



Main messages

**Global
Economic
Outlook**

Reassessing
the risks for
the global
economy

- The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated.
- The main risk to the global outlook is still coming from financial markets. Stress tests have had positive – though asymmetric – impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable.
- The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risk of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis.
- Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America.

Outline

Global
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Reassessing
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Section I

A mild fallout from fiscal consolidation in Europe

Section II

Financial tensions ease, but still the main risk

Section III

Increasing divergence in monetary policy strategies amid a heterogeneous slowdown

Section I

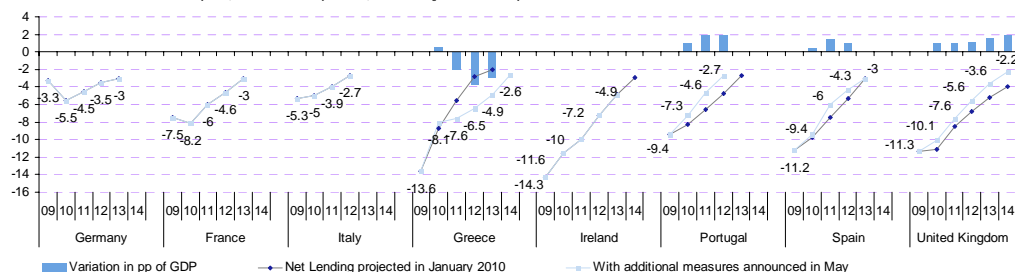
A mild fallout from fiscal consolidation in Europe

Faster fiscal
adjustment
only in some
European
countries

- Consolidation plans in Europe are being implemented according to schedules presented to the European Commission at the beginning of 2010.
- The UK, Portugal and Spain speed up their plans

Projected deficit plans

Sources: National Government to EC January 2010, announcement in May and June, note that UK figures refers to Treaty deficit



The fiscal crisis has affected the European economy mainly through reduced confidence. Thus Fiscal consolidation is a prerequisite to restore confidence

Section I

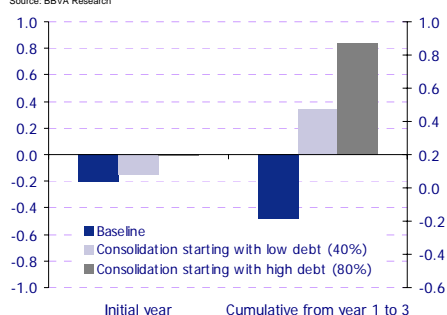
A mild fallout from fiscal consolidation in Europe

Negative effect of fiscal consolidation on growth can be mitigated

- The experience of past fiscal consolidations shows that its negative impact on economic activity is lessened when:
 - It is accompanied by structural reforms
 - It is sizable and perceived as permanent, thus increasing credibility
 - It relies more heavily on reducing expenditures than increasing taxes
 - The country starts from an already weak macroeconomic position, for example, high and increasing levels of public debt.
- In the long run, decisive fiscal consolidations boost growth.

Response of GDP growth to an increase of cyclically adjusted primary surplus of 1pp of GDP

Source: BBVA Research



Section I

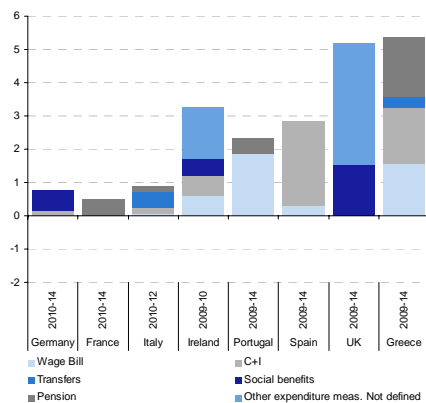
A mild fallout from fiscal consolidation in Europe

Negative effect of fiscal consolidation on European activity will be lower than commonly assumed

- Fiscal consolidation in Europe is fast and tilted towards reducing expenditure.
- Therefore, given past experiences, as long as the determination on fiscal consolidation is maintained, the negative impact on European economic activity will be limited and transitory.

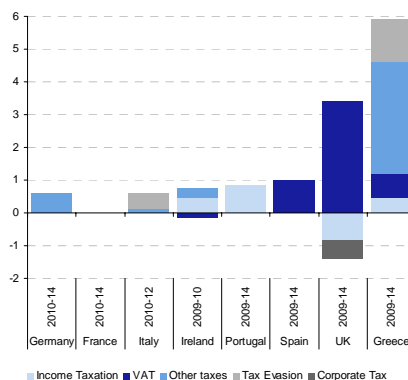
All detailed expenditure measures as % of GDP

Source: BBVA Research



All detailed revenue measures as % of GDP

Source: BBVA Research



Section I

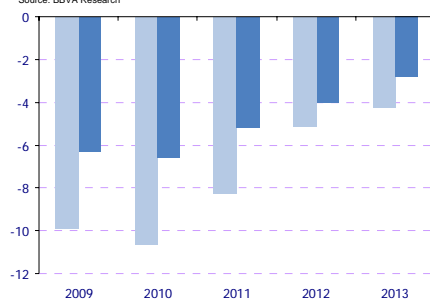
A mild fallout from fiscal consolidation in Europe

Outside Europe, consolidation plans are less advanced, but not necessarily less needed

- Other advanced economies, where fiscal impulses have been substantial and debt levels have increased at similar pace as in Europe, are relatively slow in coming to grips with reducing deficits and stabilizing debt levels.
- This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk of sudden increase in long-term rates and a displacement of private demand.

US vs. EMU: Fiscal deficit paths

Source: BBVA Research



Fuente: BBVA Research

■ EE.UU. ■ UEM

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Section II
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Section III
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Section II

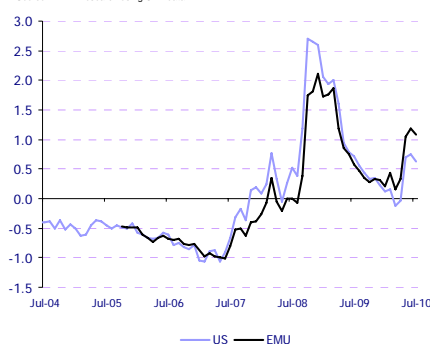
Financial tensions ease, but still the main risk

Financial tensions have been concentrated mostly in Europe

- Price indicators show a high level of stress in financial markets, on the back of fiscal concerns and the risk of weaker growth.
- Financial stress still below highs of 2008-9 and not much contagion outside Europe. Emerging economies have been particularly resilient.
- In addition, stress has been concentrated on particular segments: sovereign risk has been central to this crisis, as opposed to 2007 and 2008.

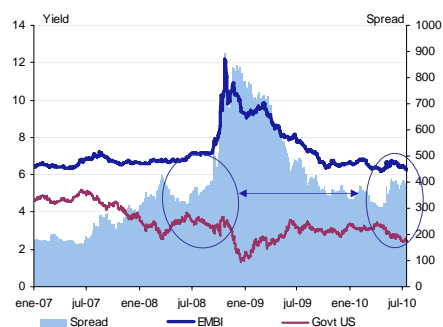
Financial stress index

Source: BBVA Research using CPB data



Bond yields: Emerging markets vs US

(EMBI vs. US 7Y Bond) Source: Datastream and BBVA Research



Section II

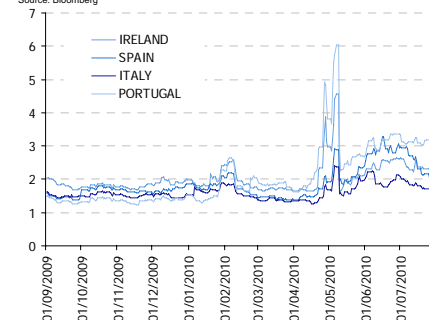
Financial tensions ease, but still the main risk

The sharp increase in financial tensions in Europe in the second quarter is starting to abate

- financial tensions have receded somewhat in the Eurozone and specially in Spain, as capital markets are partially re-opening for European peripheral countries and European financial firms and stress tests' results are being well received by market participants.

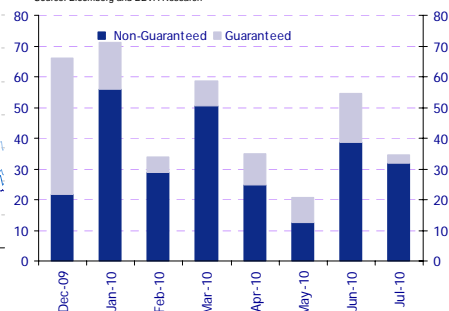
Yield on 2-year government bonds

Source: Bloomberg



EMU banks debt issuance

Source: Bloomberg and BBVA Research



Section II

Financial tensions ease, but still the main risk

The release of European stress test results has had positive effects on lowering tensions

- There has been a clear differentiation across countries.
- In particular, stress tests may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative.

Key factors	Europe	Spain
Rigorous macroeconomic scenario	✓	✓ ✓
Right pre-impairment income assumptions from macroeconomic scenario	✗	✓
Transparency	✗	✓
Differentiation among institutions	✗	✓
Estimated losses	✗	✓
Ability to raise capital	✓	✓

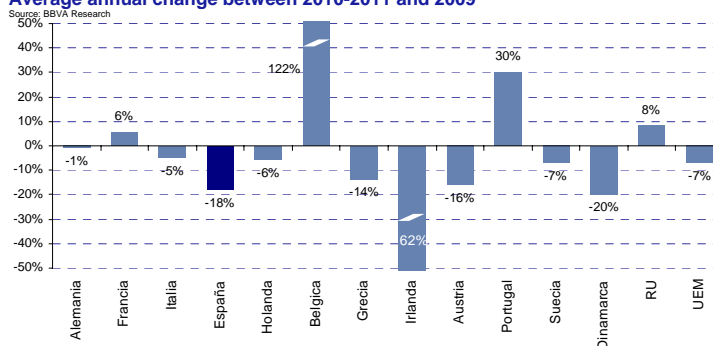
Section II

Financial tensions ease, but still the main risk

Stress tests: A more rigorous approach in Spain to estimations of pre-impairment income

- Estimations of pre-impairment income have been highly discretionary, resulting in significant differences across countries
- A more rigorous and reasonable approach in Spain can explain these differences, which should serve to dispel market concerns over capital needs in the Spanish financial institutions

Stress tests: pre-impairment income
Average annual change between 2010-2011 and 2009



Section II

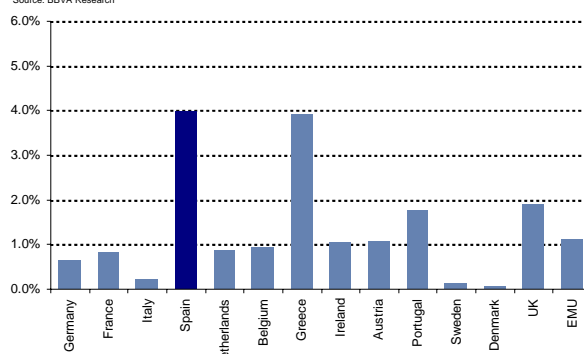
Financial tensions ease, but still the main risk

Stress tests:
a broader
coverage in
Spain means
greater
transparency

- There is a broader coverage of the exercise in Spain than in other countries, reaching almost 100% of the financial system.
- This explains why it is the country with more potential losses revealed in the financial system. This is not a sign of weakness but of greater transparency.

Net impairments as percentage of financial assets

Source: BBVA Research



All in all, capital needs for Spain are manageable and losses and margins reasonable, reinforcing the solvency of the Spanish financial system.

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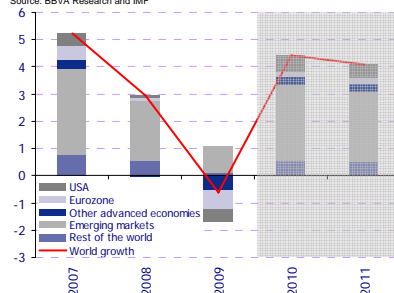
Divergence in monetary policy amid a heterogeneous slowdown

The global economy is on track for a mild slowdown in 2011

- Financial turbulence will affect confidence in Europe temporarily, mostly at the end of 2010, with carryover effects in 2011. Gradual return to potential growth thereafter.
- No contagion so far outside Europe. Other regions show deceleration of growth with respect to 2010.
 - The US will see the limits of private demand growth without fiscal and monetary policy support.
 - In China and the rest of Asia, tightening measures are steering the economy toward a soft landing, reducing the risk of overheating and property price bubbles.
 - Latin America will also slow down in 2011, but keep robust growth rates.
- In this context, divergences will continue to widen between advanced and emerging economies and within each of those groups. Emerging economies to keep accounting for the bulk of global growth

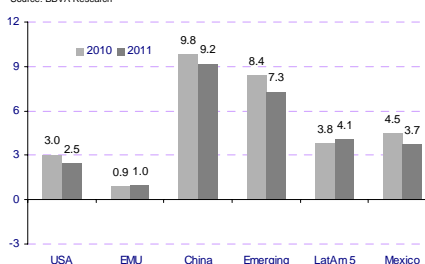
Contributions to global GDP growth

Source: BBVA Research and IMF



GDP growth forecasts

Source: BBVA Research



Section III

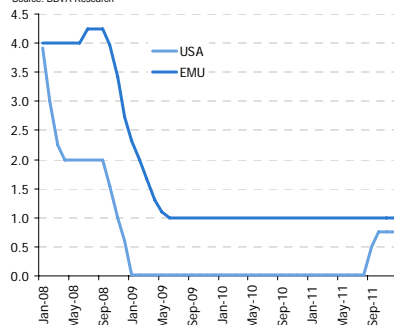
Divergence in monetary policy amid a heterogeneous slowdown

Advanced economies in no hurry to hike policy rates but emerging economies have resumed tightening

- Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period.
- Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies for an extended period.
- A faster recovery in the US will mean that the monetary exit will be earlier there than in the Euro zone, and both factors will weigh down on the euro.
- At the same time, monetary tightening is resuming in emerging economies

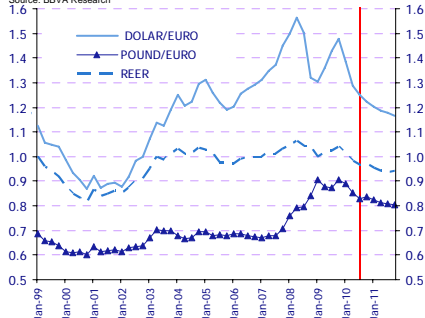
US and EMU: Official interest rates

Source: BBVA Research



Euro exchange rates

Source: BBVA Research



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Third quarter 2010

3 August 2010