Consejo Empresarial
para la
Competitividad

Spain's Equity Story

Strengths and forecasts of the Spanish economy

July 2011

Consejo Empresarial
para la
Competitividad

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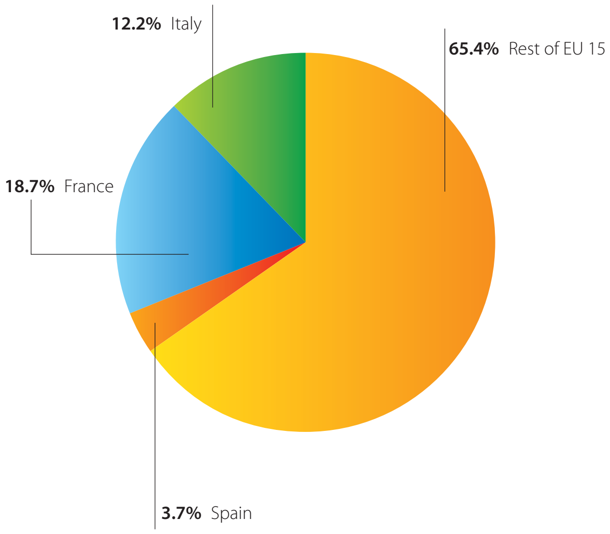
1 Executive summary

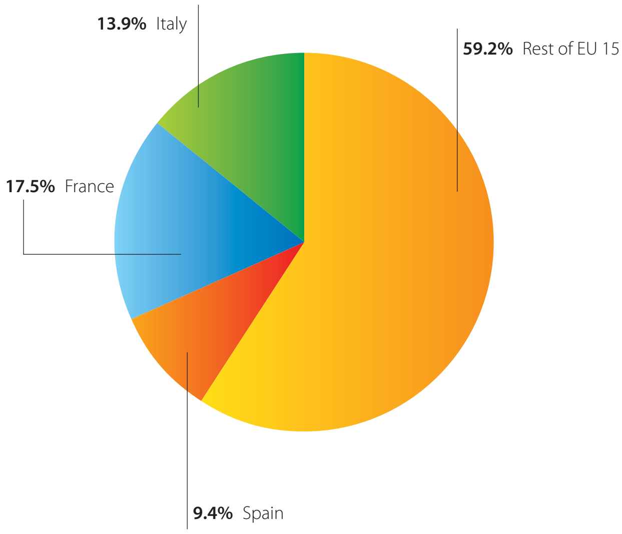
Spain, well positioned despite adjustments

Over the last 50 years, Spanish history is a narrative of social and economic success, comparable to progress in post-war Japan or Germany. Indeed, between 1960 and 2010 Spain tripled its economic weight in Europe (EU-15) and managed to come out stronger than it went into the crises of the nineteen seventies, eighties and nineties.

Share of Nominal GDP 1960



Share of Nominal GDP 2010



Source: European Commission and CEC (Business Council for Competitiveness).

Nonetheless, the present profound crisis has unveiled a series of cumulative imbalances in its economy, including high private sector debt, a large current account deficit, overvaluation of real estate assets and labour market inflexibility. The crisis has also raised national budget deficits, although less than in neighbouring countries, and mined the strength of the banking system. While of limited magnitude, this latter effect has brought to light the need for change in a financial system characterised by duality.

The challenge is to heighten the competitiveness of the national economy with measures that generate investor confidence. Three important elements will contribute to reaching that objective. Firstly, Spain has considerable strength on which to base improvements in its competitiveness. Secondly, its economic imbalances are being corrected. Lastly, the reforms undertaken in areas such as finance, labour and the consolidation and sustainability of public accounts are among the most ambitious world-wide.

As a result of those reforms and the adjustments introduced, Spain's market image has changed for the better in recent months, as attested by investor behaviour, and the country has succeeded in clearly decoupling the perception of its economy from the situation prevailing in other peripheral nations (Ireland, Greece and Portugal).

Spain can draw from its strengths to face the new era

The Spanish economy has sizeable strengths on which to base the growth of its activity and productivity in the years to come.

- It is well positioned internationally.
- It is one of Europe's foremost markets, both in terms of GDP per capita (the fourth largest European economy) and size (fifth largest EU economy in terms of GDP).
- It has leading companies in key industries whose wide diversity in high growth markets generates stable profits and the flexibility needed to cushion shocks.
- It has a dense infrastructure network, the outcome of 20 years of hefty investment.

Real foreign investment indisputably provides a good measure of the country's appeal. Moreover, Spanish companies' international presence on high growth markets has ushered in key economic change.

Foreign investment has continued to flow into Spain

It ranks seventh on the list of world-wide investment targets, and as a percentage of GDP, these inflows double the amounts hosted by countries such as Germany or Italy. Foreign multinationals generate 10% of the country's employment and added value. Three key factors make the Spanish economy attractive for investors: its infrastructure network, its high percentage of university graduates and its status as a strategic enclave.

Spanish companies' international leadership in key industries

Spain has not only succeeded in attracting foreign investment, but has been an active foreign investor. As a percentage of GDP, it is the third largest foreign investor world-wide, doubling Italian and U.S. rates and quadrupling Japan's. Spain invests more in Latin America than all but one other country.

It continues to strengthen its lead in industries such as renewable energies, logistics, transport, tourism and automobile manufacture, and has significant growth potential in industries of the future such as biotechnology, the environment, water treatment, ICT and aerospace. In addition, R&D+I investment in recent years has favoured development not only in the aforementioned industries, but in high technology and added value businesses such as e-health and e-government.

Imbalances under correction

Private sector deleveraging underway

Over the last 10 years, Spain has doubled its net indebtedness (from 45 to 100% of GDP). Beginning in 2010, however, this trend began to reverse for both households and enterprise.

Reduction of the current account deficit

Reduction of the deficit to less than half of the peak value stands as evidence that the economy has not encountered competitiveness problems. Further evidence is to be found in its exports, which have held their own in a highly competitive global environment. The primary determinant in the rise in the deficit was substantial investment growth, particularly in the construction industry, not excess consumption. Investment constraints and a considerable rise in private savings have contributed significantly to lowering the deficit.

Gradual adjustment of housing construction

The adjustment in housing investment has lowered the industry's share of GDP by half (from 9% in 2007 to 4.5% at this writing). And according to many experts, 50% of the housing market overvaluation could have now been corrected.

Banking sector: consolidation underway

Spain's financial system has been very resilient thanks to its high profitability and efficiency, generous (including anti-cyclical) provisioning and good capital and liquidity levels, as a result of the strength of its retail business. Spain has large, well capitalised, profitable and diversified financial institutions.

The depth and duration of the financial crisis after a long period of expansion has led to a crisis more usual in Spain, with substantial exposure to the real estate sector and an atomised savings bank segment, hampered in its access to wholesale markets, with different management systems and saddled with an excess of installed capacity. Nonetheless, Spain has carried out substantial reforms in the sector, facilitating restructuring, recapitalisation and a change in savings bank governance.

Structural reform underway

This reform is imperative to recover investor confidence. Analysts are now decoupling Spain from the group of peripheral economies in light of its structural strengths and the reforms in progress.

Banking sector restructuring: building a more solvent system

Although the process initiated has yet to be concluded, the reforms undertaken have strengthened the financial system and afforded it greater transparency. These measures will favour lending, although an upturn in this regard is limited by lower demand in an environment of economic adjustment. At the same time, the reform will enable these strengthened institutions to access international markets under reasonable terms.

In recent months the requests for loans addressed by Spanish financial institutions to the BCE have declined by one third.

Fiscal consolidation: stabilisation of the budget deficit and sovereign debt

Spain was in a healthy position prior to the crisis. After the crisis, a strict fiscal adjustment programme had to be implemented, thanks to which the deficit was slashed by nearly half from 2009 to 2011. This reduction, quantified as five per cent of GDP, was attained by raising revenues, upping the VAT, cutting back on spending and reversing certain discretional measures adopted at the beginning of the crisis. In 2013, Spain's deficit will revert to levels consistent with the European Stability and Growth Pact (3% of GDP), according the official forecast. Pension reform should also contribute to the long-term sustainability of public accounts.

Furthermore, certain factors limit the pressure on those accounts.

- Spain is estimated to devote 7% of its tax revenues to paying interest on its debt, a figure close to the rates paid by France and Germany.
- The maturity dates on Spanish sovereign debt are among the most diversified in Europe and the mean term is the third longest in the EU.

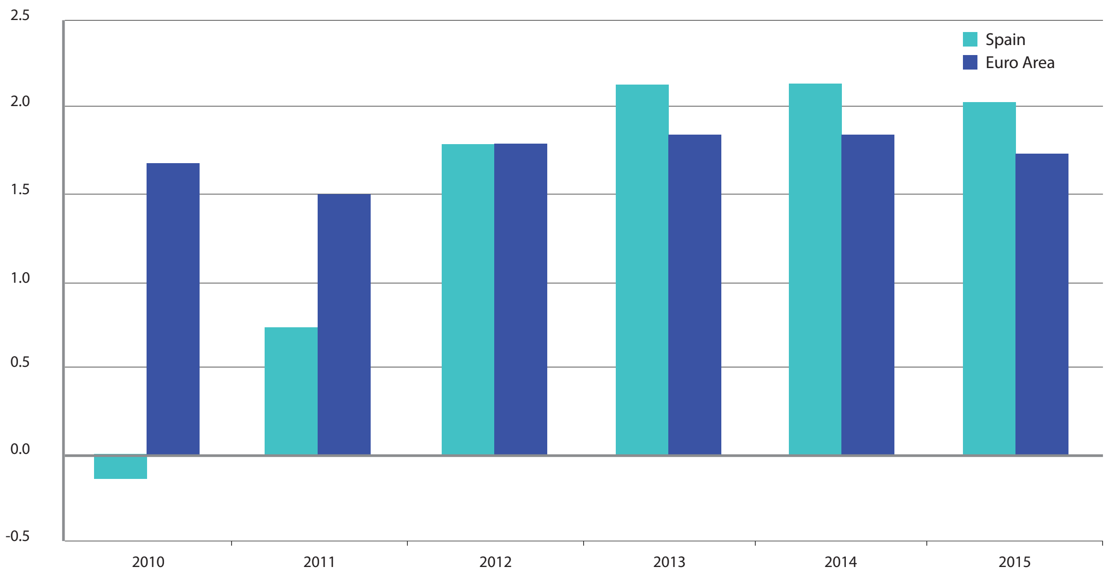
Labour market reform

Labour market reform should be headed toward greater flexibility in collective bargaining, reduction of employment contract duality and increased in-house flexibility in individual companies. These measures are geared to addressing the structural problems afflicting the labour market.

Conclusions

As the IMF notes, the Spanish economy has obvious growth potential that can be intensified by progressing in areas such as fiscal discipline, fortification of the domestic market and reduction of administrative formalities. The beneficial effects of recent reforms that have yet to be felt and the country's high quality production resources further contribute to that potential. This will call for ongoing correction of the pre-crisis imbalances and continuation of the reforms undertaken.

Spain and the Euro Area: GDP Growth Forecasts (yearly %)

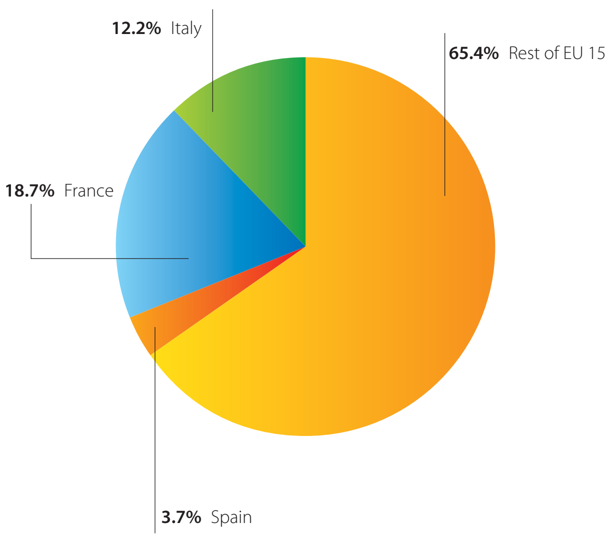


Source: IMF WED oct 10.

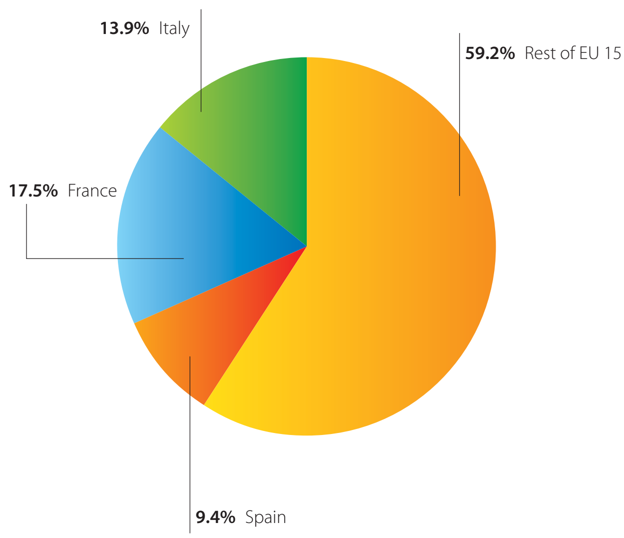
2 Spain, well positioned despite outstanding adjustments

Over the last 50 years, Spanish history is a narrative of social and economic success, comparable to progress in post-war Japan or Germany. In that period, the country tripled its weight in the total European (EU-15) economy and managed to come out stronger than it went into the crises of the nineteen seventies, eighties and nineties, growing at a faster pace than its European partners after those episodes.

Share of Nominal GDP 1960



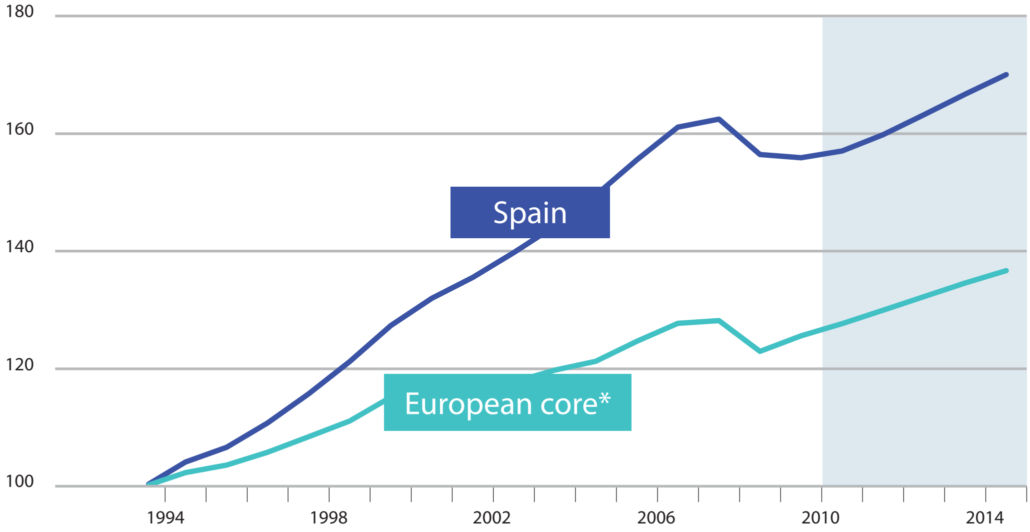
Share of Nominal GDP 2010



Source: European Commission and CEC (Business Council for Competitiveness).

After the previous crisis, Spain enjoyed 15 years of growth, with its economy expanding by over 60%, 2.3 times faster than in European core countries (Germany, France, The Netherlands, Austria and Italy - see chart). This translated into a cumulative growth differential of 34 percentage points.

GDP 1994-2014 (Based on Euroconstants; 1993=100)



* *European core countries: France, Germany, Italy, Austria and The Netherlands.*
Source: IMF forecasts 2011-2015.

After those years of strong growth and an environment characterised by low interest rates, easy credit and high confidence, however, the advent of the international crisis in 2007 lowered that differential to 29 percentage points, while unveiling certain cumulative imbalances, including:

- High trade deficit, steep rise in private sector debt and underestimation of the related risks.
- Overvaluation of real estate assets.
- Labour market inflexibility.
- High budget deficits.
- Deterioration of banking system strength.
- Over-dependence on energy imports.

After 2 years of recession, Spain's economy has now started to recover, driven by its foreign sector which in the last 6 quarters (since the economy touched bottom) has contributed over three percentage points to GDP growth (0.5 points per quarter). Domestic demand, by contrast, has continued to falter, particularly as regards investment in construction, which since the beginning of the crisis, i.e., in the last 10 quarters, has snipped 0.6 percentage points off quarterly growth. Spain should return to positive growth rates in 2011[1] and, according to International Monetary Fund estimates, the growth differential with the rest of the euro area will begin to widen beginning in 2012 and reach pre-crisis levels by 2015 (see chart on previous page).

Foreign demand will continue to be the key to guaranteeing these growth forecasts, for domestic demand will not contribute to expansion until 2012. Once the country has most of the adjustments under its belt, its economy will return to growth, albeit slowly and at rates still below the European mean.

Despite the success of recent years, two problems continue to be associated with Spain today, but both need to be qualified.

1) High private indebtedness: the levels reached were the outcome of over-investment, not of a shortage of savings. The chart below compares Spanish household savings rates to rates in other developed countries, and the following two show the variations in investment rates.

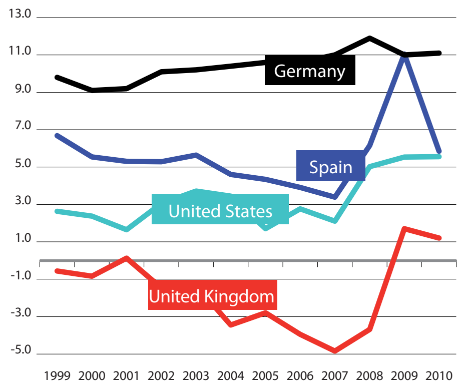
    - Spanish households have always had higher net savings[2] than households in the United States or the United Kingdom (both of which had housing bubbles), but lower than in Germany, which has a traditionally thrifty population.

1 According to the consensus opinion expressed by international analysts and organisation, the Spanish economy will grow (0.6%) in 2011 and by double that rate (1.3%) in 2012, rising gradually from that year to 2015, when it should reach rates in keeping with its potential.

2 Discounting service on latent debt.

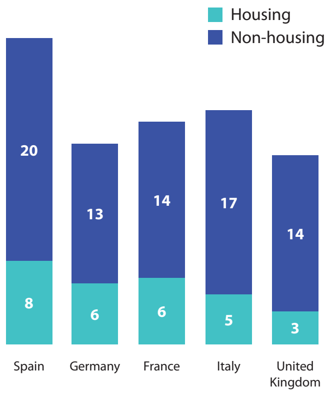
- Spain's investment rate, after the housing sector adjustment, continues to hover around levels of over 20%, far higher than in Germany or France. That rate is four percentage points higher than the second ranking European country (France) and clearly higher than the mean for the Union's "problematic countries". This means that Spain's pre-crisis investment boom was based on other more productive types of investment, where the figure has been five percentage points higher than in any other European country.

Net Household Savings, 1999-2010
(% available income)



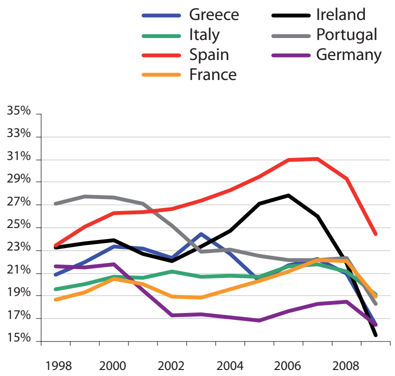
Source: Ecowin.

Investment Rate (% GDP)
Broken Down by Components (Mean 2000-07)



Source: National Statistics Offices.

Investment Rate
(% GDP)

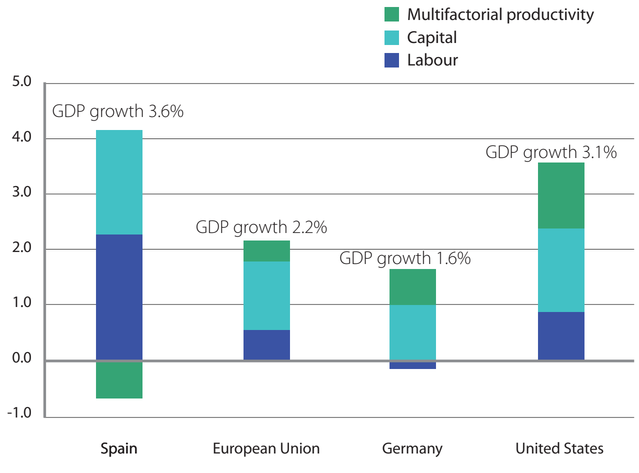


Source: AMECO, AFI and INE.

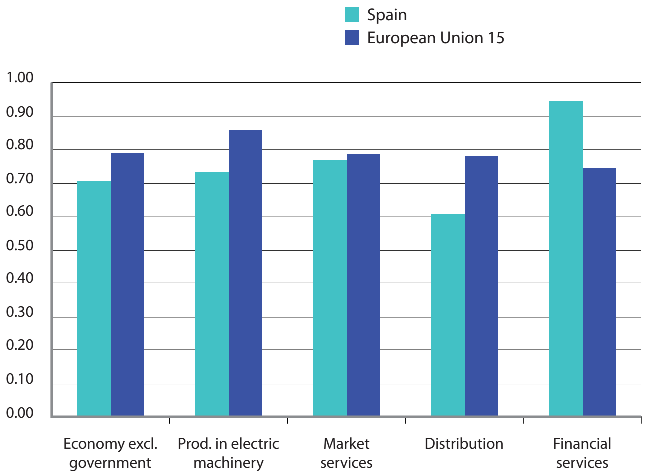
2) Despite the flagging of all competitiveness-related indicators, as shown below, Spain (together with Germany) is the only European country that has managed to maintain its world-wide share of goods exports and to raise its non-tourist service exports by over 40%. While Spain's growth in the last 15 years has not been based on productivity (see chart on the left below), that problem has plagued Europe as a whole, albeit more moderately. The Lisbon Agenda, whose premises are now being given a new impetus, was designed to address the productivity issue.

   - By industry (chart on the right below), European productivity rates stand at 75 to 85% of the American values, while Spain's range from 60 to 95%. In other words, some Spanish industries (financial services, for instance) are more productive than their European and nearly as productive as their American counterparts. The levels for market services are similar to the European figures, while the values for manufacturing and distribution are lower than the European average.

Contribution to Mean Growth 1995-2007



Comparison of European Union and Spanish Productivity (United States=1)



Source: CEC.

Hence the importance of implementing the adjustments and reforms needed to recover sustained economic growth and create jobs. The Spanish economy can rise optimistically to this challenge, for it is in good competitive standing in many respects.

1) It is well positioned internationally.
2) It is one of Europe's main markets.
3) It is an open economy with growth potential.
4) It has leading companies in key industries.
5) It has a dense infrastructure network.
6) It is one of the countries that has embraced reform most actively.

Spain, well positioned internationally

In addition to its positive economic performance during the period of prosperity, the country substantially improved its international position and presently holds a favourable, if improvable, standing, judging from a number of international ranking systems and the position of its companies by market capitalisation and sustainability.

1) On the Elcano Global Presence Index (EGPI)[3], Spain ranks 9th of a total of 54 (the 42 largest and all other European) economies, ahead of Canada, and 4th in Europe, behind Germany, France and Italy. By dimension studied, Spain is thirteenth in economy, ninth in defence, third in migration and tourism, twelfth in culture and science and sixth in development aid.

3 *Global presence is spread over five areas: economy, defence, migrations and tourism, culture and science and development aid.*

2) ANHOLT-GFK measures the impact and quality of a country's image from six perspectives[4]. Spain ranks tenth of the 50 countries analysed, up from eleventh in 2009. By perspective, the country is twelfth in exports, third in tourism, sixth in culture and society and fifteenth in governability.

3) Position of Spain's business sector: in a number of industries, Spanish companies are high on the list in Europe by market capitalisation. Repsol, for instance, ranks third in petroleum, and six of the country's utilities are among the top 20, with Iberdrola occupying fifth place, nearly tied with E.ON for fourth. In telecommunications, Telefónica is the industry leader, nearly doubling the market capitalisation of its nearest competitor. Four Spanish banks are among the top 20, with Santander ranking first at a considerable distance from its nearest competitor, BNP.

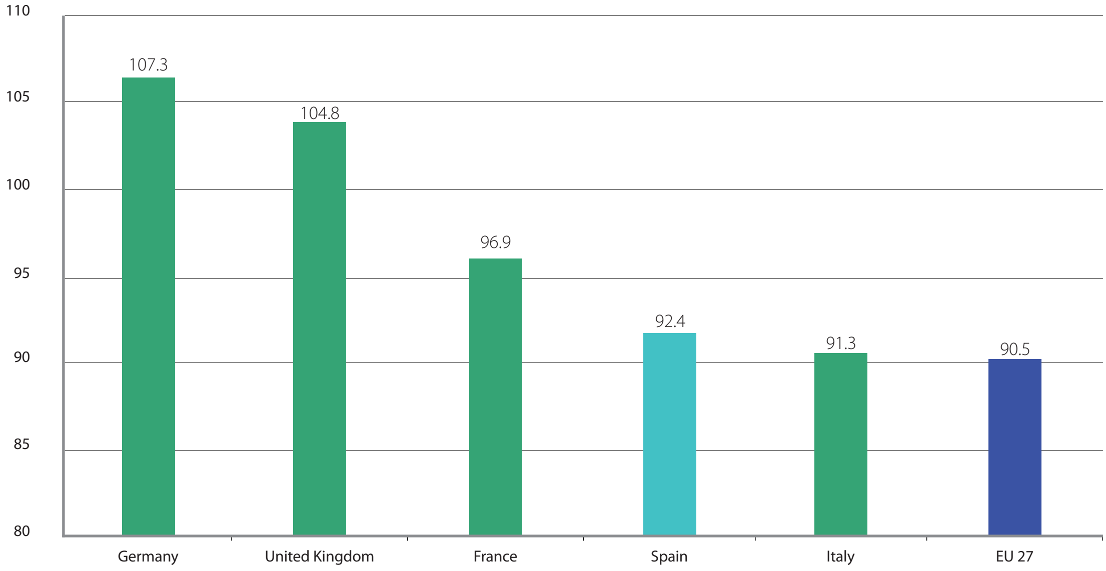
4) Global Reputation Pulse: index that uses seven dimensions[5] to measure companies' reputation based on consumer trust, admiration, good feeling and support. On this scale, four Spanish companies are among the 200 most reputable corporations world-wide: Mercadona (9th place), El Corte Inglés (14th), Inditex (60th) and Mapfre (170th).

Spain, one of Europe's main markets

Spain ranks fourth among the large European countries in GDP per capita and ahead of the EU27 average. Over the last 50 years, its GDP per capita grew by 50% in relation to the EU15 average. This steep real convergence has raised Spain's figure to close to French levels.

4 Exports, governance, culture and heritage, people (competence, education, personality), tourism and investment and immigration.
5 Products/services, innovation, work environment, integrity, social commitment, leadership and financial results.

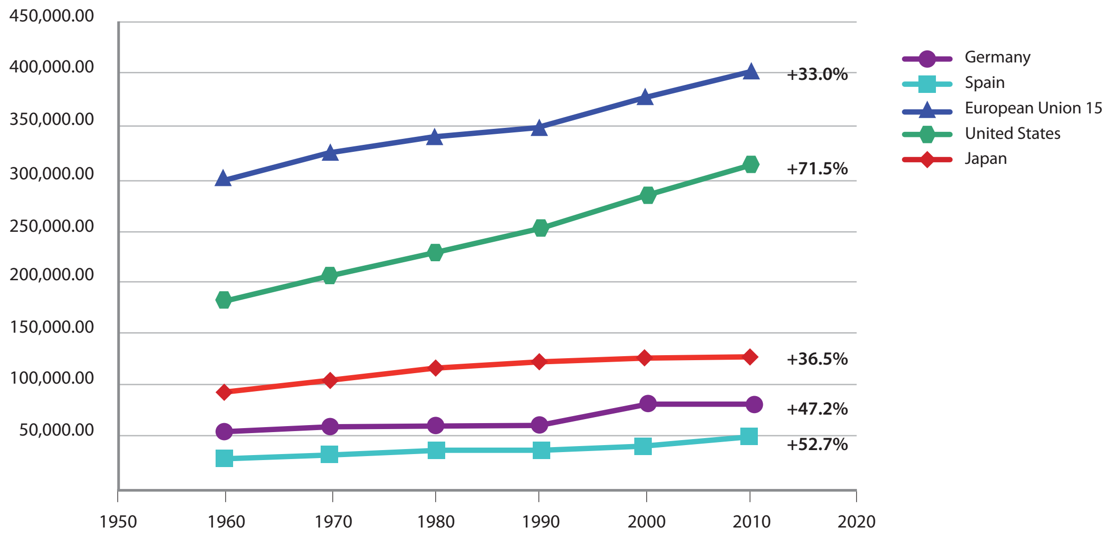
% GDP per Capita (PPP)



Source: Eurostat.

A population of 46.3 million people with a per capita GDP of 92.4% of the EU15 average constitutes a one trillion-euro market, which in purchasing power parity accounts for 9.4% of the European (EU27) total, the fifth largest of the EU27 member countries.

Variations in Population in the Last 50 Years



Source: Eurostat.

Spain's growth potential continues to be higher than for the euro area as a whole, according to the IMF's most recent forecasts for the years to come.

Comparison of Growth Forecast

	Spain				Euro area		
	MEH	IMF	OECD	EC	IMF	OECD	ECD
2011	1.3	0.6	0.9	0.8	1.5	1.7	1.6
2012	2.5	1.5	1.8	1.7	1.7	2.0	1.8
2013	2.7	2.1			1.8		
2014		2.1			1.8		
2016-2025*			2.3			1.7	

* *Potencial output.*
Source: Ministry of Economy and Finance, IMF, OECD and European Commission.

Spain's growth potential is over 2% when the following factors, among others, are taken into consideration.

- With the improvements in competitiveness underway, the outlook for growth in exports, whose share of GDP has already risen, is promising.
- The plunge in profitability in the real estate sector leads to a drastic reallocation of factors to other more productive industries.
- Excluding construction, Spain's GDP was higher than the EU average in the last ten years.

An open economy with high growth potential

Spain is one of the most open economy in the main OECD, behind South Korea, Canada and Germany. At this time, 6,000 more SMEs export on a regular basis than in 2003, bringing the total to 38,000 or just 1% of all the country's going businesses. That partly explains its light weight as an exporter of goods (1.6% share of the world-wide total, ranking 18th), but may also be indicative of growth potential, inasmuch as the number of regular exporters has risen annually by an average 5.2% over the last 10 years.

Spain has one of the world's most open and internationalised economies and holds a position of privilege in Latin America as a platform for investment inflows and outflows between that region and Europe.

Spain's exports have grown by over 40% in the last 10 years and still have room for expansion in high growth economies such as China, Russia and Brazil.

A country with leading companies in key industries

In its globalisation endeavour, Spain's business sector has diversified its geography, focusing especially on high growth markets. The result has been the generation of more stable profits, with all that entails in terms of greater flexibility and shock resistance.

Productivity in Spain's largest firms is higher than in a good many OECD countries and its listed companies account for 12.1% of the EuroStoxx 300 index, third after France and Germany. For the first time in history, Spanish companies are world leaders and benchmarks in key industries, with representatives on 12 of Forbes magazine's 38 industry lists.

- The most competitive industries, which owe their success to buoyant production and competitive advantage, account for 22% of exports, 30% of imports, 24% of manufacturing and 17% of manufacturing employment.

- Spain has companies with huge potential to grow in industries of the future such as biotechnology, the environment, water treatment and desalination, ITC and aerospace. At the same time, it continues to grow and strengthen its position in others where it is a world leader, such as renewable energies, logistics and transport and automobile components.

Dense infrastructure network

The last 20 years have seen an enormous investment effort in infrastructure, particularly as regards passenger transport and the modernisation of the country's main ports and airports, where Spain holds one of the foremost positions world-wide.

Moreover, six Spanish companies are world infrastructure leaders. Together, they have built and/or are managing nearly 40% of the main transport franchises the world over.

One of the countries that has embraced reform most actively

The reforms underway constitute a firm commitment to reduce the budget deficit, stabilise debt and drive medium- and long-term growth, primarily by:

- Being on track to meet the 2011 deficit target (6%), after meeting its 2010 objective.
- Maintaining a moderate, below-EU-average public debt/GDP ratio, with 2013/14 as the stability horizon.
- Attaining greater transparency in regional budgets.
- Implementing pension reform to ensure long-term solvency.
- Restructuring the savings banks.
- Reforming the labour market and collective bargaining.
- Reforming the service sector to improve efficiency.

3 Spain can draw from its strengths to face the new era

Real foreign investment, a good measure of the country's appeal

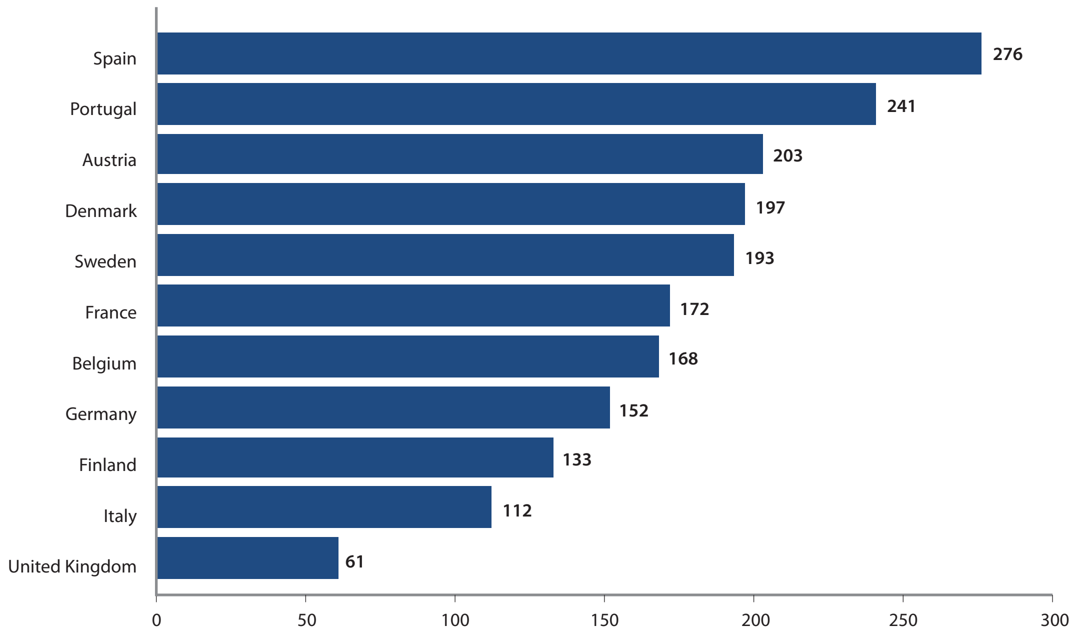
Despite financial market penalisation and doubts in recent months, real foreign investment continued to flow into the country at a healthy pace, even during the worst of the economic crisis. The mean yearly inflows accounted for 3.2% of GDP in the last four years, bringing foreign direct investment (FDI) to a figure of nearly seven billion dollars, the 7th highest world-wide and among the top five when expressed in per cent of GDP. In those terms, foreign investment rates in Spain nearly double the German and Italian figures.

A total of 10,300 foreign companies, including 75 of Forbes' top 100, have located in Spain. Are they all mistaken? Why do foreign multinationals account for over 20% of Spain's GDP, generating more than 10% of the country's jobs and added value? How can Spain attract 430 international investment projects yearly, over twice as many as Japan and Italy and nearly four times more than The The Netherlands? Spain must be a competitive country with appeal, as attested to by OECD statistics, according to which Spain places fewer restrictions on FDI than any other developed country in the world. Spain features four major strengths of particular interest to investors.

1) Infrastructure. The country is a world leader in inland infrastructure (measured in km expressway/motorway per inhabitant, not to mention its high speed railways), ranks highly in air transport with nearly twice as many passengers as Italy and handles much more port traffic, measured in tonnes, than The The Netherlands, Italy, the United Kingdom and France. This investment effort has made Spain the country with the highest investment rate, in terms of GDP, in the developed world, even when housing construction is excluded. The latter has also established a strategic position as a platform for accessing other markets, such as Latin America, based not only on cultural ties but also the opportunities afforded by Spanish enterprise present there.

- Spain has one of the world's largest motorway and expressway networks in the world (over 13,000 kilometres), after having grown by over 25% in 2006-2010.

Km of Motorway per Million Inhabitants in Europe (2006)



Source: Eurostat, Adif (Spanish railway and infrastruture agency), McKinsey and CEC.

- High speed rail lines are among the most prominent elements in that network, covering approximately 1,600 kilometres, for an increase of over 45% in the last four years.

- The two preceding points make Spain a leader in inland transport, with one of the world's highest ratios in terms of kilometres of expressway and high speed rail per million inhabitants.

- Spain is also well served by its air carriage infrastructure, which handled 192 million passengers in 2010.

- With 46 seaports, Spain ranks among the world's leaders in port traffic. More specifically, three of its harbours are among Europe's top ten in cargo traffic (Barcelona, Valencia and Algeciras).

2) Costs. Spain is at an advantage in terms of labour costs (nearly 30% lower than the EU15 average), while its productivity is nearly 10% higher than in Italy or Japan. Electric power for industrial use also carries a small price tag: 15% lower than in the United Kingdom, 30% lower than in The Netherlands and just over half of the cost in Italy. Spain's effective corporation tax rate is similar to the rates in place in other EU15 countries, and the country offers more generous tax incentives for R&D than any other OECD member.

3) Talent. A significant investment effort in education has brought the proportion of university graduates in the 25-34 age group to 39%, four points above the EU15 average. Spain offers world class specialised scientific training and its business schools enjoy international prestige. At this time, it hosts three of the world's top 20 such schools, more than any other country except the USA and the United Kingdom. Its status as the world's fifth-ranking country in broadband access also explains why its e-government platform is regarded by the international investment community to be the third most effective in the world, after the United Kingdom and the USA.

4) Strategic enclave. Spain capitalises on its geography, which underlies an essentially unique combination of three important features. Firstly, it is a member of the EU, the world's wealthiest market. Secondly, it is home to the world's 7th largest consumer market in terms of purchasing power. And lastly, it has unrivalled linguistic, cultural, institutional and entrepreneurial affinities with Latin America, the region regarded by most analysts to have the second greatest medium- and long-term growth potential in the world.

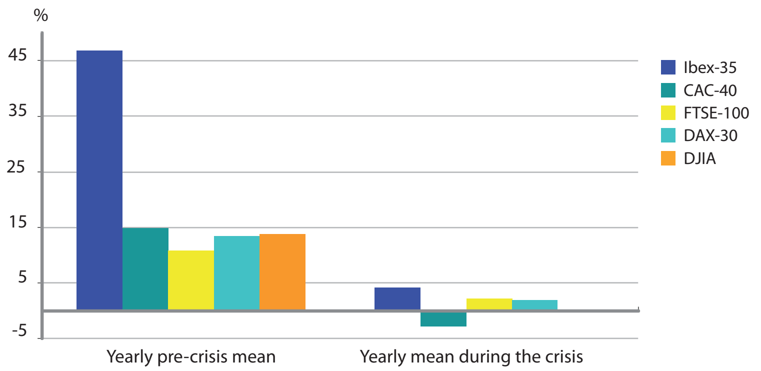
Spanish companies' international leadership in key industries

Spain has not only successfully attracted foreign investment, but has invested extensively abroad and in fact is a major source of FDI. With a stock worth over 60% of its GDP in other countries, it ranks third world-wide in foreign investment in those terms, doubling Italian and U.S. rates and quadrupling Japan's.

Moreover, investment has focused on regions with great growth potential such as Latin America, where Spain is the region's second strongest foreign investor. Over the last ten years, Spanish companies invested upward of 120 billion euros in this region, for a monthly average of €1 billion.

These facts explain the spectacular upturn in Spanish enterprise in recent years, when it has become a model of profitability for international shareholders, as the chart below shows. Shareholders in Spanish companies were the primary beneficiaries of Spain's prosperity prior to the crisis, with a mean profitability that tripled the figures reached by comparable international securities exchanges. But Spain has retained this leadership during the recent crisis. The mean yearly profitability for an Ibex-35 shareholder in this period was more than twice as high as for investors in the major international exchanges, reflecting the stability, leadership, diversification and strength of Spanish enterprise.

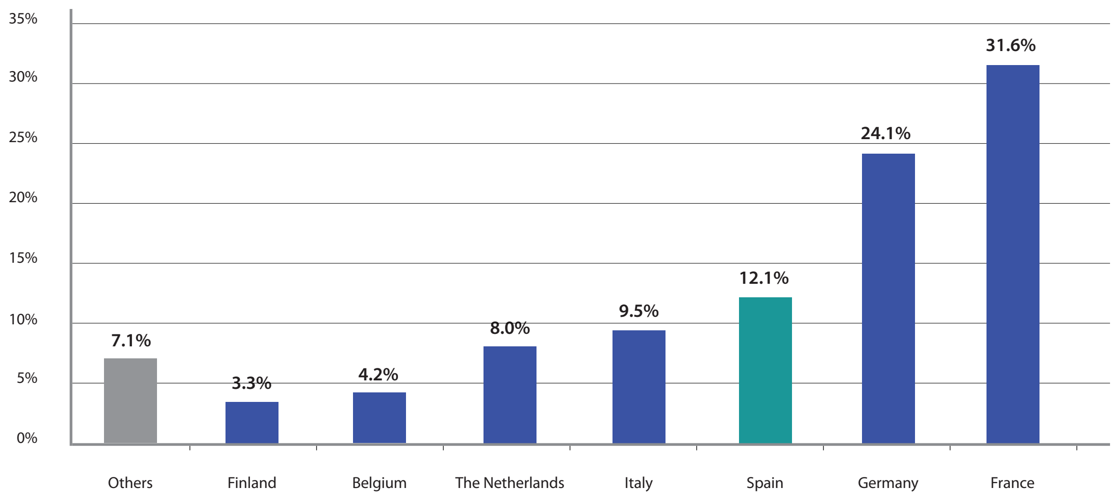
Total Shareholder Return



Source: Wharton Business School.

Spanish companies' success story translates into a very sound economic structure. Spanish companies account for 12.1% of the European EuroStoxx 300 index, third after France and Germany, while firms such as Telefónica, Iberdrola and Repsol and banks such as Santander and BBVA are in the top 10 of their respective industries in terms of market capitalization. These companies are, moreover, characterised by profitable growth and low risk thanks to their diversification, for less than 50% of their sales are generated in Spain.

EuroStoxx 300 (Securities Exchange Index for the Euro Area): share by listed company nationality



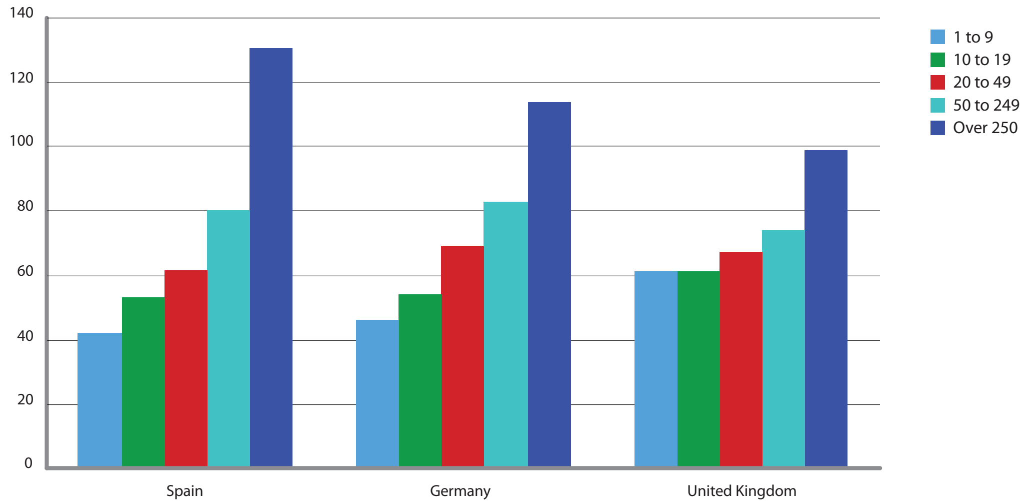
Others: Luxembourg 1.96%; Austria 1.73%; Portugal 1.58%; Greece 0.93 and Ireland 0.88%.

Source: Factset.

For the first time in history, Spanish companies are world leaders and benchmarks in key industries. Spanish companies appear in 12 of the 38 industries listed by Forbes magazine.

Large-scale Spanish companies (i.e., over 250 employees) are indisputably the most profitable world-wide owing, among others, to their high productivity. Large Spanish companies are among the most highly productive internationally, with rates 10% higher than German companies of the same size and 20% higher than comparable companies in the United Kingdom (see chart below).

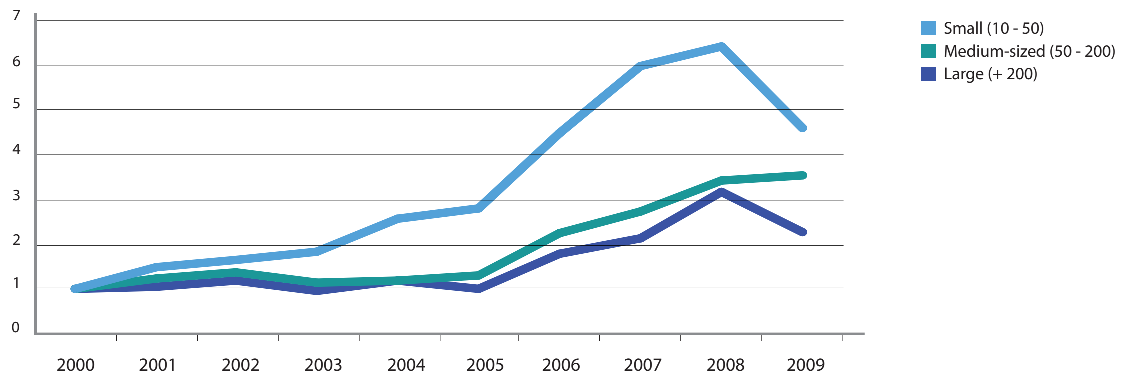
Labour Productivity by Company Size
(base 100 = average productivity of firms in USA)



Source: OECD Compendium of Productivity, formulated by CEC .

Small and medium-sized enterprises (SMEs) naturally still have room for improvement in this regard, but the relative distance between these firms and similar companies in other countries has narrowed with time[6]. The growing number of small and medium-sized exporters in recent years should bring a relative improvement in productivity with respect to comparable European businesses, for productivity improvements are attendant upon greater export intensity[7].

Spanish Exporter Growth by Company size



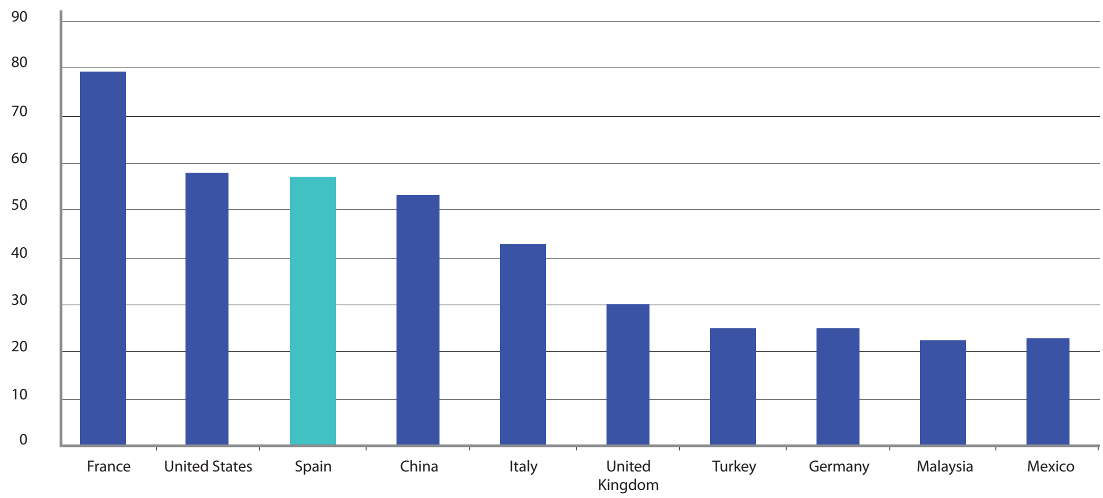
Source: ESEE (Spanish business strategy survey).

6 *The productivity differential with German SMEs is significant, for instance, only for companies with 20 to 49 employees.*
7 *According to an analysis conducted by the European Commission, doubling a company's size raises its export propensity by 10%.*

Leadership in tourism

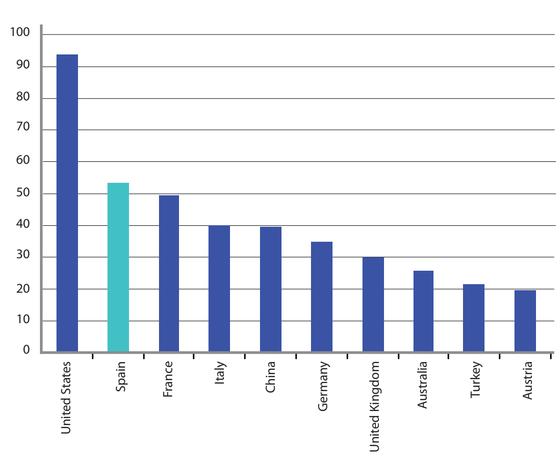
Where are Spanish firms industry leaders? The figures confirm that Spain is a tourist industry major, ranking third world-wide by number of visitors, which grew in 2010. Tourism is the Spanish economy's main source of revenues, and by that measure it is second only to the United States, i.e., ahead of France, Italy, China and Germany.

Nº of Foreign Tourists in 2009 (millions)

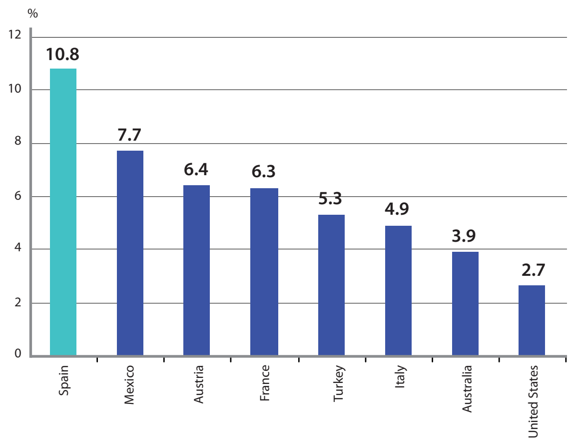


Source: AFI (private consultants), World Tourism Organisation and INE.

Tourist Industry Revenues in 2009
(billion euros)



Tourist Industry Contribution to GDP
(% in 2006)

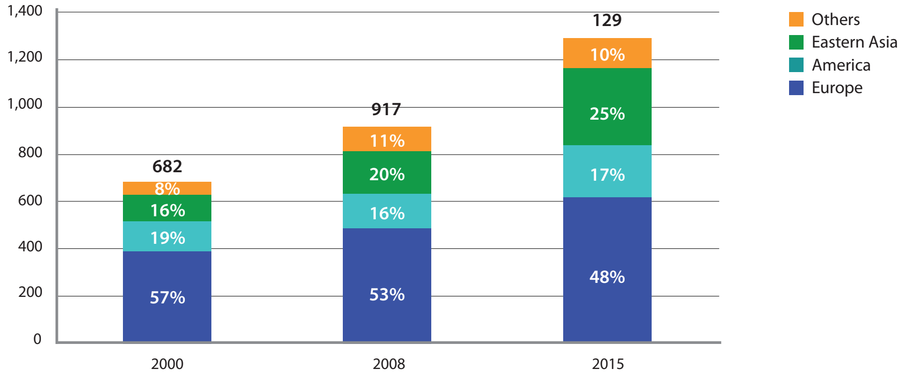


Source: AFI, World Tourism Organisation and Tourism in OECD countries 2008.

Nonetheless, its share of the international total declined in the period 2003-09 from 7.4 to 5.9%. Real tourist spending slid by 35% between 1995 and 2005.

The challenge facing Spain's tourist industry is to grow in emerging countries. France and Germany, for instance, receive 15 and 8 times more Asian tourists than Spain, respectively. And Turkey received from 6 to 15 times more Russian tourists. According to World Tourism Organisation estimates, in 2015 Asia and America will account for 65% of tourist growth (see chart below). Since Spain's share in those areas is a mere 1%, it has room to grow.

Tourists per Year and Percentage of Total (millions)



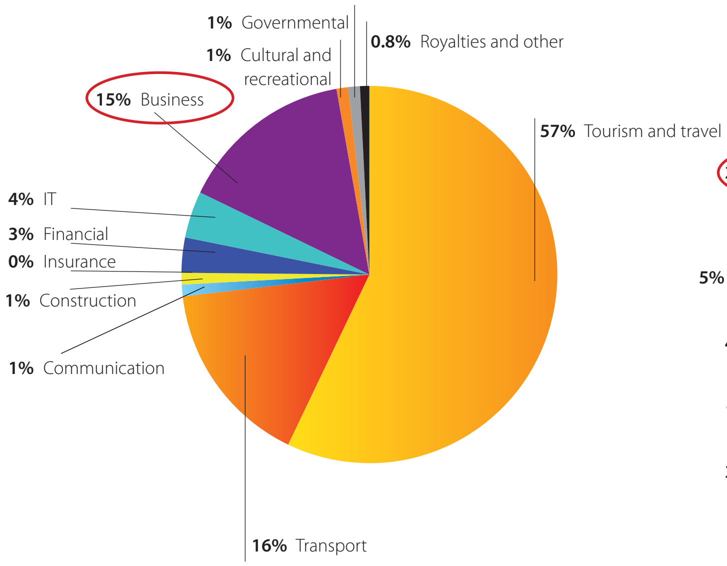
Source: OIT, INE and CEC.

Leadership in non-tourist services

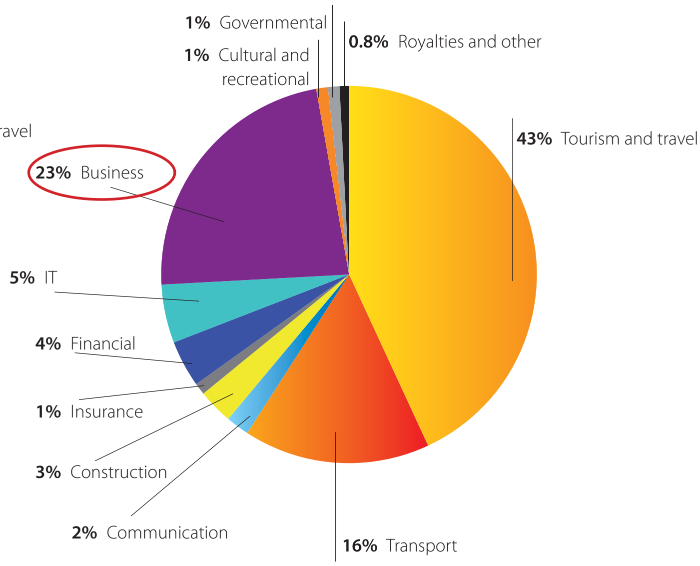
Nonetheless, Spain exports and produces more than tourist services. Otherwise, how to explain the change in the composition of Spanish exports over the last 10 years? Diversification into business services has been one of the key factors underlying the vitality of the country's exports (see charts on next page).

Non-tourist service exports rose at a mean yearly rate of 7% in the last decade, i.e., faster than world-wide service growth. As a result, Spain's export share climbed despite increased competition from certain emerging countries. The number of service exporters grew at a mean rate of 7.4% yearly from 2002 to 2007, and particularly intensely after 2005.

Spanish Service Exports by Industry
(2000)



Spanish Service Exports by Industry
(2010)



Source: AFI, Bank of Spain.

"Other business services[8]" stood out in this regard, accounting for more than 20% of the total (compared to 15% 10 years ago). Thanks to its clearly "exportable" profile, this industry is one of the potential drivers of future Spanish growth, both domestically and with a view to enhancing the stability of Spanish business growth. Nonetheless, despite the upward trend, the industry still has room to improve, as discussed in the following section.

Financial, IT and construction-related service exports have also followed a favourable pattern, although their weight in the total is still small (see chart above).

8 Legal, accounting consultants, architecture, engineering, translation and interpretation, advertising...

Lastly, the vitality of non-tourist service exports has also gone hand-in-hand with geographic diversification. The relative weight of the EU dropped by four percentage points over the last 10 years, although the region still hosts 60% of this type of Spanish exports.

In a nutshell, Spanish exports are not limited to tourist services. The country's leadership in key industries is indisputable, as the examples below show.

1) Renewable energies: three of the ten companies are Spanish: Iberdrola Renovables and Acciona (largest renewable installed capacity world-wide) and Gamesa (one of the ten largest wind turbine manufacturers). And Spain is the fifth largest country world-wide in renewable energy patents.

2) Infrastructure: 7 Spanish companies (ACS, Ferrovial, Acciona, Sacyr Vallehermoso, Abertis, FCC and OHL) are world infrastructure leaders. Together, they manage and/or build nearly 40% of the major transport franchises in the world, mainly airports, ports and motorways.

3) Automobile and automobile components industry: Spain is the eighth largest vehicle manufacturer world-wide and the second largest in Europe. This industry employs 8.7% of the country's workforce and its foreign sales account for 17.5% of its exports. Spain is, moreover, the number one manufacturer of automobile cladding world-wide.

4) Distribution and apparel: the distribution sector is very strong in certain areas, such as department stores, supermarkets and apparel. Indeed, five of the European ready-to-wear majors are Spanish, including the world leader[9], and three Spanish firms (Inditex, Mercadona and El Corte Inglés) are among the top 50 retailers world-wide.

9 *Inditex Group.*

5) Finance and insurance: two of the globe's financial majors are Spanish (Santander and BBVA); according to Global Finance, four Spanish financial institutions are among the 50 most reliable in the world; and two Spanish insurers rank among the largest in the world in their respective sub-industries.

6) Agri-food: Spain's companies are world leaders in olive oil, wine and sweets. And with 44,000 hectares under glass, Spain is among the most prominent countries in the world in the development of technologies to improve indoor farming.

7) Hotel and restaurant trade: with the recent trend toward innovation in restaurant services, Spain has taken fifth place in the number of Michelin[10] stars, behind France, Japan, Germany and Italy.

The foregoing stands as proof of the lead position occupied by Spanish enterprise, which can be expressed in very specific facts and figures. Only 10 years ago, it would have been very difficult to predict that one of Spain's companies would today own the largest mobile telephony company in the United Kingdom (O2) and be a world leader and a European benchmark in mobile telephone and broadband coverage; that its firms would manage three underground lines in London and some of the world's busiest airports (including Heathrow); that three of every five flights world-wide would be controlled using Spanish air navigation systems; that the number one vacation hotel chain would be Spanish; that two of its largest banks would dominate Latin American banking; or that Inditex would occupy such a prominent position on the international scene.

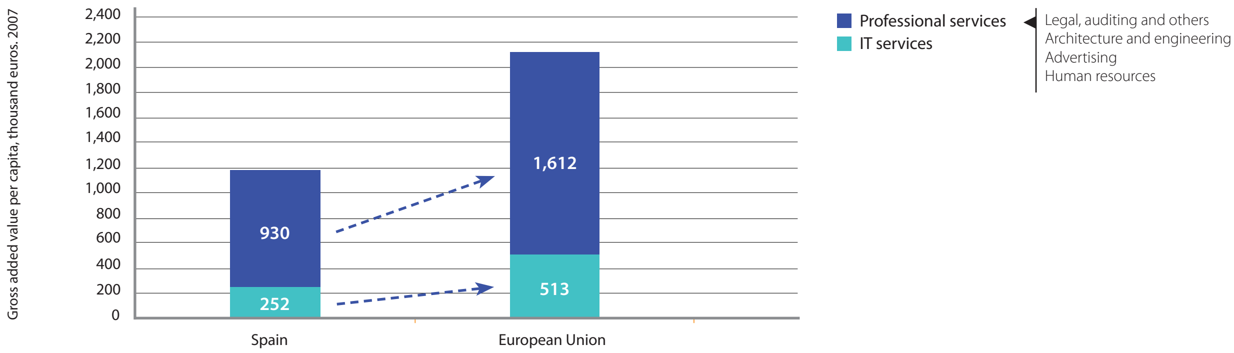
Opportunities: industries of the future with substantial contribution to growth

Opportunities in services

The contribution made by business services and trade to economic growth is still smaller in Spain than in other countries (see chart on the next page), for the added value per capita generated by these industries is 40-50% lower than in Europe, despite the similarities in cross-continental educational, development and productivity levels.

10 France has 553 restaurants with a star, Japan 347, Italy 272, Germany 225 and Spain 137 (2010 figures).

Business Services: Gross Added Value per Capita



Source: CEC.

- As shown on the chart above, Spain is far behind the rest of Europe in human resources services, with an added value per capita (AV pc) of only 38% of the European figure. The next lowest are IT services, with an AV pc of 49% of the European mean and legal, auditing and other consultant services, with an AV pc of 51%. Spain should focus on developing these three areas, for legal services account for 35% of the national total; IT services for 21% and human resources for 9%.

Spain has also made great strides in industries for the future thanks to the focus on R&D+I, especially in large but also in medium-sized firms. With a 174% increase in this area in between 1998 and 2008, Spain has substantially narrowed the gap with its European neighbours. It is second in Europe in terms of tax aid for R&D+I, an effort that is bearing fruit and favouring the development of industries with high technological content and added value, in particular those listed below.

1) Biotechnology: fifth place world-wide in biochemistry and molecular biology, with an investment of over €460 M in R&D+I. Spain has the third largest number of experimental biotechnological farming fields in the world.

2) Environment, water treatment and desalination: Spain produces more desalinated water than any other country in Europe or America and its companies are world leaders in inverse osmosis. Nearly 2,000 companies engage in the field in Spain, where over 900 desalination plants are in operation. These companies have world class expertise in the construction of such plants.

3) ICT: 9.1% market growth in Spain in the last 5 years has gone hand-in-hand with a doubling of investment in innovation (R&D+I), accounting for 40% of total private sector investment in that period. One outcome of that effort is that Spain is home to the world's third largest telecommunications company by market capitalisation.

4) E-health: Spain's health technology industry consists of a stable business network with a critical mass of 1,200 national and international companies[11]. Their combined turnover is upward of 7.4 billion euros (0.7% of GDP), 1.5 billion (20%) of which are exports. They invest from 3 to 6% of their revenues in R&D+I (three to six times the mean for other industries). Moreover, they are responsible for over 30,000 direct jobs and industry employment grew in 2005-07 at a faster pace than the national average. Indra may have accounted for 30 to 40% of Spanish investment in the industry. Telefónica has worked on network architecture and Oesía and Everis have been very active in a number of communities, as have multinationals such as IBM and HP. Lastly, Spain is a world leader and benchmark in organ transplants and cardiovascular research.

5) Aerospace: Spain has Europe's fifth highest turnover (over 5 billion euros in 2008). The industry's 800 million euros investment in 2009 accounted for 9% of private sector R&D spending.

11 In addition to the private sector, the Government is involved in industry development with its Progress Plan 2006-2012, for a sum of €448 M. Due to its development and progress in this area, the European Commission place Spain in charge of implementing e-health governance in Europe.

6) *E-government:* Spain has also made significant advances in e-government: 98% of all citizens' transactions with the Central Government can now be handled on line. This led the United Nations to distinguish Spain with its Public Service Award in June 2010 for the country's progress in new technologies. At the same time, Spain scaled 11 positions, to 9th place, on the list of the world's most highly developed countries in e-government (see table below). In Europe, Spain is fifth, behind the United Kingdom, The Netherlands, Norway and Denmark and ahead of France (6th in Europe, 10th world-wide) and Germany (8th in Europe and 15th world-wide).

E-government ranking

	E-government overall	Existing information services	Improvements in information services	On-line transactions	Services connected
1	**Republic of Korea**	Republic of Korea	United States	United States	Australia
2	**United States**	Bahrain	Republic of Korea	Republic of Korea	Canada
3	**Canada**	United States	**Spain**	Canada	Republic of Korea
4	**United Kingdom**	United Kingdom	Denmark	Colombia	Colombia
5	**The Netherlands**	Norway	United Kingdom	France	**Spain**
6	**Norway**	**Spain**	Norway	Bahrain	United Kingdom
7	**Denmark**	The Netherlands	Canada	United Kingdom	Bahrain
8	**Australia**	Canada	Singapore	Australia	Israel
9	**Spain**	Japan	The Netherlands	Norway	United States
10	**France**	New Zealand	Japan	**Spain**	New Zealand

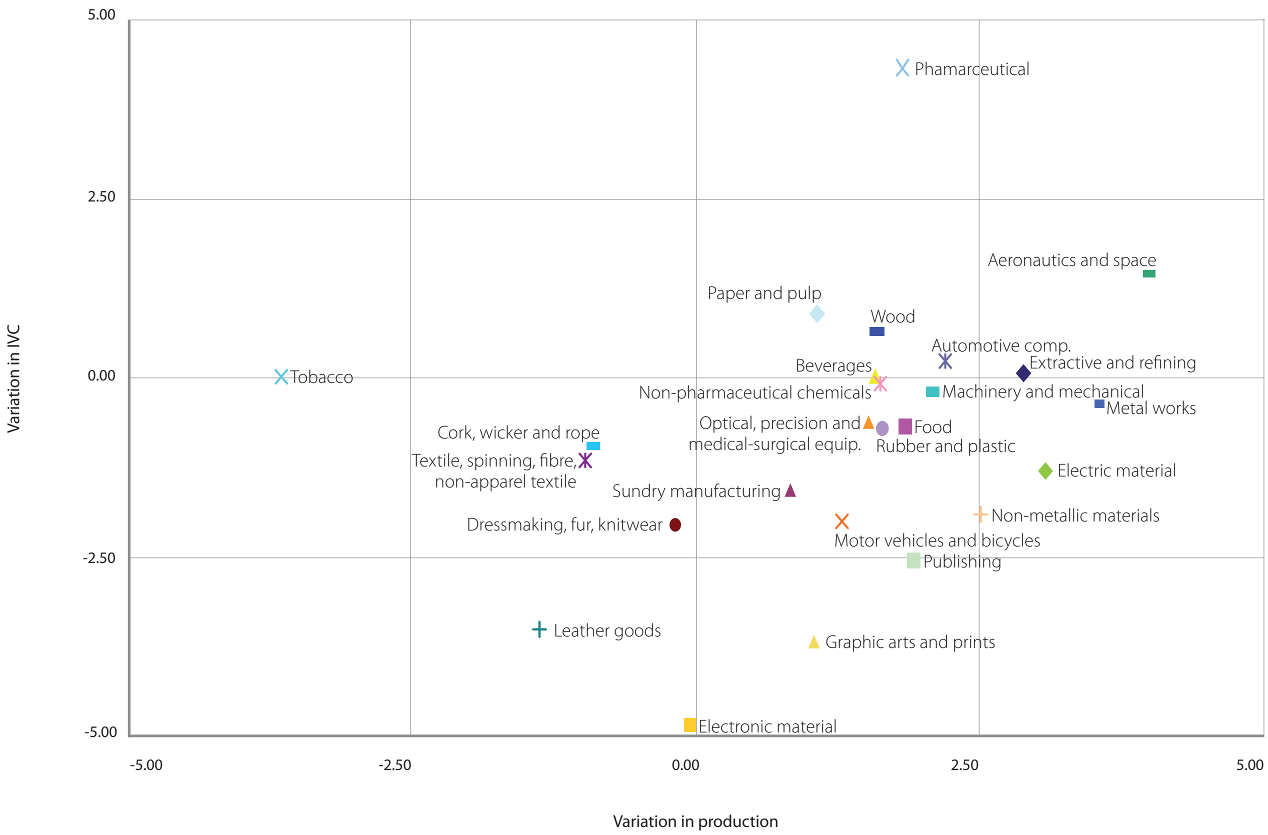
Source: United Nations E-government Survey.

- The chief improvements included the creation/development of i) electronic medical prescriptions; ii) a digital museum network; iii) a new vocational training portal; iv) the digitisation of public records; v) furtherance of the replacement of court rolls with electronic dossiers; vi) the urban and rural national police forces "By your side" programme; and vii) an electronic roads information service.

Opportunities in manufacturing

- In manufacturing, Spain needs to focus on industries such as pharmaceuticals and aeronautics that are proving to be highly competitive as a result of production dynamics and the country's own competitive edge. This process is in fact already underway, with these industries recording fairly high growth during the economic boom.

Productive Industries by Production Growth and Competitive Advantage Index (CAI) (2001 - 2007)



Source: Spanish Ministry of Industry, Tourism and Trade. Formulated by CEC.

Furthermore, very clear conclusions can be drawn from a comparison of Spain's export structure and intensity by industry to the G-4[12] mean (see table below). While Spain lags behind the average in both export added value and intensity as regards machinery and capital goods, it performs fairly comparably with the most highly developed countries in nearly all other areas.

12 Germany, France, Italy and United Kingdom.

Spanish and G-4 Export Intensity

(% of industry in total AV manufacturing and% of total industry production)

	Spain		G4	
Sector	% of manufact. AV	Export intensity	% of manufact. AV	Export intensity
Vehicles and other transport equipment	10.6	55.3	10.8	56.7
Motor vehicles*	7.5	59.5	7.2	54.6
Aeronautics and aerospace	0.9	66.1	2.2	78.4
Textile products	4.2	47.8	4.7	68.3
Machinery and capital goods	13.6	41.4	23.4	72.3
Chemical and plastic products	15.3	38.4	16.2	46.5
Pharmaceuticals	3.0	65.0	4.0	78.7
Metallic products and metals	18.2	22.3	14.7	31.8
Foodstuffs	14.3	18.6	11.9	21.6
Glass, burnt clay goods and cement	8.0	13.2	4.3	20.1
Other manufactured goods	4.8	12.6	4.0	35.0
Wood and paper manufacturing	11.0	12.2	9.9	16.1
Manufacturing industry	**100.0**	**30.6**	**100.0**	**44.6**
Industry excluding machinery		27.2		36.5

* *The automobile industry is divided into two items: "motor vehicles" and "Machinery and capital goods".*

Source: President's report on the economy, 2010 based on OECD figures.

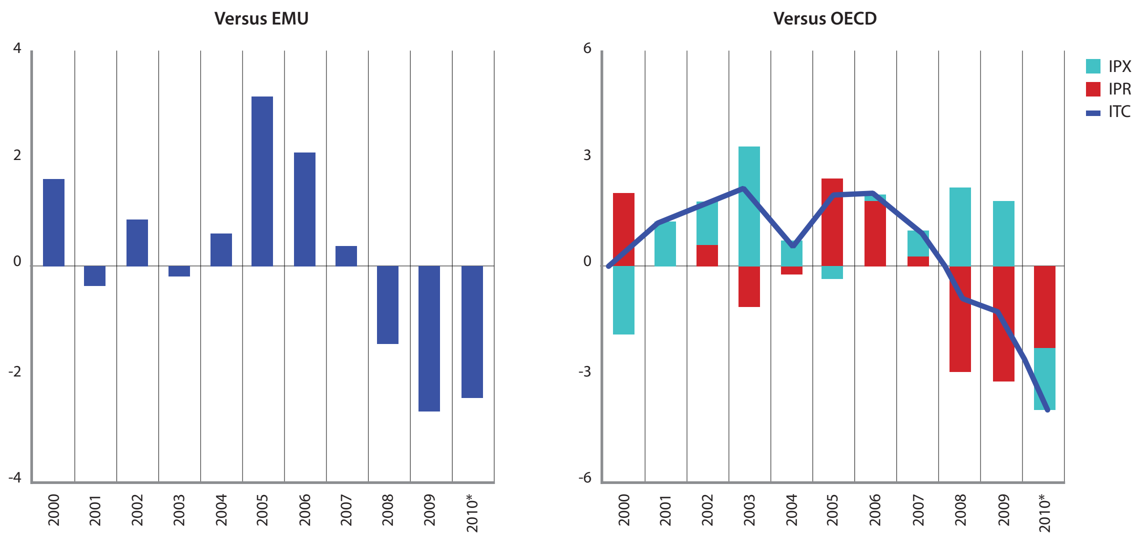
Another area whose potential is presently being furthered[13] is the capitalisation on Spain's historic and linguistic relations to enable it to serve as a bridge between Latin America and Europe. The country could well host the operational headquarters and decision-making centres for European multinationals operating in Latin America. Similarly, Spain would be the logical place for Latin American multinationals to site their European offices, following in the footsteps of Cemex, which located part of its strategic and financial department in Madrid. Spain is one of the European countries with greatest innovative potential in this regard.

13 At this time, 50% of European flights to Latin America depart from Spain.

Improvement in competitive indicators

The progressive weakening of competitiveness indicators (prices and costs) recorded in the preceding decade was checked by the onset of the crisis. Since then, Spain's numbers have evolved more favourably than in the rest of the euro area and than the OECD average (see chart below)[14]. While costs are moving in the right direction, however, moderation must be maintained (via enhanced productivity and wage constraints) to continue to recover competitiveness.

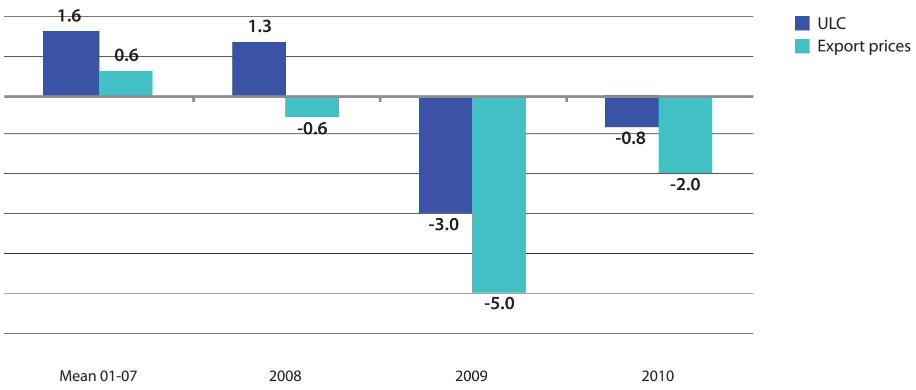
ITC and Export UVIs, Yearly Variation (%) (Negative values denote improvement)



Source: Ministry of Industry, Tourism and Trade.

14 ITC=competitiveness trend index, formulated by the Ministry of Industry, Tourism and Trade on the grounds of variations in the export price index (IPR) and exchange rate index (IPX). Increases in CTI reflect a loss of Spanish competitiveness with respect to the euro area and the OECD. 2010: January-September.*

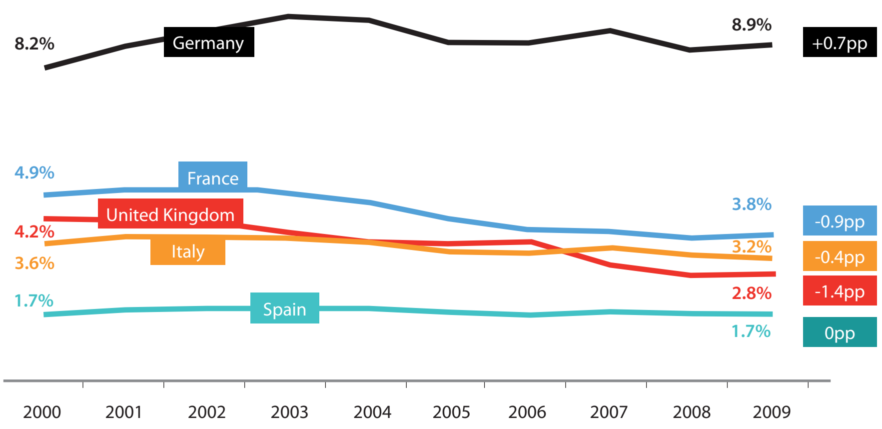
Unit Labour Costs and Export Prices
Spain-Euro Area Differential – YoY Growth Rates (pp)



Source: CEC based on Eurostat data.

Good export performance over the last 10 years, maintaining its share on the world market for goods: Spanish exports in this period have maintained their share on the world export market, following a more favourable pattern than most of the euro area countries. In fact, Spain has performed better in this respect than countries such as France, Italy and the United Kingdom, where competitiveness indicators are better. Of the European countries considered (see chart below) only Germany (with a clear improvement in cumulative competitiveness) out-performed Spain, increasing its share of the world export market by 0.7 percentage points.

Share of World Export Market, 2000-2009

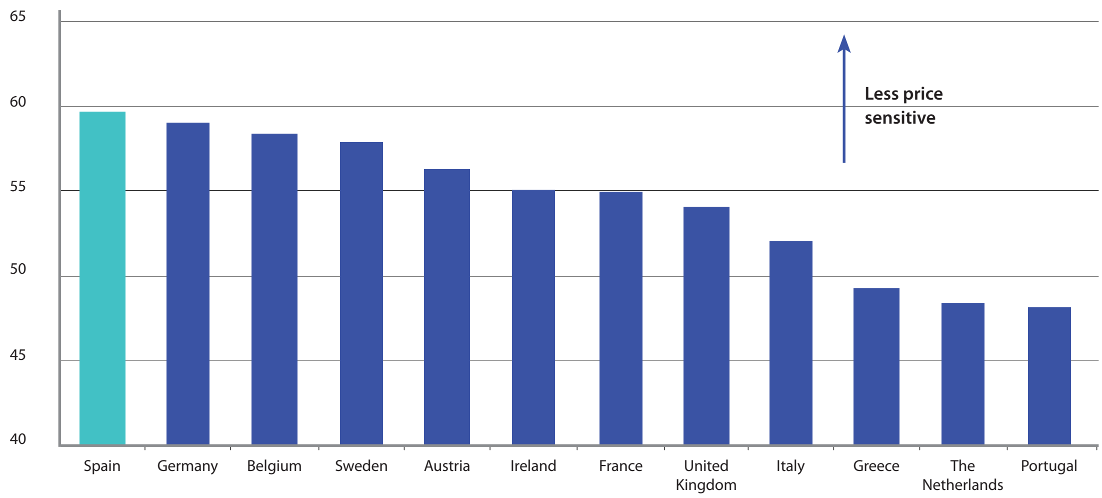


Source: CEC based on WTO data.

The export industry in Spain performed better than in comparable countries thanks to the convergence of several factors.

1) Exports with low price sensitivity: the product mix of Spanish exports, which is highly diversified and intensive in scantly price-elastic goods, has favoured good performance. This was the conclusion reached by Goldman Sachs in a recent report in which the company formulated a price sensitivity index for various European countries' exports. Further to that report, Spain's exports were less price sensitive than any of the countries studied, followed very closely by Germany (see chart below).

Export Price Sensitivity Index



Source: GS Global ECS Research, Eurostat.

2) Geographic diversification: In the last ten years, the re-steering of Spanish exports from the most developed countries, primarily in the euro area, to emerging countries where demand is more dynamic, also explains the industry's ability to maintain its market share. One of the regions that Spain has targeted most actively is emerging Asia: since 2001, Spanish exports to this area of the world grew by 14% yearly, i.e., at a steeper pace than French (10%), United Kingdom (6%) and Italian (10%) exports to Asia. Of the countries analysed, only Germany, whose exports to Asia rose by 15%, out-performed Spain in this regard. As a result, the weight of this region in Spain's export structure has more than doubled since 2001, although there is still room for much more growth to catch up with Germany, Europe's export benchmark.

Spain's Export Destinations

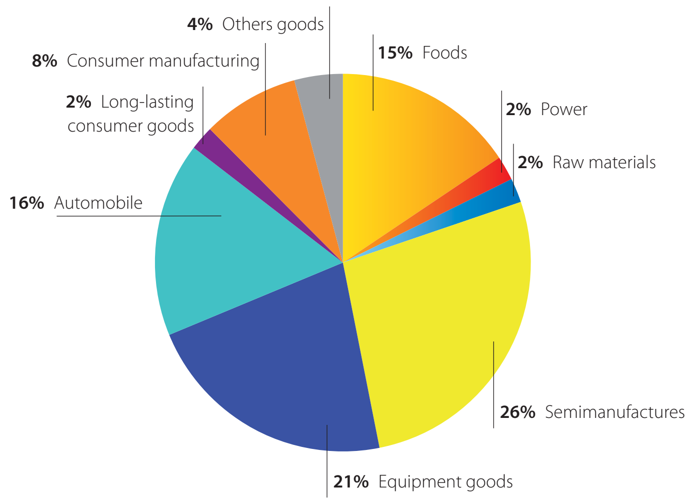
	Export quota in Spain			Export quota in Germany
Export destinies	2001	2011	Variation (pp)	2011
Africa	2.2%	3.4%	1.2	2%
Emerging Asia	1.2%	2.7%	1.5	8%
Latin America 7	4.3%	4.3%	0.0	2%
Middle East	0.9%	1.2%	0.3	2%
Russia	0.6%	1.1%	0.5	3%
United States	4.3%	3.5%	-0.8	7%
EU 15 INTRA	71%	63%	-8	49%

Emerging Asia: China, India, South Korea, Indonesia and Thailand.

Source: CEC based on Eurostat data.

3) Product diversification. A product-diversified export base with an increasing proportion of medium-high technology goods also favoured Spanish export performance.

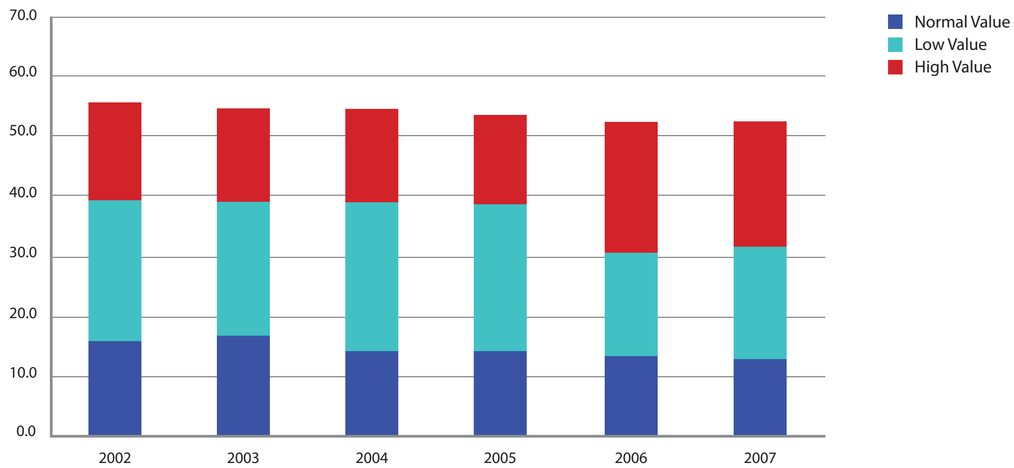
Share of Total Spanish Exports by Product Type (2010)



Source: Ministry of Industry, Tourism and Trade, AFI and UNCTAD.

4) Strong intra-industry trade, whose high vertical component (high added value) is growing. Spain has strong and increasingly high vertical intra-industry trade: its exports are more expensive than its imports, i.e., it generates added value. This very favourable state of affairs explains why the country has maintained its market share.

Industry trade in Spain



Source: Ministry of Industry, Tourism and Trade. Formulated by CEC.

Exceptional performance of non-tourist services.

- Tourism is not Spain's only service export. Diversification into other areas (essentially business services and transport) over the last 10 years has been one of the keys to its success story. During this period, Spanish non-tourist service exports grew at a much faster pace than tourism and goods exports. Far from declining, their share in total world exports grew by 40% (from 2.1% in 1999 to 2.9% in 2009), compared to the slide recorded in many comparable European countries (France, United Kingdom and Italy). Only Germany increased its share in this same period (by 15%).

- Moreover, compared to non-exporters, the companies that export services are characterised by their size, productivity, capital intensity, skilled labour and tendency to innovate. These features are common to all countries, but Spain has succeeded in raising its market share and should therefore continue to focus on this type of exports/industries.

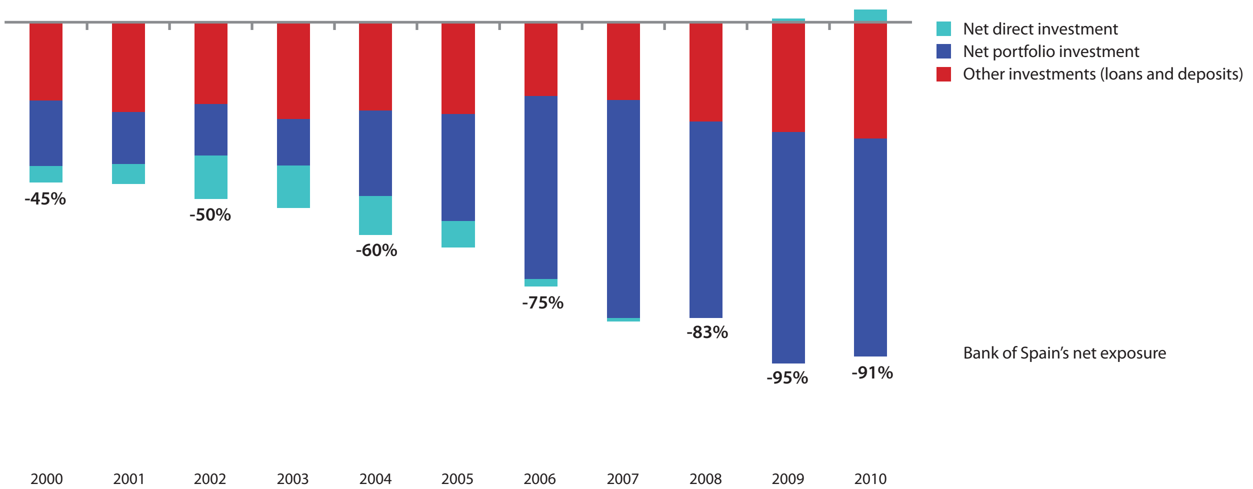
Private sector deleveraging underway

Over the last 10 years, Spain has doubled its net indebtedness, from 45% of GDP in 2000 to 100% in 2009. Underlying this trend in Spain's international investment position is the unprecedented growth of the country's net portfolio investment (80% in certificates of indebtedness), which tripled in the period considered and still stand at over 60% of GDP. By creditor type, over 90% of the increase in foreign indebtedness is accounted for by the private sector.

Nonetheless, that upward pattern was reversed in 2010, with a slight, four-percentage point correction. Fifty per cent of that correction would be explained by an improvement in Spain's relative FDI position, for the country was a net creditor for the second year running, and nearly all the rest by a decline in net (essentially private) portfolio indebtedness.

In the private sector, adjustments began as early as 2009 and in 2010 a surplus (or financing capacity) of over 4% of GDP was recorded. This offset, albeit only slightly, the deterioration in the country's public accounts in that period. These adjustments were implements in two phases: in the first, now concluded, financial savings were recomposed. The second phase, consisting of sustaining savings to pay off the debt, is still outstanding, although its adverse impact on growth is much smaller.

Spain's International Investment Position (% GDP)



Source: CEC based on Bank of Spain data.

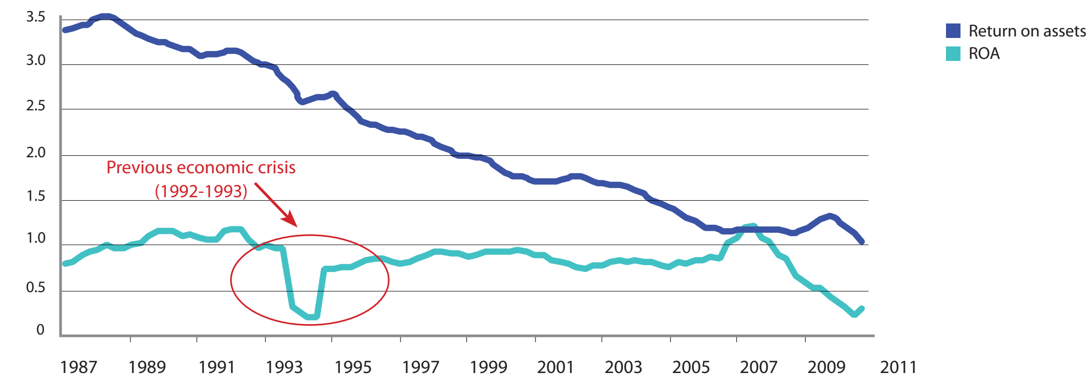
Banking sector: consolidation underway

Positioning in response to the crisis

The basic characteristics of the Spanish financial system that have made it more resilient are listed below.

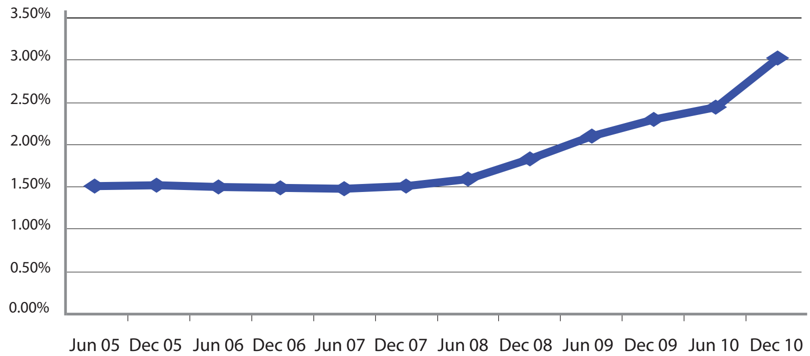
- Sound, profitable, well regulated and supervised, highly provisioned system (including anti-cyclical provisions).

Financial Institutions: ROA and Business Differential (%)



Source: Bank of Spain.

Provisions: Per Cent of Lending (Deposit banks)

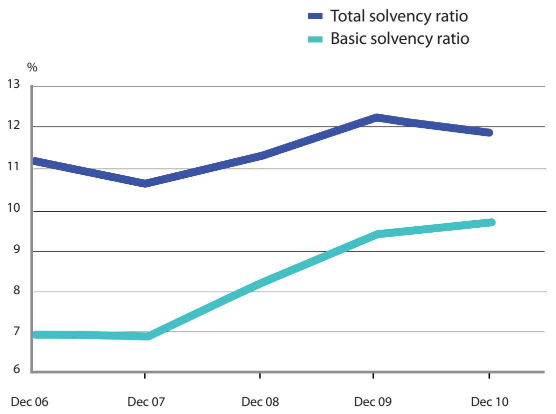


Source: Bank of Spain.

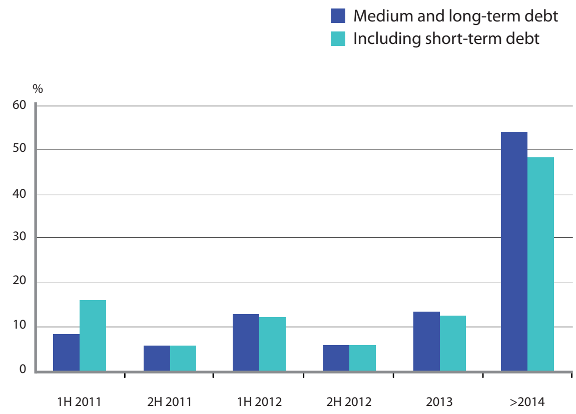
- Retail banking model characterised by:
    - Higher revenue recurrence.
    - Lower risk profile.
    - Competitive provision of services.
    - More stable and predictable results.

- High capital and liquidity levels due to the weight of the retail business, with suitable financing based on a high proportion of deposits and a wholesale debt maturity schedule spread out over time.

Variations in Total and Basic Solvency Ratios



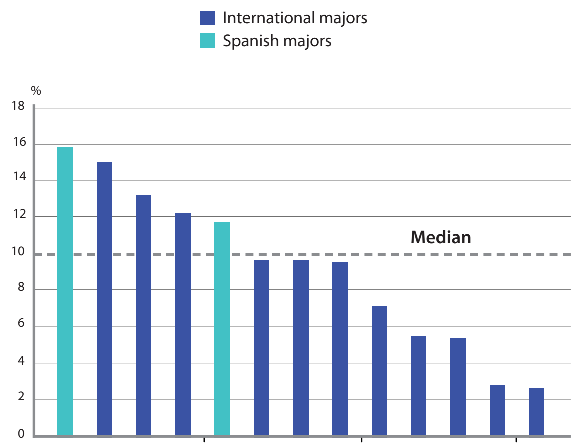
Outstanding banking sector debt by instalment maturity dates



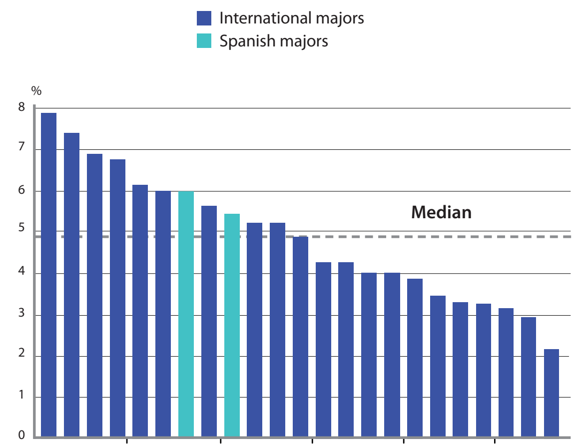
Source: Bank of Spain, Financial Stability Report May 2011.

- Large, well-capitalised, profitable and diversified institutions, with a substantial foreign presence.

ROE
(December 2010)



Shareholder Equity/Assets Ratio
(June 2010)



Source: Bank of Spain, Financial Stability Report May 2011.

Present situation

The depth and duration of the financial crisis after a long period of expansion has led to a crisis more "characteristic" of the Spanish financial system, with:

- High exposure to the real estate sector.
- An atomised savings bank segment afflicted by unsure access to wholesale markets and severe limitations to increasing its top quality capital.
- An excess of installed capacity for the foreseeable mid-term banking business.

The adjustment of these imbalances is taking place with varying intensity.

- A rehabilitation and recapitalisation process is underway.
  - Acknowledgement of nearly 90 billion euros (9% of GDP) in losses.
  - 38% of exposure to real estate hedged, with a mean LTV of 60%.

- Recapitalisation with partial public sector support: Fund for Orderly Bank Restructuring (FROB), temporary aid with a financial cost. Through 2010, around 10.6 billion euros.
- According to Bank of Spain estimates, need for up to 20 billion euros to complete recapitalisation, most to come from private funds, although the FROB will be vested with power to provide it.

• The savings banks are in the midst of intense consolidation, with a significant reduction in the number of institutions (from 45 to 17 in December 2010), resulting in increased size and solvency.

Extent of Savings Bank Restructuring

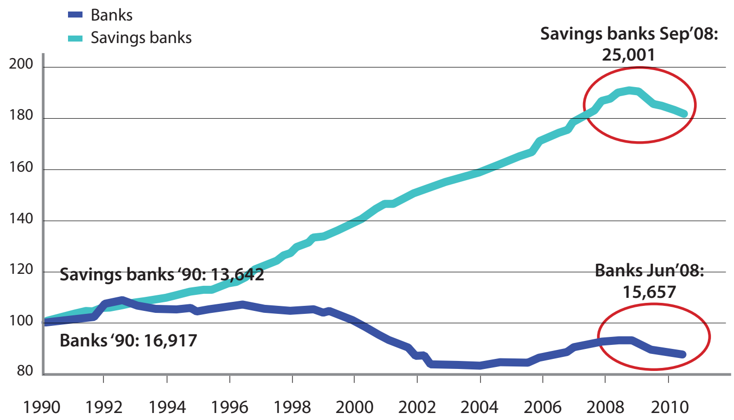
Savings banks	Institutions participating	Number of processes	Total assets (Sep-10)
Integration with FROB assistance	33	9	886
Integration without FROB assistance	7	3	326
Institutions intervened*	2	-	
Total restructuring	40	12	1,212
Rest	5		74
Total savings banks**	45		1,286

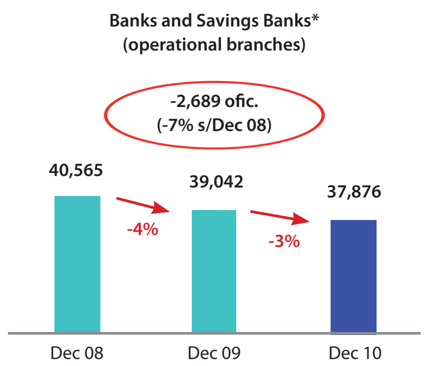
** The 2 banks intervened are participating in integration processes.*
*** CECA (Savings Banks Association) excluded.*

Source: Bank of Spain.

• Only part of the integration processes require FROB assistance. Where they do, the institutions concerned must present a structural adjustment plan to reduce the number of branches by 10 to 25%, and the headcount by 12 to 18%. These adjustments are in addition to prior cutbacks of 5 and 4%, respectively.

Spain: Operational Branches (Mar-1990=100)



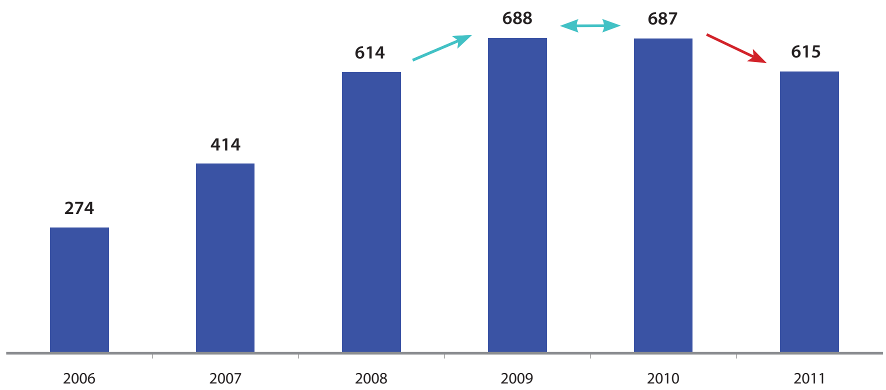


* *From Jun 2010 savings banks have transformed into banks due to the reforms of the financing system.*
Source: Bank of Spain, Oct 2010.

Gradual housing construction adjustments

After the boom in the years leading up to the crisis, the adjustment in housing investment is nearly complete: (i) activity is at historic lows, with the industry's weight in the GDP declining by half from the 9% peak in 2007 to 4.5% today (close to a record low); (ii) after stabilising in 2010, the housing stock turned clearly downward in 2011. Nonetheless, absorbing the entire stock will take time.

Unsold Housing Stock (thousand units)

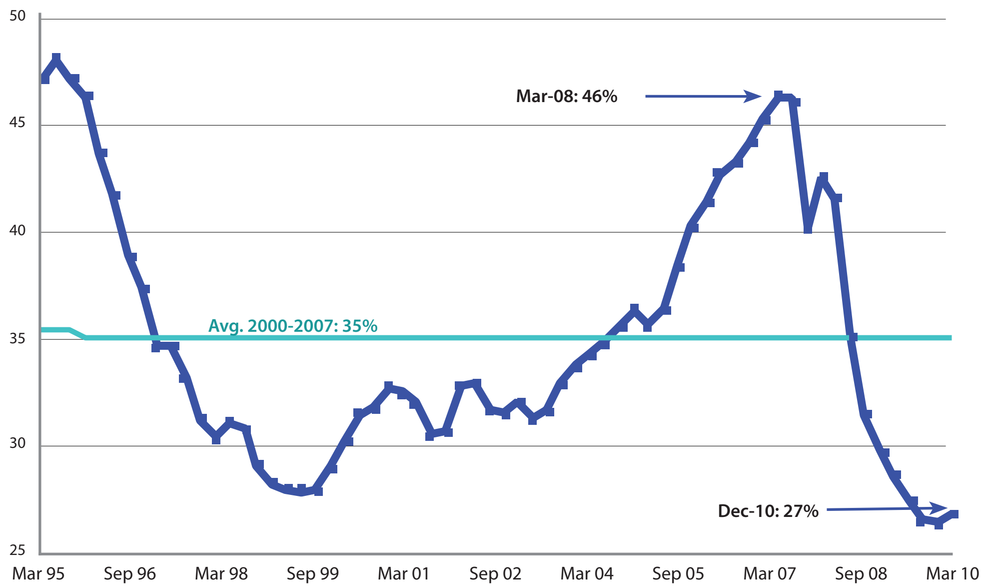


Source: Ministry of Internal Development and CEC.

- Housing prices, in turn, have come down, correcting 50% of their overvaluation. Prior to the crisis (2008), national (Bank of Spain) and international (IMF, European Commission) analyses estimated housing prices to be 20 to 25% overvalued in real terms. Given the cumulative decline of 13% recorded in 2009 and 2010, housing prices would still need to fall by 7 to 11%.

- Recovery of indicators of household accessibility to home ownership, today at historically high levels: (i) indicators of households' "financial effort"[15] are lower than at any time since the nineteen nineties and nearly 10 percentage points below the historic mean as a result of the drastic decline in interests rates during the crisis. (ii) The "housing price/available income" ratio is at 6.6, the lowest since 2004, but with room to come down even farther, judging from the levels prior to the property boom (around 3.5% in the late nineteen nineties).

Households' "Financial Effort" (% available income, with tax deductions)

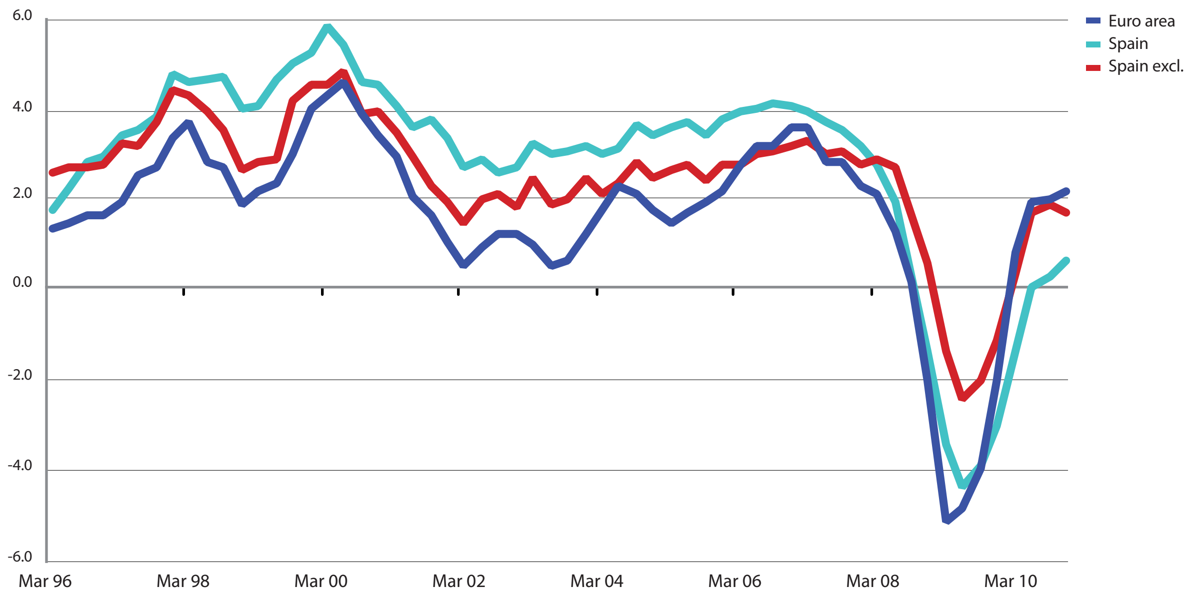


Source: Bank of Spain.

15 Financial effort = (principal + interest payment)/household available income.

- Correction of the housing construction imbalance during the crisis explains why Spain's GDP has performed more poorly than the euro area mean. Excluding construction, the Spanish economy performed better than the euro area as a whole. Excluding the construction industry from the calculations, the Spanish economy maintained a 0.6% growth differential with Europe before and during the crisis. Including construction, the differential was +1.4% before the crisis and has remained at -1.1% since.

Spain: growth with and without Construction (%)



Source: Statistics Office and CEC.

5 Structural reform underway: positive international reaction

In 2011, a number of prominent analysts and institutions have dissociated Spain from the group of so-called peripherals in light of its structural strengths and the reforms undertaken.

- Goldman Sachs (20/01/2011): "Spain has also implemented an impressive catalogue of policy reforms over the past six months. And although the country will still need to continue its drive towards structural reforms even under pessimistic assumptions Spanish public debt is unlikely to exceed 90% of GDP at the peak; hardly a case of insolvency".

- Morgan Stanley (7/03/2011 "We see seven reasons for being fundamentally more constructive on Spain's ability to set itself apart from the smaller peripherals" (growth potential, labour reform, correction of the construction bubble, competitiveness, private sector deleveraging, public sector belt-tightening and savings bank reform).

- On 14/03/2011 the Royal Bank of Scotland noted that Spain has decoupled from the other peripherals, which the bank regarded to constitute a significant change. It added that Spain has more room for manoeuvring than other countries and that its perception was that Spain would not fall.

- On 31/01/2011, Deutsche Bank expressed its belief that Spain meets the conditions to continue to grow in 2011-12. It noted that after some delay, the Government had undertaken a series of structural reforms which, combined with fiscal adjustments, had restored investor confidence. It concluded that some of the risks factored into its premium should not be exaggerated.

Banking sector restructuring: building a more solvent system

Banking system reform in Spain constitutes a radical change that has been implemented in record time. While the process has brought greater transparency (a more rigorous stress test than in the rest of Europe in 2010 and the publication by financial institutions of their real estate exposure), these measures would have been more profitably taken from the outset. Similarly, the restructuring plans for the institutions that receive public aid should be rigorous and contribute to significantly reducing what has been an oversized sector. This restructuring should be conducted without generating other types of distortion, such as aggressive and competitive deposit seeking. Sector reform and recapitalisation is underway and it is important to maintain and even increase its expected rhythm.

The imbalances accumulated by savings banks as the Spanish economy was expanding forced the Bank of Spain to restructure the Spanish financial system.

This involved a series of regulations and actions geared to making the system sounder and enhancing international confidence in the wake of the uncertainties stemming from the financial crisis and the situation in other countries.

The aim is to improve Spanish institutions' access to international wholesale financing and reduce their risk premium, with the concomitant lowering of funding costs.

The foregoing will favour lending in the medium term in the Spanish economy, where credit is presently constrained due to weak demand by solvent borrowers in an environment of economic adjustment.

Reform has adopted a dual approach to gain strength and transparency. The most significant measures are listed below.

1) Fund for Orderly Bank Restructuring (FROB) (June 2009):

- Objective: to facilitate inter-institutional integration via capital injections and streamline intervention where necessary.
- Contingent upon rationalisation (efficiency ratios of under 50% entailing branch closure and staff downsizing).
- To be paid back in 5 years at a yearly interest of not under 7.75%.
- Capacity to increase capital up to 99 billion euros.

2) New Savings Bank Act (Royal Decree 9 July 2010):

- Four channels for savings banks to face the future, depending on access to capital.
- Holdings with voting rights (max. 50% of equity: unchanged).
- Institutional Protection System formula (ISP: agreement among several savings banks to assign part of their business and management to a new commercial bank, sharing at least 40% of the capital and profits).
- Savings bank-commercial bank formula (a savings bank assigns all or part of its business to a bank in which it holds at least 50% of the capital, managing holdings and benevolence).
- Foundation-commercial bank formula (savings bank is converted into a foundation, managing benevolence and assigning all the business to a commercial bank in which it has a holding or a controlling interest).

3) Maximum transparency and expedited acknowledgement of losses:

- Stress test (summer 2010, on closing data for 2009):
  - 100% savings banks and 100% listed commercial banks.
  - Only 5 of 27 institutions failed to reach a Tier 1 ratio of > 6% in an adverse setting.
  - All 5 were savings banks/groups of savings banks: extra capital needed < €2 billion.

- New regulations on provisions (BoS Circular 3/10, effective 30-09-2010):
  - Unified and expedited recapitalisation timetables.
  - From five to one in only 12 months to cover 100% of non-performing loans.
  - Acknowledgement of the value of real estate collateral.
  - Up to 80% on ordinary place of abode; up to 50% on empty lots.
  - Expedited asset provisioning of purchased/awarded assets.
  - Minimum 20% after 12 months and 30% after 24 months.

- More information on real estate and construction industry:
  - More complete information forms.
  - Credit breakdown by purpose (rather than by national industry classification, as in former legislation).
  - Assets awarded itemised by type of asset.
  - Household mortgage portfolio classified by LTV.
  - Greater uniformity and periodicity.
  - Obligation to publish information for the first time in annual report for 2010 with closing data for 2010.

4) Financial Sector Strengthening Plan (January 2011):

- Objective: to restore confidence and facilitate financial institution funding, especially for savings banks.
- Basic measure: tightening of solvency requirements.
- Minimum 8% core capital (10% for unlisted institutions with over 20% dependence on wholesale funding) to be met by Autumn 2011.
- Priority: raise capital from private investors.
- Bank of Spain assessment of institutions meeting or able to meet requirement in September 2011.
- Guarantee of compliance with increased solvency requisites.
- FROB capital injection (investment in shares under market conditions) to meet the required level.
- Temporary investment by the FROB, never for more than 5 years.

These measures are intended to raise institutions' capitalisation levels and improve their access to funding. They will indisputably strengthen confidence in the solvency of the Spanish banking system, with the following consequences.

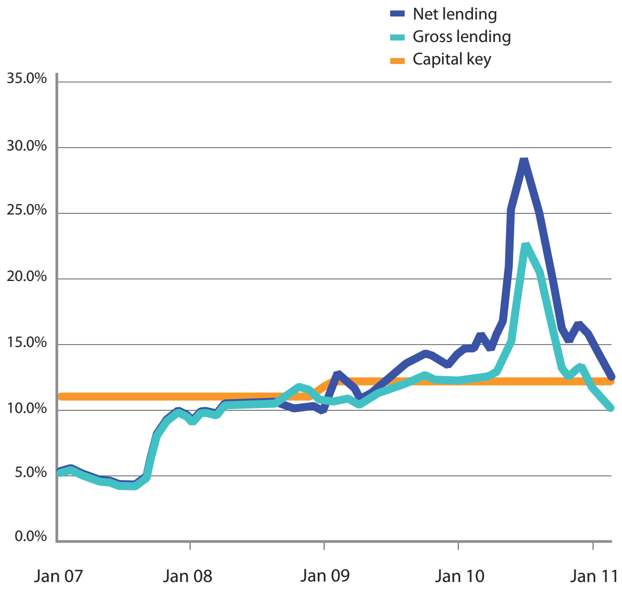
1) Readier access to capital markets thanks to the greater guarantees afforded investors.

2) More professional management as an outcome of greater market discipline.

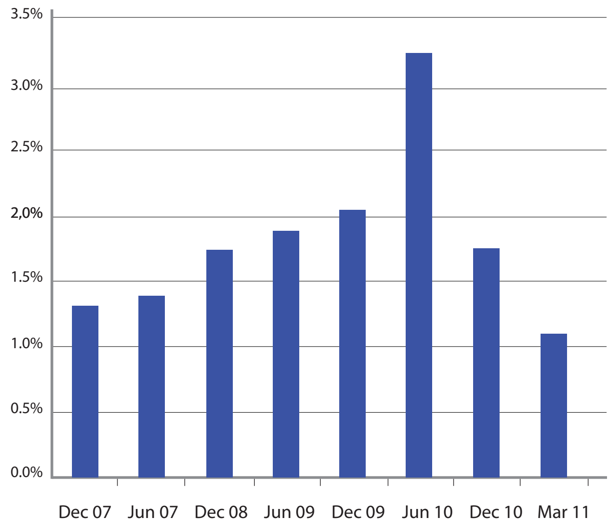
3) Maintenance of savings bank model strengths such as:
   - Proximity to local markets.
   - Focus on SME and individual customers.
   - Investment of earnings in benevolence and charity.

The initial consequences of the reforms, most prominently credibility and the resulting market stabilisation, are now visible in the decline in institutions' reliance on ECB loans (charts below): from the peak 30% of the total drawn to around 15% proportionally to key capital.

European System Gross and Net Lending to Spain
(monthly average)



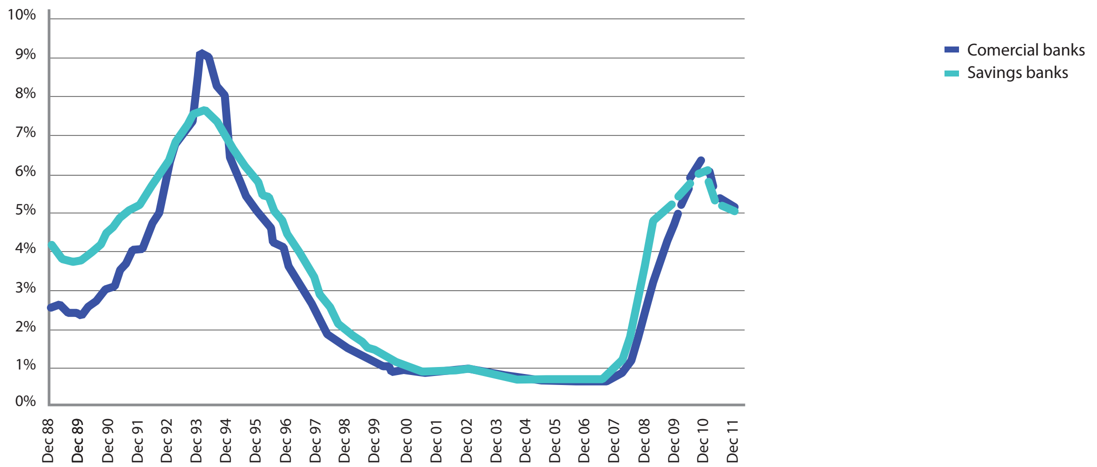
European System Net Lending
on consolidated assets



Source: Bank of Spain, Financial Stability Report May 2011.

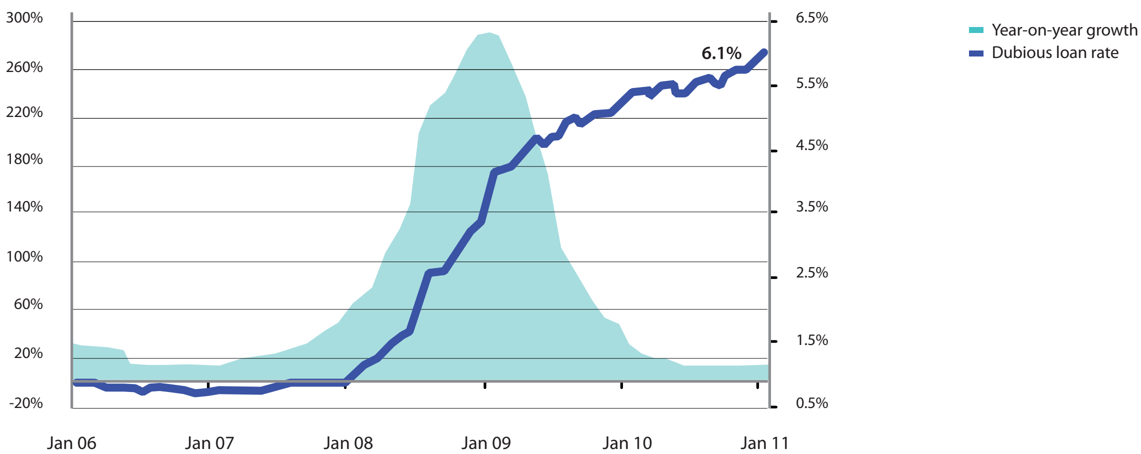
While delinquency has continued to rise in recent months, it is behaving as estimated by the IMF[16] in Apr-10 (one year ago). These levels infer that the percentage of non-performing loans should begin to decline in 2011 (see charts below: the first shows the IMF estimate and the second the actual data).

Banking System Delinquency: IMF Estimate, Apr-10 (% total lending)



Source: IMF staff estimates.

Spain: Dubious Loan Rate and Growth (Delinq./Prvt. Sec. Lns)



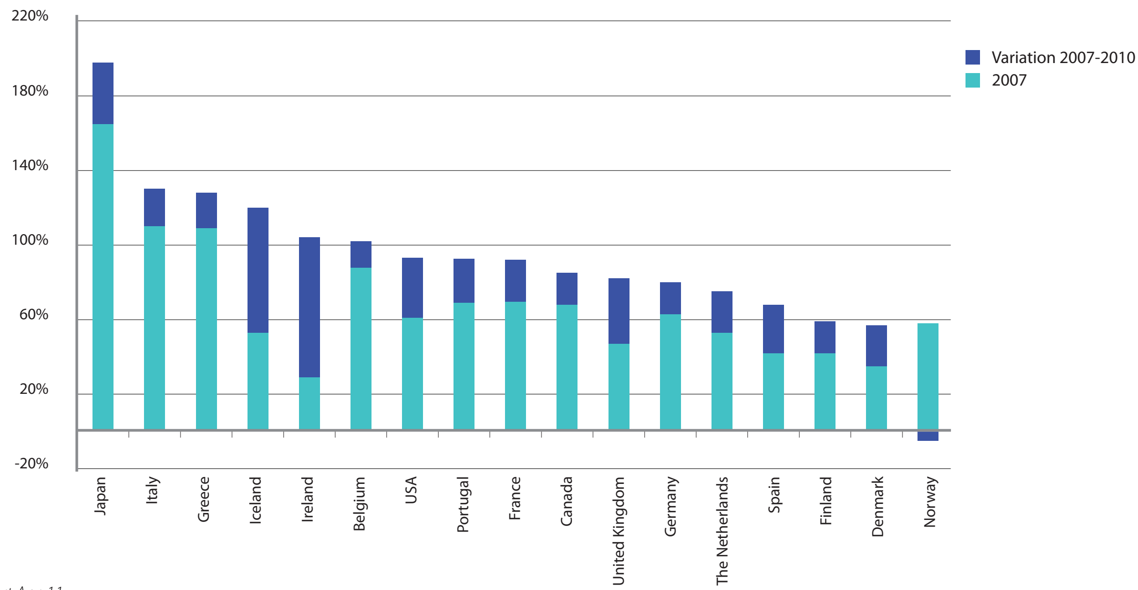
Source: Bank of Spain, March 2011.

16 Global Financial Stability Report, Apr-10: "Assessment of the Spanish Banking System".

Fiscal consolidation: stabilisation of the budget deficit and sovereign debt

Spain went into the crisis with healthier public accounts than other European economies thanks to the budget surpluses accumulated in 2004 to 2006 and its low sovereign debt/GDP ratio. While the ratio rose during the crisis, Spain continues to have one of the lowest percentages in the OECD (see chart below).

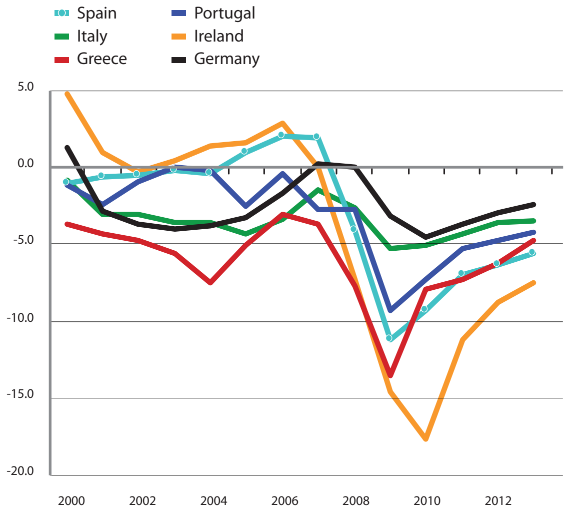
Sovereign Debt (% GDP) OECD Countries



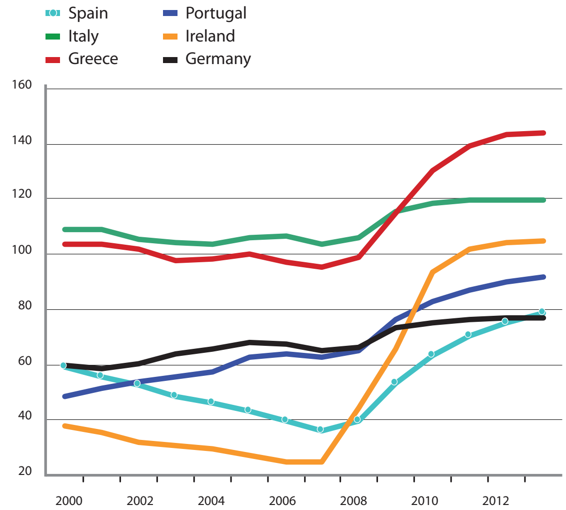
Source: OECD Interim Report Apr-11.

According to International Monetary Fund forecasts, with the public account adjustments in place, Spain's budget deficit will continue to converge on the rates prevailing in Central Europe (see chart on next page left). Despite the budgetary deficit, by 2013 the country's debt in terms of per cent of GDP will be at a level similar to Germany's and at a considerable distance from the values recorded in other Mediterranean countries (see chart on next page right).

Budget Balance (% GDP) IMF Forecast 2011-13



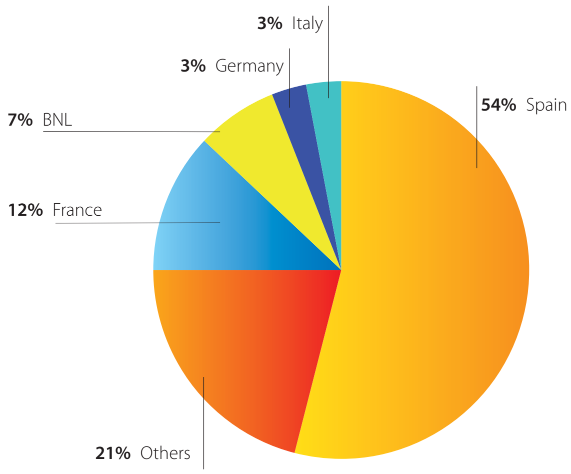
Public Debt (% GDP). IMF Forecast 2011-13



Source: AMECO.

Another characteristic of Spain's public finances is that international investors hold around 50% of its bonds (see chart below), a much lower value than in other countries.

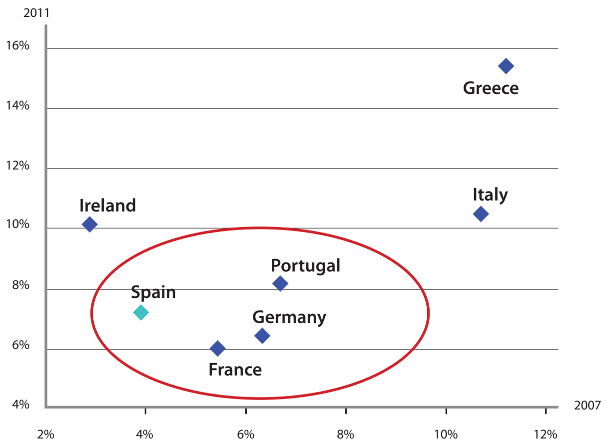
Investor countries in Spanish bonds



Source: National Treasuries 2009.

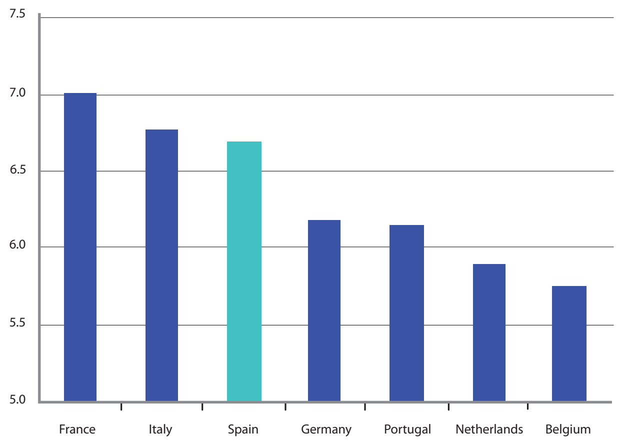
Moreover, further to European Commission forecasts, Spain is estimated to devote around the same percentage of public revenues (7%) to interest on its debt as France and Germany. Lastly, the maturity dates on Spanish debt are among the most diversified in Europe and have the third longest mean term, which lowers the risk of refinancing.

Share of Public Revenues Devoted to Debt Interests (European Commission forecast 2011)



Source: AFI, AMECO and Bloomerg.

Treasure Debt Average Maturity (years)



Source: AFI, AMECO and Bloomerg

Nonetheless, Spain is presently in the midst of fiscal consolidation with the firm objective of complying with the 3% Stability Pact target in 2013, to which the Government is staunchly committed. This plan has hinged and continues to hinge on the following objectives.

1) Spending constraints, most prominently:

- Pay cuts for public officials.
- Elimination of the "baby cheque" (cash for parents of newborns).
- Pension pay freeze.
- Elimination of the transition period for partial retirement.
- Rationalisation of drug spending.
- Cutback in public investment in infrastructure.
- Elimination of retroactive aid for households with disabled members.

Cuts in Government Spending (% of GDP)

	2010	2011
Elimination of temporary measures adopted in 2009 and 2010	0.2	0.5
Measures in 2010 and 2011 budgets	0.8	0.8
Extraordinary measures in 2010	1.0	1.0
Immediate Action Plan (January 2010)	0.5	0.0
Extraordinary measures (May 2010)	0.5	1.0
Cyclic component and others	-1.4	0.0
Total spending cuts	0.6	2.3

Source: Ministry of Economy.

2) Increase in tax revenues, via:

- Partial elimination of the housing deduction.
- Elimination of the €400 special deduction.
- Rise in VAT to 18%.
- Adjustments in electricity rates and excise tax on tobacco.

Measures to Raise Government Revenues (% of GDP)

	2010	2011
Permanent measures in 2010 budget	0.6	0.4
Rise in VAT	0.2	0.3
Rise in excise taxes	0.1	0.0
Elimination 400-euro deduction	0.3	0.1
Permanent measures in 2011 budget	0.0	0.1
Rise in excise taxes	0.0	0.1
Social and other contributions	0.0	0.0
Cyclic and other components	0.6	0.5
Total increase in revenues	1.2	1.0

Source: Ministry of Economy.

Under this plan, Spain will comply with the Stability Pact in 2013, which will call for a total GDP adjustment of 8.2 per cent compared to 2009. To this end, a programme of hefty cuts in Government spending has been approved, which will subtract 45 billion euros from expenditures in 2010-2013. The target for 2010 has been met (over-compliance by one percentage point by the Central Government, offset by the regional governments) and the Central Government has reasserted its commitment to introduce further measures in the event of any deviation in 2011 or thereafter.

Capacity (+)/Need (-) for Public Financing (% of GDP): Government Forecasts 2011-13

% of GDP	2009	2010	2011	2012	2013
Central Gov.	-9.5%	-5.9%	-2.3%	-3.2%	-2.1%
Social Sec.	0.8%	0.2%	0.4%	0.4%	0.4%
Regions	-2.0%	-3.1%	-3.3%	-1.3%	-1.1%
Local corp.	-0.5%	-0.6%	-0.8%	-0.3%	-0.2%
Total Public Administration	-11.2%	-9.3%	-6.0%	-4.4%	-3.0%

Source: Ministry of Economy.

Although the fiscal adjustment plan[17] appears to be on the right track and to conform to the fundamental principles defined by international organisations, further fiscal adjustments may be announced in the coming months to maintain the confidence of foreign investors. One such measure would be the creation of an independent tax board similar to the bodies in place in Sweden and the United Kingdom or the USA's traditional Congressional Budget Office. The second type of measures refers to restructuring regional governments. In 2010, regional indebtedness reached a record of nearly 11% of GDP, a particularly high figure which territorial governments and administrations elected in May 2011 are willing to low.

Several reasons can be put forward to explain this sudden rise: (1) the very design of the autonomous communities' financial system, with a regional organisational model that has yet to be fully defined; (2) vested political interests and (3) the regions' limited fiscal autonomy despite their broad spending competence.

This situation breeds a number of consequences. Firstly, Spain has many towns and cities (around 8 000) and one of Europe's lowest mean populations per town. Indeed, 60% are villages with a population of under 1 000 and nearly half have fewer than 500 inhabitants. One result is the high cost per inhabitant of spending on officials' remuneration, nearly five times the EU average. Finally, regional governments have a large number of public enterprises under their aegis. Symptomatically, the most highly indebted regions are the ones that were most prolific in creating such enterprises in recent years.

17 The fiscal adjustment plan belongs to the official Stability Programme 2010.

Several measures can be suggested to correct this situation. The first would be to better define the competence map, respecting basic premises of fiscal federalism such as efficiency and subsidiarity, but aiming to reduce the number of municipalities (Denmark, Sweden and recently Greece serve as examples). This should be based on two fundamental principles: regulatory quality that enhances legal certainty and the defence of market unicity.

The second group of measures should be geared to increasing regional government's budgetary discipline, improving transparency and requiring local and regional governments to render accounts on a regular basis. Although some mechanisms have been implemented of late (authorisation to issue debt and need to submit an adjustment plan to recover budgetary balance), others designed to enhance spending, revenue and debt discipline should be expedited, establishing ceilings and supervisory rules as well as clear mechanisms for evaluation, sufficiency and fiscal co-responsibility.

Greater rigour and discipline must be required of regional governments in their compliance with the fiscal adjustments to which they have committed (they manage nearly 40% of total public spending in Spain), since to date they have not managed to reverse the upward trend in budget deficits initiated in the wake of the crisis.

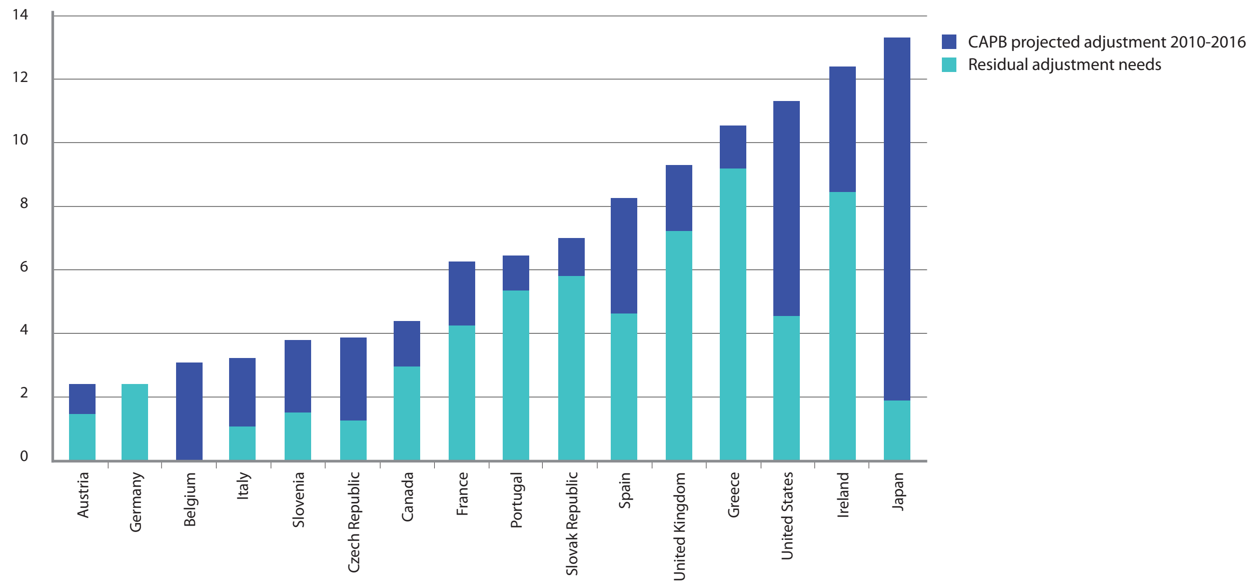
- On the whole, the regions missed the 3.1% deficit target, with a very uneven degree of compliance (overall their deficit reached 3.4% of GDP, up 1.4 pp from the preceding year). Four regions deviated by more than a full percentage point from the target figure.
- The cause of this non-compliance was less attributable to the failure to reduce spending (which was in fact lowered by over 2% of GDP) than to the decline in revenues, which came to nearly 3% of GDP.
- Moreover, in light of the prospects for moderate GDP growth in 2011, meeting the objective to reduce the deficit to 1.3% of GDP within two years will entail an unprecedented effort to contain regional spending.

In another vein, the Government forecasts 1.3% GDP growth in 2011 and 2.3% in 2012, meanwhile the consensus among analysts is lower.

- Smaller than expected growth due to declining domestic demand would call for additional adjustments to meet the deficit target. According to the impact calculations performed by Spain's Treasury, every 0.5 pp of lower growth (resulting, for instance, from a 0.4% higher household savings rate than forecast) raises the deficit by two to three tenths of a percentage point.

Despite the aforementioned progress, the adjustments appear to be insufficient to guarantee long-term debt sustainability. According to the IMF in the latest edition of its Fiscal Monitor, stabilising sovereign debt at 60% or lower in the long term will call for improvements in the cyclically adjusted primary balance (CAPB) amounting to eight per cent of GDP, four per cent (practically half) of which have yet to be specified.

Selected advanced economies: Illustrative adjustment needs and projected fiscal adjustment (Percent of GDP)



- Finally, sight should not be lost of the effect of new issue market rates on future variations in debt. According to the IMF, new issue interest rates 100 bps higher than assumed in its "illustrative scenario" would entail a rise in the medium-term tax burden (2016) of approximately one per cent of GDP.

Labour market, including collective bargaining reform

The need to modify behaviour patterns in the labour market calls for measures that transfer decision-making to the business domain, facilitate and simplify hiring and ensure clarity and celerity when job adjustments are necessary.

Labour reform has recently been approved in this regard and a Royal Decree-Law on Collective Bargaining has been published.

Labour reform hinges on three targets plus a high-powered action plan for 2011-12.

1) To reduce duality by:
   - Changing temporary hiring.
   - Encouraging permanent hiring ("promotional hiring").
   - Using the Salary Guarantee Fund (FOGASA) to cover 8 days/year of severance pay.
   - Clarifying regulations on collective layoffs for objective reasons.
   - Introducing a new device, "promotional hiring", with lower severance costs than permanent hiring to replace temporary hiring (growing faster than other forms of hiring since the reform).

Year on year variation in hiring in Spain

	2008	2009	2010								2011	
	yearly average	yearly average	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb
Permanent	-14.0	-30.0	-0.8	-8.3	-13.8	-2.7	-4.9	-6.4	0.7	8.6	8.6	-6.8
Promotional	-32.4	-57.2	-5.4	-18.0	-17.3	41.5	35.1	56.8	81.2	136.5	92.8	4.2
Temporary	-10.2	-12.8	7.3	2.7	0.7	7.7	3.4	-0.3	4.8	4.3	6.0	-1.1

Source: Ministry of Labour.

2) To make the market more flexible by:
   - Non-application of salary clauses in bargaining agreements.
   - Suspended employment or reduction in working hours as alternatives to layoffs.

3) To incentivise hiring the unemployed by:
   - Discounts on non-salary labour costs for hiring youths and women.
   - Improvements in internship conditions.
   - Regulation of placement agencies and expansion of the scope of action of temporary employment agencies.

4) High-power Action Plan for 2011-2012:
   - Employment programme for the transition to stable employment for youths up to 30 years of age and the long-term unemployed.
   - Occupational retraining programme for people whose unemployment insurance has expired.
   - Furtherance of vocational training.

Nonetheless, these measures should be supported by supplementary initiatives that seek to enhance the competitiveness of the Spanish economy, for despite some beneficial features, they are afflicted by shortcomings. In general, they fail to firmly confront the challenges posed by the country's labour market or to provide companies with tools that contribute to reversing the economic and employment crisis.

In this context, new factors should be taken into consideration in legislation on employment, which should facilitate and simplify hiring, particularly for permanent positions.

Furthermore, while in the planning, the involvement of private initiative in the labour market to attain a better match between supply and demand is not yet underway. Private placement agencies should become operational as soon as possible, drawing on the cooperation of temporary employment agencies and favouring their activities in the framework of comprehensive employment management.

Likewise, in-company flexibility in individual enterprises has to be further developed as well as linking salaries to increase in productivity and business results.

Lastly, employers, workers and policy makers should commit firmly to combat unjustified absenteeism, sensitising citizens to its adverse effects on productivity and the country's image.

Pension system reform

The reforms introduced in the pension system aim to ensure its medium-term sustainability. The key reform measures are listed below.

1) Rise in the legal retirement age from 65 to 67 over a transition period, with some exceptions, such as workers in hazardous industries or mothers who suspended their careers to care for their children.

2) Extension of the period for computing retirement benefits from 15 to 25 years. Reduction of the pension/salary ratio.

3) Increase in number of years worked, from 35 to 38.5, to qualify for a pension equal to100% of the base salary.

4) Increase in the minimum age for pre-retirement from 61 to 63.

According to a recent report published by FEDEA[18], the impact of pension spending reform would be two per cent of GDP in 2027 and four points in the longer term (2050).

18 *"El impacto sobre el gasto de la reforma de las pensiones: una primera estimación" Ángel de la Fuente (Instituto de Análisis Económico) and Rafael Doménech (BBVA Research and University of Valencia).*

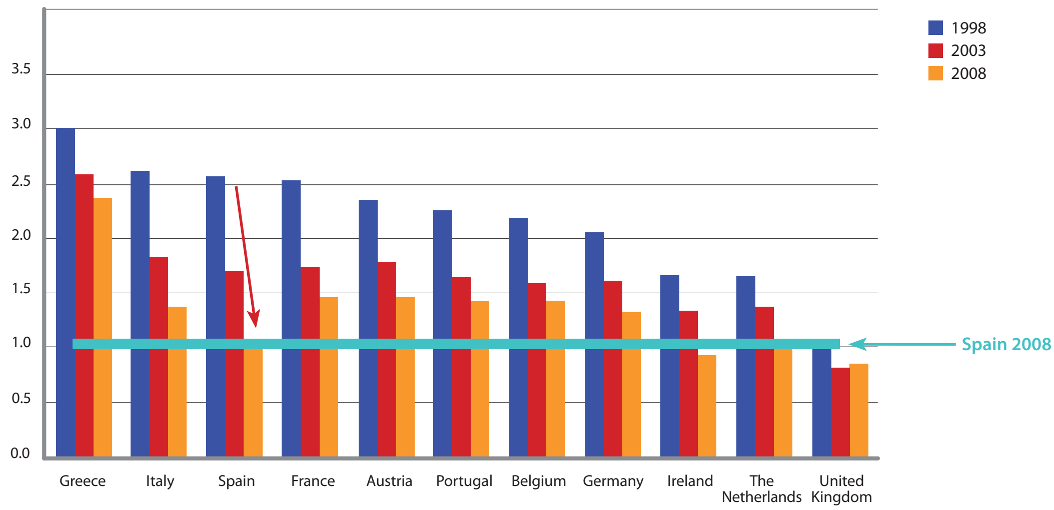
Transposition of the European Commission's Services Directive

The directive aims to create a genuine single services market in the European Union by eliminating legal and administrative barriers that presently limit inter-country service business activity.

The improvement in the regulatory framework can be expected to enhance the variety and quality of the services available to companies and citizens and improve efficiency, productivity and employment in the industries involved. It therefore broadens the service offering, which should impact growth, employment and social welfare.

In the nineteen nineties, Spain's service sector was the third most tightly regulated in Europe, after Greece and Italy. Since then, however, the Spanish sector has been amply liberalised and now stands among the most deregulated, after the United Kingdom and Ireland (see chart below).

Product Market Regulation Index (6:more restrictive; 0:less restrictive)

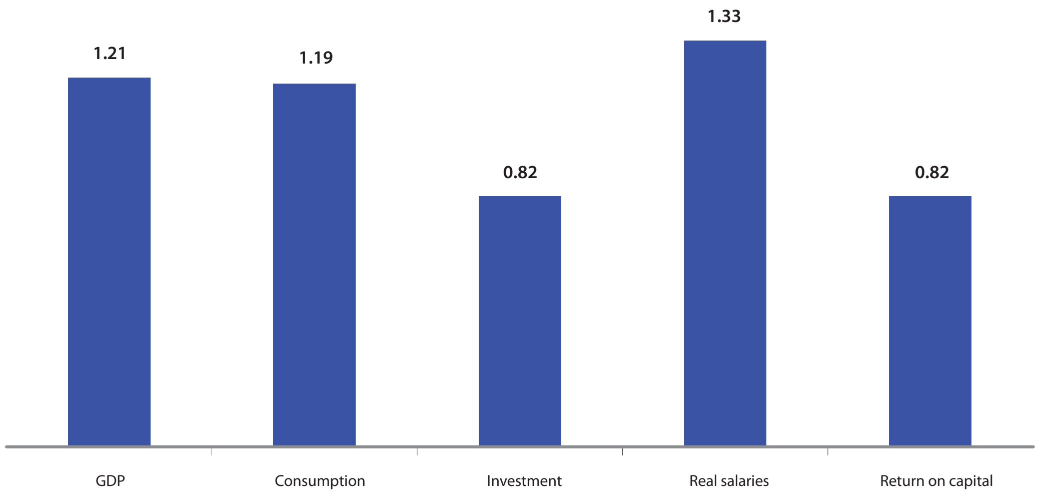


Source: OECD.

Nonetheless, certain areas are still in need of improvement, which is the aim pursued by transposition of the European Services Directive into Spanish law. This new legislation is geared to ensuring the efficient operation of the domestic service market and to improving its regulatory framework.

According to Ministry of the Economy analysts, long-term growth in Spain will be an estimated 1.2% higher if this directive is applied than if it is not (see chart below).

Impact of Services Directive on Main Economic Parameters in Spain (pp)



Source: Spanish Ministry of Economy and Finance.

Improving the competitiveness of Spain's service markets, in conjunction with a lowering of the entry barriers in these activities, could reduce sector business margins by nearly 3%, leading to a more efficient reallocation of productive resources and generating long-term gains not only in productivity, but also in real salaries and private consumption.

Despite the reduction in legal and administrative obligations provided for in the directive, however, companies continue to come up against other types of urban planning, environmental, health and similar obstacles at the regional and even the local level, that limit market unicity and hinder free business movement. All this has an adverse impact on growth potential and job creation.

Comprehensive Industrial Policy Plan 2020

The Act on Sustainable Economy provides for a Comprehensive Industrial Policy Plan 2020 (PIN), designed to confront the deterioration of industrial competitiveness and raise the manufacturing industry's weight in the country's GDP. The specific objectives pursued are listed below.

- To reduce unit labour costs in manufacturing (25% higher than in the euro area) to euro area or lower levels in 2020. This entails raising productivity by at least 1.5 points over the euro area average in the next 10 years (compared to the 0.7% average in 2000-2008).

- To further innovation and R&D, with plans to double the number of innovative companies in the next five years (40,000 new companies).

- To further SME growth and vitality: raise the percentage of medium-sized companies to the EU average (4%) through the enlargement of small and micro enterprises (this entails the upgrading of 800 concerns from small to medium-sized companies yearly).

- To increase Spanish manufacturing export intensity to mean EU levels and diversify its export targets (raise the percentage of goods exported outside the EU from the present 31% to 50% by 2020). A second aim is to raise the number of exporters to 55,000 by 2020.

- To strengthen what are regarded to be "strategic" industries (for their growth potential or for social-political issues), although no specific measures are defined, as follows:

  - Automobile.
  - Aerospace.
  - Biotechnology.
  - ITCs and digital content.
  - Environmental protection.
  - Renewable energies and energy efficiency.
  - Agri-food.

6 Main conclusions

The Spanish economy is undergoing a change in its growth patterns as a result of the unsustainability of the construction/ indebtedness binomial. The "macro" growth vectors will include favouring convergence of the country's sectoral costs and productivity on competitors' values and capitalising on its relative advantage in industries that are presently growing.

The Spanish economy has laid the foundations for recovery, combating recession via substantial adjustment of the imbalances generated during expansion and structural reform in key areas. Nonetheless, while the adjustments are in an advanced stage, they have not yet been brought to conclusion. Growth in 2011 will consequently still be modest, but the road has been paved for a new stage of growth. The productivity challenges facing Spain go hand-in-hand with the need to increase its exports and consequently raise employment levels and invest in intangibles, which would be the most productive approach, as attested to by large-scale exporter productivity and competitiveness ratios.

Recovery will be driven by the restoration of confidence with the conclusion of labour market and financial system reform and the strengthening of the European Union's institutional framework. The reforms underway will also provide for ongoing growth in traditional industries that account for high proportions of the country's GDP and have obvious competitive advantages: tourism, automobile, transport and logistics. Furthermore, growth is already being recorded in industries where Spanish companies lead the field: biotechnology, ICT, renewables and aerospace.

The country's growth potential is higher than in the EU and can be intensified by progressing in areas such as fiscal discipline, fortification of the domestic market and reduction of administrative formalities. The beneficial effects of recent reforms that have yet to be felt, the Government's firm commitment to reducing the deficit and the country's high quality production resources further contribute to that potential.

Financial investor behaviour has have recently shown that the view of Spain on international markets changed for the better in early 2011 with respect to the last quarter of 2010. The consensus opinion on Spain from the economic standpoint is that is has "touched bottom".

Moreover, Spain has succeeded in differentiating its situation from that of other peripheral European nations. The present view contrasts with the catastrophist tone that prevailed in late 2010 due to lack of actious on deficit and structural reforms.

This process has been reinforced by the message launched to key investors by a number of countries, to the effect that they are unequivocally committed to the euro, irrespective of sporadic problems that may arise around the sovereign debt of certain European countries. As a result, the political tension and sovereign debt duress prevailing in some of these countries has not been reflected in Spain's risk premium. Furthermore, meetings between investors and the Directorate General of the Treasury have yielded good results, both on the occasion of road shows and investors' recent visits to Spain.

Given the present perception of the Spanish market, investors focusing on value investments have renewed their analysis of investment opportunities in Spain.

Investor behaviour has shown that Spain's market image has been climbing in recent months, and the country has succeeded in clearly decoupling the perception of its economy from the situation prevailing in the European peripherals.

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