

# Spain Economic Outlook

Madrid. 8 February 2012

## Key themes

- 1 **The global economy will grow between 3.5% and 4%**, both 2012 and 2013
- 2 **Downward risks will be diminishing** as European policies reduce uncertainties
- 3 **Europe is now in recession, but with wide variations**
- 4 Spain's recovery depends on whether Europe can **resolve the debt and financial crisis**, and on the **adjustments and reforms being implemented**
- 5 Fiscal adjustment and external openness condition **the diversity in regional growth**
- 6 The new **Stability Pact**, the ECB's **liquidity measures** and the **structural reforms** approved in **Italy and Spain** are positive steps forward

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## Section 1

**International environment: uneven growth rates in Europe.  
lagging behind the rest of the world**

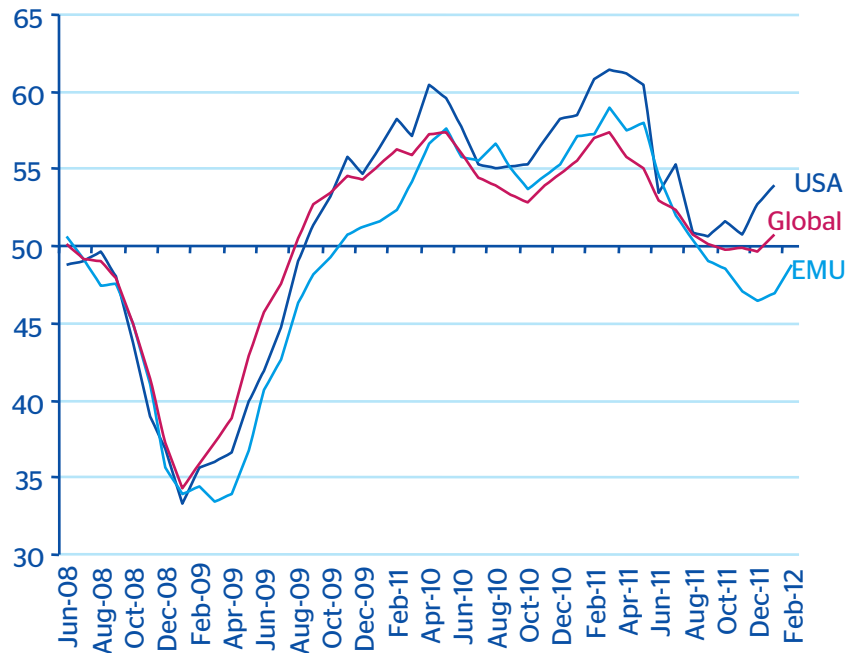
## Section 2

Spain: in recession again. and facing the challenge of preventing further job losses

# 1. Differences between regions and in their stage in the economic cycle

## Business expectations (PMI)

Source: BBVA Research based on Bloomberg data  
 \* Levels above 50 indicate expansion



**US: outlook better after risk of recession in 2H11**

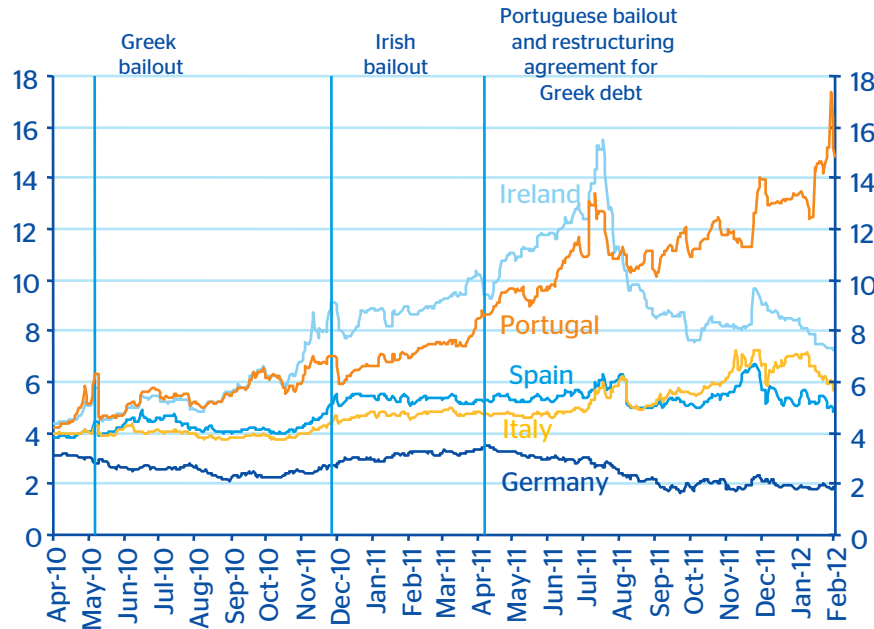
**Europe: Drop in confidence indicators and expectations in 3Q11 and 4Q11. Better in 1Q12?**

**Slight slowdown in emerging economies**

## 2. The sovereign debt crisis continues

### 10-year bond yields

Source: BBVA Research based on Bloomberg data



Peripheral countries' risk premiums remain high

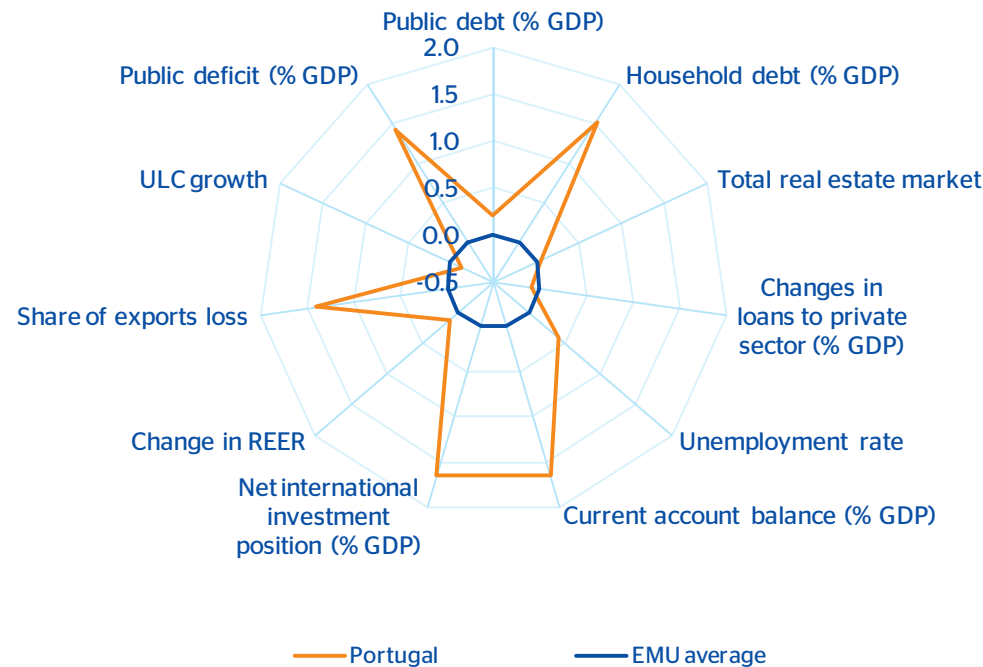
From failure in Greece to success in Ireland

Portugal is now the unknown factor in markets, with the risk of contagion from Greece

# 3. Risk of contagion to Portugal

## Portugal: macroeconomic imbalances

Source: BBVA Research based on Haver, Eurostat, OECD and WTO data



**Against: severe initial imbalances and self-fulfilling expectations**

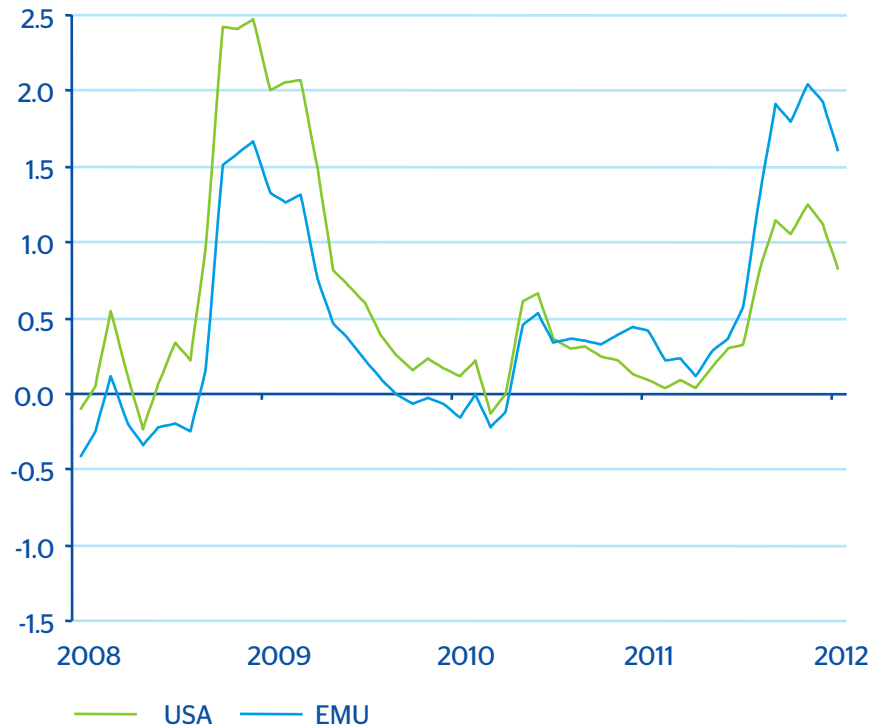
**In favour: ambitious structural reforms**

**Restructuring can be avoided, perhaps with financial support beyond 2012**

# 4. Financial pressures remain severe

**BBVA financial stress index (FSI)**

Source: BBVA Research



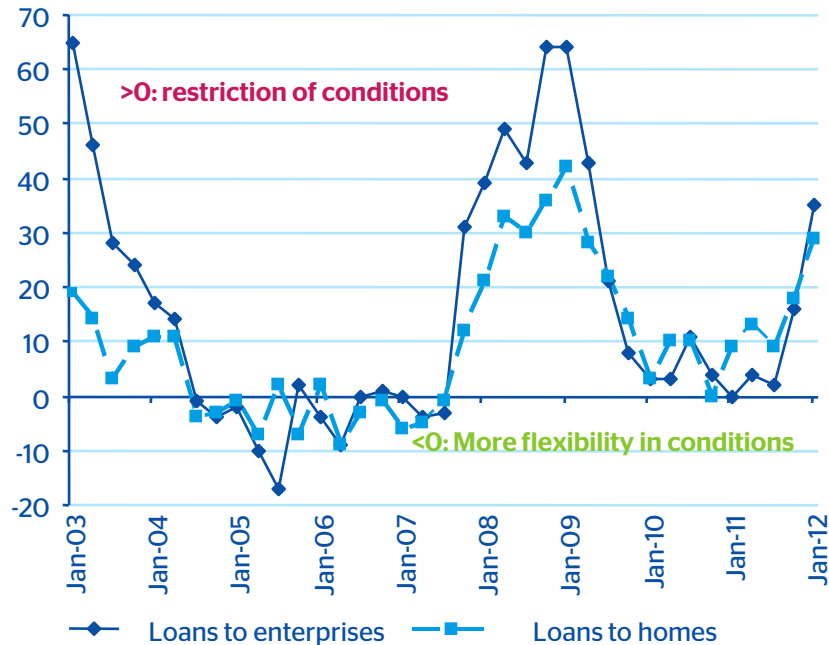
Although 3-year debt auctions are flooding the market with liquidity...

... financial stress levels in Europe remain extremely high...

... and wholesale financing markets are still imbalanced (centre/periphery)

# 5. Risk of credit tightening

**EMU: credit conditions last 3 months** (net weighted percentage)  
 Source: BBVA Research based on ECB data



Lack of solvency on the demand side and supply-side pressures are behind the downturn in lending

liquidity restrictions and stricter capital requirements...

... could explain the tougher lending terms we are seeing



## 6. 30/1 summit: towards Maastricht 2.0

### Conclusions

Stability Pact to limit structural deficit to 0.5% and introduce sanctions

The ESM to be brought forward one year to July 2012

Greek crisis: pending agreement on private haircuts and second bailout

Growth: facilitate the use of structural funds to boost jobs and SMEs

### Evaluation

In line with the fiscal package demanded by the ECB and Germany. Final text still pending

The amount and how it will work are yet to be announced, with an increase in IMF funding likely

Doubts concerning haircut participation, the sustainability of Greece's debt and its reforms

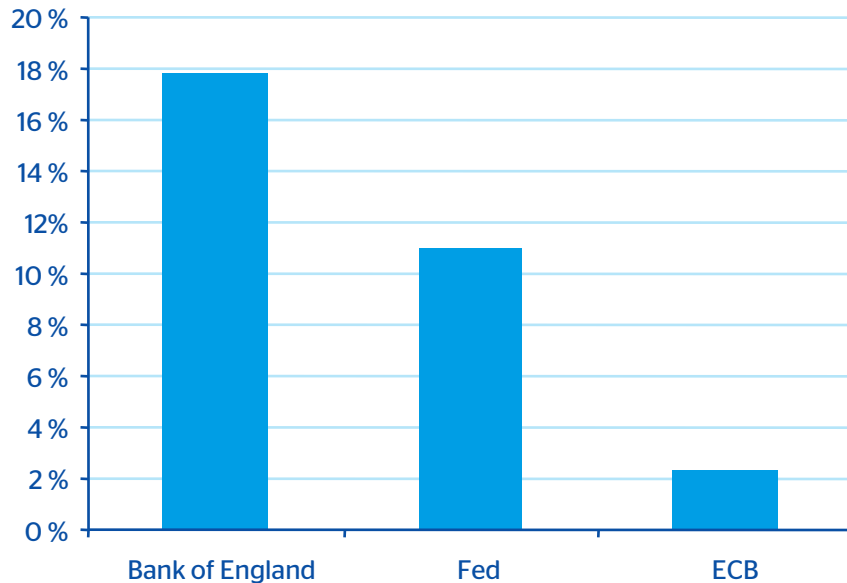
No new funds and no structural fiscal targets

# 7. Expansive but heterogeneous monetary policy

## Purchase of public debt by central banks

(% of GDP)

Source: BBVA Research based on national central banks' data



## Likely role of the ECB

- The ECB has significantly boosted banking liquidity...
- ... helping to reduce risk premiums
- The new fiscal pact and reforms could allow the ECB to be more active

## A slow, uneven and vulnerable recovery

### Risk scenario

Misadventure in Europe  
(disorderly default in Greece → contagion)

Return to recession in the US and  
bumpy landing for emerging economies

Geopolitical risks

Regulatory risks

### Baseline scenario

Orderly restructuring of Greek debt and  
EFSF+ESM prevent contagion

ECB injects sufficient liquidity and wholesale  
markets reopen to banks

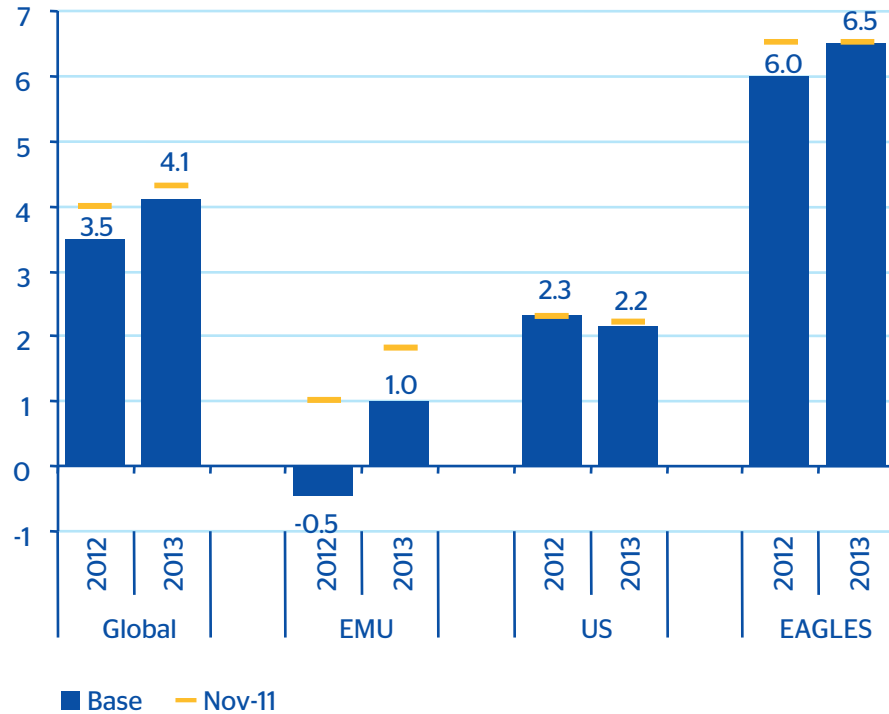
The pact and reforms help to reduce risk  
premiums

The US economy continues to recover slowly  
and emerging economies remain dynamic

# Europe falling behind rest of the world on growth

## GDP growth (% yoy)

Source: BBVA Research



Global growth slowing slightly

Significant growth downturn in Europe

Emerging economies are still showing dynamism despite global risk

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## Section 1

International environment: uneven growth rates in Europe, lagging behind the rest of the world

## Section 2

**Spain: in recession again, and facing the challenge of preventing further job losses**

# Main changes to economic scenario in 2012

## Factors determining the economic scenario

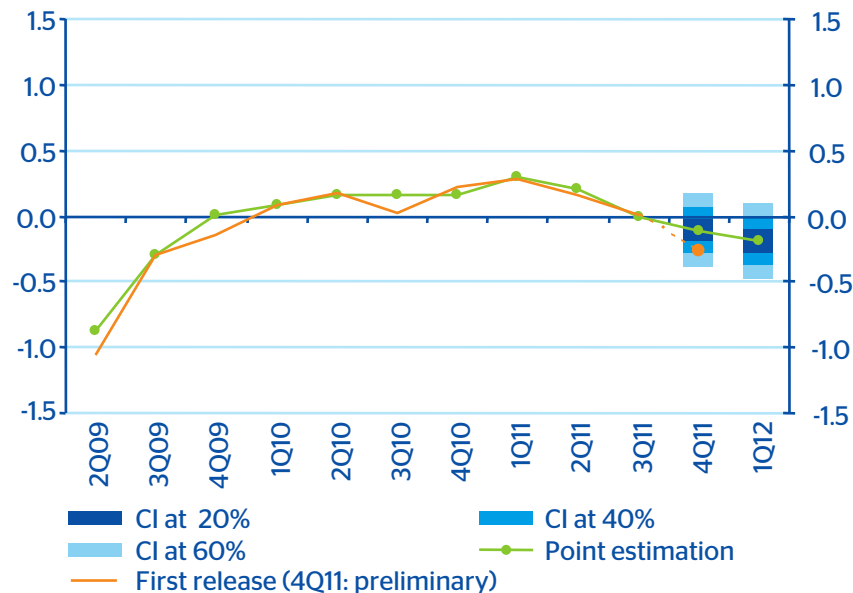
Source: BBVA Research

<b>Growth forecast three months ago</b>		<b>+1.0%</b>
<b>New factors</b>	Declining activity levels in 4Q11 despite failing to meet fiscal targets	-0.3
	Additional fiscal adjustment to make up shortfall from 2011 target	-0.8
	Financial stresses and European growth revised downward	-2.0
	More lax monetary policy and depreciation of the euro	+0.8
<b>New growth forecast for 2012</b>		<b>-1.3%</b>

# Declining economic activity

## Spain: real GDP growth and forecasts using MICA-BBVA model (%. qoq)

Source: BBVA Research  
Current forecast: 3 February



**GDP shrank by 0.3% in 4Q11...**

**...with falling internal demand and slowing exports**

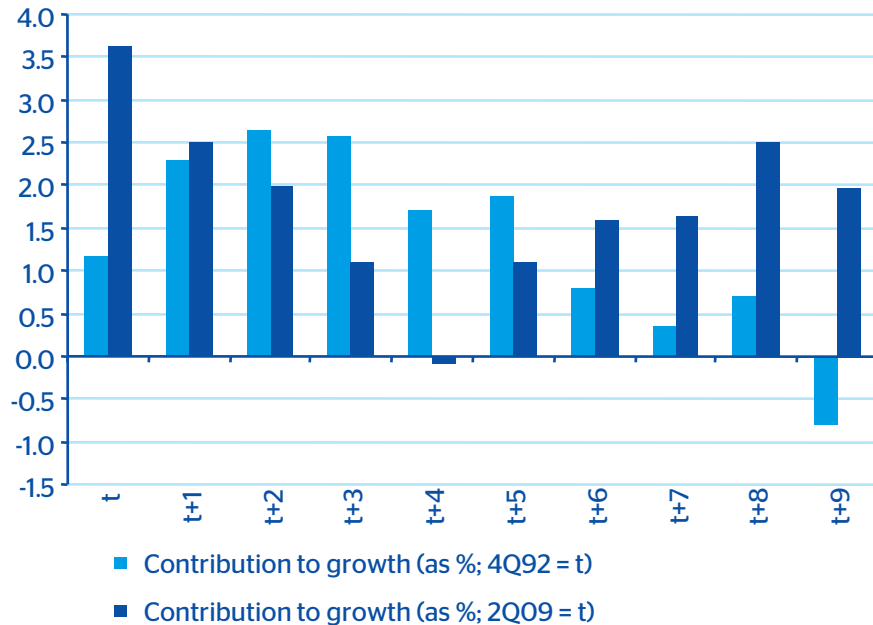
**Based on the information available, we forecast negative growth in 1Q12 (-0.2%)**

**Employment will be affected by the worsening growth prospects**

# Further contraction prevented by foreign demand

## Spain: contribution of net exports to growth

Source: BBVA Research based on INE data



Note: t refers to the period in which the exports' cyclical minimum were recorded in each recession.

Exports are higher than pre-crisis levels and 30% above their cyclical minimum...

... and are very diversified in terms of sector and region

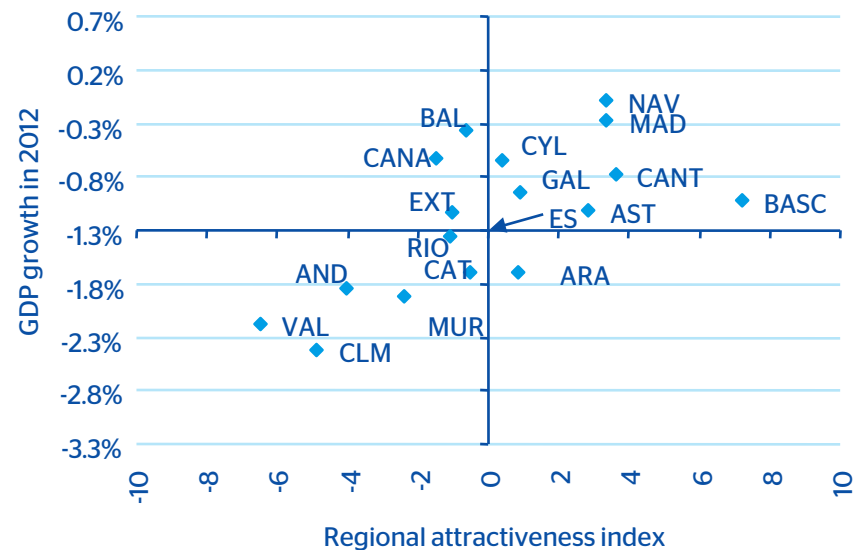
The expected depreciation of the euro and the strength of emerging markets will act as support



# Regional growth: differences in the adjustment

## Autonomous communities: regional attractiveness index and growth forecasts for 2012

Source: BBVA Research based on INE data



## Factors affecting regional growth

Fiscal adjustments and shrinking public sector, unemployment rates, indebtedness and existing imbalances

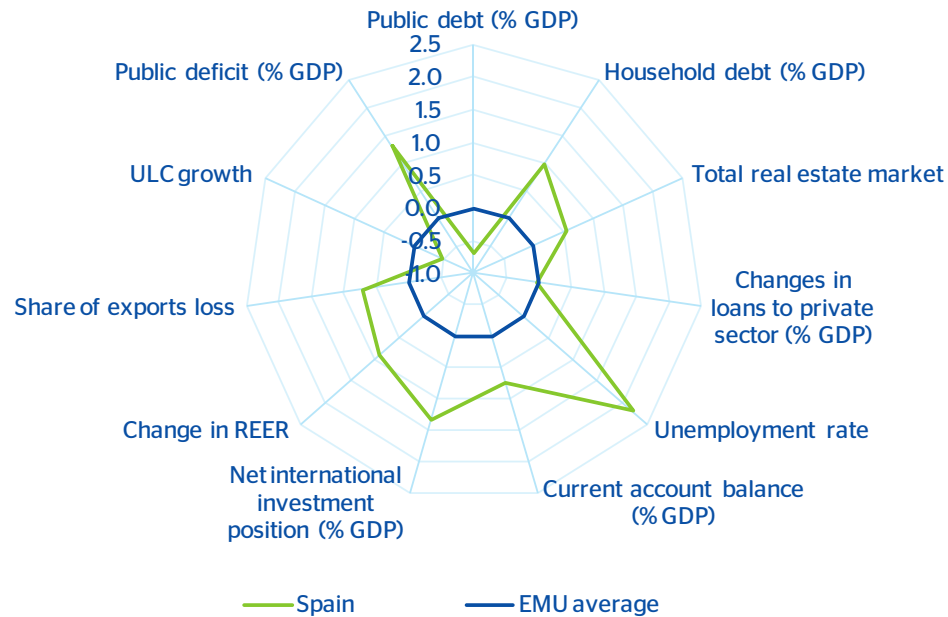
Openness to external markets and household savings levels

Heterogeneous growth

# Imbalances generated by boom and bust

## Spain: macroeconomic imbalances (*Six Pack*)

Source: BBVA Research based on INE data



A process of excessive imbalances

**Imbalances during the boom: NIIP, private debt, real estate sector, competitiveness**

**Imbalances built up during the crisis: public deficit, high unemployment**

**How long the imbalances will last depends on cuts and structural reforms**

# The challenges for economic policy

<p><b>Fiscal adjustment</b></p> <ul style="list-style-type: none"> <li>Cut AGE costs (€8.9 Bn)</li> <li>Raise personal income tax and real estate tax (€6.3 Bn)</li> <li>General Tax Control Plan (€8.4 Bn)</li> <li>Public Sector Resizing Plan</li> <li>2012 Budget</li> <li>Budgetary Stability Law</li> </ul>	<ul style="list-style-type: none"> <li>Approved</li> <li>Approved</li> <li>In progress</li> <li>In progress</li> <li>Approval expected by end of March</li> <li>Draft law approved</li> </ul>
<p><b>Financial reform</b></p> <ul style="list-style-type: none"> <li>Clean-up of the financial system</li> <li>Restructuring FROB entities</li> <li>Other (liquidity, executive remuneration)</li> </ul>	<ul style="list-style-type: none"> <li>Approved</li> <li>In progress</li> <li>FROB guarantees and salary caps approved</li> </ul>
<p><b>Structural reforms</b></p> <ul style="list-style-type: none"> <li>Labour market reform</li> <li>Youth employment plan, tax breaks, Corporate Income Tax reform</li> <li>Fiscal improvements (offsetting debt, VAT)</li> <li>Reforms affecting regulations and regulators</li> <li>Energy policy reforms</li> <li>More sustainable pension system</li> <li>Basic Health Services Law</li> <li>National Education Quality Strategy</li> </ul>	<ul style="list-style-type: none"> <li>To be approved by Council of Ministers 10 February</li> <li>Entrepreneurs, market unity, regulators</li> <li>Freeze on new subsidies. life of Garoña nuclear plant extended</li> <li>Retirement pension calculate, incentives to extend working life</li> </ul>

# 1. Fiscal adjustment focused on structural issues

## Spain: growth forecasts and public deficit

	GDP growth	Government balance	Change in cyclical component	Change in structural component
	Stability Programme (2011)			
2010	-0.1	-9.2	0.0	0.0
2011	1.3	-6.0	-0.1	3.4
2012	2.3	-4.4	0.4	1.2
Reduction in structural deficit in 2011 and 2012				4.6
BBVA scenario				
2010	0.1	-9.2		
2011	0.7	-8.2	-0.1	1.2
2012	-1.3	5.3	-1.3	4.2
Reduction in structural deficit in 2011 and 2012				5.3

## Process of fiscal consolidation

The failure to meet 2011 targets has damaged the credibility of the public sector

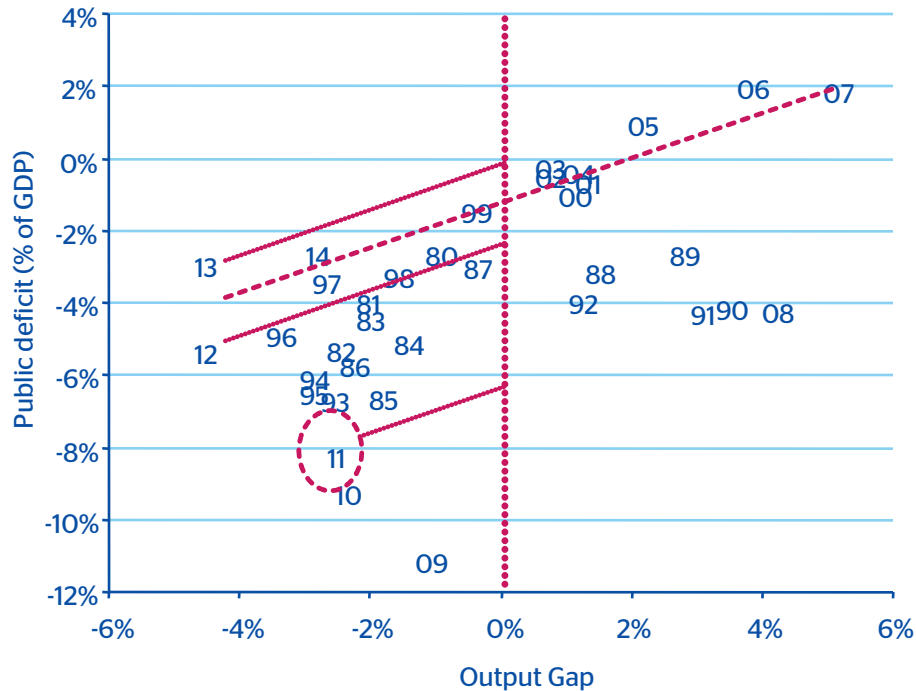
Bringing the deficit below 6% would require greater efforts than those planned in the Stability Programme

Ongoing improvements to public administrations governance and transparency are vital

# 1. Fiscal adjustment: the Budgetary Stability Law

## Spain: fiscal deficit and *output gap*

Source: BBVA Research, using MEH data



A necessary and positive reform

Reinforce commitment to medium- and long-term budgetary stability

Practical and credible mechanisms to control autonomous communities' spending (caps).

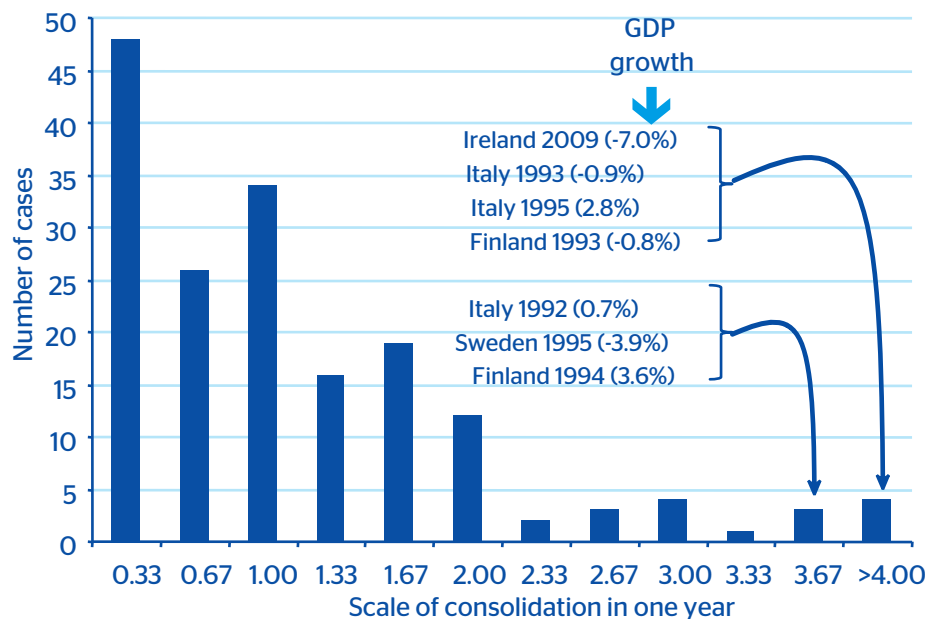
Transition to 2020 targets and sanctions must be balanced

Fiscal adjustments must be assessed in terms of structural changes

# 1. The debate on fiscal adjustment strategies

## Distribution of fiscal adjustments by size in the OECD

Source: BBVA Research based on Devries et al (2011)



## Processes of fiscal consolidation

A historical review of fiscal consolidations helps to understand the scale of the efforts

The scale of the adjustment being planned in Spain is virtually unheard of in the developed world

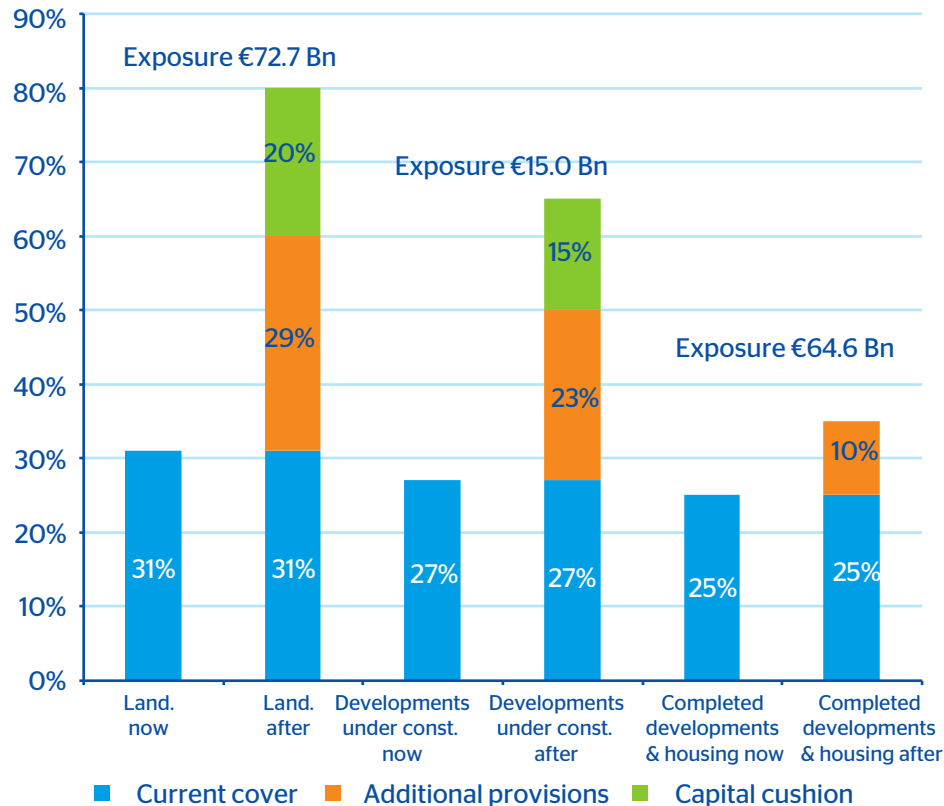
In the majority of similar cases, tax increases were almost inevitable

Based on 173 cases of fiscal consolidation between 1978 and 2009 in 17 OECD countries (Australia, Austria, Belgium, Japan, Holland, Portugal, Spain, Sweden, UK, Canada, Denmark, Finland, France, Germany, Ireland, Italy and the US)

## 2. Bank restructuring

### Troubled real estate assets: additional provisions and capital cushion

Source: BBVA Research based on MEH figures



New measures are a positive step forward

More realistic evaluation of real estate assets and better reorganization

Stricter requirements for entities. the impact of which depends on how they are applied

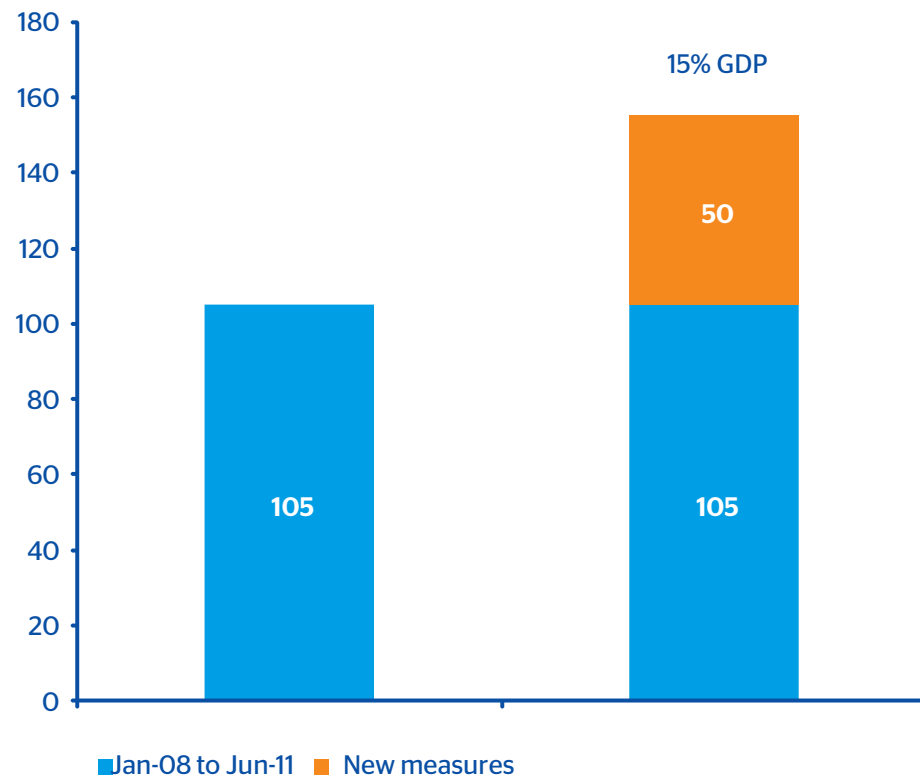
Intention of minimise the public cost of restructuring process

## 2. Bank restructuring

### Clean-up of cumulative balances

(Billion euros)

Source: BBVA Research, based on Bank of Spain data



Completing the restructuring will require

Identifying non-viable entities and finding a definitive solution for them ...

... Generating adequate mergers, speeding up the adjustment of the capacity installed...

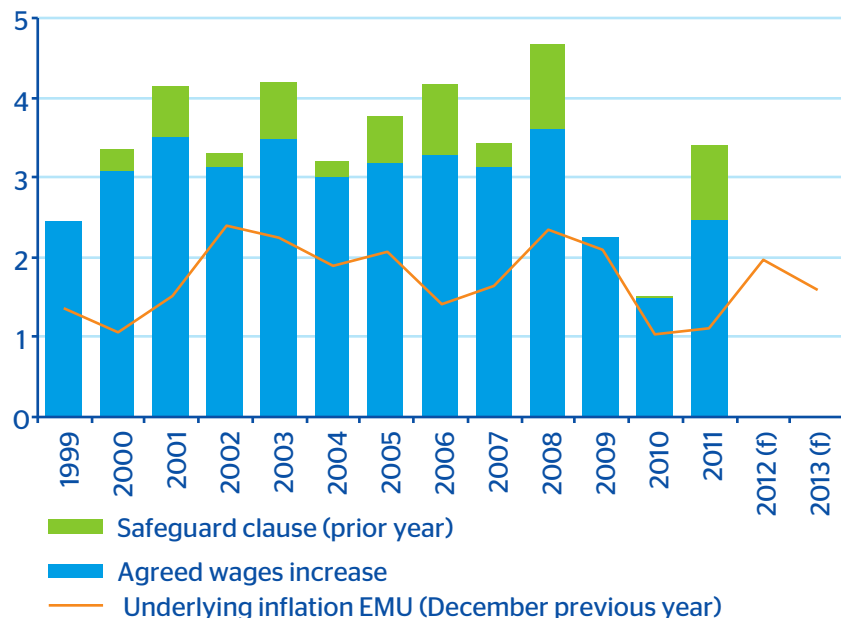
...laying the foundations to ensure credit flows to productive activities



# 3. Agreement between business organisations and unions

## Spain: salary increases built into collective bargaining agreement and t-1 safeguard clause (%)

Source: BBVA Research based on MEYSS, MEH and Eurostat data



Positive but not enough

Positive agreements on salary limits, performance-related pay and internal flexibility

The agreement helps rein in inflation → improved price competitiveness

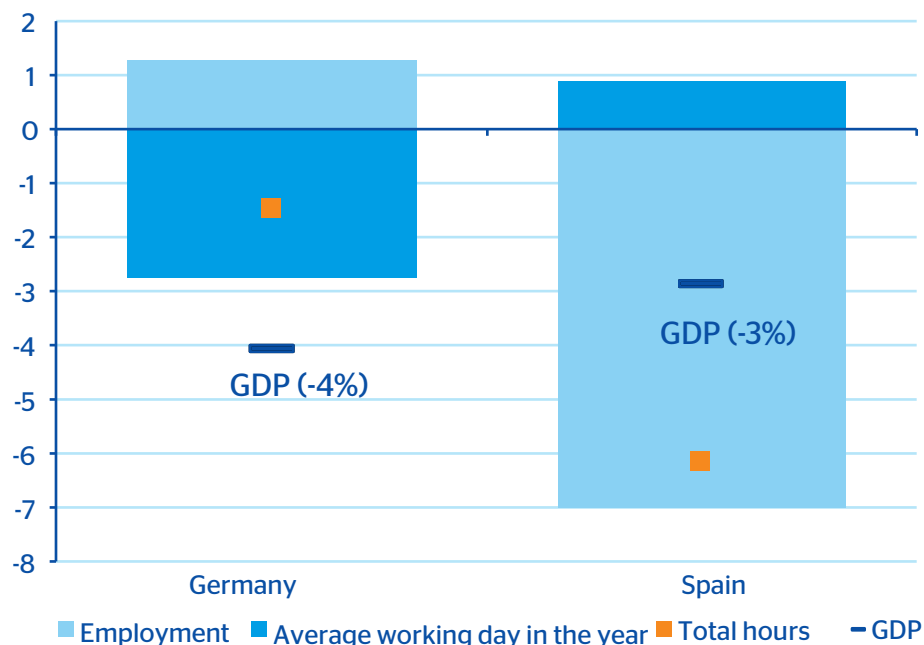
A more ambitious agreement is required to address the situation of the Spanish labour market

There is clear room for improvement in collective bargaining processes and wage opt-out clauses

### 3. Labour reforms: the remaining challenges

#### Spain: economic growth and breakdown of difference in number of hours worked

(cumulative change 2007-09, %)  
 Source: BBVA Research based on INE and EC data



From a dual market (*rigid/flexible*) to an efficient market

Adjustment concentrated on the extensive margin (jobs) rather than the intensive margin (hours per employee)

Short-term goal: prevent further job losses → adjust working day + wages flexibility and effective organization

Medium-term: more stable and productive jobs → efficient contracts, decentralization of collective bargaining and effective employment policies

Result: more competitive companies and high quality jobs

## Conclusions

- 1 **2012: another year characterised by risks and challenges**
- 2 **Uneven growth globally, in Europe and in Spain**
- 3 Spain's recovery depends on whether Europe can **resolve the debt and financial crisis**, and on the **adjustments and reforms being implemented**
- 4 The new **Stability Pact**, the ECB's **liquidity measures** and the **structural reforms** approved in **Italy and Spain** are positive steps forward.

Thank you

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# Weak growth scenario

## Macroeconomic forecasts

Source: BBVA Research based on INE, Bank of Spain and Eurostat data  
 (\*) contribution to growth

(% YoY)	2010		2011 (f)		2012 (f)		2013 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	0.7	0.8	0.0	0.2	-2.0	-0.2	-0.9	0.8
General government final consumption expenditure	0.2	0.6	-1.2	0.1	-3.1	-0.4	-1.8	0.5
Gross fixed capital formation (G.F.C.F.)	-6.2	-0.7	-4.6	1.8	-6.3	-2.6	-1.9	1.5
Equipment and cultivated assets	5.3	4.7	2.1	4.7	-5.0	-2.6	2.1	2.2
Equipment and machinery	5.5	4.1	2.1	5.4	-5.2	-1.9	1.9	2.3
Housing	-9.8	-3.6	-4.8	1.8	-6.5	-1.0	-1.5	1.2
Other constructions	-10.4	-5.2	-10.2	-3.0	-8.0	-5.2	-6.5	0.7
Changes in inventories (*)	0.0	0.5	0.1	0.1	0.0	0.0	0.0	0.0
Domestic Demand (*)	-1.0	1.0	-1.3	0.6	-3.2	-0.7	-1.3	0.9
Exports	13.5	11.3	9.2	6.8	1.6	2.6	8.2	3.3
Imports	8.9	9.5	1.6	4.8	-4.8	2.1	2.1	3.1
External Demand (*)	0.9	0.8	2.0	0.9	1.9	0.2	1.9	0.1
GDP mp	-0.1	1.8	0.7	1.5	-1.3	-0.5	0.6	1.0
<b>Pro-memoria</b>								
GDP excluding housing	0.8	2.1	1.2	1.5	-0.9	-0.5	0.8	1.0
GDP excluding construction	2.0	2.6	2.3	1.8	-0.3	-0.2	1.3	1.0
Total employment (LFS)	-2.3	-0.5	-1.9	0.5	-4.2	-0.2	-1.9	0.3
Unemployment rate (% Active pop.)	20.1	10.1	21.6	10.1	24.4	10.6	24.6	10.5
Current account balance (% GDP)	-4.6	0.1	-4.3	0.0	-3.5	0.1	-1.1	0.4
Public debt (% GDP)	60.7	85.8	67.6	86.6	72.5	88.7	74.4	88.6
Public deficit (% GDP)	-9.3	-6.2	-8.2	-4.2	-5.3	-3.0	-3.0	-2.0
CPI (average)	1.8	1.6	3.2	2.7	1.2	1.8	1.1	1.3
CPI (end of period)	3.0	2.0	2.4	2.9	0.9	1.6	1.3	1.3