Global recovery, but heightened risks

Global Economic Outlook – Second Quarter 2012

Madrid, 8 May 2012
Global growth will gradually recover in 2012 from the trough in 2011Q4. It will be between 3.5% and 4% in 2012 and 2013.

Risks to the global growth outlook are strongly tilted to the downside as the European crisis continues.

There have been some advances to solve the European crisis, but crucial steps are still pending: a more credible sovereign firewall, a roadmap to a fiscal union and a pro-growth agenda.

Emerging economies are on track for a soft landing. They will contribute about 80% of global growth in 2012 and 2013.
Contents

1  The global economy will recover gradually in 2012
2  The European crisis is still the main global risk
3  Recession in Europe, with high heterogeneity
4  Oil prices are a moderate global risk
5  Forecast revision
Global economy trough in 2011Q4

The global trough is likely to be behind us, although global growth will still be below trend and downside risks remain.

Global GDP growth (%qoq at annual rates)
Source: BBVA Research and Haver Analytics

- Wider growth divergence between US and Japan vs Europe
- Emerging economies continue growing faster than advanced economies
- Moderate global growth going forward
The rebound in Q1 is most evident in business confidence

The rebound of global activity is most evident in Asia. The recovery, however, is trapped in a modest range, with the US at the better end, the Euro area at the weaker end, and emerging markets somewhere in the middle.
US: ongoing but fragile recovery...

Recent data suggest that growth will be resilient in 2012, but will be limited by the ongoing deleveraging. The declining trend in the unemployment rate in the context of moderate growth (below previous recoveries) represents not very positive news: it reflects the exit from the labor force of a large part of working-age population.
...and fiscal policy represents one of the main risks to growth in 2013.

Monetary policy is burdened with most of the task of supporting private sector demand. But fiscal policy and structural reforms should take up the job in the medium term.

**Monetary policy**

- The recovery reduces the probability of an additional quantitative easing (QE3)
- Interest rates will be kept low for an extended period
- Nevertheless, further quantitative easing would be implemented rapidly in case the outlook deteriorates

**Fiscal Policy**

- If there are no new measures, there will be a sharp fiscal tightening at the end of 2012. It could induce a recession in 2013.
- Even with the electoral uncertainty, we expect a gradual fiscal consolidation, with slight negative effect on growth in 2013.
- The main problem is the lack of progress to tackle long-run fiscal consolidation
China is on track to a soft landing

Despite sharper-than-expected slowdown in Q1 (8.1% vs 8.9% in Q4) growth momentum should have bottomed and will rebound on policy support (monetary policy and fiscal stimulus). Recent reduction in GDP growth target for 2012 (from 8% to 7.5%) is not particularly significant because: (i) it was anticipated in the five-year plan published in 2011; (ii) 7.5% is more a floor than a target;
Latin America converges to its potential growth rate

Growth in Latin America is also proving resilient, especially due to the strength of its domestic demand. Growth projections for the region remain mostly unchanged relative to February, around 4% for the next years.

Even with some reduction in inflation, it will remain similar to 2011 levels. Except for Brazil, this will limit a reduction in official interest rates, contrary to big Asian countries (China and India).
Contents

1. The global economy will recover gradually in 2012
2. The European crisis is still the main global risk
3. Recession in Europe, with high heterogeneity
4. Oil prices are a moderate global risk
5. Forecast revision
European crisis: some timid advances, but there are important pending issues

**Advances**

1. Greek PSI implemented
2. Fiscal compact is approved
3. ECB long-term liquidity support

**Pending issues**

1. Credible liquidity firewall
2. Further advances towards a fiscal union
3. Pro-growth agenda

Persistent complacency in Europe results in muddling through the crisis, always behind the curve on what is needed.
Greece: Solvency concerns still linger.

Greece

- Many downside risks remain, threatening debt reduction path:
  - Elections on 6 May, splintered congress
  - Hard road for further reforms, close monitoring by the troika
  - Recession to continue
  - New Greek bonds already under pressure

Portugal

- Fiscal adjustment and reforms are on track
- External imbalance is closing
- Yet this will not be enough to access markets in 2013Q3.
- Our central scenario: second bailout and no restructuring

Greece and Portugal: public debt projections

Source: BBVA Research and IMF

* Optimistic scenario for Greece. Assumes growth rates close to 3% from 2015 and a primary fiscal surplus of 4.5% of GDP from 2014 (compared to 2.4% deficit in 2011).
Sovereign liquidity firewall (EFSF/ESM) not enough to reassure markets

ESM agreement 30 March

New available lending capacity: 500 bn EUR (apart from 200 bn EUR already committed by EFSF)

EFSF may continue lending until mid-2013 to cover the slow process of capitalizing the ESM

It is not enough to reassure markets, given financing needs in Spain and Italy

Increase in IMF Resources (330 bn EUR) will not necessarily be lent to Europe

But ...

ESM/EFSF resources and gross financial needs in Spain and Italy (long-term debt and deficit)

Source: BBVA Research and Bloomberg

- EFSF committed funds
- ESM lending capacity
- Spain
- Italy

Firewall
Spain & Italy gross financing needs 2012Q2-2013Q4
Spain & Italy gross financing needs 2012Q2-2013Q4
Fiscal compact is agreed, but still waiting for a roadmap for Europe

- Fiscal compact commits governments to establish a fiscal rule at constitutional level, limiting structural budget deficits to 0.5% of GDP.
- Includes reverse majority rule needed to prevent sanctions of about 0.1% of GDP for deviations.
- Still, no talk of a roadmap to a fiscal union.

Fiscal compact

- Relatively lax: transitory deviations from structural deficit rule permitted under “exceptional circumstances”.
- Risk of it being ineffective to contain deficits in the long-run.
- May be seen as not strong enough to justify a more forceful and decisive action by hardliners at the ECB or core Europe.

Still pending: a roadmap to a fiscal union

- Eurobonds: convenient as an insurance mechanism.
- Proposal of “blue” and “red” bonds has the advantage of maintaining market discipline.
- Not necessarily a union with fiscal transfers.
Provision of long-term liquidity by the ECB calmed markets temporarily...

Liquidity risk on European banks eased during the first quarter...

... and funding markets were opening up cautiously, helping to reduce sovereign spreads,

but these effects have been short-lived. Recent doubts on Spain have increased tensions

In any case, the ECB can only serve as a bridge to the long run, which depends on structural reforms and a growth agenda.
but it has also increased the exposure of banks to the sovereign

Banks: Holdings of euro area government debt over total assets (%)
Source: ECB and BBVA Research
A deepening European crisis is still the main risk to the global economy.

Crisis: It is worrisome that the tensions came back so soon after: (i) the ECB’s two LTRO; (ii) the structural reforms is Spain and Italy, and (iii) the European Council advances in the fiscal compact and the ESM.

Why?: Risk of negative feedback between fiscal austerity and recession. Risk of sovereign debt a restructuring and ESM seniority.

Solution: eliminate tail risk scenarios.

Roadmap to fiscal integration:
- Fiscal consolidation needs to be gradual and multiyear, with explicit targets. Focus on structural deficits.
- We should not rely only on austerity measures. But rather on structural reforms in exchange of a growth strategy.
- Re-launch European investment in infrastructure.

A deepening European crisis is still the main risk to the global economy.
1 The global economy will recover gradually in 2012

2 The European crisis is still the main global risk

3 Recession in Europe, with high heterogeneity

4 Oil prices are a moderate global risk

5 Forecast revision
Financial stress in Europe continues to be very high...

As the short-run effect of long-term liquidity provided by the ECB fades, financial stress has resurfaced, especially in peripheral Europe.
Europe faces a mild recession in 2012, with wide heterogeneity and high risks

In the baseline scenario we assume that European authorities will continue to take decisive measures that will gradually lower financial tensions. Nonetheless, risks to the outlook are strongly tilted to the downside. Growth in Europe will be slow relative to other advanced economies such as the US, and very heterogeneous among EMU countries. Peripheral economies will be the most affected by financial tensions and fiscal consolidation plans.

**GDP growth in US and EMU (%yoy)**

Source: BBVA Research

**GDP growth in EMU countries**

Source: BBVA Research

- US GDP growth (% yoy)
- EMU GDP growth (% yoy)
- Forecast in May-12
- Forecast in Feb-12

<table>
<thead>
<tr>
<th>Year</th>
<th>EMU</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>0.9</td>
<td>0.7</td>
<td>0.5</td>
<td>0.1</td>
<td>0.6</td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Contents

1. The global economy will recover gradually in 2012
2. The European crisis is still the main global risk
3. Recession in Europe, with high heterogeneity
4. Oil prices are a moderate global risk
5. Forecast revision
The increase in oil prices represents a moderate risk to global growth.

Part of the increase in oil prices is the result of tight supply and demand.

Geopolitical risk premium between 10-15 USD per barrel. Persistent throughout 2012.

Very limited impact on growth given scant tightening reaction by central banks.

In case of a stronger price spike growth could be affected due to the consequent increase in global risk aversion.
Contents

1 The global economy will recover gradually in 2012
2 The European crisis is still the main global risk
3 Recession in Europe, with high heterogeneity
4 Oil prices are a moderate global risk
5 Forecast revision
All in all: Growth heterogeneity among main economic areas

Growth projections remain mostly unchanged relative to the February Global Economic Outlook. Growth will continue to be very heterogeneous between Europe, US and emerging countries. All in all, risks to the projections are strongly tilted to the downside due to the European crisis.
# GDP Growth Forecasts

<table>
<thead>
<tr>
<th>Region</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World</strong></td>
<td>3.9</td>
<td>3.6</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>Developed</strong></td>
<td>1.6</td>
<td>1.5</td>
<td>1.9</td>
</tr>
<tr>
<td>US</td>
<td>1.7</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>EMU</td>
<td>1.5</td>
<td>-0.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Spain</td>
<td>0.7</td>
<td>-1.3</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Emerging</strong></td>
<td>6.2</td>
<td>5.7</td>
<td>6.0</td>
</tr>
<tr>
<td>LatAm 7</td>
<td>4.3</td>
<td>3.7</td>
<td>3.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.9</td>
<td>3.7</td>
<td>3.0</td>
</tr>
<tr>
<td>LatAm 6</td>
<td>4.5</td>
<td>3.8</td>
<td>4.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>2.7</td>
<td>3.3</td>
<td>4.3</td>
</tr>
<tr>
<td>LatAm 5</td>
<td>6.7</td>
<td>4.4</td>
<td>3.9</td>
</tr>
<tr>
<td>Argentina</td>
<td>8.8</td>
<td>3.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Chile</td>
<td>6.0</td>
<td>4.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Colombia</td>
<td>5.9</td>
<td>5.0</td>
<td>5.2</td>
</tr>
<tr>
<td>Peru</td>
<td>6.9</td>
<td>6.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Venezuela</td>
<td>4.2</td>
<td>3.9</td>
<td>1.9</td>
</tr>
<tr>
<td>EAGLES</td>
<td>6.7</td>
<td>5.8</td>
<td>6.4</td>
</tr>
<tr>
<td>Turkey</td>
<td>8.5</td>
<td>2.7</td>
<td>5.6</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>5.7</td>
<td>5.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>7.3</td>
<td>6.8</td>
<td>7.4</td>
</tr>
<tr>
<td>China</td>
<td>9.2</td>
<td>8.3</td>
<td>8.7</td>
</tr>
<tr>
<td>Emerging Asia ex China</td>
<td>5.4</td>
<td>5.2</td>
<td>6.0</td>
</tr>
</tbody>
</table>
Global recovery, but heightened risks