



Spain Economic Outlook

June 2010

Key messages

- The positive elements of the external environment of the Spanish economy are distinguished by the **recovery of the emerging countries and the US**, which would create the conditions for global economic growth of around 4%.
- However, there are significant elements of **uncertainty in Europe** deriving from increased risk aversion and the fragility of growth. In 2010, the area will grow by 0.7%.
- In this context, and once the impact of fiscal consolidation measures has been accounted for, **Spanish GDP will shrink by 0.6% in 2010**, while in **2011 it should grow by 0.7%**.
- While **considerable progress has been made regarding the necessary adjustment of the private sector** in order to reduce its high level of indebtedness, the public sector is embarking on a **rigorous fiscal adjustment**.
- The ambitious **fiscal adjustment** announced by the Spanish government is a very important step in the right direction. Its negative impact on growth in the next few quarters will be very limited. At the same time, it is a **necessary condition for guaranteeing a sustained recovery scenario** in the coming years.
- The necessary and unavoidable fiscal adjustment must be accompanied by **ambitious structural reforms in the financial sector and the labor market**.

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International scenario: the challenges ahead for a sustained recovery

The global economy is driven by two conflicting forces

Positive spillover from the cyclical upturn in the US and in the emerging markets



- **Growth in 2010:**
World: 4.2%
US 3%
Latin America 4.6%
Asia 5.8%

- **Commodity prices**

- **World trade:** will grow by 7% in 2010



Negative spillover from the increase in risk premium spreading from Europe



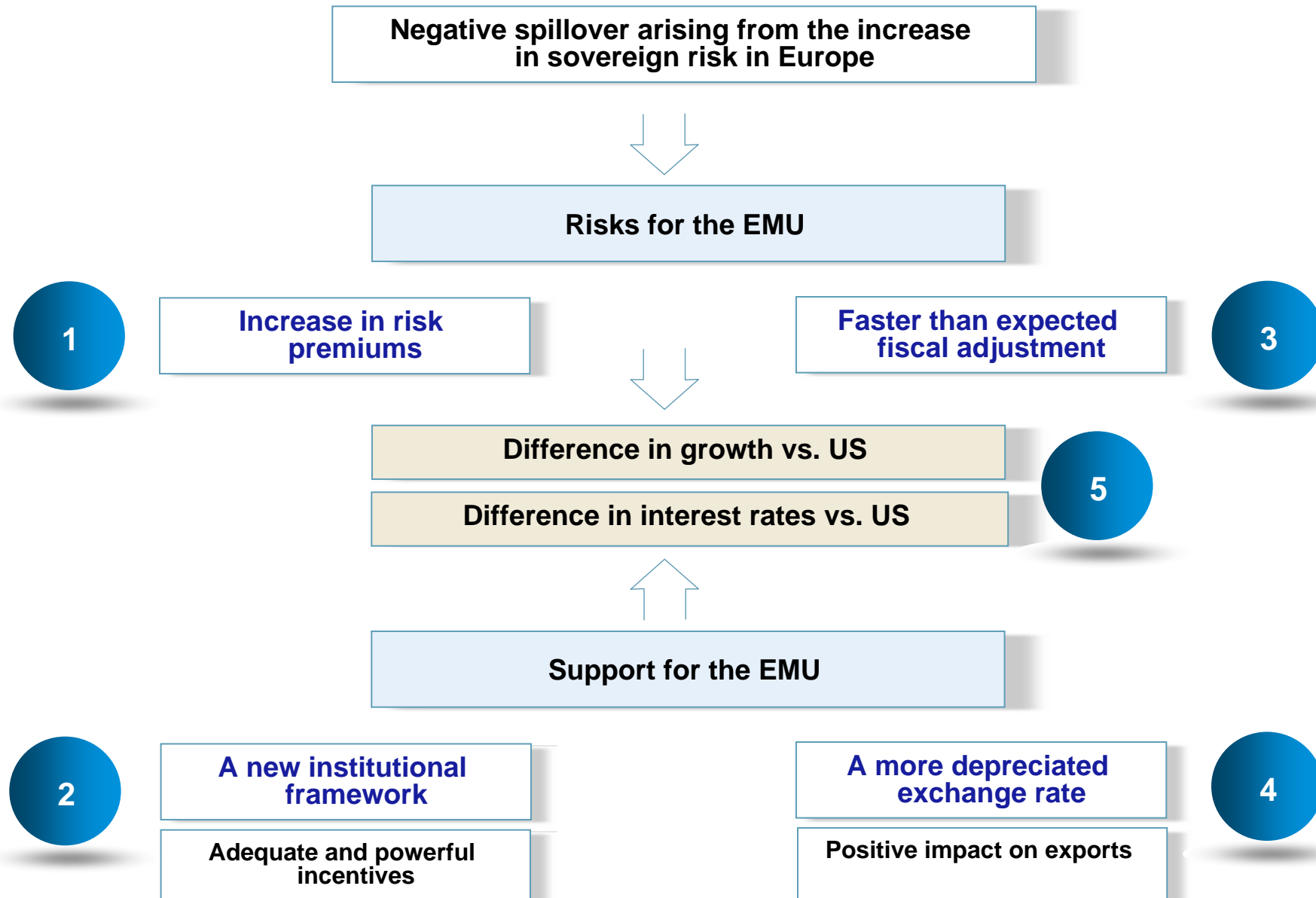
- **Risk premium**

- **Fiscal consolidation**

- **Confidence**

The European Stabilization Mechanism reduces the downward risk in the short term

International scenario: the challenges ahead for a sustained recovery



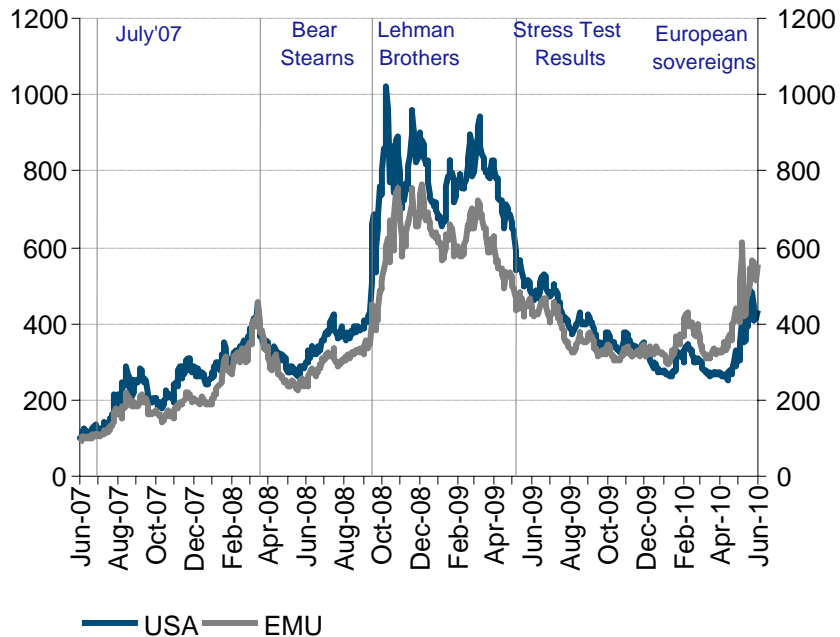
1. Increase in risk premiums

Negative spillover arising from the increase in risk premiums in Europe

Financial tensions indicator

(100 = January-07)

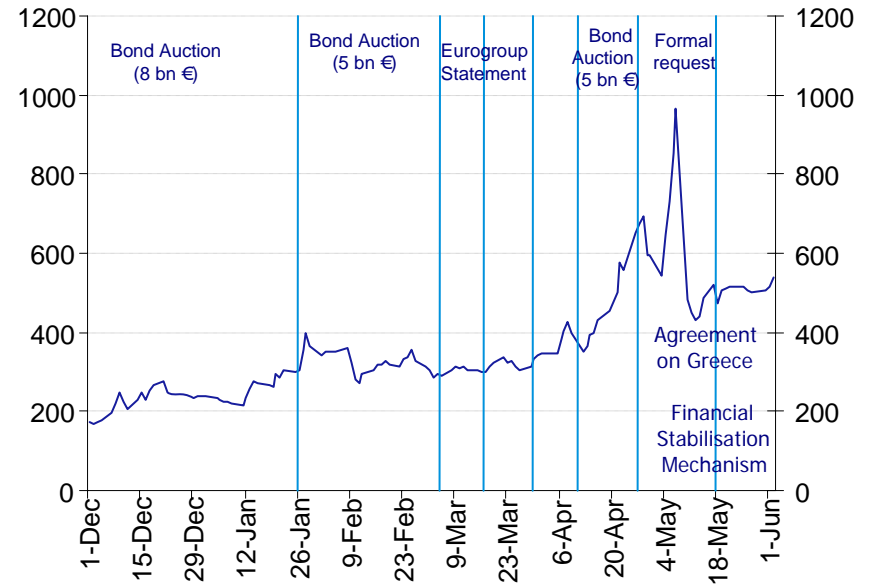
First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread
Source: BBVA Research



Greece: 10-yr sovereign spread

(bps)

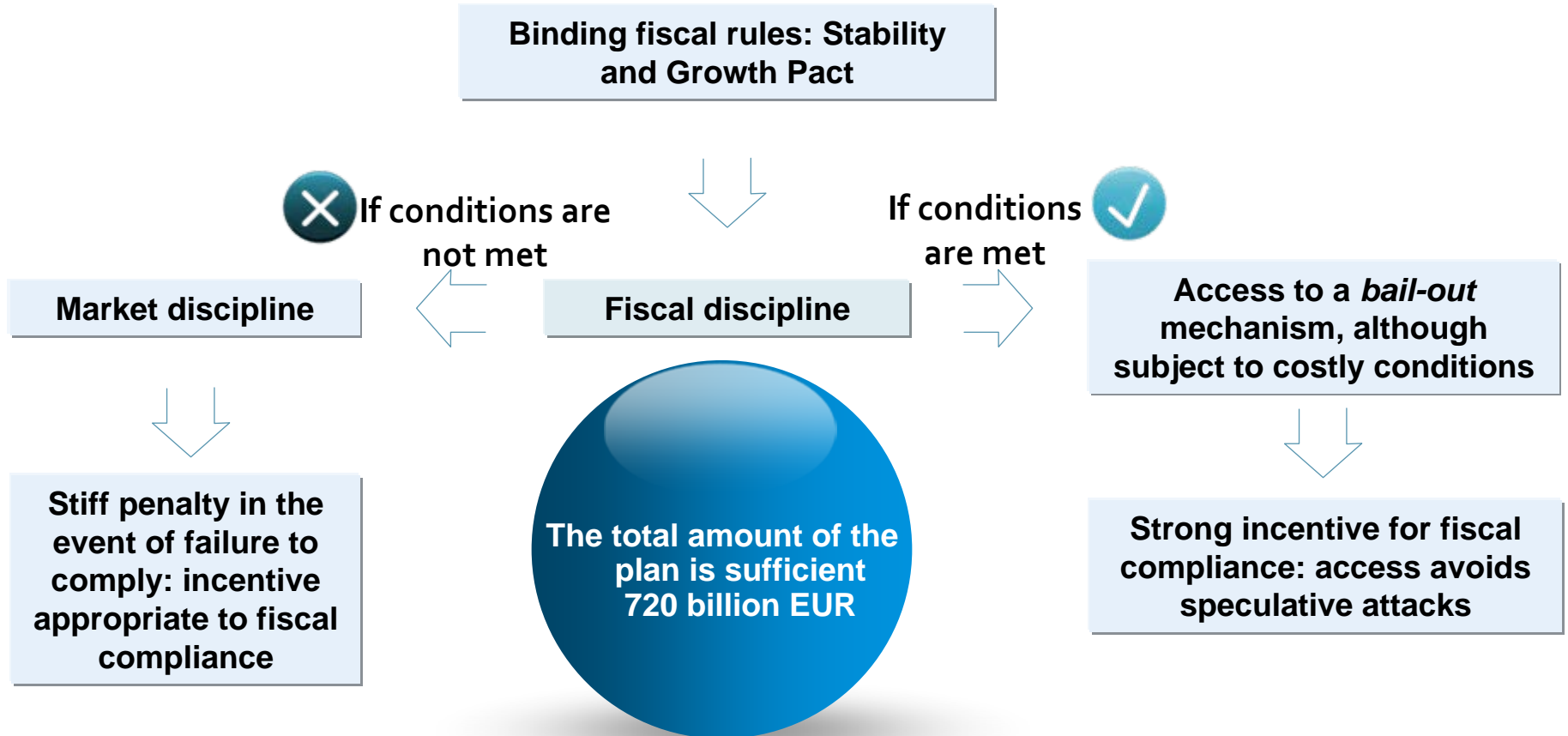
Fuente: Bloomberg and BBVA Research



2. **New institutional framework**

The European Stabilization Mechanism, together with the ECB's measures, should reduce uncertainty, at least in the short term

It seeks to harmonize market discipline mechanisms and those resulting from fiscal rules, as it makes access to the stabilization fund conditional on the implementation of a credible fiscal consolidation plan. Market discipline is reinforced with **European budget stability rules**.



3. The fiscal adjustments revealed recently follow the consolidation plans announced in late 2009

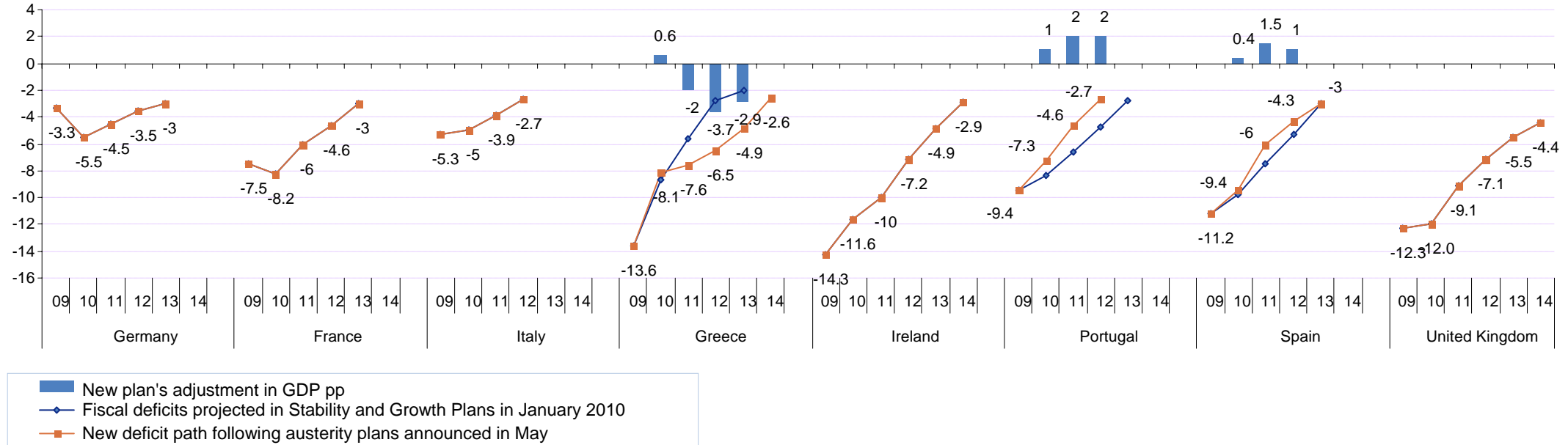
Faster fiscal adjustment

Portugal and Spain speed up their plans

The necessary adjustment is large and its effect on activity will be limited, but it will be gradual over time

Europe: fiscal deficits (% GDP)

Source: National Governments and BBVA Research



Germany, France and Italy have detailed austerity plans for 2011

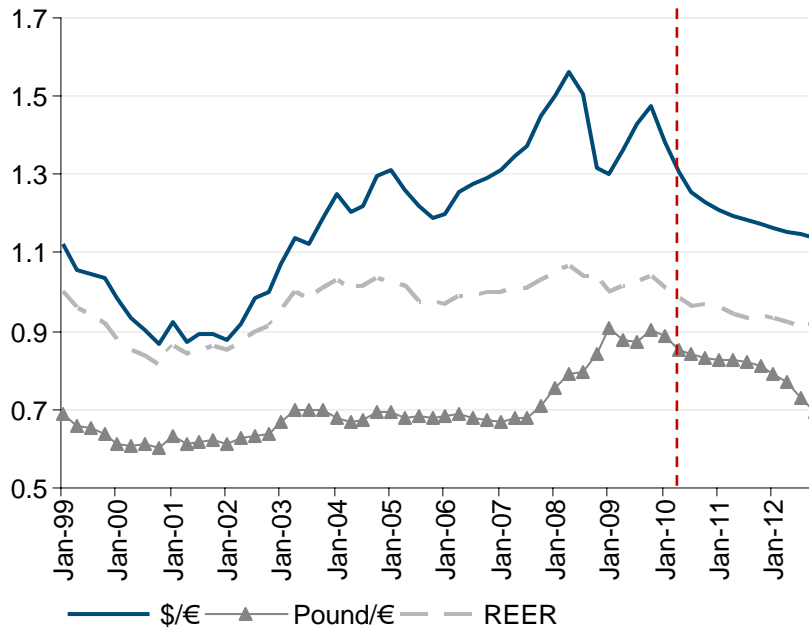
Spain and Portugal have disclosed measures for 2010 with regard to the actions contained in the stability plans. Greece's adjustment is being slower

UK will announce its new budget on June 22, and major changes are expected

4. **The faster than expected depreciation of the euro towards its long-term equilibrium value will reinforce the area's exports, although its growth has so far been lower than in the US**

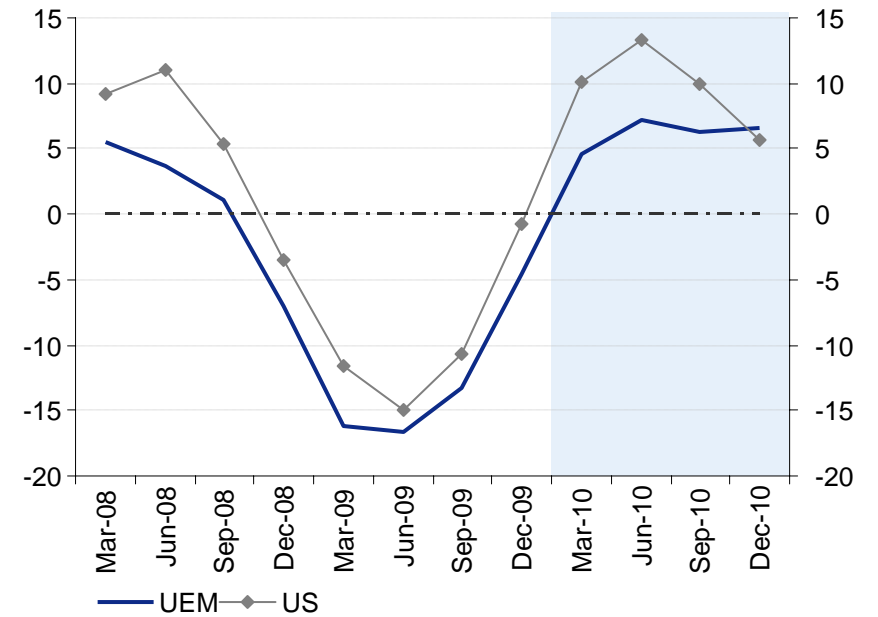
EMU: real effective exchange rate

Source: BBVA Research



Exports (% yoy)

Source: BBVA Research based on BEA and Eurostat



International scenario: the challenges ahead for a sustained recovery

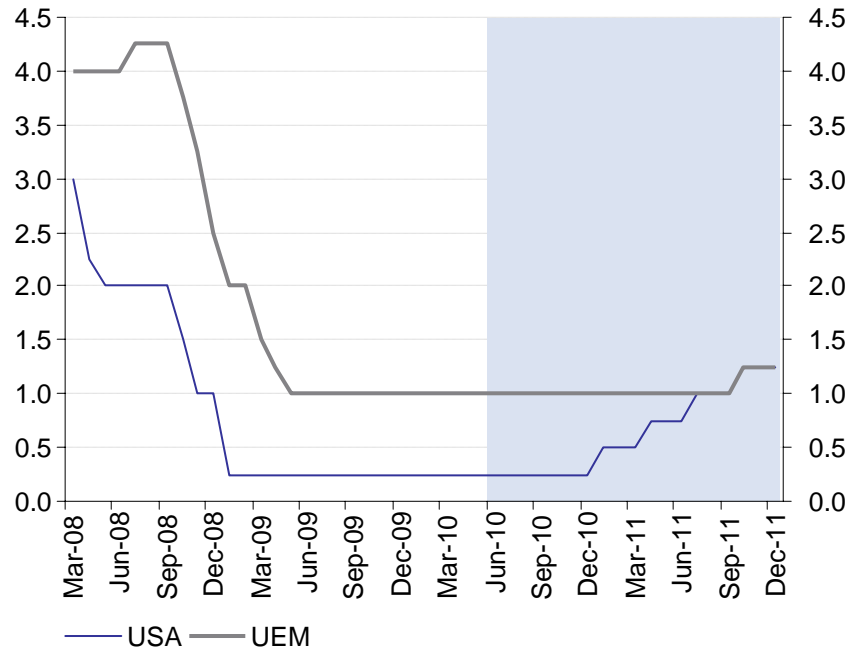
5. Low interest rates

Although economic growth could be slow from 2010 onwards, the risk of a reversal of the current trend is limited in the US and inflationary pressure is still at an early stage

In contrast, in Europe, in addition to a more fragile financial situation, the cyclical improvement seems to be uncertain and there are no inflationary pressures.

Official interest rates (%)

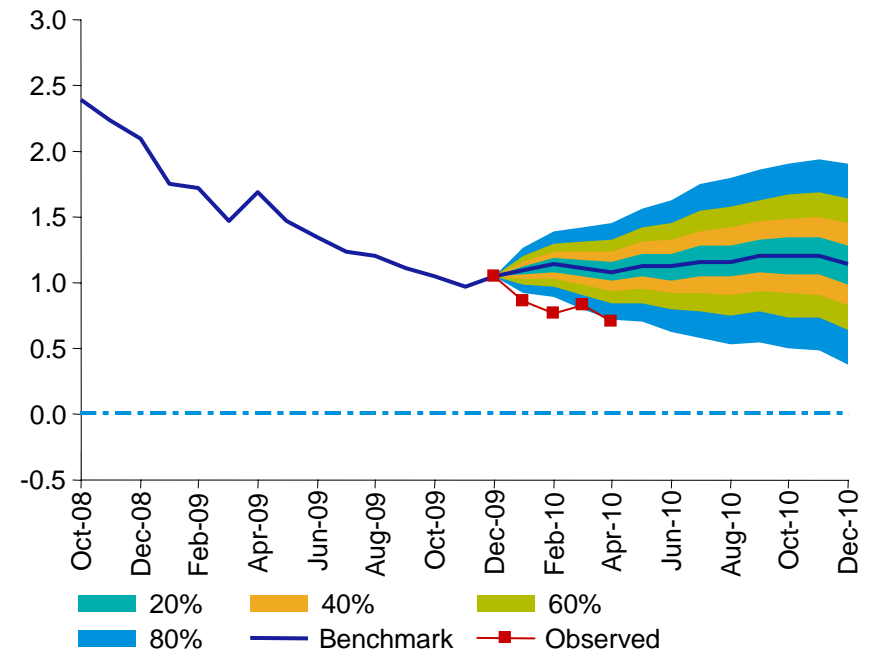
Source: BBVA Research based on ECB and Fed



EMU: Core inflation (% yoy)

Note: Benchmark based on ARIMA models

Source: BBVA Research based on Eurostat



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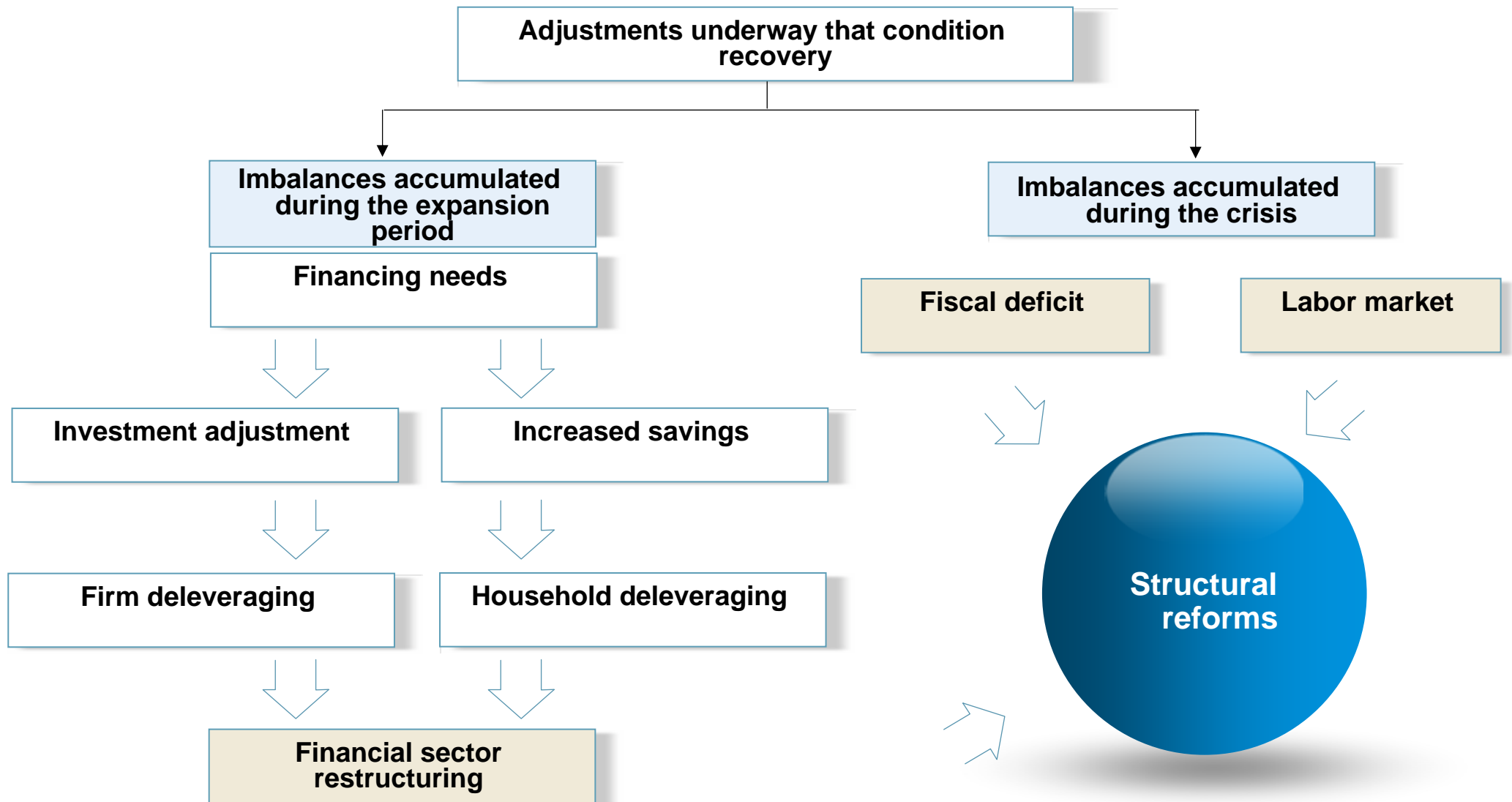
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Spain: an adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

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The need for ambitious structural reforms

An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation



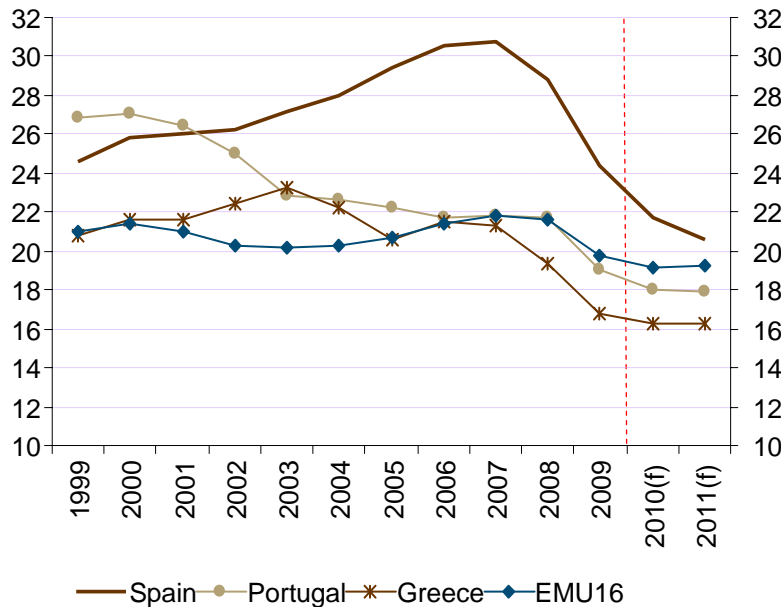
An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

An adjustment that is at an advanced stage in the private sector

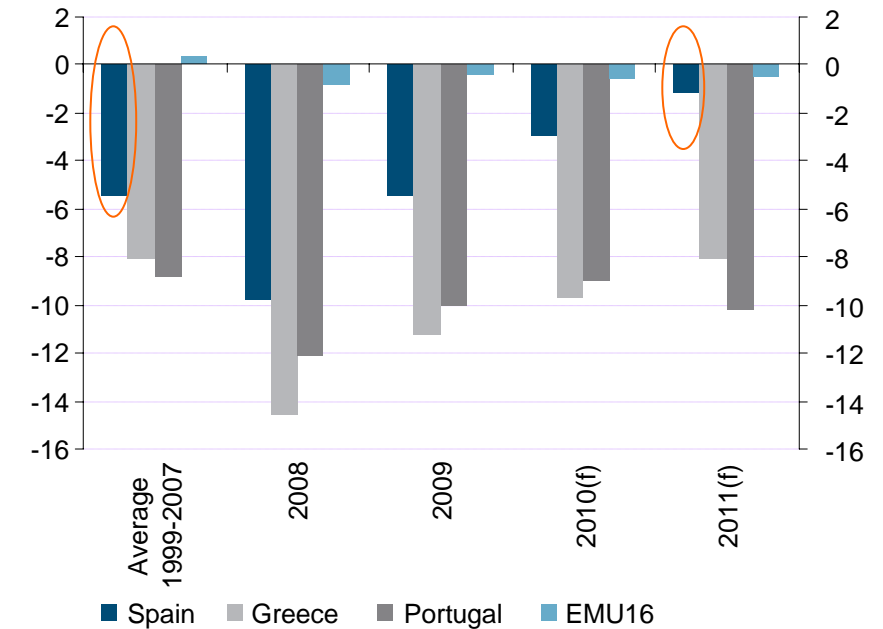
The private sector has made significant progress in its adjustment process, with a considerable reduction in its financing needs

The current account deficit recorded in recent years in Spain is a reflection of the dramatic increase in investment rather than a lack of competitiveness or a low saving rate.

Investment rate
GFCF as a share of GDP (in pp)
GFCF: Gross fixed capital formation
Source: BBVA Research from INE and AMECO



Current account balance
As a share of GDP (in pp)
Source: BBVA Research from IMF



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

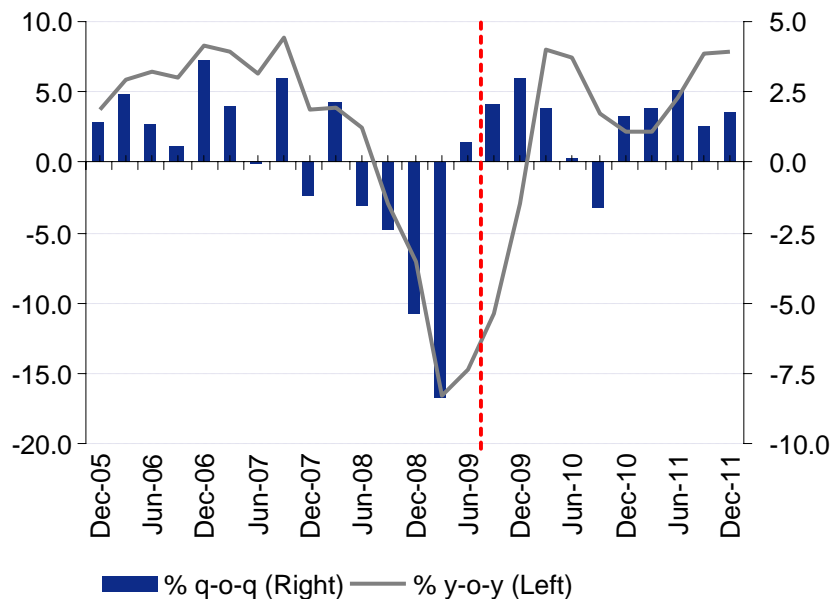
An adjustment that is at an advanced stage in the private sector

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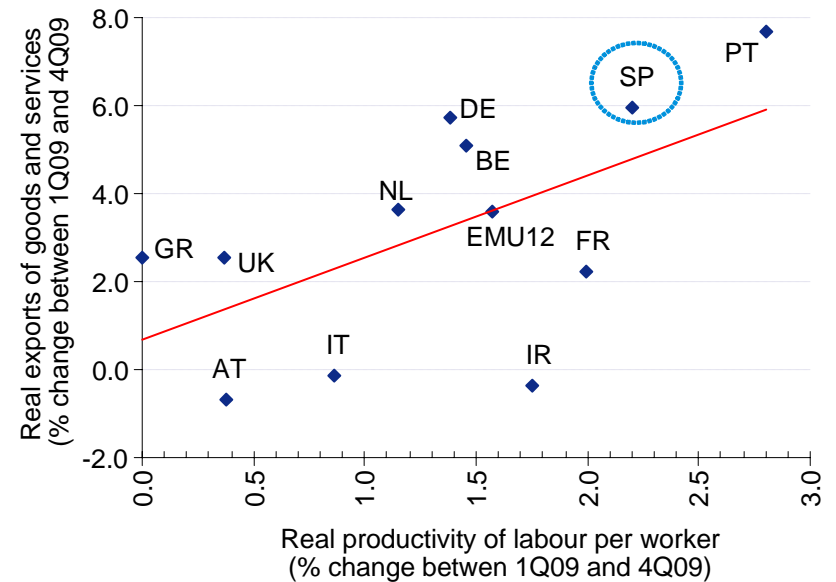
Spain: exports growth (%)

Source: BBVA Research based on INE



Spain: productivity growth and recovery of exports in 2009

Source: BBVA Research based on Eurostat



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

An adjustment that is at an advanced stage in the private sector

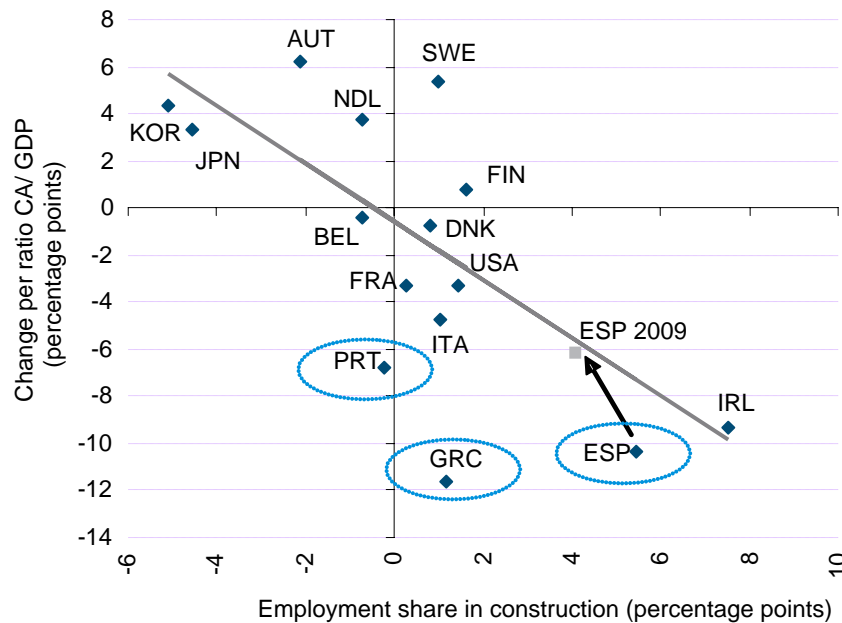
The need for financing for residential investment created imbalances in the current account

While investment is adjusting in the sector, financing needs are also adjusting at the same rate, while in other countries the adjustment process is being delayed.

Lower prices and interest rates have allowed significant improvements in access to housing.

Construction employment share and current account balance: 1996-2007

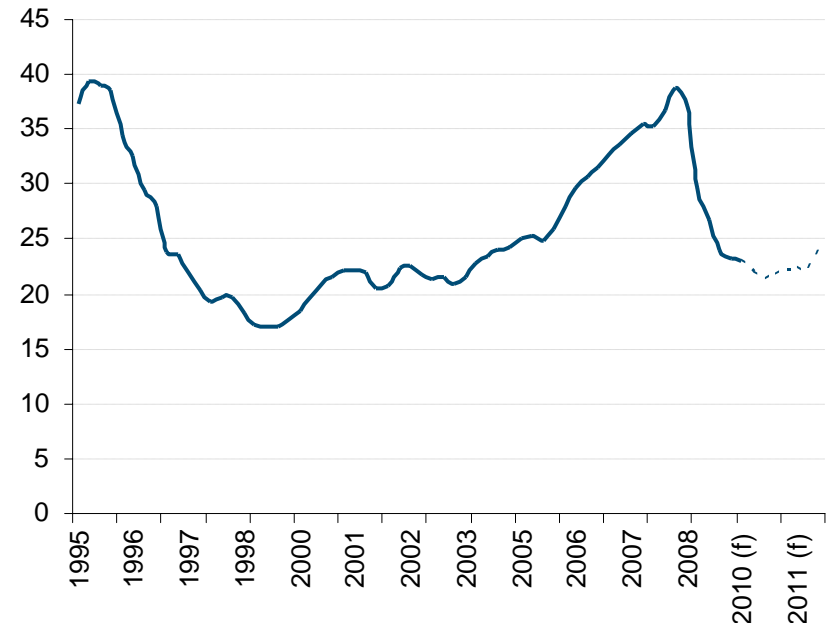
Source: BBVA Research based on AMECO



Spain: housing affordability

Tax-adjusted purchase effort as a % of household income

Source: BBVA Research based on INE, Housing Department and Registradores



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

An adjustment that is at an advanced stage in the private sector

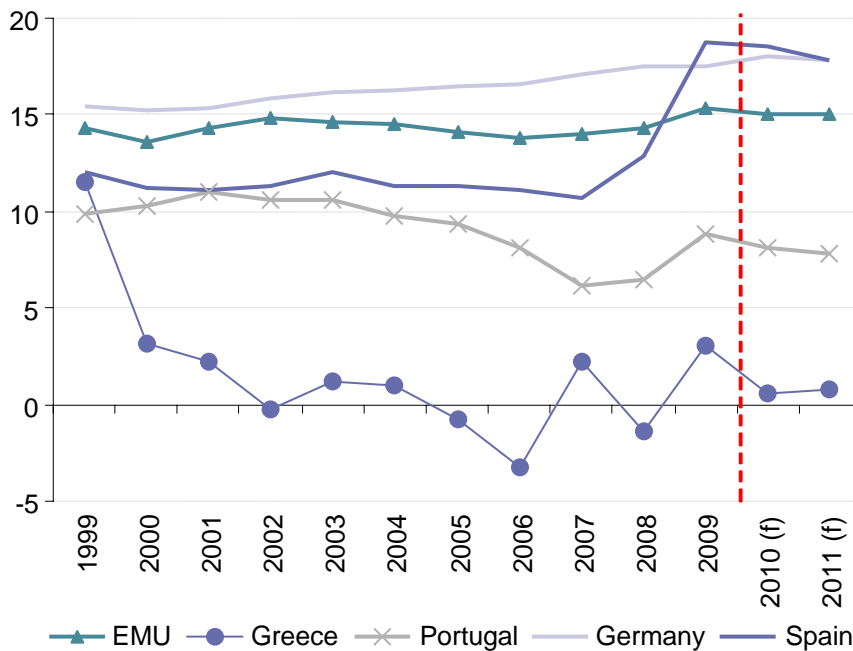
Households have also adjusted their financing needs

The adjustment in savings has been especially significant in the case of households.

The net wealth of Spanish households is higher than in other European countries.

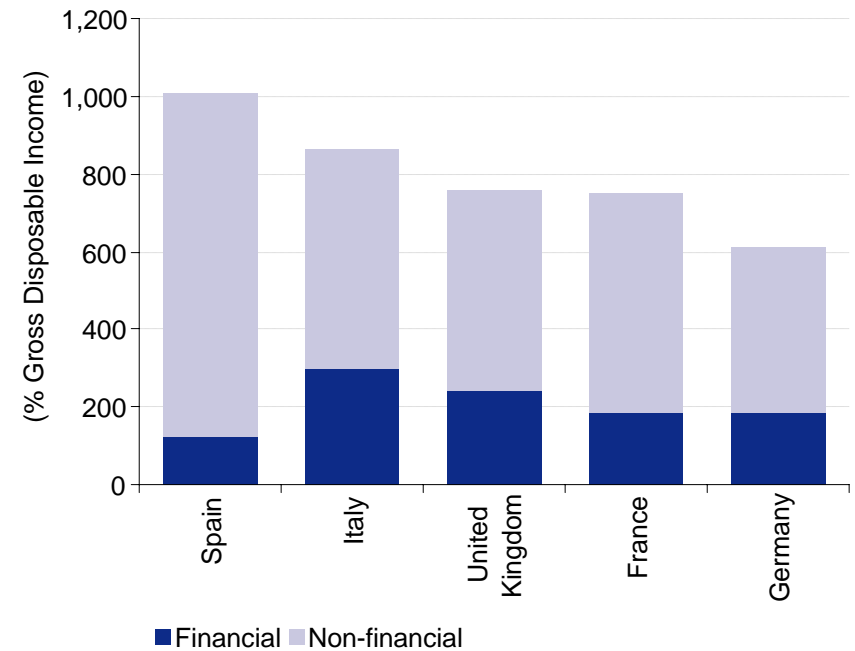
Households saving rate (% of gross disposable income)

Source: BBVA Research and AMECO



Households net wealth (2008)

Source: BBVA Research based on OECD and Bank of Spain



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Recovery in private demand

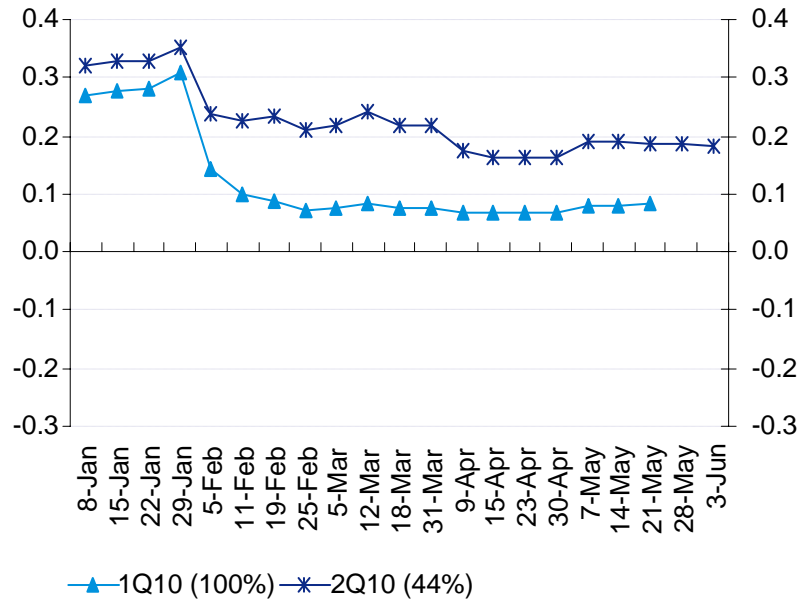
Because a large part of the adjustment in the private sector has already taken place, private demand is starting to make a positive contribution to growth

Considering the current information available for 2Q10, activity so far is behaving similarly to 1Q10.

However, uncertainty exists as regards the future.

Spain: quarterly GDP growth forecasts based on MICA-BBVA model by date of estimate

Note: the figure in brackets is the percentage of the data set known at the last estimate date relative to the quarter of reference
Source: BBVA Research



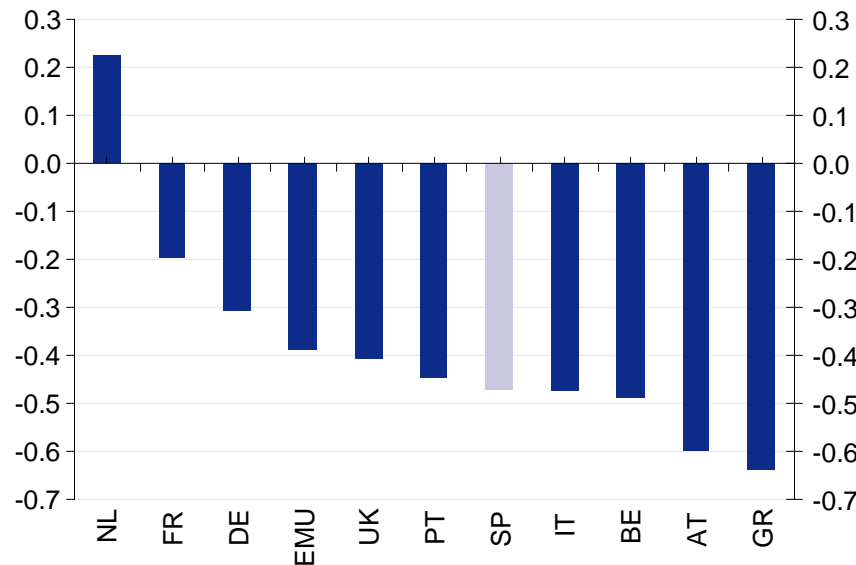
An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Increased uncertainty

Increased stress in capital markets involves an additional risk whose consolidation might result in a loss of confidence and a wavering recovery of domestic demand

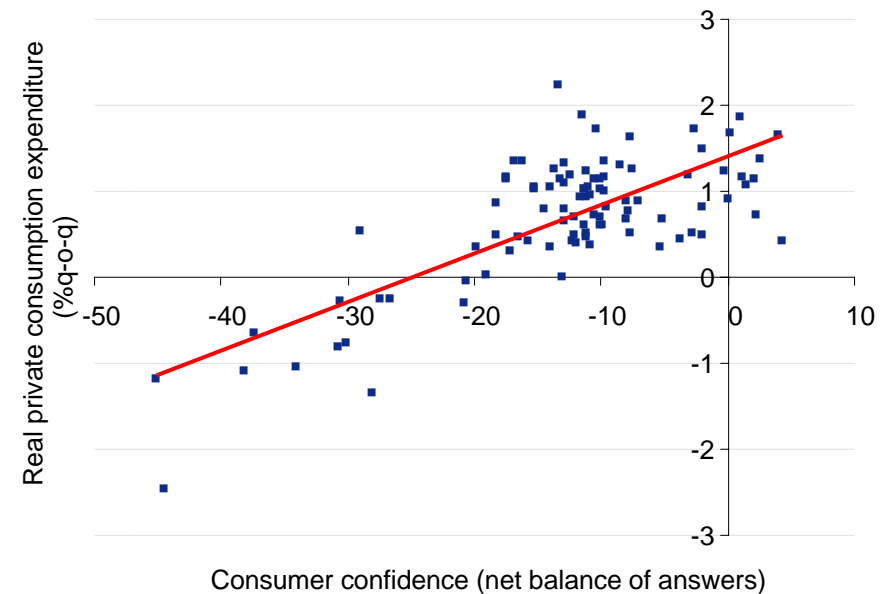
Consumer confidence in May-2010
(monthly variation of the standardized balance of answers)

Source: BBVA Research based on European Commission



Spain: private consumption and consumer
(Sample: 1986-2009)

Source: BBVA Research based on INE and European Commission



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

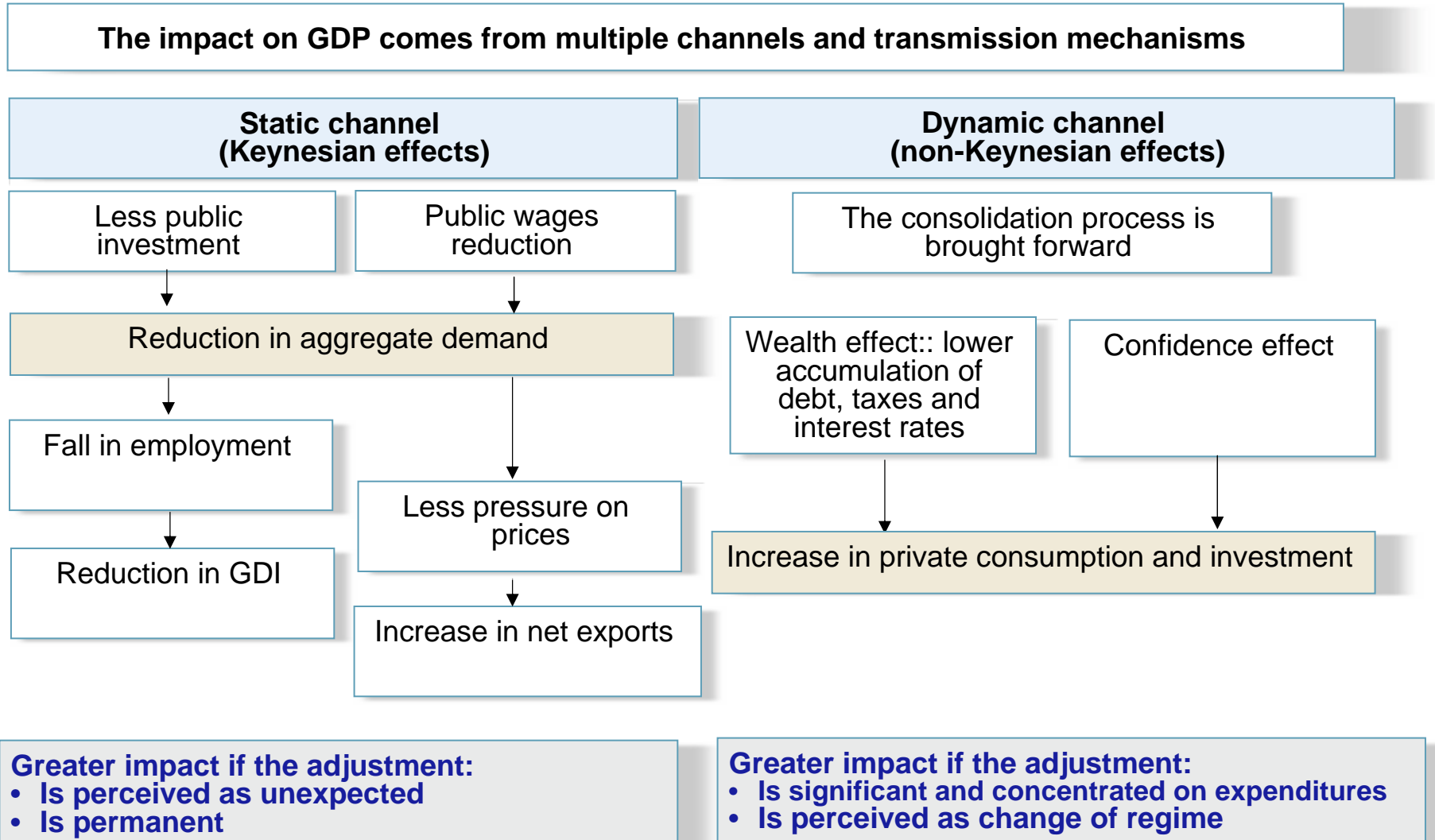
Public sector adjustment

	Measures	Reduction of public deficit (% of GDP)	Details of the measures
	Withdrawal of discretionary measures	2.7%	<ul style="list-style-type: none"> • Infrastructure Plan E (0.8% of GDP) • Removal of €400 income tax credit
Previous measures	Increase in revenues	1.0%	<ul style="list-style-type: none"> • 2 pp rise in VAT, capital income taxation and other indirect taxes
	Immediate action plan	0.5%	<ul style="list-style-type: none"> • Reduction in investment and public spending
New measures	Adjustment plan submitted to the EC	1.5%	<ul style="list-style-type: none"> • 5% pay cut and wage freeze (0.6% of GDP) • Reduction of public investment (0.6% of GDP) • No increase in pensions and other welfare policies
	Cyclical impact on deficit	1.0%	<ul style="list-style-type: none"> • Recovery of activity in 2012 and 2013
	Additional measures needed	≅1.5%	<ul style="list-style-type: none"> • Uncertainty surrounding the effectiveness of the adjustment plan is reduced
		8.2%	Deficit would fall from 11.2% in 2009 to 3% of GDP in 2013

An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Public sector adjustment

Uncertainty surrounding the short-term impact of the new fiscal measures



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Public sector adjustment

Uncertainty surrounding the short-term impact of the new fiscal measures

Factors that reduce the negative effects of the fiscal adjustment in the short term

- The measures are a change in the **time dynamics** of the adjustment

- Clears up the uncertainty surrounding the final **composition, size and credibility** of the adjustment

- If it is part of a “**change of regime**” in economic policy, it could increase the positive effects in the medium term



Reduced impact on consumption and investment

- Accelerated recovery of **price-competitiveness**



Expected increase in exports

- **If the adjustment had been postponed, the negative effects on the economy would have been much worse**

- **In the medium and long term, a rigorous fiscal adjustment will expedite the economy's recovery**

An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Public sector adjustment

Uncertainty surrounding the short-term impact of the new fiscal measures

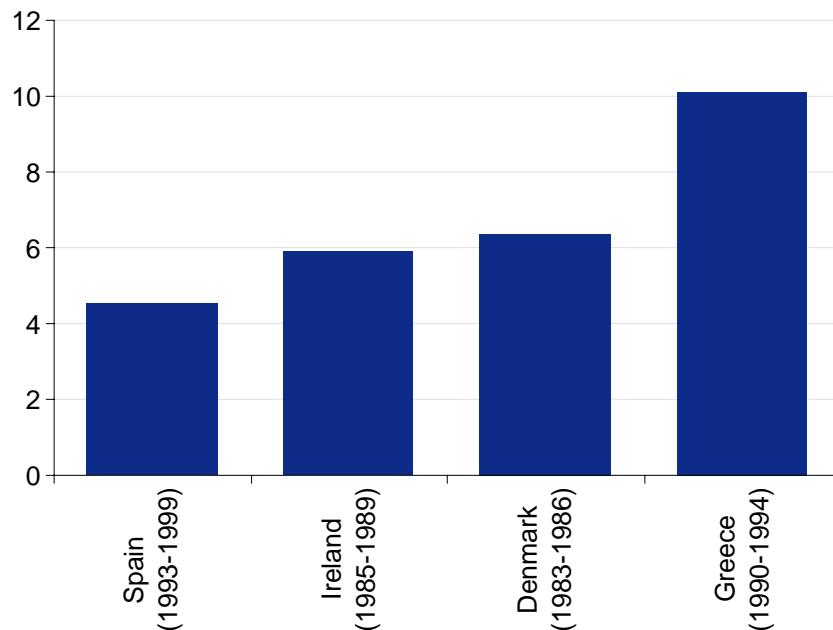
If the package is perceived as a “change of regime”, the impact on growth could be offset by an increase in private demand.

There are clear examples of this in the past. The problem is that now the fiscal adjustment coincides with an increase in uncertainty in the financial markets.

Adjustment in structural primary balance

(% of potencial GDP)

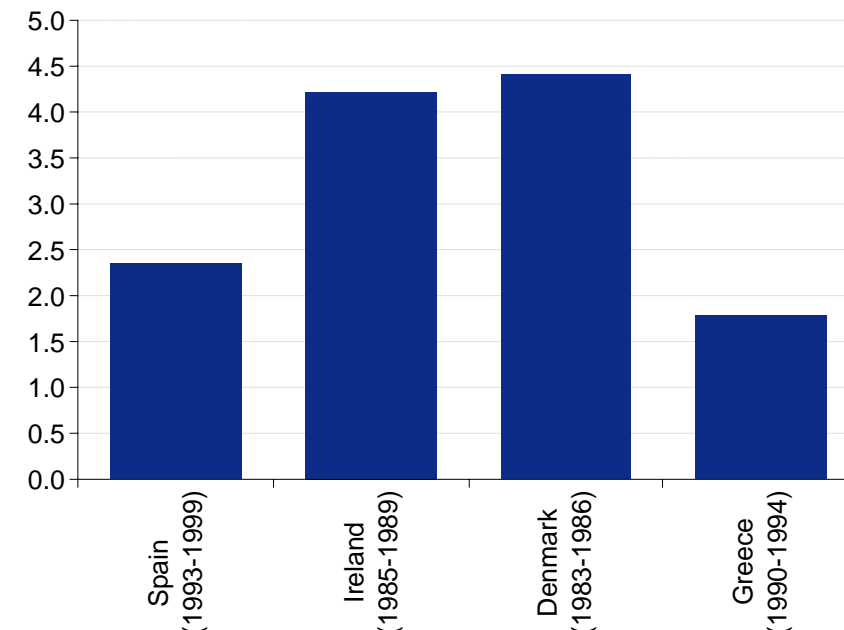
Source: BBVA Research



Private consumption

(Average annual growth rate in %)

Source: BBVA Research



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Public sector adjustment

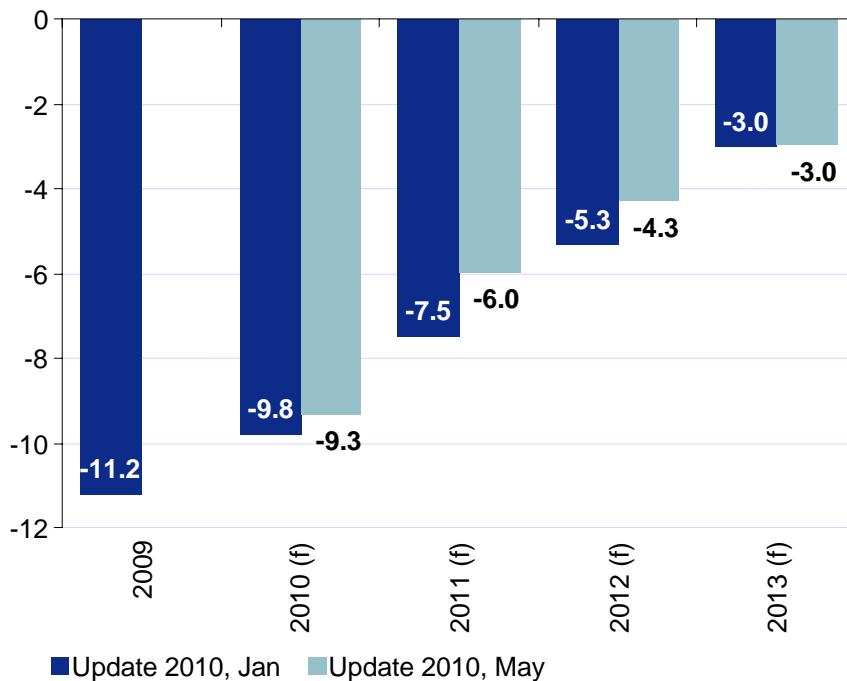
Uncertainty surrounding the short-term impact of the new fiscal measures

The adjustment measures imply a change in the time dynamics of the fiscal consolidation process.

Spain: budget balance as % of GDP

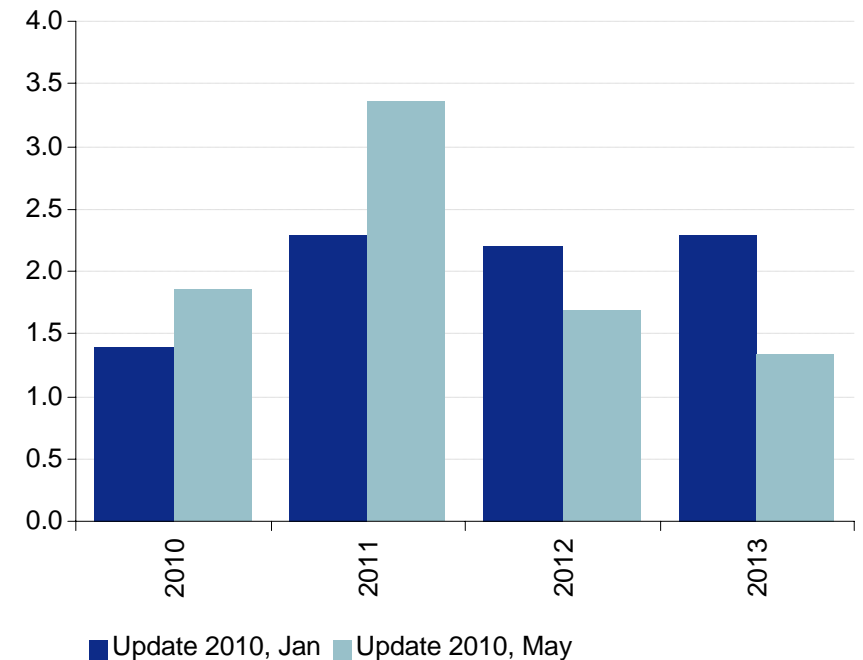
PEC scenario

Source: BBVA Research based on MEH and Central Government



Spain: improvement in expected public deficit each year (as % of GDP)

Source: BBVA Research based on MEH



An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation

Public sector adjustment

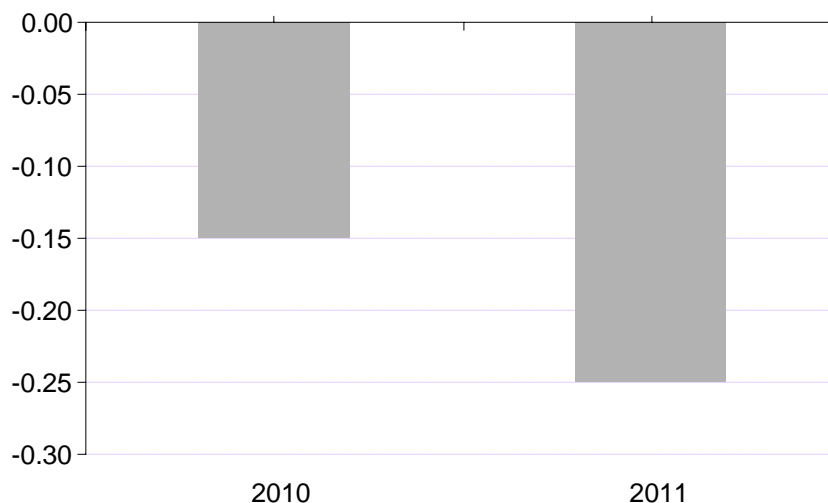
Uncertainty surrounding the short-term impact of the new fiscal measures

Fiscal consolidation is necessary, but not sufficient: it must be accompanied by other structural reforms which will determine the final effects of the fiscal adjustment on growth.

Spain: impact on GDP of the additional fiscal policy measures

(on %yoy)

Source: BBVA Research



Macroeconomic Forecasts						
(y-o-y growth rate, %)	2009		2010		2011	
	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	-5,0	-1,0	-0,2	0,1	0,4	0,6
Public consumption	3,9	2,3	1,4	0,9	0,2	0,5
Gross Fixed Capital Formation	-15,2	-10,8	-8,8	-2,8	-2,7	0,6
Equipment and other products	-20,6	-15,5	-7,9	-2,3	-1,1	0,3
Capital Goods	-22,9	-17,1	-3,8	-2,4	-0,1	-0,2
Construction	-11,1	-7,2	-9,4	-2,8	-3,7	0,9
Housing	-24,5	-9,4	-16,5	-4,7	-5,6	-0,8
Internal Demand (*)	-6,4	-3,2	-1,9	0,1	-0,4	0,8
Exports	-11,3	-12,8	5,3	6,2	5,6	7,6
Imports	-17,7	-11,4	-0,2	4,8	0,9	6,7
External Demand (*)	2,8	-0,8	1,3	0,6	1,1	0,5
GDP	-3,6	-4,0	-0,6	0,7	0,7	1,3
Pro-memoria						
GDP excluding housing	-1,8	-3,7	0,4	1,0	1,1	1,4
GDP excluding construction	-2,2	-3,7	0,8	1,2	1,5	1,3
Total employment (LFS)	-6,8	-1,8	-2,7	-0,5	-0,3	0,3
Unemployment rate (% Active pop)	18,0	9,4	19,4	10,4	19,2	10,6
Current account (%GDP)	-5,4	-0,8	-3,0	-0,6	-1,1	-0,5
Public surplus/deficit (%GDP)	-11,2	-6,3	-9,6	-6,6	-6,6	-5,2
CPI media anual	-0,3	0,3	1,2	1,0	1,0	1,2

(*) contributions to GDP growth

Source: INE, Bank of Spain and BBVA Research

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The need for ambitious structural reforms

The financial sector

The solvency problems in the financial sector are limited and need to be addressed decisively

The Spanish financial system has proven its strength. The default rate is below the one recorded in the 1990s crisis and has started to drop.

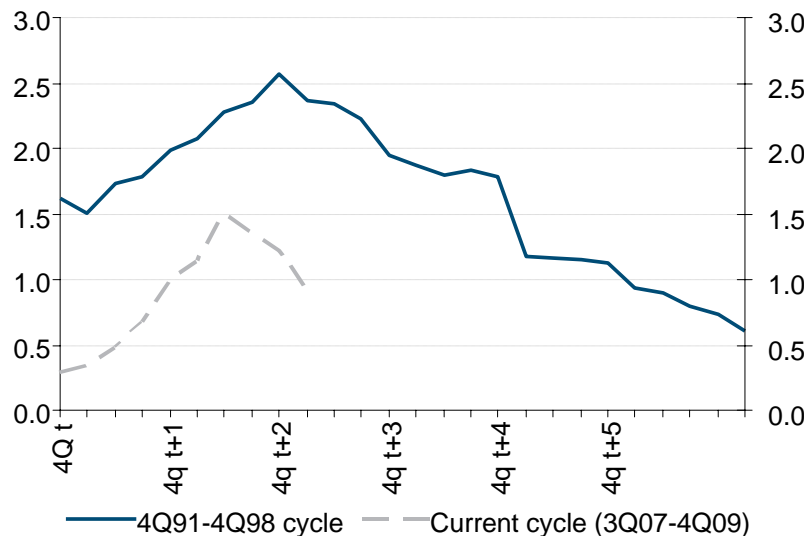
A significant part of credit is guaranteed (36% is housing credit), the exposure to construction and real estate corporates represents 25% of the total, and 30% corresponds to other production sectors, with a lower indebtedness.

The bulk of the financial system is well capitalized. Only a limited number of institutions will need capital, that we estimate at around 5% of GDP around the year 2013, which is perfectly acceptable as it corresponds to half the maximum indebtedness that the FROB can reach.

Spain: total frequency of default

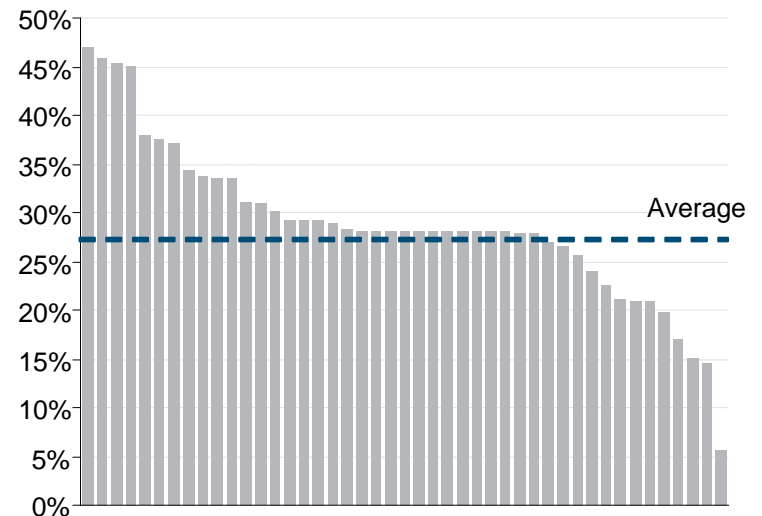
Credit to private sector (%)

* Frequency of default: number of credit that default during the quarter over the number credits in the portfolio, total credit to the private sector
Source: BBVA Research based on Bank of Spain



Spain: weight of the construction and real estate sector in the credit portfolio of financial institutions

Source: BBVA Research



The need for ambitious structural reforms

The labour market

Should the evidence observed since the mid-1990s recur, it would be possible to start creating employment with GDP growth rates of around 1%

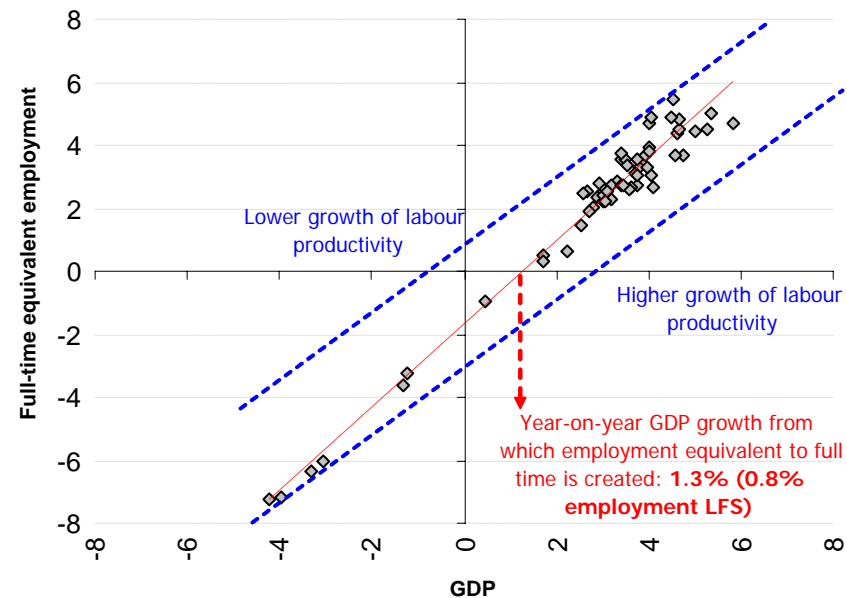
Reducing unemployment quickly requires growing well above that growth rate.

To do so, and in order to create stable and productive employment, an ambitious labor reform is needed.

Spain: GDP vs full-time equivalent employment

Q1 1996 - Q1 2010 (% yoy)

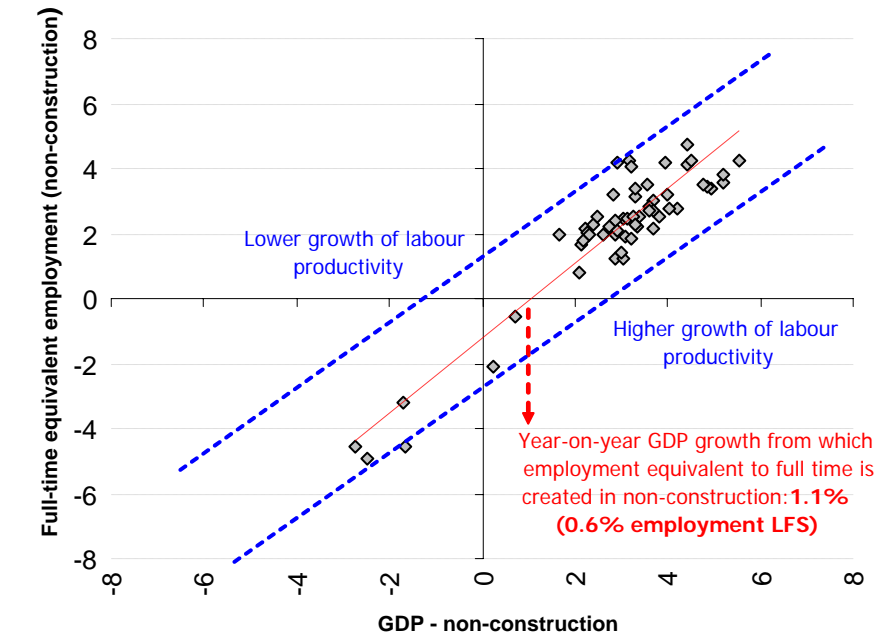
Source: BBVA Research based on NSI



Spain: economy excluding construction. GDP vs. full-time equivalent employment

Q1 1996 - Q1 2010 (% yoy)

Source: BBVA Research based on NSI



The need for ambitious structural reforms

The labour market

The functioning of the Spanish labour market is not optimal

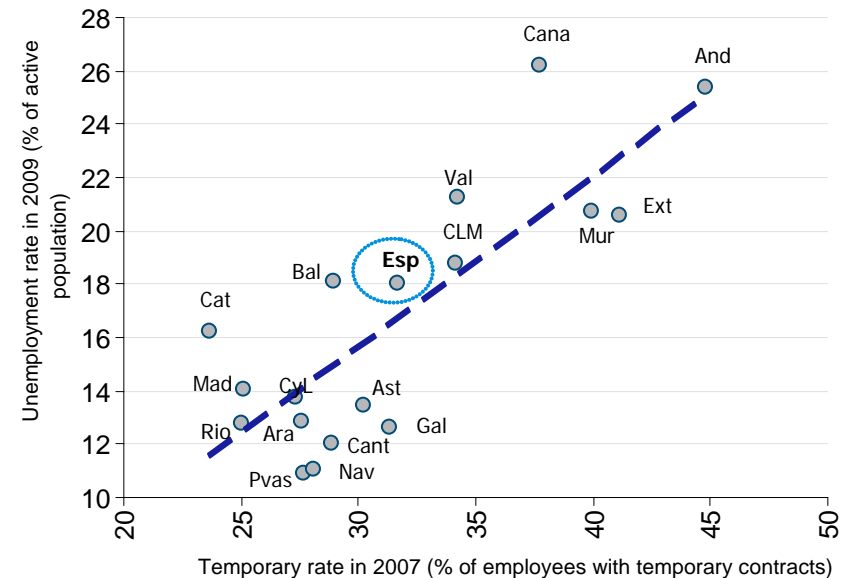


In spite of the drop recorded during the current crisis, the temporary employment rate in Spain is still 10 percentage points above the EMU, with negative effects in the medium and long-term on:

- Productivity
- On-the-job training
- Geographical mobility
- Labor mobility
- Wage setting
- Employment volatility
- Aggregate demand

Spain: temporary rate in 2007 vs unemployment rate in 2009

Source: BBVA Research based on INE



The need for ambitious structural reforms

The labour market

The functioning of the Spanish labour market is not optimal

2. Inefficient wage determination system

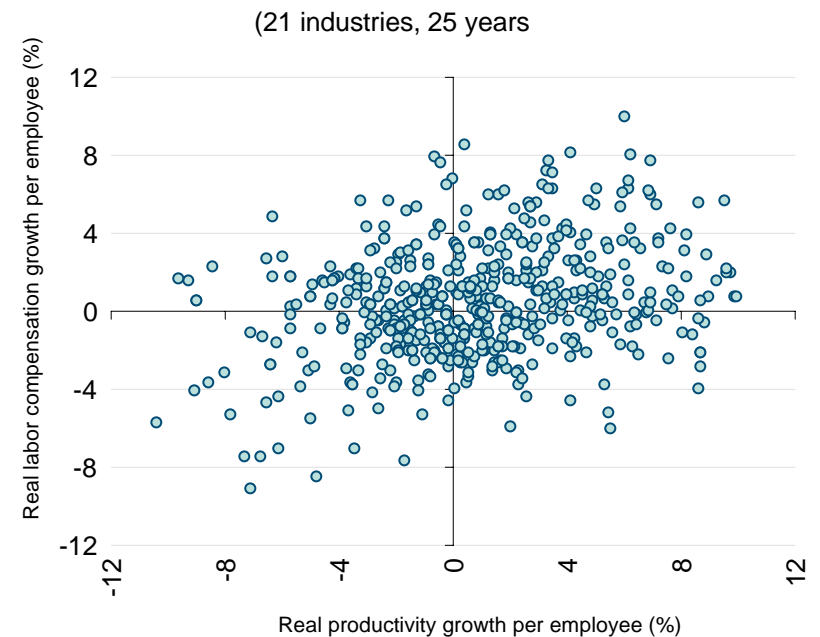
Improve collective bargaining

In countries with decentralized wage and employment conditions bargaining (e.g. UK), the wage increase is more in response to productivity gains (internal factor) than other external variables (unemployment rate).

In Spain, the correlation between productivity and wage growth is non-existent, as a result of the intermediate bargaining system.

Spain: real labour compensation vs labour productivity. Annual growth distribution (21 industries, 25 years)

Source: BBVA Research based on EU KLEMS



The need for ambitious structural reforms

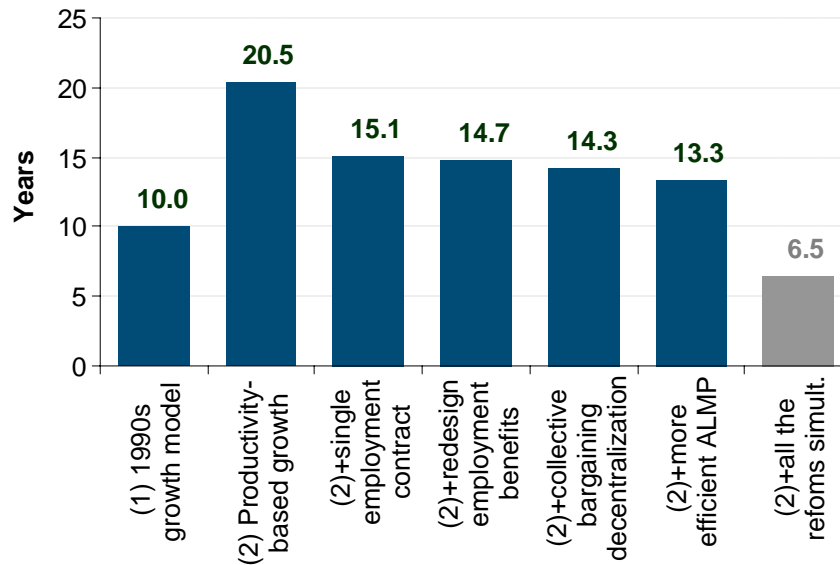
Structural reforms

In the absence of ambitious structural reforms, the economy will converge slowly at a growth rate of around 2%, slightly above the EMU growth rate.

A favorable combination of structural reforms (labor and financial), accompanied by more reforms in the future, could take the economy back to growth rates of around 3% more quickly.

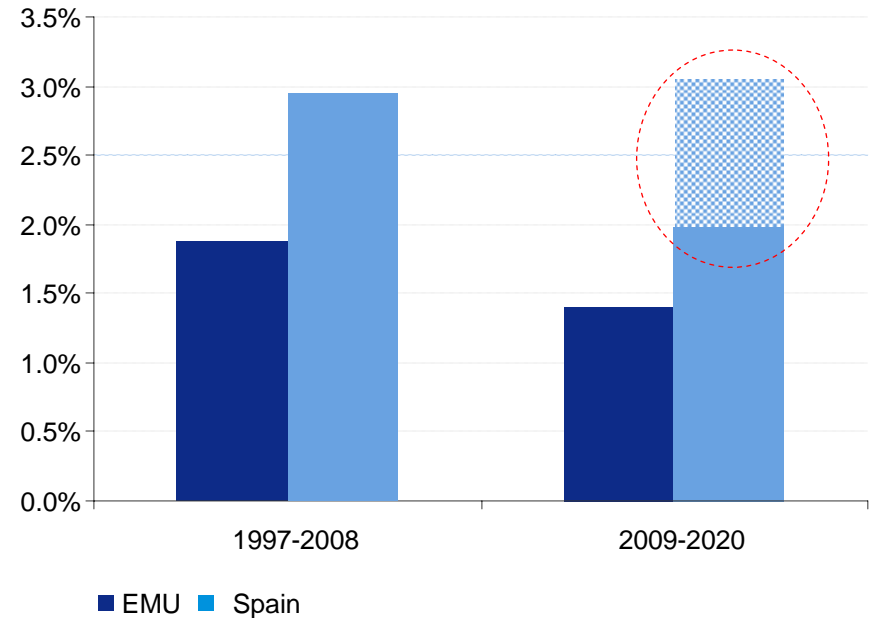
Spain: time needed to reduce the unemployment rate by 10 points in various scenarios

Source: BBVA Research based on Andres *et al.* (2009)



Spain vs. EMU: Potential GDP (% yoy)

Source: BBVA Research





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