

Reforms in Spain

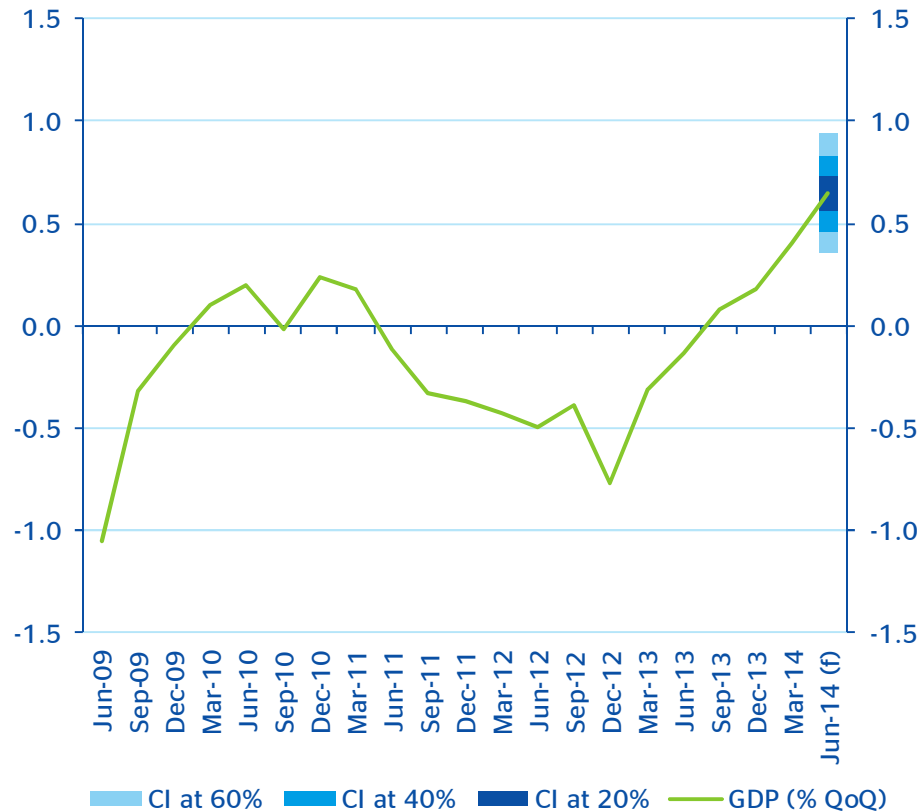
Jorge Sicilia, Chief Economist, BBVA Group

June 2014

The Spanish economy's recovery gains pace

Spain: GDP growth and MICA-BBVA forecasts (% QoQ)

Source: BBVA Research based on INE



The economy has grown for three consecutive quarters, and more strongly in 1Q14 (0.4% QoQ) ...

... thanks to better fundamentals, a lower need for fiscal adjustment, reduction of some uncertainties and import substitutions

If the favourable start to 2Q13 were to consolidate in the next few months, growth could accelerate again

Assessment of current economic conditions

1. Exports will continue to expand: above 6% y/y in 2014 and 2015

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

3. More certainty and fewer financial tensions:
10y risk premium below 120bp

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

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

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

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



The economic recovery has been in line with the stylised facts from previous cycles,...

Variables that precede the cycle	Export growth	✓
	Gross operating surplus	✓
	Investment in machinery and equipment	✓
	New credit operations (flow)	✓
	GDP growth	✓
=	Employment growth	✓
Lagging variables	Growth in stock of credit	Declining

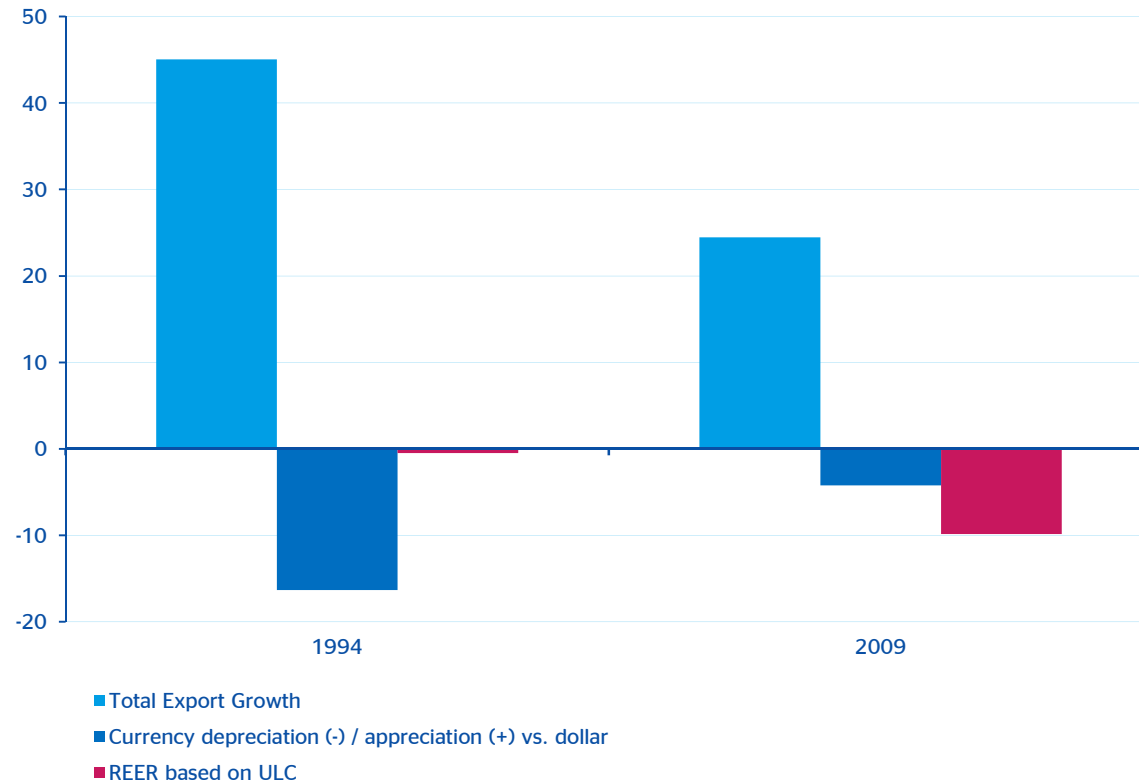


..., and this time without a currency depreciation, so competitiveness gains are not merely temporary

Spain: Export growth, exchange rate movement and ULC

(% change over the next 14 quarters after exports reached lowest level)

Source: BBVA Research based on Consensus Forecast Inc.

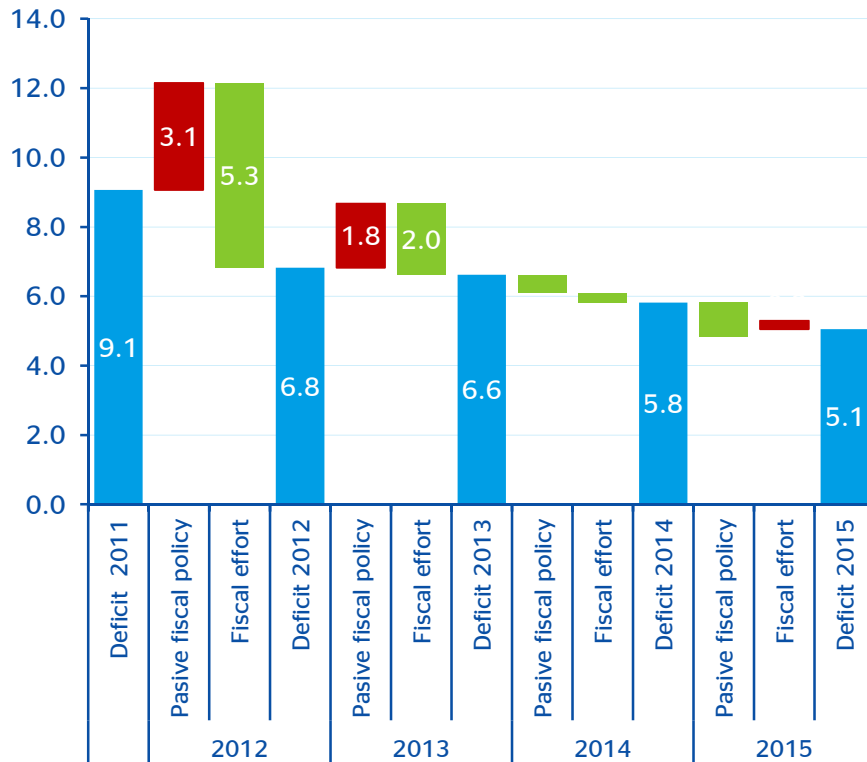


Which reforms has Spain implemented?

1. Improving sustainability of public finances

Spain: Public deficit, excluding aid to the financial sector (%GDP)

Source: BBVA Research based on MINHAP



A sizeable fiscal adjustment (7,5% of GDP in measures between 2012-13) and an improvement in institutions has been undertaken to regain confidence,...

... priority to interest payments (Constitution), the Budget Stability Law, and a fiscal authority that will evaluate fiscal policy show a strong institutional improvement ...

... that adds to revenue (VAT, Income tax) and expenditure measures (freeze in hiring, Christmas pay to public workers, co-payments in public services).

Which reforms has Spain implemented?

1. Improving sustainability of public finances

The Sustainability Factor and the Pension Revaluation Index guarantee the long-term budget equilibrium of the public system

Distinguishes between the debates on sustainability and sufficiency. All solutions are possible, except for paying current pensions through a structural deficit

Aligns the interests of pensioners and the rest of society towards (1) a more efficient system; and (2) reforms that increase employment and productivity

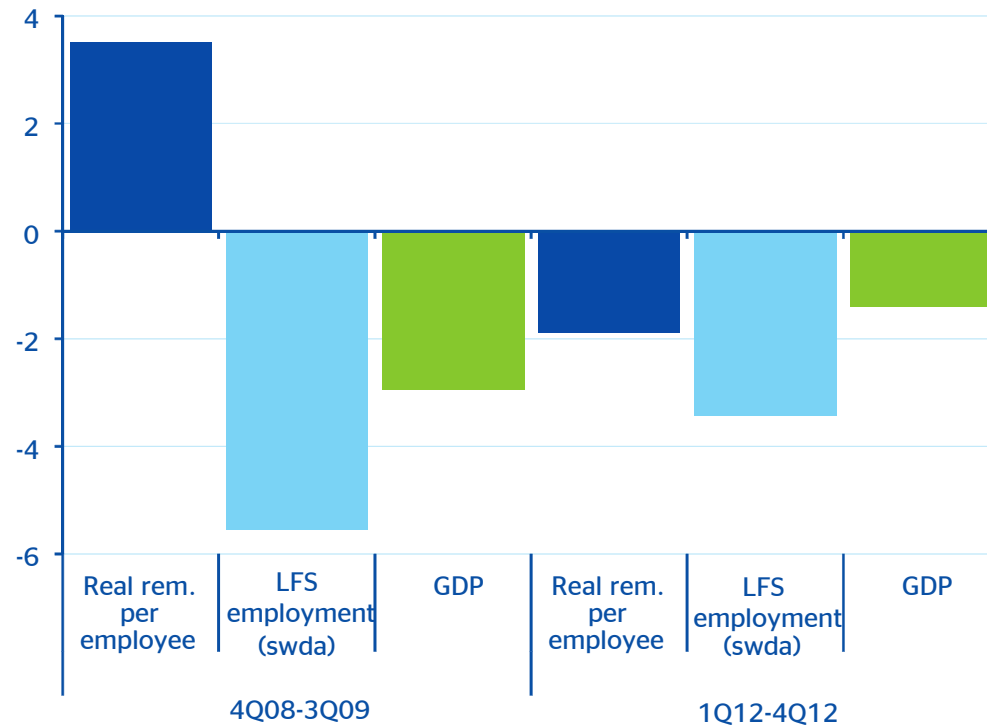
These add to other measures taken previously as (for example) the increase in the retirement age to 67

Which reforms has Spain implemented?

2. Improving competitiveness (labor market)

Spain: real wages, employment and GDP

(cumulative % change, SWDA data, %)
Source: BBVA Research



Labour market reform and the 2nd Agreement on Employment and Collective Bargaining have prevented greater job destruction

Without the wage moderation of 2012, an additional 220K jobs would have been lost

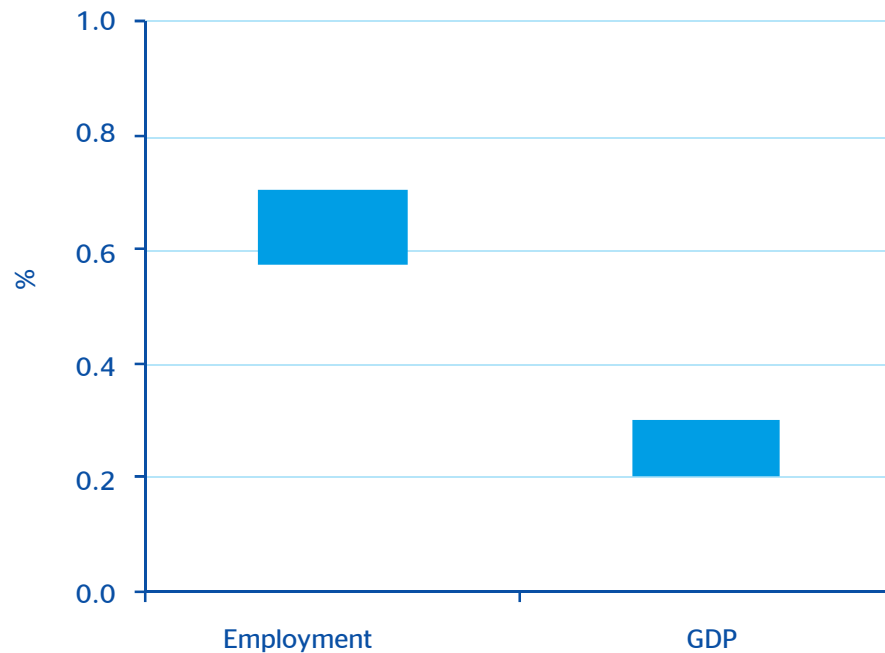
The existence of better employment institutions at the onset of the crisis might have prevented the destruction of around one million jobs

Which reforms has Spain implemented?

2. Improving competitiveness (tax system)

Spain: potential effects after a year of the flat contribution to Social Security paid for indefinite contracts

Source: BBVA Research)



Despite some weaknesses (it is not permanent and savings to the employer increase in step with the contribution base) ...

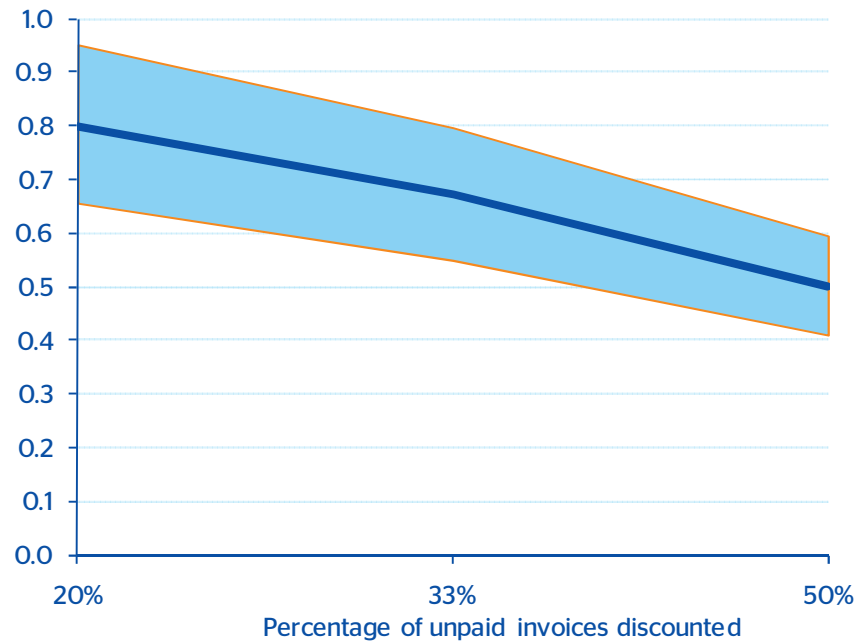
... we forecast a positive effect on employment (0.6 - 0.7%) and on GDP (0.2 - 0.3%), with a net fiscal cost of 0.12% of GDP

Which reforms has Spain implemented?

2. Improving liquidity (suppliers payment programme)

GDP impact on 2012 from the Supplier Payment Programme (pp of GDP)

Source: BBVA Research based on MINHAP



To improve firm's liquidity the Government injected 2.5% of GDP (€27Bn) to pay off local and regional government debts with suppliers

As suppliers were experiencing liquidity restrictions, the impact on growth was significant

*/ Max and Min depend on agents' level of liquidity restriction

Which reforms has Spain implemented?

3. The reestructuring of the banking system

Phase 1 of the restructuring

2008

Creation of FAAF and increased coverage of DGF

2009

Creation of FROB. Injection of 10bn € into savings banks

2010

Reform of legal framework of savings banks

2011

Minimum capital requirement of 8% (general) or 10%

Phase 2 of the restructuring: focus on asset valuation

Feb-May 2008

New regulation: 80bn € in provisions and capital buffers

June-Sep 2012

Financial assistance program, MOU and capital needs by bank

Post-MOU

Creation of Sareb and transfer of problem assets

Post-MOU

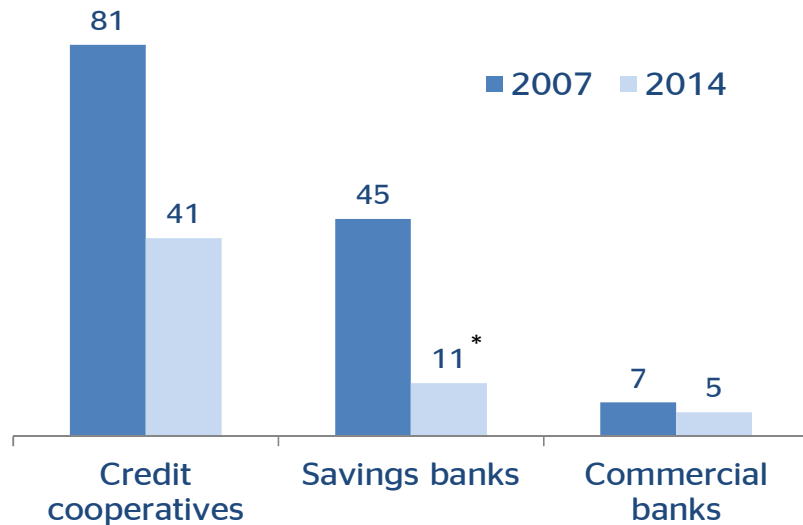
Liability management exercises (burden sharing)

Which reforms has Spain implemented?

3. The restructuring of the banking system

Number of Spanish financial entities

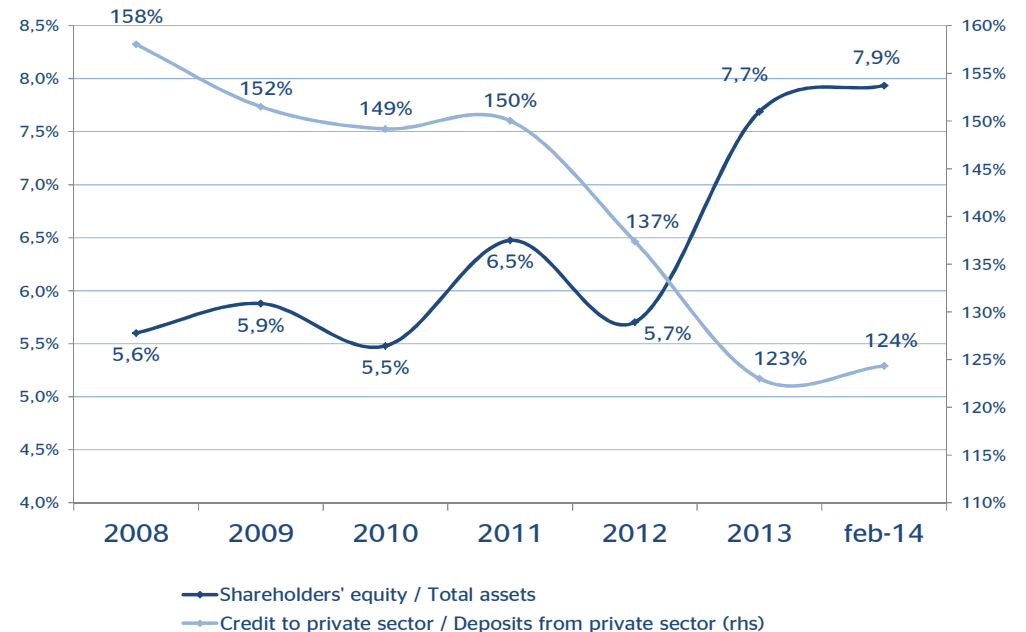
Source: BBVA Research based on Bank of Spain



(*) 9 of which have already transformed into commercial banks

Solvency and liquidity of Spanish banks

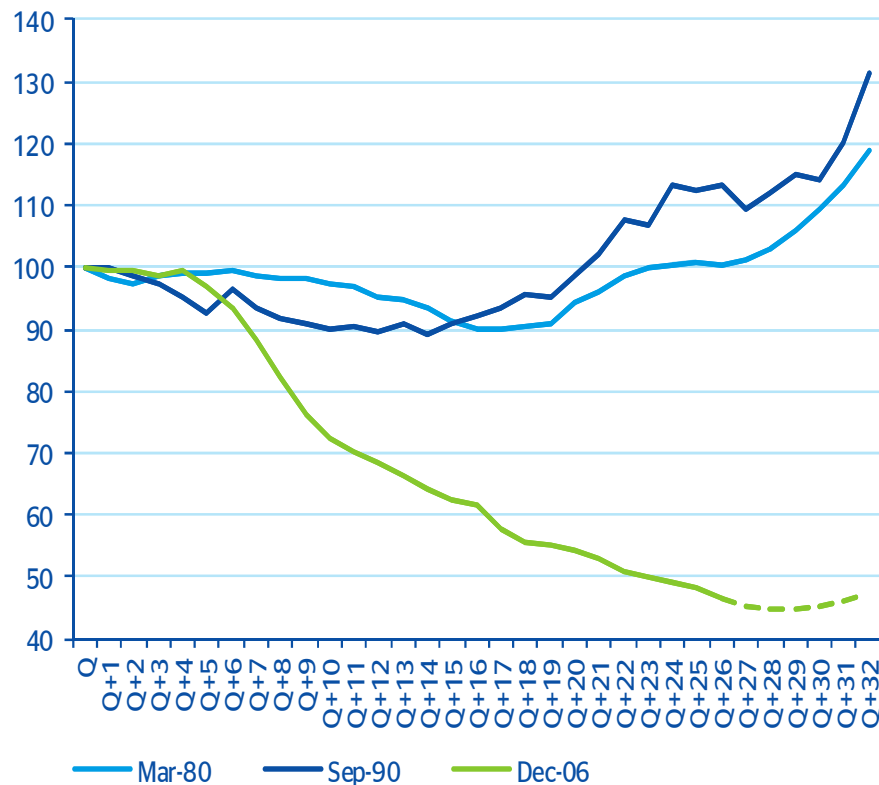
Source: BBVA Research based on Bank of Spain



We need to do more...because: The real-estate cycle is different this time

Spain: housing investment, compared with previous recessions (Maximum during expansion = 100)

Source: BBVA Research, based on INE data



The recovery of investment in the real-estate sector tends to run ahead of the cycle...

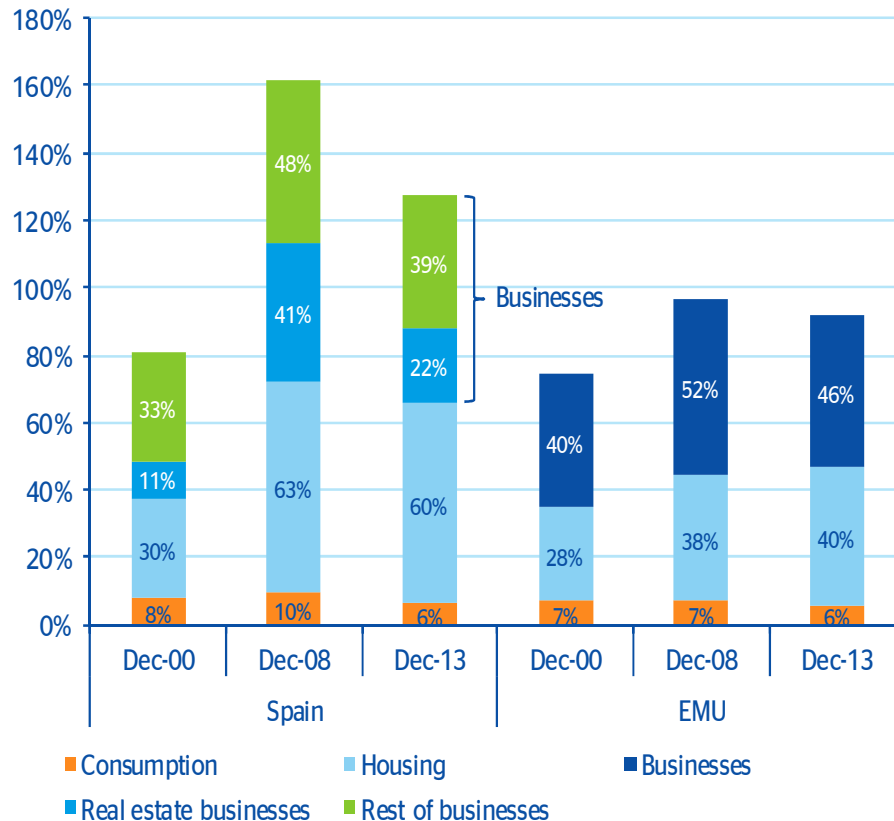
... however, the current excess of supply will make it unlikely that this time it will accompany the recovery (effect vs. cause)

The ambitious reform process must also ensure an efficient redistribution of resources between sectors

We need to do more...because: Deleverage is much needed in terms of stocks

Credit to the private sector (% GDP)

Source: ECB and Bank of Spain



Private-sector leverage is excessive. Spanish levels are above those of EMU

Deleveraging will continue in terms of the stock of outstanding credit

Compared to EMU, the most significant differences are in real estate businesses and mortgages

Potential growth is endogenous to structural reforms

Structural reforms biased to employment growth

1. Deleveraging and improvement in the finances of the Spanish economy: finalising the restructuring of the financial sector (improve profitability) and attracting foreign direct investment to promote employment

2. Public-sector reform, fiscal consolidation through growth and long-term sustainability of public finances, with an efficient tax system that create incentives to job-creation -> Report of the Experts Committee

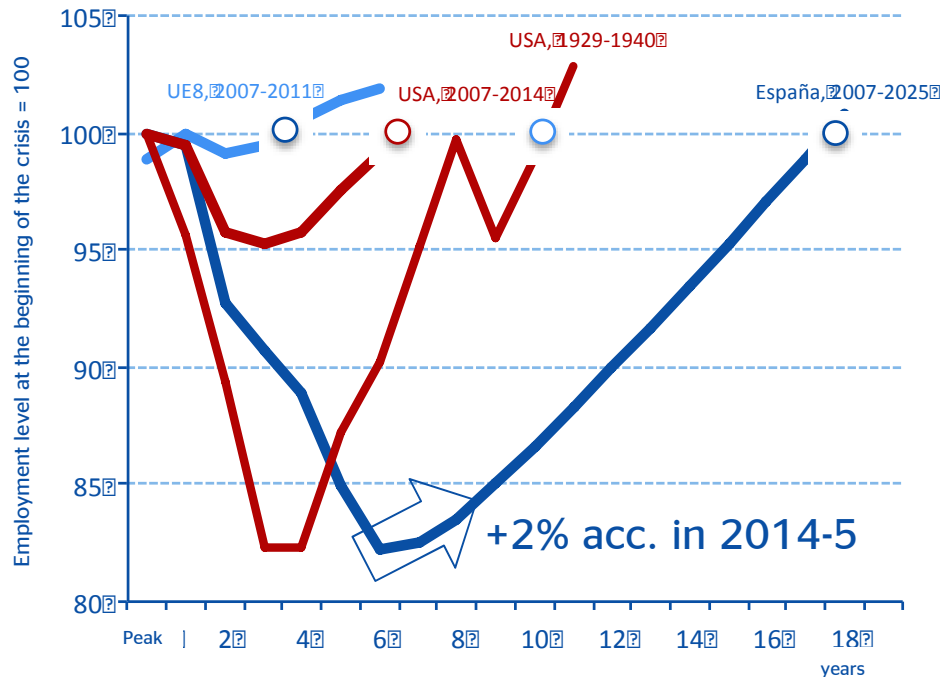
3. Reforms to improve competitiveness further (keeping internal devaluation), increase the international attraction of Spain in terms of physical, human and technological capital

4. To continue with the reforms that reduce the duality in the labour market, improve intermediation process efficiency, promote wage flexibility and increase employability -> more jobs and with better quality

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

Employment in Spain, the US and EU8

Source: Andrés and Doménech (2012)



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

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

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

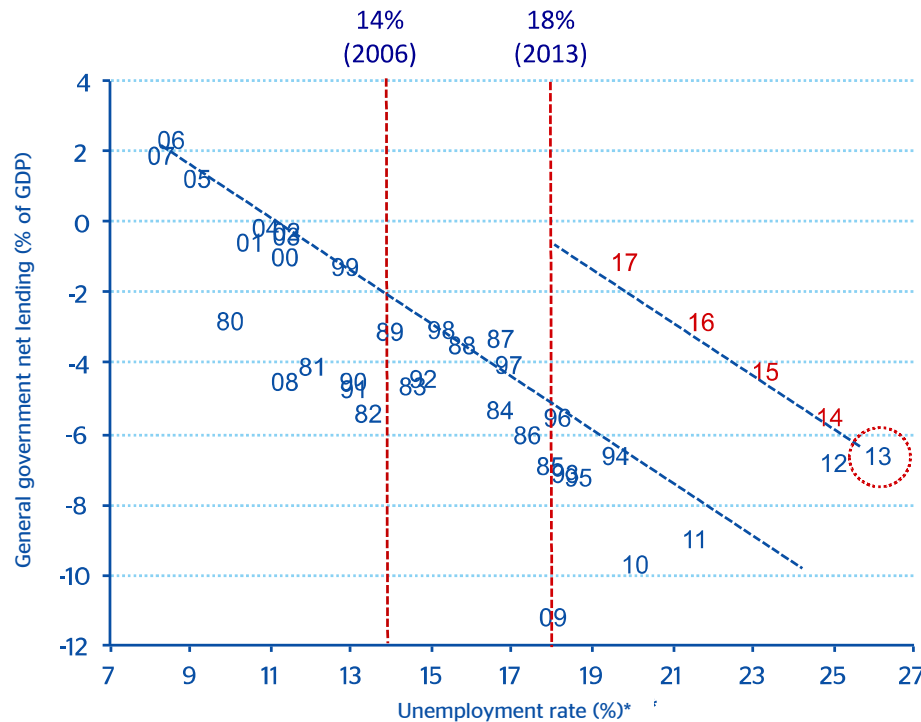
Two-hand approach: wage flexibility (vs wage moderation) to increase employment (composition effects on *W*) and more product markets competition

What else can be done?

1. A smart fiscal consolidation

Spain: unemployment rate and public budget balance

Source: BBVA Research based on Stability Programme 2014-17



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

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

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

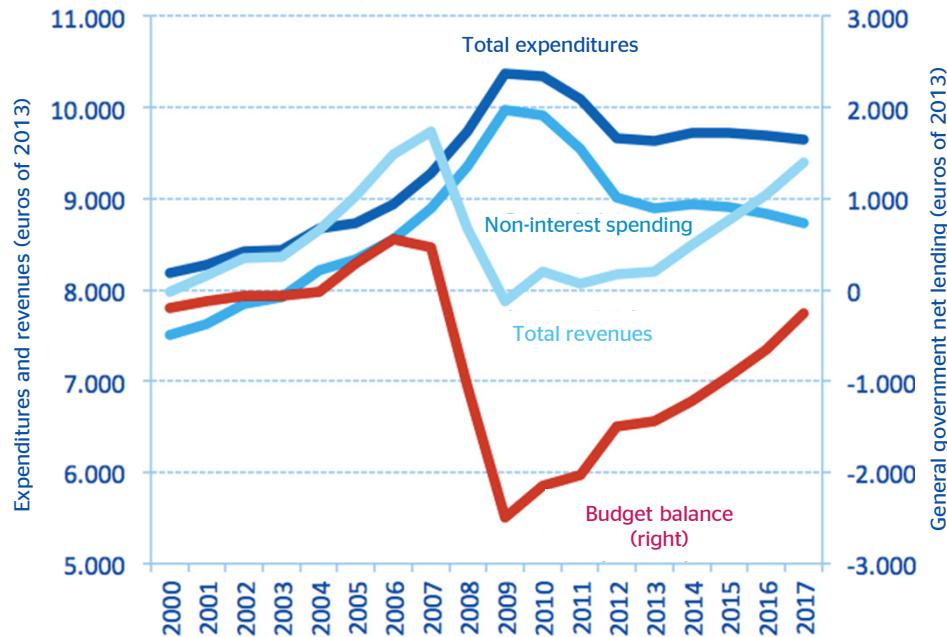
A more efficient tax structure: direct vs. indirect taxation -> more savings, more investment and more jobs

What else can be done?

1. A smart fiscal consolidation

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

Source: BBVA Research based on Stability Programme 2014-17



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

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

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

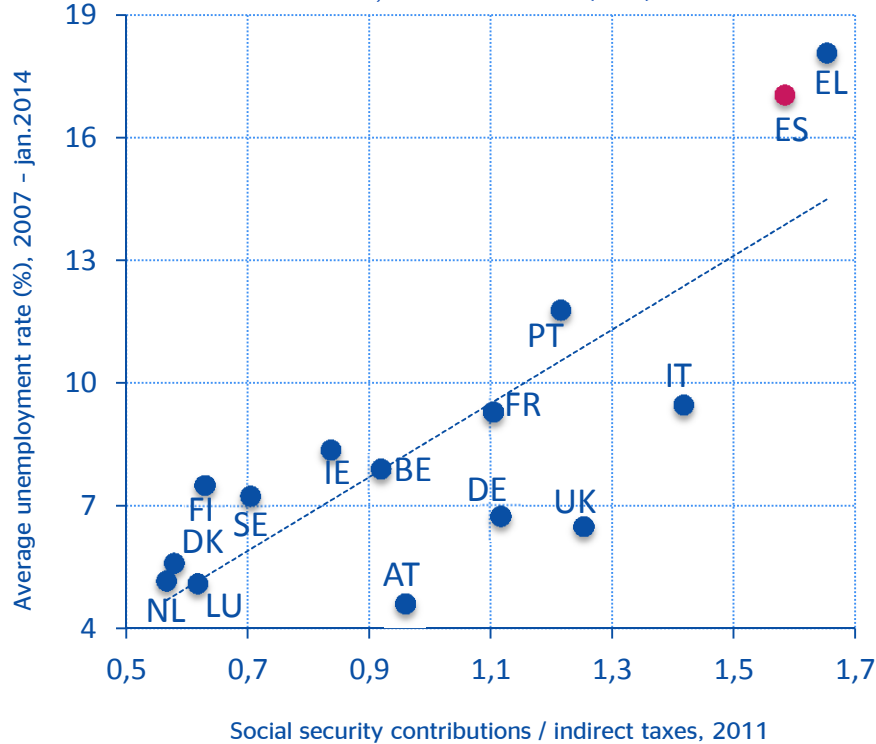
... and increase revenues through a more efficient tax structure that increases employment, growth and tax bases

What else can be done?

2. A more efficient, growth enhancing tax system

EU15: Unemployment rate and social security contributions over indirect taxes

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



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

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

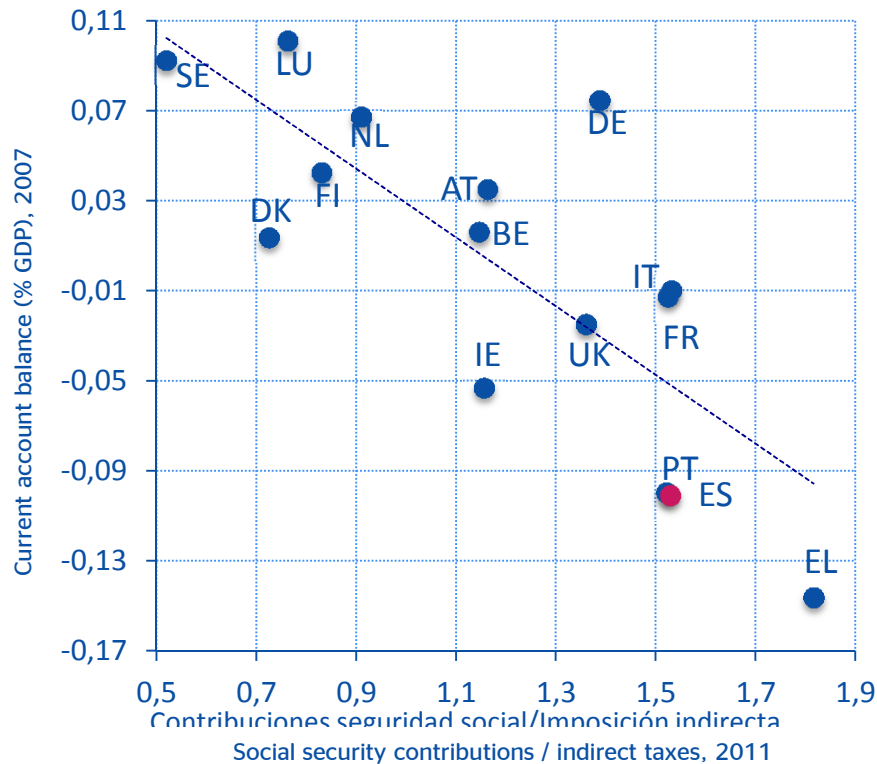
Less inequality and less hysteresis in unemployment (temporary zero social contribution rate below a certain wage level?)

What else can be done?

2. A more efficient, growth enhancing tax system

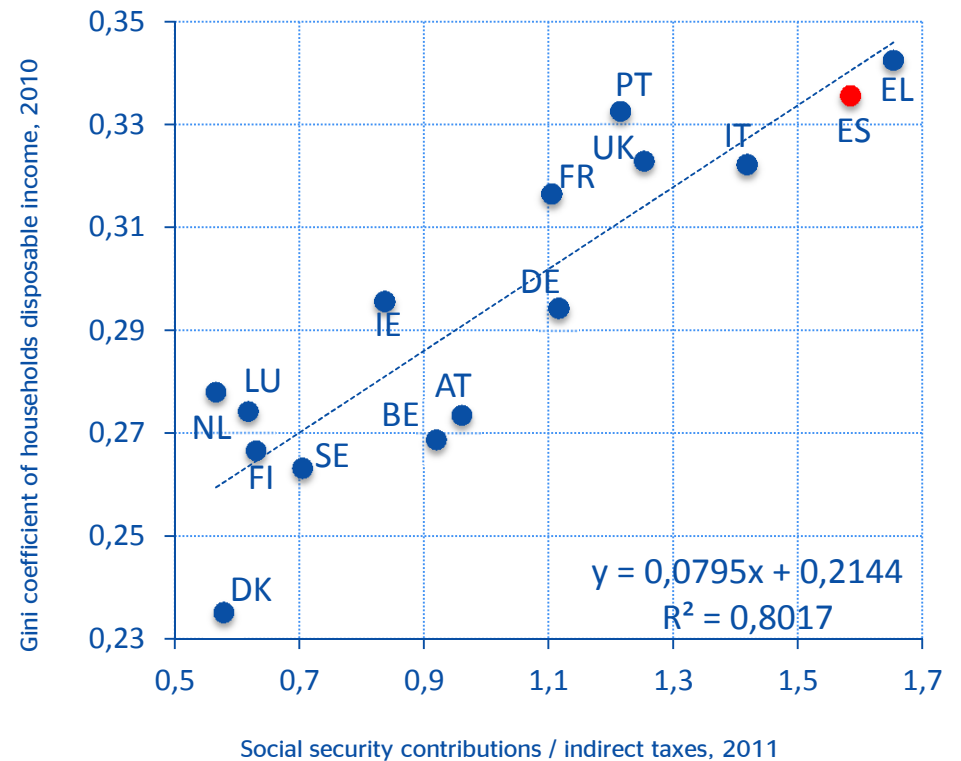
EU15: current account balance and social security contributions over indirect taxes

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



EU15: Inequality and social security contributions over indirect taxes

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

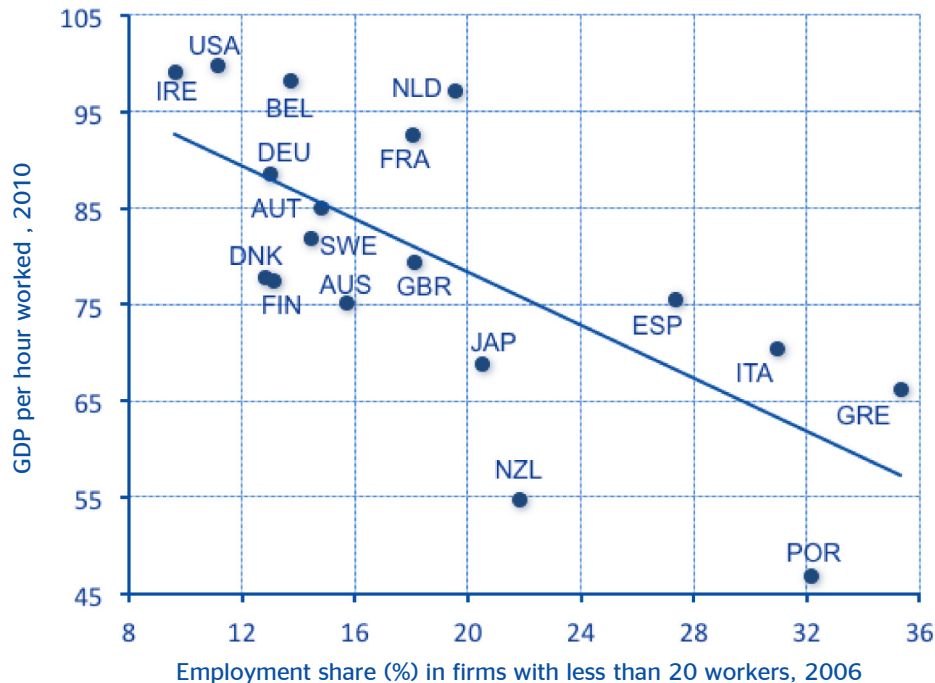


What else can be done?

3. Help firms hire, invest and export

Labor productivity and firm size, OECD

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



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

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

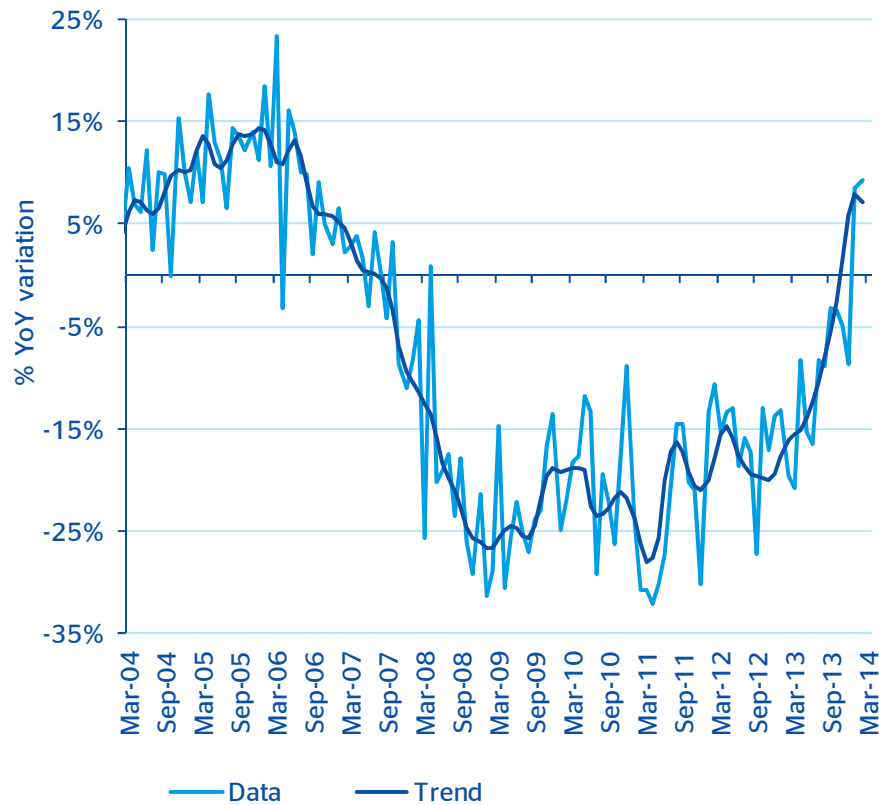
Avoid procyclical regulation (smart banking recapitalization avoiding the tightening of credit conditions) and improve responsible payment culture

What else can be done?

3. Help firms hire, invest and export

Spain: new credit retail operations (% YoY)

Source: BBVA Research based on BoS



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

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

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

What else can be done?

3. Help firms hire, invest and export

The restructuring is almost finished, but there are some pending issues: an efficient implementation of current plans is crucial for the success of the restructuring

Complete the restructuring



Quick resolution of intervened institutions, as international experience shows that public banks can be inefficient

AQR / Stress test



The exercise is pivotal to eliminate any concern about the solvency of the European banking sector

Efficiency



Above-average efficiency should not lead to complacency: networks should adapt to the new size of the market

Deleveraging of the private sector



Compatible with the provision of credit to solvent demand. Recent changes in the insolvency law should ease corporate debt restructuring

Promote banking disintermediation



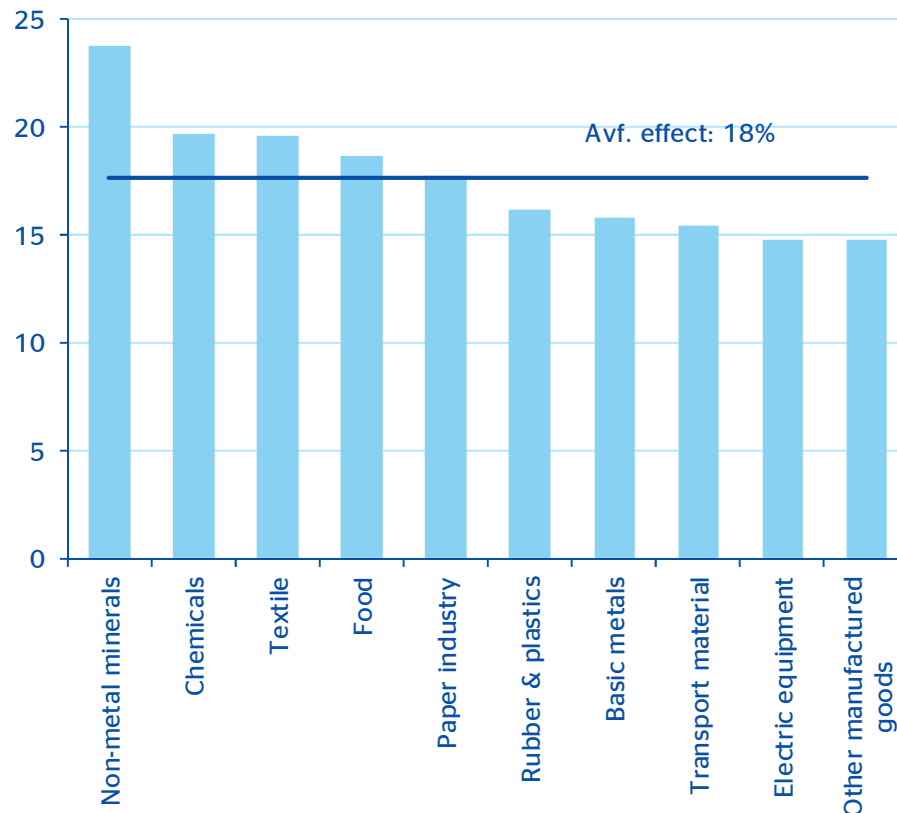
New legal framework for direct lending, non-bank lending, private equity funds

What else can be done?

3. Help firms hire, invest and export

Spain: effect on exports of adopting best regulatory practices, large corporations (accumulated variation %, 1992-2008)

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



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

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

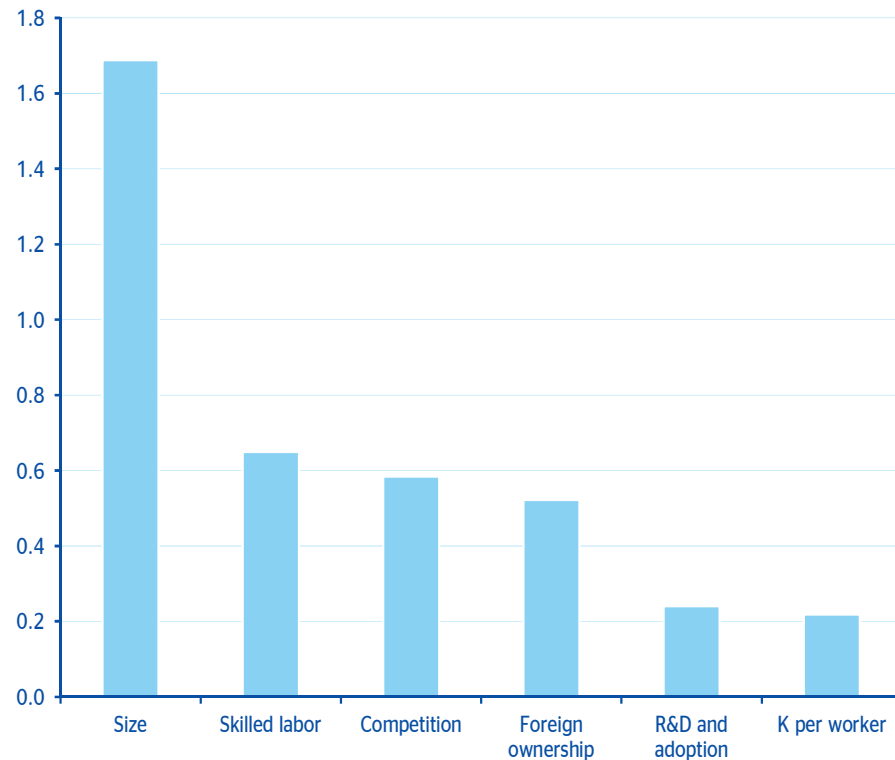
So, there is still scope for continuing to eliminate obstacles which make it difficult for companies to become more international

Spain: what else can be done?

4. Improve our competitiveness

Effect on a firm's exporting probability of an exogenous change in each determinant (%)

source: BBVA Research based on ESEE, Fundación SEPI



The most important determinant of internationalisation is a firm's size

An increase of 10 workers (on average, from 50 to 60 employees) would raise the firm's exporting probability by 1.69%

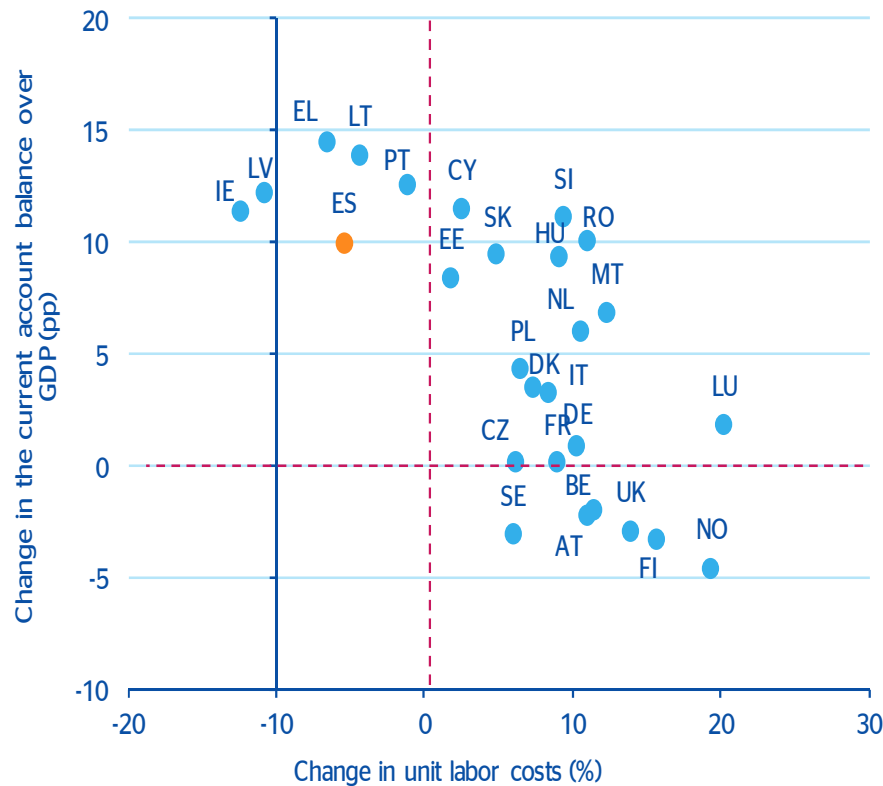
Barriers to a firm's growth remain in the tax system or in regulation, especially in services or in the labour market
Key to tackle them to improve growth incentives

Spain: what else can be done?

4. Improve our competitiveness

EU: current account and unit labour costs

change 4T08-2T13
Fuente: BBVA Research and Eurostat



Productivity gains since the beginning of the crisis have been significant (more than 12%)

and generalised, across both non-tradables and...

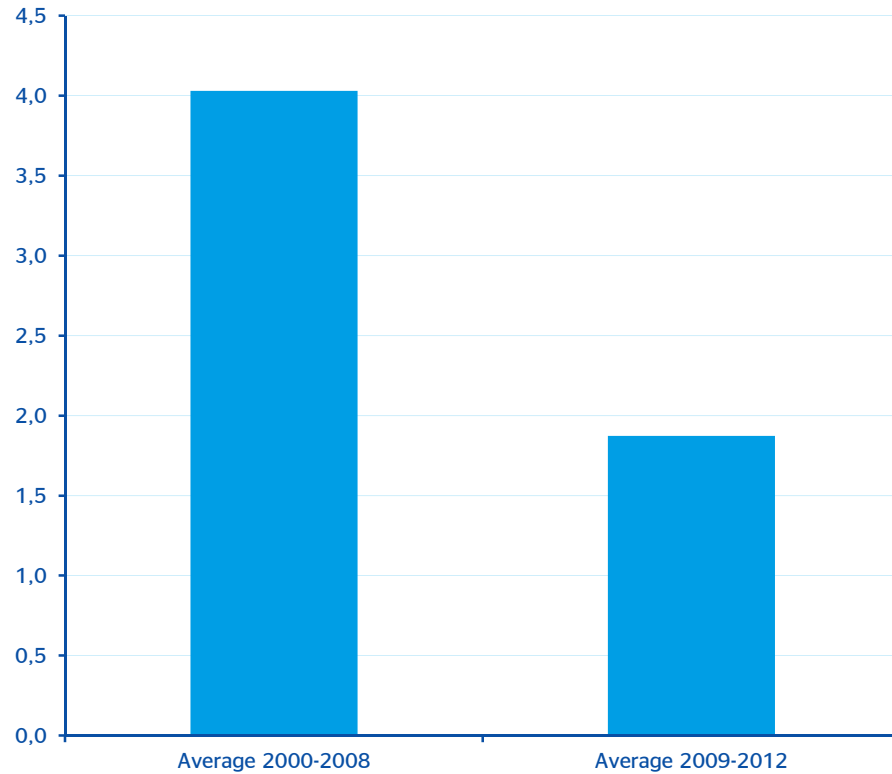
... manufactures (growing by well over 20%)

Spain: what else can be done?

4. Improve our competitiveness

Spain: FDI (% GDP)

Source: BBVA Research based on Banco de España



Strategic plan to improve competitiveness, ...

..., increase the attraction of Spain to international investors, in terms of physical capital ...

..., human capital and technological capital)

Spain: what else can be done?

5. Improvements in the labour reform

Spain: labour productivity and job creation

(Onset of the recovery = 100)

Source: BBVA Research



1. Employment response to growth: how will productivity of labour behave in the recovery?

2. Fundamentals do not account for all the growth in private consumption

3. Export prices have offset the appreciation in the exchange rate. Can exports continue to hold up?

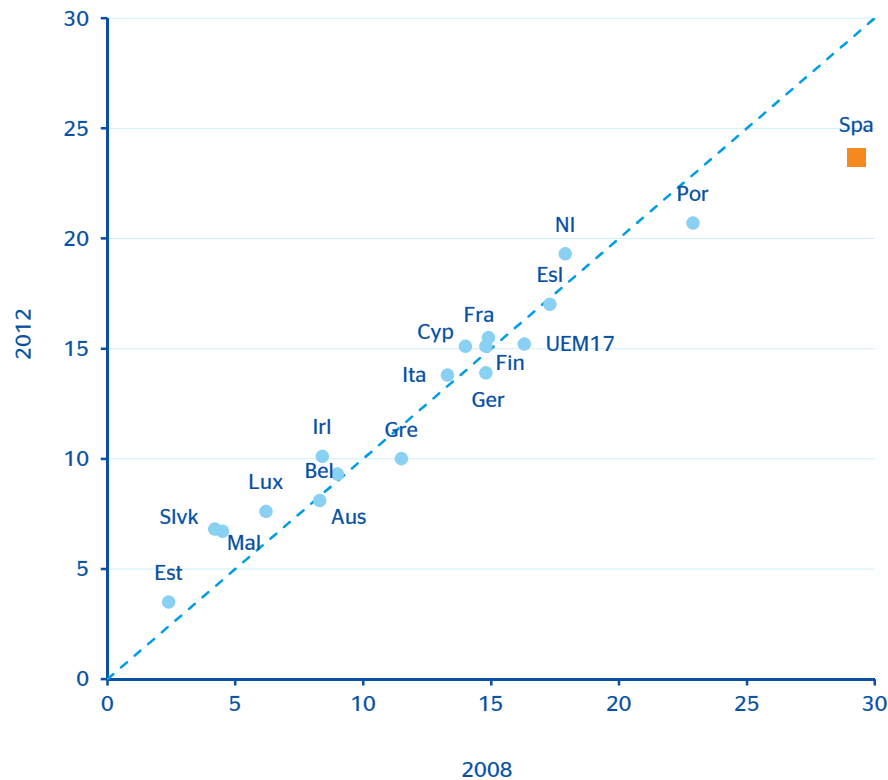
Spain: what else can be done?

5. Keep improving the labour market

Temporary Employment Rate

(% of workers with a temporary contract)

Source: BBVA Research



Promote reforms that make it more attractive to sign open-ended contracts,...

..., improve the efficiency of both active and passive labour market policies...

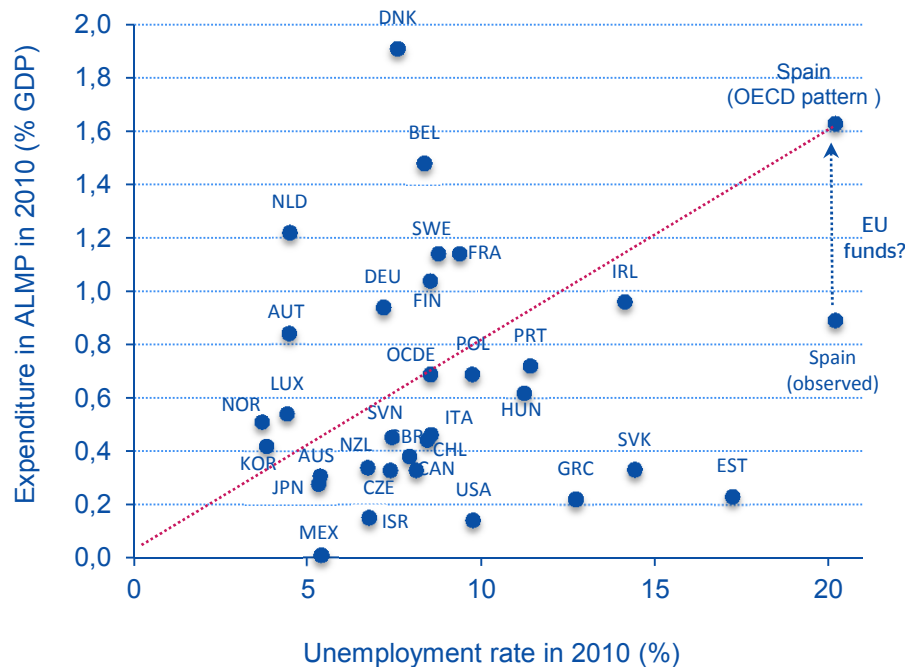
..., and raise the quality of human capital

What else can be done?

5. Keep improving the labour market

Unemployment rate and expenditure in ALMP

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



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

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

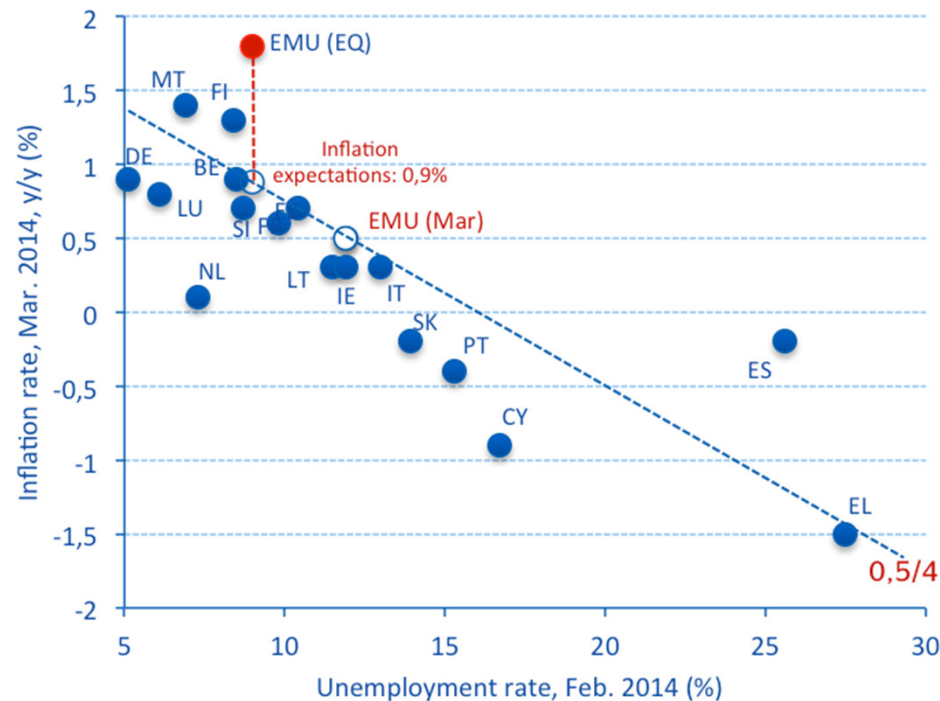
... increasing efficiency (employment activation policies, public-private partnership, continuous evaluation, dual vocational training, etc.)

What else can be done?

6. Europe has also to help

Eurozone: unemployment rate and inflation

Source: Eurostat and BBVA Research



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

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

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

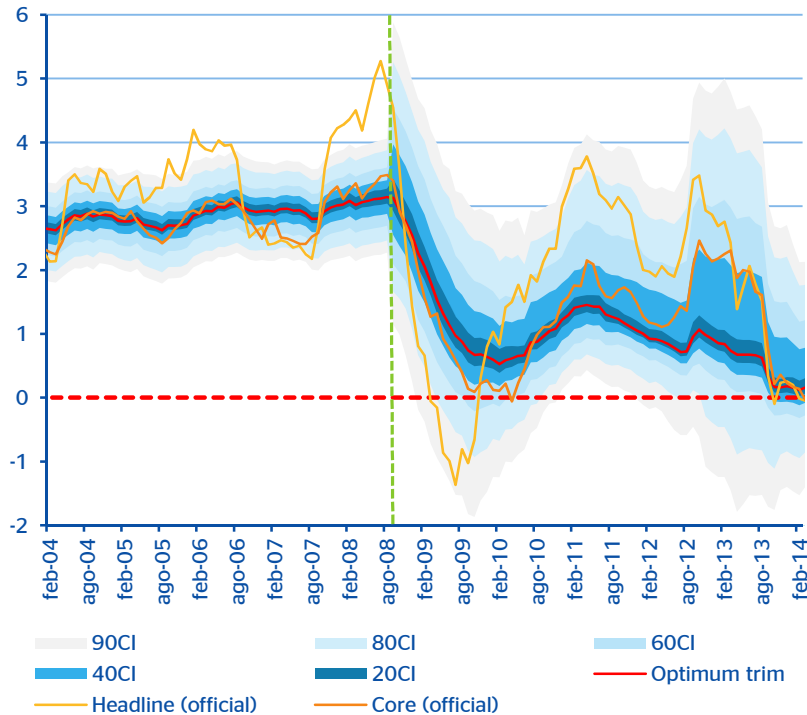
Inflation above 1% in 2015 in our base scenario and the probability of deflation is low (<10%), but adverse shocks could increase this probability

What else can be done?

6. Europe has also to help

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

Source BBVA Research based on INE



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

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

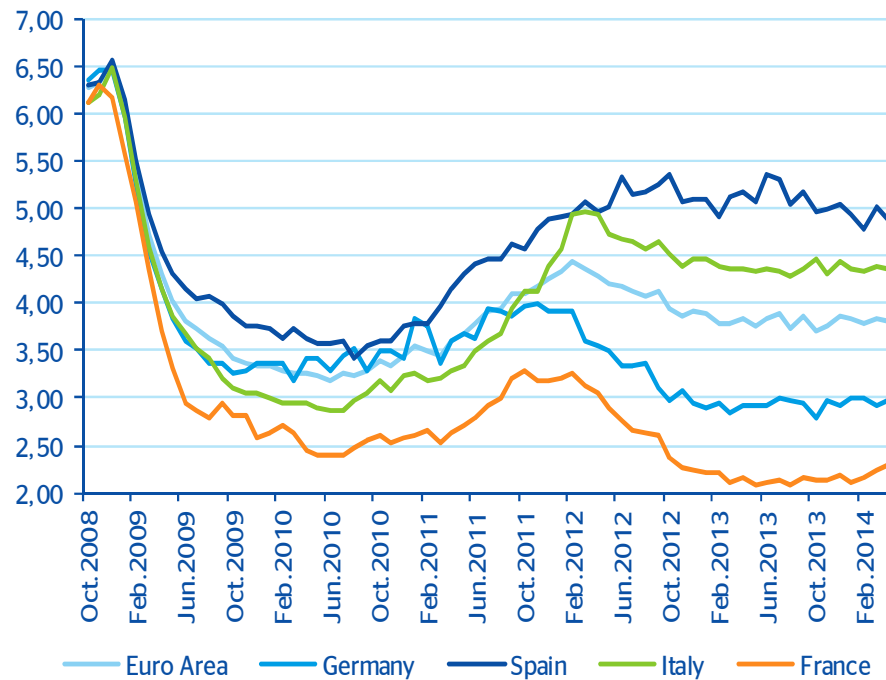
Additional efforts in terms of the deleveraging process of the private and public sectors

What else can be done?

6. Europe has also to help

Interest rates on new bank lending

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



Financial fragmentation still high

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

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



BBVA

RESEARCH

Thanks!

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June 2014