

A close-up photograph of a magnifying glass with a gold-colored frame. The lens is positioned over a map of Europe, which is slightly out of focus. The magnifying glass's handle is dark and textured. The background is a soft, blurred mix of colors, suggesting an indoor setting with natural light.

Europe Economic Outlook

June 2010

Main messages

Economic recovery on track, but uncertainty increases

- World environment: challenges ahead for a sustained recovery
- Domestic demand in the eurozone was subdued. Strong exports supported for the strength of the industrial sector.
- The first steps of the recovery are still modest
- The sovereign bond crisis, the lack of restructuring in the financial sector and the end of temporary stimulus will put a break on the recovery of domestic demand, but world trade growth and euro depreciation will partly compensate for it
- The outlook for 2010 and 2011 presents a very slow recovery, and heterogeneous across member states, while uncertainties increase
- Monetary policy to remain adequately accommodative until at least the end of 2011
- The fiscal consolidation challenge ahead is important, but the risk of a large negative effect on growth is small

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Strong fiscal consolidation, but with small negative effect on growth

Forces shaping the recovery

1

The need of consolidation in public sector budgets, accelerated by markets' pressures in some countries, will put a break to growth, though not by much

Fiscal tightening for the eurozone as a whole is likely to be very timid in 2010 (**0.1% of GDP**)

The fiscal consolidation process is more an issue for 2011 and beyond (**around 1.1% of GDP in 2011**)

Greece
Spain
Portugal
Ireland

Although some member states frontloaded fiscal adjustment measures...

Austria
Finland
Germany
Netherlands
France

... Other countries will continue to stimulate their economies over the current year

An average estimation of fiscal multipliers suggests that fiscal retrenchment is likely to result in **GDP being lower by around 0.1% in 2010 and 0.8% in 2011**

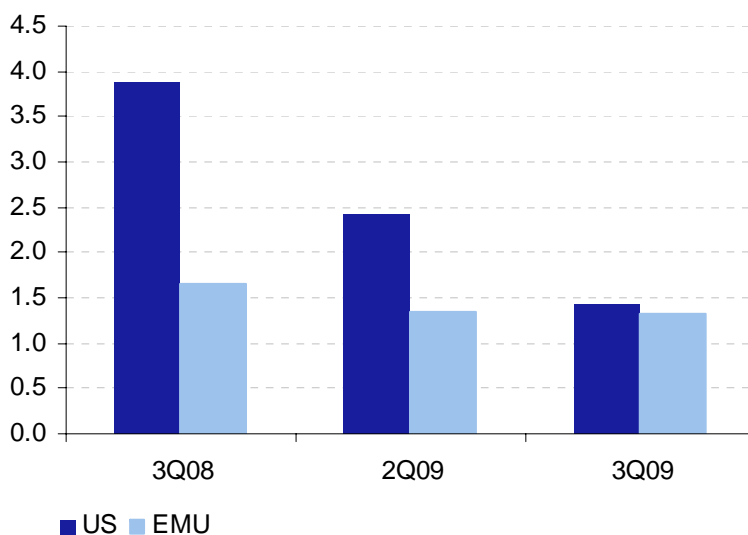
Forces shaping the recovery

2

The lack of restructuring in the European financial sector has been one of the main factors we saw behind the slow recovery since the green shoots emerged a year ago.

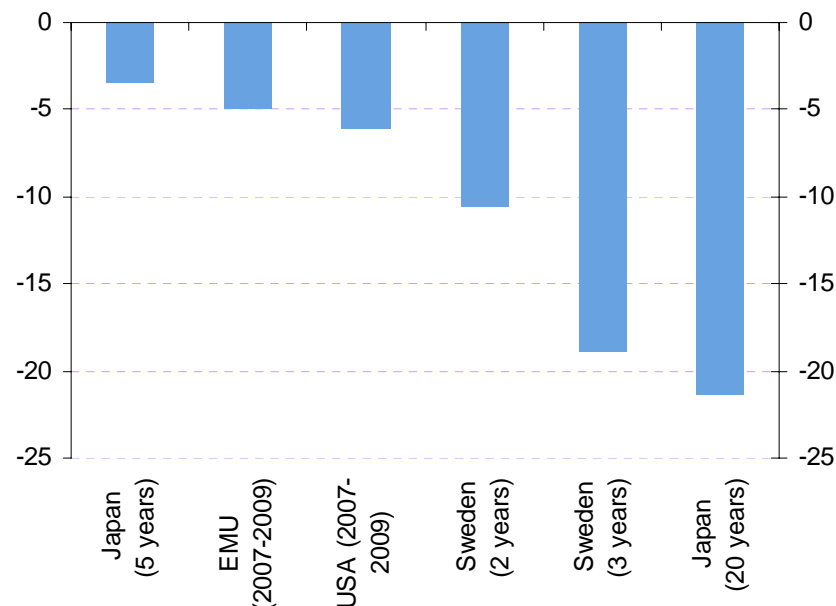
Sample of Large International banks Structured products exposure over total assets (%)

Source: BBVA Research



Decrease in the number of financial institutions (% over total institutions)

Source: BBVA Research



Japan = City banks and Regional banks

USA = Registered institutions in FDIC

Europe = Credit Institutions of Germany, France, Spain, Netherland and Italy

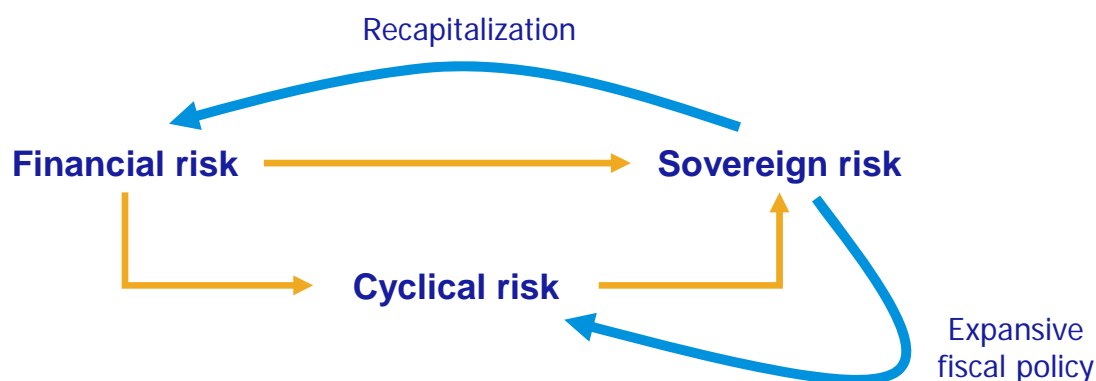
The publications of stress test in Europe should help to diminish uncertainties in the recent sovereign debt crisis

Forces shaping the recovery

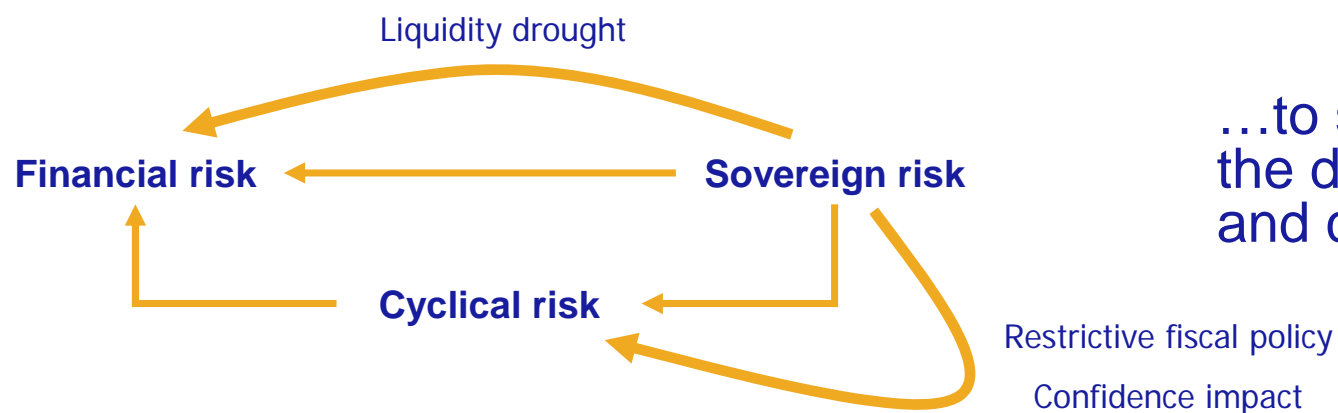
3

The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand

As a consequence of delaying action, market drivers have clearly rotated, creating a complex vicious circle.



From financial risks
being partially
compensated by
sovereign action...



...to sovereign risks as
the driver of financial
and cyclical risks

Forces shaping the recovery

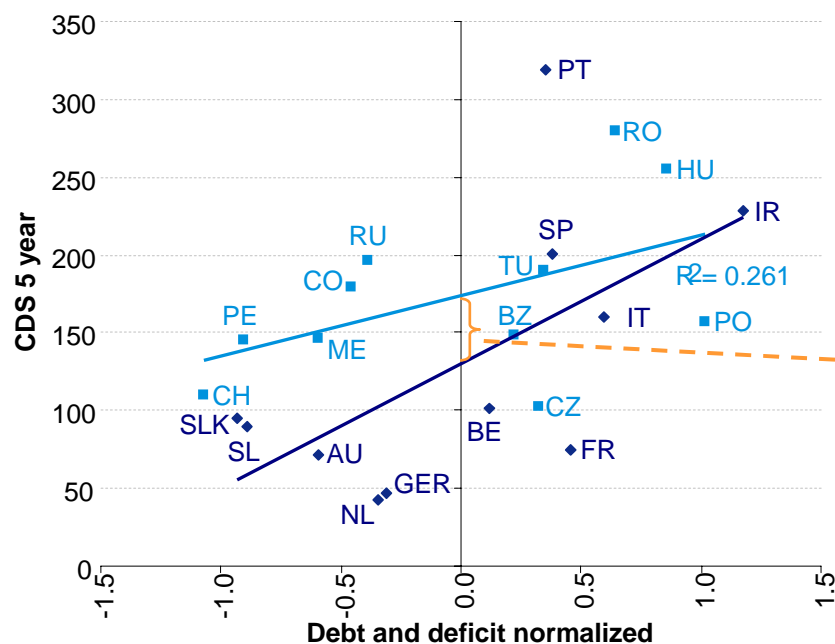
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The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand

The future of the Euro is under scrutiny, making this an European crisis at the broadest level.

Credit risk premium vs. Fiscal situation Euro members vs. Non-Euro countries

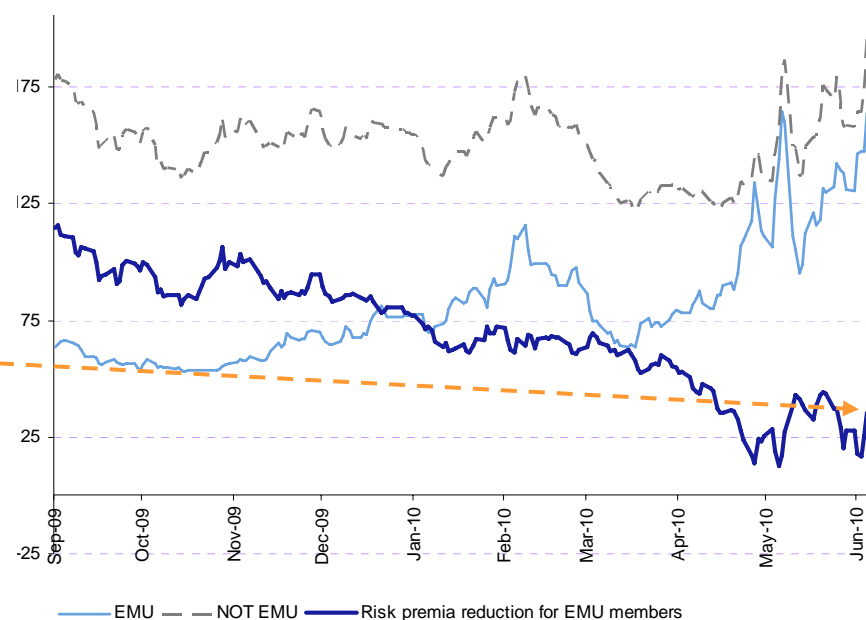
Source: BBVA Research



◆ Euro ■ NoEUro

Risk premium levels and reduction associated with EMU membership

Source: BBVA Research



Forces shaping the recovery

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The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand.

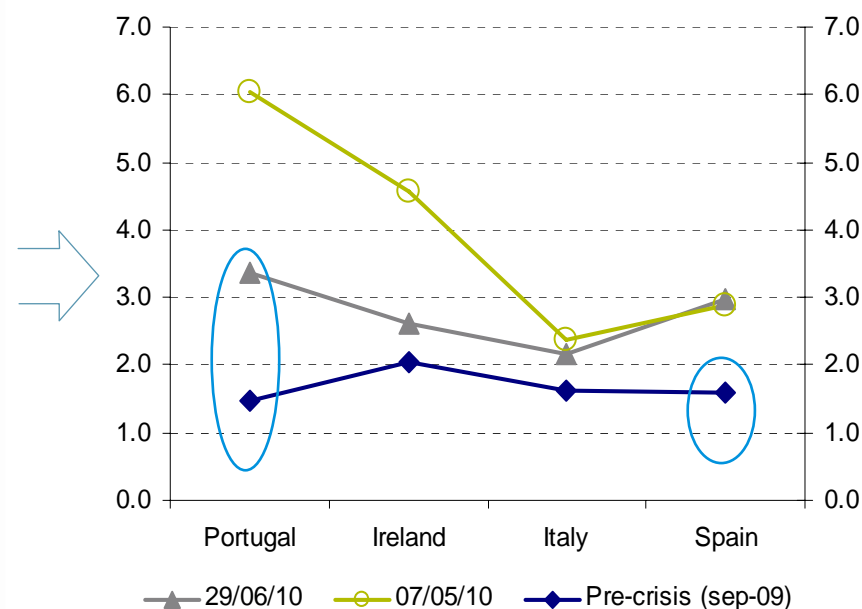
The focus is on the lagging economies, Spain and Portugal

“[...] Second, the Council is strongly committed to ensure fiscal sustainability and enhanced economic growth in all Member States and therefore agrees that plans for fiscal consolidation and structural reforms will be accelerated, where warranted. **We therefore welcome and strongly support the commitment of Portugal and Spain** to take significant additional consolidation measures in 2010 and 2011 and present them to the 18 May ECOFIN Council. **The adequacy of such measures will be assessed by the Commission in June in the context of the excessive deficit procedure.** The Council also welcomes the commitment to announce by the 18 May ECOFIN Council structural reform measures aimed at enhancing growth performance and thus indirectly fiscal sustainability henceforth.”

Source: EU Council's statement when SPV was approved

EMU countries: 2yr yield curve

Source: Bloomberg and BBVA Research



Significant fiscal efforts by these countries have resulted in no positive impact: signaling effect dominating

Forces shaping de recovery

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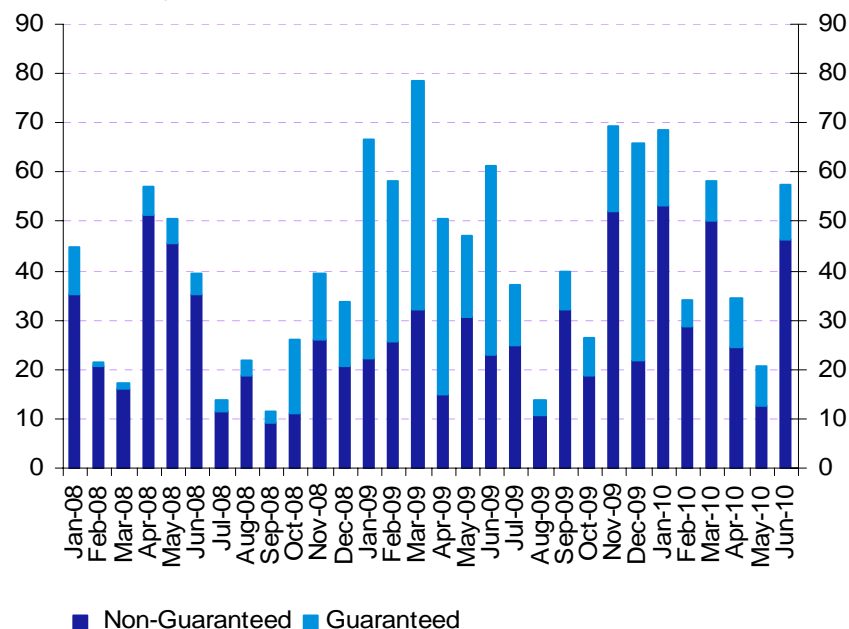
Liquidity dries up, setting the mechanism for contagion to the financial sector.

Liquidity dries up...

...particularly for the most affected economies

EMU banks debt issuance (€bn)

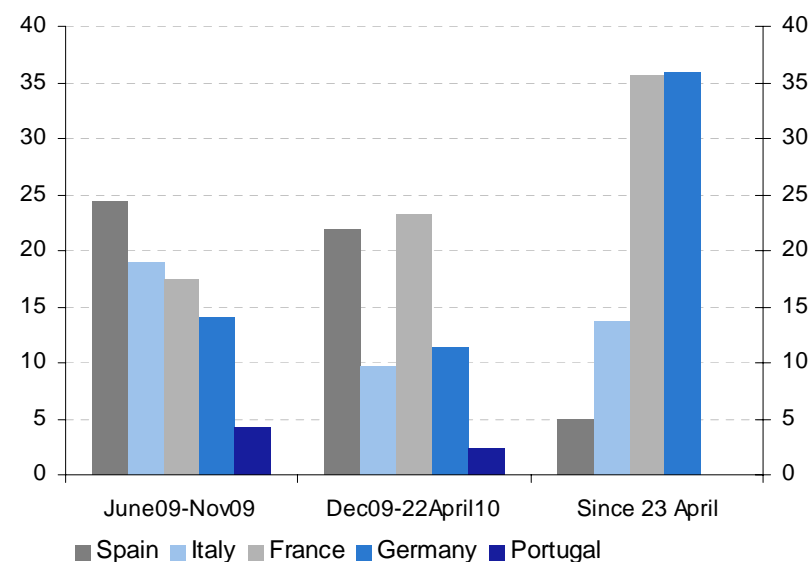
Source: Bloomberg and BBVA Research



Share of European bank debt issuance by country

* EX AB

Source: Bloomberg and BBVA Research



Forces shaping the recovery

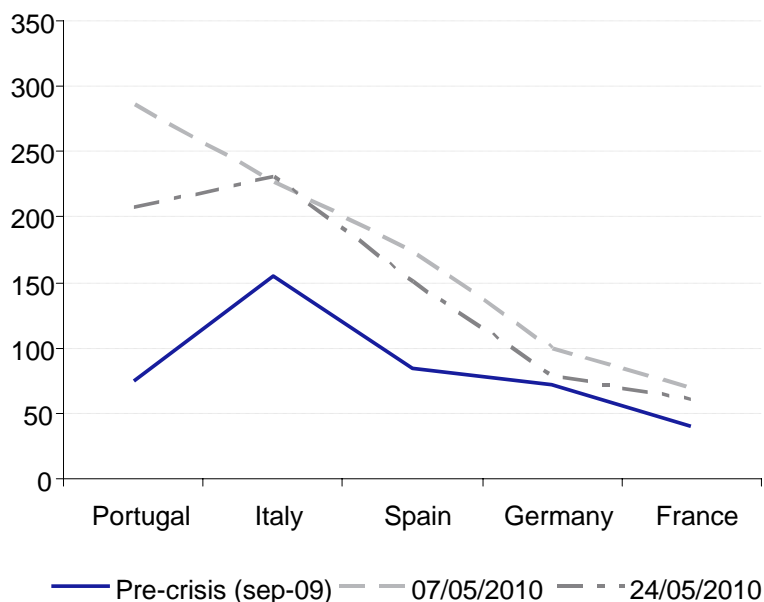
3

The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand

Additional fiscal adjustments and confidence effects imply a transmission to real activity.

5 year CDS: Flagship Telecoms

Source: BBVA Research



Markets are discounting a transmission even to the most defensive sectors, driven again by sovereign risk

Forces shaping the recovery

3

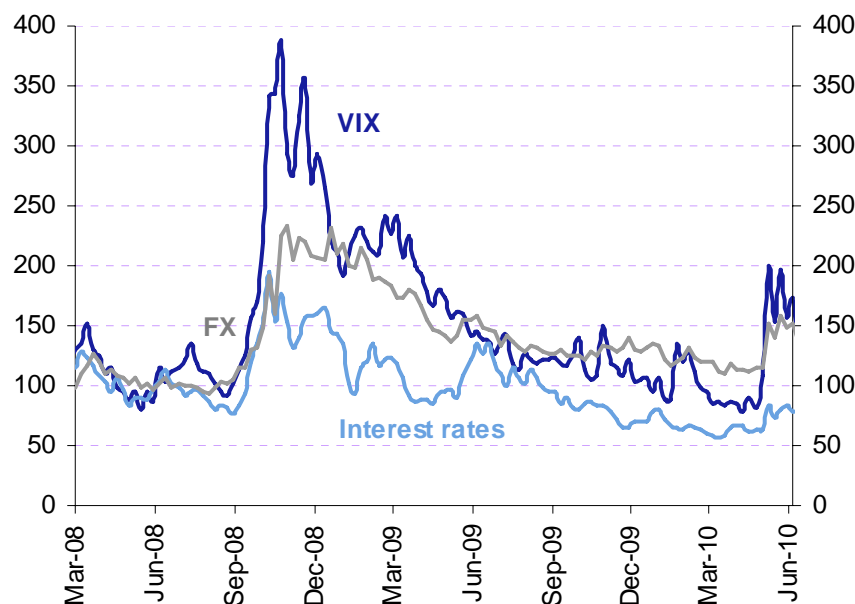
The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand

Europe is a global problem, potentially large impact on global cycle and disruption in financial markets

Short-term risks dominated by risk aversion and financial risks: generalization of financial tensions to the US in recent times

Implicit volatility measures of risk aversion

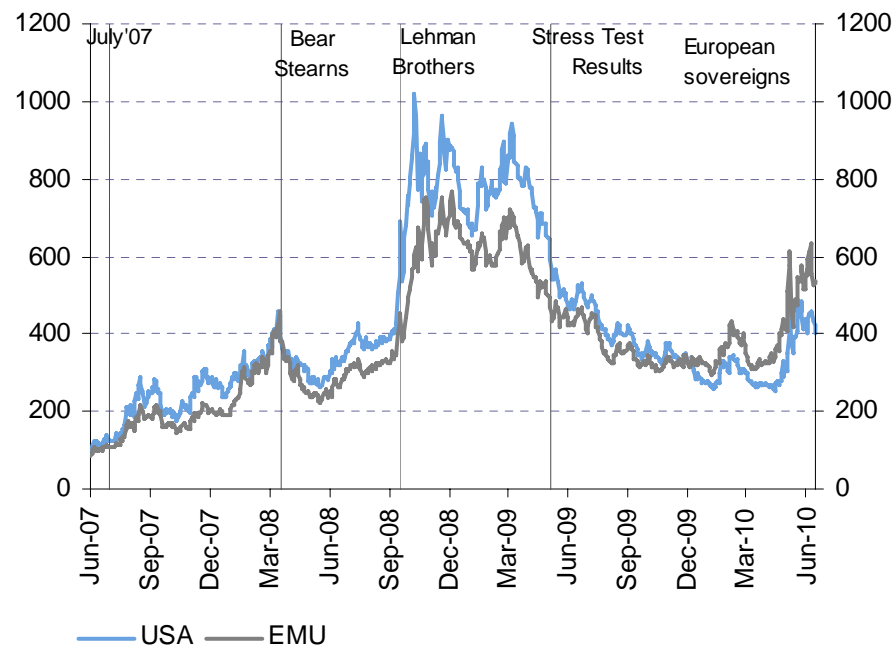
Source: Bloomberg and BBVA Research



Europe and US: financial tensions indicators

First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread

Source: Bloomberg and BBVA Research



Forces shaping the recovery

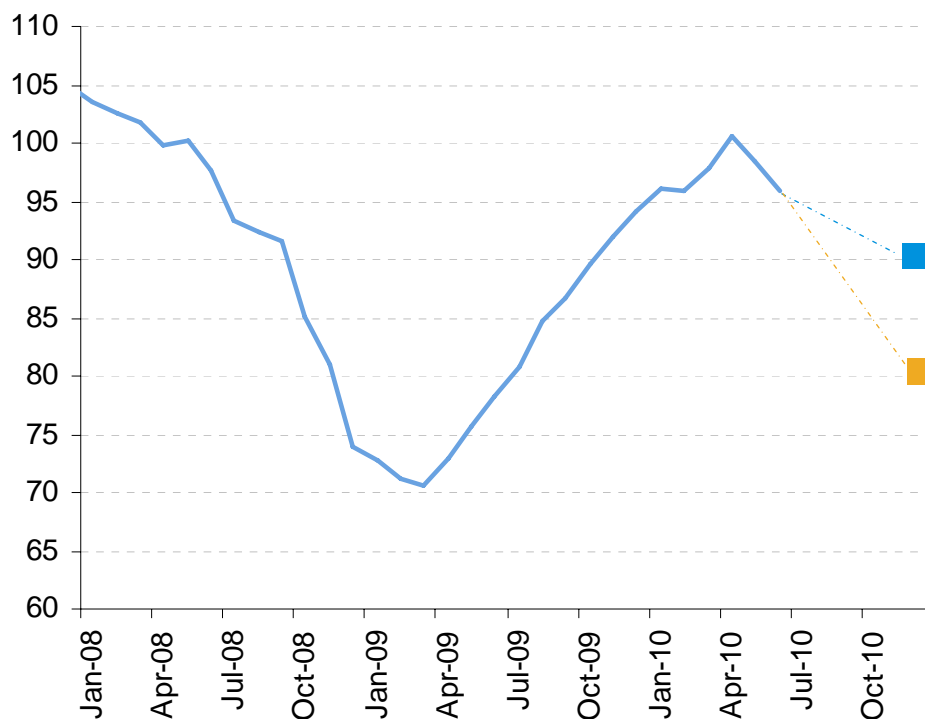
3

The sovereign debt crisis will have an effect on confidence and, in some countries, on financing costs. This will also affect domestic demand

And there is a clear risk that the European cycle turns out much worse than markets still expect, even assuming no outright impact of financial crisis (ie. default wave)

EU: Economic Sentiment Indicator

Source: BBVA Research



Scenario 1

Confidence falls as in pre-Lehman period ➡ -1pp effect on 2010 GDP

Scenario 2

Confidence falls as in recent Greek data ➡ -2 pp effect on 2010 GDP
(Risk scenario)

Forces shaping the recovery

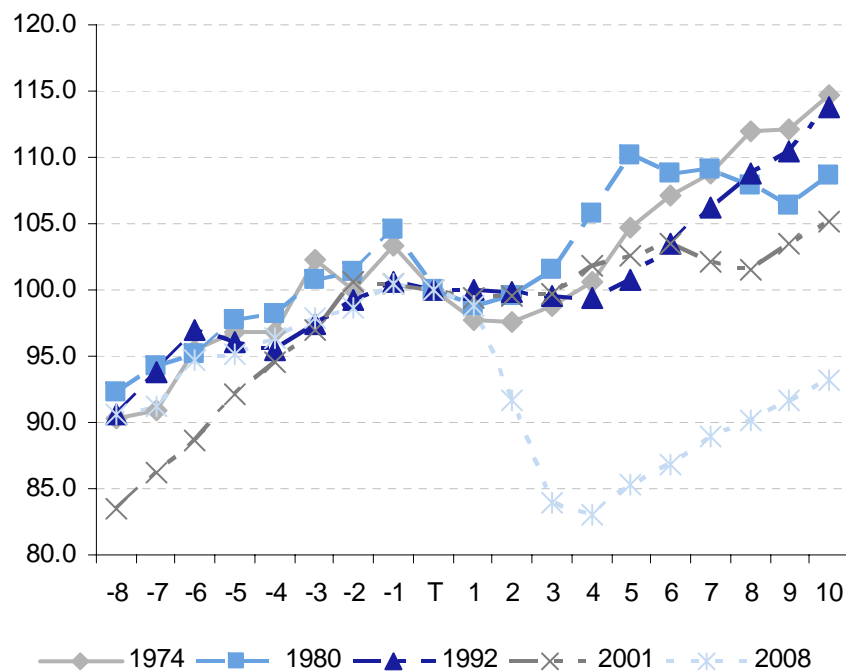
4

The scenario of an export-led recovery has been somewhat stronger than expected. Now the euro depreciation, which has taken the euro-dollar rate close to its long-term equilibrium, will help further

Exports are expected to increase robustly even before the stronger euro depreciation

Exports (Index; T=100; T=start of recession)

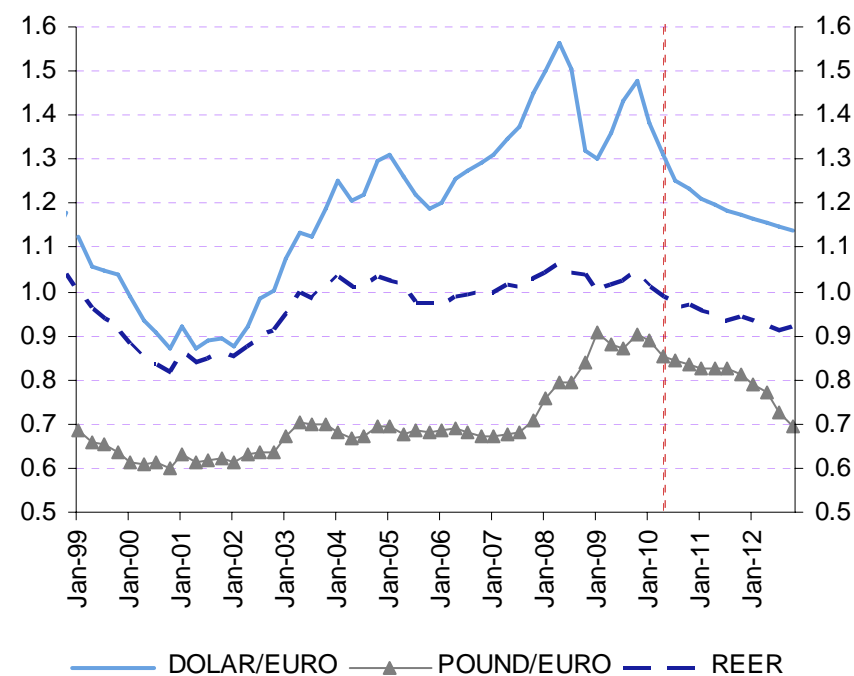
Source: AWM and BBVA Research



Euro is likely to continue to depreciate in coming months

Euro zone: Exchange rate

Source: BBVA Research



Forces shaping the recovery

4

The scenario of an export-led recovery has been somewhat stronger than expected. Now the euro depreciation, which has taken the euro-dollar rate close to its long-term equilibrium, will help further

A sustained 10% euro depreciation in 2010



Higher than expected GDP growth by around

**0.5%
in 2010**

**1.3%
in 2011**

The depreciation of the euro should offset clearly the contractive effect from the fiscal consolidation, supporting the eurozone upturn

Forces shaping the recovery

5

The reform in Europe may also help on the positive side, although more on a longer term basis. As often in the history of European integration, crisis are driving the EU to further cooperation – in this case on the fiscal front. The SPV is a steep forward

Country	Status	% Capital
Germany	Approved	27.9%
France	Approved	21%
Spain	Approved	12%
Austria	Approved	3%
Portugal	Approved	2,6%
Italy	Approved	18.4%
Netherlands	2nd vote	5.9%
Finland	Pending	1.8%
Belgium	Expected before 21 June	3.6%
Others	Pending	3.7%

Activation of SPV requires 90% of capital key approval. This is proceeding quickly. Should be ready in coming weeks. However, legal basis for SPV functioning increasingly in place, doubts about implementation remain

84% already approved

90% when Netherlands passes second vote

Margin in other countries where quick approval is expected

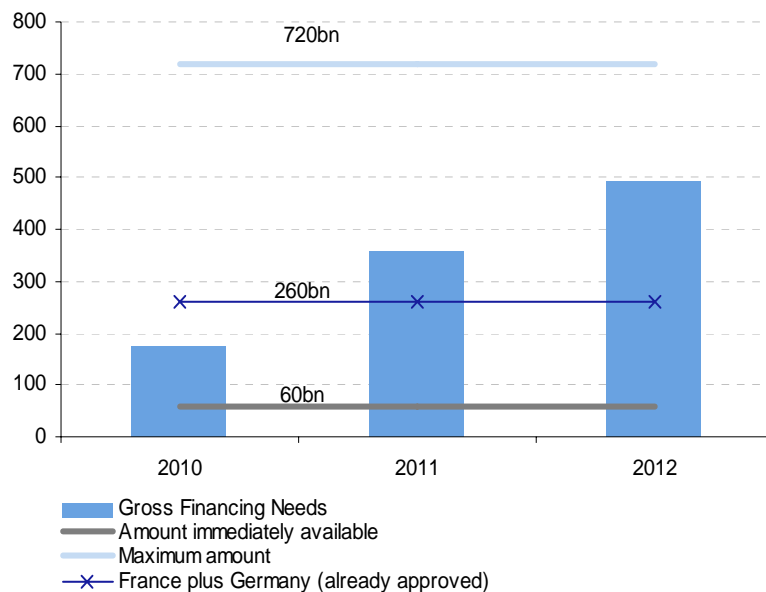
Forces shaping the recovery

5

The reform in Europe may also help on the positive side, although more on a longer term basis. As often in the history of European integration, crisis are driving the EU to further cooperation

Spain plus Portugal: accumulated gross financing needs (bn.EUR)

Source: BBVA Research

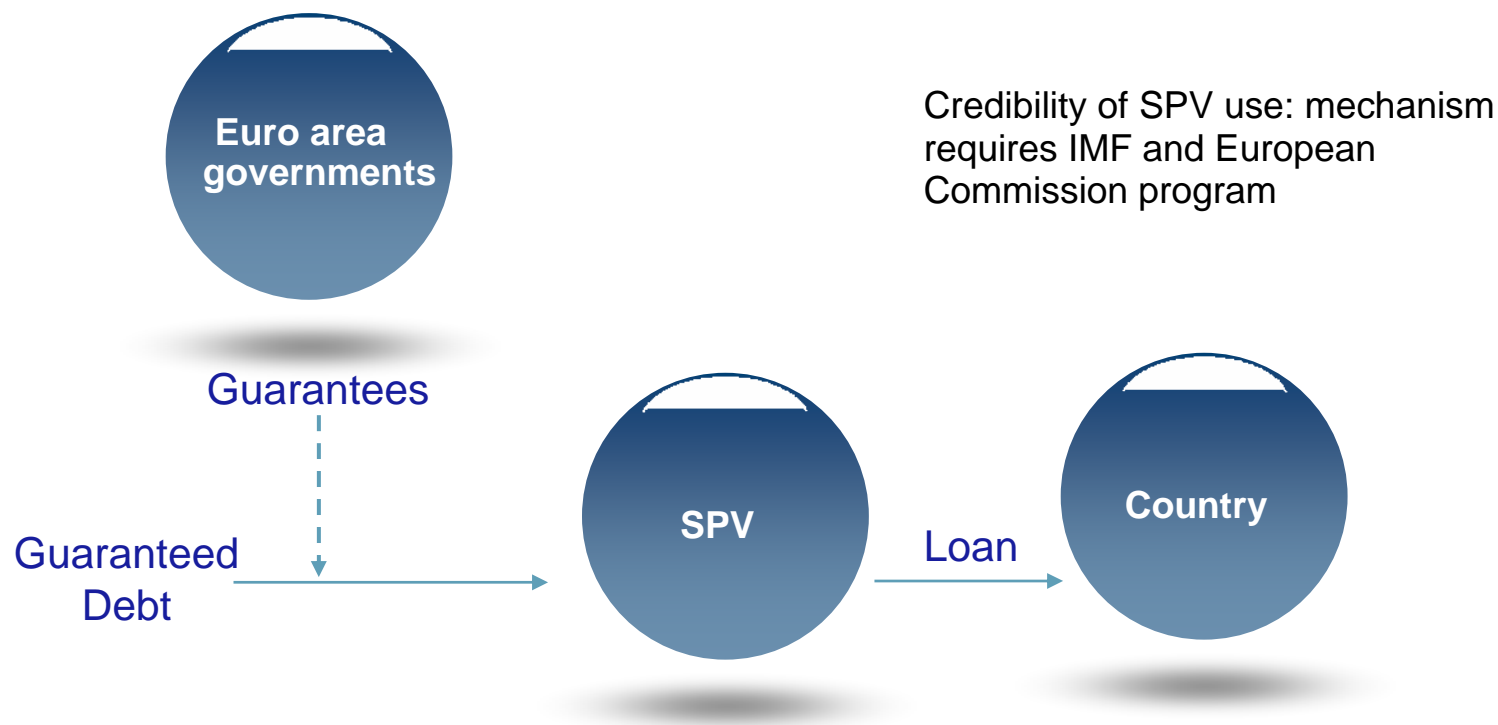


Credibility of SPV use: the total amount of funds approved is large enough, initial issuance of debt could dispel doubts

Forces shaping the recovery

5

The reform in Europe may also help on the positive side, although more on a longer term basis. As often in the history of European integration, crisis are driving the EU to further cooperation



1. Activation of SPV loans requires:

- Country “in difficulty”
- Join program with IMF, EC

2. Funding needs to be assessed jointly by IMF, ECB and Commission

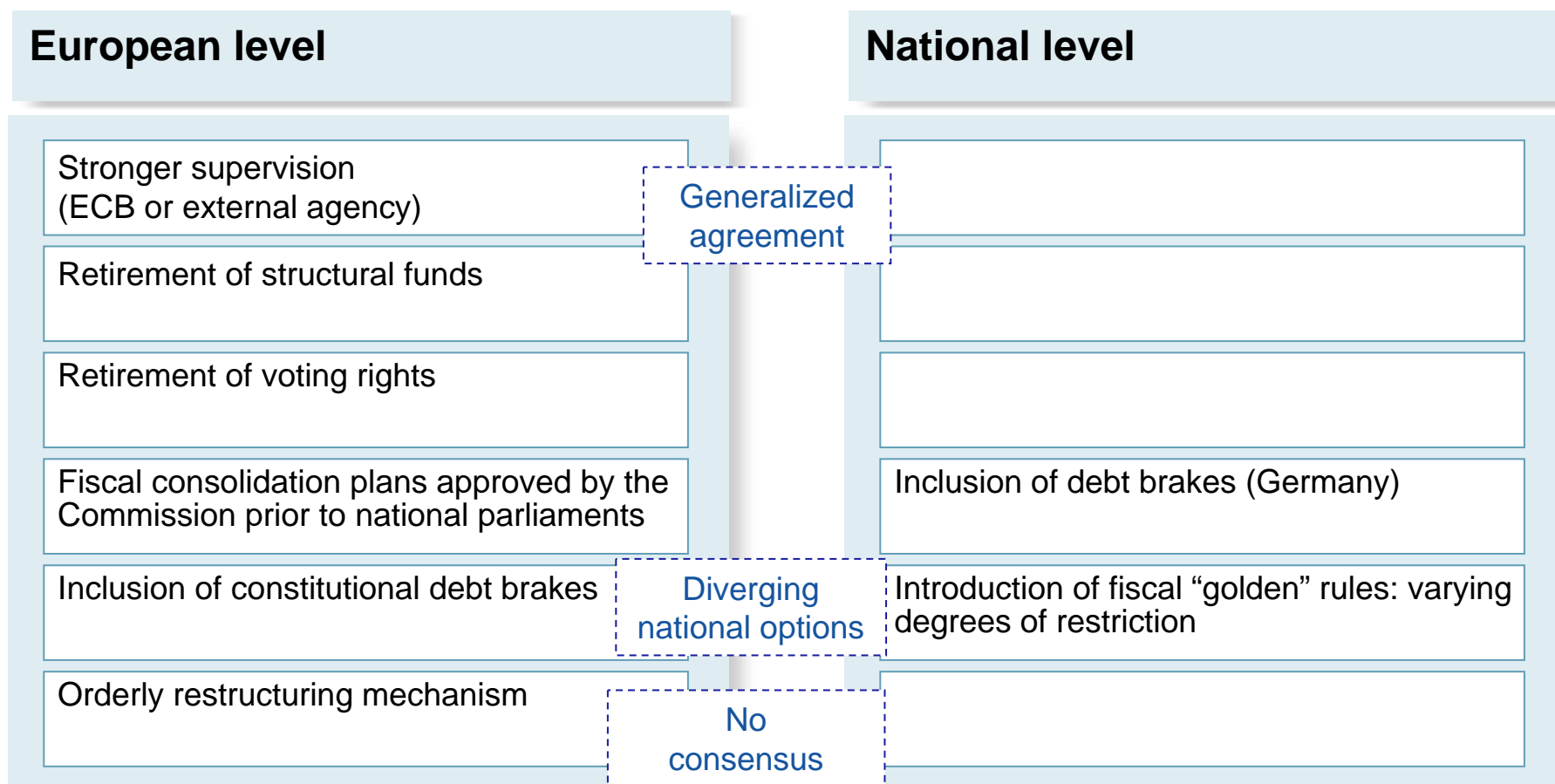
Forces shaping the recovery

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The reform in Europe may also help on the positive side, although more on a longer term basis. As often in the history of European integration, crisis are driving the EU to further cooperation

Reinforcing
fiscal rules

Strength of fiscal rules: the proposals go in the right direction



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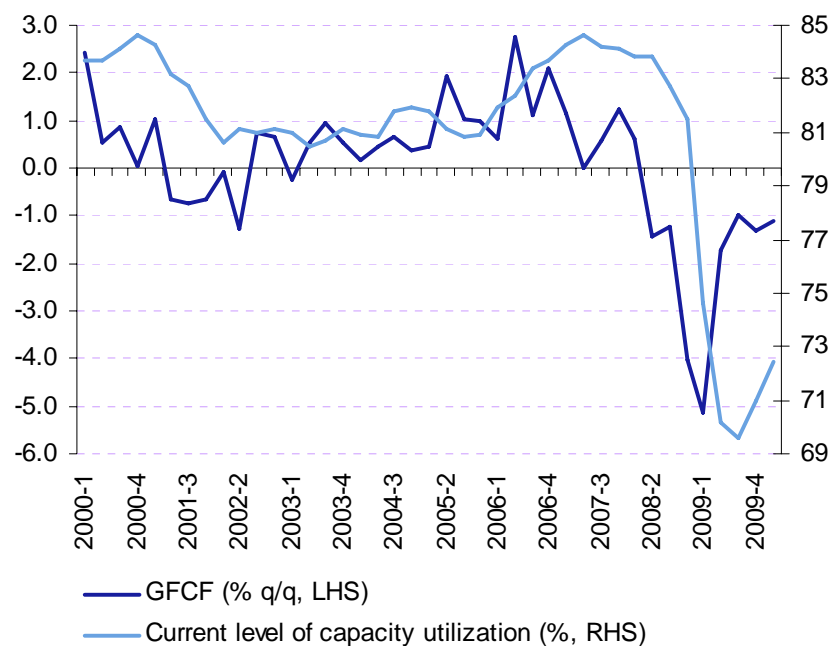
A very slow recovery, while uncertainty increases

Domestic demand was subdued, due to sharp contraction in investment and flat private consumption

Investment continues to fall, but at slower pace. The low capacity utilization is behind this weakness, together with the high uncertainty surrounding the recovery

Eurozone: Investment and capacity utilization

Source: Eurostat and European Commission

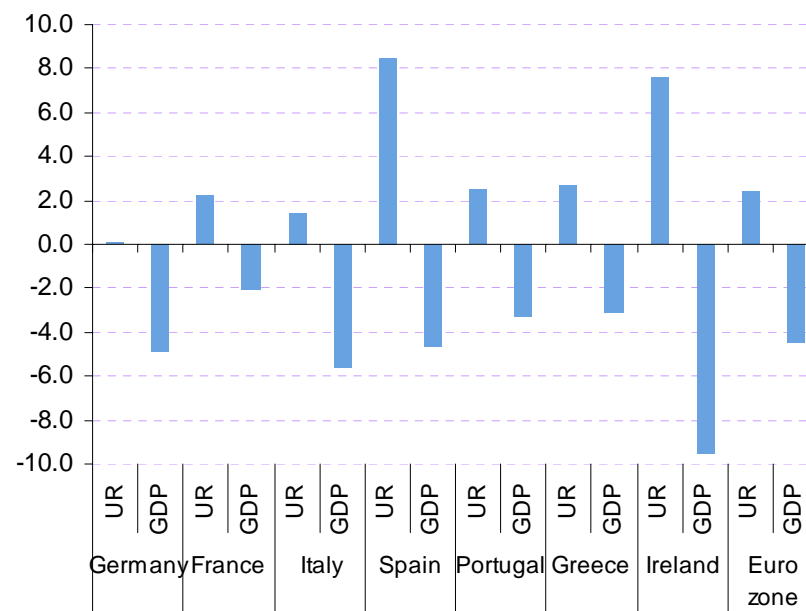


Unemployment rate in the eurozone increased around 2.5pp since mid-2008 to hit 10% in Q1.

The worsening of different national labour markets has been very uneven

Unemployment rate increase and GDP fall (since Q2 2008)

Source: Eurostat



A very slow recovery, while uncertainty increases

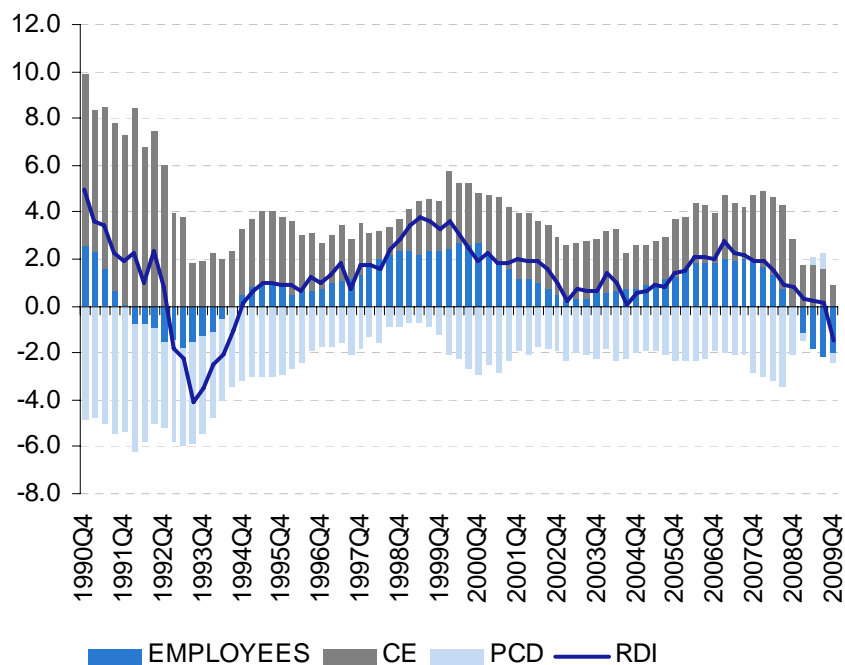
Domestic demand was subdued, due to sharp contraction in investment and flat private consumption

Job losses, coupled with lower growth in wages, resulted in lower households' disposable income which hit households' spending despite the moderation of consumer prices

In contrast with other economic downturns, the weakness of households' consumption is being much more protracted

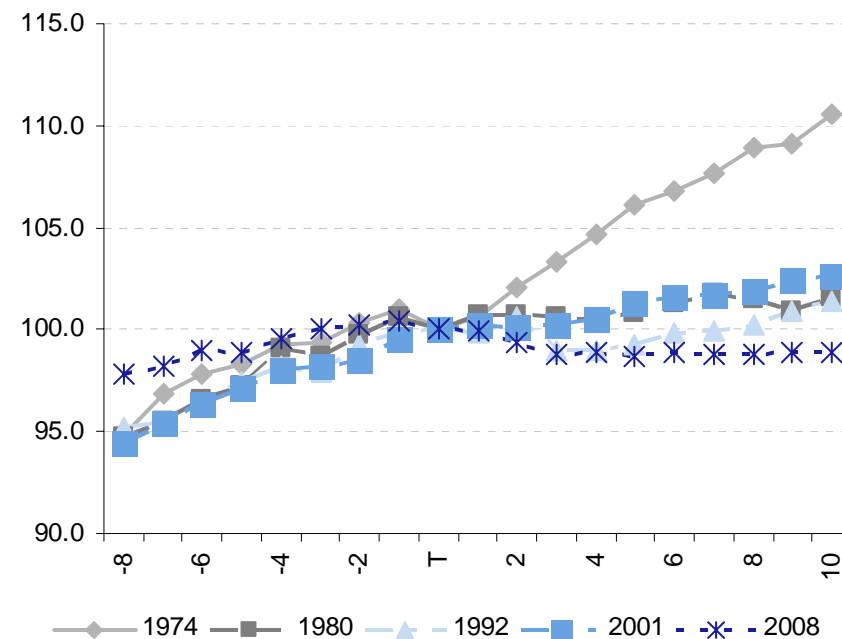
Eurozone: Real Disposable income (% y/y)

Source: ECB and BBVA Research



Private consumption, Index, T=100 start of recession

Source: AWM and BBVA Research



A very slow recovery, while uncertainty increases

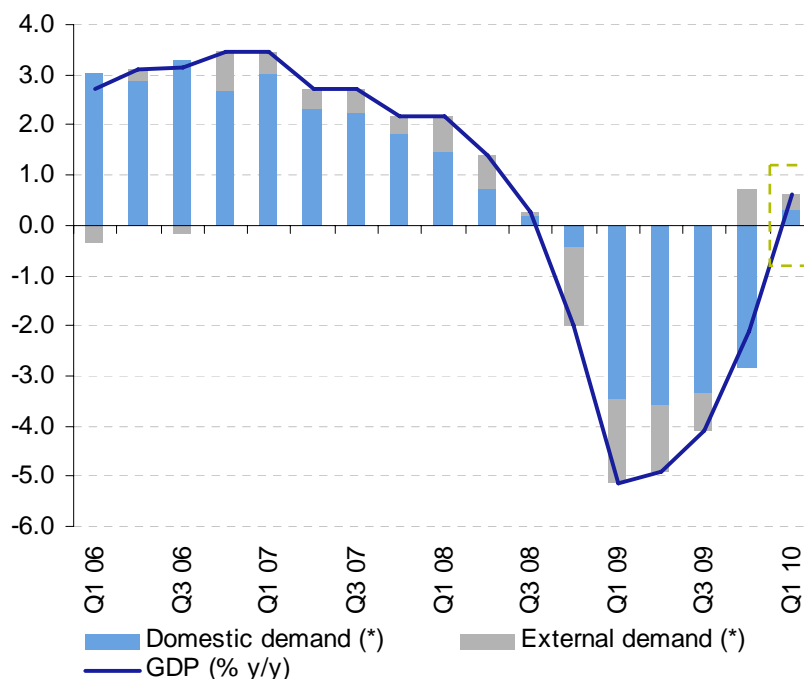
Strong exports supported for the strength of the industrial sector

Net exports contributed positively to GDP growth since Q2 2009, cushioning the sharp decline of economic activity

The growth in external demand has supported the recovery of industrial sector

Euro zone: Contribution to yoy GDP growth

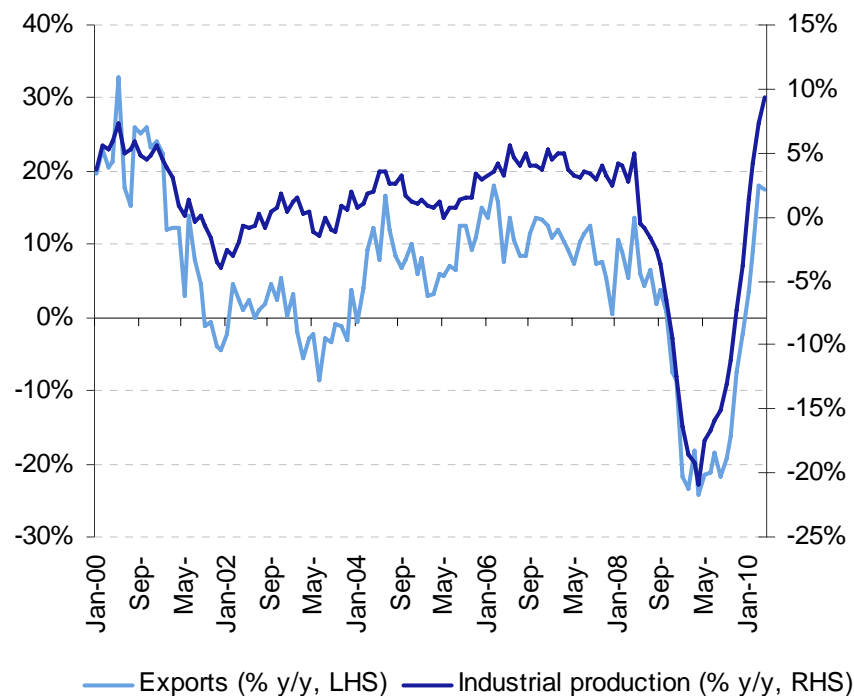
Note: (*) Contribution to yoy GDP growth
Source: ECB and BBVA Research



Lower contribution despite strong exports growth, as imports surged linked with rebuilding inventories

Eurozone: Exports and Industrial production

Source: Eurostat



A very slow recovery, while uncertainty increases

EURO AREA GDP					
	% q/q				
	Q109	Q209	Q309	Q409	Q110
Private consumption	-0.6	0.1	-0.2	0.2	-0.1
Public consumption	0.7	0.7	0.7	0.0	0.6
GFCF	-5.1	-1.7	-1.0	-1.3	-1.1
Change inventories (*)	-1.1	-0.6	0.5	0.1	0.9
Internal demand (*)	-2.4	-0.7	0.4	-0.1	0.8
Exports	-8.4	-1.1	2.8	1.7	2.5
Imports	-8.1	-2.7	2.8	1.2	4.0
External demand (*)	-0.1	0.6	0.0	0.2	-0.6
GDP	-2.5	-0.1	0.4	0.1	0.2

(*) Contribution to GDP growth

Domestic demand was subdued, due to sharp decline in investment and flat private consumption...

...offset partly by rebuilding inventories

Lower contribution despite strong exports growth, as imports surged linked with rebuilding inventories

Net exports contributed positively to GDP growth since Q2 2009, cushioning the sharp decline of economic activity

A very slow recovery, while uncertainty increases

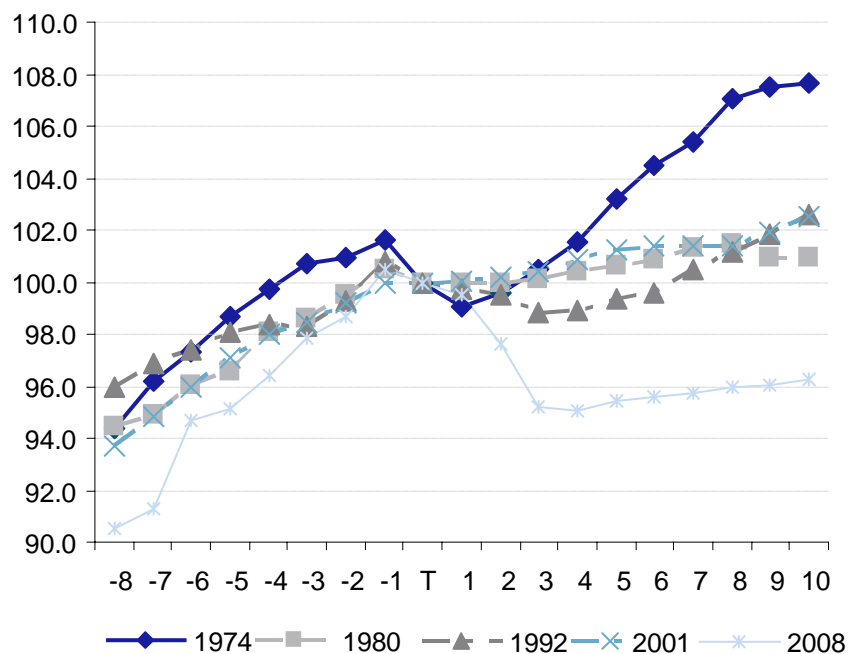
The first steps of recovery are still modest and slower than in previous episodes

The eurozone recovery is being slower...

...with member states bouncing back at different speeds

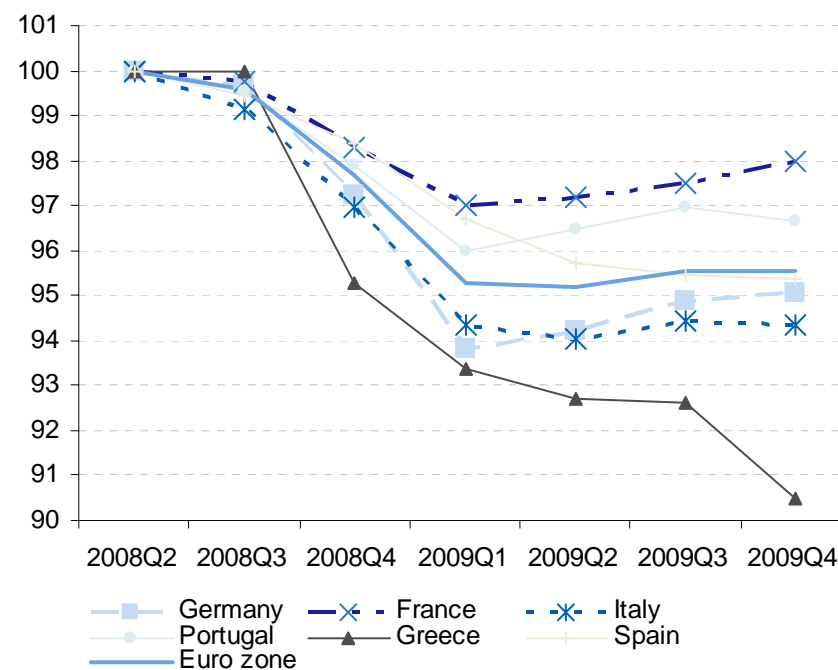
GDP (Index; T=100; T=start of recession)

Source: AWM and BBVA Research



GDP (Index, T=100, T=2008Q2)

Source: Eurostat and BBVA Research



A very slow recovery, while uncertainty increases

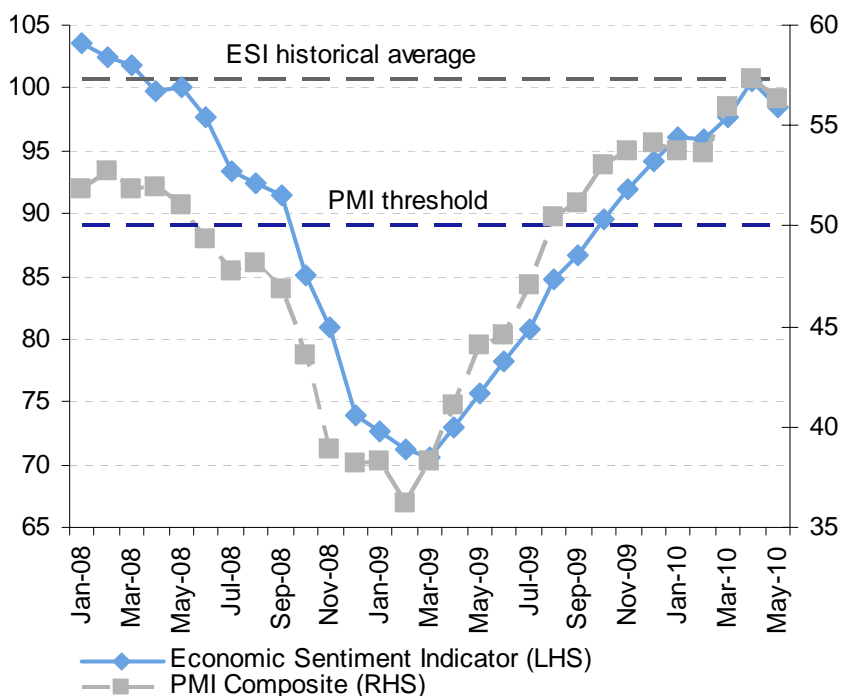
The eurozone economic recovery is gaining momentum in Q2, but the sovereign debt crisis and the announcement of a fiscal retrenchment are beginning to weigh on economic agents' confidence, highlighting the fragility of the recovery

Sentiment indicators fell in May, interrupting the upward trend observed since Q2 2009, but remaining well above levels printed in Q1

Our synthetic activity indicator suggests GDP growth in Q2 should be stronger than that observed in Q1

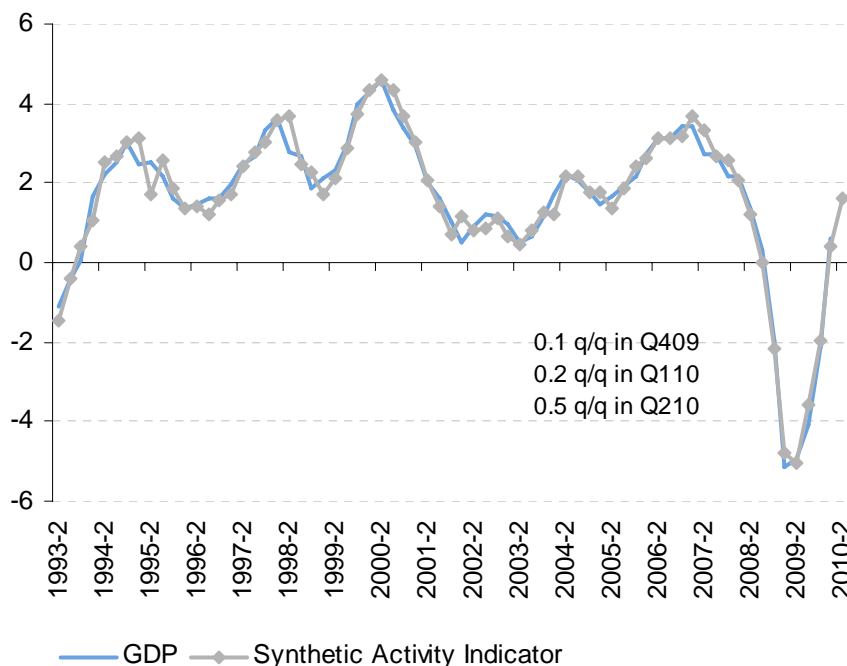
Euro zone: Economic confidence

Source: European Commission and Markit Economics



Eurozone: GDP (% y/y)

Source: Eurostat and BBVA Research



A very slow recovery, while uncertainty increases

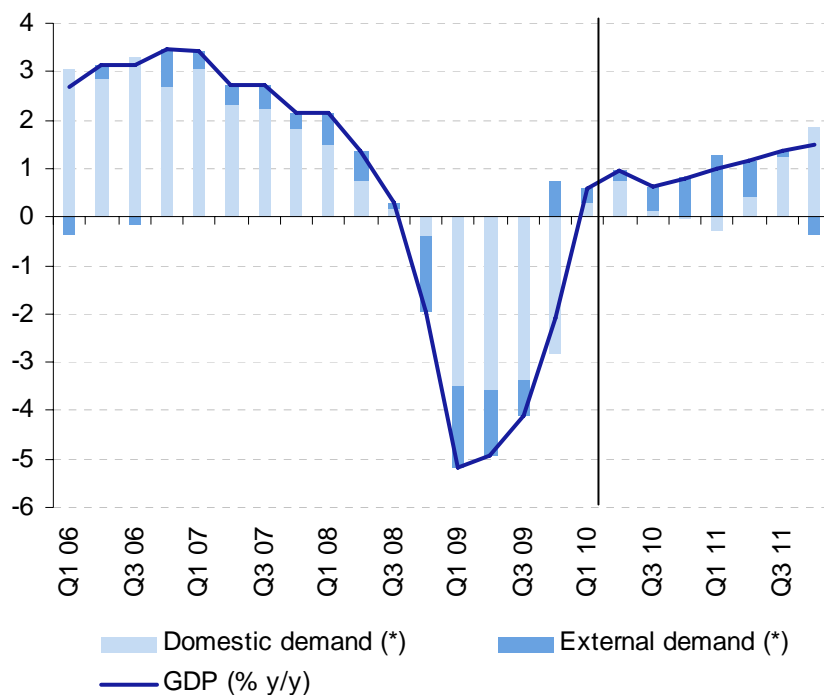
The robustness of the recovery in the eurozone is yet to be tested, as some factors behind it were temporary and the support of exports will depend on the strength of the global recovery

We expect eurozone GDP to grow at 0.7% in 2010 and 1.3% in 2011

With a heterogeneous recovery across member states

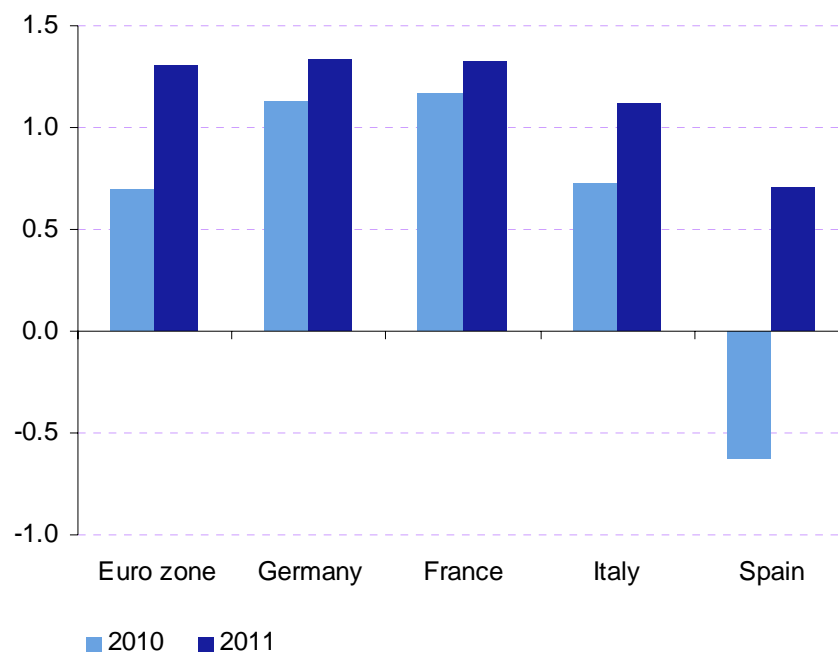
Euro zone: Contribution to yoy GDP growth

Note: (*) Contribution to yoy GDP growth
Source: Eurostat and BBVA ERD



GDP growth (% y/y)

Source: BBVA Research



A very slow recovery, while uncertainty increases

EURO AREA GDP																
	% q/q												Annual growth			
	Q109	Q209	Q309	Q409	Q110	Q210	Q310	Q410	Q111	Q211	Q311	Q411	2009	2010	2011	2012
Private consumption	-0.6	0.1	-0.2	0.2	-0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.2	-1.2	0.1	0.6	0.9
Public consumption	0.7	0.7	0.7	0.0	0.6	0.0	-0.1	-0.2	0.3	0.1	0.5	0.1	2.7	1.0	0.5	0.6
GFCF	-5.1	-1.7	-1.0	-1.3	-1.1	-0.1	-0.2	-0.1	0.6	0.3	0.3	0.4	-10.9	-3.2	0.9	1.5
Change inventories (*)	-1.1	-0.6	0.5	0.1	0.9	-0.3	-0.3	-0.2	0.3	0.1	0.2	0.1	-0.8	0.7	0.2	0.2
Internal demand (*)	-2.4	-0.7	0.4	-0.1	0.8	-0.3	-0.3	-0.3	0.5	0.4	0.5	0.3	-3.3	0.3	0.8	1.1
Exports	-8.4	-1.1	2.8	1.7	2.5	1.4	1.7	1.6	1.9	1.7	2.6	2.0	-13.2	7.4	7.6	7.8
Imports	-8.1	-2.7	2.8	1.2	4.0	0.1	0.9	0.5	2.2	1.8	3.4	2.0	-11.9	6.4	6.8	7.6
External demand (*)	-0.1	0.6	0.0	0.2	-0.6	0.5	0.3	0.5	-0.1	0.0	-0.3	0.0	-0.8	0.5	0.4	0.2
GDP	-2.5	-0.1	0.4	0.1	0.2	0.3	0.1	0.3	0.4	0.4	0.3	0.4	-4.1	0.7	1.3	1.4

(*) Contribution to GDP growth

Source: BBVA Research

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ECB exit strategy as gradual as possible, ready to give support

Although the ECB started to design the process of liquidity withdrawal in December 2009, it has taken several steps in order to maintain financial stability

Sustainability problems of public finance in Greece

Greek problems triggered higher risks in sovereign debt market in other eurozone economies



Greek collateral rules relaxed in March

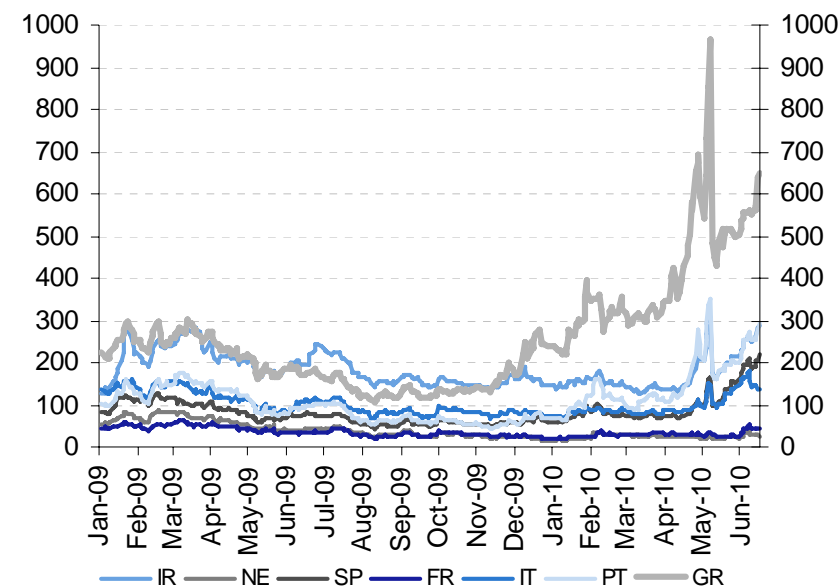
Financial Tensions Indicator 100 = January-07

First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread
Source: BBVA Research



Sovereign spreads: 10yr bond (bps)

Source: BBVA Research



ECB exit strategy as gradual as possible, ready to give support

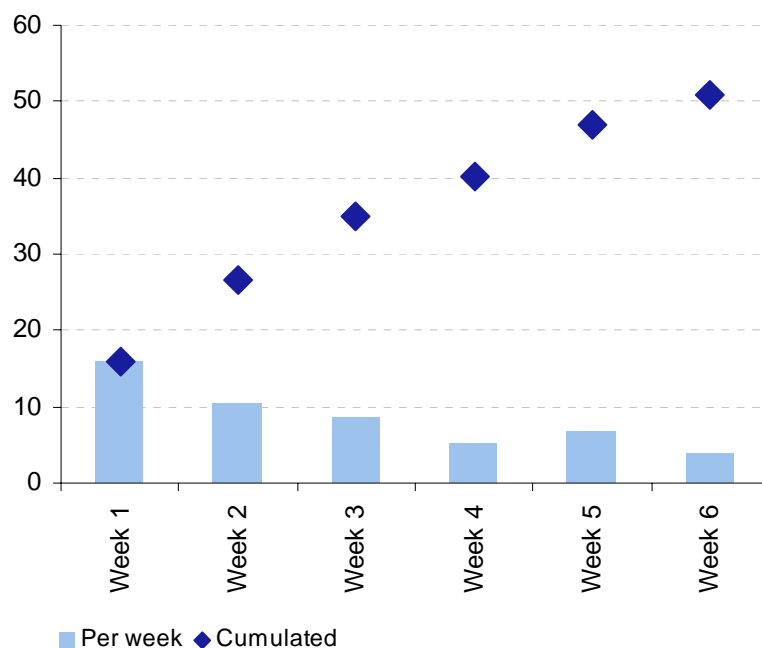
Although the ECB started to design the process of liquidity withdrawal in December 2009, it has taken several steps in order to maintain financial stability

Bond purchases have been stepped down quite fast

Even at this pace, the ECB would accumulate too much exposure relative to its preference

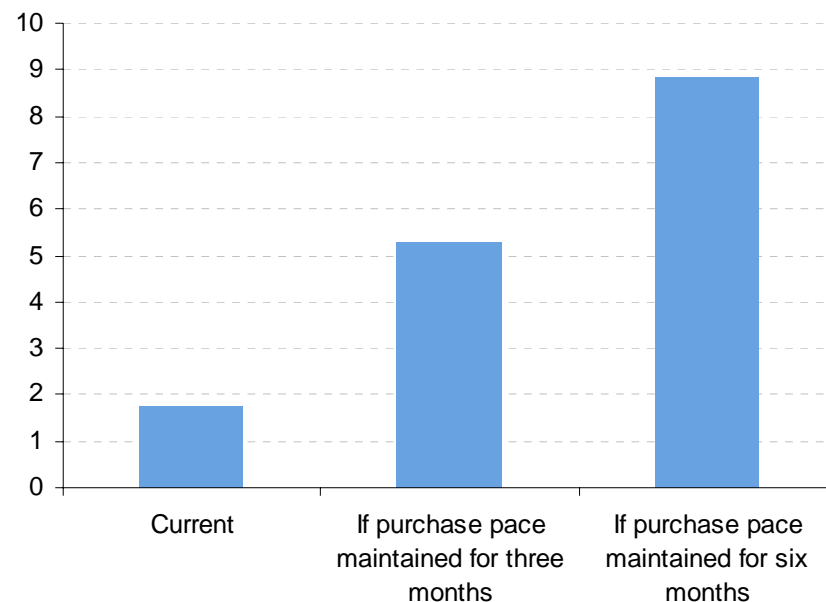
ECB: sovereign bond purchase program

Source: BBVA Research



ECB: Share of Government Debt on Balance-sheet (%)

Source: BBVA Research



ECB exit strategy as gradual as possible, ready to give support

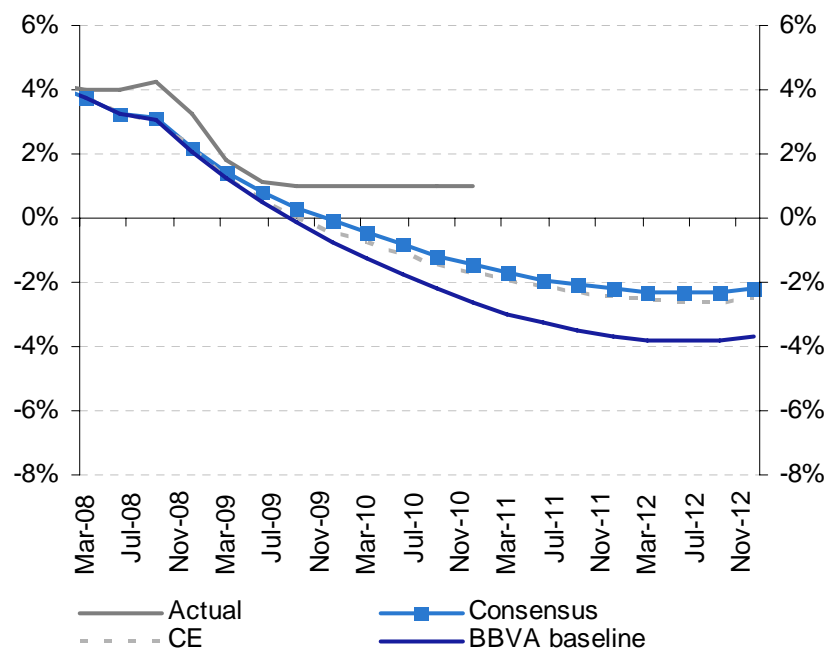
Refi interest rate to be unchanged until end-2011, helping to sustain activity as inflation is under control

After June's meeting, the ECB stands ready to continue providing liquidity to financial system, suggesting that monetary policy should be accommodative in coming months, supporting a tighter fiscal stance and reducing the risk of a financial meltdown

Taylor rule suggests that interest rate should remain at very low levels for a protracted period

Forward-Looking Taylor Rule: EMU

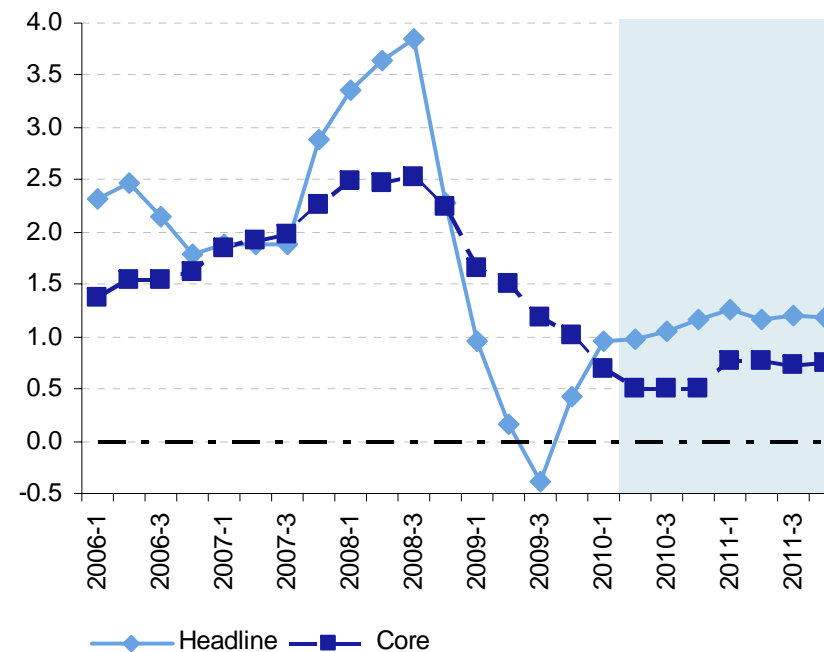
Source: ECB and BBVA Research



There is no inflationary pressures

Euro zone: Inflation (% y/y)

Source: Eurostat and BBVA Research



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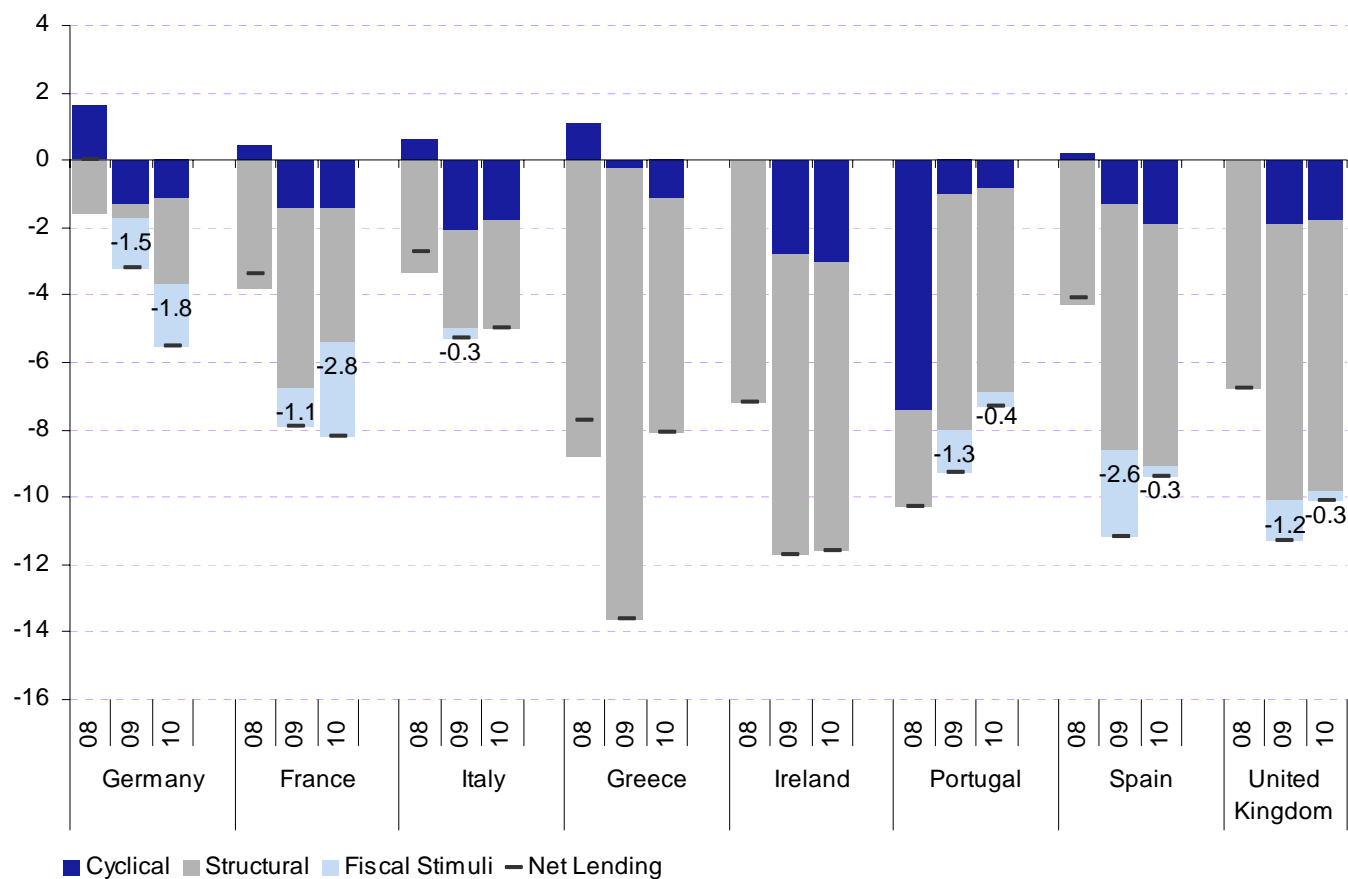
Strong fiscal consolidation, but with small negative effect on growth

Strong fiscal consolidation, but with small negative effect on growth

The response to deep recession with a stimulus and lower revenues of a permanent nature have resulted in sharp increases of public deficits

Fiscal deficits by components by countries % of GDP

Source: National Sources, European Commission and BBVA Research



Section IV

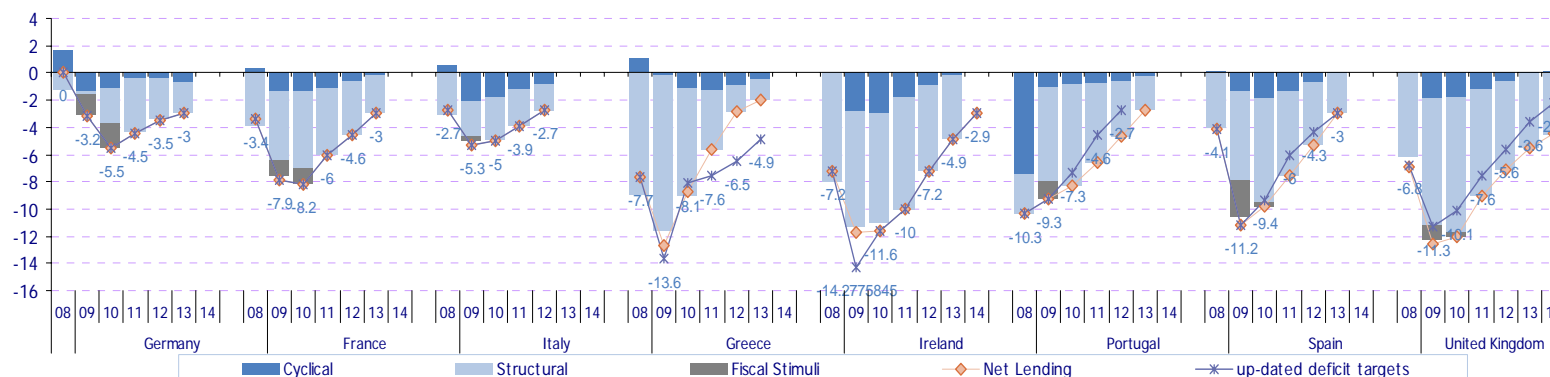
Strong fiscal consolidation, but with small negative effect on growth

The adjustment is taking place in general in line with the Stability programmes, not faster

The risk of large impact on GDP is small in large countries

Fiscal deficits projected paths

Source: National Sources, European Commission and BBVA Research



Source: National Sources, European Commission and BBVA Research

Several risks ahead for fiscal consolidation, although none of them very large:

- Interest rate risk
- Cyclical risk around economic growth projections and the effect of fiscal consolidation in growth in the short-run
- Implementation risk

A close-up photograph of a magnifying glass with a gold-colored frame. The lens is positioned over a map of Europe, which is slightly out of focus. The magnifying glass's handle is dark and textured. The background is a soft, blurred mix of colors, suggesting an indoor setting with natural light.

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