

Global and Spanish Economic Outlook

February 2014

Main messages

- 1 The global economic cycle is improving** and we expect a moderate acceleration in growth in 2014-15 supported by the developed economies
- 2 Some economic policy uncertainties have been resolved** but there are still risks, although not of a systemic nature, as was the case in the past
- 3 For the first time since the beginning of the crisis the risks to our forecasts for the Spanish economy are to the upside.** The recovery is being driven by exports, import substitution and the recovery in new lending. In addition, both financial tensions and fiscal consolidation are less intense
- 4 The scope of the reforms needs to be expanded if they are to underpin a robust and sustained recovery, and reverse the jobs destroyed within a reasonable period**

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Commitment to the reforms is crucial to consolidate the improvement in the markets and increase potential growth

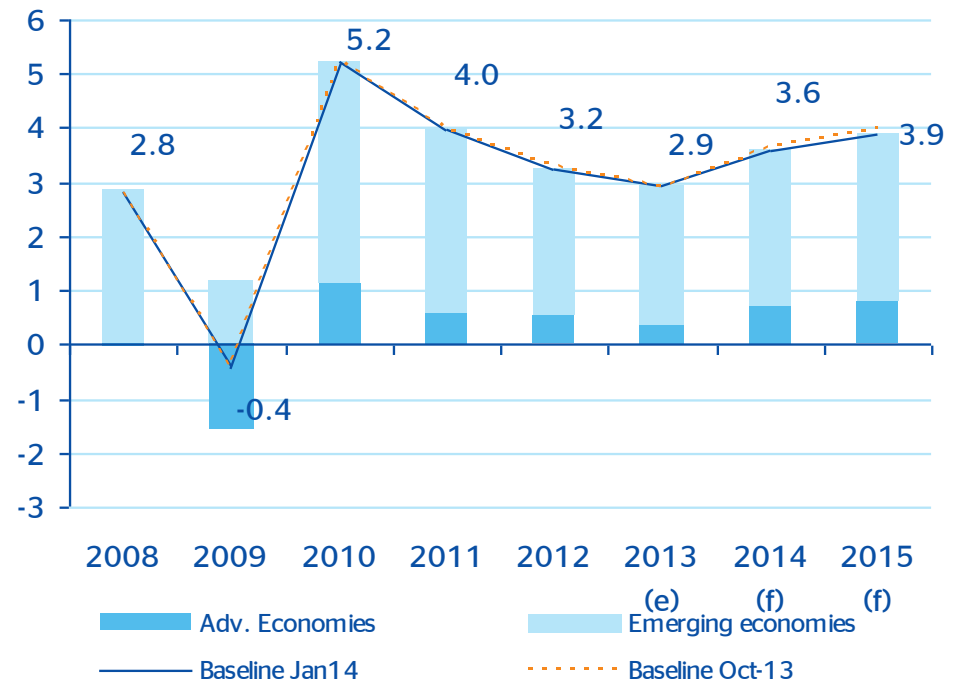
Main Messages

- 1 The **global expansion will continue in 2014-15** this time around with higher contributions from advanced economies

- 2 **Growth risks are more balanced with upward risks in the US and downward risks that remain:**
 - the **exit from QE and flows to emerging markets,**
 - the **uneven recoveries and vulnerabilities in EM, and**
 - the **eurozone**

Global GDP growth (%)

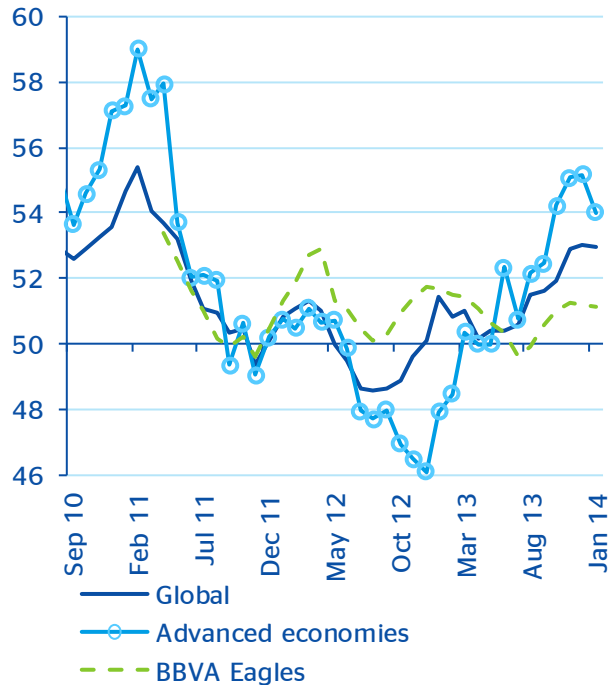
Source: BBVA Research



The global momentum is improving

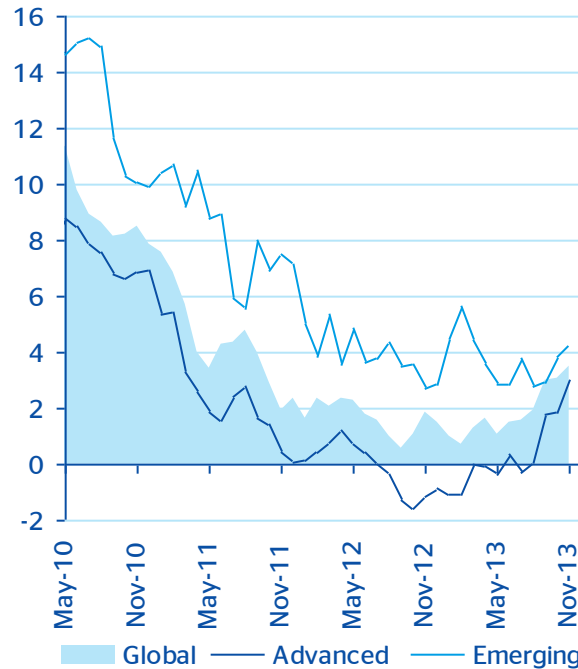
Manufacturing PMIs

Source: BBVA Research based on Markit Economics



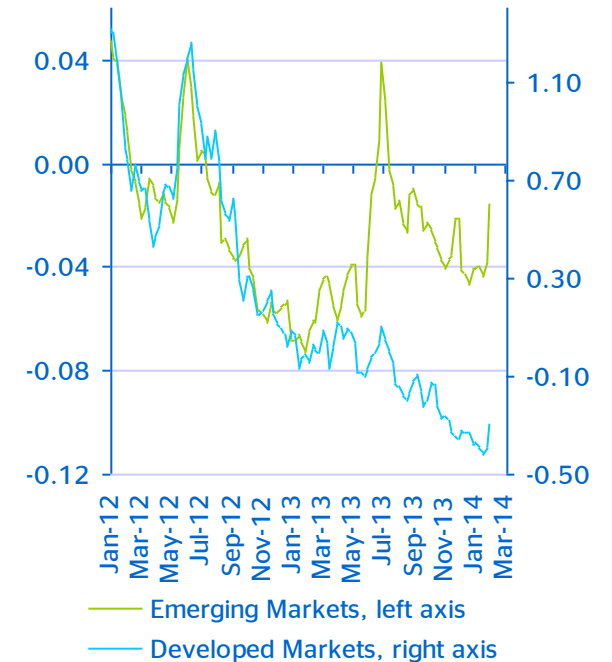
Industrial production (% yoy)

Source: CPB Netherlands



BBVA Financial Stress Index

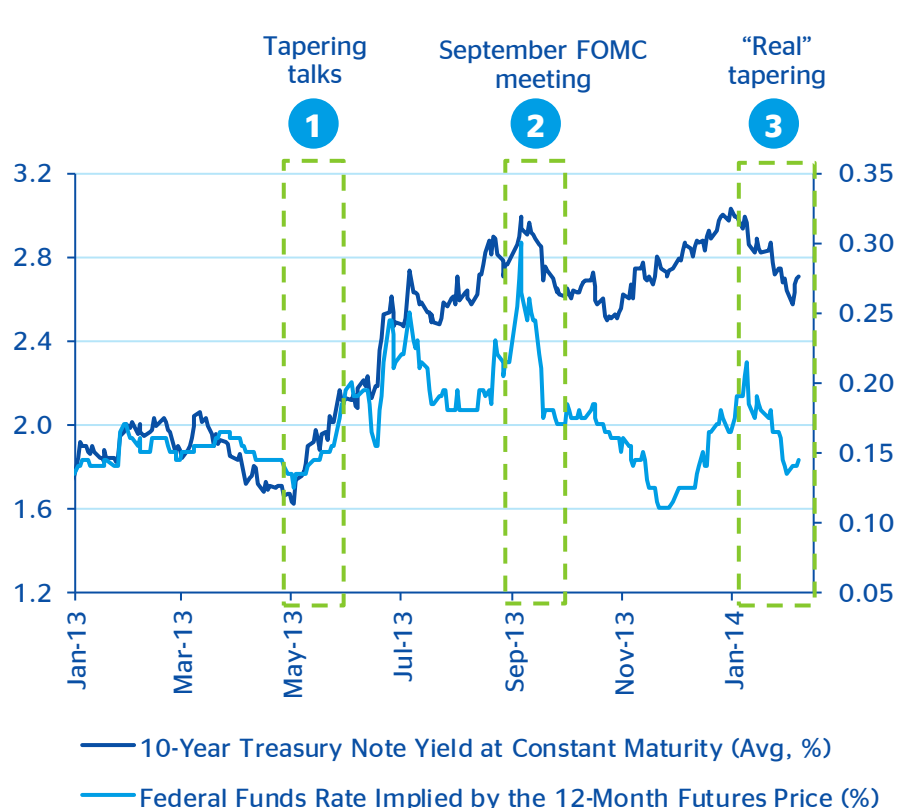
Source: BBVA Research



FED's forward guidance and ECB's room of maneuver should anchor the global financial scenario

US: Fed funds futures and long term yields (%)

Source: Bloomberg



EMU: Future of the EONIA rate and long term yields

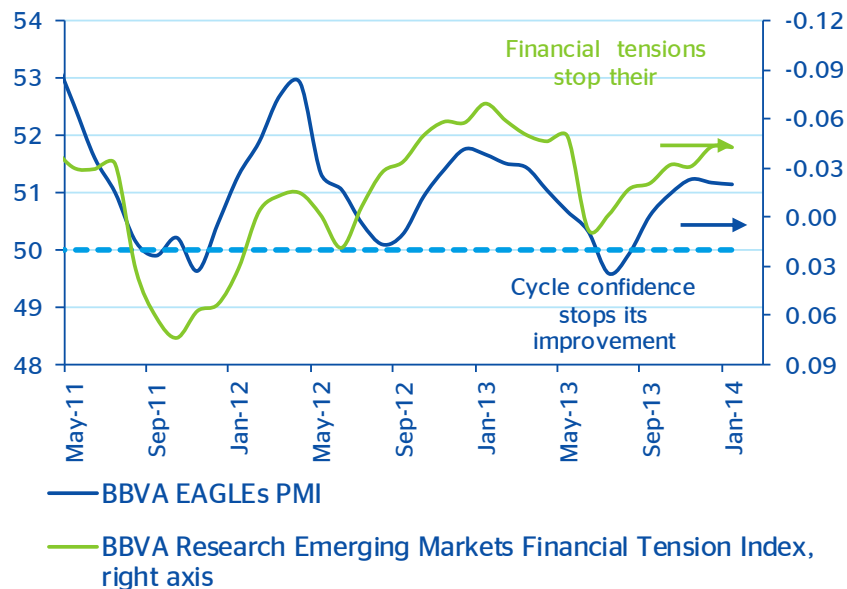
Source: Bloomberg and BBVA Research



The tightening of liquidity conditions is impacting on EM; anyway, differentiation remains

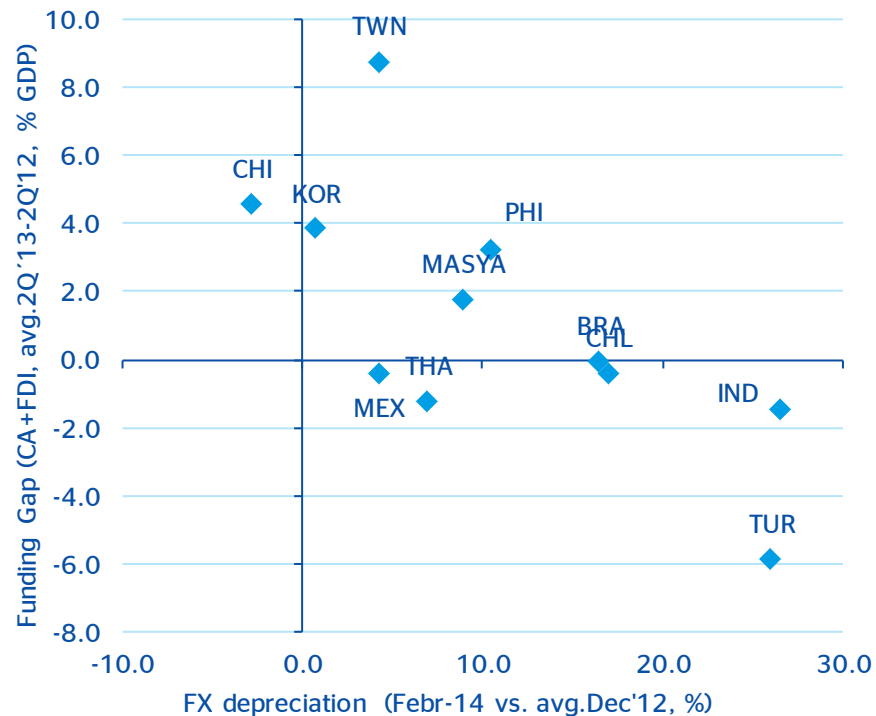
EM: economic cycle and financial tensions

Source: BBVA Research



EM: exposure to short-term capital flows and exchange rate vs USD

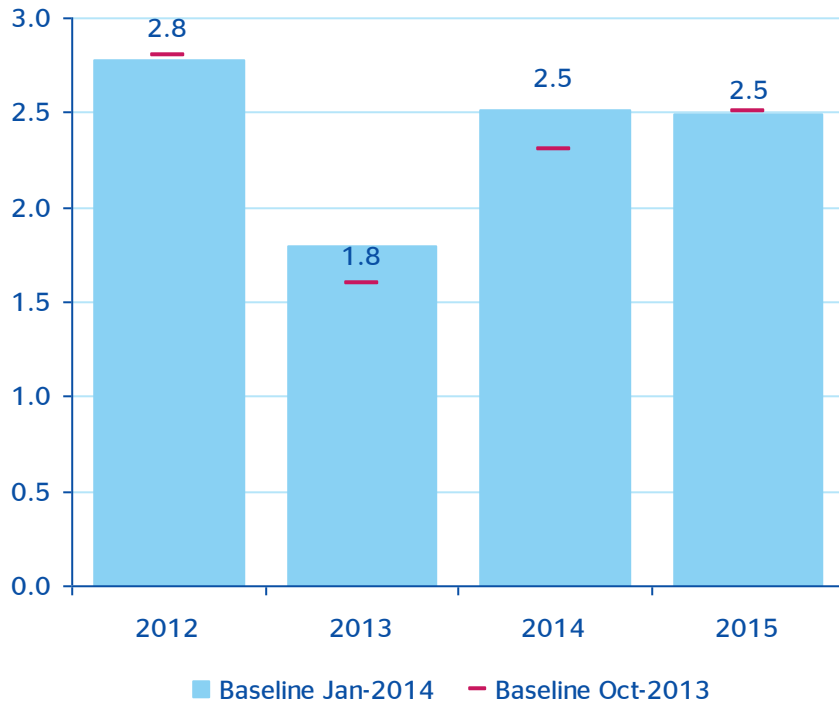
Source: BBVA Research



US: the sustained recovery and the fiscal agreement bias upwards our scenario for the US

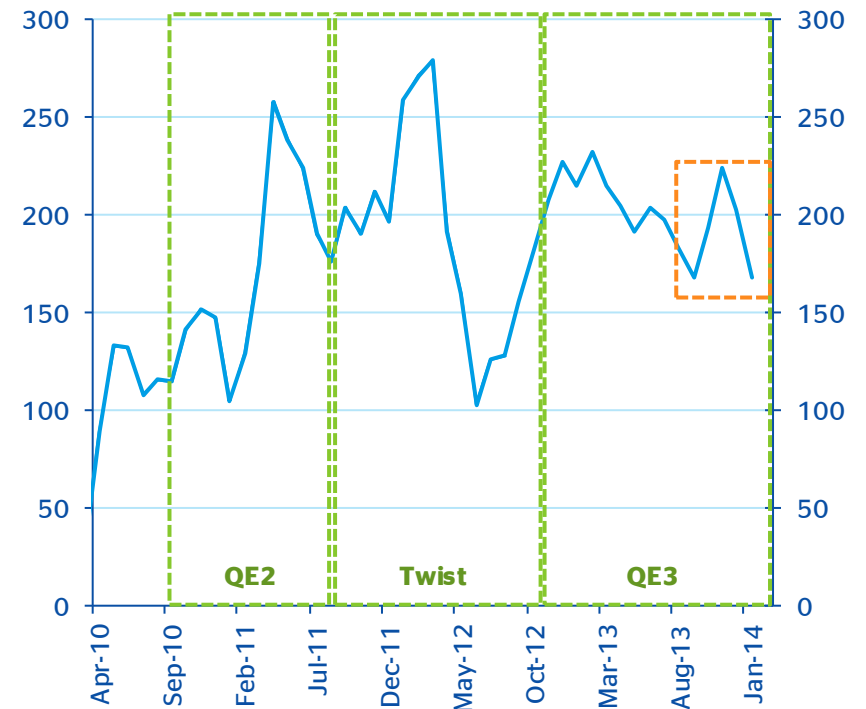
US: GDP growth (y/y)

Source: BBVA Research, BEA



US: private-sector payroll growth (monthly change, 3-month average, thousands)

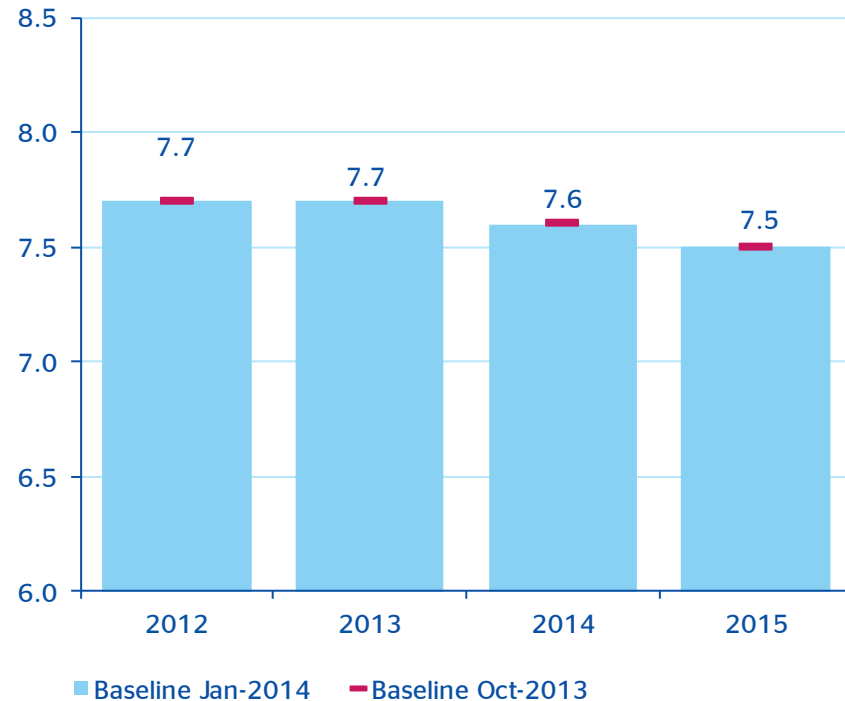
Source: Bloomberg



China: Growth momentum supported by recent stimulus measures and improving external demand

China: GDP Growth (% , y-o-y)

Source: BBVA Research



The “to-do” list of the “Third Plenum” meets our view about the needed reforms; lack of details introduces uncertainty

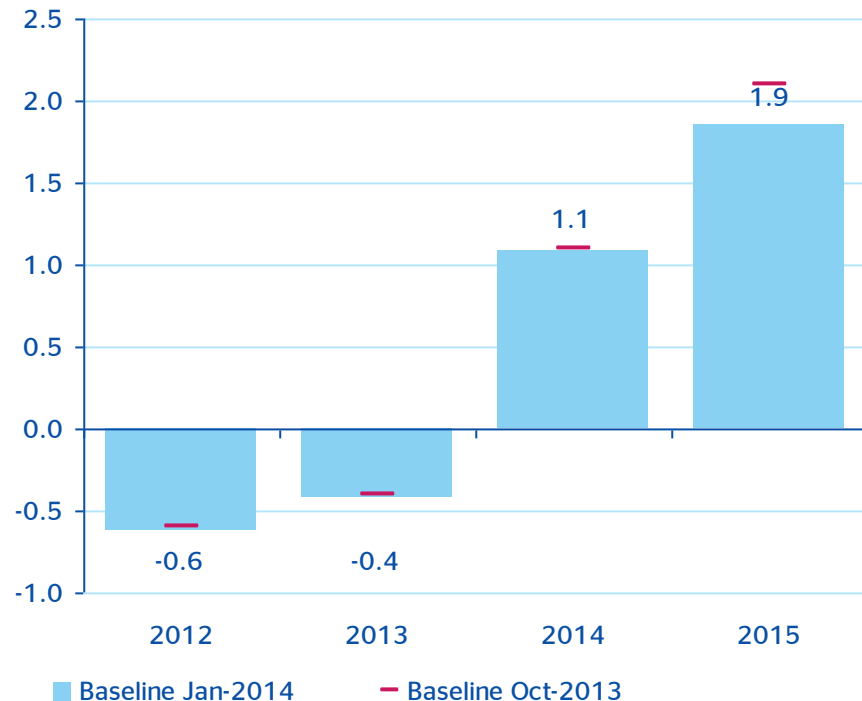
The objective of the Communist Party of China is to give markets a “decisive” role as mechanism of allocating resources

Efforts to curtail financial fragilities could lead to somewhat lower momentum in 2014H2 as the traditional engines of growth cannot be used “extensively” any more

The eurozone: positive growth with an increasing role of domestic demand

Eurozone: GDP growth (y/y)

Source: BBVA Research



Exports will remain as the main driver of growth in both 2013 and 2014

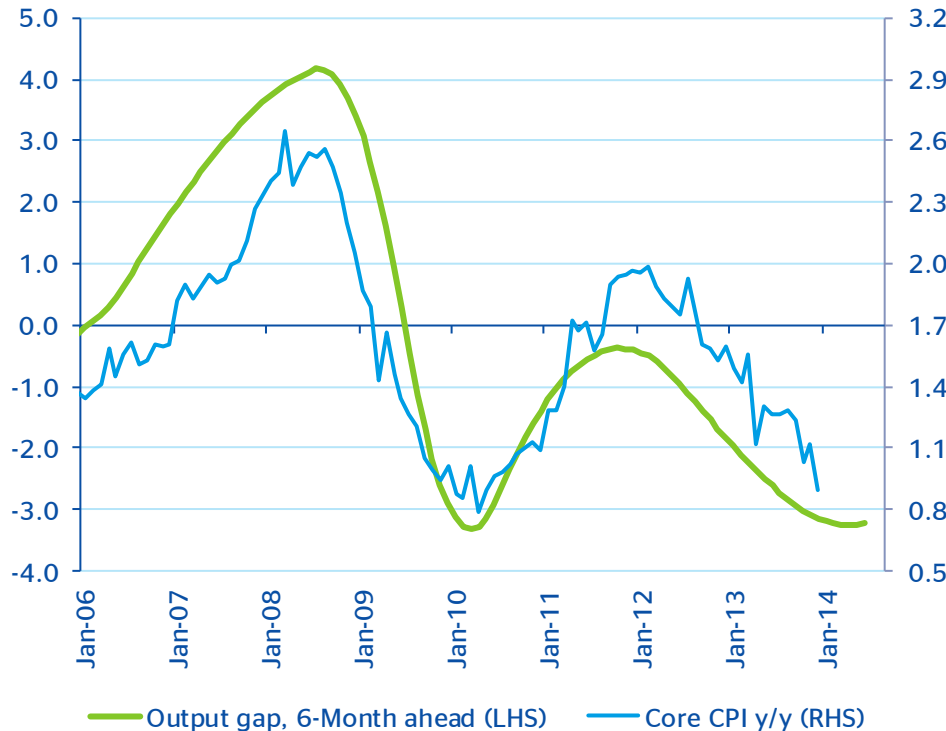
Domestic demand has weighed on growth in 2013, but will contribute to the recovery in 2014-15

Overall: lower financial tensions, higher global growth, lower fiscal drag, ECB's loosening bias and Banking Union

In the eurozone, the “double-dip” in the period 2008-13 and weak money growth have prompted inflation to fall

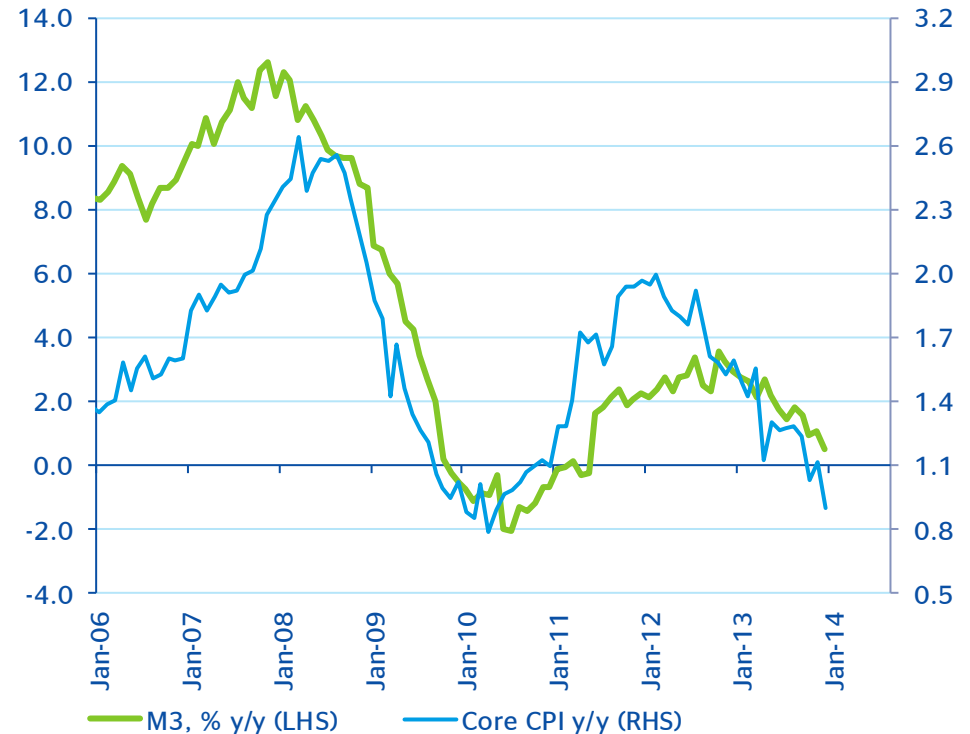
EZ: core inflation and demand pressure, % y/y and % potential GDP

Source: Eurostat, Haver and BBVA Research



EZ: core inflation and M3, % y/y

Source: Eurostat, Haver and BBVA Research

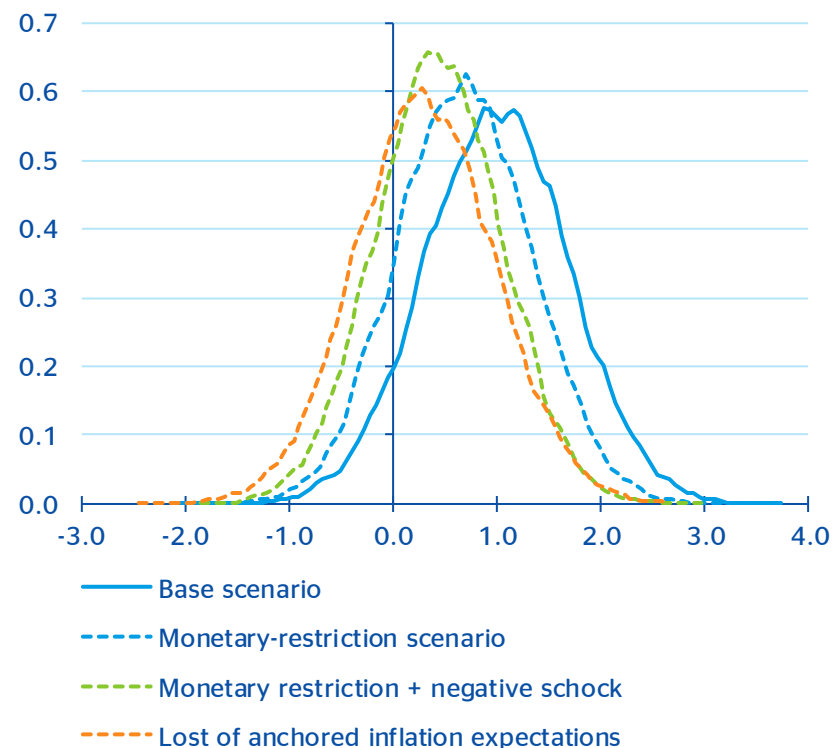


In the most likely scenario, the risk of deflation is low; yet it increases under more extreme situations

EZ: Distribution of probability of inflation

(average 2014)

Source BBVA Research



	Inflation	Prob. of deflation
Baseline scenario	1.0%	7.5%
Monetary restriction (M3 growth = 0.9%)	0.8%	14%
Monetary restriction + shock (M3 growth = 0.9%; growth <-1)	0.4%	34%
... + Unanchored expectations (M3 growth = 0.9%; growth <-1)	0.3%	47%

Interconnected risk events with potential to impact on global growth

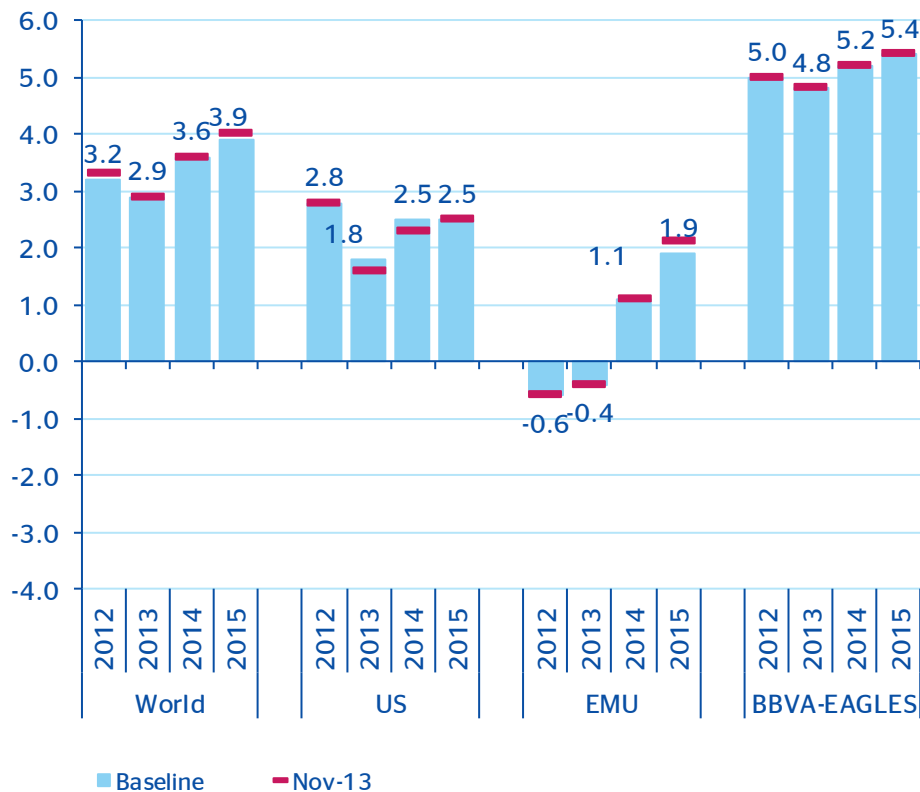


(*) Heterogeneous developments among countries

In sum, economic growth at diverse paces and with different risks

GDP growth (%yoy)

Source: BBVA Research and IMF



Growth cycle strengthens, mainly in advanced economies and in some emerging economies. Economic policy remains as a supportive factor for growth in 2014-15

To reinforce the baseline scenario, policy-makers have to tackle domestic vulnerabilities: banking issues and disinflation risks in the Eurozone, financial vulnerabilities in China, and private domestic demand in emerging economies

The impact of FED's tapering over global funding conditions, in the US and beyond, remains as a factor of uncertainty

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Global economy: a gradual acceleration supported by the developed economies

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Spain: upside risks for the first time since the beginning of the crisis

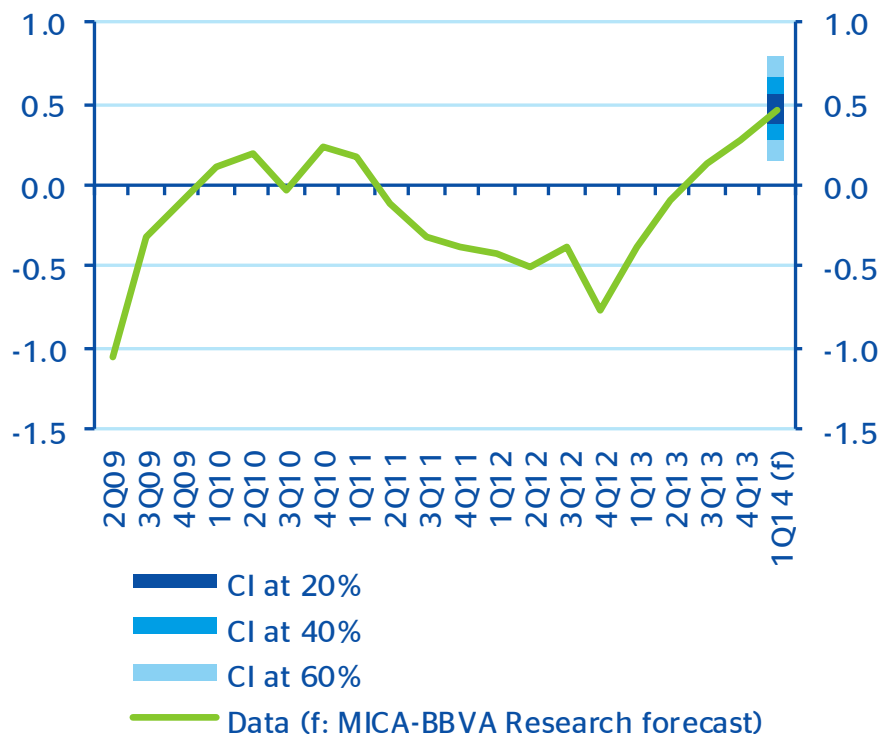
Section 3

Commitment to the reforms is crucial to consolidate the improvement in the markets and increase potential growth

The recovery of the Spanish economy is confirmed ...

Spain: GDP growth and MICA-BBVA forecasts (% QoQ)

Source: BBVA Research based on INE



After three years in recession, domestic demand started to make a positive contribution to growth again in the second half of 2013...

... as a consequence of improved fundamentals, less restrictive fiscal policy, reduced uncertainty and increased import substitution

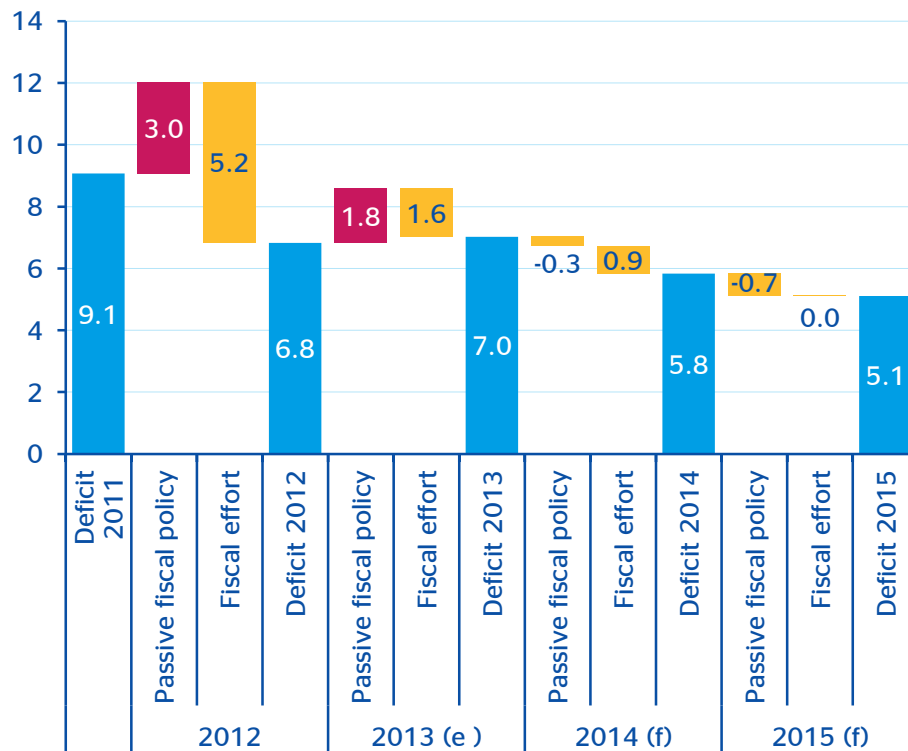
The available information points to growth of at least 0.4% in 1Q14

... and, in spite of the uncertainty regarding the deficit in 2013 ...

Public sector: breakdown of the public deficit excluding aid to the financial sector

(% GDP)

Source: BBVA Research based on MINHAP



The significant fiscal consolidation efforts in 2012 and 2013 ...

... have resulted in containment of the public deficit at around 7.0% of GDP

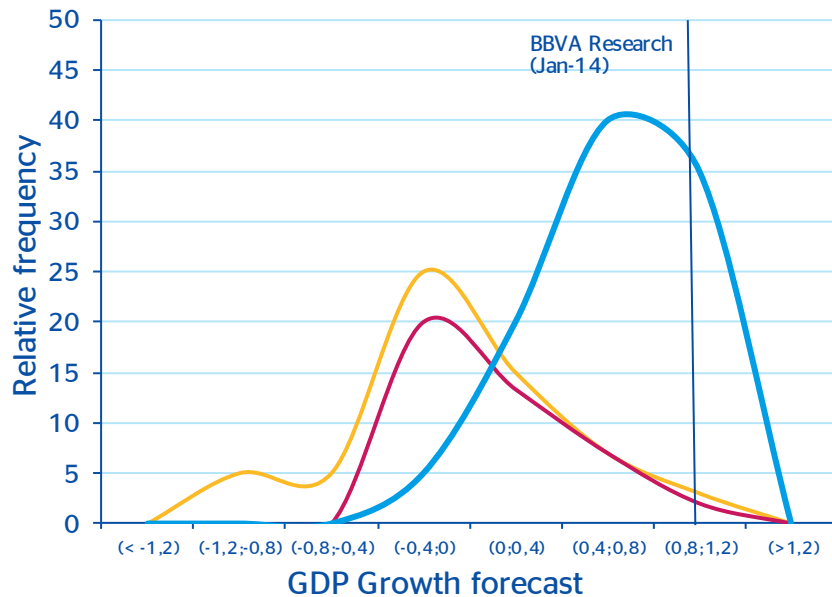
The wider the deviation from the target deficit for 2013, the greater the effort that will have to be made in 2014

... the risks are to the upside for the first time

Spain: GDP growth forecasts, 2014

(% YoY)

Source: BBVA Research based on Consensus Forecast Inc.



— July-2013 (mean: 0,2%) — Feb-2013 (mean: 0,3%)
— Jan-2014 (mean: 0,7%)

Economic policy decisions have eliminated the risk scenarios

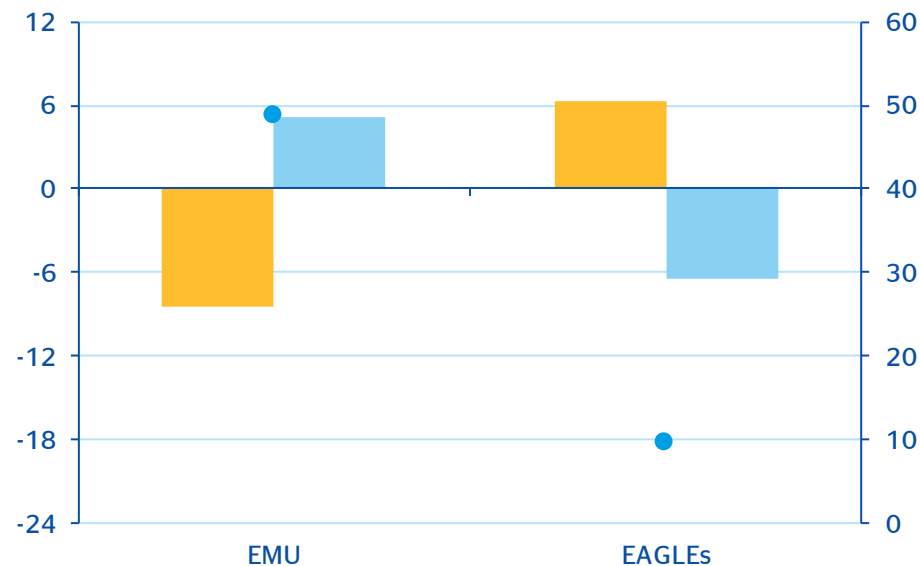
The differential performance of the Spanish economy confirms this improvement in the trend

If these trends are confirmed, growth could be even stronger than we are forecasting

Upside risks: 1. Exports will continue to expand

Spain: growth and breakdown of goods exports by broad geographical area

Source: BBVA Research based on Datacomex



■ Nominal growth, average % yoy 1Q13 (LHS)

■ Nominal growth, Oct-Nov 2013 average % yoy (LHS)

● Share over total exports (% , RHS)

We expect the recovery to continue driven by the increase in exports

The deceleration in exports is a temporary phenomenon and will reverse in a scenario of stronger global growth

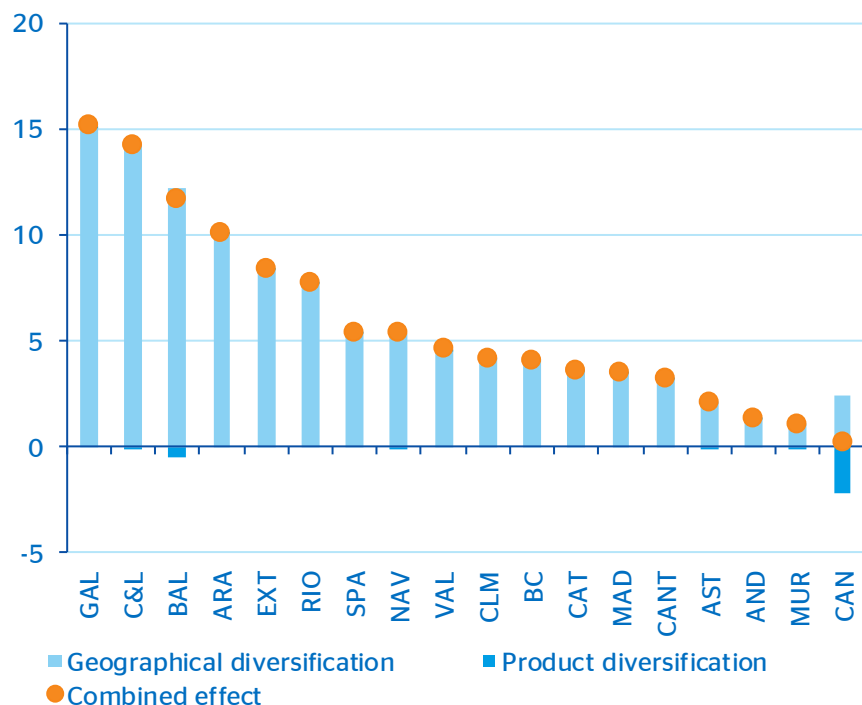
The slowing momentum in EMs has been offset by the recovery in the EMU

Upside risks:

1. Exports will continue to expand

Regions: average annual growth in exports of goods due to diversification (2009-2012)

(%, Spain: weighted average)
Source: BBVA Research



Box 3

Export growth is based on improvements in competitiveness, and above all, on diversification

On average, 75% of the growth in exports during the crisis was due to product and geographical diversification

This export diversification prevented even greater negative GDP growth

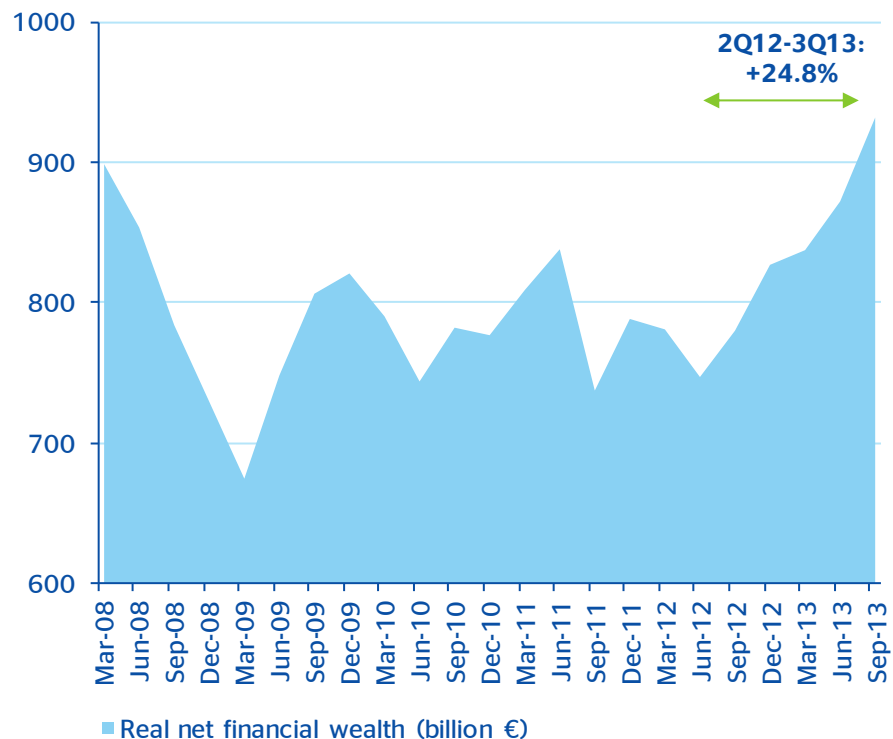
Upside risks

2. An increase in savings and financial wealth

Spain: net real household financial wealth

(Deflated by the private consumption deflator; seasonally adjusted data)

Source: BBVA Research based on Bank of Spain and INE



The increase in corporate and household savings has been an essential part of the recoveries in Spain ...

... that has helped in the deleveraging process and in the improvement in the financial situation of the private sector ...

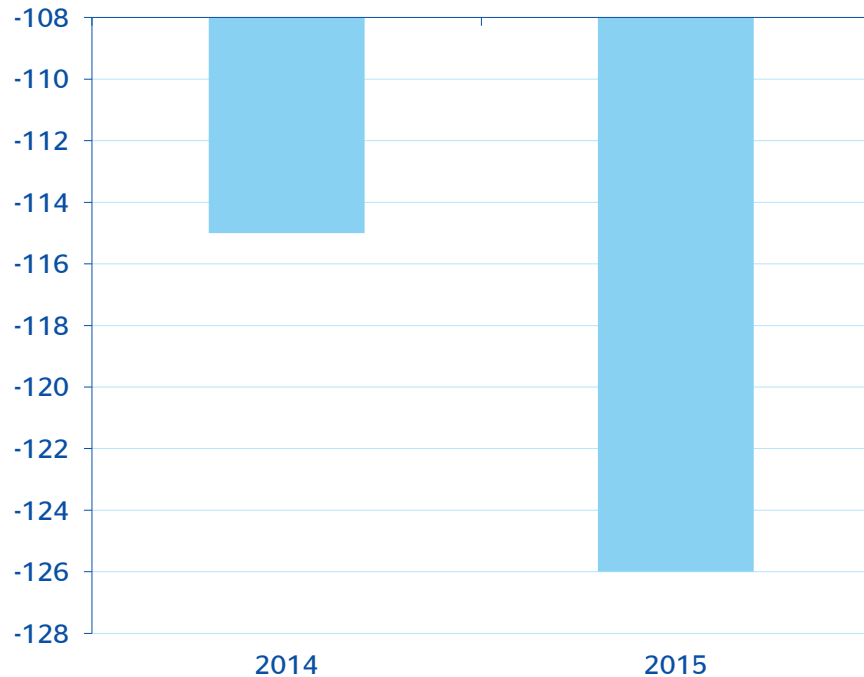
... and these, together with the stabilisation and improvement in the value of wealth, has driven an increase in consumption and investment

Upside risks

3. More certainty and fewer financial tensions

Spain: 10Y bond yield

(Difference vs. our November 2013 forecast in bp)
 Source: BBVA Research



Improved international perceptions of the Spanish economy have allowed Spain to reduce its dependence on ECB funding

Reduced financial tensions are reflected in the economy with a lag of 6-9 months

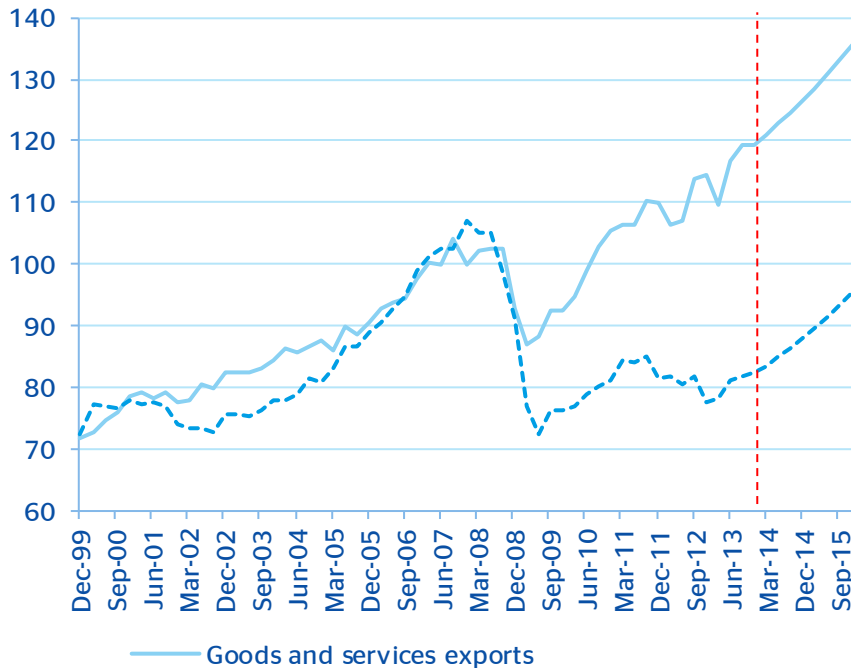
A permanent 100bp drop in sovereign interest rates implies up to one percentage point more growth for the economy

Upside risks

4. More dynamic investment

Spain: exports and investment in equipment and machinery (2008=100)

Source: BBVA Research based on INE



The recovery we expect in the EMU and the continuing export growth ...

... should translate into an increase in private-sector investment

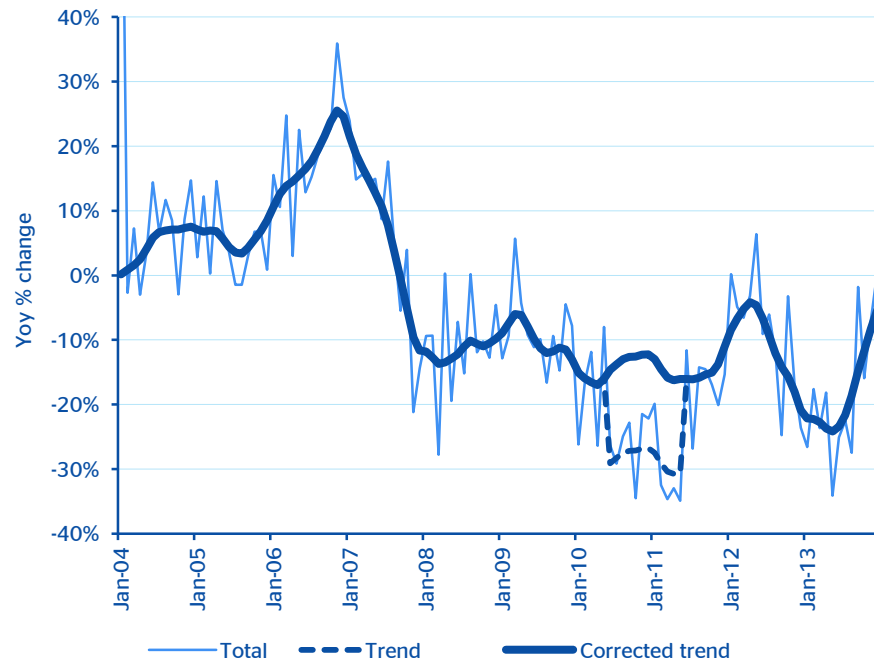
In fact, the investment in equipment and machinery had grown 6.3% by 4Q13

Upside risks

5. Improvement in new lending flows

Spain: new lending and credit to households, NPISH and non-financial entities

Source: BBVA Research based on Bank of Spain (February 2014)



The Spanish economy is going through an evitable deleveraging process ...

... that is compatible with new lending for financially viable projects

There has been a turning point and an improvement in corporate lending, which we expect to consolidate in 1H14

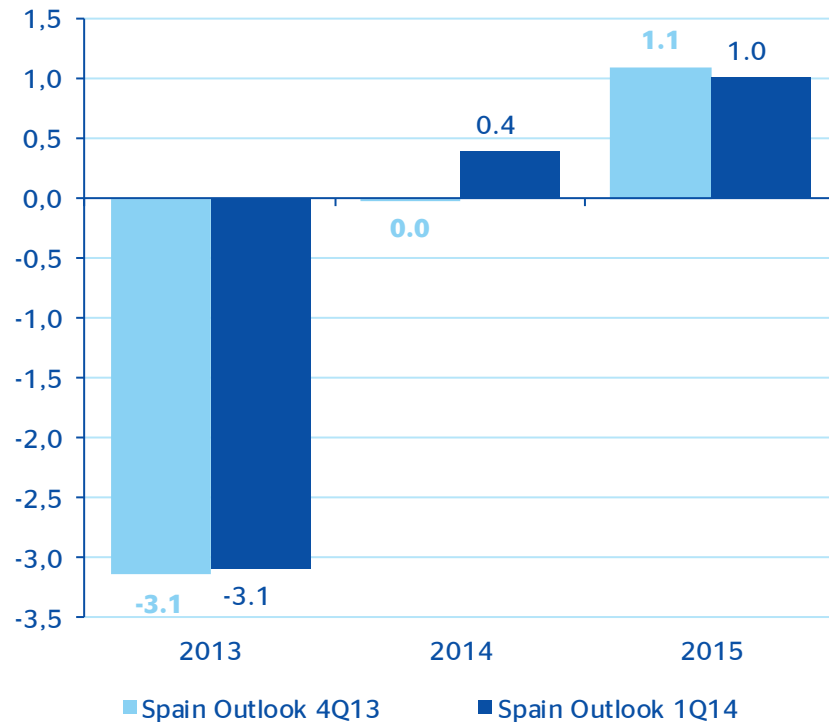
Upside risks

6. Changes in the labour market

Spain: LFS employment

(Variation in annual average, %)

Source: BBVA Research based on INE



Net job-creation has started sooner than we expected, partly as a reflection of wage moderation

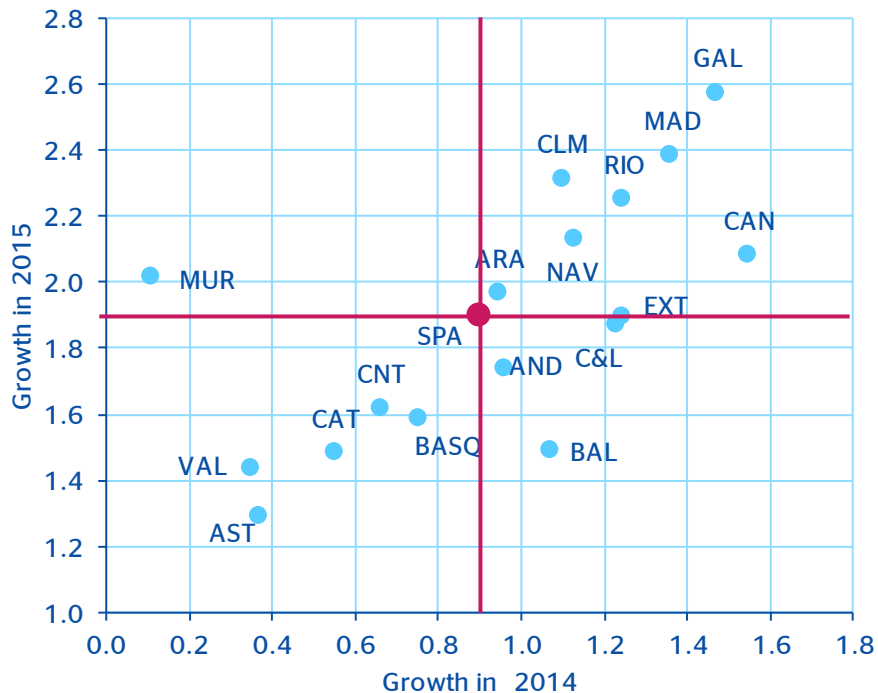
Had labour institutions been in better shape at the beginning of the crisis, millions of job losses could have been avoided

In 2014 employment will be created for the first time since the beginning of the crisis

2014: the start of the recovery

Spain: GDP growth by region

(% YoY)
Source: BBVA Research



In 2014 all the regions will return to positive growth

The progress made in correcting the imbalances and the exposure to external demand ...

... are the key to explaining the difference in the speed at which the different regions will start growing

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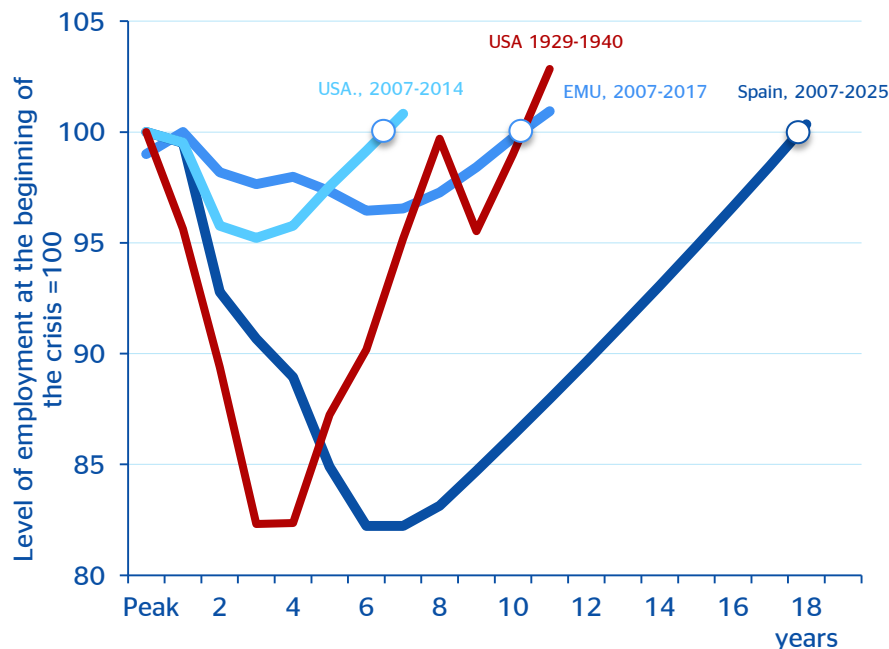
Section 3

Commitment to the reforms is crucial to consolidate the improvement in the markets and increase potential growth

The need to broaden the scope of the reform agenda

GDP growth and job-creation

Source: BBVA Research and Lebergott (1964)



The recovery in employment will be very sensitive to economic growth

The objective should be to introduce the necessary reforms to increase economic growth to close to or more than 2.5%

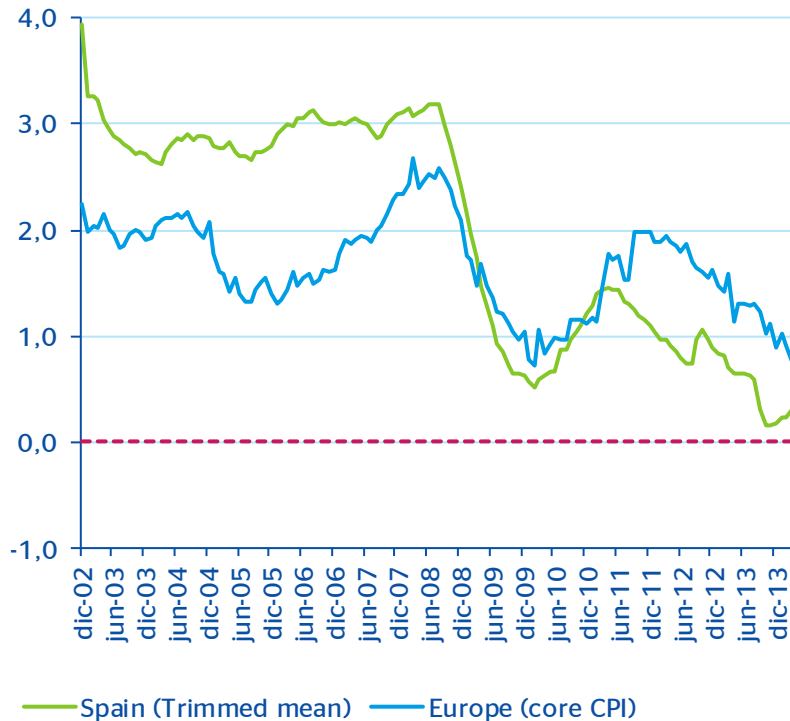
Unless this happens, job-creation will be limited and the recovery slow

Assumptions for the USA and the EMU are consistent with BBVA Research's scenario. The Spanish scenario has been built assuming both that productivity per worker rises 0,6% (as it was the case between 1992 and 2007) and that GDP grows on average 2,5.

The ECB must ensure it achieves its inflation target

Spain and EMU: inflation trend

(% YoY)
Source: BBVA Research based on INE y Eurostat



Box 1

The ECB needs to converge with its inflation target more quickly, which would help Spain deleverage ...

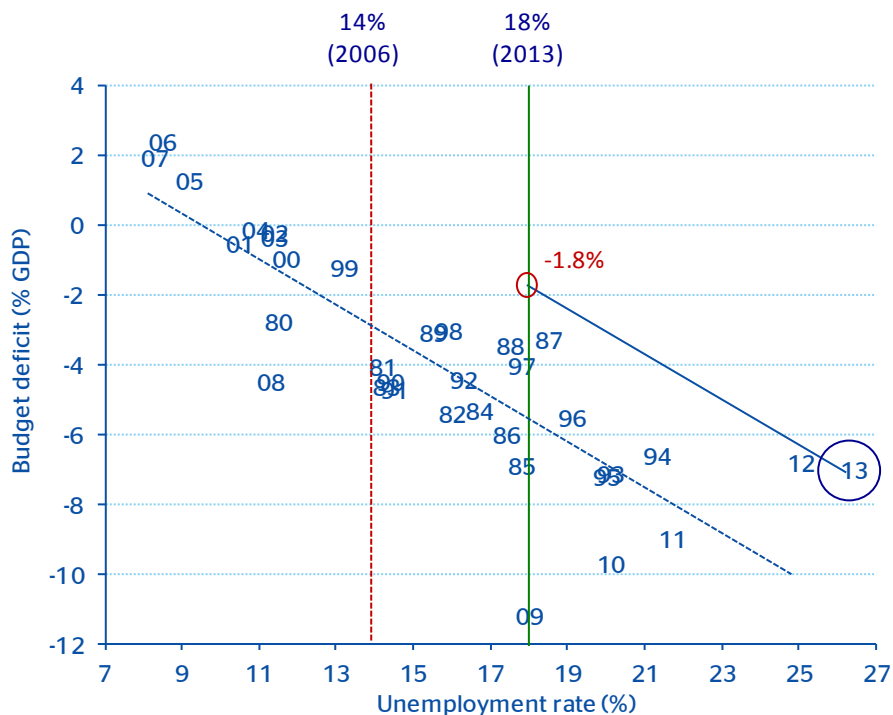
... while the Spanish economy needs to continue to improve competitiveness

The reforms that improve competitiveness and facilitate internal devaluation in Spain need to continue

An efficient tax system and fiscal sustainability

Spain: unemployment and public deficit

Source: BBVA Research based on INE and MINHAP



Box 2

Tax revenues dropped sharply in Spain as a consequence of the recession ...

... and the fiscal consolidation process requires sufficient resources to ensure that Spain's finances remain in good health...

... but with a structure that drives economic growth and job-creation, two key factors for reducing the deficit

The need to broaden the scope of the reform agenda

1. To continue the deleveraging and improvement in the finances of the Spanish economy: finalising the restructuring of the financial sector and attracting foreign direct investment

2. Public-sector reform, fiscal consolidation and long-term sustainability of public finances, with an efficient tax system that incentivises growth and job-creation

3. Reforms to improve competitiveness, increase the attraction of Spain internationally in terms of physical, human and technological capital

4. To continue with the reforms that reduce the duality in the labour market, improve the way it functions and increase employability
-> more and better-quality jobs

Global and Spanish Economic Outlook

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Macroeconomic scenario

(% YoY)	2012		2013 (f)		2014 (f)		2015 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	-2,8	-1,4	-2,5	-0,5	0,9	0,7	1,3	1,2
General government final consumption exp.	-4,8	-0,5	-1,2	0,3	-1,1	0,5	1,3	0,7
Gross fixed capital formation (G.F.C.F.)	-7,0	-3,9	-5,9	-3,1	0,2	1,6	5,2	5,0
Equipment and cultivated assets	-3,9	-4,4	0,8	-2,5	6,0	2,8	7,8	7,1
Equipment and machinery	-3,9	-4,4	0,7	-2,5	5,8	2,9	7,8	7,1
Housing	-8,7	-3,4	-8,4	-3,0	-3,4	1,0	5,0	3,6
Other constructions	-10,6	-4,8	-11,8	-4,9	-4,2	-0,7	1,5	2,9
Changes in inventories (*)	0,0	-0,5	0,0	-0,1	0,0	0,0	0,0	0,0
Domestic Demand (*)	-4,1	-2,1	-2,8	-0,9	0,4	0,8	2,0	1,7
Exports	2,1	2,7	5,2	1,2	6,5	3,5	6,7	4,9
Imports	-5,7	-0,8	0,3	0,2	5,2	3,3	7,4	5,1
External Demand (*)	2,5	1,5	1,6	0,5	0,6	0,3	-0,1	0,2
GDP mp	-1,6	-0,6	-1,2	-0,4	0,9	1,1	1,9	1,9
Pro-memoria								
GDP excluding housing	-1,2	-0,5	-0,8	-0,2	1,2	1,1	1,8	1,8
GDP excluding construction	-0,4	-0,2	-0,1	0,0	1,5	1,2	1,8	1,7
Total employment (LFS)	-4,5	-0,7	-3,1	-0,8	0,4	0,1	1,0	0,7
Unemployment rate (% Active pop.)	25,0	11,4	26,4	12,1	25,6	12,0	24,8	11,6
Current account balance (% GDP)	-1,1	1,2	0,9	2,1	1,6	2,1	1,7	2,0
Public debt (% GDP) (**)	86,0	93,0	94,7	95,6	99,1	96,1	101,4	95,7
Public deficit (% GDP)	-6,8	-3,7	-7,0	-2,8	-5,8	-2,4	-5,1	-2,1
CPI (average)	2,4	2,5	1,4	1,4	0,5	1,0	1,0	1,4
CPI (end of period)	2,9	2,2	0,3	0,8	0,7	1,3	1,2	1,5

(*) Contribution to GDP Growth

(**) Excluding aid to the banking sector in Spain

(f): forecast

Current disinflation in some advanced economies is comparable to the Great Recession episode

Core inflation in some advanced economies (% y/y)

Source: Haver and BBVA Research

