BBVA | RESEARCH

Economic Outlook

Spain

Third Quarter 2013
Economic Analysis

- **Global growth will accelerate** as developed economies recover.
- **The Spanish economy bottoms out in 2013** led by a smaller negative contribution of internal demand and export growth.
- **Asymmetric fiscal deficit targets will reduce growth dispersion** across regions during 2013.
- **At this turning point, European and Spanish institutions must secure a robust recovery.**
- **The structural current account adjustment is gaining pace,** a key achievement for reducing net external debt.

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Closing date: August 2, 2013

1. Editorial

The global economy grew by around 3% in the first half of 2013, similar to 2012, but activity slowed more than expected in 2Q13. The slowdown is explained by a number of factors: 1) tighter lending conditions following the announcement by the Federal Reserve of the exit strategy for its balance sheet expansion; 2) lower growth in emerging economies, which triggered an increase in capital flight, and pressure in China's interbank markets; 3) the lack of any meaningful progress in the construction of a European banking union capable of reducing financial fragmentation in the short term, and political uncertainty in certain peripheral economies, above all Portugal.

Global economic growth looks set to accelerate in the third quarter and reach around 4% in 2014, although most of the risks remain tilted to the downside. Developed economies should remain supported by central banks, which have either maintained or stepped up their expansionary monetary policies. Euro area countries should benefit from less intense fiscal consolidation efforts than in 2012. In emerging economies, improved conditions in developed economies, not to mention prudent use of the room for manoeuvre still existing in monetary and fiscal policy in certain countries, should reverse the ongoing slowdown. The risks to this baseline scenario are still slightly more biased to the downside than upside, although no shocks are expected with any high degree of probability.

In Spain, domestic demand fell less in 2Q13 which, coupled with the support of exports, left GDP virtually flat (-0.1% qoq). There are several reasons for this improvement. First, the ease in tension in capital markets over the past year has shored up confidence among consumers and businesses in decision-making. Second, amid recession in the EMU, Spanish firms have diversified their export markets, leveraging still robust domestic demand in emerging economies and gaining an advantage vis-à-vis other European countries. Third, the concentration of deficit-reduction efforts in the latter part of 2012 and the growing consensus over the need to ease fiscal targets in Europe resulted in less ambitious consolidation in the first half of this year. Lastly, as explained in previous editions of Spain Economic Outlook, certain reforms adopted are beginning to increase Spain's ability to grow and create jobs.

The Spanish economy is bottoming out in 2013 (-1.4%) and should stage a moderate recovery in 2014 (+0.9%). Over the next few quarters, Spain should replicate the normal pattern of recovery seen in previous economic cycles. The trend toward improvement in activity indicators appears to be gathering steam. To illustrate, data available for 3Q13 suggest the Spanish economy could actually grow, albeit slightly (+0.1% qoq). Meanwhile, exports should continue to grow in the quarters ahead, driven by internal devaluation, market diversification, global economic growth and non-price-related factors of competitiveness. Moreover, buoyant foreign sales are beginning to feed through to certain segments of domestic demand, especially investment in machinery and equipment, which likely posted its second quarter of growth in 2Q13. In addition, the adjustments made during the crisis, coupled with the increased internal flexibility companies appear to be achieving, have bolstered the gross operating surplus of firms, which stands at an all-time high as a percentage of GDP. This should underpin investment in coming quarters as uncertainties regarding the state of the economy diminish. Lastly, higher investment should feed through to a sustained recovery in employment, which should be reflected starting in the first half of 2014.

Asymmetric deficit targets should bridge the gap in growth across regions in Spain in 2013, but this only delays the inevitable adjustments the governments must make. Once again, the exposure of each regional government to external trade and the budget situation will have an impact on the economic downturn in 2013. Specifically, exposure to Europe of exporters in each region or the type of product in which they specialise have been key determinants of their trends in foreign sales. At the same time, regions with a high level of foreign tourism are benefiting from the improving outlook, helped by political uncertainty in some of their main competitors. Lastly, the decision to allow different deficit targets has implications for both 2013 and 2014, hurting regions that must make cutbacks first in the short term delaying the negative impact on those that can postpone them.

With the economy at its turning point, Europe's institutions and Spain's regional governments alike must ensure that recovery is as strong as possible. Europe needs to advance quickly towards a more genuine economic and monetary union to break the sovereign-bank risk feedback loop. It not only needs to improve the design of its institutions, but also to take advantage of the current window of opportunity in financial markets in order to accelerate growth with the appropriate supply- and demand-side policies, especially monetary policy, within the room to manoeuvre existing in the euro area as a whole.

For its part, Spain must fulfil its present commitments by adopting policies that resolve the problems affecting the economy once and for all. While greater flexibility to achieve fiscal consolidation is welcome, there is an opportunity now to replace temporary measures with permanent ones, and to redistribute the burden of adjustment in terms of both the timetable and the use of policies that minimise the negative impact on economic growth. Available data suggest that spending cuts might not be enough to offset the increase in interest costs, the cyclical downturn and the potential withdrawal of certain measures adopted at the end of last year. This raises the risk of seeing fiscal adjustment heighten in the fourth quarter this year, which would undermine the recovery. Meanwhile, if Spain misses its deficit target, confidence over the country's ability to meet its obligations would wane, increasing uncertainty, causing capital flight to reappear and pushing up funding costs for the economy as a whole.

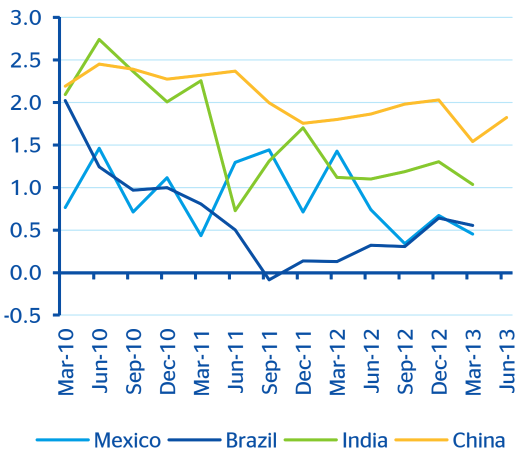
In addition, the government has agreed a strict and ambitious schedule of reforms with the European Commission. With rampant unemployment, Spain's job market needs additional measures to reduce the duality between temporary and permanent jobs and make both active and passive employment policies more efficient. At the same time, progress must be made towards completing the financial sector restructuring, removing any doubts regarding the solvency of certain financial institutions and reducing regulatory uncertainty considerably. This would be the easiest way to guarantee the flow of credit towards solvent demand. Lastly, progress needs to be made on the deregulation of certain key industries for the Spanish economy to become more competitive and maintain buoyant exports. All of the above, addressed with the appropriate determination, could enable the Spanish economy to resume the pace of growth seen before the crisis.

2. Global growth: no improvements until 2014, diversified risks

The global economy is showing cyclical weakness, above all in emerging markets, and is facing more difficult financial conditions

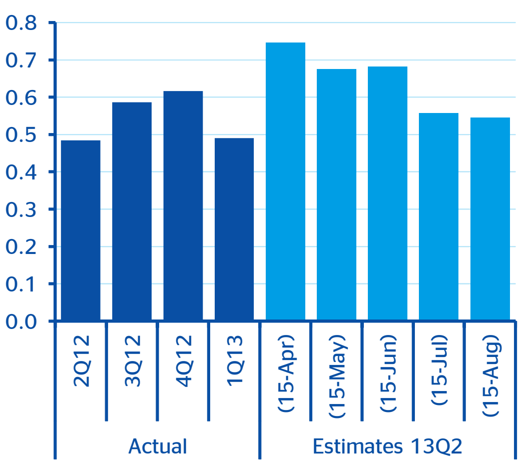
The global economic situation is less favorable than it was three months ago, when we issued our previous growth forecasts. We have therefore revised down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below the forecasts three months ago. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2 pp below the figure we forecasted last quarter. At least two reasons lie behind this deterioration and the resulting revision of our forecasts. First, **the emerging markets are experiencing a sharper slowdown than expected** (Chart 1); above all, they include more moderate growth in China. Second, there has been an unexpected event, at least at the time when it occurred: **the tightening of financial conditions at global level.** This increased stress has basically been the result of market reaction to the communication of the details given by the Fed of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

Chart 1
Emerging markets, GDP growth (% q/q, seasonally corrected)



Source: Haver

Chart 2
Growth of global GDP according to the BBVA-GAIN (% q/q)



Source: BBVA Research

Growth is still not strong enough in advanced economies and has deteriorated in emerging markets

In recent quarters, macroeconomic data have not been positive, and have even generated major concern, at least in some geographical areas. Thus the steady stream of new data has gradually reduced the estimates for quarterly global GDP growth (Chart 2).

On the one hand, the advanced economies have performed differently, but overall growth continues being far from robust, except in the case of Japan.

Growth in the U.S., while not exceedingly high (the economy has not grown above 2% since 3Q12), **has been in line with expectations**. Even so, although these growth rates are poor in comparison with other recoveries in the past, they are particularly significant given the drag on GDP of the fiscal consolidation measures implemented as a result of the partial entry into force of the public-spending sequestration and the tax rises agreed at the start of the year.

There was a disappointing start to the year in Europe, as the economy contracted for the sixth successive quarter. However, the most recent data are more favorable, it is likely that the euro zone avoided another fall in GDP over the second quarter of the year.

Meanwhile, Japan experienced an upturn in its GDP over the first quarter of 2013 and the most recent data suggest that the economy is maintaining its strength, supported by the monetary stimuli and fiscal measures adopted by the new government.

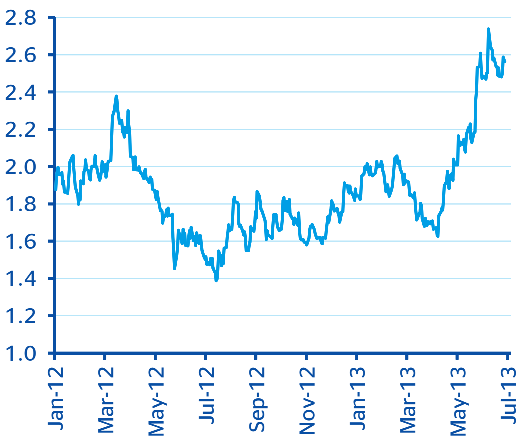
Overall, **the advanced economies have improved their cyclical behavior over recent months, but not sufficiently to modify the perception of their situation and their prospects in the most likely scenario.**

In contrast, the macroeconomic situation of the emerging markets has weakened significantly (Chart 1). In **China**, a steady slowdown has continued, putting downward pressure on growth in other emerging markets, especially those dependent on demand for commodities and also affecting economies exporting investment goods. **The slowdown in China is a result of a combination of sluggish external demand, policies aimed at curtailing domestic financial fragilities at the expense of new stimulus measures** (as analyzed in more detail below), and a structural decline in potential growth. In addition, recent data raise doubts about how fast consumption can take over from investment as a driver of medium-term growth as rebalancing of the economy unfolds.

Making the market used to less liquidity

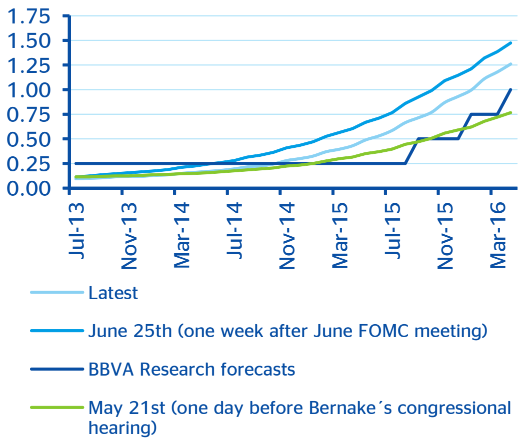
The second factor limiting optimism regarding the global economic outlook is tightening financial conditions at a global level. Although the reasons for this may be varied, **most of the shift took place in mid-May, with the details announced by the Fed of its plans to limit and then put an end to its program of monetary expansion.** In particular, the market has interpreted that in September the Fed will begin to reduce the rate of its asset purchases (from 85 billion dollars per month) and when the unemployment rate reaches 7% (expected for the second quarter of 2014) the Fed will stop buying assets. In addition, **the Fed maintains unaltered conditions that could justify interest-rate rises.** According to our forecasts, rises will begin some way into the second half of 2015, while the normalization (reduction) of the Fed's balance sheet will not begin until well into 2016.

Chart 3
Yield on 10-year U.S. public debt (%)



Source: Bloomberg

Chart 4
Futures on Fed Fund rates (%)



Source: BBVA Research based on Bloomberg

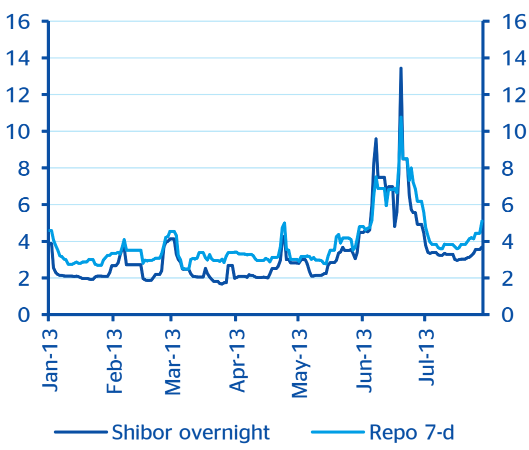
However, **market reaction to this plan (even after being clarified in all its details) has been stronger than (probably) desired by the Fed.** As can be seen in Charts 4 and 5, long-term interest rates increased by more than 100 basis points, while futures now discount the first rise in rates for the start of 2015, practically one year before expected two months ago. In our opinion, **what is being seen on the financial markets is probably partly an over-reaction,** as shown by recent downward moves in both long-term rates and expectations of shorter-term rates. Even so, **the implementation of the mechanism has generated a process of restructuring of portfolios in the face of the end of abundant liquidity,** and thus of extra demand for bonds that kept interest rates at exceptionally low levels. In our opinion, therefore, **we are being faced with the start of a cycle of normalization of financial conditions, with higher interest rates and lower demand for risk assets.**

Slowdown in China: slugish external demand and steps to limit indebtedness and the scope of shadow banking

A recent tightening of the Chinese interbank lending market (Chart 6) is an example of the side-effects of the **authorities' efforts to limit financial risks associated with rapid credit growth and a buildup in debt** (Chart 7). In addition to rapid credit growth in the formal banking system, flows from the unregulated shadow banking system, have led to a buildup in total debt already around 200 percent of GDP. Over the last year, **the authorities have adopted a variety of measures aimed at restricting the growth of credit and curtailing shadow banking activities.**

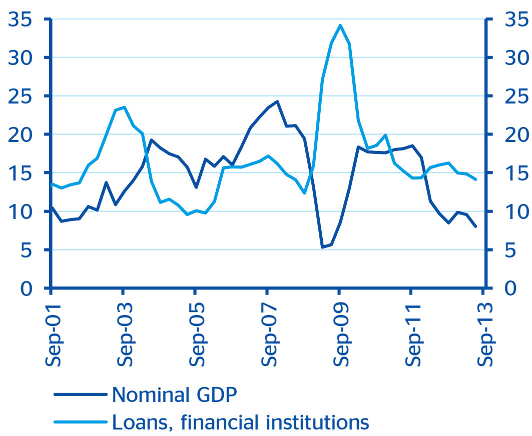
While tensions in the interbank system were temporary, it has given a signal regarding the firm will of the authorities and has revealed underlying fragilities and vulnerabilities of the financial system. Credit has not only grown at a faster pace than the economy over recent years, but has financed local government projects of dubious profitability, which were part of the stimulus measures implemented at the end of 2008 and in 2009 to counter the global post-Lehman Brothers recession. The result has been increased doubts about the capacity of the country's economy to continue to grow at recent rates in a very tight global environment.

Chart 5
China: interbank market
(7-day REPO and Shibor overnight rates, %)



Source: BBVA Research based on Bloomberg

Chart 6
China: growth of credit and GDP (% y/y)



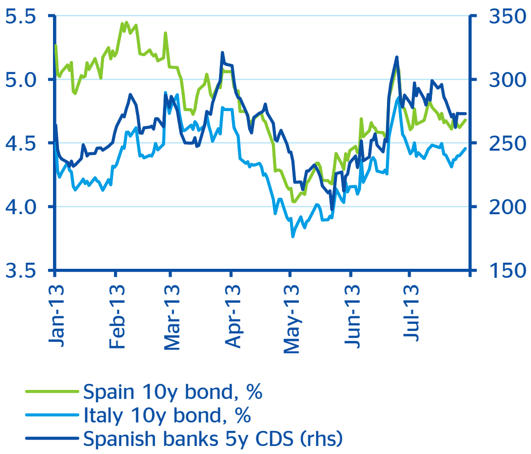
Source: BBVA Research based on Haver

The baseline scenario continues to be one of a continued moderate slowdown relative to the rapid pace of recent years. The measures taken to limit credit growth will act as a constraint on the room for stimulus measures to support growth. In addition, the Chinese authorities appear more comfortable with the current rates of GDP growth as they focus more on the quality of growth and medium-term sustainability. Even so, we still consider that the **government has room for maneuver if the growth slips below the official targets.** Moreover, we believe the authorities have resources to prevent financial risks from generating a hard landing in the near term.

Europe: prospects for recovery remain, despite the downward revision of growth in 2013

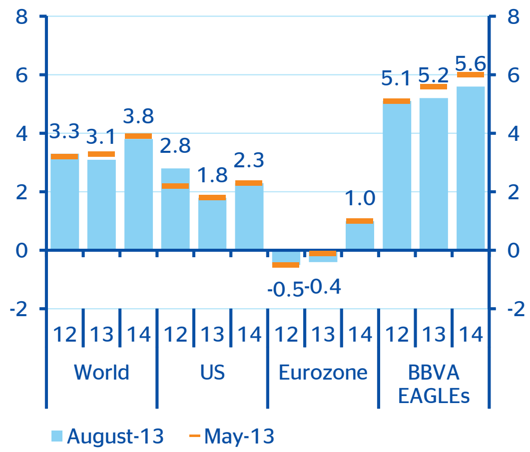
In Europe financial tensions have once more increased in recent months, and undone the improvements made in the first part of the second quarter. Although no important risk event has materialized as in previous quarters, financial stress has at times reached similar levels to the time of the Cyprus bailout crisis (see Chart 8, where this is reflected through peripheral sovereign bonds), although the volatile tone of economic activity has improved in the light of the indicators that are being released. A number of reasons lie behind this situation. First, Europe has probably also been affected by the process of portfolio restructuring following the Fed's announcement. Second, the countries of southern Europe have been affected at the same time by political stability problems. Particularly noteworthy in this respect is the case of Portugal. The episode of government instability now appears closed, but the market perception is that the government faces increasing uncertainty, making the return to the financing capital markets very difficult. There will probably be some additional aid starting in mid-2014, while the markets fear some form of debt restructuring. Third, some doubts may have arisen regarding the capacity of the ECB's OMT program to contain financial tension as a result of the judicial scrutiny it is being subjected to in Germany. Finally, the process of constructing banking union continues slowly, subject to the needs dictated by economic policy at domestic level.

Chart 7
Europe: Yields on 10-year public debt and 5 year CDS



Source: BBVA Research based on Bloomberg

Chart 8
GDP growth (%)



Source: BBVA Research based on Haver

Overall, the prospects for the economy in the euro zone remain basically unaltered. The reforms designed to improve governance in the zone will probably be boosted following the elections in Germany. However, with the external situation weaker than it has been, it will not be offer greater support than previously expected; quite the reverse. Economic policy appears to have taken a more flexible turn. There has been confirmation of the relaxation of the European Union's fiscal targets for various countries in the zone (not only the periphery). This will make fiscal policy less restrictive in 2013 and 2014. The ECB has taken additional steps to support the economy: first, in May it lowered interest rates; and second, in what is an unusual step, it showed its commitment to the maintenance of benchmark interest rates at current levels or below for a prolonged period of time, in what is a kind of weak version of forward guidance. This move probably aims to differentiate the monetary policy cycle in Europe from the cycle that has just begun in the U.S. In any event, **the macroeconomic situation in the zone remains subject to downward risks, so the time for tightening monetary policy appears far off.**

More diversified global risk events, but with lower potential impact

With respect to risk factors, it is worth noting that **the scenario is no longer dominated by a single risk factor with globally disruptive potential.** However, some risk factors remain, and others have been added, so risks are more diversified, although their potential impact on the global economy is lower than those defined in previous quarters. First of all, it is worth mentioning **the possibility that the exit process announced by the Fed from its expansive monetary policies will be disorderly.** If this did occur, and if the rates of risk-free assets rose beyond what is wanted by the Fed and we entered a process of high financial volatility, the impact on global growth through deteriorating confidence and the effect of negative wealth would not be negligible. In any event, **lower global liquidity particularly affects those economies, not only emerging, with imbalances in their balance sheets that depend most on external and short-term finance.**

A second risk factor, perhaps not imminent but to be taken into account in the short term, relates to possible unexpected events in the long reform process in China, which has to combine a variety of objectives: reduce the obvious fragility of the country's financial sector; and favor change in the growth model from credit-intensive to one more supported by consumption; and all this without a steep reduction in the rate of growth. The measures already adopted to limit credit growth in themselves represent some limit to expansion in a country where part of the growth of recent years has been supported by a high level of debt. The authorities have wide room to deal with these risk events, but in any event if this situation occurred, it could generate a more abrupt adjustment in the flow of credit to the economy and force a major slowdown in China's growth. The impact would spread beyond China and probably affect the economies dependent on Chinese demand, not only demand in the real economy but also for financial assets of the most developed economies.

Finally, **the most likely among possible risk events continues to be a worsening of the crisis in the euro area.** The situation is improving gradually, but it is still very vulnerable. The recent political instability in some southern European countries, and the slow pace of the process of constructing banking union, continue to be elements that could generate financial stress and thus tension in the real economy.

3. The growth outlook of the Spanish economy

In the last three months, uncertainty about the duration of monetary expansion in the United States, political stability in the peripheral countries and the move towards a banking union in Europe **have tested the relaxation of financial tensions. However, economic policy decisions** taken in mid-2012[1], coupled with more recent actions by the ECB to back financial stability and shore up the economic recovery[2] **have limited the increase in volatility.** In Spain, this situation is still accompanied by capital inflows and resistance to rising risk premiums, although with less intensity than in the early months of the year. Nevertheless, the transmission of monetary policy to firms and households is still hampered by the continuing fragmentation of the European financial system, which is hindering the flow of credit in countries like Spain and jeopardising the recovery.

In the real economy, activity trends among Spain's main trading partners in the first quarter of the year were worse than expected at the end of 2012, which has led to a revision, albeit moderate, of the expected growth of trade flows. However, **the global economic scenario remains compatible with a gradual recovery of activity in Europe,** strong growth in the rest of the world, risk-free interest rates at historically low levels and a slight depreciation of the euro. Accordingly, this scenario implies still robust exports, which will be the permanent supporting factor for the recovery due to the growing diversification of export markets.

In addition, some domestic factors are beginning to reduce their negative contribution to activity. For example, labour market and domestic demand (mainly private productive investment) showed less weakness during the first half of the year . This is the result of the knock-on effect of exports, but also of expectations of a smaller contraction in public and private expenditure, following the acceleration of the fiscal consolidation process towards the end of the previous year, and the confirmation of the new deficit targets for the coming years. In aggregate, these factors appear to have brought the Spanish economy near a turning point in 2Q13, thus leaving behind the most intense period of job destruction.

Therefore, **the Spanish economy is expected to undertake a modest recovery in the coming quarters,** although it will not be sufficient -in the most likely scenario- to prevent a GDP fall in the year as a whole similar to that of 2012. **Moving forward, several factors continue to point towards a consolidation of growth in 2014.** In the global economic outlook, we expect a moderate acceleration of GDP growth, with the Eurozone posting positive figures. Domestically, some internal adjustment processes will be practically completed, with fiscal policy becoming somewhat less contractionary than in 2012 and 2013. Thus, whilst we have revised our forecasts of external demand slightly downwards and of internal demand upwards, we continue to hold to our prognosis for the underlying performance of the Spanish economy: it is bottoming out in 2013, with recovery starting in 2014.

This scenario is not risk-free. Whilst the effect of the measures launched during the last twelve months have outweighed the increase in uncertainty, the relaxation in financial tensions and the resolution of the fragmentation of the European financial system are dependent on progress with structural reform processes both in Spain and Europe, where more decisive progress towards a banking union is of vital importance. Further, if the pace of growth of emerging economies should ebb - particularly in China - without a proper internal demand as the driver of growth, the recovery of the European economy and, by extension, of the Spanish economy, could be curtailed.

1: In particular, the ECB's Outright Monetary Transaction (OMT) programme; the financial assistance agreement undertaken by Europe and Spain in the Memorandum of Understanding (MoU) to strengthen the solvency of the Spanish financial system and, lastly, the set of fiscal measures unveiled by the Spanish government to bring the adjustment of public accounts into line with the targets agreed with the European Union.

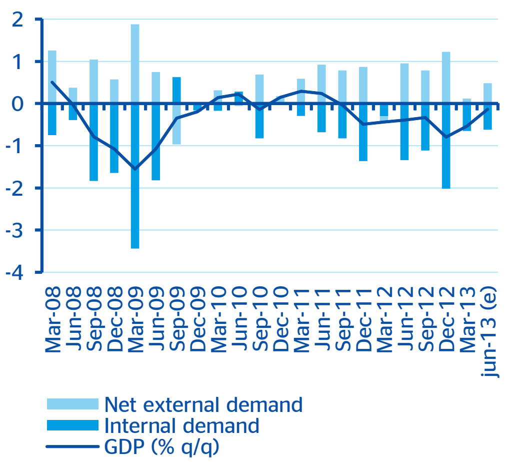
2: First of all, by lowering the benchmark interest rate to 0.5% in May. More recently, by undertaking a significant change in the orientation of monetary policy by guaranteeing that interest rates would remain low - at current rates or even lower - for a prolonged period. Lastly, in its July meeting, it eased collateral eligibility requirements to seek to ensure liquidity - especially in peripheral countries - in response to continuing fragmentation of financial markets and the slow process of creating the banking union. In the same vein, the European Council launched in July the Investment Plan for Europe with the aim of boosting the financing of small and medium-sized enterprises.

The Spanish economy neared a turning point in 2Q13

Though we do not yet have the final breakdown, the preliminary GDP forecasts released by the National Statistical Institute (INE) indicate **that the Spanish economy contracted 0.1% qoq in 2Q13**[3]. If this estimate is confirmed, the **decline in activity** between April and June was **less intense than estimated at the start of the quarter (BBVA Research: -0.3% qoq)** and than in the early part of 2013 (-0.5% qoq). Regarding the composition of growth, preliminary indicators released to date point to a slower contraction in domestic demand (contribution of -0.6 pp of GDP). Export sales recovered in the second quarter of the year, confirming the consolidation of net foreign trade as a driver of the recovery, with a contribution of 0.5 pp to qoq growth (see Chart 9).

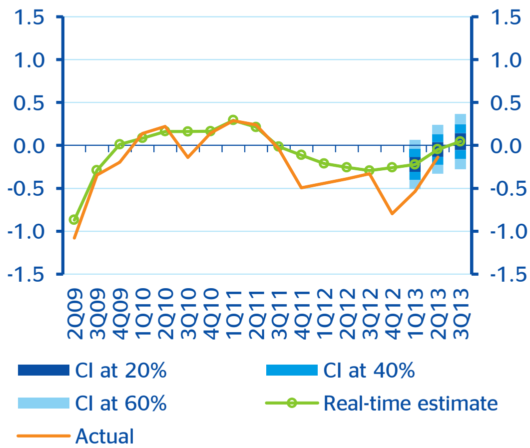
Looking forward to the third quarter of 2013, the available information indicates that the economy is entering an expansionary phase of the cycle that will be characterised by a gradual pace of recovery (MICA-BBVA Research: between 0.0% and 0.1% qoq) (see Chart 10)[4].

Chart 9
Spain: contributions to quarterly GDP growth



(e): estimate.
Source: BBVA Research based on INE

Chart 10
Spain: GDP growth and forecasts using the MICA-BBVA Model (% qoq)



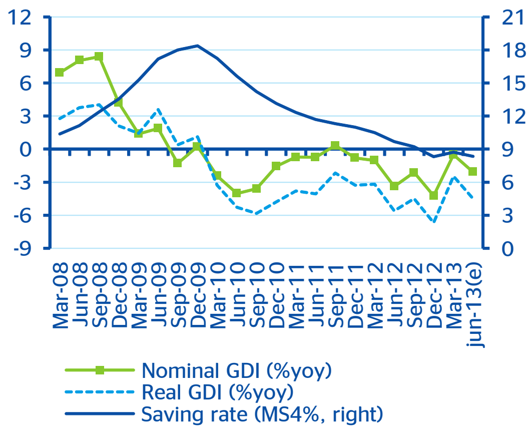
Current forecast: August 2, 2013
Source: BBVA Research based on INE

Smaller decline in private domestic demand

Preliminary demand indicators -mainly of durable goods[5] and, to a lesser extent, of services- show that the decline in households spending continued to ease in 2Q13. The lower than expected reduction in real household disposable income, an improved net financial wealth, the expected reduction in the savings rate and the Efficient Vehicle Incentives Plan (PIVE-2) [6]contributed to maintaining private consumption between April and June (see Chart 11). Thus, BBVA's synthetic consumption indicator (SCI-BBVA) and coincident consumption indicator model (MICC-BBVA) suggest that household spending contracted by around 0.2% qoq (-3.0% yoy) in 2Q13, compared to the 0.3% qoq reduction in the previous quarter (see Chart 12).

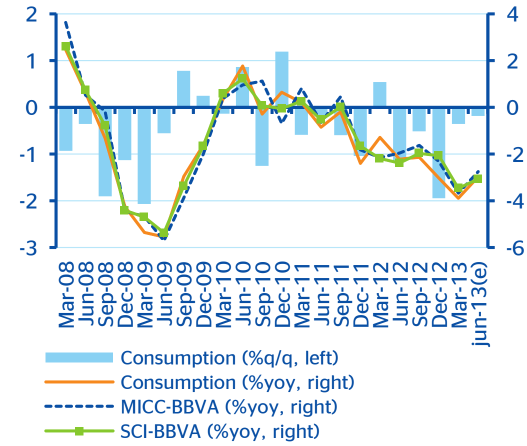
3: All figures related to the Quarterly National Accounts (CNTR) are seasonally and working-day adjusted (SWDA).
4: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-Term GDP Forecasting", BBVA WP 10/21, available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1021_tcm348-231736.pdf?ts=2542012
5: See section 3 of Consumption Outlook corresponding to the first quarter of 2013 for a detailed analysis of consumer spending by type of goods and services, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1306_Situacionconsumo_tcm346-391486.pdf?ts=1872013
6: PIVE-2 aims to replace cars and light commercial vehicles over 10 and 7 years old, respectively, with more energy-efficient vehicles. With a budget of 150 million euro, it ran until mid-July, when all its funds had been used up. The Government has embarked on PIVE-3, in force since July 28, with a smaller budget (70 million euro).

Chart 11
Spain: GDI and household savings rate



(e): estimate
Source: BBVA Research based on INE

Chart 12
Spain: observed data and real time forecast of household consumption

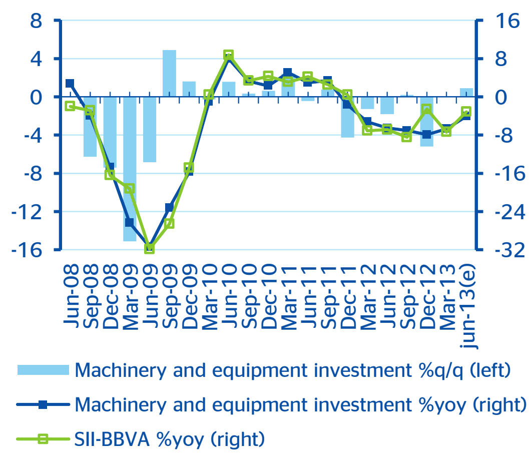


(e): estimate
Source: BBVA Research based on INE

Investment in equipment and machinery displayed a change of trend in the first quarter of the year that appears to be consolidated in the second quarter as a result of the strength of export demand and less weakness of domestic demand. Hence, a good deal of the preliminary indicators related to this demand component, and reflected in the synthetic investment indicator (SII-BBVA), point to **2Q13 growth of about 0.9% qoq** (-4.1% yoy) (see Chart 13). Confidence has recovered among equipment goods producers and capital goods imports are increasing. Sales of commercial and industrial vehicles have markedly increased, possibly fuelled by implementation of the PIMA Aire Plan in February.

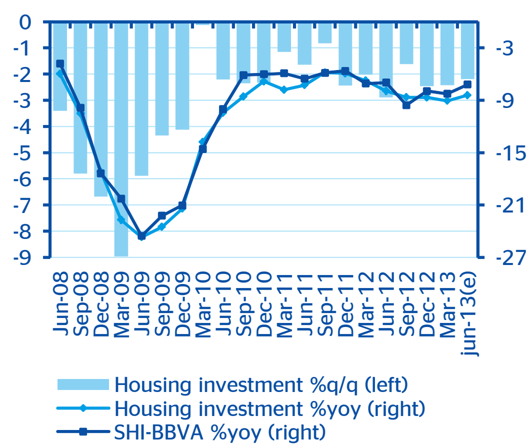
Residential investment continues to be immersed in its adjustment process, dragged down by the weakness of construction activity, which has slowed its correction. However, housing sales figures show a somewhat better performance than in the previous quarter due to the base effects caused by the change in the taxation of housing at the start of this year. Despite the improvement in demand[7], investment flows in the sector continue to be weak. Our SHI-BBVA synthetic housing investment indicator **suggests that housing investment will contract by 2.2% qoq in 1Q13 (-8.4% yoy)** (see Chart 14).

Chart 13
Spain: observed data and real time forecasts for machinery and equipment investment



(e): estimate
Source: BBVA Research based on INE

Chart 14
Spain: observed data and real time forecast of housing investment



(e): estimate
Source: BBVA Research based on INE

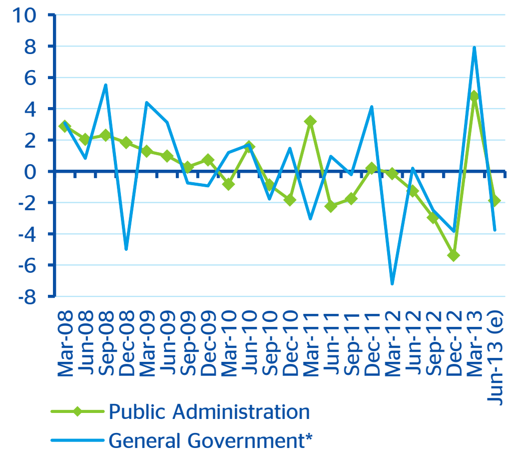
7: Transaction data for the first two months of 2Q13 published by the National Council of Notaries show average monthly growth of 2% SWDA.

Further adjustment in public consumption

Budgetary execution figures suggest that, in real terms, **public demand continued to drain growth throughout 2Q13.** Although the latest available data still show that much of the consolidation effort has focused on cutting investment, they also reveal a further adjustment in final consumption by the Central Government in nominal terms (see Chart 15). Meanwhile, public sector employment continued to deteriorate in 2Q13, although at a slower pace than in previous quarters (see Chart 16).

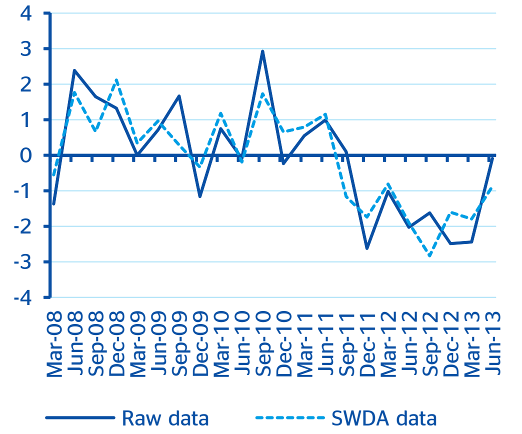
Based on this information, **it is expected that public sector expenditure fell throughout the second quarter,** but at a slower pace than in the second half of 2012. **Non-residential construction investment appears to have declined at a similar rate to previous quarters.**

Chart 15
Spain: public consumption, nominal terns (% qoq, SWDA)



(e): estimate
(*): does not include fixed capital consumption
Source: BBVA Research based on MINHAP

Chart 16
Spain: public sector employment (% qoq)



Source: BBVA Research based on INE (Labour Force Survey)

Exports recovered in the second quarter

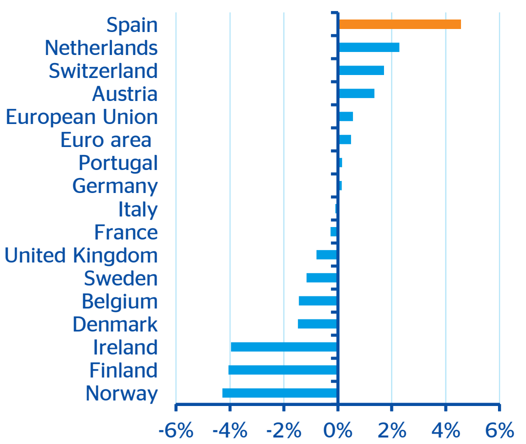
Spanish exports faced an adverse climate in the first quarter of the year, marked by a further contraction of activity in the EMU. In spite of this environment, goods exports saw healthy growth (+1.2% qoq), although it was not sufficient to offset the decline in the export of services (-6.6% qoq), which resulted in a clear fall in total exports in 1Q13 (-1.3% qoq). The surprise of the quarter was, unquestionably, the pronounced decline in non-tourism service exports (-10.7% qoq). Overall, the Spanish economy continued to export at a high year-on-year rate compared to other developed economies (see Chart 17).

Economic indicators available for 2Q13 point to a recovery of trade flows. Real exports of goods from the trade balance grew in May and corrected part of the decline recorded at the start of the quarter. Exports of goods and services by large firms expanded at a high rate till June, especially to non-EU destinations. Moreover, the industrial exports order book was higher at the end of 2Q13. These signs point towards **an expansion of export sales of goods in 2Q13, with possible growth of 0.6% qoq (+5.4% yoy).**

Albeit the downward forecast revision of the core European economies anticipated a contraction in the demand for tourism services, **political tensions in the competing countries of the eastern Mediterranean (Egypt and Turkey) are giving rise to further increases in the flow of foreign tourists to Spain.** June, with a new record of tourist arrivals on the border (6.3 million visitors) ended a positive quarter in which not only the demand from eastern European countries is performing well. Overall, foreign tourist arrivals increased by 4.2% yoy in the quarter, including an increase of 33% in the number of tourists from Russia and of 15.9% in those from the Nordic countries. Furthermore, demand from the European core also performed well: increases of 6.1% in France, 4.5% in the United Kingdom and 3.1% in Germany. **Hence, data on 2Q13 points to an upward correction of non-resident consumption in Spain of about 2.1% qoq** (see Chart 18).

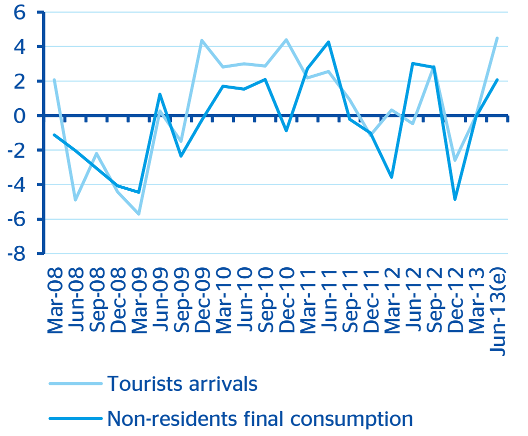
Therefore, the economic information available at the time of writing this report anticipates a recovery in services exports and continuous growth in goods exports, which would result in **an increase of 1.3% qoq (4% yoy) in total exports in 2Q13.**

Chart 17
Spain and Europe: exports of goods and services (% change 1Q12-1Q13, volume, SWDA)



Source: BBVA Research based on Eurostat

Chart 18
Spain: indicators of tourist services exports (% qoq, SWDA)



(e): estimate
Source: BBVA Research based on INE

The pace of contraction of imports continued to slow in 1Q13, due to the boost of goods exports and a slower deterioration of internal demand. In 2Q13, this dynamic appears to have consolidated - and strengthened by the recovery of service sector exports - giving rise to a mild contraction of imports (-0.2% qoq, -4.0% yoy).

Overall, preliminary economic indicators point to **a larger positive contribution of net foreign trade to growth if compared to the previous quarter (+0.5 pp versus +0.1 pp).** The positive dynamics of foreign trade variables fuelled a further correction in the current account deficit, which may have moved into positive terrain in the accumulated 12-month period.

The labour market regains its pulse

Labour market figures show that the pace of job destruction between April and June decreased by half from 1Q13. The average number of Social Security affiliates fell by 0.4% qoq SWDA in 1Q13 (-0.5% qoq including the loss of non-professional carers[8]), 0.3 percentage points less than in the previous quarter. Seasonally adjusted unemployment barely increased in 2Q13 which, combined with the decrease in unemployed job seekers[9], would suggest further shrinkage in the economically active population (see Chart 19)[10].

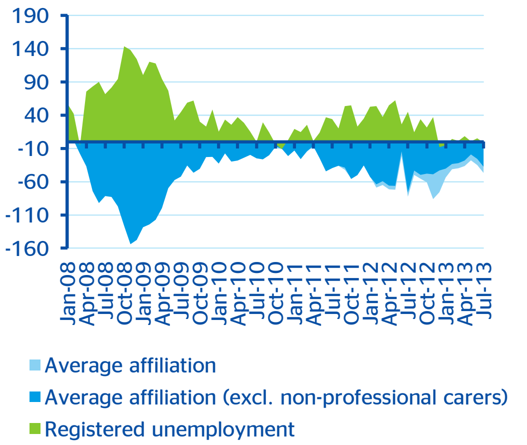
8: The Royal Decree-Law 20/2012, of 13th July, on measures to ensure budget stability and improve competitiveness, modified certain special agreements in the Social Security system for non-professional carers of dependent persons. This established that those who signed up to the agreement –which became voluntary- would be obliged to pay Social Security contributions from August 31 (85% until December 31 and 100% thereafter). This has reduced the number of affiliates by 150,000 since November.

9: In addition to the registered unemployed, unemployed job seekers include other groups - seekers of temporary employment of less than 20 hours a week, students, seekers of pre-employment services and subsidised seasonal agrarian workers - that are eligible for classification as unemployed in the Labour Force Survey.

10: Figures for July show that unemployment fell, yet Social Security affiliations did not confirm the positive surprises of previous months due to the unfavourable behaviour of the service sector. Once the data is adjusted for seasonal and calendar effects, we estimate a decline in the number of social security affiliates of 37,500 (discounting the loss of non-professional carers) and a reduction in the number of registered unemployed of 1.300. See: http://www.bbvaresearch.com/KETD/fbin/mult/130802_Flash_Espana-Paro_jul13_tcm346- 398454.pdf?ts=282013.

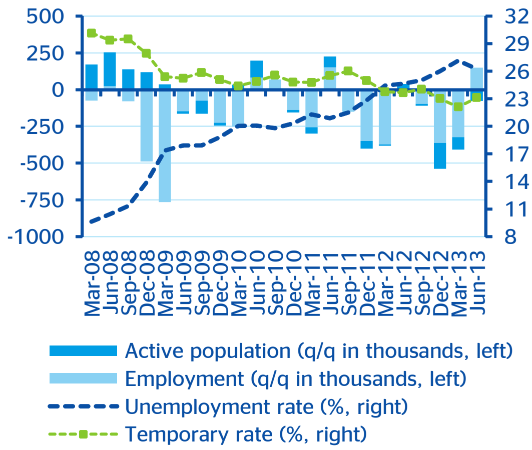
Broadly speaking, the **Labour Force Survey (LFS) for 2Q13 confirms the trend shown by social security affiliates and unemployment claims.** The seasonal employment increase (+149,100 people, -39,100 SWDA) was accompanied by a notable shrinkage in the active population (-76,100 people, -124,900 SWDA), which caused a reduction in the unemployment rate to 26.3% (26.4% SWDA), 0.9 pp less than in 1Q13. The unexpected growth of agrarian employment (+37,500 people) and the good performance of services (+154,800) offset the drop in employment in industry and construction. The number of permanent contracts fell by 50,400, whilst temporary workers grew by 162,200, due largely to favourable seasonal factors. Accordingly, the temporary employment rate increased by 1 pp to 23.1% (see Chart 20).

Chart 19
Spain: average social security affiliation and registered unemployment (monthly change in thousands of people, SWDA)



Source: BBVA Research based on MEySS

Chart 20
Spain: labour market indicators



Source: BBVA Research based on INE

Consumer prices ease off and support wage restraint

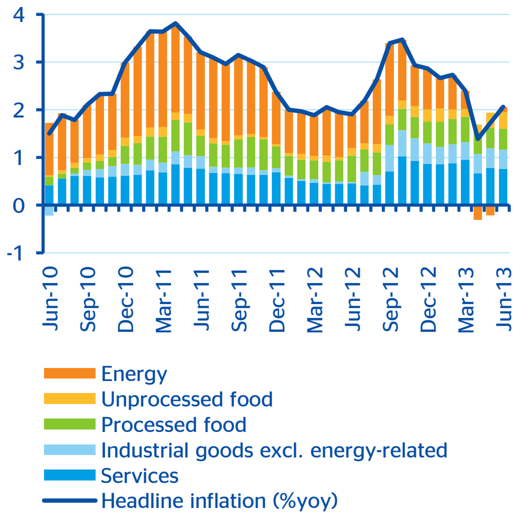
Headline inflation slowed in the second quarter by an average of 0.9 pp to 1.7% yoy[11]. This was mainly due to a larger than expected slowdown in energy prices, which even made a negative contribution to the year-on-year change in consumer prices in April and May (see Chart 21). In addition, **core inflation also slowed by 0.3 pp** in the past quarter to 1.9% yoy and contributed 0.2 pp to the overall trend.

Meanwhile, the Harmonised Index of Consumer Prices (HICP) showed that the inflation differential between **Spain and the Eurozone remained positive in the second quarter**: in terms of headline inflation, the differential appears to have averaged about 0.4 pp and, in terms of the core component, about 0.8 pp (compared to a historical average of +0.8 pp in both cases). Nonetheless, because this differentail reflects the increase in indirect taxes of 2H12, it does not constitute a direct loss of competitiveness for Spanish exports.

Given labour market weakness and the wage restraint that began in 2012, mainly resulting from the 2nd Agreement on Employment and Collective Bargaining (AENC) and the labour market reform[12], **we still do not expect any significant second-round effects from the increase in indirect taxes.** In this regard, average wage increases established in collective agreements were limited in the second quarter, as shown in Chart 22[13]. In fact, bargained salaries increased by about 0.7% yoy, only a tenth of a percent above the maximum limit set in the 2nd AECB for 2013 as a whole.

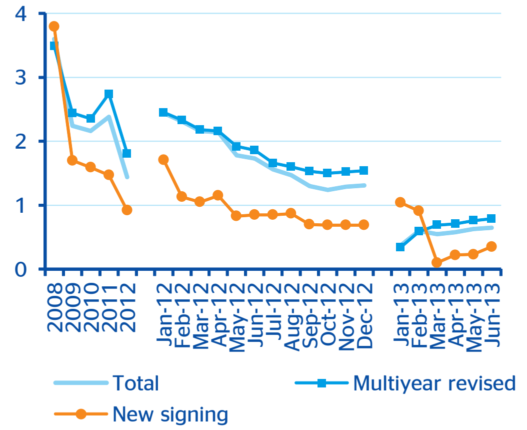
11: The leading indicator of CPI in July points to a deceleration of yoy inflation to 1.8%, which corresponds to the exhaustion of the base effect caused by the increase in pharmaceutical co-payment and the uptick in energy prices of July 2012. See http://www.bbvaresearch.com/KETD/fbin/mult/130730_Flash_Espana_IPCA_tcm346-397995.pdf?ts=3072013.
12: Box 2 in Spain Outlook corresponding to the second quarter of 2013 shows how wage restraint in 2012 helped slowdown the decline in employment. See: http://www.bbvaresearch.com/KETD/fbin/mult/1305_Situacionespana_tcm346-385826.pdf?ts=1972013.
13: Both the number of agreements signed in the first quarter of 2013 and the number of workers affected have declined from the levels of previous years. Some 744 agreements were registered to June, affecting 2.1 million workers, compared to the 1113 signed in 1H12, which covered 2.9 million workers.

Chart 21
Spain: contributions to annual CPI growth



Source: BBVA Research based on INE

Chart 22
Spain: average wage increases in collective bargaining agreements (% yoy)(*)



Annual data include the agreements registered after December of each year and incorporate the revision of the wage guarantee clause.
(*) Provisional from 2011 onwards
Source: BBVA Research based on INE

Outlook 2013-2014: a change of cycle

As discussed in the introduction to this section, the fundamentals of the Spanish economy point towards **a return to growth in the coming quarters that, nonetheless, will be insufficient to prevent an aggregate fall in GDP of approximately 1.4% in 2013. Economic activity will increase by 0.9% (see Table 1) in 2014,** due to an improvement in the international outlook, the expected reduction in the contractionary stance of fiscal policy and some internal adjustment processes nearing conclusion. Although these forecasts involve no changes in the growth figures set forth three months ago, they do include a slight downward revision in net export demand -due to lower expectations on global growth- and an upward revision in domestic demand and employment -as a result of less weakness in their components during the first quarter of the year. Overall, we hold to our prognosis of the underlying performance of the Spanish economy: after nearly five years, the crisis is bottoming out in 2013, giving way to the traditional pattern of sustained recovery in 2014.

Once again, the regional heterogeneity involved in this economic outlook will be considerable, with the exposure to export demand for goods and services (especially non-European), the pace of corrections of structural imbalances and the fiscal consolidation path being the most relevant factors explaining the regional disparity (see Section 5).

Nonetheless, even though the economic decisions taken in the past year continue to hold up financial market tension, **the recovery that is forecasted in this scenario remains conditional upon the progress of structural reforms in both Europe and in Spain and the pace of expansion of the emerging world** –particularly, of China- which are gradually taking over from traditional trading partners. If these factors are not in place, the recovery of the European economy and, by extension, of the Spanish economy, could be curtailed.

Table 1
Spain: macroeconomic forecasts

(yoy %, unless otherwise indicated)	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13 (e)	2012	2013 (f)	2014 (f)
National Final Consumption Expenditure (FCE)	-2.0	-2.3	-2.6	-3.3	-4.0	-3.6	-2.5	-3.2	-0.7
Private FCE	-1.3	-2.2	-2.1	-3.0	-3.9	-3.0	-2.1	-2.6	-0.3
Household FCE	-1.3	-2.2	-2.1	-3.0	-3.9	-3.0	-2.2	-2.6	-0.3
Public Administration FCE	-3.8	-2.8	-4.0	-4.1	-4.3	-5.4	-3.7	-4.7	-1.8
Gross capital formation	-7.1	-8.8	-9.2	-9.7	-9.0	-7.1	-8.7	-6.4	1.1
Gross fixed capital formation	-7.4	-9.2	-9.7	-10.3	-9.0	-7.1	-9.1	-6.5	1.1
Fixed material assets	-8.1	-10.0	-10.7	-11.0	-9.8	-7.8	-10.0	-7.2	0.8
Equipment, machinery and cultivated assets	-5.1	-6.4	-7.0	-7.9	-6.5	-4.0	-6.6	-2.7	5.1
Equipment and machinery	-5.2	-6.5	-7.0	-7.9	-6.7	-4.1	-6.7	-2.8	5.0
Construction	-9.5	-11.6	-12.4	-12.3	-11.3	-9.7	-11.5	-9.4	-1.4
Housing	-6.8	-7.9	-8.7	-8.7	-9.1	-8.4	-8.0	-8.4	0.0
Other buildings and constructions	-11.9	-14.9	-15.8	-15.7	-13.3	-10.9	-14.6	-10.2	-2.7
Change in inventories (*)	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.0	0.0
Domestic demand (*)	-3.1	-3.8	-4.0	-4.7	-4.9	-4.3	-3.9	-3.8	-0.3
Exports	2.1	2.7	4.2	3.2	4.5	4.0	3.1	3.6	6.8
Imports	-5.9	-5.2	-3.4	-5.4	-5.1	-4.0	-5.0	-3.8	3.6
Net trade balance (*)	2.4	2.4	2.4	2.8	2.9	2.5	2.5	2.3	1.2
GDP at mp	-0.7	-1.4	-1.6	-1.9	-2.0	-1.7	-1.4	-1.4	0.9
Pro-memoria									
GDP w/o housing investment	-0.3	-0.9	-1.2	-1.5	-1.6	-1.4	-1.0	-1.0	0.9
GDP w/o construction	0.7	0.3	0.0	-0.4	-0.7	-0.7	0.2	-0.4	1.2
Employment (LFS)	-4.0	-4.8	-4.6	-4.8	-4.6	-3.6	-4.5	-3.0	0.2
Unemployment rate (% active pop.)	24.4	24.6	25.0	26.0	27.2	26.3	25.0	26.2	25.4
Employment (FTE)	-3.7	-4.7	-4.6	-4.7	-4.5	-4.0	-4.4	-3.4	0.1
CPI (period average)	2.0	2.0	2.8	3.1	2.6	1.7	2.4	1.7	1.1

(*) Contribution to growth.
(e): estimate (f): forecast.
Source: BBVA Research based on INE

The correction of internal imbalances is nearing the end, while the positive contribution of export demand persists

First of all, **fiscal consolidation is expected to continue to drain growth in 2013 and, to a lesser extent, in 2014.** In spite of the recent extension of the deadline for reducing the public deficit to 3% of GDP, the impact of the cyclical position on public accounts and the still high cost of financing the debt mean that the fiscal burden is still significant (see Section 4). In view of the budgetary execution figures for the first quarter and the measures approved by the Government, we expect real public sector consumption to fall by 4.7% in 2013, while investment in non-residential construction will fall by 10.2%. This contraction in public sector demand will slacken off in 2014, taking the fall in actual public sector consumption and non-residential construction investment to around -1.8% and -2.7%, respectively.

With regard to private consumption, the 2012 indirect tax increase and the expected weakness in some of its determinants lead us to forecast a fall in expenditure of around -2.6% this year (versus a -3.0% forecast three months ago) and, to a lesser extent, next year of around -0.3% (versus a -0.5% forecast in May). The worsening employment situation will again decrease the contribution of salaries to household gross disposable income, which will fall in 2013 and remain practically constant in 2014. In addition, the September 2012 VAT increase will have a permanent contractionary effect on consumption levels. Furthermore, real estate wealth will continue to decline over the coming quarters. Conversely, the expected recovery in net financial wealth, the maintenance of historically low levels in household savings rate[14], the absence of demand-driven inflationary pressure and the expectation that official interest rates will remain unaltered will all soften the expected contraction in private consumption.

Although borrowing costs will remain relatively high, **2013 appears to be a year of transition for investment in equipment and machinery.** In fact, less weakness in internal demand and the strength of exports allow us to improve our overall 2013 forecast for this component of demand if compared to our scenario of three months ago. Still, **we expect a further contraction of -2.8% in the current year. In 2014, this component of investment will return to sustained growth,** due mostly to the recovery of domestic demand and the support of a healthy external demand, **ending the year with an increase of about 5.1%.**

The recovery in housing investment will take longer. In 2013, construction activity will continue to decline, albeit at a slower pace: in view of the number of new home starts, it would appear that the downturn cannot go much further[15]. Meanwhile, we expect a significant decline in sales in 2013 after the growth of 2012, although less than expected. This is partly due to the sustained foreign demand and the appeal of certain transactions to investors. Consequently, we expect a contraction in this component of investment **of around 8.5% in 2013. However, the recovery in construction and the expected improvement in demand fundamentals would prevent further declines of residential investment in 2014.**

The outlook for the foreign sector is shaped by the mild slowdown of the global economy in 2013. **Even so, global growth will still be high and point to an average export growth of 5.2% in 2013-2014,** nearly a full point lower than the growth figure expected three months ago. It should be noted, however, that the persistence of political tensions in competing countries of the eastern Mediterranean -i.e. Egypt and Turkey- introduces an upside bias to our beginning-of-the-year forecasts on tourism services exports[16].

Led by improved internal demand and still-strong export growth, imports will reduce their fall and begin to grow in our forecast period, with a mild contraction of -0.1% in 2013-2014. **The foreign sector will continue to drive growth and contribute, on average, 1.8 pp to GDP growth through 2014, paving the way for current account surpluses in both 2013 and 2014** (see Box 1).

The labour market reform and the incipient recovery mitigate job destruction in 2013 and point towards a hopeful 2014

The slower deterioration of economic activity eased the pace of job destruction in the quarter, which adds a **positive bias to our forecasts for 2013** in spite of the expected decrease in the number of public sector employees as a result of fiscal consolidation. Even if we take into account the expected decline in the active population, **the unemployment rate would increase to 26.2% for 2013 as a whole.** The recovery of growth **in 2014** and the improved efficiency of

14: See Box 2 of the Consumption Outlook corresponding to the first quarter of 2013 for a detailed analysis of the drivers of the savings rate of households in Spain over the last four decades.

15: In 2012, the number of new home starts barely exceeded 7.5% of the starts between 2004 and 2008, and, in 2013, they are expected to equal roughly 4.5% of the starts in the preceding expansionary phase.

16: The safety of the Spanish tourism market remains a strong point in comparison with its Mediterranean competitors, which may once again facilitate the absorption of demand coming from such destinations. In fact, during the 2011 revolts in the North African markets, non-resident consumption in Spanish territory increased by 6.4%, while it fell by nearly 30% in these markets (-33% and -30% in Tunisia and Egypt, respectively). A year later, these destinations recovered only a portion of their demand (+29.4% and +17% in 2012, respectively) while Spain saw a downward correction of approximately 1.0%.

the labour market brought about by the labour market reform[17] will cause **an increase in private sector employment and a slight reduction in the unemployment rate,** above all in the second half of the year[18].

Inflation expectations remain anchored below 2.0%

In spite of the recent increases in taxes (tobacco and alcoholic beverages) and in regulated prices (electricity), we expect inflation to continue to ease - at least for the rest of 2013 and the first quarter of 2014 - following the disappearance of the base effect introduced by the tax changes in 2H12. Overall, **although uncertainly about imported inflation -i.e., commodity prices- is high, no inflationary pressures can be seen on the demand side. Hence, average inflation will be roughly 1.7% this year, while we forecast 1.1% for 2014.**

17: An assessment of the labour market reform approved in February 2012 is given in Box 4 of Spain Economic Outlook corresponding to the second half of 2012.

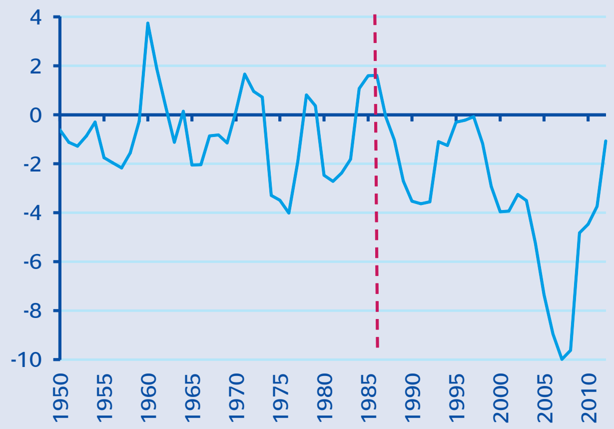
18: The labour market reform provides the necessary rebalancing between the extensive margin (employment) and the intensive margin (hours worked and wages) and aids productivity gains. These consequences, together with the change in Spain's production model, should facilitate greater job creation and a more intensive reduction in the unemployment rate for every percentage point of GDP. For more details, see: Andrés. J, J. E. Boscá, R. Doménech and J. Ferri: "Job Creation in Spain: Productivity Growth, Labour Market Reforms or both", BBVA Working Paper 10/13, Madrid. Available at:http://www.bbvaresearch.com/KETD/fbin/mult/WP_1013_tcm348-221513.pdf?ts=15112011.

Box. 1. An analysis of the performance and the determinants of the current account balance in Spain

During the 1950-2012 period, the Spanish economy registered an average deficit of 1.9% of GDP in its annual accounts with the rest of the world. From 1950 until the mid-1980s, Spain alternated brief episodes of surplus in its current account with more pronounced and lasting deficits (see Chart 23). After joining the European Economic Community (EEC) in 1986 through till 2012, the Spanish economy recorded 26 consecutive years of deficit in the current account balance. Out of that record, it stands out the deterioration that began in 1995 and culminated in 2007 with the largest deficit in Spain´s recent history (10% of GDP).

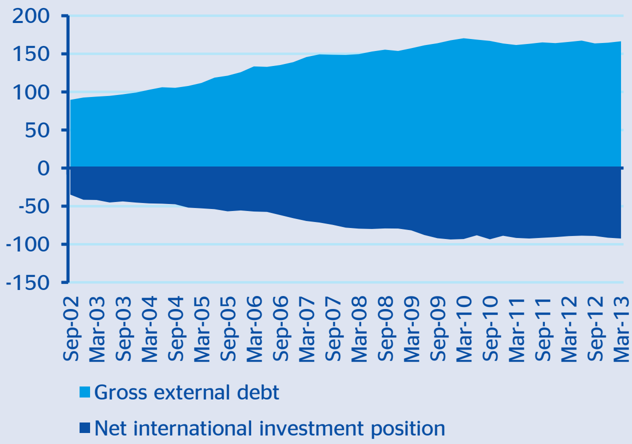
In principle, the historical deficit of the current account balance in Spain could be attributed to a process of convergence in per capita income with Europe. As an economy opens up to the outside world and modernises, it accumulates factors of production (capital and labour) and adopts more efficient technology and practices with the expectation that the future income flow derived from greater competitiveness will pay the foreign debt accumulated during the convergence period. However, even in the presence of convergence factors, the current account deficit can become problematic when it surpasses the so-called sustainability level, that is, when it is questionable whether a country's future savings will be able to address the debt accumulated in past years. The specific magnitude of the sustainability threshold is open to debate: from 5% of GDP to the value at which the ratio between the net international investment position[19] (NIIP) and GDP stabilises (see, for example, Summers (1966) and Milesi-Ferreti and Razin (1996))[20]. According to both criteria, during the pre-crisis period, the Spanish economy broadly surpassed what could be considered the sustainability level. The external deficit exceeded 5% of GDP for five consecutive years and the economy accumulated a NIIP in the range of 90% of GDP, both magnitudes difficult to mantain in the medium term (see Charts 23 and 24). During those years, the perception that the level of external debt was unsustainable dissipated by the apparently unlimited availability of foreign savings prepared to invest in Spanish private assets[21].

Chart 23
Spain: current account balance as a % of GDP, 1950-2012



Note: The vertical line represents 1986, the year of Spain´s entry into the EEC.
Source: Correa-López and de Blas (2012)

Chart 24
Spain: gross external debt and NIIP as a % of GDP



Source: BBVA Research based on Bank of Spain

19: The NIIP discounts the foreign assets that are the property of residents in Spain from the gross external debt of the Spanish economy.
20: The current account deficit threshold that the literature has traditionally identified as problematic -thus a precursor of balance of payments crises- is 5%, more so if the deficit is the result of high consumption that is financed by short-term debt and reserves. On the other hand, the stabilisation of the NIIP over GDP would reflect, among other things, both the availability of foreign capital to finance the current account deficit and the predisposition of the debtor country to pay off its foreign debt.
21: For a detailed analysis on the capital movements experienced by the Spanish economy since joining the Euro, see Box 3 of Spain´s Economic Watch corresponding to the third quarter of 2012, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1208_Situacionespana_tcm346-351334.pdf?ts=3072013

Episodes of significant deterioration of the current account deficit tend to precede the so-called periods of "reversal" or abrupt correction of the deficit. For a sample of 25 industrialized countries analysed during the 1980-1997 period, Freund (2005) found that the typical reversal begins when the current account deficit reaches 5% of GDP and that 80% of the deficit disappears in three years, although there is heterogeneity in the experiences of different countries. The Spanish economy began its last current account reversal in 2008 and, in five years, **the accumulated adjustment has reached 89%**, with 2009 and 2012 being the years that registered the largest absolute change (4.8 pp vs. 2.7 pp of GDP, respectively). In line with the pattern of correction identified in Freund (2005), the adjustment of the current account in Spain has been accompanied by declines in private investment (34%) and imports (15%), a real unit labour costs depreciation of more than 5% and export growth of 11%, the latter in the absence of the nominal exchange rate devaluation as an adjustment mechanism. Furthermore, balance of payments data available for 2013 indicate that the Spanish economy is likely to close the year with a moderate surplus. The key question is to discern to what extent the current adjustment will lead to a situation in which Spain generates structural current account surpluses.

A summary of the results of a recent study on the dynamics of the current account balance in Spain during the 1980-2012 period is provided next (see BBVA Reseach, 2013). The study adopts an analytical framework that explores the current account variation in terms of its cyclical (short term) and structural (medium- and long-term) components. The analysis takes as its departing point the macroeconomic identity between net national savings – private and public – and net foreign savings, which include the return – positive or negative – on the NIIP[22]. Among other variables, the study explores the role of the fiscal balance, relative per capita income, the initial NIIP, investment, the rate of demographic dependence and trade liberalization, as determinants of the current account balance. In addition, each explanatory variable is broken down into its three frequencies of oscillation and each one of the components is allowed to have a different effect on the current account[23]. Table 2 summarises the factors that can influence the dynamics of the current account balance and specifies the sign of the expected correlation according to the economic literature.

The analytical results show that, for the case of Spain, the variables that have the largest correlation with the current account are investment and the oil trade balance[24]. In the medium-term component, they are also significant the credit to the private sector and the old-age dependency ratio, with a negative sign, and the degree of trade liberalization, the fiscal balance and per capita GDP, with a positive sign. From a cyclical point of view, the effects of health care spending, the output gap, the volume of credit to the private sector and the change in the real effective exchange rate are significant.

22: For a revision of the methodology see, for example, Ca' Zorzi *et al*. (2012).
23: In the case of certain variables, such as the output gap, only the cyclical or short-term component is included (for further details, see BBVA Research (2012, 2013)).
24: The model is estimated in a panel of 72 countries observed during the 1980-2012 period. The data sources are IMF-WEO, World Bank, United Nations, OECD, Darvas (2012), and BBVA Research. The variables are expressed in deviation from the world average, except the dependent variable, the initial NIIP, the oil trade balance and the change in the terms of trade, since, in these cases, the world average would be zero. The model is first estimated using the Feasible Generalised Least Squares (FGLS) estimator. In a second stage, the estimate of the short- and medium-term coefficients that result from the estimation of the panel is adapted to the Spanish case. Specifically, the coefficients are re-estimated in a time series bayesian model, where the short- and medium-term coefficients of the panel model, as well their distribution, are used as prior information in the bayesian estimation. The estimation of the long-term coefficients of the panel model remains unaltered.

Table 2
Determinants of the current account balance

Variable	Expected correlation	Theoretical Mechanism
Old dependency ratio (% of total population)		A greater proportion of economically-dependent inactive individuals is associated with lower national savings.
Young dependency ratio (% of total population)	(-)	
Population growth	(-)	Variable that approximates the future working-age population.
Spending on public health care (% GDP)	(-)	Variable that approximates structural gaps in economic policy.
Investment (% GDP)	(-)	The current account deficit correlates with future productivity gains derived from higher current investment as a result of, for example, a convergence or "catching-up" process (-). If the rate of long-term investment is high, the return on this investment -through gains in productivity - will improve the current account balance (+). The (-) correlation tends to dominate the literature.
GDP per capita (PPA adjusted, U.S. dollars, in logs)	(+)	Countries with lower income and, as a result, a lower degree of development, tend to have high current account deficits, due to the combination of investments they make in order to foster economic convergence.
Fiscal balance (% GDP)	(+)	Budget deficits are associated with a worse performance of the current account balance, as the income of future generations is distributed to the current generation.
Credit to the private sector (% GDP)	(+)/(-)	A more developed financial system can give rise to greater savings (+); in contrast, it can also signal excessive ease of indebtedness, which would give rise to less savings (-).
NIIP (% GDP)	(+)	A better initial NIIP tends to be associated with a better performance in the current account balance, due to a better performance of the income balance (+). On the other hand, the better initial NIIP could facilitate the accumulation of trade deficits over a long period of time (-). The (+) correlation tends to dominate in the ilterature.
Trade liberalization (% GDP)	(+)	Variable that approximates the existence of barriers to international trade -or, in a broader sense, the costs of international trade. This variable can include other attributes, such as the degree of attractiveness for foreign direct investment.
Oil trade balance (% GDP)	(+)	High oil prices erode the energy balance of importing countries, which is associated with a worsening of the current account deficit.
Output gap (% GDP)	(-)	Variable that approximates demand shocks.
Terms of trade (% change)	(+)	An improvement in the terms of trade is associated with an increase in real disposable income and, as a result, of savings.
Real effective exchange rate	(+)	Gains in exports price-competitiveness improves the current account balance.
U.S. short-term interest rate (%)	(-)	Adverse movements in the capital markets are associated with a worsening of the current account balance.
VIX (% change)	(+)	An increase in risk aversion is associated with greater savings.

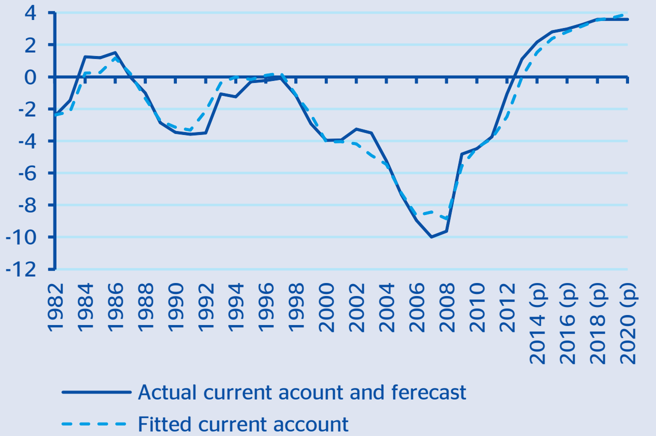
Source: BBVA Research based on Chinn and Prasad (2003), Chinn and Ito (2007), Cheung *et al.* (2010) and Ca' Zorzi et al. (2012)

Chart 25 shows the path of the observed current account and its forecast for the 2013-2020 horizon. The current account forecasts are taken from the World Economic Outlook (WEO, Apri 2013), published by the International Monetary Fund (IMF). Likewise, the chart shows the current account path adjusted by model and its forecast, such that the forecasts of the explanatory variables are taken largely from WEO[25]. The chart shows the good fit of the model over the sample period. The forecast path derived from the model is fairly similar to that of the IMF and both predict a current account balance in clear surplus in 2020. If this path were confirmed, it would mark an important step in the deleveraging process of the Spanish economy with the rest of the world.

25: Priority has been given, whenever possible, to the useof a single source for the projections of all variables.

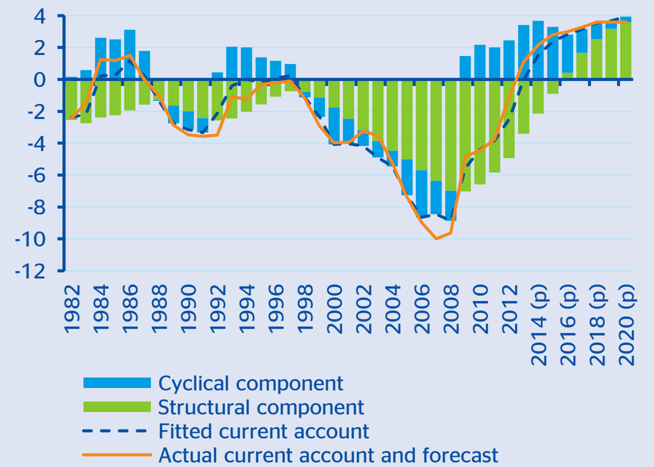
Chart 26 shows the results of the cyclical and structural decomposition of the model. **The current account in Spain has recorded structural deficits during the entire period of study.** In the decade running up to the 2008 crisis, the average weight of the structural component was 68%, albeit the cyclical component gained importance in the last four years of the economic boom. The performance of the cyclical component has contributed to reducing the size of the current account deficit in only three occasions: in the mid-1980s, during the first half of the 1990s and during the current process of reversion. In the latter case, t**he cyclical surpluses, together with the structural adjustment underway, have given traction to the correction of the deficit[26].** In 2020, the forecast path adjusted by the model would situate the NIIP of the Spanish economy at about 70% of GDP.

Chart 25
**Spain:
paths of the current account balance (as a % of GDP)**



(p) projection. The projections of the variables come from IMF-WEO. See the text for more details.
Source: BBVA Research

Chart 26
Spain: cyclical and structural components of the current account balance (as a % of GDP)

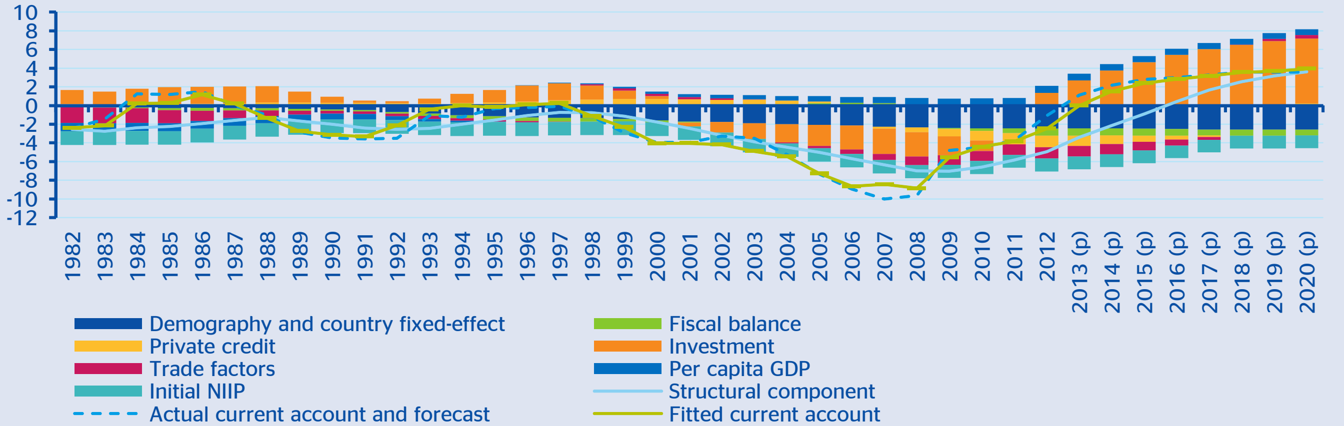


(p) projection. The projections of the variables come from IMF-WEO. See the text for more details.
Source: BBVA Research

With regard to the main factors that determine the structural current account balance, it is worth noting, on the one hand, the persistent and negative contribution of the initial NIIP[27] (see Chart 5). Also, the performance of the structural component of investment has played a significant role in the dynamics of the structural current account balance. Specifically, it is behind the structural adjustments of the mid-1980s and of the beginning of the 1990s, as well as the current account deterioration that gained traction at the beginning of the century. The demographic variables make an increasing contribution to the negative structural balance, however their contribution is slightly smaller than what one can infer from Chart 27, given that these variables incorporate a negative country fixed-effect that is considered here as structural. Finally, the structural fiscal balance, as well as the rest of the variables, have a marginal contribution to the determination of the structural deficit.

26: The weight of the cyclical component in the variation of the current account between 2007 and 2012 is greater than the weight of the structural component (76% vs. 24%), albeit this situation is reversed once we take into account the variation of the last two years, when the weight of the structural component becomes more important (85%). The IMF (2013) attributes a substantial role to the cyclical component in the adjustment process of several of the periphery economies in the Eurozone, among them Spain. Yet, alternative estimates could deliver a more balanced distribution of the cyclical and structural components in the 2007-2012 adjustment (see, for example, La Caixa, 2013 and Banco de España, 2013.
27: The initial NIIP refers to the NIIP lagged two periods.

Chart 27
Spain: decomposition of the structural current account in terms of its determinants (as a % del GDP)

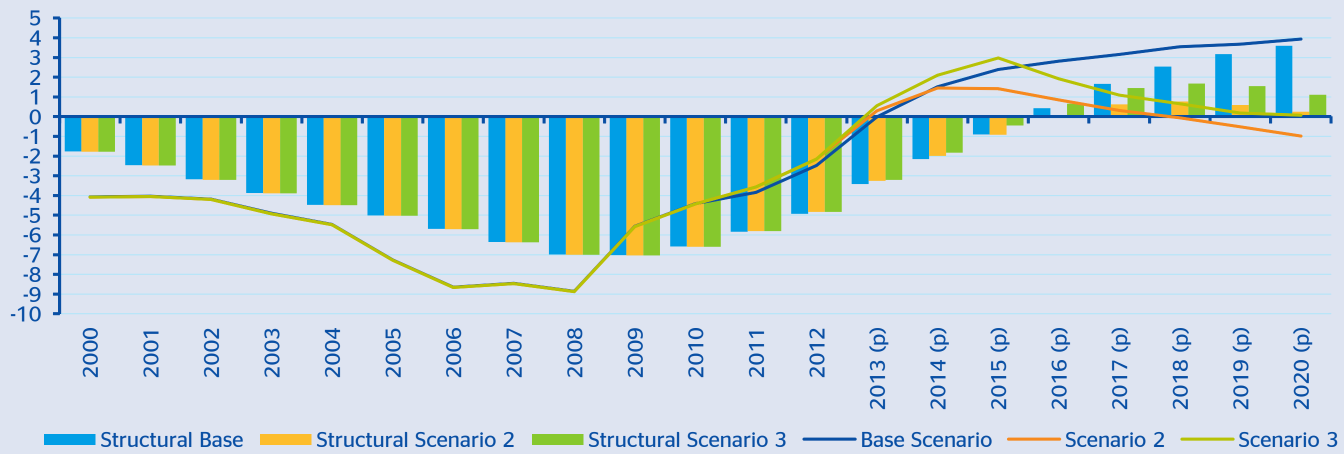


(p) projection. The projections of the variables come from IMF-WEO. See the text for more detail.
Source: BBVA Research

Given the importance of the structural component of investment in the projected path of the structural current account, we present **the simulation paths of the structural current account under three alternative scenarios for the performance of investment over GDP.** Please note that, according to the IMF forecasts, the ratio of investment to GDP will continue on an adjustment path till reaching a level close to 16% in 2018. This path implies that the Spanish economy will go from a ratio of 7 points above the world average in 2007 to a ratio of nearly 10 points below the world average in 2018.

In the so-called "base" scenario, the IMF forecasts for investment described previously are used. As a first alternative scenario (scenario 2), the forecasts of BBVA Research for the ratio of investment to GDP are introduced (24% in 2020) and, as a second alternative scenario (scenario 3), the forecasts of the OECD (22% in 2020) are used. As can be seen in Chart 28, the performance of the current account would be, ceteris paribus, less optimistic in a scenario of greater recovery of investment levels. Nonetheless, it is important to point out that **under any of the three alternative scenarios, Spain would register a structural surplus in its current account by 2016** and this would be maintained throughout the entire forecast period.

Chart 28
Spain: evolution of the fitted current account and of its structural component as a % of GDP (alternative investment scenarios)

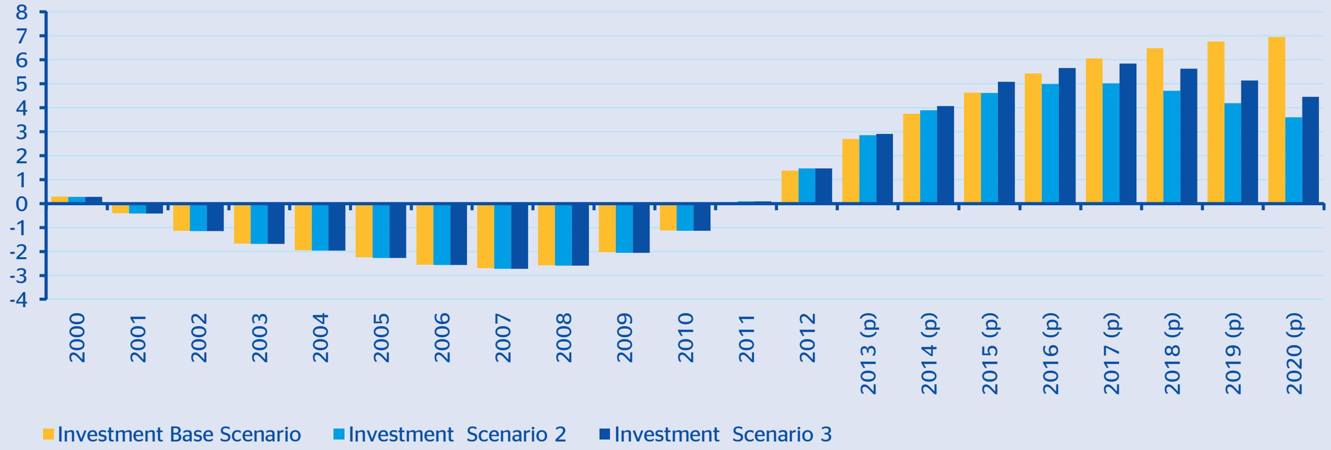


(p) projection. Base scenario: forecasts use the Investment/GDP ratio of the IMF; Scenario 2: forecasts use the Investment/GDP ratio of BBVA Research; Scenario 3: forecasts use the Investment/GDP ratio of the OECD.
Source: BBVA Research

Finally, Chart 29 shows the contribution of the structural component of the ratio of investment over GDP to the structural current account. In the three scenarios, it is expected that the structural contribution of investment would go from close to -3% of GDP in 2007 to +5-6% of GDP in 2016. From 2016 onwards, the forecasts differ to a greater extent and the contribution of investment would be in the range of 3.5% to 7% under the three alternative scenarios.

Chart 29

Spain: evolution of the structural contribution of investment as a % of GDP (alternative investment scenarios)



(p) projection. Base scenario: forecasts use the Investment/GDP ratio of the IMF; Scenario 2: forecasts use the Investment/GDP ratio of BBVA Research; Scenario 3: forecasts use the Investment/GDP ratio of the OECD.
Source: BBVA Research

In summary, from a methodological perspective based on the macroeconomic identity of savings and investment, this box shows that **the deterioration of the current account balance that the Spanish economy experienced from the mid-1990s had a substantial structural component.** Likewise, the process of reversal seen since 2008 has been supported, in an initial phase, by the gradual reduction of the structural deficit and the generation of cyclical surpluses and, in a second phase, by the pronounced reduction of the structural component of the deficit. The most important contributions to the structural deficit can be found in the performance of investment, the initial NIIP and demographics. **In the medium term, the forecasts indicate that the Spanish economy could generate structural surpluses, thus alleviating the financial pressure exerted by high external debt** on the decisions of economic agents. The generation of structural surpluses in the current account balance would mark a change in the growth pattern of the Spanish economy that would be achieved by the reorientation of productive resources towards exporting and energy saving. The rapid and efficient reassignation of these factors would facilitate the reduction of Spain´s foreign debt and the correction of one of the largest imbalances accumulated before the 2008 crisis.

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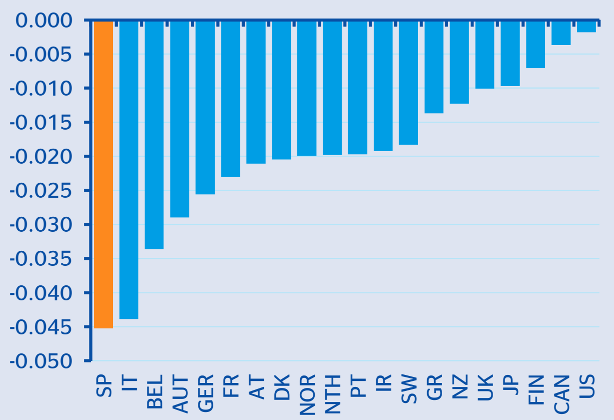
Box 2. The costs of anti-competitive regulation in Spain: an international comparison

An appropriate and stable institutional framework needs to be developed for the changes taking place in Spain's productive model to succeed in correcting the country's structural imbalances and boosting its potential growth. A key element of this institutional framework is the regulatory context in which economic activity is carried out, whose aim should be to foster and ensure competition in the marketplace. Economic literature has studied the positive effects of competition on employment, productivity, inflation and growth (e.g. see Arnold et al. (2011), Barone and Cingano (2011), Fiori et al. (2012)), although a great deal of the knock-on effects of the development of a pro-competitive regulatory framework have yet to be measured.

In the 1990s, amid a coordinated effort to boost competition throughout Europe, Spain began deregulating many of its service industries and, gradually, the country managed to increase competition among what were previously state-run monopolies. The real economic implications of the deregulation process, which gathered momentum in the mid-1990s, remains largely unquantified, mostly due to the difficulty in measuring the impact. The Regulatory Impact Indicator (RII), developed by the OECD for the 1975-2007 period, is a first attempt at measuring the knock-on effects of deregulation in Spain that may help design a roadmap for the country to converge to the world's most efficient markets. The RII measures the potential costs of anti-competitive regulation in non-manufacturing sectors (e.g. energy, transport, and communication) on other sectors of the economy that use the output of these as intermediate inputs in the production process[28].

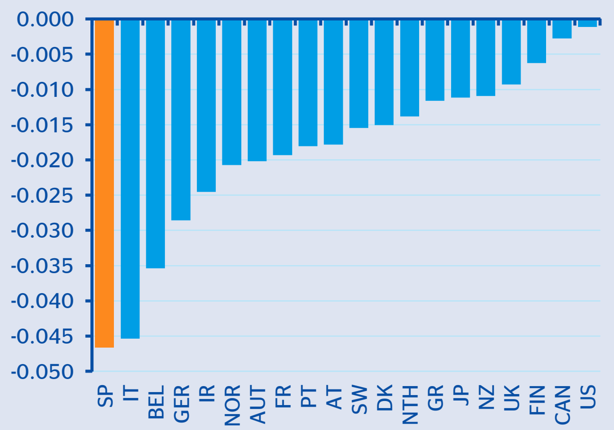
Exploring the performance of the RII in Spain's 10 manufacturing sectors and placing it in comparison with those of 19 other OECD countries, we observe that Spain achieved the largest reduction in the potential costs of anti-competitive regulation in the 1995-2007 period (see Charts 30 and 31)[29]. In the period, Spain jumped from 18th to 13th in the average manufacturing RII ranking.

Chart 30
Regulatory Impact Indicator (RII): Food products, beverages and tobacco, 1995-2007, absolute change



Note: smaller numbers indicate a larger reduction in the potential costs of anti-competitive regulation.
Source: BBVA Research based on OECD data

Chart 31
Regulatory Impact Indicator (RII): Transport equipment and motor vehicles, 1995-2007, absolute change

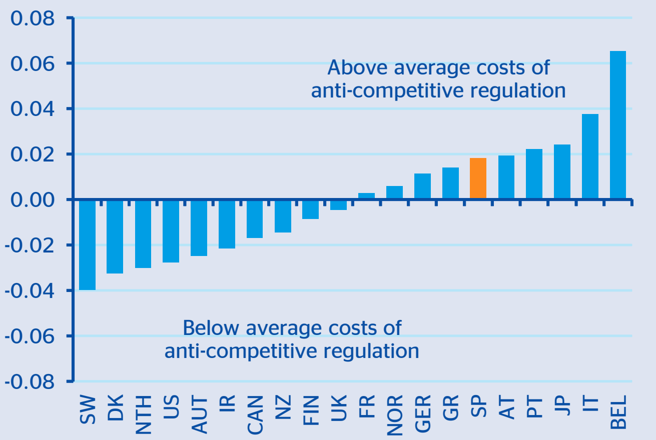


Note: smaller numbers indicate a larger reduction in the potential costs of anti-competitive regulation.
Source: BBVA Research based on OECD data

28: For a detailed description see OECD (2011), Product Market Regulation Database, available at www.oecd.org/economy/pmr.
29: The sectors analysed are: food products, beverages and tobacco; textiles and clothing; pulp, paper and printing; chemicals; rubber and plastic products; non-metallic mineral products; metals, metal products and industrial machinery; machinery and electrical materials, electronics; transport equipment and motor vehicles; furniture and other manufacturing industries.

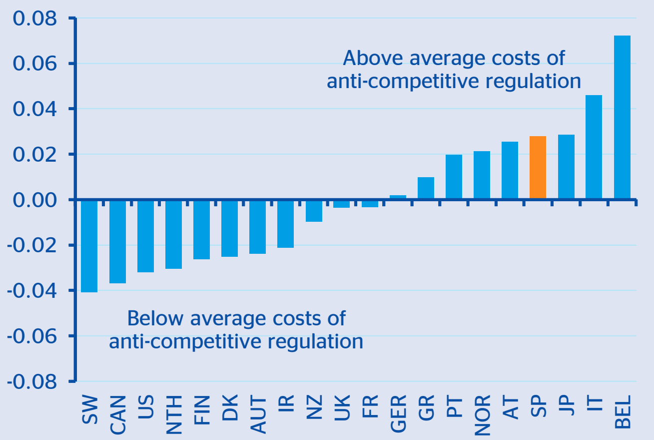
Although convergence towards the regulatory framework of the more competitive economies enabled Spain to move up five positions in the OECD ranking, the economy was characterised by a regulatory environment that, on average, imposed higher costs on manufacturing firms (see Charts 32-35). These higher costs undermined the firms' competitiveness in foreing markets in the years before the crisis.

Chart 32
Regulatory Impact Indicator (RII): Food products, beverages and tobacco, 1995-2007, deviation from sample average



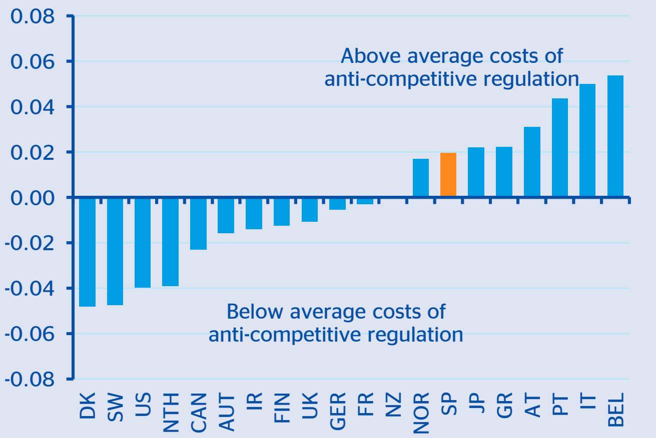
Source: BBVA Research based on OECD data

Chart 33
Regulatory Impact Indicator (RII): Textiles and clothing, 1995-2007, deviation from sample average



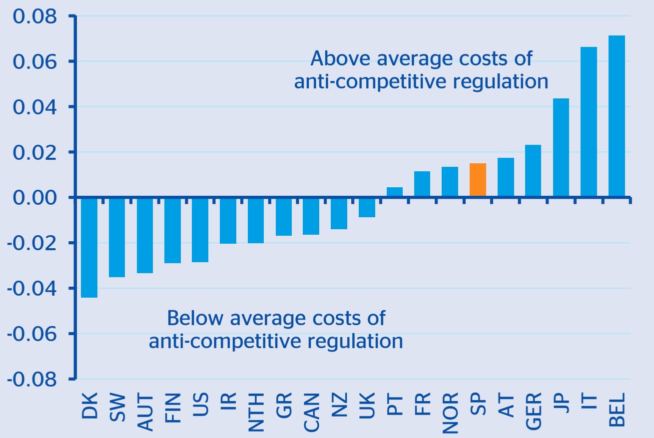
Source: BBVA Research based on OECD data

Chart 34
Regulatory Impact Indicator (RII): Chemicals, 1995-2007, deviation from sample average



Source: BBVA Research based on OECD data

Chart 35
Regulatory Impact Indicator (RII): Transport equipment and motor vehicles, 1995-2007, deviation from sample average

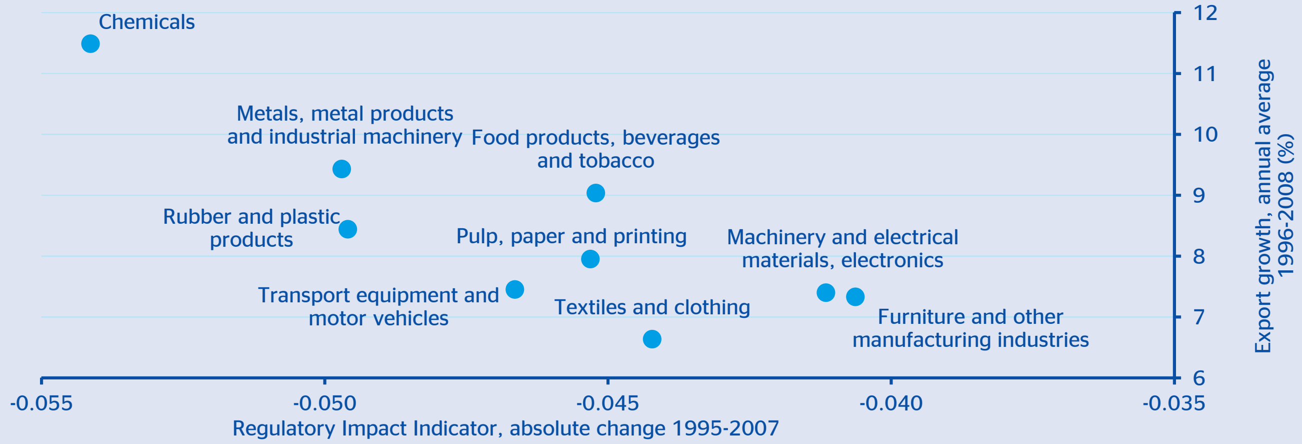


Source: BBVA Research based on OECD data

Despite the fact that the lack of competition on the energy, transport and communication sectors imposed a higher negative externality on the rest of the economy, the deregulation process benefited the manufacturing industry in Spain, even in terms of its performance in international markets. A first indication of this effect is found in the positive correlation between the change in the RII and the growth of exports. Chart 36 shows that the sectors that achieved the largest reduction in costs associated with anti-competitive regulation experienced the highest growth of exports during the pre-crisis period[30].

30:The chart excludes non-metallic mineral products, as production of these geared towards supplying the domestic construction sector.

Chart 36
Spain: Regulatory Impact Indicator (RII) and nominal exports of manufacturers, 1995-2008



Note: smaller numbers on the horizontal axis indicate a larger reduction in the potential costs of anti-competitive regulation.
Source: BBVA Research based on Datacomex and OECD data

While it remains to be explored if this correlation is maintained once we control for other determinants of exports, the evidence is at least suggestive. As a pro-competitive regulation environment is linked to better price-competitiveness (see, e.g., Correa-López et al. (2013)), the evidence shown in this box illustrates how Spanish exports might be boosted if the required institutional reforms to converge to the more advanced countries in terms of competition are carried out.

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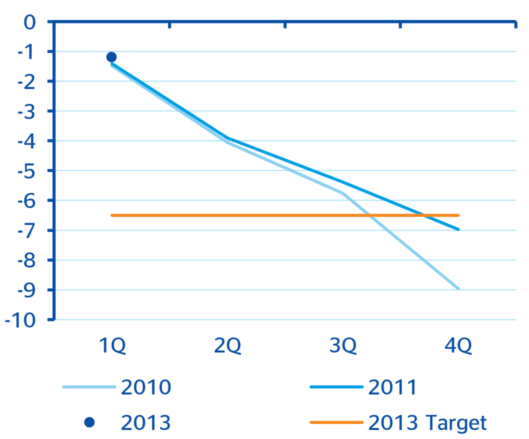
4. Fiscal adjustment continues, albeit at a less intense pace than in previous quarters

In the first quarter of 2013, the Spanish government's expenditure-control and fiscal-adjustment policy moved forward, although at a somewhat slower pace than in previous quarters. The cumulative deficit for all public administrations stood at 1.2% of GDP, two tenths below the level recorded in the first quarter of last year (see Chart 37). Until 1Q13 the central and regional governments had accumulated deficits of 1.5% and 0.1% of GDP, respectively, while local corporations and Social Security posted small surpluses underpinned by accelerated transfer payments from the central government (see Chart 38).

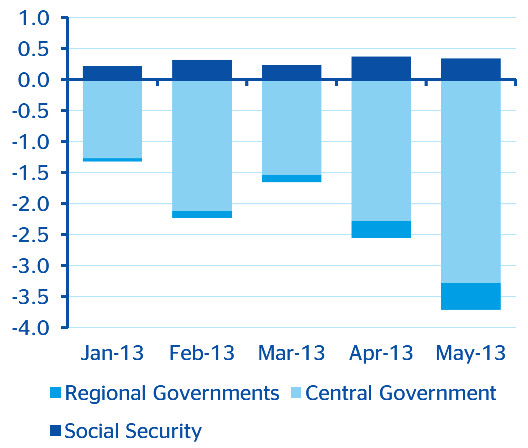
For the second quarter, the most recent data for budget execution place the cumulative deficit to May at above 3% of GDP, nearly two percentage points (pp) lower than in the first quarter. The worsening budget balance is primarily due to the Central Government deficit having increased by about 1.7pp of GDP as a result of higher interest spending, even though the decline in revenues has tapered off. The bulk of the spending adjustment continues to consist of the cutback in investment and, to a lesser extent, in employee salaries. Consequently, and given the sluggish economy, meeting the budget target will depend on how firmly the government is committed to curbing expenditures.

Chart 37
General government: net lending (+) / net borrowing (-)* position (Accumulated per year, % of GDP)



(*) Excluding aid to financial institutions
Source: BBVA Research based on MINHAP

Chart 38
General government: net lending (+) / net borrowing (-) position by subsector (% of GDP)

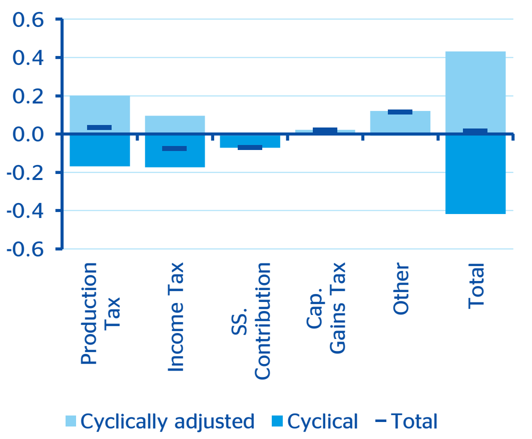


Source: BBVA Research based on MINHAP

In terms of 1Q13 revenues, although the economic downturn continued to erode the amount of resources –by about 0.4pp of GDP compared with 1Q12– **the discretionary measures implemented starting last year (tax hikes) avoided a complete collapse of revenue** (see Chart 39). The rise in structural revenue was due primarily to taxes on production –as the hike in VAT rates accounted for a structural increase equivalent to 0.2pp– and income tax, the structural resources from which grew by 0.1pp of GDP as a result of higher personal income tax and regulatory changes to corporate income tax. As a result, total revenue for the first quarter of the year remained, overall, at the same level as in 1Q12.

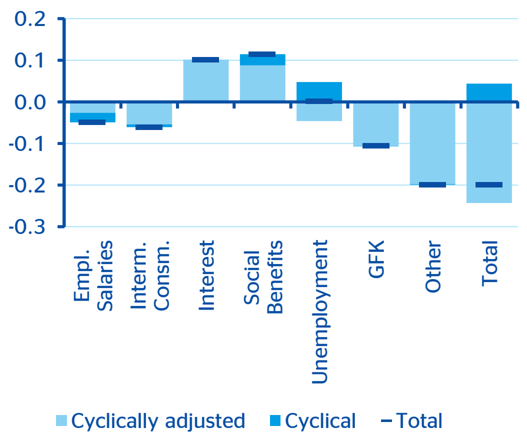
The first quarter of the year featured an adjustment to the structural component of spending, equivalent to 0.2pp of GDP compared with 1Q12 and affecting nearly all spending items (see Chart 40). The adjustment of investment spending was particularly sharp, with a structural reduction equivalent to 0.1pp of GDP. The structural adjustment was, however, not sufficient to offset higher interest payments, the cyclical deterioration of unemployment benefits and the increase in welfare provisions stemming from the adjustment of pensions. Hence, total spending of all public administrations in the first quarter of the year is likely to have declined by about 0.2pp in year-on-year terms.

Chart 39
General government: year-on-year change in non-financial resources at 1Q13 (pp of GDP)



Source: BBVA Research based on MINHAP

Chart 40
General government: year-on-year change in non-financial expenditures at 1Q13 (pp of GDP)

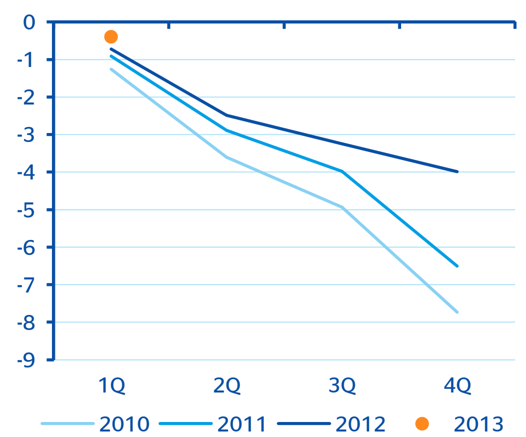


Source: BBVA Research based on MINHAP

Accordingly, the deficit for Spanish public administrations thus declined in the first quarter of the year by a bit more than two tenths of GDP, year-on-year. Given that the cyclical deterioration may have raised the 1Q13 deficit by 0.5pp of GDP according to BBVA Research estimates, the structural balance is likely to have improved by some seven tenths, standing practically in equilibrium at the close of the quarter. Moreover, if interest payments –which in the first quarter rose to 0.8% of GDP– are disregarded in the analysis, the primary structural deficits stands at 0.7% of GDP (see Charts 41 and 42).

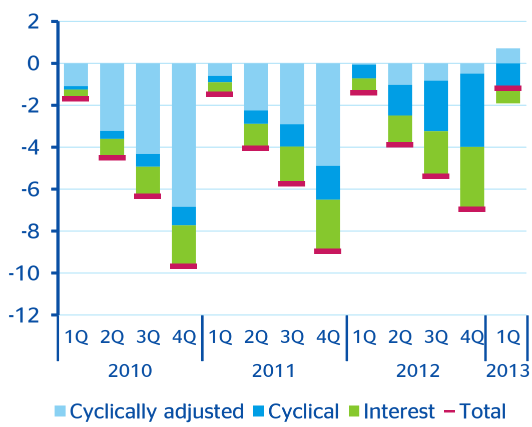
These results underscore the important effort of fiscal consolidation in structural terms. Aside from higher financing costs, the reason for the lingering deficit is, almost exclusively, the negative effect of the further decline in economic activity on public revenue and spending.

Chart 41
General government: structural balance, excluding financial sector aid (% of GDP)



Source: BBVA Research based on MINHAP

Chart 42
General government: breakdown of net lending (+) / net borrowing (-) position(% of GDP)



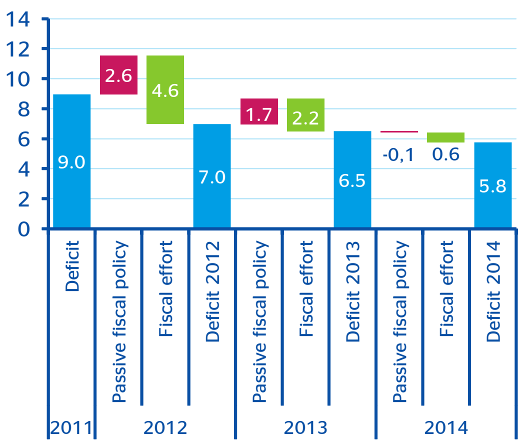
(*) Excluding aid to the financial sector.
Source: BBVA Research based on MINHAP

For 2013 overall, although we expect the fiscal adjustment policies to continue, it is likely that these are insufficient to offset the negative effects of the economic downturn on public revenues and spending and of the expected interest-rate hike. **BBVA Research forecasts therefore indicate that the cycle will take out slightly over 1 pp of GDP from expected revenues in 2013**, affecting taxes on both production and income and offsetting the structural improvement in these taxes. Consequently, government revenues will represent about 36.7% of GDP, barely 0.3pp above 2012. In addition, **the spending adjustment will be concentrated in intermediate consumption, investment** (which will decline more slowly than in the previous two years) **and, to a lesser extent, in employee salaries**, mainly due to the permanent nature of the measures to reform the civil service and restructure the dependent public sector (see Table 3).

In this context, if the announced measures are not implemented, the public deficit would increase by around 1.7 pp of GDP in 2013 due to the deteriorating economic situation, in addition to a further 0.7 pp because of the structural increase in social welfare provisions and higher interest payments (see Chart 43). **Consequently, in light of the measures announced and/or implemented, the 2013 deficit should stand at about 6.5% of GDP, in line with the new stability target approved by the European Commission in late May.** This relaxation of the stability targets will also make it possible to fulfil the target approved for **2014, when the government deficit will stand at around 5.8% of GDP**, given that both the economic cycle and the structural improvement in revenue and expenditure will begin to correct the fiscal deterioration.

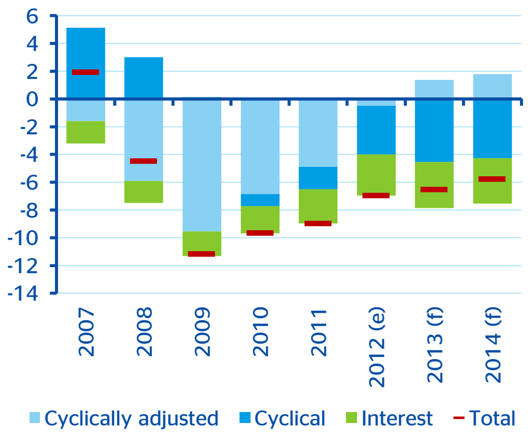
If BBVA Research projections are met, **the structural balance of Spain's government sector will stand at about 1.5% of GDP at the end of 2014** (see Chart 44), a correction of nearly 6pp since 2011.

Chart 43
General government: expected fiscal adjustment(*) (% of GDP)



(*) Excluding aid to financial institutions.
Source: BBVA Research based on MINHAP and INE

Chart 44
General government: net lending / net borrowing(*) position (% of GDP)



(*) Excluding aid to financial institutions.
Source: BBVA Research based on MINHAP and INE

The relaxation of the stability targets should create an opportunity to improve the composition of the adjustment, reducing the tax burden, improving the efficiency of the tax system and refocusing deficit reduction on expenditure. In this respect, the ceiling on government spending approved for 2014 is in line with the government's new stability target (3.8% of GDP) and with the projections of BBVA Research. According to government data, the approved spending limit entails a 2.7% increase in total non-financial spending in comparison with 2013. Nonetheless, when transfers to Social Security and the Public Employment Service are excluded, government non-financial spending falls to about 1.3%.

Likewise, in June 28, the Spanish Government approved forwarding to Parliament a bill on the creation of an Independent Fiscal Responsibility Authority (IFRA), in response to recommendations made by European institutions. Although this step forward in the legislative process for creating an IFRA is positive, ist functional dependence on Parliament would have ensured its independence.

Moreover, **the measures adopted to prevent arrears in payments by the public administration and in favour of broadening the financing for the supplier payments plan are considered positive**, although the allocation for 2013 (8,200 million euros) might prove insufficient. Lastly, the creation of a committee of experts to reform the fiscal system opens the door to simplifying the Spanish tax system by improving its efficiency and promoting growth and employment.

In any event, the effect of a good part of these measures will only be felt in the long run, and, as a result, **the risk that the stability targets will not be met in the coming two years stems from the possibility that the structural recovery of revenue will be weaker than expected, the cyclical deterioration will be worse than expected, or the pace of implementation will slow down.** The observed moderate improvement in the deficit during the first quarter also increases the likelihood that much of the adjustment will once again be postponed until the second half of the year, which could lead to economic activity again declining at a faster rate. It is therefore essential to attempt to implement new measures at a slower pace.

Table 3
General government: borrowing needs, excluding aid to the financial sector

(pp of GDP)	2011	2012	2013	2014
Compensation of employees	11.6	11.0	10.9	10.7
Intermediate consumption	5.9	5.6	5.4	5.3
Interest	2.5	3.0	3.3	3.3
Unemployment benefits	2.8	3.0	3.0	2.9
Social protection	12.6	13.0	13.4	13.5
Gross capital formation	2.9	1.7	1.5	1.3
Other expenditures	6.4	5.9	5.7	5.3
Non-financial expenditure	44.7	43.3	43.2	42.1
Taxes on production	9.9	10.2	10.6	10.6
Tax on income, wealth, etc.	9.6	10.1	10.1	10.2
Social contributions	13.2	12.8	12.5	12.3
Tax on capital gains	0.4	0.4	0.4	0.4
Other resources	2.7	2.8	3.0	2.8
Non-financial resources	35.7	36.3	36.7	36.4
Net lending / Net borrowing	-9.0	-7.0	-6.5	-5.8

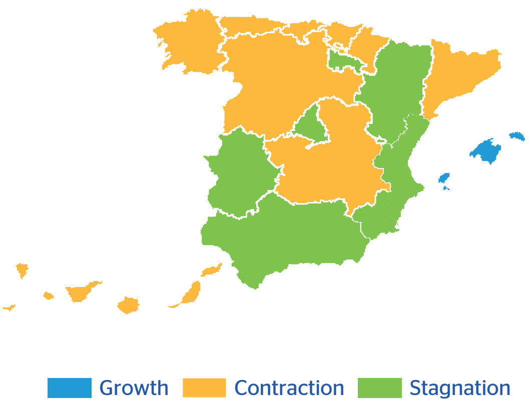
Source: BBVA Research based on MINHAP and INE

5. Asymmetric deficits and foreign demand determine the outlook for regional growth

Since the publication of the previous issue of the Spain Economic Outlook, prospects for regional economies have been affected by several factors. Although the economic data for Spain have confirmed expectations of stabilising activity, some autonomous communities have performed differently than expected. On one hand, this is explained not only by the degree of exposure of each community to foreign demand, but also by their capacity to take advantage of the growth of emerging countries in a climate of recession in Europe. On the other hand, the political uncertainty observed in some of the main tourist destinations which compete with Spain has had a positive impact on the regions which rely more heavily on foreign visitors. Finally, the ease in the deficit targets and the expectation that asymmetric targets would be set have moderated the fiscal consolidation pace of some autonomous communities. Looking ahead, these three factors will continue to be the main drivers of regional growth.

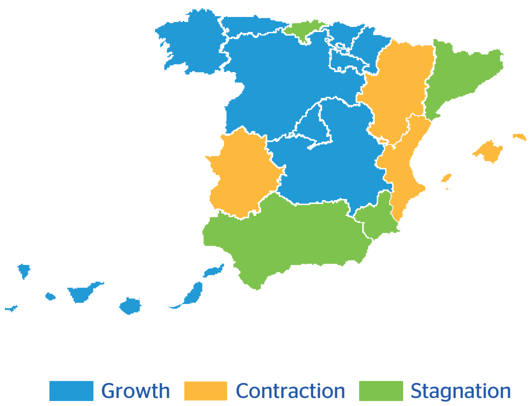
Overall, economic indicators improved (or deteriorated less) in all the autonomous regions in 2Q13, which is consistent with the view that the height of the recession is passed. For example, the surveys that BBVA Research undertakes at BBVA branch offices reflect that, for the first time in two years, the economy's performance in the second quarter of 2013 was perceived as stable, with an increasing number of autonomous communities in which the outlook for the third quarter is now of growth (see Charts 45 and 46). In general, this trend towards improvement is not exclusive to these surveys; there are also several indicators related to foreign trade and domestic demand which have shown ongoing improvement since the beginning of the year.

Chart 45
BBVA Economic Activity Survey: Balance of responses about the state of the economy during the second quarter of 2013



Source: BBVA

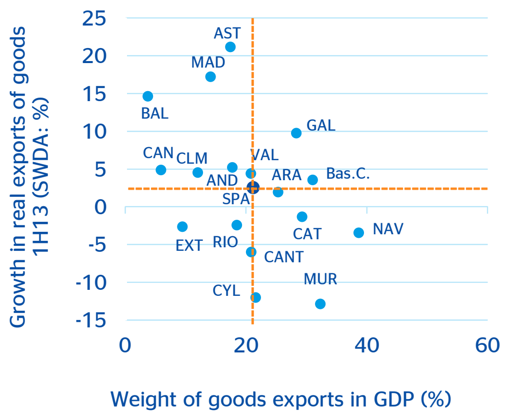
Chart 46
BBVA Economic Activity Survey: Balance of responses about the state of the economy during the third quarter of 2013



Source: BBVA

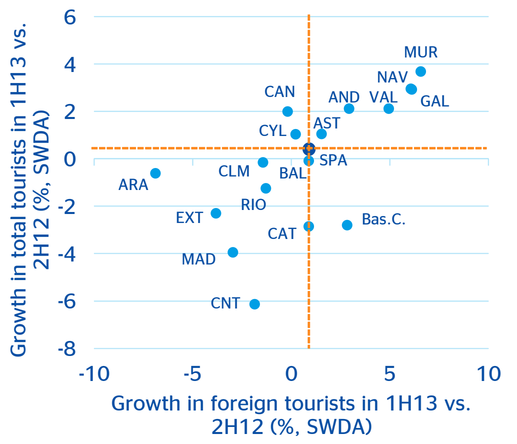
Despite the slowdown in Europe, exports of goods have remained among the most dynamic in EMU. For most regions, this is due to the capacity of firms to diversify their exports towards emerging countries which show sustained growth (see Chart 47). In others, it is explained by the lower elasticity of demand to the business cycle, as it is the case of autonomous communities with a large proportion of exports of food products (Andalusia). However, those regions with either a large proportion of European destinations or that are depedent upon the sale of equipment goods or durable goods, such as automobiles, have performed less well in terms of exports (Castille and Leon, Catalonia, La Rioja and Navarra).

Chart 47
Spain and Autonomous Communities: growth in real exports of goods and GDP weight (%)



Source: BBVA Research based on INE and Aduanas

Chart 48
Tourists arrivals



Source: BBVA Research based on INE

Foreign sales of services, especially those related to tourism, also performed strongly. There are signs of acceleration in tourism services as a result of the reaction of the markets of origin to social tensions and increased insecurity in certain destinations which compete directly with the Spanish economy. This trend has had a positive impact on most of Spain's autonomous communities, with some exceptions, especially in the case of Madrid (see Chart 48). Overall, the impact could be uneven, given the relevance of foreign markets for each community. In the Balearic Islands, foreigners represent around 80% of visitors and in Catalonia the percentage is close to 60%, whereas in Murcia just one in five visitors is foreign. Furthermore, Spanish tourists continue to hamper total arrivals of travellers, particularly in Catalonia and the Basque Country.

Finally, fiscal consolidation has been one of the main determinants of differences in regional growth over the last few years and particularly in 2012. The efforts made by the autonomous communities were unavoidable and were due to the need to restore confidence in the public administration capacity to reduce the deficit. The relaxation of the budget targets for 2013 and 2014, approved recently by the European Commission, would have been unthinkable without those efforts. As a result of the concentration of fiscal consolidation in 2012 (compared to 2011, for example) and of the growing likelihood that the greater margin awarded to the autonomous communities (an increase in the deficit target from 0.7% of GDP to 1.3%) would be divided asymmetrically, **there has been an improvement in the economic indicators of those regions with above-average imbalances** (see Table 4). In particular, Andalusia, Catalonia, Murcia and Valencia showed a less negative bias than expected for the various indicators of employment and domestic demand. These are precisely the regions which have been given a more flexible schedule to reduce the deficit over the next few months. Likewise, the autonomous communities that continue to have the previous deficit target, or a target below 1.3%, such as Madrid, Navarra or the Basque Country, do show a somewhat worse performance in the last three months.

Table 4
Autonomous Communities: Risks to forecasts for

	Forecast in May	New data	Fiscal adjustment	New forecast
Andalusia	-1.9			-1.7
Aragon	-1.4			-1.4
Asturias	-1.7			-1.7
Balearic Islands	-0.4			-0.2
Canary Islands	-0.8			-0.6
Cantabria	-1.6			-1.7
Castille-Leon	-1.5			-1.5
Castille-La Mancha	-1.7			-1.7
Catalonia	-1.5			-1.3
Extremadura	-1.0			-1.0
Galicia	-1.0			-1.1
Madrid	-0.9			-1.2
Murcia	-1.5			-1.5
Navarra	-1.4			-1.5
Basque Country	-1.2			-1.2
Rioja (La)	-1.5			-1.5
C. Valenciana	-2.5			-1.8
Spain	-1.40			-1.4

Date: July-13.
Fuente: BBVA Research

Looking ahead, it is expected that these factors will continue to explain regional growth in Spain. Furthermore, the expected recovery of Spain's main trading partners should prompt the acceleration in sales of foreign goods, especially to Europe. We also expect exports of services to continue contributing positively to growth, not only due to the impact of temporary factors, but also due to the gains in competiveness seen over the last few years. Finally, the fiscal consolidation process will continue to affect growth forecasts. Thus, despite the positive impact that a more flexible deficit target may have in the short term, in the medium to long term the targets continue to be ambitious, and therefore the easing of the cycle which will be seen in some autonomous communities will occur at the expense of sacrificing future growth in domestic demand. Although the growth imbalance across regions will fall in the short term, it is likely to increase in the medium term in the absence of reforms that increase the capacity to grow of those economies with the largest imbalances and thus permit a less traumatic process to reduce public debt.

Table 5
GDP growth forecast (%)

Region	2011	2012	2013	2014
Andalusia	0.0	-1.7	-1.7	0.6
Aragon	0.3	-1.5	-1.4	1.0
Asturias	-0.1	-2.5	-1.7	1.1
Balearic Islands	1.6	-0.3	-0.2	1.3
Canary Islands	1.7	-1.0	-0.6	1.0
Cantabria	0.6	-1.3	-1.7	0.7
Castille-Leon	1.1	-1.8	-1.5	1.4
Castille-La Mancha	-0.4	-3.0	-1.7	1.0
Catalonia	0.6	-1.0	-1.3	0.6
Extremadura	-0.9	-2.2	-1.0	1.0
Galicia	-0.1	-0.9	-1.1	1.4
Madrid	0.6	-1.3	-1.2	1.5
Murcia	0.0	-1.7	-1.5	0.3
Navarra	1.4	-1.8	-1.5	1.0
Basque Country	0.8	-1.4	-1.2	1.0
La Rioja	1.0	-2.1	-1.5	1.0
C. Valenciana	-0.1	-1.5	-1.8	0.2
Spain	**0.4**	**-1.4**	**-1.4**	**0.9**

Source: BBVA Research

6. Tables

Table 6

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate, %)	2010	2011	2012	2013	2014
United States	2.5	1.8	2.8	1.8	2.3
Eurozone	1.9	1.5	-0.5	-0.4	1.0
Germany	4.0	3.1	0.9	0.5	1.8
France	1.6	2.0	0.0	-0.1	1.1
Italy	1.7	0.5	-2.4	-1.8	0.8
Spain	-0.3	0.4	-1.4	-1.4	0.9
UK	1.7	1.1	0.2	1.0	1.9
Latin America *	6.1	4.4	2.8	2.6	3.2
Mexico	5.3	3.9	3.9	2.7	3.2
Brazil	7.5	2.7	0.9	2.3	2.9
EAGLES **	8.4	6.6	5.1	5.2	5.6
Turkey	9.2	8.5	2.3	3.7	4.8
Asia Pacific	8.2	5.8	5.3	5.3	5.6
Japan	4.7	-0.6	2.1	1.7	1.5
China	10.4	9.3	7.8	7.6	7.6
Asia (exc. China)	6.8	3.5	3.6	3.7	4.1
World	5.1	3.9	3.2	3.1	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 2, 2013
Source: BBVA Research

Table 7

Macroeconomic forecasts: 10Y interest rates (average)

	2010	2011	2012	2013	2014
US	3.2	2.8	1.8	2.3	3.0
EMU	2.8	2.6	1.6	1.6	2.2

Forecast closing date: August 2, 2013
Source: BBVA Research

Table 8

Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2010	2011	2012	2013	2014
US (EUR/USD)	0.76	0.72	0.78	0.77	0.77
EMU	1.33	1.39	1.29	1.30	1.30
UK	0.65	0.62	0.63	0.67	0.68
Japan	87.8	79.7	79.8	100.1	115.2
China	6.77	6.46	6.31	6.18	6.02

Forecast closing date: August 2, 2013
Source: BBVA Research

Table 9

Macroeconomic forecasts: official interest rates (end of period)

	2010	2011	2012	2013	2014
US	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	0.75	0.50	0.50
China	5.81	6.56	5.75	6.00	6.00

Forecast closing date: August 2, 2013
Source: BBVA Research

Table 10

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

	2010	2011	2012	2013	2014
Real GDP	1.9	1.5	-0.5	-0.4	1.0
Household consumption:	1.0	0.2	-1.3	-0.4	0.6
Public consumption	0.8	-0.1	-0.4	-0.4	0.3
Gross fixed capital formation	-0.5	1.5	-4.2	-3.6	2.3
Equipment, machinery and cultivated assets	5.6	4.5	-4.3	-4.7	3.5
Equipment and machinery	5.7	4.5	-4.3	-4.6	3.4
Construction	-4.3	-0.4	-4.8	-4.0	0.8
Housing	-2.6	0.5	-3.7	-3.0	2.1
Other buildings and other constructions	-6.0	-1.3	-5.9	-5.0	-0.6
Change in inventories (contribution to growth)	0.6	0.2	-0.5	-0.1	0.0
Domestic demand (contribution to growth)	1.3	0.6	-2.1	-1.1	0.8
Exports	11.0	6.5	2.9	1.0	3.8
Imports	9.5	4.3	-0.7	-0.5	3.7
Net exports (contribution to growth)	0.7	1.0	1.6	0.7	0.3
Pro-memoria					
GDP w/out housing investment	2.2	1.6	-0.4	-0.3	1.0
GDP w/out construction	2.7	1.8	-0.1	-0.1	1.1
Employment (LFS)	-0.5	0.4	-0.7	-0.7	0.1
Unemployment rate (% active pop.)	10.1	10.2	11.4	12.2	12.3
Current account balance (% GDP)	0.0	0.1	1.3	2.0	2.1
Public sector balance (% GDP)	-6.2	-4.2	-3.7	-2.8	-2.2
CPI annual average	1.6	2.7	2.5	1.5	1.4

Forecast closing date: August 2, 2013
Source: official institutions and BBVA Research

Table 11

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

	2010	2011	2012	2013	2014
Activity					
Real GDP	-0.3	0.4	-1.4	-1.4	0.9
Private consumption	0.7	-1.0	-2.1	-2.6	-0.3
Public consumption	1.5	-0.5	-3.7	-4.7	-1.8
Gross fixed capital formation	-5.5	-5.5	-8.7	-6.4	1.1
Capital goods	3.0	2.4	-6.7	-2.8	5.0
Construction	-9.8	-9.0	-11.5	-9.4	-1.4
Housing	-10.1	-6.7	-8.0	-8.4	0.0
Domestic demand (contribution to growth)	-0.6	-1.9	-3.9	-3.8	-0.3
Exports	11.3	7.6	3.1	3.6	6.8
Imports	9.2	-0.9	-5.0	-3.8	3.6
Net exports (contribution to growth)	0.3	2.3	2.5	2.3	1.2
GDP at current prices	0.1	1.4	-1.3	-0.6	1.9
(Billion euros)	1048.9	1063.4	1049.5	1043.3	1063.0
GDP w/out housing investment	0.5	1.0	-1.0	-1.0	0.9
GDP w/out construction	1.6	2.1	0.2	-0.4	1.2
Labour market					
Employment (LFS)	-2.3	-1.9	-4.5	-3.0	0.2
Unemployment rate (% active pop.)	20.1	21.6	25.0	26.2	25.4
Employment QSNA (equivalent to full-time)	-2.5	-1.7	-4.4	-3.4	0.1
Productivity	2.2	2.1	3.0	2.0	0.8
Prices and costs					
CPI (annual average)	1.8	3.2	2.4	1.7	1.1
GDP deflator	0.4	1.0	0.1	0.8	1.0
Household consumption deflator	2.0	2.9	2.4	1.8	1.4
Compensation per employee	0.3	0.7	-0.3	0.0	0.4
Unit labour cost (ULC)	-2.0	-1.4	-3.3	-2.0	-0.4
Foreign trade					
Current account balance (% GDP)	-4.5	-3.7	-1.1	1.0	1.7
General goverment					
Debt (% GDP)	61.5	69.3	84.1	92.4	96.4
Budget balance (% of GDP)	-9.7	-9.0	-7.0	-6.5	-5.8
Households					
Nominal disposable income	-2.9	-0.5	-2.7	-1.1	0.0
Savings rate (% of nominal income)	13.1	11.0	8.3	8.1	7.1

(*): Excluding financial aid to Spanish banks

Forecast closing date: August 2, 2013

Source: official institutions and BBVA Research

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