REFORMS BY THE GOVERNMENT OF SPAIN

COMBATING THE CRISIS WITH DETERMINATION

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I. THE ECONOMIC SITUATION IN SPAIN

In terms of Gross Domestic Product (GDP), Spain is the fourth-largest economy in the Eurozone and the fifth-largest in Europe.

Since the Economic and Monetary Union was put in place and the Euro was subsequently adopted as the single currency in 1999, Spain has systematically met all the economic commitments it assumed under the Stability and Growth Pact for the Eurozone.

- Spain experienced a long period of economic growth (with higher than EU average rates of growth) that enabled the country to achieve a higher than EU average *per capita* income (Graphic 1).

- Throughout this period, which was helped by the interest rate policy adopted by the European Central Bank (as the sole institution in the European Union with exclusive competency over monetary policy), the macro-economic data on Spain's public deficit and public debt remained within the limits established by the Stability Pact.

The first symptoms of an international financial crisis began to appear in Spain in 2008 and the internal underlying causes behind those symptoms became apparent (reasons associated with significant financial exposure to the real estate sector).

The crisis then led to reduced financial and economic activity in Spain, with GDP falling by 3.7% in 2009. A raft of economic stimulus measures were adopted to counter this situation.

The lack of positive results from those measures, a worsening of the international financial crisis and the absence of new, more effective economic measures led to an overall deterioration that is reflected in the following figures:

✓ A sharp decline in economic activity: from GDP growth of 3.6% in 2007 to -3.7% in 2009; -0.1% in 2010; 0.4% in 2011; and a forecast -1.7% in 2012.

✓ A high rate of unemployment: from 8.6% of the workforce in 2007 to 22.5% in 2011 and 24.6% at the moment.

- ✓ A correlative reduction in tax revenue and increase in public spending, which led to a public deficit of 8.9% of GDP in 2011 (from a public account surplus equal to 1.9% of GDP in 2007).

- ✓ An increase to 68.5% in the public debt-to-GDP ratio at the end of 2011 and 72.1% in June 2012 (from 40.2% in 2008). The average public debt-to-GDP ratio in the Eurozone currently stands at 87.2%.

At the same time, the increased need for finance in the Spanish economy led to difficulties in the debt market following an increase in the risk premium associated with Spanish sovereign debt. These difficulties were highlighted and fed by limitations or shortcomings within the European Monetary Union and doubts over the future of the Euro.

Therefore, since it came to power on 22 December 2011, the Government of Spain has been implementing an intensive agenda of economic reforms and budgetary measures in line with the economic guidelines and recommendations set by the European Union.

The efforts made by the Government over the course of these last eight months of power have been mainly aimed at undertaking urgent reforms to counter the economic crisis under the following principles and with the following objectives:

- ➢ Reduced public spending and increased austerity and rigour in economic management.

- ➢ Transparency, as a principle that underpins Government action and that should also underpin the action of all public authorities.

- ➢ The application of austerity measures in all public administration services, especially the regional governments.

- ➢ The sustainability of the Welfare System through streamlining and cost-containment measures.

- ➢ Economic flexibility and competitiveness to stimulate growth and the creation of jobs.

- ➢ Support for small- and medium-sized enterprises and entrepreneurs as the driving force behind economic recovery.

II. THE REFORMS ALREADY IN PLACE

The measures adopted by the Government correspond to three lines of action:

II.1. Budgetary Adjustment and Fiscal Consolidation Measures

II.2. Structural Reforms to Boost Competitiveness

II.3. Financial Stability

II.1. BUDGETARY ADJUSTMENT AND FISCAL CONSOLIDATION MEASURES

The Government of Spain is strongly committed to its process of fiscal consolidation. The measures adopted by the Government in this regard seek to achieve three objectives:

- ✓ To meet the public deficit target set for the end of this year (6.3% following the latest revision authorised by the European Commission) and for the following years in accordance with the Stability Programme 2012-2015.

- ✓ To commit and ensure responsibility by all regional authorities in terms of budgetary stability and compliance with established deficit and debt targets.

- ✓ To combat fraud committed against the Public Treasury and the Social Security system, particularly that deriving from the hidden economy, as another of the priorities for the Government's economic policy.

⇨ Budgetary Adjustment Measures to Reduce the Public Deficit

Since its first Council of Ministers meeting on 23 December 2011, the Government of Spain has adopted the following budgetary adjustment measures to control the public deficit.

- The ***Urgent Measures on Budgetary, Tax and Finance Measures Aimed at Correcting the Public Deficit*** and the ***Budget Cut Agreement*** for 2012 (adopted on 30 December 2011) generated an adjustment of 15 billion euros. Among other things, these measures included the following:

    - The freezing of public sector wages and the Public Sector Job Offer (except in those public services considered priority, where a 10% civil servant replacement rate was implemented: education, healthcare, security and defence, tax and labour inspection).

    - A tax increase for 2012 and 2013 (Personal Income Tax, Property Tax).

    - A reduction of almost 20% in the number of organic structures within the State Administration Services and of senior civil servants.

- The ***General State Budget 2012*** (approved by Parliament on 29 June 2012) includes a 17.8 billion euro reduction to the deficit of the General State Administration Services through such measures as:

    - Almost 17% less spending by ministerial departments.

    - Exceptional tax measures to increase revenue by 12.3 billion euros (companies, fiscal regularisation, etc.).

- The ***Measures Aimed at Streamlining Public Expenditure in the National Health System and Education*** (adopted on 20 April), which are issues managed by the regional governments, seek to reorganise resources more efficiently and generate a saving of 10 billion euros.

- Among other steps within the National Health System, expenditure on drugs is reduced, a Centralised Procurement Platform is established and the improper use of healthcare services by non-resident foreign citizens is controlled.

- Within the Education System, the measures affect both university education (where the principle of budgetary stability is introduced at universities) and non-university education (where greater flexibility is given to education management).

- The ***Measures Aimed at Guaranteeing Budgetary Stability and Boosting Competitiveness*** (adopted on 13 July 2012) will generate an adjustment of 65 billion euros in the period 2012-2014 through a wide range of steps in many different areas.

  - In terms of the civil service and in order to reduce spending: the extraordinary December bonus is suspended for all civil servants and all regional governments; the number of days holiday that can be chosen at will and the number of additional days holiday for length of service are reduced; changes are made to the payment regime for civil servants during temporary incapacity.

  - In terms of fiscal matters and in order to increase tax revenue: the general rate of VAT was increased from 18% to 21% and the reduced rate from 8% to 10%; the deduction in Personal Income Tax for the purchase of a primary residence will be suspended from 1 January 2013 (as recommended by the European Commission).

  - In terms of employment and Social Security: unemployment benefits are reduced from the seventh month for new benefit recipients, setting the amount of this benefit at 50% of the calculation basis; changes are made to the eligibility requirements for the Active Labour Market Insertion Benefit.

  - These measures are accompanied by a *Budget Cut Agreement worth 600 million euros, charged to the General State Budget 2012*.

- The most recent measures to be adopted so far in terms of fiscal consolidation are contained in the ***Biannual Budget Plan 2013-2014*** (approved on 3 August). This budget plan:

    - Meets the recommendations made by the European authorities.
    - Contains an overall adjustment (increased revenue and spending cuts) worth 39 billion euros in 2013 and 50.1 billion euros in 2014.
    - Guarantees compliance with the path to fiscal consolidation for reducing the deficit of all public administration services to 4.5% of GDP in 2013 and to 2.8% of GDP in 2014.
    - All public administration services will contribute towards achieving the budgetary stability targets.

⇨ Commitment to Budgetary Stability by the Regional Authorities (Annex I)

This regional commitment to meet the deficit targets is embodied in two agreements by the Fiscal and Financial Policy Council (as the body that gathers those responsible for budgetary affairs from the Central State Government and from the various governments of the autonomous regions).

- In May, all the regional governments presented Economic-Financial Rebalancing Plans that represent a saving of 18.35 billion euros and guarantees that their public deficit will be lowered to 1.5% in 2012.

- The Fiscal and Financial Policy Council meeting on 31 July approved the Stability Programme for 2013-2015, which contains deficit targets for the regional governments of 0.7% of GDP in 2013, 0.1% of GDP in 2014 and a surplus of 0.2% of GDP in 2015.

- Furthermore and by means of changes to the law, the Government has made it easier for the regional governments to make changes to the management models that govern regional public television channels (heavily in debt) so as to help lower public spending.

- Finally, the Government is making it easier for regional governments to achieve financial stability through a series of measures aimed at alleviating the difficulty they are experiencing when trying to obtain financing from the markets. On 13 July, this action culminated with the implementation of a ***"Regional Financing Mechanism"*** consisting of the creation of a Fund that the State will make available to the regional governments so as to cover their liquidity needs.

  This Liquidity Fund will be given a budget of 18 billion euros for 2012. The regional governments will have the option to adhere to this mechanism voluntarily but, by doing so, will assume a commitment to comply with certain financial and fiscal conditions. The regional governments will receive the financing but will remain solely responsible for their repayment, thus creating an incentive for fiscal discipline.

⇨ Strengthening Stability through Measures on Economic Governance

Spain's commitments to the European Union, especially in terms of budgetary stability, are being strengthened with important internal measures on economic governance, such as:

- The ***Constitutional Law on Budgetary Stability and Financial Sustainability*** (in force since 1 May 2012). This law increase discipline in public finances and guarantees control over the budgets assigned to all administration services: it requires them to achieve structural balance in all their public accounts and establish a debt ceiling as a means to ensure budgetary sustainability through strengthening the preventive and coercive public account oversight mechanisms.

- The Draft Bill on ***Transparency, Access to Public Information and Good Governance***, a fundamental issue for restoring confidence in Spain's institutions: it increases the liability of public managers in the performance of their duties and the management of public resources under a clear penalty regime. All public administration services are governed by this law.

➪ Measures to Combat Tax and Social Security Fraud

Combating fraudulent activity against the Public Treasury and the Social Security system, especially deriving from the hidden economy, has been tackled by both Plans and various Draft Bills that have already been submitted to Parliament for debate and approval.

- *Plan to Combat Irregular Employment and Social Security Fraud 2012-2013.* This plan incorporates two legislative amendments:
    - *Draft Bill on Combating Irregular Employment and Social Security Fraud*.
    - *Draft Bill amending the Constitutional Law on the Criminal Code in terms of tax offences and offences against the Social Security System*, in order to toughen the penalties applied to the most serious offences.
- *Draft Bill on Measures to Strengthen Preventive Action and Combat Tax Fraud.*

This package of measures seeks to shrink the hidden economy, increase the number of taxpayers who comply with their tax obligations and increase tax revenue by strengthening preventive action and the work undertaken by tax and labour inspectorates.

II.2. STRUCTURAL REFORMS TO BOOST COMPETITIVENESS

Cleaning up the public accounts is a necessary condition for tackling economic growth and job creation policies. However, that alone is not sufficient. The current economic crisis has established a need to undertake structural economic reforms that will make the Spanish economy more flexible and competitive.

⇨ Labour Reform

- The Government of Spain has approved an ambitious and far-reaching reform of the labour market aimed at slowing down the pace of job losses and creating new jobs as soon as possible (Graphic 2). The labour market reform is laying the groundwork for a new model of labour relations that is similar to the one found in Spain's neighbouring countries. The measures included in the reform are focused on four core areas:
  - Firstly, to increase the employability of workers. The labour intermediation system has been reformed and changes have been made to the training system.
  - Secondly, to foster new hirings (especially permanent employment contracts) in order to encourage employment. A new permanent employment contract in support of entrepreneurs has been created.
  - Thirdly, to encourage internal flexibility within companies as an alternative to lay-offs through a new collective bargaining model. Priority is given to company agreements.
  - Finally, the labour reform also contains various measures that affect the rules governing the termination of employment contracts that seek to favour labour market efficiency as an aspect associated with reducing labour market duality.
- Also in terms of employment, the Government of Spain has extended the so-called "PREPARA Plan" for the professional requalification of those people who are no longer entitled to unemployment benefit. Its objectives are to improve the effectiveness of the mechanisms used to increase the employability of those on benefits and to strengthen ties between active and passive employment policies.

⇨ Public Sector Reform

The Government of Spain has adopted numerous measures to downsize the public sector and reduce operating costs. These measures affect both the administrative public sector and the public business and foundation sector, and complete the measures implemented in this area to reduce the public deficit.

- A ***Plan to Restructure and Streamline the State Public Business and Foundation Sector*** has been implemented to create a smaller, more streamlined and more efficient sector in the current climate of austerity and public spending containment. It involves the suppression, disinvestment or liquidation of 80 mercantile companies.

- The ***Regime Governing the Remuneration of Managers and Executives in the Public Business Sector*** has been regulated, including a reduction to said remuneration. This measure cuts the number of board members at public sector companies by one hundred and sets the remuneration to be included in senior executive contracts. It represents a reduction of between 25% and 30% on average throughout the public business sector.

- A ***Plan to Streamline the Use of State-Owned Properties*** has been implemented. The various aspects of this plan include a reduction in rental expenditure, the optimisation of space occupancy and an increase in revenue. Since it was approved in March, the implementation of this plan has already generated a net saving of 17.3 million euros.

- Various ***measures to improve the efficiency of employment in the public sector*** have been adopted. Administrative structures within the General State Administration Services have been reduced by almost 20%, the public sector job offer has been frozen except in priority public services (healthcare, education, law enforcement agencies) and steps have been taken to reduce staff absenteeism within the public administration services.

- Furthermore, a ***reform of the market supervisory and regulatory bodies*** has been tackled in order to reduce the number thereof and create one single National Markets and Competition Commission.

⇨ Measures to Stimulate Economic Activity

These measures are aimed at introducing greater flexibility and competitiveness into the Spanish economy. For the most part, they respond to the Government's goal of supporting small- and medium-sized enterprises, the self-employed and entrepreneurs: activity in these business sectors accounts for 85% of the productive fabric in Spain and therefore represents the main driving force behind the Spanish economy.

- ***Measures to deregulate trade and various services*** have been approved (in force since 25 May) that seek to speed up the procedure for opening a new business, to stimulate activity in the retail sector and to foster competition. Subsequently, in June, business trading hours were deregulated by increasing the maximum number of weekday business opening hours to 90 hours per week and increasing the length of any sales period (to be decided by the trader).

- A ***Supplier Payment Plan*** was implemented by the public administration services. The majority of these suppliers are small- and medium-sized enterprises or self-employed professionals. This plan aimed to achieve a two-fold objective:

    - To settle trade debts held by local and regional authorities and restore the credibility of these authorities, while also helping to control their deficit.

    - To stimulate economic activity and create new or maintain existing jobs; this plan generated an injection of liquidity into the production economy worth approximately 30 billion euros.

- An extension was approved for ***lines of credit from the Official Credit Institute*** for the development of business projects by small- and medium-sized enterprises. This measure is injecting credit worth 22 billion euros into the Spanish economy.

- Various measures to continue promoting the ***growth of exports and overseas trade*** have been adopted. In particular, the door was opened for the privatisation of the *Compañía Española de Seguro de Crédito a la Exportación* (Spanish acronym: CESCE) [Spanish company for export insurance credit]; *Invest In Spain* (the State company for the promotion and attraction of foreign investment) was integrated into the Spanish

Institute for Foreign Trade (Spanish acronym: ICEX); and action was taken to foster the granting of credit to those business owners that sell abroad (Annex II).

- The ***Draft Bill on Measures to Increase Flexibility in and Promote the Property Rental Market*** (submitted to Parliament on 24 August) seeks to stimulate this market through a reform of its legal and fiscal framework, thus making it an effective alternative to the property market.

  - The Government of Spain has also adopted measures aimed at ***protecting mortgage holders with no resources***.

- The ***National and Comprehensive Tourism Plan 2012-2016*** was approved, which is aimed at improving the competitiveness of companies and tourist destinations in Spain, renewing Spain's global leadership in tourism and contributing to economic growth and the creation of jobs. The Plan contains 28 measures that encompass more than one hundred individual actions.

⇨ Transport Sector Reforms

The Government of Spain has undertaken a reform of the road transport sector and the passenger railway transport sector.

- As regards the former, a reform of the Terrestrial Transport Planning Act has been undertaken in order to increase the competitiveness and efficiency of the sector, improve the public service and provide greater transparency and control over both freight haulage and passenger transportation by road.

- As regards the latter, the Government approved (on 20 July) the deregulation of the passenger railway transport sector in order to improve prices and the service. A schedule has been established that sets the date for opening up the national passenger rail traffic market from 31 July 2013. The public companies in the sector are also restructured.

⇨ Justice Reform

The Government of Spain has promoted legislative measures to speed up the justice system and convert it into a factor capable of contributing to national competitiveness.

- A ***Royal Decree-Law on Civil and Mercantile Mediation*** has been approved to enhance mediation as a mechanism for resolving conflict in a voluntary, speedy, flexible and economic fashion. Its application will reduce the number of issues that are currently resolved by the ordinary justice system, thus improving its performance.

- The ***Draft Bill on a Reform of Legal Fees*** seeks to achieve a two-fold objective: on the one hand, to streamline the exercise of jurisdictional power; and, on the other hand, to ensure the maintenance of a free justice system for all those citizens who lack the resources to engage in legal action. The goal of this measure is to improve the way the courts of justice operate and avoid excessive saturation of the justice system.

II.3. FINANCIAL STABILITY

A healthy and solvent financial sector is an essential requirement for enabling credit to start flowing into business and households again and thus foster the recovery of growth and employment in Spain.

Part of the Spanish financial sector, in particular the regional savings banks, that is overly exposed to the real estate sector, has been significantly affected by the current economic crisis, the root causes of which were financial.

Therefore and together with the fiscal consolidation measures and economic reforms, the Government of Spain has promoted a financial sector restructuring process, which has culminated after its first eight months in power (a process that was initially launched by the previous government).

- A **comprehensive reform strategy** has been designed for the sector that seeks to increase solvency and flexibility in the long term for the entire banking sector so as to re-establish its access to the market and help ensure credit starts to flow into the real economy once again. This strategy has been applied in various stages and with various different measures.

    - The first measures (in February and May 2012) were approved in order to clean up and protect the balance sheets of financial entities: a process of cleaning up real estate assets was implemented; a regime governing entity mergers was established; the level of generic provisions for non-problematic assets was increased; and capital requirements will receive support from the *Fondo de Reestructuración Ordenada Bancaria* (FROB) [Fund for Ordered Bank Restructuring].

    - At the same time, in May and under an initiative from the Government, two separate external assessment reports were commissioned from Roland Berger and Oliver Wyman on the extent to which bank balance sheets have been cleaned up. This measure is an exercise in transparency (in line with criteria from the European Commission, the ECB and the IMF) to improve the credibility of the Spanish financial system and clarify any doubts regarding the banks' balance sheets.

- The assessment reports reflected recapitalisation requirements of between 16 and 26 billion euros at best and of between 51 and 62 billion euros at worst.

- With the results from those reports, the Government of Spain formally asked the Eurogroup (with support from its European partners) for financial assistance to recapitalise those entities that need recapitalisation. The amount of this assistance was to be sufficient to cover their capital needs plus an additional safety margin, up to a maximum of 100 billion euros.

- In July, the ***Memorandum of Understanding*** was signed regarding this financial assistance. The document contains a global strategy for ensuring that credit begins to flow into the real economy once again (through a process of restructuring and winding up of entities and the creation of a mechanism for separating toxic assets) and reducing the probability and seriousness of future economic crises.

- Finally, on 31 August, the Government concluded a reform of the financial system by approving the ***Royal Decree-Law on the Restructuring and Winding-Up of Credit Entities***. This legislation meets the commitments assumed under the programme of financial assistance to Spain for the recapitalisation of the banking sector and strengthens the crisis resolution instruments available to credit entities: it creates a management company to isolate the toxic assets of financial entities and enables the liquidation of unviable banks. Furthermore, it includes further regulation of the *Fondo de Reestructuración Ordenada Bancaria* (FROB) [Fund for Ordered Bank Restructuring] to strengthen its involvement in the stages of crisis management.

III. FUTURE REFORMS

At its meeting on 13 July 2012, the Government established a timeline for applying the National Programme of Reforms for the second half of the year, including the approval of 20 laws. This extensive legislative programme is aimed at providing a response to the tough economic situation in Spain and at improving the Spanish economy to achieve growth.

The measures help advance the intensive deficit correction and structural reform implementation process, and involve an extremely wide range of issues.

⇨ Public Administration Service Reform

- In this regard and in order to boost their efficiency and help control the deficit, a ***Draft Bill on the Streamlining and Sustainability of Local Administration*** will be presented to Parliament. This draft bill will include:

    - The clarification of municipal powers in order to avoid overlaps, thus generating an economic saving of at least 3.5 billion euros.
    - The removal of 3,725 minor local entities and *mancomunidades* [associations of municipalities] whose financial sustainability is not guaranteed.
    - The removal of 21,338 local councillors at the next municipal elections. Municipalities will not be able to have more than 35 local councillors.
    - A reduction in the number of public companies of a local nature.
    - The limitation of salaries paid to mayors and members of local authority organisations.

- The ***Regional Financing Mechanism*** will be developed and applied in order to ensure the financial stability of the regional governments and their contribution to meeting the deficit targets.

- A ***Draft Bill on Overseas Action by the State*** will also be presented to Parliament.

➩ Fiscal Consolidation

- Progress will be made on the process to reform the tax structure (adapting it to the system in place in the European Union) and to reduce spending in the budgets earmarked for the ministerial departments in areas not associated with growth.

- Taxation on employment will be reduced, by lowering Social Security contribution payments by 1% in 2013 and a further 1% in 2014.

➩ Social Security Pension System Reform

- A proposal on ***the sustainability of the Pension System*** will be presented to the "Toledo Pact" (a parliamentary agreement on the reform and maintenance of the public pension system) Commission. The proposal will include:

    - Regulation of the "Sustainability Factor" in order to maintain proportionality between contribution payments and the benefits paid out.
    - Measures on partial and early retirement, the aim being to bring the real retirement age closer to the legal retirement age.

➩ Energy Sector Reform

- The ***Draft Bill on an Energy Reform*** will soon be approved for a reform of this sector, the aim being to reduce the impact of energy costs on the competitiveness of the Spanish economy. The goal is to offer a definitive solution to the sizeable tariff deficit problem that exists in the Spanish energy system.

➩ Education System Reform

- The ***Draft Constitutional Law on Improving Education Quality*** will be presented to Parliament. This draft bill seeks to reduce the rate of academic failure and the number of children who leave school early, enhance student excellence, and incorporate Dual

Professional Training in a manner that is adapted to the characteristics of Spanish businesses.

⇨ Other Structural Reforms

- A ***Draft Bill on the Deregulation of Professional Services*** will be approved. The objective of this draft bill will be to promote a new regulatory framework for the professional services sector that enables the removal of obstacles to providing such services while focusing on their significant growth potential.

- Work is currently under way on an ambitious programme to ***guarantee market unity*** within Spain. The goal is to provide a structural solution to the complex regulatory framework faced by companies, which is raising their costs and slowing growth. Within the scope of this programme, a basic ***Draft Bill on Market Unity*** will be approved to serve as a framework for all further work in this area.

- A ***Draft Bill on Measures to Improve Performance in the Food Chain*** will be presented for approval. The goal is to increase the competitiveness of the food sector and achieve greater balance in commercial relations between the various operators in the food chain. Among other issues, the Law will provide legal security, facilitate the detection and handling of abusive and unfair practices, and promote a code of best trading practices in commercial contracts.

- A ***Draft Bill on the Protection and Sustainable Use of the Coast and Amendment of the Coastal Act*** will be presented for approval in order to ensure compatibility between effective environmental protection and legal security for citizens and businesses, to strengthen the protection and sustainable use of the coast and avoid any further increase in construction.

IV. CONCLUSIONS: COMBATING THE CRISIS WITH DETERMINATION

- During its first eight months in power, the Government of Spain has demonstrated:

  - Its strong and steadfast commitment to the European Union budgetary stability targets and the public deficit reduction process; it has committed to budget cuts worth more than 90 billion euros between now and 2014 to bring the public deficit down to 2.8% by 2014.

  - Its vocation and clear desire for reform: it has already approved or is currently working on rigorous economic reforms in key sectors of the Spanish economy (the public sector, the labour market, the financial sector, etc.) in order to introduce greater flexibility, competitiveness and deregulation.

- The political and parliamentary stability of the Government of Spain provides an additional guarantee for the implementation of measures and for successfully tackling the economic crisis.

- With its reformist programme, the Government of Spain has made patently clear its determination to progress with fiscal consolidation and structural reforms, the goal being to strengthen confidence in the Spanish economy and return to a path of growth.

- The Government of Spain has put domestic financial entities through a transparency and solvency guarantee process that is unprecedented in the European Union.

- Financing the Spanish economy at stable and acceptable interest rates within a framework of monetary union is inexorably linked to the stability of the Euro and the correct and proper performance of the Monetary Union. To that end, the Government of Spain is seeking the swift adoption of reforms within the European Union in order to progress towards true Economic and Monetary Union capable of overcoming the current limitations and imbalances that it is generating (Graphic 3).

- ➢ Spain believes that the objectives and decisions reflected in the Conclusions from the European Council on 28 and 29 June constitute the benchmark and starting point for further progress to be made in that direction.

- ➢ Spain wishes to play a leading role in promoting fiscal integration, in full banking integration and in the economic and political construction of the European Union (Annex III).

☛ The Government of Spain is combating the economic crisis with determination and will continue to adopt those internal decisions deemed necessary to tackle the situation. However, it calls for the same level of determination in the adoption of measures within the European Union so as to progress towards greater integration capable of restoring the principles of stability, growth, solidarity and cohesion that inspired its creation in the first place.

ANNEX I. DEFICIT COMPLIANCE BY THE SPANISH STATE AND REGIONAL GOVERNMENTS

⇨ **The policies being implemented by the Government of Spain will enable compliance at the end of the year with the budgetary stability targets set by Brussels**

Under the Excessive Deficit Procedure that Spain has been following since 2009, the Stability Programme 2012-2015 initially established an obligation to reach a figure on financing requirements for the public authorities of 3% of GDP in 2013.

However, bearing in mind that trends in this cycle have been worse than initially forecast, the decision was reached at a meeting of the ECOFIN Council on 10 July 2012 to revise the terms of the Excessive Deficit Procedure. An additional twelve months were added to the deadline for achieving a budgetary balance of 3% or less, giving Spain until 2014 to meet a new deficit target of 2.8% while maintaining a similar structural consolidation effort in the period 2012-2014 (5.3% of GDP), the primary structural effort (discounting interest) being 6.6% of GDP. This effort is being made during a period of recession, with a forecast GDP downturn of 1.5% in 2012 and 0.5% in 2013.

Public Administration Services

Budgetary Balances (% GDP) in the Stability Programme 2012-2015

	2011	2012	2013	2014
Central Government and Social Security System	-5.2	-3.5	-2.5	-1.9
Regional Governments	-3.3	-1.5	-0.5	-0.3
Local Authorities	-0.4	-0.3	0.0	0.0
PUBLIC ADMINISTRATION SERVICES TOTAL	**-8.9**	**-5.3**	**-3.0**	**-2.2**

Table 6
Public Administration Services
Budgetary Balances (% GDP). New Path

	2011	2012	2013	2014
Central Government and Social Security System	-5.2	-4.5	-3.8	-2.7
Regional Governments	-3.3	-1.5	-0.7	-0.1
Local Authorities	-0.4	-0.3	0.0	0.0
PUBLIC ADMINISTRATION SERVICES TOTAL	**-8.9**	**-6.3**	**-4.5**	**-2.8**

Macro-economic Evolution and Fiscal Effort
(% GDP, unless indicated otherwise)

	2011	2012	2013	2014
Real GDP growth (% variation)	0.7	-1.5	-0.5	1.2
Public Balance	**-8.9**	**-6.3**	**-4.5**	**-2.8**
Public balance variation	0.4	2.6	1.8	1.7
Potential GDP growth (% variation)	-0.3	-1.3	-1.4	0.0
Output gap	-4.6	-4.7	-3.8	-2.7
Cyclical balance	-2.0	-2.0	-1.6	-1.1
Cyclically Adjusted Balance	**-7.0**	**-4.3**	**-2.9**	**-1.7**
Fiscal Drive	**0.0**	**2.7**	**1.4**	**1.2**
Primary Fiscal Drive	**0.5**	**3.5**	**2.0**	**1.1**

Cleaning up the public accounts has become a priority objective for the economic policy being implemented by the Government of Spain due to a need to correct the strong imbalance from 2011 and deleverage the entire economy.

The measures intended to achieve this objective are defined in the plans for 2012: the General State Budget 2012 (an effort worth 27.3 billion euros); the economic-financial plans of the regional governments (measures worth 18.4 billion euros); and the adjustment plans of the local authorities (measures worth 3 billion euros).

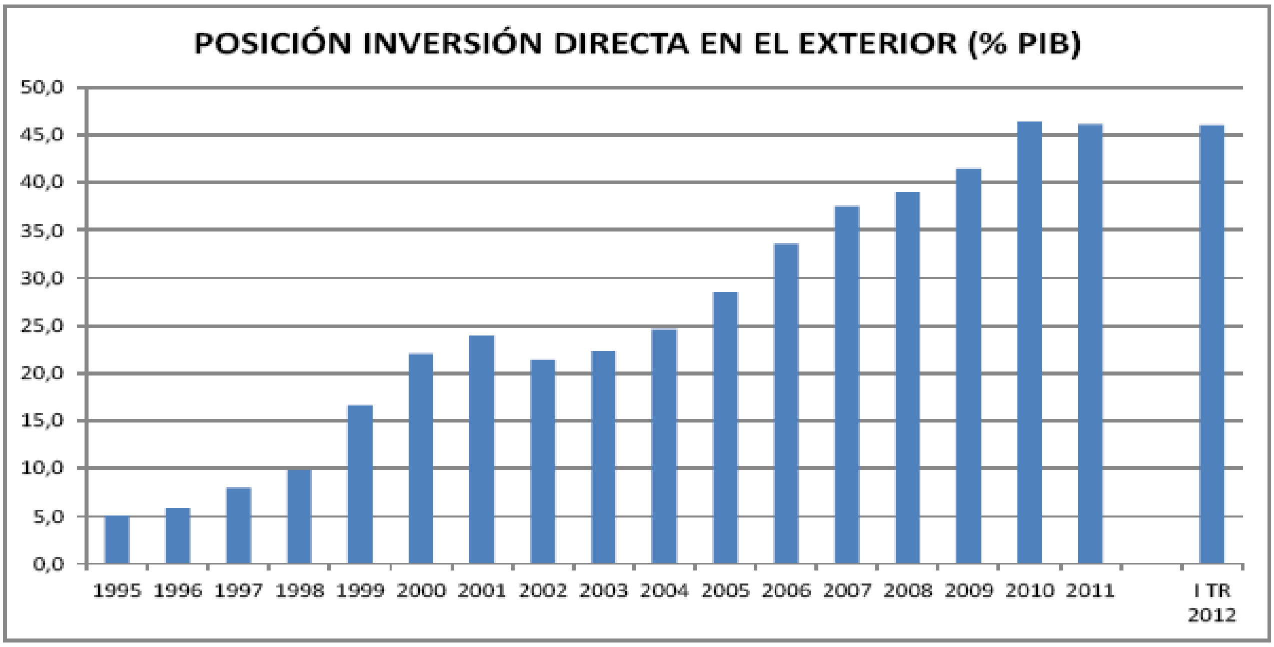
The budgetary performance data from the State have been showing a deviation over the course of recent months due to the strong recession being experienced by the economy, leading to the adoption of the additional measures defined in Royal Decree-Law 20/2012 and the Biennial Plan 2013-2014. These new measures on the General State Budget 2012 and the 2012 plans from the regional governments and local authorities represent a total additional adjustment of 50 billion euros, which, in accumulated terms, would generate a total saving of 102 billion euros.

Forecasts show that the target agreed in 2012 will be met with these additional measures thanks to improved revenue during the final months of 2012 generated by the tax measures (increased VAT, Corporate Income Tax, Special Taxes and Personal Income Tax) providing an additional 5 billion euros and cost cutting measures worth 8 billion euros (public sector employment, employment policies and Social Security policies that will also improve incentives and long-term care). This is combined with a compliance demand regarding the plans presented by the regional governments that will lead to their targets being met this year under stronger supervision within the framework of the Constitutional Law on Budgetary Stability and the imposition of conditions on the additional financing that has been provided and that will be realised through the Regional Liquidity Fund.

ANNEX II. SPAIN'S FOREING TRADE FIGURES (2007-2012)

The figures for Spain's foreign trade in goods and services were very positive between 2007 (the baseline chosen as being the year before the economic crisis) and 2011. The trend appears to be continuing into 2012 (the latest available data are for January-February):

Balance of trade	- **Drastic reduction in our trade deficit (goods)** in this period to 45.5 billion euros (from 100 billion), **basically due to increased exports** (up 19.4% to 29.46 billion euros) and a slower growth in imports (9.5%). **As a result, the overall coverage ratio of exports to imports improved substantially** from only 64.9% in 2007 to 82.6% in 2011. - **Worthy of mention are the trade surpluses between Spain and the EU and Eurozone in 2011, maintained into 2012 (January - February).** There was also a **diversification in our foreign trade balance of goods towards other markets**, both in exports (EU accounted for 66% of the total in 2011 compared with 70.7% in 2007) and imports. - The **trade deficit** of 46.3 billion in 2011 was mainly due to **China** (32.9% of the geographical areas) and **energy production** (86.2% of all sectors). - In 2011, there were nearly 123,000 **exporting companies in Spain**, 26.2% up on the figure for 2007. Most of this increase was in small exporters.
Current account:	- **A notable reduction in our traditional current-account deficit** (goods and services) from the very high levels of 10% of GDP in 2007 to 3.5% in 2011. This is basically due to a reduction in the trade deficit in goods, but also to some extent the improved balance in tourism services (basically in 2011) and to a significantly improved balance in non-tourism services (notably services to companies) during this period. - **The contribution of foreign demand to GDP growth was a positive 2.5% in 2011,** compared with a negative 0.7% in 2007, thus demonstrating the great importance at present of foreign demand as a contributor to our emergence from the crisis. This foreign contribution to GDP is actually forecast to rise slightly to 2.7% in 2012. The adjustment in the current account has been the basic reason for a **reduction in the Spanish economy's need for external capital finance**, from 9.6% of GDP in 2007 to only 3% in 2011.



(en % PIB de los ultimos cuatro trimestres)

POSICIÓN DE INVERSIÓN INTERNACIONAL

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	I TR 2012
POSICIÓN DE INVERSIÓN NETA (DEUDORA)	*28,2*	*30,6*	*33*	*40,2*	32,1	32,0	35,6	41,6	45,2	51,9	55,6	65,8	78,1	79,3	93,7	89,6	91,6	91,1
POSICIÓN INVERSIÓN DIRECTA EN EL EXTERIOR	5,1	5,9	8,0	9,8	16,6	22,0	23,9	21,4	22,3	24,6	28,5	33,6	37,5	39,0	41,5	46,4	46,1	46,0

ANNEX III. THE SPANISH PROPOSAL FOR BANKING UNION AND FISCAL UNION: A SIMPLIFIED VISION

The current economic crisis has revealed the structural and institutional failures that were built into the Economic and Monetary Union back in 1999.

The main structural failure boils down to an inconsistency between establishing one single monetary policy for all 17 Member States of the European Union that adopted the Euro and the maintenance of separate economic policies (fiscal and structural) of an almost exclusively national nature. This problem has led to two serious dysfunctions when implementing the economic policy of the European Union.

Firstly, the Economic and Monetary Union lacks any internal adjustment mechanisms to enable the effective resolution of any imbalances that arise at a national level or shocks that affect the various Member States of the Eurozone unequally. Beyond the boundaries of Monetary Union, one possible adjustment instrument would be to devaluate a currency. In the absence of such mechanisms, adjustments take place through depressions that incur significant costs to economic activity and employment.

Secondly, there is no European mechanism capable of breaking the vicious circle trapping the financial and sovereign entities. Despite the fact that the banks are operating in a common financial services market of a European nature, each individual bank is only supported by its home Member State.

When Member States are required to support troubled entities, the risk associated with those entities then spreads to the public accounts, which are the ultimate guarantee for the performance of the financial system. The very financial stability of the Member State in question is thus brought into question and the current Economic and Monetary Union has no resources enabling it to break that relationship.

This situation is generating doubts over the irreversibility of the single currency. These doubts are manifesting themselves in the growing differentials between the interest rates being required of the Member States of the Eurozone, leading to certain difficulties for some States in their efforts to return to growth and overcome the current economic crisis.

It is therefore necessary to repair these faults in the institutional architecture of the Eurozone by progressing towards the construction of a true Economic and Monetary Union. This re-launch of the European integration process would enable confidence in the common project and in the stability of the single currency to be restored.

To that end, a detailed road map with established deadlines must be produced for the achievement of Banking Union (in the short term) and Fiscal Union (in the medium term).

Banking Union would consist of three main elements: a Common Supervisory Authority; a Deposit Guarantee Fund; and an Authority with the power to restructure and liquidate troubled banks. The Supervisory Authority would be formed by the ECB and the national central banks in a structure similar to that which is used today to implement monetary policy.

Fiscal Union would be achieved gradually in stages, following a process similar to that which led to the single currency that began with the Maastricht Treaty in 1992. This process, which would restore credibility in European integration, could be undertaken in three stages.

During the first stage, Member States would be required to adopt measures to comply with certain fiscal and economic convergence criteria, including a sound process of fiscal consolidation and structural reforms. During this first stage, it would be possible to issue two-year Euro bills with guarantee limited to a percentage.

Those Member States that show progress during the first stage would pass on to a second stage, during which a European Budgetary Authority (which would have greater powers of supervision over budgetary performance) would be created to assume responsibility over the recommendation of targets and the provision of fiscal policy guidance. The same Authority would also coordinate the issue of debt. During this second stage, it would be possible to start issuing European medium-term and long-term debt so as to partially cover the needs of Member States in a joint fashion. The majority of this debt would continue to be issued by the national Treasuries.

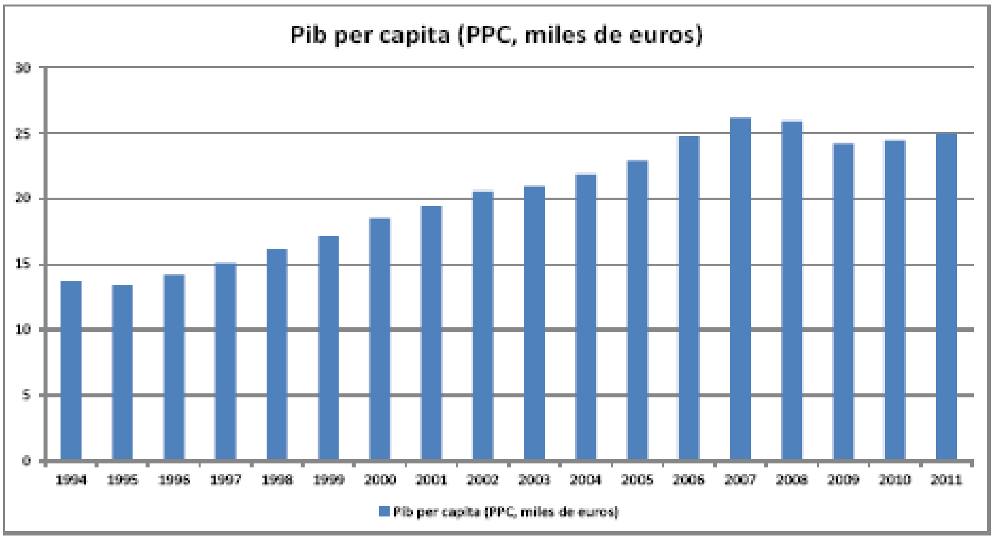
The third stage would include those Member States that comply with their economic and fiscal policy obligations, and that demonstrate significant convergence by their sovereign debt differentials in relation to the countries posting the best results. This stage would involve the Eurozone reaching joint decisions on fiscal policy targets, the implementation of fiscal policy and the issue of debt being undertaken by the European Budgetary Authority, the establishment of a mechanism to tackle asymmetric risks and the debt issued by the European Budgetary Authority being jointly guaranteed (the Member States would combine resources to guarantee payment).

Full Fiscal Union would be achieved when concluding this third and final stage.

It is important to define, as soon as possible, an ambitious timeline for simultaneously activating all the afore-mentioned points to enable the achievement of both Banking Union (approval should be granted before the end of the year) and Fiscal Union (the latter, being a longer process, should be initiated as soon as possible).

In turn, these processes should proceed together towards greater economic and political integration in such a way as to enable the recovery of confidence in the European integration process, thus generating the right climate for embarking on a positive path to economic growth and job creation.

GRAPHIC 1.GDP PER CAPITA EVOLUTION (1994-2011)

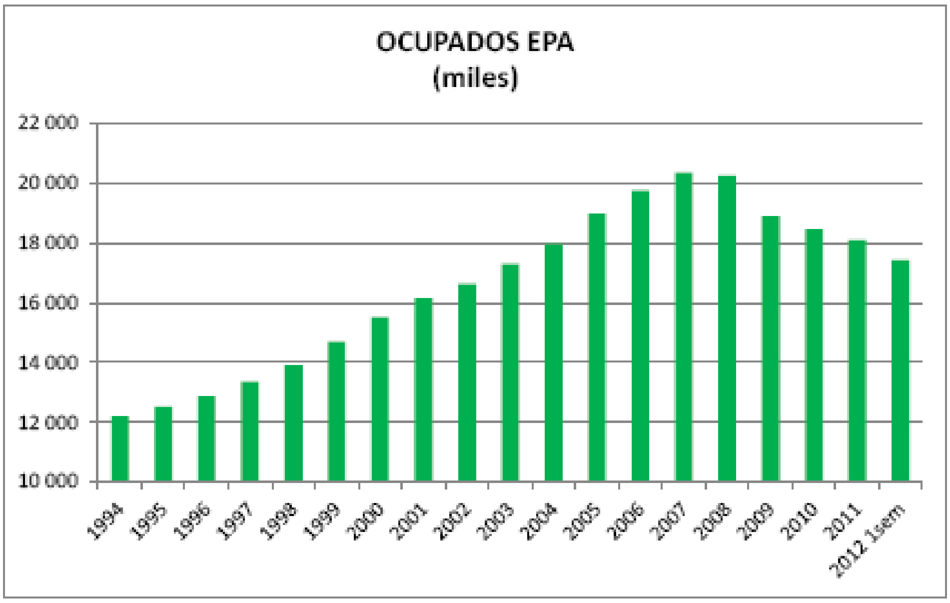


PIB per capita España, en PPC, en miles de euros.

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
13,728	13,417	14,161	15,122	16,175	17,145	18,526	19,387	20,562	20,920	21,864

2005	2006	2007	2008	2009	2010	2011
22,930	24,754	26,160	25,901	24,230	24,479	24,938

GRAPHIC 2. EMPLOYMENT EVOLUTION (1994-2012)



Ocupados EPA, en miles (último trimestre de cada año; salvo 2012, primer semestre)

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
12.208	12.512	12.872	13.346	13.904	14.690	15.506	16.146	16.630	17.296	17.971

2005	2006	2007	2008	2009	2010	2011	2012
18.973	19.748	20.356	20.258	18.888	18.457	18.105	17.425

GRAPHIC 3. SECTORIAL FINANCING GROWTH IN SPAIN 1996-2012