



BBVA Research

Spain

Economic Outlook

Madrid, February 9th 2011

Key themes

- **Divergences in the global economy** will continue as emerging and developed countries intensify their decoupling, both growth- and policy-wise.
- **Economic and institutional reforms in Europe** will be key to resolving the financial crisis.
- The Spanish economy ended **2010** with a 0.2% fall in GDP, effectively **stagnated**.
- Good progress on the government's **fiscal adjustment** and control measures: Spain will achieve its public sector deficit target.
- Spain's economic recovery will remain weak in the short term. Growth in **2011 expected to be around 0.9%**.
- In **2012 the economy will return to a growth rate of around 1.9%**, increasing net job creation and slightly reducing the unemployment rate.
- The sovereign debt crisis evidences the importance of **maintaining the reforming effort**. Spain needs to press ahead with the orderly restructuring of its financial system and continue to foster an employment-creation and growth-friendly environment.

- 1. International environment: decoupling continues**
2. Growth outlook: Boost from foreign demand while domestic demand remains weak
3. Spain and the sovereign debt crisis: essential to maintain reforming effort

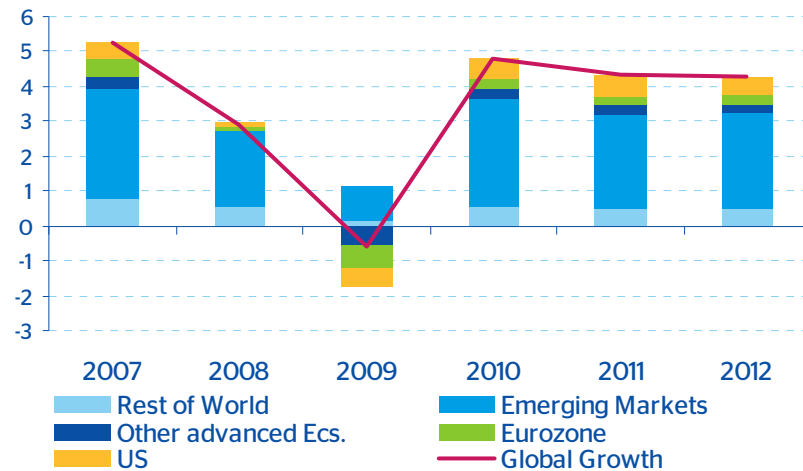
International environment

Strong growth in the global economy driven by emerging markets

- The global economy will continue its strong expansion, growing 4.4% in 2011 and 2012.
- Greater dynamism from emerging economies (especially the EAGLES©).
- Intensified decoupling among developed economies: US will continue growing faster than Europe and, within Europe, the core countries will outgrow the periphery.

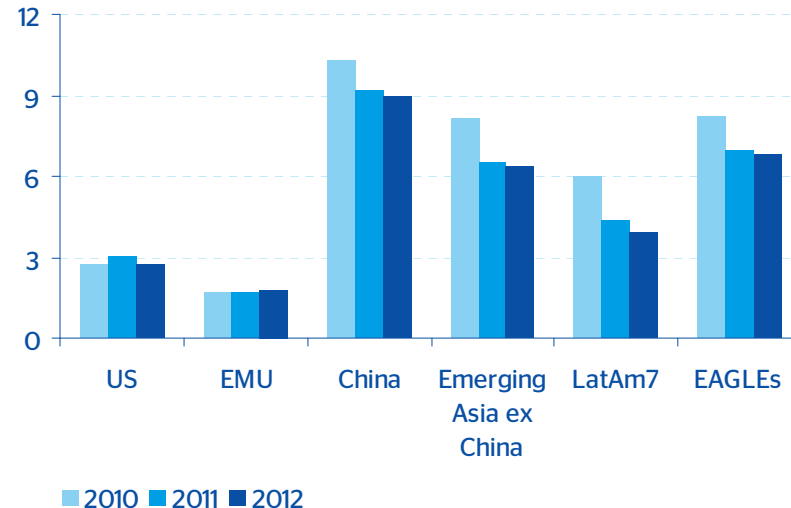
Contributions to world growth

Source: BBVA Research



Growth forecasts

Source: BBVA Research



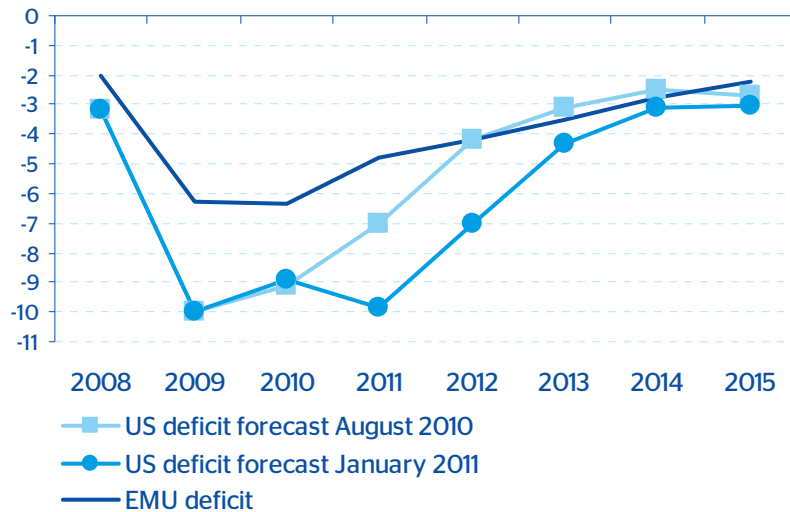
International environment

US growth outlook improves

- Our view that the danger of the US slipping back into recession has been confirmed by good macro data and the latest monetary and fiscal stimulus measures.
- Growth forecasts have been revised up by 0.7pp (to 3%) in 2011.
- Overall, growth will remain too weak to significantly reduce unemployment rates and drive a sharp growth in disposable income

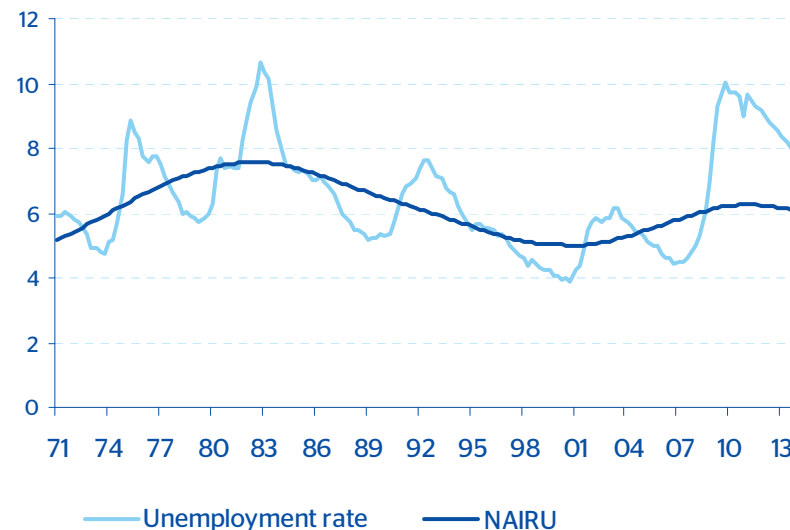
US and euro zone public deficits (% GDP)

Source: BBVA Research and CBO



US: Unemployment rate

Source: BBVA Research and Bureau of Labor Statistics



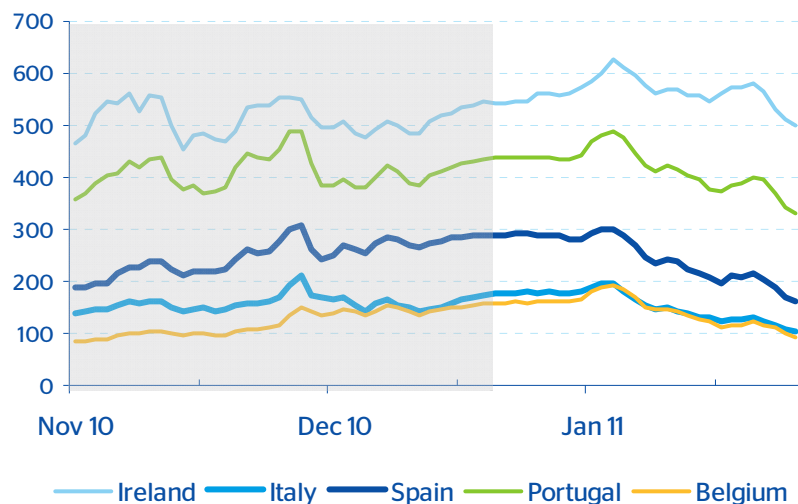
International environment

In Europe, a window of opportunity is opening to resolve the crisis and narrow cyclical divergences

- Financial tensions in Europe surged again, triggered by reduced confidence in the ability of European institutions to deal with the sovereign debt crisis.
- Credibility of stress tests were in doubt, given the developments in Ireland's financial system.
- In order to reduce decoupling between European core countries and the periphery, decisive steps towards a European governance reorganisation and economic reforms are required

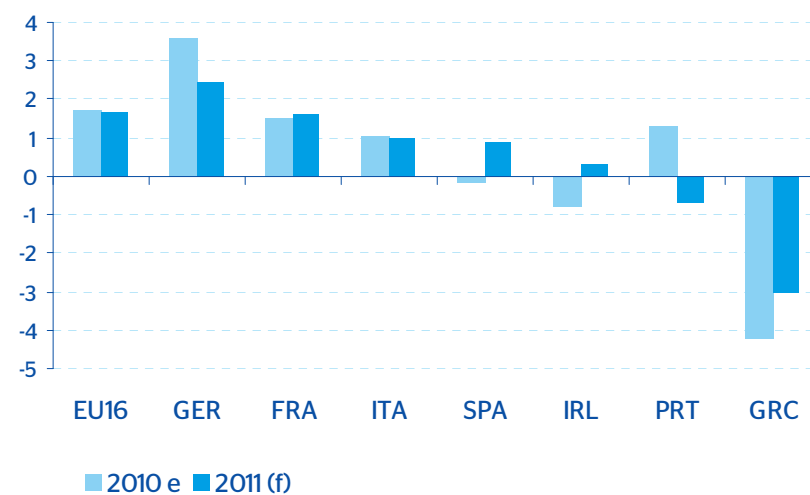
Sovereign CDS spreads versus Germany

Source: BBVA Research and Bloomberg



Euro zone growth forecasts (GDP growth, % yoy)

Source: BBVA Research



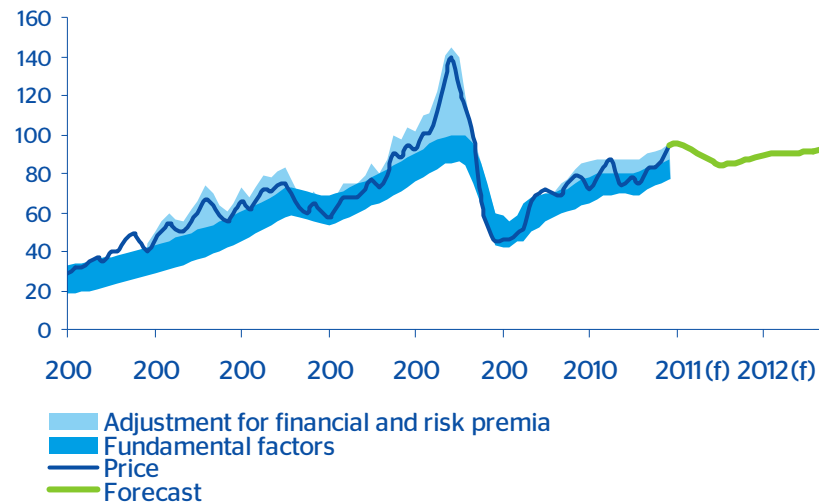
International environment

Rising commodity prices have spurred inflation indicators

- Commodity prices have been rising over recent months due to a number of short-term factors: bad weather and greater investment flows into commodity markets.
- Stabilisation of commodity prices scenario
- For now, neither inflationary expectations nor core inflation pose any threat to monetary policy

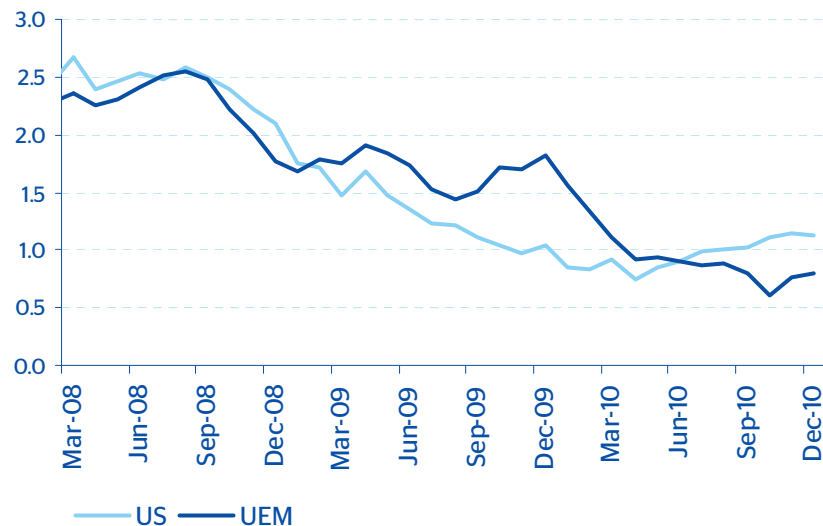
Oil price (Brent, USD per barrel)

Source: BBVA Research and Bloomberg



Core inflation, year-on-year (%)

Source: BBVA Research based on Eurostat and BA



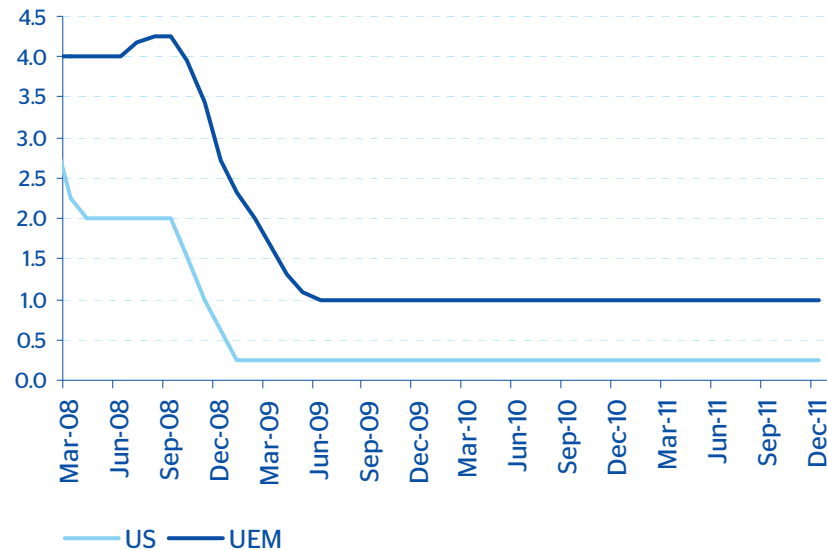
International environment

Low interest rates

- Developed countries will maintain low interest rates for an extended period.
- The easing of financial pressures in Europe will intensify upward pressure on the dollar exchange rate.
- However, the long run trend is towards a weakening of the euro versus the dollar.

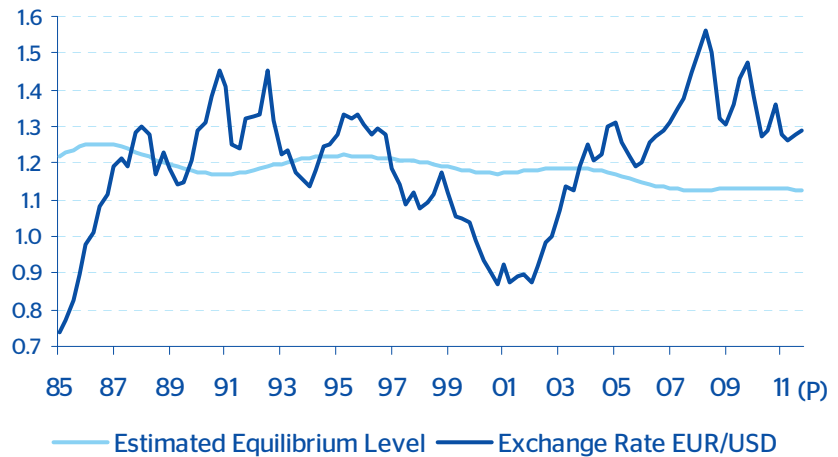
Official interest rates

Source: BBVA Research and Haver analytics



Dollar-euro exchange rate and estimated equilibrium level

Source: BBVA Research





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2. **Growth outlook: Boost from foreign demand while domestic demand remains weak**
3. Spain and the sovereign debt crisis: essential to maintain reforming effort

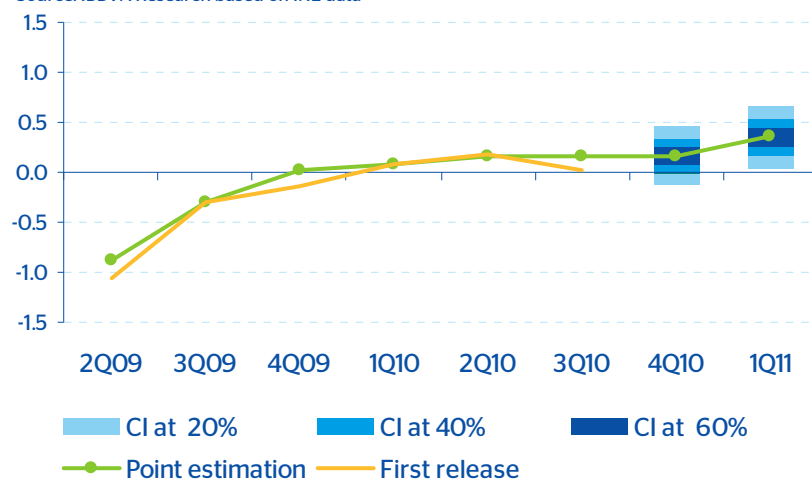
Growth outlook

After a pause in 3Q10, the Spanish economy returned to growth in 4Q10 and 1Q11

- The Spanish economy seems to have grown by one or two tenths in the fourth quarter and to be heading for two to three tenths in the first quarter of 2011.
- 2010 ended with an annual 0.2% fall in GDP, effectively stagnating.

Spain: observed GDP growth and forecasts based on MICA-BBVA model (% qoq)

Source: IBBVA Research based on INE data



However, growth was too weak to create jobs...

...private domestic demand remained roughly stagnant...

...while public domestic demand helped meeting the public sector deficit targets in 2010

Foreign demand again sustained growth in the Spanish economy

The temporary rise in crude prices mitigated the fall in the current account deficit

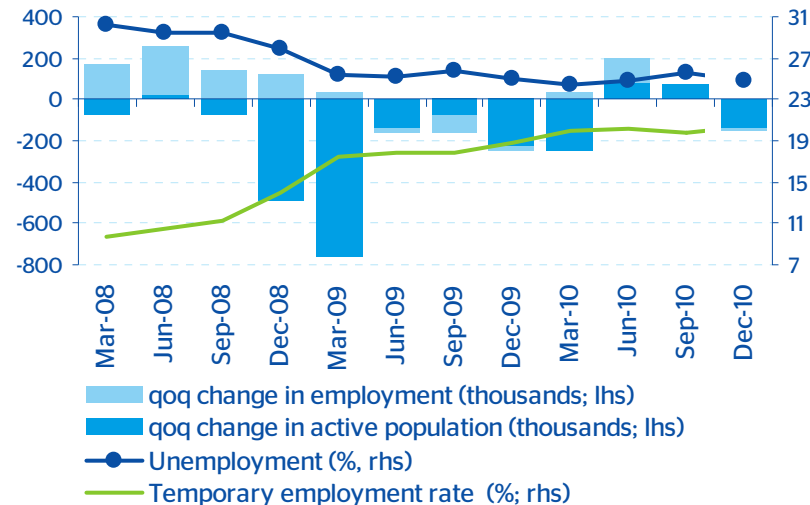
Growth outlook

After a pause in 3Q10, the Spanish economy returned to growth in 4Q10 and 1Q11

- Although the active population fell slightly, job destruction drove the unemployment rate up to 20.3% in 4Q11.
- For the full year, unemployment climbed to 20.1% as the economy destroyed a net 432,000 jobs.

Spain: labour market data

Source: BBVA Research based on INE data



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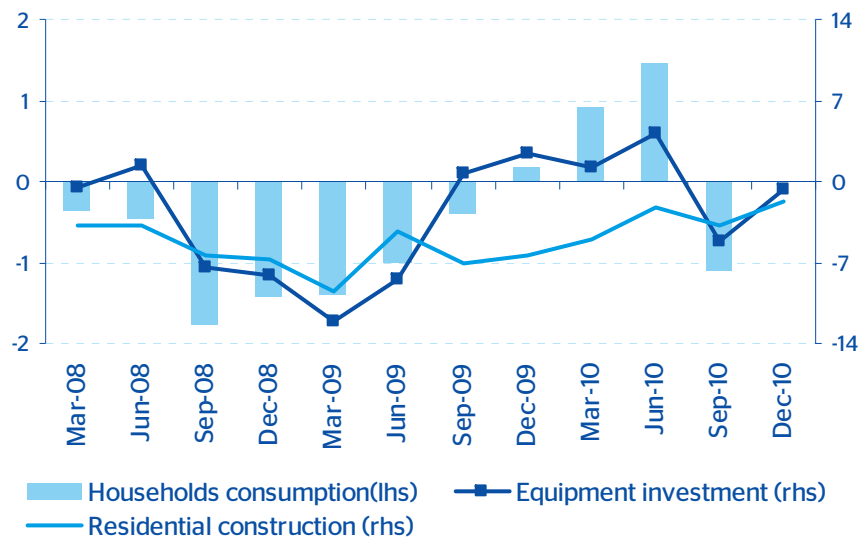
Growth outlook

After a pause in 3Q10, the Spanish economy returned to growth in 4Q10 and 1Q11

- Stripping out the impact of changes in fiscal policy, domestic demand began growing again in 4Q10, although still at a slow pace due to the weakness of its fundamentals.
- The trend in private domestic demand was dominated by fiscal policy and made a negative contribution to economic growth in 2010.

Spain: components of private domestic demand (% qoq)

Source: BBVA Research based on INE data



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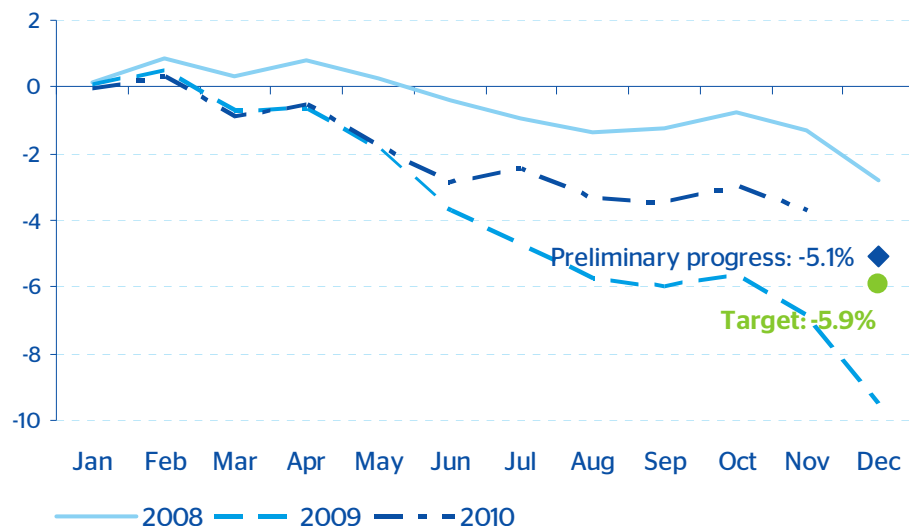
Growth outlook

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- The successful implementation of the central government's fiscal adjustment plan and control measures ensure that the public sector meets its target of -9.3% of GDP.
- Public sector consumption was effectively flat in 2010, while investment in non-residential building contracted by around 6.7%.

Central government: non-financial balance (cumulative annual % of GDP)

Source: BBVA Research, based on MEH data



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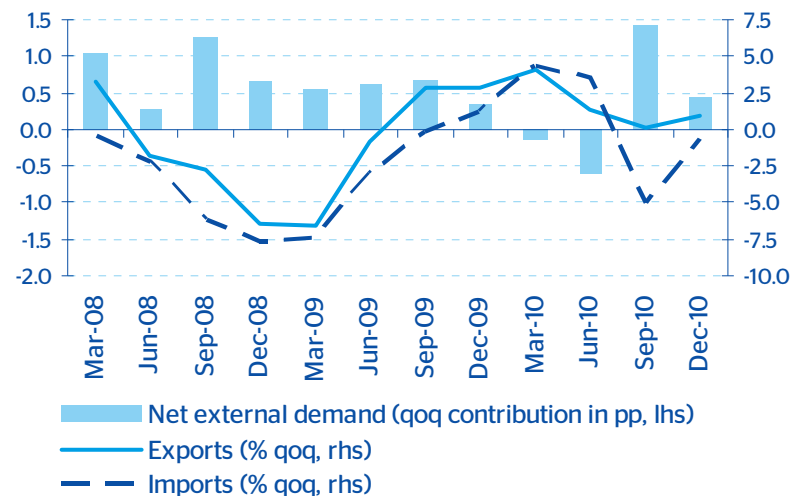
Growth outlook

After a pause in 3Q10, the Spanish economy returned to growth in 4Q10 and 1Q11

- Growth in world demand, coupled with increasing geographical diversification and sustained competitiveness gains, led Spain's exports growth in 4Q10.
- Net export demand added 1pp to economic growth in 2010.

Spain: Exports and imports

Source: BBVA Research based on INE data



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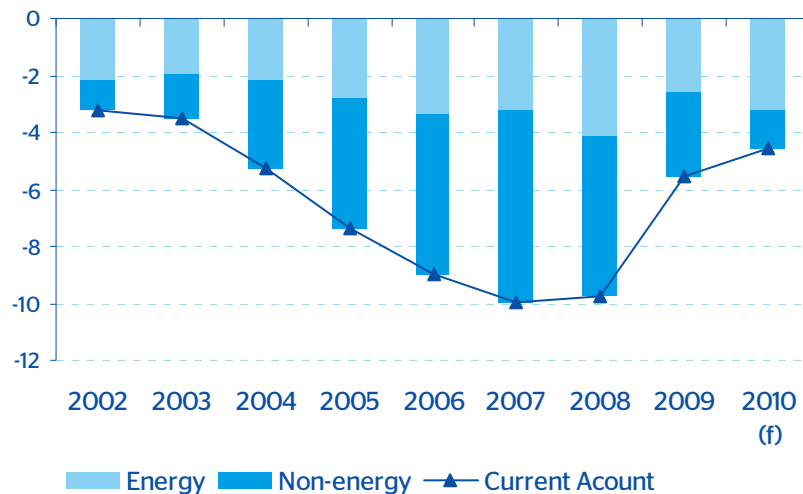
Growth outlook

After a pause in 3Q10, the Spanish economy returned to growth in 4Q10 and 1Q11

- The rise in oil prices was transitory and it did not deteriorate Spain's international competitiveness. It did, however, affect the current account balance at the end of the year.
- The current account deficit for 2010 is likely to be 4.5% of GDP, roughly 0.9 tenths below that recorded in 2009.

Spain: Energy and non-energy deficit vs current account balance

Source: BBVA Research based on BoS and Industry, Tourism and Trade data



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Growth outlook

Outlook 2011-2012: adjustments continue

Negative contribution from the public sector and weak recovery in private domestic demand.

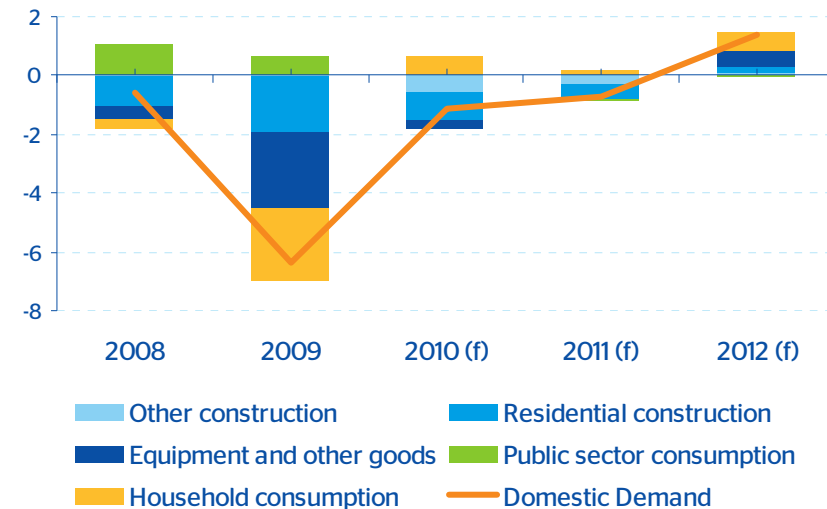
Factors affecting the outlook for 2011-2012

Domestic demand

- Fiscal consolidation
- Ongoing adjustments in the private sector
- Monetary policy set to remain accommodative
- Despite moderation, financial stress remain high

Spain: contributions to GDP growth (% yoy growth)

Source: BBVA Research based on INE and Eurostat data



Growth outlook

Outlook 2011-2012: adjustments continue

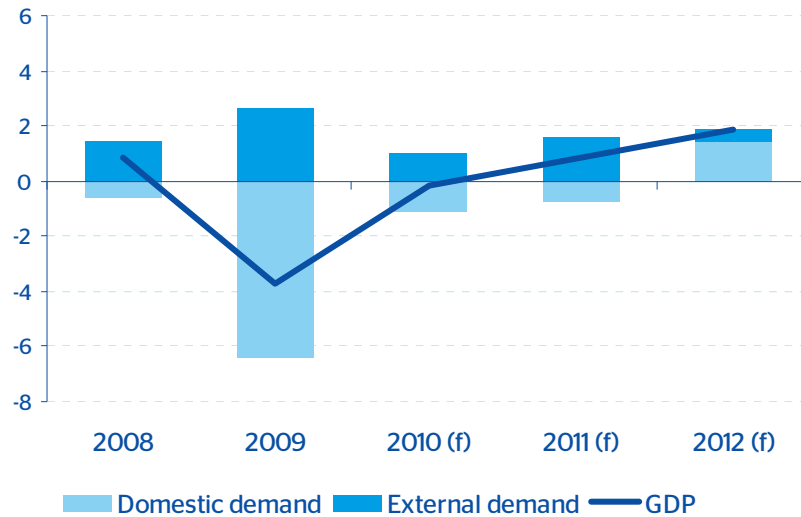
Exports will continue to lead recovery.

Factors affecting the outlook for 2011-2012

Spain: Contributions to GDP growth

(% chg, yoy)

Source: BBVA Research based on INE and Eurostat data



External demand

- Better outlook for European and global economies
- Euro exchange rate less strong than expected three months ago
- Continued gains in real competitiveness and greater diversification towards emerging economies

Growth outlook

Outlook 2011-2012: adjustments continue

- Spain's economic recovery will be weak in the short term.
- Sustained recovery will begin from 2H11. In 2012, the economy will return to 1.9% growth, enough to create jobs but not to significantly reduce the unemployment rate.

Macroeconomic forecasts

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

(y-o-y change, %)	2009		2010		2011		2012	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	-4.3	-1.0	1.1	0.7	0.2	1.0	1.2	1.5
Public consumption	3.2	2.4	0.0	0.7	-0.6	0.4	-0.3	0.7
GFCF	-16.0	-11.3	-7.6	-1.0	-2.9	1.6	3.4	2.0
Capital goods and other products	-21.2	-15.9	-2.4	2.5	0.6	2.8	5.0	3.2
Capital goods	-24.5	-17.6	1.5	3.6	0.7	2.7	5.5	3.0
Other Products	-16.2	-7.6	-7.7	-2.3	0.3	3.2	4.2	4.2
Construction	-11.9	-7.8	-11.1	-3.5	-5.3	-0.2	2.3	0.8
Housing	-24.5	-10.7	-17.3	-3.3	-7.1	-0.1	4.1	0.7
Other	-0.1	-4.9	-6.7	-3.8	-4.1	-0.3	1.0	0.8
Chg. in Inventories (*)	0.0	-0.7	0.0	1.3	0.0	0.1	0.0	0.0
Domestic Demand (*)	-6.4	-3.3	-1.1	1.7	-0.7	1.1	1.4	1.4
Exports	-11.6	-13.1	9.0	9.7	9.1	6.9	7.0	5.7
Imports	-17.8	-11.8	4.4	9.9	2.0	5.6	4.6	4.9
Net exports (*)	2.7	-0.8	1.0	0.0	1.6	0.6	0.5	0.4
GDP mp (% y-o-y)	-3.7	-4.0	-0.2	1.7	0.9	1.7	1.9	1.8
Pro-memoria								
GDP w/out housing investment	-1.9	-3.7	0.9	2.0	1.4	1.8	1.7	1.8
GDP w/out construction	-2.1	-3.6	1.6	2.3	1.9	1.9	1.8	1.9
Employment (LFS)	-6.8	-1.8	-2.3	-0.4	-0.2	0.4	1.1	0.6
Unemployment rate (% active pop.)	18.0	9.5	20.1	10.0	20.6	10.0	20.1	9.9
Current account balance (%GDP)	-5.5	-0.7	-4.5	-0.5	-3.1	0.0	-2.8	0.1
Public sector balance (%GDP)	-11.2	-6.3	-9.0	-6.5	-6.0	-4.7	-4.5	-3.9
CPI annual average	-0.3	0.3	1.8	1.6	1.9	1.8	1.3	1.6

(*) contributions to GDP growth

Growth outlook

Outlook 2011-2012: adjustments continue

- By region, the impact of the macroeconomic imbalances accumulated during the boom and the crisis will affect recovery in 2011. Spanish growth is still characterized by sharp regional divergences.

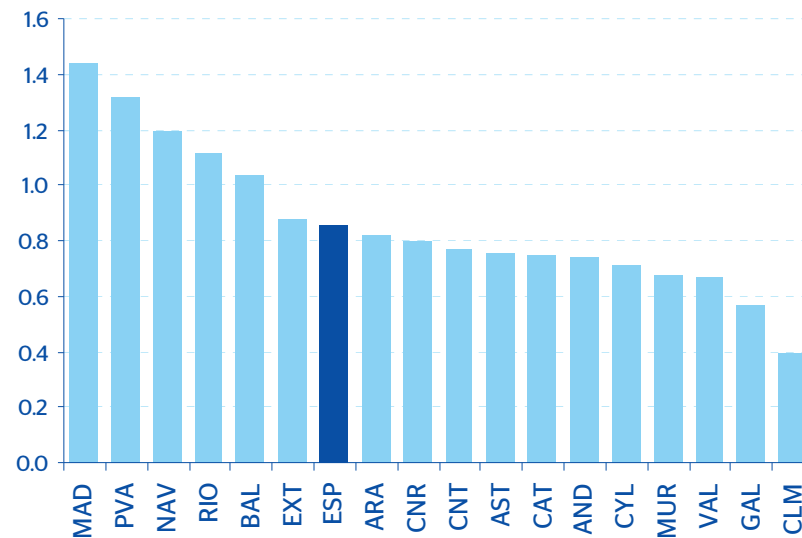
	Surplus housing supplies	Private Debt	Unemployment	Debt Autonomos Regions	Public Consolidation	External Openness	Global Index
Basque Country	✓		✓		✓		7.2
Asturias		✓					3.5
Cantabria	✓		✓				3.5
Madrid					✓		3.4
Navarre			✓		✓	✓	2.3
Aragón						●	1.2
La Rioja							1.1
Galicia							0.4
C. y León		✓					0.2
Balearic Is.		●		●		✓	-0.2
Catalonia				●		✓	-0.7
Extremadura		✓			●	●	-1.5
Canary Is.			●			✓	-1.6
Murcia	●	●	●				-4.3
C. La Mancha	●			●	●	●	-4.7
C. Valenciana				●			-4.7
Andalusia		●	●		●	●	-5.2

Source: BBVA Research based on INE data

Spain: GDP growth in 2011

By region (yoy, %)

Source: BBVA Research based on INE data



Growth outlook

However, uncertainties remain as to how dynamic the recovery will be

Downward risks

- Delays in resolving Europe's governance issues
- Failure to meet deficit targets
- Risks on financial system restructuring
- Possible second-round effects from the recent increase in crude prices

Upward risks

- Stronger growth in the global economy
- Consolidation of structural reform process:
 - long-term sustainability of public pension system
 - efficient Public Administrations funding systems, and
 - resolution of regulatory issues affecting markets for goods and services



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Maintaining reforming effort

1 European governance: progress on crisis resolution mechanisms

Short term

Address the liquidity and solvency issues in order to restore market confidence

Liquidity problems

Improve EFSF in quantity and quality

Solvency problems

- EC should determine which countries are not solvent
- The EC to decide which countries are insolvent:
 - For these countries, debt should be reduced to levels deemed sustainable (below 100% of GDP)
 - Key: Excess debt issuance to be mostly absorbed by the rest of the Eurozone governments
 - Greater conditionality

Long term

Designing a strong framework of crisis prevention (reinforced fiscal coordination) and crisis resolution to apply once the crisis is over (as from 2015)

Prevention

- European Stability Mechanism: New SGP including debt levels and macro imbalances. Reinforced sanctions. Key: make them fully automatic
- Rigorous national fiscal rules
- Eurobonds covering up to 60% of national debt and introduction of some degree of fiscal transfers across countries

Resolution

- Bail-in mechanisms to be introduced (lower rates, extension of maturities...)

Maintaining reforming effort

2 Spain: progress on financial restructuring Recapitalisation plan

Details of announcement

- September: deadline for complying with the 8% core capital minimum requirement for all banks.
- Bank of Spain will analyze whether entities are able to reach the 8% core capital minimum requirement.
- In case of perspective for non-fulfillment, the FROB will recapitalise entities after being converted into banks.

Assessment

- Awaiting for the full release of details, the plan contains favourable elements.
- Clear roadmap for the continuation of the financial system restructuring.
- Participation of the private capital in the recapitalization process encouraged,
- High probability of conversion into banks.
- Room for maneuver to recapitalisation from FROB.

The immediate recapitalisation through private capital inflows would raise credibility in international markets, increase efficiency and reduce pressure on Spanish sovereign debt

Maintaining reforming effort

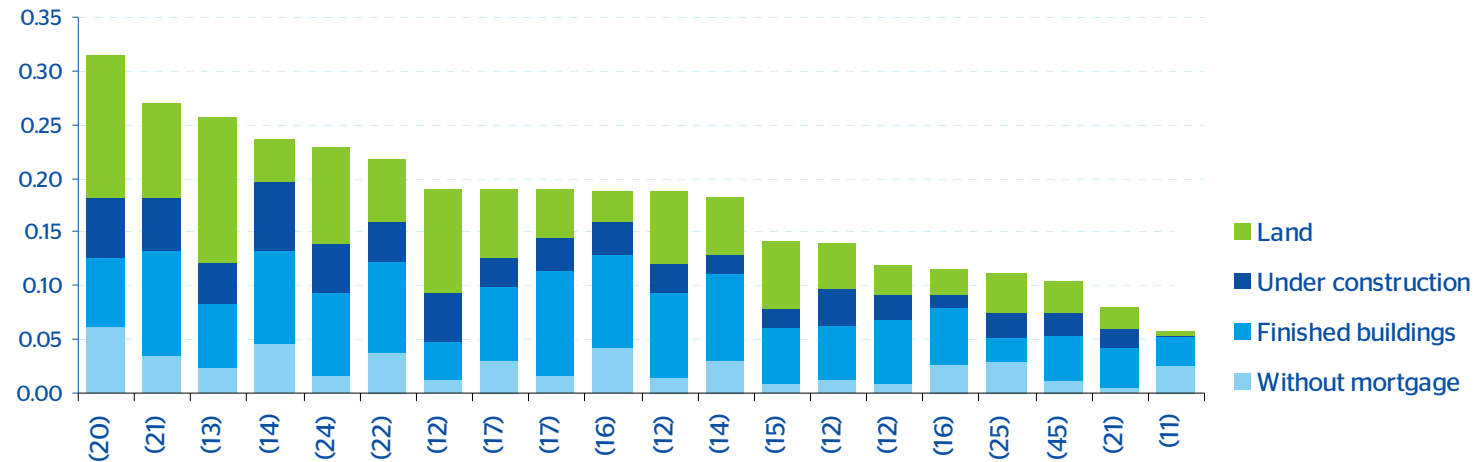
2 Spain: progress on financial restructuring

Diversity of the loan book

Exposure to property developer loans

(% of loan book)

Source: BBVA Research based on individual data



Note: NPL rate of builders and property companies in brackets

There are differences in exposure to property loans, both in composition and loan quality

Maintaining reforming effort

2 Spain: progress on financial restructuring

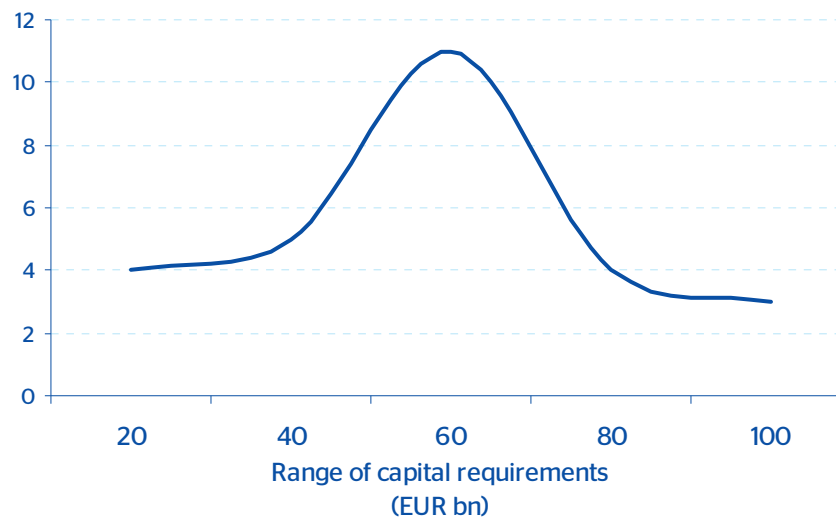
Diversity in estimates of capital requirements

- Analysts estimates use different assumptions for:
 - Forecast horizon
 - Expected losses on portfolios
 - Profits before provisions
 - Minimum capital: core 8%, Tier1 6% etc.
 - Macroeconomic and financial scenarios
- Government estimates are different: capital required to achieve a core ratio of 8% (or 9% to 10% in some cases) at the time of the test based on risk-weighted assets as of December 2010.

Estimated capital requirements

(Total estimates used: 23)

source: BBVA Research based on analysts' reports



Maintaining reforming effort

2 Spain: progress on financial restructuring

- Under the risk scenario, requirements will be limited and achievable.
- After the recapitalisation scheduled for this year, institutions will be comfortably solvent for the next few quarters.
- In a simulation of a highly probable scenario, by the end of 2012 entities with core capital below 6% will only hold 10% of total assets.

Assumptions on expected portfolio losses

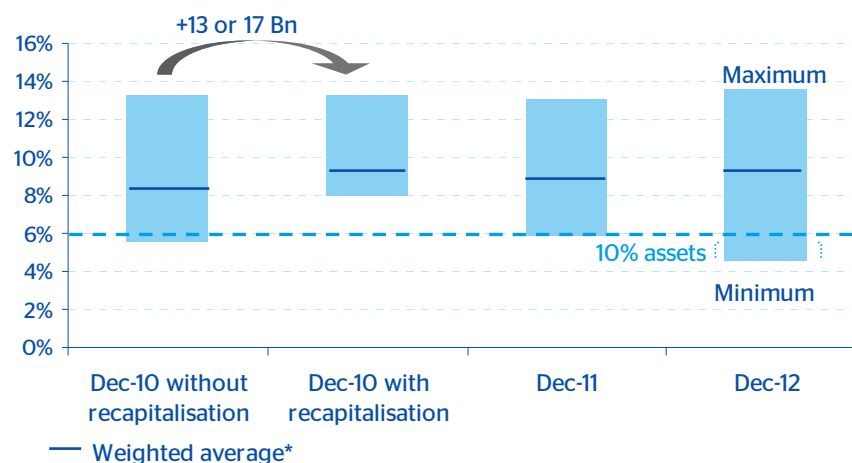
Fuente: BBVA Research

Loan Portfolio	Expected losses
Companies and corporations	5.5%
Promoters	16.6%
Allocated	37.8%
Mortgages	1.5%
Consumer loans and credit cards	10.1%

Simulation of core capital ratio

(% of risk weighted assets)

Source: BBVA Research



Maintaining reforming effort

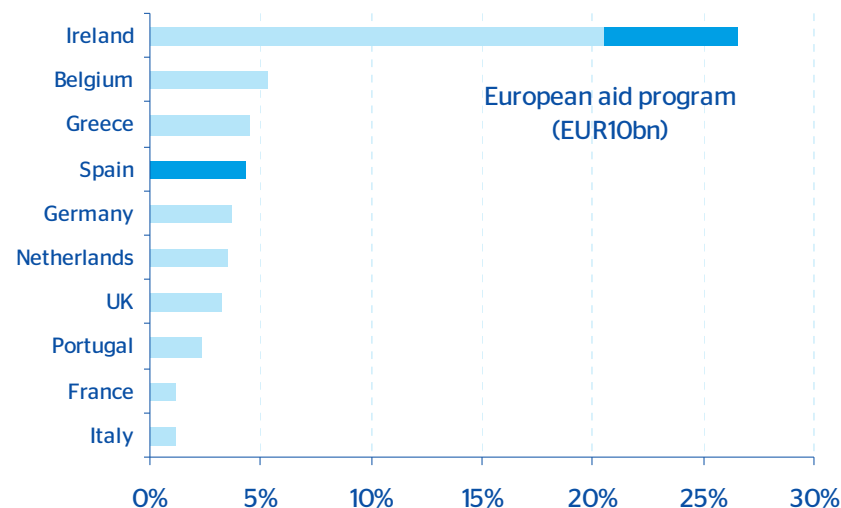
2 Spain: progress on financial restructuring

- The capital needs required by the Strengthening Plan are feasible for the State::
 - EUR 15.5bn already provided by the FROB and FGD,
 - EUR 13bn-EUR 17bn to achieve 8% core capital (or more in some cases) in December 2010,
- A reduced part of the system might require a limited amount of additional capital in the future.

- **European and Spanish regulations set conditions for entities in receipt of aid funds:**
 - Balance sheet restructuring plans (to resolve the problem of overcapacity)
 - No unfair competition in prices
 - Professionalisation of governance bodies
 - Other measures that allow the FROB to rapidly exit its capital stakes
- **International experience: Asset Protection Schemes will probably be needed in some cases**

Europe: injections of public sector capital to the banking sector (% of national GDP)

Source: BBVA Research



(*) FROB funds do not count as recapitalisation in the strict sense although they are similar in effect

Maintaining reforming effort

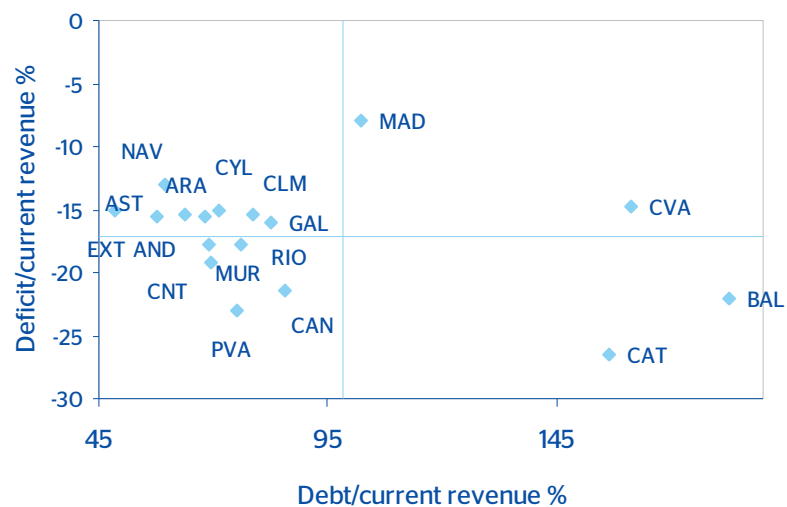
3 Extreme rigour in continuing fiscal adjustment

- Short term: transparency and fiscal discipline.
- Regional governments at greatest risk of failing their 2010 deficit targets represent 24% of national GDP. However, there is no danger of the public sector as a whole missing its target.
- Fiscal consolidation needs to continue in future, particularly in 2011.

Relative position of Spanish regions in 2011

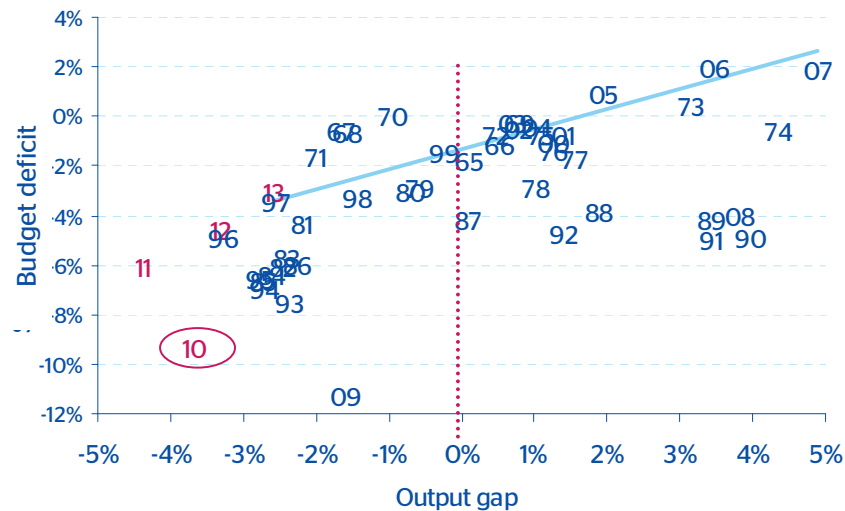
(based on budget forecasts)

Source: BBVA Research based on regional budgets and MEH data



Budget deficit vs. Output gap

Source: BBVA Research



Maintaining reforming effort

3 Extreme rigour in continuing fiscal adjustment

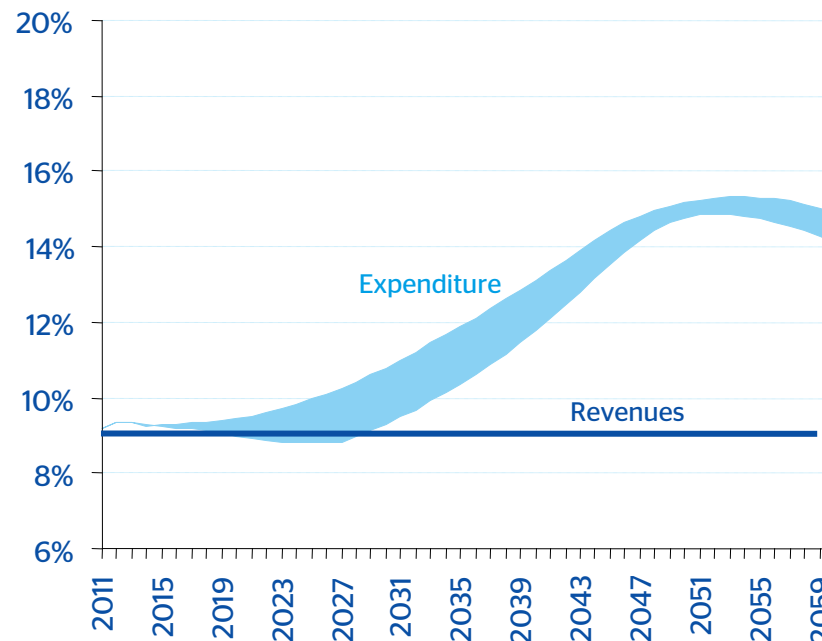
- The pension system reform will improve the outlook on the system sustainability by reducing pension expenditure over GDP.
- It is a significant reform, which introduces important changes into the system.

Sustainability Factor

- Given the existing uncertainties over employment, productivity and demography, it is convenient that the reform assessment shall start from its implementation.
- If needed, the sustainability factor should be applied before 2027.

Public pension expenditure as a % of GDP: simulations after reform

Source: BBVA Research



Maintaining reforming effort

3 Extreme rigour in continuing fiscal adjustment

There are clear similarities in the reforms of the Spanish and German public pension systems. However, the Spanish system remains more generous.

	Spain	Germany
Official retirement age	67	67
Number of contribution years at official age, for 100% base pension	38,5	45
Rate of public pension substitution before reforms	81,2%	48%
Early retirement age	61/63	63
Number of contribution years for early retirement	33	35
Rate of public pension substitution after reforms	69% (e)	43%
Sustainability correction factor	Starting as of 2027	SI
Years' credit for dependent children	2	3
Third-pillar coverage of population	7%	64%

(e): estimated value

Maintaining reforming effort

4 Sector diversification, internationalisation and company size

- Starting from a good position to increase potential growth.
- Based on profitability, comparatively low debt ratios, and international openness, there are sectors capable of leading Spanish growth over the medium to long-term horizon.

	Indebtedness		Profitability		Real GVA	Exports
	Spain	Average (AL-FR-IT)	Spain	Average (AL-FR-IT)	Share in Spanish GVA	Share in Spanish Exports
Textile industry	51.8	54.6	4.0	4.2	0.7	2.9
Manufacture of chemicals and chemical products	54.3	47.2	5.5	5.9	1.7	8.9
Hotels and restaurants	56.2	58.8	8.9	4.0	7.3	14.5
Post and telecommunications*	62.6	57.4	19.7	14.2	4.0	0.5
Transport	42.2	51.9	7.4	2.4	5.6	5.7
Automobiles and transport equipment	63.6	53.1	0.7	0.2	2.2	14.7
Electricidad, gas y suministro de agua	51.2	42.7	14.7	8.7	3.7	0.6
Basic metals and fabricated metals	43.3	55.0	6.4	4.6	2.6	4.7
Manufacture of food products, beverages and tobacco	54.1	54.4	7.3	3.5	2.7	9.4
Manufacture of office, accounting and IT machinery	56.9	33.5	1.7	0.7	0.1	0.9
Manufacture of machinery and electrical apparatus	61.4	49.9	6.1	4.3	0.8	4.4
Computer programming, consultancy and related activities	57.5	49.5	6.0	5.4	7.1	9.2
Wholesale trade and commission trade, except of motor vehicles	61.5	62.8	3.2	2.4	4.1	
Retail trade, except of motor vehicles	57.3	62.7	4.5	2.0	6.4	
TOTAL					49.0	76.4

Indebtedness: Borrowings/total assets, annual average (2000-2007). Based on Bach database

Profitability: net profit/net revenue, annual average (2000-2007). Based on Bach database

* Average (GE-IT)

Real GAV: based on INE data (sector GAV as % of GAV in 2008)

Exports: based on OECD and DATACOMEX data, 2008. Services represent 33.8% of total exports

Maintaining reforming effort

4 Sector diversification, internationalisation and company size

Increase competition

For the reorientation of the factors of production to be accompanied by a rise in employment and increased profitability, it is desirable to support labour market reforms with better regulation of product markets that:

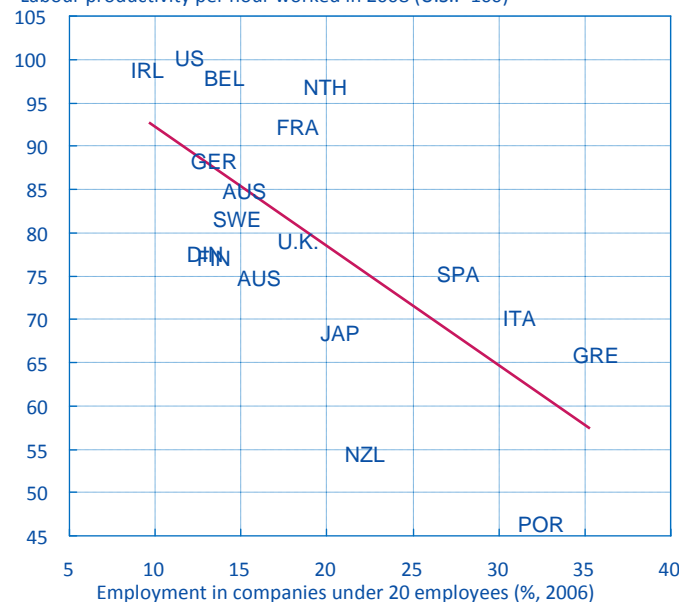
- reduce entry barriers,
- encourage the adoption of new technologies,
- promote competition, and
- encourage companies to increase size.

Company size and productivity

(Correlation: 0.7)

Source: BBVA Research

Labour productivity per hour worked in 2008 (U.S.=100)



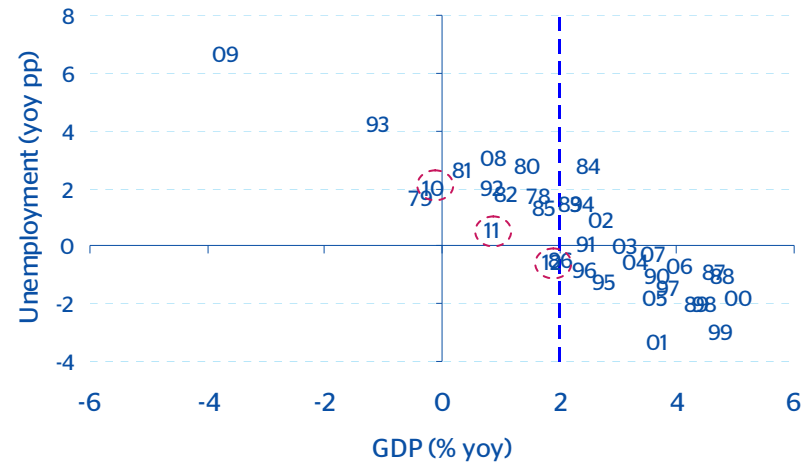
Maintaining reforming effort

5 A better functioning of the labour market

- In recent decades Spain has needed growth rates above 2% to reduce its unemployment rate.
- Reforms are required that will encourage economic growth and job creation and improve the functioning of the labour market.

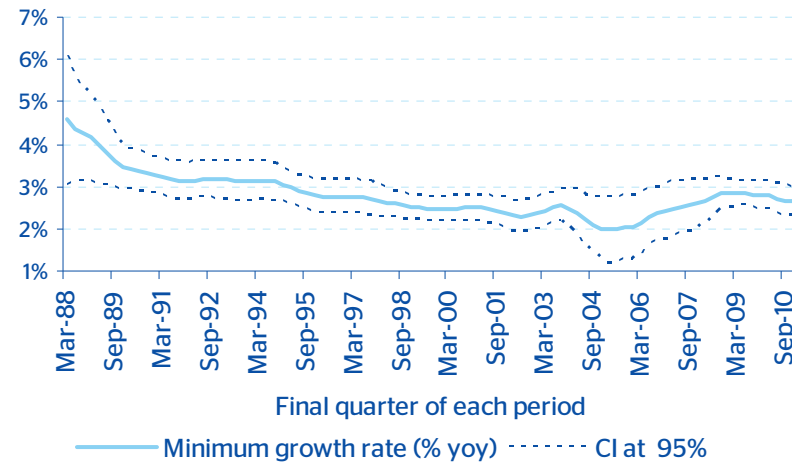
Spain: GDP growth vs change in unemployment

Source: BBVA Research based on INE data



Spain: minimum growth required to reduce unemployment (40 quarter window)

Source: BBVA Research based on INE data



Maintaining reforming effort

5 A better functioning of the labour market

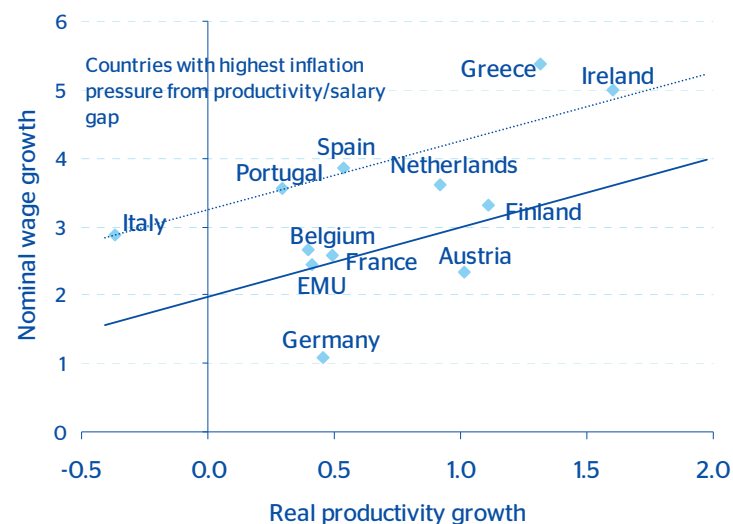
- Target: reduce uncertainty for workers –encouraging permanent contracts– and for companies – modernising the collective bargaining system.
- Inadequate wage-setting mechanism: the structure of collective bargaining in Spain is not flexible enough to cope with the heterogeneity of the various productive sectors
- Other improvements pending: reduce duality and increase in human capital.

Proposals for collective bargaining

- Salaries more related to economic conditions and company productivity
- Restrictions on duration of collective agreements
- Limits on the issues to negotiate in each area:
 - Company agreements should regulate organisational and salary issues linked to labour productivity within the company
- Elimination of salary safeguard clauses (or their conversion into symmetrical provisions)

Growth gap between wages and productivity per employee, annual average 2000-2009 (%)

Source: BBVA Research based on AMECO data



Key themes

- **Divergences in the global economy** will continue as emerging and developed countries intensify their decoupling, both growth- and policy-wise.
- **Economic and institutional reforms in Europe** will be key to resolving the financial crisis.
- The Spanish economy ended **2010** with a 0.2% fall in GDP, effectively **stagnated**.
- Good progress on the government's **fiscal adjustment** and control measures: Spain will achieve its public sector deficit target.
- Spain's economic recovery will remain weak in the short term. Growth in **2011 expected to be around 0.9%**.
- In **2012 the economy will return to a growth rate of around 1.9%**, increasing net job creation and slightly reducing the unemployment rate.
- The sovereign debt crisis evidences the importance of **maintaining the reforming effort**. Spain needs to press ahead with the orderly restructuring of its financial system and continue to foster an employment-creation and growth-friendly environment.