

Spain Economic Outlook

Madrid, 8 November 2011



Key themes

- 1 **Global growth is slowing and risks worsen expectations**
- 2 **Europe's sovereign debt crisis is affecting** the financial sector and **is turning more systemic**
- 3 **The measures proposed for Europe show a good understanding of the problems but the scope is insufficient**
- 4 **Spain:** If third quarter stagnation consolidates, growth could turn negative in the fourth quarter
- 5 Regional growth rates set to remain mixed
- 6 Recovery will depend upon both Europe effectively applying the decisions recently reached and Spain meeting its commitments and carrying out the necessary reforms



Contents

Section 1

International environment: politics takes centre stage in the economic debate

Section 2

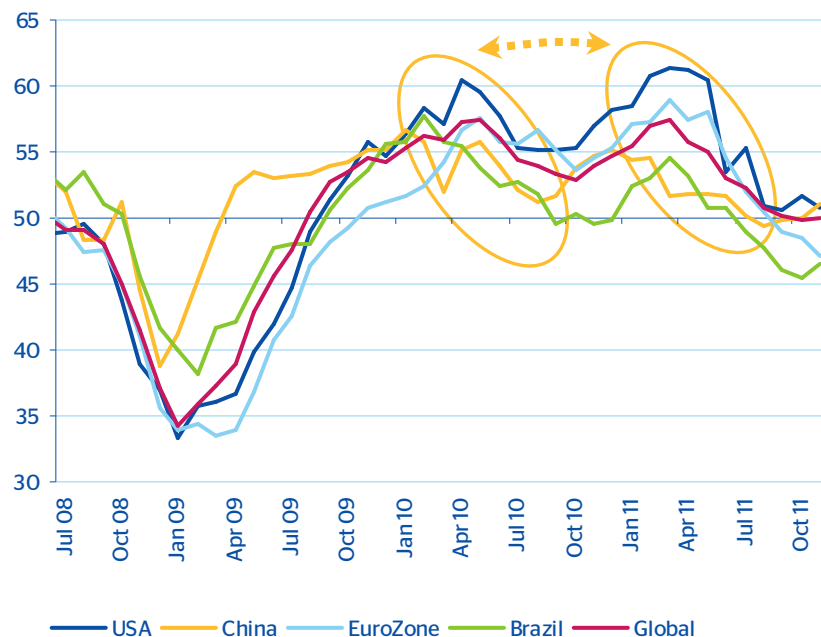
Spain: current situation and economic challenges

Worsening global situation:

1. Disappointing macroeconomic data

Business prospects (PMI)*

Source: BBVA Research based on Bloomberg data



* Values of over 50 indicate expansion

Weak growth in 2Q

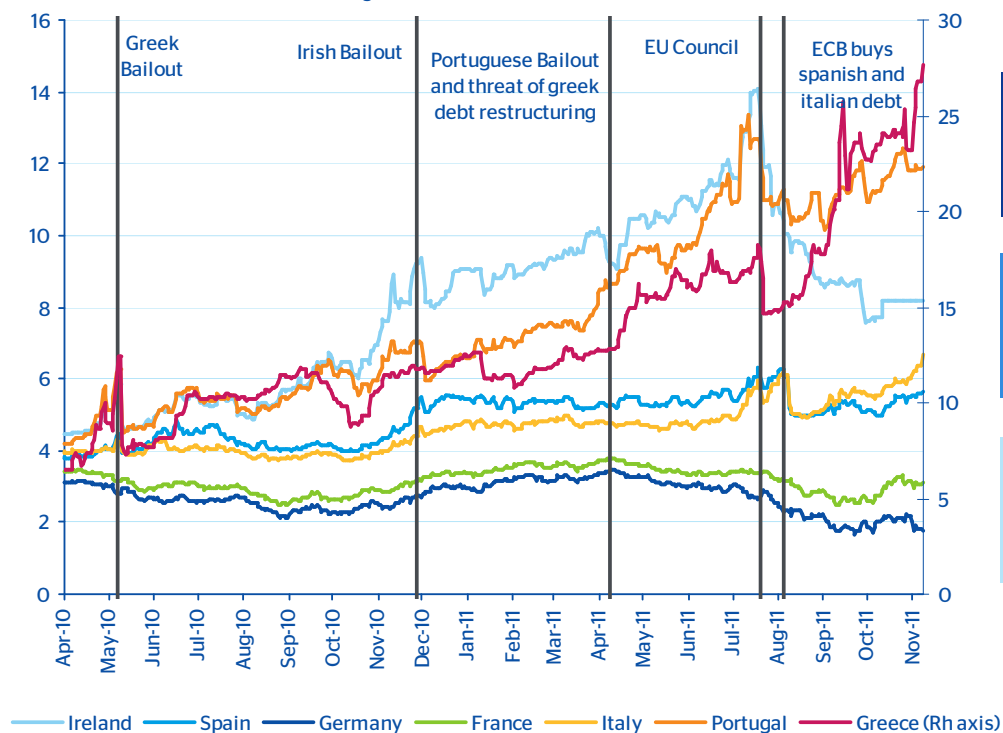
Confidence indicators and expectations fell in 3Q

Emerging economies are being affected

2. The debt crisis turns global

10-year bond interest rate

Source: BBVA Research based on Bloomberg data



The debt crisis has extended to Italy and threatens other countries ...

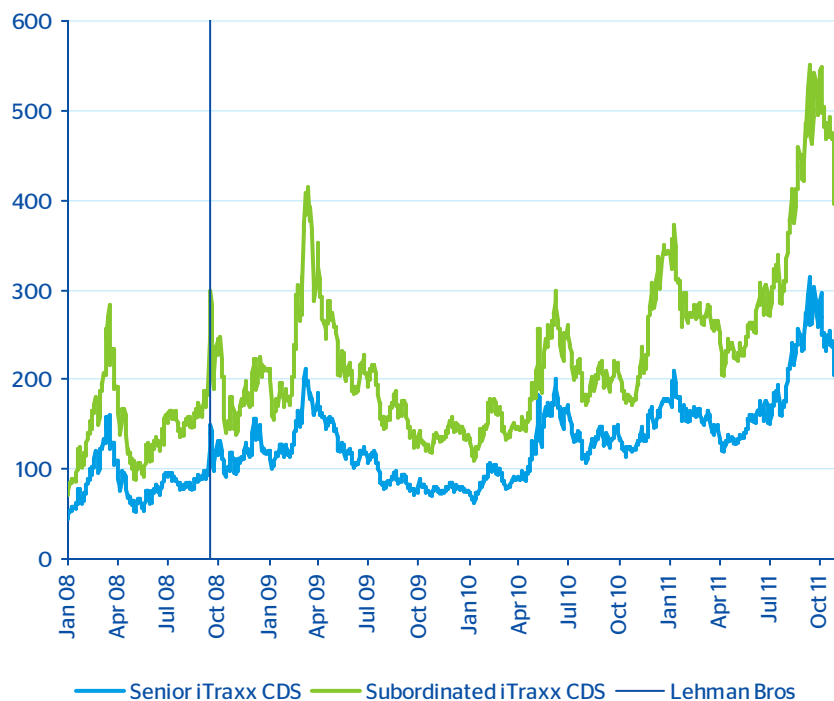
... and has become a global risk factor ...

... which explains nearly three quarters of the change in risk premiums

3. Feedback with banking risk

Credit market: Itraxx CDS (bp)

Source: BBVA Research based on Bloomberg data



The debt crisis increases concerns about banks' solvency

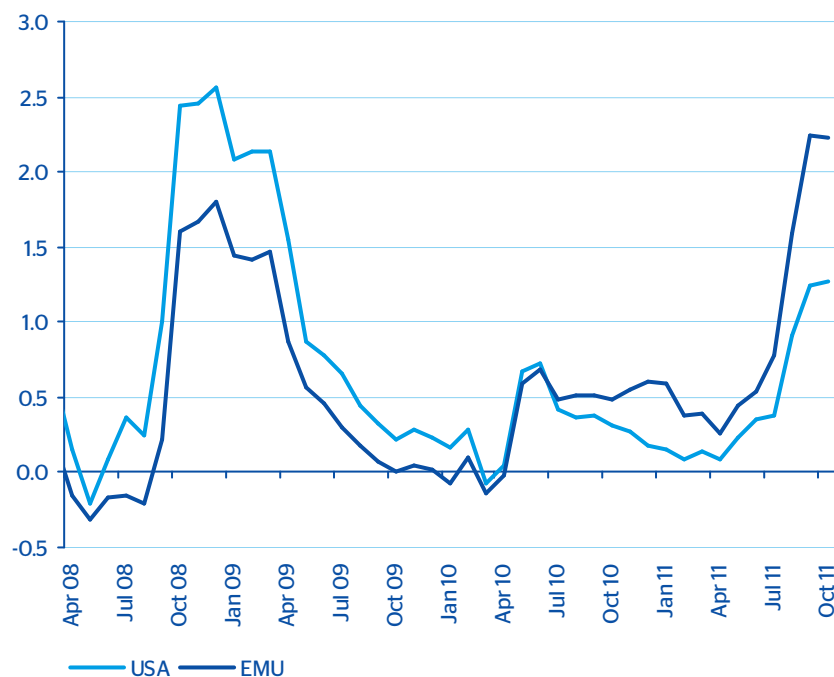
Higher finance costs are affecting activity

Recapitalisation of European banks to avoid a vicious circle

3. Feedback with banking risk

BBVA financial stress index (FSI)

Source: BBVA Research



Debt crisis + banking risk
= greater financial stress

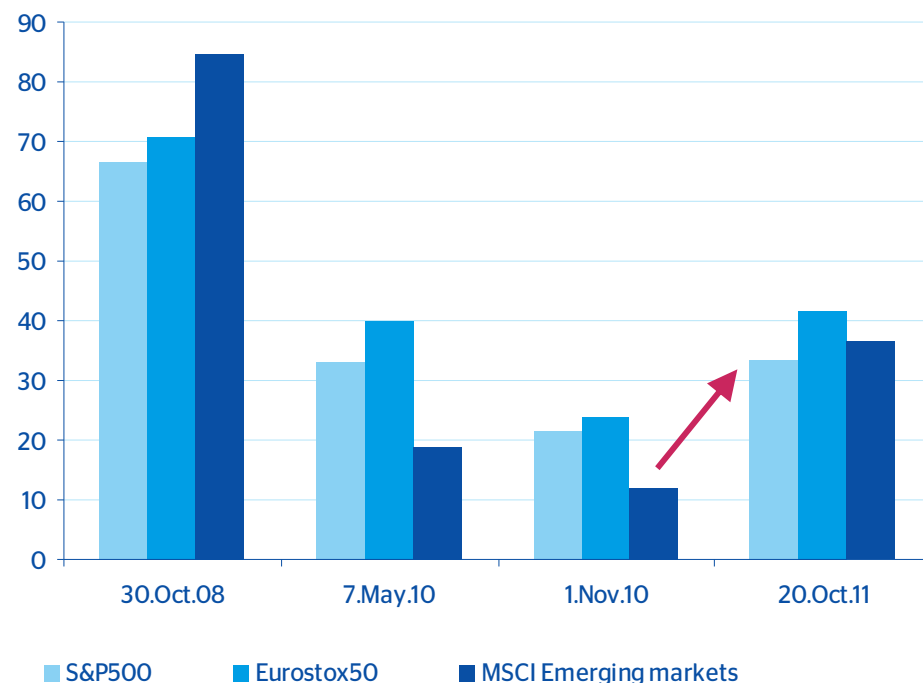
If this stress continues throughout 2012, growth
will contract 2pp (1.3 USA)

“Wait and see” is not an option given the scant
fiscal and monetary margin

4. Greater global risk affecting emerging economies

Implied stock market volatility

Source: BBVA Research based on Bloomberg data



Volatility in the debt and stock markets has risen

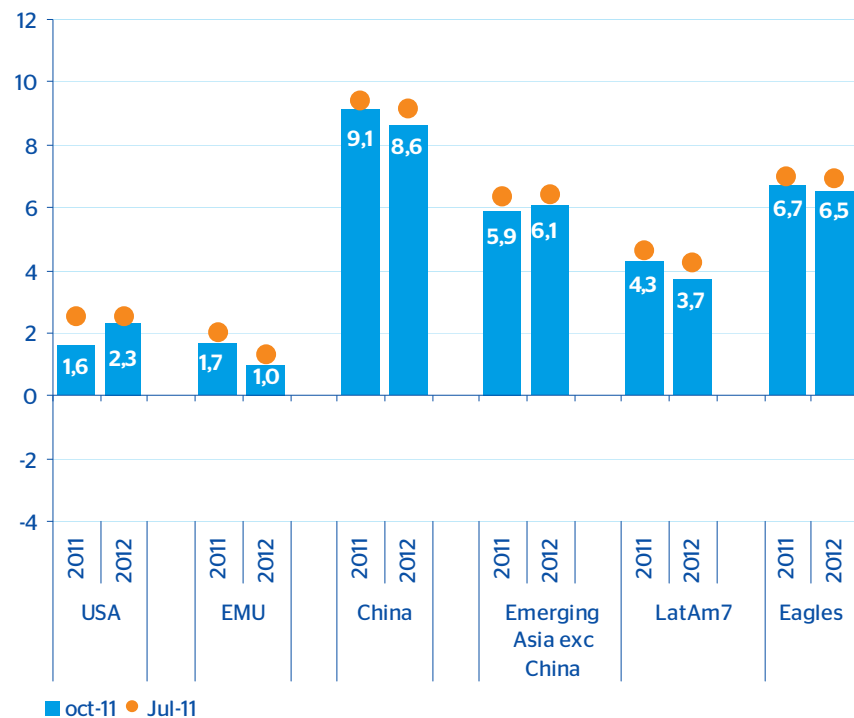
Levels not seen since autumn 2008

Risk spreading to emerging markets

Global growth scenario: emerging markets remain dynamic

GDP growth (% yoy)

Source: BBVA Research



Increasing probability of risk scenarios in Europe

Forecasts in developed economies downgraded

Emerging markets remain dynamic, despite global risk

Summit 26/10: partial solution with issues still to be resolved

What was needed?

Clear response to sustainability of Greek debt

Stronger firewalls to sovereign debt in the EMU

Drive for more reforms

Stronger banking system: capital and liquidity

Advances in eurozone governance

Result

50% haircut with doubts surrounding voluntary participation and solvency

EFSF leveraged as an insurance mechanism plus a SPV, but doubts whether sufficient

More reforms, particularly in Italy

Low efficiency of recapitalisation with doubts as to whether markets will reopen

No clear roadmap to fiscal union or Eurobonds

Recapitalising Europe's banks

Negative effects

Cost in terms of GDP will be -0.2pp the first year and -1.5pp in the long term (EC < BBVA < IIF)

Differential effect of accelerating Basel III requirements to June 2012

Variable	Year 1	Year 4
GDP	-0.10	-0.09
Consumption	-0.05	-0.06
Investment	-0.47	-0.43
Credit	-0.50	-0.33

Source: Europe Economic Outlook BBVA Research

Compensating features

Increased confidence and reopening of wholesale markets

Alternative recapitalisation strategies

1. Deleveraging of non-core activities
2. Restructuring of asset portfolio
3. Organic growth capital

Slow and weak recovery with risks that are already appearing

Core scenario

Orderly restructuring of Greece's debt and EFSF to avoid contagion

Wholesale markets reopened to Europe's banks

Global growth continues and European countries complying with commitments

Slow and weak recovery with financial stress remaining high for some time

Risk scenarios

Disorderly default of Greece's debt and the EFSF will not prevent contagion at the core

Closed markets, liquidity crisis, run on banks and/or credit crunch

Greater global economic weakness and reform fatigue

Recession in developed economies and sharper slowdown in emerging ones



Contents

Section 1

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Spain: current situation and economic challenges

Growth still weak

Determining factors

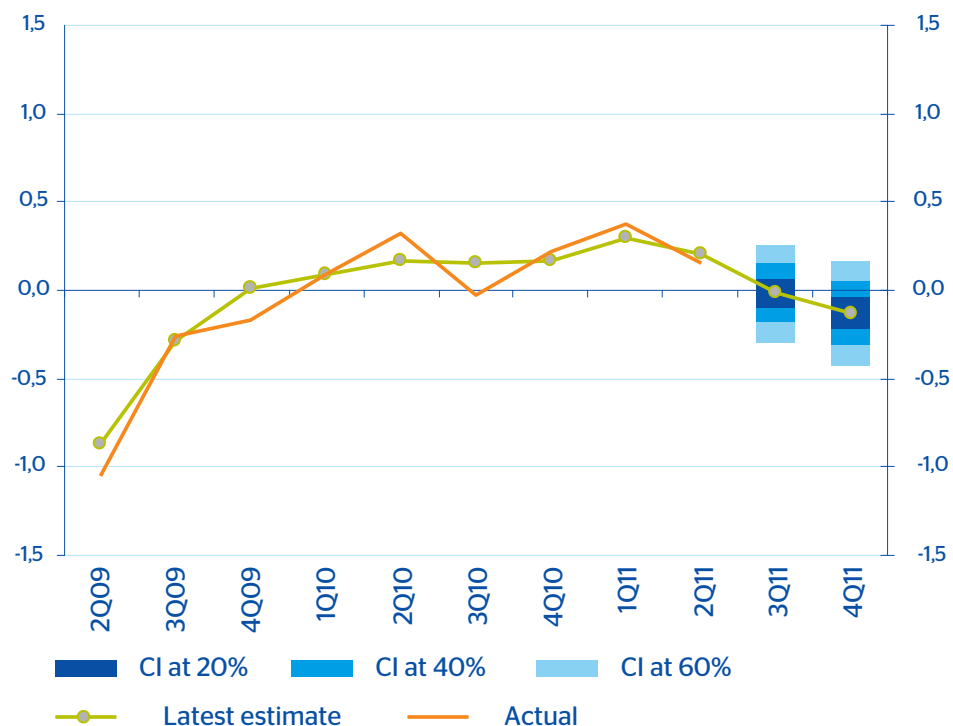
Source: BBVA Research

New factors	Factor	Effect
	Increased uncertainty in the financial markets (spreads)	Risk premiums revised slightly upwards
	Growth slowing in Europe	Negative bias on growth forecasts for Europe in 2011
	Fundamentals for internal demand are not recovering	Job destruction and deterioration of disposable income continue
	Confidence reduced	Uncertainty is high and less temporary than forecast
	Liquidity stress and return to deposits war	The incentive to hold onto capital could mean less credit available
	Fiscal uncertainty	Deficit reduction in 2H and possible measures affecting certain sectors
	Change in monetary policy	Lower interest rates
	External demand strong (tourism)	Positive surprise in services (and goods)

Growth weakening

Spain: GDP growth observed and forecasts using MICA-BBVA model (% qoq)

Source: BBVA Research
Current forecast: 4 November



Greater risk of recession

Growth in foreign demand while domestic demand remains weak

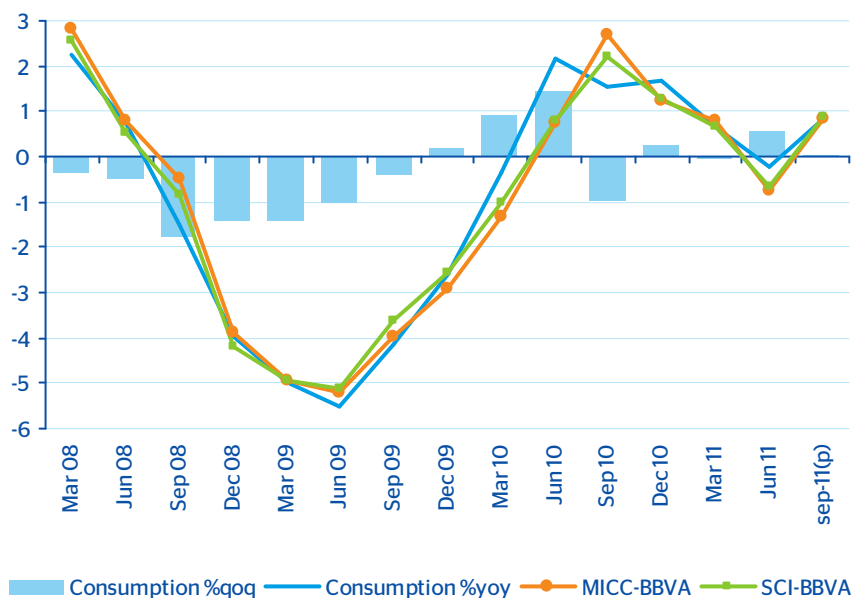
Higher risk premium

Job destruction continues

Slowdown in private consumption and real estate adjustment continue

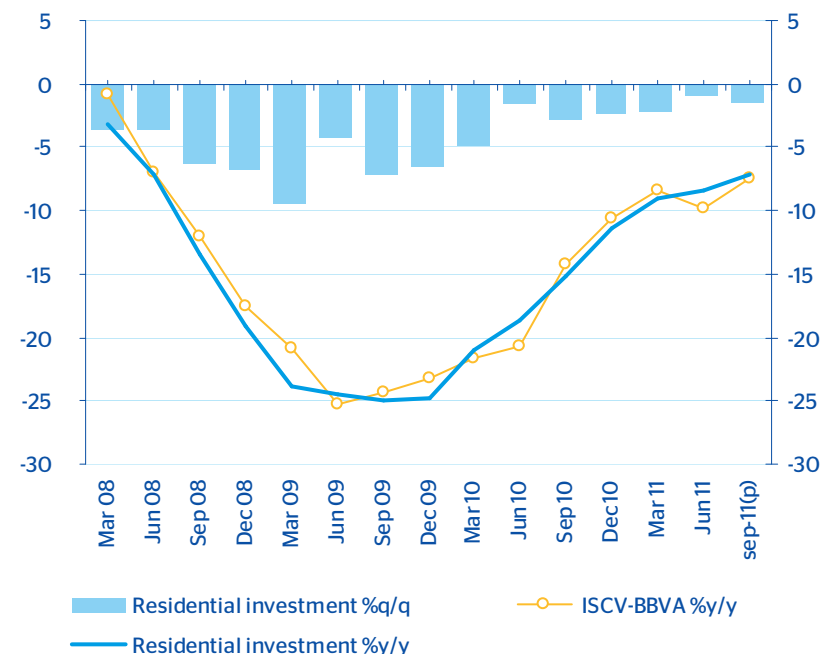
Spain: observed data and real time forecasts of household consumption

Source: BBVA Research based on INE data



Spain: observed data and real time forecasts for residential housing investment

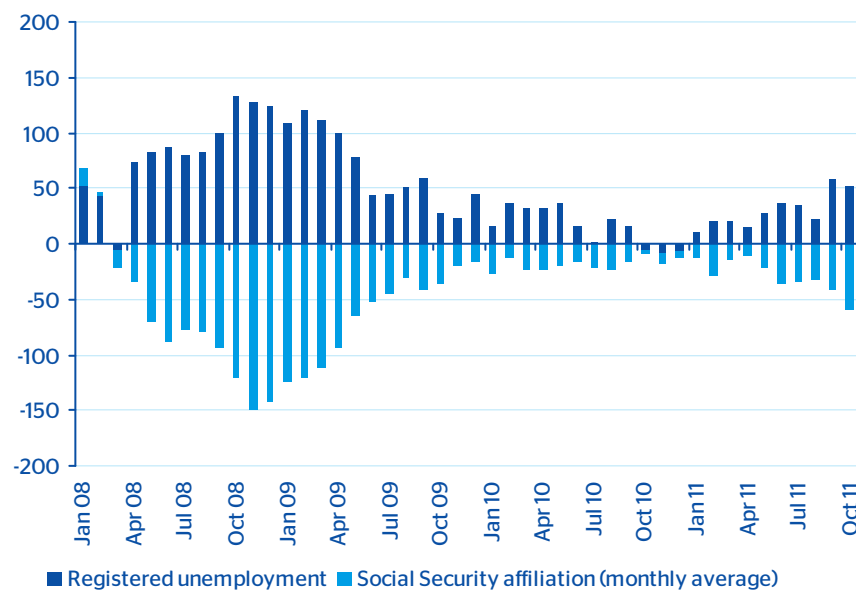
Source: BBVA Research based on INE data



Job destruction continues

Spain: registered unemployment and Social Security affiliation (thousands of people, SWDA data)

Source: BBVA Research based on MTIN (ministry of labour and immigration) data



In recent months the job market has deteriorated further ...

... negatively impacting confidence and consumption ...

... which worsens the outlook for 2012

Budgetary outturn

Spain: budget balance of public administrations

(cumulative annual, % of GDP)

Source: BBVA Research, using finance ministry data



The deficit needs to be cut by 3pp of GDP in 6 months

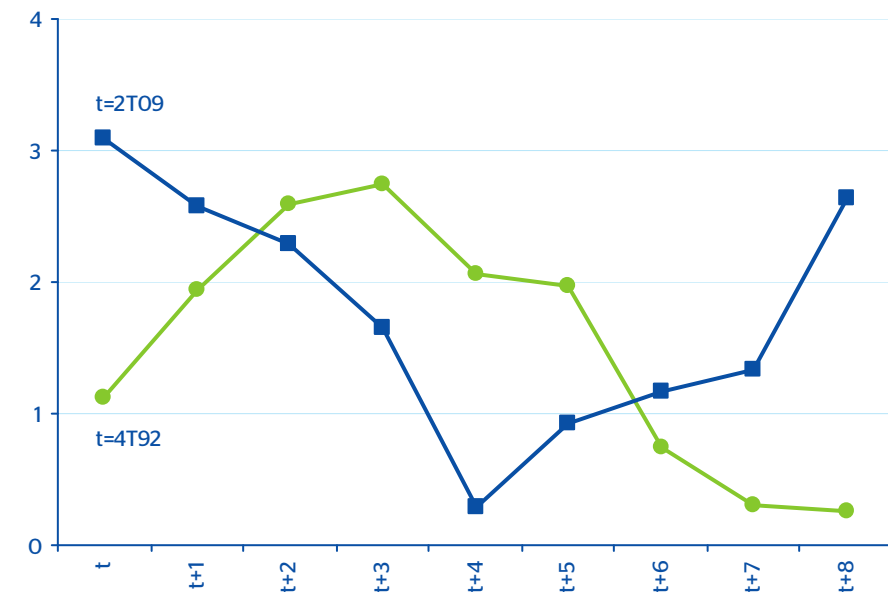
Autonomous Communities governments are unlikely to meet targets at the end of 2011

Public administrations deficit of 6.5% of GDP in December if no additional measures

Foreign trade performing well

Contribution of net foreign demand to economic growth (pp)

Source: BBVA Research based on INE and Bank of Spain data



Note: t is the quarter that recorded the local cyclical minimum

Exports are now above levels seen before the crisis

Foreign trade performing well

Exports offer very diversified sector and geographic growth

Weak growth scenario

Economic Forecasts

Source: BBVA Research based on INE and Eurostat

(y-o-y growth rate)	2010		2011		2012	
	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	1.3	0.8	0.4	0.5	0.5	0.7
Public consumption	-0.7	0.5	-0.3	0.3	-2.7	0.1
Gross Fixed Capital Formation	-7.5	-1.0	-5.1	2.4	-0.6	1.7
Equipment and other products	-2.1	3.1	-0.5	5.0	2.8	3.0
Construction	-11.1	-4.1	-8.7	-0.4	-3.2	-0.4
Housing	-16.5	-3.6	-7.4	1.5	0.9	-0.1
Domestic Demand (*)	-1.1	1.0	-1.0	1.0	-0.4	0.8
Exports	10.3	10.6	10.1	6.1	5.1	2.5
Imports	5.5	8.9	3.0	4.7	-0.3	2.1
External Demand (*)	1.0	0.8	1.8	0.7	1.4	0.3
GDP	-0.1	1.7	0.8	1.7	1.0	1.0
Pro-memoria						
GDP excluding housing	0.9	2.0	1.2	1.7	1.0	1.1
GDP excluding construction	1.7	2.4	2.2	1.9	1.6	1.2
Total employment (LFS)	-2.3	-0.4	-1.7	0.5	-0.8	0.4
Unemployment rate (% Active pop.)	20.1	10.2	21.5	9.9	22.1	9.7
Current account (%GDP)	-4.5	-0.5	-4.5	0.0	-3.0	0.2
Public surplus/deficit (%GDP)	-9.2	-6.2	-6.5	-4.5	-4.4	-3.4
CPI (yearly average)	1.8	1.6	3.1	2.6	1.2	1.6

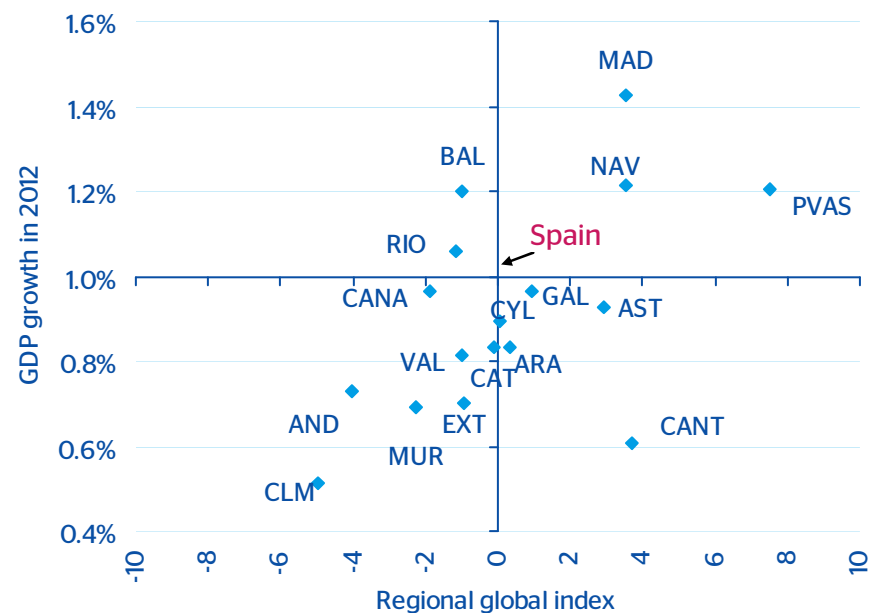
(*) contributions to GDP growth

(**) BBVA Forecasts, October 2010.

Regional growth: mixed adjustment

Global risk factors index and growth forecasts for 2012

Source: BBVA Research based on INE data



Recovery shaped by

Deleveraging and fiscal adjustment

Temporality and unemployment

Sector diversification: exposure to foreign trade and construction

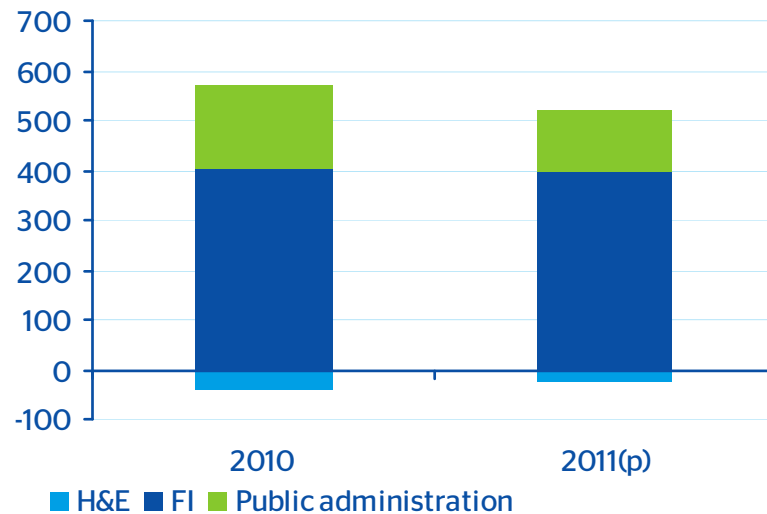


The challenges of the Spanish economy

Spain: Gross financing needs with ROW by agents

(external maximum, billion euros)

Source: BBVA Research based on INE data



Increase in
financial liabilities
+
Saving

=

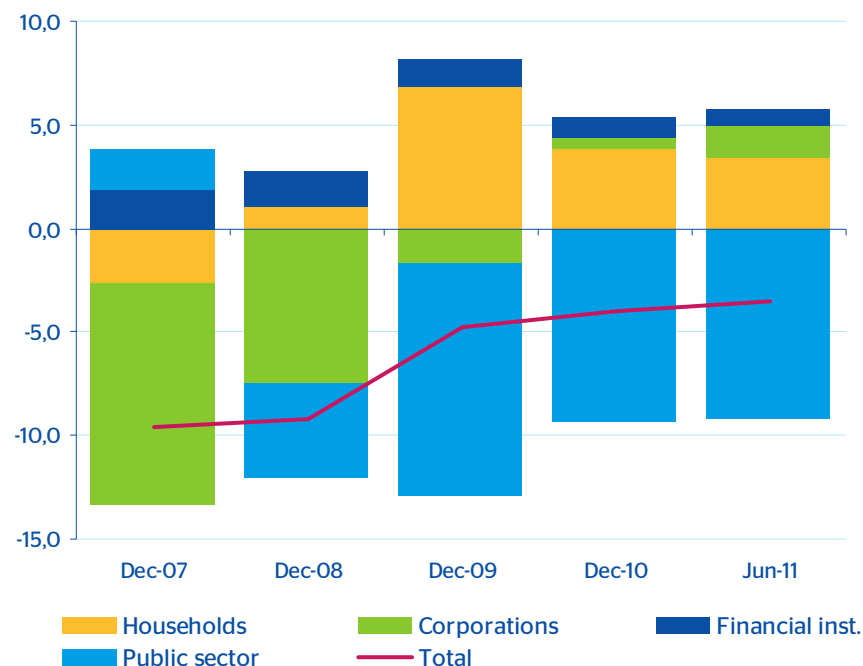
Increase in
financial assets
+
Investment

Spain needs to reduce its financing needs with the ROW: reducing flows and stocks is just as important as how this is done

The challenges of the Spanish economy

Spain: foreign financing capacity (% of GDP)

Source: BBVA Research based on INE data



Adjustment to financing needs via

Orderly deleveraging, with a strong financial system and access to market

Reduction of public deficit (S-I)

Boost to competitiveness with ambitious structural reforms

Two deleverage strategies

Increase in financial liabilities + Saving = Increase in financial assets + Investment

Deleverage with *credit crunch*

Without long term financing in wholesale markets. The short term liquidity (ECB or repos) is only a temporal relieve

Encourage national saving through liabilities war (substitution effect)

Financial assets sale. Investment contraction (with negative effect on employment)

Virtuous deleverage

Clean-ups of banking system and reopen of wholesale markets

Encourage national saving with the fiscal adjustment and more growth and employment (income effect)

Investment recovery (with positive effects on employment)

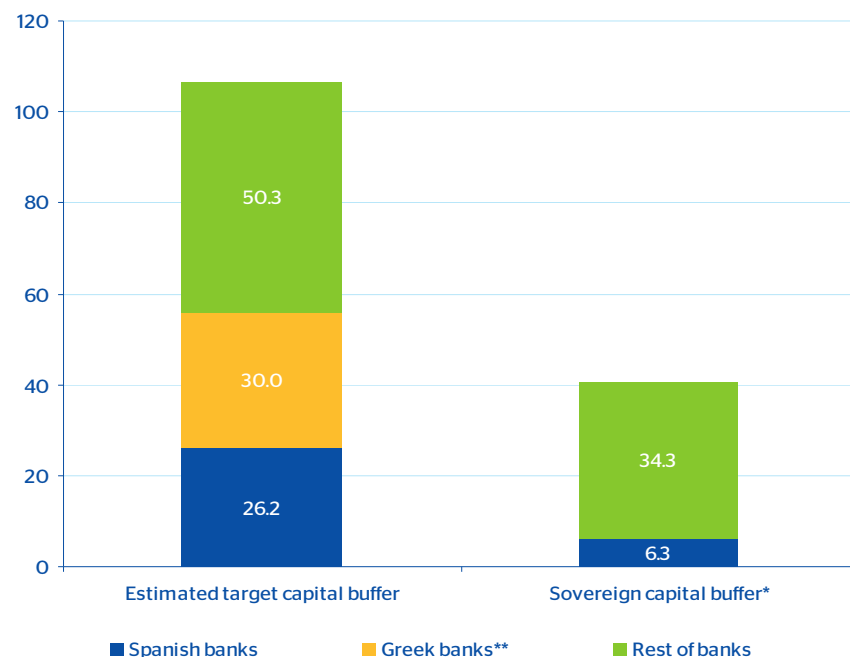
The challenge is increase saving, support investment and facilitate long term foreign debt refinance, reducing risk perception of Spanish economy

1. Bank restructuring

EBA: Estimated capital needs

(billion euros)

Source: BBVA Research, based on EBA data



* Indicative and could already be covered by core capital tier 1 if ratio exceeds 9%.

** No information provided on Greek banks to avoid conflicts with agreements of EU/IMF programmes

Beyond EBA recapitalisation:
better solvency and more liquidity

Balance clean-ups with rigorous assessment

Recapitalization of entities not meeting core capital requirements

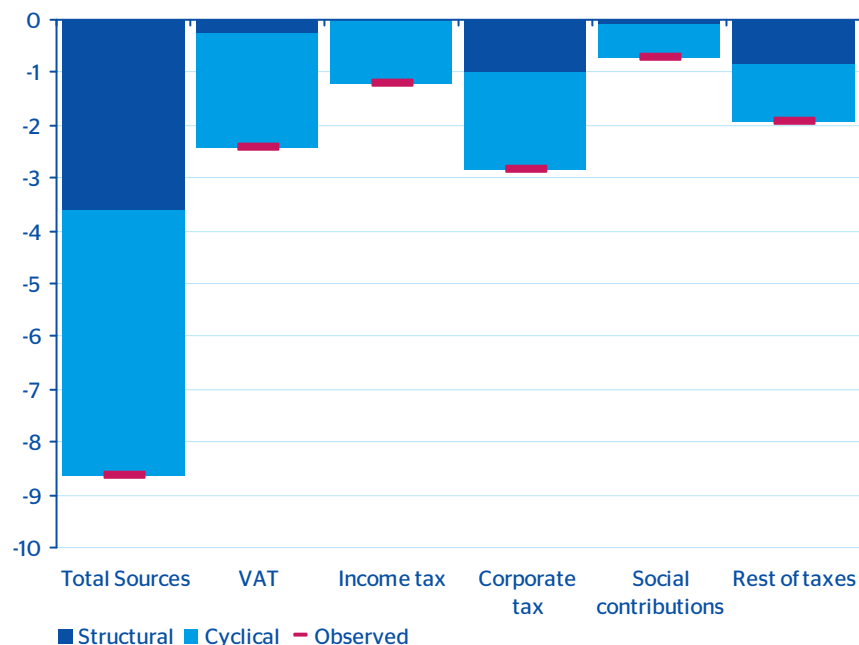
Fast restructuring of intervened entities

Reduction of excess capacity

2. Fiscal consolidation

Public administrations: change in non-financial income 2007-2009 (% potential GDP)

Source: BBVA Research based on finance ministry and INE data



More confidence in the fiscal adjustment

Lower financing requirements of public administrations

Adjust spending to constantly lower public income (% GDP)

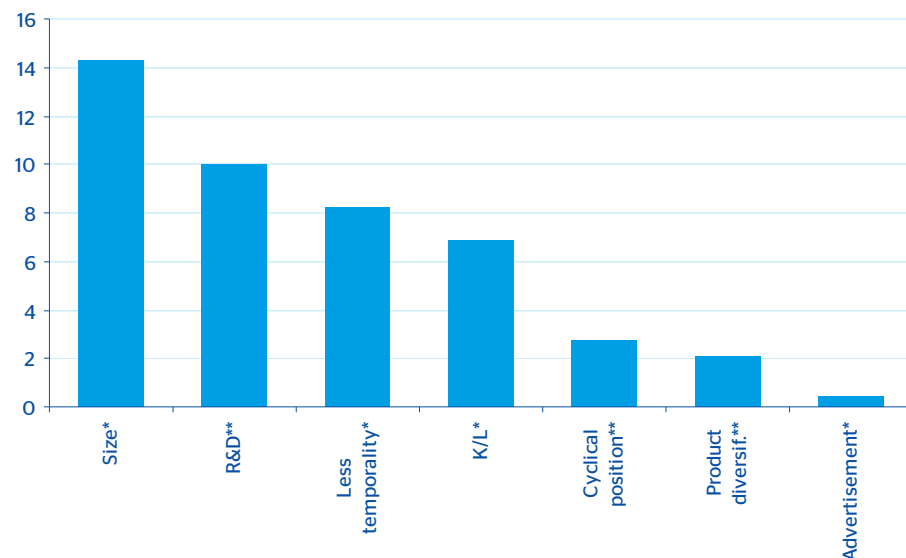
Offer certainty with an ambitious law which implements constitutional reform

Increase transparency and medium-term planning (multi-year budgets)

3. Step up pace of reform

Marginal effects on the various factors affecting export probability

Source: BBVA Research based on BSS data (SEPI foundation)



Note: * in %; ** in pp; the marginal effect of size; K/L ratio and advertisements costs are calculated based on a 1% increase in the corresponding variable; the marginal effect of temporary contracts corresponds to a one percentage point reduction on the average sample value; R&D, expansive cyclical position and diversification are categorical variables whose marginal effects is computed from value 0 to value 1 (e.g. no R&D activity to R&D activity).

Improve competitiveness

Help growth at SMEs

Reduce enterprises start-up and management costs

Ambitious collective bargaining reform

Reduce temporality and encourage professional training

3. Step up pace of reform

Reforms

Labour market

Fiscal depreciation and tax efficiency

Fiscal consolidation

Fiscal rules and transparency

Sustainable pension system

Improve regulation, competencies and competitiveness

Analysis

Spain Economic Outlook, November 2008, March 2009, February 2011 and Economic Watch, September 2011

Spain Economic Outlook, March 2009 and 3Q10

Spain Economic Outlook, November 2009

Spain Economic Outlook, November 2010 and May 2011

Spain Economic Outlook, February 2011

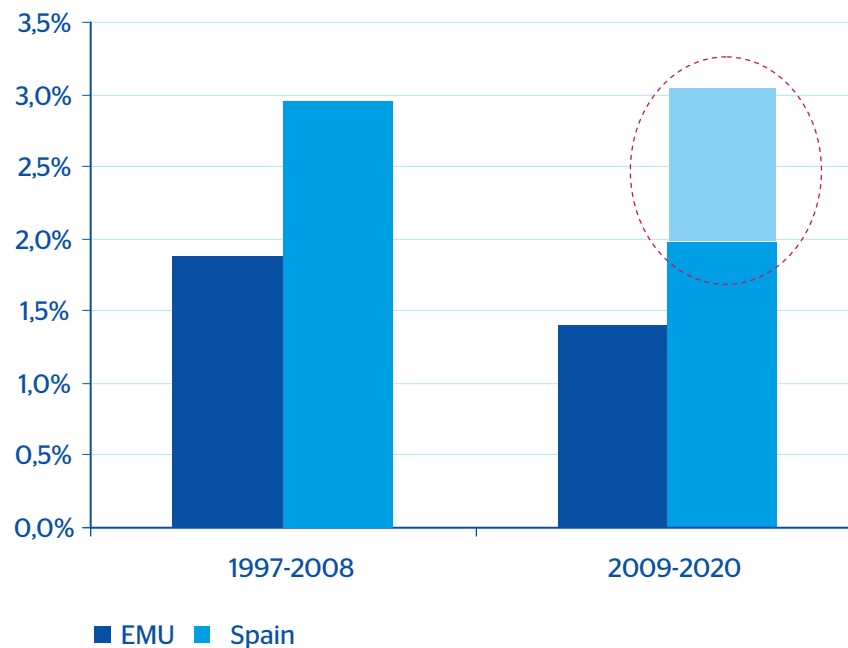
Spain Economic Outlook, November 2008 and March 2009



3. Step up pace of reform

Spain vs. EMU: Potential GDP (% yoy)

Source: BBVA Research



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