

Spain still has cards to play

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Nearly ten years after joining the Economic and Monetary Union (EMU), Spain is now faced with a deep economic crisis resulting from the collapse of its growth model based on credit and real estate.

While the interest rate convergence enabled Spain to enjoy a decade of strong growth, this growth was accompanied by the formation of major imbalances (excessive current-account deficit, real estate bubble). The impression that there was no external financing constraint, due to its EMU membership, did not encourage modernisation of the economy, even though this had become especially necessary since real estate investment had largely crowded out productive investment. The sharp increase in external debt exacerbated the Spanish economy's vulnerability to exogenous shocks.

The economic crisis of 2008-2009, by accelerating the bursting of the real estate bubble, revealed the previously concealed distortions: between 2007 and 2010, the unemployment rate rose from 8% to 20%, the budget balance went from a surplus of 2% of GDP to a deficit of 9% of GDP, and the non-performing loan rate for financial institutions rose from 1% to around 6%.

The latest casualties of the recent woes, public finances, until then held up as an example, are now under pressure from the markets. The country must give reassurance regarding its ability to surmount a crisis which is becoming chronic and threatening the sustainability of its public debt. Spain is faced with a threefold challenge: revive growth whose potential has decreased, consolidate its fiscal situation and put the financial system back on a sound footing. This triple challenge is somewhat reminiscent of the programmes put in place by the IMF and European Union in Greece, Ireland and Portugal. Although it did not experience the same excesses, Spain at present crystallises the imbalances of each of these countries that fell to market pressure (public finances in Greece, the banking sector in Ireland, growth in Portugal). In this article, we shall try to show that Spain has trumps in hand to come out of the crisis while retaining its financial independence.

From private debt...

Credit-fuelled growth partly related to joining the Economic and Monetary Union...

From the early 1990s, Spain's nominal anchoring to the European Monetary System enabled a marked slowdown in inflation. From 7% in the early 1990s, annual consumer price growth reached 3% in the early 2000s. Thanks to this disinflationary policy and successful fiscal consolidation, risk premiums in financial markets gradually declined, moving closer to those of the least inflationary European countries. With the creation of the euro zone and the credibility inherited from the Bundesbank, this process of convergence went even further, at times even reversing the hierarchy of sovereign risks which prevailed until then: between 2003 and 2007, the yield differential between Spanish 10-year interest rates and their German equivalent was sometimes negative.

Moreover, throughout the 2000s, Spanish inflation was higher than the 2% targeted by the European Central Bank (ECB), as the country's economic catch-up resulted in faster growth in consumer prices. Within the framework of a single monetary policy based on average inflation in the area, this situation generated very low, and sometimes even negative real interest rates in Spain.

Accordingly, benefiting from extremely attractive borrowing conditions, Spanish private economic agents became heavily indebted. Households, encouraged by the optimism stemming from the powerful catch-up effect and the fall in unemployment, increased their debt burden, from 68% of gross disposable income (GDI) in 2000 to 130% in 2007. Since many of them had known nothing but falling interest rates, households borrowed massively at floating rates (accounting for about 80% of loans to households in the 2000s). For their part, non-financial companies (NFC), profiting from the vigour of domestic demand but also from the macroeconomic and

financial stabilisation made possible by EMU membership, boosted their profitability through debt leverage. The debt of NFCs rose from 50% of their value added in 1997 to 131% in 2007.

...stimulating consumption but especially investment in real estate...

Due to massive borrowing, in a context of falling unemployment and high household confidence, private consumption was extremely vigorous. Between 2000 and 2007 it increased by 3.7% per year on average without this being reflected by a fall in the savings rate, which remained around 11% of GDI¹.

However, rather than consumption, it was real estate investment that benefited most from household borrowing. Between 1996 and 2007, the rate of investment in residential construction more than doubled in Spain, from 7% to 15% of GDI, while it remained around 10% in the euro zone.

The obsession with real estate was due to three factors: demographic, sociological and speculative. Between 1995 and 2008, Spain's population increased by 15%, from 40 to 46 million inhabitants, chiefly due to immigration, since the fertility rate remained very low. This influx of foreign labour naturally generated strong demand for housing. Tax policies more favourable to owners than tenants stimulated the desire of Spanish households to own property, which was also a legacy of the culture of Francoism. In 2005, the rate of home ownership reached 86%, the highest in the euro zone. Lastly, whereas the previous periods of growth of the Spanish economy (1969-1974 and 1986-1991) had already been marked by a sharp rise in property values, the period that began at the end of the 1990s undeniably had a speculative aspect due to the relatively low level of interest rates. Via very long-term mortgage loans (35 to 40 years) at low floating rates, investment in real estate, regarded as a highly profitable investment, exploded: between 2005 and 2007 more than 800 000 housing units were built per year, i.e. as much as in France, Germany and the United Kingdom combined. Boosted by debt leverage, property values surged: between 2000 and 2007, housing prices increased by 11% per year on average.

A vicious circle of inflated real estate prices and debt leverage set in: credit fuelled the rise in asset prices, amplifying the wealth effect and encouraging private economic agents to take on more debt.

...and benefiting the sheltered sectors

The construction and non-exportable service sectors (*trade, tourism and transport*) benefited fully from the vigour of domestic demand and the real estate bubble. These very labour-intensive sectors were the main drivers of the sustained growth in employment (on average 4% per year between 2000 and 2007) and corresponding fall in the unemployment rate (from 20.6% in 1997 to 8.2% in 2007). It is estimated that they account for almost half the jobs created between 1995 and 2007. They expanded at the expense of industry, whose share of value added declined from 18% in 1995 to 12% in 2007. At the same time, the weight of construction increased from 7.5% in 1995 to 12% in 2007.

The country's relative deindustrialisation resulted in a significant loss of productivity: partly because over-investment in construction crowded out productive investment and research & development, and partly because the sheltered sectors traditionally generate only small productivity gains. Between 1995 and 2007, per capita productivity in the economy declined by 0.4% per year on average.

While Spain achieved a major catch-up in terms of per capita income (mainly via the increase in the activity rate), the competitiveness gaps with the most efficient euro-zone countries widened throughout the last decade. This can be explained not only by the fall in productivity but also by high wage growth, aligned on an inflation rate in excess of the euro-zone average. Between 1999 and early 2008, unit wage costs in Spain rose 33% versus 17.2% in France and only 0.6% in Germany.

EMU membership partly explains this situation. Greater capital mobility, encouraged by the disappearance of currency risk, encouraged intra-zone productive specialisation, exacerbating the heterogeneity of the member countries. The initial competitiveness gaps therefore widened. Germany and the Netherlands specialised in the sectors of industry and exportable services in which productivity gains are high. The countries catching up (Portugal, Spain, Greece) focused rather on sheltered sectors where productivity gains are very low or even non-existent.

Increased vulnerability to exogenous shocks

Vigorous domestic demand in Spain, combined with the loss of competitiveness, resulted in a continual

Real interest rates

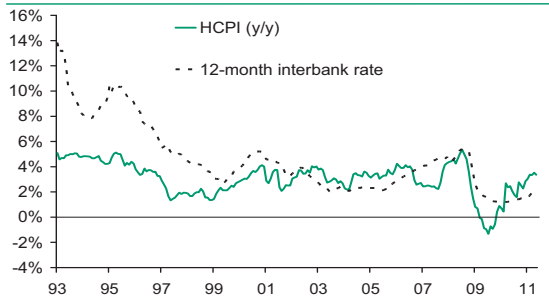


Chart 1 Source: Bank of Spain

Real estate bubble

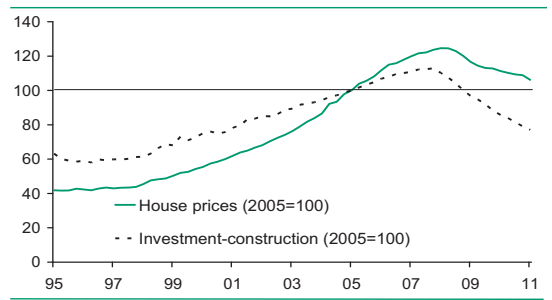


Chart 4 Source: INE

10-year sovereign bond yields

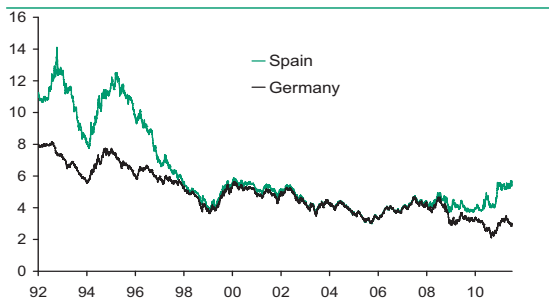


Chart 2 Source: Thomson Reuters

Construction and manufacturing (as % of GDP)

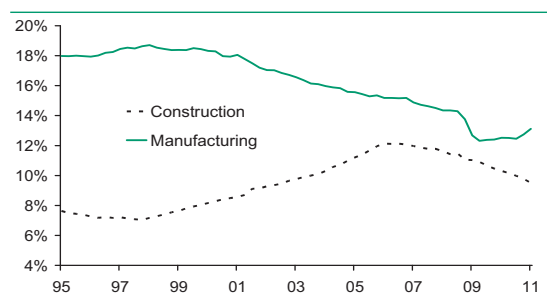


Chart 5 Source: INE

Household debt (as % of GDI)

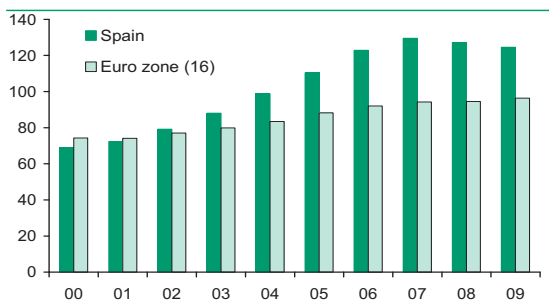


Chart 3 Source: Eurostat

Productivity and wages

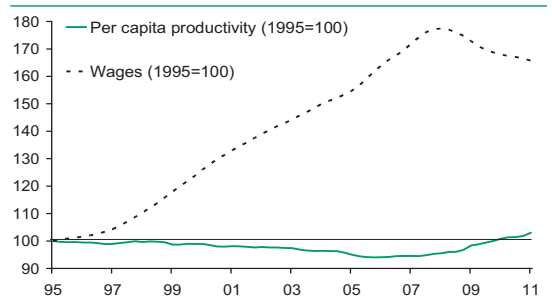


Chart 6 Source: INE

deterioration of the current-account balance in the 2000s. From a surplus of 0.1% of GDP in 1997, the current account reached a deficit of 10% in 2007. This trend was facilitated, and in some ways concealed by membership of the euro zone, since the Spanish current-account deficit dissolved into the European current-account balance.

Moreover, EMU membership considerably alleviated the external financing constraint by providing Spanish institutional investors with access to deep, liquid and cheap capital markets. Accordingly, despite national savings that were insufficient given the level of investment, the Spanish real estate and credit bubble was easily financed by non-residents, mostly Europeans. As a consequence, Spain's net external investment position deteriorated sharply and its external debt, largely private, exploded, making the country very vulnerable to exogenous financial shocks.

The global crisis precipitated the bursting of the real estate bubble

The first signs of the downturn in the real estate market appeared well before the global economic crisis. From the end of 2005, the rise in real estate prices, although sustained, began to slow down. While housing prices had increased on average by 12.5% per year between 2000 and 2005, they increased by "only" 7.5% per year between 2005 and 2008.

This trend was closely related to the ECB's monetary policy tightening. Between December 2005 and October 2008, the ECB's policy rate was gradually raised from 2% to 4.25%. At the same time, inflation slowed down, which resulted in a significant increase in Spain's real interest rates. From -0.5% in January 2006, these rates reached 3.3% in August 2007.

Households, mostly indebted at floating rates, suffered especially from the rise in the reference rate and the corresponding increase in their debt service burden between 2006 and 2008. As a consequence, credit demand contracted, as did residential investment, slowing down the rise in real estate prices.

The Lehman Brothers bankruptcy, in September 2008, acted as a catalyst in reducing the imbalances in the Spanish economy. The freeze-up of the interbank market and the ensuing credit crunch transformed the deflation of the real estate bubble into a bursting of the bubble: despite stimulus measures, real estate prices fell 7% in 2009 and 3.7% in 2010.

The depth of the Spanish crisis is due to the imbalances inherent in its growth model

The recession that Spain went through in 2009 (-3.7%) was in line with the recession experienced by the euro zone as a whole (-4.1%). However, the Spanish crisis has proved to be far deeper. Whereas the euro zone rebounded in 2010 (+1.7%), Spanish activity, still undergoing adjustment, again contracted slightly (-0.1%) without showing any real signs of recovery. The collapse in activity during the global crisis completely undermined the foundations of Spanish growth in recent years, as shown by the spectacular rise in the unemployment rate, from 8.3% in 2007 to 20% in 2010 (compared with an average rise from 7.6% to 10.1% in the euro zone). The substantial job destruction was due not only to the effects of the recession on the economy, but also, and above all, to the bursting of the real estate bubble. A large proportion of the unemployment is of a structural nature and will persist despite the economic recovery, which raises questions about the occupational conversion of former construction workers who are often not highly educated and therefore not easily employable in other jobs.

Before the crisis, the construction sector strictly speaking accounted for 13% of total employment (versus 7.5% for the euro zone as a whole). Taking into account all activities related directly or indirectly to real estate (real estate services, insurance, tourism, bank activities, etc.) it is estimated that it accounted for about 30% of total employment. Accordingly, the bursting of the real estate bubble caused not only the collapse of the construction sector but the failure of the locomotive for the economy and employment. Over 50% of the job losses in Spain between 2008 and 2010 are related to the drop in construction activity. The rise in unemployment was especially sudden because around 20% of the workers were employed on temporary job contracts, which were not renewed when the cycle turned down.

In the medium term, there are question marks concerning the economy's new growth potential, penalised by an unemployment rate which will probably remain above the euro-zone average for a long time. The adjustment of the Spanish economy is taking longer than in most euro-zone countries because the imbalances built up during the expansion phase in recent years (real estate bubble, private-sector lending bubble, current-account deficit) were more substantial. Deleveraging by all economic agents and the winding

down of the real estate bubble points to lacklustre growth until 2013, followed by long-run growth of around 1.5%-2% per year.

...to public debt

Largely cyclical budget surpluses...

Unlike the private sector, the public sector took advantage of the fall in interest rates due to joining the EMU to reduce debt. Between 1996 and 2007, the fiscal deficit was on average 0.9% of GDP (versus 2.2% of GDP for the euro zone), and there were budget surpluses between 2005 and 2007. Public debt was accordingly reduced from 67% of GDP in 1996 to 36% in 2007.

The improvement in Spain's public finances during that period was largely driven by the economic cycle. In addition to the reduction in the debt service burden due to the fall in long-term interest rates and debt reduction, the Spanish government benefited fully from the boom in domestic demand, the enlargement of the tax base and the real estate bubble which boosted fiscal revenues.

However, although the primary surplus (before interest payments) improved significantly between 1997 and 2007, increasing from 1% to 3% of GDP, the structural primary surplus (adjusted for the economic cycle) deteriorated significantly, declining from 3% to 0%. Public spending grew at a rate faster than long-run growth during the years of high growth. Having considered the fiscal revenues fuelled by the lending and real estate bubble as permanent, the Spanish authorities showed less fiscal discipline than it would seem.

...are replaced by largely structural budget deficits

The deterioration of Spain's public finances was extremely spectacular, in both its magnitude and its speed. From a surplus of 1.9% of GDP in 2007, the current-account balance reached a deficit of 11.2% of GDP in 2009. The fiscal shock of 13 percentage points of GDP can be explained, for 5 percentage points, by the effects of the recession (fall in fiscal revenues and increase in welfare spending) and the economic stimulus measures. The remainder (8 percentage points of GDP) is regarded as a permanent shortfall in revenues due to the collapse of the growth model.

The substantial fiscal revenues generated by the sharp rise in property values, both via income and wealth taxes and also via duties on real estate transactions, fell when the bubble burst. In addition, the rise in unemployment, a large part of which is structural, not only reduced the tax base but also resulted in an enduring decline in household consumer spending, i.e. in VAT revenues. The depth of the Spanish crisis will probably result in a permanent reduction in the elasticity of fiscal revenues to growth.

In general, the Spanish (and Irish) crisis revealed the shortcomings in economic and financial supervision within the euro zone and its narrow scope. The Maastricht criteria, by focusing mainly on public finance indicators, did not make it possible to get an idea of the underlying imbalances in economies that experienced bubbles. However, as the crisis showed, when these bubbles burst, the burden of private debt is often transferred to the public sphere. The largely cyclical budget surpluses have been followed by predominantly structural budget deficits.

In 2010, Spain's primary deficit was 7.3% (versus 9.4% in 2009), around 6% of which was due to a structural primary deficit. The total fiscal deficit reached 9.2% of GDP (versus 11.2% in 2009).

Cumbersome regional public finances?

Since Spain is a largely decentralised country (17 autonomous regions or *autonomias*), a large proportion of the management of public affairs is entrusted to the regions. Around 55% of public spending is controlled by local governments (the *autonomias* and, to a lesser extent, municipalities).

- Structural deficits

Regional public spending is mostly (65%) allocated to education and healthcare. This spending corresponds to medium-term investment policies and is therefore relatively insensitive to cyclical trends. Conversely, the revenues of the regions (see Box 1), like those of the central government, are very sensitive to the economic cycle.

The budget stability rules helped exacerbate the underlying imbalances. The budget balances to be complied with depend on the GDP growth rate (see Box 2) and not on its gap relative to potential growth (the output gap) which, through the cycle, determines revenue growth. Accordingly, when the economy is

growing strongly, revenues increase at a higher rate than long-run growth and finance long-term spending on education and healthcare. The deficits posted until 2007, although higher than the targets², were still very moderate because fiscal revenues were boosted by the

real estate bubble. When the cycle turned down, however, revenues plunged in line with activity, while most of the spending, downwardly rigid, continued to increase at a rate roughly equivalent to that prevailing in the past.

Box 1: Financing of the regions

The regional government financing system was changed in December 2009, replacing the former system established since 2002. On the whole, the proportion of revenues received by the regions, based on tax revenue collected at the local level, increased from 70% to 90%, which amounts to about an additional EUR 11 billion.

The regions now receive 50% of the proceeds from personal income tax (versus 33% before), 50% of VAT revenues (versus 35%) and 58% of indirect taxes on certain products such as alcohol and tobacco (versus 40%).

The new system increases regional autonomy. The regional legislative authorities can set regional tax rates provided that they maintain the progressive nature of the tax structure.

Lastly, the new financing system also lays down the principle of the harmonisation of living conditions from one region to another. There are three funds for this purpose:

- The guarantee fund ensures identical per capita financing in each region for the provision of healthcare, education and welfare services.*
- The sufficiency fund provides funds to cover the remaining expenses.*
- The convergence fund is designed to reduce the remaining disparities in per capita revenues from one region to another taking into account demographics.*

Box 2: The budget stability rules

The regions must comply with the budgetary rules laid down by the budget stability law, the main features of which are as follows:

- If real GDP growth exceeds 3%, all public authorities must have a budget surplus.*
- If real GDP growth is in a range between 2% and 3%, all public authorities must have a balanced budget.*
- If real GDP growth is less than 2%, a budget deficit is authorised, but it is limited to 0.2% of GDP for central government and 0.25% of GDP for regional governments.*

If the public authorities exceed the fixed deficit limits, they must present a medium-term budget adjustment plan which must be approved by the Council of Fiscal and Financial Policy ("CPFF"), consisting of central and regional government representatives. Given that nine of the 17 autonomias exceeded the maximum deficit set for them in 2010, they had to submit adjustment plans. A regional budget deficit limit of 3.3% of GDP has been set for 2011 (versus a deficit of 3.4% of GDP in 2010).

- A relatively moderate initial deterioration...

Until recently, the economic crisis had had only a limited impact on the budgetary accounts of the *autonomias*. In the depths of the crisis, in 2009, the deterioration of the public finances at the regional level was far less dramatic than on the central government level: between 2007 and 2009, the central government deficit ballooned by 10.5 percentage points of GDP, compared with a deficit widening by only 1.8 percentage point of GDP for the regions.

Two factors explain this difference. First, most of the economic stimulus package (about 2.5% of GDP) was covered by central government. Then, in 2008 and 2009, tax revenue transfers from central government to the regions, which are fixed in advance on the basis of estimates, were larger than actual tax collection. This difference will have to be repaid by the regions from 2012 on.

- ... but a situation which is proving worrying against a background of "fact-finding missions"

In 2010, the public authorities complied with the deficit target set in the Stability and Growth Programme. From 11.1% of GDP, the budget deficit was reduced to 9.2% of GDP. However, this good performance masks divergences at the various levels of government. For example, whereas the central government reduced its deficit more sharply than expected (from 9.4% of GDP to 5% of GDP), the deficit for the regions widened (from 2.0% of GDP to 3.4% of GDP), thus missing the assigned target (a deficit of 3.1% of GDP). The social security fund also posted a slight deficit, 0.2% of GDP, breaking with the surpluses of recent years.

The success of fiscal consolidation in the *autonomias* is brought into question by the fact that the instruments are limited by the spending structure. The main budget cuts are made where they can be implemented rapidly, e.g. in public investment, but their scope is reduced. Deeper spending cuts, in education or healthcare are not only more difficult to implement, but also entail a risk of undermining the social pact and reducing potential growth, at a time when regaining competitiveness is a major challenge.

Moreover, the recent regional elections held in May in 13 of the 17 autonomous provinces radically changed the local political landscape. The changes of majority in some *autonomias*³ aroused fears of a re-assessment of

regional budget deficits as occurred following the elections of November 2010 in Catalonia⁴. This situation is fairly standard: the incoming government aims to paint as dark as possible a picture of the budget situation it has inherited in order to take to task past mismanagement and make its coming consolidation efforts all the more appreciable.

In Spain, these "fact-finding missions" tend to show that regional fiscal deficits are under-estimated due to failure to recognise the losses of local state-owned enterprises, especially hospitals, which accumulate late payments to suppliers. A 2009 study of the Spanish healthcare system by the firm McKinsey & Co. estimated that the amount of invoices overdue by public hospitals amounted to EUR 10 billion, or 1% of GDP. All in all, private estimates assess at about EUR 30 billion (3% of GDP) the total amount of regional debt which could come out of the woodwork. Worries concerning the risk this represents for central government finances should therefore be put into perspective; the deterioration of regional public finances is admittedly rapid and more difficult to curb, but the levels remain relatively low. While the regions control over half of the spending by public authorities, their debt represents less than 20% of total public debt.

Accordingly, the main damage for the public finances is more of a political than an economic nature. It concerns the transparency of Spanish budget data and the cost of such a doubt in the markets. The most striking example is probably that of the Castile-La Mancha region, which recently came under the control of the People's Party after being run for 30 years by the Socialist Party. As soon as it took office, the new government said the region was in a situation of "complete bankruptcy", pointing to a lack of funds to pay the civil servants. The sincerity of such an announcement is hard to assess, since it seems to form very much part of an opposition strategy to win central government power.

However, the spectre of default by an *autonomia* should be ruled out immediately. Although there is no obligation for central government to rescue a bankrupt province, nobody can doubt the political necessity of such a rescue at a time when the whole country is involved in a process of deleveraging and regaining credibility in the eyes of the markets. Moreover, in order to supervise regional budget situations, the government is expected as of next year to set spending caps for the *autonomias*, in the same way as for central government. In order to enforce the austerity demanded at all levels

of the state, the government has an instrument for authorisation of borrowing in the markets which enables control over regional issuance. Although this system is not used at present, it could very well be used in the future if the budget overruns of some regions worsened.

The sustainability of public debt

The global economic crisis caused a rapid and deep deterioration of Spain's public finances, in which the imbalances had until then been masked by high nominal growth and low interest rates due to euro-zone membership. Following the bursting of the real estate bubble, the current priorities are fiscal consolidation and the search for a new growth model. In future, the government will no longer be able to count on extra revenues due to private-sector indebtedness, because the private sector is involved in a long process of deleveraging. Accordingly, Spain must carry out fiscal consolidation, stimulate activity, bring down the unemployment rate (the highest in the euro zone) and ensure the stability of a banking system in the process of restructuring.

Austerity measures to consolidate public finances

- Substantial but insufficient efforts

The Spanish government has undertaken firmly to bring its fiscal deficit back below the threshold of 3% of GDP by 2014. For this purpose, a major consolidation plan has been enacted containing measures such as 5% cut in civil servants' wages, a freeze on public-service pensions and the cancellation of an EUR 6 billion public investment programme. On the revenue side, a 2 percentage point VAT hike (from 16% to 18%) together with a 2 percentage point increase in the lower rate, to 8%, was passed by parliament. At the same time, the government has undertaken pension reform by raising the legal retirement age from 65 to 67 years. However, the social and economic accord signed with the social partners suffers from the lack of an increase in the contribution period, kept at 38.5 years.

The fiscal deficit target for 2011 is 6% of GDP (versus 9.2% in 2010). To reach it, the structural austerity effort undertaken is equivalent to 3.4 percentage points of GDP, two-thirds of which come from cuts in public spending.

Although there is indisputably a will to consolidate the government's financial situation, it seems, however, that the effort made is insufficient.

Unlike in the period preceding the crisis, the cycle is now weighing on the debt dynamic: in 2010, the Spanish government undertook a fiscal consolidation effort of 2.6 percentage points of GDP for an actual primary deficit reduction of 2.1 percentage points, which implies a cyclical loss of 0.5 percentage point of GDP, or almost 20% of the effort undertaken. The austerity effort weighs on growth because it is depressing domestic demand. As a consequence, tax revenues are lower than expected.

For 2011, the government's GDP growth projection (+1.3%) on which the adjustment plan is based seems optimistic by comparison with the consensus (European Commission and IMF: +0.8%, BNPP: +0.4%). It therefore seems that further austerity measures will have to be provided for this year if the government wants to meet the budget target that it has set for itself.

Assuming a revenue-to-output gap elasticity of 0.5⁵, *ceteris paribus*, further measures would have to be taken worth around EUR 3 billion if growth is 0.8%, and EUR 5 billion if growth is 0.4%.

Over the entire consolidation period (2011-2014), the IMF recently estimated that additional measures equivalent to EUR 20 billion would be necessary to compensate for the cyclical losses due to growth probably less strong than that on which the government's scenario is based.

- The risk of a loss of social impetus

In the long run, the sustainability of public finances is as much a political and social issue as an economic one. A country is never declared legally bankrupt by its creditors: it has the ability to raise taxes and sell its assets, and its lifetime is theoretically infinite. A lot therefore depends on the leeway a government has to tighten state fiscal policy and hence, ultimately, on its political ability to have sacrifices accepted without repealing the social pact passed with its citizens. Defaults on payments occur when the political costs of fiscal adjustment are considered too great by the government or socially unsustainable by the population.

The country's social climate and the laws governing relations between the central authority and the population are factors of prime importance. In 1980, the Romanian dictator Nicolae Ceausescu repaid the EUR 9 billion or so of debt that his country owed to international

R&D expenditure (as % of GDP) in 2007

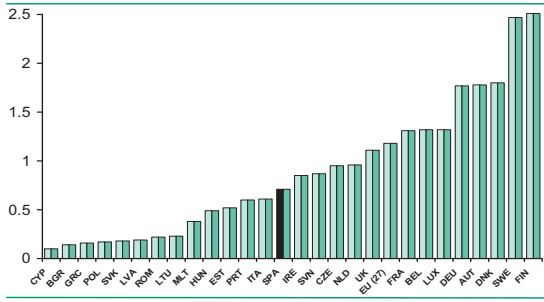


Chart 7

Source: Eurostat

General government budget balance and output gap

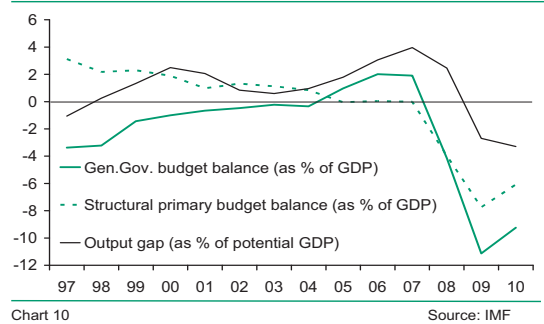


Chart 10

Source: IMF

Unite labour costs (1995=100) whole economy

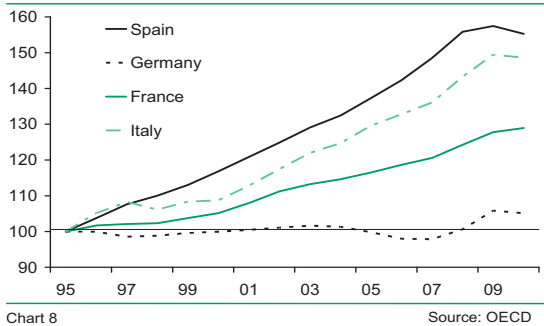


Chart 8

Source: OECD

General government budget balance

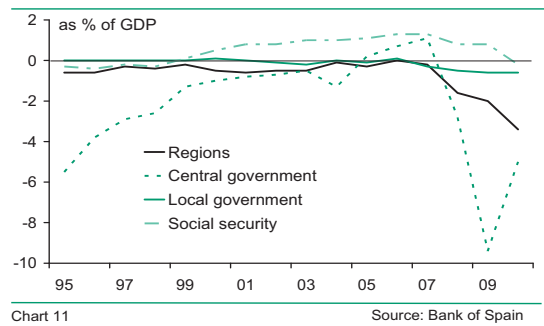


Chart 11

Source: Bank of Spain

NAWRU and unemployment rate (%)

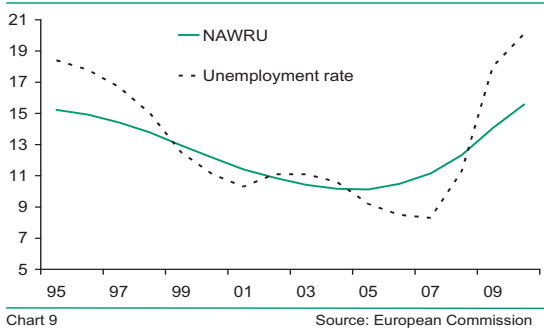


Chart 9

Source: European Commission

General government debt (% of GDP)

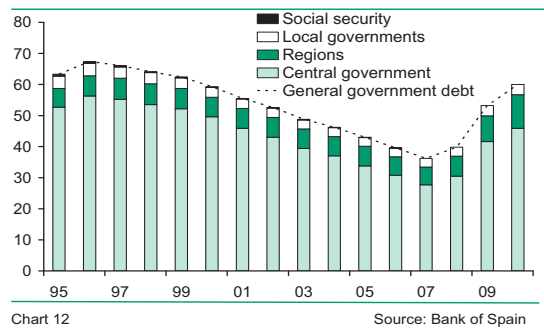


Chart 12

Source: Bank of Spain

creditors by depriving the population of the most basic public services, such as water and electricity. Of course, such sacrifices have no chance of being forced through in a democratic society, but this example underlines the political problems faced by a government undertaking to put the public finances back on a sound footing: it must reassure international investors regarding the government's solvency while maintaining political and social stability.

The election timetable therefore plays a leading role in a democracy undertaking fiscal consolidation. In the case of Spain, the next general election will be held in the spring of 2012 at the latest, and this could weaken the political determination to implement the austerity plan or finalise the ambitious structural reforms undertaken previously. However, the current head of the government, José Zapatero, has already announced that he would not be a candidate to succeed himself. Thus released from election constraints, the head of the government gives himself the necessary leeway to carry out his programme.

The main challenge for the political class will probably be to present a socially acceptable adjustment programme. The return of permanent growth is therefore essential. This would generate the tax revenues necessary to continue the fiscal consolidation and at the same time, through job creation, make the state pullout from the economy more acceptable.

Structural measures to stimulate growth and reduce unemployment

- Flagging domestic demand

While the spectre of recession seems to have been prevented, there are no real signs of a recovery in growth in Spain. The country is still in a deleveraging phase, symbolised by the reduction in the current-account deficit, from 10% of GDP in 2007 to 4.5% of GDP in 2010. This has resulted in a negative contribution of domestic demand to growth, which formerly drove activity. Moreover, the prospect of monetary tightening by the ECB could further depress household demand. Unlike in the pre-crisis period, the common monetary policy taking shape is likely to be too restrictive for Spain. A Taylor's rule type analysis⁶ shows that Spain would need an even more accommodative monetary policy than what is suggested by the current 1.50% refinancing rate. Accordingly, the cycle of

monetary tightening will slightly further complicate the situation of Spanish households, for which 80% of their mortgage loans are floating-rate and indexed to Euribor rates: Spanish disposable household income is more vulnerable to interest rate fluctuations than the euro-zone average.

- The need to regain competitiveness

A new period of economic growth implies that foreign trade takes over from domestic demand as the growth engine. For this reason, it is essential for the Spanish economy to regain competitiveness.

One way of measuring the growth in competitiveness of an economy is to compare wage growth with per capita productivity growth (this gives an idea of unit wage costs). As mentioned earlier, the boom period in Spain was characterised by excessively rapid wage growth⁷ relative to declining productivity. As a consequence, Spain's competitiveness within the euro zone deteriorated, while competition from emerging countries, combined with a strong euro, were partly responsible for a reduction in foreign market shares.

The resumption of long-run growth compatible with a decline in unemployment (around 1.5-2% per year) requires both greater flexibility in the labour market and stimulation of productivity through investment in education and research and development.

- A labour market reform to be completed

Labour market deregulation measures allow wage competitiveness to be regained rapidly.

In September 2010, the government passed an initial reform designed to make the job market more flexible and reduce the dichotomy between permanent contracts and temporary contracts. The objective was to restore companies' flexibility and dynamism by enabling them to more easily adjust their workforce to changes in the cycle. This is an extremely important subject in Spain, because the 21% unemployment rate is largely due to the collapse in construction activity and is therefore structural. This can feed on an hysteresis effect by which the long-term unemployed gradually lose the technical proficiency sought by employers. This effect is exacerbated if the rate of home ownership is high, reducing the mobility of job seekers, and also if redundancy costs are high, making it more risky to recruit someone who has not worked for a long time. Another risk related to the rigidity of the labour market is the emigration of young graduates who are unemployed or employed in precarious conditions⁸.

Following the September 2010 reform, redundancy costs were reduced, from 45 to 33 work days per year on the job for staff on permanent contracts. Moreover, if the job layoff is the consequence of financial losses for the company, the compensation has been reduced to 20 days. On the other hand, job layoff compensation has been increased by one day per year worked for temporary contracts. In theory, therefore, the reform should enable companies to regain competitiveness and thereby establish the conditions for economic recovery and, ultimately, a fall in the unemployment rate. Competitiveness could be regained rapidly: redundancies are facilitated and hence more numerous, which means that, for unchanged production, unit costs decline all the more. On the other hand, this increases the unemployment rate in the short term. It will be only once the economic recovery is firmly based that employment will recover. Thanks to the labour market reform, the fall in the unemployment rate could be faster: making redundancy conditions more flexible makes hiring conditions more flexible.

This reform, although it represents a first necessary step, nevertheless suffers from the lack of an agreement on wage bargaining. It therefore seems essential that the labour reform be supplemented by a measure designed to align wage growth on productivity growth, or at least put an end to the wage-inflation spiral. A decentralisation of wage bargaining to the corporate level, rather than to the sector or sometimes regional level, is essential to make better allowance for corporate economic realities. At the time of writing these lines, the decree for reform of the collective labour agreements is being debated in parliament with a good chance of being passed.

- Stimulating productivity

In a context of fiscal consolidation, it is essential to regain wage competitiveness for a rebound in activity. In the medium term, however, sustained, balanced growth also requires productivity gains. The surge in residential investment during the boom years crowded out productive investment and research & development. In future, the stimulation of these drivers is essential to increase labour productivity and a move upmarket by the Spanish economy.

Such a policy must be accompanied by investment in education in order to improve human capital. Now, a feature of the Spanish education system is a high rate of educational failure (31% of pupils leave the secondary

system without a qualification), which limits workers' employability, in addition to the intrinsic rigidity of the job market. The issue of education is especially crucial in that in future the construction sector will no longer be able to offer as many unskilled jobs as in the past.

This need to invest in long-term policies is at present coming up against a shortfall in available financial resources. State aid is apparently jeopardised by the need to consolidate public finances. Moreover, from 2013, Spain will no longer receive European cohesion funds. Accordingly, private funding will have to compensate for this lack of public funds. Now, apart from the will to do so, the question of the availability of funds for entrepreneurs remains to be solved. Institutional investors, weakened by the bursting of the real estate bubble, apparently do not have sufficient financial resources to make such investments, at a time when the ECB is involved in the process of raising its key interest rate.

Therefore, the recapitalisation of the banking sector seems an essential preliminary step to revive the economy and establish the conditions for its future growth.

Restructuring the financial system⁹

The recapitalisation of the banking sector represents a contingent debt for public finances since the FROB (Fund for Orderly Restructuring of the Banking System), created in 2009, enjoys an explicit and irrevocable government guarantee. The amount of the recapitalisation differs from one source to another. According to estimates by the Bank of Spain, the amount for recapitalisation of the banking sector that will be incumbent on the FROB will be EUR 15 billion. Moody's estimates that the recapitalisation requirement will amount to about EUR 50 billion.

This estimate is closely linked to assumptions regarding real estate price trends that are open to speculation. Admittedly, the correction in the real estate market since the peak (-15%) seems feeble by comparison with the correction that has taken place in Ireland (-40%). It is insufficient to fully correct the real estate bubble. The stock of housing retained on the financial institutions' balance sheets has not, until now, made it possible to fully realise the extent of the excess supply; at the same time, demand has been artificially propped up by fiscal measures such as the deductibility of loan interest. Following the gradual elimination of these measures since 1 January 2011, the real estate price correction gathered pace again.

The example of Ireland, whose public finances were brought to their knees by the bank bailout, arouses concern in financial markets. However, while the woes of the Spanish and Irish banking systems show similarities, their magnitude is completely different. Before its collapse, the Irish banking sector represented ten times Ireland's GDP, whereas the Spanish banking system represents three times Spain's GDP. Accordingly, when the Irish government injected EUR 70 billion of public money to save the banks from bankruptcy, the sum was equivalent to 45% of national income. Assuming that the same amounts were needed to recapitalise the Spanish financial institutions, which is a very conservative assumption, that would represent less than 7% of GDP.

Contribution to GDP growth

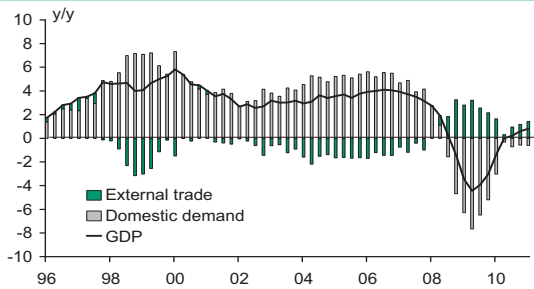


Chart 13

Source: INE

Current account (% of GDP) - 4-q ma

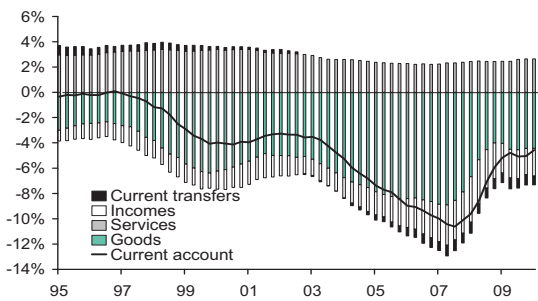


Chart 14

Source: INE

Substantial room for manoeuvre

At 60% of GDP at the end of 2010, the Spanish public debt ratio is well below the euro-zone average (84% of GDP). And yet, bond-market risk premiums have reached their highest levels (about 250-300 basis points above the Bund for the 10-year maturity) since

Employment and unemployment

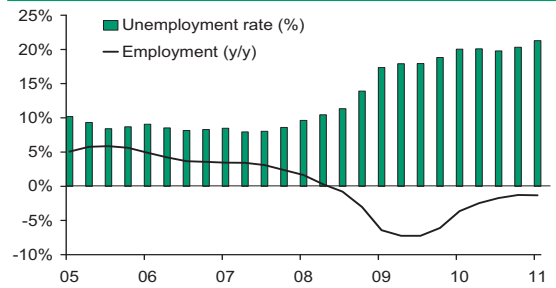


Chart 15

Source: INE

Inflation

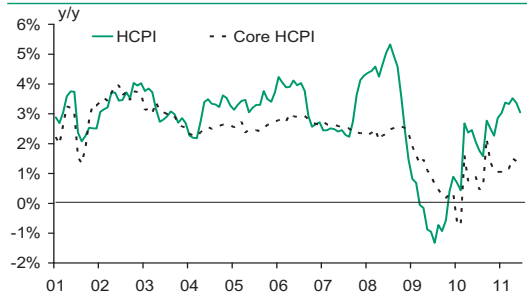


Chart 16

Source: Eurostat

Credit for construction and real estate activities

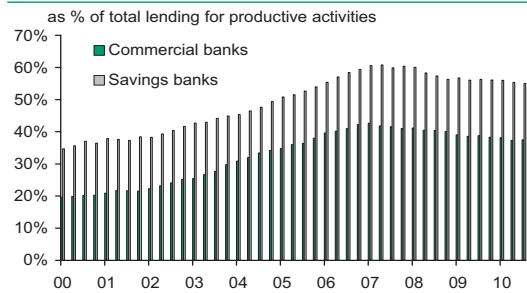


Chart 17

Source: Bank of Spain

the adoption of the euro. Market nervousness is fuelled by two factors apart from financial contagion imported from the other peripheral countries: firstly, Spain is preparing to go through an extended period of lacklustre growth which will probably slow down the process of fiscal consolidation, and secondly, the recapitalisation of the banking sector will weigh down the public debt by an amount that is as yet unknown.

Using two scenarios, we have tried to show that the Spanish public debt trajectory was perfectly sustainable even adopting, deliberately, extremely pessimistic macroeconomic assumptions.

- Core scenario

In our core scenario, GDP growth is only 0.4% this year and then tends on the 2015 horizon toward a potential growth estimated at 2%.

The low level of activity generates lost earnings in terms of tax revenues which slow down the fiscal adjustment. The fiscal deficit is brought back below the level of 3% of GDP only in 2015, i.e. two years after the date set in the Stability and Growth Programme.

The recapitalisation of the banking sector costs EUR 50 billion, in accordance with the Moody's forecast. As in the case of Ireland, this amount is included directly in the deficit, which adversely affects the 2011 budget but no longer appears in the public finances later, except via the additional interest payments generated by this extra debt.

The implicit interest rate on the public debt, equal to 3.7% in 2010, increases in the long term towards 5.0% given the increase in the Spanish government's borrowing costs in the markets.

With these assumptions, the ratio of public debt to GDP peaks at 78% in 2014, i.e. a level below the euro-zone average. It starts to decline as of 2016.

- Worst-case scenario

In the worst-case scenario, the bailout of the financial sector costs the government EUR 90 billion. The confidence shock causes the economy to plunge back into recession this year (-2.0%). Investors' risk aversion reduces the growth outlook and activity is slow to pick up again, regaining its growth potential only in 2016.

Fiscal consolidation goes outside the bounds set by the Stability and Growth Programme: the fiscal deficit does not return to 3% of GDP until 2017.

The apparent interest rate increases due to persisting investor concerns, reaching 5.5% at the end of the simulation.

With these extremely pessimistic assumptions, public debt reaches 93.6% of GDP in 2015, i.e. an increase of around 30 percentage points of GDP compared with the current level, leaving Spain very vulnerable to rising interest rates. However, rather than

the debt level, it is the conditions of stabilisation of the debt ratio that are most important when trying to assess the sustainability of public finances. Now, in this "disaster" scenario, the public debt could be stabilised with real growth of 2% and a primary surplus of 1%, which are very reasonable assumptions for a country such as Spain where the public finance problems are above all the consequences of the past excesses of the private sector.



Spain is undergoing a structural crisis which can be overcome only in the long term, through austerity measures and measures to modernise the economy. The way out involves a gradual reduction in the imbalances accumulated in the past decade (i.e. deleveraging by all economic agents and the complete correction of the real estate bubble) and a search for a new growth model, focused on innovation and competitiveness. The corollary of this adjustment is an extended period of lacklustre growth, inevitably lower than the growth which prevailed in the boom years. Linked to persistently high interest rates, Spain's public debt will continue to increase over the coming years, probably until 2015. However, unlike the other peripheral countries, the sustainability of the public debt is not brought into question. Based on the scenarios adopted, the ratio of public debt to GDP should peak at between 80% and 95% of GDP in 2015, i.e. in line with the euro-zone average.

Spain entered the crisis with a very low public debt ratio (36% of GDP) and a banking system representing a reasonable weight in national income (three times GDP, roughly in line with the European average): contrary to Ireland, the coming recapitalisation of the financial system will not substantially alter the public debt trajectory. Accordingly, the country has substantial fiscal leeway to cope with the crisis without financial assistance from the European Union and the IMF. The austerity measures implemented until now are bearing fruit despite the recession and budget overruns at the regional level. The regions represent only a limited risk for public finances, since although regional finances are deteriorating rapidly, debt levels remain very reasonable. The regions' debt accounts for less than 20% of total public debt.

Spain has time to radically reform its labour market, redefine some of the terms of the social contract and, in particular, reinvent an economic model that has shown its flaws. These challenges, although specific to Spain, nevertheless reflect a growing European awareness of the distortions that are inevitably created in a monetary union deprived of any form of fiscal federalism. In this regard, the idea of a competitiveness pact at the European level (the Euro plus Pact) can be seen as the recognition of the absolute necessity of coordination of

economic policies in the member countries. Moreover, the creation of the European Financial Stability Facility (EFSF), active until mid-2013, and its permanent successor, the European Stabilisation Mechanism (ESM), illustrate, despite divergences that are natural in a union of 17 democracies, the political will to respond to market concerns through European financial solidarity.

16 July 2011

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Scenario 1: EUR 50 billion bank bail-out

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Budget balance (% GDP)	-11.10	-9.2	-11.7	-5.8	-4.0	-2.8	-2.6	-2.3	-2.4
Primary balance (% GDP)		-7.3	-9.4(*)	-2.8	-0.8	0.5	1.0	1.5	1.5
Real GDP growth (%)		-0.1	0.4	0.8	1.2	1.5	2.0	2.0	2.0
GDP deflator (%)		1.0	0.5	1.0	1.5	1.5	1.5	2.0	2.0
Nominal GDP growth (%)		0.9	0.9	1.8	2.7	3.0	3.5	4.0	4.0
Implicit interest rate (%)		3.6	3.9	4.2	4.2	4.3	4.6	4.9	5.0
Public debt (% GDP)	53.30	60.1	71.3	75.8	77.8	78.3	78.1	77.3	76.6

Table 1

Source: BNP Paribas

* includes a 5% of GDP bank bail-out

Scenario 2: EUR 90 billion bank bail out

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Budget balance (% GDP)	-11.10	-9.2	-15.7	-7.5	-6.4	-5.4	-4.3	-3.9	-3.6
Primary balance (% GDP)		-7.3	-13.4(*)	-4.0	-2.5	-1.0	0.5	1.0	1.5
Real GDP growth (%)		-0.1	-2.0	0.0	0.5	1.0	1.5	2.0	2.0
GDP deflator (%)		1.0	0.5	1.0	1.5	1.5	1.5	1.5	2.0
Nominal GDP growth (%)		0.9	-1.5	1.0	2.0	2.5	3.0	3.5	4.0
Implicit interest rate (%)		3.6	3.9	4.5	4.7	5.0	5.2	5.3	5.5
Public debt (% GDP)	53.30	60.1	76.7	83.4	88.2	91.4	92.9	93.6	93.5

Table 2

Source: BNP Paribas

* includes a 9% of GDP bank bail-out

NOTES

¹ However, it should be specified that between 1996 and 2000 the savings rate had fallen by 5 percentage points.

² Some investment and research and development spending is deductible, which means that regional governments can post slight deficits even when economic growth is very robust.

³ At the time of writing, this concerned five regions, but negotiations for the formation of governments are still in progress in many others.

⁴ The change of majority led to a budget deficit almost three times greater than that recognised by the outgoing government

⁵ A 1 percentage point increase in the output gap "costs" 0.5 percentage point in cyclical revenue losses.

⁶ Taylor's rule is a monetary policy rule which places policy rates in parallel with the output gap, future inflation and past interest rates according to the following equation:

$$i_t = \pi_t + r^*_t + a^*_\pi (\pi_t - \pi^*_t) + a_y (y_t - \hat{y}_t)$$

where i_t is the policy rate set by the central bank at a time t , π_t is the inflation rate, π^*_t is the inflation target of the central bank, r^*_t is the real interest rate at a time t , and y_t and \hat{y}_t are the GDP and potential GDP levels respectively. a^*_π and a_y are fixed coefficients of 0.5.

⁷ Wage hikes depend on inflation, but they could be increased by an additional percentage of up to 7%.

⁸ The "indignants" movement in the Spanish populace reflects the weariness gaining hold of the working classes, especially the young, more than 40% of whom are unemployed. Within this population, the "mileuristas", young graduates with three to five years of higher education earning EUR 1 000 per month, symbolise the precarious situation of a generation which fears it will live a "lost decade". However, the weight of unemployment should be put in perspective by taking into account the growth of the informal economy (estimated at 20% of GDP) which, although it is not viable in the long run, offers a safety valve to counter the austerity measures, and could mitigate the risk of social unrest.

⁹ Regarding the situation of Spain's financial system, we refer here to the article by Delphine Cavalier, *Conjoncture*, BNP Paribas Monthly Bulletin, July-August 2011, « Spanish banks : Work in progress ».

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