

European and Spanish Economic Outlook

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London, March 31, 2014

Main messages

- 1 **The global economic cycle is improving** and we expect a moderate acceleration in growth in 2014-15 supported by the developed economies
- 2 **Some economic policy uncertainties have been resolved** but there are still risks, although not of a systemic nature, as it was the case in the past
- 3 **For the first time since the beginning of the crisis the risks to our forecasts for the Spanish economy are to the upside.** The recovery is being driven by exports, import substitution and the recovery in new lending. In addition, both financial tensions and fiscal consolidation are less intense
- 4 **The scope of the reforms needs to be expanded if they are to underpin a robust and sustained recovery, and reverse the jobs destroyed within a reasonable period**

Index

Section 1

Global economy: a gradual acceleration supported by developed economies

Section 2

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

Section 3

Commitment to the reforms is crucial to consolidate recent market improvement and increase potential growth

Global growth will increase in 2014 and 2015

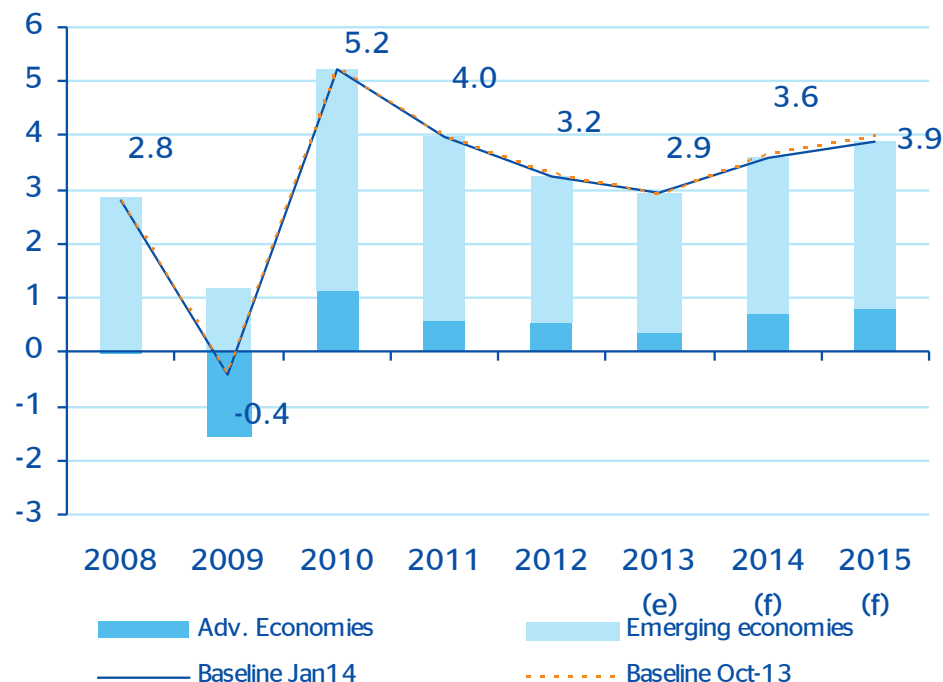
1 The **global expansion will continue in 2014-15** this time around with higher contributions from advanced economies

2 **Growth risks are more balanced** with **upward risks in the US** and downward risks that remain:

- the **exit from QE** and **flows to emerging markets**,
- the **uneven recoveries and vulnerabilities in EMs**, and
- the **Eurozone**

Global GDP growth (%)

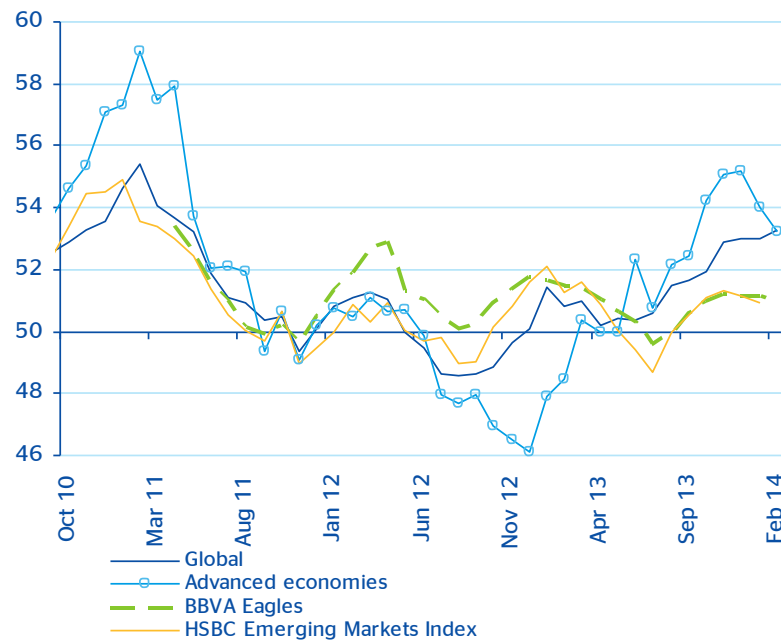
Source: BBVA Research



The global momentum is improving

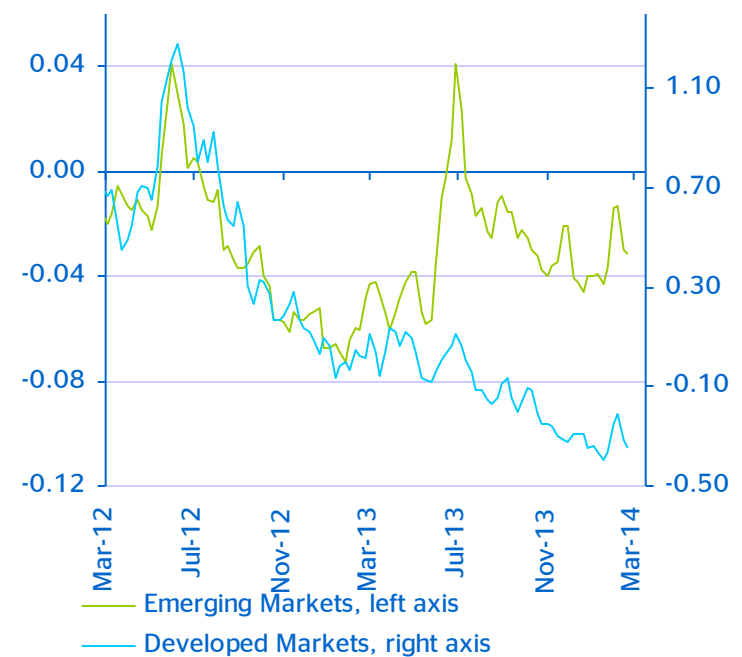
Manufacturing PMIs

Source: BBVA Research based on Markit Economics



BBVA Financial Stress Index

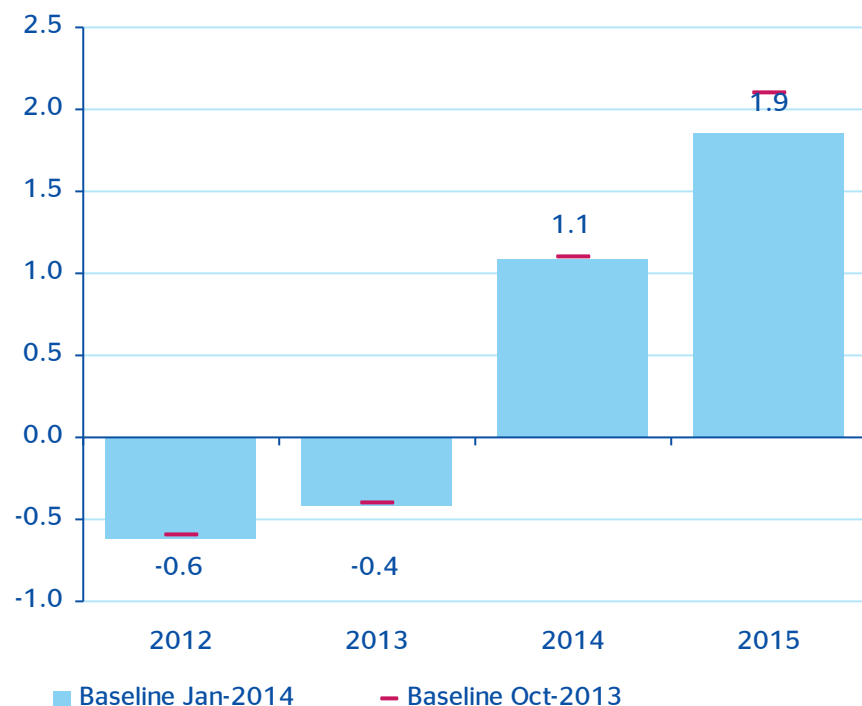
Source: BBVA Research



The eurozone: positive growth with an increasing role of domestic demand

Eurozone: GDP growth (y/y)

Source: 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 2014-15

Overall: lower financial tensions, higher global growth, lower fiscal drag, ECB's loosening bias and Banking Union

Drivers of (still slow) growth in the eurozone

1) The external environment remains positive

2) Financial conditions have improved, especially in the periphery

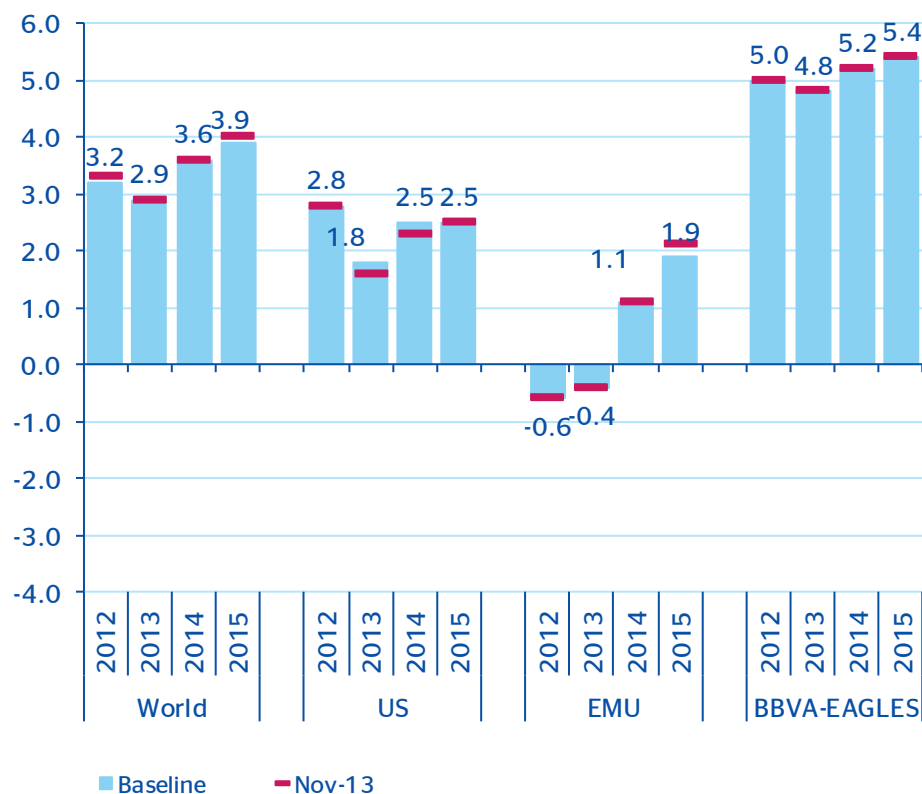
3) The fiscal stance is less restrictive

4) The banking union is advancing, with bank exams and single supervision in 2014

Growth at diverse paces and with different risks ...

GDP growth (%yoy)

Source: BBVA Research and IMF



Growth cycle strengthens, mainly in advanced economies and in some emerging economies. Economic policy remains as a supportive factor for growth in 2014-15

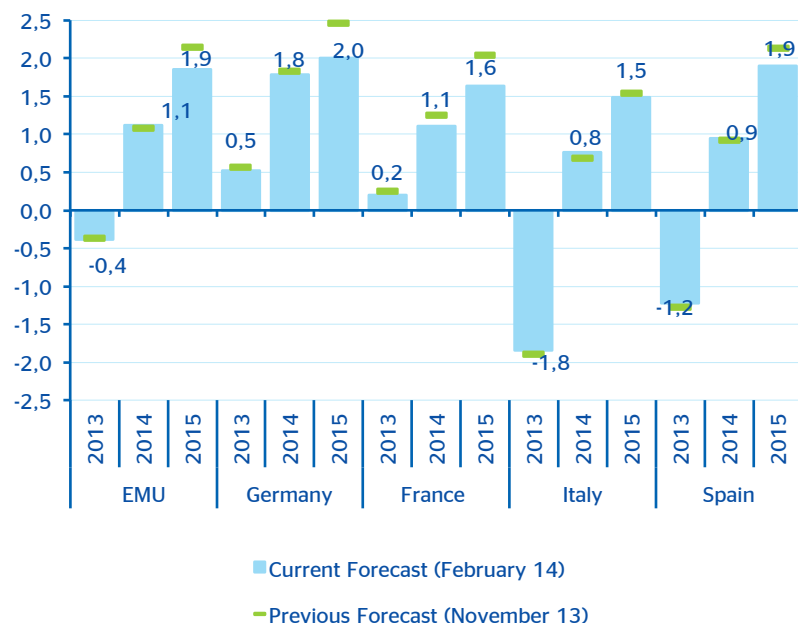
To reinforce the baseline scenario, policy-makers have to tackle domestic vulnerabilities: banking issues and disinflation risks in the Eurozone, financial vulnerabilities in China, and private domestic demand in emerging economies

The impact of FED's tapering over global funding conditions, in the US and beyond, remains as a factor of uncertainty

... with a widespread recovery across EMU countries ...

GDP growth by country (%)

Source: BBVA Research



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

France: GDP virtually flat in 2013 while the moderate recovery for 2014 will depend on the economic policy implementation

Italy: though activity stabilised in 2H13, sharp downward in 2013, Slight growth in 2014, but downside risks increase

... but with some important uncertainties for 2014

World: (1) risk of a sudden slowdown in emerging countries and its ability to rebalance its growth path (e.g., China), (2) effects on capital flows and financial conditions from Fed exit strategy, and (3) geopolitical

U.S.: (1) risks in Fed exit strategy, (2) debt ceiling and fiscal consolidation in the long run, and (3) growth potential and doubts on secular stagnation

EMU: (1) persistence of sovereign risk and financial fragmentation, (2) process to the Banking Union Bank (AQR and stress tests), (3) risk of deflation and the burden of a very low inflation, and (4) Greece and Portugal programmes

Spain: political environment, scope of structural reforms, potential growth, recovery with a very low inflation in EMU, fiscal consolidation and banking restructuring process

Asymmetric shocks and an incomplete union in EMU

	Shocks	
	Symmetric	Asymmetric
Complete union	USA	
Incomplete union		EMU

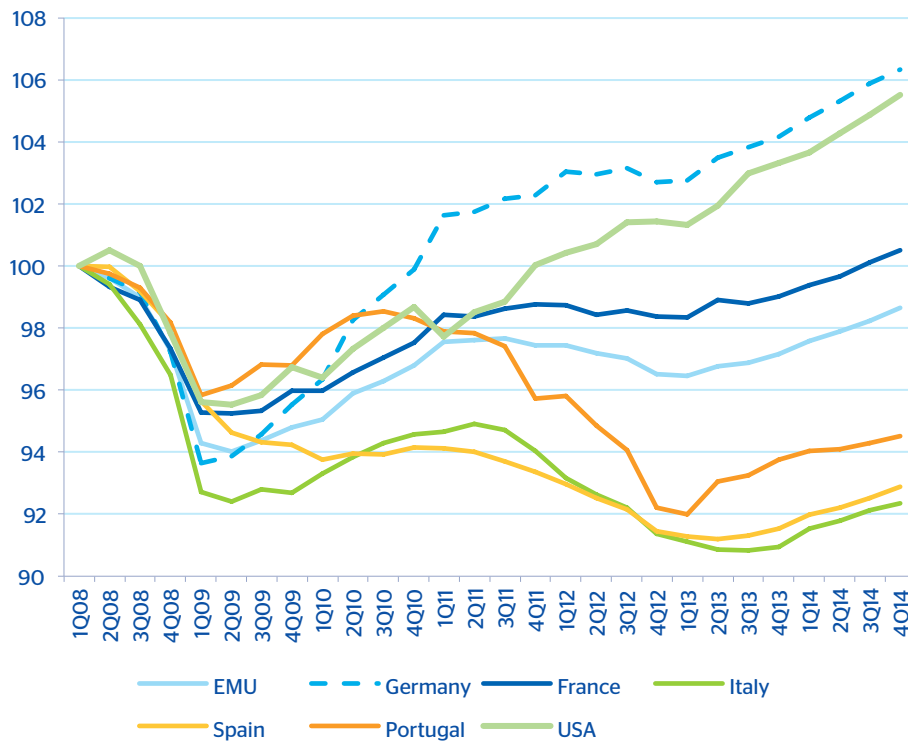
Differences in the asymmetry of shocks and institutions have resulted in very different response of economic policies during the crisis, ...

... which now are affecting the effectiveness of the ECB to ensure its inflation target and to anchor inflation expectations

Asymmetric shocks and an incomplete union in EMU

GDP per working age population 2Q08=100

Source: Eurostat and BBVA Research



As a result of the imbalances accumulated before and during the crisis, and the lack of banking, fiscal and economic union ...

... EMU countries exhibit large differences in unemployment rates and in GDP per working-age population, ...

... which are correlated with creditor and debtor positions of each country -> consensus on European economic policy is difficult

1. Financial uncertainties

Banking union: key to reduce financial fragmentation

Setting up a robust supranational framework

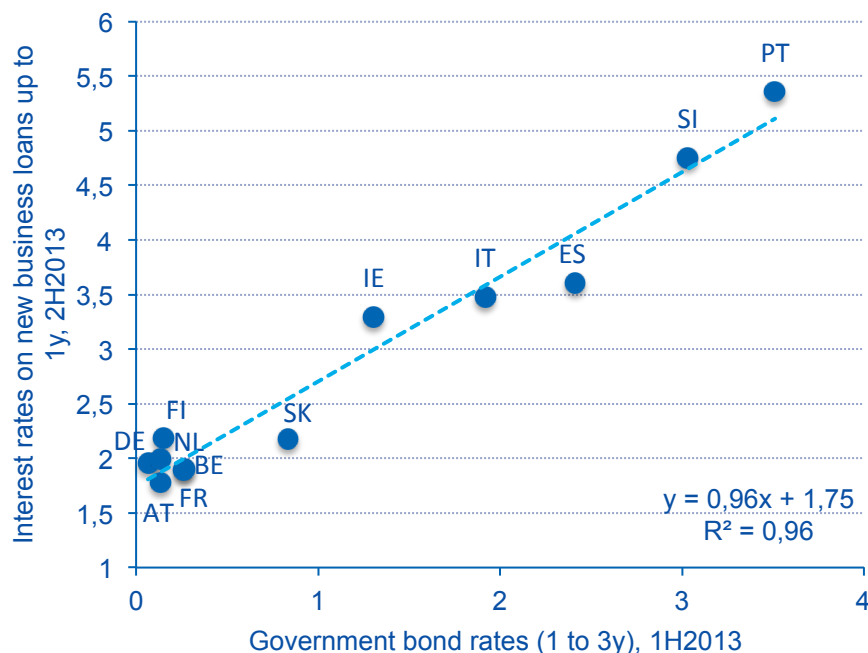


1. Financial uncertainties

Banking union: key to reduce financial fragmentation

Eurozone: interest rates of government bonds and new loans to non-financial firms, 2013

Source: BBVA Research based on ECB



Despite the significant fall of financial tensions, financial fragmentation is still important ...

... interest rates of government bonds and new loans to non-financial firms highly correlated: sovereign and banking risks spillovers still remarkable ...

... particularly in countries where inflation is low -> differences in real interest rates larger than in nominal ones

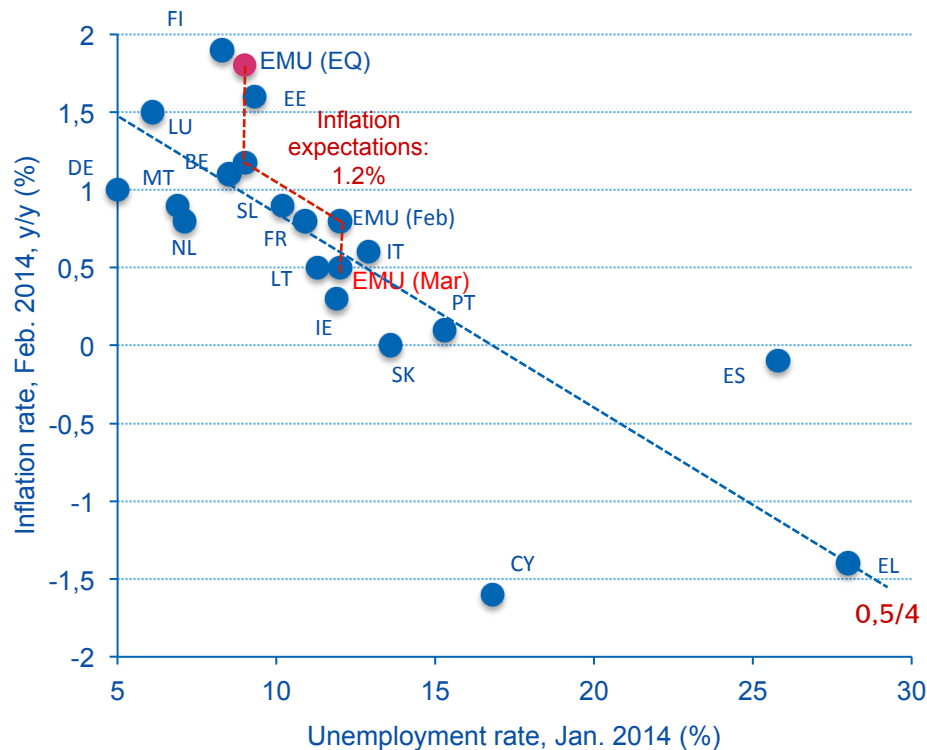
Real interest rates in EMU countries with high unemployment rate much larger than in countries with low unemployment rate

2. The costs and risks of a low inflation recovery

Trend inflation & expectations well below the ECB target

Eurozone: unemployment rate and inflation

Source: Eurostat and BBVA Research



The regression coefficient of the inflation rate on the unemployment rate is equal to 0.125, statistically significant and robust to the exclusion of Cyprus, Greece and Spain.

The double-dip recession (unemployment) and M3 growth partially explain the low rate of inflation in EMU

If 3 pp of higher unemployment explain 0.4 pp lower inflation, inflation expectations are currently less than 1.2% -> drag for the economic recovery

Inflation expectations in swaps and trimmed mean inflation (optimal selection in terms of inflation prediction for next 2/3 years) are about 1%

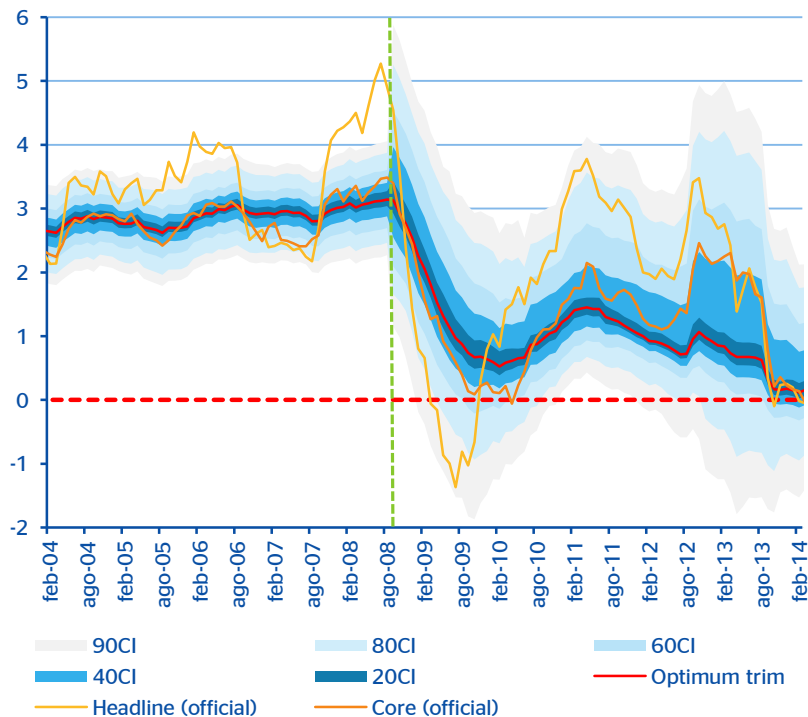
Although the probability of deflation is low (<10%) the combination of adverse shocks and expectations downward significantly increase this probability

2. The costs and risks of a low inflation recovery

Trend inflation & expectations well below the ECB target

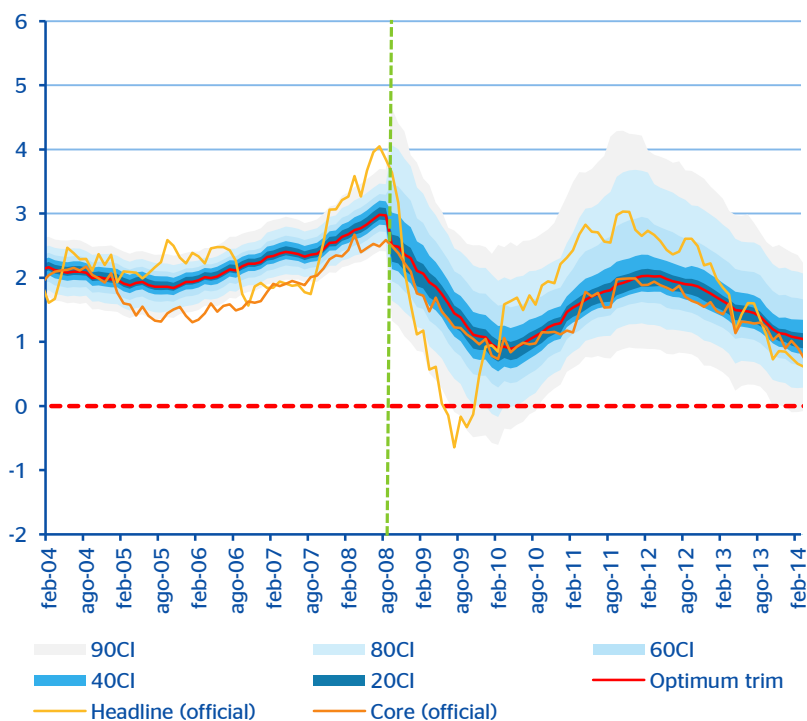
Spain: trending inflation (trimmed mean inflation, % y/y)

Source BBVA Research based on INE



Eurozone: trending inflation (trimmed mean inflation, % y/y)

Source BBVA Research based on Eurostat



2. The costs and risks of a low inflation recovery

ECB: ready for further action?

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 in the very short run

Policy pause until 2016

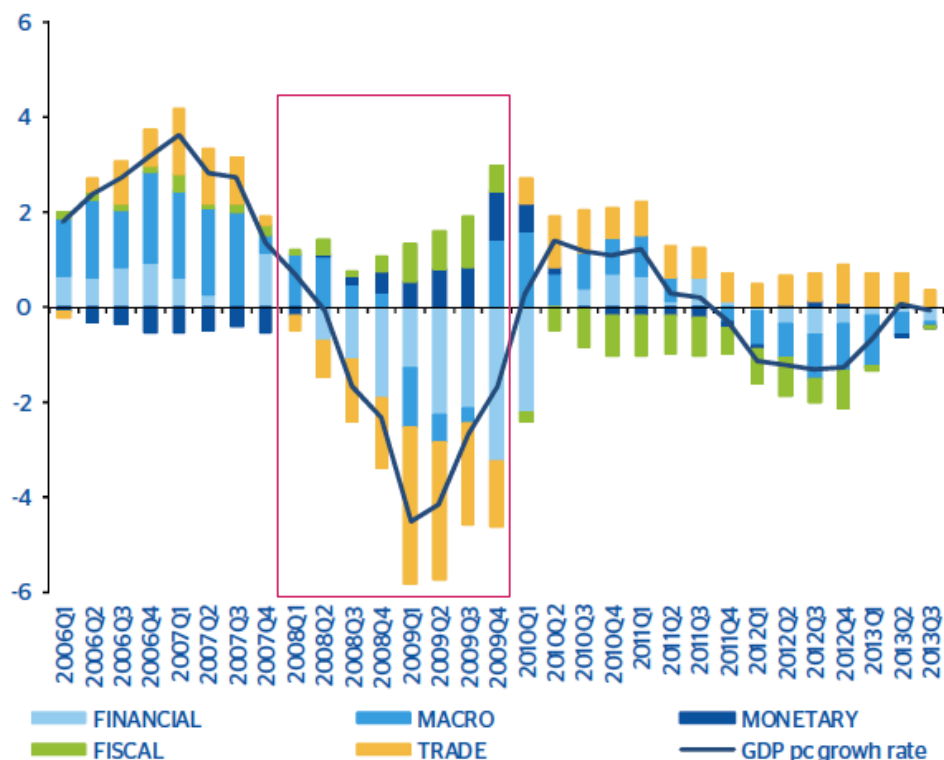
Will the ECB change its mind towards QE?

3. The risks of a sudden stop in emerging economies

EMU fragile recovery may be affected by external factors

EMU: historical decomposition of GDP per wap (% , y/y)

Source: BBVA Research



The first part of the double-dip crisis in EMU was driven by financial tensions and the collapse of external trade

Although of a milder magnitude, a sudden stop in emerging countries could have significant effects on EMU recovery

Similarly, Fed exit strategy may affect financial conditions in EMU

Index

Section 1

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Section 2

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

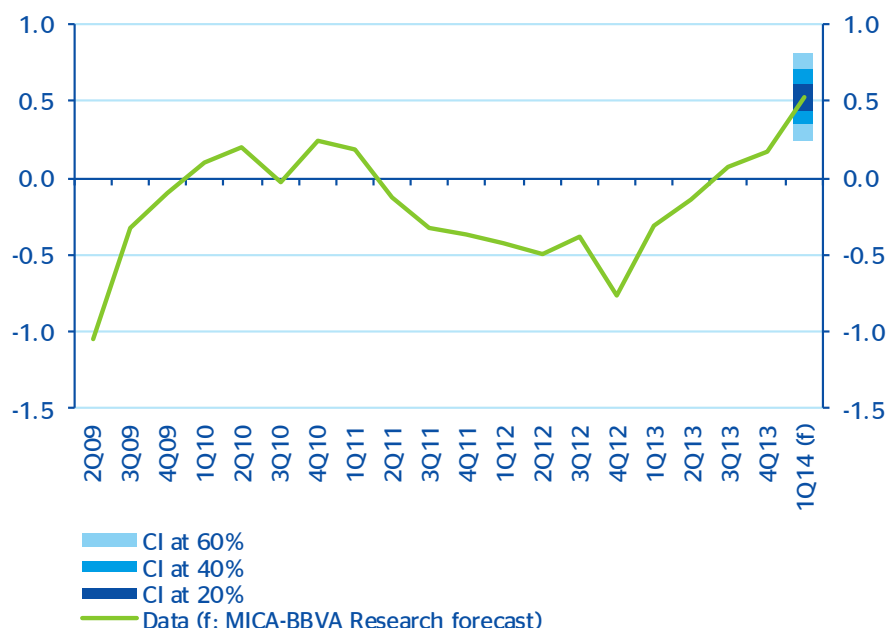
Section 3

Commitment to the reforms is crucial to consolidate the improvement in the markets and increase potential growth

The recovery of the Spanish economy 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

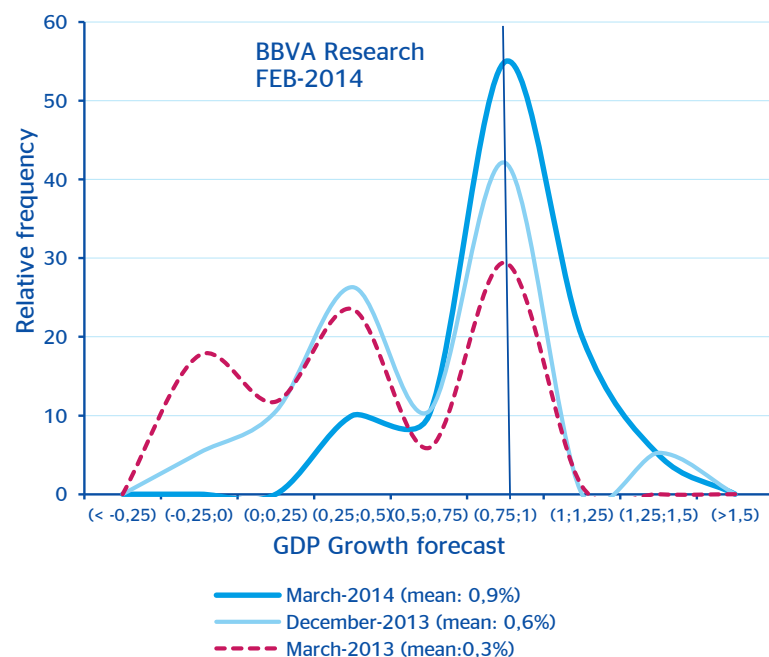
The available information points to growth of at least 0.4% in 1Q14

... 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 trend

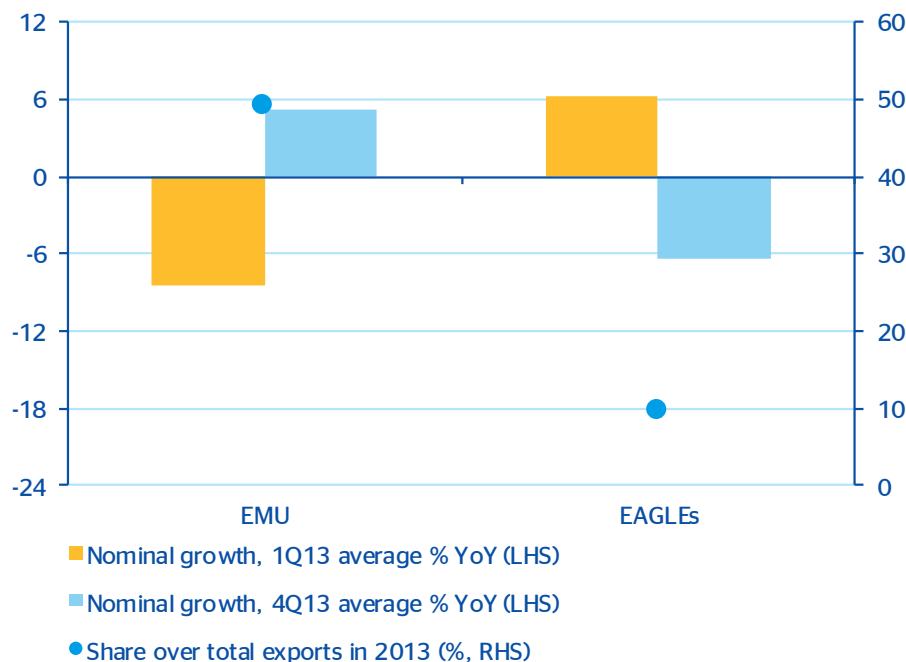
If these trends are confirmed, growth could be even stronger than we are forecasting

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 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

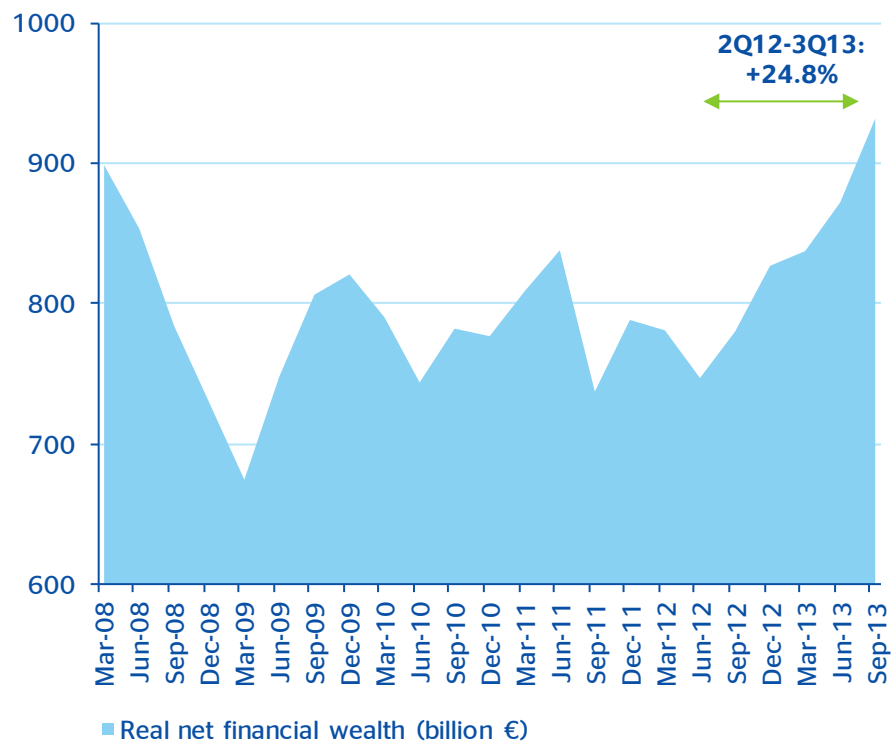
Upside risks

2. An increase in savings and financial wealth

Spain: net real household financial wealth

(Deflated by the private consumption deflator; seasonally adjusted data)

Source: BBVA Research based on Bank of Spain and INE



The increase in corporate and household savings has been an essential part of the recoveries in Spain ...

... that has helped in the deleveraging process and in the improvement in the financial situation of the private sector ...

... and these, together with the stabilisation and improvement in the value of wealth, has driven an increase in consumption and investment

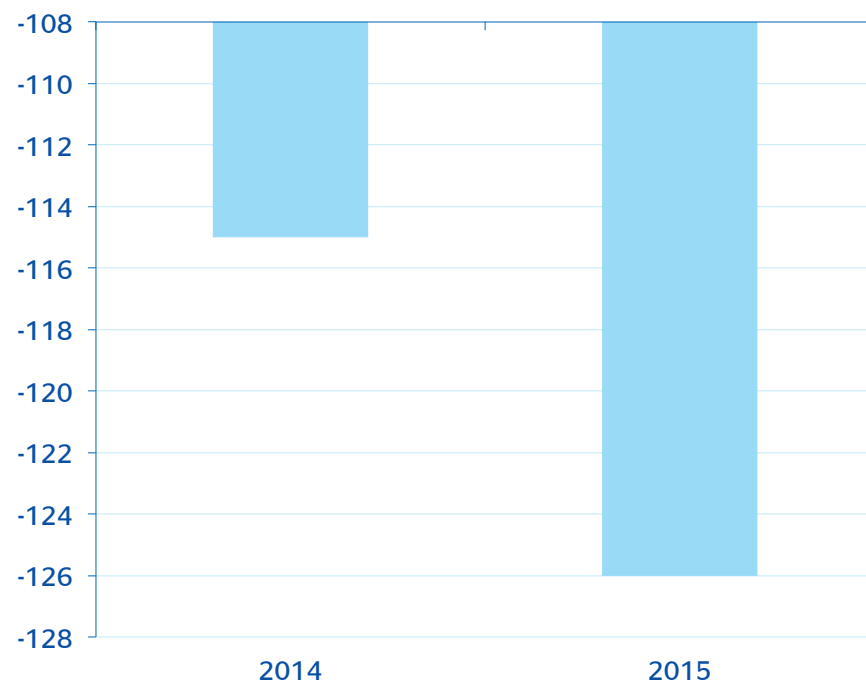
Upside risks

3. More certainty and fewer financial tensions

Spain: 10Y bond yield

(Difference vs. our November 2013 forecast in bp)

Source: BBVA Research



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

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

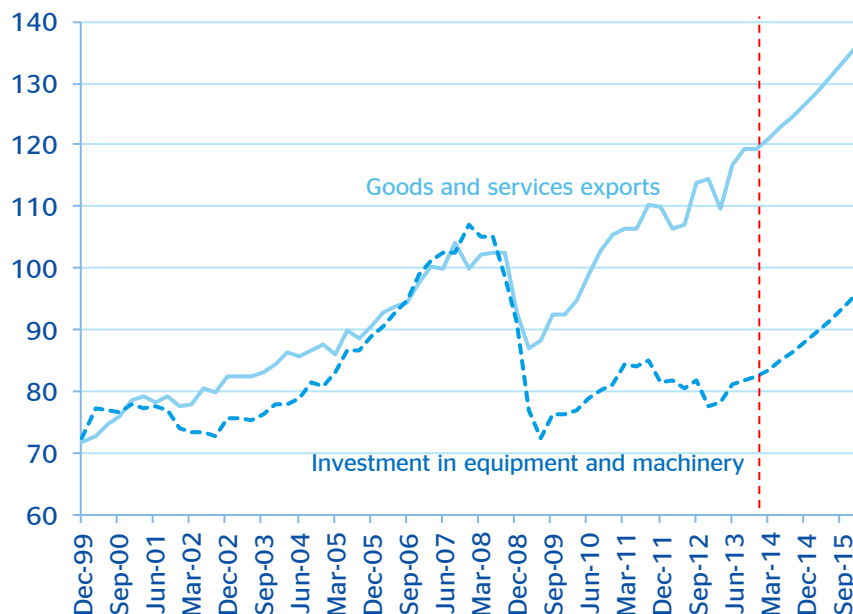
A permanent 100bp drop in sovereign interest rates implies up to one percentage point more growth for the economy

Upside risks

4. 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

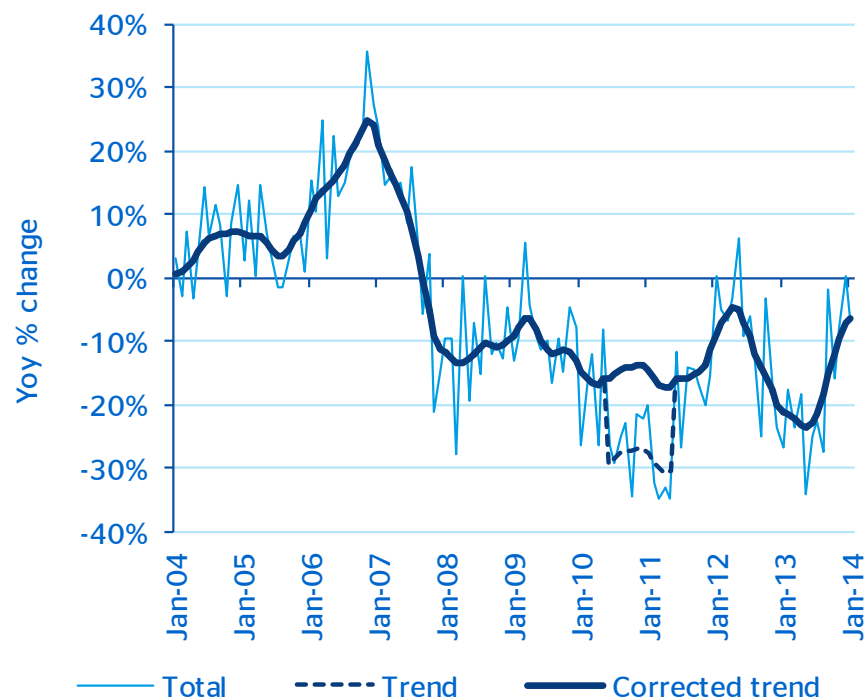
In fact, the investment in equipment and machinery had grown 6.3% by 4Q13

Upside risks

5. Improvement in new lending flows

Spain: new lending and credit to households, NPISH and non-financial entities

Source: BBVA Research based on Bank of Spain (February 2014)



The Spanish economy is going through an evitable deleveraging process ...

... that is compatible with new lending for financially viable projects

There has been a turning point and an improvement in corporate lending, which we expect to consolidate in 1H14

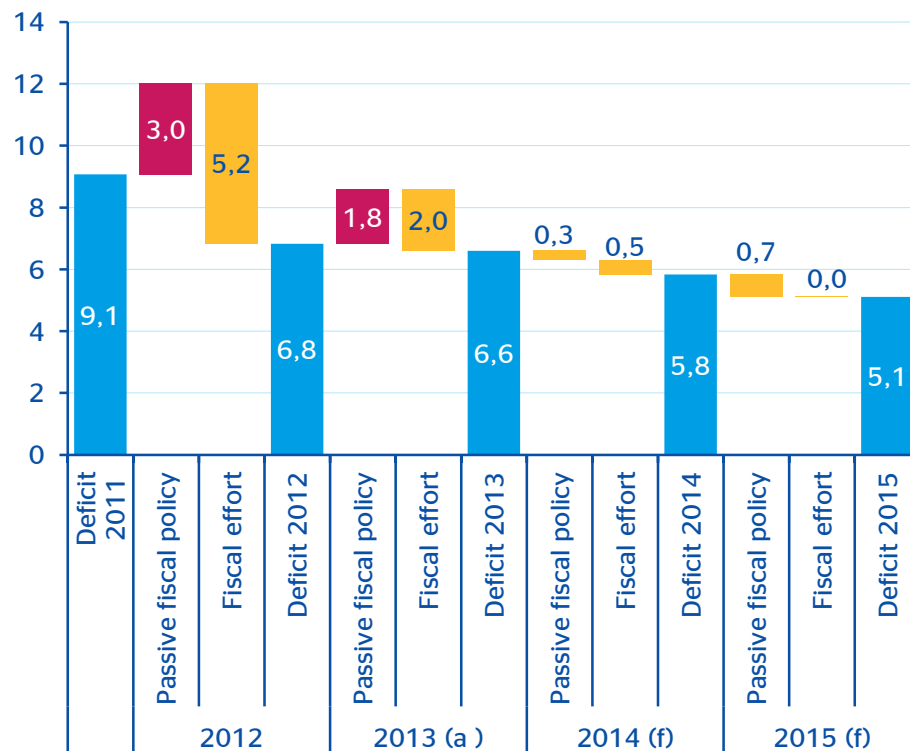
Upside risks

6. A smaller fiscal effort needed in 2014

Public sector: breakdown of the public deficit excluding aid to the financial sector

(% GDP)

Source: BBVA Research based on MINHAP



(e) advance; (f) forecast

The significant fiscal consolidation efforts in 2012 and 2013 ...

... have resulted in containment of the public deficit at 6.6% of GDP ...

... therefore allowing for a smaller fiscal effort needed in 2014

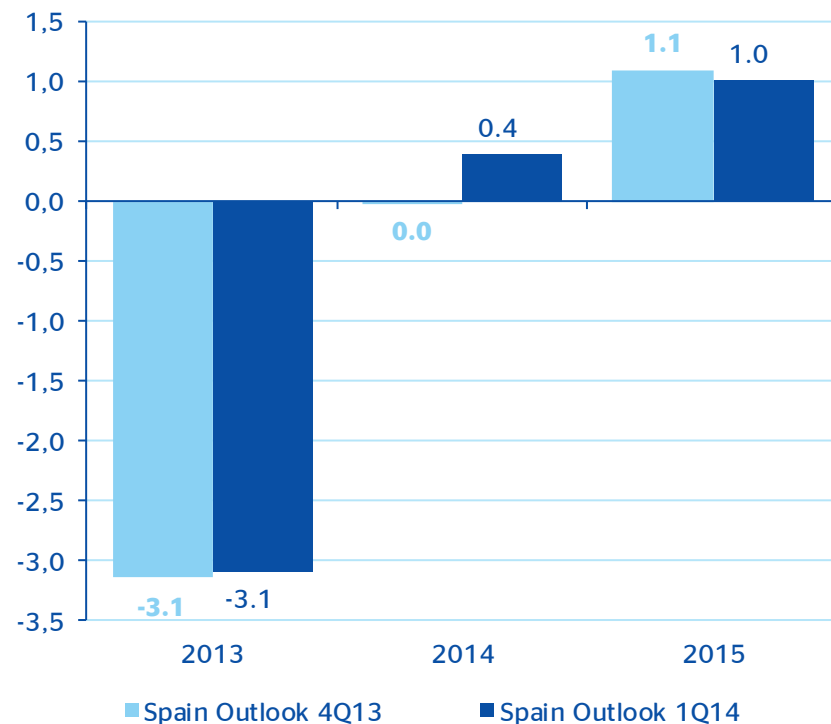
Upside risks

7. 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 better at the beginning of the crisis, millions of job losses could have been avoided

Employment growth in 2014. Additionally the fixed social security contribution for permanent contracts can boost employment

Index

Section 1

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Section 2

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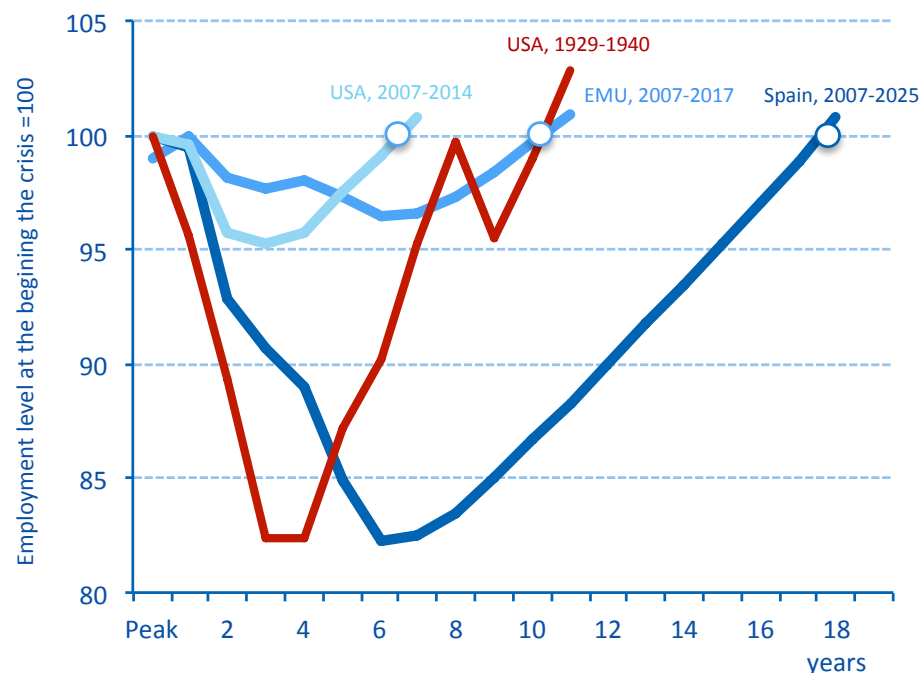
Section 3

Spain: commitment to the reforms is crucial to consolidate the improvement in the markets 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 it was the case between 1992 and 2007) and that GDP grows on average 2,5.

The recovery in employment will be very sensitive to economic growth

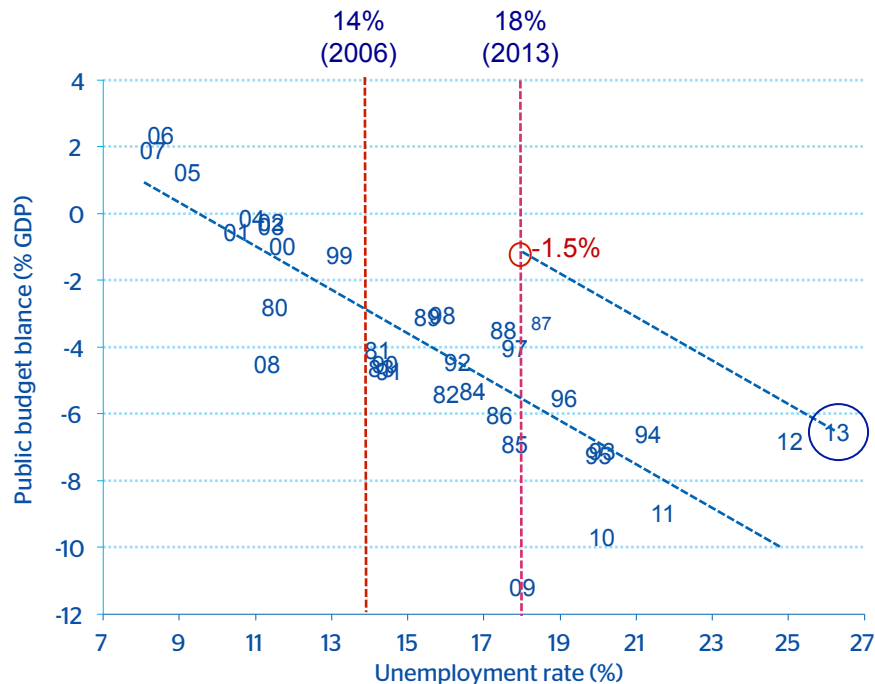
The objective should be to introduce the necessary reforms to increase economic growth to close to or more than 2.5%

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

An efficient tax system and fiscal sustainability

Spain: unemployment and public deficit

Source: BBVA Research based on INE and MINHAP



Tax revenues dropped sharply in Spain as a consequence of the recession ...

... and the fiscal consolidation process requires sufficient resources to ensure that Spain's finances remain in good health...

... but with a structure that drives economic growth and job-creation, two key factors for reducing the deficit

The need to broaden the scope of the reform agenda

1. To continue the deleveraging and improvement in the finances of the Spanish economy: finalising the restructuring of the financial sector and attracting foreign direct investment

2. Public-sector reform, fiscal consolidation and long-term sustainability of public finances, with an efficient tax system that create incentives to growth and job-creation -> Report of the Experts Committee

3. Reforms to improve competitiveness further (internal devaluation), increase the international attraction of Spain in terms of physical, human and technological capital

4. To continue with the reforms that reduce the duality in the labour market, improve the way it functions and increase employability
-> more and better-quality jobs

European and Spanish Economic Outlook

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London, March 31, 2014

Macroeconomic scenario

(% YoY)	2012		2013 (f)		2014 (f)		2015 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	-2,8	-1,4	-2,5	-0,5	0,9	0,7	1,3	1,2
General government final consumption exp.	-4,8	-0,5	-1,2	0,3	-1,1	0,5	1,3	0,7
Gross fixed capital formation (G.F.C.F.)	-7,0	-3,9	-5,9	-3,1	0,2	1,6	5,2	5,0
Equipment and cultivated assets	-3,9	-4,4	0,8	-2,5	6,0	2,8	7,8	7,1
Equipment and machinery	-3,9	-4,4	0,7	-2,5	5,8	2,9	7,8	7,1
Housing	-8,7	-3,4	-8,4	-3,0	-3,4	1,0	5,0	3,6
Other constructions	-10,6	-4,8	-11,8	-4,9	-4,2	-0,7	1,5	2,9
Changes in inventories (*)	0,0	-0,5	0,0	-0,1	0,0	0,0	0,0	0,0
Domestic Demand (*)	-4,1	-2,1	-2,8	-0,9	0,4	0,8	2,0	1,7
Exports	2,1	2,7	5,2	1,2	6,5	3,5	6,7	4,9
Imports	-5,7	-0,8	0,3	0,2	5,2	3,3	7,4	5,1
External Demand (*)	2,5	1,5	1,6	0,5	0,6	0,3	-0,1	0,2
GDP mp	-1,6	-0,6	-1,2	-0,4	0,9	1,1	1,9	1,9
Pro-memoria								
GDP excluding housing	-1,2	-0,5	-0,8	-0,2	1,2	1,1	1,8	1,8
GDP excluding construction	-0,4	-0,2	-0,1	0,0	1,5	1,2	1,8	1,7
Total employment (LFS)	-4,5	-0,7	-3,1	-0,8	0,4	0,1	1,0	0,7
Unemployment rate (% Active pop.)	25,0	11,4	26,4	12,1	25,6	12,0	24,8	11,6
Current account balance (% GDP)	-1,1	1,2	0,9	2,1	1,6	2,1	1,7	2,0
Public debt (% GDP) (**)	86,0	93,0	94,7	95,6	99,1	96,1	101,4	95,7
Public deficit (% GDP)	-6,8	-3,7	-7,0	-2,8	-5,8	-2,4	-5,1	-2,1
CPI (average)	2,4	2,5	1,4	1,4	0,5	1,0	1,0	1,4
CPI (end of period)	2,9	2,2	0,3	0,8	0,7	1,3	1,2	1,5

(*) Contribution to GDP Growth

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

(f): forecast

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..)

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