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Global slowdown and increased risks

Global Economic Outlook – Fourth quarter 2011

Madrid, 7 November 2011

Main messages

1. **Global growth slows down** especially in developed economies. Forecasts for global growth are revised down to 3.9% in 2011 and 4.1% in 2012, supported by solid growth in emerging economies.

2. **Risks to the outlook are strongly tilted to the downside, hinging on the evolution of the European debt crisis.** A quick resolution of financial stress in Europe is needed to avoid a recession there, with strong contagion to other regions.

3. **The October EU summits still leave key elements unresolved.** Partial solutions, implementation risk and bailout and reform fatigue will contribute to keep tensions in financial markets elevated in the short run.

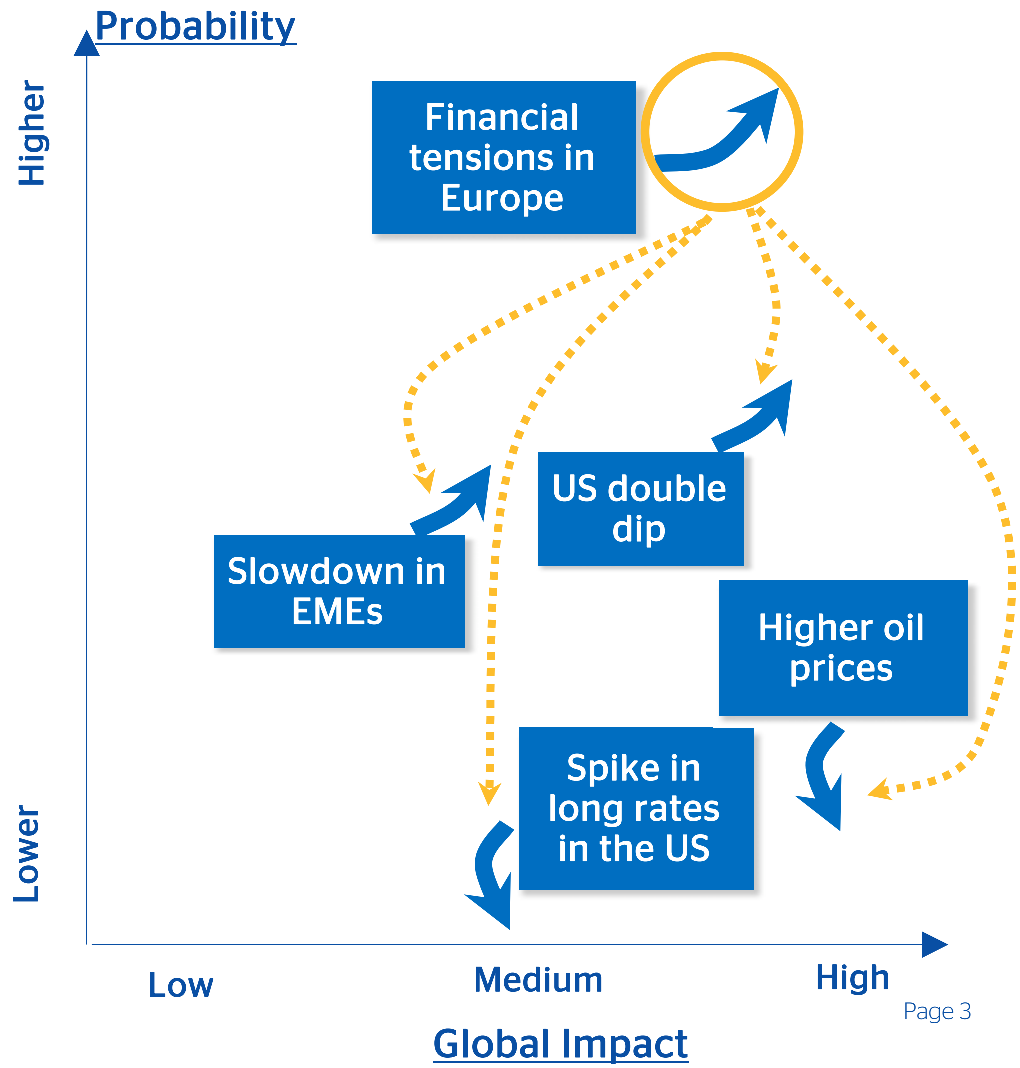
4. **US outlook improves, but structural weaknesses remain,** including from political deadlock.

5. **Emerging markets are on track for a soft landing** but with increasing external headwinds.

The European debt crisis represents the main risk to the global outlook

Change in growth forecasts from July 2011

	2011	2012
US	⇓	↓
Europe	↓	↓
LatAm7	↓	↓
China	↓	↓
Emerging Asia	↓	↓
World	↓	↓



Outline

1 **Global growth slows down**

2 Risks are strongly tilted to the downside and hinge on Europe

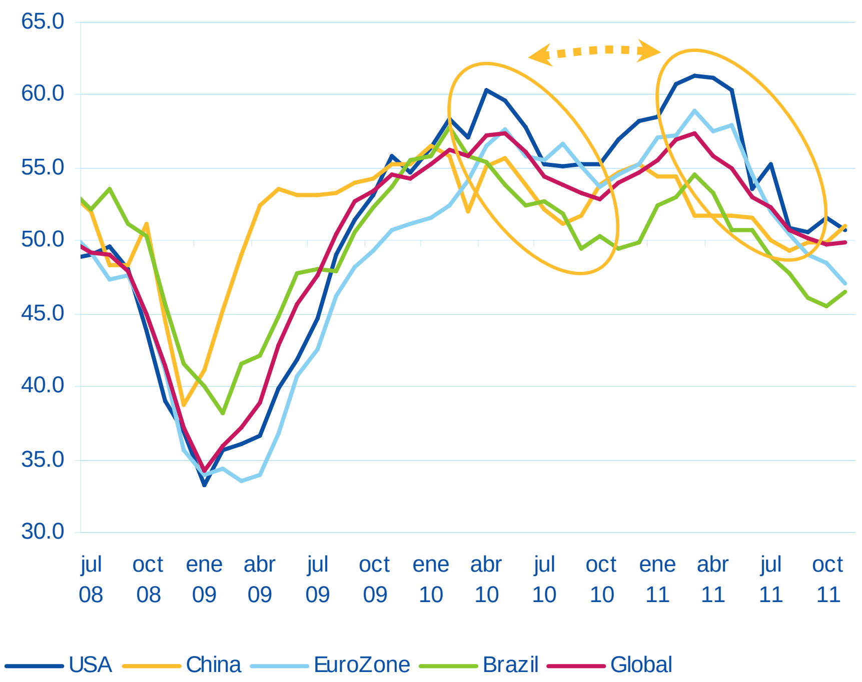
3 Slow recovery in US and soft landing in emerging markets

4 Forecast revision

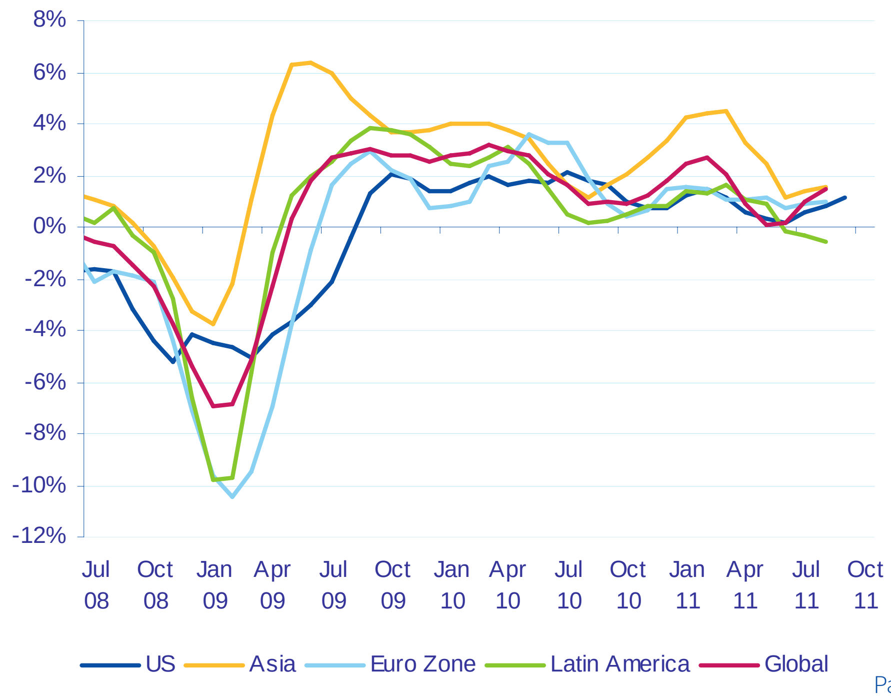
Global outlook worsened since the summer: (i) soft macro data and fears of a double dip.

Activity decelerated across the board, especially in advanced economies. It was propelled in part by temporary factors (Japan earthquake, oil prices) but also increased uncertainty about the outlook.

Business expectations (PMI)
Source: BBVA Research and Bloomberg



Industrial production (%qoq of 3-month moving avg)
Source: BBVA Research , CPB and national sources

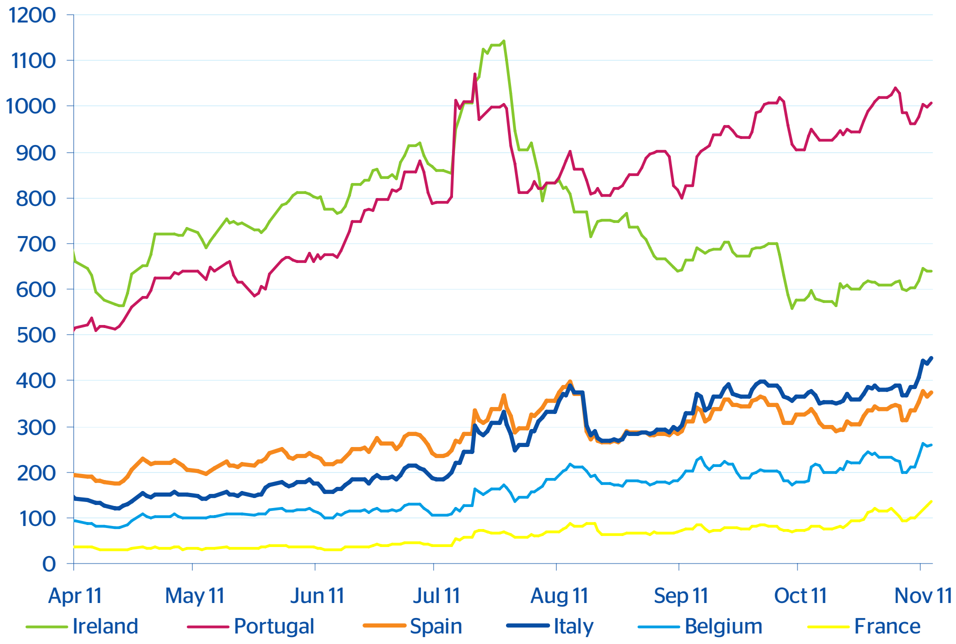


(ii) increasing doubts about comprehensive solution to sovereign crisis in Europe

In Europe, the sovereign debt crisis deepens and turns more systemic, extending to Italy and threatening core countries.

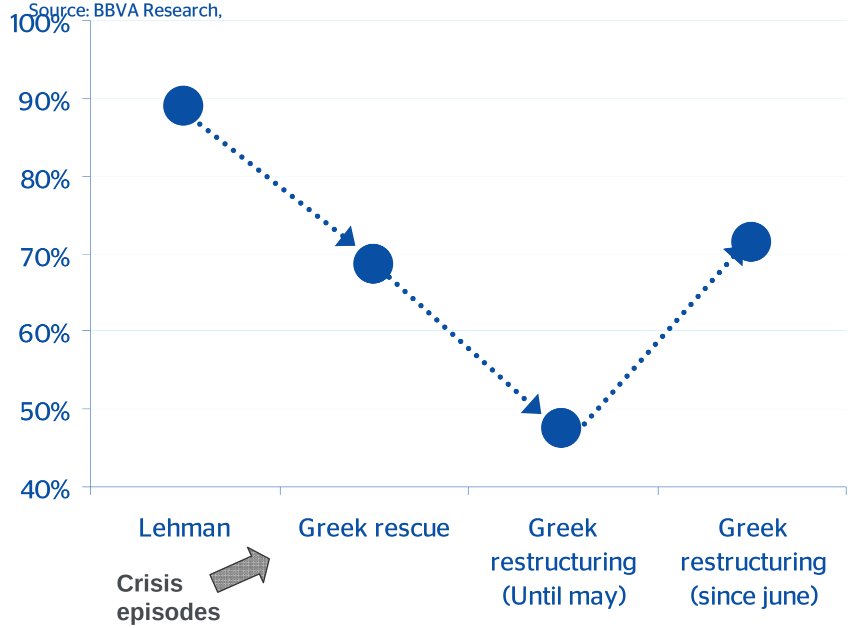
Sovereign risk premium: 10-year bond yield spreads to Germany (bp)

Source: Bloomberg and BBVA Research



10yr CDS: % of variance explained by a common factor (global risk)*

Source: BBVA Research,



*First normalized principal component of the 10yr CDS of following countries: Global: US, France, Japan, Spain, Greece, Ireland, Italy, Portugal and UK. Lehman (June08-Dec09), Greek rescue (2010) and Greek restructuring (2011)

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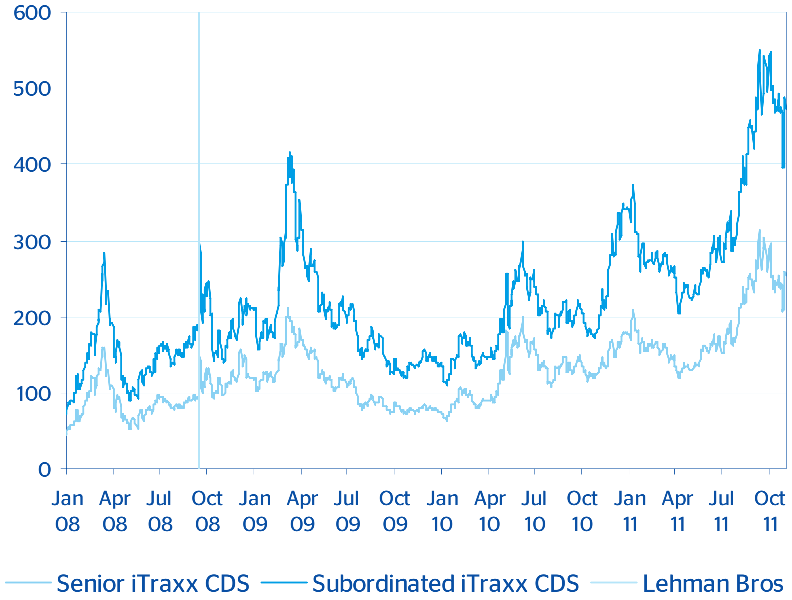
(iii) Negative feedback to financial system in Eurozone and beyond

The negative feedback between sovereign concerns and weaker banking sector has intensified, risks affecting economic activity and could start a vicious circle.

Credit market: Itraxx CDS (%)

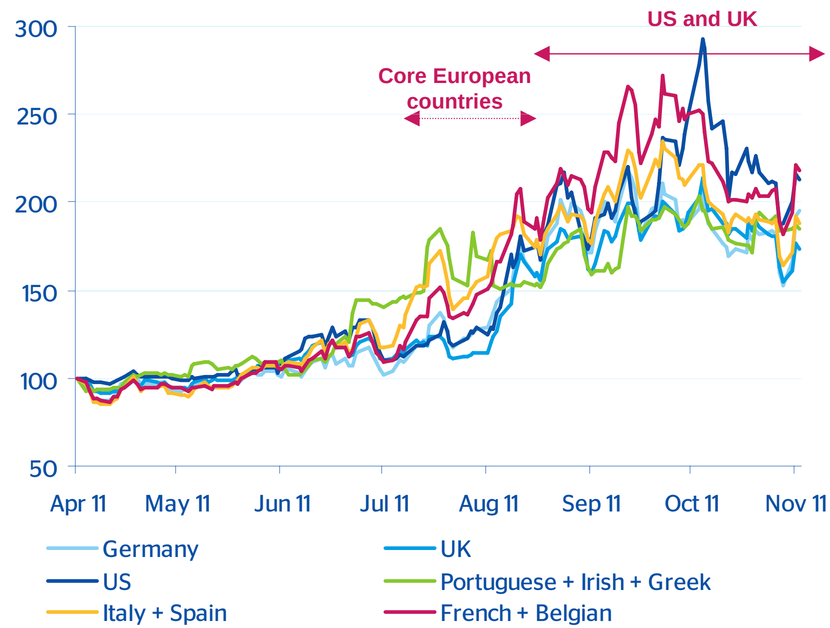
Source: Bloomberg and BBVA Research



Change in 5Y CDS bank spreads

1 Apr11=100

Source: Datastream, BBVA Research

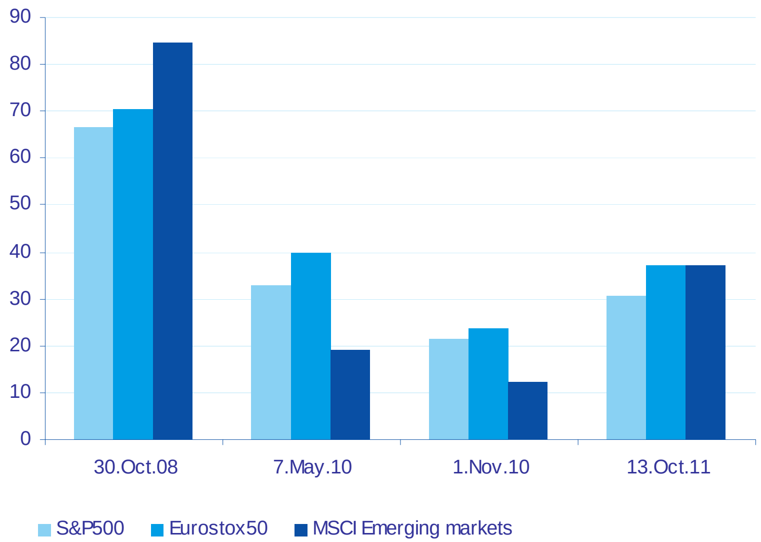


(iv) Increased global risk aversion spills into different asset classes, including EMEs

Bond and equity market volatility has increased significantly both in Europe and the US, to levels last seen in October 2008. Increased risk aversion has spilled into emerging markets, reflected in lower capital inflows.

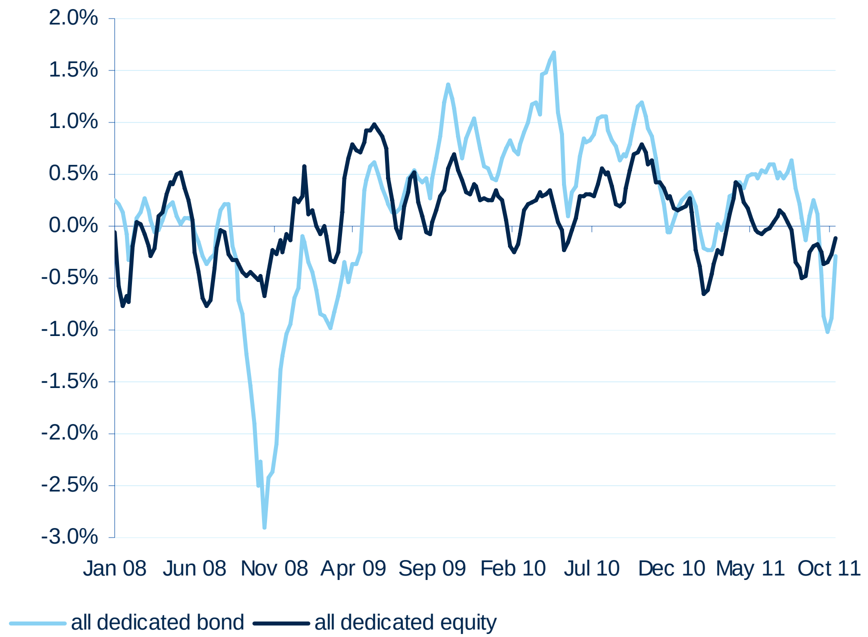
Implied Equity volatility (VIX & V2X & MSCI)

Source: Bloomberg



Flow of funds to Emerging economies as percentage of assets under management (4 week average)

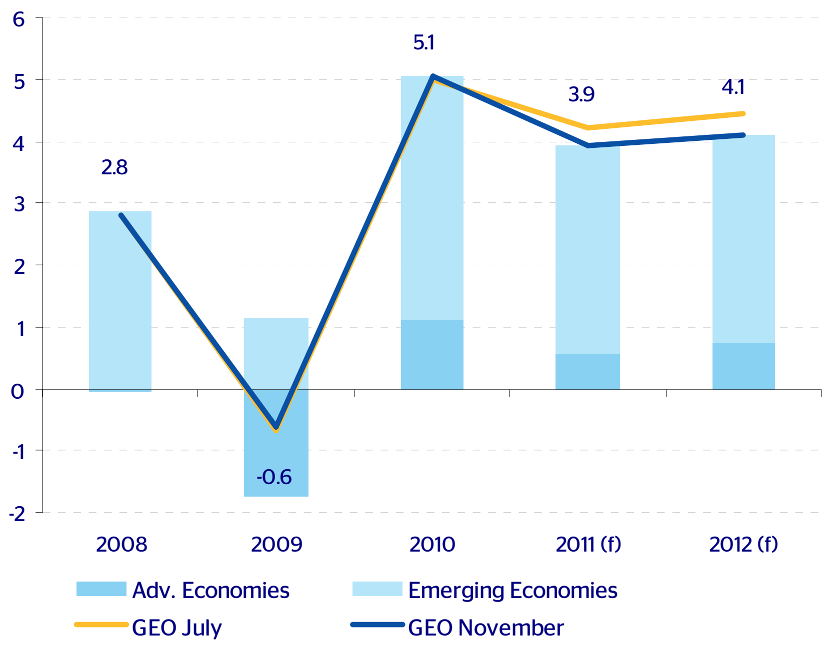
Source: BBVA Research and EPFR



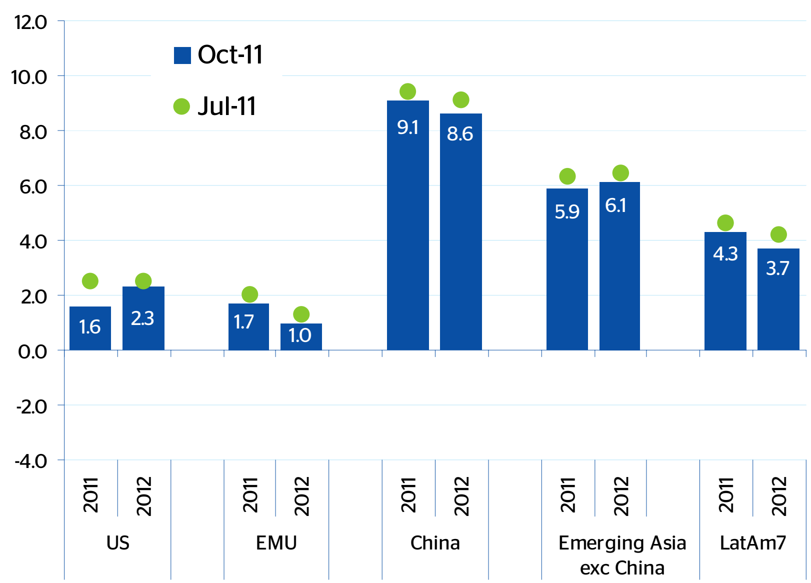
Global growth will continue to be supported by emerging economies.

Weak macro data since the summer confirms a downward adjustment of growth projections, especially in developed economies.
Probability attached to the risk scenario stemming from a European crisis is increasing.
Worsening external environment represent headwinds for emerging economies, but they are still on track for a soft landing.

Contributions to global growth (%)
Source: BBVA Research



GDP Growth (%yoy)
Source: BBVA Research



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Europe: a roadmap to exit the crisis

The debt crisis and its mismanagement challenges the viability of the monetary union itself. In the short run, the EU needs to separate insolvent from illiquid countries and ring-fence the latter.
In the long run it would be less risky to advance towards a fiscal union with less fiscal sovereignty

Short-term measures needed

- Distinguish liquidity from solvency problems: ring-fencing and reforms by troubled countries. The trouble is Italy.
- Address liquidity problems: breaking the sovereign – banking vicious circle
- Clean banks' balance sheets

Debt restructuring and isolate Greece

EFSF: conditional support in exchange for struct. reforms

ECB: flexible, unlimited liquidity support

Specifically targeted stress tests by EBA

Main trade-off: instability versus incentives

Possible solutions in the long term

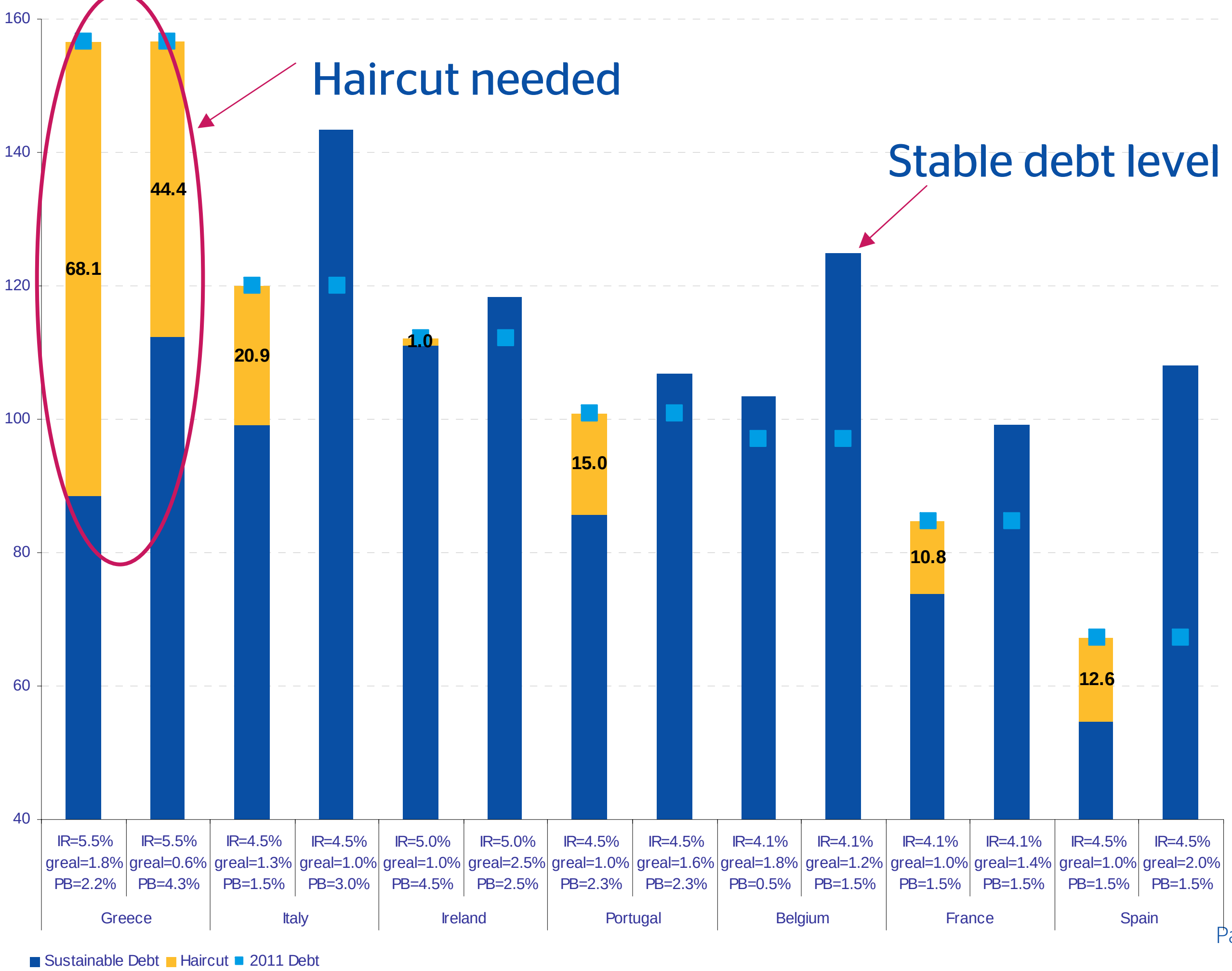
- **In any solution:** Stronger public and private surveillance is needed
    1. Keep existing treaty developing it further
    2. Fiscal union: a Grand Bargain core-periphery losing fiscal sovereignty
- **Tail risk scenario:** a break up of the Euro

A careful economic design but mainly a political decision

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

Greek debt needs to be restructured applying very strong conditionality, to prevent other countries wishing a similar treatment.

Haircut to sustainable debt
Source: BBVA Research



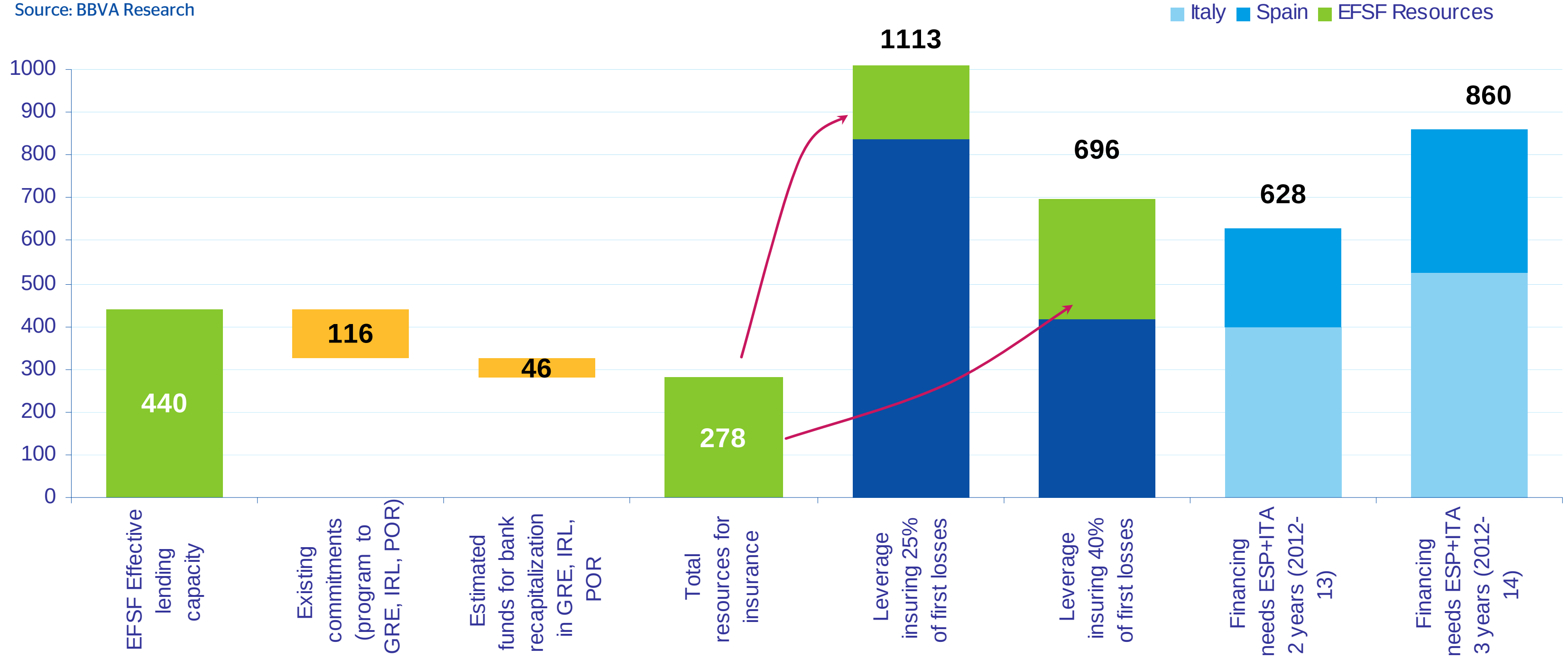
For each country, we present two feasible scenarios combining parameters of real growth (g), primary balance (PB) and interest rates (IR).

A leveraged EFSF could work, but its implementation is many weeks away

A reasonable leverage for Italy and Spain (4 times, for a 25% guarantee) would be enough to cover issuance in the next 3 years. But the ECB may still be needed as buyer-of-last-resort to restore market confidence.

EFSF resources available under a debt guarantee scheme (bn EUR)

Source: BBVA Research



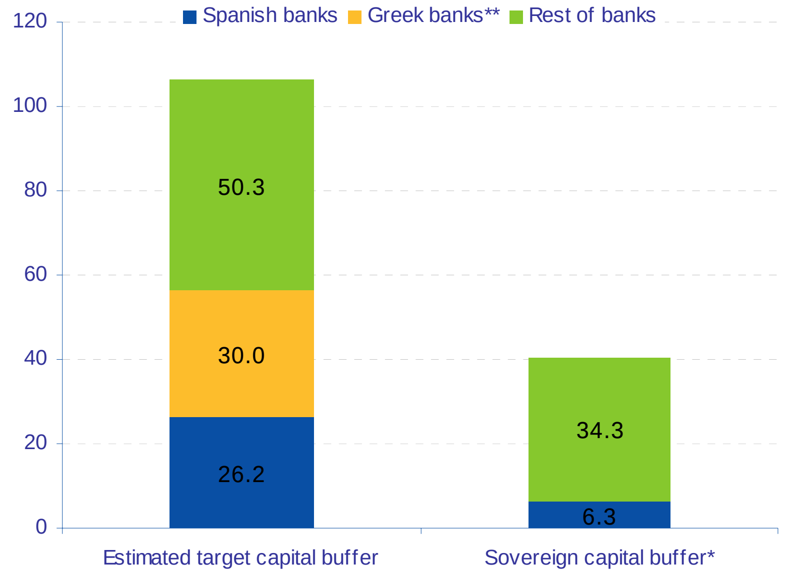
ECB needed as buyer-of-last-resort?

Recapitalization does not address bank's problems with funding and legacy assets

EU proposals for bank recapitalization are compensating moderate stress-testing of balance sheets -using market prices for sovereign portfolios but not for legacy assets- with a significant increase in capital requirements. This is an inefficient approach to solving banks' problems

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

Source: BBVA Research based on EBA and Bloomberg



* The sovereign capital buffer is indicative and can already be covered by existing CT1 capital if the CT1 ratio exceeds 9%.

** No information on the sovereign capital buffer has been provided by Greek banks, not to conflict with pre-agreed arrangements under EU/IMF programme.

Risks/caveats

- Does not address bank's balance sheet problem with legacy assets
- May actually worsen sovereign debt problem in some countries
- Will not solve problem of access to liquid funds by banks
- Risk of asset reduction and credit squeeze

October Eurozone summit: still waiting for a definitive solution to the crisis

EU summit only gives partial solutions for the three main pillars under negotiation (Greece debt, EFSF, bank recapitalization). Implementation risk is high.
Moreover, reform fatigue in the periphery (Greece) and bailout fatigue in core Europe increase. These will keep financial tensions in Europe elevated at least in the short run.

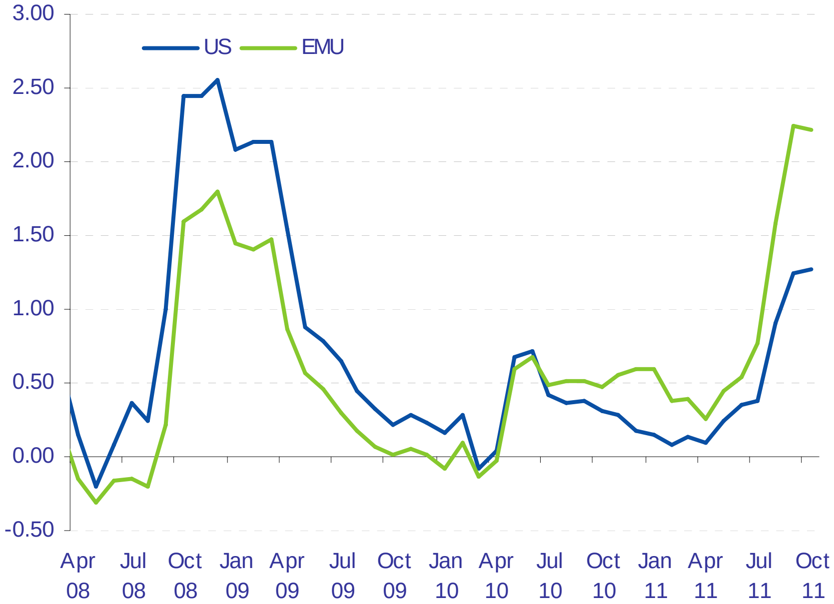
Needed from the summit	Done?	Outcome
Clear response to Greek debt sustainability		Increase in Private Sector Involvement (PSI) to 50%. Doubts linger about extent of participation and on Greek solvency
Strengthen EMU sovereign firewalls		EFSF leveraged as insurance and an SPV, but still doubts about enough firepower
Push for further reforms		More economic reforms, especially in Italy, but uncertainty about implementation
Strengthen banking sector: capital and liquidity		Inefficient, broad-based recapitalization. Guarantees for debt issuance
Advances in Euro area governance		No clear roadmap to a fiscal union and no mention of eurobonds.

Global risk scenario hinges crucially on European sovereign debt crisis

Increased financial tensions are shown to reduce growth up to one year later in US and Europe. persistently elevated tensions (at October's levels) would shave at least 2 pp of European growth in 2012

BBVA Financial Stress Index

Source: BBVA Research



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

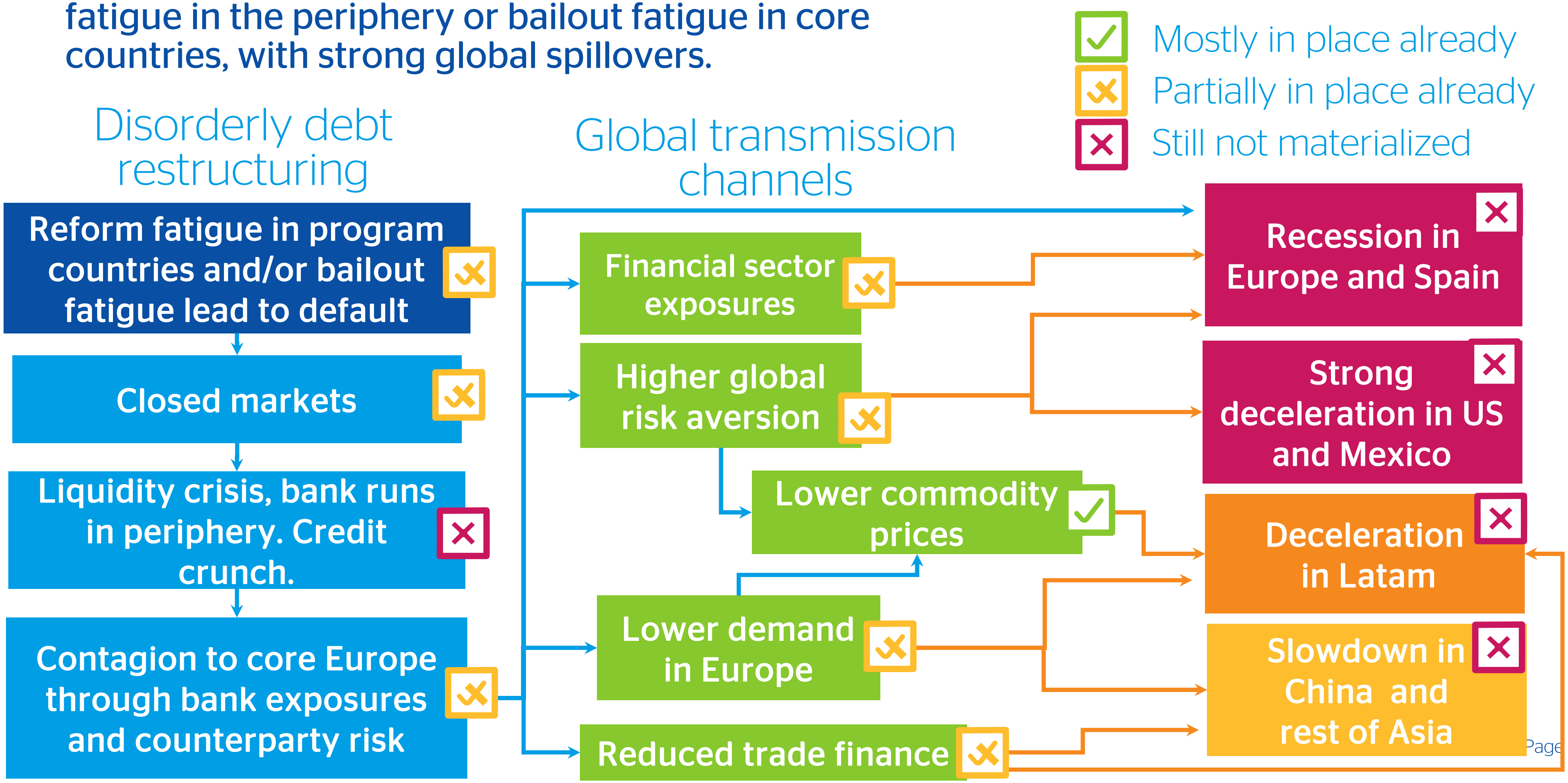
Source: BBVA Research

The outlook would be worse as:

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

Some elements that could shape the risk scenario

Europe continues to risk an "accident" due to reform fatigue in the periphery or bailout fatigue in core countries, with strong global spillovers.



Outline

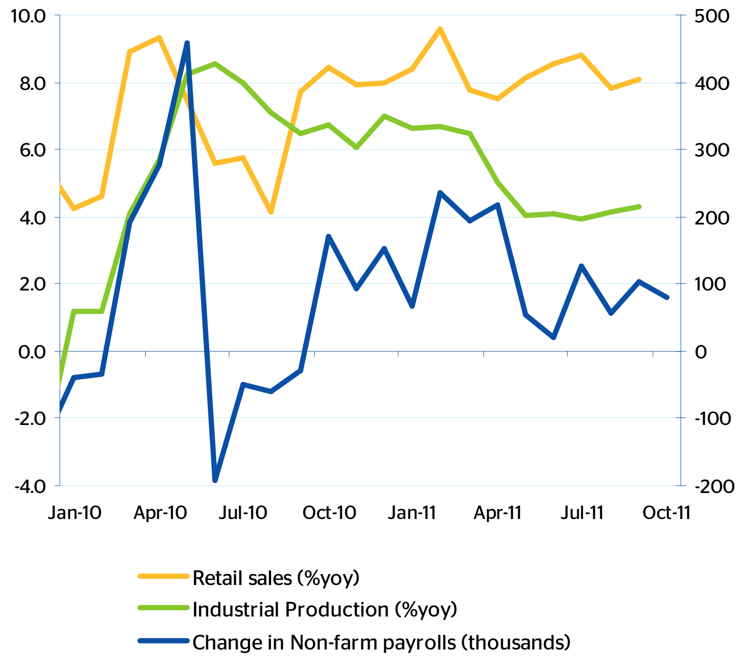
Growth improves in the US in Q3, but recovery is not yet self-sustaining

Growth has reaccelerated in the US in Q3, but structural weaknesses remain (labor market, housing), and make it more vulnerable to a shock from Europe

In addition, political brinkmanship could lead to badly timed fiscal contraction, adding downward risks to growth. At the same time, given strong political disagreements it is unlikely that a grand bargain will be reached for a credible deficit reduction in the long-run.

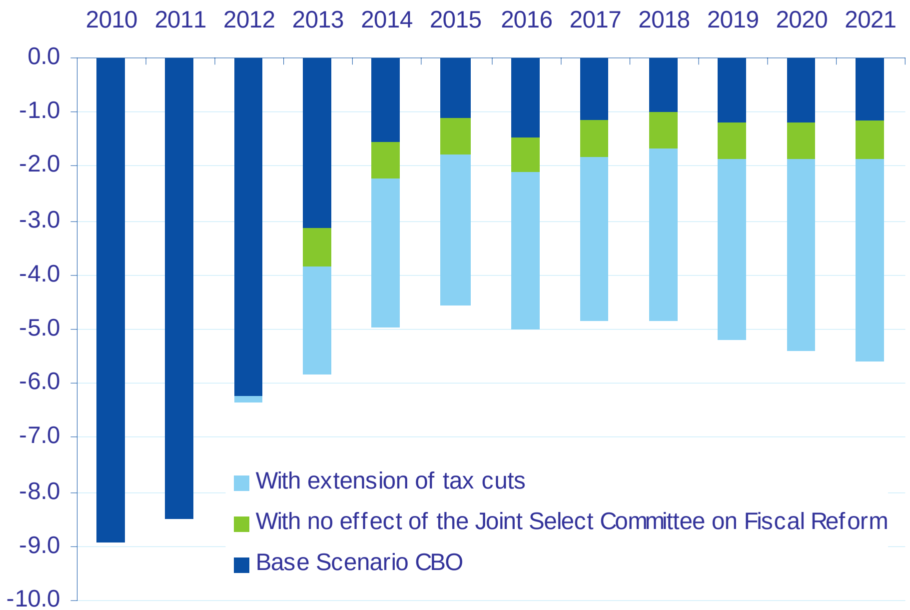
US: employment, sales and industrial production

Source: BBVA Research, BLS and Fed



US public deficit (% GDP)

Source: BBVA Research and CBO



Emerging economies are on track for a soft landing, but external risks increase.

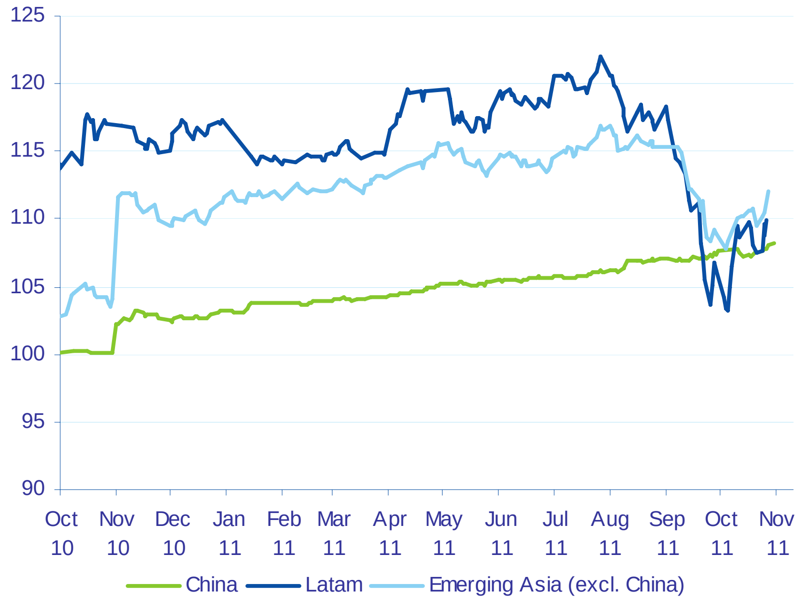
Growth in Emerging Economies remains resilient in spite of global uncertainty, given their strong domestic demand.

The most likely scenario is a soft landing in Asia and Latin America, although they have already been hit by financial headwinds, reflected in depreciated exchange rates and lower capital inflows.

If the European crisis were to impact global risk aversion and commodity prices as in 2008, emerging economies could weather it better than 3 years ago, although the impact would be sizable.

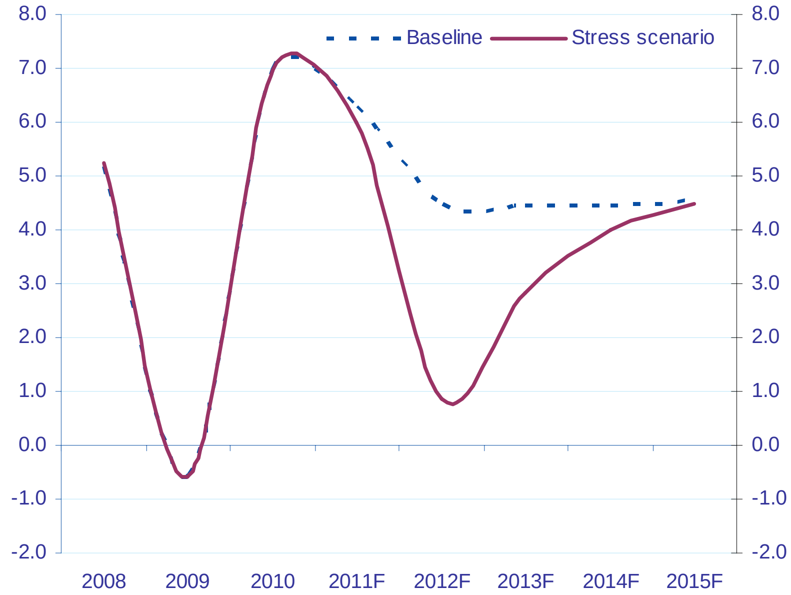
Emerging economies: exchange rate to the USD (Index Jan 2009=100)

Source: BBVA Research



GDP growth in emerging economies in a highly stressed scenario (%yoy)

Source: BBVA Research



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GDP growth forecasts

Europe: GDP growth clearly decelerating in Q3 and Q4.

US: recovery with downside risks after soft patch in first half of 2011.

Emerging economies on track for a soft landing.

Risks are strongly tilted to the downside

	GDP growth forecasts			
	2009	2010 (e)	2011 (f)	2012 (f)
US	-3.5	3.0	1.6	2.3
EMU	-4.2	1.7	1.7	1.0
LatAm 7	-2.3	6.2	4.3	3.7
China	9.2	10.4	9.1	8.6
Emerging Asia	6.7	9.2	7.5	7.4
EAGLES	4.0	8.3	6.7	6.5
World	-0.6	5.1	3.9	4.1

Main messages

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2. **Risks to the outlook are strongly tilted to the downside, hinging on the evolution of the European debt crisis.** A quick resolution of financial stress in Europe is needed to avoid a recession there, with strong contagion to other regions.

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