

European and Spanish Economic Outlook

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Main messages

- 1 **The global economic cycle is improving** and we expect a moderate acceleration in growth in 2014-15, supported by growth in 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 **The slow recovery in the eurozone continues**, thanks to favourable economic policies and an improvement in the financial environment. The comprehensive review should eventually help to reduce financial fragmentation
- 4 **For the first time since the beginning of the crisis, the bias to our forecasts for the Spanish economy is to the upside.** The recovery is being driven by exports, import substitution and the recovery in new lending
- 5 **The scope of the reforms needs to be expanded, if they are to underpin a robust and sustained recovery and**, within a reasonable period, replace the jobs destroyed

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Global economy: a gradual acceleration supported by growth in developed economies

Section 2

Europe: the slow recovery continues, the risk of deflation is very low, but...

Section 3

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

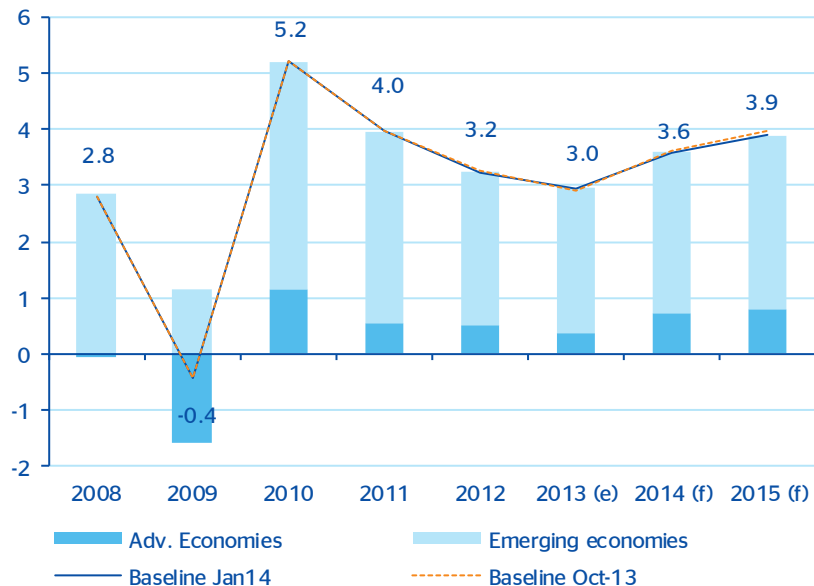
Section 4

Spain: commitment to the reform process is crucial to consolidate “recent” market improvement and increase potential growth

Main messages

Global GDP growth (%)

Source: BBVA Research



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

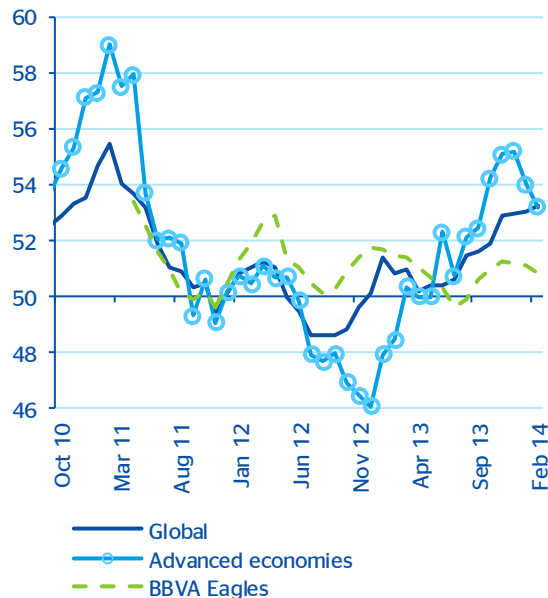
Growth risks are more balanced, with an upward bias in the US

However, downside risks remain: the exit from QE and flows to emerging markets, the uneven recoveries and vulnerabilities in EM, and, still, the eurozone

The global momentum is improving

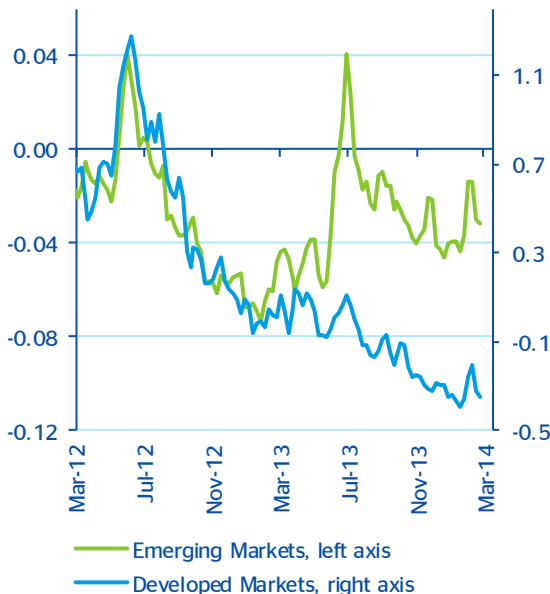
Manufacturing PMIs

Source: BBVA Research based on Markit Economics



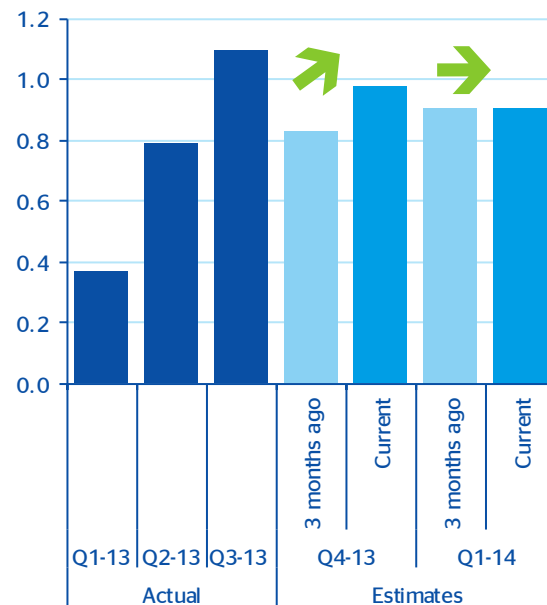
BBVA Financial Stress Index

Source: BBVA Research



BBVA GAIN

Source: BBVA Research



The global economic cycle is improving

Fed's forward guidance and ECB's room for manoeuvre should anchor the global financial scenario

US: the sustained recovery and the fiscal agreement provide upward bias to our scenario for the US (between 2.5% and 3.0%)

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

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

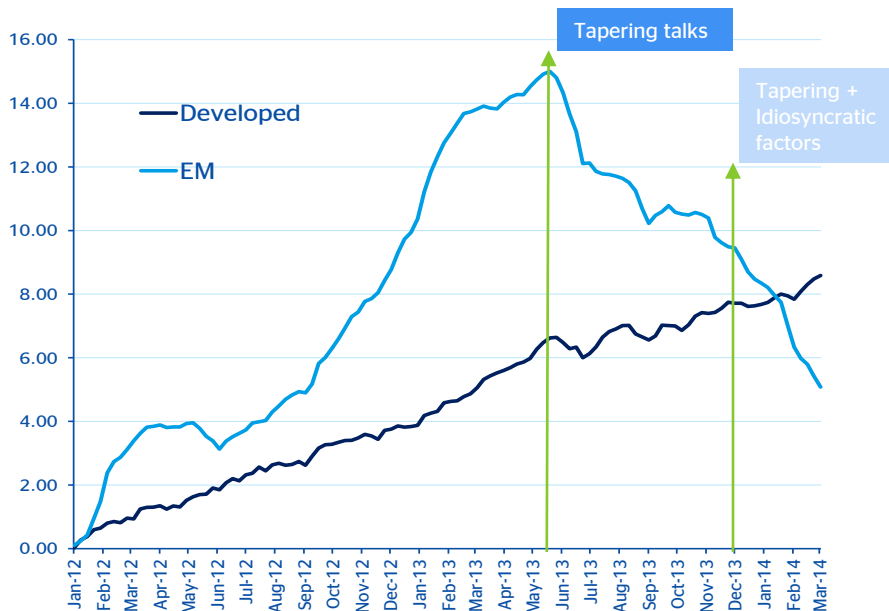
The eurozone: positive growth with an increasing contribution from domestic demand

The portfolio re-balancing away from EM to DM, triggered by Fed tapering but reinforced by idiosyncratic risks

Capital flows to Emerging and Developed Markets

(Cumulative since 2012, as % of AUM)

Source: BBVA Research, IMF and EPFR



Politics and/or policy mismanagement also played a role: doubts on Brazil and China, and idiosyncratic factors in Argentina and Turkey

Despite sound fundamentals across EM, investors remain alert with respect to those countries more reliant on capital flows

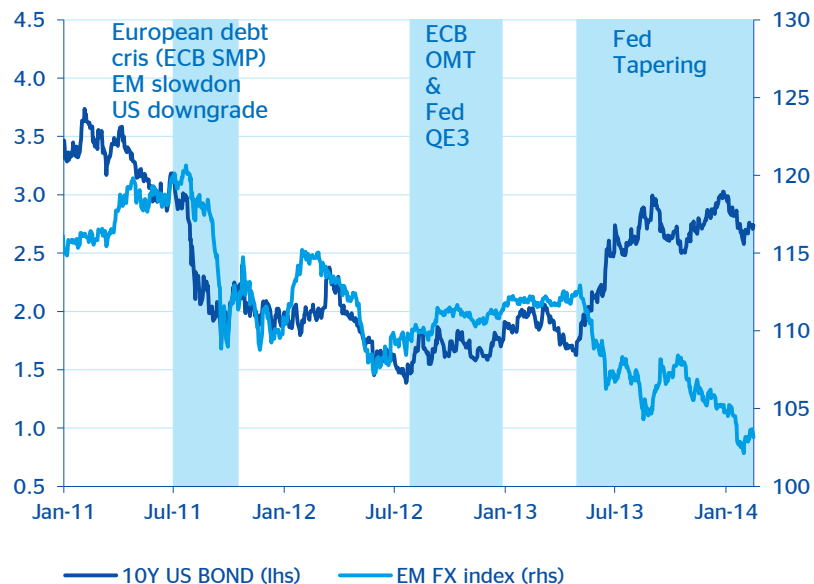
Differentiation between EMs is playing a role

The re-balancing of portfolios is benefiting the European periphery

Risk measure: EM and European periphery

EMBI and European periphery bond spread vs. Germany

Source: Bloomberg and BBVA Research



Relative risk perception of European periphery (vs. EM) is decreasing

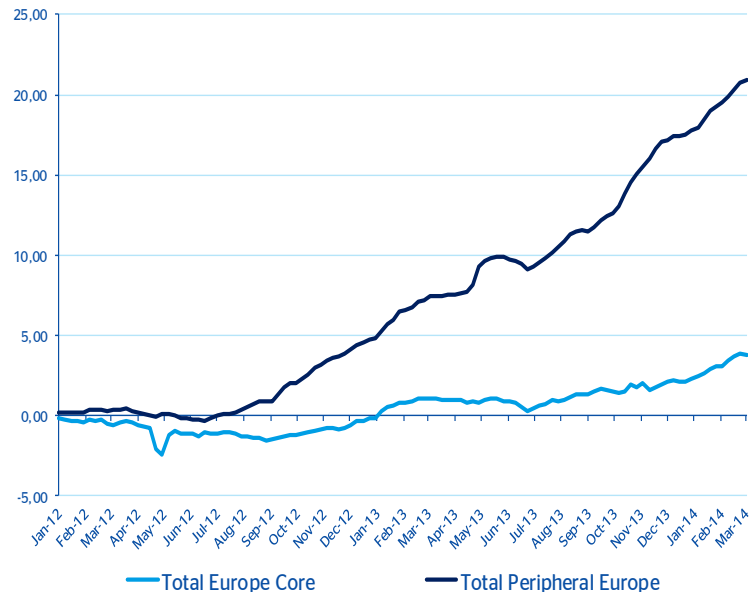
Growth perspective is also improving across Europe, particularly in some periphery countries

Portfolio flows show a strong preference for peripheral Europe, mainly supported by institutional investors

Country flows into European markets

(Accumulated country flows as a %AUM)

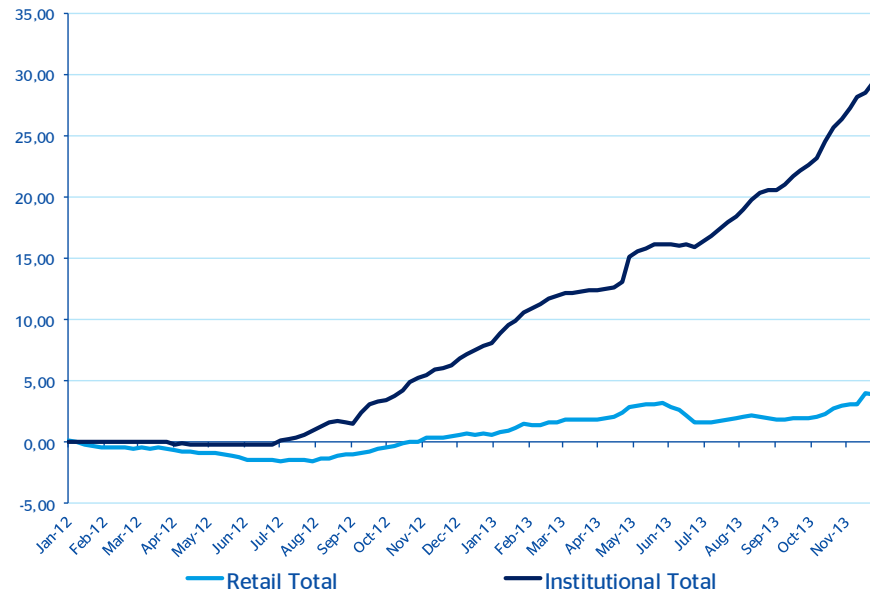
Source BBVA Research through EPFR data



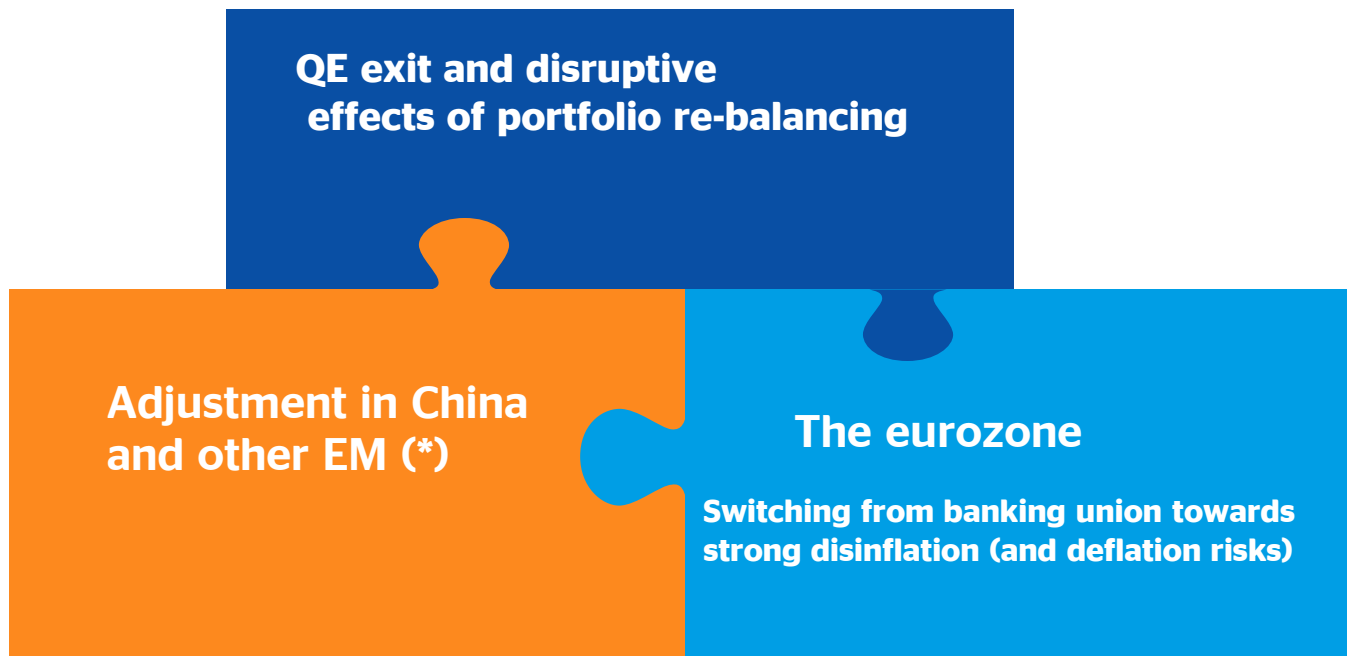
Country flows into peripheral Europe by type of investor

(Accumulated country flows as a %AUM)

Source BBVA Research through EPFR data



Interconnected risk events with the potential to impact on global growth



(*) Heterogeneous developments among countries

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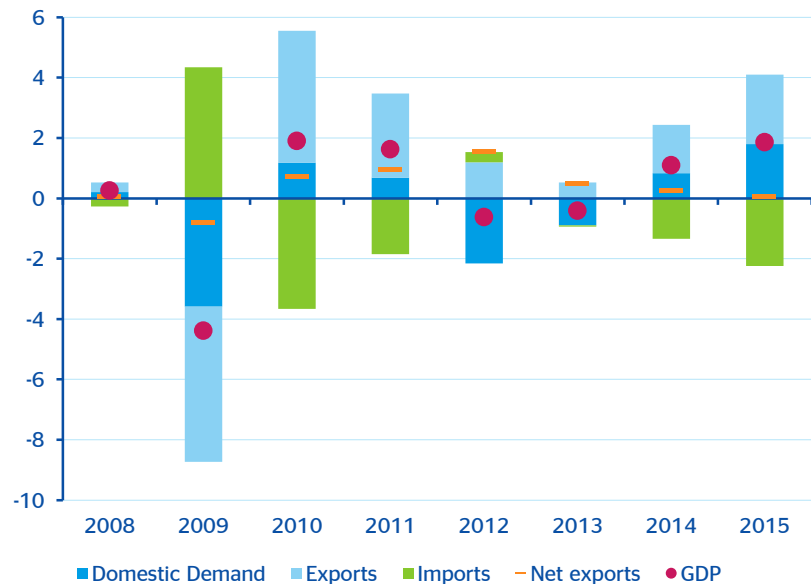
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Spain: commitment to the reform process is crucial to consolidate “recent” market improvement and increase potential growth

Gradual recovery with domestic demand playing an increasing role

EMU: annual contribution to GDP growth (pp)

Source: Eurostat and BBVA Research



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

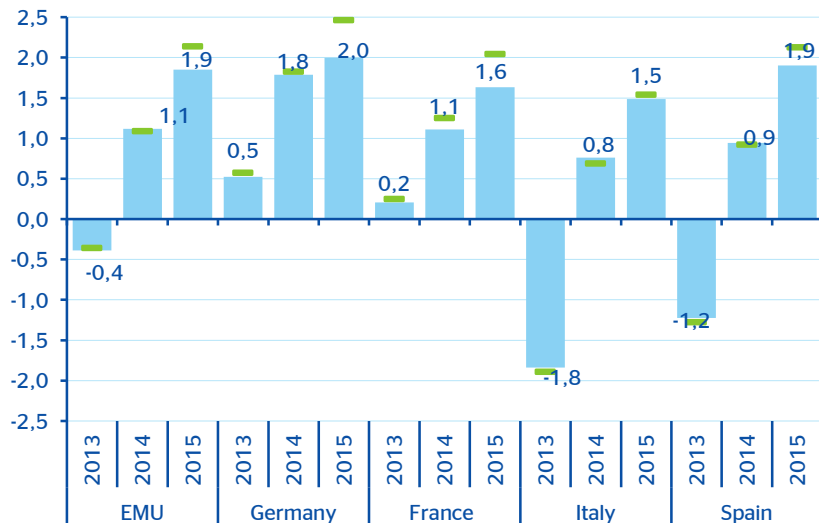
Domestic demand has weighed on growth in 2013...

... but will contribute to the recovery in 2014

Widespread mild recovery across countries

GDP growth by country (%)

Source: BBVA Research



■ Current Forecast (February 14) ■ Previous Forecast (November 13)

Germany: slight upward revision. Mild recovery on track, supported by domestic fundamentals

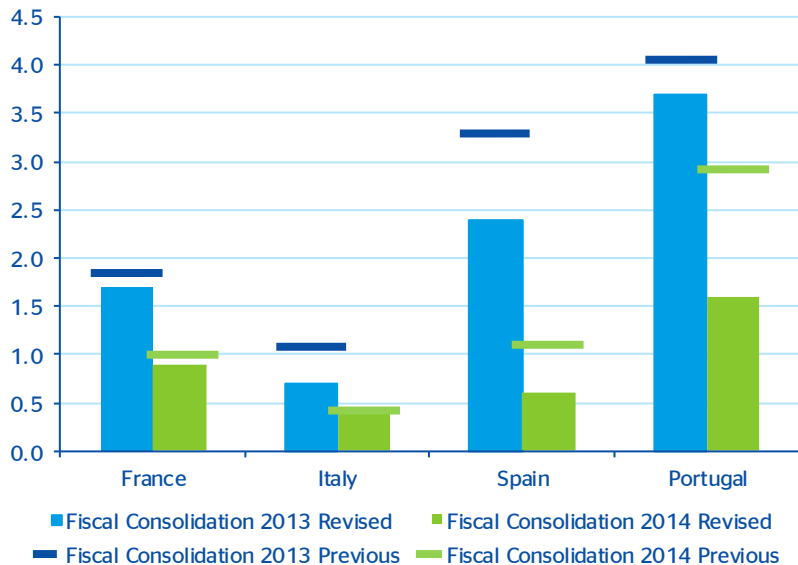
France: despite upward revision, GDP is set to remain virtually flat in 2013, while any moderate recovery in 2014 will be dependent on the implementation of economic policy

Italy: unchanged forecast. Though activity is likely to have stabilised over 2H13, sharp downward in 2013. Slight growth in 2014, but downside risks increase

The fiscal stance is less restrictive

EMU: Fiscal consolidation by country (pp of GDP)

Source: BBVA Research



The European Commission revised deficit targets in May 2013, implying slower austerity

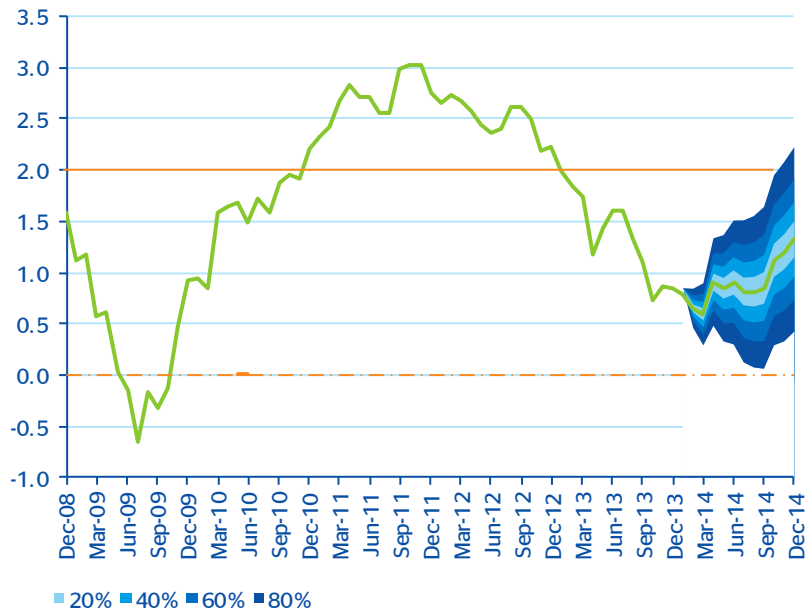
Apart from this direct effect, some countries are more relaxed about meeting their fiscal targets

Less austerity is probably also having an impact on confidence

In a “normal” world, inflation should stabilise first and then pick up in late 2014

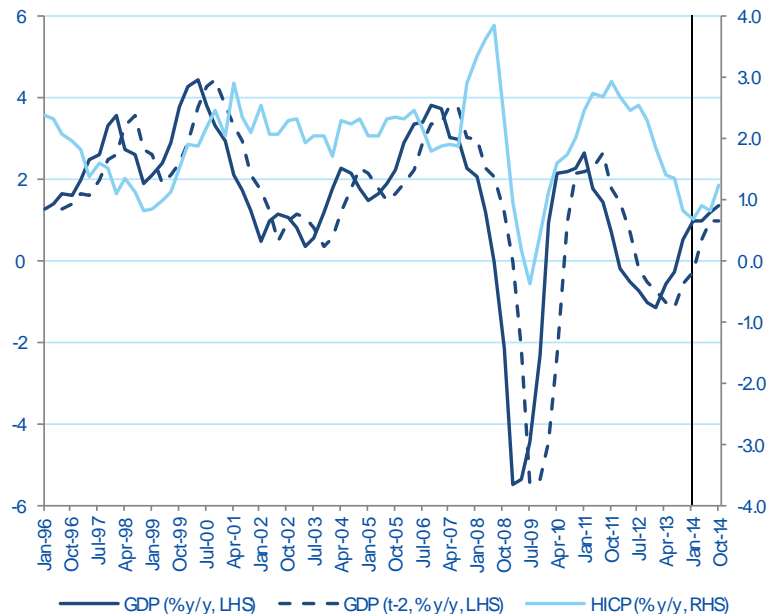
EZ: HICP inflation (% y/y)

Source: Eurostat and BBVA Research



Eurozone. GDP and prices

Source: Eurostat and BBVA Research



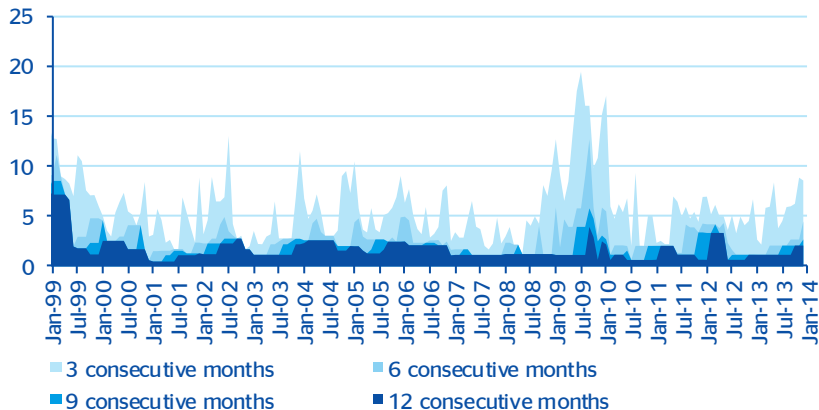
Still far from outright deflation

- Fewer than 10% of HICP items at negative inflation rates over three consecutive months, declining to 5% over six consecutive months
- The trimmed mean inflation statistic suggests that, on average, inflation will remain relatively stable at slightly above 1% YoY over the next 2 1/2 years

EZ: proxy of deflation

(% CPI items with persistent negative m/m swda rates)

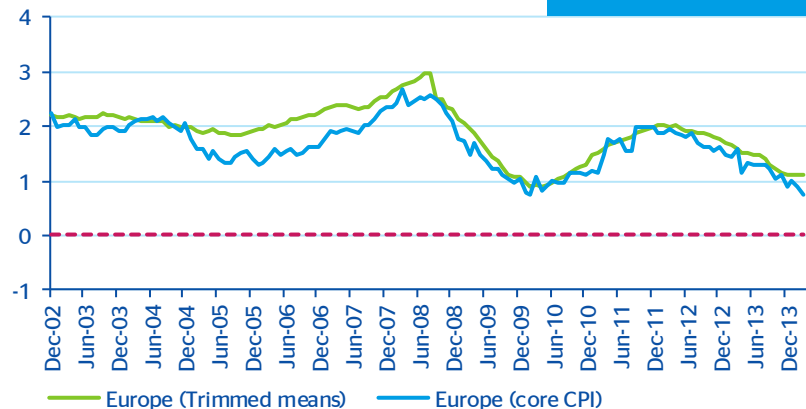
Source BBVA Research



EZ: measures of trend inflation

Source BBVA Research

Is this price stability?

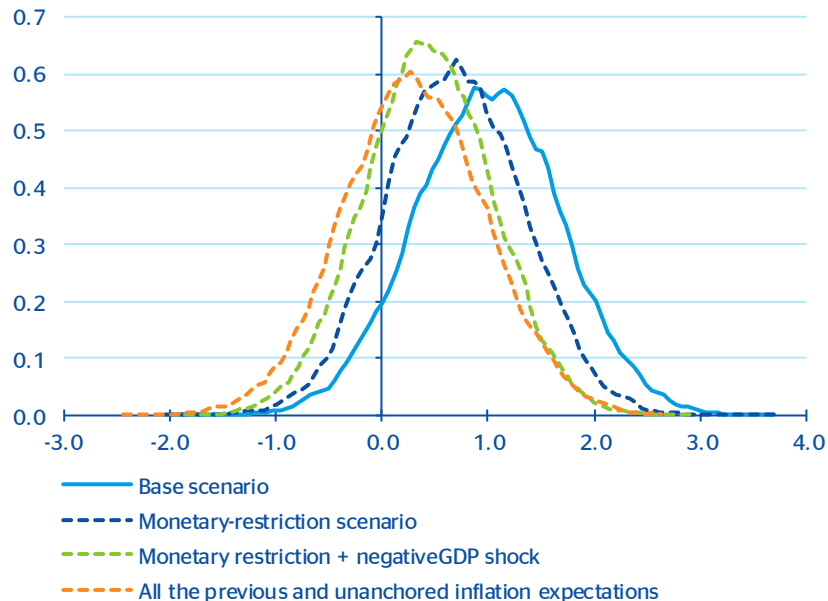


The probability of deflation increases under more extreme situations

EZ: Distribution of probability of inflation

(average 2014)

Source BBVA Research



	Inflation	Prob. of deflation
Baseline scenario	1%	7.5%
Monetary restriction (M3 growth = 0.9%)	0,8%	14%
Monetary restriction + shock (M3 growth = 0.9%; growth < -1)	0,8%	14%
Unanchored expectations (M3 growth = 0.9%; growth < -1)	0,28%	47%

Against this background, tensions could (re)emerge

Inflation expectations in the medium term are well below 2% (1.5% in 2016)

Asymmetry

Uneven adjustment across countries: under a deflationary scenario, the debt burden increases

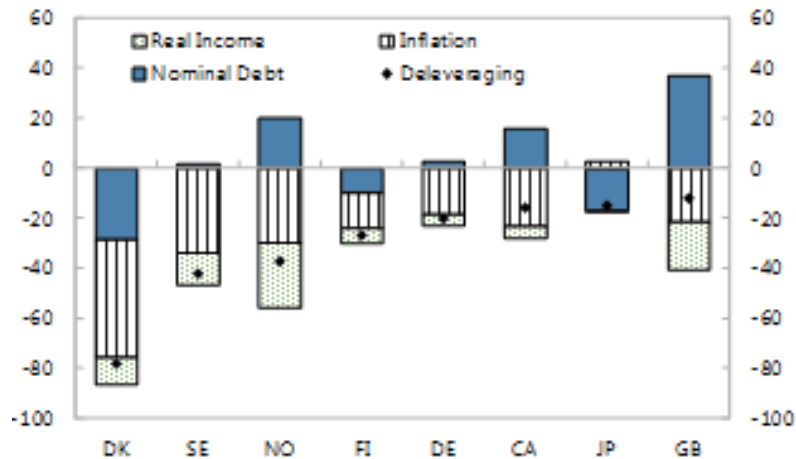


Eurozone goes from one constraint (financial fragmentation) to another (low inflation and difficult debt adjustment)

The median contribution of inflation to the reduction in debt to disposable income (ratio) was almost 70% in episodes associated with a banking crisis

Decomposition of Household Debt Reduction

(percentage points of disposable income)



Sources: WEO, Haver, OECD

ECB: No action taken (and none foreseen)

Latest

- Rates were kept **unchanged**. They retain a **downward bias**
- Mr. Draghi once again **used verbal intervention to strengthen his forward guidance**
- **Inflation significantly below 2% for a long period of time** (1.5% for 2016)
- Mr. Draghi seemed to **downplay the potential role of other instruments available for eventual further policy action**

What do we expect?

Once it has become clear that the ECB is ready to accept inflation of 1.5% in 2016 without taking further action, **the expectation of further (decisive) measures in the short-term in the absence of sizeable shocks is very low**

Any and all liquidity measures remain on the table (SMP non-sterilisation) in the event of an unwarranted tightening in money markets

Do not expect a weakening of the euro

Policy pause until 2016

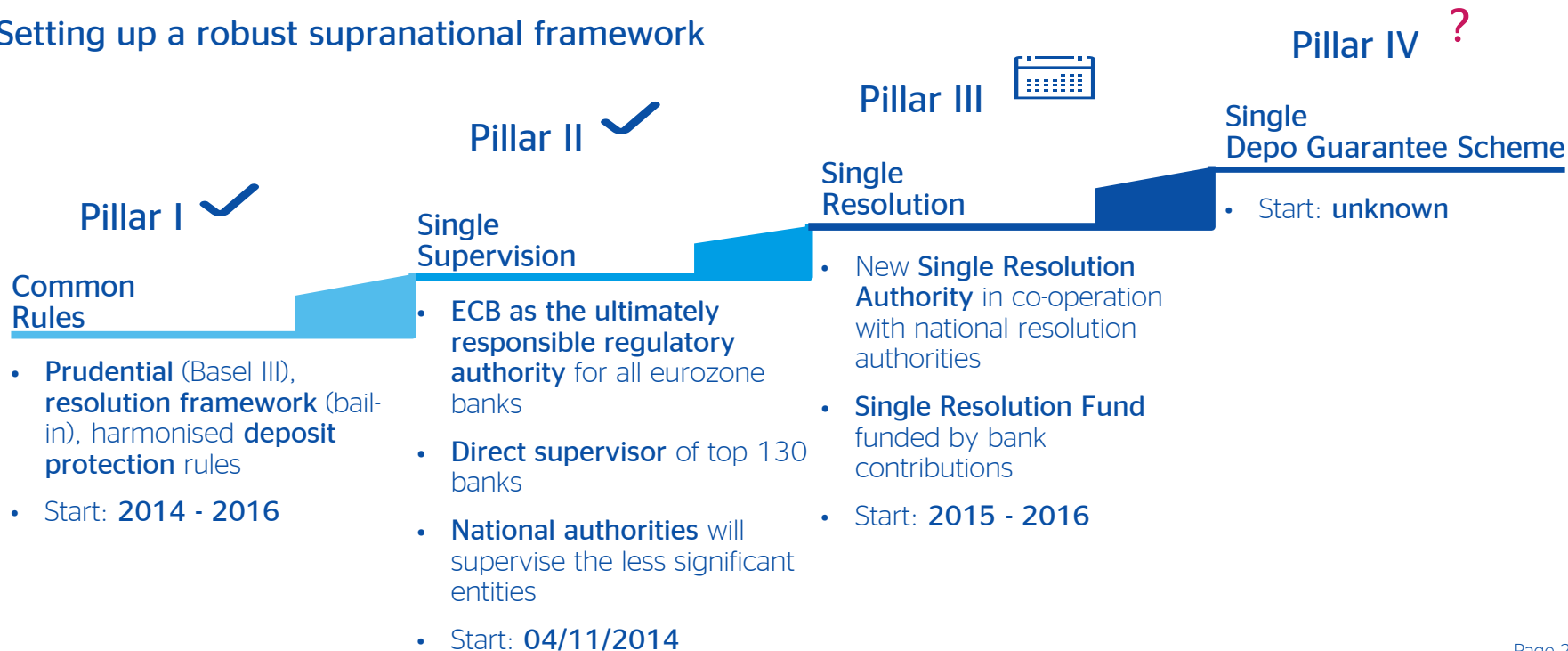
Will the ECB change its mind towards QE?

Eurozone: event calendar and pending issues

Progress on Banking Union	March, ECB AQR methodology	April, EBA stress test methodology	End of the year, SSM SSM/AQR results (possibly before Nov. 2014)
	March, SRM agreement	April, Last EU Parliamentary session. Tight deadline to endorse SRM & BBRD (April)	End of the year: Tentative deadline for IGA national ratifications (80% threshold),
Elections	May, European elections		
OMT	Pending on ECJ decision		
Peripheral countries	Portugal: exiting the programme or asking for another programme? (April)		
	Greece: additional package (Summer)		
	Italy: uncertainty over the new government		
	Spain: further fiscal adjustments needed, while facing increasing political uncertainty		

Banking union is progressing and will be a key factor in 2014

Setting up a robust supranational framework



The banking union is a true game changer, and it is advancing

BU is a milestone in European history. The highest transfer of sovereignty since the euro

Single Rulebook

Common rules are developed from a preventive perspective

Single Supervision

Single supervisory criteria will stop regulatory ring-fencing practices

Single Resolution

A centralised resolution authority will apply the same criteria for resolution actions

Backstops

The bail-in and the Resolution Fund will reduce the reliance on sovereign. Still uncertainty on the common backstop

Banking union is a necessary condition but is not sufficient on its own. We also need fiscal and political union

Progress on banking union: the ECB (SSM) has announced the main features of its comprehensive assessment

Composed of 3 pillars

Supervisory Risk Assessment to review key risks, including liquidity, leverage and funding

Asset Quality Review (AQR) to analyse the quality of banks' assets, collateral valuation and provisions

Stress Test to examine the resilience of banks' balance sheets to stress scenarios

Valuation

In principle, details point to a balanced exercise with a sufficiently wide scope

However, some issues require further clarification: bail-in, stress test methodology (April 2014), publication of data to replicate the exercise...

Transparency is pivotal to eliminating all concerns over the solvency of the European banking sector

- The exercise should be strict enough to dispel any doubts on the resilience of the balance sheets
- Particular attention should be paid to the AQR. Is it happening? Up to a point, but it is a good start

Single Supervision needs Single Resolution

When the ECB identifies problems in a particular entity, the Single Resolution Fund will act as a private backstop after a minimum bail-in

Single Supervision

**IDENTIFY LEGACY
PROBLEM (2014)**

AQR + Stress Test

**SOLVE THE LECAGY PROBLEM
(2014-15)**

- Private/partial bail-in (if state aid)
- Public national/ESM/direct recap?

Single Resolution

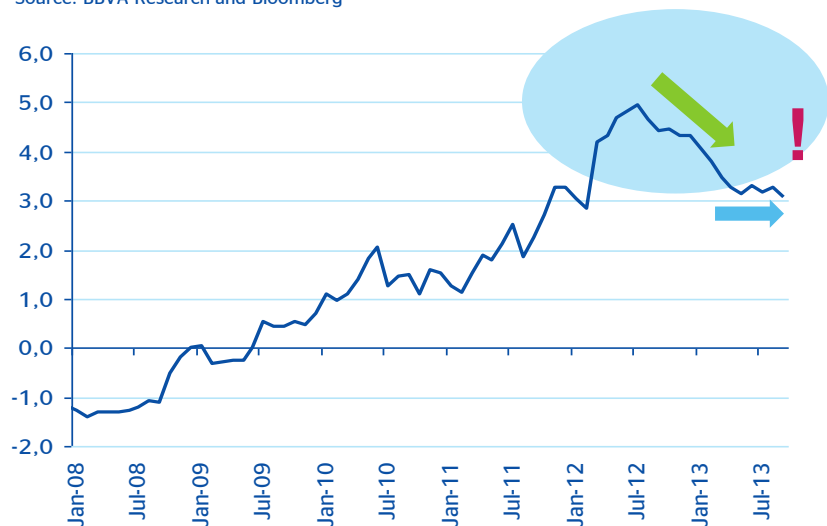
**FULLY OPERATIVE SRM
(2016)**

- **Single authority**
- **Bail-in**
- **Single Fund**
- **Common backstop?**

Banking union is expected to reduce fragmentation

Composite measure of EZ financial fragmentation*

Source: BBVA Research and Bloomberg



Break the 'doom loop' between sovereigns and banks

Strengthen the monetary union by reinforcing the institutional architecture

Restore the monetary policy transmission channel

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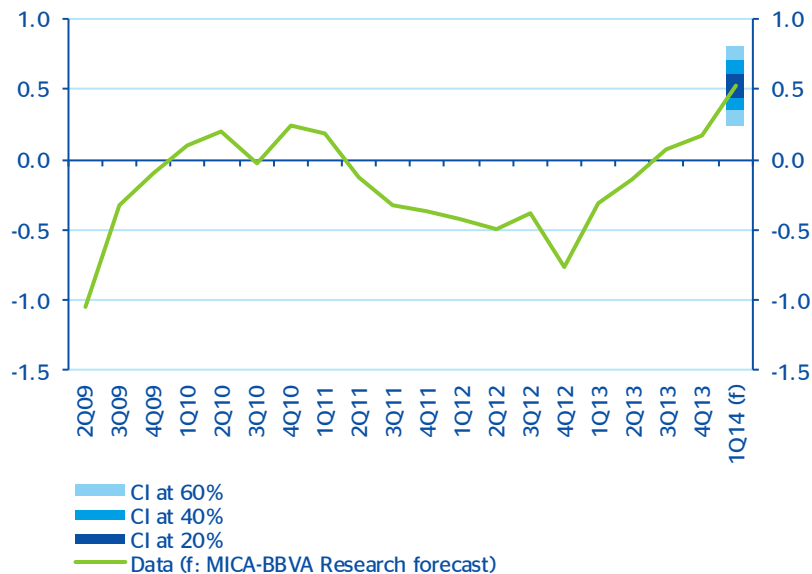
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Spain: commitment to the reform process is crucial to consolidate “recent” market development and increase potential growth

The Spanish economy's recovery 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...

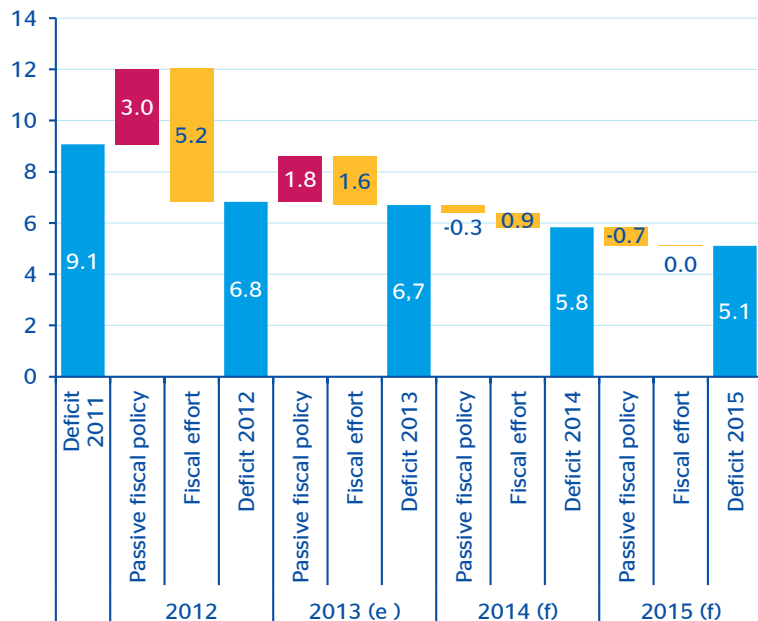
... as a consequence of improved fundamentals, less restrictive fiscal policy, reduced uncertainty and increased import substitution

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

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

General government: expected fiscal tightening* (% GDP)

Source: BBVA Research based on INE



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

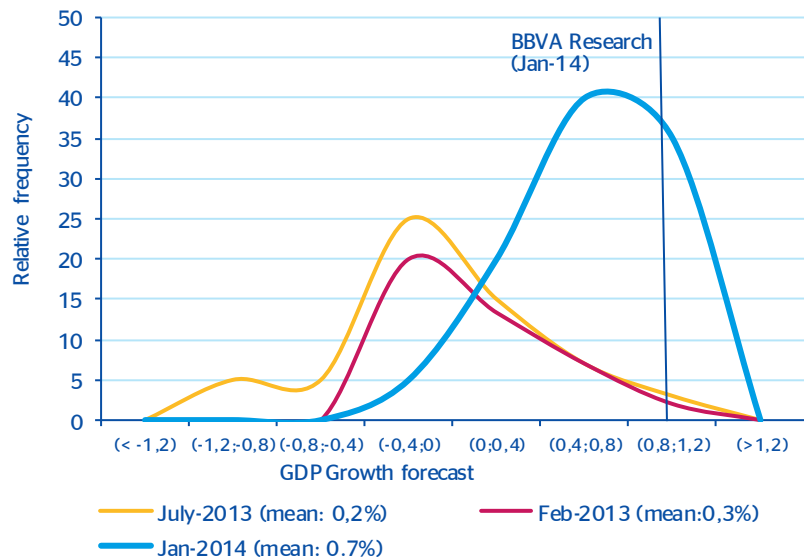
(*) Without factoring in aid to financial institutions

(e) estimate; (f) forecast

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

Spain: GDP growth forecasts, 2014 (% YoY)

Source: BBVA Research based on Consensus Forecast Inc



Economic policy decisions have eliminated the risk scenarios

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

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

... as economic recovery has been in line with the stylised facts from previous cycles,...

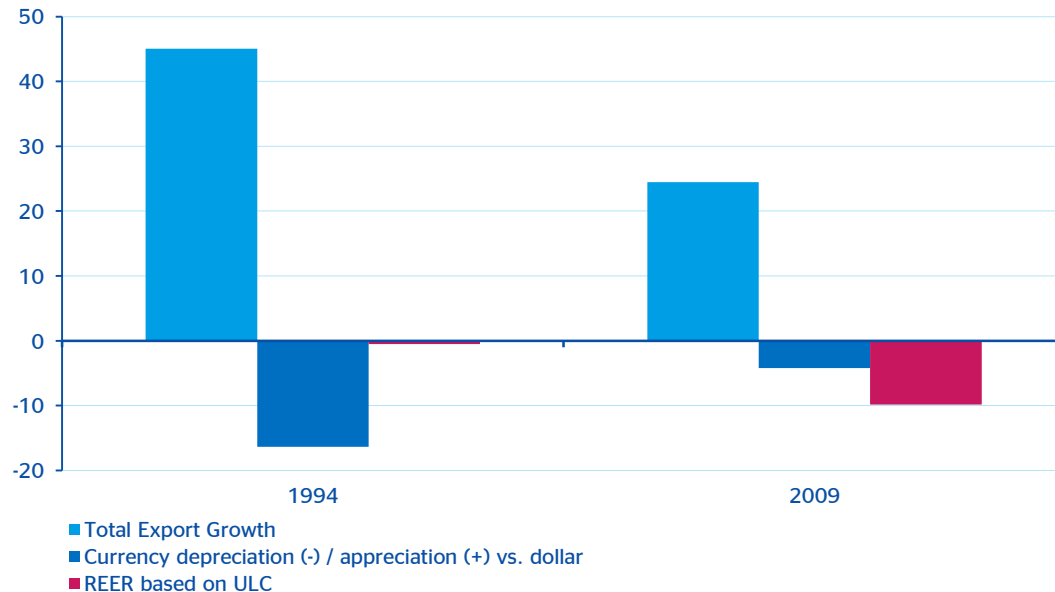
Variables that precede the cycle	Export growth	✓
	Gross operating surplus	✓
	Investment in machinery and equipment	✓
	New credit operations (flow)	✓
	GDP growth	✓
=	Employment growth	✓
Lagging variables	Growth in stock of credit	Declining

..., and this time without a currency depreciation, so competitiveness gains are not merely temporary

Spain: Export growth, exchange rate movement and ULC

(% change over the next 14 quarters after exports reached lowest level)

Source: BBVA Research based on Consensus Forecast Inc.



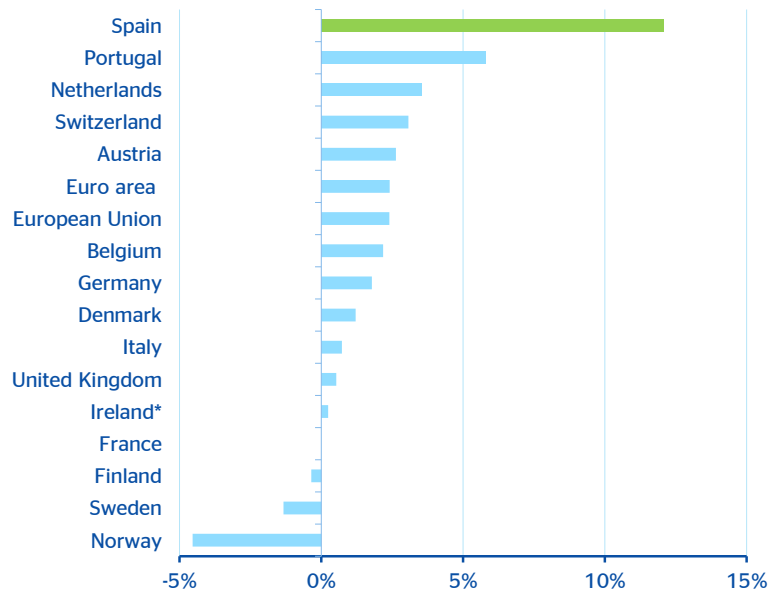
Upside risks:

1. Exports will continue to expand

Total exports

(annual cumulative change 1Q12-3Q13 in %, seasonally adjusted)

Source: BBVA Research based on INF 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...

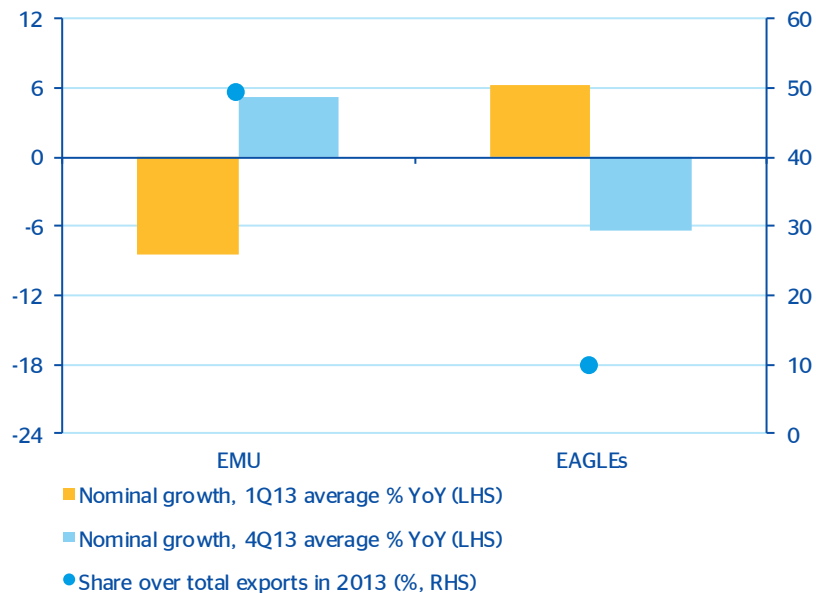
... but also to gains in Spanish competitiveness in both price and quality

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



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

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

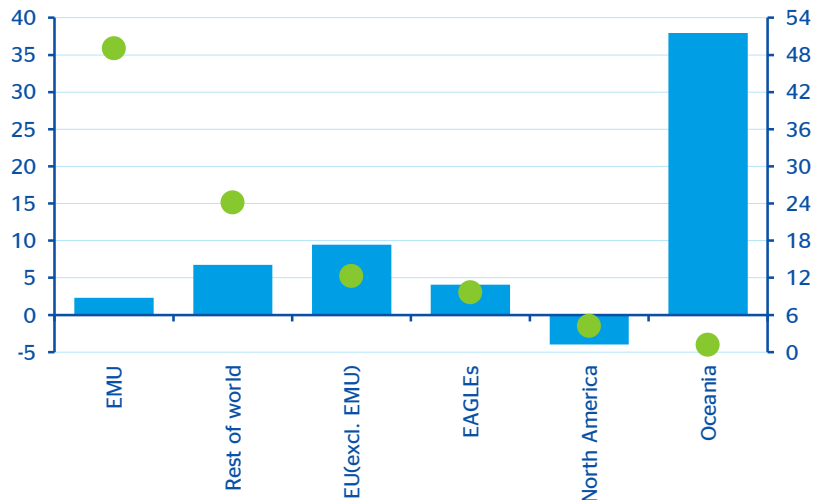
The slowing momentum in EMs has been offset by the recovery in the EMU

Upside risks:

1. Exports will continue to expand

Spain: growth and breakdown of goods exports by geographical area in 2013

Source: BBVA Research based on Datacomex



European destinations still account for a large share of goods exports

However, destinations outside Europe and North America have grown strongly ...

... representing 34.5% of total exports in 2013

■ Export growth by main geographical area in 2013, goods % YoY nominal (LHS)

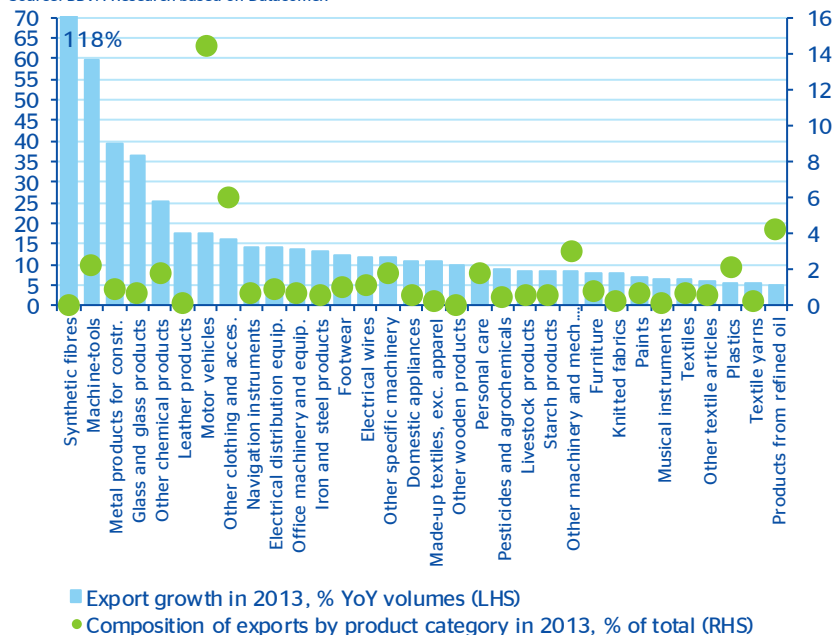
● Composition of goods exports by destination in 2013, % of total (RHS)

Upside risks:

1. Exports will continue to expand

Spain: export growth and composition by product category, volume (YoY, %)

Source: BBVA Research based on Datacomex



Likewise, a large proportion of product categories (73%) experienced positive export growth in 2013

About 50% of the export basket expanded at a rate above 5% YoY in real terms

Some key sectors for the Spanish economy, e.g. motor vehicles, chemicals and machinery & equipment, are growing at a very healthy pace

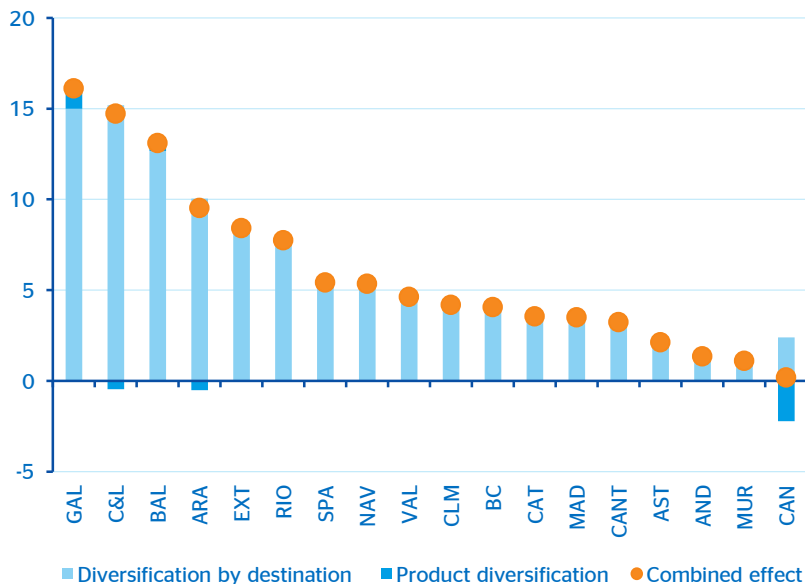
Upside risks:

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



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

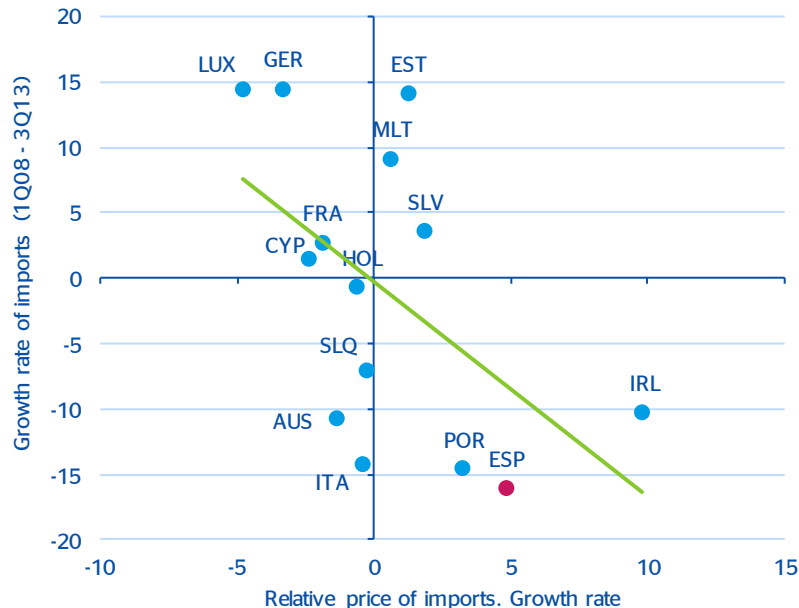
This export diversification prevented even greater negative GDP growth

Upside risks:

1. Import substitution will continue

Spain: imports of goods and services and change in relative prices (% , 1Q08-3Q13)

Source: BBVA Research based on Eurostat



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

.... 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

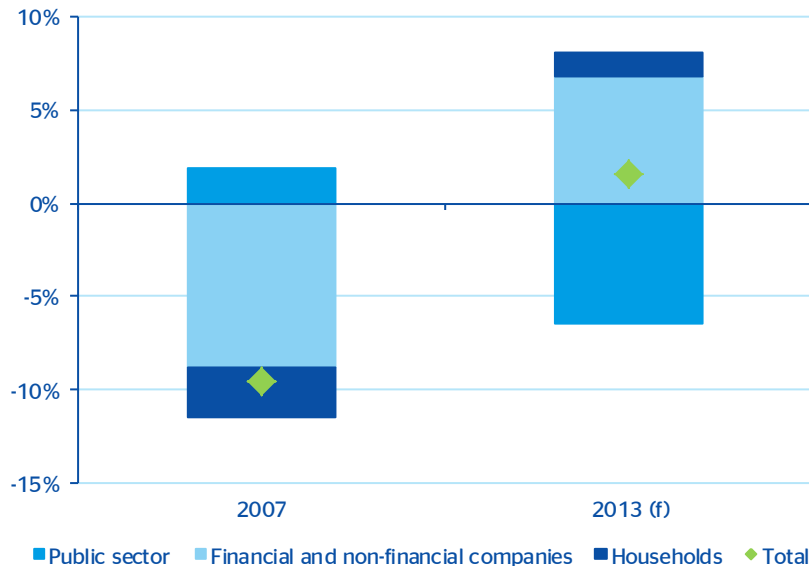
Upside risks

2. Net savings by firms have improved

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

(% of GDP)

Source: BBVA Research, based on INE data



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

... have facilitated a deleveraging process with the rest of the world over the last five years...

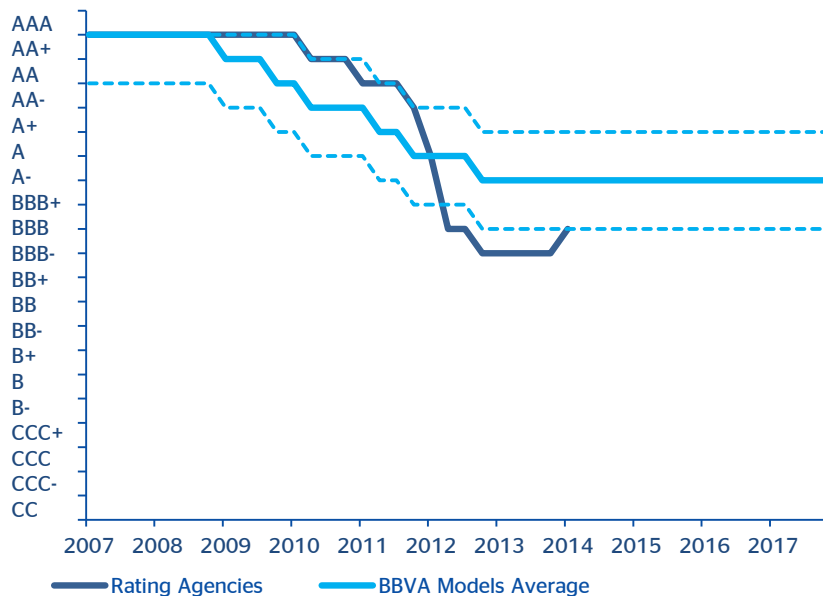
... which has improved the position of companies to increase investment once a less uncertain environment is consolidated

Upside risks

2. More certainty and fewer financial tensions

Spain: Rating by agencies and BBVA Research models

Source: BBVA Research



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

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

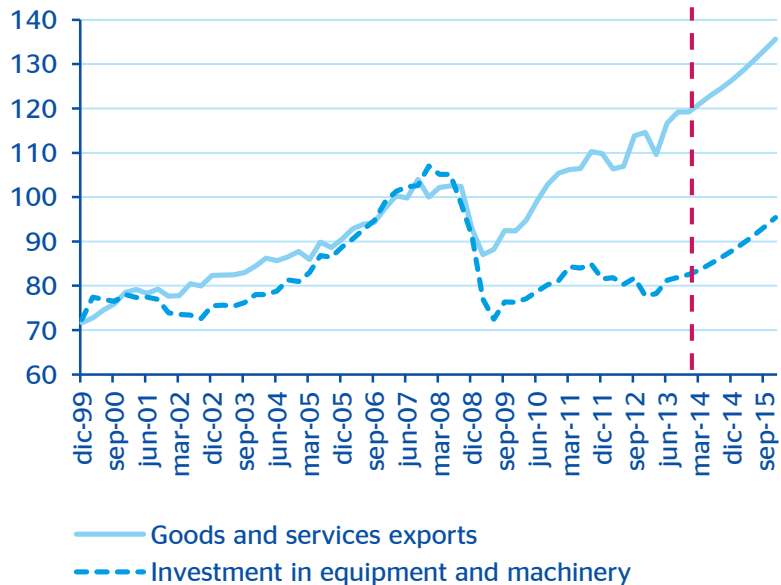
A permanent 100bp drop in sovereign interest rates implies up to one percentage point more growth for the economy

Upside risks

3. 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, investment in equipment and machinery had grown 6.3% by 4Q13

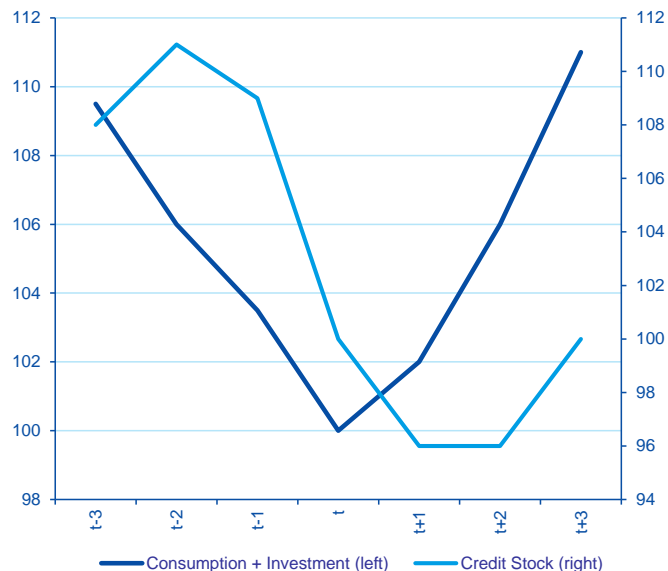
Upside risks

4. Improvement in new lending flows

Average evolution of consumption + investment and credit stock

(C+I=100 at the trough, average of crises in Finland, Japan, Norway, Spain and Sweden)

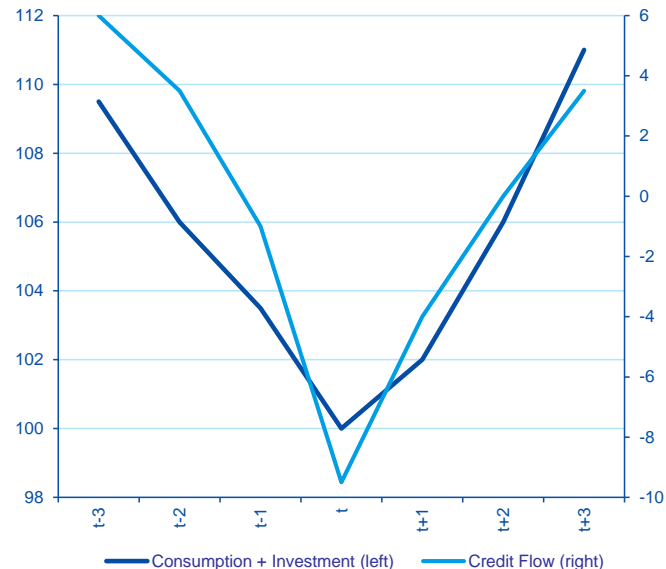
Source: Biggs et al (2009)



Average evolution of consumption + investment and credit flow

(C+I=100 at the trough, average of crises in Finland, Japan, Norway, Spain and Sweden)

Source: Biggs et al (2009)



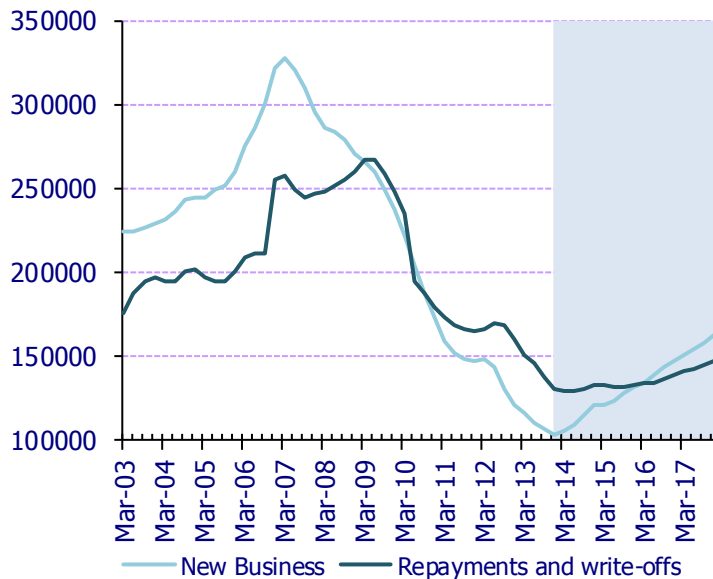
Upside risks

4. Improvement in new lending flows

Private-sector: new loans and repayments

(Quarterly figures, EUR mn)

Source: Bank of Spain and BBVA Research



Spanish statistics on new loans include 'novations' (changes in terms and conditions), so refinanced operations are included

The forecast suggests that new lending may have bottomed-out in the first half of 2013. In the future, refinancing will play a less important role

However, new lending will not exceed repayments until the end of 2015, so private-sector deleveraging has to continue

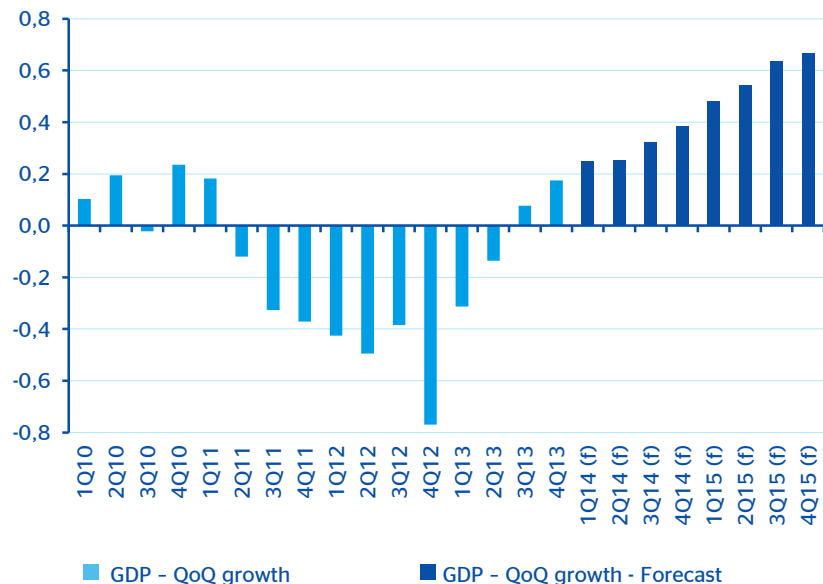
Upside risks

5. GDP is now growing

Spain: GDP

(Growth, %)

Source: BBVA Research based on INE



As scheduled, GDP began growing after exports, savings, investment in M&E, and new credit flows started going up

Growth will average around 1% in 2014, and will slowly accelerate towards an annualised pace of 2% by the end of this year

Exports should accelerate and substitute more modest domestic demand growth

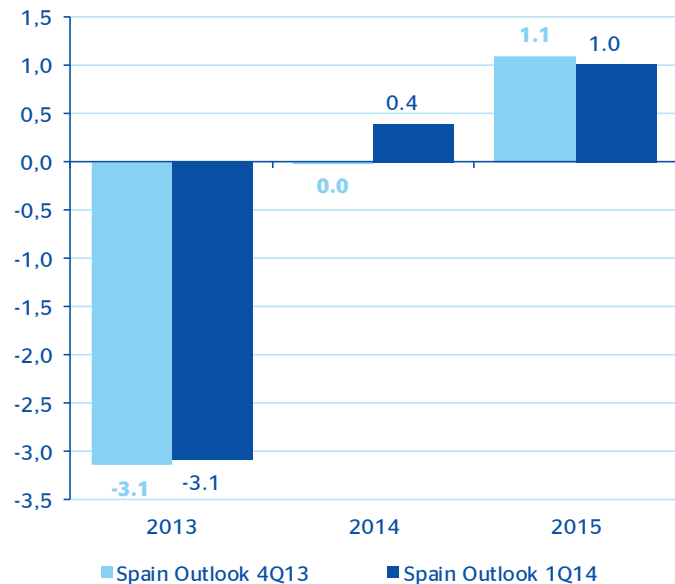
Upside risks

5. 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, a million job losses could have been avoided

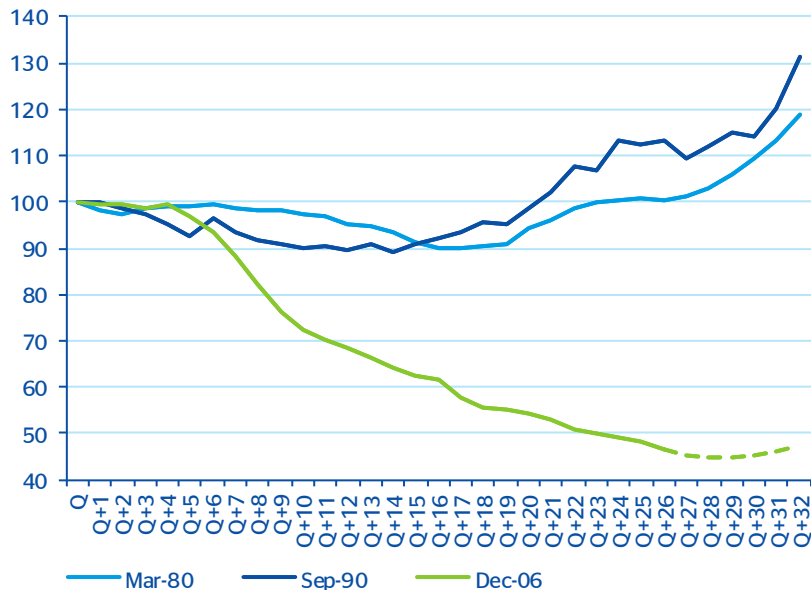
In 2014, employment will be created for the first time since the beginning of the crisis; and labour market reform has prevented the destruction of 300,000 jobs

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...

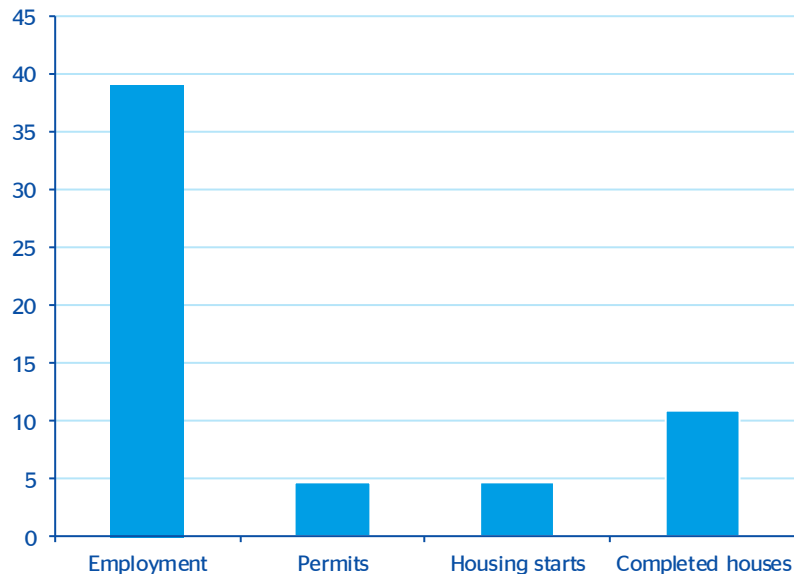
... however, the current excess of supply will make it unlikely that this time it will accompany the recovery (effect vs. cause)

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

The real-estate cycle: this time is different

Spain: Housing market variables (% average 2004-07)

Source: BBVA Research based on Ministry of Public Works



Supply-side correction has already taken place

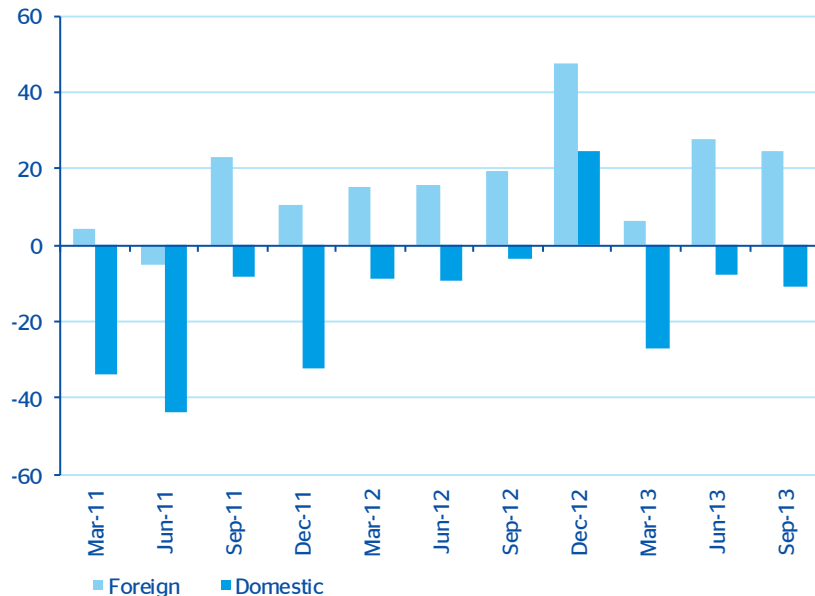
Housing starts in 2013 were only 5% of those observed at the peak of the cycle

Consequently, housing investment has suffered a large correction: in 2013 it was 4.4% of GDP, compared to 12.5% in 2006

The real-estate cycle: this time is different

Spain: home purchases (% y/y)

Source: BBVA Research based on Ministry of Public Works



Although demand has adjusted considerably, interest by foreigners has recently improved

Citizens from the UK or Germany have led the charge, but non-traditional clients (such as the Russians and Chinese) have also appeared

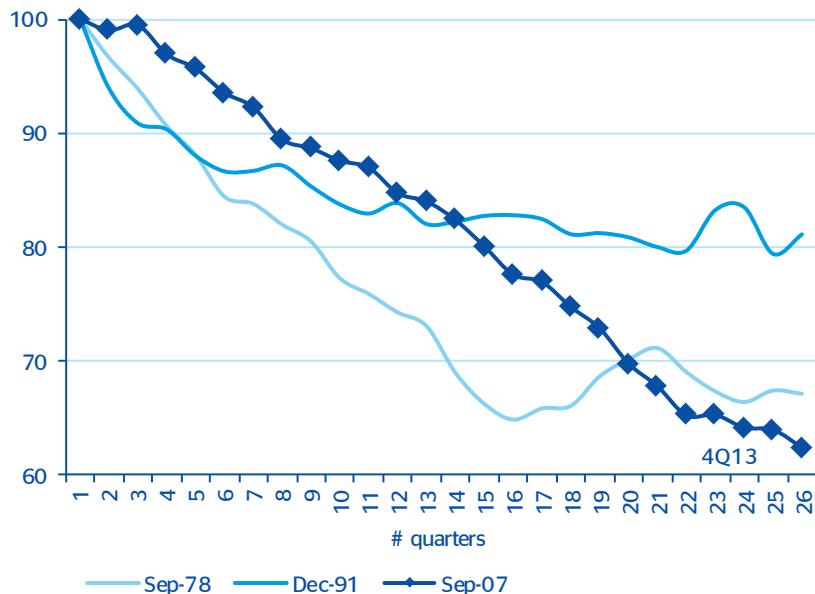
The improvement in domestic demand fundamentals leads us to believe that sales could have reached their minimum in 2013

The real-estate cycle: this time is different

Spain: Real prices in the housing sector

(100 = peak of the cycle)

Source: BBVA Research based on Ministry of Public Works



From the peak, house prices have fallen about 37.5% in real terms, the largest correction of any of the recent crises

In the coming years, a growing demand scenario is expected, within an environment of reducing housing supply

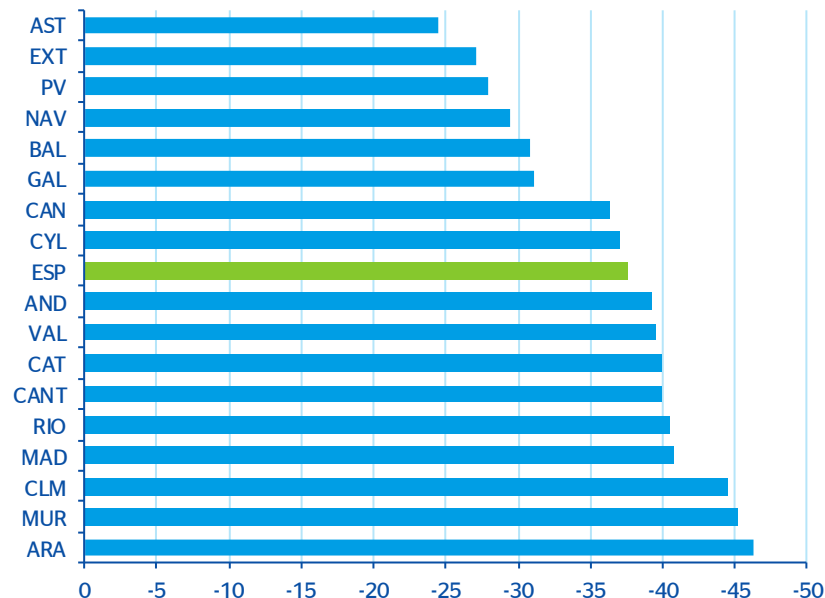
In the coming quarters, further declines in house prices will be limited: the overall fall from peak to trough will be around 40%

The real-estate cycle: this time is different

Spain: Real prices in the housing sector

(%, fall from maximum in real terms)

Source: BBVA Research based on Ministry of Public Works



The real estate market displays increasingly heterogeneous behaviour among regions

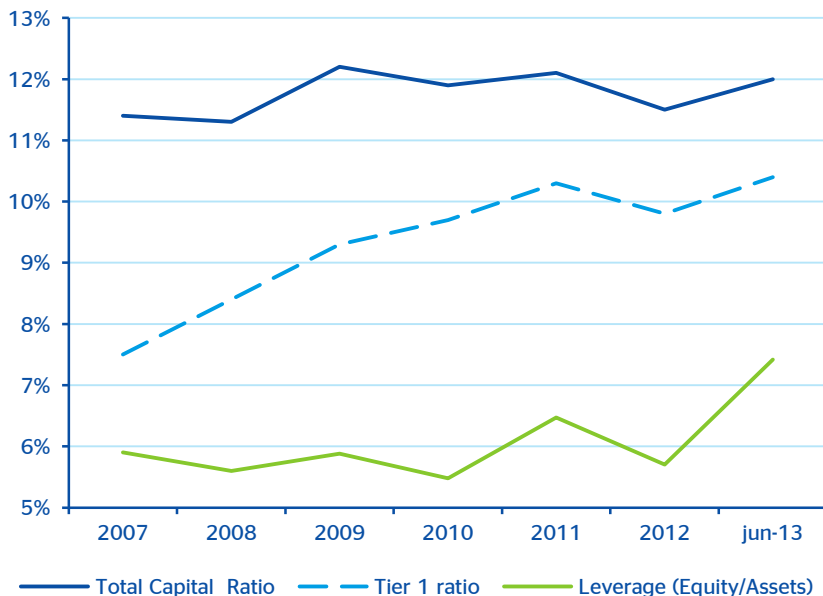
Market behaviour is closely related to the level of oversupply and exposure to foreign demand

In some regions, housing prices have accumulated several quarters of growth: Madrid, Balearic Islands, Canary Islands and Navarra

The financial system. Solvency: capital is now higher and of better quality

Spanish banking system: Capital ratios

Source: BBVA Research based on Bank of Spain



Recapitalisation of weak entities with public funds;
bail-in of subordinated debt

- Capital increases: Popular, Sabadell
- AT1 issuance: BBVA
- Liabilities management exercises

Disposal of non-core assets (equity participations,
real estate, etc.)

Deleveraging / RWA optimisation

The financial system. Solvency: what will be the impact of the comprehensive assessment on Spanish banks?

ECB 2014

Supervisory Risk Assessment to review key risks, including liquidity, leverage and funding

Asset Quality Review (AQR) to analyse the quality of the banks' assets, collateral valuation and provisions

Stress Test to examine the resilience of the banks' balance sheets to stress scenarios



Spain 2012-13

Auditors and property appraisers checked all the portfolios, the classification of loans and collateral valuations

Bank of Spain definitions of non-performing loans and forbearance are similar those of the EBA



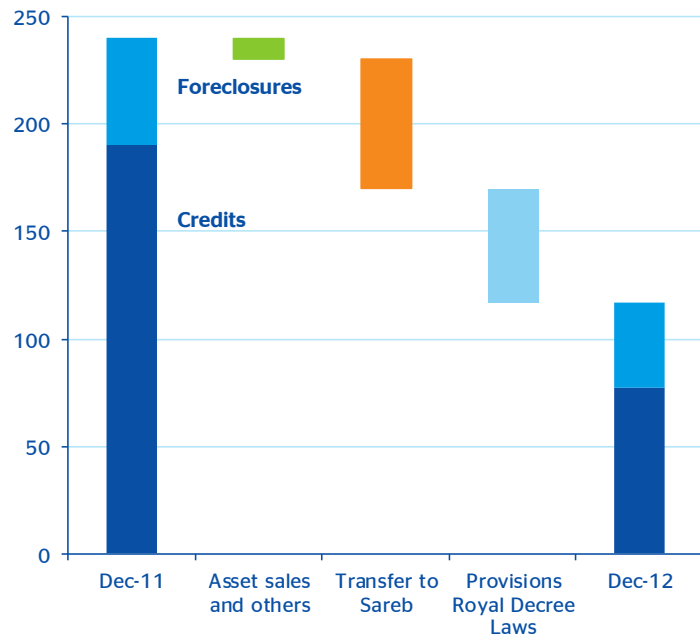
Stress test conducted by Oliver Wyman. Capital needs covered by private or public (€39bn, ESM credit line) capital injections

Spanish entities went through a similar exercise, so no major surprises are expected in the ECB comprehensive assessment

Asset quality: entities have made a big effort to improve asset quality

Real estate exposures net of provisions (EUR bn)

Source: Bank of Spain



Real estate accounted for 60% of total defaulted assets

The worst-affected entities have transferred 90% of their assets to Sareb, and are subject to restructuring plans

The exposure was unevenly distributed among entities (from 2% to 26% of total credit)

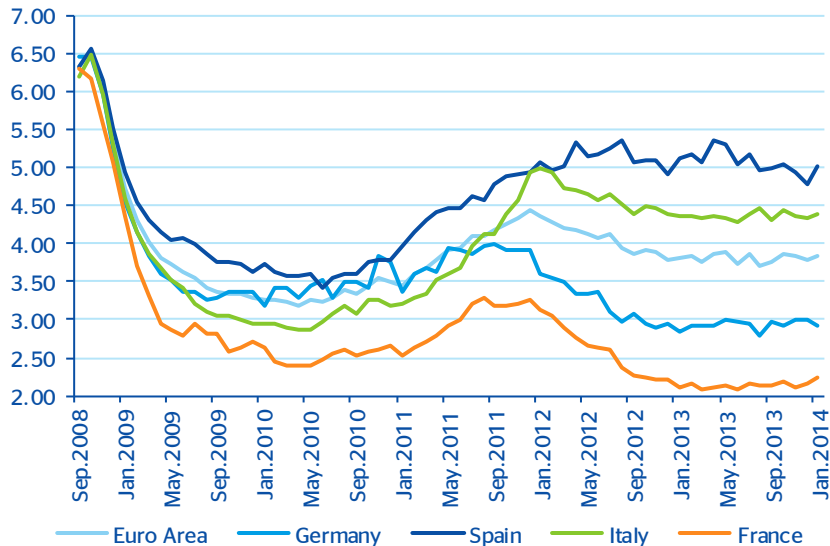
The banks have almost finished cleaning-up real estate exposures, in particular the sound entities

Liquidity: the situation has improved, but current problems are related to European fragmentation

Interest rates on new bank lending (%)

(to non-financial corporations, less than EUR1mn, less than one year)

Source: ECB



94% of the new loans in Spain have a term of up to one year

Determinants of interest rates on new bank lending

(to non-financial corporations)

Source: BBVA Research based on ECB and Bloomberg

	Germany	France	Spain	Italy
Commercial policy	1.66	--	--	--
ECB official rate	1.03	1.24	1.29	1.47
Spread 12 months (12m-Euribor)	0.59	1.21	1.6	-0.06*
Spread EMU (10y EMU-Euribor)	0.35	0.69	0.44	0.5
Spread sovereign (10y country-10y EMU)	0.17	0.46	1.22	1.05
CE Regulation 290/2009	0.15	0.54	-0.16	--

-- Does not differ significantly from zero

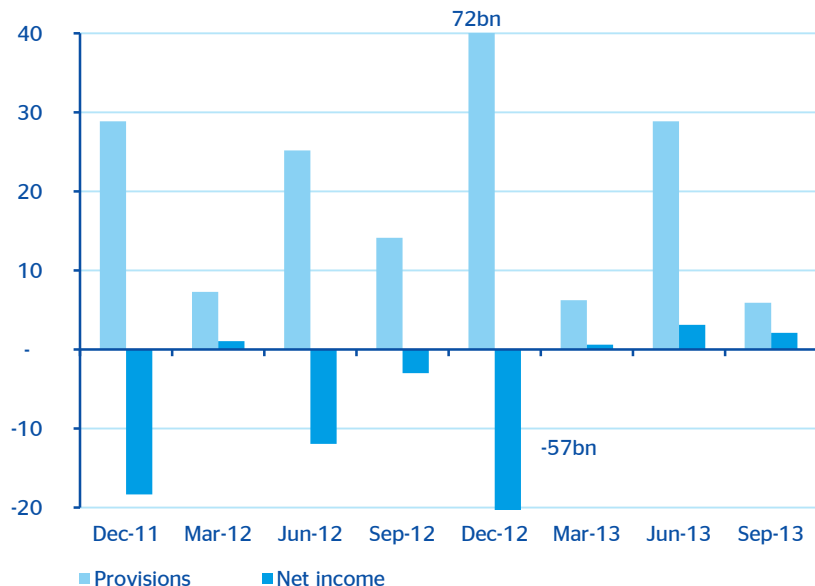
* Not significant at 20% confidence

The price of credit is affected by the sovereign risk premium. The solution to this is banking union

Profitability: on average, the system is unlikely to return to the pre-crisis levels

Net income and loan loss provisions (€bn)

Source: BBVA Research based on Bank of Spain



Average profitability will not return to the pre-crisis levels

In the future there will be lower interest rates, higher risk aversion, stricter regulation and supervision and less buoyant liquidity

However, dispersion among entities can be higher, as banks that anticipate these changes will show a better performance

Banks that have already diversified geographically will be in a better position

Risks: The restructuring is almost finished, but there are some pending issues

An efficient implementation of current plans is crucial for the success of the restructuring

Problem

Complete the restructuring

Overcapacity

Deleverage of the private sector



Desirable solution

Quick resolution of intervened institutions, as international experience shows that public banks can be inefficient

Networks should adapt to the new size of the market. Number of branches and employment have been reduced by 23% and 15% respectively (vs. 35% and 28% expected by the end of the process)

Compatible with the provision of credit to solvent demand, by most capable institutions (those with access to liquidity)

Changes in the corporate insolvency law will facilitate corporate debt restructuring

New measures announced last week remove obstacles to agreements between financial creditors and debtors

New RDL on corporate debt restructuring

Source: BBVA Research based on BOE

Measures

- ✓ Possibility of individual debt refinancing agreements
- ✓ Simplified procedures for collective debt refinancing agreements
- ✓ Reduction in the level of required majorities to impose refinancing agreements on dissident creditors
- ✓ BoS needs to develop new provisioning framework for refinanced loans
- ✓ In case of insolvency, fresh money with privileged status and old debt non-subordinated
- ✓ Takeover exemption when creditors convert into equity
- ✓ Other measures: including fiscal benefits...

Spanish Financial System

- Increases legal certainty
- If restructuring ends in insolvency, financial creditors are not in a worse position
- Foreseeable better provisioning framework
- Conversion of debt into equity raises new issues (management, capital consumption..)

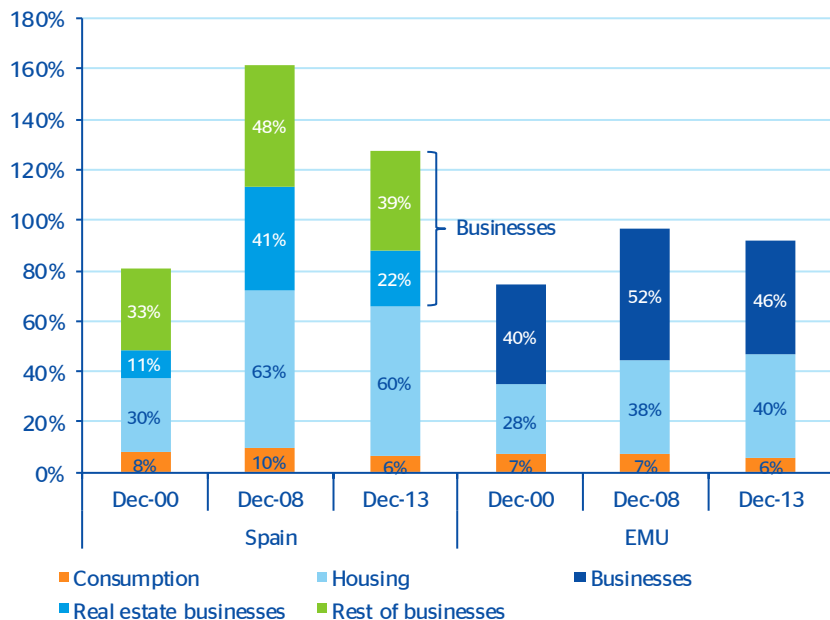
Corporates

- Deleveraging of worst quality loans
- Adjustment of debt to companies' financial capacity
- New funding for viable business plans

Pending issues: deleverage is much needed in terms of stocks

Credit to the private sector (% GDP)

Source: ECB and Bank of Spain

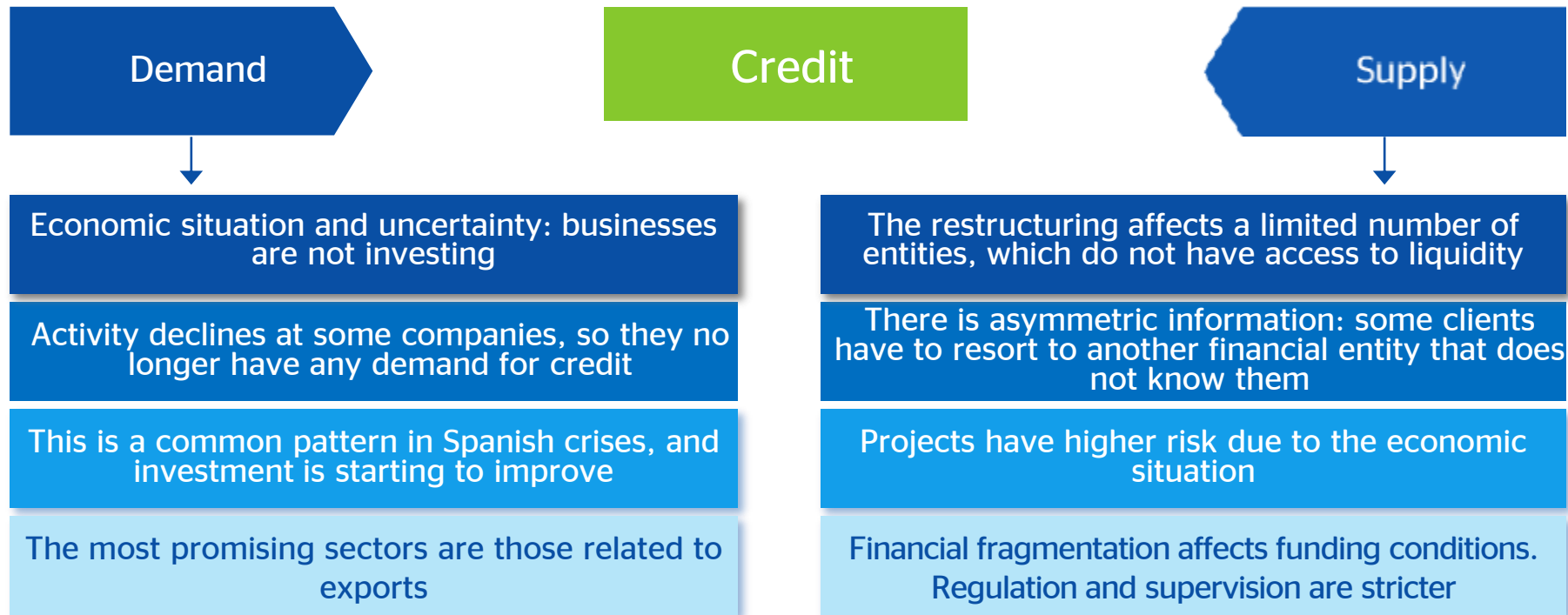


Private-sector leverage is excessive. Spanish levels are above those of EMU

Deleveraging will continue in terms of the stock of outstanding credit

Compared to EMU, the most significant differences are in real estate businesses and mortgages

Pending issues: deleverage. What factors are affecting the supply of credit?



Index

Section 1

Global economy: a gradual acceleration supported by growth in developed economies

Section 2

Europe: the slow recovery continues, the risk of deflation is very low, but...

Section 3

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

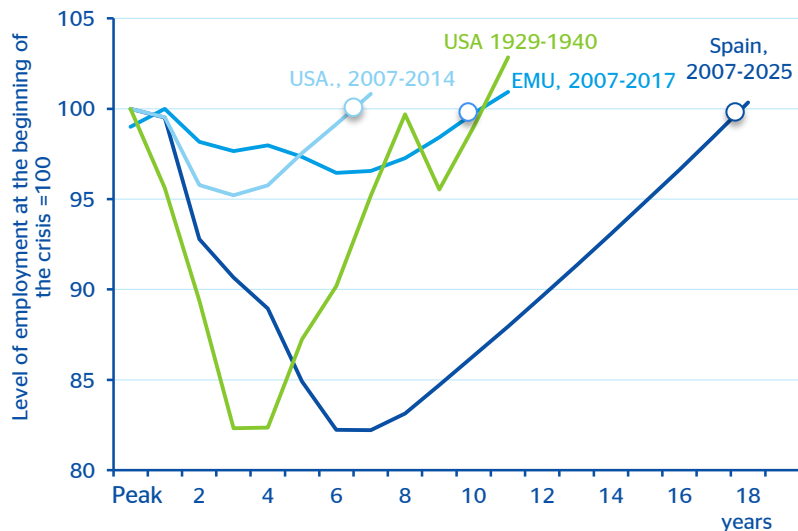
Section 4

Spain: commitment to the reform process is crucial to consolidate “recent” market improvement 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)



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 was the case between 1992 and 2007) and that GDP grows on average by 2,5%

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 above 2.5%

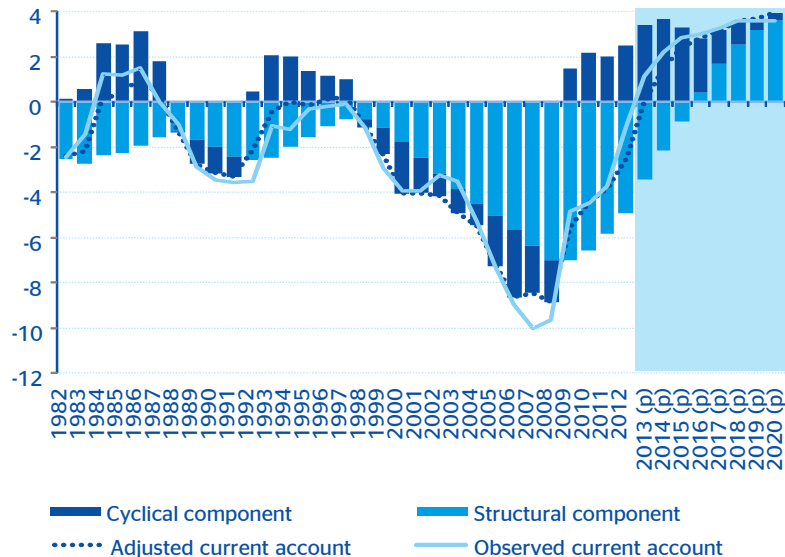
Unless this happens, job-creation will be limited and the recovery slow

Spain: what else can be done?

A. Encourage a gradual deleveraging

Spain: cyclical and structural components of the current account balance (% of GDP)

Source: BBVA Research



Deleveraging must continue, in both the private and public sectors, but at a pace consistent with economic recovery,...

..., so that the impact of the fiscal consolidation effort on growth is minimised and public finances remain sustainable

Huge balance sheet clean-up in the banking sector: total provisions of €239bn* have been charged against results since 2008

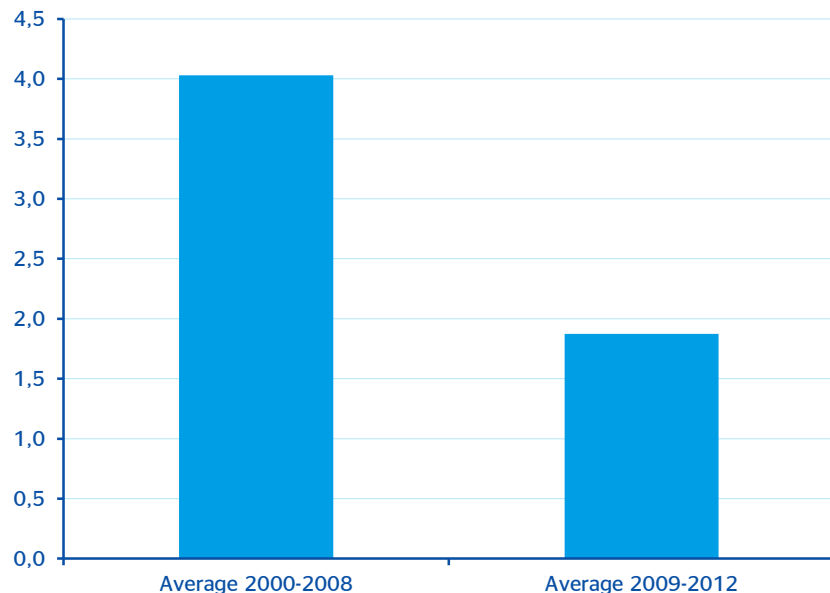
* Provisions for loan losses, repossessed assets, early retirements, restructuring charges and other

Spain: what else can be done?

B. Improve the composition of foreign financing

Spain: FDI (% GDP)

Source: BBVA Research based on Banco de España



Strategic plan to improve competitiveness, ...

..., increase the attraction of Spain to international investors, in terms of physical capital ...

..., human capital and technological capital)

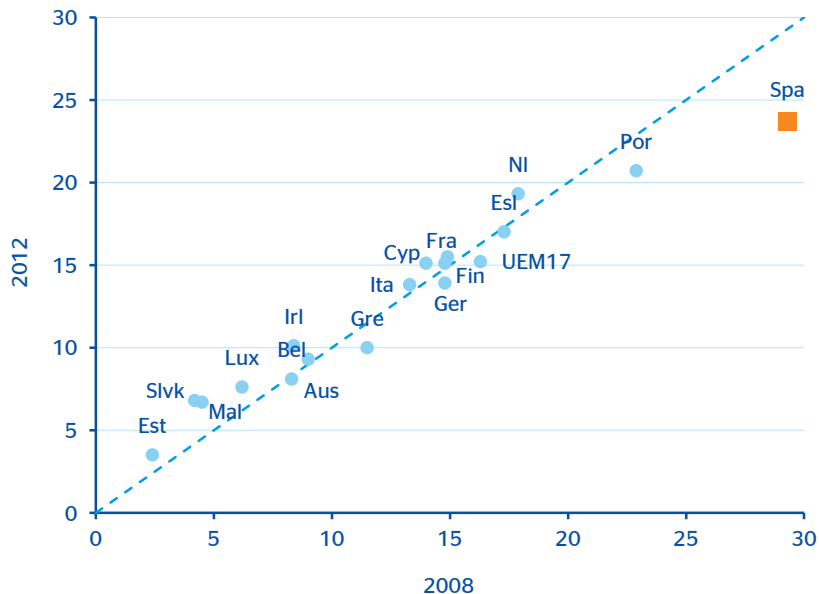
Spain: what else can be done?

C. Improvements in the labour reform

Temporary Employment Rate

(% of workers with a temporary contract)

Source: BBVA Research



Promote reforms that make it more attractive to sign open-ended contracts,...

..., improve the efficiency of both active and passive labour market policies...

..., and raise the quality of human capital

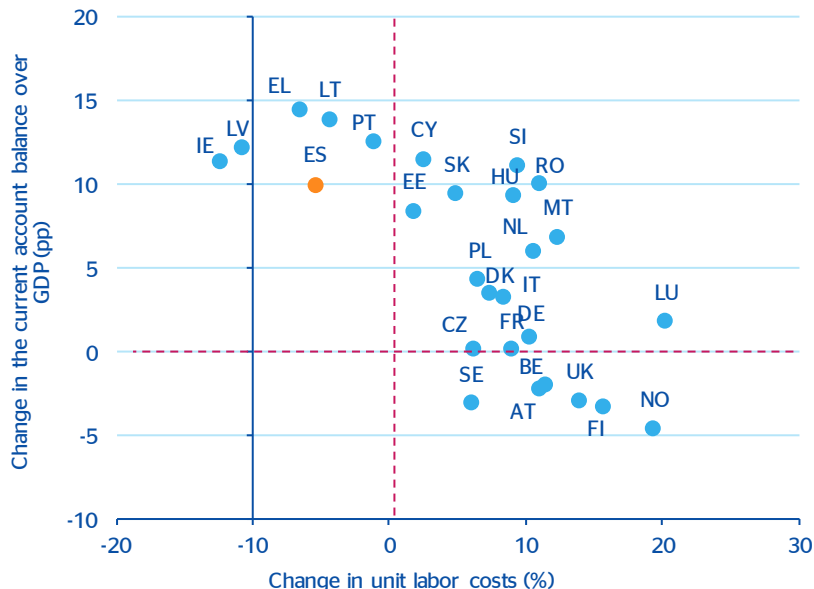
Spain: what else can be done?

D. Improve our competitiveness

EU: current account and unit labour costs

change 4T08-2T13

Fuente: BBVA Research and Eurostat



Productivity gains since the beginning of the crisis have been significant (more than 12%)

and generalised, across both non-tradables and...

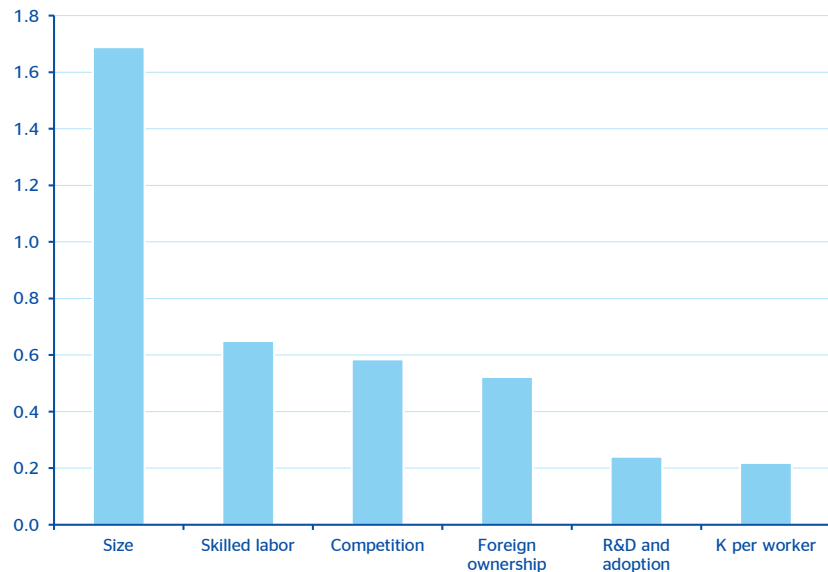
... manufactures (growing by well over 20%)

Spain: what else can be done?

D. Improve our competitiveness

Effect on a firm's exporting probability of an exogenous change in each determinant (%)

source: BBVA Research based on ESEE, Fundación SEPI



The most important determinant of internationalisation is a firm's size

An increase of 10 workers (on average, from 50 to 60 employees) would raise the firm's exporting probability by 1.69%

Barriers to a firm's growth remain in the tax system or in regulation, especially in services or in the labour market
Key to tackle them to improve growth incentives

Main messages

- 1 **The global economic cycle is improving** and we expect a moderate acceleration in growth in 2014-15, supported by growth in 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 **The slow recovery in the eurozone continues**, thanks to favourable economic policies and an improvement in the financial environment. The comprehensive review should eventually help to reduce financial fragmentation
- 4 **For the first time since the beginning of the crisis, the bias to our forecasts for the Spanish economy is to the upside.** The recovery is being driven by exports, import substitution and the recovery in new lending
- 5 **The scope of the reforms needs to be expanded, if they are to underpin a robust and sustained recovery** and, within a reasonable period, replace the jobs destroyed

European and Spanish Economic Outlook

Jorge Sicilia
Chief Economist, BBVA Group
March 2014

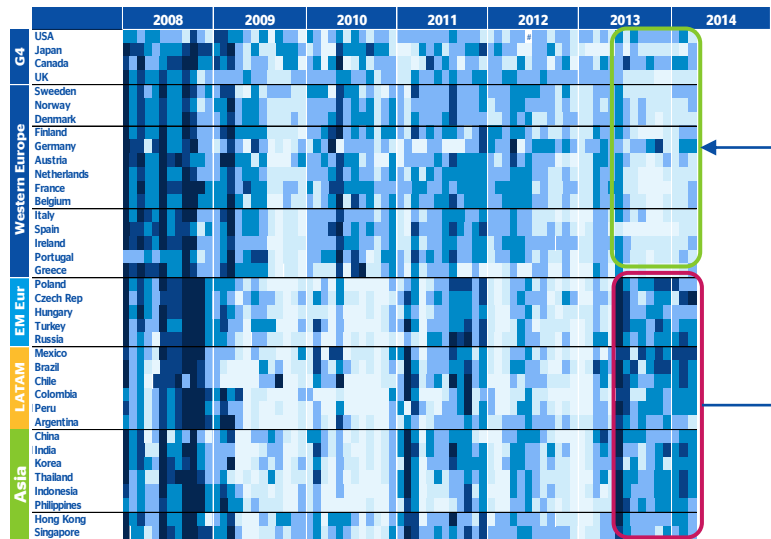
Appendix: Capital flows to Emerging Markets

Portfolio re-balancing away from EM assets continues as anticipated last summer. EU Periphery has benefited the most

BBVA Country Portfolio Flows Map

(Country Flows over total Assets)

Source: BBVA Research through EPFR data

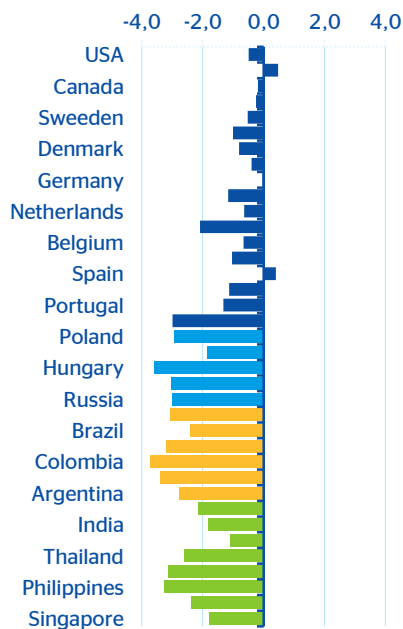


Sharp Capital Outflows (below -2 %)
 Strong Capital Outflows (between -1 % and -2 %)
 Moderate Capital Outflows (between 0 and -1 %)
 Moderate Capital Inflows (between 0 and 1 %)
 Strong Capital Inflows (between 1 % and 2 %)
 Booming Capital Inflows (greater than 2 %)

Portfolio Flows June 13

(Country Flows over Total Assets)

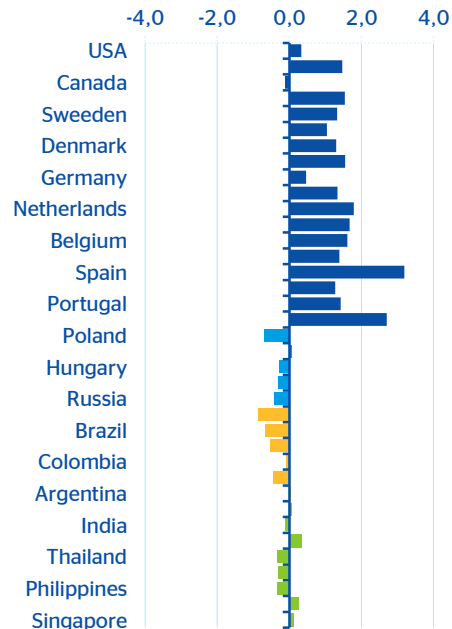
Source: BBVA Research through EPFR



Portfolio Flows July-Feb* 13

(Country Flows over Total Assets, average, * Feb estimated)

Source: BBVA Research through EPFR

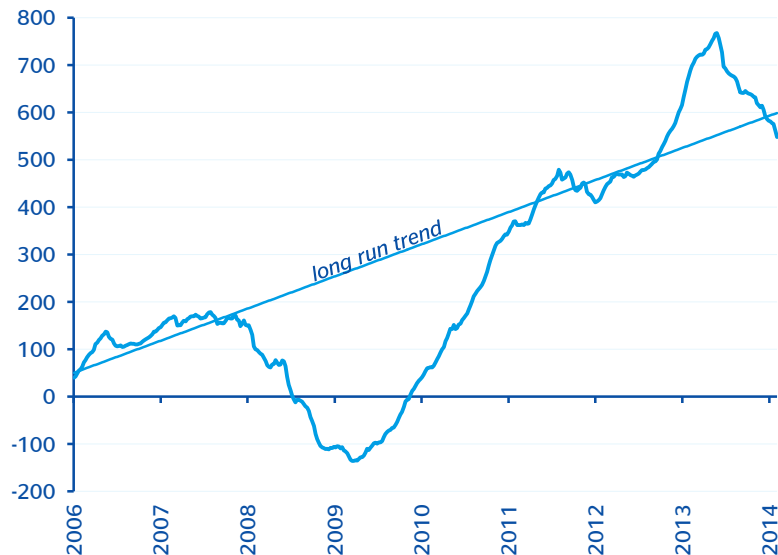


Emerging Market flows have entered the “Undershooting” phase. Further adjustment?

Emerging Markets: Cumulative Net Capital Flows

(Cumulative since 2005, US\$ bn)

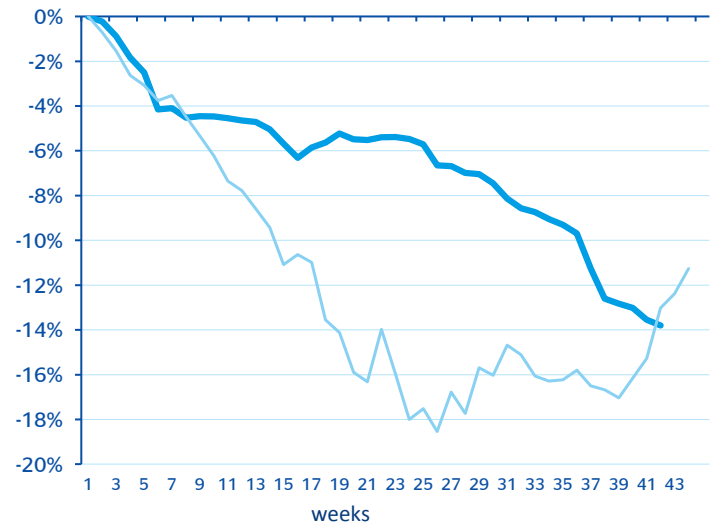
Source: BBVA Research, IMF and EPFR



Capital outflows from emerging markets, tapering vs. LB's episode

(Cumulative as % of AUM)

Source: BBVA Research, IMF and EPFR



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

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