

Global and Spanish Economic Outlook

Madrid, November 2013

Main messages

- 1 **Global growth will accelerate in 2014 as a result of a higher contribution to growth from developed economies** and despite downside risks
- 2 **The Spanish economy will start a new cycle of moderate economic growth**, based on exports, import substitution, the reduction of financial stress and a less contractionary fiscal policy.
- 3 **Heterogeneity will continue at the regional level** due to their different dependence on foreign demand, to their various needs regarding fiscal adjustment and to the advances made in correcting their imbalances
- 4 **Recovery will remain dependent on several factors**, among others, structural reforms both in Spain and Europe. As far as Europe is concerned, reducing financial fragmentation through the creation of a banking union will be key

Contents

Section 1

The global economy: economic strengthening in advanced countries and lower deterioration in emerging markets

Section 2

Spain: growth returns, although at moderate rates

Section 3

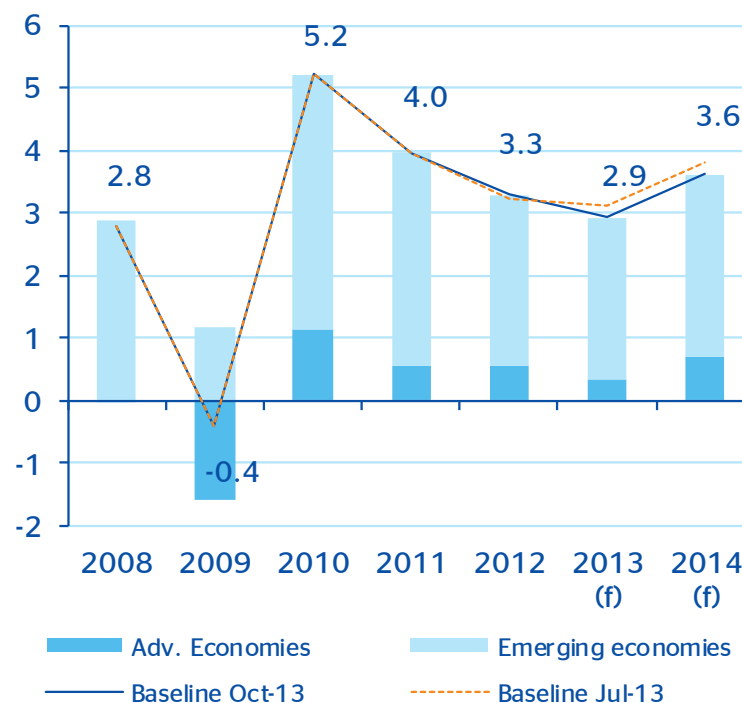
Commitment to reforms: key for consolidating the improvement in markets and increasing growth potential

Main messages

- 1 Slight **downward revision** of global growth rates on the back of slowing emerging economies, particularly in Asia. The recovery is expected to be moderate
- 2 **Risks, even if less extreme, still tilted to the downside.** The US Government shutdown and wrangle over debt ceiling add to tapering, concerns about rebalancing in China and up surging of the Eurozone crisis

Global GDP growth (%)

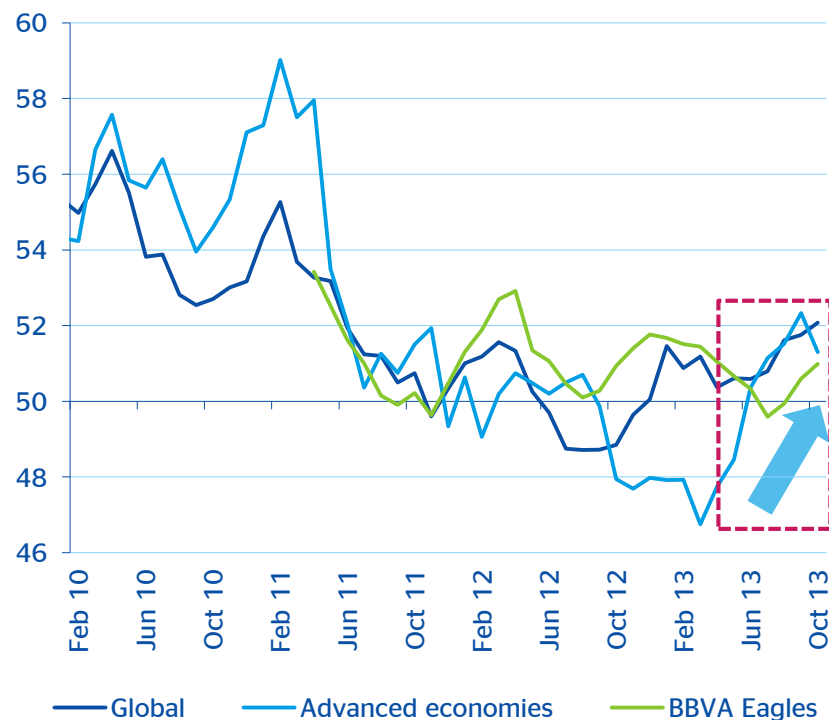
Source: BBVA Research



Advanced economies improve while deterioration in emerging markets comes to an end

Global: Manufacturing PMIs

Source: BBVA Research based on Markit Economics



Global growth rebalancing

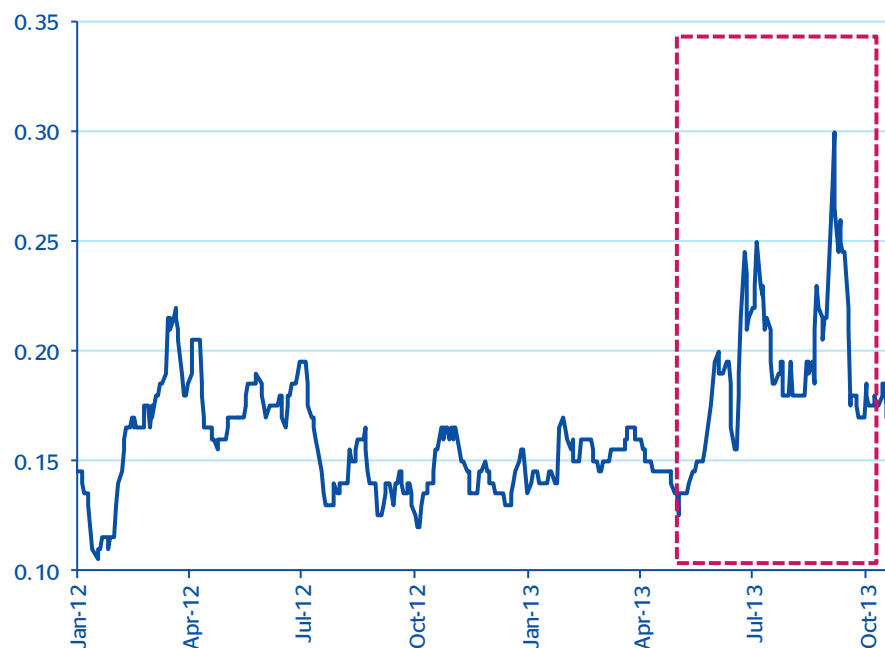
Improvement in expectations on the economic cycle within developed economies...

... waiting for GDP growth improvements

Emerging economies: financial tensions decay after the delay of US tapering...

US.: Fed Funds 12 months ahead

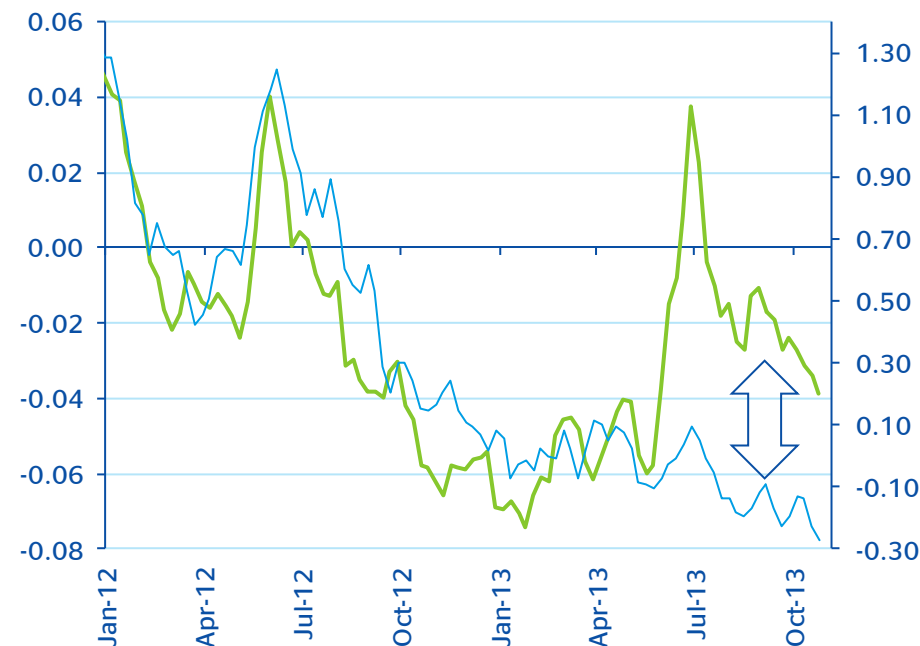
Source: Bloomberg



— 12-month ahead fed funds

BBVA Research's Financial Stress Index: developed and emerging economies

Source: BBVA Research



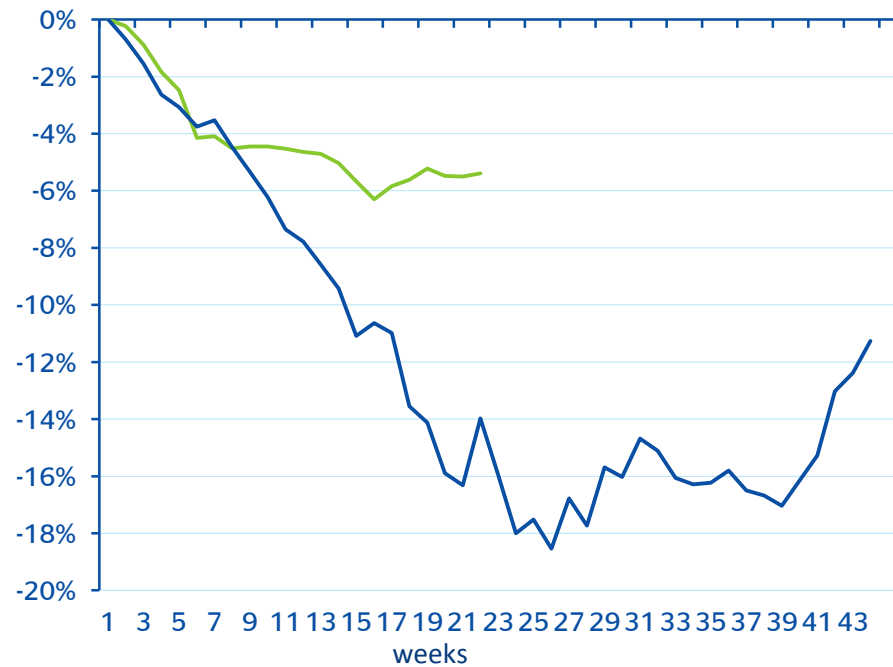
— Emerging Markets, left axis — Developed Markets, right axis

... capital outflows decrease and expectations improve

Capital inflow to emerging markets

(% total assets)

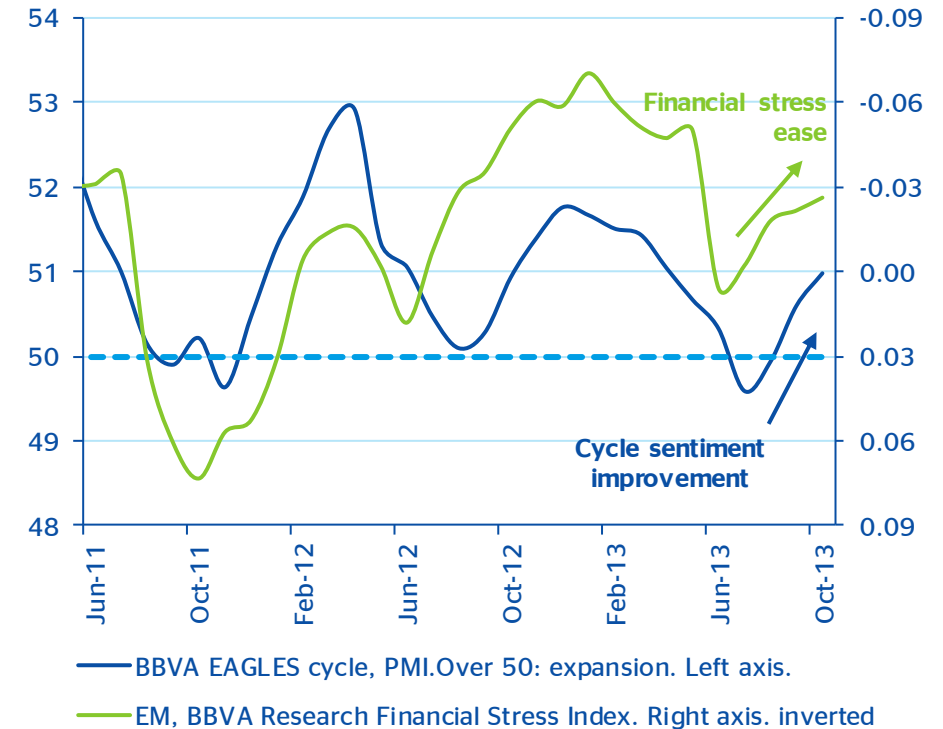
Source: BBVA Research and EPFR



— Current (Since May 2013) — Lehman Brothers (since Aug-2008)

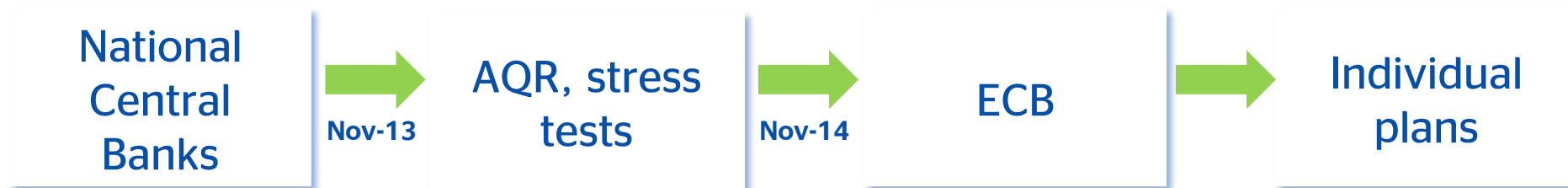
Emerging economies: economic cycle and financial tensions

Source: BBVA Research



Banking union is key to EMU's strength

¿How to reach the “single supervision” target?



How to clean up the European banking system?

- Ensuring equal criteria of financial stability
- Having a “back-stop” (national, ESM loans, ...)

How to resolve entities since 2014?

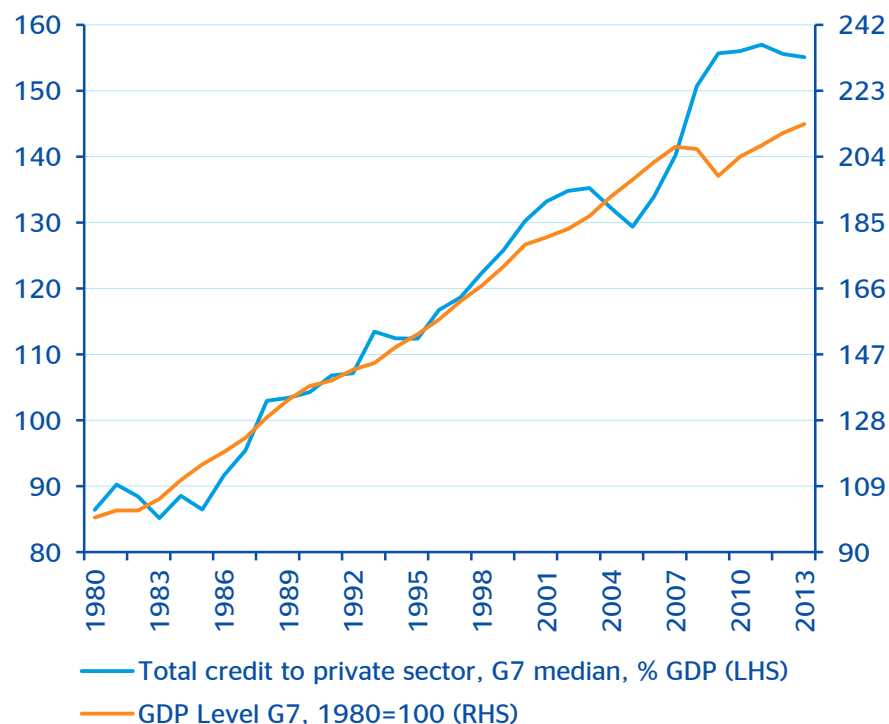
- Still much to be decided: Under what rules? Who will decide? Who will pay?

The relationship between growth and debt is not simple

Economic activity and debt in advanced economies

Real GDP and ratio of total credit to private sector over GDP. Median G7

Source: BIS, OECD and BBVA Research



Change in level of GDP and the debt-over-GDP ratio

Source: BIS, OECD and BBVA Research

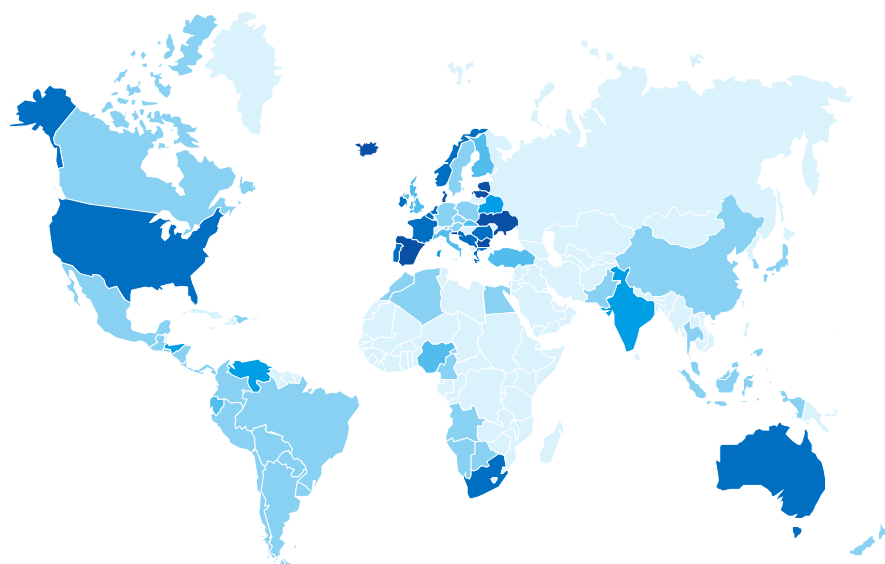


Deleveraging is needed when credit exceeds an equilibrium level -which does not only depend on GDP

Credit gap map (2007)

(deviation of GDP-credit ratio w/respect to equilibrium)

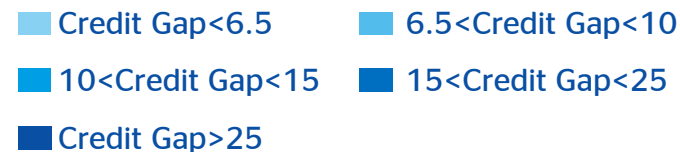
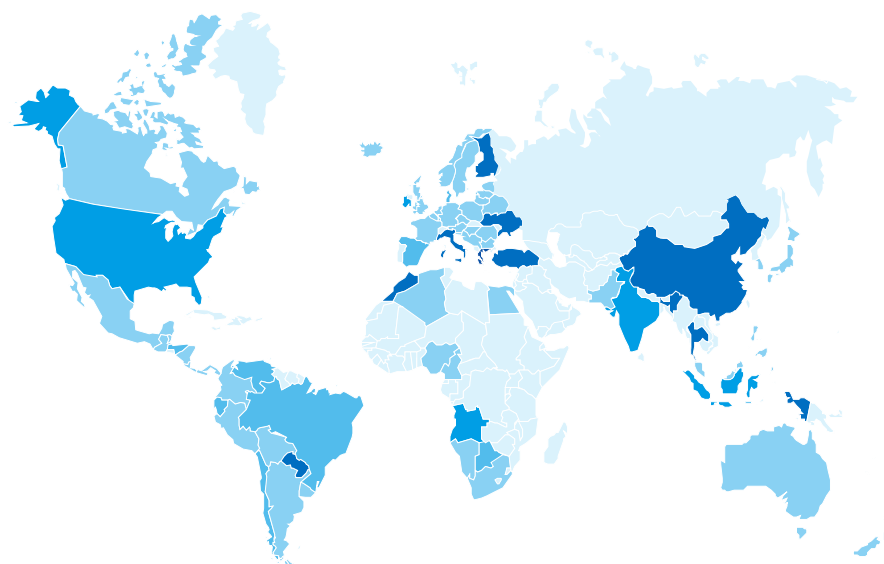
Source: BBVA Research



Credit gap map (2013)

(deviation of GDP-credit ratio w/respect to equilibrium)

Source: BBVA Research



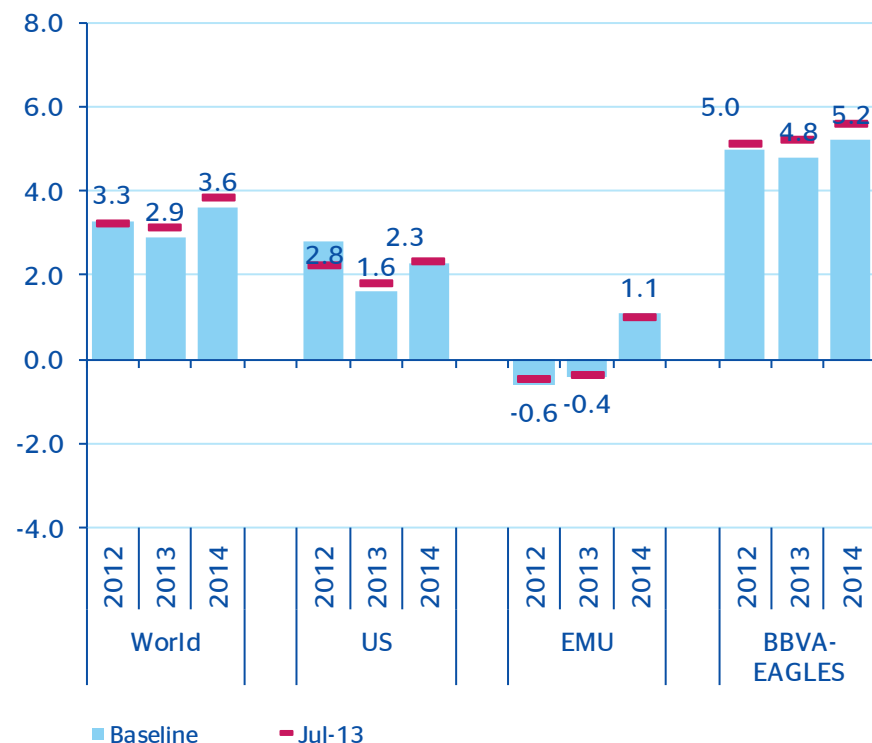
Policy design and implementation: risks tilted to the downside



A recovery with downside risks

GDP growth (%yoy)

Source: BBVA Research and IMF



Global recovery continues to be on the back of advanced economies. Risks tilted to the downside if lack of economic support

The bounded recovery makes advanced economies vulnerable to very tight financial conditions

In emerging markets, the vulnerability of some of them to a less favorable global liquidity outlook must be monitored

Contents

Section 1

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Section 2

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Section 3

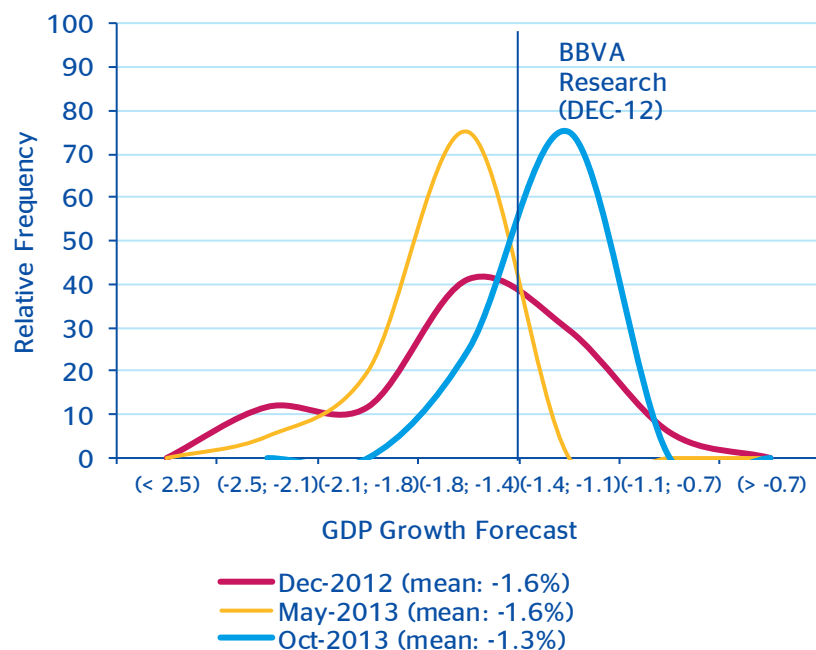
Commitment to reforms: key for consolidating the improvement in markets and increasing growth potential

Baseline scenario: forecasts converge to BBVA's

Spain: GDP growth forecasts, 2013

(% y/y)

Source: BBVA Research based on consensus forecast



Expected decline of GDP for 2013 will be less steep than expected by the consensus in the past

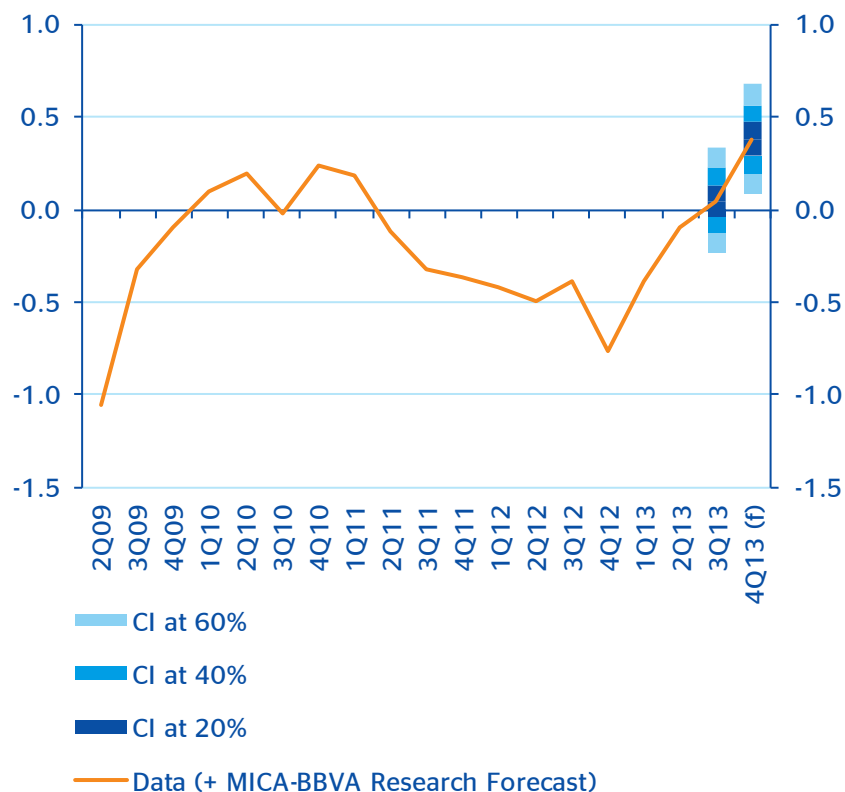
GDP forecasts converge towards BBVA's from a year ago

Reduced financial tensions at the end of 2012 anticipated an improvement in GDP

The Spanish economy is bottoming out in 2013...

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

Source: BBVA Research, based on INE data



In 3Q13, the negative contribution of domestic demand declines, while the contribution of foreign demand remains positive...

... as a result of a less contractive fiscal policy and exports maintaining their growth

The information available points to growth of around 0.3% in 4Q13

... and economic recovery is expected, in line with the stylized facts from previous cycles

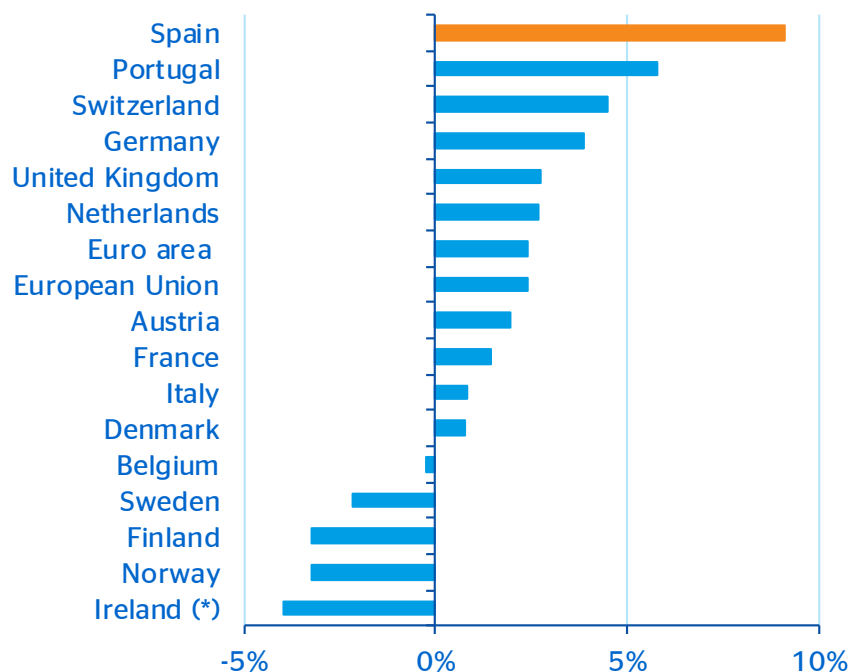
Box 1

Variables that precede the cycle	Export growth	✓
	Gross operating surplus	✓
	Investment in machinery and equipment	✓
	New credit operations (flow)	Stable
=	GDP growth	Stable
	Employment growth	Stabilizing
Lagging variables	Growth in stock of credit	Declining

Export growth: exceptional performance within the EU

Total exports (annual cumulative change 1Q12-2Q13 in %, seasonally adjusted)

Source: BBVA Research based on INE data



(*): Data until 2Q13

Spanish exports have grown in the last year despite the recession in the EU

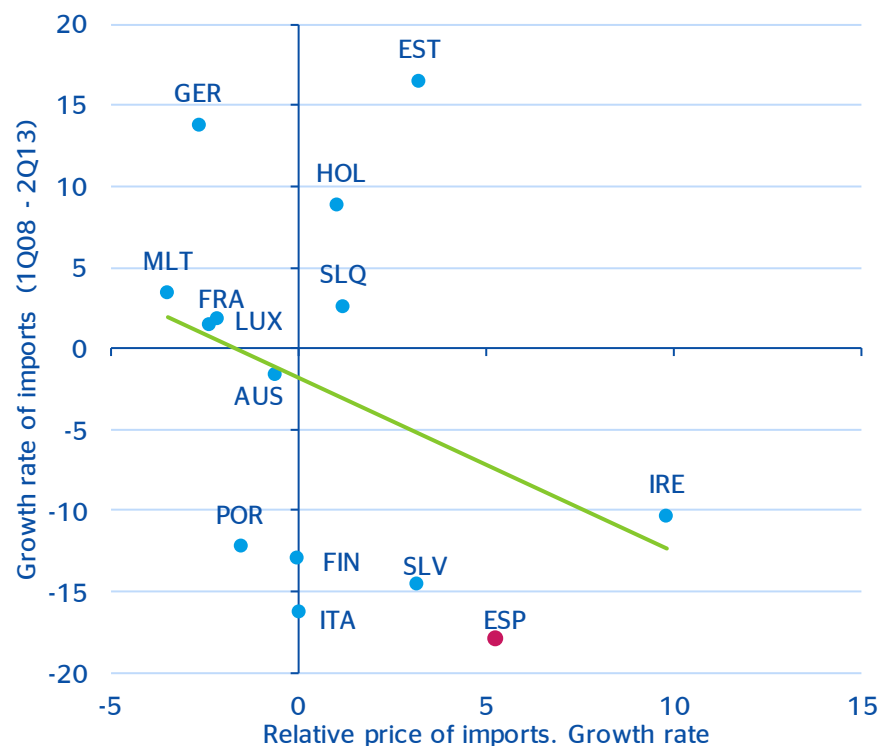
This is partly due to an increase in the share of exports to BBVA-EAGLES countries and other developed economies...

... but also to gains in Spanish competitiveness in both price and quality

Imports substitution

Spain: imports of goods and services and change in relative prices (% , 1Q08-2Q13)

Source: BBVA Research based on Eurostat



Box 2

For the first time in two decades, price competitiveness gains have been recorded in the price of domestic products against imported ones...

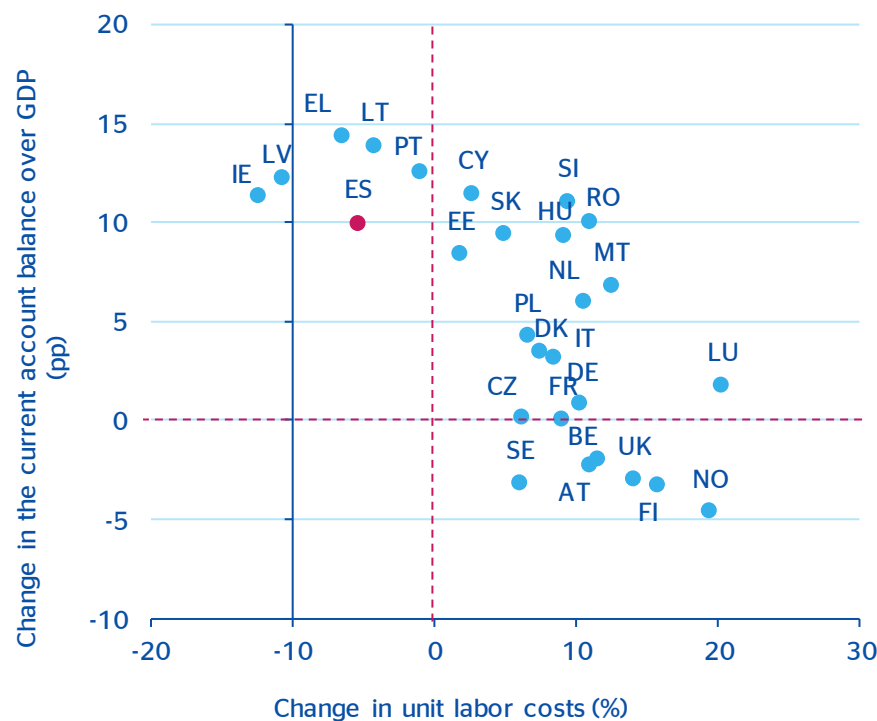
.... and they have been reinforced by a relative demand for imports that is more elastic to the relative price

It is estimated that these processes explain 42% of the fall in imports

The current-account balance: from deficit to surplus

EU: change in the current-account balance and unit labor costs, 4Q08-2Q13

Source: BBVA Research based on Eurostat



Labor productivity gains since the start of the crisis have been considerable (12%)...

and across the board: both in tradable goods and...

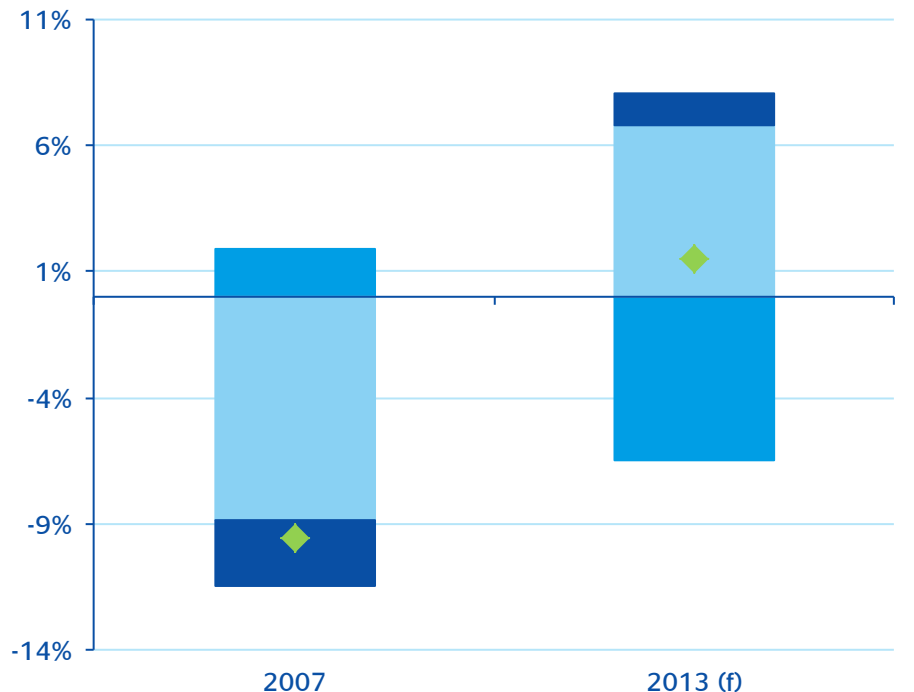
... in manufacturing and industrial goods, where growth over 20% has been registered

Wage moderation and productivity gains: the situation of companies has improved

Spain: net foreign borrowing (-) / lending (+) needs

(% of GDP)

Source: BBVA Research, based on INE data



■ Households ■ Financial and nonfinancial companies ■ Public sector ◆ Total

The maintenance of savings in the private sector and the reduction of investment...

... have allowed a deleveraging process with the rest of the world over the last 5 years...

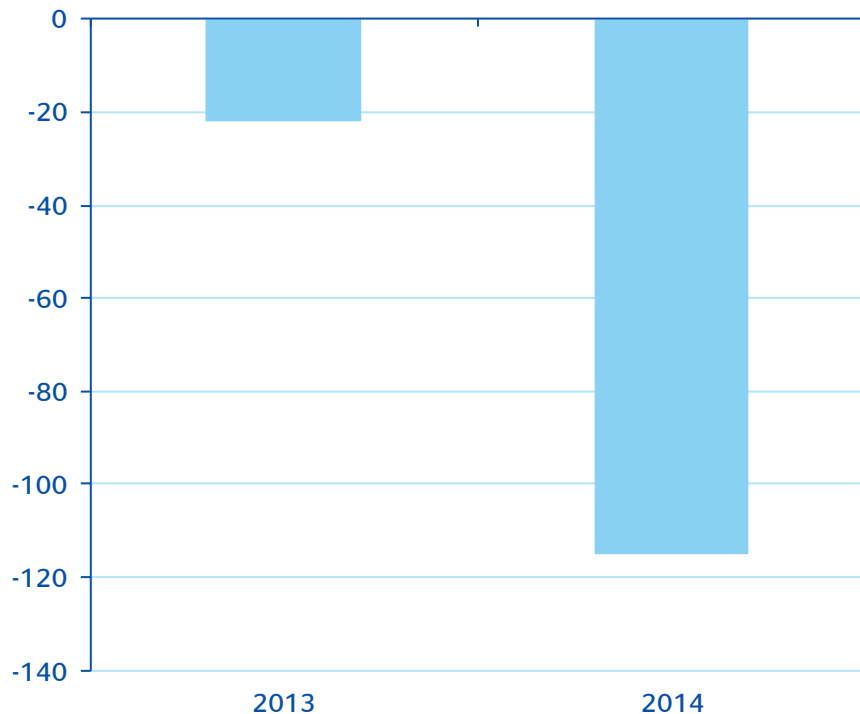
... which has improved the position of companies to increase investment once a less uncertain environment is consolidated

Less uncertainty: a better environment for investment

Spain: 10-year interest rates

(Difference with respect to May 2013 forecast)

Source: BBVA Research



The improved external perception of the Spanish economy has drastically lessened its dependence from ECB finance

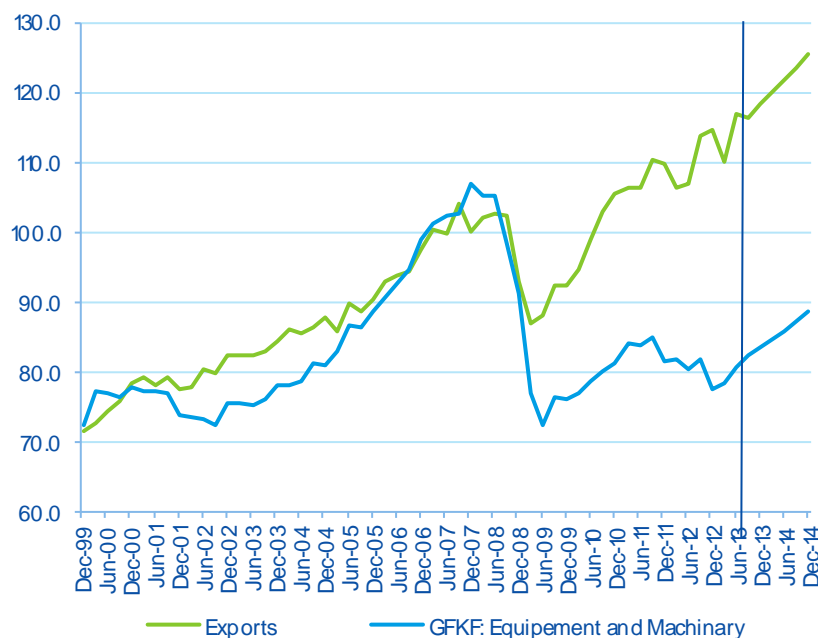
Reduced financial tensions are transmitted to the economy with a delay of between 6 to 9 months

A permanent fall of 100 bps in sovereign interest rates implies up to one extra point of GDP growth for the economy

Greater strength of investment

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

Source: BBVA Research, based on INE data



The recovery expected in the EU and the continuity of exports growth...

... should lead to a recovery of investment in the private sector

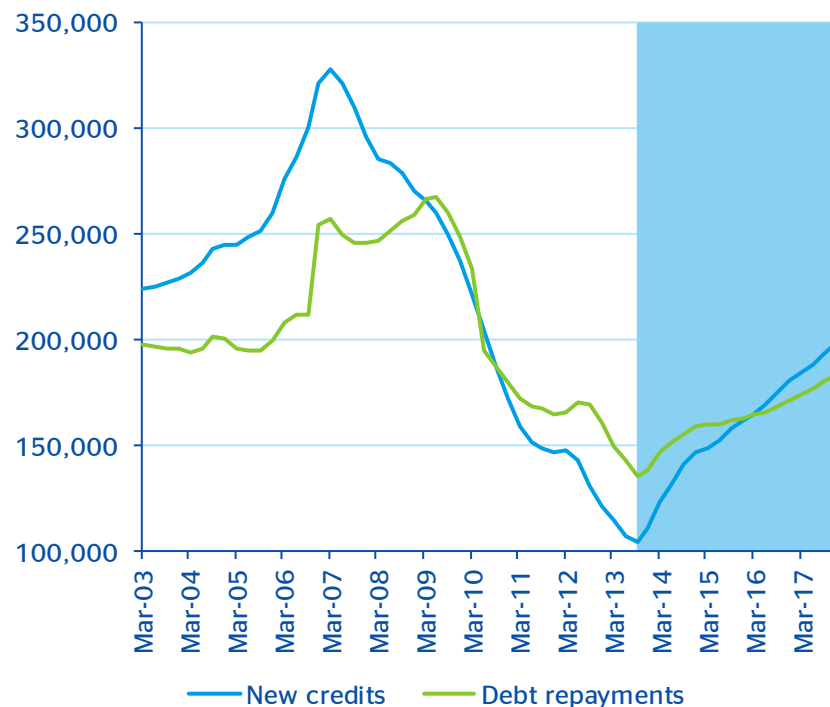
In fact, in the first three months of the year the growth rate was around 10%

Improvement of new credits

Spain: new credits and repayments to the private resident sector

(trend, million euros)

Source: BBVA Research based on Bank of Spain



Box 3

The Spanish economy has to go through an inevitable process of deleveraging...

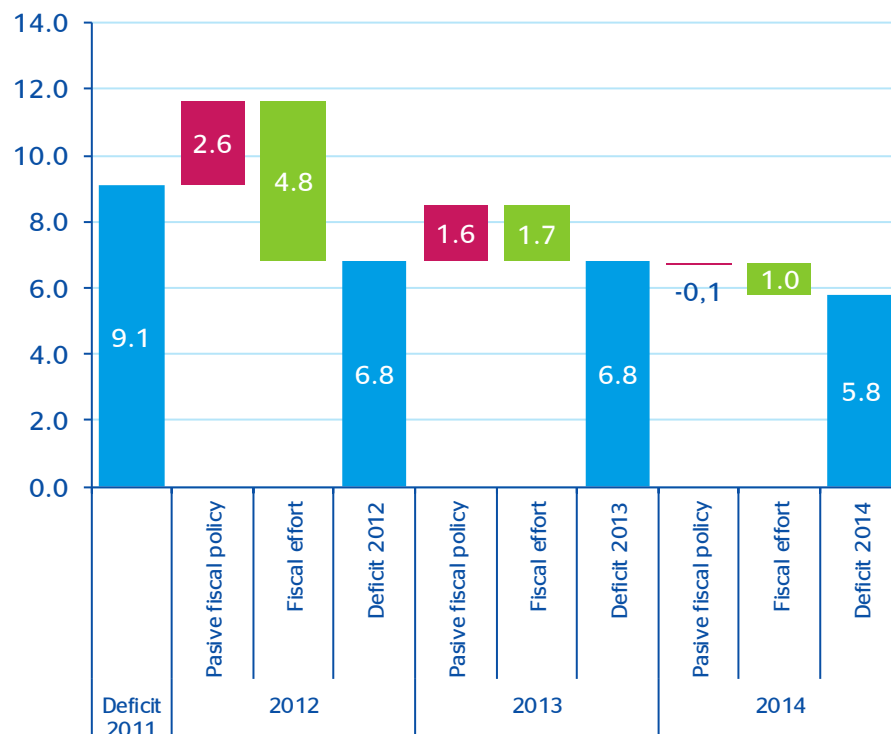
... which is not at odds with the provision of credit for solvent projects

Credit flows are expected to recover starting in the first half of 2014

Fiscal consolidation: lower short-term efforts

Spain: breakdown of public deficit excluding aid to the financial sector (% GDP)

Source: BBVA Research based on Ministry of Finance



Fiscal efforts were significant in 2012 and 2013...

... and will allow the public deficit to remain at around 6.8% of GDP

Deficit targets that are more consistent with recovery will lead to GDP growth in 2014

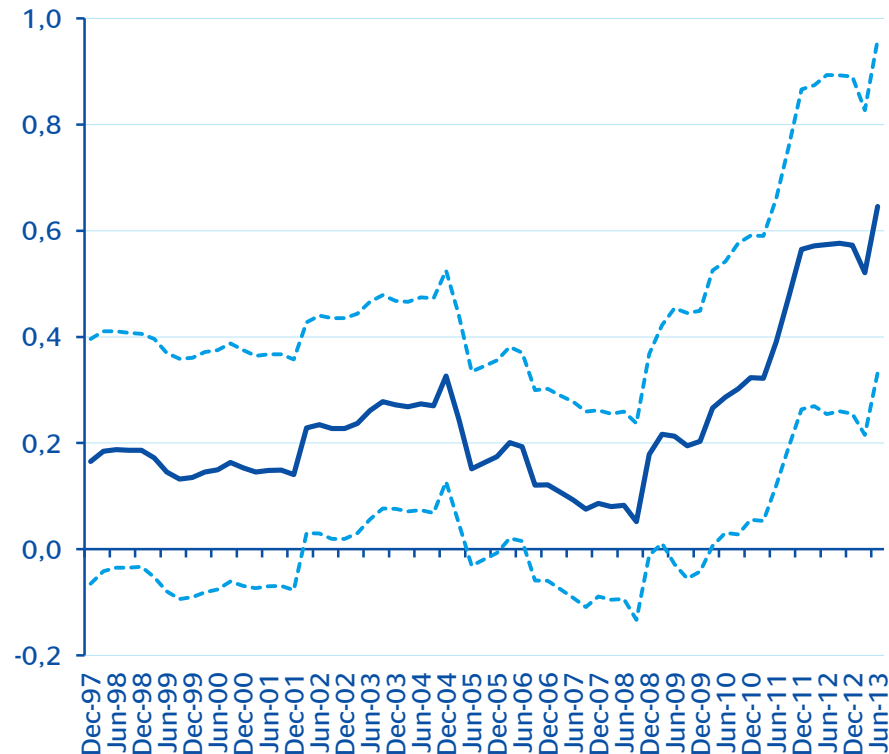
The labor market is stabilizing

Spain: short-term elasticity of employment to GDP

(q/q %)

VAR in reduced form in first differences, 72-quarters rolling window

Source: BBVA Research, based on INE data



The job destruction process has slowed down, in part as a result of wage moderation

If labor institutions had been more appropriate at the start of the crisis, the destruction of a million jobs could have been avoided

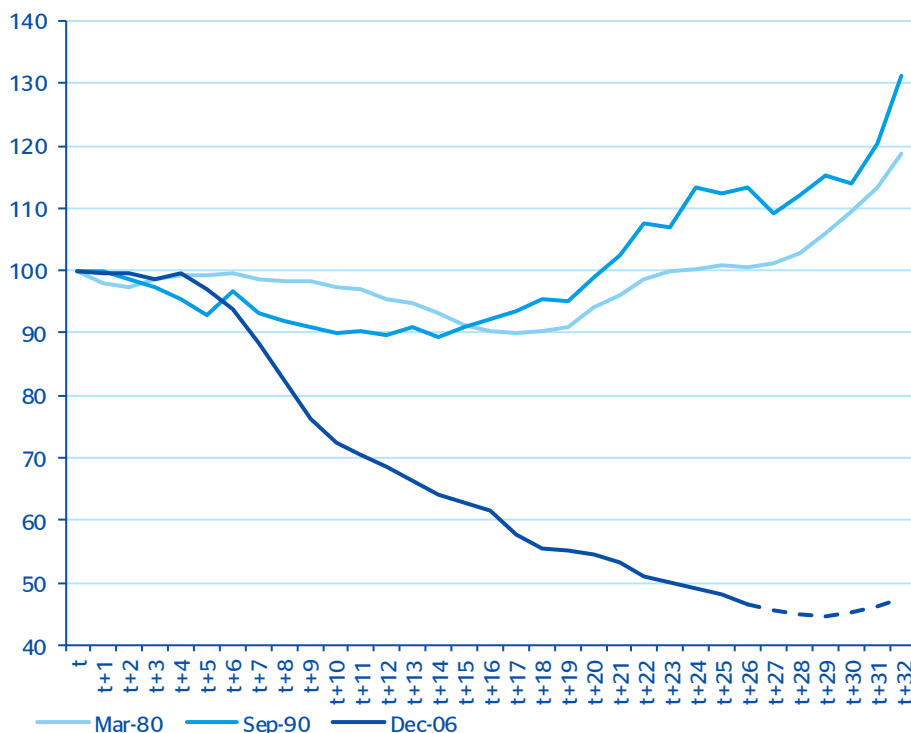
The elasticity of employment to GDP has increased during the crisis. How will it behave during the recovery?

The real-estate cycle: This time is different

Spain: housing investment, compared with previous recessions

(Maximum during expansion = 100)

Source: BBVA Research, based on INE data



The recovery of investment in the real-estate sector tends to run ahead of the cycle...

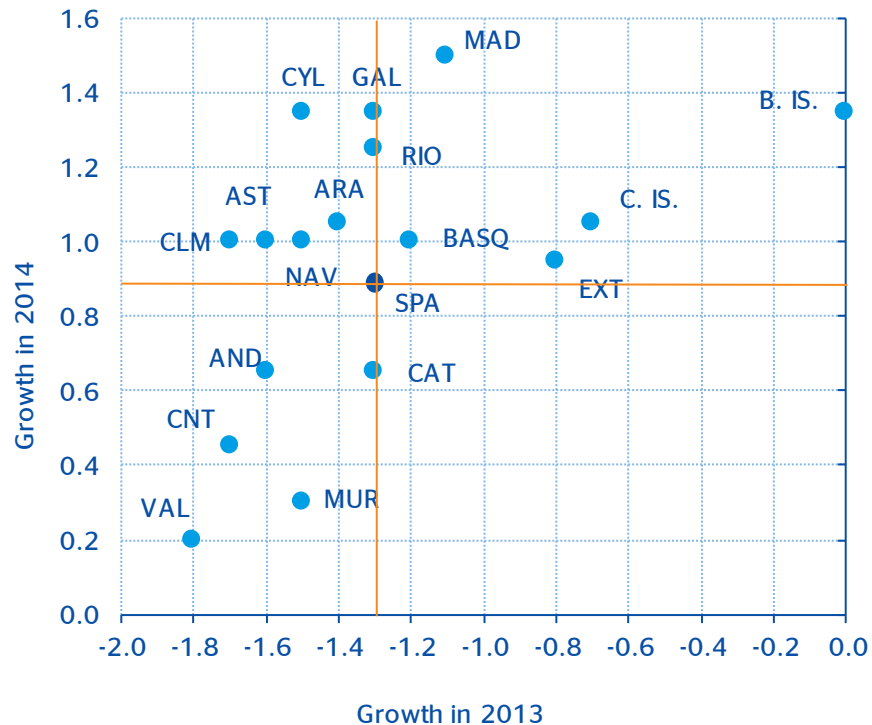
... however, the current excess of supply will make it unlikely that this time it will accompany the recovery (effect vs cause)

The ambitious reform process must also ensure an efficient redistribution of resources between sectors

2014: the start of recovery

Spain: GDP growth by autonomous region (y/y %)

Source: BBVA Research



Spain will bottom out in 2013 with a GDP fall of 1.3% and begin to grow in 2014 by 0.9%

By regions, compliance with the 2012 targets, asymmetry in the 2013 targets...

... and exposure to foreign demand will be key for recovery

Contents

Section 1

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A window of opportunity that has to be seized

The economic recovery is not assured; it is extremely sensitive to financial tensions and to the pace of reforms, and numerous risks persist

Work has to be done to make recovery a reality, ensuring a lasting improvement in markets and not wasting this opportunity, as it occurred in the past

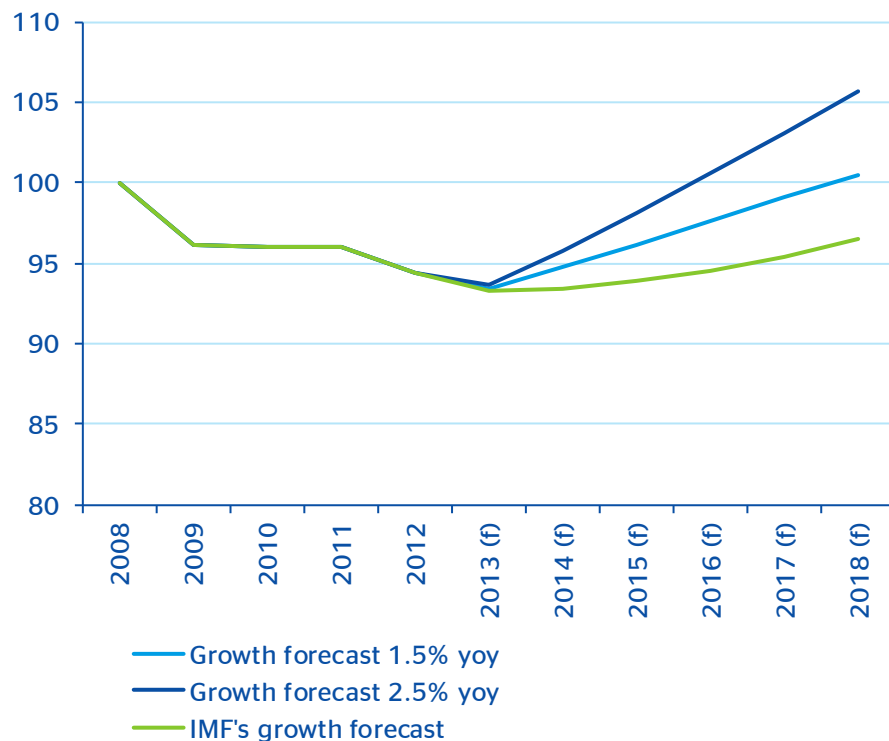
Europe must progress towards a more genuine EMU. Progress in banking union is essential and must take place over the next few quarters, together with the policies to boost growth

Spain must redouble its efforts on the adjustments underway and on the structural reforms needed to reduce unemployment and increase both its competitiveness and its capacity to attract foreign investment

The reform process has to continue

Spain: evolution of GDP under different scenarios

Source: BBVA Research



Relatively negative scenarios such as those of the IMF would imply a lost decade

The objective would be to implement the reforms needed in order to increase the economy's growth potential

In their absence, the unemployment rate will remain high and recovery will be slow

The reform process has to continue

1. Continue with the deleveraging process and improvement in financing for the Spanish economy: need to finish with the restructuring process of the financial sector
2. Reduce the risk involved in executing fiscal consolidation and guarantee the long-term sustainability of public finances (Box 4 on SF and PRI)
3. Reforms to improve competitiveness, increase Spain's attractiveness to foreign physical, human and technological capital
4. Continue with the reforms that reduce labor market dualism, improve its performance and increase employability -> more and better quality jobs

The Sustainability Factor and the Pension Revaluation Index

Box 4

Positive assessment, as it guarantees the long-term budget equilibrium of the public system

Distinguishes between the debates on sustainability and sufficiency. All solutions are possible, except for paying current pensions through a structural deficit

Aligns the interests of pensioners and the rest of society towards (1) a more efficient system; and (2) reforms that increase employment and productivity

Consistent with the proposal in the Report of the Committee of Experts

Main messages

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2013-2014 Outlook: the beginning of the recovery

Spain and Europe: macroeconomic forecasts

Source: BBVA Research based on official bodies

(% YoY)	2010		2011		2012		2013 (f)		2014 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	0,1	1,0	-1,2	0,3	-2,8	-1,4	-2,6	-0,5	0,1	0,7
General government final consumption exp.	1,5	0,6	-0,5	-0,1	-4,8	-0,5	-1,7	0,2	-1,6	0,4
Gross fixed capital formation (G.F.C.F.)	-5,5	-0,6	-5,4	1,7	-7,0	-3,8	-6,4	-3,6	0,7	2,2
Equipment and cultivated assets	4,3	5,6	5,3	4,7	-3,9	-4,2	1,0	-3,8	6,5	3,4
Equipment and machinery	5,0	5,7	5,5	4,7	-3,9	-4,2	1,1	-3,8	6,5	3,4
Housing	-11,4	-3,0	-12,5	-0,3	-8,7	-3,4	-9,0	-3,0	-0,7	2,0
Other constructions	-8,4	-6,1	-9,2	-0,2	-10,6	-4,9	-12,6	-5,7	-5,3	-0,9
Changes in inventories (*)	0,3	0,6	-0,1	0,2	0,0	-0,5	0,0	0,0	0,0	0,0
Domestic Demand (*)	-0,6	1,2	-2,1	0,7	-4,1	-2,2	-3,1	-1,0	-0,1	0,8
Exports	11,7	11,4	7,6	6,7	2,1	2,7	4,6	1,7	6,3	3,9
Imports	9,3	9,8	-0,1	4,6	-5,7	-0,8	-1,0	0,4	3,4	3,7
External Demand (*)	0,4	0,7	2,1	0,9	2,5	1,5	1,8	0,6	1,1	0,3
GDP mp	-0,2	1,9	0,1	1,6	-1,6	-0,6	-1,3	-0,4	0,9	1,1
Pro-memoria										
GDP excluding housing	0,8	2,2	1,0	1,7	-1,2	-0,5	-0,9	-0,2	1,0	1,0
GDP excluding construction	1,8	2,7	2,0	1,8	-0,4	-0,2	0,0	0,1	1,4	1,1
Total employment (LFS)	-2,3	-0,5	-1,9	0,3	-4,5	-0,7	-3,1	-0,9	0,0	0,1
Unemployment rate (% Active pop.)	20,1	10,1	21,6	10,2	25,0	11,4	26,3	12,0	25,6	12,0
Current account balance (% GDP)	-4,5	0,0	-3,8	0,1	-1,1	1,2	1,2	2,1	1,8	2,1
Public debt (% GDP) (**)	61,7	85,4	70,4	87,3	85,9	90,6	94,4	94,5	98,4	94,8
Public deficit (% GDP)	-9,6	-6,2	-9,1	-4,1	-6,8	-3,7	-6,8	-2,8	-5,8	-2,4
CPI (average)	1,8	1,6	3,2	2,7	2,4	2,5	1,5	1,5	1,1	1,4
CPI (end of period)	3,0	2,0	2,4	2,9	2,9	2,3	0,6	1,3	1,3	1,4

(*) Contribution to GDP Growth

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

(f): forecast