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Financial Stability and Fiscal Policy in Europe: The Spanish Economy

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Main messages

1. Given the limitations in the design of European institutions, heterogeneity of fiscal imbalances and banking conditions in EMU produce a distorting **financial fragmentation,** exacerbated by market fears of euro breakup and supervisory ring fencing

2. Spanish fiscal imbalance has been the result of **housing and financial bubbles. Fiscal consolidation is working**, but the process is low and costly in recession times

3. **Bank restructuring** in Spain is helping to discriminate among institutions.

4. **Solutions at the European level**: a road map to a genuine EMU, with a banking and (eventually some type of) fiscal union, and policies from ECB to restore a more normal functioning of the monetary transmission mechanism.

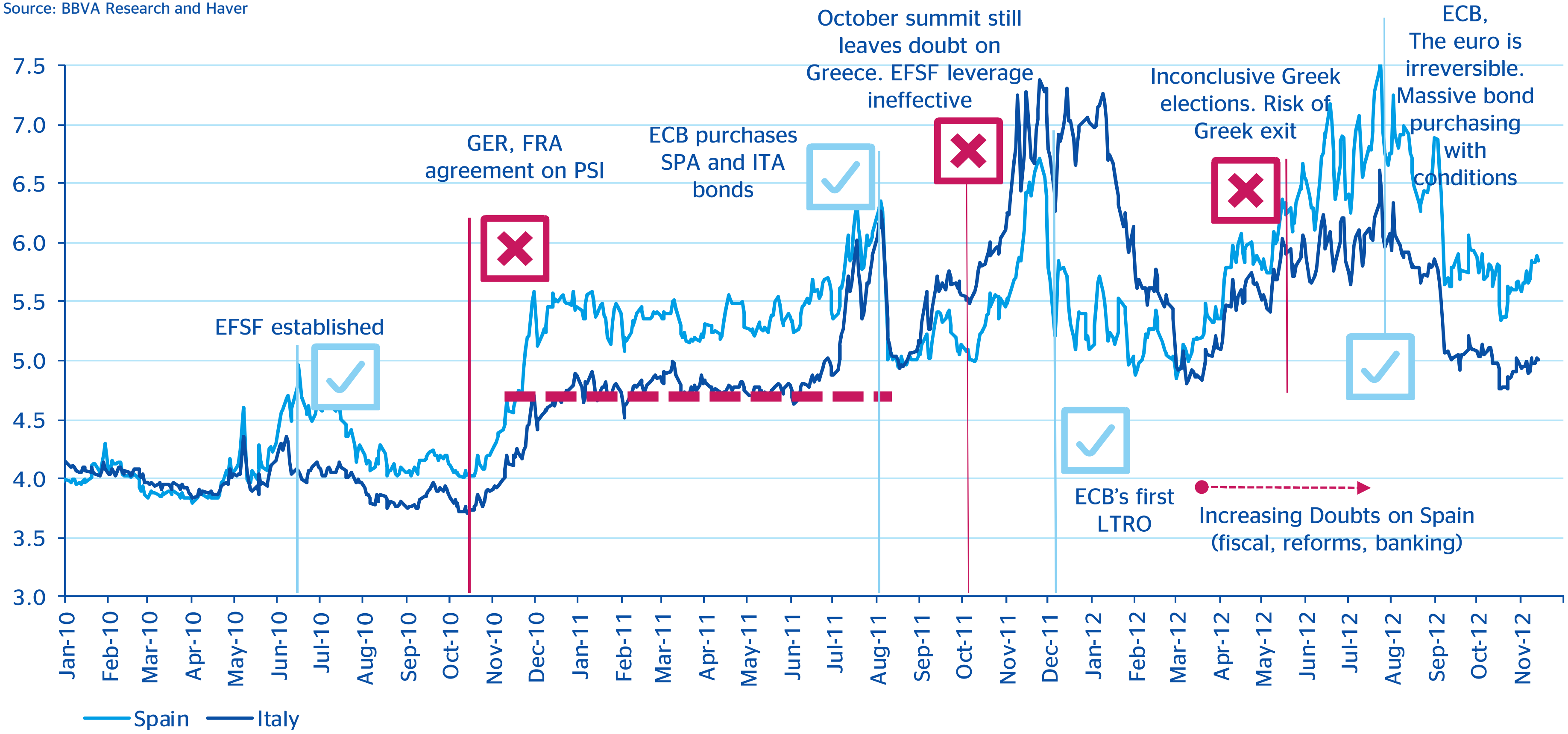
5. **Solutions at the Spanish level**: (1) fiscal adjustment, (2) complete banking restructuring, and (3) structural reforms to increase potential growth.

1. Financial Stability and Fiscal Policy in Europe

The fragmentation of financial markets in EMU

10-y yields, Spain and Italy, %

Source: BBVA Research and Haver

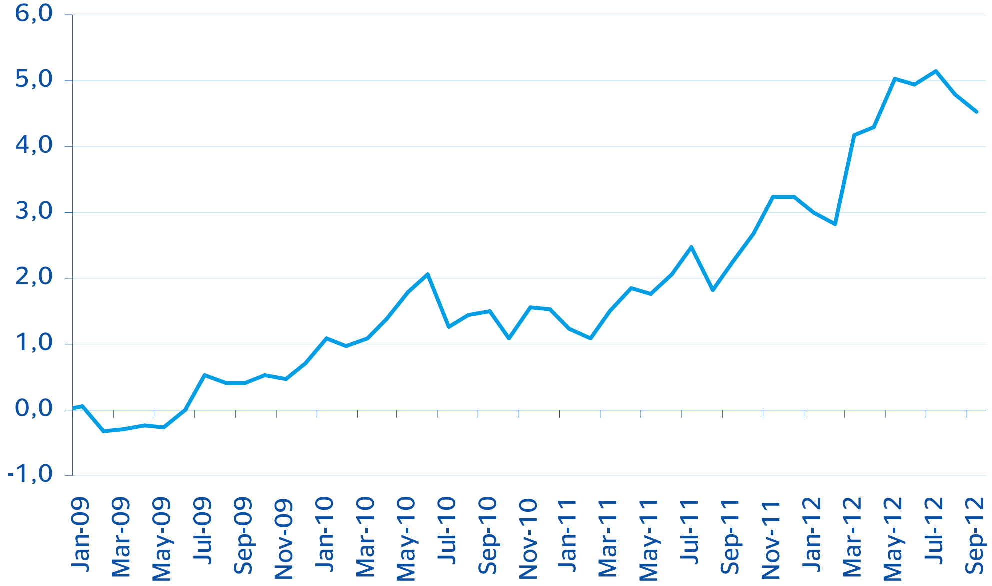


1. Financial Stability and Fiscal Policy in Europe

The fragmentation of financial markets in EMU

EMU: Composite measure of financial fragmentation*

Source: Bloomberg and BBVA Research



* Components; (i) the cross country coefficient of variation of bank lending rates to corporates and households (average) (ii) the Target 2 balances of surplus (iii) gross liquidity provision by Eurosystem as a share of bank assets and (iv) the interquartile range of Euro area countries' two-year government bond yields. To combine these varied indicators, we calculate a Z-score for each, and then estimate the first principal component of these Z-scores

Country risk premia in periphery reflect imbalances heterogeneity, but not only

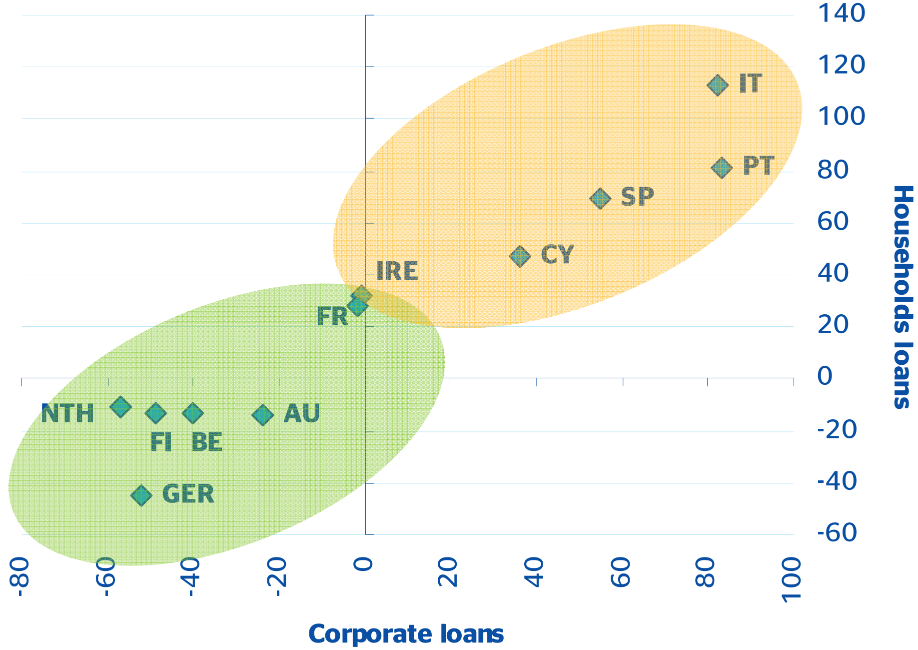
Imbalances have interacted with the convertibility risk, contributing to exacerbate financial tensions

The ECB announcement (OMT) has significantly reduced convertibility risk

1. Financial Stability and Fiscal Policy in Europe

The fragmentation of financial markets in EMU

EMU: Change in interest rate on new bank loans
(In basis points, December 2010 to July 2012)
Source: ECB, IMF and BBVA Research



* Not including ongoing merger processes and fiscal credit. With them, €54bn

The monetary policy transmission mechanism in Europe relies in banks, which reflect the tensions in funding in their lending conditions

But there is a very long way to go to return to the previous level of financial integration

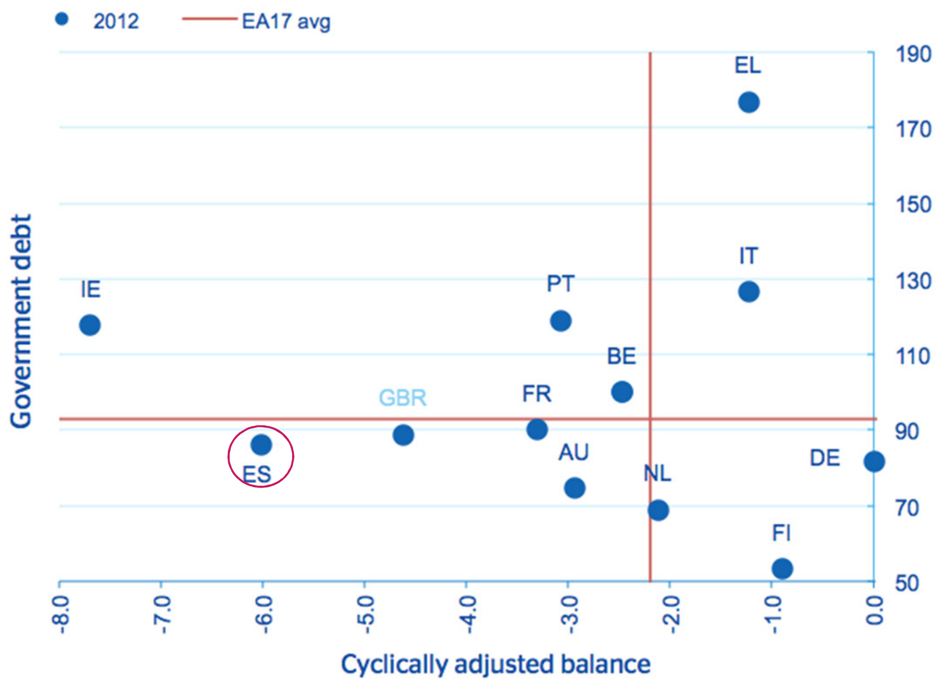
Heterogeneity among countries will remain, mainly on two fronts: fiscal and banking sector

1. Financial Stability and Fiscal Policy in Europe

Spanish imbalances in European perspective

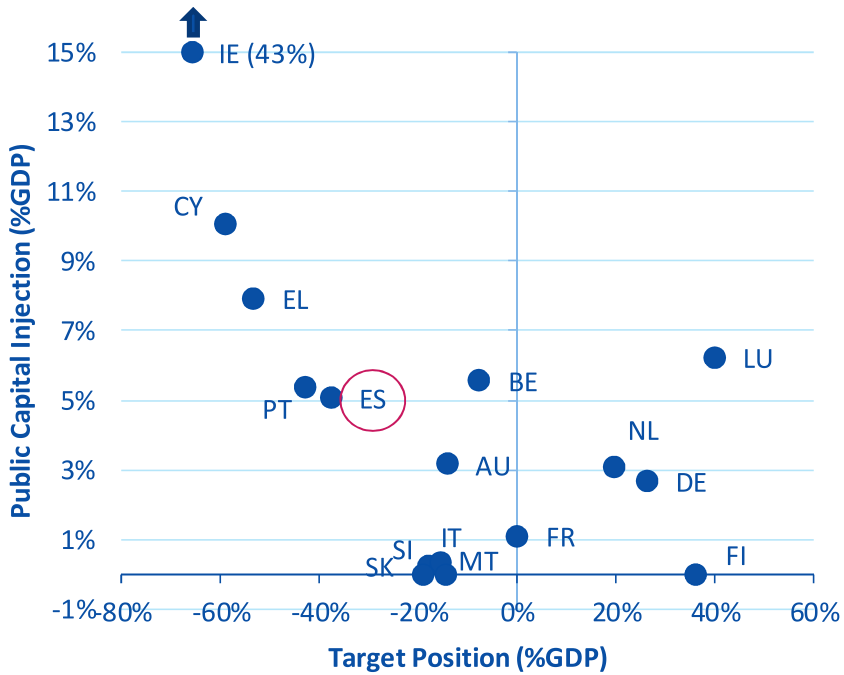
Fiscal Imbalances (% GDP)

Source: BBVA Research based on AMECO



Banking imbalances : capital injections and market openness

Source: BBVA Reaerch based on European Commissionand ECB

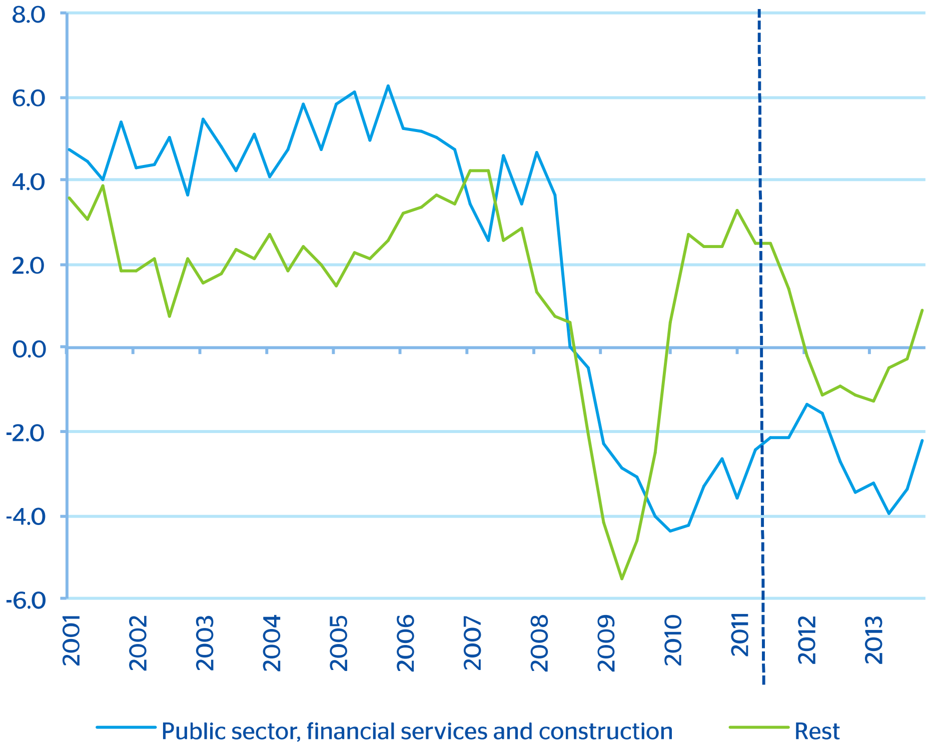


1. Financial Stability and Fiscal Policy in Europe

The three faces of the housing and financial bubble

Spain: Value added growth by sectors (%y/y)

Fuente: BBVA Research a partir de INE



Explanatory factors

Low real interest rates (EMU, risk under-pricing) and population growth due to immigration

Economic growth driven by strong demand. Potential growth of rest of sectors close to 2%

Unlimited liquidity in international financial markets, searching for low risk financial assets

Banks: high competition in volumes with low prices. Savings banks allowed to operate out of original regions and influenced by politics

A simple type of financial engineering: increase of mortgages' term and LTV with low interest rates

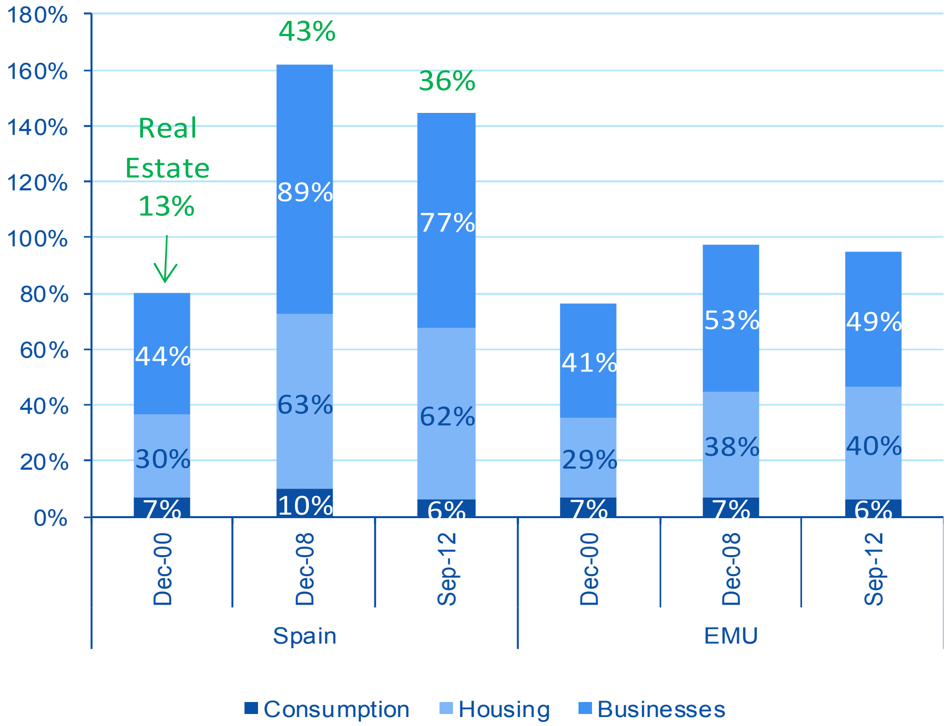
1. Financial Stability and Fiscal Policy in Europe

The three faces of the housing and financial bubble

Credit to Private Sector

(% GDP)

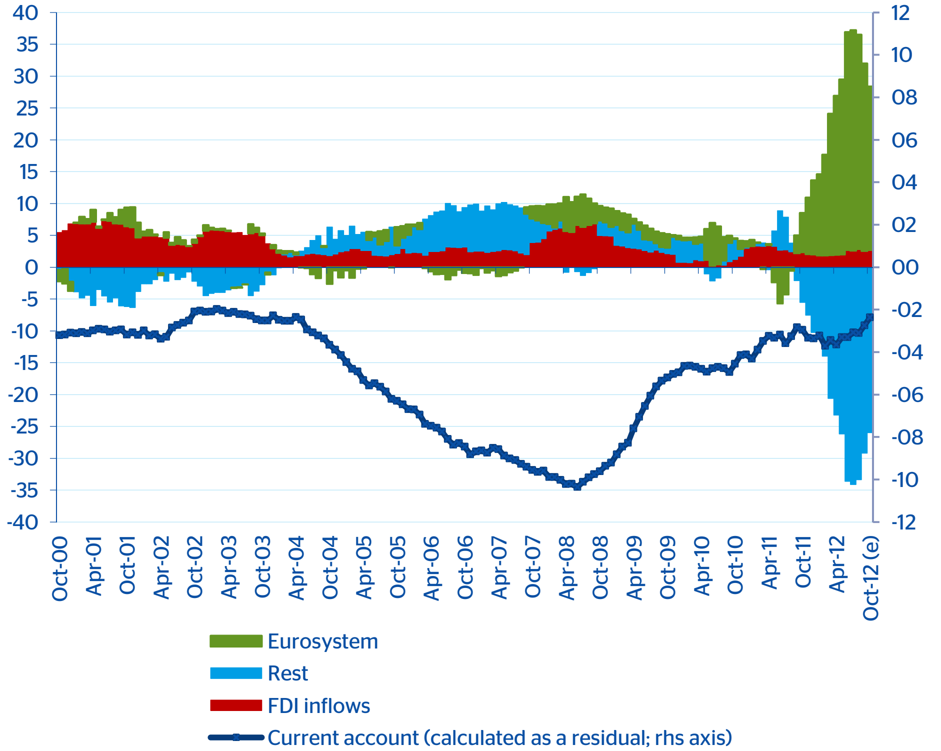
Source: BBVA Reaerch based on Bank of Spain and ECB



Spain: current account balance and capital flows

(% of GDP)

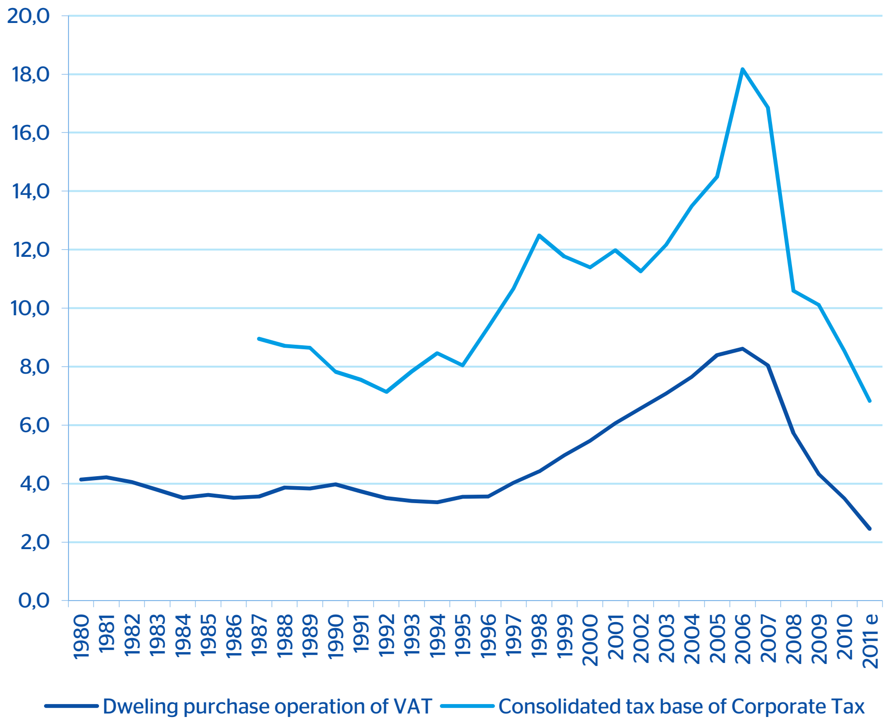
Source: BBVA Research based on Bank of Spain data



2. Fiscal Policy

The response of the fiscal balance: the bubble

Spain: Tax base for corporates and VAT as % of GDP
Source: AMECO and BBVA Research



The housing and financial bubble gave place to extraordinary revenues for the public sector:

(1) VAT for total price of houses, (2) corporate taxes of financial and real estate companies, (3) import taxes due to the huge current account deficit

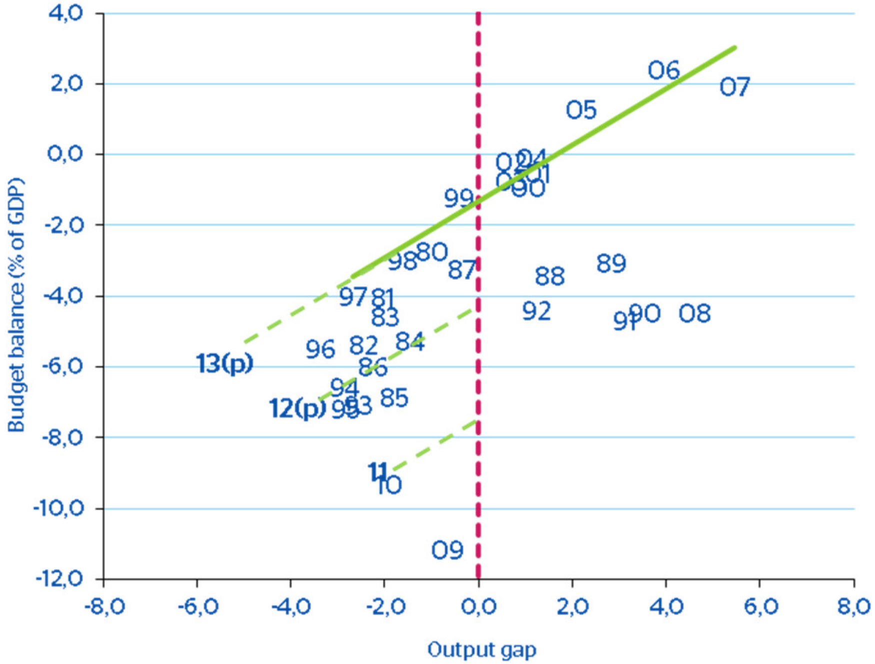
Despite the fact that these revenues were extraordinary, public spending increased in the same amount, particularly in the case of regional governments

2. Fiscal Policy

The response of the fiscal balance: the adjustment

Spain budget balance and output gap

Fuente: BBVA Research based on MINHAP and INE



Surpluses in 2005-7 based on extraordinary revenues, but structural deficit above 1.5% of GDP

With the crisis all these revenues disappeared (below their steady state values) and the Government implemented expansionary fiscal policies

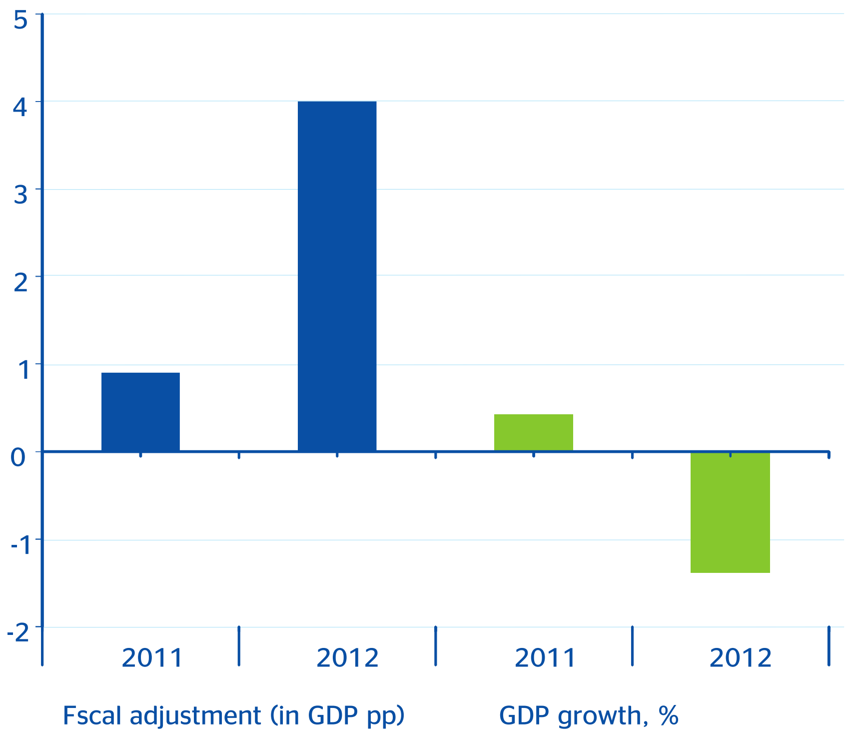
Since 2009 a significant fiscal consolidation process begun. In 2014 if target achieved, better structural deficit than in 2007.

2. Fiscal Policy

Fiscal consolidation: composition and multipliers

Spain: fiscal adjustment and GDP growth

Source: BBVA Research based on INE



Composition of fiscal adjustment towards 2014: 25% revenues measures, 75% expenditure measures

Despite the significant adjustment expected in 2012 (around 4%of GDP in measures), the economy will only contract by around 1,4%

Debate on fiscal multipliers

3. The financial sector

Banks' weaknesses became apparent after the bubble

1. The risk of credit portfolios was underestimated:
NPL represented in June 2012 16% of GDP

2. Branches and employment also boomed:
25% of excess capacity

3. Too much reliance on wholesale funding:
35% of total banking assets in 2012

4. Too much reliance on ECB funding:
35% of GDP

3. The financial sector

The MoU: a comprehensive and definitive plan

After a slow restructuring process, the MoU is a comprehensive and definitive plan

1. Solvency: The €100bn credit line exceeds the foreseeable needs (€59bn in bottom up stress test)

2. Cleaning-up of balance sheets will be further enhanced. Tremendous provisioning effort with minimum public funds

3. Bad bank: segregation of real estate assets will enhance transparency and focus on banking business

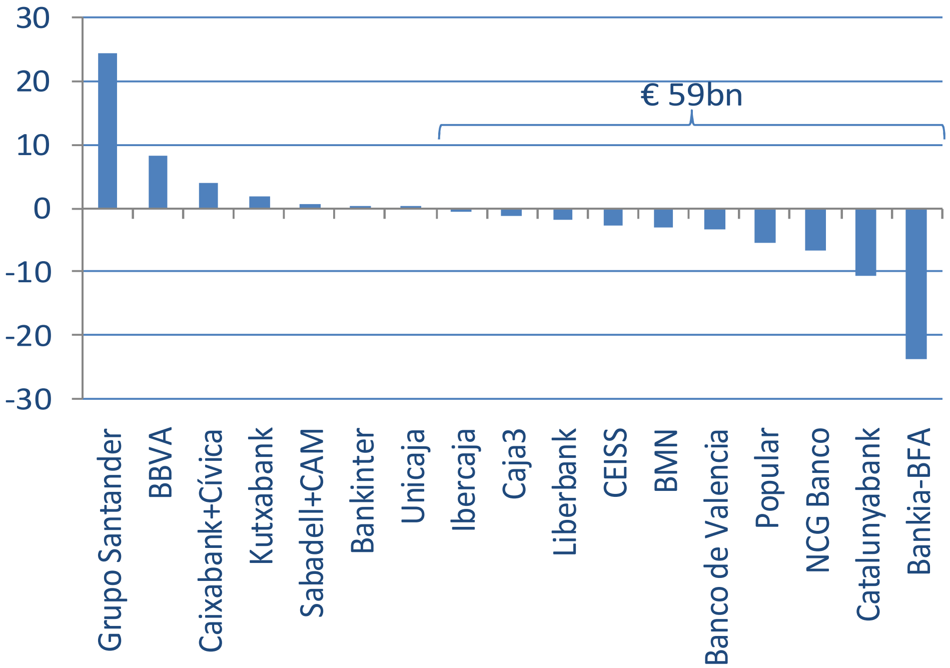
4. Mergers: further consolidation in the sector with resolution of non-viable entities and restructuring of ailing entities.

5. A new framework of crisis management, bank restructuring and resolution, with burden sharing

3. The financial sector

Stress test results: a very heterogeneous sector

Capital needs, adverse scenario* (€bn)
Source: Bank of Spain



* Not including ongoing merger processes and fiscal credit. With them, €54bn

With these results, an important step of the restructuring process has been completed

Entities will present recapitalization plans, and public capital injection will be around €40bn

The heterogeneity of the system is confirmed: Solvent institutions manage 70% of the assets

According to Bank of Spain, non-viable entities will be sold, but not liquidated

3. The financial sector

The future: drivers and determinants

Deleveraging

- Credit/GDP: from 160% to 110%
- Convergence: 5-10 years

Regulation

- More capital and liquidity
- Alternatives to bail-out for resolution

Liquidity

- 'Back to basics': deposits will play a more important role
- Banking union will avoid finacial fragmentation

Profitability

- Retail: (-) volumes (+) prices
- Wholesale: (-) liquidity (+) risk aversion
- Higher provisions

4. The solution at the European level

The road map to a more genuine EMU

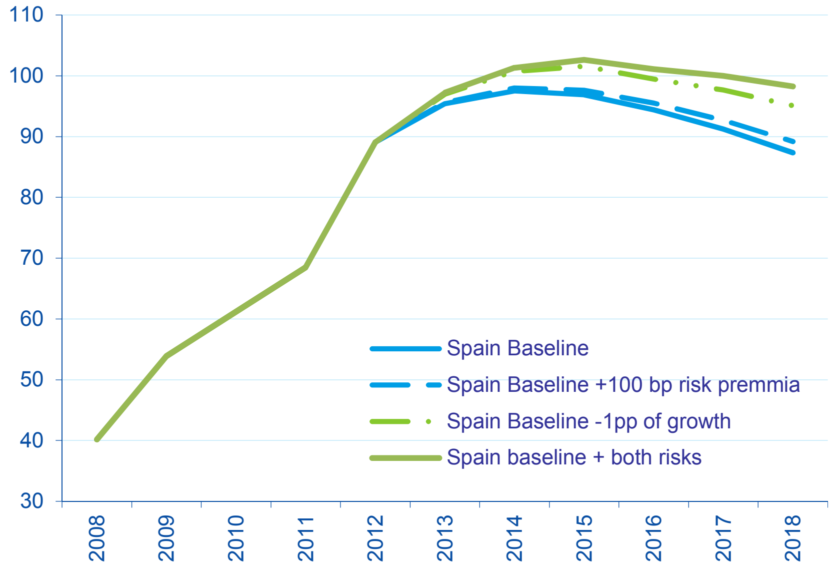
Measures adopted	• Fiscal rule (fiscal compact) • Surveillance of all imbalances (European Semester) • Permanent rescue fund (ESM) • ECB: a credible and effective backstop (OMT)
Short run: pending on approval	• Road map to a European banking supervision
Medium run advances on integration: political agreement between core & periphery	• Periphery countries: deleveraging and reforms • European level solutions: implementations of the banking union with a common supervision and direct bank recapitalization (ESM)
The final stage: A more stable monetary and economic union	• Fiscal union: sovereign debt mutualization & Treasury • Complete banking union: single resolution mechanism and deposit guarantee

5. The solution at the Spanish level

The quest for growth to correct imbalances

Spain: public debt sensitivity to different assumptions (% of GDP)

Source: BBVA Research and Minhap



Assumptions: averages (2012-2018)			
	Spread with Gemany (pp)*	GDP Nominal Growth	Primary Public Surplus (+) / Deficit (-)
Macro Baseline	278	2.6	0.9

GDP growth is crucial for the correction of imbalances (deficit, debt, credit and NPL)

Illustrative Examples: public debts sustainability exercises

No margin of maneuver for demand policies: supply policies needed

5. The solution at the Spanish level

Structural reforms: what has been done?

Reduce implementation risk of fiscal policies	Budget Stability Law, Structural budget targets
Reduce long term risks on public finances	Pension reform that increases progressively retirement age, and number of working years used to calculate pension. Copayment on medicine expenditures and justice procedures.
Labor market	Reduction of unfair dismissal costs (to 33 days per year worked from 45), clarify economic dismissals (20 days), prioritize firm agreements
Restructuring of financial sector	Sufficiently high backstop, a credible and transparent process, and a clear calendar with a specific deadline to end it decisively
Improve market regulation	Reduction of red tape (open a business). Eliminate electric tariff deficit.
Improve tax efficiency	Increase of consumption taxes, elimination of tax deduction on home purchases

5. The solution at the Spanish level

Structural reforms: what is pending?

Reduce implementation risks in fiscal policy	Aggressive implementation of Budget Stability Law
Reduction of medium term risks on public finances	Truly Independent, Credible, Budget Agency, further pension system reform (Bring forward sustainability factor, promote late retirement, etc.)
Improve competitiveness	Liberalize energy, telecom, professional services sectors
Labor market and Human capital	Improve active labor market policies, dual formation, education reform
Improve regulation	Improve property rights of leasers, reduce operating costs of firms (market unity)
Promote small firm growth	Alternative sources of funding, centralize instruments

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