

ESADE

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ECONOMIC OVERVIEW

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EDITORIAL

THE SPANISH ECONOMY'S D-DAY

The world economy started 2010 with prospects for recovery after the collapse of 2008-2009. The incipient recovery is uneven and comes from unprecedented fiscal and monetary stimulus, whose withdrawal timetable will be the subject of much debate during 2010. Unresolved, moreover, are the two basic issues underlying the outbreak of the crisis: the financial system and its reform, and the correction of the global imbalance in BOPs (balance of payments), with the United States and China central to this last issue. Both issues will be at the center of the economic debate in the near future, and their satisfactory resolution will depend on the sustained recovery of world economic activity.

In this global context, the European Union is debating how to fix this first crack in the Economic and Monetary Union (EMU). Since its introduction in 1999, the single currency has brought its advantages, but currently, more than a decade later, its drawbacks are beginning to be felt. The problem lies in the existence of major imbalances in the Member States' BOPs, the correction of which can no longer be achieved through their own monetary policy and exchange rates. The tension generated has raised new questions about the viability of the single currency project, the most ambitious undertaken in the process of European integration. Clearly, this is no minor issue, and it will surely be the subject of discussion for the foreseeable future.



Spain is struggling to restore its vital signs in this European and global context. Now that the worst problems of the global economy are, at least temporarily, behind us, blaming the international crisis for Spain's problems is no longer acceptable, and exposes the own identity of Spain's crisis. The diagnosis is very grave: a heavily indebted country with its income-generating model damaged. Furthermore, government borrowing is exacerbating foreign debt and leading the Spanish economy towards high-risk areas. Fiscal and structural measures that turn this indebtedness into solvency are essential. To do otherwise would be a social irresponsibility. This is the D-Day of the Spanish economy.

World Economy



WORLD ECONOMY: A RECOVERY IN NEED OF CONSOLIDATION (AND WITH HAZARDS)

Some good news (and some not so good)

The worst of the global crisis seems to have passed, but there are important differences between the various economies, and there remains some uncertainty about the robustness of the recovery.

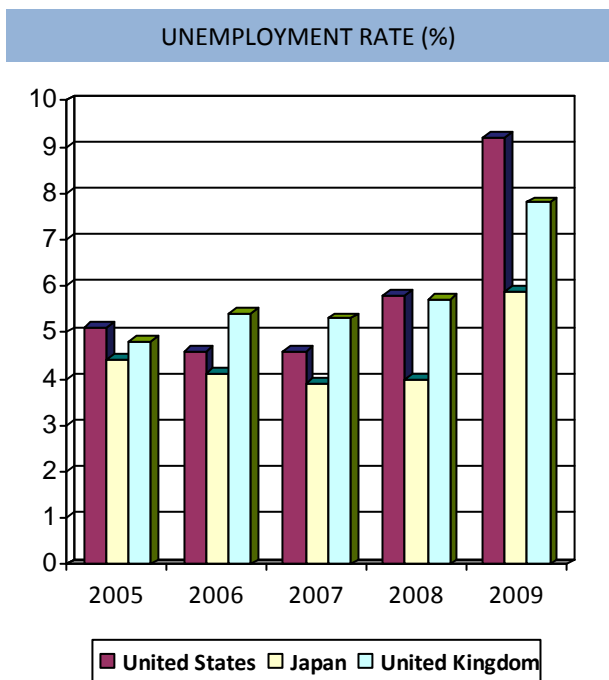
The world economy will grow again during 2010, after experiencing a setback in 2009 which was unprecedented since the Second World War. The start of the recovery is thanks to various public policies implemented throughout the entire global economy. The rescue of the financial system, the determined cut in interest rates by the principal central banks, and major fiscal stimulus packages carried out in developed economies and in a number of developing economies have taken effect and led to the recovery. These measures have helped to increase confidence and to maintain demand worldwide, and have also served to partially normalize financial conditions.

However, this recovery is very unevenly distributed among regions of the planet and even between countries within each region. The area that most contributes to this growth will be the emerging and developing economies, especially the large emerging economies of Asia. In contrast, developed countries will be rather slower to recover, to the

extent that, in many of them, weak GDP growth rates will be insufficient to create new jobs.

Globally, credit conditions are far from 'normal', which contributes to a somewhat lethargic and uncertain demand in many countries. The significant number of corporate bankruptcies and unemployment rates at historically high levels constitute serious obstacles to recovery.

Decisions regarding the phasing out of the enormous support packages deployed during 2008 and 2009 by monetary and fiscal policy, measures for the normalization of financial conditions and the correction of imbalances in BOPs are core elements of global economic debate.



United States: The giant gets up and begins to walk (although we cannot discount further setbacks)

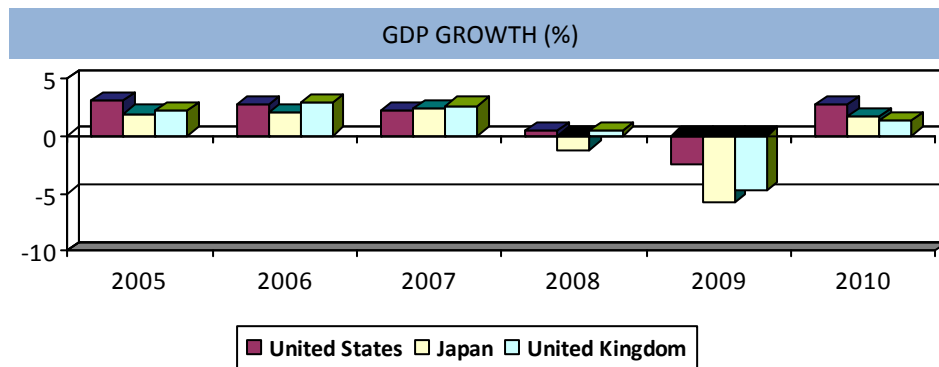
Although the growth figure for the U.S. economy was negative for the whole of 2009 (-2.5%), there were already some signs of stabilization in the second half, leaving behind the drop of 6.4% in the first half of the year and marking the start of recovery. In 2010 growth will be positive, but the magnitude of the crisis and the scars that remain in the financial sector and the overall economy mean that the U.S.'s growth will be some 2.5%, below its potential.

The financial sector appears to have avoided a systemic crisis, but its performance is still below what is needed. Credit to households and businesses continues to decline and capital markets (sale of bonds, securitization, etc.), the other possible source of corporate financing, remain at below-normal levels of activity. While the financial sector continues to inadequately fulfill its role of intermediation between household savings and investment companies, the American economy will not recover its growth potential.

The United States is actually immersed in the process of reforming its financial system to prevent a future crisis of the same nature. To achieve this, it is necessary to monitor risk, increase transparency, avoid oversized bodies and control interconnections. But it is also important that a part of the financial system can continue to take risks, because otherwise the U.S. economy cannot regain its leadership role in the development of technological innovation and its application to production processes.

"The United States has deployed the largest fiscal and monetary stimulus in response to the crisis"

The extraordinary interventions by the Federal Reserve and the Treasury prevented a full-blown recession, but recovery may be stalling. The high rate of unemployment will probably continue to rise during 2010, reaching 10% in the second half of the year, with the consequent negative effect this has on consumption, especially if families continue to prioritize the reduction of their indebtedness.



Source: IMF

The inevitably temporary nature of expansionary policies requires that private demand returns to being the driver of the economy as soon as possible. The appropriately timed withdrawal of the extraordinary support provided by macroeconomic policy is in fact one of the key challenges of the coming months. Another key challenge will be that the recovery rate of activity is not based on new external borrowing, which transcends borders and requires coordination at a global level.

Japan: a second lost decade?

The Japanese economy's very high degree of openness was the reason why it, of all the developed economies, felt the greatest initial impact of the crisis. Its GDP contracted by 1.2% in 2008 and 5.3% in 2009. But Japan's recovery in international trade, faster than expected, meant it was also the first advanced economy out of recession. It is expected that, by 2010, it will grow by around 2% (one of the highest rates among developed economies).

"Japan is in 'standby mode' and waiting for the recovery of external demand"

However, certain events have raised fears that this recovery is only temporary and, in the worst scenario, the Japanese economy will return to the stagnation it suffered for a decade, in what was a small-scale foretaste of the global recession that began in 2007: the bursting of real estate and stock

market bubbles, crises and bankruptcies in the financial sector, widespread loss of consumer confidence and persistent weak consumption, ongoing deflation, inability of monetary policy to revive the economy, and so on.

The factors that make us fear for recovery are many. The resurgence of industrial activity was due mainly to restructuring of the exporting sector stocks. Export performance will very much depend on the evolution of the American and European economies, Japan's main customers, and is therefore subject to the uncertainties affecting those economies. In turn, domestic demand continues to show the same weakness of the past fifteen years, the result of credit restrictions, rising unemployment, the effect that high public debt has on economic agents' expectations, and deflation (between 1999 and 2005 and again in 2009) that is two decades old, in either presence or threat, disrupting the plans of Japanese families and companies.



Bubbles in China

The Chinese economy was the first to recover from the crisis and dragged with it other emerging economies in the area. However, at this stage of growth some dangers and threats appear that may sap the strength from that growth and jeopardize its future viability. The financial and housing bubbles that led to the crises in economies as diverse as USA, Spain, Ireland, UK, Japan and New Zealand could also be brewing in the Chinese economy.

The danger is that China wants to maintain past rates of economic growth, substantially increasing its investment in real estate rather than investing in productive assets to ensure the continuance of long-term growth.

A number of factors are pushing in that direction. The performance of local and regional governments is measured by GDP growth and tax collection, so these local and regional governments take advantage of the fact that property investment leads to very obvious effects in the short term in a context of rising prices and optimistic buying, and overlook more effective investments for improving productivity of the economy that by nature take longer to produce results, and which, in a time of rising costs and lower profits in the manufacturing sector, provide a lower return.



Another factor to consider is that monetary policy is greatly influenced by the desire of the Chinese authorities to keep their currency weak against the U.S. dollar, following the strategy of export-led growth that has been so successful so far. This will require China to maintain a low official interest rate, following the lead of the Federal Reserve. In fact, as a result of increased inflation, the real interest rate could reach negative figures in mid-2010. This leads to strong credit growth, which in 2009 had already grown by more than 30%, and, in an economy with good growth rates like China, this abundant and cheap credit is not only financing productive projects, but also large amounts of real estate and stock market investments, and this is helping to inflate these bubbles.

Additionally, it should be noted that in 2009 credit to households still increased by 43%, which paints a scenario in which a part of economic growth is sustained by household debt. This introduces vulnerability in the financial sector if a brake on credit growth rate makes it difficult to refinance poor quality loans, which would begin to increase the default rate.

In fact, there are indications that, since mid-2009, a significant proportion of new loans are financing bad loans, meaning that the financial system could be moving into more advanced and dangerous stage of the cycle of financial bubbles.

Conscious of this risk and to reduce excess of credit, in January 2010 the economic authorities increased the minimum ratio of the banking system reserves. But this measure has not been enough to slow credit expansion, so it will require further increases in the future if banks ought to be forced to write delinquent loans on their balance sheets rather than refinance them and move the issue forward, as happened in developed countries in the years before the outbreak of the crisis.

Although the indices are below their peak in late 2007, stock prices are still high when taking into account the expected future profits. Even more danger is accumulating in some of the large Pacific coast cities where high real estate prices are clearly at levels characteristic of a bubble.

If, in the coming months, the Chinese economy follows a growth pattern that favors the continued expansion of these bubbles, then this will increase the danger that the economy will suffer a sudden stop in activity in the medium term. This would be very worrying for the entire global economy, which sees economic growth in China and neighboring countries as a prop for its own recovery.

The emerging economies: they were not invited to the party and, seeing the big picture, were the first to leave (for now)

The fact that the financial systems of developing countries were less contaminated by the toxic assets than those of developed countries suggested that the crisis would not affect these economies thanks to so-called decoupling. In the second half of 2008, however, the problems spread to these economies through a significant decline in international trade, and, in those dependent on capital inflows (especially Latin America), through the collapse of the international flow of capital.

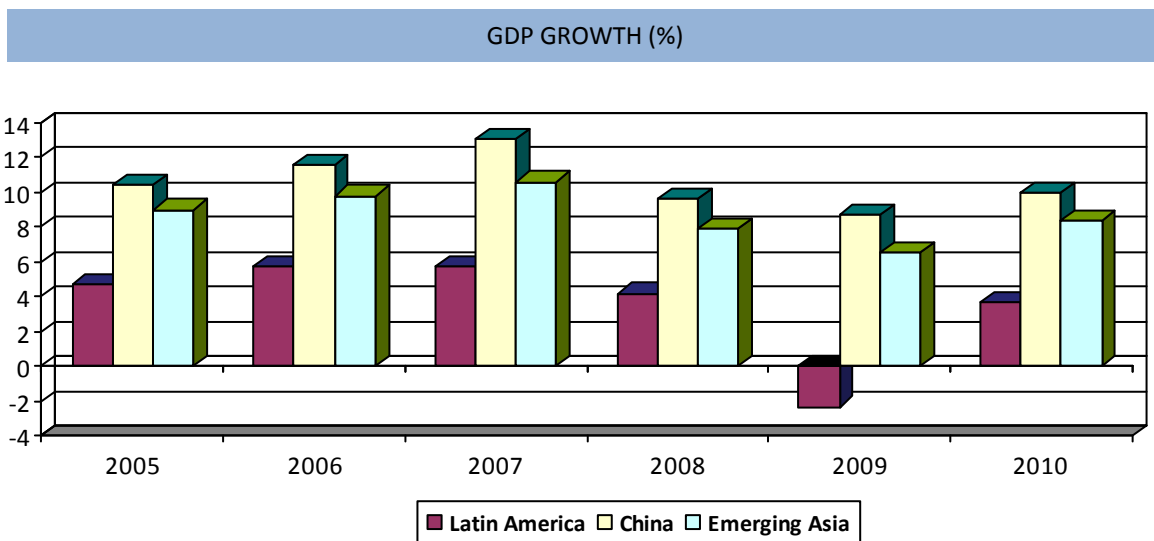
However, in the first half of 2009 it had already become apparent that developing economies, especially Asian, were coping reasonably well. This was helped by determined fiscal measures taken by governments, faster than expected recovery in international trade and strong performance of domestic demand, which was less exposed to credit restrictions than those of developed countries.

"Asia's contribution to global demand must increase substantially so that the recovery of the global economy goes hand in hand with the correction of external imbalances and thus may endure"

China's economy, which grew 13% in 2007, lost about 4 points in 2008 and 2009 but in 2010 its growth will again reach double digits. India grew by 9.4% in 2007 and also lost several points in the two following years, but in 2010 its growth will be close to 7%. The impact of the crisis was somewhat worse in the economies of Southeast Asia, which grew an average of 6.7% in 2007 and practically stagnated in

2009, but, largely thanks to China importing their products, they will grow by more than 4% in 2010.

Latin America suffered greatly from the crisis. The reason is their greater dependence on capital inflows and their high degree of interaction with the U.S. economy (especially in the case of Mexico). Brazil contracted by 0.7% in 2009 and Mexico by 7.3%. However, the impact will have been relatively brief, since average growth in the region is projected to be above 3.5% in 2010; a similar figure to before the crisis.



Source: IMF

Eurozone Economy



THE EUROZONE: A VERY SLOW EXIT FROM THE TUNNEL (AND NOT FOR EVERYONE)

A moderate and uneven recovery

In the second half of 2009, economic recovery began in the Eurozone. As in the rest of the world, recovery came sooner than expected, given the very pessimistic expectations of late 2008 and early 2009. The drivers of this recovery have been public policy and external trade.

During the second half of 2009 the Eurozone's quarterly GDP grew slightly, although 2009 overall saw a contraction of 4.0%. Growth in 2010 will be around 0.5%, still very moderate, and only in 2011 is it expected to reach a number closer to the area's potential of between 1.5% and 2%.

"Recovery is moderate and varies widely across the various member countries of the region"

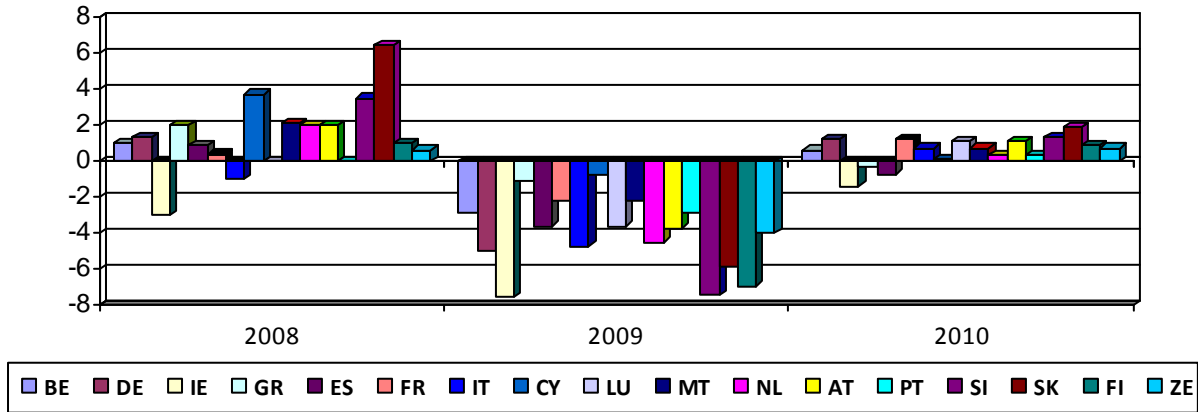
The reasons for this are diverse and include restrictive credit conditions of a financial system heavily based on banks, weak business investment due to low profits, the brake on private consumption induced by the high rate of unemployment, and difficulties in some countries continuing to cause housing bubble bursts. The average unemployment rate reached 10% in 2009 and will increase in 2010.

The two economies that have best responded so far are Germany and France. Germany suffered a severe initial impact due to the significant decline in exports driven by falling global demand and the strong Euro, but was also the first to take advantage of the recovery of international trade. France, with a somewhat larger public sector, absorbed the initial impact better and is basing its further recovery on domestic demand.

Overall, the economies that had lower external trade deficits (including Germany, France, Holland, and Austria) are recovering better, with expected growth for 2010 varying between 0.5% and 1.5%. In contrast, those whose growth was based on the construction sector with the consequent bursting of that bubble, such as Spain and Ireland, or those with less healthy government accounts, such as Greece, face major difficulties and likely negative growth in 2010.

To this must be added that, in the last months of 2009 and early 2010, the markets have been raising questions about several economies on the periphery regarding the soundness of their public accounts and whether they will meet the target for 2013, when the European Commission ruled that the public deficit of member states must not exceed 3% of GDP, as required by the Stability and Growth Pact. This problem has primarily affected Greece, which saw the interest rate of its 10-year bond ex-

EUROZONE GDP GROWTH (%)



Source: European Commission

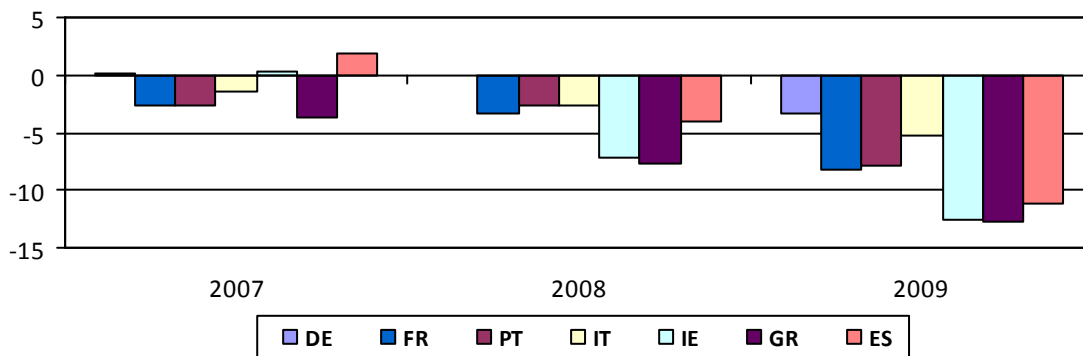
ceed 400 basis points above the German bond, but Portugal, Ireland, Spain and Italy have also seen the same markets and the European Commission itself questioning their public accounts.

"The indebted economies in the Eurozone are dragging a heavy burden that cripples their vital signs"

The debate focuses on the possible necessity for the rest of Eurozone countries to help pay the debt of a member state, and the hypothetical need for any of them to leave the Eurozone in order to devalue their currency, and this raises, for the first time since its creation, the possibility of rupture within the Eurozone.

The major adjustment plans, which involve public spending cuts and tax increases, are restrictive in nature. The need for them to take place before the consolidation, or even the beginning, of the economic recovery in these economies has kept alive the specter of recession or a prolonged period of stagnation.

PUBLIC DEFICIT (% of GDP) Selection of countries



Source: European Commission

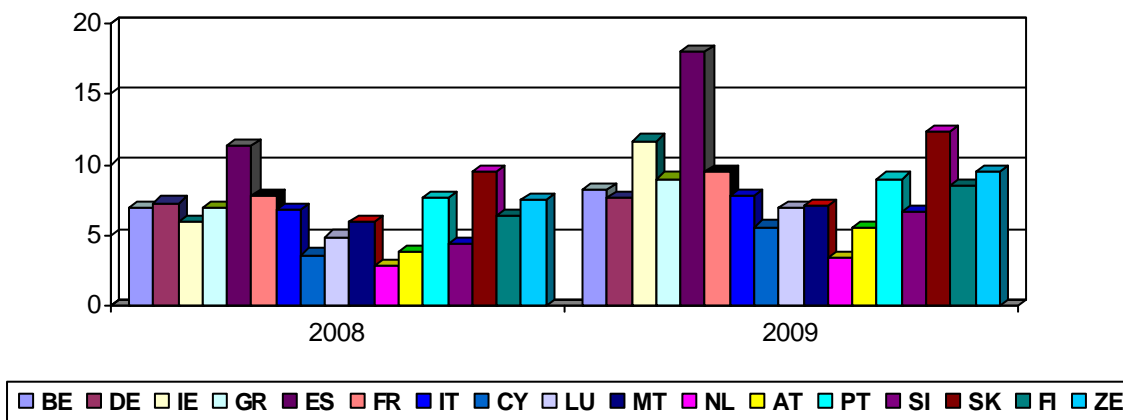
Hazards: private demand, unemployment and credit

The consolidation and speed of recovery in the area depend on a number of factors. The first one is the management of timing in implementing macro-economic policy. On the one hand, there is the moment when governments choose to reverse the trend of fiscal policies: if this is too early, growth may slow down; if too late, this can lead to excessive government borrowing which increases the risk premia of debt and pushes interest rates upward. In contrast, weak demand will keep inflation rates low, so that the ECB will have more room to rethink the pace of monetary policy normalization, in terms of the level of the current official interest rate (1%) as well as the use of unconventional measures to stimulate credit and maintain a significant flow of funds to the financial institutions, accepting as collateral a wide variety of bank assets.

Another important factor is unemployment. In the coming months many countries will reduce fiscal programs that support employment. If the unemployment rate increases above the forecast, private consumption and, consequently, recovery will be affected.

Finally, there will have to be careful monitoring of the financial sector to address the current difficulties and prevent the emergence of any new ones that might restrict the provision of credit to households and businesses. In mid-2009 the Greek government acknowledged a deficit of 3.5% of GDP, which rose in November of that year to 6%. By the end of the year the Greek government deficit turned out to be 12.7% of GDP. The markets were suspicious that official figures were unrealistic and, over the last year, the ten-year Greek government debt has seen its rate exceed 400 basis points over the German bond.

EUROZONE UNEMPLOYMENT RATE (%)



Source: European Commission

The European Commission forced the Greek government to embark upon harsh adjustment measures which will be monitored closely during the first half of 2010. The plan proposes freezing the salaries of officials, an increase in fuel taxes and the introduction of a plan to extend the retirement age. Despite this, the joint support of the IMF and EU was still necessary.

There is also a need for urgent action to prevent investors' lack of confidence reaching other economies such as the Portuguese, Spanish and Italian. The European Commission has also urged economies to initiate determined adjustment plans, because although paying some of the Greek debt would be feasible (Greece only accounts for 3% of GDP in the Eurozone), to do something similar with much larger economies such as the Spanish or Italian would be economically and politically unfeasible.

"For the first time since its inception, voices have arisen questioning the viability of a monetary union without greater political union that would allow pan-European institutions more flexibility to manage situations like the current one"

The scenario in which a member leaves the Euro to devalue its own currency is one to be avoided if at all possible. Not only could that undermine the single currency project, but also would probably plunge the restored currency or currencies into a context of monetary instability, and devaluation would negate the possibility that the economies

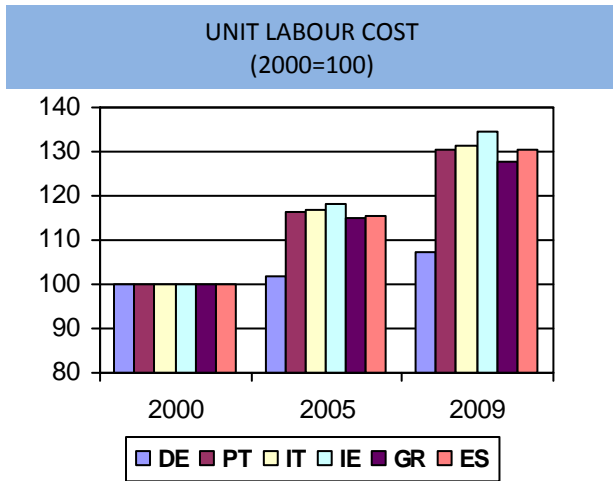
could conduct an independent monetary policy, forcing them to raise interest rates and leaving them in a state of chronic stagnation.

Public deficit, productivity and adjustment in the Eurozone

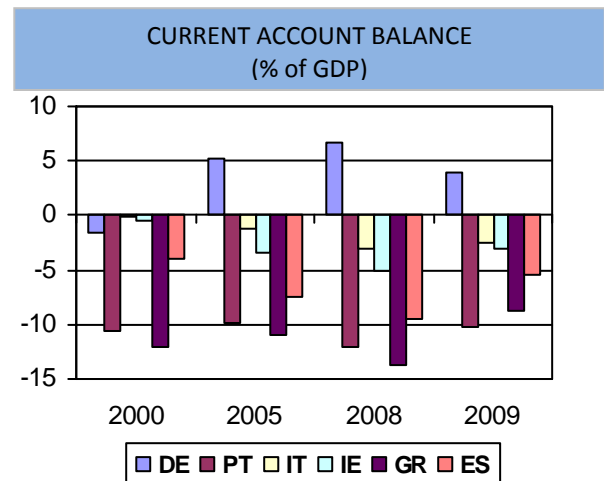
As a consequence of the expansionary fiscal policies of 2008 and 2009, all Eurozone countries' public accounts are in the red, but behind these figures are very different situations and some of the economies of the region are showing a worrying trend.

The most notable was Greece, which finally required the joint support of the IMF and the EU to meet its obligations and restructure its debt to try to minimize the risk of jeopardizing its economic recovery. The various fiscal measures taken by Greece at the request of European authorities since the beginning of 2010 were not enough to calm the markets, and the spread of Greek bonds against the German bonds in February reached alarming levels. Having at risk not only Greece but also the image and strength of the single currency, and even its own viability, the European authorities showed their willingness to promote and closely monitor the necessary severe fiscal adjustments.

What made investors doubt was that the very magnitude of the adjustments would leave the Greek economy atrophied. Being in recession, adjustment measures in the form of spending cuts, public sector payments to families, and tax



Source: European Commission



Source: European Commission

increases could prevent the onset of economic recovery and thus seriously impair the ability of the Greek government to increase revenue and also cut social spending. That is, there was a danger that the Greek economy would remain in a state of "slow death" in which no fiscal adjustment would allow it to meet its external obligations. This is why it was finally necessary to rescue Greece from part of the debt, despite the high cost in terms of image and the harm in terms of future incentives.

But other economies also have problems with their public debt, although of lesser magnitude, which at some point have set alarm bells ringing and placed them in the cross-hairs of investors and speculators. This is the case of Portugal, Italy, Spain and Ireland, who also have a serious combined problem of public and external debt. The root cause of these problems is not in policies that were needed during the last crisis. The underlying causes must be sought in structural defects accumulated during the long

previous period of growth. These defects left them in a vulnerable position when came the time to use expansionary fiscal policies to support financial systems and sustain the ailing private sector demand.

In all these economies, the expansion of credit in the last decade allowed excessive consumption and a drop in savings. In a context of strong demand pressure, margins and wages increased above productivity gains, generating a steady erosion of external competitiveness that led them to accumulate a significant shortfall in their current accounts. This was worsened still further by competition from emerging Asian economies and the extreme strength of the Euro during the period.

That is why fiscal adjustment will not be enough to restore investor confidence. It will also be necessary to take measures and structural reforms to allow recovery of external competitiveness through in-

creased productivity of the economies and flexibility of their market adjustment channels (prices, wages and mobility).

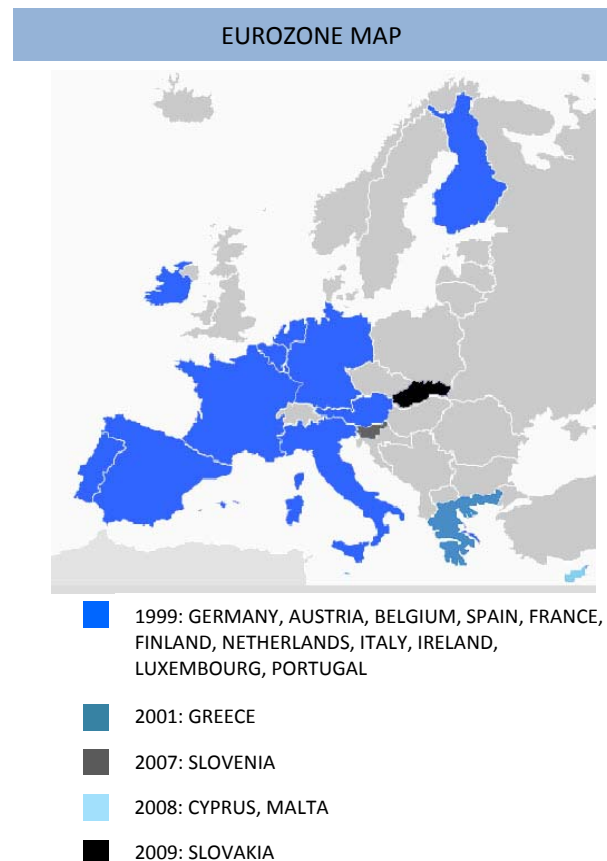
For the future viability and proper functioning of the single currency, it is not only necessary to create the institutions and appropriate protocols for the resolution of future crises. It is at least as important to create conditions that prevent the recurrence of such problems in the next period of growth. For the Euro to be viable in the future there has to be a convergence in productivity and the activation of market adjustment mechanisms to reduce the magnitude of the current account deficits and external borrowing requirements of the weakest economies. It is a slow process because it involves changes and reforms in economies, but it has to be both an objective and a means to an end of the single currency; something that European policy-makers should keep in mind.

The European Central Bank: neither too early nor too late

The ECB has already announced the start of the gradual withdrawal of its extraordinary injections of liquidity into the banking system, having overcome the risk of systemic crisis in the financial system. The withdrawal of these extraordinary sources of funding will increase the problems of public debt in those countries with greater deficit, since in 2009 a large amount of new public debt was purchased by

financial institutions taking advantage of that liquidity. This strategy, equivalent to the monetization of part of the debt, was acceptable in a time of sharp contraction in economic activity and deflationary pressures. But once the situation has improved and the specter of deflation has gone, it is bad for future price control, doesn't tackle the need to adopt more sustainable budgetary positions, and could even lead to the appearance of new bubbles in financial markets, such as an excessive rise in stock indices.

However, it is unlikely that the ECB will start an upward trend of the official interest rate during 2010, and must make that decision based on careful scrutiny of the various economies' progress.



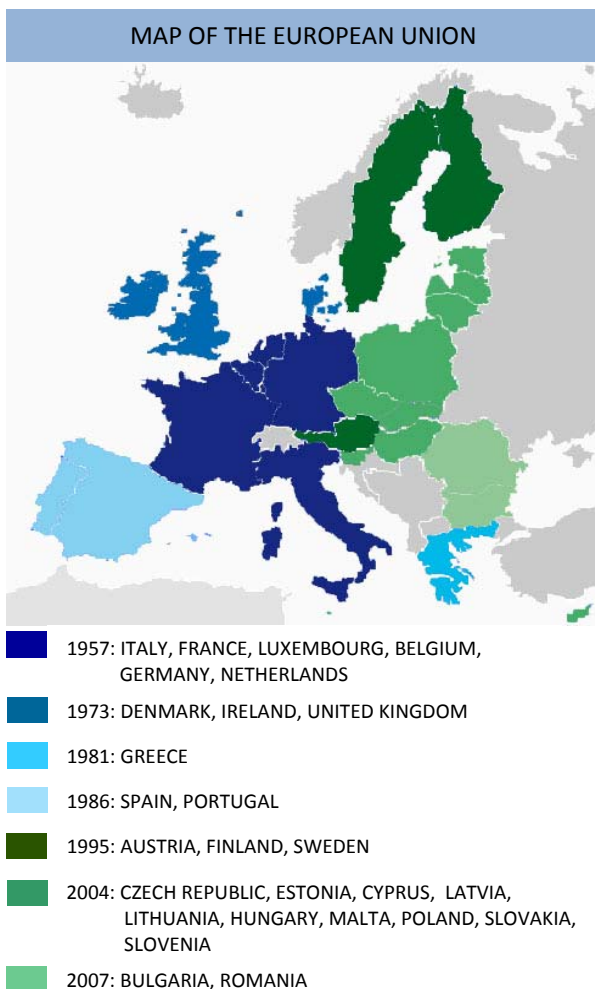
The European Union: outside the Eurozone

The UK experienced a significant decline in economic activity in 2009, being among the countries that saw the global economic crisis coincide with the bursting of the housing bubble. However, in 2010 it will grow by around 1%.

The British government has undertaken one of the most significant set of fiscal measures. As in other cases, the ability to replace the momentum of public demand with private demand will be the key

to consolidating the recovery, especially if we consider that the public borrowing capacity may be reaching its limits, which is why fiscal adjustment plans cannot be postponed much longer.

In the group of emerging economies, those of Eastern Europe are showing greater difficulties in returning to economic growth. These countries suffered particularly due to the sudden drop in the flow of foreign capital. Some of them have needed support from the IMF to compensate for imbalances appearing in their balance of payments. Recovery will be slower than in other emerging regions because international capital still shows excessive risk aversion towards this area.



Financial reform in both sides of the Atlantic

In the EU, the High Level Expert Group on Financial Supervision was commissioned to make recommendations to the European Commission. It proposed that the ECB has a primary role in macro-prudential supervision but under the leadership of a newly-created European Council for Systemic Risk. Responsibility for micro-prudential supervision will fall to another newly-created agency, the European System of Financial Supervision, since it is considered that current arrangements for cooperation between the committees of each economy's central bank are insufficient to ensure financial stability.

The High Level Expert Group has also made a considerable number of further recommendations, based on an in-depth review of the current regulatory framework for Basel II; proposing to increase minimum capital requirements but also to introduce a dynamic system of provisions to avoid its pro-cyclical nature. The Group will also perform a thorough review of the business model and funding of the rating agencies, clearly separating their credit ratings business from consultancy. It is also proposed that they revise the principles of accounting assets at market prices.

Another aspect considered is the regulation and supervision of the system of 'parallel banking', as the recent crisis has shown its potential to generate a systemic crisis. For example, hedge funds should be more transparent, and establish better information requirements.

Markets for structured products and derivatives should be simplified and require the issuing institutions to keep in their portfolio a sufficient share of the underlying risk which is not covered. Investment funds of the EU should have common rules, and remuneration of financial executives should be linked more closely with the long-term viability of the institution. The EU must develop a regulatory framework for crisis management that is consistent and clear and member states should agree on criteria for burden sharing.



On the other side of the Atlantic, the United States proposes the creation of the Financial Services Oversight Council, chaired by the Treasury, which will have among its basic objectives the improvement of regulation and supervision of financial firms, while being responsible for the supervision of systemic risk, and avoiding the inefficiencies, gaps and overlaps with the current diversity of federal agencies responsible for these functions.

It provides a more rigorous and transparent regulation of large and interconnected financial institutions. Accounting standards will be reviewed for all financial institutions and will require them to make greater advance provision on future losses due to credit. It is also intended to increase the capital and management requirements of all banking entities.

Hedge funds and other private funds such as private equities and venture capital funds should provide more transparent information so that regulators can establish whether they represent a risk to financial stability.

Moreover, not only will reforms be carried out in financial institutions but also in the markets. Among others, the markets for mortgage-backed securities and securities guaranteed by other assets, the lending of shares and other securities and CDS markets will undergo an increase in regulation to prevent them contributing negatively to any future crisis. Institutions that originate or trade securities should keep 5% of the credit risk of these securities. OTC (Over The Counter) markets will face increased transparency requirements, and they will be forced to have a centralized clearing and settlement system similar to other transparent markets such as the stock markets.

The Consumer Financial Protection Agency was created to strengthen the inadequate protection of consumers in the financial products market. The Agency will promote clear and concise information on products and protect consumers from unfair or illegal practices.

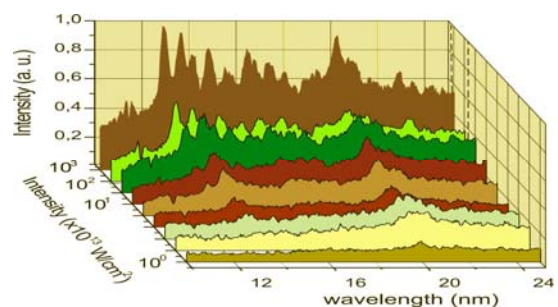
Finally, the government will provide the necessary tools to manage future financial crises more efficiently. There will be an orderly system, planned in advance, for the bankruptcy resolution of major financial institutions. In addition, the Treasury will

have emergency power to liquidate any large institution in an orderly manner if the financial system is threatened, on the authority of the President and two thirds of the members of the Federal Reserve Board.

The debate on the financial system reform has only just begun, and will be with us for the next few years as one of the basic challenges of the global economy.

Asymmetric shocks and monetary union

By creating the single European currency, countries that joined the project obtained a number of important advantages, but also were willing to accept certain inconveniences. During the growth phase the benefits became more evident: the disappearance of exchange rate uncertainty and transaction costs between currencies, creating an environment where low levels of inflation and interest favored investment, consolidation of a single market that favored companies' growth strategies, improved financial integration that increased the efficiency of investment projects, budgetary rigor, and much more besides.



However, with the arrival of the crisis, the problems that had remained somewhat hidden have surfaced over the last two years, threatening to tear the political and economic fabric of the single currency, to the extent that those most critical of the viability of the single currency project insist that the difficulties involved can force a country to abandon the Euro and ultimately jeopardize the very existence of the European monetary union. The problem revolves around so-called asymmetric shocks.

Economic theory has always pointed out the dangers that asymmetric shocks pose to the proper functioning of a monetary union. These occur when some of the economies of the region experience major problems, such as a severe recession, while others do not. That is what happened to Greece early this year; all economies in the Euro area experienced a major recession in 2009, but the magnitude was different in each case. The real asymmetric shock for the Greek economy was that their public accounts suffered a much greater deterioration than the other Eurozone countries, to the extent that there are serious doubts about Greece's ability to pay its debts alone.

For an economy in such a delicate situation, the instruments available within the monetary union are few. It does not have its own monetary policy or a central bank to adjust interest rates to the level that would be ideal for the economy. In the absence of Greece former central bank, nor can it rely on

that to monetize part of the debt, albeit at the cost of inflation. Nor can they devalue the currency to stimulate exports and thereby promote economic growth. Fiscal policy is heavily constrained by the Stability and Growth Pact under normal circumstances, and while the uniqueness of the crisis has led to a temporary relaxation of these conditions, a balance must be recovered in the near future. Moreover, in the specific case of Greece, an expansionary fiscal policy is by no means the solution, since its problem has been precisely the abusive and uncontrolled use of that instrument, generating too high a deficit and thus excessive borrowing.

We might ask ourselves what other currency areas do in a similar situation. It is entirely possible that in the United States one of the states of the union undergoes an asymmetric disturbance adversely affecting its economy at a time when the rest of the country's economy evolves in a positive way. A small U.S. state does not have any of the tools that Eurozone members have lost, but there is a federal government with full fiscal sovereignty that can take budgetary steps to help that state. By contrast, public opinion in Eurozone countries with greater weight are not in favor of paying the additional taxes needed for such action.

It is possible that a long-term solution to new asymmetric shocks may include greater fiscal leeway for European institutions or the creation of a relief fund, a kind of IMF for the Eurozone area, as



has been considered lately. But it doesn't seem like a good idea to create such mechanisms in the rush of the current pressing crisis.

Such instruments should be designed to have the wide support of public opinion, and must take into account in advance all possible future cases in order to avoid frequent reforms. Furthermore, it is vital that they don't generate perverse incentives that help lower the autonomy of each government, relying on external support in case of difficulties. But the difficulties of their creation in the short term must not make us forget that it will ultimately be necessary to take steps in that direction to improve the functioning and resilience of the European Monetary Union in future crises.

Spanish Economy



THE SPANISH ECONOMY: THE RECOVERY THAT DIDN'T COME

An apparent lack of momentum

The Spanish economy ended 2009 with a decline in GDP of 3.6% and will shrink about 0.5% in 2010. The first figure is consistent with what was experienced by most developed economies, but the small contraction in 2010 denotes a differential situation. Among developed economies, the Spanish economy will be one of the very few that will continue to decrease in 2010, and the only one of the G-20. Furthermore, no one dares to predict at what point growth rates will go over the vital 2% which would allow the creation of new jobs.

Household spending appears to be flat, and business investment is worse. The construction sector, even though its fall was moderate thanks to non-residential investment by the state, is strongly affected downwards by the increasing deterioration of residential investment. It is not expected that this sector can contribute anything to growth in the next three or four years, and when it does it will no longer have (and nor should it have, in reality) the driving role it gained during the last growth cycle.

The moderate positive contribution of the external sector is, unfortunately, due to falling imports and not to better export performance. The competitiveness of

Spanish products abroad remains one of the areas of unfinished business of the economy. The government's fiscal policy has served to offset the initial impact, but was designed to slow down events and with a focus only on the short term. The fact that the activity trend remains in negative figures in 2010 seems to suggest the ongoing economic L-shape.

Consumer and business confidence will not recover

If the economy declined by 3.6% in 2009, domestic demand made it even worse, at 6%; a difference attributable to the conduct of the foreign sector.

The evolution of consumption, with negative rates of change since the second quarter of 2008, makes it clear that families continue to feel the negative effects of the difficult access to credit, loss of jobs and the negative wealth effect caused by the decline in house values. Some positive factors including low inflation, lower interest rates on loans or increased financial wealth due to rising stock market indices have only served to slow down this fall, but not to restore consumer confidence.

As a result the savings rate has increased to historically high levels; 17.5% of disposable income in 2009. Unfortunately, these savings are only just beginning to be very modestly channeled into productive investment. Most of it is in cash or in bank

accounts: the net balance to investment funds remains negative, and only the stock market attracts the odd burst of activity.

"The credit squeeze suffered by businesses and families with viable projects is the result of mismanagement in the financial sector"

Business investment in equipment continues to decline at very high rates, although this has slowed. The fall was more than 20% in the third quarter of 2009 and more than 12% in the last quarter. Negative expectations about the evolution of the Spanish economy continue to affect companies who continue to reduce their investment in equipment in the face of sluggish domestic demand and an international demand that is only weakly recovering. The continuing credit restrictions do not help. In this area the Spanish financial institutions are among the most reluctant of the Eurozone, which creates problems especially for small and medium companies. Large ones, by contrast, have a somewhat greater margin for funding because they can go to foreign entities and the equity markets, where the situation is beginning to experience some improvement.

A short-sighted fiscal policy

The government reacted to the crisis, according to the Keynesian orthodoxy and the guidelines of the IMF, with a major fiscal stimulus. The good starting position allowed a certain margin: in 2007 the public



Elena Salgado, Minister of Economy and Finance

budget showed a surplus of 1.9% of GDP, while accumulated public debt represented only 36% of GDP.

Fiscal policies have focused on supporting demand, subsidies for maintaining jobs, and increasing unemployment benefit. No doubt, these measures have served to mitigate the impact of the crisis in the short term, but such disbursements are necessarily of limited duration, since they cause a sharp deterioration of public accounts without any measures for future correction.

Worryingly high public deficit and public debt: avoiding the Greek tragedy and escaping the Spanish farce

Despite Spain's good position at the beginning of the crisis, the behavior of automatic stabilizers and the use of expansionary fiscal policies have led to rapid growth in the public deficit. Income declines due to

falling tax revenues, both direct and indirect, while expenses grow through increased spending on unemployment benefits and public investment; thus the Spanish economy ended 2009 with a deficit exceeding 11% of GDP.

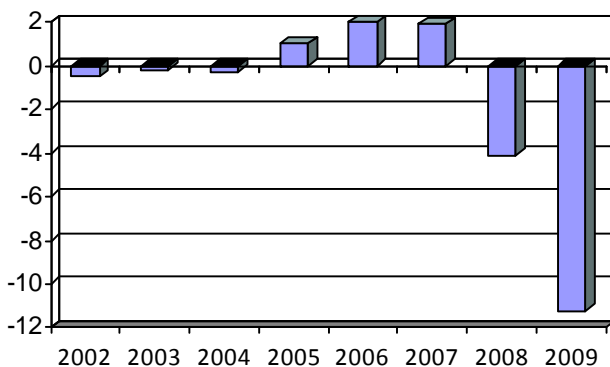
"Spain will need the complicity of the European institutions to resolve the crisis, which will only be achieved through a clear movement toward a sustainable fiscal position"

Led by the high deficit, public debt has increased substantially, from 36% of GDP at the beginning of the crisis to over 50% in 2009 and a forecast of over 60% in 2010. It is still not a very alarming level of public debt, since it is still below the Eurozone average, but its rapid deterioration and doubts about whether the government is capable of reversing the trend are causing alarm in the markets.

The financial burden associated with this debt is increasing. Due to the uncertainty in the markets the interest rate spread against the German bond has increased, and may do so further as the ECB stops the injections of extraordinary liquidity begun last year. This liquidity has allowed banks to buy debt in large quantities and avoid the upward pressure on their rates that would result if investors demanded a premium for increased risk. Moreover, the burden will increase further when the ECB begins its upward pattern of official interest rates.

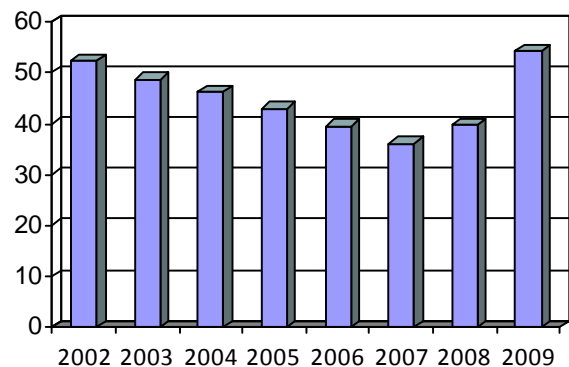
The European Commission has imposed on the Spanish economy an excessive deficit procedure which requires the authorities to restore fiscal balance in 2013. Economic recovery alone will not be enough to achieve this objective of budgetary stability and the government will need to start taking adjustment and fiscal consolidation measures as soon as possible.

PUBLIC DEFICIT OF SPANISH ECONOMY (% GDP)



Source: European Commission

PUBLIC DEBT OF SPANISH ECONOMY (% GDP)



Source: European Commission

It is likely that, in the short and medium term, the Spanish economy will need some sort of assistance from the European institutions to resolve the crisis, and movement toward a sustainable fiscal position in line with European guidelines are a prerequisite for this assistance.

Fiscal adjustment: where to cut without causing more damage?

The government has already started a tentative budget adjustment process with the rise of VAT scheduled for July 2010, on top of the tax increases on tobacco, gasoline and diesel made in May 2009. The logic underlying the increase in the rate of VAT is that indirect taxes represent the most neutral instrument in terms of potential economic growth, but certainly its increase is controversial due to its contracting effect, and from the equity point of view because it is regressive.



José Luis Rodríguez Zapatero, Prime Minister of Spain and Mariano Rajoy, Leader of the Opposition

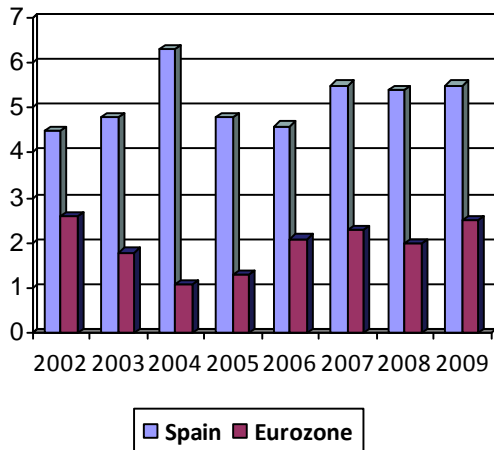
To cut the current deficit from more than 11% of GDP to 3% will be necessary both to raise public revenue and cut expenses, but this latter part will be the most important. An increase in some taxes, especially VAT, and the recovery of lost revenue are unlikely to be sufficient alone. Therefore, the correction will require reducing public expenditure as a percentage of GDP. Furthermore, this adjustment must be achieved in a time when demographic changes project an increase in spending on health and pensions, in order to maintain the current structure. Also, the rising debt and the likely rise in interest rates will increase the interest payments on debt.

What to do?

Public investment may be reduced, but should remain at levels similar to those before the start of the crisis if economic productivity is to be improved.

Public consumption should contribute to the adjustment. Core elements here are spending on public wages and spending on intermediate goods for the provision of basic public services such as health and education. The first element requires addressing the issue of the number of civil service staff and their salary levels. The second element must be seriously considering the introduction of fractional payment schemes by the user in the provision of public services.

GROWTH OF PUBLIC CONSUMPTION (%)



Source: Bank of Spain

To place the entire burden of adjustment on investment and public consumption is not the most desirable. It will also be necessary to address painful structural reforms that reduce public transfers: a review of the pension system to ensure its long-term sustainability, and labor market reform to establish more favorable conditions for employment and income generation for the state, while reducing the amount of unemployment benefits.

"The budgetary adjustment must be focused on public consumption and will require reforms that generate economic activity to reduce the relative weight of social payments"

The government's performance has been erratic and confused. Only a month after the adoption of the budget for 2010 it was necessary to propose spending

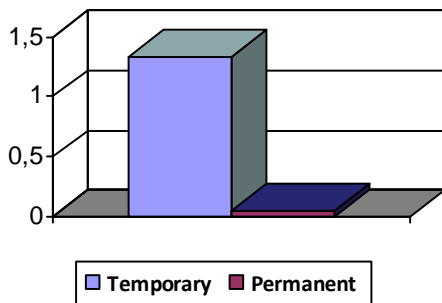
cuts of 50,000 million Euros during the period 2010-2013, and the flurry of proposals take different forms every day. It is vital that the government gains credibility and stops giving citizens, businessmen and international investors the sense that there is no thought-out and planned script. They need to avoid at all costs the appearance that fiscal policy choices seem more like a farce, with twists and unexpected occurrences, leaving the audience stunned and unable to predict a happy ending to the story.

The issue of fiscal consolidation to achieve budget stability within the Eurozone conditions is of vital importance for the future of the Spanish economy. Given the complexity of some of the reforms to be undertaken and the obvious social costs of some of them, it is necessary to avoid partisan politics and to open an honest and unprejudiced debate that definitively clarifies that Spain cannot continue living beyond its means.

Unemployment, a problem with a painful solution

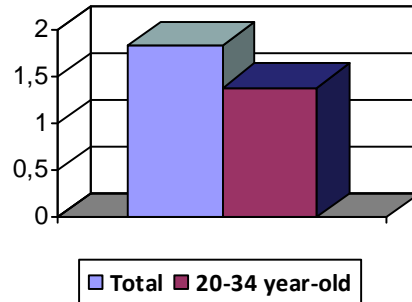
The unemployment rate in the Spanish economy exceeded 18% in late 2009 and although the job losses slowed significantly in the last quarter of the year, still reached more than 20% in 2010. This is the highest rate in the Eurozone and is more than double the average. To reduce it will take time and require sacrifices.

JOB LOSS IN SPAIN
Millions



Source: INE (National Statistics Institute of Spain)

JOB LOSS IN SPAIN
Millions



Source: INE (National Statistics Institute of Spain)

While the job loss was concentrated initially in the construction sector due to the bursting of the housing bubble, it has now spread to the rest of the economy. In 2009, the fall in employment was 15% in industry and more than 6% in the market services sector.

"The dichotomy of temporary/permanent contracts must disappear from the Spanish labor market because it is neither fair nor efficient"

Unemployment is especially high among the young - one in three people under 25 will face a relatively long phase of unemployment - and the immigrant population, in which unemployment has reached 25%. The unemployment percentage is somewhat higher among unsalaried workers than among salaried employees, and is overwhelmingly higher among temporary workers than among those who have permanent contracts, thus consolidating the dual nature of labor market in Spain.

Unemployment is for several reasons one of the main challenges for the Spanish economy, due to the impact on people's lives, the high public cost in terms of unemployment benefits, because of its potential social destabilizing effect, and because it greatly hinders the recovery of private consumption and contributes to the continuation of a low-growth situation.



Areas of actions and measures to be taken

In the fiscal area several actions are required. First, a revision of public consumption is needed, which for years has been growing faster than the economy itself. The control of expenditure in public wages and salaries is an important element in this regard, as is considering the introduction of fractional payment schemes in the provision of public services such as health and education. Secondly, it is imperative not to postpone the revision of the public pension system.

The rehabilitation of public finances would extend the implementation period of the current counter-cyclical fiscal policy without generating fear in international investors fears about the solvency of the Spanish public administrations. It would also allow a public investment policy aimed at developing sectors that can help to renovate the Spanish productivity model.

In the labor area, it is necessary to eliminate the dichotomy between temporary and permanent contracts. This must be the first step in a redesign that creates a working environment appropriate for a growth model based on stable relationships between workers and firms.

In business, it is necessary to implement tax incentives for companies to align with the public sector in developing strategic productive sectors. Similarly, discussion is needed of possible measures to encourage corporate social responsibility.

In the financial area, in anticipation of setting concrete lines of international coordination, it is necessary to accelerate the restructuring process and overhaul responsibilities in poorly managed institutions. The damage to the Spanish economy caused by bad management must not go unpunished.



Is the financial system approaching check-mate?

When the problems of the subprime crisis spread to virtually the entire global financial system, it seemed that the Spanish financial system was in a position of relative strength thanks to almost no exposure to toxic assets. However, Spain's financial crisis has come about in other ways: the severity of the downturn in the economy and a strong exposure to risk from the bursting of the housing bubble.

The delinquency rate stands at just above 5% and is likely to continue increasing due to continued deterioration of real activity and high unemployment rates. This increase in defaults was largely due to construction and property development. The delinquency ratio in this sector is approximately twice that of the private residential sector.



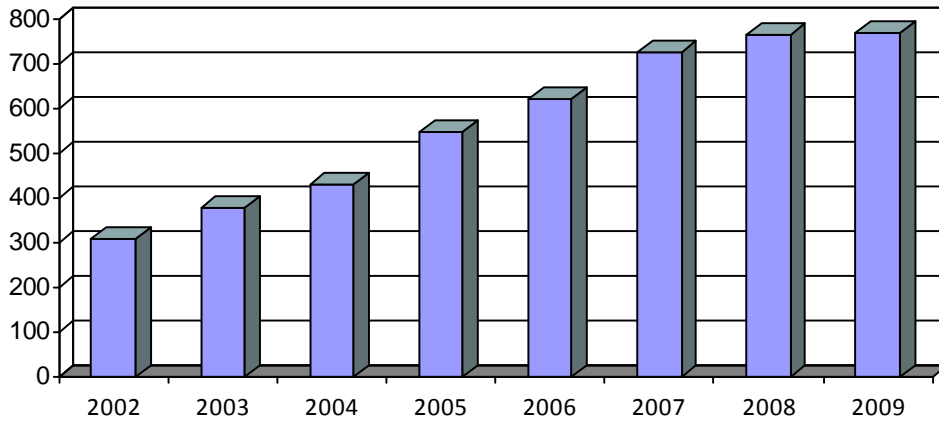
Miguel Ángel Fernández Ordóñez, Governor of the Bank of Spain

Credit to the construction industry is characterized by the real collateral offered by the building whose purchase or construction was financed. In this regard, over 85% of funds pose an LTV (loan to value, the ratio between the value of the loan and the collateral) below 0.8. This means that for the vast majority of credit, the loan value is less than 80% of the value of the property financed.

The problem is that house prices have fallen only a small fraction of the 25-30% typically seen in the bursting of any housing bubble. As the house prices go down, the LTV risk of many loans increases, so the present data are underestimating the problems which, for the financial sector, could mean an expected increase in defaults, especially given that the banks directly or indirectly own approximately 50% of real estate companies in Spain.

This is because banks were buying property development companies and their associated real estate before these companies start having trouble repaying loans, and are using their own real estate companies to place these properties on the market, in some cases using aggressive strategies such as the 40-year mortgage financing, an interest rate of Euribor plus 0% or guarantees to repurchase the property in the event of future adverse circumstances for the buyer.

EXTERNAL DEBT OF THE FINANCIAL SECTOR IN SPAIN (Billions of €)



Source: Bank of Spain

The Bank of Spain and the government have taken steps in anticipation of the financial system losses being higher than expected. The first in November 2009 increased the requirement for provisions; this may be raised again in 2010.

September 2009 saw the creation of the Banking Ordinance Restructuring Fund (FROB) to provide assistance in the process of restructuring the banking sector. This restructuring may imply the need for mergers or takeovers between banks to improve their efficiency by strengthening the equity of the resulting entity.

The worst scenarios in the sector would require injections of public capital into those financial institutions most exposed to property risk, especially some savings banks. So far, public support for the fi-

ancial system has taken the shape of guarantees to facilitate the issuance of debt or access to certain capital markets and the creation of the FROB. If injections of capital were needed, the cost for the state could be enormous and would be a further blow to public deficit figures at a time when the government is attempting the difficult process of adjusting their accounts.



Headquarters of the Bank of Spain

The reforms cannot wait

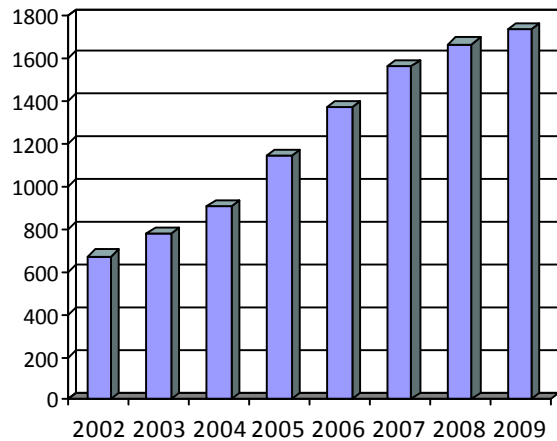
The external debt of the Spanish economy has grown dramatically in the last decade, especially since 2004. In 2009, it amounted to 1.735 billion Euros, equivalent to 170% of GDP. In 2010, it will continue to increase due to the growing need for financing the public authorities.

"The Spanish economy needs a change in direction that will restore credibility in its ability to meet its high external debt"

The argument that the authorities have room for borrowing because their finances were based on sound position is misleading and dangerous. What matters is that their indebtedness is added to the rest of the economy, which has already reached critical levels, especially thanks to the Spanish financial sector debt which accounts for 45% of the total indebtedness of the economy.

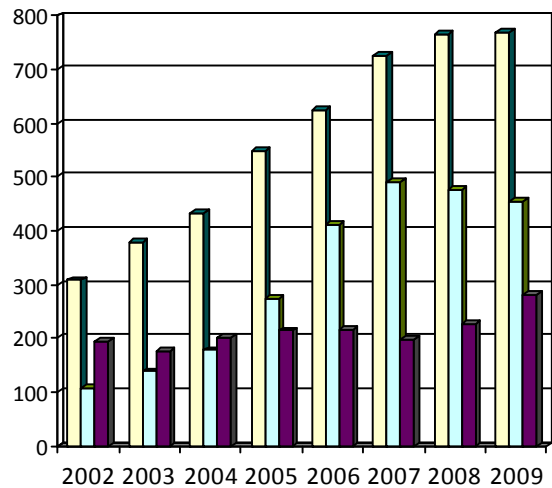
It appears that the mortgage the Spanish economy took out on its future is being called in, and measures to ensure the solvency of the economy cannot be postponed any longer. Further postponing could mean the sudden loss of international creditor confidence, which would plunge the Spanish economy into a much more complicated situation than the one it's already in.

SPANISH EXTERNAL DEBT, TOTAL
(Billions of €)



Source: Bank of Spain

SPANISH EXTERNAL DEBT, BY SECTORS
(Billions of €)



Source: Bank of Spain

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ABOUT THIS PUBLICATION

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