



BBVA

RESEARCH

Europe and Spain at the crossroads

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Risk of financial disruption

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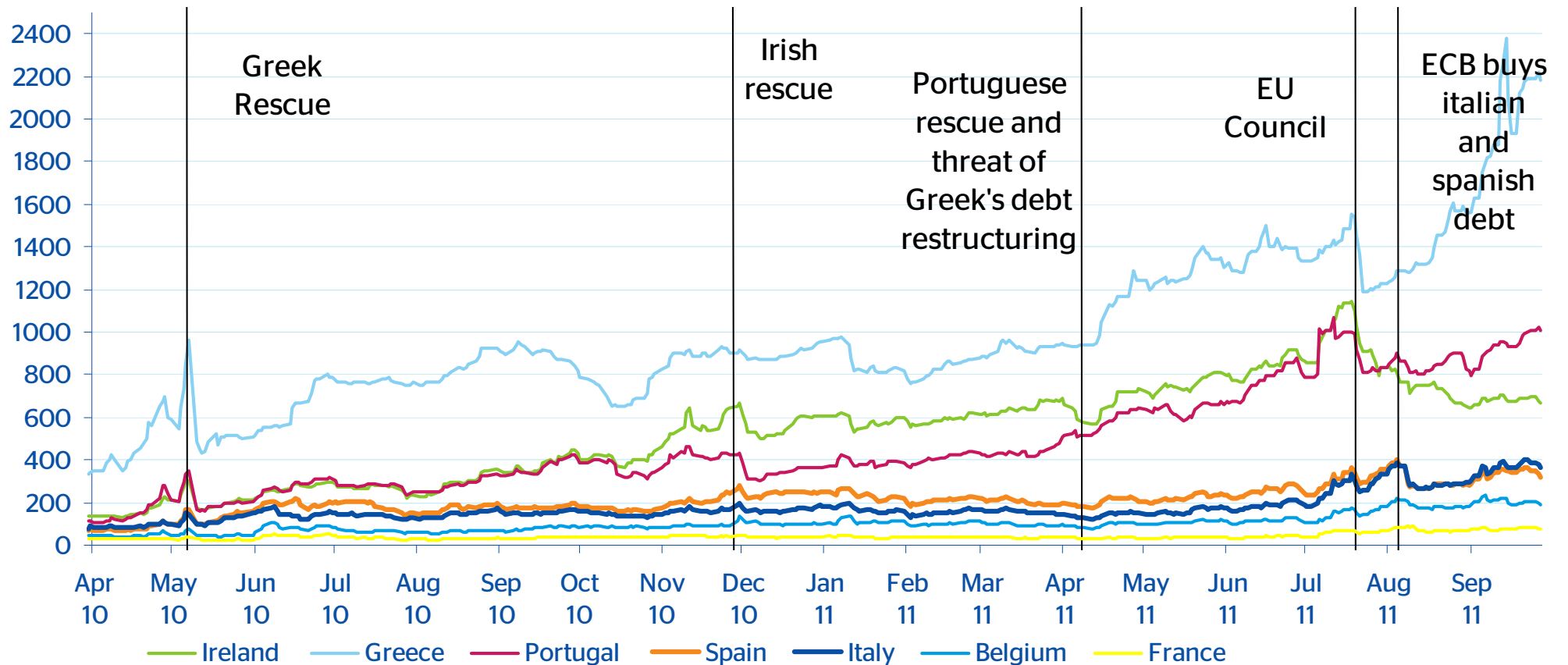
The split between developed and emerging economies in the long run

Section 1

The European sovereign crisis

Risk premium: 10-year bond yield spreads to Germany (bp)

Source: Bloomberg and BBVA Research



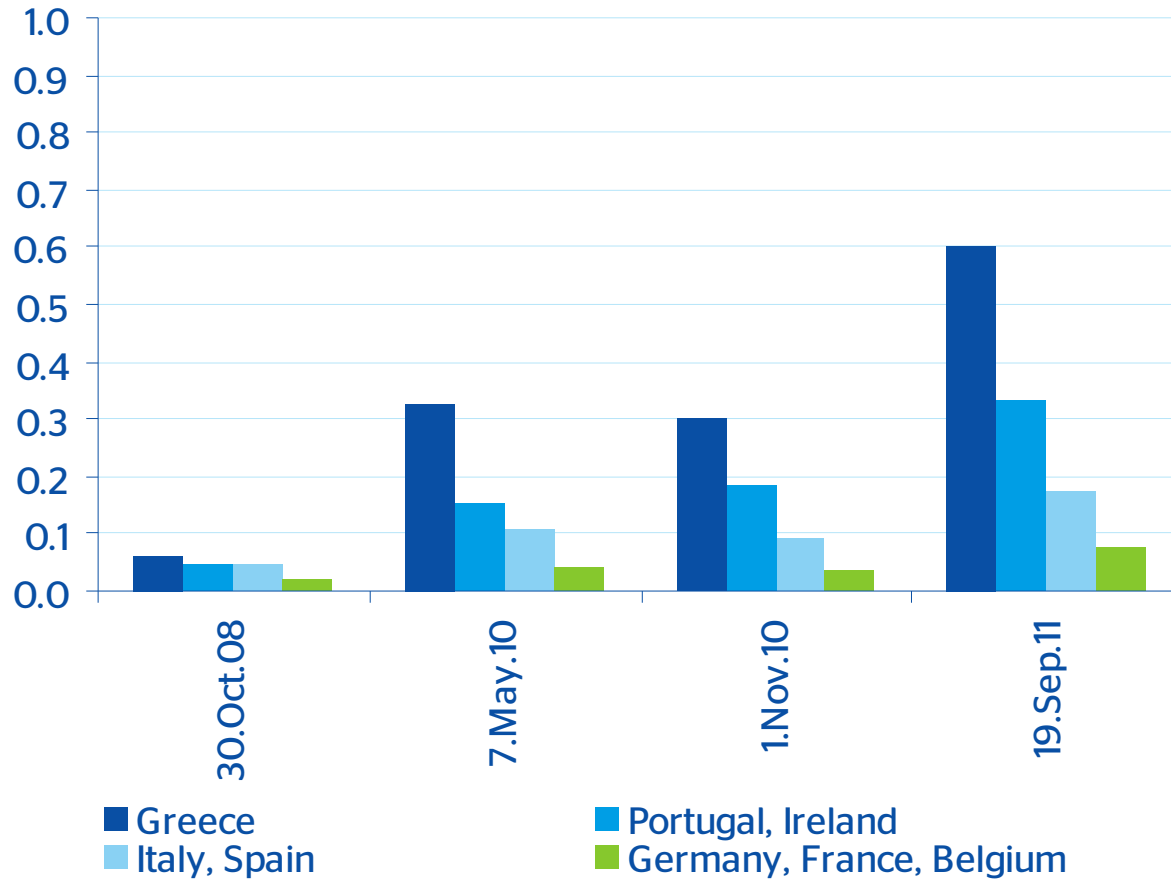
Section 1

Growing expected losses from EZ bonds

Market expected loss in 5Y government bonds

Derived from implicit default prob. In 5Y CDS; 40% recovery rate

Source: Bloomberg and BBVA Research own calculations

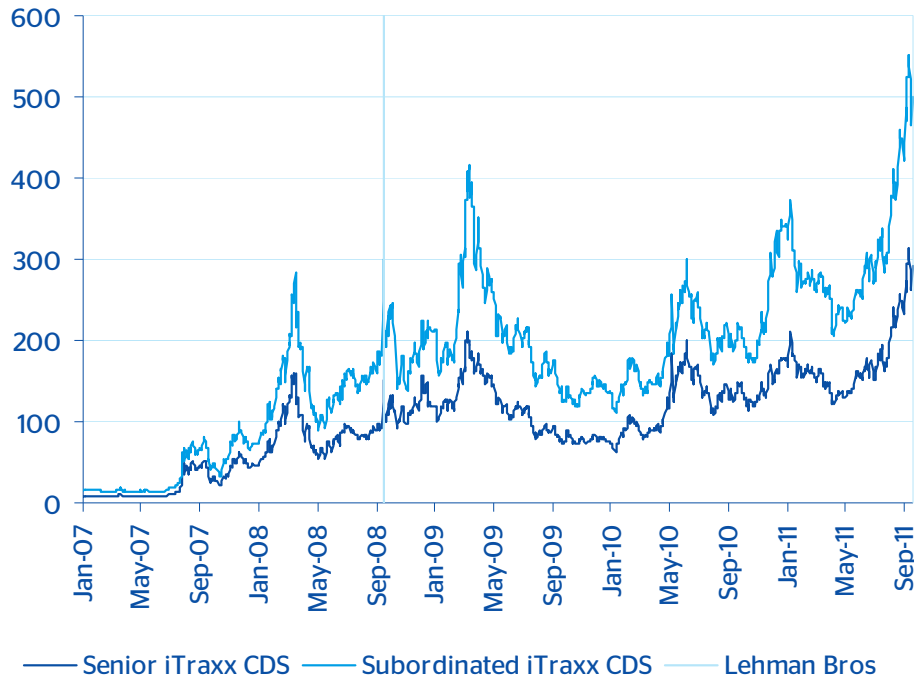


Section 1

Sovereign crisis feeds bank concerns

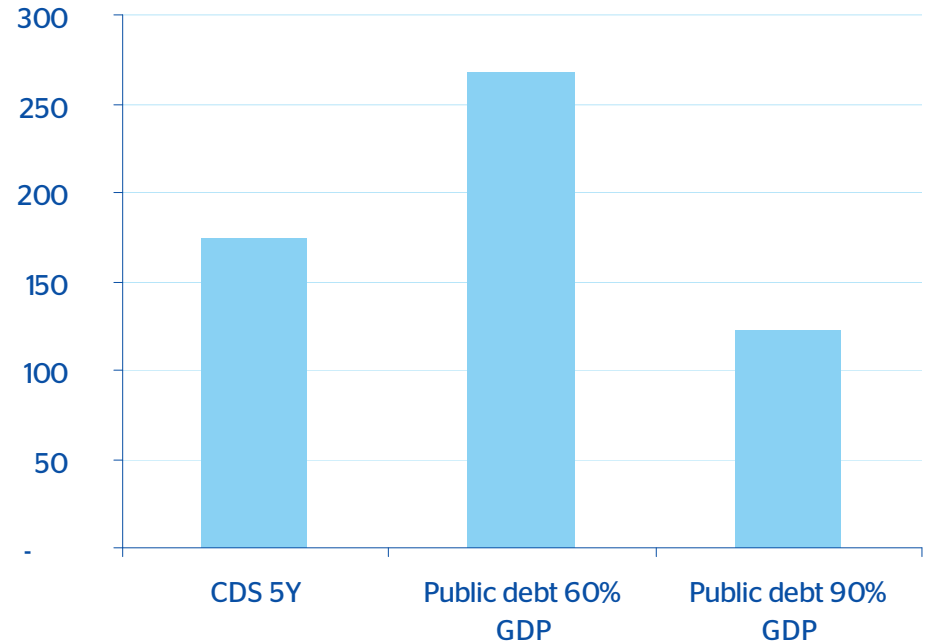
Credit market: Itraxx CDS (%)

Source: Bloomberg and BBVA Research



Losses in EBA bank sample due to sovereign* exposure (EUR bn)

Source: BBVA Research based on EBA and Bloomberg



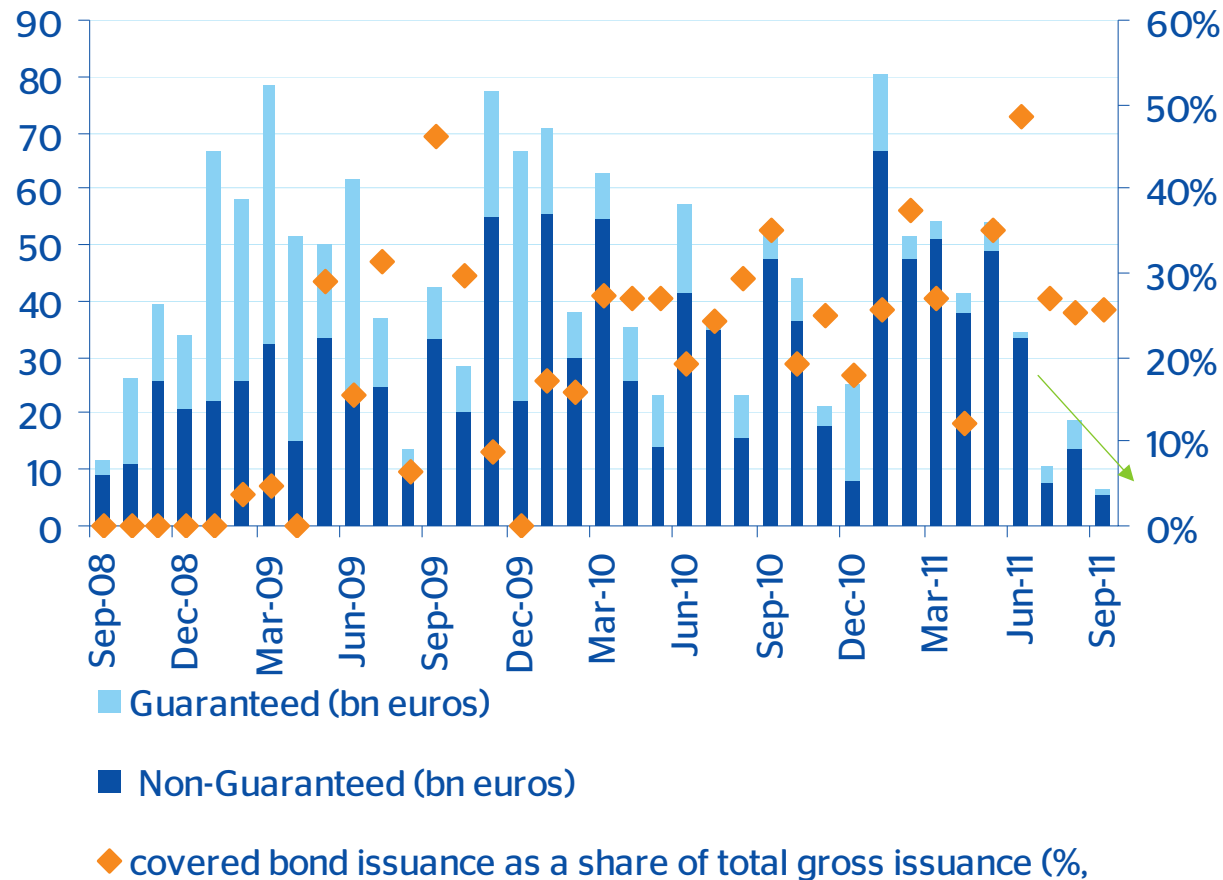
* Exposure to Portugal, Ireland, Greece, Spain, Italy and Belgium

Section 1

Bank issuance: markets virtually closed since June

European Banks bond issuance

Source: Bloomberg

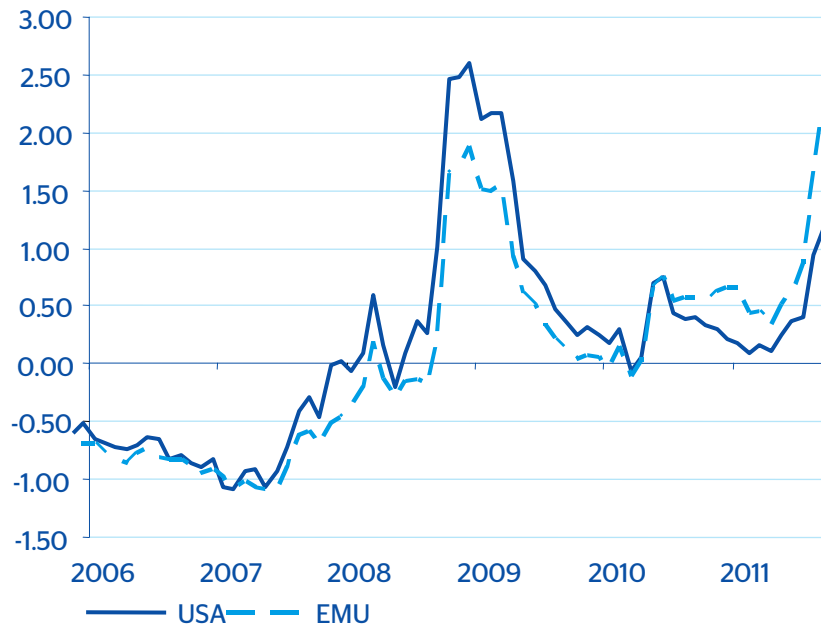


Section 1

Severe tensions in different financial market segments are a risk to growth

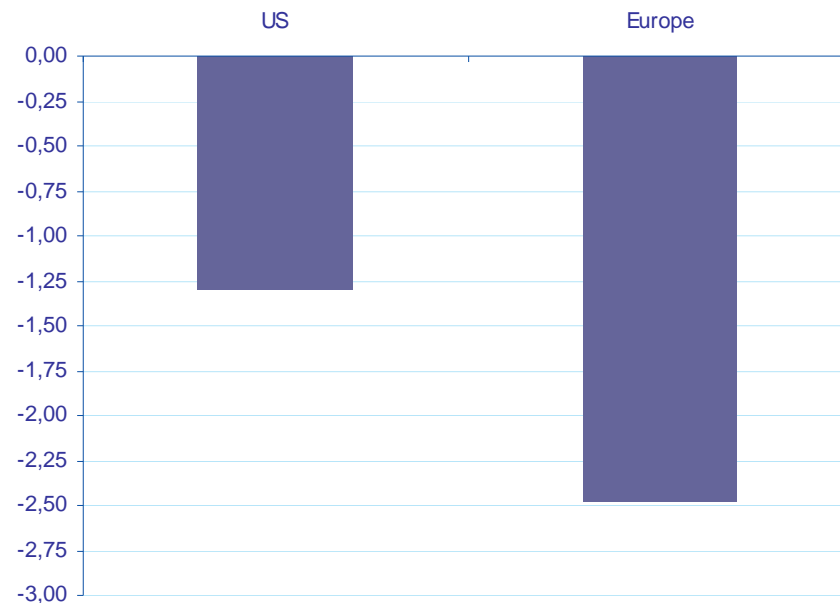
BBVA Financial Stress Index

Source: BBVA Research



Impact on 2012 GDP growth from a permanent shock in Financial Stress Index, pp

Source: BBVA Research



The outlook would be worse as:



- Option to “wait and see” for policy decisions
- Very slim margin for further policy stimulus
- Decelerating economic activity



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Section 2

Two paths to a viable monetary union

Possible solutions in the long term

1. Keep existing treaty, but more binding
2. Fiscal union: a Grand Bargain core-periphery losing fiscal sovereignty

A careful economic design (with stronger public and private surveillance) but mainly a political decision

Short-term measures

- Distinguish liquidity from solvency problems: ring-fencing in exchange for reforms
- Address liquidity problems: breaking the sovereign - banking vicious circle

Main trade-off: instability versus incentives

Debt restructuring and isolate Greece

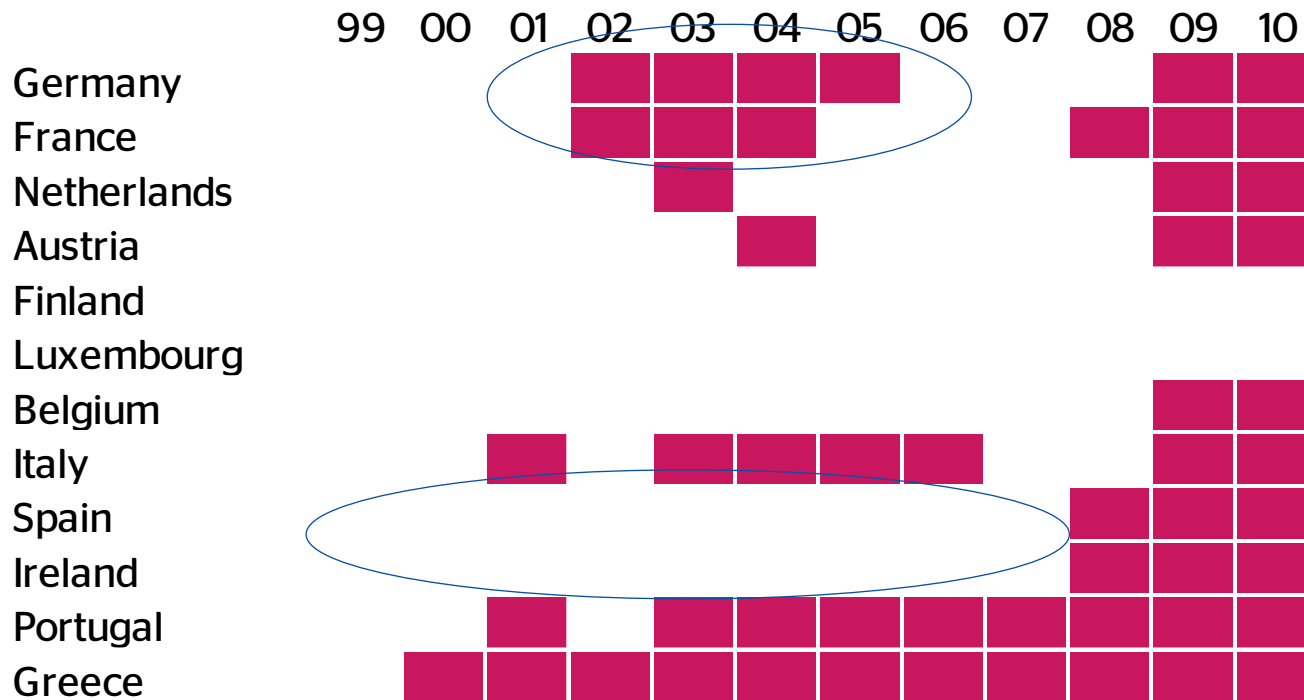
ECB: flexible, unlimited support but without formal conditionality

EFSF: conditional support but less flexible, more limited than the ECB

Did the Stability and growth Pact (SGP) act as useful prevention mechanism?

Years with public deficit above the SGP's 3% limit

Source: BBVA Research and Eurostat



- Both in Spain and Ireland, bubbles in the private sector led authorities to consider an increase in revenues as permanent
- Result: rising expenditures and high deficits when bubbles burst.

- Not considering structural deficits led to excessively low surplus in good years (+3% Ireland, +2% Spain)

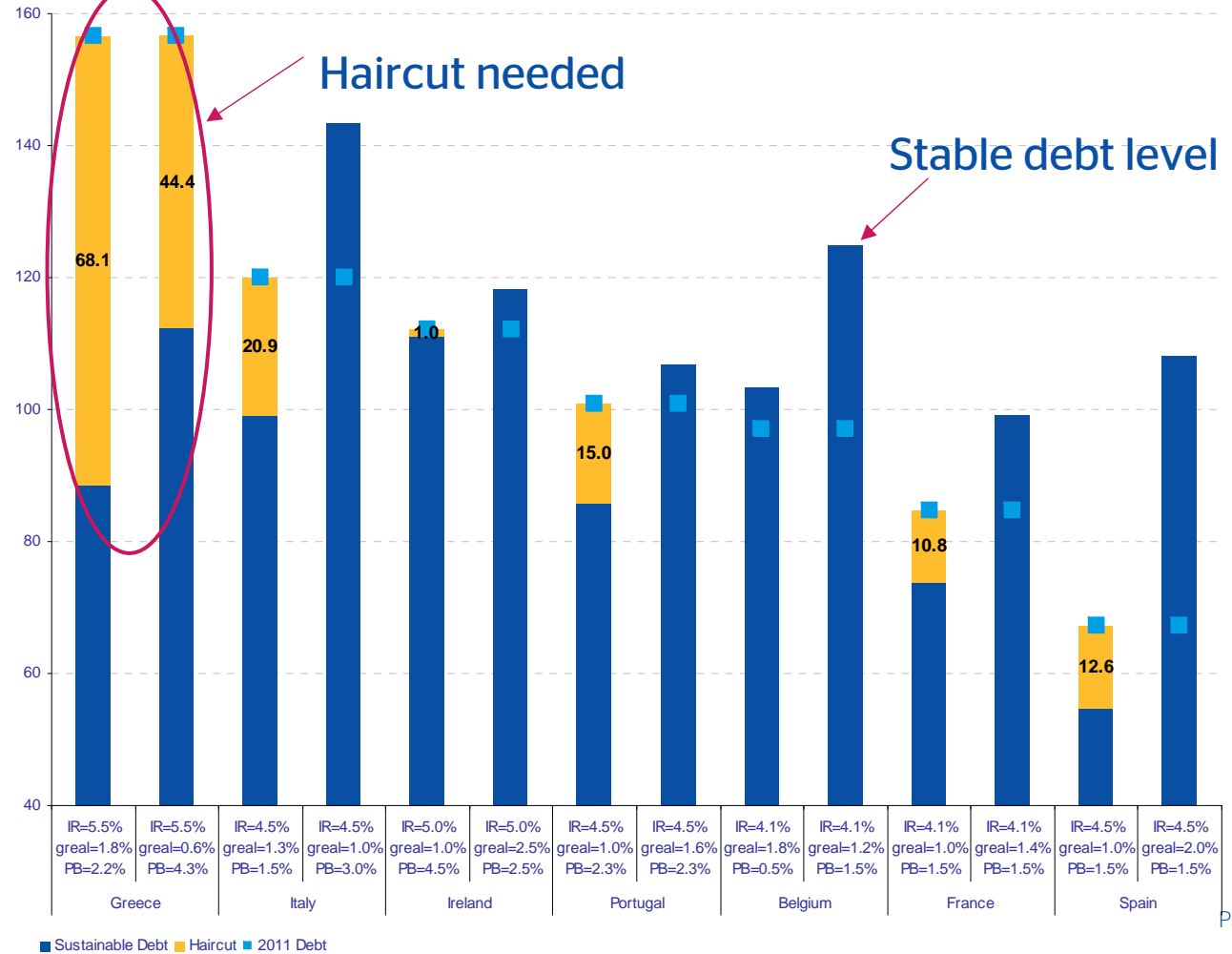
Section 2

Greece's public debt is not sustainable, but other countries' is.

For each country, we present two feasible scenarios combining parameters of real growth (g), primary balance (PB) and interest rates (IR).

Haircut to sustainable debt

Source: BBVA Research

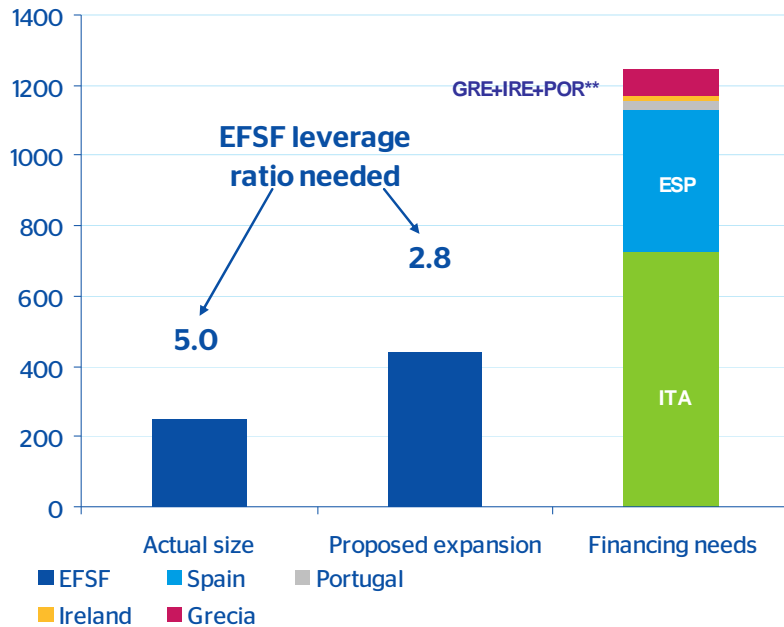


Section 2

EFSF: is leverage with the ECB an option?

GIIPS financing needs* and EFSF resources (EUR bn)

Source: BBVA Research



* Maximum amount to cover all peripherals' 3-year public financing needs

** Includes 43 bn EUR committed to POR&IRE, and an estimated €70 bn to cover Greece's deficit and the cost of potential bank recapitalization.

An expansion of EFSF could threaten AAA rating

Leveraging with ECB possible but ECB balance sheet risk

EFSF as an insurance scheme?

EFSF opened to other investors?

EFSF needs to be part of the solution, as it allows to impose conditionality

International coordinated help (IMF)?



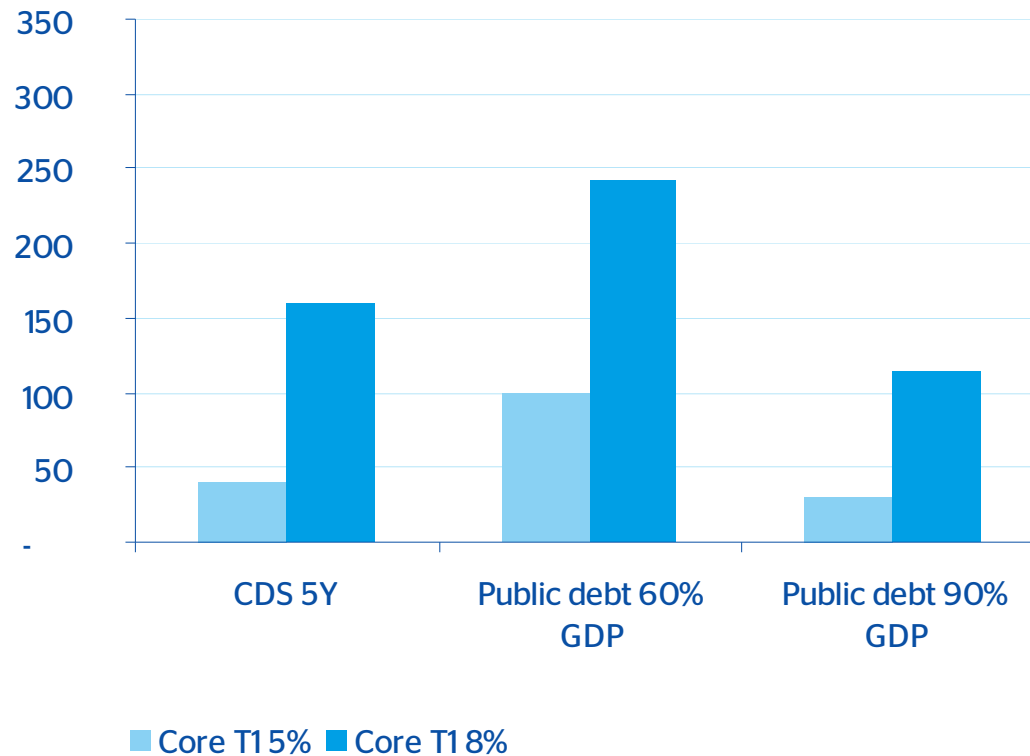
Section 2

Is bank recapitalization the best option?

Solving the sovereign crisis with bank capital makes little sense if done in isolation

Capital needs including losses due to sovereign* exposure (EUR bn, 2010)

Source: BBVA Research based on EBA and Bloomberg



* Exposure to Portugal, Ireland, Greece, Spain, Italy and Belgium

Section 2

Scenarios with higher uncertainty

Baseline Scenario

- ECB will continue buying bonds to prevent a bond market meltdown, while improved EFSF is approved and implemented (and possibly augmented)
- Bank recapitalization program.
- Greece meets IMF/EU program targets without major disruptions
- Financial tensions slowly decrease

**Weak growth,
elevated financial stress for quite some time.**

High but decreasing probability

Risk scenario

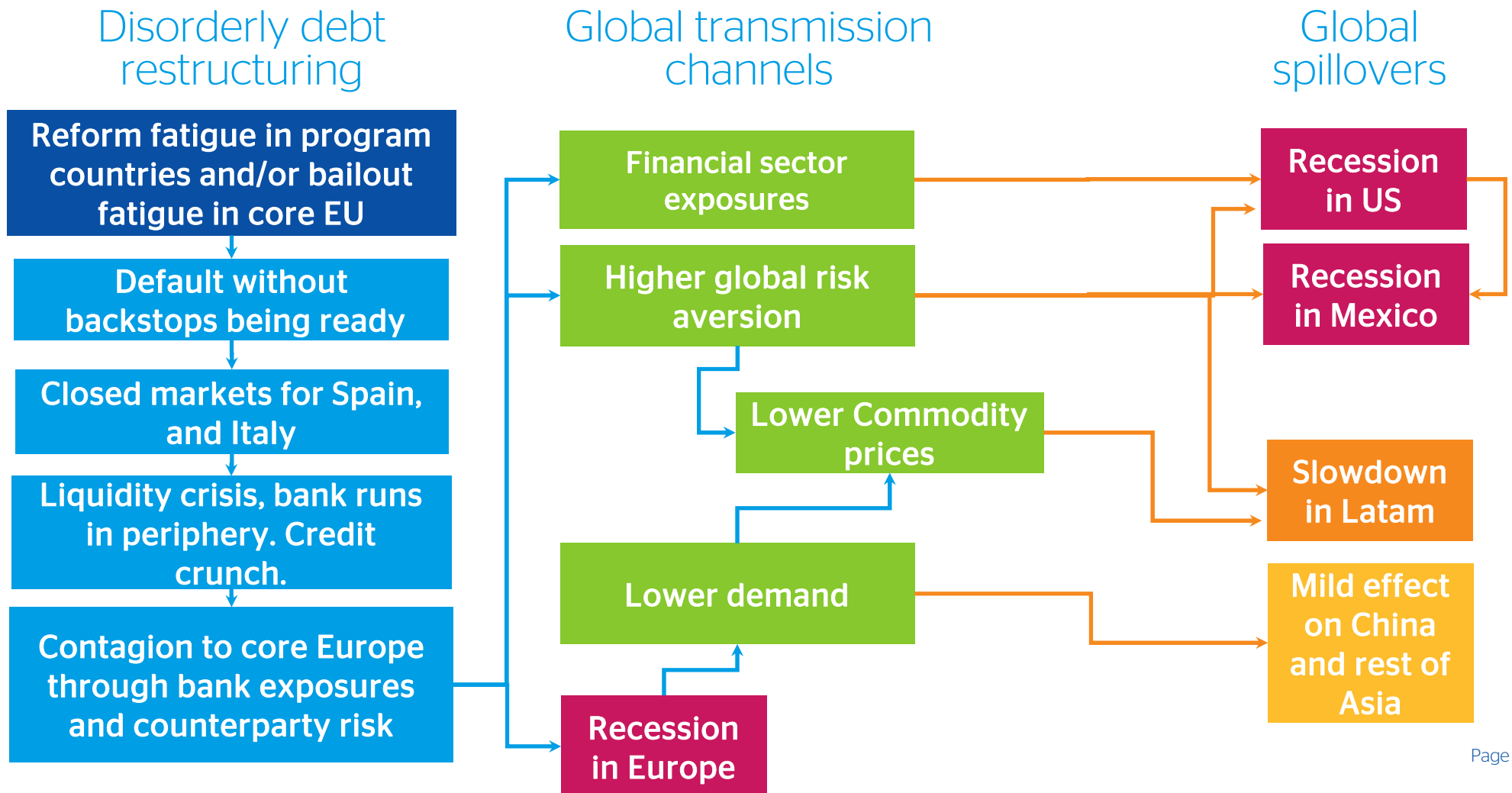
- Many potential triggers for this scenario:
 - Greek default
 - Failure to approve or implement new EFSF
 - An “accident” in some European bank
 - Increased cyclical weakness

**Recession in advanced countries
(more so in Europe).**

Medium and increasing probability

Section 2

A crisis in Europe would have global spillovers





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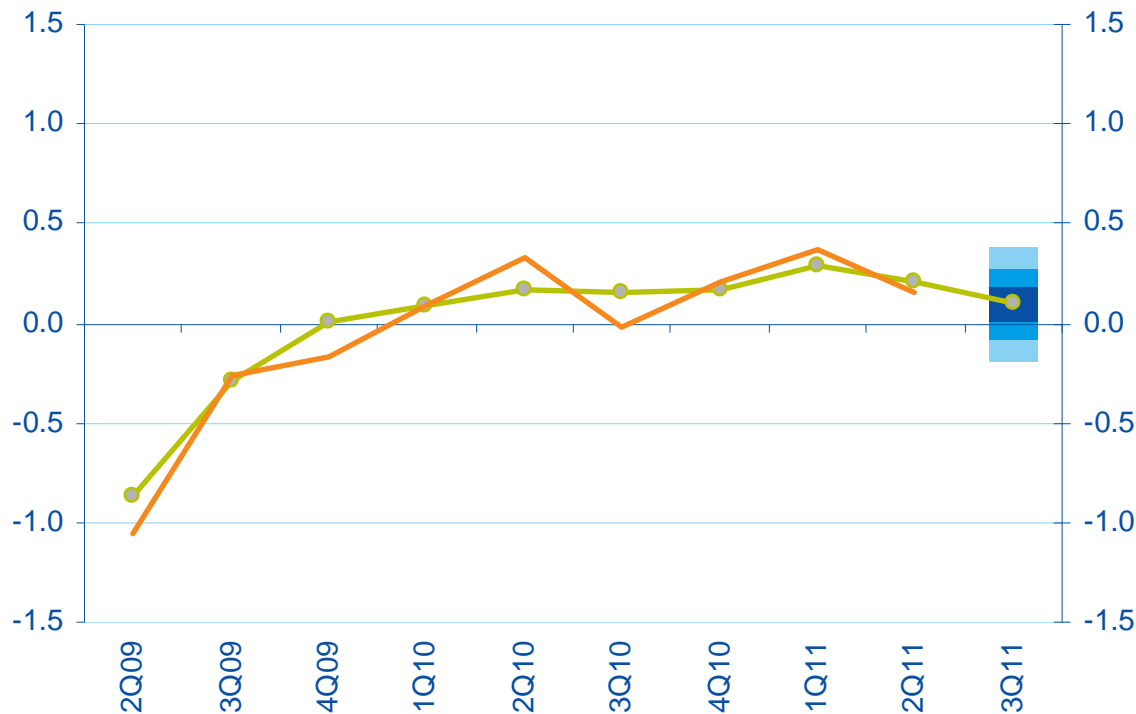
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Spain outlook: growth still weak

Spain: observed GDP growth and forecasts based on the MICA-BBVA model (% q/q)

Source: BBVA Research based on INE
Actual forecast: Sept 8th 2011



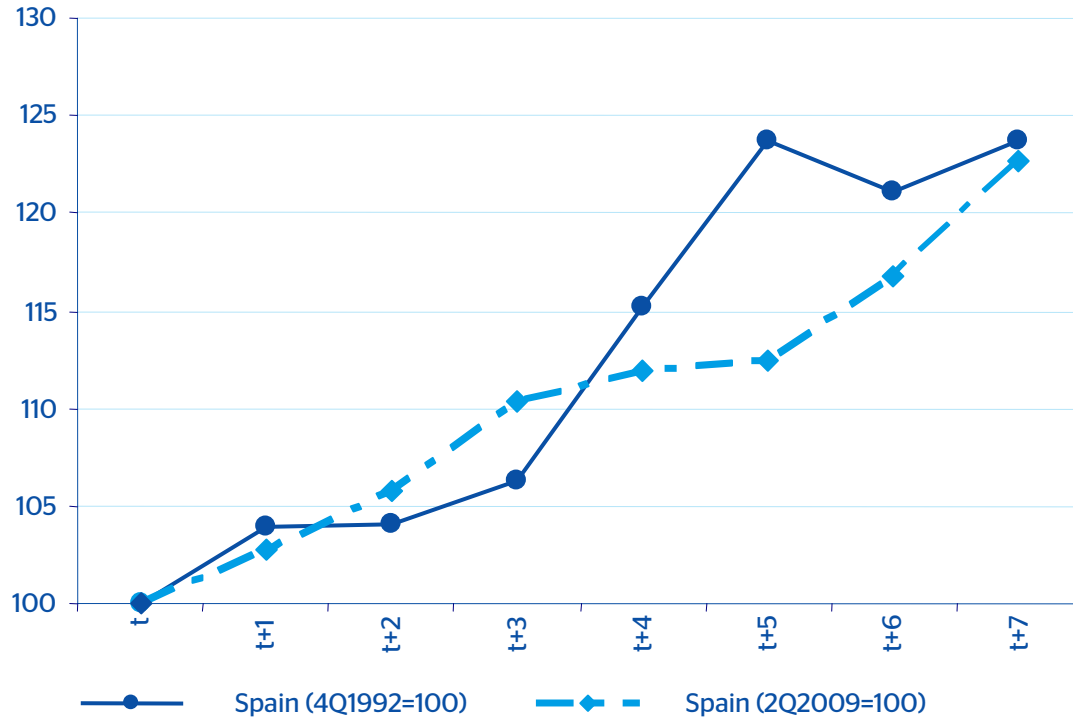
- Lack of job creation
- Weak domestic demand, fiscal adjustments
- Negative contribution to growth by domestic demand
- Foreign demand is the main driver

Section 3

Spain: foreign trade

Quarterly evolution of real goods and services exports in two end of crisis episodes

Source: BBVA Research



Note: t corresponds to the quarterly minimum in each cycle

Overall, goods and services exports:

- Above pre-crisis levels
- Performance in line with the recovery after the crisis in the 90s despite the absence of currency devaluation as in the past
- Diversified growth (sectors and countries) → [BBVA Research Web](#)

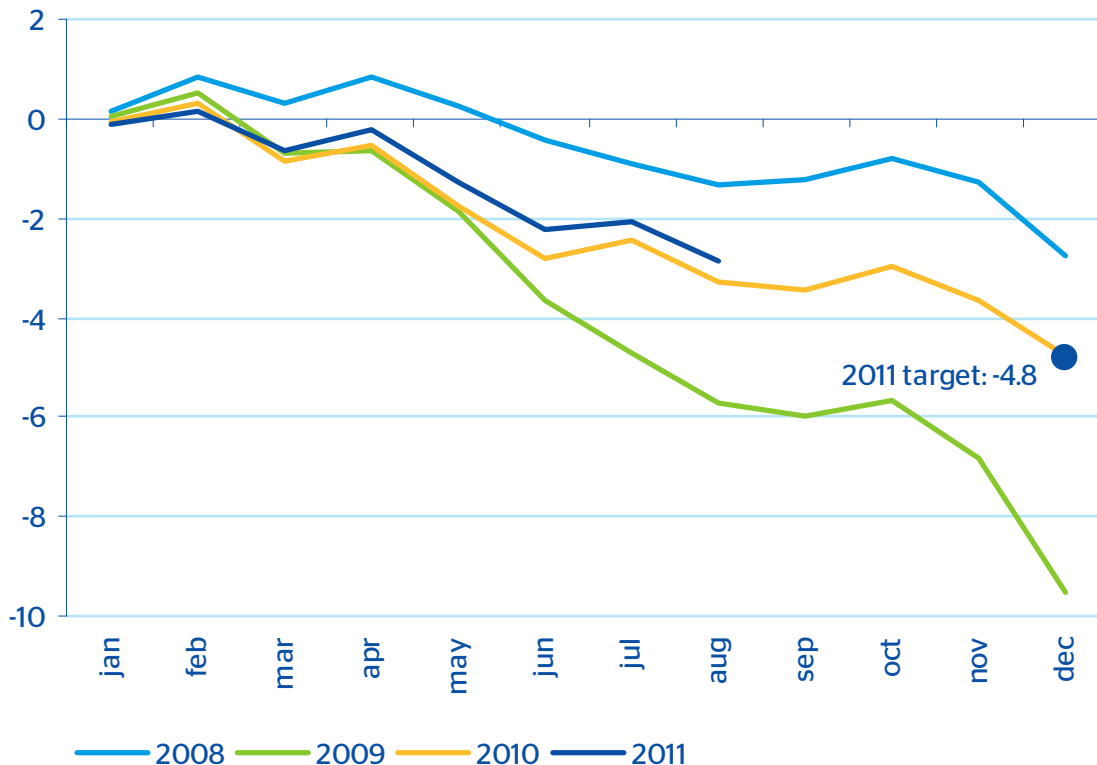
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Spain: budgetary performance

The Central Government will comply on the expenditure side, but increasing doubts in the Social Security and regional government budgets.

Central Government budget balance

(Accumulated over the year as percentage of GDP)
Source: BBVA Research based on MEH



Doubts on regional government budgets

Constitutional reform, binding in 2019.

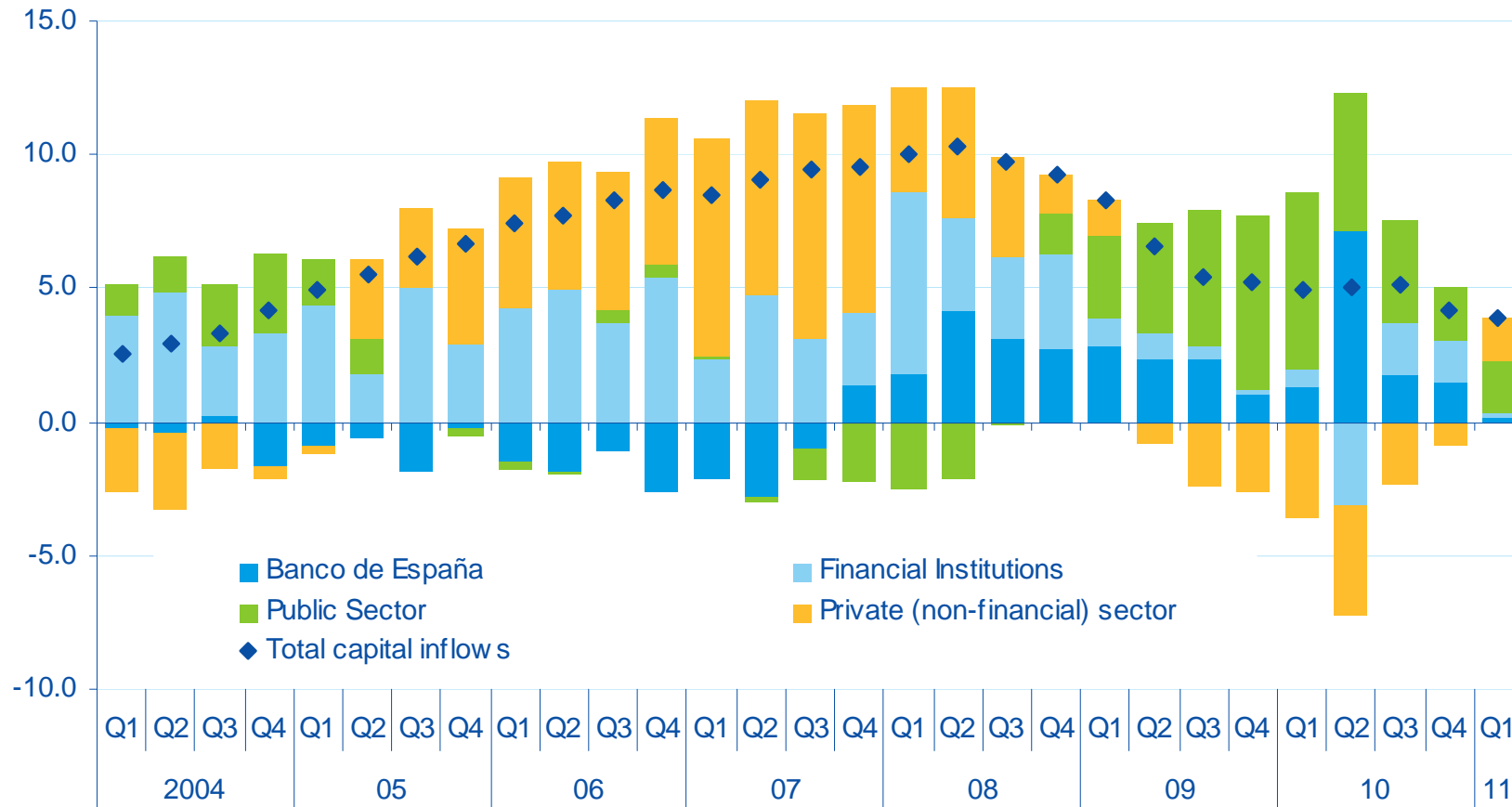


Section 3

Spain: external financing

Spain: current account deficit and its financing by type of agent (%GDP)

Source: BBVA Research based on Bank of Spain





Section 3

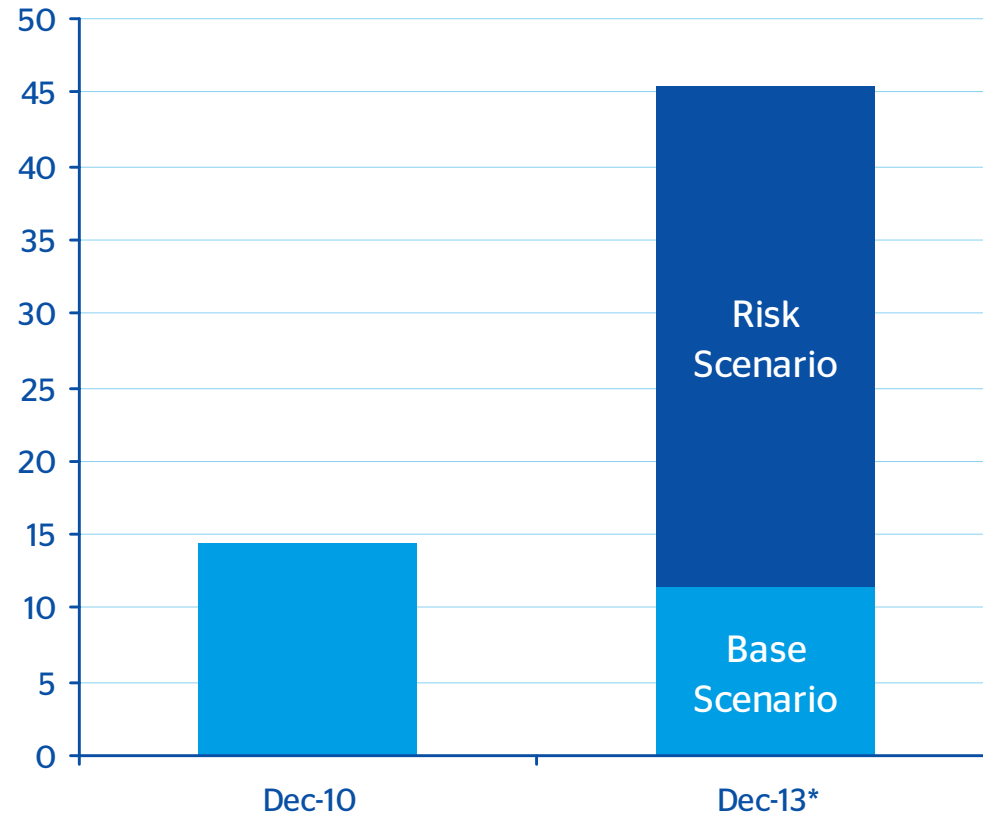
Bank restructuring

Problems are concentrated in some entities (1/3 of the system), as those with liquidity problems are often those with the poorest solvency

Capital needs

(Accumulated bn EUR, it does not include de 15,3tM already injected)

Source: BBVA Research



* 8% Minimum Capital Tier 1

Section 3

Spain needs to step up reforms

Need for structural reform in developed countries

Source: IMF and BBVA Research

	Developed Countries												Eurozone			
Medium Term	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE
Labor market	Green	Green	Green	Orange	Red	Orange	Orange	Orange	Green	Green	Orange	Green	Red	Red	Red	Red
Corporate regulations	Green	Green	Green	Orange	Orange	Green	Red	Orange	Orange	Green	Green	Orange	Red	Orange	Orange	Red
Network regulations	Green	Green	Red	Green	Orange	Green	Green	Green	Orange	Green	Green	Orange	Green	Orange	Orange	Red
Retail	Green	Green	Green	Green	Orange	Green	Red	Red	Orange	Orange	Green	Green	Orange	Orange	Orange	Red
Professional services	Green	Green	Green	Red	Orange	Green	Orange	Orange	Green	Green	Green	Green	Orange	Red	Orange	Red

Long term

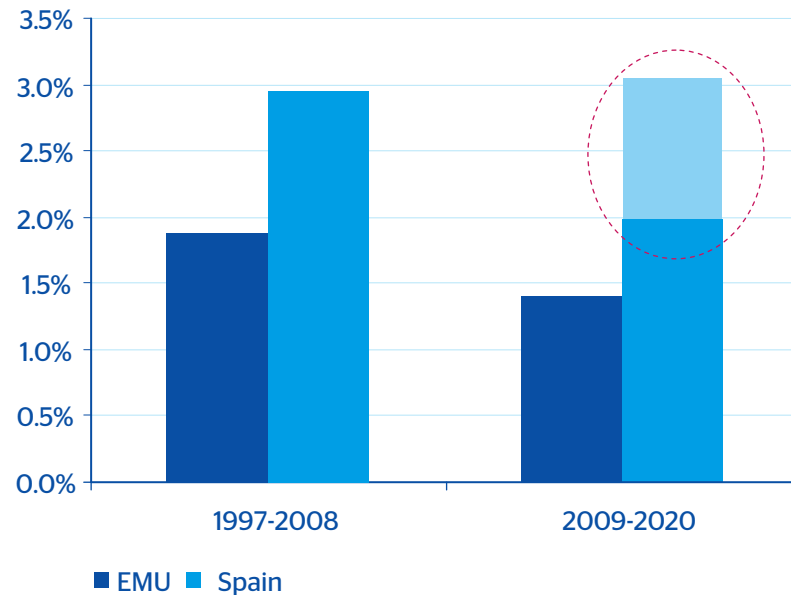
Institutions and contracts	Green	Orange	Orange	Green	Orange	Green	Orange	Green	Green	Green	Orange	Orange	Orange	Red	Red	Red
Human capital	Orange	Orange	Green	Orange	Orange	Green	Green	Orange	Green	Green	Green	Green	Red	Red	Red	Red
Infrastructure	Green	Green	Red	Green	Green	Green	Orange	Orange	Orange	Green	Green	Green	Green	Red	Orange	Red
Innovation	Green	Green	Orange	Green	Green	Green	Green	Orange	Orange	Green	Green	Green	Red	Orange	Red	Red
Average	Green	Green	Orange	Orange	Orange	Green	Orange	Orange	Orange	Green	Green	Green	Orange	Red	Orange	Red

Section 3

Ambitious reforms will pay in the medium-run

Spain vs. EMU: potential GDP (% a/a)

Source: BBVA Research



- Baseline scenario: 1 pp reduction in the unemployment rate per year during the next decade (13y to 8%)
- Structural reforms: higher potential growth and lower structural unemployment (7y to 8%)

GDP growth and its components (contribution in pp average per period)

Fuente: BBVA Research

	Potential Growth		Capital		TFP		Employment	
	1997-2008	2009-2020	1997-2008	2009-2020	1997-2008	2009-2020	1997-2008	2009-2020
Spain	2,9%	2,0%	1,2%	0,6%	0,5%	0,9%	1,3%	0,4%



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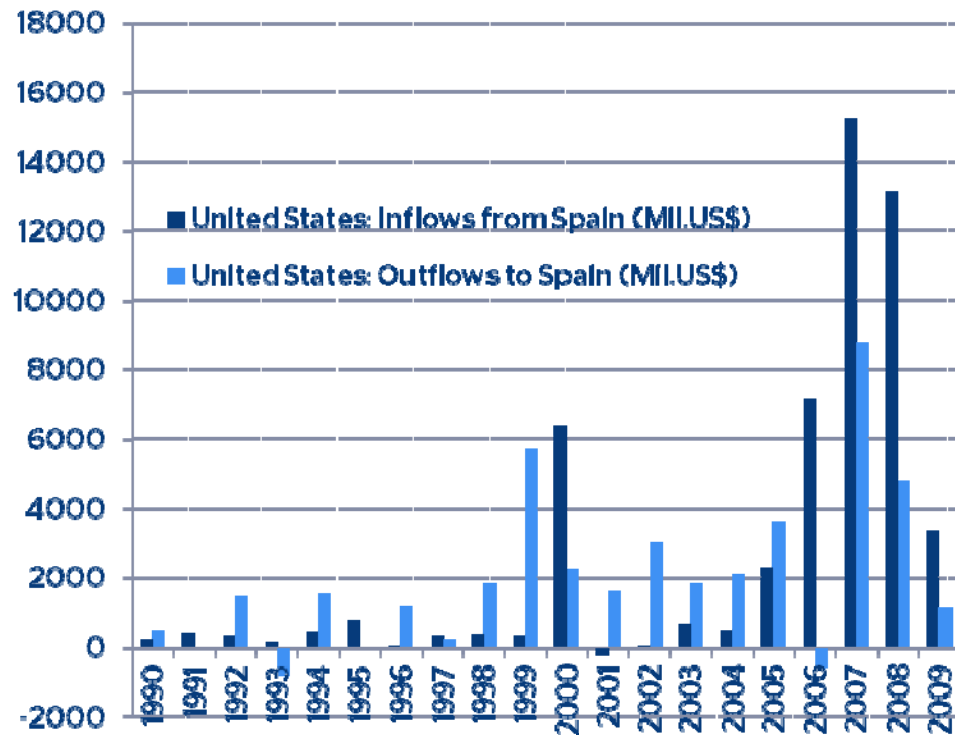
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Spain and US: Foreign Direct Investment

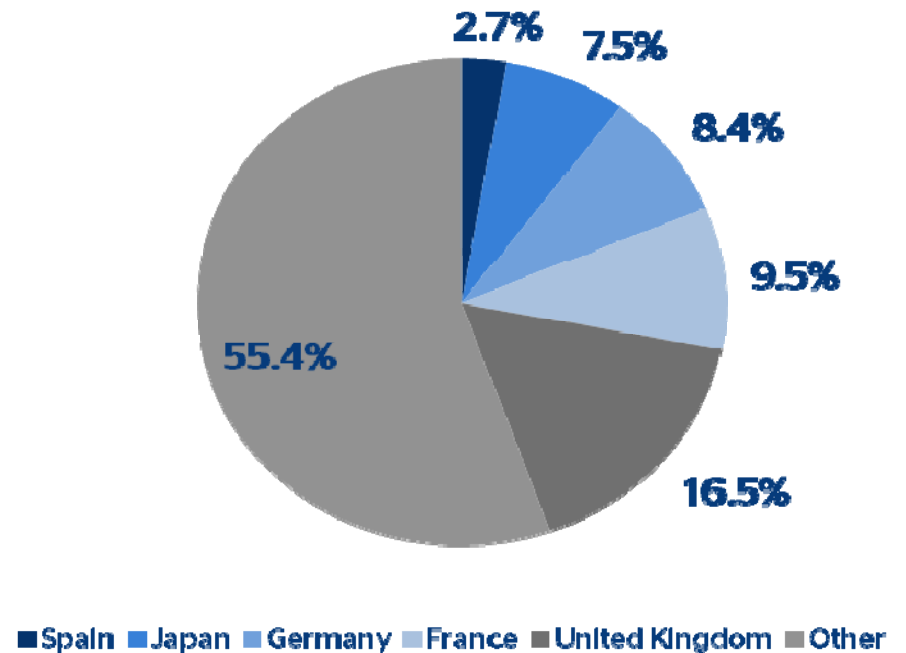
Foreign Direct Investment (USD mill.)

Source: Haver Analytics



Foreign Direct Investment in the U.S. (share of total)

Source: Haver Analytics



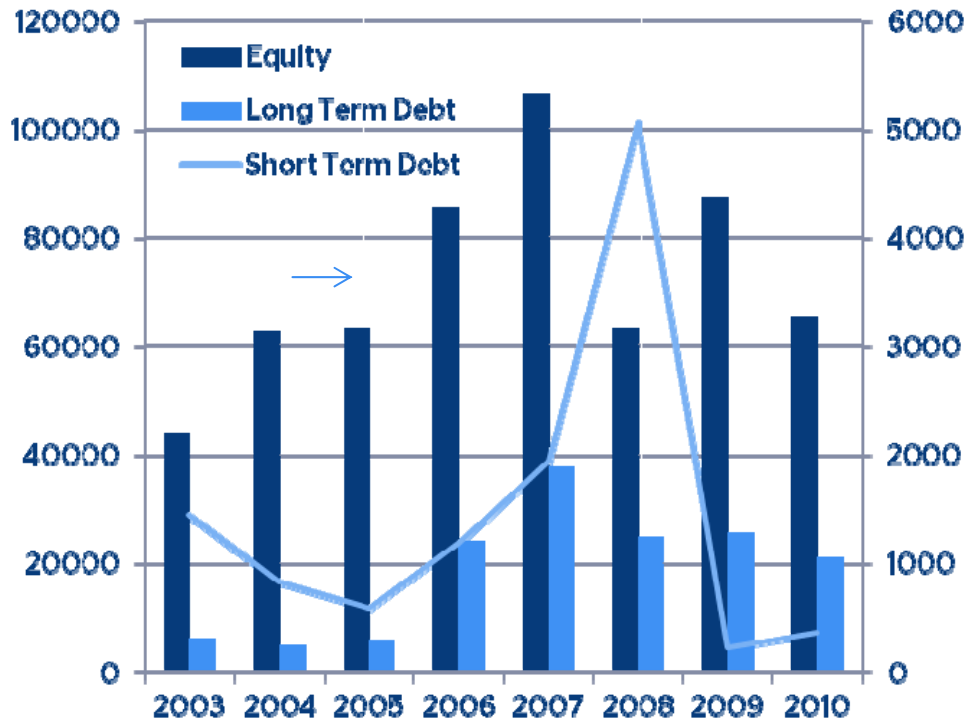


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Spain and US: Portfolio Investments

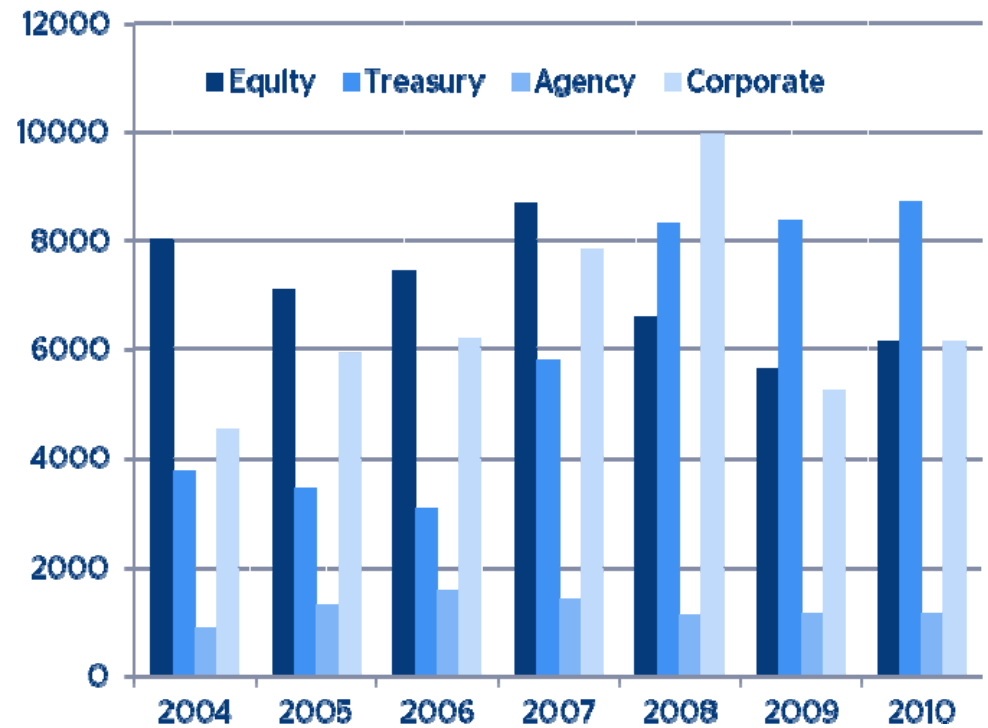
U.S. holdings of Spain's debt securities (USD mill.)

Source: Haver Analytics



Spain holdings of U.S. debt securities (USD mill.)

Source: Haver Analytics

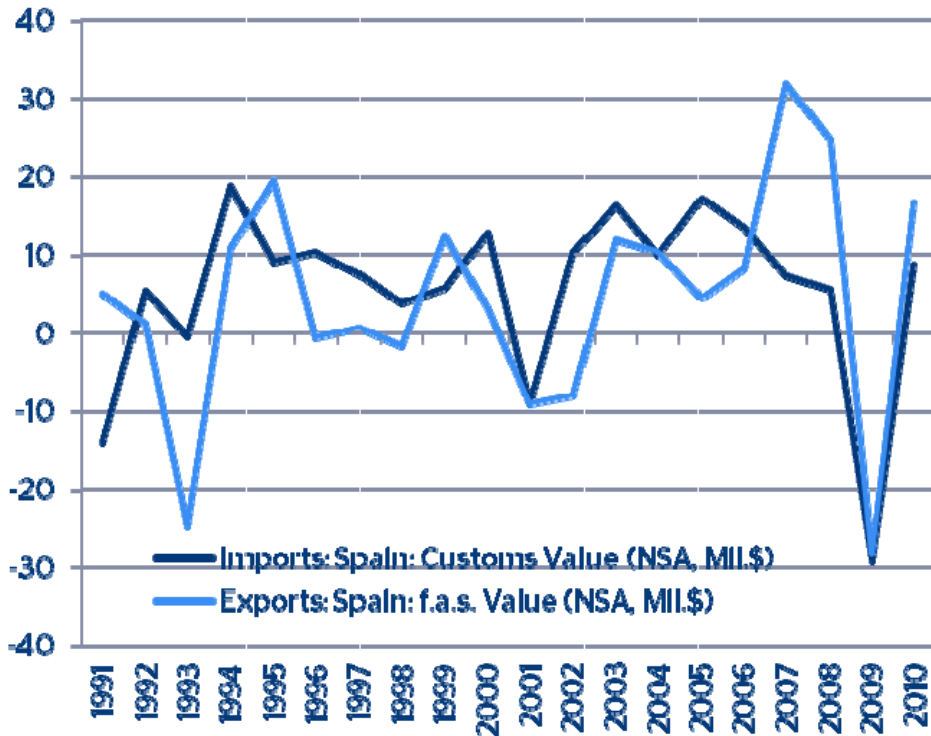


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Spain and US: International Trade

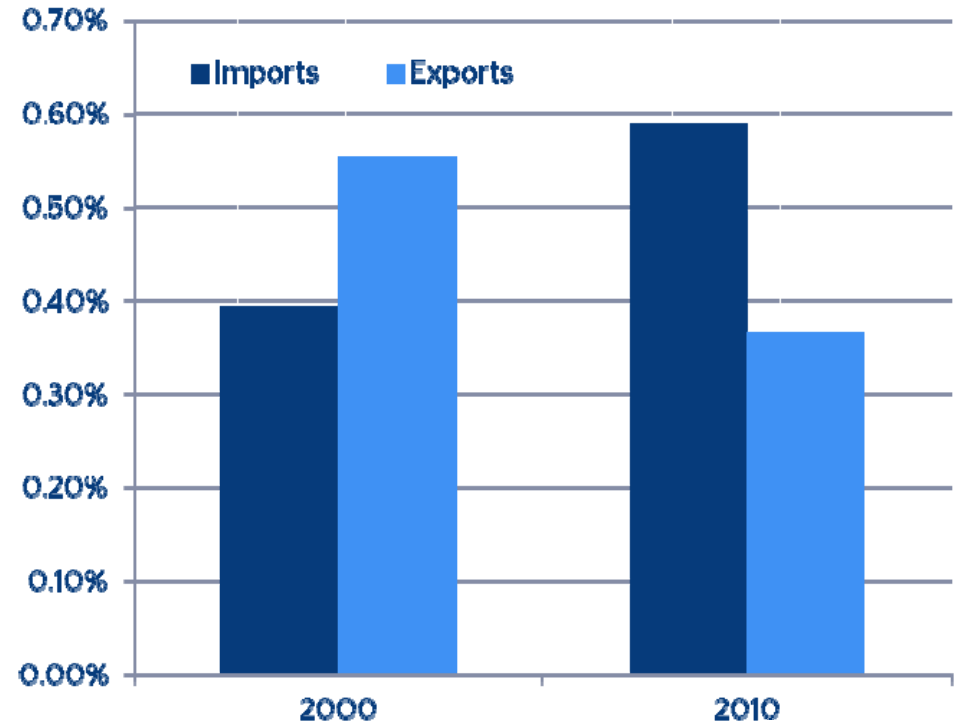
U.S. trade with Spain (% yoy)

Source: Haver Analytics



U.S International Trade with Spain (share of total, %)

Source: Haver Analytics



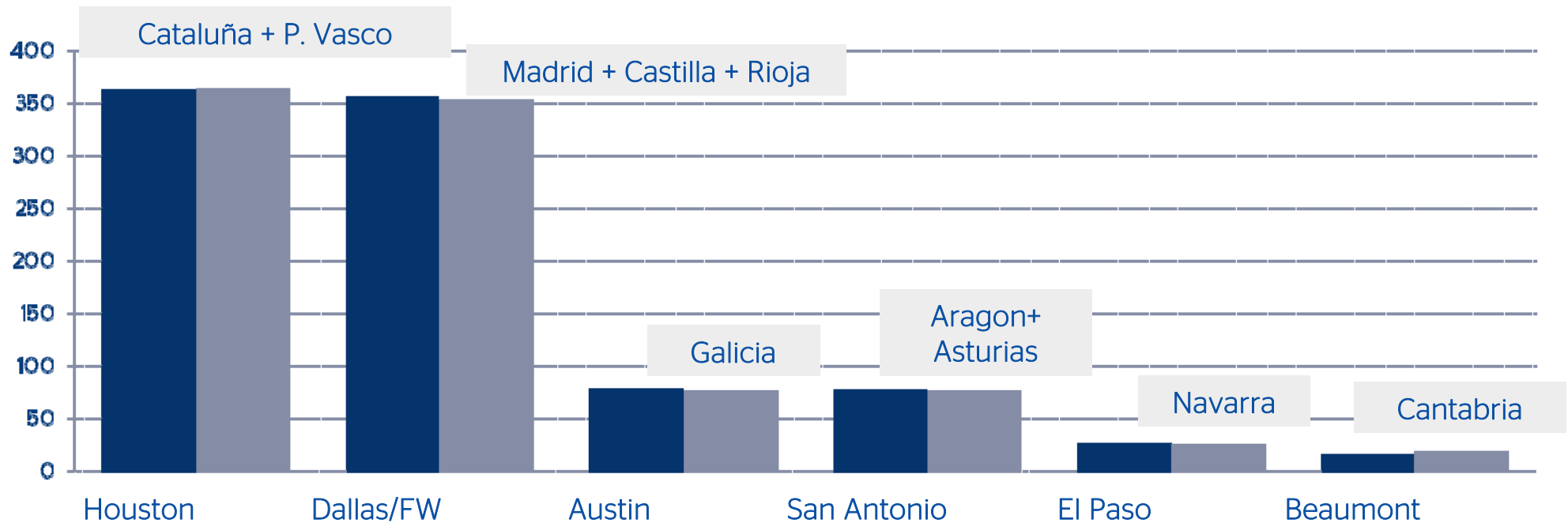
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Texas vs. Spain

	Texas	Spain
Land area, 2000 (square miles)	261,797	195,364
Population (millions)	25.1	46.7
Persons per square mile, 2000	96	239
GDP (\$trillions)	1,207	1,411
GDP per capita (\$)	50,294	30,232
Employment (millions)	10.3	18.8

Gross Domestic Product (USD mill.)

Source: BBVA Research





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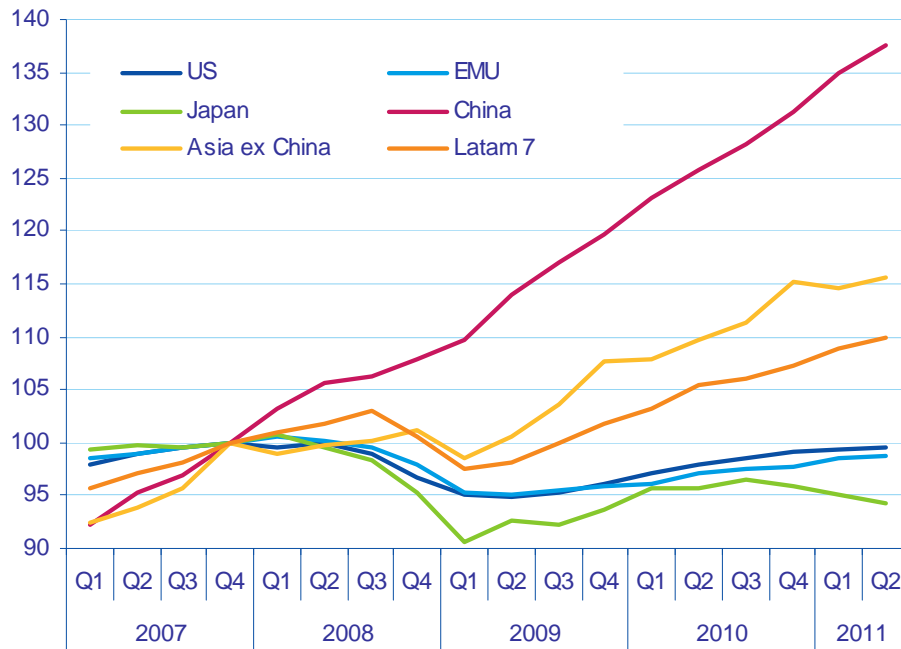
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Divergence between developed countries and EMEs, in levels and potential growth

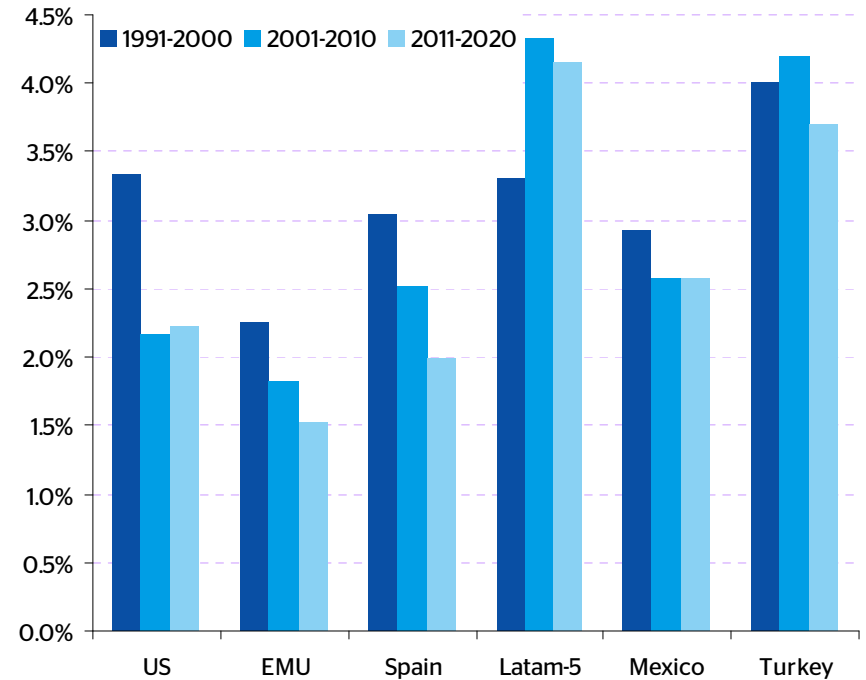
GDP levels (2007Q4=100)

Source: BBVA Research



Potential growth (% yoy average)

Source: BBVA Research



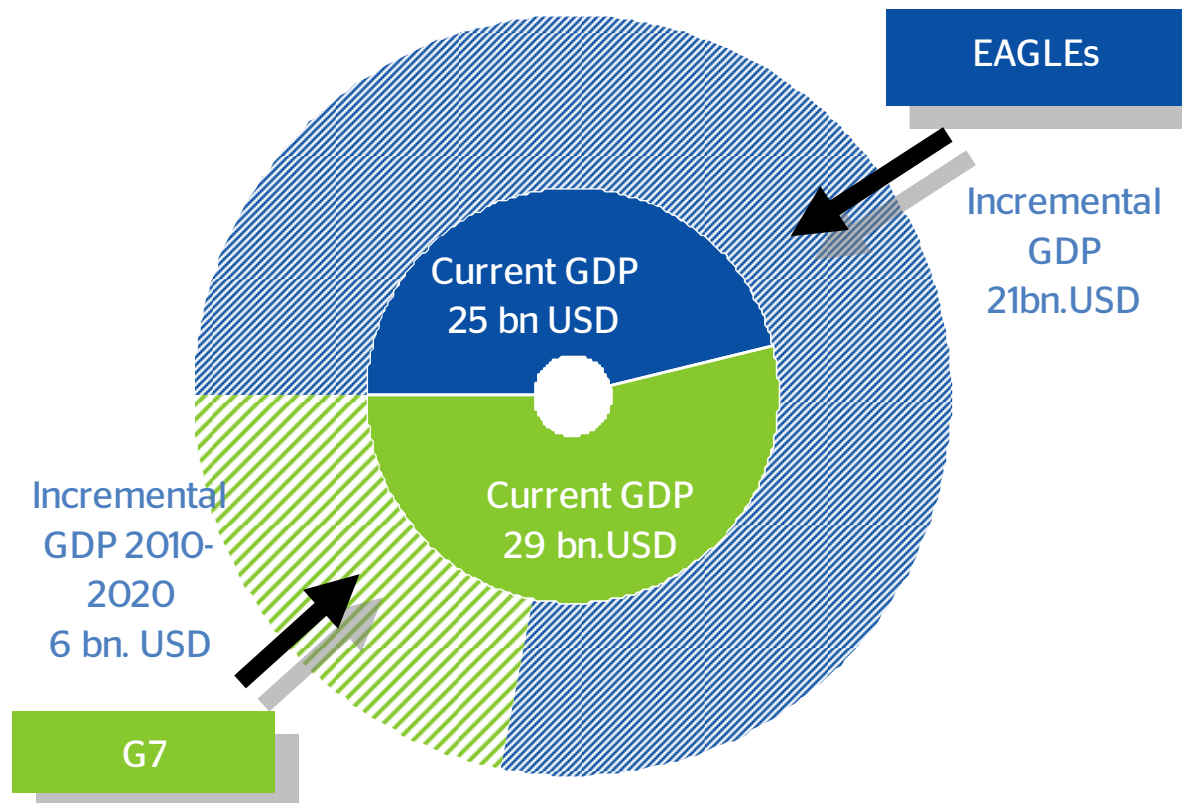
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Emerging markets' potential

EAGLEs (Emerging and Growth-Leading Economies): they will continue leading growth during the next decade.

EAGLES vs G7: current size and "incremental business"

Source: BBVA Research



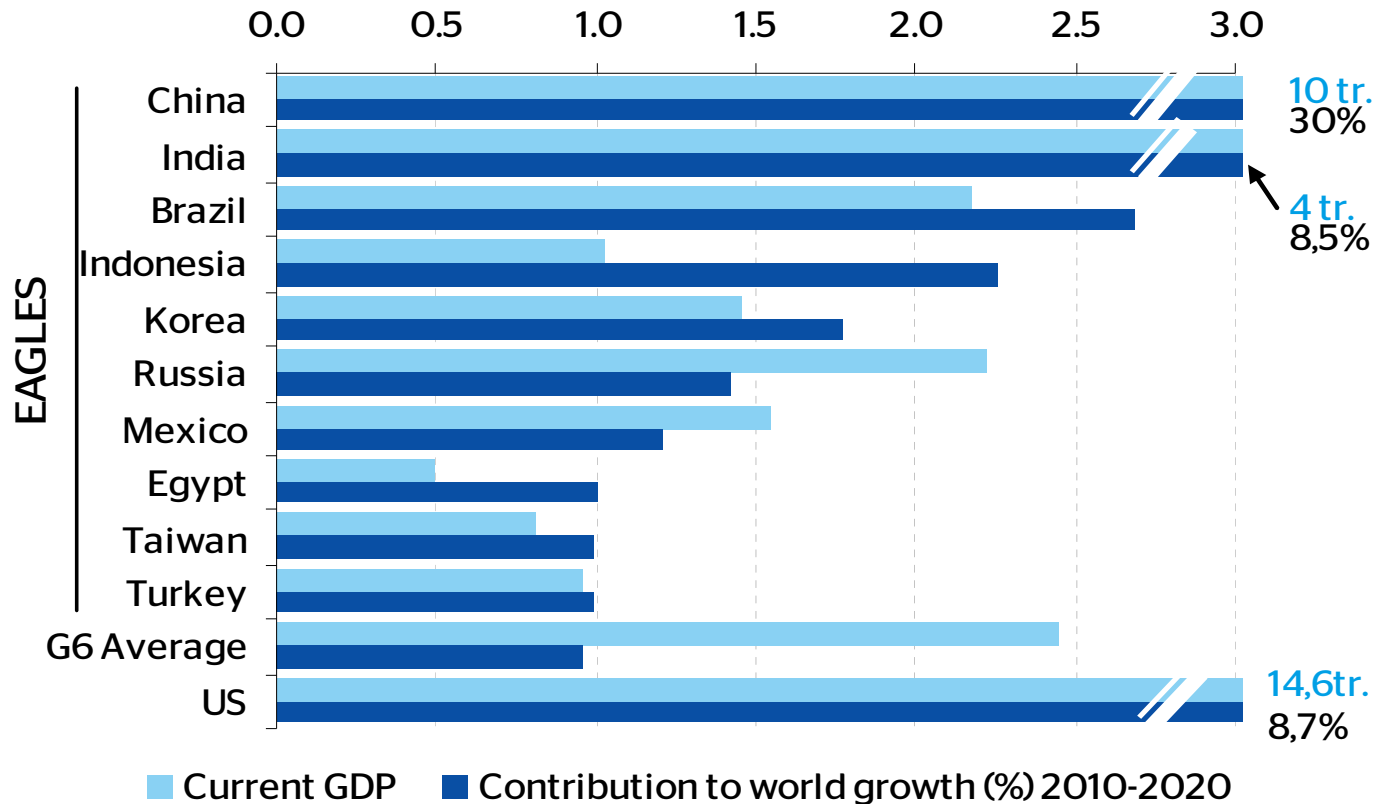
Section 5

EAGLES[©]

They will lead global growth: China and India will contribute more than US; Korea and Indonesia more than Russia; Mexico, Egypt, Taiwan and Turkey more than the G6 average.

EAGLES[©]: Current size and contribution to global growth

Source: BBVA Research



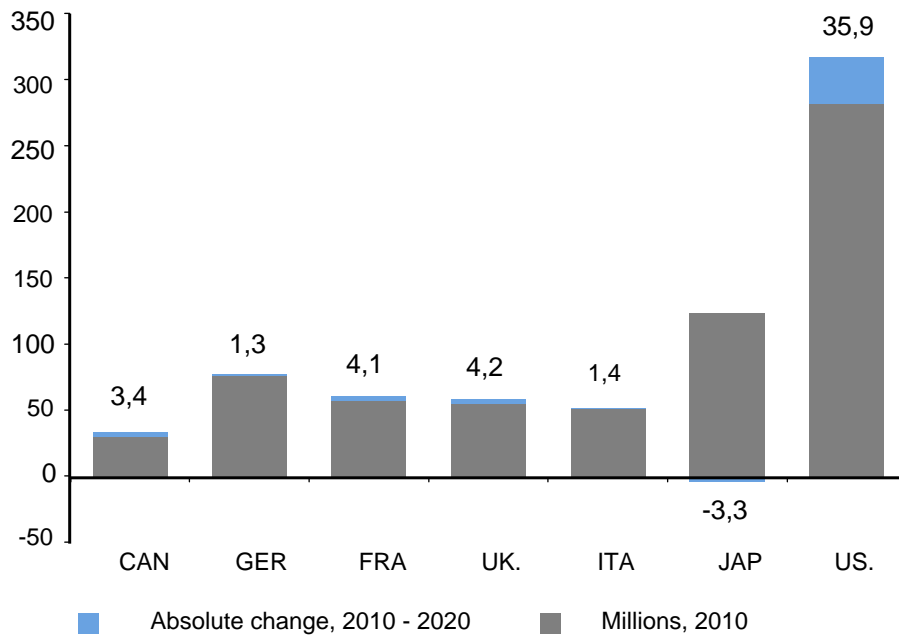
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EAGLEs: increasing middle classes and domestic demand

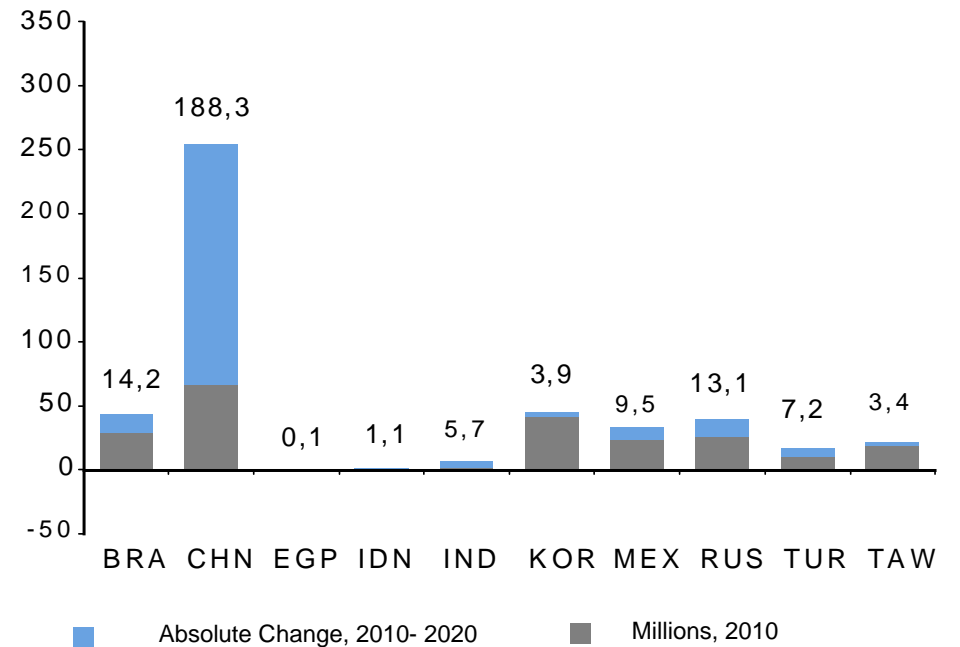
Increase of middle classes. Number of people with annual income above 9.600 USD (millions)

Source: BBVA Research

G7



EAGLEs

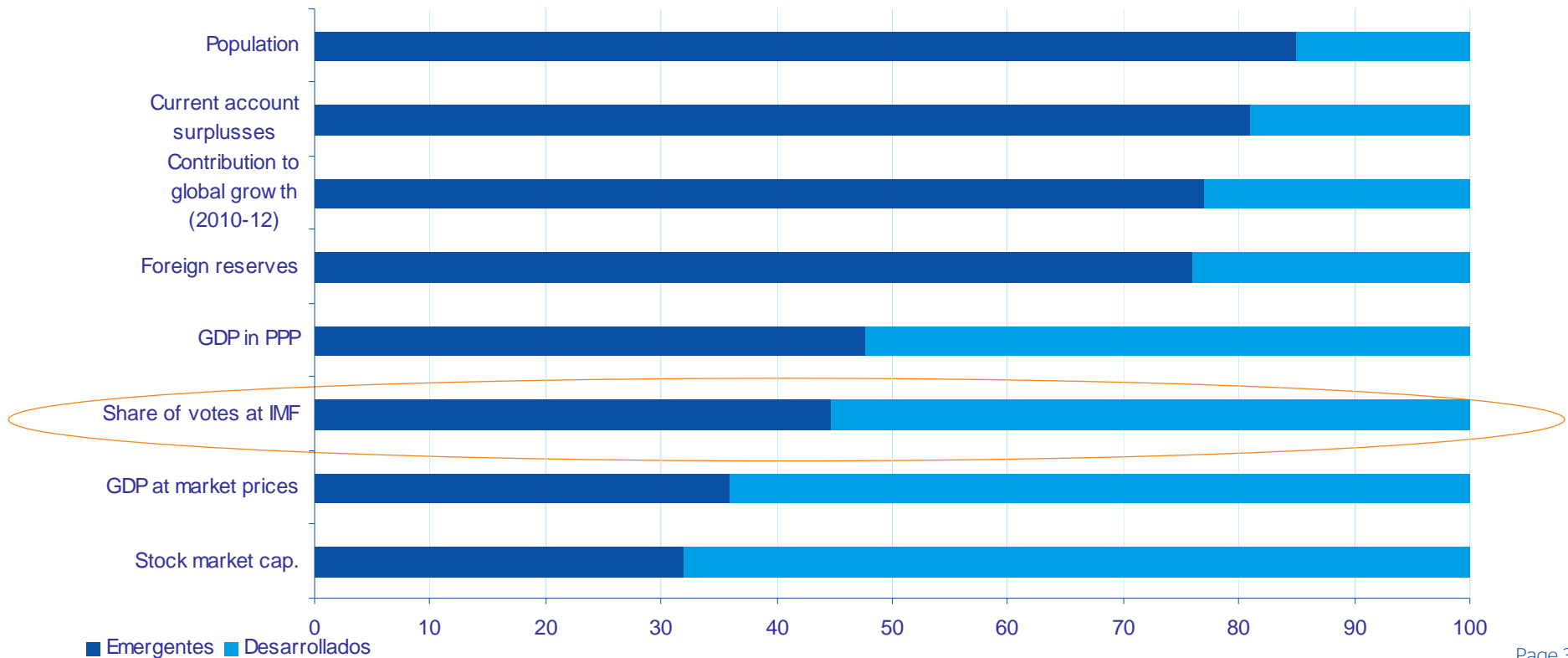


The crisis highlights the imbalance between advanced and emerging economies

The imbalance between advanced and emerging economies is not stable, especially due to the post-crisis expected dynamics.

Share of emerging and developed economies in world total (%)

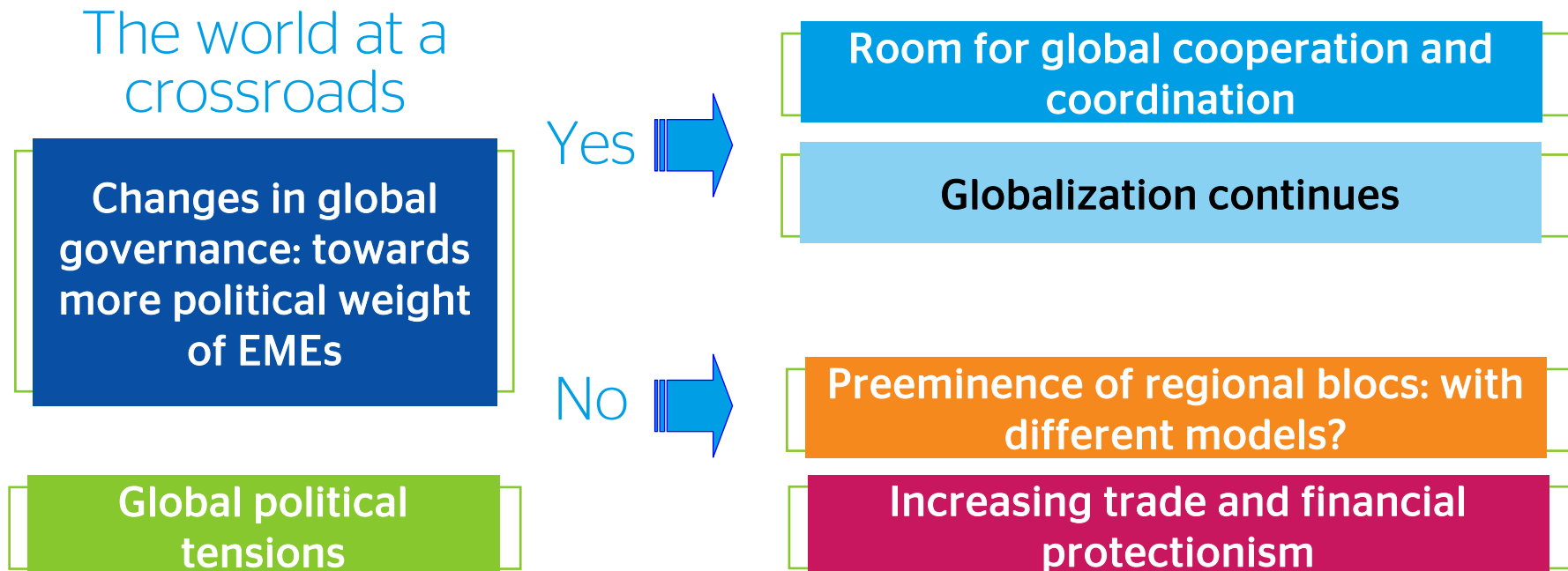
Source: BBVA Research



Global governance must adjust to the higher weight of emerging economies

Global governance must change to accommodate the increasing weight of emerging economies and secure the legitimacy of international institutions.

However, the rebalancing of global power will be difficult, as this is a zero-sum game





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Europe and Spain at the crossroads

Jorge Sicilia – Group Chief Economist – BBVA Research

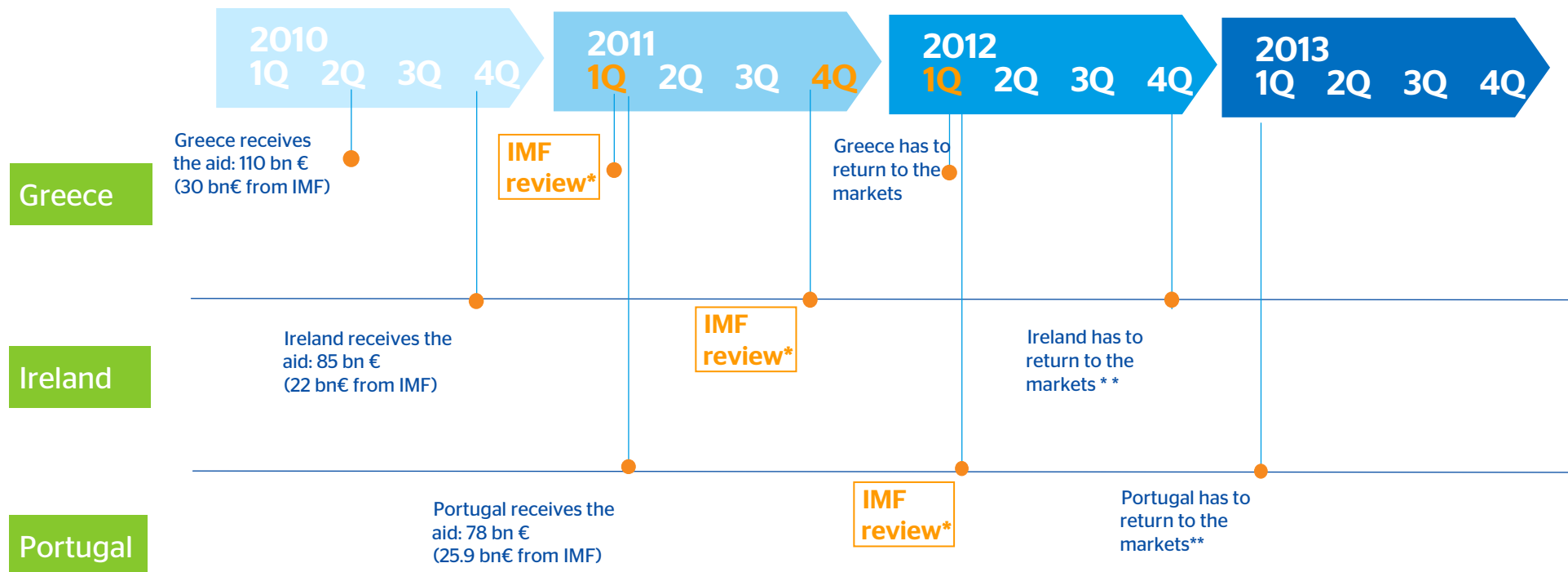
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Annex

Portuguese & Irish financing plans

But those programs also entail some risks: 1) Return to markets, if markets expectations for 2013 do no improve market volatility for Portugal and Ireland will increase in 2012; and 2) EU+IMF programs represent a decreasing portion of total financing needs



*According to IMF rules, refinancing guarantees must be in place for 12 months. That means the IMF needs to be convinced that countries can rollover their debt for the next 12 months without any problems

**Tentative quarters

Greece: increasing the risk of triggering an accident

In the short term

- Quarterly review is a source of concern, as widely expected
- **Greece needs to secure the 6th tranche (€ 8 bn), still under tough discussion**
 - But, growing difficulties in fiscal consolidation progress (**fiscal gap for 2011 1.2% of GDP**): 0.4 % cyclical, but 0.6% structural slippage on public revenues, late implementation of reforms agreed in July
 - Once again, **last minute austerity plans have been approved and additional measures are under discussion**
- **Greece still depends on the second bail-out programme** which is **conditional on a successful PSI** and also, the resolution of the **collateral debate and the approval of EFSF**
- **An imminent default of Greece** (risk of a break up of the euro) **could be the trigger for Germany to ring-fence fundamentally funded countries.**

In the medium term

- A higher haircut is unavoidable. In the baseline scenario an orderly restructuring would occur in mid 2013, or mid 2012 if the ESM is brought forward.

Towards the long-run: two possible end-games

In a flatter world, less unipolar, two possible scenarios arise.

Where's global dominance?

1

**A new center of gravity in the East
(relative decline of the West)**



Main features

- EMEs sustain higher growth**
- Increasing flows within EMEs, better access to financing**
- Main countries: China and India. Increasing middle classes**
- Developed countries rely on EMEs for capital, workers and consumers**

2

Center of power remains in the West



- Innovation remains in the West**
- Developed co's recover growth, keep relative living standards to EMEs**
- Still, EMEs keep increasing their weight on global issues**