BBVA | RESEARCH

Spain Economic Outlook

Second Quarter 2014
Economic Analysis

- **The Spanish economy will expand by more than 1% in 2014,** and create net employment for the first time since the beginning of the crisis.
- **BBVA's Economic Activity Survey confirms expectations of growth in 2Q14.**
- **The progress made on the public deficit both reduces uncertainty** and the amount of fiscal consolidation required in the coming years.
- **The decline in Social Security contributions will have a positive – although temporary – impact** on employment and permanent contracts.
- **The deregulation of the services sector is crucial** if there is to be a continuation of improvements in competitiveness or increases in exports.

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Closing date: 30 April 2014

1. Editorial

Growth forecasts for 2014 have been revised upwards, as some of the uncertainties regarding economic performance that we had three months ago have now been resolved. At the same time, we maintain our expectation that the recovery will gain traction, reaching an average of 2% in 2015. In particular, the available information appears to indicate that the deceleration in the export of goods in the second half of 2013 was a temporary phenomenon and that Spanish exports will continue to gain market share, in spite of euro appreciation and weaker internal demand in some emerging countries. Likewise, and contrary to expectations, the government practically met its deficit target, and the contraction in public consumption did not prevent the economy from continuing to expand in the latter part of 2013 (by slightly less than we expected in the last edition of this publication). On the other hand, and in spite of the moderate recovery in fundamentals, private consumption continues to expand in a sustained way. Overall, the favourable performance of final demand yielded a 0.4% QoQ increase in GDP during the first quarter of 2014.

These trends appear to be continuing during the second quarter of the year, such that we estimate that growth will continue at a similar pace. In particular, BBVA's Economic Activity Survey, which aggregates the results of the regional surveys that BBVA Research has been carrying out for the past few years (see Box 1), indicates that the rate of Spain's economic growth will be sustained in April-June. Altogether, the second quarter data suggest QoQ GDP growth of 0.4%.

Going forward, we continue to believe that global growth will be robust and reliant on ever-increasing contributions from the developed economies, even though it has not accelerated as much as it was expected. In particular, both the indicators related to the real economy and those that reveal the degree of financial market stress have continued to show a moderate recovery, consistent with the scenarios for the US and Europe introduced three months ago. This has not been the case for the Emerging Markets, and particularly not for China, where we have revised our expectations downwards, even though we believe GDP will still expand by around 7%. Thus, even though in recent weeks we have started to see a recovery in the flows towards emerging markets, the amounts are a long way from offsetting the outflows seen since the middle of last year. In any case, the above remains consistent with the confirmation of a scenario for global growth of around 3.5% in 2014 and 4.0% in 2015.

Together with global growth, the favourable performance of investment in machinery and equipment indicates that the dynamism of Spanish exports will continue. In particular, for more than a year now, the increase in productive capital in this sector has exceeded that observed in the rest of Europe. Additionally, as a proportion of internal demand, this component is nearing an all-time high and will continue to increase for the next two years. This suggests that the recovery will have three characteristic features. First, that changes in the composition of growth are still taking place, and that they are happening in sectors where companies' spare capacity appears to be gradually disappearing, what will force them to expand. Second, that these companies are not encountering restrictions to invest, either because they have the necessary resources to do so because the capital markets are now open to the larger companies, or because bank finance is now available to solvent demand, as shown by the data for credit flows to small companies. Finally, the increase in productive investment will be reflected in improved capacity for growth in the future, and that on this occasion exiting the crisis could be accompanied by a sustained increase in labour productivity, consistent with the recoveries seen in other Developed Economies.

Having met the public deficit target implies that fiscal policy will be less restrictive than we previously expected. In particular, this should reduce the uncertainties regarding the impact that the fiscal consolidation is having in Spain, either because of the differential performance of exports compared to other European countries, the effect of some well-timed policies (for example, the Supplier Payment Plan), or the implementation of slightly more aggressive structural reforms, which have generated expectations of stronger growth in the medium

term. In addition, the positive performance of public revenues, lower interest payments and the cyclical improvement in some expenditure items could imply that, at the same time as meeting its deficit target in 2014, the government could introduce some policies that reduce the relative cost of labour. In particular, reducing employer Social Security contributions for new full-time contracts could feed through into an additional 0.7% increase in employment and a 0.3% increase in GDP growth (see Box 2).

Estimates for Spain's 10-year sovereign bond yields have been reduced by 200bp since last year. At the same time, the market is still anticipating positive inflation in Spain, as noted in this report. In fact, rather than weak internal demand, what appears to be putting downward pressure on Spanish inflation is the decline in inflation across the EMU as a whole, where expectations of inflation are settling at dangerously low levels. Given the loss of competitiveness that Spain recorded during the period before the crisis, Spanish inflation should continue to post systematically smaller price rises than its principal trading partners, such that this differential feeds through into a virtuous process of rising exports and import substitution. Furthermore, the persistence of low inflation over the next two years, confirmed by the ECB itself, should be sufficient reason for the implementation of preventive policies that dissipate the risks of a deflationary process and foster improvements in competitiveness in countries like Spain.

As noted in the past, **this recovery scenario should not slow down the process of reforms in order to improve the Spanish economy's capacity for growth and foster a rapid absorption of its imbalances**. Spanish society will face very important reforms, such as the introduction of a new tax system. The objective, as noted in previous issues of this publication, should be to maintain the tax burden so as to facilitate the process of reducing the public deficit, increase the efficiency of tax collection and foster growth and job-creation, improving equality and fairness. Likewise, it is essential that firms' profit margins contribute to the process of increasing competitiveness, such that the government should be just as ambitious as it was in pursuing a better functioning of the labour market, encouraging competition in sectors that act as bottlenecks in the above-mentioned process. In particular, in this publication we show that the adoption of best regulatory practices in the services would give a substantial boost to exports (see Box 3).

2. The deceleration in China and the Fed's tighter monetary policy will determine the global scenario[1]

The global economic cycle remains robust at the start of 2014. According to our estimates, in the first quarter of 2014 global GDP hasaccelerated very slightly to around 0.8% QoQ and, according to our global activity indicator (BBVA-GAIN), we expect this pace to be maintained for the first part of the year (Figure 2.1). In the wake of this sustained global recovery is the cyclical improvement in the Developed Economies, which has offset the deceleration in some Emerging-Market Economies in Asia and Latin America. Likewise, **in the last few months, the financial markets have performed very differently in the two regions** (Figure 2.2), and with more heterogeneity among the Emerging Economies. Capital flows, asset prices, interest rates and financial-stressn indicators have basically performed in line with the outlook for rate hikes in the US, but have also been affected by geopolitical risk events in Eastern Europe. Altogether, tightening financial conditions have differed in each economy as a function of their degrees of external vulnerability and financial integration- i.e. their current account deficits, the extent of dollar-denominated liabilities or their (flexible) exchange rates.

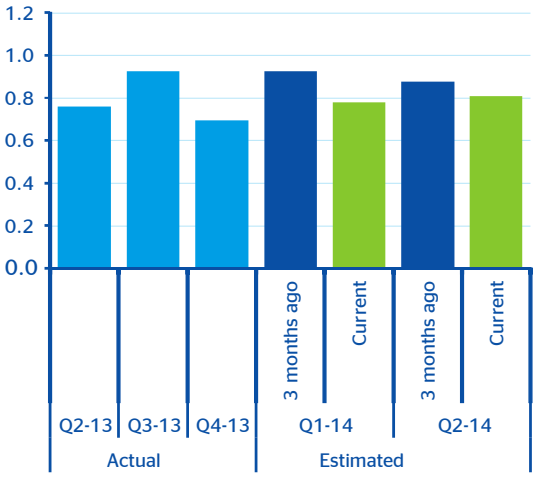
The global scenario **is the result of a combination of the policies introduced domestically but having cross-border implications**, not only in terms of higher or lower demand for goods and services (international trade), but also in the extent to which they help to alter global risk-aversion, which is reflected in the volatility of capital flows and/or the prices of financial assets and raw materials.

On the one hand, the cyclical recovery is spreading across the Developed Economiess on the back of less restrictive fiscal consolidation, fewer concerns about the sustainability of debt levels (thanks to contained financial costs) and progress on the implementation of banking union in the EMU. However, the normalisation of US monetary policy, on-going in terms of *tapering* and via expectations as far interest-rate cuts are concerned, is resulting in a rebalancing of financial portfolios at a global level. The latter is affecting particularly financing conditions and asset prices in the Emerging Economies. This contagion is nothing new, but has raised its head in a new environment: a scenario of deeper financial integration within Emerging Economiess and an extraordinarily lax monetary policy stance in the US. Symmetrically, the exit from this exceptional period will also have an impact on the financial variables.

Amongst Emerging Economies, we are also starting to see concerns about the economic slowdown in China since the Chinese New Year given the increased emphasis that the authorities are now placing on reducing vulnerabilities – via medium-term macro-prudential policies – rather than in sustaining growth in the short term.

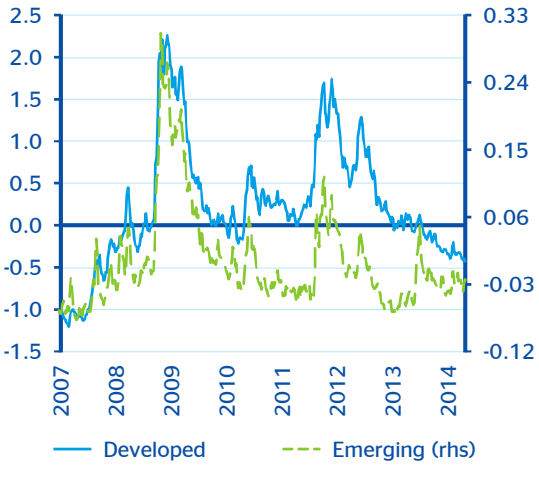
1 : For further details see Global Economic Outlook Second Quarter 2014 BBVA Research

Figure 2.1
Global growth (%, QoQ) based on BBVA-GAIN



Source: FMI and BBVA Research

Figure 2.2
BBVA Research Financial Tensions Index in Developed Economies and Emerging Economiess



Source: BBVA Research

To sum up, our evaluation of the global scenario has a downward bias compared with our estimate three months ago, which is reflected in the adjustments to our forecasts. After growing at 3.0% in 2013, **global GDP will start to accelerate again in 2014 and 2015 at around 3.4% and 3.8% respectively**, reflecting both the variations in growth expectations in diverse regions and the increased, although slight, contribution to global growth by the Developed Economies. Although there have been no significant changes in either the US or the Eurozone, downward pressures in our forecasts for 2014 and 2015 are above all visible in the Emerging Economies ofboth Asia and Latin America. **In this sense, there are still short- and medium-term downside risks to our forecast.** In the medium-term, some factors with a global impact could make themselves felt more intensely than expected in the base scenario. Amongst them, , a tighter-than-expected monetary policy on the part of the Fed, reduced global demand stemming from economic slowdown in China or a larger macroeconomic repercussion of the so-far contained geopolitical risks derived from Eastern Europe.

3. Growth outlook of the Spanish economy: the recovery takes shape

The Spanish economy started 2014 following on the recovery path initiated in the second half of 2013. The improvement in activity continued in tandem with the **progressive normalisation of the international financial markets**, in a context of **historically low risk-free interest rates.** Although the degree of **fragmentation of the European financial sector has remained high,** Spain has started to witness a recovery of credit flows in some segments.

With respect to the real economy, **the activity of the country's main economic partners has once again given mixed signals.** Thus, while the reactivation of the developed economies is consolidated, a slowdown in demand in some emerging countries has been observed. In turn, the euro exchange rate recorded an appreciation which, together with the latter factor, would entail downward pressure on foreign demand. However, **Spanish export companies have once again responded with flexibility in the face of renewed turmoil in the international scenario, and have even managed to growtheir turnover.** Thus, the slowdown in demand from the emerging world was mainly covered by European demand, and the exchange rate appreciation was offset with adjustments in the relative prices of exports.

On the domestic side, **the evolution of demand, mainly private, has surprised positively in the past months.** The latter was supported by subdued financial stress, structural reforms, the spillover effect of the foreign sector and the need to make less of a fiscal effort than in 2012. In this respect, the Spanish government can be said to have practically met its budget commitment in 2013, good news, given that a deviation of around a half point of GDP was expected.

In summary, the Spanish economy's fundamentals support a consolidation of the recovery over the coming quarters. In the most probable scenario, **activity will grow by around 1.1% in 2014 and accelerate to 1.9% in 2015**, figures that will be sufficient to create net jobs for the first time since the onset of the crisis. While the growth figure considered in this report does not significantly differ from that presented three months ago, it includes certain innovations in its composition. The slowdown in part of the emerging world and the nominal appreciation of the euro exchange rate **lend a downward bias to the net contribution of exports to growth** of two tenths until 2015. Nevertheless, over the next two years, we expect greater growth of the global economy than that observed in 2013, which together with internal devaluation will support the **growth of trade flows.** In contrast, the soundness shown by the determinants of private demand, and the lower fiscal consolidation requirements for 2014, entail an upward **revision of the contribution of domestic demand to growth** (three tenths up to 2015).

In any case, it should be remembered that **open fronts remain, the resolution of which is fundamental to consolidate the recovery.** In this regard, both **Spain and Europe should work on supply-side policies** that increase their ability to grow and to absorb unemployed labour. Additionally, it is essential that the European Central Bank gives priority to a monetary policy that keeps inflation expectations anchored.

The Spanish economy continued to consolidate its recovery

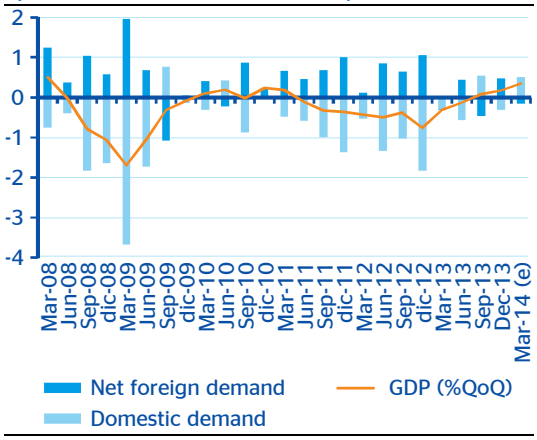
With detailed results pending release, the preliminary GDP estimate published by the National Statistics Institute (INE) indicated that **the Spanish economy grew 0.4% QoQ in 1Q14[2], slightly higher than expected three months ago (0.3%).** A confirmation of this estimate would mean that activity from January to March progressed somewhat more intensively than at the end of 2013 (0.2% QoQ in 4Q13), and would represent the first year-over-year growth figure (+0.6% YoY) since mid-2011. With respect to the growth composition, short-term

2: The itemised Quarterly National Accounting (CNTR) for 1Q14 will be released next May 29, which may lead to a revision of the preliminary estimate.

indicators point to domestic demand having **positively contributed to the pickup in activity (+0.5pp QoQ).** On the other hand, **net foreign demand shaved one-tenth of a point off growth,** given the rise in imports which, on this occasion, offset the recovery of foreign sales (see Figure 3.1).

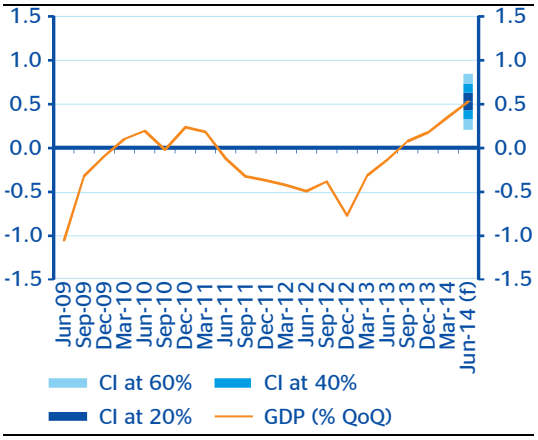
Looking towards the second quarter of 2014, the public information as of the closing date of this publication suggests that the Spanish economy continues to consolidate its recovery, and may reach **a pace of growth above that of the first quarter of the year** (MICA-BBVA: 0.4% QoQ) (see Figure 3.2)[3]. This scenario of a gradual recovery of activity is in line with the results **of BBVA's Economic Activity Survey** (see Box 1).

Figure 3.1
Spain: Contributions to Quarterly GDP Growth



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

Figure 3.2
Spain: Observed GDP Growth and MICA-BBVA Model Forecasts (% QoQ)



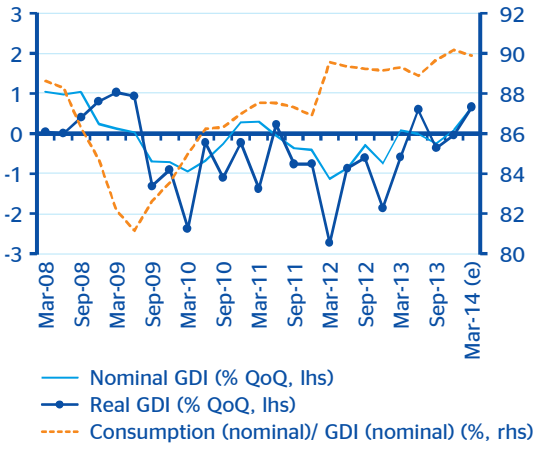
(f): forecast.
Current forecast: 30 April 2014.
Source: BBVA Research based on INE (National Statistics Institute)

Private domestic demand started the year at positive

Consumption indicators, mainly those related to durable goods[4], suggest **that household spending grew once again over the first quarter of 2014.** Improvements in both households' disposable income, and their perception of the economic situation[5], together with the increase in their net financial wealth[6] and the coming into effect of the Efficient Vehicle Incentives Programme (PIVE)[7] offset the deterioration of their real-estate wealth, consequently stimulating private consumption between January and March (see Figure 3.3). Thus, both BBVA's Synthetic Consumption Indicator (ISC-BBVA) and BBVA's Coincident Consumption Indicators Model (MICC-BBVA) point to a growth **in household spending of around three tenths in 1Q14 (1.5% YoY), roughly at the level of the previous quarter's figure** (see Figure 3.4).

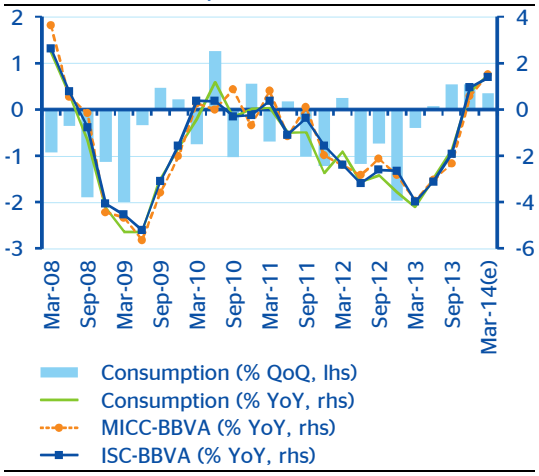
3: For further details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting," BBVA WP 10/21, available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1021_tcm348-231736.pdf?ts=2542012.
4: For a detailed analysis of the course of consumption expenditure by type of good or service, see Section 3 of the 2013 H2 issue of Situación Consumo magazine. http://www.bbvaresearch.com/KETD/fbin/mult/1312_Situacionconsumo_tcm346-416135.pdf?ts=2012014.
5: Households' perception of their future economic position has improved continuously since August 2012, which has had significant effects on their tendency to consume. For a detailed analysis of how the course of households' expectations conditions their consumption expenditure, see Box 4 of 2009 H2 issue of Situación Consumo magazine. http://www.bbvaresearch.com/KETD/fbin/mult/0912_situacionconsumoespana_tcm346-207180.pdf?ts=2012014.
6: It is estimated that a 1% quarterly rise in real net financial wealth will cause an aggregate increase in private consumption of 0.2% over the coming four quarters.
7: The goal of the PIVE is to replace private cars and light commercial vehicles over 10 and seven years old, respectively, with more energy-efficient models. According to BBVA Research estimates, the PIVE has contributed around nine tenths to private consumption since its initial announcement in October of 2012. Given the import content of automobile sales, the contribution of PIVE to economic growth would have been insignificant.

Figure 3.3
Spain: Gross Disposable Income and Propensity to Consume (swda data)



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

Figure 3.4
Spain: Actual and Real-Time Forecasts for real household consumption

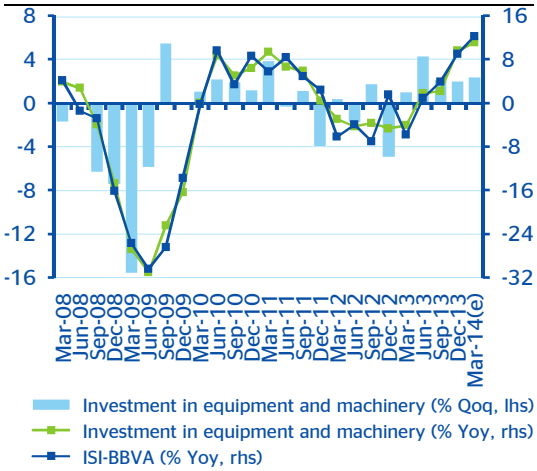


(e): estimate.
Source: BBVA Research based on INE (National Statistics Institute)

The positive mood on which gross fixed capital formation closed last year continued over the first months of 2014, thanks to the resilience of exports and the progressive recovery of domestic demand. At least, this is what is reflected by short-term indicators of investment in machinery and equipment, industrial production, equipment-goods orders, industrial confidence and capital-goods imports. Thus, for 1Q14, the Synthetic Investment Indicator (ISI-BBVA) estimates a **growth in machinery and equipment investment of 2.8% QoQ (11.5% YoY)** (see Figure 3.5).

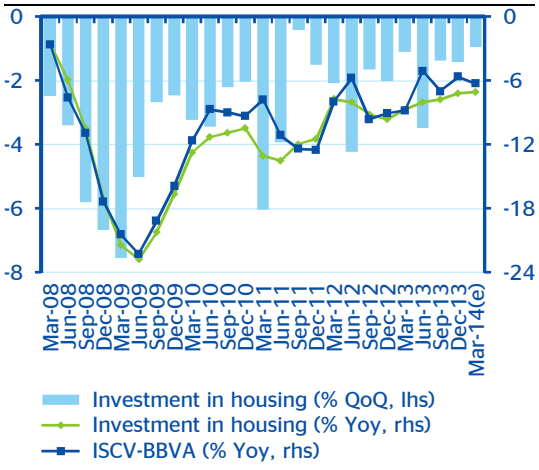
For its part, **the deterioration of investment in housing continued to moderate.** Housing building permits barely changed over the last months, remaining anchored at lows. Similarly, home sales dropped at a slower pace than that previously observed, due, in part, to the gradual recovery of demand fundamentals and to investors' and foreigners' demand remaining in good shape. Consequently, the Synthetic Housing Investment Indicator (ISCV-BBVA) suggests a **slowdown in the fall to -1.0% QoQ (-7.1% YoY)** (see Figure 3.6).

Figure 3.5
Spain: Equipment and Machinery Investment Observed Data and Real-Time Forecasts



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

Figure 3.6
Spain: Housing Investment Observed Data and Real-Time Forecasts



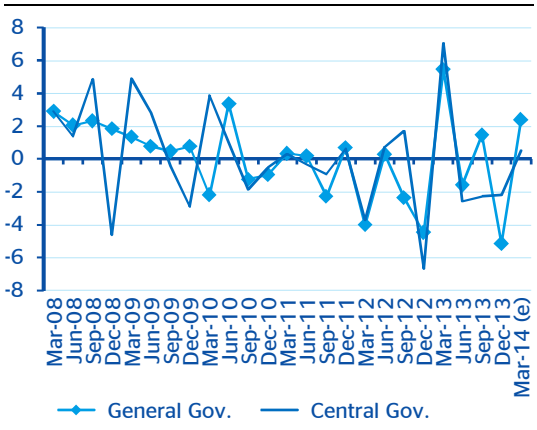
(e): estimate.
Source: BBVA Research based on INE (National Statistics Institute)

Public demand moderates its negative contribution to growth

After the major adjustment observed in the fourth quarter of 2013, **domestic demand is expected to have temporarily corrected to the upside over the first quarter of the year.** Thus, the state's latest budget performance data as of March 2014 reveal that the central government's expenditure on final consumption rose slightly once again (see Figure 3.7), to remain at around 2.4% of GDP on a 12-month aggregate basis. Also, according to the Labour Force Survey (LFS), the number of public-sector employees rose by 11,100, interrupting the downward trend that had started in 4Q11 (-397,200 employees up to 4Q13) (see Figure 3.8). In light of these data, **public consumption is estimated to have closed the quarter with an increase of around 1.3% versus the last quarter (-3.2% YoY).**

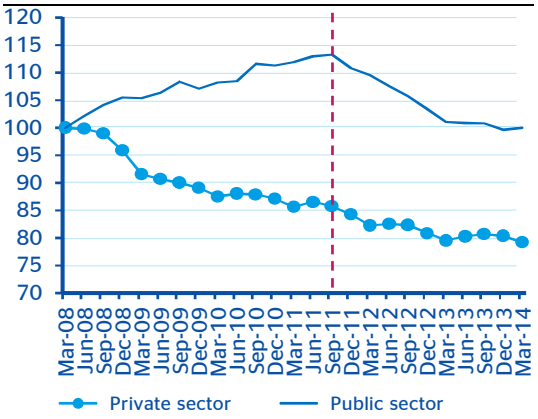
For their part, **the available budget data reveal that the adjustment in public investment is declining.** The rise in public works tenders in 2013 (17.2%) augurs a slower fall in non-residential construction, which would come in at around 1.8% QoQ in 1Q14 (-6.8% YoY).

Figure 3.7
Spain: Nominal Public Consumption
(% QoQ, swda data)



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

Figure 3.8
Spain: Employees by Sector
(1Q08 = 100)



Source: BBVA Research based on INE (EPA)

The foreign sector starts the year on an expansionary note

Over the fourth quarter of last year, Spanish exports performed in a **context of slowing demand from non-EU countries and euro appreciation.** Notwithstanding these adverse factors, the upturn in exports of non-tourism services and the resistance of goods exports made up for the contraction in exports of tourism services, which enabled the quarter to close with a healthy pace of exports (0.8% QoQ; 3.7% YoY).

The start of 2014 was characterised by a similar environment, to which Spanish exporting firms responded with flexibility. In particular, slowing emerging world demand was offset mainly by European demand, and adjustments in relative export prices continued to make up for the exchange rate appreciation (see Figures 3.9 and 3.10). **The available short-term indicators thus reveal positive signs for 1Q14.** Specifically, once seasonal and calendar effects (swda) are corrected, both the real export of goods from the balance of trade and the indicator of large companies' goods and services exports grew in January and February. Furthermore, industrial exporting companiesclosed the quarter with the best order-books' numbers since the onset of the crisis. On the other hand, foreign-tourism demand indicators reveal a certain restraint after a record year.

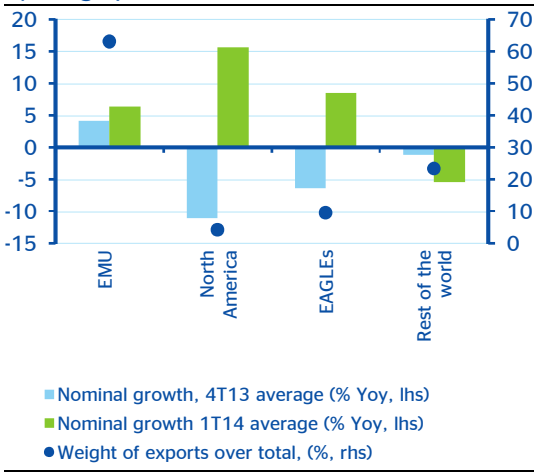
Therefore, the short-term information available at the closing of this report suggests that, over the first quarter of 2014, **foreign sales of goods accelerated (2.4% QoQ; 12.1% YoY),** and that the **recovery of non-tourism services exports continued (2.6% QoQ; 9.5% YoY).**

However, Spain's non-resident consumption figure practically stagnated (0.1% QoQ; 6.3% YoY), a fact that, in any event, implies the **stabilisation of foreign tourism flows at historical highs.** Overall, **the preliminary estimate of total exports for 1Q14 comes in at 2.1% QoQ (10.9% YoY).**

On another note, over the past year, **imports made a comeback to the growth path after two** consecutive years of contraction (0.4% annual average). Regarding the start of the year , the published short-term data confirm that this recovery **intensified in the first quarter of 2014 (2.8% QoQ; 10.7% YoY),** in line with the favourable progress of final demand.

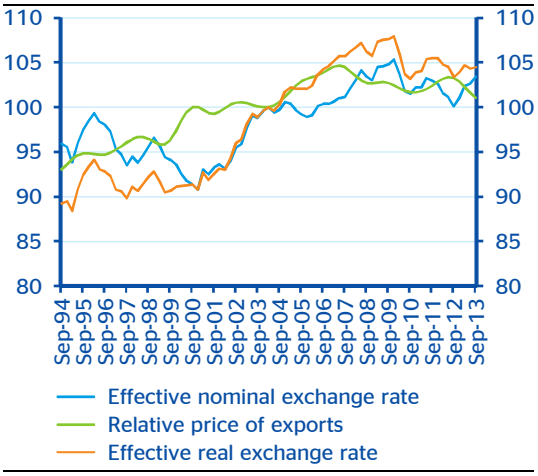
As a result of the mentioned factors, the first part of 2014 begins with a contribution of net foreign demand to growth close to zero (-0.1pp), and the stabilisation of the current-account balance surplus (around 0.8% of GDP on an annual aggregate basis).

Figure 3.9
Spain: Goods Exports Growth and Composition by Geographic Area, 1Q14 vs. 4Q13



Note: data as of Feb 14.
Source: BBVA Research based on Datacomex

Figure 3.10
Spain: REER Composition Based on the Export Deflator (versus 37 industrialised countries, 1Q04=100)



Source: BBVA Research based on European Commission

Mixed signals in the labour market

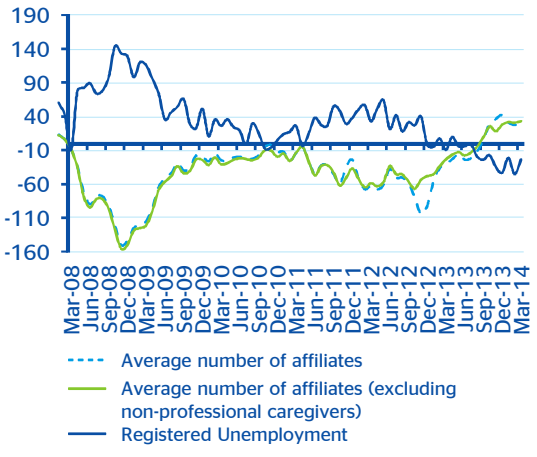
The figures for the year's first quarter suggested that the recovery of the labour market had consolidated. Growth in the average number of Social Security affiliates accelerated to 0.6% QoQ swda in 1Q14 (0.5% QoQ when discounting the loss of non-professional caregivers), **representing the second consecutive non-seasonal increase in affiliation since 1Q08** (see Figure 3.11). For its part, the recorded drop in registered unemployment deepened to -2.1% QoQ swda in 1Q14 from -1.6% for the last quarter, while hiring, both temporary (3.1% QoQ) and, above all, permanent (5.2% QoQ), grew once again from January to March (3.2% QoQ swda). Nevertheless, the percentage of temporary contracts barely dropped one tenth to 92.4% swda.

However, the Labour Force Survey (LFS) for 1Q14 was a letdown[8]. The marked fall in active population (-187,000 people, -157,000 swda) did not make up for the greater-than-expected seasonal drop in employment (-184,600 people; -15,400 swda). The unemployment rate consequently rose two tenths to 25.9% (25.3% swda). The drop in employment in 1Q14 was entirely due to a fall in the number of private sector workers, both salaried (-175,100) and self-employed (-20,600). The proportion of employees on temporary

8: Note that the EPA for 1Q14 was adapted to the 2011 Population and Housing Census. The change in the population base consisted in replacing the series of populations and homes that had hitherto been used, which were based on the 2001 census, with those for 2011. This entailed the revision of the series from the first quarter of 2002. The result is that the preceding EPA underestimated the population by almost 500,000 people in 2013. The change in the (mainly active) adult population explains around 90% of the population increase. As most of the active members surfaced are employed, the unemployment rate was revised downward by almost three tenths for 2013 overall.

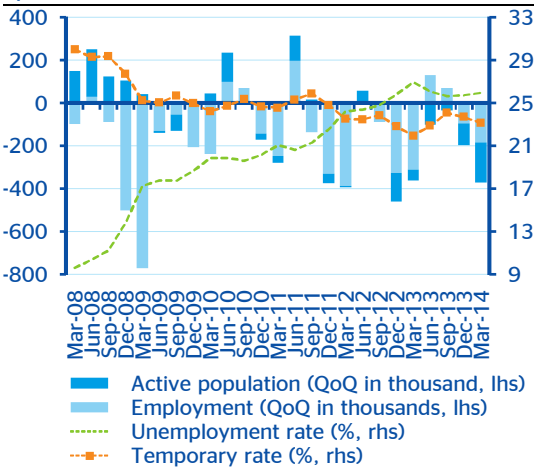
contracts dropped in 1Q14, as it also did in the fourth quarter of last year. The unfavourable seasonality caused a marked drop in the number of workers on temporary contracts (-112,400), with the temporary employment rate thus dropping five tenths to 23.1% (see Figure 3.12).

Figure 3.11
Spain: Average Social Security Affiliation and Registered Unemployment (monthly change in thousands, swda data)



Source: BBVA Research based on ME&SS

Figure 3.12
Spain: Labour Market Indicators



Source: BBVA Research based on INE (National Statistics Institute)

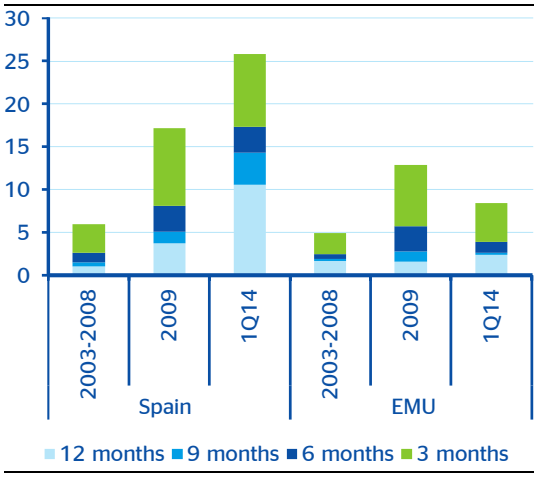
The containment of prices and costs continues

Both headline and core inflation continued to slow down in the first quarter of the year, reaching quarterly averages[9] of 0.0% YoY and 0.1% YoY, respectively. **This behaviour falls within a context of moderate European inflation rates and the need to recover price competitiveness in Spain.** Until March, inflation distribution shows that Spain recorded negative month-over-month swda rates for 10.6% of the CPI items over the entire last year, while in the case of Europe this figure came in at 2.4% (see Figure 3.13).

In line with the latter, the **inflation differential with respect to the Eurozone remained favourable to Spain.** Thus, the Harmonised Indices of Consumer Prices (HICP) records indicate that, in terms of headline inflation, said differential for March came in at -0.7 pp, and -1.0 pp in terms of the core component, versus an unfavourable historical average of +0.8 pp in both cases. For their part, **BBVA Research estimates indicate that the differential in terms of trend inflation[10] remains close to -0.8 pp** (see Figure 3.14).

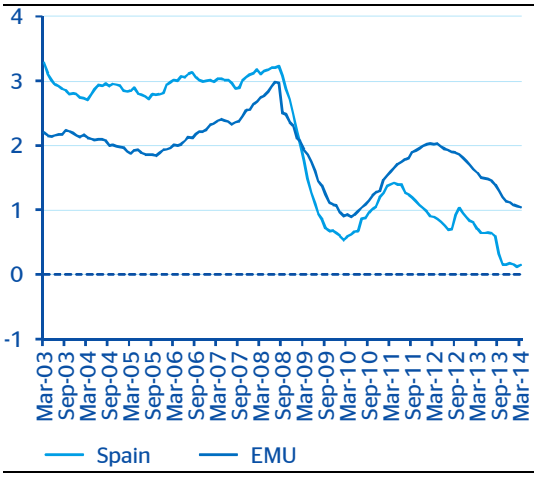
9: The preliminary CPI indicator suggests that headline inflation for April came in at 0.4% YoY: http://www.bbvaresearch.com/KETD/fbin/mult/IPCA_abr14_maq_tcm346-447920.pdf?ts=3042014.
10: For more details on the calculation of trend inflation with the trimmed mean method, see Box 1 of the 2014 Q1 issue of Situación España magazine, available at http://www.bbvaresearch.com/KETD/fbin/mult/1402_Spain_Economic_Outlook_tcm348-426396.pdf?ts=652014.

Figure 3.13
Spain and EMU: Share of CPI Line Items with Negative Monthly Rates by Diverse Degree of Persistence (swda data)



Source: BBVA Research based on INE and Eurostat

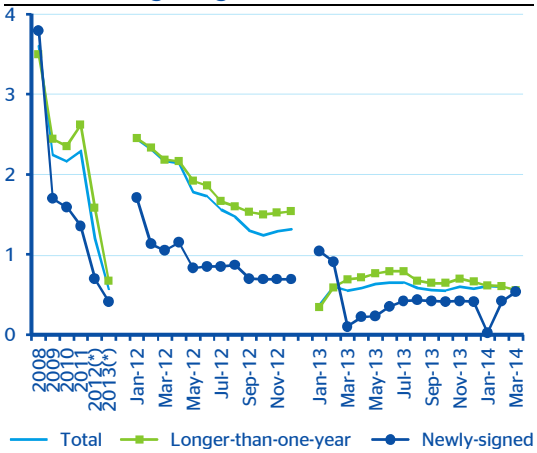
Figure 3.14
Spain and EMU: Trend Inflation (trimmed mean method, % YoY)



Source: BBVA Research based on INE and Eurostat

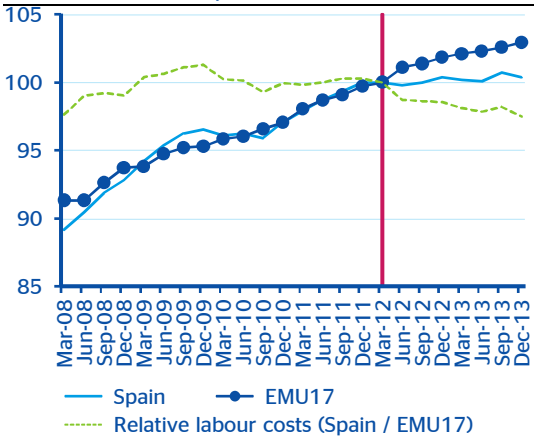
The low inflation has continued to favour the containment of wage demands in the first quarter. In this regard, the average wage growth agreed to in collective bargaining rose around 0.6% YoY from January to March (0.5% in the case of agreements signed over the current year, which only bind 173,000 workers), in line with the figure set forth as the upper limit for all of 2014 in the II Agreement on Employment and Collective Bargaining[11] (see Figure 3.15). This moderation in wages, witnessed after the labour reform's entry into force in 1Q12, has represented a gain in competitiveness versus the EMU (see Figure 3.16).

Figure 3.15
Spain: Average Wage Growth Agreed to by Collective Bargaining (%)



The annual data include the agreements recorded after December of each year, and include the review pursuant to the salary guarantee clause.
(*) Provisional data. The 2013 figure is not homogenous with that of the prior years. See: http://www.empleo.gob.es/estadisticas/cct/CCT13DicAv/ANE/Resumen_CCT_diciembre_13.htm.
Source: BBVA Research based on ME&SS

Figure 3.16
EMU: Labour Cost per Effective Hour of Work in the Market Economy (1Q12=100)



Source: BBVA Research based on Eurostat

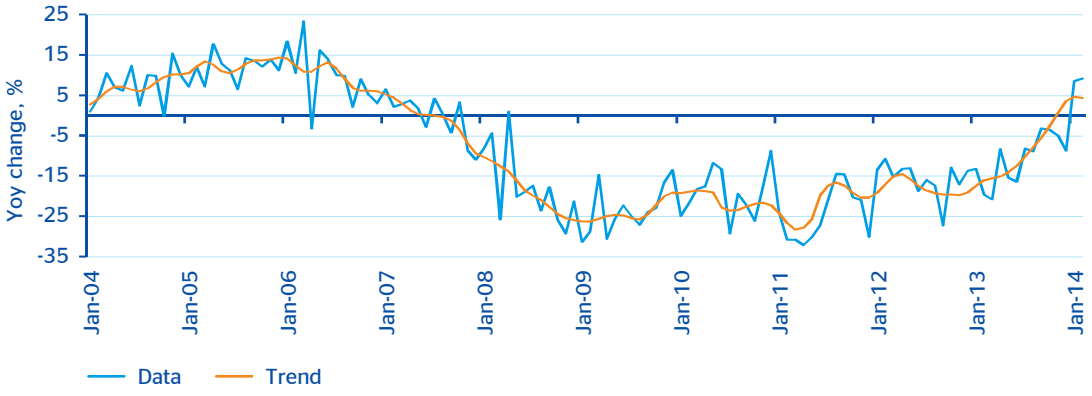
11: Note that the II AENC 2012-14 set forth that if 2013 GDP were to rise less than 1%, the wage increase would not exceed 0.6%.

Small and Medium Enterprises' credit (SMEs) drove new loan transactions

Over the last months, the statistics for **new credit transactions have once again confirmed, at least partially, the recovery expectations** expressed in the previous issue of this publication. While the total number of new transactions did not progress as expected, due to the relapse in credit to large companies (loans over EUR1mn), the remaining components associated with the retail sector, households and SMEs have evolved favourably (see Figure 3.17).

In particular, **credit to large companies recorded an average annual** drop of close to -25% over the first months of 2014 (see Figure 3.1). Masked behind this behaviour are reasons such as **the much-needed deleveraging process of highly indebted sectors** and, quite probably, the **use of other financing instruments** (loans from the rest of the world, corporate debt issuance, retained earnings, sales of non-strategic assets, etc.). Meanwhile, credit **associated with SMEs** (loans below EUR1mn), **remains on the growth trend it** started in October of last year, and so far this year has risen above 5.0% YoY. With respect to households, worth highlighting is the **strength of home loans,** which grew over 25.0% YoY over the first months of 2014, to stabilise around the monthly EUR2bn mark, after a 2013 fourth quarter with variation rates of close to -40.0% on average. In this case, consideration must be given to the negative effect caused in the first months of 2013 by transactions brought forward as a result of the expiry of tax deductions at the end of 2012. The consumer loan portfolio continued the positive trend that started in the spring of 2013, and so far over the course of 2014 has grown over 28% YoY. Finally, the "households-other" portfolio recorded a remarkable improvement in its progress since last December, though it still presents a slightly negative average growth in 2014. **Ultimately, bank financing to solvent retail sectors has experienced a clear improvement over the last months,** growing almost 9% over the first two months of 2014, in contrast with the drop in the large firms sector.

Figure 3.17
Spain: Credit to SMEs - New Transactions (% YoY)



Source: BBVA Research based on Bank of Spain

Table 3.1
Spain: New Credit Transaction Flows

		Companies			Households			
in EURmn	Total Amounts	Total	< EUR1mn	> EUR1mn	Total	Home	Consumer	Other
Monthly								
Sep-13	34,700	31,288	10,517	20,771	3,412	1,418	1,047	947
Oct-13	36,164	31,837	12,273	19,564	4,327	1,907	1,246	1,174
Nov-13	36,069	31,855	11,576	20,279	4,214	1,818	1,158	1,238
Dec-13	48,990	43,847	12,775	31,072	5,143	2,237	1,511	1,395
Jan-14	33,205	28,815	10,973	17,842	4,390	2,016	1,146	1,228
Feb-14	29,963	25,418	10,694	14,724	4,545	2,021	1,244	1,280
% Variation YoY								
Sep-13	-1.8%	-1.0%	-1.4%	-0.8%	-8.7%	-18.5%	16.1%	-13.6%
Oct-13	-15.9%	-16.4%	0.1%	-24.2%	-12.6%	-20.4%	19.2%	-22.1%
Nov-13	-7.8%	-5.0%	4.7%	-9.8%	-24.2%	-37.5%	7.0%	-21.2%
Dec-13	0.2%	7.1%	9.6%	6.1%	-35.5%	-57.7%	32.4%	-9.6%
Jan-14	-6.8%	-9.7%	5.0%	-16.9%	18.4%	27.2%	23.6%	2.6%
Feb-14	-16.0%	-20.0%	6.0%	-32.1%	17.2%	25.8%	32.5%	-3.8%

Source: BBVA Research based on Bank of Spain

Scenario for 2014-15: the recovery is strong, but not unshakeable

As noted in the introduction to this Section, the improvement **in the Spanish economy's fundamentals** hints at the continuity of the recovery over the next two years. **Activity will grow by 1.1% in 2014 and accelerate to 1.9% in 2015,** enough for the recovery to be accompanied by employment (see Figure 3.2). **Still-robust growth is expected for exports,** although somewhat less than that expected three months ago, as a result of lower emerging countries demand, notwithstanding the continuation of the internal devaluation process. Furthermore, the generalised improvement of export determinants will support the **recovery of domestic demand, at** higher levels than previously estimated, although an acceleration of growth in private consumption, which has got ahead of its fundamentals, is not to be expected. On another note, **the heterogeneity of regional growth forecasts will continue,** given the differences in each Autonomous Community's exposure to foreign demand, the pace of correction of structural imbalances and the adjustment of public finances (see Section 5).

Although some upward biases have materialised for the first time since the beginning of the crisis, there is no room for complacency. The continuity shown by the recovery makes it increasingly strong, but it remains contingent upon progress in different areas of economic policy. First is the process of structural reforms, the fiscal adjustment in both Europe and Spain, and the monetary policy of the European Central Bank. Second is the pace of expansion of the emerging economies, which have gradually become more important among the Spanish economy's export markets.

Table 3.2
Spain: Macroeconomic Forecasts

(% YoY unless otherwise indicated)	1Q13	2Q13	3Q13	4Q13	1Q14 (e)	2012	2013	2014 (f)	2015 (f)
Domestic Final Consumption Expenditure	-3.7	-3.1	-1.2	-0.3	0.3	-3.3	-2.1	0.7	1.3
Private FCE	-4.2	-3.0	-1.7	0.7	1.5	-2.8	-2.1	1.4	1.3
Household FCE	-4.2	-3.0	-1.8	0.7	1.5	-2.8	-2.1	1.4	1.3
NPISH FCE	-1.0	-0.4	0.1	0.9	2.2	-0.2	-0.1	1.2	1.3
General Government FCE	-2.3	-3.4	0.2	-3.5	-3.2	-4.8	-2.3	-1.6	1.4
Gross Capital Formation	-7.1	-6.0	-5.6	-1.8	-0.3	-6.9	-5.2	1.0	4.5
Gross Fixed Capital Formation	-7.2	-5.8	-5.3	-1.7	-0.2	-7.0	-5.1	1.0	4.7
Tangible Fixed Assets	-7.9	-6.1	-5.6	-2.5	-0.4	-7.8	-5.5	0.6	4.4
Equipment, Machinery and Cultivated Assets	-4.1	1.7	2.2	9.5	11.5	-3.9	2.2	7.9	6.9
Equipment and Machinery	-4.1	1.8	2.2	9.6	11.5	-3.9	2.2	7.9	6.9
Transportation Materials	-4.7	10.9	10.1	19.5	13.4	-8.5	8.5	10.6	6.9
Other Machinery and Capital Goods	-4.0	-1.6	-0.6	5.8	10.8	-2.1	-0.1	6.8	6.9
Construction	-9.8	-10.1	-9.8	-8.6	-6.9	-9.7	-9.6	-3.8	2.8
Housing	-8.8	-8.1	-7.8	-7.2	-7.1	-8.7	-8.0	-3.4	4.9
Other Buildings and Other Construction	-10.6	-11.9	-11.4	-9.8	-6.8	-10.6	-10.9	-4.0	1.1
Changes in Inventory (*)	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand (*)	-4.3	-3.6	-2.1	-0.6	0.2	-4.1	-2.7	0.7	1.9
Exports	2.9	9.5	3.5	3.7	10.9	2.1	4.9	6.0	5.1
Imports	-4.9	3.2	0.6	2.7	10.7	-5.7	0.4	5.4	5.4
Foreign Balance (*)	2.4	2.0	1.0	0.4	0.3	2.5	1.5	0.4	0.0
Real GDP at MP	-1.9	-1.6	-1.1	-0.2	0.5	-1.6	-1.2	1.1	1.9
Nominal GDP at MP	-0.8	-0.9	-0.7	0.0	0.0	-1.6	-0.6	1.4	3.2
Pro-memory									
GDP w/o Housing Investment	-1.5	-1.2	-0.8	0.2	0.9	-1.2	-0.9	1.3	1.8
GDP w/o Construction	-0.9	-0.5	0.0	0.9	1.4	-0.4	-0.1	1.6	1.8
Total Employment (EPA)	-4.6	-3.6	-2.9	-1.2	-0.5	-4.5	-3.1	0.3	1.4
Unemployment Rate (% Act. Pop.)	27.2	26.3	26.0	26.0	25.9	25.0	26.4	25.1	24.2
Total Employment (FTE)	-4.7	-4.0	-3.3	-1.6	-0.6	-4.8	-3.4	0.2	1.1

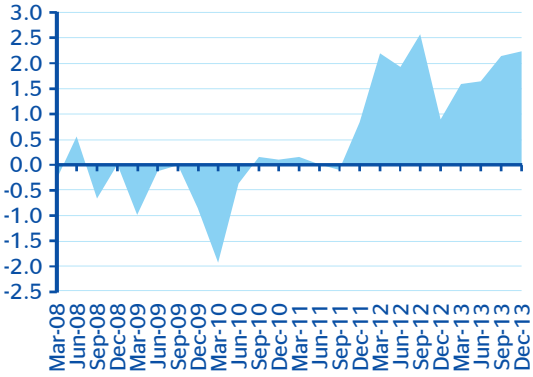
(*) Contributions to growth.
(e): estimate; (f): forecast.
Source: BBVA Research based on INE (National Statistics Institute)

A more balanced composition of growth

In the domestic area, **fiscal policy is expected to maintain its contractive stance in 2014,** albeit not as intensively as in prior years. On the expenditure side**, real public consumption is expected to shrink by -1.6% in 2014 overall**, 0.6 pp higher than the estimate provided in the prior issue of this publication. Likewise, a **deterioration is expected in non-residential construction investment (-4.0%)**, although less than the figure recorded over the last two years (-10.8% on average). When preparing BBVA Research forecasts, economic policy announcements made up to the closing of this publication are included. Therefore, given that the details of the economic measures required to meet the 2015 public deficit target have not been announced, the 2015 growth forecast assumes that fiscal policy will cease to contribute negatively to domestic demand, leading to a real growth forecast for **both public demand components of around 1.4% for this year and 1.1% for the next.** To meet the 4.2% deficit target in 2015, BBVA Research estimates that the government would have to announce additional measures equivalent to 1.0% of GDP, which would entail negative repercussions on the contribution of fiscal policy to economic growth (see Section 4). Having said that, there is evidence that the fiscal multiplier could be falling, given the increased liquidity in the capital markets, the reduction of interest rates and the recovery of credit flows.

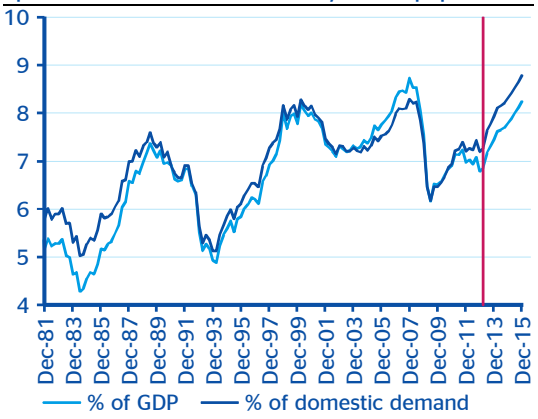
The expected improvement of its fundamentals will translate into a rise in private consumption over the course of the 2014-15 period. Thus, the expected jobs recovery will contribute to an increase in household disposable income both this year and, above all, the next. The growth in net financial wealth, the absence of inflationary demand pressures and the expectation that official interest rates will remain at historically low levels will compensate for the deterioration of real estate wealth (lower than forecasted three months ago), the uncertainty associated with the termination of the PIVE plan and the slight upturn in the savings rate toward the end of the forecasting horizon. Nevertheless, it is worth noting that Spanish households continue to spend above the levels warranted by consumption fundamentals, which helps to explain the persistent fall in their savings rate and suggests a slowdown in private spending for the medium term (see Figure 3.18). **Consumption is thus revised to the upside to 1.4% in 2014 and is expected to rise by 1.3% in 2015.**

Figure 3.18
Spain: Consumption Gap
(% of spending explained by fundamentals)



Source: BBVA Research based on INE (National Statistics Institute)

Figure 3.19
Spain: Investment in Machinery and Equipment



Source: BBVA Research based on INE (National Statistics Institute)

After a 2013 that opened the doors to growth, **2014 stands as the year of consolidation of the recovery in machinery and equipment investment. This is a** recovery that, from this point forward, will see itself **supported not only by the positive performance of the foreign sector, but also by the reactivation of domestic demand** (see Figure 3.19). Following this progress in the real economy, the improvement of financial conditions will consolidate, making access to financing cheaper and easier, which will foster the execution of new investment projects. Consequently, **the growth of this demand component will rise to 7.9% in 2014, 2.1 pp higher than the estimate of three months ago**, and way above the 2.3% level of last year. **A slowdown in growth to 6.9% is expected for 2015, 1.0 pp below the February forecast,** as a result of the expected lower growth of exports.

In contrast, **housing investment will continue to contract over the course of 2014, but at a more moderate pace than in the past.** On the aggregate supply side, the downward course of construction activity is already highly limited, the entire adjustment having been practically completed[12]. In fact, even though the unsold new homes inventory remains sizeable, **construction activity in some areas could begin to awaken over the coming quarters[13].**

Additionally, the recovery of the economy over the next two years will translate into an **improvement of domestic housing demand fundamentals such as** jobs, wealth, financial conditions and expectations which, little by little, will become noticeable in housing sales. On the side of **demand from foreigners,** the growth forecasts for the main countries of origin

12: Somewhat less than 34,000 new housing permits were approved in 2013, barely 4% of those signed in 2006.
13: We may begin to witness this in those markets where demand is displaying more activity, such as in the big cities (construction activity in Madrid rose noticeably in the last quarter of 2013) and some coastal areas where foreign demand is behaving particularly well. An example of the latter is Alicante, one of the markets with the highest growth in home sales to foreigners and where the number of permits reveals a reactivation of housing starts.

warrant the thought that, notwithstanding the potential negative impact of the current geopolitical crisis between Russia and Ukraine[14], this segment of residential demand **will continue to display strength over the next two years.** All in all, housing sales are expected to stabilise in 2014 and to begin climbing in 2015.

The current year is thus seen as a prelude to the stabilisation of the real estate sector. Consequently, **housing investment is expected to cap the year with a 3.4% drop, giving way to a recovery in 2015 (4.9%).** Nevertheless, the market will remain characterised by high heterogeneity, which is revealed by the behaviour of housing prices: while there are markets in which prices continue to fall, in others they are contained and even on the rise[15].

On the part of the foreign sector, **the growth of the world economy within the forecasting horizon suggests strong demand for Spanish exports which, thanks to a business diversification strategy,** are equipped with a greater number of tools to respond to demand slowdowns in specific geographic areas.[16] Thus, **we expect the downward pressure derived from the lower growth expected in some emerging economies,** mainly China and Latin America, **to be progressively mitigated by demand from other regions** (mainly Europe). Furthermore, **the evolution of relative prices is expected to offset the nominal appreciation of the euro,** which would lead to improvements in the real effective exchange rate for Spanish goods and services. These factors, together with competitiveness gains arising from a more favourable regulatory framework for competition (see Box 3), allow a preliminary estimate of an average **growth in exports of close to 5.6% for the 2014-15 period, 1.0pp below the estimate in the prior issue of this publication.**

As a consequence of the drive from final demand, due to the recovery of domestic demand and the growing weight of exports, **imports of goods and services would display robust growth (annual average for 2014-15: 5.4%), albeit contained by the substitution effect** arising from the gains in price competitiveness of Spanish products in the domestic market.[17] Thus, **the contribution of net foreign demand to economic growth would remain positive (0.4pp) in 2014 and reach zero in 2015,** at which time domestic demand would assume a greater role in the new expansionary cycle. At the end of the forecasting horizon, the Spanish economy would complete the structural deficit adjustment of the current account balance[18].

Net employment will be created, but the situation of the labour market leaves no room for complacency

Economic growth and the improvement of labour market efficiency will contribute to an increase in private sector jobs and a reduction of the Spanish economy's unemployment rate. Thus, for 2014 we expect job growth of 0.3% and a one-point drop in the unemployment rate to 25.1%. In 2015, the growth in the number of people employed will accelerate to 1.4%, but the drop in the unemployment rate will be similar to that forecasted for 2014, given the less favourable behaviour of the economically active population (24.2%). If the actions taken at the end of 2013 to increase the appeal of part-time jobs are successful[19], **the progress of full-time equivalent employment will be more modest.** BBVA

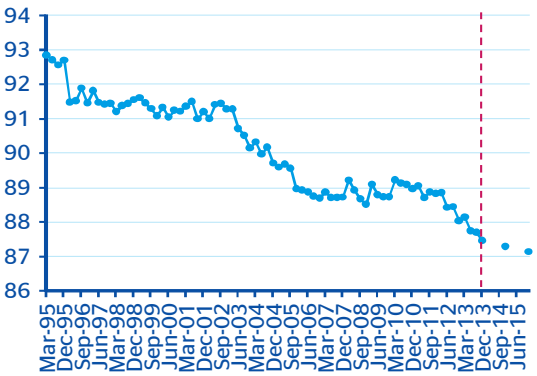
14: In 2013, Russia became the third most important country of origin among home buyers in Spain, accounting for 9% of total sales to foreigners, close to 3000 homes.
15: These are markets, such as the Balearic and Canary Islands (highly influenced by the drive of foreign demand) and Madrid, where demand is displaying a differentially better behaviour.
16: For more information on the growing diversification of Spanish exports, see Box 3 of the 2014 Q1 issue of Situación España magazine, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1402_Situacion_Espana_tcm346-423173.pdf?ts=1142014.
17: Those interested in the relative role of the income and substitution effects which underlie the behaviour of Spanish imports may refer to Box 2 of the 2013 Q4 issue of Situación España magazine, available at: http://www.bbvaresearch.com/KETD/fbin/mult/1311_Situacionespana_tcm346-410394.pdf?ts=2112014.
18: For more information on the recent evolution of and perspectives for Spain's current account balance, see the Economic Observatory entitled "Un análisis de la evolución y los determinantes del saldo por cuenta corriente en España" (Analysis of the Evolution and Determinants of Spain's Current Account Balance) available at: http://www.bbvaresearch.com/KETD/fbin/mult/131028_Observatorio_Cuenta_Corriente_Espa_a_Esp_tcm346-407130.pdf?ts=2112014.
19: For purposes of reducing the segmentation of the labour market and fostering the use of part-time contracts, the government advocated an administrative simplification of labour contracts and passed Royal Decree - Law 16/2013 on Measures to Favour Stable Hiring and Improve the Employability of Workers in December of last year. Said law authorises employers to expand the workday through supplementary hours (in those contracts stipulating a minimum of 10 weekly hours on average calculated annually), makes irregular working time distribution easier by regulating workday surpluses or deficits in pools of hours that extend beyond the current year, and allows the execution of permanent, part-time contracts to support entrepreneurs. See https://www.boe.es/boe/dias/2013/12/21/pdfs/BOE-A-2013-13426.pdf.

Research forecasts indicate that the ratio of full-time equivalent jobs to total jobs will continue to drop from the current 87.5% to 87.1% toward the end of 2015 (see Figure 3.20).

Given the economic growth forecasts described above, the expected progress of full-time equivalent employment suggests a **performance of apparent productivity of labour (APL) similar to that recorded during the previous recovery** (see Figure 3.21). To begin with, the labour market reform passed in 2012 introduced structural changes that lead to greater labour flexibility and efficiency gains of a permanent nature. Furthermore, the Spanish economy's production model is changing, and jobs will not be created in the same sectors as in the past. For example, the drop in **APL** in the construction sector during the previous recovery contributed to the poor performance of aggregate **APL**, which will not happen this time (see Figure 3.22). However, the absorption of a significant number of unemployed people with lower productivity levels than those of employed could cause a drop in average **APL**. Given that this compositional effect plays against the previous ones, the uncertainty over the expected progress of APL over the coming quarters is high (see Figure 3.23).

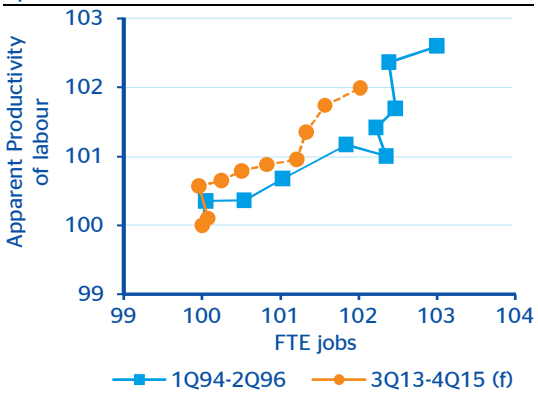
Previously mentioned improvements notwithstanding, **the situation of the Spanish labour market leaves no room for complacency.** Therefore, all measures that facilitate a faster recovery of activity and jobs are welcome. In this regard, the temporary reduction of employers' share of Social Security contributions for new permanent contracts, recently passed by the government, receives a positive assessment. Additionally, **it would be advisable to take advantage of the next tax-system reform to move forward toward a permanent and progressive reduction of the tax burden on labour,** to be offset with an increase of indirect taxes (see Figure 2).

Figure 3.20
Spain: FTE Jobs / Total Jobs (%)



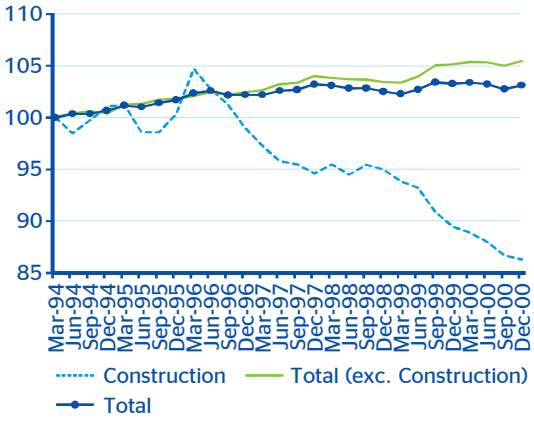
Source: BBVA Research based on INE (National Statistics Institute)

Figure 3.21
Spain: Apparent Productivity of Labour and FTE Employment (Minimum of each employment cycle = 100)



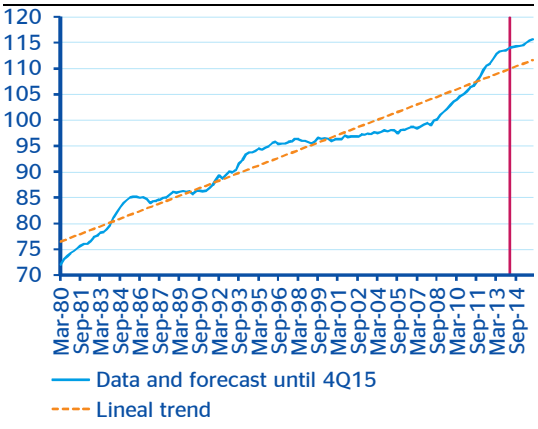
Source: BBVA Research based on INE (National Statistics Institute)

Figure 3.22
Spain: Apparent Productivity of Labour during the Recovery of the 1990s (1Q94: minimum of preceding employment cycle = 100)



Source: BBVA Research based on INE (National Statistics Institute)

Figure 3.23
Spain: Apparent Productivity of Labour (2008 = 100)



Source: BBVA Research based on INE (National Statistics Institute)

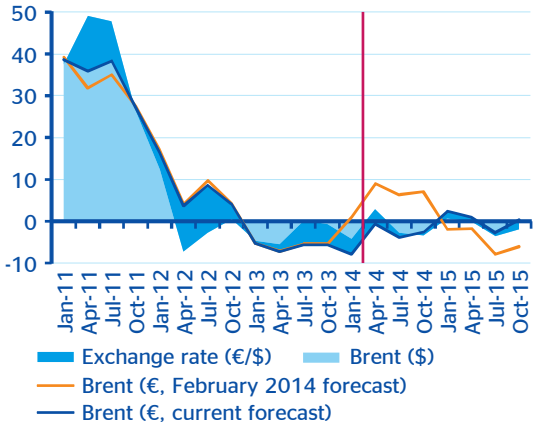
Expectations of low, but positive, inflation

In spite of the gradual recovery expected in activity and jobs, **the unemployment rate will remain high, which will limit the emergence of inflationary demand pressures. On the supply side, upward pressures on domestic prices are not envisaged either,** given that the recovery process of the Spanish economy's competitiveness is fundamentally based on production model changes and structural reforms.

Furthermore, the forecasts presented in this report include a downward **revision to oil prices** (resulting from lower demand by emerging countries)**, and a rise in the euro exchange rate,** both entailing a **greater burden on imported inflation** (see Figure 3.24)[20]. Consequently, **short-term inflation is marginally revised to the downside, but expectations remain for positive and gradual price growth over the mid-term** (see Figure 3.25). Thus, **average inflation is expected to come in at around 0.3% in 2014 and 0.9% in 2015,** which will lead the average inflation differential versus the Eurozone to remain favourable to Spain (around -0.5pp on average).

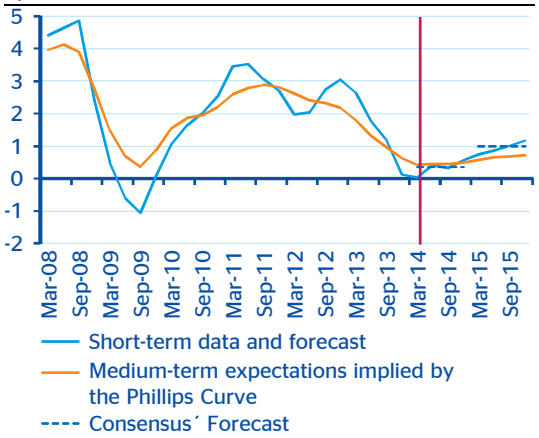
20: BBVA Research estimates indicate that a drop in the price of oil of around 5%, caused by a global demand shock, has an impact of one to two tenths on CPI. For more information on the effects of oil prices on the activity and prices of the Spanish economy, see Box 1 of the 2011 Q2 issue of Situación España magazine, available at:
http://www.bbvaresearch.com/KETD/fbin/mult/1105_Situacionespana_tcm346-256519.pdf?ts=2842014.

Figure 3.24
Price of Oil and Euro Exchange Rate (% YoY)



Note: The euro exchange rate is plotted on an inverse scale, such that negative values correlate with an appreciation.
Source: BBVA Research based on Eurostat

Figure 3.25
Spain: Inflation (% YoY)



Source: BBVA Research based on INE and Consensus Forecasts Inc.

Box 1. BBVA Economic Activity Surveys . An early monitoring tool for taking the economy's temperature

BBVA Research has been carrying out surveys using BBVA's office network on a regional basis for some time now. Their outcomes are regularly published and used in this Research department as a result of the high correlation found between economic activity and the survey's replies, and given that their outcomes are available **before** the principal official bodies publish their statistics.

In some regions such as Catalonia, the usefulness of the indicators provided is more apparent, since the survey has been carried out consistently for over 20 years. However, for the last six quarters the survey has covered the entire country, meaning that the results can start being published for the whole economy on a regular basis. In particular, the 1Q14 survey, conducted between 1 and 15 April, shows that **the economy has continued to accelerate in the first quarter of 2014, and that this improvement may carry through into the second quarter.**

The history of Economic Activity Surveys and what they offer

The first business survey took place at the beginning of European reconstruction, after World War II; it was conducted by Germany's IFO Institute in 1949 and based on interviews conducted with businessmen the previous year. Shortly afterwards, the German model was extended to INSEE, the French statistics body, and its Italian counterpart, the ISCO[21]. The Japanese Tankan index was developed in 1951 with the same methodology as were, subsequently, the PMIs. In Spain, this methodology was first used in 1961 with the Industrial Situation Survey.

Over the last few years, business climate surveys and collecting expert opinions have become established as a means of gauging the economy's health. The combination of relatively simple surveys, with information capture systems enabling them to be processed quickly, together with a selection of interviewees whose knowledge permits them to give instant answers, with a low cost in time yet high added value, mean that these statistics provide important benefits, although they do not replace others quantifying the state of the economy. First, their results are obtained quickly and can generally be interpreted directly. Second, if the sample is big enough, the data can be aggregated or disaggregated relatively easily, without losing comparability. Third, provided the experts consulted and the way of aggregating replies are well chosen, the results of the surveys tends to have a high correlation with the underlying economic variable being analysed. Finally, if there are no quantified and reliable statistics available on the economy's performance (of a region, for example) or if they are published late, a survey allows one to take the economic pulse quickly and reliably, and especially to detect its tipping points, providing much added value in taking business and economic policy decisions.

BBVA's Economic activity survey: over 20 years of analysis

The origin of this type of analysis in BBVA lies in Banca Catalana, in the mid-eighties, with a survey on the economic situation in Catalonia, published quarterly, for which findings have been recorded as far back as the third quarter of 1991. In 2008 it was extended to Andalusia and Extremadura, and it has subsequently been rolled out to all the regions. Starting in the second quarter of 2012, the survey has covered the whole country every quarter. The fieldwork for each wave is carried out over a two-week period, which begins at the end of the quarter to which it refers.

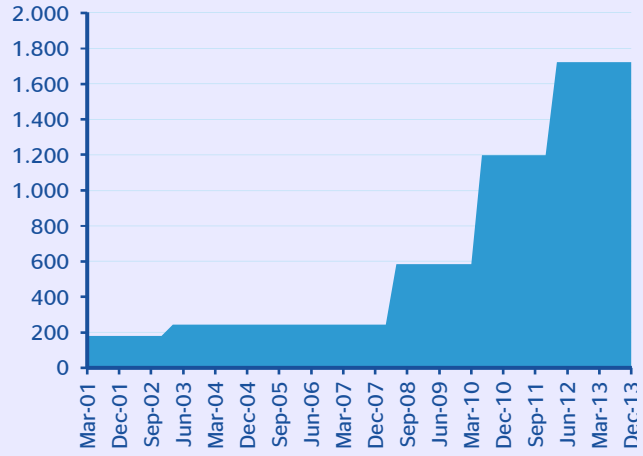
The universe of those surveyed consists of client-facing staff in the office network, who are asked questions about the behaviour of the economy in the branch's catchment area. To this end, the survey uses a relatively similar approach to that of surveys such as the conducted by the IFO, the Tankan and the Industrial Situation Survey by the Spanish Ministry of Industry's. That is, questions are asked, not about the general situation, but about the more specific surroundings in which the respondent has greater knowledge. In the case of the other surveys mentioned, this environment is the company itself, whereas in the case of BBVA, the area of influence is the office in which the person surveyed works. This is from the outset an important difference from other surveys, given that employees are being asked about something on which, although they are bound to have a high degree of knowledge, they do not have direct information. In any event, as is explained in this box, this limitation appears to be more theoretical than practical, when one considers the breadth of information contained in BBVA's Economic Activity Survey. In addition, the methodology used is exactly the same in all regions, which ensures that the data

21: On this, see the methodology used for the Industrial Situation Survey, available here: https://sede.minetur.gob.es/en-us/procedimientoselectronicos/paginas/eci_cuestionarios.aspx

is directly comparable [22]. **The volume of responses, around 1,700 in the last few waves, means that the survey is guaranteed to be representative, not only at a national level, with the information also susceptible to analysis at a regional level** and even, in some cases, in smaller areas.

Figure B.1.1. shows the number of surveys collected on average over time, increasing as more regions have been introduced. Until 2008, the survey was only carried out in Catalonia; in the first quarter of 2008 it was extended to Andalusia and Extremadura; Aragon, Cantabria, Castille La Mancha, Madrid, Navarre, La Rioja and the Basque Country were added in the second quarter of 2010; in the third quarter of 2011, Asturias, Castille León, Galicia and the Canary Islands joined; and finally, in the second quarter of 2012 the offices in the Balearic Islands, the Valencian Community and the region of Murcia started taking part. The results for the Spanish economy as a whole are available since then.

Figure B.1.1
Number of total responses: Economic Activity Survey (average per quarter)



Source: BBVA

One question of particular importance arises from the criteria used for weighting replies. On this issue, there are surveys which do not use any weighting criteria, such as the Japanese Tankan index (which lends its name to the methodology which assigns each respondent a value of 1, whatever the size) or surveys in which different sorts of weighting criteria are used. In Spain, for example, the national statistics body, the INE, does not use weighting criteria when putting together the responses for the Business Confidence Index[23] (although the regions do so when they generate their corresponding regional indexes). On the other hand, surveys such as the Industrial Climate use a double weighting to calculate the indexes [24].

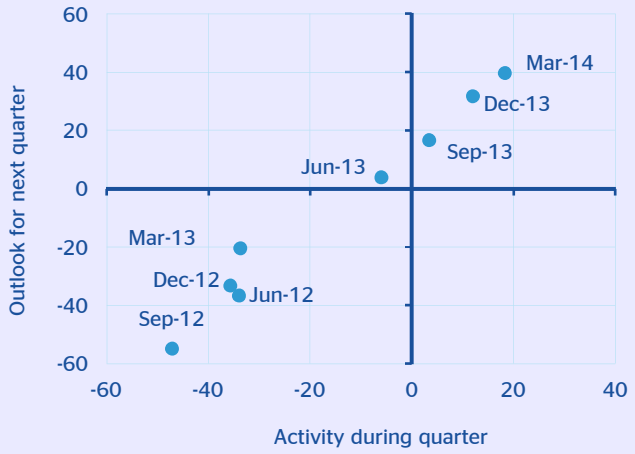
In the case of the BBVA´s Survey the weighting used is double: first, accounting for the volume of business in the surveyed professional's office (equivalent to using a weighting by company size in other surveys) so that those offices with greater business volumes have more weight in the aggregated results. The second weighting used takes into account the province's structure in terms of economic sectors, which involves allocating greater importance when aggregating the replies corresponding to a particular sector to those offices whose business focuses on that sector.

The information is analysed and treated with diffusion indexes, i.e. with balances of extreme replies expressed as a percentage. For example, in the question related to the current economic activity performance "In your understanding, in the area where your office is located, is economic activity compared to last quarter: greater, the same or lower?" the percentage of "lower" "replies (or their weighted percentage) is subtracted from the percentage of "greater" answers.The results available for Spain as a whole appear to be in clear agreement. Figure B.1.2 shows the results of the assessment of the quarter covered by the survey, and expectations for the next quarter. The Spanish economy has shown a noticeable improvement over the past year and a half, according to those surveyed. Specifically, **in the second quarter of 2013 the balance of extreme replies as to forecasts for the third quarter was already signalling an increase in activity. This view was confirmed in the next wave, and in the third quarter the replies indicating more economic activity were more numerous than those indicating a fall.**

Figure B.1.3 shows the relationship between the replies given by the people surveyed as to activity performance over the quarter and GDP growth, according to the National Statistics Institute's Quarterly National Accounts. **The majority view of positive behaviour on the part of the economy coincides with the GDP's return to positive growth;** furthermore, the improvement in the survey's results is coupled with the acceleration in quarterly GDP growth.

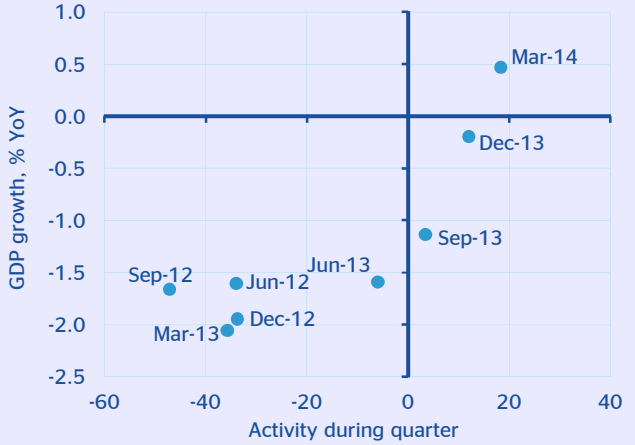
22: On this subject see Segovia Rueda, M., (January 2009) *España PMI® (Purchasing Managers' Index®). Guía del comportamiento de la economía*, Revista Índice, available in Spanish here http://www.revistaindice.com/numero32/p9.pdf
23: The methodology for this index can be downloaded here: http://www.ine.es/metodologia/t37/t3730199.pdf
24: in any event, as is the case with the Business Confidence Survey, analyses carried out on past survey performance show that there are no important trending differences between weighted and non-weighted survey results, so the conclusion will not be misleading.

Figure B.1.2
Spain: activity and forecasts



Source: BBVA

Figure B.1.3
Spain: EAS and GDP activity



Source: BBVA

With a still low number of survey waves covering the whole country, it is difficult to draw conclusions as to the survey's capacity to reflect economic performance, or to forecast its behaviour in the short term, on the basis of outlooks expected by BBVA employees for the next quarter. Nevertheless, the archive information from the surveys in Catalonia does shed some light on the reliability of the BBVA Economic Activity Survey as an analytical instrument.

In the case of **Catalonia**, the existence of **historic series from the third quarter of 1991 means that a longer-term analysis can be made** to test more robustly how close the surveys come to reality. Thus, figure B.3.4 shows Catalonia's quarterly GDP from 3Q91 (calculated by BBVA using its MICA-BBVA CAT[25] model) and its relationship with the information provided by the survey (with standardised and seasonally adjusted data).

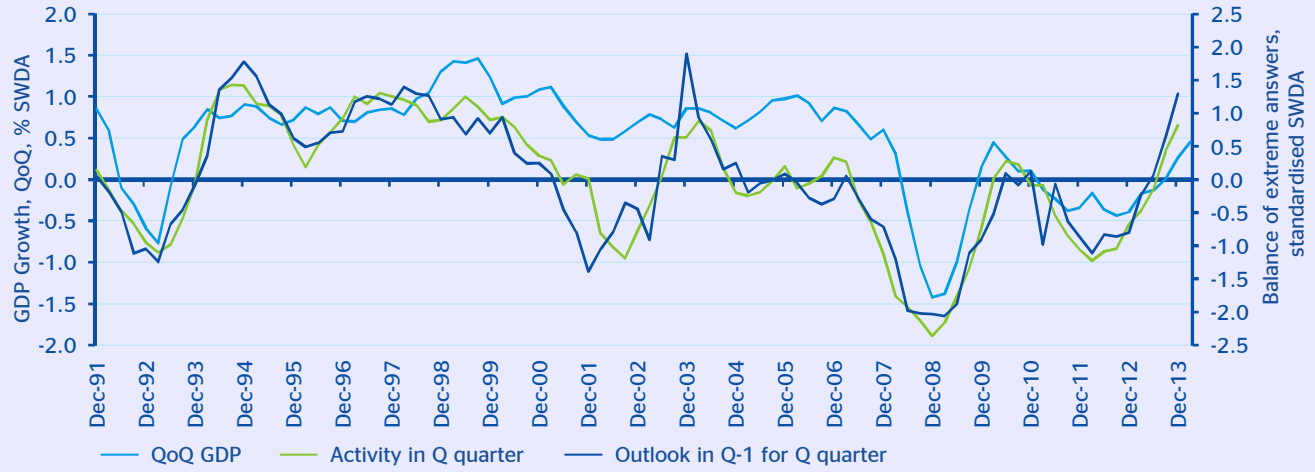
Once again, there are three important findings. First, there is a high correlation (0.89) between seasonally-adjusted data for the next quarter's outlook in wave *t* and the change in activity actually detected in wave *t+1*. In addition, there is also a high correlation between both expectations in *t-1* and economics activity observed in *t* and quarterly GDP (0.78 in both cases). The most discordant note is sounded in 2001, but this is true of most confidence surveys, which underwent a much greater correction than that experienced by GDP.

Finally, the survey shows a high level of reliability in indicating the economy's phase in terms of expansion or contraction: if the survey data are standardised from 3Q91, the economic trend has coincided with that shown by GDP in 76% of cases. If only the information from 2001 onwards is used, the proportion of times that the survey gets the direction of economic activity right is 90%.

In summary, **the BBVA Economic Activity Survey presented in this box is an additional instrument for short-term economic predictions, which enables us to discover the Spanish economy's position and perspectives.** It is put together in a similar manner to other types of surveys which have proven their usefulness for these effects; and indeed in those regions where there is a bigger sample, there is a high correlation between activity indicators and the survey responses. On this occasion, **the results confirm that activity has accelerated in the first quarter of this year over the last quarter of 2013 and that the forecasts are for this growth to continue into the second quarter of 2014**.

25: See Situació Catalunya, 1st half 2010, "Estimacions en temps real del PIB regional: resultats per a Catalunya", available here (in Catalan): http://www.bbvaresearch.com/KETD/fbin/mult/1011_situaciocatalunya_tcm346-238510.pdf?ts=2442014.

Figure B.1.4
Catalonia: BBVA Economic Activity Survey and GDP



Source: BBVA

Box 2. Does the cut in employers' Social Security contributions represent a first step towards fiscal devaluation?

Introduction

This box explains the nature of the recent cut in employers' Social Security contributions and assesses the likely impact on economic activity. The results of our simulations show that the measure will have a positive impact on GDP (between two and three decimal points), on employment (between six and seven points) and permanent contracts , by reducing the cost of labour and making temporary contracts relatively more expensive. However, various issues could limit the expected benefits. These include the temporary nature of the measure, uncertainty over how it will be financed, and the fact that savings for the employer increase more than proportionally with the contribution base. It would be desirable to use the forthcoming reform of the tax system to move towards a permanent, progressive reduction of taxes on labour, to be offset by an increase in indirect taxation.

Description of the measure

At the end of February, the Spanish government approved a significant cut in employers' Social Security contributions for new, permanent contracts signed between 25 February and 31 December this year with the objective of fostering stable job-creation[26]. The rebate consists of a flat-rate employers' contribution of EUR100 per month in respect of ordinary contingencies for new employees under full-time permanent contracts, and a flat rate of EUR75 or EUR50 for part-time permanent contracts depending on the number of working hours concerned. Employers will benefit from the rebate for 24 months[27] providing they meet the following conditions:

- The firm must be up-to-date with all tax and Social Security obligations at the date of hiring and must remain so while the contribution rebate is applicable. Employers disqualified from benefits under job-creation schemes as a result of infractions will not be eligible for the rebate.
- The firms qualifying for the rebate may not be preceded by the application of redundancy plans within the last six months.
- The firms qualifying for the rebate may not be preceded by any individual terminations on disciplinary or objective grounds found by the courts to constitute unfair dismissal within the last six months[28].
- New permanent contracts must increase both the number of permanent jobs and the firm's total headcount compared to the previous month.
- The level of permanent jobs and the total headcount resulting from the new contract must be maintained for a period of at least 3 years. Objective and disciplinary dismissals on fair grounds will not be taken into account for these purposes.

Employers failing to meet any of the conditions for application of the rebate will be required to redress the benefits applied, either in whole or in part depending on the infractions concerned.

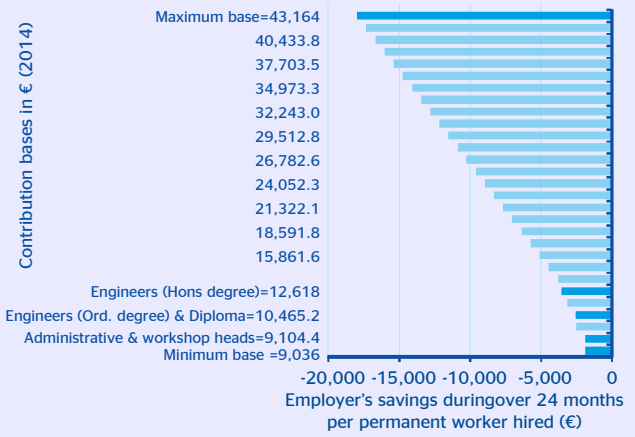
Pros and cons: a qualitative assessment

The cut in employers' contributions for new permanent contracts is a welcome measure, which will lower firms' labour costs and could, therefore, help foster job-creation by encouraging firms to bring forward hiring from 2015 to 2014 (anticipation effect) and speed up the process of internal devaluation, thereby helping to restore the country's competitiveness. Furthermore, the measure explicitly targets permanent contracts, and it should therefore reduce the rate of temporary employment. A further positive feature of the measure is its simplicity. The reform is easy for employers to understand and assess, which should ensure quick, widespread uptake. Finally, there may be some increase in labour market mobility between firms, because the rebate in Social Security charges is not restricted to contracts made with the unemployed or economically inactive population.

However, certain objections to the measure might be made. In the first place, the reform comes after labour costs were raised still higher by the inclusion of remuneration in kind in the Social Security contribution base at the end of 2013[29]. Second, by construction, the rebate's relative benefits for employers decrease as the employee´s contribution base increases. Workers with low contribution bases are, however, the ones more likely to be jobless -and those for whom labour demand is more sensitive to changes in labour costs[30]. As it can be seen in Figure R.2.1, the benefit ranges from 22% for the minimum contribution base to 42% for the maximum.

26: See Royal Decree Law 3/2014, of 28 February, concerning urgent measures to foster job-creation and permanent contracting, available at: http://www.boe.es/boe/dias/2014/03/01/pdfs/BOE-A-2014-2220.pdf
27: Firms with less than ten employees will be entitled to a 50% cut in their ordinary contingencies contribution for a further 12 months for any new employees taken on under permanent contracts.
28: Redundancies or dismissals prior to 25 February 2014 will not apply for these purposes.
29: See BBVA (2014).
30: See Orsin *et al.* 2014.

Figure B.2.1
Spain: Maximum saving on employers' Social Security contributions per permanent employee contracted under the new scheme (cumulative over 24 months)



Source: BBVA Research

Third, the reform consists of a temporary measure, and thus it will not provide a definitive solution to the segmentation of the Spanish labour market as it fails to address the perennial gap between the costs inherent to permanent and temporary contracts of employment. Finally, it carries, like all such incentives, a "deadweight cost" because it will benefit a certain number of jobs at the margin which would have been created in any event[31].

Quantification of macroeconomic effects

A cost-benefit analysis is needed to assess the reform in terms both of direct costs and of the effects of the resulting reduction in labour costs on jobs and the economic activity, unemployment benefits paid, and tax revenues.

Two simulations of the rebate's short-term effects have been run, with similar results in both cases. The first consisted of inferring the effects on employment and economic activity of a reduction in the cost of Social Security contributions payable on new, full-time hirings. Under prudent assumptions with regard to the evolution of the Social Security contribution rate, the rate of temporary employment and the behaviour of employers (see Appendix), the measure will provide an additional 0.6% cut in gross wage costs for the Spanish economy as a whole in 2014. This reduction in labour costs will give rise to a 13.3% increase in the number of permanent contracts made in 2014 compared to the base scenario, translating into additional full-time equivalent (FTE) job-creation of 0.7% in 2014 (around 110,000 FTE jobs).

The second simulation was carried out using the REMS model (Boscá *et al*., 2011)[32], which allows examination of the general equilibrium effects of the flat rate established. In this case, the reduction in employers' contributions would cause a 0.6% increase in FTE employment compared to the base scenario over the ten months in which the measure will be applied[33]. The additional jobs created would in turn raise consumer spending by around three decimal points in 2014 compared to a scenario with no rebates, producing a 0.2% increase in GDP.

Taking into account both the direct and induced effects, it is estimated that the measure will produce savings in unemployment benefits and additional tax revenues totalling around EUR1.2bn. Overall, though, the budgeted cost of the measure (EUR2.5bn) will result in restrictions on other fiscal policy measures designed to reduce the tax burden in the short run.

What if the cut was permanent?

Despite the temporary nature of the reform, we have for the sake of argument simulated long-run effects under the hypothesis of a permanent cut in employers' Social Security contributions for all new permanent contracts resulting in the accumulation of effects over time so that all existing permanent contracts would eventually be renewed.

Like the quantification of effects for 2014, reasonable assumptions were made about the evolution of the temporary employment rate, the labour careers of permanent employees, the adoption of supplementary measures to ameliorate the segmentation of the labour market, and the adoption of policies to cut public spending in order to achieve balanced budgets in the long run (see Appendix). In this scenario, the rebate would reduce wage costs by 2.4% if it were made permanent. This figure is the outcome of comparing the net present value of labour costs in respect of all permanent contracts with and without the rebate for the first two years of the contract (including the 50% reduction in the contribution for ordinary contingencies in the third year for firms with less than 10 employees).

In case of an optimum design of additional measures, the reduction in wage costs would generate a long-term increase in employment of 3.1% (around

31: In 2013 a total of 94,600 permanent contracts were made per month even in the absence of the rebate.
32: REMS is an acronym of "Rational Expectations Model for the Spanish economy". For further details of the model, see Boscá *et al*. (2011).
33: Job-creation is slightly lower than in the first simulation, because one of the measure's secondary effects is to raise the overall wages earned by employees slightly.

500,000 jobs).[34] This outcome would be less attractive if the budgetary cost of the measure were offset by increasing taxes rather than cutting government transfers. Even in the case of less distorting (i.e. indirect) taxes, the fiscal adjustment would have a negative impact on the economic activity and on employment, as Boscá, Doménech and Ferri (2013) found in the case of fiscal devaluation.

Fiscal devaluation: the optimum alternative

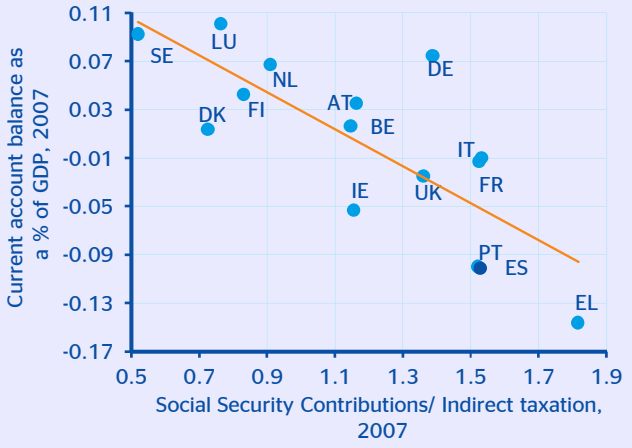
As mentioned at the beginning of this box, the temporary reduction in employers' Social Security contributions in respect of ordinary contingencies for new permanent employees will intensify the process of internal devaluation in the Spanish economy. Against this proposal, in the long run it would be preferable to move towards a permanent, across-the-board cut in employers' contributions for all employees, although this might be more modest. The higher cost of such an alternative could be offset by an increase in indirect taxation. This redistribution of the tax burden would result in a fiscal devaluation that would have significant effects for economic activity and employment.

As the economic literature shows[35], a reduction in employers' Social Security contributions would lower labour costs and moderate the prices of domestically produced goods and services, while an increase in indirect taxes, and especially VAT, would raise the relative prices of imported goods (given that exports are VAT exempt). This policy would, then, improve competitiveness-prices of the economy. As reflected in Figure B.2.2, Spain has significant room for improvement.

A necessary condition for the success of fiscal devaluation is the degree to which changes in the tax system are passed through to the final prices of goods and services. The greater the competition in product markets and the lower the level of wage pressures, the larger will be the effect of any cut in Social Security taxes on the prices of exported goods. Likewise, the prices of imported goods would rise considerably if importers passed on any increase in VAT in order to maintain their profit margins.

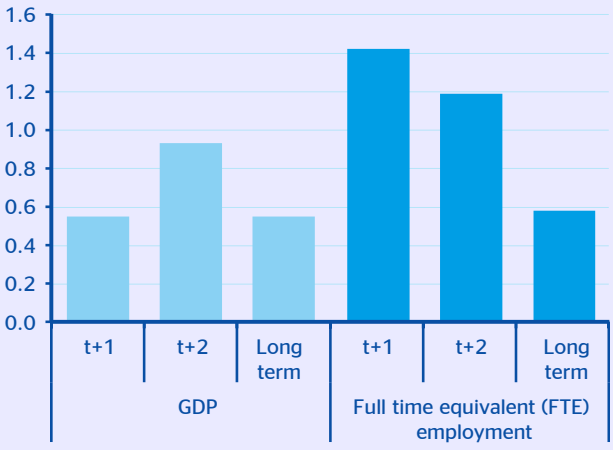
Therefore, the method used to assess the potential macroeconomic repercussions of fiscal devaluation needs to account for the dynamic responses of the agents interacting in the economy to changes in taxation, given the rigidities which may exist in price- and wage-setting mechanisms. Using the REMS model, BBVA (2009) and Boscá, Doménech and Ferri (2013) calculated the effects of a 3.5 point cut in the effective rate of employers' Social Security contributions financed by a 2 point increase in indirect taxes. The consequences of this fiscal devaluation would be positive in terms of both jobs and economic growth. As shown in Figure B.2.3, creation of equivalent full-time jobs would be on average 1.3% higher than in the scenario without reform in the first two years (over 200,000 FTE jobs), and GDP would increase by an additional 0.7 percentage points. In the long run, wage pressures would moderate job-creation figures to an additional 0.6% compared to the base scenario.

Figure B.2.2
EU 15: relationship between the current account balance and implicit Social Security contribution rates



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

Figure B.2.3
Spain: estimated effects of fiscal devaluation: -3.5 pp cut in employers' contribution, +2 pp increase in indirect taxes (% change compared to base scenario)



Source: BBVA Research based on BBVA (2009), and Boscá, Doménech and Ferri (2013)

34: We did not consider other recently approved measures like the extension of the contribution base to all formerly exempt remuneration items, which would partially offset the gains described in this box.
35: See European Commission (1993), BBVA (2009), Boscá, Doménech and Ferri (2013), and Orsini et al. (2014), among others.

In short, the temporary cut in employers' Social Security contributions will help moderate the temporary employment rate in the Spanish economy and will provide a boost for the creation of permanent jobs and economic growth in the current year. Despite the measure's weaknesses (i.e., its temporary nature, problems of fairness and a significant deadweight cost), we estimate that it will increase employment by 0.7% and GDP by 0.2% in 2014 compared to a scenario with no reform. Taking both direct and induced effects into account, we believe the measure will allow the recovery of half of the budgeted cost (EUR1.2bn), which will result in short-term restrictions on other fiscal policies.

Although the flat rate will temporarily intensify the process of internal devaluation in the economy, it would be desirable to move towards a redistribution of the tax burden that would permanently reduce the taxation on labour while raising indirect taxes. This fiscal devaluation would have significant short- and long-run effects for jobs and the economic activity in Spain.

Appendix

Assumptions applied to estimate the effects of reducing employers' Social Security contributions for new permanent contracts:

- In our base scenario, net job-creation (45.000 employees, 35.000 full-time equivalent jobs) implies between 1.1 and 1.2 million permanent contracts made in 2014.
- In the short term, it is assumed that this job-creation will hardly affect the percentage of employees on temporary contracts. Accordingly, 81% of people in work will be wage earners on permanent contracts and self-employed workers.
- The flat rate represents on average 55% cut in the effective contribution rate. This assumption reflects the average reduction in the contribution rate paid by Spanish firms.
- The following assumptions were applied in the calculation of the measure´s effects in 2014:
  - Firms with more than 10 employees will internalize the reduction in Social Security contributions for 2015 applying a 9.5% discount rate (interest rate at 4% and probability of 4.5% that the new indefinite will have terminated one year later).
  - Firms with less than 10 employees (around 40% of total jobs) will also internalize the 50% cut in Social Security contributions during 2016.
- The following assumptions were made to estimate long-run effects on employment:
  - The maximum survival horizon for permanent contracts is 38 years and the temporary employment rate converges with the EU average as a result of additional measures designed to mitigate the duality between permanent and temporary contracts.
  - Non-distorting measures will be adopted to lower public spending and rebalance the budget in the long run (e.g. cuts in government transfers).
- The real wage elasticity of employment is assumed to be 1.5 based on the estimation of structural VAR for the Spanish economy[36] and the results obtained from the REMS model.

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http://ec.europa.eu/economy_finance/publications/country_focus/2014/pdf/cf_vol11_issue5_en.pdf

36: See BBVA (2013).

Box 3. The effect of anti-competitive regulation on the real exports of firms in Spain

This box quantifies the consequences associated with lowering service sector barriers to competition on the export segment of Spain's manufacturing industry. The results of the analysis reveal that **easing competition restrictions on the provision of key services for manufacturers has a positive and significant effect on export volumes** at the firm level. Estimates suggest that the largest firms substantially increased their exports as a result of the deregulation of the 1990s and 2000s. On the other hand, **SMEs received less of a boost in exports**, possibly ending up at a relative disadvantage in terms of getting the best contractual conditions arising from deregulation in the provision of services. Had the Spanish economy adopted the best regulatory practices for services in the 1992-2008 period, the export volume of large manufacturing firms would have been, on average, 18% higher.

Motivation

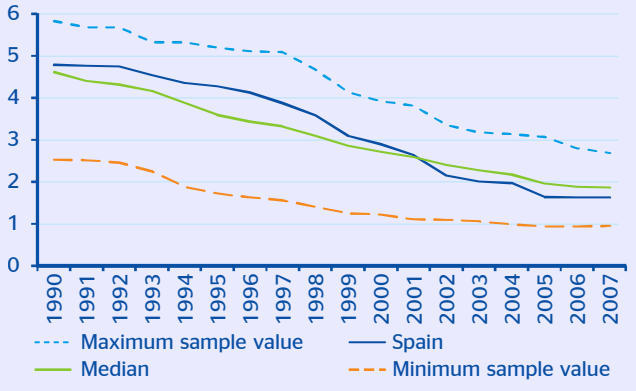
Within a coordinated effort to foster competition in European countries, in the 1990s Spain began to deregulate a significant part of its service sector, which had hitherto been dominated by state monopolies. **The change of the regulatory framework entailed an easing of effective barriers to entry for new firms, favouring market structures that were capable of generating more competitive results** in suitable service markets (such as energy, transportation, communications, retail sales and professional services). Within this context, **Spain made a considerable deregulation effort**, which led to an improvement of the country's position on the OECD's Product Market Regulation (PMR) aggregate ranking, from 7th of 20 economies in 1990 to 16th at the dawn of the financial crisis (see Figure B.3.1)[37].

The quantification of the economic impact of this set of reforms in OECD countries is now being addressed in the literature[38], with a particular focus on its effect on the industrial sector. Barone and Cingano (2011), for example, found that countries with a more competitive regulatory framework for services boasted higher added value, productivity and export growth rates in the manufacturing sectors that most intensively use services as production process inputs. From this result, we can infer that **regulation of the service sector influences the specialisation and international trade patterns of advanced economies.**

In this context, and in light of their exposure **to the competitive pressure of international markets, we can expect inadequate service sector regulation to be particularly detrimental to goods-exporting firms.** The theoretical mechanism that links regulation with export volumes at the firm level operates through **intermediate input prices** or, in more general terms, through the contractual conditions of exchange between service providers and goods-producing companies. In a context of deregulation, in which the number of competitors in the service market rises or the contractual bargaining power of service providers falls, exporting firms would rely on the pro-competitive effects derived from the lower costs of input services.

For purposes of quantifying the economic benefit of eliminating competition barriers in the service sector, **the following sections present an estimate of the effect of deregulation on the export volumes of Spanish firms.** The Spanish case stands out not only due to the deregulation drive of the 1990s and 2000s, but also because Spain's economy kept a relatively stable share of exports in GDP, even though a considerable proportion of economic resources was channeled into meeting the growing domestic expenditure needs during the pre-crisis expansionary period (see Figure B.3.2).

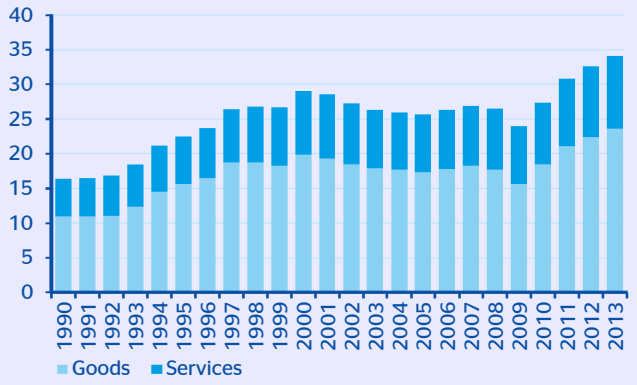
Figure B.3.1
OECD: Product Market Regulation Indicator, statistics for Spain and 20 OECD countries



Note: The PMR takes values from 0 to 6, such that a lower value of the indicator proxies a more efficient product market.
Source: BBVA Research based on OECD

37: The PMR is an aggregate indicator that measures regulatory conditions in product markets (see Conway and Nicoletti, 2006). The indicator takes values from 0 to 6, such that a lower indicator value captures a more efficient product market.
38: See, for example, Barone and Cingano (2011) and Bourlès *et al.* (2013).

Figure B.3.2
Spain: Share of goods and services exports in GDP



Source: BBVA Research based on INE (National Statistics Institute)

Data and econometric strategy[39]

Based on data from the *Business Strategies Survey* (ESEE), conducted by the SEPI Foundation, **an annual sampling of 1752 export companies from 10 manufacturing sectors was analysed for the 1991-2008 period[40].** In turn, the sample was divided into two sub-samples in accordance with firm size: 647 large firms (over 200 employees) and 848 SMEs (10 to 200 employees), to assess if there is a differential effect of anti-competitive regulation in services according to firm size[41]. The panel data is unbalanced, with an average number of observations per firm of eight years.

As shown in Table B.3.1, **large exporting firms have a higher volume of foreign sales, are more efficient, older, make more intensive use of capital per employee, and present a better financial position when compared with SMEs.** Furthermore, they have a greater market share in their main market and a higher presence of foreign capital in their ownership structure.

Table B.3.1
Spain: Descriptive statistics of exporting firms in manufacturing, 1991-2008

	Large Export Companies		Export SMEs	
Variables	Mean	Standard Deviation	Mean	Standard Deviation
Real Exports (in logs)	16.57	1.73	13.43	1.89
TFP (in logs)	2.75	1.50	2.53	1.22
Real Capital Stock per Employee (in logs)	10.67	0.82	9.89	0.94
Size (in logs)	6.31	0.75	3.77	0.81
Market Share in Main Market (%)	19.99	22.39	10.94	19.67
Long-Term Debt-to-Own Funds Ratio	0.35	5.54	0.51	2.57
Age (in logs)	3.32	0.83	2.83	0.91
Foreign Interest (%)	46.45	47.59	13.15	32.08

Note: firm size is measured by number of employees.
Source: Correa-López and Doménech (2014)

The variable that measures **anti-competitive service sector regulation (*REG*) is built from two different data sources,** which are combined as follows:

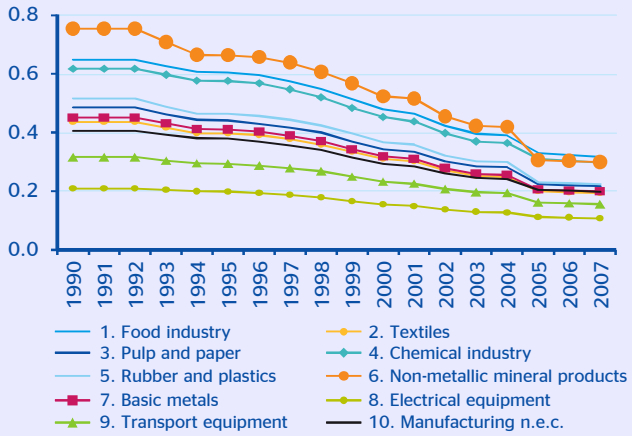
$$REG_{jt} = \sum_{s=1}^{4} \omega_{js} Z_{st}\,, \qquad (1)$$

where Z_{st} captures the time evolution of the regulation indicators of four service sector activities (specifically: energy, transportation, communications and professional services), and ω_{js} estimates the dependence of the manufacturing industry j on the inputs produced by the activity of services s. The set of indicators included in Z_{st} **quantifies information on the existence of restrictions to competition in market *s*, classified into three areas: barriers to entry, vertical integration and market conduct[42].** The measurement of manufacturers' direct dependence ω_{js} is obtained from the technical coefficients of the harmonised Input-Output Tables published by the OECD. The baseline used by the basic model is the regulation variable built from the US Input-Output Table for the year 2000, although results based on the UK's Input-Output Table for that year are also presented[43].

39: The analysis presented below is based on Correa-López and Doménech (2014).
40: All companies that exported in all of the years in which they appear in the sampling were considered exporting firms.
41: Companies that changed size tiers during the sampling period were thus excluded. Worth noting is that the business size definition is in accordance with ESEE representativeness criteria.
42: A detailed description of the indicators is available at the OECD Product Market Regulation Database, www.oecd.org/economy/pmr.
43: The literature often uses the Input-Output coefficients of the country which shows, on average, the lowest level of anti-competitive regulation of the available sample (in this case, the US for the 1975-2007 period and the UK for the 1990-2007 period), in order capture, as close as possible, the technological dependence of each manufacturing industry for each service sector activity.

Figure B.3.3 displays the evolution of the regulation indicator for the ten manufacturing sectors included in the sample. The variability observed among sectors over time reflects differences in each manufacturing industry's level of dependence on the service sector, in the composition of service sector activities included as inputs and in the deregulation level and trend of each service.

Figure B.3.3
Spain: Indicator of anti-competitive service sector regulation by manufacturing Industry



Note: Higher values of the indicator reflect a greater impact of anti-competitive service sector regulations on manufacturing.
Source: Correa-López and Doménech (2014)

Subsequently, **a specification in which real exports (in logarithms) - *lnx* - are determined by a set of explanatory** variables is estimated, as follows:

$$lnx_{it} = \alpha + \beta lnx_{it-1} + \gamma \Pi_{it} + \delta REG_{jt-1} + \Phi dev_t + \eta_j + \lambda_t + \mu_i + \varepsilon_{it}, \quad (2)$$

where the lag of the dependent variable captures export persistence. Π_{it} is a vector of variables which include firm attributes such as Total Factor Productivity (TFP), capital intensity, size, market share, long-term debt-to-own funds ratio, company age and dummies for foreign multinational status and recessionary market. Given that deregulation can affect exports with a certain lag, the regulation variable enters lagged by one period. Furthermore, a dummy variable which captures nominal devaluations of the peseta is included, as well as year and industry effects. Lastly, the error term includes two orthogonal components: fixed effects and an idiosyncratic part. **The model is estimated by System Generalised Method of Moments** (Arellano and Bover, 1995; Blundelly Bond, 1998), which allows addressing endogeneity problems[44].

Results

Large Firms

Columns 1 and 2 on Table B.3.2 show the model's estimate for the sample of large firms. **The results point to the existence of a negative and significant effect of anti-competitive regulation in the provision of services on the export volumes of large manufacturing firms.** The magnitude of the effect is not trivial: a point estimate of -1.189, as noted in column 1, entails an **elasticity of exports to services regulation of -0.43%.** In addition to the importance of persistence mechanisms, the results indicate that capital intensity, firm size and, particularly, TFP have a positive and significant effect on the foreign sales of large manufacturing firms. Specifically, in accordance with the results presented in column 1, **a 1% increase in TFP is associated with a 1.3% increase in exports, and a 1% increase in company size correlates with a 0.7% growth in exports.** Furthermore, being owned by a foreign multinational entails greater export activity. Lastly, the results reveal that the devaluations of the first half of the 1990s had a positive and significant effect on export volumes at the company level, while age presents a negative correlation with export activity. In contrast, company market share and the ratio of its long-term debt with financial institutions are not significant determinants of export volumes. With respect to this last point, the long-term debt ratio may capture the channel through which large firms finance long-term investment projects or entry into export markets, instead of using it to cover the variable and less substantial costs of selling abroad.

To examine the relative role of the regulatory framework of each of the four service sector activities, disaggregated regulation indicators for each service were constructed. Subsequently, these indicators were included, alternatively, in the econometric specification that explains export volumes at the firm level. Columns 3 and 4 on Table B.3.2 present the model's estimates for those regulation indicators that are significant when the US Input-Output Table is used as baseline. The point estimates of energy and transportation regulation have the expected signs, with exports having an average elasticity to regulation of -0.1% and -0.23% respectively, while the results for the rest of the variables remain robust. This evidence suggests that **the deregulation of the transportation and energy sectors which began in the early 1990s in Spain had particularly large effects for the volume of foreign sales** of large manufacturing firms.

44: The recommendations of Roodman (2009) were followed with respect to restricting the number of lags that are used as instruments for each endogenous variable and collapsing the instrument matrix. Furthermore, the validity of the instruments (Hansen and Difference-in-Hansen tests) and of the specification (Arellano-Bond test) were systematically tested. For further details, see Correa-López and Doménech (2014).

Table B.3.2
Spain: Determinants of real exports, large firms, 1992-2008

Dependent variable: logarithm of real exports

	(1) US 2000	(2) UK 2000	(3) US 2000	(4) US 2000
Regressors	**Aggregate**	**Aggregate**	**Energy**	**Transportation**
Log exports (t-1)	0.360***	0.357***	0.360***	0.357***
TFP (in logs)	1.332***	1.355***	1.345***	1.344***
Real K Stock per Employee (in logs)	0.369*	0.369*	0.368*	0.361*
Size (in logs)	0.682**	0.687**	0.681**	0.669**
Market Share (%)	0.000	0.000	0.000	0.000
Long-term Debt Ratio	-0.001	-0.001	-0.001	-0.001
Age (in logs)	-0.094***	-0.096***	-0.095***	-0.094***
REG (t-1)	-1.189**	-1.582***	-2.831*	-1.621*
Devaluation	0.533**	0.650***	0.408**	0.402**
Multinational	0.142**	0.142**	0.143**	0.144**
Recession	0.419	0.418	0.426	0.438

Notes: all specifications include a constant and industry and year dummies; *** denotes statistical significance at 1%, ** at 5% and * at 10%; GMM estimation; standard errors corrected (Windmeijer). The devaluation dummy takes a value of 1 in 1992, 1993 and 1995. The estimates across columns differ in the Input-Output Table used as baseline, as well as in the level of aggregation of services regulation.
Source: Correa-López and Doménech (2014)

Small and medium-sized enterprises

Given their lower bargaining power, theoretical mechanisms suggest that **the relationship between regulation and SMEs' export volumes** could be less significant than the one quantified in the case of large firms. Indeed, after estimating the baseline specification for SMEs using the aggregate regulation indicator, no evidence was found to support this study's hypothesis. However, if the regulatory framework of each service is considered separately, **evidence is obtained of a negative relationship between anti-competitive regulation in energy-related services and the export volume of smaller-sized companies.** Columns (1) and (2) of Table B.3.3 illustrate this result. When the relationship is significant, the magnitude of the effect of regulation on exports is relevant, roughly -0.14% in terms of elasticity. **Table B.3.3 also reveals the importance of TFP and company size as determinants of SME export volumes, with elasticities of 1.9% and 1%, respectively**. Moreover, the estimates suggest that, in the case of SMEs, a recessionary domestic market and the number of industrial establishments are negatively correlated with exports. Among other factors, this last result might reflect the presence of a growth strategy which favours reaching the domestic market over accessing foreign markets by increasing scale or improving location.

Table B.3.3
Spain: Determinants of real exports, SMEs, 1992-2008

Dependent variable: logarithm of real exports

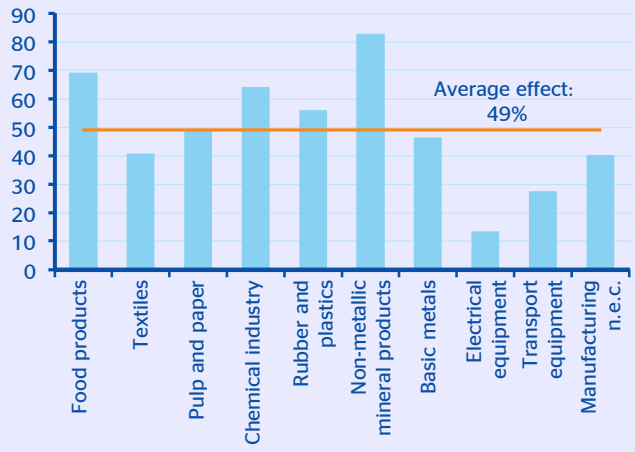
	(1) US 2000	(2) UK 2000
Regressors		
Log exports (t-1)	0.363***	0.364***
TFP (in logs)	1.904***	1.908***
Real K Stock per Employee (in logs)	0.246	0.244
Size (in logs)	0.999***	1.004***
Long-term Debt Ratio	0.007	0.006
Age (in logs)	-0.111*	-0.110*
ENERGY REG(t-1)	-2.414	-2.596*
Devaluation	1.567***	1.656***
Multinational	-0.180	-0.183
Recession	0.901***	0.910***
Industrial Establishments (units)	-0.460***	-0.461***
Financial Depth	0.063	0.060

Notes: see notes to Table B.3.2; the level of financial depth is measured by the product of the country's financial development (estimated by the private sector credit to GDP ratio) and the short-term liquidity needs of the manufacturing sector (estimated by the inventory to sales ratio of US industries for the 1980-1999 period), see Kroszner*et al.* (2007)).
Source: Correa-López and Doménech (2014)

Simulations

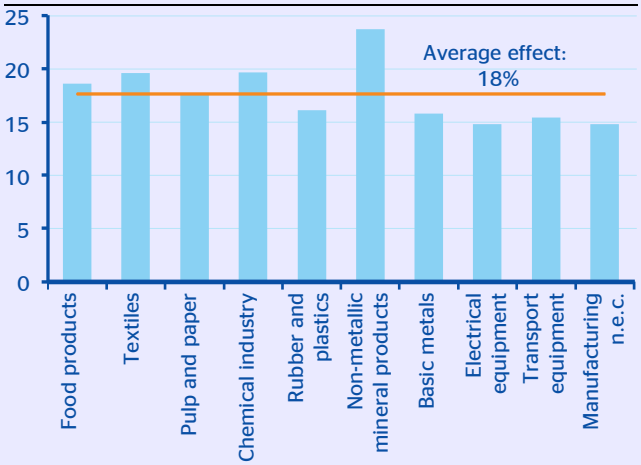
Using the model estimation for large firms reported in column (1) of Table B.3.2, **two simulation exercises were conducted for the purposes of illustrating the impact on exports of adopting a more efficient service sector regulatory framework.** The first exercise compares the total volume of exports at the industry level simulated by the model with its counterpart under the assumption that, all other things being equal, the regulation of each service would have remained constant at the 1990 level throughout the entire sample period. **Figure B.3.4 shows that the effect of lower service sector regulation on exports had significant effects:** from the lower gains recorded in electrical and optical equipment (13.4%) and transportation materials (27.7%), to the greater gains obtained by the chemical (64.2%), food (69.4%) and non-metallic mineral product industries (82.9%).**On average, large firms exports rose by 49%** between 1992 and 2008 as a result of reducing competition restrictions in the service sector. Furthermore, Figure B.3.5 quantifies the impact on real exports of adopting the "best regulatory framework" over the sample period, the latter defined as the average of the regulation indicators of the three OECD countries with the most favourable regulation for competition in 2007. **Once again, the simulation exercise confirms that the adoption of the best regulatory practices in services would have increased real exports of goods by 18% on average.**

Figure B.3.4
Simulation I: Effect on exports of deregulation vs. non-deregulation from 1990 onward, large firms, total variation by industry in %



Source: Correa-López and Doménech (2014)

Figure B.3.5
Simulation II: Effect on exports of adopting the best regulatory practices, large firms, total variation by industry in %



Source: Correa-López and Doménech (2014)

Conclusion

The economic literature has established the positive effects that competition exerts on employment, productivity, inflation and growth[45]. This recent effort notwithstanding, **many of the externalities associated with the development of an efficient regulatory framework have yet to be assessed.** This box has made progress in quantifying the consequences on manufacturing exports of lowering barriers to competition in the service sector. **The analysis has shown that the effects of deregulation are positive, of considerable magnitude, and that differ with firm size.** Thus, large firms significantly increased their real exports as a result of the deregulation of the 1990s and 2000s. On the other hand, SMEs received less of a boost to exports, possibly ending up at a relative disadvantage with respect to getting the best contractual conditions arising from the deregulation of the provision of services.

Given that the regulatory context in which the markets for goods operate in Spain is still far from being efficient (OECD, 2014), **we can expect the convergence with the most advanced countries in matters of competition to once again increase the volume of exports** of manufacturing companies. The new export drive would be accompanied by a more intensive use of those service sector segments in which less progress in matters of competition has been achieved, specifically, in professional services for businesses.

45: See Arnold et al. (2011), Barone and Cingano (2011) and Fiori et al. (2012), among others.

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4. The improvement in activity will lead to a further reduction in the deficit

At the close of 2013, the deficit for general government bodies came in at 6.6% of GDP[46], meaning that the stability target was practically met (see Figure 4.1). As explained in more detail below, a significant effort has been made in 2013, which increases the probability of Spain meeting the 2014 target. This is, thus, an important step in ensuring the sustainability of public accounts, bolstering the credibility of the government's deficit reduction process.

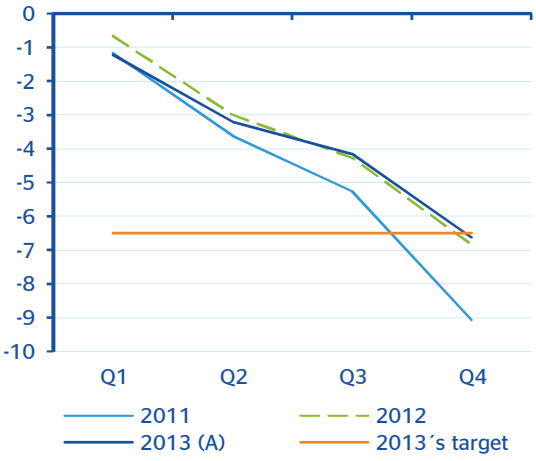
Although barely two tenths lower than the deficit recorded at the end of 2012, the 2013 deficit figure denotes a continuation of the fiscal effort made in prior fiscal years, given the adverse context faced by public revenues and expenditures, which were exposed to the economic cycle, financial market stress and demographic trends. According to our estimates, all these factors increased the deficit in 2013 by around 1.8 percentaje points (pp) of GDP. Consequently, if they were to offset the cyclical and structural deterioration, **Spanish governments overall had to implement an adjustment of roughly 2.0 pp of GDP, to thus be capable of reducing the deficit to 6.6% of GDP. While the adjustment was less intense than that seen over 2012** (around 5.3pp), it was nevertheless considerable.

At a government level, **the adjustment was once again centered on the Autonomous Communities which**, although failing to meet their target (-1.3% of GDP), closed 2013 with a deficit of 1.5% of GDP, 0.3pp less than in 2012. For their part, local corporations (city and provincial councils) improved their 2012 performance by two tenths and recorded a surplus of 0.4% of GDP, thus exceeding their balanced-budget target. Lastly, **the numbers for both the central government and, especially, the Social Security came in worse than those they recorded for 2012**. The central government increased its deficit to 4.3% of GDP, above the -3.8% target. The Social Security recorded a deficit of 1.2% of GDP, 0.2pp higher than that of 2012 (see Figure 4.2).

As in past years, the figures reveal that the **greatest contribution to the consolidation once again came from public revenues.** Public revenues rose by 0.6 pp of GDP over the course of 2013, offsetting the 0.4pp increase in expenditures. Revenues, thus, climbed to 37.8% of GDP (similar to the level of the early 2000s), recouping half of the fall witnessed since the onset of the crisis. For its part, public expenditure at the end of 2013 came in at 44.8% of GDP, 0.4 pp higher than in 2012, at levels that are still much higher than those recorded at the beginning of the crisis.

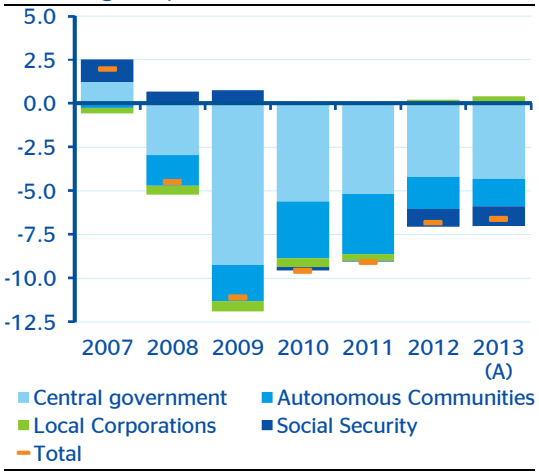
46: A more detailed analysis of the 2013 close is available(in Spanish) at http://www.bbvaresearch.com/KETD/fbin/mult/140404_Flash_Espana_CierreAAPP13_tcm346-442781.pdf?ts=2142014.

Figure 4.1
General government : net lending (+) / net borrowing (-)(*) (Yearly aggregate. % GDP)



(*) Without taking into account the amount of aid to financial institutions. (A) Advance
Source: BBVA Research based on MINHAP

Figure 4.2
General government: net lending (+) / net borrowing (-) by subsector(*) (% GDP)



(*) Without taking into account the amount of aid to financial institutions and adjusted for the 2008 and 2009 negative settlements of territorial financing. (A) Advance
Source: BBVA Research based on MINHAP

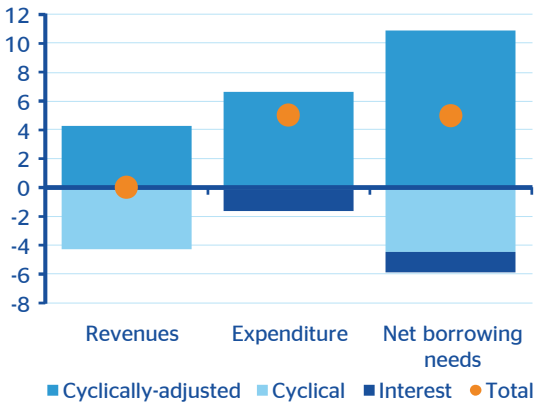
To perform an assessment of the size of the fiscal consolidation which has been underway since 2010, revenues and expenditures can be broken down into two factors: one cyclical, associated with the cyclical variations of activity; the other structural, arising from discretionary decisions on economic policy or from the constant deterioration of the economy's ability to grow. Analysing the evolution of revenues over the consolidation period (2010-13), Figure 4.3 reveals how **the tax increases in force since the onset of the crisis have practically offset the fall in revenues caused by the deterioration of activity**. Said measures raised governments' cyclically-adjusted revenues by around 4.3pp of potential GDP with resources from income and production taxes[47]. Cyclically-adjusted public resources thus amounted to around 39.3% of potential GDP in 2013, a level unseen since the mid-1990s.

The rise in tax resources took place even though the taxable bases with respect to potential GDP dropped over the course of the four years of consolidation (see Figure 4.4). Thus, between 2009 and 2013, VAT revenues dropped by 8.2pp of potential GDP, of which roughly 4.8pp are attributed to the evolution of the economic cycle, and 3.4 pp to a structural drop in final consumption expenditure subject to VAT. Likewise, the economic contraction of the last years led to a drop in gross household income equivalent to 6.8pp of potential GDP, somewhat less than half of which can be attributed to the cycle. In contrast, the regulatory changes approved for the corporate income tax have raised the structural component of the tax base by almost 2 pp of potential GDP, offsetting a portion of the more than 3 pp of cyclical contraction in said taxable income. As a result, total taxable corporate income dropped by 1.4pp of potential GDP between 2009 and 2013.

Given their fundamentally discretionary nature, **the automatic stabilisers had less of an impact on public expenditure.** According to our estimates, the deterioration of activity caused expenditures to rise by somewhat over two tenths of potential GDP, thus leading to an estimate of a structural fall in public expenditures of more than 5 pp between 2010 and 2013. **The adjustment of the structural component was observed in line items such as compensation of employees, unemployment benefits and, above all, investment**. Consequently, said adjustment was more than enough to offset the rise in interest payments (1.4 pp of potential GDP) and social benefits (0.7 pp).

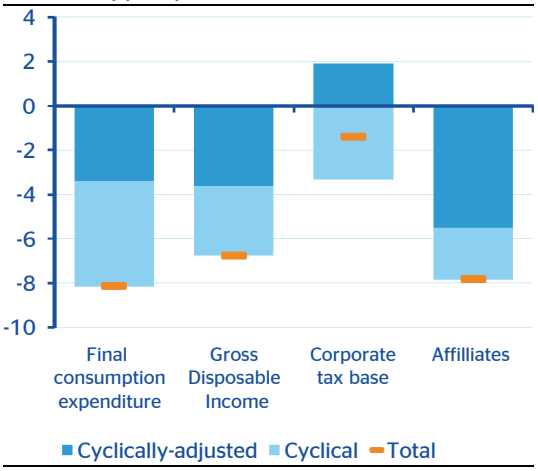
47: The personal income tax increase and the regulatory changes of corporate income tax entailed a structural increase of close to two percentage points of potential GDP, while the increase in production taxes contributed three points.

Figure 4.3
General government: breakdown of fiscal adjustment 2010-2013 (pp of potential GDP)



Note: (+) Higher revenues or lower expenditures reduce the deficit; (-) Lower revenues or higher expenditures increase the deficit
Source: BBVA Research based on MINHAP and INE

Figure 4.4
General government: variations in tax bases 2010-13 (pp of potential GDP)



Source: BBVA Research based on MINHAP

Looking towards 2014 and 2015, our forecasts anticipate that **public expenditure control policies will remain in line with those submitted in the 2014 Budgetary Plan**[48], given that as of this publication's closing date the details of the 2013-16 Stability Programme Update were not known. Adjustment of total public expenditure is expected to continue at a slightly higher pace of 0.6pp of GDP per year, favoured by an improvement in the economic environment and lower financial market stresses. **The adjustment of discretionary spending will centre on the compensation of employees** (due to the maintenance of measures such as the freezing of public salaries and the curtailment of public job offers), **and on investment expenditures, which will fall at a more moderate pace than previous years.** Consequently, public expenditures at the end of 2015 will come in at around 43.2% of GDP, still higher than the levels observed in the early 2000s.

On the revenue side, our forecasts suggest that the **economic cycle will drive tax revenues somewhat over half a percentage point of GDP each year, affecting both production and income taxes.** A portion of this revenue improvement will be offset by, among other items, the discount in welfare contributions to encourage permanent employment contracts, and by the 2015 expiry of the supplementary levy included in the personal income tax. Thus, 2014 public revenues will rise to 38.1% of GDP, two tenths higher than the 2013 close (see Table 4.1), and remain practically stable in 2015.

48: Our forecasts do not consider measures of uncertain quantification, such as revenues derived from the crackdown on fraud or the impact of local government reform.

Table 4.1
General government: net borrowing, excluding aid to the financial sector

% of GDP	2012	2013 (A)	2014 (f)	2015 (f)
Compensation of employees	11.2	11.3	11.2	11.1
Intermediate Consumption	5.7	5.5	5.4	5.3
Interest	3.0	3.4	3.5	3.3
Unemployment Benefits	3.1	2.9	2.6	2.5
Social Benefits	13.2	13.7	13.8	13.7
Gross Capital Formation	1.7	1.5	1.4	1.4
Other Expenditures	6.0	6.0	6.0	5.9
Non-Financial Expenditures	44.0	44.4	44.0	43.2
Taxes on production	10.5	11.0	11.1	11.3
Taxes on income, wealth, etc.	10.3	10.3	10.5	10.3
Social Contributions	13.0	12.8	12.7	12.8
Capital Taxes	0.4	0.5	0.5	0.5
Other Revenues	3.1	3.2	3.2	3.3
Non-Financial Revenues	37.2	37.8	38.1	38.2
Net borrowing	**-6.8**	**-6.6**	**-5.8**	**-5.1**
Stability Target	-6.3	-6.5	-5.8	-4.2

Source: BBVA Research based on MINHAP and INE

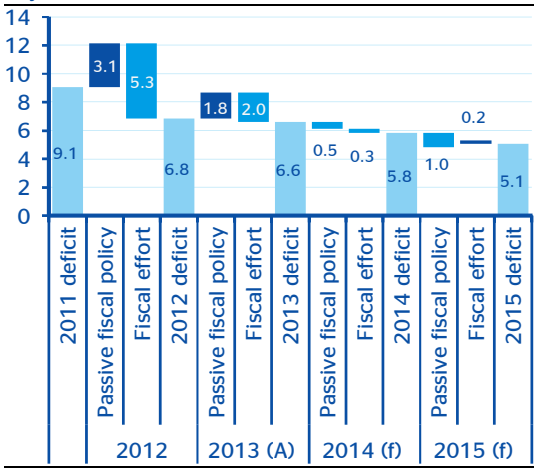
Within this context and for 2014, we expect the positive effects of the economic recovery to offset the expected structural increase of expenditure on social benefits and debt interest, which will reduce the deficit by around five tenths of GDP. In conjunction with the latter, and according to our forecasts, the impact of the fiscal adjustment measures taken over these years will contain the public deficit by somewhat more than 0.3pp of GDP. As a result, **the 2014 deficit will come in at around 5.8% of GDP, in line with the budgetary stability target** (see Figure 4.5). For 2015, the economic cycle is expected to continue correcting the fiscal deterioration, due to both the effect of automatic stabilisers and less stress from the interest burden and social benefits. In a scenario without changes to fiscal policy[49], **the 2015 deficit would remain at around 5.1% of GDP, higher than the -4.2% target agreed for said year**. Therefore, were our GDP growth forecasts (and their impact on public accounts) to be met, the government would still have to determine measures for roughly one GDP point to continue with the fiscal consolidation process.

An important item to highlight, once again based on our calculations, is that the cyclically-adjusted public balance would come in at around 1.5% of GDP in 2014 and 2015. If we were to discount interest payment amounts, **Spain would have started recording primary structural surpluses from the end of 2013 onwards** (see Figure 4.6). The latter implies that if the measures taken to date were of a permanent nature, the economic recovery expected over the next years should considerably improve public accounts, leading them to a deficit of 1.5% of GDP on average. While this is very good news, the high level of public debt and the commitments acquired under the Budgetary Stability Law[50] and the European Fiscal Compact mandate a continuation of the process of improving imbalances in the sector. In this regard, it would be advisable that any measure adopted be targeted toward improving the composition of the adjustment, promoting a tax structure that encourages economic growth and guarantees the provision of the services that society demands, and focusing fiscal imbalance corrections on eliminating the inefficiencies in public expenditures. In this respect, the next

49: That is, they are prepared without taking into account the effects of the announced fiscal reform, any other measures related to government reform, or those that may be included in the 2013-16 Stability Programme.
50: Structural balance and debt below 60% of GDP.

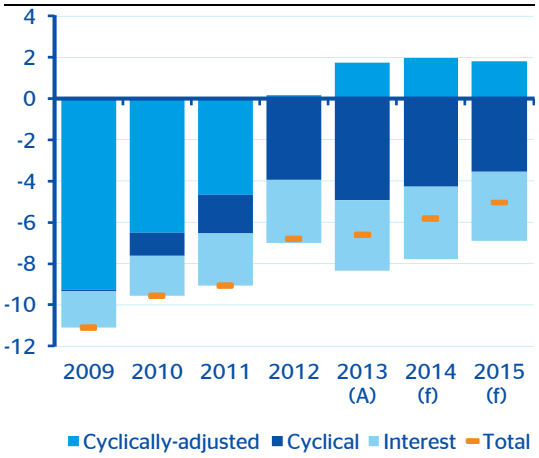
fiscal reform should design a simple and efficient tax system, with measures that reduce the taxation of income while increasing the burden of consumption taxes, in line with the indications of the Committee of Experts' Report and in accordance with European Commission and IMF guidelines. Likewise, the reform of local governments, passed into law last December, should clarify the regime of competencies between government levels and improve the efficiency of local corporations (city and provincial councils). Nevertheless, the lengthy time frames set forth by the law for its enforcement, as well as the difficulties of its implementation, lead to the expectation that savings will not be seen until well into 2015.

Figure 4.5
General government: expected fiscal adjustment(*) (% GDP)



(*) Without taking into account the amount of aid to financial institutions
(A): Advance; (f): forecast
Source: BBVA Research based on MINHAP and INE

Figure 4.6
General government: net lending (+) / net borrowing (-)(*)
(% GDP)



(*) Without taking into account the amount of aid to financial institutions
(A): Advance; (f): forecast
Source: BBVA Research based on MINHAP and INE

5. The regions: tourism, exports and fiscal non-compliance determine heterogeneity across regions

Throughout the first quarter of 2014, available information has confirmed our regional scenario from last report: the recovery is slowly spreading throughout Spanish regions. Even so, there are some deviations from BBVA Research forecasts. The deviations are to the upside in the Valencian Community and, to a lesser degree, in Catalonia, Castile-La Mancha and Aragon, supported by the non-compliance with the deficit target and improved performance in foreign sales, both in goods and tourism. They are, however, to the downside in Asturias, Castile Leon, Cantabria, La Rioja, Basque Country and Murcia, where those factors were not such strong (see Figure 5.1).

Throughout this quarter, three issues have affected regional forecasts. First, the **regional public administrations published their 2013´s end-of-year figures**, which demonstrate, again, a fiscal effort related to the deficit, but also that some regions, once again, failed to meet the target agreed. Second, the National Statistics Institute published its **initial estimates of the 2013 Regional Accounts (CRE in Spanish).** Furthermore, **short-term data is available for an additional quarter.**

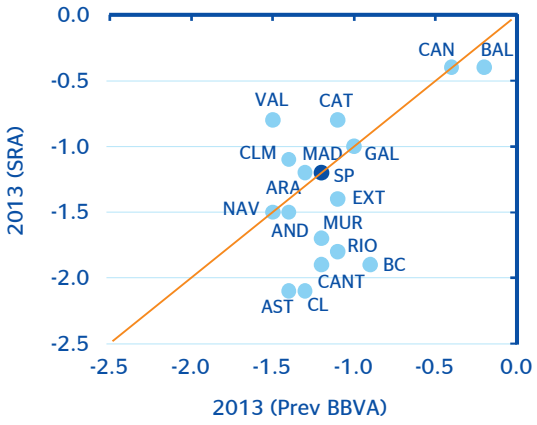
As is analysed in Section 4 of this report, **Spanish regions, as a whole, missed the deficit target by 2pp of GDP in 2013.** However this was not the case everywhere. Murcia, Castile La Mancha, the Valencian Community, Catalonia and Navarre were the regions which did not meet the target. At the other extreme, the Balearics, Castile Leon and the Canary Islands met it comfortably, actually bettering it in each case by 2pp. In the light of how this adjustment played out through the whole year, in our last quarterly report we predicted that some regions would relax their fiscal adjustment somewhat in 2013; this prediction included all the regions which ended up not meeting their targets and, in addition, the Madrid region and the Basque Country. The scenario at that time assumed that the regions would apply a similar adjustment in 4Q13 to the one in 4Q12, even though we knew that this would mean that some would meet the targets comfortably (for example, by around 8pp in the Canary Islands and Extremadura). This would have meant a lower fiscal effort for 2014, and even a certain margin for meeting this year's target in the mentioned cases.

2013 deficit data reflect that **although the regions continued applying fiscal consolidation to a certain extent , the effort was lower than the one assumed in the BBVA Research´s scenario.** Furthermore, among those which were at risk of non-compliance in the last quarter, only Madrid and the Basque Country have made further adjustments to meet the target (see Figure 5.2).

Together with the lack of budgetary discipline, the foreign sector also sustained growth in some regions. Real exports of goods grew in the Valencian Community, Castile La Mancha, Galicia and Castile Leon. Andalusia, which started the year well, experienced a slight deceleration in goods exports, but is still in the black, while in other regions such as the **Balearic Islands, Cantabria and Extremadura, foreign sales fell.** In some regions where the foreign sector is vital, such as in the Basque Country, exports remained slack, not contributing, thus, significantly to economic growth.

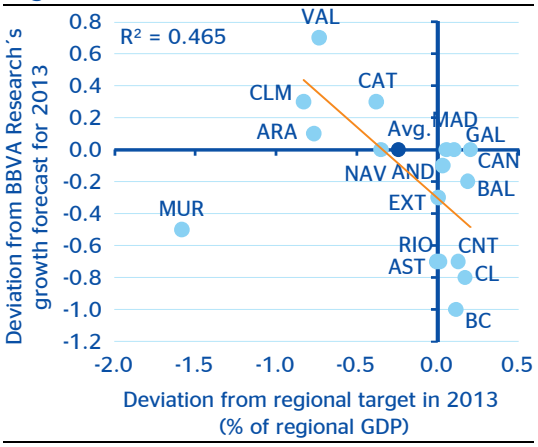
In addition to the positive contribution of goods exports, the islands and Mediterranean regions also benefited from the positive effect of tourism, which in 2013 grew again, with domestic visitors joining foreign demand.

Figure 5.1
Regions: GDP growth (%) in 2013



Source: INE and BBVA Research

Figure 5.2
Regional deficit in 2013 and forecast error

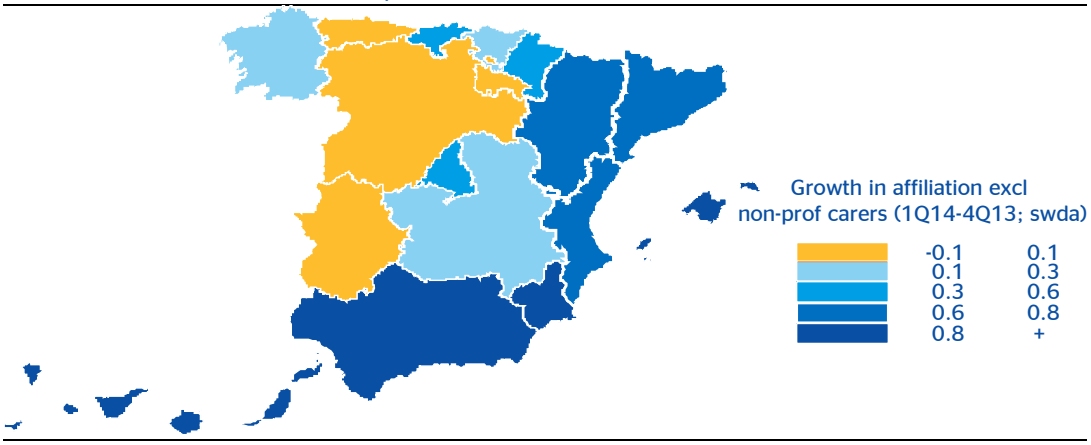


Source: BBVA Research based on INE and MINHAP

In the first quarter of 2014 the indicators performed as expected. Labour market and domestic demand indicators went up across the board. Employment performance reflected, as other indicators did, that recovery would be arriving earlier to the Mediterranean regions, the Balearic and Canary archipelagos and Madrid, to the detriment of the Northwest, Basque Country and La Rioja (see Figure 5.3), where it seems to be lagged. This behaviour is explained by three factors. First is the relaxation in 2013 of fiscal tightening, which will probably continue into 2014 given that there are no additional measures to offset the deviation. Second, tourism is still contributing positively to growth. Finally, exports continue to behave similarly to previous quarters, with the Basque Country not yet in recovery.

The performance signs in terms of past fiscal-consolidation efforts , and in particular, **the repeated non-compliance with the deficit target on the part of certain regions, have inclined BBVA Research to revise fiscal-policy criterion.** Specifically, for 2014, we assume that those regions which met their target of 1% of GDP in their 2013 deficit will not need to make additional efforts in 2014. When it comes to the rest, we assume that they will make the adjustment considered in their budgets, which started off in all cases on the assumption that the deficit target would be met, and as such, provided for a moderate degree of tightening. This assumption also includes the non-compliant regions, at least until the measures which must be introduced in their economic and financial programmes as a result of the deviation are announced. In the absence of such measures, we assume that those regions which did not meet their deficit targets in 2013 will again fail to do so in 2014, until specific policies to correct this deviation are implemented. In short, **the updated estimate of the fiscal adjustments to be carried out by the regions leads us to expect a lower level of adjustment in 2014.**

Figure 5.3
Growth in affiliates to Social Security in 1Q14 (swda, %)



Source: BBVA Research based on Social Security

Goods trading is being sustained by the recovery in European demand, which ought to continue over the next few quarters. If, during the toughest phase of the crisis, exports recovered thanks to improved sales to Emerging Markets, in the last few quarters this behaviour has shifted to Europe, and should continue throughout this year and the next. The European recovery is making the solid acceleration in exports on the part of Galicia, Castile Leon and Cantabria possible; in the case of the first two, with an improvement in the automotive sector, which we are also seeing in the Valencian Community. The importance of foreign trade for the regions of the Northeast is thus underpinning their recovery, while Cantabria's lower weight of foreign trade on GDP means that the former contributes to a lower degreeto its economic growth. At the other end of the scale, goods exports would be again decreasing their contribution to growth in Madrid and the Basque Country, due to their greater orientation towards markets outside the EU.

Foreign tourism ought still to have a differential effect in 2014 on those regions particularly oriented to this sector, although less so than in previous years, as the results from the first quarter in Catalonia and the Balearics seem to be indicating. On the other hand, the progressive recovery of **Spanish domestic demand may translate into an improvement in tourism by residents, which may have a particularly positive impact in the Valencian Community, Murcia and Andalusia,** three regions in which tourism by residents has more weight than the international variety and which were already performing better in 2013.

Only **in the Canaries are the short-term data accelerating faster than forecast,** putting pressure for an upside review of forecast for this region thanks to tourism's strong performance. Furthermore, these results are coming out at a moment when a certain deceleration in the sector might have been expected, after the record number of visitors reached in the last two years, although subject to performance data from the Easter period. in other regions with a lot of foreign tourism (Balearics, Catalonia) there are some initial signs of a degree of exhaustion in the arrival of visitors at hotels. In any event, high levels of uncertainty looming both in competing destination markets (North Africa, Turkey) and some source markets (Russia and Eastern Europe) introduce a dash of volatility to these market's performance in the regions most oriented towards foreign tourism.

Table 5.1 summarises the effects impacting on BBVA Research's regional forecasts. Compared with January´s forecasts, the fiscal bias may be smaller than formerly predicted in the Canary Islands, Castile-La Mancha, Extremadura and Galicia. Short-term data known (including the Regional Accounts' initial estimate of 2013 GDP) implies a more negative bias in the Basque Country, La Rioja, Extremadura, Cantabria and the Balearics. On the other hand, it would lend

a bias to the upside in the case of the Canary Islands, Andalusia, Catalonia, the Valencian Community and, to a lesser degree, in Galicia.

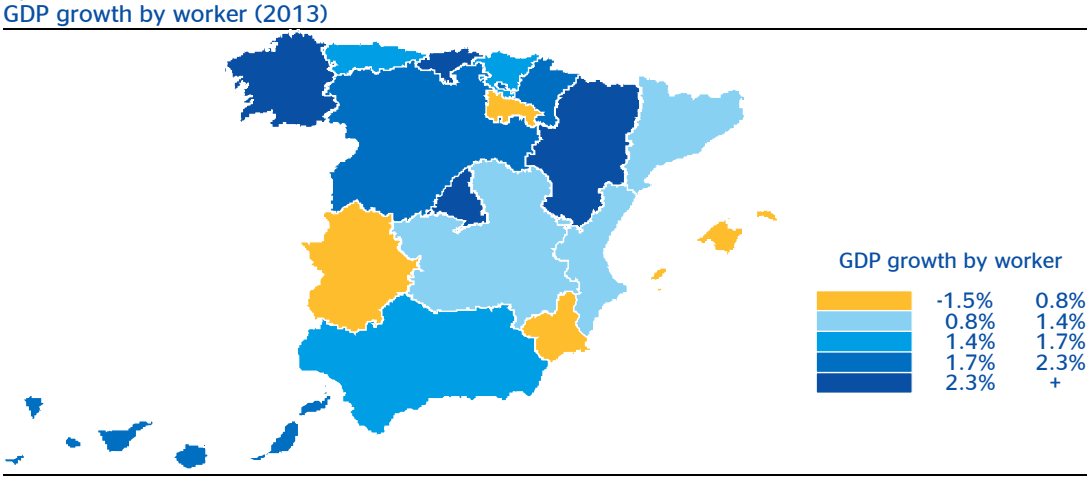
In the medium term, **the correction of less severe structural imbalances to which regional economies were subject will mean that these will reduce its negative impact on future growth.** Differences in the leveraging levels in the private sector and in regional deficits are being reduced, which will lead to other more structural factors gaining importance in the recovery. In any event, these factors will not be evident until the end of 2015.

In the short term, although the regional public sector could be less of a burden on growth than in the past years, its effects may still affect those regions with higher levels of borrowing (Catalonia, Valencian Community). Furthermore, improvement in activity is not occurring uniformly around all the regions. In Eastern and Southern regions there is higher growth in employment, which may be related to tourism, while in the Northern regions there is higher productivity growth (as occurred in former recoveries) (see Figure 5.4). This heterogeneity in employment may result in differences between regions in terms of household income behaviour in the short term and, as such, in aggregate consumption, which may come in addition to tourism demand from residents in the rest of Spain. Recovery in domestic demand, therefore, could have a relatively differentiated impact by regions.

Meanwhile, the regions' foreign-demand recovery could be helped insofar as it is linked to the recovery of consumption in Europe (because of recovery in demand) to a higher extent than a recovery in investment (in view of lower impetus in European exports). This is sustaining the automotive production specialists in particular (Galicia, Castile Leon, Aragon, Navarre) and to a lesser degree to those specialising in equipment goods (Basque Country, Asturias).

In summary, **the recovery which started gradually in 2013, will continue in 2014 and will accelerate in 2015.** Lower fiscal consolidation and improved internal demand, given that the imbalances are being corrected, together with growth in goods and services exports in which the geographic composition is reoriented towards Europe, are the factors making up this recovery.

Figure 5.3
GDP growth by worker (2013)



Source: BBVA Research based on INE (National Statistics Institute)

Table 5.1
Justification for the revision in the forecasts for 2014

	Forecast made in January	Bias because of new information	Fiscal bias	Forecast in May
Andalusia	1.0			1.5
Aragon	0.9			1.1
Asturias	0.4			0.6
Balearic Islands	1.1			1.2
Canary Islands	1.5			2.0
Cantabria	0.7			0.7
Castile Leon	1.2			1.3
Castile-La Mancha	1.1			0.9
Catalonia	0.6			0.9
Extremadura	1.2			1.1
Galicia	1.5			1.4
Madrid	1.4			1.5
Murcia	0.1			0.5
Navarre	1.1			1.6
Basque Country	0.8			0.9
Rioja (La)	1.2			1.2
Valencian Commun.	0.4			0.8
Spain	0.9			1.1

■ Negative bias over earlier growth forecast. ■ Positive bias over earlier growth forecast.
Date: 30th April 2014.
Source: BBVA Research

Table 5.2
GDP growth by region

Region	2011	2012	2013	2014(f)	2015(f)
Andalusia	0.2	-2.1	-1.5	1.5	1.7
Aragon	-0.2	-1.9	-1.2	1.1	2.0
Asturias	0.4	-2.1	-2.1	0.6	1.3
Balearic Islands	1.0	-0.8	-0.4	1.2	1.6
Canary Islands	0.4	-1.4	-0.4	2.0	2.2
Cantabria	-0.8	-0.9	-1.9	0.7	1.6
Castile Leon	1.1	-2.0	-2.1	1.3	1.9
Castile-La Mancha	0.1	-3.1	-1.1	0.9	2.3
Catalonia	-0.4	-1.3	-0.8	0.9	1.5
Extremadura	-0.9	-2.8	-1.4	1.1	1.9
Galicia	-0.5	-0.9	-1.0	1.4	2.4
Madrid	0.7	-1.6	-1.2	1.5	2.4
Murcia	-1.0	-2.0	-1.7	0.5	2.0
Navarre	1.4	-1.6	-1.5	1.6	2.1
Basque Country	0.2	-1.3	-1.9	0.9	1.7
Rioja (La)	0.9	-2.0	-1.8	1.2	2.3
Valencian Community	-1.1	-1.6	-0.8	0.8	1.5
Spain	**0.1**	**-1.6**	**-1.2**	**1.1**	**1.9**

Date: 30th April 2014.
Source: INE (National Statistics Institute) and BBVA Research

6. Tables

Table 6.1
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate, %)	2011	2012	2013	2014	2015
United States	1.8	2.8	1.9	2.5	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Germany	3.4	0.9	0.5	1.8	2.0
France	2.0	0.0	0.3	0.9	1.5
Italy	0.6	-2.4	-1.8	0.7	1.4
Spain	0.1	-1.6	-1.2	1.1	1.9
UK	1.1	0.3	1.7	2.8	2.4
Latin America *	4.1	2.6	2.3	2.3	2.5
Mexico	4.0	3.7	1.1	3.4	3.0
Brazil	2.7	1.0	2.3	2.0	1.6
EAGLES **	6.7	5.0	5.3	5.3	5.6
Turkey	8.5	2.4	4.0	1.5	5.1
Asia Pacific	6.1	5.2	5.2	5.0	5.2
Japan	-0.5	1.5	1.5	1.1	1.3
China	9.3	7.7	7.7	7.2	7.0
Asia (exc. China)	3.8	3.5	3.3	3.5	3.9
World	4.0	3.2	3.0	3.4	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Mexico, Russia, Turkey
Forecast closing date: 30 April 2014
Source: BBVA Research

Table 6.2
Macroeconomic forecasts: 10Y interest rates (average)

	2011	2012	2013	2014	2015
US	2.8	1.8	2.3	3.0	3.7
EMU	2.6	1.6	1.6	1.7	2.4

Forecast closing date: 30 April 2014
Source: BBVA Research

Table 6.3
Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2011	2012	2013	2014	2015
US (EUR/USD)	0.72	0.78	0.75	0.74	0.75
EMU	1.39	1.29	1.33	1.35	1.33
UK	1.60	1.59	1.56	1.65	1.69
Japan	79.7	79.81	97.56	108.02	117.08
China	6.46	6.31	6.20	6.11	5.91

Forecast closing date: 30 April 2014
Source: BBVA Research

Table 6.4
Macroeconomic forecasts: official interest rates (end of period)

	2011	2012	2013	2014	2015
US	0.25	0.25	0.25	0.25	0.50
EMU	1.00	0.75	0.25	0.25	0.25
China	6.56	5.75	6.00	6.00	6.00

Forecast closing date: 30 April 2014
Source: BBVA Research

Table 6.5
EMU: macroeconomic forecasts (YoY change, %, unless otherwise indicated)

	2011	2012	2013	2014	2015
Real GDP	1.6	-0.6	-0.4	1.1	1.9
Household consumption:	0.3	-1.4	-0.7	0.8	1.3
Public consumption	-0.1	-0.6	0.1	0.3	0.7
Gross fixed capital formation	1.8	-3.8	-2.9	3.1	5.1
Equipment, machinery and cultivated assets	4.9	-4.3	-1.9	5.1	6.9
Equipment and machinery	5.0	-4.3	-1.9	5.2	7.0
Construction	-0.2	-4.0	-4.0	0.8	3.6
Housing	-0.3	-3.3	-3.6	1.1	3.9
Other buildings and other constructions	-0.2	-4.7	-4.3	0.5	3.2
Change in inventories (contribution to growth)	0.2	-0.5	-0.1	0.0	0.0
Domestic demand (contribution to growth)	0.7	-2.1	-1.0	1.0	1.8
Exports	6.7	2.7	1.4	3.1	4.2
Imports	4.7	-0.8	0.0	3.1	4.6
Net exports (contribution to growth)	0.9	1.5	0.6	0.1	0.0
Pro-memoria					
GDP w/out housing investment	1.7	-0.4	-0.2	1.1	1.7
GDP w/out construction	1.8	-0.2	0.0	1.2	1.7
Employment (LFS)	0.3	-0.7	-0.9	0.1	0.7
Unemployment rate (% active pop.)	10.1	11.3	12.0	11.9	11.4
Current account balance (% GDP)	0.1	1.2	2.3	2.2	2.1
Public sector balance (% GDP)	-4.1	-3.7	-3.0	-2.6	-2.1
CPI annual average	2.7	2.5	1.4	0.9	1.3
CPI end-of-period	2.7	2.3	0.8	1.1	1.4

Forecast closing date: 30 April 2014
Source: BBVA Research

Table 6.6
Spain: macroeconomic forecasts (YoY change, %, unless otherwise indicated)

	2011	2012	2013	2014	2015
Activity					
Real GDP	0.1	-1.6	-1.2	1.1	1.9
Private consumption	-1.2	-2.8	-2.1	1.4	1.3
Public consumption	-0.5	-4.8	-2.3	-1.6	1.4
Gross fixed capital formation	-5.6	-6.9	-5.2	1.0	4.5
Capital goods	5.5	-3.9	2.2	7.9	6.9
Construction	-10.8	-9.7	-9.6	-3.8	2.8
Housing	-12.5	-8.7	-8.0	-3.4	4.9
Domestic demand (contribution to growth)	-2.1	-4.1	-2.7	0.7	1.9
Exports	7.6	2.1	4.9	6.0	5.1
Imports	-0.1	-5.7	0.4	5.4	5.4
Net exports (contribution to growth)	2.1	2.5	1.5	0.4	0.0
Nominal GDP	0.1	-1.6	-0.6	1.4	3.2
(EUR bn)	1,046.3	1,029.3	1,023.0	1,037.3	1,070.8
GDP w/out housing investment	1.0	-1.2	-0.9	1.3	1.8
GDP w/out construction	2.0	-0.4	-0.1	1.6	1.8
Labour market					
Employment (LFS)	-1.6	-4.3	-2.8	0.3	1.4
Unemployment rate (% active pop.)	21.4	24.8	26.1	25.1	24.2
Employment QNA (full-time equivalent)	-2.2	-4.8	-3.4	0.2	1.1
Productivity	2.3	3.1	2.2	0.8	0.8
Prices and costs					
CPI (annual average)	3.2	2.4	1.4	0.3	0.9
CPI (end-of-period)	2.4	2.9	0.3	0.5	1.2
GDP deflator	0.0	0.0	0.6	0.3	1.3
Compensation per employee	1.3	0.2	0.7	-1.0	1.2
Unit labour cost (ULC)	-0.9	-2.9	-1.5	-1.8	0.4
Foreign trade					
Current account balance (% GDP)	-3.7	-1.2	0.8	1.3	1.5
Public sector					
Debt (% GDP)	70.5	86.0	93.9	98.4	100.4
Budget balance (% of GDP)	-9.1	-6.8	-6.6	-5.8	-5.1
Households					
Nominal disposable income	0.0	-2.8	-0.7	-0.6	1.7
Savings rate (% of nominal income)	12.7	10.5	10.6	8.6	8.1

(*): Excluding financial aid to Spanish banks.
Forecast closing date: 30 April 2014.
Source: Official bodies and BBVA Research

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