BBVA Research

Spain

Economic Outlook

Fourth Quarter 2010

Economic Analysis

- The global economy is growing thanks to emerging economies but economic policy debates still rage.
- Tensions in European financial markets are still a source of concern.
- Even though the outlook is improving, the Spanish economy is still waiting for a sustained recovery.
- Making a virtue out of necessity: structural reforms are crucial to boost growth and to lower Spain's sovereign risk in the markets.

Index

Closing date: Octubre 29, 2010

1. Summary

The outlook for the global economy over the next two years continues to reflect a significant gap between growth in advanced and emerging economies, even though authorities in some emerging economies, particularly China, have embarked on a managed slowdown to prevent their economies from reheating.

In the US, weak domestic demand following the end of fiscal stimulus measures, household deleveraging and an unstable labour market all point to the fact that private spending recovery will be slow. Even though recent concerns about the US housing sector seem exaggerated, the effect on consumption and the decreasing likelihood of further fiscal stimulus measures mean that the country will be slower to exit this crisis than on previous occasions. Even though the country appears highly unlikely to fall back into a recession, the slowing recovery and the lack of strong domestic demand could trigger further monetary expansion which could be interpreted as a way of putting pressure on the rest of the world to increase its aggregate demand.

There have been significant changes in Europe following the decisive progress made in fiscal consolidation, the measures adopted to help those countries in great difficulties and the stress tests in the banking sector.

On the one hand, the markets have begun to differentiate between the various sovereign bonds, thereby lowering the risk of a systemic event. The markets have therefore begun to open up, albeit selectively. However, pressure in the European sovereign debt markets remains the main source of risk in the region. On the other hand, the euro's recent appreciation poses an additional cyclical challenge as those European economies which have performed well in recent quarters have been boosted by foreign demand. This makes it all the more important to continue dealing decisively with the causes of the region's macroeconomic vulnerability such as fiscal sustainability and external imbalances. Further delays in restructuring the weakest parts of the banking systems must also be avoided. Therefore, in order to sustain long-term growth, further structural and institutional reforms are needed. Reforms that are not only necessary to raise production capacity, stimulate job creation and improve long-term welfare, but also can help countries to achieve medium and long-term budget stability targets.

After reporting positive growth in the first half, the Spanish economy was once again facing the risk of presenting negative quarterly growth. These forecasts were based on four factors that were shaping the economic situation: persistent uncertainty and volatility in the financial markets, poor prospects for exports following the end of fiscal stimulus measures in Europe, a quickening of the pace of fiscal consolidation in Spain since the end of 2Q10 and weak private domestic demand due to ongoing adjustments. Even though these factors still exist, expectations have improved and have confirmed that third quarter growth could be around 0%. Firstly, even though uncertainty is still affecting the financial markets in Spain, liquidity restrictions have eased, and there is a clear positive differentiation between Spanish assets vs. other European countries' assets. Given the Spanish economy's financing needs and its reliance on foreign capital markets, this means lower negative pressure on growth forecasts than that seen at the beginning of the third quarter. Secondly, the European economy, the main driver of Spanish exports, has undergone a more robust recovery than expected. Thirdly, the negative impact of fiscal consolidation could in fact be less than had it not been accompanied by actions such as labour reform or the restructuring of the financial system. And finally, despite some weak fundamentals, domestic demand growth was positive in the first half. Furthermore, this improvement was due to more than just households deciding to bring forward expenditure before July's VAT hike. This evidence is in line with BBVA Research's view on the effects of fiscal consolidation as we outlined in our June report.

In any event, in the short term the economy remains stagnant, with growth rates that are insufficient to generate employment and persisting doubts regarding the sustainability of some of the factors which lie behind the economy's improvement in recent months. In particular, regarding external factors, uncertainty in the financial markets remains high while the recovery in Europe could be hampered by various factors such as the euro's appreciation, fiscal consolidation or the restructuring process at certain financial entities. Turning to Spain, increased domestic demand in the first half of the year is largely due to temporary factors such as lower precautionary savings, less uncertainty and consumers bringing forward certain purchases before the introduction of various fiscal consolidation measures (for example the VAT hike, the end of the Plan 2000E and the elimination at the beginning of 2011 of the tax deduction on primary home purchases). Also, the need for public administrations to continue rolling out tough fiscal consolidation measures will mean that public spending will contribute negatively to growth. This, combined with the reforms introduced by the Central Government, will keep growth weak yet positive in 2011.

Over the medium term, the Spanish economy still faces serious risks and the government must maintain the sense of urgency with which it rolled out various reforms during the summer. In particular, the restructuring of part of the Spanish financial system needs to be strengthened and to keep going forward, accelerating its transformation and resizing and guaranteeing an adequate level of capitalization in line with the new global banking regulation. The public authorities must continue guaranteeing that the fiscal deficit targets remain a priority. The sound performance of public revenue appears to indicate that the Spanish government will meet its year-end target of a deficit of 5.9% of GDP and this could in fact be achieved with room to spare. In any event, any unexpected improvement should be used to spur on compliance with the 2011 target and, under no circumstances, should budgetary discipline slacken. The autonomous authorities and local governments must also play a role in the fiscal consolidation process and more efficient rules need to be developed which guarantee budget stability throughout the government as well as providing the general public, and the markets in particular, with better and more budget outturn information. The Spanish government's role is clear, but public authorities must also pursue a proactive policy aimed at providing more information and greater transparency, or uncertainty regarding the quality of public finances could linger, which would cause tension regarding Spanish public debt. In other words, a rigorous fiscal adjustment is a necessary step but will not be enough: the markets also demand regular and timely information on budget outturn which clearly shows that fiscal consolidation is progressing as planned and that the annual targets will be met comfortably. In these circumstances, regional governments must make a virtue out of necessity.

Finally, even though the labour market reform was a step in the right direction, uncertainty regarding its development and implementation remains high, making it difficult to assess its potential impact on unemployment rates and economic growth. By ambitiously implementing this reform and launching an active information campaign regarding its benefits, the Government has in its power the means to improve expectations and hasten recovery by easing corporate and household uncertainty. This reform has to be rolled out in tandem with others to help Spain stand out from other countries. These reforms should aid to achieve an ordered deleveraging process among households and firms while also guaranteeing the sustainability of public finances in the medium term. They must also improve regulation in the goods and services markets, encourage a more efficient tax system, reduce the economy's financings needs and create a better qualified active population. These structural measures need to be fine-tuned and consolidated to create more favourable conditions for private sector investment and attract foreign financing and create jobs, helping the Spanish economy emerge from the crisis primed for further growth.

2. Global prospects: slow in the North, fast in the South

The global economy continues to grow strongly, mainly in emerging countries, while economic and financial concerns dominate in advanced economies

Global growth remains strong and is expected to reach 4.7% in 2010 and 4.1% in 2011 (Chart 1), virtually unchanged with respect to our forecasts from three months ago. This sound performance is largely due to strong emerging economies which have been less hit by the financial crisis and, therefore, have recovered quicker. Meanwhile, there are fresh concerns regarding the US economy to add to the financial woes in Europe where macroeconomic and financial adjustments are still underway. In this regard, the outlook for the global economy over the next two years continues to reflect a significant gap between growth in advanced and emerging economies (Chart 2) even though authorities in some emerging economies have embarked on a controlled slowdown to prevent their economies from overheating.

Nevertheless, there are important differences in the policies in each of these groups. Monetary expansion in the US will intensify compared to Europe (and other countries), which has caused the dollar to depreciate against the euro, thereby complicating recovery in Europe. In emerging economies there is still a strong asymmetry between exchange rate policies in Asia and Latin America which is causing the Latin American countries to shoulder (along with the euro) a large part of the exchange rate appreciation due to renewed relaxing of US monetary policy.

Growth in the US could remain weak due to continued household deleveraging, although there is little risk of the country plunging back into recession

Relatively weak economic activity indicators for the US in the past quarter have prompted fears of a fresh recession. The weakness seen in some key sectors which had directly benefitted from fiscal aid provided by purchasing incentives (housing and durable goods) is an important indication that private demand in the US is unable to recover swiftly. This is not only the result of households deleveraging but also due to the weak labour market. This will continue to favour saving rates not seen since the second half of the 90s. Even though this is a step in the right direction towards rebalancing the US growth model, economic concerns have also increased as consumption (one of the mainstays for recovery in previous recessions) looks set to remain weak and could be offset, only partially, by companies investing more in capital goods.

We believe that recent concerns regarding the housing sector in the US are unfounded and that the likelihood of prices dipping again is remote given that they have already fallen by around 30%. There are worrying factors however such as increased inventories in the housing market and a possible increase in supply due to new foreclosures (either because of NPL rates or because home owners are unwilling to keep up repayments when faced with negative equity). There are also favourable elements of support such as improved home ownership access since the start of the crisis and demographic trends which should continue to drive future demand. It is therefore highly unlikely that we will see prices fall further –in any event the banking system should be able to withstand a moderate fall–, and house prices are more likely to stabilise while reabsorbing previous excesses.

In short, the drag on consumption and the low probability of further fiscal stimulus –given the current size of the deficit and the political arena, especially if there is a change in the balance of power following Congressional elections in November–, should be partially offset by a recovery in private investment and exports. This would mean that the US could exit the recession much slower than in previous cycles (Chart 3) which is in line with our long-standing forecasts. However, the country appears highly unlikely to fall back into a recession. In any case, strong internal demand could cause the US to put increasing pressure on the rest of the world (particularly those countries with a current account surplus) to increase demand and help global re-balancing. Fresh monetary expansion in the US could be interpreted as a way of putting pressure on the rest of the world to induce part of this adjustment.

In Europe, activity has grown quicker than expected but without signs that domestic demand is recovering and taking over from exports

Second-quarter accounts data for the euro zone were surprisingly high with qoq growth of 1% largely due to net exports and their effect on investment. Private consumption barely grew, casting doubt on any sustainable recovery in the medium term. In recent months there has been a marked differentiation between Northern European countries, which have enjoyed strong growth, and their Southern cousins, where growth has been more moderate and more diverse. Growth in Germany was impressive, boosted by exports to emerging countries as well as seasonal factors which drove the construction sector, recovering inventories and the “rebound” effect following the decline in activity. Third-quarter data would appear to suggest that the slowdown forecast for the second half is in fact upon us. That said, it is slower than expected and we are seeing conflicting signals from confidence indicators which in some cases have remained high, and real indicators, which are still failing to reflect this improvement. The little data there is for the fourth quarter are still relatively positive.

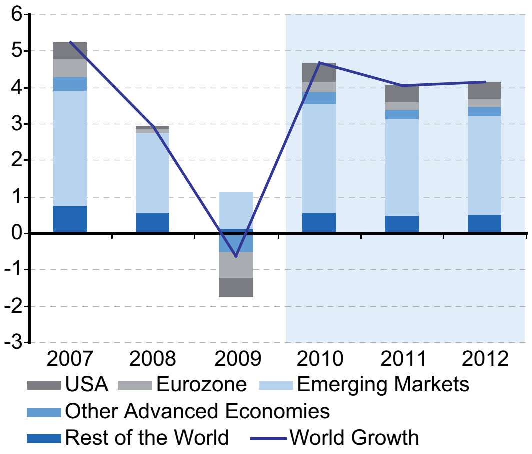
Financial stress in Europe is still a cause for concern although systemic risk is lower than before the summer. Fiscal consolidation remains paramount to sustaining confidence and should not negatively affect longer term growth

Euro zone growth will remain moderate, following the decisive progress made regarding fiscal consolidation, the measures adopted to help those countries in great difficulties and the stress tests in the banking sector. On the one hand, even though sovereign debt average spreads have remained fairly stable, markets have begun to differentiate between the various sovereign bonds, thereby lowering the risk of a systemic event. Likewise, the markets have begun to open, albeit selectively, and new debt issues are a clear sign that pressure is easing.

In spite of this, pressure in the European financial markets remains the main source of risk in the region (Chart 4), particularly due to the correlation between concerns about sovereign debt and risks in the financial sector, bearing in mind their domestic and international exposure. Also, the euro’s recent strength brings an added difficulty as those economies which have outperformed have been buoyed by foreign demand. This makes it all the more important to continue dealing decisively in the short term with the causes of the region’s macroeconomic vulnerability such as fiscal sustainability and external imbalances. Further delays in restructuring the weakest parts of the banking systems must also be avoided. The key is to continue restoring confidence to reduce pressure in the markets and return strength and autonomy of demand to the private sector. Also, in order to sustain long-term growth, a number of structural and institutional reforms are needed and must be aimed at avoiding and resolving future fiscal imbalances.

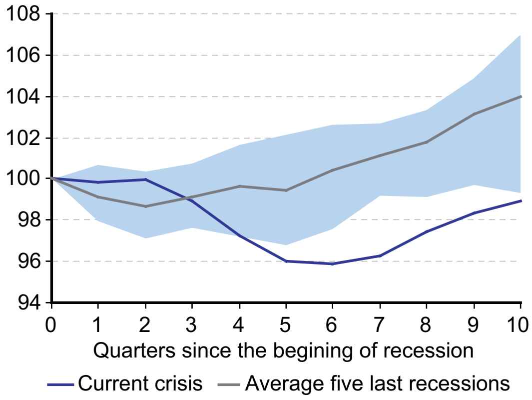
This way, faced with the challenges of fiscal consolidation, renewed confidence in the financial system and bank restructuring, the outlook for the next couple of years in Europe remains one of relatively slow recovery overall. That said, there are some major differences between those countries at the heart of Europe which have seen fewer imbalances during expansion and which are now reaping the rewards of foreign demand (mainly, emerging economies), and peripherals where more serious adjustments are needed. Even for those countries at the heart of Europe, providing the impetus does not shift from foreign demand towards a marked recovery by consumption and investment, something which is still indiscernible, recovery will not be sufficiently apathetic to be self-sustainable. For 2011 growth of over 1% is forecast for the euro zone after reaching 1.6% this year, with Germany outperforming France and peripheral countries. Inflation looks set to remain below 2%, as the production gap is still quite wide.

Chart 1
Global GDP growth and contributions (%)



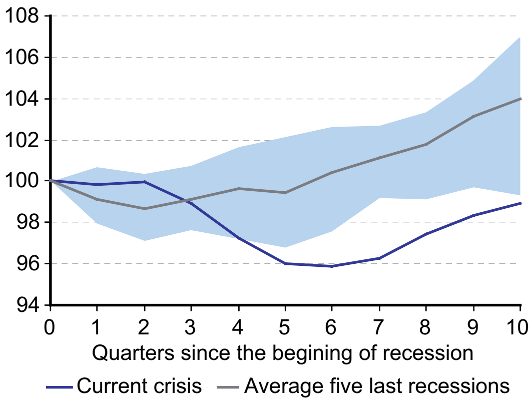
Source: BBVA Research

Chart 2
GDP level: 2007=100



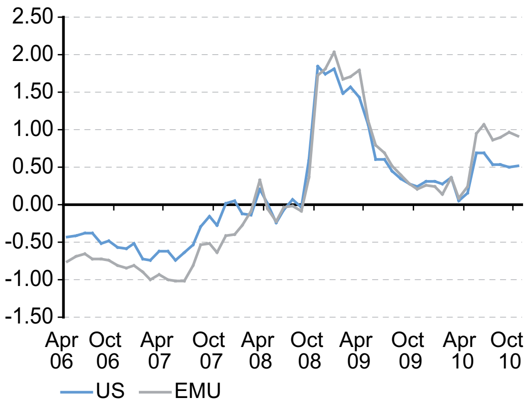
* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research and Datastream

Chart 3
US GDP: current cycle vs. previous recessions*. Beginning of each recession=100



* Shaded area: range of GDP during last 5 recessions
Source: BBVA Research and NBER

Chart 4
BBVA Financial Stress index



Source: BBVA Research

Monetary policy in the advanced economies will be expansionary for some time yet, putting pressure on exchange rates throughout the world

A very low growth outlook and weak inflationary pressure in advanced economies should sustain very low long-term interest rates in the three main advanced economies (the US, Europe and Japan). However, against a backdrop marked by renewed economic concerns and limited scope for additional fiscal stimulus, markets' attention is focused on a further round of unconventional monetary expansion measures (Quantitative Easing 2 or QE2). Expectation surrounding this increase in liquidity has brought about a generalised reduction in dollar crosses, even against the euro. Looking forward, given that the majority of the monetary expansionary measures have been priced in by the markets, EUR/USD exchange rates will largely depend on relative growth outlooks (which favour the US against the EMU), as well as monetary policy in both areas and investment flows. At the same time, we expect bullish pressure to remain on exchange rates in emerging economies given the increase in global liquidity, stronger economic fundamentals and positive yield spreads which favour further capital inflows.

Emerging markets are facing greater economic policy dilemmas given the strong growth, abundant global liquidity and neighbour's exchange rate intervention

Emerging economies are growing apace, with Asia leading global recovery. In both Asia and Latin America, private domestic demand is replacing economic policy stimulus as the main source of recovery. Moving forward, growth should slow in Asia given the reduced stimulus from the global inventory cycle, weaker foreign demand and the withdrawal of economic stimulus policies, all of which will reduce the risk of these economies reheating. Despite this, the region will remain the leading contributor to global growth.

Both Asia and Latin America are facing increasingly serious dilemmas with regard to monetary and exchange rate policy as they decide whether to cool strong domestic demand and avoid strong inflows of capital or whether to remain competitive vs. foreign markets. Some countries have begun to introduce measures to dissuade strong inflows of capital while others have delayed toughening up their monetary policy.

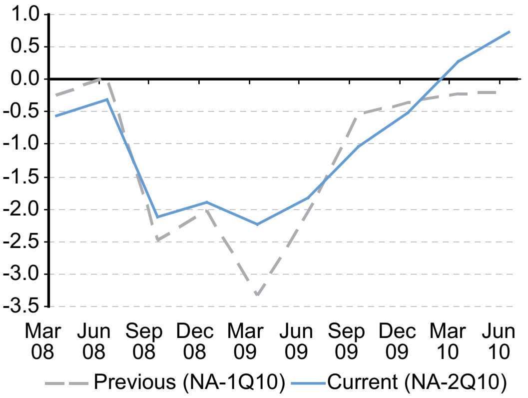
Considering the relative lack of flexibility of exchange rates in China (and to a lesser extent in the rest of Asia), Latin America needs to take on a large part of this adjustment up to the point where future currency appreciations will begin to affect growth. Therefore, many countries in the region are considering further exchange rate interventions even though experience has shown that this is not particularly effective. These should help slow rising exchange rates but not prevent them. There is also the risk that increased intervention in the currency markets could trigger trade reprisals. This highlights the importance of being more flexible with regard to the currency markets in Asia (particularly in China), with a view to creating more room for economic policies to manoeuvre in the rest of the world.

3. Re-assessment of Spain's economic growth prospects

After reporting positive growth in the first half of the year, our previous Spain Economic Outlook[1] forecasts pointed that the Spanish economy was once again running the risk of negative quarterly growth in the second half of 2010. Those expectations were mainly based on four factors that were strongly conditioning the performance of the Spanish economy: the persistent uncertainty and volatility in the financial markets, a weaker outlook for exports following the end of fiscal stimulus measures in Europe, the speed up of the pace of fiscal consolidation in Spain since the end of 2Q10, and finally, a weak private domestic demand which, based on the first three factors, was expected to worsen and unable to offset, at least partly, the expected worsening in the contribution of the public sector demand. Furthermore, the fall in final demand was expected to produce a downwards adjustment, albeit limited and transitory, of some production, investment and hiring decisions at Spanish companies which could negatively impact the labour market.

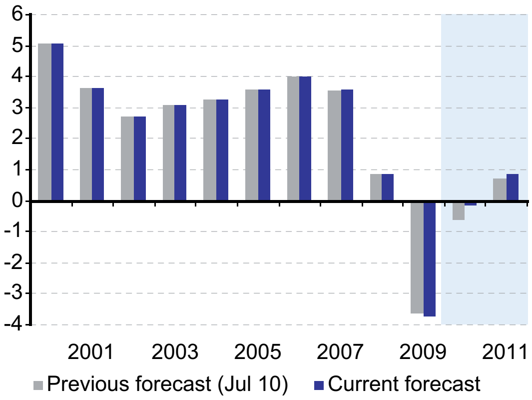
Even though these factors persist in the Spanish economy, there are slight differences which have prompted us to reassess our forecasts for the rest of the year and, to a lesser extent, for 2011. Firstly, even though there is still uncertainty in the financial markets, there has been a clear positive differentiation between Spanish assets vs. other countries' assets, such as Ireland and Portugal, and an easing of liquidity tensions. Given the Spanish economy's financing needs and its reliance on foreign capital markets, this implies a lower negative pressure on growth forecasts than the assumed one at the beginning of the 3Q10. Secondly, the European economy, the main driver of Spanish exports, has undergone a more robust recovery than expected which has prompted us to revise upwards our growth forecasts for the year. And finally, preliminary estimates of the national accounts data for 2009, coupled with the quarterly figures for 2Q10 released at the end of August, revealed a relatively stronger performance by domestic demand in 1H10, leaving a less adverse starting point now that fiscal consolidation is beginning to pick up (see Chart 5). Against this backdrop, GDP could shrink by close to 0.2% in 2010 overall.

Chart 5
Spain: domestic demand (contribution to quarterly GDP growth in %)



Source: BBVA Research based on INE data

Chart 6
Spain: GDP growth (% yoy)



Source: BBVA Research based on INE data

1: See Spain Economic Outlook for 3Q10.

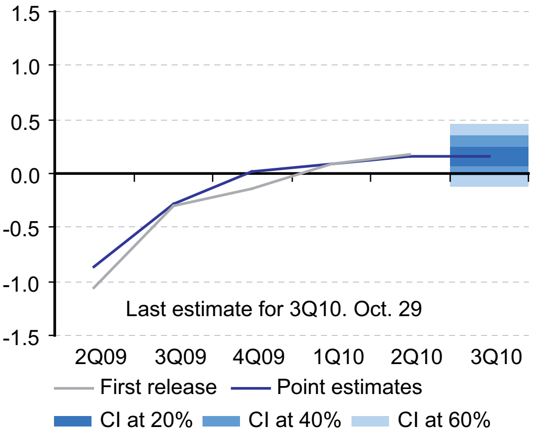
Nevertheless, doubts remain about the sustainability of some of the factors which lie behind the economy's better than expected performance in recent months. In particular, regarding external factors, uncertainty in the financial markets remains high while recovery in Europe could be hampered by several factors such as the euro's appreciation, fiscal consolidation or the restructuring process at certain financial entities. Regarding domestic factors, increased domestic demand in the first half of the year was largely due to temporary factors such as lower precautionary savings and consumers bringing forward certain purchases before the introduction of various fiscal consolidation measures (i.e., the VAT hike, the end of the Plan 2000E and the elimination of the deduction for primary home purchases scheduled as of the beginning of 2011). Also, this fiscal consolidation process could further hamper growth next year. We therefore anticipate recovery, despite the relative improvement in the outlook, to remain weak with a GDP growth around 0.9% in 2011 (see Chart 6).

The Spanish economy continued to grow at around 0% in 3Q10

Pending official data for the third quarter, preliminary economic indicators point to a GDP growth rate of around 0% for 3Q10. In particular, short-term GDP forecasts using the MICA-BBVA[2] model suggest that growth was once again sluggish in 3Q10, at around the levels seen in the first half of the year (see Chart 7). However, this outlook is a remarked improvement on the forecasts from three months ago. Notwithstanding, we should note that Spanish economic recovery is still too weak, with activity being virtually stagnant and unable to support sustained job creation. Besides, the speed up of fiscal consolidation has exerted downward pressure on private domestic demand (although this is partially offset by the outperformance of other factors), thus being the qoq improvement in GDP largely attributed to the positive contribution of net foreign trade (see Chart 8).

Chart 7

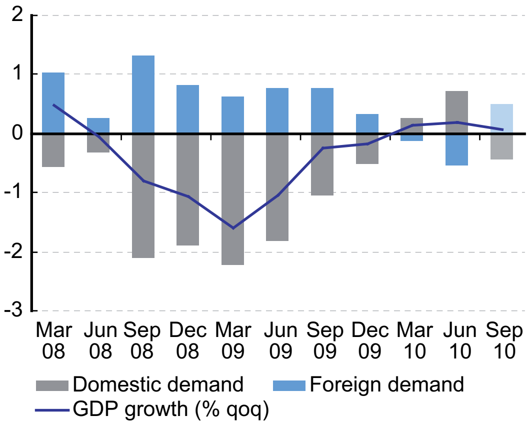
Spain: GDP growth forecasts using MICA-BBVA model (% qoq)



Source: BBVA Research based on INE data

Chart 8

Spain: contributions to quarterly GDP growth (%)



Source: BBVA Research based on INE data

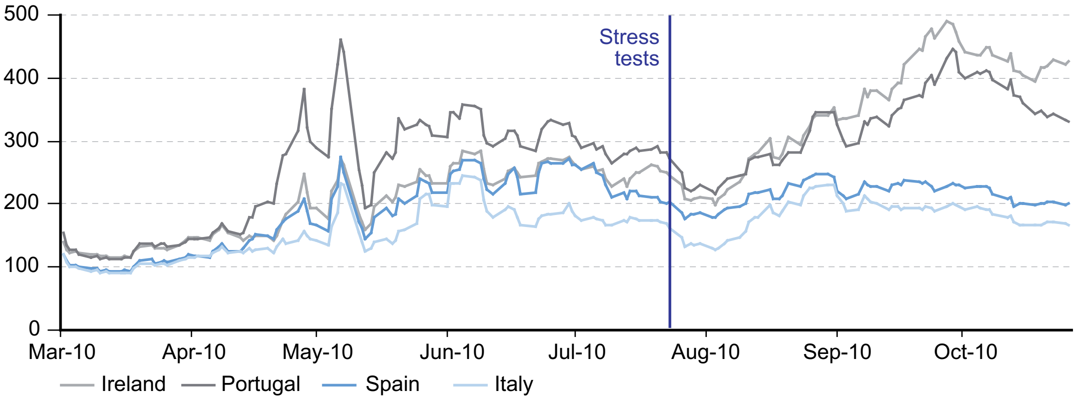
The risk premia have lessened while liquidity pressures are easing, notably improving the foreign outlook with regard to the Spanish economy

During the past quarter, the European financial markets have been facing a new peripheral risk episode, this time due to the increase in Ireland's risk premium associated with the costs of bailing out its banking system. In this occasion, however, the most remarkable element have been the Spanish positive differentiation against other peripheral countries such as Portugal and, to a lesser extent, Greece. Ireland's and Portugal's sovereign risk premia have risen by around 200 basic points while Spain's and Italy's have remained relatively stable (see Chart 9).

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

Chart 9

Sovereign risk premium (5Y CDS in bps)



Source: BBVA Research based on Bloomberg data

This performance has been translated through financing markets that have experienced some normalization, although this has been selective for those countries with better macro and financial fundamentals. This contrasts with the period prior to release of the stress tests where the markets were closed indiscriminately. Spain has been one of the main beneficiaries of this situation which has enabled the government and some financial entities to issue debt with a positive outcome. It is worth noting that this reopening has only been partial with only large and medium-sized financial firms having market access. The market for Autonomous Communities' debt issues remains open pending.

Thanks to the normalisation of the debt markets, the easing in the interbank market and the reactivation of the international repo markets, the Spanish financial system has not needed to tap European Central Bank (ECB) funding as much in the past two months. Financial entities look less and less likely to need to tap ECB funding as the debt markets continue to open up, although more vulnerable entities will continue to request funding.

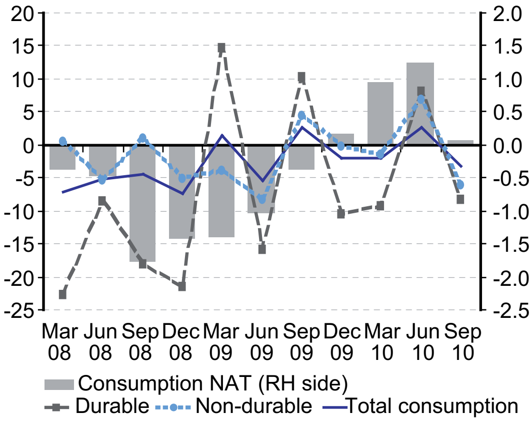
The healthier economic backdrop partially offsets the quickening fiscal consolidation process consequences on private domestic demand

Turning to household consumption, the probable transfer to 1H10 of spending, driven by the VAT hike at the beginning of July, and the withdrawal of fiscal stimulus measures (such as the Plan 2000E), triggered a notable slowdown in 3Q10 (see Chart 10). Sales in the services sector[3], domestic sales by large enterprises, retail sales and, more importantly, car registrations all slumped in 3Q10 (see Chart 11). However, seasonally- and working day adjusted data (SWDA) showed that the decline in spending was concentrated in July, when sales in the services sector contracted 6.3% mom, domestic sales by large enterprises fell by 12.7% mom, retail sales dropped 2.1% mom and car registrations were down by 33.0% mom (SWDA).

3: NB. Even though the service sector sales index, drawn up by the INE, indicates supply, it is also a reliable indication of demand. For more detailed information see: http://www.ine.es/jaxi/menu.do?type=pcaxis&path=/t37/p183&file=inebase&L=0.

Chart 10

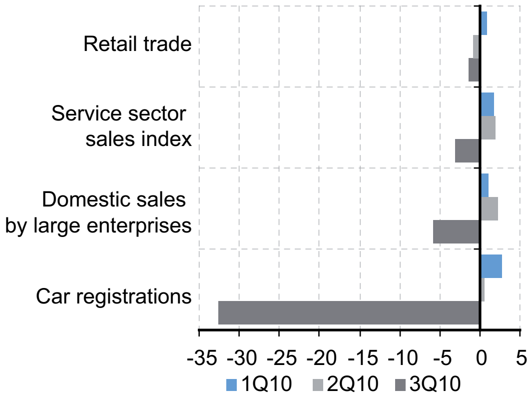
Spain: final household spending and availability of consumer goods (SWDA, quarterly averages , % qoq)



3Q10 data: July and August averages and forecast for final household consumer spending
Source: BBVA Research based on MEH and INE data

Chart 11

Spain: consumer spending indicators (SWDA, % qoq)



3Q10 data: July and August averages for the service sector sales index and domestic sales by large enterprises
Source: BBVA Research based on INE, AEAT and ANFAC data

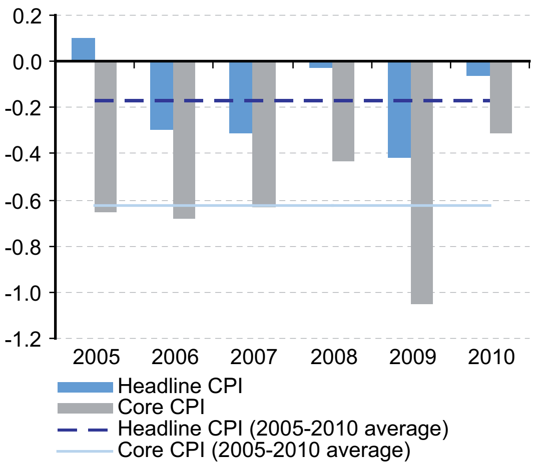
Also, the incomplete pass-through from the VAT hike to prices, together with its fundamentals' suggests consumption did not slow as much as expected at the end of 2Q10. CPI data for September showed that the effect of the VAT hike was moderate and may have run its course. The q-o-q change in headline inflation and the core component were -0.1% q-o-q and -0.3% q-o-q, respectively, 0.3pp and 0.7pp higher than in 3Q09, and only one or three-tenths of a percent higher than previous years' averages for the quarter (see Chart 12). Neither labour market performance in the third quarter nor public sector salary cuts, effective in June, seems to show that household income dropped in higher extent than during the previous quarters. Chart 13 shows that while total real wages fell in 3Q10 they did so less than in the second quarter.

Also, the financial burden on households was virtually unchanged in 3Q10: according to our estimates, the percentage of household's wages used to pay off debt remained below 14% between July and September. Likewise, household uncertainty regarding the economy did not change enough either to drive a sharp decline in spending on consumption[4]. Once again, Chart 13 shows how the potentially adverse impact on consumption of a drop in household confidence over their current and future financial situations could be offset by improved confidence regarding the current situation and future outlook for the Spanish economy.

Therefore, as we put forward in our Economic Watch report of 13 October, although household consumer spending lost steam in 3Q10, available data indicate that the deterioration was less severe than forecast at the beginning of the quarter. In this regard, our Model of Coincident indicators with Consumption model (MICC-BBVA) shows virtually no growth in private consumption in 3Q10 after a 1.2% increase in 2Q10.

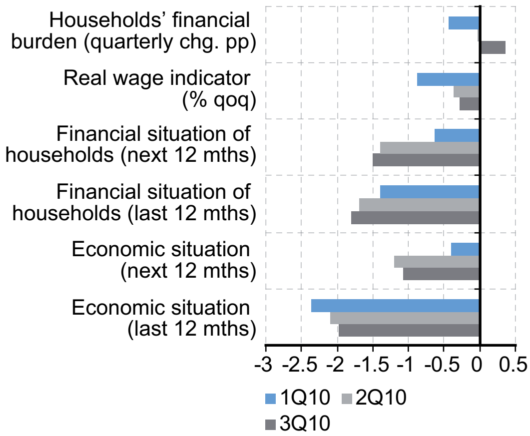
4: The quarterly non-financial accounts for institutional sectors show that household savings in 2Q10 fell 1.5 pp to 16.2% of gross disposable income.

Chart 12
Spain: inflation in 3Q10 (% qoq)



Source: BBVA Research based on INE data

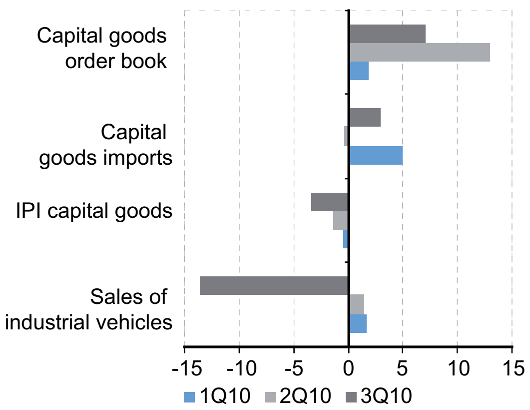
Chart 13
Spain: key drivers for household consumption



The confidence indicators measure normalised quarterly wage averages
Source: BBVA Research based on INE, BoS, MEH and EC

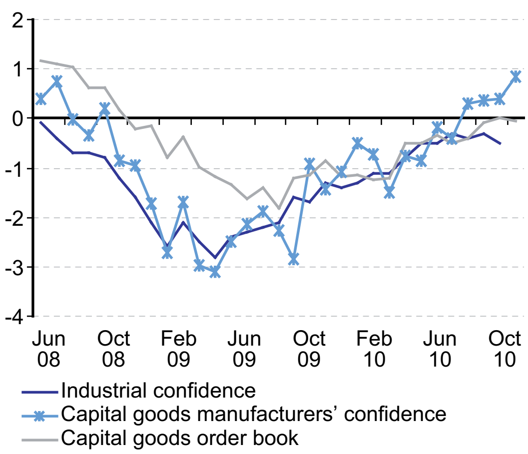
Turning to investment in capital goods, data for the third quarter show a slowdown in this component of aggregate demand, mostly in July, as was the case with household consumption. That said, signals remain mixed, but as a whole they point to a more moderate decline in business investment in 3Q10 than we had been anticipating at the beginning of the quarter. On the one hand, according to our estimates, both sales of industrial vehicles and industrial production of capital goods, seasonally- and working day-adjusted, fell sharply in the third quarter (see Chart 14). On the other hand, imports of capital goods (SWDA) in July and August rose 1.0% mom and 3.5% mom, respectively, which point to a 2.9% increase for imports for the third quarter as a whole if this trend held steady in September. Besides, new industrial orders of capital goods and production expectations regarding this investment component trended upward throughout 3Q10, far outstripping the industrial confidence performance (see Chart 15). Accordingly with the recent trend for capital investment indicators, its fundamentals suggest a lower than forecast decline at the beginning of 3Q10. Our estimates indicate that both, expected corporate earnings as a percentage of GDP and the real cost of capital remained broadly unchanged in 3Q10. furthermore, production capacity utilisation (SWDA) rose by 1.4 pp to 73.7% (80.3% on average between 1995 and 2007).

Chart 14
Spain: capital investment indicators



* 3Q10 data: average for July and August
Source: BBVA Research based on INE, Customs, MICT and MEH data

Chart 15
Spain: industrial confidence (normalised data)



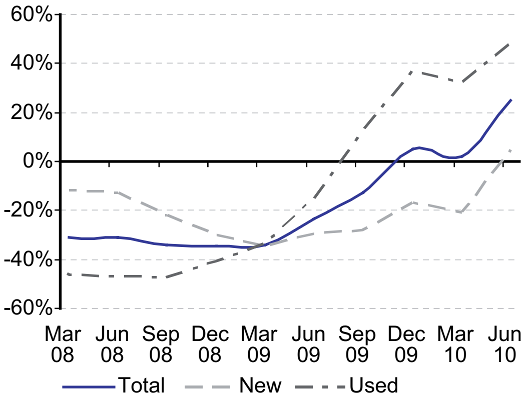
Source: BBVA Research based on European Commission and MICT data

Housing investment has been shaped by the fiscal changes due to take effect in January 2011. The elimination of the deduction for primary home purchases for homeowners with annual gross income above 24,107.2 euros has prompted homebuyers to bring forward residential investment. This effect will lessen in the second half of the year. In fact, this move is likely to have highlighted the negative impact of the VAT increase in 3Q10. Residential demand data from the Association of Land and Mercantile Registrars of Spain for July and August showed that this is picking up (see Chart 16). Even though there is a lag time for registrations, in these two months of the third quarter sales rose 3.5% mom on average (SWDA), well above the previous year's average (-0.3% mom SWDA).

However, the supply has been showing less dynamism. Residential building permits data for the second quarter were lower than in 2009 and the data for July and August appear to indicate that residential activity in the third quarter will also be lower. As a result, the outlook for 2010 once again shows a decline in the number of permits to just over 100,000. The higher contraction on the supply and recovering demand are helping to reduce the inventory of unsold homes which, at year-end, could be 95,000 units lower than at the beginning of the year. However, excess supply remains high and construction and promotion firms continue to curb new projects. Summarizing, housing investment will have contracted once again in 3Q10 although to a lesser extent than in previous quarters with investment forecast to decline around 2% qoq (see Chart 17).

Chart 16

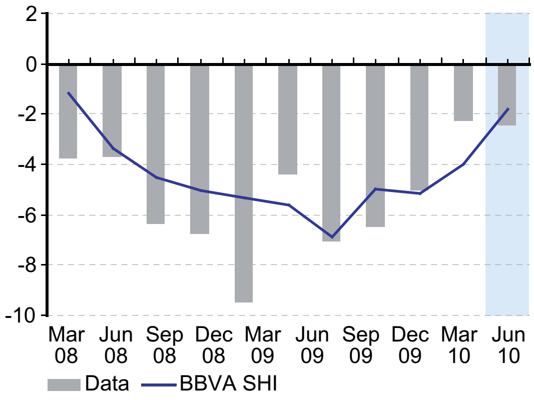
Spain: home purchases * (% yoy)



Source: BBVA Research based on MVIV data

Chart 17

Housing investment and BBVA Synthetic Housing Indicator (SHI)



Source: BBVA Research based on INE data

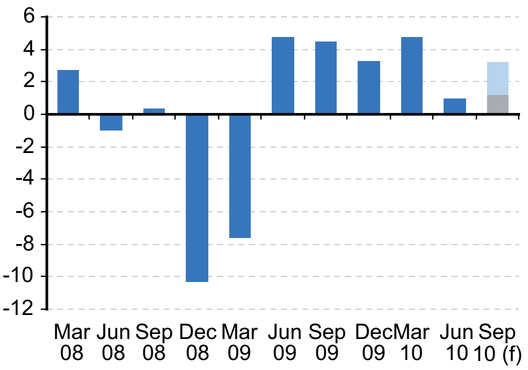
Meanwhile, the recovery in budget outturn makes it increasingly likely the Central Government will meet its year-end budget deficit target

The state accounts have corroborated the recovery in income and, specially have showed the contraction in spending, together with the increasingly probability for the government to fulfil the targeted deficit this year (5.9% of GDP). Turning to income, one of the reasons for this improvement is enhanced consumption performance during the first half, the normalisation of certain income flows (VAT) and the implementation of measures announced over the past year (personal income tax). Looking ahead, the slowdown in domestic demand should ease income growth, although in the case of indirect taxes, the VAT increase should offset this slowdown. On the spending side there have been significant cutbacks in investment and current transfers (non-renewable of discretionary programmes). This reduction in spending will have a direct negative effect on activity over the coming months. However, as we have said on previous publications, the effective implementation of these measures explains, at least partly, the improved confidence, liquidity and risk premiums in the Spanish economy. Therefore, up to now, the verdict on the impact of fiscal consolidation is that, once the direct and indirect effects have been taken into account, this has been limited, as we stated in June's issue of Spain Economic Outlook.

Despite the growth slowdown in Europe and the euro exchange rate appreciation, the external sector made a positive contribution to Spanish GDP growth in 3Q10

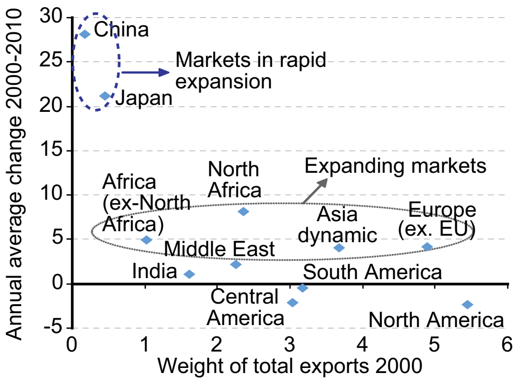
In line with our analysis in the past two editions of Spain Economic Outlook, Spanish exports of goods and services continue emerging as a permanent support for the economic activity recovery. Improved global economic data in the first half of the year, gains in competitiveness in terms of unit labour costs and the increasing geographic diversification of Spanish exports, considering the current uncertainty concerning currency markets, anticipate a good performance of this variable. The trade balance data released to date and corresponding to the third quarter point to an upward correction in the forecasts made at the start of the quarter. Specifically, the qoq increase in exports could be up to two points higher than initially forecast (see Chart 18). Underlying this sound performance are the gains in competitiveness/price during a large part of the quarter which have also helped expand the range of destinations for Spanish exports (see Chart 19). In this regard, we would note the continuing increase in the weight of exports of Spanish goods to outside the EU which has risen from 28% to 34% in the past decade. And finally, it is expected that, after various months characterised by the current account deficit stabilization, it returns to the path of moderate adjustment as the trade balance deficit will narrow down due to strong export data and confirmation of the positive results from the services sector showed since the beginning of the summer period.

Chart 18
Spain: exports of goods in real terms (% qoq, SWDA)



Note: Sep 2010 forecast based on trade balance data (Customs)
Source: BBVA Research based on Customs and INE data

Chart 19
Spain: non-EU exports of goods. Weight in 2000 and change 2000-2010 (%)



Source: BBVA Research based on Datacomex

The indicators available at the date of publication point to a favourable performance by incoming tourism for the third quarter as a whole. Despite the 52.3 million foreign tourists to the end of August 2010 are still well off the 58 million recorded at the peak of the expansionary phase, some indicators are beginning to show positive signals. On the one hand, both overnight stays and tourist visits are consolidating the positive yoy growth rates (even taking into account the effects of the volcanic ash cloud at the beginning of the second quarter). On the other hand, hotel occupancy rates returned to 70% in August, 3 pp higher than the same period the previous year. This was partly helped by the sharp adjustment in prices which have fallen 9% since 2008. All in all, the improvement in visitor numbers and overnight stays implies that in August tourist expenditure rose 5.8% yoy despite declining confidence and lower hotel prices, triggering a practical freeze on average expenditure (+0.1 yoy in the quarter to August).

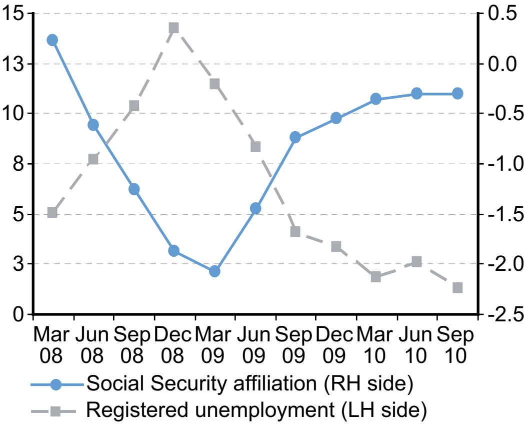
The labour market continues to adjust at the pace set in recent quarters. There is no evidence of additional deterioration as a result of weakening domestic demand

Turning to the labour market, indicators for 3Q10 showed that, once the negative seasonal variations inherent to that quarter are adjusted for, job destruction has not accelerated. This way, Social Security affiliation (quarterly average) decreased by 0.4% qoq (SWDA) in the third quarter as a whole, figure in line with the previous year reduction, and despite the favourable employment behaviour in the services sector which increased 0.1% qoq (SWDA). Meanwhile, registered unemployment continue to rise and were up 1.3% qoq (SWDA), half as much as in 2Q10 (see Chart 20). The recent publication of the

Labour Force Survey (LFS) for 3Q10 confirms this performance. Unlike in 2Q10, job creation (69.9 thousand people) and the stagnation of the active population (-0.8 thousand) caused unemployment to fall 0.3pp to 19.8% of the active population (see Chart 21). Adjusted for seasonal factors, the estimated decline in employment was around 25 thousand, 15 thousand lower than in 2Q10.

Chart 20

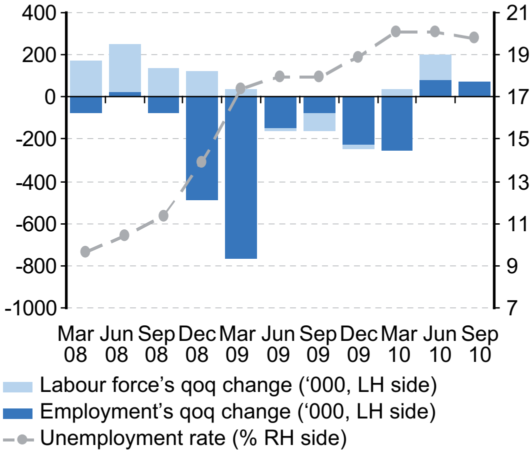
Spain: Social Security affiliation (average) and registered unemployment (% qoq, SWDA)



Source: BBVA Research based on MTIN and SPEE data

Chart 21

Spain: employment, labour force and unemployment rate



Source: BBVA Research based on INE data

Progress on underway adjustments points to Spanish GDP growth in 2011 of around 0.9%

As has been commented above, despite the relative improvement, , the Spanish economy recovery is expected to remain weak during the next year. GDP is expected to continue showing moderate qoq growth (positive), which will put growth for the year as a whole at around 0.9%. This will be accompanied by destruction in full-time equivalent employment of around 0.3% (although we could see positive employment growth rates in the second half of the year) and contained inflation of around 1.7%. The negative contribution from the public sector along with weak recovery for private domestic demand and strong exports, despite moderate slowdown, will shape aggregate demand in the coming year (see Table 1).

Table 1

Spain: macroeconomic forecasts

(% y-o-y)	1Q10	2Q10	3Q10	4Q10	2009	2010	2011
Household consumption:	-0.3	2.0	2.5	2.4	-4.3	1.6	1.0
Public consumption	-0.2	0.4	0.2	0.6	3.2	0.2	-0.5
GFCF	-10.5	-7.0	-6.1	-5.3	-16.0	-7.2	-1.8
Capital goods and other products	-9.2	-0.1	0.6	-0.9	-21.2	-2.4	2.3
Capital goods	-4.8	8.7	6.8	4.1	-24.5	3.7	4.1
Construction	-11.4	-11.4	-10.6	-8.5	-11.9	-10.5	-4.6
Housing	-21.1	-19.3	-15.3	-10.7	-24.5	-16.6	-6.5
Other	-4.1	-5.7	-7.6	-7.3	-0.1	-6.2	-3.3
Chg. in inventories (*)	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Domestic demand (*)	**-2.8**	**-0.5**	**0.0**	**0.4**	**-6.4**	**-0.7**	**0.0**
Exports	8.8	10.5	10.9	9.8	-11.6	10.0	8.0
Imports	2.0	8.1	9.2	8.4	-17.8	6.9	3.8
Net exports (*)	**1.5**	**0.4**	**0.2**	**0.2**	**2.7**	**0.6**	**0.9**
GDP mp (% y-o-y)	**-1.3**	**-0.1**	**0.2**	**0.5**	**-3.7**	**-0.2**	**0.9**
GDP mp (% q-o-q)	**0.1**	**0.2**	**0.1**	**0.1**			
Pro-memoria							
GDP w/out housing investment	-0.1	1.1	1.2	1.2	-1.9	0.8	1.3
GDP w/out construction	0.3	1.8	2.0	2.0	-2.1	1.5	1.8
Employment (LFS)	-3.6	-2.5	-1.7	-1.5	-6.8	-2.2	-0.2
Unemployment rate (% active pop.)	20.0	20.1	19.8	20.8	18.0	20.1	20.6
Employment (FTE)	-3.7	-2.5	-2.0	-1.5	-6.6	-2.3	-0.3

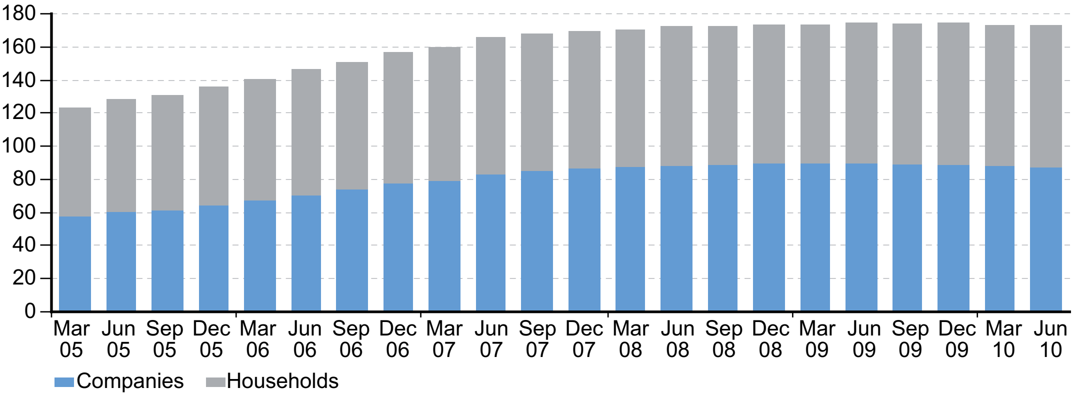
(*) contribution to growth
Source: INE and BBVA Research forecasts

This economic scenario for 2011 will be characterized by a number of factors which include the following. Firstly, the budget outturn data for 2010 corroborate the government's commitment to fulfil its fiscal consolidation objective, which suggests that public spending will continue to adjust with a view to reaching budget targets. in this vain its worth noting the public sector wage cuts in current spending. This spending control can also be seen in the 2011 State General Budget (SGB 11) although it does focus more on cutbacks in infrastructure and discretionary spending while revenues are increasing moderately, helped by the tax hikes implemented in 2010. Public funds will benefit from the VAT hike which, judging by the limited transfer to prices seen in 3Q10, could have a limited negative effect on investment and private consumption. As we have seen since the start of the summer, the effect this will have on growth could be partially offset by its contribution to the gradual improvement in confidence in the Spanish economy, easing liquidity and risk premium pressures.

Secondly, while household and corporate deleveraging in Spain remains pending, (see Chart 22) and fundamentals remain weak, we do not expect private domestic demand to pick up speedily. Also, the recent interest rate hike for term deposits could kick-start private saving in the economy as a whole in detriment to current consumption and investment (see Section 4.a.).

Chart 22

Spain: credit to private sector (% GDP)



Source: BBVA Research based on INE and BdE data

Turning to consumption, expected reduced job destruction in 2011 will partly offset the effects of the worsening non-wage component of household gross disposable income which was caused, among other things, by the freeze of contributive pension as of 2011 and the depletion of non-contributive unemployment benefits. Wealth however, particularly house wealth, will not contribute positively to consumption in 2011 given the expected decline in housing prices. Nonetheless, private spending will remain supported by relatively low interest rates which will keep households' financial burden at a similar level to that seen this year. Finally, even though uncertainty will remain relatively high, we do not expect the savings rate increases associated with lost in consumer confidence (i.e., precautionary savings). In sum, household spending is expected to rise weakly in 2011 to around 1%. Turning to business investment, given that final demand is recovering timidly both in Europe and Spain, we expect moderate improvements in corporate earnings as well as lower downward pressure on the real cost of capital. Both factors, combined with a staggered reduction in uncertainty in the financial markets, will contribute positively to a moderate growth in capital investment and other products, which will however still remain below pre-crisis levels. Also, the slowdown in housing investment in 2011 will also continue to ease, although not enough to end the year with positive growth rates. Looking forward, the real estate sector will continue to correct the imbalances of recent years and there is uncertainty surrounding the potential impact of bringing forward sales in 2010 due to the elimination of tax benefits. Conversely, in 2011 we could see a lukewarm recovery in new home starts.

Finally, our forecasts point to strong growth in Spanish exports in 2011, although this will be less intense than in 2010. As we have said above, the main factors behind this strength are gains in competitiveness thanks to unit labour costs and, particularly, the wider geographic scope of Spanish exports. Weak demand in the EMU, which could lead to GDP growth in Europe of 1.2% (1.6% in 2010), is largely behind the expected slowdown (EMU is recipient of nearly 60% of Spanish exports),. Summarizing, Spanish exports of goods and services will remain as a permanent support for economic activity recovery both in the short and medium term.

However, it is unclear how dynamic the recovery will be

Even though the macroeconomic forecasts in this report point to growth slightly above those published in our previous report, we would stress that there are still factors which could trigger a worsening of the outlook for the Spanish economy in 2011. Firstly, a sharper slowdown in the global economy due to lower growth of domestic demand in developed countries in 2011 and/or a significant increase in the pace of the euro's appreciation seen in recent weeks could weaken the contribution to growth of Spanish exports with a lower volume of global trade combined with a reduction in exports; a lower penetration of non-EMU markets and the replacement of non-EMU imports with intra-EMU imports in the monetary union. Taken into account that the contribution of the public sector will be negative in 2011 and the domestic private demand will remain weak, loss of strength in exports could affect the recovery of the Spanish economy.

Secondly, and as we have been stressing in recent months, the financial markets still pose the main risk to the economy. As will be noted in Section 4.b. below, is imperative that the government continues to maintain a strict compliance to its public deficit targets at all levels and that the markets continue to give to Spain a positive differentiation as a result of the non-relaxation of the recent reform momentum.

Otherwise, the failure to fulfil these objectives could lead to episodes of liquidity pressures similar to what we saw in May and June 2010, which will compromise the economy's recovery. It is worth remembering that the breathing space awarded to the Spanish economy by the capital markets is conditional and any efforts made to increase transparency and reduce uncertainty will be well received.

There are also risks on the upside. Particularly, the success of heterodox policies in developed countries could trigger higher growth in domestic demand. The adoption of ambitious labour reforms could lead to a more intense reduction in unemployment and temporary contracts. Finally, an agenda of structural reforms which shall guarantee long-term sustainability of the pension system, increase the efficiency of public authorities' funding systems, or shall solve the regulation problems in the markets for goods and services, would provide a more favourable macroeconomic setting which would encourage business activity and job creation and thus boost recovery.

4. The necessary consolidation and intensification of the reform process

As was explained in previous sections, in recent months the perception of the Spanish economy has taken a turn for the better as the result of a series of actions which have underscored, for both foreign and domestic investors, the relative improvement of the country's fundamentals. However, the Spanish economy still faces serious risks and the government must maintain the urgent tone with which it rolled out various reforms in the summer. In particular, the restructuring of part of the Spanish financial system needs to continue, accelerating its transformation and guaranteeing an adequate level of capitalization in line with the new global banking regulation. Furthermore, public authorities must continue guaranteeing that the fiscal deficit targets remain a priority. The sound performance of public revenue appears to indicate that the central government will meet its year-end target with a deficit of 5.9% of GDP and that this could in fact be achieved with greater ease than expected. In any event, any improvement should be put towards compliance with the 2011 target and, under no circumstances, should budgetary discipline slacken. The autonomous authorities and local governments must also play a role in the fiscal consolidation process and more efficient rules need to be developed which guarantee budget stability throughout the government as well as providing the general public, and the markets in particular, with better and more budget outturn information. Finally, even though the labour market reform was a step in the right direction, uncertainty regarding its development and implementation remains high, making it difficult to assess its potential impact on unemployment rates and economic growth. This reform must be rolled out in tandem with others to help Spain stand out from other countries. These structural measures need to be consolidated and taken further so as to create more favourable conditions for companies to invest, and to attract foreign financing and create jobs so that the Spanish economy can exit the crisis quicker and start enjoying greater growth potential.

4.a. The Spanish Financial System: a restructuring that should continue

After the publication of the stress tests in July, the situation of the different European financial systems diverged considerably. While peripheral countries, such as Greece, Portugal, and in particular Ireland, have seen their risk premiums continue rising, the indices of the Spanish system decoupled and approached the European average, staying practically constant since July. This in turn, made it easer to obtain funding via the international markets, and since that date, 35% percent of the issuance of the European financial system has been by Spanish entities, especially medium-sized and large ones.

The Irish financial system shows different characteristics than the Spanish one, such as its large relative size in relation to the Irish economy (double that of Spain in proportion to GDP), and its solvency problems. In regard to the second point, the capital injections of public funds could reach over 43 billion euros in the government's base scenario, close to 30% of Ireland's GDP, vs. a Spanish FROB that barely represents 1% of Spanish GDP. Although in both cases the crisis was triggered by the drop in real estate prices, the Irish crisis was not as well handled. For example, the important government guarantees backing bank deposits to bolster liquidity did not solve the solvency problem and the initial evaluation of the system was overly optimistic. This obliged the government to increase its initial capital injection into Anglo Irish with three more injections (eventually representing 70% of total public injections). Furthermore, they had to increase its bad bank NAMA haircuts several times.

In the Spanish case, the restructuring of the financial system has only just begun and it is of critical importance that they continue. In terms of overcapacity, the branch closures announced, which represent on average the 12% of the total, are still far from the 25% needed according to an estimation based on reached sufficient efficiency levels. These changes could be carried out without fundamentally affecting the Spanish business model, characterised by an ample branch network and a reduced number of personnel per office.

In the second place, the write-downs in asset portfolios has still not been completed and part of the refinanced loans will end up in default again, for which reason, the non-performing loans (NPL cycle) has not reached its peak at all the institutions. This is especially important right now, given that the Bank of Spain's new provisions calendar has entered into force, and is hurting entities' earnings via non-performing loans and via foreclosed assets. Although the sector's solvency problems appear to be manageable, they are concentrated in a group of entities that should be subject to additional measures.

Furthermore, these changes should be implemented during the current process of deleveraging by the private sector. As past experience shows, banking crises tend to be accompanied by an extended period of deleveraging, which lasts for nine years[5] on average, and which should return debt levels to their long term equilibrium zone. One fourth of Spanish lending is to real estate and construction companies, which must now deleverage so that resources can be allocated to more productive sectors going forward. Furthermore, the debt should be limited so that households' and firms' debt burden remains at sustainable levels.

Lastly, the effectiveness of the reforms enacted has yet to be fully assessed. Following the announced plans, the number of savings banks (cajas) operating in the market went from 45 to 18 and their average size increased from about 30 billion euros to some 70 billion euros. However, the integration plans have still not been fully defined, merged entities are still not operating jointly, and none of them have issued securities jointly.

Table 2
Average size of savings banks in Spain

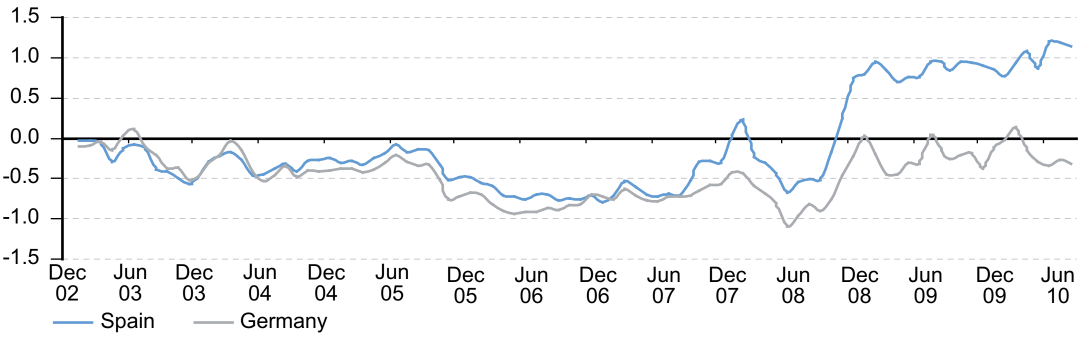
	Participating entities	Resulting entities	Total assets (in billion €)	Total assets per entity (in billion €)
Total restructuring:	39	12	1.180	98
Other	6	6	103	17
Total number of savings banks after the restructuring	18	18	1.283	71
Total number of savings banks before the restructuring	45	45	1.283	29

Source: BBVA Research based on Bank of Spain data

In short, the restructuring of the Spanish financial system should not be considered complete. The fact that the process was implemented at a slower rate last quarter is having negative consequences on market competition. Evidence of this is the fact that certain entities are experiencing difficulties obtaining funding from foreign investors. This is reflected by higher interest rates being offered for deposits, which negatively impacts margins. Since the end of 2008, the spread between the price paid for new deposits and the one year Euribor rate has increased by 150 basis points in Spain. This trend is not being seen in other European financial systems such as in Germany, where this spread barely changed during the crisis.

The restructuring underway in the Spanish financial system today should be driven by both the industry and regulators, as well as the rest of the system authorities, in such a way that the Spanish financial system enters into the post-crisis world from a solid position.

Chart 23
Spain: spread between interest rates for term deposits and the 12m euribor(pp)



Source: BBVA Research, based on Bank of Spain data

5: See Reinhart, C. M. and V. R. Reinhart (2010): "After the Fall", NBER Working Paper 16334.

4.b. Fiscal consolidation on all levels of government: making a virtue out of necessity

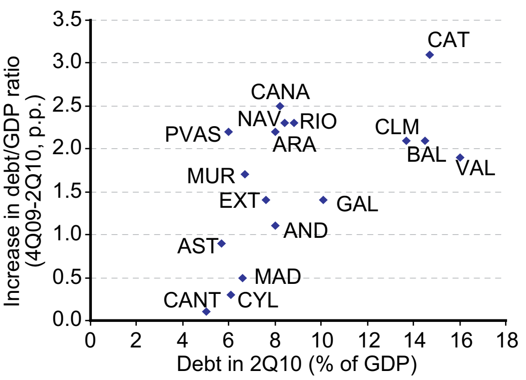
The fiscal consolidation process is the cornerstone of the reforms implemented in the Spanish economy in the last several months. In this regard, the government has demonstrated its commitment to budgetary sustainability by establishing feasible and ambitious objectives, an approach which has been one of the biggest factors in rebuilding the confidence of external and domestic savers. In particular, the government announced last May the changes to the public deficit targets for 2010 and 2011, moving forward part of the consolidation process initially scheduled for subsequent years. The government highlighted, both then and in the presentation of the Central Government Budget for 2011, that expenditure cuts would be the main means for reducing the deficit. As indicated in previous analysis, this strategy of consolidation is the most appropriate, because it strengthens the credibility of the adjustment process and minimises its impact on growth in the medium term.

This shift in policy towards greater fiscal austerity, combined with the results of the stress tests on the Spanish banking system, has been very well received by markets, as evidenced by the fact that the Spanish Treasury has been able to place its bond issues in recent months with spreads vs. German bonds that were significantly lower than those registered in May and June. Markets' improved perception of Spain's public debt has allowed Spanish spreads to decouple from those of Ireland and Portugal, where spreads have widened considerably since the middle of August.

However, this reduction in Spain's sovereign risk has not been generalised, but rather, quite selective: it has affected the Central Government debt but not autonomous regions' debt, which has remained impacted by financial tensions. As a result of the doubts and uncertainties of the current context, caused by the high growth of debt in recent quarters (see chart 24), the financing needs of the autonomous regions in recent months could not be covered by issues in wholesale markets (see chart 25), and they have therefore had to resort to private issues, lines of credit, etc, or even issues in retail markets.

Chart 24

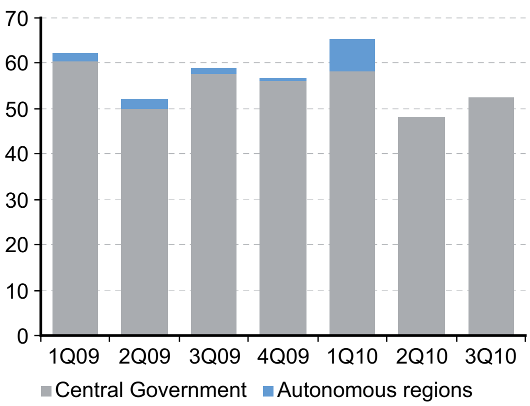
Savings Bank debt



Source: BBVA Research, based on Bank of Spain data

Chart 25

Spain: public debt issues (in billion €)



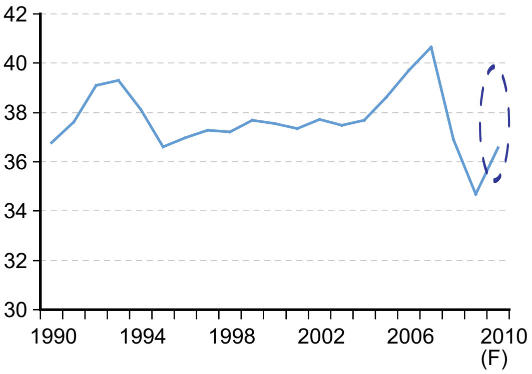
Source: BBVA Research, based on Spanish Treasury and Bloomberg data

The difficulties experienced by certain public authorities seeking to finance their deficit, underscore that the success of the consolidation process also requires the commitment and participation of the autonomous regions and local governments. To guarantee that these administrations assume their corresponding portion of the cutbacks, it would be necessary to introduce more efficient rules that guarantee budgetary stability at different levels of government, and to improve the quality and quantity of information regarding the execution of the budget. The Spanish government's role is clear, but all public administrations must also pursue a proactive policy aimed at providing more information and greater transparency, or uncertainty regarding the quality of their finances as a whole could linger, which would imply that risk premiums would stay at unnecessarily high levels for this segment of the Spanish public debt. In other words a rigorous fiscal adjustment is a necessary step for normalising the situation, but will not be enough: markets also demand detailed and large amounts of information regarding the execution of the budget, which clearly demonstrate that the fiscal consolidation is advancing at the scheduled pace and that the annual budget targets are being met satisfactorily. Given these circumstances, regional governments must make a virtue out of necessity.

The recent performance of public finances suggest that the Spanish government may meet its 2010 deficit targets with greater ease than expected

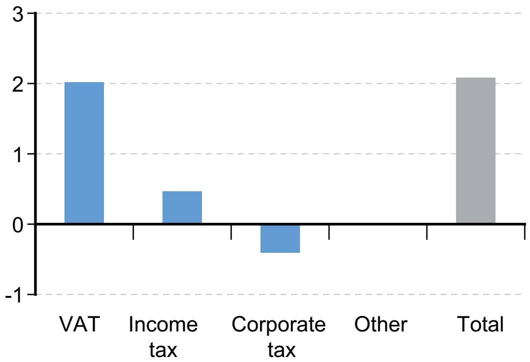
The recent performance of Spanish government's public finances raises the likelihood that the 2010 deficit target will be met, and that this may even be achieved with greater ease than expected. The main explanation for the good budget outturn is linked to the performance of public revenues, which in the year to date (2010) have grown at a higher rate than budgeted initially, and at a faster rate than GDP (see Chart 26). Specifically, the implementation of the extraordinary measures, such as the suppression of the €400 income tax (IRPF) deduction or the increase in the VAT rate partially explain why public revenues have climbed two percentage points of GDP higher in 2010 than in 2009. The revenues linked to VAT have performed particularly well, thanks in part to the recovery in domestic demand in the first half-year period and especially to VAT returns with respect to 2009 and the payment of instalments for purchases carried out in previous years. Similarly, the 2010 revenues from income tax (IRPF) could end up half a percentage point of GDP higher than in 2009, despite the current context in which families incomes are contracting (see Chart 27). As has already been discussed in previous editions of this report, in both cases, any recovery in revenues would imply that a share of their drop in 2009 was only temporary.

Chart 26
**Spain:
public administration revenue (% GDP)**



F= forecast
Source: BBVA Research, based on Ministry of Economy and Finance data

Chart 27
Spain: forecast for changes in public administration revenue in 2010 (% GDP)



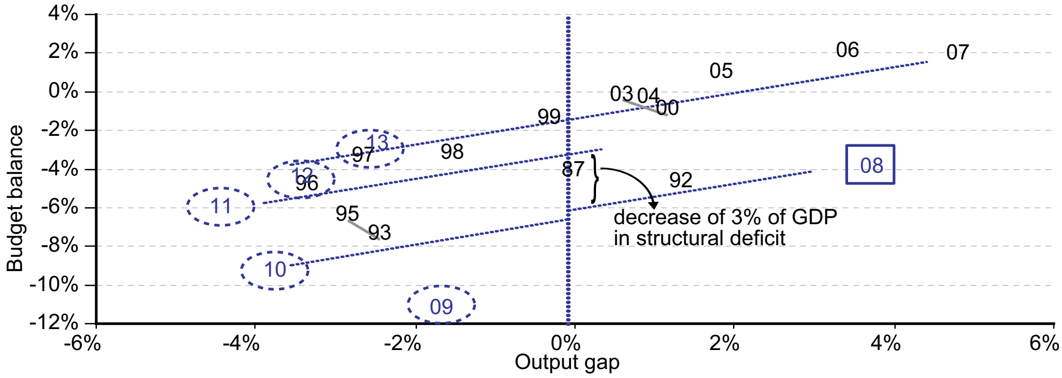
Source: BBVA Research, based on Ministry of Economy and Finance data

Any budgetary improvement that may occur in 2010 should be used to reduce the deficit, while maintaining strict controls over expenses

The performance of the budget outturn up to September suggest that there is a possibility that public revenues will be higher than expected. To ensure that this occurs, the Spanish government should take advantage of the situation to reduce the 2010 deficit below the scheduled target of 5.9% of GDP. This option would be highly advisable for two reasons. In the first place because it would give a positive surprise that would be quite well received by markets. And in the second place, because it would be in line with the goal of budgetary stability in the coming years, in which the improvement in revenues is expected to contribute less to the reduction in the deficit than in 2010, and will therefore require deeper cuts in spending. As a result, to reach the goal of a deficit of 6% of GDP by the end of 2011, there would need to be a cut in expenditure amounting to almost 2.5 percentage points of GDP. Of these cuts, one part will be achieved directly through measures that have already been implemented, such as reductions to public salaries, reductions in new hirings, and curtailed investment, while the other will be achieved by not renewing the discretionary spending plans already announced.

Chart 28

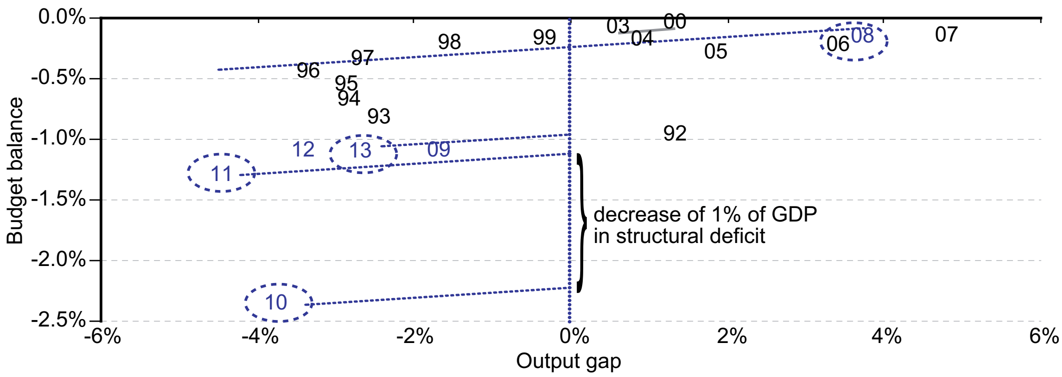
Spain: budget balance for public administrations (in aggregate) vs. output gap (%)



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

Chart 29

Spain: budget balance for autonomous communities (in aggregate) vs. output gap (%)



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

To help dispel market uncertainty, regional governments should offer more and better information in real time regarding their budget outturn

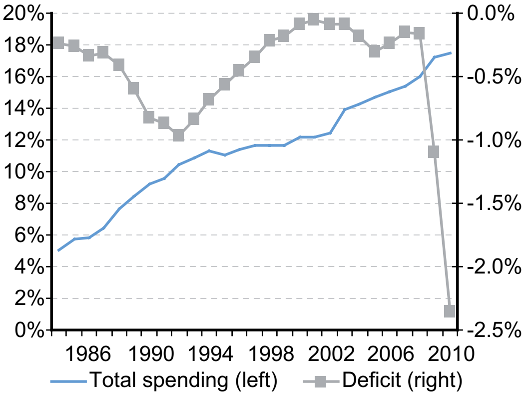
However, despite the government's good performance in executing its budget, the markets continue to doubt the capacity of the public administrations as a whole to meet budgetary stability targets. In part this is due to the extraordinary effort that would be necessary to meet these targets. Specifically, almost all of the public deficit reduction in 2011 will occur through a reduction of the structural deficit (see Chart 28). And autonomous regions will represent about a third of this adjustment effort (see Chart 29).

In this regard, one of the factors affecting the current situation that had less of an impact in other recessions in the Spanish economy, is the greater weighting of the territorial administrations, and in particular, the autonomous regions, in total public spending and in the public deficit. The transformation of the Statute of Autonomy means that the autonomous regions manage practically the same volume of the expenditure as the central government. In 2008, central government spending represented 15.2% of GDP, while autonomous regions' spending totalled 16% of GDP. As a result of variations in the spending breakdowns of different administrations, cyclical impacts are also different, as can be seen in unemployment benefits, among other items. In 2009, Central Government spending represented 19.6% of GDP, while autonomous regions' spending was less, amounting to 17.2% of GDP. Part of this change will be corrected when the disbursals corresponding to territorial financing in 2009 are settled, although the available official information shows that the contribution of the autonomous regions to the increase in the deficit is considerably less than that of the central government.

In any event, autonomous regions have become, for the first time, a relevant player in the management of public financing, a situation which did not occur in previous crises. In fact, the target for the deficit of 2.4% of GDP for 2010, is far higher than the 1% reached in 1992 (see Chart 30), and means that the autonomous regions contribute approximately 26% of the total deficit expected for the entire public sector (9.3%). Although its debt volume (9.8% of GDP in 2Q10) represents only one sixth of Spanish public debt, the refinancing schedule for autonomous regions' debt, the existence of "no bail-out" clauses in the regulation and the strong growth of the deficit in the last two years has not gone unnoticed by markets, which harbour doubts as to whether the Stability Plan targets will be met by regional governments, given the political costs which would be incurred by these governments were they to carry out significant spending cuts before the autonomous regions' elections in the coming months.

Chart 30

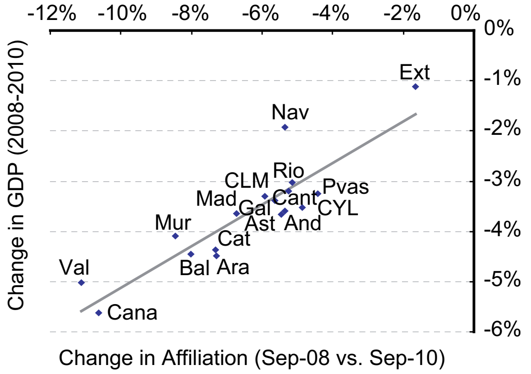
Autonomous regions: Deficit and Spending (% GDP)



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

Chart 31

Spain: drop in GDP and in affiliations during crisis



Source: BBVA Research, based on National Statistics Institute (INE) and Ministry of Labour and Immigration (MTIN) data

However, the perception that there exists a high fiscal risk for the autonomous communities as a whole, is supported in part by an analysis of the situation that is overly aggregated and superficial in certain regards. This analysis ignores the differences between the different autonomous regions in terms of their productive specialisation, sensitivity to the economic cycle, current debt levels and debt accumulation in recent quarters. For example, Chart 31 shows that the drop in GDP and in employment registered in the last two years has varied significantly, depending on the community. Therefore, while Extremadura has maintained practically constant levels for both these items, which would leave the fiscal base practically unchanged, other regions, such as the Canary Islands and the Valencia Region have registered sharp drops in both income levels and employment, with the consequent effects on tax revenues.

The information available to date, which is extremely heterogeneous in terms of volume and presentation format (depending on the autonomous region), appears to indicate that certain regions will meet the deficit target set for 2010 and that the central administration's control over regional accounts and debts is an important milestone which increases the probability of compliance with the deficit objectives. In any event, to improve the analysis of the autonomous regions' public accounts, and to obtain sufficient granularity for markets to discriminate between the different fiscal situations of each region, it would be necessary to have information on multi-annual scenarios for revenues and spending, on the specific plans for their respective fiscal adjustments, as well as estimates of the impact of the new autonomous financing system for the public accounts of each region, and clear, accessible and rapidly delivered information on the performance of revenues and expenses for the year underway. Monthly information regarding the budgetary outturn, such as that which is provided by the central government, is only available in a few autonomous regions, and is only partially available in the majority of cases, for which reason it is urgent that these autonomous region administrations offer the detailed and clear information that debt markets require with a certain frequency in order to dispel the uncertainties currently holding sway and gain access to financing at lower prices.

Table 3

Degree of transparency of autonomous region's information related to public accounts

	Autonomous regions with information	
Budgetary outturn	**Number**	**% of total number of autonomous regions**
Complete and monthly	6	35%
Complete and at least quarterly	9	53%
Some type of information (complete or incomplete)	12	71%
Without information	5	29%
Availability of data concerning budgetary outturn on the Internet		
Easy	7	41%
Difficult	4	24%
Nonexistent	6	35%
Availability of data about public debt on the Internet		
Debt breakdown	4	24%
Updated information on debt breakdown	1	6%
Nonexistent	12	71%
Multi-annual budgets	0	0%
Periodic budgetary information in English	3	18%

Source: BBVA Research

It is necessary to make progress in rolling out new control mechanisms for local and regional governments' accounts

In recent months the European Union has embarked on a profound discussion about improving governance in Europe as a way of correcting existing disequilibria, some of which existed before the crisis, and which were subsequently exacerbated by the recession. Agreements and concrete proposals are already well underway to correct these imbalances, but it would only be reasonable for these new regulations to also be applied to the different levels of governance in each country. This is not a new debate, and when the Stability and Growth Pact was discussed in the EU, the modification and approval of rules relating to balanced budgets for Spanish public administrations was deemed to be an appropriate measure, and these rules have been in force for years (Budgetary Stability Law)[6]. However, it is now necessary to design new rules adapted to the new European Framework, reinforcing the existing institutions (for example, the Fiscal and Financial Policy Board) and coordinating the fiscal policy in the most effective manner and as early as possible. The European Semester initiative is a good example of early stages budgetary coordination between European countries, which requires an analysis of the implications of its implementation on the budgetary process of the autonomous regions and the degree to which similar rules can be rolled out by the Spanish Fiscal and Financial Policy Board.

The different levels of government should bear in mind that markets discriminate against governments that do not meet their budgetary stability targets. The recent experience of Ireland and Portugal is a good example of how tensions in markets increase rapidly when doubts are raised as to whether countries will meet their deficit targets. The lesson here is clear: the risks facing public accounts should not be underestimated and governments must be vigilant and ensure that their budgetary consolidation processes continue apace. Among the possible risks, we would highlight the following. First, not all revenues are recovering to the same degree: corporation tax revenues continue falling and this negative trend is expected to continue so long as there is not a significant and sustained recovery in companies' earnings.

6: See, for example, González-Páramo, J. M. (2001): Costs and benefits of fiscal discipline: The Budgetary Stability Law in perspective. Institute of Fiscal Studies, Ministry of Economy and Finance; González-Páramo, J. M (2003): "The State and the Territorial Tax Authorities and the challenges of budgetary stability", Revista de Estudios Regionales, 66, 19-39; y Corrales, F., R. Doménech and J. Varela (2002): "The Spanish Economy's Cyclical and Structural Budget Balance", Hacienda Pública Española, 162(3), 9-33.

In a similar manner, the performance of social security contributions will be very affected by the recovery in employment. Second, the high growth rates of public revenues –such as those from VAT– are temporary and will decrease in the coming quarters, generating a certain degree of uncertainty about the levels of different public revenues with respect to the GDP. Thirdly, the nominal growth forecast in the 2011 General Government Budget is more optimistic than the one presented in this report, which does not necessarily mean that the deficit target of 6% will not be met at the end of 2011. As underscored previously, it is possible that the ease with which the 2010 targets might be met could provide some manoeuvring room for meeting 2011 targets (even though a lower nominal growth rate is expected next year), but only if strict control is maintained over public spending despite the better revenue situation. Lastly, part of the adjustment expected in the 2011 deficit will be derived from a significant reduction in spending by all the public administrations in an election year for the majority of the autonomous regions and for all the town councils.

Together with the deficit targets set in the 15 June 2010 Framework Agreement, in compliance with the Stability and Growth Pact, and the new procedure for authorizing debt issuances by the Autonomous Communities, which gives more control to the Ministry of Economy and Finance[7], financial markets are also playing an important role in imposing budgetary discipline on autonomous regions. Like any other issuer, regional governments will have to provide investors with the best information available so that they can correctly evaluate the risk entailed in buying their debt. Without a greater commitment to transparency and detailed and up-to-date information on the fiscal adjustment, investor uncertainty will continue to present a major barrier to a truly effective reopening of the wholesale markets, especially on the international level.

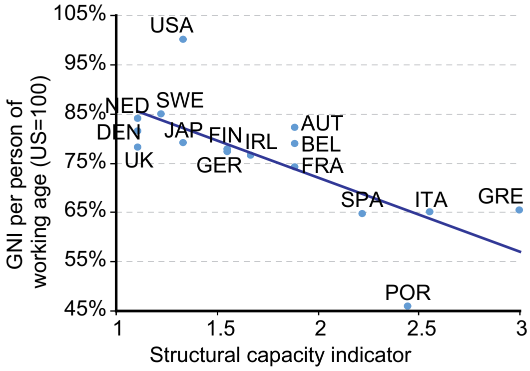
4.c. Structural reforms, income per head and country risk

As we have argued before in these pages, to push ahead and to consolidate structural reforms is crucial if the Spanish economy is to quicken its pace of recovery and ultimately raise its potential growth rate. International evidence is conclusive and set out in the extensive empirical literature on the issue[8]. Chart 32, is a simple illustration of the benefits of a reform process heading in the right direction. It shows the relationship between income per head and the structural capacity of 16 advanced economies (including Spain). To avoid distorting the relationship between these two variables due to the varying impacts of the 2009 crisis, the y axis shows GDP per person of working age in 2008 (relative to the US). For the x axis we have constructed a structural capacity indicator (SCI) for these economies, based on IMF data[9] (see Table 4). To transform the qualitative information into a quantitative indicator we can use in our analysis, we scored each of the three categories applied by the IMF from 1 to 3. A higher score indicates a greater need for structural reforms. In this way we can arrive at an average score for each country and for each of the nine indicators in Table 4.

7: Along with the quarterly monitoring of budget spending, since 2010 permission to borrow has been granted by the Ministry of the Economy and Tax in three tranches, each conditional on meeting deficit reduction targets.
8: See, for instance, Nicoletti, G and Scarpetta, S. (2003) “Regulation, productivity and growth: OECD evidence”, Economic Policy, vol 18 (36), 9 – 72, OECD (2008), Going for Growth, Paris or de la Fuente, A. and R. Doménech (2010): “Ageing and Real Convergence: Challenges and Proposals”, in J. F. Jimeno (ed.), Spain and the Euro. The Ten First Years. Bank of Spain Madrid, 2010, as well as other sources cited in these works.
9: IMF (2010), Regional Economic Outlook: Europe. Washington.

Chart 32

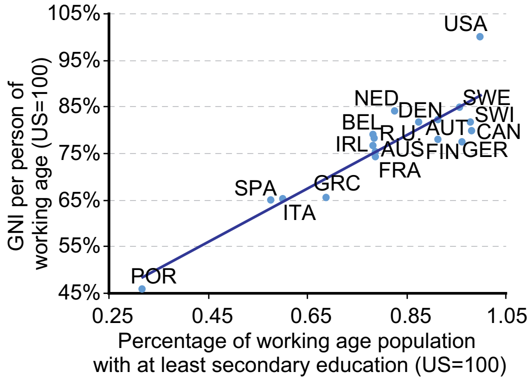
Structural capacity and income per working age person (%)



Source: BBVA Research based on IMF and OECD data

Chart 33

Human capital and income per working age person (%)



Source: BBVA Research based on OECD data

Table 4

Need for structural reform in developed countries

Medium term	GER	FRA	NET	BEL	ITA	SPA	POR	GRE	AUS	FIN	IRL	DEN	SWE	UK	USA	JAP	Avg.
Labour market	2	3	2	2	3	3	3	3	2	1	1	1	2	1	1	1	1.9
Corporate regulations	2	2	1	3	2	3	2	3	2	2	1	1	1	1	1	2	1.8
Network regulations	1	2	1	1	2	1	2	3	1	2	3	1	1	1	1	2	1.6
Retail sales	1	2	1	3	2	2	2	3	3	2	1	2	1	1	2	1	1.8
Professional services	3	2	1	2	3	2	2	3	2	1	1	1	1	1	1	1	1.7
Long term																	
Institutions & contracts	1	2	1	2	3	2	3	3	1	1	2	1	2	1	2	2	1.8
Human capital	2	2	1	1	3	3	3	3	2	1	1	1	1	2	2	1	1.8
Infrastructure	1	1	1	2	3	1	2	3	2	2	3	1	1	1	1	1	1.6
Innovation	1	1	1	1	2	3	3	3	2	2	2	1	1	1	1	1	1.6
Average	1.6	1.9	1.1	1.9	2.6	2.2	2.4	3.0	1.9	1.6	1.7	1.1	1.2	1.1	1.3	1.3	1.7

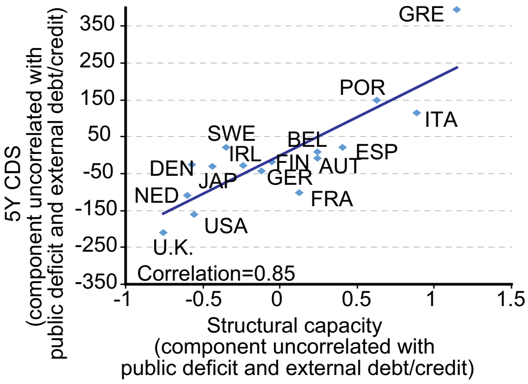
Source: IMF and BBVA Research

As Chart 32 shows, relative income per head is closely correlated to the SCI (-0.73). Spain in particular is very close to the regression curve that makes it possible to predict the relative income based on the SCI, though slightly below since its employment rate (employed as a percentage of working age population) is lower than the other countries in the sample. Spain only scores positively in 2 of the 9 factors analysed: infrastructure and perceptions of regulation in telecoms, gas and electricity sectors. In contrast, it scores below average in the other indicators, and strikingly negatively in areas such as the labour market and corporate issues. However, the biggest source of concern is the perceived gap in factors linked to long-term productivity, such as human capital and innovation. The same table shows that a broad consensus and changes in legislation, at different governmental levels, to allow continued improvements in regulation of work, goods and services markets would have positive benefits in the medium term. However, most of the improvements in human capital and innovation need time to mature before they can start to raise the economy's potential growth. Chart 33 shows the massive importance of human capital for income per head (the correlation between the two variables is 0.90). In this chart, human capital has been approximated as the percentage of high school graduates in the working age population. There is an obvious and significant gap between Spain and other advanced economies. One worrying aspect of this is that demographic variables tend to persist for a long time, so narrowing this gap will take time, even if levels of educational failure in Spanish schools are quickly brought down to the levels of better-schooled countries wiping out differences in human capital between cohorts joining the workforce in future years.

Differences in the structural capacity of economies have implications for their productive capacity and this explains why financial markets are so concerned with progress in structural reform, particularly in Spain. The correlation between our structural capacity indicator and country risk premium, measured by the 5Y

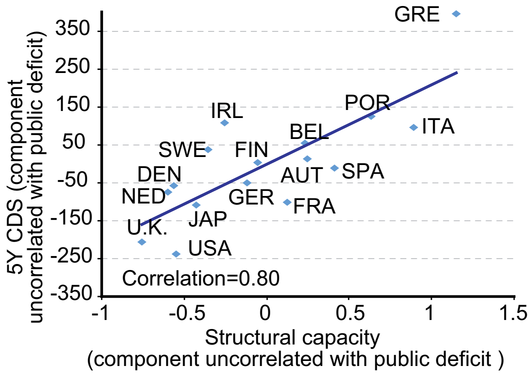
CDS, is high and positive (0.75). Countries in most need of structural reform have the highest levels of country risk premium. According to our results, the structural capacity indicator comes out as the most robust and statistically significant variable in a regression analysis alongside more usual risk factors such as public sector deficit, public debt, external debt, credit, international financial position, etc[10]. Charts 34 and 35 show the close correlation (0.85) between the SCI and country risk premium, once the impacts of public sector deficit and external debt/credit ratio are stripped out of both variables, revealing their orthogonal components based on the latter factors[11]. This positive relationship confirms that one of the concerns of international financial markets relates to economies' medium-term growth potential. Many economies will have to absorb heavy quantities of debt in the future, which will always be easier if households, companies and the government are able to deleverage in a context of strong economic growth. To sum up, it is important to press boldly ahead with the reform process in Spain not only to generate higher employment and income per head over the medium and long terms, but also to reduce the risk perceptions of financial markets in the short term.

Chart 34
Structural capacity and country risk



Source: BBVA Research based on IMF data

Chart 35
Structural capacity and country risk



Source: BBVA Research based on IMF data

10:See Attinasi, M. G., C. Checherita, and Ch. Nickel (2009): "What Explains The Surge In Euro Area Sovereign Spreads During The Financial Crisis Of 2007-09?", Working Paper Series no. 1131, European Central Bank, and Sgherri, S. and E. Zoli (2009): "Euro Area Sovereign Risk During the Crisis", IMF Working Paper 09/222, International Monetary Fund. Neither of these two papers, unlike the analysis we conducted here, includes any indicator for the structural capacity or potential of the economy.
11: The slope of the regression curve shown in Chart 34 is equal to the regression coefficient of the SCI variable in an equation where the dependent variable is the CDS and which includes the public sector deficit as additional regressor.

Tables

Table 5

Macroeconomic forecasts: Gross Domestic Product

(y-o-y growth, %)	2007	2008	2009	2010	2011
US	2.1	0.4	-2.6	2.7	2.3
EMU	2.9	0.3	-4.0	1.6	1.2
Germany	2.8	0.7	-4.7	3.2	1.8
Francie	2.3	0.1	-2.5	1.6	1.4
Italy	1.4	-1.3	-5.1	1.1	0.8
Spain	3.6	0.9	-3.7	-0.2	0.9
UK	2.6	-0.1	-4.9	1.7	1.9
Latin America*	5.8	4.0	-2.4	5.8	4.2
Asia	7.6	4.2	2.0	6.8	5.5
China	14.2	9.6	9.1	10.1	9.2
Asia (excluding China)	5.2	2.1	-0.7	5.6	4.1
World	5.3	3.0	-0.6	4.7	4.1

Closing date: 29 October 2010
* Argentina, Brasil, Chile, Colombia, México, Perú, Venezuela
Source: BBVA Research

Table 6

Macroeconomic forecasts: 10Y interest rates (average)

	2007	2008	2009	2010	2011
US	4.6	3.6	3.2	3.0	2.4
EMU	4.2	4.0	3.3	2.7	2.4

Closing date: 29 October 2010
Source: BBVA Research

Table 7

Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2007	2008	2009	2010	2011
US (EUR/USD)	0.7	0.7	0.7	0.8	0.8
EMU	1.4	1.5	1.4	1.3	1.3
UK	2.0	1.8	1.6	1.6	1.6
China	7.6	6.9	6.8	6.5	6.3

Closing date: 29 October 2010
Source: BBVA Research

Table 8

Macroeconomic forecasts: official interest rates (end of period)

	2007	2008	2009	2010	2011
US	4.3	0.6	0.3	0.3	0.3
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1

Closing date: 29 October 2010
Source: BBVA Research

Table 9

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

	2007	2008	2009	2010	2011
Household consumption:	1.7	0.3	-1.1	0.7	1.1
Public consumption	2.2	2.2	2.4	0.9	0.4
GFCF	4.6	-0.9	-11.3	-1.3	1.0
Capital goods and other products	7.7	0.8	-15.7	1.6	1.4
Capital goods	8.6	0.7	-17.4	2.8	1.4
Construction	2.3	-2.2	-7.9	-3.7	0.2
Housing	1.1	-4.7	-10.8	-3.6	0.0
Domestic demand (*)	**2.6**	**0.5**	**-3.3**	**1.6**	**1.0**
Exports	6.3	0.7	-13.1	9.1	4.4
Imports	5.8	0.8	-11.8	9.2	4.0
Net exports (*)	**0.3**	**0.0**	**-0.8**	**0.0**	**0.2**
GDP mp (% y-o-y)	**2.9**	**0.4**	**-4.0**	**1.6**	**1.2**
Pro-memoria:					
GDP w/out housing investment	2.9	0.7	-3.6	1.9	1.2
GDP w/out construction	2.8	0.7	-3.6	2.2	1.3
Employment (LFS)	2.0	0.9	-1.8	-0.5	0.2
Unemployment rate (% active pop.)	7.5	7.6	9.4	10.1	10.2
Current account balance (% GDP)	0.1	-1.1	-0.6	-0.5	-0.2
Public sector balance (% GDP)	-0.6	-2.0	-6.3	-6.8	-5.5
CPI annual average	2.1	3.3	0.3	1.6	1.7

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

Table 10

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

	2007	2008	2009	2010	2011
Activity					
Real GDP at market prices	3.6	0.9	-3.7	-0.2	0.9
Private consumption	3.7	-0.6	-4.3	1.6	1.0
Public consumption	5.5	5.8	3.2	0.2	-0.5
Gross fixed capital formation	4.5	-4.8	-16.0	-7.2	-1.8
Capital goods	10.4	-2.5	-24.5	3.7	4.1
Construction	3.2	-5.9	-11.9	-10.5	-4.6
Housing	2.5	-10.7	-24.5	-16.6	-6.5
Other construction	4.0	-0.8	-0.1	-6.2	-3.3
Other goods	0.8	-4.1	-16.2	-10.9	-0.2
Chg in inventories (*)	-0.1	0.1	0.0	0.0	0.0
Domestic demand (*)	4.4	-0.6	-6.4	-0.7	0.0
Exports of goods and services	6.7	-1.1	-11.6	10.0	8.0
Imports of goods and services	8.0	-5.3	-17.8	6.9	3.8
Net exports (*)	-0.8	1.5	2.7	0.6	0.9
GDP at current prices	7.0	3.3	-3.1	0.4	2.1
Billion euros	1053.5	1088.1	1053.9	1057.6	1079.5
Prices and Costs					
GDP deflator	3.3	2.4	0.6	0.5	1.2
Household consumption deflator	3.2	3.5	0.1	2.3	1.3
CPI	2.8	4.1	-0.3	1.8	1.7
Compensation per employee	4.8	6.4	4.1	1.4	1.5
Unit labour cost (ULC)	4.0	4.9	1.0	-0.7	0.3
Foreign trade					
Trade balance (% GDP)	-8.6	-8.0	-4.3	-4.6	-3.0
Current account balance (% GDP)	-10.0	-9.7	-5.5	-4.8	-3.7
Government sector					
Debt (% PIB)	36.2	39.7	53.2	63.6	69.7
Public Administration balance (% PIB)	1.9	-4.1	-11.2	-9.3	-6.0
Labour market					
Active population (LFS)	2.8	3.0	0.8	0.3	0.5
Employment (LFS)	3.1	-0.5	-6.8	-2.2	-0.2
Change, thousands of people	608.3	-98.3	-1369.7	-422.7	-35.9
Full-time equivalent employment (CNTR)	2.8	-0.5	-6.6	-2.3	-0.3
Unemployment rate (% active pop.)	8.3	11.3	18.0	20.1	20.6
Productivity	0.7	1.4	2.9	2.1	1.2
Households					
Real disposable income	2.8	2.4	1.6	-2.9	-1.1
Nominal disposable income	6.1	6.0	1.7	-0.7	0.2
Savings rate (% of nominal income)	10.8	13.5	18.1	13.9	12.2

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

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