

Europe's future

New York, Oct 22 2015



Main messages

- **Global outlook:** moderate growth under an uncertain scenario in emerging economies.
- **Eurozone:** resilient domestic demand but subject to external, political and geopolitical risks.
- **Spain:** we expect growth of 3.2% in 2015, although with a downward bias and with risks related to political uncertainty.
- **Banking Union** has to be completed and further integration in Europe pursued. It will not be easy!
- **Financial sector challenges:** profitability, crisis legacy, deleveraging



1 Global

Prospects of modest growth

World Economic growth

(% of GDP)



- The current economic recovery is atypical and fragile
- World growth will not surpass the pre-crisis level
- The outlook is uncertain and continues to have downside risks

An uncertain scenario among the emerging economies...

Great uncertainty due to:



Doubts over China's economy



The effects of low commodity prices



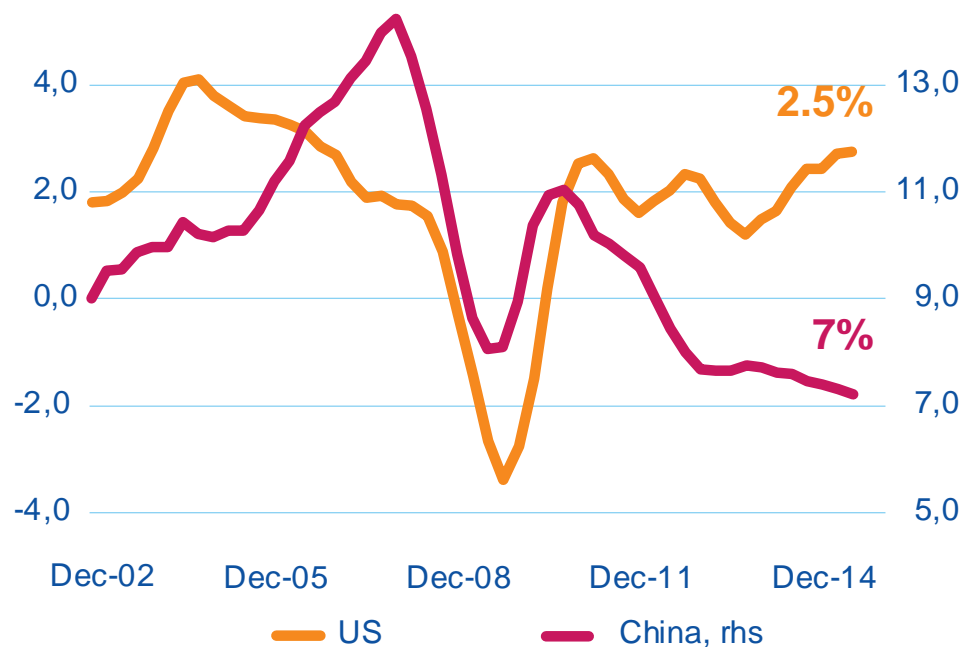
The imminence of the Fed rate hike cycle



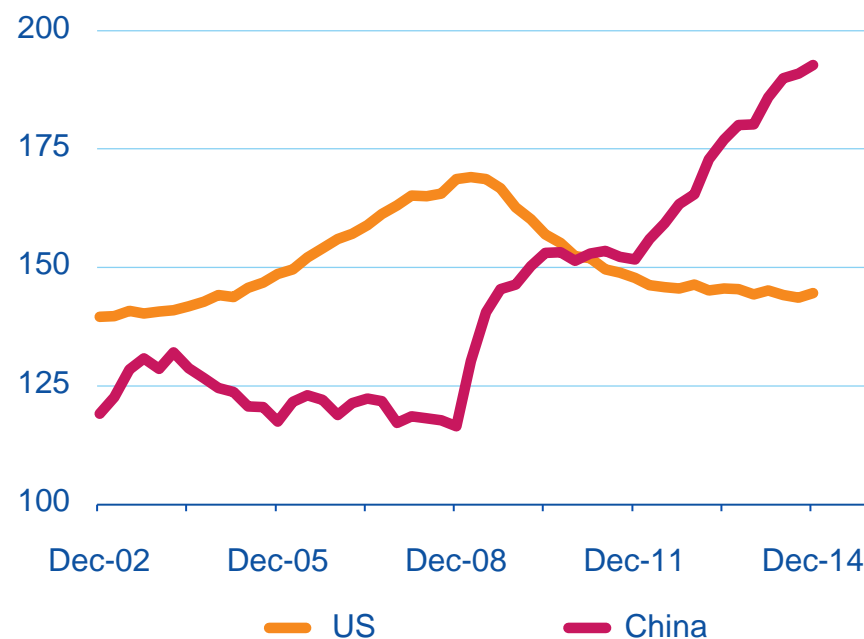
The lack of credibility of certain economic policies

...and yet, after the Great Recession, we are where we would have hoped to be (more or less) back then

Growth switch from EM to DM ... GDP growth, YoY, (4Q MA)



... and debt switch from DM to EM Non Financial Private Sector, GDP %



What are the risks? Biased towards EM



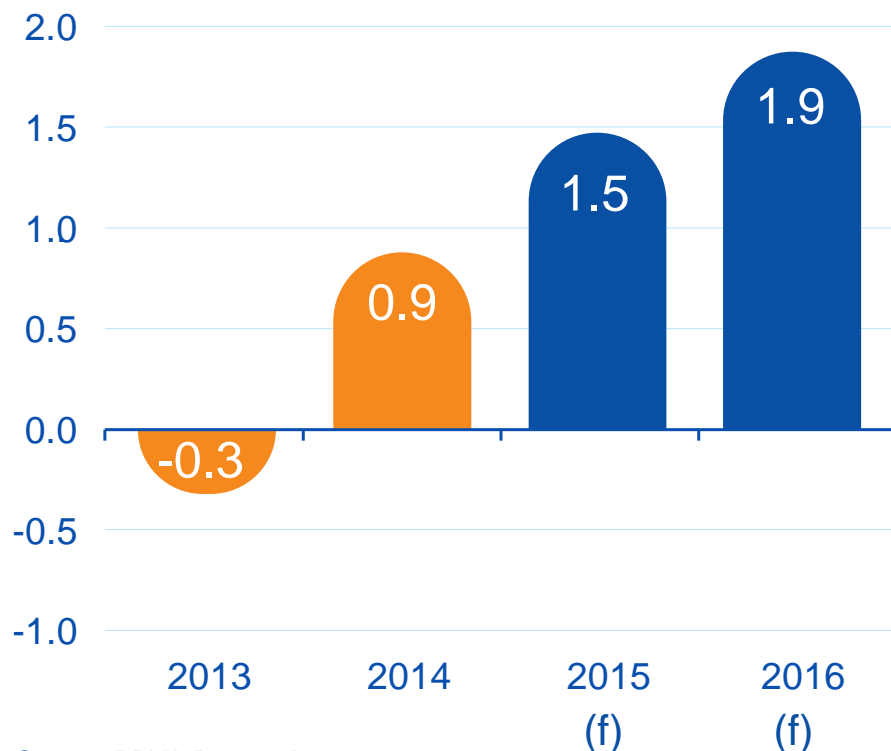


2 Europe

Europe: weak foreign demand but resilient domestic forces

Economic growth

(% of GDP)



Source: BBVA Research

- Domestic demand is strengthening
- The external environment is more negative, except for the boost from the oil price slide ...
- ... which is lifting disposable income and feeding towards higher consumption

An overview of the drivers of growth in the eurozone



Low oil prices

Solid domestic factors
(confidence, labour
market, credit)

Resilience, despite
recent events (elections,
geopolitics, China's
news)



Neutral fiscal policy
QE until Sep'16 / OMT

Positive impact of
structural reforms in
the periphery



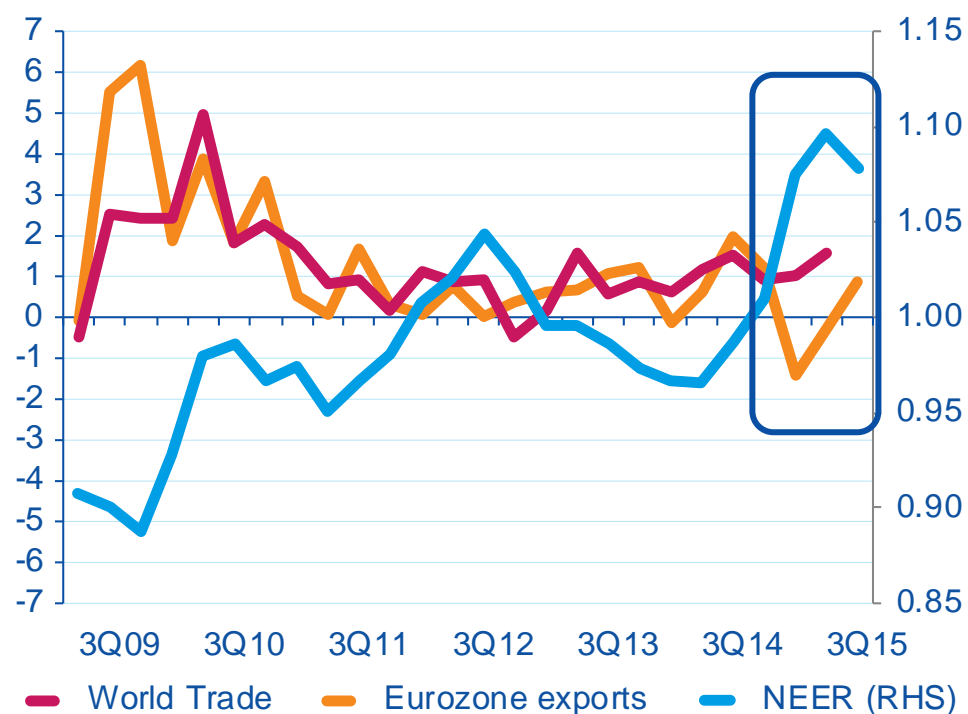
Global slowdown: China
and emerging markets

A lower than expected
depreciation of the euro

Greece lingering, and
new domestic shocks
(refugees, VW?)

Lower foreign demand, though main traders' projected to remain resilient

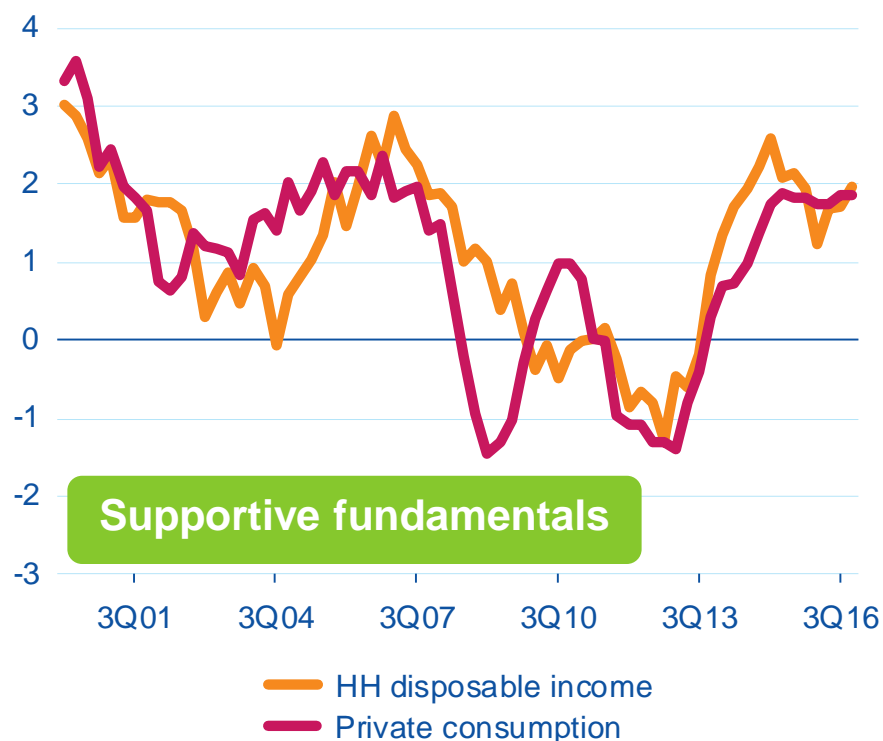
World trade and EZ exports (% QoQ) and NEER



- Sharp depreciation of the euro since mid-2014 helped to mitigate the fall of World trade in the first half of 2015
- Global trade might be recovering in Q3

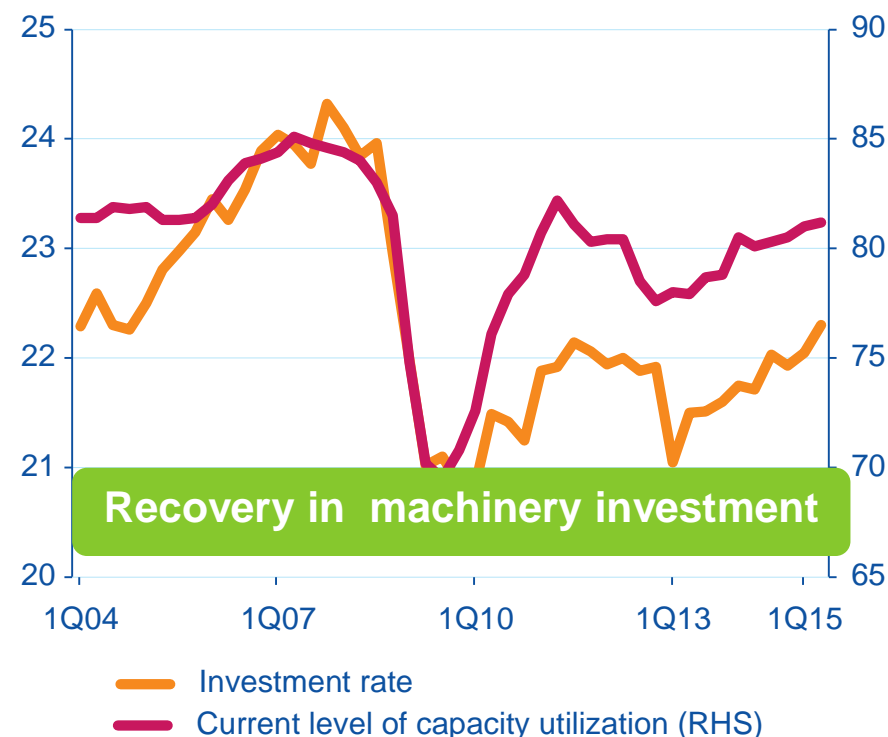
Strong private consumption; uneven investment recovery

Eurozone: private consumption and real labour income (% YoY)



Source: Eurostat and BBVA Research

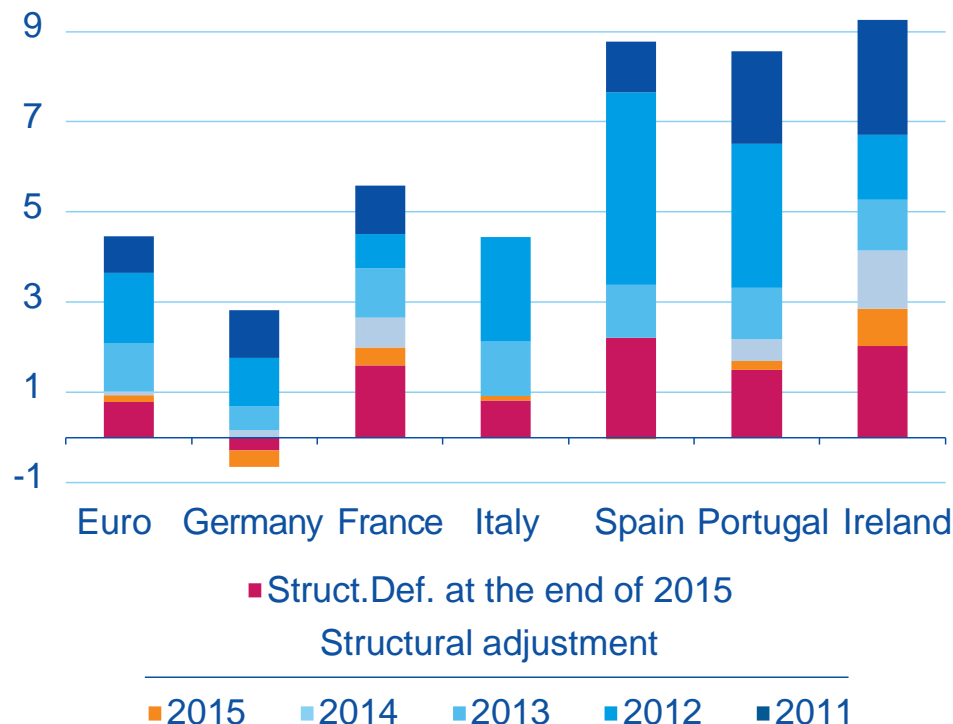
Eurozone: investment rate and capacity utilization (%)



Source: Eurostat and BBVA Research

More favorable fiscal policy than in previous years

EMU: structural deficit adjustment 2010-2015 (%GDP)



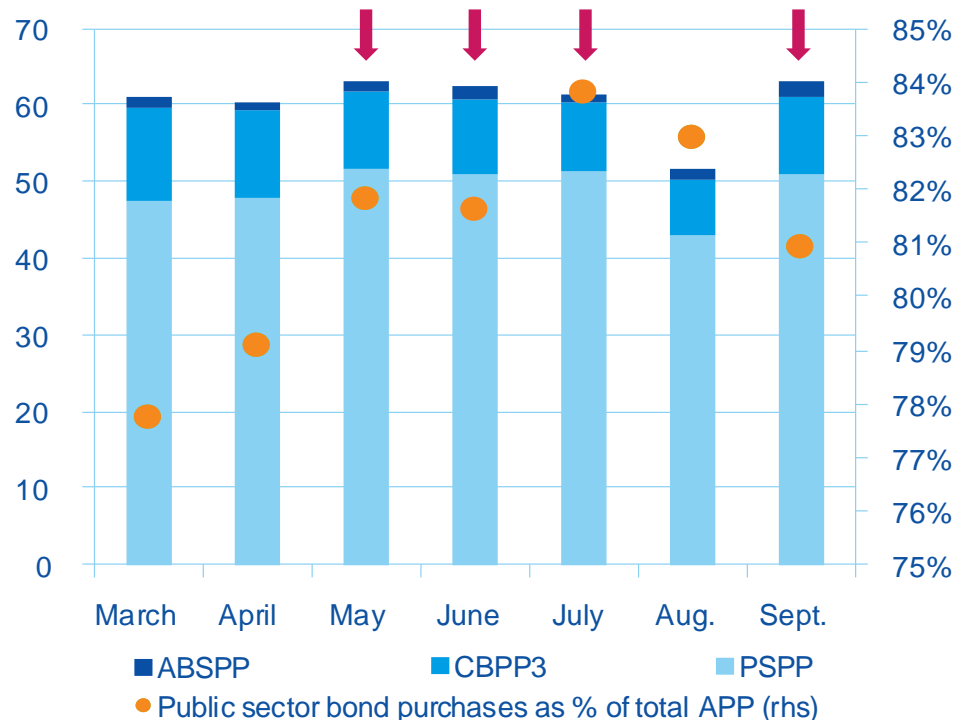
Source: BBVA Research and IMF

- Almost neutral fiscal policy in 2015
- European Commission more careful in not forcing pro-cyclical adjustments
- Relaxation of fiscal effort in exchange for structural reforms

The ECB remains firm on full implementation of QE and its willingness and ability to act if needed

ECB Monthly purchases under the APP, bn EUR

Some frontloading ahead of lower market liquidity

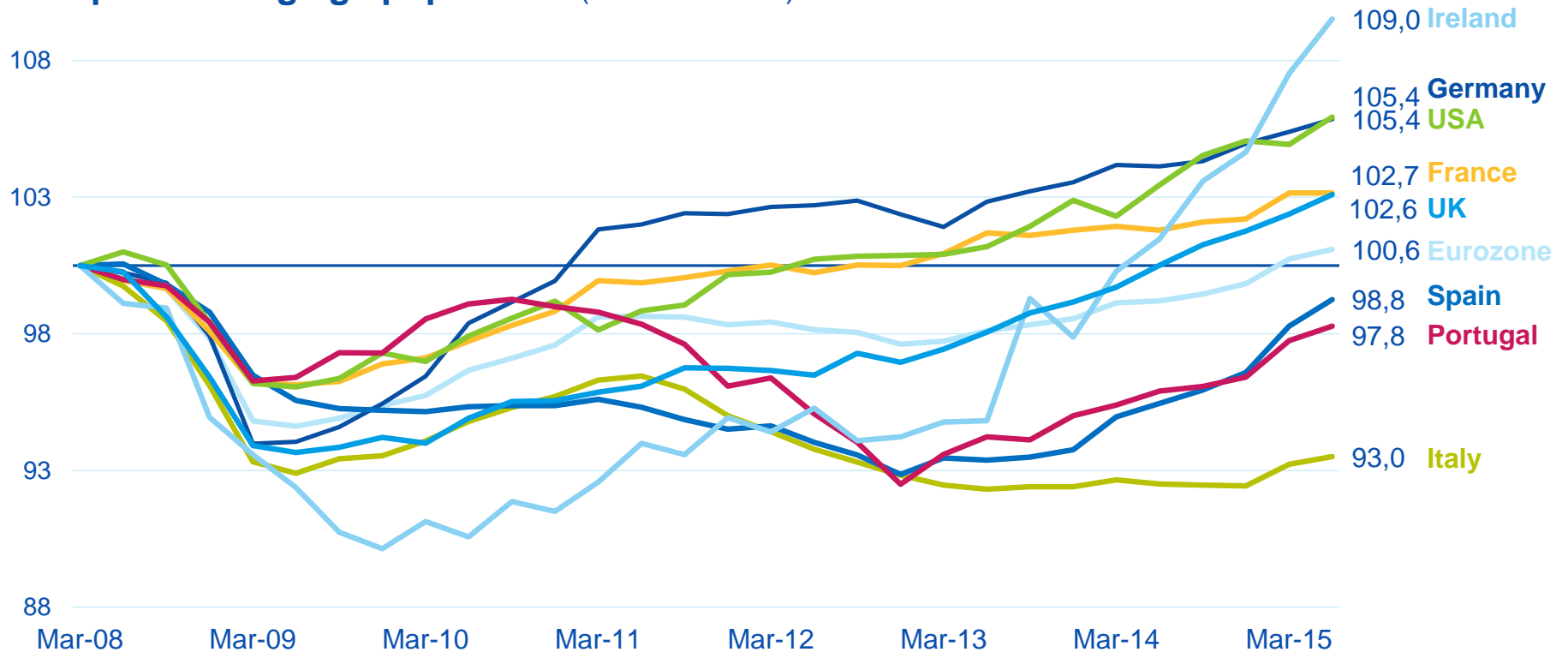


Source: Bloomberg and BBVA Research

- Markets are increasingly pricing in more QE
- Despite being premature for the ECB to take action, they lose no chance (also today!) to state that they are very willing to act
- Risks are undoubtedly towards a QE extension, especially if the risk scenario of low growth materializes.

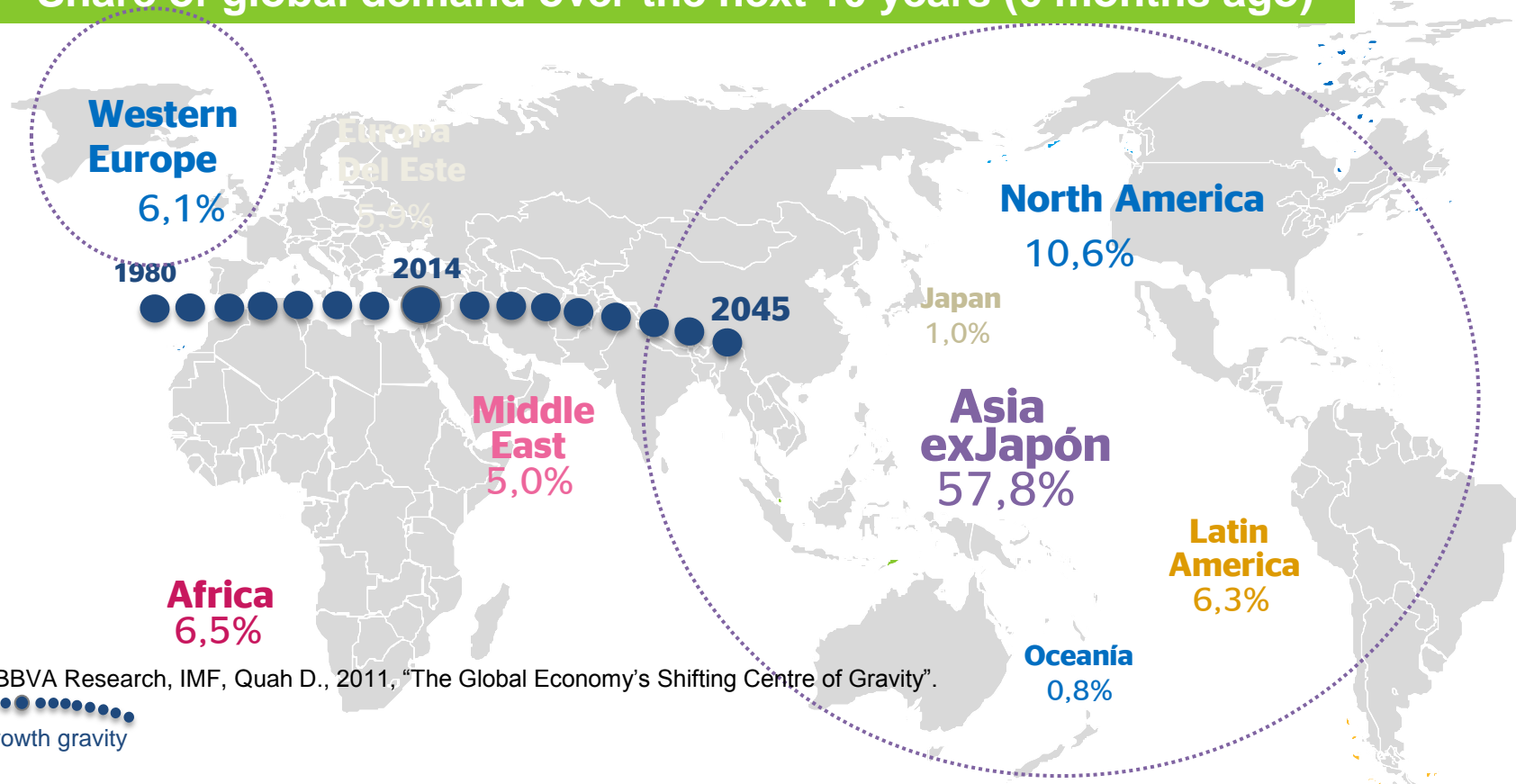
Where do we stand after the crisis?

GDP per working age population (Q1-2008=100)



Where do we stand in spite of the crisis?

Share of global demand over the next 10 years (6 months ago)



Source: BBVA Research, IMF, Quah D., 2011, "The Global Economy's Shifting Centre of Gravity".

World growth gravity

Asia-Pacific will Explain around **75%** of the increase in GDP between 2014 and 2024.

Structural reforms needed also in core countries

France

- Labor markets
- Product market and services liberalization
- Reducing size of public sector and tax burden

Italy

- Reforming public sector and reduce tax burden
- Completing political reforms

Germany

- Services liberalization
- Improving infrastructure

Eurozone

- Address demographic decline. A common immigration policy?
- Further reform labor markets and promote labor mobility
- Multiple reforms to enhance productivity growth

Europe: Many risks pointing downwards aside from the lack of advances in further integration

China

→ Uncertainties about the magnitude of the deceleration, and on the command on the situation by Chinese authorities

Other EME's

→ Impact from China, low commodity prices, potential domestic policy mistakes

US

→ Complications from Fed exit

Geopolitical

→ Ukraine and Russia, ISIS and larger inflow of refugees

Political woes

→ Failure to implement reforms

Stagnation

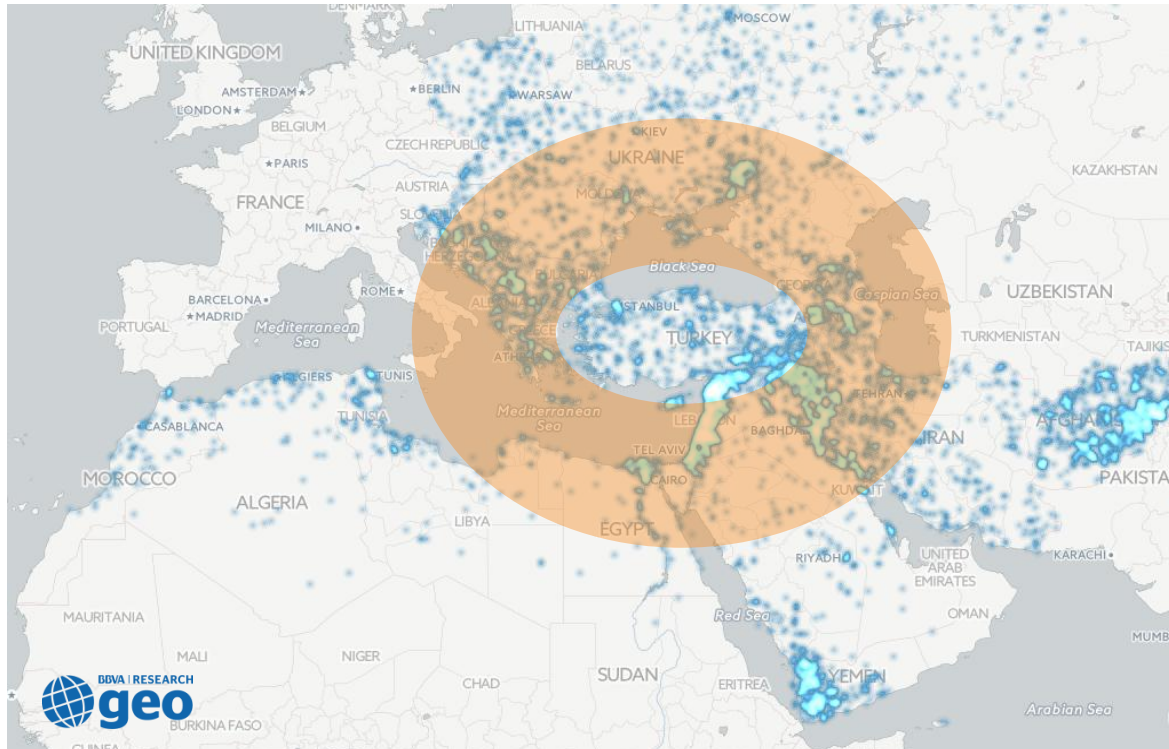
→ Elections and populist governments, complications from refugee crisis

Greece

→ Lack of recovery and no ownership of the reforms

Geopolitical Risks: A complex framework especially close to Europe

BBVA conflict heatmap (Jan to Sep-15)
(Number of conflicts / Total events)



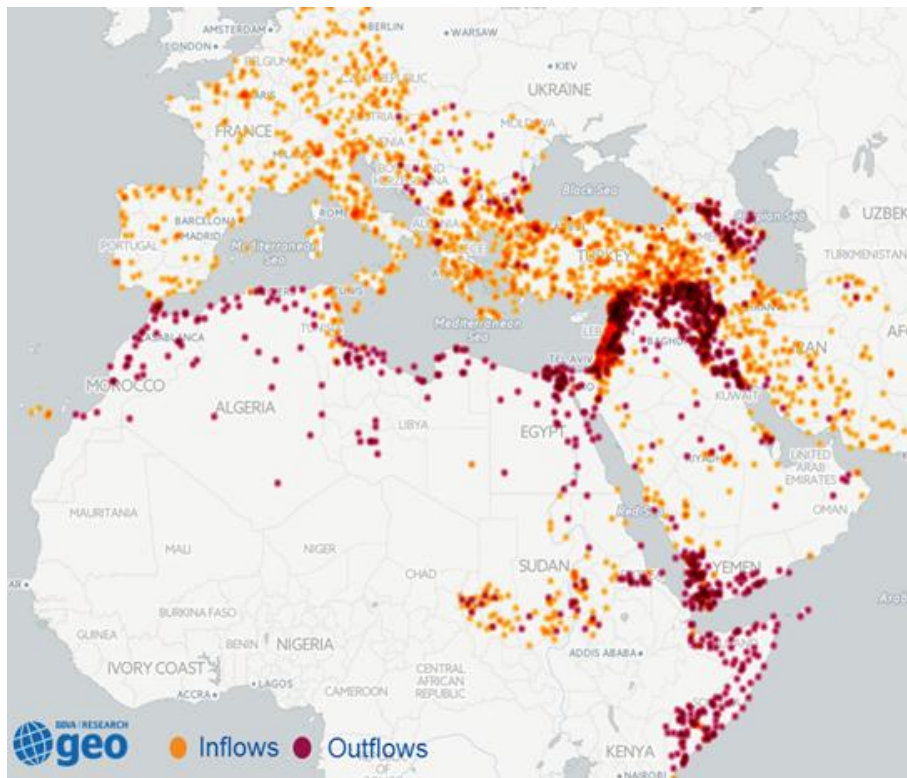
- ISIS attacks in MENA and Turkey while many countries are involved (Turkey, Russia, Iran China)
- Fighting intensified in Ukraine
- Refugee crisis escalates

Source: www.gdelt.org and BBVA Research

The refugee crisis reinforces political rifts in Europe but also opens up a long-term growth opportunity

BBVA Research Refugees Flows Map (1H 2015)

(Number of media citations about refugees' inflows and outflows)



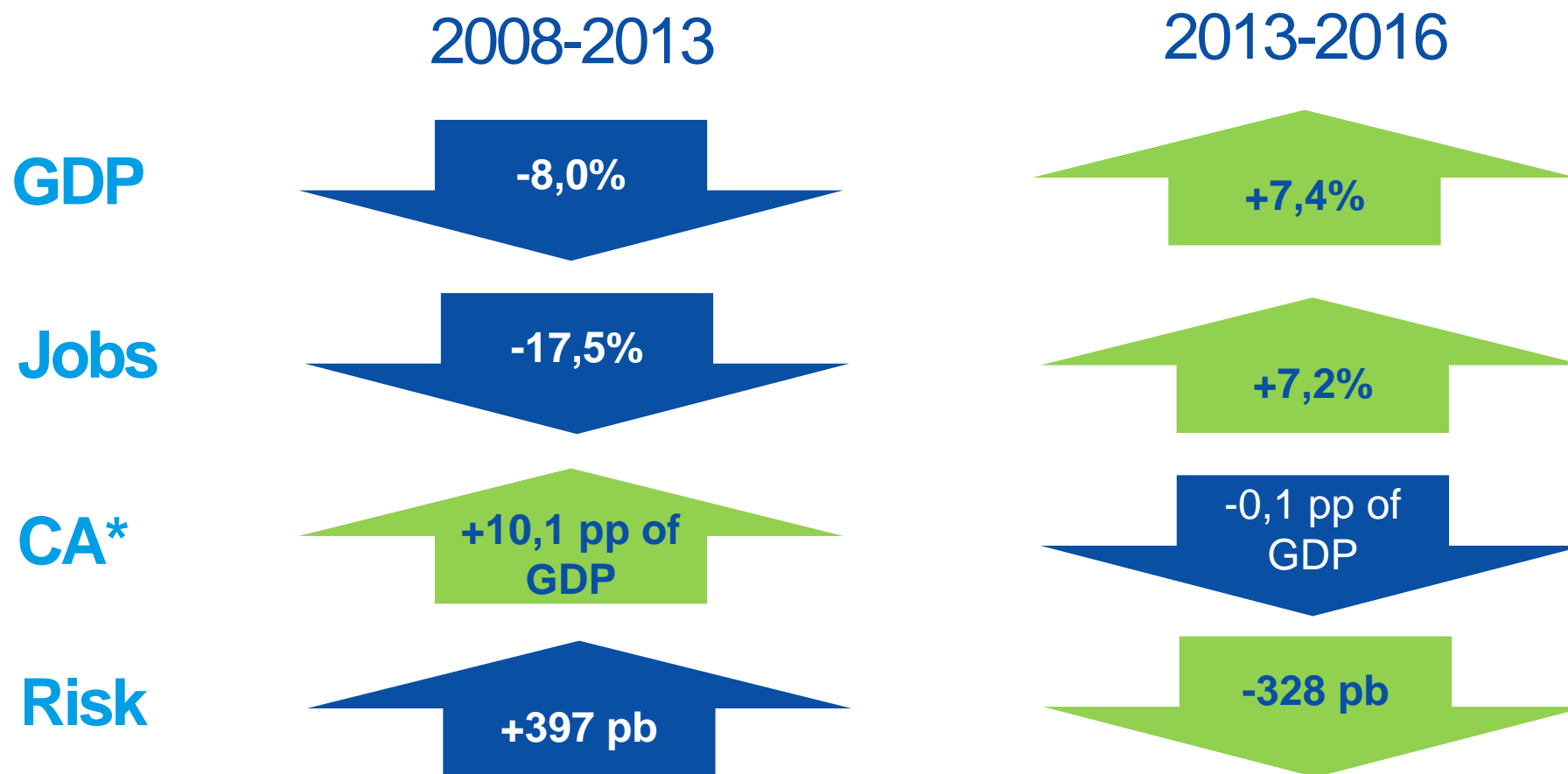
- The Middle East & North Africa are facing complex and multiple emergency situations
- During 1S2015 around 350.000 refugees reached Europe, now accelerating
- Defining a comprehensive EU action plan is crucial

Source: www.gdelt.org & BBVA Research



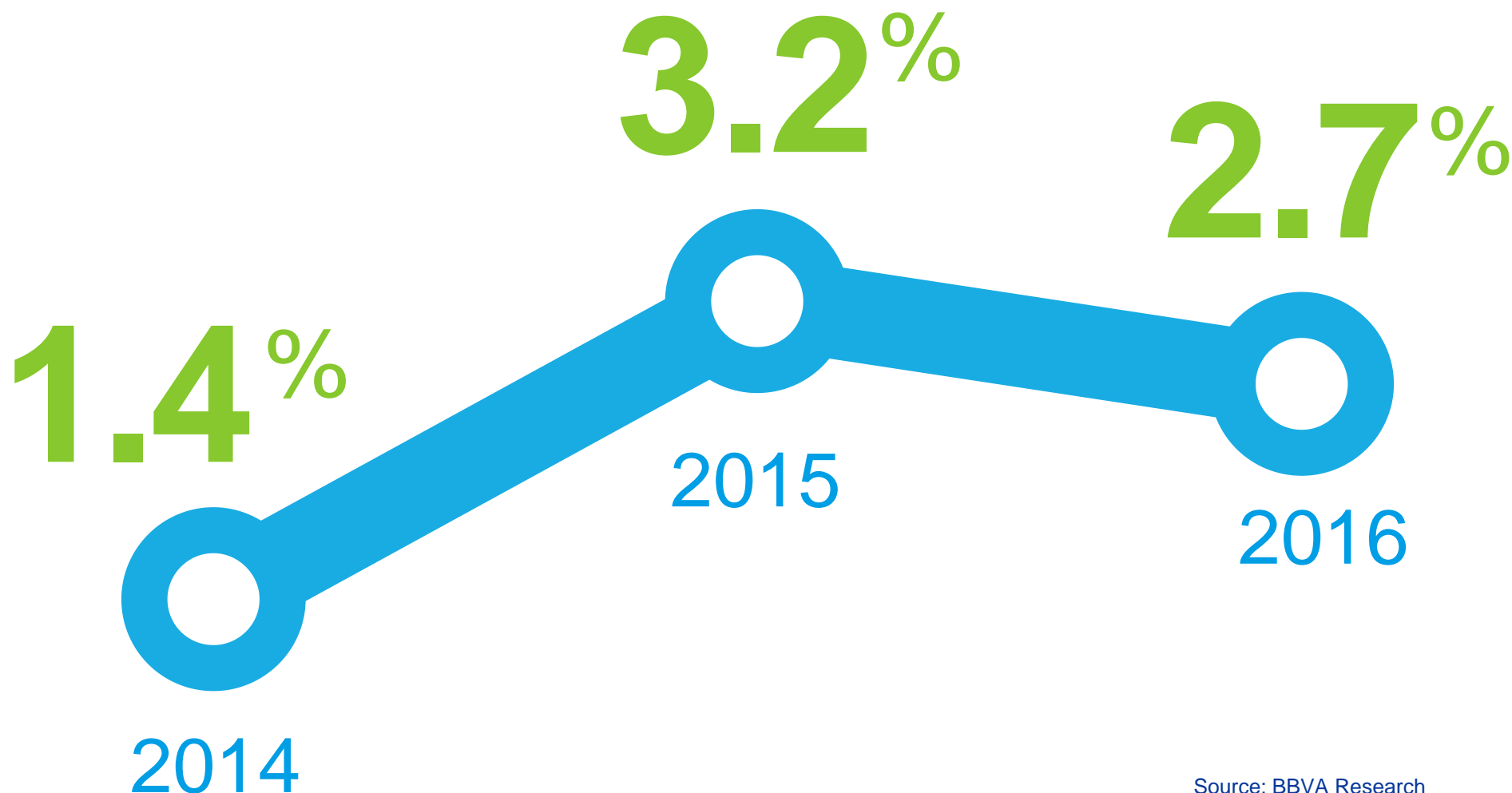
3 Spain

Spain: a tremendous adjustment



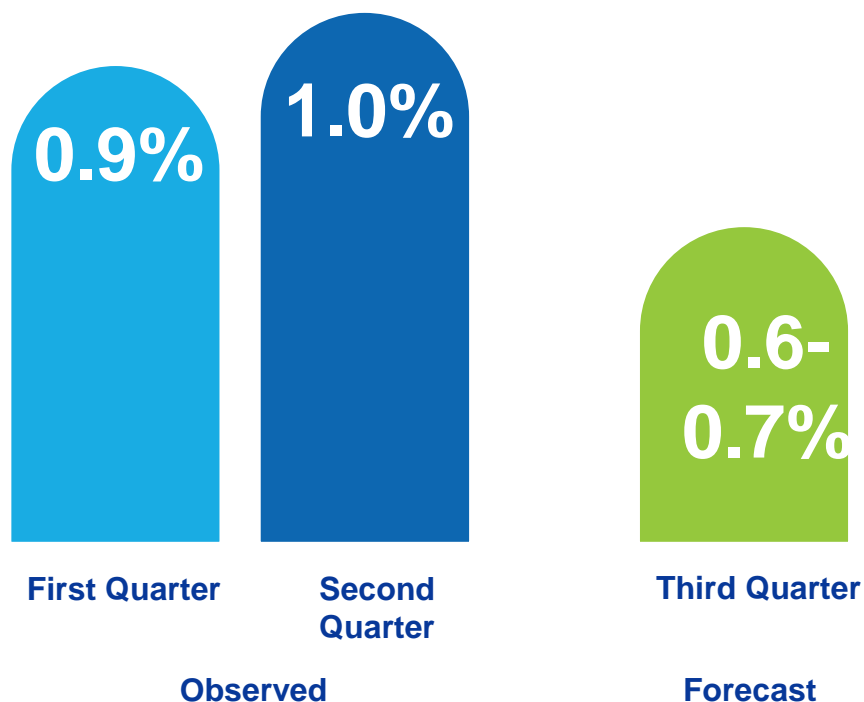
*/ Current Account

Spain: We are keeping our forecasts for 2015



We are keeping our forecasts for 2015

Quarterly GDP growth and MICA-BBVA forecasts



- The Spanish economy grew by a little more than expected in the second quarter ...
- ... although a slowdown is expected in the third

We are keeping our forecasts for 2015

Average contributions to GDP growth in the second quarter

(Yoy growth rate)

Private consumption and machinery and equipment investment

2.5

Public sector consumption and residential investment 0.6

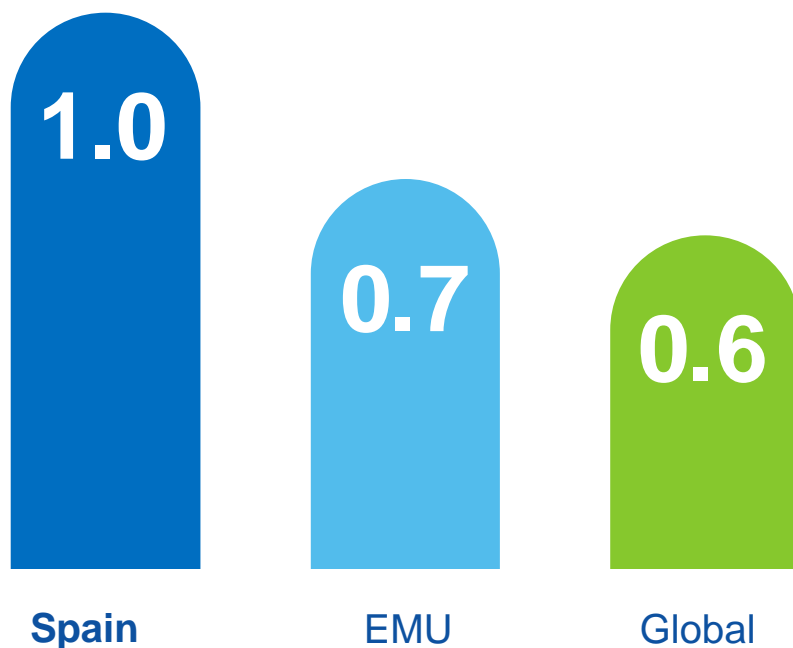
Rest 0.1

- Most growth is from both private and public **domestic demand**
- **Machinery and equipment** investment has surprised on the high side and continues to contribute to growth in 3Q15

For Oil price fall

Impact on of oil at USD50 a barrel

(pp of average annual growth in 2015-16)



- The oil price slide could add as much as **one point to growth**

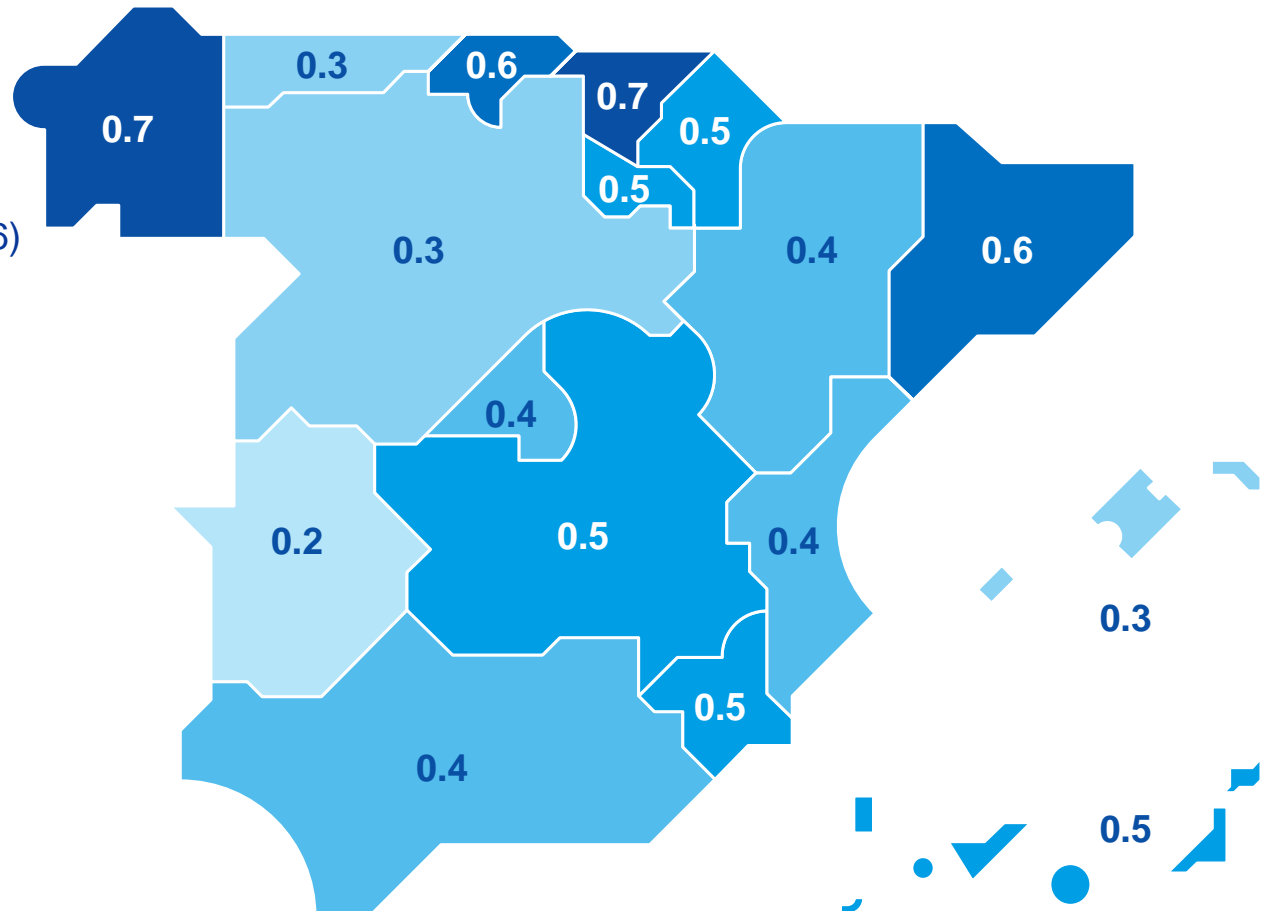
For Euro exchange rate favours exports

**Estimated effect on GDP after
one year of a 10% depreciation
in the EUR/USD rate**

(pp of average annual growth in 2015-16)

+0.5%

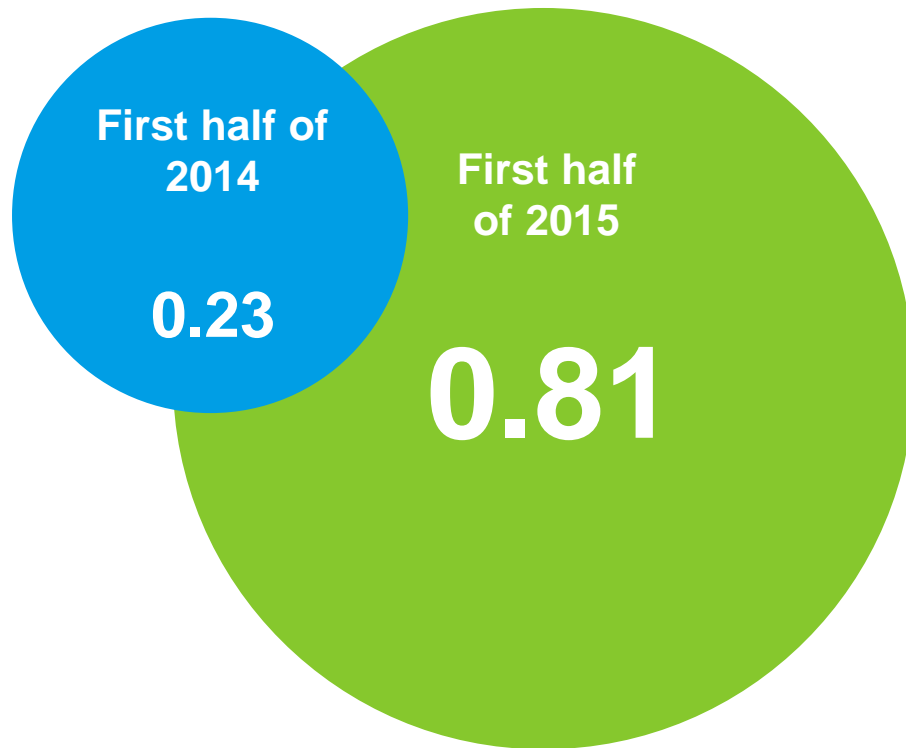
Effect on
Spanish GDP



For Expansionary fiscal and monetary policy

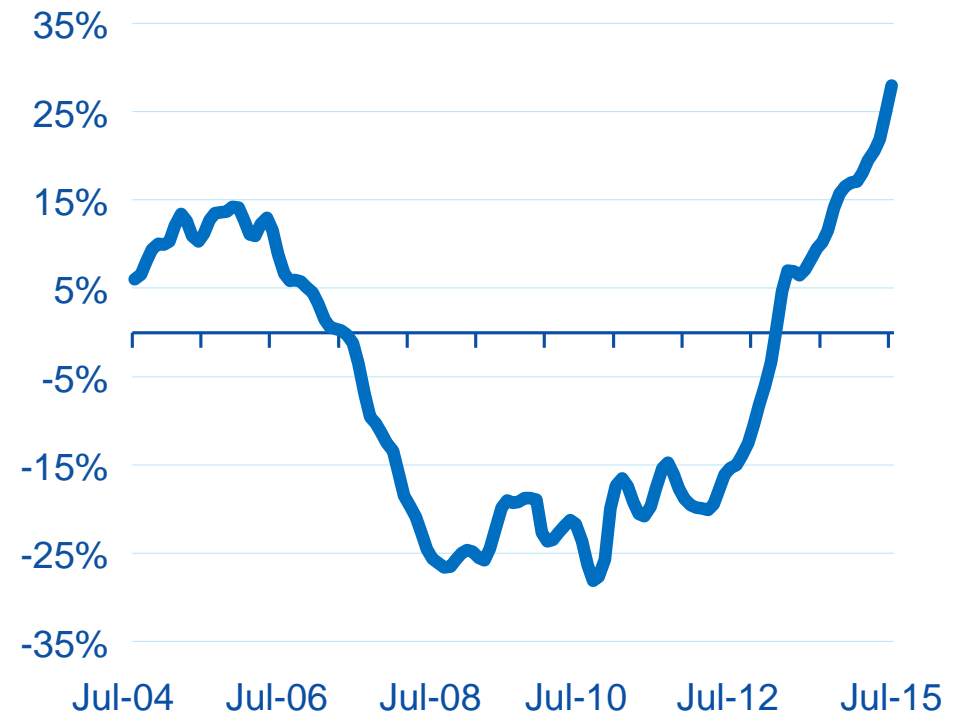
Contribution of public sector consumption to growth

(pp of annualised quarterly growth)



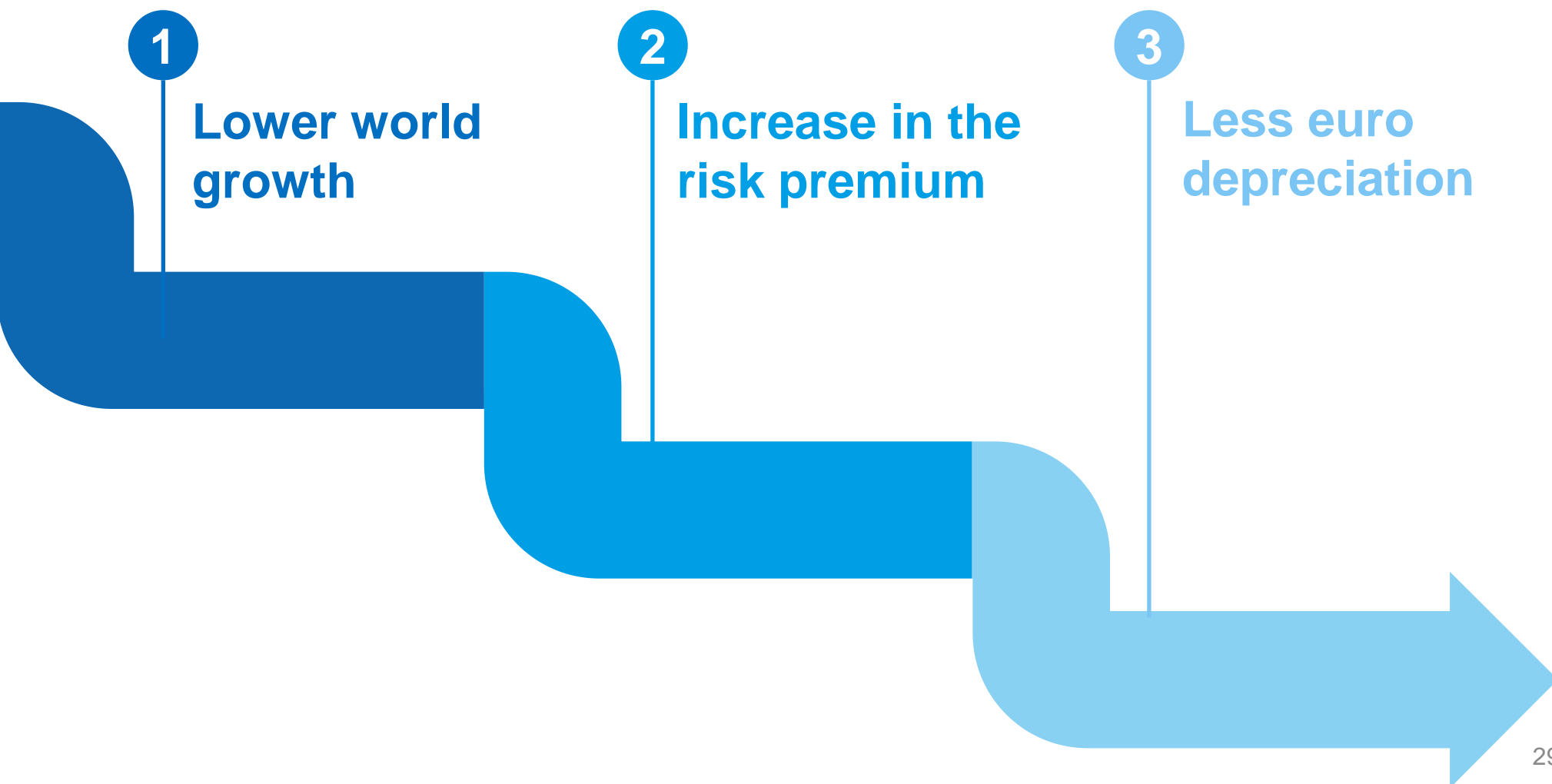
New retail lending transactions

(% YoY)



Against

A somewhat less encouraging environment than before

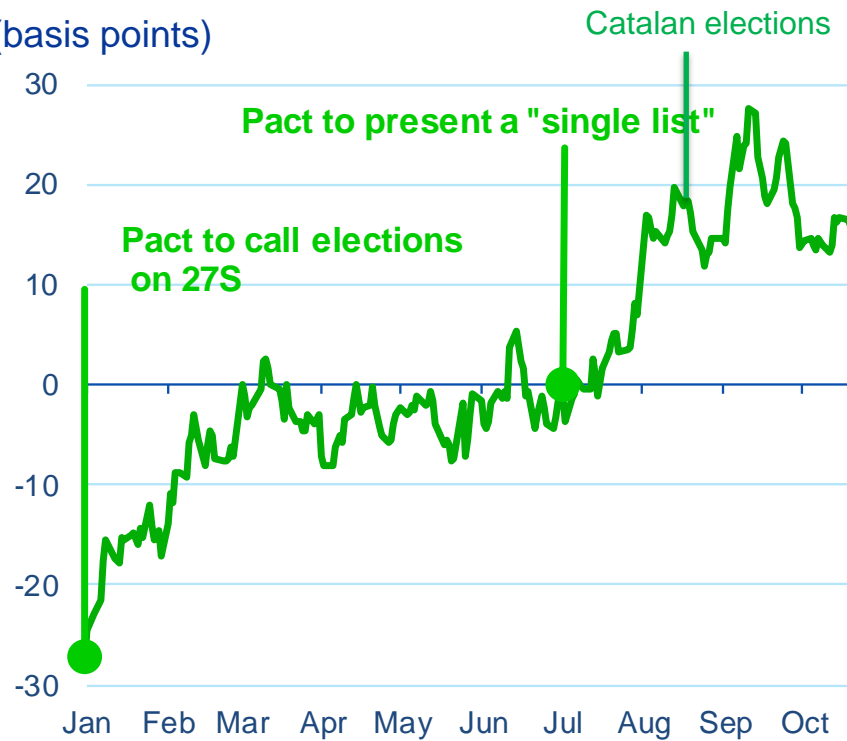


Risks

Political uncertainty

Spain/Italy risk premium differential

(basis points)



- **The Spanish risk premium is rising** with respect to Italy
- The political uncertainty could have begun to have an impact on private spending
- Anecdotal evidence....

Risks

Government deficit

Deficit of the public administrations (% GDP)

Target



4.2

- The risk of **failing to meet 2015 budget targets** is rising

Expected deficit

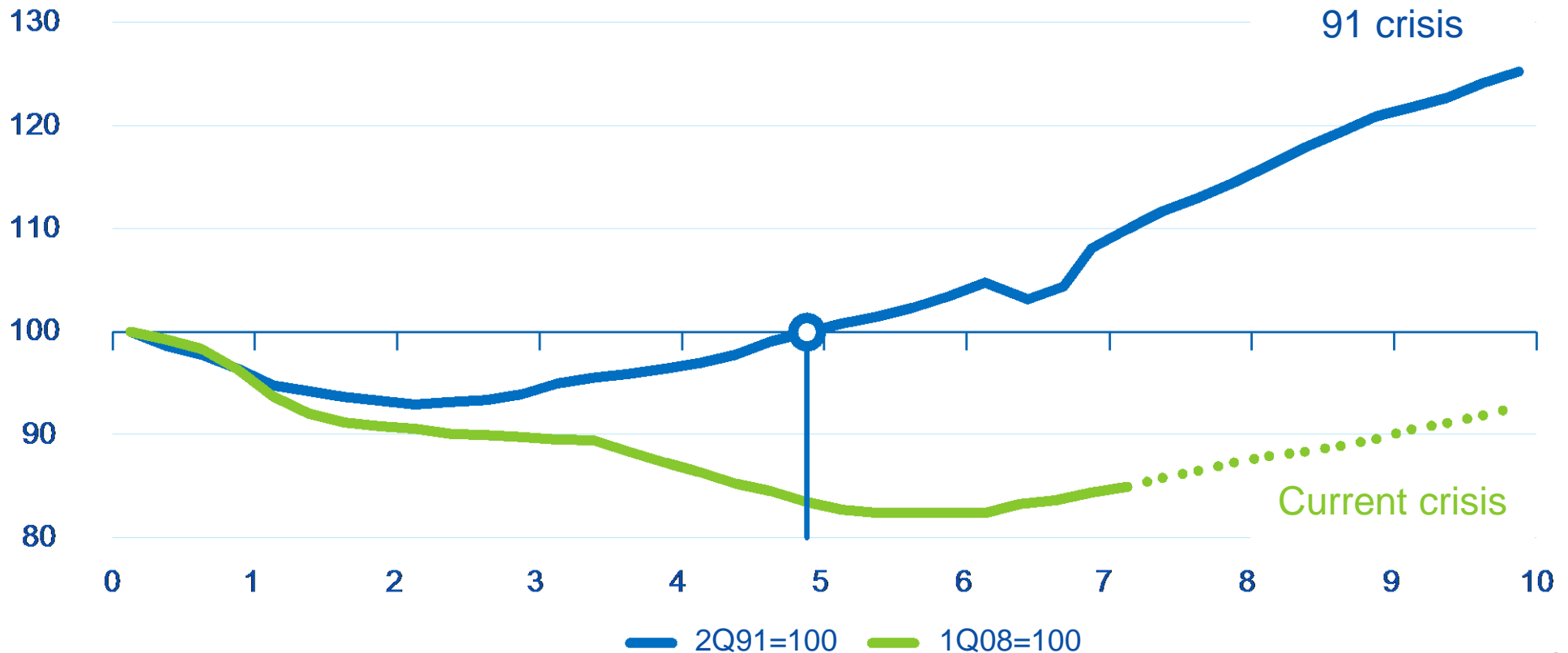


4.5

Assessment

A long and deep crisis

Years passed until pre-crisis employment levels are attained



Continuing the process of structural reforms to ensure a sustainable and inclusive growth

Labour market

Internal flexibility
Quality of contracts
Long-term
unemployment

Public sector

Consolidation
Tax reform
Efficiency

Competitiveness

Size of firms
Exports
R&D

Long run factors

Better education
Training
Institutions



4 Banking Union and challenges for the financial system

A lot has already been achieved with Banking Union 1.0

There is a new genuinely European institutional setup

1. Single Rulebook → Level playing field: CRDIV, BRRD, DGS

2. Single Supervision → No supervisory ring-fencing

3. Single Resolution → Cross border resolution & Resolution costs mutualized (private funds)

Fragmentation has considerably eased but credit conditions still depend on location

Greece, first test to Banking Union 1.0: Very good progress but so much more needs to be done

The Five Presidents Report shows the way forward

FINANCIAL UNION

BANKING UNION 2.0

- Capital Markets Union
- Sovereign Treatment Revision*



FISCAL & ECONOMIC UNION

- Formalized economic convergence*
- Fiscal stabilization function *



POLITICAL UNION

- EZ Parliament and Econ. Government
- One external representation
- EZ Treasury*

GENUINE
EMU by
2025?

→ **Immediate
priority:**

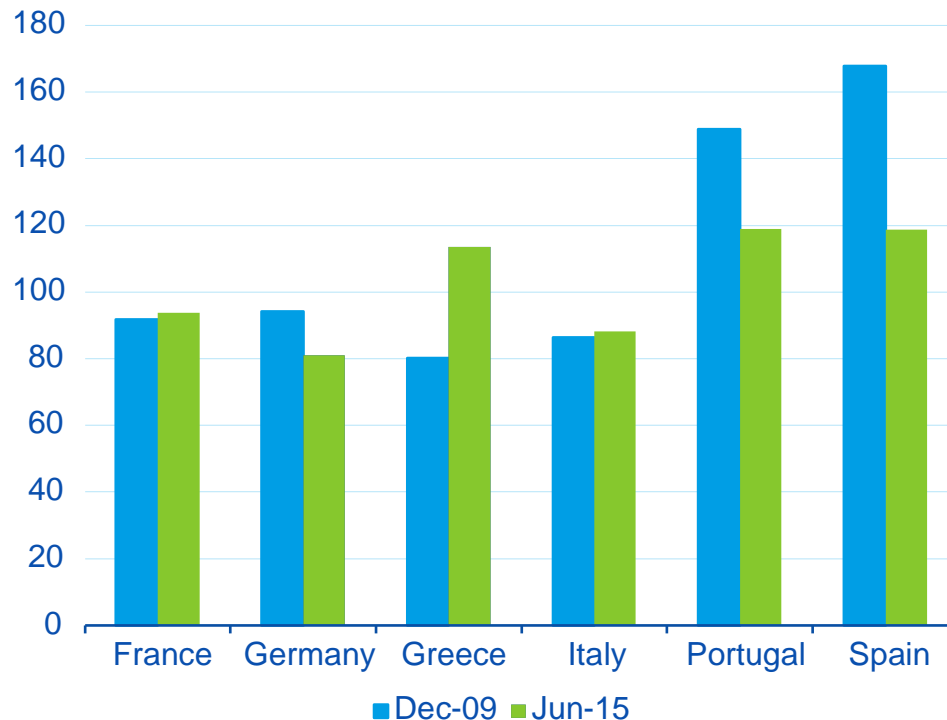


1. European Deposit Insurance Scheme: for now, re-insurance at European level
2. Fiscal backstop for the SRF

* Second Stage: after 2017

Challenges for the European Financial System: Deleverage

Credit to the Private Sector (% GDP)

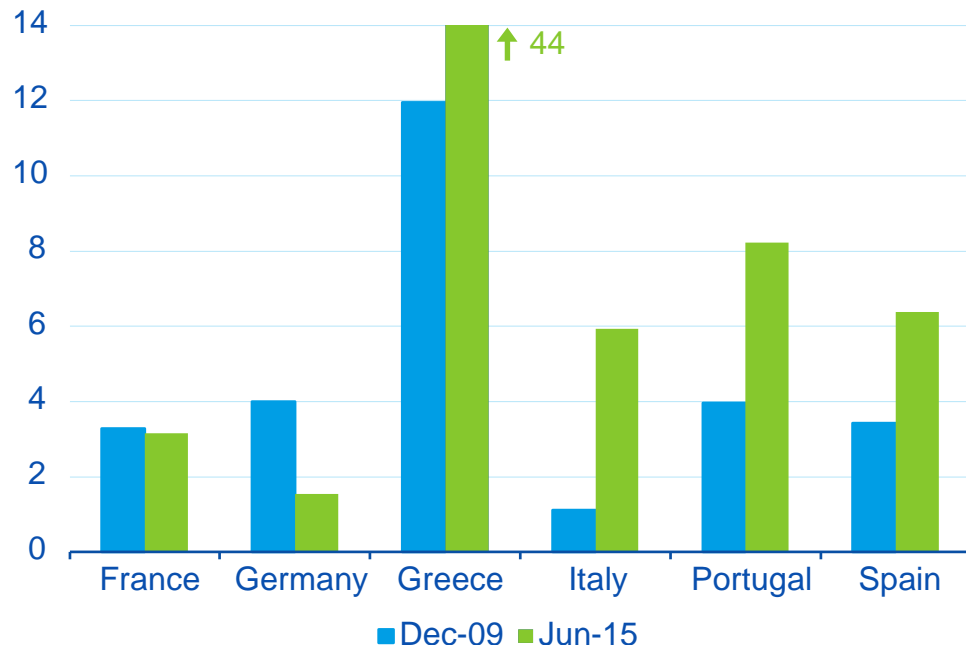


- In some countries, credit is still far from its equilibrium level and credit composition is still not balanced (like real estate firms in Spain)
- The reduction of the credit stock has to be compatible with new credit to solvent demand

Challenges for the European Financial System: Legacy from the crisis

Share of central bank funding in credit institutions' liabilities

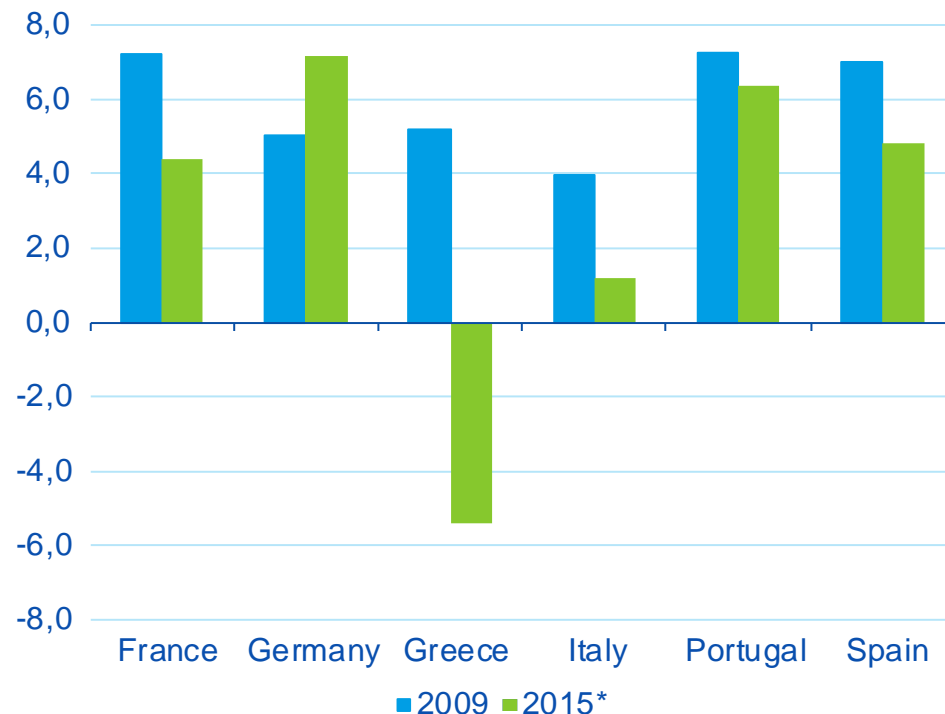
(total liabilities excluding capital, %)



- **Liquidity:** It is crucial to restore the functioning of the interbank and wholesale markets (substituted by ECB liquidity)
- Public participation in banks should be reduced, as it can bring inefficiencies

Challenges for the European Financial System: Profitability has not returned to pre-crisis levels

Return on Equity
(%)



- **Why?:** low interest rates, risk aversion, stricter regulation and supervision, lower liquidity and competition from non-bank players
- **What can be done?:** Cost cutting has to come from a significant change, like digital banking or further consolidation (first domestic and second pan-European)

Europe's future

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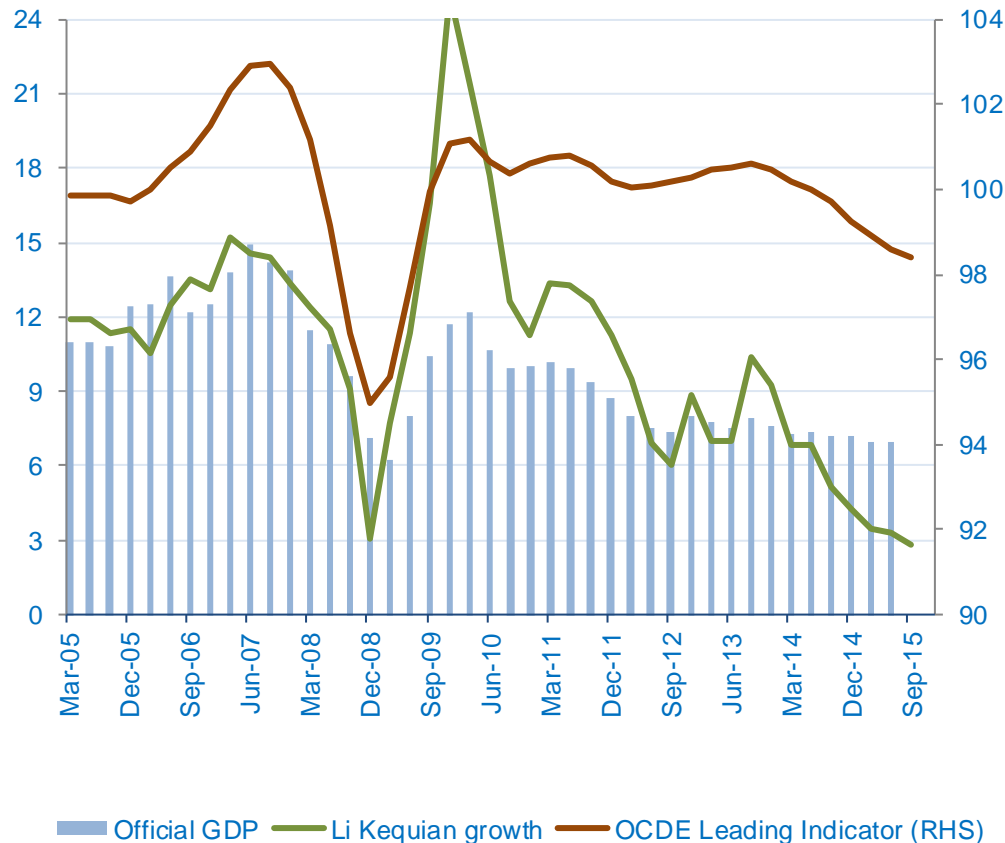


In China a sharp downward trend in economic indicators puts in doubt the soft-landing scenario

China: Economic growth, alternative indicators

(YoY, %)

Source: BBVA Research



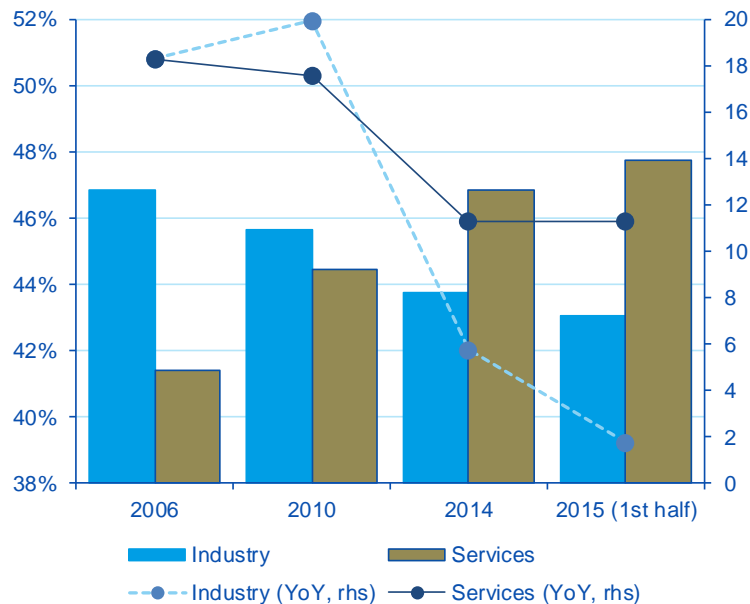
- Alternative measures of economic growth (Li Kequian) and synthetic leading indicators (OECD) are slowing faster than GDP
- ...
- ... However, both might overweight manufacturing activities vs services activities

In China, the rebalancing to services and urban employment goes on

China: sectorial breakdown

GDP %

Source: BBVA Research

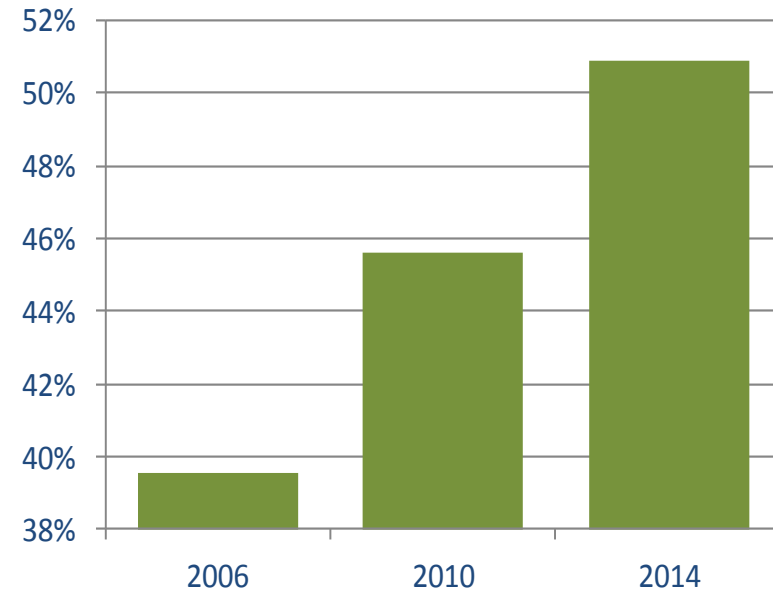


GDP, %	2013	2014	2015	2016
current forecast	7,7	7,3	6,7	6,2

China: urban employment, % total

GDP %

Source: BBVA Research

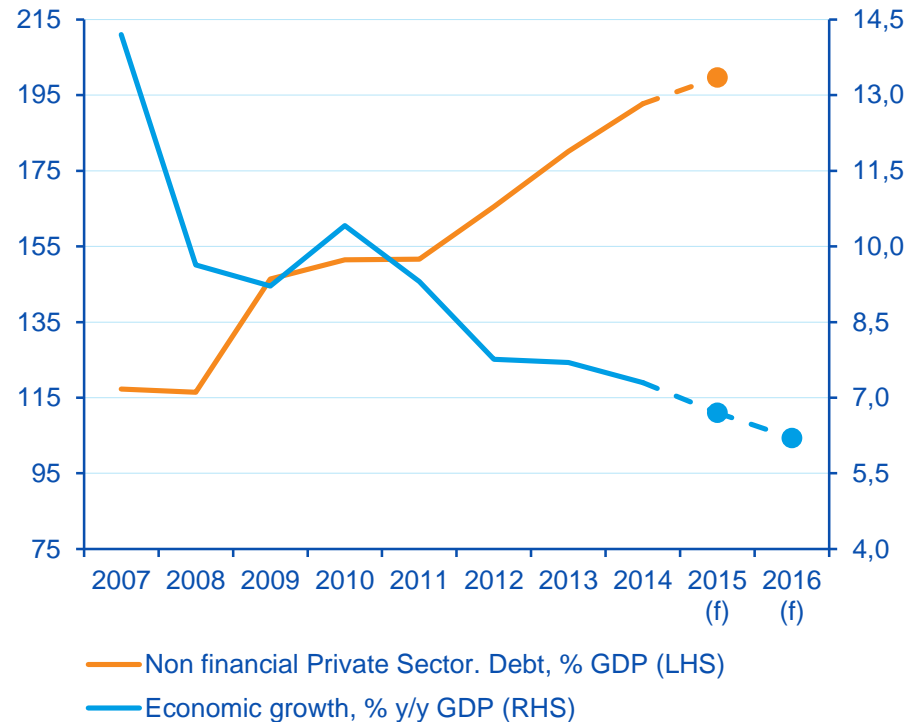


Urban Employment	2012	2013	2014
Annual change, millions	11.9	11.4	10.7

Still, risks are clearly biased to the downside as the challenges China faces are huge

China: debt and growth

Source: BBVA Research

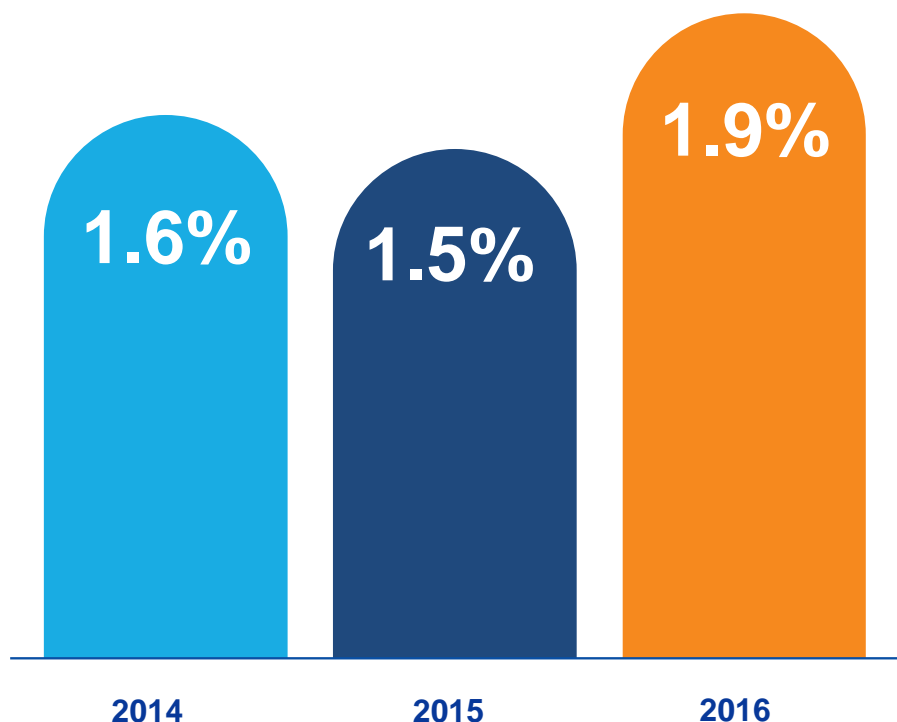


- China turned on the taps in 2008, pushing up debt leading to inefficient investments, and perhaps financial bubbles
- The risk: tensions between decentralizing economic decisions and keeping political control

Germany: robust domestic fundamentals

GDP growth

(%)

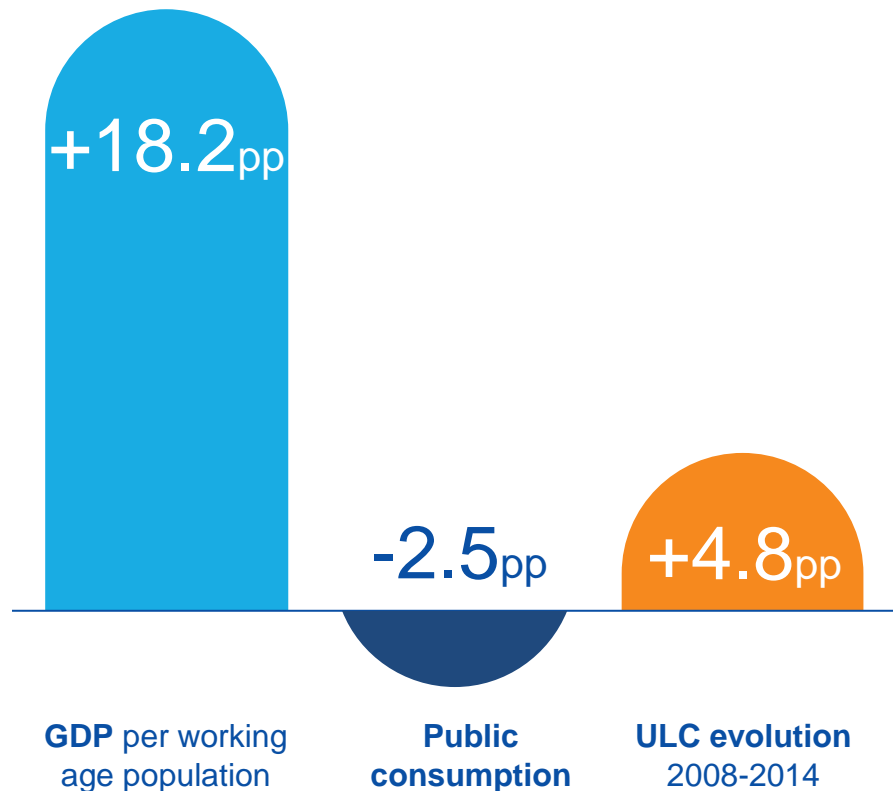


Source: Eurostat and BBVA Research

- Private consumption continues to grow at rates consistent with favorable labour market conditions
- Lower global demand hampers the growth of exports
- The uncertainty caused by geopolitical conflicts could lead businesses to further delay their investment plans to 2016

Germany: solid labour market

Deviation from EZ18 average (pp)

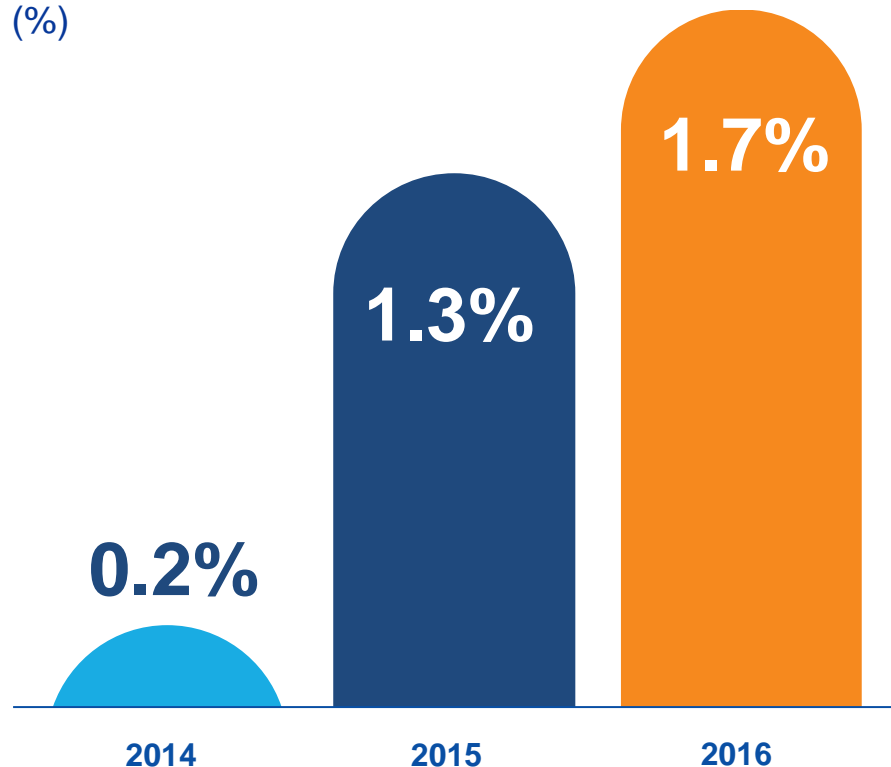


Source: BBVA Research and Eurostat

- The positive divergence with the average of the area is gradually expanding
- Increased public investment would help correct the current account surplus
- The competitive advantages of German companies from the rest of EMU have been reduced, mainly since 2012.

France: doubts in 2015 but more balanced growth expected in 2016

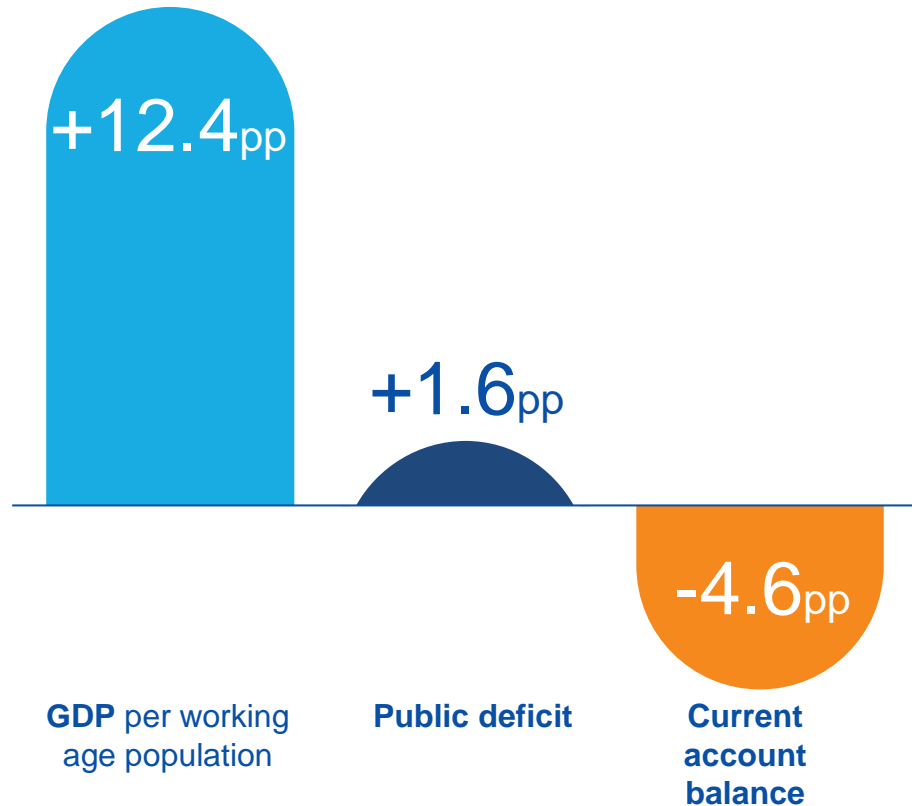
GDP growth
(%)



- The recovery in 2015 and 2016 will be based on domestic factors, especially consumption
- The delay in the adjustment of the deficit should also help
- The loss of competitiveness is the main problem in the medium term

France: the easing of fiscal targets will help the economy recover

Deviation from EZ18 average (pp)

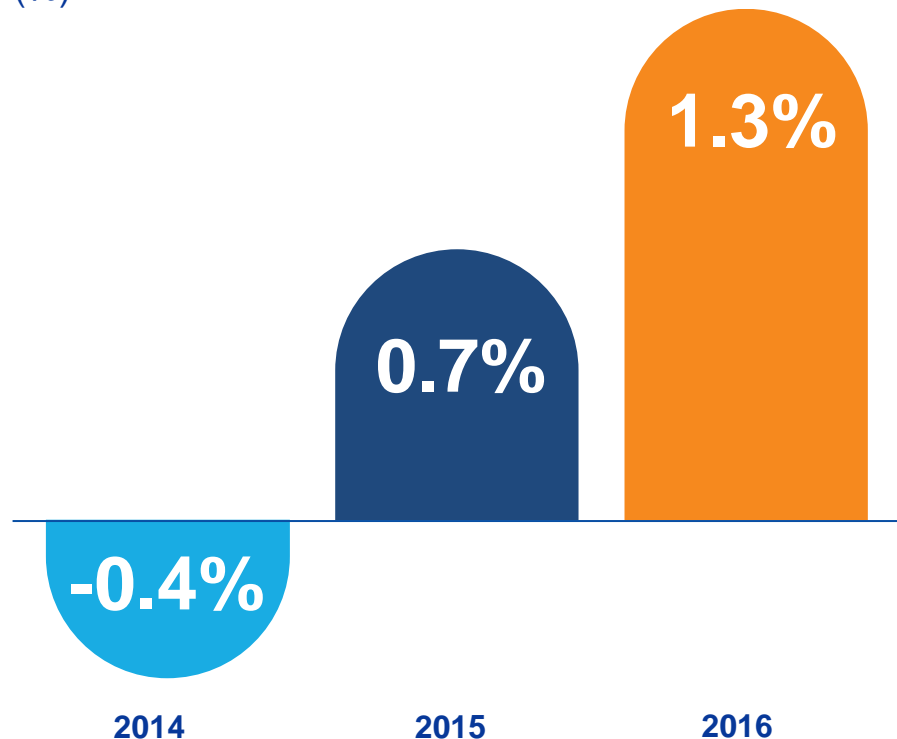


- Stable income above average
- Timid reforms underway
- France has failed to correct the current account deficit in recent years, as other countries did

Source: BBVA Research and Eurostat

Italy: more optimism, and moderate growth in 2015

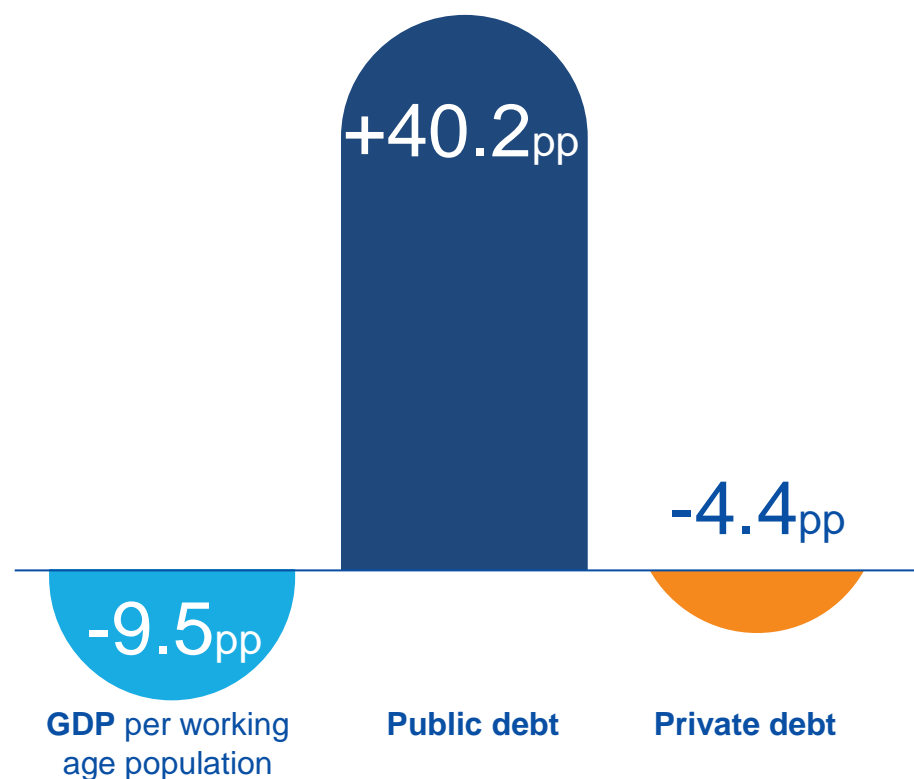
GDP growth
(%)



- We continue to expect a slow recovery in 2015 (0.7%), driven by exports and investment
- Investment will continue to improve as reforms aimed at improving the business environment are implemented
- The declaration of unconstitutionality of cost-cutting measures can slow fiscal adjustment

Italy: reforms are coming; they are badly needed to increase the growth potential

Deviation from EZ18 average (pp)



- Income has deteriorated sharply in the past two decades
- A slow privatization program is delaying debt reduction (132.1% of GDP in 2014)
- The private sector has been able to correct the high debt imbalance more rapidly