



Europe and Spain Economic Outlook

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Key messages

- Although recovery has proven stronger than anticipated, **Europe's financial stress is a cause for serious concern**. Nevertheless, systemic risk is lower than before the summer
- **QE2 has already been mostly priced into the market**. Some uncertainties about its effectiveness: low long-run interest rates and volatility of exchanges rates.
- **A story of dual growth**: the global economy continues to grow apace, driven mainly by emerging economies, while uncertainties predominate in developed economies
- Myths vs. reality: The **Spanish economy is undergoing an intense adjustment process**, reversing excessive investment, especially in the residential construction sector, accumulated during the boom period. Investment will remain at relatively high levels, as will the saving rate
- The **current account deficit** has been adjusted by 5 percentage points in just two years. Unlike other European countries, no underlying problems regarding a significant loss in competitiveness.
- The wealth position of **households** is sound and they have quickly increased their saving rate to face a gradual deleveraging process
- **Firms**, except in the construction and real estate sector, are recording the right debt and solvency levels and relatively high profitability ratios
- On aggregate, the **Spanish financial system** is recording sound solvency and liquidity levels, and no excess leverage. However, part of the system is restructuring, although the cost is affordable.
- The **fiscal consolidation process underway is demanding but on target**. 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.
- Tackling the **reform process with determination** 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.

Contents

Section I

Europe: international environment and financial tensions

Section II

The adjustments of the Spanish Economy

Section III

The reform process

Section I

Europe: international environment and financial tensions

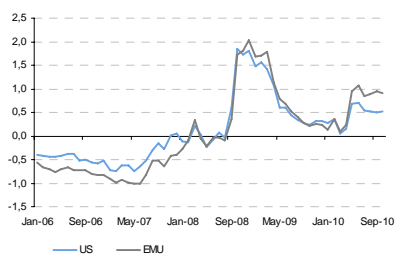
Financial pressure acute but systemic risk under control

- **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

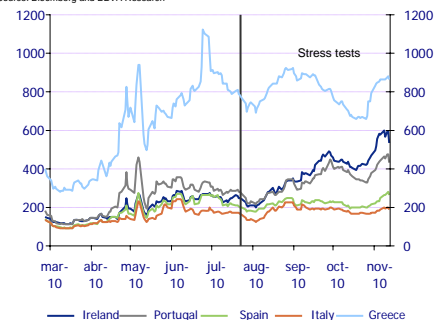
BBVA financial stress index

Source: BBVA Research



Sovereign CDS spreads for European peripherals

Source: Bloomberg and BBVA Research

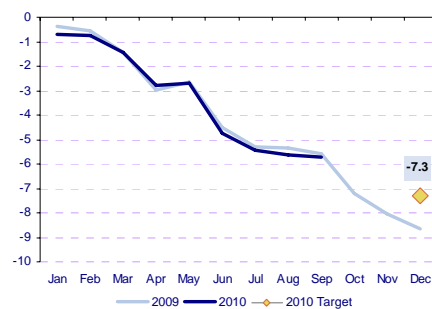


Europe: international environment and financial tensions

Portugal fiscal outlook

- Up to September the **budget execution** has been similar to that of last year, **raising doubts on the fulfillment of the target for this year**
- To meet this year target the government has assumed the assets and future commitments of the pension system of Portugal Telecom, but this is only a one off solution for 2010.
- Further measures, as asked by the EC (e.g., wage cuts), are included in the 2011 budget after the agreement with the opposition.

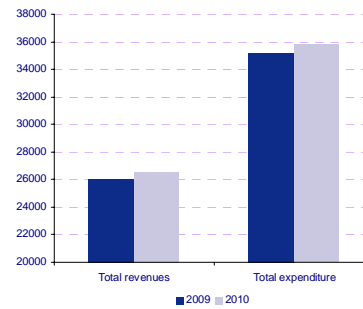
Portugal: Budget execution (% of GDP)



Source: Direcção Geral do Orçamento and BBVA

Portugal: Revenues and expenditures up to September

Source: Ministério das Finanças and BBVA Research

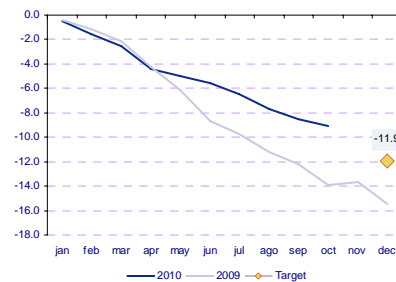


Europe: international environment and financial tensions

Ireland fiscal outlook

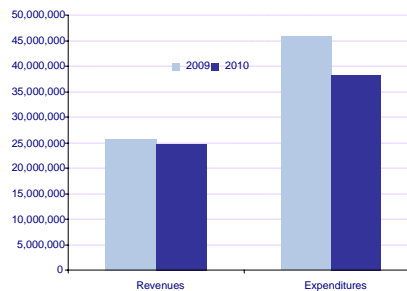
- Current budget execution broadly in line with target, although the deficit level is still very high.
- The needed consolidation package for 2011-2014 has been revised upwards to €15 billion from €7.5 billion. In 2011, cuts should amount to 6 bn or 3.8% of GDP
- Budget for 2011 to be presented to Parliament by Dec 7th. The Government has a thin majority in parliament as is negotiating detailed measures with opposition at the moment, with harder negotiations than expected.

Ireland: current budget execution (% GDP)



Ireland: Revenues and expenditures up to October

Source: Ministério das Finanças and BBVA Research

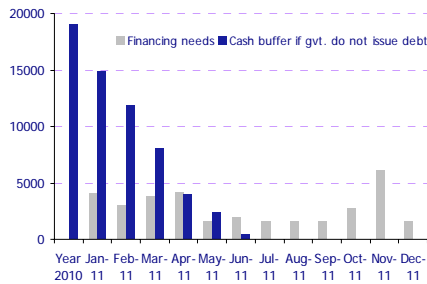


Europe: international environment and financial tensions

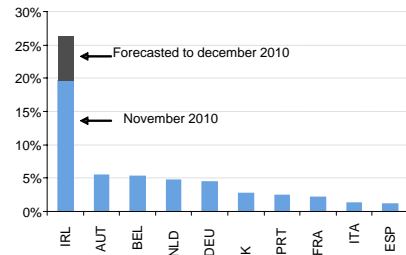
Ireland: Resistance to undertake a tax burden increase, especially corporate

- The use of fiscal margin has been limited: no increase in taxes
- Despite the leeway for further consolidation through increased taxation, Ireland has resisted changing its growth model based on attracting FDI.
- **The banking system crisis has caused a sovereign debt problem.**

Ireland: financing needs and Treasury cash (€millions)
Resource: BBVA Research



Injections of Public Capital (% of GDP)
Source: BBVA Research

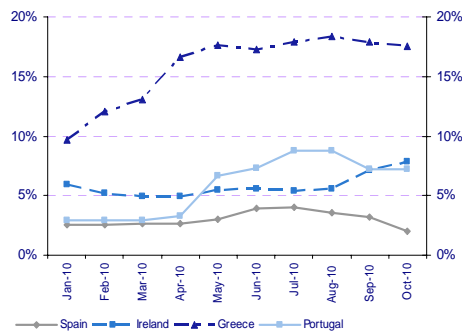


Europe: international environment and financial tensions

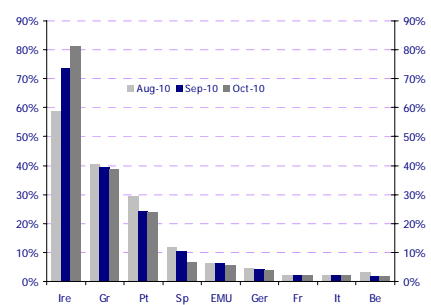
Ireland: increasing reliance of banking system on ECB funding

- The difficulties of banking sector financing have been an increasing resource to the ECB.
- ECB tightens conditions of financing access.
- Constancio "The problems of the Irish banking sector are not only problems of liquidity but, in some cases, also problems of capital"

Euro area banks: % of total assets funded by ECB liquidity
Resource: BBVA Research



Euro area banks: ECB liquidity (% of GDP)
Resource: BBVA Research



Source: Datastream, Central Banks and BBVA ERD

Europe: international environment and financial tensions

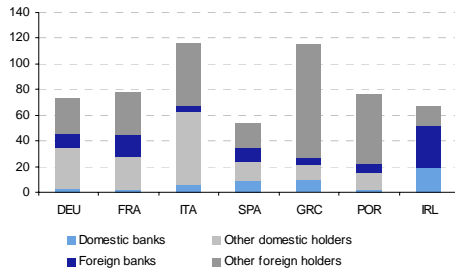
Financial pressure acute but systemic risk under control

• 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

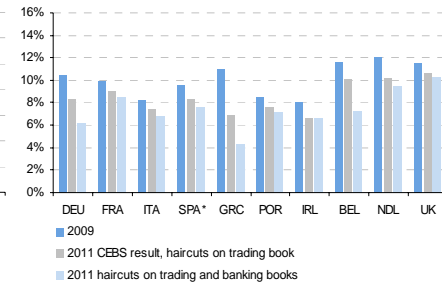
Sovereign debt holders (% of GDP)

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



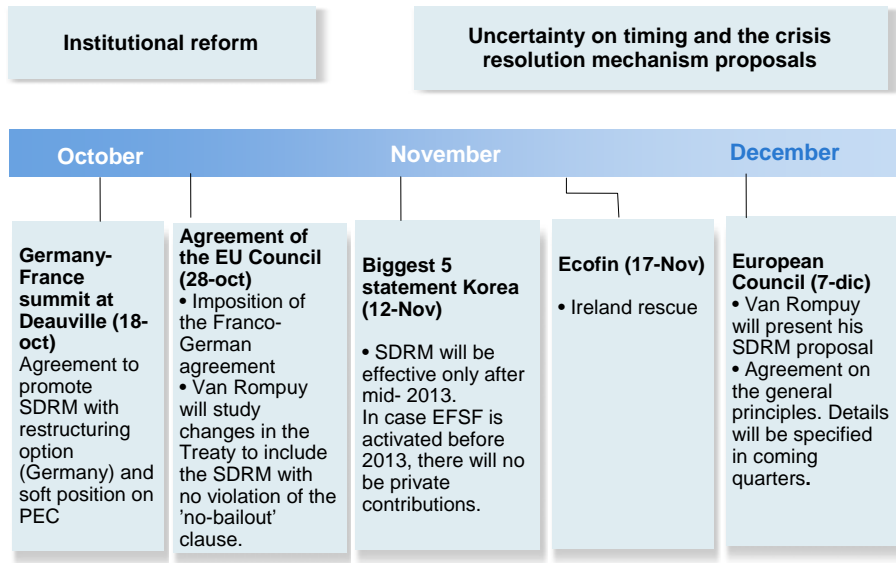
Sensitivity analysis: average Tier 1 ratio under different sovereign stress scenarios

Source: BBVA Research based on C-EBS data



Europe: international environment and financial tensions

Uncertainties about the SDRM

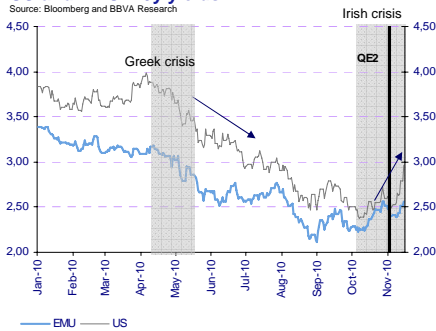


Europe: international environment and financial tensions

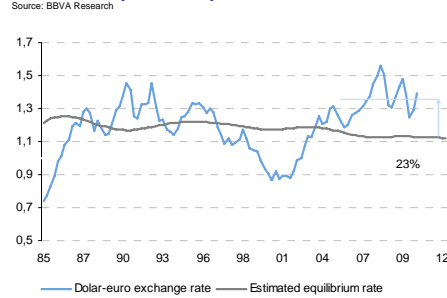
Fed monetary policy has weakened the dollar

- **Some uncertainties about the effectiveness of QE2:** low long-run interest rates and volatility of exchanges 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.

US and EMU: 10y yields



Dollar-euro exchange rate and estimated equilibrium point

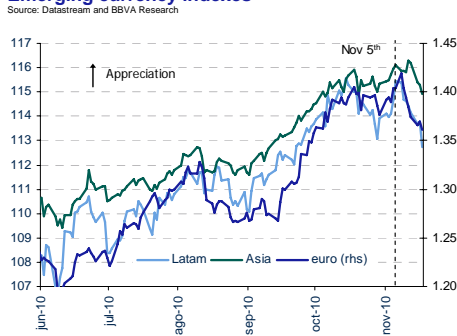


Europe: international environment and financial tensions

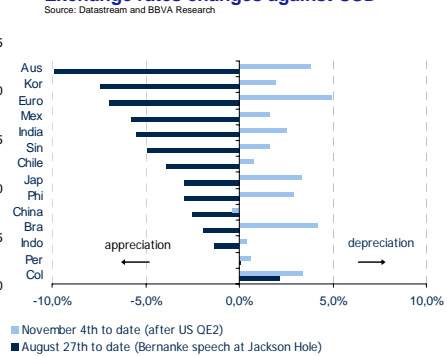
Fed monetary policy has weakened the dollar

- After confirmation of QE2, the appreciation trend of emerging markets' currencies has been halted, with currencies stabilizing around a range
- Latam shows a mild tendency towards depreciation
- All in all, emerging markets FX remain strong, given that USD appreciation against EUR during November has been much stronger

Emerging currency indexes



Exchange rates changes against USD



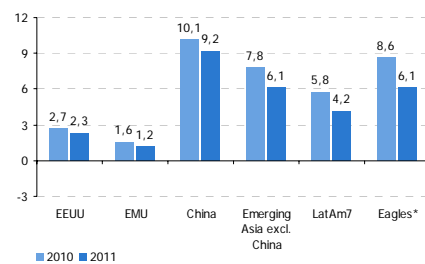
Europe: international environment and financial tensions

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
 - The outlook for muted growth coupled with tame inflationary pressures in developed economies spells protracted reduced interest rates

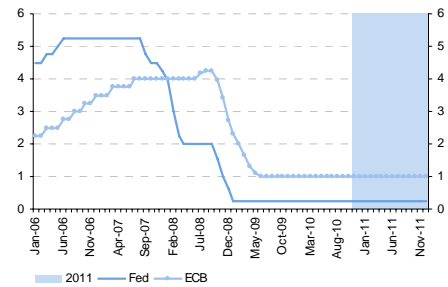
GDP growth forecasts (%)

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



Official interest rates estimates (%)

Source: BBVA Research based on Fed and ECB data



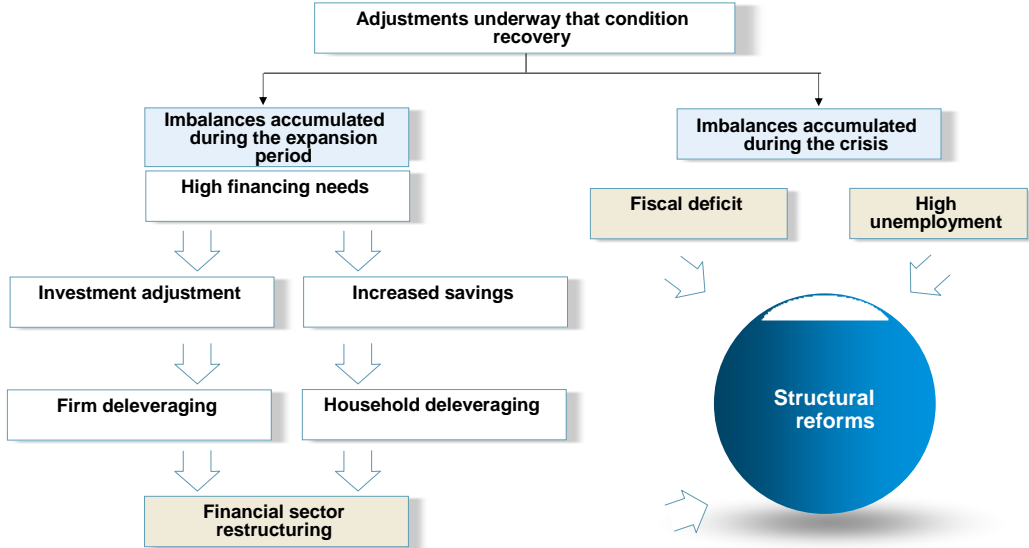
Contents

Section I
International environment

Section II
The adjustments of the Spanish Economy

Section III
The reform process

The adjustments of the Spanish Economy



The adjustments of the Spanish Economy

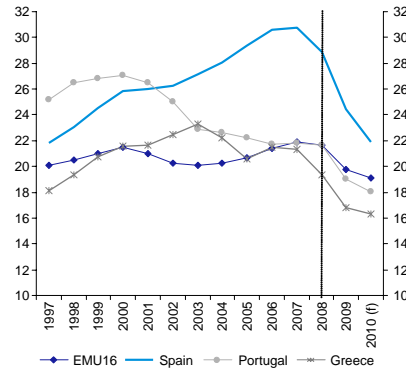
High investment rate behind the current account deficit

The current account deficit recorded in recent years in Spain is a reflection of the significant increase in investment rather than a lack of competitiveness or a low saving rate

In Spain, the investment rate represented 31% of GDP in 2007, an unprecedented level and well above 22%, the maximum recorded that year for the EMU-16 as a whole

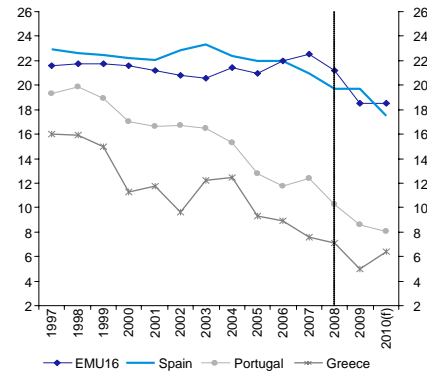
Domestic Investment Rate (GFCF as percentage of GDP)

BBVA Research based on INE and AMECO



Domestic Saving Rate. As a percentage of GDP

Source: BBVA Research based on INE and AMECO



The adjustments of the Spanish Economy

Solid exports shares despite international competition

There has been a significant adjustment in the current account deficit

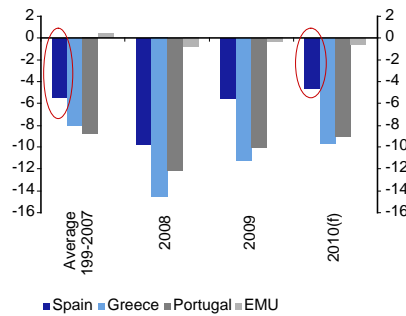
Since June 2008 the current account deficit in Spain has fallen by 50% (5 percentage points of GDP).

The closing of growth differentials vs. trading partners is the main cause underlying the quick adjustment in Spain's foreign deficit in the 2H08 and during 2009

No lack of competitiveness in international trade. Since the creation of Euro, Spain in one of the economies with a better performance in terms of world export quotas among advanced countries

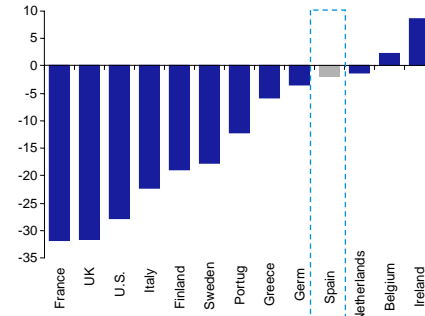
Current account balance. As percentage of GDP

Source: BBVA Research and IMF



World export quotas. Goods and Market Services. Variation rate 1999-2009 (pp)

Source: BBVA Research based on WTO and IMF



The adjustments of the Spanish Economy

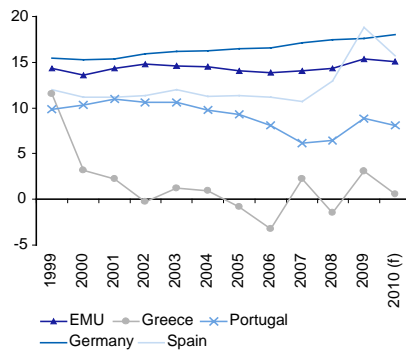
High saving and low default rates

The adjustment in saving has been especially significant in the case of households. During the expansion period, household lending grew considerably, reaching similar levels to those in leading European countries.

Households' debt levels are relatively high (similar to the USA, UK, and other European countries), but households' default rates are lower than recorded in the previous crisis, and are already falling

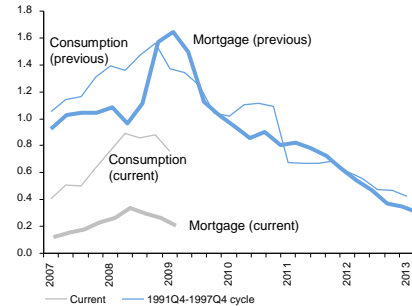
Household's saving rate (% of gross disposable income)

Source: BBVA Research based on AMECO



Consumption Credit Frequency of Default

Source: BBVA Research based on Bank of Spain



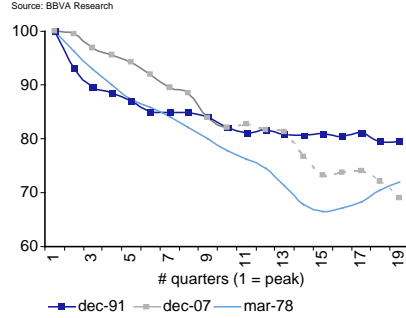
The adjustments of the Spanish Economy

Wealth adjustment of households

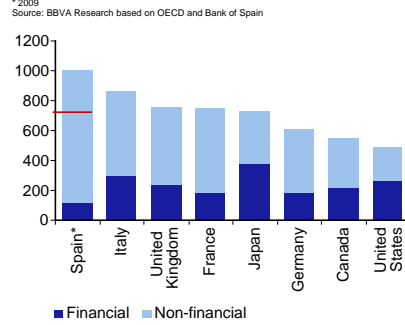
The net wealth of Spanish households is higher than in other European countries. A 30% drop in house prices would reduce the Spanish ratio to 742%, still above most developed countries

Households that have got into debt are not those which are in the worst repayment situation

Spain: Real prices in the housing sector (100 = peak of the cycle)



Households Net Wealth (% Gross Disposable Income 2008)



The adjustments of the Spanish Economy

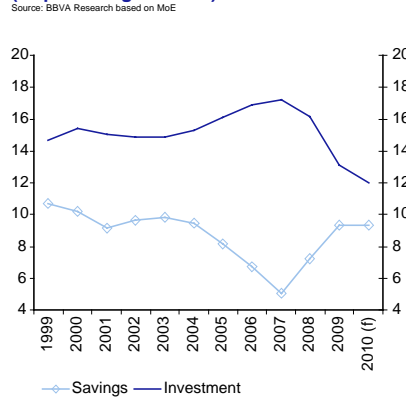
Corporate sector: smaller financing needs

Firms have also adjusted their saving and investment decisions. Investment has fallen, partly due to the adjustment of the real estate sector.

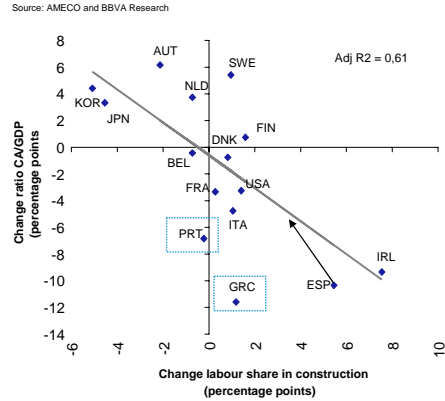
The residential investment boom also helps to explain the current account deficit.

Corporate financing needs have continued to drop from 11% of GDP in 2007 to around 2% in 2010

Spain. Firms' Savings and Gross Investment (as percentage of GDP)



Labour share in construction and current account balance: 1996-2007



The adjustments of the Spanish Economy

High heterogeneity in the debt levels

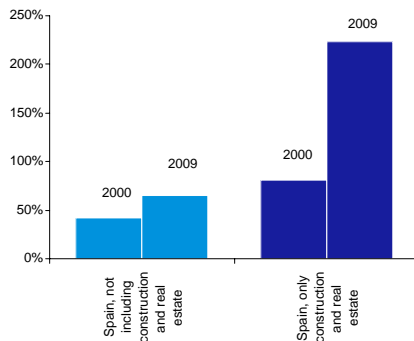
The rise in corporate debt has been concentrated in loans to the real estate sector, which need to be deleveraged

Loans for other activities (not including construction and real estate activities) as a proportion of GDP have grown at moderate rates, reaching levels that are similar to those observed in other countries

Frequencies of default for construction and real state firms are similar to the crisis in the nineties, but for the rest of companies they are significant smaller

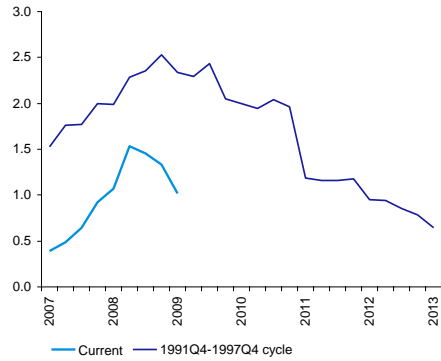
Spain, Corporate Credit/GVA in sector

Source: BBVA Research



Other Companies Frequency of Default

Source: BBVA Research based on Bank of Spain



The adjustments of the Spanish Economy

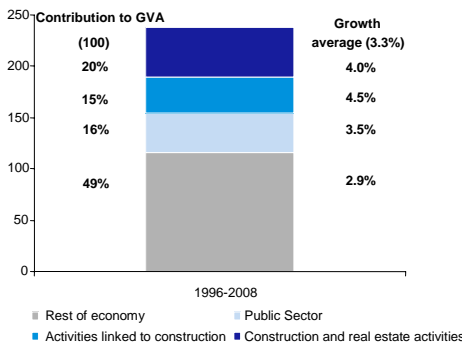
A more diversified pattern of growth than usually expected

From 1996 to 2008, the Spanish economy has generated €240 thousand million in Gross Value Added (GVA) (35% from the construction and real estate sectors and related activities such as metal works, machinery rental and machinery and equipment manufacturing)

The remaining GVA (65%) is distributed between the public sector (16%) and other sectors unrelated to construction (49%). In these sectors, the rate of growth has been also relatively high (around 3%)

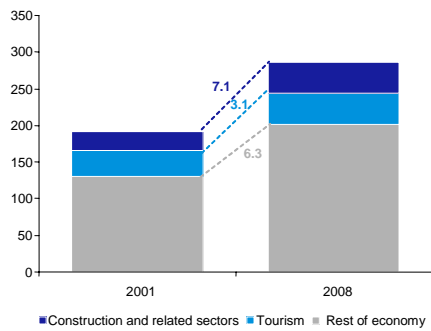
Spain: GVA growth 1996-2008 (Billion euros and average annual growth rates)

Source: BBVA Research based on INE and EU KLEMS



Spain: Growth in exports 2001-2008 (Billion euros and average annual growth rates in %)

Source: BBVA Research based on IMF and INE



The adjustments of the Spanish Economy

Stress test: a solvent exercise that shows how solid the Spanish financial system is

Ongoing mergers, the new Savings Banks Act (LORCA) and stress tests are crucial steps within the Spanish financial system restructuring

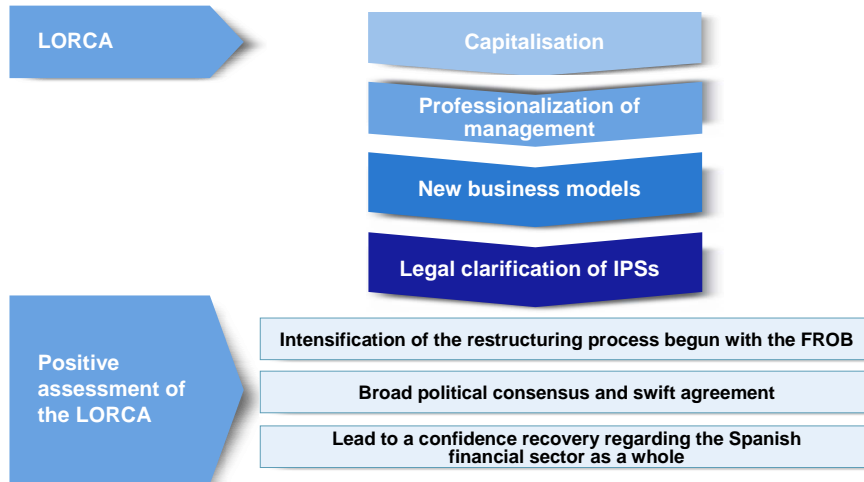
The publication of the stress tests marked a turning point in the market's valuation of the entire financial system as the exercise was conducted with rigor and the results were credible. Contributing to this were:

Key variables	Europe	Spain
Rigorous macroeconomic scenario	✓	✓ ✓
Right pre-impairment income assumptions from macroeconomic scenario	✗	✓
Transparency	✗	✓
Differentiation among institutions	✗	✓
Estimated losses	✗	✓
Ability to raise capital	✓	✓

The adjustments of the Spanish Economy

Ongoing mergers, the new Savings Banks Act (LORCA) and stress tests are crucial steps within the Spanish financial system restructuring

LORCA: a positive assessment



The adjustments of the Spanish Economy

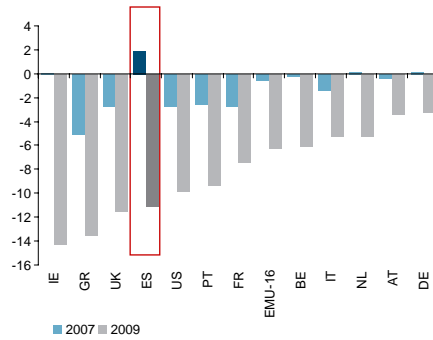
A large public deficit and a relatively low level of debt

Although the decline in the budget balance in Spain was sizeable in 2008 and 2009, Spain's public debt (as a percentage of GDP) is still relatively low

The rise in public debt was greater in other countries like Ireland and the UK. Spain's level of public debt in 2009 was much lower than the EMU average (around 80%)

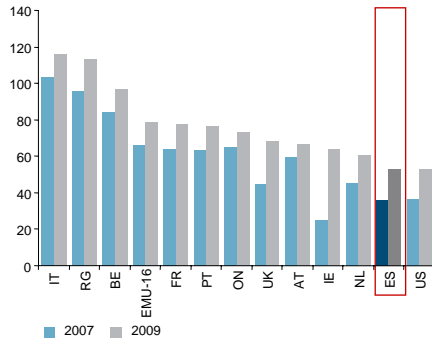
Budget balance as percentage of GDP

Source: BBVA Research based on Eurostat and CBO



Public debt as percentage of GDP

Source: BBVA Research based on Eurostat and CBO



The adjustments of the Spanish Economy

A feasible fiscal consolidation

The Government aims to reduce the public deficit by around 5% of GDP between 2009 and 2011

Measures	Reduction of public deficit (% of GDP)	Details of the measures
Discretionary measures	2.7%	<ul style="list-style-type: none"> • Infrastructure Plan E (0.8% of GDP) • Removal of €400 income tax credit (1% of GDP) • Measures included in expenditure ceiling for 2011
Increase in revenues	1.0%	<ul style="list-style-type: none"> • 2 pp rise in VAT and other indirect taxes
Immediate action plan	0.5%	<ul style="list-style-type: none"> • Mainly current expenses
Adjustment plan submitted to the EC	1.5%	<ul style="list-style-type: none"> • 5% pay cut and wage freeze (0.6% of GDP) • Reduction of public investment (0.6% of GDP) • No increase in pensions and welfare policies
Cyclical impact on deficit	-0.5%	<ul style="list-style-type: none"> • Growth short of potential in 2010 and 2011
	5.2%	Deficit falls from 11.2% to 6% of GDP in two years

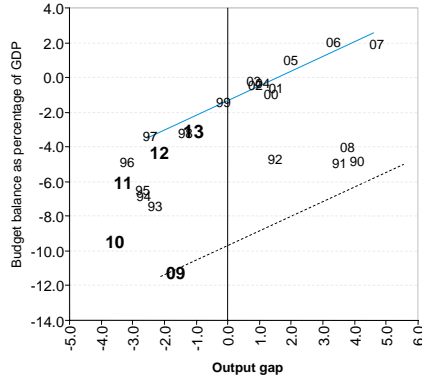
The adjustments of the Spanish Economy

A correction of structural deficit

This plan involves a considerable correction in the structural deficit, which boosts the credibility of the fiscal targets

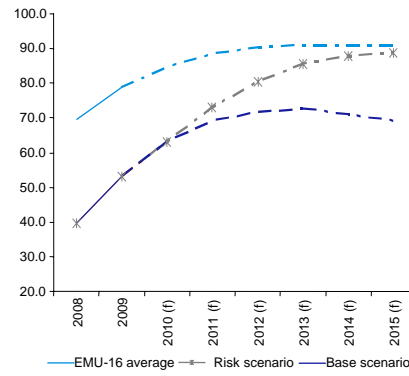
Spain: Budget balance vs Output gap

Source: BBVA Research based on MoE and INE



Spain: public debt (% of GDP)

Source: BBVA Research based on MoE and Government



Different scenario assumptions (Average 2010-2013)

	Base	Risk scenario	EMU-16
Interest rate	4.3	4.6	3.9
Nominal growth	3.2	1.4	2.6
Public deficit	-6.2	-8.1	-5.1

Source: BBVA Research based on MoE and Government

The adjustments of the Spanish Economy

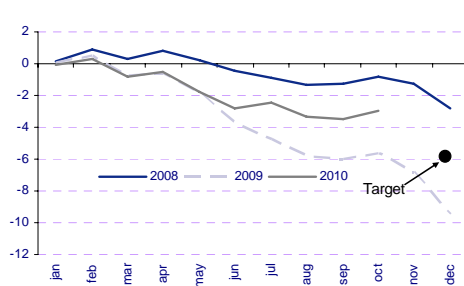
Revenues increasing and expenditures falling

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

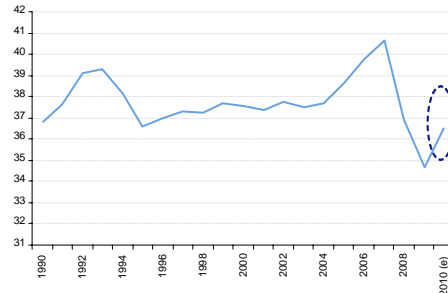
Spain: Central Government deficit (Cumulative annual deficit, % GDP)

Source: BBVA Research, using finance ministry data



Spain: Total Government Revenues (% of GDP)

Source: BBVA Research and finance ministry



The adjustments of the Spanish Economy

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

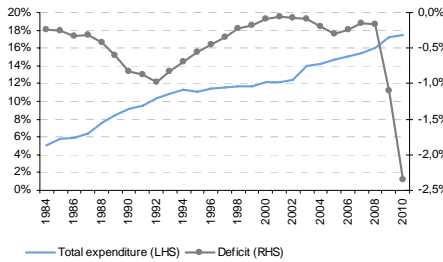
Broad market concerns put the onus on the regional administrations to disclose more and enhanced information on their budget performance...

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**

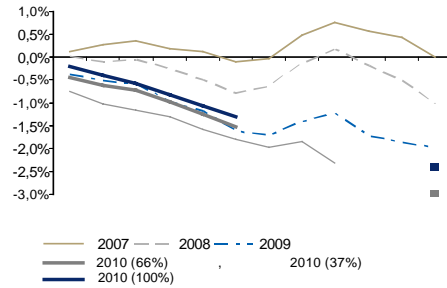
Spain: Regional governments Deficit and Spending (% GDP)

Source: BBVA Research, using finance ministry data



Spain: Budget surplus of regional governments (% of GDP)

Source: BBVA Research, regional governments and Banco de España



The adjustments of the Spanish Economy

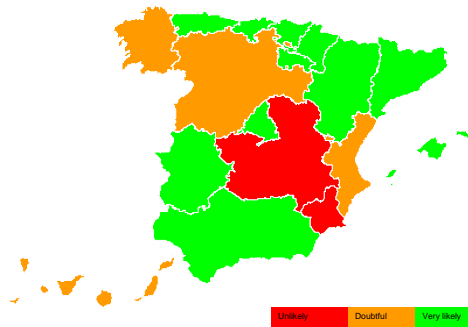
Fiscal consolidation at all levels of government: making a virtue out of necessity

During the first half of the year, regional governments' budget deficit amounted to 1% of GDP, which makes them increasingly likely to meet their deficit target (2,4% of GDP) at the end of 2010.

The regions with higher risk of failure to comply with their deficit target accounts for barely 6% of Spain's GDP.

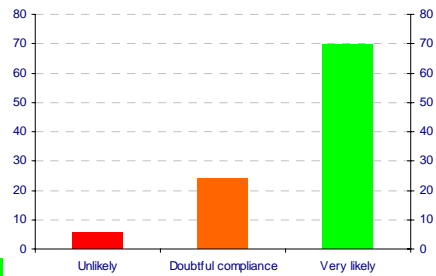
Spain: Regional governments likelihood to reach their deficit target in 2010

Fuente: BBVA Research a partir de MEH



Regional governments' share in Spain's GDP, by likelihood to reach their deficit target in 2010

Fuente: BBVA Research a partir de INE



The adjustments of the Spanish Economy

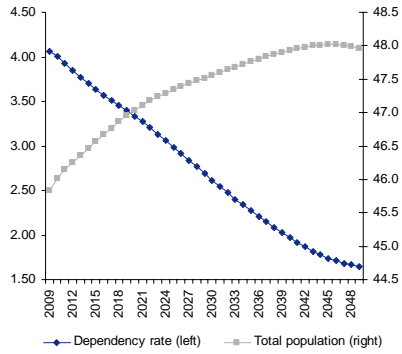
The reform of the public pension system

A credible fiscal adjustment must also include a pension reform

Fewer workers per retiree and a longer life expectancy call for a change in the system

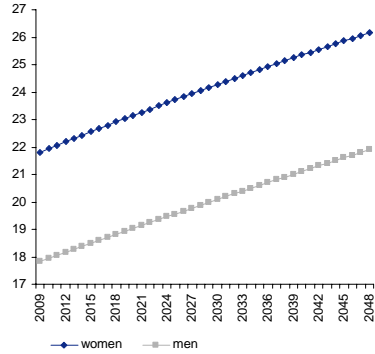
Dependency rate (population between 16-64 over 65-100) and total population

BBVA Research based on INE



Life expectancy after reaching 65 years old

Source: BBVA Research based on INE



Contents

Section I
International environment

Section II
The adjustments of the Spanish Economy

Section III
The reform process

The reform process

Need of structural reforms

- 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																	
	GER	FRA	NETH	BEL	ITA	SP	POR	GRE	AUS	FIN	IRL	DEN	SWE	UK	US	JAP	Avg
Medium term																	
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

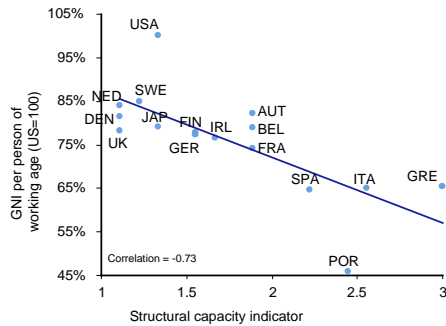
The reform process

Need of structural reforms

- 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

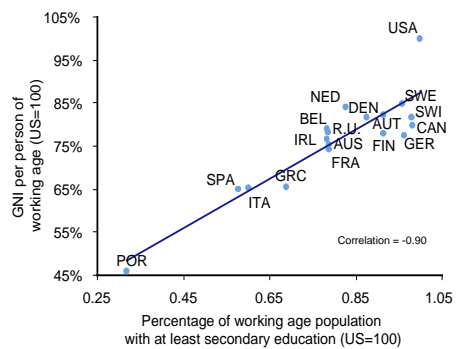
Structural capacity and income per working age person (%)

Source: BBVA Research based on OECD and IMF data



Human capital and income per working age person (%)

Source: BBVA Research and OECD



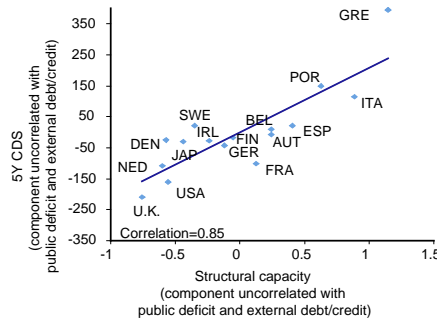
The reform process

Need of structural reforms

- **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



The reform process

It is important to maintain the determination and will to accelerate a good implementation of the most important reforms under way

Reform	Current State	Further actions	Likelihood
Fiscal: Central	On target	VAT below the levels of most EU countries	Only in 2012 and if targets are not met
Fiscal: Regions	On target at the aggregate, but high market uncertainty due to lack transparency	Institutionalize budget review process, making data available to the public Public services fees at regional level	Very likely Only if push comes to shove
Labor market	Under way	Collective wage bargaining reform and Austrian model Information campaign and clarification	Very likely Likely but uncertain results
Long term public finances	Under way	Push forward with pension reform regardless of support	Very likely
Services directive	Passed by national parliament. Under discussion in regions	Further reduced burdens on professional services and retail trade. Ensure good implementation at regional level.	Likely but some uncertain results
Economic Sustainability Law	Under way	Lower administrative costs for firms Pacts with the opposition regarding education and energy generation	Very likely Less likely in the short run

The reform process

Labour Market Reform

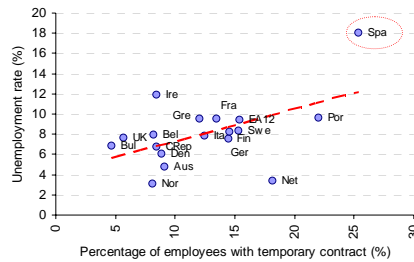
The reduction of the high unemployment rate (20%) is one of the most important challenges of the Spanish economy. There are two reasons for the high structural unemployment rate

Labour market duality

Collective bargaining

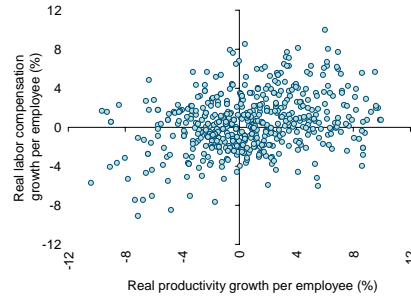
Temporary employment rate vs unemployment rate (2009)

Source: BBVA Research based on Eurostat



Spain: real labour compensation vs labour productivity. Annual growth distribution (21 industries, 25 years)

Source: BBVA Research based on EU KLEMS/BBVA Research based on INE



The reform process

Productivity, firm size and regulations

Largest Spanish companies are as productive as those in the United States. But the Spanish economy suffers from a composition problem compared with the USA: small and medium enterprises have a lower productivity, and represent a larger share in terms of production and employment.

In countries with better regulations, there are more incentives to increase the average size of firms, close to the minimum efficient scale of operation

Labor productivity and firm size (% to the US average)

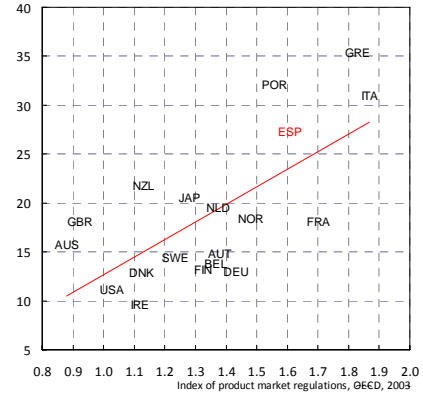
Source: OECD and BBVA Research

	Number of employees				
	1-9	10-19	20-49	50-249	+250
Spain	40.6	51.4	58.9	77	125.7
USA	54.1	46.8	53.8	68.3	129.8

Firm size and product market regulations

Source: OECD and BBVA Research

Share of employment in firms with fewer than 20 employees, 2006



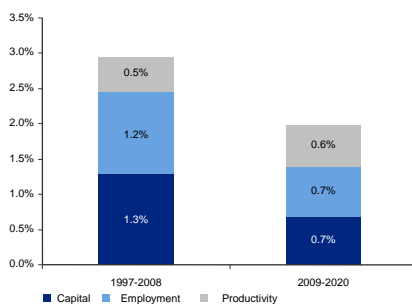
The reform process

Structural reforms and potential growth

In the absence of ambitious structural reforms, the economy would converge at a 2% growth rate, still above the EMU growth rate. A favourable combination of structural reforms could take the economy back to growth rates of around 3%

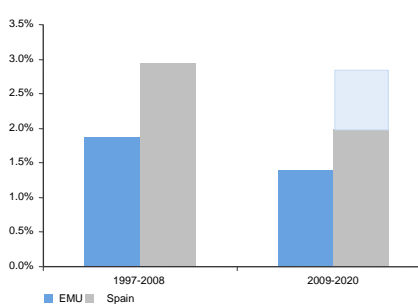
Spain: contribution to potential growth

(Yoy change)
Source: BBVA Research



Spain and EMU: Potential GDP

(Yoy % var.)
Source: BBVA Research



Key messages

- Although recovery has proven stronger than anticipated, **Europe's financial stress is a cause for serious concern**. Nevertheless, systemic risk is lower than before the summer
- **QE2 has already been mostly priced into the market**. Some uncertainties about its effectiveness: low long-run interest rates and volatility of exchanges rates.
- **A story of dual growth**: the global economy continues to grow apace, driven mainly by emerging economies, while uncertainties predominate in developed economies
- Myths vs. reality: The **Spanish economy is undergoing an intense adjustment process**, reversing excessive investment, especially in the residential construction sector, accumulated during the boom period. Investment will remain at relatively high levels, as will the saving rate
- The **current account deficit** has been adjusted by 5 percentage points in just two years. Unlike other European countries, no underlying problems regarding a significant loss in competitiveness.
- The wealth position of **households** is sound and they have quickly increased their saving rate to face a gradual deleveraging process
- **Firms**, except in the construction and real estate sector, are recording the right debt and solvency levels and relatively high profitability ratios
- On aggregate, the **Spanish financial system** is recording sound solvency and liquidity levels, and no excess leverage. However, part of the system is restructuring, although the cost is affordable.
- The **fiscal consolidation process underway is demanding but on target**. 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.
- Tackling the **reform process with determination** 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.

BBVA Research



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