BBVA | RESEARCH

Economic Outlook

Spain

First Quarter 2013
Economic Analysis

- **The reduction of uncertainty improves the global economy outlook**
- **Moving forward on the banking and economic union** is needed to sustain the recovery in Europe
- **2013: the year the Spanish economy bottoms out and begins to recover?**
- **Better prospects come with some risks,** requiring the stregthening of a virtuous circle in which reforms, confidence and growth can feed off each other

Index

Closing date: February 8, 2013

1. Editorial

The perception regarding the prospects of the global economy has improved during the last three months as a result of a relaxation of financial tensions in Europe, the last-minute agreement to side-step the fiscal cliff in the US and accelerating activity in emerging economies, such as China. This more favourable environment has been shaped by some economic policy decisions taken, and it is expected to drive up global GDP growth from 3.2% in 2012 to 3.6% in 2013 and 4.1% in 2014. **Nevertheless, the continuity of this incipient recovery requires apt policy decisions** in the US and the eurozone. In the latter region, it is vital to build momentum on the banking union front, starting with effective implementation of the agreements reached on single supervision and progress on initiatives to foster bank resolution procedures.

In addition to the ECB's decisions and progress on the banking union front, **in Spain several other factors have also helped ease financial market stress, contributing to the gradual re-opening of the financial markets** and reversing the exodus of foreign capital witnessed in 1H12. Firstly, the government's austerity efforts are beginning to pay off. This is tangible in the preliminary estimates pointing to growth in public revenue coupled with a reduction in public spending in 2012, despite the recessionary backdrop. Secondly, significant progress has been made on recapitalising and restructuring the Spanish financial system. Thirdly, the correction of the balance of payments deficit has accelerated, showing a surplus in the last three months. Lastly, the contraction in GDP in 2012 (-1.4%), in line with BBVA Research's estimates, was less severe than had been foreshadowed earlier in the year (particularly by foreign analysts), which translates into a lower probability today that Spain will be caught in a vicious circle of recession-burgeoning public deficit-need for further cuts.

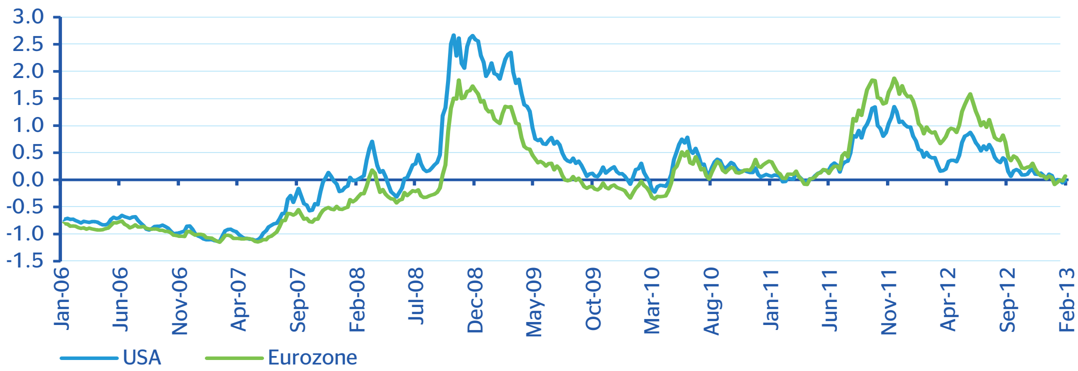
The economy is likely to hit bottom in 2013, contracting by an estimated -1.1%. The fact that the private sector continues to make cuts, coupled with the implementation of measures to achieve what is still very ambitious fiscal consolidation, guarantees that internal demand will contract again this year. **However, there are reasons to believe that the economy will display moderate growth** of around 1.1% **in 2014**. Exports have proven surprisingly buoyant, seeking out new destinations to offset the slump in European demand and remaining competitive. If the global economic recovery consolidates and financial tension remains in check, investment prospects are likely to improve. Meanwhile, the supply-side correction is drawing to an end in the real estate sector. Although absorption of the lingering imbalances is likely to prove slow, the sector will stop subtracting from growth in the years to come. Lastly, in 2014 the fiscal consolidation effort will require a smaller sacrifice relative to those taken in the two years prior.

This scenario is by no means risk-free. Although financial stress has eased without the need to call on the ECB for support, with strings attached, the economy is still exposed to internal and external risk events. **Therefore it is vital to take advantage of the window of opportunity** that has opened up to seize the initiative and **drive fresh and decisive progress in Europe and Spain, paving the way for a virtuous circle in which reforms, confidence and growth can feed off each other.** As mentioned, in Europe progress towards a banking union will be crucial. In Spain, irrespective of whether the 2013 deficit target is relaxed once again, the government at all levels must evaluate its progress on fiscal consolidation month by month in light of the usual uncertainty surrounding revenue generation in a recessionary environment and in order to ensure effective control over public spending. Beyond fiscal consolidation, the Spanish economy still has to face up to an uphill reform agenda to achieve market unity, deregulate the services sector, enhance the flow of credit to businesses, boost the nation's human and technology capital, increase government productivity, ensure the sustainability of the pension system and reduce energy dependence, among others. Given the seriousness of the situation in the job market, it is vital to ensure that all of the mechanisms introduced under the umbrella of the last round of labour market reforms work as intended and to adopt additional measures designed to reduce the incidence of temporary contracts, boost productivity and skills, accelerate the reallocation of jobs among companies and sectors and render active and passive employment policies more efficient.

2. Global economic scenario: better mood and lower tail risks

Over the past three months, some threats to the global economic recovery have partly faded, sparking a tide of renewed optimism. Financial markets have seen tensions decrease to two-year lows (see Chart 1), particularly in Europe, and almost all assets have benefited from this change in perception. Fading threats to the stability of the global economy have also boosted confidence among consumers and firms. Surging confidence has spread among regions with a few rare exceptions. However, these market and confidence rebounds have not prompted any significant change in activity yet. According to our global activity indicator, the slowdown the global economy underwent in much of 2012 came to an end in the fourth quarter of that year. The most recent data have reinforced the perception that the global GDP is accelerating, yet from low levels (below its historical average) and at just a slight brisker pace. According to our estimates, the global GDP in 2012 grew by 3.2%, down from 3.9% in 2011.

Chart 1
BBVA financial stress index



Source: BBVA Research

Economic resilience to uncertainties and advances in the implementation of policies lie behind improved confidence

Data show that China is not heading for a hard landing. Since the third quarter of 2012, the GDP growth has accelerated – as we had been expecting – and the slowdown has come to an end. Investment has accounted for much of the rebound in GDP, on the back of stimulus policies implemented more deftly in 2012 than in 2009. Furthermore, some tentative signs of stronger exports have also emerged, on demand from Asian countries and the US, whereas exports to Europe and Japan have remained a drag. In addition to this, the transfer of political power has been proceeding smoothly.[1] However, there are still some concerns about the sustainability of China's growth. Local debt and the pace of shadow banking lending are probably the biggest financial threats to growth. Even in the short term those threats could be a constraint for the implementation of new stimulus measures if needed.

The rebound of the Chinese economy has been hailed in markets as a factor in the global economic resilience and, in particular, in other export-oriented economies and in commodity prices, in particular in Latin America. Although the outlook for China's growth is not as upbeat as in the past, markets seem relieved to have seen the fading of the risk of a severe slowdown.

1: The new leadership team has signaled that it intends to maintain policy continuity with respect to growth-supportive policies and economic reforms. Policy targets as to GDP growth are likely to be 7.5%, the same as in 2012

The US did not fall off the cliff and, in fact, its economy is withstanding uncertainty remarkably well. In spite of a GDP decline in the 4Q12 (-0.1% in annualized terms), the underlying picture is brighter.[2] It had long been argued that consumers and firms withheld their spending, as a reflection of the impact that automatic spending cuts and tax hikes worth some 4% of GDP could have on their finances. However, consumption growth has remained quite stable over the past quarters, averaging a growth rate slightly below the pre-crisis levels. At the same time, the housing sector has undoubtedly gained momentum. However, it is difficult to measure the impact of fiscal uncertainty on economic indicators, especially when other policies, such as the monetary policy through the quantitative-easing program, may have succeeded in offsetting (partially) the negative impact of fiscal uncertainty.

The fiscal deal at the turn of the year that extended most of the 2001/2003/2010 tax cuts and delayed the so-called “expenditure sequester” for two months, among other changes, was welcomed by markets. It avoids a larger drag on the economy and it helps improve the US public-debt sustainability. However, the agreement did not deal with two potential sources of uncertainty. On the one hand, the expenditure sequester is scheduled to take place at the beginning of March. If implemented, there would be an additional drag on the economy of 0.8% of GDP. On the other hand, there was no permanent agreement on the debt ceiling, although a later deal suspended this ceiling until mid-May. Hence, in coming weeks more negotiations will take place to avoid a sharp economic contraction in 2013 and, at the same time, to contribute to fiscal sustainability. However, a grand bargain is unlikely as long as policymakers continue kicking the can and fail to reach a bipartisan compromise to make hard choices.

Europe did its part: advances in the banking-union process reinforce the commitment to preserve the euro. The deal on Greece has shown that Europe is committed to maintaining Greece in the eurozone. European policy makers struck a deal with the Greek authorities on some details of the bail-out program that allowed the disbursement of its second tranche. The second factor supporting the positive perception from Europe refers to the banking-union process due to advances made at the December EU summit. The process seems critical to breaking the vicious circle between government and banking finances, and also to stemming the tide of capital outflows besetting some countries in Europe’s periphery. Agreements reached at the December EU summit were not as ambitious as had first been hinted, but are still quite positive since they include a clear calendar for implementing a single supervision mechanism and initial steps towards a single resolution mechanism.

Finally, the ECB’s OMT program seems to be having long-lasting effects as a real backstop, preventing financial tensions from escalating, even if neither Spain nor Italy (the natural candidates) have asked for its activation. That situation may continue because governments of core and peripheral countries lack incentives to undergo such a process. With Spain’s bonds yielding 5 – 5.5% and Italy’s at 4 – 4.5%, the funding of the public debt does not require the request of ESM intervention in the primary market and the ECB’s OMT in the secondary. Second, the OMT may well continue being seen as a real backstop if the ECB commitment to step in in case Spain or Italy asked for the bailout (which would surely result in yields dropping) is credible. Yet, it would also be necessary for the authorities’ commitments in asking for a bail out (if funding costs soared) to prove credible.

The baseline scenario does not change in spite of better mood

The rebound in China’s economy, the partial deal on how to tackle the fiscal cliff in the US, and the effects from the ECB’s OMT announcement are all good reasons to think that the world economy may have avoided the tail-risk event some market participants were partially pricing in. However, changes in fundamentals are less conclusive. As a consequence, a soft recovery continues being the most likely outlook, as hard data pointing to a stronger rebound is elusive.

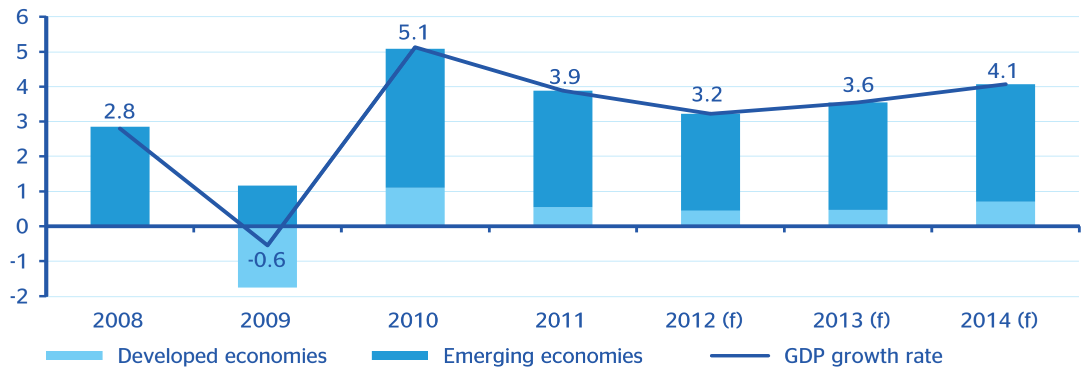
2: The aggregate figure was dragged down by volatile components (private stock building and federal defense spending) along with exports.

On the one hand, even if the US avoided falling off the fiscal cliff, US politicians will still have to agree on some key issues, such as the sequester and the debt ceiling. Either of them could derail the process. Even if agreements are reached, in 2013 the fiscal policy will turn tighter, squeezing household incomes. The real estate sector may be recovering, but the deleveraging process is still a factor at play, and the external sector is far from buoyant. Therefore, we maintain the outlook for the US economy, although we reckon there is scope for potential positive surprises. In 2013 we expect the US economy to grow by 1.8% (down from 2.2% in 2012) and by 2.3% in 2014.

In the eurozone the improvement of financial markets was not followed by activity data in the last quarter of the year, although there are clear signs of recovery in soft data. Tail risks may well have disappeared. The periphery remains mired in recession, dragged down by fiscal consolidation and funding conditions. Even if the external sector improves and exports drive the GDP up, some economies still have a path ahead beset with deleveraging and fiscal austerity. However, some leading indicators in Germany and other core countries are pointing to better prospects at the beginning of 2013. As a consequence, we roughly maintain our forecast for the eurozone: a rebound of a mere 0.3% in 2013 (after a contraction of 0.5% in 2012), leading to a 1.3% increase in 2014. The decoupling between the core countries and the periphery will persist throughout the forecasting period.

China is arguably the economy where the outlook has become clearer in the short term. The new authorities are committed to sustained growth and that must be interpreted as a clear intention to use loose economic policy. We have revised our projections slightly upwards and now China is likely to grow by 8% in 2013 and 2014. The robustness of China's economy and the resilience of the US economy will play a role in supporting demand in most emerging countries. In Latin America as a whole, we revised our forecasts slightly downwards, due to weaker situations in Brazil and Argentina. In 2013, the Latin American economies will grow by 3.5%, whereas in 2014 they will by 3.7%, approaching to their growth potential. In turn, emerging Asia will show a more robust growth, accelerating its pace to 6.6% in 2013, up from 6.1% in 2012.

Chart 2
World GDP growth rate



Source: BBVA Research

The uncertainty surrounding the global economic outlook looks set to remain high and tilted to the downside, but open to potential upside surprises for the first time in the past three years. The eurozone poses the biggest risk. Although the new institutional benchmark limits the probability and the potential impact, financial tensions may return for different reasons. First, the periphery of Europe could miss its current fiscal targets. If governments react with more austerity, the downturn may intensify. However, this risk has low probability because the European Commission has made it clear that no further adjustment will be forced on these countries if targets are not met as a consequence of cyclical considerations. At the same time, that is likely to roil markets and make it necessary for those countries to ask for a bailout. In this regard, although the ECB seems ready to intervene, any potential wrangling between core and peripheral countries as to the conditionality attached is a possible source of instability. Other factors may also play a role, like the details of the bank bailout for Cyprus, yet to be fixed, or political events such as the Italian elections. If financial tensions increased as a consequence of one or several of those triggers, the eurozone would continue in recession in 2013 too.

The other significant source of risk stems from the US political disagreement on how to deal with the fiscal deficit. Part of the original fiscal cliff has been avoided, but the remaining two issues – the sequester and the debt ceiling – still lie ahead. On the one hand, the wrangling over these issues may be a source of uncertainty that could hold back consumer spending and investment. On the other, if agreements are not reached, the tightening in fiscal policy could be enough to bring the US economy back to feeble growth rates.

According to our own estimations, if both risks materialized the world economy would grow nearly a percentage point less than in the baseline scenario, well below its historical average. The adequate implementation of eurozone-governance agreements and further pacts on fiscal issues in the US are necessary conditions for a sustained global recovery.

3. Outlook for Spanish economic growth

Financial markets have shown considerable improvement over the last three months thanks to lower uncertainty surrounding economic policy decisions in both emerging economies and, mainly, in developed economies. This lower volatility in Spain has encouraged a return of capital inflows and led to lower risk premiums for funding in both the public and private sector. In addition, the performance of real economy in the country's main trading partners remains in line with forecasts. Although this represents a standstill for European economic activity, it is also consistent with strong growth in the rest of world, historically low risk-free interest rates and a slight strengthening of the Euro which, in balance, should create a favourable backdrop to boost Spanish exports.

Domestically, the economy exhibited a less negative performance than forecasted for the last quarter of the year although it was not enough to cut the decline in GDP for the year as a whole (-1.4%). After the major upturn in the third quarter, sales overseas fell back towards the end of the year although export activity is still buoyant. In light of this, the better economic performance is likely due to a smaller drop in domestic demand than expected three months earlier. Assuming the government presents a deficit in line with this earlier forecast, the main change seems to be linked to how the fiscal adjustment is affecting private demand. Specifically, the Spanish experience seems to point to fiscal multipliers being below what would be expected given the current situation (see Box 1).

In light of this, the Spanish economy is expected to continue in recession for the coming quarters and, in the most likely scenario, to show a decline in GDP in 2013 somewhat below that in 2012. Looking forward, several factors support a return to growth in 2014. These include the expected recovery in global growth, the general strength seen in exports and the knock-on effect the latter may have on the domestic economy (especially investment in machinery and equipment), a less restrictive fiscal policy stance than seen in 2012 and 2013, and some domestic adjustments practically coming to an end (investment and employment in the housing sector).

Nevertheless, the Spanish economy remains exposed to several risks. The most important of these is linked to the possible fragility of lower financial tensions in the face of external or domestic events.

Spanish economy in 2012: a return to recession

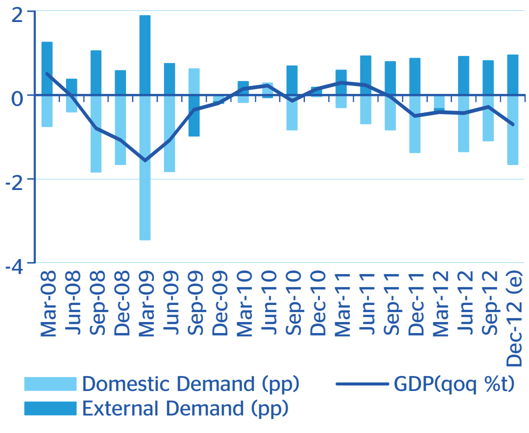
After moderate growth in 2011, forecasts looked to 2012 being a year of major adjustments which, although inevitable, would unavoidably push the economy back into recession. This added to the financial markets turmoil and the GDP drop in Europe resulted in an output contraction for 2012 as a whole.

In this sense, and with detailed breakdown still to come in, the GDP flash estimate from the National Institute of Statistics (INE) pointed that the Spanish economy contracted by 0.7% qoq in 4Q12, giving an annual drop of around -1.4%.[3] If this is confirmed, the decline in output between October and December would be higher than that seen in the previous three quarters although somewhat lower than that expected at the end of 3Q12 (BBVA Research: -0.9% qoq). With regard to how growth breaks down, conjunctural indicators released before the closing date for this report confirm a steeper decline in domestic demand (a -1.6pp contribution to GDP decline) mainly as a result of the fiscal measures put into place between the end of 3Q12 and the start of 4Q12. Therefore, activity should have again leaned on net external demand which, despite the correction in foreign sales, should have contributed 0.9pp to quarterly growth (see Chart 3).

3: The breakdown of Quarterly National Accounts (CNTR) for 4Q12 will be released on 28th February with a possible revision of the early figures.

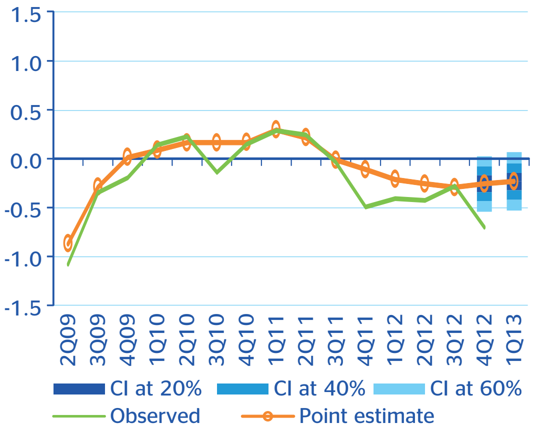
Looking to the first quarter of 2013, available data point to a continued contraction in output which, nonetheless, would represent a slowdown in the pace of decline compared to that seen in the final stages of 2012 (MICA-BBVA : up to 0.2 or 0.3% qoq) (see Chart 4).[4]

Chart 3
Spain: contributions to quarterly GDP growth



(e): estimate
Source: BBVA Research based on National Institute of Statistics data

Chart 4
Spain: observed GDP growth and MICA-BBVA Model forecasts (% qoq)



Current forecast: 8th February 2013
Source: BBVA Research based on National Institute of Statistics data

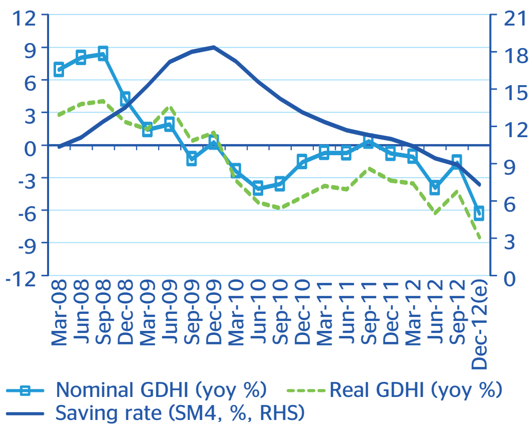
Private domestic demand sped up its decline due to new fiscal measures

After a third quarter characterized by a lower drop in private consumption, partial demand indicators, mainly for durable goods[5] and, to a lesser extent, services suggest household spending re-continued its rate of decline in 4Q12. This performance was impacted by the VAT changes that came into force in September (higher general and reduced rates and a change to taxable bases) and by the persistent decline in real gross available income and real estate wealth which offsets the forecast improvement in their net financial wealth and lower saving rate (see Chart 5). In this vein, the BBVA Synthetic Consumption Indicator (SCI-BBVA) and the BBVA Model of Indicators Coincident with Consumption (MICC-BBVA) point to household spending contracting around 1.3% qoq (-2.2% yoy) in 4Q12, more than double the previous quarter (see Chart 6). In this way, private consumption should have declined around 1.9% in 2012 after dropping by 1.0% in 2011.

4: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21, available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1021_tcm348-231736.pdf?ts=2542012

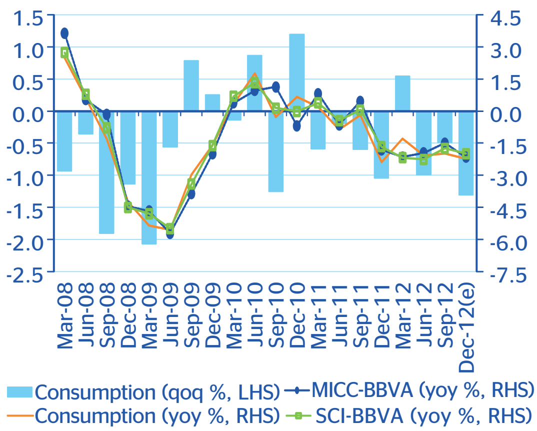
5: See section 3 in the Consumption Outlook magazine from the second quarter of 2012 for a detailed analysis of consumer spending patterns by types of goods or services. http://www.bbvaresearch.com/KETD/fbin/mult/1212_Situacionconsumo_tcm346-363646.pdf?ts=2312013

Chart 5
Spain: GHDI and households' saving rate



(e) estimate
Source:BBVA Research based on National Institute of Statistics data

Chart 6
Spain: observed and forecast data in real time on households' consumption

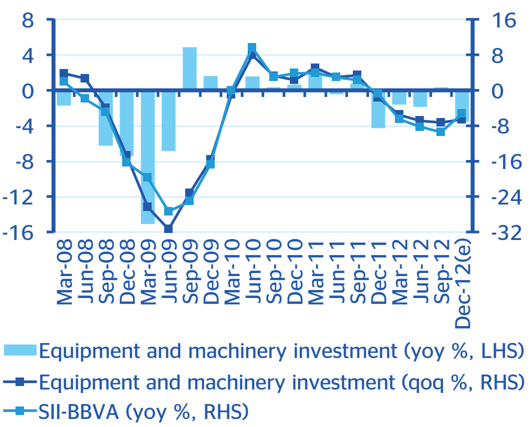


(e) estimate
Source: BBVA Research based on National Institute of Statistics data

In turn, figures released at the closing date of this report confirm the economic situation continued to be unfavourable for implementing new private investment projects. In this sense, easing financial tensions in the last part of 2012 did not prevent the investment in machinery and equipment to end the year as a drain on growth, especially due to the continued negative influence from domestic demand. The Synthetic Investment Indicator (SII-BBVA) points to a 2.2% qoq contraction in this item of demand, meaning 2012 should have ended with a 6.3% decline in comparison to the previous year (see Chart 7).

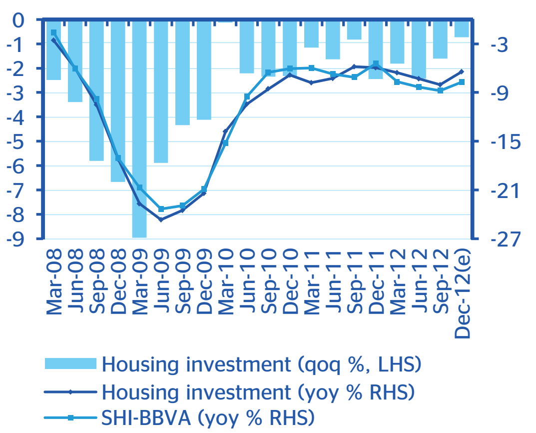
In turn, housing investment should have continued on its adjustment trajectory. Nonetheless, and although residential activity continues to stagnate at minimum levels, our estimates suggest that the last quarter of the year should have seen higher sales due to demand being brought forward before the tax deduction for buying a property was eliminated and VAT hike in January of 2013. In any event, the effect on sales is expected to have been below that seen with the previous change in tax laws for the housing sector (January 2011), especially given worsening household income levels. In short, 4Q12 is expected to see a smaller contraction in housing investment than in previous quarters (SHI BBVA -0.7% qoq). This means that during 2012 this investment item should have declined 7.1% in comparison to 2011, accumulating five years of decline (see Chart 8).

Chart 7
España:
Spain: observed and forecast data in real time for investment in machinery and equipment



(e): estimate
Source: BBVA Research based on National Institute of Statistics data

Chart 8
Spain: observed and forecast data in real time for investment in residential property



(e): estimate
Source: BBVA Research based on National Institute of Statistics data

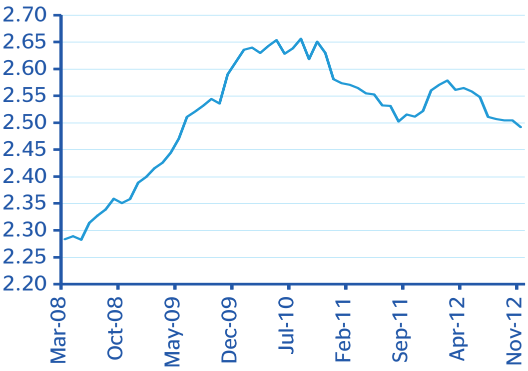
As expected, the adjustment in public demand intensified in the final part of 2012

After the major adjustment in consumption and public investment in 3Q12, available figures point to this demand items continuing to decline throughout 4Q12. In this way, the latest national budgetary execution data to November 2012 show final consumption expenditure for central government continued to drop, coming in below 2.5% of GDP on a twelve month cumulative (see Chart 9). At the same time, according to the Labour Force Survey (LFS), the number of employees in public administrations has experienced a sustained decline throughout 2012. The seasonally and working day adjusted data (SWDA) show that the number of public employees is about 2.9 million people in 4Q12, in front of more of 3.2 million in June 2011 (see Chart 10). These figures mean public consumption is forecast to end the year with around a 4.0% decline in comparison to the previous year.

In turn, released execution figures continue to show that much of the effort in fiscal consolidation remains concentrated in cutting investment, meaning the contraction in non-residential construction for 4Q12 is likely to have been higher than that seen in 3Q12. This would mean that the year ended with a reduction of around 15.5% with respect to 2011.

Chart 9

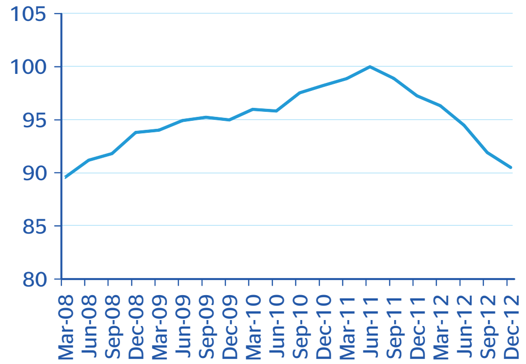
Spain: estimated government final consumption expenditure (cumulative 12 months. % GDP)



(*) Fixed capital consumption excluded
Source: BBVA Research based on MINHAP data

Chart 10

Spain: employees in public administration (local maximum Jun-11=100, SWDA data)



Source: BBVA Research based on MEySS data

The last part of 2012 ends with a slowdown in export activity, although net trade continues to make a positive contribution to growth

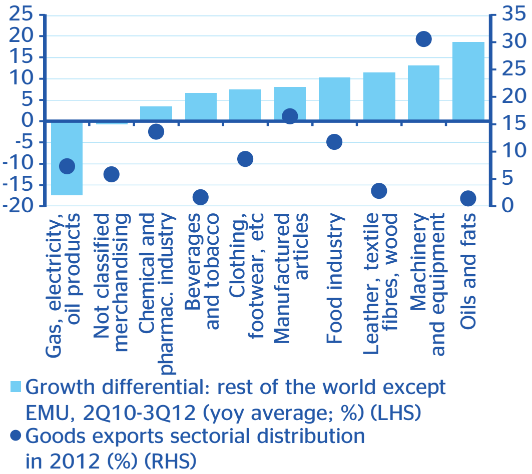
Activity indicators for 4Q12 from the EMU point to a slowdown in Spanish exports' demand, as confirmed by the leading indicators of the balance of trade. Thus, after the major upturn registered in 3Q12, the last quarter of the year would end with a contraction in goods exports of around -1% qoq. Despite this drop, export volumes have increased at a healthy rate during 2012. Specifically, goods exports would have expanded by 3.4% yoy, a remarkable figure given the high level of uncertainty that the financial situation in Europe has introduced to the global economy and the subsequent impact on the demand from Spain's main trading partners. This export dynamism is supported by the destinations' differentiation and the wide range of sectors opting for geographical diversification. (see Chart 11).

Services exports should have come in along the same lines (-0.3% qoq and +2.9% yoy). Foreign tourism came to a standstill in the fourth quarter after the positive performance recorded in summer. Real foreign tourist spending[6] fell around 1.5% (qoq, SWDA) due to the decline in incoming foreign tourists (-3.2%) after the major growth over the two previous quarters (see

6: Deflacted by final conpsumption prices of the non-residents in the nacional territory

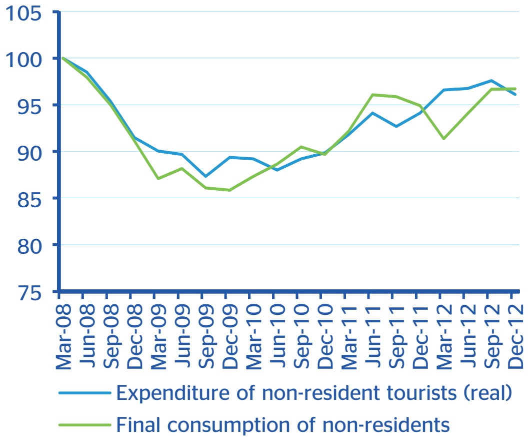
Chart 12). In this way, the year ended positively: increased spending (real) by foreign tourists of 3.8% with respect to 2011 and a record number of visitors (40.1 million), confirming BBVA Research forecasts. In turn, available information points to demand drying up in the fourth quarter of 2012 and possibly extending into the first quarter of 2013. According to the matching tourism indicators model (MICT) from BBVA and Google, over-night stays in Spanish hotels by overseas visitors in January and February should remain stable (around 0.3% yoy in both months).

Chart 11
Spain: real goods exports growth differential by geographical area and sectorial distribution of exports (SITC sector classification)



Source: BBVA Research based on AEAT data

Chart 12
Spain: expenditure by foreign tourists and real non-resident consumption (100= Mar 08, SWDA)

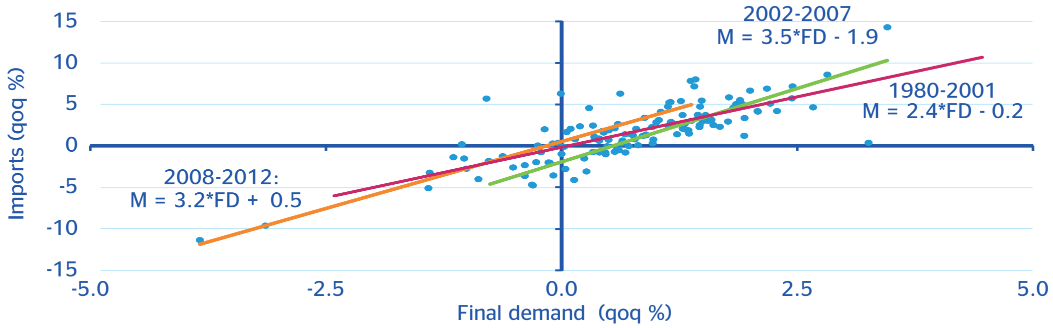


Source: BBVA Research based on National Institute of Statistics and EGATUR data

The downward correction of exports, alongside lower domestic demand, led to a major contraction of imports between October and December (-3.8% qoq). As Chart 13 shows, the import component of final demand in the Spanish economy (i.e. domestic demand plus exports) continues to be high, helping to at least partly explain that GDP has not recorded a higher contraction in 4Q12 despite the intense reduction in domestic demand. Indeed, empirical evidence suggests that for every pp correction in final demand, there is an average change in imports above 3.0pp; this amount increased significantly from the near 2.5pp before the introduction of the Euro although has remained mostly unchanged since the start of the current economic crisis.

Overall, the aforementioned elements point to a positive net trade contribution to growth slightly above that seen in the third quarter (+0.9pp vs. +0.8pp). In short, the conjuntural economic indicators released to date suggest the decline in imports could come in at -4.7% for 2012 as a whole, which would have contributed to inch up the positive contribution to growth from net trade (2.5pp). High export growth alongside reduced imports led to the second highest year-on-year adjustment in the current account deficit since the start of the crisis (2.1pp to produce an estimated external deficit of -1.4% of GDP).

Chart 13
Spain: implicit import elasticity (M) to final demand (FD)



Source: BBVA Research based on National Institute of Statistics data

Labour market continues to worsen in 4Q12

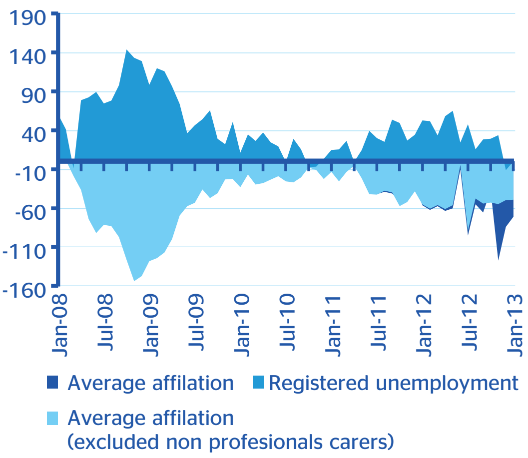
When changes due to seasonal and working day reasons (SWDA) and the distortion due to changes in the special non-professional carers agreement in the Dependency Act are excluded,[7] job market data show the rate of job losses between October and December came in similar to that seen in 3Q12. In this sense, average Social Security affiliation fell 1.0% qoq SWDA in 4Q12 (1.4% qoq if the loss of non-professional carers is included). Nevertheless, the increase in registered unemployment (1.6% qoq SWDA) was lower than that seen in 3Q12 (2.3% qoq SWDA). This would point to a decrease in the economically active population (see Chart 14).[8] In general terms, the Labour Force Survey (LFS) for 4Q12 confirmed the performance shown in affiliation and unemployment figures. Despite the lower active population (-176,000 people, 116,000 SWDA), the decline in employment (-363,200 people, -259,000 SWDA) led to a 1pp increase in the unemployment rate to 26.0% (26.1% SWDA). Lower public employment (-74,500 people in 4Q12 and -172,500 for the year as a whole) meant the service sector represented eight out of ten jobs lost in the fourth quarter, followed by construction and manufacturing. Whilst permanent contract numbers fell by 91,100 employees, temporary contracts saw a 216,600 drop mainly due to declining employment in the public sector and an unfavourable seasonality. Consequently, the temporary employment rate declined 1pp to 23.0% (23.1% SWDA) (see Chart 15).

The data for 4Q12 ended a year characterised by a new worsening in labour market figures. On average, the Spanish economy lost 822,700 net jobs, 78.5% in the private sector (mainly in services and construction) with 56.1% being temporary contracts. This led to a higher unemployment rate (up 3.4pp to 25.0%) despite a 56,200-person drop in the active population. The positive note for 2012 came in the form of higher self-employment, up by 41,000.

7: Royal Decree-Law 20/2012 of 13th July on measures to guarantee budget stability and boost competitiveness modified the special agreements in the Social Security system for non-professional carers of dependent persons. Specifically, parties to the agreement (which is now voluntary) will be obliged to pay Social Security contributions from 31st August (85% to 31st December and 100% thereafter). This led to 146,672 fewer registered carers in November and December. See: http://www.boe.es/boe/dias/2012/07/14/pdfs/BOE-A-2012-9364.pdf

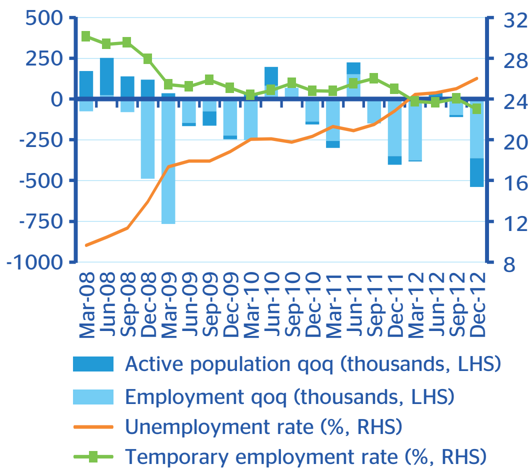
8: January figures show the job market continued to worsen, albeit at a lower-than-expected rate. When the figures are adjusted for seasonal nature and working days, a 50,000-person drop is forecast for Social Security affiliation with registered unemployment at a standstill. See: http://www.bbvaresearch.com/KETD/fbin/mult/130204_Flash_Espana-Paro_en13_tcm346-372332.pdf?ts=522013

Chart 14
Spain: average Social Security affiliation and registered unemployment (monthly change in thousands of people, SWDA data)



Source: BBVA Research based on MEySS data

Chart 15
Spain: labour market indicators



Source: BBVA Research based on National Institute of Statistics data

Surprise drop in consumer prices

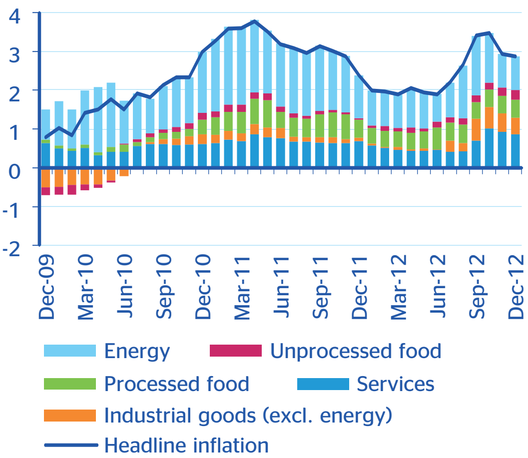
Data for 4Q12 confirmed the upturn in consumer prices in the central part of the year were not due to domestic inflationary pressure but to exogenous demand factors such as upward pressure in commodity prices (mainly oil and food), higher pharmacy co-payment rates from July and higher VAT in September. Specifically, after a slight upturn in October, both headline and core inflation saw a downward surprise in 4Q12, respectively hitting 2.9% yoy and 1.6% yoy in December (2.4% yoy and 1.6% yoy on average for 2012 as a whole).[9] This was a result of a slowdown in energy prices which, in turn, affected some core inflation items more than expected (see Chart 16). Furthermore, the early winter sales campaign also contributed to the downward change seen in this consumer prices component.

In turn, the Harmonised Consumer Price Index (HCPI) shows the difference in inflation with the Eurozone remained positive in the fourth quarter of 2012. In terms of headline inflation, the price differential should have come in around 0.8pp in December (historical average of +0.8pp) whilst if we take the core component as a reference, the difference would come in around 0.7pp (compared to an historical average of +0.8pp). In any event, since this performance is largely due to the increase of indirect taxes, it does not represent a direct loss of competitiveness for Spanish exports.

In short, given the weakness in the job market, no second round effects are expected from higher energy prices and the VAT increase in 2012. In this regard, average salary increases agreed by collective bargaining remained steady in the last quarter, especially in newly-signed agreements (see Chart 17). Nonetheless, total wages continued to increase above 0.5%. This figure was established as a maximum limit in the 2nd Employment and Collective Bargaining Agreement 2012-2014, signed by employers and unions at the end of January last year which continues to have a negative effect on the labour market adjustment.

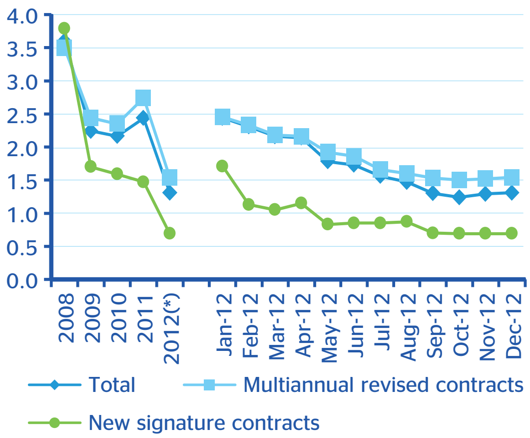
9: The forward CPI indicator for December points to a drop in annual inflation to 2.6% which, according to the National Institute of Statistics press release, is a result of lower inflationary pressure on energy prices. See: http://www.bbvaresearch.com/KETD/fbin/mult/130131_Flash_Espana-Avance_del_IPC_en13_tcm346-371999.pdf?ts=622013

Chart 16
Spain: contributions to year-on-year CPI growth (pp)



Source: BBVA Research based on National Institute of Statistics data

Chart 17
Spain: average salary growth agreed by collective bargaining (%)



Annual data include agreements recorded after December each year and include the salary guarantee clause revision
(*) Provisional data
Source: BBVA Research based on MEySS data

2013-2014 scenario: bottoming-out in 2013 and beginning the recovery in 2014

As stated in the introduction to this section, the determinants for Spain's economy evolution remain consistent with a continued contraction in activity in coming quarters which, in the most likely scenario, will lead to a -1.1% drop in GDP in 2013. Looking to 2014, domestic adjustments practically coming to an end, lower downward pressure expected from fiscal policy and, finally, stronger exports as a support to growth (with recovery in traditional markets and strong growth in newer markets) all point to a 1.1% rise in GDP for the year (see Table 1). As seen from the start of the crisis, these economic outlooks will continue to be characterised by highly heterogeneous performance in regional economies, with the fiscal adjustment and external sector again being the most important determining factors for divergence (see Box 3).

In any event, it should be highlighted that although downward risks have considerably decreased in comparison to what was forecast in our previous publication, the recovery forecast in this scenario continues to be dependent on consolidating improved confidence in the European economy and, particularly, in the Spanish economy.

Table 1
Spain: macroeconomic forecasts

(yoy %, unless otherwise indicated)	1Q12	2Q12	3Q12	4Q12 (e)	2011	2012 (e)	2013 (f)	2014 (f)
National Final Consumption Expenditure (FCE)	-1.9	-2.3	-2.5	-3.0	-0.8	-2.4	-4.0	-0.7
Private FCE	-1.3	-2.1	-1.9	-2.2	-1.0	-1.9	-2.8	-0.3
Household FCE	-1.3	-2.1	-2.0	-2.2	-0.8	-1.9	-2.8	-0.3
Public Administration FCE	-3.7	-2.9	-3.9	-5.4	-0.5	-4.0	-7.2	-1.8
Gross capital formation	-7.4	-9.2	-9.7	-9.1	-5.5	-8.8	-6.8	2.6
Gross fixed capital formation	-7.5	-9.2	-9.9	-9.3	-5.3	-9.0	-6.8	2.6
Fixed material assets	-8.2	-10.1	-10.9	-10.4	-5.8	-9.9	-7.4	2.4
Equipment, machinery and cultivated assets	-5.4	-6.8	-7.2	-5.0	2.3	-6.1	-1.5	6.4
Equipment and machinery	-5.5	-6.9	-7.3	-5.3	2.4	-6.3	-1.7	6.4
Construction	-9.4	-11.5	-12.6	-12.8	-9.0	-11.5	-10.2	0.3
Housing	-6.6	-7.3	-8.0	-6.4	-6.7	-7.1	-8.3	2.1
Other buildings and other constructions	-12.0	-15.3	-16.7	-18.5	-11.0	-15.5	-12.2	-1.6
Intangible fixed assets	3.1	2.9	4.7	4.9	3.1	3.9	0.4	5.4
Change in inventories (*)	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Domestic demand (*)	**-3.1**	**-3.8**	**-4.0**	**-4.3**	**-1.9**	**-3.8**	**-4.6**	**0.0**
Exports	2.4	2.9	4.3	3.4	7.6	3.3	6.3	8.2
Imports	-5.8	-5.1	-3.5	-4.5	-0.9	-4.7	-4.4	5.8
Net trade balance (*)	**2.4**	**2.4**	**2.4**	**2.5**	**2.3**	**2.5**	**3.4**	**1.1**
GDP at mp	**-0.7**	**-1.4**	**-1.6**	**-1.6**	**0.4**	**-1.4**	**-1.1**	**1.1**
Pro-memoria								
GDP w/o housing investment	-0.3	-1.0	-1.2	-1.5	1.0	-1.0	-0.7	1.0
GDP w/o construction	0.7	0.3	0.1	-0.1	2.1	0.2	0.1	1.2
Employment (LFS)	-4.0	-4.8	-4.6	-4.8	-1.9	-4.5	-3.8	-0.2
Unemployment rate (%active pop.)	24.4	24.6	25.0	26.0	21.6	25.0	26.8	26.1
Employment (FTE)	-3.7	-4.7	-4.6	-4.3	-1.7	-4.3	-3.4	-0.4

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

Improved activity set to positively impact job creation in 2014

The flagging in declining economic activity will minimise job losses this year, which will not stop unemployment rising (over 26% for 2013 as a whole) in spite of the expected decline in the active population. Growth recovery in 2014 and the expected improvement in efficiency in the labour market thanks to the labour reforms passed in February last year[10] will lead to higher employment and a slight drop in the unemployment rate, especially in the second half of the year.[11]

10: Box 4 from the SpainWatch magazine for the second quarter of 2012 offered an assessment of the labour market reform passed in 2012.
11: The labour reform should provide the necessary re-balancing between the extensive (employment) and intensive (working hours and pay) margin adjustment, reduce segmentation and increase productivity. These consequences, linked with the production model change currently being seen in the Spanish economy, should aid higher job creation and a more intense drop in the unemployment rate for each GDP point. For further details, see: Andrés. J., J. E. Boscá, R. Doménech and J. Ferri: "Job Creation in Spain: Productivity Growth, Labour Market Reforms or both", BBVA Working Paper 10/13, Madrid. Available at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1013_tcm348-221513.pdf?ts=15112011

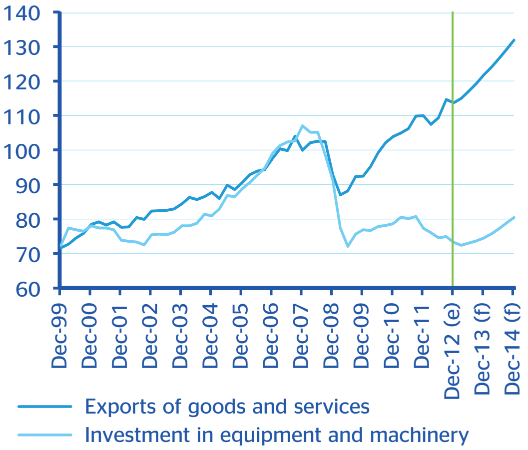
As external demand is set to strengthen as a support for the Spanish economy, domestic demand will cease to be a negative drain on growth throughout 2014

Firstly, fiscal consolidation is expected to continue its negative contribution to growth throughout 2013, less so in 2014. Specifically, the impact from the cyclical downturn in the economy on public revenue and expenditure and the higher cost of public debt mean future efforts remain significant. In this sense, and as a result of the measures announced by the government, public consumption is forecast to see a 7.2% decline in 2013 in real terms, whilst investment in non-residential construction should drop around 12.2%. This contraction in both components of public demand will slow throughout 2014 and, according to BBVA Research forecasts, should come in around -1.8% and -1.6% respectively. In total, the reduction in public deficit will knock around 3pp of GDP off domestic demand in 2013, lower than the over 4pp seen in 2012. Meanwhile, the introduction of measures equivalent to just 1pp of GDP are expected in 2014. Despite this, the likely deviation of around 1pp of GDP in the deficit target for 2012 (6.3% of GDP), alongside more optimistic government macroeconomic forecasts than those at BBVA Research, increase the likelihood of missing the stability target for 2013 (-4.5% of GDP). Although this scenario would lead to the adoption of additional fiscal consolidation measures, a new relaxation of public deficit targets similar to the one agreed in the middle of last year, cannot be ruled out. The major effort the country is making, alongside a less favourable setting for growth in a context of consolidation for public balances, would support this.

With regard to private consumption, higher indirect taxation in 2012 and the worsening outlook for some of its determinants point to a decline in expenditure this year of around -2.8% and, to a lesser extent, in the following year (-0.3%). In this vein, the decline in employment will lead to a new reduction in the salary component to the households' gross available income in 2013 and a standstill in 2014. Furthermore, the VAT hike in September 2012 (and purchases being brought forward because of this) will continue leading to a significant contraction in consumer spending over the coming months. Moreover, real estate wealth will continue to fall back throughout the entire forecast period. On the other hand, the recovery in net financial wealth, the reduction in households' saving rate to levels considerably below those seen in the previous cycle, the lack of inflationary demand pressures and official interest rates remaining at low levels, will cushion the expected contraction in private consumption.

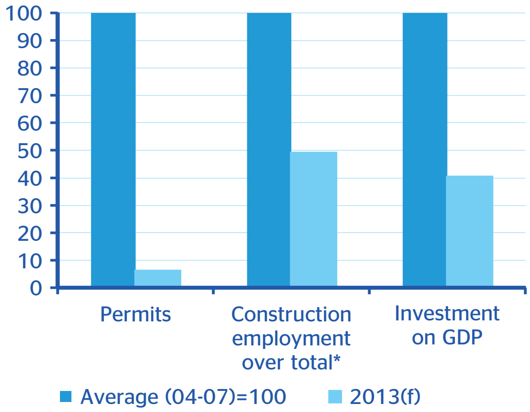
In terms of investment in machinery and equipment, 2013 looks like a transition year from the relapse in 2012 to expected recovery in 2014. This investment item will continue to see downward pressure in 2013 due to weak domestic demand and the continued high cost of funding. In the meantime, the solid performance in exports will continue to act as a support (see Chart 18). This will still not be enough, however, to avoid a new contraction for the year as a whole (-1.7% yoy). In contrast, the recovery in domestic demand and continued positive external demand will lead to 6.4% yoy growth in this component in 2014.

Chart 18
Spain: exports and investment in machinery and equipment (2008=100)



(e): estimated
(f): forecast
Source: BBVA Research based on National Institute of Statistics data

Chart 19
Real estate sector indicators in the pre-crisis period and forecasts for 2013



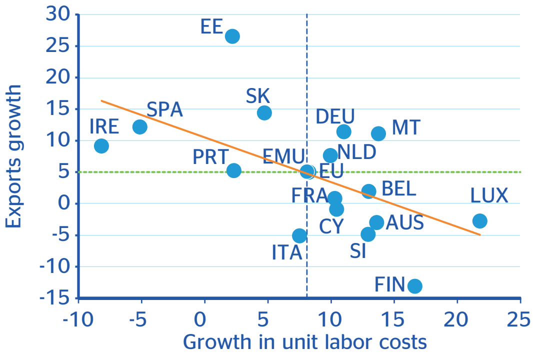
(p): forecast
(*): the value shown for 2013 corresponds to the data recorded in 3Q12
Source: BBVA Research based on official national institutions

In the same way, the negative contribution to domestic demand growth from investment in housing should diminish considerably in the second half of 2013. Investment decisions in 2013 will continue to be set by the deleveraging process in sector's firms and, therefore, activity will remain at minimal levels. Nonetheless, the adjustment on the supply side has been significant and could be coming to an end as reflected in the major drop seen in housing starts and employment in the sector (see Chart 19). This does not mean that a strong recovery in investment will be seen in coming years since the aggregate over-supply remains high, although the adjustment is in progress. In addition, the market will need to face up to new circumstances that will add to uncertainty such as the consequences of the restructuring process of a part of the financial system, the implementation of the Sareb , the elimination of tax benefits for property purchases and higher VAT, the reform of rent legislation and new regulations for Socimi (REITs). In any event, new housing over-supply is expected to again decline in 2013 (albeit a modest drop) following the pattern of 2012 - the first year to see a significant decrease in housing stock. Indeed, unsold new housing in some regions such as Cantabria, Navarre, the Basque Country and Madrid is currently around 2% of residential stock (in comparison to 4% for Spain as a whole). This is relatively close to what would be an optimal inventory level (1.5% of stock), showing that the real estate market imbalance in these regions is close to be corrected. There is also major housing demand from overseas buyers which could strengthen this year once uncertainty on financial markets dissipates and sets off a greater appetite for risk. In short, housing investment is expected to contract by around 8.3% yoy in 2013 with 2014 being when investment starts to see positive, albeit moderate, growth rates (+2.1% for the year as a whole), after seven years of declines and a cumulative contraction above 50%.

With regard to the external sector, an improved performance in the global economy in 2013 and 2014 would act as a counterweight for weak growth in the EMU, favouring the return of high export growth. In this way, as the improvements in competitiveness and overseas market niches strengthen, export growth in goods and services could come in at around an annual 7% average for the period. These forecasts include the possibility of a stronger real effective exchange rate in comparison to the scenario of three months ago. Nevertheless, as stated in previous publications, although reduced unit labour costs seem to support continued export dynamism (see Chart 20), the effect of the exchange rate seems to be less clear; in fact, it does not explain the positive export performance in the pre-crisis period.[12]

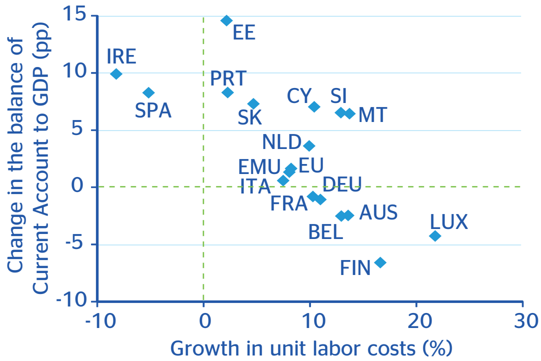
12: Box 4 in the SpainWatch magazine for the fourth quarter of 2012 explored the link between the real effective exchange rate and the export share for a group of advanced economies from the end of the 90s.

Chart 20
Spain: exports cumulative growth and unit labour costs, 1Q2008-3Q2012



Source: BBVA Research based on Eurostat data

Chart 21
Spain: current account and unit labour cost evolution, 1Q2008-3Q2012



Positive values in the vertical axis point to an improvement in the current account balance, and viceversa
Source: BBVA based on Eurostat data

As a result of declining domestic demand, imports of goods and services should continue to decrease in 2013 (-4.1% yoy) and gain traction from 2014 on (+5.7% yoy), when domestic demand should start to come out of its decline. Over the next two years, economic growth would again come from net trade and the Spanish economy would complete its current account deficit adjustment process (see Chart 21).

Box 1. Fiscal adjustments and economic growth in Europe[13]

One of the most controversial topics of the current financial crisis has been the effect of fiscal policy on economic growth. In recent months, this debate has been shaken by the results of the analysis carried out for the World Economic Outlook (October 2012) by the IMF, recently expanded by Blanchard and Leigh (2013). According to these results, the fiscal adjustments could be having a more contractionary effect on GDP than expected.

The stabilizing effects of fiscal policy on production levels are usually measured using a fiscal multiplier, which is defined as the variation of GDP in relation to the discretionary variance of the public deficit (spending, G*, less public income, T*), having removed the cyclical part due to automatic stabilizers:

$$\Delta PIB / (\Delta G^{*}-\Delta T^{*})$$

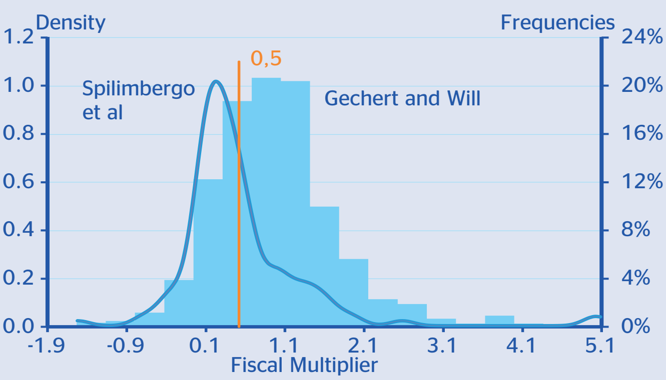
In an interesting article published in the Wall Street Journal in 2009, Robert Barro explained very simply how the fiscal multiplier can be interpreted. When the multiplier is equal to the unit, if the government purchases an aeroplane or builds a bridge, total economic production increases by the exact amount required to manufacture the aeroplane or build the bridge without reducing the production of other goods. In this way, consumption and investment in the private sector remain unaffected. If the multiplier is higher than the unit, as Barro states “the process is even more marvellous”: in addition to increasing production on the aeroplane or bridge, GDP increase even more because of consumption and/or private investment.

Why is it important whether the multiplier is higher or lower for fiscal adjustment? If the multiplier is very high, the negative effects of fiscal austerity on GDP can cause a reduction in income which is greater than the ex-ante expected saving with the adjustment. In this situation, fiscal consolidation could be self-destructive, which is why economists (e.g. De Long and Summers, 2012) have even defended having to increase public expenditure in order for the deficit to reduce.

In practice, empirical evidence provides a variety of fiscal multiplier values, for various reasons. Firstly, because it is difficult to isolate the effects of fiscal expansionary policies from other perturbations that are simultaneously affecting the economy. Secondly, because the fiscal multiplier depends on the composition of fiscal stimulus and the specific characteristics of each economy, in the face of certain situations that vary over time. Examples of these characteristics are the degree of external openness, the exchange rate regime, the response of monetary policy, the stress levels of public balances, the existence of credit restrictions on the financial system, the level of external borrowing and private sector debt, the percentage of agents that consume only on the basis of their current income, or if the short-term stimulus measures are announced simultaneously with long-term consolidation measures.

As an example of the diversity that exists in fiscal multiplier estimations, Chart 22 indicates the high dispersion of the values that are collected in two literary panoramas. In Chart 22 the line (left axis) represents the density function of the multipliers compiled by Spilimbergo, Symansky and Schindler (2009), which ranges between -1.5 and 5.2, with an average of 0.54. Gechert and Will (2012) analysed a wider sample of 89 studies, on which a meta-analysis of 754 fiscal multipliers was carried out, the frequency distribution of which is represented via the bars in Chart 1 (right axis). These authors conclude that the multiplier varies between 2.82 (the maximum impact of military spending, in Neo-Keynesian general balance models when the interest rates reach zero) and -1.3 (the effect of an increase in transfers in a real cyclic model when imports constitute 50% of GDP).

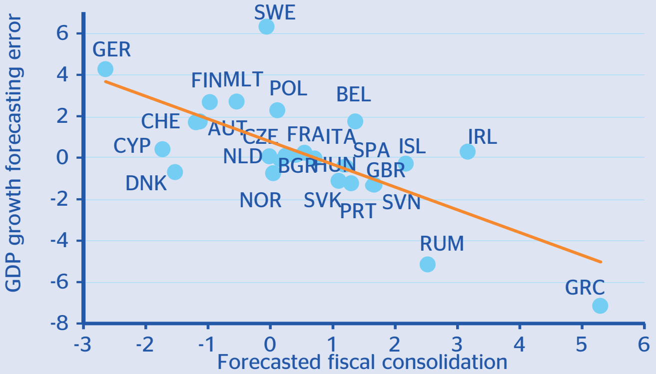
Chart 22
Fiscal multipliers: Density function and distribution of two panoramic frequencies



Source: authors' estimation based on the panoramic of Spilimbergo, Symansky and Schindler (2009) and Gechert and Will (2012)

1: This box summarises the results of a forthcoming Economic Observatory (Andrés and Doménech, 2013).

Chart 23
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: Blanchard and Leigh (2013)

Before the crisis a fiscal multiplier of 0.5 was normally accepted as standard. This multiplier has normally been used to evaluate fiscal consolidations over the last years (IMF 2010). However, Blanchard and Leigh's results (2013) have questioned this value, upon finding systematic errors in the GDP growth estimates for 2010 and 2011, which were negatively correlated with the fiscal consolidation estimates for those two years.

The evidence is summarised in Chart 23, using a sample of 26 European countries. The horizontal axis represents the fiscal consolidation forecasted in 2010 by the IMF for 2010 and 2011, and the vertical axis represents the forecasting error for GDP growth for these two years. Under the hypothesis of efficient use of the information available, the forecasting error should not be correlated with forecasted fiscal consolidation. However, in Chart 23 the regression coefficient between both variables is -1.095 and is statistically significant (with a t-ratio equal to -4.85).

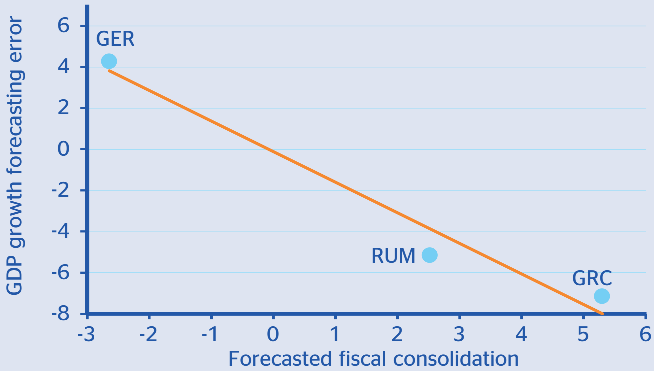
Given that the IMF's GDP estimates take into account the forecasted fiscal adjustments, the conclusion extracted by Blanchard and Leigh is that the multipliers were higher. If on average the multiplier used was 0.5, evidence would suggest that the fiscal multiplier in 2010 and 2011 could have been 1.6 (0.5+1.095).

Although Blanchard and Leigh interpret these results quite cautiously, their analysis has certainly meant that there is now a majority who accepts that fiscal multipliers are higher than the unit and that the fiscal austerity taken on by some European countries must be questioned.

How robust are these results? In response to criticism from Giles (2012 a and b), Blanchard and Leigh carried out different robustness tests, indicating that the results depend on the countries and periods analysed; the fiscal multiplier however is, generally , higher than the unit and is statistically significant when Germany and Greece are excluded.

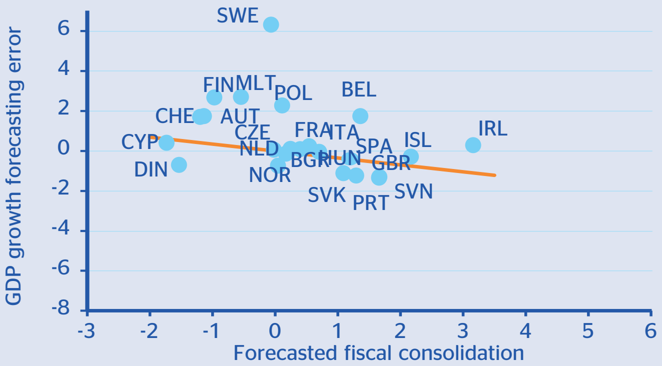
More detailed analysis of the evidence indicated by Chart 23 suggests that Blanchard and Leigh's results were very much influenced by a third country: Romania. Chart 24 analyses the relationship between the forecasted fiscal consolidation and the forecasting error in economic growth for Germany, Greece and Romania, reaching a clearly negative relationship (the gradient of the line is equal to -1.49). As for Chart 25, this demonstrates the regression for the remaining 23 countries. In this case the correlation is much smaller and is no longer statistically significant (the regression coefficient falls to -0.347). Therefore, in this sample of 23 European countries, including Spain, it cannot be concluded that the fiscal adjustment has affected growth any more than forecasted. The same results are obtained through analysis of the European Commission, the OECD and the Euro Intelligence Unit's forecasts. In other words, the results obtained for Germany, Greece and Romania cannot be generalised for the other countries. It would suggest that in these three concrete cases, it is necessary to carry out more detailed analysis of the reasons for which the forecasting errors were so high.

Chart 24
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: authors' estimation based on Blanchard and Leigh's data (2013)

Chart 25
Forecasted fiscal consolidation and GDP growth prediction error, 2010-11



Source: authors' estimation based on Blanchard and Leigh's data (2013)

In summary, based on the aforementioned results and reviewing the abundance of existing empirical literature, the following conclusions can be drawn:

- the multiplier depends on the type of fiscal measure: composition is important;
- the multiplier depends on the specific characteristics of each economy;
- although as a general rule a fiscal multiplier between 0.5 and 1 is an acceptable approximation, the different combinations of measures, countries and periods mean that the fiscal multiplier is very wide ranging.

These results indicate that the stabilizing effects of fiscal policies, whether expansionary or adjustment-like, must be carefully evaluated, with the most detailed cost/benefit analysis possible for each specific case, depending on the economy and time under consideration.

In the same way that at the start of the crisis it was emphasized that the expansive fiscal policies applied should be TTT (Timely, Targeted and Temporary), now the adjustment and fiscal consolidation policies should be TTP: Timely, Targeted and Permanent. Timely because they must be carried out with an appropriate pace for them to be effective in reducing the deficit without endangering growth more than necessary, and trustworthy for the financial markets that finance the governments. Targeted because not all public spending (income) has to be reduced (increased) equally, since not all spending policies are equally effective, nor do they have the same effects on growth and on the distribution of their costs between the economic agents. And Permanent because the only way of reducing the structural fiscal deficit is through adjustment policies with permanent effects on public balances.

References

Andrés, J. and R. Domenech (2013): "Ajustes fiscales y crecimiento económico en Europa". Economic Watch, BBVA Research (forthcoming).

Barro, R. (2009): "Government Spending Is No Free Lunch". The Wall Street Journal. 22nd January.

Blanchard, O. and D. Leigh (2013): "Growth Forecast Errors and Fiscal Multipliers". IMF Working Paper WP/13/1.

DeLong, B. and L. H. Summers (2012): "Fiscal Policy in a Depressed Economy". Brookings Papers on Economic Activity, Spring.

IMF (2010): *World Economic Outlook*. Recovery, Risk, and Rebalancing. October.

IMF (2012): *World Economic Outlook. Coping with High Debt and Sluggish Growth*. October.

Gechert. S. and H. Will (2012): "Fiscal Multipliers: A Meta Regression Analysis," IMF Working Paper 97-2012.

Giles, C. (2012a): "Has the IMF proved multipliers are really large? (wonkish)". *Financial Times,* 12th October.

Giles, C. (2012b): "Robustness of IMF data scrutinised". *Financial Times,* 12th October.

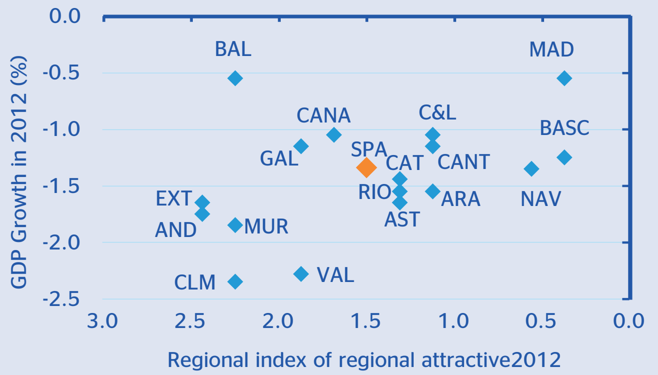
Spilimbergo, A., S. Symansky and M. Schindler (2009): "Fiscal Multipliers". IMF Staff Position Note SPN/09/11.

Box 2. Fiscal adjustment and the external sector highlight regional differences

Different regional performances continued throughout 2012, mainly due to three factors: the pace in correcting past aggregate imbalances in the private sector, the ongoing fiscal adjustment and export performance (for both goods and services).

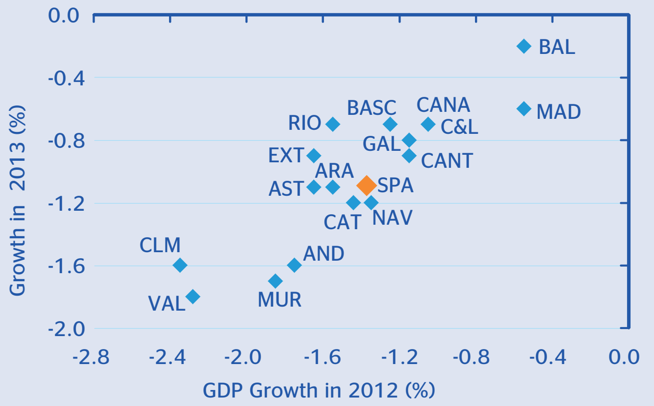
The first major aspect limiting the chances of recovery is linked to the private sector's aggregate imbalances dating to the pre-crisis period and how quickly they are being absorbed. Although previous editions of this magazine have already commented on these factors[14], the leverage of businesses and households, new housing over-supply or the unemployment rate continue to limit private consumer behaviour and business investment. In particular, regions in the south and west as well as the Canary Islands continue to see the highest drop in domestic demand, whereas regions in the north and Madrid show a relative advantage that is reflected in a smaller decline in consumer spending and domestic investment. This situation will remain throughout 2013 in both instances, with these corrections possibly coming to an end in some regions by the end of the year (see Charts 26 and 27).

Chart 26
Regional GDP growth in 2012 and index of regional attractive



Source: BBVA Research

Chart 27
Regional GDP growth in 2012 and 2013



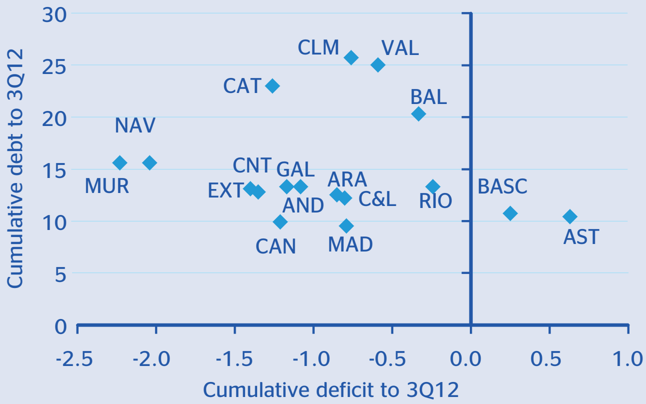
Source: BBVA Research

The second factor set to affect output performance over the coming quarters will be fiscal adjustment. In particular, regional growth's evolution will be impacted by a) the deviation with respect to the 2012 deficit target (1.5% of GDP), the reasons behind the non-compliance, and the kind of policies put in place in order to correct the deviation where necessary; b) the change in transfers from central government due to the introduction of the regional funding system, and c) the likelihood of accessing capital markets in order to finance the imbalance in public balances. In this sense, although all regions presented adjustment plans allowing for compliance with the deficit target at the start of 2012, it is highly likely that this was not attainable in some regions given the progress seen in data corresponding to the third quarter of 2012 (see Chart 28). In the majority of instances showing possible non-compliance, most of the forecast was supported by expectations of higher revenue than was actually the case, alongside spending adjustment measures that were implemented late or only partially. This means the fiscal effort in these regions would have been lower-than-expected, leading to a smaller GDP contraction than would have been the case if the target had been achieved.

14: See SpainWatch 2nd quarter 2012, available for download at: http://www.bbvaresearch.com/KETD/fbin/mult/1205_Situacionespana_tcm346-326621.pdf?ts=2912013

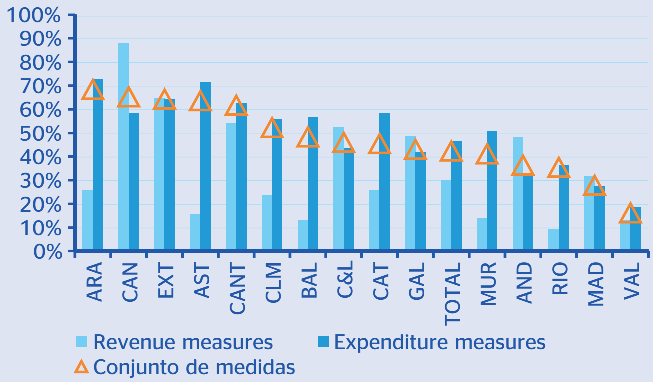
Specifically, regions wrote an Economic and Financial Plan (PEF) in April to correct the failure to comply with the 2011 deficit and to plug the gap in the initial budgets for 2012. In most regions, these measures, mainly centred on spending, should have allowed the 1.5% deficit target to be hit. Nevertheless, the level of non-compliance to September (the last period with data) seems to point that the implementation was slow (see Chart 29). Accordingly, the level of implementation of these measures for all regions in September was 42% of the forecast amount (30% in revenue measures and 47% in spending), albeit with high variations. It should also be taken into account that revenue increase measures in Andalusia, Asturias, Aragón, Castile-La Mancha, the Balearic Islands, Valencia, Catalonia and Murcia include asset sales. The impossibility of making most of these transactions effective is the reason why these regions show lower implementation levels concerning to their revenue measures. This puts the likelihood of PEF compliance into question for most of them (and therefore, the deficit target).

Chart 28
Regional government deficit and debt in 3Q12 (% of GDP)



Source: BBVA Research based on MINHAP data

Chart 29
Implementation level in the third quarter of 2012 for fiscal consolidation measures set out in the April 2012 PEFs



Source: BBVA Research based on MINHAP data

The knock-on effect is that, in principle, this adjustment should be transferred to 2013 in which the regional target deficit is 0.7% of GDP, assuming an additional effort for the current year. The budgets passed by all regions, however, assume compliance with the 2012 target as a starting point, implying that those who have failed to comply, will need to present additional adjustment plans (as was the case the previous year). These plans would come into effect over the year and include enough efforts to achieve the target. Since said measures have still to be put forward, thus making it impossible to assess their impact on economic output, the forecasts set out here only include the fiscal policies announced before this publication's deadline. Moreover, it is increasingly likely that the deficit target will be made more flexible for all regions in reaction to the drop in public revenue due to the recession and in spite of the measures introduced. If this greater flexibility affected the regions' targets (which would be highly desirable), those regions with a lower exposure to the economic cycle would benefit most, i.e. those facing a lower likelihood of declining revenues in 2013. This is not a direct consequence of making the target more flexible itself, but from the restriction of demanding the same deficit target to regions with a high level of variety and exposure to aggregate imbalances in the pre-crisis period.

On the other hand, the changes in the size of central government transfers in the current year are added to the necessary adjustment to compensate for the deviation in 2012 and hitting the target in 2013. These changes are down to two sources: firstly, the readjustment in control variables for national government transfers to regions due to the implementation of the regional funding system introduced by Law 22/2009. As a result of this law, the weight of payments on account of tax revenue set out in the National Budget for 2013 increases in some regions. This should mean a permanent improvement in revenue that in, Cantabria or Extremadura for example, totals 9 and 8 tenths of GDP in with respect to 2012, or 6 tenths in the case of La Rioja[15] (see Table 2).

Secondly, regional revenue collection corresponding to 2011 will be paid in 2013, compensating for the difference between payments made during that year and what was effectively paid by the regions, both for transferred taxes and for the Global Sufficiency and Guarantee Funds (Fondo de Suficiencia Global and Fondo de Garantía). Due to the forecast error for revenue in 2010, settlement for payments received in 2012 was particularly positive for some regions (e.g. Madrid). Consequently, this means a revenue increase or loss (in this case, temporarily) for some regions. Lastly, the required fiscal adjustment in regions is affected by the debt volume and its funding requirements. Regions with lower debt levels are taking advantage of the window of opportunity at the start of 2013 to attain funding in the markets. Meanwhile, those with higher leverage and continued difficulty and expense in accessing markets (if not left out) are seeing how their access to the FLA (Regional Liquidity Fund) is actually increasing their debt burden. This will therefore mean differential efforts in reducing expenditure are required (or a higher tax burden) in an attempt to accomplish with deficit targets, negatively impacting growth. Moreover, this liquidity restriction increases the risk of regions using their suppliers as a funding source, delaying payments and exacerbating the output correction at local level.

In any case, even if a region fails to accomplish with the deficit target in 2013, they should progress in fiscal adjustment, leaving a smaller part for 2014. Consequently, this factor would weaken in terms of limiting growth next year, especially in those regions with relatively low debt levels. Looking ahead, it should be pointed out that there is a constitutional limit on regional debt (13% of GDP) and the current gap from the said ceiling is fairly sizeable in some regions. This means the fiscal efforts will need to continue there beyond 2014.

Table 2
Change in funding for payments on account between 2012 and 2013 in regions with common regime

	Change (% GDP)			
	By account settlements from previous (1)	**By transfers in current year (2)**	**Total (3)=(1)+(2**	**In EURmn**
Andalusia	0.1	0.3	0.4	583.48
Aragon	-0.1	0.3	0.2	63.90
Asturias	-0.1	0.3	0.2	35.25
Balearic Islands	0.3	-0.4	-0.1	-22.52
Canary Islands	0.3	0.1	0.3	143.84
Cantabria	-0.5	0.9	0.4	46.51
Castile and León	-0.1	0.3	0.2	95.97
Castile-La Mancha	-0.4	0.4	0.0	-13.38
Catalonia	0.0	0.1	0.0	37.15
Extremadura	-0.3	0.8	0.4	74.52
Galicia	-0.1	0.3	0.2	122.02
Madrid	-0.5	0.0	-0.5	-998.81
Murcia	0.1	0.2	0.3	75.37
La Rioja	-0.6	0.6	0.0	3.17
Valencian Com.	0.2	-0.1	0.1	119.39
Total Regions	**-0.1**	**0.1**	**0.0**	**437.40**

Source: MINHAP and BBVA Research

The third important factor for establishing growth is external sector behaviour. The stagnant European economy in 2012 has had an impact on both exports and foreign tourism. After two years of strong growth in both variables, they showed a clear depletion in 2012. Goods exports increased by 3% (nominal to November, last figures released) whilst the number of foreign tourists in hotels rose 1.5%. Both variables showed double-digit growth in 2011[16].

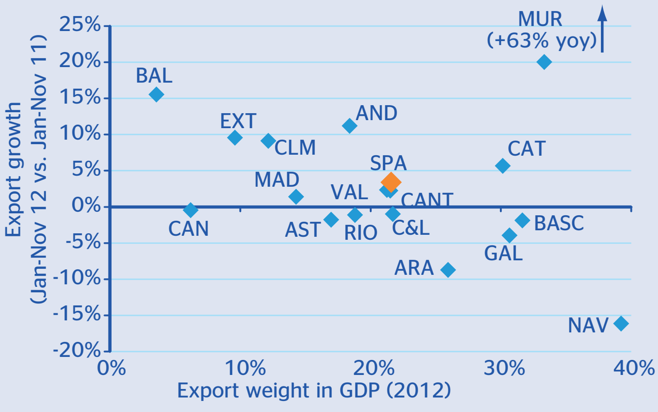
15: For a deeper analyis about regions financing, see: BBVA Research (2013), WP13/03; *El sistema de financiación regional: la liquidación de 2010 y algunas reflexiones sobre la reciente reforma*, avalaible at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1303_tcm346-364251.pdf?ts=722013. BBVA Research (2012) WP 12/27, *Algunas propuestas para la reforma del sistema de financiación de las comunidades autónomas de régimen común*, avalaible at: http://www.bbvaresearch.com/KETD/fbin/mult/WP_1227_tcm346-362203.pdf?ts=722013, or BBVA Research (2012) WP12/23 *El nuevo sistema de financiación de las Comunidades Autónomas de régimen común: un análisis crítico y datos homogéneos para 2009 y 2010*, avalaible at http://www.bbvaresearch.com/KETD/fbin/mult/WP_1223_tcm346-360838.pdf?ts=722013
16: See section 2 in the same publication for more information.

Two important factors can be discerned in recent years for regional exports: on the one hand, greater globalisation (higher in regions with a lower export weight) seen in higher average export growth since the start of the crisis. On the other, the important correlation between regional export growth and EMU growth. This is not surprising since, on average, this destination represents over 60% of exports. Given the inertia in regions with a lower export weighting, it is clear that they would again see somewhat higher growth for exports in 2013 than those regions that already have a strong export base. Nonetheless, this higher growth will not be enough to compensate for the lower weight and, accordingly, the contribution to GDP growth will continue to be lower in regions with a smaller external sector[17] (see Chart 30).

Something similar may occur in the tourism sector. After the high growth seen in previous years, economies with a major weighting for overseas tourism have experienced a slight downturn in the arrival of foreign tourists (notably in the Canary Islands) which could be rectified in 2013 thanks to an improved economic outlook in the main countries of origin. In any event, slight growth in overseas tourism in Mediterranean and island regions represents a higher contribution to growth than in northern and inland regions (except for Madrid) where the weight of tourism is minimal and continues to rely on weak domestic demand.

Chart 30

Weight and growth of exports overseas (%)



Source: BBVA Research based on Datacomex data

In short, 2013 is likely to see the effects of fiscal consolidation and the correction of domestic imbalances generally predominating over positive news from the external sector. With a slightly milder scenario for Europe as a whole towards 2014 and with no significant changes for the rest of the world, but having progressed in domestic adjustment and fiscal consolidation, we could start to see a recovery in inter-regional convergence within a positive growth scenario. Here, the external sector could also contribute to this convergence given the market share forecast for less open regions.

Table 3

Spain: real GDP growth by region

	2011	2012	2013	2014
Andalusia	0.0	-1.7	-1.6	1.1
Aragon	0.3	-1.5	-1.1	1.3
Asturias	-0.1	-1.6	-1.1	1.0
Balearic Islands	1.6	-0.5	-0.2	1.4
Canary Islands	1.7	-1.0	-0.7	1.0
Cantabria	0.5	-1.1	-0.9	1.1
Castile and León	1.1	-1.0	-0.7	1.4
Castile-La Mancha	-0.4	-2.3	-1.6	0.8
Catalonia	0.6	-1.4	-1.2	1.2
Extremadura	-0.9	-1.6	-0.9	1.0
Galicia	-0.1	-1.1	-0.8	1.2
Madrid	0.6	-0.5	-0.6	1.4
Murcia	0.0	-1.8	-1.7	0.8
Navarra	1.4	-1.3	-1.2	1.1
Basque Country	0.8	-1.2	-0.7	1.2
Rioja (La)	0.9	-1.5	-0.7	1.2
Valencian Community	-0.2	-2.3	-1.8	0.7
Spain	**0.4**	**-1.4**	**-1.1**	**1.1**

Source: BBVA Research

17: Export growth in Murcia has been especially affected by a refinery opening in Escombreras in 2011, which has increased fuel output. Once production stabilises, growth rates should become more stable.

Box 3. The restructuring of the Spanish financial system makes progress

In the last few months, Spain's financial system situation has made important progress taking adequate steps to restore confidence. The needed public capital injection has been quantified at €39 billion, well below the €100 billion of available funding. These funds have already started to be disbursed. The total amount of public capital injected will be around 5% of GDP, which is considered manageable and in line with the amount needed in other European countries. Also, before the end of 2012, Group 1[18] financial entities have transferred €36 billion of real estate assets to the Sareb (bank restructuring asset management agency). Group 2 entities' real estate assets with an estimated value of 15 billion Euros will also be transferred in the next months.

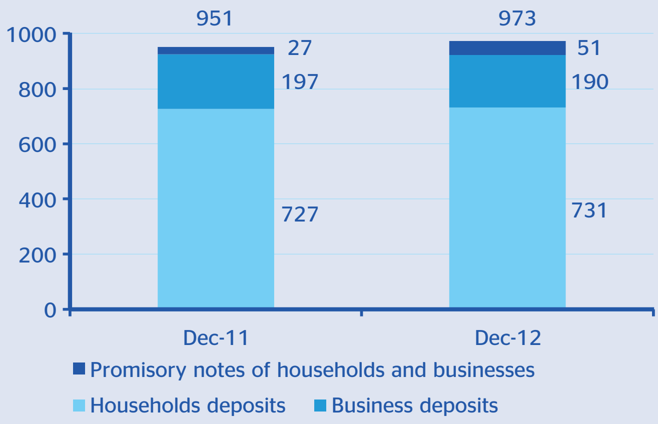
Currently, and following Brussels guidelines, institutions with solvency issues are undergoing a process of adjustment of their installed capacity, getting ready to go public and, in some cases, negotiating their integration into, or merging with, other institutions.

The measures taken to recapitalize the part of the Spanish financial system with solvency issues (very limited, accounting for only 30% of the total assets) have improved the solvent Spanish credit institutions' access to market liquidity. Some entities have been able to tap the markets, still at a high cost. This helped to reduce the dependency on the European Central Bank (ECB) funding at the end of 2012, and to the early repayment in 2013 of part of the ECB's extraordinary liquidity auctions.

The rest of the businesses and the public administration are taking advantage of the credit institutions' better liquidity environment. The improved tone of the markets is starting to impact all sources of wholesale funding. Thus, the repo market, through clearing houses, is growing again, supported by the recent cost reduction of using Spanish collateral (due to the lower risk premium). Also, the primary debt market is reopening for the more solvent institutions, although at higher prices than before the crisis.

The total amount of deposits and promissory notes in the hands of households and businesses were up €21 billion in 2012, which confirms that despite certain isolated deposit withdrawals during the year, a more detailed look at the statistics proves that there has not been any massive outflow of deposits in 2012.

Chart 31
Spain: resources in the hands of households and resident businesses (€ Billion)



Source: BBVA Research based on Bank of Spain and AIAF data

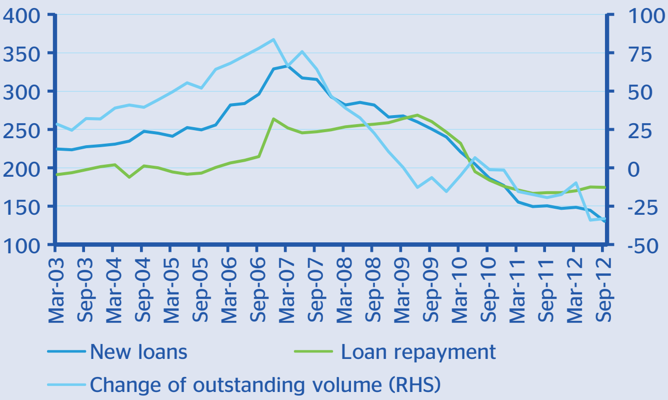
On the other hand, the Spanish financial entities have made a great provisioning effort, in part to comply with the two enacted royal decrees on credit institutions' exposure to real estate. These expenses, together with a worsening economic background have eroded the profitability of the institutions.

In order to continue improving the confidence in the Spanish financial system, it is paramount to fulfil the implementation of the current plans. Specifically, progress must be made to: i) carry out the restructuring of the less solvent institutions, through quick auctions of the intervened ones in order to avoid inefficiencies and to adjust the installed capacity; ii) start liquidating Sareb assets; and iii) continue the deleveraging of the most indebted segments, in such a way that the provision of credit to solvent demand is maintained.

In this regard, the statistics published by the Bank of Spain suggest that a reduction of the outstanding lending volume and a curb in the decline in the number of new loans to the private sector are taking place simultaneously. However, the Bank of Spain includes in this category a very diverse set of transactions, like refinancing and novations, which have little to do with new business. In order to assess the success of the financial system reform, a more adequate set of statistics needs to be available. A breakdown of funding per economic sector and business size would make easier the assessment of the steps taken.

18: For a breakdown of financial institutions per group, see BBVA Research (2012), "The restructuring process of the Spanish financial system", in Spain Watch, fourth quarter.

Chart 32
Credit to the private sector (€ Billion, SWDA)



Source: BBVA Research based on Bank of Spain data

Although the implementation of the Memorandum of Understanding (MoU) is being made in an orderly manner and according to an ambitious schedule, some of the commitments still must be executed. In March 2013, a new credit recording procedure will come into force. Currently, there is a draft being discussed. Issues like lending concentration and transactions with related parties must be addressed in the medium term.

New initiatives to promote lending to SMEs

One of the keys to sustained economic growth and job recovery in Spain is the promotion of funding for the Small and Medium Sized Enterprises (SMEs). That's why new public and private initiatives are being developed to make funding available to SMEs, both through banks and non-banking institutions.

The most effective initiatives meet simultaneously the following criteria: (1) have a greater potential impact on business funding, (2) have immediate, short-term impacts, and (3) have a reduced impact on the Public budget.

On the bank funding front, the ICO (Official Credit Institution) bridging credit lines could be provided with greater flexibility, particularly in terms of pricing for businesses with a higher risk profile. To promote funding of working capital, the following measures may be useful: the reduction of the tax cost of high quality bills of exchange (to make their discount easier); the strengthening of business insurance companies through public guarantees (Crédito y Caución, Cesce…); banks may be awarded the right to collect a part of VAT so that they may advance the proceeds to the SMEs; and the creation of a trading platform of commercial paper.

Also, it would be interesting to promote the internationalization of the SMEs, either using ICO lines or through public or private guarantees. There are also initiatives to promote the Mutual Guarantee Companies (Sociedades de Garantía Recíproca, SGRs) making them more solvent and bigger. A better coordination or consolidation of regional SGRs would improve their efficiency, as would any strengthening of their synergies with the ICO.

On the regulatory side, there are several initiatives to reduce the capital consumption of loans to SMEs. A proposal aimed at reducing the risk weighting of these exposures is being debated in congress.

On the non-banking funding side, the expected impact is more mid to long-term. Among the new initiatives being discussed is the creation of an agile and efficient Fixed Income Alternative Market (Mercado Alternativo de Renta Fija, MARF), which, at the beginning, would be focused on issues by medium-sized and large companies. In order to further develop these initiatives it is vital to have local credit rating institutions.

Additionally, there are initiatives to promote capital investment in SMEs through public-private co-financing. This group of proposals include initiatives like seed capital (or business angels), venture capital, funds of funds and crowdfunding (or peer-to-peer funding). It would be interesting to promote these initiatives through fiscal incentives and, in some cases, the creation of best practice codes or standards in order to provide them with legal certainty.

4. Reduction of public deficit gains momentum despite recession

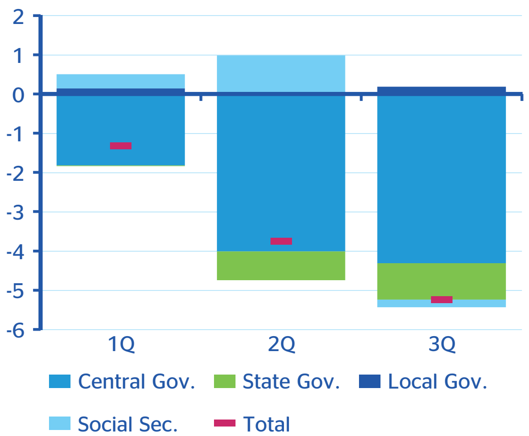
In the third quarter of 2012, the balance sheet of public finances showed modest and even positive progress towards meeting the end-of-year objectives, given the improvement despite the slowing economy. As a result of the above, the probability of not meeting the target set (-6.3% of GDP) has increased considerably. Nevertheless, the Government has demonstrated an ability to reduce the public deficit against the backdrop of a recession, which should improve the outlook regarding the sustainability of Spain's public debt.

The accumulated Spanish public deficit increased 1.5p.p. in the third quarter of 2012, that is -5.2% of GDP, excluding the aid to financial institutions (0.9p.p. of GDP), and slightly over 1 p.p. of the end-of-year target (see Chart 33). The increase in the public deficit, by agent (Chart 34), was concentrated on Social Security, which closed Q3 2012 with a deficit of 0.2% with respect to GDP, compared to a surplus of almost 1p.p. that had accumulated in the first six months of the year. For its part, both the central government and the autonomous communities countered the rate of growth in the deficit in Q3 2012 to 4.3% and 0.9% of GDP, respectively.

Chart 33
Spain: net lending (+)/ net borrowing of the public administrations (-) (*)
(Accumulated per year. % GDP)

(*) Not including the amount of aid to the financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration)

Chart 34
Spain: net lending (+)/ net borrowing of the public administrations in 2012 (-) by subsector(*)
(Accumulated per year. % GDP)



(*) Not including the amount of aid to the financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration)

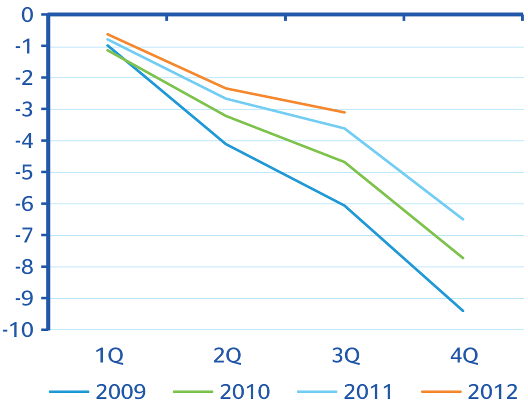
The deterioration observed in the Social Security accounts illustrates the impact of the drop in activity and the fall in employment on the public deficit. The cyclical deterioration is absorbing the majority of the adjustments that have been applied. Thus, based on BBVA Research estimates, the contracting trend in the economic cycle has drained about 1.2p.p. from total accumulated public revenue as of Q3 2012, absorbing the increase of almost one percentage point in the structural revenue arising from the approved measures. This improvement stemmed from the hike in VAT -which yielded a structural increase of 0.4p.p. of GDP- as well as the rise in personal income tax and the regulatory changes to Spanish corporation tax -which yielded a structural increase of 0.6p.p. of GDP-. As a result, total public revenue was down slightly -by 0.3p.p. of GDP-.

Similarly, the impact of activity on the public balances is being offset largely by the structural adjustments to expenditures. In particular, we can observe an adjustment to the structural component of spending, of 1p.p. of accumulated GDP during the first three quarters of 2012.

Although this adjustment is generalized to practically all items of expenditure, it is centred on investment, which is accumulating a structural decline of 0.7p.p. of GDP. However, this structural adjustment has not been enough to offset the increase in the interest expense -which is up almost 0.4p.p. of GDP-; the effect of the cyclical decline in unemployment benefits -which are up 0.1p.p. of GDP-; and the increase in payments relating to other Social Security entitlements -up 0.3p.p. of GDP- which is a result of both the government approved adjustment to pensions for 2012, and the structural increase in payment obligations. Thus, total accumulated public expenditure as of Q3 2012 is approximately 30.5% of GDP, barely 0.2p.p. less than the cumulative figure as of September 2011.

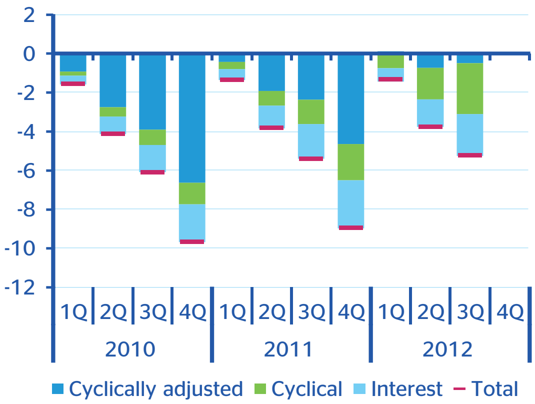
Therefore, the structural adjustment to the primary balance for General government was nearly 2p.p. of GDP up to September 2012. If in addition to this adjustment, we add the impact of the economic cycle (-1.4p.p. of GDP as of 3Q12), the primary deficit totalled -3.1% of cumulative GDP as of 3Q12. Although this result clearly shows the significant fiscal consolidation effort underway, the further decline in economic activity, along with increased pressure on the Spanish public debt, largely explain the variance in the deficit from the approved stability targets (see Charts 35 and 36).

Chart 35
Spain: primary balance of the public administrations (*) (Accumulated per year. % GDP)



(*) Not including the amount of aid to financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration) and INE (Spanish National Institute of Statistics)

Chart 36
Spain: breakdown of net borrowing of the public administrations (*) (Accumulated per year. % GDP)



(*)Not including the amount of aid to financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration)

With respect to year end, current Central government budget data (actual) show that the accumulated deficit grew slightly in November 2012 to 4.3% of GDP, 2 tenths below the year-end target. These figures reveal an accelerated spending adjustment, which fell for the first time year-on-year, and significantly, in terms of both remuneration of employee and intermediate consumption. Similarly, the November figures confirm that most of the adjustment is being made to capital expenditure. For its part, both actual income up to November, and the recently presented information, point towards a recovery in tax revenue, driven both by the slowing rate of refunds and growth in gross revenue and most importantly, the impact of the increase in VAT rates and the regulatory changes in Spanish corporation tax.

Within this context, despite it is expected that the fiscal adjustment was accelerated in 4Q12, since a significant share of the announced measures would have had a greater impact on Q4 (e.g., the increase in the rate of VAT and the elimination of the Christmas extra-pay for public employees), it is not likely to be enough to correct the negative effects of the decline in activity on revenue and expenses and the estimated rise in interest. Thus, according to estimates by BBVA Research, during the final quarter of 2012 the cycle drained about 0.5p.p. of GDP in terms of tax revenue, absorbing most of the structural improvement and yielding public revenue around 36% of GDP, barely 0.2p.p. above the level in 2011. This poor performance in revenue means that the consolidation effort depends on expenditures, with a particularly heavy impact on employee remuneration (due to the cut in the Christmas extra-pay mentioned above), investment spending and, to a lesser extent, other current expenditures (see Table 4). As a result, the General government is expected to close 2012 with a deficit of approximately 7.2% of GDP, almost 1p.p. above the stability target (-6.3%).

This variance in the 2012 deficit target means that is less likely of meeting the 2013 target and, therefore, the 2014 target. As shown in Chart 37, in if the measures already announced were not ultimately implemented, the 2013 public deficit would increase by approximately 1p.p. as a result of the effects of the economic slowdown on the deficit, and by another point for the structural increase in Social Security entitlements and the increase in the interest expense. Therefore, to meet the deficit target as of the end of 2013 (-4.5%), the global adjustment effort must exceed 4.7p.p. of GDP, for which measures equivalent to some 3.2p.p. have already been announced and/or implemented. Therefore, in the absence of additional tax consolidation measures, the 2013 deficit would stand at approximately 5.9% of GDP -1.5p.p. above the target- if the European Commission does not make the deficit targets more flexible. This variance would go on into 2014, when both the economic cycle and the structural improvement to revenue and expenses would begin to compensate the decrease in tax revenue, but not so much as to offset the variance in the deficit during previous years.

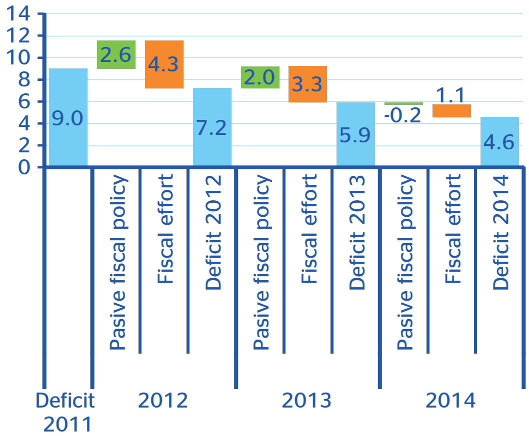
In spite of this, should the forecasts made by BBVA Research be fulfilled, the public structural balance (i.e., after discounting the effects of the economic cycle) would be close to the target of 0% of GDP in 2014 (see Chart 38), accumulating a correction of almost 7p.p. in just three years- an unprecedented adjustment in other tax consolidation processes in developed countries, both in terms of magnitude and speed. Nevertheless, as already mentioned in the previous publication of this report, one negative aspect of the adjustment is that a significant portion of the measures that have been implemented are only temporary (e.g., the increase in personal income tax levied valid for 2012 and 2013 only, the cut in the Christmas extra-pay in 2012, part of the adjustment to investment spending, etc.), requiring rigorous implementation of the measures already announced to replace them or the need to apply new ones. This latter event may be particularly important for the autonomous communities since some of them may have been too optimistic in their revenue forecasts for 2013. As the year progresses, and in the event that these forecasts are not met, the Government will have to make use of the instruments established both through the Budget Stability Law and the commitments acquired as a result of using to the Autonomous Community Liquidity Fund and, accordingly, consolidate the process of reducing the deficit of autonomous communities.

Moving forward, there is still uncertainty as to the Government's ability to reduce the deficit to 3% of GDP by 2014, although getting it down to approximately 7% of GDP in 2012 was a step in the right direction. If additional measures are required, the best thing would be for them to focus on reducing inefficiencies in public expenditure or using indirect taxation in order to minimize the impact on economic activity.

Lastly, the Government has committed to creating an independent fiscal agency in the first quarter of 2013, based on the recommendations of the European Commission. As explained right from the start of the publication, this reform is crucial if Spain is to stand out for better institutional efficiency and transparency that allow it to continue to regain confidence in terms of the country's public finances. A transparent, easy-to-replicate, public methodology for developing its diagnosis on the economy's cyclical position, its own budget, functional dependence on Congress and management by acknowledged experts are just some of the features that this entity must adopted if it is to be successful.

Chart 37

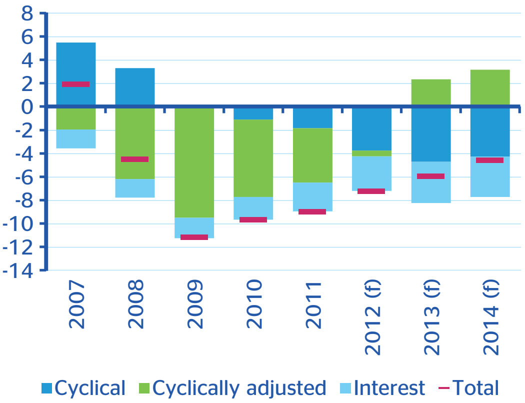
Spain: estimated fiscal adjustment of the public administrations (*) (% GDP)



(*) Not including the amount of the aid to financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration) and INE (Spanish National Institute of Statistics)

Chart 38

Spain: net lending / net borrowing of the public administrations (*) (% GDP)



(*)Not including the amount of the aid to financial institutions.
Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration) and INE (Spanish National Institute of Statistics)

Table 4

AA.PP: budget balance adjustment. Excluding the financial sector aids

		2012			2013		2014	
		Adjustment						
(pp of GDP)	2011	3Q12	4Q12 (f)	Forecast	Adjust.	Forecast	Adjust.	Forecast
Compensations of employees	11.6	-0.18	-0.64	10.8	-0.54	10.3	-0.31	9.9
Intermidiate consumption	5.9	-0.04	-0.26	5.6	0.07	5.6	-0.20	5.4
Interest	2.5	0.35	0.14	2.9	0.61	3.6	-0.10	3.5
Unemployment benefit	2.8	0.13	0.07	3.0	0.14	3.2	-0.14	3.0
Social protection	12.6	0.30	0.14	13.0	0.46	13.5	0.04	13.5
Gross capital formation	2.9	-0.72	-0.25	1.9	-0.67	1.2	-0.39	0.9
Other expenditures	6.4	-0.33	-0.27	5.9	-0.86	5.0	-0.47	4.5
Non-financial expenditures	**44.7**	**-0.50**	**-1.07**	**43.1**	**-0.80**	**42.3**	**-1.58**	**40.7**
Taxes on production	9.9	-0.09	0.11	9.9	0.48	10.4	-0.05	10.3
Taxes on income, wealth, etc.	9.6	0.07	0.45	10.1	-0.30	9.8	-0.18	9.6
Social contributions	13.2	-0.23	-0.02	12.9	-0.19	12.7	-0.02	12.7
Taxes on capital	0.4	0.01	-0.20	0.2	0.03	0.2	0.00	0.2
Other revenues	2.7	-0.07	0.16	2.8	0.48	3.3	0.01	3.3
Non-financial revenues	**35.7**	**-0.31**	**0.49**	**35.9**	**0.49**	**36.4**	**-0.24**	**36.1**
Net lending / net borrowing	**-9.0**	**0.19**	**1.56**	**-7.2**	**1.29**	**-5.9**	**1.34**	**-4.6**
Financial sector aid	0.48			1.42				

Source: BBVA Research based on MINHAP (Spanish Ministry of Finance and Public Administration) and INE (Spanish National Institute of Statistics)

5. Tables

Table 5

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate, %)	2010	2011	2012	2013	2014
United States	2.4	1.8	2.2	1.8	2.3
Eurozone	1.9	1.5	-0.5	0.3	1.3
Germany	4.0	3.1	0.9	1.0	2.0
France	1.6	1.7	0.0	0.4	1.5
Italy	1.8	0.6	-2.1	-0.7	0.9
Spain	-0.3	0.4	-1.3	-1.1	1.1
UK	1.8	0.9	0.0	1.0	1.9
Latin America *	6.2	4.3	2.8	3.5	3.7
Mexico	5.4	3.9	3.9	3.1	3.1
Brazil	7.6	2.7	0.9	3.6	4.0
EAGLES **	8.4	6.6	5.1	5.8	6.1
Turkey	9.2	8.5	2.6	4.4	5.5
Asia Pacific	8.2	5.7	5.2	5.6	5.8
China	10.4	9.2	7.7	8.0	8.0
Asia (exc. China)	6.7	3.4	3.6	4.0	4.4
World	5.1	3.9	3.2	3.6	4.1

* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: February 8 , 2013
Source: BBVA Research

Table 6

Macroeconomic forecasts: 10Y interest rates (average)

	2010	2011	2012	2013	2014
US	3.2	2.8	1.8	2.0	2.6
EMU	2.8	2.6	1.6	2.0	2.9

Closing date: February 8 , 2013
Source: BBVA Research

Table 7

Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2010	2011	2012	2013	2014
US (EUR/USD)	0.76	0.72	0.78	0.77	0.75
EMU	1.33	1.39	1.29	1.31	1.34
UK	1.55	1.60	1.59	1.52	1.53
China	6.77	6.46	6.31	6.16	6.02

Closing date: February 8 , 2013
Source: BBVA Research

Table 8

Macroeconomic forecasts: official interest rates (end of period)

	2010	2011	2012	2013	2014
US	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	0.75	0.75	1.25
China	5.81	6.56	5.75	6.00	6.00

Closing date: February 8 , 2013
Source: BBVA Research

Table 9

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

	2010	2011	2012	2013	2014
Real GDP	2.0	1.5	-0.5	0.3	1.3
Household consumption:	0.9	0.1	-1.2	-0.3	0.9
Public consumption	0.7	-0.1	-0.2	-0.5	0.2
Gross fixed capital formation	-0.3	1.6	-3.8	-1.3	3.3
Equipment, machinery and cultivated assets	6.3	4.6	-6.0	-2.3	4.9
Equipment and machinery	6.4	4.6	-6.0	-2.4	4.9
Construction	-4.4	-0.3	-3.1	-1.5	2.0
Housing	-2.9	0.8	-1.7	-1.2	2.6
Other buildings and other constructions	-5.9	-1.4	-4.6	-1.8	1.3
Change in inventories (contribution to growth)	0.6	0.2	-0.5	0.0	0.0
Domestic demand (contribution to growth)	1.2	0.5	-2.0	-0.5	1.1
Exports	11.0	6.5	3.1	3.3	3.8
Imports	9.5	4.3	-0.4	1.8	3.8
Net exports (contribution to growth)	0.7	1.0	1.5	0.8	0.2
Pro-memoria					
GDP w/out housing investment	2.2	1.5	-0.4	0.3	1.3
GDP w/out construction	2.8	1.7	-0.1	0.4	1.3
Employment (LFS)	-0.5	0.5	-0.7	-0.5	0.4
Unemployment rate (% active pop.)	10.1	10.2	11.4	11.8	11.4
Current account balance (% GDP)	0.0	0.1	1.1	1.3	1.4
Public sector balance (% GDP)	-6.2	-4.1	-3.0	-2.3	-1.8
CPI annual average	1.6	2.7	2.5	1.6	1.5

Closing date: February 8 , 2013
Source: official institutions and BBVA Research

Table 10

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

	2010	2011	2012	2013	2014
Activity					
Real GDP	-0.3	0.4	-1.4	-1.1	1.1
Private consumption	0.7	-1.0	-1.9	-2.8	-0.3
Public consumption	1.5	-0.5	-4.0	-7.2	-1.8
Gross fixed capital formation	-5.5	-5.5	-8.8	-6.8	2.6
Capital goods	3.0	2.4	-6.3	-1.7	6.4
Construction	-9.8	-9.0	-11.5	-10.2	0.3
Housing	-10.1	-6.7	-7.1	-8.3	2.1
Domestic demand (contribution to growth)	-0.6	-1.9	-3.8	-4.6	0.0
Exports	11.3	7.6	3.3	6.3	8.2
Imports	9.2	-0.9	-4.7	-4.4	5.8
Net exports (contribution to growth)	0.3	2.3	2.5	3.4	1.1
GDP at current prices	0.1	1.4	-0.9	0.3	2.1
(Billion euros)	1048.9	1063.4	1053.9	1057.5	1080.0
GDP w/out housing investment	0.5	1.0	-1.0	-0.7	1.0
GDP w/out construction	1.6	2.1	0.2	0.1	1.2
Labour market					
Employment (LFS)	-2.3	-1.9	-4.5	-3.8	-0.2
Unemployment rate (% active pop.)	20.1	21.6	25.0	26.8	26.1
Employment QSNA (equivalent to full-time)	-2.5	-1.7	-4.3	-3.4	-0.4
Productivity	2.2	2.1	3.0	2.2	1.5
Prices and costs					
CPI (annual average)	1.8	3.2	2.4	2.0	1.1
GDP deflator	0.4	1.0	0.5	1.5	1.0
Household consumption deflator	2.0	2.9	2.5	2.0	1.2
Compensation per employee	0.3	0.7	0.3	0.1	0.1
Unit labour cost (ULC)	-2.0	-1.4	-2.7	-2.1	-1.4
Foreign trade					
Current account balance (% GDP)	-4.5	-3.5	-1.4	0.3	0.9
General goverment					
Debt (% GDP)	61.5	69.3	87.2	93.7	96.4
Budget balance (% of GDP)	-9.7	-9.0	-7.2	-5.9	-4.6
Households					
Nominal disposable income	-2.9	-0.5	-3.3	-1.5	0.4
Savings rate (% of nominal income)	13.1	11.0	7.3	6.6	6.1

(*): Excluding financial aid to Spanish banks
Closing date: February 8 , 2013
Source: official institutions and BBVA Research

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

This report has been produced by the Spain Unit:

Chief Econmist for Developed Economies
Rafael Doménech
+34 91 537 36 72
r.domenech@bbva.com

Spain
Miguel Cardoso
+34 91 374 39 61
miguel.cardoso@bbva.com

Anabel Arador
+ 34 93 401 40 42
ana.arador@grupobbva.com

Joseba Barandiaran
+34 94 487 67 39
joseba.barandia@bbva.com

Xavier Callol
+34 91 374 75 28
xavier.callol@bbva.com

Mónica Correa
+34 91 374 64 01
monica.correa@bbva.com

Juan Ramón García
+34 91 374 33 39
juanramon.gl@bbva.com

Ángel Gavilán
+34 91 374 52 62
angel.gavilan@bbva.com

Félix Lores
+34 91 374 01 82
felix.lores@bbva.com

Antonio Marín
+34 648 600 596
antonio.marin.campos@bbva.com

Myriam Montañez
+34 954 24 74 86
miriam.montanez@bbva.com

Mercedes Nogal
+34 91 807 51 44
mmercedes.nogal@bbva.com

Virginia Pou
+34 91 537 77 23
virginia.pou@bbva.com

Juan Ruiz
+34 646 825 405
juan.ruiz2@bbva.com

Pep Ruiz
+34 91 537 55 67
ruiz.aguirre@bbva.com

Camilo Andrés Ulloa
+34 91 537 84 73
camiloandres.ulloa@bbva.com

With the contribution of:

Europe
Miguel Jiménez
+34 91 537 37 76
mjimenezg@bbva.com

Financial Systems
Macarena Ruesta
+34 91 374 33 21
esperanza.ruesta@bbva.com

Economic Scenarios
Julián Cubero
+34 91 374 49 98
juan.cubero@bbva.com

BBVA Research

Contact details:

BBVA Research
Paseo Castellana, 81 - 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com
Depósito Legal: M-31254-2000