Letter from the Editors

Since 2010, credit to the Spanish non-financial private sector has been either flat, or contracting, across most key industries as shown in the exhibit at the end of this letter.

The trend is worrisome, given the importance of credit flows to the real economy to reactivate economic growth. In recent weeks, we have seen relaxation of credit conditions, helping some large Spanish corporates meet their financing/refinancing needs. Nevertheless, the majority of smaller sized Spanish corporations still define access to finance as one of their principal problems, with financing terms in Spain being among the most restrictive in the Euro Area.

In this January issue of the SEFO, together with our standard contributions on macroeconomic and financial system outlook, we provide an analysis of the financing situation of one of the most important fragments of the Spanish corporate sector – the Small and Medium Size Enterprise (SME). In Spain, 99.9% of businesses have fewer than 250 workers and provide 74.5% of the economy's employment – a figure significantly above the Euro Area average of 63.6%. However, the outlook for SME access to bank credit under reasonable terms remains very challenging and companies' expectations about future credit conditions are negative. In order for Spain's economy to recover, credit flows to SMEs too must show normalization, although probably below pre-crisis levels. Public and other measures may provide some support while the financial sector continues its normalization process, but in the longer term, sufficient credit to the private sector must be supported by well functioning Spanish banks.

Given the aforementioned persistent difficulties in securing bank credit, developing alternative debt and equity financing options for SMEs is imperative. However, overcoming investor's risk perceptions, illiquidity, cost to the issuer and regulatory barriers may prove challenging.

With regard to the Spanish financial system, we examine in this issue continued significant progress on completion of Spain's MoU for financial sector assistance and the outstanding measures that remain to be taken in 2013, such as commencement of Sareb activities and completion of new bank restructuring plans. Further completion of these and other agreed upon measures will be critical to eliminating existing uncertainty about the Sareb and the health of the Spanish financial system as a whole.

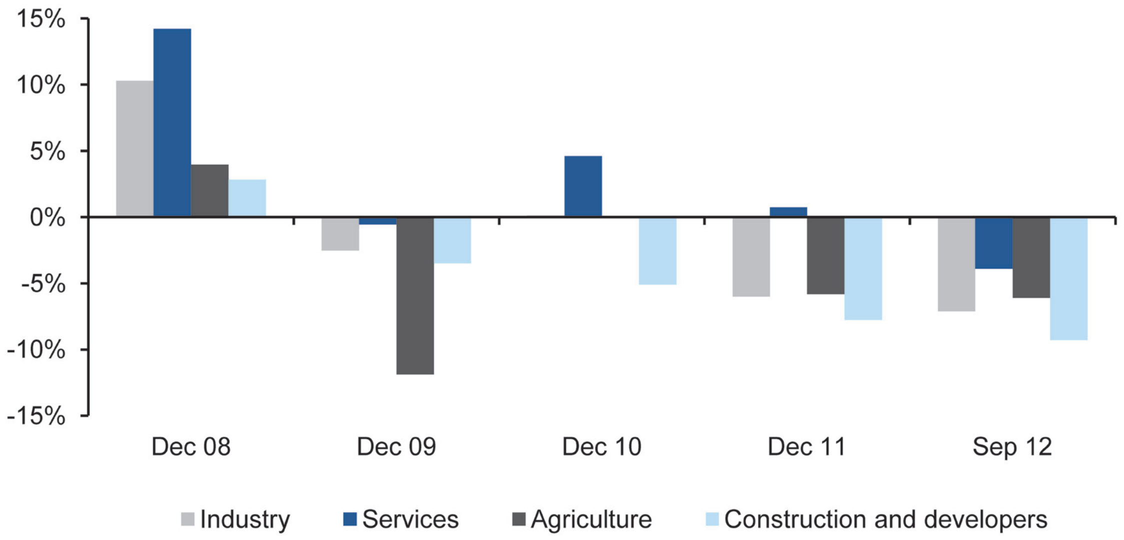
With respect to Spain's economic and financial conditions, there has been some recent improvement in the sovereign risk premium, facilitating Government debt issuance. Although, as we discuss in this SEFO, meeting the central, regional and local governments' financing needs will be just as difficult in 2013 as in 2012, if not more so. With respect to the real economy, activity and employment indicators remain disappointing, and we await to see the results of fiscal consolidation efforts on the deficit.

In conclusion, although Spain's situation is challenging, macroeconomic imbalances and asset prices are correcting. Investors must differentiate across potential opportunities. In this regard, we present our readers with a special feature called *The case for investing in Spain today*, which provides some rationale for potentially attractive risk adjusted investment returns in the country now.

Exhibit

Credit to Spanish non-financial private sector

% change year on year



Sources: Bank of Spain, Afi - Analistas Financieros Internacionales, S.A.