

Portugal in the european cross-roads

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International environment: politics takes centre stage in the economic debate

Section 2

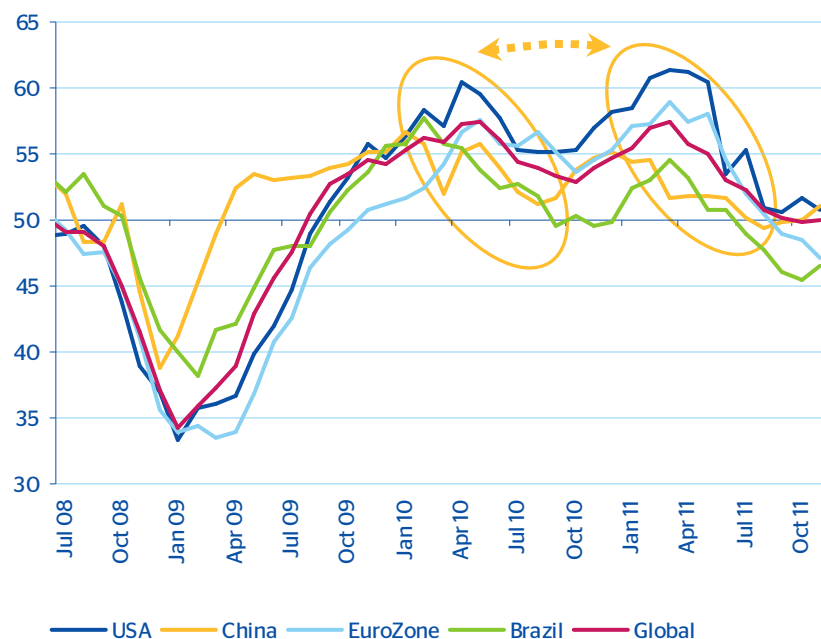
Spain: current situation and economic challenges

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

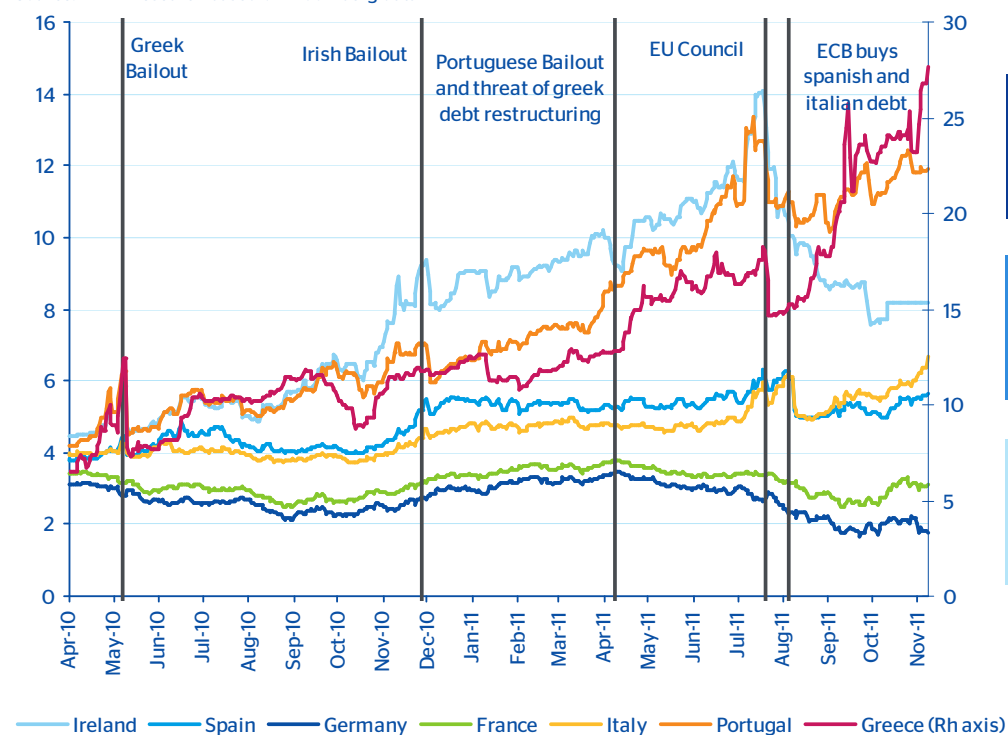
Confidence indicators and expectations fell in 3Q

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 ...

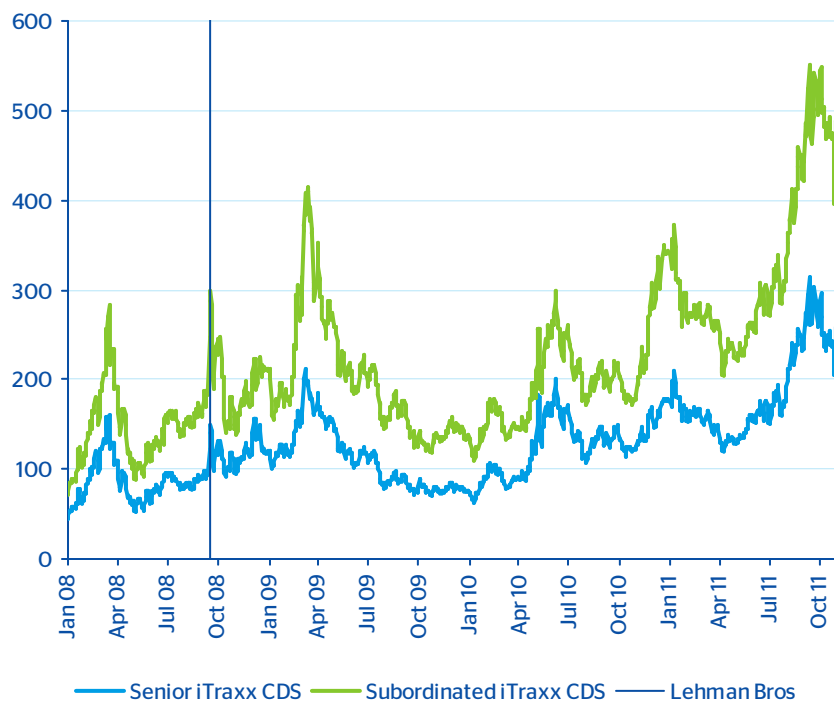
... and has become a global risk factor ...

... 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

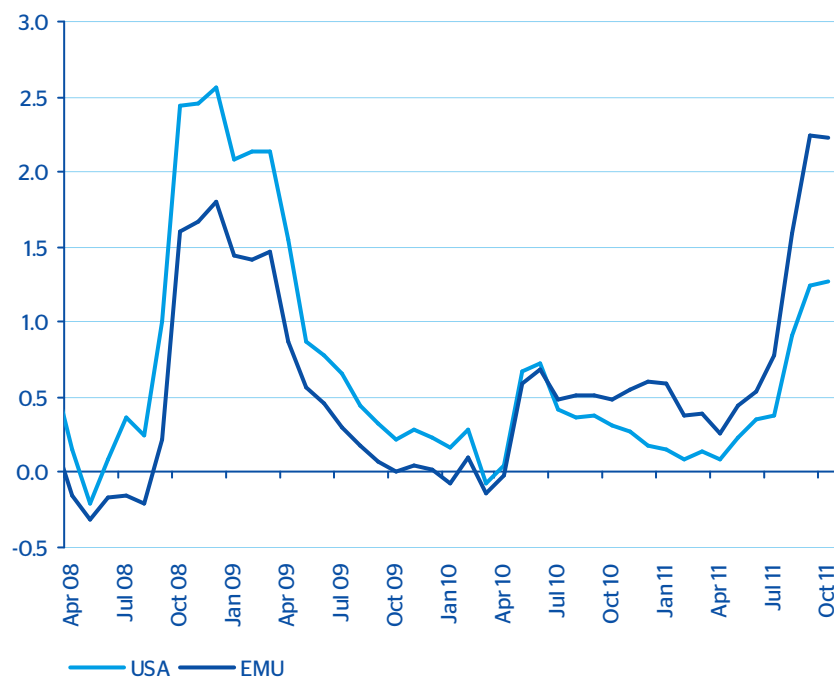
Higher finance costs are affecting activity

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

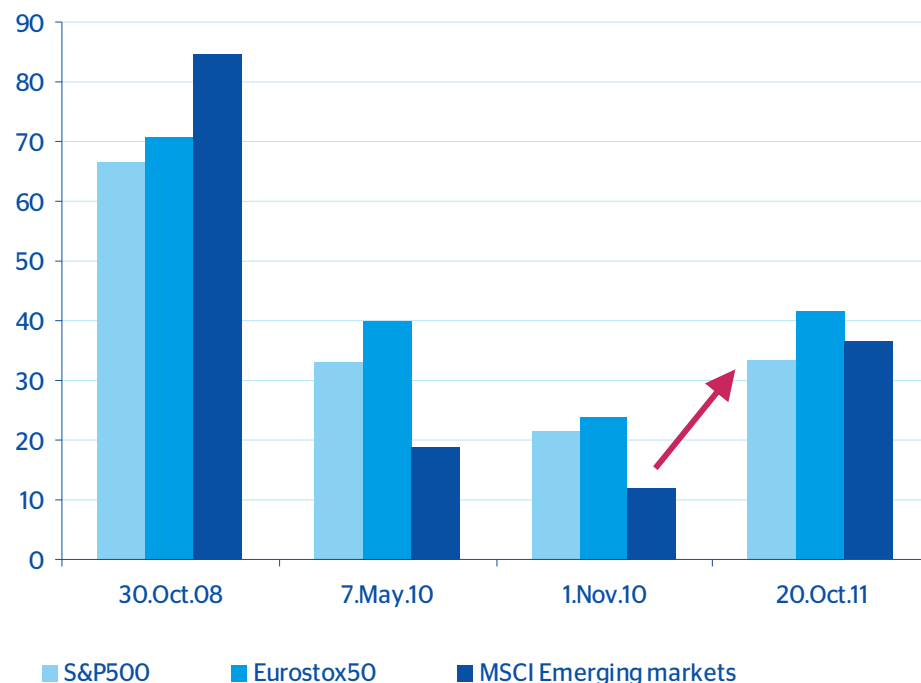
If this stress continues throughout 2012, growth
will contract 2pp (1.3 USA)

“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

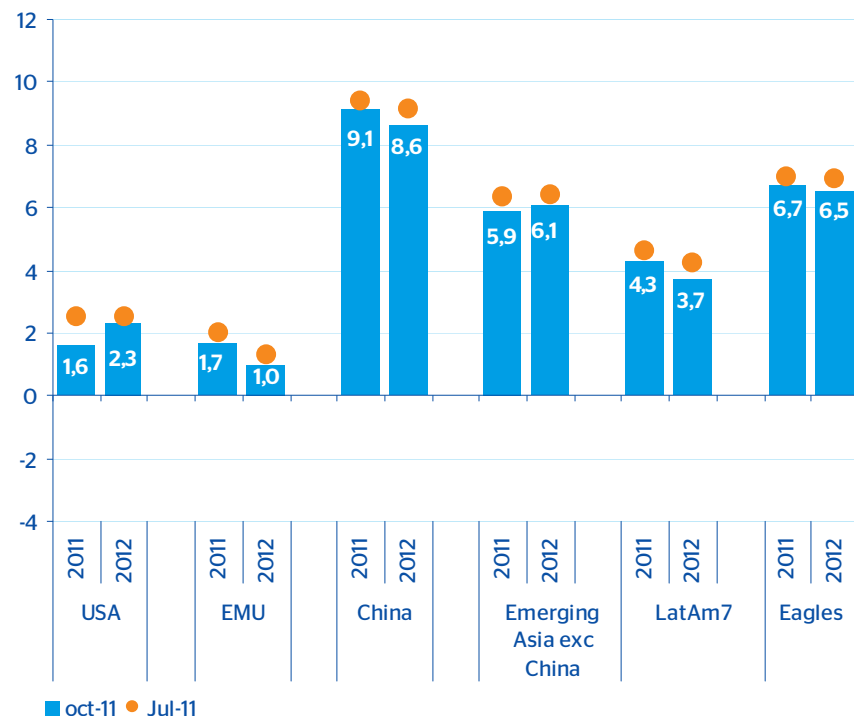
Levels not seen since autumn 2008

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



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Spain and Portugal: current situation and economic challenges

Spain and Portugal: Activity drivers

Determining factors

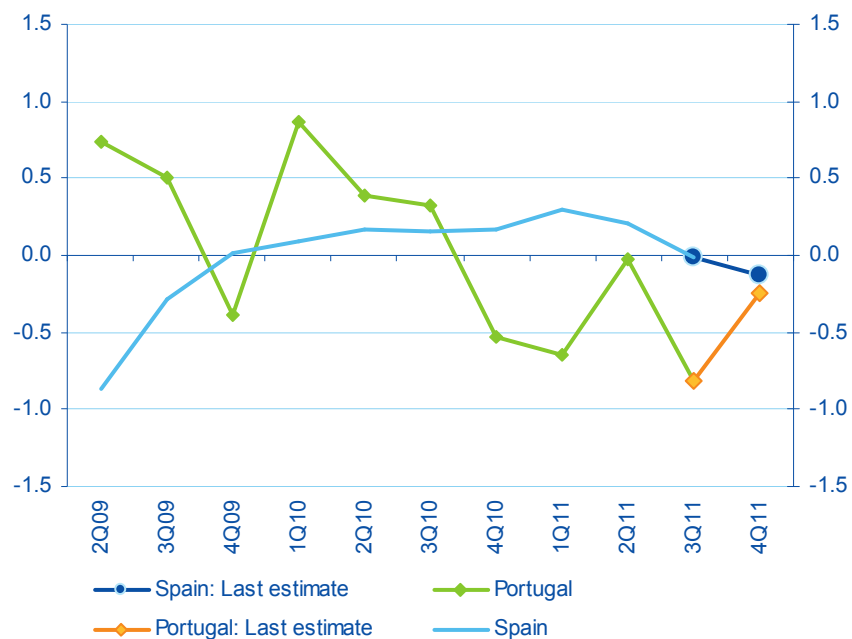
Source: BBVA Research

New factors	Factor	Effect
	Increased uncertainty in the financial markets (spreads)	PRT: Risks remain at high levels ESP: Risk premiums revised slightly upwards
	Growth slowing in Europe	PRT and ESP: Negative bias on growth forecasts for Europe in 2011
	Fundamentals for internal demand are not recovering	PRT and ESP: Job destruction and deterioration of disposable income continue
	Confidence reduced	PRT: Confidence at minimum levels ESP: Uncertainty is high and less temporary than forecast
	Liquidity stress and return to deposits war	PRT and ESP: the incentive to hold onto capital could mean less credit available
	Fiscal uncertainty	PRT: slippages rise concerns for '12, ESP: Lower growth due to more fiscal adjustments
	Change in monetary policy	ESP and PRT: Lower interest rates
	External demand strong (tourism)	Positive surprise in services (and goods)

Gloomy short-term outlook

Spain and Portugal: 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

Private consumption

Slowed down in Spain ...

... while in Portugal is adjusting sharply as a consequence of fiscal retrenchment

Spain: Consumption, retail sales and confidence

Source: BBVA Research based on INE data



◆ Priv. Cons. % y/y (LHS) ▲ Retail Sales Vol. % y/y (LHS)
 × Consumer Conf. % Balance (RHS)

Portugal: Consumption, retail sales and confidence

Source: European Commission, INE and BBVA Research



◆ Priv. Cons. % y/y (LHS) ▲ Retail Sales Vol. % y/y (LHS)
 × Consumer Conf. % Balance (RHS)

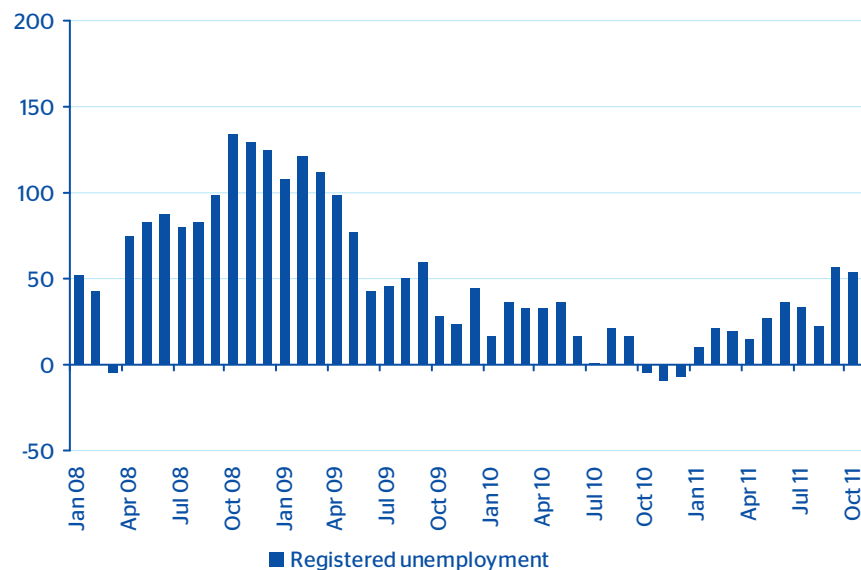
Job destruction continues

Further deterioration of job market, with negative effects on confidence and consumption, which worsens the outlook for 2012

Spain: registered unemployment

(thousands of people, SWDA data)

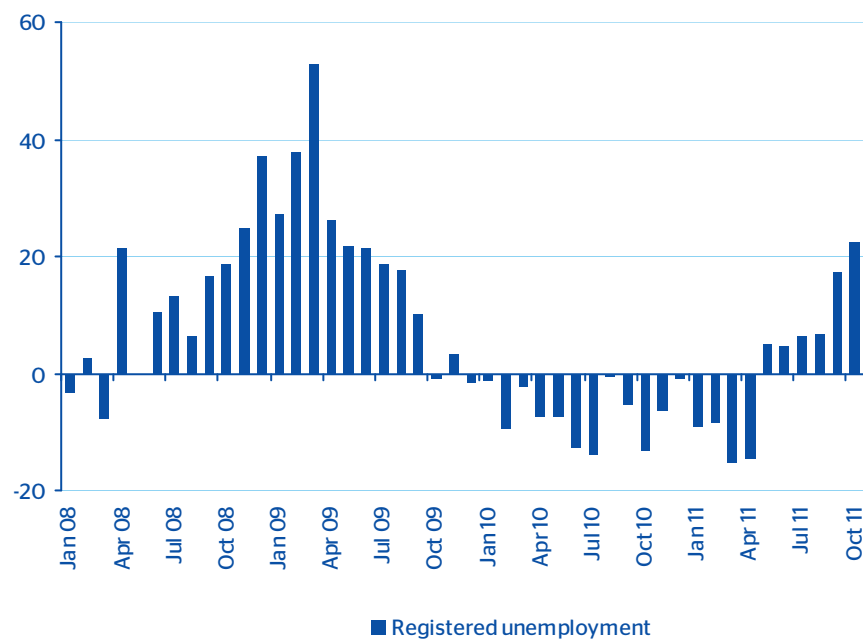
Source: BBVA Research based on MTIN (ministry of labour and immigration) data



Portugal: registered unemployment

(thousands of people, SWDA data)

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



Doubts about fiscal consolidation

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

Deficit will reach a -6.3% of GDP if no additional measures are taken, while target is -5.9%.

Spain: budget balance of public administrations

(cumulative annual, % of GDP)

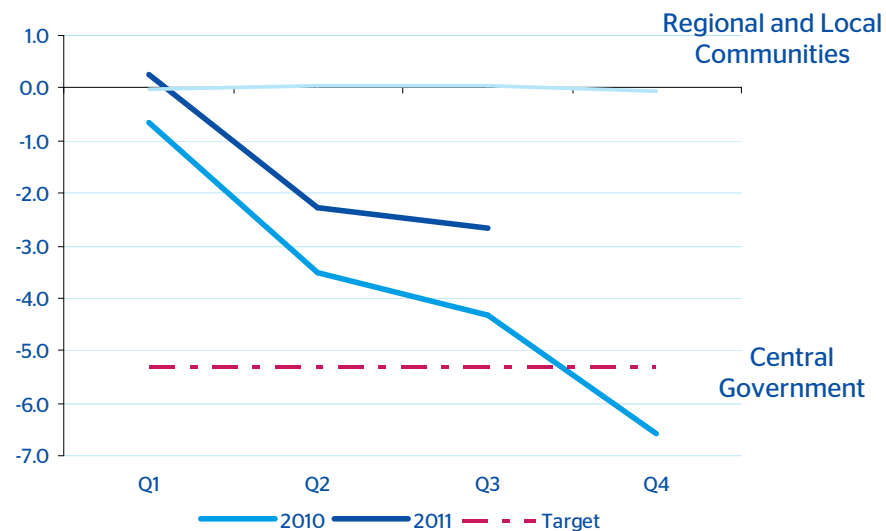
Source: BBVA Research, using finance ministry data



Portugal: budget balance of public administrations

(cumulative annual, % of GDP)

Source: BBVA Research, using DGO data



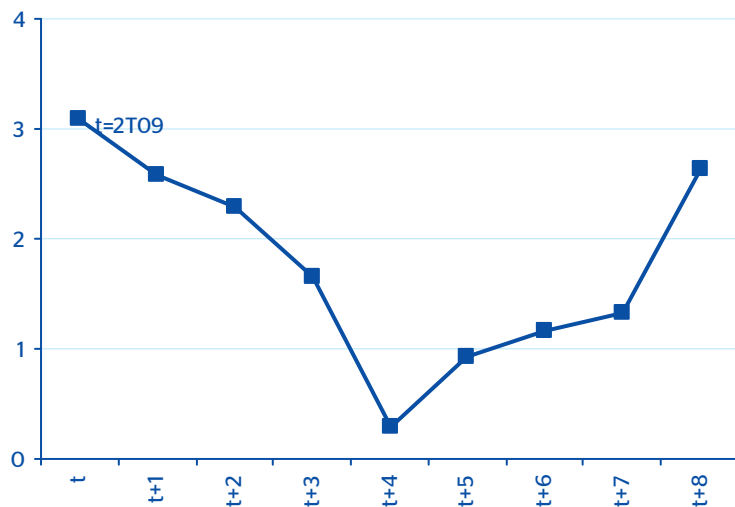
Foreign trade performing well so far

Exports above pre-crisis level and increasing diversification (sectors and countries)

Net exports have been the main driver of growth, particularly in 2011

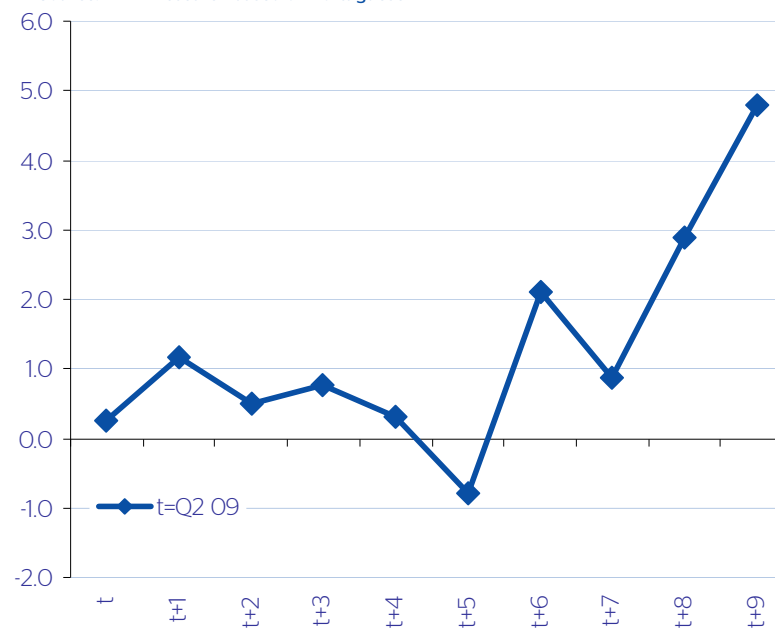
Spain: Contribution of net foreign demand to economic growth (pp)

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



Portugal: Contribution of net foreign demand to economic growth (pp)

Source: BBVA Research based on Portuguese INE



Weak growth scenario

Economic Forecasts

Source: BBVA Research based on INE and Eurostat

Economic Forecasts

Source: BBVA Research based on INE and Eurostat

(y-o-y growth rate)	2010			2011			2012		
	Portugal	Spain	EMU	Portugal	Spain	EMU	Portugal	Spain	EMU
Household consumption	2.3	1.3	0.8	-4.2	0.4	0.5	-3.4	0.5	0.7
Public consumption	1.2	-0.7	0.5	-4.6	-0.3	0.3	-2.8	-2.7	0.1
Gross Fixed Capital Formation	-4.9	-7.5	-1.0	-9.7	-5.1	2.4	-6.9	-0.6	1.7
Domestic Demand (*)	0.7	-1.1	1.0	-6.1	-1.0	1.0	-4.1	-0.4	0.8
Exports	8.8	10.3	10.6	7.2	10.1	6.1	5.8	5.1	2.5
Imports	5.1	5.5	8.9	-6.1	3.0	4.7	-1.5	-0.3	2.1
External Demand (*)	1.3	1.0	0.8	-1.4	1.8	0.7	-1.5	1.4	0.3
GDP	1.3	-0.1	1.7	-1.4	0.8	1.7	-1.5	1.0	1.0
Pro-memoria									
Total employment (LFS)	-1.5	-2.3	-0.4	-1.0	-1.7	0.5	-1.3	-0.8	0.4
Unemployment rate (% Active pop.)	12.0	20.1	10.2	12.4	21.5	9.9	13.3	22.1	9.7
Current account (%GDP)	-9.7	-4.5	-0.5	-7.6	-4.5	0.0	-5.0	-3.0	0.2
Public surplus/deficit (%GDP)	-9.8	-9.2	-6.2	-6.3	-6.5	-4.5	-4.7	-4.4	-3.4
CPI (yearly average)	1.4	1.8	1.6	3.4	3.1	2.6	2.9	1.2	1.6

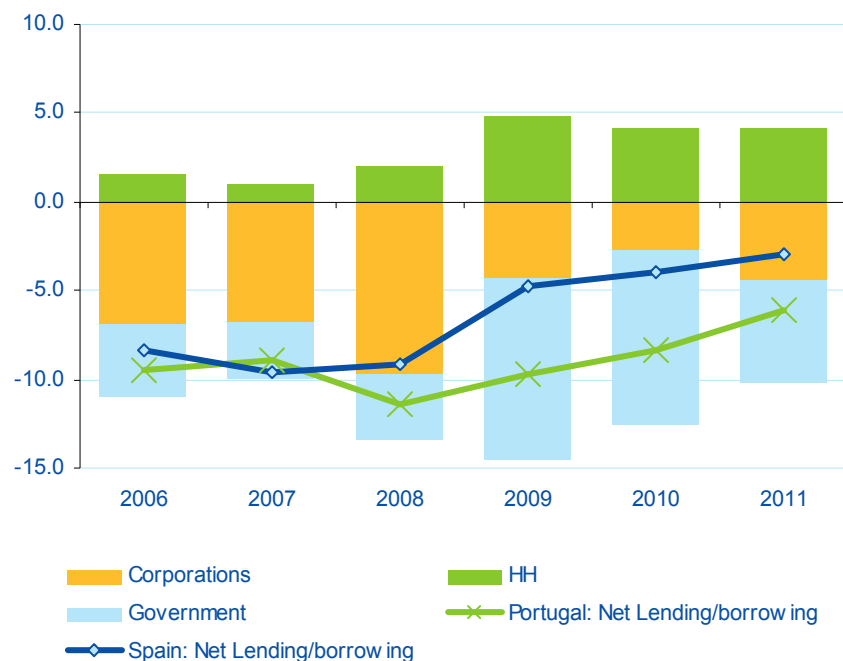
(*) contributions to GDP growth

(**) BBVA Forecasts, October 2010.

The challenges ahead

Spain and Portugal: foreign financing capacity (% of GDP)

Source: BBVA Research based on AMECO data



Adjustment to financing needs via

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

Reduction of public deficit ($S-I$)

Boost to competitiveness with ambitious structural reforms

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

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)

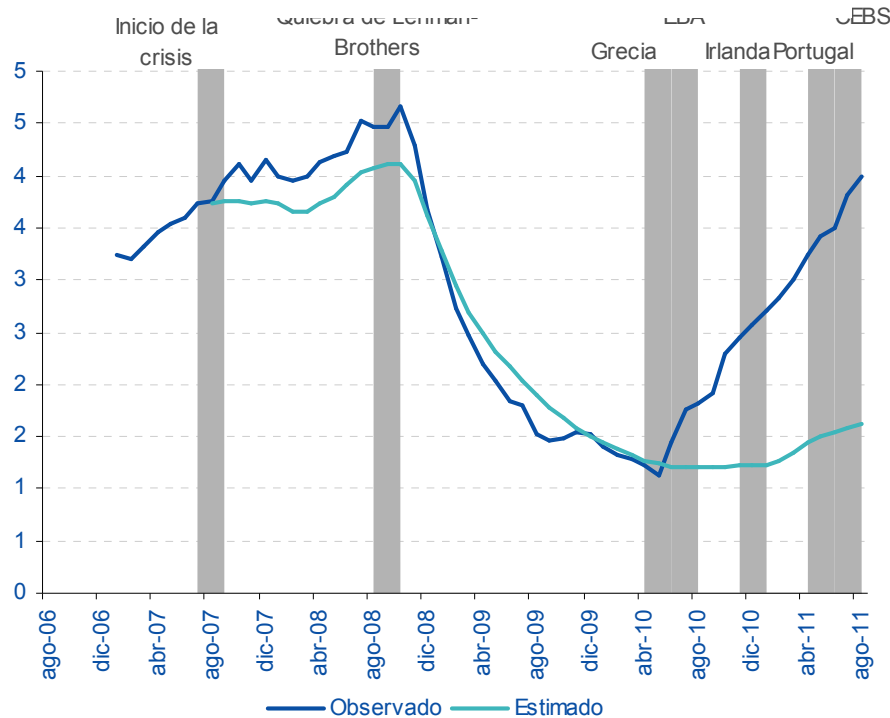
Investment recovery (with positive effects on employment)

The challenge is to increase saving, support investment and facilitate long term foreign debt refinance, reducing risk perception of both economies

1. Bank restructuring

Interest rates and new deposits

Source: BBVA Research



Beyond EBA recapitalisation:
better solvency and more liquidity

Sector recapitalization: term, entry price, instruments and credit promotion

Creation of a bad bank and rescue fund for the construction sector

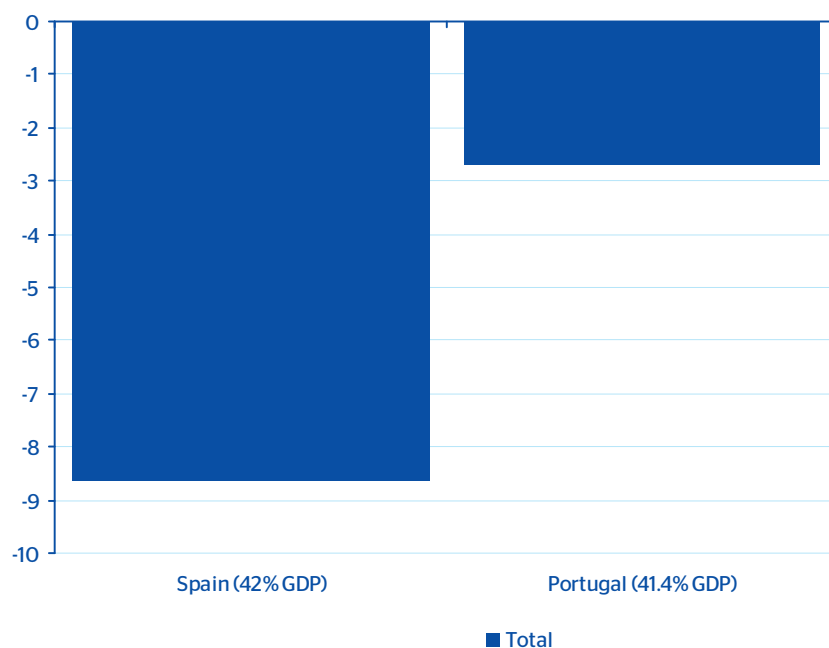
Transfer of Pension funds to Social Security

Penalty to high compensation deposits

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)

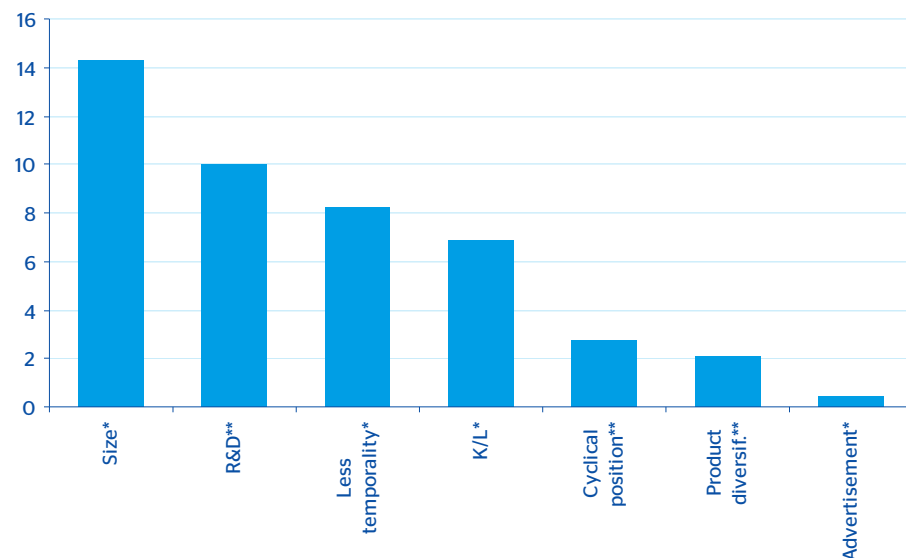
Offer certainty with an ambitious law which implements constitutional reform

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

3. Step up pace of reform

Marginal effects on the various factors affecting export probability of Spanish firms

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

Troika assessment

Second review | 7-16 November mission

Economic activity

2011: better than expected
2012: **more negative and tilted to the downside**

Fiscal adjustment

2011 slippages corrected with structural measures and bank pension funds transfer.
2012 measures are bold and tilted towards a export led model,
but risks at the local and regional levels, and SOE

Financial sector

Portuguese banks subject to challenges to strengthen capital

Structural reforms

COMPETITIVENESS: wage cut in the public sector spill over in the private.
COMPETITION: Liberalization in telecommunication.
Avoid reform fatigue

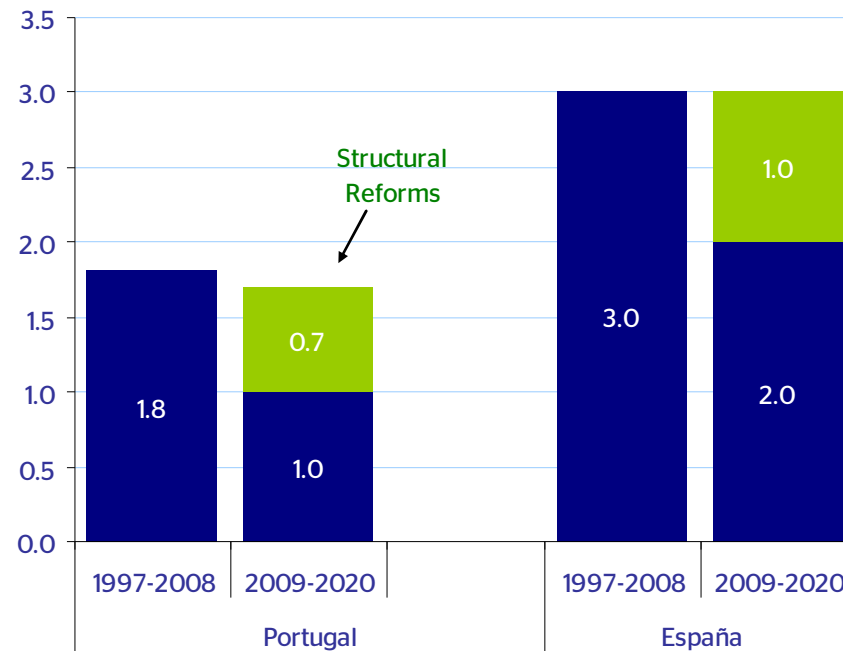
The troika approved the disbursement of 8 bn €



3. Step up pace of reform

Spain vs. Portugal: Potential GDP (% yoy)

Source: BBVA Research



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