



Kingdom of Spain

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

April 2010

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

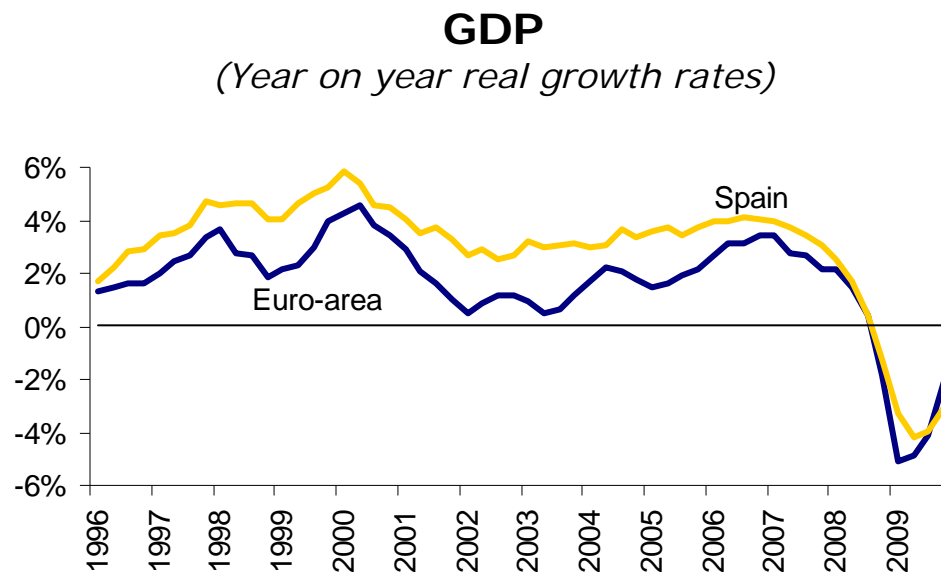
Highlights

- **Long growth cycle** previous to the international crisis
- **Important challenges ahead:** Unemployment and deficit, a consequence of the crisis but also symptoms of underlying structural shortcomings
- A new **far-reaching policy strategy**.
 - Fiscal consolidation: A cut of **5.7%** of GDP in structural primary deficit in 2010-2013
 - Structural reforms: Sustainable Economy, Bank Reorganisation, Pensions, Labour Market
 - Consistent with further integration of Spain in EMU: discipline, flexibility, cohesion
- **Strengths:** Sound financial system, low Debt/GDP

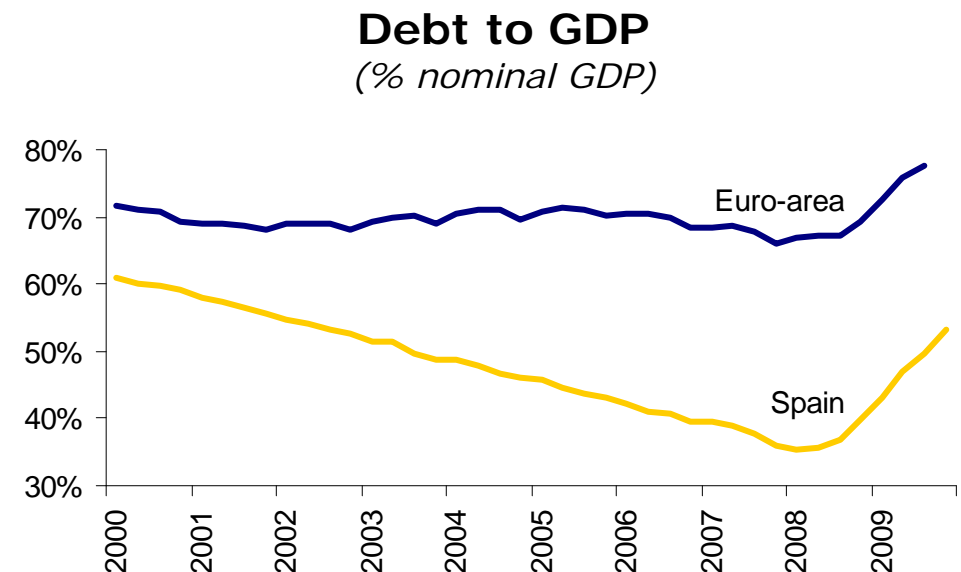
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1994-2008: Convergence and Debt reduction

- 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



Source: Eurostat.

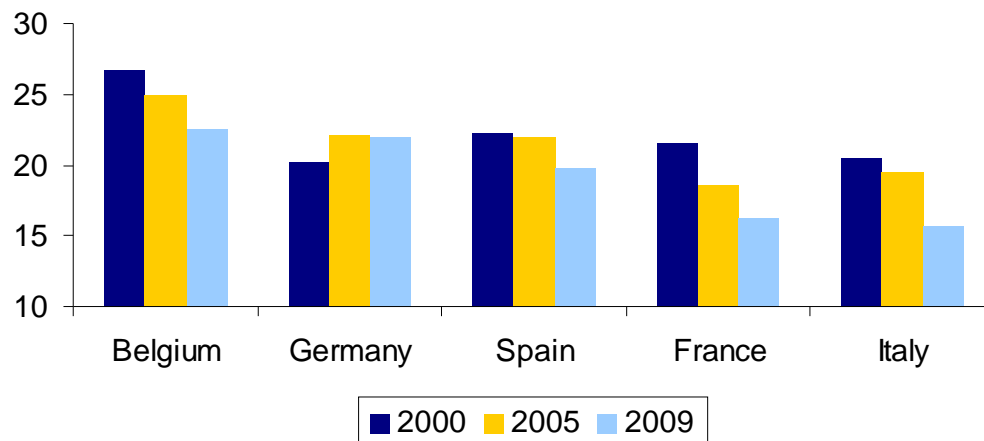


Source: Eurostat.

Investment binge: housing and beyond

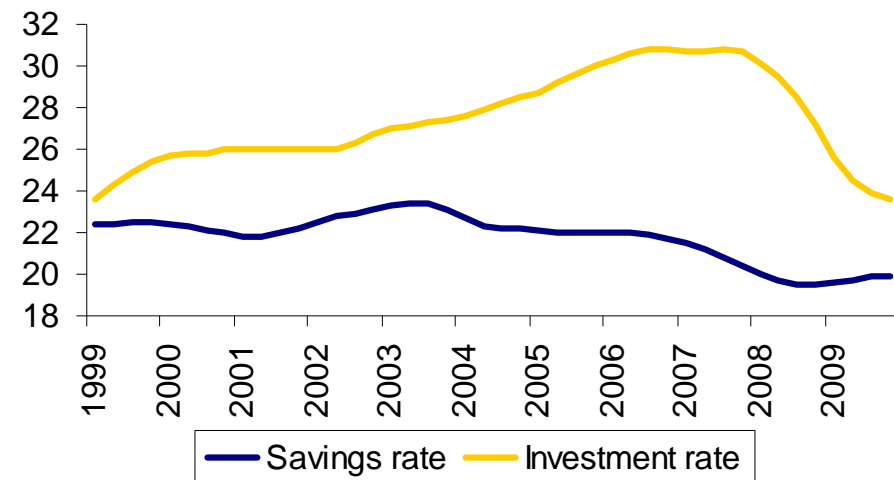
- Domestic demand was fuelled by a soaring investment rate, with the national savings rate staying close to Eurozone average
- The housing boom is part of the story, but not the whole story

Savings rate
(% nominal GDP)



Source: Eurostat.

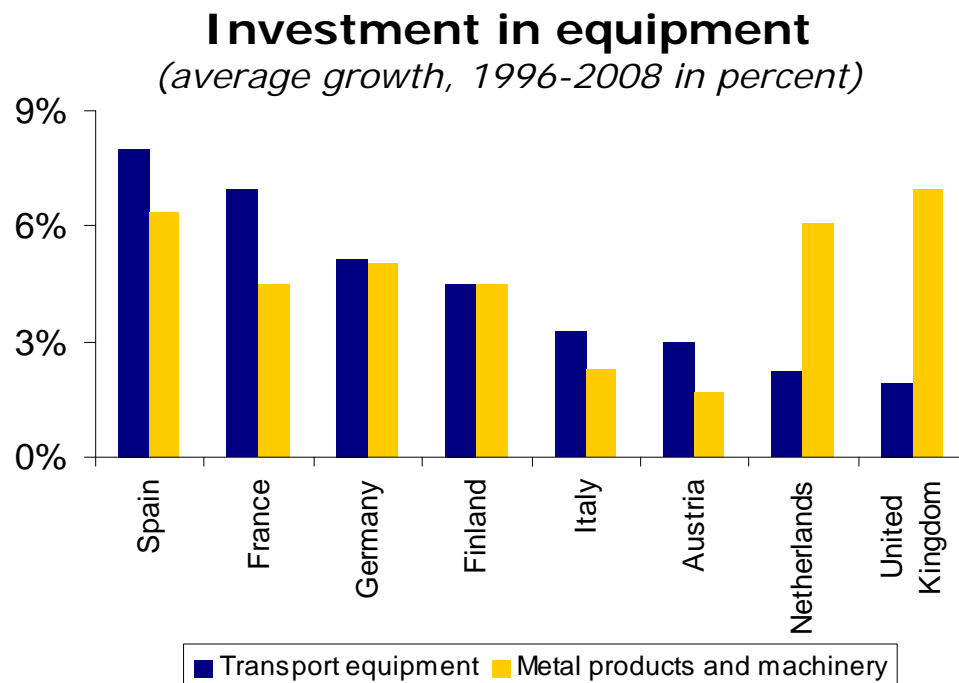
Investment rate vs. Savings rate
(% nominal GDP)



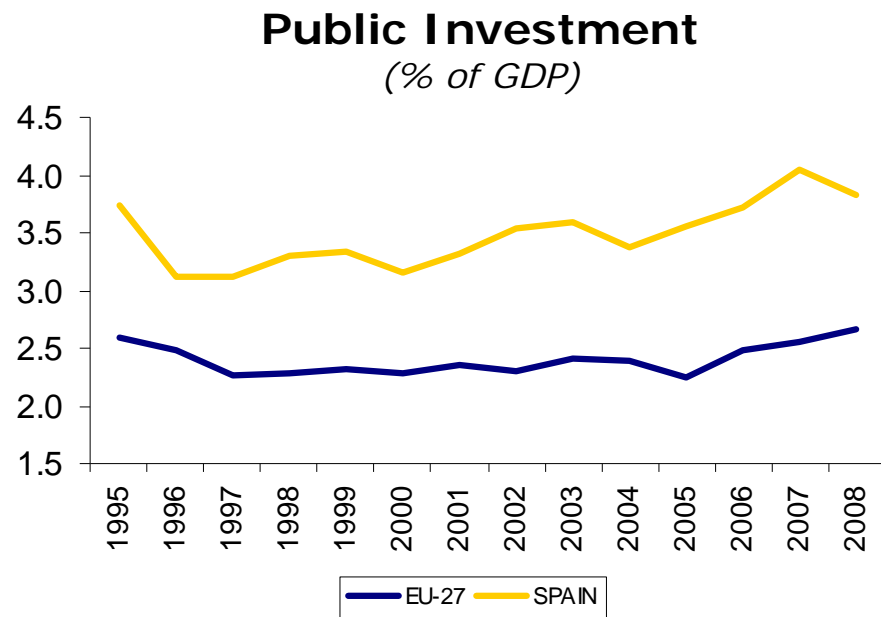
Source: National Statistics Institute, Spain.

Investment binge: housing and beyond

- The residential real estate sector grabbed a non-sustainable share of GDP and employment, but Spain has also invested heavily in equipment, infrastructure and Research & Development



Source: Eurostat.



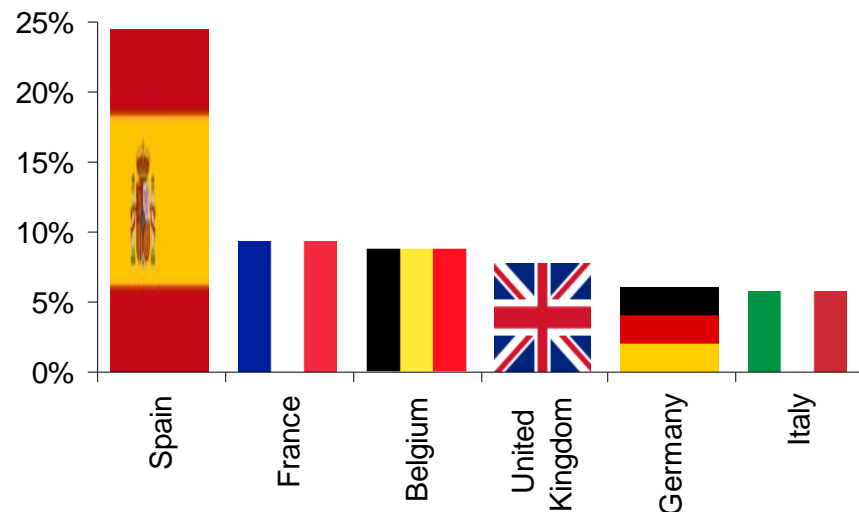
Source: Eurostat.

Intensive in employment

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

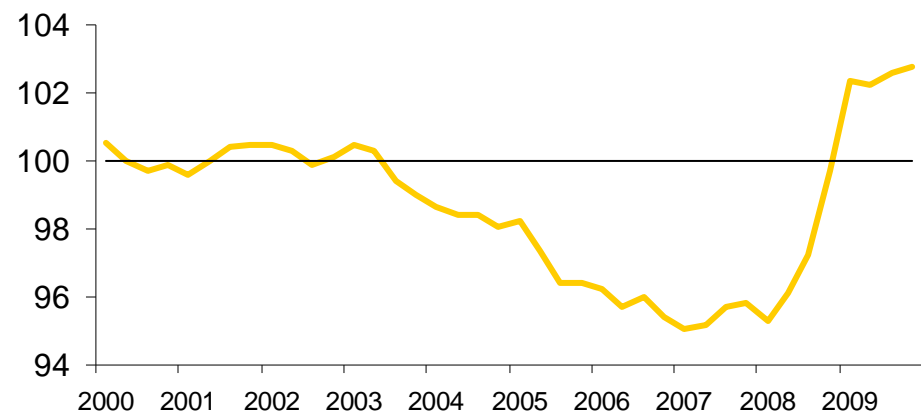
Active population

(Cumulative growth rates from 2000 to 2009)



Labour productivity

(Relative to Euro Area)

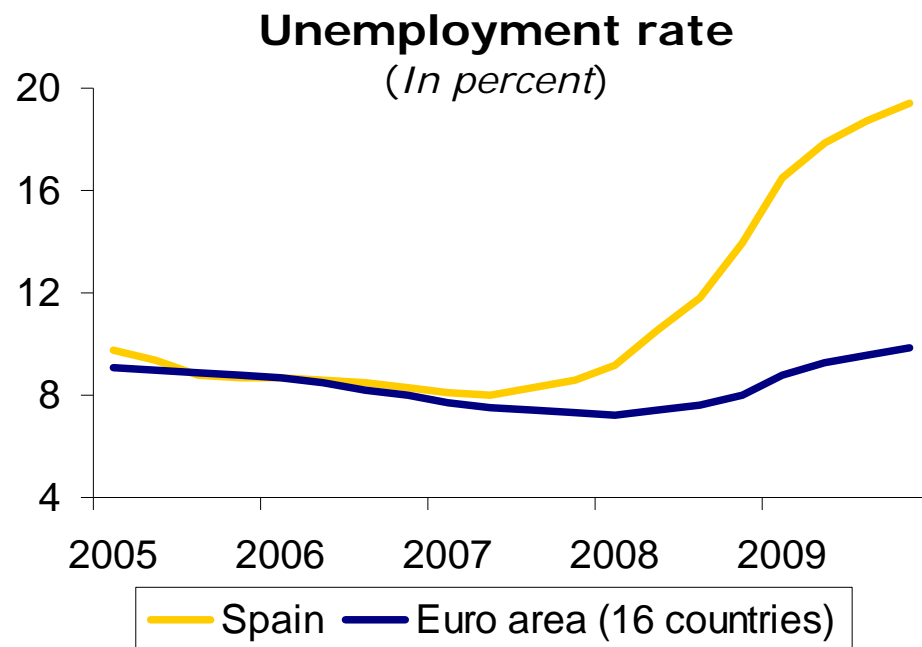


Source: Eurostat. Labor Force Survey.

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The crisis prompts an abrupt adjustment

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



Sources: Eurostat. Labor Force Survey.

Sectoral employment
(total number)

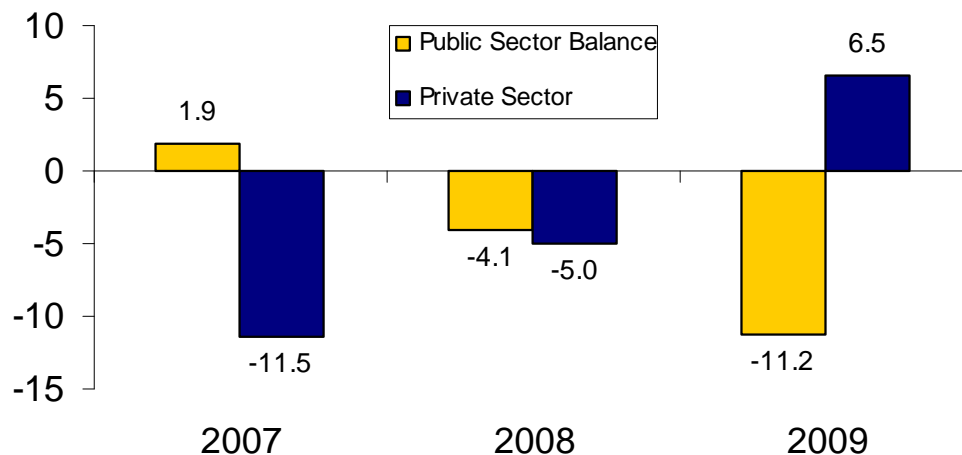
	2008	2009	Difference	(%)
Total	20,257.7	18,888.0	1,369.7	-6.8%
Services	13,786.4	13,438.7	347.8	-2.5%
Industry	3,198.9	2,775.0	423.9	-13.3%
Construction	2,453.4	1,888.3	565.2	-23.0%
Agriculture	818.9	786.1	32.9	-4.0%

Source: National Statistics Institute, Spain.

Changes in sectoral and external balances

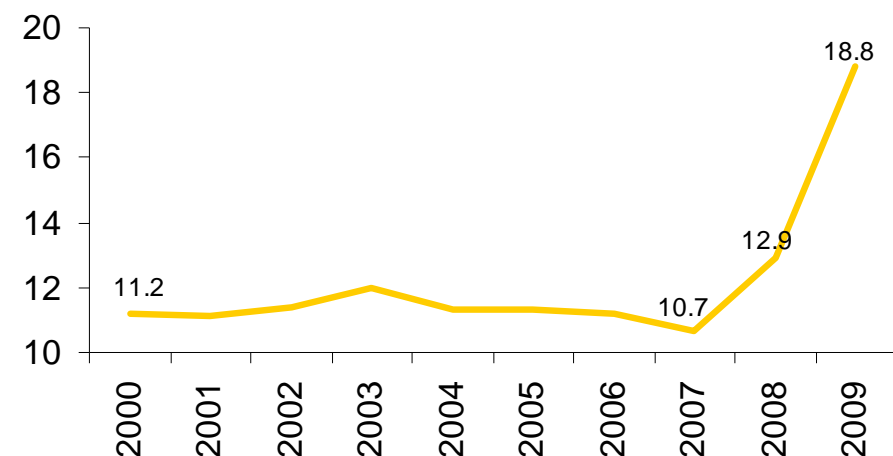
- Large swing in private sector balance: plummeting Investment and soaring Savings
- Government Deficit jumps, but 2.5 points of GDP are one-off
- Current Account deficit has halved in 2009

Sectoral balances
(% of GDP)



Source: National Statistics Institute, Spain.

Households' savings rate
(% of Gross Disposable Income)



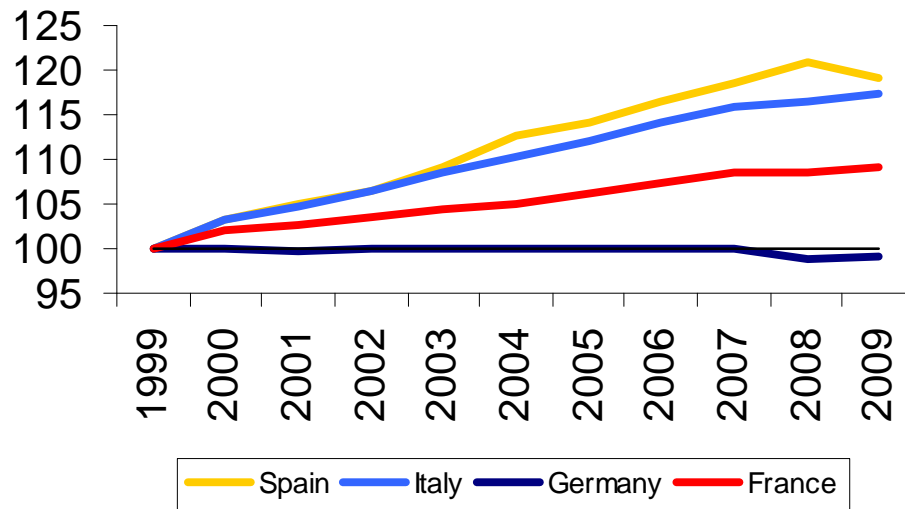
Source: National Statistics Institute, Spain.

Cost competitiveness

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

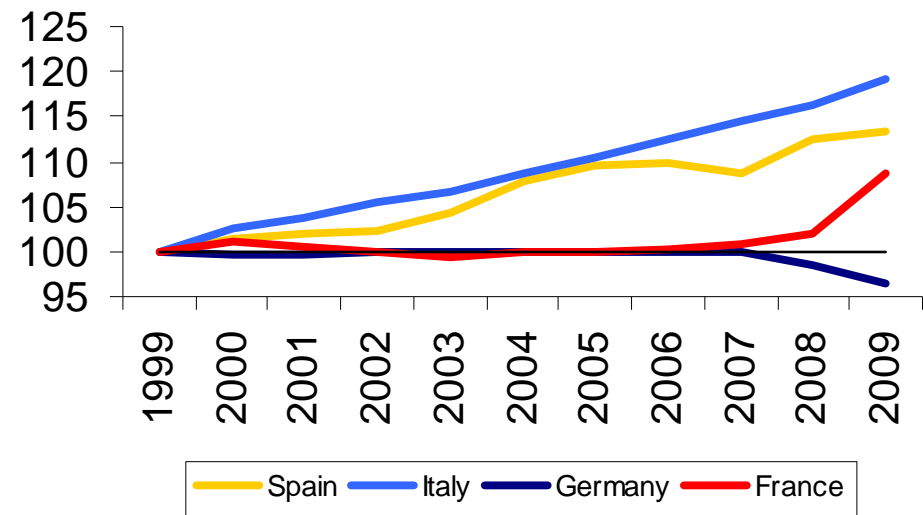
Deflator Index

(Relative to eurozone 1999=100)



Manufacturing deflator index

(Relative to eurozone 1999=100)



Source: Eurostat.

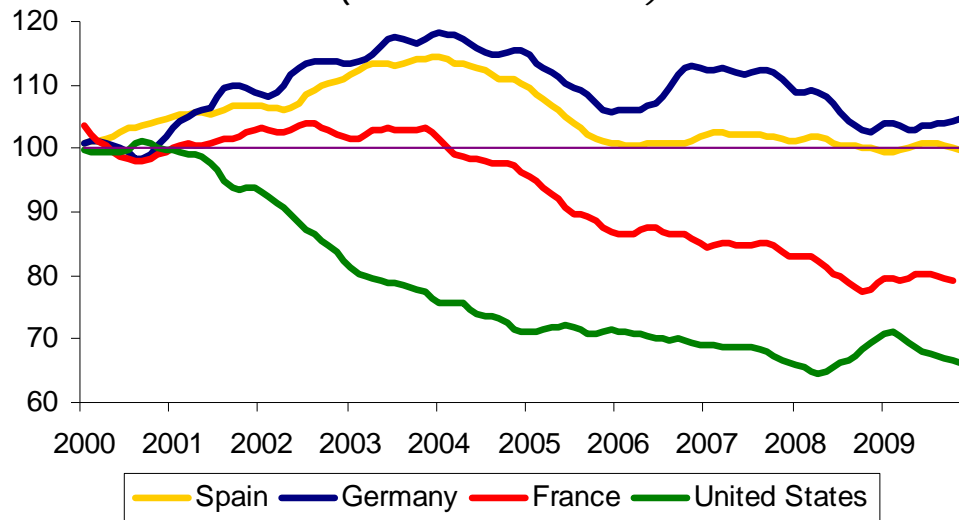
Source: Eurostat

Exports show underlying improvement in supply

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

Share in world merchandise exports

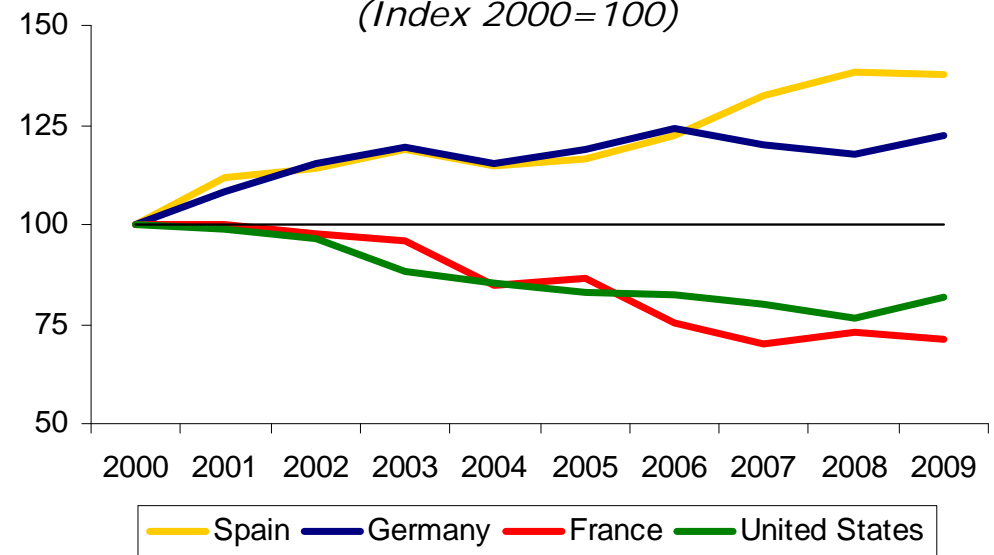
(Index 2000=100)



Source: International Monetary Fund.

Share in world exports of services *

(Index 2000=100)



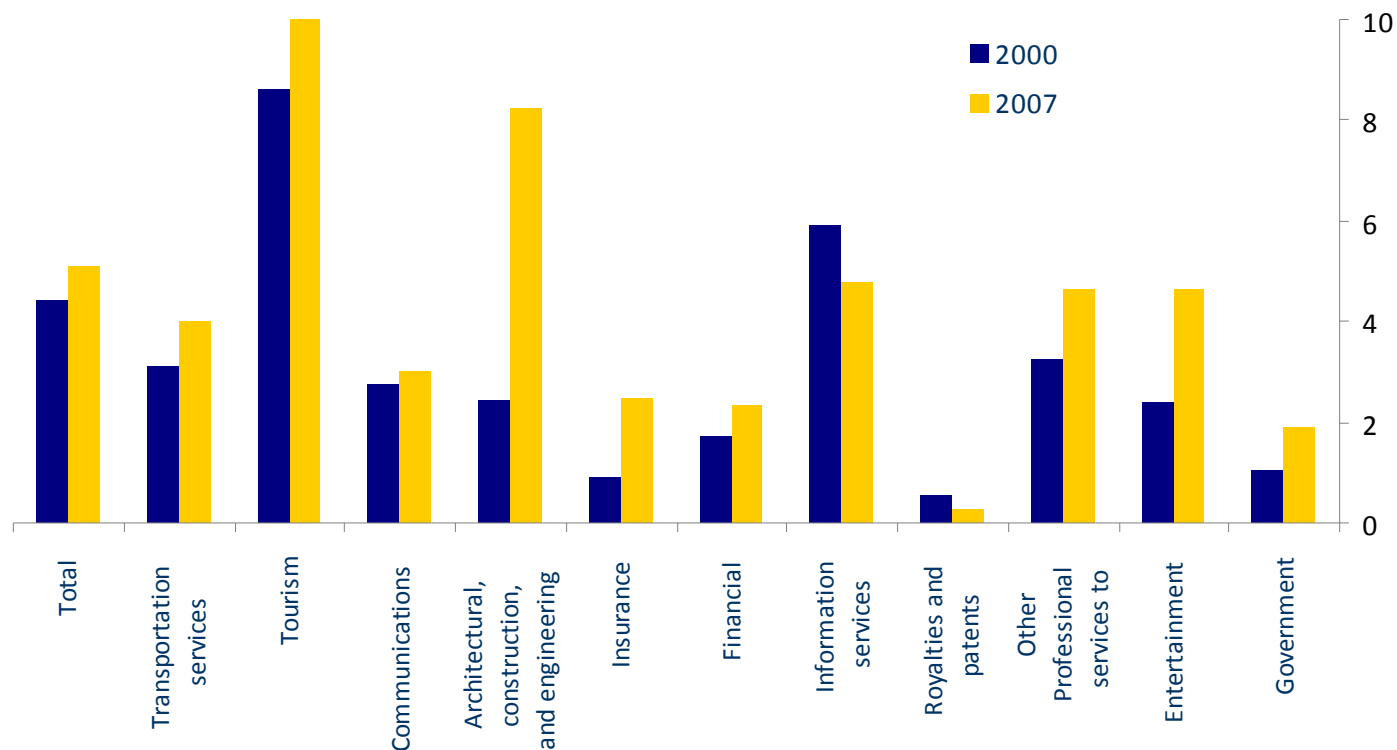
Source: World Trade Organisation and forecast.

* 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

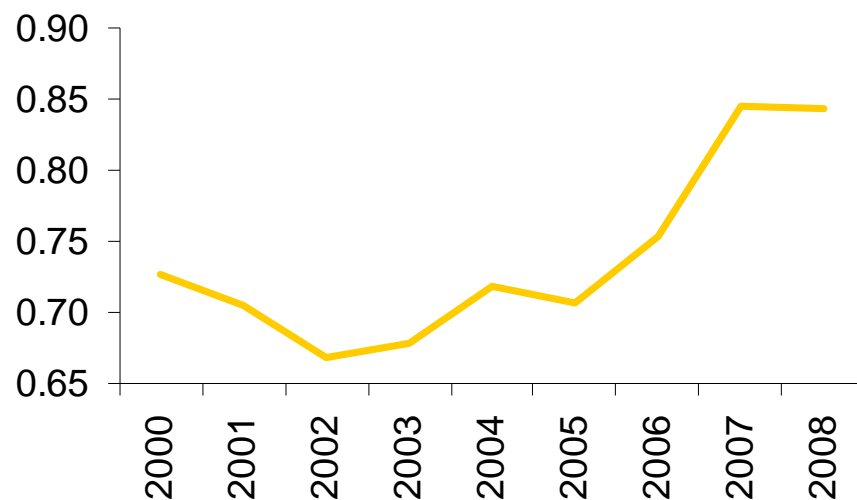


Source: OECD.

FDI flows have increased significantly

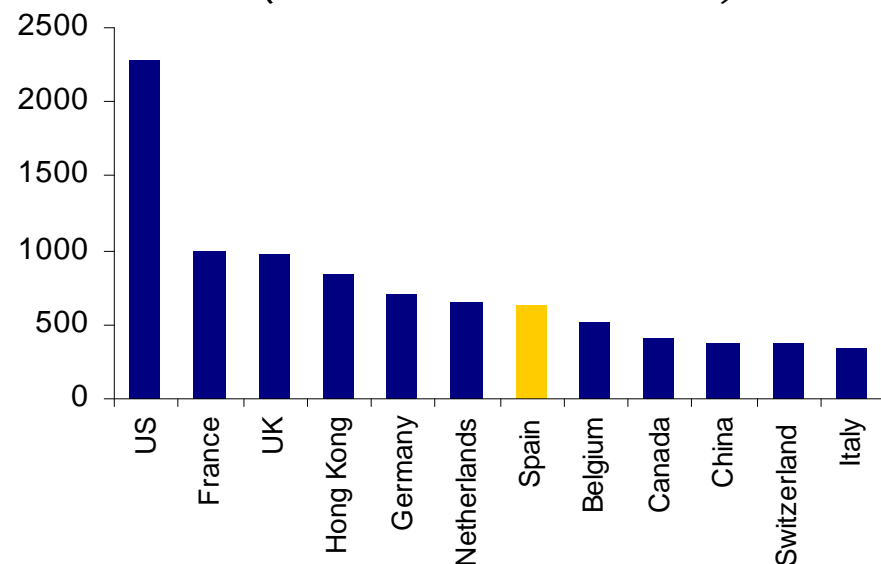
- Outward FDI stock per capita has grown faster in Spain than in the Eurozone
- Spain remains a major destination of international investment

Outward FDI stock. Relative to Eurozone



Source: World Investment Report 2009

Top receivers of FDI
(Stock in billions of US \$)



Source: World Investment Report 2009

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Policy Strategy for Sustainable Growth

- **Prudent Macroeconomic Scenario 2010-2013**
- **Agreement on Fiscal Consolidation to bring the deficit back to 3% in 2013**
- **Structural Reforms:**
 - Sustainable Economy Law
 - 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

Macroeconomic scenario 2009-2013 (Growth rate in percent)	2009	2010	2011	2012	2013
GDP	-3.6	-0.3	1.8	2.9	3.1
Final Consumption Expenditure	-2.7	0.3	1.7	2.2	2.1
Gross Fixed Capital Formation	-15.3	-6.5	0.3	4.2	5.9
National Demand (contribution to GDP growth)	-6.4	-1.4	1.4	2.6	3.0
Exports of Goods and Services	-11.5	2.8	5.2	6.9	7.4
Imports of Goods and Services	-17.9	-1.3	3.7	5.8	6.8
External demand (contribution to GDP growth)	2.8	1.1	0.4	0.3	0.1

Sources: National Accounts and 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

Fiscal Adjustment Path 2009-2013 <i>(Growth rate in percent)</i>	2009	2010	2011	2012	2013
GDP	-3.6	-0.3	1.8	2.9	3.1
General Government Budget Balance (% of GDP)	-11.2	-9.8	-7.5	-5.3	-3.0
General Government Gross Debt (% of GDP)	55.2	65.9	71.9	74.3	74.1

Source: National Accounts and 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 2.5% points of GDP in 2009's total deficit
- Total size of planned fiscal policy adjustment (structural terms): 5.7% of GDP

Fiscal Position	2009	2013
General Government Balance (1)	-11.4	-3.0
Cyclical component (2)	-1.4	0.0
Interest Payments (3)	-1.9	-3.1
Temporary measures (4)	-2.5	0.0
Structural Primary Balance (1)-(2)-(3)-(4)	-5.6	0.1

Source: Annual update of the Stability Programme.

Fiscal restraint measures

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

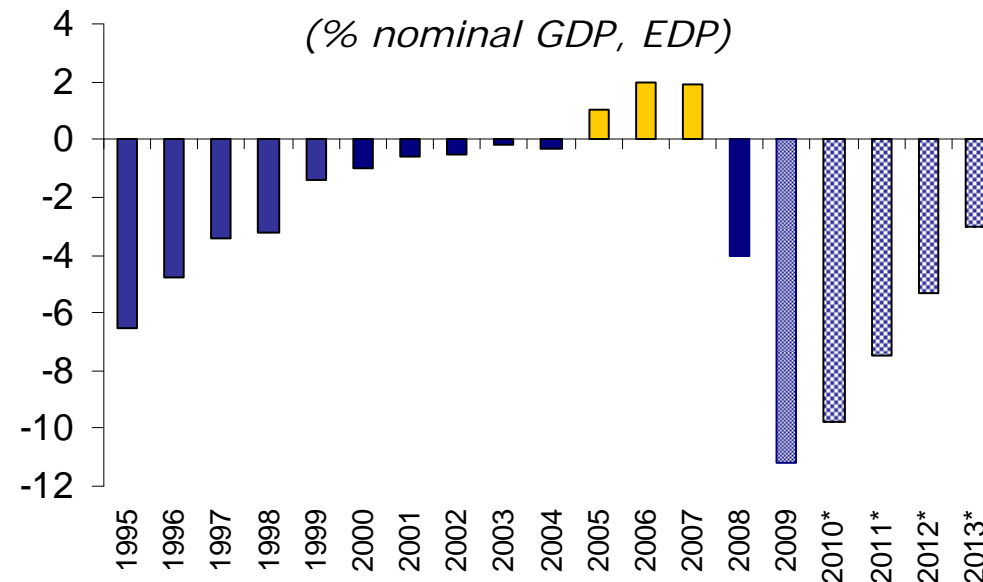
Source: Annual update of the Stability Programme.

- **Restraint in wage outlays for all public administrations: 10% replacement rate, no new temporary hiring and strong moderation in wages**
- **Sizable cuts in investment, transfers and subsidies**
- **Specific measures adopted:**
 - General agreement on fiscal restraint with regional Governments
 - Healthcare spending cuts
 - Restructuring of the Public sector

Can we implement this?

- We have done it in the past, which proves the effectiveness of our fiscal rules
- Shared commitment to fiscal discipline and margin to secure further reductions in the deficit
- Subject to multilateral EMU surveillance

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

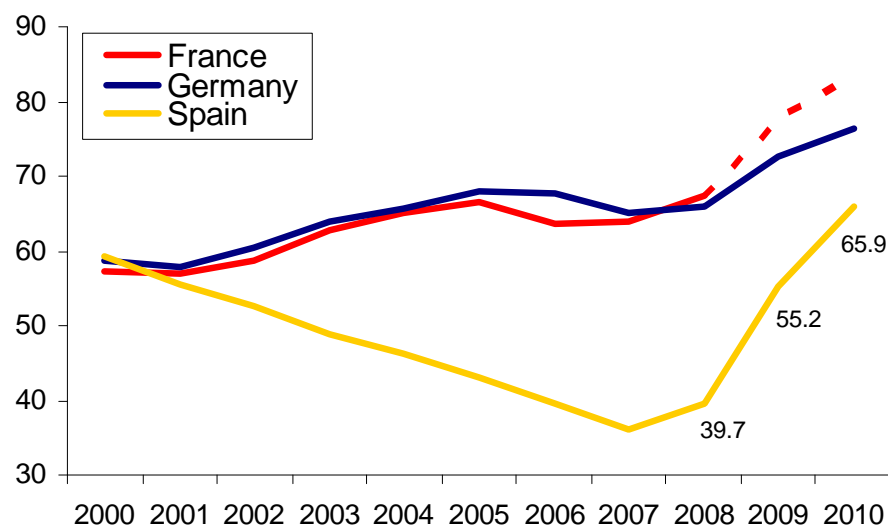


* Annual update of the Stability Programme.

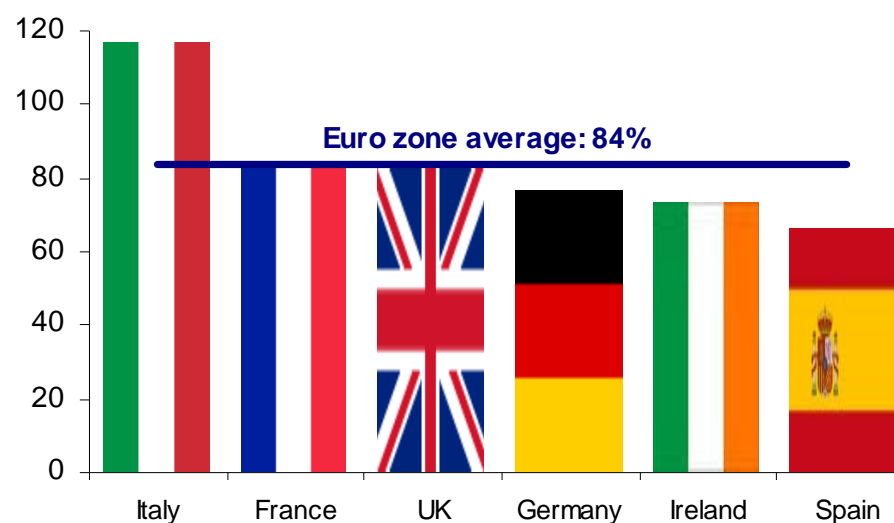
Debt dynamics

- **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**

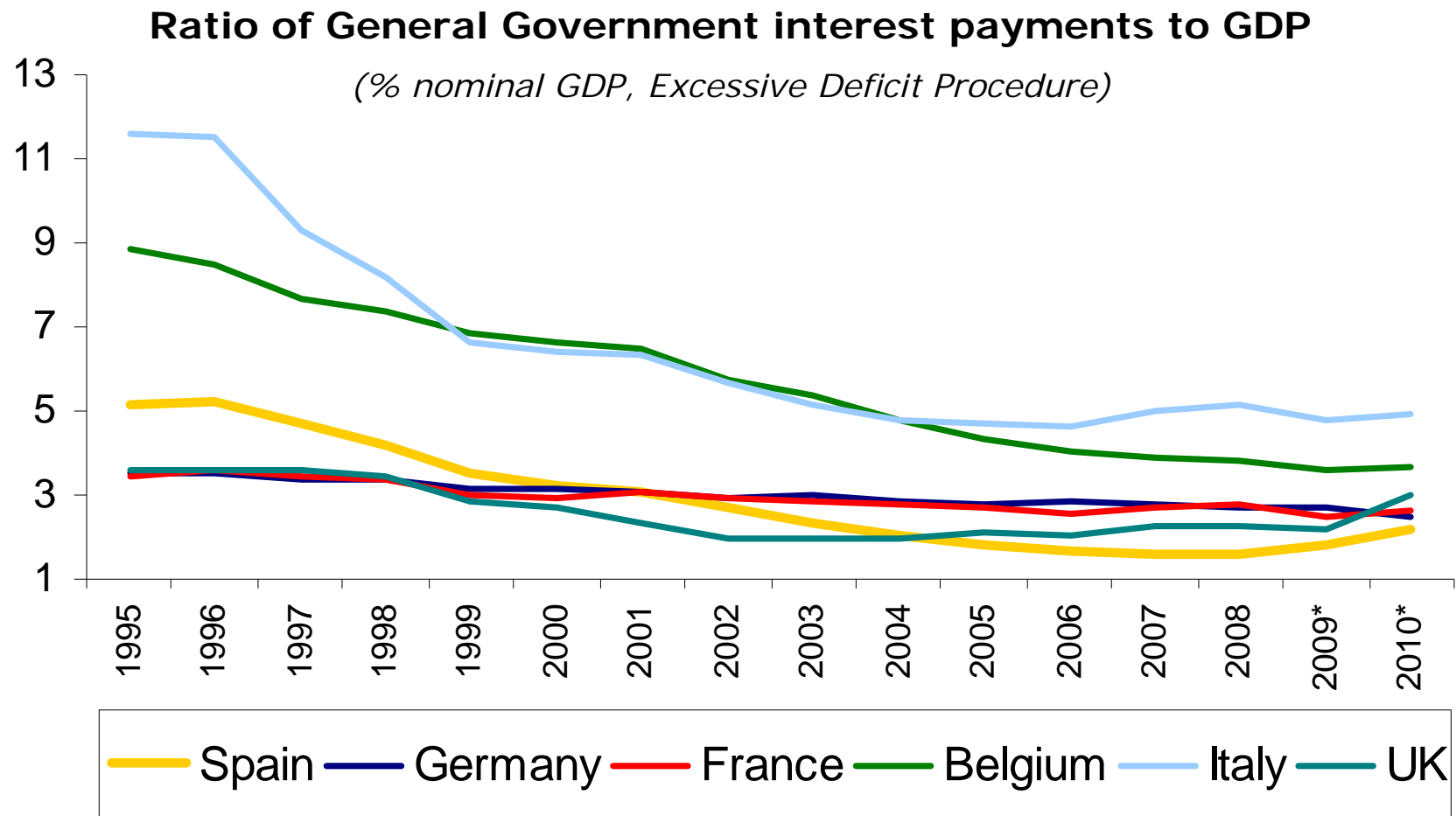


**Gross Debt-to-GDP (%)
2010 forecasts**



Sources: European Commission and national annual updates of the Stability Programmes.

Lowest interest burden within affordable limits



Source: National Updated Stability Programmes.

Sustainable Economy Law

- **Improving the institutional environment for business:** by modernising and simplifying government activities as well as increasing government's fiscal discipline
- **Fostering competitiveness:** by reducing the administrative burden on new companies and reducing red tape
- **Fostering modernization:** by 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 internationalisation of businesses

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

Residential Real Estate Sector

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

The financial system remains resilient

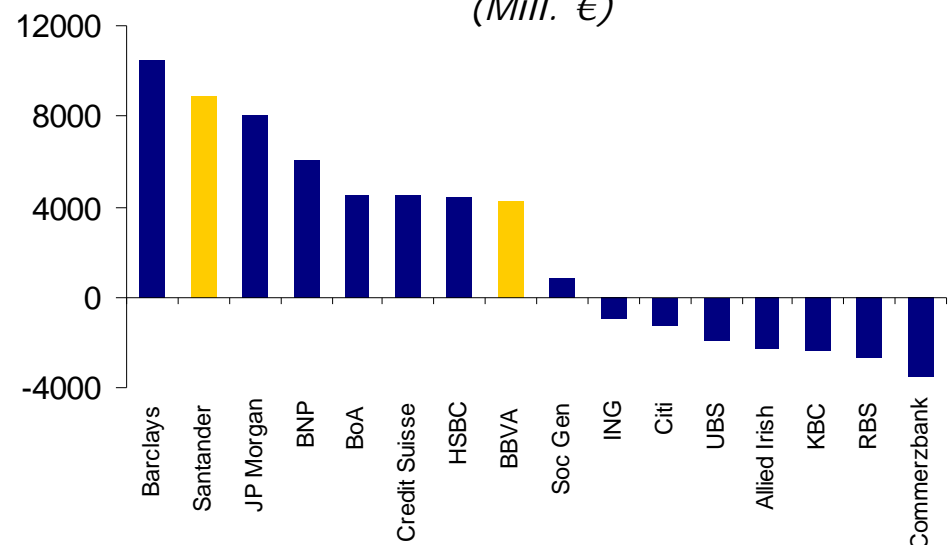
- A crisis weathered without public sector rescue operations, and the two largest Spanish banks increasing their market share
- Reasons for system resiliency: retail business model, strict regulatory and supervisory framework and efficiency drivers

Capital Support Measures for European Banks (Dec. 2009), bn.€			
Country	Approved	Materialized	(%)
Italy	20	2	10%
Portugal	4	0	0%
Greece	13	8	62%
Austria	35	10	29%
Spain*	27	0	0%
Netherlands	107	74	69%
France	27	27	100%
Germany	145	85	59%
Ireland	12	12	100%
UK	301	262	87%
Belgium	23	23	100%

Sources: European Commission, Economic Forecast Report Autumn 2009 and Spanish Treasury.

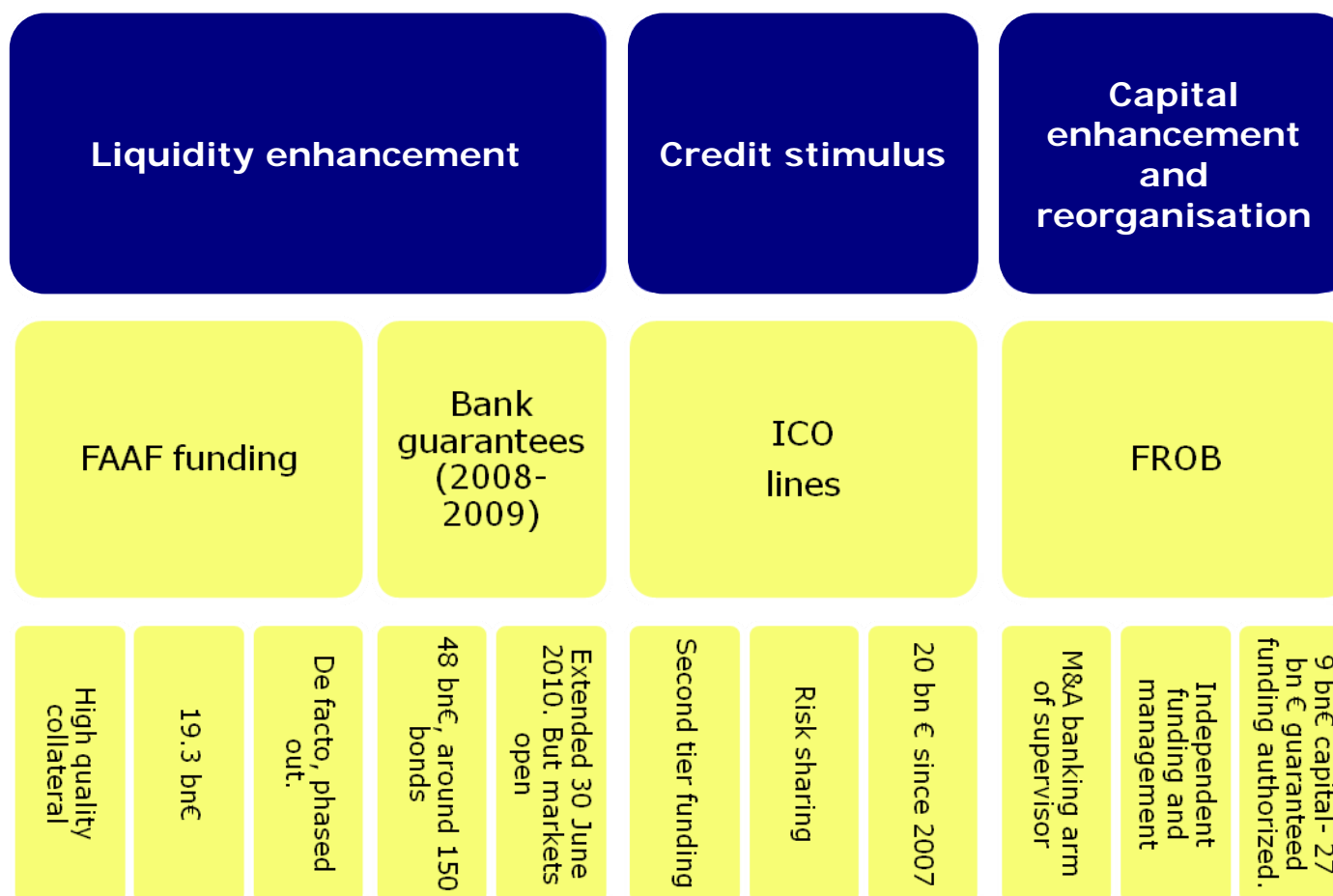
* CCM intervention has been funded privately by the Deposit Guarantee Fund (ca. 1 bn€).

Net attributable profits, 2009
(Mill. €)



Source: Bloomberg.

Preventive measures to tackle an entrenched world financial crisis

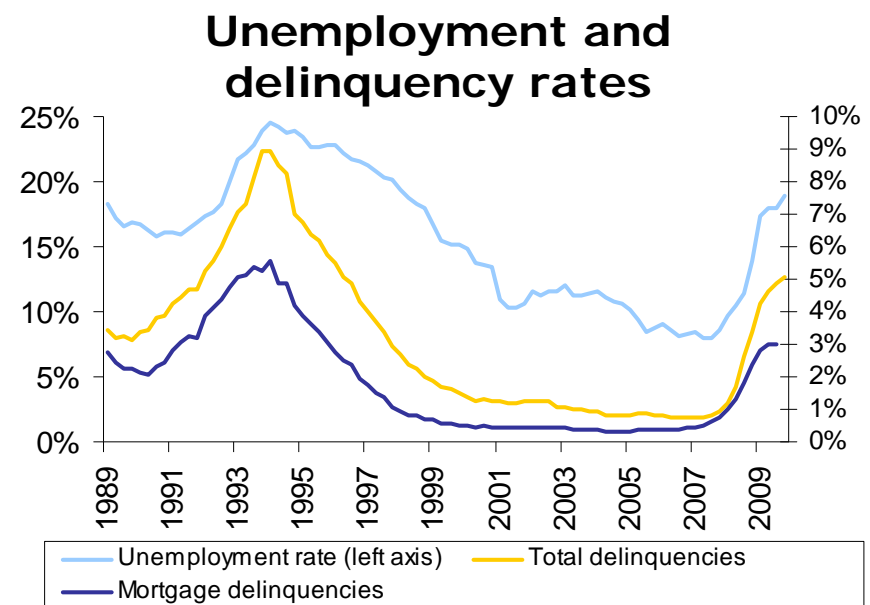


Banking book vulnerabilities remain in check

- Delinquencies from mortgage loans to households are protected by a **solid collateral framework** already tested in the 1990s
- Spanish banks have low exposure to consumption loans
- The main risk stem from losses from **lending to real estate developers**
- IMF GFSR forecasts delinquencies to peak in 2010Q3 at ca. 6.1%

Spanish Banks' credit portfolio (Dec. 2009)		
	Share of loans	Delinquency rate
SME and Corporate	29.3%	3.40%
Comercial real estate	24.7%	9.61%
Mortgage lending	35.6%	2.89%
Consumption lending	8.7%	6.91%
TOTAL PORTFOLIO	100.0%	5.08%

Source: Bank of Spain.



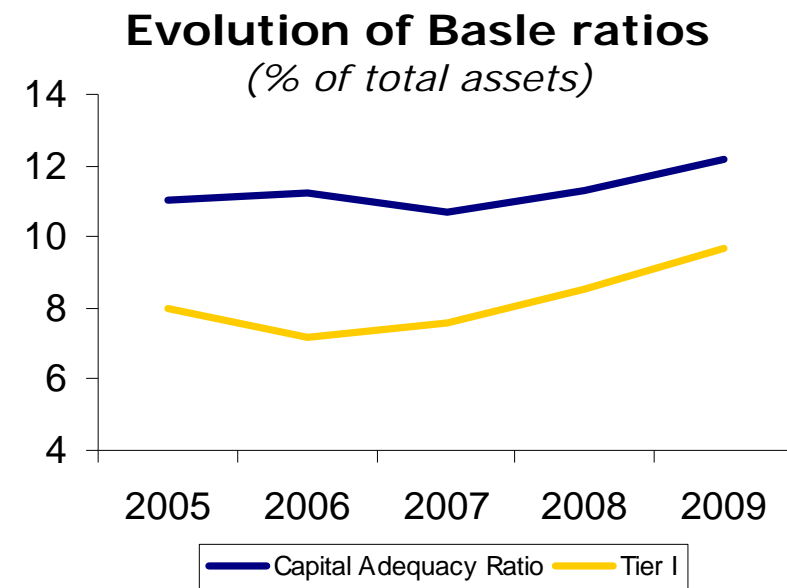
Source: Bank of Spain and National Statistics Institute.

Buffers against losses offer further comfort

- A rules-based provisioning system, enhanced by dynamic provisioning, has so far been instrumental in maintaining banks' resiliency
- Banks' profitability provides another important cushion
- Capital adequacy remains sound on an aggregate basis
- Synergies achieved from banking sector restructuring offer further protection

Commercial real estate: exposure and coverage (Dec. 2009)		
	Magnitude (bn €)	Coverage by specific reserves
Exposure	445.0	
Doubtful	42.8	41.4%
Substandard	59.0	12.9%
Repossessions	59.7	21.8%
Write-offs	4.0	100.0%
Total exposure at risk	165.5	25.6%
Coverage including dynamic provision		35.0%
Coverage including operating income proj.		71.0%

Source: Bank of Spain.



Source: Bank of Spain.

FROB: a tool for restructuring the banking sector

Rationale for the initiative

- Overcoming fragmentation in the banking 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 (limit 2% RWA).

Asset Operations

- Acquisition of convertible preference shares with market-oriented remuneration.
- Already a functioning programme with three approved mergers, with more in the pipeline

Funding

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

Pension System Reform

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

Labour Market Reform

- **Five main guidelines:**
 - Stability in employment, by reducing market segmentation
 - Reform of the 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

- 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 programme
- 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

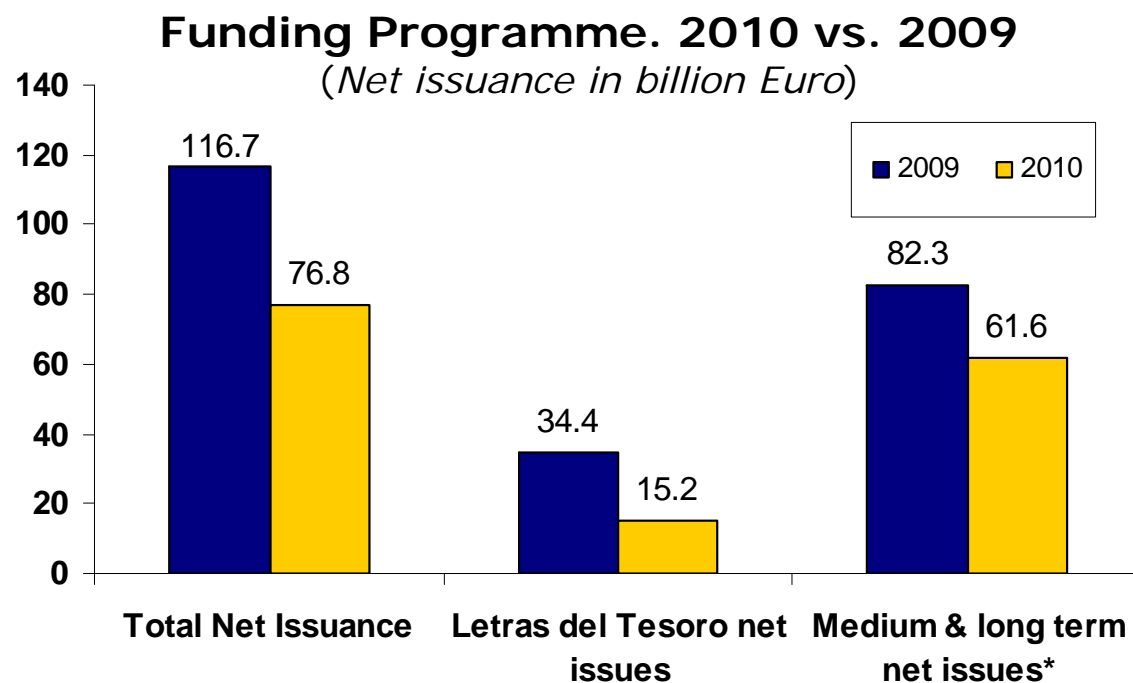
The funding strategy

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

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

- **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 4th Tuesday
 - 18-month T-bills relaunched: auction 3rd Tuesday

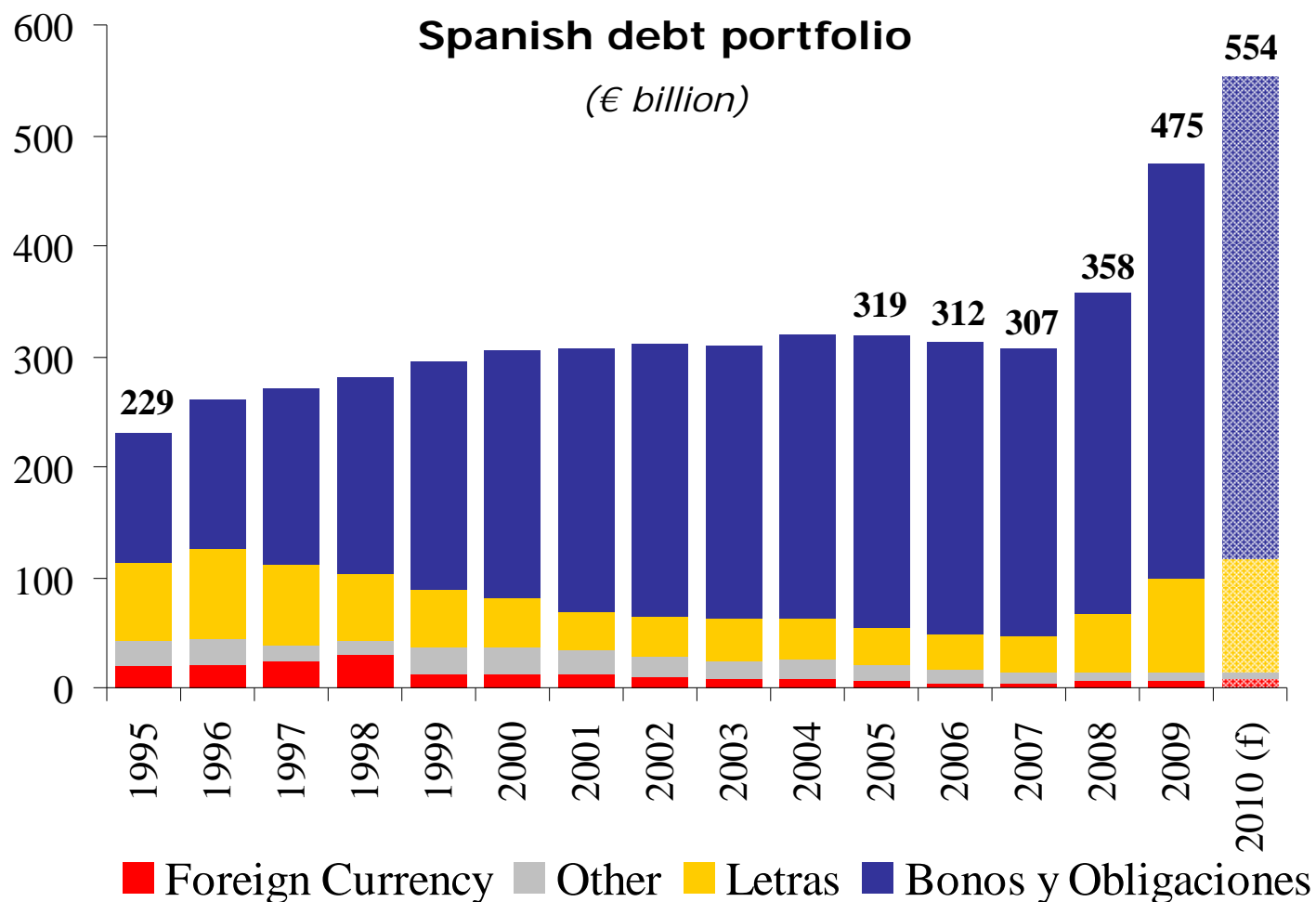
Medium- and long-term funding

- **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:**
 - 3-year benchmark B 2.30% 04/2013 issued until 15 bn €
 - 5-year benchmark in B 3.00% 04/2015 issued until 15 bn €
- **Obligaciones del Estado:**
 - New 10-year benchmark O 4.00% 04/2020, successfully syndicated in January and tapped in a March auction.
 - New 15-year benchmark O 4.85% 07/2025, successfully syndicated in February, to be tapped in an April auction.
- **30.6% of the issuance programme and 48.9% of the redemption programme by March 31st 2010.**

Diversification of funding sources

- **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
- **3-Year *Floating Rate Note* 3-Month EURIBOR-10 bps, October 2012 (€ 3.0 billion) & 5-Year *Floating Rate Note* 3-Month EURIBOR+45 bps, March 2015 (€ 1.5 billion)**
- **Projects:**
 - European inflation-linked issues (HICP-ex tobacco)
 - Schuldschein loans

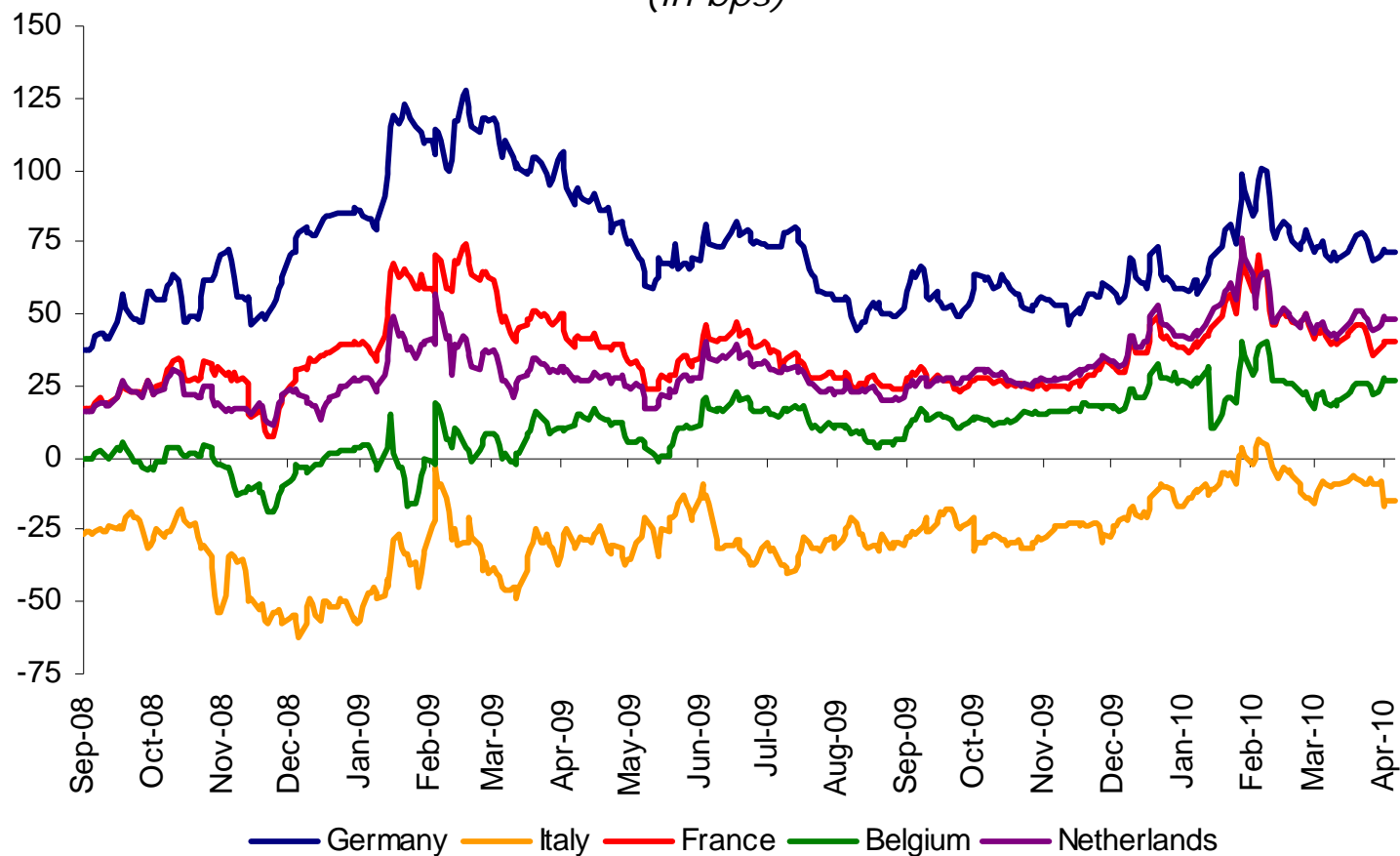
Main features of Treasury funding strategy



Source: Dirección General del Tesoro y Política Financiera.

Spreads have proved resilient

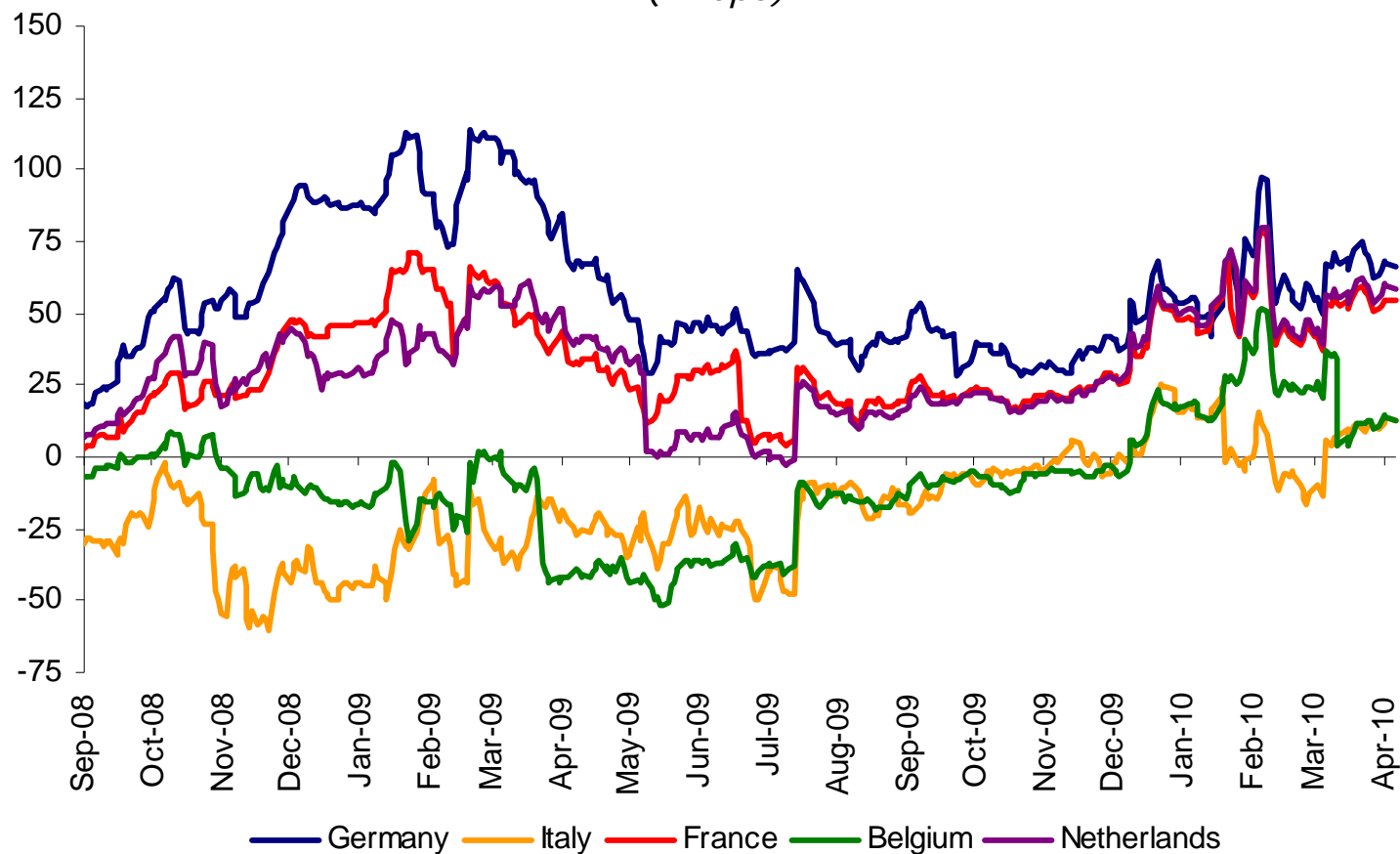
Spread of the Spanish 10-year bond vs. main European peers
(in bps)



Source: Bloomberg.

Spreads have proved resilient

Spread of the Spanish 5-year bond vs. main European peers
(in bps)



Source: Bloomberg.

An attractive market to invest in

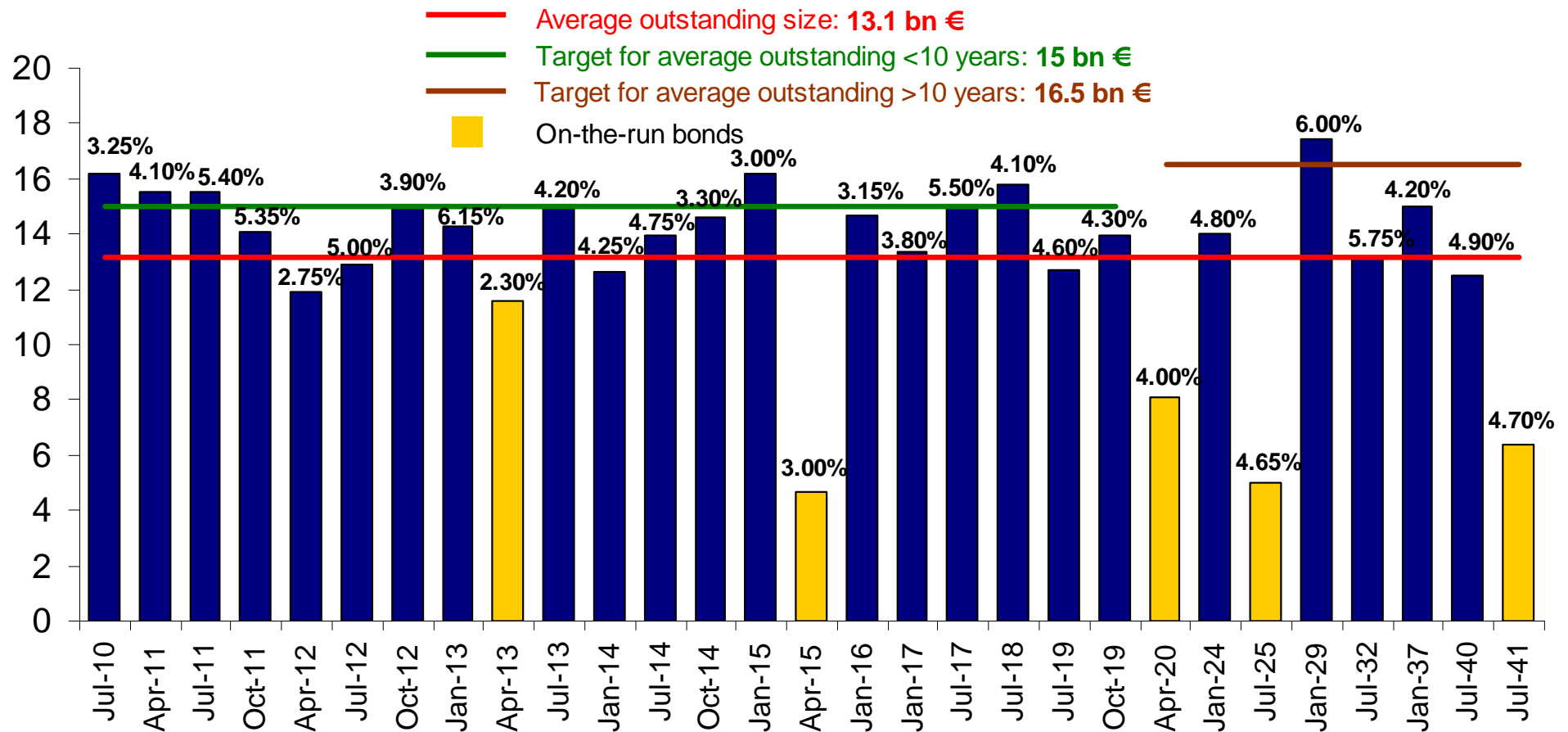
Attractive prices

Liquid instruments

Solid and efficient
infrastructure

Diversified investor
base

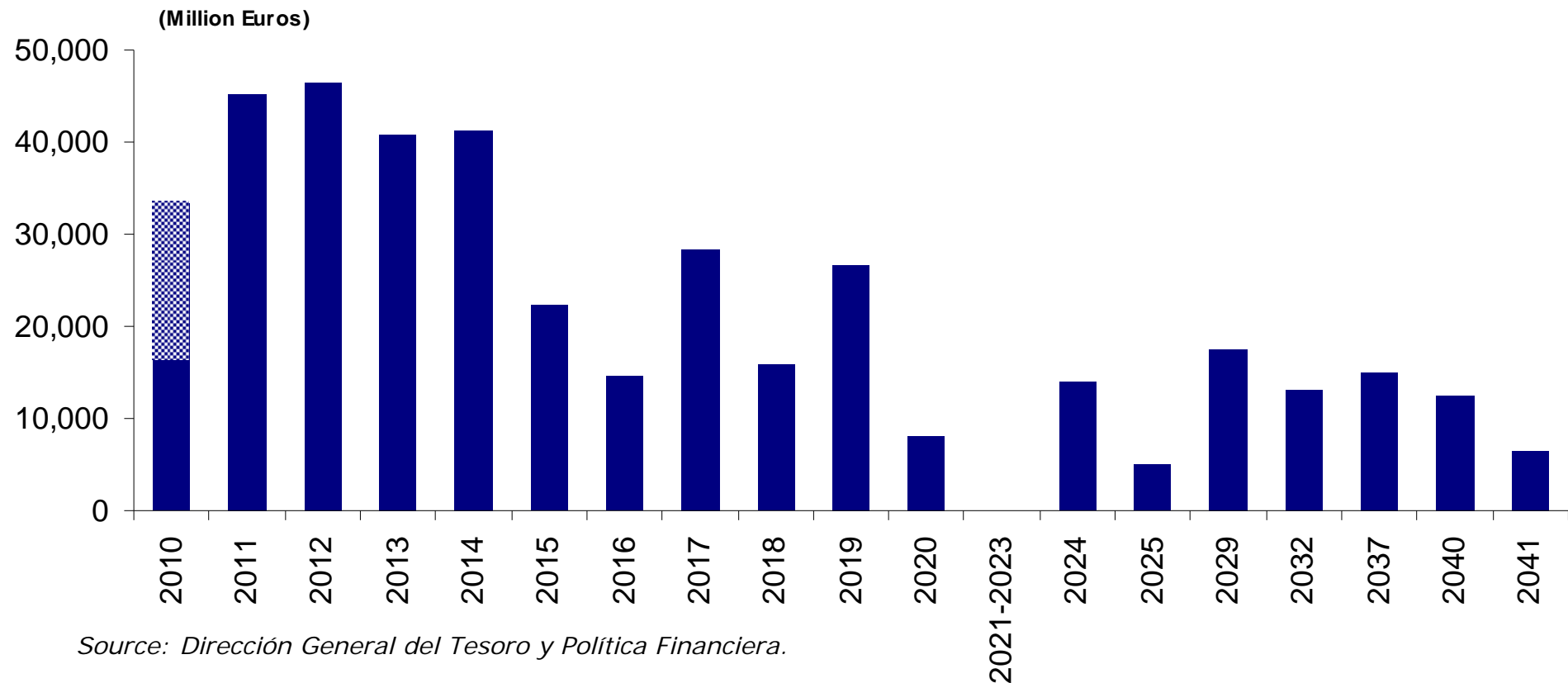
Increase in market liquidity



Source: Dirección General del Tesoro y Política Financiera.

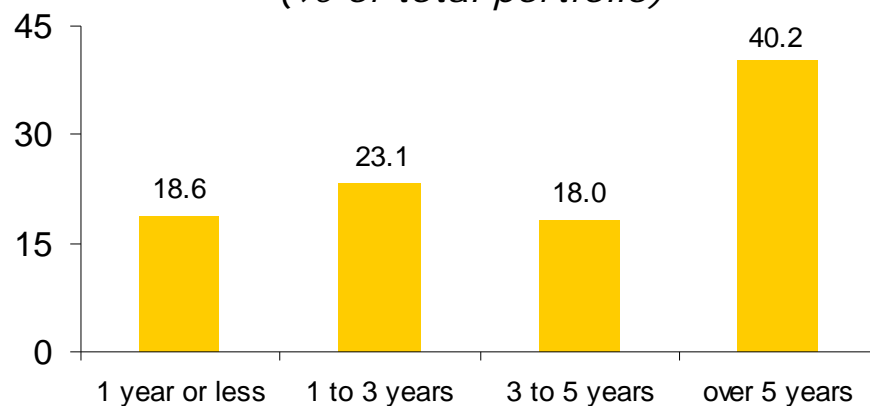
Low Debt Refinancing Risk...

Redemption profile of Bonos & Obligaciones



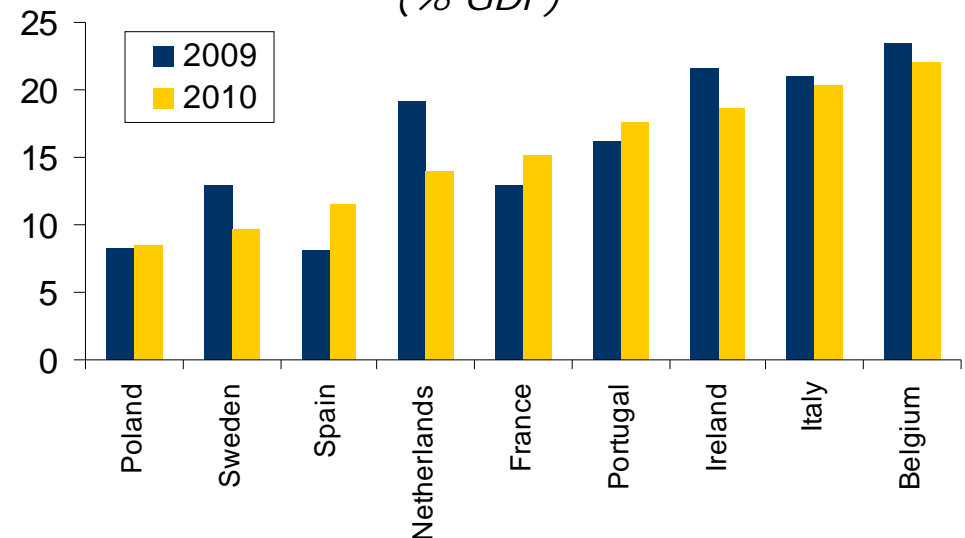
Low Debt Refinancing Risk...

Government Debt roll-over risk
(% of total portfolio)



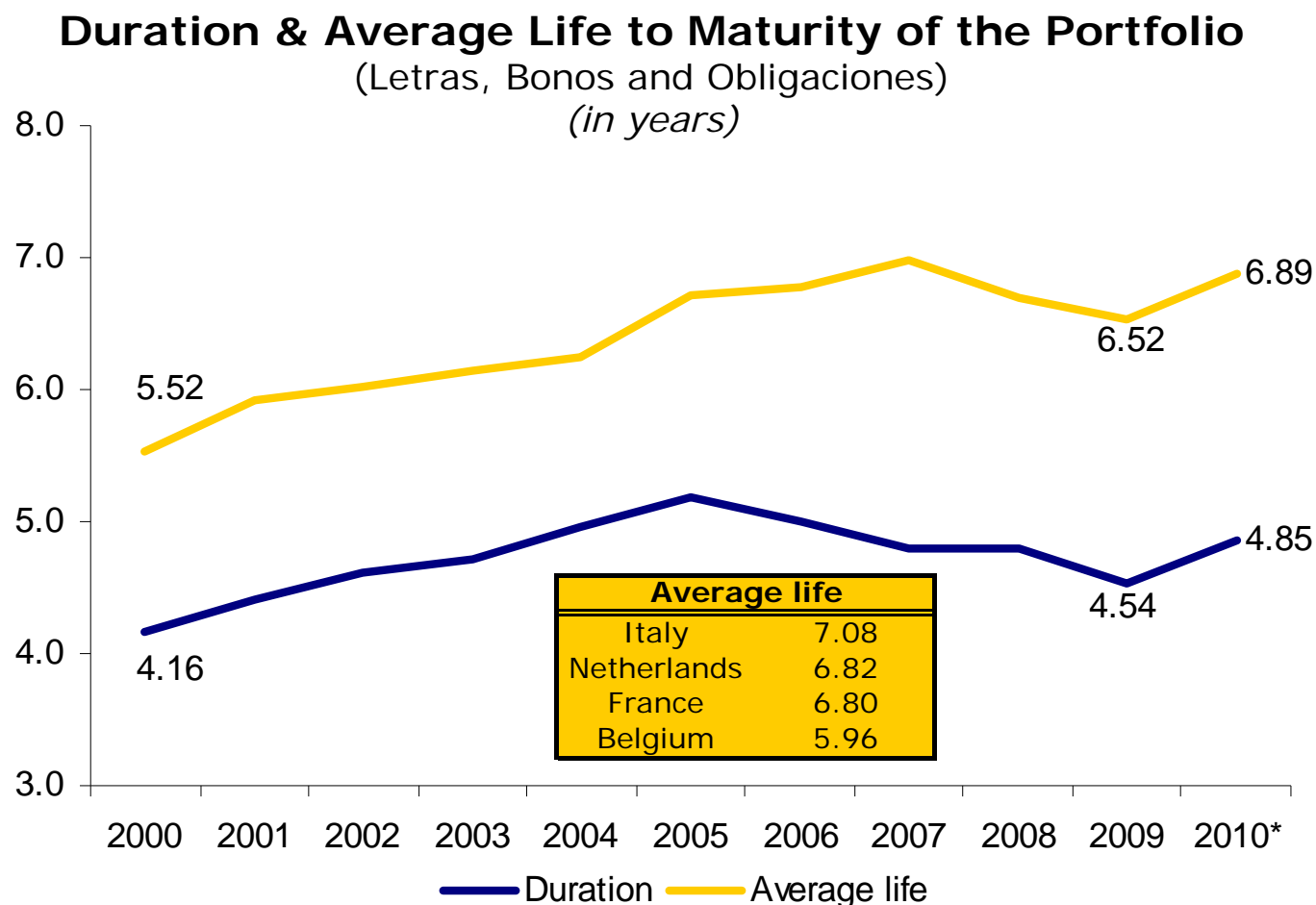
Source: Dirección General del Tesoro y Política Financiera.
(February 2010)

Government Debt Roll-over ratio
(% GDP)



Source: Standard & Poor's.

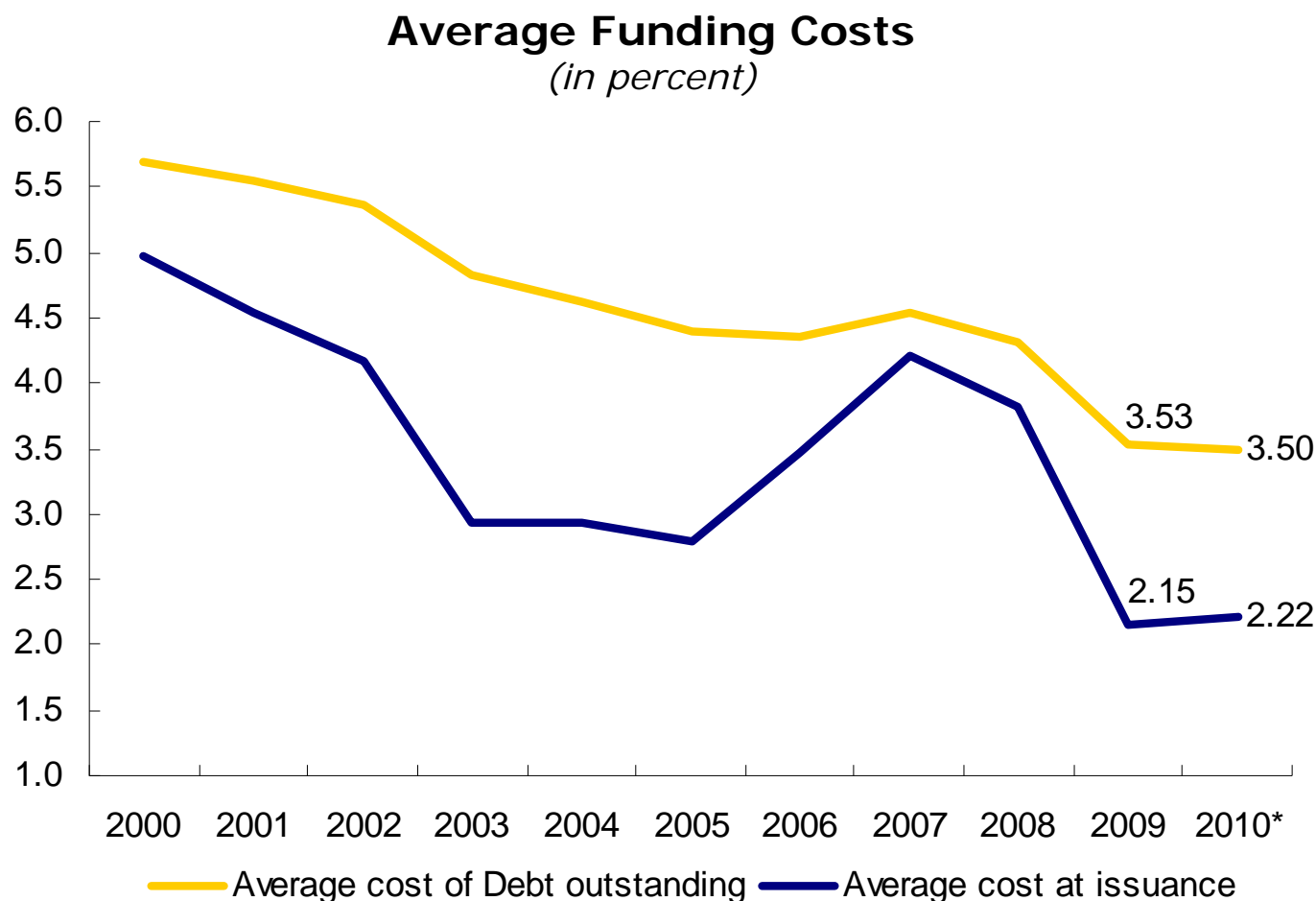
...Thanks to relatively high duration and average life to maturity...



Source: Dirección General del Tesoro y Política Financiera.

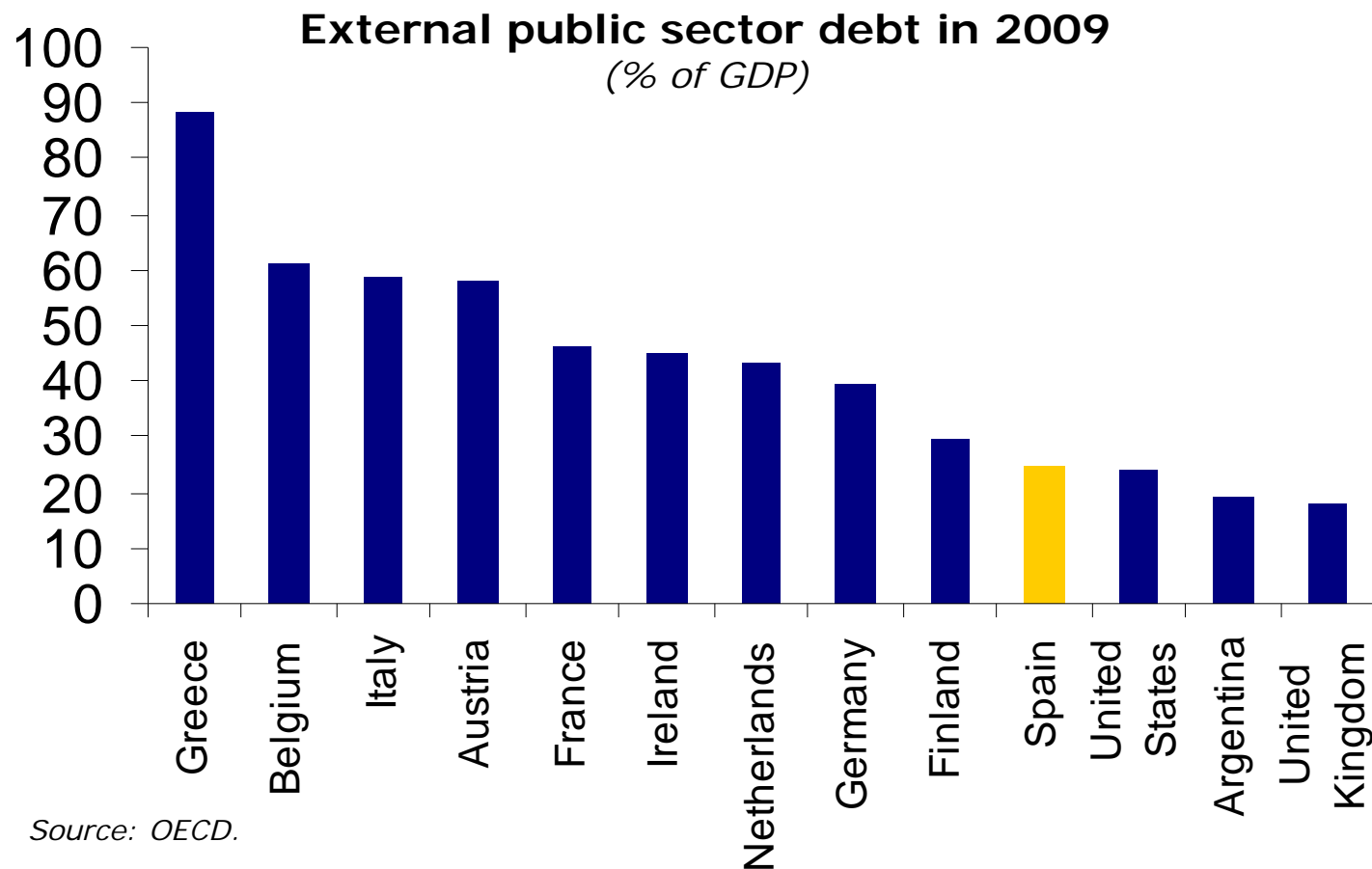
*As of 31st March 2010

...while achieving lower Funding Costs

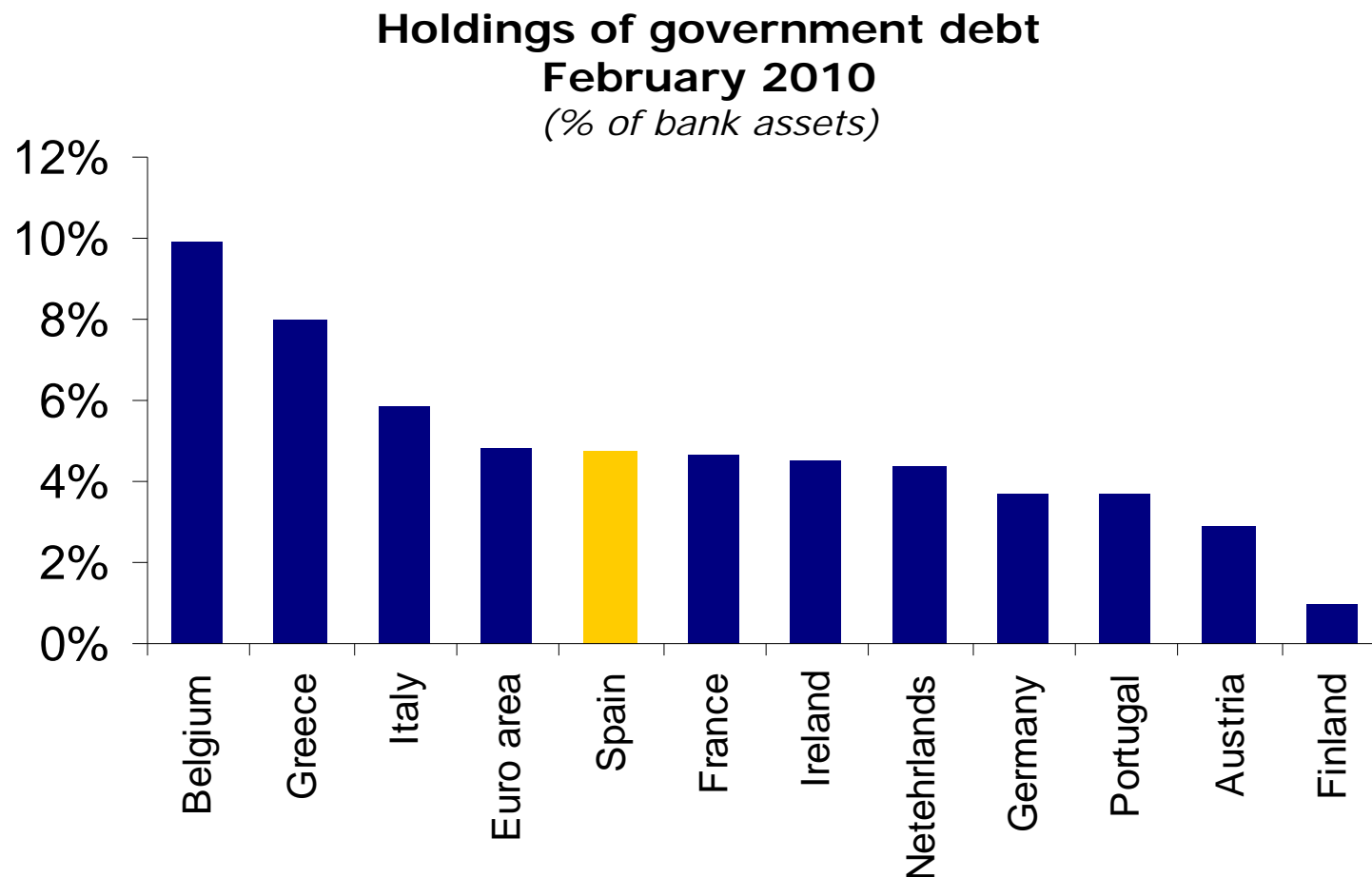


Source: Dirección General del Tesoro y Política Financiera. *As of 31st March 2010

Reliance on foreign funding relatively moderate

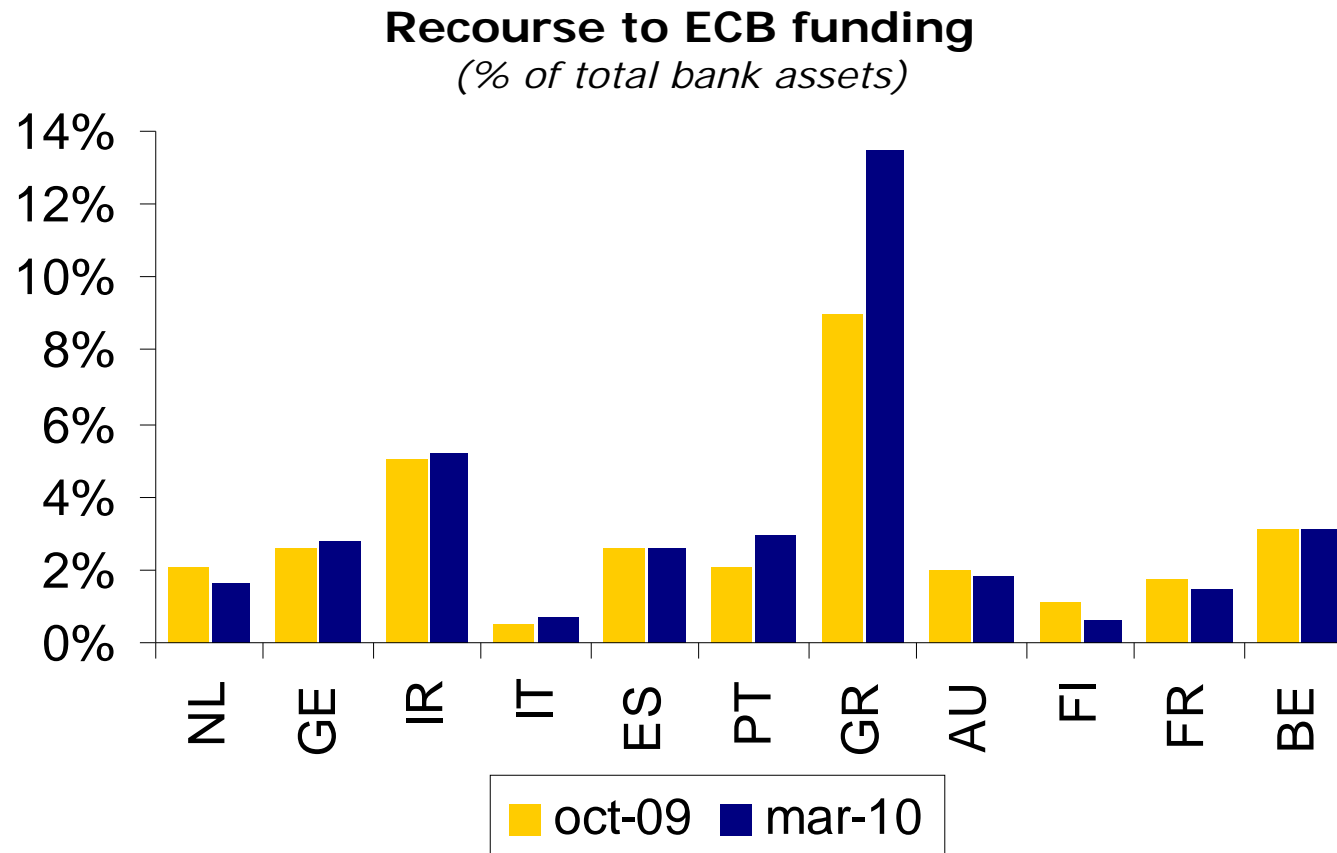


Banks financing of government debt in line with Eurozone average



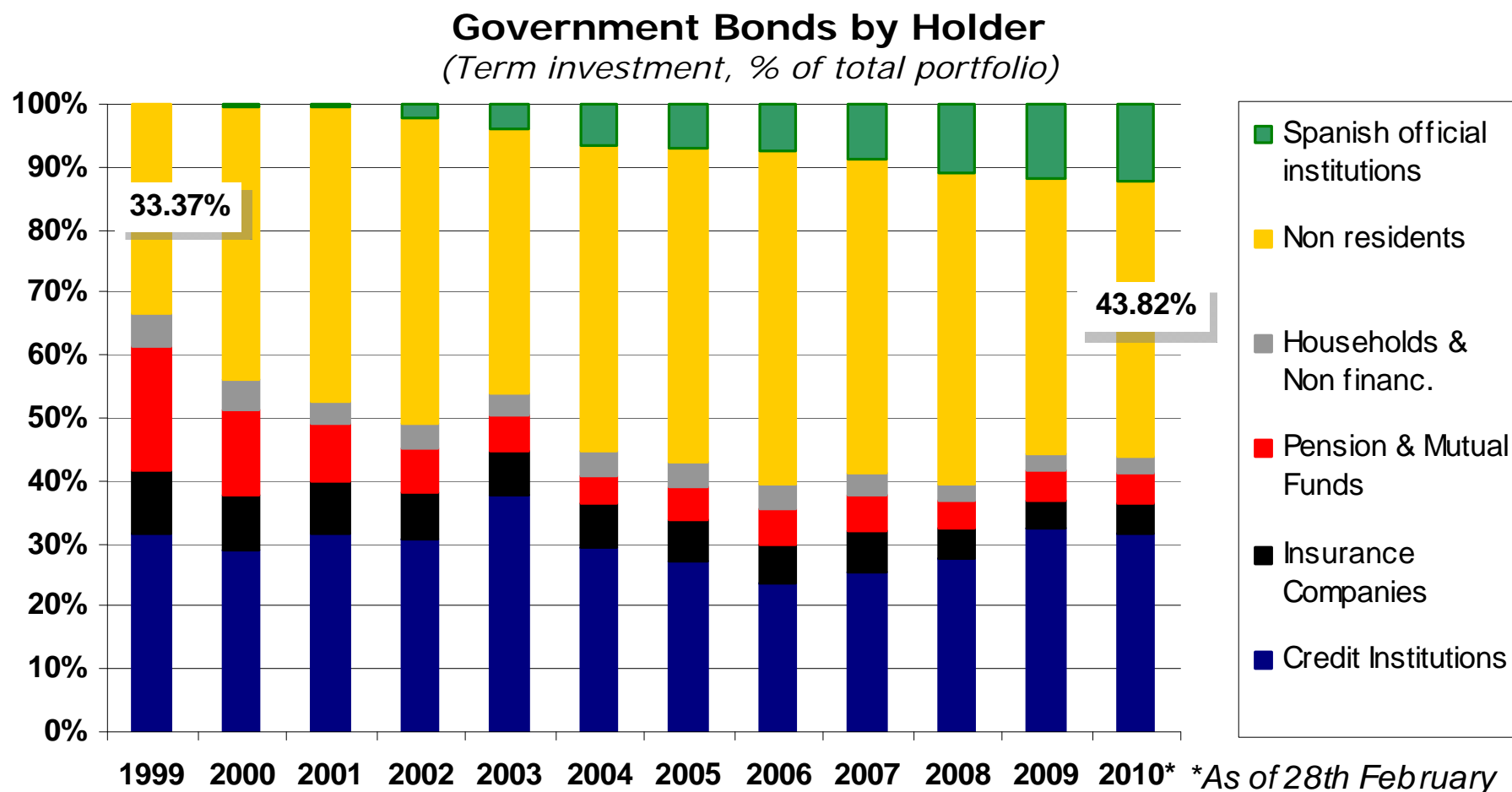
Source: European Central Bank.

Spanish Banks' funding from ECB around Eurozone average



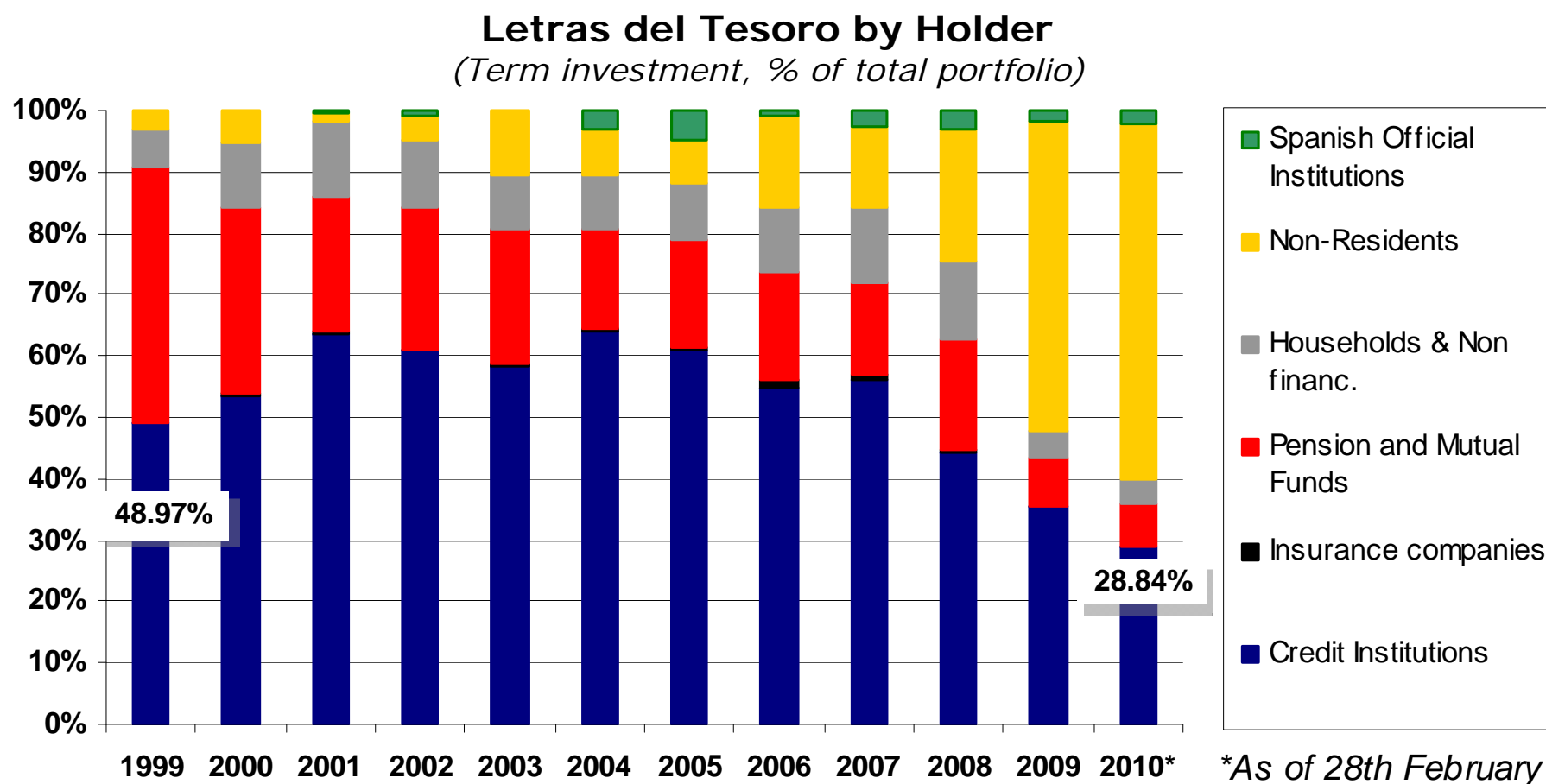
Source: Deutsche Bank and ECB.

Stable and diversified investor base



Source: Dirección General del Tesoro y Política Financiera.

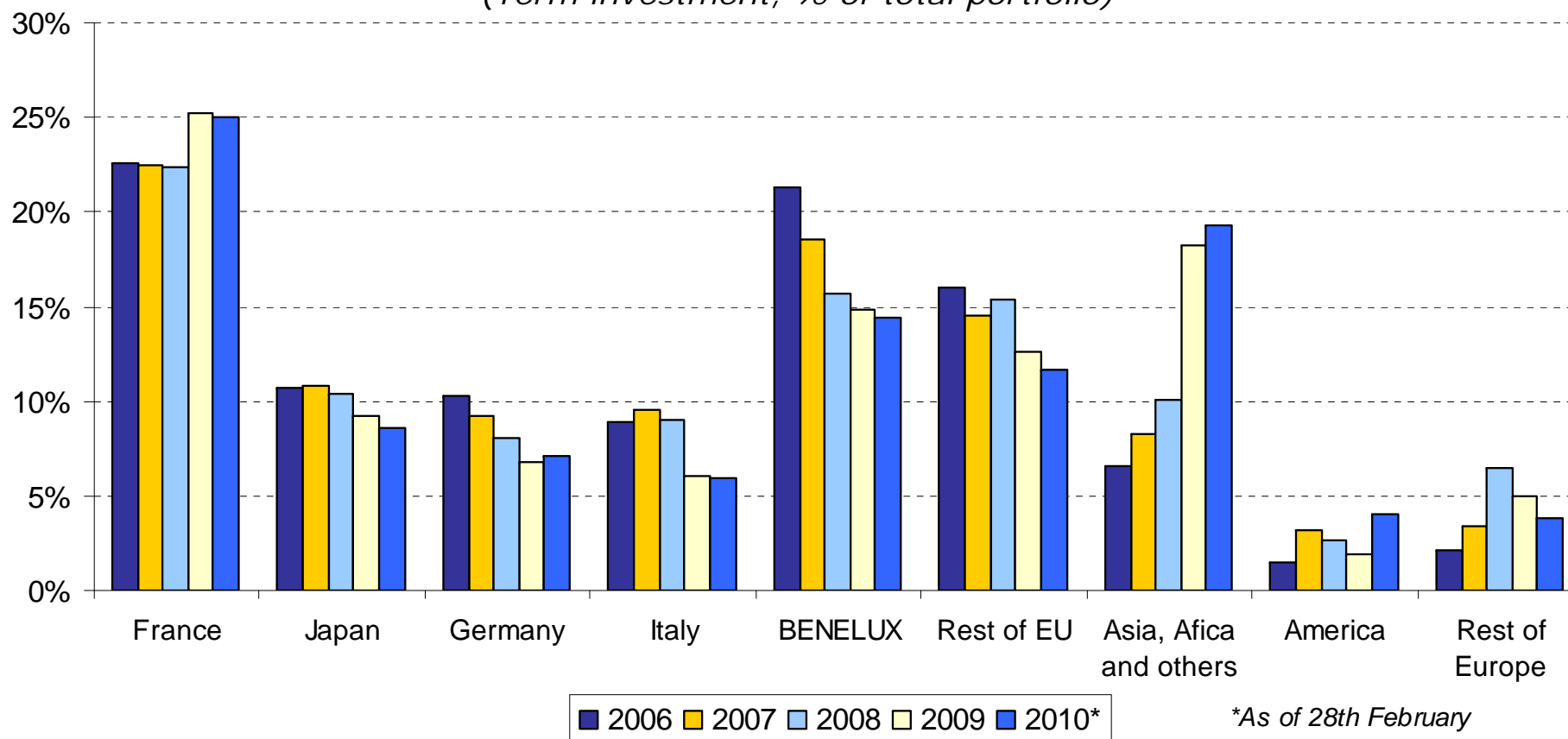
Stable and diversified investor base



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.

Thank you for your attention

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Annex: Recent statements of Credit Rating Agencies on Spain

Standard & Poor's: AA+, negative outlook (December 2009)

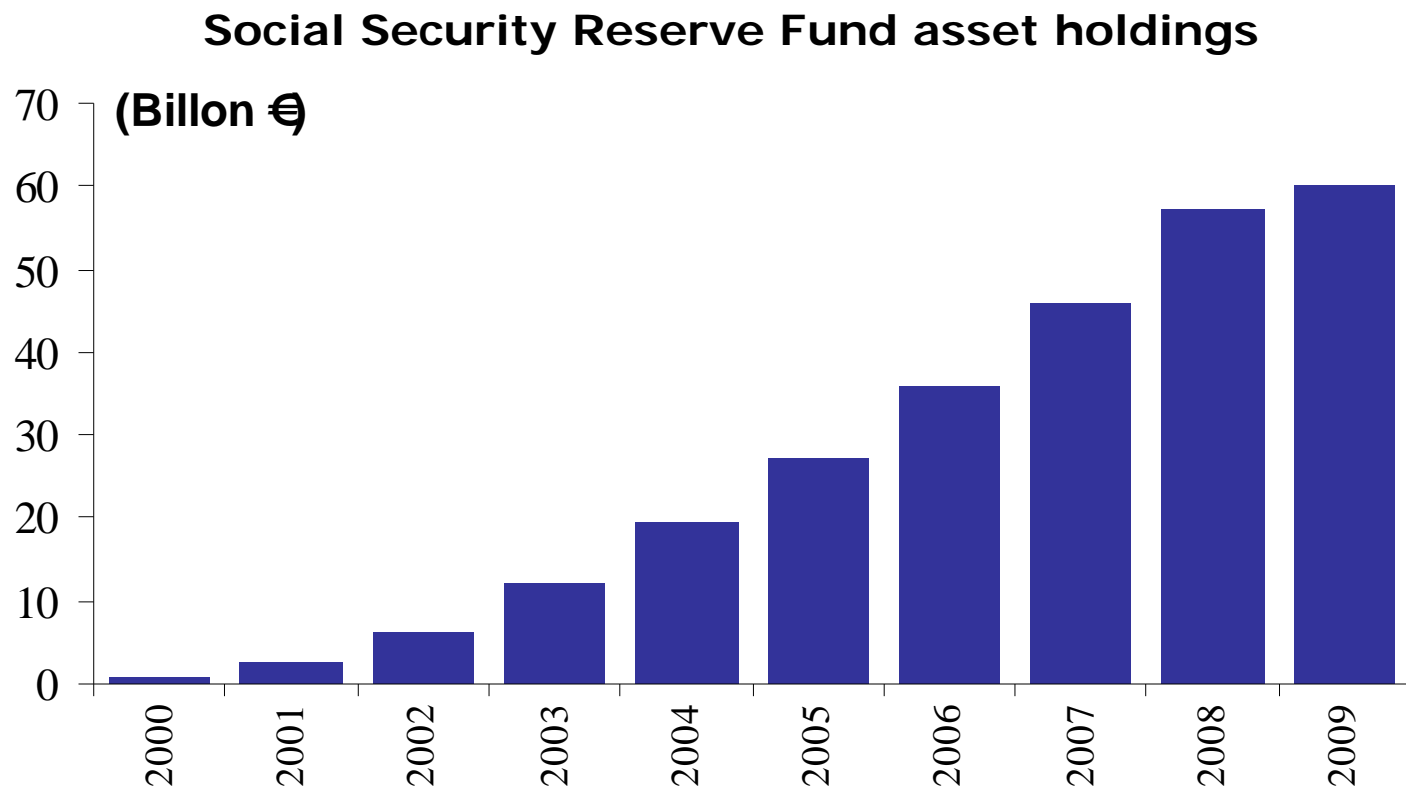
...**"The negative outlook ... remains in place in the absence of more aggressive and tangible actions by the authorities** to tackle Spain's economic and fiscal imbalances. Any deterioration over and above our current expectations could put further downward pressure on the ratings."

Moody's: Aaa (February 2010)

... "given the **commitment to fiscal consolidation across the political spectrum** and the support for such a stance in the country at large, we are **confident that any necessary measures will be forthcoming**. The deficit may not fall to 3% of GDP in 2013, but any overrun is likely to be limited to a year at most, **thereby providing a crucial underpinning for the government's Aaa rating.**"

Fitch: AAA

Annex: the Social Security Reserve Fund



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

Annex: Sustainable Economy Law & General Agreement on Fiscal Sustainability

Competitiveness

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

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.

Environment

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

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.