Europe’s Economic Perspectives in a Global Context

HKFFIA Speaker Luncheon
Hong Kong, 5 March 2013

Alicia Garcia Herrero
Chief Economist for Emerging Markets
Key themes

• The perception regarding the prospects of the global economic scenario has improved as a result of a relaxation of financial tensions, particularly in Europe, and the last-minute agreement to side-step the fiscal cliff in the US.

• Improvement in Europe’s financial tensions rooted on (i) ECB initiative, (ii) Greek rescue, (iii) steps towards banking union, (iv) big adjustment of periphery

• We expect a stagnant European economy for 2013 (0.3% in the eurozone as a whole), led by Germany but with the periphery still in recession.

• This stagnant but still positive scenario is, however, not absent of risks: Political instability in Italy, the banking union project stalling, Greek debt sustainability, the Cyprus’s situation.

• Spain’s economy should have bottomed and proceeding with banking restructuring. However, it is still very dependent on the above risks.
Contents

Section 1
Global economy: better mood and lower tail risks

Section 2
Eurozone: financial and fiscal drivers for the outlook

Section 3
Outlook: very slow recovery for 2013 and 2014

Section 4
Risks to baseline scenario: still tilted to the downside

Section 5
What about Spain?
The perception of the global economic scenario improves

The ease in financial stress drives an improvement in global economic activity
Global growth will accelerate in 2013 and 2014...

Improved confidence boosts activity

Progress in governance in Europe and further agreements on the US fiscal deficit are necessary conditions for recovery

The most extreme risk scenarios are less likely now thanks to the response by economic policies
... but growth looks set to remain uneven across regions

GDP growth (% yoy)
Source: BBVA Research

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>3.6</td>
<td>4.1</td>
</tr>
<tr>
<td>USA</td>
<td>1.8</td>
<td>2.3</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Eagles</td>
<td>5.8</td>
<td>6.1</td>
</tr>
</tbody>
</table>

2013: Feb-13 - Nov-12
Contents

Section 1
Global economy: better mood and lower tail risks

Section 2
Eurozone: financial and fiscal drivers for the outlook

Section 3
Outlook: very slow recovery for 2013 and 2014

Section 4
Risks to baseline scenario: still tilted to the downside

Section 5
What about Spain?
Eurozone: Gloomy outlook, but tail risks fade

<table>
<thead>
<tr>
<th>Key drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECB's OMT dispelled fears about the break-up of the euro</td>
</tr>
<tr>
<td>New agreement on Greek debt</td>
</tr>
<tr>
<td>Progress towards a banking union does not disappoint</td>
</tr>
<tr>
<td>Improvement in financial conditions, though tensions persist</td>
</tr>
<tr>
<td>Current account adjustment in the periphery really happening</td>
</tr>
</tbody>
</table>
ECB: decisive commitment to avoid a euro break-up

**Main positives**

1. **A shift in ECB attitude** towards financial market failure, implying a change in expectations
   1. 
2. **Very significant reduction of market risk of euro break-up**
3. **Sufficient backstop** that surpasses the limited amounts of the available rescue funds (ESM)

**Caveats**

1. **The OMT is a conditional backstop**:
   - Needs to be requested
   - Countries need to fulfill conditionality
   - ECB has to show commitment to maintain it if countries miss part of the conditionality
2. **The Bundesbank opposition** reduces the margin of manouvre of the ECB for further decisions.
Greece: More support to improve debt sustainability

**Detail of Greek deal**

- Main measures are: debt buyback (reducing debt by 11.2pp of GDP by 2024), lower rates (2.5pp) and foregone ECB profits (4.4pp).
- Debt to GDP ratio close to 124% of GDP in 2020, declining to 118% in 2022.
- **Significance:**
  - Clear signal by the eurozone that it will not let countries go from the euro
  - Temporary relief for 2013. A further restructuring of official sector debt may be reopened after German elections
  - Still many uncertainties on long term-debt sustainability

---

**Public debt (% GDP)**

Source: BBVA Research
Banking Union: 2 out of 4 pillars on track

Good news, but more is needed. Stick to agreed calendar

- Single rulebook
  - Necessary but insufficient

- Single Supervisor (SSM)
  - Will stop regulatory ringfencing but insufficient

- Single Resolution Mechanism (SRM)
  - ESM direct bank recapitalisation (Eurogroup, June 2013)
    - Probably not for this crisis. Legacy assets should be dealt with earlier.

- Single Deposit Guarantee Fund (DGS)
  - The great ignored/unknown

- 2012-2013: ✔️
- 2013-2014: ✔️
- 2014-2015: 📅
- ?
With lower tail-risk, uncertainty in the periphery remains high but contained...

10y sovereign spread vs. Germany (bps)

Source: BBVA Research
Some periphery banks are issuing debt...

The biggest peripheral banks achieved cheaper funding than their sovereigns, but heterogeneity remains.

Will the reopening of bank bond markets in Ireland and Portugal signal a return to more normal funding conditions in Europe?

The better market sentiment and strong investor demand is also allowing banks to move up the credit curve, with longer-dated issues, and even some bank have issued subordinated debt.

EMU banks debt issuance*: market share (%)
Source Bloomberg and BBVA Research

*Non-guaranteed debt
Core countries: Germany, France, Netherlands, Austria, Belgium and Finland
Capital is starting to go again towards the periphery

Spanish and Italian public debt held by non-residents* (as % of total debt)

*Ex-ECB. Term investment portfolio
Source: Bloomberg and BBVA Research

Spanish and Italian debt held by foreigners. EUR bn. monthly variation
Source: Spanish Tesoro and BBVA Research
Financial fragmentation lower but still high

* Components: (i) the cross country coefficient of variation of bank lending rates to corporates and households (average) (ii) the Target 2 balances of surplus (iii) gross liquidity provision by Eurosystem as a share of bank assets and (iv) the interquartile range of Euro area countries’ two-year government bond yields. To combine these varied indicators, we calculate a Z-score for each, and then estimate the first principal component of these Z-scores.
Ongoing fiscal consolidation still sizable in 2013

Fiscal slippages likely but EC also more permissive

General Government deficit and fiscal effort (% of GDP)
Source: Eurostat and BBVA Research

<table>
<thead>
<tr>
<th></th>
<th>Fiscal consolidation (% GDP)</th>
<th>Public deficit (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2012</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.2</td>
<td>-0.1</td>
</tr>
<tr>
<td>France</td>
<td>1.1</td>
<td>-0.2</td>
</tr>
<tr>
<td>Italy</td>
<td>1.9</td>
<td>-0.1</td>
</tr>
<tr>
<td>Spain**</td>
<td>4.3</td>
<td>-0.1</td>
</tr>
<tr>
<td>Portugal*</td>
<td>3.7</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>2013</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>-0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>France</td>
<td>1.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Italy</td>
<td>1.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Spain**</td>
<td>3.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Portugal*</td>
<td>2.7</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>2014</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>France</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Italy</td>
<td>1.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Spain**</td>
<td>3.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Portugal*</td>
<td>2.5</td>
<td>1.5</td>
</tr>
</tbody>
</table>

* Portugal: one-off measures in 2011 and 2012 are included
** Spain: financial sector package is not included
The adjustment of current account deficits has been very fast during the crisis...

... not only due to cyclical factors

Good behaviour of export market shares in the periphery suggest that the external deficit problem had more to do with over-spending rather than competitiveness
Contents

Section 1
Global economy: better mood and lower tail risks

Section 2
Eurozone: financial and fiscal drivers for the outlook

Section 3
Outlook: very slow recovery for 2013 and 2014

Section 4
Risks to baseline scenario: still tilted to the downside

Section 5
What about Spain?
GDP fall in 4Q12 widespread but some recovery in 2013

MICA-BBVA model: eurozone activity could be growing in early 2013 +0.2% q/q
Improvement in confidence surveys, though still not reflected in hard data

Confidence improving in the periphery at France, but still at very low levels

Recovery much more apparent in Germany, also reflected in other indicators (PMI's, IFO)
All in all, we expect a slow recovery starting 2013

Recovery in 2013 very moderate, and based on net exports

Domestic demand to contribute to growth only in 2014
... led by in Germany, although the periphery will remain in recession

**EMU: Growth forecasts by country**

*Source: BBVA Research*

The decoupling between Germany and the periphery will persist in 2013

France has provided signs of weakness recently, and is subject to downward risks
Contents

Section 1
Global economy: better mood and lower tail risks

Section 2
Eurozone: financial and fiscal drivers for the outlook

Section 3
Outlook: very slow recovery for 2013 and 2014

Section 4
Risks to baseline scenario: still tilted to the downside

Section 5
What about Spain?
Risk factors to the eurozone scenario and pending issues

- Achievement of budget deficit targets (based on one-off measures) and fiscal multipliers
- Cyprus bailout agreements
- Political instability in Italy
- An excessive appreciation of the euro
- Greek debt sustainability
- Implementation risks of the agreements reached at European level (activation of OMT, progress in banking union...)

Eurozone
Impact of an euro appreciation differs considerably across countries

Eurozone: estimated impact of a 10% appreciation of euro-dollar on extra-euro exports
Source BBVA Research

-2.5 -2.0 -1.5 -1.0 -0.5 0.0
Spain Germany France Italy

Germany and Spain would suffer less than France or especially Italy

This result is consistent with recent declarations from different European authorities (i.e. more worries in France than in Germany).

However, the Italian political crisis is reverting the euro-dollar to previous levels. The risk of appreciation is now smaller.
Contents

Section 1
Global economy: better mood and lower tail risks

Section 2
Eurozone: financial and fiscal drivers for the outlook

Section 3
Outlook: very slow recovery for 2013 and 2014

Section 4
Risks to baseline scenario: still tilted to the downside

Section 5
What about Spain?
Spain: GDP growth and MICA-BBVA forecasts (% qoq)

Source: BBVA Research based on INE data

2012: finally better than expected

In spring, 28.6% of analysts polled expected Spanish GDP to contract more than 2.1% in 2012 (50% between 1.4% and 1.8%)

Although the pace of decline accelerated in 4Q12, the second half of 2012 beat expectations

We expect negative growth in 1Q13, but not as severe as in 4Q12
2013: the year the economy should bottom out

Spain: domestic demand, exports and imports
(4Q2007=100)
Source: BBVA Research based on INE data

Slight improvement in forecast GDP for 2013, with a 1.1% contraction, due to the knock-on effect of 2012

Highly mixed performances by exports, domestic demand and imports -> a dual economy for firms

Significant reduction in the current account deficit
2013: the year the economy should bottom out

The unemployment rate should peak during 2013

A smaller active population and improved GDP should allow the unemployment rate to ease slightly in 2014

Additional measures and reforms are needed to reduce unemployment faster

Spain: unemployment rate (%)
Source: BBVA Research

The unemployment rate should peak during 2013

A smaller active population and improved GDP should allow the unemployment rate to ease slightly in 2014

Additional measures and reforms are needed to reduce unemployment faster

Spain: unemployment rate (%)
Source: BBVA Research
Spain’s bank restructuring happening

<table>
<thead>
<tr>
<th>Problem</th>
<th>Solution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset quality: real estate</td>
<td>Higher provisions, enough capital (severe stress test) and transfer to Sareb</td>
</tr>
<tr>
<td>Asset quality: other portfolios</td>
<td>Higher provisions (preparing new regulation), enough capital (severe stress test), independent audits</td>
</tr>
<tr>
<td>Lack of differentiation among entities</td>
<td>Stress test (capital needs in entities with 30% assets), additional transparency requirements</td>
</tr>
<tr>
<td>Capital needs above government’s capacity</td>
<td>ESM credit line is a credible backstop. Total injections 5% GDP (like UK), manageable burden to public debt</td>
</tr>
<tr>
<td>45 savings banks <em>(cajas)</em>, with peculiar legal form</td>
<td>11 now, and 9 have become banks. New <em>cajas</em> regulation removing political influence.</td>
</tr>
<tr>
<td>Late reaction, in part due to institutional problems</td>
<td>Clarification and reinforcement of FROB-Bank of Spain functions. Regulation on crisis management, restructuring and resolution frameworks</td>
</tr>
</tbody>
</table>
Provisioning effort has been significant

Despite the increase in non-performing loans, the two Royal Decree Laws of 2012 and the individual effort of entities have enabled Spain to keep high coverage ratios

**Bank Provisions to Nonperforming Loans** (2012 or latest available, %)

Source: IMF

New regulation is being prepared to make the effect of the RDLs permanent, and dynamic provisions will be recalibrated.
Limited impact on public finances

Public capital injections (%GDP)
Source: National central banks and Eurostat

Even after injecting €39bn in the financial system, the amount of public capital poured into the system is limited when compared to other European countries.

*FROB 1 and 2 and EUR 39bn from Europe
Liquidity conditions should be restored

In Europe, it is crucial to restore the functioning of the interbank and wholesale markets, to break the vicious circle between banks and sovereigns and to reduce the fragmentation in the retail markets.

LTROs can be cancelled at the end of January 2013, so further reductions are expected.
All in all

- Improvement in Europe’s financial tensions are rooted on policy measures but also adjustment in the periphery
- Europe to remain stagnant in 2013 recovering further in 2014
- Still many risks ahead but moving slowly in the right direction
- Spain’s economy should start to bottom out but very slowly. Banking reform on going but the whole thing dependent on the above risks
Europe’s Economic Perspectives in a Global Context

HKFFIA Speaker Luncheon
Hong Kong, 5 March 2013

Alicia Garcia Herrero
Chief Economist for Emerging Markets