BBVA Research

Spain

Economic Outlook

Second Quarter 2010

Economic Analysis

- International outlook: challenges ahead for a sustained recovery
- The Spanish economy continues to recover, albeit at a slow pace, but may yet be affected by ongoing uncertainties
- While, the private sector has already taken considerable steps towards reducing its level of debt, the public sector has to embark on a rigorous fiscal adjustment
- The fiscal adjustment measures will have a limited impact on growth
- The necessary and feasible fiscal adjustment must be accompanied by ambitious structural reforms of the financial sector and labour market

Contents

Summary 3

A. International outlook: challenges ahead for a sustained recovery 5

B. The Spanish economy continues to recover, albeit at a slow pace, but may yet be affected by ongoing uncertainties 9

C. An adjustment that is at an advanced stage in the private sector and a necessary and feasible fiscal consolidation 14

D. Structural reforms are essential for lowering debt and fuelling economic growth 22

Tables 28

Closing date: June 4, 2010

Summary

The world economy is currently dominated by two opposing forces: on the one hand, emerging countries and the US are recovering healthily and proving a catalyst for world trade (which should result in global economic growth of 4.2% for 2010); and on the other, countries (mainly European) with high levels of public debt and limited capacity for their private sectors to delever, which have suffered significant increases in their sovereign risk and financial market uncertainty. These uncertainties have translated into a very significant increase in the volatility of European assets, and this in turn encouraged investment portfolios to reduce their exposure to these assets. This then further undermined confidence in the EU's economic outlook, at least for the short term. Even though the rescue package agreed a few weeks ago by the European Council (EC) has managed to avoid worst-case scenarios and has eased fears over the EU's capacity to introduce effective measures to deal with the foreign financing problems of the most highly leveraged member states, the European Stabilisation Mechanism has been unable to ease uncertainties in financial markets and bring risk premiums back to more comfortable levels.

One of the advantages of the mechanism agreed on is that it makes access to the stabilisation fund set up by member countries conditional on the introduction of fiscal consolidation plans that are credible over the medium term, and which must be approved by both the EC and ECOFIN. The move represents an important first step by the EU in the process of designing efficient fiscal rules within a monetary union. It provides countries with the right incentives and sufficient power to embark on ambitious budget consolidation plans. A country that is unable to convince the other members that it has introduced suitable fiscal adjustment measures will not be able to benefit from the stabilisation fund if and when it requires financial support from the EU. In such a case, the country would find itself at the mercy of financial markets. As a result, the disciplinarian role of financial markets is enhanced, as is that of the EU (with regards to compliance with budget stability targets).

Financial market uncertainty makes it particularly difficult to evaluate the impact on short-term growth caused by the acceleration of fiscal adjustment policies introduced by several European countries. During periods of fiscal stress caused by problems relating to the sustainability of public finances, a credible fiscal adjustment accompanied by an improvement in the macroeconomic environment can ensure that increased private consumption and investment resulting from improved expectations and confidence more than offsets declining public expenditure and that it therefore has a growth-generating impact even in the short term. Fiscal reforms in Ireland (1985-1989), Denmark (1983-1986) and Spain (1993-1999) are good examples of this phenomenon. Having said this, in times of extreme uncertainty in which expectations take time to improve, the fiscal adjustment can have a negative impact on growth. In the current scenario, this would involve an even clearer decoupling of the European and US economies. Nevertheless, these negative short-term effects of fiscal adjustment may be offset by the euro's sharp depreciation in the past few months and the resulting upbeat trend in net exports. The likely consequences of these factors conditioning the EU's recovery are, firstly, the growing possibility of a divergence in monetary policy expectations between Europe and the US, and secondly, a consolidation of the euro/dollar exchange rate close to current levels (which unlike a few months ago, are now close to their long-term equilibrium).

Against this volatile market environment, the Spanish economy showed positive quarter-on-quarter growth in 1Q10 for the first time since the start of the crisis. This included a more virtuous breakdown of aggregate demand, in which private demand has taken up the reins from the public sector. More specifically, a recovery in household spending has been detected, and just when fiscal incentives are weakening. In addition, Spain's exports are showing stronger growth than those of other European countries, which appear to be supported by significant increases in labor productivity. This Q1 growth could continue through to Q2, with the data available at the beginning of June signalling another positive growth figure (0.2%), providing there is a consolidation of the last two months' trends during June.

But this means that the pick up in activity is still too slow, and that as yet it is unable to generate any sustainable growth in employment. The slow pace is partly the result of the adjustments currently taking place in the European and Spanish economies. As we mentioned before, Europe's recovery looks likely to remain weak and volatile. Despite the measures described above, the increase in uncertainty in capital markets has been dramatic and we should not rule out a relatively swift spill over to the real economy, not only via the financial channel but also via confidence. Meanwhile, the private sector has already taken considerable steps towards reducing its level of debt, but it is now the public sector's turn to follow a rigorous consolidation plan. For example, faced with surplus investment in certain sectors businesses have embarked on an adjustment process that looks likely to reduce the investment rate by

9pp of GDP between 2007 and 2010 (more than half of this is explained by the adjustment in the real state sector). As for households, the savings ratio looks set to finish 2010 some 7pp above its 2007 level (measured as a percentage of disposable household incomes). All the indications are that the bulk of the adjustment in the private sector is now complete.

With regards to public sector adjustment, a series of contractionary fiscal measures are due to be introduced during the third quarter that could have a negative effect on internal demand. In addition to the new measures aimed at accelerating the reduction in the budget deficit to 3% of GDP by 2013, there is the VAT increase planned for July. Regarding the latter, the effects on the economy are probably being felt right now, with consumers probably bringing forward certain purchases of durable goods and investment decisions (so as to avoid the additional VAT). This intertemporal effect on spending decisions is therefore likely to have a negative impact on activity during 3Q10, and to a lesser extent during 4Q10. The Government has also taken a major step in the right direction with its decision to introduce several public spending cuts (5% reduction in civil servants' pay, investment cutbacks, etc), as these will not only accelerate the fiscal adjustment targeted in the Stability Programme approved in January but also increase the credibility of the fiscal consolidation process. However, for the reasons given above it looks likely that these measures' immediate impact on internal demand, although small, is going to be negative. Our estimates point towards an accumulated reduction in GDP growth in 2010 and 2011 of 40 basis points.

However, as in other European countries uncertainty remains as to the short-term effect of the fiscal adjustment measures announced by the Government. The impact on business activity is conditioned by a range of factors, some of which are conflicting. First, the measures help to clarify the size of the required fiscal consolidation and its substance. In this respect, the weight of the adjustment will be borne by public spending, which maximises the likelihood of success. Second, the reform package will accelerate the previously-announced fiscal consolidation programme, leaving its 2013 targets unchanged and only affecting the pace at which the deficit is reduced. That is to say, the new measures do not involve additional reductions in the budget over the medium term, but they are simply bringing forward the fiscal adjustments that would have been introduced in 2012 and 2013. This is an important point, given that some consumers and businesses that had taken precautionary-savings decisions could now decide to revert these when they realise that the costs of the plan will be lower and more realistic. Thirdly, we cannot rule out the possibility of an unexpectedly strong impact from the wealth effect and increased confidence resulting from the additional fiscal measures, as they limit growth in public sector debt and the increase in the risk premium, as they enhance the plan's credibility, and as the policies behind the deficit-reduction process are set out clearly. As we mentioned earlier, this positive wealth effect and resurgence in confidence tends to be all the greater when the process of fiscal consolidation is perceived as a "regime change", i.e., when it is accompanied by a string of structural reforms that enhances economic growth and leads to a significant improvement in confidence. Given the Spanish economy's need to raise foreign financing, improved expectations could be absolutely crucial, and it is particularly important that these measures manage to boost investor confidence in international financial markets.

In the short term, and irrespective of other reforms which must be implemented later, the final outcome of the restructuring of the Spanish financial system and labour market reform are both crucial. With regards to the former, it is important to remember that Spain's financial system, in aggregate terms and relative to those in other advanced economies, has proved to be sound. In any case, the Spanish financial system is heterogeneous, and the potential liquidity and solvency problems are limited to a limited number of entities. The bulk of Spanish financial institutions have a surplus of capital; however, given that economic recovery is set to be slow and fragile, one segment of the system will have significant capital needs. According to BBVA Research's estimates, these needs are approximately 5% of GDP (until the end of 2013) and they are perfectly manageable for the Spanish economy, representing approximately half the maximum in debt edness of the FROB (Fund for Orderly Bank Restructuring). It is necessary to implement a decisive stimulus to bring about significant and rapid restructuring that can dispel the doubts in international financial markets about these lenders, so that they can obtain the foreign funding they need to underpin the business investment that the recovery will require.

As for labour market reform and as we have been saying for some time now at BBVA Research[1], it is vital that the end result involves the removal of the inefficient duality still prevailing between permanent and temporary workers, without increasing the cost of labor for businesses, and a reference framework should be put in place for decentralised collective bargaining that sets wages in line with the specific situation of each business and fosters productivity gains. If the reform successfully addresses these issues, economic recovery will be brought forward, growth potential will be considerably greater, the way will be paved for suitable fiscal consolidation, and households, businesses and public authorities will be better able to lighten their debt burdens.

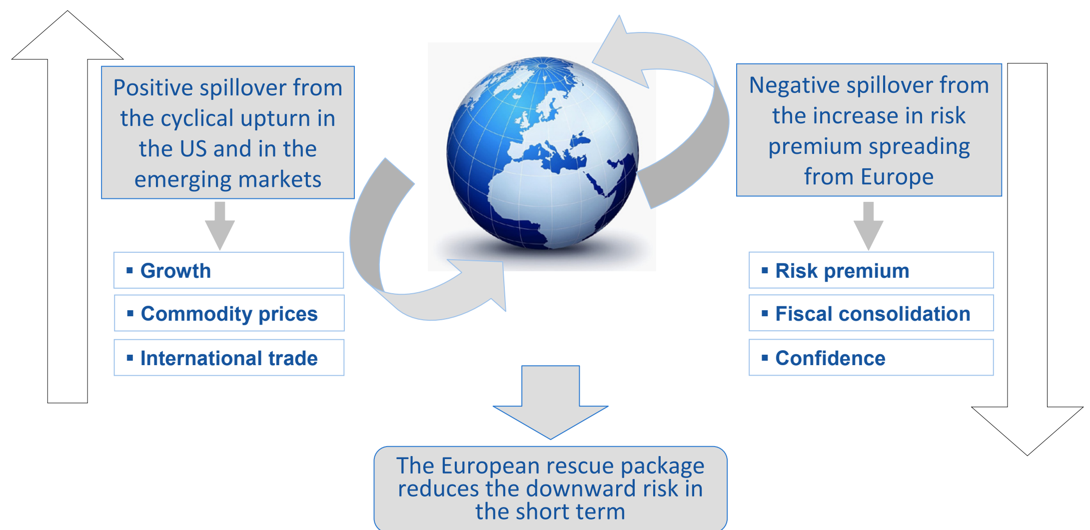
1: In particular, see the March edition of "Situación España".

A. International outlook: challenges ahead for a sustained recovery

The world economy is currently dominated by two opposing forces: on the one hand, the positive economic impetus from emerging markets and the US; and on the other, the high risk premiums that dominate Europe. The EU's rescue package may have reduced short-term uncertainty but medium-term risks are still on the downside

The economic situation has improved substantially over the last few quarters, thanks to the recovery by emerging economies and the US. World trade is expanding at an annual 7% and our forecasts suggest the global economy will grow by 4.2% in 2010. That said, doubts persist as to the capacity of the euro zone to tackle the heavy debts run up by some countries, although recent cost-cutting measures have gone some way towards assuaging these doubts. Yet, despite these efforts, certain doubts, which have been forcing up sovereign yield spreads and feeding financial instability, remain. It is a situation that not only threatens the European economy, but it may also have a knock-on effect on the rest of the world.

Chart 1
Two conflicting forces leading the world economy



Source: BBVA Research

After the short-term boost from the expansionary fiscal and monetary policies implemented around the world, the recovery's sustainability is not fully guaranteed beyond 2010, particularly in developed economies

Although the economic recovery became widespread in early 2010, there are marked differences in the pace of growth between countries. This is due to the varying degrees with which fiscal and monetary policy have been applied. These policies have proved particularly effective on economic growth in China and the US. At the same time, emerging economies are benefiting from stronger domestic demand and their recovery looks much more robust. As expansionary policies are diluted, however, doubts are being raised over the sustainability of the recovery beyond 2010 in the developed economies.

Recovery in the euro zone will be slow, due to weaknesses in the financial system and fiscal consolidation

The European economy has always been slower to emerge from recession than the US, because of structural features that make it less resilient to shocks and slower to adapt to the new situation. In the current environment, the situation is being worsened by two negative factors that are likely to make the adjustment particularly slow: the slow pace of reform in Europe's financial system, with only a very gradual recapitalisation process, which restricts the financing capacity of the zone's banks medium and long term; and the need to rein in public sector deficits through retrenchment plans that are bound to have a negative impact on activity over the next few years.

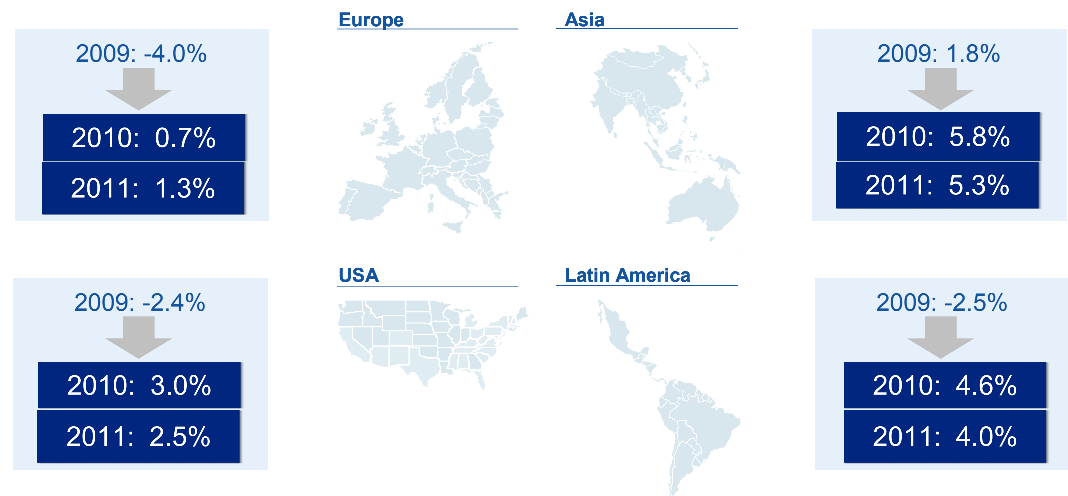
The level of impact of these two factors is still unclear: with regards to its financial system, Europe has never faced a financial crisis on such a scale, and its banks' balance sheets are not disclosed in the kind of detail that international financial markets demand, due to an opaque approach to recognizing losses at many of the zone's banks. Nor can we know with any precision what impact the need to rebuild capital will have on banks' ability to lend. As for fiscal adjustment, the deficit reduction for the zone as a whole of approximately three and a half percent of GDP over the next four years will have a direct negative impact on demand, but this will be increasingly diluted over time and will also be offset by a positive effect on confidence and financing costs in the real economy once fiscal targets are seen to be met. Overall, although there will be disparities between countries, these plans are unlikely to reduce annual growth in euro zone GDP by more than a few tenths of a percent.

The euro's decline will bolster recovery via exports

The big factor powering the euro zone economy over recent months has been exports, which in turn have encouraged a rise in orders and industrial activity. The recovery is being led from abroad, while domestic demand is barely growing.

The accelerated depreciation of the euro in recent weeks, triggered by market doubts about the implementation of fiscal adjustment plans, has merely taken the euro back towards to its equilibrium value (around USD 1.20) faster than expected. While such a rapid adjustment in exchange rates is generally undesirable, the movement should help exports over the coming quarters.

Chart 2
Growth heterogeneity by region



Source: BBVA Research

The economic-policy response to Europe's sovereign debt crisis was stuttering, but ultimately convincing, and should help normalise the financial position

The reason why the risks of a financing crisis in a small euro zone country such as Greece spread to others and ultimately infected the zone as a whole has to do with the slow reflexes of the European authorities, who failed to treat the crisis of confidence with quick and convincing measures when it first broke out. The economic and political costs have been much greater than they should have been, but in the end, substantial measures have been taken and they should be effective:

1. The Greek bailout package and subsequent support plan for the zone as a whole via the European Stabilisation Mechanism will mobilise up to EUR 750 billion in funds, if necessary (enough to cover the combined sovereign borrowing requirements of Greece, Portugal and Spain over the next three years).
2. The ECB was reluctant to take monetary easing measures, but when it became unavoidable extended its full allotment facilities, relaxed collateral requirements for repos using Greek debt and, finally, began to buy public and corporate bonds directly. Official interest rates were left at 1% and are likely to stay there until late 2011. This outlook contrasts with that in the US, where the first rate rises are expected early in 2011 since the risk of a reversal in the current trend is fairly limited and inflationary pressures are barely beginning.
3. To complement the financial support, zone nations have proposed coordinating their fiscal policies more efficiently, showing that the European project sometimes advances best and quickest after times of crisis. Although doubts surround the process (it is hard to exercise effective fiscal control over national public accounts without sacrificing sovereignty), the process should at least lead to greater scrutiny of public and private sector imbalances in the future.

Markets have demonstrated the limits of counter-cyclical fiscal policies. Economies with high levels of public debt and limited deleveraging in the private sector are highly vulnerable to rises in interest rates and risk premiums

At times of increased risk aversion, financial markets tend to be more forward-looking and can detect inconsistencies in macro-economic policies that they would normally gloss over in the boom times. Despite the substantial rescue package provided in Europe, significant risk premiums are still priced into the market amid uncertainties about the progress towards fiscal consolidation. The spreading contagion clearly illustrates the fragility of the current scenario. Economic history is riddled with examples of "baseless contagions" spreading from some countries to others at times of crisis. In these cases, geographical proximity or economic similarities matter more than differences between fundamentals. In truth, the current contagion cannot be wholly justified either by financial channels, feeding out from the Greek crisis, or by any similarity in fundamentals. Even if this is debatable, there is still an overriding need by some countries to boost their credibility so as to counter pressures from international investors.

Fiscal consolidation over the long term is the biggest challenge facing developed countries

There is increasing concern about the long-term consequences of rising public debt. This will inevitably lead to upward pressure on real interest rates and high risk premiums for a long time to come. Even as the recent contagion gradually dissipates, markets will still increasingly discriminate between countries based on the credibility of their fiscal position.

The lack of a deep restructuring of the financial sector together with looming regulatory reform could threaten the pace of recovery

The uncertainty coming from the financial sector is fundamentally of two types. First, there is the slow pace of restructuring in the financial industry, particularly in Europe, which raises the threat of a creditless recovery. This is an area of growing concern, as past experience and empirical evidence both show the crucial importance of credit in the early stages of economic recovery. Second, there is also uncertainty about the regulatory reforms which have now been set in motion. The likeliest outcome is a significant increase in capital and liquidity requirements, which could limit the banking sector's capacity to increase lending over the next few years at the speed that economic activity would demand.

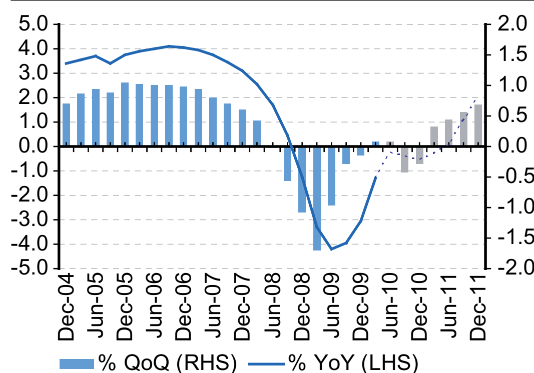
B. The Spanish economy continues to recover, albeit at a slow pace, but may yet be affected by ongoing uncertainties

In 1Q10, the Spanish economy recorded its first positive quarterly growth rate since the beginning of the crisis. Spain thus joins the rest of the EMU in the phase of consolidating its economic stabilisation. Besides the positive growth figure, the breakdown of aggregate demand came as some relief, showing private demand normalising, just as the international environment is demanding a faster fiscal consolidation than had initially been planned. Over the next few quarters, the economy will experience several exogenous shocks that could make growth more volatile. These will be partly related to the stepped-up of the fiscal consolidation process, but they will mostly reflect the uncertainties and volatility in capital markets, the falling price of sovereign bonds and the depreciation of the euro.

In recent quarters the adjustment by the Spanish economy has continued to ease gradually

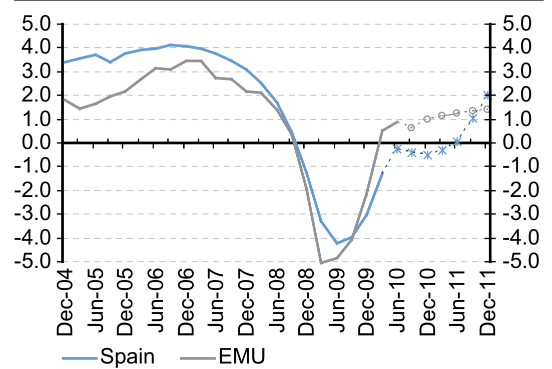
After economic activity fell off sharply in early 2009 and then declined more slowly in the latter part of the year, the Spanish economy began 2010 with a return to modest growth in GDP (+0.1% in 1Q10 quarter-on-quarter), the first positive growth rate in nearly two years (see Chart 3). Despite this, job destruction was running at around 100,000 full-time-equivalent jobs in 1Q10, figure in line with the previous quarter fall (-132,000), but well below the contraction seen in early 2009 (-574,000 jobs destroyed in 1Q09). Overall, even though weak activity and employment are still evident in the main economic data for the first part of the year, the Spanish economy has not missed out on the continuing, though very modest, economic upturn showed by its neighbouring countries in the last few quarters (see Chart 4).

Chart 3
Spain: GDP growth



Source: BBVA Research based on INE

Chart 4
Spain and EMU: GDP (% yoy)



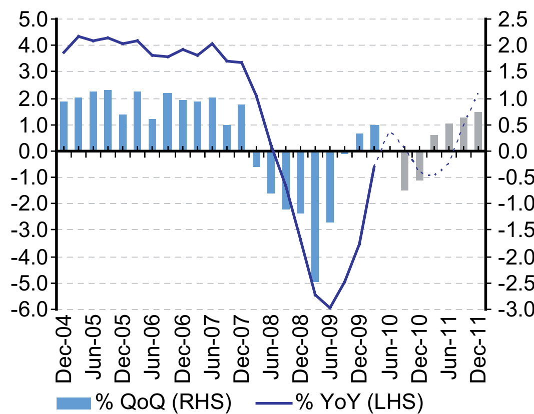
Source: BBVA Research based on INE and Eurostat

Despite the gradual weakening of the fiscal stimulus, private demand is showing signs of improvement

Until the end of 3Q09, the conjunctural improvement of the Spanish economy was heavily supported on transitory fiscal stimulus, which was successful in slowing the sharp rate of contraction seen in early 2009. Since then the fiscal impulse measures have been gradually withdrawn, raising doubts about the economy's capability to grow in the current environment. However, during recent quarters private demand in Spain has shown clear signs of recovery, while export demand has continued its positive contribution to GDP growth. In this vein, although the labour market is still manifestly weak and

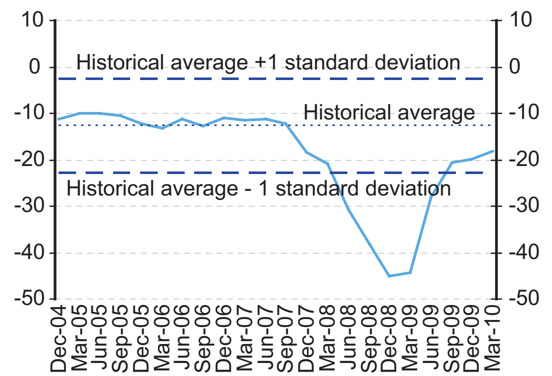
gross disposable income shows no sign of recovering, private consumption has performed better than expected with positive qoq growth rates in 4Q09 and 1Q10 of 0.3% and 0.5%, respectively (see Chart 5). Temporary factors partially accounted for in forecasts made in late 2009, such as the bringing forward of private spending ahead of the VAT rise scheduled for July 2010, have undoubtedly boosted growth in this component of aggregate demand. Nevertheless, the gradual recovery of consumer confidence, as labour market uncertainty continues to recede, and the resulting reduction in precautionary savings have been a major factor supporting this recovery (see chart 6).

Chart 5
Spain: growth in private consumption



Source: BBVA Research based on INE

Chart 6
Spain: consumer confidence (net balance of answers)



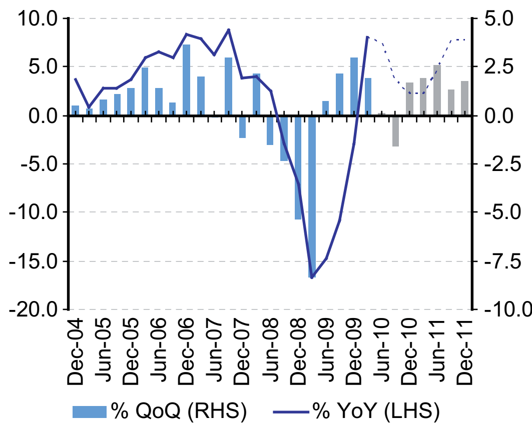
Source: BBVA Research based on European Commission

Another segment of demand that has been directly and indirectly affected by countercyclical fiscal policy is investment, particularly in capital goods. After two quarters of growth it turned negative again, falling 1.2% qoq in 1Q10. However, this setback to the corporate-investment recovery was expected given the winding down of fiscal stimulus measures that had directly boosted the purchase of transport equipment (mainly passenger cars). In fact, the downward correction is really quite small compared with the strong deterioration registered by this component of demand since the start of the economic crisis (average quarterly decline of 7.9% qoq between 3Q08 and 2Q09).

As we explain below, excess supply built up over years in the real estate sector continues to cause a correction in the supply of new homes. Specifically, investment in housing fell again in qoq terms, this time by 5.4%, although the rate of adjustment for this item continues to slow down, showing that the steepest phase of the correction is now behind us.

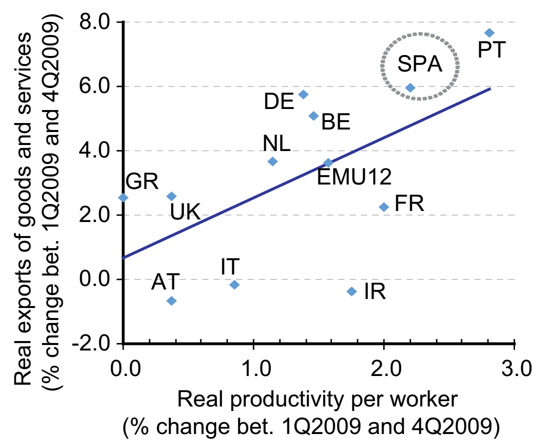
Finally, with regards to the external sector, Spanish exports have maintained the robust stance showed since early 2009, with four consecutive quarters of positive growth (see Chart 7). Although this recovery has unquestionably been helped by the recent trend in the global economy and specifically that of the euro area (recorded positive qoq growth since 3Q09) as well as by the weaker euro, it should be stressed that the increase in labour productivity and the steady fall in payroll costs have allowed Spanish companies, particularly exporters, to outperform the rest of the economy through the current crisis, growing faster than in most other EU countries (see Chart 8) and holding on to their export share in world's markets.

Chart 7
Spain: exports growth



Source: BBVA Research based on INE

Chart 8
Spain: productivity growth and recovery of exports in 2009

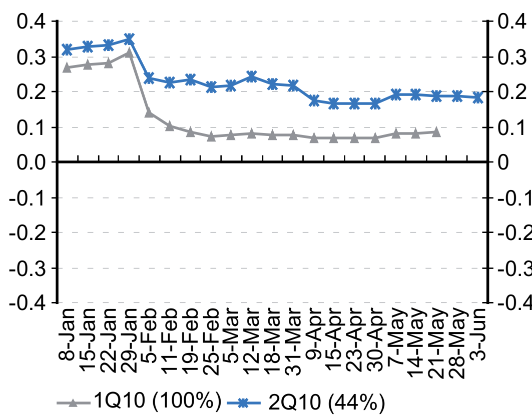


Source: BBVA Research based on Eurostat data

The Spanish economy will register modest growth again in 2Q10

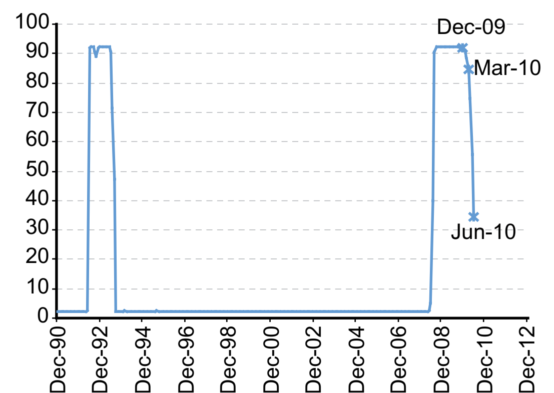
Assuming that June shows the same trend as April and May, economic data available at the time of writing this report suggests that the Spanish economy has continued to stabilise, and that performance in 2Q10 could be similar to that observed in 1Q (see Chart 9). As a result, the probability of recession will fall further this quarter, even though it remains high (see Chart 10). However, although recovery is ongoing, it is happening at too slow a pace and, if we strip out the labour market seasonal improvement in May, it is not enough to support a sustained growth in employment.

Chart 9
Spain: quarterly GDP growth forecasts of 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 benchmark quarter
Source: BBVA Research based on INE

Chart 10
Spain: probability of recession (%)



Source: BBVA Research based on INE

However, adjustments in progress will imply negative GDP growth again for 2010 as a whole

Given the weak pace of recovery, we expect the Spanish economy to experience additional quarters of negative growth during the following quarters (possibly in 3Q), although any further contraction is likely to be far less severe than that seen in 2008 and 2009. The factors behind this temporary setback in the economic uptrend derive mainly from the fiscal consolidation programmes being pushed through in Spain and Europe and from the increased uncertainty in international financial markets. Firstly, despite the medium and long-term benefits for the Spanish economy of fiscal consolidation, it is likely that the increase in VAT in July 2010 will have a negative impact on activity[2]. Secondly, the additional public expenditure cuts recently approved by the Spanish government will entail a decline in public consumption and public investment that will be reflected in growth rates slightly below those estimated before the latest austerity package was announced (see Table 1). Nonetheless, it must be stressed that recent decisions to achieve fiscal consolidation represent a bringing forward of the fiscal adjustment plan already included in January's Stability Programme, and should therefore be seen positively as a major step in the right direction. The recent turbulence in financial markets, led by sharp rises in sovereign spreads and falls in Europe's leading stock markets, make it clear that, given the financing requirements of the Spanish economy and its reliance on foreign capital markets, the failure to implement such measures would have clearly meant the end of economic recovery, substantially raising the chances of a severe relapse into recession. Finally, the reversal of expansionary fiscal policies in neighbouring countries will have a downward-preasure effect on the contribution made by the export sector, undermining some of the strength of Spanish exports.

Table 1

Spain: macroeconomic forecasts

(yoy growth, %)	1Q10	2Q10	3Q10	4Q10	2008	2009	2010	2011
Household consumption	-0.6	0.7	0.0	-0.8	-0.6	-5.0	-0.2	0.4
Public consumption	1.5	2.0	0.5	1.8	5.5	3.9	1.4	0.2
GFCF	-9.9	-8.2	-8.3	-8.9	-4.4	-15.2	-8.8	-2.7
Capital goods and other products	-8.8	-5.7	-7.2	-10.0	-2.7	-20.6	-7.9	-1.1
Construction	-10.6	-9.7	-9.0	-8.3	-5.5	-11.1	-9.4	-3.7
Housing	-20.7	-18.1	-15.3	-11.9	-10.3	-24.5	-16.5	-5.6
Other construcction	-2.8	-3.7	-4.8	-6.0	-0.4	1.6	-4.3	-2.4
Chg in inventories (*)	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Domestic demand (*)	-2.5	-1.2	-1.8	-2.1	-0.5	-6.4	-1.9	-0.4
Exports	8.0	7.4	3.5	2.2	-1.0	-11.3	5.3	5.6
Imports	2.6	3.2	-2.3	-4.3	-4.9	-17.7	-0.2	0.9
Net trade balance (*)	1.2	0.9	1.4	1.6	1.4	2.8	1.3	1.1
GDP mp (% yoy)	-1.3	-0.3	-0.4	-0.8	0.9	-3.6	-0.6	0.7
GDP mp (% qoq)	0.1	0.1	-0.4	-0.3				
Pro-memoria								
GDP w/out housing investment	-0.1	0.8	0.5	0.2	2.0	-1.8	0.4	1.1
GDP w/out construction	0.3	1.3	1.0	0.8	2.3	-2.2	0.8	1.5
Employment (LFS)	-3.6	-2.6	-2.4	-2.1	-0.5	-6.8	-2.7	-0.3
Unemployment rate (% active pop.)	20.0	19.3	18.9	19.4	11.3	18.0	19.4	19.2
Employment (FTE)	-3.6	-2.7	-2.5	-2.2	-0.6	-6.7	-2.7	-0.5

(*) contribution to GDP growth
Source: INE and BBVA Research forecasts

2: For details of our analysis of the impact that tax changes will have on the Spanish economy see Spain Watch for November 2009.

Although the short-term impact of fiscal consolidation may be very limited

While the macroeconomic forecasts in this report show growth rates slightly below those in our previous scenario (see Global Outlook, May 2010), other factors at work may lead to a better scenario for the Spanish economy. First, the euro's depreciation over recent weeks will give a significant boost to Spain's exports in two ways: by greater penetration of non-EMU markets where demand is currently growing faster than in Europe; and by the substitution of extra-EMU imports with intra-EMU imports.

Secondly, it is possible that the additional fiscal consolidation will end up having a limited impact if it is accompanied by the right policies and if the uncertainties currently besetting international financial markets recede significantly. Specifically, empirical evidence shows that in some phases of primary-deficit slashing some countries actually experienced economic growth as rising private demand more than compensate for falling public demand. As we discuss below, the package presented by the government meets many of the conditions necessary for private demand to offset the negative impact of shrinking public spending. Consequently, we cannot rule out the possibility of an unexpectedly strong impact from the wealth effect and the increase in confidence resulting from the fiscal consolidation programme, as the growth in public sector debt is lowered, the rise in the risk premium is limited, the plan's credibility is enhanced, and the policies behind the deficit-reduction process are set out clearly. This positive wealth effect and the resurgent confidence tend to increase as the process of fiscal consolidation is perceived as an “economic-regime change”, i.e., when it is accompanied by a set of structural reforms designed to enhance economic growth. Given the Spanish economy's need to raise foreign financing, it is particularly important that these policy measures boost investor confidence in international financial markets.

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

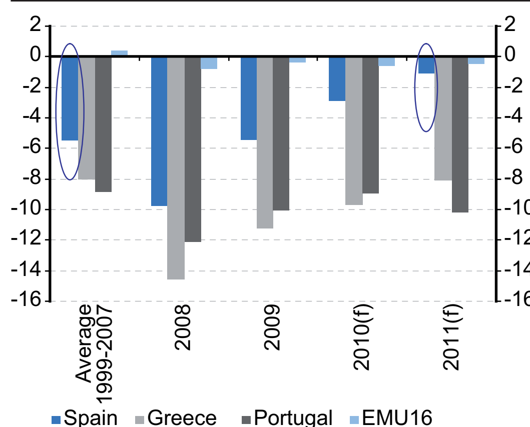
Apart from the uncertainty surrounding the short-term outlook, it is clear that the Spanish economy is in the midst of a significant adjustment process which entails correcting some of the imbalances accumulated during the years of economic boom, other imbalances which have arisen as a result of attempts to combat the crisis, and others which the economic slump has brought to light. For example, the correction in the economy's financing needs and the corporate and household deleveraging process resulting from it will represent a drag on domestic demand in the medium term. At the same time, the government made intensive use of fiscal policy for counter-cyclical purposes in 2008 and 2009, but, as already noted, the current climate in capital markets is making it clear that these measures cannot continue much longer. Finally, the crisis has exposed the labour market's inefficiency as a lever for change. Therefore, if changes in the growth outlook are to occur, ambitious decisions involving major structural reform must be made.

The significant reduction in the current account deficit distinguishes Spain from other EU economies

Since the single currency was introduced, Spain's external balance has been characterised, first, by a sharp deterioration in the current account deficit, a deterioration seen across all sub-balances and in particular the merchandise trade balance, and, second, by a major correction in the deficit starting in mid-2008, likewise led by an adjustment in the merchandise trade balance. The correction in Spain's current account deficit is remarkable; specifically, the deficit narrowed by half to 5.4% of GDP in 2009, and forecasts call for it to shrink to less than 3% in the next two years. Compared with the large trade deficits run by other European economies, the pace of deficit correction in Spain has been swift and continuous (see chart 11).

Chart 11

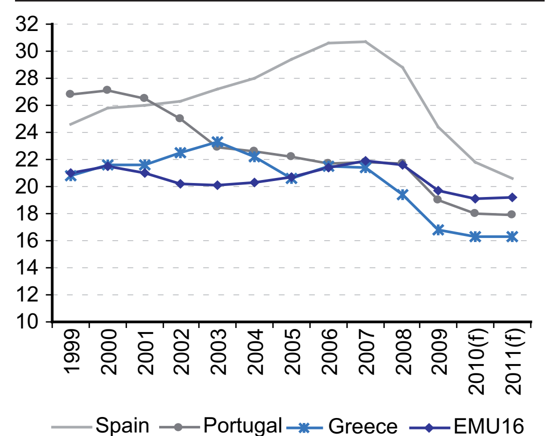
Spain: current account balance (as a percentage of GDP)



Source: BBVA Research based on INE

Chart 12

Domestic investment rate (GFCF as a percentage of GDP)



Source: BBVA Research based on INE

This adjustment is due more to a reduction of the high investment figures of the past few years than to a lack of competitiveness or a low savings rate

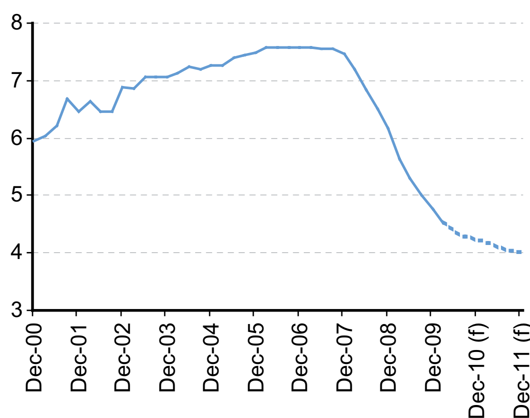
The deterioration in the current account deficit which began in 2004, along with its incipient correction, are due largely to the excess of investment seen in the period preceding the crisis, rather than to a low savings rate (see chart 12). On the latter point, it is worth noting that the Spanish economy continues to register a relatively high savings rate, around 20% of GDP, closely tracking the savings rate in the euro zone. As explained below, some of the excess investment may be explained by an increase in residential property investment.

On the other hand, in the past decade the Spanish economy has seen a deterioration in some indicators of competitiveness of the goods and services it produces. Specifically, from the time Spain joined the euro until mid-2004, the real exchange rate of tradable goods appreciated by approximately 5%, and later stabilised. This trend indicates that by 2004 Spain had exhausted its competitive advantage of joining the euro at a relatively depreciated nominal exchange rate. Evidence also shows that deterioration in the real exchange rate has been particularly acute in the non-tradable goods category, though the latest figures show that this appreciation is stabilising. Nevertheless, and despite the unfavourable trend these competitiveness indicators reveal, the competitiveness of exports has remained sufficiently high for the goods and services produced in Spain to maintain their share on the global export market, amid a trade environment characterised by the emergence of major manufacturing countries such as China and India at the expense of historical world powers such as the US, UK and France.

Residential property supply continues to correct, though at a slower pace

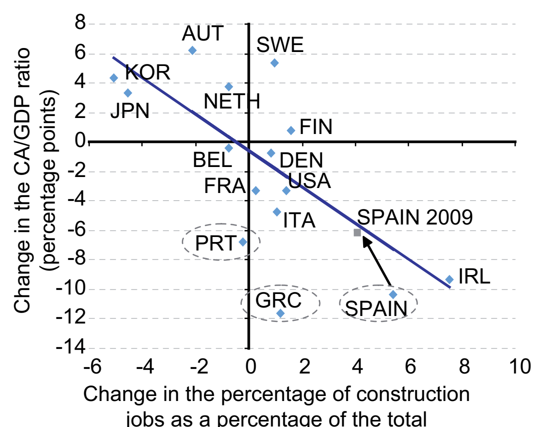
Part of the adjustment in investment is linked to a correction of accumulated imbalances in the residential property market. In particular, housing investment as a percentage of GDP is forecast to shrink from 9.3% in 2007 to 4.5% in 2010 (see chart 13). This correction has prompted a significant change in the number of permits for new housing, which has fallen steadily since mid-2007, translating directly into a sharp drop in housing starts, which is the ideal reaction to an unsold stock of new homes needing to be absorbed into the market. One of the consequences of this residential investment correction is a decrease in the share of construction jobs as a percentage of total employment, which is closely linked to a narrowing current account deficit, as shown by international evidence in chart 14.

Chart 13
Spain: Housing investment/GDP (% in constant prices)



Source: INE and BBVA Research

Chart 14
Weight of construction on total employment and current account balance (1996-2007)



Source: AMECO and BBVA Research

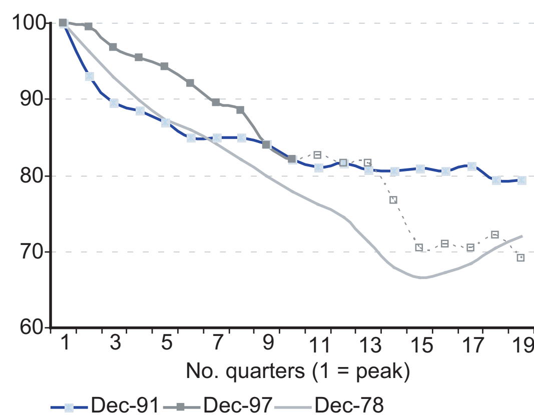
The end of a tax deduction on home purchases, a correction in housing prices and continuing attractive financing conditions will prompt the stock of unsold housing inventory to begin to be absorbed in 2010

Following a nearly three-year slump, demand for housing rebounded in the fourth quarter of 2009, according to housing transaction figures released by the Ministry of Housing. Much of the housing demand that had remained on the sidelines awaiting improvement in the economic outlook and financing conditions has begun to return to the market. This trend is likely to continue throughout 2010, and not only because financing conditions will remain appealing. For instance, this will be the last year in which buyers whose income exceeds €24,000 gross per year can benefit from the homebuyer's tax deduction, which is likely to speed home purchases among buyers uncertain of whether to jump into the market: based on the average mortgage, the elimination of the tax credit would be equivalent to an ex-ante increase in housing prices of between 6% and 16%[3]. Additionally, while housing prices to date have dropped by more than 11% from their all-time highs[4], they will continue to fall this year, (though at a lesser rate than in 2009). In any event, the declines will improve affordability ratios (see charts 15 and 16).

The foregoing means that the inventory of unsold housing will begin to be absorbed over the course of this year. The intensity of inventory absorption will vary depending upon the region, the conditions and location of each residence. It should be emphasised that it is unnecessary to eliminate the entire inventory of new, unsold homes in order to see a recovery in housing sector investment. Instead, about 700,000 home sales should suffice, since a base level of inventory is required for the residential property industry to function properly and because, given the huge disparities in housing types and locations, some existing homes are in areas that do not exert supply pressure on the rest of the market. Furthermore, when market fundamentals are taken into account (household creation, immigration, demographics), potential annual housing demand is likely to stand at around 350,000 houses for the next few years.

Chart 15

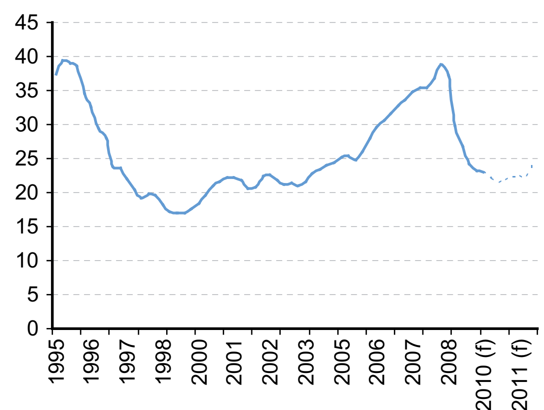
Spain: cycles of real housing prices (100= cycle peak)



Source: BBVA Research

Chart 16

Spain: housing affordability Mortgage repayment as a % of weighted pre-tax earnings



Source: BBVA Research based on Ministry of Housing, INE and Registrars

3: Ex-post the elimination of the tax credit will be reflected in an equivalent drop in price. Abundant empirical evidence for the Spanish economy indicates that tax credits for homebuyers were translated nearly entirely into prices, thus benefiting sellers rather than buyers.
4: According to official statistics which, due to construction, may reflect a delay in reporting true market price declines.

Corporate and household deleveraging continues in an orderly fashion

In addition to the adjustment in investment in the residential property market, companies and households are in the process of reducing spending to improve their position following high growth in indebtedness during the years of economic expansion. On one hand, the outlook for rising household income has been affected by the expectation of lower total labor income, which is the result of falling employment. Meanwhile, declines in their asset prices (particularly real estate) have had a direct impact on the valuation of household wealth. It is partly for this reason that the savings rate among Spanish households has posted one of the sharpest increases in Europe since the crisis started (only trailing that of Ireland), even though savings levels were already relatively high thanks to the convergence and growth process in Spain in recent years. This partly explains why net household wealth still compares very favourably with that of other countries such as the UK, Italy, France and Germany.

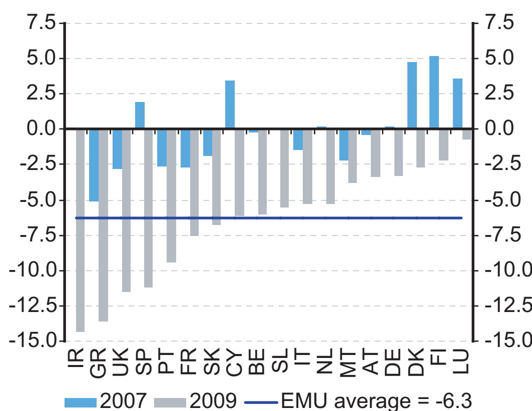
The government's fiscal adjustment is necessary, unavoidable and feasible

In addition to the adjustment seen in certain areas of the private sector, the fiscal stimulus implemented in 2008 and 2009 and the drop in revenue as a result of the correction of certain imbalances, must be corrected in 2010 and subsequent years with a series of measures geared towards containing growth in the deficit and government debt. In particular, the Spanish General Government deficit stood at 11.2% of GDP in 2009, 13p.p. below the surplus of 1.9% registered at the end of 2007, right at the beginning of the economic crisis. While the deterioration in public accounts is generalised across all EU countries, Spain's is among the worst, exceeded only by Ireland, whose deficit has widened by 14.4 p.p. to 14.3% of GDP, and easily surpassing the 6p.p. deterioration for EMU countries as a whole (-6.3% in 2009) (see chart 17).

Although the deterioration in the Spanish government budget balance is very significant, and, as a result, government debt has jumped by 17 p.p. to 53.2% of GDP in 2009, the latter remains relatively low compared with the EMU average of 78.7% (see chart 18).

Chart 17

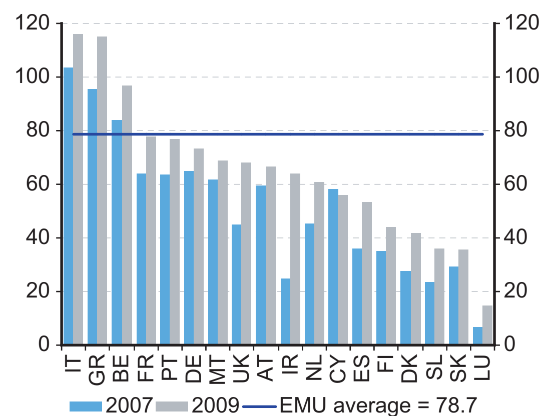
Budget balance (as % of GDP)



Source: EUROSTAT

Chart 18

Government debt (as a % of GDP)



Source: EUROSTAT

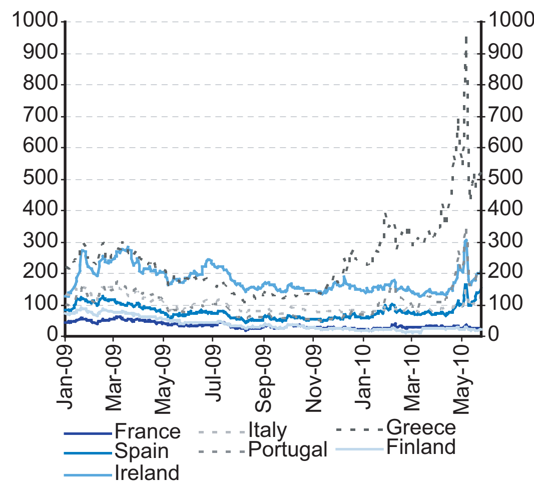
This widespread deterioration in the budget balance and the ongoing increase in European public debt have called into question the solvency of EU states' public sectors. In the past few months, this uncertainty has been reflected both in the rating downgrades on the government debt of countries such as Greece, Portugal and Spain, and also in the notable widening of sovereign spreads with the German bond (see chart 19). This performance in sovereign spreads reflects, not only the growing concern in international markets about certain countries' ability to meet their future financial obligations, but also an ebbing willingness on the part of investors to finance governments, which means that government borrowing is becoming more expensive. As a consequence, rising risk premiums on public debt translate into greater borrowing costs in the private sector, penalising private investment and growth in the medium and long term.

In accordance with existing empirical literature, two key determining factors can be identified in the performance of sovereign spreads: first, country-specific credit risk, which reflects the solvency of

expectations regarding fiscal circumstances, and second, international risk aversion, which, in periods of uncertainty, may discriminate between different countries (Attinasi, et al., 2009). Using as an explanatory variable of country-specific credit risk the average of European Commission[5] forecasts on the public deficit to GDP ratio for the next two years (measured as a differential vs. forecasts for Germany), chart 20 illustrates that the market is penalising more severely those countries with the highest public deficit forecasts.

Chart 19

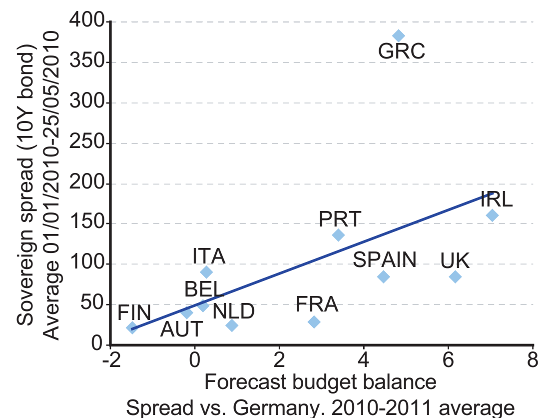
Sovereign spreads: 10Y bonds



Source: Bloomberg

Chart 20

Sovereign spreads vs. forecast budget balances



Source: BBVA Research based on Bloomberg and AMECO

Against this backdrop of ongoing deterioration in Spanish public accounts and plunging market confidence in the public sector, the Spanish government has unveiled a fiscal reform package to be implemented in several stages

This process began with the 2010 Central Government Budget, which, in addition to already-announced increases in VAT and capital gains tax and the withdrawal of some of the fiscal stimulus measures passed in 2008[6], included a 4% cut in government spending vs. 2009. The combined effect of these measures will be to lower the deficit by 1.7p.p. of GDP, according to government figures.

These measures were added to those adopted in the updated Stability Programme for 2009-2013. This led to the 2010 Immediate Action Plan, which represented a further cut in state spending of 0.5 p.p. of GDP (of which around 60% is linked to decreases in government investment, both direct and indirect), and extraordinary deficit-reduction measures approved by the Cabinet on May 20 following the tension in international markets early in the month. These last measures, which do not change the medium-term targets but instead bring forward the fiscal consolidation process, represent an additional reduction in the public deficit of 1.5 p.p. of GDP (0.5 p.p. in 2010 and 1.0 p.p. in 2011). The widest-reaching measures include a reduction and freeze on government salaries and an additional cut in public expenditures.

5: Spring forecast 2010.

6: An increase in the general VAT rate from 16% to 18%, and an increase in the reduced rate from 7% to 8%, increase in capital gains tax from 18% to 19% for the first €6,000 and to 21% on amounts exceeding €6,000, and partial elimination of a 400euro deduction in personal income tax.

Chart 21
Details of the fiscal adjustment plan

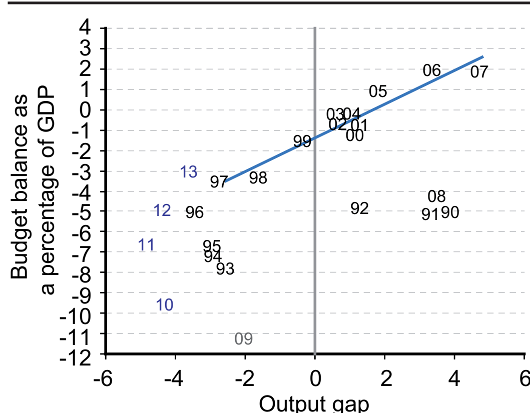
Measures	Budget deficit reduction (as % of GDP)	**Details of measures**
Withdrawal of discretionary measures	2.7%	• Plan E in infrastructure (0.8% of GDP) • Elimination of a EUR400 personal income tax deduction
Revenue increase	1.0%	• 2p.p. rise in VAT, capital gains and other indirect taxes
Immediate action plan	0.5%	• Reduction in investment and public sector consumption
Adjustment plan presented to the EC	1.5%	• 5-percent reduction in wages followed by freeze (0.6% of GDP) • Cut in public investment (0.6% of GDP) • No cost-of-living adjustment to pensions and benefits
Cyclical impact on the deficit	1.0%	• Cyclical improvement through to 2013
Additional measures required	≅ 1.5%	**• Reduces uncertainty regarding the adjustment plan's effectiveness**
	8.2%	**• Deficit shrinks from 11.2% in 2009 to 3% of GDP in 2013**

Source: BBVA Research

In short, all the fiscal adjustment measures unveiled by the government are geared towards meeting the 3% of GDP deficit target for 2013, with the bulk of the effort focussed on cutting public spending (approximately 80%). This would mean that, as illustrated in chart 22, should these targets be met, the 2013 structural deficit would return to around -1%, a level similar to that prior to the economic crisis. It would represent an annual average adjustment of the structural deficit of not less than 1.5 p.p., in accordance with the commitments taken on with the EU. This means that the latest government measures would lower the structural deficit between 2009 and 2011 (following the elimination of the fiscal stimulus measures which accounted for 2.7% of GDP in 2009) by around 4 p.p., with between 1.5 p.p. and 2 p.p. of GDP pending in the final two years of the consolidation period. While the proposed reform package is stringent and ambitious, this is not the first time that the Spanish economy has faced such a challenge. From 1993 to 1997, the structural deficit was cut by slightly more than 4 p.p. (see chart 23).

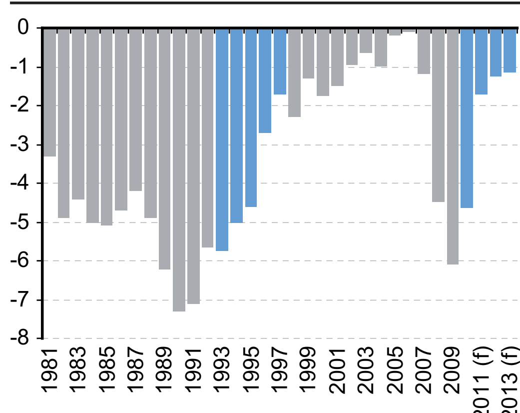
In this sense, achieving the current target is feasible if all tiers of government make a firm and rigorous commitment to containing public spending. To this end, the central government would ideally introduce additional public spending control measures, such as a cap on spending by autonomous communities. Additionally, and given that the drop in government revenues in recent years is due to a structural erosion of the tax base, other reforms are also going to be required; reforms, such as an overhaul of the labour market, that will consolidate and spur on economic recovery and reduce the uncertainty surrounding the solvency of Spanish public accounts.

Chart 22
Spain: budget balance vs. output gap



Source: BBVA Research based on MEH

Chart 23
Spain: public administration structural deficit (% of GDP)



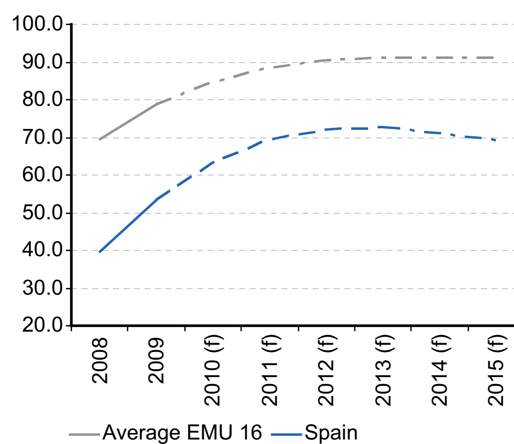
Source: BBVA Research based on MEH and INE

Despite its substantial increase as a result of accumulated deficits, Spanish public debt will remain lower than the EMU average

As a result of this scenario, which calls for the deficit to continue rising in coming years, public debt looks set to exceed by the end of 2010 the 60% threshold set by the Protocol on Excessive Deficit, ultimately reaching 73% of GDP by the end of the fiscal consolidation period (see chart 24). Based on these figures, public debt will climb by more than 25 p.p. in four years (which in absolute terms means more than doubling the €381 billion registered in 2007), though it would still trail the 91% average forecast for EMU countries for end-year 2013. Once the convergence target is reached, and based on the premise that the structural balance will remain constant at around -1% in the long term, Spanish public debt should steadily decline to under the 60% threshold in 2021. If this scenario evolves, public debt would clearly be sustainable, leaving room to address the pressure on public accounts posed by an aging population in the medium and long term, which must give rise in coming years to an overhaul of the pension system as part of the Toledo Pact. The purpose of said overhaul would be to adjust the retirement age to increased life expectancy and to calculate pensions based on contributions made throughout the individual's working life rather than the final years of employment.

Chart 24

Spain: government debt (as % of GDP)



Source: BBVA Research based on MEH and government data

The fiscal reform package meets most of the conditions necessary for private consumption to offset the negative impact of shrinking public spending

In light of the present uncertainty in financial markets, it is particularly difficult to assess the effects on short-term growth of the acceleration of the fiscal reform package implemented by the Spanish government, as is the case in other European countries. During periods of fiscal stress due to problems with the sustainability of public finances, a credible fiscal adjustment accompanied by an improvement in the macroeconomic environment can ensure that increased private consumption and investment, resulting from improved expectations, and net exports more than offset declining public expenditure and, therefore, have a growth-generating impact even in the short term. Fiscal reforms in Ireland (1985-1989), Denmark (1983-1986) and Spain (1993-1999) are good examples of this phenomenon. However, in an environment of considerable uncertainty in which expectations do not improve quickly, fiscal reform may have a negative impact on growth. Nevertheless, these negative short-term effects of fiscal adjustment may be offset by the euro's sharp depreciation in the past few months and the upbeat trend in the Spanish export sector.

Apart from these issues, which act as countervailing forces to one another, any assessment of the effects of the fiscal adjustment on the Spanish economy's growth for 2010 and 2011 will be influenced by other elements which must be taken into account. First, the measures help to clarify the size of the required fiscal consolidation and its substance. It has been announced that most of the adjustment will be in public expenditure, which increases the plan's chances of success and minimises its long-term impact on economic growth. Second, the reform package will accelerate the previously-announced fiscal consolidation programme without changing 2013 targets, with only the pace of the public deficit

reduction set to change. The measures do not include further reductions in the public deficit in the medium term, but simply move forward the fiscal policies that would have been implemented in 2012 and 2013. Third, the wealth effect and rising confidence prompted by fiscal consolidation may be significant, by restricting growth in public debt, limiting rising risk premiums, lending credibility to the plan and clearly outlining the policies driving the deficit reduction process.

As a result of all of these factors, our core assessment in the current environment is that the acceleration of the fiscal adjustment will have an effect equivalent to -0.1% on GDP in 2010 and of -0.3% on GDP in 2011, vs. our previous scenario which included the trend for fiscal consolidation in the Stability Programme announced at the beginning of the year. However, these effects may even be less intense if the uncertainty in international financial markets ebbs significantly and if the fiscal reform process is perceived as a “regime change” by economic agents. To this end, the fiscal overhaul must be accompanied by a series of structural reforms that boost economic growth and generate significant improvement in economic agents’ confidence. Given the Spanish economy’s need to raise foreign financing, it is particularly important to boost investor confidence in international financial markets with these measures. In the short term, and irrespective of other reforms which must be implemented later, both the final outcome of the restructuring of the Spanish financial system and labour market reform are crucial.

D. Structural reforms are essential for lowering debt and fuelling economic growth

Spanish financial system: a restructuring that it is vital to implement quickly and efficiently

While the Spanish financial industry's solvency problems are limited, they need to be tackled decisively, especially given the present environment with its high risk premiums and low market confidence

There can be no doubt that the Spanish financial system overall is sound. At the same time, the system is highly heterogeneous, and a limited number of entities may have solvency problems.

To arrive at an estimate of the Spanish financial system's capital needs, we carried out a projective study based on the macroeconomic and financial scenarios outlined in this report. It was determined that a financial institution has capital needs when its Tier 1 ratio is lower than 7%, and the forecast horizon was set for year-end 2013. The study was conducted from two different standpoints: top-down, forecasting the aggregate data for the financial system as a whole, and bottom-up, using figures for each financial institution and aggregating the results. Both exercises generated very similar conclusions. Two main items were projected out. First, profit before provisions was estimated, using the outlook for interest rates and outstanding balances and spreads for lending, deposit and funding businesses. Second, provisions were calculated based on expected performance of portfolio quality (projected bad debts) and the initial generic fund.

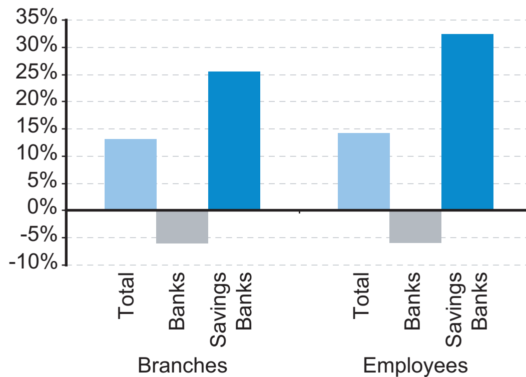
Based on this analysis, limited and perfectly manageable capital needs where estimated for the Spanish economy (using the slow-and-weak recovery scenario detailed in this report). The bulk of the Spanish banking system has a surplus of capital. Based on our estimates, the capital needs of troubled lenders will stand at around 5% of GDP. This figure is equivalent to about half of the maximum debt level allowed for Spain's FROB (Fund for Orderly Bank Restructuring).

Urgent action is needed to address the problem of overcapacity in the Spanish financial system

Although some consolidation processes have been announced, it is necessary to implement a decisive stimulus to bring about significant and rapid restructuring that can dispel the doubts in international financial markets about these lenders, so that they can obtain the foreign funding needed to underpin the business investment that the recovery will require.

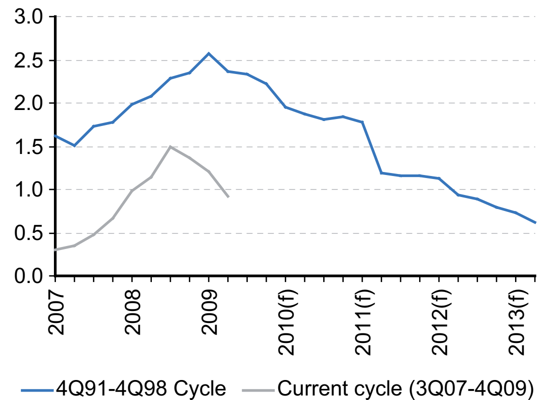
In the past decade, the number of branches in the financial industry has risen by 12%. However, this performance varies dramatically between banks, which have cut their number of branches by 5%, and savings banks, whose number of branches has soared 25%, as illustrated in chart 25. The challenge going forward is to implement an industry restructuring process that can achieve capacity reduction where it is most needed.

Chart 25
Spain: breakdown of the number of branches and employees (2000-2009 growth rate)



Source: BBVA Research, based on Bank of Spain data

Chart 26
Spain: default frequency on loans to the private sector* (%)



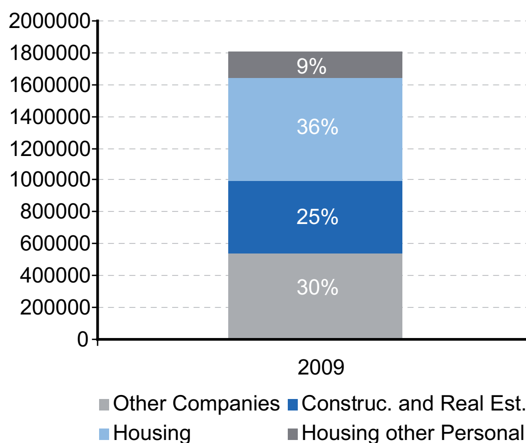
* Default frequency: number of transactions falling into arrears in the quarter as a percentage of transactions in the portfolio, total loans to the private sector
Source: BBVA Research, based on Bank of Spain data

There are some support factors in the sector. First, the bad debt cycle is less acute than in previous downturns

Against a backdrop of low growth and job losses, the Spanish financial system has witnessed a rise in the bad debt ratio. However, this increase is mild compared with previous economic downturns. For a meaningful comparison, the default frequency of the system's loan portfolio is used. This rate refers to the number of transactions falling into arrears each quarter as a percentage of transactions in the financial system's loan portfolio. As shown in chart 26, which compares the current crisis with that of the 1990s, despite the recent increase, the default frequency in the financial system remains markedly lower than during the previous downturn.

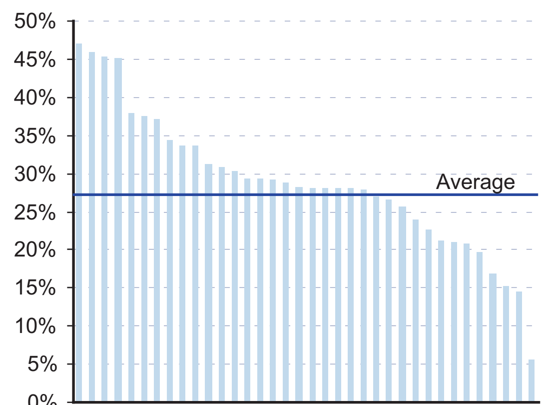
To put the default frequency of loan portfolios into perspective, it must be noted that a significant number of housing loans are secured by real guarantees. Indeed, 36% of the loan portfolio consists of housing loans. However, lenders are also heterogeneous in their exposure to the real estate sector, as seen in chart 28.

Chart 27
Spain: outstanding loans to the private sector* (millions of EUR)



Source: Bank of Spain

Chart 28
Spain: weight of the construction and real estate sectors in total loan portfolio

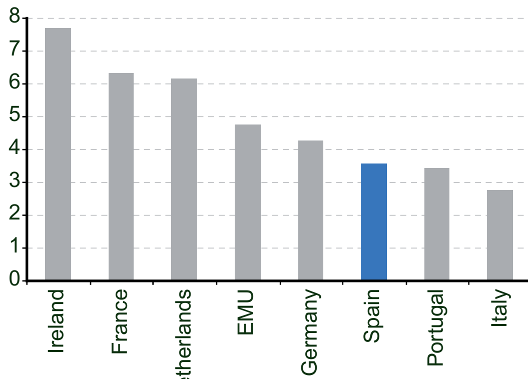


Source: Entitities' annual accounts and analysts

Second, a universal banking model requires diversification of resources

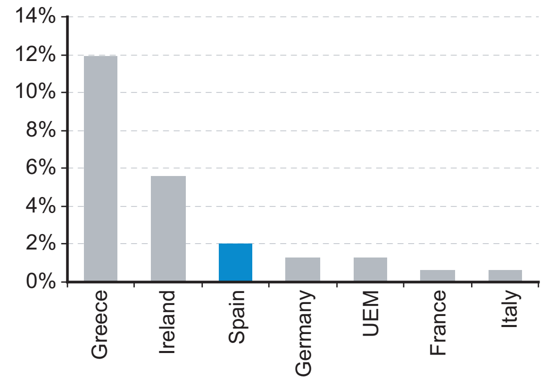
As would be expected from a banking industry that is heavily retail oriented, the system has a significant deposit base. Deposits represent 65% of bank liabilities and 88% of loans. In this framework, funds obtained from the ECB are in line with the EMU average, as illustrated in chart 30.

Chart 29
Bank assets as % of GDP (2009)



Source: BBVA Research based on Fitch and ECB data

Chart 30
EU banks: % of assets funded by ECB liquidity



Source: BBVA Research based on Datastream and Central Banks

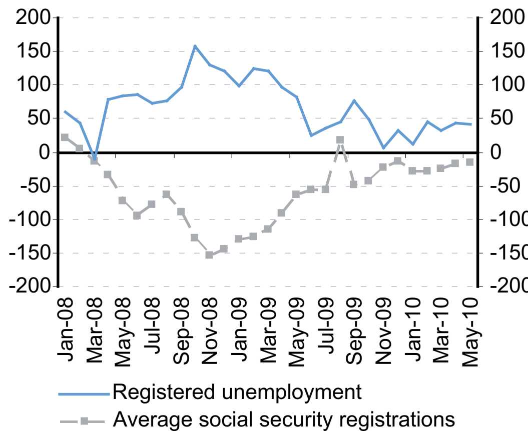
The second key structural reform that must be implemented urgently is that of the labour market

This would improve job expectations and would slow the correction in the deleveraging, disinvestment and fiscal consolidation processes, strengthening the financial position of households, companies and the public sector. However, the crisis has revealed the Spanish labour market's shortcomings and inefficiencies, which are raising doubts and several unknowns. In particular, given the current situation, two specific questions arise: what would the economy's growth rate need to be for it to begin generating jobs? What can be done to speed up this process?

With regards to the first question, we would emphasise that the pace of job destruction has slowed in recent months. Correcting the raw figures for seasonal and calendar effects for each month, the increase in unemployed people registering with government employment services offices seems to have stabilised at around 40,000 people in the past quarter, a figure which is significantly lower than the average in the second half of 2008 and the first quarter of 2009 (110,000), though slightly higher than the figure estimated for the previous quarter (25,000) (see chart 31). Given declining employment – primarily among workers on temporary contracts[7] – the unemployment rate climbed to 20% in the first quarter of 2010 (see chart 32).

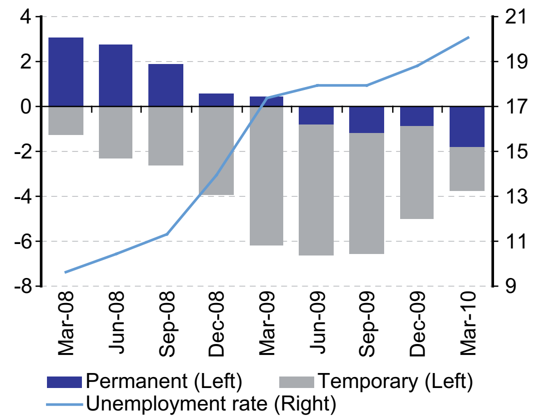
7: It should be noted that job destruction in Spain's current crisis is explained primarily by employers' refusal to renew temporary contracts: since the first quarter of 2008, more than 1.5 million salaried workers – in net terms – have lost their jobs. 90% of these workers were on temporary contracts.

Chart 31
Spain: registered unemployment and average social security registrations, (monthly change in thousands of people, sa data)



*sa: seasonally adjusted
Source: BBVA Research, based on MTIN data

Chart 32
Spain: wage earned breakdown (Contributions to % yoy employment growth)

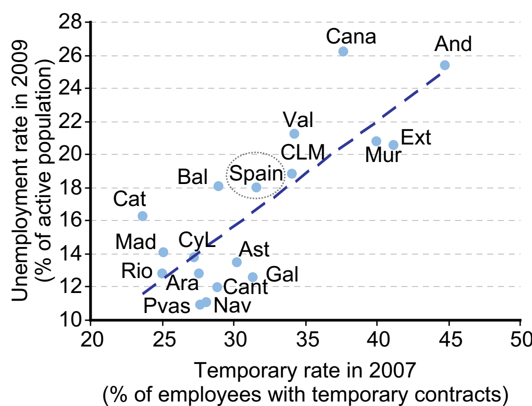


Source: BBVA Research based on NSI

The change in the unemployment rate has varied from region to region

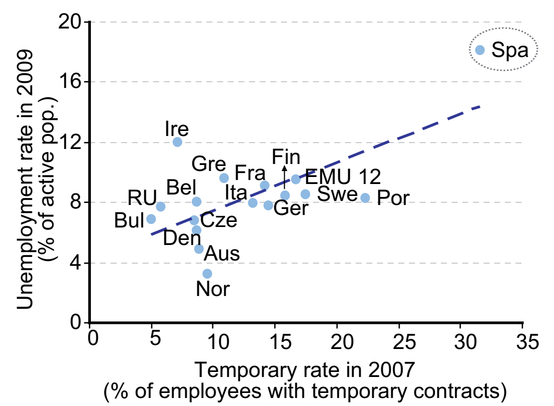
In general terms, the autonomous communities that had the highest rate of temporary employment prior to the crisis are the ones where unemployment has climbed the most, as shown in chart 33. Similarly, chart 34 illustrates the link between the unemployment rate and the percentage of temporary workers on a country-by-country basis.

Chart 33
Spain: temporary rate in 2007 vs unemployment rate in 2009



Source: BBVA Research based on INE

Chart 34
Temporary rate in 2007 vs unemployment rate in 2009



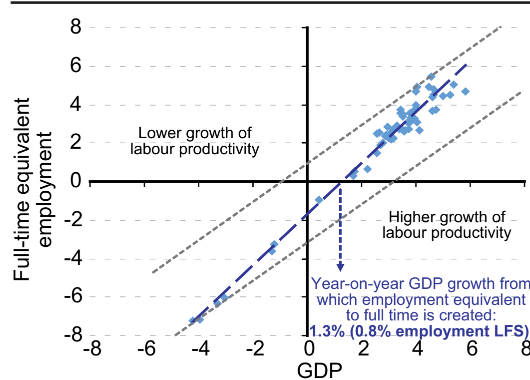
Source: BBVA Research based on Eurostat

The economy must expand by more than 1% in order to create jobs

Bearing in mind the economic growth expected over the coming quarters, it is worth asking whether the Spanish economy is doomed to experience a jobless recovery. Chart 35 shows that since the mid-1990s, yoy economic growth has had to exceed 1.3% in order for the economy to create jobs (full-time equivalent positions). While intuition would suggest that faced with the collapse of a labour-intensive industry like construction, the growth threshold for creating jobs should be higher, figures actually indicate the opposite to be true.[8] When the construction business is left out of the calculations, the rest of the economy only needed to grow above 1.1% to generate jobs (see chart 36).

Chart 35

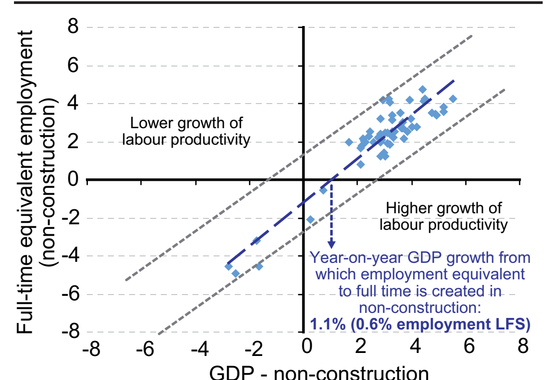
Spain: GDP vs full-time equivalent employment Q1 1996 - Q1 2010 (% yoy)



Source: BBVA Research based on NSI

Chart 36

Spain: economy excluding construction. GDP vs. full-time equivalent employment Q1 1996 - Q1 2010 (% yoy)



Source: BBVA Research based on NSI

Nevertheless, to reduce structural unemployment and boost apparent labour productivity, the appropiate reforms are needed

Even though the Spanish economy has in the past been capable of creating jobs with GDP growth of around 1%, a growth trend like the one currently expected will not be sufficient to significantly lower Spain's persistently high rate of structural unemployment[9] (see chart 37) unless it is accompanied by structural reforms. Similarly, any change to the productive model that does not call for the implementation of measures geared towards effectively resolving the labour market's dysfunctional aspects may spark a relative increase in the demand for qualified workers, but would not guarantee the absorption of all low-skilled unemployed from declining sectors.

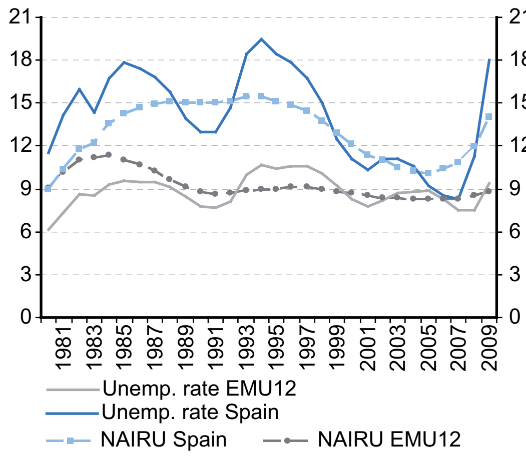
To create jobs at a pace that ensures a swift reduction in the unemployment rate, the Spanish economy needs to grow well above the 1% threshold. Only the implementation of appropriate reforms in the labour market that can chip away at the two-tier labour market, bolster the link between intra-company salary growth and productivity, and increase the efficiency and effectiveness of active labour market policies and the unemployment benefits system, would simultaneously fuel rising productivity and a relatively rapid decrease in unemployment[10](see chart 38).

According to our estimates, the implementation of these and other complementary reforms in the market for goods and services could boost the Spanish economy's growth potential to levels approaching 3% in the next 15 years. As mentioned earlier, these reforms are essential to providing incentives for job creation, for facilitating a shift to a more efficient and productive economy, and for allowing faster deleveraging both in the private and public sectors.

8: This is due, among other factors, to the fact that this industry includes civil works construction (not very labour intensive) and residential construction (highly labour intensive).
9: Even during the peak of job creation (2007), the Spanish unemployment rate only dropped to 8.3%.
10: Andrés and Domenéch (2010) document the difficulty in creating jobs and boosting productivity comparing the Okun law (the link between growth and changes in unemployment) in Spain with that of the EU15. While the relationship between the two variables has remained quite stable in Europe, in Spain the Okun law has sloped more since 1983, which implies an extraordinary capacity to reduce unemployment during expansionary phases which far exceeds the European average, even during periods of very high growth in the labour force, while, in contrast, it climbs rapidly during recessions.

Chart 37

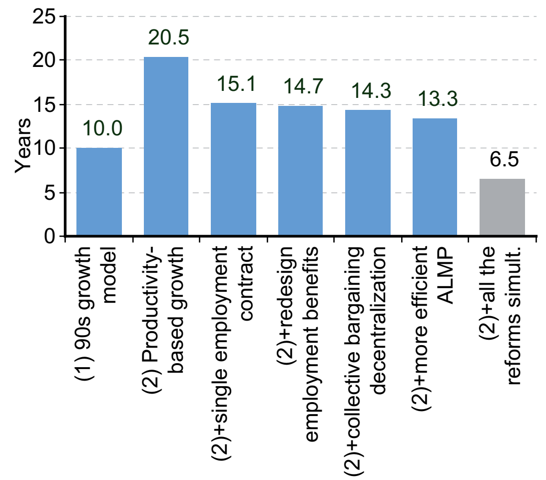
Spain vs EMU12: unemployment rate (% of active population)



NAIRU: Non-Accelerating Inflation Rate of Unemployment
Source: BBVA Research based on AMECO

Chart 38

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



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

Tables

Table 1

Macroeconomic forecasts: Gross Domestic Product

(Annual rates, %)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.4	3.0	2.5
EMU	2.7	0.5	-4.0	0.7	1.3
Germany	2.6	1.0	-4.8	0.4	1.8
France	2.3	0.3	-2.1	0.6	1.1
Italy	1.4	-1.3	-5.1	0.6	1.1
Spain	3.6	0.9	-3.6	-0.6	0.7
United Kingdom	2.6	0.5	-4.9	0.8	1.5
Latin America*	5.8	4.0	-2.5	4.6	4.0
Mexico	3.3	1.5	-6.6	5.0	3.8
LatAm5 **	7.8	5.0	-1.4	2.9	3.6
Asia	7.3	4.0	1.8	5.8	5.3
China	14.2	9.6	8.7	9.8	9.2
Asia (ex-China)	5.1	2.1	-0.8	4.2	3.8
World	5.3	3.0	-0.7	4.2	4.1

Source: BBVA Research
Publication date: 30 April 2010
*Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
**Argentina, Chile, Colombia, Peru, Venezuela

Table 2

Macroeconomic forecasts: 10Y interest rates (average)

	2007	2008	2009	2010	2011
United States	4.6	3.6	3.2	3.9	4.3
EMU	4.2	4.0	3.3	3.3	3.6

Source: BBVA Research
Publication date: 30.04.10

Table 3

Macroeconomic forecasts: exchange rates (average)

Dollars ($) per national currency	2007	2008	2009	2010	2011
US (EUR/USD)	0.73	0.68	0.72	0.78	0.84
EMU	1.37	1.47	1.39	1.29	1.19
UK	2.00	1.82	1.56	1.52	1.43
China	7.61	6.95	6.83	6.70	6.39

Source: BBVA Research
Publication date: 30.04.10

Table 4

Macroeconomic forecasts: official interest rates (end of period)

	2007	2008	2009	2010	2011
US	4.33	0.63	0.25	0.13	1.25
EMU	4.00	2.50	1.00	1.00	1.25
China	6.93	6.86	5.31	5.65	5.99

Source: BBVA Research
Publication date: 30.04.10

Table 5

EMU: Macroeconomic forecasts (Year-on-year change in %, unless otherwise indicated)

	2007	2008	2009	2010	2011
Household consumption	1.6	0.4	-1.0	0.1	0.6
Public consumption	2.3	2.1	2.3	0.9	0.5
GFCF	4.7	-0.9	-10.8	-2.8	0.6
Capital goods and other products	7.8	0.8	-15.5	-2.3	0.3
Capital goods	8.4	0.7	-17.1	-2.4	-0.2
Construction	2.3	-2.1	-7.2	-2.8	0.9
Housing	1.2	-4.7	-9.4	-4.7	-0.8
Domestic demand (*)	**2.3**	**0.5**	**-3.2**	**0.1**	**0.8**
Exports	6.3	0.8	-12.8	6.2	7.6
Imports	5.5	0.9	-11.4	4.8	6.7
Net trade balance (*)	**0.4**	**0.0**	**-0.8**	**0.6**	**0.5**
GDP mp (% yoy)	**2.7**	**0.5**	**-4.0**	**0.7**	**1.3**
Pro-memoria					
GDP w/out housing investment	2.8	0.8	-3.7	1.0	1.4
GDP w/out construction	2.8	0.8	-3.7	1.2	1.3
Employment (LFS)	2.0	0.9	-1.8	-0.5	0.3
Unemployment rate (% active pop.)	7.5	7.6	9.4	10.4	10.6
Current account balance (% GDP)	0.1	-1.1	-0.8	-0.6	-0.5
Public sector balance (% GDP)	-0.6	-2.0	-6.3	-6.6	-5.2
CPI annual average	2.1	3.3	0.3	1.0	1.2

(*) contribution to GDP growth
Source: official institutions and BBVA Research

Table 6
Spain: Macroeconomic forecasts
(Year-on-year change in %, unless otherwise indicated)

	2007	2008	2009	2010	2011
Activity					
Real GDP at market prices	3.6	0.9	-3.6	-0.6	0.7
Private Consumption	3.6	-0.6	-5.0	-0.2	0.4
Public consumption	5.5	5.5	3.9	1.4	0.2
Gross fixed capital formation	4.6	-4.4	-15.2	-8.8	-2.7
Capital goods	9.0	-1.8	-22.9	-3.8	-0.1
Construction	3.2	-5.5	-11.1	-9.4	-3.7
Housing	3.0	-10.3	-24.5	-16.5	-5.6
Other construction	3.3	-0.4	1.6	-4.3	-2.4
Other Products	3.6	-4.3	-17.3	-13.7	-2.6
Chg in inventories (*)	-0.1	0.1	0.0	0.0	0.0
Domestic demand (*)	4.4	-0.5	-6.4	-1.9	-0.4
Exports of goods and services	6.6	-1.0	-11.3	5.3	5.6
Imports of goods and services	8.0	-4.9	-17.7	-0.2	0.9
Net trade balance (*)	-0.9	1.4	2.8	1.3	1.1
GDP at current prices	7.0	3.4	-3.4	0.4	1.5
Billions of euros	1052.7	1088.5	1051.2	1055.3	1071.2
Prices and costs					
GDP deflator	3.3	2.5	0.2	1.0	0.8
Household consumption deflator	3.2	3.7	-0.7	1.8	0.9
CPI	2.8	4.1	-0.3	1.2	1.0
Compensation per employee	4.5	6.1	3.7	1.8	2.4
Unit labour cost (ULC)	3.8	4.6	0.4	-0.3	1.2
Foreign trade					
Trade Balance (% GDP)	-8.7	-8.0	-4.3	-2.8	-1.6
Current account balance (%GDP)	-10.0	-9.7	-5.4	-3.0	-1.1
Government sector					
Debt (%GDP)	36.2	39.7	53.2	63.7	69.8
Public administration balance (% GDP)	1.9	-4.1	-11.2	-9.6	-6.6
Labour market					
Active population (LFS)	2.8	3.0	0.8	-1.0	-0.7
Employment (LFS)	3.1	-0.5	-6.8	-2.7	-0.3
Change (in thousands of people)	608.3	-98.3	-1369.7	-508.0	-59.5
Full-time equivalent employment (CNTR)	2.8	-0.6	-6.7	-2.7	-0.5
Unemployment rate (% active pop.)	8.3	11.3	18.0	19.4	19.2
Productivity	0.7	1.5	3.1	2.1	1.2
Households					
Real disposable income	3.0	2.2	1.8	-1.4	-0.4
Nominal disposable income	6.3	6.0	1.1	0.4	0.5
Savings rate (% of nominal income)	10.7	12.9	18.8	17.8	17.1

(*) Contribution to GDP growth
Source: official institutions and BBVA Research

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