



The Spanish Economy: Adjustments, Perspectives and Challenges

Rafael Doménech
Chief Economist for Spain and Europe

London, September 15, 2010

Key messages

- Myths vs. reality: most analysis of the Spanish economy are too simple: reality is more complex and requires a more detailed scrutiny, for both the previous expansion and the current recession.
- The 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 excess consumption or a significant loss in competitiveness** have been detected
- The **wealth position of households** is sound and they have quickly increased their saving rate to face a gradual deleveraging process
- **Businesses**, except 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 feasible. The latest measures have significantly boosted the credibility of the fiscal adjustment plan
- The restructuring of the financial sector, fiscal consolidation and labour market reform seem to be key **structural reforms** that could allow for a quicker recovery in the short run.

Structure of the presentation

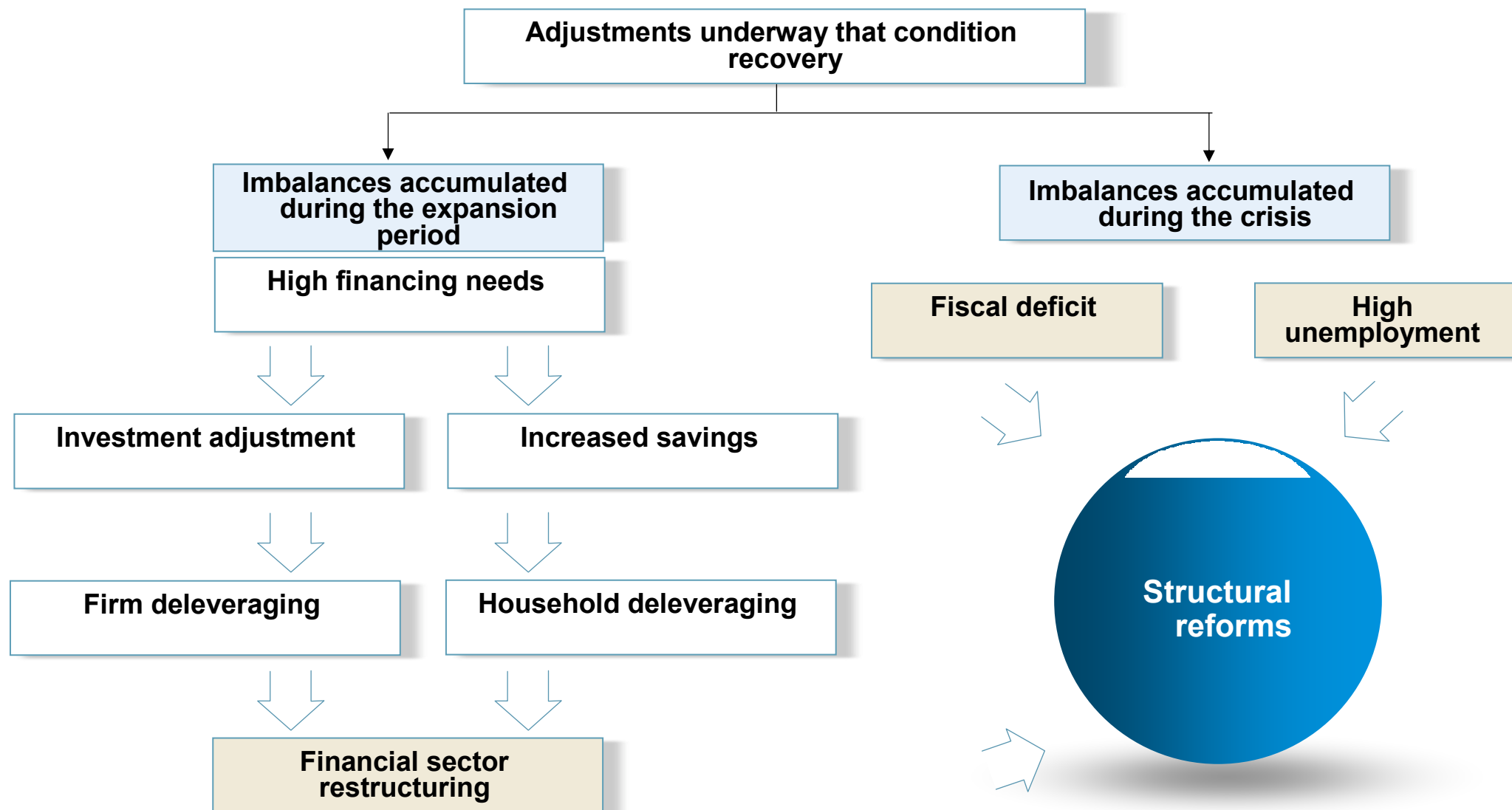


Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Competitiveness and the current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

Competitiveness and the current account adjustment

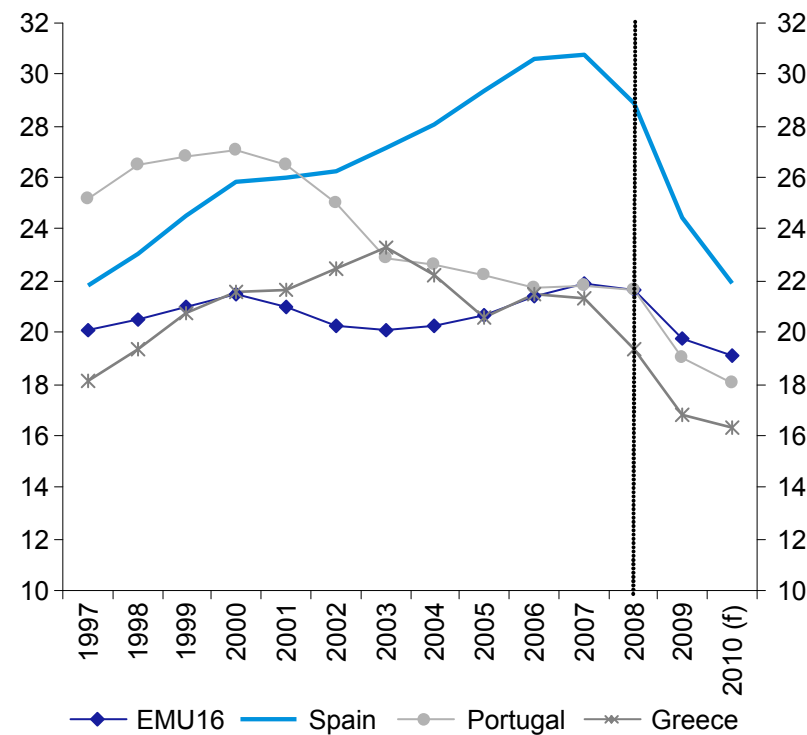
High investment rate behind the current account deficit

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

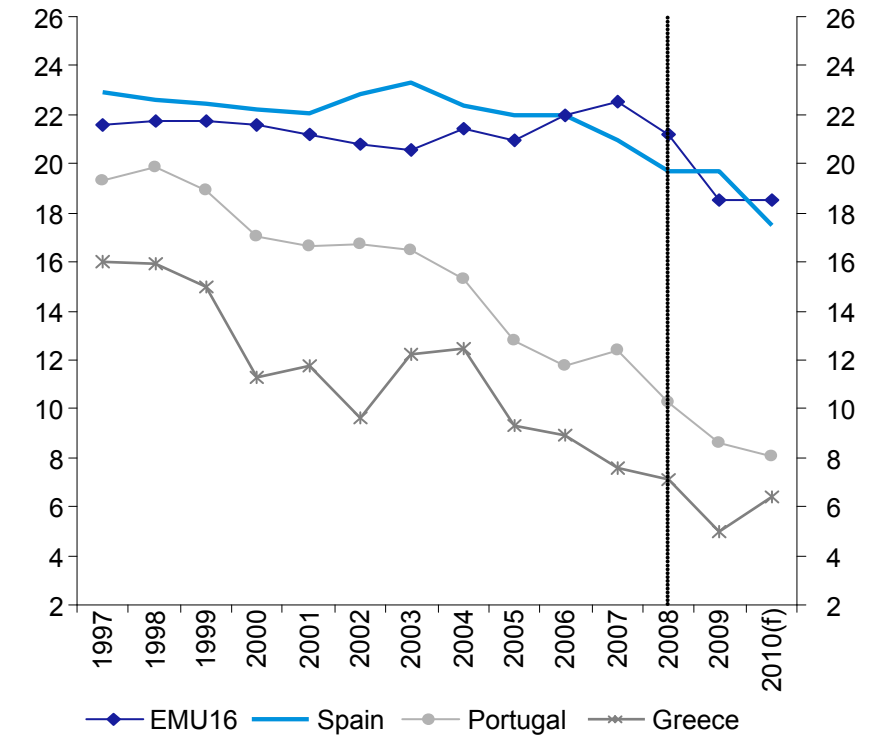
Domestic Investment Rate (GFCF as percentage of GDP)

BBVA Research based on INE and AMECO



Domestic Saving Rate. As a percentage of GDP

Source: BBVA Research based on INE and AMECO



Competitiveness and the current account adjustment

Solid exports
shares
despite
international
competition

There has been a significant adjustment in the current account deficit

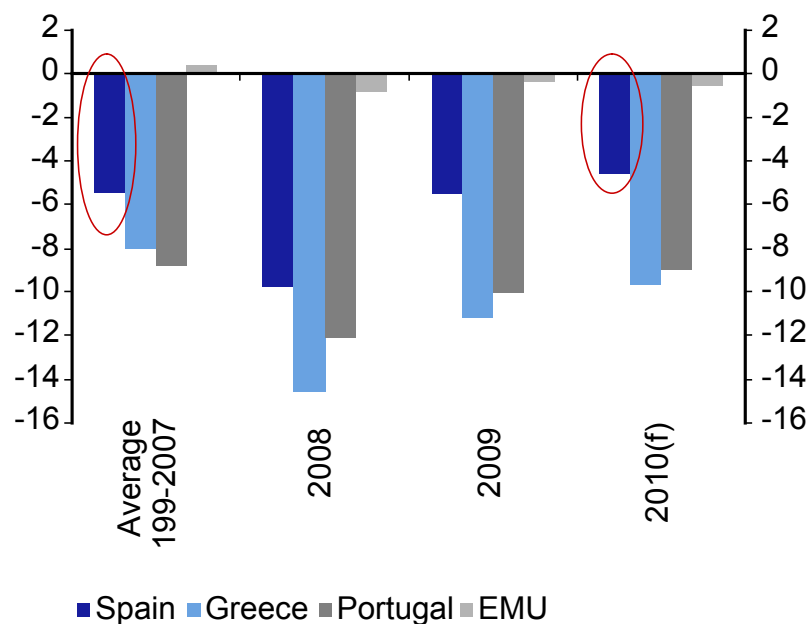
Since June 2008 the current account deficit in Spain has fallen by 50% (5 percentage points of GDP).

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

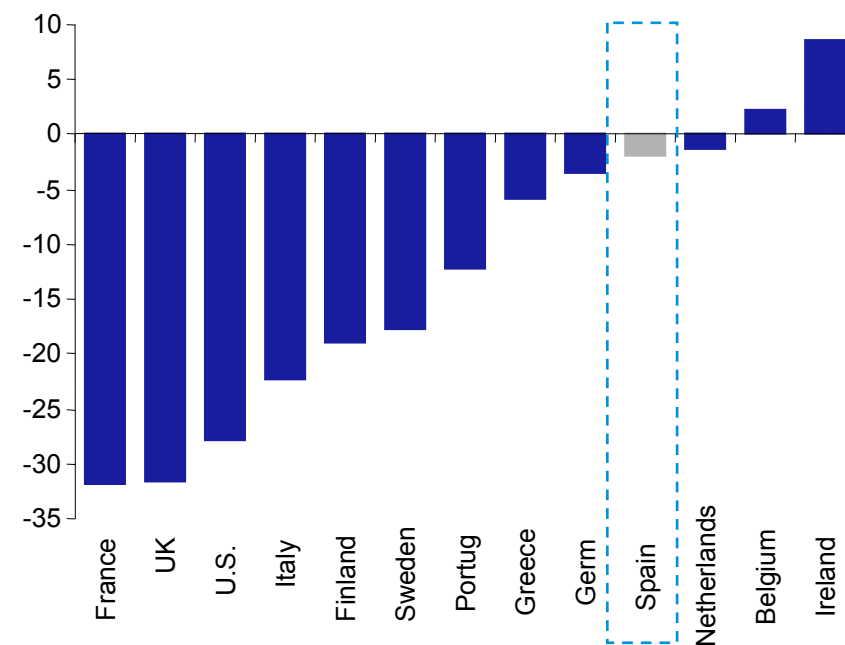


Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

Household adjustment

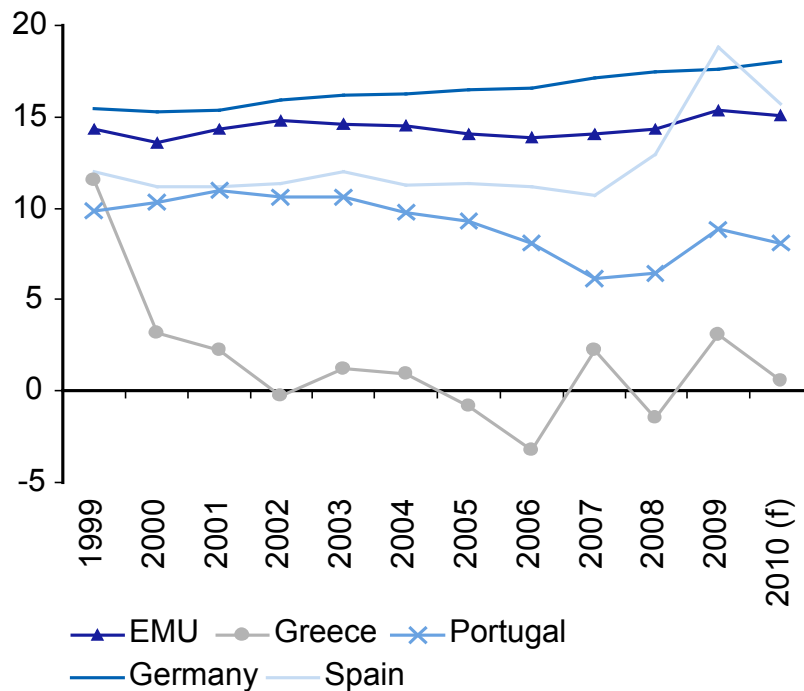
High saving
and low
default rates

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

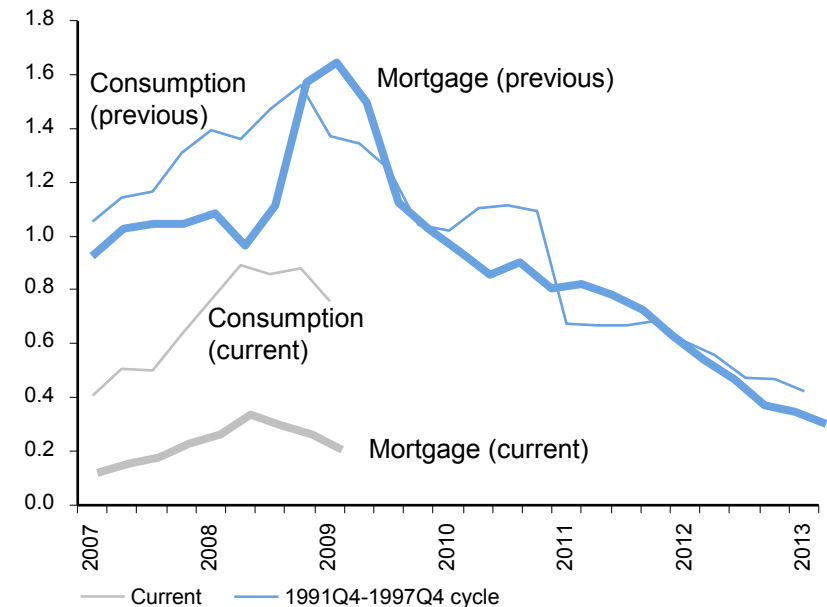
Household's saving rate (% of gross disposable income)

Source: BBVA Research based on AMECO



Consumption Credit Frequency of Default

Source: BBVA Research based on Bank of Spain



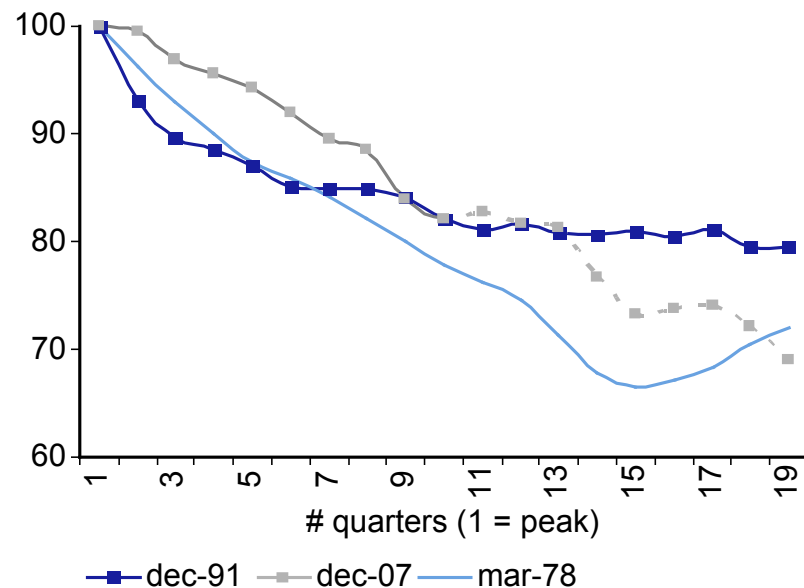
Corporate adjustment

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)

Source: BBVA Research



Households Net Wealth (% Gross Disposable Income 2008)

* 2009

Source: BBVA Research based on OECD and Bank of Spain

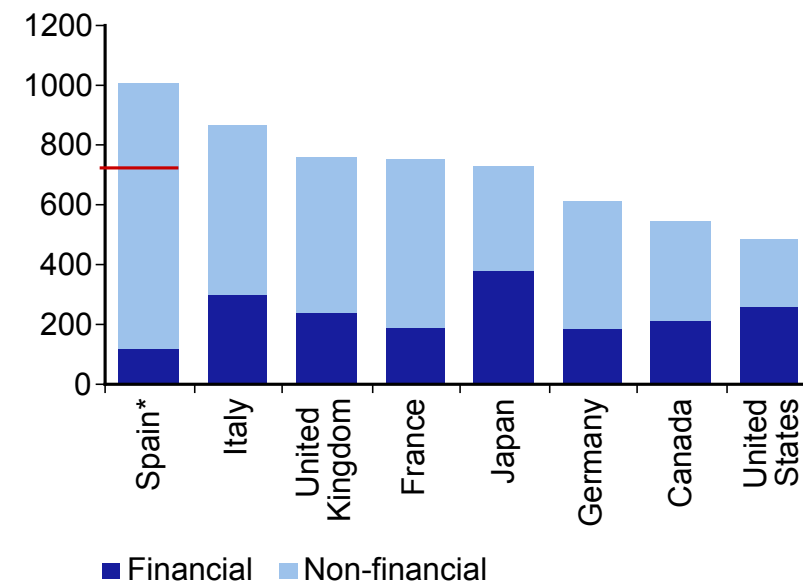


Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

Corporate adjustment

Smaller financing needs

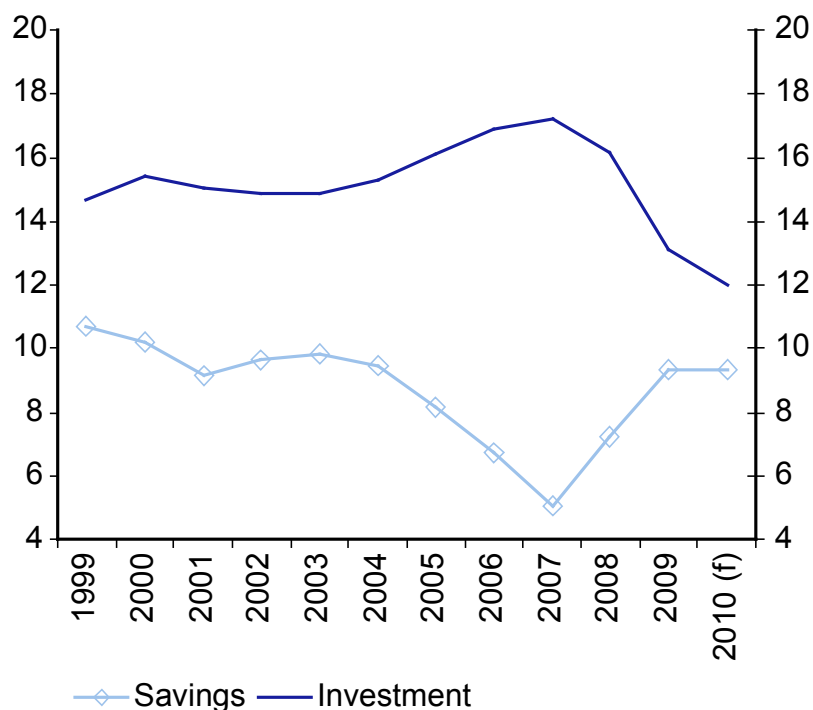
Firms have also adjusted their saving and investment decisions. Investment has fallen, partly due to the adjustment of the real estate sector.

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

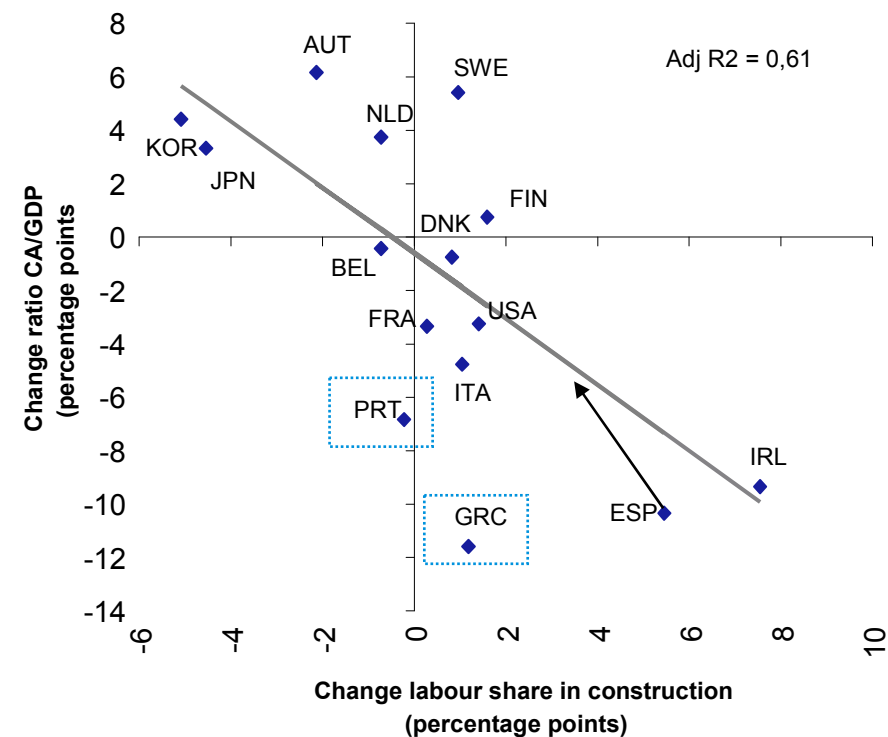
Spain. Firms' Savings and Gross Investment (as percentage of GDP)

Source: BBVA Research based on MoE



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

Source: AMECO and BBVA Research



Corporate adjustment

High
heterogeneity
in the debt
levels

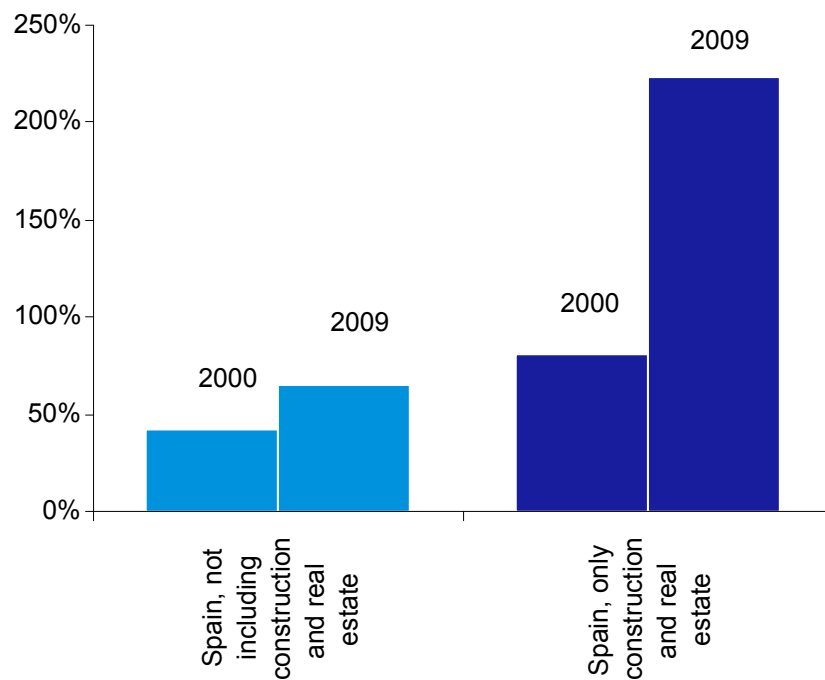
The rise in corporate debt has been concentrated in loans to the real estate sector, which need to be deleveraged

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

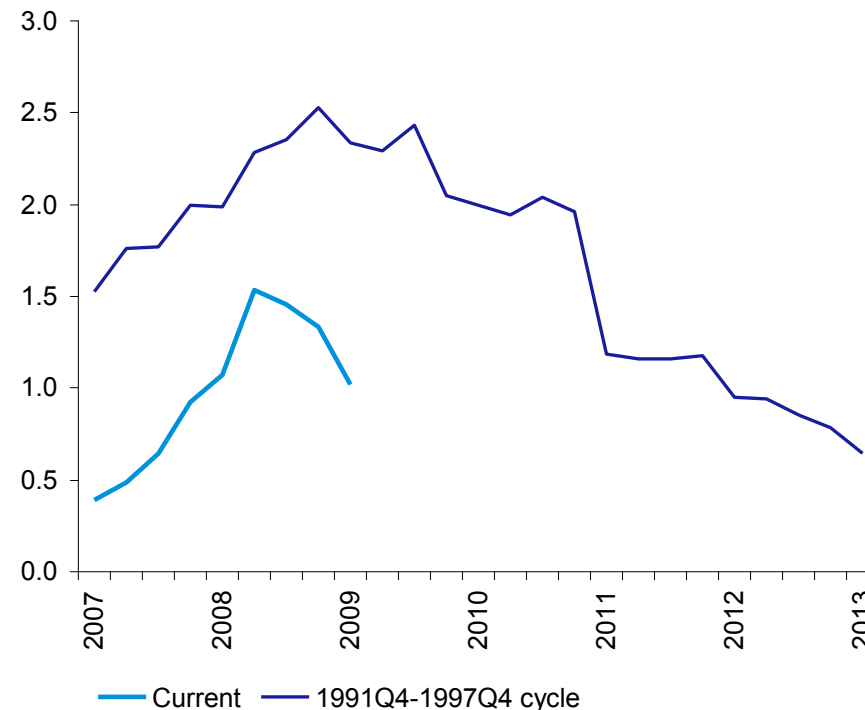
Spain, Corporate Credit/GVA in sector

Source: BBVA Research



Other Companies Frequency of Default

Source: BBVA Research based on Bank of Spain



Corporate adjustment

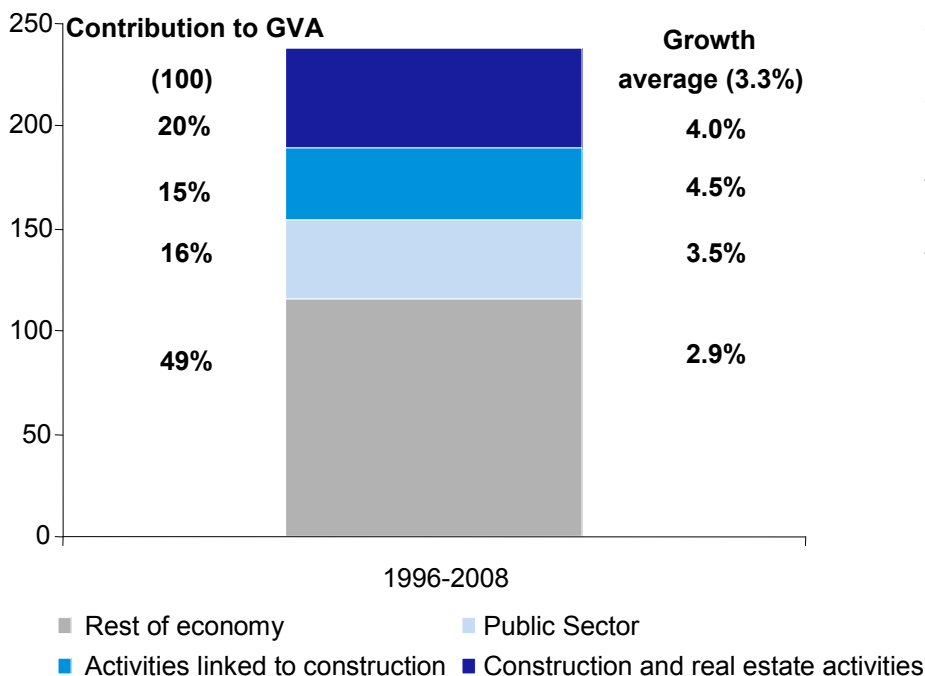
A more diversified pattern of growth than usually expected

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

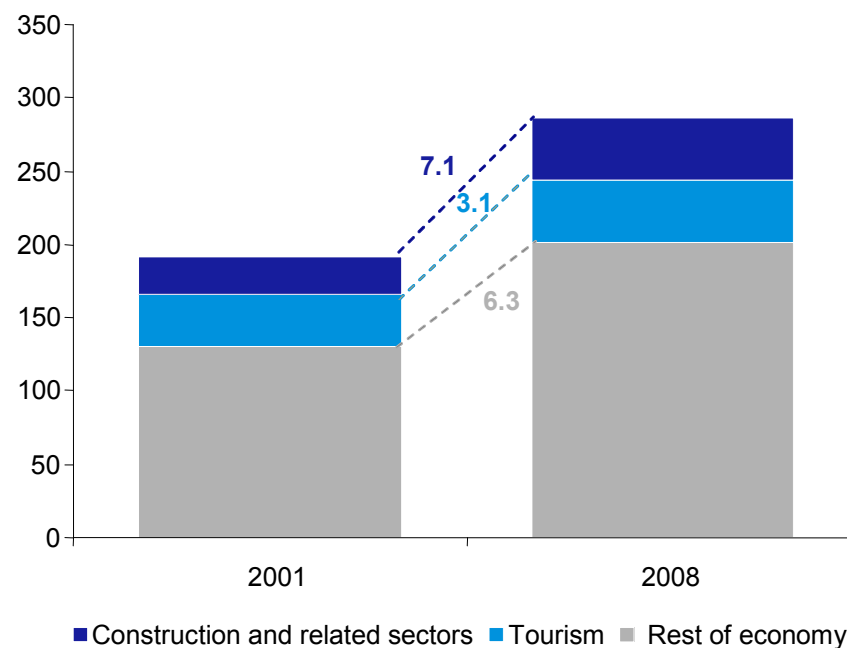


Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

Financial Sector Adjustment

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

LORCA:
a 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

Financial Sector Adjustment

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	✓	✓

Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

The public sector adjustment

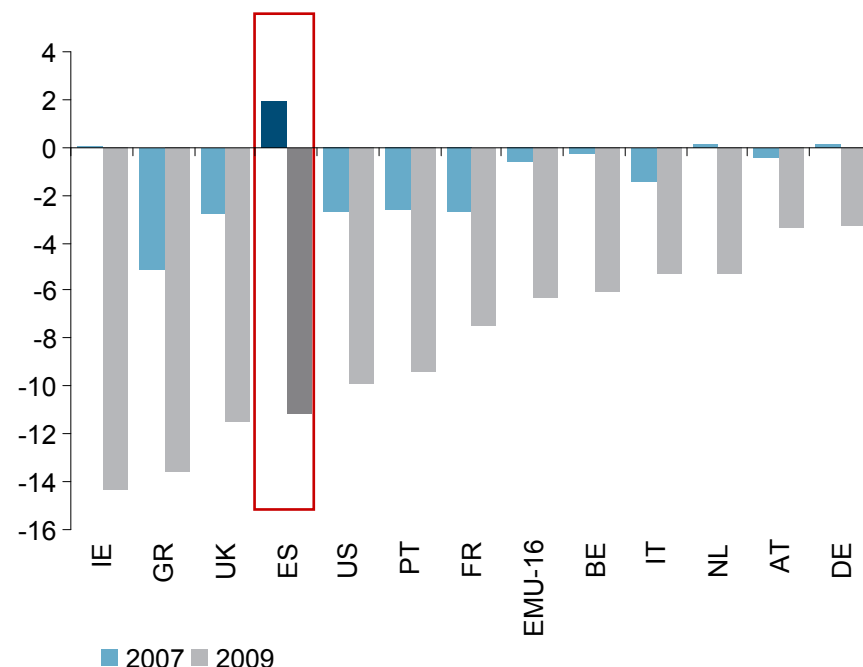
A large public deficit and a relatively low level of debt

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%)

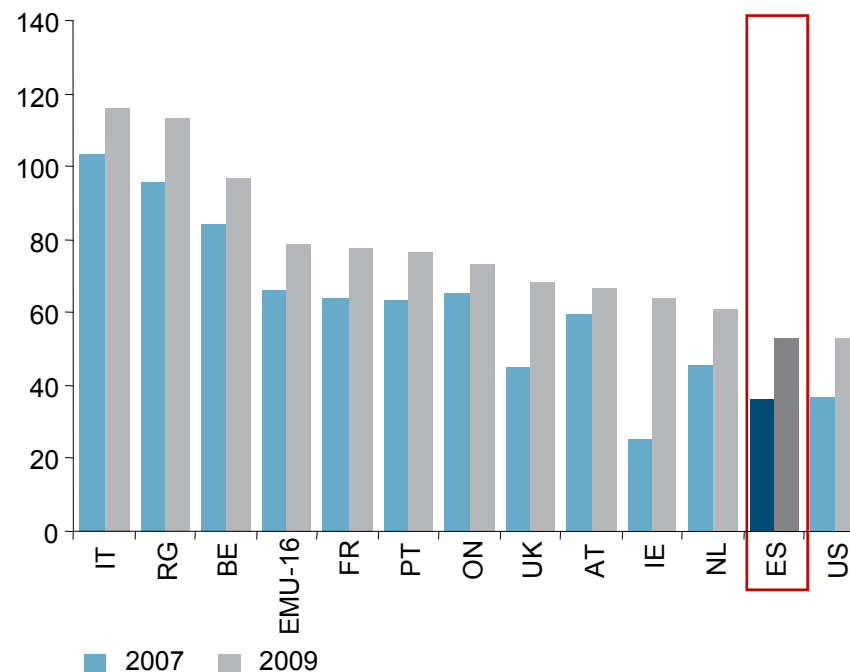
Budget balance as percentage of GDP

Source: BBVA Research based on Eurostat and CBO



Public debt as percentage of GDP

Source: BBVA Research based on Eurostat and CBO



The public sector adjustment

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

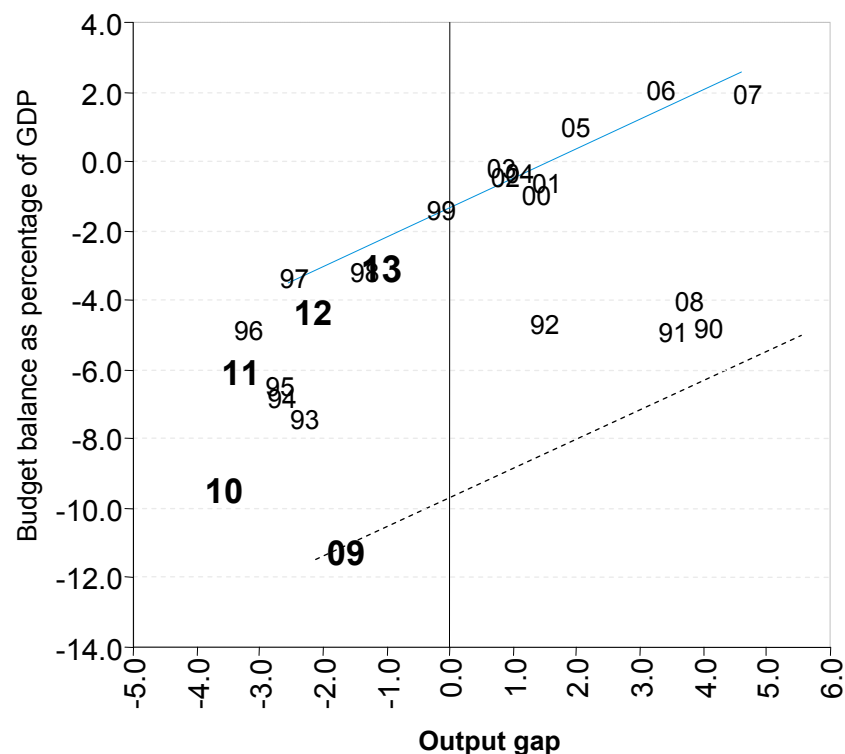
The public sector adjustment

A correction of
structural
deficit

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

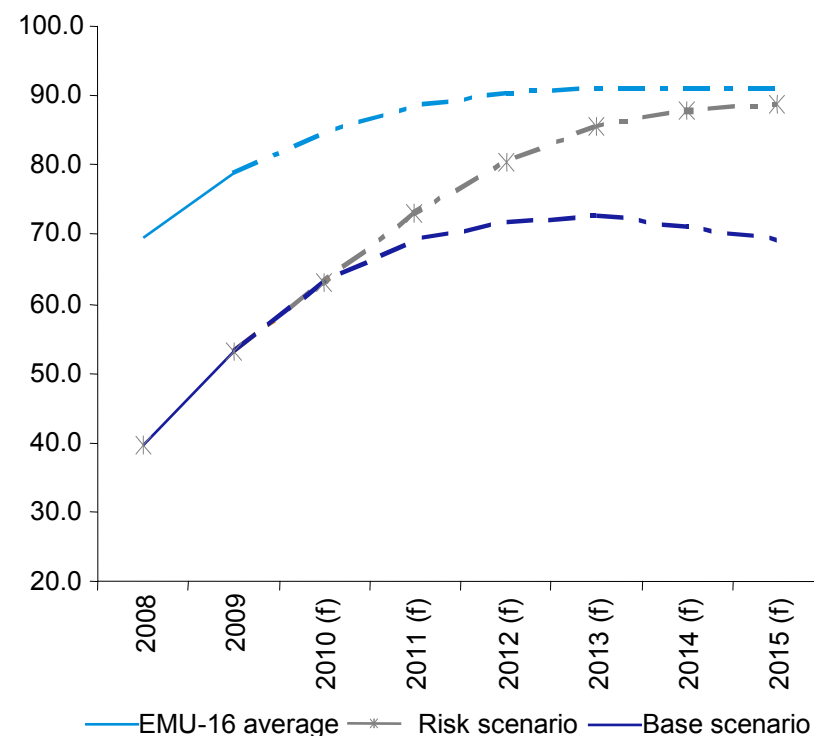
Spain: Budget balance vs Output gap

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

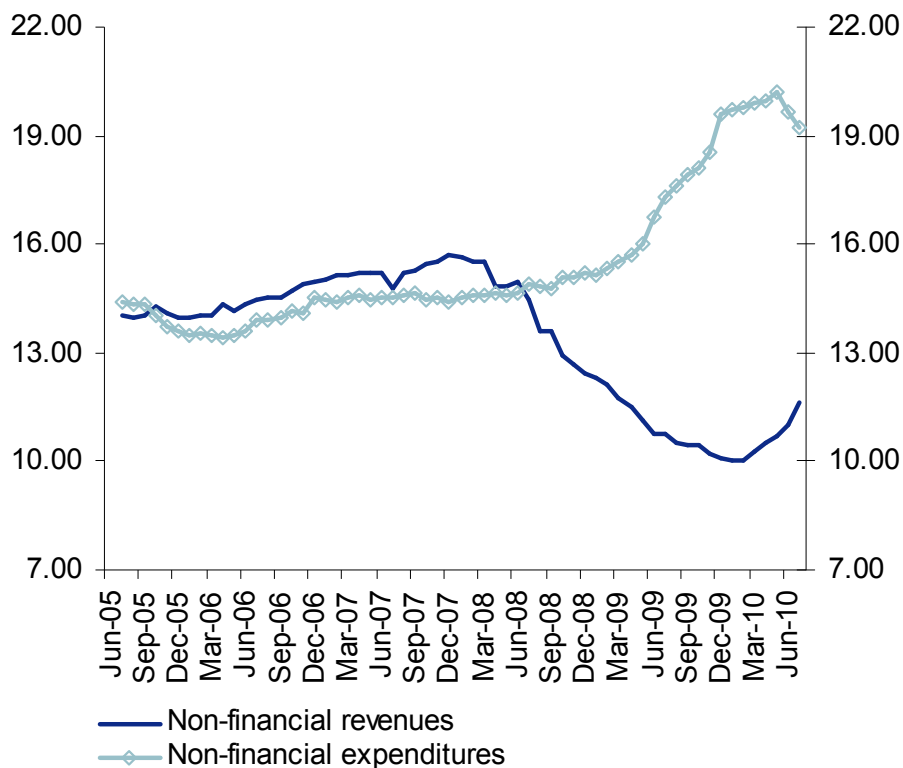
The public sector adjustment

Revenues
increasing
and
expenditures
falling

The central government is ahead of schedule and the likelihood of meeting end of year targets is increasing significantly

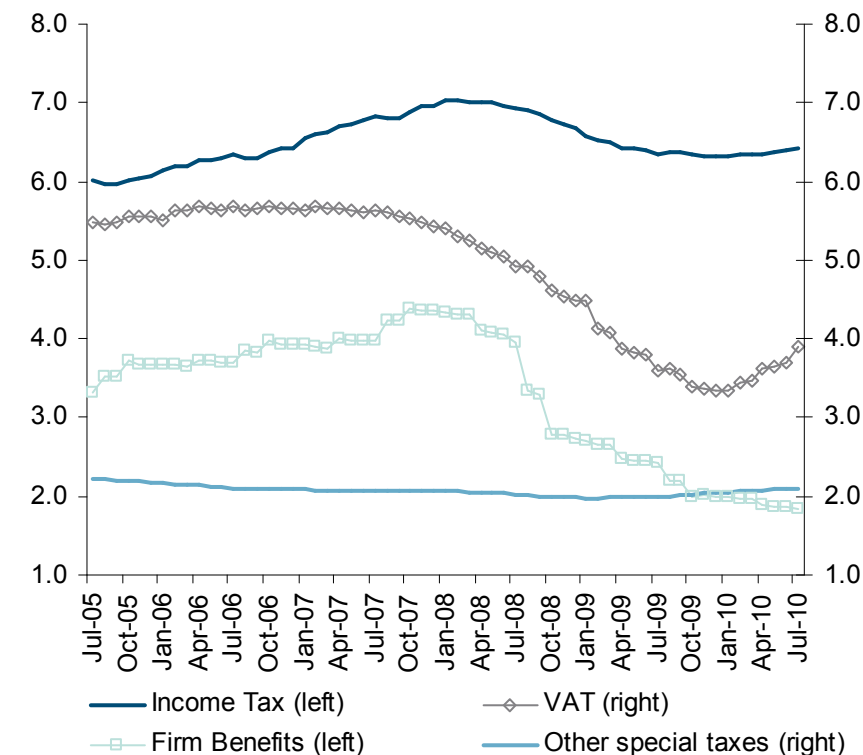
Central government: non-financial revenues and expenditures accumulated over 12 months. (percentage of GDP)

Source: BBVA Research from IGAE and INE



Tax revenues in homogeneous terms Accumulated over 12 months. (percentage of GDP)

Source: BBVA Research from AEAT and INE



The public sector adjustment

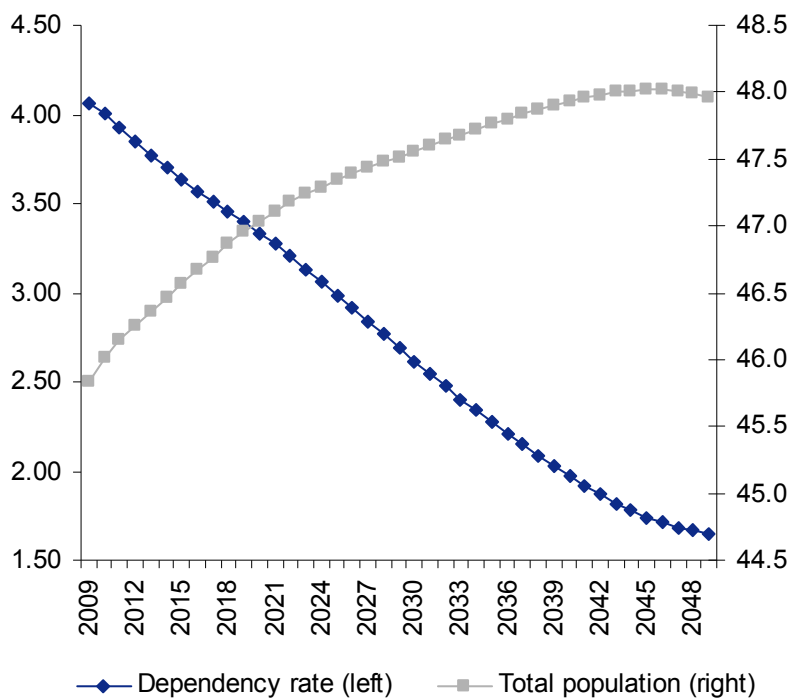
The reform of the public pension system

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

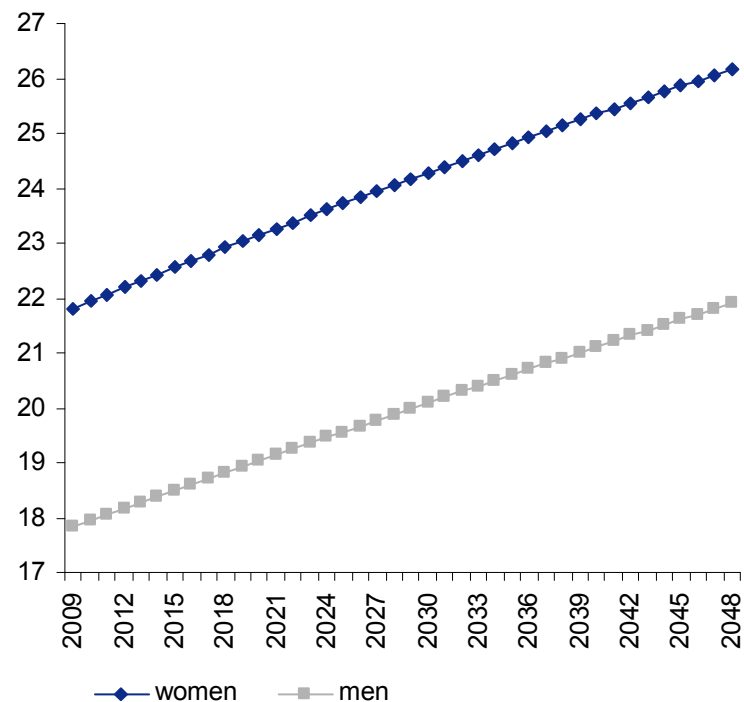


Table of Contents

The Spanish Economy: Adjustment Perspectives and Challenges

Section I

Current account adjustment

Section II

Household adjustment

Section III

Corporate adjustment

Section IV

Financial sector adjustment

Section V

Public sector adjustment

Section VI

Structural reforms

Structural reforms

Economic performance and structural reforms

Fiscal consolidation and private deleveraging will be easier the higher the rate of growth of GDP.

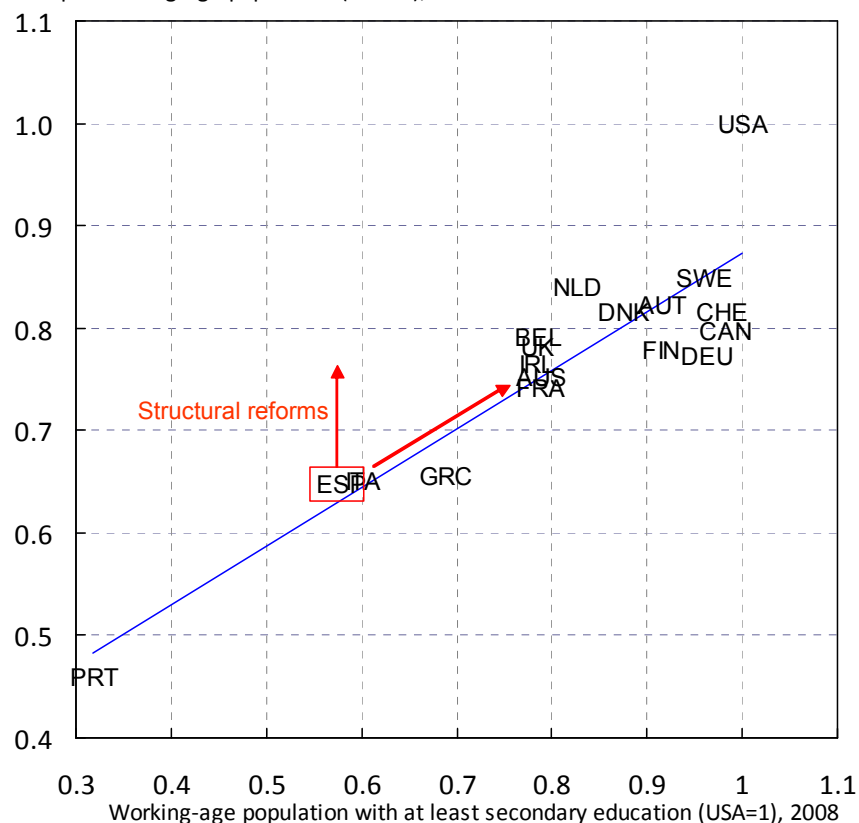
In the long run, the main determinant of per capita income is human capital. Closing the **human capital gap** will take some decades.

In the meantime it is crucial to use all available factors efficiently. This is the **objective of structural reforms**: to improve economic environment as much as possible to increase employment in more productive jobs.

Per capita income and human capital, 2008

Source: OECD and BBVA Research

GNI per working-age population (USA=1), 2008



Structural reforms

Labour Market Reform

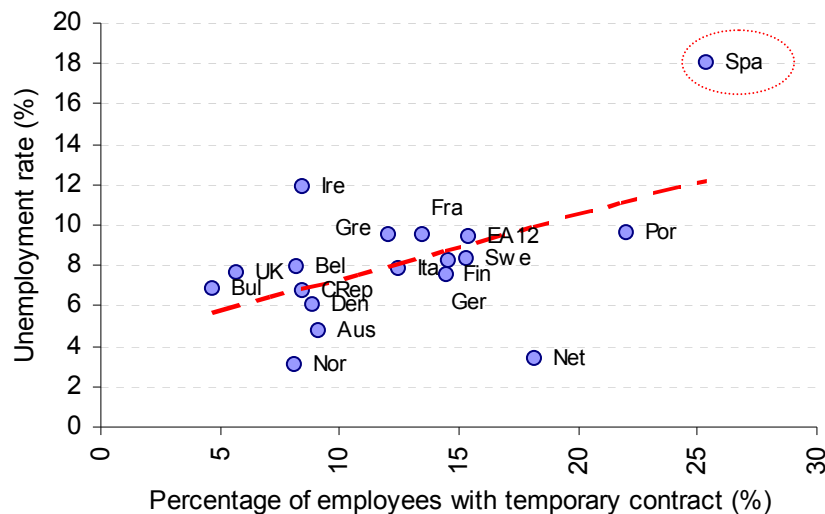
The reduction of the high unemployment rate (20%) is one of the most important challenges of the Spanish economy. There are two reasons for the high structural unemployment rate

Labour market duality

Collective bargaining

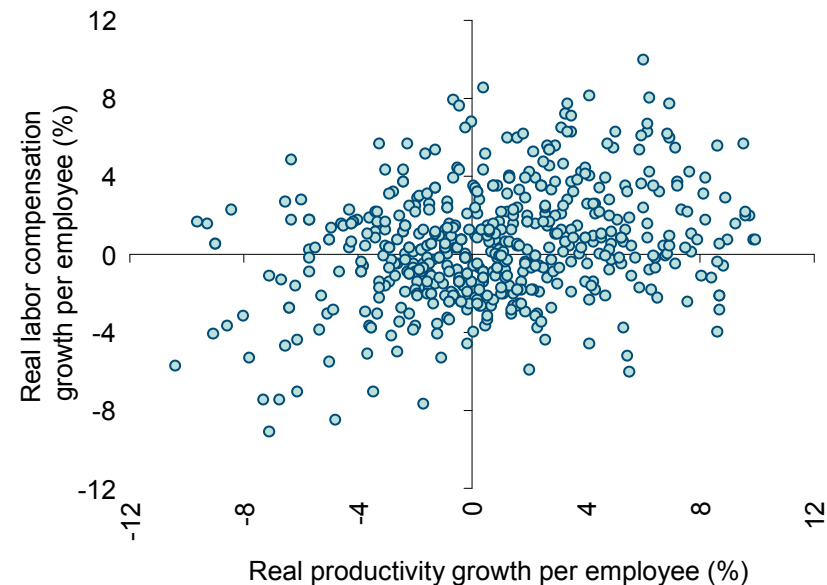
Temporary employment rate vs unemployment rate (2009)

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 KLEMSBBVA Research based on INE



Structural reforms

Labour Market Reform

Labour market reform: a step in the right direction with some doubts about its final effectiveness

Duality

Decrease in dismissal costs between permanent and temporary contracts (although it remains relatively high)

Dismissal costs

Lowering of dismissal of permanent workers (from 45 to 33 days, which is still high)

Wage determination

More flexibility in wage bargaining (uncertainty regarding legal process where there is no agreement)

Internal flexibility in working conditions

More flexibility, similar to German “Kurzarbeit”, but conditioned to internal agreement

Future financing of dismissal costs

Similar to the Austrian system (not implemented yet)

Structural reforms

Other Structural Reforms

Other reforms are also needed in order to improve potential GDP growth

Challenges

Long-term sustainability of public finances

Energy deficit and external dependence

Product market regulations

Educational system reform

Proposals

Improve financing of social services (health, education, etc.)

Improve efficiency of tax system (more towards indirect taxation)

Increase prices to reflect market rates, explore nuclear power

Implementation of Services Directive: lower administrative costs, competition in certain markets, optimal size, etc.

A social pact to improve education quality.

Structural reforms

Productivity and firm size

Relative productivity is related to the size of Spanish companies.

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...**

Labour productivity and firm size					
	Number of employees				
	1-9	10-19	20-49	50-249	+250
Industry (% of the sector average)					
Spain	53.4	67.7	77.6	101.4	165.5
United States	54.1	46.8	53.8	68.3	129.8
Whole economy (% to the US average)					
Spain	40.6	51.4	58.9	77	125.7
United States	54.1	46.8	53.8	68.3	129.8

Source: OECD (2008) and BBVA Research.

Labour market adjustment and structural reforms

Productivity and firm size

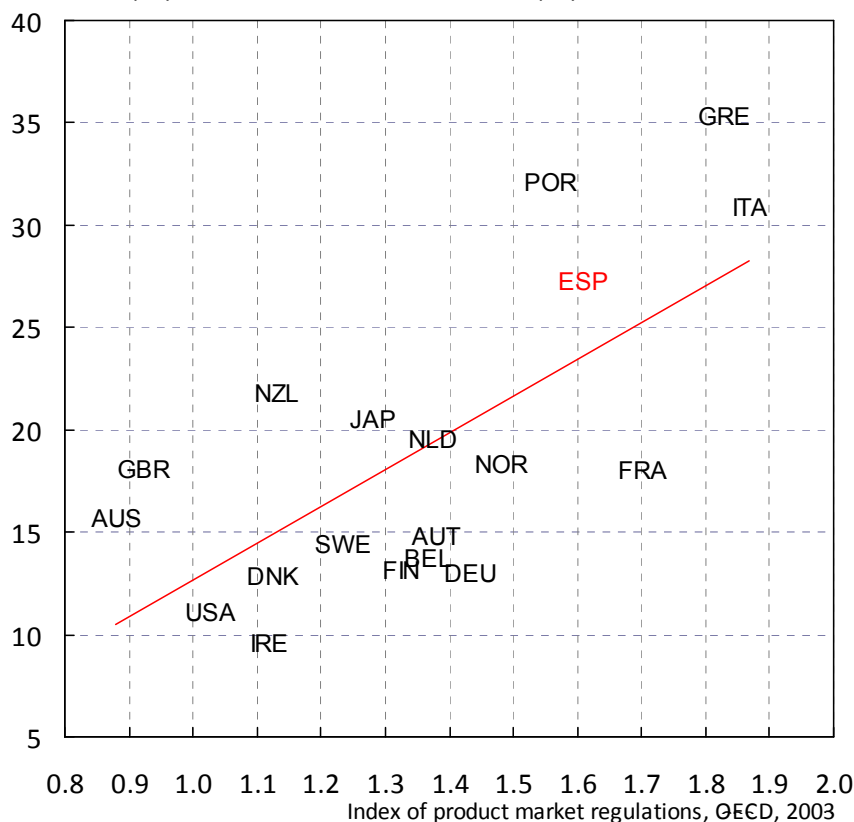
Small and medium enterprises have a lower productivity and **represent a larger share in terms of production and employment.**

In countries where product markets are better regulated, there are more incentives to increase the average size of firms, close to the minimum efficient scale of operation.

Firm size and product market regulations

Source: OECD and BBVA Research

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



Structural reforms

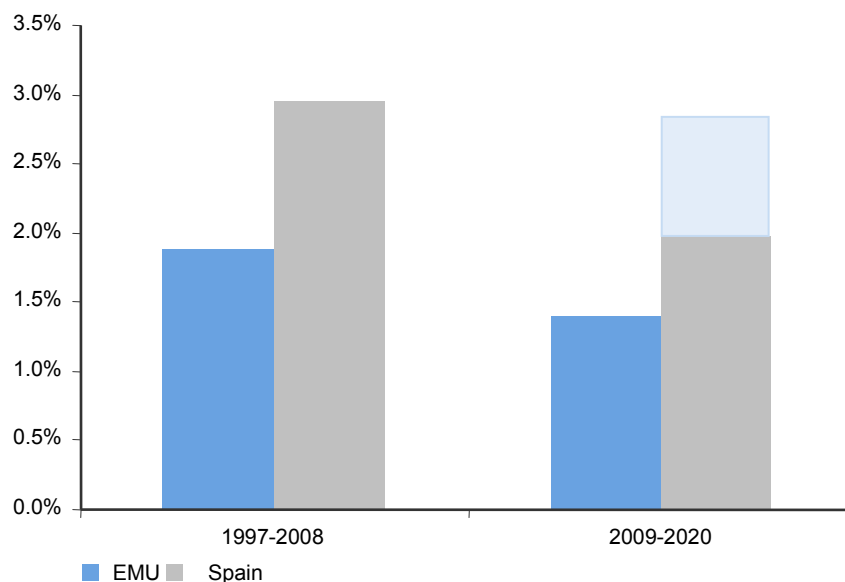
Structural reforms and potential growth

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 and EMU: Potential GDP

(Yoy % var.)

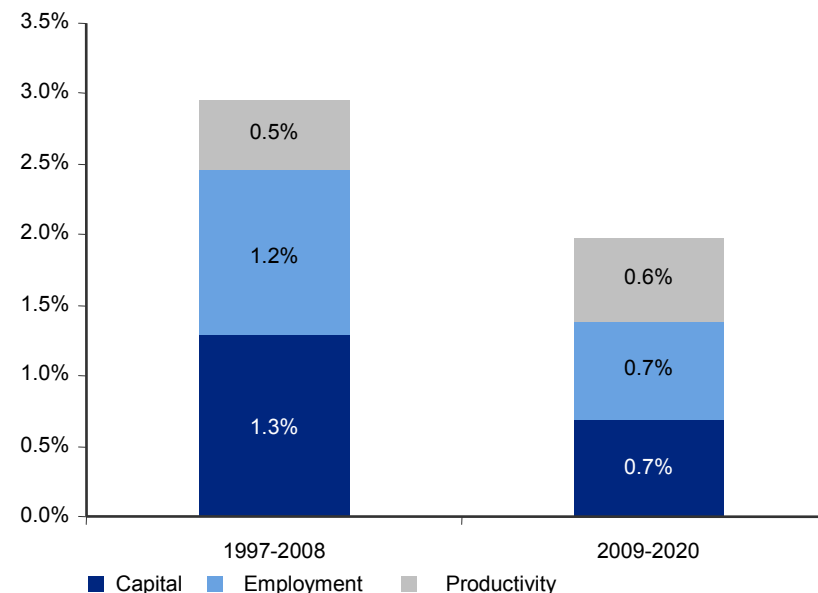
Source: BBVA Research



Spain: contribution to potential growth

(Yoy change)

Source: BBVA Research



Key messages

- Myths vs. reality: most analysis of the Spanish economy are too simple: reality is more complex and requires a more detailed scrutiny, for both the previous expansion and the current recession.
- The 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 excess consumption or a significant loss in competitiveness** have been detected
- The **wealth position of households** is sound and they have quickly increased their saving rate to face a gradual deleveraging process
- **Businesses**, except 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 feasible. The latest measures have significantly boosted the credibility of the fiscal adjustment plan
- The restructuring of the financial sector, fiscal consolidation and labour market reform seem to be key **structural reforms** that could allow for a quicker recovery in the short run.



The Spanish Economy: Adjustments, Perspectives and Challenges

Rafael Doménech
Chief Economist for Spain and Europe

London, September 15, 2010