How high European risk really is

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Presentation divided in two parts

1. Europe’s situation and what is to be expected in the short/medium term
   - Key messages
   - Forces shaping the recovery
   - Uncertainties
   - ECB exit strategy as gradual as possible
   - Strong fiscal consolidation
2. The specific case of Spain
   - An adjustment that is at an advanced stage specially in the private sector
   - The need for ambitious structural reforms

Main messages on Europe

- Europe has several challenges ahead to reduce sovereign risk mainly
- Key factor is how fast the recovery will come
- Risks are tilted on the downward side but they smaller than generally thought

- On the policy side:
  - Monetary policy to remain adequately accommodative until at least the end of 2011
  - The challenge of fiscal consolidation ahead, while important, should not have a sizeable negative effect on growth

Forces shaping the recovery

1 Fiscal consolidation will not reduce growth massively

Fiscal tightening for the eurozone as a whole is likely to be very timid in 2010 **(0.1% of GDP)**

The fiscal consolidation process is more an issue for 2011 and beyond **(around 1.1% of GDP in 2011)**

- Greece
- Spain
- Portugal
- Ireland

Although some member states fronloaded fiscal adjusment measures…

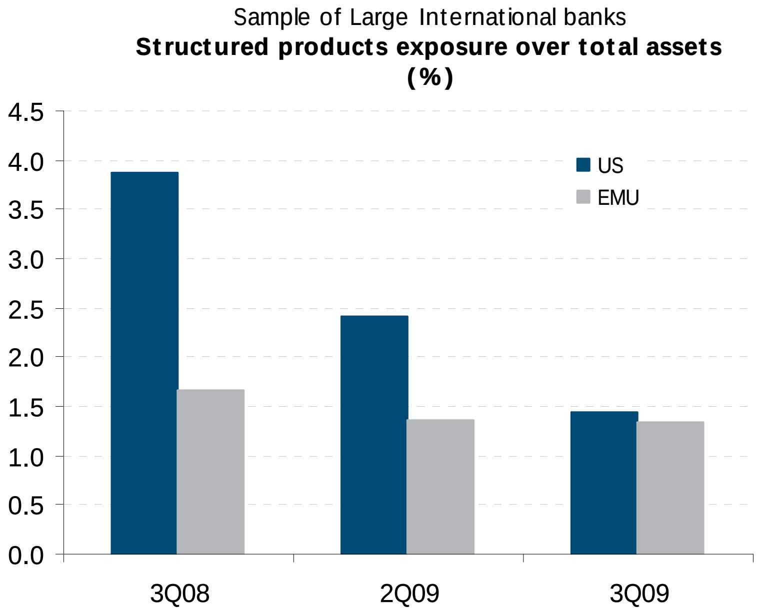
An average fiscal multipliers stimation suggest that fiscal retrenchment is likely to result in **GDP being lower by around 0.1% in 2010 and 0.8% in 2011**.

- Austria
- Finland
- Germany
- Netherlands
- France

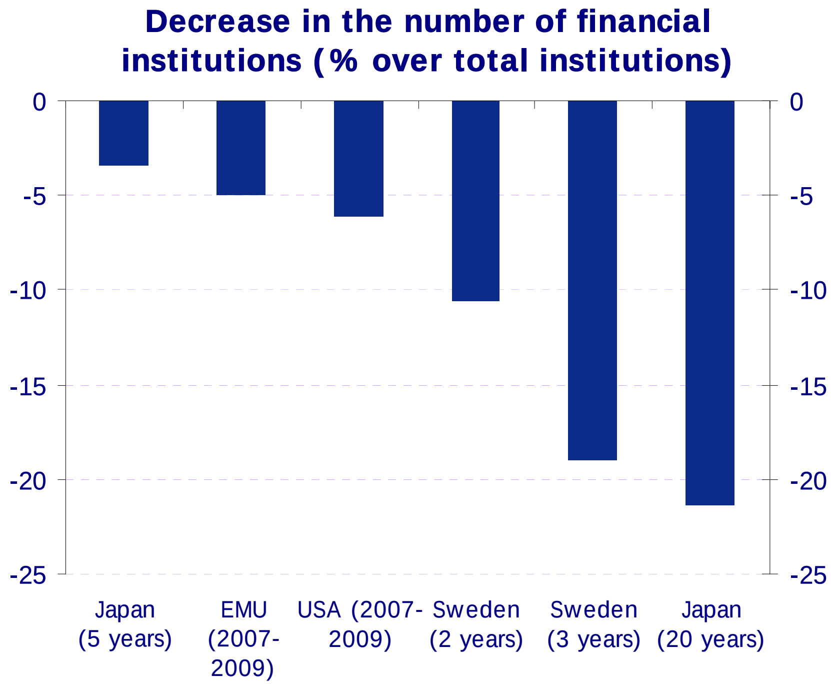
... Other countries will continue to estimulate their economies over the current year

Forces shaping the recovery

2 The lack of restructuring in the European financial sector



Source: BBVA Research



Source: BBVA Research

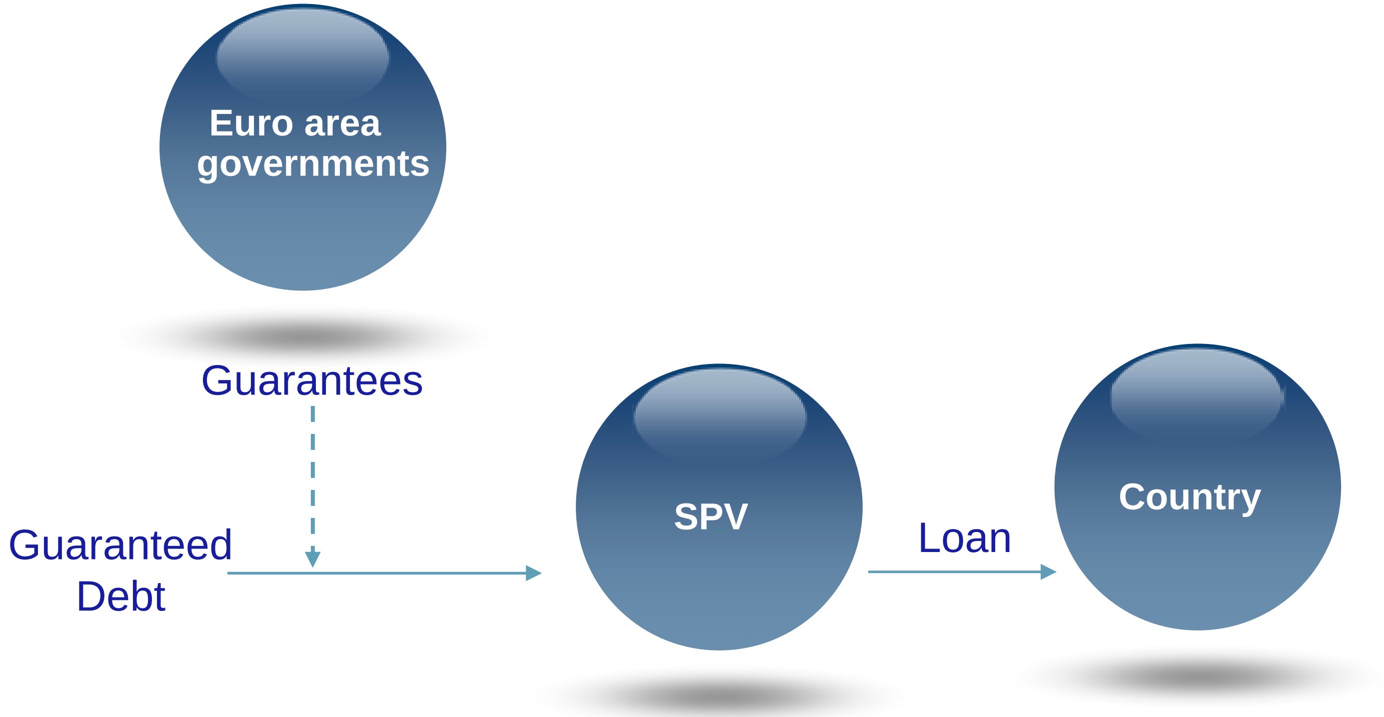
Japan = City banks and Regional banks
USA =Registered institutions in FDIC
Europe = Credit Institutions of Germany, France, Spain, Netherland and Italy

The publications of stress test in Europe should help to diminish uncertainties in the recent sovereign debt crisis

Forces shaping the recovery

3 The reform in Europe may also help on the positive side, although more on a longer term basis. As often in the history of European integration, crisis are driving the EU to further cooperation

Credibility of SPV use: mechanism requires IMF and European Commission program



1. Activation of SPV loans requires:
   - Country “in difficulty”
   - Join program with IMF, EC
2. Funding needs to be assessed jointly by IMF, ECB and Commission

Uncertainties in the recovery

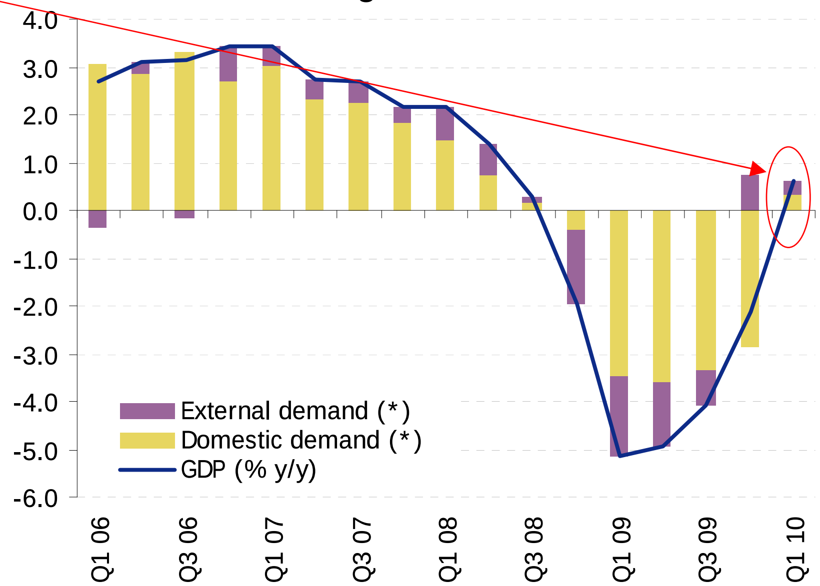
Strong exports supported for the strength of the industrial sector

Net exports contributed positively to GDP growth since Q2 2009, cushioning the sharp decline of economic activity

The growth in external demand has supported the recovery of industrial sector

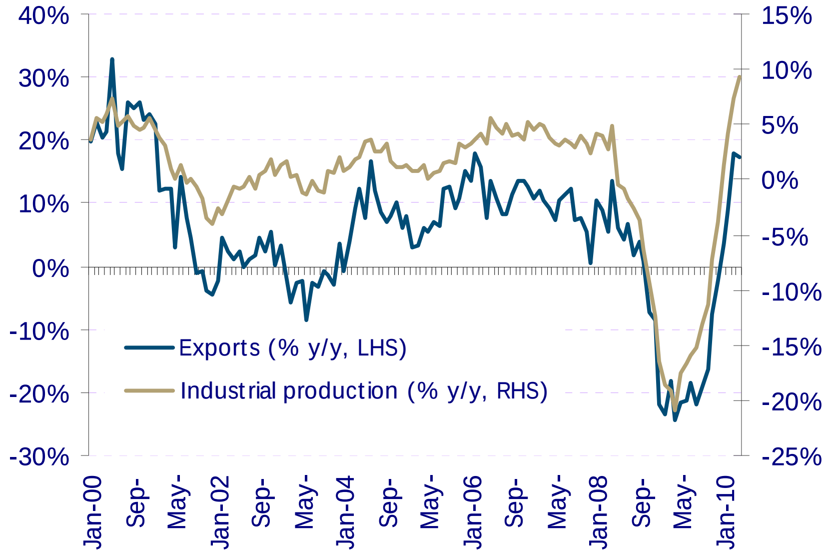
Lower contribution despite strong exports growth, as imports surged linked with rebuilding inventories

Euro zone: Contribution to yoy GDP growth



Source: Eurostat and BBVA Research
Note: (*) Conntribution to yoy GDP growth

Eurozone: Exports and Industrial production

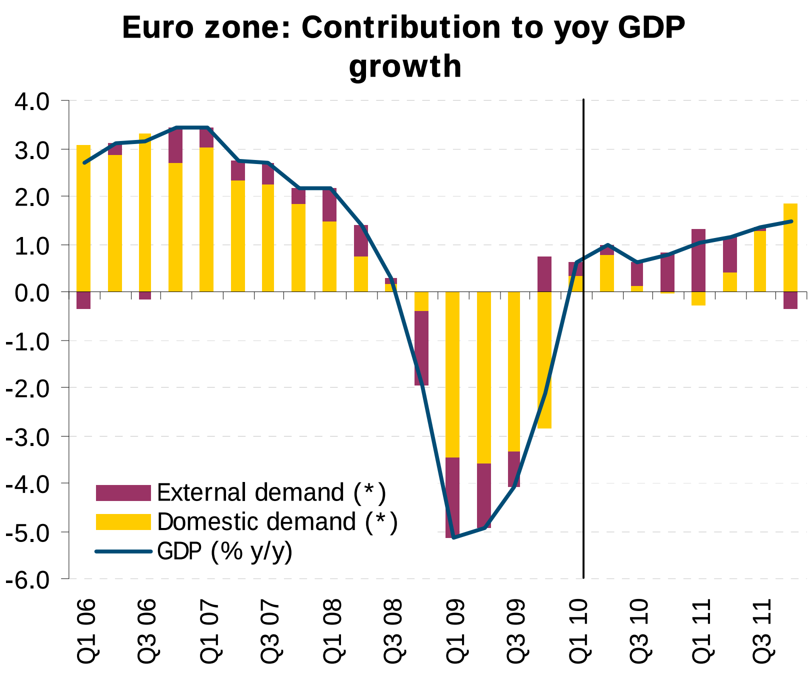


Source: Eurostat

Uncertainties in the recovery

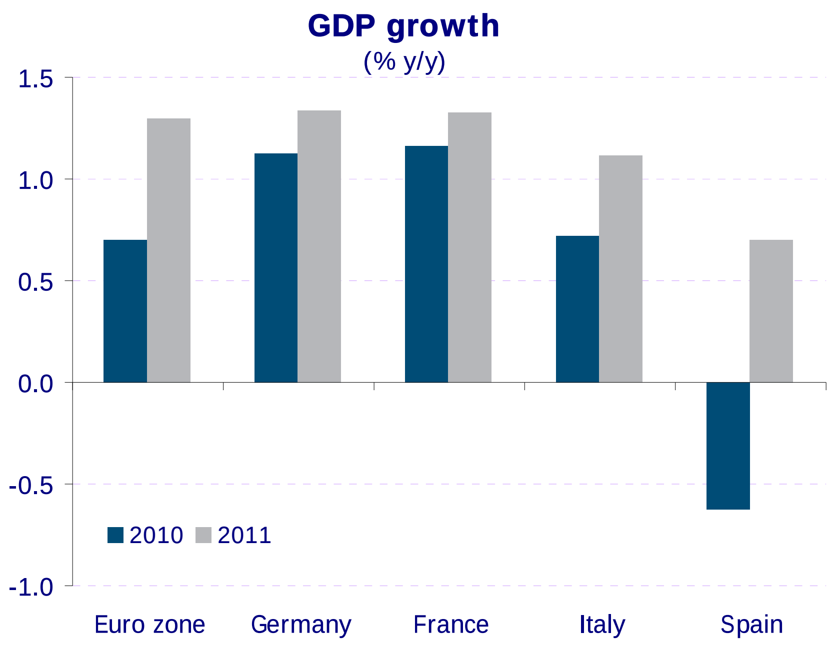
The robustness of the recovery in the eurozone is yet to be tested, as some factors behind it were temporary and the support of exports will depend on the strength of the global recovery

We expect eurozone GDP to grow at 0.7% in 2010 and 1.3% in 2011



Source: Eurostat and BBVA ERD
Note: (*) Conntribution to yoy GDP growth

With a heterogeneous recovery across member states



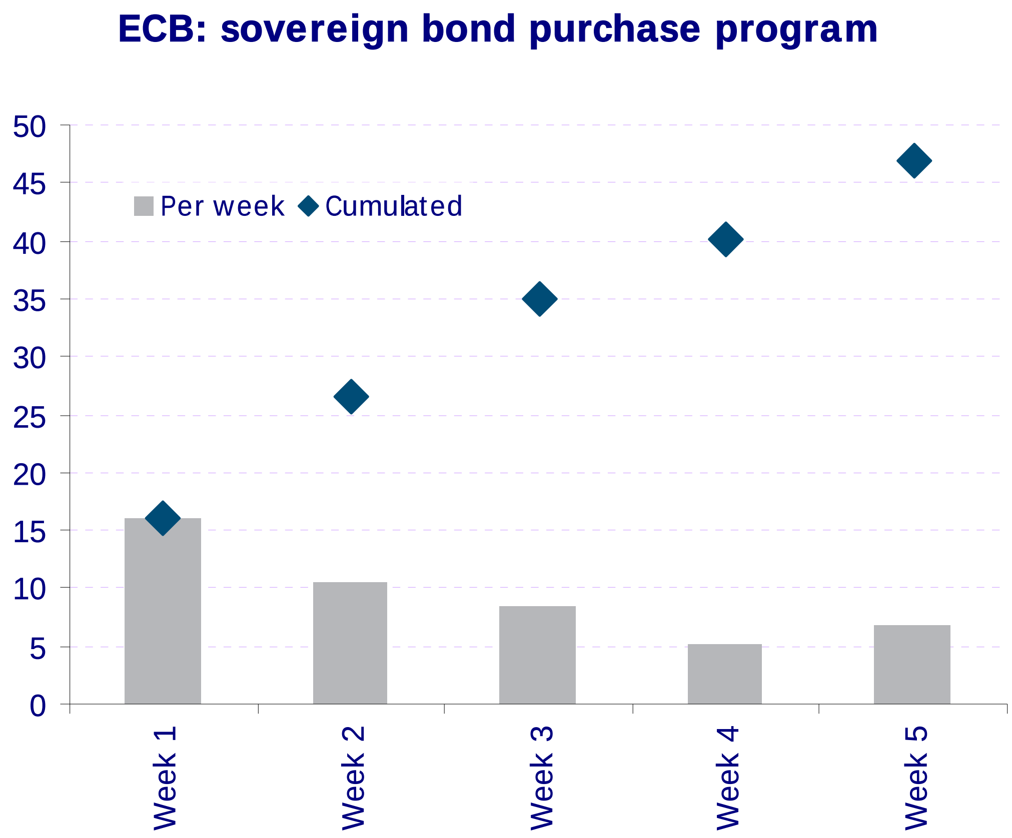
Source: BBVA Research

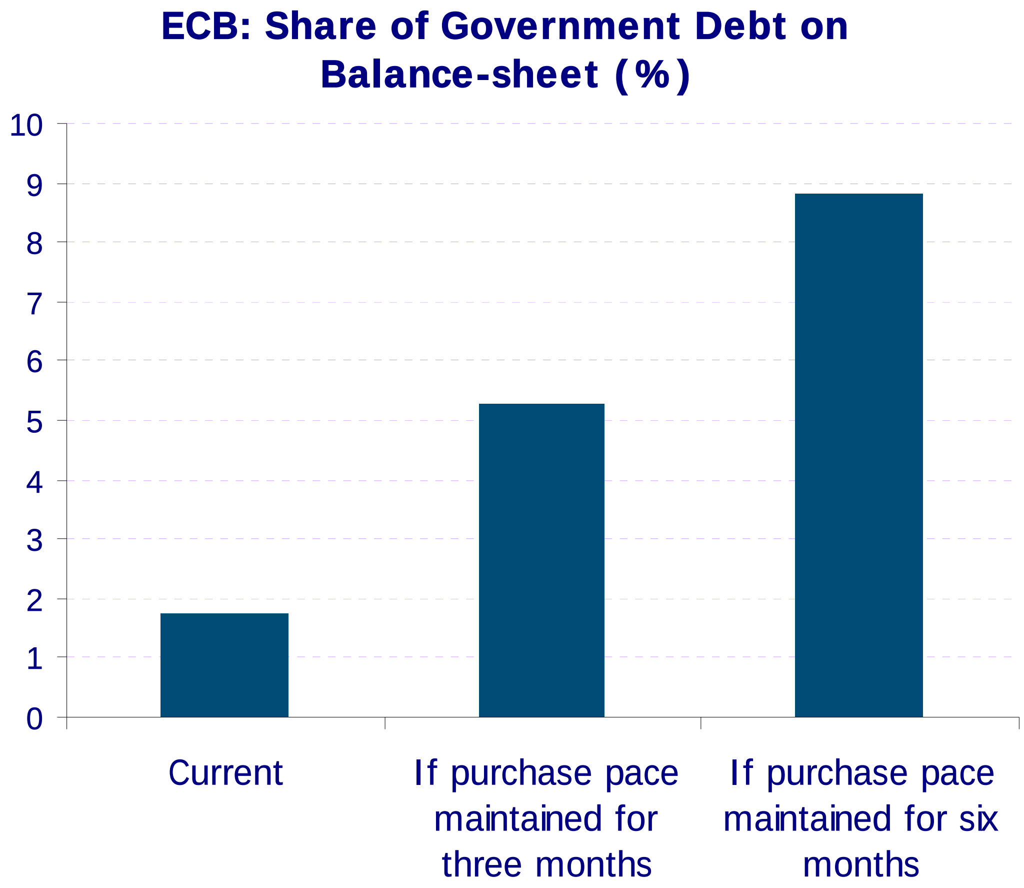
ECB exit strategy as gradual as possible, ready to give support

Although the ECB started to design the process of liquidity withdrawal in December 2009, it has taken several steps in order to maintain financial stability

Bond purchases have been stepped down quite fast

Even at this pace, the ECB would accumulate too much exposure relative to its preference

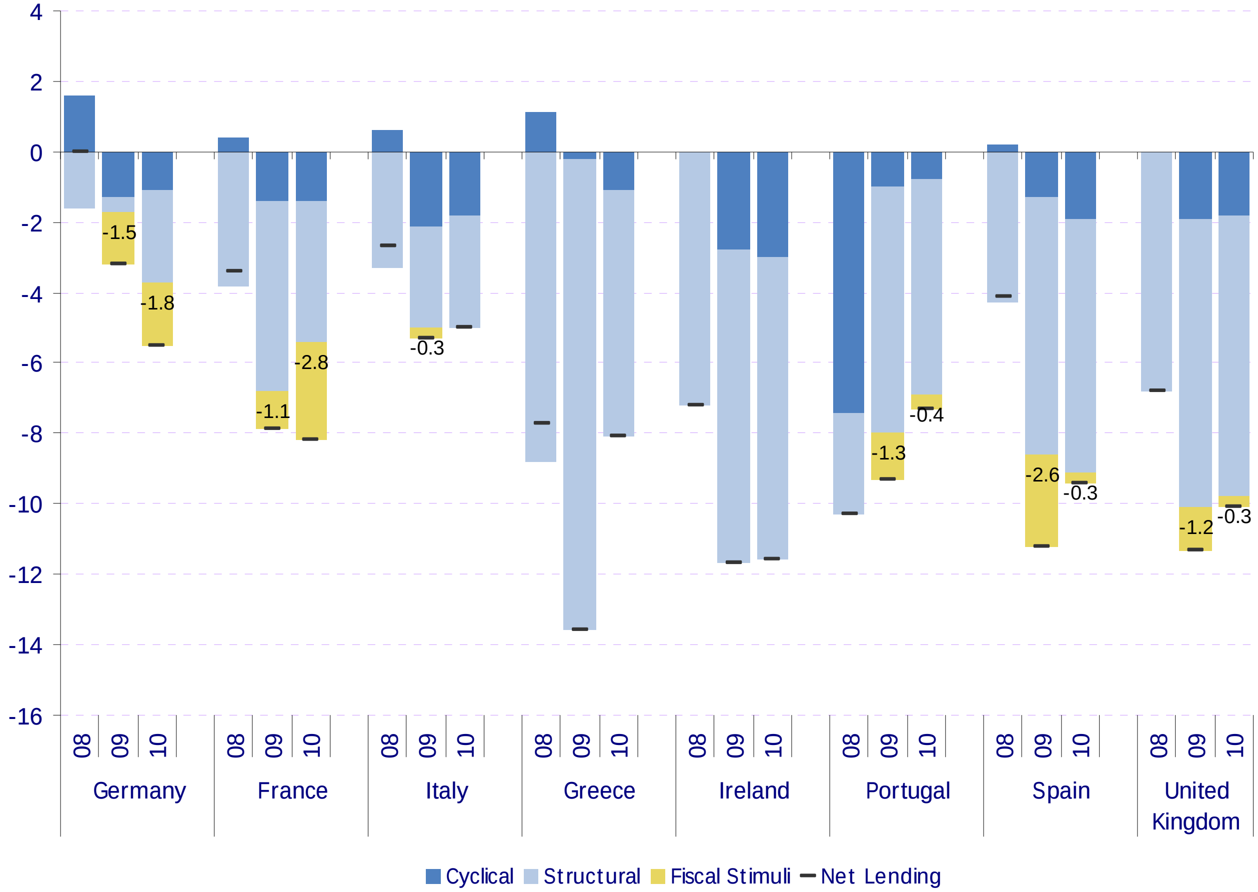




Strong fiscal consolidation but with small negative effect on growth

The response to deep recession with a stimulus and lower revenues of a permanent nature have resulted in sharp increases of public deficits

Fiscal deficits by components by countries % of GDP



Source: National Sources, European Commission and BBVA Research

All in all

Negative spillover arising from the increase in sovereign risk in Europe

Risks for the EMU

1 Increase in risk premiums

3 Faster than expected fiscal adjustment

Difference in growth vs. US

Difference in interest rates vs. US

5

Support for the EMU

2 A new institutional framework

Adequate and powerful incentives

4 A more depreciated exchange rate

Positive impact on exports

Some thoughts on Spain

- While **considerable progress has been made regarding the necessary adjustment of the private sector** in order to reduce its high level of indebtedness, the public sector is embarking on a **rigorous fiscal adjustment**
- The ambitious **fiscal adjustment** announced by the Spanish government is a very important step in the right direction.
- Its negative impact on growth in the next few quarters will be very limited. At the same time, it is a **necessary condition for guaranteeing a sustained recovery scenario** in the coming years
- The necessary and unavoidable fiscal adjustment must be accompanied by **ambitious structural reforms in the financial sector and the labor market**

An adjustment that is at an advanced stage specially in the private sector

Adjustments underway that condition recovery

Imbalances accumulated during the expansion period

Financing needs

Investment adjustment

Increased savings

Firm deleveraging

Household deleveraging

Financial sector restructuring

Imbalances accumulated during the crisis

Fiscal deficit

Labor market

Structural reforms

An adjustment that is at an advanced stage in the private sector

Current account adjustment

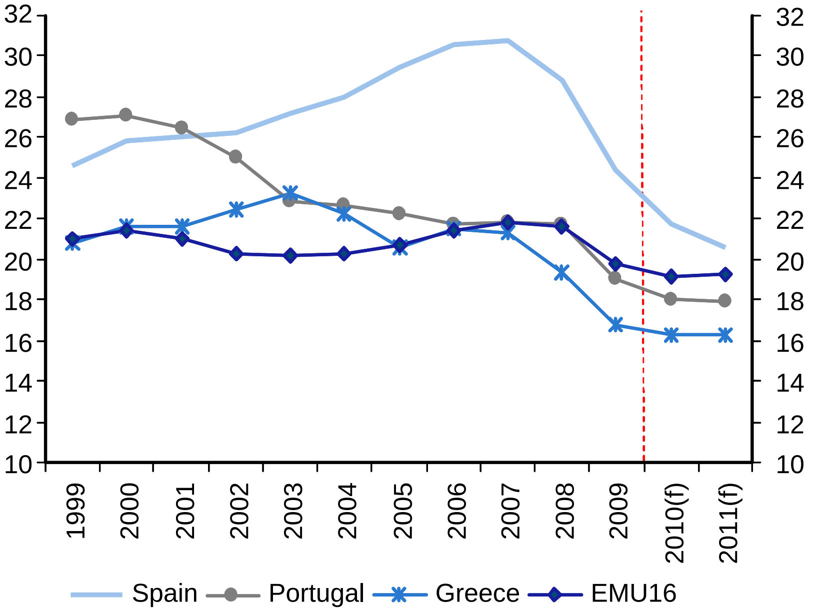
The private sector has made significant progress with a considerable reduction in its financing needs

Investment rate

GFCF as a share of GDP (in pp)

GFCF: Gross fixed capital formation

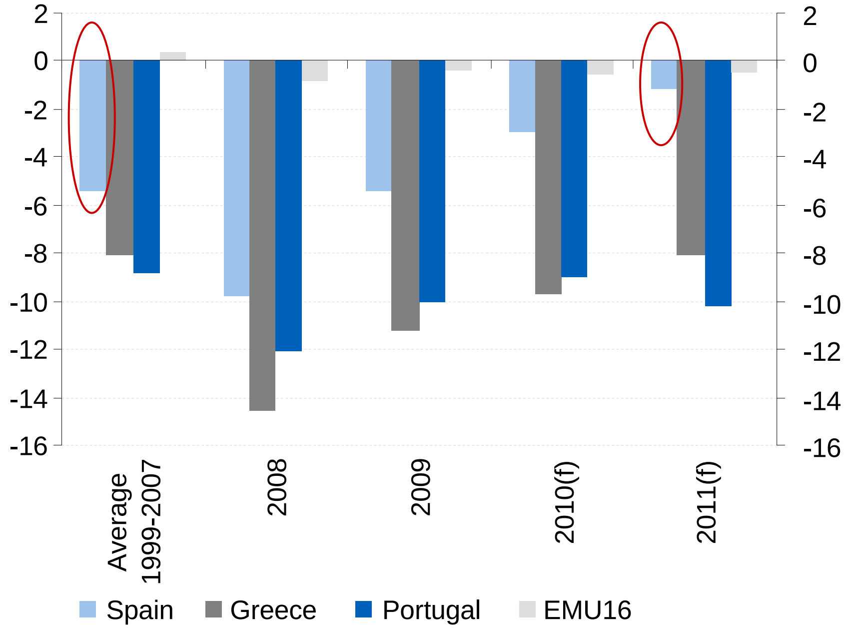
Source: BBVA Research from INE and AMECO



Current account balance

As a share of GDP (in pp)

Source: BBVA Research from IMF



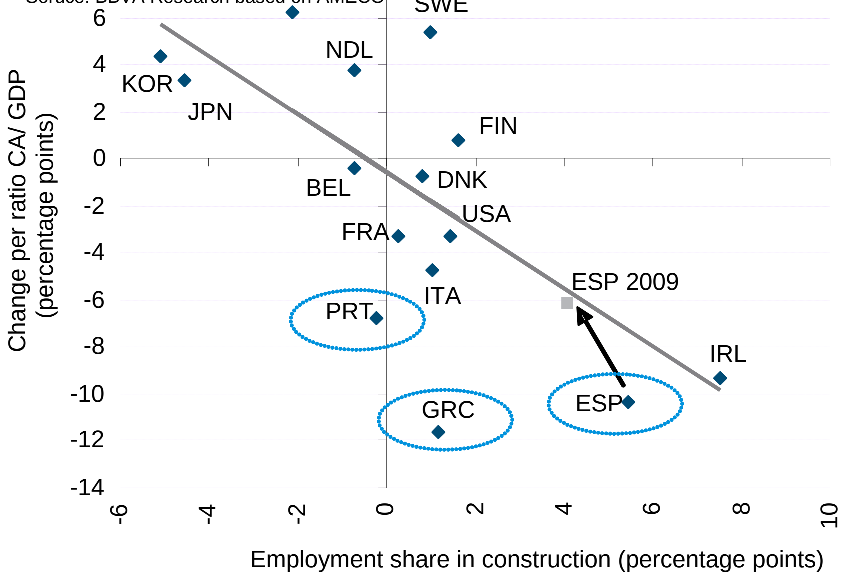
An adjustment that is at an advanced stage in the private sector

Real Estate adjustment

The need for financing for residential investment created imbalances in the current account

Construction employment share and current account balance: 1996-2007

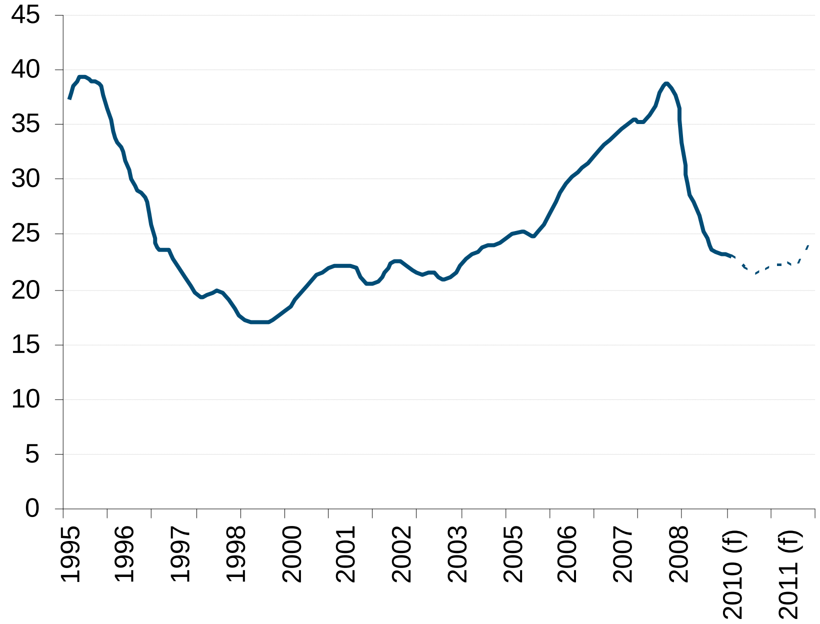
Soruce: BBVA Research based on AMECO



Spain: housing affordability

Tax-adjusted purchase effort as a % of household income

Source: BBVA Research based on INE, Housing Department and Registradores



An adjustment that is at an advanced stage in the private sector

Private deleveraging adjustment

Households have also adjusted their financing needs

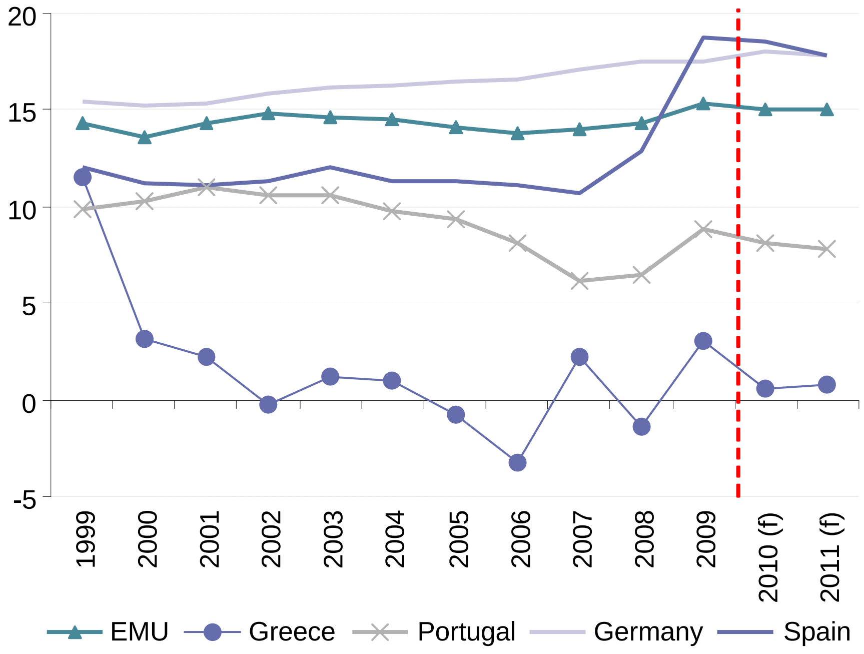
The adjustment in savings has been especially significant in the case of households.

The net wealth of Spanish households is higher than in other European countries.

Households saving rate

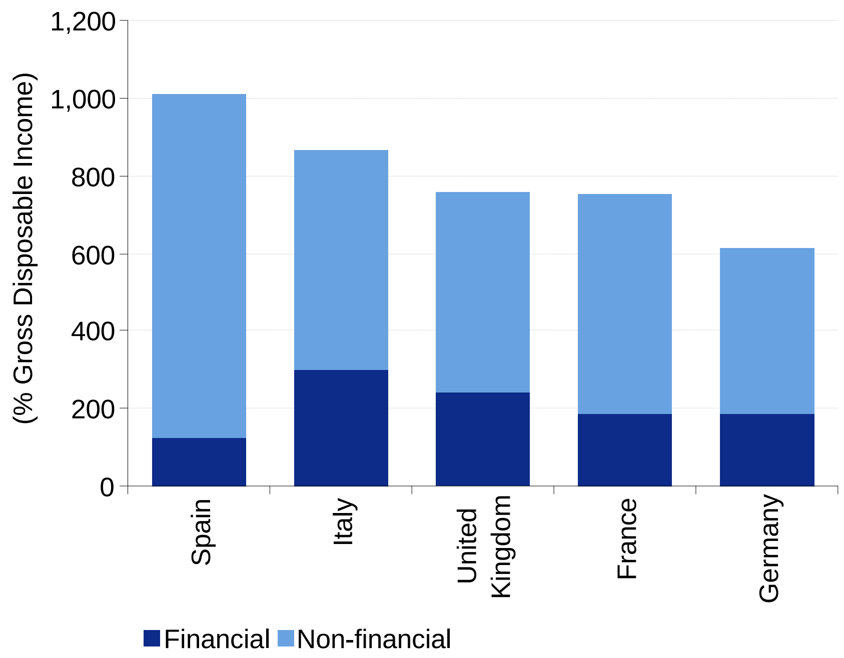
(% of gross disposable income)

Source: BBVA Research and AMECO



Households net wealth (2008)

Source: BBVA Research based on OECD and Bank of Spain



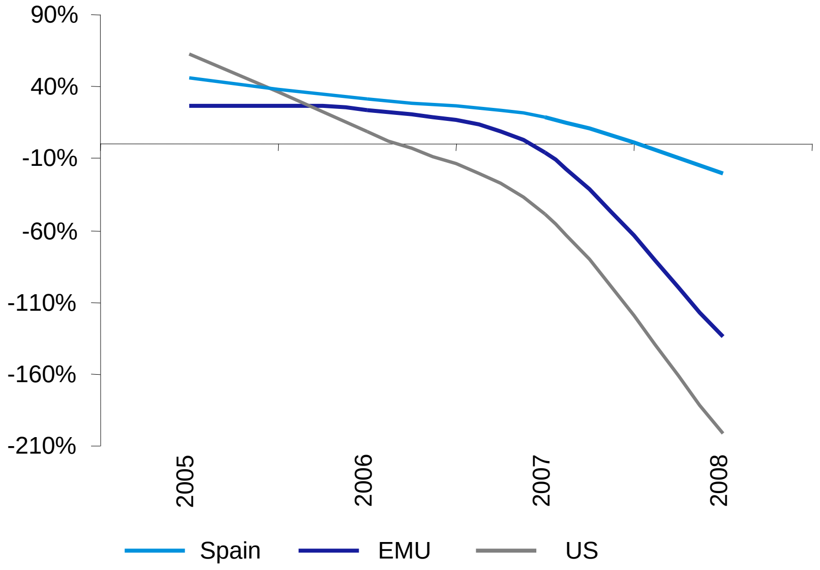
The need for ambitious structural reforms

The financial sector

The Spanish financial sector has dealt well with the first stage of the crisis, with notable profit stability and no need for public capital injections

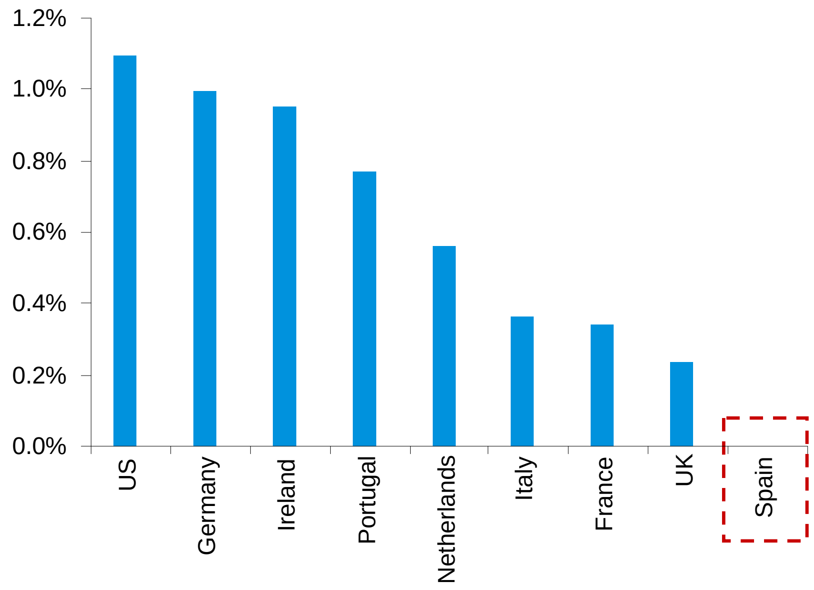
Profit Before Tax (Year-on-Year Growth)

Data on the 20 largest banks by assets for each area
Source: Bankscope



Public Capital Injections as a % of Total Banking Assets

Source: European Commission and BBVA ERD



The need for ambitious structural reforms

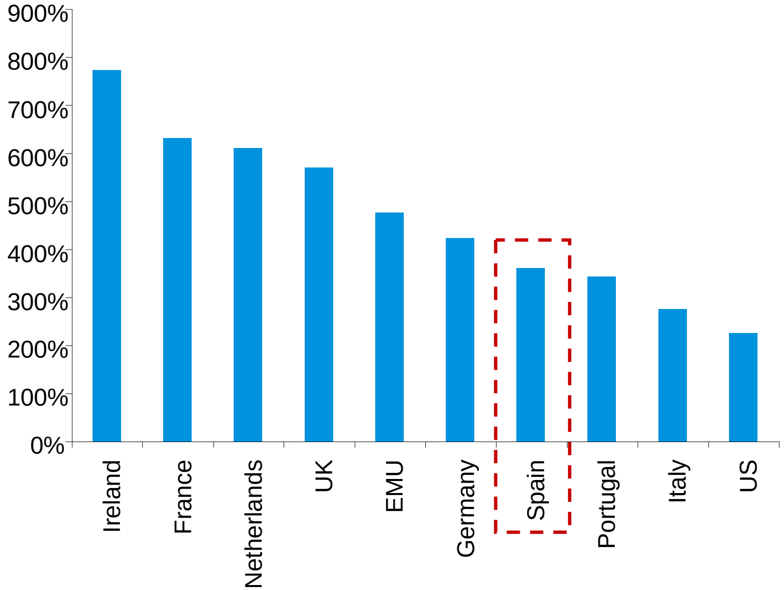
The financial sector

This positive evolution amid the worst financial crisis since the Great Depression has been possible due to relative strengths of the Spanish banking system:

- **Low leverage levels**
- **Prudence and strict regulation** prevent institutions from acquiring structured assets, thus limiting losses and fostering solid balance sheet
- **Universal Banking Model** also helps to take advantage of a solid deposit base
- **High** and sustained **efficiency ratios**

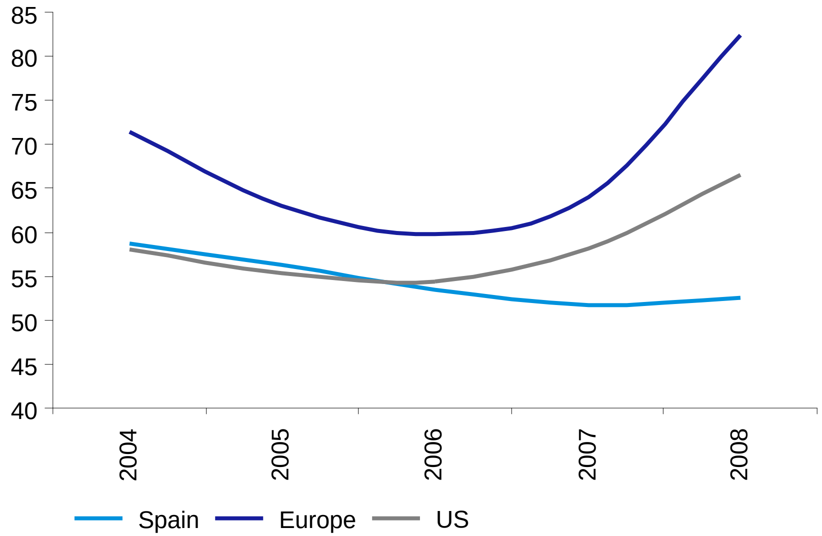
Banking Sector Assets Comparison'09 % GDP

Source: Fitch, Fed and ECB 0



Efficiency Ratio (Cost to Income): 20 largest banks

Source: Bankscope



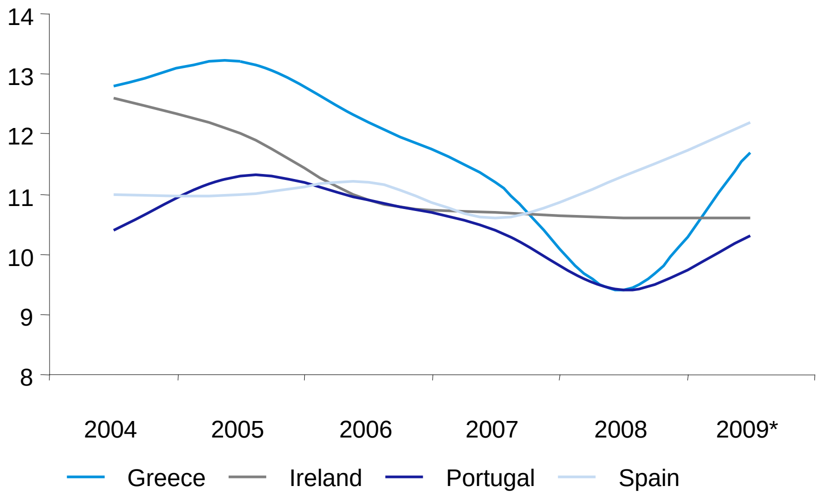
The need for ambitious structural reforms

The financial sector

- **The non-performing ratio has increased in line with current economic conditions, but it remains below the path seen in previous recessions.** Besides, it is adequately covered by provisions, with a coverage rate of 60% according to the IMF
- **Funds obtained from the ECB only account for 2% of banking assets**, and are in line with the weight of the Spanish economy on the Eurozone, even after considering the recent increase

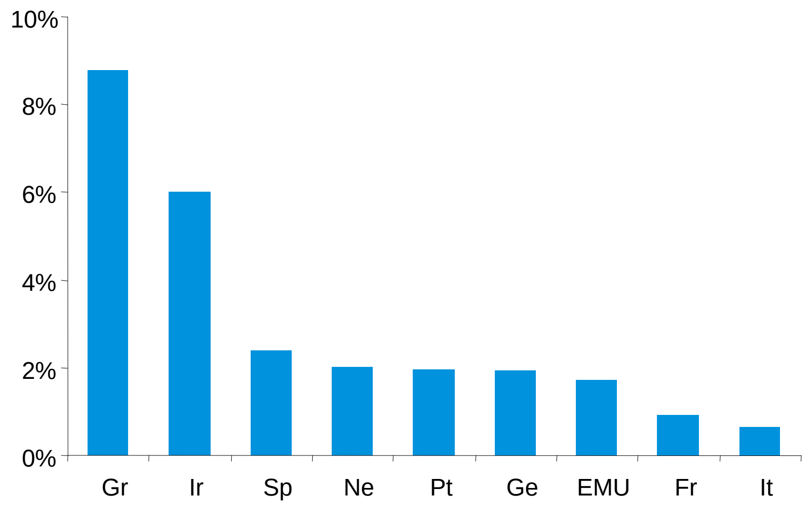
Bank Regulatory Capital to Risk-weighted Assets

*Last data available
Source: IMF



Euro Area Banks: % of Total Assets Funded by ECB Liquidity

Source: Datastream, Central Banks and BBVA Research



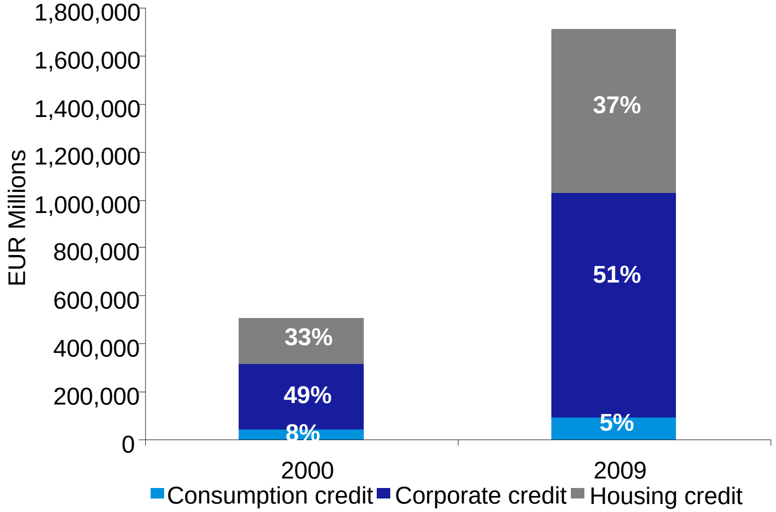
The financial sector

However, the Spanish Banking System anticipates several difficulties ahead, with some institutions potentially facing solvency problems as a result of:

- A **high proportion of mortgage loans and credit to construction and real estate sectors**
- **Overcapacity** in the system following the boom years

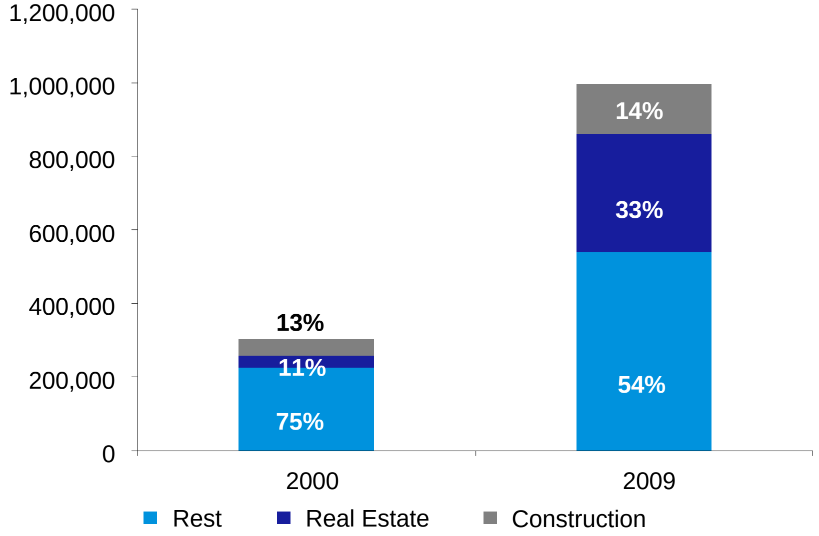
Outstanding Credit to Private Sector

Source: Bank of Spain



Outstanding Credit to Corporate Sector

Source: Bank of Spain



All in all

- Spain situation is difficult as that of other countries with to large fiscal and current account deficits but this is a flow problem. The stock problem (specially that of public debt) is still limited: well below European average
- While it will be important to substitute construction as key sector for growth, it must be acknowledge that Spain has actually undergone an investment boom and not only a construction boom
- The key for Spain is to be able to generate grow so that the fiscla adjustment is not so painful
- Changing the growth model is key

Thank you!