

The Spanish Economy and The European Crisis

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International environment: continued global growth and the European Crisis

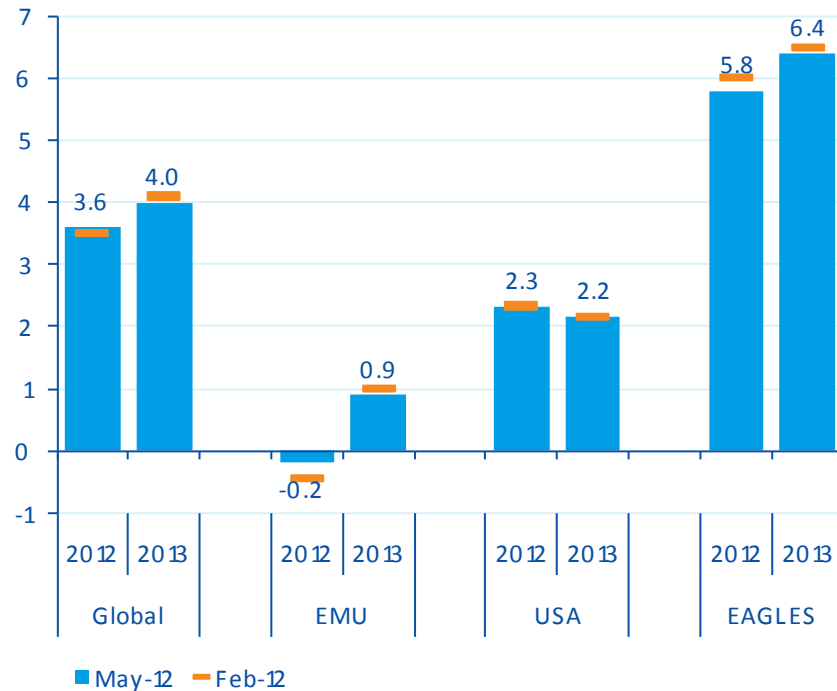
Section 2

The Spanish economy at a crossroads

Europe decoupling from global growth

GDP growth (% yoy)

Source: BBVA Research



- The debt crisis continues, with Greece under the spotlight and concerns about Spain
- High levels of financial stress in Europe, with a risk of credit restrictions
- Stability Treaty: towards Maastricht 2.0. More emphasis on growth
- Expansive, but no homogeneous, monetary policies by the Fed, the Bank of England and the ECB
- A slow, heterogeneous and vulnerable recovery

The European crisis continues

Significant progress...

Restructuring of Greek debt and bringing forward the ESM

Approval of the Stability Treaty

Reforms in Portugal, Spain, and Italy

Long-term ECB liquidity provision

... but still with challenges ahead

1. Access to financial markets

2. Need for efficient firewalls: Spain financial assistance and others

3. Growth agenda

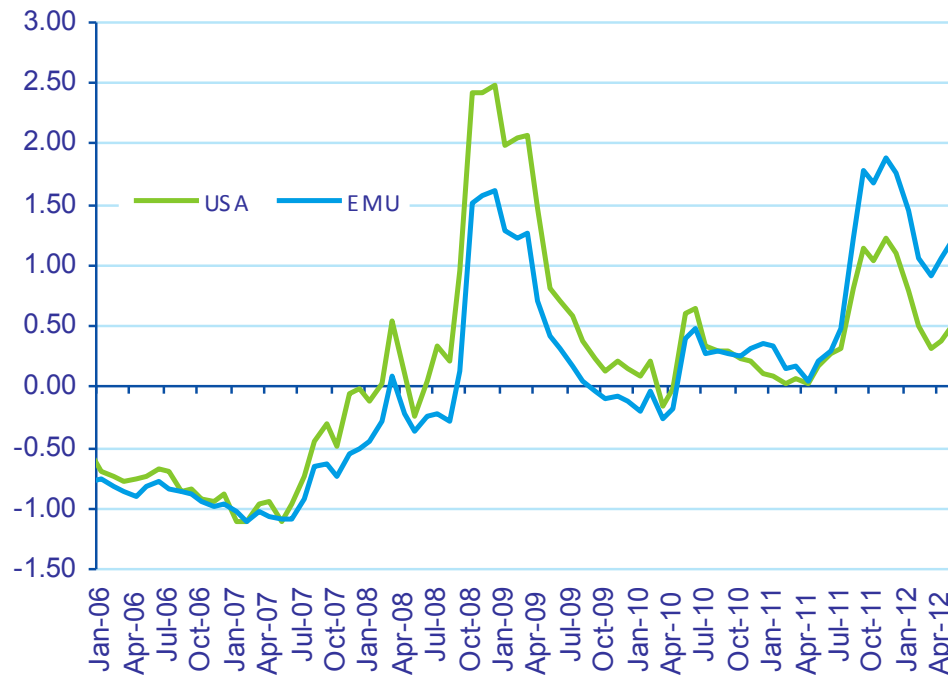
4. A clear road map towards a fiscal union and financial integration

To date, the authorities have been a step behind the events
→ half measures to overcome the crisis

The European crisis continues

BBVA Financial Stress Index

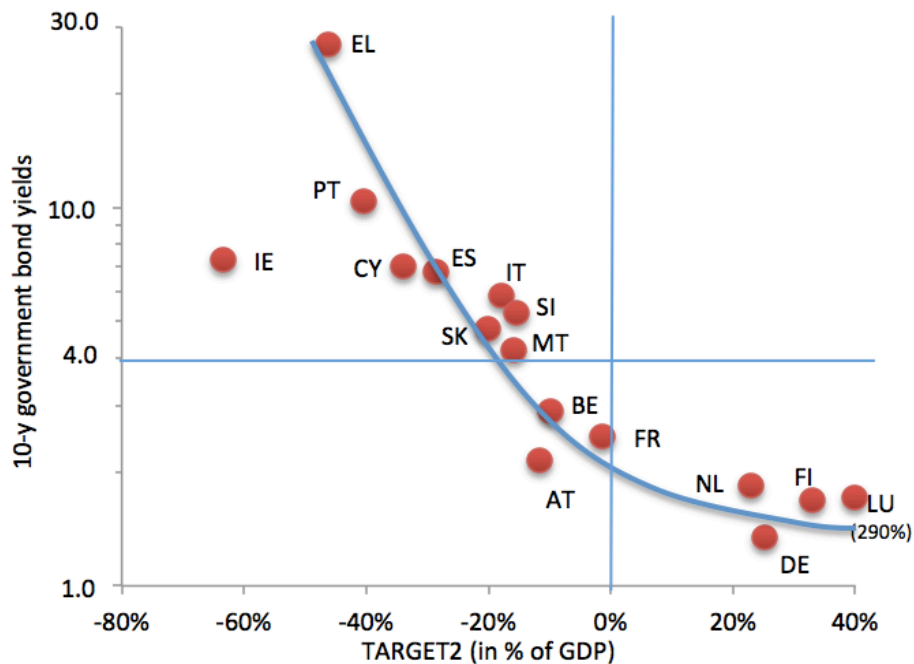
Source: Bloomberg and BBVA Research



1. Access to financial markets

Interest rates and TARGET2

Source: ECB and BBVA Research



Differences in interest rates and the dependence on the ECB: two sides of the same coin

Reducing financial tensions: a precondition for the success of fiscal adjustments and structural reforms

The need for a political agreement

2. Need for efficient firewalls

The financial assistance to Spain is a positive step ...

The EUR 100bn of financial assistance is a sufficiently high backstop, announced before the results of the stress tests

Removes uncertainty about funding sources and increases the credibility of the restructuring process

It differentiates Spain from the cases of other peripherals like Greece, Portugal or Ireland

... that should be complemented with additional European measures

Breaking up the correlation between sovereign and banking risk (SMP by ECB, EBA, ...)

Efficient use of available resources by the ESM to anchor markets expectations about the euro and risk premia

Short-run measures consistent with long-run objectives

2. Need for efficient firewalls

Rick premium	What is needed?	What is the reality?
Exchange rate	Clear roadmap to completely remove the expectations of an euro break up	There are major disagreements between members. A winding road
Fiscal policy	Meeting fiscal targets to reduce the increase in debt	Public debt increases and doubts about preferred status of EFSF/ESM
Banking restructuring	Banking union and direct capital injection from ESM	Backstop + credibility ... details still pending
Growth	A roadmap with a credible strategy for long-term growth	No news

3. Growth plan

A growth plan that complements fiscal adjustment

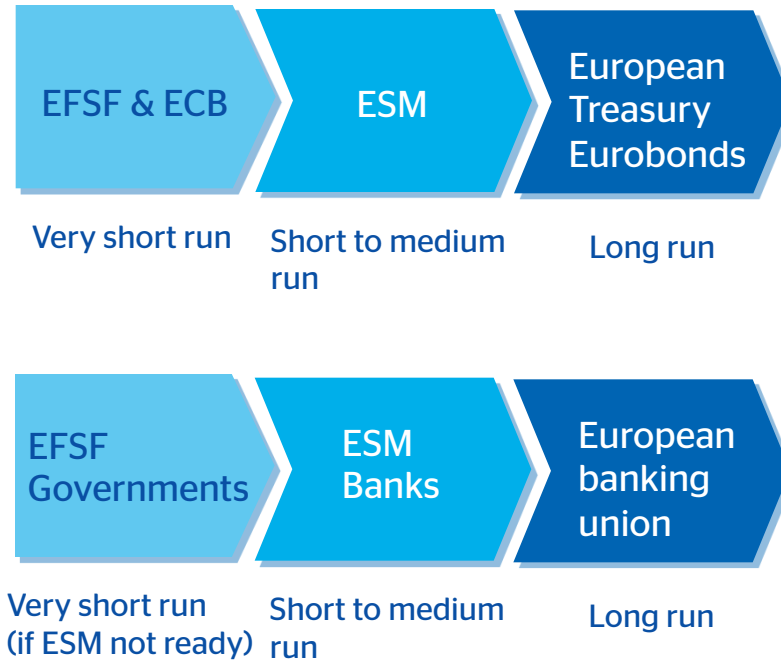
Clear route map for the future of EMU

Balance between growth and austerity:
reforms in exchange for a growth strategy

Gradual fiscal adjustment with multi-year plans.
Focus on structural deficits as the Treaty proposes

Short-term objective: to avoid the risk of an austerity-recession
vicious circle and the doubts regarding sovereign debt solvency

4. A clear road map towards a fiscal and financial union



4. A clear road map towards a fiscal and financial union

A fiscal union

Eurobonds: a convenient mechanism for mutualising risk

The "blue" and "red" bond proposal ensures a degree of market discipline

In the mean time, the ESM could be more efficient reducing the volatility of risk premia

A banking union

A single rule book and European supervisor

A single European Deposit Guarantee Insurance System

A single European rescue fund

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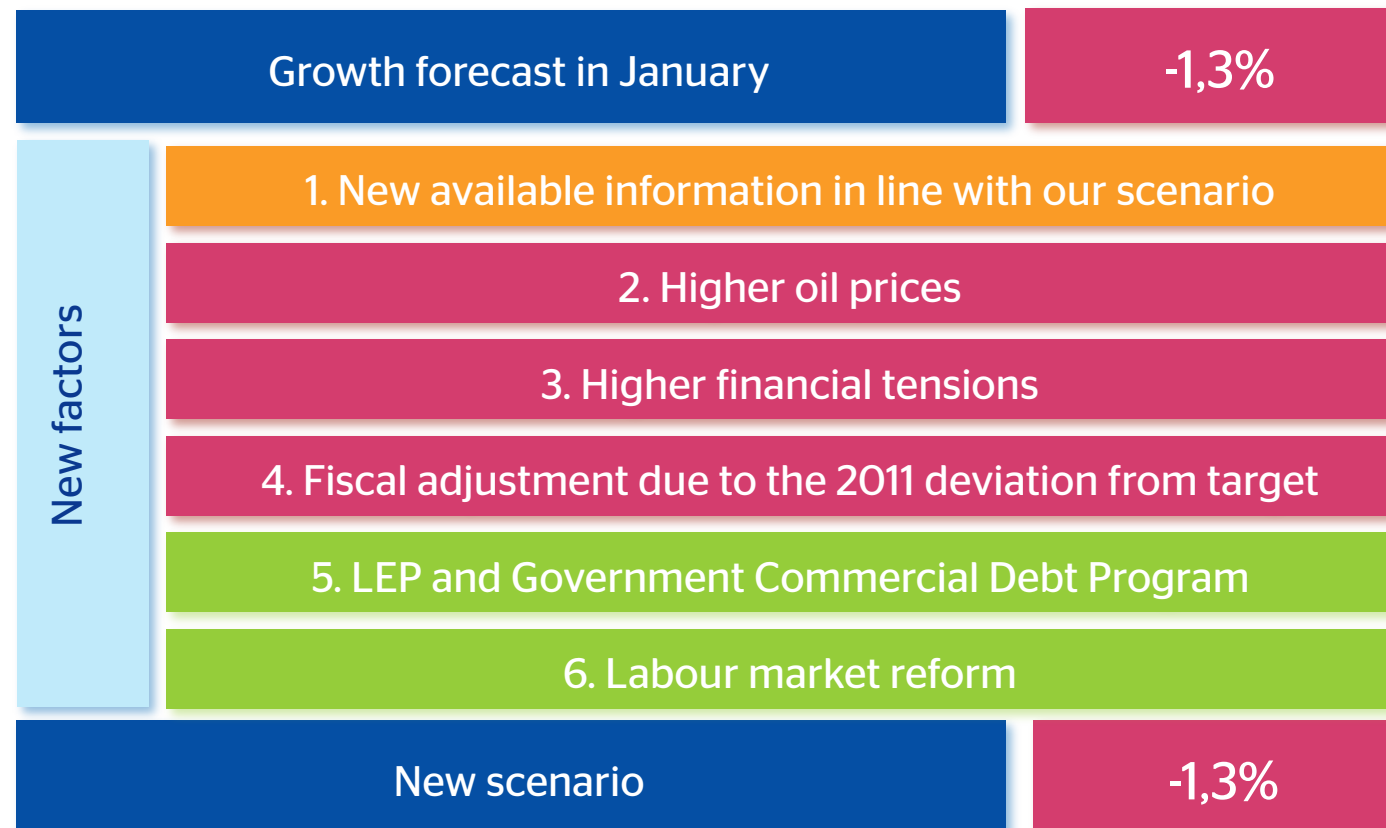
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The Spanish economy at a crossroads

Main changes in the economic scenario for 2012

Factors determining the economic scenario

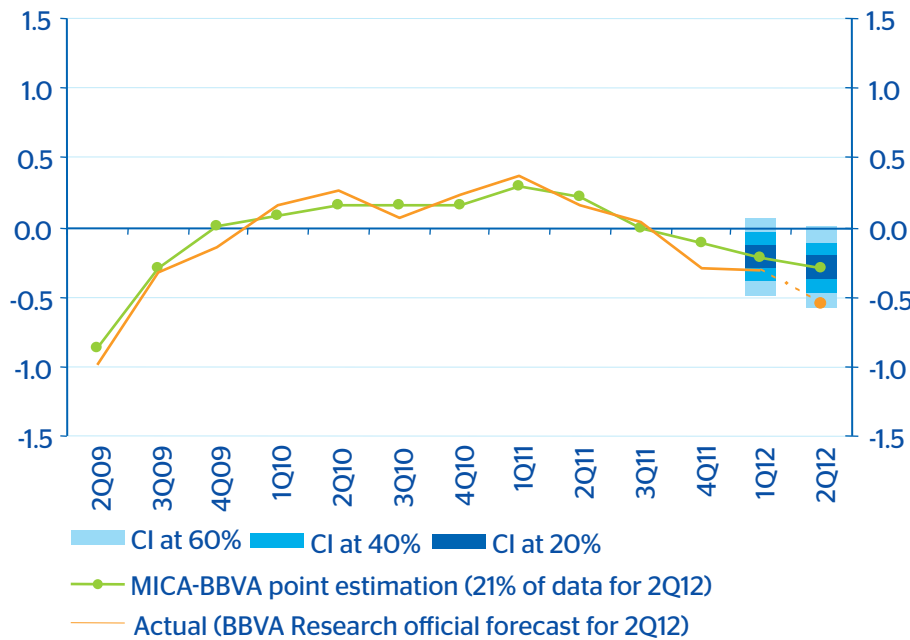
Source: BBVA Research



Available data confirms the scenario

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

Source: BBVA Research
Current forecast: 4 May



The Spanish economy entered technical recession in 1Q12...

...albeit with no acceleration in the rate of deterioration versus 4Q11

Published data indicates that 2Q12 growth is likely to have remained negative

Employment continues to be hindered by the negative outlook for growth

Increased financial tensions

Despite the ECB liquidity, the progress being made in Europe, and the reforms in Spain, markets are still cautious due to:

The difficulties to reach the 2012 and 2013 deficit targets.
The fear that fiscal austerity may lead to a vicious circle

The potentially higher cost of bank restructuring as a result of the adjustment in the real estate sector and the slower growth

The higher amount of sovereign debt on banks' balance sheets: negative interaction between sovereign and banking risks

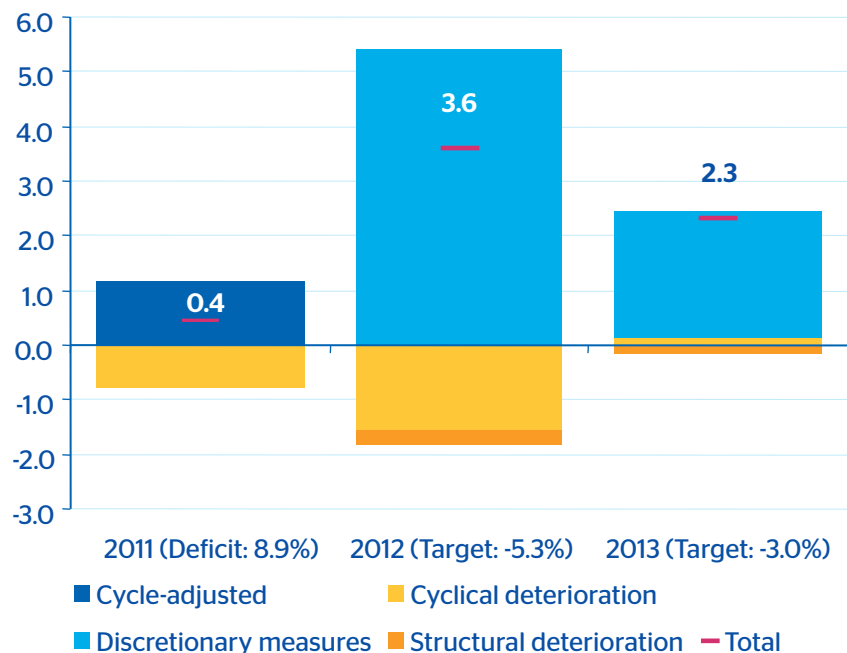
The idea that both Europe and Spain have lacked a medium and long-term strategic plan

Fiscal deficit: the challenge for 2012

General government: budget balance adjustment

(pp of GDP)

Source: BBVA Research based on MINHAP



Unobservable components model results

In a no-policy change scenario, the deficit would increase by 1.9 pp of GDP in 2012

Significant cyclical deterioration in 2012

The discretionary measures needed amount to more than 5 pp of GDP to reach the target of -5,3%

Already announced 4.7 pp. Additional asset sales could help reach target if needed

Fiscal deficit: the challenge for 2012

General government: measures taken in 2012

(pp of GDP)

Source: BBVA Research

	Billions	% GDP
Deficit 2011(a)	-91,4	-8,9
Target 2012 (b)	-57,1	-5,3
Difference (c=b-a)	34,3	3,6
Additional adjustment (d)	20,7	1,9
Total adjustment (c+d)	55,0	5,1
Measures already taken		
Central Gov.: 2012 Budget	25,7	2,4
Local Gov.: real estate tax	0,9	0,1
Social seg.: Tax evasion reduction	1,9	0,2
Local Gov.: overlaps and unowend powers	0,1	0,0
Regional Gov.: Reestructuring programs 2012-2014	18,3	1,7
Local Gov.: Reestructuring programs	3,1	0,3
Central Gov.: expenditures cuts	0,3	0,0
Total medidas	50,3	4,7
Nominal GDP	1074,7	

Measures taken so far amount 4,7 pp of GDP

Central government announced measures equivalent to half of the adjustment

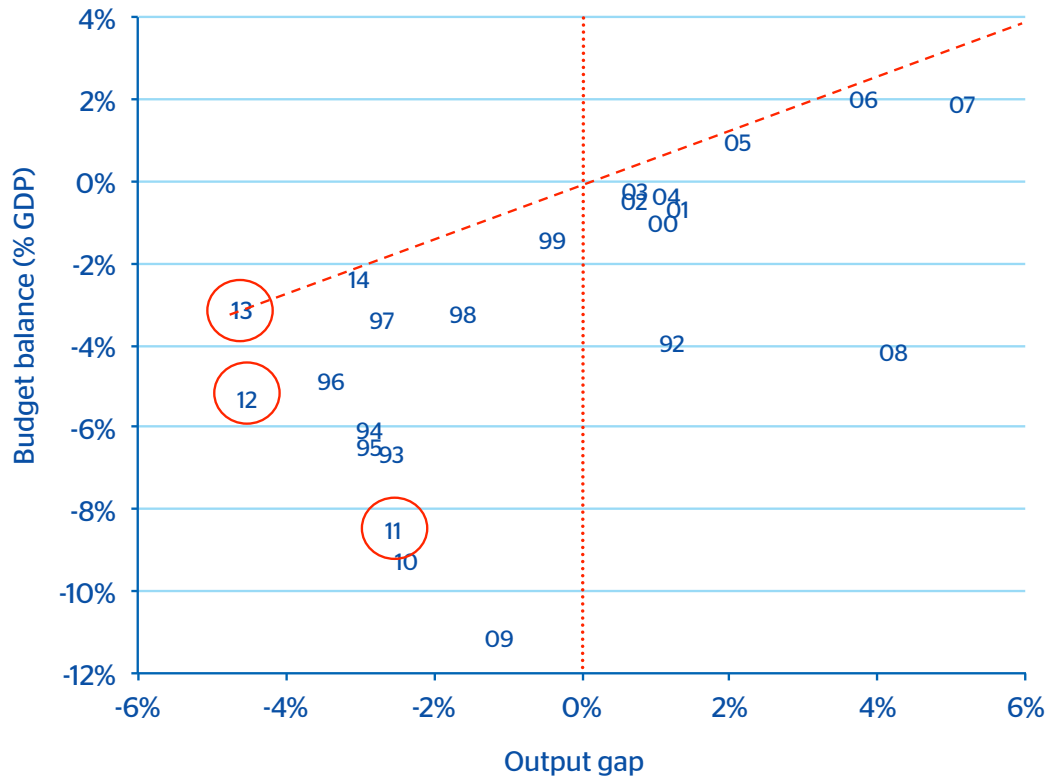
Privatizations, one-offs in 2011 and additional measures could help reach this year's target

Fiscal deficit: the challenge for 2012 and 2013

General government: budget balance and output gap

(pp of GDP)

Source: BBVA Research based on MINHAP



Significant reduction of the structural component

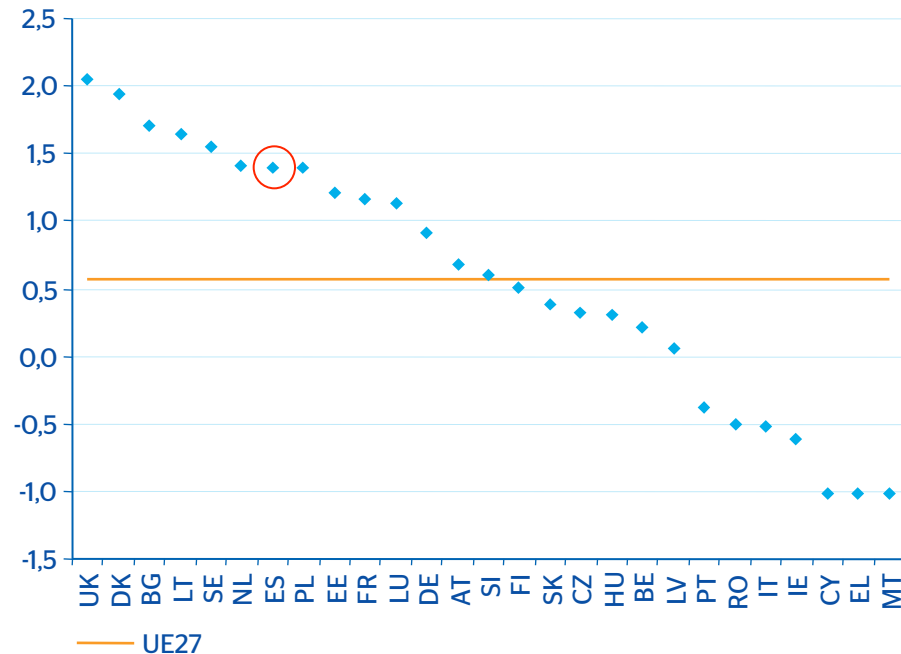
If 2013 target is achieved, structural deficit close to 0%.

A slow and steady fiscal consolidation needed

The new Fiscal Stability Law

EU27: fiscal rules index (2010)

Source: BBVA Research based on the European Commission



Spain has been one of the first countries implementing the new Stability Treaty

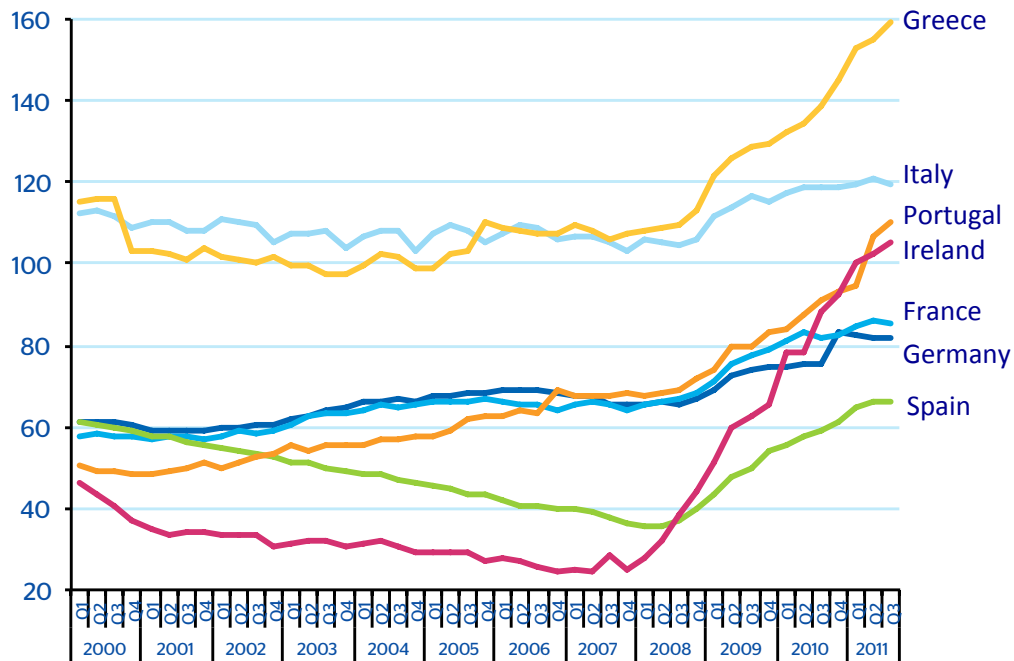
Structural target and better monitoring of regional governments

The new law improves further the fiscal rules index

Public debt low but increasing due to high deficits

Public debt as percentage of GDP

Source: BBVA Research based on Eurostat and CBO



Fiscal consolidation needed

Public debt remains at levels well below the European average even for non-EDP debt

Fiscal consolidation earlier than in most of countries but deviating from target in 2011

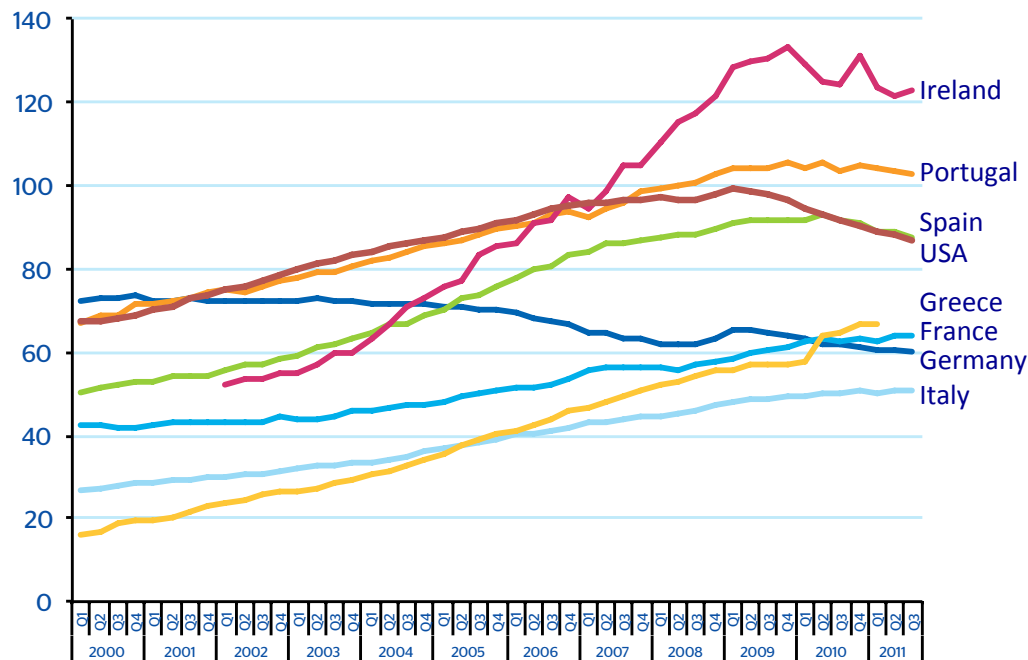
New Stability Law and new measures to reduce the deficit in 2012

Household debt deleveraging slowly

Households debt

(% of GDP)

Source: BBVA Research based on Eurostat



Improvement of household's balance sheet

Spanish households debt similar to US levels. Slower deleveraging (higher property ratio)

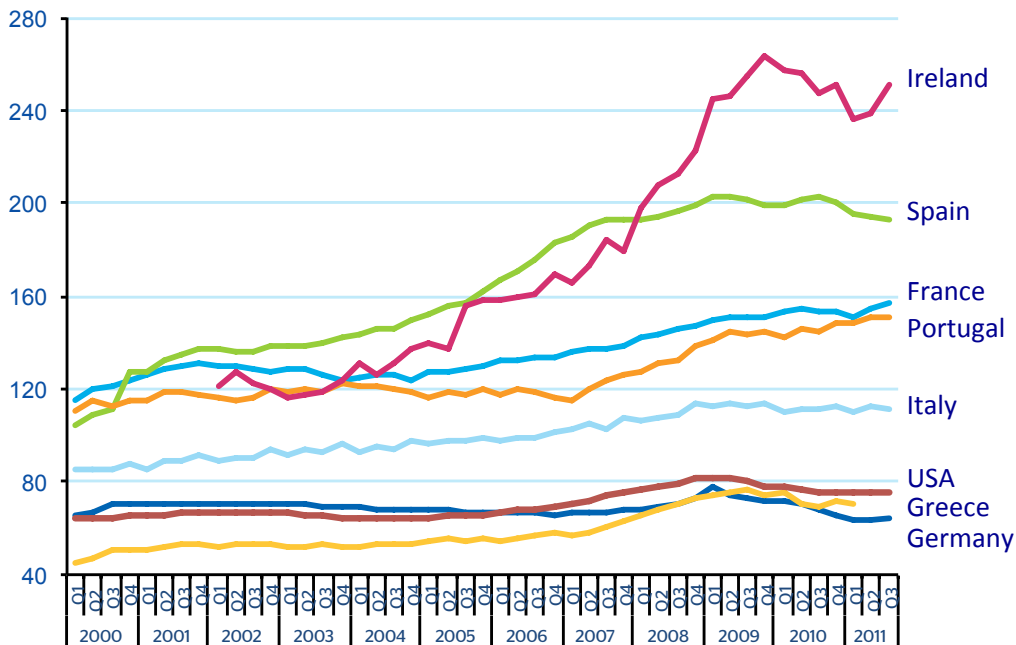
Households increased savings rates and their holdings of financial assets during the crisis

A 40% fall in house prices would put wealth position (% GDP) at similar levels as in other developed economies.

Corporate debt deleveraging: duality across sectors

Corporate debt

(% of GDP)
Source: BBVA Research



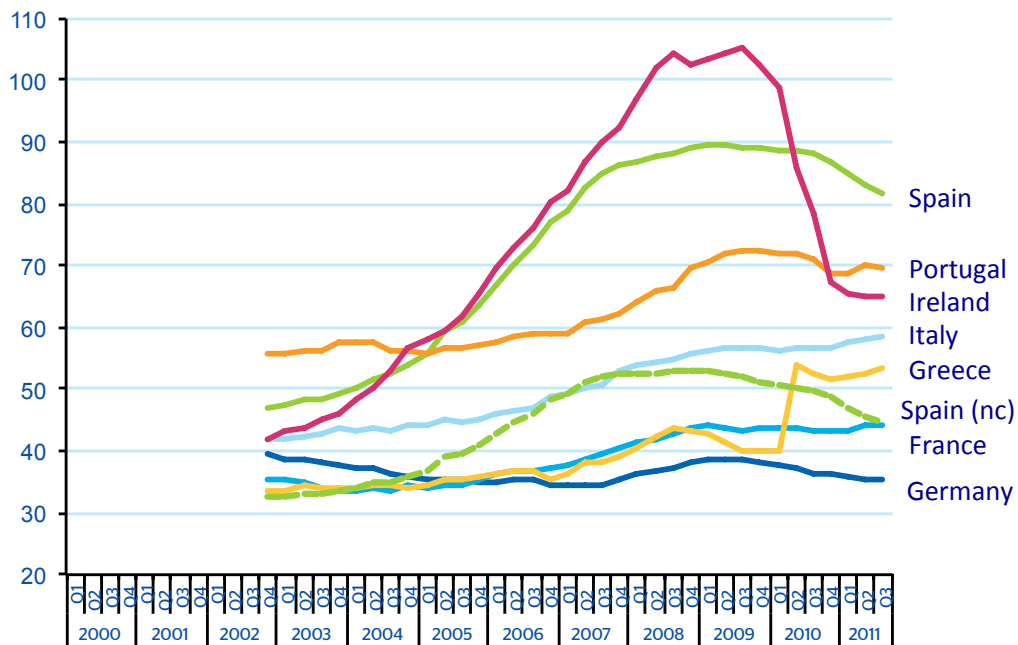
Corporate Debt

- Large differences across countries
- Spanish duality: corporate debt concentrated in construction and real estate
- Deleveraging will continue in sectors and firms with large levels of debt

Corporate debt deleveraging: duality across sectors

Corporate credit

(% of GDP)
Source: BBVA Research



Corporate credit

Again large differences across countries

Spanish duality: corporate credit in sectors others than construction similar to France

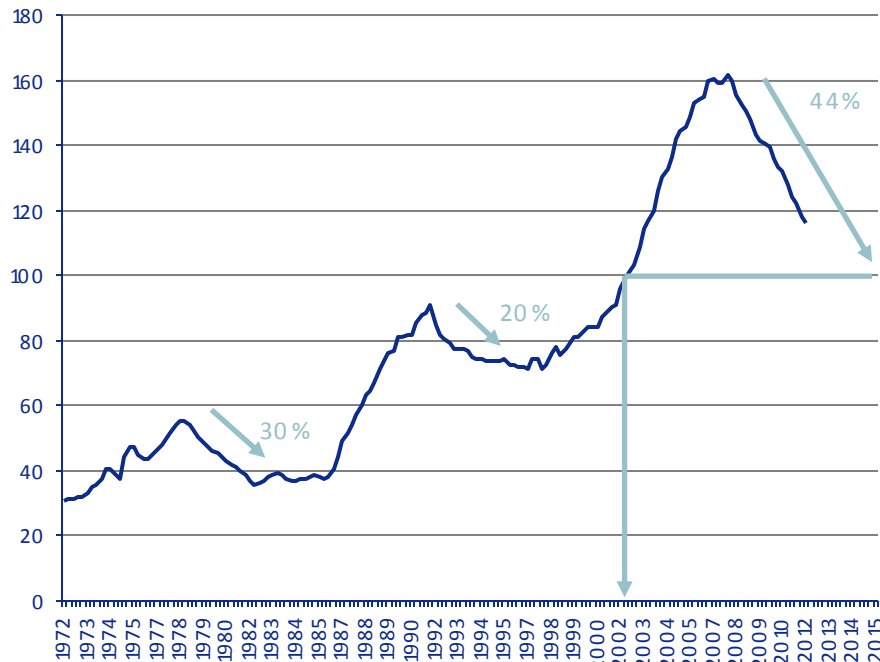
Selective default of firms in high leveraged sectors (as in Ireland?)

Real estate market adjusting to levels before the boom

Spain: Real prices in the housing sector

(1Q2002=100)

Source: BBVA Research based on INE



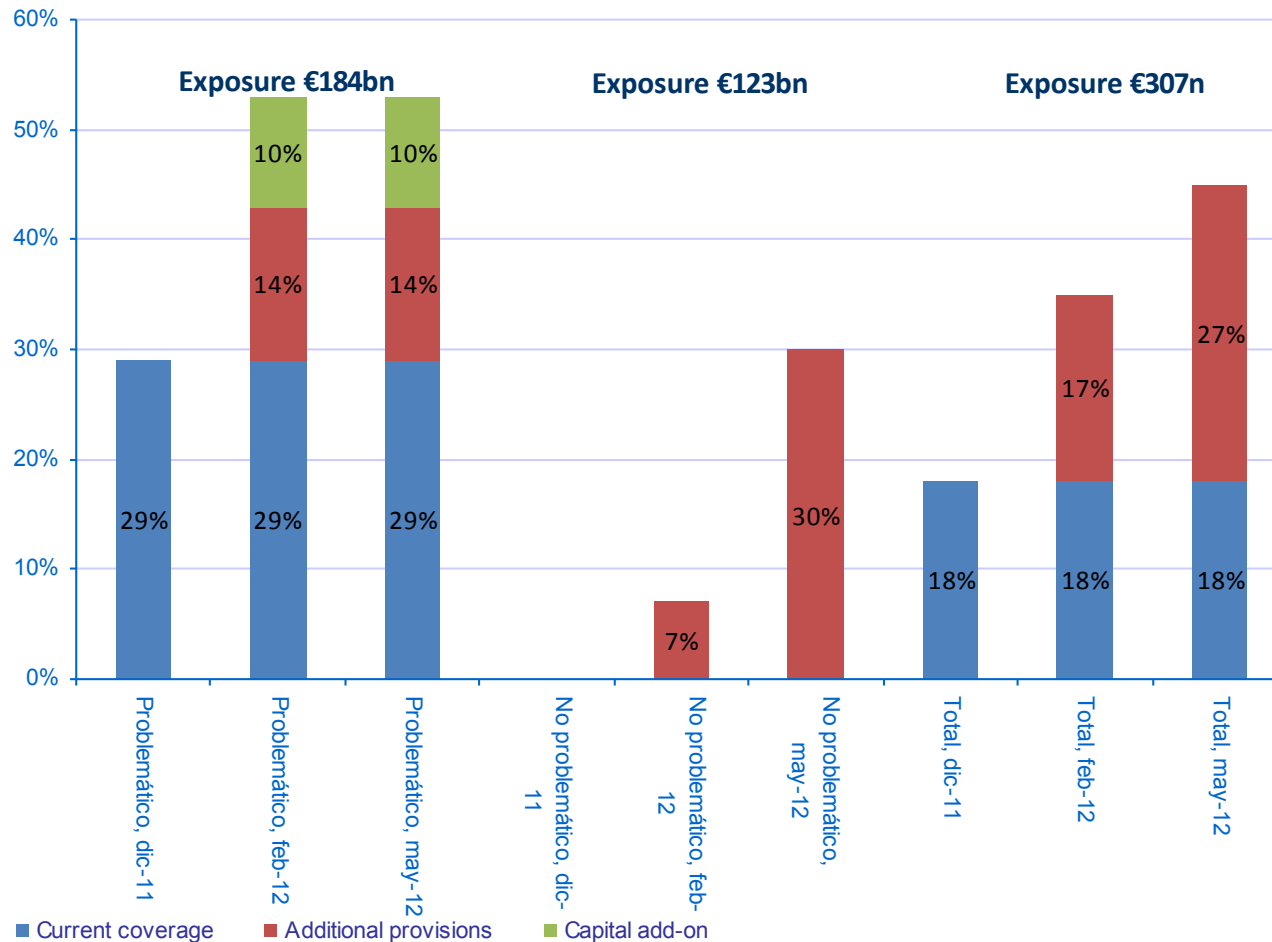
Oversupply of unsold homes is around 700K, below 3 years of potential demand

Real prices still have room to go down (12% more), but it is a very heterogeneous market

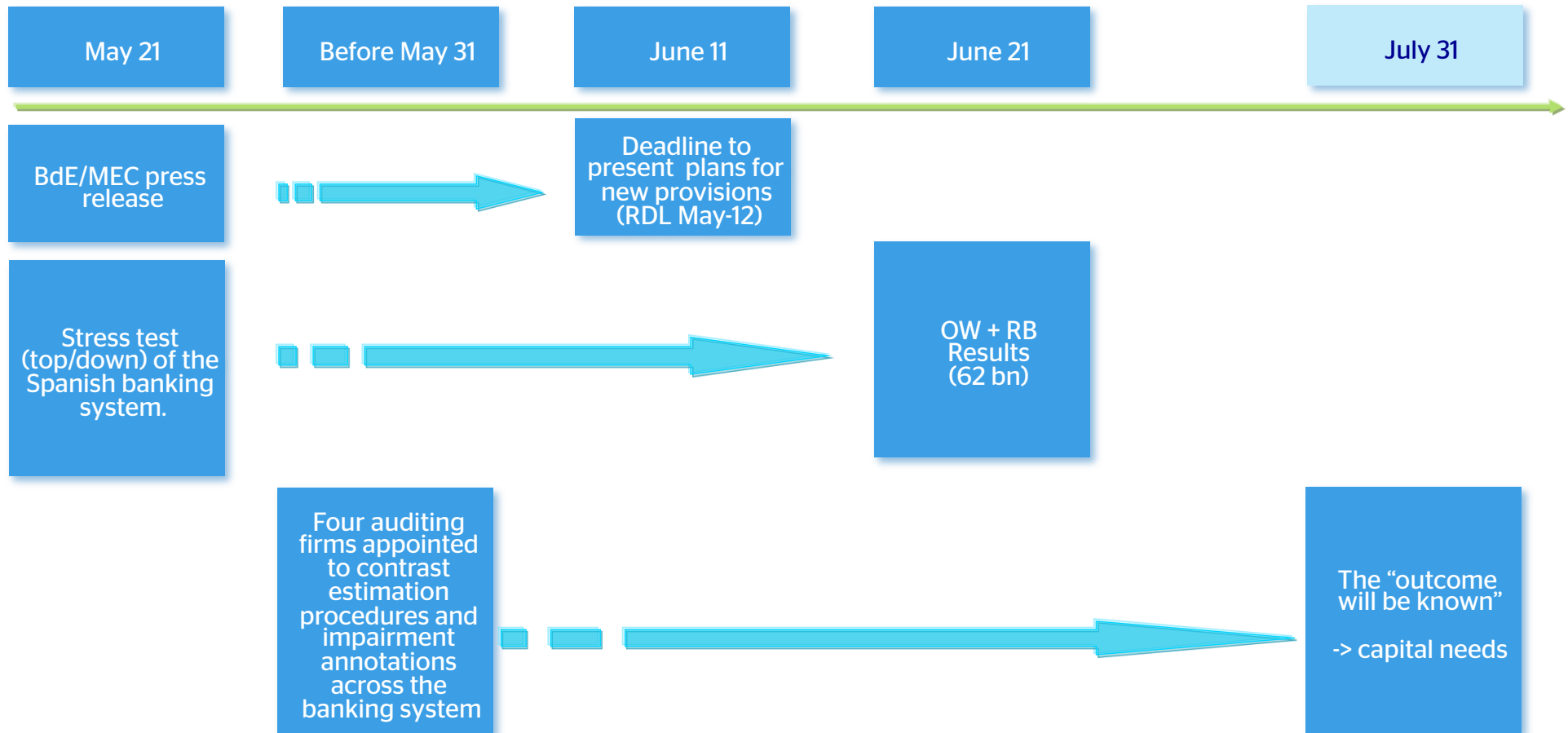
Open question: an overshooting of prices?

The banking system reform

Coverage of problematic and non-problematic real estate portfolio



The banking system reform



The banking system reform

Positive aspects

The independent valuation of portfolios could give credibility to the process

The coverage of the real estate portfolio, where the bulk of the problems lie, is reinforced

The transfer of repossessed assets to 'bad banks' could be positive for institutions in a worse situation, if they find investors

Spain needs to import credibility and regain its own

Negative aspects

The loss of credibility, after several definitive reforms

High uncertainty over coming months, doubts on portfolios valuation, no roadmap for creation of 'bad banks', difficulties to find investors ...

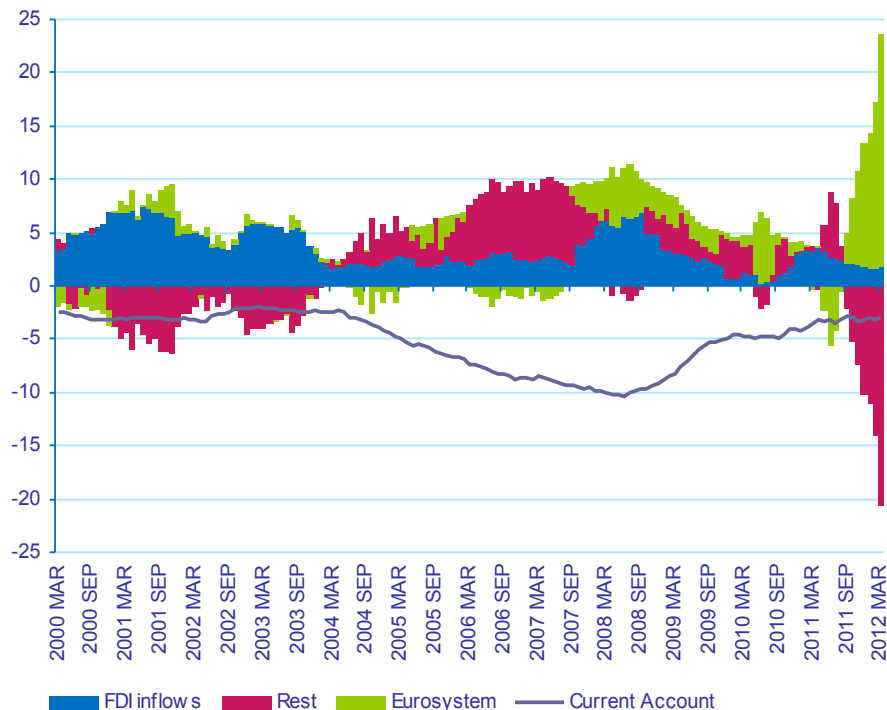
Real estate provisions are too severe for good banks with non-problematic assets

Non discrimination and no clear road map for non viable entities

Three Achilles' heels: 1. High funding needs

Spain: Balance of payments and capital flows

Source: BBVA Research and Bank of Spain.



It's liquidity, not solvency

The strong adjustment on the Spanish net borrowing will continue in 2012, but ...

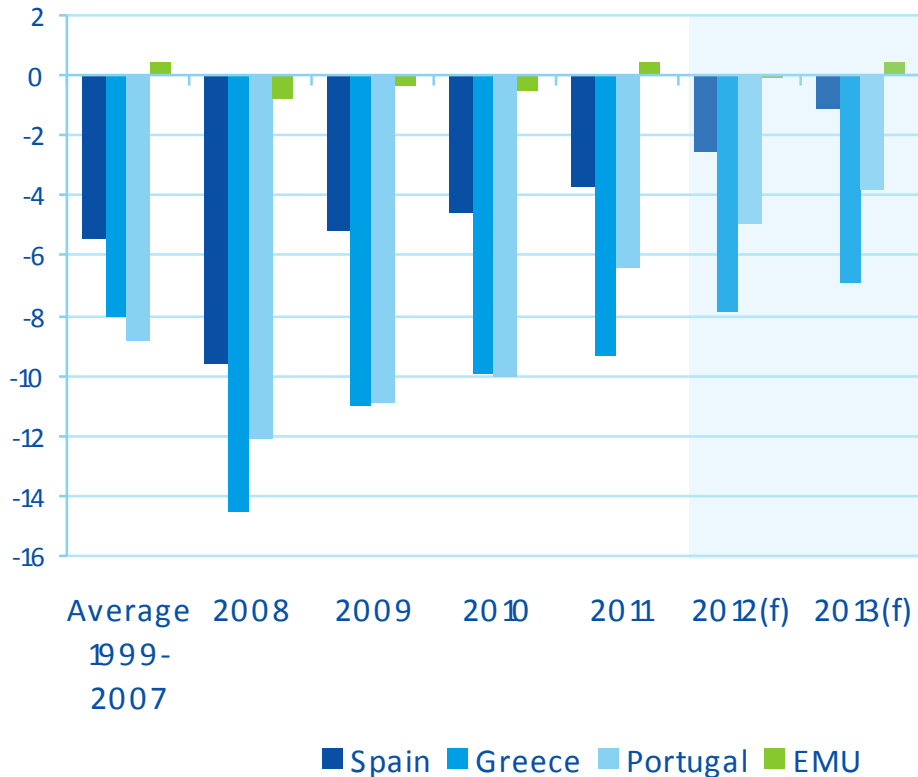
... at the same time, maturities are still very large in 2012

Self-fulfilling prophecy: if financial markets close the situation would be unsustainable

Three Achilles' heels: 1. High funding needs

Current account balance. As percentage of GDP

Source: BBVA Research and IMF

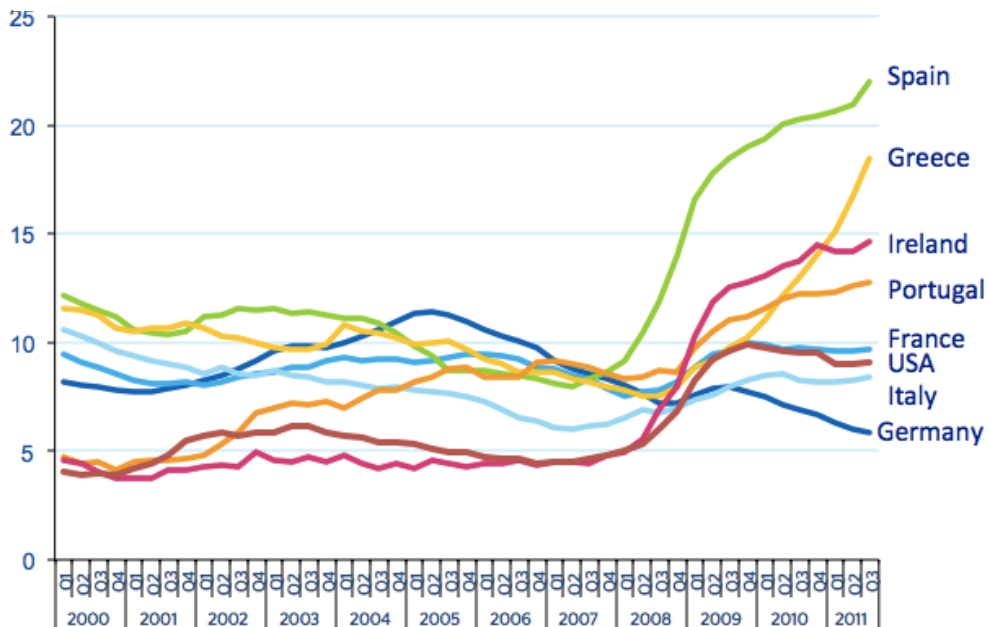


- Strong adjustment in latest years despite the deficit in energy account
- Imbalances explained mainly by growth differentials and high investment, rather than loss of competitiveness
- Spanish share on world exports has remained relatively constant (vs. 30% drops in US or UK)
- Firm size duality: large firms are as productive as in US, France or Germany

Three Achilles' heels: 2. High unemployment rate

Unemployment rates

Source: BBVA Research, Haver



Substantial, well-targeted & integral reform

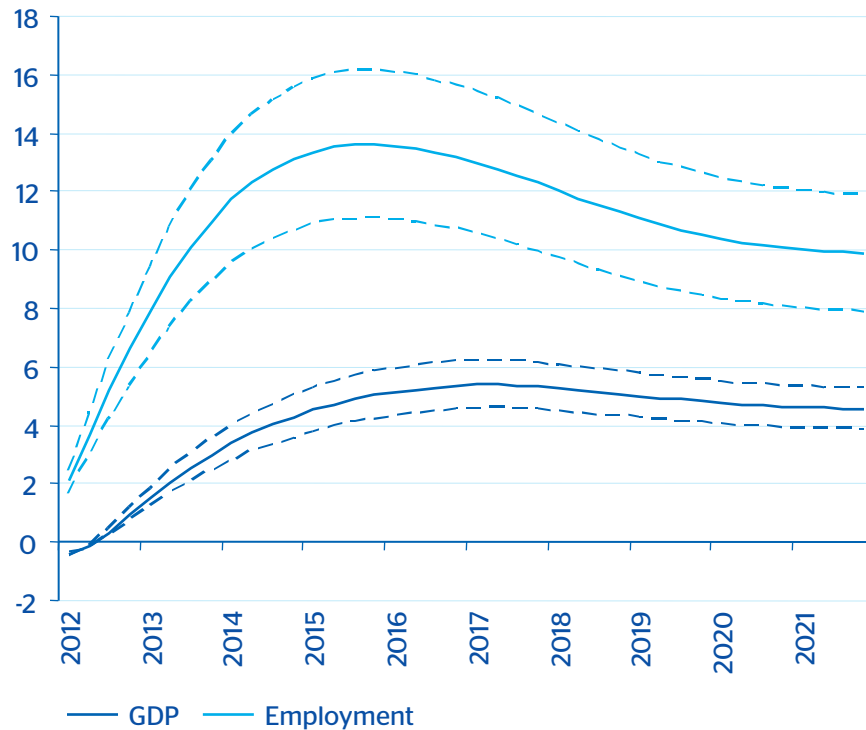
- Substantial increase of internal flexibility (hours and wages)
- Firm-level agreements are prioritized and opt-out processes are facilitated
- Slight reduction of the severance payment gap between temporal and permanent employees
- Legal uncertainty is removed, also for old contracts -> internal devaluation
- Young workers' learning and training promoted

If the reform is well implemented and explained to both firm owners and workers some of the expected job destruction in 2012 could be avoided

Three Achilles' heels: 2. High unemployment rate

Spain: response to labour market reform

(% deviation from trend)
Source: BBVA Research



DSGE results of a full implementation of the labor market reform

GDP: short-run effect 0.2% and long-run effect 4.5%

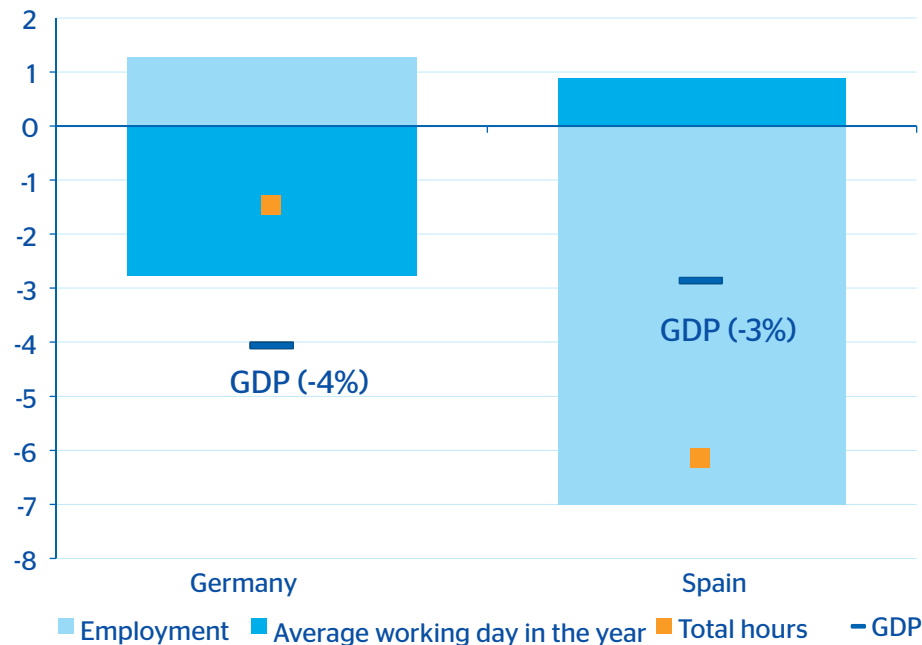
Employment: short run 4.4% and long run 10%. Lower effects for full-time employment

Real wages: short run -0.1% and long run 1%. Greater effects for labor income

Three Achilles' heels: 2. High unemployment rate

Spain: economic growth and breakdown of difference in number of hours worked

(cumulative change 2007-09, %)
Source: BBVA Research based on INE and EC data



The challenge: from adjustment to growth

Short-term goal: prevent further job losses → adjust working hours + wage flexibility and effective organisation

Estimate growth where is scant and take advantage where it prospers

Reallocation of productive factors to firms and more dynamic sectors (foreign sector)

Eliminate internal growth barriers through a more favorable regulatory environment

Three Achilles' heels: 3. The quest for growth

Labor market	Implemented a preliminary version and waiting for the final version after parliamentary approval
Fiscal consolidation	Credible <i>ex ante</i> multiyear measures. Avoid self-defeating austerity Commercial debt of local and regional governments (2.5% of GDP) covered by CG -> fiscal stimulus close to 0,75% of GDP
Financial system	Put an end to financial markets doubts about the solvency of the banking system to reduce financial costs
Competitiveness	Next in line. Improve regulation, increase competition and reduce administrative costs. Fiscal devaluation?
Energy dependency	Reduce energy dependency, green taxes, better regulation, explore all options
Education and R&D	Most important challenge in the long run. A pact to reduce high school drop-out rates, and to improve vocational training -> R+D

Annex

Three Achilles' heels: 3. The quest for growth

Structural capacity in developed economies

Source: IMF and BBVA Research

	Liberal Market Economies			Coordinated Market Economies									Mixed market Economies				Avge.
	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Medium Term																	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	1	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
TIC regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail regulations	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services reg.	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
Long term																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infrastructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
Innovation	1	1	2	1	1	1	1	2	2	1	1	1	3	2	3	3	1.6
Average	1.1	1.3	1.7	1.6	1.9	1.1	1.9	1.9	1.6	1.1	1.2	1.3	2	2.6	2.4	3.0	1.7

After the labor market reform, the next objective in the short run should be to improve regulations -> structural capacity at 1.5, that is, better than core EMU countries

Conclusions

- 2012: another year characterized by risks and challenges, with **Europe and Spain falling behind rest of the world on growth.**
- The new **Stability Pact and the ECB's liquidity** measures are positive steps forward but are not enough: a **more credible firewall needed.**
- The Spanish economy is adjusting quickly. **Substantial reforms**, as the recent labor market reform, needed to stimulate **growth** and reduce the **unemployment rate.**
- **Solvency** problems are firm specific (real estate sector and few banks) and manageable.
- **Public sector debt** is not a problem if regional governments deficits are curbed.
- It is all about **liquidity**: high dependence on financial markets and risks of self-fulfilling prophecies.
- Create a virtuous circle (reduction of imbalances and reforms) to restore **credibility and reduce uncertainty: crucial for positive effects of economic policy measures.**

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