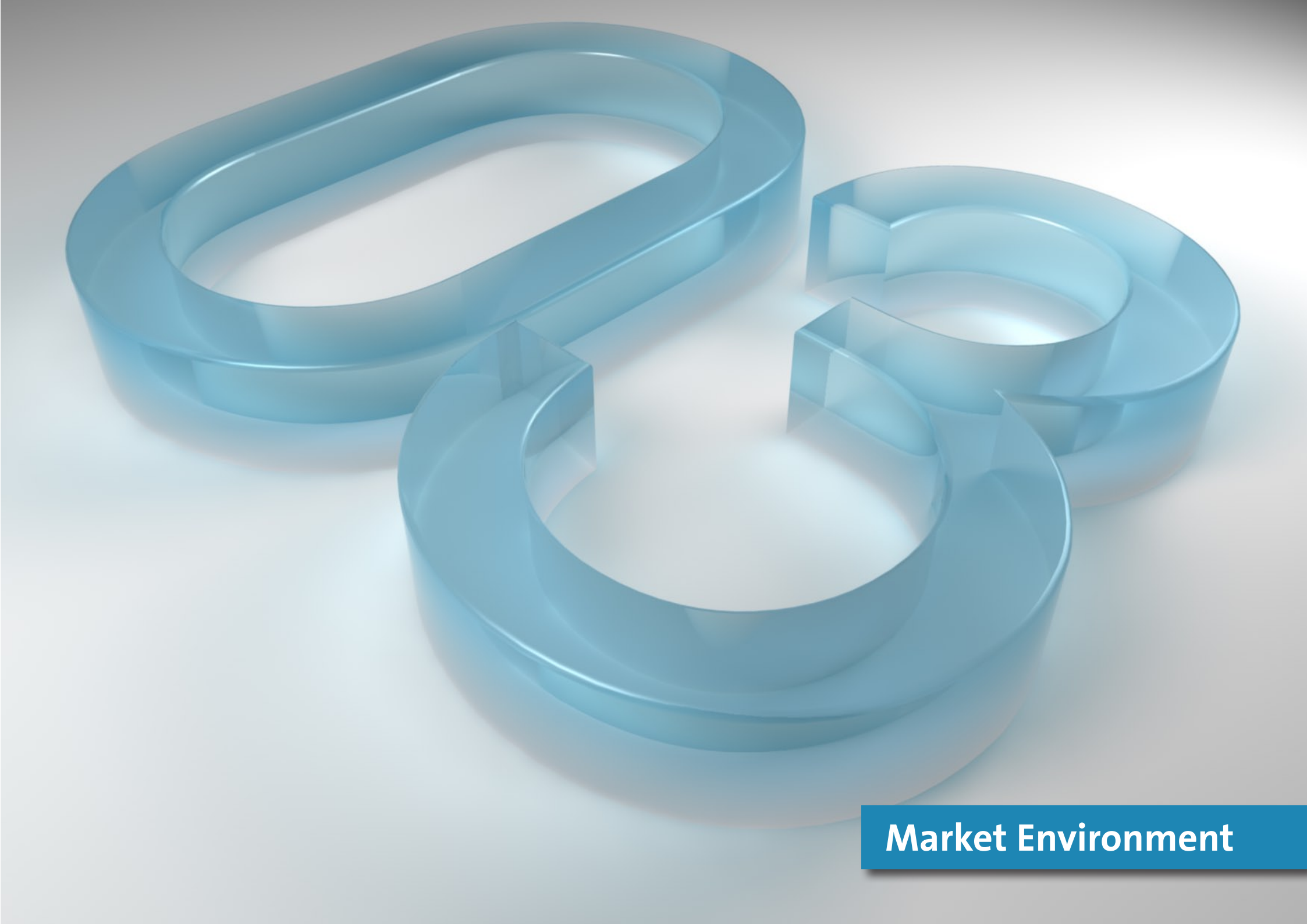

Market Environment

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Market Environment

The balance of activity in the markets and business areas managed by BME in 2010 was consistently affected by the risks shaping the environment, mainly in connection with the extreme vulnerability of the global financial sector despite the enormous amount of funds that have been moved to prevent its collapse.

The economy

The stock markets were in a state of permanent uncertainty throughout the year, associated with the positive, but weak and incipient economic growth emerging in the developed nations. As reflected by various episodes of sharp declines in share prices during the year, there is still a need for the public sector and public institutions to play an active role in finding a solution for the crisis through stabilisation policies that will enable a transition to growth where the financial system is a positive factor and not a source of mistrust (as it has been until now after almost three years of instability). Investors are viewing with extreme caution plans that aim to match economic recovery with the digestion of large volumes of debt incurred by the private sector in the run up to the crisis and by the public sector to get through it.

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2010 was a year of slight improvements in forecasts and economic growth in developed countries, good overall performance by emerging markets and a perception shared by most analysts that in the risk of economic downturn would persist in the medium term, mainly because the return to financial stability, which had been considered largely under control, has been significantly delayed. The deficiencies affecting the channels through which capital and credit should flow are preventing funds from being efficiently allocated among the various investment alternatives, affecting a large part of the options to generate product, trade and wealth on a worldwide scale. The clearest evidence of this systemic risk occurred in the last few weeks of 2010 when thousands of millions of euros were moved to bail out the Irish banking system when its problems had apparently been resolved in June after the bail out of Greece. This event clearly affected the year-end share prices of listed companies in 2010. It was also particularly significant in Mediterranean European countries which were penalised for the negative impact of their macroeconomic imbalances on country risk.

Forecast scenarios

IMF forecasts for the world's different economic regions and countries clearly reflect the uncertainties underlying the sustainability of the general growth trend witnessed in 2010. At the beginning of the year, the IMF was forecasting an increase in world trade of 12% in 2010 and a rise of 5% in GDP with significant variations between regions. In the developed world, product was expected to increase by 3% (-3.4% in 2009) and by 7.1% in the emerging nations (2.6% in 2009). Within the first group, the growth forecast for the newly-industrialised Asian countries stands out (8.2%), while for economic heavyweights such as the US, Germany and Japan forecasts were 2.8%, 3.6% and 4.3% respectively. Among the developed nations, Spain is the only country where the IMF expects GDP to fall in 2010 (-0.2%), motivated without doubt by the slump in construction (the country's main growth driver in previous years) and the difficulties encountered in creating alternative employment opportunities in the short term.

The projected scenario for 2010 unfolded largely as expected thanks to the seeds of recovery in internal demand emerging in advanced economies. Recovery is slow but fairly consistent in terms of consumption and stronger in terms of investment in durable goods. It also means that external demand is shaping GDP growth in different countries (particularly visible in Germany). However, this short term projection is overshadowed by the slightly longer term outlook for various factors that directly affect global economic growth. For 2011, the IMF expects trade volumes to grow by 7.1% and GDP to climb 4.4%. A total GDP rise of 2.5% for the developed economies (3% for the USA, 1.5% for the eurozone) is being forecast, and a rise of 6.5% for the emerging nations. These figures are

IMF economic forecasts (October 2010 and updated GDP and trade forecasts Jan 2011)

GDP growth (%)	Actual	Forecast	
	2009	2010	2011
Gross world product	**-0.6**	**5.0**	**4.4**
Advanced economies	**-3.4**	**3.0**	**2.5**
U.S.	-2.6	2.8	3.0
Japan	-6.3	4.3	1.6
U.K.	-4.9	1.7	2.0
Eurozone	**-4.1**	**1.8**	**1.5**
Germany	-4.7	3.6	2.2
Spain	**-3.7**	**-0.2**	**0.6**
Recently industrialised Asian economies	-0.9	8.2	4.7
Emerging and developing economies	**2.6**	**7.1**	**6.5**
Latin America and Caribbean	-1.8	5.9	4.3
China	9.2	10.3	9.6
India	5.7	9.7	8.4
TRADE volume (annual %)	**-10.7**	**12.0**	**7.1**
Imports			
Advanced economies	-12.4	11.1	5.5
Emerging and developing economies	-8.0	13.8	9.3
Exports			
Advanced economies	-11.9	11.4	6.2
Emerging and developing economies	-7.5	12.8	9.2

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Consumer prices (% annual)	Actual	Proyecciones	
	2009	2010	2011
Advanced economies	**0.1**	**1.5**	**1.6**
U.S.	-0.3	1.4	1.0
Japan	-1.4	-1.0	-0.3
U.K.	2.1	3.1	2.5
Eurozone	**0.3**	**1.6**	**1.5**
Germany	0.2	1.3	1.4
Spain	**-0.2**	**1.5**	**1.1**
Recently industrialised Asian economies	1.3	2.6	2.5
Emerging and developing economies	**5.2**	**6.3**	**6.0**

Budget deficit (% of GDP) (structural balance)			
U.S.	-7.2	-8.0	-7.1
Japan	-7.3	-7.6	-7.2
U.K.	-8.3	-7.9	-6.2
Eurozone	**-4.3**	**-4.5**	**-3.6**
Germany	-0.8	-3.1	-2.9
Spain	**-**	**-**	**-**

Gross public debt (% of GDP)			
U.S.	84.3	92.7	99.3
Japan	217.6	225.9	234.1
U.K.	68.5	76.7	81.9
Eurozone	**79.0**	**84.1**	**87.0**
Germany	73.5	75.3	76.5
Spain	**53.2**	**63.1**	**69.8**

Current account balance (% of GDP)	Actual	Proyecciones	
	2009	2010	2011
Advanced economies	**-0.3**	**-0.3**	**-0.1**
U.S.	-2.7	-3.2	-2.6
Japan	2.8	3.1	2.3
U.K.	-0.9	-0.8	-0.8
Eurozone	**-0.6**	**0.2**	**0.5**
Germany	4.9	6.1	5.8
Spain	**-5.5**	**-5.2**	**-4.8**
Recently industrialised Asian economies	8.5	7.1	6.9

Unemployment rate (% of active population)			
Advanced economies	**8.0**	**8.3**	**8.2**
U.S.	9.3	9.7	9.6
Japan	5.1	5.1	5.0
U.K.	7.5	7.9	7.4
Eurozone	**9.4**	**10.1**	**10.0**
Germany	7.5	7.1	7.1
Spain	**18.0**	**19.9**	**19.3**
Recently industrialised Asian economies	4.3	3.8	3.7

worse than the figures reported in 2010 when logic dictates that if the recovery trend were consistent, they should improve. Three factors are behind this scenario, fuelling uncertainty over the possibility of achieving sustained, balanced and solid growth in the world economy.

The first relates to the impact of financial crises on trade. A report issued by the IMF analysing the effects of financial and debt crises over the past 40 years maintains that imports remain below normal levels for several years after the end of this type of crisis. Furthermore, this is more noticeable in economies hit hardest by banking crises, with high current account deficits and weak lending conditions, among other factors. These are trends that affect some of the world's most developed economies. Fiscal stimulus measures introduced over the past two years have mitigated the fall in product but the withdrawal of these measures must give way to fiscal consolidation and private consumption in the developed nations is still showing signs of weakness, held back by persistently high jobless levels and the difficulties faced by households and companies to gain access to credit. The forecast medium term scenario implies a slow recovery with emerging markets, where the crisis has caused less financial damage, replacing part of their growth based on net exports with a higher component of domestic consumption and investment.

The second factor is the need to implement credible, far-reaching fiscal consolidation plans, which to date are not forthcoming. Many major countries will need to implement further measures to reduce public spending and raise taxes. While private consumption is not sufficiently strong to take the initiative and support growth, this factor will be of particularly concern over the next few quarters. Studies indicate that in the short/medium term a reduction in the public deficit of 1% of GDP tends to reduce product by half a point and increase the unemployment rate by almost a quarter of a point in developed countries. This is bad news for the immediate economic outlook as the same studies suggest that the negative impact on GDP growth tends to be greater when there is limited scope to reduce interest rates and when several countries carry out the required budgetary consolidation simultaneously.

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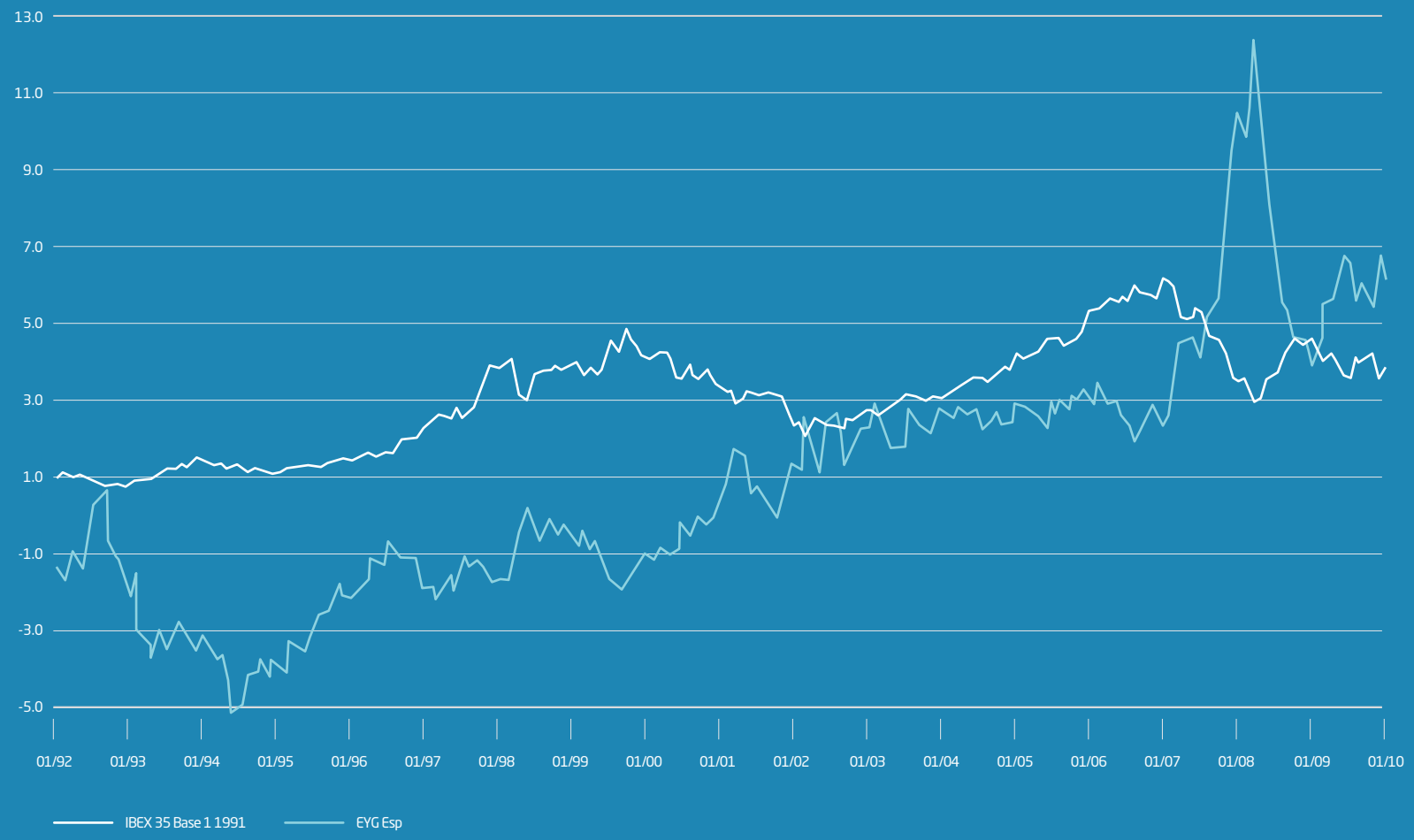
Country risk: The financial sector is dragging down prices

At the end of the year, we can say that in terms of share price performance, "country risk" has not been sufficiently mitigated by the positive trends in revenues and corporate earnings released by companies listed on the Spanish stock markets; a group of entities with a clear international leadership vocation whose revenues derive largely from foreign markets and which have channeled internal and external savings to finance their international expansion. As reflected by the Earnings Yield Gap (EYG) in the Spanish stock market an abnormally high risk premium has been applied on the shares of these listed companies for several years now. The EYG measures the difference between the earnings yield as the inverse of forward P/E (price or share price / earnings or number of times the market price factors in a company's earnings) and the yield on Spanish 10-year bond, considered, in this case, as a lower risk instrument.

Earnings Yield Gap (EYG): Spain vs IBEX 35 (monthly data 1991-2010)
EYG is the difference between the inverse P/E and 10Y rates IBEX 35 Base 1 31/12/1991



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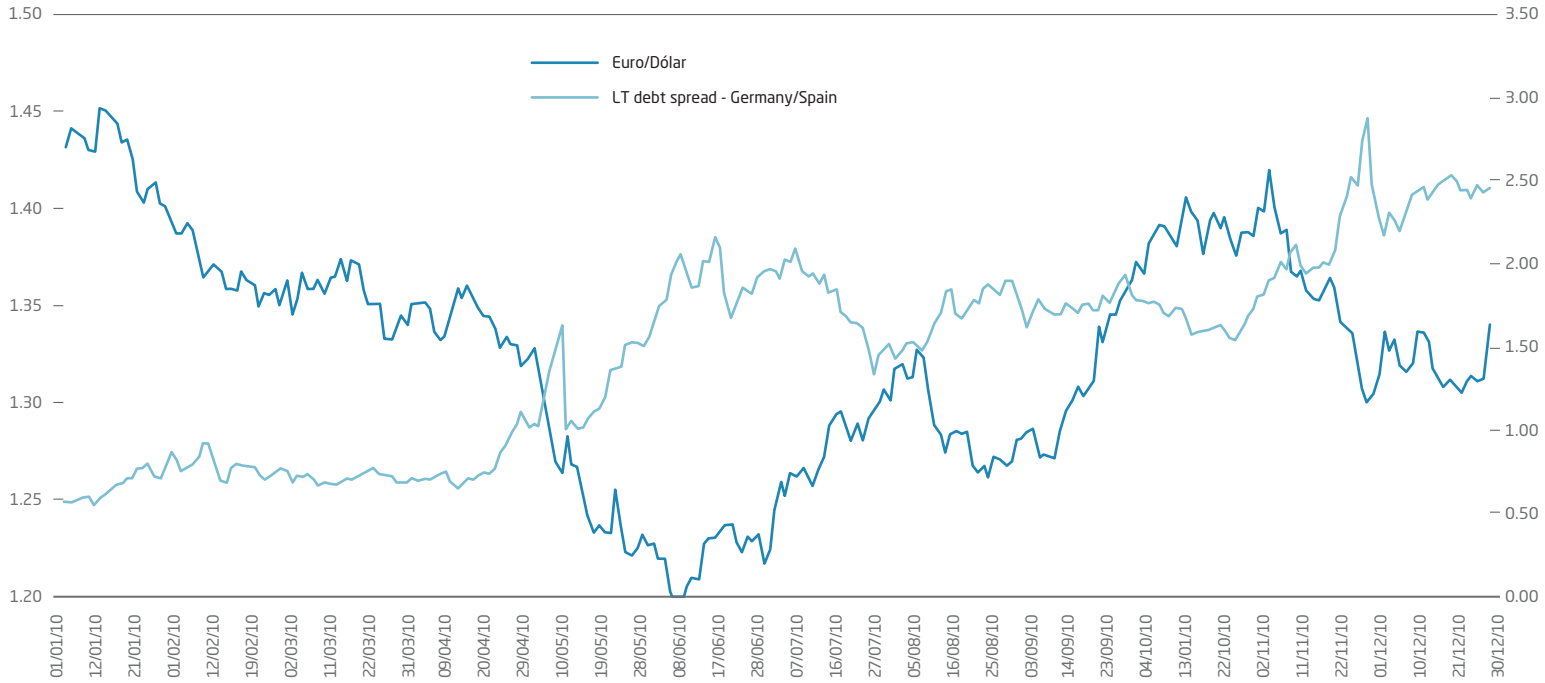
Uncertainty associated with weak growth and high debt levels

The third risk factor jeopardising the sustainability of global economic growth is linked to this need for fiscal consolidation. This risk was latent in the markets throughout 2010, sparking instability and high levels of volatility: the need to wipe out the large volumes of outstanding public and private debt without compromising the international financial order. The need to wipe out the excessive levels of debt present in the growth models of developed economies for most of the last decade has become a much greater challenge than it was expected to be at the initial stages of the financial crisis. The need to de-gear the entire system and shore up capital, especially in the financial industry, has become an enormous international intellectual and regulatory challenge that questions both the timing and the strength of the economic recovery. It also highlights the advantages and the potential of the regulated stock markets as reliable instruments of support in the process of recapitalising and stabilising the system.

Unfortunately a large part of the afore-mentioned risks have materialised as a result of the tension affecting the European sovereign debt market and are still weighing down the stock markets. These events give more credibility to the arguments put forward by the IMF in its World Economic Outlook and Global Financial Stability Report published in October which addresses the risks affecting short term economic recovery. According to the IMF, "macroeconomic and financial conditions will remain unstable so long as fundamental economic deficiencies exist and the necessary reforms are not implemented. Economic policy in the developed nations has less room for manoeuvre and there are a great number of challenges still to be resolved in the area of prudential policy. Refinancing requirements in the second half of 2010 and in 2011 will be considerable. For instance, among the developed nations Japan will have to issue a large volume of treasury bills and public bonds for an amount of over 40% of its GDP. In France, Italy and the US, this figure will stand at over 20% of GDP. With such large volumes passing through the markets, small disruptions may occur which will spread rapidly among the sovereign debt markets and could cause changes in investor confidence (...). Furthermore, the financial sector is still fragile. Banks are facing significant financing requirements in a market shaped by strong risk aversion (...). Little progress has been made in extending fund maturities and therefore more than US$4 billion in debt is pending refinancing over the next two years (...). In the eurozone, the build up of refinancing tensions could cause more problems for banking systems. If left unresolved, these tensions could put pressure on the

Euro and sovereign risk premium 2010



degearing process and cause a negative interaction between the eurozone banking system and the regional economies (...) Given the complex links between and within countries, these problems could spread rapidly".

Spain: Low activity volumes and difficulties winning credibility on the markets

The market volatility seen in 2010 reflected how sovereign risk, the financing of the banking system and the forthcoming regulatory reform are a cause for concern. The lack of any sound and credible fiscal consolidation plans for the medium term, means that there are still risks affecting the recovery of the sovereign debt market. Other factors are also holding back recovery such as the weakness of the property markets, the decline in fiscal stimulus measures and the high unemployment rate. These factors are hitting Spain particularly hard as the country's dependence on foreign financing makes it especially sensitive to any loss of confidence that prevents access to these financial resources, particularly by credit entities, which channel the bulk of these funds to households and companies.

Spain - Macroeconomic scenario 2010-2011

	2010			2011		
	EC (November 10)	Funcas (9 November 10)	Government (September 2010)	EC (November 10)	Funcas (9 November 10)	Government (September 2010)
Macroeconomic figures						
GDP	**-0.2**	**-0.2**	**-0.3**	**0.7**	**0.8**	**1.3**
Household consumption	1.1	**1.2**	**0.5**	**0.9**	**1.0**	**1.8**
Public consumption	0.0	**-0.2**	**0.6**	**-1.3**	**-1.1**	**-1.6**
GFCF	-7.9	-7.7	-8.5	-3.1	-3.9	-1.5
Capital goods	3.0	-2.5	1.8	3.7	1.5	4.2
Construction	-11.4	-11.3	-11.2	-7.0	-8.0	-4.5
Domestic demand	-1.2	-1.1	-1.6	-0.4	-0.5	0.4
Exports	9.1	9.2	9.3	5.5	5.8	6.4
Imports	4.5	4.8	3.3	1.4	0.9	2.9
Foreign balance (contrib. to GDP)	-	0.9	-	-	1.3	-
Other indicators						
Employment	-2.3	-2.3	-2.2	-0.2	-0.4	0.3
Unemployment rate (% total workforce)	20.1	20.0	19.8	20.2	20.4	19.3
Unit labour costs	1.0	-1.0	0.8	0.7	-0.2	0.7
Hosehold savings rate (% of GDI)	-	16.0	-	-	13.9	-
Balance of payments (% GDP)	-4.8	-4.6	-4.0	-3.8	-3.5	-3.4
Financing capacity or requirements (% of GDP)	-	-4.0	-	-3.7	-3.1	-
Pub Admin balance (% GDP)	**-9.3**	**-9.5**	**-9.3**	**-6.4**	**-6.5**	**-6.0**
Gross public debt (% of GDP)	**-**	**63.1**	**-**	**-**	**69.8**	**-**

In 2010 economic recovery in Spain was weak (GDP up 0.1% year-on-year in 3Q) and closely linked to transitory stimuli associated with public support programmes for spending and earlier-than-expected consumption or investment decisions taken by households and companies ahead of the indirect tax rise on 1 July. Only exports appeared to maintain some degree of strength, making net external demand one of the drivers of Spanish economic growth in a context where internal demand is severely held back by the 20% unemployment rate, lower salary growth, restrictive financing conditions and the pressing need shore up the financial position of both the public and private sector.

In relation to these factors, a decline in the savings rate started to emerge after almost two years of consecutive increases, although it still remains much higher than the average level of the last two decades. Certain improvements in cost and price competitiveness were also noted in the last few quarters but real productivity advances still need to be achieved.

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Financial tension, interest rates and the risk premium

2010 was clearly a year in which many markets and sectors of the real economy were marked by global financial tension. This was especially evident in those markets were public debt is traded, an activity which BME is exposed to.

In 2008, the corporate debt market was undermined by the lack of confidence in the real situation of banks and the slump in economic activity, while in 2010 tensions affected the public debt of those countries with a more critical fiscal position and weaker growth, in a new episode of the already lengthy global financial crisis.

In the eurozone, the slump in Greek sovereign debt prices in the first part of the year, followed by Ireland, suggested the need for a coordinated and orderly bailout which would ensure the financing of these two countries over a long period of time and prevent them having to turn to the debt markets. Despite this concerted action, the loss of confidence had a knock-on effect on the public debt of other eurozone nations, including Portugal, Spain and Italy, driving up yields and the rate spread between eurozone public debt and German bonds.

Lastly, the massive public debt issues carried out by member states to finance the cost of the measures to support and reactivate their economies have started to take their toll, mitigating effects such as the lack of inflation expectations and expansive monetary policy measures or the acquisition of large amounts of public debt by central banks and credit institutions.

Factors that have fuelled tension in global fixed income markets, and particularly in the currency markets, include the slowdown in the economic recovery in developed nations, particularly evident in the second half of the year and reflected in 2011 forecasts, and the scant impact that economic recovery is having on employment. This situation has led the central banks not only to keep intervention rates at historic lows but also to implement expansive monetary policies in some cases as extreme as the policies announced by FED in November involving purchase of fixed income assets for the amount of almost USD 1 billion. The ECB has adopted a more cautious stance, although keeping rates at low levels and supplying unlimited liquidity to financial entities in the eurozone. On top of this disparity between the measures adopted by the world's leading monetary authorities, the monetary restriction measures implemented in other parts of the world such as China, SE Asia and Latin America, where economic recovery is brighter and more solid, created a breeding ground for another source of tension arising during the year, tensions affecting the currency markets.

As in the previous year, the objective behind the low benchmark rates and other monetary expansion measures adopted is to reactivate the interbank market and increase lending to companies and households. According to reports issued by the ECB and other major international financial bodies, this is still one of the main weaknesses of the developed economies, where the debt markets have become a key financing tool for corporations, the government and other public bodies. In contrast to 2008, interest rates in the European corporate debt markets were largely tension-free.

10Y bond yields
Spain - Germany (2007-2010). Daily data

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Therefore, some improvements in activity were seen in 2010 compared to the forecasts made at the beginning of the year but these were clearly insufficient to change the markets' perception that economic recovery in Spain is not sufficient dynamic to create jobs or boost production at the pace envisaged in the 2011 government budget. The financial markets are assessing the solvency of Spain on a medium term horizon. Despite the improvement in earnings and equity achieved by a large part of the major non-financial companies and the significant increase in fiscal revenues (45%) in 2010, the markets are not giving credibility to either the quantitative targets established for the far-reaching reforms considered as a result of the debt crisis prior to the summer of 2010, or to the pace at which these reforms are being rolled out. The raft of measures adopted is even considered to be insufficient, perhaps due to the record high level reached by the risk premium applied on Spanish debt in the last few days of November (more than 3 points).

Companies

In 2010, the economic backdrop obliged companies to delay some of their expansion plans in order to re-organise their equity structure, consolidate their main sources of income, further adjust costs and move back into profits. In line with these objectives, and thanks largely to the geographical diversification of the revenue sources of the main listed Spanish companies, in 2010 gradual progress was made towards restructuring earnings by listed companies as a whole. At the close of the third quarter, EBIT reported by Spanish listed companies as a whole in their main market stood at €37,293 million, up 12.7% compared to the same period in the previous year.

Of this total amount, €25,790 million was generated by industrial and services companies and the remaining €11,502 million by banking entities. The two groups are showing a different performance. The first reported an increase of 30% in total profits while banking entities saw a drop of 13%.

The good earnings performance marked by industrial and services companies is largely underpinned by the improvement in revenues. The aggregate amount for this item increased by nearly 11% in the first nine months of 2010 compared to the 7% fall seen to September 2009. Earnings growth accompanied by an increase in revenues is a good indication of how a company is progressing. This parallel performance differs clearly from the previous year when the recovery in earnings was supported almost exclusively by cost savings while in this period the increase in sales is one of the drivers of earnings.

External demand is one factor behind this rise in revenues. The strong international expansion policies pursued by Spanish companies over the past few years have transformed many of these entities into leading multinationals with operations in different countries, appearing in the rankings of top multinationals carried out by

The Bolsa de Madrid building and BME Headquarters.

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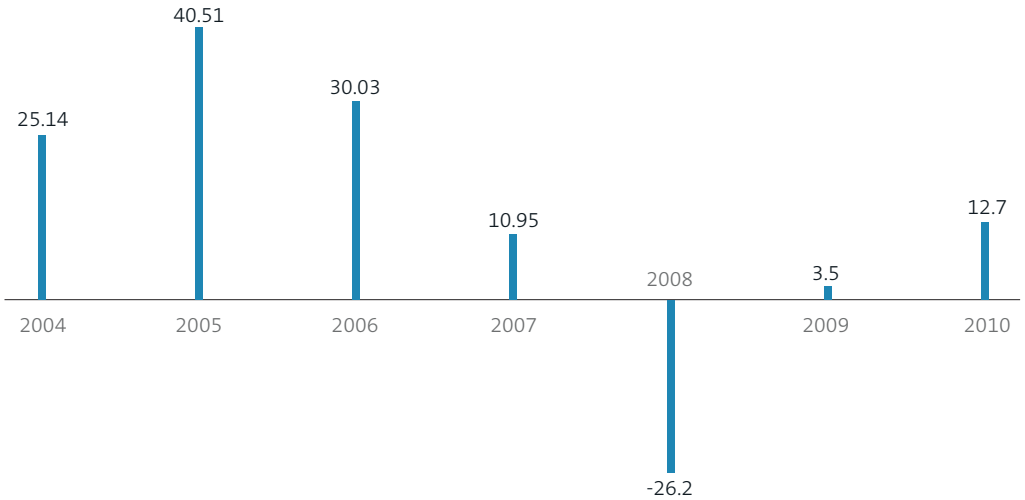
Debate on the Spanish economy during the VI MedCap Forum.

institutions of renowned prestige. This increased geographical diversification has clearly enabled Spanish companies to mitigate the effects of the crisis, while at the same time growing in powerful emerging market economies, especially in Latin America, so depending less on the still-stagnant Spanish economy.

At the end of the first half, data relating to the geographical distribution of revenues reflected how more than half of revenues from sales (52%) made by the big industrial and services companies belonging to the Ibex 35 are generated abroad, growing 16% compared to June 2009.

Banks are feeling the impact of the crisis on their financial statements. This decline in earnings owes to various factors. On one hand, the tightening of the interest margin (+2.7% in total). According to the Bank of Spain, this tightening was partly caused by the contraction of economy activity and end of the positive effect of interest rate cuts, which were taken more rapidly to liability costs than to asset returns. Another factor has had a negative impact on this margin: the recent rise in the interest rate curve in the eurozone. Additionally, the higher allocations made for provisions and impairment by different entities have held back earnings in the sector.

Annual performance of earnings attributed to majority shareholder
Domestic companies listed on the Spanish Exchange. Annual rate of change (%) To 3Q in 2010.



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Market Environment

On top of the policy rolled out by these financial entities to continue strengthening their solvency ratios, we would note some degree of stabilisation in the latest bad debt figures.

Expanding this analysis demonstrates that there are clear differences within the group of Spanish listed companies but it is noteworthy that 90 of these companies were turning a profit at September. Of these, 45 reported an increase in EBIT and 15 moved into profit from a loss in 2009. 31 companies were reporting a loss at the close of the period (42 at September 2009).

Regulation

The current financial crisis, which brought to light the anomalies of the international financial system, has marked the pace and the reach of the regulation approved in 2010. The ebb and flow of the crisis over the year forced EU member states to adopt exceptional measures to mitigate economic deterioration and ensure the stability of the single currency. Invention in Greece and Ireland, and the adjustments made to the Spanish economy to reduce the public deficit, are good examples of these measures. The remaining regulations approved over the course of the year were also shaped by the situation of the economy and the markets. A large part of the legislation passed by international bodies and the Spanish government has been aimed at restoring investors' confidence in the financial system by establishing greater controls to give more security and transparency to the markets. This process contains important initiatives that suggest that the stock markets have been called on to play a key role in improving control and transparency in the workings of the financial markets.

Overall, the regulations adopted in Spain in 2010, both initiatives arising in the EC and activities undertaken by the Spanish authorities, have the same objectives: to mitigate the difficult economic situation and strengthen confidence in the Spanish financial system.

Anticrisis measures

Of the exceptional measures approved during the year to combat the economic crisis (" anticrisis measures"), two have affected critical sectors of society. The reform of the labour market was one of these and a series of structural measures have been introduced in order to reduce unemployment and boost the productivity of the Spanish economy. The other measure is the programme to cut public spending. Through this legislation, which reflects the contribution of Spain to the stability of the single currency, civil servants' salaries have been reduced by 5% and the pension review slated for 2011 has been suspended, among other cutbacks.

The BME Chairman accompanied by major Spanish business leaders.

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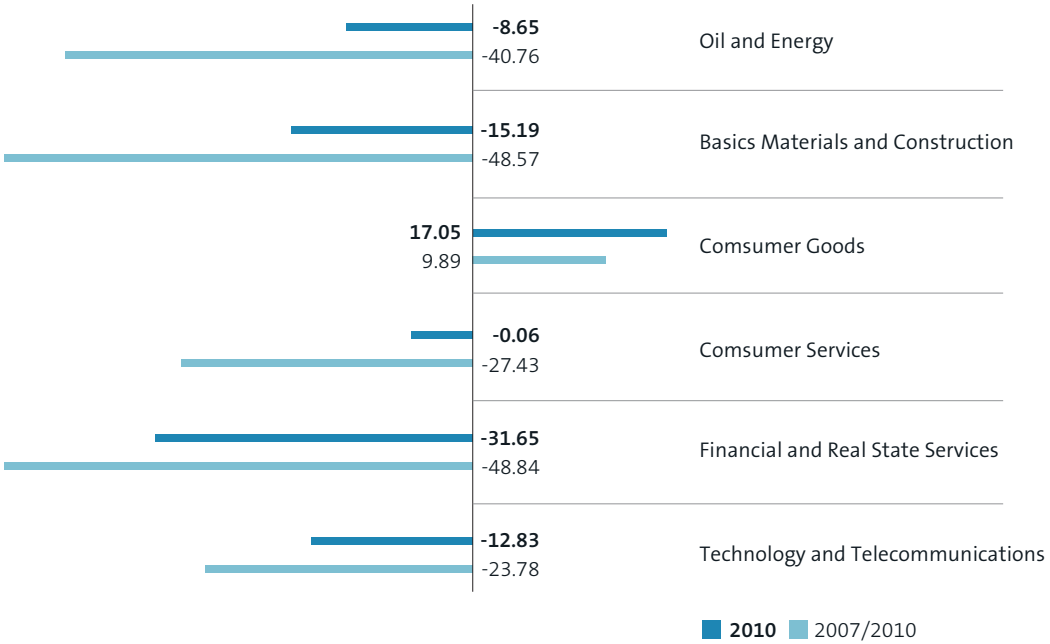
Antonio Zoido highlights the commitment of Spain to Latin America.

These exceptional measures include the reform of the Legal Framework for Savings Banks. This reform has been introduced to strengthen the Spanish financial sector. It contemplates enabling savings banks to issue participating shares with voting rights.

Performance of sector indices on the spanish stock market
% Change



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Market Environment

Adjustments and structural reforms in Spain: the international markets are asking for speed, specifics and depth

Over the past few years, Spanish budgetary policy has responded sharply to the global economic and financial crisis, in parallel with the measures to support the financial sector and actions undertaken by the ECB. The European central bank significantly has reduced its benchmark rates and adopted a wide range of conventional and non-conventional measures to prevent liquidity tensions from hampering the operation of the European financial system.

During this time, the fiscal policy employed has helped to mitigate the negative effects of the crisis on the Spanish economy. However, at the same time the public account surplus rapidly became a sizeable deficit and public debt started to increase sharply, fuelled by the government's need to secure financing and the higher risk premiums applied by the markets.

This situation, which became even more serious in that last few weeks of 2010 following the events in Ireland, first came to the fore in May and June when the fiscal crisis in Greece suddenly caused investors to become aware of the problems affecting the sustainability of this country's deficit and debt and to start to look carefully for similar potential risk among other member states, including Spain. At that moment the economic authorities acted firmly to attempt to head off what was an extremely adverse trend for national interests. Pressured by many international bodies, the government announced the implementation of several important fiscal, employment and financial measures.

On the budgetary front, the rollout of the fiscal consolidation programme announced in January in compliance with EU commitments was strengthened and accelerated. With this objective, on 20 May a raft of measures was passed aimed at reducing expenditure by more than €15,000 million between 2010 and 2011 (around 1.5% of GDP), on top of the cutbacks and tax increases previously approved. Some of these measures were rolled out in June and addressed sensitive issues such as civil servants' salaries, social benefits and public investment. In line with these actions, new deficit targets were set: 9.3% of GDP in 2010, 6% in 2011, 4.4% in 2012 and 3% in 2013. This scenario contemplated stabilising the public debt ratio at slightly below 75% of GDP from 2012 onwards.

However, as reiterated by the governor of the Bank of Spain in various appearances, "the viability of any credible budgetary consolidation strategy requires the adoption of institutional reforms in the labour market to make a radical change in employment trends possible". On 16 June, the government approved a labour market reform which was passed by parliament two months later, on 17 September. The objective of this reform is to encourage permanent employment contracts and give companies more flexibility in an attempt to find a solution to two of the key deficiencies of the Spanish labour market which are hampering the creation and maintenance of jobs.

Another major step in the reform of the financial system this year was the approval of the new Savings Banks Act (Ley de Cajas). By opening these entities to private capital, the new law will allow them to face the future without any need for help from taxpayers, and also comply with the strict capital quality requirements established in Basel III regulations. The first step was to downsize the sector through a series of mergers, on occasion between savings banks in different regions, orchestrated by the Bank of Spain. The funding necessary to restructure and streamline the Spanish savings banks sector is officially stated at around €20,000 million, of which a significant part may be raised through the securities markets.

However, the turmoil affecting the sovereign debt markets towards the end of 2010 seemed to indicate that all these measures may not be sufficient to ensure the solvency of the Spanish economy on a medium- and long-term horizon. As a result, the international community is asking Spain to urgently reform its pension system and adopt formulas to forge a compromise between the autonomous communities and local corporations to achieve budgetary stability. The decisions taken in the first three months of 2011 suggest that the Spanish authorities understand this to be necessary. In addition to measures to make the Spanish economy more competitive, ensure stricter criteria are followed when making forecasts and above all specific and timely deadlines for addressing all of these issues. The nation's credibility is in jeopardy and, consequently, access to funding at a reasonable price without which its future will be more than uncertain - it will be insecure and compromised.

Bank of Spain.

Inauguration of VI MedCap Forum of medium and small capitalisation companies.

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Strengthening the transparency and the security of the markets

A second block of regulatory measures includes the EC initiatives undertaken to strengthen the transparency and security of the markets and Spanish regulations derived from these such as the measures adopted by the Spanish authorities for the same end.

In September, the European Parliament approved the European financial supervision package designed to identify and prevent future economic crises. The measure includes the creation of three new European authorities to monitor banks, insurance companies and the markets. It also creates another body, the European Systemic Risk Board, which will be responsible for alerting of possible increases in risk in the EU economy. These authorities will start operating in January 2011.

The implementation of this supervisory system will require the reform of the three sectors which the new authorities will monitor: Insurance, Banks and securities markets. These reforms are currently being prepared via a directive known as the "omnibus directive", that will introduce reforms in the directives governing financial conglomerates, market abuse, financial instruments (MiFID directive), transparency and prospectuses, among others.

As part of the process undertaken since the start of the financial crisis to address the needs of reforming financial regulation, the European Commission stated more than a year ago that it was necessary to establish greater control, security and transparency in the trading of OTC products, to prevent as far as possible markets from becoming dark areas capable of contaminating the whole system if problems arise. In this context, in September BME announced the creation of a register (Regis-TR) for operations made using OTC derivatives in order to gain greater control, security and transparency in the trading of these products. This is one more example of how the stock markets can contribute efficiently to improving control and transparency in the financial markets.

In tandem with the initiatives undertaken by the stock market regulators in other countries, the CNMV executive committee ruled in May to extend the obligation of reporting all short positions in all securities of companies listed in the official secondary markets. This decision was made in accordance with the framework proposed by the Committee of European Securities Regulators (CESR).

Investor protection and other domestic measures

In the domestic arena, many of the regulations approved this year introduce measures aimed at protecting investors. To this end, new mechanisms have been created to increase communication between shareholders through electronic forums and shareholders' associations (Audit Law); the criminal responsibility of companies has been regulated and a new offense included, "investor fraud" (Organic Law of the Penal Code); Investment Service Companies (ESIS) must disclose information relating to their activities to the CNMV; and the legislation governing compensation systems for investors has been amended (Royal Decree 628/2010).

In regard to market legislation, changes have been made in the Regulations of the Law on Collective Investment Institutions, establishing the possibility of operating with ETFs in the form of SICAVs (Royal Decree 749/2010) and a new regulation for official secondary markets for futures, options and other financial derivative instruments has been created. (Royal Decree 1282/2010). It is also important to point out that Spanish companies law has been unified through the Enterprise Act (Royal Legislative Decree 1/2010), and clauses restricting voting rights in listed companies have been banned (Audit Law 12/2010).

Lastly, on 3 December the Council of Ministers approved a royal decree law containing fiscal, labour and liberalisation measures designed to encourage immediate investment and job creation. In the fiscal sphere, income tax for SMEs has been reduced, exemptions have been increased and company transactions for the purpose of creating, capitalising and maintaining companies are exempt from Property Transfer Tax and Stamp Duty . Obligatory fees for clearing houses have been eliminated and the procedures and costs for setting up a company have been streamlined. The Public Employment Service has been strengthened to better help the unemployed. AENA and the State Lottery have been restructured to improve the efficiency of their management and involve the private sector. And, to reduce tobacco consumption and boost fiscal consolidation, the tax on tobacco (Impuesto sobre las Labores del Tabaco) has been raised.

Debate on the state of the Spanish economy, celebrated at la Bolsa.

3

Market Environment

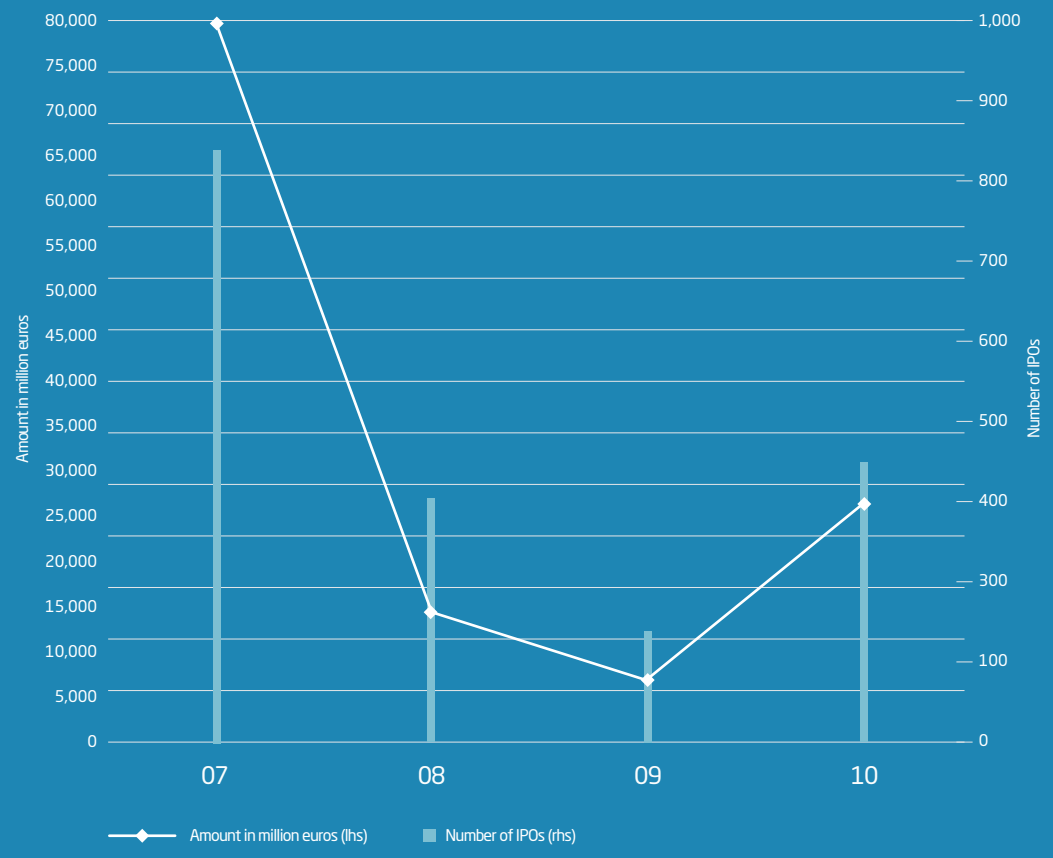
Financing through the stock market is starting to reactivate

One of the main lessons to be learned from the economic and financial crisis that has hit the developed economies so hard is that debt must be reduced and that the excessive reliance on credit (virtually closed over the past few two years) does not contribute to sustained economic growth at either local or global level. In this search for a new balance where the weight of quality capital resources become vital for the equilibrium and progress of companies, the role of the stock markets will be reinforced.

In 2010 few issuers approached the market for financing in all developed economies but this trend is gradually changing. According to data released by PricewaterhouseCoopers' IPO Watch Europe, the number of new listings on the European stock markets in 2010 suggest that 2009 was a turning point. The value of the IPOs in Europe in the year was €26,322 million, a ninefold increase on the figure seen in the previous year and the number of operations (384) tripled the number carried out in 2009. The number of operations and percentage increase remained consistent although the total value was slightly lower as the perception of uncertainty surrounding the stabilisation of the financial system, public finances and growth in economic activity continue to hold back large transactions.

In Spain, IPOs started to rise in 2010 with 12 new companies joining the stock market via IPO or share offerings, with an effective placement volume of €3,104 million. It is worth noting that in 2009 there were only two IPOs for a total effective amount of €19.32 million, compared to €13,770 million in 2010.

IPOs in Europe



Source: PriceWaterhouseCoopers