

Spain Watch

Economic Research Department

April 2008



The materialization of an adverse external environment...

... and a more acute downturn in housing...

... lead to a marked slowdown in 2008 and 2009

Labour market dynamism suffers. Job creation will moderate significantly in 2008 and is likely to stagnate in 2009

Index

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1. In summary	3
2. The economy in an adverse global environment	5
3. Risk factors which could have a greater impact in the future	12
Box: "Impact of an adverse financial shock in Spain"	14
Box: "The labour market in the new scenario for the Spanish economy "	19
4. Summary of forecasts	24

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1. In summary

High level of uncertainty in the forecasts

The Spanish economy started 2008 facing a more adverse global scenario, where some of the risk factors foreseen at the end of last year actually materialized. In addition, the slowdown which had already started in housing has become sharper in recent months and it is increasingly likely to become even more acute in the future. All of this builds a scenario of greater deceleration, where the level of uncertainty in respect of forecasts is unusually high.

Negative impact of the change in the global environment

Starting from the external environment, it seems clear that the global financial crisis is more serious than had been anticipated. A faithful reflection of this situation is the faster pace of the adoption of regulatory, fiscal and monetary measures, which seek to put a floor to this situation. It is already clear that the financial situation will have an impact on the real economy, in different ways. This situation affects the Spanish economy, which is very dependent upon external financing and the performance of the international financial markets. A context of slower economic growth in developed countries, mainly the United States and Europe, implies less buoyancy in Spain's export sector and, ultimately, slower growth of investment. Domestic demand will also be affected by the existence of higher risk premiums.

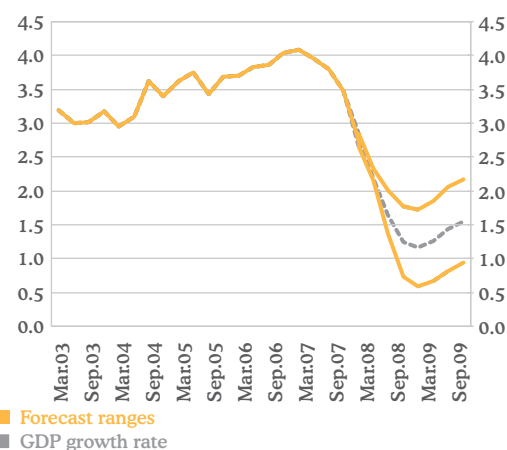
In a context where doubts about growth are higher in the U.S. economy, and where the Federal Reserve has speeded up interest rate cuts, the euro has appreciated more than expected, reducing the competitiveness of Spanish exports. Moreover, the depreciation of the dollar is one of the reasons for the increase in oil prices, which are significantly higher than forecast at the end of 2007. Oil prices have a large financial component, which looks unlikely to be diluted in the short term. Consequently, higher oil prices imply less disposable income for Spanish households and a drain on their consumption, and have already brought an increase in the inflation spread which has a negative effect on Spanish competitiveness.

The change in the global scenario has another effect in terms of monetary policy. The relative resistance of the European economy to this unfavourable scenario and the higher inflation, produced by the increase in food and energy prices, means that expectations of the Central European Bank dropping interest rates are being held back. It seems today that interest rates are unlikely to be dropped before September and, thus, the support that might be expected from the easing of monetary conditions is held back in time.

A more acute downturn in housing

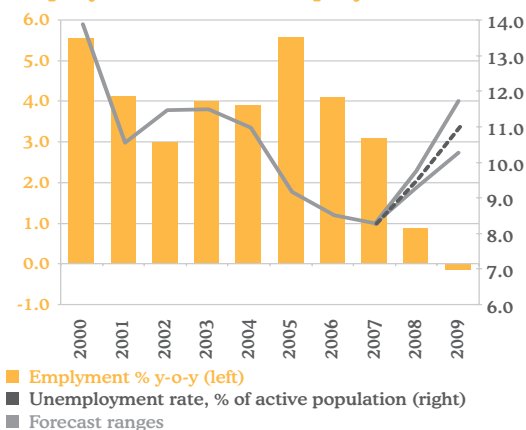
In the housing sector, the downturn has become more acute. It is reasonable to believe that this trend will continue and the sector will lose weight in economic activity in the next two years. This type of slowdown is likely to produce a situation of undershooting, or an excessive downward reaction, as expectations can speed up the downturn. Moreover, in view of the characteristics of housing investment, the downturn is likely to become more acute in 2009 and to reach a negative growth rate of 14.5%, which is almost double the figure expected for 2008. The entire construction sector will stop creating jobs

Spain: GDP growth forecast (% y-o-y)



Source: INE and BBVA Economic Research Department

Employment and unemployment rate



Source: INE and BBVA Economic Research Department
Note: bias in 2005 due to methodological change of LF survey

and nearly 400 thousand jobs will be destroyed in the sector in the next two years, although the range of the forecast is wide in an uncertain environment and could imply between 330 and 450 thousand jobs fewer in the sector. Job destruction will be greater in 2009 than in 2008. However, the rest of the economy presents enough fundamentals to grow at rates close to its tendential level, provided that the downward risk factors do not eventually materialize, in which case growth would also slow.

The slowdown will last until 2009

Given the combination of these factors, Spanish economic growth will slow down significantly in 2008, and this process will last until next year. In view of the uncertainty existing in this context, the most reasonable thing is to offer a range for the forecast. Thus, a growth range of between 2.2% and 1.7% seems reasonable for 2008, with a central trend which can be used as a benchmark for a detailed macroeconomic table. This central trend could be of 1.9%. Logically enough, the forecast range is wider for 2009, and is between 2.0% and 0.8%. In this case, if the most likely figure were to be given, the balance of risks would at the moment point to 1.4% as the central trend. The lowest growth rate is expected to be registered at the beginning of 2009, with the growth profile rising slightly after that.

With this outlook for activity, the economy will continue to create jobs in 2008, although at a much slower rate than in previous years. In the economy as a whole, the job creation rate will range between 0.4% and 1.4%. However, employment is much more likely to stagnate in 2009. In a context of slightly slower growth of the labour force, the unemployment rate will rise to reach rates of 11% on average next year, nearly three points higher than the 2007 figure. The estimates made suggest that part of this deterioration in the unemployment rate has a tendential component, and is not purely cyclical.

Fiscal policy, with room for manoeuvre

However, there are many differences between this deceleration of the Spanish economy and previous episodes. The structural differences of the economy have been insisted upon, but there is one aspect which is of particular interest in this context: the fact that fiscal policy has room for manoeuvre. In Spain, where there are probably slightly fewer automatic stabilizers than in other developed countries, it is a good time to adopt discretionary anti-cyclical measures. Experience in other countries shows that the most efficient measures in this sense are the ones taken at the right moment, a moment which is determined by the cyclical conditions of the economy, and which are well aimed at their target and generally temporary. Here, measures such as short-term tax reductions, temporary extensions of unemployment benefits or an increase in public spending on infrastructure or housing could be options worth considering.

In addition, it should be pointed out that, in a context of a global financial shock, the soundness and the strong accumulation of provisions in the Spanish financial system during the period of expansion are key supports for the economy as a whole.

2. The economy in an adverse global environment

Last autumn, it became clear that the Spanish economy was at the start of a slowdown. However, the elements of inertia in growth seemed to suggest that economic activity would reach growth rates of over 2.5% in 2008 and of 2% in 2009. Since then the changes in the global economic environment have led to lower growth expectations.

A slowdown which is becoming more acute, and has led to the lowering of growth forecasts

The signs of an economic slowdown were already evident last autumn. After reaching a growth rate of 4.1% in the first quarter of the year, activity was growing at 3.5% in the last quarter. Although the average growth figures for 2007 were of 3.8%, similar to the previous year, the slower profile of the economy and the composition of growth clearly showed a change in cycle. Domestic demand slowed in 2007 as a whole, and increased by half a point less than the previous year, mainly as a result of more moderate household spending on consumption and a reduction in investment in housing. The notable buoyancy of investment in capital goods, which surprisingly rose, was one of the reasons why domestic demand did not slow to a greater extent. For its part, the external demand reduced its negative contribution to growth.

Two elements stood out at that time in the analysis of the Spanish economy. The first was the fact that, as had been forecast, the economy was slowing and doing so very gradually. It was moving towards a composition of growth which was regarded as more sustainable. The second was that, following reasonable assumptions, it seemed that the inertia of the economy was sufficient to limit the intensity of the slowdown. Taking this into account, growth forecasts of over 2.5% for 2008 and of 2% for 2009 were more than reasonable.

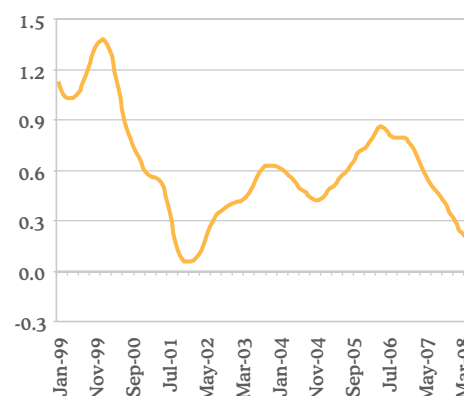
The start of 2008 brought a change in these expectations and it became clear in the spring that the slowdown has become more acute. The information on the economic situation, synthesized in BBVA's activity indicator which is shown in the adjoining chart, clearly shows that the slowdown is moving faster. The evidence of moderation is fairly generalized and is seen in the performance of the household spending indicators (retail sales and auto sales, especially), in the trends shown in business figures (with stagnation in domestic sales) and in transactions in the housing sector.

So far, the slowdown has been cyclical, as is clear when growth is broken down into its trend and cycle components.¹ Thus, it is confirmed that the cycle peaked in the third quarter of 2007, while the tendential component remained stable at 3.1%, the same figure as in the previous two years.

In the labour market, all the available indicators show that the profile of the slowdown is becoming more acute. Thus, in the first quarter of 2008, job creation (Social Security subscribers) was of 1.4%, the lowest figure since 1996. A good reflection of these changes is to be found in the tendential performance of unemployment, which has been increasing

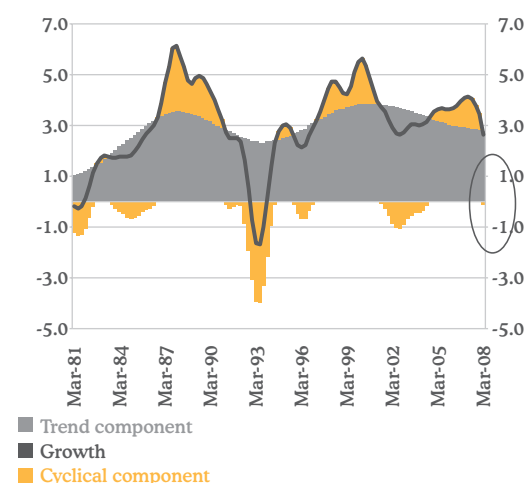
¹ Following the methodology described in Doménech, R. and V. Gómez (2005), "Ciclo económico y desempleo estructural en la economía española", *Investigaciones Económicas*, vol. XXIX (2), 259-288.

Chart 2.1.
BBVA Activity Indicator



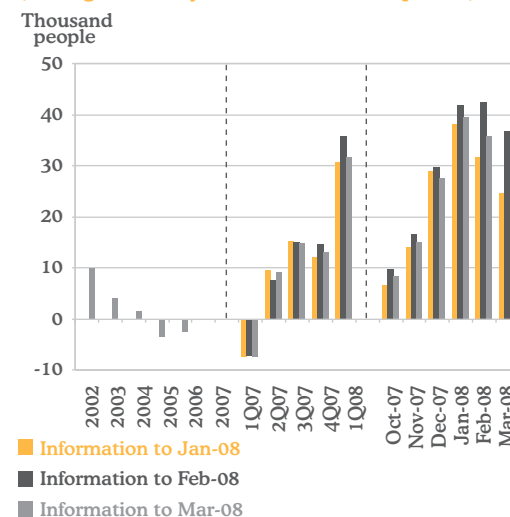
Source: BBVA Economic Research Department

Chart 2.2.
GDP Contributions to growth rate
(% y-o-y)



Source: BBVA Economic Research Department

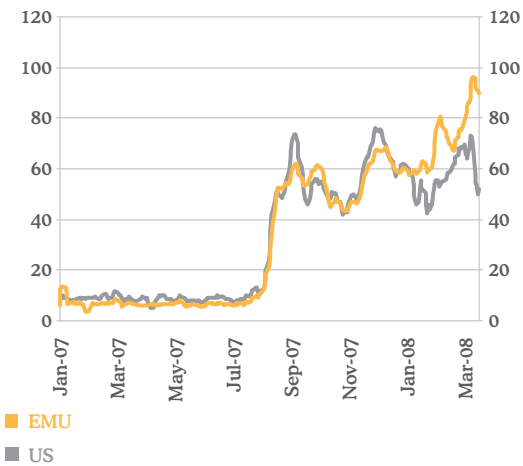
Chart 2.3.
Trend in registered unemployment
(average monthly variation for each period)



Source: BBVA Economic Research Department

Chart 2.4.

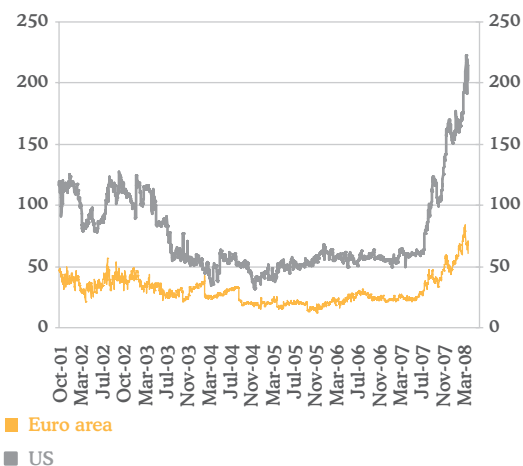
Indicator of interbank liquidity tensions (12M LIBOR – 12M monetary policy expectations)



Source: Bloomberg, 12M LIBOR-12M OIS (Overnight Index Swap), 5 day moving average

Chart 2.5.

5-year credit spread in the AA banking sector in US and Europe



Source: Bloomberg

every month by between 20 and 40 thousand people since last December, as compared to levels of approximately 10 thousand in previous months. The cyclical deterioration in unemployment seems to have been joined by worse performance of the tendential component, in a market which was showing signs of becoming tighter, with very low unemployment rates in some sectors and geographical regions, which could be affecting the nature of the downturn.

All of these indicators are no more than evidence of the need to revise Spanish growth forecasts for the next two years. But when the reasons for the change in forecasts are analyzed, the deterioration of the economy's external environment must inevitably be referred to. It is sufficient to remember that the Spanish economy is highly dependent on foreign financing, as is not only shown by its high deficit on current account, but also by the fact that Spanish companies have accumulated a significant volume of financial assets abroad. But, what is it that has changed in the global environment?

A more uncertain global environment which has led to the lowering of growth forecasts in the OECD, to the appreciation of the euro and to higher oil prices

Since last summer, financial markets have been involved in a financial crisis, which is lasting longer and is more serious than might have been expected. And this in spite of the measures which have been adopted in different spheres, especially in the USA.

This financial crisis has been reflected in the shortage of liquidity, amongst other things. In particular, the liquidity tensions have been seen in the interbank interest rates, which have wide spreads with the interest rates expected by the market. The spread is particularly wide in Europe, in the longest interbank market maturities, especially the 12-month. To cope with this situation, the Federal Reserve designed a wide set of measures which range from increasing access to the discount window of depository institutions and larger repo programmes for primary dealers, to the creation of new term lending facilities. Generally speaking, although net liquidity injected by the Federal Reserve has risen from almost zero at the beginning of 2007 to nearly 200 billion dollars, the tensions in the interbank market persist. Finally, the Federal Reserve has even been involved in the rescue of Bear Stearns. In Europe, the provision of liquidity has hardly increased at all, although the first auctions to take place for six months maturity were recently announced, but their efficacy is probably limited.

Another reflection of the crisis has been seen in the performance of credit spreads, which have widened significantly in the financial sector and outside it. This partly implies the end of a period of undervaluation of risk, but it also shows a situation where bank losses, which are already almost above 200 billion dollars, imply a change in scenario. If the unrealized losses according to the composition of balance sheets and the performance of asset prices are added to this, the institutions primary concern will be to maintain their capital ratios, as compared to a previous period dominated by the multiplying effect of credit in a context of financial innovation, new products and new agents.

Lastly, the crisis is leading to a reduction in stock market prices. The equity markets, which remained relatively unaffected by this episode in the early days of the crisis, were finally hit at the beginning of 2008. If they initially discounted that the crisis would remain in the financial sphere, since the start of the year they have been conscious that the

situation would have a impact on real economy and thus their price levels have fallen.

Recently, in view of the severity of the crisis, more efforts have been made to take measures in different spheres, especially in the regulatory field in USA. However, with all the uncertainties existing at the moment, it does not look as if the situation will be resolved in the short term. Consequently, the outlook for growth in USA and EMU has been lowered, as can be seen in Table 2.1. After growing by 2.1% in 2007, US economic growth is expected to be between 0.8% and 1.4% in 2008, about one percentage point lower than what was expected at the end of last year. Recent figures also suggest that activity is more likely to be at the bottom of this range. In view of the deterioration of growth expectations and in this context of financial crisis, the Federal Reserve has dropped its interest rates from 5.25% to 2.25%, and further cuts are very likely.

In Europe too, the cyclical slowdown in the economy is expected to become more acute. However, so far, it has been putting up notable resistance. Although the range of the growth forecast is between 1.1% and 1.7% for 2008, after 2.6% last year, information for the first quarter shows that it is somewhat more likely to reach the top of the range. The economy's relative resistance, accompanied by inflation figures which have surprised on the upside, has led expectations of interest rate cuts to be put back. It is increasingly unlikely that the ECB drop its interest rates before the summer. The central forecast is for a cut of 50 basis points at most, which would take place in two reductions as from September.

The recent divergence between growth forecasts for Europe and the United States and between their monetary policies has provoked the appreciation of the euro or, in other words, the depreciation of the dollar. The dollar seems more likely to remain at around 1.5 against the euro throughout 2008, which undermines the competitiveness of economies like Spain's. It also has another side effect: in a context of a weak dollar, some commodities, and particularly oil, become safe-haven financial assets for investors. As a result, their prices go up significantly. Thus, the forecast for oil prices rises to nearly 86 dollars on average in 2008, a considerable increase on the price at the end of 2007 (79 dollars). Higher oil prices increase the downward risks in respect of activity and the upward risks in respect of inflation.

This more adverse global environment implies slower growth of Spanish disposable household income and less dynamic exports

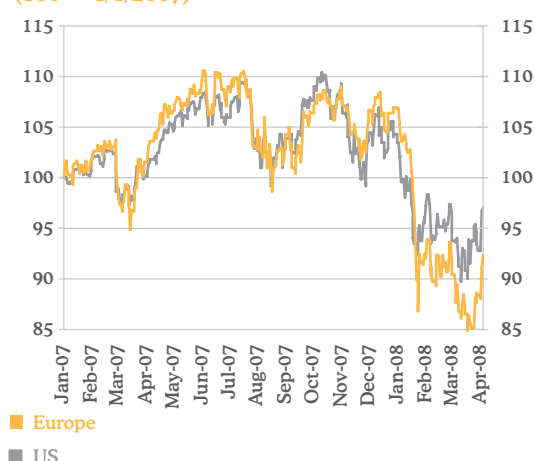
The change in the foreign environment described above has a notable impact on the Spanish economy in different ways. In particular, we will analyse the impact of slower growth in the rest of the world, the effect of reduced competitiveness because of the appreciation of the euro and the wider inflation spread, and the impact of higher oil prices.

Firstly, as mentioned earlier, economic growth, especially in developed countries, has been revised downwards, which implies slower growth of Spanish exports and, eventually, of investment too. Specifically, forecasts for European growth have been lowered by 0.4 and 0.6 pp in 2008 and 2009 respectively, while growth in the USA has been lowered by 1.2 and 1 pp for the same years. This implies a reduction in OECD growth of 0.7 and 0.6 pp, as is shown in the adjoining table.

Chart 2.6.

Stock Market performance in the US and Europe

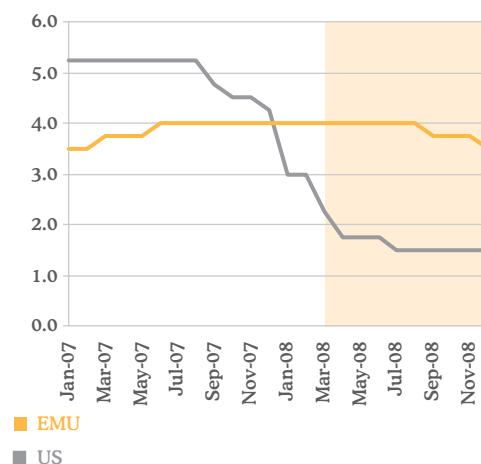
(100 = 1/1/2007)



Source: Bloomberg and BBVA Economic Research Department

Chart 2.7.

Official interest rates in the US and EMU



Source: BBVA Economic Research Department

Table 2.1. Change in forecasts since autumn (% y-o-y)

	2008			2009		
	Current	Dec-07	Change (pp)*	Current	Dec-07	Change (pp)+
Growth						
EMU	1.1 - 1.7	1.8	-0.4	0.9 - 2.0	2.1	-0.6
US	0.8 - 1.4	2.2	-1.2	1.1 - 1.9	2.6	-1.0
OECD	1.1 - 1.9	2.2	-0.7	1.2 - 2.2	2.4	-0.6
World	3.6 - 4.0	4.3	-0.5	3.7 - 4.3	4.5	-0.5
Oil prices	85.9	79.3	6.6**	75	61.2	13.8**
\$/€ exchange rate	1.53	1.43	7.0***	1.45	1.36	6.6***
REER Spain (1999=100)	127.6	123.8	3.0***	129.6	125.5	3.3***

* To central trend

** Change in dollars

*** Change in percent

Source: BBVA Economic Research Department

Table 2.2. Exports. Impact of changes in global scenario

(deviation of growth rate in pp to baseline scenario)

	Due to external growth		Due to exchange rate		Total impact	
	2008	2009	2008	2009	2008	2009
In goods to EMU	-1.1	-1.5	—	—	-1.1	-1.5
In goods to rest of world	-0.7	-2.9	-2.0	-1.0	-2.6	-3.9
In services	-1.7	-3.3	-0.8	-1.9	-2.5	-5.1
Combined goods and services (*)	-1.2	-2.5	-0.8	-0.9	-2.0	-3.4

(*) With relative weights for 2007

Source: BBVA Economic Research Department

When the direct impact on exports of slower growth in other countries is analyzed, it can be concluded that sales to foreign countries will fall by just over one point in 2008 and by 2.5 points in 2009, simply because of the impact of a less buoyant global economy. This is a reason for expecting export growth to slow from the rates of over 5% observed in 2007. In terms of economic growth, given the weight of exports in the GDP, the detraction stemming from less dynamism in the rest of the world can be put at half a point in 2008, and nearly one point in 2009. This change obviously does not mean that the foreign sector's contribution to growth will fall, since it is only a partial exercise, in which import performance has not been included. The more-than-likely downturn in imports will offset the more moderate export growth, as will be seen later.

Thus, this deterioration in world growth is directly reflected in the performance of the foreign sector. However, it undoubtedly has an indirect effect on other domestic demand variables. Another way of approaching the impact of the foreign sector is to consider a model with two economies, where Spain would be a "region" in the euro zone, the "rest of the world" in this case. A shock in terms of slower growth in the "rest of the world" would imply growth of the Spanish economy of 0.4 pp less in 2008.

Another element with a negative impact on the economy is the appreciation of the euro. As mentioned earlier, forecasts for the euro have moved towards stronger appreciation in 2008, as compared to previous forecasts. The deviation in the performance of the euro with respect to the forecasts made last autumn is appreciation of 7% in 2008 and 6.6% in 2009. If the evolution of the price spread is added to this performance, it can be estimated that the real effective exchange rate the economy will be dealing with could have appreciated by around 3% with respect to the previous scenario. Consequently, given the elasticity of exports in respect of the real effective exchange rate, a downward deviation in their growth of nearly one percentage point in 2008 and 2009 can be expected because of this factor alone.

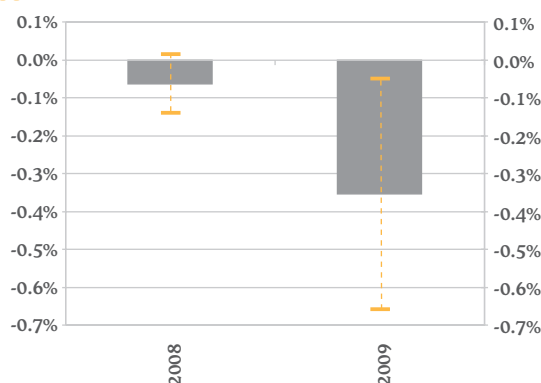
Thirdly, it is important to analyze the role played by the change in oil forecasts in the Spanish economy. Although the final impact on the economy is uncertain, we are going to try to approach it in two ways. On the one hand, the use of a model which considers the dynamic relations between domestic and foreign growth, inflation, the evolution of non-energy costs and oil prices enables us to estimate that the change in forecasts for oil is consistent with a reduction in expected growth of around one percentage point in 2008 and between three and four in 2009. As the chart shows, the ranges of uncertainty of the estimate are important, although in any event it seems that if the new scenario for oil prices is verified, their impact on earlier growth forecasts would be persistent and more intense in 2009.

On the other hand, the increase in oil prices implies a greater transfer of income to abroad, from both households and companies. In the case of households, if they fail to change the pattern of their consumption of energy products (auto fuels, heating and the electricity tariff), the weight of these products in their spending (8.3% of the total) would mean that the new outlook for oil prices in euros would reduce their disposable income by around 0.3% and 1.3% in 2008 and 2009 respectively. This would bring a downturn in consumption, a difference which, according to the consumption function estimated at BBVA ERD, would be of around 0.1 and 0.4 percentage points in real terms with respect to the previous base scenario. The impact calculated in this manner is proportionally very similar to what is obtained for the GDP as a whole through the previous model.

Chart 2.8.

Impact on growth of changes to oil price forecast

(pp to baseline scenario)



Source: BBVA Economic Research Department

The new global environment means higher inflation in the Spanish economy, with a balance of rising risks in the forecasts

Inflation rose at the end of 2007 as a result of tensions in the international food and energy commodities markets, which affected the most volatile components of the basket consumption. Inflation is currently at the highest rates of recent years² and the inflation spread with EMU has risen to reach a level which has been over one percentage point in the past few months. The performance of the components in the basket has been diverse, with more moderate inflation in non-energy industrial goods (which have a spread with EMU favourable to Spain) and the maintenance of higher inflation in services, of around 3.8%. Thus, it is significant that the period of “double inflation” in the economy is over, a period characterized by positive inflation spreads in non-energy industrial goods and in services.

The forecasts point to inflation which would have reached its annual high in March and which should now start to slow. Inflation could fall below 4% as from June and, underpinned by the base effect, reach around 3% in the fourth quarter of the year. All things considered, our inflation forecast for 2008 is of 3.7%, as compared to the 2007 average of 2.8%. For its part, core inflation has also been under pressure from processed food. It could also remain at current levels until the fourth quarter of the year, and end 2008 at an average of just over 3%. Inflationary tensions should remit to a greater extent in 2009, when we forecast average inflation of 2.7%.

In the balance of risks of the forecast, first it should be remembered that inflationary tensions in food do not yet appear to be remitting. The performance of the oil market adds another element with an upward bias. The forecast is based on an average oil price of 86 dollars in 2008, although in recent times, oil forecasts have been outstripped by reality. The use of oil as a financial asset at times of uncertainty and when the dollar depreciates (together with the classic effects of geopolitical uncertainty, and the more recent effect of pressures on demand from emerging countries) adds a balance of upward biases in its performance. Lastly, it should also be remembered that second-round effects which might push the CPI up cannot be ruled out, although none seem to have been observed to date. The intensification of the economic slowdown which is in progress could be one of the elements that could contribute to lower inflation.

For the first time in a slowdown, fiscal policy has clear room for manoeuvre, which means that the need for adopting appropriate measures must be considered

There is a variety of differences which separate Spain from the economic situation it found itself in in previous slowdowns, and a very important one is the fact the fiscal policy has room for manoeuvre. The Government has obtained a surplus in the past three years, which represented 2.2% of the GDP in 2007. These figures contrast with the deficit of 0.6 points of the GDP in 2001-02 and, especially, with the deficit of 4% of the GDP in 1992, before the last recession. Thus, the Spanish economy has plenty of room for manoeuvre in terms of boosting the economy on a cyclical basis through fiscal expansion.

Considering BBVA ERD's central growth scenario, it is estimated that the public surplus will reach around 0.3% of the GDP in 2008 and could

² A percentage of 4.6% according to the leading indicator for the Harmonized CPI for March, the latest figure known when this report was completed.

Chart 2.9.
Spain-EMU inflation gap, harmonised CPI (pp)

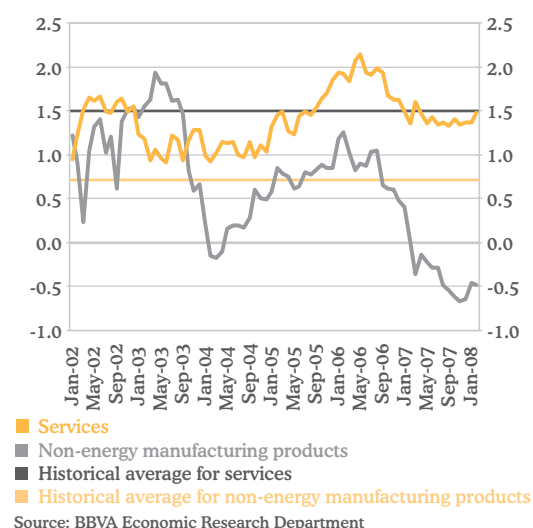


Chart 2.10.
Spain: Inflation
(Quarterly y-o-y growth)

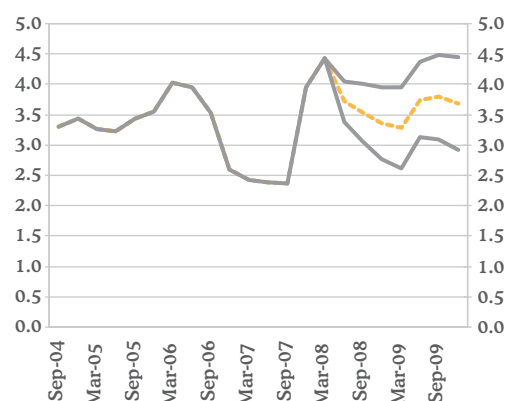


Chart 2.11.
Public sector surplus (+) / deficit (-), in % of GDP

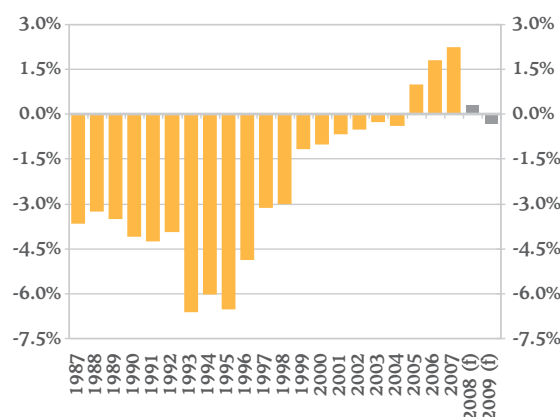


Chart 2.12.

Public deficit, maintaining constant debt level

(in % of GDP)

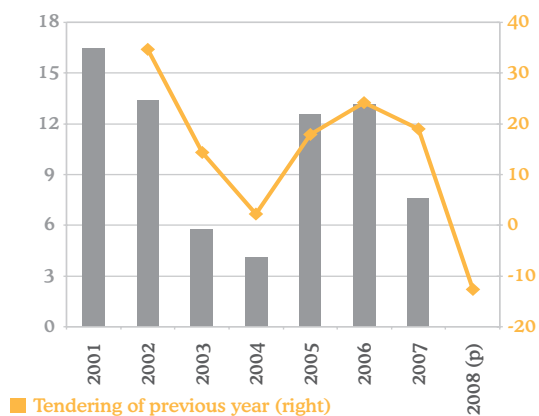


■ EDP limit
 ■ Deficit adjusted to current level of debt (36.2%)
 Source: BBVA Economic Research Department

Chart 2.13.

Public investment and tendering

(% y-o-y)



■ Tendering of previous year (right)
 ■ Investment
 Source: SEOPAN and BBVA Economic Research Department

be slightly negative in 2009. These forecasts do not include the effect of any possible discretionary fiscal policy measures which might be announced, apart from the Personal Income Tax rebate of 400 euros per tax return announced for June and which is expected to be repeated in 2009. These figures would make it possible to continue to reduce the balance of public debt as a percentage of the GDP. Consequently, further deficits could be incurred, maintaining the debt ratio and without reaching the 3% deficit limit established in EMU.

An anti-cyclical fiscal policy should meet three criteria³. First, it must be rapidly implemented, in time to offset the cyclical slowdown. Second, it should be considered as a transitory measure which can be withdrawn when the cycle picks up, so that there is no long-term fiscal deterioration and impacts on long-term interest rate expectations are avoided. And, lastly, the measures should be efficacious, i.e. they must have a major impact on final spending for each additional point of the deficit.

In recent times, in the international arena, but especially in Europe, central banks and international organizations have taken the view that discretionary anti-cyclical policies are not advisable. This stance is justified by the argument that automatic stabilizers successfully play their role of acting quickly and only temporarily when there are changes in cycle, and because the fiscal incentive policies implemented in the eighties, were asymmetrical, with no adjustment in the good times to compensate for the expansion made in the bad. It is also argued that the time between the moment the deterioration of the economic situation is recognized and the time when policy measures have a real effect is too long. Debates are required in parliament and delays occur in approving and implementing the measures, which can imply that the measures are not so effective or may even be counterproductive if they come when the cyclical situation starts to change.

In practice, in the nineties there was not much room for anti-cyclical policies because of the efforts being made to meet the Convergence Plans in order to access European Monetary Union. More recently, in the present decade, there has been some relaxation in Europe, with high deficits in some countries (France and Italy, amongst others) which failed to adjust their public accounts to an economic situation that was clearly improving. The case of Germany is better, with fiscal equilibrium achieved in 2007, although only after two years of high growth, above potential.

In Spain there are arguments for conducting an anti-cyclical policy which goes beyond automatic stabilizers. Firstly, in a Monetary Union with a common monetary policy and with unsynchronized cycles (something which is starting to resemble the present situation, with Germany showing greater resistance to the slowdown than other countries in the region), fiscal policy is the only rapid-response instrument for stabilizing the economy in certain countries. Secondly, in countries which have accumulated surpluses and have reduced debt during the periods of high growth, like Spain, there is room for manoeuvre. Especially, if there is a fiscal policy rule which guarantees sustainability in the long-term and which reduces the negative effects on long-term interest rates, through an expectations effect. Lastly, there are probably fewer automatic stabilizers in Spain than in other countries in the region (unemployment benefits which are below the European average, especially in terms of duration, and lower marginal Personal Income Tax rates).

³ See Elmendorf, D. W. and J. Furman (2008): "If, When, How: A primer on fiscal stimulus", The Hamilton Project, Strategy Papers.

The fact that there have been no efficacious anti-cyclical policies in Europe does not mean that they are not possible or desirable. The United States has provided good examples of this. Detailed analyses of discretionary policies in the United States also help to draw conclusions about what a good anti-cyclical policy would be in terms of the criteria of timing, temporariness and efficacy mentioned earlier.

The main measure of the discretionary fiscal policy announced so far in Spain is of a limited magnitude. We are referring to the 400 euro rebate for Personal Income Tax taxpayers, which represents 0.5% of the GDP. The impact of this measure on growth is difficult to evaluate until the details are known (which taxpayers will benefit, whether the rebate will be given at a certain time or over the year, whether it will be of a temporary or permanent nature...). A preliminary calculation of the impact using BBVA ERD's consumption function suggests that it will increase household consumption by between 0.2 and 0.3 pp. In any event, the impact would be all the greater, the more the measure is directed at the sectors of the population with less propensity to save (through an income ceiling), if it is applied at the right time and if it is transitory, so as not to produce a deterioration in the structural deficit.

Other anti-cyclical measures are possible, each with their own characteristics. Some of them have already been mentioned in the public debate:

- A reduction in marginal Personal Income Tax rates: in principle, it would not be a temporary measure and would require a slow period of implementation. It would have greater impact in the short term if it was mainly applied to the lower income brackets (the ones which have greater propensity to consumption). Generalized reductions in marginal rates make more sense as a long-term supply policy than as an anti-cyclical policy.
- An increase in public spending on infrastructures or subsidized housing: in principle, it has the advantage of being a temporary measure, with a direct effect on final spending, apart from helping to raise the economy's output capacity. Delays in implementation can be variable, depending on the type of investment but, in principle it can be a relatively rapid measure. Public investment has increased in importance in the past few years and represented 3.8% of the GDP in 2007, 7 pp more than at the beginning of the decade. However, the performance of public tenders, a leading indicator of investment actually made, (Chart 2.13), is a warning sign, as it fell by 13% in 2007 (although it is also true that the downturn is at least partly due to the election cycle). If investment goes to developing subsidized housing, it would be better for it to go to housing for rent, to boost this market and to prevent downturns in prices at a time of excess housing supply.
- Extending unemployment benefits to certain groups of unemployed people: this would be extremely effective, since it would affect a group of people with a high propensity to consume, and its application would be automatic. It would need to be a temporary measure to limit the impact on the structural deficit and to not serve to discourage working in the long term.
- A temporary reduction in Social Security contributions for workers with wages below a certain limit. This would also be a rapid effective measure, with an impact more complementary to the effect of the extension of unemployment benefits (as it applies to different groups). The effect on the sustainability of pensions would be minimum if the measure is temporary, and in any case, it could be offset through a Government transfer to the Social Security Pension Fund.

3. Risk factors which could have a greater impact in the future

Some of the risk factors that we identify in the economy could have a greater impact in coming months. In particular, we are concerned by a possible spreading of the financial crisis, and also by the possibility that the downturn in the housing sector may intensify if expectations deteriorate. Hence it seems reasonable to us to make our growth forecasts in terms of ranges.

Risk factors to monitor: the extension and intensity of the financial crisis, and a more acute downturn in the real estate sector

Having noted that the deterioration of the global environment implies a downward revision of the growth of the Spanish economy, it is important to point out that the outlook is not free of some risks which may or may not intensify in the coming months. Because of this, we think it is reasonable to make our forecasts using ranges which aim to encompass the uncertainties that the economy is facing. Establishing one central growth forecast will only be of use as a benchmark for the detailed macroeconomic table at the end of this section.

We think there are two key risk factors with most probability of intensifying and which should be monitored at the start of 2008. The first of these is the intensity and duration of the financial crisis, and the second is the possibility of a more acute downturn in the real estate sector as expectations deteriorate.

For the first of these factors, if difficulties in accessing financing continue, and liquidity tensions persevere, then the final impact on economic growth will be greater. This is particularly significant for the Spanish economy. In recent years, borrowing requirements have grown rapidly. These are largely the reflection of some of the most notable developments in the economy, such as the increased household investment in real estate and also the major rise in companies' overseas investments. The increase in domestic investment has been accompanied by an increase in the borrowing requirements of the current account, which in 2007 totalled 96 billion euros, a significant rise from 57 billion euros in 2004. The pattern of accumulating external financial assets also implies a further increase in the economy's borrowing requirements. In 2007 these requirements amounted to 83 billion euros, or close to the same level as those stemming from the current account. In a context of slower global growth, and more moderate investment levels, we expect asset accumulation to ease to between 64 and 84 billion euros in 2008, always in reasonable scenarios where different degrees of intensity of the global financial shock are assumed. As the adjoining table shows, this implies that the Spanish economy is facing a very high net variation in financial liabilities, even when adjusting for the volume of direct investment into Spain (which is very stable at around 20 billion euros)¹. Thus, if the financial shock becomes more intense and lasts much longer, there will clearly be a greater impact on the growth of the Spanish economy.

¹This figure only includes net borrowing requirements, to which debt maturities must be added to obtain total borrowing requirements. In 2007, there were total debt maturities of over 200 billion euros, and the figure will be similar in 2008.

Table 3.1. Net variation in financial liabilities of the Spanish economy

In EUR bn

	Financing of current account (1)	Net acquisition of financial assets (2)	Net variation in financial liabilities (3)	Foreign direct investment in Spain (4)	Net adjusted variation in financial liabilities (5=3-4)
2004	57	96	153	20	133
2005	75	151	226	20	206
2006	96	145	240	16	225
2007(e)	96	83	179	21	159
2008(p)	38-89	64-84	103-173	14-18	89-155

Source: BBVA Economic Research Department

If the financial crisis continues, it could have a significant downward impact on economic growth

The first risk factor that could intensify is the extension and deeper impact of the financial crisis. To be able to estimate the consequences of a lasting financial shock on economic growth, we need to identify a variable which can be used as an approximation for the current shock. As the consequences of the crisis are to be found in the more expensive conditions for wholesale financing, a good indicator is the spread between the interbank interest rate and 3-month Spanish Treasury Bills (the TED spread). The Chart 3.1 shows the quarterly performance of this spread and shows that we have to go back to 1993, in the midst of a recession and a crisis in the European Monetary System, to find spreads as high as they are now. Although in the first quarter of 2008 the spread narrowed compared to the average for the fourth quarter, financial tensions, which had seemed to remit after the highs of December (at 100 bp), reappeared, and are well above the levels that were considered normal before last summer, at around 14 bp.

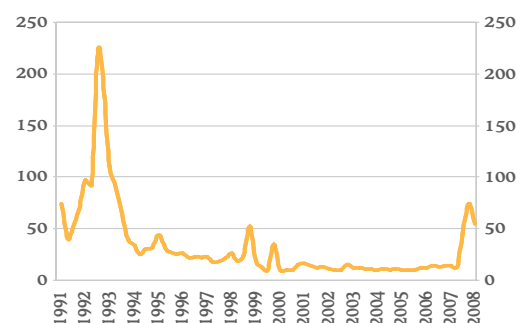
In an simulation² we can obtain the effects that the persistence of this crisis could have on the Spanish economy in terms of lower GDP growth. We assume two scenarios of differing durations for the financial crisis. In the first, the spread remains at high levels (50 bp) for the first two quarters of the year, and then falls to a stable level in 2009, although above the level before the crisis, at around 30 bp. In the second scenario, financial tension continues until the fourth quarter of 2008 (at 50 bp) and then falls, again to a level higher than before the crisis. The return to the pre-crisis level would not occur as rapidly and would be slightly above the level obtained in the first scenario.

In both scenarios there is a very significant slowdown in credit growth, which is naturally greater in the scenario where tensions are more persistent. Specifically, in the scenario where the financial crisis is more rapidly resolved, credit growth would slow by 2 pp compared to a situation with no financial tension. In the scenario of a longer crisis, throughout 2008, credit growth in the Spanish economy would be 4.2 pp and 6.6 pp slower in 2008 and 2009, respectively, than in a situation with no tensions. Hence the impact of these scenarios on the GDP is significant: a financial crisis of the scale and intensity described would have a cost, in terms of the GDP, which would range from half a point in each of the two years if the crisis was rapidly resolved (0.5 pp and 0.4 pp in 2008 and 2009, respectively) to around one percentage point if the tensions persisted throughout 2008 (0.8 pp in 2008 and 1.1 pp in 2009).

The way that this sort of shock enters the credit channel implies a restriction in credit supply. The slowdown in credit recorded so far seems to be primarily due to variables on the demand side. Evidence of a restriction in supply is very preliminary, although the latest Bank Lending Surveys reflect tougher conditions for awarding loans, and these reflect a certain re-evaluation by the banks of the risks being assumed.

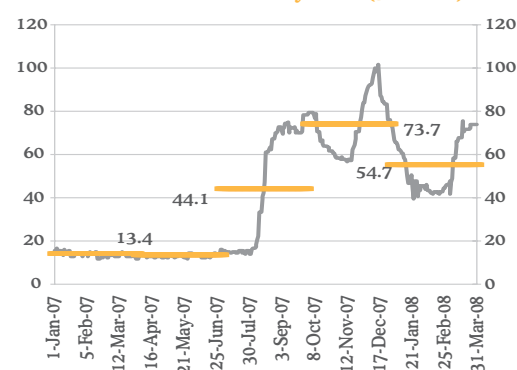
² For a theoretical description of the simulation, see the section "Impact of an adverse financial shock in Spain".

Chart 3.1.
Spain. 3 months TED spread in bp
(Interbank rate-Treasury bill)



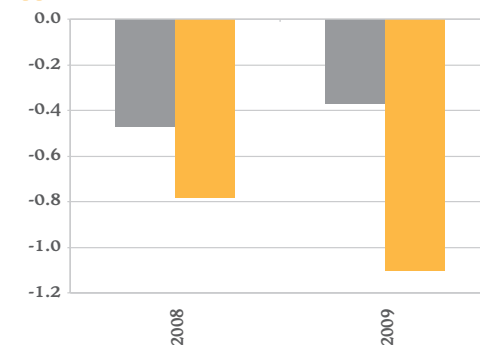
Source: Bank of Spain, Bloomberg, BBVA Economic Research Department

Chart 3.2.
Spain, TED spread
Interbank market -Treasury Bills (3month)



Source: BBVA Economic Research Department

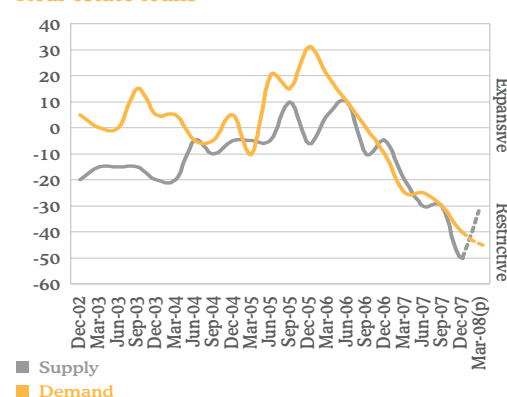
Chart 3.3.
Spain, effect of financial crisis on GDP
(pp)



■ Shock in spread until June-08
■ Shock in spread until Dec-08

Source: BBVA Economic Research Department

Chart 3.4.
Bank lending survey
Real estate loans



■ Supply
■ Demand

Source: BBVA Economic Research Department

Impact of an adverse financial shock in Spain

Since mid 2007, there has been significant tensions in global financial markets, which has resulted in a rise in financing costs and a reduction in lending volumes. These have impacted both the European and the Spanish financial market.

In this context, it is important to understand how and to what extent these tensions in wholesale financial markets could impact retail financing and economic activity.

In order to quantify the effect that these events could have on the Spanish economy, we use a VAR (vector autoregressive model). The model has the following dynamic structure:

$$y_t = C + A_1 y_{t-1} + A_2 y_{t-2} + B_1 r_{t-1} + B_2 r_{t-2} + e_t$$

where the vector of endogenous variables, y_t includes: real GDP (logarithm), inflation rate, spread between the interbank 3-month rate and the 3-month treasury bill, and total loans in real terms. The variable r_t is the interest rate on the 3-month treasury bill which is included as a control variable.¹ C , A_1 , A_2 , B_1 and B_2 are matrices of parameters which have been estimated² by OLS with quarterly data since 1993.

Using this model, we can isolate the effect of an adverse financial disturbance and quantify its impact on the most important macroeconomic variables.

In a VAR model, structural disturbances are not directly identified. To do this, we use a model which enables us to identify these disturbances through errors in the model (e_t). The identification of the disturbances is not straightforward, as different methods can deliver very different results. In this exercise, identification is based on sign restrictions.³ The appeal of this is that, if the restrictions are appropriate, it is compatible with the implications that are typical of DSGE models (Dynamic Stochastic General Equilibrium models), and this is not the case for other identification methods. In addition, this identification method is very flexible, as it imposes very loose restrictions on identification. In this model, we define an adverse financial disturbance as that which simultaneously generates a rise in the spread between the interbank rate and the risk free

rate, and a slowdown in the rate of lending growth in real terms.³ This adverse financial disturbance should be understood as an adverse shock in supply in the banking sector, with a simultaneous contraction in lending volumes and a rise in the interbank funding premium.

Chart 1 shows how the main macroeconomic variables respond to the disturbance that we have identified. The size of this disturbance has been normalised, with the spread rising 30 bp on average in the first quarter.⁴ Although in this analysis the disturbance occurs just once, its effects are not over immediately but persist for between two and three years.

Because of this disturbance, the slowdown in the year-on-year growth in lending is around 5 pp on average in the first year (compared to a scenario with no disturbance), and a little over 3 pp in the second year. The year-on-year GDP growth rate slows by 1 pp in the first year and by 0.6 pp in the second year.⁵

An exercise for the current situation

After building and estimating this econometric instrument, we now use it to analyse the situation of the Spanish economy in the short term, combining the information from the impulse-response functions as described above with the forecasts of the model.

Using the information available until the fourth quarter of 2007, we forecast the endogenous variables of the model for the next two years without including any type of additional disturbance.⁶ The model forecasts that after reaching high levels, the spread quickly returns to lower levels with a moderate impact on other economic variables. This rapid normalisation has already been seen in other periods in which this variable has risen, and hence the model is accurately reflecting historical trends. However, our hypothesis is that this time the financial problems will last longer than in previous periods of financial uncertainty. Because of this, we carried out the following exercise: we added to the unconditional forecast of the model the impact of an adverse financial disturbance, so that, in one case, the spread remains at levels of 50 bp until the middle of the year and then gradually falls in its own time, and in the

¹ The interest rate is exogenous to the system, as it is largely determined by the ECB's monetary policy, established according to the macroeconomic conditions of the eurozone. For the period before the single currency, the macroeconomic restrictions in place to converge with the Euro implied an interest rate that was highly influenced by conditions that were exogenous to Spain. However, we did carry out an exercise where the interest rate was included as an endogenous variable, with no significant change in results.

² For more detail on the means of identification using sign restrictions, see Harald Uhlig, (2005), "What are the effects of monetary policy on output? Results from an agnostic identification procedure", *Journal of Monetary Economics* No. 52.

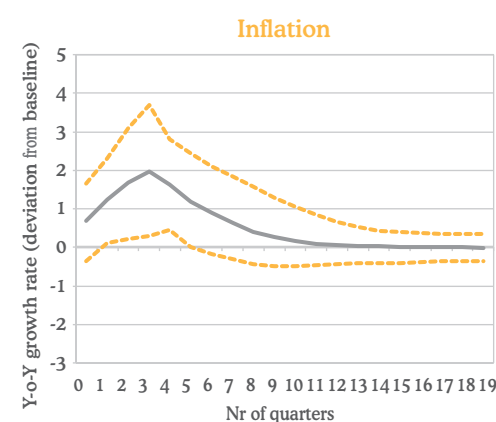
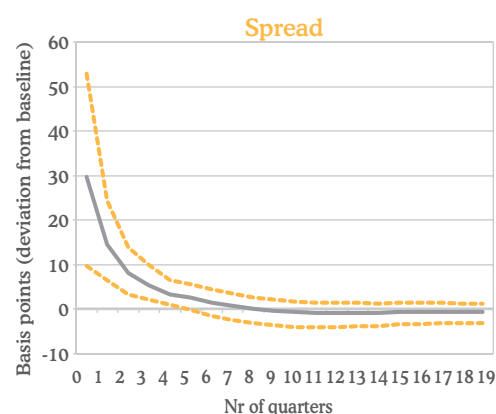
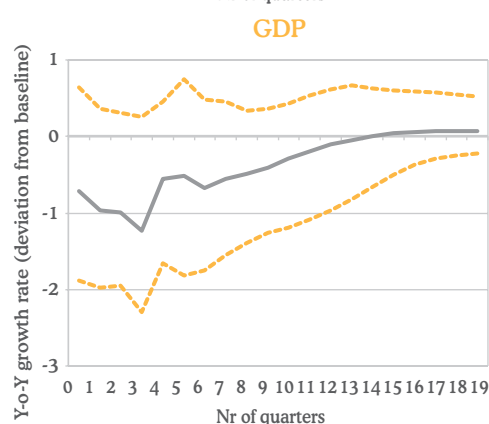
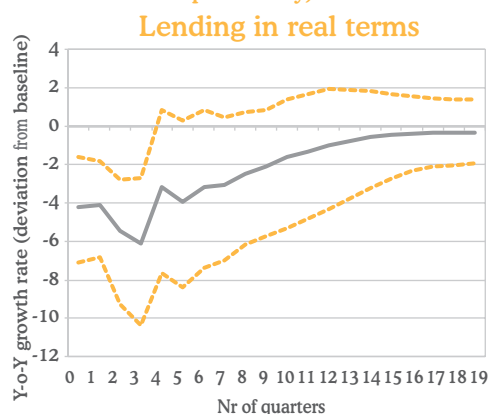
³ i.e., the sign condition used for the identification of the impulse response function of the spread in this shock is positive, while for real lending it is negative.

⁴ The response of the spread and of other variables is in the deviation from the baseline scenario of no shocks.

⁵ Note that no sign restriction has been imposed for the response of GDP, but that it does move in the expected direction. It is important to note that the confidence interval is wide, so it is not possible to rule out a non-significant response from this variable.

⁶ It is also necessary to use forecasts for the 3-month treasury bill interest rate, which we assume to be equal to our forecasts for the ECB Refi rate.

Chart 1: Impulse-response functions to an adverse financial shock of 30 bp on average
(interval of 68% central probability)

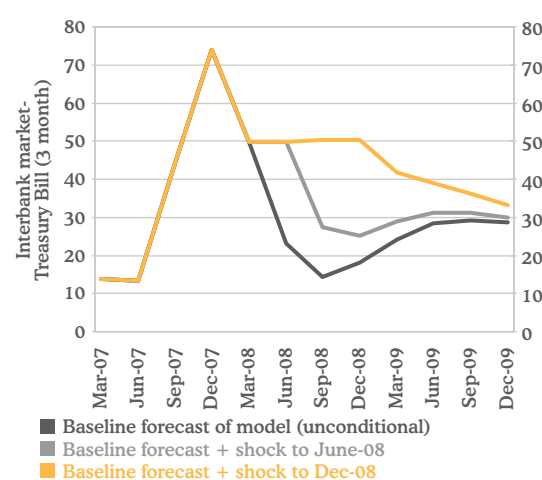


Source: BBVA Economic Research Department

other case with the tensions last until the end of 2008, with a spread of 50 bp until the end of the year. The differences between these two scenarios can be clearly seen in Chart 2. In these two cases, the impact on the economy of the financial upsets persisting until the middle of this year is of 0.5 pp on the GDP, with an impact of 0.8 pp if the problems last longer.

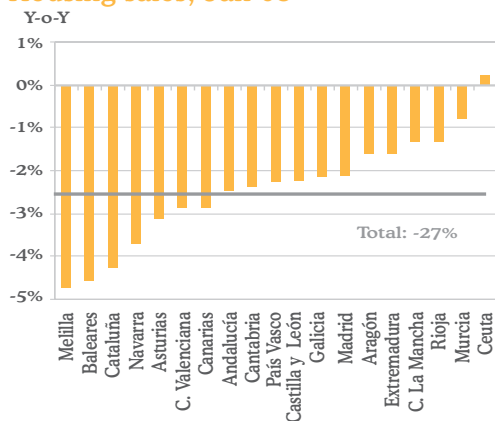
In conclusion, the exercise we carried out provides evidence supporting the general perception that tougher financial conditions will adversely affect activity levels, and that we should hence expect the current financial problems to lead to lower growth rates than those we previously forecast. In addition, the impact on the economy will be greater, the longer that this period of tension and uncertainty lasts.

Chart 2: TED-Spread in different scenarios (bp)



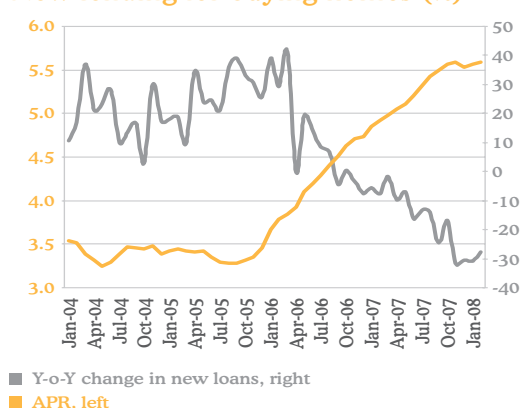
Source: BBVA Economic Research Department

Chart 3.5.
Housing sales, Jan 08



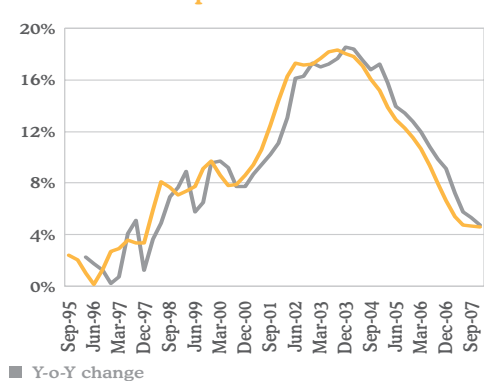
Source: INE, ETDP

Chart 3.6.
New lending for buying homes (%)



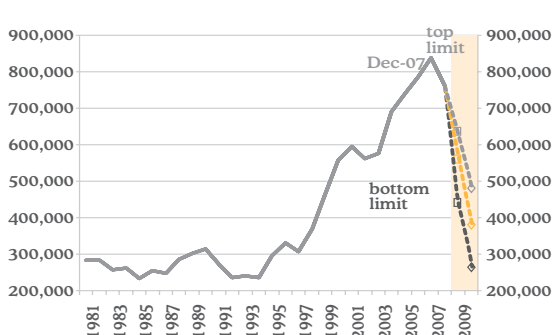
Source: Bank of Spain

Chart 3.7.
Rise in house prices



Source: BBVA Economic Research Department using Housing Ministry data

Chart 3.8.
Housing permits
Alternative scenarios



Source: Development Ministry and BBVA Economic Research Department

The real estate sector could face a more acute slowdown if there is a significant deterioration in expectations

The most recent data from the real estate sector in Spain point to an intensification of the correction process which began two years ago. On the side of housing demand, there have been signs of moderation since 2005, the year when the number of housing starts was greater, with the highest employment growth and the lowest interest rates for acquiring property in the last cycle. Since then, the high level of household indebtedness and the rises in interest rates have led to a deterioration in housing accessibility. Currently, not including taxes, families have to put 26% of income to paying for a loan to acquire a property in current financial conditions, with an interest rate 2.3 pp higher than the lowest level recorded, with most of this increase (1.9 pp) occurring in the last two years. This process has had an impact on real estate transactions, which declined by a total of 14% in 2007. The effect can also be seen in new loans for home-buying, which dropped by 15% in 2007.

Supply began to show clear signs of weakness in mid-2007, and is falling faster than demand, which is necessary in order to avoid a rise in stock in housing sales. In December, new building permits fell by 25%, from 866 thousand in 2006 to 651 thousand at the end of 2007 (corrected for the CTE effect).³

In this context of an adjustment in volumes, property prices have continued the correction that began at the end of 2003. Prices have now had 16 quarters of gradual deceleration, from year-on-year 18.5% to 4.8% at the end of 2007. Although in recent months the downturn in prices has accelerated, the main point to be made is that the slowdown is proving to be much gentler than in previous real estate corrections in Spain, and than the slowdowns experienced by other developed countries which have experienced similar real estate growth.

In 2008, we expect the current trends to continue, with a more intense correction in volumes and a relatively more moderate correction in prices. On the demand side, families will have the support of a slight improvement in accessibility ratios. Firstly, we expect the European Central Bank to drop interest rates from September by around 50 basis points. This factor, combined with weaker property prices, will lead to an improvement in accessibility ratios. However, this will be less than was expected in the autumn, due to the delay in interest rate cuts from the ECB. These positive factors will also be offset by tighter financing conditions due to the international financial situation, which could act as a brake on mortgage operations with a higher risk profile.

However, since the summer of 2007, the global economic slowdown resulting from the turbulence in the financial situation has led to a deterioration in the expectations of market players, which will prolong the weakness in real estate sales. Thus, the performance of the economy and of employment will be key factors when determining the situation of the sector in coming years.

Supply will continue to correct until it reaches a volume that is more in line with potential market growth. We do not expect housing permits to exceed around 500 thousand this year and 320 thousand in 2009. In this context of falling volumes, real estate prices will continue to gradually adjust, with negative year-on-year rates from the end of 2008.

³ Código Técnico de Edificación, or Technical Building Code, a regulatory change which introduced a bias in the permits series.

It is important to note that the current correction is continuing to take place in a relatively favourable context, compared to previous corrections. There are several factors which supporting the market: families are in a very sound financial situation and will eventually benefit from a relaxation of monetary policy, there is sustained household creation by residents and non-residents, the financial system is solvent and well-provisioned, and the public sector is in a fiscal position which allows anti-cyclical policies to be implemented.

However, the correction in the sector could intensify if there is a significant deterioration in expectations, in which case the downward adjustment could be greater, adding further uncertainty to the economy. It should not be forgotten that expectations can accelerate a correction, and generate an excessive downward reaction.

The impact on the economy of a more acute downturn in the real estate sector

To measure the impact which a more acute downturn in the real estate sector could have on the economy in general, and on other areas of activity, we used a model that looks at the relations between Gross Value Added (GVA) and employment in the construction sector and the rest of the economy.⁴

In these exercises, the impact of the real estate shock on economic growth is obtained as the difference between the GDP growth forecast using the long term trend for investment in construction (which does not include a slowdown in the housing sector) and the forecast for various scenarios of investment in housing.⁵ We have used the following three scenarios (Table 3.2.):

1. Housing investment falls by 3.5% in 2008 and 7.0% in 2009, based on the forecasts from BBVA ERD in December 2007.
2. The correction in the sector intensifies, and housing permits return to their average level for the second half of the 1990s, with housing investment falling by 5.5% in 2008 and 11.3% in 2009.
3. The number of housing permits falls to its average for the first half of the 1990s, which would lead to a 9.5% drop in housing investment in 2008, and a 17.7% downturn in 2009.

The results from the model indicate that the effect on GDP would be limited in the short term (2008) and more intense in the medium term (2009). This is consistent with the fact that in some countries, such as Spain, where housing block constructions predominate, the inertia of investment in housing is greater, so that the immediate impact of a drop in the number of housing starts is relatively limited.⁶

⁴ We used a Bayesian VAR model with time-variable coefficients. In addition to activity and employment variables, the model also uses housing prices, consumer goods prices, and interest rates. The period covered by the sample used runs from the first quarter of 1988 to the fourth quarter of 2007. For a detailed explanation of the estimation method, see: Doan, T., R. Litterman y C. Sims (1984), "Forecasting and conditional projection using realistic prior distributions", with discussion, *Econometric Reviews*, 3, 1-144, y Canova, F. (2007), *Methods for Applied Macroeconomic Research*, Princeton University Press.

⁵ Investment in housing is determined by the number of housing permits in the current and preceding year. The lack of a specific series for employment in the housing sub-sector means that each scenario for investment in housing is transformed into a scenario for total investment in the construction sector.

⁶ See: "Building and real estate sector adjustment in other developed economies." Real Estate Watch, December 2007, 7-8, BBVA ERD

Table 3.2. Housing investment

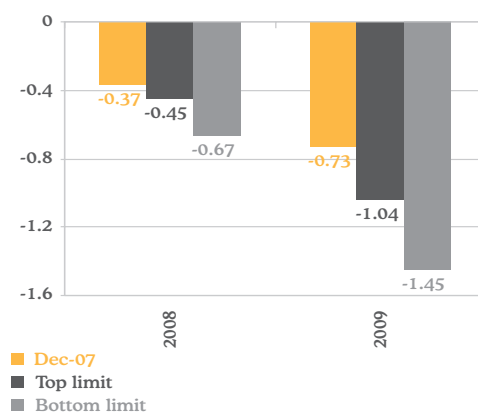
Scenarios for 2008-2009 (% Y-o-Y growth)

	Trend	Forecasts	Current forecast	
		Dec 2007	Top limit	Bottom limit
2008	4.2	-3.5	-5.5	-9.5
2009	3.6	-7.0	-11.3	-17.7

Source: BBVA Economic Research Department

Chart 3.9.

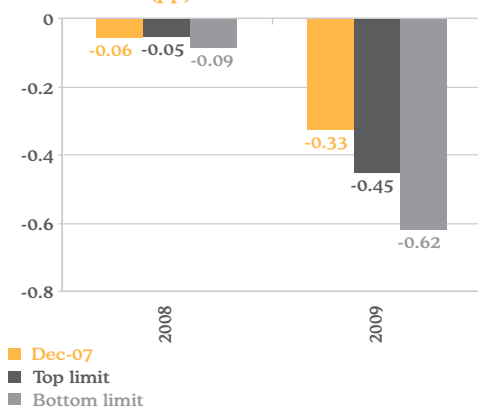
Construction. Impact on total GDP.
Difference to long term trend of investment in construction (pp)



Source: BBVA Economic Research Department

Chart 3.10.

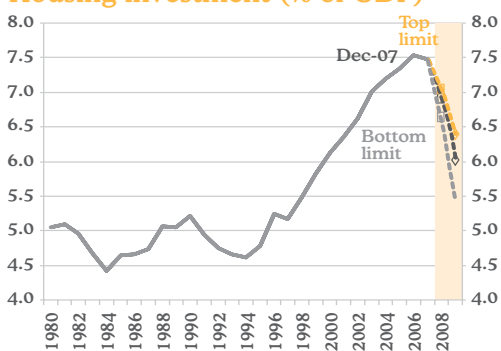
Impact of the intensification of real estate adjustment on GDP (excluding construction)
Difference to long term trend of investment in construction (pp)



Source: BBVA Economic Research Department

Chart 3.11.

Housing investment (% of GDP)

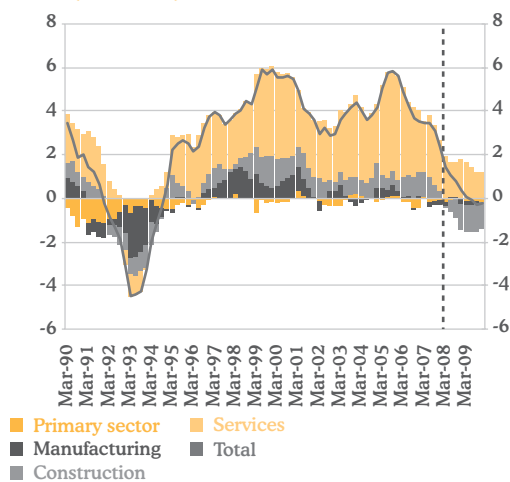


Source: INE and BBVA Economic Research Department

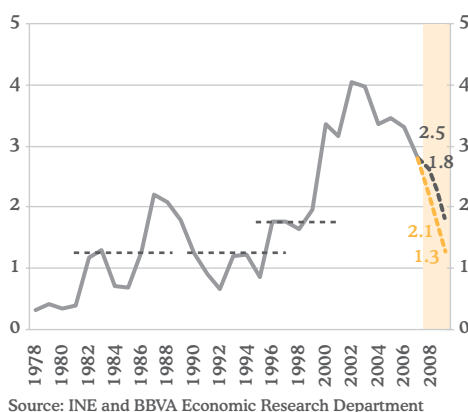
Table 3.3. Spain: Labour market forecast (LFS)

	2007	2008		2009	
		Bottom limit	Top limit	Bottom limit	Top limit
Total employment (000's)	20356.0	20442.0	20635.2	20245.7	20778.4
Change in 000's	608.3	86.0	279.3	-196.3	143.1
Change in %	3.1	0.4	1.4	-1.0	0.7
In construction (000's)	2697.4	2532.4	2592.4	2245.5	2364.7
Change in 000's	154.4	-165.0	-105.0	-286.9	-227.7
Change in %	6.1	-6.1	-3.9	-11.3	-8.8
In rest of economy (000's)	17658.6	17909.6	18042.9	18000.2	18413.7
Change in 000's	453.9	251.0	384.3	90.6	370.8
Change in %	2.6	1.4	2.2	0.5	2.1
Jobless (000's)	1833.93	2208.02	2109.42	2689.30	2375.69
Change in 000's	-3.2	374.1	275.5	481.3	266.3
Change in %	-0.2	20.4	15.0	21.8	12.6
Active population (000's)	22189.9	22650.0	22744.7	22935.0	23154.1
Change in 000's	605.1	460.1	554.8	285.0	409.4
Change in %	2.8	2.1	2.5	1.3	1.8
Unemployment rate	8.3	9.7	9.3	11.7	10.3

Source: INE and BBVA Economic Research Department

Chart 3.12
Employment. Contribution to growth rate (% Y-o-Y)

Source: INE and BBVA Economic Research Department

Chart 3.13
Active population
Historical trend and forecasts
(% Y-o-Y growth)

Source: INE and BBVA Economic Research Department

Chart 3.9 summarises the effects on activity of the various scenarios that were analysed. If housing supply corrects gradually, as we believed in December 2007, ceteris paribus the GDP would shrink by 0.4 pp in 2008 and 0.7 pp in 2009. When this is compared with scenario where investment grows in line with its long term trend, it would imply a rate of around 4%. However, the most recent data from the sector are pointing to a more acute correction. If we add this more acute correction to our model, the impact on the economy as a whole would rise to [0.5;0.7] percentage points in 2008, and [1.0;1.5] in 2009. Hence, the change in the scenario between December and April represents between -0.1 and -0.3 pp less growth in 2008, and -0.3 to -0.7 pp less in 2009.

As construction could drag down other sectors of the economy, the total effect on the GDP of the real estate correction will be the sum of the direct impact of the slowdown in the sector itself, and the impact on other economic activity. The results of the model (Chart 3.10.) show that the effect on the GVA of the rest of the economy is practically zero in 2008, whatever the scenario used, but is significant in 2009: the intensification of the real estate correction means that between 45% and 62% of the downturn in economic growth in 2009 will be a result of the indirect slowdown of the rest of the economy. In other words, if the shock in the construction sector does not intensify, the rest of the economy in 2008 will grow at rates of around 3%, in line with its tendential growth, which reflects its relatively sound fundamentals. If the real estate slowdown intensifies, the growth of the rest of the economy could fall to just 2% in 2009.

Due to the magnitude of the downturn in housing investment, its weight in GDP will decline in 2008 and 2009 (Chart 3.11.). If in December 2007 the share of investment in housing in the GDP was expected to fall by 0.5 pp in 2008 and 0.6 pp in 2009, the intensification of the correction now indicates that housing investment will lose even more weight: between 1.5 and 2.0 accumulated percentage points in 2008 and 2009.

A significant impact on employment, which will fall in the construction sector in 2008 and 2009. The economy as a whole will continue to create employment in 2008.

As we saw in the previous section, the construction sector is undergoing a significant adjustment in terms of activity. This deeper slowdown will have a significant impact on employment. Our forecasts indicate that employment will be destroyed in the construction sector in 2008 and in 2009. Net job destruction in the construction sector in 2008-2009 could range from 333,000 to 452,000 jobs, depending on the scale of the correction. While there will be a significant fall in the job creation rate in other areas of the economy, this rate will still be positive. In 2008, we expect the Spanish economy, excluding construction, to create between 251,000 and 384,000 jobs, with job creation outside the construction sector falling in 2009 to between 91,000 and 371,000 jobs, according to the bottom and top levels forecast for economic growth⁷. In addition, by sectors, only services will make a positive contribution to job creation in 2008 and 2009, but at a significantly lower rate than in previous years (Chart 3.12).

⁷ Between 2003 and 2007, the average annual job creation rate, excluding the construction sector, was 3.8%, or 602 thousand jobs per year.

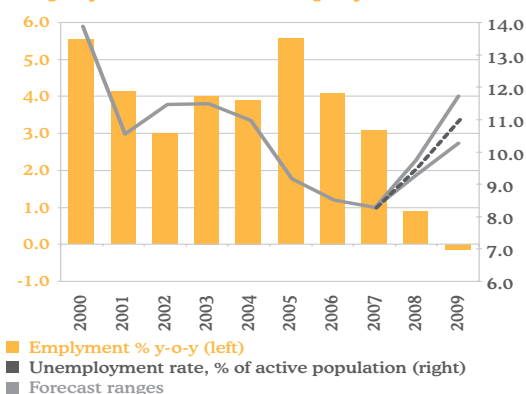
In the economy as a whole, job creation will slow in 2008, in line with the expected slowdown in activity. In 2008, the year-on-year job creation rate will be between 0.4% and 1.4%, or between 86 and 279 thousand new jobs. But in 2009, a sharper slowdown in employment is likely, with job creation rates of between -1% (destruction of 196 thousand jobs) and 0.7% (creation of 143 thousand jobs).

As a result of the more acute economic slowdown, the probability of a person in employment becoming unemployed will increase in 2008 and 2009. This will lead to a rise in the number of unemployed people, even though the probability of transition from inactivity to unemployment decreases (as should be expected for pro-cyclical reasons). We forecast a rise in the number of unemployed of between 15.0% and 20.4% in 2008, or, in other words, between 276,000 and 374,000 people. In 2009, the confidence interval for the unemployment growth rate is wider, between 12.6% (266,000 more people unemployed) and 21.8% (481,000 people more), due to the greater uncertainty. Thus, taking the central figure of these intervals, the number of people unemployed in the Spanish economy will rise by over 650,000 in 2008-2009, from 1,833,000 in 2007 to 2,500,000 in 2009.

Given the expected development of the total labour force (Chart 3.13), which will grow by 1 to 1.3 pp less for cyclical reasons, and because of the demographic impact of the expected moderation in immigration, the unemployment rate in the Spanish economy will be 9.5% of the total labour force in 2008, in a range of 9.3% to 9.7%, and 11.0% in 2009, with a range of 10.3% to 11.7%. This means that unemployment could return to the levels of the first half of this decade (Chart 3.14).

Chart 3.14

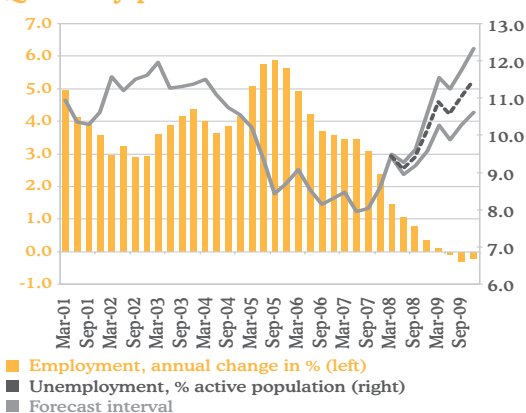
Employment and unemployment rate



Source: INE and BBVA Economic Research Department
Note: bias in 2005 due to methodology change in Labour Force Survey

Chart 3.15

Employment and unemployment rate. Quarterly profile.



Source: INE and BBVA Economic Research Department
Note: bias in 2005 due to methodology change in Labour Force Survey

The labour market in the new scenario for the Spanish economy

The most recent data has confirmed an intensification in the slowdown of the Spanish economy since it began to cool at the beginning of 2007, in terms of both activity and job creation. The final increase in unemployment trend recorded by the Public Employment Services in the first quarter of the year was 144.5 thousand people, 35 thousand more than was expected in December.

As the performance of economic activity is closely linked to employment, it is appropriate to now analyse how the sharper slowdown of the economy could impact the pace of job creation. Firstly, we identify the labour flows which determine the net creation of employment. Secondly, we use the model of non-observable components of Doménech and Gómez (2005) in order to break down the unemployment rate into its cyclical and structural components, in the expected scenario for economic growth.

Firstly, we estimated, for the period of March 1999 to December 2007, the probability of moving from one employment situation to another, depending on the personal and labour characteristics of the individuals and on the business cycle¹. As indicators for the cycle, we used two variables: the year-on-year variation in quarterly GDP, which reflects the effect of the cycle, and the first difference between these rates, which shows whether economic growth is accelerating or slowing down.

With the growth scenario forecast by BBVA ERD for 2008 and 2009, we expect that, although the impact of the slowdown on the probabilities of moving from employment to unemployment and to inactivity will be limited, above all in the short term (the probability of remaining employed is slightly pro-cyclical, while flows to both unemployment and to inactivity are of an anti-cyclical nature), the probabilities of

¹ For a detailed description of the model, see: Fernández, C. and J. R. García (2008), "Perspectivas del empleo ante el cambio de ciclo: un análisis de flujos", BBVA Working Paper No. 0802.

moving into employment will fall significantly, reflecting the expected pro-cyclical pattern. The predicted probabilities for entering employment from unemployment and from inactivity will fall by 6 and 4.4 pp respectively in the next two years. The overall result of the changes in the transition probabilities will be a slowdown in occupation of between 0.4% and 1.4%, depending on the final figure for GDP growth. In 2009, we expect stagnation in employment, and estimate a variation of between -1.0% and 0.7%.

In order to find out whether the unemployment rate detailed above is a temporary or a structural phenomenon, we use the model of non-observable components proposed by Doménech and Gómez (2005), which allows us to estimate the structural unemployment rate of the economy, in accordance with Okun's law².

The results obtained show that the structural unemployment rate (usually known as the non-accelerating inflation rate of unemployment, NAIRU), after falling since the mid 1990s, has risen gradually since the third quarter of 2006 (0.3 pp) to its current level of 9.7%. With the economic slowdown intensifying, the unemployment trend will continue to rise to close to 10.8% at the end of 2009³. In contrast, the cyclical component of unemployment will continue to be less than zero in the first half of 2008, with a negative contribution to the unemployment rate. In the fourth quarter of 2008, the cyclical unemployment rate will become positive again, rising throughout 2009 to represent 1 pp of the estimated unemployment rate at the end of the year.

When we analyse the composition of the unemployment rate in the current slowdown, and compare it with the previous slowdown, we can see some significant differences. Firstly, the rise in unemployment now has more of a structural component in 2008 and 2009, while between the fourth quarter of 2000 and the first quarter of 2004, the deterioration was entirely cyclical, with no significant impact on the structural unemployment rate. The table shows that the expected deterioration of the structural rate of unemployment will be greater than in the recession of the 1990s, while the expected rise in cyclical unemployment will be similar to what it was in the slowdown at the beginning of the decade. One of the reasons for the rise in the structural component of unemployment could be related to the situation of full employment in the Spanish labour market, especially in some regions⁴. When the labour market is at the limit of its capacity

² Compatible with the existence of a negative relationship between the cyclical components of the unemployment rate and of GDP.

³ In 2009, the results of the model indicate that NAIRU will be below the estimated unemployment rate, so the labour market will not generate additional inflationary pressure.

⁴ The regions with the lowest average unemployment rate in 2007 were: Navarra (4.8% of the total labour force), Aragón (5.3%), La Rioja (5.7%), Cantabria (5.9%), Basque Country (6.1%), Madrid (6.3%), Catalonia (6.7%).

to absorb workers, a deterioration of the economic situation will have to result in a rise in the structural unemployment rate.

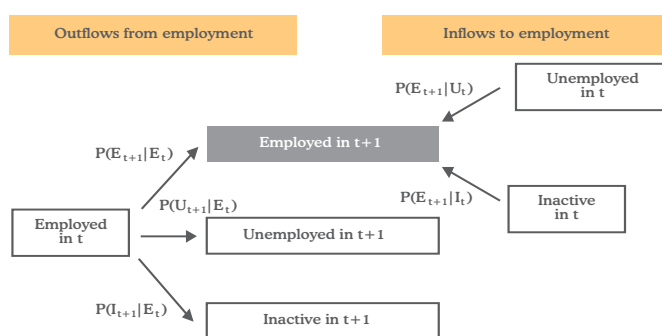
Secondly, the deterioration of the unemployment rate is now taking place at the same time as the slowdown in economic activity- as was the case in the recession at the start of the 1990s- while in the slowdown at the start of this century, the rise in unemployment took place after the start of the decline in the output gap. The predictions of our model indicate that the current deterioration of the economic situation will not result in the common pattern of employment adjusting after a lag to changes in the level of economic activity.

The main reason why the deterioration in the unemployment rate is now taking place at the same time as the slowdown in the economy may be related to the increased flexibility of the Spanish labour market, especially in the construction sector, which is suffering from the most intense adjustment to employment. The temporary rate in construction was 53.2% in the fourth quarter of 2007, almost twice the rest of the sectors (27.7%), as the chart shows. As the firing and replacement costs are lower for workers on a temporary contract, when economic activity slows down, employment adjusts more quickly and easily. However, this could also be understood as a sign that companies may be interpreting the intensification of the economic slowdown as more of a structural than a cyclical event, and are adjusting the size of their workforces in a relatively more intense way.

To end these comments, we should note that the results obtained depend on the expected rate of the slowdown in the economy. Because of the economic uncertainty in Spain and the rest of the world, a change in the level of expected growth would have a significant impact on these results and on these conclusions⁵.

⁵ The deterioration of structural unemployment is significantly less if we extend the period of analysis and include an economic recovery in 2010 and 2011.

Net job creation. Flow chart.



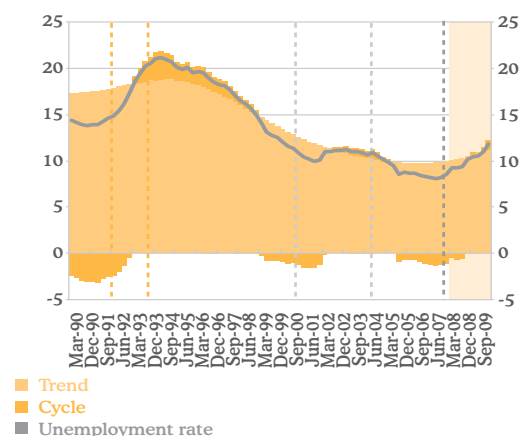
Source: BBVA Economic Research Department

Model of labour flows. Predicted transition probabilities for 2008-2009 (Annual average)

	2006-2007	2007-2008	2008-2009
Flows of remaining in/leaving employment			
Employment > employment	91.0	90.7	90.0
Employment > unemployment	3.4	3.7	4.0
Employment > inactivity	5.6	5.7	6.1
Flows of entry to employment			
Unemployment > employment	48.8	46.1	42.8
Inactivity > employment	14.4	12.4	10.0

Source: BBVA Economic Research Department

Unemployment rate. Contributions (%)



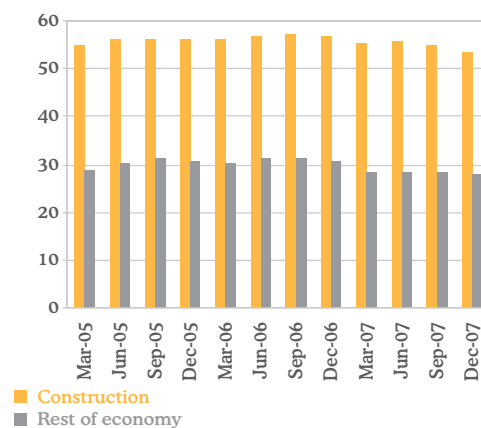
Note: the dot lines show the periods of GDP slowdown, based on the estimated output gap
Source: INE and BBVA Economic Research Department

Contributions to expected growth of GDP

	Unemployment (% of active population)		
	Total	Trend (NAIRU)	Cycle
2007	8.2	9.5	-1.3
2008	9.5	9.9	-0.4
Mar-08	9.3	9.7	-0.5
Jun-08	9.2	9.8	-0.6
Sep-08	9.4	10.0	-0.6
Dec-08	10.1	10.1	0.0
2009	10.9	10.5	0.4
Mar-09	10.4	10.3	0.2
Jun-09	10.5	10.4	0.1
Sep-09	11.0	10.6	0.4
Dec-09	11.8	10.8	1.0

Source: BBVA Economic Research Department

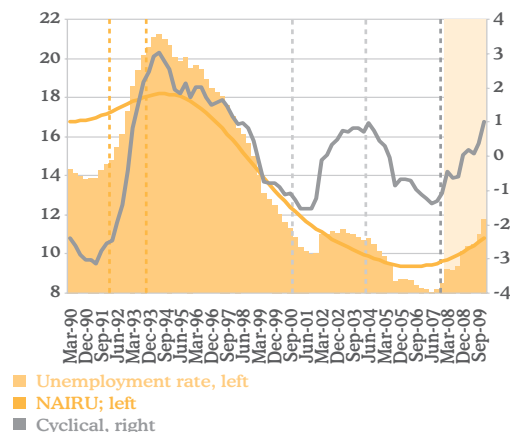
Temporary rate. Construction vs. rest of economy (in %)



Source: INE and BBVA Economic Research Department

Unemployment rate.

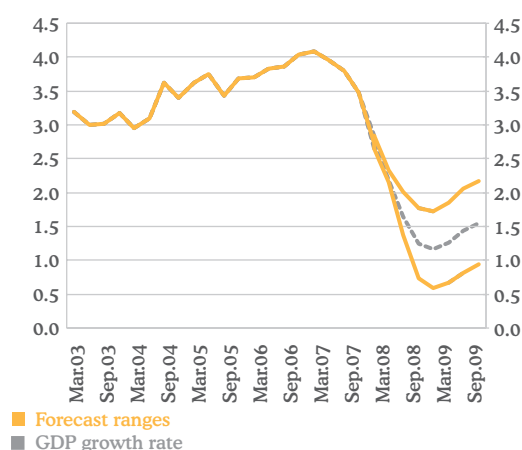
Structural and cyclical components (%)



Note: the dot lines show the periods of GDP slowdown based on the estimated output gap
Source: INE and BBVA Economic Research Department

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Chart 3.16
Spain: GDP growth forecasts (% Y-o-Y)



Source: INE and BBVA Economic Research Department

The current level of uncertainty means that it is more appropriate to make forecasts in terms of ranges

All of the factors we have mentioned so far call for caution in forecasts and, in particular, for ranges to be used to cover the uncertainties facing the economy. Depending on the final magnitude of the current financial crisis, and on the intensity of the real estate correction, the range of growth could be between 1.7% and 2.2% in 2008. In order to have a benchmark for a detailed macroeconomic forecast, we use a central growth trend of 1.9% for this period, which is 0.7 pp lower than our previous growth forecast (December 2007).

The growth profile in 2008 will be one of a slowdown which will gradually become more intense as the quarters go by, from the 2.7% year-on-year rate that we estimate for the first quarter of 2008, to 1.2% in the fourth quarter of the year, the lowest rate since the fourth quarter of 1993.

Such a significant reduction in expected growth in 2008 is based on the sharp downturn in domestic demand. The foreign sector will be less dynamic, in terms of both imports and exports, because of the slowdown in global growth and the downturn in domestic demand. However, the moderation in imports is expected to be more intense. This implies that the foreign sector will detract less from growth than in 2007, and partly offset the sharper slowdown in domestic demand, where growth will fall by an annual 2.4 pp to 1.9%. Except for public consumption, growth in all components of demand will be lower than it was in 2007. This will be more intense in investments, as a result of the sharp slowdown in investment in capital goods, from exceptionally high levels in recent quarters, and also because of the downturn in construction, of -2.2% in total and -7.5% in investment in housing. According to our estimates, investment in housing had already gone into recession in the first quarter of 2008, and we do not expect a recovery from this in the whole of the horizon forecast.

Table 3.4. Spain. GDP, Base 2000

YoY rates	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	2006	2007	2008	2009
Household consumption	3.5	3.4	3.1	2.7	2.2	1.9	1.6	1.2	3.7	3.1	1.7	1.2
Public consumption	6.1	5.0	5.1	4.4	4.7	5.0	5.8	6.2	4.8	5.2	5.4	5.2
GFCF	6.3	6.7	5.8	4.8	2.4	0.8	-0.7	-1.9	6.8	5.9	0.1	-2.2
Capital goods	13.1	13.1	11.6	8.6	6.1	2.5	1.5	-0.3	10.4	11.6	2.5	-1.9
Construction	4.9	4.6	3.8	2.9	-0.3	-1.1	-3.2	-4.4	6.0	4.0	-2.2	-3.8
Housing	4.0	3.7	2.9	1.8	-4.0	-5.0	-9.0	-12.0	6.4	3.1	-7.5	-14.5
Other	5.8	5.6	4.8	4.0	3.0	2.5	2.0	2.5	5.5	5.1	2.5	4.9
Domestic demand (*)	5.1	4.9	4.5	3.9	2.9	2.3	1.8	1.3	5.1	4.6	2.1	1.1
Exports	3.6	4.7	7.7	5.1	4.3	3.1	1.1	1.0	5.1	5.3	2.4	2.0
Imports	6.0	6.7	8.4	5.4	3.7	2.6	1.3	0.9	8.3	6.6	2.2	0.8
Trade balance (*)	-1.0	-0.9	-0.7	-0.4	-0.2	-0.1	-0.2	-0.1	-1.2	-0.7	-0.1	0.3
GDP	4.1	4.0	3.8	3.5	2.7	2.2	1.6	1.2	3.9	3.8	1.9	1.4
Quarterly rate	1.0	0.9	0.7	0.8	0.2	0.4	0.2	0.4				
Pro-forma												
GDP without investment in housing	4.0	4.0	3.8	3.7	3.3	2.8	2.5	2.3	3.4	3.9	2.7	2.5
GDP without construction	3.9	3.8	3.7	3.6	3.3	2.8	2.6	2.3	3.2	3.8	2.7	2.3
Total employment (LFS)	3.4	3.4	3.1	2.4	1.4	1.1	0.8	0.3	4.1	3.1	0.9	-0.1
Of which, construction	9.4	7.6	4.9	2.7	-0.8	-3.9	-6.4	-8.9	7.9	6.1	-5.0	-10.0
Other sectors	2.6	2.8	2.8	2.3	1.8	1.8	1.9	1.7	3.5	2.6	1.8	1.3
Total employment (National Accounts)	3.3	3.1	3.0	2.5	1.2	0.8	0.5	0.1	3.2	3.0	0.6	-0.3
Of which, construction	7.4	6.9	5.3	3.3	-1.0	-4.1	-6.6	-9.1	5.4	5.7	-5.2	-10.2
Other sectors	2.6	2.5	2.6	2.4	1.6	1.6	1.6	1.5	2.8	2.5	1.6	1.2
Unemployment rate (% active popu.)	8.5	8.0	8.0	8.6	9.4	9.1	9.4	10.1	8.5	8.3	9.5	11.0

Source: INE and BBVA Economic Research Department

The slowdown will continue into 2009, although the lowest growth rate will probably be reached at the beginning of that year and then the growth path will thus be slightly upward

The slowdown in the economy should continue into 2009. According to our estimates, growth could be as much as 2%, but we do not rule out a fall to 0.8%. Again based on a central trend, the economy could be expected to slow by an additional half a percentage point (from 1.9% in 2008) to 1.4% in 2009. In 2009, the external demand will make a slightly positive contribution, for the first time since 1997. Household consumption should continue to moderate, this time by half a point to 1.2%. In addition, we expect a downturn in investment in both capital goods and construction. However, looking at the growth profile for the full year, we find that the low point will be at the start of the year, and about 1.2%. The year will end on a better note, as growth will rise slightly over the year, to end at 1.6% in the last quarter.

In short, the Spanish economy is facing a period of deceleration, after a long period of sustained growth. However, this will be largely cyclical. If we break down expected economic growth into structural and temporary elements, we find that GDP tendential growth slows by just 0.1 pp in 2008 and not at all in 2009, while the output gap shrinks by 1 pp in 2008 and falls throughout 2009 to -1.4%. This result indicates that, as in the fourth quarter of 2007 and the first quarter of 2008, the expected deterioration of the economic situation continues to be essentially cyclical.

If we compare the current economic slowdown with the previous slowdown, we find that the expected cyclical adjustment in 2008 and 2009 will be greater (table 3.6). Between the fourth quarter of 2000 and the first quarter of 2004, the cyclical component of the GDP reduced economic growth by 0.5% on average, while between the fourth quarter of 2007 and the fourth quarter of 2009 the expected impact will be 1.1%. However, the negative contribution from the cycle will not approach the levels of the recession at the start of the 1990s: between March 1992 and September 1993, the cyclical component of GDP cut the economic growth of Spain by 2.5 pp.

In conclusion, we have lowered our expectations for the Spanish economic growth since last autumn. The possibility of an increase in the intensity of some risk factors means that it is more appropriate to make forecasts in terms of ranges. We expect growth to be between 1.7% and 2.2% in 2008, and 0.8% and 2.0% in 2009. Looking at the growth profile, the low point for growth is likely to be reached at the start of 2009.

Table 3.5. Contributions to expected GDP growth rate

	Trend vs Cyclical		
	GDP	Trend	Cycle
2007	3.9	3.1	0.8
2008	1.9	3.0	-1.0
Mar-08	2.7	3.0	-0.3
Jun-08	2.2	3.0	-0.7
Sep-08	1.6	3.0	-1.3
Dec-08	1.2	3.0	-1.7
2009	1.4	3.0	-1.6
Mar-09	1.2	3.0	-1.8
Jun-09	1.3	3.0	-1.7
Sep-09	1.4	3.0	-1.5
Dec-09	1.6	3.0	-1.4

Source: BBVA Economic Research Department

Table 3.6. Contributions to economic growth during current slowdown and previous slowdowns

Trend vs cycle

	Average variation of contributions to GDP growth (pp)		
	Average observed rate	Trend component	Cyclical component
Mar-92/Sep-93	-0.1	2.4	-2.5
Dec-00/Mar-04	3.2	3.7	-0.5
Dec-07/Dec-09	1.9	3.0	-1.1

Source: INE and BBVA Economic Research Department

4. Summary of forecasts

EMU (% y-o-y change, unless otherwise stated)

	2003	2004	2005	2006	2007	2008	2009
Real GDP	0.8	1.8	1.7	2.9	2.6	1.4	1.5
Private consumption	1.2	1.5	1.6	1.8	1.4	1.1	1.6
Public consumption	1.7	1.4	1.5	2.0	2.1	1.6	2.3
Gross fixed capital formation	1.3	2.0	3.0	5.2	4.8	1.3	0.0
Change in inventories	0.1	0.1	0.1	0.1	-0.1	-0.1	0.0
Domestic demand	1.5	1.7	1.9	2.7	2.2	1.2	1.4
Exports (goods and services)	1.2	6.7	4.9	8.1	5.9	3.7	4.1
Imports (goods and services)	3.2	6.5	5.7	7.8	5.2	3.1	4.0
External demand	-0.7	0.2	-0.2	0.2	0.4	0.3	0.1
Prices							
CPI	2.1	2.1	2.2	2.2	2.1	2.9	1.9
Core CPI	2.0	2.1	1.5	1.5	2.0	2.6	1.9
Labour market							
Employment	0.6	0.8	0.8	1.5	1.7	1.0	0.9
Unemployment rate	8.7	8.9	8.9	8.3	7.3	7.0	6.7
Public sector							
Deficit (% GDP)	-3.1	-2.9	-2.5	-1.6	-0.7	-0.8	-1.0
Export sector							
Current account balance (% GDP)	0.5	1.2	0.3	0.0	0.2	-0.3	-0.4

International environment (% y-o-y change)

	Real GDP growth (%)				Inflation** (%)			
	2006	2007	2008	2009	2006	2007	2008	2009
US	2.9	2.2	1.0	1.6	3.2	2.9	3.2	2.3
Japan	2.4	2.0	1.4	1.8	0.2	0.0	0.6	0.5
Latam *	5.4	5.7	4.7	4.3	5.1	6.3	6.2	4.6

*Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela
** Latam forecasts are for end of period

Financial variables (end of period)

	Official rate (%)				10Y interest rate (%)*			
	02/04/08	Jun-08	Dec-08	Jun-09	02/04/08	Jun-08	Dec-08	Jun-09
EMU*	4.00	4.00	3.50	3.50	3.96	3.8	4.0	4.1
US	2.25	1.75	1.50	2.00	3.55	3.5	3.5	3.7

* 10Y interest rates based on German Bund

	Exchange rate (vs euro)*				Brent crude (dollars per barrel)*			
	02/04/08	Jun-08	Dec-08	Jun-09	02/04/08	Jun-08	Dec-08	Jun-09
US dollar	1.56	1.56	1.51	1.47	100.2	87.7	78.9	75.0

* Average over period

Summary of forecasts for the Spanish economy

(% y-o-y change, unless stated otherwise)

	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP at 2000 prices	3.6	2.7	3.1	3.3	3.6	3.9	3.8	1.9	1.4
Private consumption	3.4	2.8	2.9	4.2	4.2	3.7	3.1	1.7	1.2
Public consumption	3.9	4.5	4.8	6.3	5.5	4.8	5.2	5.4	5.2
Gross fixed capital formation	4.8	3.4	5.9	5.1	6.9	6.8	5.9	0.1	-2.2
Capital goods	-0.3	-2.9	4.1	5.1	9.2	10.4	11.6	2.5	-1.9
Construction	7.6	6.3	6.2	5.4	6.1	6.0	4.0	-2.2	-3.8
Residential	7.5	7.0	9.3	5.9	5.9	6.4	3.1	-7.5	-14.5
Other	7.7	5.6	3.5	5.0	6.3	5.5	5.1	2.5	4.9
Other products	5.8	5.0	7.2	3.8	6.4	4.6	4.2	3.5	2.0
Change in inventories (*)	-0.1	0.0	-0.1	0.0	-0.1	0.1	0.0	0.0	0.0
Domestic demand (*)	3.9	3.3	3.9	4.9	5.3	5.1	4.6	2.1	1.1
Exports (goods and services)	4.2	2.0	3.7	4.2	2.6	5.1	5.3	2.4	2.0
Imports (goods and services)	4.5	3.7	6.2	9.6	7.7	8.3	6.6	2.2	0.8
Net external balance (*)	-0.2	-0.6	-0.8	-1.7	-1.6	-1.2	-0.7	-0.1	0.3
GDP at market prices	8.0	7.1	7.4	7.4	8.0	8.0	7.0	5.0	4.4
EUR mn	680,678	729,206	782,929	841,042	908,450	980,954	1,049,914	1,102,429	1,150,564
Prices and costs									
GDP deflator	4.2	4.3	4.1	4.0	4.2	4.0	3.1	3.0	3.0
Household consumption deflator	3.4	2.8	3.1	3.6	3.4	3.4	2.8	3.4	2.9
CPI	3.5	3.5	2.9	3.0	3.4	3.5	2.8	3.7	2.7
Inflation gap with EMU (p.p.)	1.2	1.3	0.9	0.9	1.2	1.3	0.6	0.8	0.8
Remuneration per employee	3.6	3.3	3.6	3.0	2.8	3.0	3.6	3.5	3.5
Unit labour cost (ULC)	3.2	2.9	2.9	2.4	2.5	2.7	2.7	2.2	1.9
Labour market									
Active population (LFS)	0.3	4.1	4.0	3.3	3.5	3.3	2.8	2.3	1.5
Employment (LFS)	4.1	3.0	4.0	3.9	5.6	4.1	3.1	0.9	-0.1
Change in thousands of persons	640	484	666	675	1002	774	608	183	-27
Employment (national accounts, FTE)	3.2	2.3	2.4	2.7	3.2	3.2	3.0	0.6	-0.3
Unemployment rate	10.6	11.5	11.5	11.0	9.2	8.5	8.3	9.5	11.0
Productivity	0.4	0.4	0.7	0.6	0.4	0.7	0.9	1.3	1.6
Public sector									
National debt (% GDP)	55.5	52.5	48.7	46.2	43.0	39.7	36.2	34.0	32.6
Public sector surplus/deficit (% GDP)	-0.7	-0.5	-0.2	-0.4	1.0	1.8	2.2	0.3	-0.3
External sector									
Balance of trade (% GDP)	-6.3	-5.8	-5.9	-7.2	-8.6	-9.1	-9.4	-9.8	-9.4
Current account balance (% GDP)	-3.9	-3.3	-3.5	-5.3	-7.3	-8.8	-10.1	-10.2	-9.8
Households									
Real disposable income	3.4	3.5	3.6	3.6	4.2	3.2	3.2	1.1	0.4
Nominal disposable income	6.8	6.3	6.7	7.2	7.6	6.6	5.9	4.4	3.2
Savings rate (% nominal income)	11.1	11.4	12.0	11.3	11.0	10.5	10.4	11.2	11.0

Source: official statistics and BBVA Economic Research Department

(*) Contribution to GDP growth

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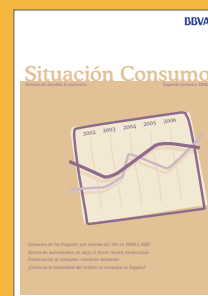
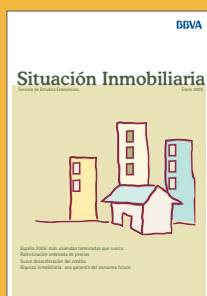
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