

Spain's Macroeconomic Outlook and Policy Agenda

Comments to Spain 2014 Article IV Consultation Concluding
Statement of the IMF Mission

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The recovery as the result of reforms and adjustments

IMF's diagnosis

1. Fiscal consolidation and pension system reform -> reduction in current and future structural deficits

2. Banking restructuring -> gross flows of credit growing

3. European efforts (OMT) + (1) +(2) - > More certainty and fewer financial tensions: 10y risk premium around 15 0bp

4. The labor market reform and wage flexibility are helping turn job destruction to job creation (BBVA Research, 2013)



Without these efforts, the recession might still be continuing and unemployment still rising

More measures for a stronger and long-lasting recovery

IMF's recommendations

1. Helping firms expand, hire, and invest: voluntary code of conduct and more capital for banks, government participation and personal insolvency

2. Lowering regulatory barriers to boost jobs and growth: Market Unity law, professional services, better ALMP, lower duality and *W* at firm level

3. Pursuing growth- and job-friendly fiscal consolidation: higher indirect taxes, lower social security contributions and corporate income tax rates

4. More support from Europe: lower borrowing cost, higher demand of Spanish exports and inflation close to 2% in EMU



Higher growth and inclusive recovery for the unemployed

Current economic conditions

1. Exports will continue to expand in 2014 and 2015

2. An increase in savings and financial wealth (+25% from 2H2012)

3. More certainty and fewer financial tensions:
10y risk premium below 160bp

4. More dynamic investment in machinery and equipment: above 6% y/y
in 4Q2014

5. Improvement in new lending flows: growth above 6% y/y in Mar. 2014
for SME

6. A smaller fiscal effort needed in 2014: 0.5 pp in 2014 (2pp in 2013 and
5pp in 2012) and smaller fiscal multiplier than the one assumed by IMF

7. Net job-creation started sooner than expected: +2.4% saar in 1Q2014,
above 2% accumulated in 2014 and 2015 and social security flat rate

Potential growth is endogenous to structural reforms

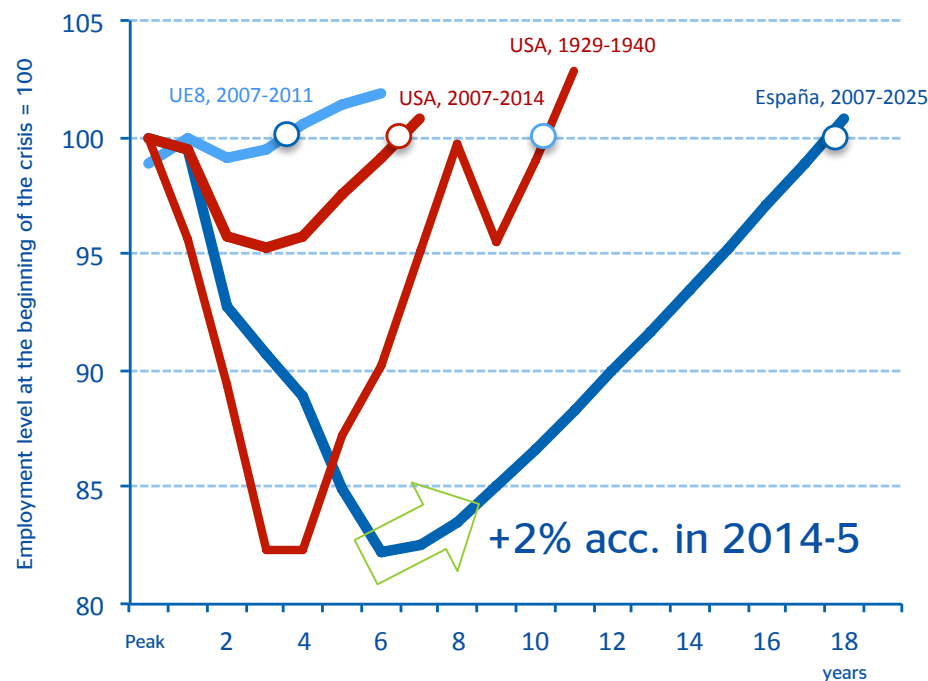
Structural reforms biased to employment growth

1. Deleveraging and improvement in the finances of the Spanish economy: finalising the restructuring of the financial sector (improve profitability) and attracting foreign direct investment to promote employment
2. Public-sector reform, fiscal consolidation through growth and long-term sustainability of public finances, with an efficient tax system that create incentives to job-creation -> Report of the Experts Committee
3. Reforms to improve competitiveness further (keeping internal devaluation), increase the international attraction of Spain in terms of physical, human and technological capital
4. To continue with the reforms that reduce the duality in the labour market, improve intermediation process efficiency, promote wage flexibility and increase employability -> more jobs and with better quality

GDP growth target: at least 2,5% until 2025

Employment in Spain, the US and EU8

Source: Andrés and Doménech (2012)



EU8: Sweden, UK, Denmark, Finland, Germany, Netherlands, Austria and Belgium.

Labor market problems go far beyond the high *U* rate
 -> the more urgent challenge for Spain -> smart fiscal consolidation, welfare state, deleveraging, inequality

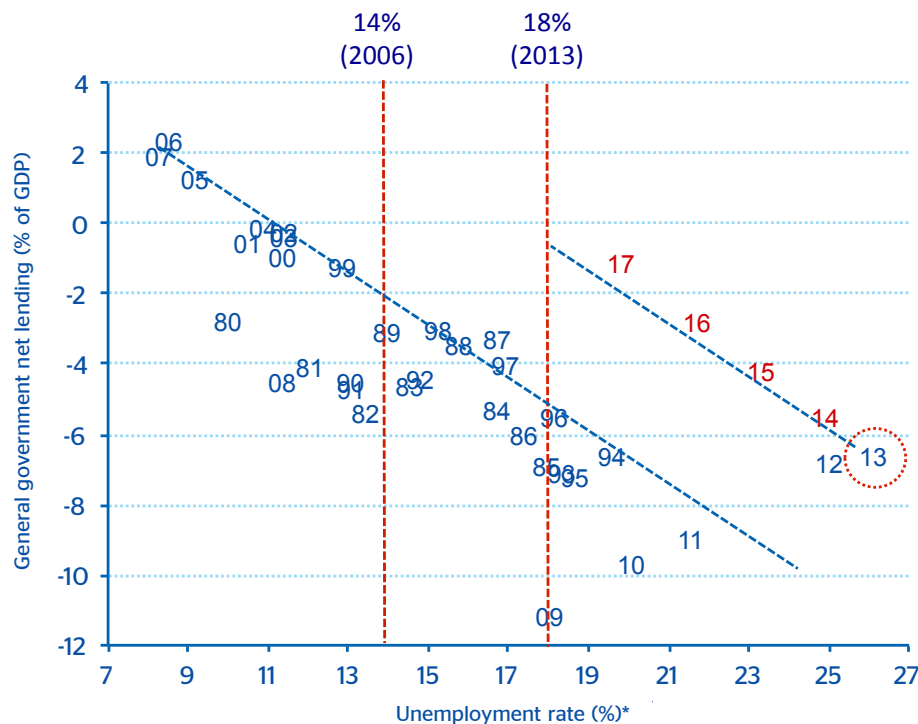
Collective bargaining at firm level (wages flexibility), smart severance payment system, fiscal devaluation, more and better active and passive LM policies

Two-hand approach: wage flexibility (vs wage moderation) to increase employment (composition effects on *W*) and more product markets competition

Employment growth and fiscal consolidation

Spain: unemployment rate and public budget balance

Source: BBVA Research based on Stability Programme 2014-17



* Unemployment rate based on Fuente (2012):
"Series enlazadas de los principales agregados nacionales de la EPA, 1964-2009"

A smart fiscal consolidation (timely, targeted and permanent) based on the reduction of the unemployment rate (also structural)

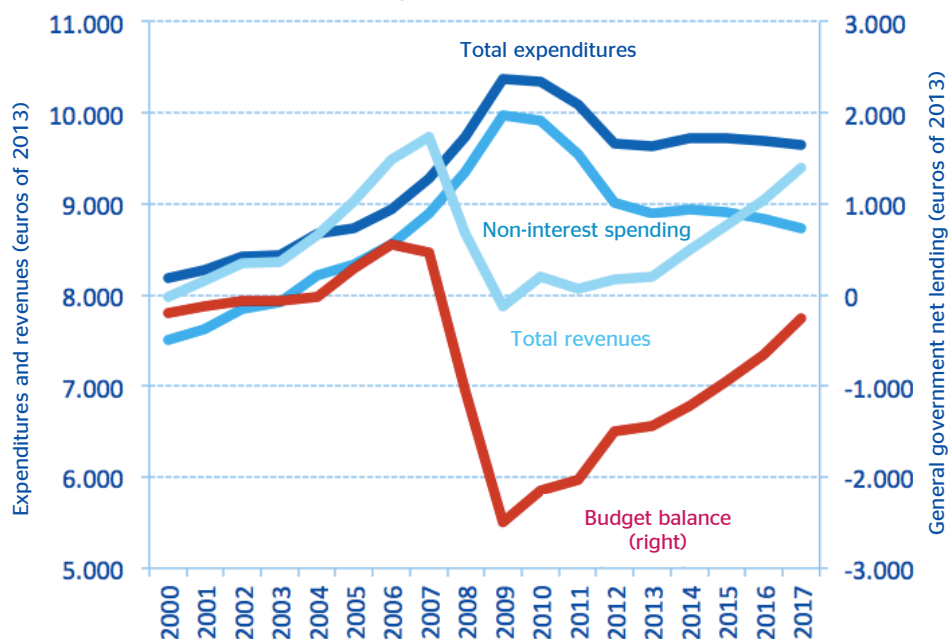
Size and composition of public spending, and higher efficiency of public administrations

A more efficient tax structure: direct vs. indirect taxation -> more savings, more investment and more jobs

Employment growth and fiscal consolidation

Spain: public revenues, expenditures and budget balance in per capita terms

Source: BBVA Research based on Stability Programme 2014-17



* GDP in 2013 1023 bn of euros. Population 2013: 47,129,783.
 Public spending and net lending do not include banking restructuring costs.

Smart fiscal consolidation: avoid restrictive fiscal policies (e.g., increased tax rates or spending cuts w/o higher efficiency)

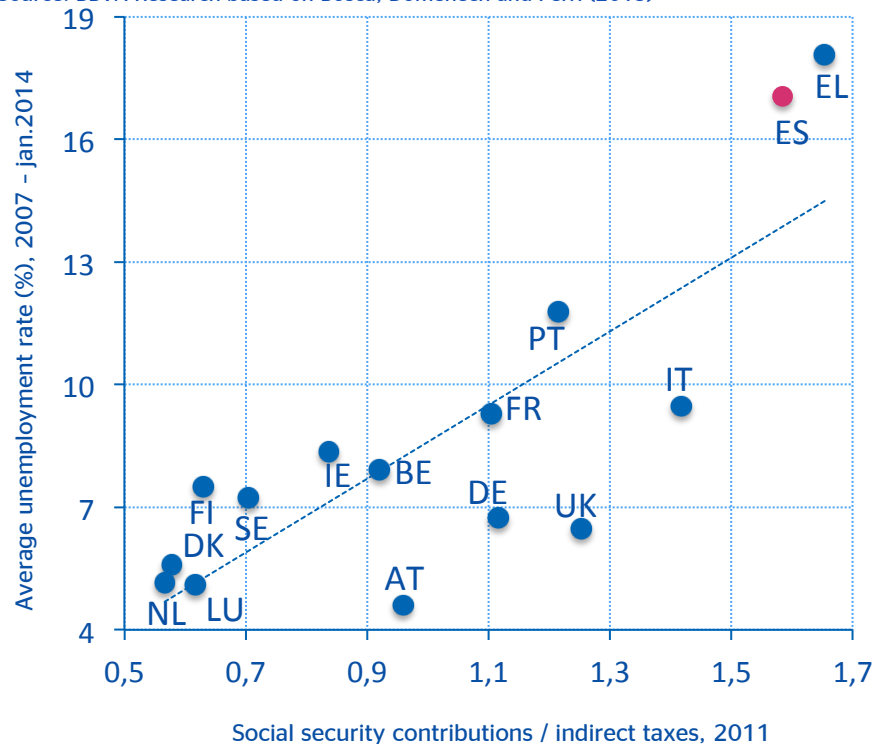
Maintain real public expenditures in per capita terms at the 2007 levels (changing composition and increasing efficiency) ...

... and increase revenues through a more efficient tax structure that increases employment, growth and tax bases

Fiscal devaluation

EU15: Unemployment rate and social security contributions over indirect taxes

Source: BBVA Research based on Boscá, Doménech and Ferri (2013)



More employment, GDP and private consumption -> more public revenues

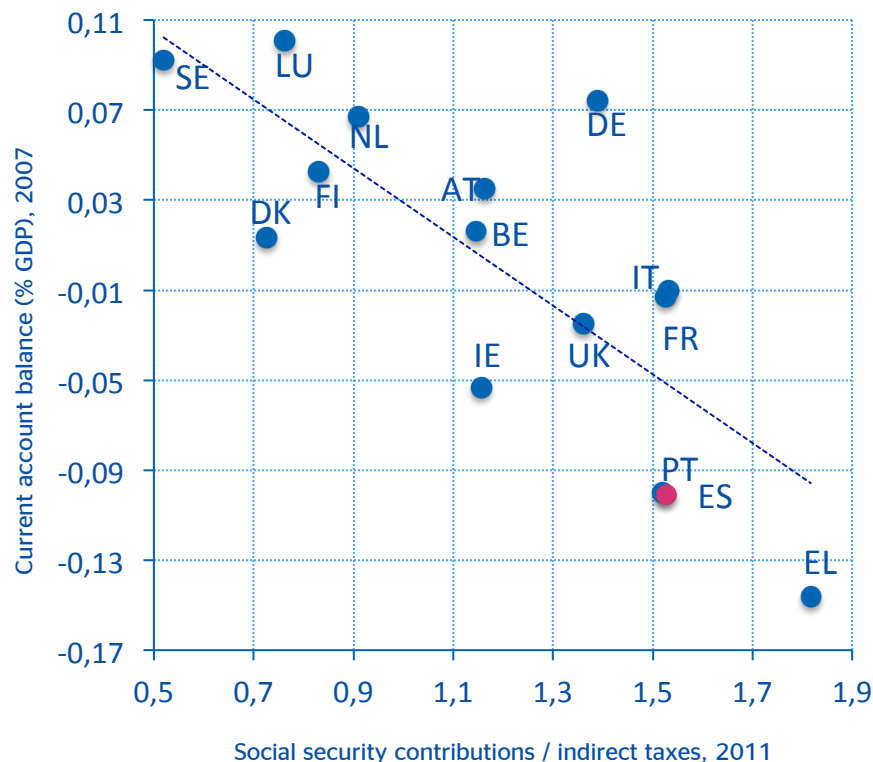
Improvement if international competitiveness -> improvement of the current account balance

Less inequality and less hysteresis in unemployment (temporary zero social contribution rate below a certain wage level?)

Fiscal devaluation

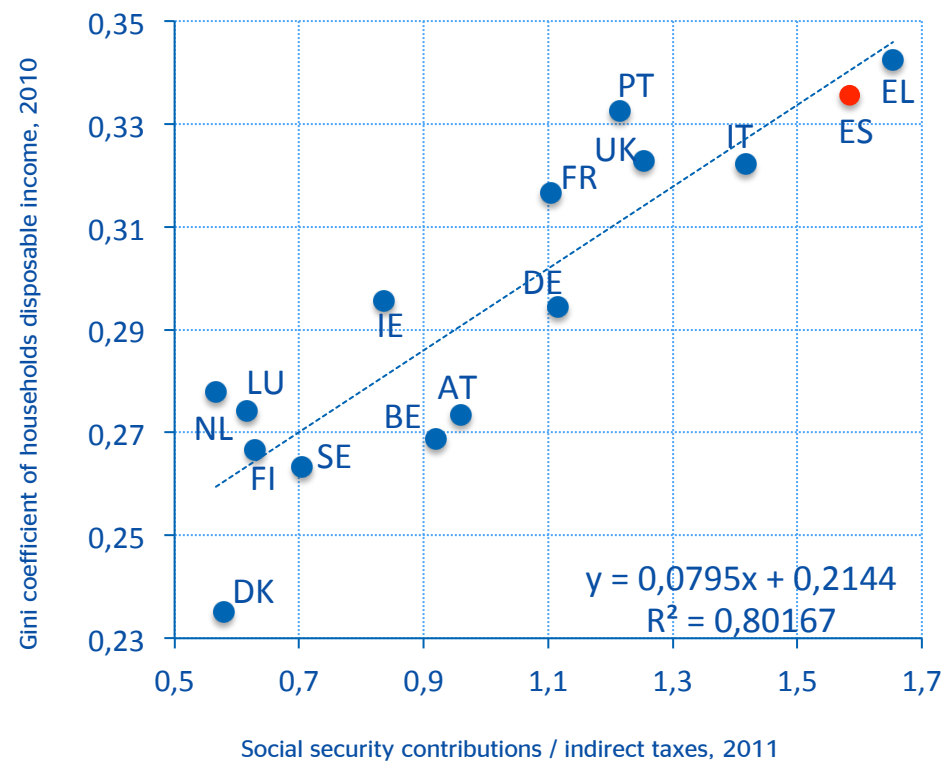
EU15: current account balance and social security contributions over indirect taxes

Source: BBVA Research based on Boscá, Doménech and Ferri (2013) <http://goo.gl/OaQIIQ>



EU15: Inequality and social security contributions over indirect taxes

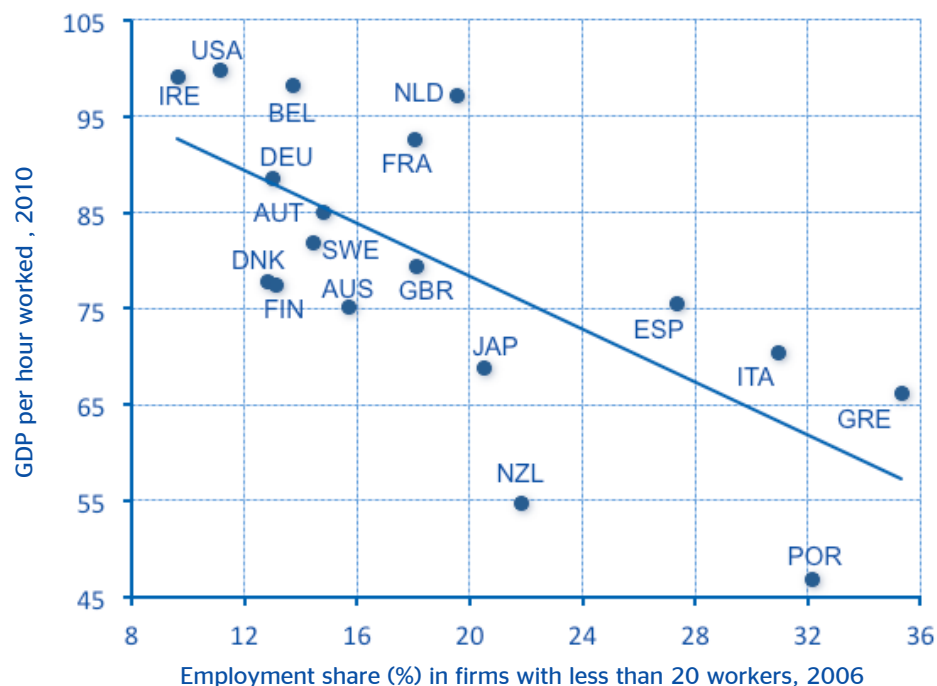
Source: BBVA Research based on Boscá, Doménech and Ferri (2013) <http://goo.gl/OaQIIQ>



Helping firms expand, hire and invest

Labor productivity and firm size, OECD

Source: Boscá, Doménech, Ferri and Varela (2011)



Better product markets regulations and lower red tape costs
-> incentives to increase firm size

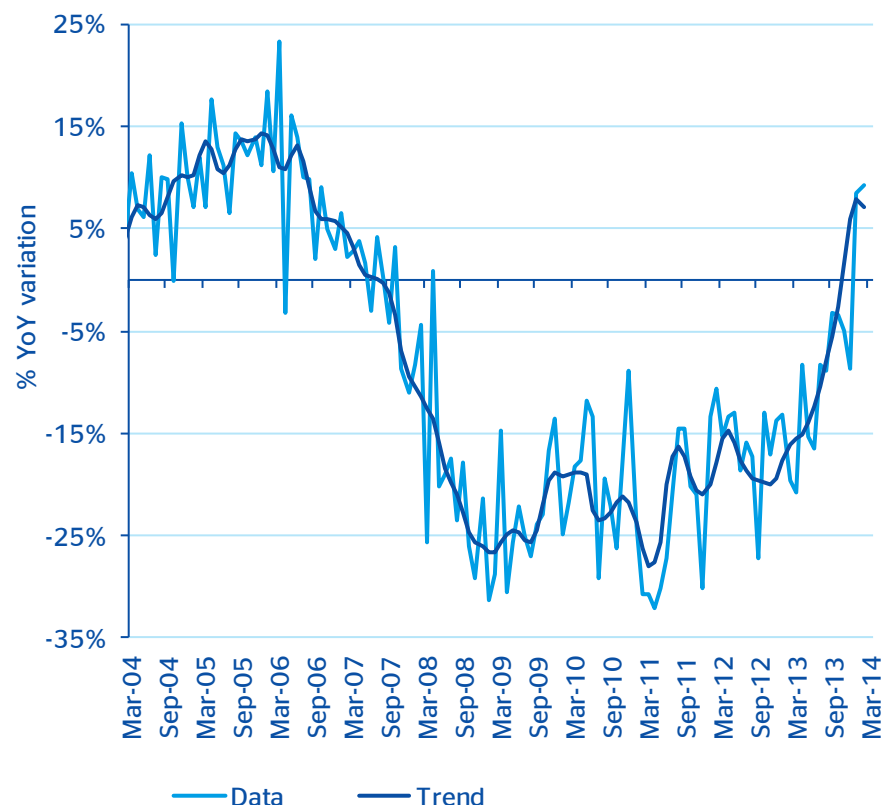
Debt restructuring and refinancing:
government participation, incentives for M&A
and analysis of corporates' default probability
and ratings (big data + BoS?) -> ECB liquidity

Avoid procyclical regulation (smart banking
recapitalization avoiding the tightening of
credit conditions) and improve responsible
payment culture

Helping firms expand, hire and invest

Spain: new credit retail operations (% YoY)

Source: BBVA Research based on BoS



Flows of new credit operations improving

The Spanish economy is going through an unavoidable process of debt reduction ...

... which is compatible with credit provision for solvent projects

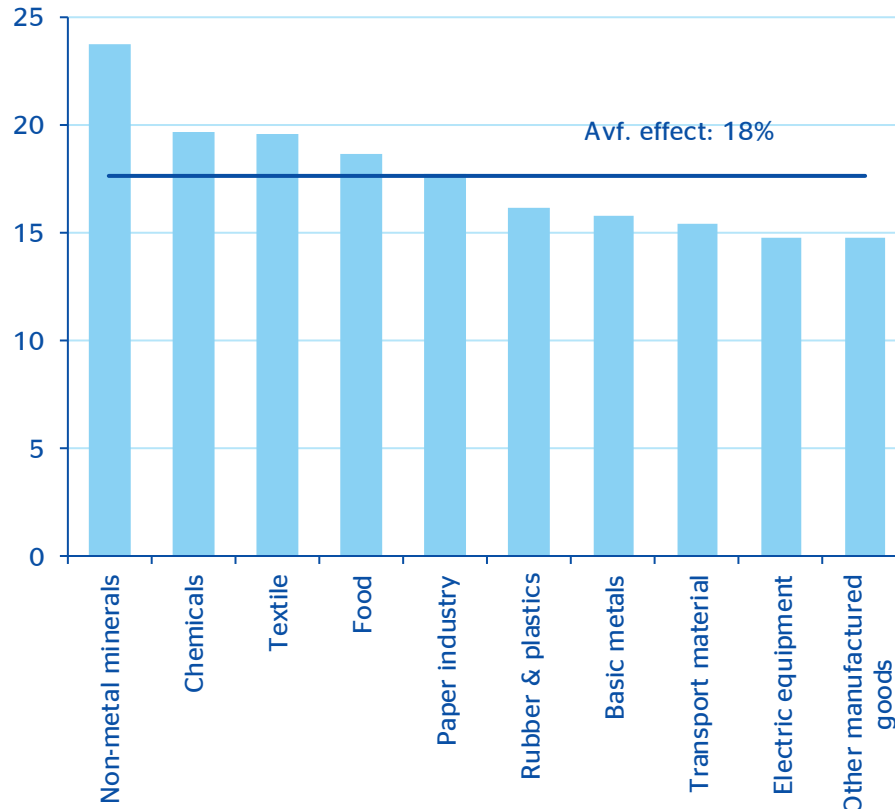
A turning point is already visible, together with an improvement in credit flows to households and SMEs, which will be strengthened in 1H14

Helping firms expand, hire and invest ... and export

Spain: effect on exports of adopting best regulatory practices, large corporations (accumulated

variation %, 1992-2008)

Source: BBVA Research based on Correa-López & Doménech (2014)



Thanks to the process of deregulation in the services sector since 1990, manufacturing exports are 50% higher

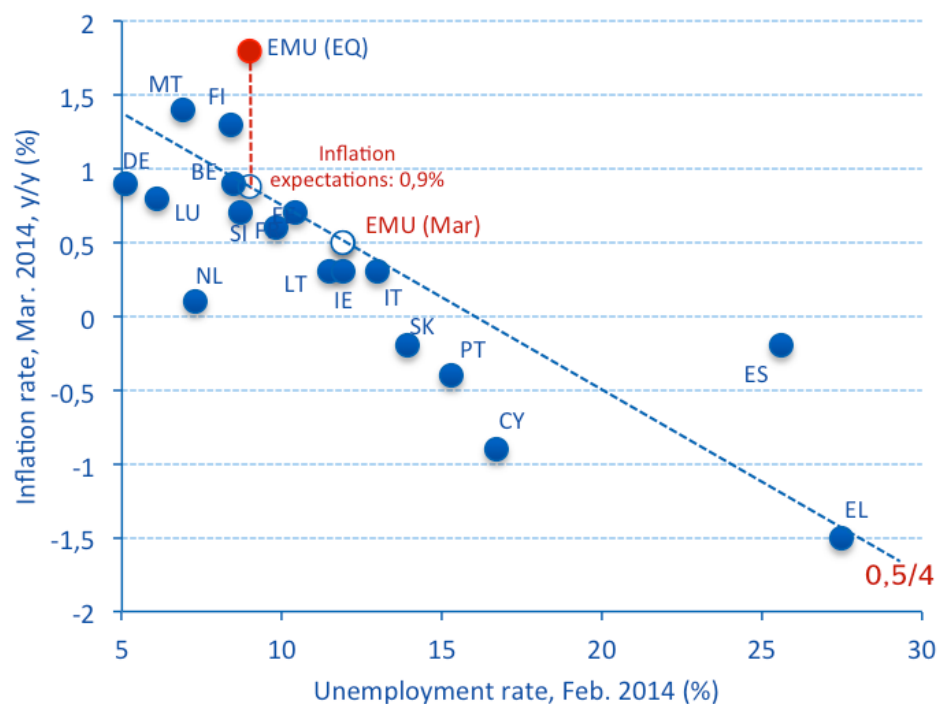
Had international best practices been adopted, exports would have been a further 18% higher

So, there is still scope for continuing to eliminate obstacles which make it difficult for companies to become more international

EMU inflation expectations well below the ECB target ...

Eurozone: unemployment rate and inflation

Source: Eurostat and BBVA Research



If 3 pp of higher unemployment explain 0.4 pp lower inflation, inflation expectations are currently less than 1% -> drag for the recovery

Inflation expectations in swaps and trimmed mean inflation (optimal selection for inflation forecasts for the next 2/3y) slightly below 1%

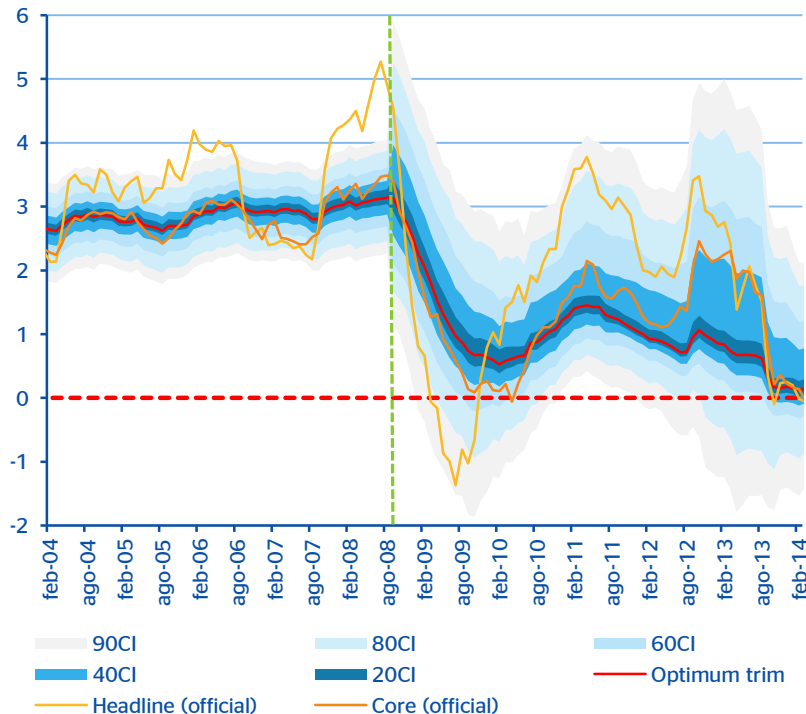
Inflation above 1% in 2015 in our base scenario and the probability of deflation is low (<10%), but adverse shocks could increase this probability

The regression coefficient of the inflation rate on the unemployment rate is equal to 0.125, statistically significant and robust to the exclusion of Cyprus, Greece and Spain.

... imposing additional costs to the Spanish recovery

Spain: trend inflation (trimmed mean inflation, % y/y)

Source BBVA Research based on INE



Exchange rate appreciation
-> costs in terms of external debt reduction

Additional efforts in terms of internal
devaluation and the reallocation of factors
across sectors

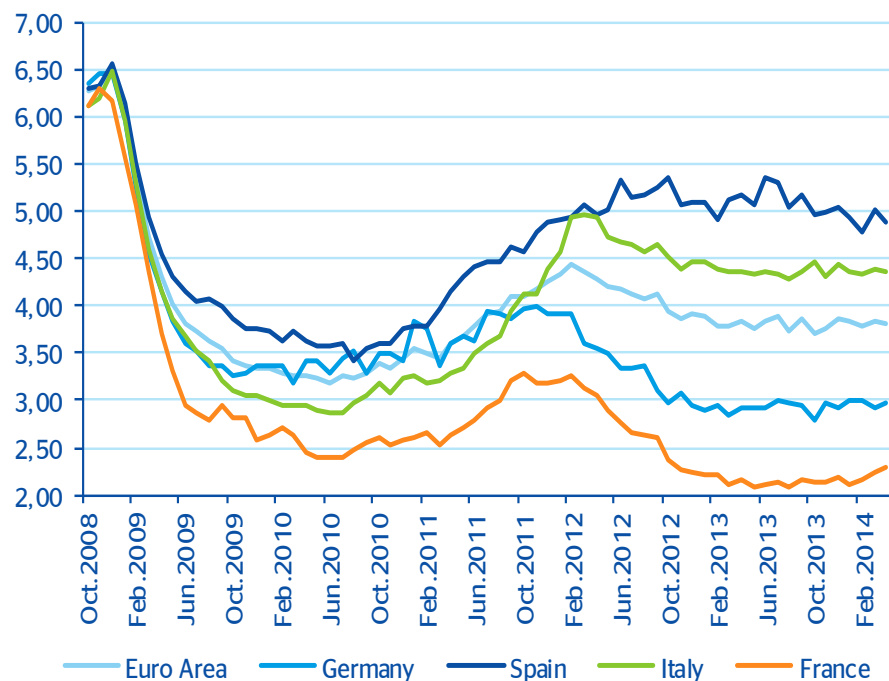
Additional efforts in terms of the deleveraging
process of the private and public sectors

EMU: Financial fragmentation

Interest rates on new bank lending

(to non-financial corporations, less than 1 million €, less than 1 year, %)

Source: ECB



Financial fragmentation still high

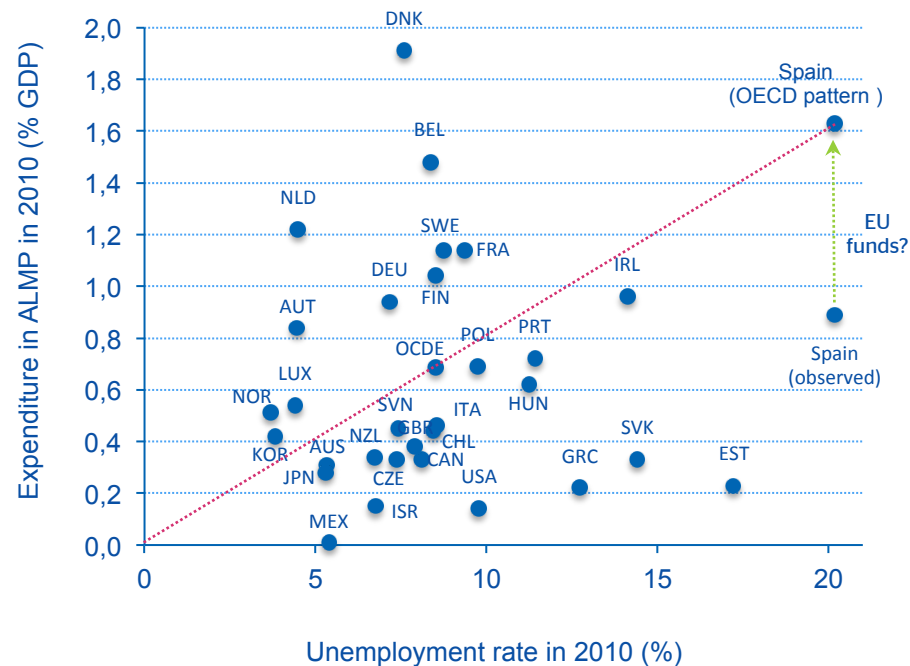
To reduce financial fragmentation the European banking union is crucial, as well as ...

... measures to lower funding costs while banks absorb non-profitable loans, changing the composition of balance sheets with new credit

EU: more support for active labor market policies

Unemployment rate and expenditure in ALMP

Source: BBVA Research based on Andrés and Doménech (2014)



Spain should almost double Active Labor Market Policies in order to converge to the OECD pattern, ...

... with the help of additional European funds (x4 + conditional on results), ...

... increasing efficiency (employment activation policies, public-private partnership, continuous evaluation, dual vocational training, etc.)

Conclusions

- 1 A similar assessment of current economic conditions and the recovery**
We expect an acceleration in growth in 2014-15
- 2 Similar recommendations for a stronger and long-lasting recovery & beyond**
Growth and employment creation are endogenous to structural reforms
- 3 Employment creation** as the best way for inclusive growth and welfare improvement -> **ambitious, continuous and deeper structural reforms:**
 - Labor and product markets policies
 - Efficient public expenditure and fiscal reform (fiscal devaluation)
 - Promote M&A and other measures to increase firm size
 - Long-run policies (do not forget human capital!)
 - Policies at the European level (ECB, banking union, growth and employment, ...)

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