

## 4. The Spanish economy

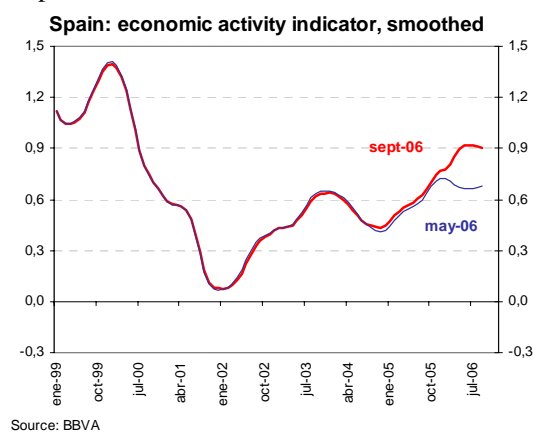
### Higher growth in 2006; 3.3% in 2007

The current situation of the Spanish economy has improved in the past few months. The BBVA-ISA synthetic economic activity indicator, with information up to September, is at a higher level than in May. This will pan out to annual growth of 3.8% in the third quarter of 2006, above the average in the first half of the year. The improvement in the current situation derives from industrial activity indicators driven by strength at the European level and in the construction sector.

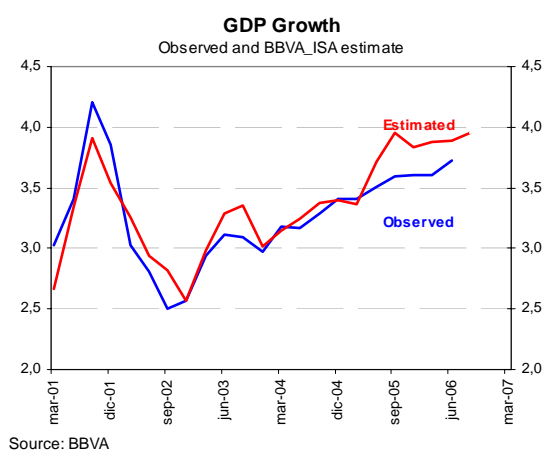
In addition, in its latest update of the National Accounts, the INE revised upwards its growth estimates for 2004 and 2005 (from 3.1% and 3.4% to 3.2% and 3.5% respectively) as a result of a lower contribution from domestic demand, which was more than offset by a fall in the negative contribution of the foreign sector<sup>1</sup>. However, the recent evolution of the main indicators for the Spanish economy, and the estimates given by the BBVA-ISA<sup>2</sup>, along with the growing differences in the population estimates incorporated into the National Accounts and the most recent registrations by the administration, point to the possibility of a further upward revision in the level of GDP, and its growth in the next few quarters.

On this basis, the growth forecast for 2006 has been raised from 3.6% to 3.7% and the 3.3% projection for 2007 is maintained, albeit accompanied by more balanced growth. Growth will continue to slow gradually in the next few quarters as a result of a weakening in some of the key contributors to corporate and household demand, such as financial conditions, which will tighten progressively in an environment of rapid growth in debt. In 2007, the slowdown in household spending will outweigh the push given by increased external demand for exports and investment in equipment, underpinned by favorable developments in corporate earnings. In addition, the continued increase in domestic prices compared with those for imports will continue to favour growth in purchases of overseas goods and services.

Graph 1



Graph 2



### Spain, GDP Base 2000

% change y/y	3tr05	4tr05	1tr06	2tr06	3tr06	4tr06	1tr07	2tr07	3tr07	4tr07	2003	2004	2005	2006	2007
Household consumption	4,1	3,8	3,8	3,6	3,5	3,4	3,4	3,2	3,0	2,9	2,8	4,2	4,2	3,6	3,1
Public consumption	4,5	4,9	4,4	4,4	4,5	4,5	4,4	4,5	4,3	4,1	4,8	6,3	4,8	4,5	4,3
Gross fixed and capital formation	7,1	6,6	6,3	6,2	6,5	5,9	5,9	5,1	4,8	4,4	5,9	5,0	7,0	6,2	5,1
Capital goods others products	8,3	8,1	7,1	6,8	7,4	6,6	6,7	6,3	6,3	6,2	5,3	4,4	8,4	7,0	6,4
Capital Goods	8,2	8,5	8,5	9,0	10,0	8,1	8,0	7,2	7,0	6,7	2,5	3,7	8,8	8,9	7,2
Other Products	8,5	7,6	4,9	3,3	3,0	4,0	4,5	4,7	5,0	5,5	7,7	4,4	7,7	3,8	4,9
Construction	6,2	5,6	5,7	5,6	5,8	5,3	5,2	4,2	3,5	2,8	6,3	5,5	6,0	5,6	3,9
Housing	6,8	5,0	7,2	6,5	7,2	6,7	5,5	4,5	3,5	3,0	9,4	5,9	5,8	6,9	4,1
Other	5,7	6,2	4,2	4,8	4,5	4,1	4,9	3,9	3,5	2,7	3,4	5,0	6,2	4,4	3,8
Inventories (*)	0,0	0,0	0,2	0,1	0,0	0,0	0,0	0,0	0,0	0,0	-0,1	0,0	0,0	0,1	0,0
<b>Domestic Demand (*)</b>	<b>5,2</b>	<b>5,0</b>	<b>5,0</b>	<b>4,8</b>	<b>4,9</b>	<b>4,7</b>	<b>4,5</b>	<b>4,3</b>	<b>4,0</b>	<b>3,8</b>	<b>3,9</b>	<b>4,9</b>	<b>5,2</b>	<b>4,9</b>	<b>4,2</b>
Exports	2,5	2,3	9,5	5,3	6,0	8,3	4,1	5,4	6,8	6,2	3,7	4,1	1,5	7,1	5,6
Goods	0,1	-0,3	13,0	4,7	6,3	9,6	4,0	5,3	6,6	5,9	5,2	5,1	0,0	8,4	5,4
Imports	7,7	6,6	12,4	7,9	7,6	9,0	5,9	6,6	7,4	6,6	6,2	9,6	7,0	9,2	6,6
Goods	6,6	5,0	11,3	7,5	7,1	8,2	5,2	6,3	6,9	6,5	6,7	9,7	6,6	8,5	6,2
<b>Net exports (*)</b>	<b>-1,6</b>	<b>-1,4</b>	<b>-1,4</b>	<b>-1,1</b>	<b>-1,1</b>	<b>-1,0</b>	<b>-1,1</b>	<b>-1,0</b>	<b>-0,8</b>	<b>-0,8</b>	<b>-0,9</b>	<b>-1,7</b>	<b>-1,7</b>	<b>-1,1</b>	<b>-0,9</b>
<b>GDP mp</b>	<b>3,6</b>	<b>3,6</b>	<b>3,6</b>	<b>3,7</b>	<b>3,8</b>	<b>3,7</b>	<b>3,4</b>	<b>3,3</b>	<b>3,2</b>	<b>3,1</b>	<b>3,0</b>	<b>3,2</b>	<b>3,5</b>	<b>3,7</b>	<b>3,3</b>

(\*) Contribution to GDP growth

Source: INE and BBVA estimates

<sup>1</sup> The increase in household spending was revised downwards by 0.2 points in 2005, while growth in investment was lowered from 8.7% to 8.4%. Real growth in public consumption was revised upwards by 0.3 points. For its part, the notable increase in net trade is a result of an upward revision in exports and a downward revision for imports.

<sup>2</sup> See the box on the Synthetic Economic Activity Indicator in Spain in *Situación España*, July 2006.

Third quarter of 2006: growth of 3.8% with stronger domestic demand and the same drag from the foreign sector

During the third quarter of 2006 the pace of economic activity remained strong, with quarter-on-quarter growth of 0.9%, the same as in the previous three months. This translated into year-on-year growth of 3.8%, up 0.1 points from the second quarter. Domestic demand halted its slowdown for a while, and increased its contribution to growth to 4.9 points, while net trade continued to shave 1.1 points off the total as was the case in the previous quarter despite the expected recovery in exports, particularly of goods.

A breakdown of the components of growth in the third quarter points to a continuation of the slowing trend in household spending, in contrast to the push given by gross capital formation, both in equipment and construction, particularly residential property. Thus, the Synthetic Investment in Equipment and Others Indicator (BBVA-ISInv<sup>3</sup>) shows stronger growth in investment in equipment than in the previous quarters, while investment in construction has stabilized at an annual growth rate of 5.8% despite the change in the evolution of its main components.

Within the construction sector, one should highlight the renewed strength of investment in housing. The synthetic leading housing indicator (BBVA-IS-Housing leading<sup>4</sup>) shows a falling trend since 2003, hitting a minimum in the second quarter of 2006 before recovering in the third. On the other hand, the upward trend seen in the coincident indicator (BBVA-IS-Housing coincident<sup>5</sup>) in the past few quarters seems to have run its course at the start of 2006. Therefore, putting the two indicators together, we obtain an estimate for investment in housing for Q306 above that for Q206. The longer-term prospects point to a gradual petering out due to the impact on demand of tighter conditions for entry to the property market.

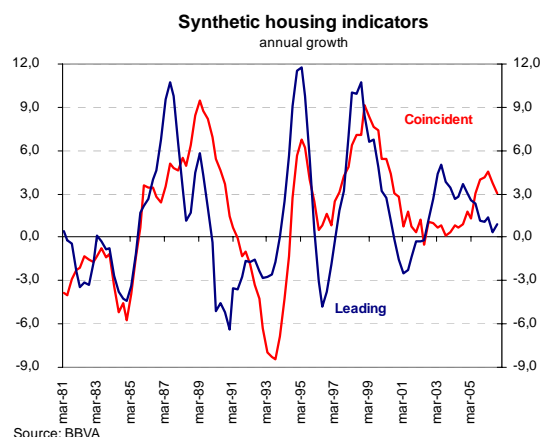
Finally, one should highlight the changes introduced in the Investment in Construction series in the new National Accounts using 2000 as the base year (CN-2000), compared with those with 1995 as the base year (CN-1995). The quarterly rates in the series adjusted for seasonal and calendar effects for Investment in Construction in CN-2000 show an increase in volatility from 2000 with respect to the rates for CN-1995. This has also been accompanied by a markedly seasonal behaviour in the third quarter of every year.

**Households: slowdown in consumption, fall in savings, and prospects for an increase in the financial burden**

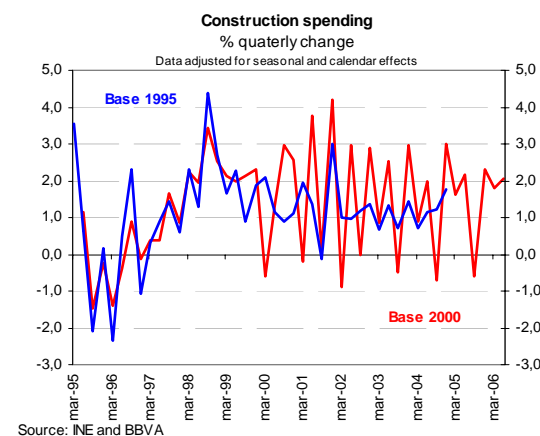
Household spending has shown a slowing trend since the start of 2005, as seen, for example, in the indicators for spending on durable goods (automobiles). This slowdown has also been the case for indicators for spending on services, such as air transport, but the trend was recently interrupted in the case of retail sales, which reflects spending on non-durables.

The forecasts for a slowdown in consumption are based on the expected evolution of their key determinants: household income and wealth. As of the middle of 2006, nominal disposable income is in a phase of slightly slower growth, to which should be added the impact of inflation, which increases somewhat the pace of the deceleration in real terms. As regards wealth, the

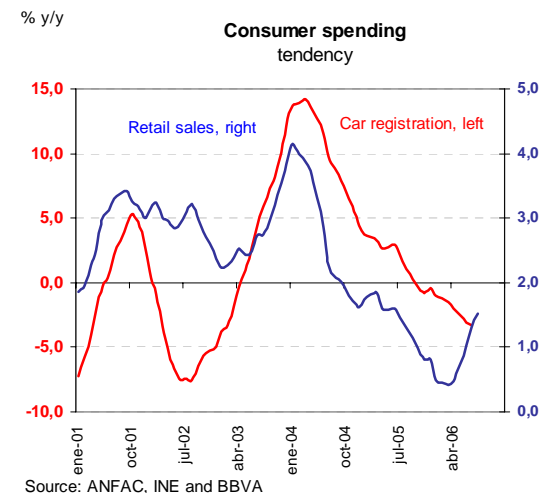
Graph 3



Graph 4



Graph 5



3 Drawn up with the same methodology for the ISA-Spain using data on output, imports and registrations of capital goods and vehicles.

4 Drawn up using building permit data, housing starts, expected output in the sector, and industrial production of non-metallic minerals.

5 Includes information on cement consumption, Social Security registrations, unemployment and industrial production.

slowing trend has been more marked. We calculate that real growth rates have fallen from 15% in 2004 to levels close to 8% in 2006, with a further slowdown expected in 2007. The main factor behind this development is house prices, where nominal growth rates have fallen from levels of 18% to slightly below 10% in Q306.

In addition, the slowdown in the fundamentals of consumption is showing itself to be stronger than that of household spending on housing, and personal consumption, which has led to a fall in the savings rate (9.4% of disposable income at the middle of 2006, one point less than a year earlier) and an increase in financing requirements. Households have continued to increase their position as net borrowers in 2006. As a result, the debt ratio could increase again to over 125% of disposable income by the end of this year. Higher debt levels have been accompanied by an increase in the financing burden, which has undergone a major rise in the past few years, and currently stands at 14% of household disposable income. Given that there is a lag of about six months in the passing on of interest-rate changes to financing costs, and assuming a slight slowdown in lending in 2007, the debt-service burden next year could increase by three points from current levels.

Employment constitutes the main support for household income. Prospects for the labour market continue to be positive, with an increase in the employment rate of close to 4%, and an expected average unemployment rate in 2006 of 8.5% of the active population, falling to below 8% in 2007. Wage increase moderation as a result of increased supply deriving from the immigrant population and more women entering the labour market will continue to underpin the evolution of employment in Spain. Finally, the recent reform of the labour market aimed at reducing the ratio of workers on temporary contracts appears to be taking time to bear fruit. The EPA Labour Force survey in the third quarter showed a slight increase in the ratio despite the measures that have been approved<sup>6</sup>.

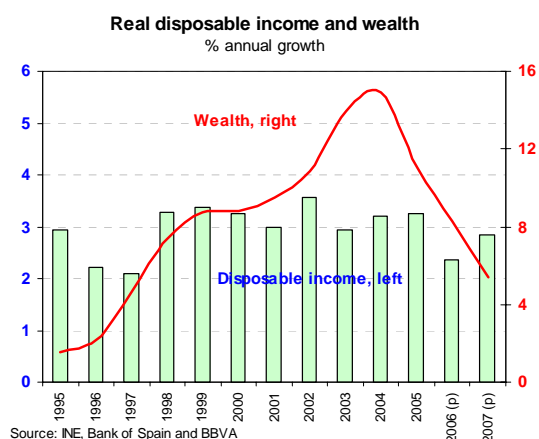
### Housing: slowdown in demand and prices and a drop in activity?

After the year started off with renewed strength as a result of favourable current economic conditions, and one-off events such as the appearance of certain captive demand from the regularization of immigrants, demand for housing is starting to show signs of having run its course. The determining factors indicated above (a slight slowdown in household income and tighter financing conditions) are making it increasingly difficult for households to gain access to the home-ownership market. In fact, the accessibility ratios have seen their worst deterioration since the end of the 1980s as a

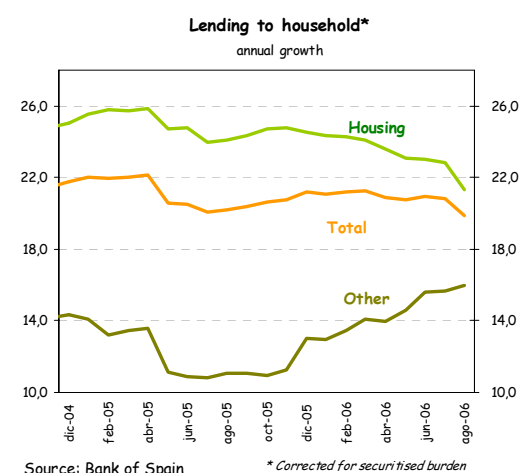
<sup>6</sup> In the recently approved labour market reform the following measures stand out:

- Any worker who has had at least two temporary contracts for the same position with the same company covering at least 24 months within a period of 30 months is automatically awarded a permanent contract.
- Gradual reduction in social security contributions for unemployment in permanent contracts. As of July 1, 2008, this will stand at 5.5% for permanent contracts and 6.7% for temporary contracts.
- Extension of the application of the contract to encourage permanent contracting to temporary contracts established before December 31, 2007
- Substituting the system of Social Security contribution credits for employers for one of fixed amounts (1,200 euros in most cases), limiting the availability of these credits to only new permanent contracts (as opposed to cases of employees whose temporary contracts were converted into permanent ones).
- Shock action plan: incentives to be given for employers to make temporary employees permanent before the end of 2006 (800 euros for each year of permanent contract up to three years) for all age groups, including males aged between 30 and 45 years, provided the permanent contract has a duration of at least three years.

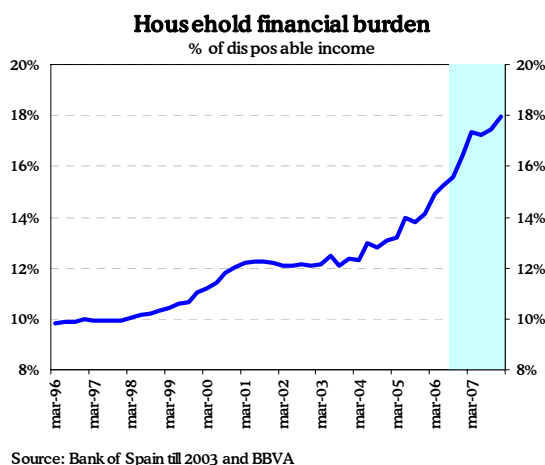
Graph 6



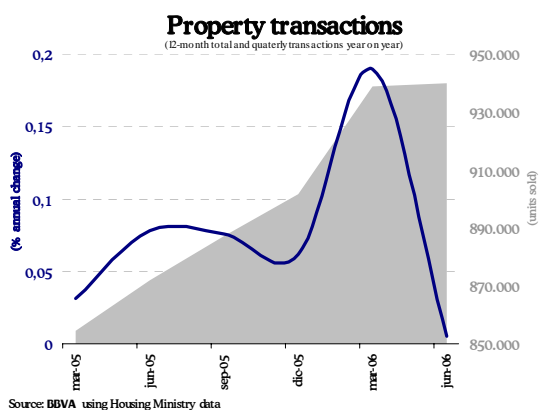
Graph 7



Graph 8



Graph 9



consequence of increases in mortgage rates, as well as rises in house prices above those of household revenues. This has been reflected in a slowdown in the number of property transactions, which increased by less than 1% in the second quarter of the year compared with the same period a year earlier.

The developments in demand are reflected in the evolution of house prices. Thus, the figures for the third quarter of the year show a continuation of the gradual slowdown which started at the end of 2003. Although the pace of this has been below that seen in previous years, after the slowdown seen at the end of 2005 and in the first quarter of 2006, house prices have returned to a downward trend, and showed year-on-year increases of 9.8% in the third quarter, the lowest rate of growth in the past five years. This evolution in prices has been general for the autonomous regions as a whole. With the exception of Aragon, the trend in house prices in the rest of the regions in the third quarter has been for slower rates of increase than those seen at the end of 2005.

In clear contrast, activity in the residential construction sector rather than slowing has picked up. Housing starts remain at record levels, and stood in August in annual terms at 850,000 units (including refurbishments), an increase of 13% over the same period in 2005. However, this figure could reflect the fact the Building Technical Code has come into effect, which has raised minimum construction standards and increased costs. As a result, property developers may have brought forward their requests for permits for construction projects which were due to be begun in the short term. This might mean that part of the increase in the past few months should be corrected in the next few months. All in all, although it is difficult to quantify the impact of this development, it is probably not enough on its own to explain the pick-up in housing starts.

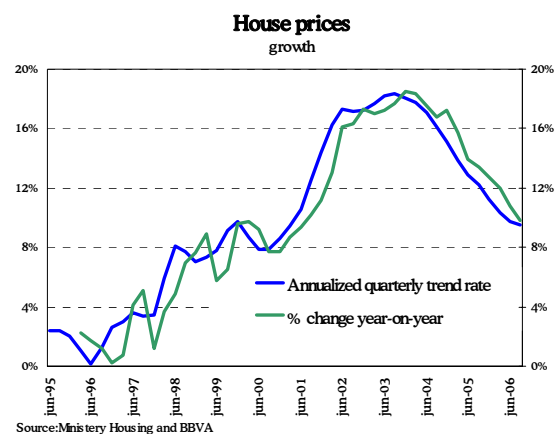
Despite the temporary imbalance between the direction of the market and construction activity, a gradual slowdown in the property market is expected in the next few quarters. The slight slowdown expected in growth in household income and the upward trend for interest rates will continue to tighten the conditions of entry to the housing market. This is also the case for financial burden indicators, which have deteriorated significantly. This trend will continue in the next few quarters, causing a reduction in the extent to which households take on new financial obligations. Likewise, the level of activity is expected to adjust to the new market conditions. As seen in the leading BBVA-IS-Housing indicator, investment in housing is expected to slow in the next few months, which should be reflected in a fall in the number of housing starts. House prices, in line with the current trend in the market, will continue with the gradual slowdown seen in the past few years, and should increase at a rate of 9% at the end of this year and 5% at the end of 2007.

### External sector

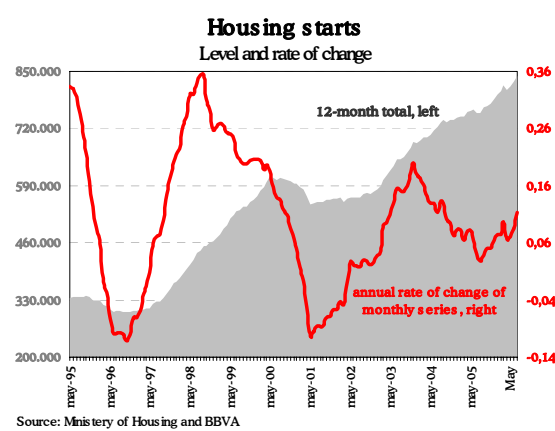
The consolidation of growth in Europe will allow exports of Spanish goods to move to rates above those seen in the period 2000-2005, although the accumulated deterioration in the price competitiveness of the domestic economy will continue to weigh on growth in overseas shipments.

The outlook for sales of tourism services is less positive, with real falls in growth in the first half of 2006, despite the positive trend shown by a number of fundamental determinants of demand in the tourism sector. Thus, the economic upturn in the major European economies and the resulting increase in tourists coming from these countries do not appear to be showing up to the same extent in the income they generate. Given that our services prices are not rising faster than those of other countries, real income from tourism must be suffering from the increased competition and changes in the patterns of tourism demand.

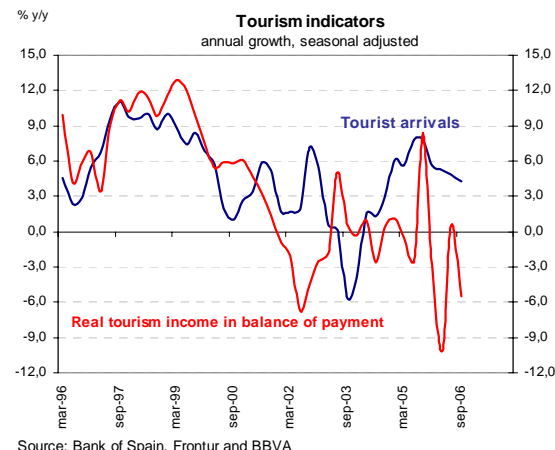
Graph 10



Graph 11



Graph 12



With regard to imports, the expansion has continued to be driven by a fall in prices relative to domestic prices. For this reason, despite the moderating impact of domestic consumption, imports in real terms are expected to amount to a high of 40% of GDP in 2007 (exports will represent 31%). The recovery in industrial activity to meet foreign demand is also contributing to this process. This is reflected in the strong growth of imports of intermediate goods across all sectors of industry, irrespective of the level of technology.

### Lower inflation outlook

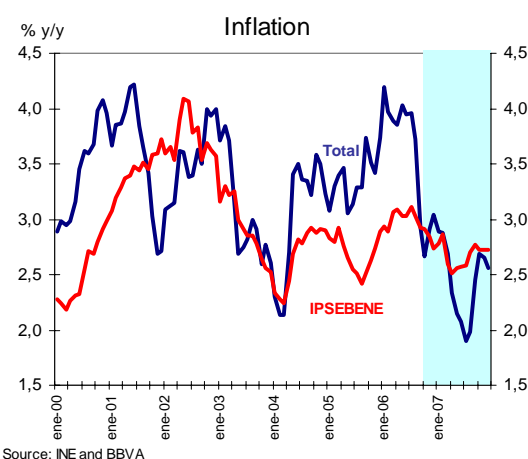
The prospect of weaker consumption and a downward correction in the prices of some commodities, particularly the price of oil, reduce our inflation projections for 2006 and 2007 by 0.1 and 0.2 points, respectively, from those presented in the July issue of *Situación Spain*. Average inflation is therefore expected to come in at 3.6% in 2006 and 2.5% in 2007.

During the third quarter of 2006, inflation slowed by one percentage point, to a rate of 2.9% in September. This decline is mainly due to a fall in the price of oil, which has dropped to levels just below 60 dollars a barrel from over 73 dollars a barrel in July and August (historical highs). Underlying inflation also seems to be turning downwards, especially in its goods component. Non-energy industrial goods, which account for one-third of the CPI, have surprised on the downside relative to forecasts that pointed to an annual rate of 1.3% in September. Services prices, on the other hand, have been registering steady rates of advance around 3.9% for the past 6 months. The rate of increase of these prices is expected to slow slightly in 2007.

In addition to the impact of commodities and slower consumption growth, a further factor underpinning the lower inflation outlook for 2007 is the absence of second-round effects in wages. The sharp rise in the supply of labour as a result of immigration and greater numbers of women entering the labour market is contributing to negative wage developments: growth in wage costs per employee is lower than the rate negotiated in collective bargaining agreements as workers with lower than average wages enter employment. However, this only mitigates the effects of rigidities in the wage determination process in Spain's economy. These rigidities hold back labour cost adjustment and productivity, while the inflation catch-up clauses help to keep prices sticky. That said, it is foreseeable that in 2007 these clauses will not be activated with reference to the current year since end-year inflation is projected at around 3%, a rate slightly below the wage rise of 3.2% negotiated in collective bargaining up to September.

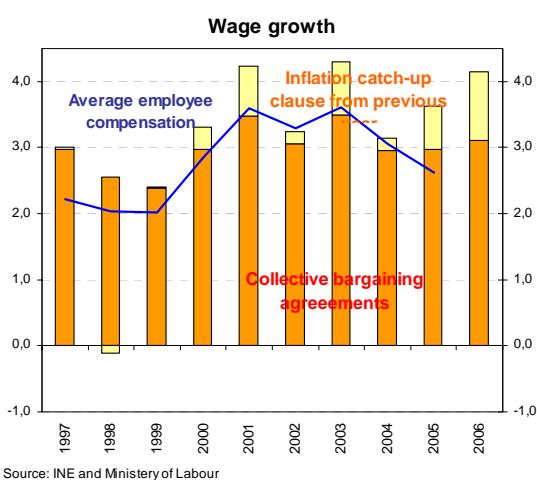
In 2007 there is expected to be a further fall in the inflation differential with the EMU, even without taking into account the helpful impact of the VAT hike in Germany. We have examined the inflation expectations of Spain and the EMU from the viewpoint of both supply and demand, including the information and forecasts relating to growth in both areas<sup>7</sup>. With both types of instruments, one finds a reduction in the inflation differential both for the CPI as well as in the underlying index. Bearing in mind this result, and the expected development of growth in domestic demand in 2006 and 2007, with the prospect of slower growth in domestic demand in Spain and stronger growth in EMU based on rising domestic demand, we expect the inflation differential to fall in 2007 to around 1 percentage point, a figure near the historical average. If the upward impact resulting from the VAT hike in Germany is added to this, the differential finally registered in 2007 is likely to

Graph 13



Source: INE and BBVA

Graph 14



Source: INE and Ministry of Labour

Graph 15

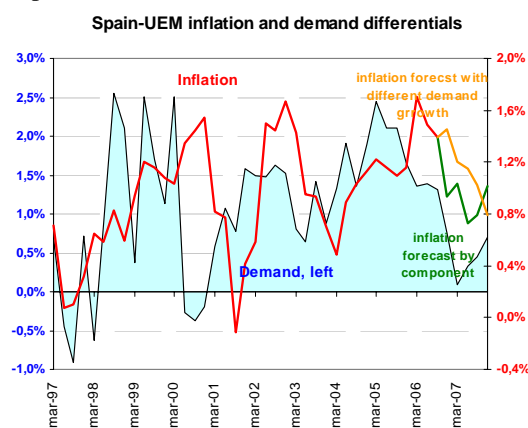


Table 2

Estimated inflation differential		2006	2007*
Supply components	CPI	1,5	0,9
	Core	1,6	1,1
Demand differential	CPI	1,5	1,0
	Core	1,5	1,1

(\*) German VAT effect not included

<sup>7</sup> On average, approximately half of Spain's 1.1 point inflation differential with the EMU is attributable to its different cyclical situation. In this sense, there is an average gap of 1.3 percentage points between domestic demand in the two areas. For a more comprehensive look at the contribution of demand to inflation, see *Situación España* of July 2006, pp. 15-16, and "Spain, the inflation differential and economic cycle", both available at <http://serviciodeestudios.bbva.com>.

be closer to 0.5 points. However, this "artificial" narrowing of the differential will have no economic importance in terms of the competitiveness of relative prices in the Spanish economy<sup>8</sup> since Spanish products sold in Germany will be levied with the same rate of VAT as German products.

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<sup>8</sup> As long as it does not lead to an upward spiral in wage demands in Germany to compensate for the reduction in workers' disposable income.