



Spain Economic Outlook

Fourth quarter 2010

Key messages

- **The global economy continues to grow apace, driven mainly by emerging economies**, while financial uncertainty and concerns over the sustainability of the recovery predominate in developed economies
- **In Europe, business activity has proven stronger than anticipated, but there are no signs yet of a clear-cut recovery in domestic demand** to take the baton from exports. Financial stress remains a cause for concern, although systemic risk is lower than before the summer
- **In Spain, the probability of negative quarterly GDP rates in the second half has narrowed substantially**. Even though the outlook is improving, the Spanish economy is not yet at the point of staging a sustained recovery capable of creating jobs
- **If Spanish assets are to continue to outperform** their European counterparts in the financial markets, **very decisive structural reforms are unavoidable**
- **The restructuring of a limited part of the Spanish financial system needs to gain momentum**, picking up the speed of transformation and downsizing
- **The authorities need to continue to reiterate and prove that their fiscal deficit-cutting targets are a priority**. Market concerns put the onus on the regional administrations to disclose more and enhanced information on their budget performance

Contents

Spain
Economic
Outlook
Fourth quarter
2010

Section I

International environment

Section II

Re-assessment of Spain's economic prospects

Section III

The necessary consolidation and intensification of the reform process

International environment

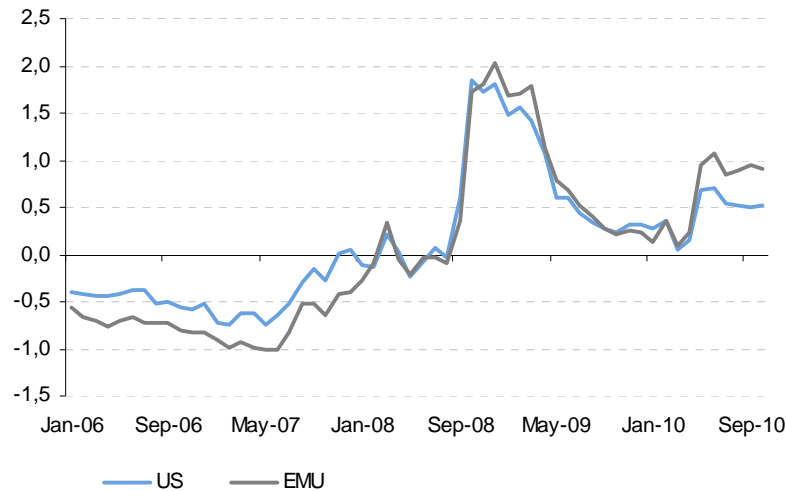
Financial pressure acute but systemic risk under control

- **Financial stress in Europe remains intense**

- Thanks to the support measures rolled out by the various European governments, and most particularly following publication of the stress tests, the markets have begun to discriminate among European assets (mainly sovereign debt). This contrasts with the dynamics prevailing prior to publication of the results of the stress tests, when risk aversion predominated
- The growing discrimination reduces systemic risk. This reduced risk is also evident in the reopening of the market, albeit selective

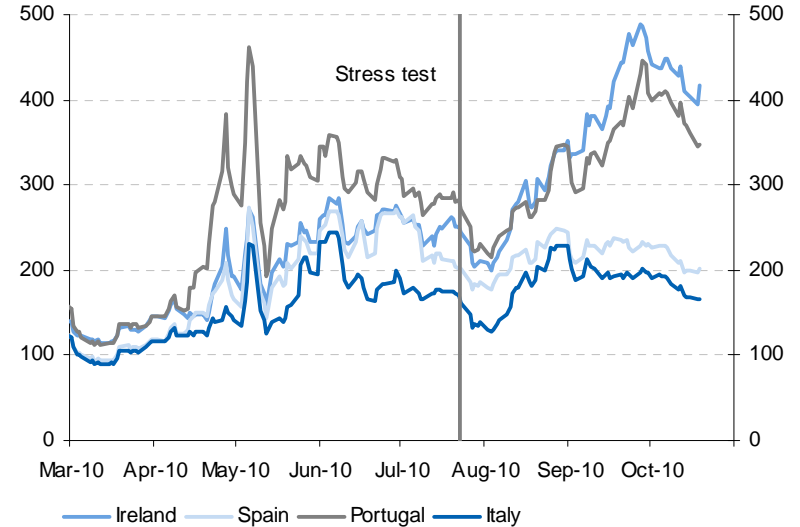
BBVA financial stress index

Source: BBVA Research



Sovereign CDS spreads for European peripherals

Source: Bloomberg and BBVA Research



International environment

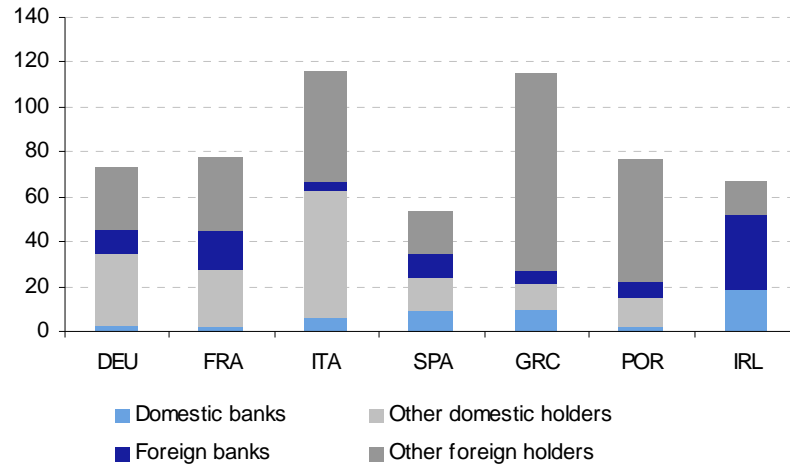
Financial pressure acute but systemic risk under control

• **Financial stress in Europe remains intense**

- Despite growing discrimination, financial stress remains the European region's biggest threat, particularly given the link between sovereign issues and the banking sector's exposure to them

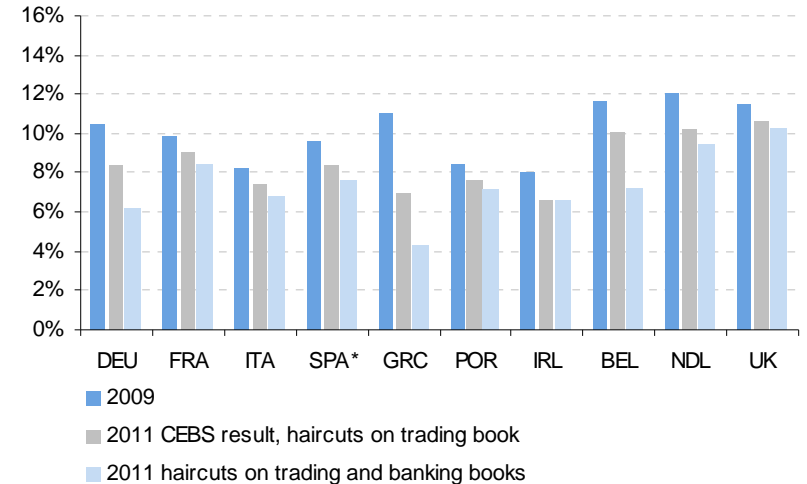
Sovereign debt holders (% of GDP)

Source: Joint BIS-World Bank-IMF database and BBVA Research



Sensitivity analysis: average Tier 1 ratio under different sovereign stress scenarios

Source: BBVA Research based on C-EBS data



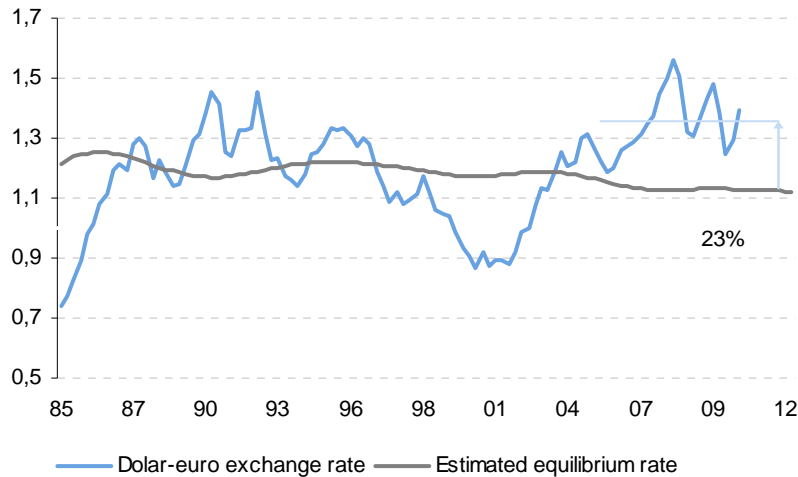
International environment

Lax monetary policy stateside has weakened the dollar

- **The outlook for muted growth coupled with tame inflationary pressures in developed economies spells protracted reduced interest rates**
 - As QE2 has already been mostly priced into the market, the euro should have peaked against the dollar. Prolonged exchange rate imbalances have not proven sustainable for significant periods of time. From now on, currency movements will depend more on perception of the two regions' relative monetary policies

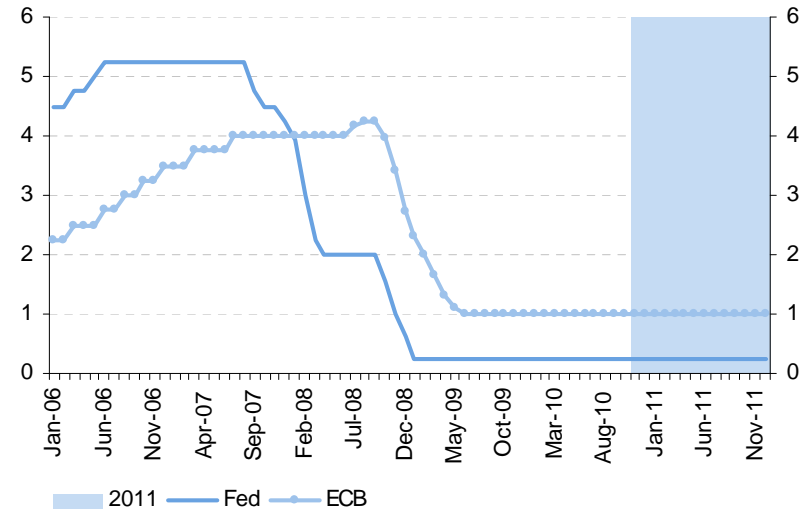
Dollar-euro exchange rate and estimated equilibrium point

Source: BBVA Research



Official interest rates (%)

Source: BBVA Research based on Fed and ECB data



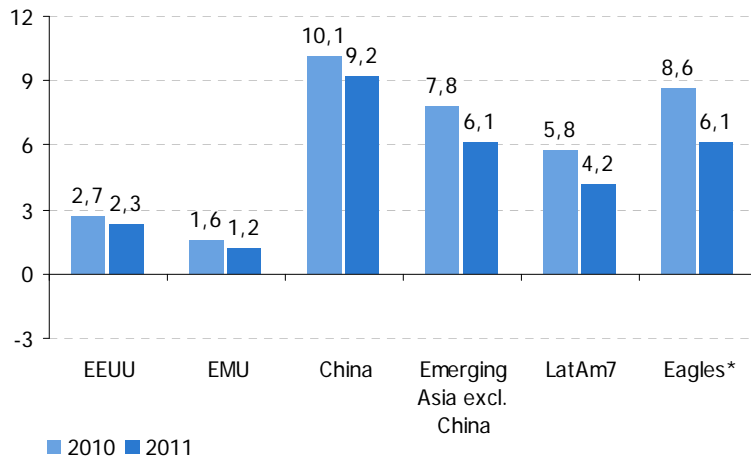
International environment

A story of dual deceleration

- **The world economy looks set to grow by 4.7% in 2010 and by 4.1% in 2011**
 - The emerging economies will continue to shake off the crisis with alacrity, remaining the biggest contributors to global growth. An orchestrated soft landing will reduce the risk of overheating
 - Weak private spending in developed economies will make for a protracted slowdown
 - Given the prospects for relative growth rates and the absence of substantial changes in the outlook for monetary policy going forward, the euro should have peaked. Medium term, it should begin to gradually weaken against the dollar

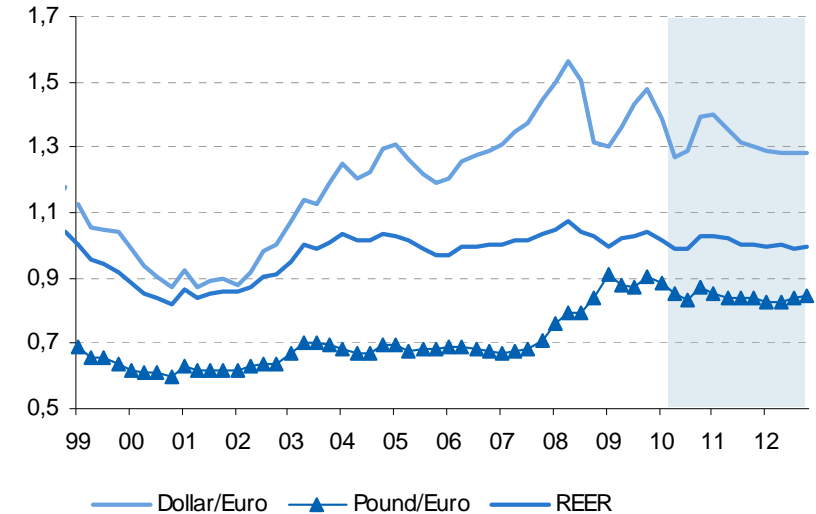
GDP growth forecasts (%)

*Eagles: Emerging And Growth-Leading Economies (Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan and Turkey)
Source: BBVA Research



Euro exchange rates

Source: BBVA Research



Contents

Spain
Economic
Outlook
Fourth quarter
2010

Section I
International environment

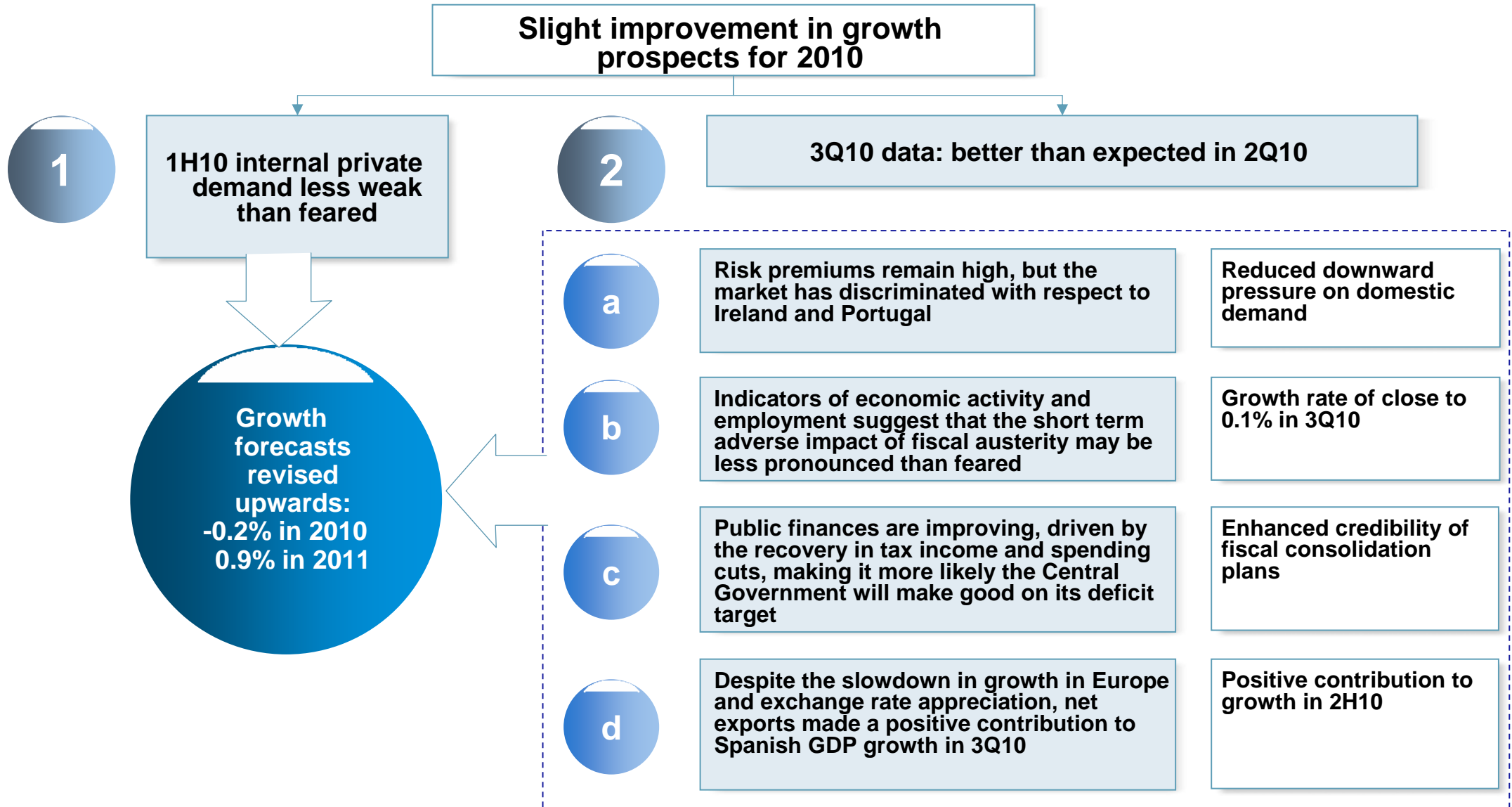
Section II

Re-assessment of Spain's economic prospects

Section III

The necessary consolidation and intensification of the reform process

Re-assessment of Spain's economic prospects



Re-assessment of Spain's economic prospects

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1H10 domestic private demand less weak than feared

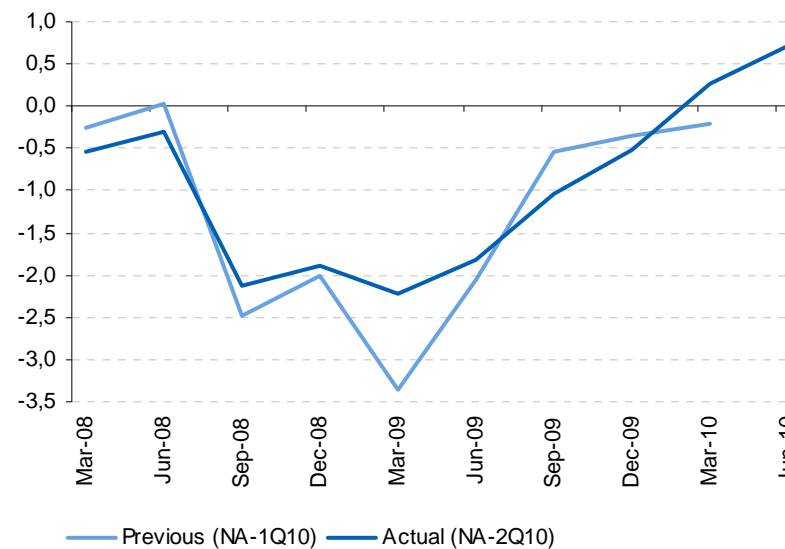
Preliminary estimates of the 2009 national accounts, coupled with the quarterly figures for 2Q10 announced at the end of August, specifically the breakdown of growth, revealed a **relatively stronger performance in domestic demand in 1H10**



Less adverse starting point even though accelerated fiscal consolidation has begun

Spain: domestic demand
(Percentage contribution to quarterly GDP growth)

Source: BBVA Research based on INE data



Re-assessment of Spain's economic prospects

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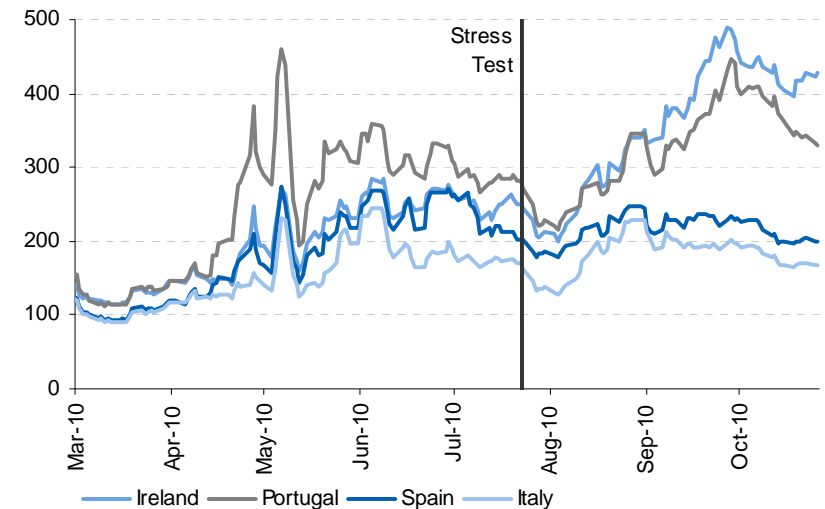
- **3Q10 data: better than expected at the quarter outset**

- While risk premiums remain high, Spanish assets have clearly outperformed those of nations such as Ireland and Portugal, with the liquidity crunch easing

Because of the Spanish economy's financing requirements and its dependence on the foreign capital markets, **the ease-up in financial stress spells reduced downward pressure on economic growth**

Sovereign risk premiums (5Y CDS spreads in bps)

Source: BBVA Research



Re-assessment of Spain's economic prospects



• **3Q10 data: better than expected at the quarter outset**

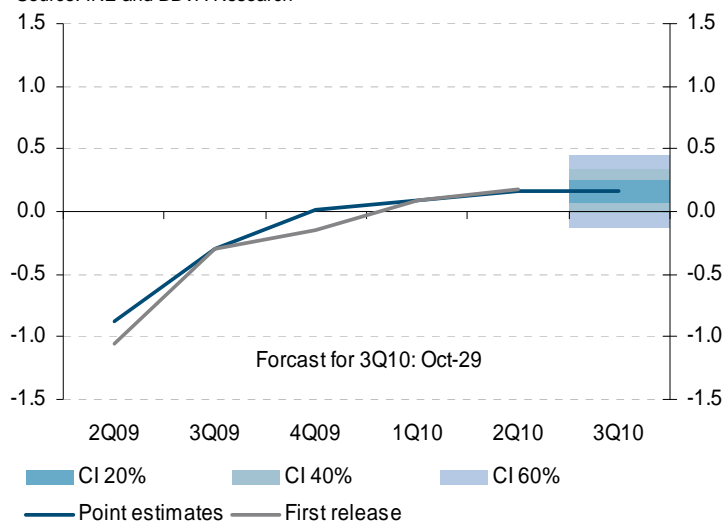
- Indicators of economic activity and employment suggest that the short-term adverse impact of fiscal austerity may be less pronounced than feared

The Spanish economy continued to **grow at a rate of close to 0.1% in 3Q10**. The healthier economic backdrop will have partially offset the impact of the quickening fiscal consolidation process on private domestic demand

The job market continues to correct at the pace set in recent quarters. **There is no evidence of additional deterioration as a result of weakening internal demand**

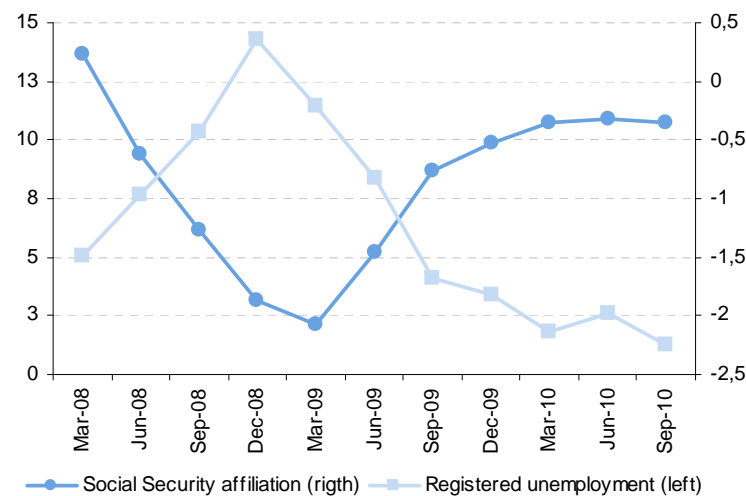
Spain: observed GDP growth and forecasts as per the MICA-BBVA model (% qoq)

Source: INE and BBVA Research



Spain: social security affiliation and registered unemployment (% qoq, swda)

Source: BBVA Research based on labour ministry and state employment service data



Re-assessment of Spain's economic prospects



• **3Q10 data: better than expected at the quarter outset**

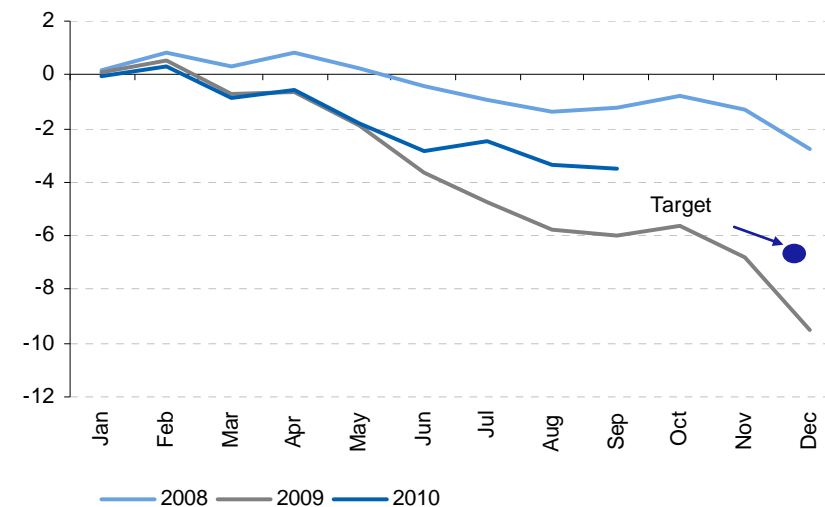
- State finances are improving, driven by the recovery in tax revenues and spending cuts, making it more likely the Central Government will make good on its year-end deficit target

The Central Government data corroborate the **recovery in revenues and contraction in spending** and the likelihood of attaining the targeted deficit (5.9% of GDP) this year has increased considerably

- **Revenues:** enhanced consumption performance during the first half, the normalisation of certain income flows (VAT) and the implementation of measures announced over the past year (personal income tax).
- **Expenses:** significant cutbacks in investment and current transfers (non-renewal of discretionary programs)

Spain: Central Government deficit (Cumulative annual deficit, % GDP)

Source: BBVA Research, using finance ministry data



Re-assessment of Spain's economic prospects

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• **3Q10 data: better than expected at the quarter outset**

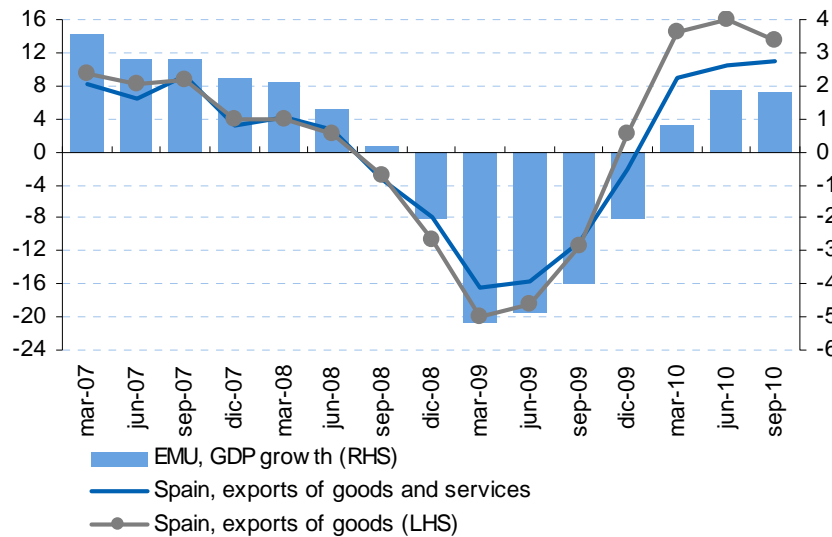
- Despite the slowdown in growth in Europe and exchange rate appreciation, the trade sector made a positive contribution to Spanish GDP growth in 3Q10

Although the European economy is expected to slow and the nominal component of the REER to appreciate...

... the gains in price competitiveness eked out during most of the quarter were underpinned by the improvement in the foreign trade sector, in turn driven by growing diversification of exports to non-EMU markets

Spanish exports of goods and services and growth in the EMU(% yoy)

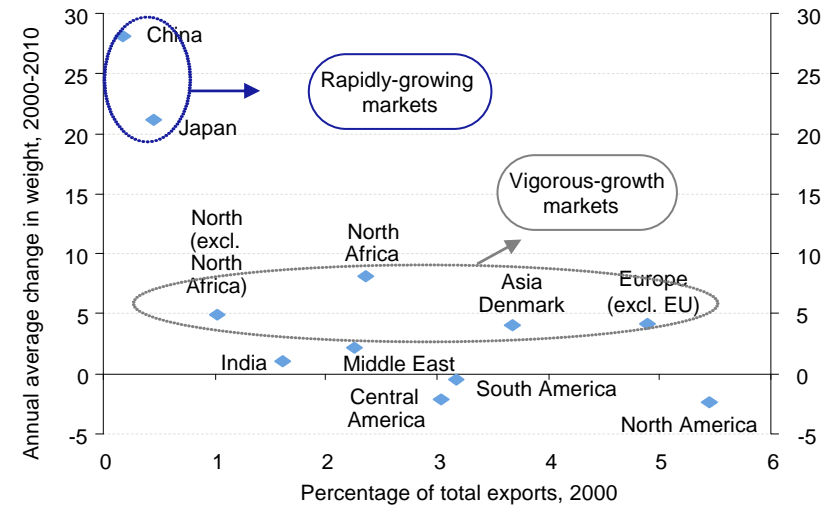
Source: BBVA Research based on INE and Eurostat data



Spain: non-EU exports of goods. Weight in 2000 and change in weight 2000-2010

(%)

Source: BBVA Research based on Datacomex data



Re-assessment of Spain's economic prospects

Despite the relative improvement in expectations, the Spanish economy is set to sustain only weak economic recovery next year

Factors that shape the outlook for 2011

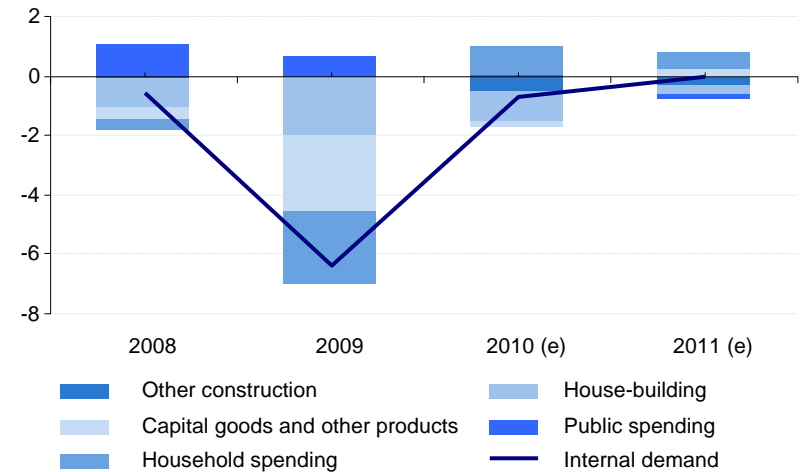
Internal demand

- **Fiscal consolidation**
 - Reduced consumption and public spending
 - Gradual improvement in confidence in the Spanish economy (lower liquidity crunch and risk premiums)
- **Private sector deleveraging**
- **Low interest rates and tamed inflation**
 - Reduced pressured on financial burden
 - Low cost of using capital



Spain: contributions to GDP growth (pp)

Source: BBVA Research based on INE data



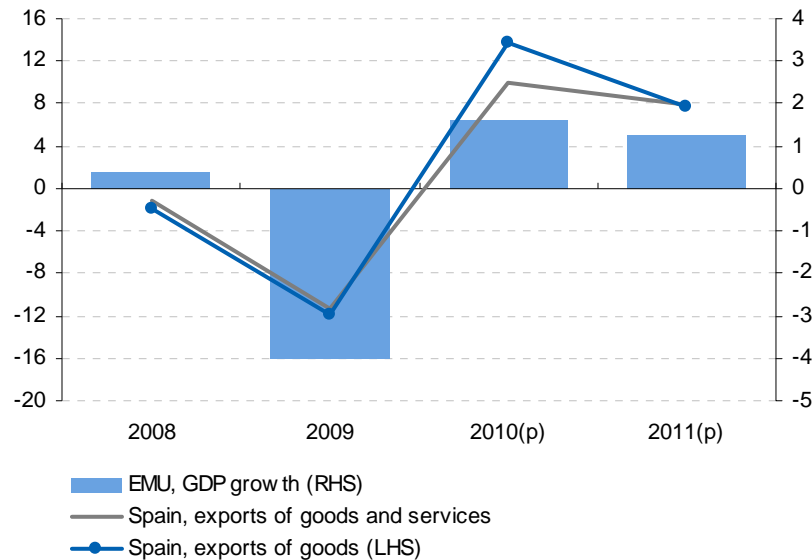
Re-assessment of Spain's economic prospects

Despite the relative improvement in expectations, the Spanish economy is set to sustain only weak economic recovery next year

Factors that shape the outlook for 2011

Spanish exports and growth in the EMU (% chg, yoy)

Source: BBVA Research based on INE and Eurostat data



External demand

- **Slowdown of European economy** -
- **Competitiveness (moderate growth of ULCs)** +
- **Spanish exports are increasingly diversified by market** +

Re-assessment of Spain's economic prospects

- **Despite the relative improvement in expectations, the Spanish economy is set to sustain only weak economic recovery next year**
 - Progress on rebalancing underway points to Spanish GDP growth in 2011 of around 0.9%

Economic Forecasts						
(y-o-y growth rate)	2009		2010		2011	
	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	-4.3	-1.1	1.6	0.7	1.0	1.1
Public consumption	3.2	2.4	0.2	0.9	-0.5	0.4
Gross Fixed Capital Formation	-16.0	-11.3	-7.2	-1.3	-1.8	1.0
Equipment and other products	-21.2	-15.7	-2.4	1.6	2.3	1.4
Capital Goods	-24.5	-17.4	3.7	2.8	4.1	1.4
Construction	-11.9	-7.9	-10.5	-3.7	-4.6	0.2
Housing	-24.5	-10.8	-16.6	-3.6	-6.5	0.0
Other Construction	-0.1	-5.0	-6.2	-3.8	-3.3	0.3
Domestic Demand (*)	-6.4	-3.3	-0.7	1.6	0.0	1.0
Exports	-11.6	-13.1	10.0	9.1	8.0	4.4
Imports	-17.8	-11.8	6.9	9.2	3.8	4.0
External Demand (*)	2.7	-0.8	0.6	0.0	0.9	0.2
GDP	-3.7	-4.0	-0.2	1.6	0.9	1.2
Pro-memoria						
GDP excluding housing	-1.9	-3.6	0.8	1.9	1.3	1.2
GDP excluding construction	-2.1	-3.6	1.5	2.2	1.8	1.3
Total employment (LFS)	-6.8	-1.8	-2.2	-0.5	-0.2	0.2
Unemployment rate (% Active pop.)	18.0	9.4	20.1	10.1	20.6	10.2
Current account (%GDP)	-5.5	-0.6	-4.8	-0.5	-3.7	-0.2
Public surplus/deficit (%GDP)	-11.2	-6.3	-9.3	-6.8	-6.0	-5.5
CPI media anual	-0.3	0.3	1.8	1.6	1.7	1.7

(*) contributions to GDP growth

Source:BBVA Research based on INE and Eurostat

Re-assessment of Spain's economic prospects

However, it is unclear how dynamic any recovery will be

Risk factors

More pronounced global economic slowdown

Significant increase in pace of euro appreciation

Heightened financial stress due to:

- failure to meet public deficit targets, or
- loss of momentum in newly-adopted drive to reform

Upside

Success of expansionary monetary policies in certain developed economies

Improved performance of job market spurred by labour reform

Implementation of structural reforms in bid to ensure:

- long-term sustainability of public pension system
- efficient regional governing funding systems, and
- resolution of regulatory issues affecting markets for goods and services

Contents

Spain
Economic
Outlook
Fourth quarter
2010

Section I
International environment

Section II
Re-assessment of Spain's economic prospects

Section III

The necessary consolidation and intensification of the reform process

- Spanish financial system: unfinished business
- Fiscal consolidation at all levels of government: making a virtue out of necessity
- Structural reforms, income per capita and country risk

The necessary consolidation and intensification of the reform process

Spanish financial system: unfinished business

- **There are unfinished business in the restructuring of the Spanish financial system**
 - **The market's perception that the restructuring is making slow progress** is hampering the reopening of the wholesale markets
 - The difficulties some entities are encountering in raising funding are evident in the higher rates being offered on deposits, squeezing margins.

Overcapacity: still far from efficiency threshold

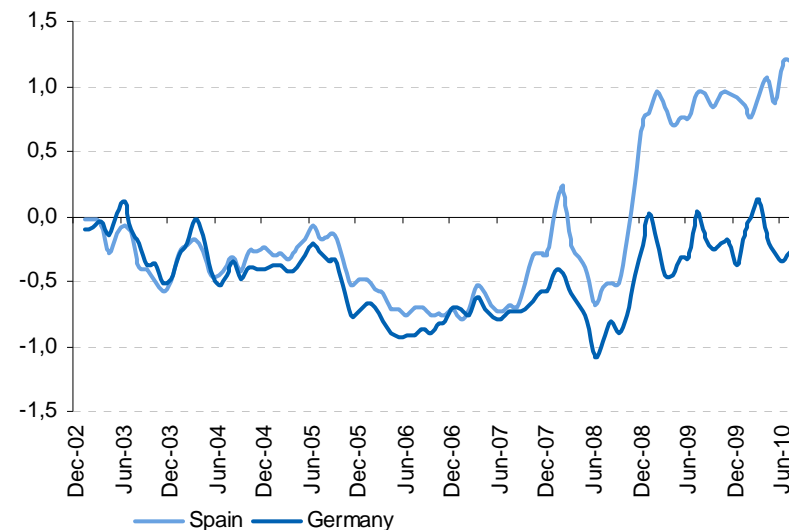
Solvency problems: demarcated, sustainable and concentrated in a group of entities which must take additional measures

Integration plans: not yet outlined

- The merged entities are still not operating jointly and none of them have tried to tap the financial markets jointly

Spread between rates offered on term deposits and 12m Euribor (pp)

Source: BBVA Research based on central bank data



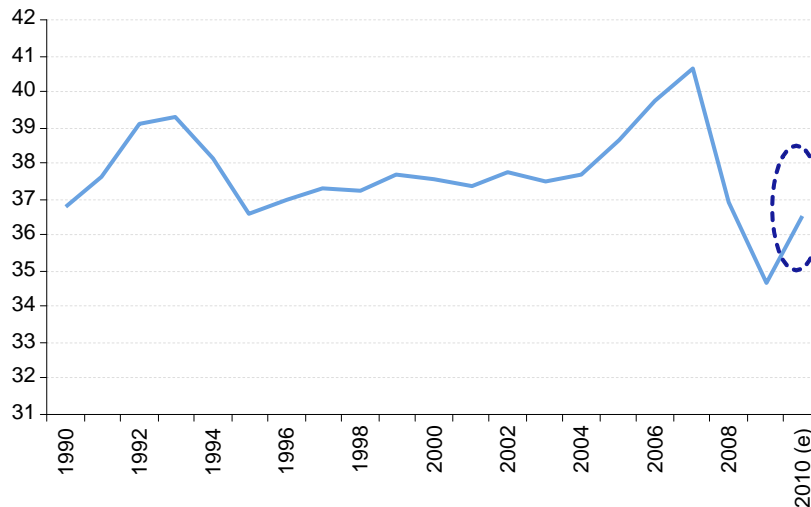
The necessary consolidation and intensification of the reform process

Fiscal consolidation at all levels of government: making a virtue out of necessity

- **The recent trend in the public finances suggests that the Spanish Central government may meet its 2010 deficit targets more comfortably than expected.**
 - The implementation of extraordinary measures such as the elimination of the €400 income tax deduction and the VAT hike partially explain why the tax take as a percentage of GDP will be 2pp higher in 2010 than in 2009

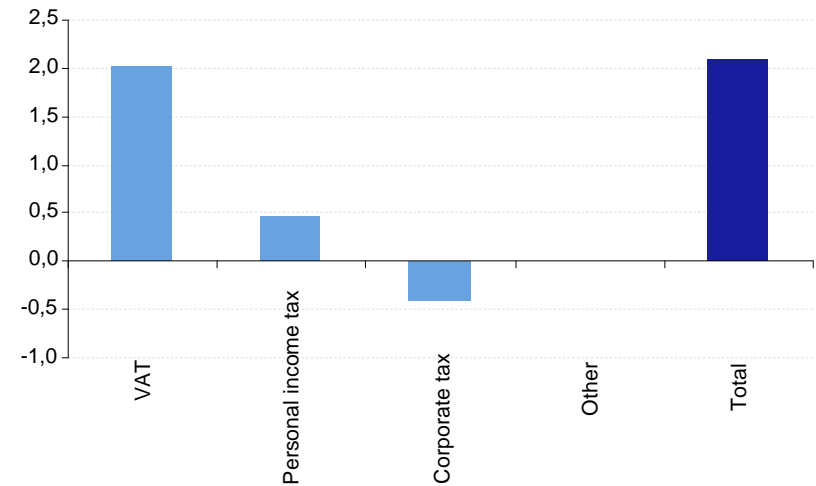
Spain: Total Government Revenues
(% of GDP)

Source: BBVA Research and finance ministry



Spain: change in Total Government Revenues in 2010
(% of GDP)

Source: BBVA Research, using finance ministry data



Any budgetary improvement which may occur in 2010 should be used to reduce the deficit, maintaining strict control over spending

The necessary consolidation and intensification of the reform process

Fiscal consolidation at all levels of government: making a virtue out of necessity

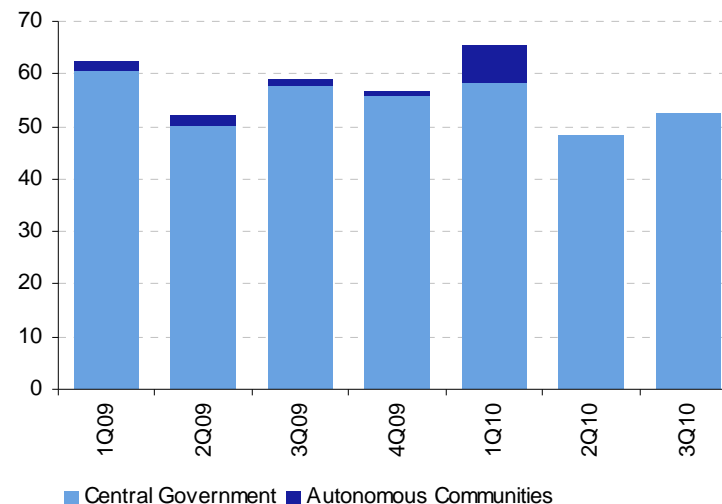
- **Broad market concerns put the onus on the regional administrations to disclose more and better information on their budget performance**

The shift in economic policy towards **greater fiscal austerity**, coupled with the results of the Spanish bank system **stress tests**, **has been well-received by the markets**, allowing the Treasury to place its debt...

... however lingering uncertainties have meant that the regional authorities' financing requirements have not been able to be covered via wholesale market fund-raising in recent months

Spain: public debt issuance
(€ bn)

Source: BBVA Research, based on Spanish Treasury and Bloomberg data



It is important to introduce new measures for controlling the local and regional governments' accounts

The necessary consolidation and intensification of the reform process

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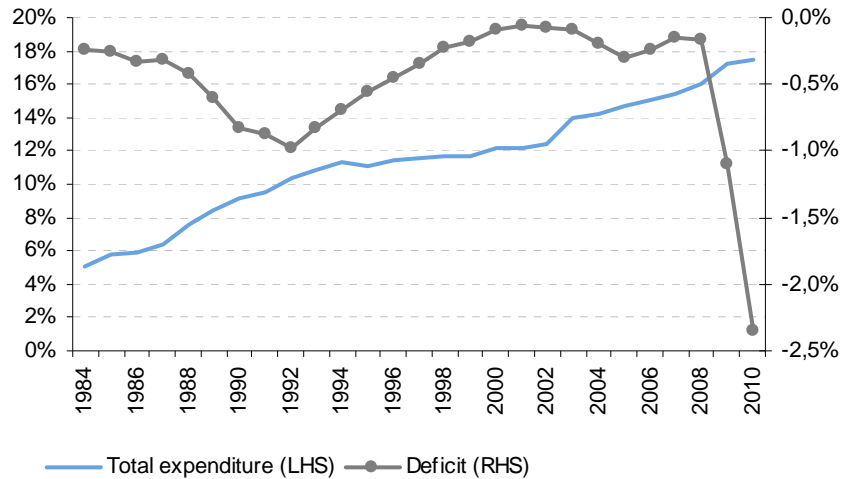
Broad market concerns put the onus on the regional administrations to disclose more and enhanced information on their budget performance...

Although the **regional governments** have had a far smaller hand in driving up the deficit than the state, the size of these authorities makes them a **new player to be reckoned with in the management of the public finances**, one that was not a force in earlier crises

Indeed, **one-third of the public deficit reduction programmed for 2011 is predicated on lowering the regional administrations' structural deficits**

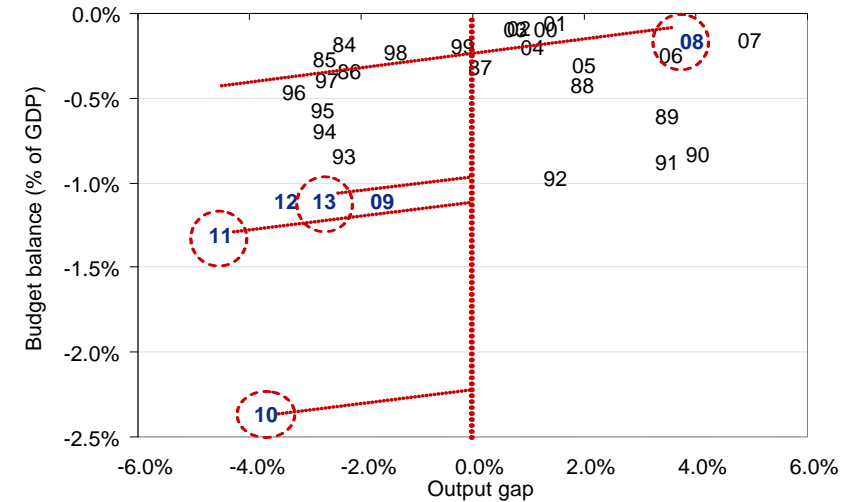
Autonomous regions: Deficit and Spending (% GDP)

Source: BBVA Research, using finance ministry data



Regional administration budget balance vs. output gap (%)

Source: BBVA Research and finance ministry



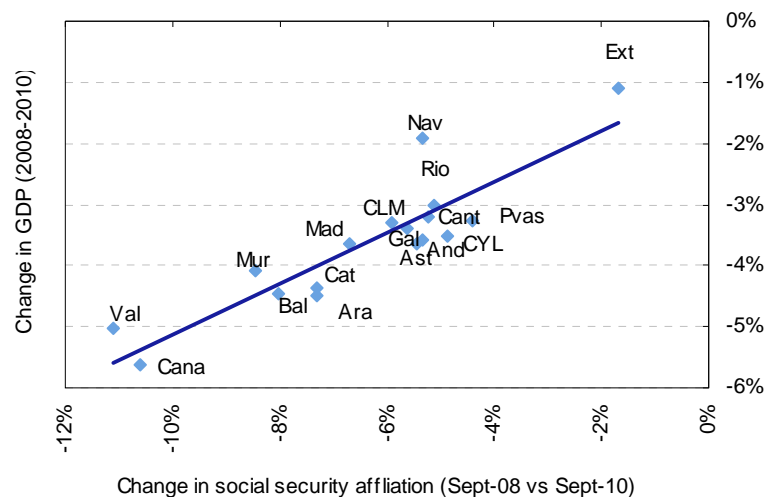
The necessary consolidation and intensification of the reform process

Fiscal consolidation at all levels of government: making a virtue of necessity

- ... nonetheless, the perception that the regional authorities pose a fiscal threat is based on analysis that is overly top-down and often times insufficiently detailed
 - Productive specialisation, the response to the economic cycle, the levels of debt outstanding and the amount of fresh debt taken on in recent quarters vary significantly by regional administration

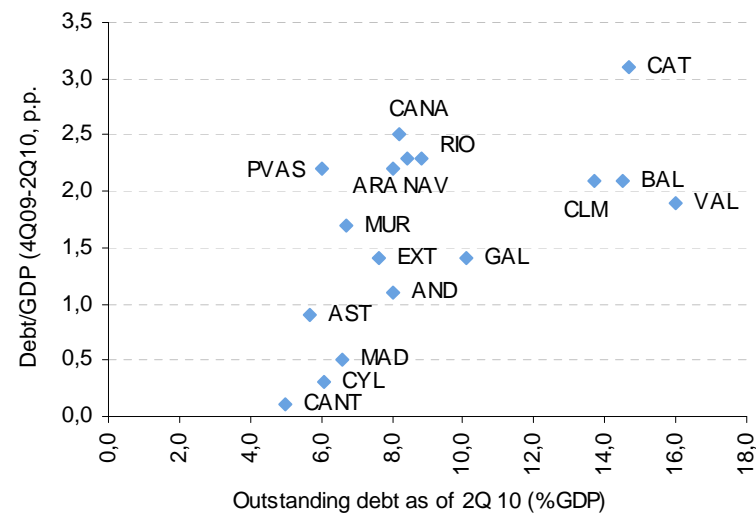
Spain: drop in GDP and in affiliations, 2008-2010 (%)

(%)
Source: BBVA Research based on labour ministry and INE data



Regional administration debt

Source: Bank of Spain



The necessary consolidation and intensification of the reform process

Fiscal consolidation at all levels of government: making a virtue of necessity

... nonetheless, the perception that the regional authorities pose a fiscal threat is based on analysis that is overly top-down and often times insufficiently detailed

Transparency of public finances			
		Regional administrations providing information	
Budgetary outturn		Number	% of total regional
	Full monthly information	6	35%
	Full information released at least quarterly	9	53%
	Some type of information (full or partial)	12	71%
	No information	5	29%
Availability of budgetary data on the Internet			
	Easy to access	7	41%
	Difficult to access	4	24%
	Non-existent	6	35%
Availability of public debt data on the Internet			
	Breakdown of debt	4	24%
	Updated information on the breakdown of debt	1	6%
	Non-existent	12	71%
Multi-annual budgets		0	0%
Regular budgetary information released in English		3	18%

Source: BBVA Research

An enhanced analysis of the regional administrations' public finances that would enable the market to correctly discern between them requires information regarding:

- multiple year revenue and spending forecasts/scenarios
- specific fiscal austerity programs
- estimates of the impact of how the changes in the regional financing regime will impact each administration's public finances
- clear, accessible and swift information on the trends in revenue and spending in the year in progress (monthly)

The necessary consolidation and intensification of the reform process

Need for structural reform

- **If the Spanish economy is to accelerate on the path towards a higher growth potential recovery, structural reform is crucial**
 - Spain stands apart for its level of infrastructure and the perception of how its telecommunications, gas and power markets are regulated.
 - However, it is tracking below average on four key indicators.

Need for structural reform in developed countries																	
Medium term	GER	FRA	NETH	BEL	ITA	SP	POR	GRE	AUS	FIN	IRL	DEN	SWE	UK	US	JAP	Avg
Labour market	2	3	2	2	3	3	3	3	2	1	1	1	2	1	1	1	1.9
Corporate regulations	2	2	1	3	2	3	2	3	2	2	1	1	1	1	1	2	1.8
Network regulations	1	2	1	1	2	1	2	3	1	2	3	1	1	1	1	2	1.6
Retail	1	2	1	3	2	2	2	3	3	2	1	2	1	1	2	1	1.8
Professional services	3	2	1	2	3	2	2	3	2	1	1	1	1	1	1	1	1.7
Long term																	
Institutions and contracts	1	2	1	2	3	2	3	3	1	1	2	1	2	1	2	2	1.8
Human capital	2	2	1	1	3	3	3	3	2	1	1	1	1	2	2	1	1.8
Infrastructure	1	1	1	2	3	1	2	3	2	2	3	1	1	1	1	1	1.6
Innovation	1	1	1	1	2	3	3	3	2	2	2	1	1	1	1	1	1.6
Average	1.6	1.9	1.1	1.9	2.6	2.2	2.4	3.0	1.9	1.6	1.7	1.1	1.2	1.1	1.3	1.3	1.7

Source: IMF and BBVA Research

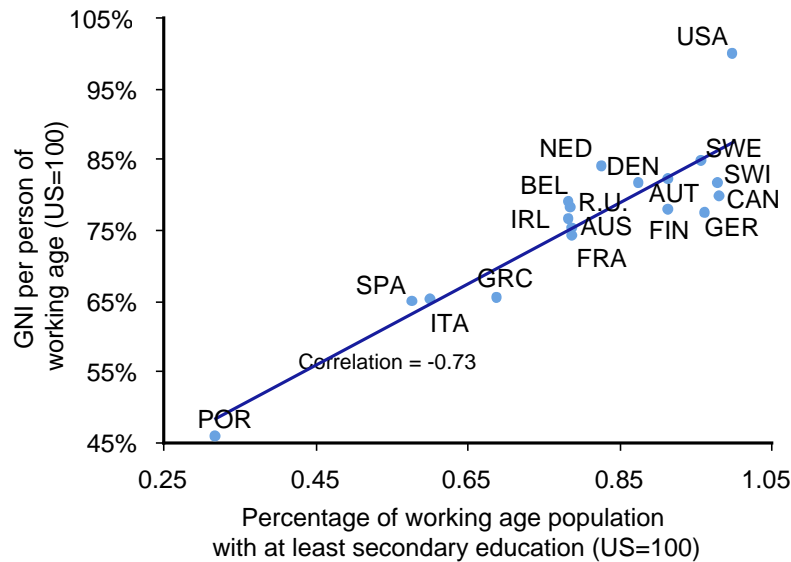
The necessary consolidation and intensification of the reform process

Need for structural reform

- **If the Spanish economy is to accelerate on the path towards a higher growth potential recovery, structural reform is crucial**
 - The international empirical evidence is conclusive

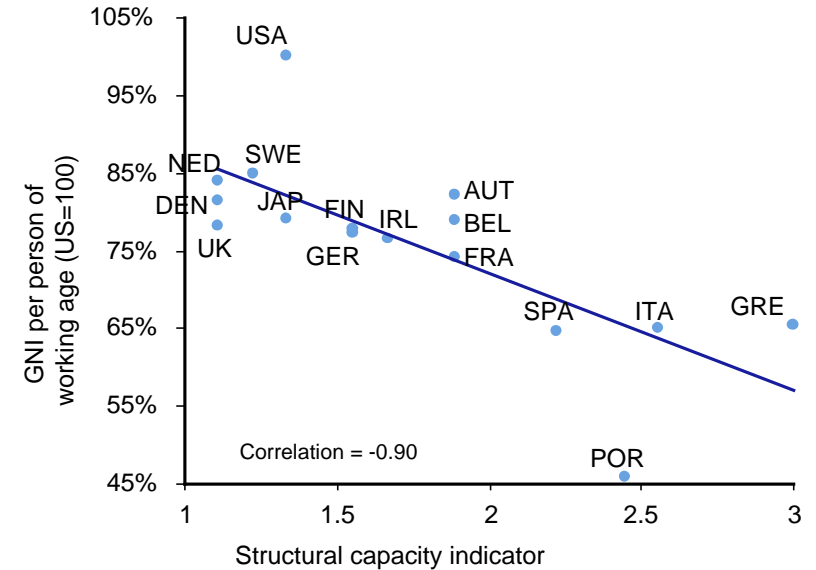
Structural capacity and income per working age person (%)

Source: BBVA Research based on OECD and IMF data



Human capital and income per working age person (%)

Source: BBVA Research and OECD



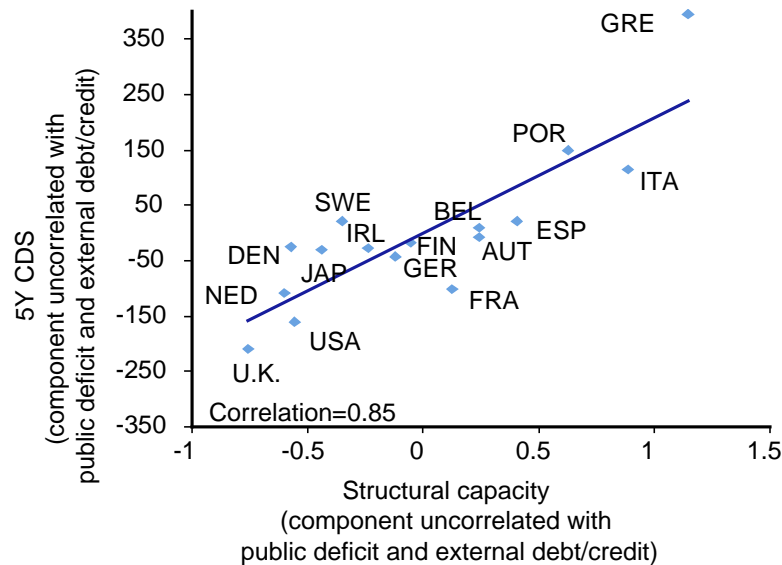
The necessary consolidation and intensification of the reform process

Need for structural reform

- **If the Spanish economy is to accelerate on the path towards a higher growth potential recovery, structural reform is crucial**
 - Tackling the reform process in a determined manner is vital not only for the long-term generation of higher employment and income per capita, it is also crucial to reducing the risk premium in the international financial markets short-term

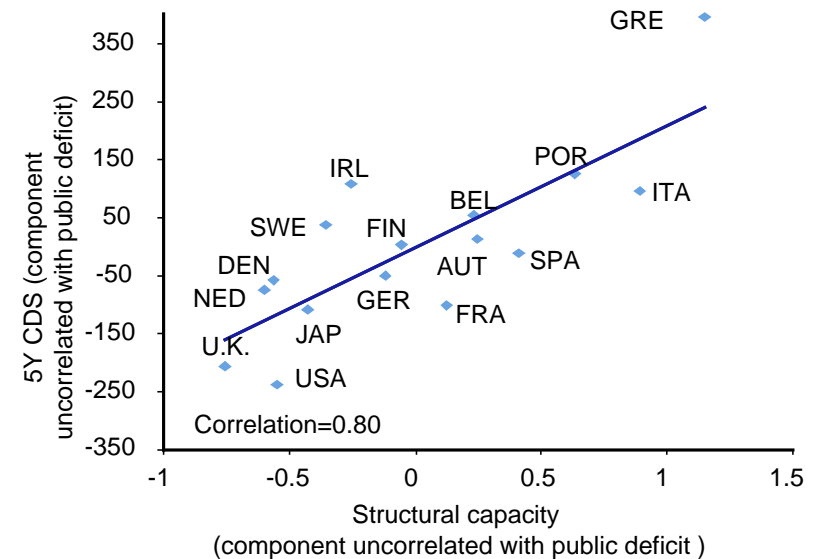
Structural capacity and country risk

Source: BBVA Research



Structural capacity and country risk

Source: BBVA Research



Key messages

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- **In Europe, business activity has proven stronger than anticipated, but there are no signs yet of a clear-cut recovery in domestic demand** to take the baton from exports. Financial stress remains a cause for concern, although systemic risk is lower than before the summer
- **In Spain, the probability of negative quarterly GDP rates in the second half has narrowed substantially**. Even though the outlook is improving, the Spanish economy is not yet at the point of staging a sustained recovery capable of creating jobs
- **If Spanish assets are to continue to outperform** their European counterparts in the financial markets, **very decisive structural reforms are unavoidable**
- **The restructuring of a limited part of the Spanish financial system needs to gain momentum**, picking up the speed of transformation and downsizing
- **The authorities need to continue to reiterate and prove that their fiscal deficit-cutting targets are a priority**. Market concerns put the onus on the regional administrations to disclose more and enhanced information on their budget performance



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