



***Kingdom of Spain***

***Economic Policy and 2010 Funding  
Strategy***

**Secretary of State for the Economy**  
February 2010



- **Highlights**
- **The long growth cycle and the crisis**
- **Fiscal consolidation and structural reform**
- **Funding Strategy of the Kingdom of Spain**

## Highlights

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- **Long growth cycle** previous to the international crisis
- Important challenges ahead: **Unemployment and deficit**, consequence of the crisis but also symptoms of underlying structural shortcomings
- The **Spanish Government is determined to act:**
  - Fiscal consolidation: A cut of **5.7%** of GDP in structural primary deficit in 2010-2013
  - Structural reforms to boost potential GDP: Sustainable Economy, Bank Reorganisation, Pensions, Labour Market
- **Strengths:** Sound financial system, low Debt/GDP, institutional ability for reform

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- **Highlights**

- **The long growth cycle and the crisis**

- **Fiscal consolidation and structural reform**

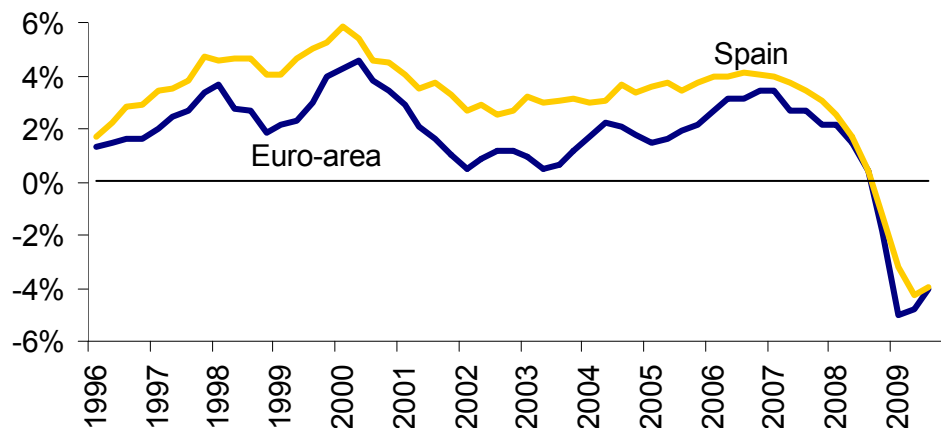
- **Funding Strategy of the Kingdom of Spain**

## 1994-2008: Convergence and Debt reduction

- **GDP per capita has leapt forward, exceeding the average of EU-25**
- **Fiscal rigour during the good times allowed debt to GDP to be more than halved**

### GDP

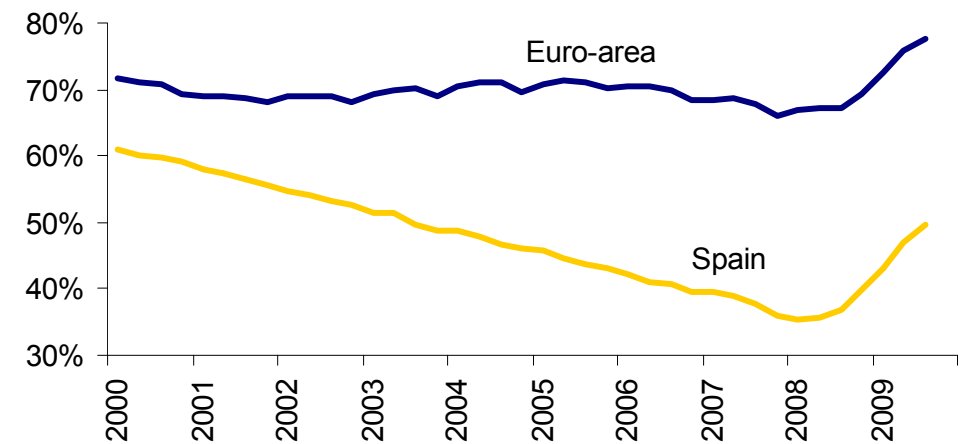
(Year on year real growth rates)



Source: Eurostat.

### Debt to GDP

(% nominal GDP)

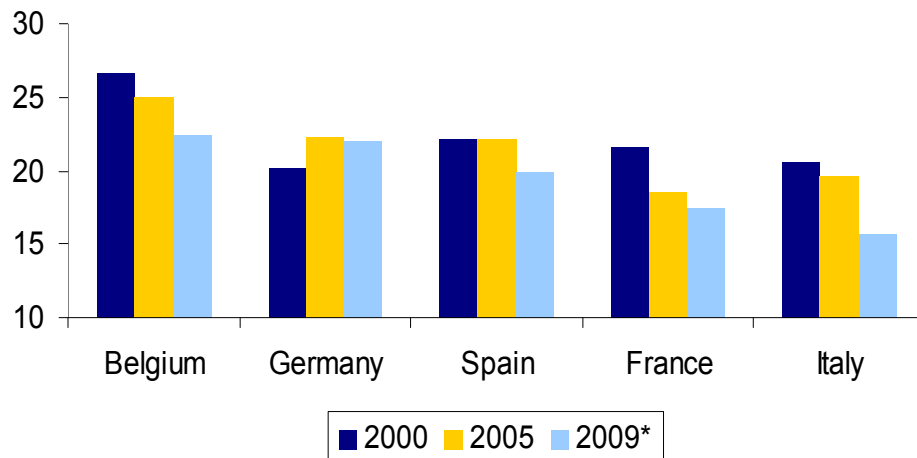


Source: Eurostat.

## Investment binge: housing and beyond

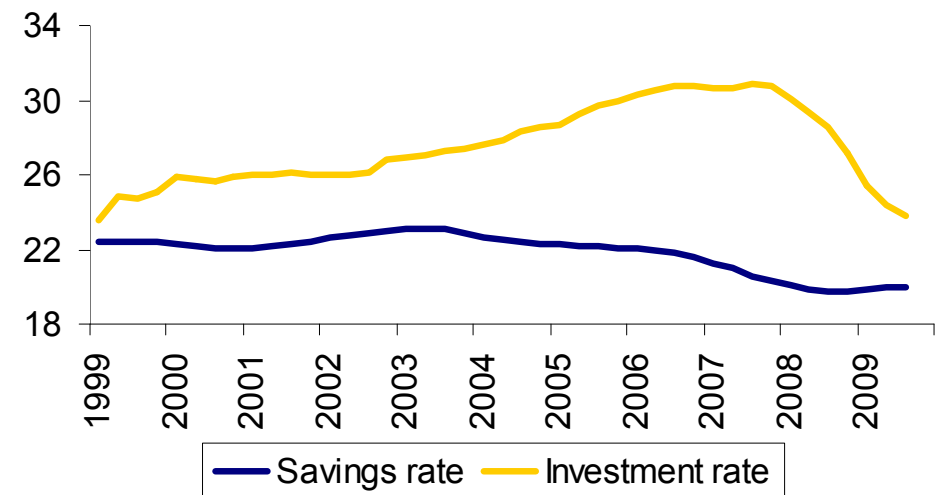
- **What has fuelled domestic demand is a soaring investment rate, with the national savings rate staying close to Eurozone average**
- **The housing boom is part of the story, but not the whole story**

**Savings rate**  
(% nominal GDP)



Source: Eurostat.  
\* 2009Q3

**Investment rate vs. Savings rate**  
(% nominal GDP)



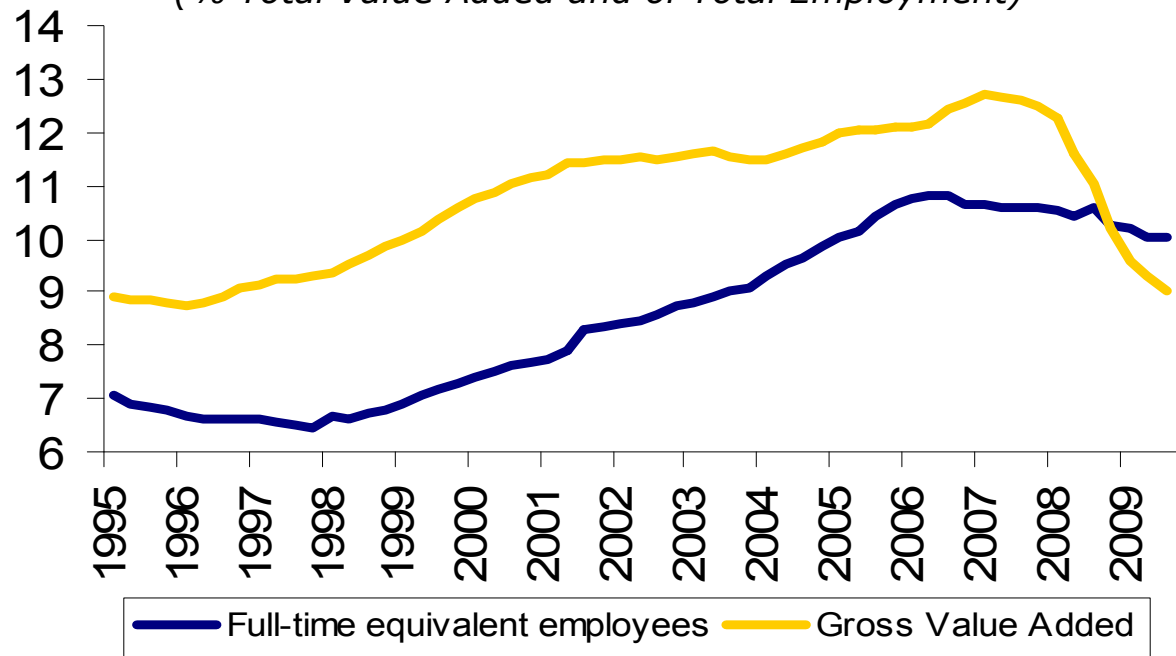
Source: Eurostat.

## Investment binge: housing and beyond

- The residential real estate sector grabbed a non-sustainable share of GDP and employment...

### Construction Sector: Gross Value Added and Employment

(% Total Value Added and of Total Employment)



Source: National Statistics Institute, Spain.

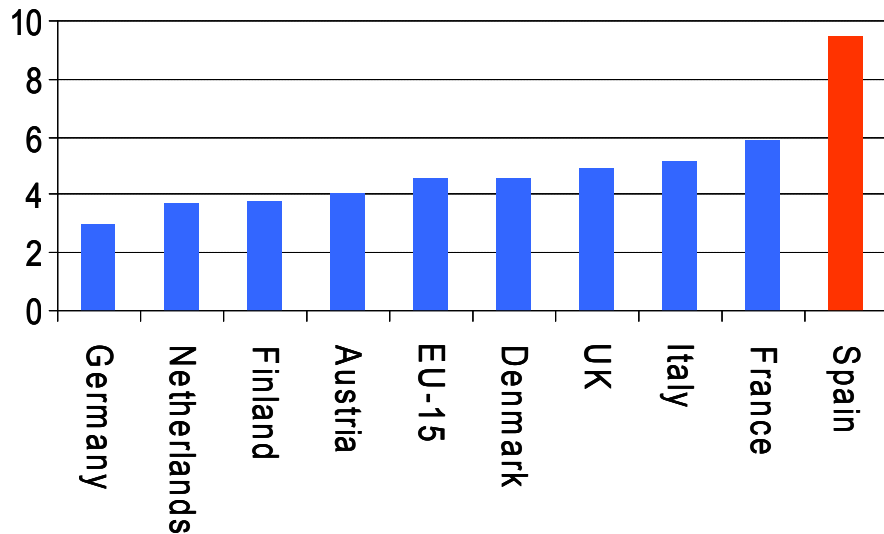


## Investment binge: housing and beyond

- ...but Spain has also invested heavily in equipment, infrastructure and Research and Development

### Investment in equipment

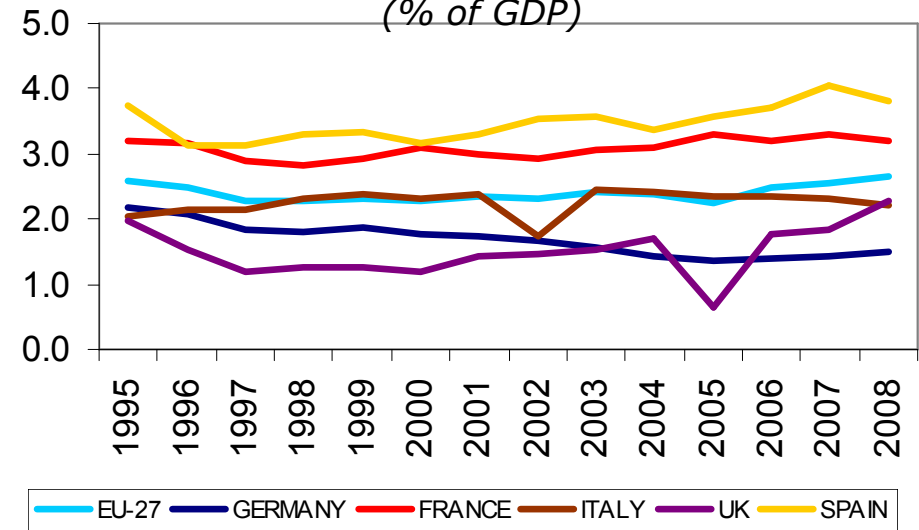
(average growth, 1995-2008 in percent)



Source: Eurostat.

### Public Investment

(% of GDP)

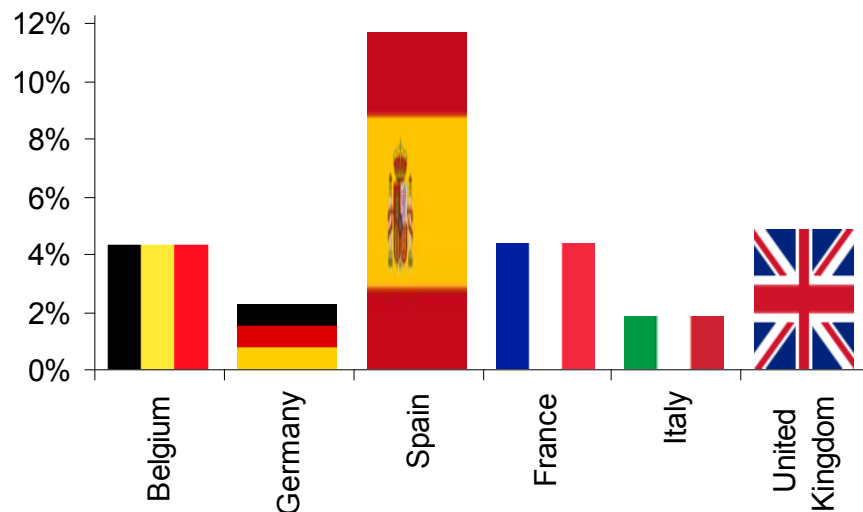


## Intensive in employment

- Residential construction attracted low skilled labour, dragging productivity lower
- Labour supply matched this demand with the help of immigration flows

### Active population

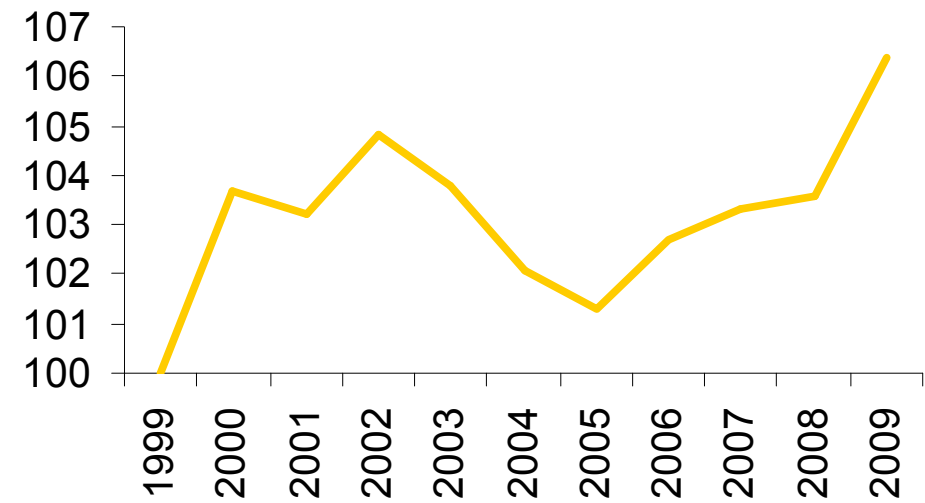
(Growth rates from 2005Q1 to 2009Q3)



Source: Eurostat. Labor Force Survey.

### Labor productivity

(Relative to EU-27, PPP)



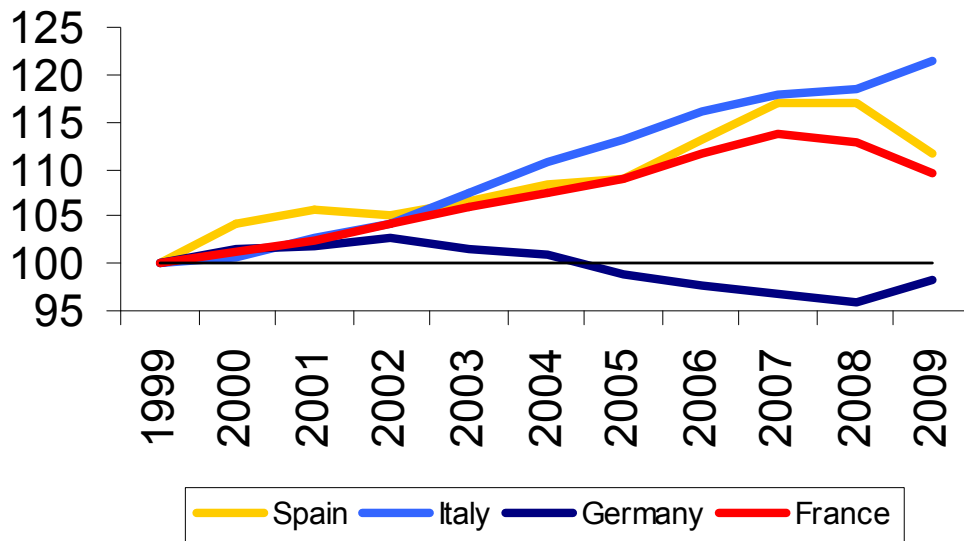
Source: Eurostat. Labor Force Survey.

## Cost competitiveness

- **Loss of competitiveness has been moderate in the tradable sector**
- **Nominal divergence stems from non-tradables (where the bulk of the adjustment is taking place)**

### Unit labour cost index

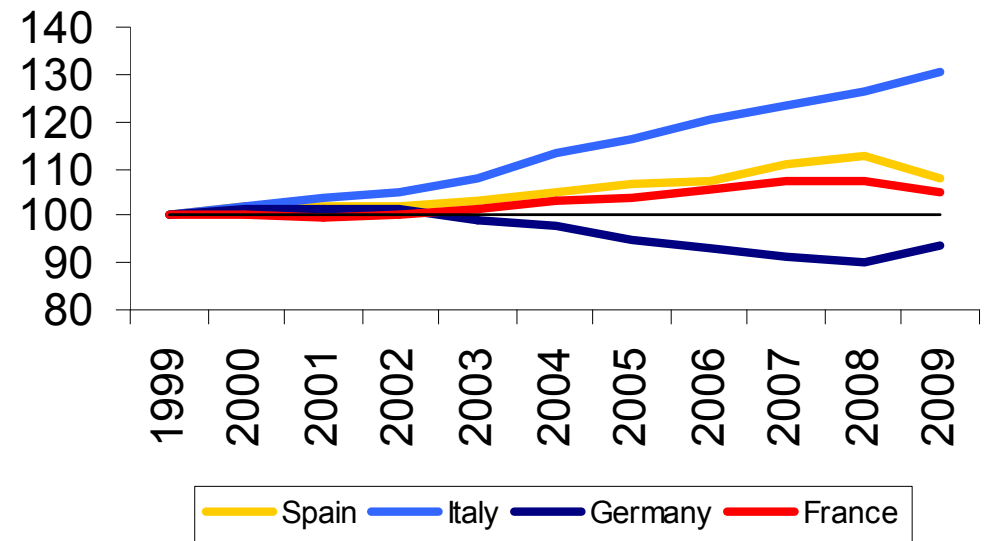
(Relative to eurozone 1999=100)



Source: Eurostat.

### Manufacturing ULC index

(Relative to eurozone 1999=100)

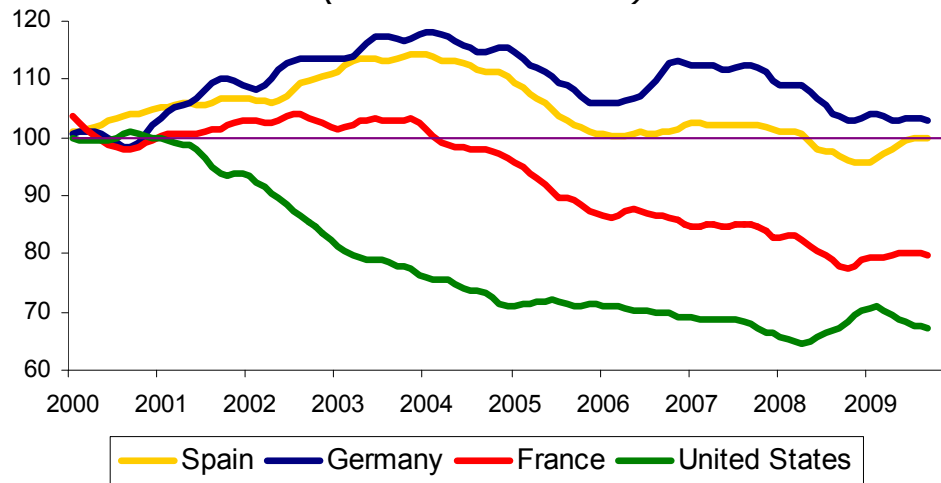


Source: Eurostat

## Exports show underlying improvement in supply

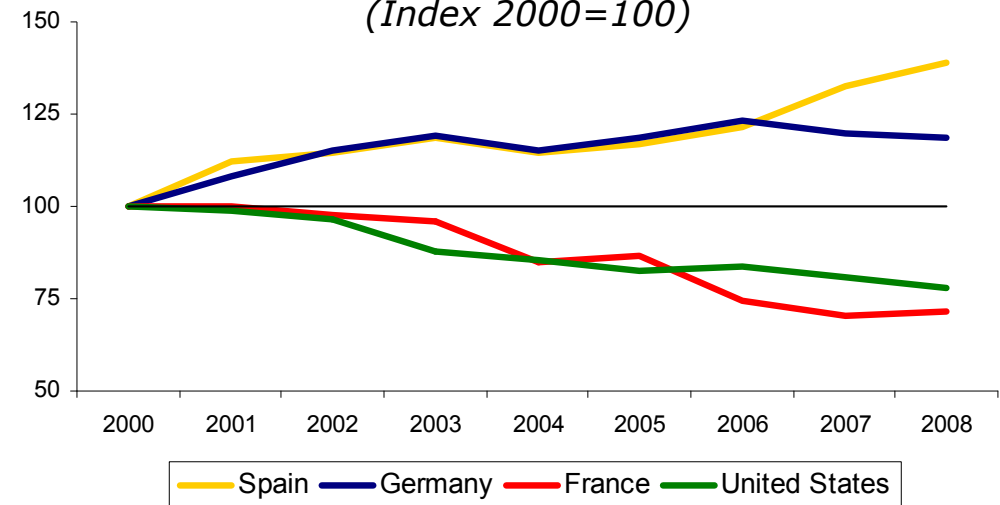
- In spite of brisk domestic demand and waning price competitiveness...
- ...Spain's market shares have outperformed most of peers

**Share in world merchandise exports**  
(Index 2000=100)



Source: International Monetary Fund.

**Share in world exports of services\***  
(Index 2000=100)



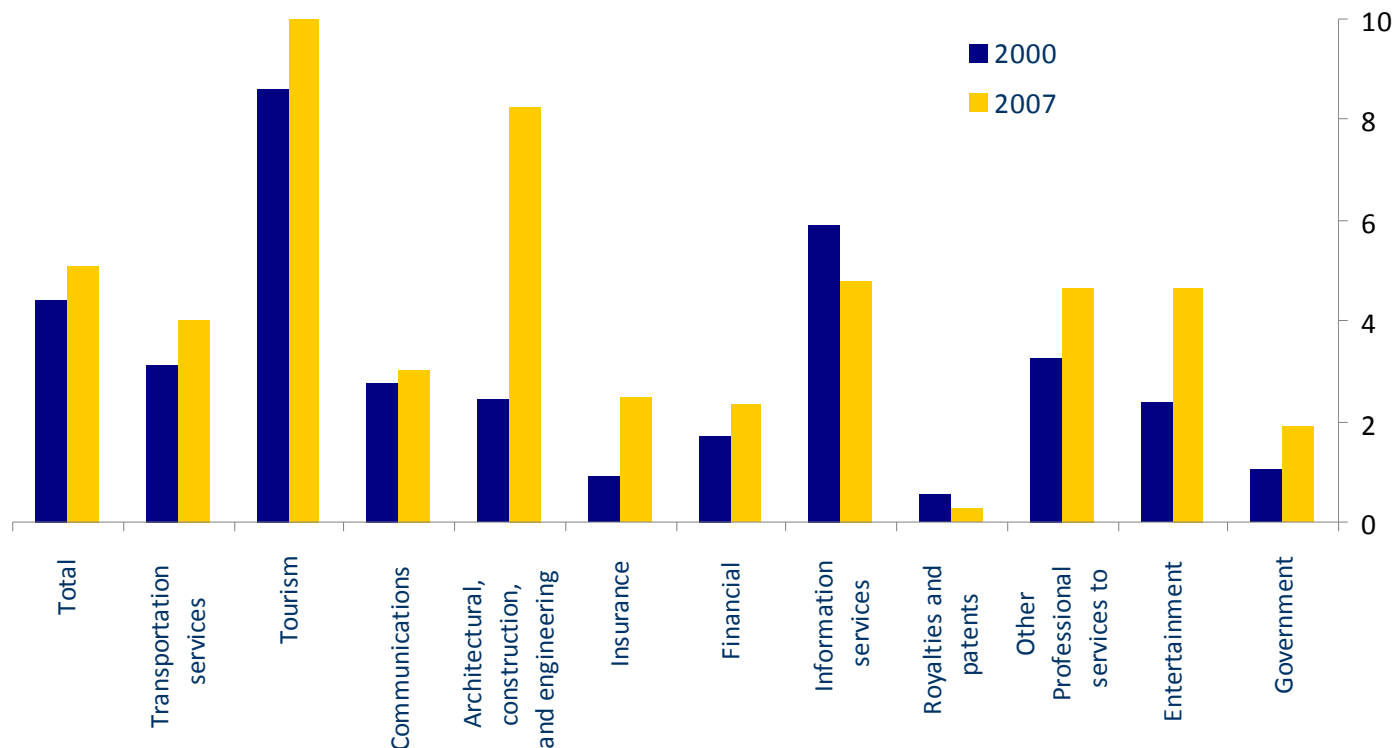
Source: World Trade Organisation.

\* Services other than transportation and travel.

## Services Exports' market share has increased significantly

- Among others, services related to architecture, construction and engineering have more than doubled market share

Share of service exports in the OCDE, by service

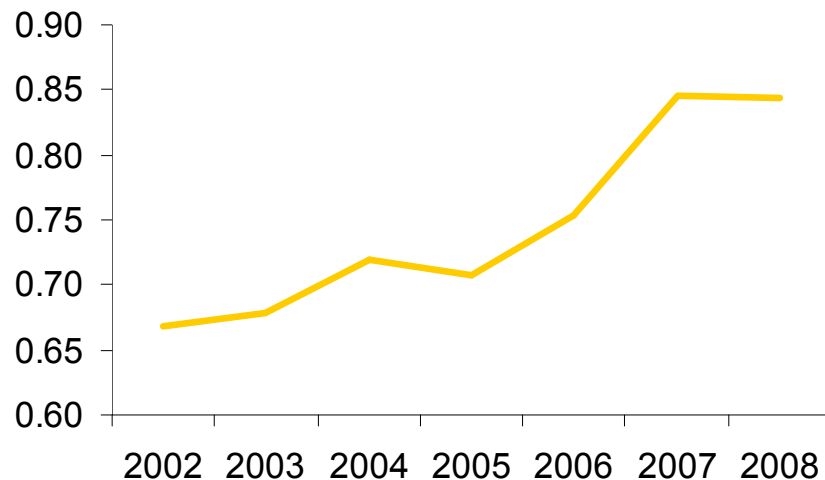


Source: OECD.

## FDI flows have increased significantly

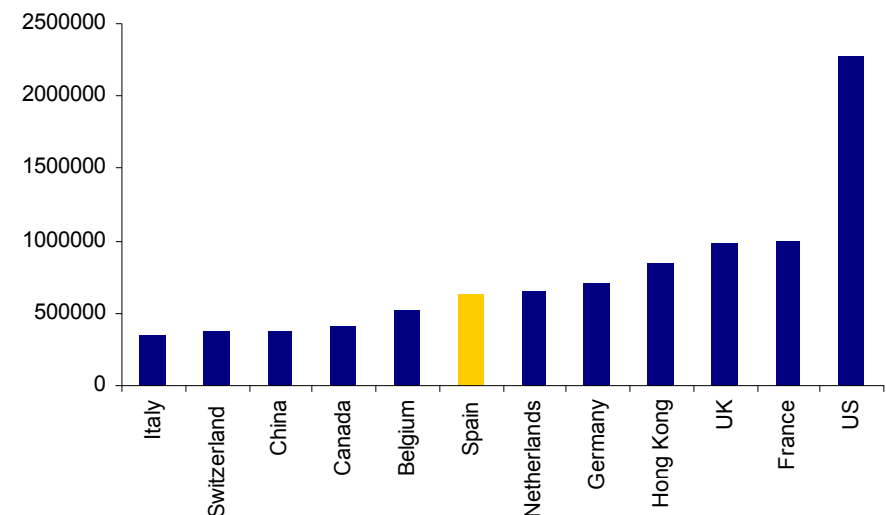
- **Outward FDI stock per capita has grown faster in Spain than in the Eurozone**
- **Remains a major destination of international investment**

**Outward FDI stock per capita relative to Eurozone**



Source: World Investment Report 2009

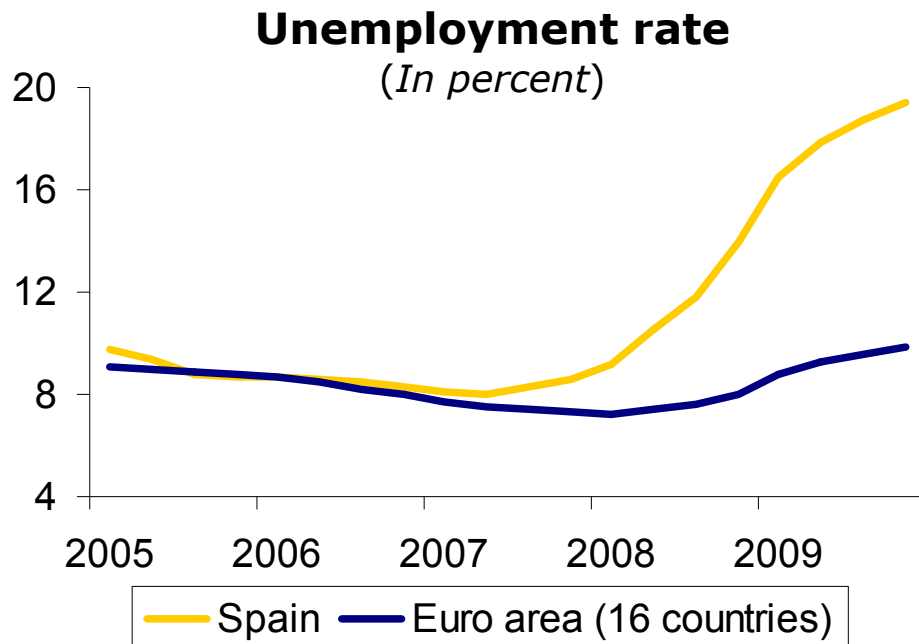
**Top receivers of FDI in 2008**  
(Stock in millions of US \$)



Source: World Investment Report 2009

## The crisis prompts an abrupt adjustment

- **Rapid downsizing of residential sector: output, L (mainly in temporary contracts)**
- **Ripple effects on employment in other sectors**



Sources: Eurostat. Labor Force Survey.

### Sectoral employment

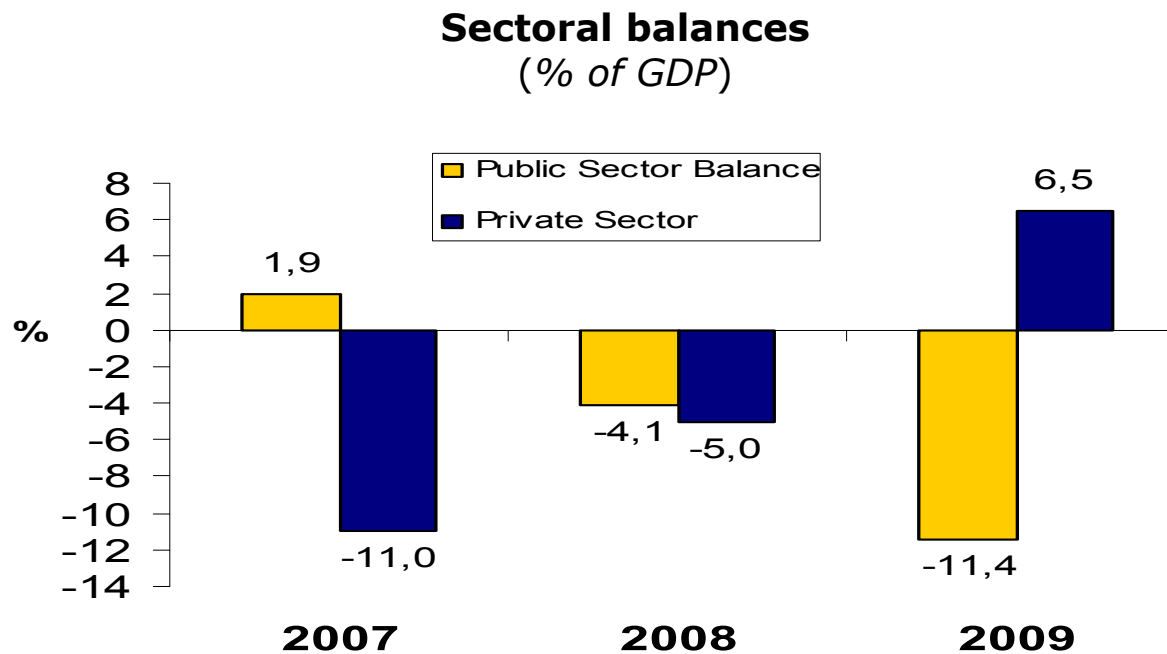
(total number)

	july 2008	sept 2009	dif	%
<b>Total</b>	19.382.121	17.935.095	-1.447.026	(100)
<b>Construction</b>	2.361.177	1.752.157	-609.021	(42,1)
<b>Industry</b>	2.731.068	2.377.211	-353.857	(24,5)
<b>Services</b>	13.150.027	12.599.061	-550.966	(38,1)

Sources: Eurostat. Labor Force Survey.

## Changes in sectoral and external balances

- Large swing in private sector balance: plummeting Investment and soaring Savings
- Government Deficit jumps, but 2.5 points of GDP are one-off
- Current Account deficit has halved in 2009



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## **Policy Strategy for Sustainable Growth**

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- **Prudent Macroeconomic Scenario 2010-2013**
- **Agreement on Fiscal Consolidation to bring the deficit back to 3% in 2013**
- **Structural Reforms:**
  - Structural Reforms in the goods markets
  - Public Pensions System
  - Labour Market
  - Banking sector Restructuring

## The Government's Macroeconomic scenario

- **The output gap will be closed by 2013, after peaking in 2010**
- **External demand contribution to GDP will gradually wane as domestic demand gathers steam**
- **Potential growth will recover from a trough of 0.6% in 2010 to 1.6% in 2013**

<b>Macroeconomic scenario 2009-2013</b> <i>(Growth rate in percent)</i>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>GDP</b>	<b>-3.6</b>	<b>-0.3</b>	<b>1.8</b>	<b>2.9</b>	<b>3.1</b>
Final Consumption Expenditure	-2.4	0.3	1.7	2.2	2.1
Gross Fixed Capital Formation	-15.7	-6.5	0.3	4.2	5.9
<b>National Demand (contribution to GDP growth)</b>	<b>-6.4</b>	<b>-1.4</b>	<b>1.4</b>	<b>2.6</b>	<b>3.0</b>
Exports of Goods and Services	-12.4	2.8	5.2	6.9	7.4
Imports of Goods and Services	-18.7	-1.3	3.7	5.8	6.8
<b>External demand (contribution to GDP growth)</b>	<b>2.8</b>	<b>1.1</b>	<b>0.4</b>	<b>0.3</b>	<b>0.1</b>

Source: Annual update of the Stability Programme.

## Fiscal consolidation strategy

- **Substantial reduction in Spending and moderate increase in Revenues**
- **Already in 2010 a 2.2% cut in structural deficit**

<b>Fiscal Adjustment Path 2009-2013</b> <i>(Growth rate in percent)</i>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
<b>GDP</b>	-3.6	-0.3	1.8	2.9	3.1
<b>General Government Budget Balance (% of GDP)</b>	-11.4	-9.8	-7.5	-5.3	-3.0
<b>General Government Gross Debt (% of GDP)</b>	55.2	65.9	71.9	74.3	74.1

Source: Annual update of the Stability Programme.

## Starting and final points of fiscal consolidation

- **Temporary measures (changes in tax collection, one off investment funds) account for 2.4% points of GDP in 2009's total deficit**
- **Total size of fiscal policy adjustment (structural terms): 5.7% of GDP**

<b>Fiscal position</b>	<b>2009</b>	<b>2013</b>
<b>General Government Balance (1)</b>	<b>-11,4</b>	<b>-3</b>
<b>Cyclical component (2)</b>	<b>-1,4</b>	<b>0</b>
<b>Interest payments (3)</b>	<b>-1,9</b>	<b>-3,1</b>
<b>Temporary measures (4)</b>	<b>-2,5</b>	<b>0</b>
<b>Structural Primary Balance (1)-(2)-(3)-(4)</b>	<b>-5,6</b>	<b>0,1</b>

*Source: Annual update of the Stability Programme.*

## Fiscal restraint measures

<b>Measures adopted and announced (% of GDP)</b>			
	<b>Revenues</b>	<b>Expenditures</b>	
<b>2010 Budget</b>	VAT	0.7	
	Excise Taxes	0.3	
	400€ Tax Rebate Reform	0.4	
	Savings Tax Reform	0.1	
	SME Corporate Tax Reform	-0.1	
	<b>Government Expenditure</b>		<b>-0.8</b>
New Measures*	<b>Additional cut in 2010 Expenditure</b>		<b>-0.5</b>
	<b>Central Government Austerity Plan 2011-2013</b>		<b>-2.6</b>
	<b>Regional and local government Spending cuts</b>		<b>-0.5</b>

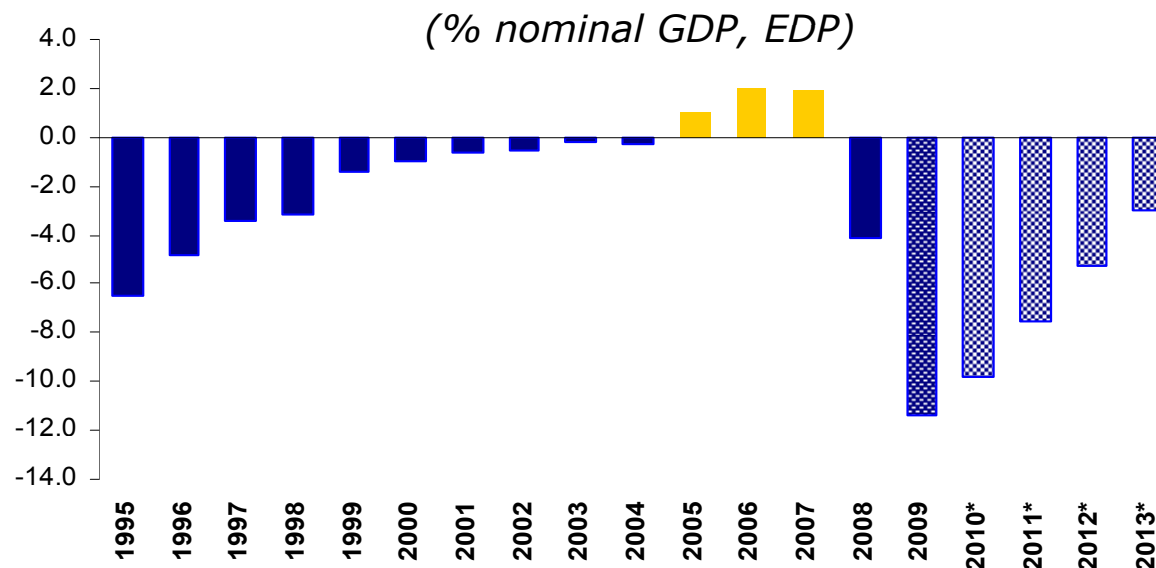
Source: Annual update of the Stability Programme.

- Restraint in wage outlays for all public administrations through:
  - 10% replacement rate
  - No new temporary hiring
  - Strong moderation in wages
- Sizable cuts in investment, transfers and subsidies

## Can we implement this?

- We have done it in the past, which proves our compromise, the quality of our public finances, and the success of our fiscal discipline.
- Shared commitment to fiscal discipline and margin to secure further reductions in the deficit

### Net Lending (+)/Borrowing (-) of General Government



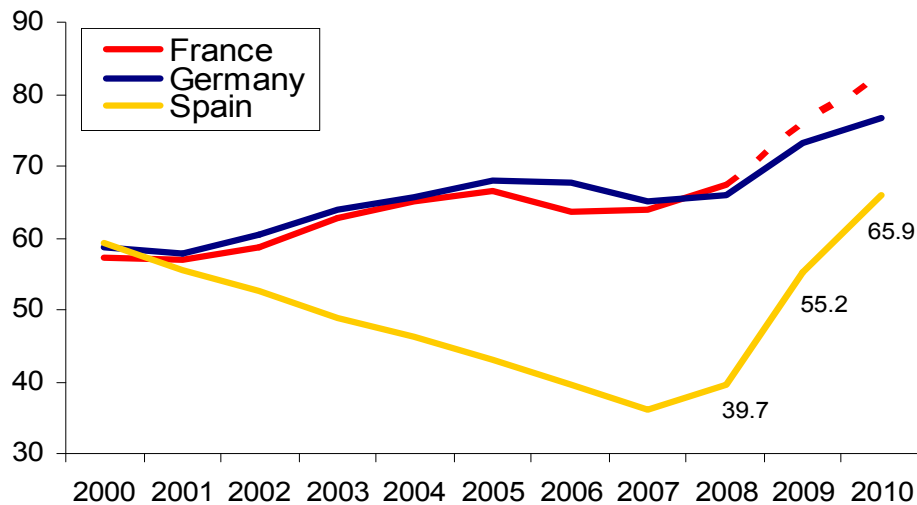
\* Annual update of the Stability Programme.



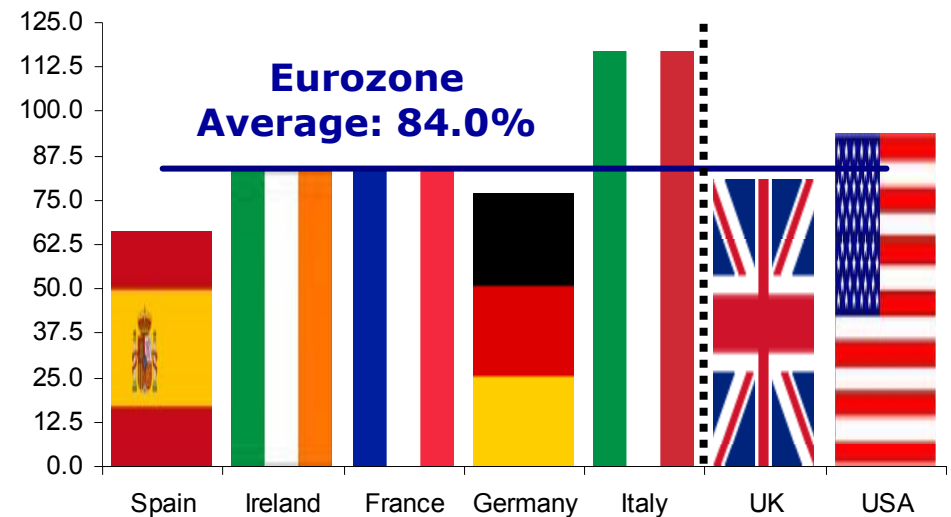
## Debt dynamics

- Even after the impact of strong stabilisation policies, Spain's Debt to GDP is significantly lower than the Eurozone average

**Gross Debt-to-GDP (%)  
2000-2010**



**Gross Debt-to-GDP (%)  
2010F**



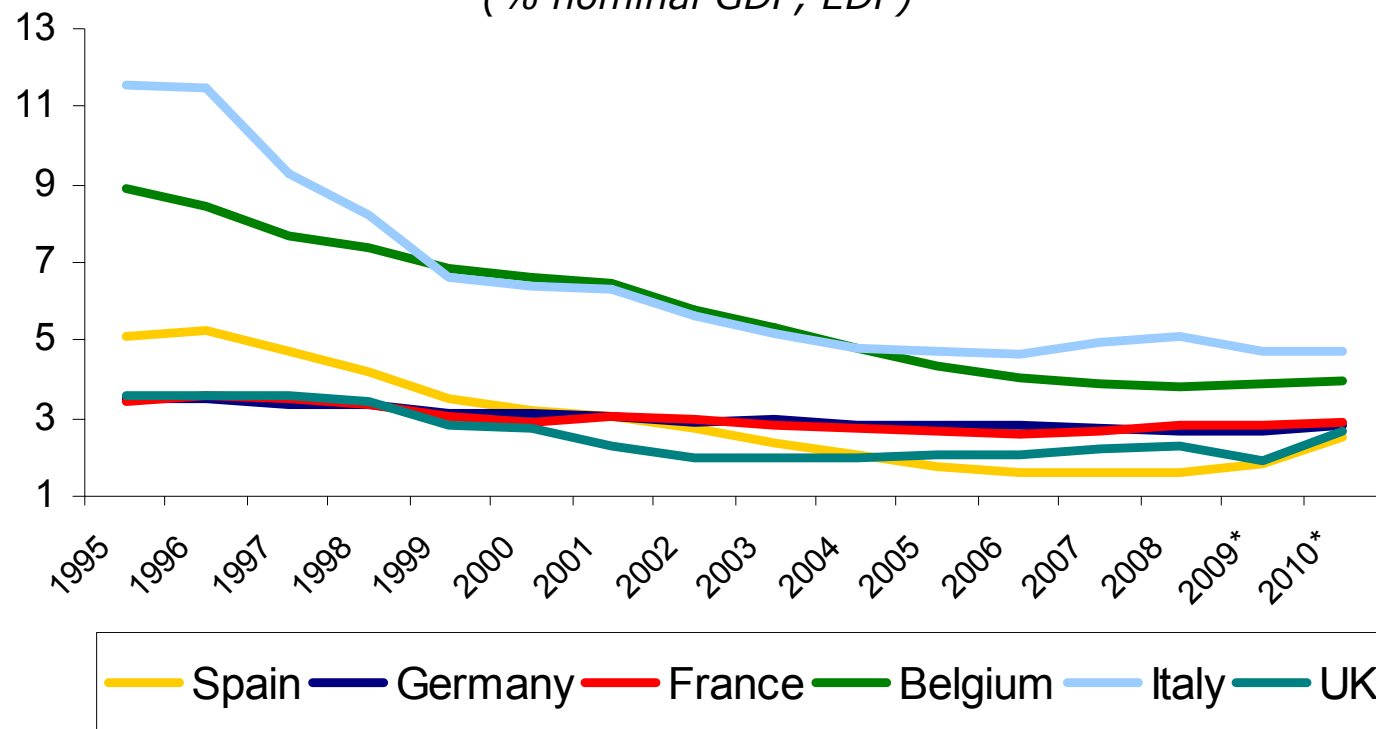
Sources: European Commission, Annual update of the Stability Programme and International Monetary Fund.



## Lowest interest burden within affordable limits

### Ratio of interests to GDP of General Government

(% nominal GDP, EDP)



Source: European Commission.

\* European Economic Forecast Autumn 2009, European Commission.

## Structural Reforms in product markets

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- **Improving the institutional environment for business:** by modernizing and simplifying government activities as well as increasing general government discipline
- **Fostering competitiveness:** by reducing the administrative burden of creating companies and reducing red tape
- **Fostering modernization:** promoting sectors that are at the base of economic activity (R&D, innovation and training), improving support for their integration into the overall value chain, and facilitating the internationalization of businesses

**Estimated impact on GDP  $\Rightarrow$  + 0.32% in Potential GDP**

## **Residential Real Estate Sector**

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- **Phasing out fiscal incentives for housing ownership from 2011 (deduction of mortgage payments)**
- **Removing barriers to the development of the rental market:**
  - **Same fiscal treatment than ownership**
  - **Creation of REITS**
  - **Legal changes to strengthen certainty for landlords**
- **Tax Incentives for refurbishment provide some support**

## Preventive financial support measures

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**Liquidity enhancement**

**Credit  
stimulus**

**Capital  
enhancement  
and  
reorganisation**

## The financial system remains resilient

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- Main source of perceived vulnerability regards losses stemming from lending to real estate developers
- Bank of Spain stress test: **Operating income over 3 years is able to absorb losses of 40%** of the portfolio of lending to real estate developers.
- **Extreme assumptions** of stress test: **PD of 40%**(3 times the peak of 1993) and **LGD of 100 %** (highly implausible)

## **FROB: a tool for restructuring the banking sector**

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### **Rationale for the initiative**

- Overcoming fragmentation in the savings and banks sector.
- Achievement of economies of scale to digest low interest margins and real estate impact.

### **Governance**

- Independent management.
- Strong accountability to Parliament.
- Authorized by DG Competition.

### **Asset Operations**

- Support to integration processes subject to conditions set by the banking supervisor.
- Instrumented through convertible preference shares with market-oriented remuneration.

### **Funding**

- Public-private mix of capital (9 bn€).
- Agency-like funding programme coordinated with the sovereign programme.

## **Pension System Reform**

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### **Proposed Measures:**

- **A progressive increase in the retirement age (to 67 years)**
- Strengthening relationship between contributions and benefits
- A more flexible relationship between complementary social security and the public system
- Possible adjustment of other parameters of the current system

### **Expected Results: Sustainability of the pension system**

## Labour Market Reform

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- **Five main guidelines:**

- Stability in employment, by reducing market segmentation
- Reform of Collective Bargaining system
- Incentives for young workers' employment and education
- Promotion of the integration of women in the labour market
- Worker intermediation and greater control of temporary occupational disability claims

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## Highlights of Funding Strategy

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- Significant **reduction in net funding** requirements and persistence of sound risk metrics
- **Liquidity, transparency and predictability** will continue as guiding principles for the execution of our auction program
- As for syndications, timing is dictated by the limit size of the line to be replaced (16.5 bn for longer tenors) and market conditions.
- Innovations for 2010: 18-month T-bills reappear, Euro inflation linker still a project
- Maintain our **stable and diversified investor base**

## The funding strategy

### Tesoro Funding in 2010

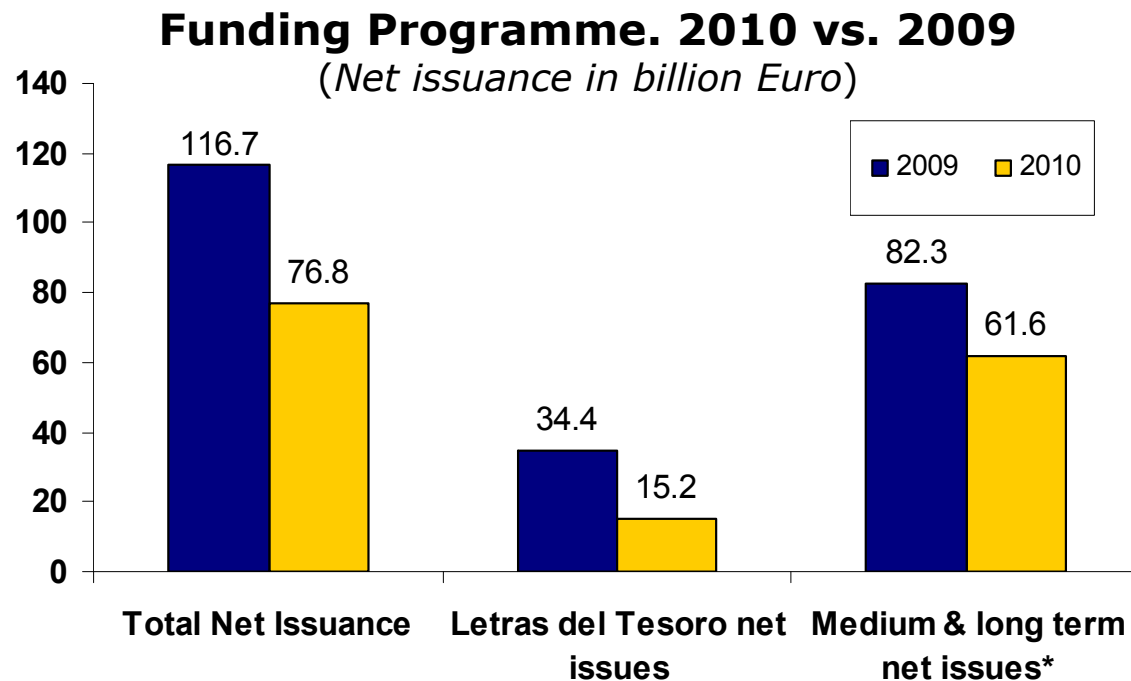
(Billion euro)

<b>1: Funding requirement = Net Issuance</b>	<b>76.8</b>
2: Redemptions bonds 2010	35.4
3: Net issuance medium long term	61.6
<b>4 = 2 + 3 Gross Issuance Medium-Long Term</b>	<b>97,0</b>
5: Net Increase T-Bills	15.2
6: Assumption of RTVE debt	1.5
<b>7 = 3 + 5 + 6: Net change outstanding debt</b>	<b>78.3</b>
<b>8: Forecast Outstanding Central Government Debt at end 2010</b>	<b>553.5</b>

Source: General State Budgets Bill 2010

## Funding programme in perspective

- **Cut in Net Issuance: lower cash deficit and no exceptional increase in net financial assets**



(\*) Includes foreign currency issues.

Source: Dirección General del Tesoro y Política Financiera.

## Short-term funding

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- **Net issuance in 2009** in line with initial announcement: 34.4 bn€. Gross issuance breakdown:
  - 3-month Letras: 19.7 bn€
  - 6-month Letras: 31.6 bn€
  - 12-month Letras: 58.0 bn€
- **Innovations in 2010:**
  - Calendar change: 3- and 6-month Letras auction 4<sup>th</sup> Tuesday
  - 18-month T-bills relaunched: auction 3<sup>rd</sup> Tuesday

## Medium- and long-term funding

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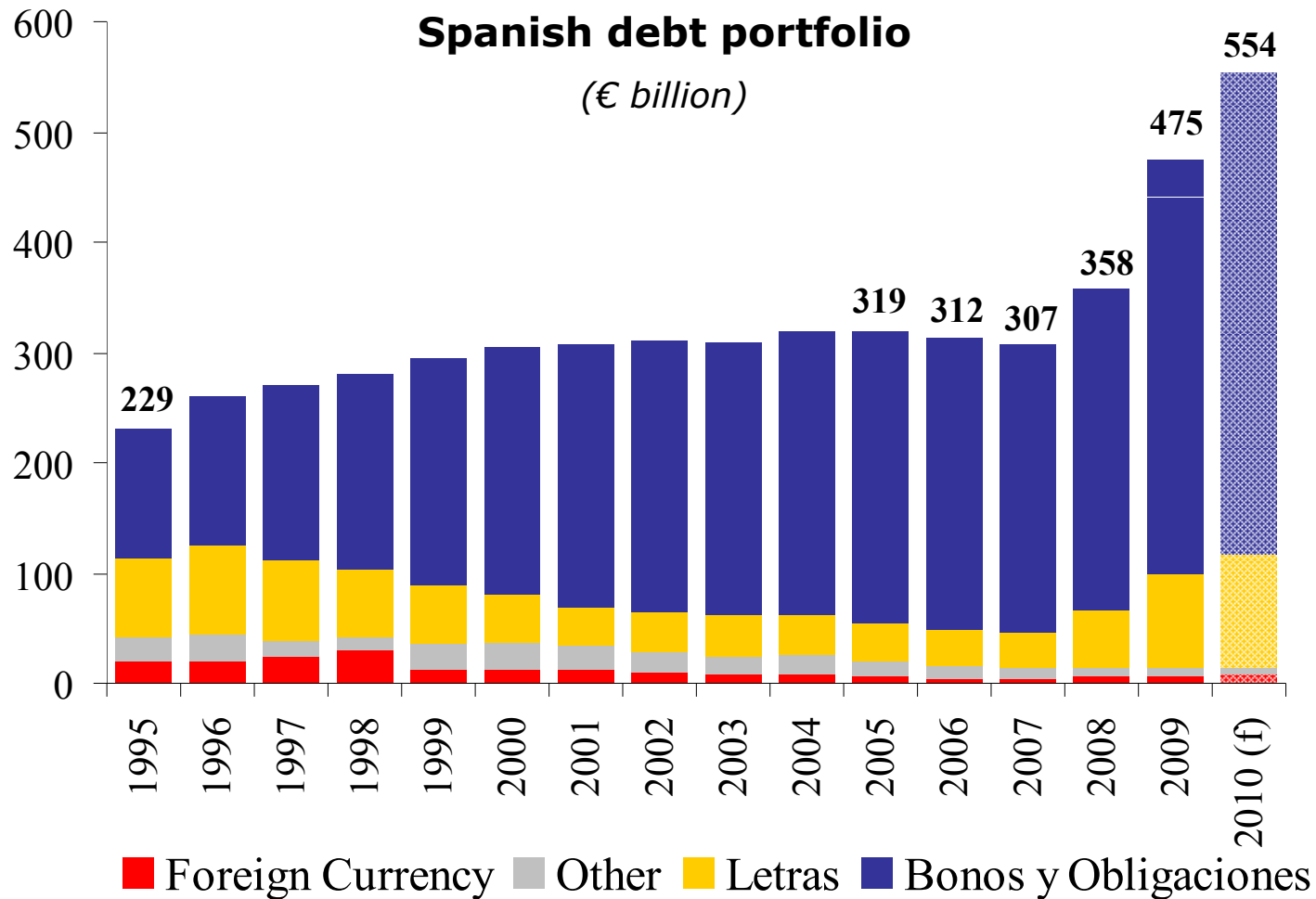
- **Gross issuance:** 2009 overshooting (ca. 25 bn €) due to higher than expected impact of the crisis
- **Auction procedures unchanged:** Quarterly calendar + potential off-the-run lines announced Friday prior to the auction
- **Limit size per line:** increased to 16.5 bn € for longer lines
- **Bonos del Estado:**
  - New 5-year benchmark in March
  - Current 3-year benchmark B 2.30% 04/2013 issued until 15 bn €
- **Obligaciones del Estado:**
  - New 10 year O 4.00% 04/2020 (5 bn €) successfully syndicated in January
  - Next syndication a 15 year line, to replace the matured O 4.80% Jan-2024), expected for February depending on market conditions

## Diversification of funding sources

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- **Recent foreign currency issuance:**
  - Eurobond 2.75% March 2012 (\$ 1.0 billion)
  - Eurobond 2.00% October 2012 (\$ 2.5 billion)
  - Tesoro Público is open to additional foreign currency issuance
- ***Floating Rate Note 3-Month EURIBOR-10 bps, October 2012 (€ 3.0 billion)***. Possible retapping in 2010
- **Projects:**
  - European inflation-linked issues (HICP-ex tobacco)
  - Schuldschein loans

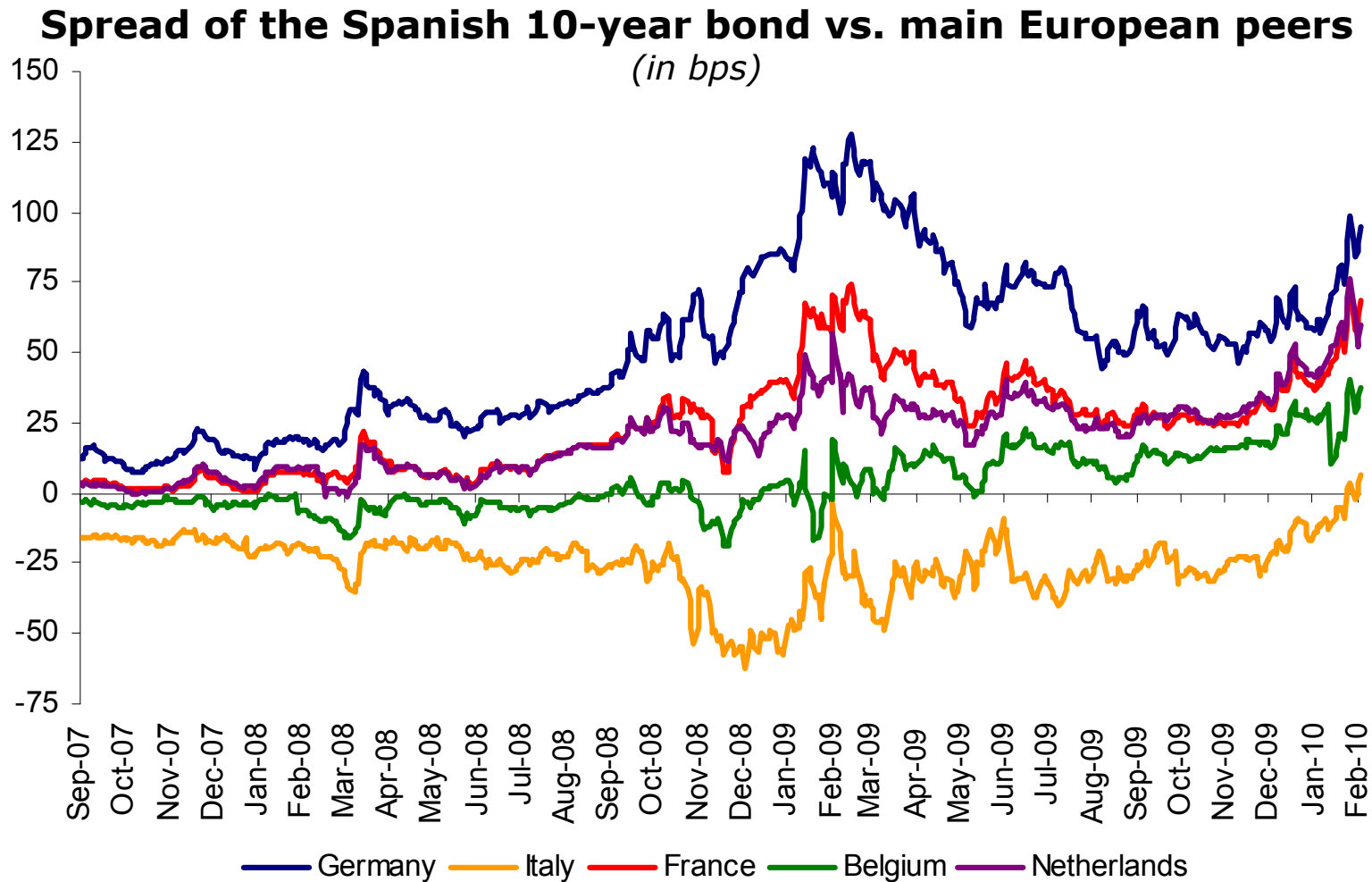
## Main features of Treasury funding strategy



Source: Dirección General del Tesoro y Política Financiera.



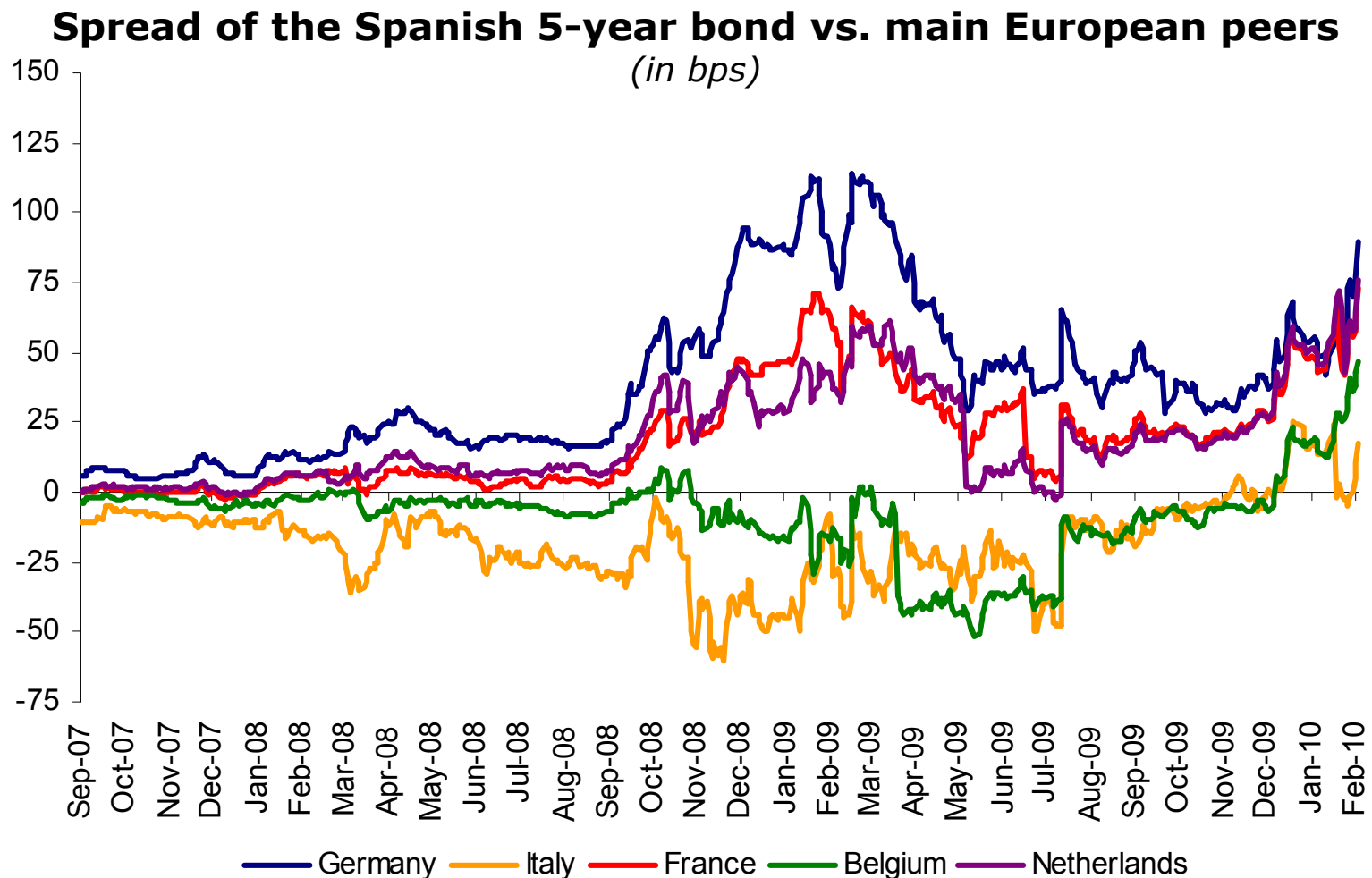
## Recent widening might be an opportunity



Source: Bloomberg.



## Cheapening concentrated in the front end



Source: Bloomberg.

## An attractive market to invest in

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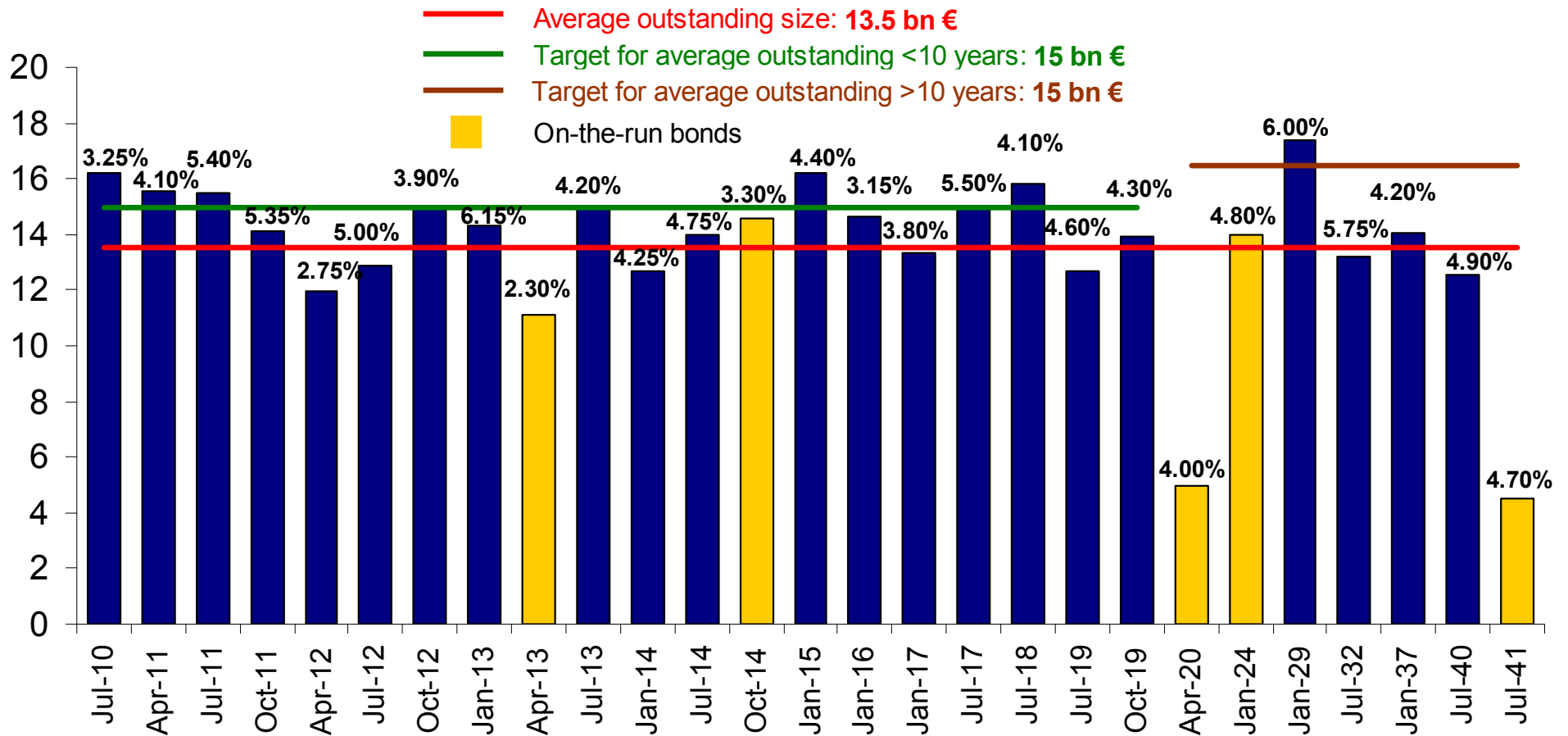
Attractive prices

Liquid instruments

Solid and efficient  
infrastructure

Diversified investor  
base

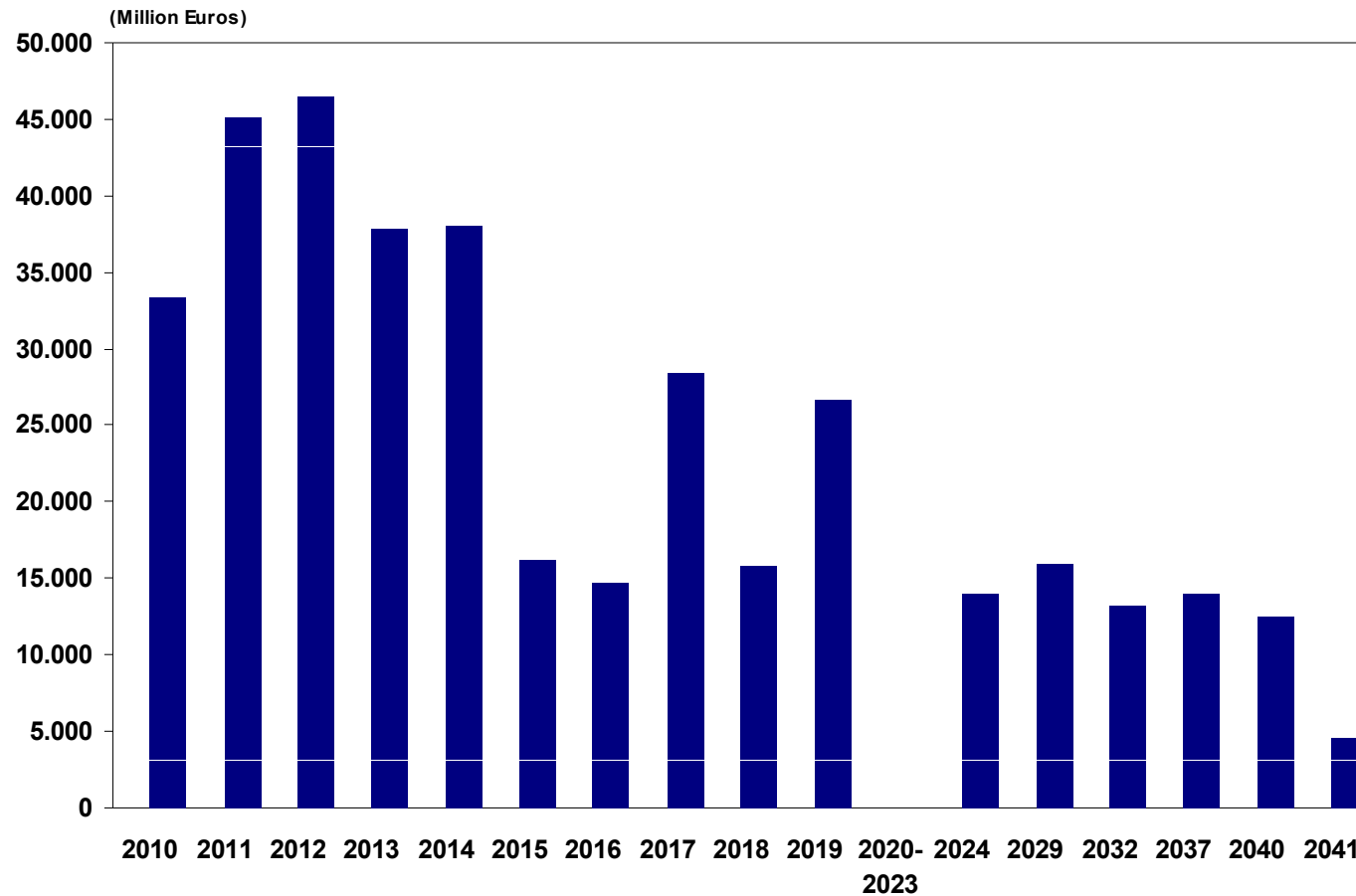
## Increase in market liquidity



Source: Dirección General del Tesoro y Política Financiera.

## Low Debt Refinancing Risk...

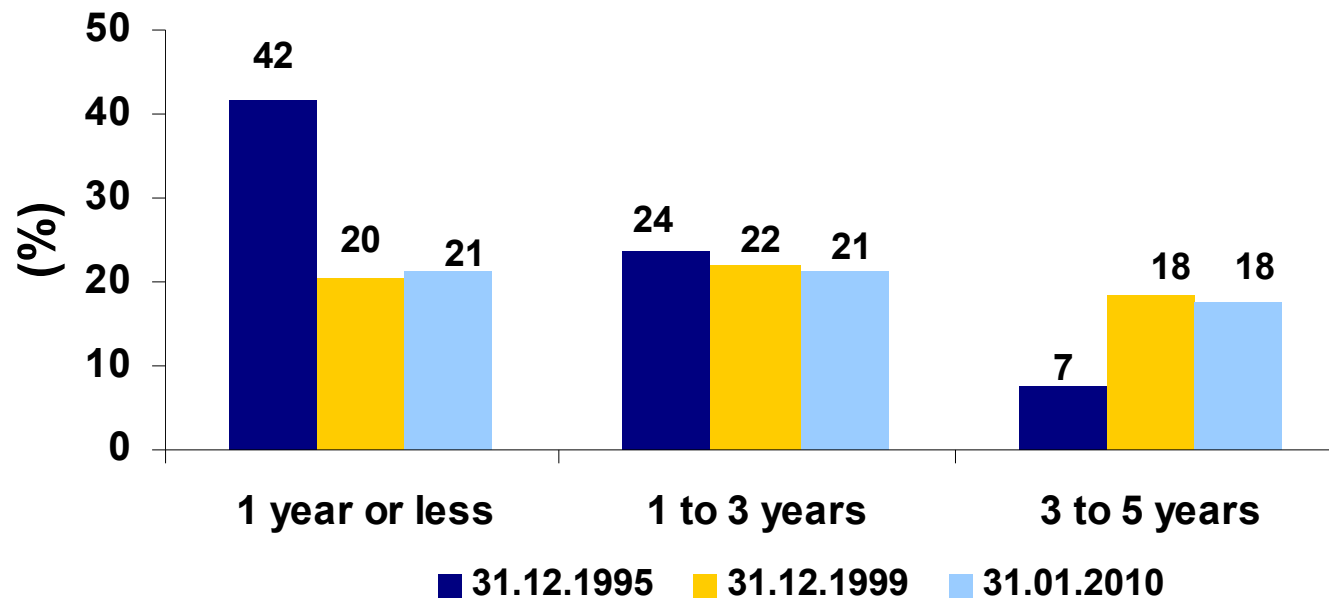
### Redemption profile of Bonos & Obligaciones



Source: Dirección General del Tesoro y Política Financiera.

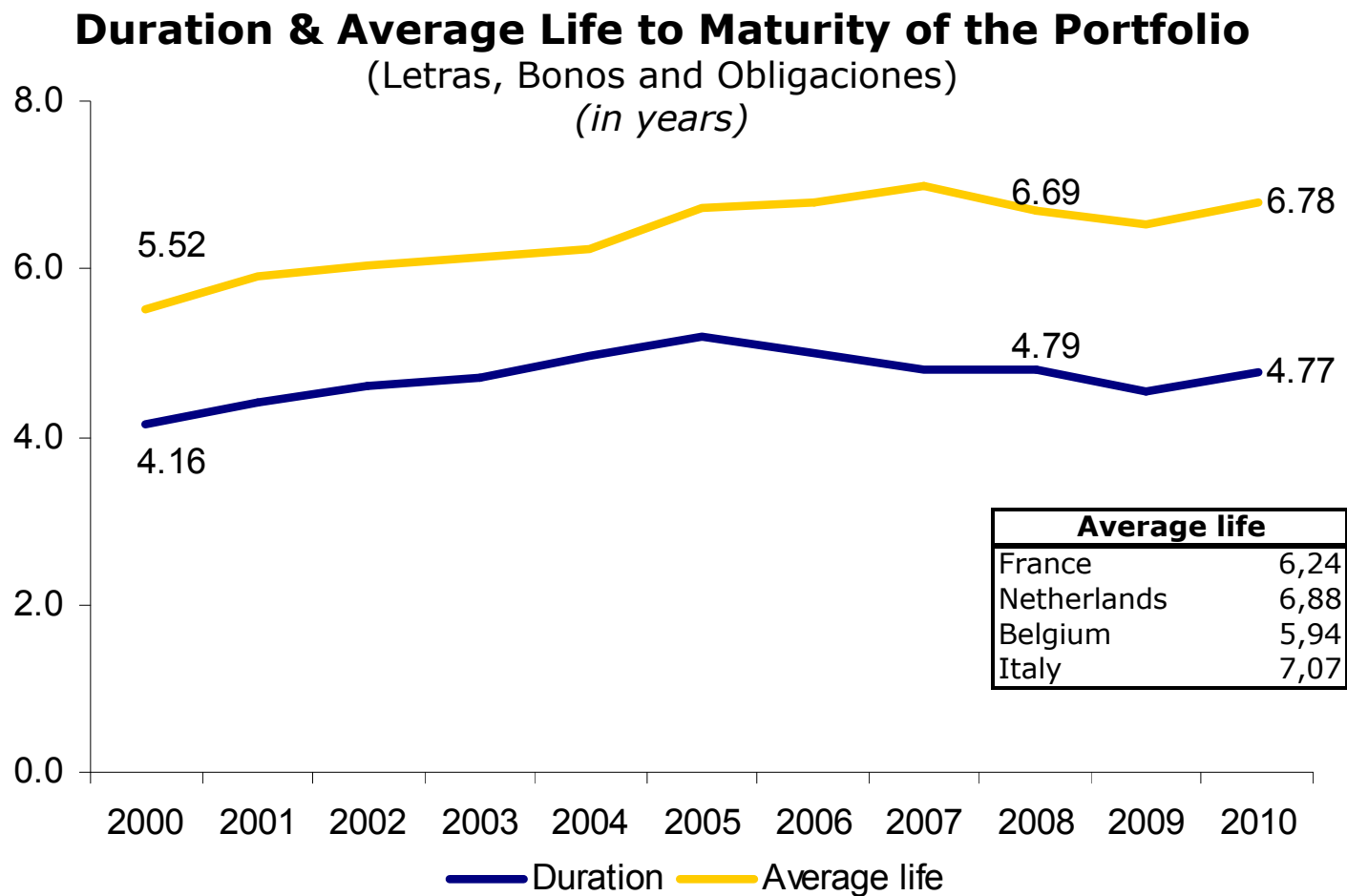
## Low Debt Refinancing Risk...

### Central Government Debt refinancing risk (in % of the total portfolio)



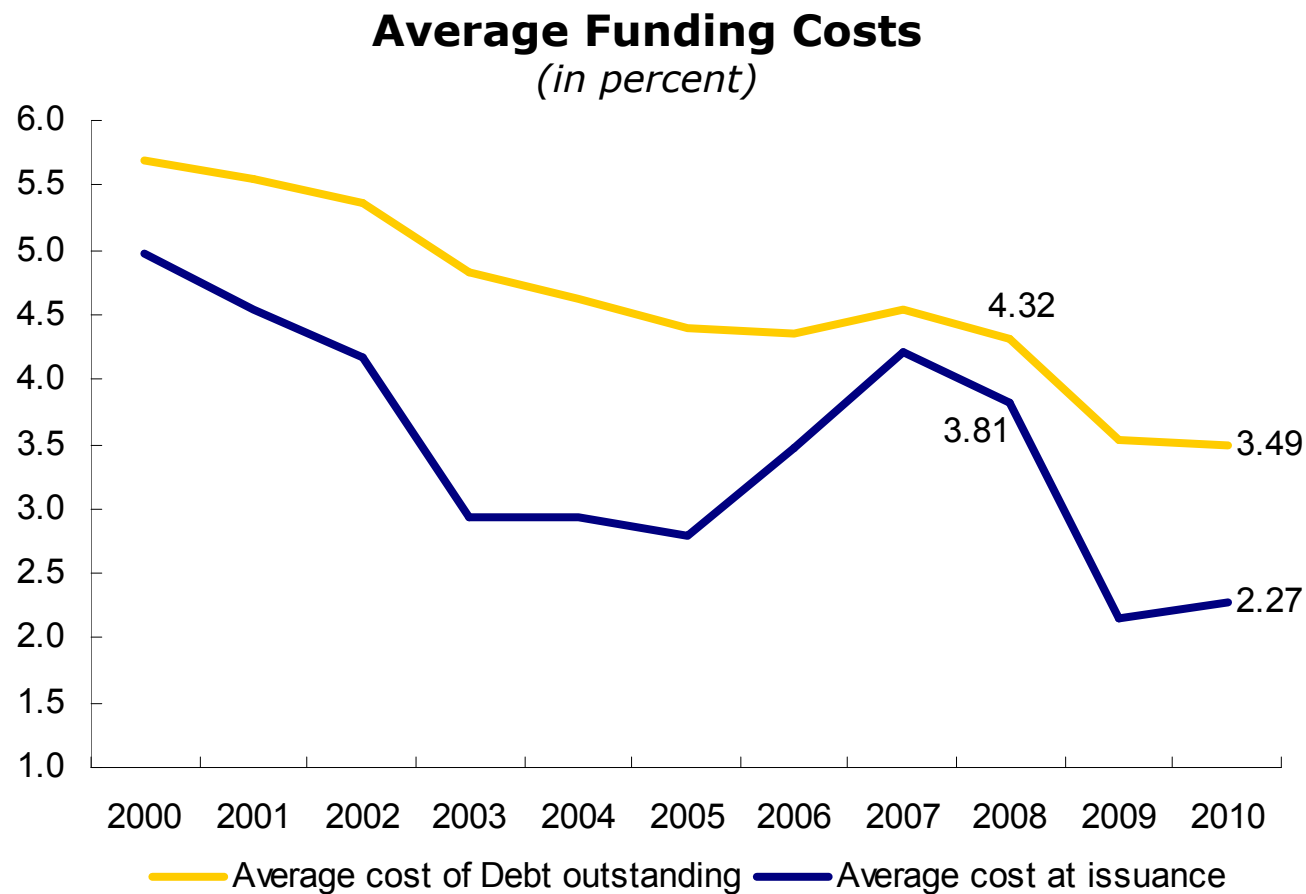
Source: Dirección General del Tesoro y Política Financiera.

## ...Thanks to relatively high duration and average life to maturity...



Source: Dirección General del Tesoro y Política Financiera.

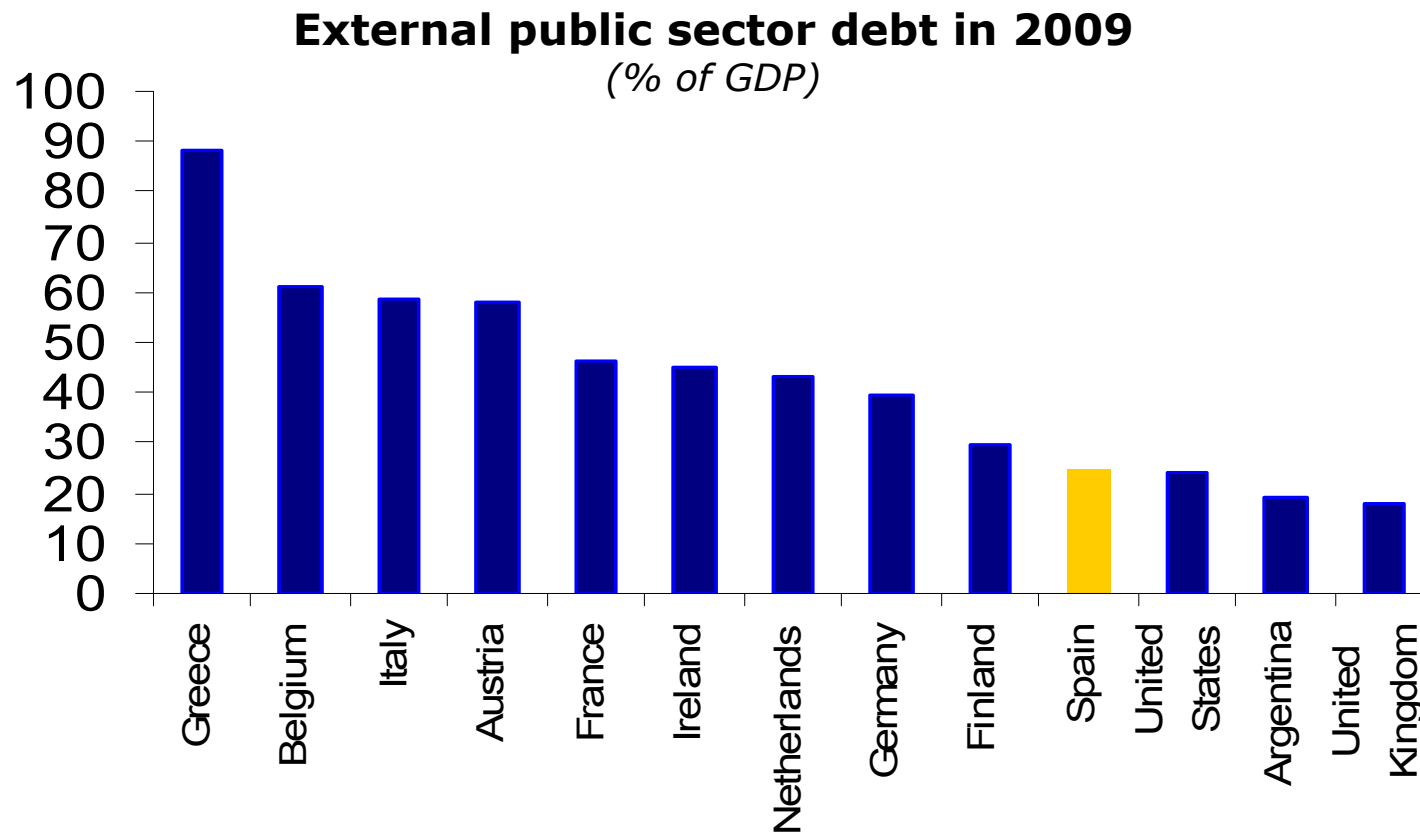
## ...while achieving lower Funding Costs



Source: Dirección General del Tesoro y Política Financiera.



## Reliance on foreign funding relatively moderate

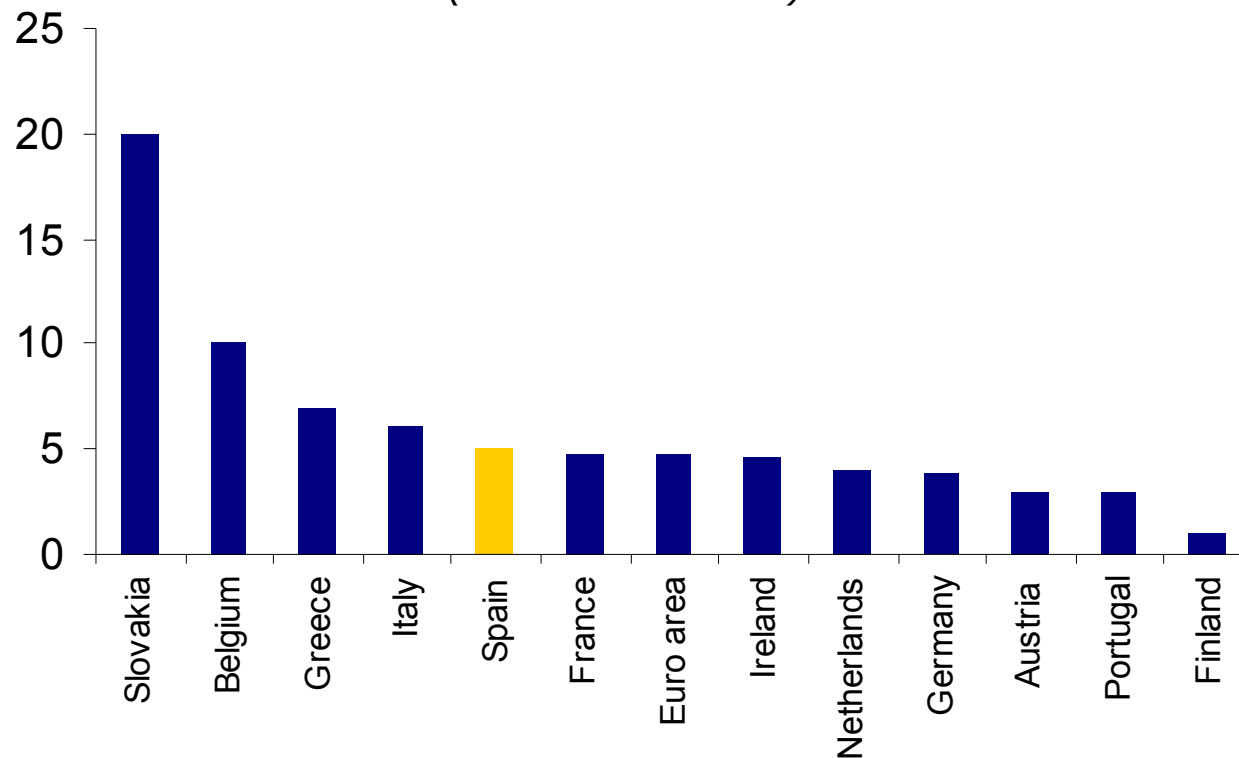


Source: OECD.



## Banks financing of government debt in line with Eurozone average

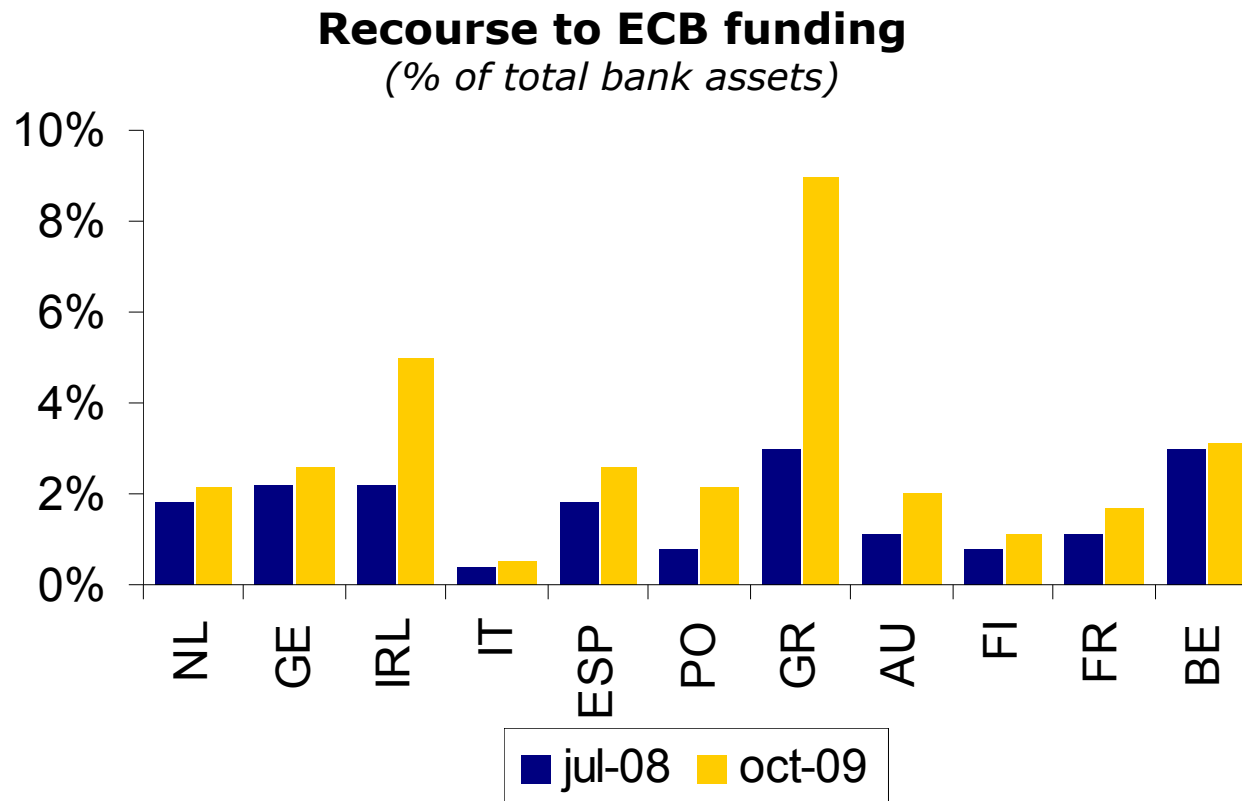
**Holdings of government debt November 2009**  
(% of bank assets)



Source: Citi.

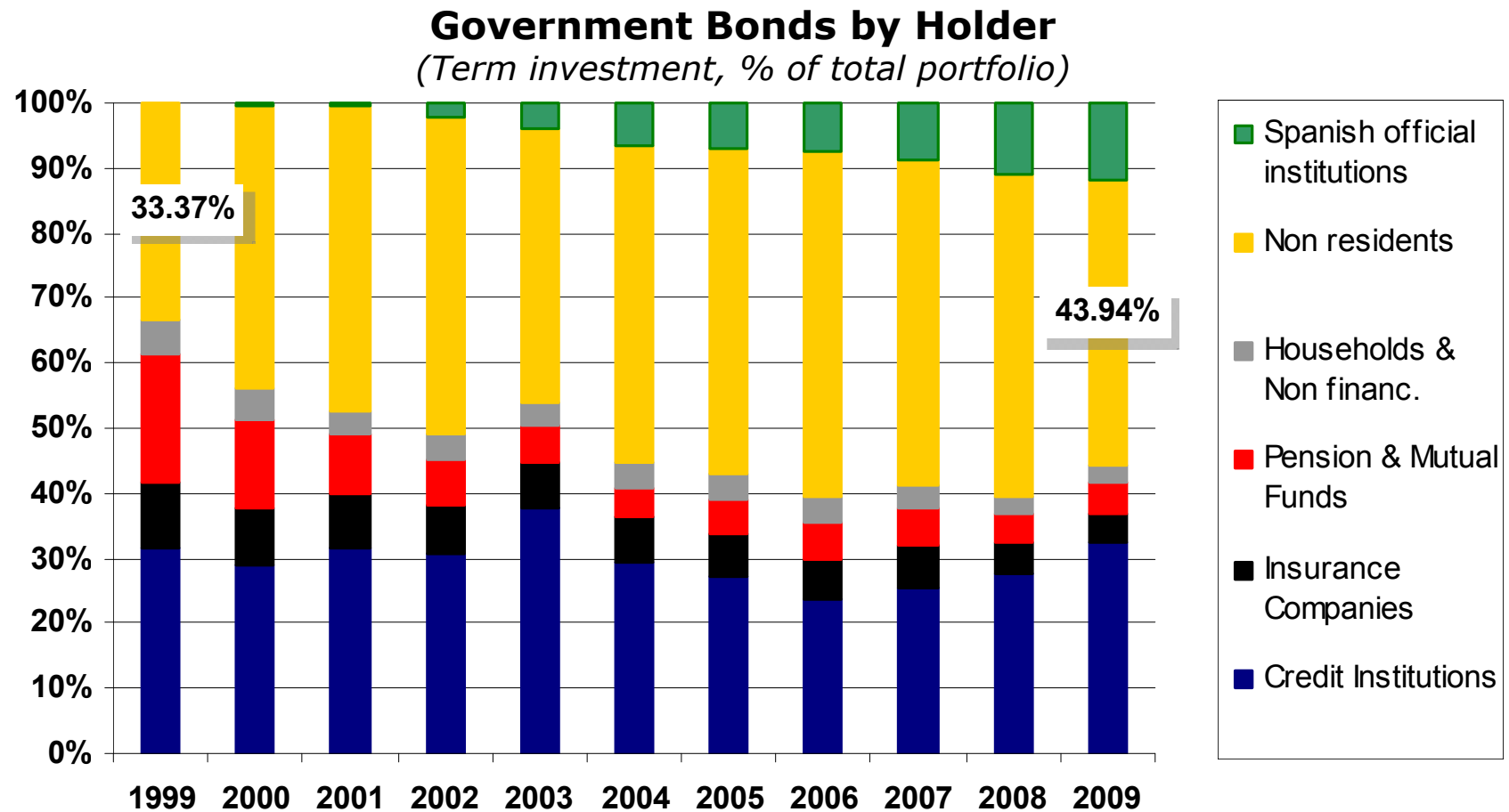


## Spanish Banks' funding from ECB around Eurozone average



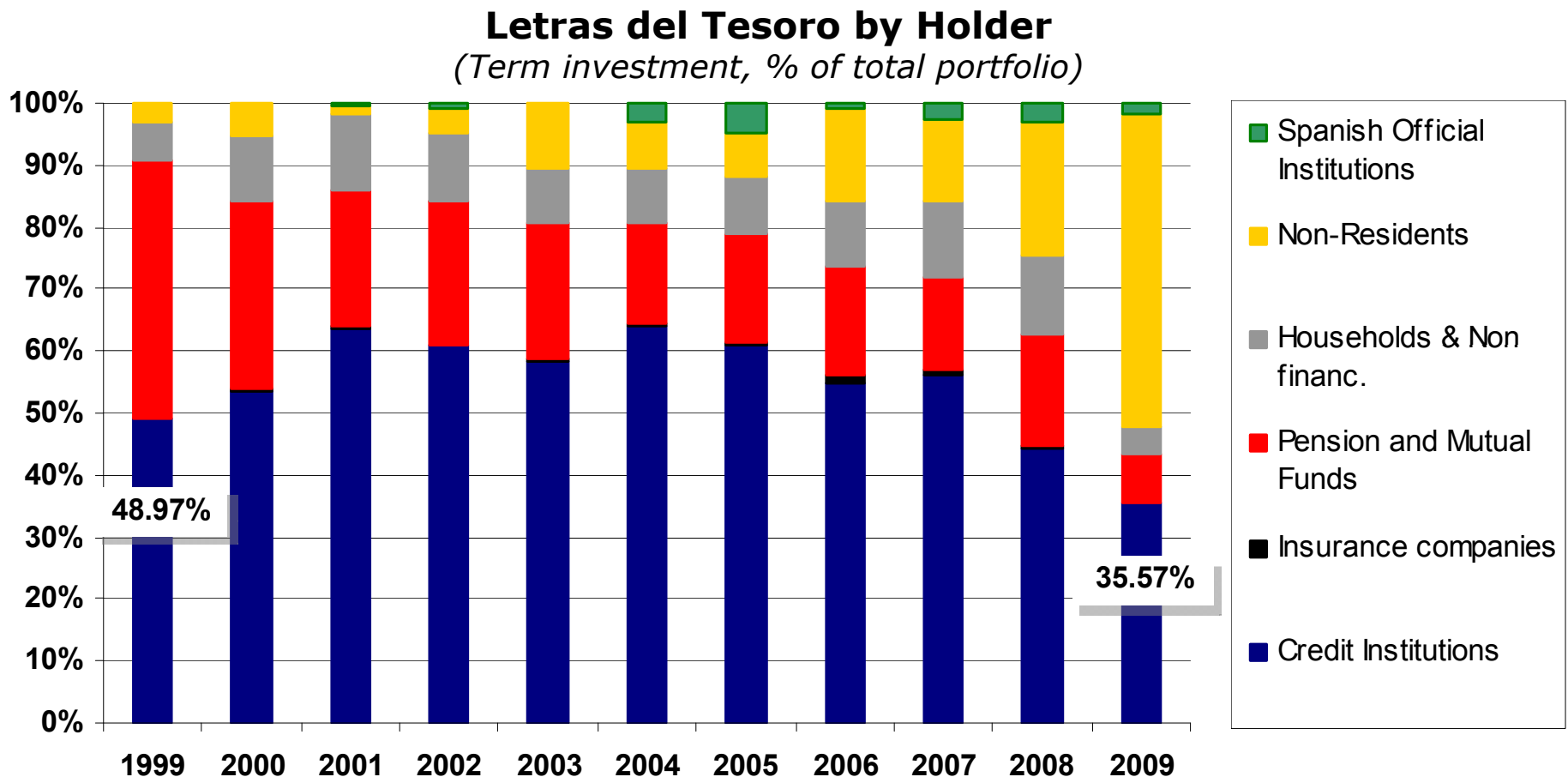
Source: Deutsche Bank.

## Stable and diversified investor base



Source: Dirección General del Tesoro y Política Financiera.

## Stable and diversified investor base

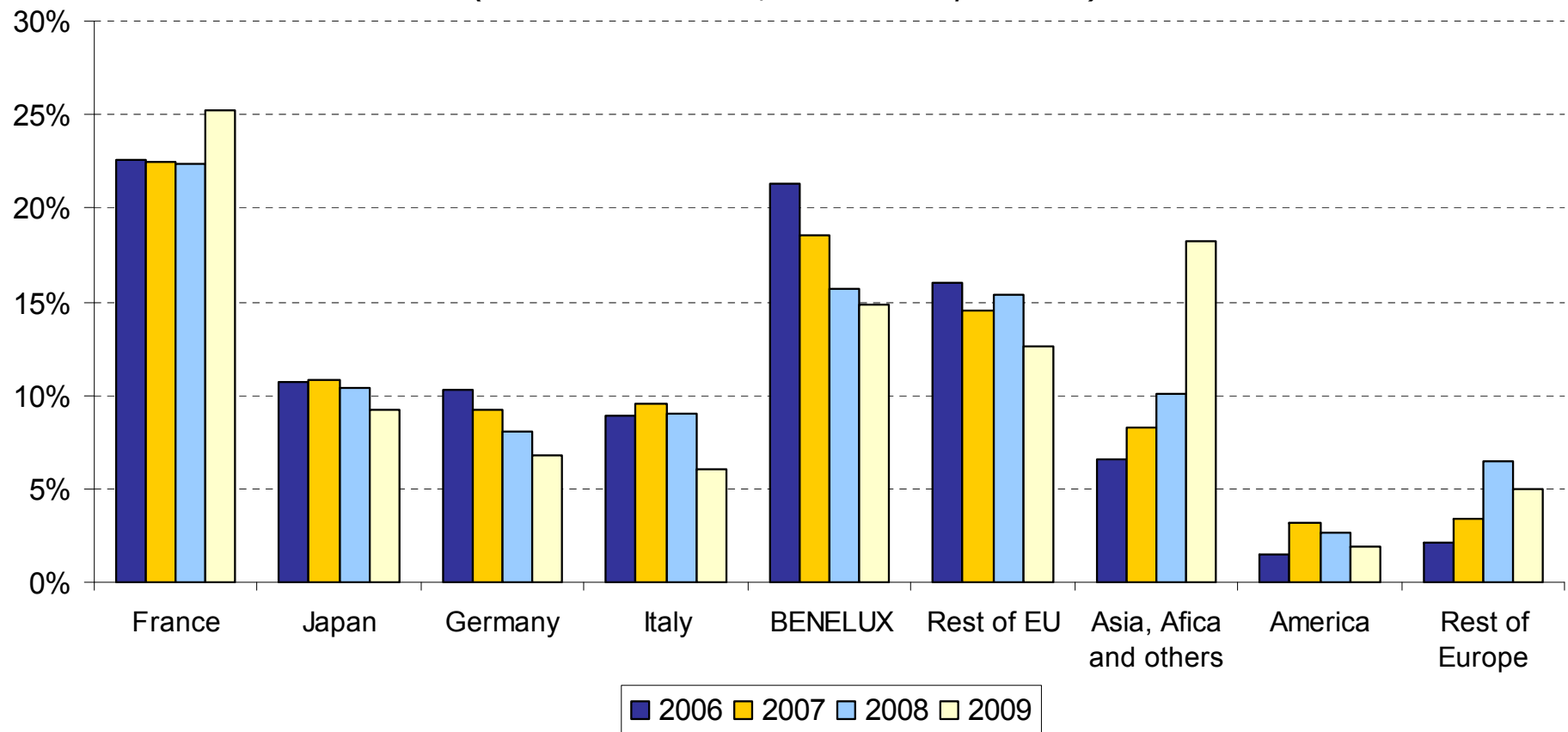


Source: Dirección General del Tesoro y Política Financiera.



## Stable and diversified investor base

**Government Bonds by Holder**  
(Term investment, % of total portfolio)



Source: Dirección General del Tesoro y Política Financiera.

## **Top Primary Dealers in 2009**

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### **Bonos y Obligaciones**

**Barclays**

**BBVA**

**Calyon**

**Santander**

**Société Générale**

**Letras**

**BBVA**

**Santander**

**Société Générale**

## Thank you for your attention

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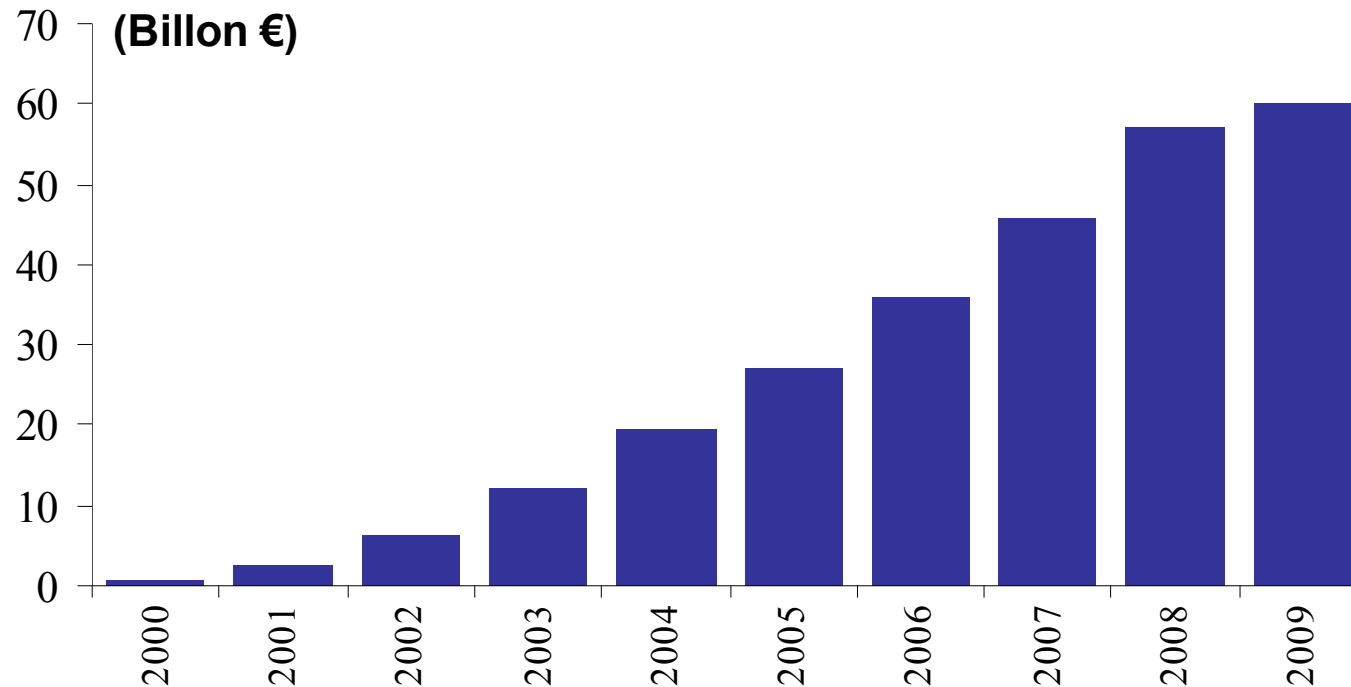
Reuters: TESORO

Bloomberg: TESO

Internet: [www.tesoro.es](http://www.tesoro.es)

## Annex: the Social Security Reserve Fund

### Social Security Reserve Fund asset holdings



The Social Security Reserve Fund amounted in December 2009 to approximately 5.7% (€ 60bn) of GDP.

## **Annex: Ley de Economía Sostenible & General Agreement on Fiscal Sustainability**

### **Competitiveness**

- Society of Information.
- Science, R&D.
- Internationalisation of SME's.
- Education.
- Reduction of administrative burden.

### **Environment**

- Energy Policy.
- CO2 Emission-reduction.
- Efficiency of transport and infrastructure.

### **Tax measures**

- Rental market: equal treatment with ownership.
- Elimination of tax rebates: i.e. relief on mortgage payments, 400€ rebate on income tax.
- Corporate Income Tax rebates related to R&D and to the environment.

### **Fiscal Sustainability**

- Spanish regions to formulate quarterly reports to the Fiscal Policy Council.
- Correction and surveillance of fiscal deficits.
- Debt/GDP ratio to reach limit of 60% by 2013.