5	2.6	1.7	0.1	0.9
Employment (LFS)	-1.8	-0.5	0.3	-0.5	0.0
Unemployment rate (% active pop.)	9.6	10.1	10.2	10.9	11.0
Current account balance (% GDP)	0.1	0.2	0.4	0.8	1.2
Public sector balance (% GDP)	-6.4	-6.2	-4.1	-3.1	-2.3
CPI annual average	0.3	1.6	2.7	2.4	1.5

Forecast closing date: April 30, 2012
Source: official organisms and BBVA Research

Table 13

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

	2009	2010	2011	2012	2013
Activity					
Real GDP	-3.7	-0.1	0.7	-1.3	0.6
Private consumption	-4.3	0.8	-0.1	-2.0	-0.9
Public consumption	3.8	0.2	-2.2	-8.0	-5.6
Gross fixed capital formation	-16.4	-6.0	-5.2	-7.5	-1.0
Capital goods	-22.6	5.5	1.6	-4.6	2.8
Construction	-15.4	-10.1	-8.1	-9.2	-3.2
Housing	-22.0	-9.8	-4.9	-6.6	-1.6
Domestic demand (contribution to growth)	-6.5	-1.0	-1.8	-4.5	-1.8
Exports	-10.2	13.5	9.1	4.0	8.9
Imports	-16.9	8.9	-0.1	-6.2	1.6
External demand (contribution to growth)	2.8	0.9	2.5	3.1	2.4
GDP at current prices	-3.7	0.3	2.1	0.0	1.6
(Billion euros)	1047.8	1051.3	1073.4	1073.9	1091.5
GDP w/out housing investment	-1.5	0.8	1.2	-0.9	0.7
GDP w/out construction	-0.8	2.0	2.3	0.0	1.1
Labour market					
Employment (LFS)	-6.8	-2.3	-1.9	-4.6	-2.0
Unemployment rate (% active pop.)	18.0	20.1	21.6	24.6	24.8
Employment QSNA (full-time equivalent)	-6.4	-2.6	-2.0	-4.3	-2.0
Productivity	2.7	2.6	2.7	3.0	2.6
Prices and costs					
CPI (annual average)	-0.3	1.8	3.2	1.9	0.7
GDP deflator	0.1	0.4	1.4	1.4	1.1
Household consumption deflator	-1.2	2.4	3.2	2.1	1.0
Compensation per employee	4.3	0.0	0.8	1.7	4.6
Unit labour cost (ULC)	1.6	-2.6	-1.9	-1.3	2.1
Foreign trade					
Current account balance (% GDP)	-4.8	-4.5	-3.5	-1.9	-0.4
Public sector					
Debt (% GDP)	53.9	61.2	68.5	79.8	82.3
Public sector balance (% of GDP)	-11.2	-9.3	-8.5	-5.3	-3.0
Households					
Nominal disposable income	0.9	-2.4	0.4	-3.1	-0.3
Savings rate (% of nominal income)	18.5	13.9	11.6	8.7	8.4

Forecast closing date: April 30, 2012
Source: official organisms and BBVA Research

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