Consejo Empresarial
para la
Competitividad

Economic growth and sustainability in Spain

May 2012

Consejo Empresarial
para la
Competitividad

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Layout by:
IMAGIA*officina*.es
Printed by:
EGRAF, S.A.
Date of publication:
May 2012
Legal deposit:
M-19789-2012

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1 Spain, short-and medium-term growth and sustainable foreign interests

Economy will bottom out in the fourth quarter of 2012.

- With **exports** rising by 3.4%, the foreign sector will add 0.7pp to quarter on quarter growth.
- Unprecedented improvements in **competitiveness** and productivity are sustaining the upturn in exports, contributing to Spain's continued leadership in key industries such as tourism and driving top of the line performance in other added value services.
- On the back of **reform**, Spanish labour market flexibility and costs will converge to conditions prevailing in Europe, paving the way for a turnaround by year-end.
- **Large-scale international expansion by Spanish companies** has led to world leadership positions in key sectors. The country's platform for targeting Latin America generates considerable potential for development.

Spain's foreign debt is sustainable, since taking into account FDI inflows, its international debt position (net of incoming FDI) amounts to just 42% of GDP.

- The country's record-breaking **current account** adjustment will be sustained, reducing its deficit to below **2%**.
- High **foreign direct investment (FDI)**, which over-finances the current account, stands as proof of the country's appeal.
- The **private sector's positive** foreign assets net of debt are **worth 16pp** of GDP, excluding mortgage bonds, in which repayment is not an issue in light of household savings.

Public deficit targets can be met, with the aid of asset sales.

Consolidation and restructuring of the banking system is proceeding apace.

- **Losses are fully bounded** and the financial system is able to withstand housing price reductions on the order of 50%, in as much as the year-end provisions envisaged will amount to approximately 20% of GDP.

Spain's **stock of new housing**, which at year end 2011 stood at **around 680 000 units**, has remained steady over the last 3 years, for the decline in number of units completed has been attendant upon an equivalent downturn in the number of transactions. The excess is expected to be **absorbed in 3 to 4 years**, when equilibrium should be reached at 200 000 to 250 000 new units.

In light of all the foregoing, a country **risk premium** on the order of **150** basis points would be more consistent with the fundamentals of the Spanish economy.

2 The Spanish economy will bottom out in 4Q 2012

Spain's economy will improve throughout 2012

While the Spanish economy will shrink by 1.4% in 2012, cyclical dynamics will gradually improve at the end of the third quarter, when the effect of fiscal adjustments will be felt most intensely. Further to the analyses conducted (and other forecasts notwithstanding), negative growth will end in the fourth quarter (see Figure 1), under the combined impact of foreign sector expansion, improvement in confidence and households' positive financial balance (3.5pp of their income or €25 bn).

Figure 1. Spanish GDP: year-on-year growth and quarterly dynamics

	2012	2013	1Q12	2Q12	3Q12	4Q12
GDP	-1.4	0.5	-0.3	-0.5	-1.0	0.0

Performance will be compromised most in the third quarter in the wake of fiscal adjustments:

i) An increase in income tax from February 2012 will reduce households' income by €240/year, or 1.3%.
ii) The additional measures adopted in the national budget that will come into effect in May will constrain public spending.

The elimination of one-off fiscal effects from 4Q 2012 onward, along with greater economic vigour in the country's main trading partners, will enable the foreign sector to compensate for domestic demand and the economy to attain zero growth in 4Q 2012.

Broken down by components, domestic demand will reduce growth by 4.2pp, almost two-thirds of which will be compensated for by foreign demand (+2.8pp) (see Figure 2).

Figure 2. Breakdown of Spanish GDP year-on-year growth

	2012
GDP	-1.4
Domestic demand	**-4.2**
Household consumption	-1.8
Investment	-7.1
Public consumption	-8.0
Foreign demand	**2.8**
Exports	3.6
Imports	-5.5

The domestic demand figure reflects a **1.8%** contraction in **private consumption in 2012**, mainly due to a 4.5% decline in households' disposable income. Half of this downturn can be attributed to the employment situation and the other half equally to the impact of the rise in income tax (1.3pp) and the fall in real wages. Net job creation will be close to zero in the last quarter of 2012. Implementation of the labour reform, which will stabilise the economy, as well as the beneficial impact of the payment of bills to suppliers with the credit lines granted for that purpose by the Official Credit Institute (Spanish initials, ICO), will contribute to that result.

- Income contraction will reduce private consumption by 2.3pp.
- The adjustment in housing prices (a further 10% decline is forecasted for 2012) will impact consumption adversely, by -0.8pp.
- Financial wealth will fall by 4.8% in real terms due to a 13%[1] decline in the share prices and investment funds that comprise 30% of households' financial portfolio. This will reduce their consumption by 0.1pp.
- Lastly, lower interest rates in 2012 and their beneficial effect on the financial burden will increase consumption by 0.3pp.

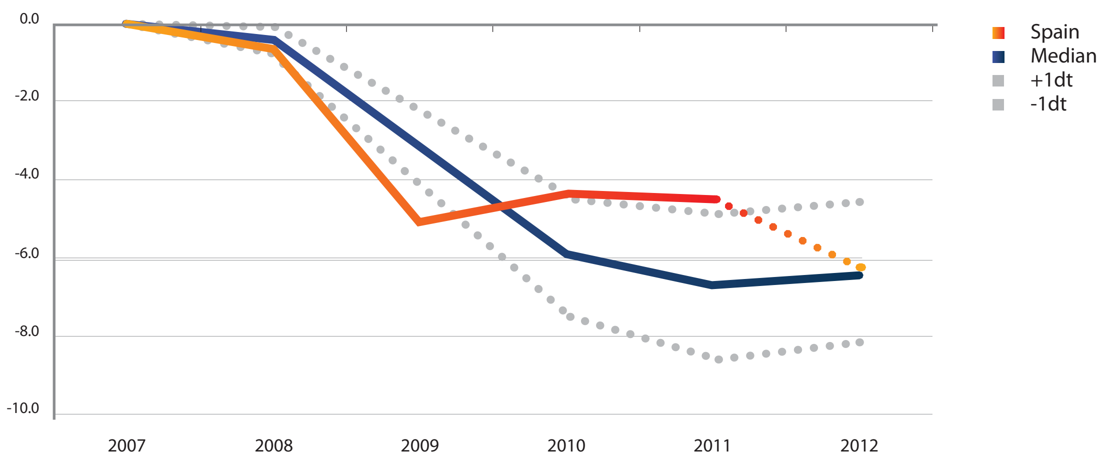
The sum of the above components would reflect an overall decline in consumption of 2.9% in 2012. The financial leeway available to households will nonetheless add a full percentage point to consumption, limiting contraction to just 1.8%.

- Thus, while household savings in 4Q 2011 were slightly below the historic average of 11.6% of disposable income, the financial balance, i.e., the difference between that rate and debt payment and new investments, will amount to €17.2 bn or 2.6pp above the historic mean. If this margin were to be spent entirely on consumption, it would climb by 3%, attaining the levels recorded in late 2008.
- In keeping with developments in preceding years and from a more conservative perspective, however, consumption is expected to benefit from only 1 of the aforementioned 2.6pp in 2012 (4.2pp and 2.2pp in 2010 and 2011 respectively).

1 On the grounds of the decline in the IBEX 35 from 31 Dec. 2011 to the average for April, which implies an annual revaluation in the index of about 5% from the 18 April levels.

How does this 1.8% decline in private consumption compare with developments in similar recessions? Such a downturn, which is deemed to be consistent with a cumulative reduction in consumption of around 6% since the onset of the crisis, resembles the pattern observed in other developed countries experiencing real estate and credit adjustment (see Figure 3).

Figure 3. Cumulative decline (pp) in private consumption during recessions preceded by years with a steep rise in household indebtedness



Source: IMF.
Analysis based on a sample of 99 episodes of real estate crises in 95 from 1980 to date.

The foreign sector will contribute 2.8pp to growth, compensating for a decline in domestic (and ultimately housing industry) demand, further to behaviour observed since the onset of the crisis, which mirrors the Spanish economy's proven capacity to find other ways to grow. In fact, if construction is omitted from the equation, Spain has grown by 1.6% since the fourth quarter of 2009, and it is only 2.4% off its record pre-crisis GDP, figures that are comparable to patterns in the rest of Europe.

The above figures include the short-term positive impact on business activity of **the injection by the Instituto de Crédito Oficial (ICO) of €50 bn from May**, to expedite outstanding payments to small and medium-sized enterprise (SME) suppliers to regional and local administrations. This sum is split into the two tranches:

- The first consists of a 30 bn euro, 10 year syndicated loan with a 2 year grace period for regional and local government suppliers, which may be increased

to 35 bn. This sum will be paid out through a Fund for Financing Payments to Suppliers, to be endowed by over 80 financial institutions, headed by the ICO, which will put up 7 bn euros.

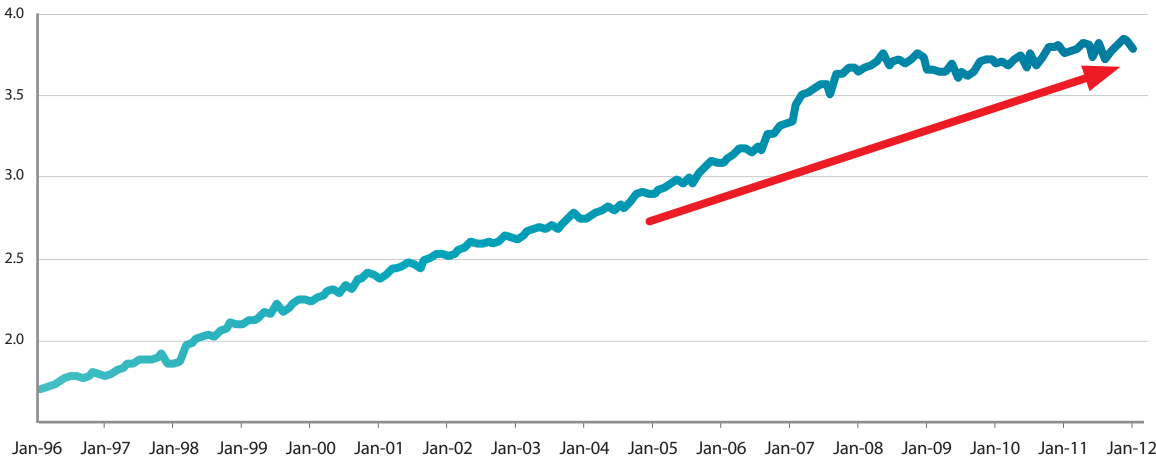
- In the second, the five ICO credit lines for SMEs and entrepreneurs will be supplemented by 22 bn euros (up 16% from 2011). These lines include: i) a 9 bn euro ICO investment for vehicle and machinery procurement; ii) a two-fold increase in the ICO international expansion line to 2 bn euros; iii) capacity hikes in the ICO liquidity line from 6 to 8 bn and the ICO entrepreneur line from 750 million to 2 bn, while the ICO building rehabilitation line will also be raised to reactivate the real estate market.

Short-term promise for the Spanish labour market

Certain features of the Spanish labour market, listed below, also afford cause for satisfaction in the short term:

- Despite the drop in total employment, **30% of the labour force** (3.8 million people) **work in sectors with positive job growth**. Outstanding amongst these are tourism-related (hotels and restaurants), consultancy and R&D activities (see Figure 4).
- **ICO will inject** €50 bn for the payment of bills in 2012, which will translate into the creation of **75 000 to 100 000 jobs**.

Figure 4. Variations in employment in industries with positive growth (millions)



Franchising provides a further example of business vigour, for the number of establishments opening up in Spain in 2011 grew by 3.2%. These new concerns accounted for **3.9% of all employment generated**, i.e., 241 000 jobs, and a 7% rise in turnover, matching the 2008 peak.

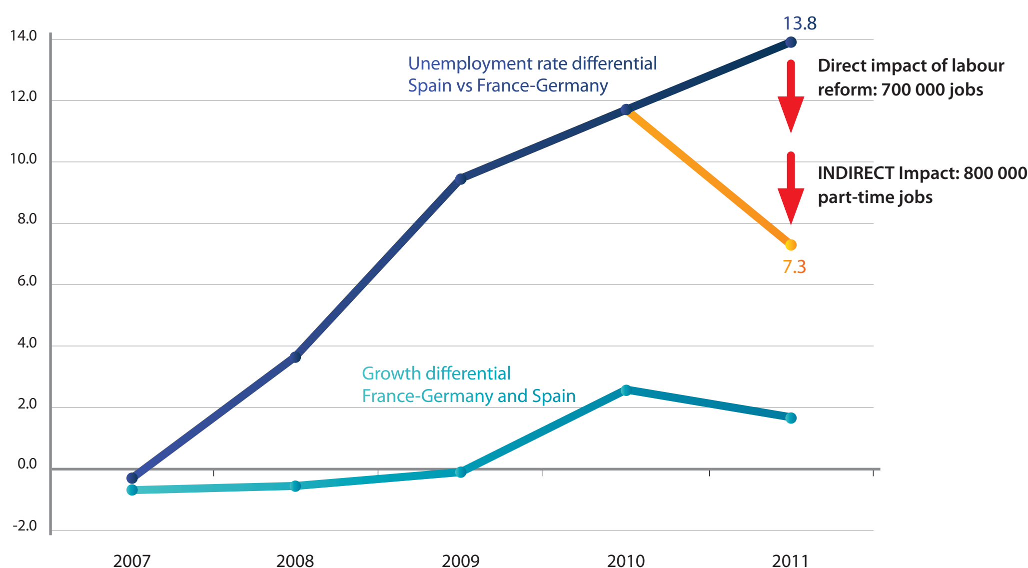
Spanish labour reform aligns market flexibility and costs with the rest of Europe

The circumstances prevailing in the Spanish labour market can be explained in part by shortcomings in its labour framework, which have an adverse impact on both structural unemployment and on the gap between its growth and unemployment differentials.

Nevertheless, Spain is currently in the midst of the longest and most intense reform of its contemporary labour law, and has even reached agreements such as the one on 25 January between employers' organisations and trade unions for 2012-2014. Such pacts will indubitably spur advances in this regard.

An analysis of the gap between the growth and unemployment differentials illustrated in the diagram below, shows that while Spanish GDP growth was 1.7pp below the average for Germany and France (see Figure 5, turquoise line), its unemployment was 13.8 times higher (see Figure 5, blue line).

Figure 5. Cycle-adjusted comparison of growth and unemployment: Spain vs France-Germany



This gap is attributable to two factors:

- Approximately half is due to the construction industry downturn. According to the Spanish active population survey (EPA), 1.5 million jobs have been lost in the construction industry since the onset of the crisis. This decline is directly responsible for 7.5pp of the rise in unemployment[2] rate.
- The rest can be attributed to the more dynamic implementation of a number of structural reforms in Germany and France[3].

Two are the channels whereby the reform approved may have a significant impact on the labour market:

- Lower severance costs and greater flexibility in wage bargaining (the reform positions both on a par with the European average) will translate into the creation of 700 000 jobs, since these two features of the former legislation are responsible for around 50% of the country's structural unemployment differential with the rest of Europe.

2 The number of jobs in this industry plummeted from 2.7 million in 3Q 2007 to 1.2 million in 1Q 2012.
3 Samuel Bentolila et al. "Two-Tier Labor Markets in the Great Recession France vs Spain".

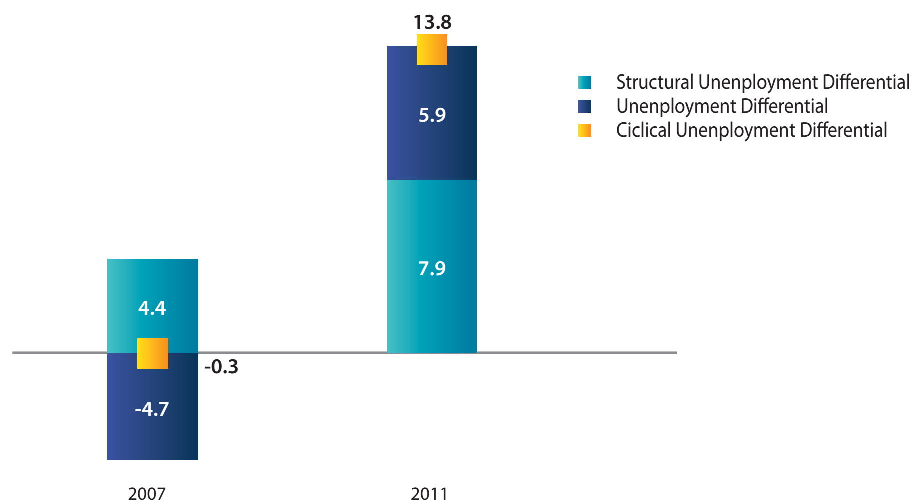
- In addition, the in-house flexibility introduced should drive part-time employment, a formula that is significantly less common in Spain than in other European Union countries (14% as compared to over 20%). If the reform raises part-time employment to European levels, up to 800 000 new jobs would come to market, reducing the unemployment differential by a further 3pp. The resulting figure would be commensurate with the growth differential (see Figure 5, yellow line).

Further to an analysis of unemployment rate trends from the perspective of structural[4] and cyclical[5] unemployment, today's structural unemployment rate is estimated at 16% and the cyclical rate at 8.4%.

In 2007 Spain's total unemployment rate was 0.3pp below the average for France and Germany as a result of:

- A 4.7pp cyclical unemployment differential in Spain's favour.
- A structural unemployment differential of 4.4pp against Spain (see Figure 6).

Figure 6. Unemployment rate differential: Spain vs France-Germany



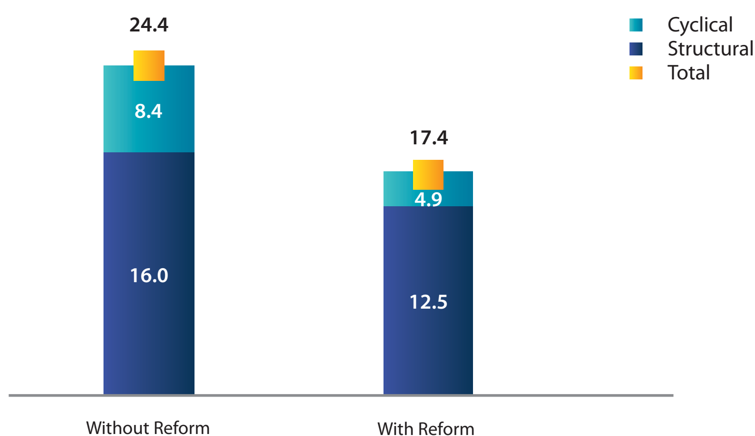
4 Unemployment rate if the economy were to grow in accordance with its potential.
5 Unemployment rate at a given point in time, which disappears when the economy returns to its average growth rate.

At year-end 2011, the unemployment differential between Spain and the French-German average was nearly 14pp. This 76% increase was due to a rise in the cyclical unemployment rate of almost 11pp (from -4.7pp to +5.9pp), 60% of which was attributable to the construction industry. Structural unemployment, however, rose by only 3.5pp, (24% of total increase).

- If the differential between Spanish and European unemployment rates were exclusively structural, Spain's unemployment rate would today stand at about 16% (around 8pp below the current rate).
- The **labour reform prioritises reduction of the structural component of the Spanish unemployment rate**. A second aim is to lower the variability of the cyclical component by impacting factors (wages, hours worked) other than job destruction-related events.

The reform (see the preceding item) seeks to reduce the structural component differential between Spain and the "core" European rate to the 4.4pp that prevailed in 2007. The indirect effect of reform would be to lower the cyclical component to approximately 2.1pp. **In the medium term, these measures could trim Spanish unemployment down to 17.4%**.

Figure 7. Impact of labour reform on unemployment



3 Export growth reflects Spanish firms' competitive advantage and the potential of a large natural market: Latin America

Unprecedented improvement in competitiveness and productivity

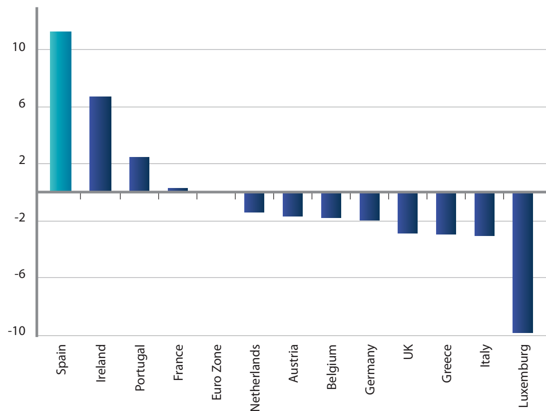
Following a decade of stagnation in competitiveness indicators, Spain has shown an unprecedented recovery in those measures since the onset of the crisis. Indeed, its improvement has been much more intense than in the rest of the euro zone countries, as attested to by the exceptional performance of exports mentioned above. Improvement is visible regardless of the indicator used:

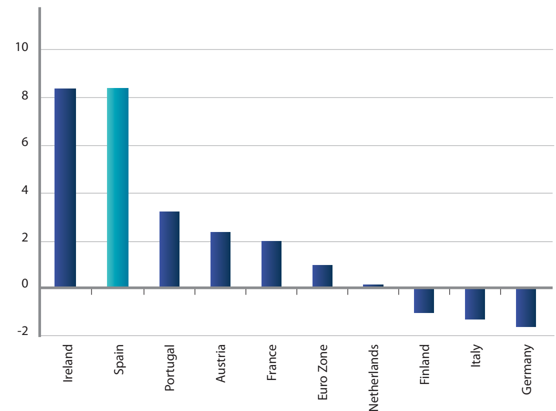
i. **Unit labour costs (ULCs) have declined steeply, by 4.3% since early 2008, and almost 6% since the 2009 peak**. That downturn contrasts with a 6.5% increase in the euro zone as a whole and 9% in Germany (Ireland was the only country where labour costs dropped more in the period analysed). The factors underlying ULC performance are listed below:

   - Wage containment has led to practically non-existent nominal rises over the last 2 years, as opposed to Europe's average annual increase of 3.7%.
   - More importantly, **productivity has risen sharply, measured not only as GDP perworker (11% since the onset of the crisis, the highest of any of the euro zone countries), but also in terms of GDP per hour worked. The latter grew by over 8% since 2008**, a figure bettered only by Ireland amongst the euro zone countries. (In Germany, for example, both GDP per worker and per hour worked has slid by almost 2% since the crisis began). In fact, productivity has improved despite the lengthening of the working day in Spain by 2.6% since the beginning of the crisis. The rest of the OECD has recorded downturns in this indicator.

Figure 8. Variation in productivity per employee in the euro zone and the United Kingdom
(%, 1Q 2008-4Q 2011)

Figure 9. Variation in productivity per hour worked in the euro zone and the United Kingdom
(%, 1Q2008-4Q2011)

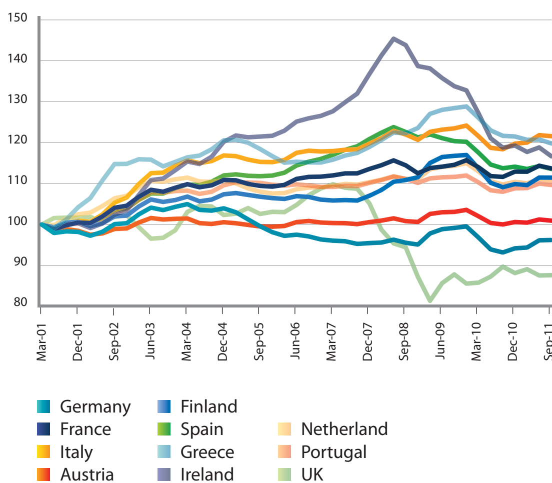


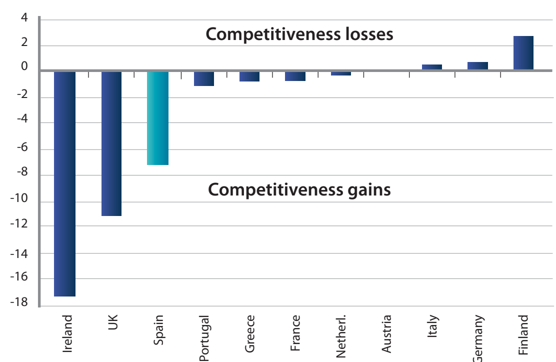


ii. **The real effective exchange rate (REER) has depreciated by around 7% cumulatively since 2008**, as opposed to depreciation of 1.4% in the euro zone as a whole and an appreciation of nearly 1% in Germany. Half of the competitiveness lost in the first 8 years of the century was recovered between 2009 and 2011.

Figure 10. Real effective exchange rate vs 36 industrial economies (%variation , 1Q 2008-3Q 2011)

Figure 11. Real effective exchange rate vs 36 industrial economies (1Q 2001=100)





Source: BBVA Research, based on European Commision figures.
Note: Economy´s nominal unit labour cost used as price index.

iii. **The inflation differential with the euro zone has been corrected and is now favourable to** Spain, both for tradable goods (0.6% on average since 2Q 2008) and services (since mid-2009).

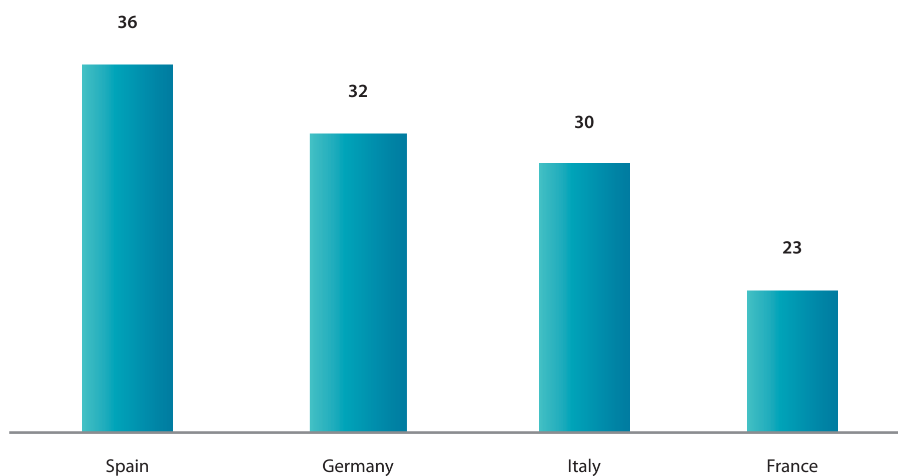
Exports are leading the change in the growth model

Exports of Spanish goods have climbed by €54.6 bn since 2009 to a total of €214.5 bn in 2011. This constitutes a **cumulative growth rate of 36% and a rise equal to 5.1% of GDP**.

- **Higher equipment and manufactured goods sales, up by €45 bn, are responsible for 83% of this improvement.**
- **Exports to Latin America, China and India have practically doubled (up €6 bn)**, while total imports from these countries rose more slowly during the period (60 and 73%, respectively).
- Exports to the euro zone rose by €22 bn (on €113 bn).

As the chart in Figure 12 below shows, since the **crisis-induced nadir**, exports have recovered more swiftly in Spain than in any of the other countries analysed.

Figure 12. Cumulative variation in exports since the nadir, 2009-2011

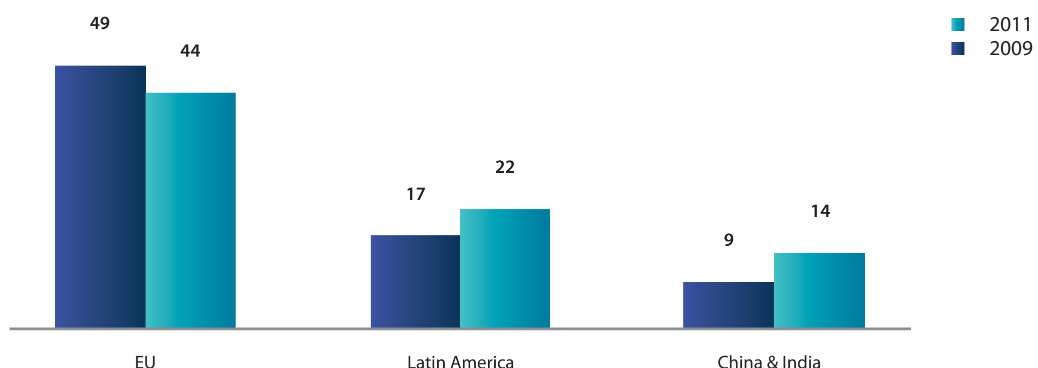


By year-end 2011, exports had risen 36% since 2009 (18.2% since 2007), compared to 23% for France (5.2%), 32% for Germany (12.6%) and 30% for Italy (1.6%). According to the 2012 growth forecast, Spain would also stand at the high end in this group, with a 2.1% rise for the year (vs 1.3% for France, 1.7% for Germany and an estimated 0.9% for Italy), according to IMF data.

The rapid growth of Spanish exports implies that its economy is increasingly open. Thus, the total contribution of exports to GDP climbed from 22.8% in 1Q 2009 to 30.5% in 4Q 2011. That contribution was nonetheless below both the euro zone average (44% of GDP) and Germany's 50.6% of GDP. Such figures are an indication that Spain has sufficient margin for continued export growth.

Along with exports figures, the number of Spanish companies exporting has also risen, by 12.5% in 2011 and by 14% since 2009, to the current total of 122 987 companies. The export sector has also diversified regionally (see Figure 13), as dependence on the European Union weakened (44% of companies exported to Europe in 2011 vs 49% in 2009). The EU nonetheless remains the country's major trading partner, with 54 169 Spanish companies exporting to the region. The number of companies operating in Latin America and China and India also rose. Since 2009, the cumulative increase in exports to Latin America came to 44%, and to 80% to China and India jointly, with 22% and 14%, respectively, of all exporters operating in these regions. This confirms the recent change of course toward new markets.

Figure 13. Per cent of Spanish companies exporting to EU, Latin America and China-India

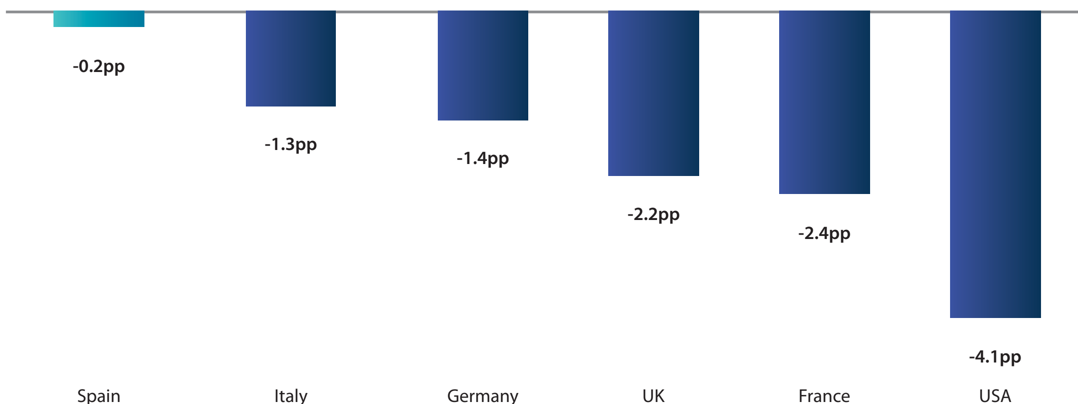


The sector with highest added value, industrial products and capital goods, also showed highest growth: up by 42.1% since 2009, its total exports amounted to €153.1 bn. In fact, it now accounts for 71% of the total, after an increase of 4pp since 2009. Automobile exports, one example of this trend, rose by €23 bn or 55% from 2009 to 2011. Higher exports were also recorded in other sectors, such as agri-food and consumer goods, up 18.6% and 16.7%, respectively, although the weight of both in the total figure declined.

With the rise of the emerging economies and their growing international footprint, most developed economies' share of world exports has flagged. **An analysis of comparable countries shows that since 1999 Spain has been one of the most successful in maintaining its world market share (see Figure 14)**. For example, in just over a decade the United States has lost over 4pp, while France and the United Kingdom have lost more than 2pp. Even Germany, while remaining one of the most competitive economies in global terms, has seen its share decline by almost 1.5pp.

Spanish performance can be attributed to the **increase of nearly US$200 bn in its exports in the period 1999-2011**. While other comparable countries also managed to raise the value of their exports considerably, their world-wide share nevertheless fell significantly more than Spain's.

Figure 14. Variation in share of world exports, 1999-2011 (pp)



Service sector exports: maintaining leadership in tourism and excelling in other value-added services

Lastly, Spain has consistently maintained its world leadership in the tourist industry. According to the most recent statistics, the number of overnight stays by foreign nationals grew by 12.7% year-on-year in 2011, while the overall increase, counting domestic tourists as well, came to 6.4%.

- Foreign tourist inflows are expected to grow by 2.7% in 2012. This would bring the total to 58.4 million and give Spain the top spot in Europe in terms of number of tourists hosted.
- World-wide, Spain ranks second in total and per-tourist[6] revenues, with a total of $52.5 bn or $996 per tourist. Only the United States has higher figures, at $103.5 bn and $1 731, respectively, while performance by Spain's more direct competitors such as France ($46.6 bn and $606) and Italy ($38.8 bn, $890) is lower.
- The foreign surplus booked under the tourism and travel item has consistently exceeded 20 bn euros yearly since 1998 and in 2011 it amounted to over 30.6 bn. The strategic importance of the tourist industry in balancing the Spanish economy's foreign accounts cannot be overstated. It is also a major source of jobs, accounting on the whole (including restaurants, accommodation, transport and others) for more than 10% of the country's total employment.

Non-tourist service exports rose by €11.3 bn between 2009 and 2011, or 16%. This was one of the highest rates in the larger European economies, on a par with France, and 5pp ahead of Germany. In all, 53% of the rise was attributable to products and transport-related and financial services, while business services totalled US$3.5 bn. These items showed growth rates of over 30%.

6 *Data for 2010, World Tourism Organisation.*

4 A sustainable foreign position

Spain's net debt position internationally is 42% of GDP

Foreign debt net of foreign assets stands at 42% of GDP, and declines to 16% of GDP if covered bonds are excluded (see Figure 15).

Figure 15. Spain's net international investment position by sectors (2011)

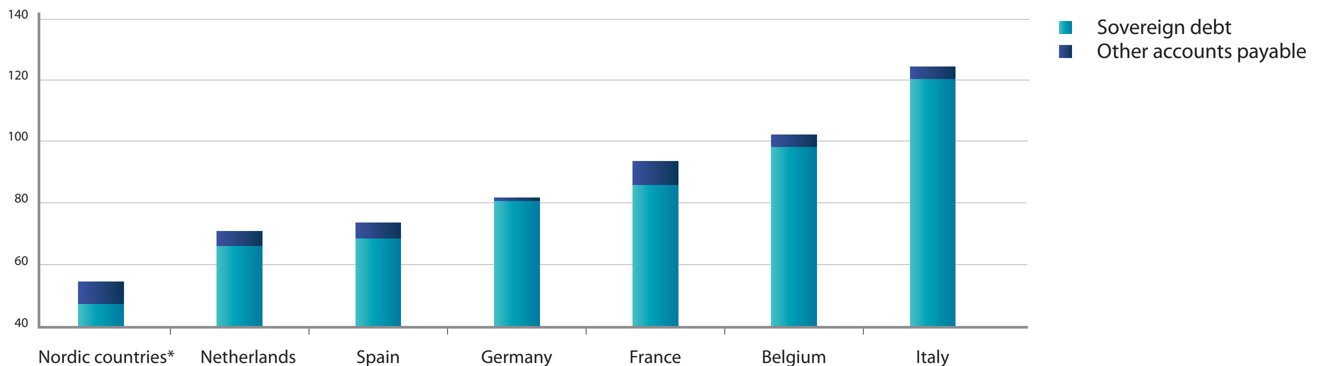
	bn euros	% GDP
Net Public, Total	**-337**	**-31%**
Assets	121	11%
Liabilities	458	43%
Covered Bonds	**-276**	**-26%**
Private Sector, Net Asset	**169**	**16%**
Assets	1 213	113%
Gross Private External Debt (excl. Covered Bonds)	1 044	97%
Total Net External Debt	**-444**	**-42%**

Source: Bank of Spain, International Investment Position.
Note (1) FDI is allocated to the private sector and reserves are regarded as central bank assets.

By item, the **public sector's debt position was slightly over 30% of GDP**, in the mid-range between Italy (38% of GDP) and Germany (14% of GDP), and far below countries such as Austria (51% of GDP). Debt adjustment is expected to continue as the public deficit gradually declines.

In addition, as Figure 16 shows, Spanish sovereign debt, including other commitments not included in the European Commission's definition, is lower than the levels in place in Germany, France and Italy.

Figure 16. International comparison: "expanded" sovereign debt (% GDP)



** Nordic countries: average of Finland and Denmark.*
Source: Bank of Spain and IMF.

Private sector foreign debt in covered bonds, in turn, is equal to 26% of GDP. This debt is offset by mortgage payments, which, in light of households' overall financial health (see the following paragraphs), should give investors no cause for concern, for savings suffice to cover this debt.

Excluding covered bonds, the remainder of the **private sector shows a positive net balance of approximately €172 bn (16% of GDP)**. This position can be largely explained by the following:

- Total private assets are worth 113% of GDP, mainly from Spanish companies' intense direct investment abroad, with Latin America hosting a fair proportion of the total €496 bn (46% of GDP). By value, the country's FDI in Latin American accounts for 50% of Europe's total investment there.
- Foreign liabilities or debt total 97% of GDP. This total excludes equity capital (equivalent to 50% of GDP), mostly comprising FDI inflows[7] that by definition entail no repayment obligation.

Adding this equity capital (50% of GDP) to Spain's net foreign debt position (42% of GDP) yields the 92% net foreign position reflected in official data.

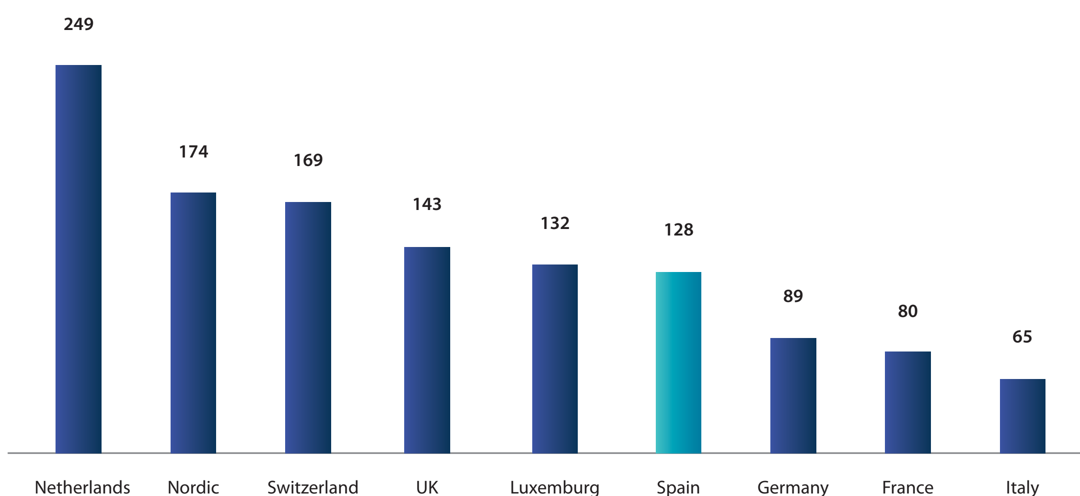
Why are households not a cause for concern? **Because their indebtedness is in proportion to the levels observed in other European countries, while the financial burden is lower and deleveraging is underway, associated with a savings ratio in line with the historical mean**.

- **Since the mid-2010 peak, Spanish households' debt has fallen by almost 7pp of GDP vs the 0.5pp decline recorded in the euro zone excluding Spain**. This constitutes a 49 bn euro downturn.

7 *This includes foreign actors' capital holdings in Spanish companies.*

- Although Spanish households' debt to GDP ratio is higher than in Italy, France and Germany, a comparison to other European countries in terms of disposable income (the real indicator of repayment capacity) shows **Spain to be in the mid-range and clearly below the Netherlands (120pp less), Switzerland, UK and the Nordic countries** (46pp less debt with income) (see Figure 17).

Figure 17. Household debt/disposable income (%, 2010)



- Even so, the **financial burden (amortisation + interest) in Spain**[8] **amounted to 25% of disposable income, below the level in France (28%) and similar to the rates in place in Germany and Italy** in 2008, as well as to Spain's historic average.
- Lastly, with the savings to disposable income ratio holding steady at 11.6. **Spanish families have a 25 bn euro**[9] **surplus after debt payback and acquisitions. This is equal to approximately 2.3% of GDP** at year-end 2011.

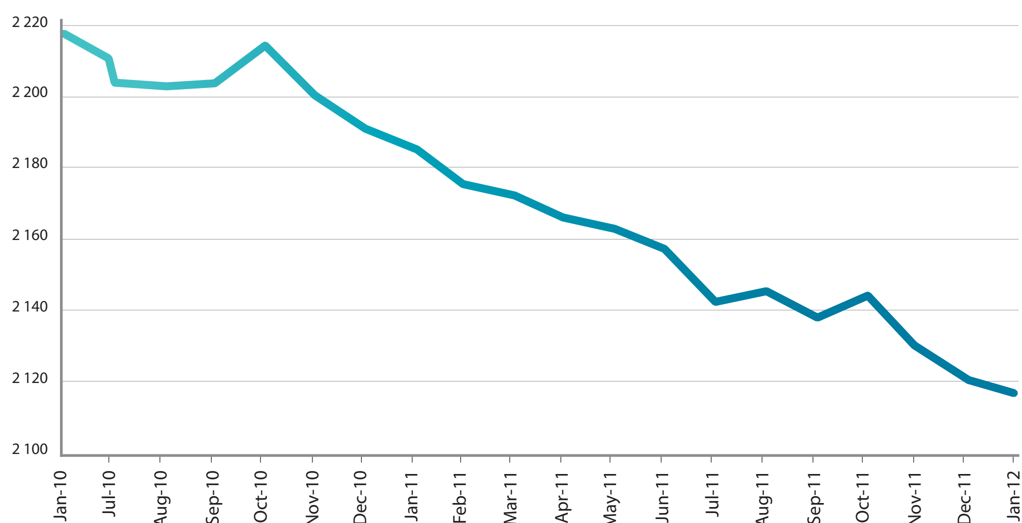
As in households, **deleveraging is underway in the business sector, more intensely than in other countries**. While Spanish business indebtedness fell by 8pp of GDP from its 2010 peak, debt in the euro zone excluding Spain dipped by only 0.9pp.

8 Most recent standardised European data available from the ECB.

9 Households' payment capacity is defined as the difference between savings and investments. In other words, positive capacity is an indication that investments are smaller than savings and that, therefore, not only is borrowing unnecessary but that savings exceed investment needs.

Thus, overall, since the second quarter of 2010, household and company debt has declined by over 100 bn euros (around 15pp of GDP) (see Figure 18).

Figure 18. Household + company non-financial loans (bn euros)

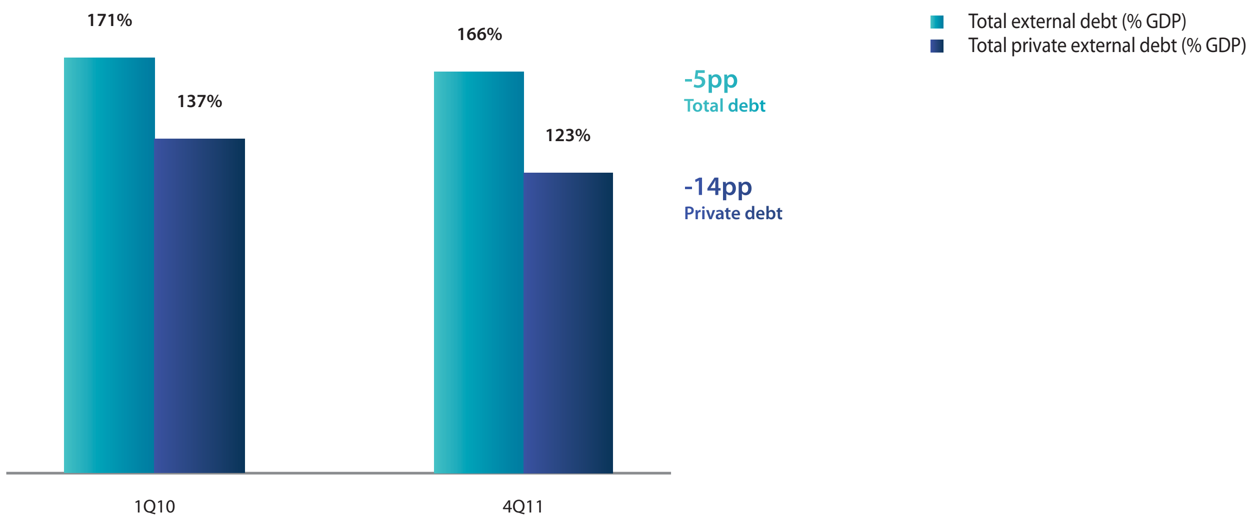


Furthermore, Spanish companies are recording 10.6% increase in operating profits, for a 42% margin over added value and an investment level of nearly 25% of the added value generated. This is to be added to an available **cash flow net of investments of close to 16.8 bn euros, or approximately 1.6% of GDP** at year-end 2011.

The Spanish business sector, excluding the real estate and property development industries, is not highly indebted (50% of GDP net of real estate) when compared to the European average (53%). Consequently, intense deleveraging is not strictly needed in this segment.

Spain's gross foreign debt (166% of GDP) **is therefore lower** than in countries such as France or Austria (208% of GDP), and on a par with Germany's. Moreover, according to recent quarterly data, the ratio of both **total foreign debt (public and private) and foreign private debt to GDP** has begun to decline (see Figure 19). Since peaking in 1Q 2010, private debt **has slid by about 14pp of GDP**, while total indebtedness fell by 5pp.

Figure 19. Foreign debt

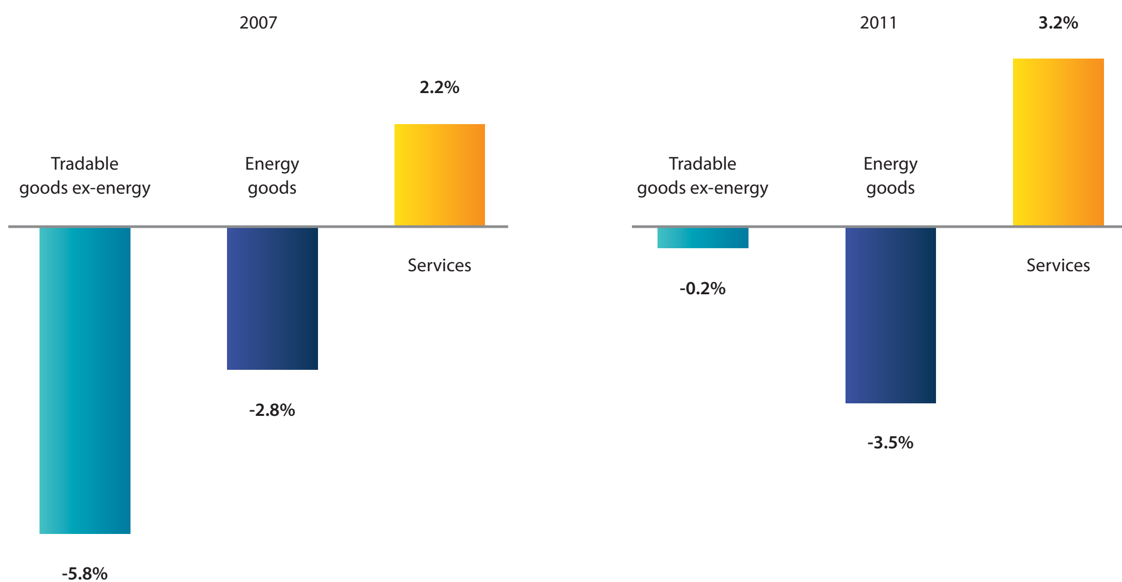


The record decline in the current account deficit will continue in the future, lowering Spain's dependence on the foreign sector and ensuring external debt sustainability.

Beginning in 1997 and the ten year economic "boom", Spain's current account deficit grew steadily (see Figure 20), peaking in 2008 at 10% of GDP. With the onset of the economic crisis and the improvement in exports outlined above, the

deficit has tumbled to practically one third of that figure, or 3.5% of GDP in 2011. That near record-breaking 6.5pp decline is the largest observed in the euro zone countries since the inception of the crisis.

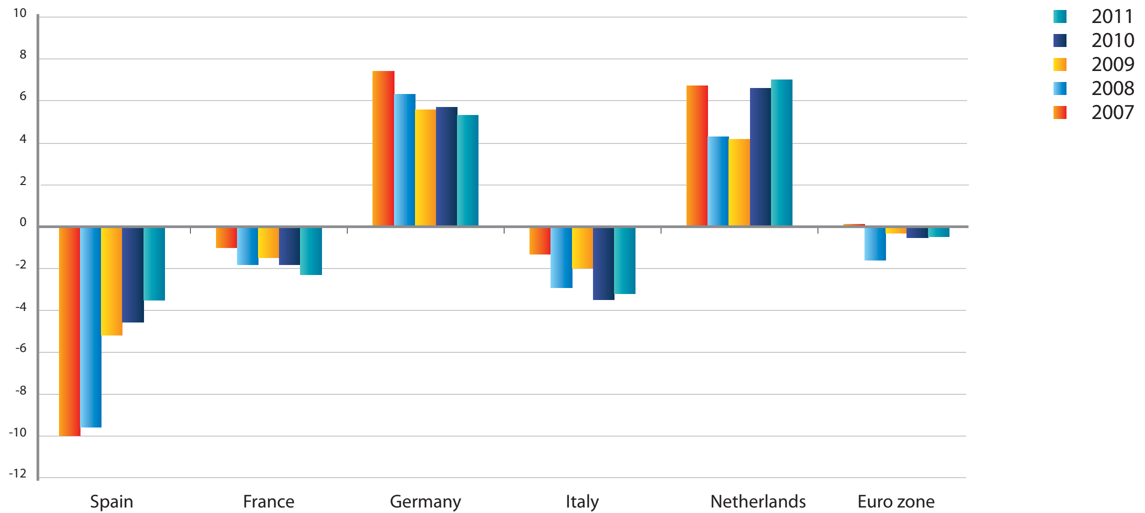
Figure 20. Variation in current account balance (% of GDP)



The current account correction mirrors the spectacular advance in the ex-energy balance of trade. The deficit in this "ex-energy" balance peaked at nearly 6% of GDP in 2007, although it has all but disappeared in just 4 years (see Figure 20). The improvement in the balance of trade could have been even larger if the country were less dependent on foreign energy, whose price has risen steeply worldwide.

Spain's deficit is currently similar to Italy's and near the level in place in France.

Figure 21. Variations in current account (% GDP)



According to analysts[10], this improvement in external accounts will be sustained in the future, and the forecast is for a current account deficit of less than 1% of GDP and a trade deficit of less than 2.5% of GDP against a four-year horizon (see Figure 22).

Figure 22. Current account and trade balance (% GDP)

	2012	2013	2014	2015	2016
Current Account (% GDP)	-2.1%	-1.7%	-1.3%	-0.8%	-0.4%
Trade Balance (% GDP)	-2.3%	-2.1%	-2.2%	-2.0%	-1.7%

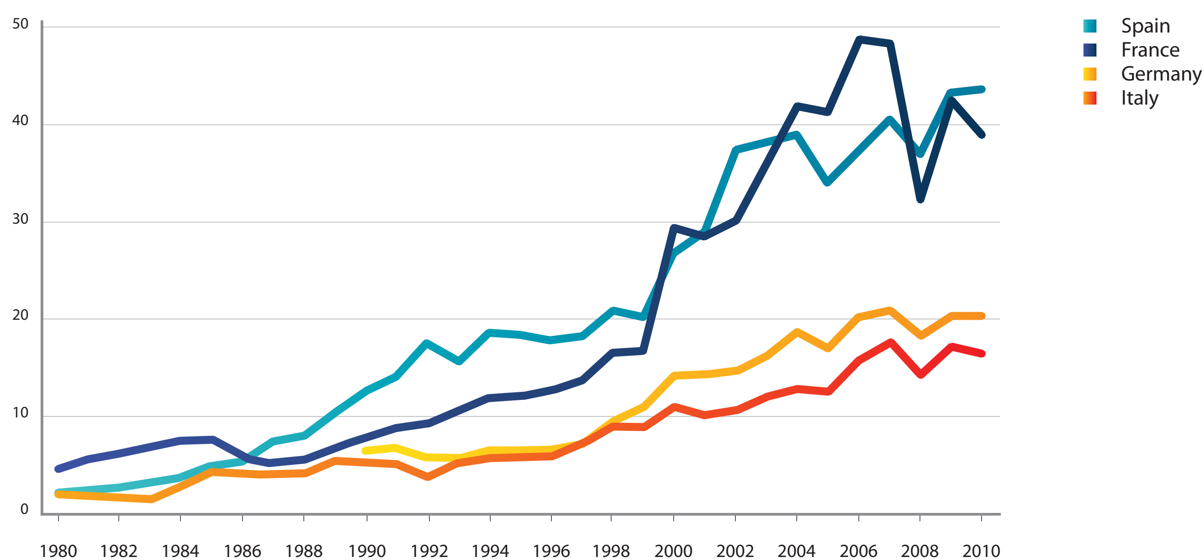
Furthermore, the current account deficit could be amply funded by FDI flows, which averaged 2.4% of GDP p.a. in the last two years (2010 and 2011) and 3% of GDP in the last ten.

10 Consensus Forecast, March 2012.

FDI inflows that more than offset the current account deficit stand as proof of Spain's appeal

With inflows of €30 bn in 2010 and €19 bn in 2011, cumulative FDI from 1980 amounted to 44% of GDP, nearly trebling the Italian figure and more than doubling Germany's. Moreover, FDI has continued to flow into Spain despite the crisis, whereas it has stagnated in Italy and Germany and deteriorated in France (see Figure 23).

Figure 23. Stock of FDI in Spain, France, Germany and Italy (% GDP)



Spain's appeal is based not only on its population size, the fourth-largest in Europe, but also of its status as an ideal jumping board to one of the world's most dynamic growth regions, Latin America with its population of 600 million and a rapidly expanding middle class (up by 150 million over the last 10 years).

This connection has also made Spain an attractive FDI target for Latin America's increasingly important multinationals, which view the country as an ideal platform for entering the European market. Forbes' most recent ranking of the world's 2 000 largest listed companies includes 70 from Latin America (33 Brazilian, 16 Mexican, 9 Chilean, 6 Colombian, 2 Argentinean, 2 Peruvian, 1 Venezuelan and 1 Panamanian) that are keen on expanding in Europe.

Spain is the third most attractive R&D location in Europe for foreign companies[11]. In the last 5 years, one of every three investment projects hosted was in high technology industries involving substantial R&D. Since 2003, only the United Kingdom and France have hosted more foreign R&D launches, while approximately the same number were opened in Spain and Ireland. Foreign companies who are world leaders in research-intensive industries such as pharmaceuticals or high technology (DuPont in Asturias) have chosen Spain to set up their research centres.

Spain remains in the world's top 15 for "brand" image or reputation, and, alongside Germany and Switzerland, is the only European country with at least 2 cities amongst Europe's preferred investment targets, i.e., the 20 locations regarded as the most attractive or desirable for doing business on the continent[12]. The availability of qualified staff, ready market access and the quality of inter-city and international transport and telecommunications networks are among the features that give Spanish cities a competitive edge in attracting foreign investors.

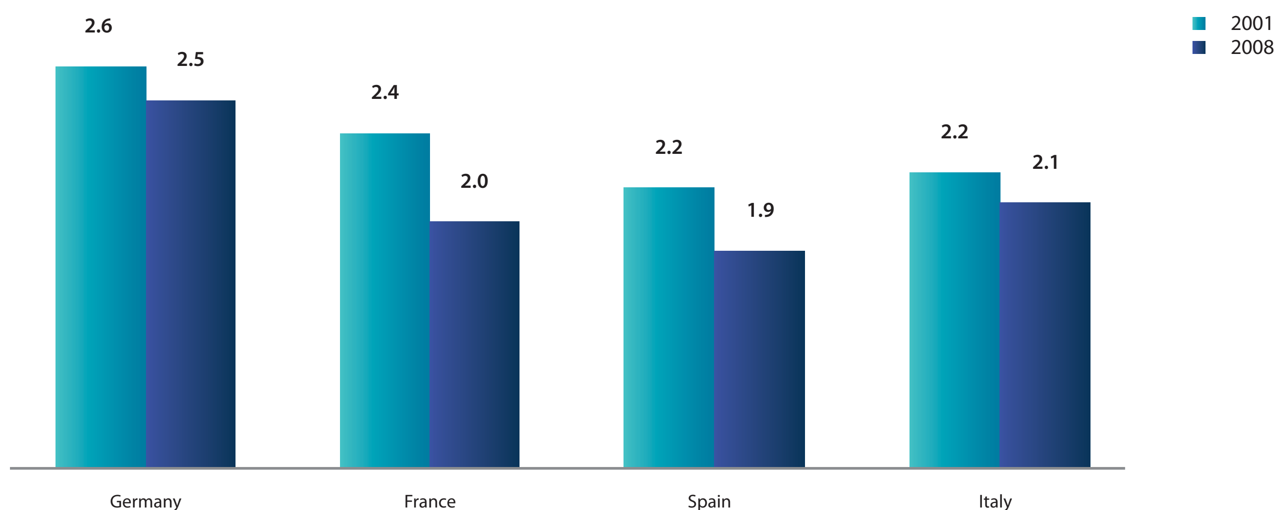
Spain continues to be a world reference in talent, ranking 3rd or 4th amongst European Monetary Union countries in terms of talent recruitment and the quality of its compulsory education, as well as its universities and business schools[13].

11 "La I+D de las empresas extranjeras en España: hacia una mayor colaboración", Complutense University of Madrid, 2012.
12 "European Cities Monitor 2011", Cushman & Wakefield.
13 Heidrick y Struggles. "Mapping global talent. Essays and Insights", 2012.

The country stands in fourth place in the Monetary Union for connectivity[14], one of the keys to potential growth and increasing productivity.

Regional inequality is lower in Spain than the other three large European nations (Germany, France and Italy), and imbalances have been reduced in recent years. While regional convergence is a Europe-wide pattern, it has been more intensive in Spain (where the ratio dropped by 12%) and France (a 15% fall) than in other comparable countries, including Italy and Germany (with reductions of around 5%.

Figure 24. Regional convergence in Europe: richest region/poorest region GDP per capita



Spain ranks sixth in the European Union for economic freedom[15], above comparable countries like France, Italy and Belgium.

14 Connectivity Scorecard 2011.
15 Index of Economic Freedom 2012.

5 Charting the course to budgetary stability while safeguarding growth

In 2011, pooling all levels of government, the public deficit came to 8.9% of GDP, exceeding the 6% target. Two-thirds of this deviation was attributable to the regions or autonomous communities and 20% to the social security system. Analysis has shown that 90% of the deviation was owing to over-estimated revenues.

Due to this wider gap in 2011, the deficit will have to be trimmed by 63 bn euros (5.9pp of GDP) in two years (through 2013) and additional measures, estimated to amount to 21.5 bn euros (2.0pp of GDP) will be needed to offset the impact of economic deterioration on the deficit. Therefore, **in all, the 2013 target entails adjustments totalling 84.5 bn euros** (7.9pp of GDP), around **59.5 bn** of which **will have to be implemented in 2012.**

To date, the **measures announced for 2012-13 (for €66 324 bn) are as follows**:

- The Central Government will adjust for €25 311 bn in 2012 (75% by raising revenues and the remainder by lowering expenditure) and €13 337 bn in 2013 (67% revenues and 33% expenditure).
- The regional governments will institute a €21 409 bn adjustment in 2012 (30% revenues and 70% expenditure) and €6 267 bn in 2013. This will include constraints in healthcare and education.

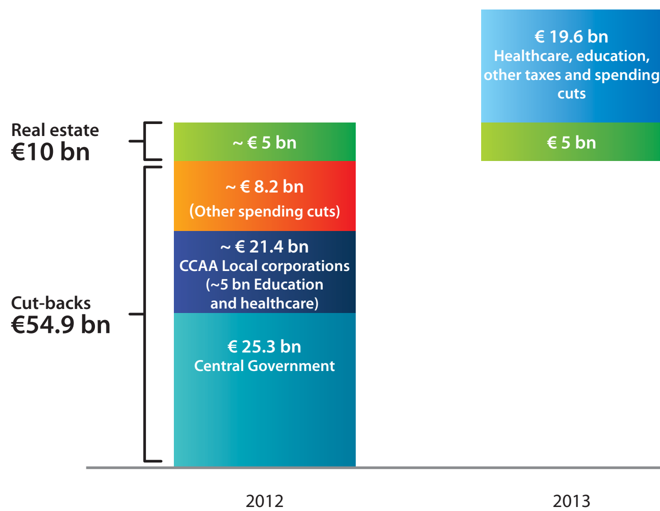
Moreover, the ultimate target can be reached by capitalising on other sources of savings and revenues, such as cuts in government spending (90% of the total) and the elimination of tax relief measures (10%), which would together total 20 bn euros.

In as much as the tax burden in Spain is lower than in most countries that have had to institute such adjustments, the country has ample room for manoeuvre.

Lastly, the government could also readily raise €10 bn by selling real estate assets. In addition, the Spanish State still holds stakes in companies and other assets worth at least 30 bn euros (although the stock is higher), a sum that could be used to lower debt via bond repurchases. Both options are envisaged in the National Reform Plan[16].

16 A Financial Coordination Committee for Real Estate and Asset Measures has been created to implement a public assets action and rationalisation plan. The action envisaged includes: i) inventorying the State's owned or leased property assets (by late April 2012); ii) negotiating lower rents on leased property; iii) instituting an action plan for owned assets to restructure occupancy and lower costs; and iv) reaching a restructuring and rationalisation agreement for State-owned companies.

Figure 25. Fiscal adjustments to meet the 2012-13 targets (~€84 bn)



The measures announced and the margins in place make the target credible, although ease of compliance will be uneven. While the Central Government can comfortably meet its objectives, the autonomous communities will need to announce additional measures and curb their dependence on transitory factors. Measures such as the new **Budgetary Stability Act** and the implementation of the **payment plan for suppliers** strengthen Central Government's mechanisms to control regional accounts.

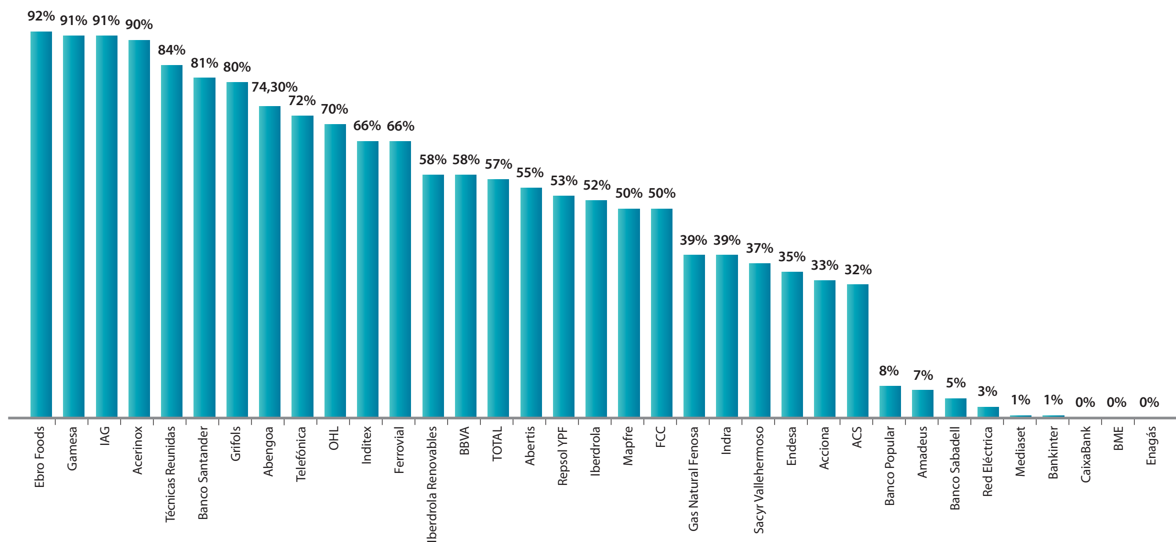
If Europe, pursuant to its commitment to maintain a small (or in Spain's case, nil) structural deficit, decides to gear its action toward reducing the structural deficit, the margin would be much wider. The **structural deficit** the one obtained substracting structural revenues from structural spending **would be approximately equal to 2% of GDP at year-end 2012**. If the target deficit of 3% of GDP is attained in 2013 (fiscal deficit), the government will have lowered the structural balance to around the 0% target. **In that case, the objective laid down in the Budgetary Stability Act and the Treaty of Stability, Coordination and Governance, would be achieved seven years ahead of schedule**.

6 Spanish companies are highly competitive

Intense international expansion of Spanish firms, whose foreign subsidiaries book sales of over €200 bn

The successful internationalisation of large-scale Spanish companies in recent years should encourage Spanish SMEs to venture abroad, learning from that model and capitalising on the attendant business opportunities. In 2011, 6 of every 10 euros invoiced by Ibex 35 companies (with HQs in Spain) were generated abroad. In total, foreign business generated €207 bn in revenues, and on average, practically half of IBEX 35 companies' operating profit before tax and interest is attributable to their presence abroad[17]. By industries, manufacturing is most prone to locate in other countries, with foreign turnover of close to 70% of the total. In 2010, 35 to 79% of Business Competitiveness Council members' turnover was generated outside Spain. The graph below shows the foreign turnover for all IBEX 35 companies.

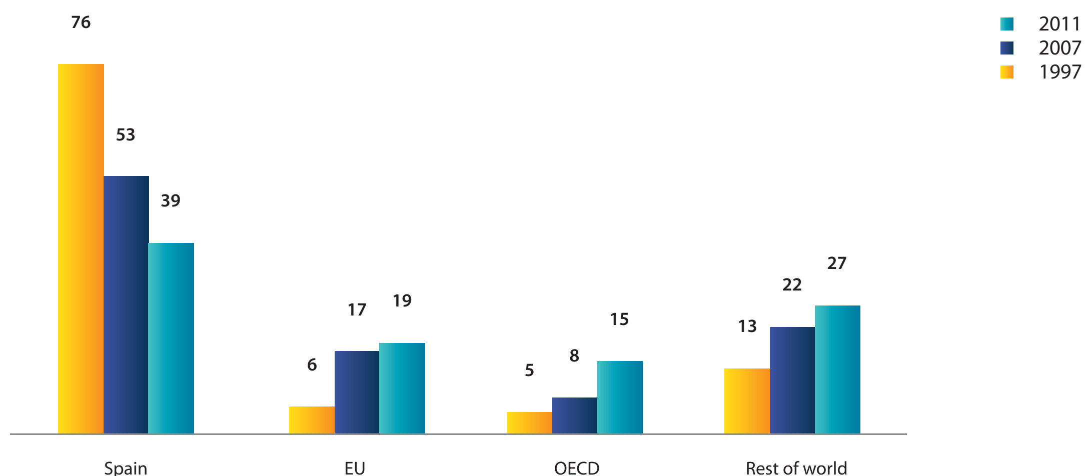
Figure 26. IBEX-35 companies' foreign turnover as a % of total (June 2011)



17 Information supplied by Banco Santander, referred to 2010.

Furthermore, Spanish large-scale companies have increasingly focused their international expansion on emerging markets (Latin America and Asia), thereby benefiting from these economies' higher growth rates over the last ten years.

Figure 27. IBEX 35 companies: % of foreign revenues



Source: CNMV (the Spanish stock market regulator).

Franchising is another clear example of the **international expansion of Spanish firms**. In 2011 the number of Spanish franchises operating abroad rose by 3.4%, climbing to a record of 242 firms. Present in 112 countries, they totalled nearly 11 200 establishments, up by 9.7% over 2010. This irreversible trend is driven by the dynamics of the business itself, the assistance for participation in foreign trade fairs and support from the country's commercial offices abroad. Spanish franchises are therefore expected to continue to penetrate international markets.

Large Spanish companies have taken world-wide leadership positions

Large Spanish firms have adopted an international focus that has earned them world leadership positions in key industries. Some of the most prominent examples are summarised below:

- Telefonica is the market leader in 5 countries (Spain, Brazil, Argentina, Chile and Peru), and has a significant presence in 25 countries in Latin America and Europe. In all, it provides telecommunications services to over 300 million customers. In addition, thanks to its industry alliances, it reaches over 700 million clients, 10% of the world's population.
- Banco Santander, the euro zone's largest bank by stock market capitalisation, conducts business in ten major markets (Brazil, Spain, United Kingdom, Mexico, Portugal, Germany, Chile, Argentina, Poland and United States). BBVA, which is present in over 32 countries, is the industry leader in Spain, Portugal, Mexico and Latin America, and holds strong positions in the US, Turkey and China.
- Inditex is world leader in fashion retail, with eight trading formats and over 5 520 establishments in 82 countries. Along with Mercadona and El Corte Inglés, Inditex is among the world's 50 largest retailers. Mango is another world major: this number two Spanish textile exporter has over 2 000 stores in 105 countries.
- Spain also has a transnational major in insurance: Mapfre holds the top position in Spain and Latin America and has been present abroad since it began to internationalise in the mid-nineteen eighties. It now operates in over 44 countries on five continents.
- Spain is a world leader in the field of renewable energies. Iberdrola the leading wind farm operator world-wide by installed power (top spot in the US, the United Kingdom, Spain and eastern Europe) and one of the planet's largest electricity companies, conducting business in over 40 countries. Acciona is also one of top 10 wind farm operators in the world in terms of installed power, with an active presence in over 30 countries across five continents. In other renewables Abengoa is the European leader in thermo-solar power, and is also Europe's biggest bio-ethanol producer (as well as one of the main producers in the US and Brazil and the only producer worldwide with production facilities on three continents), with over 80 significant projects in 20 countries.

- A total of six Spanish infrastructure companies **(ACS, Acciona, Ferrovial, Abertis, FCC and OHL)** manage or have built nearly 40% of the world's main transport concessions, primarily airports, ports and motorways.
- The Spanish subsidiaries of Volkswagen, General Motors, Ford, Fiat and others make Spain the world's ninth and Europe's second largest automobile producer (first in industrial vehicles). Companies like Grupo Antolín ensure Spain's leadership in vehicle interiors manufacture.
- **Grifols**, a pharmaceutical major, is world leader in blood product technology and the third-largest manufacturer of blood derivatives. Its sizeable footprint covers Latin America, Europe, south-east Asia, Japan, Australia and China.
- **Sol Meliá** is the world's number one holiday hotel chain. It has prime positioning, since over 70% of its 300 hotels are in key tourist destinations the world over. **Barceló** Viajes, in turn, is present in over 17 countries and **Iberostar**, a national and international tourist industry leader, conducts business in 19.
- **Acerinox**, has the greatest stainless steel output capacity in the world (at 3.5 million tonnes) and operates in over 80 countries.

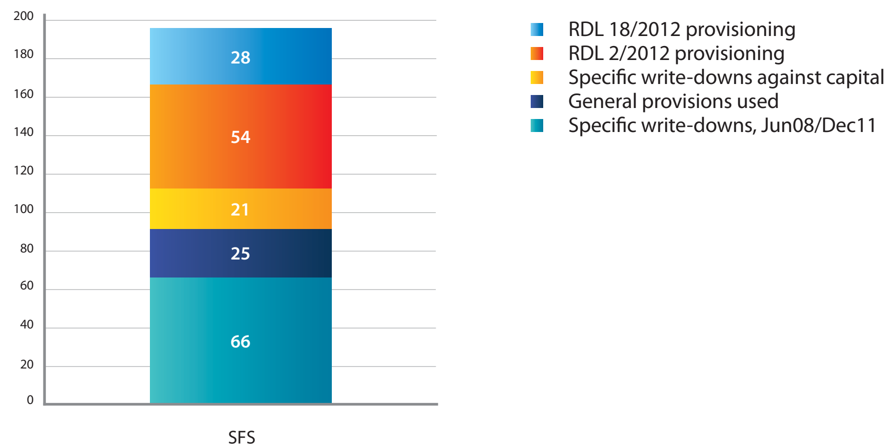
But Spain's large corporations are not the only companies responsible for international business expansion. **Smaller businesses have also successfully ventured abroad, and some have become world leaders in specific** growth and added value industries, such as:

i) High value added electronics and biotechnology.
ii) Consultancy and internet.
iii) Engineering and manufacturing.
iv) Fashion and restaurants.
v) Primary and natural resource processing.

7 Banking industry losses are clearly bounded

The banking industry has already made a determined effort to assume a significant portion of write-downs. In fact, provisions since 2007 have been worth €190 bn, figure that includes the measures set out in two recent royal decree-laws, RDLs 2/2012 and 18/2012.

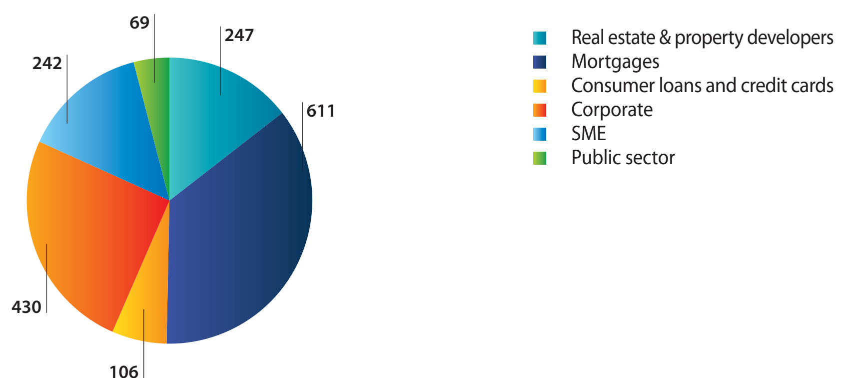
Figure 28. Spanish financial system losses since the onset of the crisis (in bn euros)



Source: Bank of Spain.

Despite from the provisioning for the real estate and property developer portfolio mandated by Royal Decrees 2/2012 and 18/2012, investors are questioning the losses that the financial sector might suffer in the rest of its loan portfolios, especially if the economic cycle proves to be more adverse than expected. However, an analysis of these portfolios, even assuming very severe conditions, shows that all losses are clearly bounded.

Figure 29. Spanish financial system exposure (bn euros)

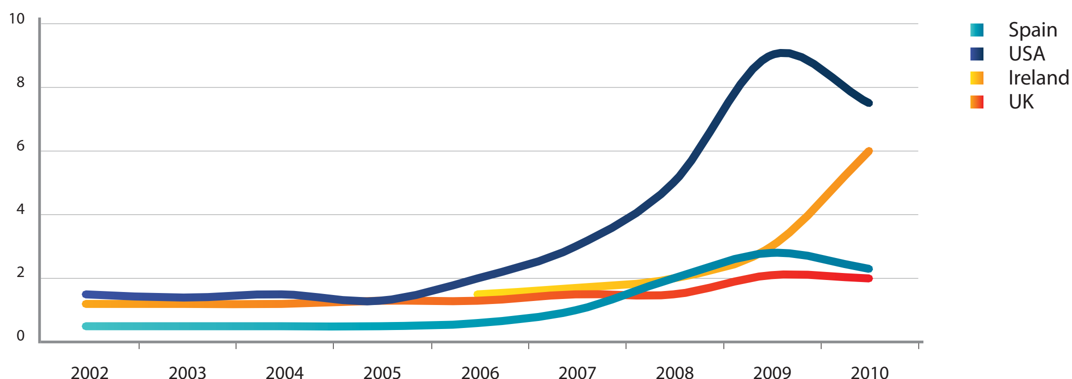


Source: Bank of Spain.

A loan portfolio analysis shows that while the rate of non-performing mortgages rose during the crisis, it remains at a moderate 3% and it is not expected to rise sharply in future. This can be attributed to several factors:

- Since prudent criteria were applied in granting these loans, the quality of the mortgage portfolio in the Spanish financial system is high, and at 62%, its LTV (loan to value) is lower than the 73% average prevailing in Europe.
- In Spain, the risk of mortgage default peaks 2 or 3 years after the loan is granted. Consequently, loans issued in 2006 and 2007 have already passed that landmark.
- Moreover, any refinancing undertaken has been conducted to Bank of Spain criteria and each institution's good practice standards.
- Refinancing has been fairly succesfull, with a high rate of return to health.
- The mortgage default rate is still at levels distant from the peaks recorded in other financial systems, such as in Ireland or the US (see Figure 30).

Figure 30. Non-performing mortgage rate (selected countries)



Source: IMF.

A comparative analysis of the Spanish financial system's mortgage portfolio reveals considerable strengths (see Figure 31).

Figure 31. Spanish mortgage portfolio indicators

		Germany	USA	Spain	France	Italy
Mortgage loans	% GDP	41%	74%	64%	43%	24%
	y-o-y	1.2%	-1.2%	-2.0%	6.2%	4.4%
Type of housing loan	Outstanding balance	4.5%		3.1%	3.9%	3.7%
Proportion of variable rates	%	16.0%	5.0%	83.2%	35.0%	66.5%
% home ownership	%	46.0%	67.0%	85.0%	57.8%	72.0%
Interest payments deductible		No	Yes	Yes	Yes	Yes
Foreclosure costs	% loan	7.5%		10.0%	9.5%	
Duration of foreclosure proceedings	Months	8		8	20	56
Mean LTV	%	70%	79%	62%	91%	65%

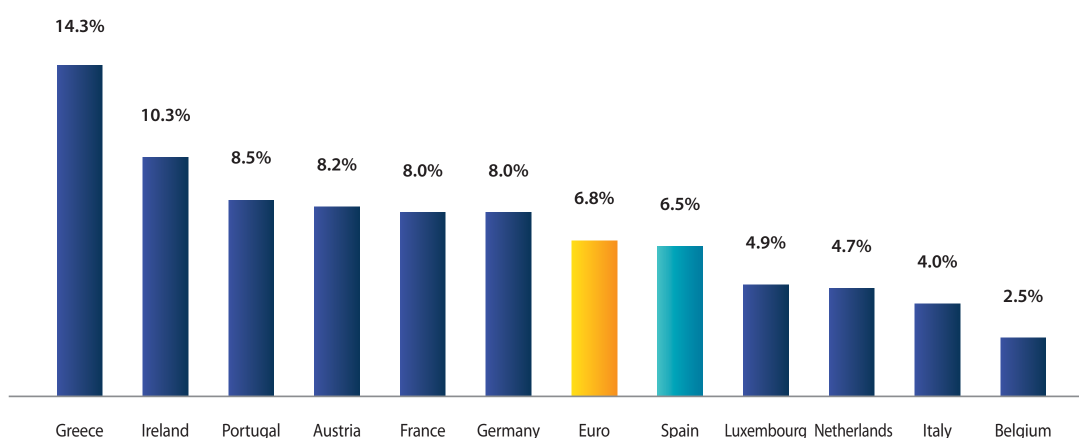
Source: BBVA Research.

- Firstly, in spite of the fact that housing loans amount to a high percentage of GDP, growth has been curbed, as shown by the negative year-on-year rates.
- Secondly, since mortgage interest rates are very low, the financial burden (payment/monthly income) is fairly small. These low rates are the result of the application of variable interest rates to most mortgages.
- The high percentage of owner-occupied housing in the Spanish economy makes honouring mortgage payments a priority in the family economy for sociological reasons.
- Lastly, although household wealth has declined due to the downturn in property prices, it is comparable to levels in place in other developed countries.

A second important segment comprises non-real estate, non-property development companies. Although loss forecasts may rise in the current phase of the cycle, industry fundamentals constitute a sound foundation. Indeed, the Spanish business sector, excluding the real estate and property development industry, is not highly indebted (50% of GDP in non-real estate), compared to the European average (53%), and is not therefore in need of any material deleveraging.

Lastly, the volume of the consumer loan portfolio is very small and loan terms are much shorter than in other areas. Any losses that might be expected in this sector are tightly bounded.

Figure 32. Consumer loans as % of GDP



Source: ECB.

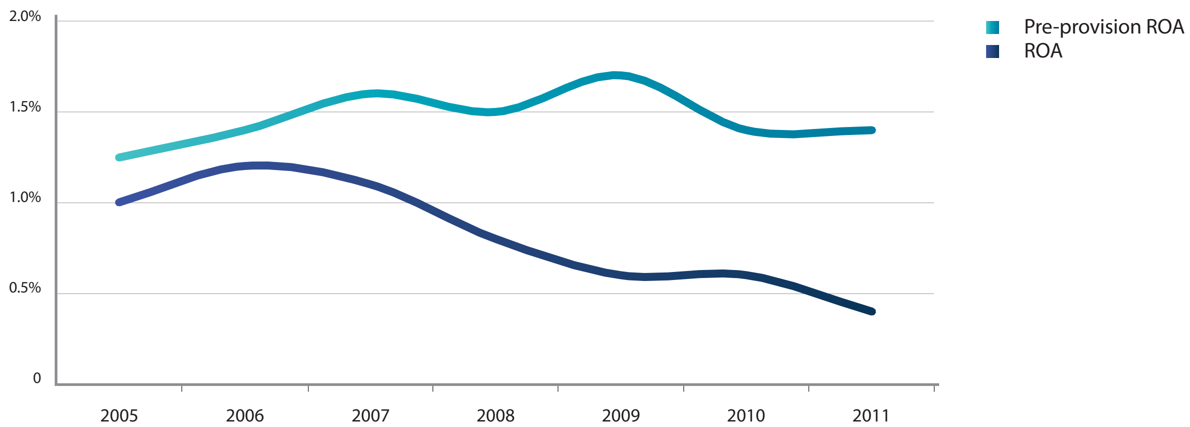
At this writing, the provisions in place for non-real estate, non-property developer portfolios stand at around 20 bn euros. The approximate coverage rate for default on consumer loans is 82% and for business loans 39%. These ratios are much higher than even the most pessimistic estimates of expected losses. Consequently, these portfolios should pose no problem in the medium term.

A number of analyses conclude that the inclusion of these three portfolios would lead to substantial losses. Nonetheless, the initial assumptions used in those analyses are overly pessimistic. Focusing on the mortgage portfolio, for instance, several analysts expect losses from 1 to 3%, estimating pre-provisioning write-offs for this portfolio of from 5 to 15 bn euros. Losses over 2%, however, would require non-performing loan rates on the order of 8%, which is more than double the current rate. Severity, in turn, would have to reach 25%, which would call for a mean drop of over 50% in housing values, given LTV, which presently stands at 62%.

Furthermore, the Spanish financial sector's earnings have proven to be resilient, with pre-provisioning profits since 2010 in the order of 30 bn euros. Under adverse macroeconomic scenarios, that figure might dip to around 27 bn. In short, if the portfolios described above deteriorated, the financial system would in a position to cushion future losses.

Moreover, other industry features bolster the income statement for the Spanish financial system. Firstly, higher performing margins for new operations raise average spreads. Secondly, the provisions required are one-off measures that will have no future effect. Thirdly, the commercial, customer-oriented banking model has proven able to generate operating profits (ex provisions). Finally, the capacity adjustments underway will have beneficial medium-term effects.

Figure 33. ROA before and after provisions

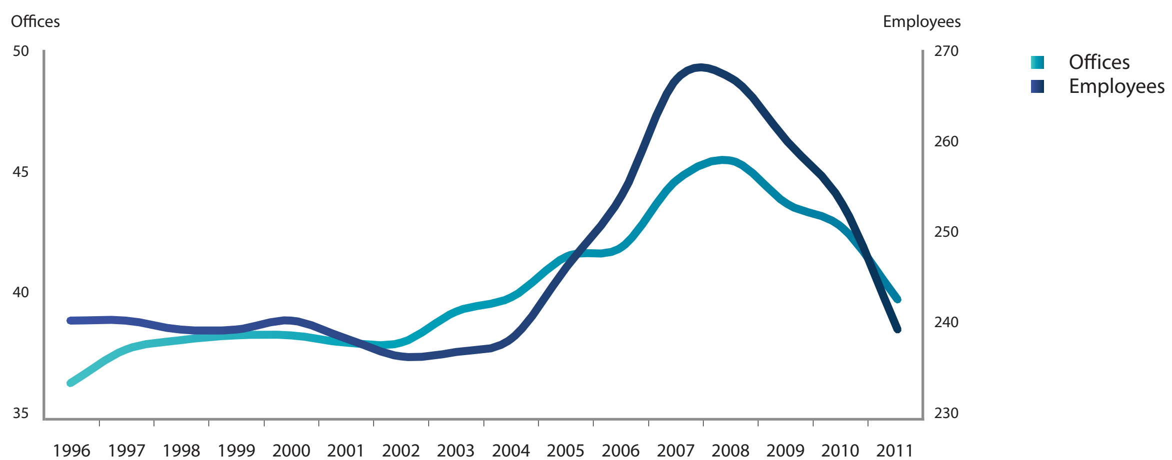


Source: ECB.

Since the onset of the economic crisis, Spanish authorities have put a good deal of effort into restructuring the country's banking system. Thus, **the number of institutions forming part of the system declined from 50 prior to the crisis to the current 14**, including the two institutions (Unnim and CAM) that were auctioned, the three under FROB (fund for orderly bank restructuring) custodianship (Banco de Valencia, Caixa Catalunya and NovaGaliciaBanco) and the takeovers of Banca Cívica (by La Caixa), Unnim (by BBVA) and Ceiss (by Unicaja). In addition, savings banks have now acquired commercial bank status. By the end of this year an estimated 15% of the banking system, with assets of 50% of GDP, will have been restructured.

Significant progress has also been made in terms of system rationalisation, with a substantial 12% reduction in the number of branch offices and employees. In depth reform of the national banking system is therefore underway.

Figure 34. Number of employees and branch offices in the Spanish financial system (thous.)



Source: Bank of Spain.

Restoring the financial industry to health will have no significant impact on the stock of sovereign debt

Royal Decree-laws 2/2012 of 3 February and 18/2012 of 12 May on financial system provisioning pave the way for a more concentrated, efficient and well-managed industry, with sustainable results and the ability to raise funds on the capital markets.

After application of Royal Decree-Law 18/2012, the sector **will have accumulated provisions and write-offs for a value of approximately €200 bn since the beginning of the crisis**.

- This translates into around 45% coverage of real estate exposure (54% of problematic and 30% of "normal" assets).
- It entails what is deemed to be a reasonable level of provisioning, 4-5% of the entire portfolio (2/3 for loans to large companies and residential mortgages, which are performing well, and 10% for consumer loans, which, given their short life, reached their lowest point in 2009-2011).
- The total figure, near 20% of GDP, is equivalent to 13-14% of the national banks' private sector loan portfolio, which stands at €1.5 trillion. Set against the backdrop of international experience elsewhere, this is a reasonable level.
- This loss scenario conforms to market analysts' base case.
- **Consequently, the claim that the absorption of crisis-induced losses is drawing to an end is backed by sound argument.**

This level of provisioning can be absorbed by the financial industry with a **very limited cost for the public sector**:

- **The industry has already provisioned or written off sums for €120 bn**.
- **The system can absorb €30 bn against capital generation of its own**, including the results for the next 2 years (pre-provisioning profits for each of the two years to come is estimated at €25-30 bn). Moreover, diversified institutions with significant business units abroad, together with foreign banks operating in Spain (which can resort to earnings and capital generation outside their domestic business), account for one-third of the system's loan portfolio.

- **The Deposit Guarantee Fund can absorb nearly €30 bn** (an extant €8 bn + €20 bn against industry contributions over the next 8-10 years). Although in the short term some analysts may regard this additional cost to constitute sovereign debt (given the time lag between system losses and contributions), in the medium term the costs will be assumed by the financial system itself. In light of pre-provision earnings stability, sustained even in an environment characterised by crisis and low interest, the risk that the financial system would be unable to assume the cost of its contributions to the Fund is deemed to be negligible.
- **The gross cost to the public sector (excluding the Deposit Guarantee Fund) will have no material impact on the total stock of sovereign debt**.

Re-structuring must, however, be suitably conducted, to which purpose the following measures are imperative:

- The capital plans that financial institutions submit to the Bank of Spain must be assessed with all due diligence. Action must be taken swiftly in the event of insolvencies to remove uncertainties as rapidly as possible. The State's recent injection of capital in BANKIA is in consistent with these premises.
- Incentives should be established to ensure that only mergers that make economic sense are approved, and political or other criteria disregarded.
- Entities with solvency problems must be identified and a permanent solution provided. The analysis of the industry by specialised independent firms in conjunction with the Bank of Spain will contribute to this end.
- A well-designed auction process for institutions judged to be unviable must be initiated: i) buyer pre-rating (based on their solvency, size, management capacity, experience of mergers); ii) simultaneous auctions to provide for combined or prioritised bids; iii) bidding price as the only quantitative criterion relevant to award; and iv) protection schemes to safeguard against potential losses.
- The reduction of over-capacity should be expedited. The number of branch offices fell by 12% between 2009 and 2011, while staff numbers in the industry declined by 10%. In addition, the number of savings banks has been lowered considerably since the onset of the crisis and application of RDL 2/2012 is expected to reinforce such consolidation.
- Transparent restructuring is essential to building the foundations on which credit can begin to flow again to productive activities, meeting the needs of solvent demand.

Further financial reform to dispel doubts about property portfolio provisioning: Royal Decree 18/2012

In May, the Government adopted further action to reform the Spanish financial system, with a dual aim: i) to complete real estate portfolio provisioning and ii) to enhance sector transparency.

The first component of Royal Decree 18/2012 focuses on the **provisioning and sale of real estate assets**, to **restore the health of the respective portfolios** through the implementation of two measures:

1. Institutions are required to supplement the sums provisioned under Royal Decree 2/2012:
   - The financial sector as a whole will provision a total of 28 bn euros before year-end 2012.
   - With that measure, the total provisions for the (problematic and non-problematic) real estate portfolio will amount to 137 bn euros in December 2012 (up from 55 bn in December 2011), against a total exposure of 307 bn (see Figure 35).
   - Property portfolio coverage will come to 45% of the total, compared to 18% in December 2011.
   - **This volume of provisioning is more than sufficient to dispel doubts of whatsoever nature about the portfolio. The result may even be over-provisioning**, as acknowledged by the legislation itself, insofar as it envisages the possible use of such provisions for other purposes if they are not consumed before year-end 2013.
   - **The timing is speedy: institutions must submit their plans within one month and the new provisions must be in place before year-end 2012. In the event of a shortfall in** equity or core capital, institutions may apply to the FROB (fund for orderly bank restructuring) for capital injections in the form of ordinary shares or contingent convertible bonds, also known as CoCos. In the latter case, institutions will be charged double the State's five-year financing costs.

- The overall provision established for the "normal" portfolio (30%) suffices to absorb any potential deterioration in these assets.

Figure 35. Developer loan-related real estate portfolios in the Spanish financial system: summary of exposure and provisioning

bn euros	Exposure	Provisions			
		Total	Dec-11	RDL 2/2012 measures Feb-12	RDL 18/2012 measures May-12
Total portfolio	**307**	**137**	**54**	**54**	**28**
Problematic	184	100	54	45	
Non-problematic	123	37		9	28
As percentage of total exposure					
Total portfolio		**45%**	**18%**	**17%**	**10%**
Problematic		54%	29%	25%	
Non-problematic		30%		7%	23%

Source: Ministry of Economy and Competitiveness, May 2012.

2. **Management companies** will be mandatory **to handle the real estate assets awarded**, which will be transferred for their fair value or book value less any provisions made. This measure will:
    - Segregate property asset management from institutions' loan business.
    - Enhance sector transparency.
    - Attract foreign capital, in particular investors specialising in the management of such assets.

The second component of reform is the introduction of two independent organisations, which will work in close conjunction with the Bank of Spain, to appraise institutions' entire loan portfolio. This component is crucial to the recovery of investor confidence.

In short, the reform approved in May constitutes a giant step toward recovering confidence in the Spanish financial sector and **completely eliminating any possible doubts about real estate portfolio provisioning needs**.

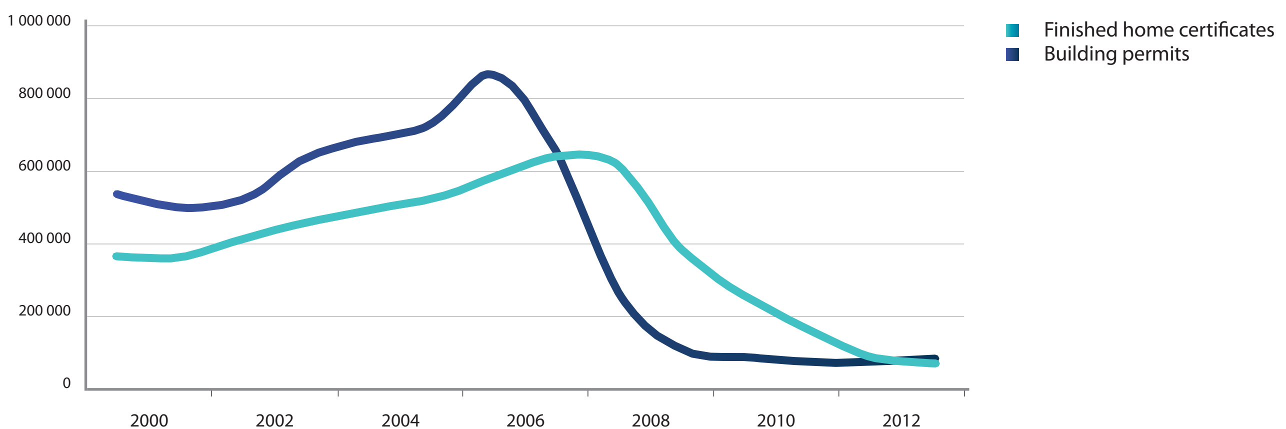
8 Spanish real estate: excess supply will be re-absorbed in 3-4 years

The impact of real estate activity on macroeconomic flows is drawing to an end

The real state sector is expected to lower economic growth by only 0.3 and 0.1pp in the next 2 years, compared to a mean negative contribution of 1.2pp over the last four.

On the supply side, **some sixty thousand units were built** in 2011, the lowest figure in recent history, and 89% below the annual average for the period 2000-2007. This is **far fewer than the number of dwellings per year**[18] **needed by the economy in the next 10 years, which ranges from 150 000 to 250 000**, depending on the estimate of new households created.

Figure 36. Spain: residential building permits and finished homes (units)



Source: Ministry of Internal Development, April 2012.

Residential investment as a percentage of GDP has declined by half in the last 5 years, from 12.5% in 2006 to 6.6% in 2011, and now stands at levels lower than the historic average and **matches European figures.**

Demand-side data suggest that sales in 2011 were down by more than 60% from the 2006 figure, although the 347 000 homes sold is commensurate with pre-boom levels.

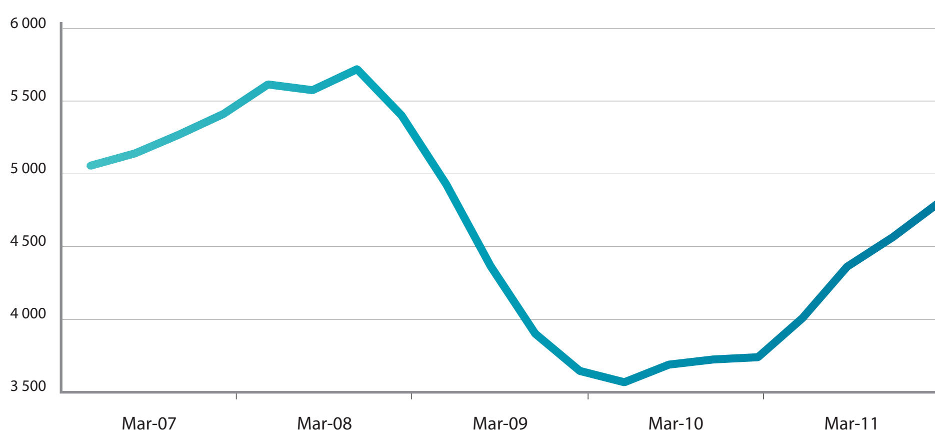
18 The economic crisis depresses household formation to below demographic trends (the current net pace is 140 000/year), although the rate will pick up as the 'macro' situation improves.

Despite a worsening of financial conditions for accessing credit, according to the Bank of Spain's hypothetical measure of new mortgage payments as a percentage of family income, **the burden on households has declined by over 15pp from the 2008 peak. The 29% recorded in the fourth quarter of 2011 conforms to the historic average**. The factors favouring such improvements include price adjustment and fiscal measures to stimulate demand, such as the reintroduction of the tax deduction for housing, one-off initiatives such as the VAT reduction for house purchases to 4%, and of course the reduction in interest rates. Similarly, the measures set out in RDL 18/2012, which include a 50% exemption in capital gains tax on the sale of real estate assets in 2012, are expected to fuel this process.

The new rules in RDL 18/2012 that **encourage housing rentals** will also contribute to invigorating the real estate market.

The weight of foreign demand in housing is growing: in 2011, foreign investment came to €4 747 bn (around 50 000 units per annum), 32% above the March 2010 nadir.

Figure 37. Foreign investment in housing (million euros)

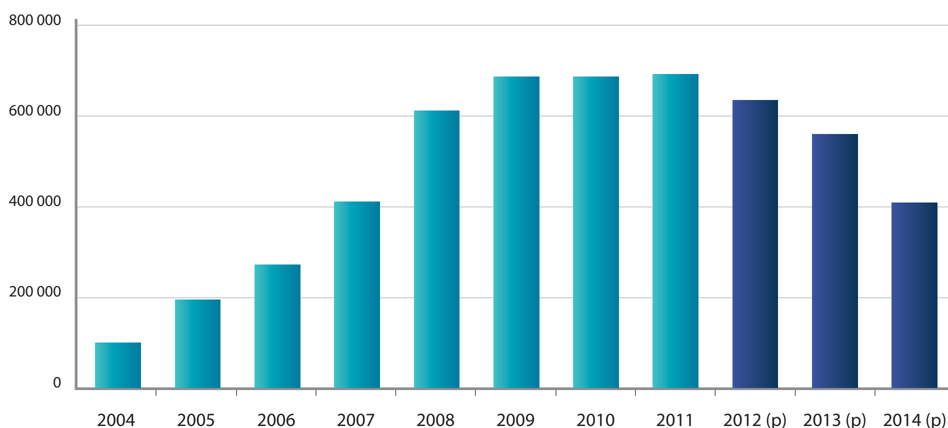


The housing stock is falling

The **stock of new housing** at year-end 2011 **was around 680 000 units**, essentially the same as in the two preceding years (the decline in the number of new units was offset by a downturn in the number of transactions).

The **housing glut is expected to disappear in 3 to 4 years**, when the target, i.e., equilibrium stock of around 200 000 to 250 000 new dwellings, should be reached.

Figure 38. Spain: stock of new housing for sale (units)



Source: Ministry of Housing and SESAN, March 2012.

Prices just 10% off corrected levels

Between the first quarter of 2007 and the first quarter of 2012, **housing prices slumped by 22% on average**[19] (27% in real terms), to the levels prevailing in 2003. The price imbalance identified by a number of academic studies has been nearly corrected[20].

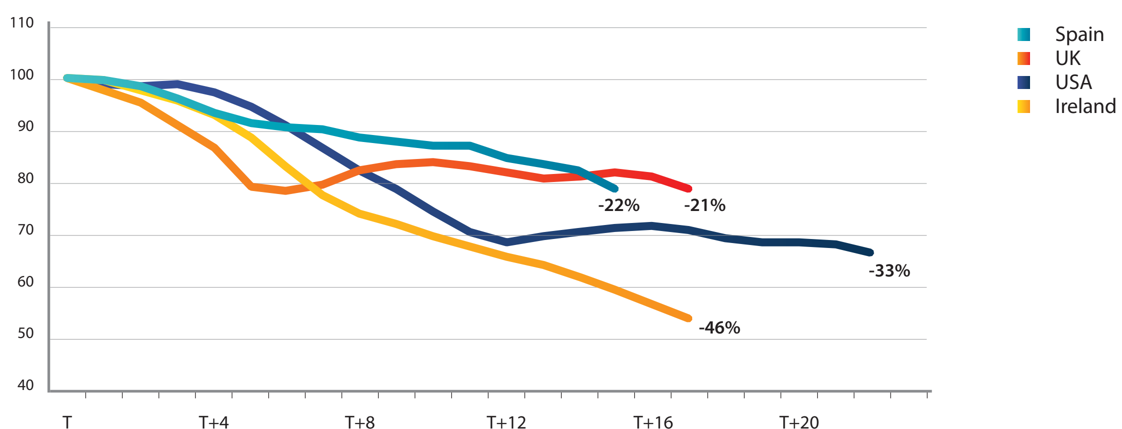
19 Figure drawn from Ministry of the Economy data. Private institutions such as TINSA set the adjustment at around 30%.
20 See the compendium of estimates in the IMF Country Report No. 11/216. Spain: Selected Issues.

Price adjustments have varied widely from region to region, with face value reductions of around 40% on the Mediterranean coast, as opposed to more moderate corrections in other regions (14% in Asturias, Extremadura and the Basque Country).

A further decline of around 10% is expected in 2012, although prices are unlikely to fall much farther, for two reasons:

- The intensity and timing of the present downturn are similar to the patterns observed in historic house price corrections in previous real estate crises in Spain.
- The slide is also similar to housing price corrections in other economies (United Kingdom) with a similar housing boom.

Figure 39. Variation in housing prices (peak=100)



Moreover, the reasons that keep housing prices higher than in other economies are still in place:

a. A decline in structural interest rates.
b. Mortgage market development.
c. Rising household income.

A highly provisioned financial system able to withstand 50% declines in housing prices

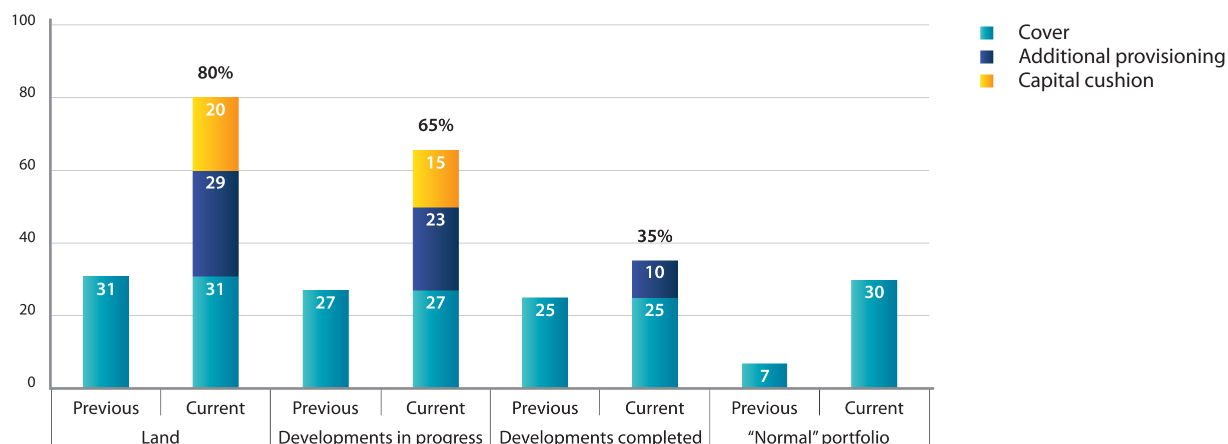
Banking industry exposure to the real estate-property development sector is around 300 bn euros.

The declining demand discussed above had a significant impact on the quality of the property developer loan portfolio. A solid 58% of that exposure (€175 bn) is rated as non-performing or sub-standard, or the respective security has been attached.

Pursuant to the latest legislation on financial system reform, provisioning requirements have been raised to 80% for land, 65% for developments in progress and 35% for finished developments rated as problematic. A 30% cushion has been established for the portfolio currently rated as normal. This has two implications:

- The coverage of real estate exposure must be raised from the present 104 bn to 137 bn, meaning that real estate-property development loan portfolio coverage will be 45% at the end of this year.
- Institutions are presently submitting their plans to the Bank of Spain, describing how coverage will be reached by year-end. The measures envisaged include using part of the generic cover built up previously and booking the charge against profits and net equity in the case of merged institutions, to supplement provisions by the respective proportion.

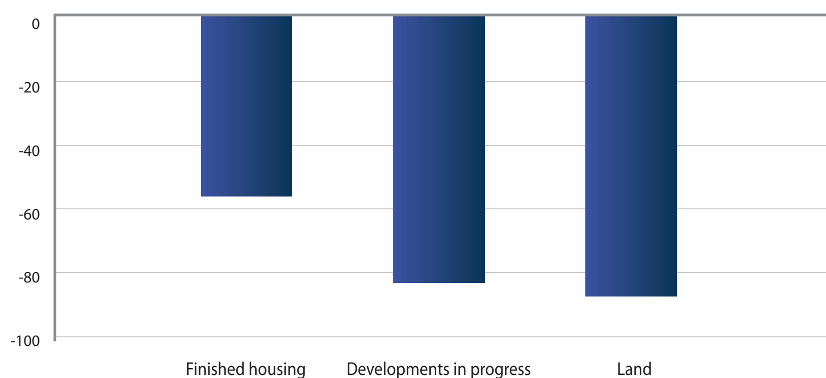
Figure 40. Additional provisions and the capital cushion (% coverage)



Source: Ministry of the Economy, April 2012.

According to Bank of Spain's calculations and given the average loan-to-value ratio in banks' portfolios, with current provisions for problematic assets, **institutions would be able to withstand declines of around 53% in housing prices, 82% in housing in progress and 87% in land**. Such declines would denote a very extreme scenario in light of the aforementioned factors.

Figure 41. Declines in prices compatible with the new provisioning percentages and the loan-to-value ratio for the problematic loan portfolio



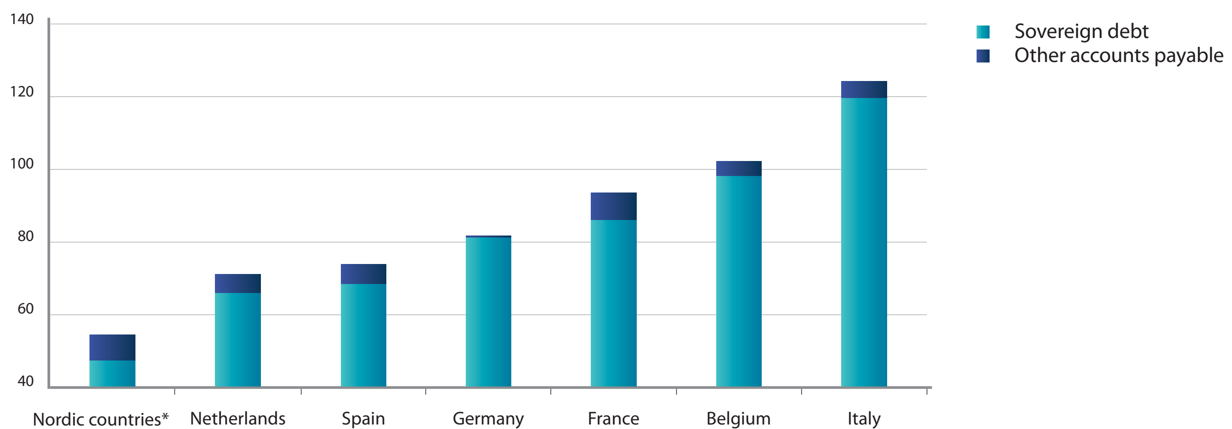
Source: Bank of Spain, April 2012.

9 Spain, over-penalised by sovereign debt markets

Spain has the lowest sovereign debt/GDP ratio (68.5% of GDP) when compared with the three biggest countries in the Euro Zone, (with ratios upward of 80%), and has committed to a higher fiscal adjustment than all three.

- Spain's official sovereign debt, in accordance with the European Commission's definition, stands at 68.5%, which is comparable to the figures in place in other European countries.
- Unpaid bills and State-owned companies' debts are not included in the official debt-to-GDP ratio as calculated by the European Comission. If, however, its definition were expanded to include all other accounts payable (to suppliers for instance), Spain's debt would amount to 75% of GDP. Under that criterion, however, it would be lower than in most other countries (see Figure 42).

Figure 42. International comparison: "expanded" public debt (% GDP)



Nordic countries: average for Finland and Denmark.
Source: Bank of Spain and IMF.

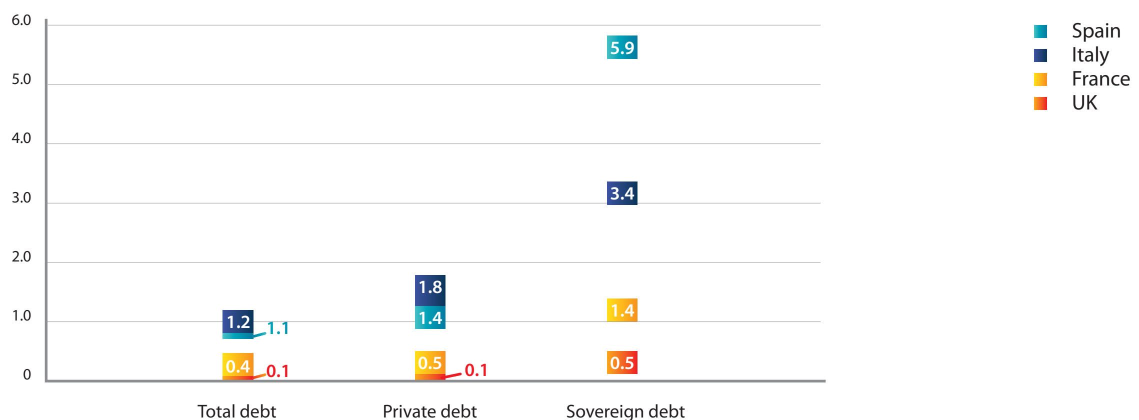
Spain's current sovereign spread of around 400 basis points[21] cannot be justified by the size or composition of its debt, its budget deficit or its growth potential[22].

21 Data from 5 April 2012.
22 Defined as long-term expected growth for each of the economies by the IMF in the Sept. 11 WEO.

The chart below illustrates the ratio between Spain's risk premium and total debt, private debt and public debt (expressed as a% of GDP), alongside the ratios for the United Kingdom, France and Italy. So measured, the current risk premium penalises Spain from 3 to 4 times more than France and over 10-fold more than the United Kingdom.

- Each point of total debt raises the United Kingdom's risk premium by 0.1 basis points and France's by 0.4, but for Spain by 1.1 bp.
- Spain's sovereign debt is the component most highly over-penalised: each point of sovereign debt translates into 0.5 bp of risk premium for the United Kingdom, 1.4 for France and close to 6 for Spain.
- Each point of private debt in the United Kingdom and in France raises their premium by 0.1 and 0.5 basis points, respectively, (much the same as for total debt). By that same measure, Spain's premium rises by 1.8 bp.

Figure 43. Risk premium/debt (% GDP):
markets over-penalise Italy and Spain vs France and the United Kingdom

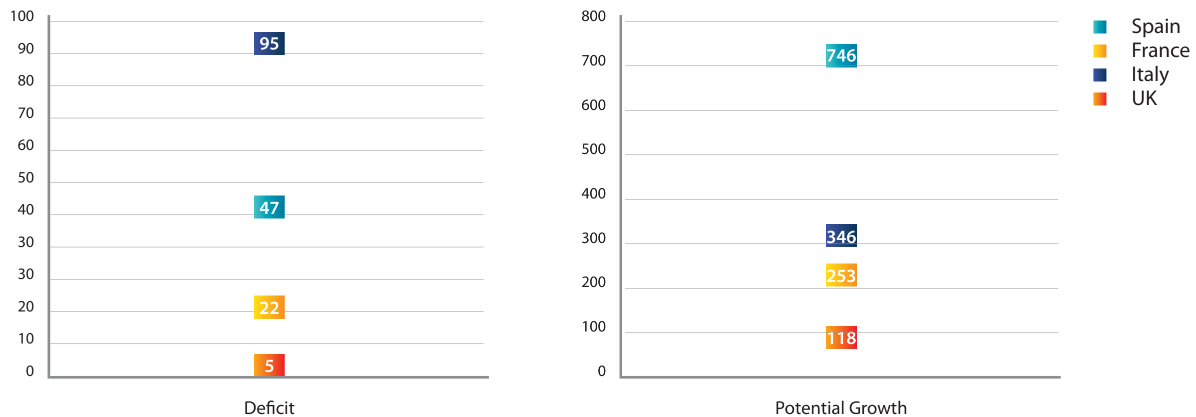


Source: Formulated by authors from McKinsey Global Institute data.

In addition (see Figure 44), each point of fiscal deficit is equal to just 5 basis points of risk premium in the case of the United Kingdom, and 22 basis points of premium for France case. The Spanish premium quadruples the French figure.

The situation vis-à-vis potential growth is similar: Spain is penalised 3 times as much as France, and 6 times more than the United Kingdom.

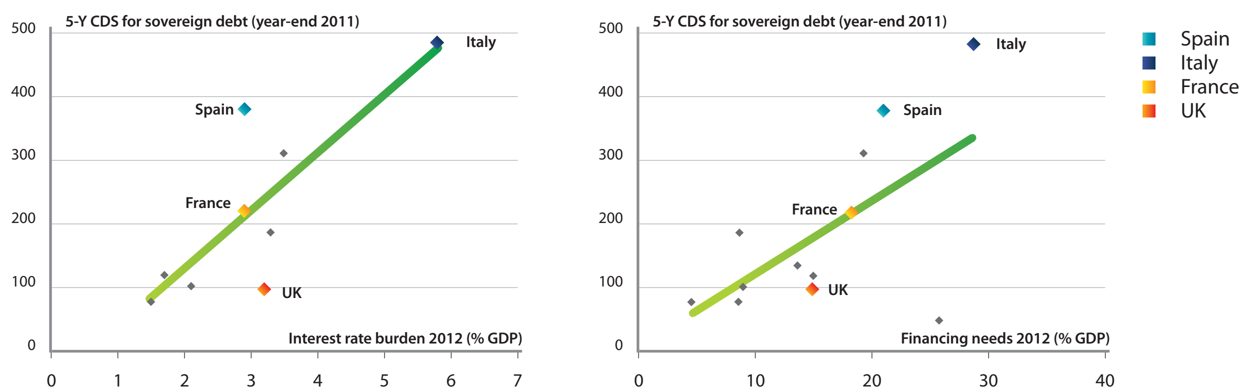
Figure 44. Risk premium vs budget deficit — Risk premium vs potential GDP growth*



* *Budget deficit calculated as the risk premium/sovereign debt ratio and growth potential as the risk premium/inverse of growth potential ratio to illustrate the inverse relationship between the two variables.*
Source: IMF.

The risk premium is also found to over-penalise Spain from the standpoint of variables such as borrowing or the interest rate burden. The charts below show the relationship between these two variables and the risk premium for a set of comparable countries. In both cases Spain's risk premium is substantially higher than might be extrapolated from the international comparison, whereas the United Kingdom benefits from a more favourable position than merited in light of its fiscal parameters.

Figure 45. CDS for Spain, France, Italy and United Kingdom

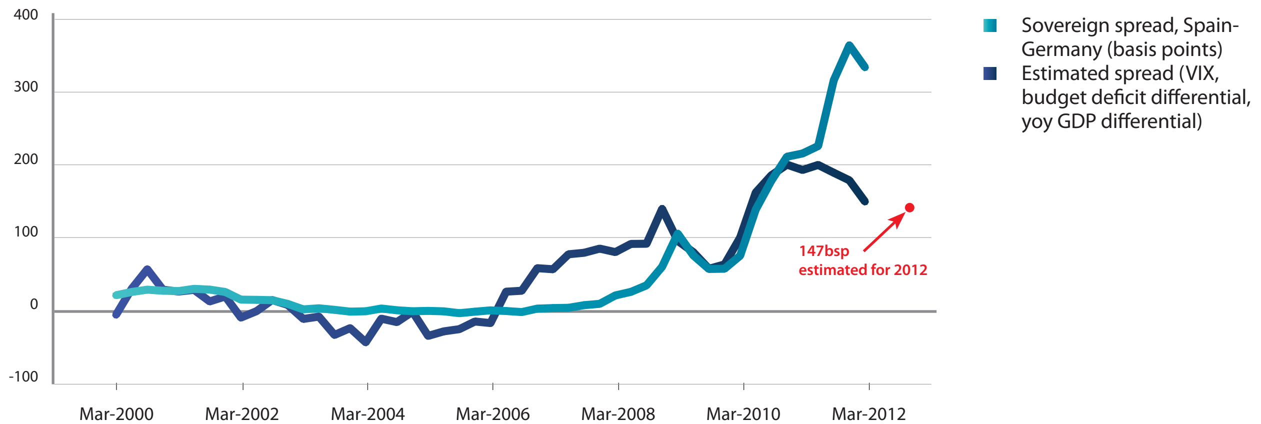


Spanish's risk premium over German financing costs should stand at around 150 basis points, further to historical patterns and on the grounds of the two countries' relative fiscal positions, year-on-year growth differential and stock market volatility (measured by the VIX index).

In 2012 as a whole, an improvement in Spain's relative fiscal position vs Germany of around 3 points of GDP would compensate for the slight difference in their respective business cycles (with a rise in the differential from 1.7pp in 1Q 2012 to 2pp)[23], to maintain a reasonable differential. The current risk premium, however, is actually more than double the estimated figure.

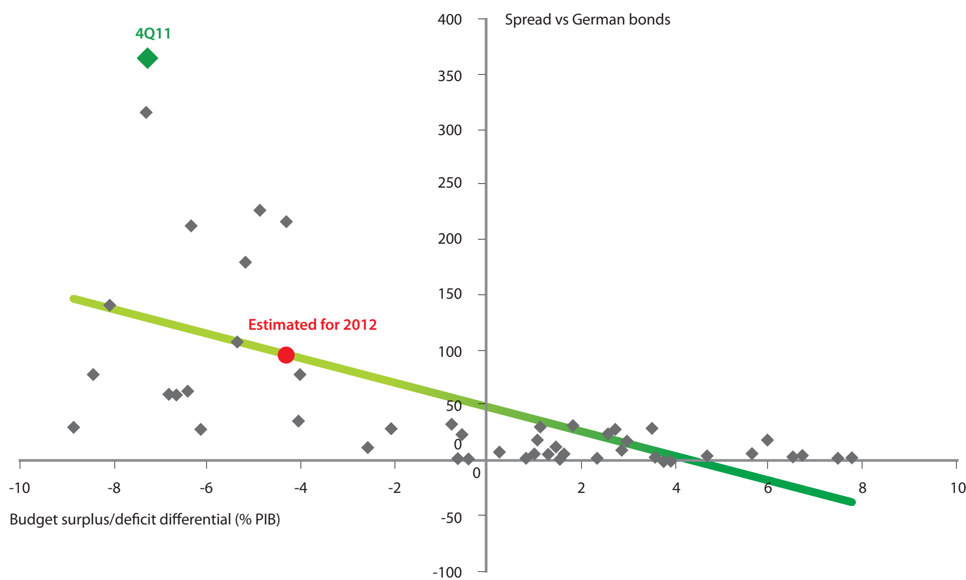
23 Assuming that the VIX global risk indicator holds steady at the at average 1Q 2012 levels (18.2 points), which is less than one standard deviation below its historic average (22 points).

Figure 46. Current and estimated sovereign debt spread, Spain-Germany



The chart shows the deviation between the market-listed premium and the budget deficit differential[24], which today would only justify a sovereign spread of 129 basis points, and 96 basis points throughout 2012.

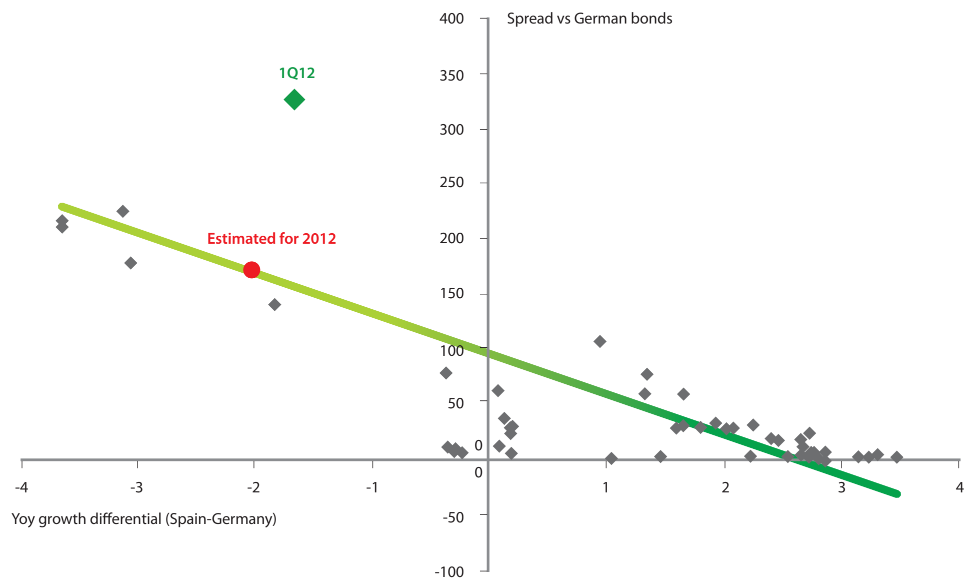
Figure 47. Budget surplus/deficit differential and spread vs German bonds (4Q 2011)



24 Difference = surplus (+) /deficit (-) for Spain less surplus (+) /deficit (-) for Germany, both expressed as a percentage of GDP.

In terms of the GDP growth differential between Spain and Germany, the hypothetical spread would be equal to 147 basis points in 1Q 2012 and 157 basis points in 2012 as a whole.

Figure 48. Budget surplus/deficit differential and spread vs German bonds (1Q 2012)



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