BBVA Research

Spain

Economic Outlook

First Quarter 2011

Economic Analysis

- Divergences in growth will determine economic policy responses around the world.
- Europe's governance problems demand a comprehensive solution.
- In Spain, growth will continue to be export-led as domestic demand will remain weak.
- The extent of recapitalisation of the Spanish financial system will be limited and will deliver a sound solvency position.
- A sense of urgency must be maintained regarding the push for ambitious structural reforms.

BBVA

Index

Closing date: 4 February 2011

1. Summary

Global growth remains strong. Having ended 2010 with a growth rate of 4.8%, the world economy is looking in healthier shape than seemed possible twelve months ago, set for only a mild slowdown to 4.4% growth in 2011 and 2012. Mainly this is because of improved prospects for the advanced economies. The short-term growth outlook in the US is stronger as fiscal adjustment has been pushed back and the big European core economies are turning in solid performances, decoupled from the struggling periphery.

The divergences within this picture have three big consequences for the global economic outlook. First, the growth gap between advanced and emerging economies will mean they will pursue contrasting macroeconomic policies. Second, the divergence in US and EU growth rates –along with financial tensions– will put downward pressure on the euro. Finally, the widening divergence in growth rates within the euro zone will create strains for the region's common monetary policy. On this last point, just as the economies of the core countries have been picking up, tensions have re-emerged in Europe's financial markets, especially in peripheral countries.

Growth in the euro zone as a whole was somewhat higher than expected in 2010, particularly in Germany which was able to profit from strong demand in emerging markets. As a result, the German economy grew by 3.6% in 2010, well ahead of early-year forecasts, although there is still little sign of this healthy export demand being passed through rising household spending. Progress in the euro zone's two other big economies, France and Italy, has been positive but less impressive. Overall the euro zone appears to have grown by 1.7% in 2010. This expansionary trend should carry on in 2011, but at a more modest pace than in mid-2010 and resulting again in GDP growth of 1.7%. Household consumption and investment will play a larger part, with a corresponding reduction in the contribution to growth of exports and public spending, impacted by the fiscal adjustment plans being applied not only in peripheral countries but also in France, Italy and Germany.

Meanwhile, the resurgence of tensions in Europe's financial markets was due to two factors. First, uncertainty about whether European institutions could get on top of the sovereign debt crisis. Second, growing doubts about the credibility of the stress tests on the financial system after it became necessary to bail out Irish banks shortly after tests had found they were well-capitalised. These two issues fed a climate of concern about the failure of some peripheral countries, including Ireland and Portugal, to meet their fiscal deficit targets and doubts about whether certain European economies could grow fast enough to sustain their debt burdens. As we discuss below, this highlights the need for a comprehensive solution, not only to resolve the current crisis but also to lay down a sound mechanism for the prevention and resolution of future crises.

In Spain, 2010 looks to have ended with an annual 0.2% fall in GDP, which implies virtual stagnation. Details of growth for the full year and the short-term trend both show weak domestic demand coupled with a push from export demand, apparently caused by the shift in fiscal policy and surprising fundamental strength of Spanish exports.

After making broad and effective use of expansionary fiscal policy in the most acute period of the financial crisis, the Spanish government launched in 2010 an ambitious program of fiscal consolidation. This process was stepped up in the second half of last year, partly in response to the rise of international financial tensions during the spring. New discretionary measures were taken and a timetable laid down for essential structural reforms that would correct the macroeconomic imbalances built up both before and during the crisis. As a result, domestic demand in 2010 was heavily impacted by fiscal policy: directly, through the progressive squeeze on public sector demand, and indirectly, through the impact on the consumption and investment decisions of private agents. Meanwhile, Spain's export growth, which has been positive since the third quarter of 2009, consolidated its role as the driver of economic recovery during 2010. Rising global demand and greater geographical diversification of sales plus continued gains in the competitiveness of Spanish goods and services underpin the results for 2010.

Looking ahead, the main forces behind economic growth for the Spanish economy look unlikely to change soon. The country needs to keep up the pace of fiscal consolidation and the public sector will therefore continue to make a negative contribution to growth throughout the forecast horizon (2011-2012). The pace of recovery in private domestic demand in the short and medium terms will continue to be hampered by weak fundamentals and the final phase of some of the private sector adjustments (deleveraging and the residential construction sector). On top of these factors, there has also been a short-term resurgence of tensions on the financial markets, which, given the Spanish economy's heavy reliance on external funding, could pose an additional downside risk to activity. Finally, the growth seen in net exports will continue to be driven by Europe's growth prospects, a euro slightly weaker than was expected three months ago, geographical diversification and further improvements to the competitiveness of Spanish exporters. Overall, we expect the pace of growth in the Spanish economy to remain modest over coming quarters with the economy growing by around 0.9% for the year as a whole. A sustained and job-creating recovery may start to be seen during the second half of 2011 with 2012 being the year when the Spanish economy gets back to around 2.0% growth, enough to generate net jobs for the first time since the crisis hit but not enough to significantly reduce the unemployment rate, unless the active population all but ceases to grow. That said, the pace of growth will be far from evenly spread across Spain's regions. Their varying levels of exposure to the economic drivers in 2011-2012, described above, will result in very mixed rates of recovery.

This scenario presents some risks and both their likelihood and possible impacts on the Spanish economy will depend crucially on the degree of progress towards the creation of institutions that guarantee an orderly resolution to the current and future sovereign debt crises in Europe. To tackle liquidity issues, Europe needs to expand the EFSF at least up to its nominal provision and, even more crucially, make it easier to use. At the same time, it needs to rigorously apply the promised rules on fiscal conditionality and structural reforms so as to reduce moral hazard on the part of governments. To defuse the solvency issues, it would be desirable to objectively determine which countries are going to be solvent once the current adjustments are complete and which countries will still be in trouble, and then take measures to reduce the debt burden of the bankrupt countries. So, a strong mechanism for prevention and resolution of future crises needs to be put in place for the long term. On the prevention front, the key issue is to avoid excessive imbalances in the public finances of single currency members or, where such imbalances exist, to ensure their funding is not under threat. Forward-looking scrutiny of fiscal positions through the fiscal semester project, the new oversight criteria for private sector imbalances (which were the root of the fiscal crisis in many countries) and the size of public sector debt (not just the deficit), strengthened and automatic sanctions and incentives to adopt appropriate economic policies, are all measures that could help avoid future crises and enhance stability throughout Europe. It would also be useful to implement fiscal rules at national level that would include a reduction in structural deficits. Regarding the rules for resolving future crises and in the interest of restoring some market discipline, it is right to define mechanisms whereby the private sector would share in the adjustment costs, but these should not be overly severe or they risk triggering contagion effects. If the preventative approach fails and it becomes necessary to restructure a country's public sector debt, reducing the present value of private investment, collective action clauses are a good option. Private participation in restructuring should be a credible threat but one that will only be applied as a last resort through mechanisms that are less drastic than simple debt writedowns. In these circumstances, restructuring by extending maturities or cutting interest rates seems the most appropriate measure.

In Spain, irrespective of the solutions adopted to create European-scale institutions, the government should maintain the sense of urgency with which it has tackled the reform process in recent months. On the fiscal front, not only have the overall targets been met but attempts have been made to provide more information and greater transparency on the execution of the budget at all tiers of government and, moreover, the Fiscal and Financial Policy Council has enhanced its credibility by moving decisively to deal with autonomous regions that missed their targets. That said, different regional governments achieved different degrees of compliance with their 2010 fiscal targets and this poses a risk. The 2011 budgets are credible in principle but, given the challenge posed by the 2011 fiscal targets, the government should be alert to any slippage and quick to clamp down.

We also welcome the new measures set in place to demonstrate the solidity of the Spanish financial system. Stricter transparency requirements for property portfolios and liquidity positions, the new Europe-wide stress tests and the Financial Sector Reinforcement Plan to accelerate increases in capital requirements are all steps in the right direction and, if implemented quickly and appropriately, should dispel current doubts about a limited part of the Spanish financial system. Immediate recapitalisation via the input of fresh private capital would enhance credibility on international markets, boost system efficiency and ease the pressure on Spain's public sector debt. Where FROB aid is unavoidable, compliance with European regulations governing competition and state aid will require rigorous clean-up and restructuring plans (which should help to solve the problem of an oversized sector), no unfair competition on price setting the professionalisation of governance bodies and other measures that would allow the FROB rapidly to exit the capital of the entities receiving bailouts.

Among other reforms needed to improve perceptions of Spain's potential economic growth, we particularly welcome the deadlines set for bringing forward proposals on the key matters of changes to the pension system and collective bargaining process.

The deal struck between the government and social partners, and which other political parties may also sign up to, while not perfect, should help improve perceptions about the long term sustainability of the pension system, particularly if the final reform includes appropriate guarantees. There is a long transition period, from 2013 to 2027, designed to give people time to make appropriate economic decisions. As a result, given the uncertainties on many fronts, the system could yet slip back into deficit before the transition is complete. The deal addresses this after 2027 through a sustainability factor under which the “system parameters” would be revised every five years to reflect changes in life expectancy, so as to guarantee its financial sustainability. It would be better if these reviews started as soon as possible, and certainly during the transition period, to avoid the pension system going into deficit before 2027 and that all variables which might affect its financial sustainability should be included in the review.

Regarding the labour market, reforms should serve not only to accelerate job creation but also to reduce uncertainty for workers –incentivising permanent contracts– and for companies –modernising the collective bargaining system. It is essential that this last reform gives workers and companies greater flexibility, ensuring that productivity gains pass through into higher wages and mitigating the impact on employment of the adjustments companies will need to make as they adapt to constantly evolving markets. The current system does not incentivize competitiveness at companies and is largely responsible for the high unemployment rates that inflict the Spanish economy. An ambitious reform of collective bargaining would help ensure that the recovery in the coming years generates more jobs than in previous cycles. More flexible and efficient negotiating processes should allow employees and companies to set wage increases based on the economic situations of firms. If this is to happen, clauses that automatically link salaries to inflation in collective agreements need to be eliminated and this should be accompanied by measures to increase competition. The medium- and long-term outcome would be to link salaries to productivity, without additional costs in terms of employment, efficiency, erosion of the purchasing power of wages, or uneven effects on income distribution.

2. International environment: decoupling under way

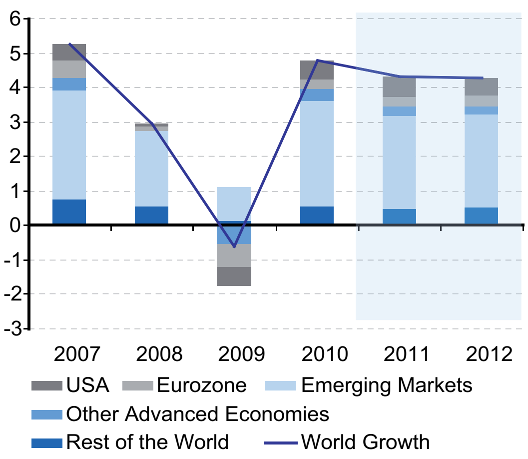
Decoupling of the world economy will intensify, both growth and policy wise

Global growth remains strong. Having ended 2010 with a growth rate of 4.8%, the world economy is set for a mild slowdown to 4.4% in 2011 and 2012, a better performance than seemed possible twelve months ago. This is because of improved prospects for the advanced economies, where (i) the short-term growth outlook in the US is looking stronger after the fiscal stimulus and (ii) the big European core economies are turning in a solid performance, decoupled from peripheral countries that are struggling with pressures from financial markets. In fact, even as tensions in Europe's financial markets worsened during the final quarter of 2010, economic activity in the region actually picked up showing –at least temporarily– a measure of decoupling also between the real and financial economies. In general, the growth model for the global economy is virtually unchanged. The main driver remains the emerging markets, led by Asia, particularly China and India (Chart 1), while the developed world continues to lose ground, more so in Europe than in the US.

Taken as a whole, these decouplings have three big consequences for the future. First, the divergence in growth between advanced and emerging economies will mean continued divergence in their respective macro-economic policies too. Monetary policies remain massively expansionary in the US and Europe, encouraging investors to seek out yield elsewhere (in emerging markets and, increasingly, in commodities). At the same time signs of overheating are starting to appear in some Asian and Latam countries. This is driving authorities in the countries affected to consider tightening monetary policy earlier than expected to head off incipient symptoms of inflation, especially in Asia (Chart 2). The resulting incentives for capital inflows to emerging economies will intensify the dilemmas already facing policy makers in both continents: should they tighten policy to ensure a smooth transition or seek to avoid sharp and sudden strengthening of their exchange rates?.

Chart 1

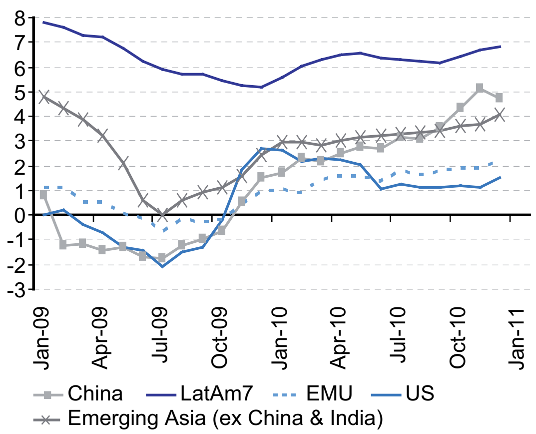
Global GDP growth and contributions (pp)



Source: BBVA Research

Chart 2

Inflation (% yoy)



Source: BBVA Research and Datastream

Second, the decoupling of US and EU growth –along with financial risk– are putting downward pressure on the euro and, perhaps more importantly, will continue to focus market attention on the EU's problems in achieving growth amid high levels of public debt. This is one of the key reasons –the others are the differing scale of central bank programs to buy government debt and pressures on Europe's economic governance– for markets' muted response to the latest delays in US fiscal consolidation plan. The contrast between this lack of reaction and the punishment exerted on some European countries could not be sharper.

Finally, the increased decoupling seen within the euro zone is starting to put pressure on the region's collective monetary policy, already torn between incipient risks of inflation, especially in the core states, and the need to continue supporting financial stability, especially –but not only– in peripheral economies.

Growth heads up in the main advanced economies, but fragilities persist. The possibility that the US could slip back into recession, which we always viewed as unlikely, has now dissipated, but the risk of rising long-term interest rates has come to the fore

As we expected, the US did not slip back into recession and the prospect of it doing so in the future has dwindled considerably since last summer. This shift in sentiment is down to four fundamental factors. First, better macro data toward the end of 2010 showed that household consumption was proving more resilient than expected. Second, the decisive measures taken by the Federal Reserve, implementing a second round of quantitative easing (QE2) supported the price of debt in particular and assets in general. Thirdly, dissipating uncertainty and rising corporate confidence should favour investment. Finally, perhaps the most important point, the approval of a new fiscal stimulus package at the end of 2010, represents a major push toward reactivating economic growth. As a result, we have raised our 2011 growth forecast by 0.7 percentage points to 3%.

However, weaknesses remain. Property markets are still fragile and could spring unwelcome surprises. Household incomes are still weak as economic recovery remains too slow to cut unemployment significantly. Also, lending growth and securitisation channels remain frail. While none of these factors is enough to derail recovery, we continue to see a scenario where any additional pressure could damage the economy. For now, the outlook of gradual economic recovery with low inflationary pressure on the demand side will ensure monetary policy remains expansionary for an extended period.

Nor should we forget the lessons of the sovereign debt crisis in Europe. The launch of the new fiscal stimulus late in 2010 has given new impetus to growth in the short term at a time when fears of a relapse into recession were being raised. But the solidity and persistence of the factors that stopped bond markets to react negatively to the delay in the US fiscal consolidation plan should not be overstated. Central bank bond buying and tensions in Europe (as well as a flight-to-quality to US government debt) are factors that will inevitably vanish in the medium term. Before this happens, the US will need to show its clear commitment to fiscal consolidation or, if not, it will face a sudden jump in long-term interest rates. Rating agencies have already started to flag up this risk. There is time to address it, but talks and plans need to get under way as soon as possible to ease long-term fiscal concerns.

Economic and institutional reforms in Europe will be key to resolving the financial crisis

Since October 2010, financial tensions have returned to Europe (Chart 3), especially to its peripheral countries. Worries about both fiscal sustainability and losses in the financial sector resurfaced, driving up sovereign debt spreads and putting pressure on state funding. However, unlike in May, there was only limited contagion to other European countries and beyond the EU's borders.

The rise in financial market tensions was mainly due to two factors. First, widespread uncertainty in markets about whether Europe's institutions would be able to tackle the sovereign debt crisis. This increased the tension among private investors guarded at the suggestion that they would have to take up some of the losses from possible restructurings after 2013 and that, in all likelihood, there would have to be cuts on existing debt to restore sustainable budgets. Second, growing doubts about the credibility of the stress tests on the financial system, after it became necessary to bail out Irish banks shortly after tests had found they were adequately capitalised. These two issues fed into a climate of concern about whether some peripheral countries, including Ireland and Portugal, could meet their fiscal deficit targets and whether some European economies could grow fast enough to sustain their debt burdens.

The fragile recovery in financial markets since last summer shows they are increasingly focused on the problems of solvency affecting sovereign debt rather than merely worried about liquidity. This in turn highlights the need to put in place a comprehensive solution, not only to resolve the current crisis but also to lay down a sound mechanism for the prevention and resolution of future crises. On the prevention front, Europe needs closer fiscal coordination, providing mechanisms that can absorb any tension in specific countries, and sharper scrutiny of fiscal and macro-economic issues (including the build-up of imbalances in the private sector). As for crisis resolution measures, the continent needs a clear and transparent mechanism that spells out who will take the losses, thereby avoiding the excessive market volatility that uncertainty on this point inevitably causes, even if at this stage it is more important to establish an appropriate transitional mechanism.

The financial crisis in Europe's periphery had no major impact on activity in the euro zone's large states, which will continue to grow at a modest pace in 2011

As already mentioned, the financial contagion from the latest episode of crisis has been fairly limited, particularly among the leading European countries, as growth across the EMU as a whole was somewhat stronger than expected.

Recovery has been stronger than expected in Germany, which has benefited from firm demand for its exports in emerging markets, especially Asia and especially for capital goods. Exports rose fast in 2010 encouraging investment, which made a major contribution to growth in the third quarter of 2010. Overall, the German economy grew by 3.6% in 2010, well ahead of early-year forecasts, and this meant that the fiscal position was far better than anticipated. What has not happened yet is any clear pass-through from external demand to domestic consumption. Despite falling unemployment and rising confidence, retail sales are flat and national accounts figures for private consumption are still not confirming any rise in domestic demand that would make the recovery better balanced. Our forecasts for 2011, while still more modest than the results for 2010, do foresee a more balanced expansion, helped by stronger employment and firmer investment demand as capacity utilisation nears its limits and companies start to add capital. Uncertainty over the euro zone as a whole and the impact that a poorly resolved financial crisis could have on the German banking system are the main downside risks to the German economy.

Progress in the euro zone's two other large economies, France and Italy, has been positive but less impressive. France had held up better than Germany in the early quarters of recovery, thanks to resilient household consumption. It achieved a well-balanced recovery throughout 2010, with modest growth in consumption and investment and strongly rising exports, but with a lesser contribution from net trade reflecting a high level of imports. That said, growth was considerably slower than in Germany (1.5% vs 3.6%). In Italy, recovery was even more sluggish (1.1% in 2010) with a dynamic export sector but substantially weaker private consumption.

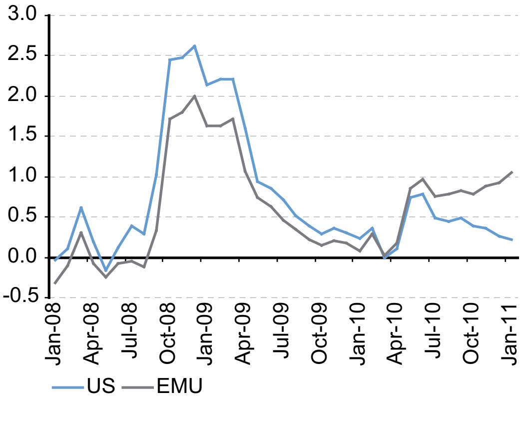
The euro zone as a whole grew by 1.7% in 2010, with private and public consumption both rising 0.7%, but investment in negative territory (partly due to the construction sector but also affected by a base effect present from late 2009). Exports grew strongly, up by nearly 10%. But so too did imports, largely as part of inventory rebuilding which contributed a big share of GDP growth (more than a percentage point). It is clear now that over the year as a whole, external demand played a bigger role than expected and probably the rebound in activity after the 2009 slump had been generally underestimated.

The growth trend should carry on in 2011, but at a more modest pace than in the middle of 2010 which means that euro zone GDP should again grow by 1.7%. Household consumption and investment will play a bigger part with a corresponding dip in the contribution of exports and public spending, impacted by the fiscal adjustment plans being applied not only in peripheral countries but also in France, Italy and Germany (which have put off until 2011 their efforts to adjust the structural deficits that peripheral countries were forced to tackle last year). Germany's growth will continue to outstrip that of France and Italy, but the gap will narrow. The main drivers of growth will again be sustained export demand and a general climate of confidence as systemic risk from the financial system gradually dissipates. Fiscal policy will have a contractive effect, although this will be modest for the euro zone as a whole.

Growth in European peripheral countries will continue to lag well behind the euro zone average, due to their fierce fiscal adjustment programmes, higher, though decreasing, interest rates (particularly for Greece, Ireland and Portugal) and the ongoing adjustments in the real state sector, especially in Ireland and Spain,. So, while Greece will remain in recession, Portuguese GDP will fall moderately and the Irish economy will probably stagnate, although with major uncertainties given the likely change of the party in government and the yet inconclusive resolution of its banking crisis.

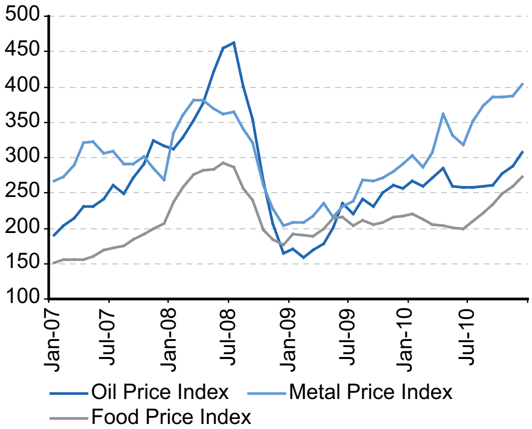
Nevertheless, this decoupling between the financial pressures on peripheral countries and real economic activity in Europe will not last long unless there is a fast agreement on comprehensive reform to the euro zone's governance and unless countries continue to bring forward economic reforms that will ease their fiscal vulnerability, restructure financial systems and boost potential growth. The agreement to be reached at the next meeting of the European Council will be crucial here. This is the biggest risk facing the European economy as a whole.

Chart 3
BBVA financial stress index



Source: BBVA Research

Chart 4
Commodity prices



Source: BBVA Research

Commodity prices will stabilise but inflationary risks are on the rise in emerging economies, which will continue growing strongly

Commodity prices have experienced a general rise in recent months, taking some metals to all-time highs (Chart 4). This rally is consistent with what seems to be the start of a long-term upward trend in raw material prices driven by rising demand from emerging economies, even though there are other short-term factors at play that have fed this latest surge, at least in some types of commodities. For instance, the sharp jump in food prices during the last two months is largely the result of short-term factors affecting supply (bad weather), which should ease off in 2011. Also, taking advantage of the plentiful environment of global liquidity, investors have been attracted into commodities as an asset type, boosting financial premia across the board.

From now on, we expect commodity prices in general to stabilise around their current levels. In the case of food, this will happen as harvests get back to normal in 2011. In the case of metals, the rise in stocks will start to affect prices. Only in the case of oil we anticipate a tighter market that will continue to drive prices slightly upward in 2011 but which will gradually ease back. The subsequent easing will be helped by a likely respite in Europe's financial tensions, which should divert investment flows away from commodities and toward other assets with lower risk premia. That said, the risks still have an upside bias as strong Asian demand will continue to put pressure on prices over the medium term.

The rise in the prices of commodities has been part responsible for the rise in inflation seen across emerging economies at the end of 2010 (Chart 2). Specifically, the increase in food prices has directly and severely impacted inflation in a number of countries (especially in Asia) and risks contributing to generalised inflation. However, looking ahead, the expected stabilisation of food prices will tend to diminish this as an input to inflation figures. While price risks have also risen in developed countries, these are less severe than in the developing world since food prices make up a smaller share of the CPI, they have ample spare productive capacity and expectations that inflation will remain controlled will help limit inflationary pressures.

More worrying for emerging markets is the sharp growth and heavy inflows of capital to Asia and Latin America. These are starting to generate risks of overheating, evidenced by a rise in inflation but also in a rapid expansion of credit and soaring asset prices. We expect Asian economies to continue growing strongly. In our view, the authorities will nonetheless be able to steer them to a soft landing and avoid overheating, although risks are greater than they were three months ago. Powered by domestic demand and high commodity prices, Latin America will grow strongly in 2011, converging towards a potential growth rate of around 4% across the region. As already mentioned, the main challenge facing both regions will be managing the policy dilemmas posed by heavy inflows of capital. We expect most countries to continue tightening monetary policy while simultaneously putting in place ever stricter administrative controls to inhibit such flows and taking prudential steps to cap credit growth, particularly in Asia.

3. Growth outlook for the Spanish economy

In Spain, 2010 appears to have ended with an annual 0.2% fall in GDP, effectively stagnation. The breakdown of growth for the full year and the short-term trend both show weak domestic demand coupled with a push from export demand, apparently caused by the changes in the tone of fiscal policy in Spain and the euro zone and by the fundamental strength of Spanish exports.

After making extensive and effective use of expansionary fiscal policy in the most acute period of the financial crisis, the Spanish government in 2010 launched an ambitious program of fiscal consolidation. This process was stepped up in the second half of last year, partly in response to the rise of international financial tensions last spring. New discretionary measures were taken and a timetable laid down for essential structural reforms that would correct the macro-economic imbalances accumulated both before and during the crisis. As a result, domestic demand in 2010 was heavily impacted by fiscal policy, directly, through the progressive squeeze on public sector demand, and indirectly, through the impact on the consumption and investment decisions of private agents. During the first half of the year, in particular, aware that much of the fiscal stimulus was about to end, households brought forward their consumption giving rise, for instance, to the first positive quarterly values for private consumption since the crisis began. Once into the third quarter there was a downside correction reflecting the new tax regime and new policy on public spending (rise in VAT, end of Plan 2000E and wage cuts for civil servants). Finally, discounting the changes to fiscal policy, domestic demand began growing again in the year's final quarter, although still at a slow pace due to the weakness of its fundamentals.

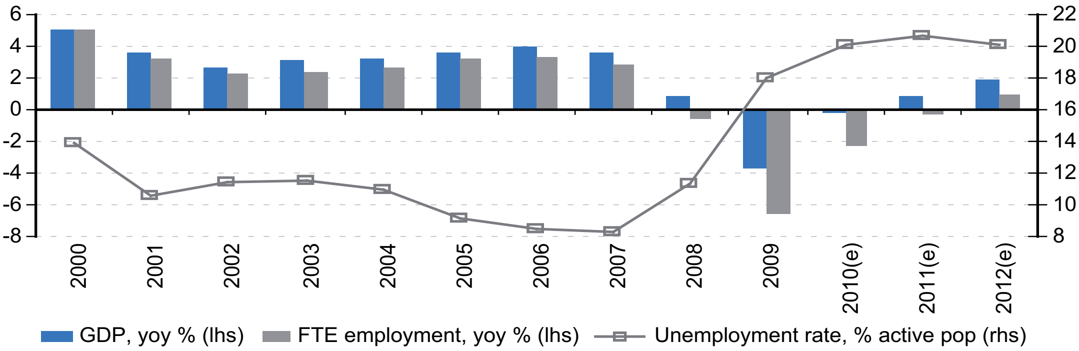
Meanwhile, Spain's net trade, which had been positive since the third quarter of 2009, consolidated its role as a permanent driver of economic recovery during 2010. Rising global demand and geographical diversification together with continued gains in competitiveness of Spanish exports support the results for 2010. That said, in parallel with the adjustment of public finances in the Spanish economy, the end of fiscal stimuli across Europe also affected the performance of Spanish exports, albeit modestly, prompting a short-lived dip in 3Q10. Having discounted fiscal changes in Europe and Spain, Spanish exports were back on their sustained growth trend in the fourth quarter, underpinned by strong fundamentals, such that net trade made a positive contribution to GDP growth.

Looking ahead, the growth profile of the Spanish economy looks unlikely to change suddenly. The country needs to keep up the pace of fiscal consolidation and the public sector will therefore continue to make a negative contribution to growth throughout the forecast horizon (2011-2012). The pace of recovery in private domestic demand in the short and medium term will continue to be hampered by weak fundamentals and the final phase of private sector deleveraging. On top of this, we are also seeing a short-term resurgence of international financial stress, which, given the Spanish economy's heavy reliance on external funding, is a downside factor. Finally, the growth in net trade will continue to be driven by geographical diversification and further improvements in competitiveness, despite the short-term impact of energy prices. In the absence of significant pass-through from financial stress to the real economy, improving expectations for growth worldwide and in Europe, compared to those anticipated in our last report[1], coupled with a slightly weaker euro than we expected at the time, will contribute to a positive performance of Spanish exports. Overall, we expect the pace of growth in the Spanish economy to remain modest over coming quarters, with the economy growing by around 0.9% for the year as a whole. A sustained and job-creating recovery will start during the second half of 2011, with 2012 being the year when the Spanish economy gets back to around 1.9% growth, enough to generate net jobs for the first time since the crisis hit but not enough to significantly reduce the unemployment rate, unless the active population all but ceases to grow (Chart 5).

1: See Spain Economic Outlook for 4Q10.

Chart 5

Spain: GDP, employment and unemployment rate



(e) Estimate.
Source: BBVA Research based on INE data

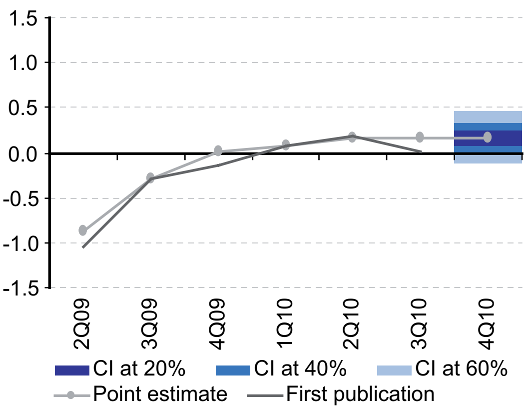
That said, the pace of growth will be far from evenly spread across Spain's various regions. Their varying levels of exposure to economic drivers in 2011-2012, described above, will result in a widely heterogenous recovery, mainly in 2011. In 2012, once differences in imbalances start to correct, we are likely to see a slight reduction in the dispersion of growth rates.

After a pause in the third quarter, the Spanish economy returned to growth in the last quarter of 2010

Until official data is released, preliminary economic indicators show GDP growth of around 1 or 2 tenths of a point in the fourth quarter 2010. Short-term GDP forecasts using the MICA-BBVA[2] model suggest that growth was again sluggish in the fourth quarter, at around the levels seen in the first half of 2010 (Chart 6), which would mean GDP for the full year shrank by around -0.2%. That said, and although these forecasts show the economy picking up again after stalling in 3Q10, two points need to be made. First, the recovery of the Spanish economy remains weak and activity is still effectively stagnant. Second, even though forecasts have already discounted much of the squeeze on private domestic demand from fast-track fiscal consolidation, Spain's weak fundamentals, suggested by the partial indicators for spending and investment during the quarter, mean we can only look for a less negative trend rather than positive growth. As a result, the quarterly improvement in GDP will probably be due to the positive contribution of net trade (Chart 7).

Chart 6

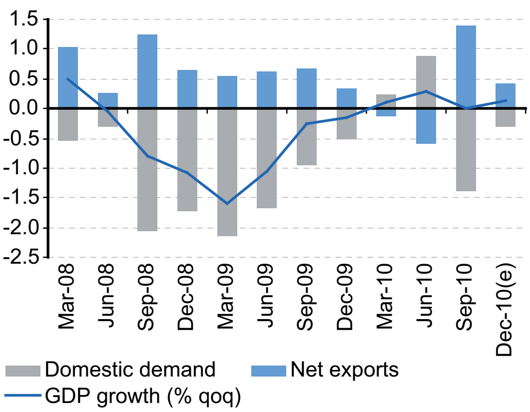
Spain: GDP growth forecasts using MICA-BBVA model (% qoq)



Note: Last estimate for 4Q10: 4 February 2011.
Source: BBVA Research

Chart 7

Spain: contributions to quarterly GDP growth (pp)



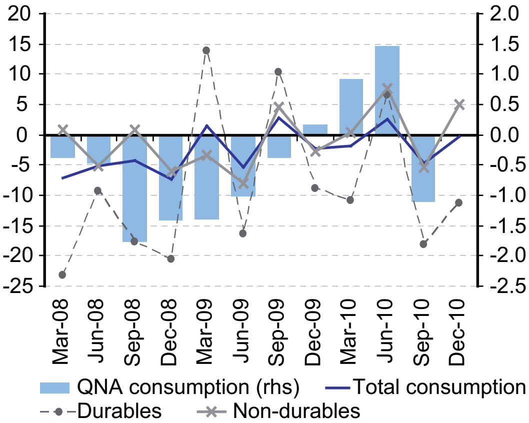
(e) Estimate.
Source: BBVA Research based on INE data

2: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting", BBVA WP 10/21.

Discounting the shift in tone of fiscal policy, private demand was virtually stagnant in 4Q10

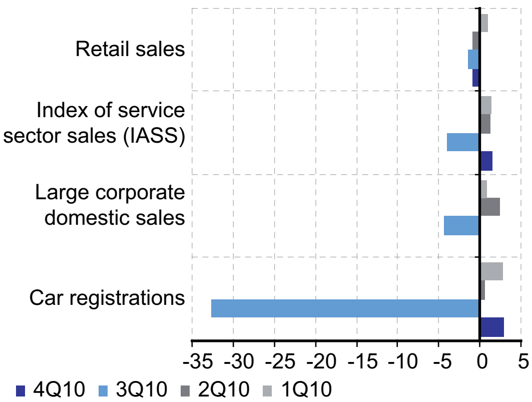
The decline in household spending during 3Q10, prompted by the early July VAT rise and the withdrawal of the fiscal stimulus (Plan 2000E), came to a halt in the final quarter of the year, with spending indicators showing a mixed performance (Chart 8). The rise in car registrations and consumption of services contrasts with a fall in sales at retailers and large corporates (Chart 9). As a result, both BBVA's synthetic consumption indicator and our coincident consumption indicators model (CCIM-BBVA) point to stable spending in 4Q10. Fourth quarter consumer data brings to a close a year dominated by the impact of fiscal consolidation on private spending. Tax rises and the end of Plan 2000E incentivized consumers to bring forward their purchases –especially of durable goods– in the first half of the year and led to the slump in spending during 3Q10. Overall, final consumer spending by households rose by around 1.1% in 2010, a significant improvement on the previous two years (-0.6% in 2008 and -4.3% in 2009).

Chart 8
Spain: final household consumer spending and availability of consumer goods



Note: SWDA data, quarterly averages, % qoq
Source: BBVA Research based on Finance Ministry and INE data

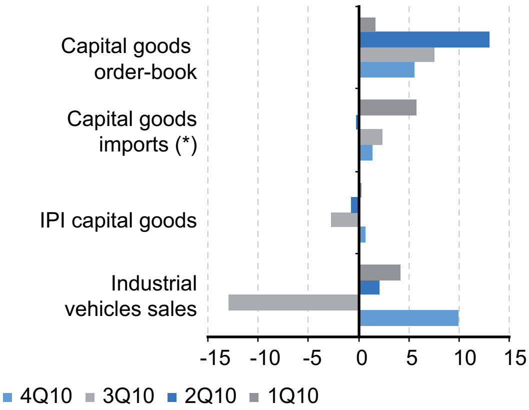
Chart 9
Spain: consumption indicators (SWDA, % qoq)



Note: IASS and Large corporate domestic sales: December forecasts
Source: BBVA Research based on INE, AEAT and ANFAC data

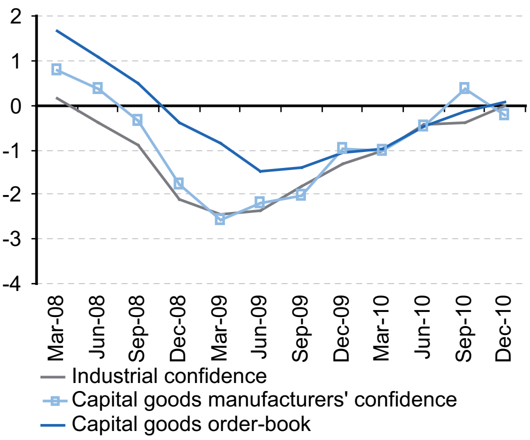
As for business investment, economic data for the fourth quarter indicates this item again fell, albeit less sharply than in 3Q10. However, signals remain mixed, particularly on capital investment. Good news included a recovery in registrations of industrial vehicles (Chart 10) after the steep decline of 3Q10, due to the end of fiscal stimulus measures similar to those that drove spending on private vehicles in 1H10. Bad news included a slump in industrial confidence measured by producers of such goods, which had held up throughout 3Q10 (Chart 11) only to drop back below its long-term average in the final quarter. On balance, our synthetic capital investment indicator suggests a contraction of close to 1% qoq in 4Q10 (-5.2% qoq in 3Q10). So, although the current adjustment in the construction sector has continued to drag down this investment item, strong export momentum coupled with renewed spending on transportation equipment should mean 2010 ends with growth of around 1.5%, compared to the near 25% fall seen in 2009.

Chart 10
**Spain:
Investment indicators (% qoq)**



* Data to November 2010
Source: BBVA Research based on official data

Chart 11
**Spain:
industrial confidence (normalised data)**

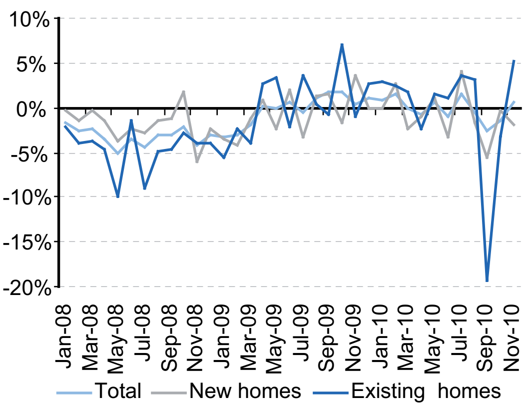


Source: BBVA Research based on European Commission and MICT data

Staying with investment, the performance of the property market in the fourth quarter 2010, based on data available at the time of publication, could have been worse than expected at the start of the quarter. The rise in VAT followed by the end, as from January 2011, of government tax breaks for home purchasers incentivized demand for property last year. However, the impact of the tax changes was expected to be greater on acquisitions made in 4Q10. On average, monthly growth in residential sales during October and November, adjusted for seasonal and calendar factors, was negative and more severe than the average fall in the previous nine months (Chart 12). So, expectations of further corrections to property prices and the undertakings by some autonomous regions to maintain their share of the home credit for all taxpayers irrespective of income, seems to have mitigated the effect of homebuyers bringing forward their purchases seen throughout the year.

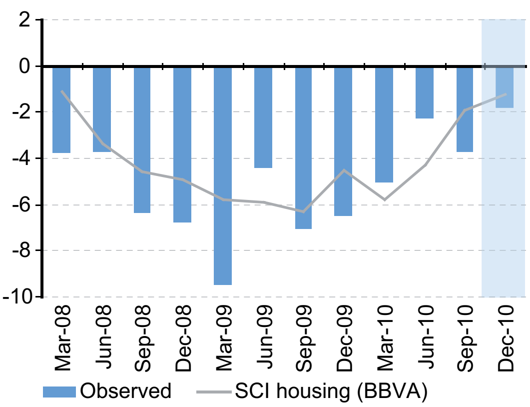
Meanwhile, residential activity in the year's fourth quarter also fell short of expectations. New building permits granted in October and November prompted downward revisions to forecasts for 4Q10 and the whole year (92,000 permits). Although supply in 4Q10 contracted more sharply than in 3Q10, which has implications for investment in coming months, the pace of decline seen since mid-2009 eased, directly reducing the fall in residential investment. The result was that residential investment shrank again in the fourth quarter but less sharply than in the third. Residential investment in 4Q10 looks to have fallen by just under 2.0% qoq (Chart 13) giving a full-year contraction for 2010 of around 17.7%.

Chart 12
**Spain:
home purchases by type (% mom, SWDA)**



Source: BBVA Research based on INE data

Chart 13
Spain: investment in residential construction and BBVA synthetic consumption indicator SCI-housing (% qoq)

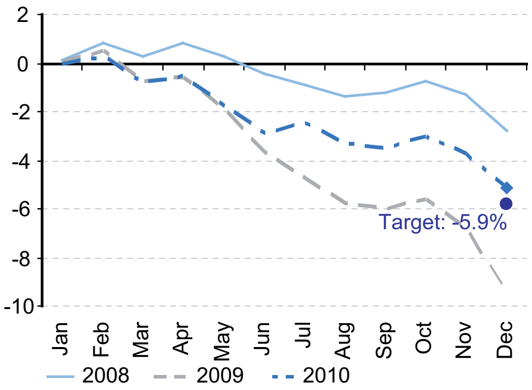


Source: BBVA Research based on INE data

Data on budget execution, consistent with the reduction of public sector demand, suggests that autonomous regions as a whole have met their deficit targets

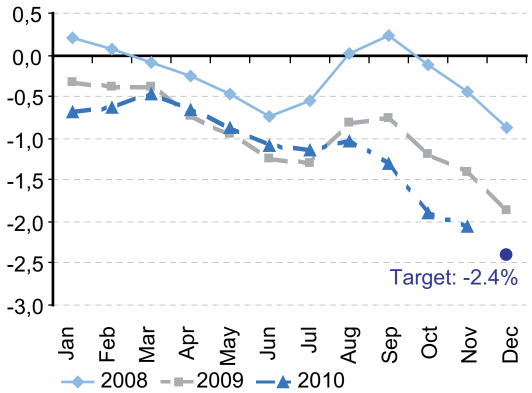
End-2010 data released by the government confirms that it has hit its stability target with room to spare. This should allow it to reach its 9.3% of GDP target for the deficit across all tiers of government. Although we have no breakdown as yet of the end of the year data, such result implies an unexpectedly strong performance in terms of tax revenues, as factors such as the normalisation of VAT revenue, the rise in the marginal rate and the end of the EUR 300 personal income tax allowance more than made up for slowing domestic demand. Budget compliance by autonomous regions in 3Q10 resulted in a combined deficit of 1.24% of GDP, leaving a margin of 1.2pp which should be enough to ensure they finish the year near target (-2.4%). In light of subsequent information[3] and the scanty data on the outturn of regional budgets in November, the autonomous tier of government continues to pose the biggest threat to the budget deficit target. However, any slippage should not go much beyond -2.4%. Even so, the broad success of the fiscal adjustment plan and control measures taken by the central government indicate the 2010 deficit for all tiers of government will be around 9%.

Chart 14
Central government: non-financial balance (cumulative annual % of GDP)



Source: BBVA Research, based on Ministry of Economy and Finance data

Chart 15
Autonomous regions: non-financial balance (cumulative annual % of GDP)*



* Based on budgetary outcomes of seven regional governments, which jointly represent 53.6% of Spanish GDP
Source: BBVA Research based on autonomous region data

So, the progress toward rebalancing public finances, largely driven by the adjustment to current spending, has been accompanied by a steady moderation in public sector demand in real terms. In consequence, as set out in the breakdown of the national accounts, after expanding 5.8% and 3.2% in 2008 and 2009, respectively, public spending was virtually flat in 2010 as a whole, a result that is only comparable with the 0.6% growth seen in 1994 when the Spanish economy was undergoing a similar process of fiscal consolidation. In a similar vein, investment in non-residential construction probably shrank by around 6.7% in 2010, although part of this would have been due to, besides public sector cuts, the sharp adjustment currently undertaken by the private construction business.

Once again, net foreign trade contributed positively to Spanish economic growth

Goods and services exports slowed down in the 3Q10, partly due to the end of the European fiscal stimulus and a slight appreciation of the euro. However, this impact was short-lived and opened the way for a recovery in 4Q10 with growth estimated at 1.0% qoq. The indicators available to date, corresponding to the exports of goods in the balance of trade, anticipate that exports grew by 1.4% qoq (Chart 16), slightly less than forecast in the last edition of this report[4]. Similarly, available indicators on services exports point to a favourable trend in inward tourism. In 4Q10 the number of travellers coming to Spain maintained the uptrend of previous quarters. Inflows of foreign tourists dipped by 4.6% yoy in December, partly as a result of the strike by air traffic controllers, but the smoothly rising trend seen over the first three quarters was ultimately sustained through the fourth. Note, here, that December's disruption to air travel had more to do with flights leaving Spain than with tourists arriving (it is low season) and that most domestic travellers found alternative means of transportation. Even in

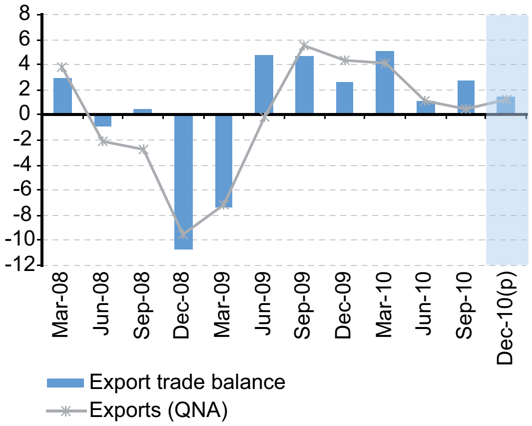
3: Mainly, the disclosure of a EUR 7 billion deficit by the Generalitat de Catalunya, more than a percentage point short of its target of stability.
4: See Spain Economic Outlook for 4Q10.

these circumstances, there was a strong recovery in foreign tourism, evidenced by a jump in numbers of foreign travellers booking into hotels for 4Q10 (+1.4% qoq SWDA) and for the year as a whole (+11.9% yoy). In 2010, travellers staying in hotel accommodation rose by 6.5%, to 82.2 million. The improving international environment helped boost foreign visitor numbers by 11.9% over the year, while slack domestic demand meant that Spanish tourist numbers rose by just 2.7%.

Regarding imports, balance of trade figures show goods imports falling slightly in 4Q10, in line with the forecast trend for private consumption and projected growth in total imports from the national quarterly statistics. As a result, net trade contributed positively to GDP growth in 4Q10. Overall, 2010 was notable for the strength of Spain's external sector supporting economic activity and contributing around 1% to GDP growth, in the context of a recovering global economy, gains in competitiveness and increasing diversification of the destination countries for Spain's exports, particularly to the EAGLEs[5] (Chart 17).

Chart 16

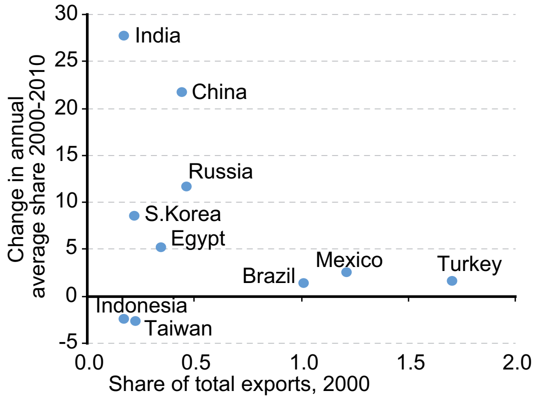
Spain: exports of goods in volume (% qoq, SWDA)



Source: Source: BBVA Research based on INE and Customs data

Chart 17

Spain: exports to EAGLE countries. Weight in 2000 and change 2000-2010



Source: BBVA Research based on Datacomex

Finally, balance of payments data released so far for the final quarter of the year indicates a modest reduction in the current account deficit, led by the adjustment of the deficit of the goods balance and the good performance of the surplus in services. So, although the increase in crude prices during the fourth quarter will probably impact the energy deficit, we can still expect 2010 to end with a current account deficit of 4.5% of GDP, about 0.9 tenths of a point below the 2009 deficit, thereby helping to ease the external funding requirements of the Spanish economy[6]

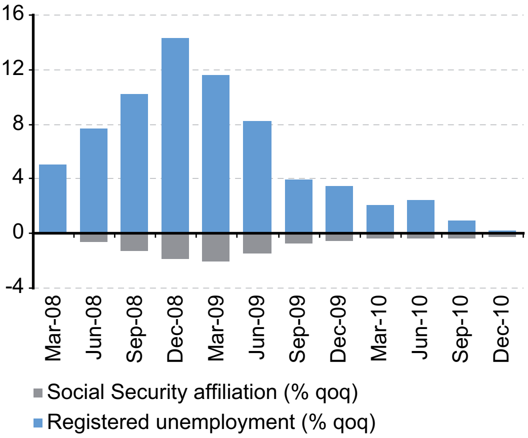
5: Emerging and Growth-Leading Economies, a category recently coined by BBVA Research. For further details see BBVA's eagles, in our Economic Watch of November 2010.
6: See table 1. The Spanish economy has heavy external funding requirements, but the adjustment process is consolidating, page 19

In 4Q10 the job market continued to correct at the pace set in previous quarters

Labour market indicators for 4Q10 show no change (Chart 18). Adjusting for seasonal effects, the increase in unemployment slowed significantly, although the economy was still unable to create jobs. Whereas social security contributor numbers fell at virtually the same pace as in 3Q10 (-0.2% qoq SWDA compared to -0.3% in 3Q10), unemployment rose significantly more slowly at a seasonally-adjusted 0.2% qoq according to SWDA (from 1.0% qoq in 3Q10). The Labour Force Survey (LFS) for 4Q10 confirmed the same trend. Employment fell in line with expectations, mainly for seasonal reasons (-138,700 jobs gross, -52,700 SWDA). Despite the slight fall in active population (-16,700), job destruction –concentrated in temporary employees and construction workers– prompted an rise in unemployment to 20.3% and a fall in the proportion of temporary employment to 24.8% (Chart 19).

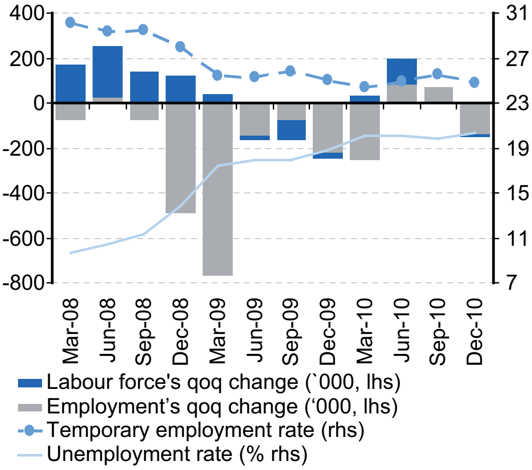
The LFS fourth quarter figures were the last in a year that saw the approval of Law 35/2010, on 17 September, introducing urgent labour market reforms, which was a big advance on previous employment law. Its medium and long term impact on the extent of segmentation of the labour market and job creation will, however, be limited[7]. Over the full year, unemployment rose to 20.1% as the economy destroyed 432,000 net jobs, 40.5% of them permanent and 55.0% in the construction sector.

Chart 18
Spain: Social Security affiliation (average) and registered unemployment*



*SWDA data
Source: BBVA Research based on MTIN (Ministry of Labour and Immigration) data

Chart 19
Spain: labour market data



Source: BBVA Research

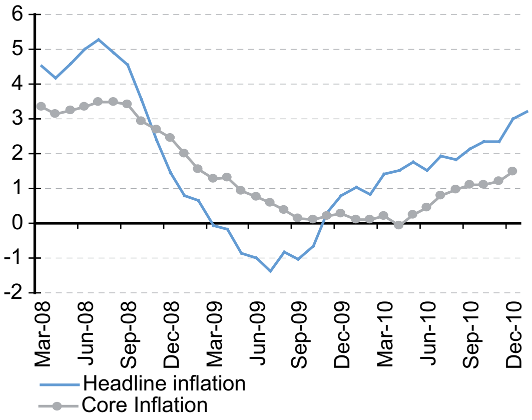
Prices rose faster toward the end of the year as a result of the transitory increase in crude prices

After a third quarter when VAT increases had not been fully passed on to consumer prices, the year's final quarter brought a transitory spike in the price of crude and another rise in special taxes (particularly on tobacco). Headline inflation rose to 3.0% yoy late in the year (Chart 20), which therefore ended with average yoy inflation of around 1.8%. Core inflation, meanwhile, edged up only slowly, to 1.5% yoy in December taking the 2010 average to 0.6%. Consequently, we have still seen no second-round effects owing to the weakness of domestic demand, although inflationary pressures from energy prices are still present in the short term. Also, since the increase in the price of crude is likely to be short-lived and many of the price increases in 2010 reflected tax changes that do not affect exports, inflation did no significant harm to Spain's international competitiveness. Although the inflation differential to the euro zone average was 0.7% in December for headline inflation (Chart 21) the core differential –positive for the first time since January 2009– remains relatively low.

7: See Spain Economic Outlook 3Q10 for an analysis of Law 35/2010

Chart 20

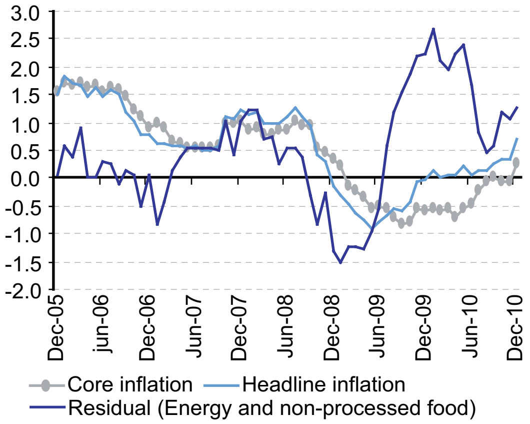
Spain: inflation (% yoy)



Source: Source: BBVA Research based on INE data

Chart 21

Spain-EMU inflation differential (pp)



Source: : BBVA Research based on Eurostat data

Outlook 2011-2012: adjustments continue. Sustained recovery should get under way in the second half of this year

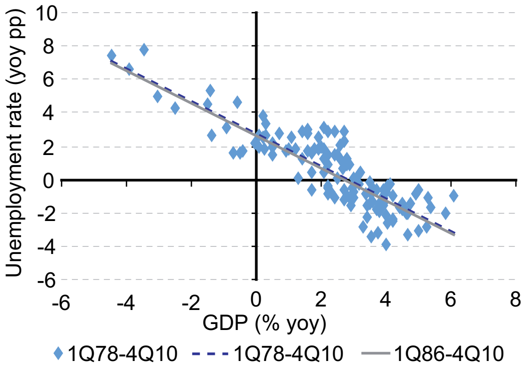
As we said in the introduction, the Spanish economy's recovery is likely to remain weak over the short and medium term. GDP is expected to continue showing moderate qoq growth, which will put growth for 2010 at around 0.9% The second half of 2011 should bring the start of sustained recovery and the first signs of job creation. But it will not be until 2012 –when the economy should again be growing at around 1.9%– that employment will start to grow in net terms for the full year.

Although our forecasts indicate net job creation will begin in the second half of this year, SWDA unemployment will continue to increase throughout 2011 and fall only slightly in the second half of 2012. Chart 23 shows that the relationship between GDP growth and the change in unemployment (Okun's law) is clearly linear. Assuming the Okun's law has not changed in the last three decades, the economy would have to grow at around 2.8% to start reducing the unemployment rate, a figure that has fallen to 2.6% since Spain joined the EEC. However, the relationship between joblessness and growth has not been stable over time. Looking at a 40 quarter window, the elasticity of unemployment to economic growth rose –in absolute terms– between the end of the 1970s and the crisis of the early 1990s. After the recession and legalisation of the workplacement agencies in 1994, the relationship rose continuously until the current crisis hit and reduced it by 0.25 points (Chart 23)[8]. The level of GDP growth required to reduce the unemployment rate fell from over 4.5% yoy (1.3% qoq) in the late 70s to 2.0% yoy (0.4% qoq) by the mid-90s. From then on, it rose continually until the onset of the current crisis.

All in all, it seems likely that over the next two years the growth rate required to reduce unemployment will be lower than the Okun's law currently suggests as, given the unfavourable demographic trend projected by the INE[9] and expectations that transitions from inactivity to activity will barely change, the active population is not expected to grow significantly. Our forecasts suggest that labour market participation will grow by less than 0.5% on average in 2011 and 2012. In light of this unpromising demographic outlook, further labour market reforms could take the unemployment-reducing growth threshold below 2%.

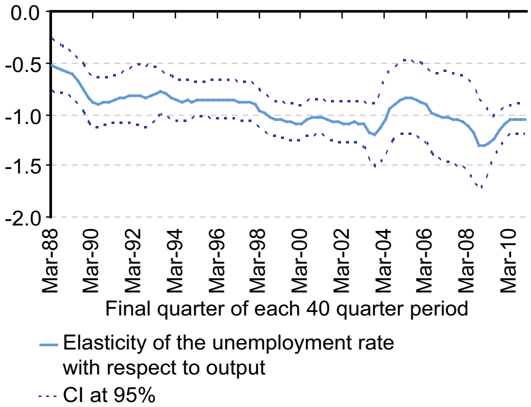
8: Unemployment appears to show a degree of inertia and the effect of changes to economic growth on the unemployment rate linger on through time. Specifically, time should be shifted back two periods for the change in unemployment and one period for GDP growth. When estimating Okun's law for this dynamic, it transpires that the long-term elasticity of the unemployment rate to GDP is double (-0.8) that of contemporary elasticity (-0.4).
9: Latest population projections for the short term 2010-2020 (available here) show that while the total population will grow by 0.7% between 2010 and 2012 the working age population (between 16 and 64) will fall by 0.4%.

Chart 22
Spain: GDP growth and change in unemployment rate



Source: BBVA Research based on INE data

Chart 23
Spain: change in Okun's law, 40-quarter window



Source: BBVA Research based on INE data

Regarding the composition of growth, the economic scenario for 2011 and 2012 depends on a number of factors. First, the continuation of current fiscal policy given the need to press ahead with the process of consolidating public finances. Second, gradual progress toward correcting the imbalances built up both before and during the economic crisis (e.g., oversupply of residential construction, indebtedness of the private sector and the high rate of unemployment). Third, a potential resolution of the latest episode of market uncertainty over European sovereign debt. Fourth, a continuation of accommodative monetary policy in the euro zone given the transitory nature of recent inflationary pressures from rising energy prices. Finally, an improved growth outlook, both global and in the EMU, and the euro's return to somewhere close to its long-term equilibrium rate. In sum, the negative contribution from the public sector along with weak recovery of private domestic demand and potentially strong exports will shape aggregate demand in the coming year (Table 1). In 2012, with the completion of some of the adjustments made in the private sector since the start of the crisis, coupled with a modest slowdown in Spanish exports, domestic demand should make its first contribution to growth since 2007. The latter despite the direct negative impact that fiscal consolidation will continue to have and a lower-than-expected contribution from net foreign demand in 2010 and 2011.

Looking at the first of these factors underpinning the two-year forecasts, both budget outcomes for 2010 and the General State Budget for 2011 (PGE 11) confirm the government's determination to meet its fiscal consolidation target. The public sector deficit should therefore continue to fall throughout the forecast horizon and reach its target of 3% of GDP by 2013. As a result, public sector demand will likely continue to adjust downward in the next two years when, for the first time since records began, public sector consumption is likely to shrink. Similarly, investment in other construction will probably fall in 2011 although, as a result of a strengthening private sector, 2012 could bring a return to modest growth of around 1%.

Table 1
Spain: macroeconomic forecasts

(yoy %, unless otherwise stated)	1Q10	2Q10	3Q10	4Q10	2009	2010	2011	2012
Household consumption	-0.3	2.2	1.4	1.3	-4.3	1.1	0.2	1.2
Public consumption	-0.5	0.1	-0.1	0.3	3.2	0.0	-0.6	-0.3
GFCF	-10.4	-6.8	-7.0	-6.1	-16.0	-7.6	-2.9	3.4
Capital goods and other products	-9.0	0.4	0.0	-0.8	-21.2	-2.4	0.6	5.0
Capital goods	-4.4	8.7	2.4	-0.7	-24.5	1.5	0.7	5.5
Construction	-11.4	-11.4	-11.6	-9.8	-11.9	-11.1	-5.3	2.3
Housing	-21.1	-19.3	-16.4	-12.3	-24.5	-17.3	-7.1	4.1
Other	-4.1	-5.7	-8.5	-8.4	-0.1	-6.7	-4.1	1.0
Chg. in inventories (*)	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Domestic demand (*)	**-2.9**	**-0.3**	**-0.8**	**-0.6**	**-6.4**	**-1.1**	**-0.7**	**1.4**
Exports	9.1	11.6	8.7	6.7	-11.6	9.0	9.1	7.0
Imports	2.3	9.3	3.9	1.9	-17.8	4.4	2.0	4.6
Net exports (*)	**1.5**	**0.3**	**1.0**	**1.1**	**2.7**	**1.0**	**1.6**	**0.5**
GDP mp (% yoy)	**-1.4**	**0.0**	**0.2**	**0.5**	**-3.7**	**-0.2**	**0.9**	**1.9**
GDP mp (% qoq)	**0.1**	**0.3**	**0.0**	**0.1**				
Pro-memoria								
GDP w/out housing investment	-0.2	1.1	1.3	1.3	-1.9	0.9	1.4	1.7
GDP w/out construction	0.3	1.9	2.2	2.2	-2.1	1.6	1.9	1.8
Employment (LFS)	-3.6	-2.5	-1.7	-1.3	-6.8	-2.3	-0.2	1.1
Unemployment rate (% active pop.)	20.0	20.1	19.8	20.3	18.0	20.1	20.6	20.1
Employment (FTE)	-3.7	-2.5	-1.7	-1.3	-6.6	-2.3	-0.3	0.9

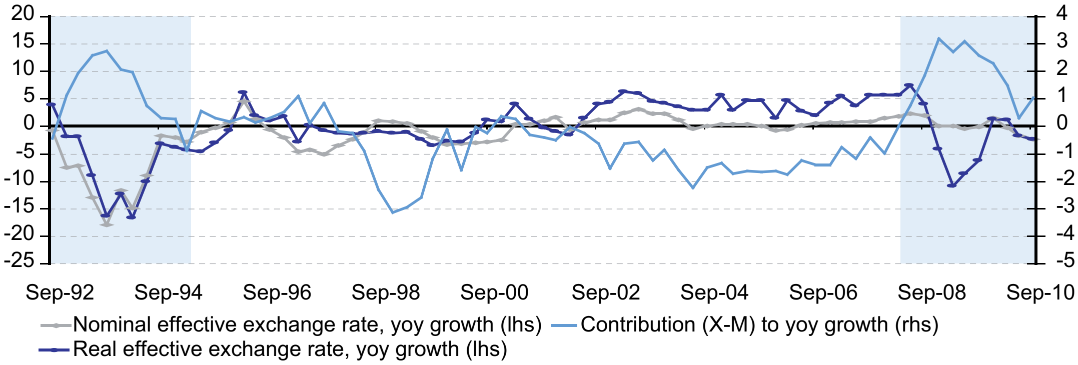
(*) Contribution to growth
Source: INE and BBVA Research forecasts

Private consumption was affected by consumers bringing forward purchases of goods and services to the first half of last year, which might otherwise have happened in the second half or later. This has created a tough base effect for household spending in the first half of 2011, which will gradually fade out over the forecast horizon. Also, the expected easing of job destruction in 2011 will not be enough to offset a worsening non-wage component in household gross disposable income caused, among other things, by the failure to increase government pension contributions and expiring unemployment benefit entitlements. In 2012, the slight growth in employment will drive the first rise in disposable income since 2009. Nor will household wealth, mainly property, help boost consumption in 2011-2012 as housing prices are set to fall further in coming quarters. In contrast, private spending will continue to draw support from relatively low interest rates, which will keep the financial burden on households at round 13% of gross disposable income, similar to the level of 2010. Finally, even though uncertainty will remain relatively high, we do not expect significant changes in the savings rate associated with periods of low consumer confidence, although the ongoing deleveraging of Spain's households will not permit any major early reduction in savings rates. As a result, the growth rate of household consumption is expected to slow to 0.2% in 2011 before rising to 1.2% in 2012.

Turning to business investment, with final demand recovering timidly in Spain and the inflationary threat in Europe likely to be short-lived, we expect very modest improvements in corporate earnings as well as lower downward pressure on the real cost of capital. Both these factors will make a positive contribution to corporate investment in the short and medium terms, although in the coming quarters the latest episode of financial stress could act as a break, given the Spanish economy's heavy reliance on foreign capital. As a consequence, investment in capital and other goods is expected to grow only modestly in 2011, by around 0.6%, after three years of falls. In 2012, once current uncertainty in international financial markets has been progressively disappear, conditions will be in place for renewed robust growth in this component of aggregate demand: this time at around 5%. Residential investment will deteriorate further in 2011 (-7.1% yoy), even though the bulk of necessary adjustments have already been made. This is still an improvement on 2009 and estimates for 2010 (-24.5% and -17.7%, respectively). The first positive growth rates are expected for the first half of 2012 and could be relatively high given the low starting point. Growth for the year could consequently be 4.1%.

Finally, looking at export performance over the medium-term, our estimates suggest that Spain will maintain its export drive in 2011 and, less strongly, in 2012, with goods and services exports rising between 7% to 9% annually. Unlike the crisis that Spain faced in the early nineties, when currency devaluation reduced the real effective exchange rate by around 15% year-on-year, the improvement of competitiveness in this crisis came from favourable movements in the relative price of production factors in comparison to other countries and, to a lesser extent, from the depreciation of the euro (Chart 24), highlighting the flexibility and responsiveness of Spanish exporters in a tough international environment. Looking ahead over the next two years, the factors underlying the strong projected performance of exports are gains in competitiveness, recovery of the global economy and geographical diversification of exports, mainly towards the increasingly important EAGLE economies as well as to Germany as the growth engine of the EU. In conclusion, Spanish exports of goods and services will continue to provide fundamental support to Spain's economic activity in both the short and the medium term.

Chart 24
Spain: competitiveness and contribution to growth of net exports, %*



* The REER is based on unit labour costs of manufactures. Periods shown shaded are the last two recessions. Negative REER or NEER figures (i.e. depreciation) imply gains in competitiveness
Source: BBVA Research based on INE, IMF and BoS data

However, the pace of growth will be far from evenly spread across Spain's regions[10]

As in the last period of expansion and as we have been seeing since the crisis began, Spain's economic growth will continue to be marked by wide disparities between its regions for the next two years. Factors affecting the Spanish economy will apply in all parts of Spain, but their regional impact will vary, based on the vulnerability of each region to each specific factor. For instance, in the short and medium term, growth of regional economies will reflect their exposure to external demand while domestic demand remains relatively weak.

There is also the ongoing process of fiscal consolidation at regional and central government level. This is expected to have a greater impact the more the local economy depends on the public sector and the greater the need for the regional government to push through cuts. Specifically, regions with a high local deficit (the Mediterranean coastal governments and Castile La Mancha), or lower per capita incomes (and therefore greater reliance on state transfers and investments) could find their growth prospects curtailed under this economic scenario.

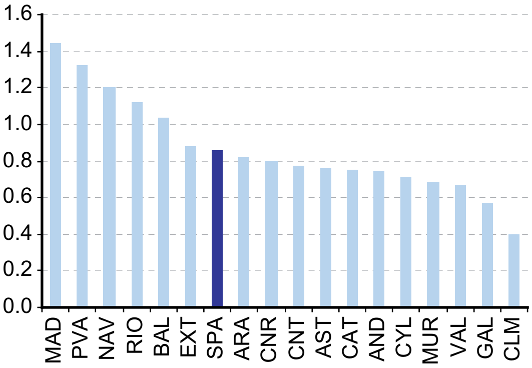
Also, the correction of internal imbalances built up during the expansion and through the crisis, will affect the pace of recovery for domestic demand. Regions with relatively low property overhangs on the market, substantially lower unemployment rates and a greater proportion of jobless receiving benefits, or lower levels of personal debt, might expect to enjoy consumption and private investment levels above the Spanish average. These factors are generally common to the regions of northern Spain.

Finally, given the driving role of foreign trade, particularly in 2011, the ability to meet strengthening global demand will be decisive for the speed of recovery. One would expect that regions whose economies are more open would benefit the most, both through tourism and export orders. However, there is an exception. The end of European fiscal aid will make it hard to maintain the relatively high growth of the automobile sector in 2010, with an impact on activity in some regions (notably Castile & León and Galicia, which will also be affected by the end of the Xacobeo year), preventing them achieving the differential growth rates over the Spanish average that long-term analysis would lead us to expect.

10: This section summarises the main conclusions of the Regional Watch report on estimating Spanish GDP by region. The report will be available shortly on the BBVA Research website.

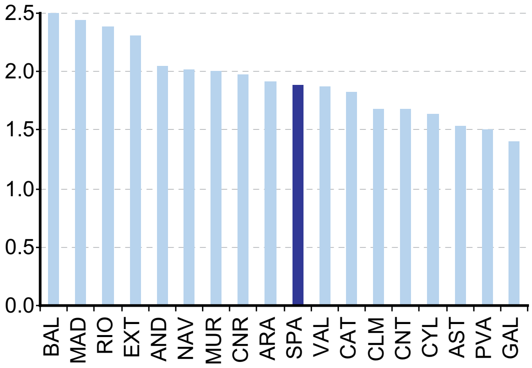
To sum up, Spain's economic growth over the coming year will be around 0.9%, but growth rates in its different regions will range from 0.2% to 1.5%. Regions such as Madrid, the Basque Country and Navarre will lead the economic recovery while others such as Castille La Mancha, Galicia, Valencia and Murcia will lag clearly behind. In 2012, insofar as the factors causing imbalances gradually correct, at least in part, these divergences in regional growth should tend to narrow. In this environment, therefore, the regions with greatest penetration in fast-growing foreign markets will be the winners. The process of interregional convergence in Spain will again make little progress.

Chart 25
Spain:
GDP growth in 2011 by region (yoy, %)



Source: BBVA Research based on INE data

Chart 26
Spain:
GDP growth in 2012 by region (yoy, %)



Source: BBVA Research based on INE data

The strength of recovery is still uncertain

While the macro-economic forecasts in this report put the contribution of domestic demand slightly lower than in our last scenario (see Spain Economic Outlook 4Q10), a number of factors could improve the prospects for the Spanish economy. After the recent surge in financial tensions across Europe, the Spanish government continues to enhance the transparency of public sector finances and to consolidate the process of structural reform. The fast and ambitious introduction of the reforms that have been announced will be critical to improving market confidence, accelerating the recovery in activity and employment, and easing pressure on private domestic demand (see Section 4 of this report).

At the same time, there are downside risks that could slow the pace of both domestic and external demand. Chief among these is the incipient threat of inflation affecting Spain and the wider euro zone. Although the recent surge in oil prices is temporary in nature and –given weak domestic demand– has failed to pass through to non-energy prices in any significant way, it is too soon to rule out second round effects in the short term. Second, although its long-term impact will be positive, the recent increase in capital requirements for Spain's financial institutions will have to be accompanied by an opening up of financial markets or it will tend to undermine banks' lending. It is therefore essential that the industry continues its process of orderly restructuring. Finally, delays in resolving Europe's governance problems could mean financial stress drags needlessly on, worsening downside pressures on the Spanish recovery (see Section 4 of this report).

Box 1. The Spanish economy has large external funding needs, but the adjustment process is consolidating

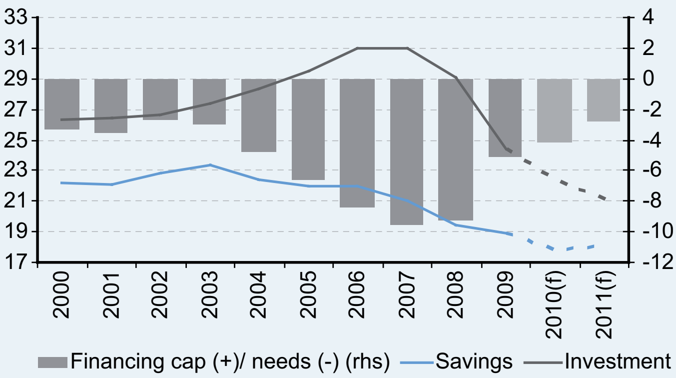
Since 2008 the financing needs of the Spanish economy have been in decline, mainly due to a slump in investment.

The sustained fall in investment rates since 2008, coupled with a modest decline in the savings rate, has virtually halved the Spanish economy's financing requirements. As a result, the deficit in 2010 was around 4% of GDP. Within this process of adjustment, the behaviour of economic agents has varied: high levels of private savings more than offset the steep reduction in savings by the public sector while the decline in investment rates was led by the private sector, mainly households.

In 2011, the imbalances in the economy should continue to correct, albeit at a slower pace. Breaking this down by agent, households will further cut their investment via the reduction in home purchases, but this will not be enough to offset the fall in savings as a result of rising consumption and falling gross disposable income. As a result, households are likely to see a fall in their funding capacity. Companies, meanwhile, after the severe adjustments made in 2008 and 2009, will maintain their investment rates and increase their savings rates, which will substantially reduce their financing needs. Finally, in line with the continuing process of fiscal consolidation begun in 2010, the public sector is expected to record a big improvement in its savings ratio, although this will still be negative for the year as a whole.

Chart 27

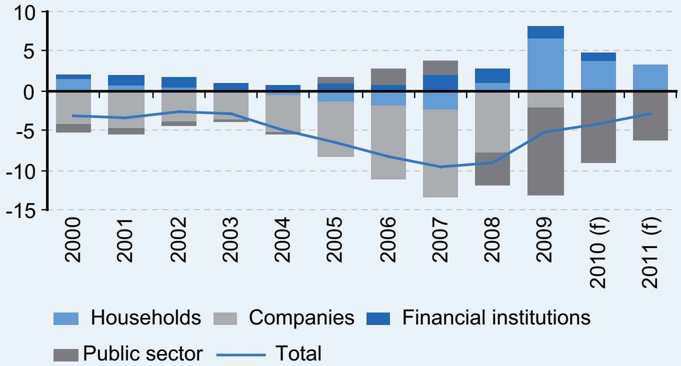
Financing requirements: savings and investment (% GDP)



Source: BBVA Research based on BoS data

Chart 28

Financing requirements by agent (% GDP)



Source: BBVA Research based on BoS data

In the current climate of financial uncertainty, non-financial agents are tending to replace external with domestic sources of finance. Only the public administration has access to funding from the rest of the world

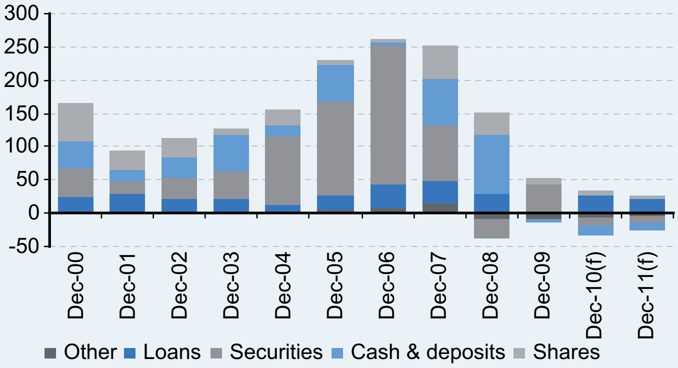
Despite the sharp adjustment seen in the financing needs of the Spanish economy, the projected deficit for 2011 will again need to be financed internationally. The current climate of financial uncertainty could affect the conditions for accessing such funding. Before the crisis, the financial institutions were capturing the funding needed from the rest of the world. Now, however, the government is virtually the only agent to have access to financing from abroad. The financial position of companies changed with the onset of the crisis, they demanded funding, in net terms, between 2007 and 2010, which they will again do in 2011, albeit to a lesser extent.

Closer scrutiny of financial institutions shows how in the expansion phase non-monetary financial institutions were the biggest raisers of foreign finance (this was the era of proliferating securitisation and investment funds). Meanwhile, monetary financial institutions (mainly banks and savings banks), which were busily expanding, were also capturing foreign funds by issuing securities. All that changed from 2007 when financial institutions in general switched to getting most of their finance from the ECB. They will probably do so again this year, although we are also seeing other sources coming back onstream such as, for instance, the interbank market.

The instruments deployed to fund the Spanish economy have also changed since the first financial turbulence hit in September 2007, with a marked shift toward short-term funding rather than the long-term instruments that were the standard source of finance between 2004 and the crunch. Currently. the main sources of finance for Spain's economy are ECB liquidity auctions and securities issued by the various tiers of government. It is also apparent that, as from the second quarter of 2010, Spanish economic agents have been unwinding positions in international assets and repatriating capital to supply their own funding needs. Something that, in our forecasts, is likely to continue, although to a lesser degree, throughout 2011.

Chart 29

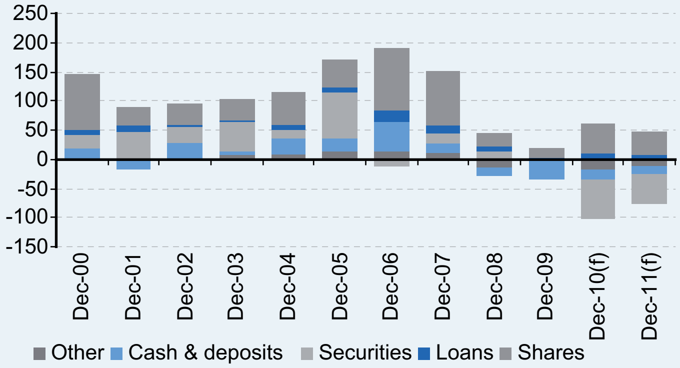
Net liabilities with the rest of world. By instrument. Billion euros



Source: BBVA Research based on BoS data

Chart 30

Financial assets with the rest of world. By instrument. Billion euros



Source: BBVA Research based on BoS data

4. Spain and the sovereign debt crisis: essential to keep up the pace of reform

Over the last few months, the functioning of the financial markets has been marked by two new episodes of sovereign crisis. As it is argued in the previous issue of Spain Economic Outlook, the first of these occurred in October and stemmed from ongoing uncertainty about the solvency of the Irish financial system and its impact on that country's sovereign debt. This episode ended on 21 November when the Irish asked for funds from the European authorities. However, the bailout barely helped contain the rising uncertainty apparent on the markets. The factors underlying the sovereign debt crisis, such as the lack of consensus across the EU on how to resolve the liquidity and solvency issues that threatened some of its member states and the internal structural weaknesses of some peripheral economies, continued to be present. Accordingly, at the start of 2011, financial markets once again experienced a surge in risk premia, mainly on fears that Portugal would become the third country to ask for assisstance from to the EU, both because of potential problems meeting its fiscal targets and, above all, because of deteriorating expectations about the sustainability of Portugal's sovereign debt amid high risk premiums and low growth. This time, other countries, including Belgium and Italy, were also affected. In the case of Spain, these three elements (uncertainty about European governance, contagion and association with the problems seen in Ireland and Portugal) prompted a rise in risk premia that drove the Spanish government to bring forward some of the processes meant to tackle those doubts about the Spanish economy. Although Spain's financial system is far from suffering the same solvency problems that afflict Ireland's and although, even in worst-case scenarios, the sustainability of Spain's public debt is not in doubt, the structural reforms pushed through by the government were necessary to back up these undoubted truths. Moreover, it is of key importance that progress continues to be made in transparency of information, both in the public accounts and in the financial sector, and that the government retains its sense of urgency about restructuring a limited segment of the financial system and driving forward other structural reforms to boost the potential growth of Spain's economy.

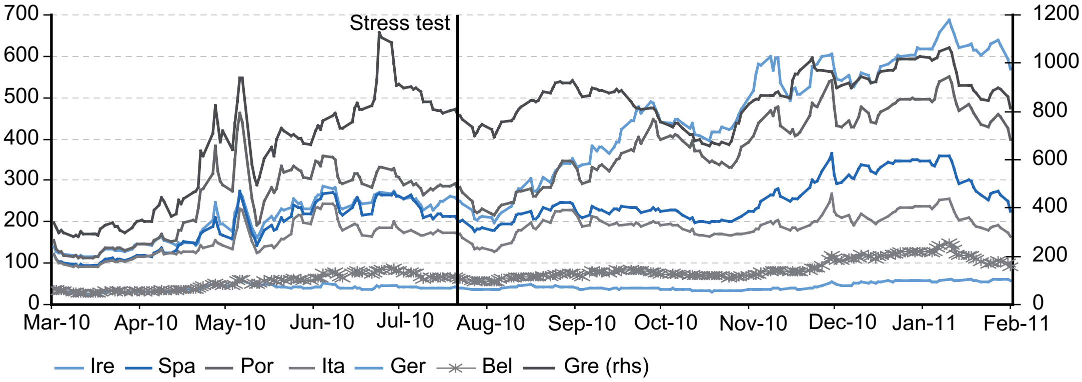
The perception of greater consensus on the mechanisms to resolve sovereign debt crises in Europe helped ease market tension

The spike in sovereign risk late in 2010 partly shut debt markets down again, prompting a rise in the Spanish financial system's reliance on ECB funding in December after four months of falls. As governments and financial institutions in some European countries struggled to raise market funds, January brought some factors that helped to ease financial stress. There is reason to expect a gradual consolidation of this reduction in financial stress in Europe, and specifically in Spain, if two premises are fulfilled: 1) The issue of pan-European governance needs to be resolved, i.e. governments must follow through on reforms to the current EFSF[11] to deal with the problems of struggling countries and put in place a permanent mechanism for resolving future crises. 2) Structural reforms and fiscal consolidation must be decisively pursued in the right direction so as to fully dispel doubts about the solvency of part of Spain's financial system and improve the perceived growth potential of the Spanish economy.

11: European Financial Stability Facility.

Chart 31

Sovereign risk premium (5Y CDS in bps)



Source: BBVA Research based on Bloomberg data

European governance: an appropriate institutional framework

After a series of rumours and discussions about how to put through definitive reforms to European governance, the only firm decision taken by the Council of Europe in December was to set up a permanent stability fund as from 2013. Besides continuing work on reform of the stability and growth pact (SGP) it was decided to draft a proposal –to be presented at the Council meeting at the end of March– to definitively resolve the current crisis and simultaneously provide a way to manage future crises, including an appropriate fiscal policy framework to complement the single monetary policy. Proposals on the table vary, but in our view must include a number of elements. Specifically, in the short term, a way must be found not only to resolve the liquidity problems currently facing several European governments (and spilling over into their private sectors) but also to tackle their sovereign solvency issues. Attacking long-term solvency problems by simply providing liquidity is unsatisfactory as a solution.

So, to address the liquidity problems, it is necessary to increase the size of the EFSF to at least its nominal amount (EUR 440bn, which along with other European funds and the sums made available by the IMF could provide resources of EUR 750bn). Yet, more importantly, the fund must be made more flexible in practise by allowing it to intervene in secondary markets (narrowing sovereign spreads without the need to approve a rescue package) and the interest rates it charges must be reduced. This last point is crucial. Experience has shown in Greece and Ireland that excessive rates in an environment of severe fiscal consolidation can strangle economic recovery. The demanding budgetary conditions and structural reforms already in place should be enough to mitigate the moral hazard for governments (i.e. disincentivize them from seeking a bailout).

If solvency problems are to be resolved, they must be confronted in the short term so as to restore market confidence. If this is to happen, it would be desirable for a European level body (probably the European Commission) to establish objectively which countries are going to be solvent after the adjustments now under way and due to be completed between 2013 and 2014. Once identified, solutions should be proposed to bring down their public sector debts to a sustainable proportion of GDP. In the current climate of uncertain financial markets, it is unrealistic to think this writedown to existing public sector debt[12] could involve private investors, for fear of triggering contagion to other sovereign debt issuers and the European banking system. Losses should be borne by other euro zone member states. One possible mechanism to achieve this reduction is to lend funds to the afflicted countries so that they can buy back their own debt on the secondary market. Another is to provide very long-term loans to these countries at lower interest rates.

Also, a strong mechanism for prevention and resolution of future crises needs to be put in place for the long term. On the prevention front, the key issue is to avoid excessive imbalances in the public finances of single currency members or, where such imbalances exist, to ensure their funding is not under threat. The European stabilisation mechanism, already in place, is a good tool. It includes forward-looking scrutiny of fiscal positions through the European semester project, new oversight criteria for private sector imbalances (which were the root of the fiscal crisis in many countries) and

12: Remember that European countries have already officially promised that the private sector will not have to take losses on public debt issued before 2013. Any solution that breaks this promise would pose a serious problem of credibility for European institutions and countries.

the size of public sector debt (not just the deficit) as well as strengthened and automatic sanctions. This last point is important. One of the resolutions at October's meeting of the Council of Europe raised the possibility of waiving sanctions by qualified majority vote. If accepted this would weaken the mechanism. Fiscal rules for reducing national structural deficits could also help, although they would be hard to standardise for different countries. The absence of sanctions means that such rules may well be flouted, as happened in the past. Experience over the last decade has taught us that besides a system of sanctions, which are necessary, we need to identify incentives that would reward virtuous behaviour at macroeconomic level.

In the medium term, we would also need an issue of Eurobonds to cover a certain percentage of the debt. This would be a clear breach of the "no bail-out" rules and something that would require greater coordination of fiscal policies to make it politically acceptable. This, in turn, would mean major changes to European treaties.

Regarding the mechanisms for resolving future crises and to re-establish a degree of market discipline, it would also be a good idea to define mechanisms whereby the private sector would share the costs in the interest of minimising moral hazard. But these should not be overly severe or they risk triggering effects of contagion. If the preventative approach fails and it becomes necessary to restructure a country's public sector debt, reducing the present value of private investment, collective action clauses are a good option. Private participation in restructuring should be a credible threat but one that will only be applied as a last resort, and preferably through mechanisms that are less drastic than simple debt writedowns (extending maturities or cutting coupons).

In Spain, the restructuring of the financial system is essential to rebuilding confidence and its costs are limited

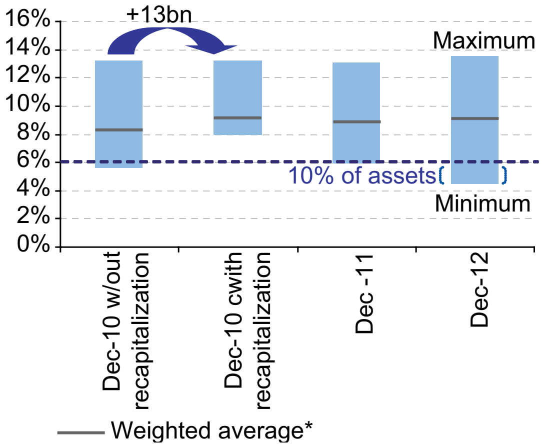
The Spanish financial system is engaged in one of the biggest restructurings of its history. Although the system as a whole is solvent, big differences between institutions means that some will need capital in the next two years as they attempt to clean out their loan books. That said, under core and risky scenarios alike, these financing needs are limited and, if they are to be partly met from public capital, would not put at risk the long-term sustainability of public sector debt, as has happened in other countries. Both the regulator and the government have put forward a series of reforms to facilitate the recapitalisation of these institutions with private funding, which, though lacking in detail, should help improve the information about the solvency of this part of Spain's financial system.

The ongoing restructuring will transform the traditional model of savings banks and create instead a financial system of larger, more concentrated and more solvent institutions. The 45 savings banks that existed in 2009 should be reduced during the next few months to just 17, with average assets of EUR 76bn each compared to EUR 27bn in December 2009. To date, eleven institutions have received help from the Fund for Orderly Bank Restructuring (FROB) or Deposit Guarantee Fund (DGF), totalling EUR 16bn. Funding provided by the FROB has so far represented 13% of its capacity and has all been injected via preference shares convertible into savings bank shares.

The Spanish financial system as a whole is solvent although differences between financial entities mean that some need to strengthen their capital. Therefore, the problem of solvency in Spain is limited in scale and in the number of entities affected, even given the new core capital requirements of 8% or higher in some cases. Based on information published at 31 December 2010, achieving this level of core capital would create additional capital needs for a small number of institutions, totalling around EUR 13bn. With this capital injection, ideally from private sources, the system as a whole would have core capital of nearly 9%, well above that of the banking systems in other European countries. Institutions would then enjoy a relatively ample capital cushion as they embarked on the clean-up of their loan books over the next few quarters. In fact, if we model core capital over 2011 and 2012 on a loan-loss scenario similar to that used by the CEBS[13], total core capital in the Spanish system would be above 9% at the end of 2012 and only a small number of entities (holding less than 10% of the system's assets) would have core capital of 6%. Even in a risky scenario, capital requirements would be limited and manageable, which would pose no danger to the medium- and long-term sustainability of public debt if public funds had to be called on. Remember that Spain enjoys some leeway on the assumptions used in the stress tests as the percentage of assets included in the tests and estimated losses show that the Spanish tests were carried out under far stricter conditions than those in other European countries (Table 2).

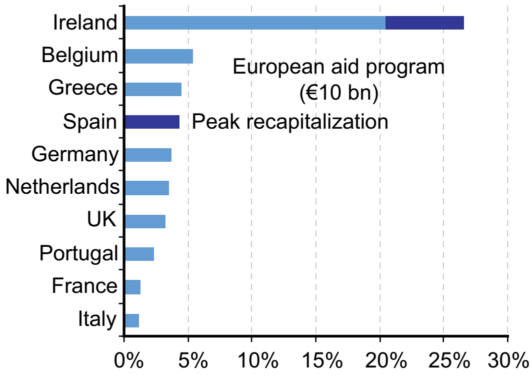
13: Specifically, it assumes losses of 37.8% on repossessed property assets, 16.6% on developers, 10.1% on consumer loans and cards, 5.5% on companies and corporate loans and 1.5% on mortgages.

Chart 32
Simulation of core capital ratio (% of risk weighted assets)



* Weighted assets
Source: BBVA Research

Gráfico 33
Europe: Public capital injected into the banking sector (% of national GDP)



* FROB funds do not strictly count as recapitalisations although their effects are similar
Source: BBVA Research

Table 2
Characteristics of CEBS stress tests, 2010-11 (June 2010)

	Spain	Ireland
Number of entities	27	2
% coverage of assets	98%	45%
Fall in commercial property prices	-65%	-25%
Fall in residential prices	-24%	-22%
Net losses (% financial assets)	4%	1%

Source: BBVA Research based on CEBS data

These figures are lower than those injected in other European countries such as Austria, Belgium, Germany, the Netherlands or Greece and much less than the 20% of GDP that went to bail out the Irish banks. On this point, it should be recalled that Spain's financial system is very different from Ireland's. First, the Irish financial system is oversized with banking assets equivalent to 771% of GDP in 2009 compared to 357% in Spain. Second, better regulation and oversight in Spain meant that despite suffering a similar fall in GDP, the default rates of Spanish banks were around 6% compared to 10% in Ireland[14]. Third, the Spanish financial system can draw on a diverse range of funding sources unlike what happened in Ireland, whose banks took around 80% of GDP in ECB funding in 2010 compared to 7% in Spain.

While the system as a whole may be solvent, uncertainties persist in financial markets and these need to be addressed as soon as possible. Measures like the Bank of Spain's new transparency rules or the new European stress tests should help. On the first point, the Bank of Spain has asked all financial institutions to publish an additional breakdown of their developer and housing loan books, as well as their liquidity position in the first months of this year. These new requirements will help clarify institutions' exposure and coverage, which will in turn allow financial markets to better discriminate between entities. The new European stress tests, on the other hand, will measure institutions' solvency and, for the first time, their liquidity, which should give a clearer picture of each. Results are expected to be published toward the middle of the year. Finally, entities should continue to adapt their size to the market in which they operate. Existing branches and employees will have to be trimmed to create institutions with cheaper cost structures and greater operating efficiency.

14: Given that Irish banks were offloading their worst loans to the National Asset Management Agency (NAMA) their original NPL rates would have been still higher.

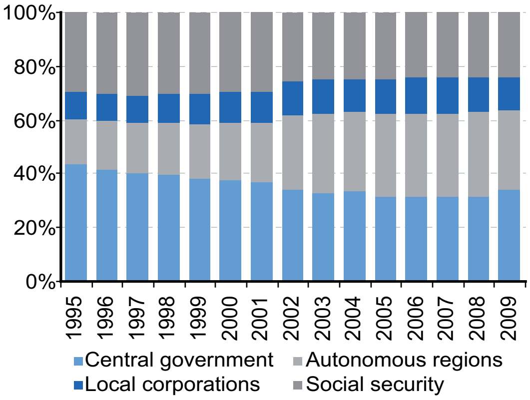
Also, the Spanish government's new proposals for capital requirements under the recently announced Financial Sector Reinforcement Plan impose minimum core capital of 8% and generally move in the right direction. Among its plus points, it sets out a clear roadmap for the capitalisation, support and entry of private capital into financial institutions, makes it more likely that more financial business will be transferred to banks and makes it possible for the Bank of Spain to intervene where necessary. Once the new regulations are approved before the end of February, the definition of core capital will be clarified and entities will have to comply with higher capital requirements. Meeting these extra requirements should give Spanish institutions some room for manoeuvre, so that they can approach the coming quarters with a stronger solvency cushion. Once the details of the government's measures and the institutions' situation are known, it will be easier to assess the scale of the proposal.

In any event, immediate recapitalisation via the input of fresh private capital would enhance credibility on international markets, boost system efficiency and, no less importantly, ease the burden on Spain's public sector debt. Where FROB aid is unavoidable, compliance with the European regulations governing competition and state aid, not to mention Spanish regulations, will require rigorous clean-up and restructuring plans (which resolve the problem of excess supply), no excessive competition on price, the professionalisation of governance bodies and other measures that would allow FROB rapidly to exit the capital of the entities receiving bailouts. International experience in, for instance, the US has taught us that withdrawing public capital may require specific solutions for institutions that have structural viability problems. Among these, assets protection schemes of various sorts will probably need to be considered.

Autonomous regions must comply strictly with 2011 budgets, imposing spending cuts of around 3%

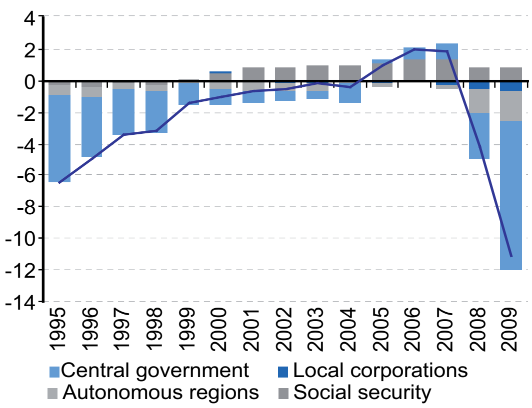
Once the process of decentralising fiscal control from the state to the autonomous regions is complete, the fiscal consolidation of regional governments becomes all the more vital to ensure that any adjustment plan for the Spanish public sector is viable. During the crisis of the 1990s, the regional public sector was relatively small (responsible for spending only around 10% of GDP), but by the end of 2009, spending by autonomous regions made up more than 17% of GDP and nearly 40% of total Spanish public sector expenditures. As a result, market pressure surrounding the need for fiscal adjustment has concentrated on this tier of government, with increased demands for transparency in their management, better information on their actions and greater efficiency all round.

Chart 34
Spain: share of public spending by tier of government



Source: BBVA Research based on Eurostat data

Chart 35
Spain: financing capacity (+) or need (-)(% GDP)



Source: BBVA Research based on Eurostat data

The fiscal consolidation currently affecting every tier of Spain's government is mirrored in the budgets passed by the autonomous regions for 2011. These include, for the first time, all the resources assigned under the new Autonomous Financing System[15], which provides greater financial autonomy but also demands a greater level of fiscal responsibility. This implies a reduced reliance on state transfers, with funding for devolved responsibilities coming largely from tax receipts. Despite this, and despite the

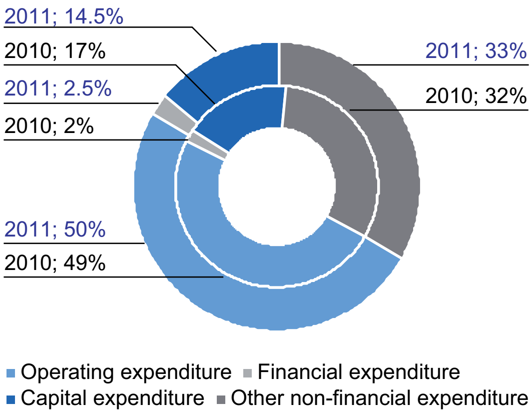
15: Under the new financing system, the percentages of revenues delegated to the regions rise from 33% to 50% of personal income tax, 35% to 50% of VAT, and 40% to 58% of special taxes; a guarantee fund for core public services is set up as well as a global sufficiency fund to ensure adequate financing of all responsibilities that are transferred. Two other convergence funds are also created, one for competitiveness and one for cooperation, to reduce gaps in the funding enjoyed by different regions.

rising pressure on some regional budgets, receipts estimated for 2011 show a slight fall from the initial 2010 forecasts.

The combination of this trend in regional receipts and the need for fiscal consolidation has resulted in severe spending cuts in regional budgets. So much so, that, based on published figures, their spending will actually fall as a share of GDP for the first time. As a result, according to budget figures, the regions will be managing over EUR 165bn in spending during the next year (equivalent to 15% of GDP), with regional spending cut by nearly 6% from the 2010 budget. Looking at the structure of non-financial spending, the biggest reductions are concentrated on capital budgets and, to a lesser degree, running costs (personnel and purchases of goods and services), which together make up more than 60% of total regional spending. This is fundamental. It reinforces the credibility of much of the savings plan, grounding it in measures that have already happened (5% cut in public sector wages), or which will be relatively easy to implement (investment cuts).

Chart 36

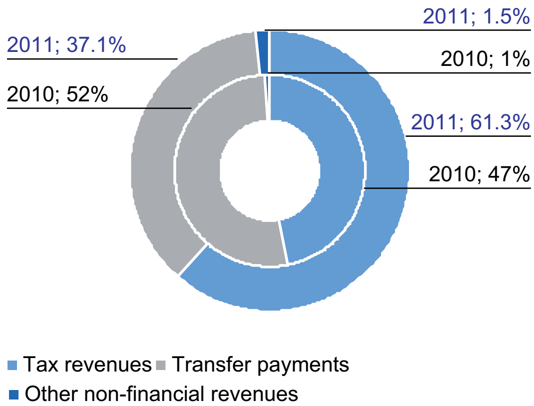
Autonomous regions: structure of non-financial spending and initial loans



Source: BBVA Research based on autonomous regions data

Chart 37

Autonomous regions: structure of non-financial revenues and initial forecasts



Source: BBVA Research based on autonomous regions data

Against this backdrop of inevitable spending cuts and likely slow-growing receipts, autonomous regions expect to generate current savings during the year of more than EUR 3bn (nearly 0.3% of GDP), substantially improving their 2010 forecasts as only three regions (Canary Islands, Extremadura and Murcia) expect to record negative savings. Investment (direct and indirect, via capital transfers) has been heavily cut from the previous year, down by more than 19%. As a result, the total non-financial deficit on regional budgets as presented is around 1.3% of GDP, meeting the stability target set for 2011.

Budgets for 2011 include ambitious adjustment plans and are feasible, although achieving these targets will take a determined effort and strict compliance by each and every region. On this point, although it is highly likely that the 2010 deficit came in very close to target, it is also possible that the final figures will show wide disparities in compliance with the stability targets agreed by the Fiscal and Financial Policy Council (FFPC). It was therefore particularly heartening to see the implementation of the various control mechanisms, notably the need for authorisation to issue debt and the requirement to draw up an adjustment plan that would put the budget back on track toward stability. We can also expect further spending cuts, despite the extra pain involved, from the adoption of measures such as those recently announced by Catalonia to cut spending by 10%, with similar announcements planned by Murcia and Castile La Mancha[16] . If, as the year wears on, doubts emerge about one or other region's compliance, it is essential that the central government takes decisive and preferably preventative action, as it has done so far.

Based on these forecasts, assuming that Catalonia sets a budget to meet the 1.3% target, total debt across all autonomous regions is set to rise by just over one percentage point of GDP. Adding in the repayments scheduled for 2011 and the portion of the 2010 budget that was not financed from that year's receipts, the gross borrowing requirement for Spain's autonomous public sector should be around EUR 35bn. This would leave autonomous public debt below 14% by the end of 2011, still well above the levels of other similarly rated European regions.

16: At the time of writing, these three regions were drawing up adjustment plans which will have to be approved by the Finance Ministry.

Table 3

Main budget ratios for the autonomous public sector. Initial budgets for 2011

	Gross saving (GS)		Investment (I)		Non-financial balance (NFB)		Financial burden (FB)	Net borrowing requirement
	EUR m	% GS/CI	EUR m	% I/NFS	EUR m	% NFB/CI	(FB/CI)	(EUR m)
Common regime								
Andalusia	317	1.3	5,386	17.8	-2,294	-9.1	7.7	2,064
Aragón	14	0.3	751	14.6	-465	-10.6	6.3	457
Asturias	35	1.0	906	21.6	-388	-11.7	6.5	352
Canary Is.	-264	-4.9	912	13.8	-598	-11.0	7.4	594
Cantabria	115	5.9	389	17.4	-205	-10.5	11.1	189
Castile & León	255	3.2	1,905	19.6	-837	-10.4	5.0	672
Castile La Mancha	582	7.8	1,691	19.8	-473	-6.4	1.7	473
Catalonia	n.a.		n.a.		n.a.		n.a.	n.a.
C. Valenciana	364	3.1	1,927	14.5	-1,170	-10.0	5.6	1,151
Extremadura	-13	-0.3	957	18.9	-420	-10.3	4.6	475
Galicia	295	3.4	1,603	16.0	-624	-7.2	7.0	513
Balearic Is.	1	0.0	674	19.3	-622	-22.0	6.8	622
La Rioja	47	4.4	219	17.8	-116	-11.0	5.3	112
Madrid	731	4.5	1,140	6.8	-242	-1.5	7.3	-951
Murcia	-48	-1.2	691	14.5	-356	-8.8	4.6	298
Foral regime								
Navarre	558	14.5	873	21.0	-289	-7.5	1.6	289
Basque Country	286	3.2	1,445	14.2	-831	-9.2	3.7	645
Total autonomous regions	**3,274**	**2.8**	**21,470**	**15.8**	**-9,931**	**-8.5**	**6.0**	**7,954**

Note: at the time of writing the Autonomous Community of Catalonia was still drafting its budget
NFS: non-financial spending; CI: current income
Source: BBVA Research based on autonomous region data

Reform of the pension system will improve the medium-term outlook for public finances but will probably require further adjustments

The need to reform the Spanish pension system has been amply documented in recent years[17]. Although the system was in surplus during the expansionary phase of the last economic cycle, demographic trends suggest that dependency is set to worsen significantly while life expectancy is increasing year on year. As a result, spending is expected to rise faster than income over coming years. Needing to improve perceptions of its present and future financing needs, the government has released the main points of its Draft Law on the Updating, Strengthening and Modernisation of the Social Security System, the result of an important deal struck with the unions and employers' organisations.

The main aim of the new measures will be to reduce the projected rise in spending within the system and, given the announcements made so far, there seems every chance that this aim will be achieved. Specifically, the measures include an effective raising of the retirement age (from 65 to 67, or 61 to 63 for early retirement), a transition to a longer period of contributions to calculate pensions (from 15 to 25 years) and a rise in the number of years needed to earn a full pension (from 35 to 38.5 years). This is not a perfect deal. But taken together these measures will help put the system in a significantly stronger position in the medium term compared to where it is now.

17: See, for instance, J. Alonso and J. A. Herce (2003): "Balance del sistema de pensiones y boom migratorio en España. Proyecciones del modelo MODPENS de FEDEA", Working Paper 2003-02, FEDEA; M. Balmaseda, A. Melguizo and D. Taguas (2006): "Las reformas necesarias en el sistema de pensiones contributivas en España," Moneda y Crédito 222; R. Doménech and A. Melguizo (2008): "Projecting pension expenditures in Spain: on uncertainty, communication and transparency," in D. Franco (ed.), Fiscal Sustainability: Analytical Developments and Emerging Policy Issues. Banca d'Italia; A. de la Fuente and R. Doménech (2010): "Ageing and real convergence: Challenges and Proposals", in J. F. Jimeno (ed.), Spain and the euro. The first ten years, Bank of Spain; or J. Díaz Giménez and J. Díaz Saavedra (2006): "The demographic and educational transitions and the sustainability of the Spanish public pension system." Moneda y Crédito (222).

Assessment of the other changes will depend on how their details are implemented or modified on the way through Parliament. Specifically, the changes seek to incorporate special system contributors (farm workers and the self-employed) into the general system and to provide incentives for a longer working life with proportional increases to the pension for each year worked.

Until we see the details that allow a more precise quantification of its impacts, a number of points remain that could inhibit the potential positive aspects of the reform. First, a long transition period, from 2013 to 2027 when the changes will be fully implemented, is essential so that economic agents have time to adjust their behaviour. As a result, the reforms do not wholly rule out the system going into deficit before this transition period is over. To deal with this, the government has said that the "system parameters" would be revised every five years as from 2027 to reflect changes in life expectancy, so as to guarantee its financial sustainability. It would be good if these reviews start as soon as possible and during the transition period, to avoid the pension system going into deficit before 2027 and that all variables which might affect its financial sustainability should be included in the review. Secondly, it would be better if the reform encouraged future measures to better inform workers about their future entitlements. This could be achieved through a system of notional accounts, which would allow them to take better decisions on their work and savings to try and achieve an adequate pension. Finally, there is the possibility that the reform may make it costlier to hire young people in the short term as companies that fund training or research programmes will be expected to pay social security contributions on behalf of the beneficiaries, on the same basis as under training contracts. As this is a necessary measure to incentivize the accumulation of human capital in the Spanish economy, to avoid driving up costs and eroding demand for this type of contract, salaries need to at least partly reflect the future benefits accrued via these contributions.

The reform of Spanish pensions is in some ways similar to that imposed in Germany. The main features are an increase in the standard retirement age to 67 and a long transition period before it comes into full effect (until 2027 in Spain and 2029 in Germany). However, there are several points that suggest the German reforms were more drastic than those in Spain. Regarding early retirement entitlements, for instance, in Spain it would be possible to retire at 63 with 33 years' contributions (or at 61 if a company crisis can be cited), while Germans would need to pay 35 years' contributions to retire at 63. Another major difference is that Germany is already applying a correction factor to pensions to maintain their financial sustainability. In Spain, however, no such adjustment would be applied until 2007. Finally, a likely fall in the substitution rate as a result of these reforms would be offset in Germany through heavy tax incentives to make voluntary contributions to pension plans that could boost substitution rates by up to 20 points. In Spain's case, the introduction of a third pillar offering better cover is left as a point for future investigation.

Table 4

Reform of the pension system: Spain vs Germany

Spain	Germany	Spain	Germany	Spain	Germany
Official retirement age		**Number of contribution years at official age to get 100% base pension**		**Rate of public pension substitution before reforms**	
67	67	38.5	45	81,2	48%
Early retirement age		**Number of contribution years for early retirement**		**Rate of public pension substitution after reforms**	
61/63	63	33	35	69e	43%
Sustainability correction factor		**Years' credit for dependent children**		**Third-pillar coverage of population**	
From 2027	Yes	2	3	7%	64%

e: estimated
Source: BBVA Research

The government is pressing ahead with reforms aimed at improving the competitiveness of the Spanish economy

Over recent months, alongside the restructuring of the financial sector, reforms to the pension system and compliance with fiscal targets, the government has announced a series of reforms designed to improve the competitiveness of Spain's economy in the medium term, on a number of fronts: reducing some of the taxes paid by companies, reducing the heavy administrative cost of setting up a company and partly-privatising some publicly owned companies.

These measures are welcome and a step in the right direction. However, in the case of the cut to Companies Tax, the reform penalises companies for scale by restricting the tax cut to SMEs. As for privatisations, the government needs to make progress on the legal framework, labour relations and encourage efficiency of publicly owned companies if it is to maximise the income from stakes that will be non-controlling. Elsewhere, the government has also announced a reduction in the administrative costs to companies, which should be particularly intense at all levels of government given the comparative disadvantage this puts on Spanish companies against their competitors in other developed countries (see Tables 5 and 6).

Table 5
Spain in the Doing Business 2011 ranking*

Ease of doing business	**49**
Closing a business	19
Dealing with construction permits	49
Enforcing contracts	52
Registering property	54
Trading across borders	54
Paying taxes	71
Protecting investors	93
Starting a business	**147**

* For a description of methodology, see the World Bank, Doing Business 2011
Source: World Bank

Table 6
Doing Business 2011 indicators for calculating ease of starting a business

	OECD	Spain
Procedures (number)	5.6	10
Time (days)	13.8	47
Cost (% of income per capita)	5.3	15.1
Paid-in minimum capital (% of income per capita)	15.3	13.5

* For a description of methodology, see the World Bank, Doing Business 2011
Source: World Bank

Continuation of the reform process will be fundamental to Spain's transition to a new productive model

The government is making progress in a reform process that should help boost the growth potential of Spain's economy. However, reorientation of the growth model means pushing through highly ambitious structural reforms that encourage the expansion of new and more productive sectors capable of creating more jobs.

Nowadays, a sizable share of Spain's business activity is ready to press ahead with this change . Table 6 shows an array of sectors where Spanish companies compare favourably to their European counterparts in areas that will be of key importance to the economic model over coming years: indebtedness, profitability, openness to external demand and current share of the economy. These criteria were selected based on evidence that the move to a new pattern of growth will require building up business areas that can be developed with greater dependence on own capital, offer relatively high profitability and can attract external demand.

Table 7
International comparison of sectoral indicators

	Indebtedness		Profitability		Real GVA	Exports
	Spain	Average (GE-FR-IT)	Spain	Average (GE-FR-IT)	Share in Spanish GVA	Share in Spanish exports
Hotels and restaurants	56.2	58.8	8.9	4.0	7.3	14.5
Computer programming, consulting and related business	57.5	49.5	6.0	5.4	7.1	9.2
Retail trade, except motor vehicles	57.3	62.7	4.5	2.0	6.4	
Transport	42.2	51.9	7.4	2.4	5.6	5.7
Wholesale trade and commission trade, except of motor vehicles	61.5	62.8	3.2	2.4	4.1	
Post and telecommunications*	62.6	61.4	19.7	0.2	4.0	0.5
Electricity, gas and water supply	51.2	42.7	14.7	8.7	3.7	0.6
Manufacture of food, beverages and tobacco	54.1	54.4	7.3	3.5	2.7	9.4
Basic metals and manufacture of fabricated metal products	43.3	55.0	6.4	4.6	2.6	4.7
Automobiles and transport equipment	63.6	53.1	0.7	0.2	2.2	14.7
Manufacture of chemicals and chemical products	54.3	47.2	5.5	5.9	1.7	8.9
Manufacture of machinery and electrical apparatus	61.4	49.9	6.1	4.3	0.8	4.4
Textile industry	51.8	54.6	4.0	4.2	0.7	2.9
Manufacture of office, accounting and IT machinery	56.9	33.5	1.7	0.7	0.1	0.9
TOTAL					**49.0**	**76.4**

Indebtedness: borrowings/total assets, annual average (2000-2007). Based on Bach database
Profitability: net profit/net revenue, annual average (2000-2007). Based on Bach database
* Average (GE-IT)
Real GVA: based on INE data (sector GVA as % of GVA in 2008)
Exports: based on OECD and DATACOMEX data, 2008. Services represent 33.8% of total exports
Source: BBVA Research based on BACH, INE and DATACOMEX data

As Table 7 shows, many sectors in the Spanish economy have debt levels similar to those seen in neighbouring economies, and should therefore be relatively unaffected by the deleveraging process, as well as being generally more profitable than the European average. This group of sectors, which generate nearly 80% of the domestic export market, was key to maintaining Spain's share of the global export market after the move to the euro. They also generate a significant share of the economy's GVA, attracting direct foreign investment and making Spain one of the leading countries for inward capital flows, capturing 3.4% of global investment flows in recent years.

Given the strong starting position of much of Spain's business sector, it is critical that the government helps by introducing structural reforms that encourage expansion and increase the economy's potential growth rate. Of particular importance will be labour market reforms and measures that boost competitiveness, allow for the ordered deleveraging of the private sector, reduce the economy's financing needs and improve the quality of human capital.

An ambitious agenda that includes reforms to boost competitiveness in the Spanish economy by linking wages to productivity

As for the next steps, the government has set a time limit for the social partners to agree changes that will improve the collective bargaining process. As we have pointed out in previous editions of the Spain Economic Outlook, this reform is key. It should create a better relationship between wages and productivity, starting by diminishing the use of index-linking salaries to inflation and encouraging negotiation at sector and company level. It might be argued that wage revision clauses made sense in an environment of high domestic inflation, a flexible exchange rate and a closed economy. When price rises were high and volatile, there were costs to renegotiating contracts, the economy could maintain competitiveness in other ways (devaluation of the exchange rate) and wage-indexing was less costly than it is today.

However, over the last 20 years, uncertainty on inflation has eased considerably. Furthermore, despite the many benefits that the euro has brought to Spain, it has also removed a macroeconomic tool that could be used to maintain short-term competitiveness in an economy suffering real disruption.

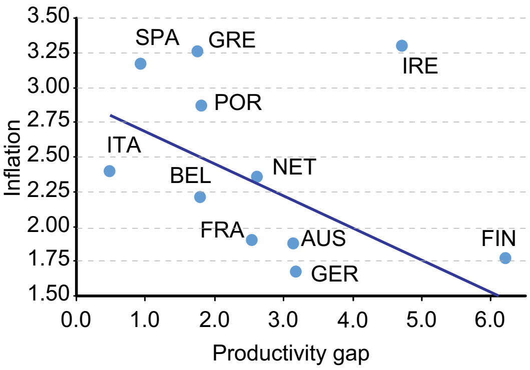
This flexibility is now gone and needs to be replaced by other mechanisms that will allow efficient adjustments to the Spanish economy.

In this environment, the aim of modernising the collective bargaining framework should be to make wages reflect the productivity of workers and the economic situation of the companies concerned (Chart 38). This is particularly important in a climate where Spanish companies have to become more competitive: when salaries rise in line with real productivity and corporate profits rise at the same pace, prices can be kept constant, eliminating inflationary pressure. This means that wages would not lose purchasing power. In fact, any attempt to raise nominal wages faster than productivity runs into one of two problems: either 1) inflation rises faster to compensate for nominal salaries outstripping real productivity, preventing any real gain in purchasing power and eroding competitiveness compared to Spain's main trading partners, or 2) inflation rises less strongly, but at the cost of higher unemployment, a rise in the black economy and a worse distribution of income as employees who keep their jobs gain purchasing power while those who are out of work see their income slashed. Chart 39 shows how Spain's annual average inflation has been higher than that of other EMU-12 countries in the last decade due to the lack of correlation between productivity gains and wage rises.

This means that the best way to safeguard employees' jobs and purchasing power is through greater flexibility and efficiency in the negotiating process, which allows workers and employers to set salary increases in light of not only inflation but also the specific and varied factors of their sector or economic position. If this is to happen, clauses index-linking salaries in collective agreements need to be eliminated and this should be accompanied by measures to increase competition. The medium- and long-term result would be to link salaries to productivity, without additional costs in terms of employment, efficiency, or distribution of income.

Chart 38

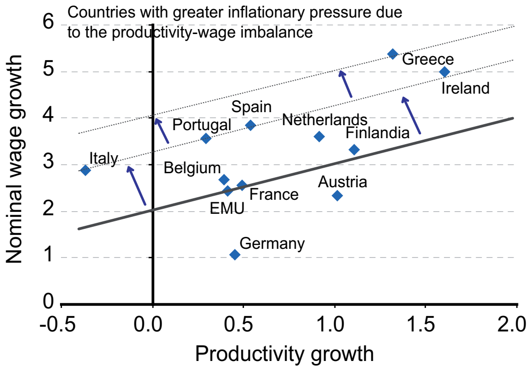
Inflation and productivity growth (tradables vs non-tradables) (1999-2008 average)



Source: AMECO and BBVA Research

Chart 39

Difference between nominal wage growth and productivity growth, 2000-2009 annual average (%)*



* Productivity is measured as GDP divided by number of employees (preferably FTE when data is available). EMU is the euro area 12

Source: BBVA Research based on AMECO data

5. Tables

Table 8

Macroeconomic forecasts: Gross Domestic Product

(Tasas anuales, %)	2008	2009	2010	2011	2012
US	0.4	-2.6	2.8	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.8
Germany	0.7	-4.7	3.6	2.4	1.9
France	0.1	-2.5	1.5	1.6	1.8
Italy	-1.3	-5.1	1.1	1.0	1.1
Spain	0.9	-3.7	-0.2	0.9	1.9
UK	-0.1	-4.9	1.4	1.7	1.9
Latin America*	4.0	-2.4	6.0	4.4	3.9
EAGLES**	6.6	3.5	8.3	7.0	6.8
Asia	5.6	3.7	8.1	6.5	6.4
China	9.6	9.2	10.3	9.2	9.0
Asia (excluding China)	2.9	0.1	6.7	4.8	4.7
World	3.0	-0.6	4.8	4.4	4.4

Closing date: 31 January 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brasil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 9

Macroeconomic forecasts: 10Y interest rates (average)

	2008	2009	2010	2011	2012
US	3.6	3.2	3.2	3.4	3.8
EMU	4.0	3.3	2.8	3.1	3.1

Closing date: 31 January 2011
Source: BBVA Research

Table 10

Macroeconomic forecasts: exchange rates (average)

US dollars ($) per national currency	2008	2009	2010	2011	2012
US (EUR/USD)	0.68	0.72	0.76	0.79	0.78
EMU	1.47	1.39	1.33	1.27	1.29
UK	1.82	1.56	1.55	1.53	1.52
China	6.95	6.83	6.77	6.46	6.10

Closing date: 31 January 2011
Source: BBVA Research

Table 11

Macroeconomic forecasts: official interest rates (end of period)

	2008	2009	2010	2011	2012
US	0.61	0.25	0.25	0.25	0.50
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	7.06

Closing date: 31 January 2011
Source: BBVA Research

Table 12

EMU: macroeconomic forecasts (y-o-y change, %, unless otherwise indicated)

	2008	2009	2010	2011	2012
Household consumption:	0.3	-1.0	0.7	1.0	1.5
Public consumption	2.2	2.4	0.7	0.4	0.7
GFCF	-0.9	-11.3	-1.0	1.6	2.0
Capital goods and other products	0.8	-15.9	2.5	2.8	3.2
Capital goods	0.7	-17.6	3.6	2.7	3.0
Construction	-2.2	-7.8	-3.5	-0.2	0.8
Housing	-4.7	-10.7	-3.3	-0.1	0.7
Domestic demand (*)	**0.5**	**-3.3**	**1.7**	**1.1**	**1.4**
Exports	0.7	-13.1	9.7	6.9	5.7
Imports	0.8	-11.8	9.9	5.6	4.9
Net exports (*)	**0.0**	**-0.8**	**0.0**	**0.6**	**0.4**
GDP mp (% y-o-y)	**0.4**	**-4.0**	**1.7**	**1.7**	**1.8**
Pro-memoria:					
GDP w/out housing investment	0.7	-3.7	2.0	1.8	1.8
GDP w/out construction	0.7	-3.6	2.3	1.9	1.9
Employment (LFS)	0.9	-1.8	-0.4	0.4	0.6
Unemployment rate (% active pop.)	7.6	9.5	10.0	10.0	9.9
Current account balance (% GDP)	-1.1	-0.7	-0.5	0.0	0.1
Public sector balance (% GDP)	-2.0	-6.3	-6.5	-4.7	-3.9
CPI annual average	3.3	0.3	1.6	1.8	1.6

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

Table 13
Spain: macroeconomic forecasts (y-o-y change, %, unless otherwise indicated)

	2008	2009	2010	2011	2012
Activity					
Real GDP at market prices	0.9	-3.7	-0.2	0.9	1.9
Private consumption	-0.6	-4.3	1.1	0.2	1.2
Public consumption	5.8	3.2	0.0	-0.6	-0.3
Gross fixed capital formation	-4.8	-16.0	-7.6	-2.9	3.4
Capital goods	-2.5	-24.5	1.5	0.7	5.5
Construction	-5.9	-11.9	-11.1	-5.3	2.3
Housing	-10.7	-24.5	-17.3	-7.1	4.1
Other construction	-0.8	-0.1	-6.7	-4.1	1.0
Other goods	-4.1	-16.2	-7.7	0.3	4.2
Chg in inventories (*)	0.1	0.0	0.0	0.0	0.0
Domestic demand (*)	-0.6	-6.4	-1.1	-0.7	1.4
Exports of goods and services	-1.1	-11.6	9.0	9.1	7.0
Imports of goods and services	-5.3	-17.8	4.4	2.0	4.6
Net exports (*)	1.5	2.7	1.0	1.6	0.5
GDP at current prices	3.3	-3.1	0.9	2.7	3.2
Billion euros	1088.1	1053.9	1063.2	1091.5	1126.4
Prices and Costs					
GDP deflator	2.4	0.6	1.1	1.8	1.3
Household consumption deflator	3.5	0.1	2.5	1.7	1.0
CPI	4.1	-0.3	1.8	1.9	1.3
Compensation per employee	6.3	4.1	1.2	2.2	2.6
Unit labour cost (ULC)	4.9	1.0	-1.0	1.1	1.6
Foreign trade					
Trade balance (% GDP)	-8.0	-4.3	-4.1	-2.7	-2.4
Current account balance (% GDP)	-9.7	-5.5	-4.5	-3.1	-2.8
Government sector					
Debt (% GDP)	39.8	53.2	62.8	67.7	70.6
Public Administration balance (% GDP)	-4.1	-11.2	-9.0	-6.0	-4.5
Labour market					
Active population (LFS)	3.0	0.8	0.2	0.5	0.4
Employment (LFS)	-0.5	-6.8	-2.3	-0.2	1.1
Change, thousands of people	-98.3	-1369.7	-431.5	-34.7	199.6
Full-time equivalent employment (QNA)	-0.5	-6.6	-2.3	-0.3	0.9
Unemployment rate (% active pop.)	11.3	18.0	20.1	20.6	20.1
Productivity	1.4	2.9	2.2	1.1	0.9
Households					
Real disposable income	2.4	1.6	-5.0	-1.7	1.9
Nominal disposable income	6.0	1.7	-2.6	0.0	3.0
Savings rate (% of nominal income)	13.5	18.1	12.7	11.1	11.7

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

DISCLAIMER

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

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

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

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

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

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

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA and the rest of entities in the BBVA Group which are not members of the New York Stock Exchange or the National Association of Securities Dealers, Inc., are not subject to the rules of disclosure affecting such members.

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

This report has been produced by the Spain and Europe Unit:

Chief Economist
Rafael Doménech
+34 91 537 36 72
r.domenech@grupobbva.com

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

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

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

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

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

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

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

Isabel Mohedano
+34 91 374 62 66
isabel.mohedano@grupobbva.com

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

Financial Systems
Ana Rubio
+34 91 374 33 42
arubiog@grupobbva.com

Macarena Ruesta
+34 91 374 33 21
esperanza.ruesta@grupobbva.com

Carlos Corcóstegui
+34 91 374 88 99
carlos.corcostegui@grupobbva.com

Economic Scenarios
Juan Ruiz
+34 91 374 58 87
juan.ruiz@grupobbva.com

Financial Scenarios
María Martínez Álvarez
+34 91 537 66 83
maria.martinez.alvarez@grupobbva.com

Pensions
Javier Alonso
+34 91 537 67 65
javier.alonso.meseguer@grupobbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@grupobbva.com

Regulatory Affairs
María Abascal
maria.abascal@grupobbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

Spain and Europe:
Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

United States and Mexico:

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country *Emerging Markets* Analysis
Daniel Navia
daniel.navia@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

South America
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Contact details

BBVA Research
Paseo Castellana, 81 - 7ª planta
28046 Madrid (España)
Tel.: +34 91 374 60 00 y 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@grupobbva.com
www.bbvaresearch.com
Legal Deposit: M-31254-2000