

# Economic Outlook

## Spain

Fourth Quarter 2012  
Economic Analysis

- **The risk of a euro break-up fades after the measures announced by the EMU**
- **Europe needs a credible**, effective and permanent political agreement between creditor and debtor countries.
- **Spain: the recession continues** but is less intense in the third quarter.
- **Towards sustainability:** fiscal measures are bearing fruit but the recession is hampering efforts to meet the budget deficit target.
- **Implementation of structural reforms is** more necessary than ever before.

## Index

1. Editorial.....	3
2. In quest of stability in the eurozone: “whatever it takes” .....	5
3. Growth outlook for the Spanish economy: the recession will continue in 2013 .....	9
Box 1. Restructuring of the Spanish financial system .....	20
Box 2. Raising productivity: a major challenge.....	22
Box 3. Real estate crises and housing prices: an international perspective .....	24
Box 4. Export shares, real effective exchange rates and the Spanish puzzle.....	25
4. Significant fiscal adjustment, but probably not enough to meet targets.....	28
5. Tables.....	33

Closing date: November 2, 2012

## 1. Editorial

Spanish economic activity and employment figures continue to adjust, a process that is most likely to extend into the first half of 2013, causing GDP to shrink by 1.4% this year and next. Although third quarter activity declined less sharply than forecast three months ago and the statements made by the Economic and Monetary Union (EMU) have considerably reduced the risk of a break-up of the euro, the short-term outlook remains bleak. Moreover, uncertainty over whether the Government will meet its 2012 and 2013 fiscal deficit targets and doubts surrounding the conditionality (especially fiscal conditionality) which could be agreed on should Spain eventually request aid from the European Stability Mechanism (ESM) and the European Central Bank (ECB), pose a significant risk to economic growth in 2013, the scale of which is currently difficult to gauge.

As we have already seen, a significant cause of Spain's high risk premium is the fact that the financial markets had already been pricing in a high probability of a euro break-up. Policies adopted in recent months have helped dissipate these fears, leading to a significant reduction in the interest rates being paid by the Spanish public sector. We have also seen foreign demand for government debt increase and an incipient reopening of the private debt market.

Europe is currently working on a road map for bank and fiscal union. In this regard, it is essential that the agreements adopted establish a credible and permanent political commitment between eurozone countries, and that the foundations are laid to create institutions capable of solving the type of problems that have rocked Europe for the past four years. A single banking supervisor, direct recapitalisation of the financial system by the ESM and the establishment of a European fiscal authority with power to veto eurozone countries' budgets, are necessary (although non-sufficient) conditions to achieving a greater credibility for the European project.

Economic activity indicators for the past three months show that the Spanish economy is still in recession but the contraction is less intense than originally forecast. Even though information supporting this unexpected turn of events is partial, several factors could be behind it. Firstly, the impact of the Supplier Payment Plan, implemented during the second quarter of the year, could have been greater than expected. Since this is a provisional measure and given that liquidity problems persist in the various autonomous regions -as borne out by the need to set up the Regional Liquidity Fund (RLF)-, this positive effect will be temporary. Second, exports are marking a positive trend despite the worsening economies of Spain's main trading partners. Not only has the decline in exports to European countries slowed in absolute terms, but increased exports to emerging economies have helped Spanish producers. The continuation of this favourable trend, even in the face of conditions as adverse as those seen in recent months, is extremely positive and confirms that once domestic demand recovers, we will see a return to growth and this growth could even be relatively high. Finally, the Government has announced a far-reaching legislative calendar to implement a series of reforms aimed at eliminating "bottlenecks" in sectors which have traditionally hampered the competitiveness of the Spanish economy. Of particular importance is the speed with which it has pushed through legislation to comply with the terms of the Memorandum of Understanding to speed up and to decrease the cost of restructuring of part of the financial system. Likewise, the condition of establishing a credible road map which will be more supportive to future growth has already been met.

Meanwhile, if fiscal consolidation has been less rigorous than expected, this could lead to a less optimistic view of improved economic activity. In fact, although major advances have been made to reduce public spending, these do not appear to be enough to meet the 2012 deficit target, given the decline in revenue. Although the measures announced were viewed as sufficient -even though some were delayed-, the implementation risk warned some months ago appears to be materialising. In terms of growth, this would mean that part of the adjustment will be delayed until 2013 and that uncertainty over the measures to be announced to offset any deviation from the year-end deficit target could result in decisions on private sector spending to be left unaddressed. Moreover, even though the Government has decided that the bulk of

the remaining adjustment will be concentrated on spending (thereby minimising the impact on growth if it focuses on improving efficiency), in the future we expect to see incentives to increase the tax burden. These include the temporary nature of some of the measures announced (such as the reduction in public sector wages and the increase in income tax) and the uncertainty surrounding the outcome of other measures (e.g. public sector reform).

In any case, it is worth remembering that, even if the Government fails to comply with its 2012 deficit target, available data appears to indicate that the structural imbalance in the public accounts will be reduced more substantially than ever before in the developed economies. According to BBVA Research estimates, if the Government had not introduced discretionary fiscal measures throughout the year, the public deficit at the end of 2012 would be of 11.5% of GDP (excluding aid given to the financial system) due to the recession, the higher debt service burden and the increase in social security beneficiaries. Therefore, in order to reduce the deficit to around 7%, as we are forecasting, the fiscal effort (structural deficit reduction) will be greater than 4% of GDP. This reduction in the structural deficit indicates that fiscal consolidation is having the desired effect, but that, given the current economic circumstances, the process is slow and very costly. Therefore, the adjustment must be viewed positively as it places public finances on the path to sustainability and demonstrates that the medium-term fiscal consolidation target may be credible.

All of this is crucial when we speculate on the conditions which would accompany a hypothetical aid programme for the Spanish economy under the terms established by the ECB through Outright Monetary Transactions (OMT). Within the framework of this programme, Spain and Europe need to guarantee that fiscal adjustments are assessed in structural terms (taking into account the economic downturn) and not using nominal targets, as has been the case up until now. It is therefore vital that the country restores credibility and trust in its dealings with Europe, so that the OMT program, if needed, brings about a significant decline in Spain's funding costs and help to fully reopen the financial markets. If this does not occur, the (direct and indirect) impact of fiscal policy on the decline of internal demand in 2013 could increase, especially while transmission mechanisms of monetary policy remain obstructed.

This assessment of the objectives achieved in structural terms may be seriously supported by the Government's announcement of creating an independent fiscal authority to evaluate the state of the economy cyclical situation and its impact on public finances. Details have not been released but its implementation could significantly increase the credibility of Spain's fiscal policy if: a) it is truly independent; b) it is transparent in its methodology; and c) its members are professionals with a proven track record. Likewise, it is essential that the Government moves towards a more efficient tax system, one which increases the burden on consumption and decreases tax rates on income and capital. Additionally, it must proceed with plans to reform the pension system to guarantee its sustainability, bringing forward the application of the correction factor as projected.

Finally, it is essential that the Government does not waiver from its structural reform agenda, pushing through all legal changes necessary to help reduce companies' operating costs and which will, in turn, help make them more competitive. Completing the restructuring of the financial sector is key to this. The recent announcement of how the new "bad bank" (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria, or Sareb) will work is intended to generate a suitable balance between the need to attract private capital to its shareholder structure and also avoid the resurgence of doubts as to the solvency of some financial institutions. The transfer prices are lower than those that would arise by applying the expected losses estimated by Oliver Wyman in the baseline scenario, which is justified because of the en bloc acquisition of the assets, the coverage of Sareb's risks, the consideration of certain expenses borne and the outlook for the divestment of assets. Therefore, these prices should not be considered a benchmark in the valuation of bank assets not transferred.

## 2. In quest of stability in the eurozone: “whatever it takes”

### **The eurozone slipped backed into recession, dragged mainly by the periphery**

The world economy is expected to continue its soft recovery with a GDP growth rate of 3.5% in 2013 (3.2% in 2012, 4.1% on average in 2010-12). It is supported by lower risk aversion, following the influential decisions taken by central banks, especially the ECB. However, three factors stand out among those that could make this outlook deteriorate significantly: first and foremost, troubles in Europe, if the euro break-up fears that loomed large during the first half of the year among market participants resurface; second, in the US, the still-hanging threat of the so-called fiscal cliff, i.e., a spending-cut and tax-hike package worth 4% of GDP due to come into effect at the beginning of 2013 that would push the US economy back into recession; third, a severe slowdown in the emerging economies, in particular in China and some commodity-oriented economies, if Chinese appetite for raw materials decreased.

### **Central bankers to the rescue; other policy makers should follow suit**

Against a backdrop of high uncertainty and threats to the world economy, over the past months authorities across the world - in particular central bankers in the eurozone and the US - have taken significant steps forward. Those bold measures have spared the world economy from a systemic event that would have been comparable with the financial developments of late 2008. Both central banks have built a bridge to a new institutional environment in the case of Europe, and to a new fiscal pact in the US; these actions have paved the way for other policy makers to use their room for manoeuvre. However, the FED's actions are more open-ended than the ECB's due to different conditionality: strict fiscal fulfilment is compulsory in Europe, whereas labour market improvement is the objective in the US.

### **Europe is decided to do whatever it takes**

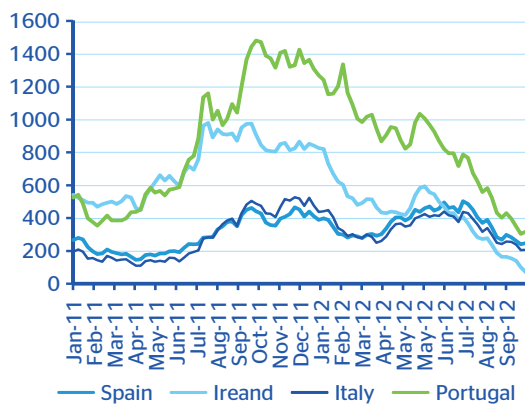
In our view, when the European Central Bank (ECB) President Mario Draghi announced the implementation of a new bond-purchase programme (Outright Monetary Transactions, or OMT) in late July, the institution took a decisive step to put an end to the debt crisis in Europe.<sup>1</sup> Under certain conditions (see our September ECB Watch for further details), the ECB could intervene in the secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached some agreements to reinforce the currency union: a broad roadmap towards a single banking supervision, far-reaching plans covering fiscal issues and growth-supporting measures. The rationale behind the Draghi announcement is clear. Yields on some peripheral bonds are elevated because markets are partly pricing in eurozone break-up fears, compromising the ECB's mandate amid a severe financial fragmentation. Since that is “unacceptable,” the ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with “strict and effective conditionality.” The existence of a lender of last resort under fiscal conditionality dispels fears of the reversibility of the euro in its current configuration.

---

<sup>1</sup>: For more information see our September report ECB Watch, available at: [http://serviciodeestudios.bbva.com/KETD/fbin/mult/ECB\\_Watch\\_Sep12\\_tcm348-356910.pdf?ts=15112012](http://serviciodeestudios.bbva.com/KETD/fbin/mult/ECB_Watch_Sep12_tcm348-356910.pdf?ts=15112012)

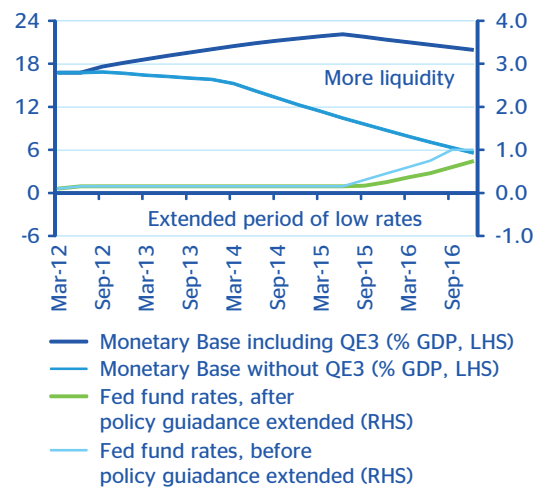
Under extreme market pressure and looming euro break-up fears, some action from European leaders and the ECB had long been expected. However, the ECB move was more decisive than anticipated. The OMT programme makes the ECB a credible backstop. As a consequence break-up fears are not justified and will continue to be so as long as this process continues. Tensions in financial markets have eased significantly since June (see Chart 1) and, in our view, the maintenance of this situation in spite of recent adverse market events is proof of its capacity to dispel doubts.

Chart 1  
Financial Stress Index for eurozone countries<sup>2</sup>



Source: BBVA Research

Chart 2  
QE3 and extended policy guidance



Source: BBVA Rresearch

Other elements have recently reinforced the currency union in Europe. First, the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place, after the German Constitutional Court backed Germany's involvement. Second, the process for achieving a banking union in Europe (as set last June at a Eurogroup meeting) continues moving forward, although grinding slowly. The implementation of a full banking union consists of four different elements: joint supervision, common regulation, a common body for banking resolution and a pan-European deposit-guarantee scheme. Given the scale of the task ahead, the full implementation is likely to be a long-lasting process. Yet European leaders agreed to set a calendar for banking supervision by January and more details are due to be agreed on at the Eurogroup meeting in December. In June they had agreed on direct banking recapitalization from the ESM, something that we deemed key in order to eliminate the risk emerging from the sovereign-banking feedback loop. However, there are other ways to reach the overriding goal of preventing regulatory ring-fencing and the goal of breaking the sovereign and bank risk that can be also explored. Certainly, the banking-union project needs to move forward fast.

At the end of the process, we think the eurozone will eventually come up with a full package that will reinforce its governance. As we have long argued, it should comprise a banking union, a fiscal union and a lender of last resort to prevent fragmentation. Progress has been made on all of these fronts. Probably that progress has not been ambitious enough to revert the current dynamic quickly. Yet, policy makers seem committed enough to the process and we think the worst of the crisis may, at last, be over. In the short term, the ECB's programme and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations in peripheral countries, allowing them to keep market access. At the same time, the proper implementation of the banking-union plans and further definition of the fiscal-union design will be a key factor to the long-term sustainability of the eurozone.

2: The BBVA Research Financial Stress Index (FSI) is a synthetic indicator that summarizes movements of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (spread between interbank rate and free-risk asset at 3-months term).

## The Fed will continue with its policy as long as needed

With the US economy growing at low rates, the unemployment rate remaining persistently high and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the whopping US deficit down was the last thing the US economy was in need of. Against this backdrop, the Fed did not hesitate. First, and in accordance with its “forward-guidance policy,” the Fed announced that it intends to keep rates at its current low levels at least until mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery.

This further monetary loosening will be different from previous rounds. First, the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries in an attempt to improve financial conditions for households. Second, the Fed will continue with this policy for a considerable period of time, even after the recovery strengthens and the labour market improves substantially; i.e., it will not give up buying MBS when growth starts picking up (see our [US Fed Watch](#) for further details).<sup>3</sup>

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the “fiscal cliff,” but it is not a silver bullet if not accompanied by fiscal actions. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will drag the economy down. With QE3 and policy guidance, the Fed does its part to give the economy the boost it needs to avoid slipping back into recession in 2013. In fact, according to our estimates, monetary loosening could contribute just a few tenths of a percentage point (pp) to GDP growth in 2013, but from 2014 onwards the effect will be more substantial. Regarding inflation, the impact will be small and delayed (see chapter 3 of this report).<sup>4</sup> However, it seems to us that the FED’s tolerance to higher inflation will depend on growth and labour market improvement.

The potential effects of QE3 are not restricted to the US economy. As previous programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs in those countries, boosting the availability of credit, their growth rates and also their inflation. Our estimates show that QE3 (plus the Draghi effect) could have a lower impact than QE1 due to comparative evolution of risk premium and capital inflows in the emerging economies. In any case, that will depend on domestic-policy response to capital inflows (see chapter 3).<sup>5</sup>

## Central bankers’ responses are not enough to bring the global economy back to a firm expansion

The world economy may have avoided decelerating to the slowest growth in the last 30 years (apart from the 2009 great recession) but the low growth environment continues. The advanced economies have been losing momentum since 2011 as one should expect given the current deleveraging environment. More recently the emerging economies have been hit too. In this regard, the trade channel has been intense in bringing exports and GDP growth down (see chart 3). Certainly that is the case in the three largest emerging economies. Brazil’s economy almost stalled in the first half of the year; India’s GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the most recent data points to a bottoming-out.

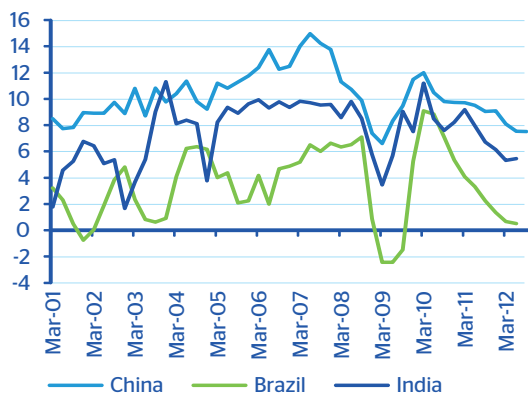
---

3: For more information, see our September U.S. Fed Watch at: [http://www.bbva.com/research/KETD/fbin/mult/120913\\_FedWatchEEUU\\_169\\_tcm348-357366.pdf](http://www.bbva.com/research/KETD/fbin/mult/120913_FedWatchEEUU_169_tcm348-357366.pdf)

4: For more details see Chapter 4 of the Global Economic Outlook of the fourth quarter of 2012.

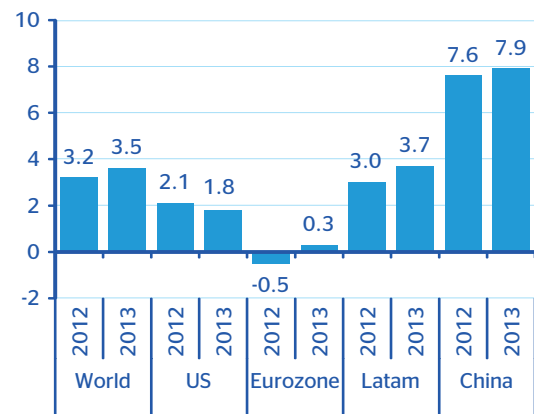
5: For more details see Chapter 3 of the Global Economic Outlook of the fourth quarter of 2012.

Chart 3  
Emerging economies: GDP growth rate (% y-o-y)



Source: BBVA Research and Haver

Chart 4  
GDP growth rate



Source: BBVA Research and Haver

However, the actions that have been taken by central banks in the US and in the eurozone are partly dispelling some doubts and improving the outlook. Under our baseline scenario, growth in the eurozone is likely to gain momentum entering 2013. Although the eurozone's GDP will decrease in 2012 (-0.5%), it will rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will remain close to 8% both years due to expected policy stimulus to compensate partially the slowdown it is experiencing. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. First, this scenario assumes that the recent wrangling over financial supervision does not substantially affect June's agreements, so the vicious link between sovereign and bank risk is broken and the monetary policy transmission, which in the eurozone is conducted mainly by banks, works again. Second, we assume that the mechanism in place to eliminate the "convertibility risks" is activated in full if needed. This will keep yields in peripheral economies contained, but substantial reductions will happen at the same time as Europe progresses in its new institutional arrangement and the commitments are fulfilled. The ESM/ECB's intervention could be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt, and to levels that will make reforms have a long-lasting impact. This implies that both countries retain market access and investment-grade ratings and deliver on their fiscal commitments or are granted extensions to meet them (ideally in terms of their structural fiscal balances). On this issue, it should be considered the risk from negative feedback loops between fiscal adjustment and economic growth and also the possibility that negative fiscal multipliers may be higher than previously expected, at least in the short-term. Finally, in this scenario, Greece will continue being part of the euro, which will, in turn, require further support from Europe by additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, too many things could still go wrong, but policy makers tend to find solutions to Europe's problems when crunch time approaches.



### 3. Growth outlook for the Spanish economy: the recession will continue in 2013

#### Europe and Spain are making gradual advances in the measures needed to drive long-term economic growth

Since financial stress heightened at the beginning of May, the European and Spanish authorities have adopted actions aimed at dissipating doubts concerning economic policy and outlook in the medium to long term. For the eurozone as a whole, the introduction of the ECB's OMT programme (see Section 2), has cleared up any doubts as to the reversibility of the euro project and offers a window of opportunity for those member states who continue to face financing problems even though they have undertaken structural reforms and/or adjustments whose benefits are yet to be felt. Likewise, steps are being made toward banking union in Europe which is vital to break the vicious circle between sovereign and bank risk within the monetary union.

Likewise, in Spain plans to introduce the economic policies outlined in July continue apace, following the sharp rise in funding costs and difficulties in accessing finance. Also, the process of restructuring the financial system has followed the road map agreed with the rest of the Europe in the Memorandum of Understanding (see Box 1)<sup>6</sup>. Turning to the budget, in August the Government approved its biannual budget plan for 2013-2014 and, in September, its General Government Budget for 2013 (PGE13)<sup>7</sup>, which contents do not reflect an additional consolidation effort to that outlined in the set of fiscal measures approved in July (see Section 4)<sup>8</sup>. Lastly, the Government has also announced a far-reaching legislative calendar to push through reforms based on the National Reform Programme (NRP) as well the European Commission's recommendations. This plan includes measures already approved and currently being implemented (e.g. labour market reform and the deregulation of the retail industry); reforms that have been announced (e.g. education reform and measures to boost the rental sector); and others yet to be carried out (further changes to the pension system, professional services, the single market, etc.) which, as a whole, will help to improve the outlook for potential growth in the Spanish economy (see Box 2).

However, short-term drivers of the Spanish economy remain extremely weak, indicating that the economy will continue to contract in the near future.

In short, the Spanish economy looks set to remain in recession in the next several quarters. First, despite the measures announced by the ECB, access to external finance is likely to remain limited over the coming months, not to mention relatively expensive, for both the public and private sectors. Second, growth prospects for Europe as a whole remain bleak, which will mean weaker demand in the EU for goods and services produced in Spain. And finally, oil prices have once again risen due to geopolitical tensions, which in turn are limiting demand in Spain's productive system.

Turning to domestic factors, the continued correction of accumulated imbalances will continue to affect private demand and supply. Likewise, recent information indicates that the contractionary tone of fiscal policy looks set to continue throughout the forecast period. Even though the structural effort to realign Spain's public finances is to be applauded, and should be recognised by the EU authorities, uncertainty as to whether the Government will be able to comply with

6: The terms and conditions of the Memorandum of Understanding signed on 20 of July are available at: <http://www.mineco.gob.es/portal/site/mineco/menuitem.aa5c961c0709f0fe3e85b782026041a0/?vgnnextoid=7c9f2f207c415310VgnVCM1000001d04140aRCRD>

7: Available at: <http://www.lamoncloa.gob.es/NR/rdonlyres/EFF72C06-60CF-4C23-BD67-7BC820DA88E7/210757/Planpresupuesto-rio201320146.pdf> y <http://www.sepg.pap.minhap.gob.es/sitios/sepg/es-ES/Presupuestos/ProyectoPGE/Paginas/ProyectoPGE2013.aspx>

8: In Box 2 of the Spain Economic Outlook for the third quarter of 2012 the measures approved by the Council of Ministers on 13 July 2012 (<http://www.boe.es/boe/dias/2012/07/14/pdfs/BOE-A-2012-9364.pdf>) are evaluated.

its 2012 budget targets prevails. This is due to doubts surrounding the adjustment of regional governments' accounts, the cyclical deterioration seen in some revenue and expense items, pressure on borrowing costs for national debt and adverse demographic trends. If Spain does formally request financial aid from the ECB and maintains its current budgetary targets for 2013, growth forecasts for the year could be negatively impacted, although this could be offset by the sharp decline in the Spanish risk premium which would follow such a request.

Even so, certain factors will continue to act as a counterbalance. The ECB's monetary and liquidity policy will be more prone to provide support to aggregate demand and financial stability, which could provide positive support over the coming months, provided that intervention by the monetary authority in the secondary markets helps restore the transmission mechanisms of monetary policy. Likewise, given the sluggishness of European demand, export companies are expected to shift their production towards emerging countries which, despite suffering a gradual slowdown, will continue to grow at a significantly higher rate than the developed markets. Finally, and even though its effect is due to run out shortly, the Supplier Payment Programme (which has mobilised resources accounting for about 2.5% of GDP) should continue to have a positive impact in the final months of the financial year.

In short, the Spanish economy looks set to remain in recession over the next several quarters, with the most likely scenario showing GDP contracting by around 1.4% for all of 2012 and for 2013. While the developments in the scenario described above have not prompted us to revise our growth forecasts for 2012-2013, we would note that while lower than forecast three months ago, the risks are still on the downside.

## The Spanish economy continued to contract in the third quarter at the same pace as in the first half

Though final breakdowns are still out, GDP flash estimate released by the National Statistics Institute (INE) indicate that the Spanish economy contracted 0.3% qoq in 3Q12, marking four straight quarters of decline<sup>9,10</sup>. If this estimate is confirmed, the decline in activity between July and September would have been less intense than estimated three months ago (BBVA Research: -0.7% qoq), as noted in our most recent GDP estimates in real time (MICA-BBVA -0.3% qoq, see Chart 5)<sup>11</sup> which, on the other hand, continue to warn that the contraction will continue in the current quarter (see Chart 6). Also, preliminary economic indicators published to date indicate that most of the components of domestic demand continued to contract, subtracting 1.1pp from GDP overall (0.3pp less than in 2Q12).

It is likely that the composition of growth once again featured an increase in net trade, and this probably contributed 0.7pp to output (see Chart 7) as a result of much higher sales abroad and despite the rise in imports.

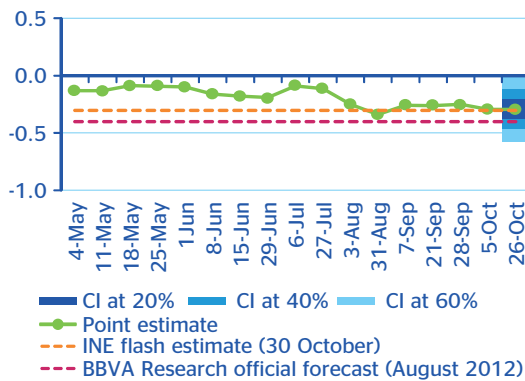
---

9: Complying with the review calendar of Spain's National Accounts, the breakdown of the full-time employment equivalent (CNTR) report for 2Q12 incorporated the revision of the historical series since 2008 (<http://www.ine.es/prensa/np733.pdf>). According to these reviews, in 2011 the Spanish economy would have grown three tenths less than previous forecasts (+0.7%), due to somewhat lower net external demand and weaker domestic demand

10: 3Q12 Quarterly National Accounts will be published the 15 of November, with a possible revision of the forecast data.

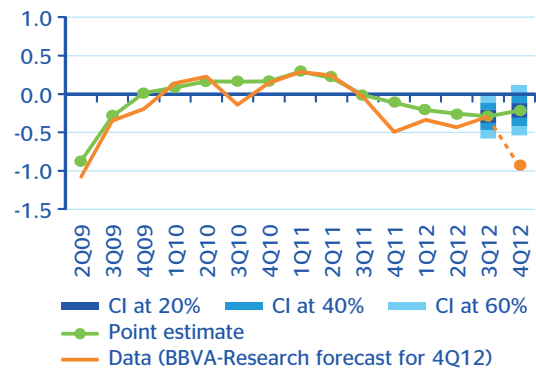
11: For more details on the MICA-BBVA model, see Camacho, M. and R. Doménech (2010): "MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting". BBVA WP 10/21, available at: [http://www.bbva.com/KETD/fbin/mult/WP\\_1021\\_tcm348-231736.pdf?ts=2542012](http://www.bbva.com/KETD/fbin/mult/WP_1021_tcm348-231736.pdf?ts=2542012)

Chart 5  
Spain: 3Q12 GDP growth forecasts using the MICA-BBVA model by forecast date (% qoq)



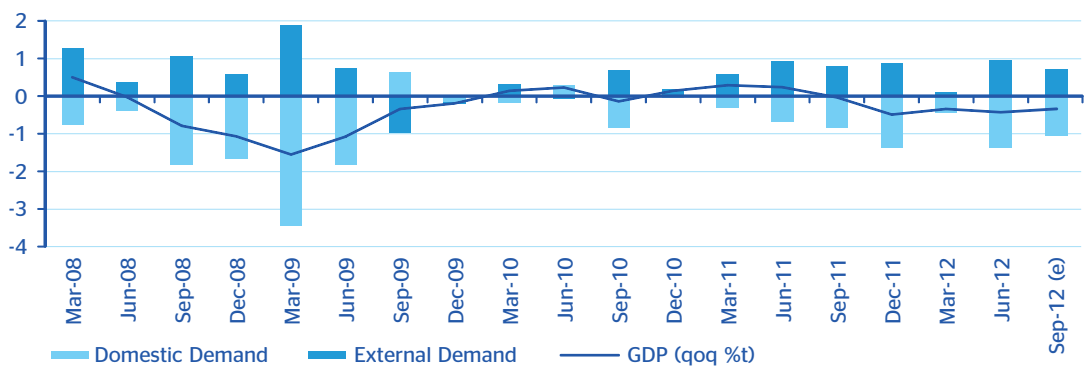
Source: BBVA Research based on INE data

Chart 6  
Spain: GDP growth and forecasts using MICA-BBVA model (% qoq)



\* Current forecast: 2 November 2012  
Source: BBVA Research based on INE data

Chart 7  
Spain: contributions to quarterly GDP growth.

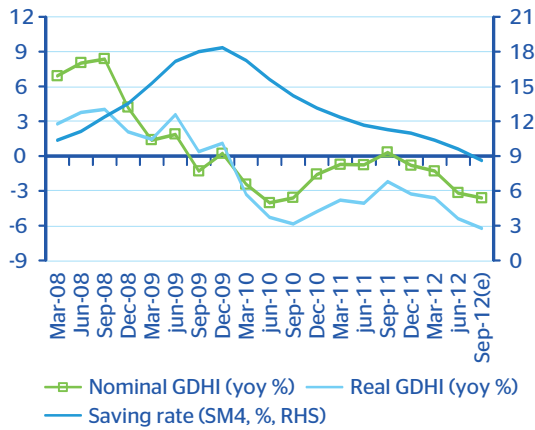


(e):estimation  
Source: BBVA Research based on INE data

## Private domestic demand continued to wane, shaped by the fiscal measures adopted

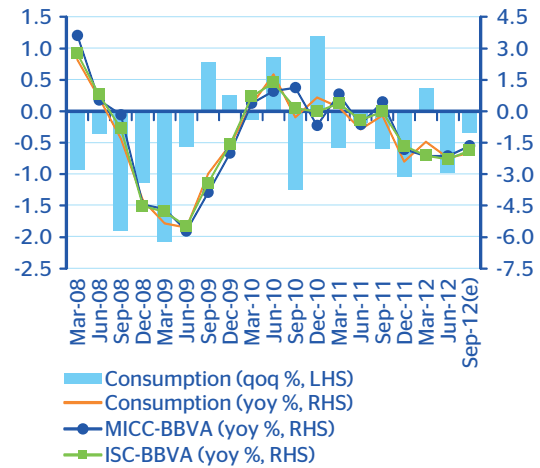
After a second quarter characterised by the decline in private expenditure, preliminary demand indicators –mainly for durable goods and, to a lesser extent, services- show that the decline in household spending eased during 3Q12. This trend was shaped by consumers bringing forward purchases before the VAT changes came into effect in September (the general and reduced rates were increased and tax bases were amended) and by the forecast decrease in household saving rate which partially offset the decline in disposable income and net wealth, both financial and real estate (see Chart 8).BBVA’s synthetic consumption indicator (SCI-BBVA) and our coincident consumption indicators model (MICC-BBVA) suggest that household spending contracted by a further 0.3% qoq (-2.0% yoy) in 3Q12, half the amount seen in the previous quarter (see Chart 9).

Chart 8  
Spain: GDHI and household saving rate



Source: BBVA Research based on INE data

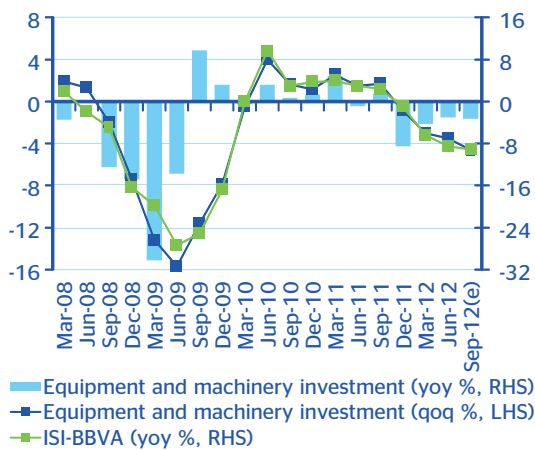
Chart 9  
Spain: actual data and real time forecast of household consumption



e):forecast  
Source: BBVA Research based on INE data

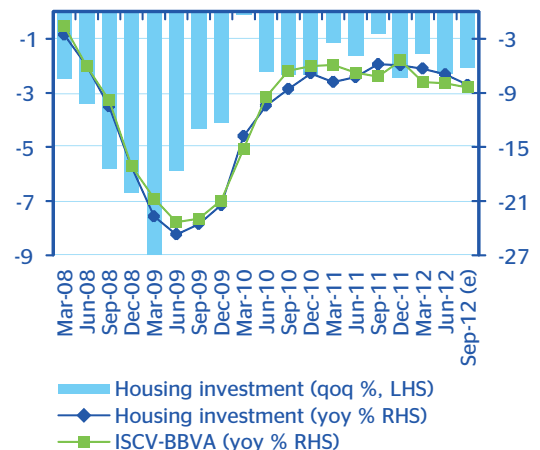
Also, private investment data indicate that its main components declined further in the third quarter. Investment in capital goods remained adversely shaped by sluggish internal demand, the contractionary fiscal policy and, finally, the ongoing difficulties in obtaining financing despite the partial relaxation of financial tensions in Europe. The BBVA synthetic investment indicator (SII-BBVA) shows that this demand item, which is still finding its only support in trade outflows between June and September, contracted further by around 1.5% qoq (-9.2% yoy) (see Chart 10). Equally, housing investment also fell again due to continued correction of cumulative imbalances and the cyclical downturn of the Spanish economy. Thus, even though the number of property purchase and sale transactions showed a positive trend in the two first months of the quarter (probably as a consequence of the tax changes announced at the beginning of the period), cumulative correction in real property prices up to 3Q12 advanced to 32.2% and residential activity remained at lows (see Box 3). In sum, we have still not seen any significant changes in the rate of decline in housing investment which, according to our synthetic indicator (SHI-BBVA), would have been around -2.1% in the quarter (-8.1% yoy) (see Chart 11).

Chart 10  
Spain: actual data and real time forecasts for capital goods investment



e):forecast  
Source: BBVA Research based on INE data

Chart 11  
Spain: actual data and real time forecasts for housing investment



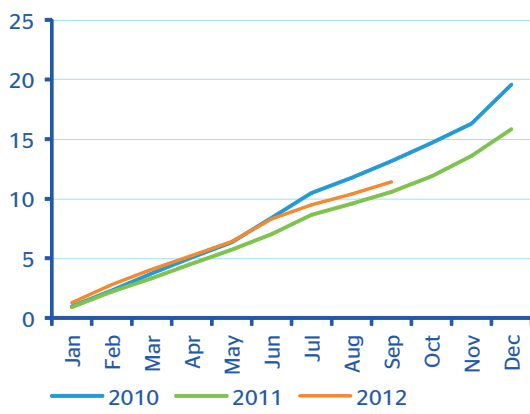
e):forecast  
Source: BBVA Research based on INE data

## The adjustment in public demand in 1S12 was lower than forecast, we therefore expect this to intensify in the second half

Government budget data for the third quarter indicate that the growth in spending eased to September 2012 (see Chart 12), with a generalised adjustment in practically all expense items, although still focused on investment cutbacks, and, to a lesser extent, intermediate consumption and wages. Thus, final consumer spending by the central government continues to decline and looks set to return to the same levels seen in mid-2009, for the 12-month period (see Chart 13). Equally, regional governments are showing decreases in virtually all expense items, due in part to larger cutbacks than in previous years.

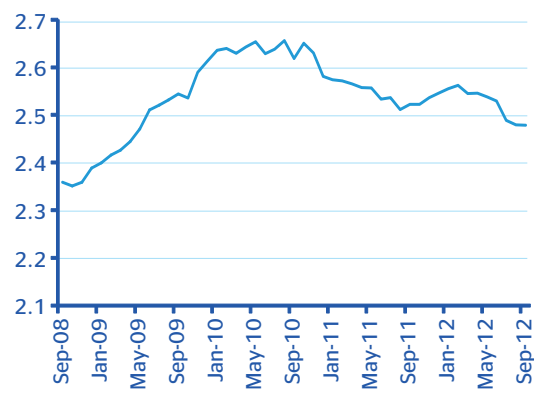
In light of this information, and with 3Q12 data for the rest of the tiers of government yet to be released, we expect the adjustment in public spending to have intensified during the first few months of the second semester, as many of the fiscal consolidation measures announced came into effect in this period. On the other hand, due to the forecast cutbacks in public investment we expect non-residential construction to continue to decline rapidly.

Chart 12  
Spain:  
Government non-financial employment (% GDP)



Source: BBVA Research, based on MINHAP data

Chart 13  
Spain: final government spending  
(12-month cumulative % monthly GDP)



Source: BBVA Research, based on MINHAP data

## The high increase in exports once again helped to prevent the Spanish economy contracting further in 3Q12

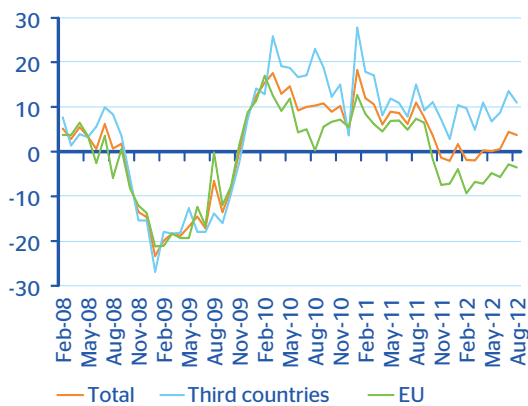
Spanish exports began the second half of the year against a backdrop of high financial instability in Europe, uncertainty surrounding EMU growth and ongoing problems in tapping domestic and external funding sources. On the basis of this data alone, these factors would have triggered downward pressure on exports during 3Q12 following the moderate recovery witnessed in the previous quarter. However, economic indicators available to date suggest the opposite. Specifically, in addition to the moderate increase in July, goods exports in volume from the balance of trade showed a high monthly increase in August. Looking ahead to the end of the quarter, the export order book for industry indicates that this positive trend will continue. Therefore, information available indicates strong growth in goods exports, standing at 3.8% in 3Q12, supported, at least partially, by the fact that destination countries continue to outperform Spain, as a result of the lack of growth in the main developed markets, particularly in Europe (see Chart 14).

Services exports performed similarly (+2.2% qoq). Foreign tourism remains healthy, after a summer which saw an increase in the number of foreign visitors booking into hotels (+3.1% yoy in 3Q12) and, particularly, overnight stays (+4.5% yoy in the same period), especially in September (see Chart 15). On balance, foreign tourists spent €14.2bn during the summer campaign (+8.0% yoy) thanks to the higher number of visitors as well as a higher average tourist spending.

Forecasts for the autumn campaign indicate that the growth in the tourist inflows will slow compared to the previous months. According to the BBVA-Google model of coincident tourism indicators (MCTI), foreign overnight stays in Spanish hotels in October and November could be up to 2.7% yoy, which would keep tourist inflows above the 40 million mark for 2012, confirming the new record we forecast three months ago.

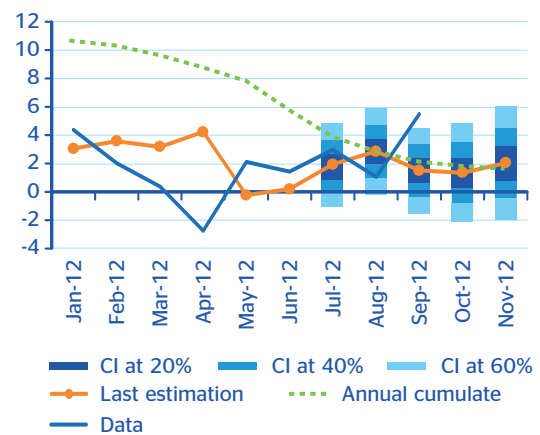
The recovery in exports, as well as the effect of households bringing forward purchases before the VAT hike in September, favoured a moderate increase in imports after three consecutive quarters of declines. Thus, economic indicators released to date suggest that the improvement in purchases from abroad could have reached 1.6% qoq, although the negative trend registered by consumer and capital goods looks set to continue in the short term. In sum, these factors indicate a slightly lower positive contribution by net external demand to growth during 3Q12 than in the previous quarter, although with a better composition.

Chart 14  
**Spain: exports of goods and services by large enterprises (% yoy)**



Source: BBVA Research based on AEAT data

Chart 15  
**Spain: tourist inflows and Google-BBVA MICT forecasts (% yoy)**



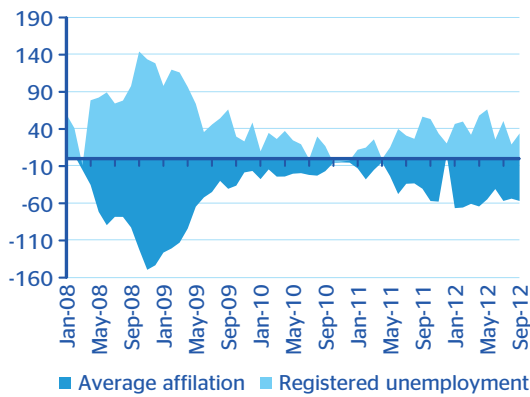
Source: BBVA Research and Google based on INE data

### Slowdown in job destruction in 3Q12

Seasonally- and calendar-adjusted (SWDA) data indicate that the pace of job destruction eased slightly between June and September. Thus, average social security affiliation declined 0.9% yoy SWDA in 3Q12, one tenth of a point less than in the previous quarter. Consequently, the increase in registered unemployment (2.4% qoq SWDA) was lower than in 2Q12 (3.4% qoq SWDA) (see Chart 16). Broadly speaking, the Labour Force Survey (LFS) for 3Q12 confirmed the same trend as that registered by administrative data. In spite of the decline in the active population (-12 thousand people, 0.3 thousand SWDA), job losses (-97.0 thousand people, -169.7 thousand SWDA) -mostly wage earners in the services and construction industry- drove the unemployment rate up by 0.4pp to 25.0% (25.3% SWDA). Whereas permanent hires declined by 179.4 thousand, temporary hires increased by 15.3 thousand due to the seasonal contribution of the private sector (34.9 thousand). Therefore, the temporary employment rate increased 0.4pp to 24.0% (23.3% SWDA) (see Chart 17).

Chart 16

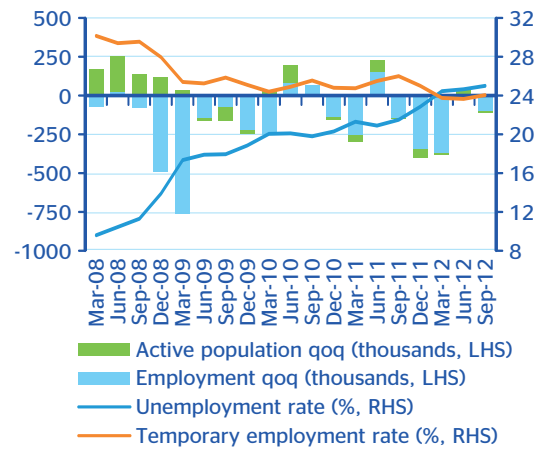
Spain: average social security affiliation and registered unemployment (monthly change, thousand people, SWDA)



Source: BBVA Research based on INE data

Chart 17

Spain: labour market indicators



Source: BBVA Research based on INE data

## In spite of the increase in consumer prices in 3Q12, wage moderation remained unchanged

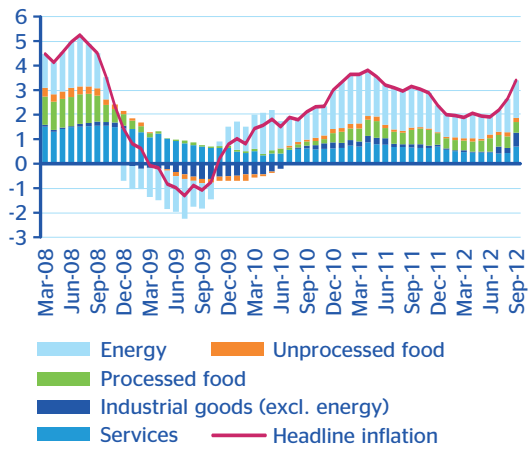
In September both headline and core inflation rose sharply, to 3.4% yoy and 2.1% yoy, respectively.<sup>12</sup> Far from being caused by inflationary pressure in the domestic market, these figures are the result of factors exogenous to demand, such as the upward pressure on commodity prices- mainly oil and food-, the increase in drug co-payments starting in July and the VAT hike in September. As we can see in Chart 18, the first factor explains practically half the 1.5pp increase in headline inflation up until the VAT hike in September (0.7pp). Meanwhile, the increase in co-payments caused drug and other pharmaceutical products prices to raise 22.7% yoy until August, contributing 0.19 pp to the rise in headline inflation (0.24pp in the case of core inflation). Finally, but no less important, according to our preliminary estimates, the partial effect of the VAT hike (about 35%) would have meant a 0.7-0.8pp increase in prices in September. However, we cannot rule out the tax burden having an additional effect on final prices over the coming months.

Meanwhile, the Harmonised Index of Consumer Prices (HICP) showed that the inflation spread between Spain and the eurozone returned to positive territory in the third quarter. In terms of headline inflation, the price spread in September would have been at its historical average (0.8pp), whereas, using the core component as reference, it would have been around 0.4pp (compared to the historical average of +0.8pp). However, we would note that since to a certain extent this is due to the increase in indirect taxes, it does not imply a direct loss of the competitive position of Spanish exports.

Therefore, given the weakness of demand, we do not anticipate any second round effects from wage increases due to upward pressure on energy prices and the VAT hike. In this regard, wage increases agreed in collective bargaining agreements continued to decline during the last quarter, especially in new agreements (see Chart 19). However, wages have continued to grow above 0.5%, the maximum amount established in the 2nd Employment and Collective Bargaining Agreement 2012-2014 signed by the CEOE, CEPYME, CCOO and UGT on 25 January 2012, which is negatively impacting the adjustment of the labour market.

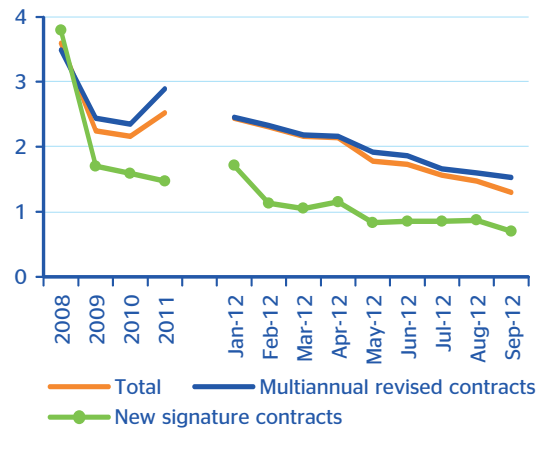
<sup>12</sup>: The October CPI previous indicator points out an acceleration of annual inflation around 3.5%, corresponding with a rise in core inflation.

Chart 18  
Spain: contributions to annual CPI growth



Source: BBVA Research based on INE data

Chart 19  
Spain: wage increases agreed in collective bargaining agreements (% yoy)



Annual data include the agreements registered after December of each year and incorporate the revision of the wage guarantee clause

Source: BBVA Research based on INE data

## Outlook for 2012-2013: prospects for the Spanish economy remain unchanged in the short term

As we noted in the introduction to this section, despite the progress made on structural reforms, both in Europe and Spain, the drivers of the Spanish economy remain consistent with a decline in activity of about 1.4% in 2012 and 2013 (see Table 1). In particular, the impact on activity of the increasing pressure on oil prices (around 9 dollars per barrel in 2012 and in 2013), and the reduced growth forecasts for the eurozone (-0.2pp in 2012) is offset by a lower risk premium than we forecast three months ago (-12bp in 2012 and -45bp in 2013). However, the risks in this scenario, the product of high uncertainty, remain on the downside, although to a lesser extent than we had estimated in the previous edition of this publication.



Table 1

## Spain:macroeconomic forecasts

(yoy %, unless otherwise indicated)	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12 (e)	2011	2012 (f)	2013 (f)
National Final Consumption Expenditure (FCE)	0.6	-0.8	-1.0	-2.1	-2.0	-2.4	-2.3	-0.8	-2.4	-3.9
Private FCE	0.0	-1.0	-0.4	-2.5	-1.4	-2.2	-1.9	-1.0	-2.0	-2.9
Household FCE	0.2	-0.9	-0.2	-2.4	-1.5	-2.2	-2.0	-0.8	-2.1	-2.9
Public Administration FCE	2.2	-0.5	-2.7	-1.1	-3.6	-3.0	-3.2	-0.5	-3.6	-6.9
Gross capital formation	-5.9	-5.1	-4.6	-6.5	-7.6	-9.3	-10.9	-5.5	-9.5	-7.4
Gross fixed capital formation	-6.0	-4.9	-4.2	-6.0	-7.7	-9.4	-11.2	-5.3	-9.7	-7.5
Fixed material assets	-6.7	-5.4	-4.7	-6.6	-8.4	-10.3	-12.1	-5.8	-10.5	-8.0
Equipment, machinery and cultivated assets	4.9	2.9	3.5	-1.7	-5.9	-6.9	-9.2	2.3	-7.6	-3.7
Equipment and machinery	5.1	3.0	3.4	-1.7	-6.0	-7.0	-9.2	2.4	-7.7	-3.8
Construction	-10.8	-8.5	-8.0	-8.6	-9.5	-11.8	-13.4	-9.0	-11.8	-10.0
Housing	-7.8	-7.3	-5.8	-5.9	-6.3	-7.0	-8.1	-6.7	-6.8	-8.4
Other buildings and other constructions	-13.5	-9.6	-9.9	-10.9	-12.3	-16.0	-18.1	-11.0	-16.3	-11.7
Intangible fixed assets	4.1	1.4	4.9	2.0	3.0	2.9	1.0	3.1	2.0	-1.6
Change in inventories (*)	0.0	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0
Domestic demand (*)	-0.9	-1.8	-1.8	-3.1	-3.2	-3.9	-4.2	-1.9	-4.0	-4.7
Exports	10.2	7.1	7.6	5.8	2.8	3.3	3.5	7.6	3.8	8.2
Imports	4.5	-1.6	-1.2	-4.9	-5.9	-5.4	-4.7	-0.9	-4.7	-1.8
Net trade balance (*)	1.4	2.4	2.5	3.1	2.6	2.6	2.6	2.3	2.6	3.3
GDP at mp	0.5	0.5	0.6	0.0	-0.6	-1.3	-1.6	0.4	-1.4	-1.4
Pro-memoria:										
GDP w/o housing investment	1.2	1.1	1.1	0.4	-0.2	-0.9	-1.3	1.0	-1.1	-1.0
GDP w/o construction	2.7	2.1	2.1	1.4	0.8	0.4	0.1	2.1	0.2	-0.3
Employment (LFS)	-1.3	-0.9	-2.1	-3.3	-4.0	-4.8	-4.6	-1.9	-4.4	-3.4
Unemployment rate (%active pop.)	21.3	20.9	21.5	22.8	24.4	24.6	25.0	21.6	25.0	26.1
Employment (FTE)	-1.4	-0.9	-1.6	-2.9	-3.6	-4.6	-4.6	-1.7	-4.2	-3.2

(\*) Contribution to growth

(e): estimate (f):forecast

Source:BBVA Research based on INE data

## The decrease in employer social security contributions could have mitigated job destruction over the next two-year period

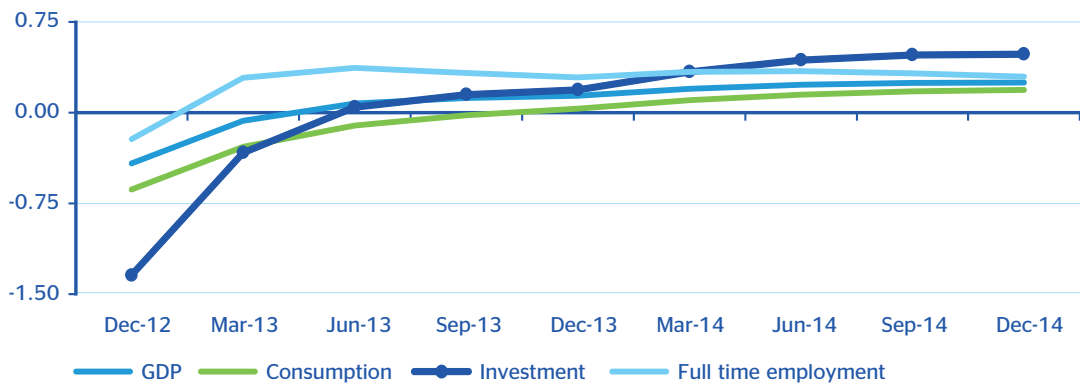
Against this backdrop, employment figures look set to fall further in 4Q12 and 2013, causing the unemployment rate to rise to around 26% at the end of next year despite the expected reduction in the size of the active population. Although the labour market reform passed in February<sup>13</sup> will not prevent job destruction in the short term, it could: 1) help facilitate the rebalancing needed between the extensive margin (workers employed) and the intensive margin (number of hours worked and wages), 2) reduce segmentation, and 3) boost productivity. In this regard, our forecasts indicate that growth of apparent labour productivity will surpass 2.8% this year and 1.8% in 2013, significantly above the average increase recorded in the past three decades (1.2%).

13: Box 4 of Spain Economic Outlook for the second quarter of 2012 assesses the labour market reform and puts forward options for suggested improvements (e.g. a reduction in the period for negotiating new collective bargaining agreements) which were subsequently included in Law 3/2012, of 6 July on urgent measures to reform the labour market (<http://www.boe.es/boe/dias/2012/07/07/pdfs/BOE-A-2012-9110.pdf>).

The forecast deterioration of the job market could have been eased by the reduction in employers' social security contributions in 2013 (1 point) and 2014 (2 points), a measure announced by the Government in July which was finally not included in the draft budget for 2013. The devaluation caused by the reduction in the contribution burden and the VAT hike in September 2012 could lead to cumulative growth in employment of around 0.3% from now to the end of 2014, as shown in Chart 20<sup>14</sup>.

Chart 20

**Spain: impact on activity and employment of a 2pp decrease in social security contributions to 2014 financed by a 3pp increase in VAT (deviation from scenario ex-reform, pp)**



Source: BBVA Research

**Despite a robust performance, growth in net trade will be insufficient to offset the decline in domestic demand**

Firstly, the additional fiscal consolidation measures adopted in July, together with the budgetary plans outlined by the Government in its General Government Budget for 2013 and still-high financing costs, lead us to believe that public domestic demand will continue to undermine growth. In real terms, under Spanish National Accounts, public consumption looks set to fall 3.6% and investment in non-residential construction by 16.3% in 2012. Further decreases in 2013 are likely: our estimates point to an additional decline in public consumption of 6.9% and in other construction investment of 11.7%.

However, these forecasts are subject to greater uncertainty than three months ago. Particularly as the impact of announced consolidation measures is less than expected partially due to the higher-than-expected cyclical deterioration in revenues and public spending. This lowers the chances of meeting the deficit target for the year (-6.3% of GDP). This probable deviation, together with the fact that the macroeconomic forecasts for 2013 released by the Government are more upbeat than those compiled by BBVA Research, make it increasingly unlikely that the 2013 budget deficit of -4.5% will be met. We would therefore not rule out the announcement of new measures to meet this goal. The Government's decision on whether or not to accept the ECB's aid, along with the sharp decline in the Spanish risk premium which would follow such a decision, will be key in determining the full impact of the Government failing to meet its 2012 targets.

Turning now to private consumption, the increase in indirect taxation and the worse outlook for the factors determining private consumption herald decreases in spending throughout the forecast period (around 2.1% in 2012 and 2.9% in 2013). The deterioration of employment will trigger a decline in the wage component of household gross disposable income. Additionally, the VAT increase in September 2012 -and the fact that consumers brought forward certain purchases before this was in place - will cause consumption to contract over the coming months,

14: In Section 4 of Spain Economic Outlook for the first quarter of 2009 we proposed a permanent 3.5 reduction in the effective rate of employer social security contributions in exchange for a 2pp increase in the average effective rate of tax on consumption. The results of the estimates indicate that such a fiscal devaluation would lead to a 0.6% increase in GDP and a 1.4% increase in full-time equivalent employment in the first year of the reform.

as can be seen in Chart 20. Also, net financial wealth is unlikely to recover until 2014, while real estate activity is expected to fall throughout the forecast period. Conversely, the reduction in the household saving rate to pre-crisis levels, the absence of inflationary pressure on demand and official interest rates at low levels will all limit the contraction in private consumption over the next year.

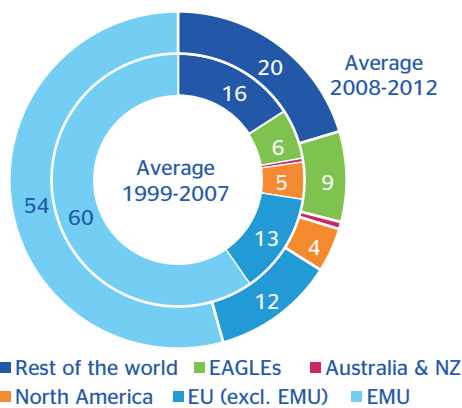
Meanwhile, trends in capital goods investment will be shaped mainly by the weakness of domestic demand and difficulties accessing credit, despite the decline in financing costs compared to the forecast from three months ago. We forecast a contraction in this demand component of around -7.7% in 2012 and estimate recovery around mid-2013 (-3.8% for the full year) underpinned by the consolidation of improved growth prospects for Spanish exports. Our outlook for housing investment for 2012 and 2013, however, has not changed greatly over the past three months. Specifically, in addition to the factors mentioned previously –persisting cyclical downturn, finance difficulties– and the ongoing adjustment in the sector, the VAT hike and the elimination of the deduction on the purchase of primary residences from January 2013 are probably encouraging consumers to bring forward demand at the end of 2012. Nevertheless, we expect this investment segment to contract throughout the forecast period (around -6.8% in 2012 and -8.4% in 2013).

We should note that the creation of Sareb (“bad bank”) is an important development in terms of helping residential investment to recover in the medium term. Even though we doubt its existence will have a direct impact on investment in the short term, since the transfer of assets in question will not signify new residential investment, it could help demand recover in the medium term (not before 2014). This all depends on how long it will take Sareb to dispose of its stock of finished property and conclude unfinished projects. The shorter it takes, the more rapidly housing investment will recover.

Finally, given the forecast of weak growth in the EMU, exports in 2012-2013 will remain shaped by the ability of exporter companies to differentiate themselves and consolidate their market share in areas of greater potential growth (see Box 4). Thus, exports of goods and services could now end up growing 3.8% in 2012, which is higher than we expected three months ago, boosted by strong export figures to emerging countries (see Chart 21). In 2013, with the European economy gradually moving away from contraction and the global economy growing at a rate of 3.5%, exports will once again increase, even up to 8.2%, in line with the average seen in the previous two-year period (2010-2011: +9.4%). As a result of the knock-on effect of a more positive forecast for exports, the decline in imports could ease, in both 2012 and 2013, although the contraction in internal demand does not indicate an increase until well beyond 2013. Again, the two-year period looks set to feature a positive contribution by net exports to growth and a correction of the current account deficit (see Chart 22).

Chart 21

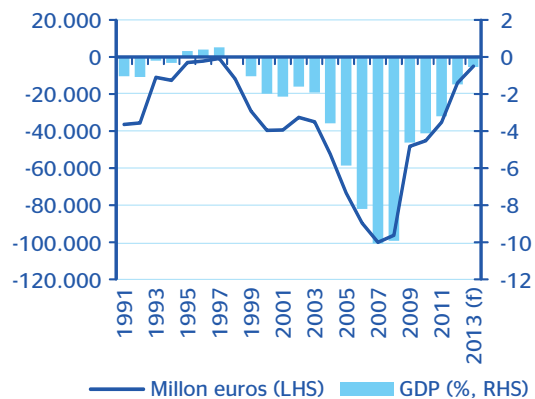
**Spain: geographical composition of exports of goods before and during the economic crisis, (%)**



Source: BBVA Research based on Datacomex data

Chart 22

**Spain: current account balance**



Source: BBVA Research, based on Bank of Spain data

## Box 1. Restructuring of the Spanish financial system

Progress has been made in the restructuring of Spain's financial system over the past few months. Since the Eurogroup agreed to lend the country 100 billion euros to shore up the solvency of its financial system, the Spanish authorities have been adopting the measures included in the Memorandum of Understanding (MoU). The Royal Decree Law on the Restructuring and Resolution of Credit Institutions was approved towards the end of August, while the results of the bottom-up stress tests performed on individual banks were released in September. In October, more details were released on the asset management company (Sareb) to which the most problematic assets of banks requiring public aid will be transferred. The process must be handled quickly and, if necessary, the banks that have come under State control must be resolved.

Royal Decree Law on the Restructuring and Resolution of Credit Institutions: (1) regulates early action, restructuring and orderly resolution processes for credit institutions, (2), establishes the legal regime for the Fund for Orderly Bank Restructuring (FROB) and its general framework for action, (3) sets out the general operating framework of the asset management company, (4) reinforces the protection of retail investors, (5) governs the actions required in relation to preference shares (*participaciones preferentes*) and regulates subordinated debt in order to ensure that the burden of restructuring costs is distributed appropriately.

These measures provide a crucial tool for managing the bank crisis and have been put in place ahead of the European Bank Resolution Directive under discussion at present. They also represent an important step forward in reforming the system by reinforcing the instruments, the role of public institutions, and the bank restructuring and resolution processes. Positive highlights of the legislation include:

- Clarification of the responsibilities of the Deposit Guarantee Fund (FGD) and of the FROB. The responsibilities of the FGD will be limited to protecting deposits, while the FROB will have much greater power in bank restructuring and, specifically, resolution processes.
- The bank recapitalisation cost burden sharing ("bail-in") is limited to shareholders and subordinated creditors, not senior creditors. This could have a knock-on effect on the rest of the system, hindering entry by investors in future debt placements in the market. Meanwhile, the ranking among creditors is maintained, with a principle in place whereby no creditor should sustain any more losses than those that correspond to it in the event of liquidation. All these principles help reduce uncertainty, generate legal security and help stabilise the financial system.

The variety of instruments made available to the FROB afford it greater room for manoeuvre. These include instruments used internationally, such as the "bridge bank", the "bad bank" or the "asset management company", capital injection, injection of contingent convertible debt (CoCos) and full or partial asset sales.

The second milestone alongside the new legislation was the publication of the results of the bottom-up stress test exercise conducted by consulting firm Oliver Wyman on 14 Spanish bank groups. This was an unprecedented exercise of transparency in Europe. The results indicated a capital deficit of 54 billion euros in the adverse scenario, slightly more than half the loan agreed between Spain and its European partners for the recapitalisation of Spanish banks and in line with the findings of consultants after the top-down analysis of the financial system, as well as those of BBVA Research. The seven banks showing capital needs represent nearly 30% of the system's total assets, while the capital requirements of the four banks controlled by the FROB account for 86% of these needs.

The capital needs identified derive from a detailed analysis of loans to the private resident sector, foreclosed assets and the ability of the banks to absorb losses in the adverse scenario. The government estimates that public capital injections would fall to around 40 billion euros due to: (i) the transfer of assets to the Sareb; (ii) the assumption of losses by holders of hybrid and subordinated instruments; (iii) the capital the banks manage to raise in the market and (iv) asset disposals.

Knowing the individual capital needs of each bank and verifying the differences among institutions in the system is crucial before the banks with problems can be cleaned up and confidence restored to the Spanish financial system, which is vital if Spanish banks want to tap wholesale markets for funds and reduce their dependence on the European Central Bank.

The third major development was the presentation of the structure of the Asset Management Company arising in the bank restructuring (Sareb), expected to be approved by the Spanish cabinet in November. This company, in which the FROB will have a non-majority holding, will be in charge of managing real-estate-related assets transferred from banks under government control and the other banks requiring public support. The value of the assets that Sareb will manage has been estimated at 60 billion euros, of which 45 billion will come from the four banks under government control.

The transfer prices of the assets will be similar to the prices inferred from the expected losses in Oliver Wyman's

adverse scenario. This should help make Sareb profitable and, therefore, attract private investors. As indicated above, the FROB will have a non-majority holding, so Sareb will not be computed as government debt. These private investors would preferably be non-resident. The transfer prices are lower than those that would arise by applying the expected losses estimated by Oliver Wyman in the baseline scenario, which is justified because of the en bloc acquisition of the assets, the coverage of Sareb's risks, the consideration of certain expenses borne and the outlook for the divestment of assets. Accordingly, the transfer prices should not be considered a benchmark in the valuation of bank assets not transferred.

The creation of the Sareb allows the troubled entities to segregate their worse quality assets, dispelling doubts over the transparency and valuation of the assets and reducing the uncertainty regarding the viability of these banks. While the banks will have to recognise losses on the asset transfers, they will be recapitalised later with public support.

The next step in the restructuring process is the presentation to the Bank of Spain of restructuring or resolution plans by the banks showing capital shortfalls. This process needs to be carried out as soon as possible. The plans will be approved by the Bank of Spain and the European Commission, after which the banks will be classified into the groups specified in the MoU (Groups 2 and 3). The transfer of real estate assets and the recapitalisation of the four banks controlled by the FROB (Group 1) are expected to begin by the end of the year.

In short, the Spanish financial system is in the midst of a restructuring process that has made significant inroads over the last quarter, enabling Spain to comply with the roadmap agreed with Europe. These measures should enable the market to separate healthy banks from the rest, restore investor confidence, reduce dependence on the European Central Bank gradually and lay the foundations for a more capitalised, efficient and healthy financial system that better adapts to the needs of the Spanish economy.

## Box 2. Raising productivity: a major challenge

One of the main variables in determining the well-being of an economy over the long run is productivity, i.e. the amount of goods and services produced for each unit of factor of production (fundamentally, physical capital and labour)<sup>15</sup>. Unlike trends in the working age population per capita or in the employment rate, an economy's productivity can grow indefinitely over time, ensuring increases in per capita income for coming generations. Productivity increases not only have positive long-term effects on economic well-being, but also help maintain healthy public finances, reduce private deleveraging and foster the internationalisation of production. The economic literature identifies a set of determinants of productivity, such as investment in R&D, quality of human capital or the operation of the economy within an adequate institutional framework guaranteeing free competition in the markets for goods and services.

From the mid 1990s until the current crisis unfolded, the productivity of the Spanish economy -measured as gross value added per hour worked- barely grew at an average of 0.6% a year (Chart 23), causing the productivity gap between Spain and the main advanced economies to widen.

Although productivity growth has gathered pace temporarily -due mostly to continuous job destruction rather than a substantial improvement in its determinants- the disappointing long-term trend means the increases in per capita income obtained over the two last decades are more vulnerable to falls in employment and adverse demographic changes.

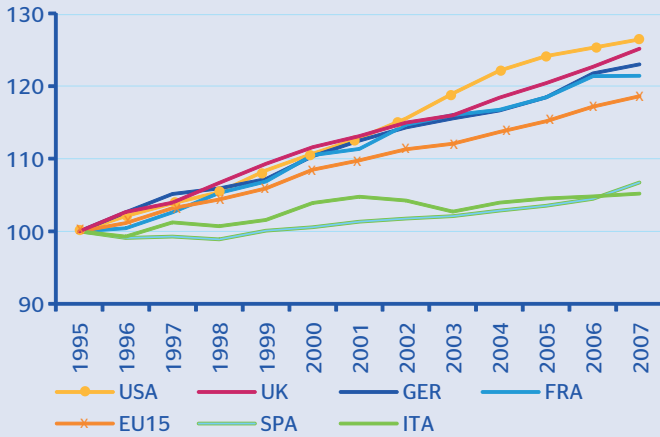
Therefore, the challenge is to raise productivity growth rate and sustain it, by affecting its determinants. In this context, the far-reaching proposal included in the National Reform Programme (see section 5)<sup>16</sup> would mark a major step forward if, inter alia, it helps to effectively eliminate administrative barriers to free competition in the markets for goods and services, promotes market unity and monitors the efficient implementation of the European services directive. Charts 24 and 25 show the negative correlation between productivity growth and the average degree of regulation in the retail sales and business services industries. On average, economies with looser regulation of an industry tend to register higher productivity growth in this industry, not to mention the positive external effects generated on productivity for the rest of the economy. With economies becoming increasingly service-oriented, a competitive services market is a necessary condition for achieving productivity gains. Spain boasts enormous growth potential in this area, especially in the development of business services (e.g. legal, engineering, architecture, accounting, business management, human resources, advertising), whose relative contribution to GVA per capita is still below the average of the advanced countries<sup>17</sup> and which are making important inroads in global markets (Chart 26). Making regulations more flexible and streamlining them, removing barriers to the establishment of new companies and exports, accessing real information flow on the supplier of the service or the institutional promotion of the benefits of outsourcing would lay the foundations for raising productivity at the firm level and on aggregate, in the short and medium term.

15: Productivity usually refers to the marginal product of the labour factor or to the marginal product obtained when combining capital and labour, the latter case known as total factor productivity (TFP) or productive efficiency.

16: Available at: [www.mineco.gob.es/stfls/mineco/prensa/ficheros/noticias/2012](http://www.mineco.gob.es/stfls/mineco/prensa/ficheros/noticias/2012).

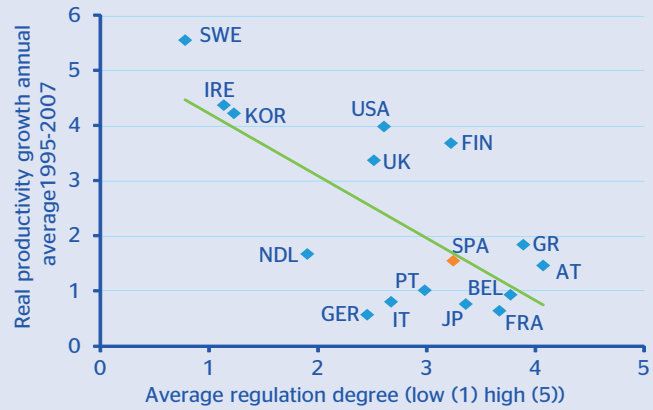
17: See Beltrán et al. (2010) "Una agenda de crecimiento para España", McKinsey & Company - Fedea.

Chart 23  
Productivity:  
real gross value added per hour worked, 1995 =100



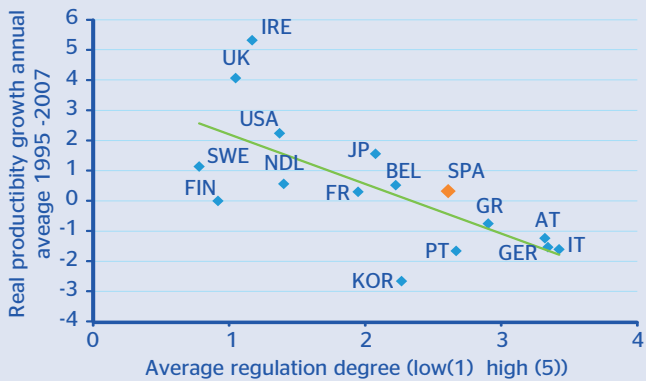
Source:BBVA Research based on EUKLEMS data

Chart 24  
Regulation and productivity growth in retail sales,  
average 1995-2007



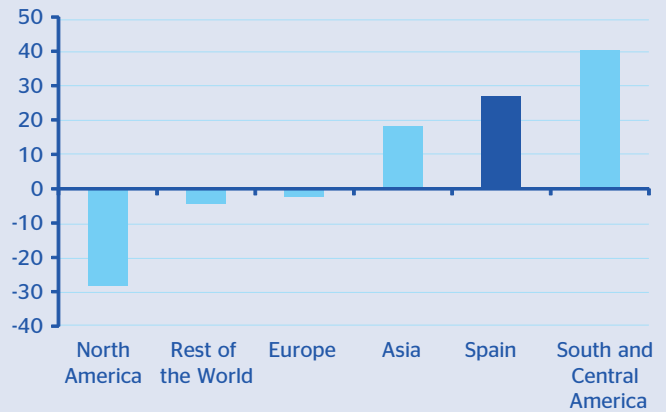
Source: BBVA Research based on EUKLEMS and OECD data

Chart 25  
Regulación y crecimiento de la productividad en el sector de  
servicios empresariales, promedio 1995-2007



Fuente: BBVA Research a partir de EUKLEMS y OCDE

Chart 26  
Tasa de variación de la cuota exportadora por áreas  
geográficas: otros servicios empresariales, 2000-2011 (%)



Fuente: BBVA Research a partir de OMC

### Box 3. Real estate crises and housing prices: an international perspective

Housing prices in Spain have fallen for 20 consecutive quarters and are now down by a total of 32.2% in real terms. This is not Spain's first real estate crisis, but it will probably go down as its worst, at least in terms of prices correction<sup>18</sup>.

This box compares the ongoing contraction in residential construction in Spain with recent real estate crises in other developed economies. For the analysis we use a panel of countries where the downturn in residential construction has been accompanied by a contraction in GDP<sup>19</sup>.

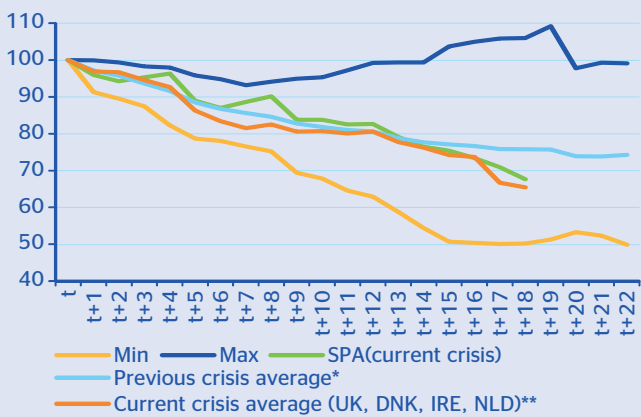
Chart 27 illustrates how the current fall in housing prices in Spain was similar to the average declines in previous property crises, deviating only over the past year, with

sharper falls. Spain is not the only country that deviates from the average, as other European countries which are also currently immersed in a real estate crisis. Specifically, in the UK, Denmark, Ireland and Netherlands, housing prices have largely fallen by as much as in Spain, with the market dropping sharply in recent quarters.

Economic behaviour, meanwhile, has been widely different. Initially, GDP contracted considerably further in Spain in the current real estate crisis, while the recovery has been slower than during other crises (see Chart 28). However, compared to the other countries suffering real estate crises mentioned above, the deterioration of the Spanish economy has been similar, with negligible differences.

Chart 27

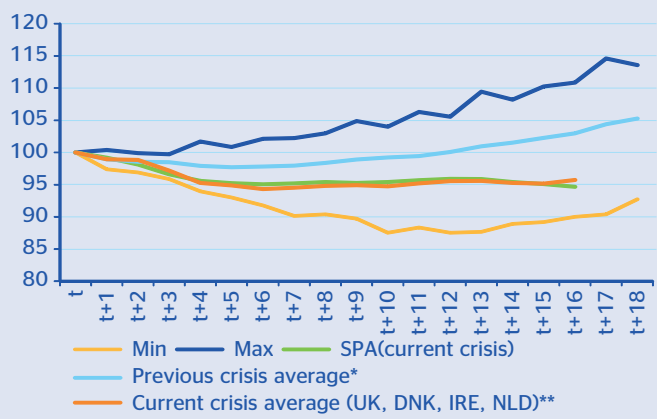
Changes in housing prices in real terms from highs in different real estate crises (real terms)



Note: t is the time period during which prices reached their peak  
\* Refers to past real estate crises  
\*\* Refers to the ongoing real estate crisis  
Source: BBVA Research based on Haver data

Chart 28

GDP in real terms during real estate crises



Note: t is the time period during which prices reached their peak  
\* Refers to past real estate crises  
\*\* Refers to the ongoing real estate crisis  
Source: BBVA Research based on Haver data

In conclusion, the present contraction of housing prices in Spain, which is in line with the average of previous crises, has accentuated over the past few quarters, precisely when the European debt crisis heightened. Moreover, this behaviour is not exclusive to Spain. Other economies,

mostly European, are following similar trends. This first approximation indicates that the current scenario is different to previous crises, with prices falling faster and the economy recovering more slowly.

18: The latest real estate crises in Spain began in the second half of 1978 and the end of 1991. Real housing prices fell by around 35% in the first and slightly over 21% in the second.

19: We define a real estate crisis as a period when housing prices fall more than 10% in real terms and GDP contracts at least at some point during the downturn. The sample includes crises in the following countries (the period in which housing prices began falling is show in parentheses): UK (3Q73), JAP (4Q73), FIN (2274), SP (2Q78), NLD (2Q79), US (1Q79), UK (1Q80), CAN (1Q81), NOR (4Q86), FIN (1Q89), UK (3Q89), CAN (1Q90), FRA (2Q91), SP (4Q91), ITA (3Q82), NOR (2Q07) and FRA (4Q07).

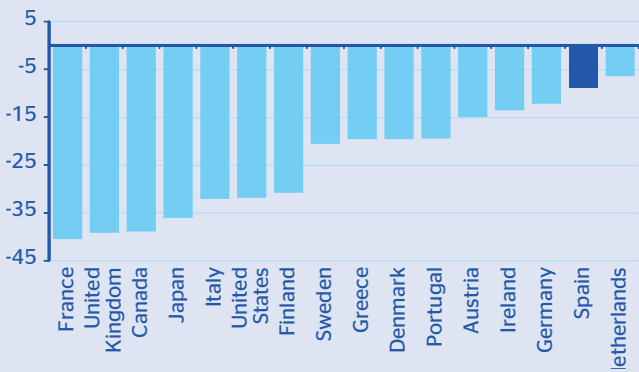


**Box 4. Export shares, real effective exchange rates and the Spanish puzzle**

One feature of Spain's economic performance since joining EMU is the good performance of exports of goods and services in the world's markets despite the increasing penetration of China, India and several other emerging economies in global trade. Specifically, Spain's share of exports between 1999 and 2011 barely fell by 8.9%, whereas the shares of other leading industrialised

economies fell by between 20% and 40% (see Chart 29). This positive feature is not well known, and, placed in contrast to the rise in unit labour costs (ULCs) relative to the rest of the industrialized countries (Chart 30) and the ensuing loss of competitiveness gave rise to the "Spanish puzzle" (Antràs et al., 2010).

Chart 29  
**Change in global share of exports of goods and services, 1999-2011 (%)**

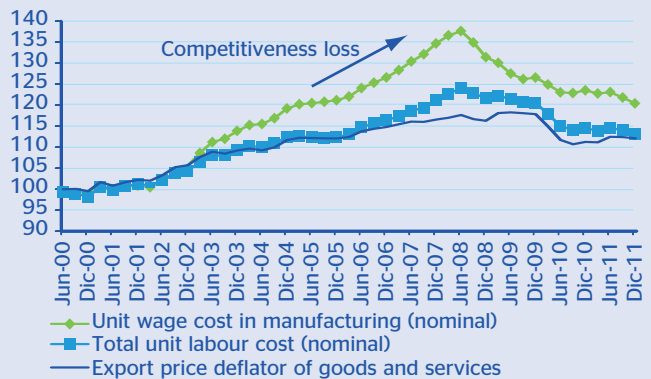


Source: BBVA Research based on WTO data

This box attempts to reconcile the contradictory evidence behind the Spanish puzzle, indicating the potential underlying factors behind the relatively good performance of Spain's export share despite adverse movements in relative prices. Chart 31 summarises two interesting and relatively unknown results for the main European economies, the US, Canada and Japan between 1999 and 2011.

The first is that there is no clear relationship between gains or losses of competitiveness derived from the indicators used most often (e.g. ULCs, inflation differentials.) and exports shares variations. As the Chart shows, even when export prices are chosen as a competitiveness indicator over less representative indicators of export competitiveness, such as ULCs or inflation, the two variables show a positive correlation (0.22), yet not statistically significant.

Chart 30  
**Spain: real effective exchange rate: Spain vs. 36 industrial countries, alternative deflators, 1Q00=100**



Source: BBVA Research based on European Commission data

Analytically, the change in export shares ( $ex_t - ex_t^w$ ) can be decomposed into the change in relative export prices ( $p_t^x - p_t^w$ ) and the change of an equation residual ( $s_t^x$ ) made up of the remaining variables that affect export shares:

$$(1) \Delta(ex_t - ex_t^w) = \Delta s_t^x - \sigma \Delta(p_t^x - p_t^w)$$

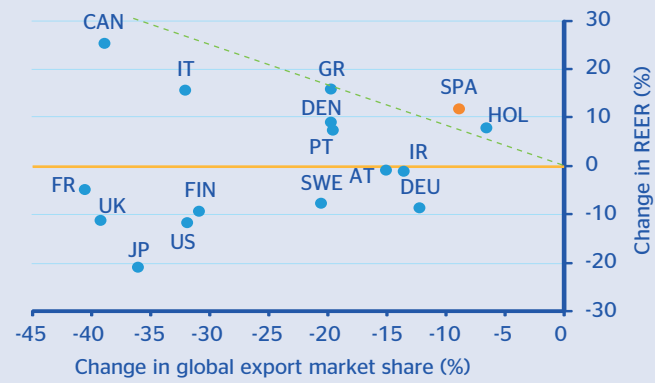
where  $\sigma$  is the price elasticity of exports, which in line with existing literature is assumed to be equal to -1.25 (slope of the dashed line in Chart 31)<sup>20</sup>. As illustrated, in Chart 31 the changes in  $s_t^x$  are as important as the variations in relative prices. Countries like Germany, France, the UK or the US, with similar changes in relative prices to determine share variation, show decreases in shares ranging from 12% in Germany to 40% in France. Table 2 shows the results of the disaggregation of export shares between the two components of the equation (1) for the countries in the sample of the chart between 1999 and 2011.

20: In open economy models, exports (EX) are generally represented using the following equation:

$$EX_t = S_t (P_t^x / P_t^w)^\sigma EX_t^w$$

where  $P^x$  is the price of exports of the domestic economy,  $P^w$  is the price of exports of global competitors,  $\sigma$  is the price elasticity of exports,  $EX^w$  is global demand for exports and  $S$  is a residual variable reflecting the changes in global export share ( $EX/EX^w$ ) not explained by changes in relative prices. Taking logarithms (variables in lower case) and calculating time differences leads to equation (1). Ratto, Werner and Veld (2009) estimate a price elasticity of exports equal to 1.25 for the EMU, very similar to the one estimated in Boscá et al. (2011) for Spain (1.30), and slightly below the range estimated by Adolfson et al. (2008).

Chart 31  
Cumulative change in global export share and relative export prices of goods and services, 1999-2011



Source: BBVA Research based on European Commission and WTO data

Table 2  
Cumulative decomposition of global market shares of exports of goods and services between relative prices and residual variables, 1999-2011

	Mkt share	Price	Residual
Netherlands	-6.4	-9.8	3.4
Spain	-8.9	-14.9	6.0
Germany	-12.2	10.9	-23.1
Ireland	-13.6	1.6	-15.2
Austria	-15.0	1.2	-16.2
Portugal	-19.5	-9.1	-10.4
Denmark	-19.6	-11.3	-8.3
Greece	-19.6	-19.6	0.0
Sweden	-20.6	9.8	-30.4
Finland	-30.8	11.8	-42.6
USA	-31.9	14.9	-46.7
Italy	-32.1	-19.4	-12.7
Japan	-36.1	26.1	-62.2
Canada	-38.9	-31.5	-7.4
UK	-39.2	14.1	-53.3
France	-40.5	6.3	-46.8

Source: BBVA Research

The second result obtained from Chart 31 is that Spain's export share not only decreased less than in the majority of the advanced economies, but stripping out the impact of relative export prices, it actually rose. The dashed line with a negative slope (-1.25) shows precisely the combinations of changes in relative prices and shares such that  $\Delta s_t = 0$ ; i.e. there is no change in the residual. Parallel shifts of this line to the right (left) reflect gains (losses) in global market shares while keeping relative prices constant. Spain shows the largest increase in the residual variable st of any country; 6pp between 1999 and 2011. If Spain had experienced the real exchanges rate depreciation of, say, Germany, its exports market share would have increased 20pp (equivalent to 6% of Spanish GDP).

As ULCs rose faster than relative export prices between 1999 and 2011 (see Chart 30), their ability to explain export shares decreases<sup>21</sup>. Moreover, aggregate ULCs are not a good indicator of the competitiveness of exporting firms. Specifically, ULCs of the larger exporting firms performed better than those of the rest of the companies, while these firms' exports rose at a considerably higher pace than those of small- and medium-sized enterprises (SMEs) (Antràs et al., 2010). Therefore, we must explore firm-level data to identify the set of non-price factors that determine market share variation and that, ultimately, explain the changes in stx. Among these factors, the literature has already identified, for example, the product and services quality, the internationalisation strategy and the importance of reallocating resources efficiently among industries and firms (Rodríguez-Crespo et al., 2012; Correa-López and Doménech, 2012).

21: Altomonte et al. (2012) called attention to the information actually contained in aggregate competitiveness measures -such as the real effective exchange rate- because of the dispersion and aggregation biases present in their construction.

## References

Adolfson, M., Laséen, S., Lindé, J. and Villani, M. (2008), "Bayesian Estimation of an Open Economy DSGE Model with Incomplete Pass-through", *Journal of International Economics* 72, 481-511.

Altomonte, C., Aquilante, T. and Ottaviano, G.I.P. (2012), "The Trigger of Competitiveness - The EFIGE Cross Country Report", *Bruegel Blueprint Series*, Vol. XVII.

Anràs, P., Segura-Cayuela, R. and Rodríguez-Rodríguez, D. (2010), "Firms in International Trade (with an Application to Spain)", *SERIEs Invited Lecture at the XXXV Simposio de la Asociación Española de Economía*.

Boscá, J.E., R. Doménech, J. Ferri and J. Varela (2011), *The Spanish Economy: A General Equilibrium Perspective*. Palgrave MacMillan.

Correa-López, M. and Doménech R. (2012), "The Internationalisation of Spanish Firms", *BBVA Working Paper*, to be released soon.

Ratto, M., Werner, R. and Veld, J. (2009), "QUEST III: An Estimated Open-Economy DSGE Model of the Euro Area with Fiscal and Monetary Policy", *Economic Modelling* 26, 222-233.

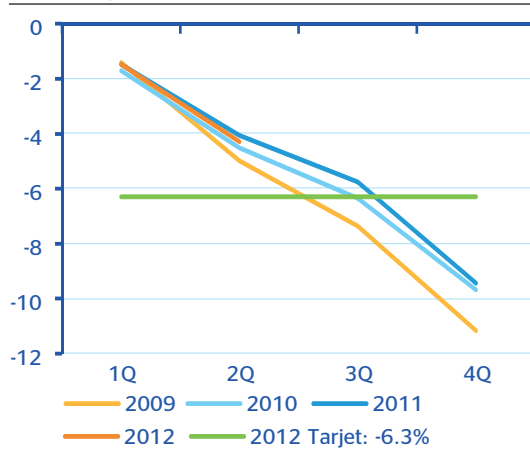
Rodríguez Crespo, A., Pérez-Quirós, G. and Segura Cayuela, R. (2012), "Competitiveness Indicators: The Importance of an Efficient Allocation of Resources", *Economic Bulletin* (January), Bank of Spain.

## 4. Significant fiscal adjustment, but probably not enough to meet targets

Spain showed a cumulative deficit for all public administrations at the end of 2Q12 of 3.8% of GDP excluding aid to financial institutions (-0.5pp of GDP) (see Chart 32). The Spanish Government continued to implement its policy of control over expenditure and fiscal adjustment throughout the first half of 2012, but this was not enough to offset the negative effect of the economic downturn on public accounts particularly tax revenue- and the increase in interest expenses caused by financial market pressure on sovereign debt. As Chart 33 illustrates, the central and regional governments accumulated deficits of 4.0% and 0.8% of GDP, respectively, at the end of 2Q12, while local corporations and the Social Security showed small surpluses underpinned by accelerated transfer payments from the central government. These figures were modest with respect to meeting the year-end targets, especially by the central government, which was a mere 0.5pp off its target, so we can expect fiscal adjustment to be intensified in the second half of the year.

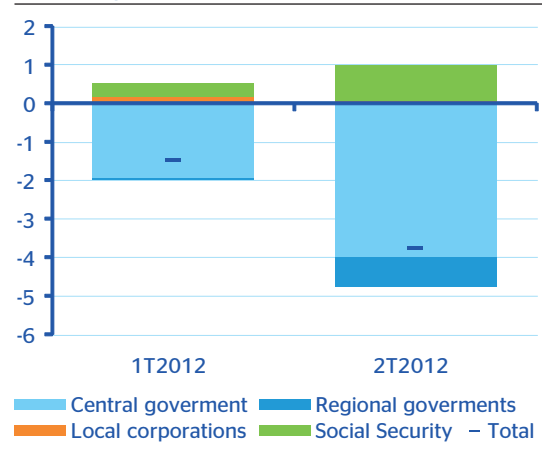
For the third quarter, the latest government budget outturn data show a cumulative deficit to September 2012 of 4.4% of GDP, marking an improvement of 0.4pp from the previous deficit. Still affecting performance are adverse trends in tax revenue, the increase in interest expenses and early transfers to other levels of public administration, mainly regional governments and the Social Security. Regional government budget data to August also show a slight improvement in the budget deficit, which remains around the 0.5% accumulated to the end of the second quarter this year. In both cases, adjustments continue to focus on cutbacks to investment and, to a lesser extent, intermediate consumption. Discretionary measures adopted increasing the tax burden have not had a significant impact. So, with the economy still struggling, whether budget targets are met will depend on the effect of measures still to be taken and on the firm commitment to curb expenditure.

Chart 32  
General Government: net lending (+) / net borrowing (-) (\*) (YTD,% of GDP)



(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research based on MINHAP data

Chart 33  
General Government: net lending (+) / net borrowing (-) (\*) (YTD,% of GDP)

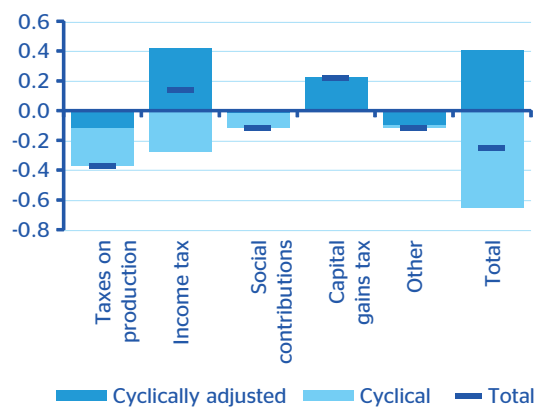


(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research based on MINHAP data

Analysing trends in income and expenditure to 2Q12, Charts 34 and 35 decompose the reduction into two factors, one cyclical and one structural<sup>22</sup>. Specifically, Chart 34 shows how public revenue has fallen due to the economic downturn (the cyclical component) and how the discretionary measures adopted since the beginning of the year (tax hikes) have prevented it from falling further. These measures have boosted the structural revenue of the General Government by around 0.4pp of GDP through income tax receipts -the increase in personal income tax withholding and changes in corporate tax legislation have triggered a structural increase of 0.4pp of GDP- and capital gains tax collections -whose structural income increased by 0.2pp of GDP-. However, the economic downturn in the first two quarters of 2012 resulted in a reduction of over 0.7pp of GDP of public revenue, counteracting most of the structural efforts made with tax hikes. Accordingly, total revenue has barely increased by 0.2pp of GDP.

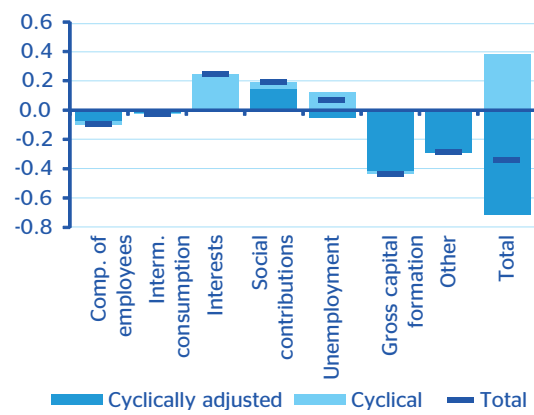
Meanwhile, automatic stabilisers have had less of an impact on public expenditure given their mostly discretionary nature. The first two quarters of the year featured an adjustment in the structural component of almost 0.7pp of GDP, with adjustments in virtually all expenditure items (see Chart 35), but especially in investment, which shows a structural decrease of 0.4pp of GDP. Nevertheless, this structural adjustment has not been enough to make up for the increase in interest expenses -of 0.2pp of GDP- and in unemployment benefit payments -of an additional 0.1pp of GDP-. Furthermore, the updates to pensions approved by the Government for 2012 have raised the payment of the rest of social benefits by 0.2pp, leaving total cumulative annual expenditure of the public administrations at around 44.5% of GDP, a mere 0.3pp less than the cumulative total at the end of December 2011.

Chart 34  
General Government: adjustment in non-financial revenue in 1H12 (pp of GDP)



Source: BBVA Research based on MINHAP and INE dat

Chart 35  
General Government: adjustment in non-financial expenditure in 1H12(\*) (pp of GDP)



(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research based on MINHAP data

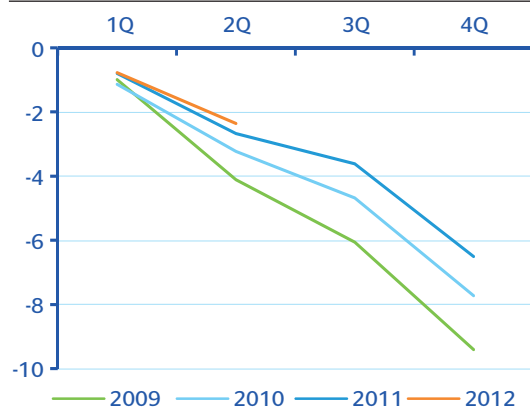
22: Each revenue and expense item is decomposed into the part related to discretionary decisions (the structural part) and the part related to cyclical swings in the economy (the cyclical part), identifying both effects on each item and their tax bases. Accordingly, the bases of each item ( $b_{i,t}$ ) can be divided into three unobservable components: structural ( $b_{i,t}^s$ ), cyclical ( $b_{i,t}^c$ ), and irregular ( $\epsilon_{i,t}^b$ ).

$$b_{i,t} \equiv b_{i,t}^s + b_{i,t}^c + \epsilon_{i,t}^b$$

where, the cyclical component  $b_{i,t}^c$ , depends on the stage of the economic cycle. Similarly, for every period  $t$ , the amount of each income or expense item ( $r_{i,t}$ ) is broken down into the sum of three unobservable components: structural ( $r_{i,t}^s$ ), cyclical ( $r_{i,t}^c$ ) and irregular ( $\epsilon_{i,t}^r$ ), the first two of which depend on the structural part and the cyclical part of their base. The structural decomposition of the bases and items used is based on a model of unobservable components whose trends are inferred using a Kalman filter and estimated for maximum likelihood. The details and complete results of these estimations will be addressed in a forthcoming BBVA Research working document available on the web: [www.bbva-research.com](http://www.bbva-research.com).

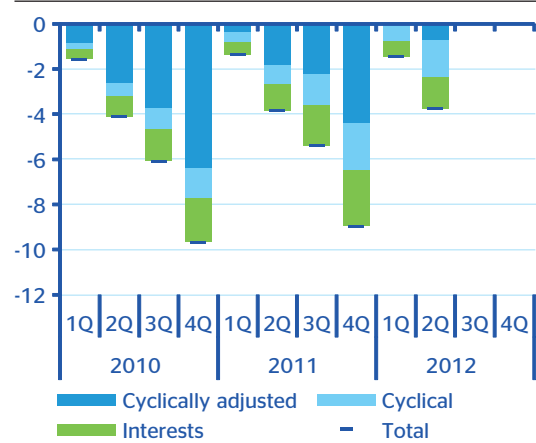
Trends in revenue and expenditure triggered a structural adjustment to the primary balance of all General Government in the first half of 2012 of 1.1pp of GDP. Adding the negative effect of the automatic stabilisers (0.8pp of GDP in 1H12), the cumulative annual primary deficit reached -2.4% of GDP (see Chart 36). Although this result shows the fiscal consolidation efforts being made since the middle of 2010 -the structural deficit has narrowed by nearly 2pp since 2Q10- the sharper deterioration in economic activity, coupled with increased pressure on Spanish public debt, largely explain the deviation of the deficit from the approved stability targets (Charts 36 and 37).

Chart 36  
**General Government: primary balance (\*) (YTD,% of GDP)**



(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research based on MINHAP and INE data

Chart 37  
**General Government: decomposition of net borrowing (\*) (YTD,% of GDP)**

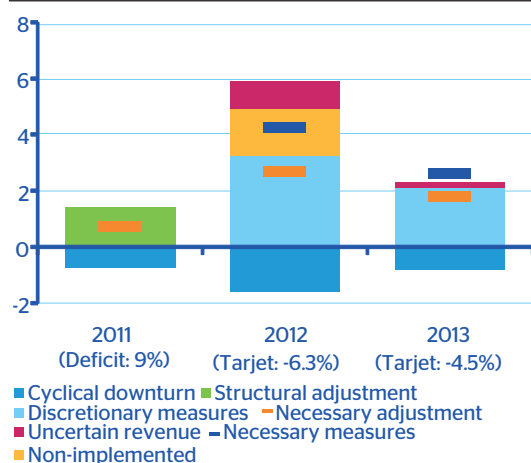


(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research, based on MINHAP data

In this respect, the results of the Government's fiscal consolidation policy have been somewhat modest in the first half of the year; with more than 2.5pp in adjustments still needed to meet its approved stability target of a deficit equivalent to 6.3% of GDP by the end of the year (see Table 3). Although the adjustment is likely to intensify during the second half of the year -a large part of the announced measures (e.g. VAT hike, elimination of the extra payment at Christmas or some measures contained in the economic-financial plans of the regions) take effect in 2S12- this will probably be insufficient to make up for the negative effects of the downturn in activity on revenue and expenditure. BBVA Research estimates that the current pace of economic growth will cause government revenue as a percentage of GDP to fall (by 0.7pp) to 36%, a mere 0.4pp above 2011 levels. Given the weak performance on the revenue side, pressure on consolidation will stem from expenditure, where the economic and financial components combine to represent around 0.5pp of GDP. In this context, spending cuts could be sharpest in compensation of employees (more from the aforementioned elimination of the extra payment at Christmas than government job losses), investment and, to a lesser extent, other current expenditures. In all, the total deficit for Spanish public administrations could end 2012 at around 7.2% of GDP, above the stability target.

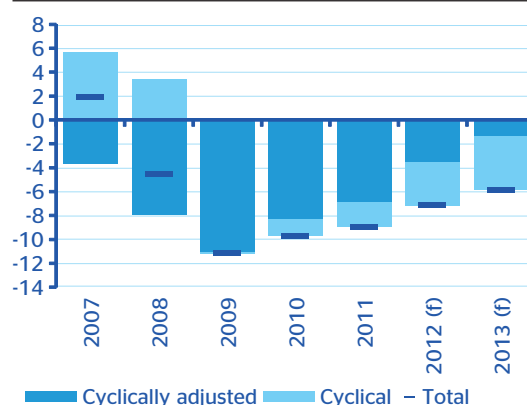
The size of this deviation (nearly 1pp of GDP) from the 2012 target means that the 2013 target is less likely to be met. As Chart 35 illustrates, it will be necessary to reduce the deficit by 2.7pp of GDP next year, while the effect of the economic downturn on the deficit is projected to stand at above -0.8pp of GDP. Reaching the deficit target by the end of 2013 would require fiscal adjustment measures equivalent to about 3.5pp of GDP. An amount equivalent to 2.3pp has been already announced, so without additional measures, the deficit for 2013 looks set to be about 1.5pp above the target (4.5% of GDP).

Chart 38  
General Government: necessary fiscal adjustment to reach the target (% of GDP)



Source: BBVA Research based on MINHAP and INE data

Chart 39  
General Government: net lending (+) / net borrowing (-) capacity or requirement (\*) (% of GDP)



(\*) Excludes the amount of aid provided to financial institutions  
Source: BBVA Research based on MINHAP and INE data

Table 3  
General Government: adjustment to net borrowing excluding aid to the financial sector

(% of GDP)	Adjustment			2012		2013	
	2011	1S12	2S12	BBVA Research	Govt.	Adj.	BBVA Research
Compensation of employees	11.6	-0.10	-0.79	10.8	10.7	0.2	11.0
Intermediate consumption	5.9	-0.03	-0.31	5.5	5.0	0.0	5.6
Interest	2.5	0.25	0.38	3.1	3.2	0.4	3.5
Unemployment benefits	2.8	0.07	0.15	3.1		0.1	3.2
Social payments	12.6	0.19	0.16	13.0	15.9	0.4	13.5
Gross capital formation	2.9	-0.44	-0.38	2.1	1.8	-0.4	1.7
Other expenditure	6.4	-0.29	-0.59	5.6	5.9	-1.4	4.2
Non-financial payments	44.7	-0.34	-1.36	43.2	42.5	-0.6	42.6
Taxes on production	9.9	-0.37	0.26	9.8	9.9	0.7	10.5
Income, property tax, etc	9.6	0.14	0.21	10.0	10.5	-0.3	9.6
Social security contributions	13.2	-0.12	-0.05	13.1	12.8	0.1	13.1
Tax on capital gains	0.4	0.22	-0.04	0.5	0.3	0.1	0.6
Other revenue	2.7	-0.11	0.04	2.7	2.7	0.2	2.9
Non-financial revenue	35.7	-0.25	0.41	36.1	36.2	0.6	36.7
Borrowing capacity/requirement	-9.0	-0.09	-1.78	-7.2	-6.3	-1.3	-5.9

(1) Government forecast including unemployment benefits  
Source: BBVA Research based on MINHAP and INE data

Even though the announced measures are not making up for the negative impact of the economy on the deficit due to the economic context, they are severe and entail a huge sacrifice, and put public finances on the path toward sustainability. So, if BBVA Research forecasts are on the mark and the measures announced in the 2012-2015 plan are considered, the public structural balance could be close to the target of 0% of GDP in 2014, six years ahead of the commitment included in the new Budget Stability Law. Spain has adjusted its public finances faster and further than any other developed country undergoing fiscal consolidation. We would point out that part

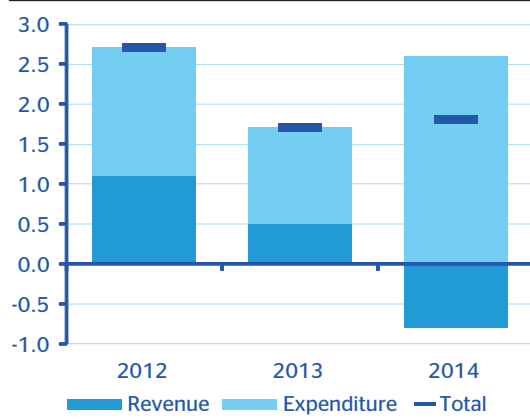
of this acceleration in deficit reduction is due to the failure to reach the target in 2011, which led measures to be concentrated in 2012. In fact, according to the Government, over half of the measures to be adopted in the 2012-2015 period to meet fiscal commitments will have been adopted in the first year of the plan. While this significantly undermines growth in domestic demand, the Government is proposing that 75% of the announced measures through to 2015 target expenditure and only 25% target revenue (see Chart 40). Insofar as there are inefficiencies in the execution of public policies and these are corrected to curb expenditure, the greater role of expenditure in the fiscal consolidation process should minimise the impact of this process on growth. Furthermore, many permanent revenue measures have been adopted this year, which is good news because it reduces the future uncertainty of the private sector.

Nevertheless, an especially negative aspect of some of the measures announced until now is that many are temporary (e.g. hike in personal income tax withholding for just 2012 and 2013, the elimination of the extra payment for Christmas in 2012). Additionally, the adjustment seems to be concentrated on investment, which in 2013 looks set to amount to less than 2% of GDP, in line with levels seen in the UK, Germany, Belgium or Denmark. However, as these countries have larger public sectors and higher per capita income than Spain (see Chart 41), such low levels of public investment in Spain do not appear sustainable. This, coupled with the increasing risk of new tax hikes, raises concerns over the quality of the measures adopted; there are still uncertainties over whether the restructuring of public spending will make it more efficient. Looking ahead, there are still several important reforms to be undertaken and these need to be carried out with the smallest impact on economic growth as possible.

Finally, Spain needs to continue shoring up confidence over its institutions, particularly the country's fiscal institutions, because there is the chance that it will miss its deficit targets again. A key step in this direction is the Government's announcement that it is to create an independent fiscal authority to assess the cyclical state of the economy and its impact on public finances. Although no details in this respect are available, this measure could go a long way to raising the credibility of fiscal policy in Spain, if: a) it is truly independent, b) it is transparent in its methodology, and c) its members are professionals with proven track record.

Chart 40

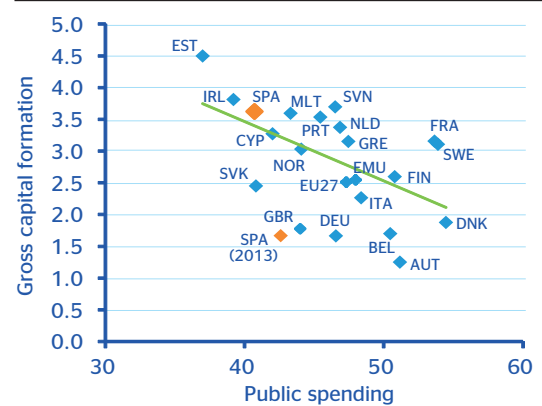
**General Government: composition of planned fiscal adjustment in the 2013-2014 Budget Plan\* (pp of GDP)**



(\*): positive amounts reduce and negative amounts increase the deficit  
Source: BBVA Research based on MINHAP and INE data

Chart 41

**Europe: investment and public expenditure (% of GDP)**



Source: BBVA Research based on Eurostat data



## 5. Tables

Table 4

### Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.1	2.4	1.8	2.1	1.8
Eurozone	-4.3	1.9	1.5	-0.5	0.3
Germany	-5.1	4.0	3.1	0.9	1.3
France	-3.1	1.6	1.7	0.1	0.5
Italy	-5.5	1.8	0.5	-2.4	-0.6
Spain	-3.7	-0.3	0.4	-1.4	-1.4
UK	-4.0	1.8	0.9	-0.1	1.3
Latin America *	-2.2	6.2	4.3	3.0	3.7
Mexico	-6.1	5.4	3.9	3.7	3.0
Brazil	-0.3	7.6	2.7	1.6	4.2
EAGLES **	4.0	8.4	6.7	5.2	5.8
Turkey	-4.9	9.2	8.5	3.0	4.5
Asia Pacific	4.1	8.2	5.8	5.2	5.5
China	9.2	10.4	9.2	7.6	7.9
Asia (exc. China)	0.8	6.7	3.5	3.7	3.9
World	-0.6	5.1	3.9	3.2	3.5

\* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

\*\* Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: November 2, 2012

Source: BBVA Research

Table 5

### Macroeconomic forecasts: 10Y interest rates (average)

	2009	2010	2011	2012	2013
US	3.2	3.2	2.8	1.8	2.1
EMU	3.3	2.8	2.6	1.6	2.1

Closing date: 2 November 2012

Source: BBVA Research

Table 6

### Macroeconomic forecasts: exchange rates (average)

US dollars (\$) per national currency	2009	2010	2011	2012	2013
US (EUR/USD)	0.72	0.76	0.72	0.78	0.77
EMU	1.39	1.33	1.39	1.28	1.30
UK	1.56	1.55	1.60	1.59	1.66
China	6.83	6.77	6.46	6.32	6.26

Closing date: 2 November 2012

Source: BBVA Research

Table 7

**Macroeconomic forecasts: official interest rates (end of period)**

	2009	2010	2011	2012	2013
US	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	0.75
China	5.31	5.81	6.56	5.75	5.75

Closing date: 2 November 2012

Source: BBVA Research

Table 8

**EMU: macroeconomic forecasts (yoy change, %, unless otherwise indicated)**

	2009	2010	2011	2012	2013
Real GDP	-4.3	1.9	1.5	-0.5	0.3
Household consumption:	-0.9	0.9	0.1	-1.0	0.0
Public consumption	2.6	0.7	-0.1	-0.1	-0.5
Gross fixed capital formation	-12.7	-0.3	1.6	-3.6	-0.6
Equipment, machinery and cultivated assets	-18.7	6.3	4.2	-5.3	-0.8
Equipment and machinery	-18.8	6.4	4.3	-5.3	-0.8
Construction	-9.9	-4.4	-0.2	-3.4	-1.4
Housing	-12.5	-2.9	0.9	-1.9	0.4
Other buildings and other constructions	-7.0	-5.9	-1.4	-5.1	-3.3
Change in inventories (contribution to growth)	-0.9	0.6	0.1	-0.5	0.0
Domestic demand (contribution to growth)	-3.6	1.2	0.5	-1.8	-0.3
Exports	-12.4	11.0	6.4	3.1	3.2
Imports	-11.0	9.4	4.2	0.1	2.2
Net exports (contribution to growth)	-0.8	0.7	1.0	1.3	0.5

**Pro-memoria**

GDP w/out housing investment	-3.8	2.2	1.5	-0.4	0.3
GDP w/out construction	-3.6	2.7	1.7	-0.2	0.4
Employment (LFS)	-1.8	-0.5	0.5	-0.8	-0.3
Unemployment rate (% active pop.)	9.6	10.1	10.2	11.4	11.8
Current account balance (% GDP)	0.1	-0.1	0.0	1.2	1.2
Public sector balance (% GDP)	-6.3	-6.2	-4.1	-3.2	-2.3
CPI annual average	0.3	1.6	2.7	2.5	1.8

Closing date: 2 November 2012

Source: official institutions and BBVA Research

Table 9

**Spain: macroeconomic forecasts (yoy change, %, unless otherwise indicated)**

	2009	2010	2011	2012	2013
<b>Actividad</b>					
Real GDP	-3.7	-0.3	0.4	-1.4	-1.4
Private consumption	-3.8	0.7	-1.0	-2.0	-2.9
Public consumption	3.7	1.5	-0.5	-3.6	-6.9
Gross fixed capital formation	-17.9	-5.5	-5.5	-9.5	-7.4
Capital goods	-24.5	3.0	2.4	-7.7	-3.8
Construction	-16.6	-9.8	-9.0	-11.8	-10.0
Housing	-23.1	-10.1	-6.7	-6.8	-8.4
Domestic demand (contribution to growth)	-6.6	-0.6	-1.9	-4.0	-4.7
Exports	-10.0	11.3	7.6	3.8	8.2
Imports	-17.2	9.2	-0.9	-4.7	-1.8
Net exports (contribution to growth)	2.9	0.3	2.3	2.6	3.3
GDP at current prices	-3.7	0.1	1.4	-0.6	0.7
(Billion euros)	1048.1	1048.9	1063.4	1057.4	1065.0
GDP w/out housing investment	-1.4	0.5	1.0	-1.0	-0.9
GDP w/out construction	-0.5	1.6	2.1	0.3	-0.2
<b>Labour market</b>					
Employment (LFS)	-6.8	-2.3	-1.9	-4.4	-3.4
Unemployment rate (% active pop.)	18.0	20.1	21.6	25.0	26.1
Employment QSNA (equivalent to full-time)	-6.2	-2.5	-1.7	-4.2	-3.2
Productivity	2.5	2.2	2.1	2.8	1.8
<b>Prices and costs</b>					
CPI (annual average)	-0.3	1.8	3.2	2.5	2.3
GDP deflator	0.1	0.4	1.0	0.8	2.1
Household consumption deflator	-1.1	2.0	2.9	2.5	2.6
Compensation per employee	4.2	0.3	0.7	1.5	2.1
Unit labour cost (ULC)	1.7	-2.0	-1.4	-1.3	0.4
<b>Foreign trade</b>					
Current account balance (% GDP)	-4.8	-4.5	-3.5	-1.4	-0.5
<b>General government</b>					
Debt (% GDP)	53.9	61.3	69.1	85.2	91.4
Budget balance (% of GDP)	-11.2	-9.7	-9.0	-7.2	-5.9
<b>Households</b>					
Nominal disposable income	0.6	-2.9	-0.5	-3.1	-1.5
Savings rate (% of nominal income)	17.8	13.1	11.0	7.6	6.6

(\*): Excluding financial aid to Spanish banks

Closing date: 2 November 2012

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.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons. 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 is not a member of the FINRA and is 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](http://www.bbva.com) / Corporate Governance".**

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.

**This report has been produced by the Spain Unit:**
*Chief Economist for Developed Economies*

**Rafael Doménech**  
 +34 91 537 36 72  
 r.domenech@bbva.com

## Spain

**Miguel Cardoso**  
 +34 91 374 39 61  
 miguel.cardoso@bbva.com

**Anabel Arador**  
 +34 93 401 40 42  
 ana.arador@grupobbva.com

**Joseba Barandiaran**  
 +34 94 487 67 39  
 joseba.barandia@bbva.com

**Xavier Callol**  
 +34 91 374 75 28  
 xavier.callol@bbva.com

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

**Juan Ramón García**  
 +34 91 374 33 39  
 juanramon.gj@bbva.com

**Ángel Gavilán**  
 +34 91 374 52 62  
 angel.gavilan@bbva.com

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

**Antonio Marín**  
 +34 648 600 596  
 antonio.marin.campos@bbva.com

**Myriam Montañez**  
 +34 954 24 74 86  
 miriam.montanez@bbva.com

**Mercedes Nogal**  
 +34 91 807 51 44  
 mmercedes.nogal@bbva.com

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

**Juan Ruiz**  
 +34 646 825 405  
 juan.ruiz2@bbva.com

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

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

*With the contribution of:*

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

Financial Systems  
**Olga Cerqueira**  
 +34 629 366 301  
 olga-gouveia@bbva.com

Economics Scenarios  
**Julián Cubero**  
 +34 91 374 49 98  
 juan.cubero@bbva.com

**BBVA Research**
*Group Chief Economist*  
**Jorge Sicilia**
*Emerging Markets:*

**Alicia García-Herrero**  
 alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis

**Álvaro Ortiz Vidal-Abarca**  
 alvaro.ortiz@bbva.com

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

Latam Coordination

**Juan Ruiz**  
 juan.ruiz@bbva.com

Argentina  
**Gloria Sorensen**  
 gsorensen@bbva.com

Chile  
**Alejandro Puente**  
 apuente@bbva.com

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

Peru  
**Hugo Perea**  
 hperea@grupobbva.com.pe

Venezuela  
**Oswaldo López**  
 oswaldo\_lopez@provincial.com

Mexico  
**Adolfo Albo**  
 a.albo@bbva.bancomer.com  
 Macroeconomic Analysis Mexico

*Developed Economies:*

**Rafael Doménech**  
 r.domenech@bbva.com

Spain  
**Miguel Cardoso**  
 miguel.cardoso@bbva.com

Europe  
**Miguel Jiménez**  
 mjimenezg@bbva.com

United States  
**Nathaniel Karp**  
 nathaniel.karp@bbvacompass.com

*Financial Systems & Regulation:*

**Santiago Fernández de Lis**  
 sfernandezdelis@bbva.com

Financial Systems  
**Ana Rubio**  
 arubiog@bbva.com

Pensions  
**David Tuesta**  
 david.tuesta@bbva.com

Regulation and Public Policy  
**María Abascal**  
 maria.abascal@bbva.com

*Global Areas:*

Economic Scenarios  
**Julián Cubero**  
 juan.cubero@bbva.com

Financial Scenarios  
**Sonsoles Castillo**  
 s.castillo@bbva.com

Innovation & Processes  
**Clara Barrabés**  
 clara.barrabes@bbva.com

*Market & Client Strategy:*

**Antonio Pulido**  
 ant.pulido@grupobbva.com

Equity Global  
**Ana Munera**  
 ana.munera@grupobbva.com

Global Credit  
**Javier Serna**  
 Javier.Serna@bbvauk.com

Global Interest Rates, FX  
 and Commodities  
**Luis Enrique Rodríguez**  
 luisen.rodriguez@grupobbva.com

**Contact details:**

**BBVA Research**  
 Paseo Castellana, 81 - 7th floor  
 28046 Madrid (Spain)  
 Tel.: +34 91 374 60 00 and +34 91 537 70 00  
 Fax: +34 91 374 30 25  
 bbvaresearch@bbva.com  
 www.bbvaresearch.com  
 Depósito Legal: M-31254-2000