

The Spanish Economy: Current Adjustments and Future Outlook

Jorge Sicilia, Chief Economist, BBVA Group

BBVA Fixed Income Conference: Spain

February 5th, 2013

Key messages

- 1 The Spanish economy is facing **strong domestic and external headwinds**, as a result of the absorption of previously accumulated imbalances and past uncertainty regarding the Euro
- 2 Europe has taken **huge steps towards reducing uncertainty and fragmentation**, the ultimate goal being a stable fiscal, banking, monetary and real union
- 3 After absorbing currently held imbalances, **reforms** being implemented **should increase the economy's medium term growth perspectives**, up to a level around 2% per year
- 4 **There are specific sectors capable** of generating the growth required, although policy must be **aimed at increasing productivity and size across firms** to shore it up
- 5 If implemented efficiently, **the National Reform Program would be a step in the right direction** towards a long-term roadmap for Spain, pushing growth above 2%

Index

Section 1

Diagnosis of the situation

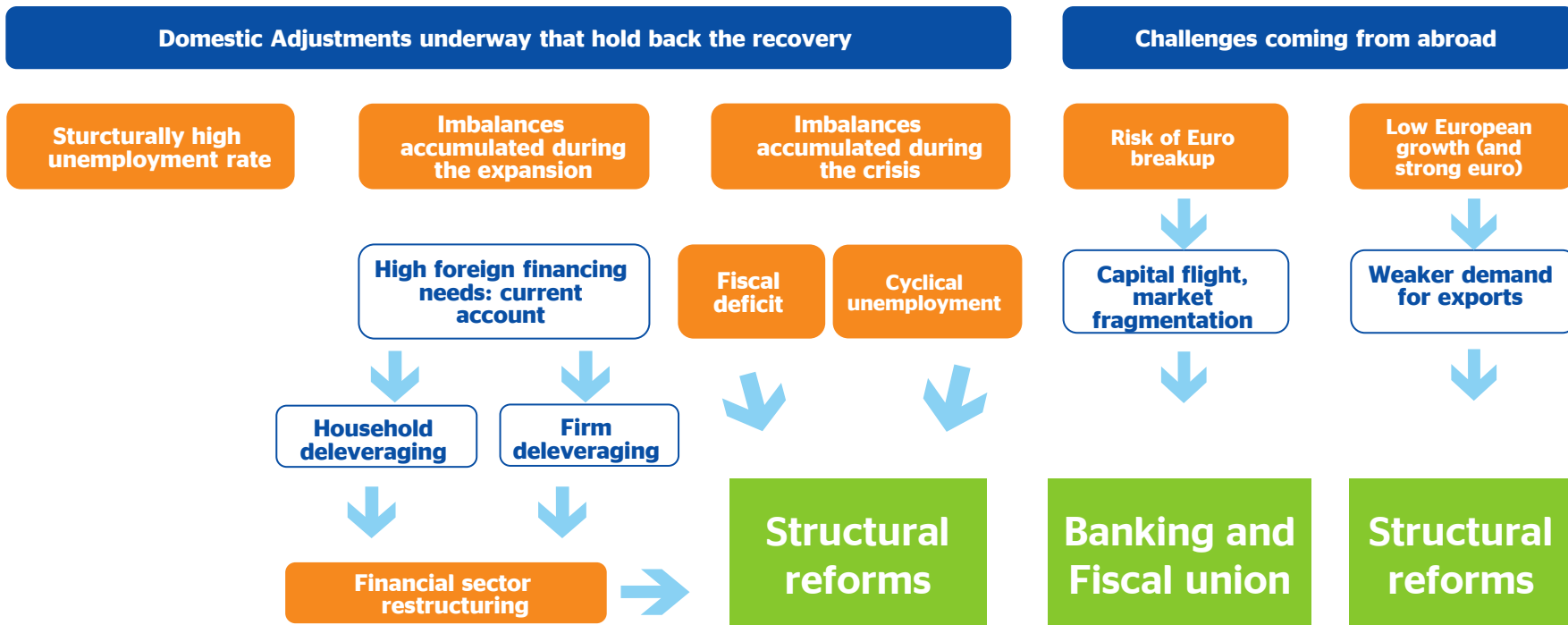
Section 2

Europe: advances in governance normalize financial markets, but work remains ahead

Section 3

Spain: challenges ahead, but reforms are improving the country's growth potential

The Spanish economy is facing domestic and external challenges



Index

Section 1

Diagnosis of the situation

Section 2

Europe: advances in governance normalize financial markets, but work remains ahead

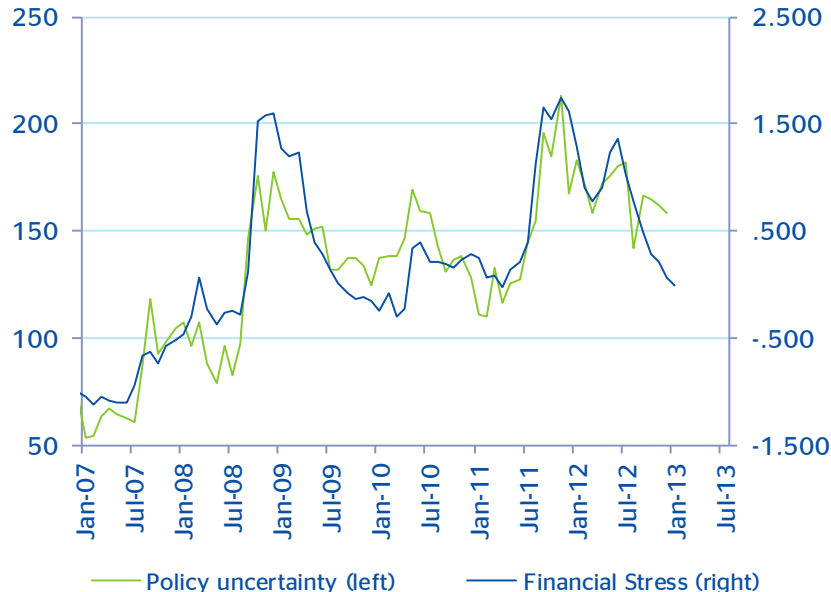
Section 3

Spain: challenges ahead, but reforms are improving the country's growth potential

Europe: policy decisions are reducing financial tensions

Eurozone, proxies for uncertainty Policy Uncertainty Index and Financial Stress Index

Source: Bloomberg, BBVA Research



The announcements by the ECB have contributed to:

Preventing a systemic risk event from occurring

Ensuring the functioning of the monetary policy in the Eurozone

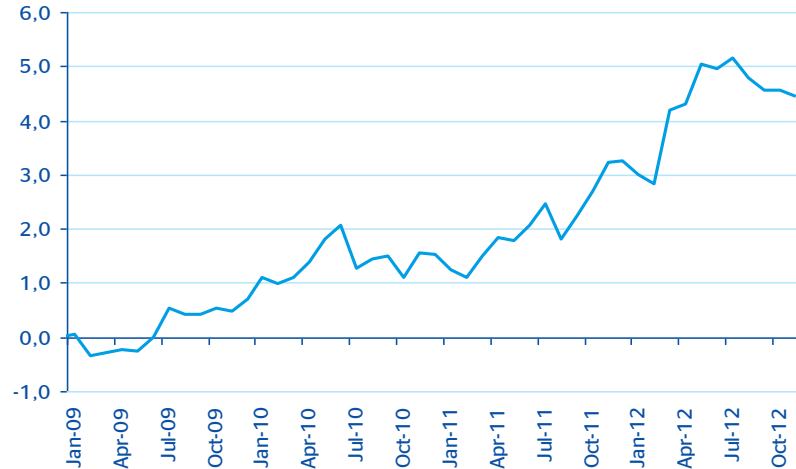
Reducing the upward pressure on the risk premium and capital flows in Spain

Reducing risk aversion: there has been a slow reopening of private debt markets

Europe: although improving, fragmentation remains

Composite measure of Euro Area financial fragmentation*

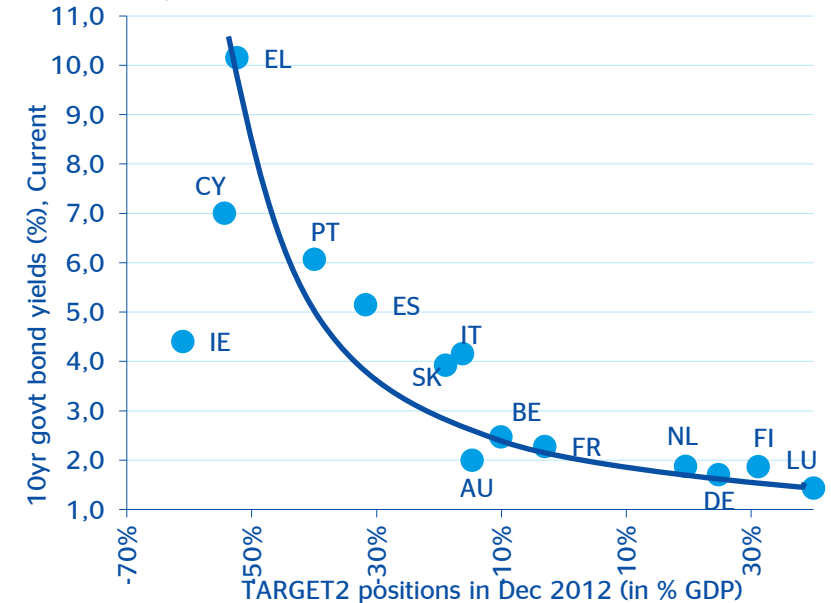
Source: Bloomberg and BBVA Research



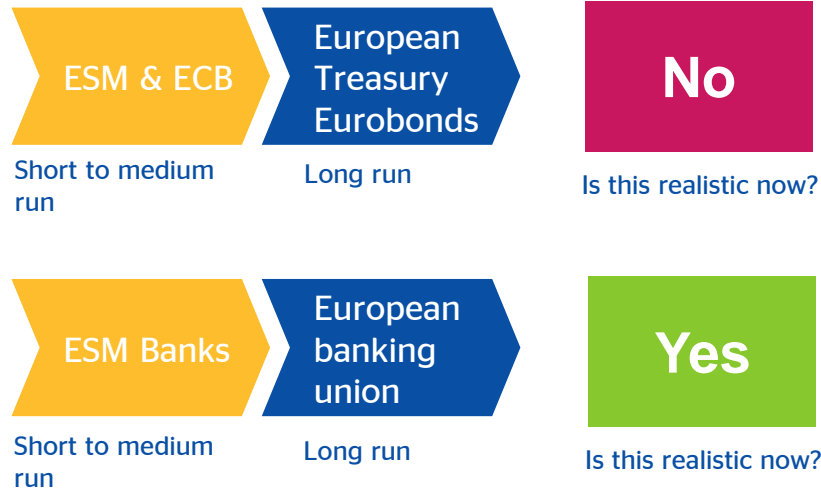
* first principal component of (i) the cross country dispersion (specifically, coefficient of variation) of bank lending rates to corporates and households (average) (ii) the Target 2 balances of surplus (iii) gross liquidity provision by Eurosystem as a share of bank assets and (iv) the interquartile range of Euro area countries' two-year government bond yields

Net balance with Eurosystem/target and 2y Government bond yields (%)

Source: Bloomberg and BBVA Research



A strategy for Europe: (1) a road map to a genuine monetary union



The solution has benefits but costs too -> long and tortuous process

Problem 1: How to distribute the solution costs in the short term between the members?

Problem 2: How to design a time-consistent solution and the conditions to carry it out?

The final stage:
A more stable monetary and economic union

A strategy for Europe: (1) a road map to a genuine monetary union

Fiscal union

After December's summit new advances in the fiscal union have been delayed

The Stability Treaty and the Six Pack seem to be enough for the moment ...

... without any commitment to debt mutualisation or additional budget controls

Banking union

European regulations and single supervision in 2014

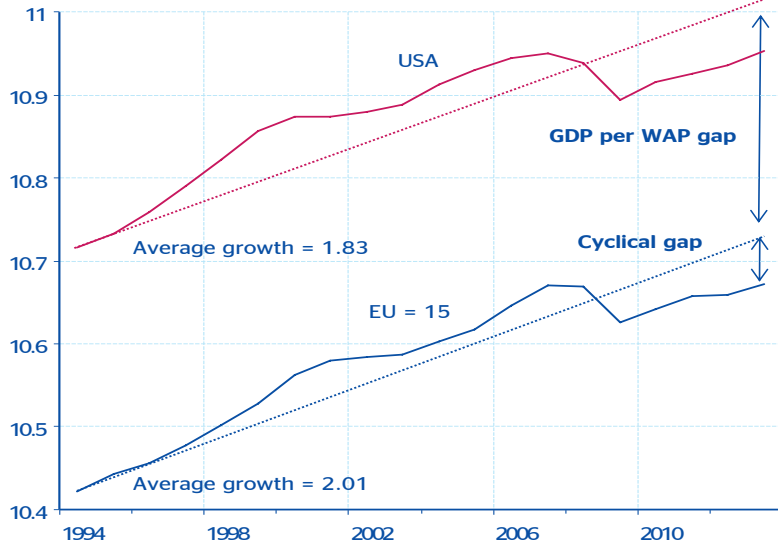
Single resolution mechanism and direct recapitalization schemes to be developed in 2013 ...

... without any commitment to implement an European Deposit Guarantee Fund

A strategy for Europe: (2) policies to foster long-term growth

GDP per working-age population

Source: BBVA Research



Trend components estimated from 1970 to 2012

European gap with the US to be tackled by short-term and long-term strategies

EU15 cyclical gap with the 1970-2012 trend: around 5%

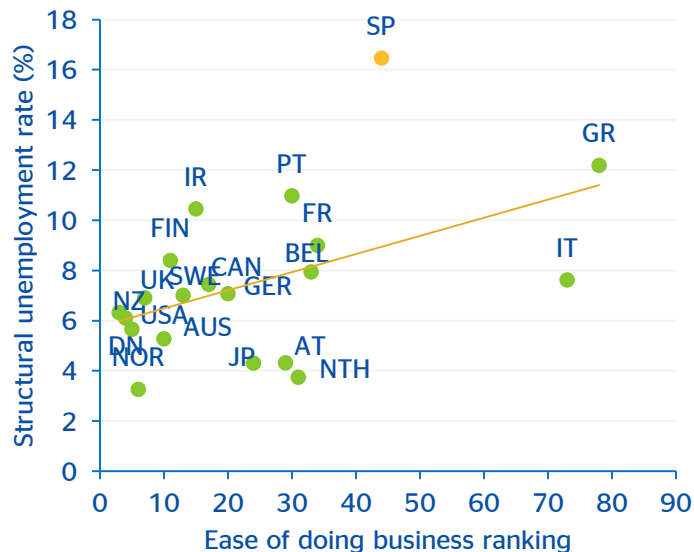
EU15 trend gap with the USA: around 25%

Needed: (1) a recovery strategy in the short run, and (2) a long-run growth strategy

A strategy for Europe: (2) policies to foster long-term growth

Doing Business and structural unemployment

Source: BBVA Research based on OECD and Doing Business



Heterogeneity in institutions is coherent with unemployment gaps

Institutions are crucial for long-term growth

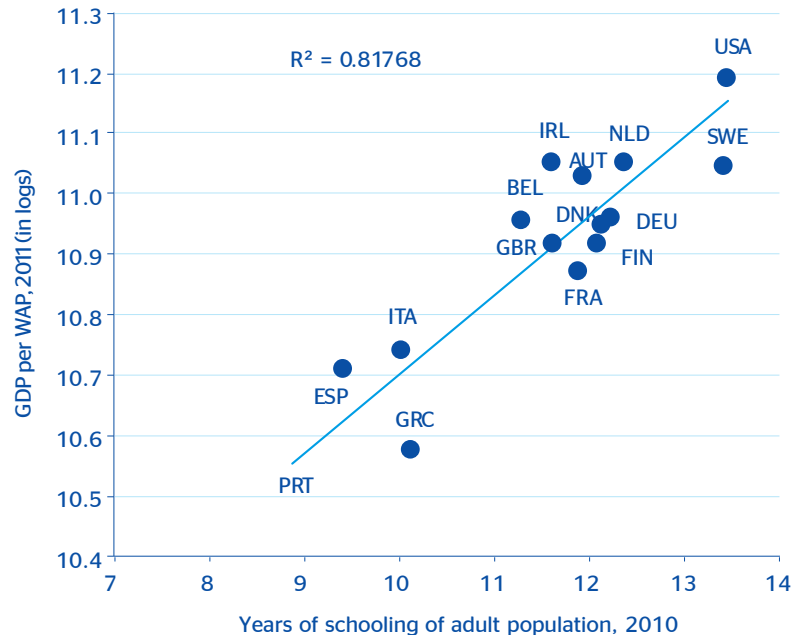
Huge differences among European countries

Interaction with other economic long-run determinants

A strategy for Europe: (2) policies to foster long-term growth

Schooling of adult population and GDP per WAP

Source: de la Fuente and Doménech (2012)



Human capital is directly related with income level

Human capital is one of the main determinants of GDP per working-age population and other economic variables (U, R&D, etc.)

Huge differences among European countries

Increasing human capital levels in some countries will be a very slow process (demographics) -> on-the-job training (labour markets reforms)

Index

Section 1

Diagnosis of the situation

Section 2

Europe: advances in governance normalize financial markets, but work remains ahead

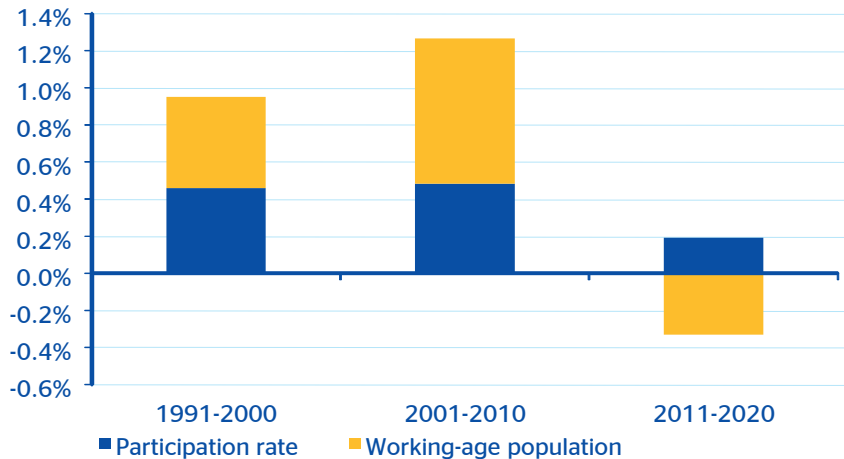
Section 3

Spain: challenges ahead, but reforms are improving the country's growth potential

Problems going forward: a) lower immigration

Spain: contributions to potential GDP

Source: BBVA Research



Reduced scope for job creation

Spain's National Statistics Institute is forecasting a contraction in immigration in the years to come

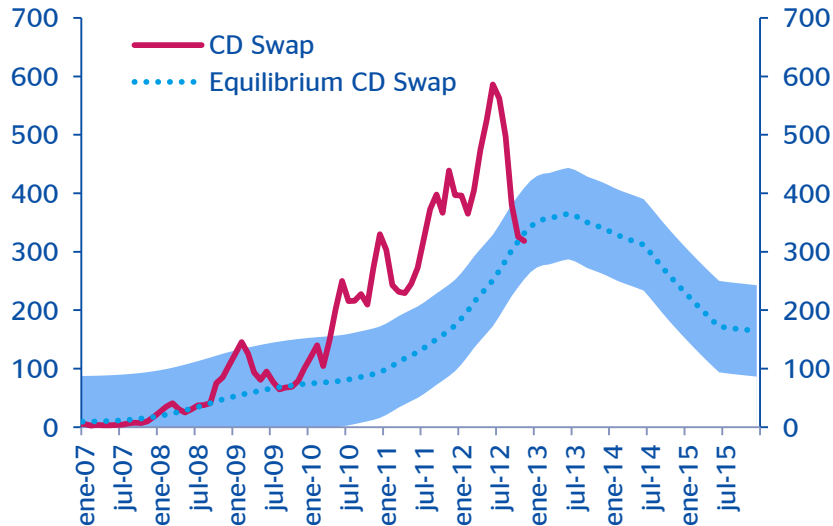
The participation rate (especially female) appears to have stabilised

What can be done to boost the economy's ability to create jobs?

Problems going forward: b) borrowing costs

Steady-state risk premium based on fundamentals

Source: BBVA Research



Expensive (and little) financing

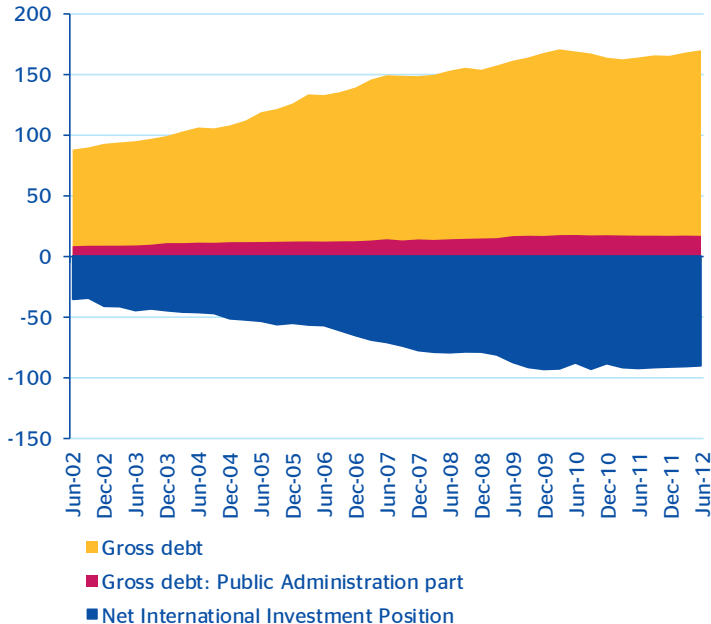
The increase in public and private borrowings is translating into higher structural risk premia

In addition, risks associated with Europe drove borrowing costs way above fundamentals

Problems going forward: c) deleveraging

External borrowings and net international investment position (share of GDP)

Source: BBVA Research, based on Bank of Spain data



Overreliance on external borrowings

Excessive debt is a burden for the economy and hinders recovery

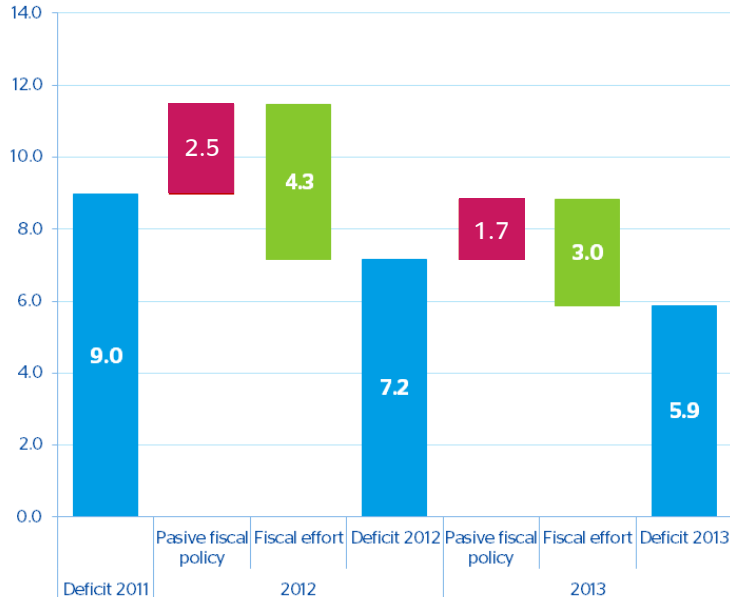
Deleveraging processes tend to be protracted (between 5 and 10 years)

Measures for up to 9% of GDP have been announced by the Government to correct fiscal imbalances

Problems going forward: c) deleveraging

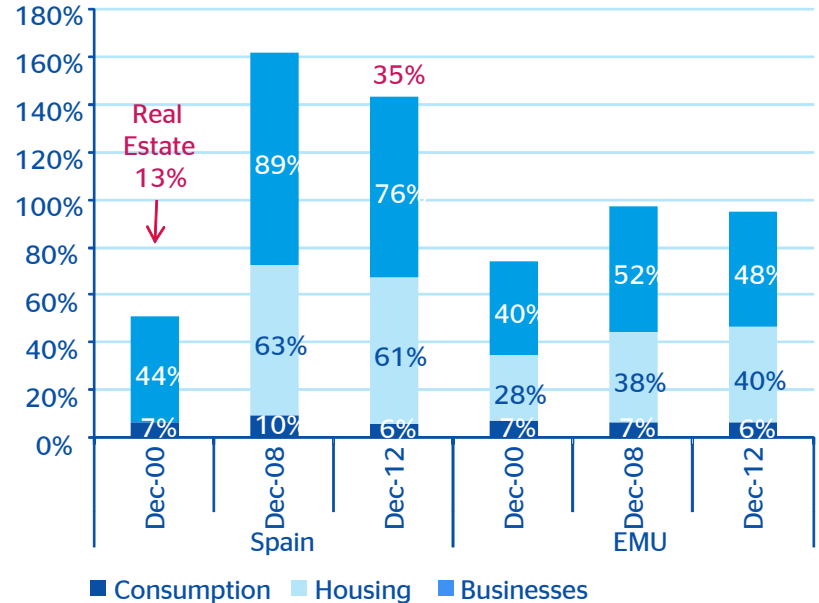
General government fiscal adjustment

Excluding financial sector aid. (% GDP)
Source: BBVA Research based on INE and MINHAP



Credit to the private sector (% GDP)

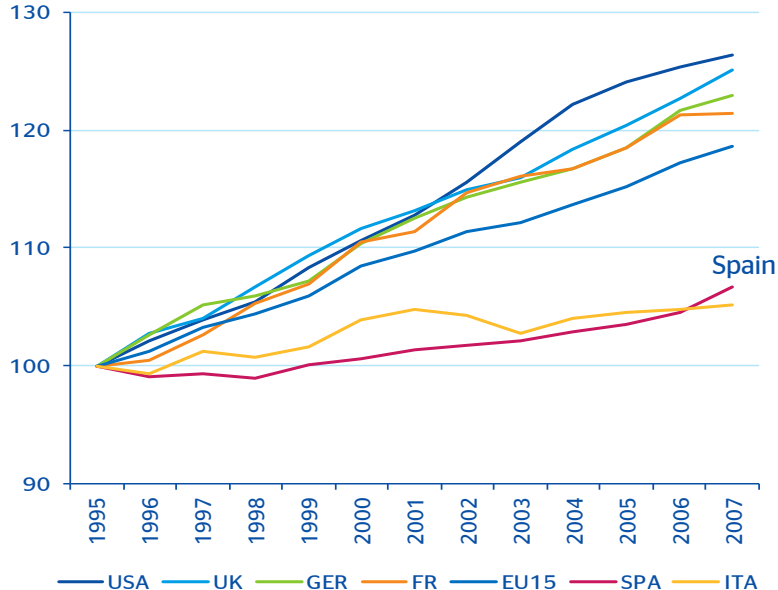
Source: ECB and Bank of Spain



Problems going forward: d) productivity gap

Productivity: gross added value per hour worked, in volume, 1995=100

Source: BBVA Research, using EU KLEMS data



The challenge is to create jobs and reduce the productivity gap

During the boom years, Spain's productivity gap widened with respect to the leading economies

Until the current economic crisis, aggregate productivity grew by a scant 0.6% per year on average

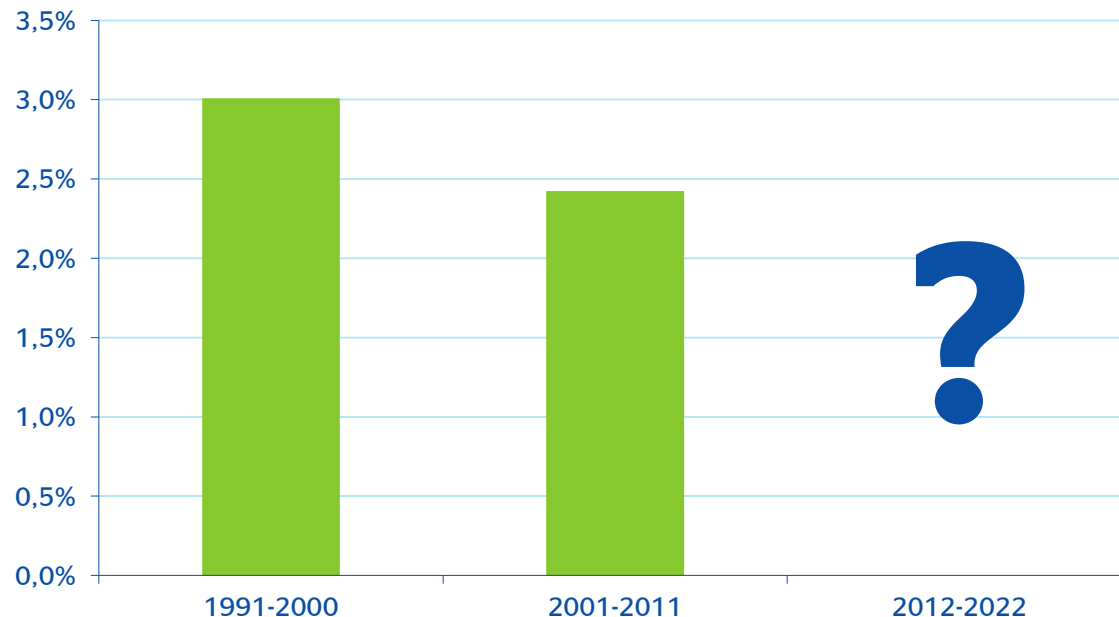
Productivity gains facilitate the sustainability of public accounts, private sector deleveraging and international expansion

Two questions going forward:

1. Where will trend GDP growth be in the near future?

Spain: Trend GDP growth (% yoy)

Fuente: BBVA Research

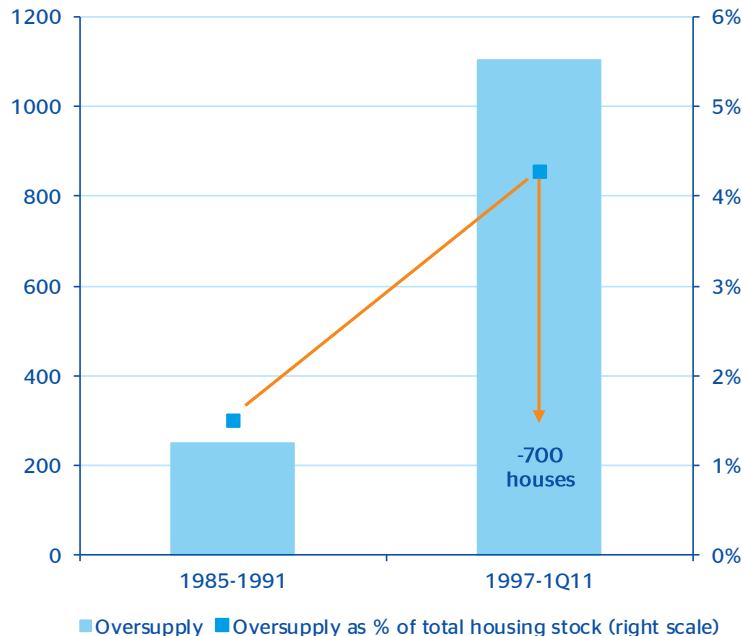


Two questions going forward:

2. In which sectors will Spain grow?

Spain: housing oversupply

Source: BBVA Research



The need for new sources of growth

Construction and construction related sectors accounted for close to 35% of the Spanish economy

These sectors grew at a rate above 4% per year in the 15 years before the crisis

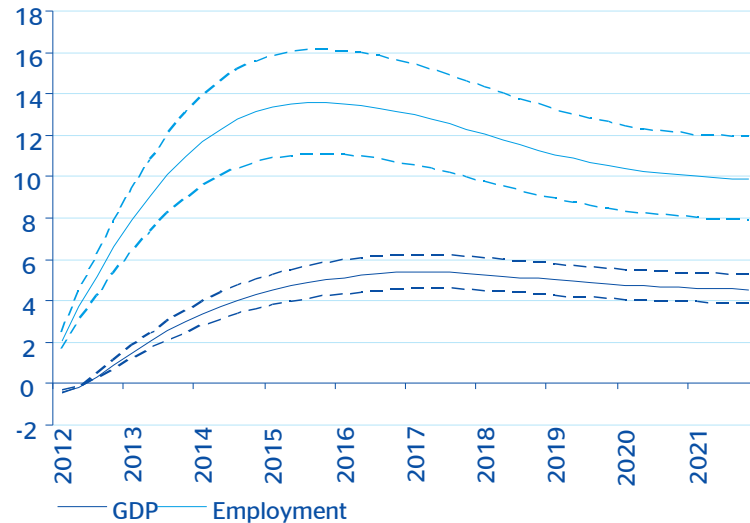
Absorption of sector imbalances will be slow and will take time

Answers: a) Improving job creation

Impact of labour market reform

(Difference vs. no reform scenario, %)

Source: BBVA Research



Tackling unemployment

In light of more adverse demographic and immigration trends, the challenge is to bring unemployment down

Key problems of the Spanish labor market: duality, wage indexation, lack of flexibility for firms, inefficient active policies

The 2012 reform increases flexibility, lowers dismissal costs and improves the collective bargaining mechanism

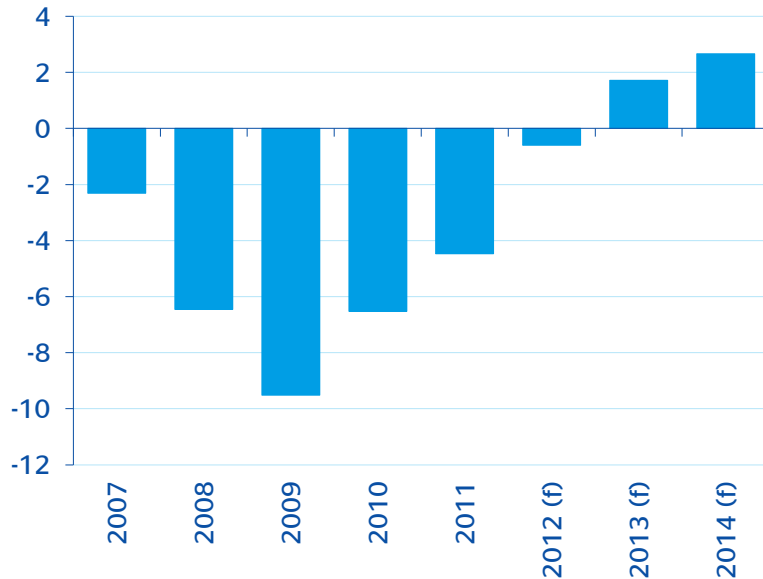
The rate of employment in the medium term will be around 10% higher than if no reform had been done (4 points of GDP)

Answers: b) Reducing borrowing costs

Primary structural deficit (-) / surplus (+) (% of GDP)

Excluding financial sector aid. (% GDP)

Source: BBVA Research based on INE and MINHAP



Fiscal consolidation process

The Government has presented a multiyear (up to 2014),...

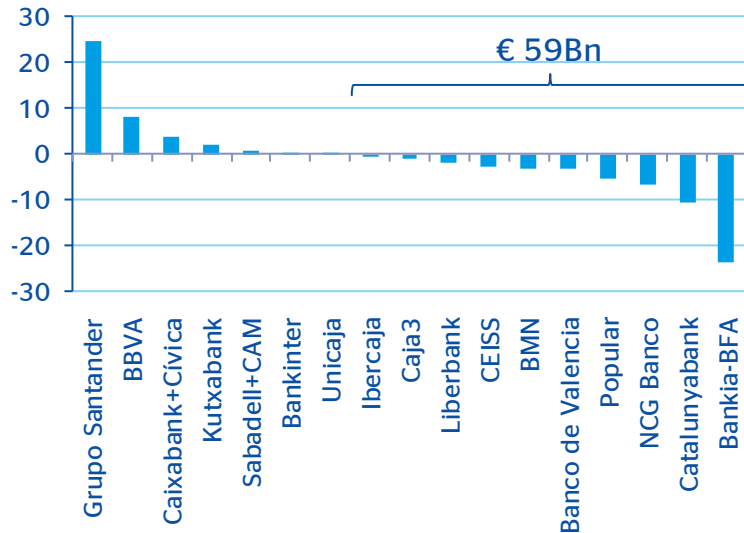
... sizeable (9% of GDP in measures), credible plan that minimizes its negative impact on growth (relies on expenditure reduction)

A primary structural fiscal surplus is expected for 2013 if the Government delivers on its program

Answers: b) Reducing borrowing costs

Capital requirements of financial institutions in the adverse scenario* (EUR Bn)

Source: Bank of Spain



One more step has been completed in the bank restructuring

Recapitalisation plans: EUR40Bn euros in forecast public capital injections

The diverse nature of the system has been confirmed: the solvent institutions have 70% of the assets

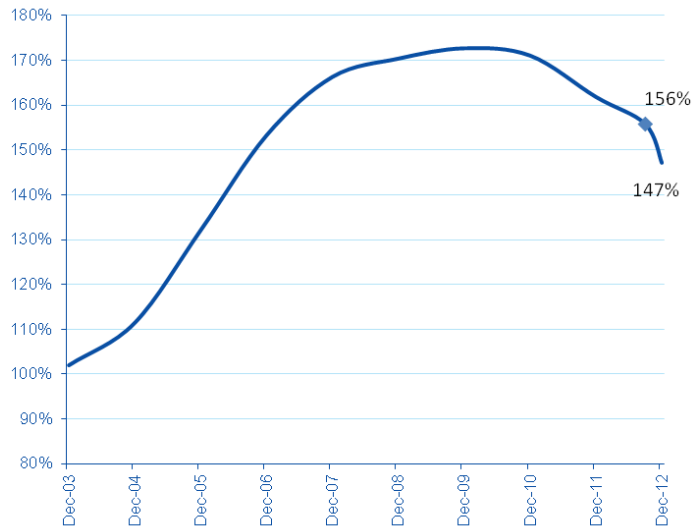
Transferring assets to the Asset Management Company (Sareb), with discounts to attract private capital and not consolidate as public debt

* Does not include mergers under way or fiscal credit (with it EUR54Bn)

Answers: c) accelerating the deleveraging process

Bank credit to private sector* (% GDP)

Source: Bank of Spain, FDIC and Bank of England



A steady process accelerated by write-offs and SAREB

The deleveraging process is ongoing, and amounts now to around 25pp of GDP

The recent transfer of €54bn of real estate loans to Sareb works as a write-off

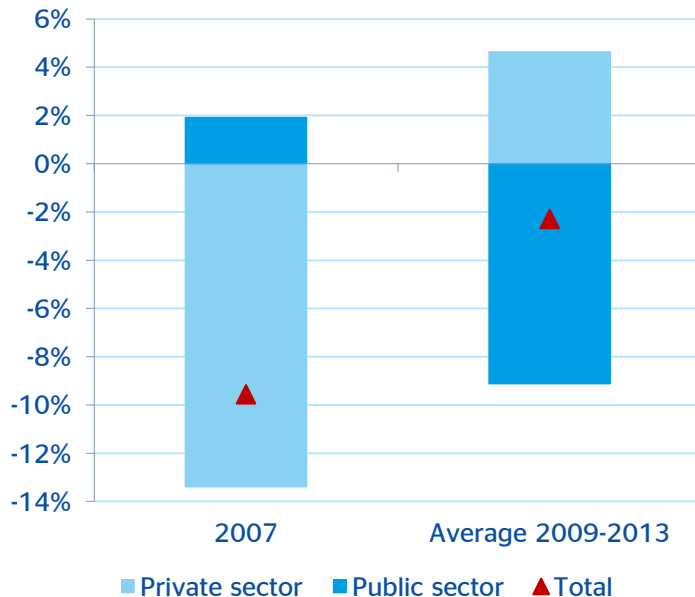
Another transfer of around €18bn (2% GDP) is expected for Feb-13

* Without out-of-balance securitisations

Answers: c) accelerating the deleveraging process

Spain: foreign financing needs (% of GDP)

Source: BBVA Research based on Bank of Spain data



The private sector is deleveraging

2013 will mark the fifth year in a row in which the private sector will show a considerable foreign financing surplus

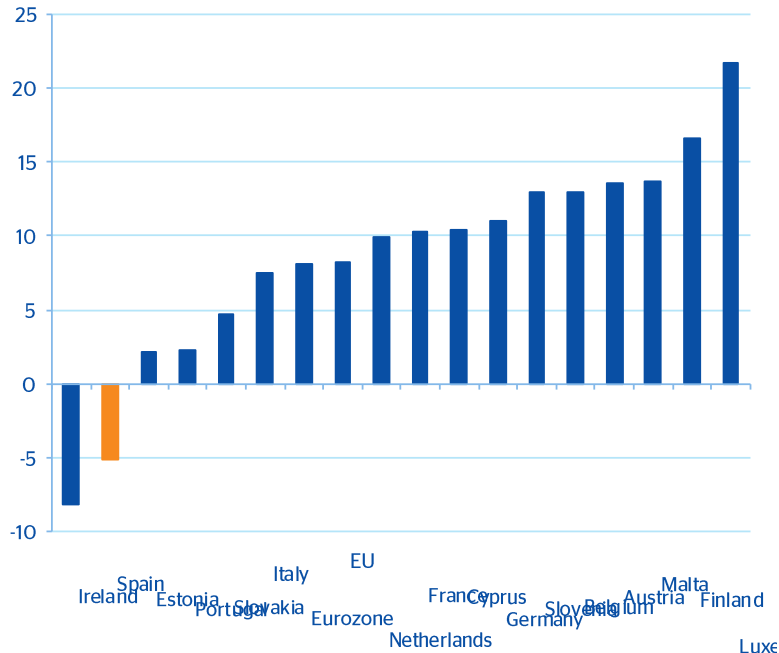
The current account is likely to be in equilibrium in 2013 and show a surplus in 2014

Asset accumulation means that the net asset position of the private sector has improved considerably

Answers: d) increasing productivity with reforms

Eurozone: unit labour costs (change since 2008Q1, %)

Source: Eurostat, BBVA Research



The rise of productivity

Productivity gains have been large since the beginning of the crisis (12%)

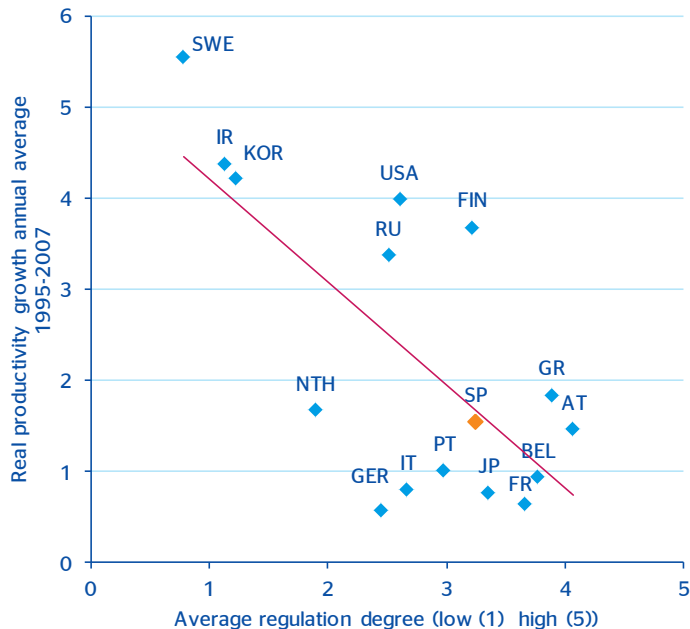
They have been widespread and not concentrated in residential construction

Tradeables like manufacturing and industry have had gains above 20%

Answers: d) increasing productivity with reforms, the need for more efficiency and deregulation

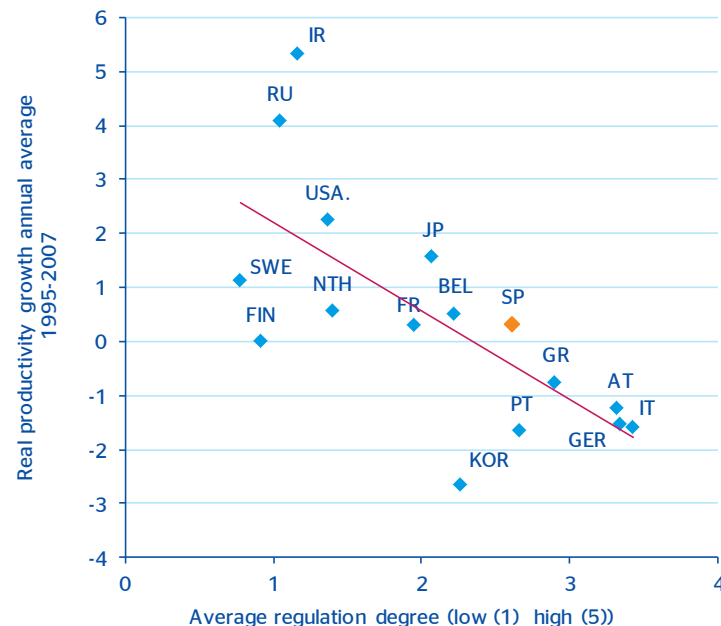
Regulation and productivity gains in the retail sector

Source: BBVA Research based on EUKLEMS and OECD data



Regulation and productivity gains in the business services sector

Source: BBVA Research based on EUKLEMS and OECD data



Answers: d) increasing productivity with reforms, the need for size

Characteristics of companies that exported during the year compared to those that did not

Manufacturers. Ratio of medians, average 1990-2010
Source: BBVA Research based on business strategy survey data (SEPI Foundation)



Large firms in Spain are as productive as their counterparts

A mere 12% of Spanish firms exported goods and 9% exported non-tourism services between 2001 and 2011

Significant concentration: just 1% of the highest-volume exporters accounted for 67% of all exports

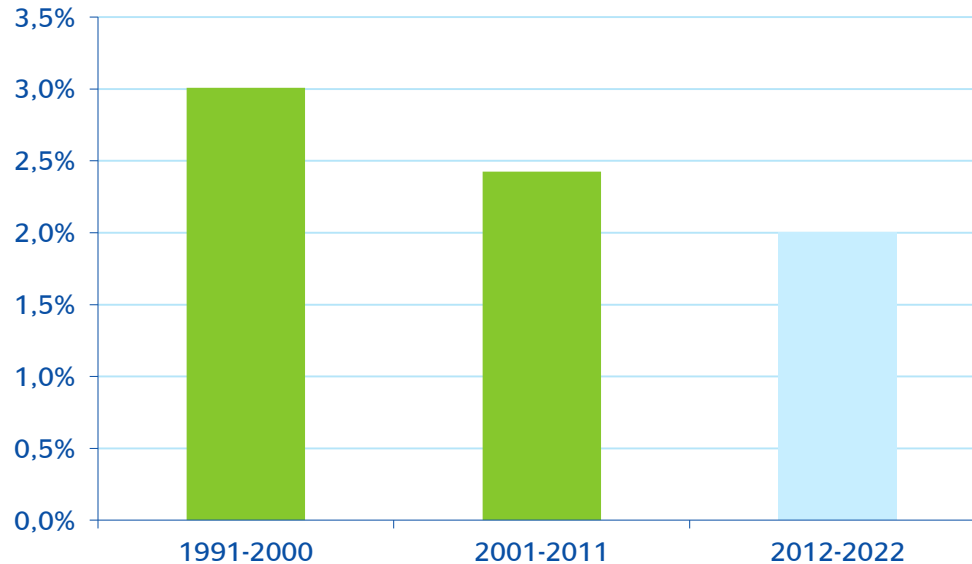
The low percentage of exporter firms in Spain points to an underlying export selection effect

The *productivity threshold* dividing exporters from non-exporters is well above average sector productivity levels

GDP growth is likely to be at around 2% (or even more)

Spain: Trend GDP growth (% yoy)

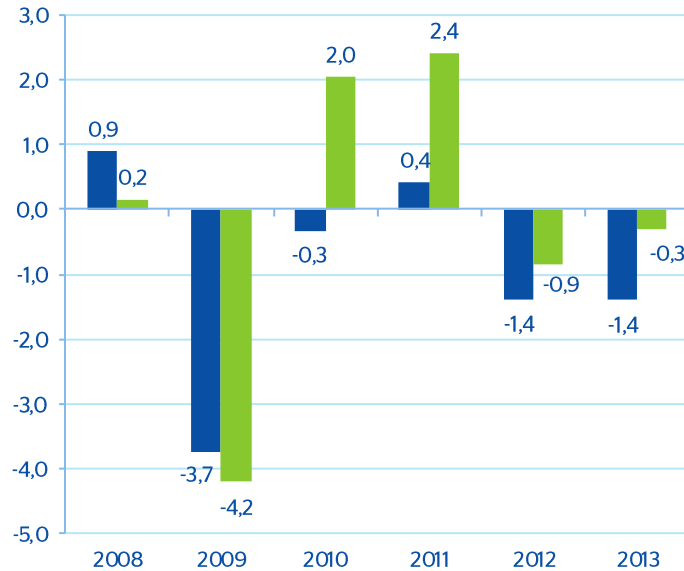
Fuente: BBVA Research



Answers: e) Strong candidates to support this growth

Spain: GDP growth (%YoY)

Source: BBVA Research based on INE



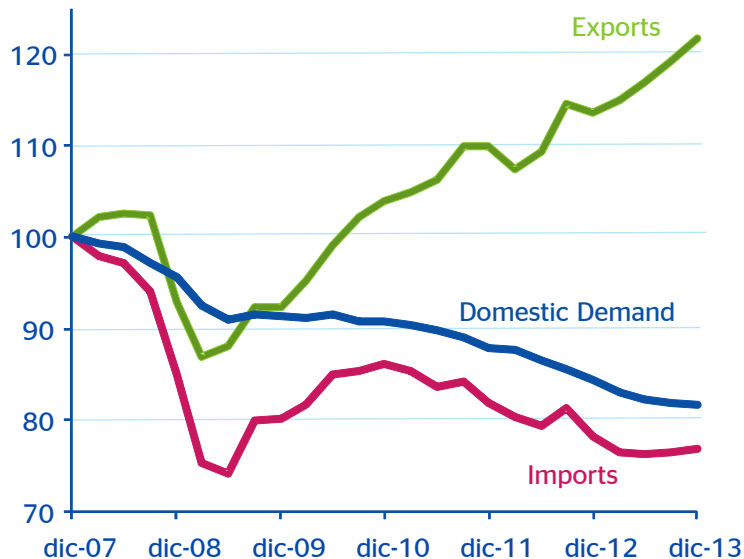
■ GDP ■ GDP excluding: public sector, financial services and construction

Which sectors will drive growth? Exports

Spain: domestic demand, exports and imports

(4Q07=100)

Source: BBVA Research based on INE



Exports are now well above their pre crisis levels

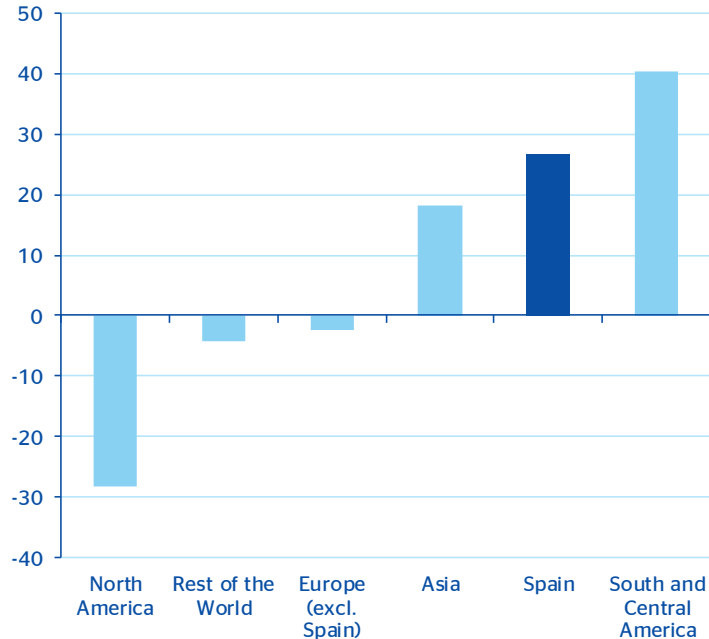
Diversification is improving in terms of destination as exports to non European countries keep growing at two digit numbers

Improvement in ULCs explains in part such story, but it doesn't seem to explain the good performance before the crisis

Which sectors will drive growth? Services

Change in share of exports by geography: other business services, 2000-2011 (%)

Source: BBVA Research based on WTO data



Tap into the burgeoning global service trade

Since 2000 Spain has performed well in terms of its trade in other business services (legal, engineering, architectural, management, marketing, etc.)

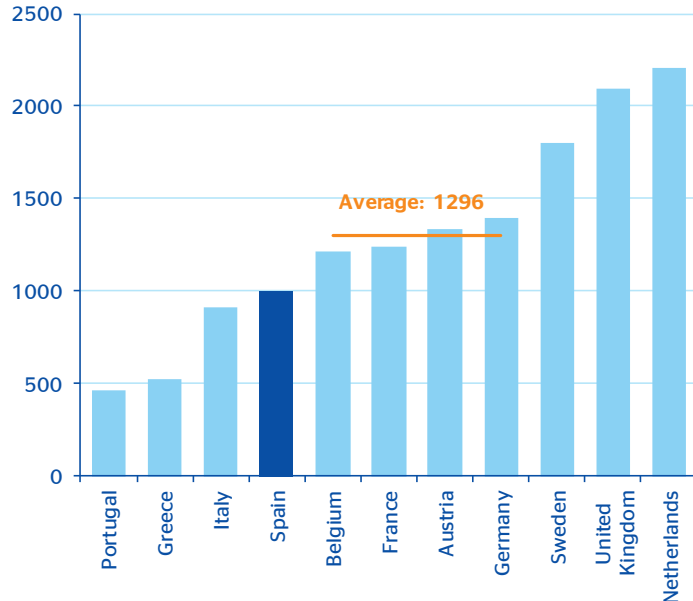
Its exports share has increased from 2.5% to 3.2%, significantly outperforming other regions

As the global enterprise landscape expands, the export of these kinds of services presents a significant growth opportunity

Which sectors will drive growth? Services

GVA per capita at factor cost: business services, 2009 (euros)

Source: BBVA Research based on Eurostat data



Convergence with Europe on service sector breakdown

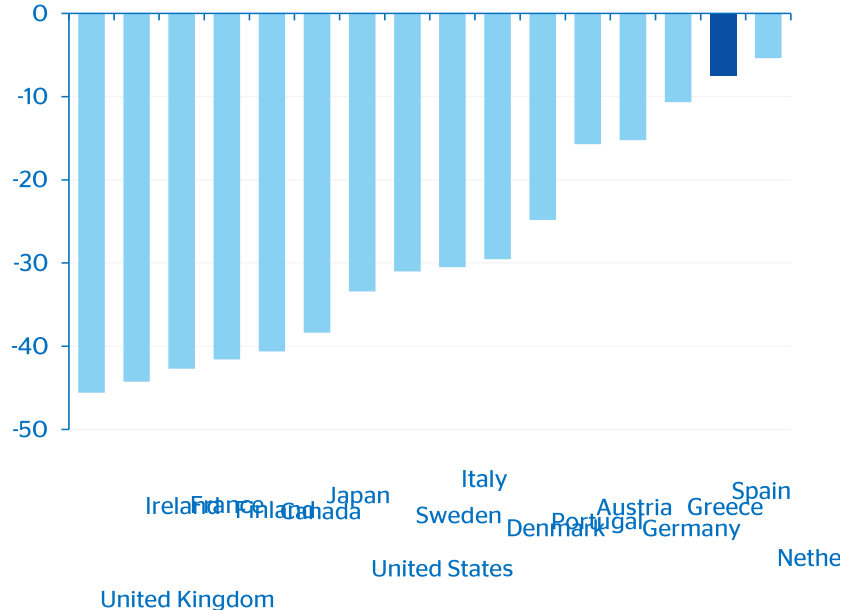
There is considerable scope for development of business services (programming, information services and other business services)

These services require specialisation, can be outsourced and are largely exportable. Positive spillover effects for the rest of the economy

Which sectors will drive growth? Goods

World export share in goods markets, % variation in 1999-2011

Source: BVA Research from WTO



The Spanish puzzle: factors linked to the business environment

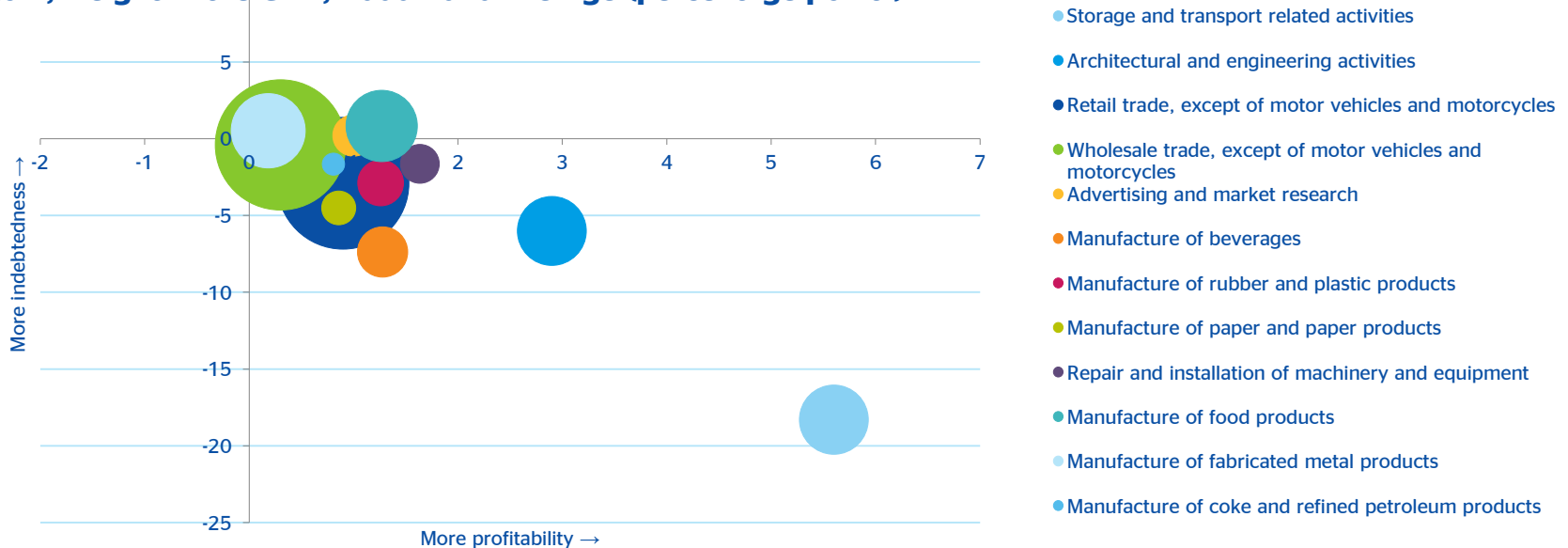
Unlike other countries, between 1999 and 2011 Spain's share of exports barely fell by 8.9%

If the effect of relative export prices were eliminated, the Spanish share would have increased

The prices are important, but other factors in the business environment are more so

Which sectors will drive growth? Goods

Profitability and indebtedness differential with respect to Europe in services and goods sectors, weight in the GVA, 2000-2010 average (percentage points)

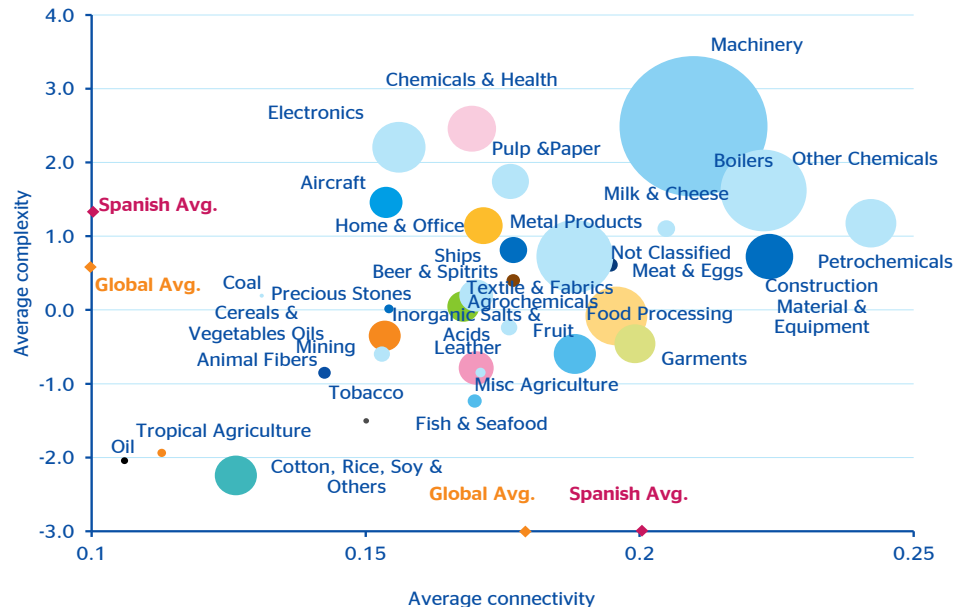


Note: Profitability is calculated as net profit over net turnover; indebtedness is calculated as total debt over total actives; Europe includes Germany, Italy, France, Belgium and Portugal. GVA data correspond to 2008. Selected sectors are those with an average change in profitability for the period 2000-2007 and the period 2008-2010 higher than the median change in profitability, and taking into account the exporter behavior. Sources: BBVA Research based on BACH and INE.

Which sectors will drive growth? Goods

Spain: Sector complexity, connectivity of Spanish exports and domestic distribution of goods exports by sector 1999-2011

Source: BBVA Research from Datacomex and Hausmann et al., 2011



Key messages

- 1 The Spanish economy is facing **strong domestic and external headwinds**, as a result of the absorption of previously accumulated imbalances and past uncertainty regarding the Euro
- 2 Europe has taken **huge steps towards reducing uncertainty and fragmentation**, the ultimate goal being a stable fiscal, banking, monetary and real union
- 3 After absorbing currently held imbalances, **reforms** being implemented **should increase the economy's medium term growth perspectives**, up to a level around 2% per year
- 4 **There are specific sectors capable** of generating the growth required, although policy must be **aimed at increasing productivity and size across firms** to shore it up
- 5 If implemented efficiently, **the National Reform Program would be a step in the right direction** towards a long-term roadmap for Spain, pushing growth above 2%

THANK YOU FOR YOUR ATTENTION!

WWW.BBVARESEARCH.COM

(check our ipad app bbvaresearch)

The Spanish Economy: Current Adjustments and Future Outlook

Jorge Sicilia, Chief Economist, BBVA Group

BBVA Fixed Income Conference: Spain

February 5th, 2013

Appendix

Outlook for 2012-2013

Spain and Europe: macroeconomic forecasts

Source: INE, Bank of Spain, Eurostat and BBVA Research forecasts

(Yoy growth rate)	2010		2011		2012 (f)		2013 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
FCE, Homes	0.6	0.9	-0.8	0.1	-2.1	-1.0	-2.9	0.0
G.C.F AA.PP	1.5	0.7	-0.5	-0.1	-3.6	-0.1	-6.9	-0.5
Gross fixed capital formation	-6.2	-0.3	-5.3	1.6	-9.7	-3.6	-7.5	-0.6
Equipment, machinery and cultivated asset	2.6	6.3	2.3	4.2	-7.6	-5.3	-3.7	-0.8
Equipment and machinery	3.0	6.4	2.4	4.3	-7.7	-5.3	-3.8	-0.8
Construction	-9.8	-4.4	-9.0	-0.2	-11.8	-3.4	-10.0	-1.4
Housing	-10.1	-2.9	-6.7	0.9	-6.8	-1.9	-8.4	0.4
Other buildings and other construction	-9.6	-5.9	-11.0	-1.4	-16.3	-5.1	-11.7	-3.3
Change in inventories (*)	0.1	0.6	-0.1	0.1	0.0	-0.5	0.0	0.0
Domestic demand (*)	-0.6	1.2	-1.9	0.5	-4.0	-1.8	-4.7	-0.3
Exports	11.3	11.0	7.6	6.4	3.8	3.1	8.2	3.2
Imports	9.2	9.4	-0.9	4.2	-4.7	0.1	-1.8	2.2
Net trade balance (*)	0.3	0.7	2.3	1.0	2.6	1.3	3.3	0.5
GDP at mp	-0.3	1.9	0.4	1.5	-1.4	-0.5	-1.4	0.3
Pro-memoria								
GDP w/o housing investment	0.5	2.2	1.0	1.5	-1.0	-0.4	-0.9	0.3
GDP w/o construction	1.6	2.7	2.1	1.7	0.3	-0.2	-0.2	0.4
Employment (LFS)	-2.3	-0.5	-1.9	0.5	-4.4	-0.8	-3.4	-0.3
Unemployment rate (% active pop)	20.1	10.1	21.6	10.2	25.0	11.4	26.1	11.8
Current account balance (% of GDP)	-4.5	-0.1	-3.5	0.0	-1.4	1.2	-0.5	1.2
Debt (% GDP) (**)	61.3	85.5	69.1	87.3	85.2	89.5	96.2	90.4
Public sector balance (% of GDP) (**)	-9.7	-6.2	-9.0	-4.1	-7.2	-3.2	-5.9	-2.3
CPI (average period)	1.8	1.6	3.2	2.7	2.5	2.5	2.3	1.8
CPI (end of period)	3.0	2.0	2.4	2.9	3.5	2.4	1.3	1.6

(*) contribution to growth

(**) excluding in Spain aid to the banking sector

Answers: b) Reducing borrowing costs

Problematic assets have been transferred to SAREB

Intervened entities have transferred €36 bn and others will transfer around €15bn
Maximum size: €90bn. Maximum term: 15 years

Only one bad bank. There may be sub-bad banks per asset category, so as to attract investors

Capital: 8% of its assets (25% equity and 75% subordinated debt). FROB holds a minority and private investors the majority

Transfer price: Haircut of 63% for foreclosed assets and of 45.6% on loans (similar to OW adverse scenario)

Reforms: what else can be done?

**Reduce fiscal
austerity execution
risk**

Enforce the Budget Stability Act

Replace measures unlikely to prosper in existing plans with tax increases or permanent spending cuts

**Reduce medium and
long term risks to
public finances**

Pension system sustainability: rapid increase in retirement age, sustainability factor as a function of the Social Security Administration's financial position, extended working life

Healthcare and education system reform

An Independent Fiscal Authority

Reforms: what else can be done?

Long-term strategic plan

Improve recent labour reform. Reduction of types of contracts, improvement of active policies, further reduction dismissal costs.

Enhanced tax efficiency: reduce taxation on employment and capital in exchange for greater taxation on home ownership and consumption

Skill enhancement and regulatory improvements. Deregulation of professional services. Market Unity Act

Measures designed to make Spanish firms more competitive abroad

Measures to stimulate the housing market: rental market incentives