RESEARCH

Spain Economic Outlook

Third Quarter 2011

Madrid, 4 August 2011

Key themes

1. **Economic policies and outlook:** prospects dictated by delays in decisions on how to tackle budget problems in Europe and the US
2. **Europe:** the July summit brought positive surprises regarding liquidity support measures, but Greece's solvency issues have yet to be cleared up. Economies with high risk premiums have already seen growth undermined as a result
3. **Spain:** GDP growth in the second quarter of around 0.3% qoq (0.8% yoy), still too weak for sustained job creation. The Spanish economy is still stuck in a pattern of low activity and employment, with forecasts pointing towards 1% growth for 2011
4. The higher contribution to growth by net trade is still one of the positive aspects of the ongoing adjustment
5. There has been no change in the pace of adjustment and reform which offset rising uncertainty on international financial markets

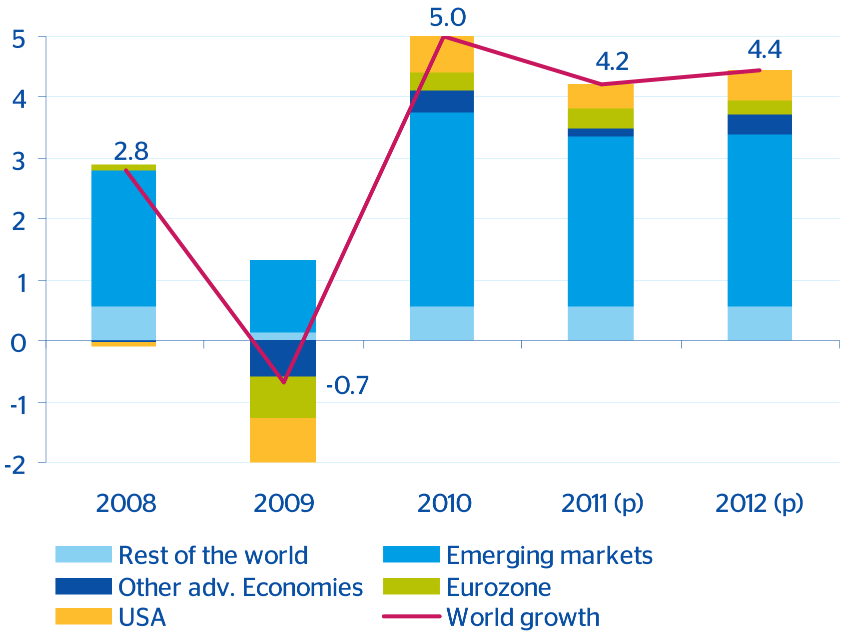
Contents

Global growth still driven by emerging economies

- The global economy slowed slightly in the first half of 2011
- Global growth should remain robust, driven by emerging economies, as the slowdown was caused by short-lived factors (e.g. high oil prices, disruption to the Japanese supply chain caused by the earthquake)

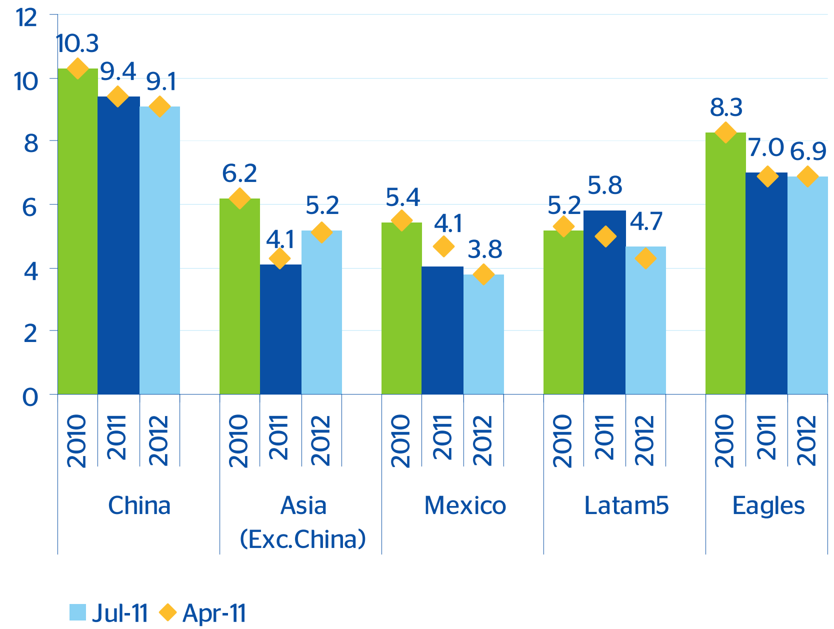
Contribution to global growth (%)

Source: BBVA Research



Growth in Asia and Latin America (% yoy)

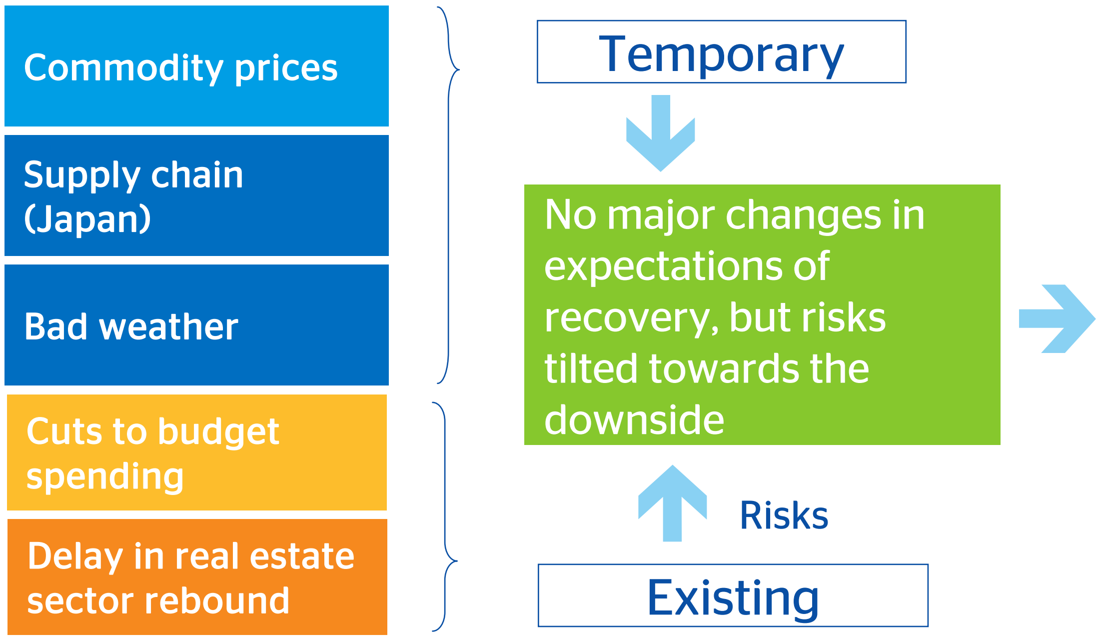
Source: BBVA Research



US: a temporary blip

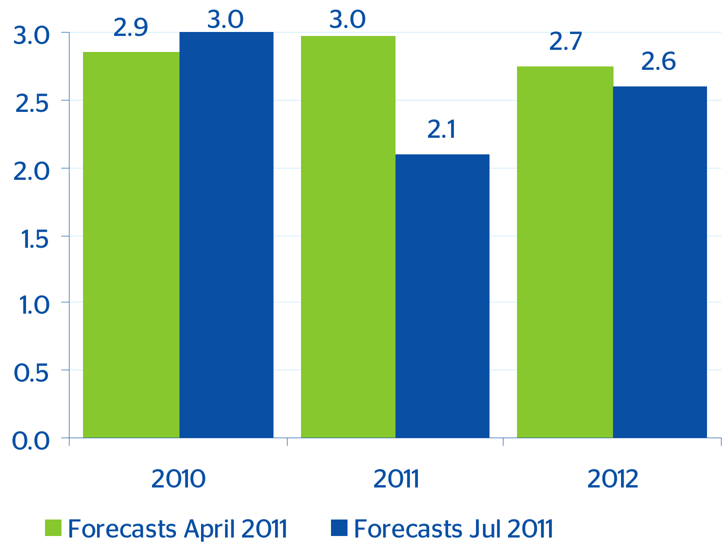
- The recovery has lost steam in 2011, mainly due to one-off factors, although the US economy remains structurally weak after the financial crisis: struggling real estate market, deleveraging and tough lending conditions
- Inflationary pressures remain benign. The Fed still needs clear signs before changing its tightening policy

Weak growth in H1 2011



US: GDP growth (%)

Source: BBVA Research

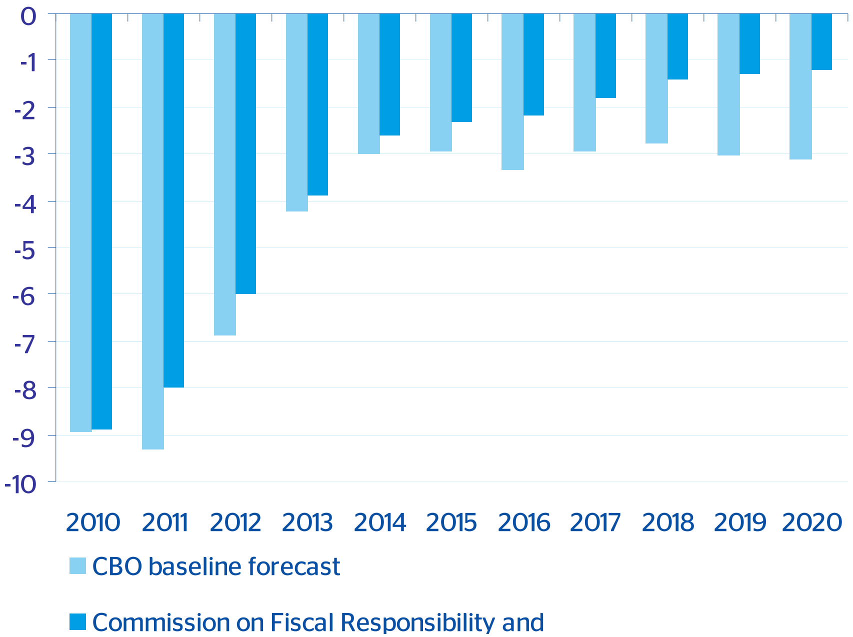


US: more than a debt ceiling is needed: long-term consolidation

The agreement to raise the US debt ceiling prevented technical default by the country. Nevertheless, it does not clear up all doubts surrounding a long-term solution to curb the deficit and stabilise debt

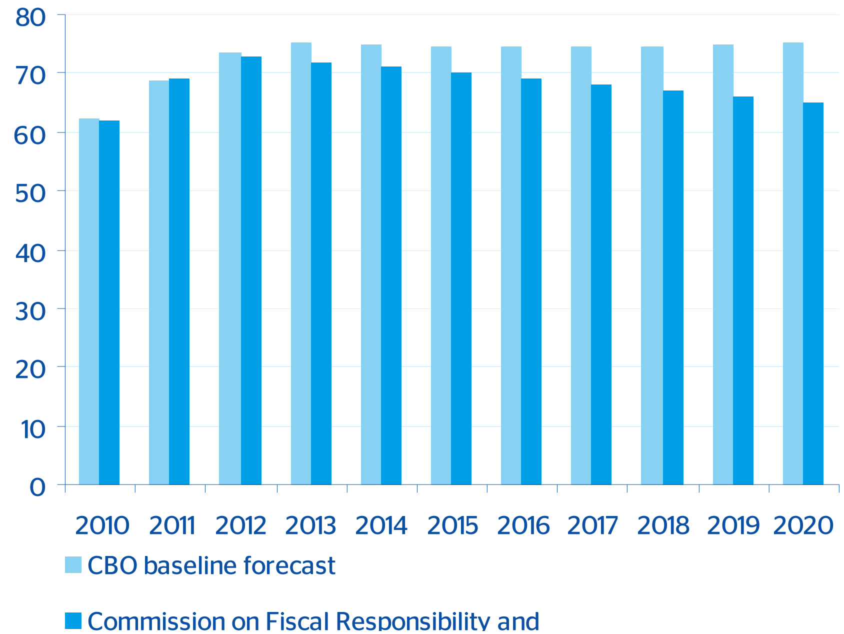
US: budget deficit (% of GDP)

Source: BBVA Research, CBO and Commission on Fiscal Responsibility and Reform



US: public debt (% of GDP)*

Source: BBVA Research, CBO and Commission on Fiscal Responsibility and Reform

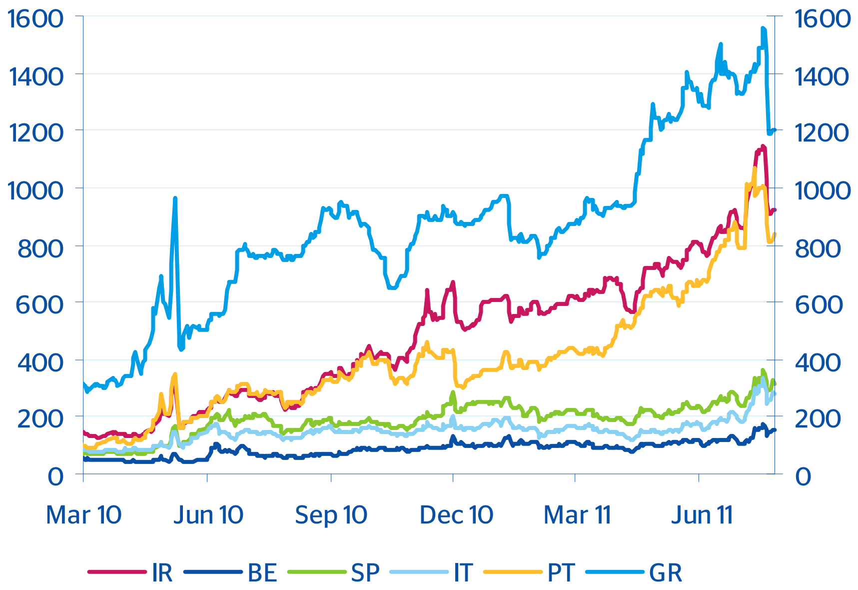


Financial stress in Europe will affect the periphery more than the core

- In Europe, healthy growth in Q1 and Q2 led to a slight upward revision to the 2011 growth forecast
- The decoupling between European core and peripheral countries should continue in 2011 and 2012. Wider bond spreads will undermine growth of countries with high risk premiums

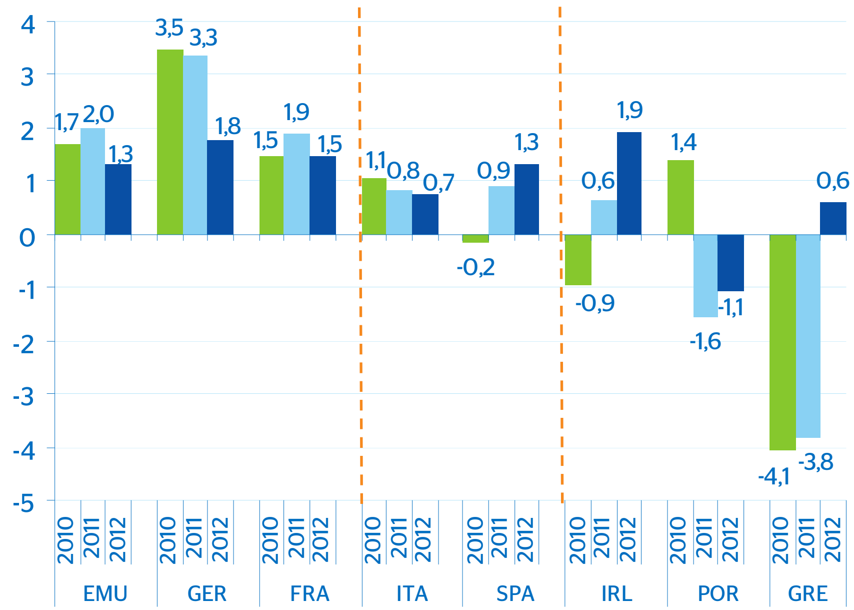
Sovereign bond spreads (vs. the German 10-year bond)

Source: BBVA Research



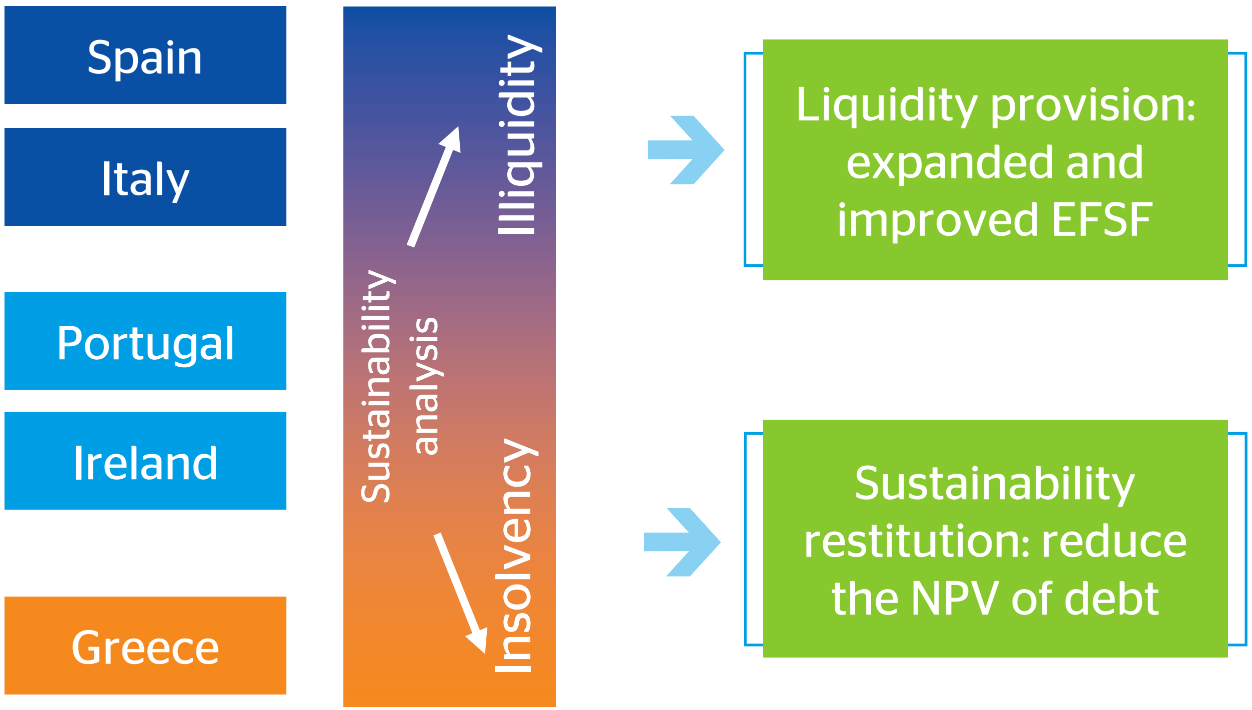
EMU: GDP growth

Source: BBVA Research



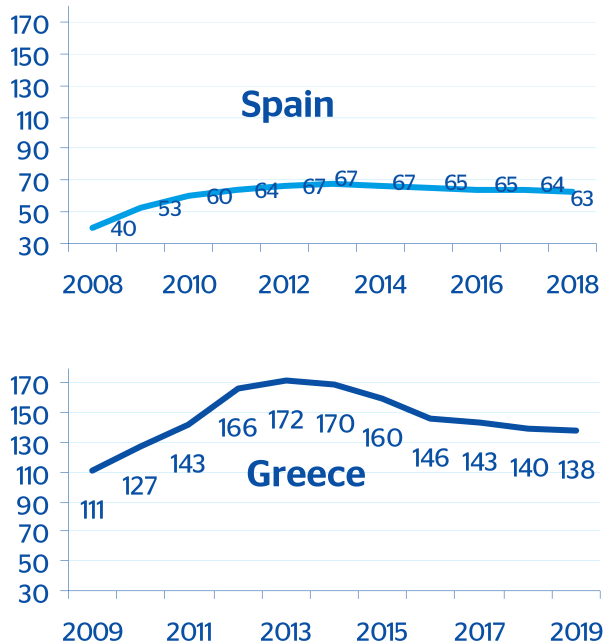
Insolvent countries must be separated from liquidity-strapped countries to prevent contagion

To solve financial stress in Europe, a distinction must be made between countries faced with solvency issues and those with liquidity problems. For the first group, solvency must be restored by slashing debt. For the second group, a strong mechanism for providing liquidity is needed



Public debt (% of GDP)

Source: BBVA Research



What are the key features of each pillar?

Strict conditionality is required to achieve debt reduction. To provide liquidity, the EFSF must be expanded and improved, with a certain degree of conditionality. Both pillars should steer Europe not only towards monetary union, but to some extent, fiscal union

Liquidity provision: expanded and improved EFSF

- Larger and more flexible EFSF
- Pre-emptive lending (FCL)
- Bond purchases on secondary markets
- Lending not only to governments

\+ Conditionality

Sustainability restitution: reduce the NPV of debt

- Official bailout or private haircuts
- Avoid collapse of the banking system

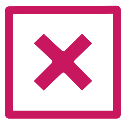
\+ Extremely conditionality

End result: mini fiscal union

- Eurobonds
- Fiscal rules

July summit: EU authorities make surprise liquidity support announcement

The 21 July summit did not address all solvency concerns, but attempted to isolate peripheral countries from Greece

What the summit needed	Achieved?	What was agreed on 21 July
Expanded EFSF, pre-emptive lending (e.g. FCL) and bond purchases on secondary markets		All of this, but... ...the size of the EFSF was unchanged
Decision on a public bailout or reach agreement on substantial write-down of NPV of debt		Rescheduling and debt repurchases, but limited reduction in debt
Creation of Eurobonds to cover debt up to 50% of GDP and imposition of conditionality		No agreement on Eurobonds

What's left to do after the summit?

In addition to executing the agreements and clarifying significant details (EFSF, private sector involvement), the EU authorities must devise a powerful mechanism to provide liquidity, lend credibility to the continuation of reforms and proceed towards greater fiscal unity

3 pillars for progress	Work to be done
Provide sufficient support to liquidity to ward off speculators	• Achieve a broad core-periphery agreement
Proceed with economic reforms	• Implement ongoing programmes • Design a timetable for more reforms
Achieve a tighter fiscal union	• Announce the creation of Eurobonds quickly, with fiscal rules and strict control. Imple-mentation with the ESM in 2013

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Spain: growth still weak

Determining factors of the macroeconomic scenario

Source: BBVA Research

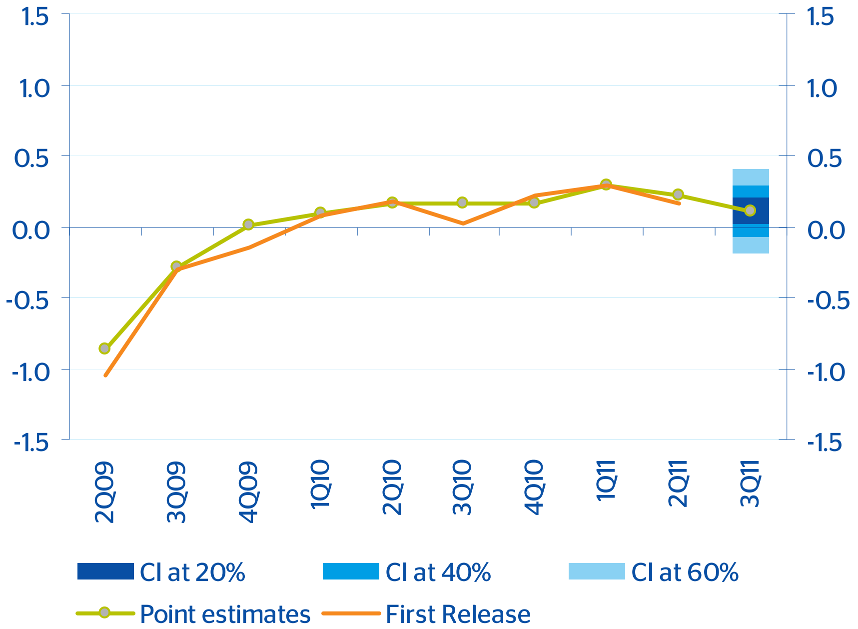
	FACTOR		Impact on GDP
New factors	Data for 1Q 2011	• Slightly higher-than-expected GDP growth	2011: (+) 2012: (+)
	Structural reforms	• As expected: limited reform to collective bargaining, which does not solve the problems.	2011: ≈ 2012: ≈
	Fiscal consolidation	• Higher-than-expected public consumption in Q1 2011, signalling sharper cutbacks in H2 2011	2011: ≈ 2012: ≈
	Monetary policy	• The ECB would bring forward interest-rate hikes from 2012 to the end of 2011	2011: (-) 2012: (-)
	Financial stress	• Increase in forecast risk premiums (+50bp on average in 2011 and 2012)	2011: (-) 2012: (-)
	Foreign demand	• Slowdown in global growth and a strong euro vs. the dollar, but higher growth in the EMU in 2011	2011: (+) 2012: (-)
		Current forecast	2011: 0.9% 2012: 1.3%

Spain: growth still weak

Growth in Q1 2011 topped expectations, but Q2 2011 numbers were broadly the same as Q1 2011 and in line with forecasts of three months ago

Spain: actual GDP growth and MICA-BBVA model forecasts (% qoq) Current forecast: 3 August 2011

Source: BBVA Research



The main characteristics of the short-term outlook for the Spanish economy are still:

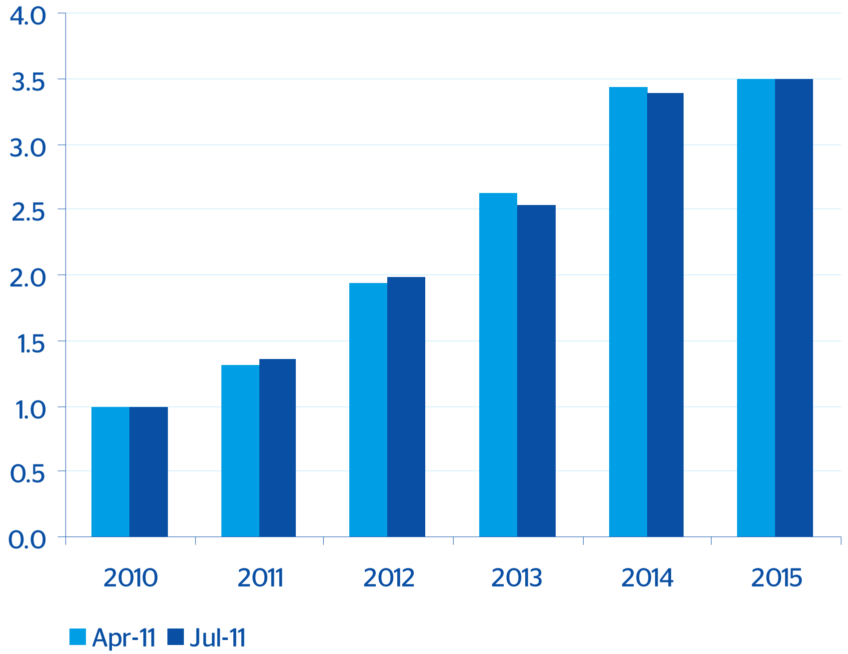
- **Lack of job creation**
- **Weak domestic demand**
- **Negative contribution to growth by domestic demand**
- **Sharp growth in foreign demand**

Spain: growth still weak

The ECB could bring forward the start of its tightening campaign to the last quarter of 2011, raising key rates to 1.75% by year-end and 2.0% in Q1 2012, provided the European sovereign debt crisis is cleared up

ECB. Interest rate forecasts

Source: BBVA Research



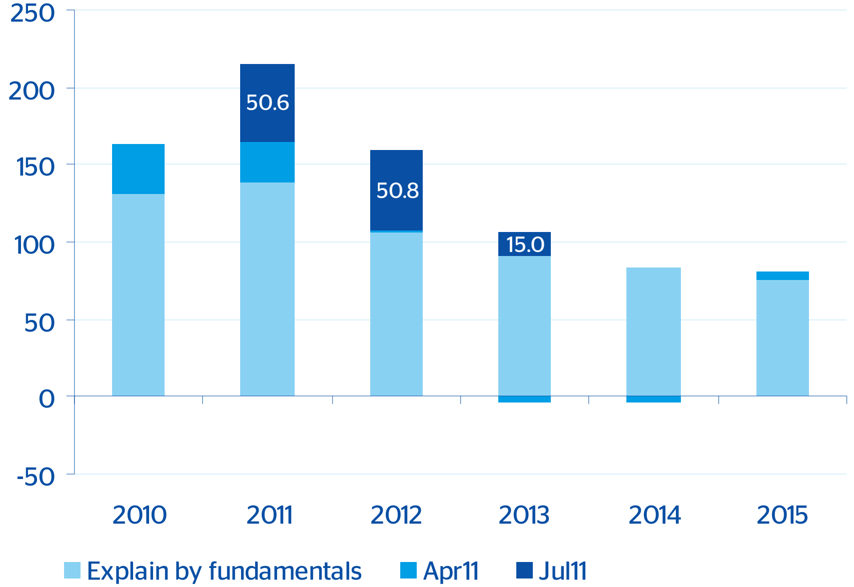
- The interest rate scenario is not that different, so the impact of raising rates earlier would be limited
- **In general, higher interest rates than expected three months ago would only detract marginally from growth in 2012**

Spain: growth still weak

Heightened pressure in sovereign debt markets (larger risk premiums: +50bp in 2011 and 2012, but short-lived) would dampen GDP growth

Spain: sovereign risk premium
(vs. German 10Y bond)

Source: BBVA Reserach



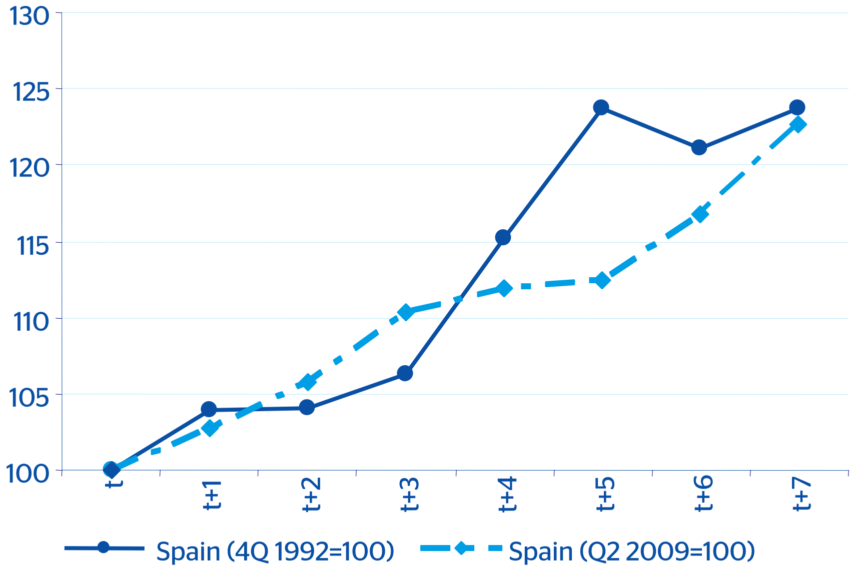
The cumulative effect of this factor alone would be a decrease in GDP growth of 5 tenths in 2012 from forecasts three months ago

Spain: growth still weak

More upbeat prospects for the EMU in 2011 than before could be offset by the slowdown in global economic growth and a slightly stronger euro

Qoq change in goods and services exports during the end-phase of two periods of crisis (in real terms)

Source: BBVA Research based on INE



Note: t is the quarter that recorded the local cyclical low

Goods and services exports:

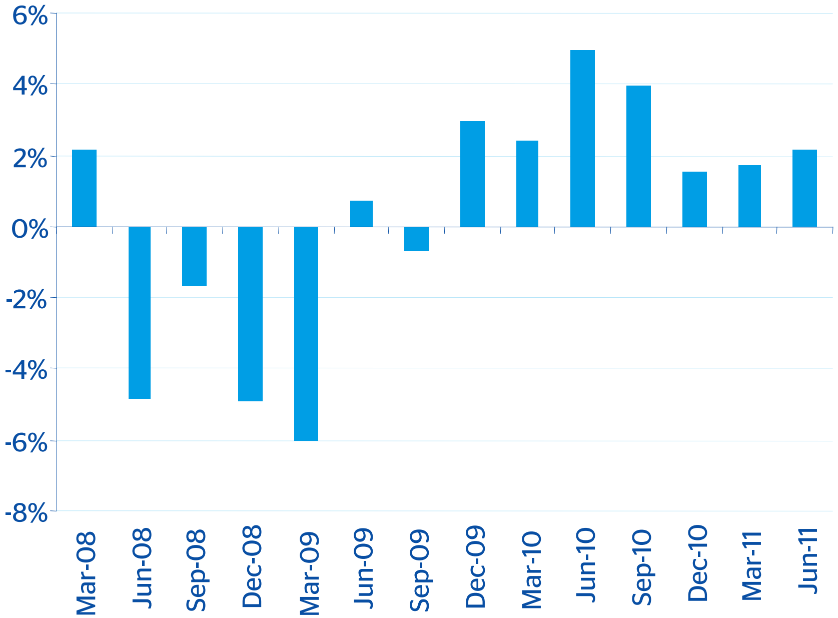
- Above pre-financial crisis levels
- Performance in line with similar crisis periods despite the absence of currency depreciation as in the past
- Diversified growth

Spain: growth still weak

Foreign demand

Stronger growth in the EMU in 2011 could be offset by the slowdown in global economic growth and a slightly stronger euro

Foreign tourist arrivals (qoq, % SWDA)
Source: INE and BBVA Research



A rebound in tourism is particularly important for employment

Spain: growth still weak

Economic forecasts

Source: INE, Bank of Spain, Eurostat and BBVA Research

(yoy %)	2010		2011		2012	
	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	1.3	0.8	0.3	1.2	0.6	1.3
Public Administration's consump	-0.7	0.3	-0.2	0.6	-1.3	0.1
GFCF	-7.5	-1.0	-4.9	3.3	-0.4	2.7
Capital goods and other prod	-2.1	3.1	0.6	6.1	3.0	4.0
Construction	-11.1	-3.9	-9.1	0.0	-2.9	0.8
Housing	-16.5	-2.9	-7.5	0.6	0.9	1.0
Domestic demand (*)	-1.1	0.9	-1.0	1.5	0.0	1.2
Exports	10.3	11.1	11.0	6.4	6.0	3.2
Imports	5.5	9.3	3.7	5.6	1.0	3.2
Net trade balance (*)	1.0	0.8	1.8	0.5	1.3	0.1
GDP at mp (yoy %)	-0.1	1.7	0.9	2.0	1.3	1.3
Pro-memoria						
GDP w/o housing investment	0.9	1.9	1.3	2.1	1.3	1.3
GDP w/o construction	1.7	2.3	2.3	2.2	1.9	1.4
Employment (LFS)	-2.3	-0.4	-1.1	0.5	0.4	0.7
Unemployment rate (% active pop	20.1	10.2	21.0	9.8	20.9	9.5
Current account balance (% of GD	-4.5	-0.4	-4.0	-0.2	-1.6	-0.1
Public sector balance (% of GDP)	-9.2	-6.0	-6.0	-4.4	-4.4	-3.6
Annual average CPI	1.8	1.6	3.0	2.7	1.4	1.8

(*) contribution to growth

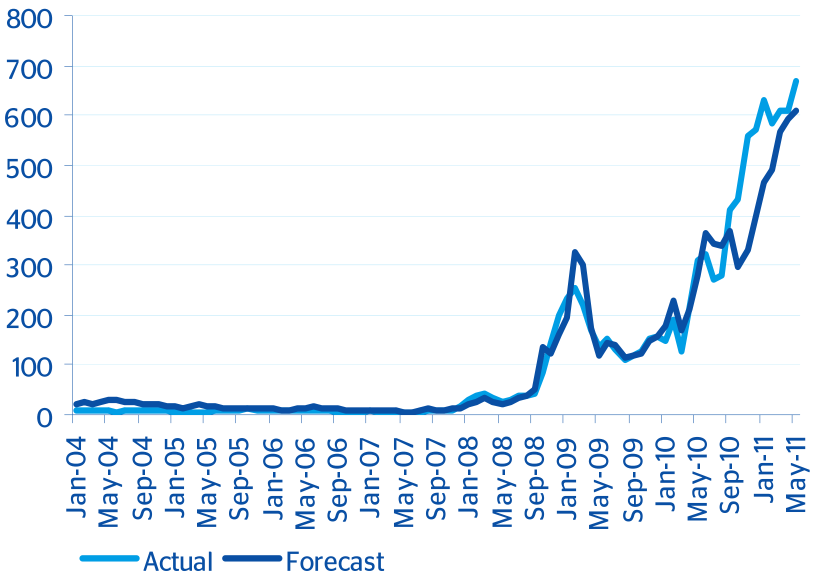
Contents

Spain must proceed to make sweeping reforms

- Fundamentals indicate that the countries which have been bailed out effectively suffered from solvency problems, whereas Spain and Italy are undergoing a liquidity crunch
- For this situation to continue, more ambitious reforms must be carried out

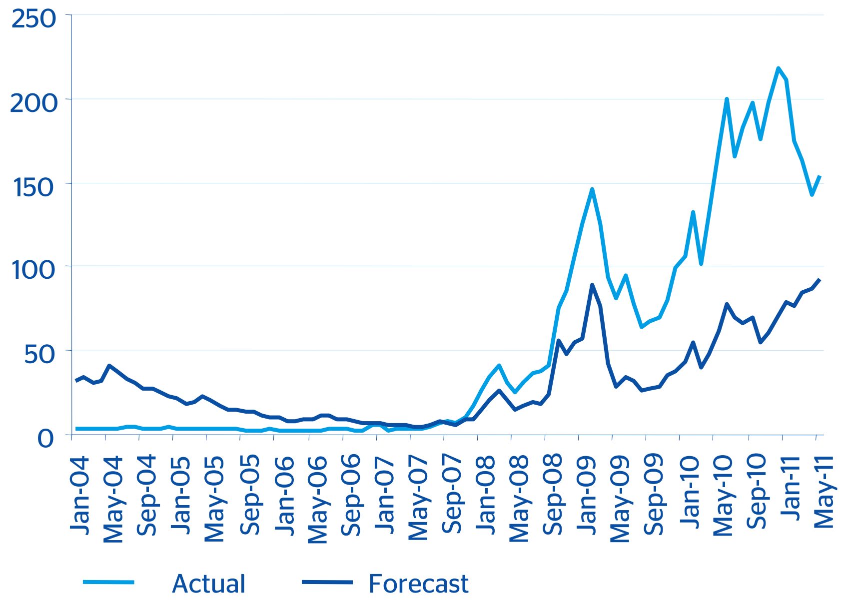
Sovereign CDS: actual and equilibrium Greece, Portugal and Ireland

Source: BBVA Research



Sovereign CDS: actual and equilibrium Spain, Italy, Belgium

Source: BBVA Research

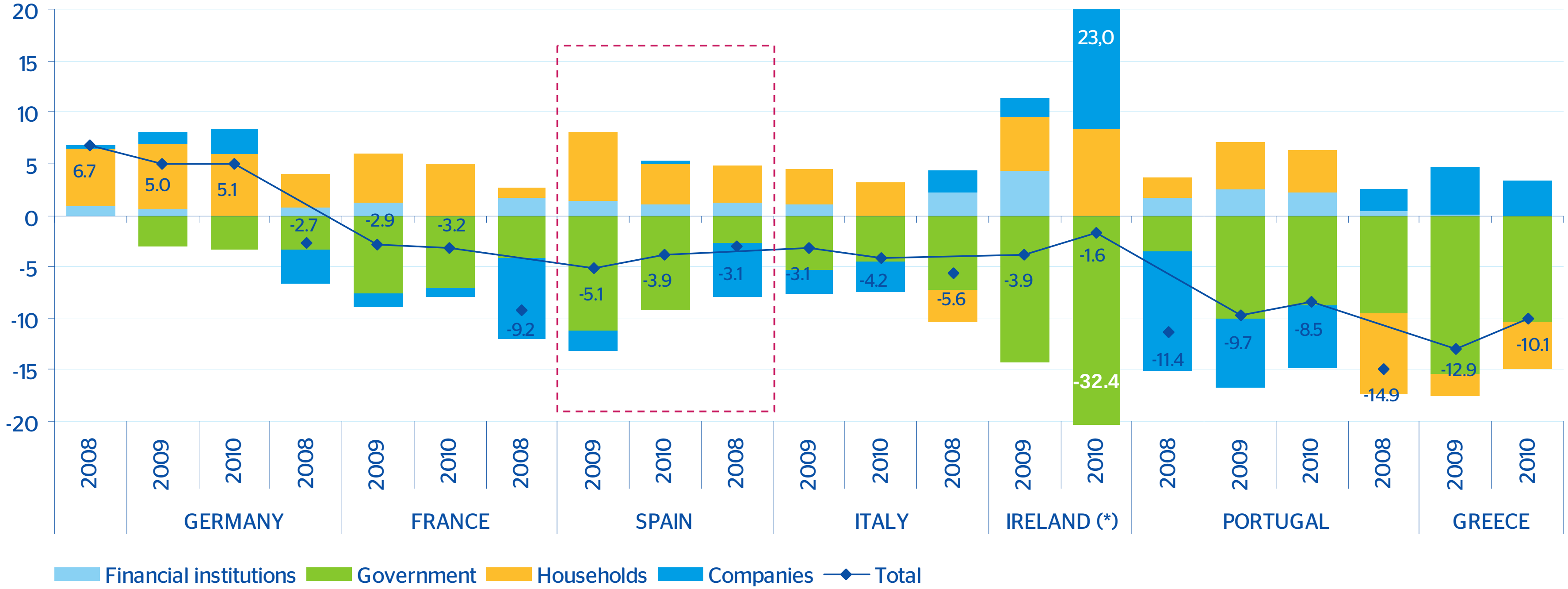


Concerns stem from the Spanish economy's hefty financing requirement

- Spain has already made some progress by lowering its financing requirement relative to other countries via sharp cuts to investment and an increase in the household saving rate
- However, public sector saving has declined.

EMU: Financing capacity (+)/requirements (-) by agent (% GDP)

Source: BBVA Research based on AMECO data



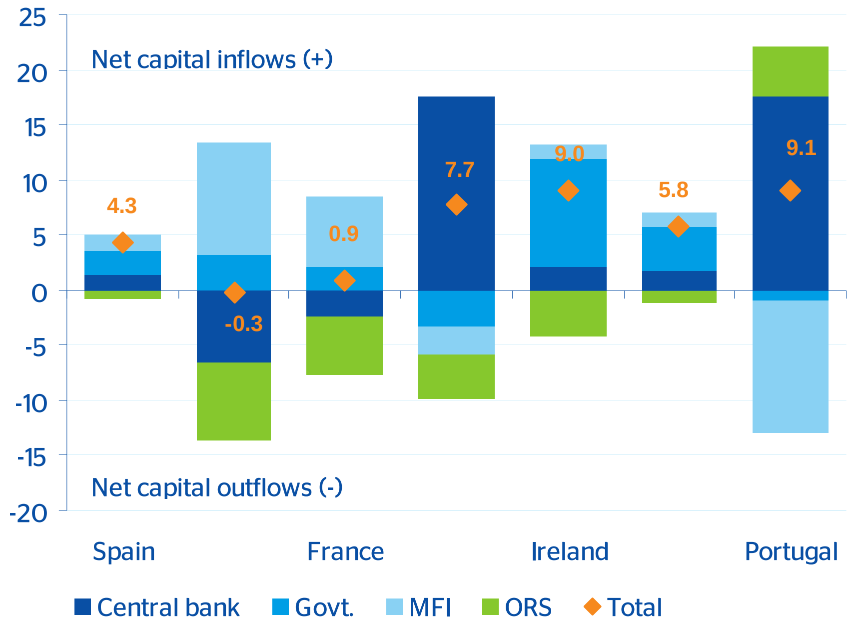
(*) Irish data series for government and Companies are truncated

Spain has managed to differentiate itself: the government can still tap markets

Unlike other countries in the periphery, which have been forced to turn to the ECB for liquidity, the Spanish government has been able to meet its financing requirement abroad, albeit at a higher price

EMU: net capital inflows 2010 (% GDP)

Source: BBVA Research from Haver data



Note: a net rise in financial liabilities or fall in financial assets results in net capital inflows, while opposite movements give rise to net capital outflows.

Spain must be pro-active to keep contagion from spreading

Spain shares many of the concerns of the three other peripheral countries, and efforts should be made to distance itself

Problems in the periphery		Risks linked to Spain
1 Greece	• High deficits and debt • Doubts surrounding public accounts • High foreign deficit	Regional government deficits
2 Ireland	• Oversized banking industry • Private indebtedness • Real estate bubble	Bank restructuring
3 Portugal	• Scant growth and productivity • Rigid public deficit • Stubborn foreign deficit	Incomplete reforms (e.g. labor market)

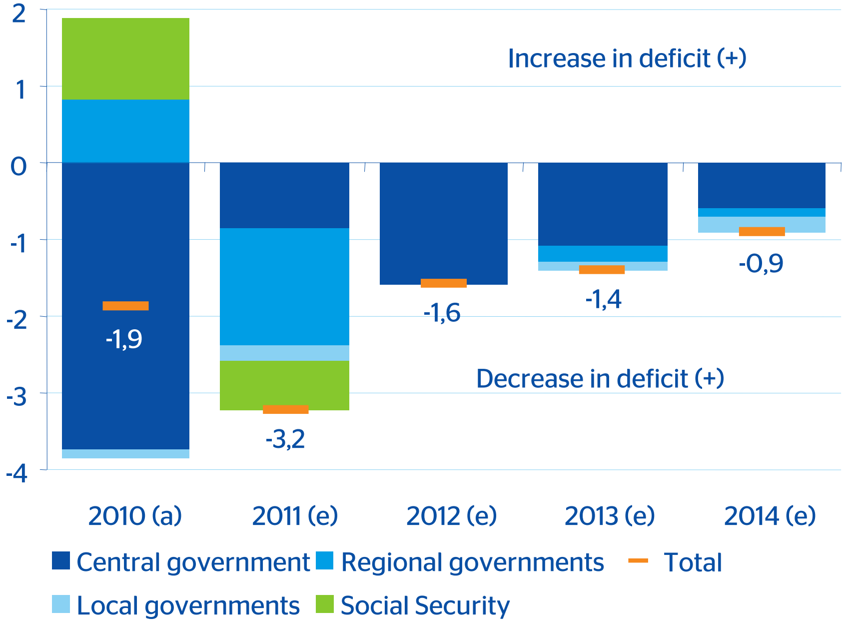
Maximum fiscal rigour

Meeting budget targets would bring down the risk premium significantly

- **The target is ambitious:** a reduction in the regional government deficit of 6pp of GDP to 3% in 2013
- **In 2011, the bulk falls on the regional governments:** they must lower the deficit by 1.5pp, making nearly 90% of the required adjustment in 2011 to guarantee that the 2013 target will be met

Contribution to fiscal adjustment * (pp of GDP)

Source: BBVA Research, using finance ministry data



(*) Excluding impact of regional deficit financing

Proposals

- Transparency and multi-year budgets for all public administrations
- Fiscal rules limiting spending to trend nominal GDP growth
- Fiscal Policy Advisory Council reporting to legislative bodies

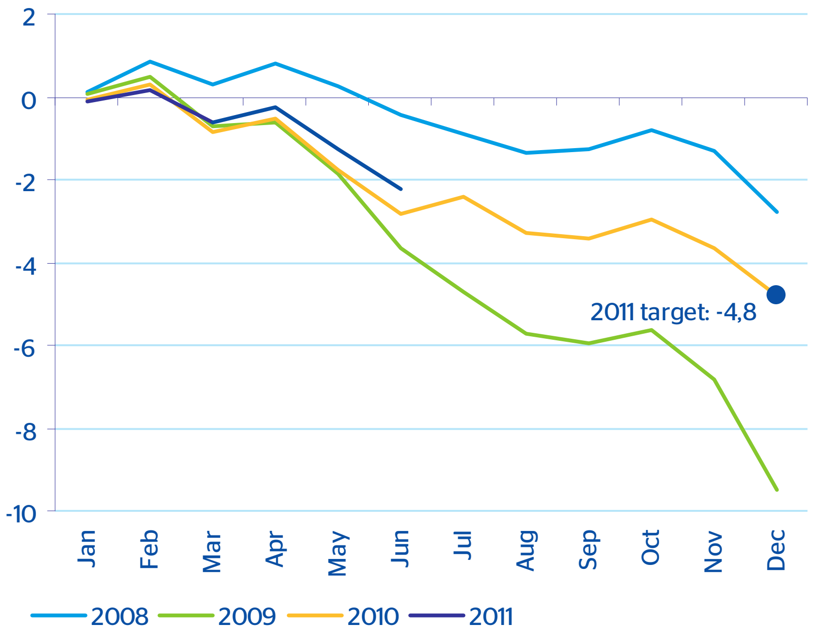
Maximum fiscal rigour

- The state will comply, with revenue potentially exceeding forecasts by a few tenths
- The question mark lies with the Social Security and especially in the out-turn of regional government spending

Central government: non-financial balance

(cumulative annual, % of GDP)

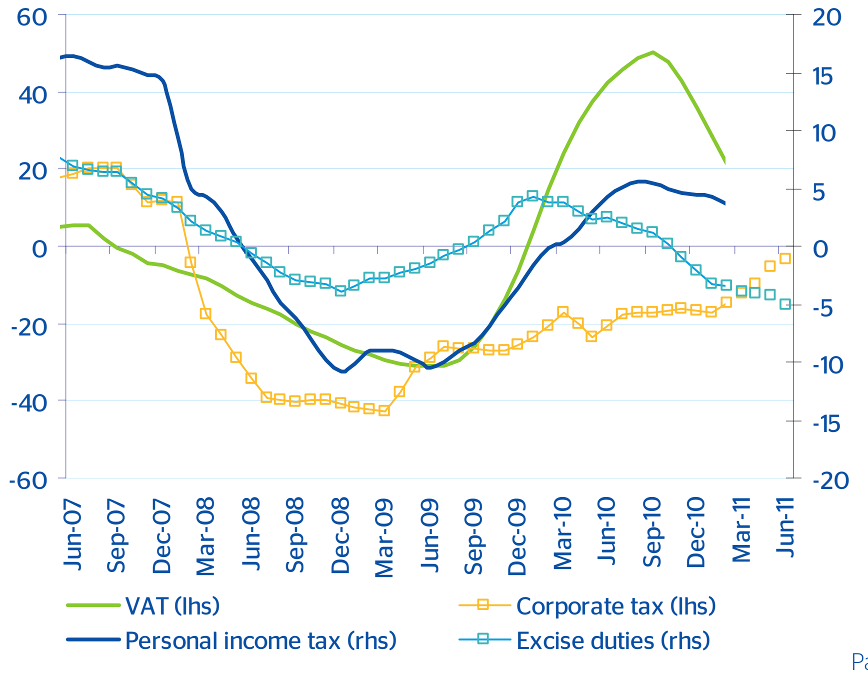
Source: BBVA Research, using finance ministry data



Tax revenues

(% like-for-like yoy change in 12m centred moving average)

Source: BBVA Research based on AEAT data

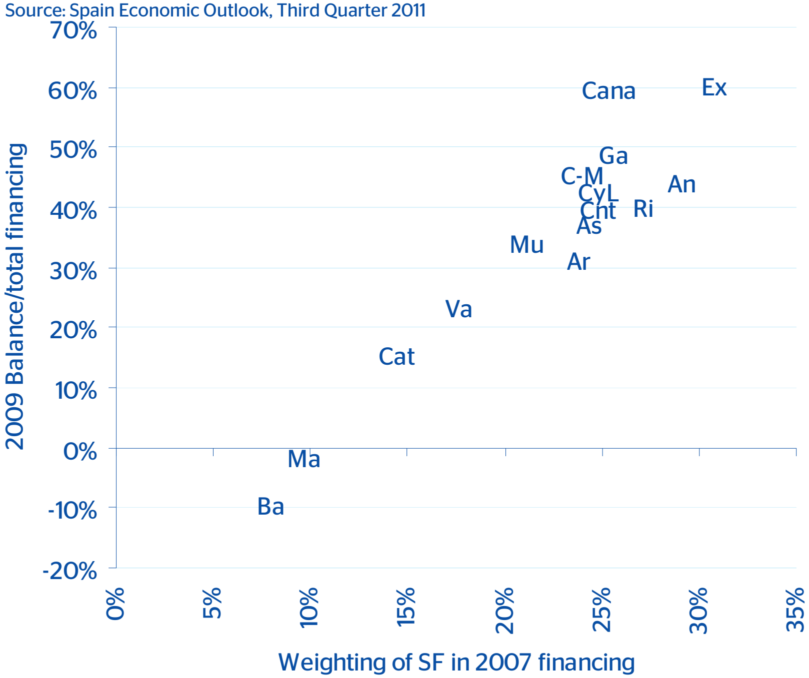


Maximum fiscal rigour

- The regional governments must reimburse the state for slightly over 20% of their total financing for 2009
- In view of the sharp fall in the Sufficiency Fund, those regions that relied more heavily on it have to return larger amounts.

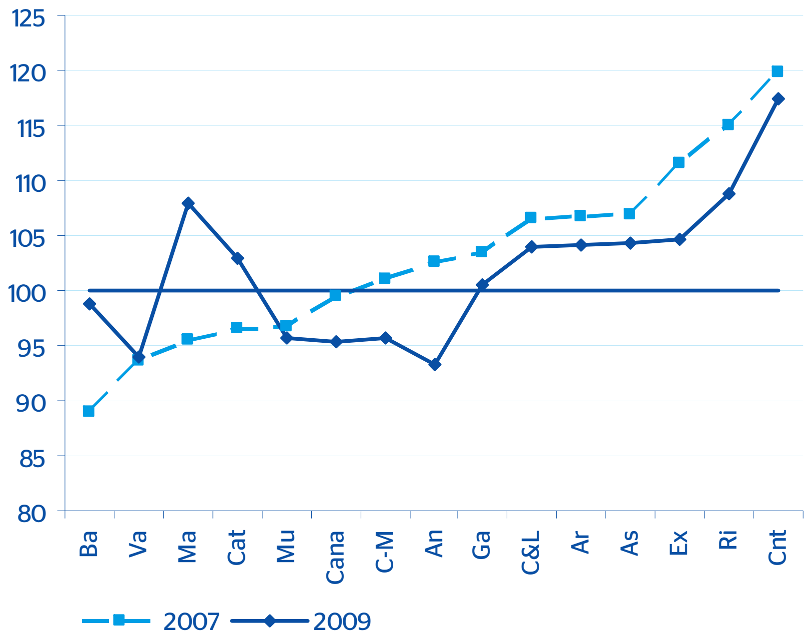
Balance owed in 2009 as a percentage of total regional financing vs. the weighting of Sufficiency Fund in 2007 theoretical financing

Source: Spain Economic Outlook, Third Quarter 2011



Theoretical finance on comparable responsibilities per adjusted pop, 2007 vs. 2009

Source: Spain Economic Outlook, Third Quarter 2011



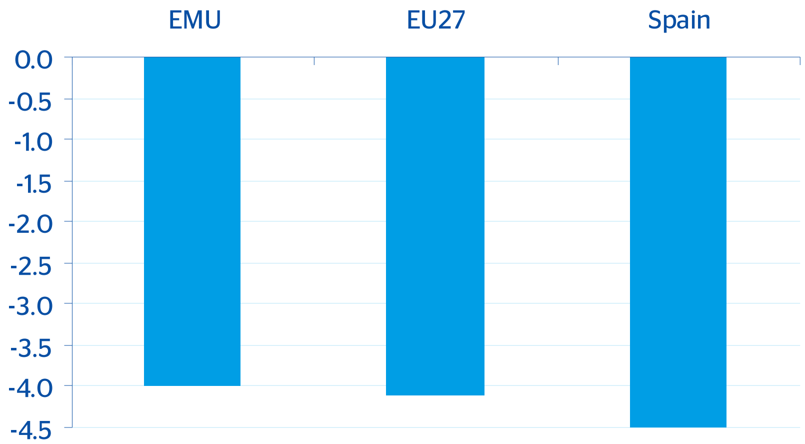
Bank restructuring

Stress tests: a more transparent and rigorous exercise in Spain

Larger shock to GDP growth

Stress tests: cumulative decline in GDP after two years, deviation from baseline scenario

Source: BBVA Research and EBA

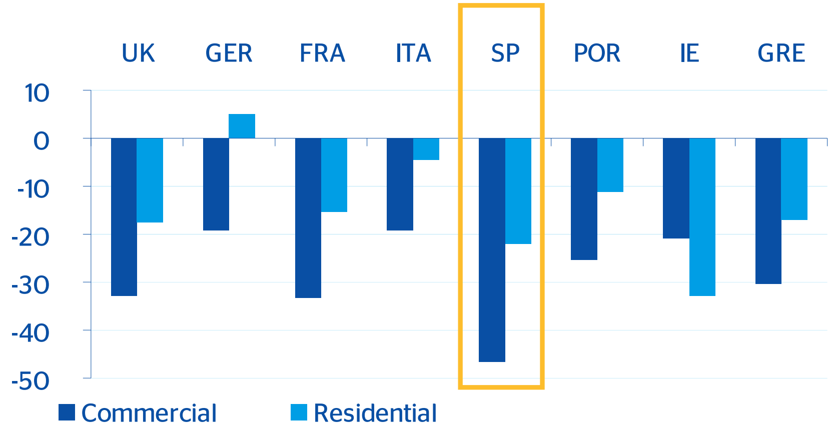


Broader coverage: 90% of the Spanish system, compared to the EU average of 60%

Sharp (absolute and relative) fall in housing prices

Stress tests: cumulative decline in real estate prices

Source: BBVA Research and EBA

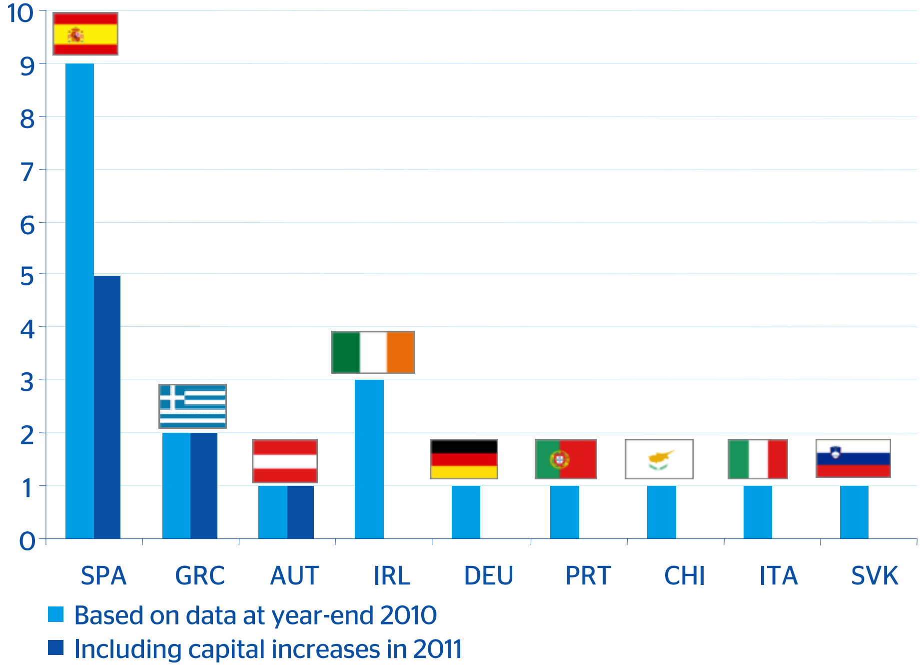


Bank restructuring

- In the more adverse scenario, the Core Tier 1 capital ratio would decline from 7.4% to 7.3%. However, considering other elements that absorb losses (e.g. general allowances, convertible bonds) the ratio would stand at 8.6%

Stress tests: institutions with a Core Tier 1 capital ratio below 5%

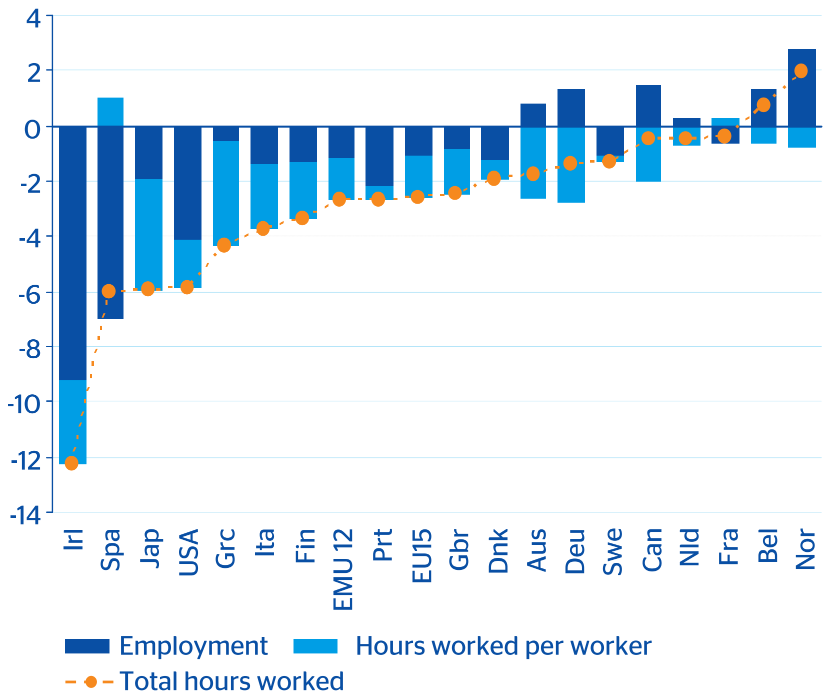
Source: BBVA Research and EBA



Factoring in general and anti-cyclical provisions, and convertible bond issues, no Spanish bank would require an extraordinary capital injection

Insufficient labour market reform

Breakdown of the fall in employment during the recession (% contribution to change in total number of hours worked between 2007 and 2009)
Source: BBVA Research



Considerations

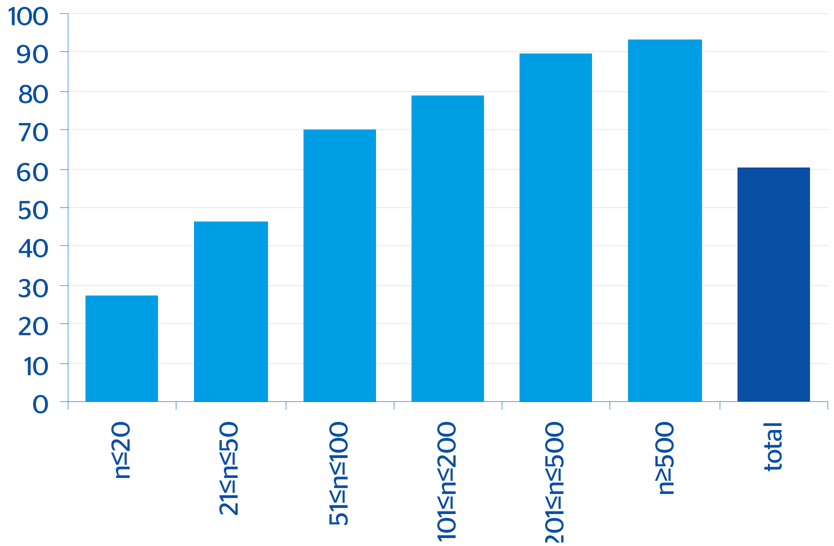
- Tenuous progress in signing of corporate collective bargaining agreements
- Arbitration does not eliminate "ultra-activity"
- Proposal still restrictive in terms of internal flexibility
- The possibility of removing wage-related clauses from collective agreements is still complicated
- The effectiveness of the reform will depend on the goodwill of the parties

Driving an improvement in productivity

- In Spain, aggregate exports of goods show a positive correlation to company size, a key factor in international expansion
- Initiative to boost the growth of small businesses is crucial to exploit economies of scale.

Percentage of exporting firms by company size (average 1990-2009)

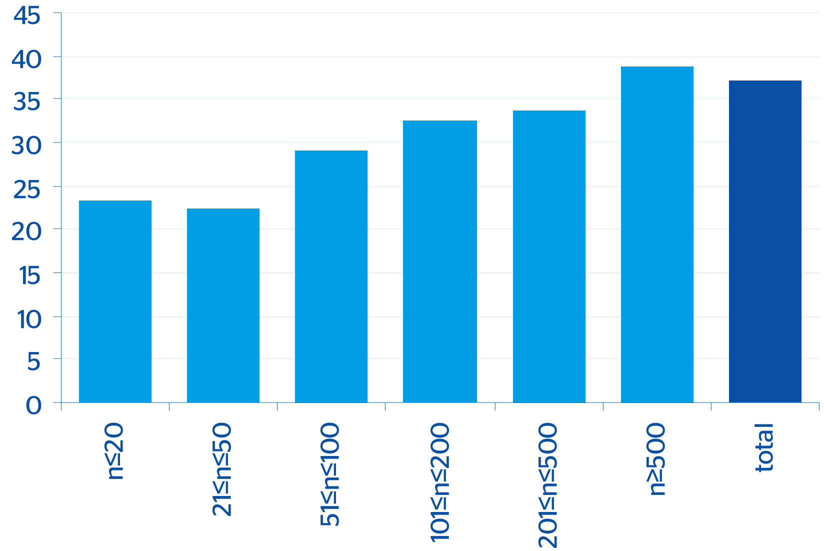
Source: BBVA Research based on BSS data (SEPI foundation)



Note: n is the number of employees

Value of exports as a share of total sales by company size (average 1990-2009, %)

Source: BBVA Research based on BSS data (SEPI foundation)



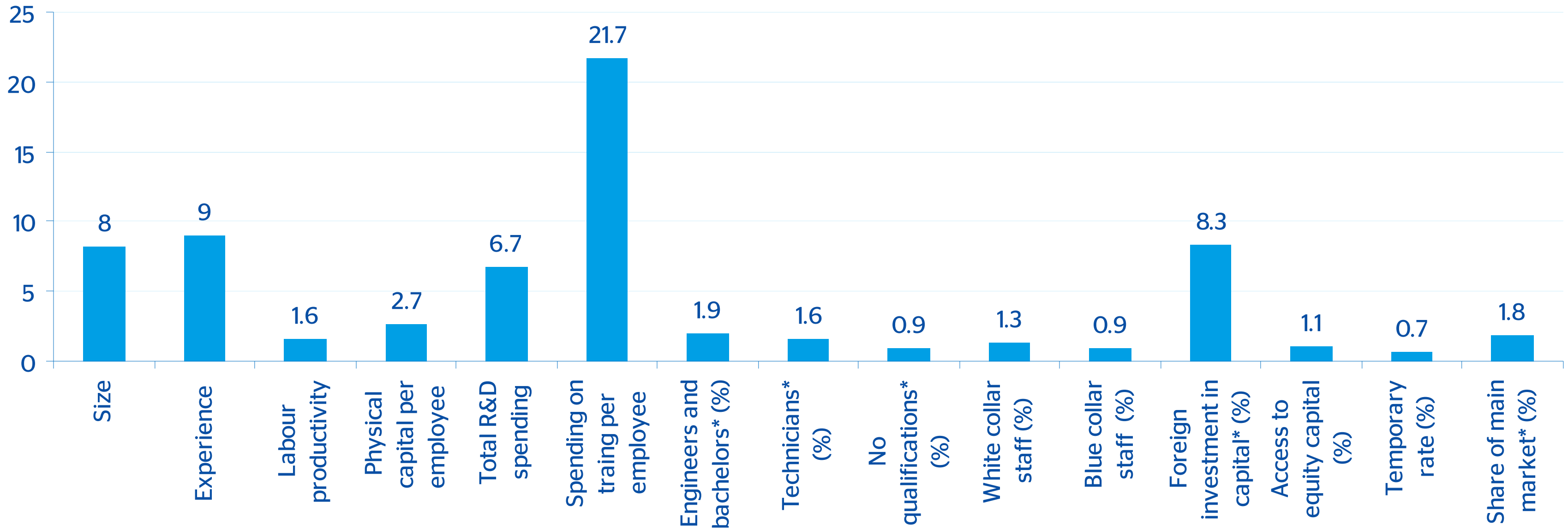
Note: n is the number of employees

Driving an improvement in productivity

- In addition to their larger size, exporters have greater experience, better productivity and, particularly, higher physical capital per employee, and they are more willing to invest in R&D than non-exporters, making them more competitive abroad.

Differentiating features of exporters versus non-exporters, average 1990-2009

(ratio of medians)
Source: BBVA Research based on BSS data (SEPI foundation)

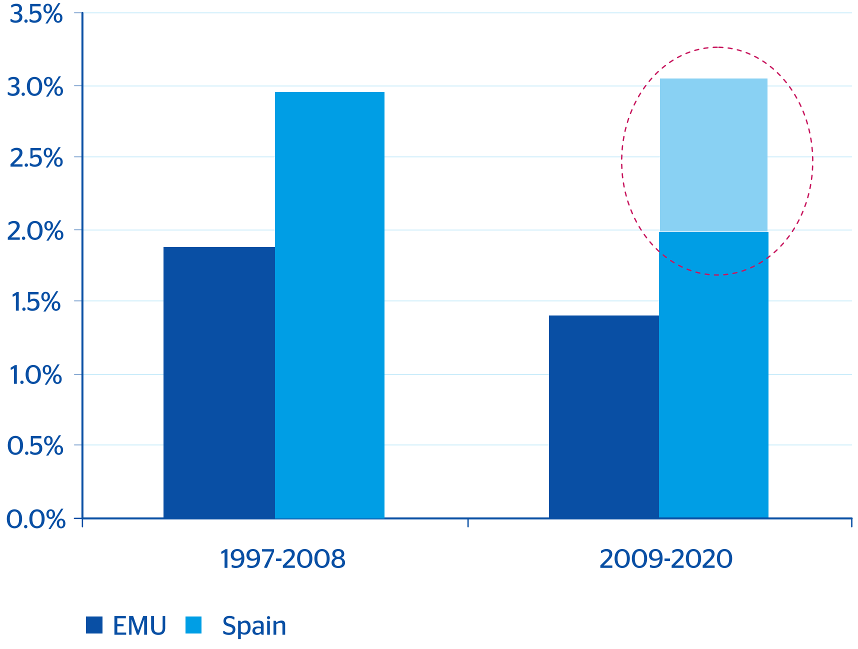


Note: Size refers to number of employees; experience is measured as the difference between the year the company was founded and the average foundation date for all companies in the sample; productivity (VA per employee), physical capital and external spending on training are expressed in thousands of euros per employee; R&D spending is in thousands of euros; foreign-owned capital as a share of the company's total capital; access to equity capital is equity capital/equity and liabilities; * figure is the average; experience, R&D spending and spending on training show the absolute difference between the medians of the distribution.

Spain needs to step up reforms

- The risk premium is higher than the country's fundamentals and would decrease if the solvency issues in Europe are cleared up and other internal reforms are pushed through:

Spain vs. EMU: potential GDP (% yoy)
Source: BBVA Research



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