



Update on “Accelerating fiscal adjustment and structural rebalancing in Spain”

July 2010

- **Highlights on the macroeconomic adjustment**
- **Update on Acceleration of fiscal adjustment**
- **Update on Finalising key structural reforms**
- **Update on Funding and Debt Management**

Real economy adjustment: rapid progress but need to build further muscle

- **The economy is rapidly correcting three major imbalances caused by excess investment in housing , laying the ground for healthier growth:**
 - 1.Excessive weight of Residential Real Estate (RRE) in GDP**
 - 2.Rapid expansion of credit and leverage in the private sector**
 - 3.Current Account Deficit (competitiveness and productivity)**
- **Short term cost is higher deficit and unemployment**
- **Policy is tackling the deficit and addressing structural bottlenecks as a means to kick-start growth and job creation**

Objective ⇒ GROWTH within a strengthened EMU

Highlights

- **The Government has risen to the challenge by accelerating the implementation of its planned policy strategy:**
 - Budgetary process for 2011 which together with recent measures will take the deficit down to **6% of GDP in 2011** is ongoing
 - Financial sector reform and stress tests
 - Saving Bank's Law
 - Labour market reform
- **Recent macroeconomic data in line with aggregate forecast**
 - Q2:2010 GDP forecasts by analysts (0.1-0.2% expected), Exports (16,4% from Jan-May 2010 to Jan-May 2009), Industrial production (5.1% yoy in May), Sales (4.7% yoy in May), Unemployment (-83.600 in June)

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All levels of government involved

Net of the effect of the liquidation system settlements

Breakdown by Government Unit	2009	2010	2011	2012	2013
General Government Budget Balance (% of GDP)	-11.2	-9.3	-6.0	-4.4	-3.0
- Central Government	-9.5	-6.7	-4.8	-3.2	-2.1
- Autonomous Regions	-2.0	-2.4	-1.3	-1.3	-1.1
- Local Authorities	-0.5	-0.4	-0.3	-0.3	-0.2
- Social Security	0.8	0.2	0.4	0.4	0.4

Source: National Accounts and Ministerio de Economía y Hacienda.

- According to the European Commission after measures taken in May there was the need to further specify the consolidation effort to reach -6% in 2011
- The Gap was of 1,75% of GDP
- Up to difference in growth forecast, this gap is closed with:
 - Approval of the expenditure ceiling for the central government
 - Approval of the budget deficit for 2011 for autonomous regions

All levels of government involved

- **Central Government expenditure ceiling for 2011**

- Ceiling of € 150.1 billion (122.3 billion excluding autonomous regions financing system)

- 7.7% reduction with respect to Budget 2010

Approved
on 21/07

- **Autonomous Regions consolidation path**

Approved
on 27/07

- **Additional control mechanisms approved in June:**

- Authorisation for new issuance of debt by Regions conditioned on semi-annual review of achievement of deficit targets

- Local governments unable to enlarge long term borrowing in 2011

Approved
on 15/06

- **Implementation through Budget 2011**

September

Mid-year budgetary execution of the Central Government in line with consolidation plan

- **Revenues amount to € 56.8 billion (€ 46.4 billion in 2009)**
 - Direct and indirect tax revenues register positive growth rates: VAT 31.3%, Excise tax 7.2%, Income tax 3.6%, Corporate tax -14.5%
 - 10.6% yoy increase in tax revenues from these figures (8.1 in Budget for 2010)
- **Expenditures reach € 86.5 billion (€ 85.9 billion in 2009)**
 - One-off measures, public investment adjustment, and May extraordinary measures explain the slowdown compared to the Jan-May period
 - Figures are distorted by the different transfer calendar this year implying a deeper adjustment to materialize during the rest of the year
- **The cumulated deficit is € 29.8 billion (€ 39.5 billion in 2009)**
 - This means a year-on-year reduction of 24.3%
 - Primary deficit of € 21.3 billion (€ 31.6 billion in 2009)

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Banking system: Resilient overall, but on-going restructuring needed to be completed

- **Restructuring process through FROB** Finalized
30/06
- **Stress tests are an important step providing transparency on the adequacy of the restructuring process** Released
23/07
- **Regulatory reform of saving banks was needed to allow adaptation to new playing field** Approved
09/07

Restructuring of Cajas Sector

Entity	Total Assets €Million	% of total savings banks' assets	Financial support €Million	Supporting Fund
UNNIM	28,463	2.2%	380	FROB
DIADA	79,329	6.1%	1,250	FROB
ESPIGA	46,351	3.7%	525	FROB
BANCA CIVICA	45,724	3.6%	0	Not requiring
UNICAJA-JAEN	35,155	2.8%	0	Not requiring
CAJASOL-GUADALAJARA	31,450	2.4%	0	Not requiring
BROGAN	77,480	6.0%	1,162	FROB
CAM-CAJASTUR*	127,267	9.9%	5,268	FROB+DGS
CAJASUR-BBK	48,726	3.8%	392	FROB
LA CAIXA-GIRONA	260,561	20.3%	0	Not requiring
C.MURCIA-GRANADA	72,105	5.6%	916	FROB
CAJAMADRID-BANCAJA	337,257	26.3%	4,465	FROB
CAI+CCBURGOS+BAD	20,807	1.6%	0	Not requiring
Total underway	1,210,675	94.3%	14,358	

- 13 restructuring processes involving 40 out of 45 saving banks
 - 5 without any support
 - 6 with support up to 2% RWA
 - 2 liquidations
- FROB conditionality: 25% of branch closure and 15 to 18% of employment reduction on average
- Extended deadline Dec 31st (recapitalization from stress test)

Source: Bank of Spain and FROB

* Includes €1,493 M from FROB and €3,775 M from DGS

Stress Test

- Methodology determined by CEBS with the possible scenarios
- Additional coverage and severity introduced by BoS
 - 95% of the banking sector
 - Assumption on exposure to real estate portfolios
 - Assumptions in NOI evolution
- Main Figures:
 - Macro variables: -2.6 % of GDP
 - Finished house prices: -28% from peak. Land and non finished houses: -61% and -50%
 - Conservative assumptions for the net operating income evolution (-35% to -40% in Saving Banks)

Additional severity

- Hypothetical impairment losses are 9.5% for savings banks, similar to US SCAP (9.1%)
- Against risk-weighted assets SCAP losses were 7.7%, 12.6% for Spanish savings banks
- This figure compares well to historical episodes: Finland (1990-93; 4.3%); Sweden and Norway (1990-93; 2.7%); Korea (1997-99; 11.6%)

Spain's resiliency

Nº	Group	% assets/total system		Capital needed
		indiv	acum	
1	0049-GRUPO SANTANDER	32,2	32,2	
2	0182-GRUPO BBVA	15,4	47,6	
3	5200 JÚPITER	9,9	57,5	
4	5201 CAIXA	7,9	65,4	
5	5196 BASE	3,9	69,3	
6	0075-BANCO POPULAR ESPAÑOL, S.A.	3,8	73,1	
7	0081-BANCO DE SABADELL, S.A.	2,4	75,5	
8	5101 DIADA	2,3	77,8	1.032
9	5086 BREOGÁN	2,3	80,1	
10	5173 MARE NOSTRUM	2,1	82,2	
11	0128-BANKINTER, S.A.	1,6	83,8	
12	5051 ESPIGA	1,4	85,2	127
13	5139 BANCA CÍVICA	1,4	86,6	406
14	2085-CAJA DE AHORROS Y M.P. DE ZARAGOZA, ARAGON Y RIOJA	1,3	87,9	
15	5150 UNICAJA	1,0	88,9	
16	0072-BANCO PASTOR, S.A.	0,9	89,8	
17	5151 CAJASOL	0,9	90,7	
18	2095-BILBAO BIZKAIA KUTXA,AURREZKI KUTXA ETA BAHITETXEA (BBK)	0,9	91,6	
19	5052 UNNIM	0,8	92,4	270
20	2101-CAJA DE AHORROS Y M.P. DE GIPUZKOA Y SAN SEBASTIAN (KUTXA)	0,6	93,0	
21	5202 CAJA3	0,6	93,6	
22	2024-CAJA DE AHORROS Y M.P. DE CORDOBA (CAJASUR)	0,5	94,1	
23	0061-BANCA MARCH, S.A.	0,4	94,5	
24	0042-BANCO GUIPUZCOANO, S.A.	0,3	94,8	
25	2097-CAJA DE AHORROS DE VITORIA Y ALAVA (VITAL)	0,3	95,1	
26	2045-CAJA DE AHORROS Y M.P. DE ONTINYENT	0,0	95,1	
27	2056-COLONIA - CAIXA D'ESTALVIS DE POLLENÇA	0,0	95,2	

European
minimum scope

Spanish
wider scope

Saving Banks: Features of the regulatory reform

- Demystifying Saving Banks:
 - Major force in extending services and in creating a highly competitive environment and significant driving force for growth, savings, allocation of resources and financial inclusion
 - Support for social, cultural and educational projects
 - Subject to the same supervisory and prudential regime applied to all credit institutions
- But new context required a reform of the law
 - Higher future capital requirements both in quantity and in quality 
 - Need for greater flexibility in access to capital resources**
 - Growing complexity of financial activity has also reached saving banks, traditionally focused on a retail-oriented business model 
 - Need to make corporate governance more professional and transparent in line with corporate governance of commercial banks**

Saving Banks (1): Better Corporate Governance

- **More professional management**
 - New requirements on knowledge and expertise are included regarding control functions, directors and managers
 - Establishment of a new Appointment and Remuneration Committee
- **Better representation of all stakeholders**
 - Prohibition of elected positions and high level officials to be members of governing bodies
 - Dispositions on conflicts of interest have been included
 - Ceilings on the voting shares for public entities reduced from 50 percent to 40 percent
 - Establishment of a new Social Duties Committee
- **Enhanced transparency**
 - Establishment of the obligation to publish an annual report on corporate governance

Saving Banks (2): Strengthening the ability to raise capital

Four alternatives to improve their ability to raise capital:

- **Maintain their existing saving bank structure, with widened possibilities to issue preferred stock with political rights**
- **Integrate part of their structure in a consolidated group (which is a Bank)**
- **Transfer its financial activity to a bank in which they hold a majority stake**
- **Transfer their financial activity to a commercial bank in which they will have a non majority stake and transform into a foundation**

Labour market reform: Four major objectives (1)

Objective 1: Achieving a closer relationship between working conditions and the specific situation of the firm

1. Effective opt out from collective bargaining if there is agreement among employer and workers (arbitrage possible in case of disagreement)
2. Reasons for objective dismissals are clarified and procedures simplified

• **Objective 2: Reducing segmentation**

3. Reasons for objective dismissals are clarified and procedures simplified
4. The “contrato de fomento” is generalized and a capitalization fund for dismissals, formation, mobility or retirement will be developed
5. Temporary contracts termination payments will be increased smoothly from 8 days per year to 12 in 2015 starting in 2012

Labour market reform: Four major objectives (2)

Objective 3: Improve matching in the labour market

6. Temporary Agency Work Directive will be transposed, eliminating current restrictions
7. Private for-profit employment Agencies will be authorized to operate

- **Objective 4: Enhancing human capital**

8. Eligibility for training contracts is extended
9. Social Security rebates will be applied preferentially to unemployed unskilled workers up to the age of 30 and over 45
10. Short time working arrangement that favours the reduction of hours as opposed to dismissals as margin of adjustment

Labour market reform: Current status

- Approved on 16/06, fully in place
- Undergoing parliamentary process (approved by congress on 29/07) that pushes further some of the objectives:
 - Ensuring the effectiveness of opt out clauses both for wages and working conditions
 - Objective dismissals can be justified with forward looking reasons, not only realised losses
 - Improving legal certainty for companies
 - Fine tuning new legislation for small firms
 - Further generalization of the “contrato de fomento”

Upcoming reforms: Services

- **Substantial reduction of administrative burdens on professionals**
 - Red tape associated to ex-ante supervision by professional organizations (“colegios”) is greatly reduced
 - Freedom of election of supervisor
 - The reform will save 815M€ a year for professionals
- **New regulation on professional services**
 - The government is planning a comprehensive revision of restrictions hampering provision of professional services
 - The reform could push long term growth of potential GDP by 0,7%
 - Restrictions on entry will be greatly reduced
 - More freedom to operate and competition among professionals
 - Effective protection of consumers with less burdens on entrepreneurs

Upcoming reforms: Pension reform

- The current financial situation of the Social Security System is sound:
 - The recorded surplus until June 2010 was 0.9% of GDP
 - The Social Security Reserve Fund cumulated assets by 5.99% of GDP until June this year
- But ageing makes necessary a reform. The Government made a proposal in Jan 2010. Main measures included were:
 - An increase in the statutory retirement age from 65 to 67
 - Reinforcing the relation 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
- Current debate in Parliament

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Funding programme executed at the pace initially planned

- Close to 65% of the initially projected medium- and long-term gross funding executed
- Tomorrow's redemption completes the bond redemption schedule for 2010
- Auctions resiliency even under stressed market conditions: unchanged average ratio of demand to supply volumes

Bid to cover ratios in auctions

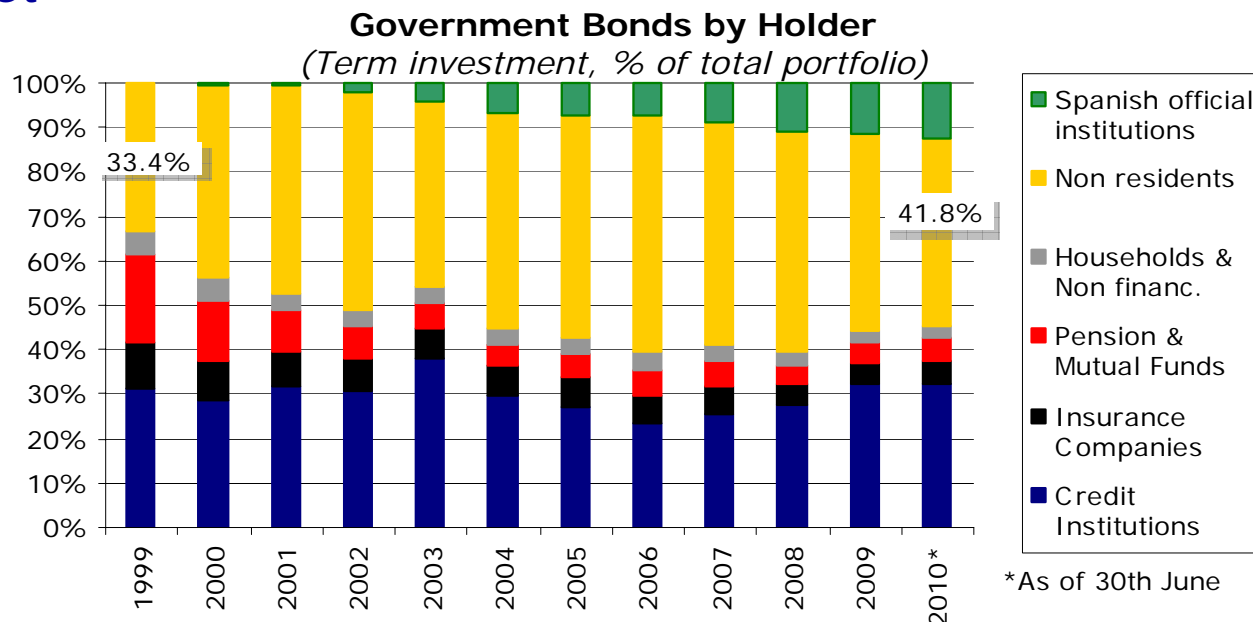
YEAR	LETRAS	BONOS AND OBLIGACIONES	AVERAGE BID-TO-COVER RATIO
2007	2.2	2.3	2.2
2008	1.7	1.7	1.7
2009	2.1	1.9	2.0
2010*	2.3	2.0	2.1

* Until July 2010

Source: Dirección General del Tesoro y Política Financiera.

A harshly tested stable investor base

- The relative role of resident and non-resident buying has remained largely stable, notwithstanding temporary deviations
- Any question mark about the involvement of non-residents has been dispelled by the 15Y and 10Y syndications in February and July, respectively
- The limited and temporary portfolio rebalancing between domestic banks and non-residents between March and June demonstrates the resiliency of the Spanish market

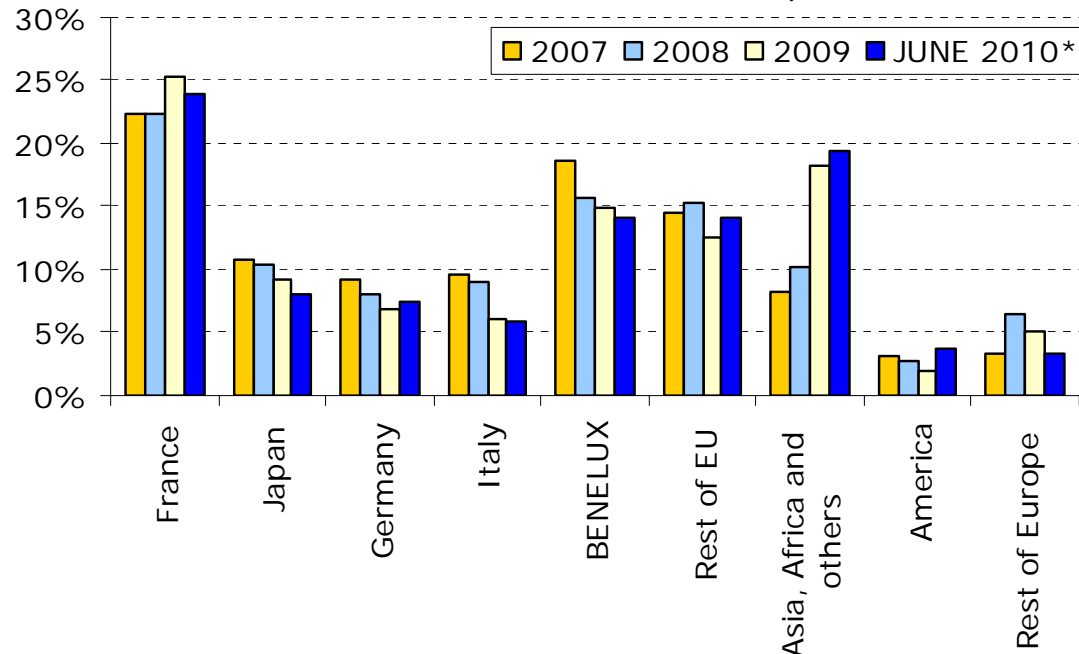


Source: Dirección General del Tesoro y Política Financiera.

The investor base has remained stable

- The geographical distribution of holdings of government bonds has remained relatively stable during the last two years
- An exception is the category depicting Asia, Africa and the rest of the world

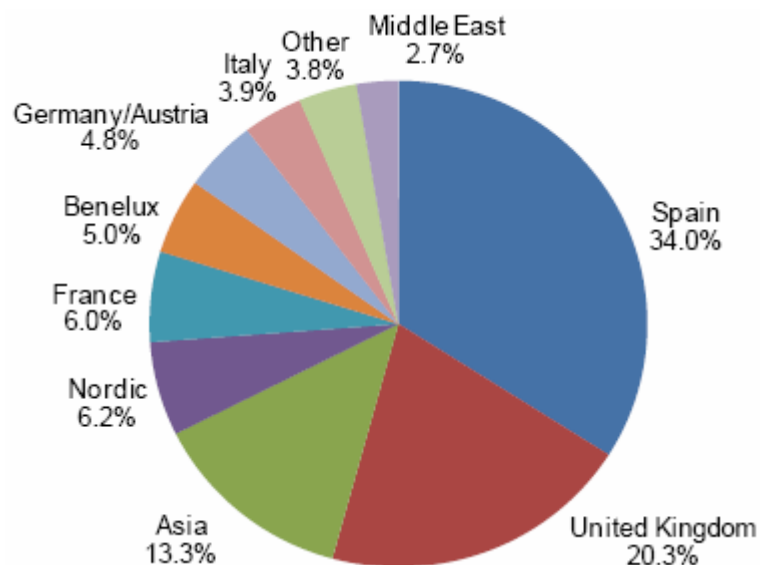
Geographical distribution of non-resident holders of government bonds
(Term investment, % of non-resident portfolio)



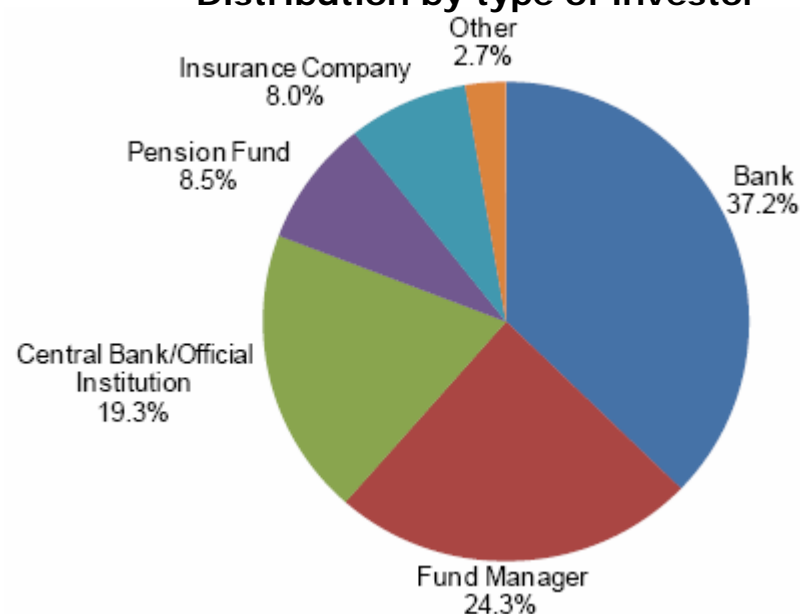
The funding programme: July 10-Year benchmark syndication

- On 6th July 2010, new 6 bn€ 4.85% 10-Year benchmark issue with a maturity date of 31 October 2020. The transaction was priced to give a spread of 195 bps over mid-swaps from the initial price guidance was set at “Mid Swaps +200 bps area”
- The order book presented a demand in excess of 14.5 bn€. In response to its focus on quality of distribution the final notional amount was set at 6.0 bn€

Geographical distribution



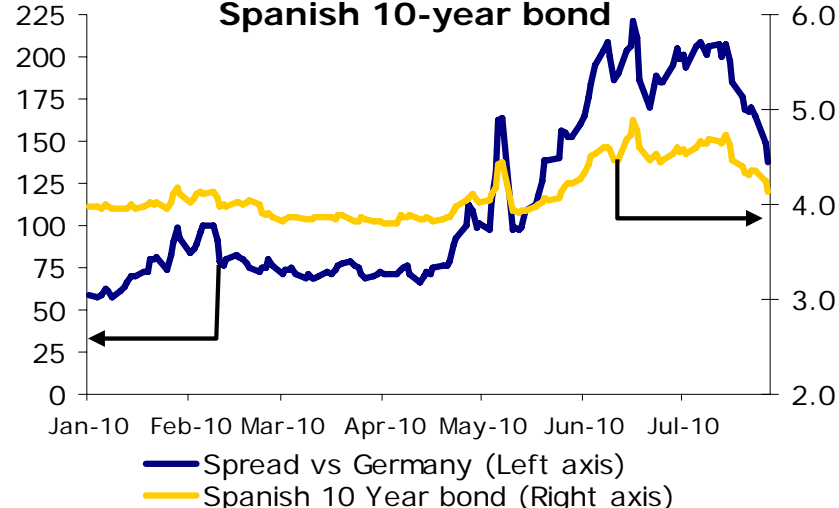
Distribution by type of investor



The price mechanism has started to price in policy measures adopted

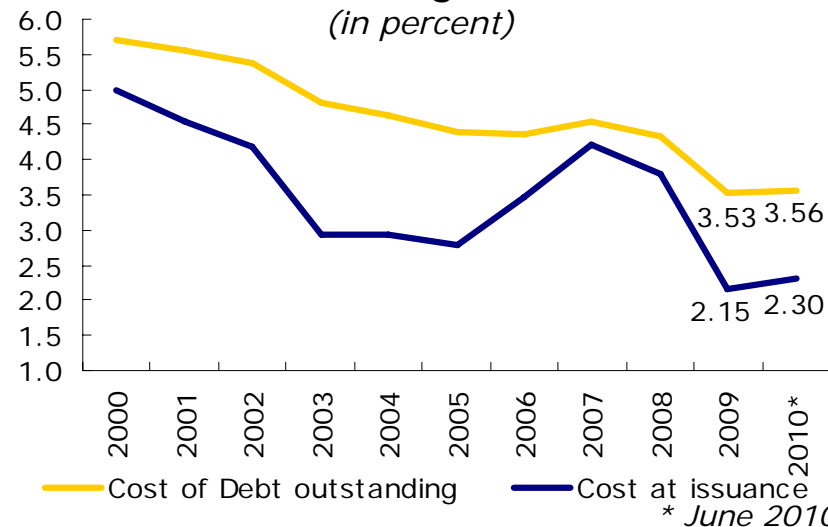
- High volatility prevailing during most of March, April and May has been replaced by more normal operations based on price and value
- A relevant conclusion we draw from this episode for the future is the differential risks posed by gross and net issuance
- Yield curve spread distortions caused by vanishing liquidity have started to be drastically corrected with a 70 b.p. rally in July as extreme fears have been relieved by policy measures
- More spread compression to come driven by value and pending rebalancing of euro indexes

Spread vs Germany and absolute yield of the Spanish 10-year bond



Source: Bloomberg.

Cost of debt outstanding and cost at issuance (in percent)



Source: Dirección General del Tesoro y Política Financiera.

Thank you for your attention

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