

Global and Spanish Outlook

May 2014

Key messages

- 1 **The global economic cycle is improving**, although growth is not accelerating as expected, particularly in emerging economies
- 2 **Some economic policy uncertainties are being dispelled** but some risks remain, although they are no longer systemic as in previous years
- 3 **Spain confirms the biases to the upside in growth, which will be above 1% in 2014**. Uncertainties such as those associated with the deceleration in export growth and non-compliance with the deficit target, with its impact on GDP, are being resolved positively
- 4 **Reforms are having a positive effect on the economy**. However, the effort can and ought to be greater if the recovery is to strengthen. A more efficient tax system, which includes a fiscal devaluation, or an ambitious reform of the services sector might raise exports noticeably

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Section 1

World economy: the recovery continues, but is not accelerating

Section 2

Spain: the biases to the upside are confirmed

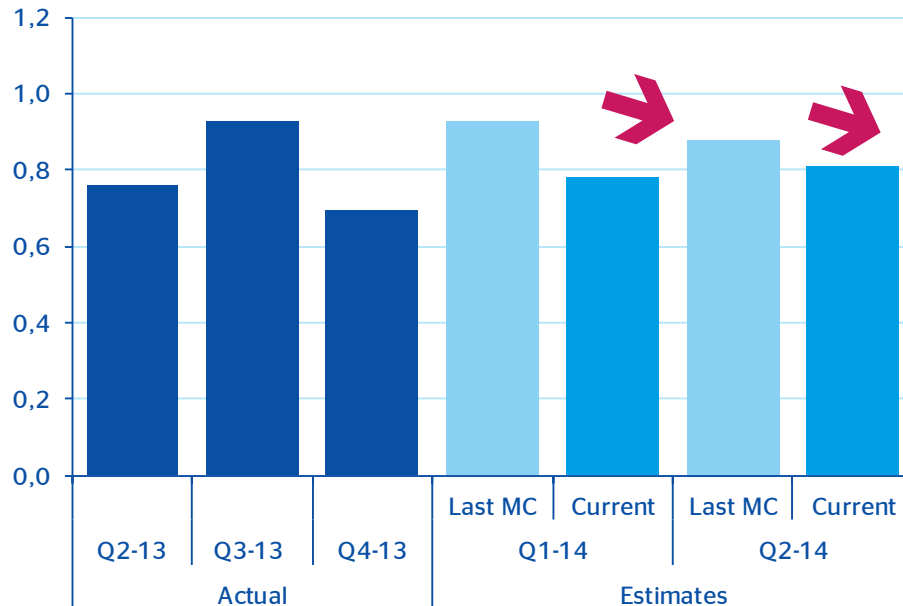
Section 3

Commitment to the reforms is essential in consolidating the improvement in markets and increasing growth potential

Global cycle: growth remains robust at a quarterly 0.8% in the first half of the year

World GDP growth (% QoQ)

Based on BBVA-GAIN
Source: BBVA Research



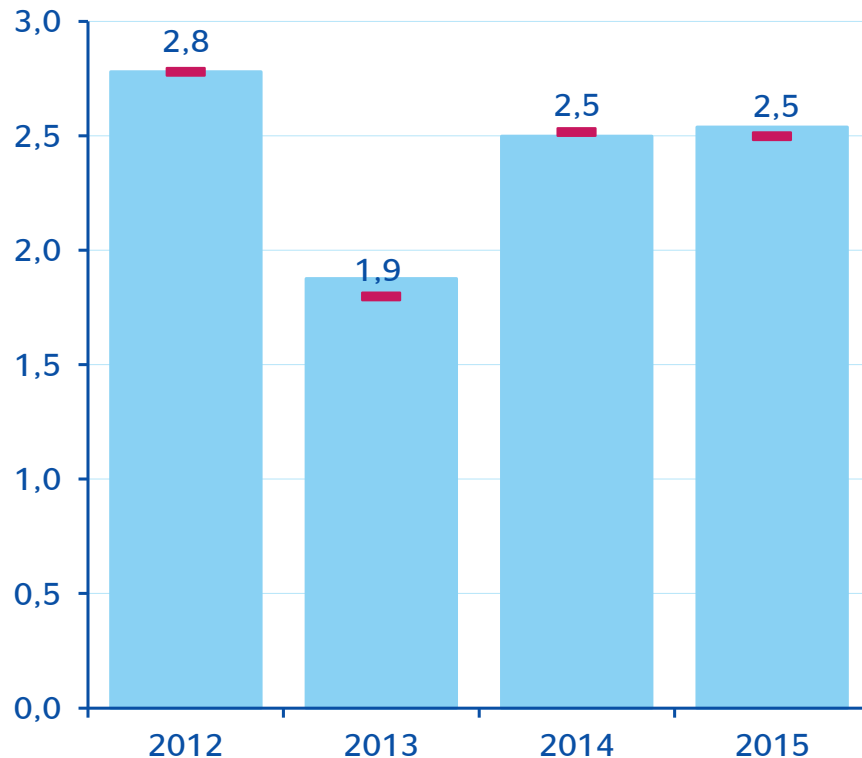
Growth is still robust and financial conditions have also eased in emerging economies, but incoming information reveals no acceleration of global growth in the first half of 2014

Overall, higher growth in developed economies is partly offsetting lower growth in emerging economies

US: growth is in line with our baseline scenario

US: GDP growth (% YoY)

Source: BBVA Research, BEA



■ Baseline Apr-2014 ■ Baseline Jan-2014

We maintain our baseline scenario for growth. The 1Q14 slowdown should be short-lived (bad weather related)

The balance of risks remains slightly biased to the upside

The Fed will end tapering by the end of the year, and will start increasing rates in the second half of 2015

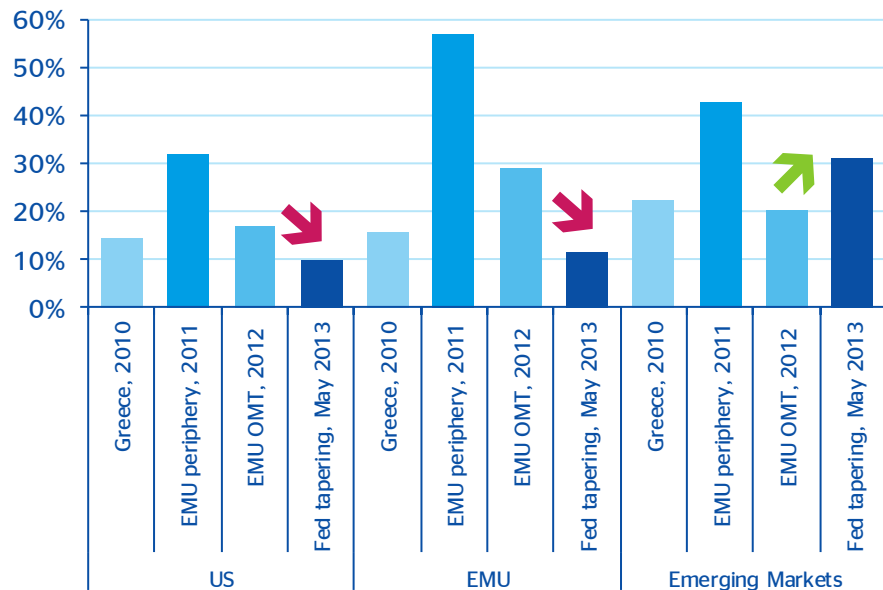
Monetary return to normal in the US is an event of global impact in financial markets

In May 2013 markets perceived that the end to the Fed's balance-sheet expansion was near, which increased global volatility, especially in emerging markets

Exchange rate volatility was higher in emerging economies with larger external financial dependency

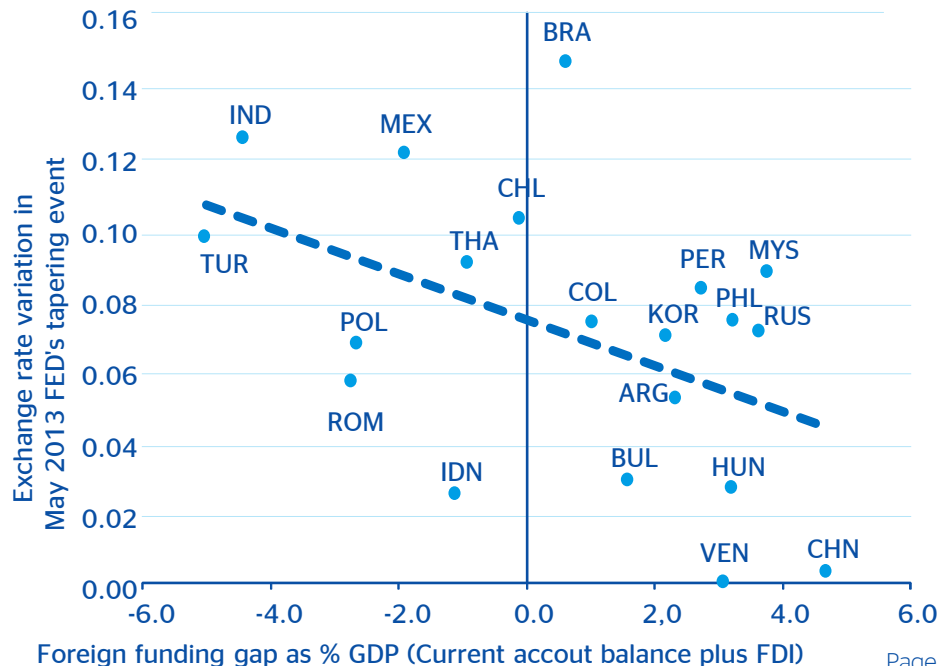
Financial tensions vs. Lehman

BBVA Research's Financial Tension Index vs. Lehman=100%
Source: BBVA Research



Exchange rate volatility in May-June 2013 and external financial needs

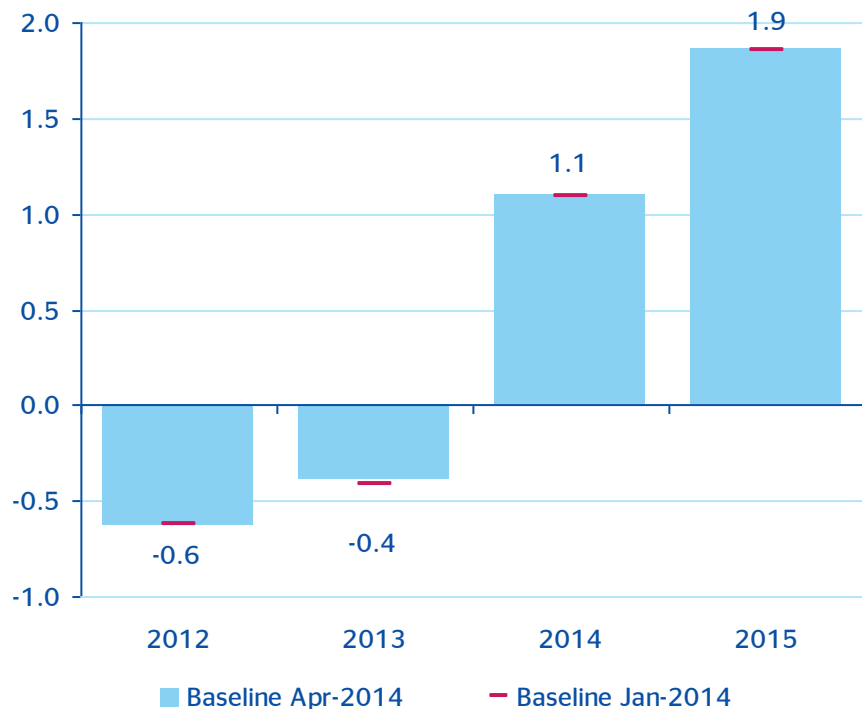
Source: BBVA Research



Eurozone: economic growth is consolidating, as expected ...

Eurozone: GDP growth (% YoY)

Source: BBVA Research



Domestic demand will contribute to the recovery in 2014, especially in investment

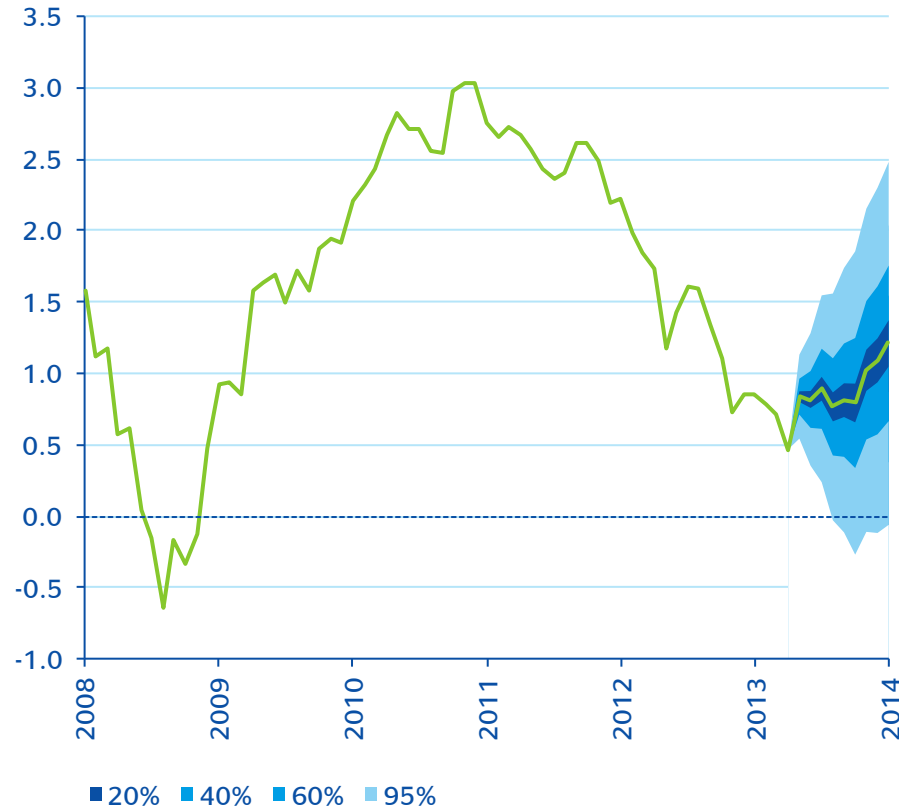
The euro's strength will slow down the contribution of external demand to growth

Banking union, in place through the AQR and the ST, should support the credit recovery in 2015, signaling the end of the crisis

...which should favour a decrease in deflation risks

Inflation in the eurozone: baseline scenario (% YoY)

Source: BBVA Research



Downside surprises on headline inflation have increased the risk of unanchored expectations

Downward pressures come from the Euro's appreciation and lower raw-material prices

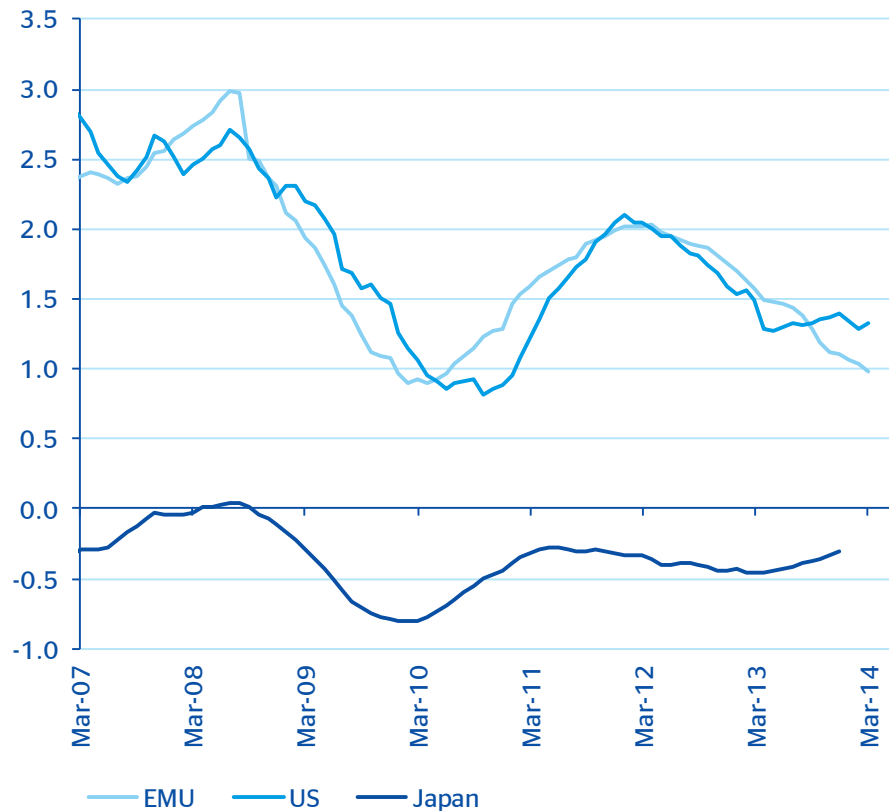
The current recovery in demand, lower financial stress and improved credit supply reduce deflation risks

“Too low” inflation for “too long” is a risk for the recovery

Inflation pressure in developed economies (% YoY)

Trimmed mean of CPI in the eurozone and Japan, and PCE in the US

Source: BBVA Research and Dallas Fed



Optimised measures of inflation tensions show the lack of upside inflation pressures as a whole

Decreasing inflation in the eurozone makes it vulnerable to additional negative shocks

The ECB seems ready to take further action if needed. Even if not very likely, a QE is being considered

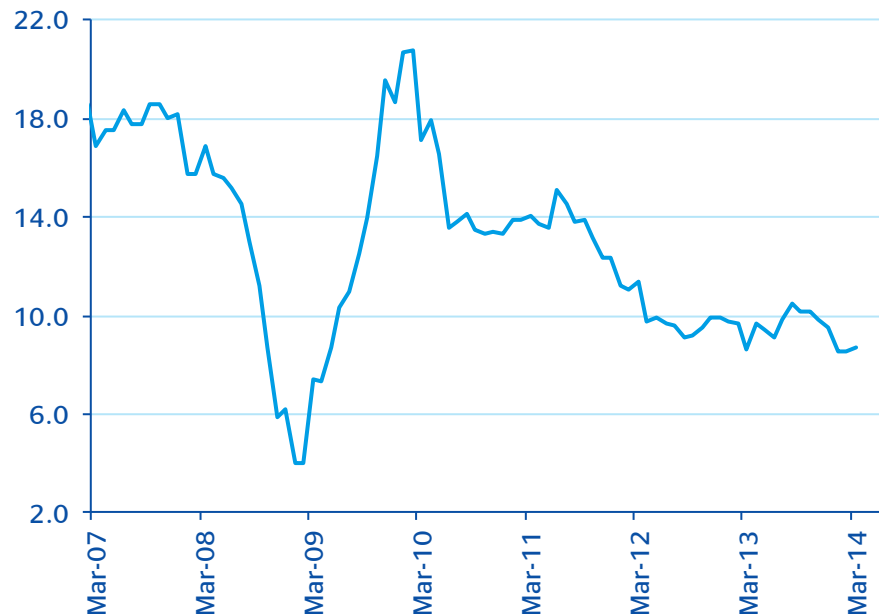
Chinese growth weakens in the beginning of 2014

China's indicators are losing momentum ...

... as the authorities are more focused on reducing vulnerabilities with less room for manoeuvre in the short term

China: industrial production, YoY %

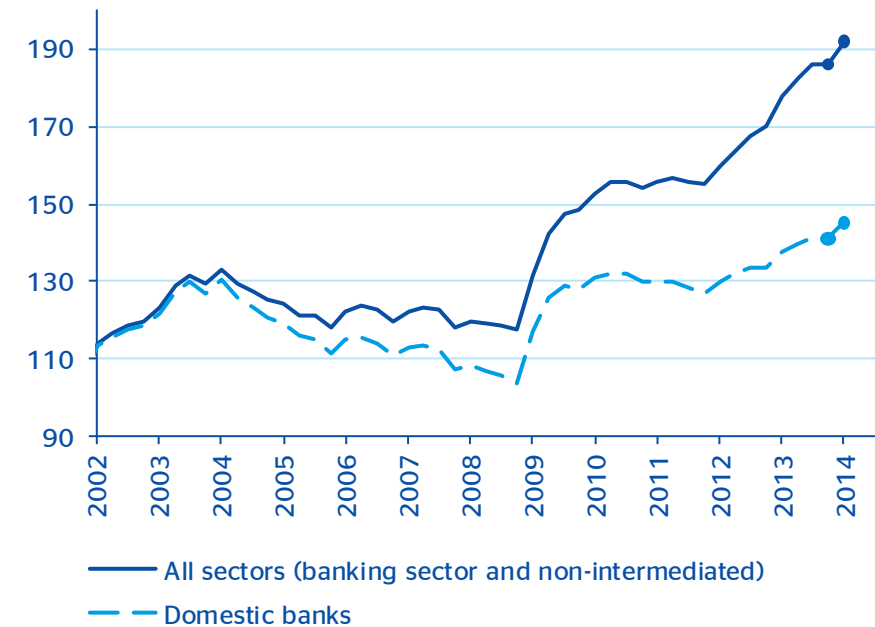
Source: Haver and BBVA Research



China: debt in the non-financial private sector

Total debt as % GDP

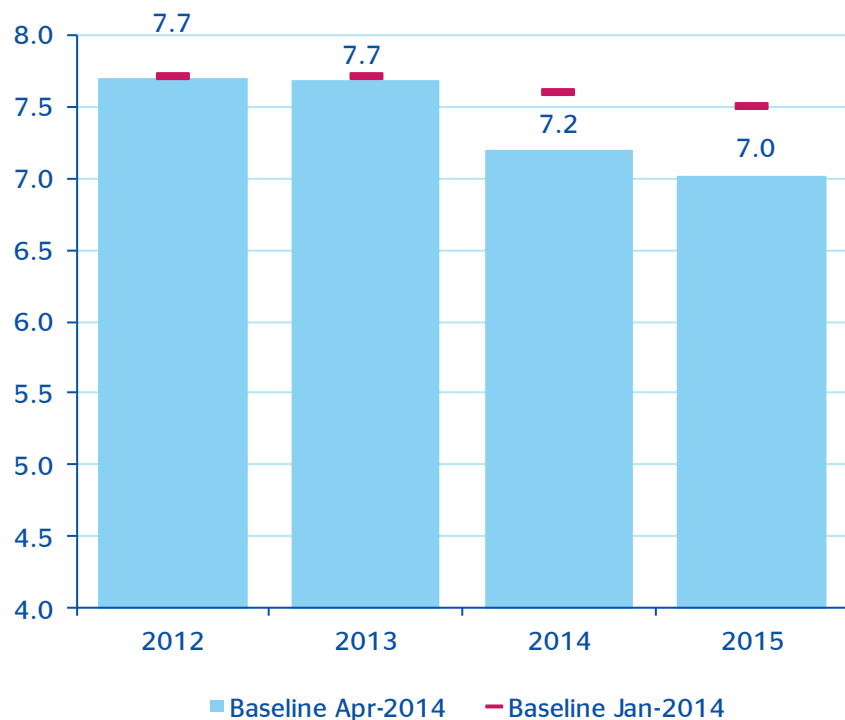
Source: BBVA Research, BIS and OECD



China: the baseline scenario has been revised downwards due to the recent moderation and new targets on economic policy

China: GDP growth (% YoY)

Source: BBVA Research



The government will continue with economic reforms, and will implement measures to reduce financial risks

We expect a greater adjustment in investment than in consumption

In case of higher-than-expected deceleration in the economy (below 7%), there is room for public intervention (investment in infrastructure, fiscal stimulus)

What could be the impact of lower growth in China on other economic areas?

GDP growth, impact of an adjustment in China's growth. Ranking from higher to lower impact

Source: BBVA Research

Ranking	Economic area
1	Latin America
2	Japan
3	Eurozone
4	US

Roughly every pp of lower growth in China reduces global growth by 0.4, mainly through the trade channel (lower foreign demand from China)

If, in addition to this channel, lower Chinese growth would cause higher global financial volatility, the impact in world GDP could double to almost 1.0

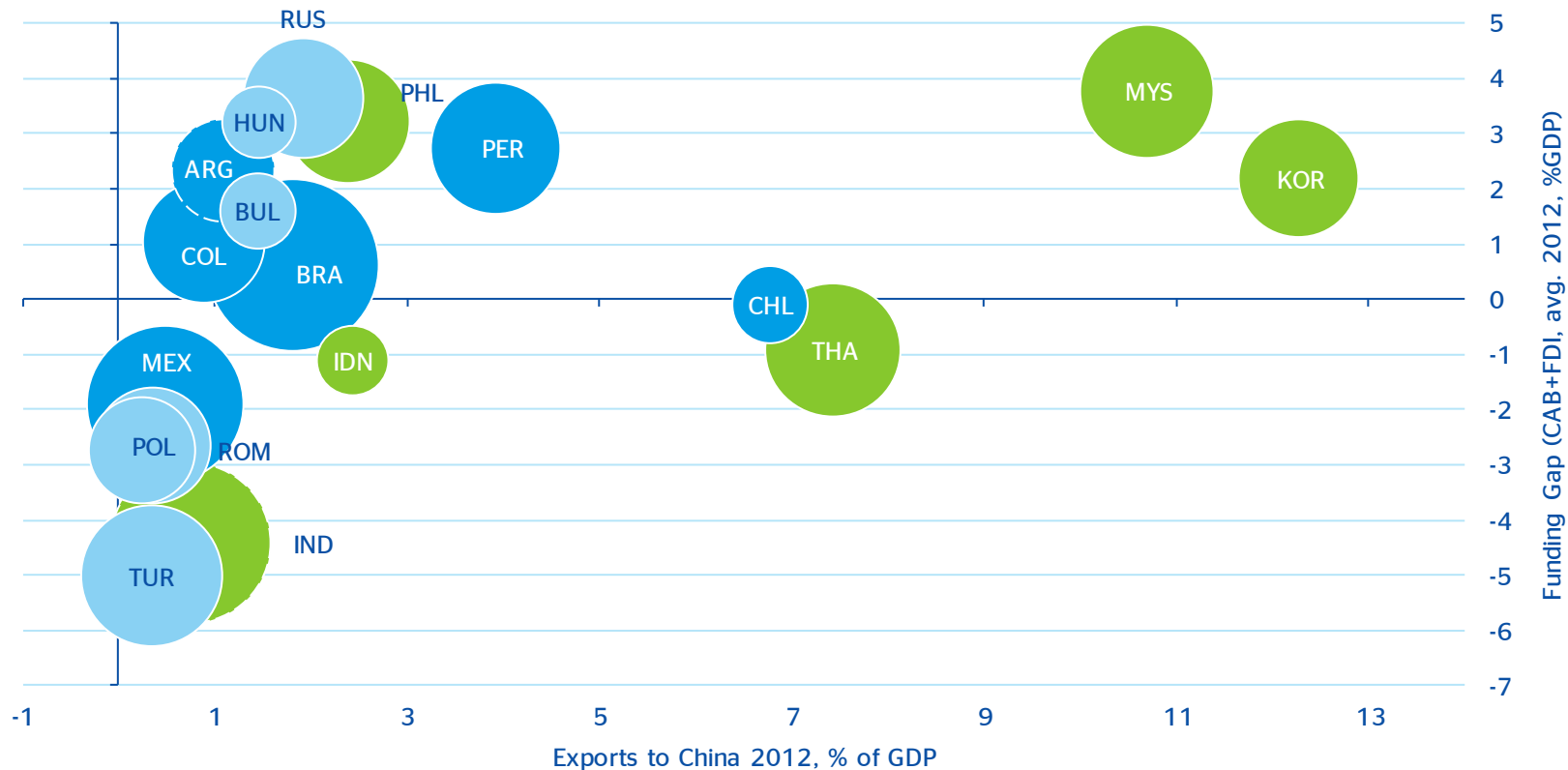
All in all, differences will remain in the impact expected between geographical areas

All in all, heterogeneity characterises the impact of deceleration in China or an interest rate rise in the US

Emerging Markets' exposure to China's slowdown and foreign funding needs

The size of the circle is proportional to the exchange rate volatility in the Fed's tapering episode, May 2013

Source: BBVA Research

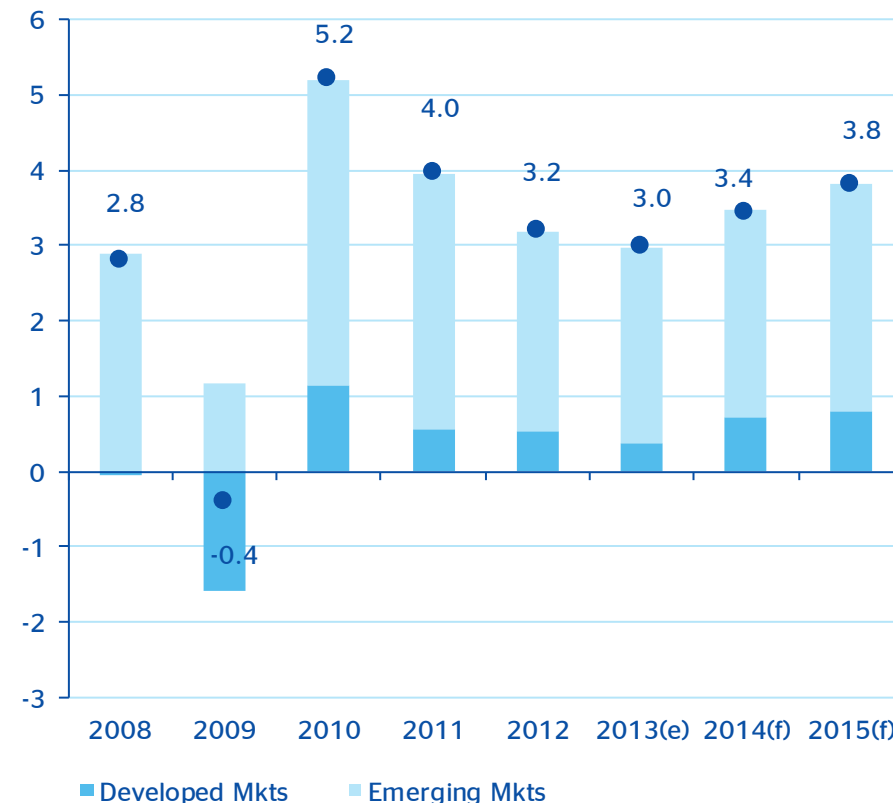


To sum up global growth will continue, with a monetary return to normal ahead

- 1 **Global expansion will continue, with China growing less** than previously but without immediate risks of a sudden adjustment
- 2 The combination of the **Fed's tightening (diverging further from ECB policy) and adjustments in China's growth** will be the dominant drivers in the coming months, with an heterogeneous impact on EM

Global GDP growth (%)

Source: BBVA Research



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Spain: the biases to the upside are confirmed

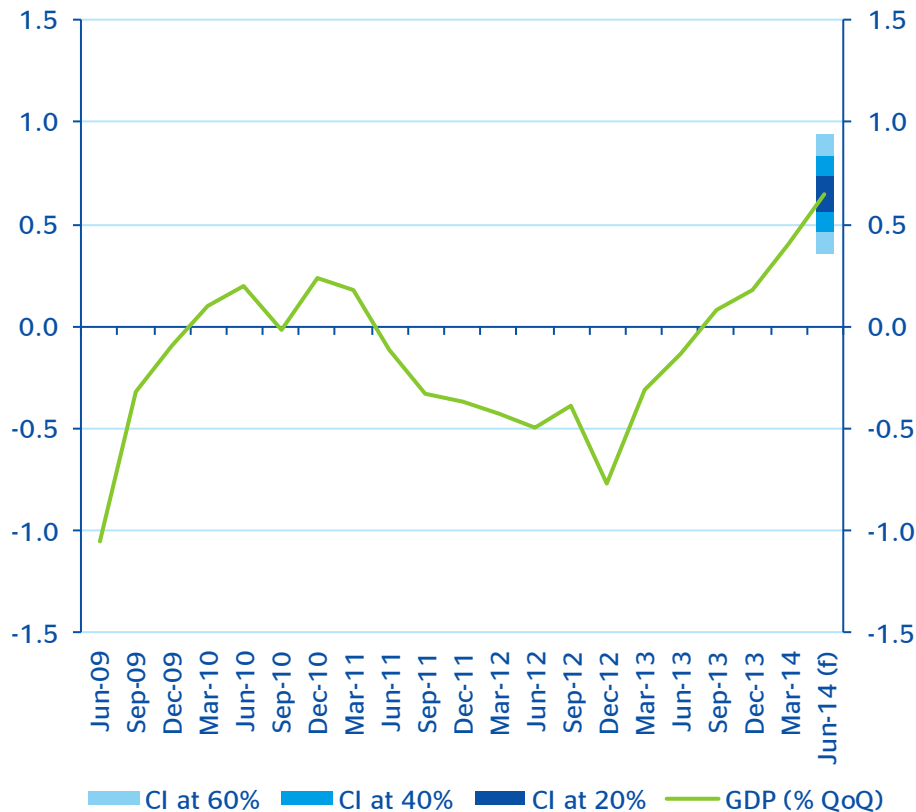
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Commitment to the reforms is essential in consolidating the improvement in markets and increasing growth potential

The Spanish economy's recovery accelerates

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

Source: BBVA Research based on INE



The economy has grown for three consecutive quarters, and more strongly in 1Q14 (0.4% QoQ) ...

... thanks to better fundamentals, a lower need for fiscal adjustment, reduction of some uncertainties and import substitutions

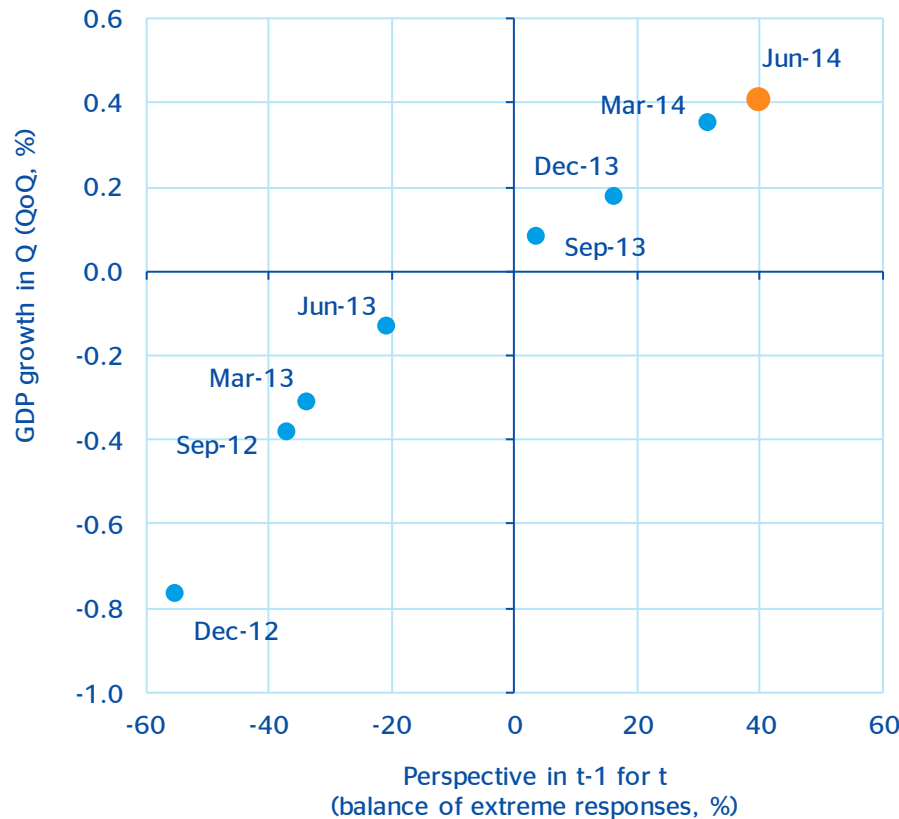
If the favourable start to 2Q13 were to consolidate in the next few months, growth could accelerate again

The Spanish economy's recovery accelerates

Spain: BBVA Economic Activity Survey

(Balance of extreme replies, %)

Source: BBVA Research



Box 1

This expansion in activity is confirmed by data from the BBVA Economic Activity Survey ...

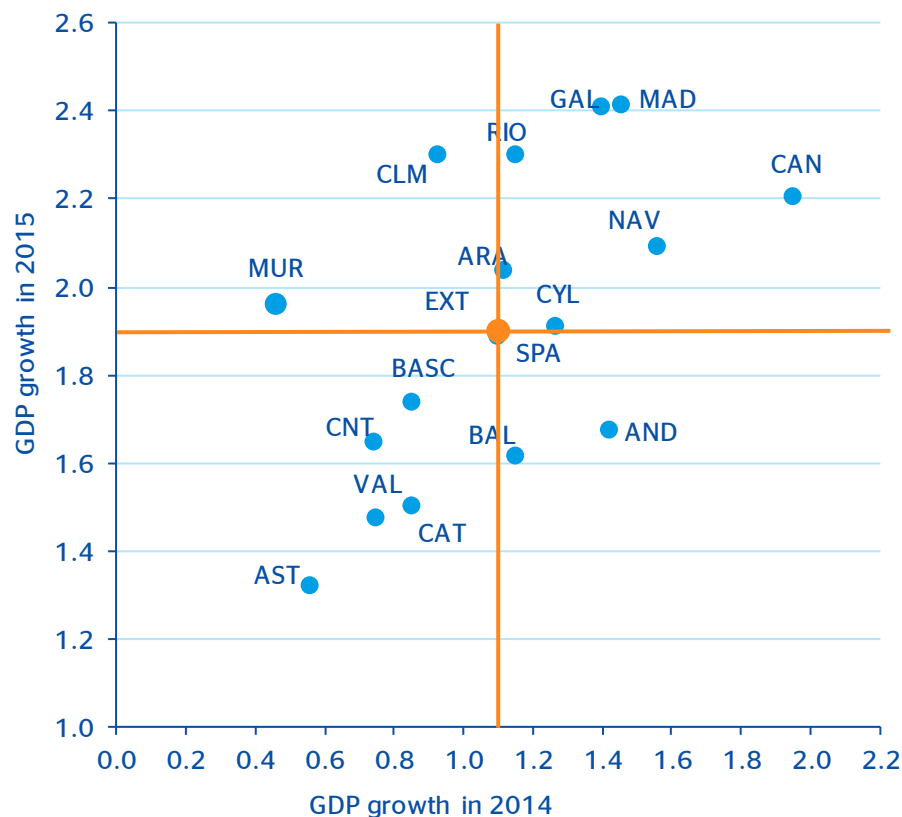
... which is highly correlated with activity in those regions with a wide response base ...

... and the results of which will be presented quarterly from now onwards

The regions continue to be heterogeneous

Spain: GDP growth by region (%YoY)

Source: BBVA Research



We have revised 2014 growth upwards, from 0.9% to 1.1%, and maintain our 1.9% forecast for 2015

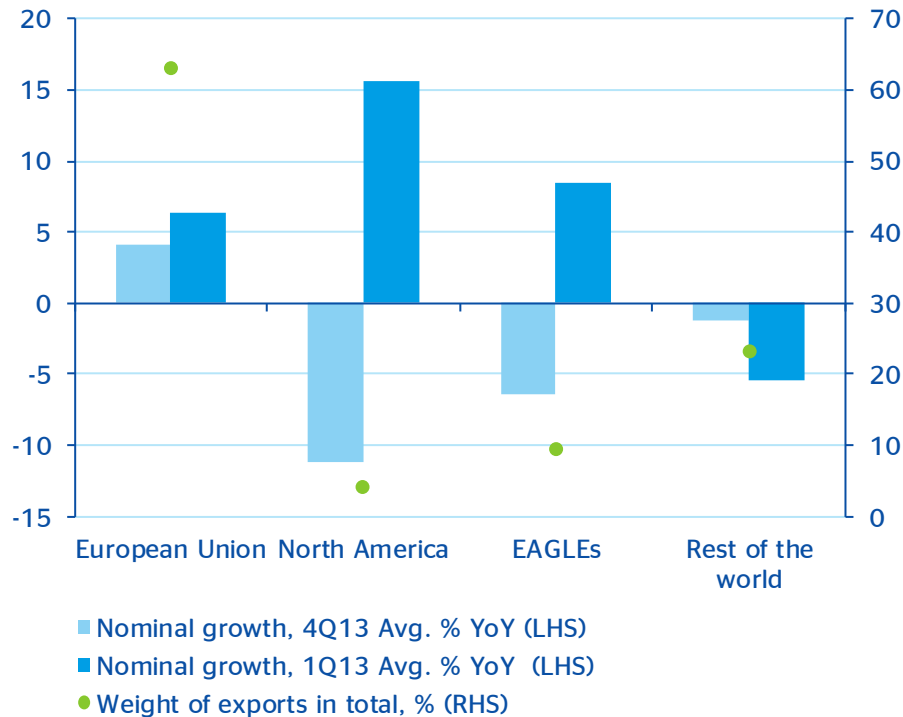
Heterogenous progress in correcting imbalances and exposure to foreign demand ...

... are key to explaining the regions' different growth rates

Some uncertainties have been positively resolved: 1. Exports continue to grow

Spain: growth and composition in goods exports by geographic areas

Source: BBVA Research based on Datacomex



Deceleration in goods exports at the end of 2013 seems to have been temporary

Services exports continue to grow, although more modestly than in 2013

Improved global perspectives will enable exports to continue growing in coming months

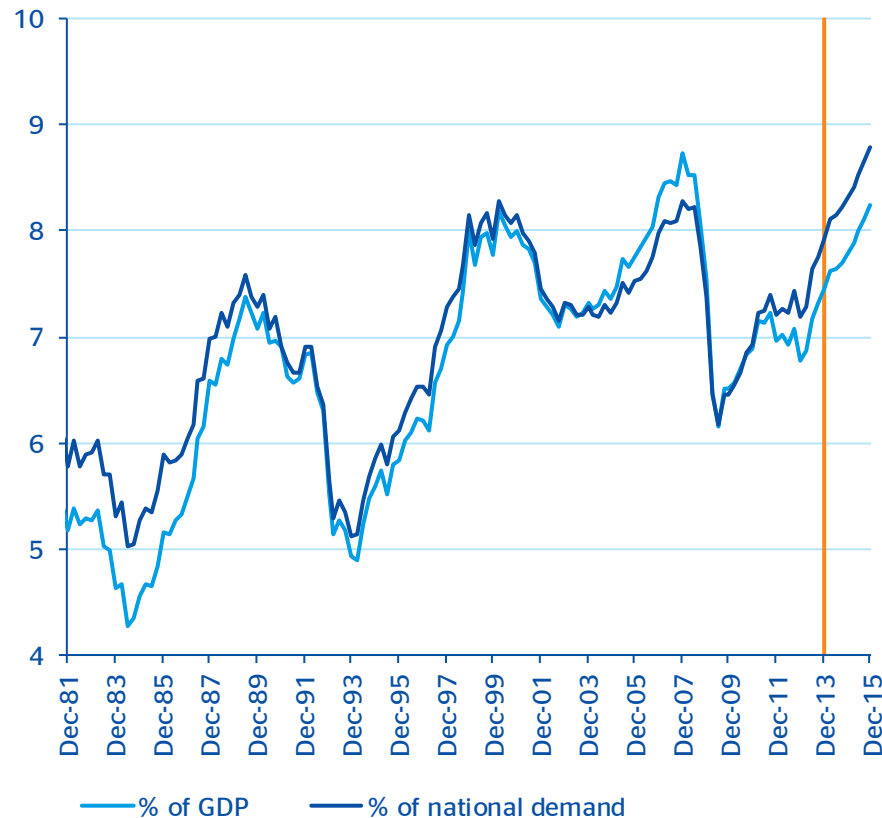
Note: data to February 2014

Some uncertainties have been positively resolved:

2. Investment gathers pace

Spain: investment in machinery and equipment (M&E)

(Real ratios at 2008 prices)
Source: BBVA Research based on INE



Whereas investment in M&E has grown by 8.3% in Europe since it touched bottom in 2Q09, in Spain it has grown by 17.6%

Today it already represents 45% of total investment and over 8% of real domestic demand (all-time high) ...

... which is consistent with the change in the productive model, oriented more towards the foreign sector

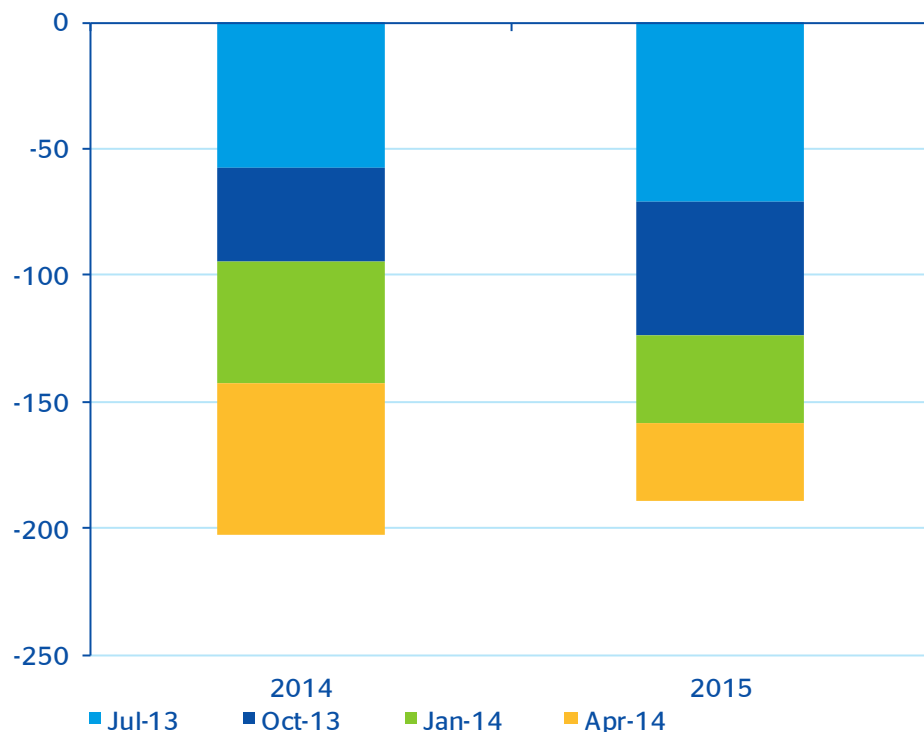
Some uncertainties have been positively resolved:

3. Lower financial tensions

Spain: 10-year bond interest rate

(Difference over earlier forecasts in bp)

Source: BBVA Research



Better perception from abroad has reduced dependency on the ECB and improved access of large companies to wholesale markets

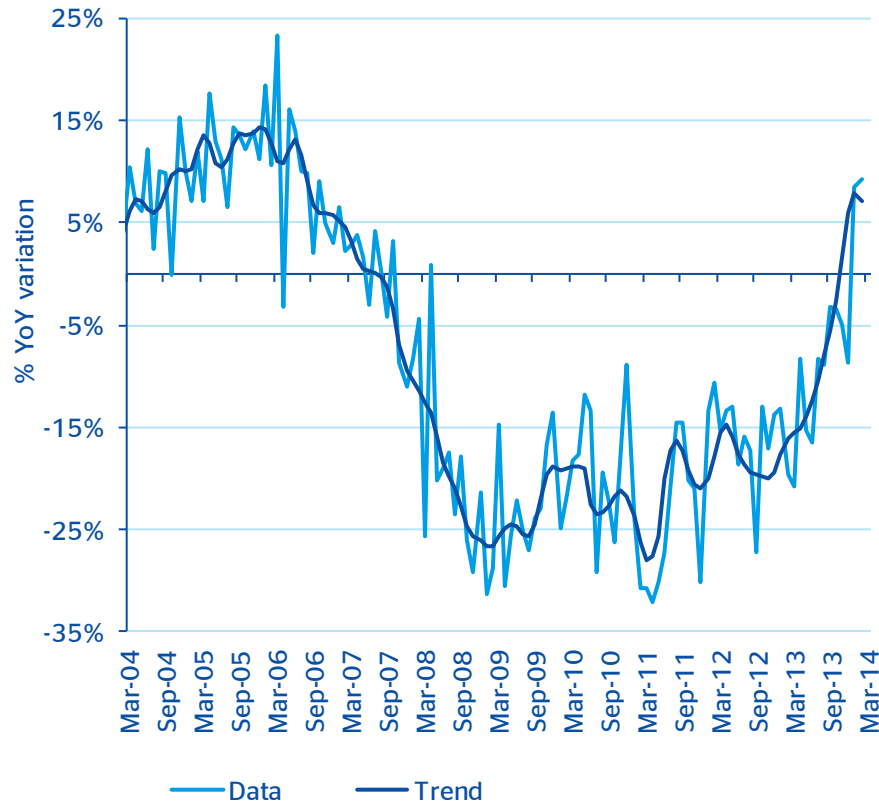
Lower financial tensions are felt in the economy with a six to nine month time lag

A permanent drop of 100bp in sovereign interest rates implies up to 1% more growth for the economy

Some uncertainties have been positively resolved: 4. Flows of new credit operations are improving

Spain: new credit retail operations (% YoY)

Source: BBVA Research based on BoS



The Spanish economy is going through an unavoidable process of debt reduction ...

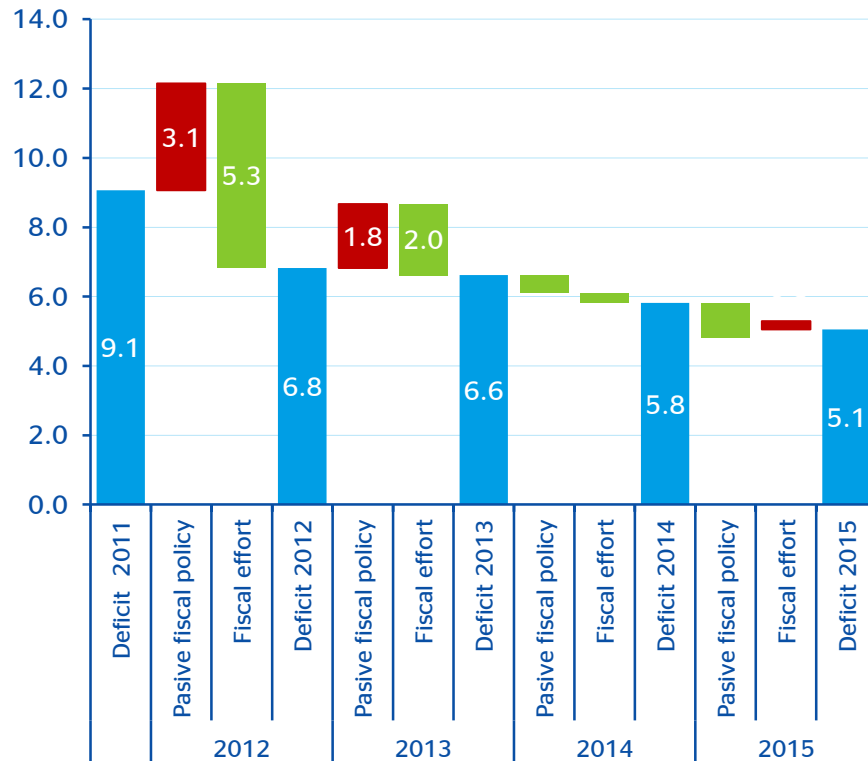
... which is compatible with credit provision for solvent projects

A turning point is already visible, together with an improvement in credit flows to households and SMEs, which will be strengthened in 1H14

Some uncertainties have been positively resolved: 5. GDP growth and meeting fiscal targets

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

Source: BBVA Research based on MINHAP



Fiscal adjustments made at the end of 2013 and the recovery both significantly increase the likelihood of compliance in 2014,...

... although doubts remain over the response of public revenue to economic growth and the impact of the local authorities' reform ...

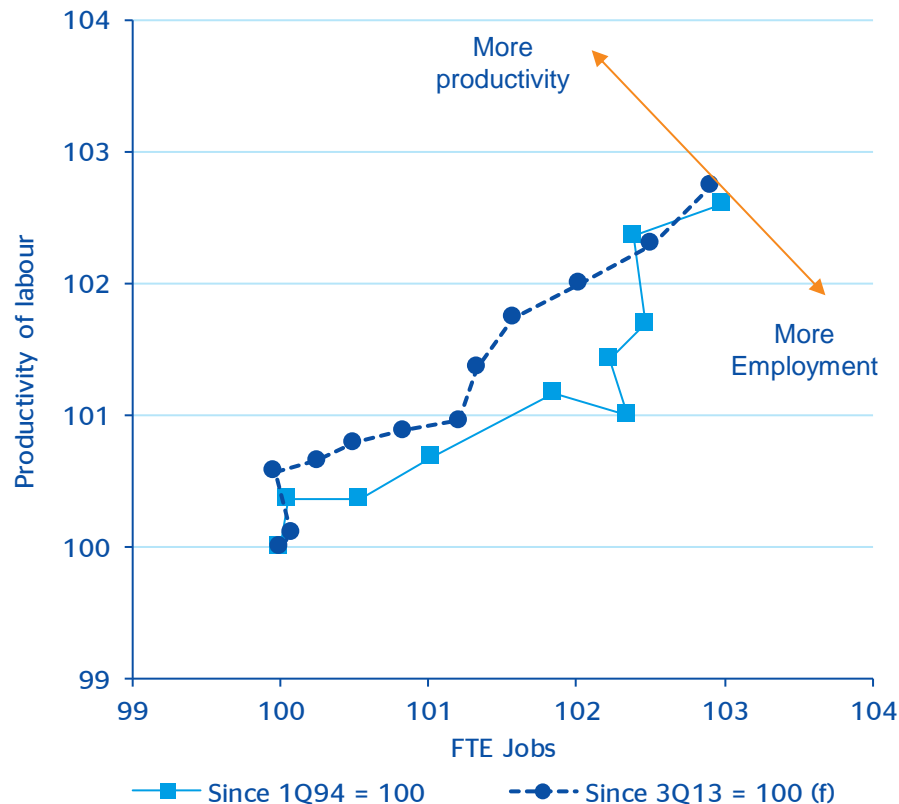
... as well as the tax reform and the regions' budgetary measures for 2015

Although some uncertainties persist

Spain: labour productivity and job creation

(Onset of the recovery = 100)

Source: BBVA Research



1. Employment response to growth: how will productivity of labour behave in the recovery?

2. Fundamentals do not account for all the growth in private consumption

3. Export prices have offset the appreciation in the exchange rate. Can exports continue to hold up?

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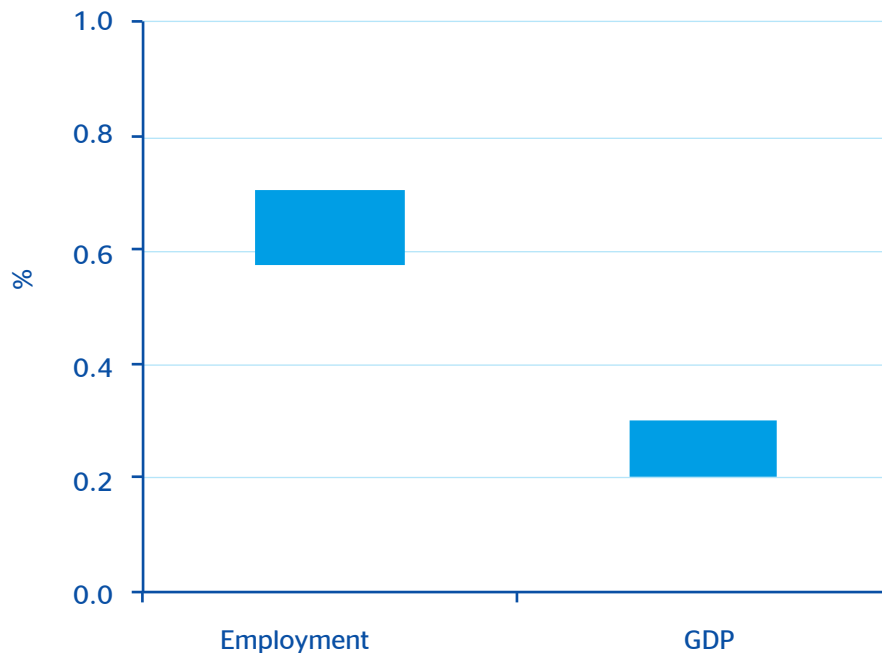
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The need to go further with the reforms

Spain: potential effects after a year of the flat contribution to Social Security paid for indefinite contracts

Source: BBVA Research)



Box 2

Despite some weaknesses (it is not permanent and savings to the employer increase in step with the contribution base) ...

... we forecast a positive effect on employment (0.6 - 0.7%) and on GDP (0.2 - 0.3%), with a net fiscal cost of 0.12% of GDP

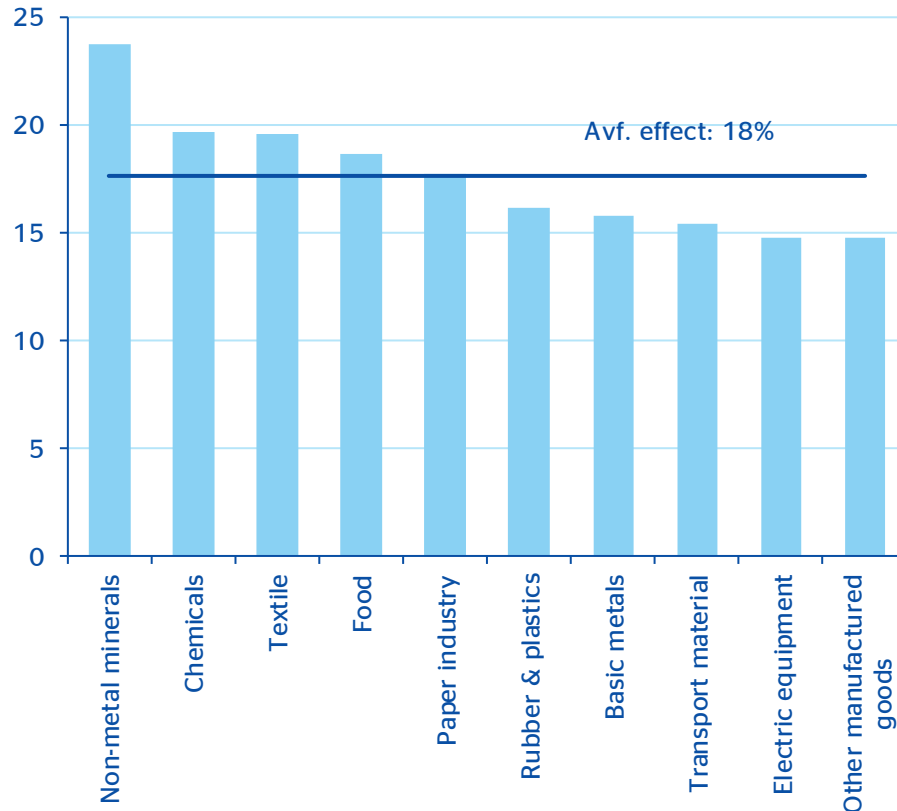
New measures: fiscal devaluation, incentivising open-ended contracts, improving active employment policies

The need to go further with the reforms

Spain: effect on exports of adopting best regulatory practices, large corporations (accumulated variation %, 1992-2008)

variation %, 1992-2008)

Source: BBVA Research based on Correa-López & Doménech (2014)



Box 3

Thanks to the process of deregulation in the services sector since 1990, manufacturing exports are 50% higher

Had international best practices been adopted, exports would have been a further 18% higher

So, there is still scope for continuing to eliminate obstacles which make it difficult for companies to become more international

The need to go further with the reforms

1. Reduce debt and improve financing in the Spanish economy: complete the restructuring of the financial sector and attract direct foreign investment

2. Public administrations reform, fiscal consolidation and long-term sustainability of public finances, with an efficient fiscal system that incentivises growth and the creation of employment
-> Experts Committee report

3. Reforms with which to improve productivity, the size of companies, competitiveness and Spain's perception abroad, to attract inward physical, human and technological capital

4. Going further with reforms that improve the efficiency of active employment policies, reduce the two-tier nature of the labour market and make it work better -more employment, and of higher quality

Global and Spanish Outlook

May 2014

Macro-economic scenario

Spain and Europe: macro-economic forecasts

Source: BBVA Research based on INE and Eurostat

(% YoY)	2012		2013		2014 (f)		2015 (f)	
	Spain	EMU	Spain	EMU	Spain	EMU	Spain	EMU
Households final consumption expenditure	-2.8	-1.4	-2.1	-0.7	1.4	0.8	1.3	1.3
General government final consumption exp.	-4.8	-0.6	-2.3	0.1	-1.6	0.3	1.4	0.7
Gross fixed capital formation (G.F.C.F.)	-7.0	-3.8	-5.1	-2.9	1.0	3.1	4.7	5.1
Equipment and machinery	-3.9	-4.3	2.2	-1.9	7.9	5.2	6.9	7.0
Housing	-8.7	-3.3	-8.0	-3.6	-3.4	1.1	4.9	3.9
Other constructions	-10.6	-4.7	-10.9	-4.3	-4.0	0.5	1.1	3.2
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	-2.7	-1.0	0.7	1.0	1.9	1.8
Exports	2.1	2.7	4.9	1.4	6.0	3.1	5.1	4.2
Imports	-5.7	-0.8	0.4	0.0	5.4	3.1	5.4	4.6
External Demand (*)	2.5	1.5	1.5	0.6	0.4	0.1	0.0	0.0
GDP mp	-1.6	-0.6	-1.2	-0.4	1.1	1.1	1.9	1.9

Pro-memoria

GDP excluding housing	-1.2	-0.4	-0.9	-0.2	1.3	1.1	1.8	1.7
GDP excluding construction	-0.4	-0.2	-0.1	0.0	1.6	1.2	1.8	1.7
Total employment (LFS)	-4.3	-0.7	-2.8	-0.9	0.3	0.1	1.4	0.7
Unemployment rate (% Active pop.)	24.8	11.3	26.1	12.0	25.1	11.9	24.2	11.4
Current account balance (% GDP)	-1.2	1.2	0.8	2.3	1.3	2.2	1.5	2.1
Public debt (% GDP) (**)	86.0	93.0	93.9	95.2	98.4	95.9	100.4	95.5
Public deficit (% GDP)	-10.5	-3.7	-7.1	-3.0	-5.8	-2.6	-5.1	-2.1
CPI (average)	2.4	2.5	1.4	1.4	0.3	0.9	0.9	1.3
CPI (end of period)	2.9	2.3	0.3	0.8	0.5	1.1	1.2	1.4

(*) Contribution to GDP Growth

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

(f): forecast