



Spain Economic Outlook

Third quarter 2010

Key messages

- The main risk for the global economy is still coming from financial markets.
- Stress tests have had positive – though asymmetric – impacts in Europe. The tests, conducted with greater transparency and under more severe macroeconomic scenarios in Spain than in the rest of Europe, showed significant resilience in the Spanish financial system.
- The global economy is on track for a mild and differentiated slowdown. Growth gaps between advanced and emerging economies and across countries of those regions will continue to increase.
- The Spanish economy grew slightly during 1Q10 and 2Q10, but uncertainties remain about its performance in the second half. GDP could contract by around 0.6% in 2010 as a whole, but could rise by 0.7% in 2011.
- In the most probable scenario, confidence is likely to continue to improve going forward, while risk perception will probably continue to dissipate. Risk premiums do not yet reflect the fundamentals of the Spanish economy..
- The Spanish fiscal consolidation process, supported mainly by expenditure cuts, satisfy the necessary requirements to be successful.
- Respite granting by financial markets to the Spanish economy is conditional and depends on the persistence of the structural reforms process crucial to guarantee sustained economic growth and employment creation.

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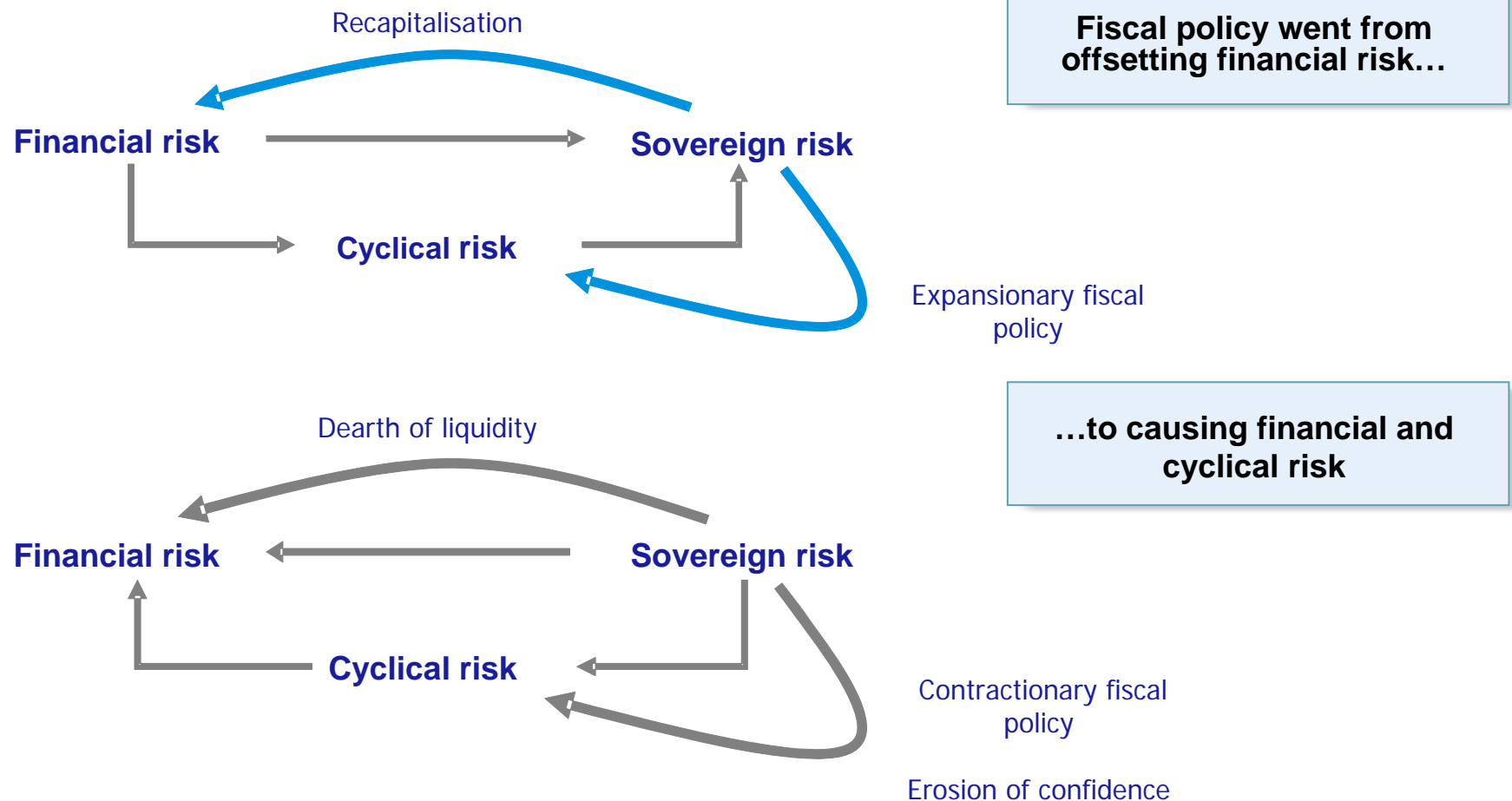
Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

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Re-assessment of global economic prospects

Financial risks deriving from the sovereign debt problems became a vicious circle, ultimately pushing up market risk and absorbing liquidity, especially in Europe



Re-assessment of global economic prospects

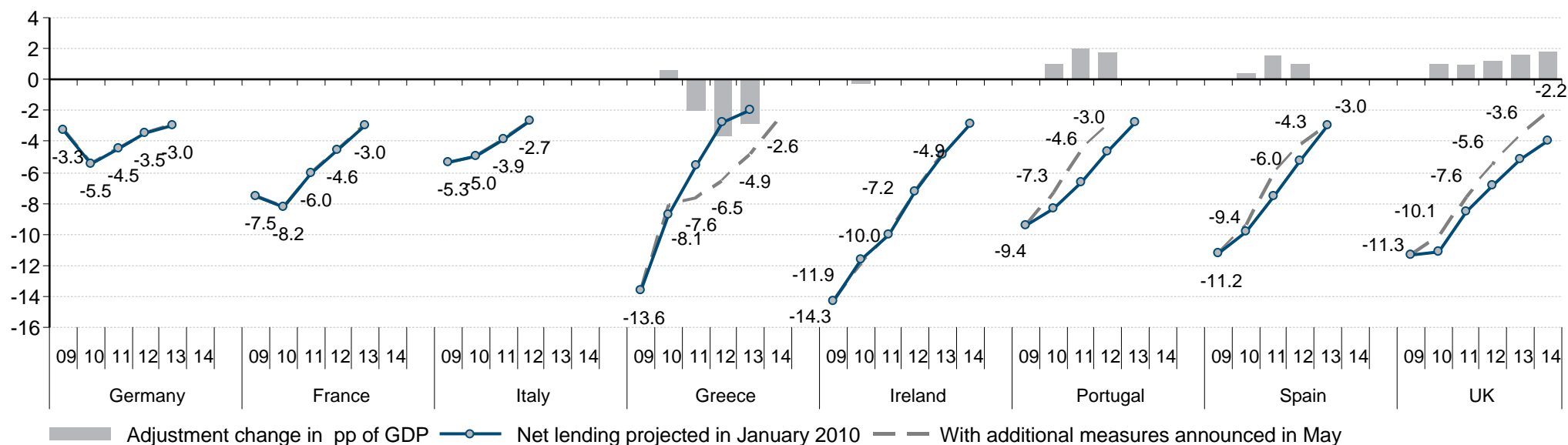
Sovereign risk Faster fiscal adjustment only in some European countries

Consolidation plans in Europe are being implemented in line with a schedule submitted to the European Commission (EC) in early 2010 (UK, Portugal and Spain have stepped up their plans)

Europe: projected deficit plans

(% of GDP)

Source : National governments and EC. UK: data refer to definition included in Maastricht Treaty



Re-assessment of global economic prospects

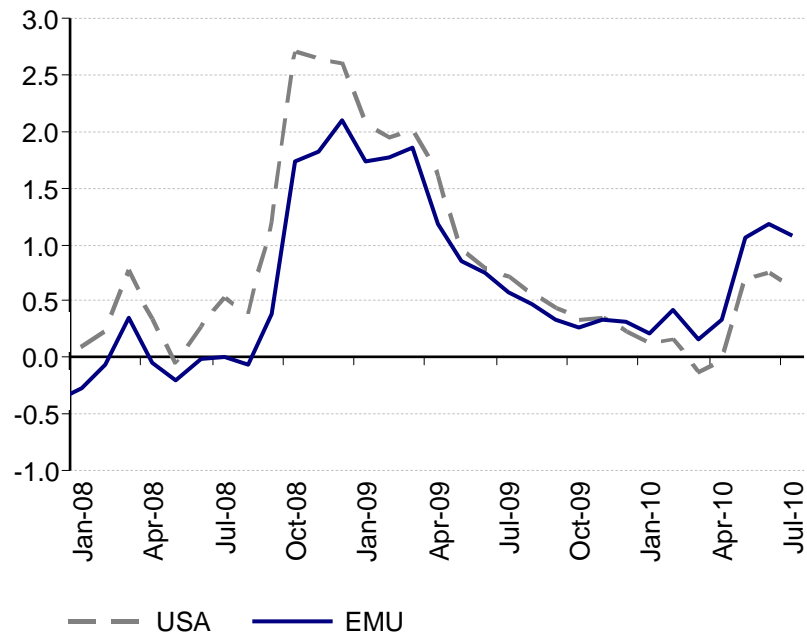
Financial risk The main risk for the global economic outlook is still coming from financial markets

However, financial pressures seen in the second half of 2010 are starting to ease

The results of the stress tests have been well received. Capital markets are opening up again partially for noncore European countries

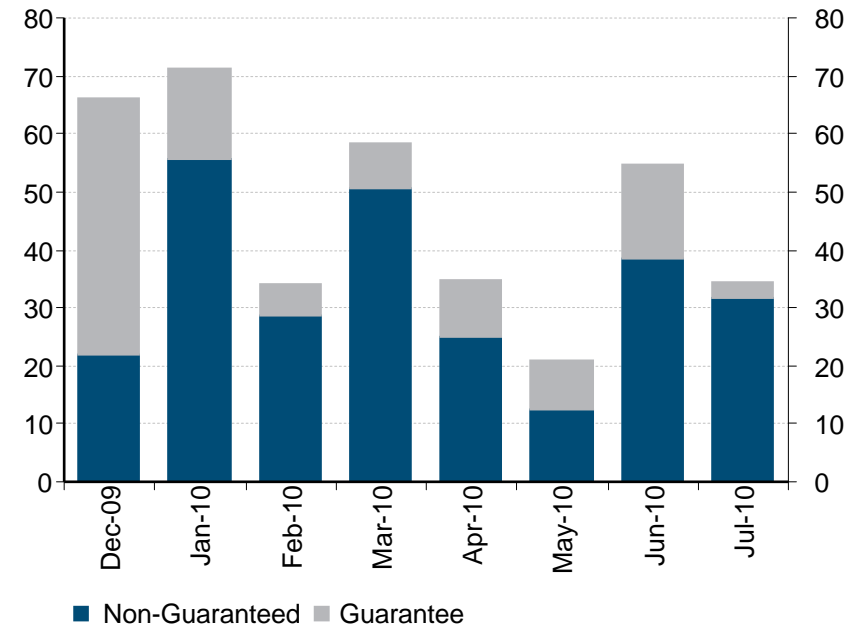
Financial stress index

Source : Eurostat and EC



EMU banks debt issuance (€Bn)

Source: Bloomberg and BBVA Research



Re-assessment of global economic prospects

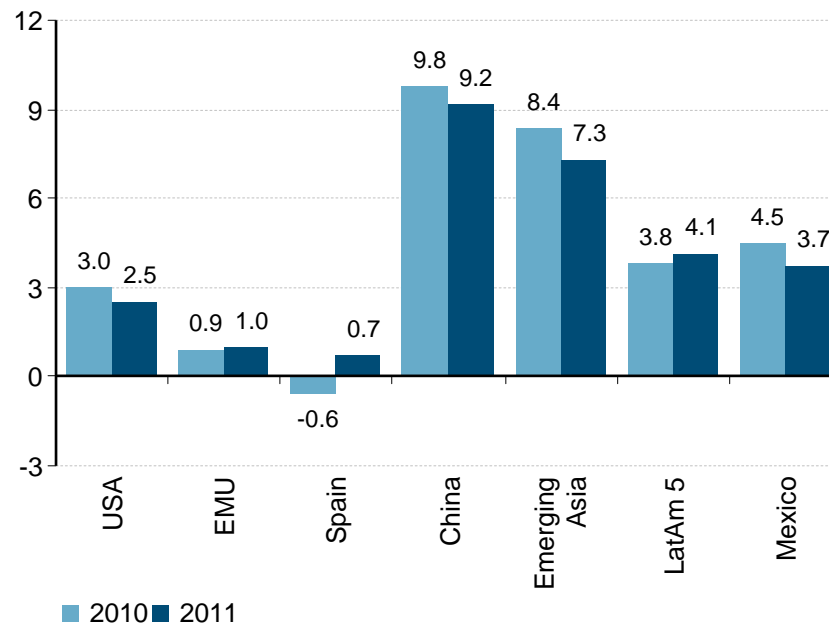
Cyclical risk In this context, growth divergences between developed and emerging economies, and across countries of those regions, will continue to increase...

The global economy is on track for a mild and differentiated slowdown

In Asia, a moderating growth trend should reduce the risk of overheating. In the US private demand will remain weak without policy support. In Europe confidence will be negatively affected by the fallout from the financial crisis.

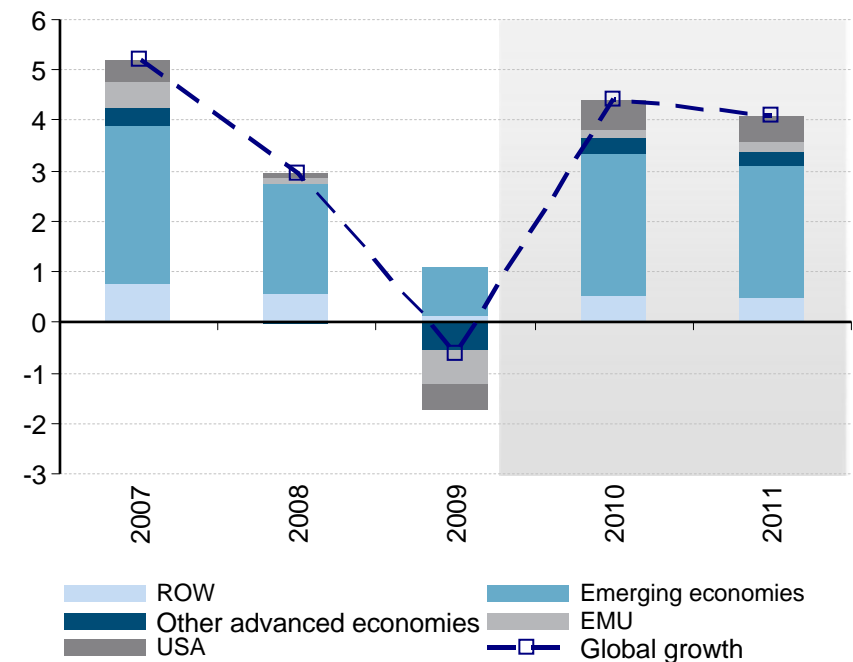
GDP growth forecasts (%)

Source: BBVA Research



Contributions to global GDP growth (pp)

Source: BBVA Research based on IMF data



Re-assessment of global economic prospects

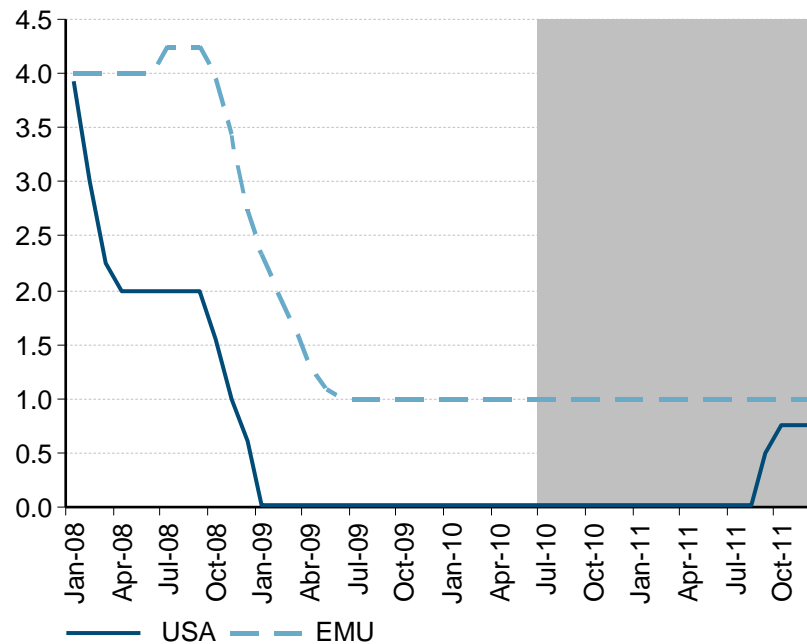
...leading to slight differences in monetary policy between USA and EMU

Financial strain in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises as well as to keep very low policy rates for an extended period.

Inflationary pressures in both areas will remain low, enabling central banks to maintain flexible monetary policies. A faster recovery in the US would bring a change in monetary policy earlier than in the euro area. Both factors would weigh on the euro.

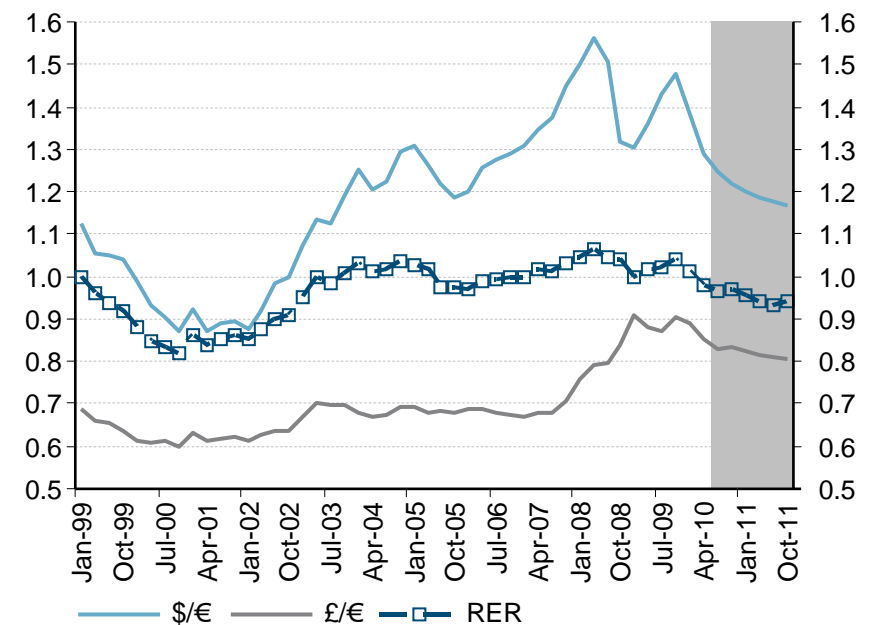
US and EMU: official interest rates

Source: BBVA Research



Euro exchange rates

Source: BBVA Research



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Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

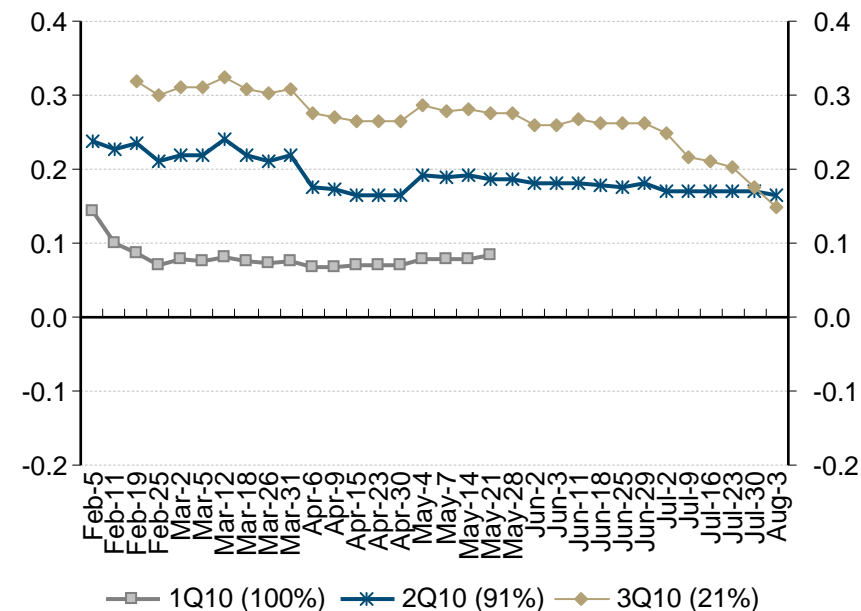
The Spanish economy recorded moderate growth again in the second quarter of 2010

In 2Q10, the Spanish economy grew slightly faster than in 1Q10

As in 1Q10, external demand contribution offset sluggish domestic demand

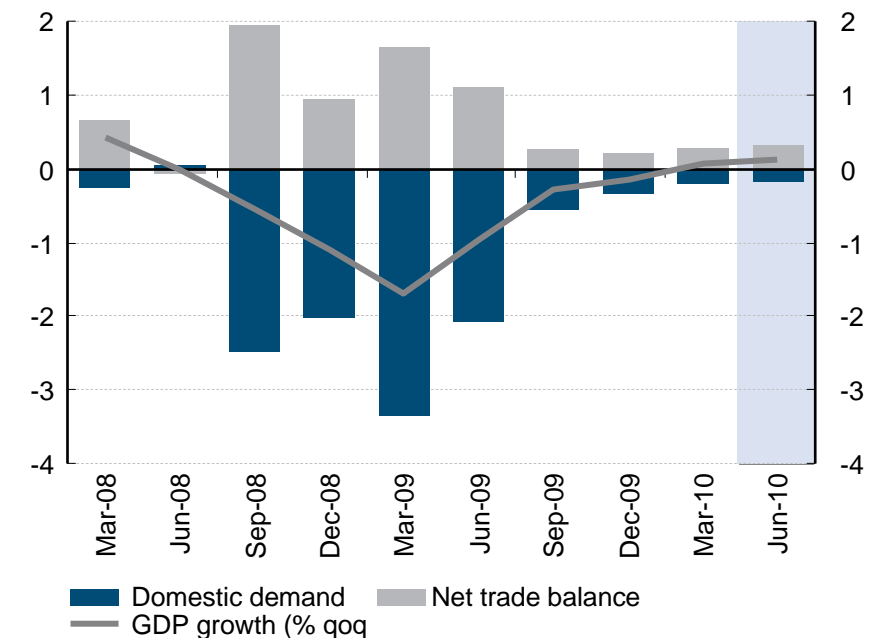
Spain: quarterly GDP growth forecasts. MICA-BBVA model.

In brackets is the percentage of the information set available for the reference quarter at the time of the latest estimate.
Source: BBVA Research



Spain: Contributions to quarterly GDP growth (%)

(%)
Source: BBVA Research based on INE data



Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

The main features defining the Spanish economic juncture are sluggish domestic demand, weak employment, and strong exports.

Weakness of domestic demand

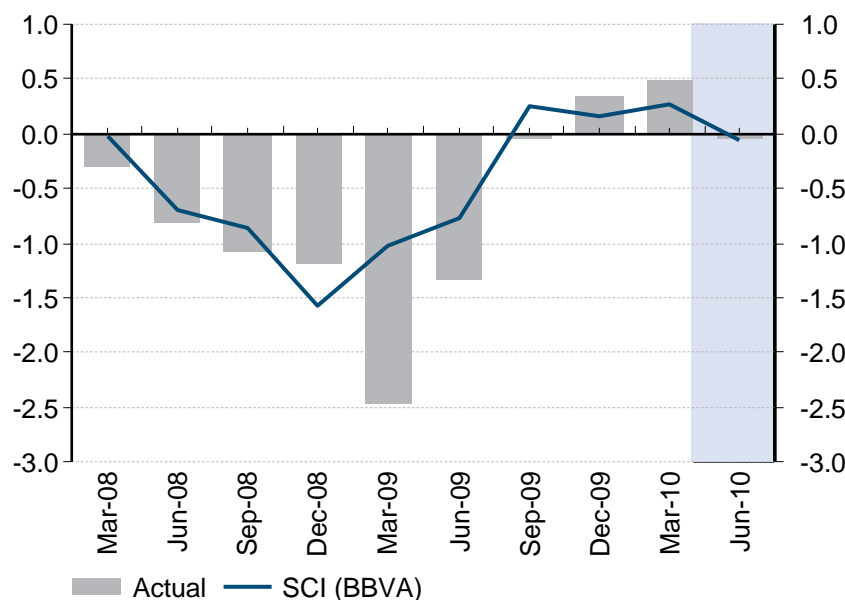
The steady loss of steam of its main drivers, plus the slight erosion in consumer confidence and the weakening of fiscal stimulus measures, explain **the weakness of consumption**

Despite there are mixed signals, on balance data point to a further **downward correction of investment in capital goods**, which could be temporary depending on the persistence of financial pressures

Spain: private consumption and BBVA Synthetic Consumption Indicator (SCI)

(% qoq)

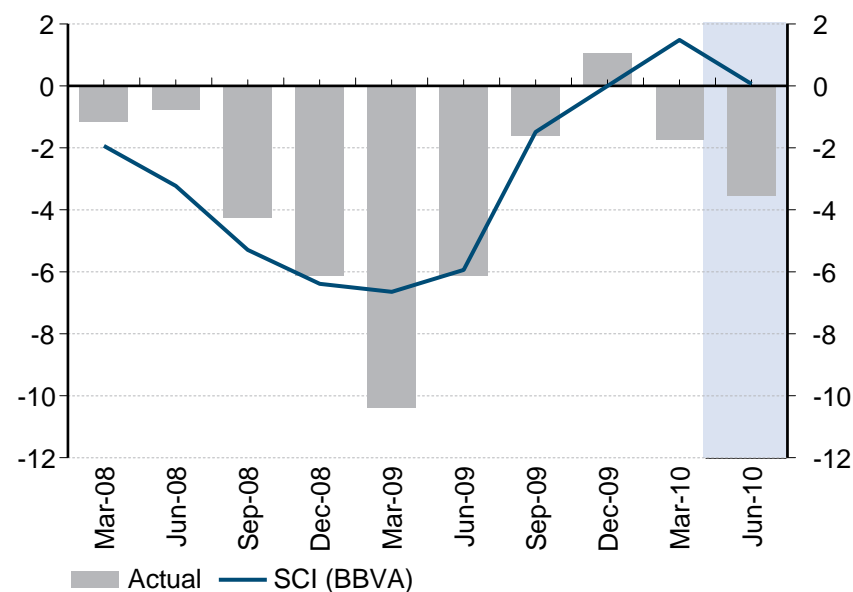
Source: BBVA Research based on INE data



Spain: investment in capital goods and others and BBVA synthetic investment indicator (SII) - business

(% qoq)

Source: BBVA Research based on INE data



Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

The main features defining the Spanish economic juncture are sluggish domestic demand, weak employment, and strong exports.

Employment destruction

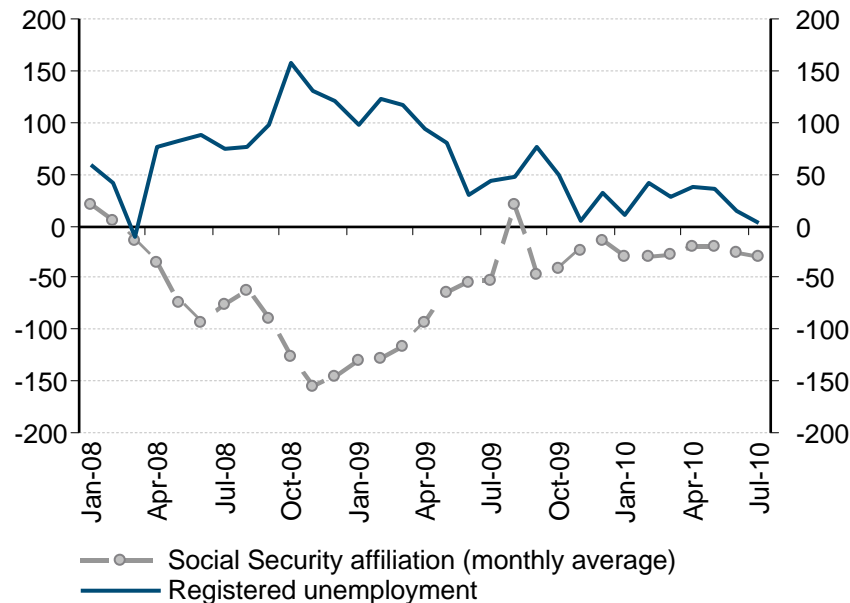
Employment is not yet showing signs of improvement, with no significant changes after seasonal adjustments

Higher growth in labour market participation than job creation triggered a **further increase in the unemployment rate in 2Q10** to 20.1%

Registered unemployment and Social Security affiliation

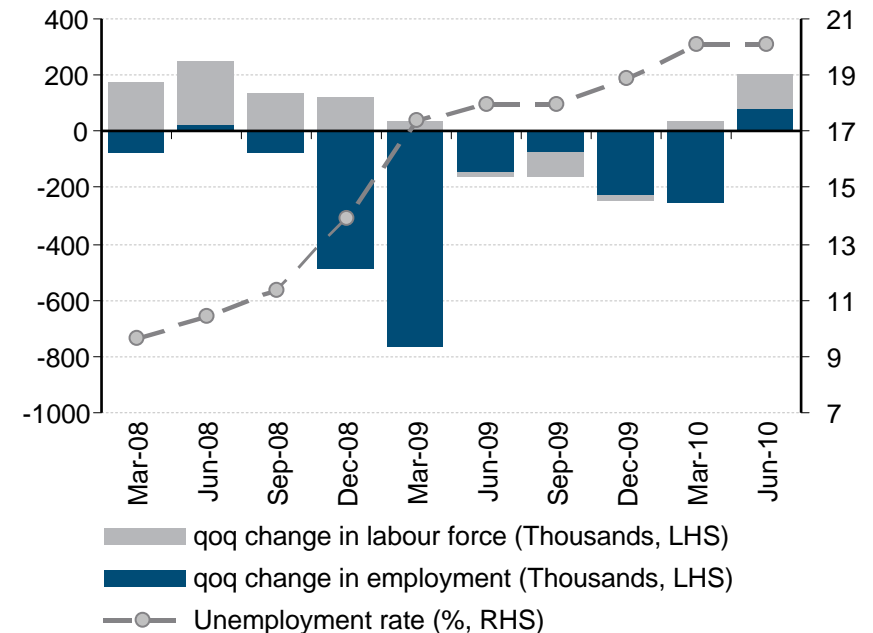
(mom change in thousands, swda)

Source: BBVA Research based on SPEE and MTIN data



Spain: employment, labour force and unemployment rate

Source: BBVA Research based on INE data



Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

The main features defining the Spanish economic juncture are sluggish domestic demand, weak employment, and strong exports.

Strong exports

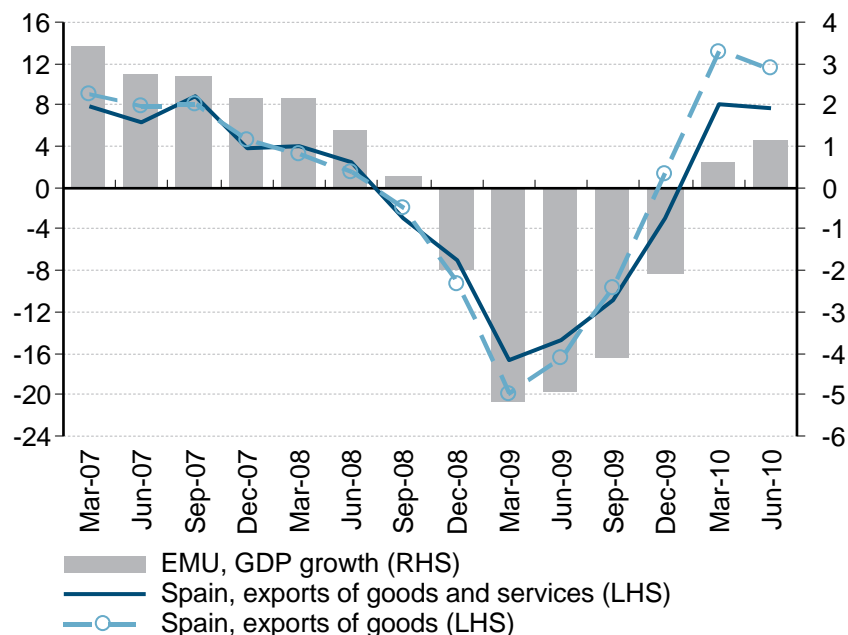
the **Spanish exports sector** continued to play the major role as a **driver of recovery in 2Q10**

The ongoing, albeit moderate, economic recovery in Europe and gains in competitiveness in terms of the real effective exchange rate (REER) are the underlying factors behind the jump in Spanish exports

Spanish exports of goods and services and EMU GDP growth

(% yoy)

Source: BBVA Research based on INE and Eurostat data

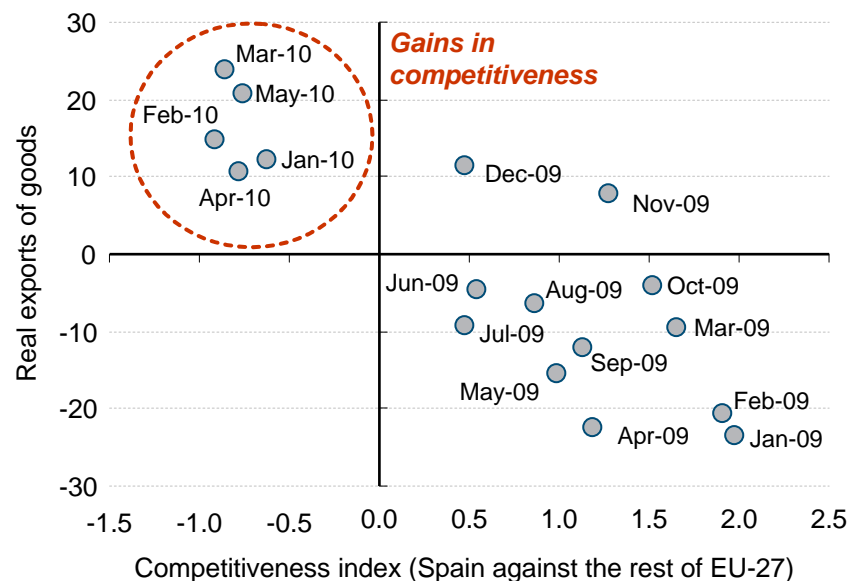


Spain: real exports of goods and industrial prices based competitiveness index

(% yoy)

Shifts to the left imply improvements in competitiveness

Source: BBVA Research based on INE and MITyC data



Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

The adjustments in progress are likely to entail negative GDP growth in 2H10

Financial stress

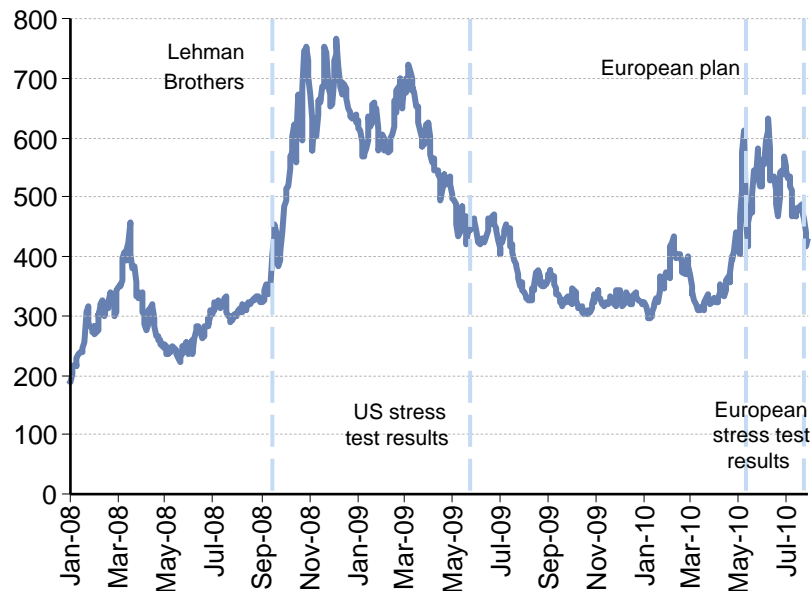
The acceleration of the fiscal consolidation process, coupled with remaining uncertainties and ongoing volatility in capital markets could have a negative impact, albeit limited and temporary, on Spanish economic growth

Despite the approval of the European stabilisation mechanism, financial stress remains high

Risk premiums do not yet reflect the fundamentals of the Spanish economy

EMU: Financial stress indicator

Source: BBVA Research

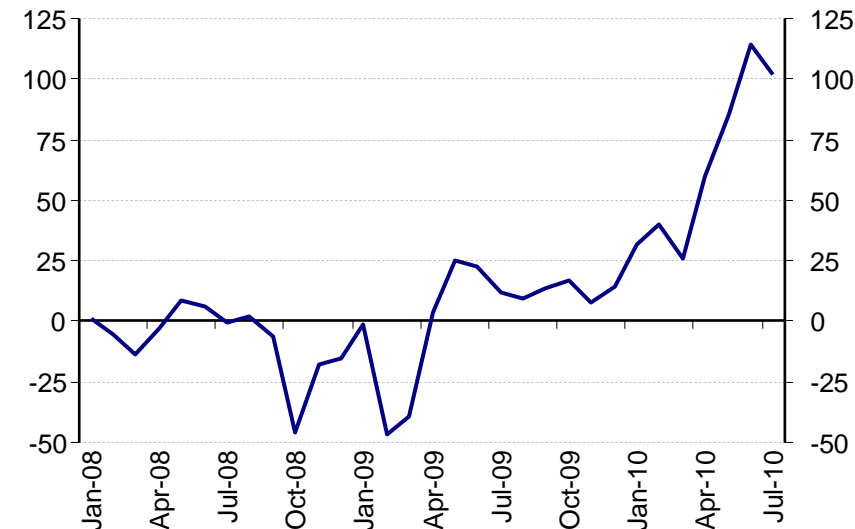


Spain: degree of market overvaluation in country risk indicators

(bp)

The line represents the spread between present value (sovereign 5Y CDS) and the estimated structural CDS (calculated using an econometric model based on fundamentals)

Source: BBVA Research



Spanish Economy: 1H10 in positive but it remains the uncertainty about 2H10

The adjustments in progress are likely to entail negative GDP growth in 2H10

In this scenario, **the Spanish economy could contract 0.6% in 2010, before growing again in 2011**

| Macroeconomic forecasts | | | | | | |
|------------------------------------|-------------|-------------|-------------|------------|-------------|------------|
| (% chg. yoy) | 2009 | | 2010 | | 2011 | |
| | Spain | EMU | Spain | EMU | Spain | EMU |
| Household consumption | -5.0 | -1.2 | -0.3 | 0.0 | 0.3 | 0.4 |
| Public consumption | 3.9 | 2.7 | 1.4 | 1.0 | 0.2 | 0.5 |
| GFCF | -15.2 | -10.9 | -9.5 | -3.4 | -3.2 | 0.3 |
| Capital goods and other products | -20.6 | -15.1 | -9.4 | -1.5 | -1.9 | 0.8 |
| Capital goods | -22.9 | -16.5 | -5.5 | -0.9 | -1.0 | 0.5 |
| Construction | -11.1 | -7.6 | -9.5 | -5.1 | -4.0 | -0.4 |
| Housing | -24.5 | -9.8 | -16.8 | -5.3 | -6.1 | -0.7 |
| Domestic Demand (*) | -6.4 | -3.3 | -2.2 | 0.5 | -0.6 | 0.4 |
| Exports | -11.3 | -13.2 | 6.6 | 7.7 | 7.3 | 7.9 |
| Imports | -17.7 | -11.9 | 0.0 | 6.9 | 1.5 | 6.7 |
| Net trade balance (*) | 2.8 | -0.8 | 1.5 | 0.4 | 1.3 | 0.6 |
| GDP at mp (% yoy) | -3.6 | -4.1 | -0.6 | 0.9 | 0.7 | 1.0 |
| Pro-memoria | | | | | | |
| GDP w/o housing investment | -1.8 | -3.8 | 0.4 | 1.1 | 1.2 | 1.3 |
| GDP w/o construction | -2.2 | -3.7 | 0.9 | 1.2 | 1.5 | 1.3 |
| Employment (LFS) | -6.8 | -1.8 | -2.6 | -0.5 | -0.3 | 0.3 |
| Unemployment rate (% active pop.) | 18.0 | 9.4 | 19.6 | 10.4 | 19.4 | 10.6 |
| Current account balance (% of GDP) | -5.5 | -0.8 | -4.2 | -0.5 | -2.7 | -0.2 |
| Public deficit (% of GDP) | -11.2 | -6.3 | -9.6 | -6.8 | -6.6 | -5.5 |
| CPI (annual average) | -0.3 | 0.3 | 1.6 | 1.3 | 1.4 | 1.2 |

(*) contribution to GDP growth

Source: BBVA Research based on data from official institutions

The Spanish economy: good first half, but concerns about the second half

However, upside risks cannot be ruled out, even in the short term

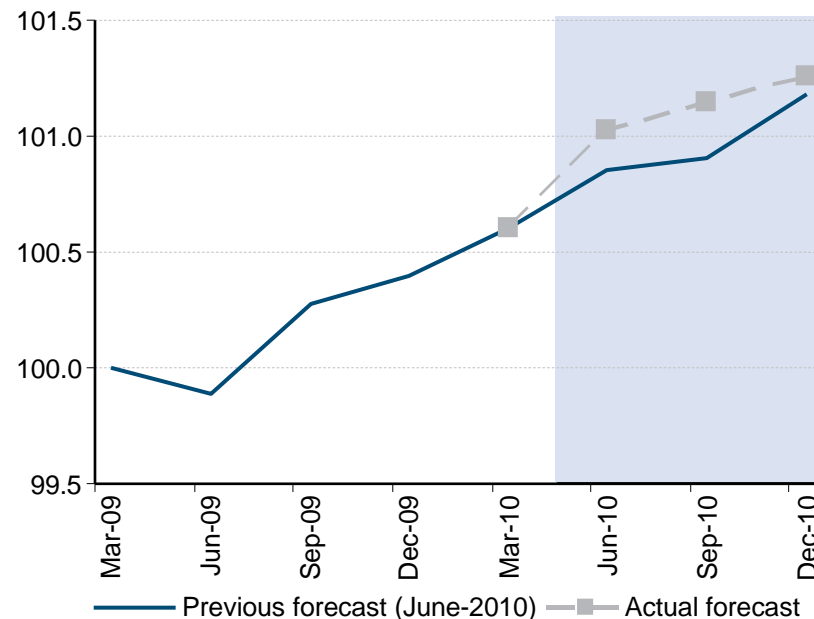
At the start of 3Q10, **the euro area**, which receives close to 60% of Spanish exports, was **outperforming projections** at the end of June (0.2 pp above previous forecasts)

Meanwhile, **the response by net trade to a weaker euro could be better than expected** if the degree of diversification of Spanish exports towards non-euro area destinations, where demand is stronger, continues to increase

EMU: GDP growth forecasts

(Mar-09 = 100)

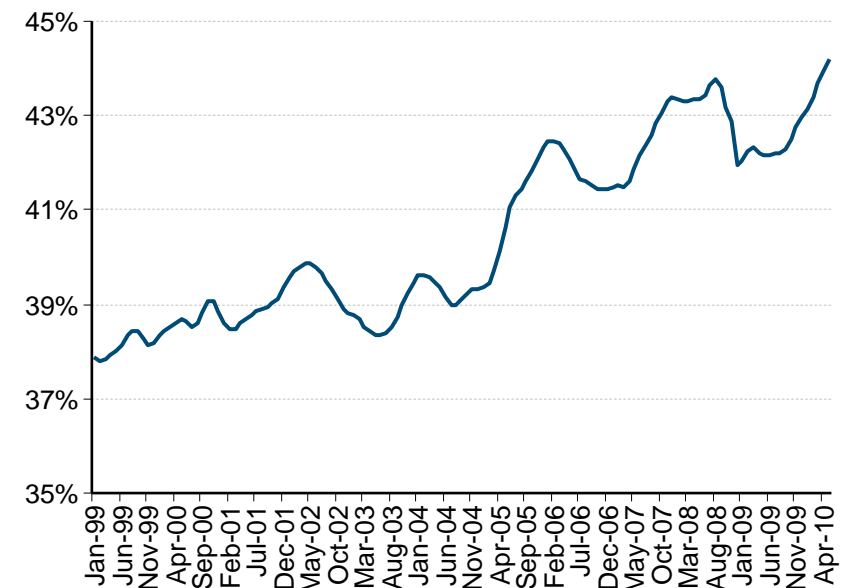
Source: BBVA Research



Spain: weight of non-EMU exports of goods

(% of total exports of goods. Trend)

Source: BBVA Research based on MITYC data



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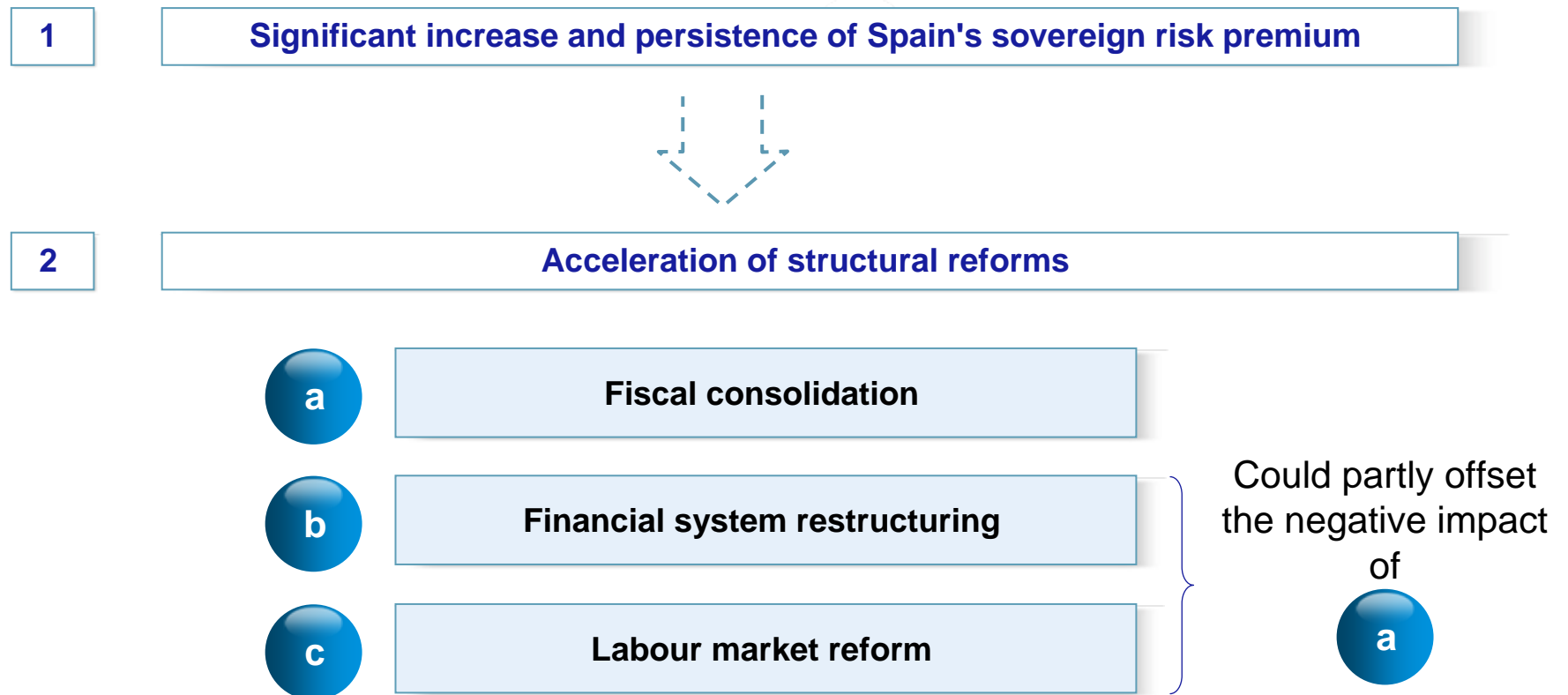
The Spanish economy: good first half, but concerns about the second half

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Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation

Over the last quarter, two events have changed the core scenario



The reforms are a step in the right direction. However, the Spanish economy is facing big enough challenges for an ambitious approach in those areas which have not yet been fully defined

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



The groundwork for an ambitious fiscal consolidation has been laid. It will be feasible if the fiscal adjustment is conducted strictly by all public administrations

Once the policies behind the spending ceiling for 2011 are defined, almost 80% of the adjustment towards a deficit of 3% of GDP in 2013 will have been achieved two years ahead of schedule

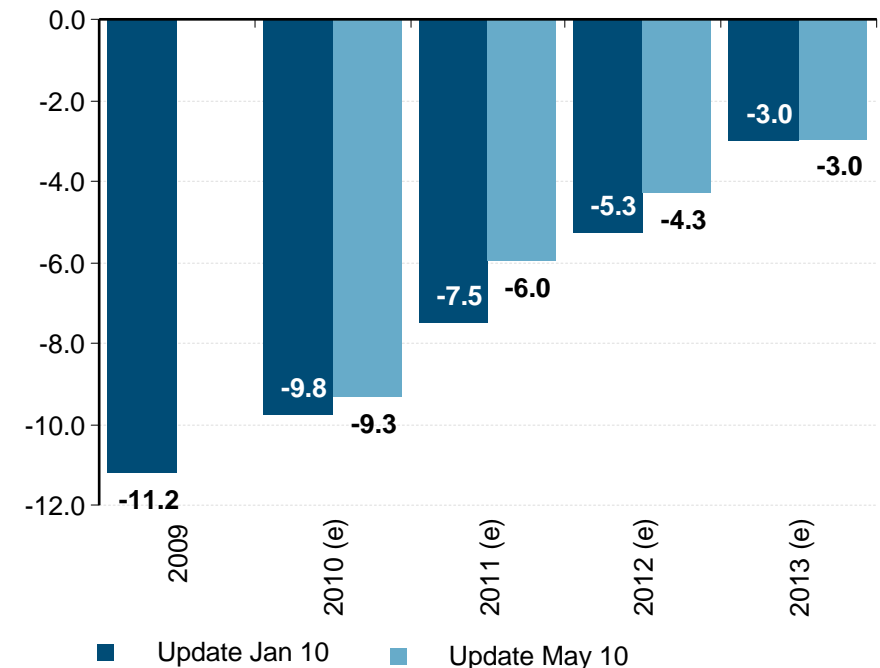
Going forward the Spanish government must:

1. Prioritise cutbacks in current expenditure before continuing to adjust **public investment**
2. Avoid an increase in the already-high **fiscal progressivity**
3. Progress towards a **more efficient, simple and competitive tax system** compared to the rest of Europe

Spain: budget balance as % of GDP

PEC scenario

Source: BBVA Research based on MEH and government data



Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



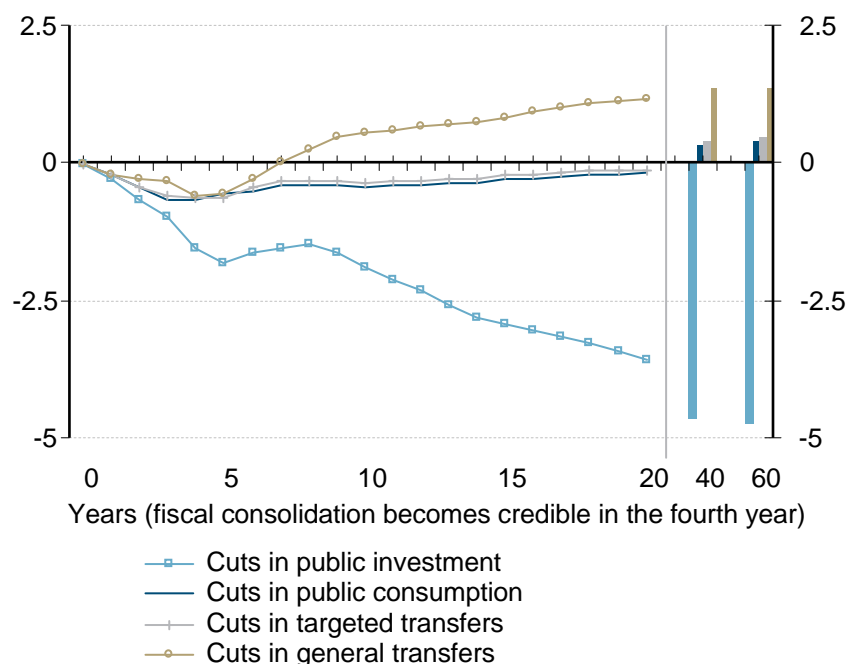
The groundwork for an ambitious fiscal consolidation has been laid. It will be feasible if the fiscal adjustment is conducted strictly by all public administrations

1. Decrease in current expenditure rather than investment

Empirical evidence indicates that fiscal consolidation through cutbacks to public investment has a negative impact on GDP growth as the reduction in capital has similar effects to those of a negative productivity shock

US: impact on GDP of fiscal adjustment (-1pp of the deficit) via expenditure (difference from core scenario, pp)

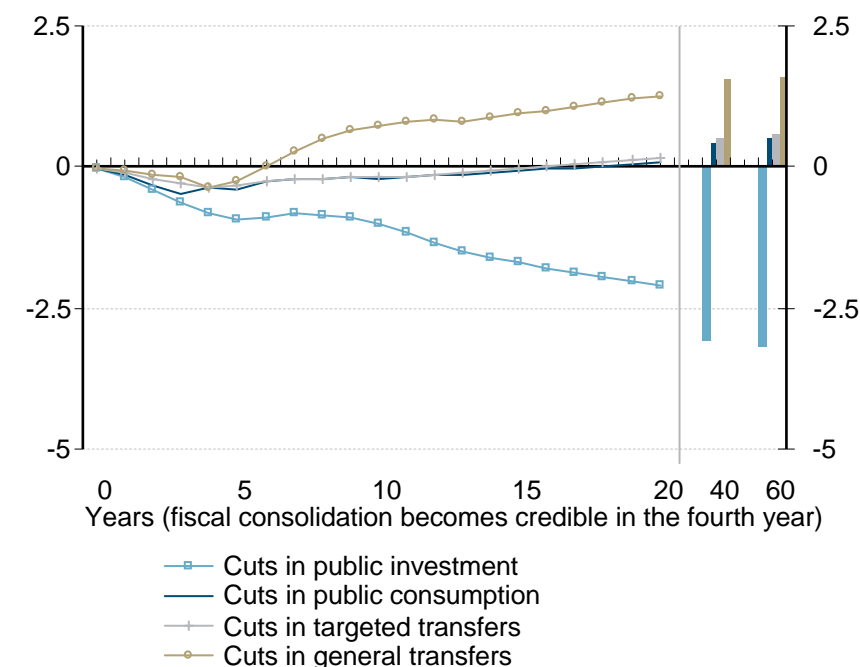
Source: Clinton, K. *et al* (2010).



EMU*: impact on GDP of fiscal adjustment (-1pp of the deficit) via expenditure (difference from core scenario, pp)

(*) excluding Germany

Source: Clinton, K. *et al* (2010).



Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



The groundwork for an ambitious fiscal consolidation has been lay. It will be feasible if the fiscal adjustment is conducted strictly by all public administrations

2. Fiscal progressivity on employment income

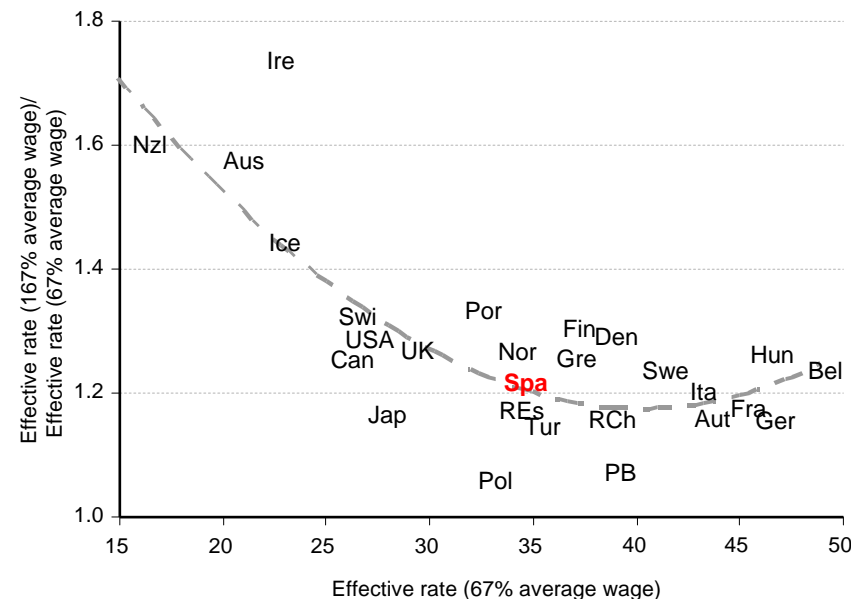
The **negative effects of greater progressivity of employment income taxation**, which in Spain is already higher than the EU average, must be considered

Additional increases in marginal tax rates would generate **disincentives to accumulate human capital and jobs in Spain among the population with higher standards of education**, compared with other economies where the tax burden is lower, undermining the recruitment of talent and the potential of the Spanish economy

Fiscal progressivity of employment income tax in the OECD

AW: average wages

Source: BBVA Research based on OECD data



Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



The groundwork for an ambitious fiscal consolidation has been lay. It will be feasible if the fiscal adjustment is conducted strictly by all public administrations

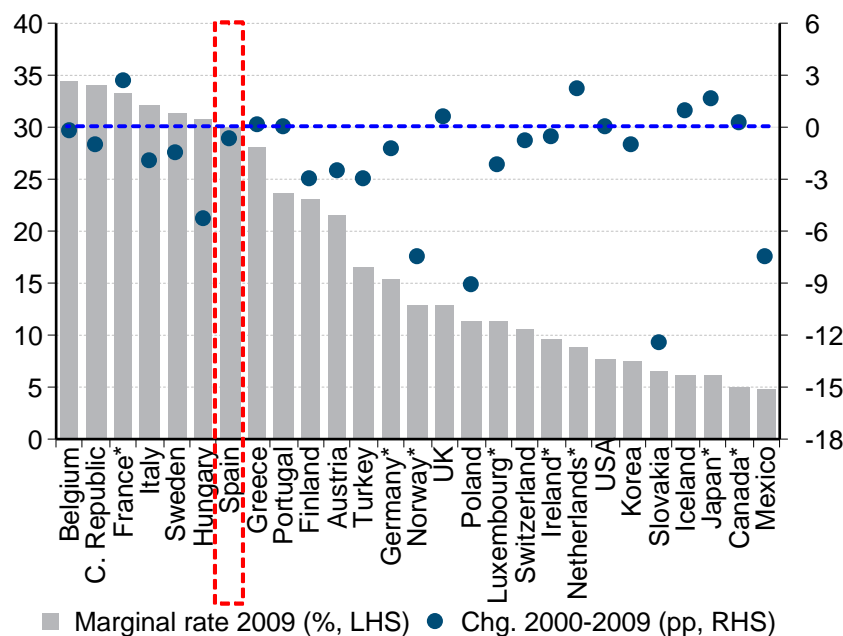
3. A more efficient tax system

It would be advisable to **make the Spanish tax system more efficient** bearing in mind three factors:

1. The tax burden on labour income is high in Spain than in other EU countries
2. Corporation tax is high in comparative terms
3. Indirect taxation is relatively low

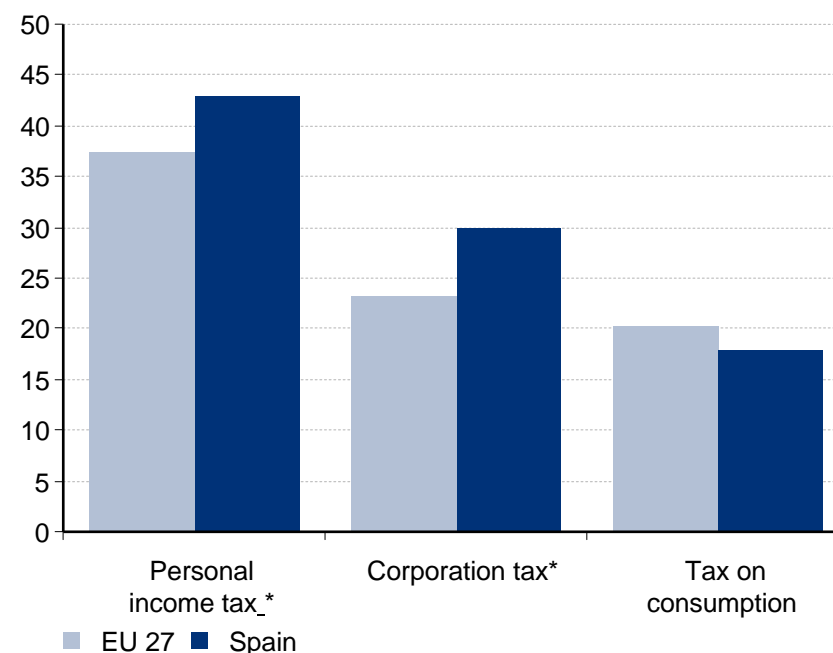
OECD: employer social security contribution rates

*Sikmple average of marginal rates per income bracket
Source: BBVA Research based on OECD data



Tax rates in Europe and Spain

(*) Marginal rate
Source: BBVA Research based on Eurostat and OECD data



Stepping up the pace of reform is crucial to securing sustained growth and job creation



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

Ongoing mergers: a first step in the right direction

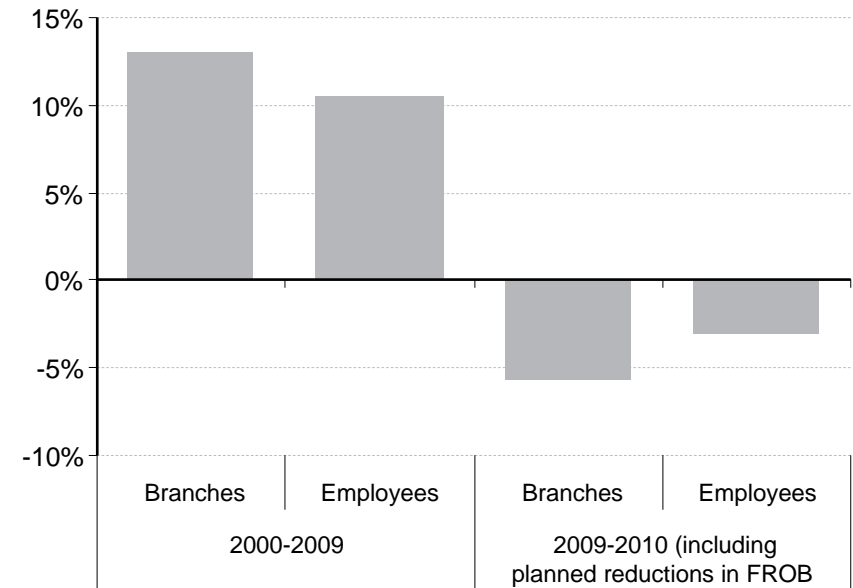
The Spanish financial system restructuring process has been stepped up in the second half of this year, with a significant number of applications for mergers that were submitted shortly before 30 June, when the FROB was due to expire.

So far, 12 billion Euros have been disbursed and job cuts (3% of the total banking system) and branch closures (5% of the total) have been announced. These figures indicate that, although the sector's surplus capacity has been reduced, **further consolidation is needed.**

Spain: branch offices and employees in the financial system

(% yoy)

Source: BBVA Research based on BoS data Título



Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



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

LORCA: positive assessment

LORCA

Capitalisation

Professionalization of management

New business models

Legal clarification of IPSs

Positive assessment of the LORCA

Intensification of the restructuring process begun with the FROB

Broad political consensus and swift agreement

Lead to a confidence recovery regarding the Spanish financial sector as a whole

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



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

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

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 | ✓ | ✓ |

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



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

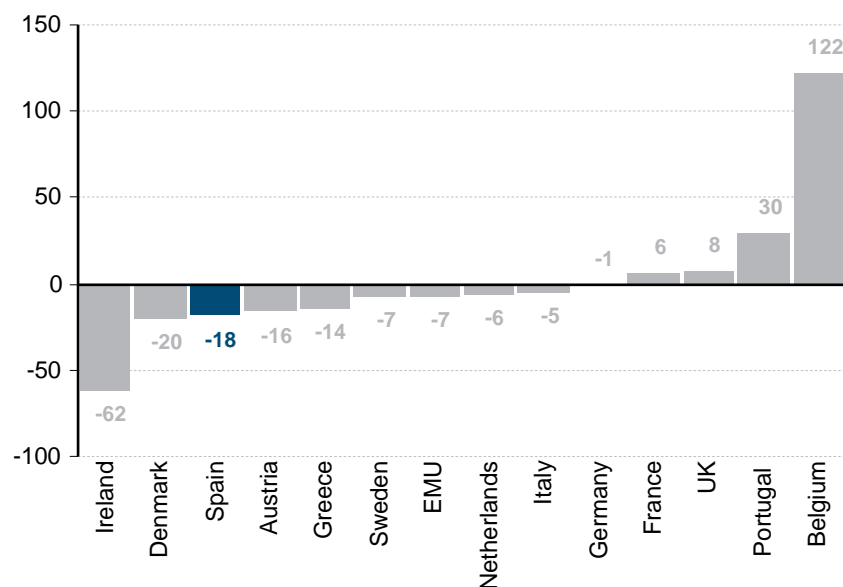
Ongoing mergers, the new Savings Banks Act (LORCA) and stress tests are crucial steps within the Spanish financial system restructuring

Estimations of pre-impairment income have been highly discretionary, resulting in significant differences across countries. In Spain, reasonable assumptions of thinner margins

The coverage of the tests is broader in Spain. This would explain why estimated losses are higher than in other countries; it is not a sign of weakness of the system, but rather of greater transparency

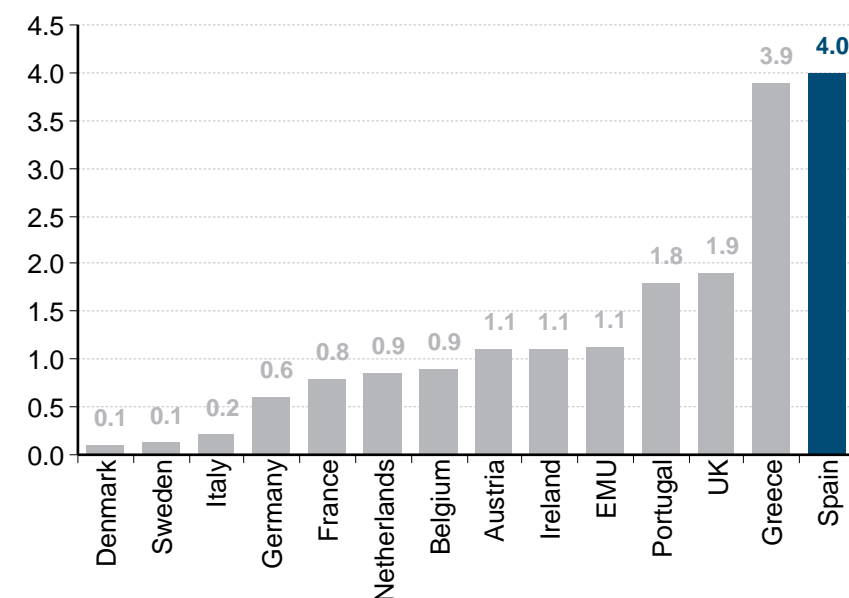
Stress tests: pre-impairment income Average annual change between 2010-2011 and 2009

Source: CEBS and BBVA Research



Net impairments as percentage of financial assets

Source: CEBS and BBVA Research



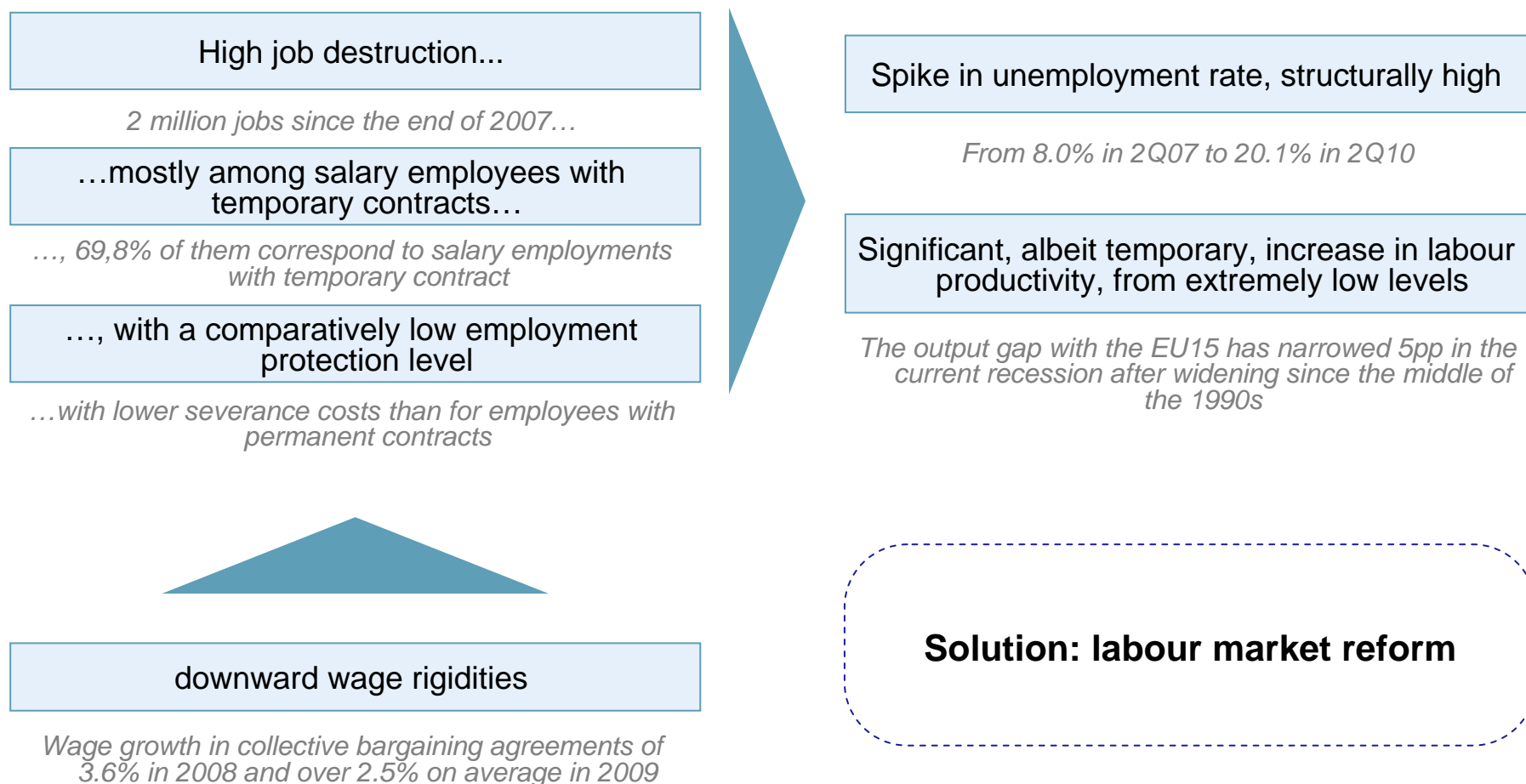
The Spanish financial system's capital requirements are manageable and the losses and margins reasonable, reinforcing the solvency of the Spanish financial system

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



Labour market reform: a step in the right direction, but doubts about its effectiveness

The main problems of Spain's labour market: high job destruction, duality, downward wage rigidities, structurally high unemployment and low productivity growth



Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



Labour market reform: a step in the right direction, but doubts about its effectiveness

The **labour reform** approved recently is a **step in the right direction** towards solving the problems plaguing Spain's labour market...

1. **It is a step towards the necessary re-balancing of recruitment and dismissal costs among temporary and permanent workers**
 - The reform generalises the Employment Contract to Promote Permanent Hiring (CFPI), whereby severance for fair dismissal on objective grounds is 33 days' salary per year worked.
 - Severance for dismissal under temporary contracts is increased progressively: one day salary per year worked from 2012 up to 12 days per year worked in 2015.
 - The Wage Guarantee Fund (FOGASA) will pay 8 days of severance for new permanent contracts until the capitalisation fund comes into force in early 2012.
 - The reform helps clarify the technical, organisational and productivity-related grounds for objective dismissal, and would introduce the principle of minimum reasonability, which could speed up the process of fair dismissal on financial grounds.
2. **It leaves open to agreement between companies and union representatives the decision to temporarily not apply the wage regime set forth in the higher-level collective bargaining agreement** when the company's prospects could be damaged because of its application
3. **Companies' internal flexibility instruments are strengthened** by allowing working conditions to be changed (working hours, distribution of time, shifts, etc.) due to financial, technical, organisation or productivity-related causes through consultation with the workers' legal representatives.
 - Temporary suspension of contracts and shorter schemes are encouraged, with the Social Security Administration covering the ensuing wage ("German model").

Stepping up the pace of structural reforms to guarantee sustained economic growth and employment creation



Labour market reform: a step in the right direction, but doubts about its effectiveness

..., but a **quick and efficient resolution to all the rigidities** characterizing the Spanish labour market **requires further advancements**, which may still come during the parliamentary processing stage

i. Duality and the rebalancing of employment protection

- The reform does not reduce the broad range of contracts still existing, so its effect on the duality of the labour market remains doubtful
- The role of FOGASA in bringing severance costs into line with be limited
- The RDL does not remove all doubts surrounding concurrence of financial causes for terminating a contract. While the legal uncertainty has diminished compared with the previous system, there is still enough uncertainty to jeopardise permanent hiring

Optimal alternative:

- a new **single contract** –not affecting contracts currently in force- with severance costs that increase in line with the number of years the worker has been at the company; and
- a **severance insurance system financed through social security contributions**, similar to the one in place in Austria, which would accumulate in individual accounts

ii. Collective bargaining and wage opt-out clauses

- RDL 10/2010 do not include all the requirement modifications to the current wage-setting mechanism nor to the collective bargaining system

Collective bargaining decentralization

- a) Removal of the principle of general automatic efficacy in higher level collective bargaining agreements,
- b) Setting limits on the maximum validity period without new bargaining (principle of ultra-activity)
- c) Establishing the topics to be negotiated in each sphere, leaving organizational and wage aspects for the company-specific agreements

For the reform to be as effective as possible, it must be actively implemented and continuously monitored

Key messages

- The main risk for the global economy is still coming from financial markets.
- Stress tests have had positive – though asymmetric – impacts in Europe. The tests, conducted with greater transparency and under more severe macroeconomic scenarios in Spain than in the rest of Europe, showed significant resilience in the Spanish financial system.
- The global economy is on track for a mild and differentiated slowdown. Growth gaps between advanced and emerging economies and across countries of those regions will continue to increase.
- The Spanish economy grew slightly during 1Q10 and 2Q10, but uncertainties remain about its performance in the second half. GDP could contract by around 0.6% in 2010 as a whole, but could rise by 0.7% in 2011.
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